THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

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Macroeconomic highlights

GDP

First-quarter GDP reached BGN 9.8 billion at current prices while going up by 5.6% in real terms on a year earlier due to the robust growth in fixed capital formation and inventory investment. The vigorous gross fixed capital formation (21.4% up) matched fully the intentions of entrepreneurs stated in business surveys to enhance 2006 investment. The strong investment activity was mainly propelled by the private sector, which accounted for over 90% of total investment in the country. By industry, the most significant contribution to investment growth was posted by the processing industries where the nominal-term rise in tangible assets stepped up as high as 52.3%. Investment was also boosted by strongly performing industries over the past couple of years, e.g. the real estate market and construction, which boasted high investment growth rates of 119 and 97.9% respectively. Having risen on a rather healthy clip in the past couple of quarters, agri-food investments advanced most robustly by 184.4%, spurred probably by the improved EU fund absorption capacity rate under SAPARD.

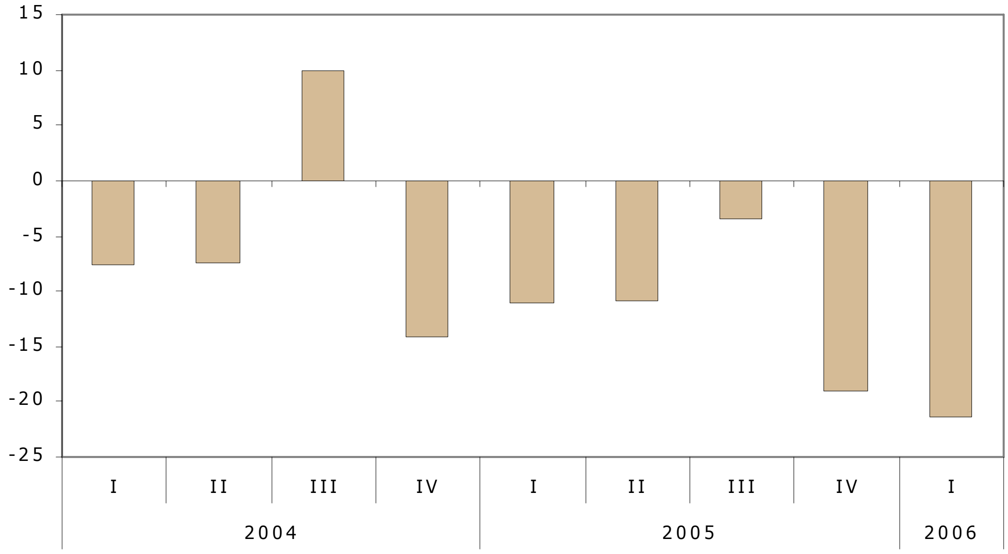
The contribution of inventories to GDP growth was up at about 4 percentage points. The large share of inventory change in GDP was triggered by construction and trade. Industrial output and sales data point to stockpiling in some industries as follows: electricity, gaseous fuel and heating generation and supply; vehicles, cars excluded; non-ferrous metal production and casting; manufactures of other non-metal mineral raw materials; publishing and printing; timber and textiles. On the whole, output growth outstripped sales in about 54% of the industries, leading to stockpiling having to do with the volatility of the oil markets world wide.

As a result of the robust investment growth, the current account deficit deteriorated further due to the scarcity of savings. Over the January-March period, the share of national savings within GDP amounted to a modest 9% vs. 12% on a year earlier. The lower share was almost entirely due to the decreasing net inflows into the country, as domestic savings remained almost unchanged at 6% (6.6% in the first quarter of 2005). As for the institutional sectors, the government reported a more modest accumulation of savings of 9.8% of GDP vs. 12.4% on a year earlier. Private-sector savings ran again negative at their level of 0.5% of GDP in the first quarter of 2005.

On the demand side, exports made the most robust positive contribution (7.5 percentage points) to Q1 growth, rising by 12.9% in real terms on a year earlier and now enjoying a higher share within GDP of 63.7% (5.1 percentage points up). However, the external balance in the three months to April was negative, running into a sizable deficit of BGN 2.4 billion vs. 1.4 billion on a year earlier due to the strong real growth in imports (20%), whose share in GDP stepped up by 13.7 percentage points to 88.35%.

Since the start of the year, consumption slowed down, advancing by a modest 4.8% at constant prices (7% in the first quarter of 2005). Both private and public consumption went on the decrease by about 2 percentage points each to 5.3 and 2.9% respectively on a year earlier. The share of market produce within household consumption carried on rising, with the strongest increase being posted by non-food items and catering establishments and restaurants (13 and 8.7% up).

Saving - Investment ratio to GDP



Source: BNB, NSI, AEAF

On the supply side, the manufacturing sector and services posted a positive contribution to growth in both GDP and gross value added in the economy (a real-term rise in GVA of 6.4%). The manufacturing sector reported the strongest 12-month real GVA growth of 8.8%, and it share within GDP advanced to 29%.

The high Q1 real growth was due to both the strong nominal-term rise (15.3% on a year earlier) and lower than expected deflator (4% on a 12-month basis). The broadening difference between the deflator and local producer prices (8.2% relative to the same period last year) implies that export prices made up for the higher domestic prices. Put in other words, local manufacturers exported key items of the chemical industry, medical, precise and optical apparatuses and instruments, and food at lower prices on a year earlier. As a result, exports in the above industries went on the decrease in real terms, with most producers turning to the local markets and hence increasing domestic sales.

The chemical industry posted high export sales contrary to the general tendency of foreign market shrinkage and stronger domestic sales, spurred by the price drop worldwide. However, it is also the industry shouldering the heaviest costs related to the country's commitments upon accession to the EU. The requirement that all chemical industries in the Community should be granted environmental permits calls for sizable investment injections on the part of local manufacturers and accounts for the restructuring of the industry expected.

Industrial Sales in January-March 2006

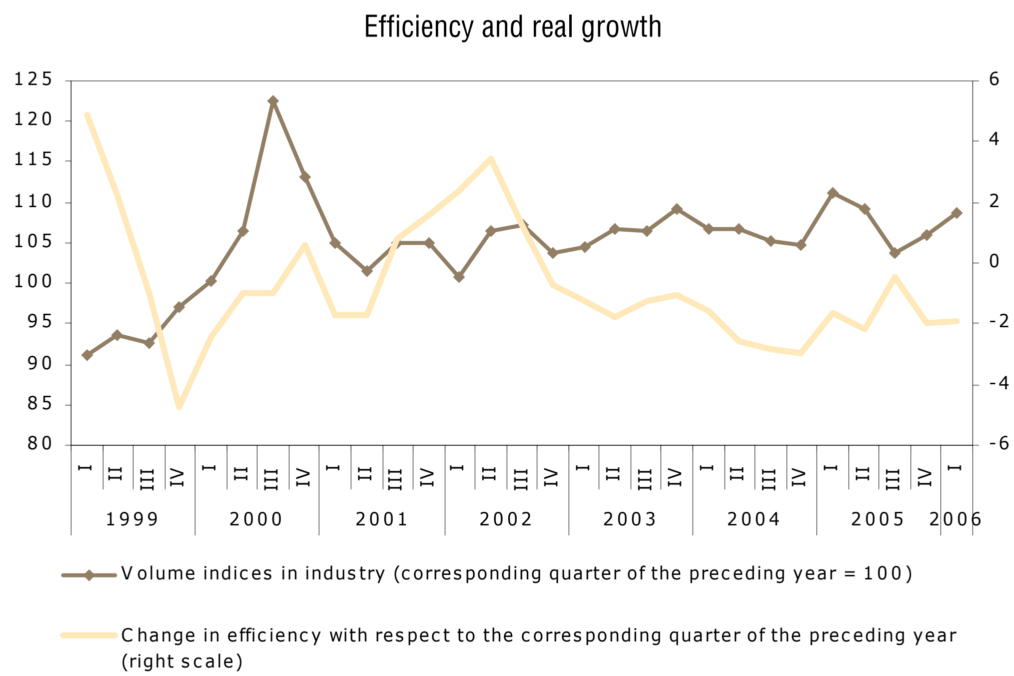
(on a year earlier)

	Real-Term Change (%)	
	Total	**Export sales**
Sectors Reporting a Significant Positive Contribution to Sales Growth		
Coke, refined oil products and nuclear fuel	26.1*	43.9*
Electric, optical and other equipment	16.8	20.0
Metallurgy and metal manufactures, machinery excluded	4.1	0.7
Electricity, gas and water generation and supply	3.8	16.7
Sectors Reporting a Significant Negative Contribution to Sales Growth		
Paper and cardboard; publishing	-4.0	-22.1

* AEAF estimates

Source: NSI, AEAF

First-quarter sales stepped up by 8.2% on a year earlier, fuelled by foreign demand. Export sales went up by 13.5% relative to the same period of 2005, whereas domestic sales rose by a modest 3.2%. The strong performance of sales was mostly shaped by the sales in the oil processing industry, non-ferrous metal and non- metal raw material extraction, office and computing equipment and electric machinery and apparatuses.



Source: NSI, AEAF

In the first quarter, efficiency in the manufacturing industry, as measured as the ratio of gross value added to gross output, stepped down by 1.9% on an annual basis, with the processing industries reporting the strongest decline. The higher prices of energy resources and some metals gave only a partial account of the above deterioration. At the same time efficiency stepped up significantly in electricity, heating, gas and water generation and supply due to the market liberalization, the sale of the seven district electricity supply companies in early 2005 in particular. However, labour efficiency in the sector may be put at risk with the closedown of nuclear power units 3 and 4 of the Kozlodui Atomic Power Station foreseen.

The construction sector went on performing in a rather vigorous manner posting a real-term rise in gross value added and gross output of 13 and 14.2% respectively, which matched the acceleration in real estate prices on a quarter earlier.

Services increased by 6% at constant prices, making a 3.11 percentage point contribution to GDP growth. All service industries made a positive contribution to the quarter-on-quarter change in value added, with retail trade and finance in the lead with 12.7 and 14.6% respectively. Growth in finance was also coupled with a more efficient performance of the branch, i.e. a decline in unit production costs.

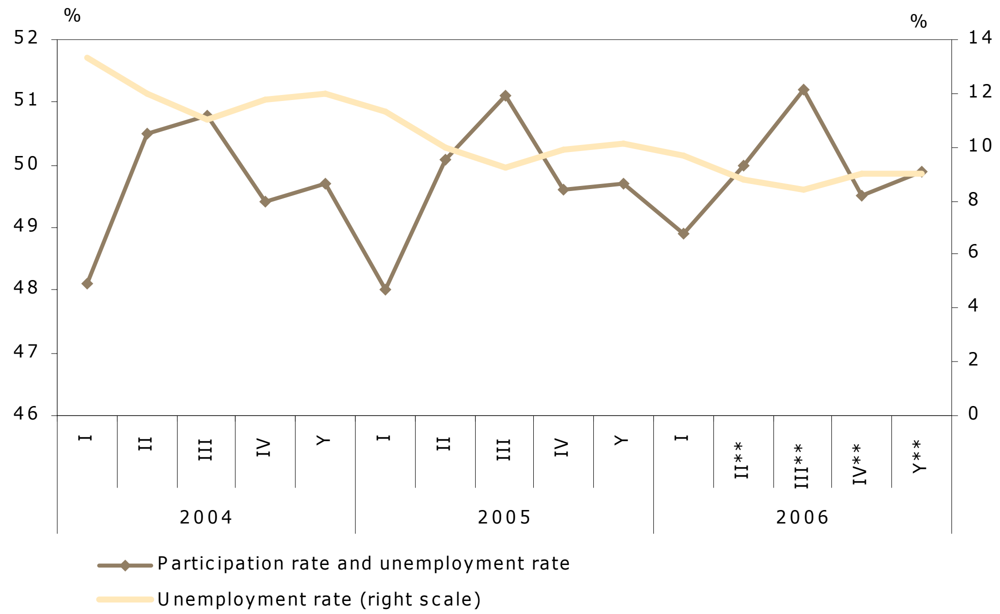
At the same time, agriculture was the only sector that posted a valued added decline (-3.4%) over the January-March period. However, it should be noted that efficiency did not decrease, as intermediate consumption reported a real-term decrease proportionate to the decline in gross output and valued added. The increase in some farm-gate prices, together with the lower yield expectations, was an indication of persistent undersupply, implying that farming will make again a negative contribution to economic growth.

Employment and the jobless rate

Steady economic growth has provided solid ground for the increasing employment and declining jobless rate in the economy. According to NSI labour force survey data, Q1 average employed numbers stepped up by over 102 thousand (3.6%) on a year earlier. The robust private-sector demand for labour resulted in higher employment. Over the January-March'06 period, private-sector employed ran some 118 thousand (6%) higher on average relative to the same period of 2005. The employed total in the first quarter went on the increase by and large due to the construction sector, the processing industries, transport and communications, real estate transactions, which matched data on the increased business activity in the above industries.

The strong labour demand on the part of private-sector employers led not only to a declining jobless rate in the country but also made some part of the discouraged numbers join the workforce again. As a result, on a year earlier the participation rate in the economy (of the population at 15 years of age and over) advanced rather significantly by 0.9 points to 48.9%.

Unemployment and participation rate* in the economy



* of people aged 15 and over
** forecast

Source: NSI, AEAF

Q1 unemployed numbered 315.2 thousand, going down by 47.1 thousand on a year earlier. According to labour force survey data, the jobless rate stepped down as low as 9.7%, posting a one-year drop of 1.6 points. The country's unemployment decreased as a result of the sustainable private-sector job creation and lower end-of-2005 redundancies. The above developments were further enhanced by the administrative statistics of the Employment Agency on registered unemployed, indicating that the Q1 jobless inflow declined by 16.2% on a year earlier. Registered unemployment carried on decreasing in April and May, running at its lowest (9.6%) since September 1991. With the seasonal upswing in the market, the impact of the active labour market measures and programmes weakened. However, the early-2006 start of employment promotion and vocational training projects under the Employment Promotion Act provided subsidized employment to 90 534 job seekers on average in the four months to May, or some 10.7% down on a year earlier.

Income and productivity

Although stepping up faster in nominal terms compared to the preceding years, Q1 wages reported a certain slowdown in real growth. Overall for the economy average wages in the three month to April advanced by about 10% in nominal terms and 1.9% in real terms on a year earlier. The slower increase in the purchasing power of the population was due to the higher inflation throughout January to March.

First-quarter wages (overall in the economy) averaged BGN 329 (BGN 397 and 298 respectively in the public and private sector). On a year earlier, private-sector wages posted a real-term rise of 4.1%, whereas wages in the public sector decreased by 0.7%. Real income growth in the private sector ran at a 3-year high, with the Q1 strongest contribution to it being reported by the service sector, in particular trade, car repair, personal belongings and household goods. It is also possible that some part of this growth was due to the lower social insurance contribution rates in effect since early 2006. As a result, some part of the previously unreported private-sector income has been now recorded by the official statistics, accounting for the stronger real wage growth in the sector. The above assumptions are based on budget revenue data, in particular data on the revenue amounts from social insurance contributions in the five months to June this year.

The upward trend in income was further evidenced by household budget survey data. Average money income per capita in the first quarter stepped up by 4.7% on a year earlier, boosted by income from employment, pensions and entrepreneurship.

Growth rates of productivity and real wages

Source: AEAF, NSI

On a year earlier, Q1 productivity in the economy stepped up by 2.7% in real terms. 12-month real GVA growth per employed outstripped average wages in almost all sectors. By sector of the economy, the manufacturing industries reported the strongest year-on-year real increase of 4% (on an annual basis), followed by services and agriculture with 1.9 and 1.8% respectively. A breakdown by industry, however, indicates that the most robust contribution to growth in productivity overall for the economy was posted by finance and electricity generation and supply (38.2 and 28.3% on a 12-month basis). Productivity in finance stepped up fostered by the strong rise in GVA, given a 17% year-on-year drop in the employed numbers. As for electricity generation and supply, the indicator advanced due mostly to the growth in GVA of over 14% in the wake of the market liberalization in the industry. At the same time, productivity declined in the construction sector and transport and communications by -5.2 and-1.4% on a year earlier.

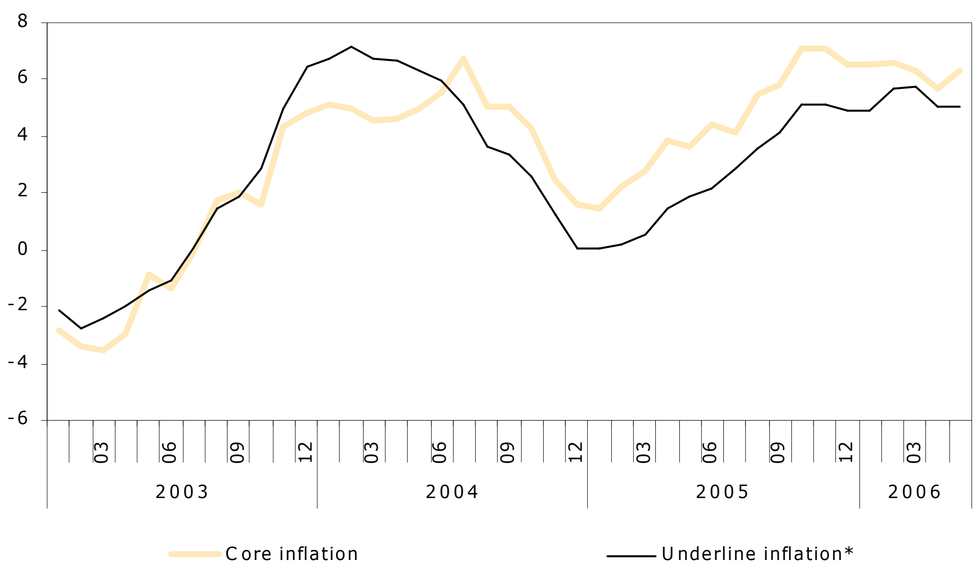
Inflation

The April and May rise in prices ran higher than expected due mainly to the price dynamics of food items, tradables and fuels. Market prices stepped up by 2.32% in the four months to May. Dairy and meat prices in the same two months went off the usual seasonal pattern. Meat price dynamics was strongly influenced by the steady recovering poultry prices amidst dispelled fears as to the health hazards posed by bird flue and rebounding consumer confidence. On the other hand, changes in dairy prices had to do with the compliance checks of the public health authorities and bringing the dairy farms and processing establishments into line with EU acquis. At the same time it should be noted that according to data of the Agriculture Ministry milk animal numbers and agricultural holdings, keeping about 70% of the milk animals in the country, have gone on the decrease. All this, together with the absence of any significant changes in the export and import picture in the industry, resulted in relatively higher dairy prices in the local markets. Following the record highs of February, sugar prices began to steadily decline, running however still well over the levels on a year earlier (41.88% in May). Cumulative food price inflation in the five months to June amounted to 3.28%, making a 1.22 percentage point contribution to overall inflation.

Since the start of the year tradables posted a 0.84% increase, running at a record high since 2001. Furniture and footwear reported a relative strong rise of 1.96 and 1.7% respectively. The contribution of tradables to overall inflation is estimated at 0.13 percentage points.

In April crude oil prices worldwide stepped up drastically, advancing by 12.71% on average on a month earlier and affecting local fuel prices, in spite of the favourable dynamics of early 2006 (cumulative price deflation of 3.69% until March and a 4.25% increase by May). The contribution of fuels to the country's inflation amounted to 0.12 percentage points.

Core inflation, base: corresponding month of previous year



* core inflation, excluding unproccesed food and market-priced energy

Source: NSI, AEAF

April and May did not see any significant change in administered prices. Since the start of the year administered prices advanced by 12.91%, making a 2.75 percentage point contribution to inflation.

The consumer price level went up by 4.55% since the start of the year while rising by 6.69% on a 12-month average.

Balance of payments

The current account deficit over the March-April period carried on deteriorating on a year earlier up to MEUR 791.3, posting or a most dramatic increase 88.4% relative to end-April'05. The deficit worsened under the impact of the sizable trade deficit in March and ever growing expenditures on services. Exports in April picked up at a rather healthy clip, outstripping imports and cushioned the adverse effect of the negative trade balance on the current account deficit. The financial account amounted to MEUR 816, making up fully for the deficit on the current account.

Having risen by MEUR 651.4 (or 29.1% up) on a year earlier, imports (CIF) in the March-April period amounted to MEUR 2887.5 due mostly to the strong energy imports. Over the same period, average crude oil import prices (USD) went up by 26.4%. Imports grew as boosted not only by the higher crude oil prices but the larger volumes imported (57.8%) as well. The balance on trade in crude oil, oil products and gas ran negative at MEUR 338.7, deteriorating by 37.5%. March and April sustained the upward trend in non-ferrous metal prices. All this led to stronger non-ferrous imports, enjoying the highest share in the import total.

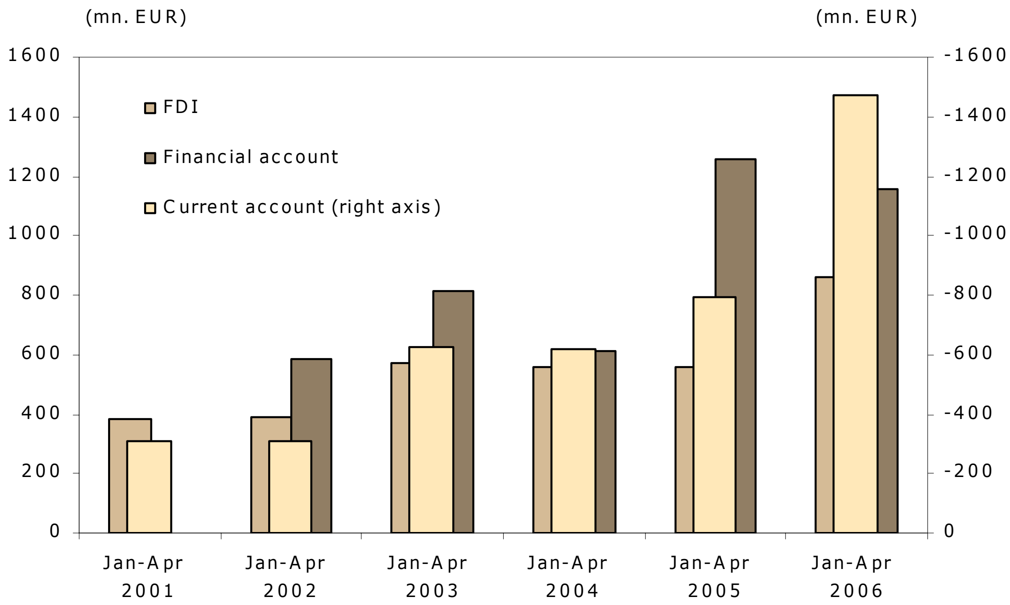
Reporting some MEUR 423.7 worth of an increase on a year earlier, exports in March and April amounted to MEUR 1963.5 due, by and large, to the stronger export performance of oil products. The robust foreign demand and higher exports to Singapore and Yemen resulted in a two-fold increase in volumes. Advancing by 32.4% in April alone, exports ran well over import growth, triggered mostly by the vigorous rise in energy goods. The item, accounting for the highest share in total exports, i.e. raw materials reported a 17.2% year-on-year increase. Copper and other metal exports, enjoying the heaviest weight in the group of raw materials, picked up in value terms under the impact of the ever-rising non-ferrous metal prices.

Trade turnover in the March-April period ran the highest to EU-15 where some 47% of the country's exports and 40% of the imports is focused. On a year earlier, the relative share of Russia in the import total went on the increase, spurred by the stronger importation of energy goods. Exports to Asian and Balkan countries also improved. At the same time, the share of turnover with the EU declined.

The service balance (net) ran negative at MEUR 160.1, deteriorating by MEUR 112.9 relative to the March-April period of 2005. Furthermore, the period under review did not witness any increase in the revenue amounts from foreign holiday makers. The enormous deficit was triggered by the growing expenditures on the other services item. In addition, transportation costs as related to growth in international trade went on the increase (29.2% up). Also, as more and more Bulgarian citizens traveled abroad, the net service balance worsened further.

This trend is likely to persist in the following months as well, fuelled by the operation of some low-budget air carriers and stiffer foreign competition in the tourism market.

Financial account, FDI and the current account



Source: BNB

Current transfers net in the period surveyed amounted to MEUR 93.6, going down by 28.6% on a year earlier due mainly to the lower money transfers and lack of allocations from the EU pre-ins.

FDI in the March-April period amounted to MEUR 370.5 and MEUR 858.3 in the four months to May, with some 40% of them being Greenfield investments.

The foreign currency deposits of commercial banks abroad advanced by MEUR 279.1, rising by MEUR 501.9 in March. April, however, witnessed the withdrawal of some MEUR 222.8 worth of deposits. Net non-financial sector credit amounted to MEUR 295.8, whereas the deposits of non-residents at local banks went up by MEUR 399 in March and April.

The overall balance in the same period ran positive at MEUR 452.1, improving by MEUR 68.1 on a year earlier. BNB FX reserves stepped up by MEUR 427.4.

Financial sector

Money supply in the March-May period increased by 5.7% (BGN 1.4 billion) due mostly to the 8.5% rise in the highly-liquid M1 of BGN 1 billion. Reporting a slower growth rate (3.3% or BGN 425.7 million), quasi money posted a lesser contribution to the higher money supply. Overnight deposit reported the strongest 3-month rise, running some 11.8% (BGN 823.5

million) higher as of the end of May relative to end-February. Deposits of agreed maturity of up to 2 years followed suit, advancing significantly by 3.2% or BGN 345.6 million. All in all, money supply growth in the period surveyed had to do with an increase in net foreign assets and a decline in net domestic assets.

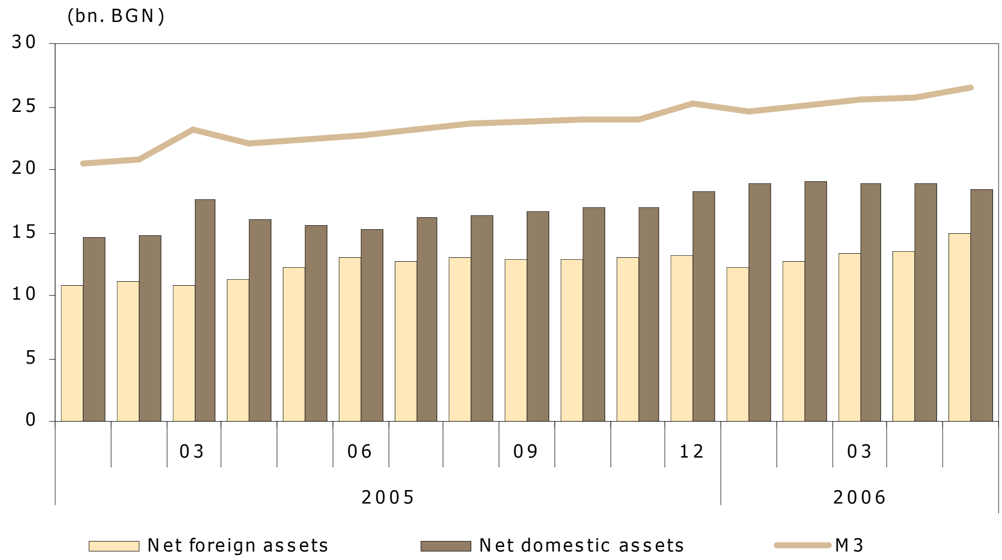
The 17.2% (BGN 2.2 billion) increase in net foreign assets was boosted almost entirely by the 15.1% growth of BGN 1.9 billion in BNB net foreign assets, its FX reserves in particular. The latter stepped up most robustly by 13.6% (BGN 1.8 billion), spurred by the positive change in the government deposit with the Central Bank and reserves of commercial banks. Net foreign bank assets posted a 3-month rise of BGN 267.6 million relative to February due to the sale of credit to non-resident banks and the transformation of domestic assets into foreign assets. It followed that most banks have replenished their resources and did not need foreign injections any longer, as evidenced by the ever-declining growth rate of foreign assets.

The 3.3% (BGN 476.1 million) drop in net domestic assets throughout March to May was solely due to the decline in claims on the government sector worth slightly over BGN 1 billion, which, however, the higher claims on the non-government sector (2.6%, or BGN 487.2 million) failed to make up for. Claims on the government sector were mainly influenced by the robust tax revenue amounts in May and April, as well as the strong budget performance, hence the huge May surplus. Claims on the non-government sector went on the rise due to the higher claims on households and financial institutions (6%, BGN 430.1 million and 24.6%, BGN 37 million respectively up). As for households, housing loans took the lead, followed by other loans, whereas consumer loans remained almost unchanged on a quarter earlier. On the other hand, claims on non-financial enterprises went down negligibly by BGN 3.5 million, including the decrease in claims on credit of a bare 0.2% (BGN 27.2 million) over the March-May period. A possible reason for the above dynamics had to do with the massive credit sale to local and non-resident financial institutions on the part of commercial banks. According to the data made available since the start of 2006, total credit sales ran well over BGN 1.5 billion[1], amounting to BGN 611.9 million in May alone.

The measures of the Central Bank aimed at raising the minimum required reserves of commercial banks and the requirement that they should be deposited in a two-, three- and fourfold amount, have banks exceeded the credit growth ceilings laid down in Regulation #21, resulted in an even stronger decrease in the growth rate of bank credit portfolios. As of end-May, loan extensions to non-financial institutions and other customers stepped up by only 2.4% relative to February (vs. 12.2% over the March-May period on a year earlier), while going up by 17% relative to May'05 (vs. a most drastic rise of 48.2% in the May'04- May'05 period). Following the latest arrangement with the IMF, the Central Bank amended the minimum reserve requirements (in effect from 4th August this year) aimed at slackening lending restrictions in a gradual manner. The arguments in favour of the above amendments to the credit policies had to do with the loan growth slowdown (especially in the preceding couple of months), stability of the banking system, the rather longish period of tough restrictions and their repercussions on the competitive position of the local commercial banks vis-à-vis leading EU banking institutions in the wake of the country's accession to the Community. Following the negligible March rise in loan extensions to non-financial institutions and other customers of 0.3% and moderate increase in April (2.3%), credit portfolios in May stepped down for a second time in 2006 (-0.28%), with the decrease affecting trade credit in the utmost.

[1] As per credit sales data released in *Dynamics of Selected Monetary Indicators*, made available in BNB monetary statistics.

Money supply



Source: BNB

Mortgage loans carried on reporting the strongest growth in both absolute and relative terms (12.8 vs. 27.5% on a year earlier). Consumer credit, on the other hand, posted a slower rate, advancing rather negligibly by only BGN 62 million in the March-May period (BGN 560.3 million in the same period of 2005). The slowdown in consumer lending led to lower Q1 growth in individual consumption.

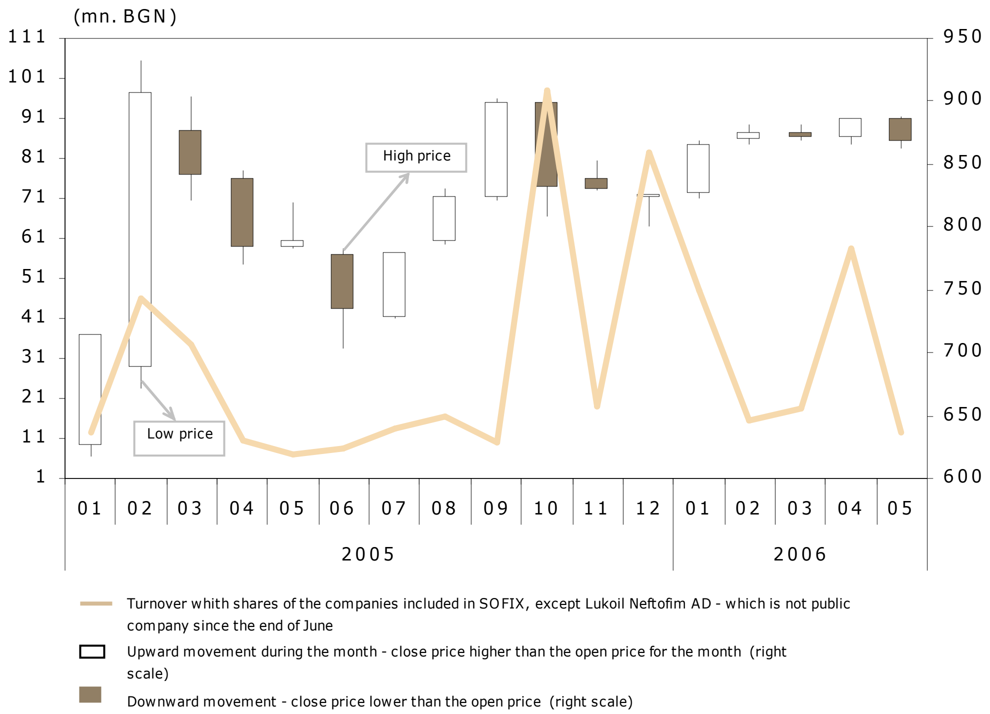
Commercial banks remained active deposit-takers. Credit extensions went on the rise due to the larger amounts of deposits attracted from local economic agents, with non-resident banks stepping down in importance in the fund accumulation process. The deposits of non-financial institutions and other customers posted a most vigorous increase of BGN 1803 million (vs. BGN 1155.3 million in the same period on a year earlier), exceeding the credit growth reported fourfold. At the same time, the deposits of financial institutions stepped up by a modest BGN 263 million (vs. BGN 697 million on a year earlier).

Exchange rate trading

April and May witnessed a strong rise not only in the share prices of the companies making up the SOFIX but in turnover volumes as well. In April, stock exchange liquidity increased most significantly, and turnover stepped up twofold due by and large to trading in the shares Sopharma AD whose prices hit a new record high. Trading in the shares of Biovet AD-Peshtera and the Central Cooperative Bank had also a rather healthy effect on the stock exchange developments in the same month.

In the first half of May the prices of the listed companies were strongly influenced by expectations as to the monitoring report on Bulgaria's progress towards accession, holding steadily high only to go on the downswing following the publication of the Commission's findings. As a result, the stock exchange indices went on the decrease. The following couple of months are expected to witness a smoother movement in both indices and quotations, as the share prices of most companies have come closer to a point of equilibrium.

Trading turnover and SOFIX dynamics



Source: BSE, AEAF

Government budget

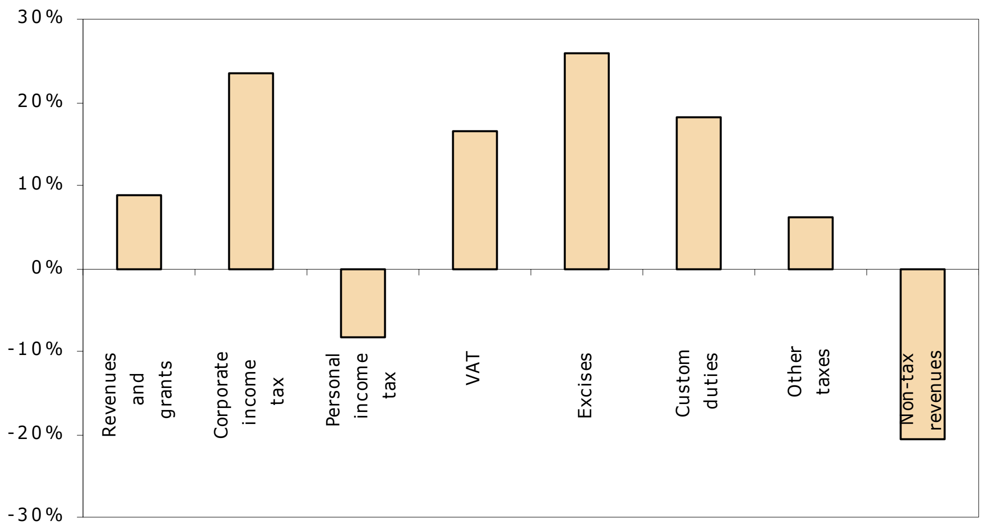
The consolidated budget ran a cash surplus worth BGN 872.9 million (as of end-April), with some 83% of it being generated in the March-April period alone. The ratio of the surplus to GDP (2006 forecasts) ran at 1.9% as of the end of April, going 0.3 percentage points higher than in the first four months of 2005.

The robust budget surplus was only possible due to the strong revenue performance. Revenues in March and April reported a 7.6% year-on-year rise, boosted mostly by the 17% growth in tax revenues. Indirect tax receipts stepped up by 19% as a result of the vigorous import growth. The larger import volumes of fuels, copper and other raw materials since the start of the year led to higher VAT revenues in March and April (16.4% up on a year earlier), with VAT revenues from imports rising by 32.8%, whereas VAT amounts from domestic transactions went on the decrease. Revenues from excise duties followed suit going up by 26%, strongly influenced by the higher gas oil and car fuel imports. The higher rates in force since the start of the year led to large revenue amounts from excise duties on tobaccos. Furthermore, customs collections in the same two months advanced by 18.2% on a year earlier.

Direct tax revenues stepped up by 13.2% due mostly to the strong contribution of corporate tax revenue, as the improved financial performance of companies led to a 23.5% year-on-year increase. At the same time, March and April witnessed an 8.3% decline in personal income tax revenues following the introduction of the household income taxation practices in early 2006. According to MoF data, some BGN 50 million worth of tax relief eligibility declarations were filed by the end of April, with 53.8% of the above sum being refunded to tax payers within the period surveyed. The expectations are that the amounts declared and subject to refund will go on the increase following the processing of data. At MoF estimate, tax credit refund will total BGN 80 million. Income from property decreased by 53.5% as a result of the higher 2005 base, having to do with one-off payments on licence and property sales in March and April 2005.

The 6 percentage point decrease in the social security contribution rate (in force since the start of 2006) led to lower budget collections (7.5% down on a year earlier). However, according to data of the National Social Insurance Institute, social insurance revenues in the five months to June outperformed projections by 10.8%. Furthermore, tax collection improved mainly as a result of the growing number of insured, following the decrease in the contributions due.

Annual growth by revenue item in the March-April period



Source: MoF, AEAF

Consolidated budget expenditures in March and April reported a rather slow growth rate, rising by 2.1% on a year earlier. However, spending on social insurance increased by 17.8%. Health insurance payments stepped up by 26% due mostly to the increased expenditures on dental and hospital health care, whereas social insurance payments advanced by 16% having to do with the increase in minimum and maximum pensions. The latter were offset by the higher transfers to NSII on a year earlier, remaining still within the projections of the 2006 Government Budget Act.

The drastic drop in subsidy allocations (-77.9%) had to do with the higher 2005 base of the one-time extensions to the Tobacco Fund in April last year. The 2006 Budget Act provides for a lower share of subsidies in GDP in favour of capital expenditures. Capital spending went down too by 30.5% relative to March and April 2005, accounting, however, for 11% of the 2006 budget projections in the four months to May.

Total interest expenditures in the three months to April ran some 5.1% lower on a year earlier due to the 8.9% decline in foreign debt payments following the buyback of Bradies in 2005. Foreign government and government-guaranteed debt totaled BGN 9.6 billion as of end-April, going some 17.7% down on a year earlier. Domestic government and government-guaranteed debt stepped up by 8.5%, resulting in an 11.6% rise in domestic interest payments. The implicit interest rate on total government debt advanced by 0.19 percentage points, relative to the January - April '05 period, to 2.79%.

Forecasts

Underlying assumptions

Throughout March to May crude oil prices carried on rising, breaking through the psychological barrier of USD 70 per barrel amidst a spate of bad news as to Iran's nuclear programme and oil supply disruptions (caused by social unrest in Nigeria and the nationalization of the Bolivian oil industry). All this called for revisions in oil price estimates, giving way to expectations that average 2006 prices will hover around USD 67-68 per barrel. Despite the revisions of the IEA global oil demand forecast, market uncertainty remains rampant under the impact of the constantly deteriorating geopolitical situation in the Middle East. All this implies both strong price volatility and retention of prices at levels well over USD 65 per barrel.

Metal prices hit a record high (a 69% rise in copper prices relative to the end of 2005), but unlike crude oil, metal price dynamics was mostly driven by the robust demand of the developing economies, China in particular. Furthermore, a number of extra factors at work on the supply side, e.g. bottlenecks faced by key manufacturers in Chili and Mexico (frequent strikes, etc.) exerted an upward pressure on prices. Therefore, based on the current market developments non-ferrous metal price forecasts have been revised upwards (31%), in spite of expectations of a steady downward trend throughout 2006.

The record high crude oil and metal prices made inflationary expectations in the developed economies all the stronger and monetary authorities initiated a number of measures to put the brakes on any higher price inflation in the future. Euro-area inflation in May stepped up as high as 2.5%, fuelled not only by the indirect effect of energy prices but the vigorous growth in credit and monetary aggregates as well. Given the above considerations, current forecasts draw upon a slight upward adjustment in the six-month LIBOR (in EUR) of a 0.1 percentage points relative to the preceding two quarters.

Six-month LIBOR forecasts (USD) underwent revisions of a similar proportion, as the Fed Reserve has continued to raise the fed funds rate in pursuit of tough monetary policies, despite indications of a certain growth slowdown in the US economy. Again, a major factor at play had to do with the sky-high oil prices and the strong inflationary pressure, which is expected to somewhat weaken as business activity slows down.

The ever-rising interest rates in the Euro area and the US economy perpetuate strong and steady EUR/USD exchange rate volatility, without, however, hampering the appreciation of the single European currency since March. The reasons behind the above developments had to do with the lost USD's ground to the other key currencies and market concerns about the huge US current-account deficit. Therefore, current forecasts take into account the EUR's appreciation, and highlight expectations within the narrow band of USD 1.25-1.26 per EUR. The slight upward revision of 2006 Euro-area real growth estimates from 2.1 to 2.2% provides a brighter scenario for Bulgarian exports vis-à-vis earlier forecasts.

GDP

Next quarter is to sustain the strong expectations of a steady moderate growth in the Bulgarian economy of 5.45% in real terms. The exportation of goods is to pick up by 15.3% in real terms, running some 2 percentage points higher vis-à-vis earlier estimates. However, the downward adjustment in the exportation of services is expected to offset the above rise, making total export growth hold at about 11.1%. Private consumption will go on the increase, as boosted by the ever-growing household income and robust consumer lending. Private-sector investments will be by and large financed by foreign savings, producing an adverse effect on the current account balance and generating sizable imports. The external-sector balance (net) is to remain negative, posting a contribution of around -3.5 percentage points.

Inventory change and its contribution to GDP growth need special attention. The long-expected revisions failed to take place, resulting in significant adjustments in forecasts, hence investment estimates. Stockpiling in the economy generates debts and undermines further the current account deficit.

Employment and the jobless rate

Expectations as to the labour market developments by the end of 2006 are based on a steady upward trend in employment and a declining jobless rate. The better than expected performance of the two indicators in the first half-year period vis-à-vis earlier estimates called for certain revisions of 2006 forecasts. Nevertheless, average employed numbers are to step up at a slower pace on a year earlier of about 1.6% on an annual basis and will be strongly influenced by expectations of stable growth in the economy. Employment growth by the end of the year is to steadily slow down, with much of this slowdown being due to the public administration redundancies planned. Besides, government intervention by way of active measures and programmes is to have a weaker effect on the labour market. Employed numbers are to report a most insignificant 12-month rise as late as the year’s end, making the most robust contribution to the indicator’s slowdown on an annual basis.

Average employed numbers in 2006 will go on the increase as a result of the boosted business activity in the private sector. Sustainable job creation in the primary labour market will help reduce the jobless numbers and make out-of-labour force cohorts join the country’s workforce again. As a result, the participation rate is to advance by about 0.2 percentage points on a yearly’s average to 49.9%. The jobless rate is expected to run at about 9%, going some 1.1 points down vs. the 2005 average.

Income and productivity

Economic growth and labour market upswing in the next quarters will sustain the healthy pace of both average wages and productivity in the economy. Overall for the economy, twelve-month productivity growth is expected to outstrip real wages. The swift advance of the private sector will boost productivity, eventually resulting in higher real income.

Inflation

Current 2006 estimates take into account some underlying assumptions as to crude oil prices, adverse price fluctuations of food and tradables as well as the planned administered price change. As a result, annual and average annual inflation forecasts had to undergo significant revisions, having to do with updates of 12-month market price inflation and rescheduled administered price change.

Estimates of food price inflation in 2006 have been revised upwards. Food prices are to step up by 2.78% on an annual basis due mostly to the adverse dairy and meat price fluctuations expected. According to preliminary data of the Agriculture Ministry, the bulk of manufacturers may cease operations failing to meet EU food safety requirements, bringing about major supply disruptions and pushing prices up.

Fuel price forecasts have been, too, revised upwards based on strong expectations of a more expensive crude oil and termination of the agreement between the government and key manufacturers of car fuels. However, if crude oil prices hold steady at the current record-high levels, manufacturers of oil products will be unable to keep local prices low.

The contribution of market prices to overall inflation is estimated at 2.58 percentage points.

Forecasts of cumulative administered price inflation have been revised insignificantly following the rescheduling of water supply and heating price updates. As a result, certain adjustments have been made in both average annual administered price change and overall inflation estimates. As indicated in some earlier publications, the preferential day-time rates of electricity consumption (up to 75 kWh) will be removed, and electricity prices raised. In addition, forecasts draw upon a rise in heating prices in summer and a hike in water supply charges in autumn. Administered prices are expected to step up by a robust 21.68%, posting a 4.62 percentage point contribution to overall inflation.

Overall inflation is to run at 7.20% as of the year’s end, advancing by 7.92% on a year earlier.

Balance of payments

The dynamics of the balance of payments flows in the four months to May led to significant adjustments in external sector estimates. As a result, current account forecasts have been revised upwards by 3 percentage points to -14.3% of GDP due to the ever-worsening trade deficit (by 2 percentage points to 22.7% of GDP) and lower surplus on services (1 percentage point down to 2.7% of GDP).

The above revisions had to do with the interplay of dominant trends underway. In the first place this was the trade deficit in goods worsening under the combined impact of underlying developments characteristic of the converging economies, e.g. acceleration of current investments and consumption at the expense of savings, and short-lived shocks.

Following the slowdown in real growth, as induced by negative shocks like the flood damages in the third quarter and capacity adjustment of key exporters, 2006 exports are expected to rebound. Forecasts point to a 29% nominal-term rise, running some 7 percentage points higher than April estimates. This revision was triggered by expectations of higher oil and non-ferrous metal prices, which pushed the deflator up to about 11-12%, with real export growth anticipated to run around 15%. The stronger export expectations were also predetermined by the robust foreign demand, market expansion and, above all, the production and marketing policies of large exporters in the oil processing industry and metallurgy.

Revisions in export estimates entail as a rule changes in import forecasts. Imports are expected to step up not only due to vigorous consumption and investments but stockpiling aimed at enhancing production and follow-up exportation as well, given high energy and raw material prices worldwide. The ultimate result is huge trade deficit, generated under outstripping growth in exports vis-à-vis imports.

Second, the current account deficit will further deteriorate due to the trend turnaround in net services, tourism and other services in particular, contained in the 2006 slowdown forecasts.

The poorer than expected receipts from tourism in the three months to April called for a more conservative approach to revenue growth forecasts in 2006. Although the reasons for the decrease remain largely unclear, managers in the industry have unofficially stated that revenues will hardly ever post the same growth rates as in the high holiday seasons of 2002/2004. At the same time, as household income goes on the increase and more and more Bulgarian citizens can afford holidays abroad as a first choice at fair prices, the surplus on revenues from tourism is to further shrink.

Third, the surplus on services is expected to deteriorate as a result of the growing commission payments on consulting since the second quarter of 2005. All this considered and relying on data already published, 2006 estimates highlight a certain rise in the deficit on the other services item.

The importance of net services in ensuring net foreign cash inflows has stepped down. Therefore, the country's trade deficit will be mainly covered by private and government transfers, which are expected to account for about 20% of the trade balance in goods. Net income may contribute to a lower current account deficit, but this will be mostly due to employee compensations, as the growing private foreign debt and robust investment, given rising interest rates, pre-suppose also larger amounts of income outflows.

The next quarters are expected to sustain 2006 AEAF FDI forecasts for they fully match the vigorous and steady inflow growth posted since the start of the year. Because of its larger size, FDI will now make up for about 70% of the current account deficit, i.e. in approximately the same proportion as in 2005. At the same time, the fast rising interest rates worldwide do not, at least currently, hinder private-sector economic agents from borrowing money from abroad. Therefore, in spite of the slight revisions in the EU and US monetary policy assumptions, FDI estimates will be largely sustained.

The financial account flows affect the current account on an ongoing basis. However, they are also indicative of expectations as to its future performance, implying that the Bulgarian economy is facing a major problem of the growing private-sector debt. All this means higher debt servicing costs, which, given the rising interest rates worldwide, will result in a deteriorating net income balance. Unlike them, FDI are a decisive factor, giving the economy a strong boost under the country's macroeconomic stability and significant progress on economic integration.

Financial sector

Current estimates as to money supply growth in 2006 point to a year-on-year decline to about 18%, with the downward revisions being mostly due to the lower private-sector credit and poorer contribution of BNB FX reserves expected. Commercial bank net foreign assets are anticipated to report a different pattern of dynamics, posting, unlike the preceding years, a positive contribution to broad money increase. The trend turnaround started in 2005 and is to persist well into 2006, based essentially on the transformation of domestic into foreign assets by way of credit sale to non-resident banks. Besides the lower credit growth, the contribution of net foreign assets to money stock is to step up at the expense of net domestic assets. As for the monetary aggregates, the highly-liquid M1 is expected to enhance its share within M3 growth at the expense of quasi money due to the relatively high contribution of final consumption to GDP, implying a higher demand for liquidity, hence a lower rise in time deposits, triggered by curtailed lending.

Drawing upon some underlying assumptions, credit interest estimates point to a certain retention and a likely short-lived negligible advance of the 2006 rates. Credit interest will hold steady due to the rising rates in a global aspect, leading to lower amounts attracted from non-residents. This, in turn, may bring about a rise in deposit interest, given the weaker deposit growth expected, affecting loan interest rates. In addition, have there been any alterations in BNB credit growth policies, loan interest rates will go on the decrease, as local interbank market competition is expected to gain new impetus.

Credit growth by the end of 2006 is expected to remain within the ceilings laid down in BNB Regulation #21. Given the actual increase in loans in the first quarter, annual credit growth is estimated at about 21%. However, it should be noted that this is the maximum growth rate loans can report within the credit ceilings. On the other hand, as credit sale to non-resident banks has resulted in a significantly lower credit increase, end-of-year growth is likely to run well below the above projections. Household loans are expected to report the most robust growth in 2006 as well. At the same time, following some amendments to the banking supervision requirements, mortgage loans are expected report a strong decline. The amended Regulation #8 provides for banks to enhance mortgage loan provisioning aimed at reducing credit risk, as borrowers would, otherwise find it difficult to back up loans with higher security. All in all, 12-month credit growth by private-sector segment, is to report a steady dynamics following the drastic shrinkage of early 2006 and is likely to even step up slightly as of the year’s end.

Government budget

Revenue growth estimates remain unchanged vis-à-vis earlier forecasts. Budget performance, however, has pointed to some minor discrepancies without calling for revisions on the revenue side. Total revenue growth is expected to slow down relative to the first four months to May due to the lower VAT revenue amounts. On the one hand, quarterly forecasts indicate a rather slack pace of imports resulting in lower VAT amounts, compared to early 2006. On the other, the size of VAT refunds has gone on the increase and is likely to step up even further by the end of the year (due to the March amendments to the VAT Act providing for voluntary registration of tax payers reporting turnover volumes of BGN 25 to 50 million). All this implies a growing number of companies eligible for VAT refunding, hence a larger size of VAT refunds.

Excise revenue dynamics is expected to follow the reverse pattern, as they are to pick up in the following months due to the higher duty rate on cigarettes in force since the start of the year. The delayed use of the new excise labels and bands as well as the backlog of excise goods accounted for the sluggish early-year pace of revenue growth. However, the impact of the above factors has already been taken into account in earlier forecasts, and as their effect is wearing off, excise revenue estimates by the end of the year will remain unchanged.

Revenues from social insurance contributions will be largely influenced by the reduced contribution rate since the start of the year. Performance in the four months to May indicates that any other factor at work, e.g. insured numbers, insurable income, etc. has come to the opposite effect. The over-performance since the beginning of the year has justified some earlier forecast figures and assumptions that the lower social insurance contribution will also have a healthy effect on the tax base.

The retention of total revenue estimates reinforces the findings of the previous growth report that the 3% surplus of GDP, agreed upon with the IMF, can be only achieved on the basis of tough expenditure discipline. Employment redundancies in public administration will become a key source of budget cost savings. Their direct effect is not apparent in the pay-roll statements while being indirectly evidenced by the decline in maintenance costs. Subsidy allocations and capital spending are the other two expenditure items expected to go on the decrease, as they are essentially discretionary costs, which can be controlled throughout the year. All this may entail rather adverse consequences as well, as the implementation of the ambitious 2006 budget investment programme may fail to take place.

On the whole, however, budget performance since the start of year and expectations indicate that the 3% target surplus is feasible. The consolidated budget surplus in the four months to May improved significantly on a year earlier. At the same time, the revenue slowdown forecasts are expected to exert some pressure on the fiscal position, which can be otherwise offset by curtailing budget spending to the legal limits of 93% of the Budget Act projections. Budget authorities will have to resort to the above limits because current forecasts point to a current account deficit of well over 12% of GDP, invoking the safeguard clauses as to expenditures.

Forecast errors

- BNB methodological revisions led to some discrepancies between the historical import and export figures in the balance-of-payments statistics and national accounts data, making forecast and historical figures until 2005 incomparable with the implications of the growth estimates.
- Crude oil dynamics remains a major source of forecasts errors.
- Food price fluctuations may pose a major risk to forecasts. As already pointed out, the downbeat expectations for the food processing industry may never come true if manufacturers gear themselves to the tough requirements by restructuring production capacity. Besides, the strong crop yields expected (fruit and vegetables) may push the prices of unprocessed food down, making up for the adverse developments in the processing industry. Also, electricity and heating price change may fall short of expectations.
- Any increase in fixed telephone line charges may result in a higher service price inflation, as a follow-up update in BTC pricing policies (turned down by the Commission on Communications Regulation) may push prices up.
- Cigarette prices (imports in particular) may go on the decrease in the wake of the tobacco market liberalization of mid-2006. Current estimates, however, do take into account the price change, as there are a number of administrative inadequacies.
- Oil imports since the start of the year have been by and large boosted by stockpiling in the manufacturing sector aimed at enhancing production and follow-up exportation. Contracting vast amounts at rising energy prices worldwide implies strong volatility of import prices, jeopardizing quarterly estimates (allowing for a likely underestimation or overestimation of forecasts by quarter).

In the Spotlight

Minimum wages as of 1st January 2007

Minimum wages have been in the limelight of much controversy in the past few months. In its draft income strategy, the Ministry of Labour and Social Policies has proposed an amount of about BGN 174.80 to 219 as of early 2007. The increment foreseen triggered a number of public debates. Major criticisms had to do with the likely adverse effect on competitiveness in the economy as a result of the higher labour costs, as well as with the poorer job opportunities for workforce of low productivity. Ministry experts, however, believe that the increment proposed is reasonable, as current minimum wages fail to protect the lowest-income groups of the population.

According to AEAF estimates, minimum wages of about BGN 170-180 as of 1st January 2007 are feasible because the increase runs in line with the growth rate in the economy, i.e. minimum wages growth will be consistent with nominal GDP change.

AEAF estimates draw above all upon the ratio of minimum wages to average wages. Furthermore, assessing the two indicators together means providing a clearer picture of average income dynamics in the economy. According to NSI employed and wage data, the above ratio ran at about 47% in 2005 and is expected to slow down to around 46% in 2006 (vs. 34 to 50% in the EU member states). Assuming that this is the benchmark band the ratio in Bulgaria is to change, it follows that it has neared a ceiling of a kind and any other upward movement is undesirable. Put in more precise words, a faster increase in minimum wages, provided it has not resulted in a proportionate rise in the average country's wages, may lead to strongly compressed low income from wages while jeopardizing labour force flexibility. The above findings provide a solid ground for a key assumption in AEAF minimum wage estimates, i.e. a *minimum wages/average wages* ratio of 46% is feasible, as it dwells on reporting data, on the one hand, and is compatible with EU levels, on the other.

Given the above scenario, if minimum wages as of 1st January 2007 step up to about BGN 170 to 180, their nominal-term growth will run at 6 to 13% relative to 2006. At AEAF estimate, 2007 nominal GDP growth is expected to amount to about 9.5%. The higher nominal minimum wage growth vis-à-vis nominal GDP implies that wage change will run consistent with local price dynamics and productivity performance, all of them leading factors in the Ministry of Labour and Social Policies income strategies. The juxtaposition of the expected average wages in nominal terms and GDP growth indicates that both indicators will follow more or less pattern of dynamics in 2007. Also, it is possible for nominal-term average wages to slightly outstrip GDP at some point in the future, given the minimum wage ceilings in force. This, however, is unlikely to exert a serious pressure on employers as a result of the higher labour costs. The dynamics of the two indicators of the past several years has pointed to an outstripping GDP growth vis-à-vis average wages in the economy, with some of the years witnessing a normal turnaround. Besides, the share of employee compensations within GDP stepped down from 38.8% in 1998 to 34.5% in 2005. Average employee compensations as percentage of GDP in the EU member states run at about 51%, implying that Bulgaria is lagging considerably behind the indicator in the Community but also that there is in the economy some stronger average wage growth potential vis-à-vis GDP in nominal terms.

Drawing upon the above conclusions, AEAF analysts believe that a minimum wage amount of about BGN 170 or 180 as of 1st January 2007 is feasible. Nevertheless, it should be noted that minimum wages should not be employed as an instrument of impact on the country's wage dynamics. EU applies well-tested income update practices on a regular basis, dwelling on social dialogue between trade unions and employer organizations, taking into account the overall economic environment in a country, the different industries and company conditions. Wages are thus related to the results of any business activity while retaining their purchasing power as a factor of production. There are some differences across the member states as to the indicators exploited to gauge economic dynamics, but the rationale of the wage formation process is largely sustained. As of today, there is no collective bargaining by industry in the local private sector due mainly to the low trade union density. The indicator in Bulgaria hardly ever surpasses 25% vs. some 30% in the EU on average. On the other hand, improving social dialogue means drafting legal measures for the employer organizations, membership requirements, their functions and responsibilities, defining the level of representation and identifying national representatives. EU enlargement poses a number of challenges to be faced by the acceding countries, Bulgaria including. In this sense, the development and real pace of social dialogue aimed at effectively involving local trade unions and employers at EU level is a decisive factor at work.

In conclusion, proposals as to a rise in minimum wages as of early 2007 should be reasonably grounded and above all economically feasible. Minimum wages should carry on performing a key social role, providing protection to the so-called working poor while not putting the country's sustainable development at risk.

Macroeconomic Indicators 2004 - 2006 [1]

		Reported data								Forecasts							
		2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	2005	Q1 2006 forecast	Q1 2006 reported	Q2 2006 previous	Q2 2006 revised	Q3 2006 previous	Q3 2006 revised	Q4 2006 previous	Q4 2006 revised	2006 previous	2006 revised
Exchange rate USD/BGN, p.a.		1.57	1.49	1.55	1.60	1.66	1.58	1.63 [2]	1.63	1.61 [2]	1.56	1.62	1.56	1.60	1.55	1.61	1.57
Petroleum spot price (APSP)		37.8	46.1	50.8	60.0	56.5	53.4	61.0 [2]	61.0	62.5	68.5	62.0	69.7	61.5	69.5	61.7	67.2
EU Area Real GDP growth	%	1.7	0.6	1.9	1.5	1.4	1.4	1.7	2.1	2.0	2.2	2.2	2.2	2.3	2.3	2.1	2.2
LIBOR U.S. dollar deposits	%	1.9	3.1	3.5	4.0	4.5	3.8	4.9 [2]	4.9	5.3	5.3	5.6	5.7	5.9	6.0	5.4	5.5
GDP, current prices	mn BGN	38 275	8 755	9 822	11 755	11 616	41 948	9 568	9 815	10 850	10 906	13 086	13 148	12 736	12 623	46 241	46 529
GNP, current prices	mn BGN	38 741	8 873	9 998	11 847	11 714	42 432	9 642	9 894	10 999	11 099	13 184	13 323	12 825	12 774	46 651	47 045
GDP, real growth	%	5.7	5.9	6.5	4.6	5.5	5.5	4.4	5.6	5.6	5.2	6.0	5.5	5.6	5.4	5.5	5.45
Consumption, real growth	%	5.1	7.0	5.9	8.9	5.5	6.8	5.5	4.8	4.2	5.2	3.7	4.5	4.1	5.4	4.3	5.0
Investment, real growth	%	14.7	9.0	21.3	43.9	18.3	23.3	13.2	37.4	8.1	11.6	3.8	10.5	12.0	12.0	9.0	16
Exports GNFS, real growth	%	13.0	9.2	12.0	1.1	8.9	7.2	10.3	12.9	10.5	9.8	14.0	10.9	9.9	11.1	11.3	11.1
Imports GNFS, real growth	%	14.1	10.8	15.3	18.8	12.9	14.6	13.1	20.0	8.7	11.0	9.7	11.2	9.4	12.0	10.1	13.2
Inflation, corresponding period of previous year = 100	%	3.98	1.95	1.21	3.32	6.45	6.45	4.13 [2]	4.13	2.47	3.28	3.37	4.06	6.41	7.20	6.41	7.20
Inflation, previous year = 100	%	6.15	3.59	4.44	4.35	7.77	5.04	6.53 [2]	6.53	7.16	7.79	6.27	7.06	9.52	10.30	7.37	7.92
Core inflation, corresponding period of previous year = 100	%	4.6	2.17	3.96	5.16	6.91	4.54	6.48 [2]	6.48	5.06	6.05	4.19	5.17	2.57	3.48	4.56	5.28
Administrative prices, corresponding period of previous year = 100	%	11.04	8.74	7.74	4.04	5.85	6.54	13.76 [2]	13.76	17.70	17.13	17.08	17.15	22.08	22.28	17.70	17.62
Current account balance	mn EUR	-1 131	-551	-565	-230	-1 185	-2 531	-867	-1 108	-564	-692	55	-87	-1 295	-1 522	-2 671	-3 409
Current account balance, % to GDP		-5.8	-12.3	-11.3	-3.8	-19.9	-11.8	-17.7	-22.1	-10.2	-12.4	0.8	-1.3	-19.9	-23.6	-11.3	-14.3
Exports	mn EUR	7 985	2 081	2 305	2 414	2 654	9 454	2 653	2 667	2 804	3 020	3 005	3 250	3 029	3 259	11 492	12 195
Imports	mn EUR	10 938	2 785	3 420	3 588	4 030	13 823	3 583	3 705	4 044	4 317	4 149	4 515	4 592	5 049	16 368	17 587
M3, p.a.	mn BGN	18 033	21 488	22 407	23 540	24 403	22 960	25 105 [2]	25 105	26 490	26 625	28 042	28 575	29 308	29 392	27 236	27 424
Reserve money, p.a.	mn BGN	5 505	6 622	7 060	7 611	8 043	7 334	8 287 [2]	8 287	8 545	9 089	9 347	9 853	10 229	10 313	8 144	9 385
Total revenues	mn BGN	15 855	4 167	4 678	4 396	4 772	18 012	4 443	4 381	4 820	4 820	4 641	4 641	5 132	5 132	19 035	19 035
Tax revenues	mn BGN	12 774	3 404	3 530	3 594	3 956	14 484	3 677	3 693	3 860	3 860	3 855	3 855	4 286	4 286	15 678	15 678
Unemployment rate	%	12.0	11.3	10.0	9.2	9.9	10.1	10.4	9.7	9.3	8.8	9.0	8.4	9.8	9.0	9.6	9.0
Participion rate	%	49.7	48.0	50.1	51.1	49.6	49.7	48.2	48.9	50.4	50.0	51.7	51.2	50.2	49.5	50.1	49.9

[1] The forecast is based on data as of june 2006. That is why it is different from the forecasts presented in previous AEAF publications.

[2] Reported data.

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