BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2004

(semiannual survey)

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EXECUTIVE SUMMARY

In the first half-year period of 2004, the Bulgarian economy sustained the general trends of performance of the preceding years as followed:

- Sustainable growth in the economy was further boosted, with the countrys GDP stepping up by 5.6% at constant prices on a year earlier, hitting a five years record high;

- As a result of the high economic growth reported and active government labour market measures, Q2 unemployment rate went down as low as 12%, reporting a record low ever since the NSI started conducting labour force surveys. All this has been coupled with a stepwise increase in employment as well as a certain rebound of the participation rate in the economy;

- The currency board arrangement remained stable, and reserve money (M1/FX reserves) went some 31.1 percentage points up to 228.3%. Having run rather high in end 2003, the countrys inflation in early 2004 set back at its normal rates amounting to 0.17% over the Jan-June period (periods cumulative);

- Bank lending went on the increase, with non-government sector credit registering a most robust growth. As a result, the non-government credit/GDP ratio reached some 31.8% in June. Housing, mortgage and consumer loans stepped up most vigorously as did credit to non-financial enterprises. In addition, long-term bank loans have again outstripped short-term credit in both absolute and relative terms;

- Furthermore, the government budget remained stable due mostly to the vigorous performance on the revenue side. In the first half-year period of 2004, the general budget ran some BGN 879.6mn worth of a cash surplus, allowing the government to carry on the tax reform exercise and downscale cuts in direct taxes, as planned. At the same time, the government opted for implementing a balanced budget (a cash balance close to 0% of GDP) in end year, making the current account deficit run lower;

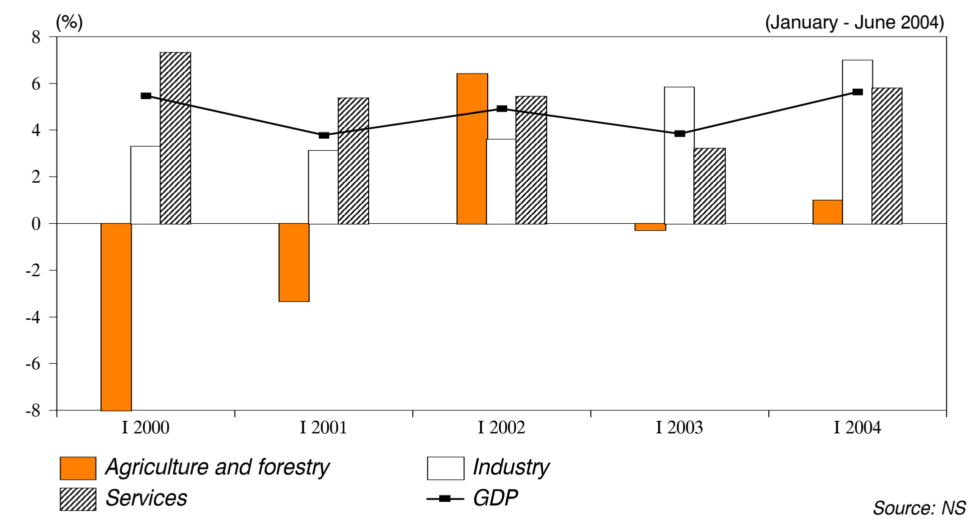
- The current account deficit of the balance of payments remained still rather high, covered, however, in full by the financial account surplus, triggered by the robust growth in FDI. In the six months to July, FDI totalled MEUR 978.6, hitting a six months high ever since the start of the transition period. This was partly due to the sizable revenues from the sale of the Bulgarian Telecom as well as the licence of the third GSM operator. FDI growth was mostly associated with the privatisation exercise underway, though;

- Due solely to the economic growth over the past couple years and the first half-year period of 2004, the country s credit rating has been continuously upgraded and Bulgaria was given its first investment standing of BBB-/positive outlook by S&Ps. ❑

SUSTAINABLE ECONOMIC GROWTH

In the first half-year period of 2004, the countrys GDP reached BGN 16.9 billion, reporting a year-on-year rise of 5.6%. All sectors of the economy made some contribution to the six-month sustainable growth.

Real gross value added growths by economic sectors



On the supply side, the service sector reported the most robust contribution to gross value added (GVA) growth not only because of its large share within GVA but also because of the faster growth rate on a year earlier, with finance (17.4%), trade (12%) and communications (11.5%) in the lead. Furthermore, tourism performed most vigorously. At preliminary estimate, the number of holiday makers, visiting Bulgaria in the six months to July ran some 20% up on a year earlier. Revenues from tourism (EUR) increased by about 25% in nominal terms, according to balance of payments statistics.

The manufacturing sector reported a most sizable rise in value added of 7% vis-□-vis the other sectors of the economy. All manufacturing industries made a positive contribution to value added growth headed by the processing industries. At the same time, the highest valued added growth was posted by the extraction and mining industry (15.5%).

On a year earlier, sales in the first half of 2004 stepped up by 20.1% due mainly to the strong contribution of export sales, which reported a 38.6% rise and accounted for 39% of total sales. On a 12-month basis, all manufacturing industries registered a certain increase in sales. On the other hand, domestic sales went up by 6.4%, running close to the sectors GVA growth.

Growth in the manufacturing sector was mainly fostered by *metal production and casting*, which was responsible for some 38% of total sales. Sales in the industry are heavily dependent on international price dynamics. The favourable structure of relative prices triggered mostly by the higher demand worldwide is expected to persist well by the end of the year. The increased industrial output in the European Union, the USA and Japan as well as the persistent growth in the Chinese economy, notwithstanding action to cool it off, are anticipated to hold main commodity prices steady at reasonable levels for the Bulgarian producers at least in the short run.

Industries posting a positive contribution to sales growth	Real-term change (%) Total	Export sales	Domestic sales
Metal production and casting	69.6	96.5	-3.8
Food and beverages	15.1	34.4	10.3
Machinery, equipment and household appliances	35.2	55.4	9.4
Metal products, machinery and equipment excluded	52.4	96.9	32.6
Textiles and products thereof, clothing excluded	38.2	40.6	32.5
Clothing, leatherwear included: skin dressing	20.3	25.6	6.1

Source: NSI, AEAF

The food industry reported a six-month high in sales. It was also the industry making the largest contribution to growth in domestic sales. Furthermore, it should be noted that most food enterprises registered a significant rise in export sales (35%), showing explicitly that competitiveness in the industry had improved tremendously both in the foreign and home markets.

Growth in the construction sector over the past few years was the main reason behind the satisfactory performance of some manufacturing industries such as: *metal products, machinery and equipment excluded*; *manufacture of other non-metal mineral raw material*; as well as the *manufacture of non-metal raw material*. All the three industries made a major contribution to the year-on-year rise in domestic sales, with the higher demand for their products failing still, however, to affect the dynamics of producer prices, which were steadily rising at a rate close to the manufacturing sectors average.

Industries like *textiles and products thereof, clothing excluded* and *clothing, leatherwear included: skin dressing* posted, as a rule, a significant contribution to sales growth. However, in the first half-year period of 2004, they followed a different pattern of sales dynamics, as followed: while the former grew faster, reporting a considerable increase in both domestic and export sales, the tailoring industry registered a much slower rate of export sales rise on a year earlier. As a result, most producers tried to partly make up for the declining export sales by fostering domestic sales by about 6%.

At the same time, domestic textile sales outstripped total sales in the industry, implying that the share of clothes produced as piecework has decreased at the expense of clothes the production of which relies on local raw materials.

Value added in the construction sector stepped up by 4.6% due largely to the higher domestic demand for residential and office buildings. Real estate prices have risen most vigorously over the past year and a half. Q2 average prices in the country ran some 44% higher on a year earlier, going 27.8% up in Sofia alone. Mortgage loans have meanwhile reported a 40.6% increase of BGN 184mn in absolute terms. Real estate prices may further go up as a result of the growing expectations as to their dynamics following the countrys accession to the European Union. At present, the relatively moderate growth in the construction sector is unlikely to meet the ever-rising demand, which may be in part redirected to the purchase of buildings already constructed. On a year earlier, construction design project approvals ran 66% higher, implying that entrepreneurs are seeking ways to boost the supply of new buildings to satisfy demand. This is further influenced by the high gross profit margin and prices, giving an additional incentive to new companies to enter the sector. NSI business surveys point to increased competition and demand. The boosted business activity in the construction sector has been further evidenced by preliminary data on GDP by component of final use. The growing inventories in the sector made a significant contribution to GDP growth, which was largely due to the higher prices of uncompleted building sites.

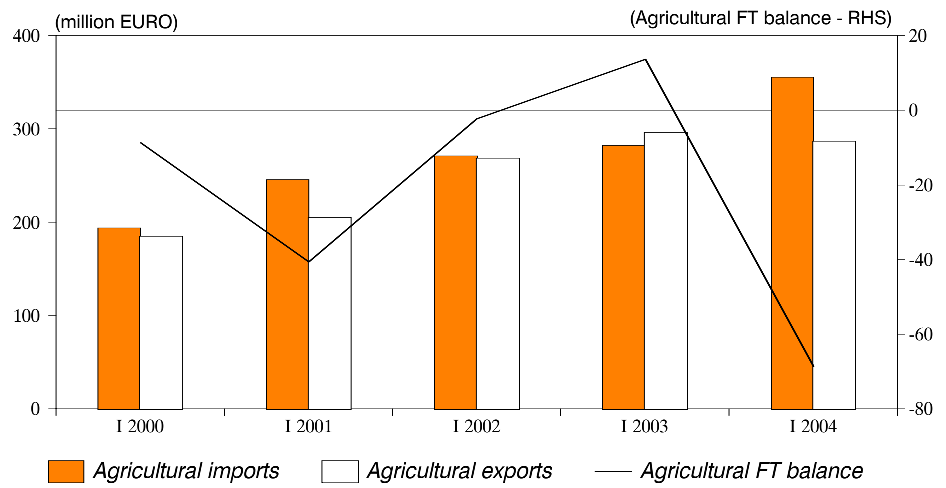
Stiff competition in the sector is expected to result not only in certain equilibrium between supply and demand but also in price fluctuations of lower magnitude in the short term. On the other hand, construction was the only sector where the average business climate indicator in the first half-year period of 2003 ran considerably lower on a year earlier due wholly to respondents current business situation assessments. However, their business expectations remained rather upbeat, rising by more than 6 percentage points from 33.7 to 39.9% on a 12-month basis.

On a year earlier, GVA in agriculture and forestry reported a 1% real-term rise due to the robust contribution of grain production. According to data of the Ministry of Agriculture and Forestry (MAF), 2004 wheat and barley harvest is expected to amount to about 3.8 and 1 million tons respectively, or well above preliminary estimates. Furthermore, crop yields are expected to hit a record high of 390 kg/decare (wheat) and 365 kg/decare (barley), given average yields over the past few years of around 305 and 300 kg per decare.

At the same time, fruit and vegetable production as well livestock production registered an output contraction, contributing to the relatively weak growth in the agricultural sector. The supply forecast is for some 220 thousand tons of field tomatoes and 144 thousand tons of peppers, or 45 and 31% down relative to the same period of 2003. Therefore, agricultural output stepped down mainly as a result of the downbeat expectations for the 2004 average yields and areas under crops.[1]

The problems experienced by the agricultural sector have led to a drastic deterioration in the countrys agricultural trade balance in the first half-year period of 2004. This was by and large due to the poor last years yields of cereals, fostering imports in return. Furthermore, it was the insufficient local supply which has failed to meet the growing demand for raw materials of the food industry, implying that competitiveness was still low as there are mostly small producers with poor mechanisation of their operations. The higher 2004 expectations as to wheat and barley yields will not only lead to declining agricultural imports but will also promote the sectors export performance in the second half-year period. Nevertheless, the agricultural trade deficit is expected to persist well throughout the year due mostly to the poor economic indicators of vegetable production. At the same time, lower vegetable output kept prices relatively high. To safeguard local producers, the 2004

Imports and Exports of Agricultural Commodities



Source: NSI, BNB, AEAF

[1] *2002-2004 Outlook on tomato, pepper and onion production, MAF, Marketing Department.*

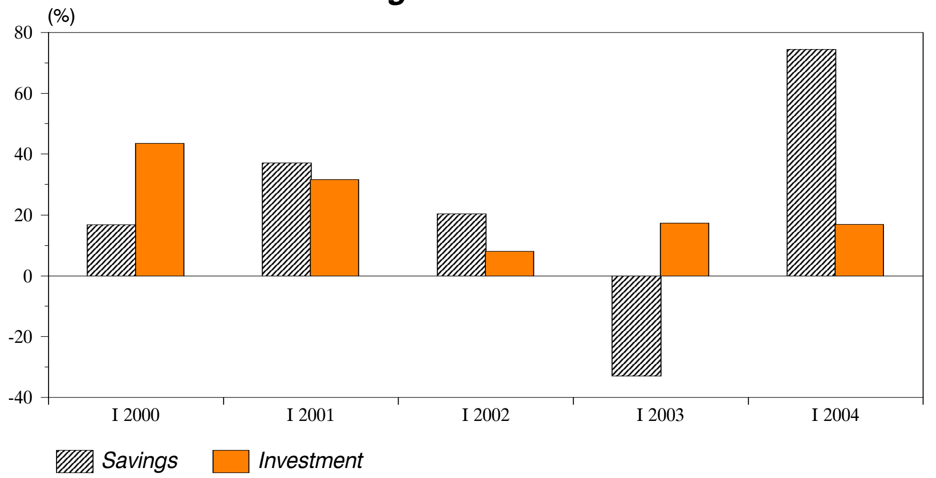
Customs Tariff has provided for a new period (May-April) where the duty rates amounted to the final bound duties (60%+ EUR 298/ton) which Bulgaria was able to apply as a member of WTO. As a result, greenhouse tomato imports over the same period contracted to 1 196 tons from 6 662 tons on a year earlier.[2]

Another positive development in the agricultural sector had to do with the faster investment process under SAPARD. The first half-year period of 2004 saw the approval and completion of projects amounting to an investment worth of 20 and 10% respectively of the sector s GVA. As of early June, the EU subsidies contracted accounted for 86% of the financing agreements over the 2000-2003 period. In addition, the implementation of projects on another 7 measures accredited under SAPARD have been given the go-ahead since the start of the year. These are mostly public-sector projects where access to financing is easier and are, therefore, expected to speed up EU fund absorption.

On the demand side, GDP stepped up mainly as a result of the rising investments and consumption. Domestic demand reported an 8.8% increase. The contribution of investment demand to total growth ran at 5.5 percentage points. Furthermore, gross fixed capital formation has reported a 12-month rise (12.6%) for another year in a row, outstripping the countrys economic growth rate. The high share of investments in GDP was partly due to the larger amounts of construction work-in-progress triggered by the boosted economic and investment activity in the construction sector and high prices of buildings still in the making. This was further evidenced by the balance of payments statistics, pointing to a fast and robust growth in FDI, the bulk of which had nothing to do with the privatisation exercise. The increased investment activity also led to a significant improvement in the countrys business environment, as revealed by the higher values of the business climate indicator and growing consumer and business confidence in the economy, the manufacturing sector in particular.

Final consumption reported a 4.7% real-term rise, lagging, however, behind growth in the economy. As result, its share within GDP stepped down by about 1 percentage point. Private consumption also declined from 7.7% in the first half-year period of 2003 to 5.2% in 2004, with the reasons behind the year-on-year slowdown being rather difficult to assess at present. On the one hand, it could have been the high growth rate of savings, which went up by most vigorously (74%) vs. a decrease on a year earlier. Their share within GDP reached 13% in the first half-year period of 2004, rising by 5% relative to the same period of 2003. The outstripping growth in

Saving – investment*



* nominal growths, corresponding period of previous year = 100

Source: NSI, BNB, AEAF

[2] *Ibid.*

savings vis-à-vis investments brought about a 3 percentage point improvement in the savings-investments deficit to 8% of GDP. On the other hand, private consumption growth may have slowed down due to the relatively slower increase in personal income, in particular income from employment. According to preliminary data, obtained from NSI surveys on wages and employed on labour contracts and civil servants, the average monthly wages in the economy in the six months to Jul04 increased by 6.2% in nominal terms on a year earlier while decreasing by 0.35% at constant prices (deflated by the periods average of the CPI). However, other NSI sources of data have given a somewhat different picture of the wage dynamics in the first half-year period of 2004. According to household budget survey data, for example, money income from employment per household on average stepped up by about 8% in nominal terms on a year earlier, or about 1.5% in real terms. GDP statistics by income approach and labour force surveys reveal a similar picture, pointing to an 8.5% rise in the compensation amounts per employee in the economy (labour force survey data) and a 10.6% nominal-term increase in income from wages (i.e. compensations minus social insurance contributions) alone. It is therefore possible that the discrepancy in the data obtained form the former survey and the other NSI statistics is mainly due to the growing difference between the labour costs officially reported by companies and the wages actually paid. According to the latter two sources of information, i.e. the surveys on household budgets and GDP by income approach, and labour force surveys, the real change in wages ran close but slightly below growth in productivity in the economy, showing that companies as a whole had not lost any of their competitiveness due to the wage dynamics in the first half-year period of 2004.

Productivity*

	Value added growth	Wage growth	Growth in productivity
Total	**5.8**	**3.1**	**2.6**
Agriculture and forestry	**1.0**	**0.5**	**0.5**
Manufacturing sector	**7.0**	**4.6**	**2.3**
Extraction and mining	15.5	-5.6	22.5
Processing industries	7.6	4.0	3.4
Electricity and heating	4.4	6.4	-1.9
Construction	4.7	9.2	-4.1
Services	**5.8**	**2.7**	**3.0**
Transport and communications	6.3	-0.1	6.4
Trade	12.0	2.4	9.4
Finance	17.4	16.4	0.8
Other	3.1	3.1	0.0

* First half-year period of 2004

Source: NSI, AEAF

The slow increase in average wages in spite of the economic growth reported was one of the reasons why the government decided on a significant rise in minimum wages of 25% that is to take place from the start of 2005. This measure, however, gave rise to a number of heated debates as to its appropriateness and voiced opinions that the government was seeking ways to administer wage dynamics. In actual fact, the major concerns on the government economic agenda to improve the countrys business climate and enhance macroeconomic stability have to do mainly with the achievement of sustainable growth in the economy, and hence income growth (income from wages including). Furthermore, the concerted and continuous efforts of the government and its partners to streamline business rules, alleviate the tax burden and restructure the countrys monopolises, etc. have served the same purpose. It is therefore wrong to claim that the government is trying to raise average wages by only making some adjustments in minimum wages or by updating wages in the budgetary sector. More important, the measure applied is expected to come to the following effect:

- reducing employment in some firms in an attempt to avoid any further rise in labour costs or decrease in profit, provided the current employed numbers are retained or else not adequately reduced. This, however, is likelier to happen in some labour-intensive industries, facing strong competition from countries enjoying the same comparative advantage, i.e. low labour costs;

- hamstringing the share of the grey economy, bringing unreported pay to light, which may take place in the bigger labour markets (Sofia and Varna) reporting as a rule low unemployment rates where it is practically impossible, even at present, to hire work force at a lower pay rate than the minimum wage levels set for 2005;

- increasing budget allocations to provide for employment promotion measures and programmes unless their scope is properly limited from the start of 2005, accordingly.

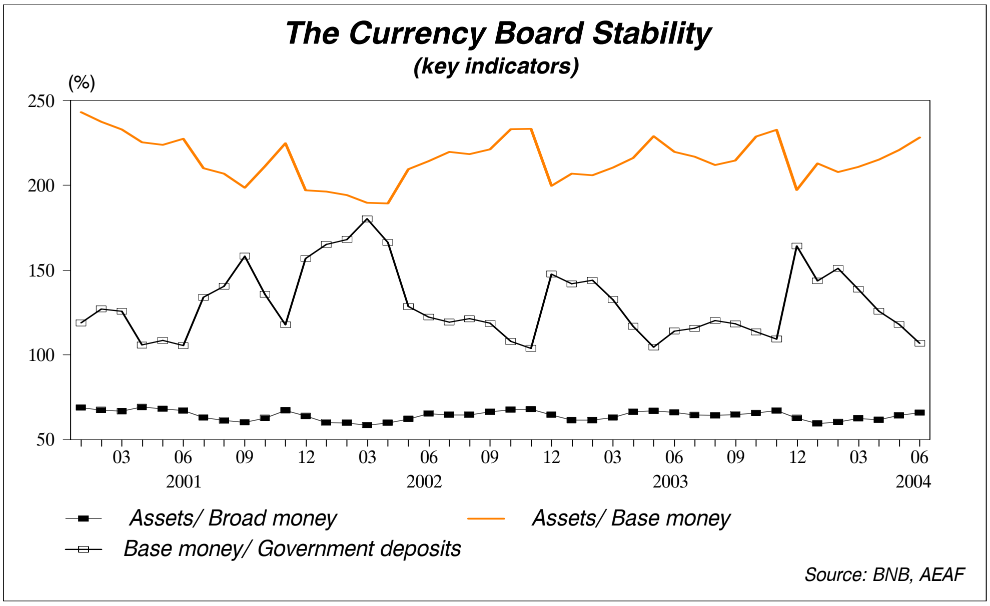
And yet, even according to the other data sources, real wage growth has been lagging behind the countrys economic growth, having a curbing effect on private consumption. At the same time, another factor at work, i.e. increased bank lending, in particular the robust growth in consumer loans, produced the reverse effect, sending consumption too high.

Foreign demand, as measured by exports, stepped up by 9.6% in real terms on a year earlier. Nevertheless, the external sector has made a negative contribution to GDP growth due mostly to the fast growing imports (14.2%) spurred by the higher consumption and investment activity in the economy as well as by the boosted business activity of the local companies and greater demand for imported raw materials. ❑

STABLE AND PREDICTABLE ENVIRONMENT

The sustainable growth over the last couple of years was mainly due to the countrys macroeconomic stability achieved, and further enhanced by the currency board arrangement, which remained stable in the first half year-period of 2004 as well. As of June, the balance-sheet value of the Issuing Department of the Bulgarian National Bank (BNB) reached BGN 11 952.7mn (MEUR 6 111.3). As a result, the foreign assets of the Central Bank stepped up by 15.1% relative to end-2003 and 26.5% on a year earlier. Net revenues on the government deposit following the robust performance of the government budget made a significant contribution to the stability of the currency board. Furthermore, the withdrawal of the deposits of the central government, falling due in May, from commercial banks and follow-up transfer to BNB aimed at restricting the credit expansion of commercial banks resulted in a certain increase in the fiscal reserve account, and hence gross FX reserves. Last but not least, FX reserves stepped up as a result of the revenues from the sale of the Bulgarian Telecom and licence of the third GSM operator.

Despite the payments on the countrys foreign debt made over the same period, the reserve money coverage rate, i.e. M1/FX reserves went some 31.1 percentage points up to 228.3%, and that of broad money 3.2% to 65.8% relative to end-2003.

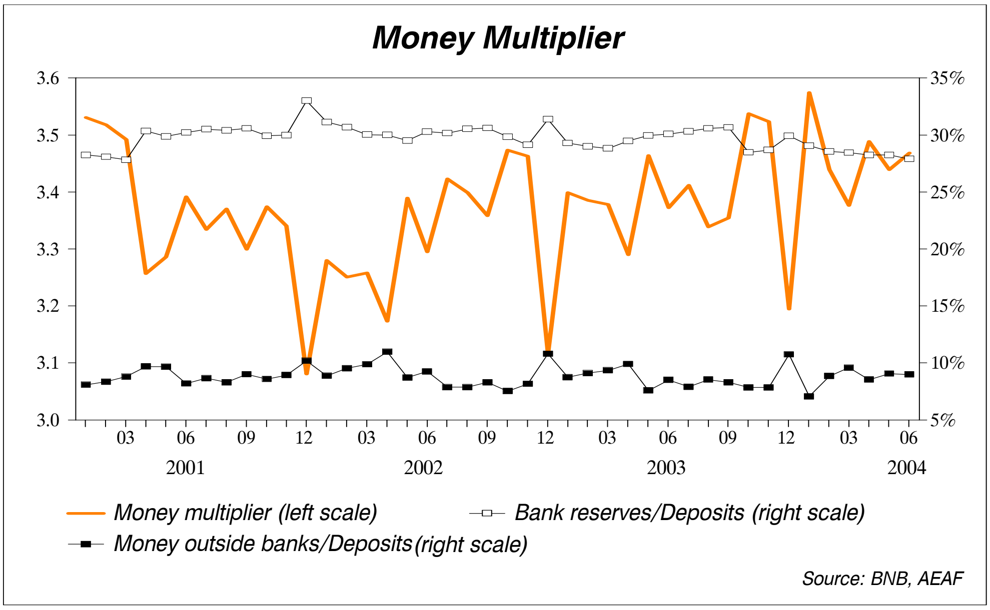


Highly-liquid money (M1) increased by 4.9% (BGN 392mn) and made a rather negligible contribution to broad money growth. Of all M1 components, money in circulation reported the most insignificant 6-month rise of only 2.2% due to the tax payments to the budget and growing role of banks as intermediaries in settlement transactions. Overnight deposits rose by 7.4% (BGN 305.7mn) due to the strong contribution of the foreign currency deposits of the non-financial enterprises. In the first half-year period of 2004, money supply growth was mainly triggered by the sizable rise in quasi money (13.9% or approximately BGN 1.2 billion up). The foreign currency component of quasi money went on outstripping its BGN component (16.4 and 10.7% up), enjoying again a larger relative share and making this difference all the more pronounced within the deposit total[3].

[3] *Overnight and long-term deposits, not covered by the money supply.*

All foreign currency deposits reported an aggregate increase of 19.5% (BGN 1.2 billion) vs. only a 5.9% (BGN 393.3mn) rise in BGN deposits. Long-term deposits sustained their last years upward trend, now going up most vigorously by 56.1% or BGN 113.3mn and accounting for 21.9% (15.8% in Dec04) of total deposits. Households registered the largest contribution to the six-month deposit growth in quasi money (13%, BGN 889.2mn up). At the same time, following a turnaround in their downward trend, the deposits of the non-financial enterprises went on the increase (9%, or BGN 405.9mn). Both households and non-financial enterprises opted for money deposits in foreign currency.

On the side of the money supply mechanism, the money multiplier made an important contribution to broad money growth, whereas the monetary base decreased. The money multiplier stepped up to 3.47 in end-June from 3.15 in Dec03 due to declining ratio of money in circulation to deposits (from 30.5% to 27.9% over the same period).

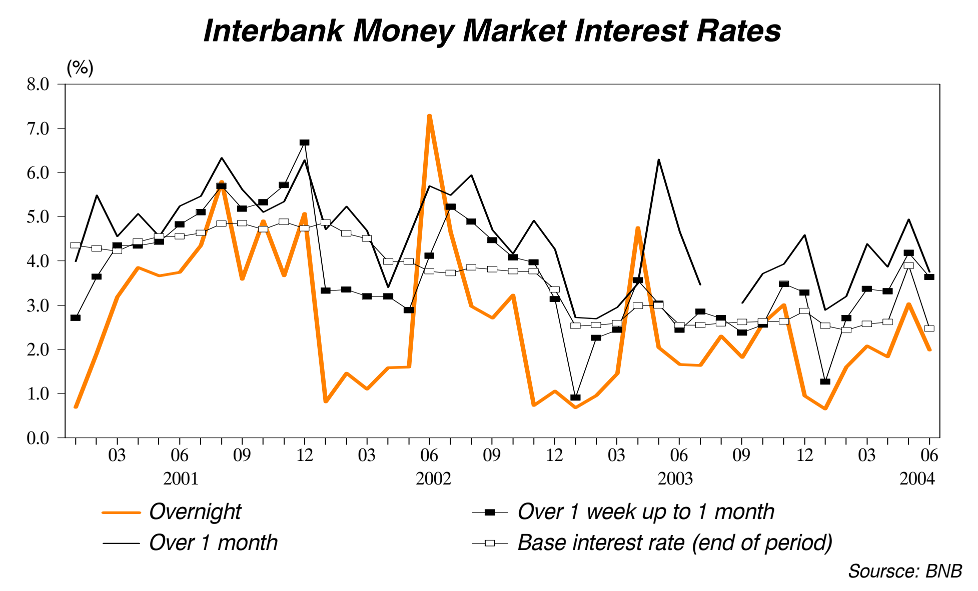


Monetary Base and Money Supply Mechanism

	Over the 30.06.2002 - 30.06.2003 period	Over the 30.06.2003 - 30.06.2004 period
Monetary base change (in BGN million)	611.7	932.7
Coefficient of money multiplier variation (%)	□□ 3.28 □□ 3.33	□□ 3.33 □□ 3.47
Change in M3 by factor:		
1. due to a change in money multiplier (in BGN million)	188.0	598.4
2. due to a change in M3	2005.3	3105.2
3. due to a change in money multiplier and monetary base	31.1	129.7
Change in M3 (in BGN billion) =1+2+3	**2224.4**	**3833.3**

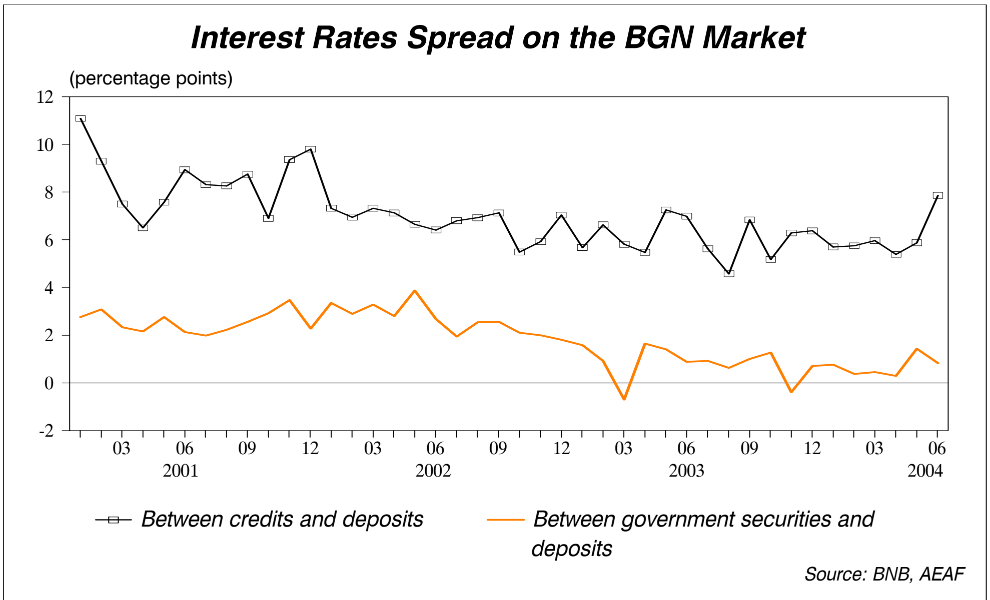
Source: BNB, AEAF.

On a year earlier, domestic credit reported a 6.3% increase of BGN 644.4mn in end-June. Government-sector credit declined by BGN 1.3 billion due to the budget surplus as well as the revenues from the sale of the Bulgarian Telecom and licence of the third GSM operator. Claims on the non-government sector went up by 20.9% (about BGN 2bn), while the non-government sector credit/GDP ratio was steadily rising throughout the six-month period to reach 31.8% in June vs. 27.6% in end-2003. Foreign currency credit prevailed over BGN loans due, most probably, to the higher growth in foreign currency deposits as well as the mobilisation of foreign resources to cater for bank lending. The FX and BGN components of non-government credit increased by 27.1% (BGN 1.1bn) and 16.3% (BGN 881.9mn) respectively. At the same time, the highest six-month growth of some 32% was posted by household loans, the bulk of which were extended in BGN. As extensions in foreign currency grew significantly, loans to non-financial enterprises rose by 17.5% (BGN 1.1bn). Furthermore, long-term credit carried on outstripping short-tem loans in both absolute and relative terms, giving a clear indication of the growing confidence in the banking system and upbeat expectations of economic agents as to the performance of the Bulgarian economy.



As of end-June04, the base interest rate declined by 40 b.p. down to 2.46%, having hit a record high of 3.89% in end-May when the average annual yield rate on 3-month government securities at the primary actions stepped up, on the one hand, and the concerted action of the government and the Central Bank to curb credit expansion to enterprises and households led to a significant decrease in liquidity (BGN) in the banking system, on the other. In the first half-year period of 2004, the average weighted interest rate in the interbank money market fluctuated within the broad band of 0.71-3.09%, reaching a peak in May when liquidity in the banking system ran rather low. In June, however, interbank interest rates stepped down on a month earlier.

On a year earlier, the average interest rate spread between short-term loans in BGN and time BGN deposits went down by 0.22% to 6.09%. Despite the slightly higher lending rates in end-June, the spread carried on declining due to the most recent developments in the banking sector.



The high growth in the economy and stable performance of the currency board were coupled with a relatively low inflation rate, in spite of the impact of a number of pro-inflationary factors at work. Six-month inflation amounted to 0.17% (periods cumulative), whereas the consumer price level stepped up by 7.27% on a year earlier.

The relatively high 12-month inflation rate was due to the high food price dynamics in the last months of 2003, as triggered by the poor grain and wheat harvest and shortages reported not only in Bulgaria but some Central and East European countries as well. As a result, bread prices in the second half-year period of 2003 reported a most drastic increase of 32.4%, producing a strongly adverse effect on the countrys inflation. However, the upbeat expectations as to the 2004 wheat harvest brought about a turnaround in the food price dynamics, and by the end of June, bread prices had already decreased by 2.64%, growing into a major factor behind the lower food price inflation since the start of the year. Consequently, six-month core inflation ran negative at 1.92%.

Core Inflation by Commodity Group (m/m)

Commodity group	***January***	***February***	***March***	***April***	***May***	***June***
Food items	*1.30*	*0.35*	*-0.28*	*0.41*	*-1.46*	*-4.22*
Tradables	*0.04*	*-0.28*	*0.03*	*-0.28*	*-0.29*	*-0.26*
Non-tradables	*0.99*	*0.18*	*0.13*	*0.19*	*0.15*	*0.26*
Fuels	*0.69*	*-2.35*	*-1.12*	*0.62*	*4.32*	*-2.03*
Core inflation	***0.94***	***0***	***-0.19***	***0.24***	***-0.52***	***-2.37***

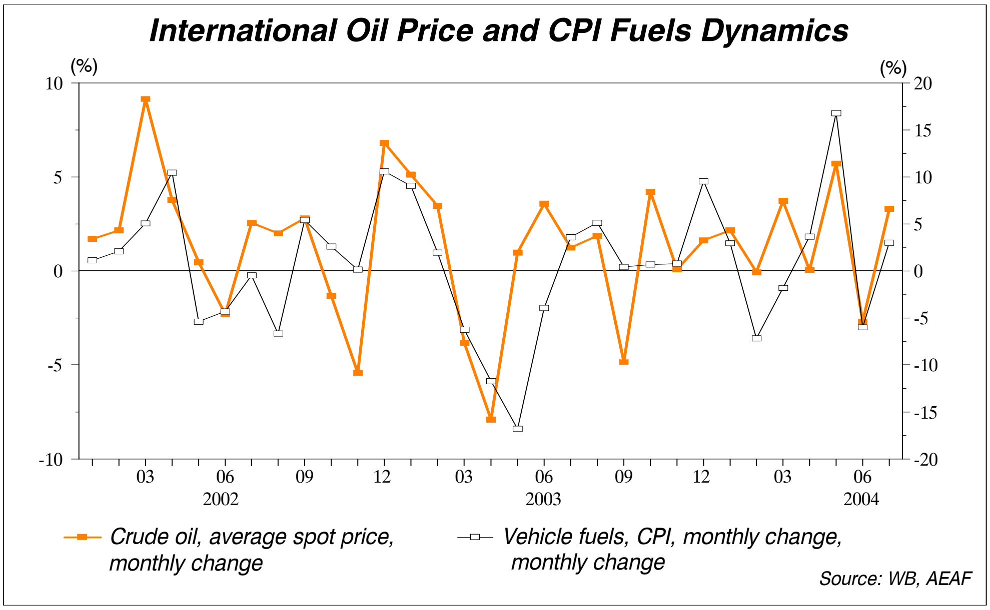
Source: NSI, AEAF.

Core inflation reports not only food price change but the price dynamics of tradables and non-tradables[4] and fuels as well. The 2003 upward trend in crude oil prices persisted well into the first half-year period of 2004 when prices hit a peak in March (7.5% up) only to be followed by another robust increase of 11.4 percentage points in May. The expensive oil prices were spurred not only by speculations and apprehensions having to do with some political, military and economic uncertainties and supply risks in major exporting countries like Iraq, Russia, Nigeria and Venezuela, but certain market imbalances in place as well. All this has given rise to expectations for a higher oil demand on the part of China, North America and Asia. At the same time, estimates of the International Energy Agency[5] point to a rather low level of oil stocks worldwide and highly limited capacity operations. The global demand forecast is for a 3.2% rise (2.5mb/d), whereas non-OPEC supply is expected to step up by a modest 1.6 mb/d.

The direct impact of the international oil price dynamics on the country s inflation is passed on by car fuels and heating oil supply. And, if all this used to happen with a lag of 1 month, the impact has been now rendered immediately since the start of the year. In April, fuel prices went up by 1.83%, to be followed by a most drastic rise of 8.4% in May, reporting a 0.12 percentage point contribution to total inflation in June.

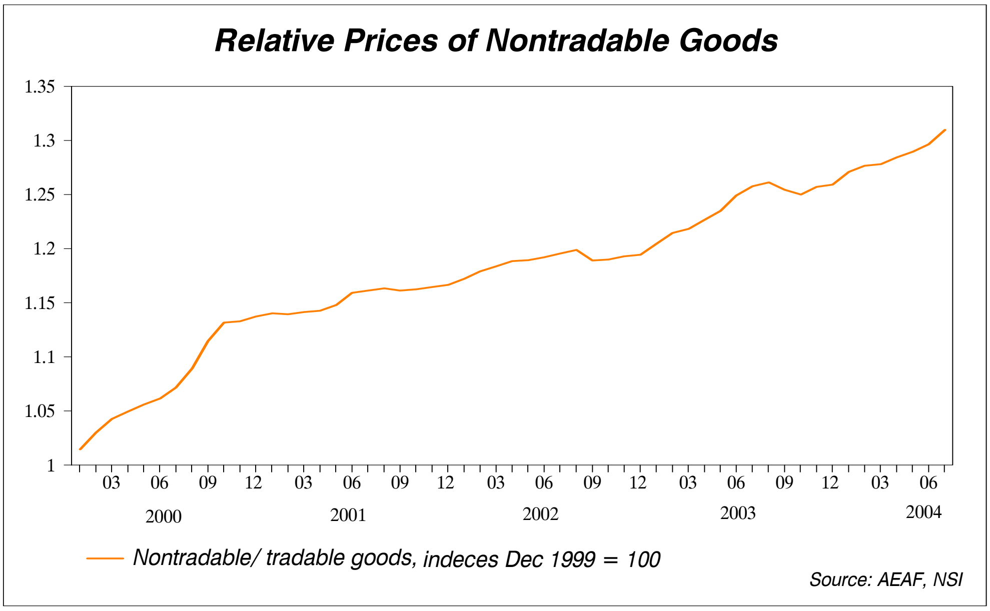
As expected, the prices of tradables and non-tradables did not show any strong volatility, sustaining the tendency of the last couple of years of service prices towards outstripping the price increase in tradables. The higher foreign trade turnover volumes have led to decreasing differences in the foreign and domestic prices of tradables. Since non-tradables manifest as a rule a higher demand elasticity vis-□-vis income, countries where the living standard is higher report higher price levels of non-tradable goods and services. On the other hand, as Bulgaria accedes to the European Union, the convergence in productivity and the

[4] *Market service prices are accounted for as non-tradables.*
[5] *International Energy Agency - http:/www.iea.org.*



standard of living is expected to lead to a price level convergence. In the five months to June, non-tradables reported a 1.9% price rise, whereas the prices of tradables ran some 1.04% cheaper.

In 2004, the share of administered prices in the CPI basket stepped up insignificantly on a year earlier due mainly to the altered weights of some administratively priced goods and services rather than any change in the number of items, which remained constant. More specifically, a most notable change affected the weights of electricity and heating, the prices of which went up by 14.20 and 9.99% respectively. As a result, household expenditures on heating and electricity went on the increase. Furthermore, the higher excise duty rates on fuels and tobacco products applicable since January have brought about a certain increase in inflation. Nevertheless, the pro-inflationary pressure exerted by the above fiscal measures was rather short-lived, taking effect in the first two months of the year only (the higher rates on tobacco products have affected the CPI dynamics for two months in a row until the cigarette stocks with the lower excise duty rates were used up). In addition, in May the Bulgarian Telecom revised its price list, raising the prices of city calls and the subscription fee rate. However, over the same period, there occurred some other changes in the administered price group, but the weight of the items in the CPI was so low that they failed to affect inflation.



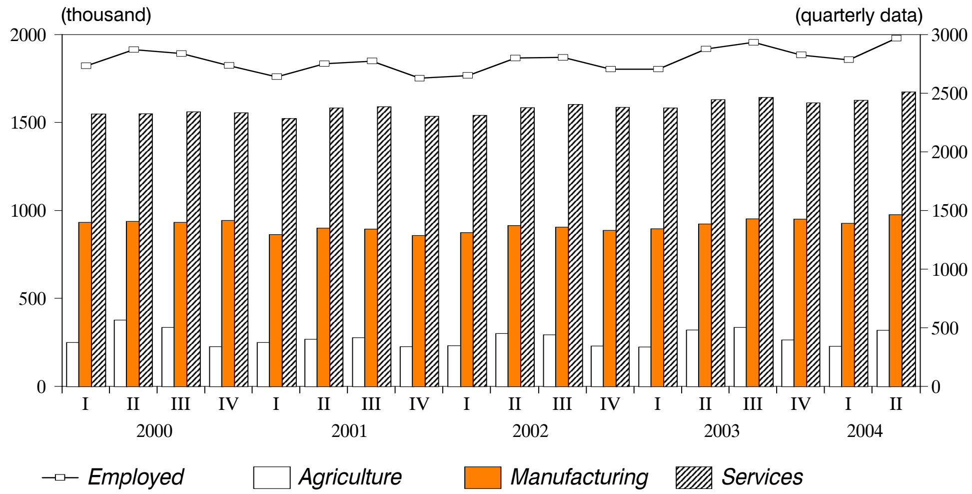
Administered price inflation in the five to June amounted to 6.56%, making a 1.62 percentage point contribution to total inflation. ❑

GROWING EMPLOYMENT AND A DECLINING JOBLESS RATE

Growth in the economy and the successful restructuring exercise over the last couple of years have led to growing employment and a declining jobless rate in the country. This was further reinforced by the active labour market measures of the government that spurred the labour market upswing currently discernible.

According to the NSI labour force surveys, the average employed numbers in the first half-year period of 2004 stepped up by 3.1% (86.7 thousand) up to 2 876.8 thousand. The countrys employment has gone on the increase due mainly to the rapid development of the private sector in the past twelve months. Data obtained from the labour force surveys point to a 9.7% year-on-year rise in private-sector employment (174 thousand up) and a 9% decrease of 88.9 thousand in public-sector employed. The stable macroeconomic environment and improved terms of business resulted in more jobs and higher demand in the primary labour market. The above findings were further reinforced by NSI data on the number of employed on labour contracts and civil servants[6]. In the six months to July, the average monthly number of employed in the economy went up by 5.5% (111 thousand) relative to the same period of 2003 due solely to the higher employed numbers in the private sector (8.6% or 108.6 thousand up). The number of employed posted a most healthy gain in private-sector services, with all industries reporting an increase in employment. Furthermore, in 61% of the manufacturing industries, employment was steadily going up. The construction sector where staff numbers rose by 16.7% on a year earlier reported a most notable increase. In addition, more and more entrepreneurs have identified qualified work force scarcities as a pressing problem faced by the sector.

Number of Employed and Structure of Employment by Sector



Source: NSI

As they enjoy a large relative share in the manufacturing sector, the processing industries where private ownership prevails had a crucial role in the employment dynamics. Most of them registered increasing

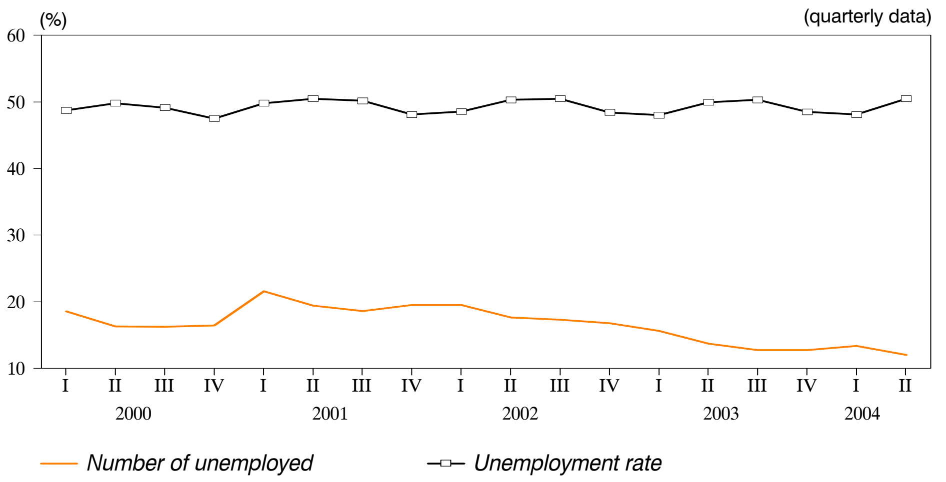
[6] *From data on the employed numbers, working days in a month, wage bill and other labour costs.*

employed numbers as followed: *paper, cardboard production and publishing* (18.3%); *rubber and plastics* (16.1%); and *products of other non-metal mineral raw materials* (12.8%). On the other hand, the number of employed declined in some private-sector industries as followed: *coke, refined oil products and nuclear fuel* (13.1%); and *manufacture of chemical substances, products and fibres* (13.3%) due to the ongoing effort to optimise employment in enterprises still in the restructuring. At the same time, a certain reduction (6.1%) in employment was also discerned in *electricity, gas and water generation and supply*. However, the trend is to be further sustained, as there will more redundancies with the privatisation of the electricity supply companies.

The average number of public-sector employed in the first half-year period of 2004 ran slightly below 765 thousand, and only about one-third of the industries reported an increase in employment. However, they have a relatively large weight to shape the dynamics of the employed total in the public sector. On a 12-month basis, employment ran the highest (18.4%) in *other welfare services*. The robust growth had to do with the active labour market policies of the government, the programme *From Social Aid to Employment Promotion* in particular. On a year earlier, the average payroll numbers in *public administration* and *obligatory social insurance* stepped up by 8% in the six months to July04.

The steady downward trend in the countrys unemployment rate of the last two years persisted well into the first two quarters of 2004, as indicated by the data of the NSI labour force surveys and administrative statistics of the Employment Agency (EA). According to the NSI labour force surveys, on a year earlier, the number of unemployed in the first half-year period of 2004 declined by 61 thousand jobless on average. The unemployment rate amounted to 12.7% of the countrys labour force, going some 2 percentage points down relative to the same period of 2003. In the second quarter, the relative share of jobless in the active working population stepped down to 12%, hitting a record low ever since the NSI started conducting labour force surveys in 1993. In addition, together with the decrease in the jobless rate, the Statistical Office reported a decline in the number of discouraged, which sent the participation rate in the economy slightly up to 49.3% in the first half-year period of 2004. Active job creation on the part of the private sector and under the government employment promotion programmes „encouraged“ some part of the out-of-the labour force cohort to join the market again. First half-year data from the labour force surveys evidenced the general downward trend in the number of registered unemployed. According to EA statistics, the average monthly number of unemployed over the Jan-Jun04 period went some 13.1% down on a year earlier. Throughout the period, the unemployed total was steadily

Number of Unemployed and Unemployment Rate*



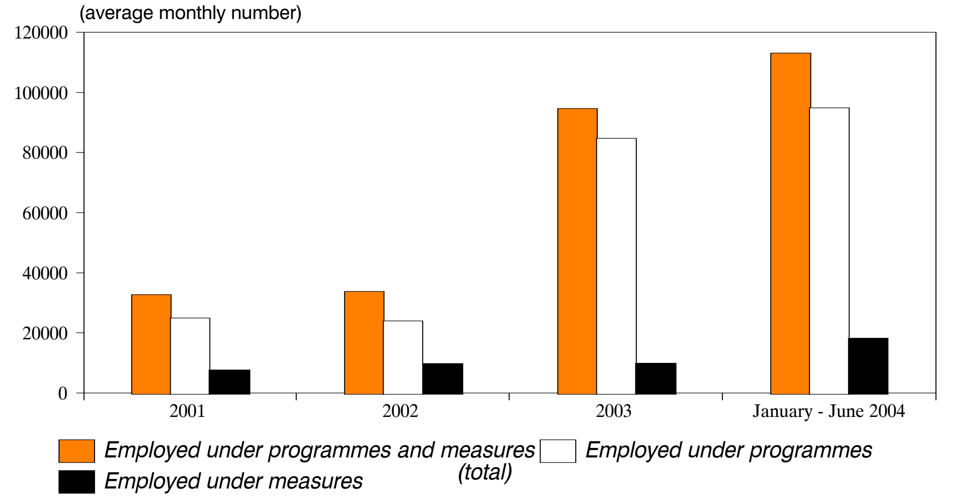
* Persons over the age of 15

Source: NSI

decreasing to reach 452.4 thousand in end-June, setting back at its levels of the second half of 1998 when the indicator had gone on the increase in the wake of the restructuring processes in the economy.

According to AEAF estimates, the lower unemployment rate in the first half-year period of 2004 was by and large due to the private-sector jobs created in the economy rather than the effect of the active labour market measures and programmes. At the same time, EA data indicate that rising by 6.2% relative to the same period of 2003 the average monthly number of job seekers who had started new jobs now amounted to 32.6 thousand, with about 88% of them finding jobs in the primary labour market through the intermediation of the job centres (or 21.9% up on a year earlier). The job vacancies posted by the private sector reported a significant year-on-year growth of 32.1%, whereas the vacancies occupied rose most vigorously by 48.6%. The scope of the active labour market measures and programmes had meanwhile broadened, though at a lower pace compared to last year. Over the same period, the average monthly number of employed under the different employment promotion measures and programmes ran some 33.2 thousand higher on a year earlier. However, it should be noted that the job centres are only one way of announcing new jobs and job seeking. Therefore, the contribution of the private sector to job creation in the economy is estimated to be a lot larger than the one apparent in the EA statistics.

People employed under Active Labour Market Measures



Source: Employment Agency

As in the preceding years, the active labour market policies of the government were again targeted at the risk unemployment cohorts, with the emphasis being placed on measures preventing spells of long-term unemployment and reinforcing the social integration of the disadvantage group on the labour market. Evaluations of the current measures and programmes have set off *From Social Aid to Employment Promotion* as a major source of supply of and demand for subsidised employment in the economy. The projects approved under the same programme created some 98 203 new jobs. In the six months to July, it provided employment to 91.7 thousand jobless on a monthly average, accounting for around 81% of all people working under active labour market measures and programmes. According to the National Employment Action Plan adopted in February, the programme is expected to cover some 70 thousand jobless, implying that its scope has been broadened well above the level planned, and since it has given priority to long-term unemployed, the number of jobless from unemployment cohort declined by 13.6% on a year earlier. However, the latters share within the jobless total has decreased insignificantly, running still rather high at 52.3%. Furthermore, in the first half-year period of 2004, the scope of some safeguard measures on the labour policy agenda was further enlarged to give incentives to employers hiring jobless of the disadvantage group in the market. In the Jan-

Jun04 period, the number of employed under the various employment promotion measures amounted to 18.2 thousand on a monthly average, reporting a nearly 2-fold rise on a year earlier. Measures, having to do with the key employment policy priorities reported a most robust performance. Most employers have made the best use of the incentives under the employment promotion patterns designed to combat youth unemployment and develop workforce skills as part of the lifelong learning process. Another positive development of the active labour market policies is that they have placed special emphasis on the cohort of the disabled, and made employers show keener interest as the people with lifelong reduced working capacity has gone on the increase.

To improve the employability of registered unemployed, the vocational training and qualification courses of the Employment Agency covered more jobless cohorts, with over two-thirds of the trainees being involved in other employment programmes and measures too. The number of trainees who had completed professional qualification courses ran twice as high as in 2003, but enjoyed again a rather insignificant share in the jobless total. Raising the professional qualifications of unemployed means giving them extra flexibility in the labour market and more job opportunities in the real sector of the economy, and has therefore been a major concern on the employment policy agenda in 2004 as well.

The labour market dynamics in the first half-year period of 2004 shows that subsidised job creation was still a key source of employment in the economy. However, it is early to assess the effect of these programmes on sustainable employment, as there are in the primary labour market no performance indicators to show how successful the measures have been, once the unemployed have joined them. A great deal of evaluation is yet to be made as to the effectiveness of the active labour market measures and programmes, allowing for forecasts of the employment dynamics in a medium-term perspective. In any case, government labour policies should be aimed at restricting their scope. In 2005, the programme of the government *From Social Aid to Employment Promotion* is foreseen to provide employment to 65 thousand jobless, relying on some BGN 127mn worth of budget allocations[7] to that end. However, a major challenge to the economic agenda in the long run remains the reallocation of resources to cater for active labour market policies applied to the real sector of the economy where sustainable employment is created. In addition, improving the countrys business environment means fostering labour demand and raising wages. ❑

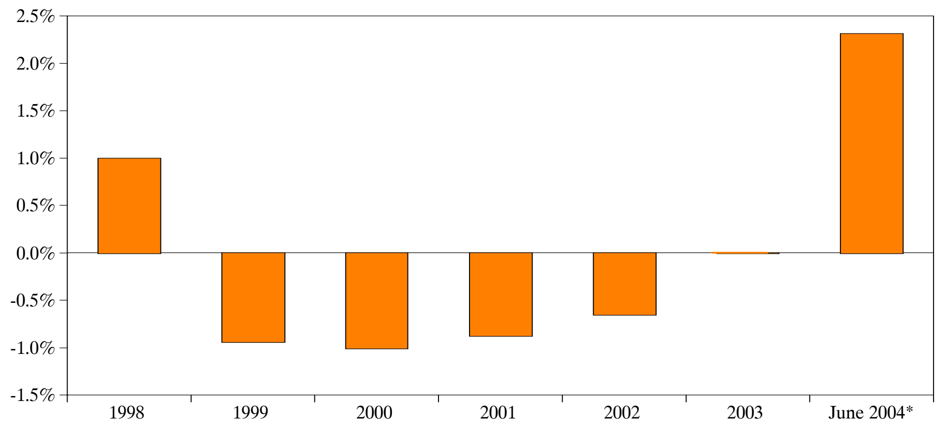
[7] *According to data of the Ministry of Labour and Social Policy.*

ROBUST TAX REVENUE GROWTH AND A SIZABLE GOVERNMENT BUDGET SURPLUS

Fiscal policies in the first half-year period of 2004 focused mainly on the revenue performance of the budget, hence the accumulation of a large consolidated budget surplus, and measures to curb the credit expansion of commercial banks. At the same time, it is noteworthy that though attempting to achieve a sustainable budget balance in a prudential manner, the fiscal sector has had a rather destabilising effect on the economy as a result of its unpredictability.

At preliminary estimate of the Ministry of Finance, the cash balance of the consolidated government budget over the Jan-Jun04 period hit a record high of BGN 879.6mn or 2.3%[8] of the 2004 GDP forecasts. The hefty budget surplus was triggered by the vigorous revenue performance rather than any tough constraints on expenditure growth. Budget performance in the six months to July has given solid grounds for expectations of a significant rise on the expenditure side. Such an uneven pattern of expenditure distribution over the year is largely due to some seasonal factors at work, as well as the hard and fast budgeting rule to plan expenditures throughout the year. However, these policies have a destabilising effect on the other sectors of the economy, as they exert certain pressures on the current account of the balance of payments and the inflation rate. Therefore, further effort is needed to achieve a more even distribution of expenditures in a year.

Overall Bbalance of the consolidated Budget (% of GDP)



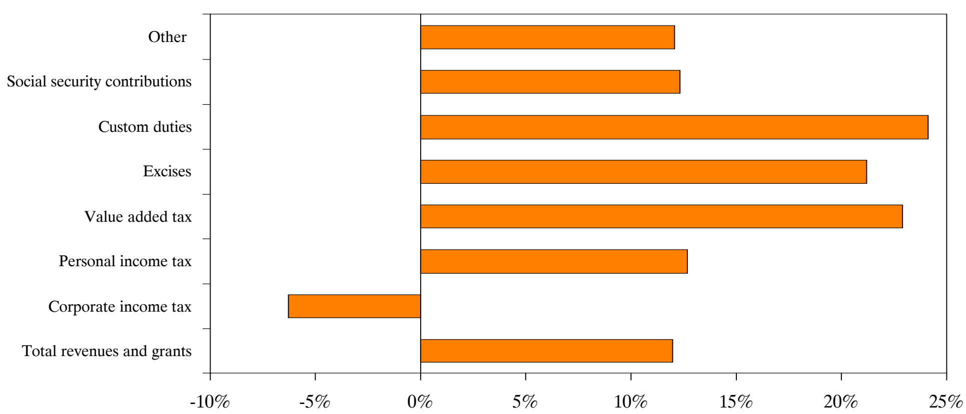
* Preliminary data

Source: MF, AEAF

The reasons behind the mistimed enormous end-of year growth in expenditures are as follows: on the one hand, this has been the regular over-performance of budget revenues, leading to the accumulation of hefty deficits throughout the year. Over-performance is expected to run at about 5% partly due to the overcautious revenue budgeting practices in place. However, a certain amount of conservatism is justifiable, for it ensures an additional safety buffer in case of adverse developments in the economy, but over-performance in the past few years shows that revenues have been programmed in a most conservative manner. On the other hand,

[8] BGN 38 021mn.

Growth of the tax revenues compared to the same period of the previous year*



* First half 2004

Source: MF

a major requirement under the Budget Act allows for about 90 to 93% of the budget appropriations to be actually spent, practically institutionalising the uneven performance of revenues. This legal measure is important in that it provides for built-in safeguards against possible budget risks, but needs only to be applied within a limited period of time, e.g. by the end of the first half-year period, when budget revenues have already manifested a distinct patter of performance.

As in 2003, a key factor at work behind the high revenues had to do again with the growing countrys consumption. Also, strong imports made an important contribution, bringing about a significant rise in indirect tax revenues. In addition, budget revenues stepped up as a result of the higher excise duty rates on fuels and cigarettes, which were now running closer to the EU minimum rates. They had a direct effect on revenues from excise duties while affecting indirectly VAT revenues by increasing the tax base.

Attempting to alleviate the tax burden as percentage of GDP in a stepwise way, the government used a downscale cut of the rate on the lowest tax bracket applied to personal income tax payers from 15 to 12%. At the same time, non-taxable income stepped up from BGN 110 to 120. Furthermore, the corporate income tax rate decreased by 4 percentage points down to 19.5%. The measures pertaining to the personal income tax failed to affect revenue volumes, as the concurrent rise in both wages and employment made up for their effect. On the whole, household disposable income has gone up by about 0.8% and resulted in an increase in private consumption of around 0.2%, according to AEAF estimates. Wage growth and higher employment as well as the recent update in the social insurance thresholds led to a sizable increase in the revenue amounts from social security contributions in the first half-year period of 2004. On the other hand, the reduced corporate income tax rate spurred a drastic shrinkage in first-quarter revenues from the same tax to be, in part, offset in the second quarter by the compensation amounts paid under the previous rate applied to the corporate income tax payers.

Despite the altered tax policies effective since the start of the year, tax revenues stepped up by about one per cent to 35.9% as percentage of GDP. However, the assumptions of the AEAF analysts are that the real tax burden should be accounted for as net taxes on budget transfers to the other sectors of the economy, i.e. subsidies, pensions, as well as social aid expenditures. Therefore, the tax burden, thus calculated, will step up again in relation to GDP by 1.5 percentage points to 18% due not only to the robust consolidated budget revenues but also to the unchanged level of subsidies over the same period.

General Government Budget Expenditures by Function (as % of total expenditures)

I. General public services	6.6%
II. Defence and security	13.2%
III. Education	10.4%
IV. Health care	10.7%
V. Social insurance and welfare	36.7%
VI. Housing construction, public amenities and utilities, environmental protection	3.0%
VII. Recreation, culture and religion	1.9%
VIII. Economic affairs and services	11.1%
I□. Other expenditure, non-classified elsewhere	6.3%

Source: MoF

Education, health care and the judiciary reform exercise were again the main priorities on the 2004 budget agenda. However, a breakdown of budget expenditures by function indicates that these priorities were only partially implemented giving way to other expenditure policy concerns focused on social payments and defence and security spending. Growth in social payments was solely due to the higher pensions following the early-year rise in the maximum pension ceiling aimed at improving the living standard of retirees. Keeping a satisfactory collection rate of social insurance contributions will allow for a further increase in pension amounts next year. Higher budget spending on defence and security fully matched the expenditure policy priority of the government and was mainly associated with the countrys accession to NATO as well as the pressing needs to ensure funding for military missions abroad and huge expenditure amounts to cater for the judiciary reform.

Interest payments went on the decrease due to the low interest rates in the international interbank markets. As a result, government consumption outstripped growth in the consolidated budget expenditure total and made a higher contribution (0.5% up in the first quarter) to economic growth. The bulk of this contribution was attributed to collective consumption at the expense of final government spending, facing major financing problems in health care.

As the Ministry of Health Care has made some uniform financing arrangements for state and municipal hospitals alike, funding is now to be essentially treatment-based, irrespective of the source of financing, be it from the National Health Insurance Fund (NHIF) along clinical paths or the Health Care Ministry by applying average prices for the different classes of diseases. The budget has provided some BGN 280mn for hospital funding to be allocated via the Ministry of Health Care (BGN 90mn for municipal hospitals and BGN 190mn for state hospitals) and another BGN 305mn through the National Health Insurance Fund (BGN 245mn worth of allocations for hospital health care and BGN 60mn from the operating reserve fund).

The financing arrangements have been mainly designed to prevent hospitals from running up even bigger debts as well as to improve to quality of health care services. But the funding patterns failed to be applied, as there was no framework agreement reached in 2004, which made treatment along the new clinical paths unrealistic and the health care system went on charging patients at the 2003 rates.

The Fund s revenues in the first half-year period reported a 15% rise up to BGN 402mn due mostly to the larger amounts of social insurance contributions paid by self-insured and some other categories of the insured (farmers, tobacco producers, unemployed, etc.). As a result of the measures undertaken by the National Social Insurance Institute to improve the contribution collection rate, some 340 thousand people had reclaimed their health insurance rights, and another 93 thousand had re-scheduled payments by the end of May. As of end-June some 2.1 million people were already in debt to the health insurance system, and about 200 thousand never bothered to pay any contributions.

NHIF expenditures in the six months to July stepped up by 14% to BGN 415mn, though the system went on operating under the terms and conditions of the 2003 National Framework Agreement, i.e. at lower rates than the rates laid down in the Funds budget and no new clinical paths were included. By the end of June the Fund had spent 66% of the 2004 allocations for hospital health care funding vs. 44% of the budget in 2003. All this calls for an urgent update of the 2004 budget. In its act of findings the Chamber of Auditors came across a number of malpractices in fund spending and implementing the Accounting Act, resulting in inadequate reports as to financial conditions of the Fund. In addition, all the paper work done by GPs created conditions for paying for services never rendered. Hospitals tend to report formally treatment along cheaper clinical paths at the rates of the higher paid paths, attempting to finance outstanding debts.

In 2004, hospitals went on running vast amounts of debt, implying that health care financing, hospital funding in particular, is a most acute problem of the fiscal system. In end-2003, the government extended some BGN 130mn worth of central budget allocations to meet hospital debt, and BGN 76mn in July, only to be followed by another BGN 50mn of extensions in August. It is obvious that the funding pattern chosen is not feasible. It has been meant to provide for the largest hospitals to sidestep financial hardship, and now it has been these same hospitals with the biggest patient flow that reported vast debts in arrears on medications, consumables and overheads due to the low prices paid for the clinical paths and average prices set by the Ministry of Heath Care. However, medical service prices have risen by 2.3% since January.

The 2004 budget deficit has been initially targeted at 0.7% of GDP. The government, however, made certain revisions, trying to achieve a balanced budget for a second year in a row. Also, fiscal policies underwent some changes following the April IMF mission to Bulgaria and in an attempt to put the brakes on the credit expansion of commercial banks and the current account deficit of the balance of payments. Given the current budget deficit, the achievement of a balanced budget seems feasible, producing a healthy effect on the current account estimated at 0.7% of GDP, other things being equal.

Another measure on the fiscal policy agenda related to credit expansion restraints had to do with the withdrawal of government deposits from the banking system to curtail liquidity. In 2003, some part of the fiscal reserve account was withdrawn from the Central Bank and deposited at commercial bank, seeking a higher return on budget savings. Following the IMF arrangement, government deposits with commercial banks have gone on a steady decrease, from BGN 611mn in end-March to BGN 355.6mn in end- June. The withdrawal of government funds resulted only in a short-lived rise in the base interest rate, set at the monthly primary auctions of three-month government securities, indicating that banks had adjusted to the new realities and were now pursuing other sources of financing. The consolidation of government funds in a deposit account with the Central Bank is justifiable, for it will further circumscribe its attempts to interfere with the countrys monetary policies, which are within the purview and exclusive competences of BNB. Also, seeking a higher return means higher risks and is, therefore, unacceptable as regards government budget functions.

Budget financing data show that the government did not allow commercial banks to carry on with their credit expansion in the first half-year period of 2004. The consolidated budget surplus itself, together with the decrease in government deposits with banks implied that budget transactions relied on the withdrawal of money in circulation. In addition, the net issue of government securities over the same period ran positive at BGN 238mn, although there was no deficit to finance, exploring another avenue for draining liquidity from the banking system and hampering bank credit expansion.

Stronger financing by way of government securities issued in the domestic market fully matched the policy of increasing the share of the domestic debt within the total. Domestic debt reported a 6-month increase of 10.5%, and its share stepped up to 15.6% vs. 13.5% in end-2003. It can then be expected that positive financing by way of government securities and draining of liquidity from the banking system will persist as the share of the domestic debt runs still rather low. At the same time, the countrys foreign debt went some 2.2% up relative to the end of 2003, reaching BGN 14.9 billion in end-June due mostly to exchange rate fluctuations because net foreign liabilities over the same period ran negative. End-of-period total government debt amounted to 45.9% of GDP, declining by 3.2 percentage points in the six months to July. The buyback of Bardies in July as well as a persistent primary surplus should result in another government debt decrease in both absolute and relative terms by the end of the year. ❑

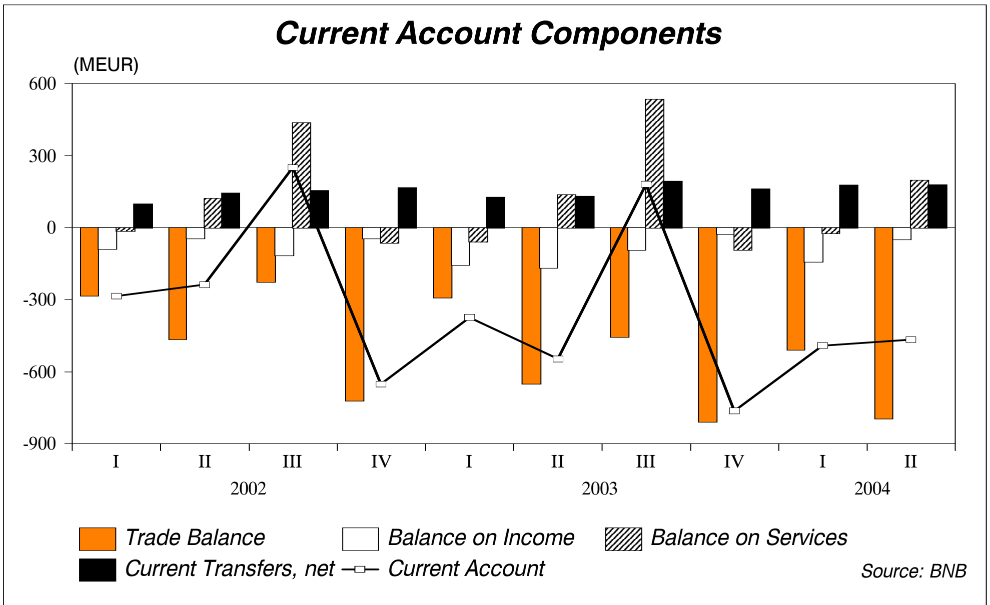
HIGH CURRENT ACCOUNT DEFICIT OF THE BALANCE OF PAYMENTS

In the six months to July, the current account deficit of the balance of payments went as high as MEUR 946.5 or 10.9% of the GDP reported over the same period. On a year earlier, the deficit remained almost unchanged in nominal terms at MEUR 922 while improving as a percentage of GDP (11.8% in 2003).

Current Account Items (year-on-year change)

Item	June 2003 (in MEUR)	June 2004 (in MEUR)	Absolute-term change	As %
Current account	-922.0	-946.5	-24.5	2.7
Exports (fob)	3251.7	3613.1	361.4	11.1
Imports (fob)	-4192.1	-4915.6	-723.5	17.3
Trade balance	-940.4	-1302.6	-362.2	38.5
Services (credit)	1106.8	1321.2	214.4	19.4
Services (debit)	-1025.9	-1147.4	-121.5	11.8
Services (net)	80.9	173.9	93.0	115.0
Income (net)	-320.2	-169.2	151.0	-47.2
Transfers (net)	257.7	351.4	93.7	36.4

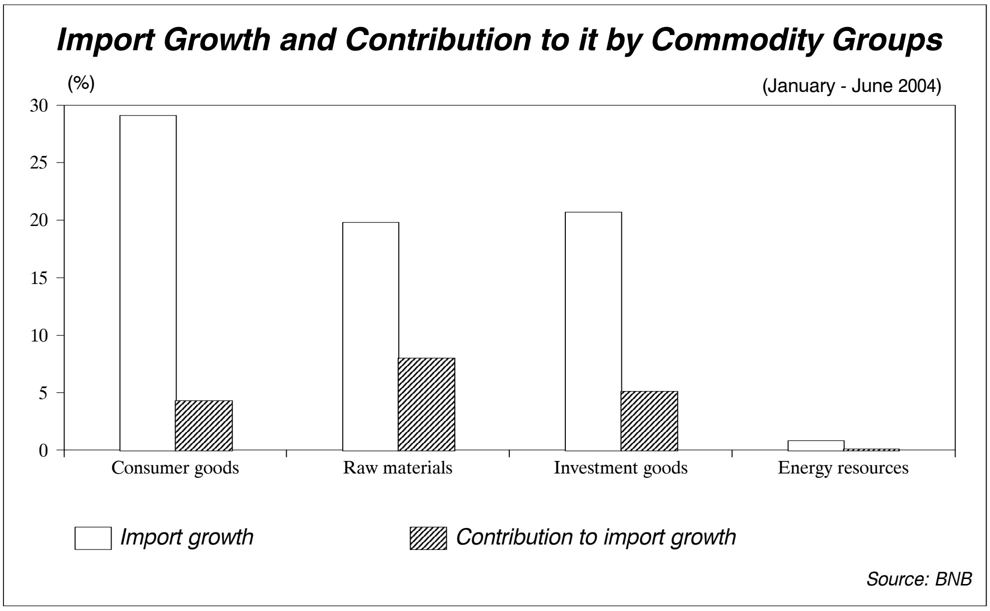
Source: BNB



The huge current account deficit was mainly triggered by the deteriorating trade balance. Though rising rather fast, exports went on lagging behind import growth. In volume terms, imports in the first half-year period of 2004 reported a year-on-year increase of 17.3% up to MEUR 4 915.6. Over the same period, stepping up by 11.1%, exports amounted to MEUR 3 613.1. The countrys trade deficit worsened to MEUR 1 302.6 or 15.1% of GDP vs. 12% on a year earlier.

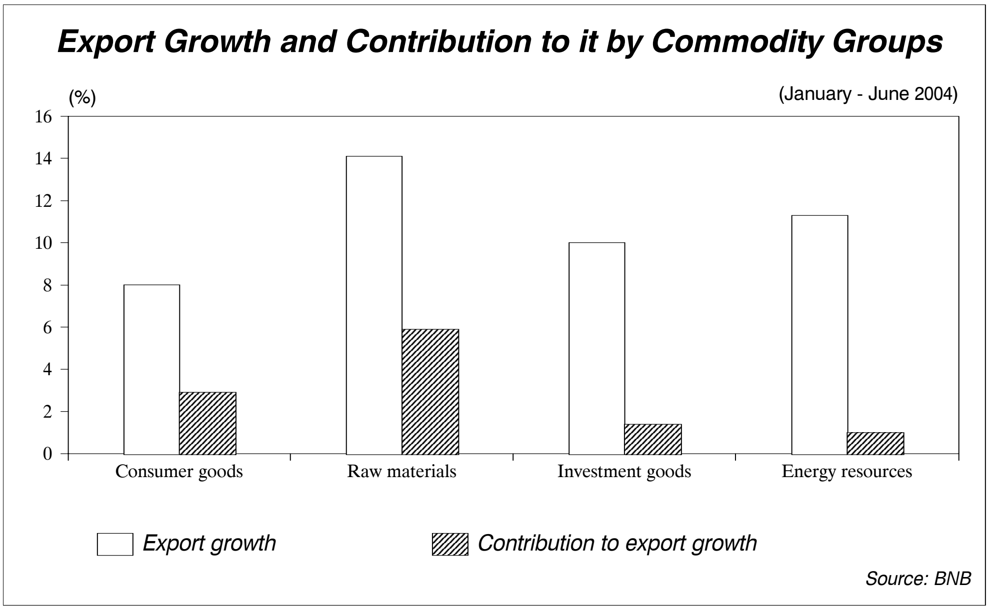
The 8% growth in total imports was due to the robust rise (19.8%) in raw material imports. The above item went on the increase as a result of the contribution of the export-oriented industries. The MEUR 89.6 worth of an increase in cast iron, iron and steel imports corresponded to MEUR 89.5 higher export of the same products, with this vigorous growth being spurred by the high metal prices. On the other hand, the weaker than expected export performance of the clothing and footwear industries (MEUR 54.9 down) resulted in an increase in textile imports of only MEUR 31. Investment goods imports reported a 20.7% growth up to MEUR 1 350, making a 5.1 percentage point contribution to total imports due to the boosted investment activity in the country. Growth in investment goods imports fully matched national accounts data, which pointed to a 16.9% nominal-term rise in gross fixed capital formation.

The expectations that consumer loan growth would slow down and bring about a certain shrinkage in consumer goods imports failed to come true. Imports carried on rising at a rather fast rate (17%) and reported a 4.3% contribution to the total. Furthermore, a comparison with the six-month GDP statistics, whereby final consumption stepped up by 8.6% in nominal terms, indicates that consumers have opted for imported goods. The higher domestic demand was essentially met by imports with no local counterparts (household appliances 32.5%) but also by imports with local counterparts (drugs and cosmetics 43.2%). At the same time, car imports went up by MEUR 48.8 or 45.1% due largely to the inadequacies in old car valuation practices, as the number of imported cars have declined. Valuation is based on horse power, which is incorrect and wrong. However, in early-2004 the coefficients of value per kW were amended, doubling the VAT base and boosting cheaper imports. At the same time, car imports stepped up in value terms.



The lost USDs ground of the to the Bulgarian currency relative to the 1998-2002 period and 2003, as well as crude oil price fluctuations affected import dynamics. In the first half-year period of 2004, energy imports increased by only 1%. In addition, crude oil imports contracted by 9.6% in volume terms, whereas the average import prices went up by 4%. At the same time, gas imports reported a 16.4% volume-term rise, with import prices going some 6% lower on a year earlier. According to BNB estimates, the cumulative effect of the crude oil and gas price dynamics over the Jan-Jun period resulted in a MEUR 2.1 worth of an improvement in the countrys trade balance.

Import growth amounted to around 55% of GDP. However, the imports/GDP ratio in most Central European countries runs a lot higher, hitting, in some cases, 65%. On the other hand, trade turnover is expected to go on the increase with the integration of the Bulgarian economy into the EU internal market. Therefore, any decrease in the countrys trade deficit will depend heavily on the competitiveness of Bulgarian products and the attraction of larger FDI inflows in the export-led industries.



Stepping up by 11.1% on a year earlier, Bulgarian exports in the first half-year period amounted to MEUR 3613.1. The ever-depreciating USD to the EUR, hence to the BGN, produced a most adverse effect on the competitiveness of local products, growing into a key factor behind the 2.9 percentage point rise in the relative share of EUR exports (up to 63.6%) on a year earlier. On the other hand, the higher foreign demand and increase in some main commodity prices have favoured the countrys export performance, fostering a 14.1% increase in raw material exports, including cast iron, iron and steel exports (MEUR 89.5, or 31.4%) and non-ferrous metal exports (MEUR 85.9, or 36.3% up). At the same time, a major challenge to be faced by the current account in the following years has to do with a possible price decline worldwide, entailing weaker export performance of the same industries.

Consumer goods exports followed a slower growth rate on a year earlier due basically to the largest export item, clothing and footwear, which has stepped up by only 7.7% vs. 16% in the same period of 2003. The export decrease may have been due to the loss of competitiveness consequent on the higher labour costs in the country. Competitive imports from countries where labour costs run still low are expected to step up most robustly from the beginning of 2005 when the European Union will remove all non-tariff barriers to trade with China.

Food and cigarette exports went up by 16% and 40% respectively. At the same time, the value of drugs, cosmetics and beverages exported declined. Investment goods exports reported a significant year-on-year increase of 10%. Machinery, vehicle and other equipment exports have been following a steady upward trend since 2002. Unlike textiles, these are products of high value added. Therefore, boosted production and strong export performance of the above industries in the foreign markets will be key to the development of the economy.

Oil product exports contracted by 43.4 thousand tons (4.1%). However, revenues from these exports reported a MEUR 7 rise on a 12-month basis due to the higher oil prices. Following the 2003 shrinkage, electricity exports gained impetus in the first half-year period and posted a 42.2% increase, or MEUR 24.5.

The faster growth rate in the developed economies and steady appreciation of the Bulgarian currency to the USD were the main factors at work shaping the countrys export performance in the six months to July. Bulgarian exports to the EU (25) and the Balkan countries stepped up by 11.7% and 22.1% respectively. Six-month growth in exports to the EU (15) remained strong at 10.6% vs. 11.6% in 2003. About 80% of Bulgarian exports were destined to the EU-25 market and the Balkan countries, and only some 4% to the USA, 1.4% to Russia and 5% to Asia, revealing major export orientation patterns of the local producers to the Euro area. This is a normal development with a view to the countrys integration into the EU market, which, however, may turn into a strong dependence of the local economy on the market conditions in the Union. Germany had again the lead among Bulgarias major trading partners, accounting for 10.8% of exports and 14% of imports, followed by Italy, responsible for 13.5% of exports and 10.1% of imports, and Greece (11% of exports and 6.4% of imports). The countrys trade deficit with Russia and Ukraine, and China amounted to MEUR 817.3 (MEUR 136.9 up on a year) and MEUR 142.5 (MEUR 72.4 up) respectively.

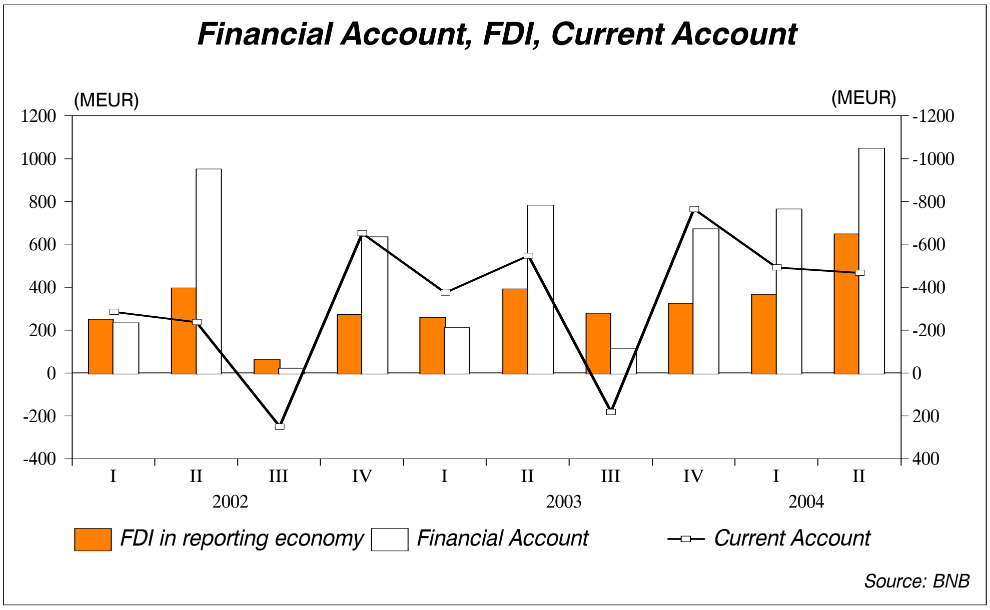
Growth in both exports and imports is expected to run well over 15% by the end of 2004, producing an adverse effect on the current account. On the other hand, exports may go on the increase only if boosted by the improved competitiveness of Bulgaria products, favourable international price dynamics, higher foreign demand and the stabilisation of the US currency to the EUR. At the same time, imports are expected to remain strong underpinned by the bustling lending and investment activity in the country as well as the ever-growing needs of the export-oriented industries for raw material input.

Rising by MEUR 93 on a year earlier, net revenue from services in the first half-year period of 2004 amounted to MEUR 173.8. The current account deficit can be curtailed by way of higher revenues from tourism, which reported a 25% year-on-year rise up to MEUR 646.3. The balance on the same item stepped up as high as MEUR 305.8. The number of holiday makers, visiting Bulgaria, went up by 20%. Spending on the part of Bulgarian holiday makers abroad increased by MEUR 68 up to MEUR 340.5. At the same time, net expenditures on transport services amounted to MEUR 151.2 vs. MEUR 107 in the same period of 2003. The high dynamics of transport services and negative item balance were due to the strong correlation with commodity trade, which reported most robust growth rates. Throughout 2004 as well, services, tourism in particular, will be the main source of revenues, covering some 20% of the trade deficit. Given the worsened trade balance, the balance on the *income, current transfers* and *services* items improved, however. The transfers from Bulgarian citizens working abroad, revenues from tourism and lower dividend payments have made up in part for the deteriorating trade deficit.

Over the past few years, the income balance has been running negative due mostly to the ever-growing foreign ownership in the country, bringing about a certain increase in the interest payments on intra-firm credit and dividends to foreign owners. Furthermore, as the first half-year period of 2004 did not witness any large payments, the income balance improved but remained negative at MEUR 169.2. The MEUR 16.1 worth of a decrease in income credit was partly due to the low interest rates on the international interbank markets.

The year-on-year increase in current transfers, in particular private transfers, which stepped up most vigorously by 35%, or MEUR 93, to MEUR 361, had a tangible healthy effect on the current account balance. The inflow of EU pre-ins amounted to MEUR 46.4, remaining almost unchanged on a year earlier. At the same time, net current transfers went on covering more than 25% of the countrys trade deficit while promoting import growth, consumer goods in particular.

Over the first half-year period of 2004, the financial account ran negative at MEUR 1 469.6, posting some MEUR 476.6 worth of a year-on-year improvement due mostly to the foreign credit extensions to the non-financial sector and the increasing deposit amounts of non-residents with Bulgarian commercial banks.



However, the reason behind the growing inflows on the financial account had to do with the low foreign interest rates.

Over the same period, the portfolio investments of residents abroad stepped up by MEUR 48.6 due solely to the higher portfolio investments made by the Bulgarian commercial banks.

June saw a certain decline in the amounts of Bradies and Globals held by residents, leading to a MEUR 9 worth of a rise in the *portfolio investments-liabilities* item in the six months to July. Commercial banks deposits abroad stepped up by MEUR 235.9 due wholly to the transfers consequent on the Mobiltel transaction (MEUR 180) and the MEUR 75 worth of syndicated loan extension. The above transactions excluded, the tendency of the last two years towards decreasing deposit amounts abroad has gone on the downswing. The largest contribution to the financial account surplus was posted by the MEUR 768.6 worth of a rise in the *other investments-liabilities* item. The above growth was due to all items excluding general government loans. The deposits of non-residents at local banks amounted to MEUR 229.7. Net credit extensions to the private non-financial sector ran at MEUR 310.6, whereas commercial banks liabilities went up by MEUR 143. The financial inflows into the country reported a 12-month volume-term rise and are expected to sustain their upward trend in the medium term due to the countrys boosted lending and investment activity as well as the global forecast for an insignificant change in the interest rate difference in the Bulgarian, the EU and the US interbank markets.

Having attracted some MEUR 253.9 worth of FDI in 2003, Bulgaria now ranked among the forerunning Central and Eastern European countries reporting the most of FDI. In the first half-period of 2004, FDI totalled MEUR 978.6, fully covering the current account deficit. Revenues from privatisation amounted to MEUR 242.9, including the receipts from the sale of the Bulgarian Telecom. The rise in BTC capital was accounted as a rise in equity from non-privatisation deals. By the end of 2004, revenues from the sale of the electricity supply companies are anticipated to run at some MEUR 690, and the FDI to surpass EUR 2 billion. In addition, at preliminary estimate, reinvested profit is to report a MEUR 19.7 worth of a year-on-year increase. By country, the largest FDI amounts were reported by Austria, the Netherlands and Luxemburg. However, it should be noted that the growing foreign ownership in the country has led to a certain rise in the outflow of interest and dividend payments to foreign owners on intra-firm credit (the bulk of FDI are in the form of intra-firm credit). Furthermore, there are expected larger investment outflows in the near future.

In the first half-year period of 2004, the countrys balance of payments ran positive at MEUR 749.1. BNB reserves over the same period stepped up by MEUR 782.8, and despite higher imports, the BNB reserves/ imports ratio reached 6 months vs. 5.6 months in the same period of 2003. Since the start of the year, net use of IMF credit went up by MEUR 13.9, and net liabilities to the World Bank by MEUR 19.8. ❑

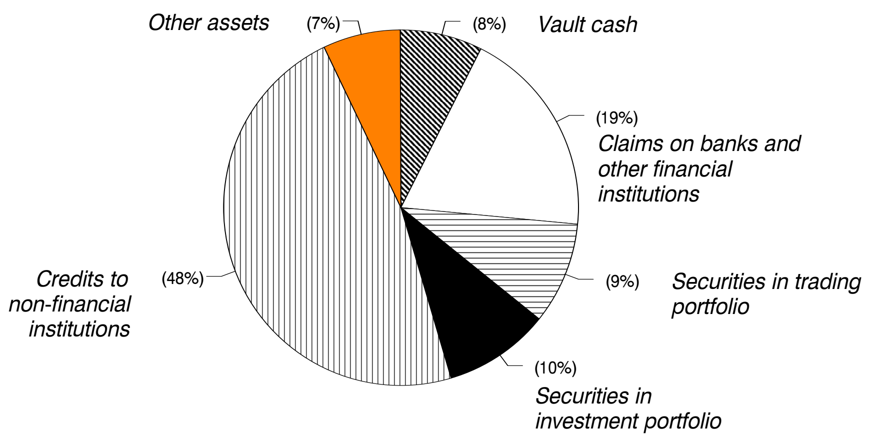
HIGH GROWTH RATE OF NON-GOVERNMENT SECTOR CREDIT

In the first half of 2004 the financial system was one of the most vigorously developing sectors in the country. According to NSI data, financial services reported a most robust real-term growth of 17.4%. The countrys macroeconomic stability and sustainable growth as well as the successfully concluded privatisation of the sector and intensified competition were among the primary contributors to this dynamic development.

The banking system assets grew by BGN 4 735 million (30.8%), reaching some BGN 20 096 million in end-June. The expansion of commercial banks credit activity emerged as the key development trend of the banking system. The share of lending to non-financial institutions and other clients in total bank assets reached 54.2% against 47.5% in end-June 2003 while stepping up to 30.2% as a percentage to GDP from 22.1% a year ago. Commercial banks credit has been expanding at accelerated rates and while, until recently, measures were sought to boost lending in the economy so as to foster economic growth, currently the most topical issue is to take appropriate action to cool down the credit activity because of the growing current account deficit.

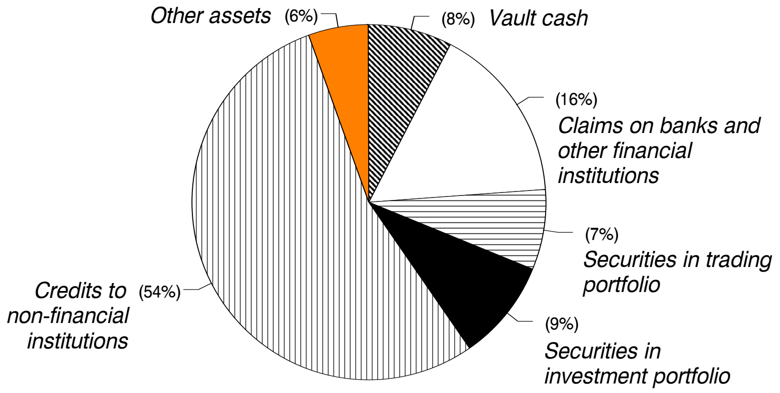
The sizeable growth rate of non-government sector credit was triggered by the low interest rates

Commercial Banks Assets as of 30.06.2003



Source: BNB

Commercial Banks Assets as of 30.06.2004



Source: BNB

on the international markets. This motivated commercial banks to seek ways to restructure their assets to achieve higher rate of return on them thereby demonstrating typical market behaviour aimed at optimisation and higher gains. Furthermore, the macroeconomic stability and sustainable growth as well as the improved business environment in recent years lowered credit risk in the country and encouraged commercial banks to expand their credit activity and focus on local economic agents. The serious real estate market upturn observed lately also contributed to the growth of lending since real estate emerged as a lucrative investment and demand for mortgage credits went up. The future accession of Bulgaria to the EU and the integration of the domestic market with the single European one force the Bulgarian producers to comply with the production and quality standards adopted in the EU. Therefore, a number of enterprises will have to invest in new production equipment and technologies. Although such projects may be financed by the various pre-accession instruments, the majority of Bulgarian producers will be compelled to resort to lending in order to implement their investment projects.

Residential mortgage loans had doubled in volume over the preceding twelve months. The potential of this market segment is quite high inducing commercial banks to liberally grant mortgage credits moreover so as their collateral is regarded as most secure. Households consumer lending reported a sizeable rise of BGN 952.3 million yet its growth pace had somewhat slackened as compared to the previous years.

The measures taken jointly by the central bank and the government to curb the growth of lending were as follows: withdrawal of the fiscal reserve from the commercial banks, introduction of a credit register[9] of loans worth under BGN 10 thousand and announcement and introduction of some additional regulatory requirements to curb the rise of banks credit portfolios, namely enlargement of the deposit base for calculation of the minimum required reserves (the deposit base will now also incorporate the attracted fixed-term deposits of over two years and 4% on their total amount must be put aside as minimum required reserves[10]); strengthening of banking supervision on the granting of loans classified as big exposures; and reduction of bank risk exposure groups from five to four with loans more than 90 days delinquent being classifies as non-performing with the respective 100% allocation of provisions to cover impairment loss for non-performing exposures.

Some of the measures were introduced as early as April 2004 and consequently, May and June witnessed a gradual slackening of the growth rate of lending and the withdrawal of liquidity from the banking system. Commercial banks were forced to sell government securities from their trading portfolios to maintain liquidity and in May and June alone investment in the trading portfolio declined by BGN 154.4 million. As a result, the base interest rate stepped up to 2.86% in May and 3.84% in June following the lower demand for government securities. In May, the interest rate on interbank placements notably rose as well. The withdrawal of government deposits from commercial banks in May coincided with the deadline for payment of income tax due for 2003 which further intensified the effect of the implemented measures.

However, there is solid ground to believe that the steps taken to curb the growth rate of lending in Bulgaria are, taken alone, unlikely to bring about a remarkable improvement of the trade balance of the

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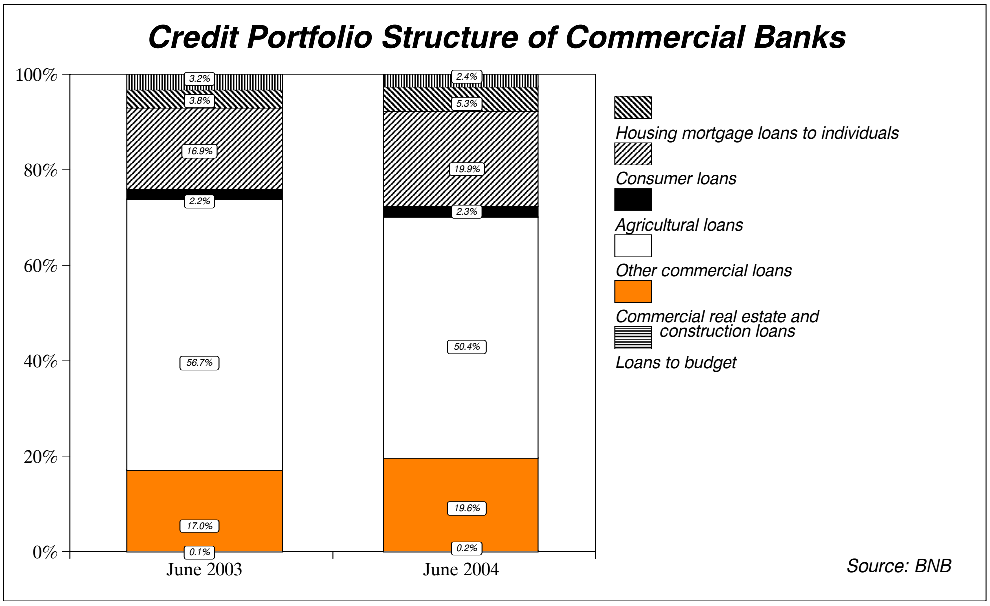
[9] The credit register will contain information about each banking system debtor and commercial banks will use it to obtain and exchange credit history information about potential borrowers.

[10] The change in the base for calculation of the minimum required reserves entered into force on 1 July 2004. 1 October 2004 saw the introduction of yet another change concerning commercial banks vault cash.

country. The share of consumer goods in total imports is far smaller than the respective shares of raw materials and investment goods. Furthermore, the business activity of leasing houses has been expanding extremely fast lately as most of them have signed contracts with the big chains of stores selling predominantly imported goods. Given the fact that no action has been so far taken to restrict the operation of leasing houses, the ultimate effect of the measures curbing bank lending on final import consumption will be partial. At the same time, commercial banks will be pressed to revise their credit policies given their current reduced liquidity and will ultimately cut the amount of newly granted loans. The contingent cutback in the volumes of lending may reflect upon the extended corporate and residential credits which, in turn, might influence the investment activity. The liquidity of collaterals on corporate and mortgage loans is sometimes relatively low and therefore any insolvency of the borrower is likely to create temporary liquidity problems for the bank-creditor. The stability of the banking system may be jeopardised by a sharp plunge in the prices of real estate as the latter are traditionally used as collateral for these types of credit.

The sustained growth rate of bank lending in the first half of 2004 has not led to any sharp deterioration in the quality of commercial banks credit portfolios. Thus, as of end-March 2004, some 92.99% of bank risk exposures were classified as standard (against 90.96% in March 2003) while only 2.48% of credit exposures were classified as a loss as compared to 2.73% reported a year earlier. As a result of the August 2003 amendments to BNBs Ordinance No9, commercial banks credit portfolios improved regardless of the ongoing credit expansion.

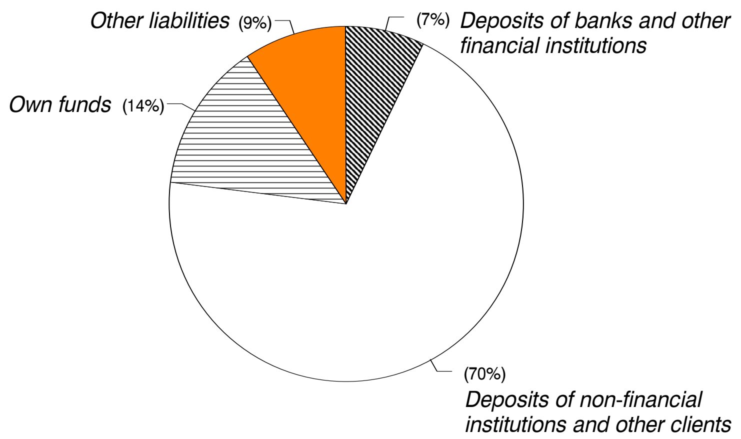


Commercial banks capital adequacy indicators sustained significantly higher levels than those fixed by BNBs Ordinance No8. As of end-March 2004, the banking sector overall capital adequacy ran at 21.28%, against 24.32% reported a year earlier. The value of this indicator has been following a steady downward trend due to the increased credit activity of commercial banks and the outstripping growth rate of the risk component of assets relative to that of the capital base.

As of end-March 2004, the banking system maintained slightly higher liquidity as gauged by primary liquidity indicator (9.87%) than in end-March 2003. The higher primary liquidity in the end of the first quarter of 2004 is likely to have been induced by the announced intention of the government to withdraw its deposits from commercial banks. At the same time, the value of secondary liquidity indicator had stepped down from 27.12% in end-March 2003 to 24.64% in end-March 2004 mainly as a result of the contraction of investment in commercial banks trading portfolios.

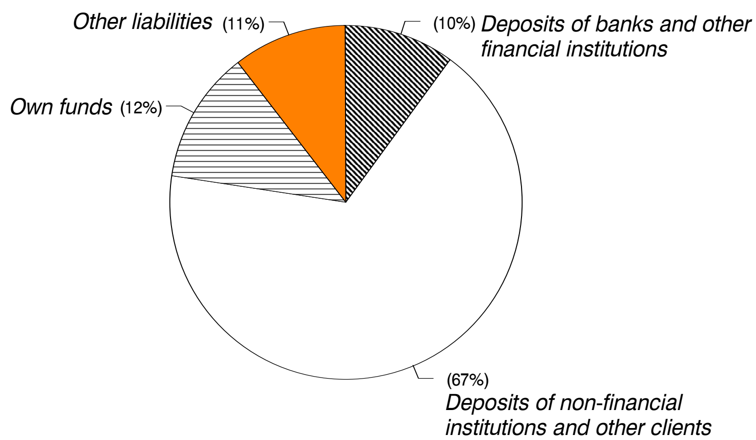
In the structure of commercial banks liabilities, the share of deposits of non-financial institutions and other clients stepped down by 2.42 percentage points at the expense of the growing weight (2.9 percentage points up) of deposits of banks and other financial institutions. Regardless of the 26.3% year-on-year growth of deposits of non-financial institutions and other clients reported in end-June 2004, their growth pace has been lagging behind the growth rate of assets. Commercial banks had managed to attract a hefty amount of time deposits from other banks (some BGN 642.6 million more relative to June 2003) in order to be able to finance their credit expansion. Although the deposits of Bulgarian commercial banks in foreign banks had increased by BGN 552.8 million[11], their net foreign assets had fallen by some BGN 180.2 million due to the large size of deposits attracted from abroad. Furthermore, commercial banks borrowing from international financial institutions had also grown. In June, RaiffeisenBank secured a syndicated loan worth MEUR 75 while some other commercial banks have signed credit line agreements with the European Bank for Reconstruction and Development and other banks.

Commercial Banks Liabilities as of 30.06.2003



Source: BNB

Commercial Banks Liabilities as of 30.06.2003



Source: BNB

Competition among banks became even stronger in the first half of 2004. The Concentration Coefficient and Herfindahl Index as regards bank assets and deposits went on the decrease. Competition in the sphere of deposits will further intensify because of the need to attract more resources to finance the granting of new credits. The Concentration Coefficient as regards bank claims also

[11] *According to data from commercial banks analytical reports.*

declined relative to June 2003, remaining however relatively high due to the credit expansion policy embarked upon by larger banks in contrast to their rather conservative credit policy pursued before.

The financial condition of the Bulgarian banking system remained stable throughout the first half of 2004.

Measures of Concentration in the Banking Sector

	VI.2000	VI.2001	VI.2002	VI.2003	VI.2004
Bank assets					
Herfindahl Index	0.11	0.09	0.08	0.08	0.07
Concentration Coefficient (%)	55.2	51.4	49.9	47.00	43.83
Claims on Non-financial Institutions and Other Clients					
Herfindahl Index	0.08	0.07	0.07	0.07	0.07
Concentration Coefficient (%)	43.6	41.3	41.6	44.08	42.42
Deposits of Non-financial Institutions and Other Clients					
Herfindahl Index	0.13	0.11	0.10	0.09	0.08
Concentration Coefficient (%)	62.2	58.2	55.8	53.07	48.67

Source: J. Miller, S. Petranov - „Banking in the Bulgarian Economy“, BNB, AEAF.

In end-June 2004, commercial banks net profit amounted to BGN 224 million, stepping up by 2.6% on a year earlier. The three largest banks were again bigger profit-makers, accounting for 51.6% of banking sector profit against 57.5% reported in end-June 2003. The profitability indicators also improved in the period under review. The net interest income/balance sheet value ratio stepped up, indicative of the good management of attracted resources aimed at profit optimisation. The non-interest expenditures/balance sheet value ratio declined, thus pointing out the improved management of operating expenditures.

The analysis of the structure of operating profit reveals that larger banks were more profitable than smaller

Profitability Indicators of the Banking System*

(% of average assets)	VI.2001	VI.2002	VI.2003	VI.2004
Net profit	3.85	2.13	2.95	1.4
Operating profit	4.62	2.61	3.55	1.8
Net interest income	4.37	3.84	4.67	3.1
Operating expenditures	4.72	4.31	4.47	2.5
Foreign currency revaluation	0.66	0.15	0.25	0.0

** On an annual basis*

Source: BNB, AEAF

banks. Smaller banks operating expenditures tended to be rather high. The non-interest expenditures/ operating profit ratio amounted to 200.7% in small banks, hitting the highest value in all bank groups. Any future consolidation of small banks would improve their overall profitability and make them abler to cope with competitive pressure in the sector.

The dynamic and stable development of non-bank financial institutions was sustained in the first six

Operating Profit and Operating Loss of Commercial Banks as of 30 June 2004

	Group I	Group II	Group III
Net income from interest and dividend	94.1%	194.1%	86.9%
Net credit provisions	-7.0%	-36.0%	8.0%
Profit/loss (trading portfolio)	3.7%	16.1%	-2.1%
Profit/loss (Available for Sale Investments)	2.5%	1.8%	0.1%
Profit/loss (Held to Maturity Investments)	0.9%	-0.2%	0.0%
Other non-interest income	37.6%	95.9%	44.4%
Non-interest expenditures	-72.2%	-200.7%	-80.4%

* „+“ denotes a positive contribution to profit; „-“ denotes a negative contribution to profit

Source: BNB, AEAF

months of 2004. The values of all indicators gauging the depth of financial intermediation of these institutions further improved. Market capitalisation increased to 7.3% from 5.2% in end-June 2003. As of end-June 2004, insurance penetration ran at 2.2% (vs. 1.99% in end-June 2003). The ratio of pension funds assets to GDP and gross national savings stepped up to 1.7% and 11.5% respectively (vs. 1.2% and 10.1% in end-June 2003). Regardless of the growing role of non-bank financial institutions in the last two years, the countrys financial system was still dominated by the banking system. The reason behind such developments is to be found in the relatively late emergence and participation of these financial intermediaries in the redistribution of financial wealth in the economy rather than in the absence of a clear regulatory framework or stimuli for their development.

As of end-June 2004, the amount of accumulated assets in pension funds had reached BGN 615.4 million, stepping up by 50.5% on a year earlier. Universal funds assets reported the fasted year-on-year growth rate of 124%, reaching BGN 167.3 million in end-June 2004. Some 1.68 million people (accounting for 70.9% of all insured in pension funds) were insured in universal funds which, coupled with the higher insurance contribution rate[12] in 2004 predetermined the fast growth pace of accumulated resources in the individual accounts of the insured persons. The funds raised by occupational funds amounted to BGN 167.7 million vs. BGN 119.4 million in end-June 2003. Voluntary pension insurance funds had raised the largest volume of funds (BGN 280.4 million vs. BGN 214.8 million in end-June 2003). The concentration of assets with all types of funds underwent some minor changes, still remaining rather high. The anticipated effects from the restructuring of the pension insurance market, viz. the merger of *Doverie* pension insurance company with *Bulgarsko pensionnoosiguritelno drujestvo* in the first half of 2003 and the licensing of *DZI Pension Insurance* in end-2003 are still to be seen. The four biggest voluntary[13] and universal[14] funds were responsible for about 90% of all assets, whereas the four largest occupational[15] funds managed some 91.9%.

The first half of 2004 sustained the ongoing process of diversification of pension funds investment

[12] In 2004 the insurance contribution rate was raised from 2% to 3%.
[13] Doverie, Allianz Bulgaria, ING and Lukoil-Garant Bulgaria voluntary pension funds.
[14] Doverie, Allianz Bulgaria, ING and Saglasie universal pension funds.
[15] Doverie, Allianz Bulgaria, Saglasie and Lukoil-Garant Bulgaria occupational pension funds.

Depth of Financial Intermediation % of GDP

	XII.2001	VI.2002	XII.2002	VI.2003	XII.2003	VI.2004
Commercial bank assets	41.13%	39.90%	45.04%	46.46%	50.34%	55.75%
Pension fund assets	0.63%	0.76%	1.03%	1.24%	1.48%	1.71%
Insurance premiums	1.61%	1.71%	1.90%	1.99%	1.94%	2.20%
Market capitalisation of the stock exchange	3.72%	4.14%	4.25%	5.22%	7.82%	7.30%

Source: BNB, FSC, AEAF, BSE-Sofia

portfolios within the limits provided by law. Pension funds still refrained from investing abroad because of the low interest levels at the international markets. They opted for investing locally and thereby succeeded in ensuring higher rate of return. In end-June 2004, the share of government securities in total investment of universal funds had declined from 73.3% a year ago to 65.3%. Although occupational funds preserved almost the same level of investment in government securities (68.6% in end-June 2004), the weight of these investments in their portfolios in the second quarter of 2004 declined on a quarter earlier. This dynamics is likely to have been triggered by the price reduction of government securities in May 2004 as a result of the measures jointly undertaken by the government and the central bank to withdraw liquidity from commercial banks. The fall of government securities prices affected the pension funds rate of return in May, yet this does not raise any concerns since pension funds are long-term investors and therefore what matters is their development and profitability in the long run.

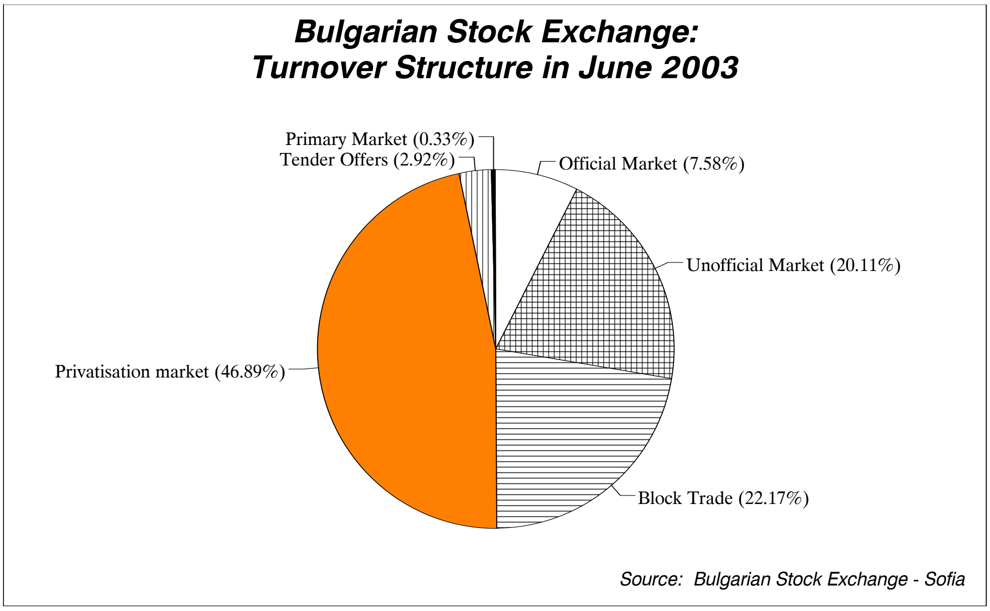
The share of investment in bank deposits of all types of pension funds went on the decrease at the expense of the higher weight of securities listed in the regulated markets. As of end-June 2004, universal and occupational funds had invested 19.4% and 16.8% respectively in shares, corporate bonds and mortgage bonds. The active participation of these long-term investors on the local capital market had a positive effect on its development.

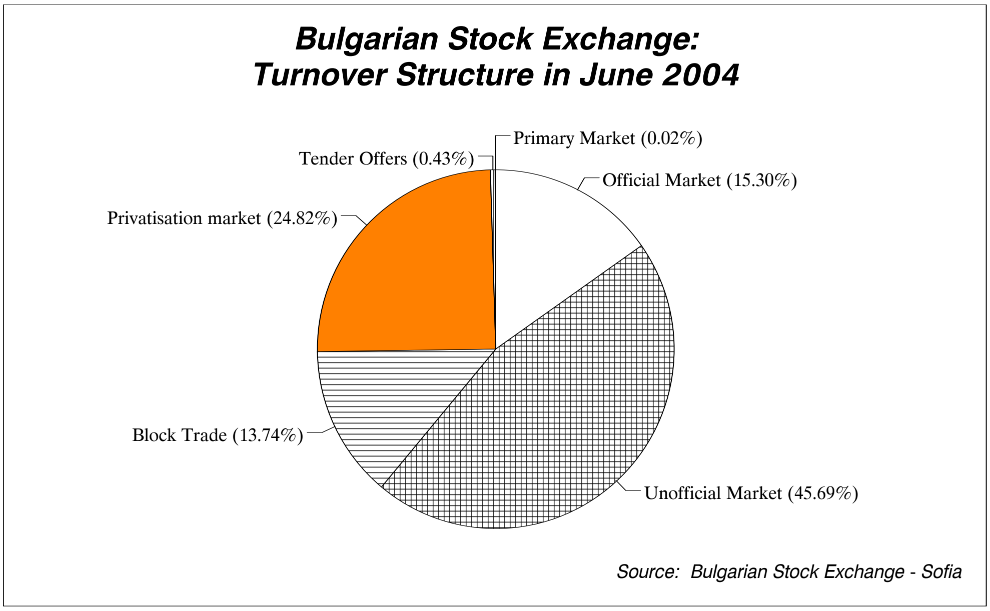
Pension funds, and universal funds in particular, are expected to swiftly accumulate huge resources in the future and therefore penetration of the pension insurance market is projected to increase to about 2% of GDP.

The steady upward in the dynamics of the insurance market was sustained throughout the first half of 2004. In end-June 2004, insurance companies reported a 22.4% year-on-year gross premium income growth up to BGN 372.5 million. Premium income in the general insurance industry grew by 20.6% on a 12-month basis. It is noteworthy that companies in the life insurance segment also reported an increase of premium income of 38.6% (year-on-year). Life insurance companies recovered after the sizeable fall of premiums in 2003 triggered by the income tax evasion schemes used in 2002.

As of end-June 2004, concentration in the general insurance industry had declined in contrast to its dynamics in the life insurance segment. The four biggest life insurance companies managed some 78.6% of the premium income vs. 78.4% in end-June 2003. The period under review witnessed a reversal of the market positions of the largest companies on the market *DZI* and *Allianz Bulgaria* with the latter life insurance company taking the lead. The four biggest general insurance companies managed some 62.6% of the premium income against 68.7% in end-June 2003. Herfindahl Index and the Concentration Coefficient followed similar dynamics in both sectors.

In the first six months of 2004, Bulgarias capital market sustained its upward trend of stable and dynamic development observed in the last three years. The volumes traded at the Bulgarian Stock Exchange (BSE) reached BGN 428.7 million, reporting an 8.4% growth on a year earlier. The increase of turnover in the first half of 2004 was due to trading in single shares and more specifically to the volumes traded at the over-the-counter market (BGN 195.9 million or 45.7% of total turnover at the BSE) rather than to privatisation deals and block trading as was the case in the respective period of 2003. All segments of the over-the-counter market reported notable increases of the volumes traded with the over-the-counter market of bonds reporting a most robust growth of 510% up to BGN 29.9 million. In 2004, new corporate bond issues were listed for trading, namely those of Reiffeisenbank (worth USD 32.104 million) and the second issue of TBI Credit (BGN 8 million). These issues were first placed privately and were only afterwards listed for trading on the stock exchange. The strategy to place bonds privately and subsequently list them on the stock exchange is preferred by bond issuers with a view to successfully placing the issues.

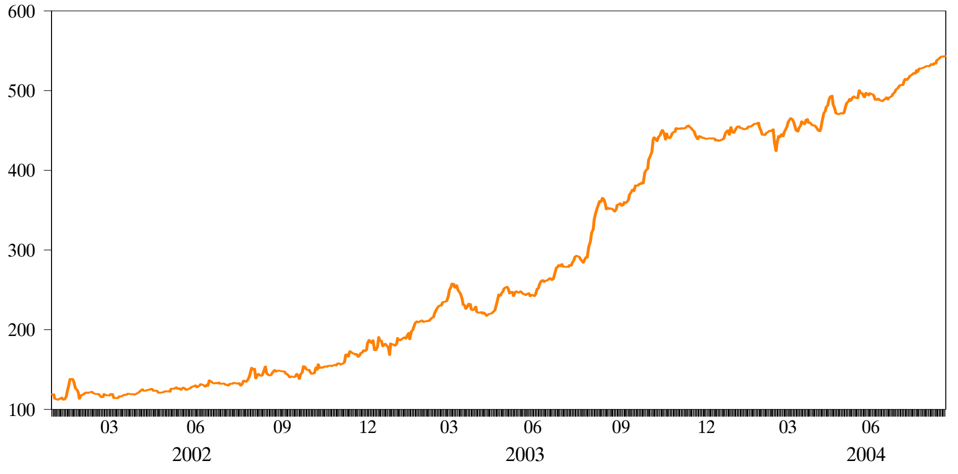




Compensatory instruments had a notable contribution to the increase of BSE turnover. The pick-up of trade in compensatory instruments and investment bonds was predetermined by the possibility to use these paper backed instruments in the privatisation of firms at the announced public tenders. In 2004, the BSE launched centralised public tenders for the sale of government-owned shares and remote public auctions for the sale of shares of limited liability companies. Demand for compensatory instruments and investment bonds and their prices were strongly influenced by the performance of public tenders. In early-2004, the prices of compensatory instruments hovered around 21%-22% of their face value to reach 24%-25% of their face value in March and April. As for trading in single shares, some BGN 66 million worth of compensatory instruments were traded in the first half of 2004 vs. BGN 40.3 million as of end-June 2003. Block deals in compensatory instruments ran a total of BGN 33.5 million against BGN 43.3 million reported in the first half of 2003.

The official stock exchange index, SOFIX, hit new record high values in 2004, peaking at 506.71 points on 30 June. In end-June 2004, the index reported an 81.2% rise on a year earlier while stepping up by 11.5% relative to end-2003 as a result of the upswing in the share prices of the companies, making up the index. In the first six months of 2004, the most notable price increase (considerably outstripping the growth rate of SOFIX) was registered by the shares of *Blagoevgrad BT* (78.5% up), *Neochim* (55.9%), Central Cooperative Bank (55.4%) and *Bulgartabac* Holding (39.6%).

Bulgarian Stock Exchange Index (SOFIX)



Source: Bulgarian Stock Exchange - Sofia

In spite of the improvement of all indicators gauging the development of the Bulgarian capital market, the markets role in the financial system is still minor and it is unable to meet the requirements of a functioning market economy. ❑

IMPROVED INTERNATIONAL RATING OF THE BULGARIAN ECONOMY

Confidence in the Bulgarian economy went on improving in 2004, as evidenced by the upgraded credit standing by three rating agencies. On 24 June 2004, S&Ps awarded Bulgaria its first investment rating (BBB-), assessing the economic outlook as stable. The other two credit rating agencies followed suit, revising their credit risk assessments in August. Fitch gave the country its first investment risk standing of BBB-/stable outlook, whereas JCRA raised Bulgarias rating to BBB-/positive outlook. The improved assessments of the countrys credit and investment risk were due not only to the significant progress made on the political, economic and budget reform agenda with a view to Bulgarias accession to the European Union but also to the fact that the country has been successfully fulfilling two of the Maastricht criteria[16], without being required to, at present. Furthermore, the countrys standings improved as a result of the conclusion of the accession negotiation process with the EU, as the last four negotiation chapters[17] were provisionally closed in June 2004.

Agency	Fitch			JCRA		
Country	**Rating**	**Outlook**	**Date**	**Rating**	**Outlook**	**Date**
Bulgaria	*BBB-*	*positive*	*4 August 2004*	*BBB-*	*positive*	*11 August 2004*
Croatia	*BBB*	*positive*	*8 July 2003*			
Cyprus	*A+*	*positive*	*4 November 2003*			
Czech Republic	*A-*	*stable*	*20 June 2003*	*A*	*stable*	*1 May 2003*
Estonia	*A*	*positive*	*7 July 2004*			
Hungary	*A-*	*negative*	*15 July 2003*	*A+*	*stable*	*22 March 2004*
Latvia	*A-*	*positive*	*7 July 2004*			
Lithuania	*A-*	*positive*	*7 July 2004*			
Malta	*A*	*positive*	*4 November 2003*			
Poland	*BBB+*	*stable*	*6 May 2004*	*A-*	*stable*	*8 May 2003*
Romania	*BB*	*positive*	*22 January 2004*	*BB*	*positive*	*17 December 2003*
Slovak Republic	*BBB+*	*positive*	*7 July 2004*	*A-*	*stable*	*19 April 2004*
Slovenia	*AA-*	*positive*	*7 July 2004*			
Turkey	*B+*	*positive*	*25 August 2004*			

Source: MF, Fitch, JCRA

The improved economic outlook of Bulgaria, having to do with the countrys accession to the EU and macroeconomic stability, is also mirrored in the degree of business cooperation and depth of business relations between Bulgaria and the EU member-states.

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[16] *Without the long-term interest rate and price stability criteria.*
[17] *Chapter 6 „Competition“; Chapter 7 „Agriculture“; Chapter 21 „Regional Policies“; and Chapter 29 „Budgetary and Financial Issues“.*

Bulgarian Companies with Foreign Interest as of September 2004

Country	As of September 2004		2004 □.	
	number	%	number	%
New EU member-states	**730**	**22.3**	**40**	**17.9**
Czech	77	10.5	5	12.5
RepublicEstonia	5	0.7	0	0.0
Hungary	61	8.4	3	7.5
Latvia	4	0.5	0	0.0
Lithuania	1	0.1	0	0.0
Poland	20	2.7	1	2.5
Slovakia	17	2.3	0	0.0
Slovenia	10	1.4	1	2.5
Malta	16	2.2	2	5.0
Cypress	519	71.1	28	70.0
EU-15	**2299**	**70.3**	**166**	**74.1**
Austria	323	14.0	24	18.8
Belgium	51	2.2	3	0.0
Denmark	44	1.9	9	6.3
Germany	450	19.6	19	18.8
Greece	322	14.0	28	6.3
Ireland (Eire)	28	1.2	0	0.0
Italy	261	11.4	26	6.3
Luxemburg	74	3.2	7	3.1
Spain	47	2.0	6	0.0
Sweden	20	0.9	1	3.1
Great Britain	272	11.8	12	0.0
Netherlands	236	10.3	19	9.4
Finland	11	0.5	1	0.0
France	135	5.9	7	3.1
Portugal	25	1.1	4	0.0
Other	**240**	**7.3**	**18**	**8.0**
Romania	25	10.4	7	38.9
Turkey	133	55.4	10	55.6
Croatia	6	2.5	0	0.0
Macedonia	33	13.8	1	5.6
Albania	0	0.0	0	0.0
Bosnia and Herzegovina	1	0.4	0	0.0
Yugoslavia	42	17.5	0	0.0
Total	**3269**	**100.0**	**224**	**100.0**

Source: BULSTAT, NSI

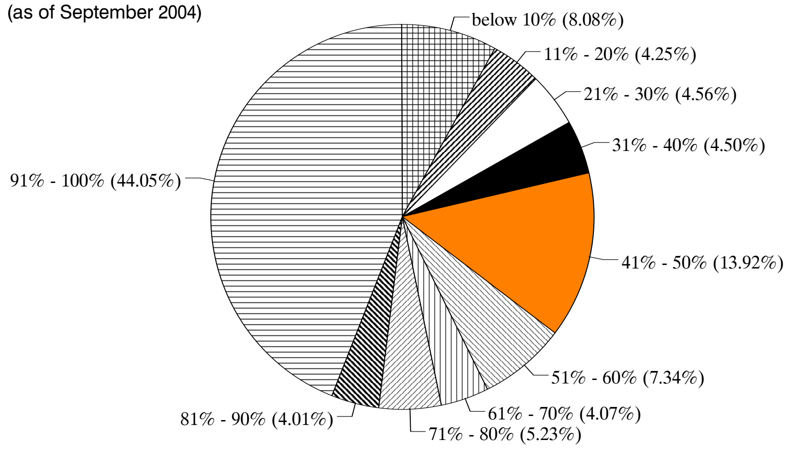
Foreign interest in local capital is one form of business cooperation, allowing for the penetration of foreign managerial and technological know-how, which can be identified as a major weakness of the Bulgarian private companies. Another key advantage of business cooperation has to do with the exchange of experience and the introduction of innovations and the best international practices. As of 14 September 2004, there were established some 3269 local companies with foreign interest[18], with Cyprus in the lead with 15.9%, followed by Germany (13.8%), Austria and Greece (9.9%).

The number of branches of foreign legal entities is indicative of the countrys improved business climate and attractability to foreign investors. As of September 2004, there emerged 251 active economic agents[19], with some 28 and 21 new branches of foreign companies being opened in 2003 and 2004 respectively, as followed: 15.5% from Greece; 12% from Germany and Turkey; 10.8% from Great Britain; and 6% from the Czech Republic. It is noteworthy that local company capital was dominated by foreign interest from the developed economies, e.g. EU member states. The same applies to the origin of foreign companies, opening their own branches in Bulgaria. Taking into account that company expansion in the new EU member states is yet to take place, it can be expected that they may re-channel their capital to the Bulgarian market, irrespective of the form of penetration, be it interest in local firms or by opening their own branches.

The scope of activity of local companies with foreign interest is rather diversified, with the greatest concentration being reported by services (35.8% or 1 158 firms) and trade (wholesale, retail trade and intermediation) (34.3% or 1 111 firms). Of all trading companies, some 47.8% of them are involved in wholesale trade, 32.9% in intermediation, and only 19.3% in retail trade. It can be therefore concluded that foreign companies and investors have turned essentially to business activities yielding higher capital turnover and relying on relatively low investment injections. A similar structure has been discerned with regard to foreign company branches in Bulgaria 37.9% of the branches are involved in wholesale trade and intermediation and 29.4% in the service industry, reflecting some uncertainty in countrys business environment, having to do with the often amended business legislation.

Foreign Investment Shares in the Capital of the Bulgarian Enterprises

(as of September 2004)



Source: Bulstat, National Statistical Institute

In 2097 of the cases (61.4%) foreign companies own more than 51% of the Bulgarian company capital. The majority of firms (44.1%) own between 91% and 100% of the capital of the local company, indicating the long-term interests of foreign companies. In only 13.9% of the cases foreign companies own less than 50% of the local companys capital. ❑

[18] *According to BULSTAT data, NSI.*
[19] *According to BULSTAT data, NSI.*

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