

The cover art is a complex, multi-layered illustration. At the top, a grey eagle with spread wings is set against a background of architectural blueprints and technical drawings. Below the eagle, the title 'Economic Review' is written in a large, bold, white sans-serif font. To the right of the title, the date 'February 2005' is printed in a smaller, black sans-serif font. The middle section of the cover features a wide, horizontal band with a repeating pattern of interlocking blue and green diamond shapes. Below this band, a large, detailed illustration of a lion is rendered in a blue, cross-hatched style. The lion is shown in profile, facing right, with a thick, textured mane. The background behind the lion is a dense, intricate pattern of small circles and lines in shades of brown and white. In the bottom left corner, the text 'BULGARIAN NATIONAL BANK' is printed in a white, bold, sans-serif font. The entire cover is framed by a dark teal vertical bar on the left side.

Economic Review

February 2005

BULGARIAN
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BANK

Economic Review

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BULGARIAN
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BANK

Bulgarian monetary policy regime seeks national currency stability with a view to price stability. The BNB Economic Review presents information and analysis of balance of payments dynamics, monetary and credit aggregates, their link with the development of the real economy, and their bearing on price stability. External environment is also analysed since the Bulgarian economy is influenced by international economic fluctuations. This publication contains quantitative assessments of the development in major macroeconomic indicators in the short run: inflation, economic growth, monetary and credit aggregate dynamics and interest rates.

The February 2005 *Economic Review* was approved for publication by the BNB Governing Council at its 3 February 2005 meeting. It employs statistical data published by 31 January 2005.

Please address notes, comments and suggestions to the BNB Economic Research and Projections Directorate at 1000 Sofia, 1 Alexander Battenberg Square, or to econreview@bnbank.org.

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Fax: (+359 2) 980 2425, 980 6493
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Abbreviations

BCC	Bank Consolidation Company
BIR	Base interest rate
BOP	balance of payments
BTC	Bulgarian Telecommunications Company
b. p.	basis points
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
EA	Employment Agency
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
FDI	foreign direct investment
GDP	Gross Domestic Product
IEA	International Energy Agency
IMF	International Monetary Fund
ISM	Institute for Supply Management
LIBOR	London Inter-bank Offered Rate
M1	narrow money
M2	M1 and quasi-money
M3	broad money
MF	Ministry of Finance
NPISHs	Non-profit institutions serving households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	Purchasing Power Parity
WB	World Bank

Summary

Global economic growth rates started to slow down at the end of 2004: a process which is anticipated to continue in 2005. Nevertheless, world economic environment stayed favourable. Crude oil price rises were a major inflationary factor in 2004. However, in 2005 prices are expected to stabilise at some USD 40 *per* Brent barrel.

Market expectations of a 25 basis points rise in the US federal funds interest rates at the Federal Reserve's Monetary Policy Committee's first meeting in February were confirmed. Another 25 basis points rise is expected at the Committee's next meeting in March. Market expectations are for US federal funds interest rates to rise to 3.5 per cent by the end of 2005 and ECB policy to sustain in the first half of 2005.

Volatile international economic situation in 2004 did not affect adversely the Bulgarian economy. Balance of payments financial flows covered the current account deficit and backed Bulgaria's international reserve growth: by end-September international reserves reached EUR 6770.4 million.

Reserve money grew by some 34 per cent by end-2004. Commercial bank deposits with the BNB increased considerably by the close of 2004 reflecting the amendments to the Regulation on the minimum required reserves enforced in the second half of the year. The overall effect of these amendments was a rise in the average daily amount of minimum required reserves coming to BGN 657 million in December 2004 compared with their June 2004 level. Broad money sustained its dynamic development, with households providing the bulk of lev resources to the banking system. Dramatic money supply growth reflected increased commercial bank claims on the non-government sector: an annual increase of some 48.7 per cent by end-December.

Rising household income as a result of increased employment, along with optimism of businesses about their future development, determined credit demand dynamics. Inflow of external resources (non-resident deposits and loans) into the banking system offset withdrawal of liquidity resulting from the amendments to the Regulation on the minimum required reserves and allowed commercial banks to pursue their aggressive lending policy. Although the relatively high credit growth does not threaten financial stability, and interest rates in Bulgaria show a downward trend, banks' credit portfolios may worsen in case of deterioration in the economic situation. Therefore, the BNB will continue to undertake measures to intensify the control over the credit quality and lending rates.

Sustainable growth of the Bulgarian economy at high rates reflected both the active domestic demand and increased exports. Competitiveness of the Bulgarian economy, and particularly that of industry, continued improving. This will extend foreign markets for the Bulgarian producers and decrease import rates as a result of the greater supply of, and demand for, domestic goods in the domestic market.

Due to the openness of the Bulgarian economy, domestic demand for tradable goods did not exert inflationary pressure. Improving cost competitiveness contributed to the overall price stability. Inflation rates were driven by adjustments of administratively controlled prices and partially by international oil price dynamics. Inflation accumulated by end-2004 was close to the anticipated rate: four per cent.

Positive trends in economic development and particularly businesses' improved financial performance resulting in their enhanced cost competitiveness and increasing efficiency suggest 5.2 to 5.3 per cent economic growth and some seven to eight per cent industry value added growth in the first half of 2005. Rising investment in the services sector also signals favourable conditions, hence sector's growth is anticipated to stay high. Monetary and credit aggregates are expected to preserve their end-2004 growth rates in the first quarter of 2005 and to slightly decrease in the second quarter. Inflation may reach two per cent by the close of March 2005 due to seasonal factors and rises in excise duties on beer and strong alcoholic beverages, although it is expected to be compensated by seasonal falls in food prices by mid-2005.

1. External Environment

Current Business Situation

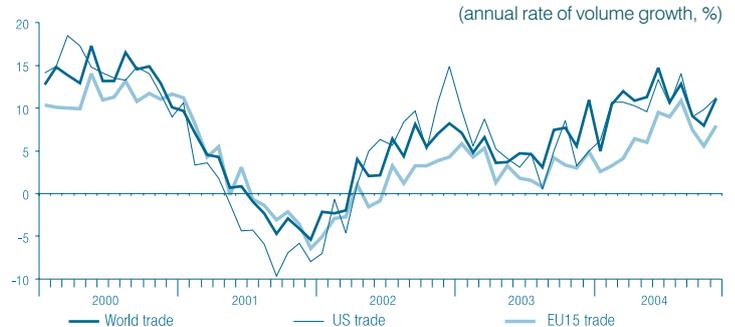
Global economic activity gradually slowed down in the fourth quarter of 2004. Acceleration of the first six months gave way to moderate and sustainable growth. In the fourth quarter of 2004 economic indicators for industry reached their lowest values for the year, nevertheless they remained in the expansion zone. Over the last three months of 2004 services were the major business climate indicator, while pessimism prevailed in industry. International trade also reported a drop in volume growth mainly due to decreased euro area trade volumes.

In the first half of 2005 global economic conditions are expected to be favourable. The negative effect of the rises in the price of crude oil and its sub-products on inflation growth will decline gradually.

The USA

The US economic activity stayed high in the second half of 2004 prompted by robust private and investment consumption. Over 2004 GDP grew by 4.4 per cent, which exceeded by some one percentage point the potential growth assessment and contributed to the higher production facility utilisation. Active domestic demand coupled with weaker growth in the other industrialised countries further increased US external imbalances. Rising trade deficit had a negative impact on growth (as in the previous periods) and exerted pressure for the US dollar depreciation on foreign exchange markets.

Chart 1
World Trade

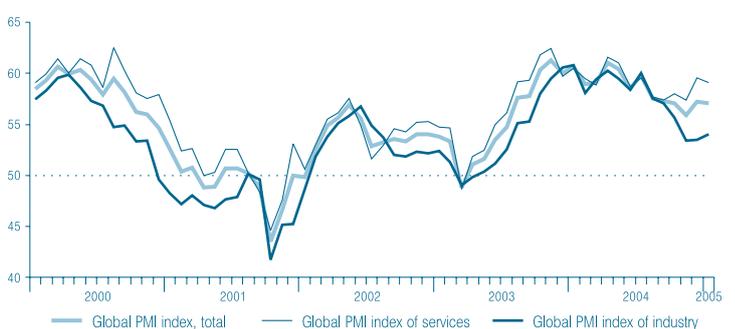


Source: CPB Netherlands Bureau for Economic Policy Analysis.

...global economic activity gradually slowed down...

...the negative effect of the rises in the price of crude oil and its sub-products on inflation growth will decline gradually...

Chart 2
Global PMI Indices



Source: NTC Research, JP Morgan.

...the US economic activity stayed high in the second half of 2004 prompted by robust private and investment consumption...

Chart 3
Contribution to US Growth by Component



Source: Bureau of Economic Analysis.

A slight slowdown in US economic activity to its potential growth rate was in evidence owing to increased interest rates and exhausted fiscal stimuli of the previous years. The record high in household indebtedness, the low savings level and the uncertainty about the sources of current account and budget deficit financing threatened US growth.

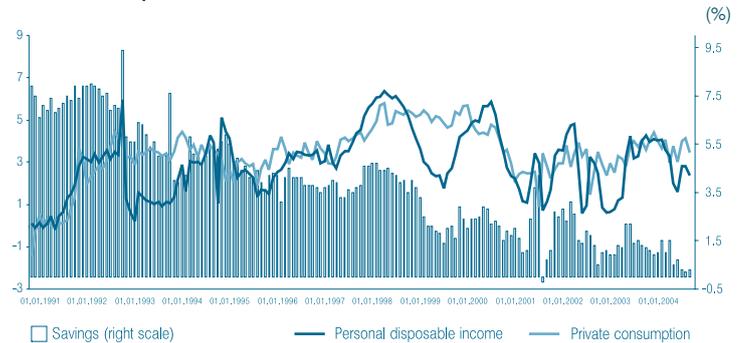
US inflation continued rising as a result of record high oil prices reached in 2004, vivid domestic demand, and growing opportunities of banks to transfer rising production costs to the end-use consumer. US dollar depreciation also had its contribution, import price inflation (excluding crude oil import price) reaching its highest values for the last nine years.

Prompted by these factors, inflation rose from 2.5 per cent at the close of the third quarter to 3.3 per cent by end-December 2004. The more sustainable core inflation (excluding food and energy commodities) showed similar behaviour rising to 2.2 per cent by end-2004. Although inflationary expectations remained under control, the Federal Reserve reported price pressure and gave rise to expectations of sustained upward trend in interest rates.

In the first quarter of 2005 inflation dynamics will be determined by rising production capacity utilisation and high prices of major raw materials. Growing unit labour cost will have key significance reflecting in turn a slowdown in productivity growth. Despite these factors, in the first quarter consumer price inflation is likely to drop below three per cent on an annual basis due to the previous year base effect. Economic agents' inflationary expectations will remain stable owing to Federal Reserve's anti-inflationary policy and institutions' willingness to continue tightening monetary policy.

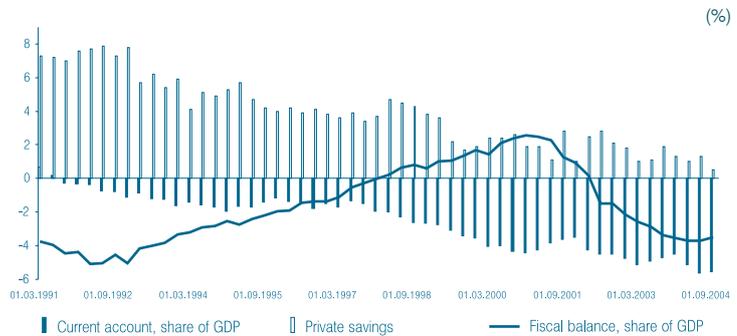
... the record high in household indebtedness, the low savings level and the uncertainty about the sources of current account and budget deficit financing threatened US growth...

Chart 4
US Consumption Trends



Source: Bloomberg.

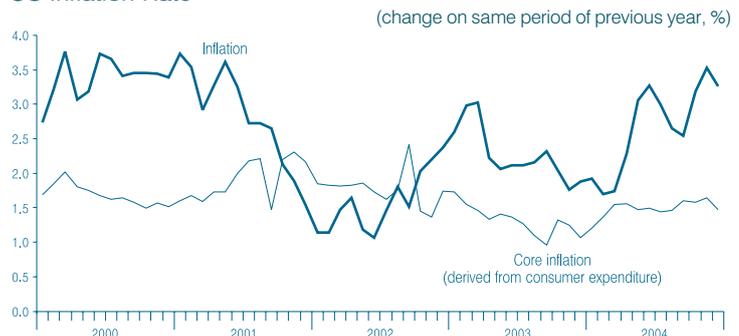
Chart 5
US Double Deficits



Source: Bloomberg.

... inflationary pressure will continue reflecting stable domestic demand, rising production capacity utilisation and high prices of major raw materials...

Chart 6
US Inflation Rate



Source: Bureau of Labour Statistics, Bureau of Economic Analysis.

Note: The US core inflation is measured by personal consumption expenditures index excluding energy and food expenditures.

The US labour market gradual recovery was sustained to the end of 2004. New jobs outside the agricultural sector reached 2,200,000 in 2004 posting the highest growth for the last five years, services contributing most significantly to this effect. Employment in industry increased slowly reflecting restructuring related to moving production processes to other countries, such as India and China.

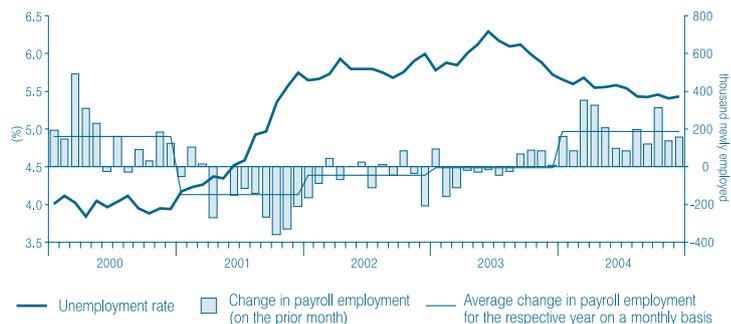
US unemployment stayed within the 5.4 to 5.5 per cent range in the second half of 2004, well below the 2003 six per cent average. Labour market recovery slowed down compared with the previous cycle and the rate of creating new jobs accelerated only in 2004. Labour market is expected to improve moderately in the following months.

In October leading economic indicators reached some of their lowest values for the year; however, the trend was reversed in the last two months of 2004. Optimism was expressed in the estimates of both consumers and businesses. High values reflected anticipation of new orders coupled with stable private consumption. The positive change in attitudes may be due to seasonal factors and in the first half of 2005 indicators' levels may fall.

Over the last quarter of 2004 US interest rates continued rising after the Federal Reserve increased the federal funds interest rate by 25 basis points at its meetings in November and December. The policy of transparency and adequate communication that accompanied each change, as well as the lack of any significant surprises in core inflation behaviour and the sustainable economic growth kept monetary market interest rate fluctuations within a relatively narrow band. Following the changes, the reserve funds real interest rate which may be taken as a measure of monetary policy restrictiveness came very close to zero. The six-month LIBOR in US dollars rose from 2.2 per cent to 2.8 per cent by end-2004, its fluctuations subsiding steadily.

Chart 7

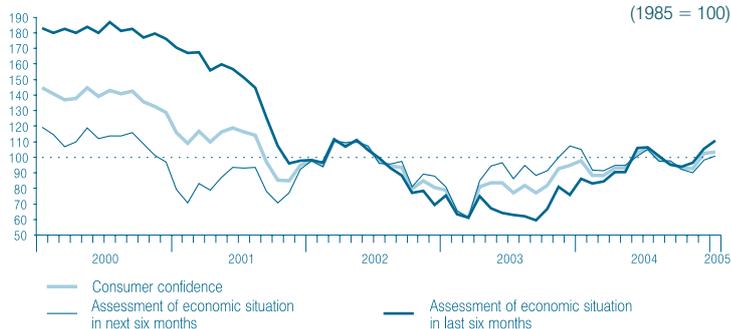
US Unemployment Rate and Change in Payroll Employment



Source: Bureau of Labour Statistics.

Chart 8

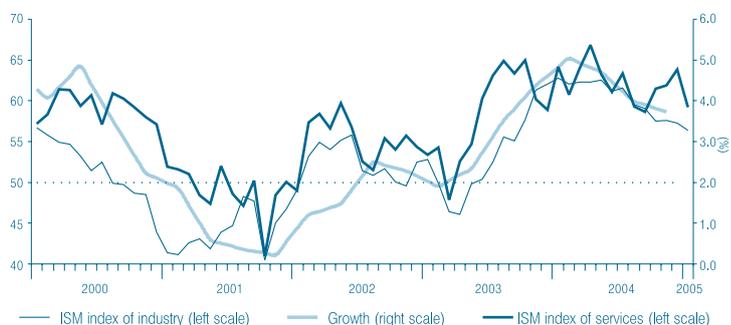
US Consumer Confidence Indicators



Source: Conference Board.

Chart 9

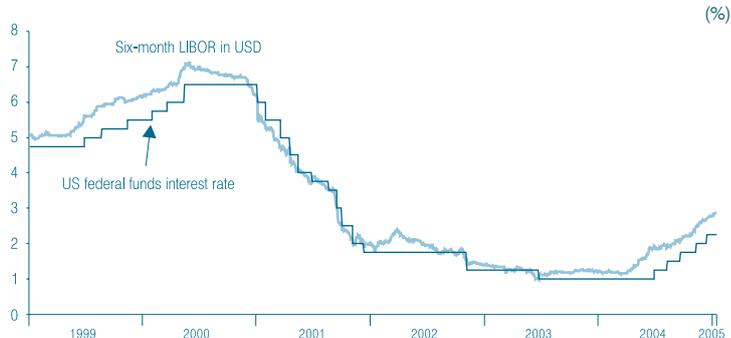
US PMIs and Growth



Source: Institute for Supply Management.

Chart 10

US Federal Funds Rate and Six-month LIBOR in US Dollars



Source: Bloomberg.

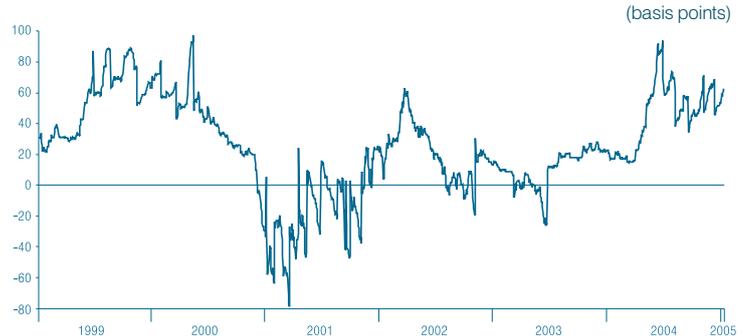
Monetary policy is still stimulating and according to current market expectations the Federal Reserve will continue to raise the interest rate in 'measured steps' until it reaches the neutral level of some 3.5 per cent by the close of 2005. Approaching the neutral limit, the next steps forward changing the monetary policy will depend to a great extent on the nature of obtained economic data and mostly on current and expected inflation dynamics. At the start of 2005 futures markets showed stable expectations that federal funds interest rate would be raised by 25 basis points at the next two meetings of the Committee in February and March; the first increase has already been realised. Market expectations of an interest rate change in the second quarter are relatively more volatile; nevertheless, those of a new 25 basis points rise dominate. This stabilised the spread between one-year and six-month LIBOR within the range of 10 to 25 basis points. Given the current market projections, there might be a positive surprise: inflation rising more than anticipated which may lead to a faster interest rate growth than it is normal at the attained levels of the yield curve and futures contracts prices.

The Euro Area

Euro area economic growth dropped from 0.5 per cent in the second quarter to 0.3 per cent in the third quarter of 2004, economic growth slowing down to 1.8 per cent (2.1 per cent in the second quarter) on an annual basis. This was owing to the weaker export growth (1.2 per cent on the previous quarter) reflecting a temporary fall in external demand. Retained 0.2 per cent final consumption growth against the second quarter was insufficient to boost overall economic activity. The stable contribution of private investment to growth was surprising. It resulted from rehabilitated corporate balances backed by the low interest rates. Lower growth rate in the coming quarters will be driven by accumulation of commodity inventories which rose by 0.8 per cent in the third quarter of 2004 against the prior quarter. The factor behind finished output accumulation was the expected strong consumption which did not materialise.

...over the fourth quarter of 2004 interest rates in US dollars continued their upward trend...

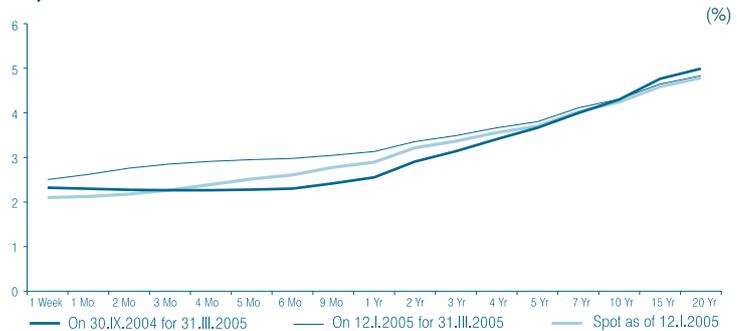
Chart 11
Spread between Interest Rate on US Federal Funds and Six-month LIBOR



Source: Bloomberg.

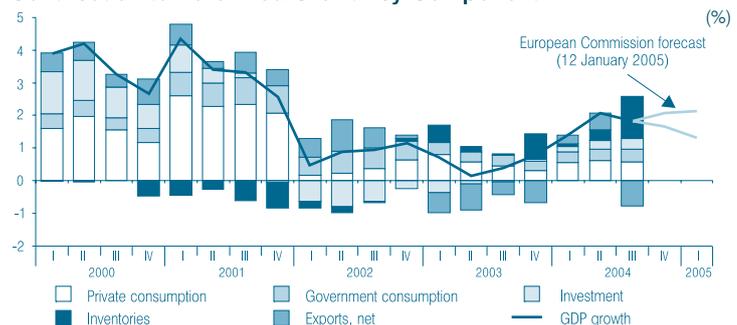
...at the start of 2005 futures markets showed stable expectations that federal funds interest rate would be raised by 25 basis points in February and March...

Chart 12
Expected US Yield Curve



Source: Bloomberg.

Chart 13
Contribution to Euro Area Growth by Component



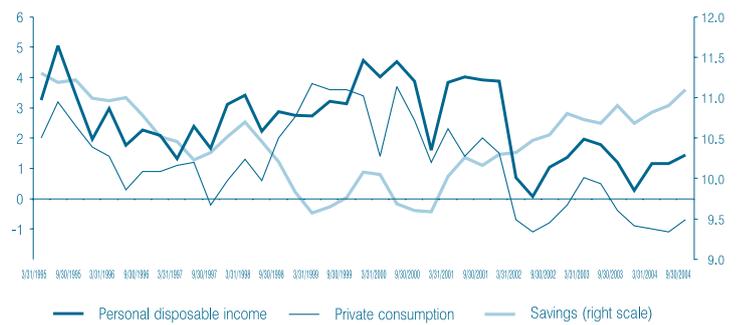
Source: Eurostat, European Commission.

In the second half of 2004 euro area inflation stayed at a level of over two per cent reaching by end-December 2.4 per cent on an annual basis. Price rises resulted primarily from the appreciation of oil and other energy resources. Despite the general trend, the second half of 2004 saw stable core inflation (1.9 per cent on an annual basis) which indicates that there is no secondary pressure of fuel price rises at the present moment.

In 2004 the euro area reported 8.9 per cent unemployment. Corporations continued to reduce expenditure aiming to increase revenue. Unit labour cost growth rate has been falling steadily for the last two and a half years, this indicator growing by just 1.9 per cent in the third quarter of 2004 on an annual basis: considerably below this period's inflation rate. The employment component of most current indicators decreased in the last few months owing to worsened euro area economic environment.

Chart 14

Consumption Trends in Germany (on an Annual Basis)

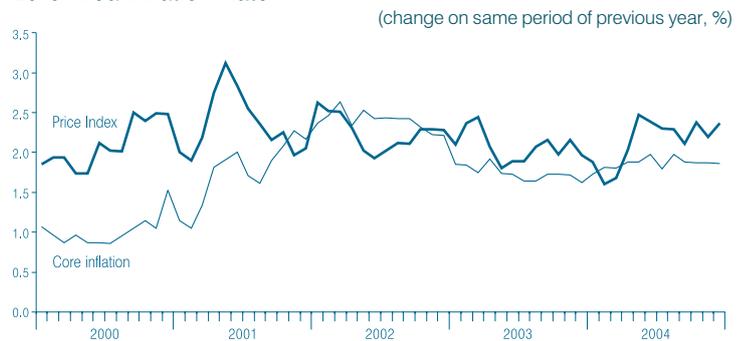


Source: Bloomberg.

...there is no secondary pressure of real price rises on the price level at the present moment ...

Chart 15

Euro Area Inflation Rate

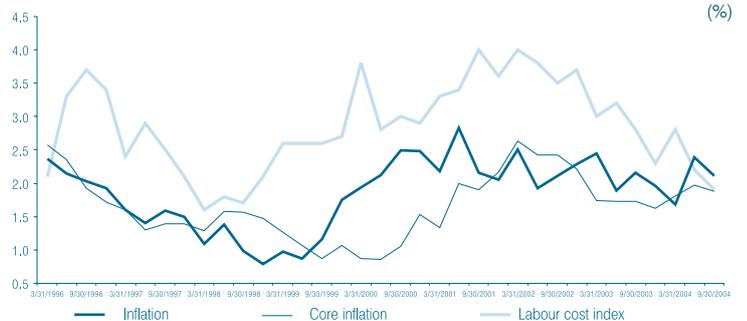


Source: Eurostat.

Note: Euro area core inflation excludes changes in energy, food, alcoholic drinks and tobacco prices.

Chart 16

Euro Area Inflation and Labour Cost (on an Annual Basis)

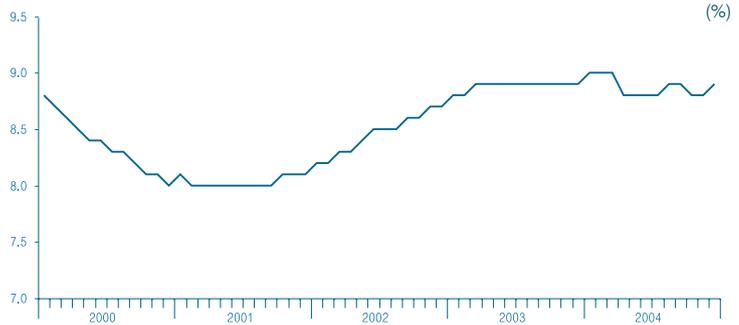


Source: Bloomberg.

Leading economic indicators dropped in the last few months signalling a further slowdown in economic activity. December saw a moderate increase in production and business activity indicators. Nevertheless, major components such as export orders and output expectations posted a decrease.

Euro area economic activity is expected to decline in the first quarter of 2005. Estimates showed that euro appreciation and high crude oil prices would push up the risks of growth slowdown. Recent ECB forecasts were revised downward, with the 2005 growth projected within the 1.4 to 2.4 per cent band.

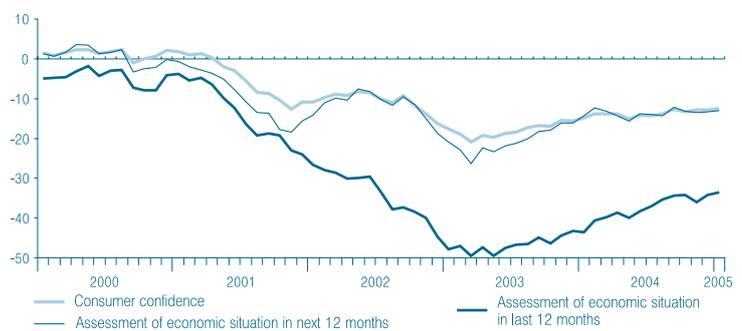
Chart 17
Euro Area Unemployment Rate



Source: Eurostat.

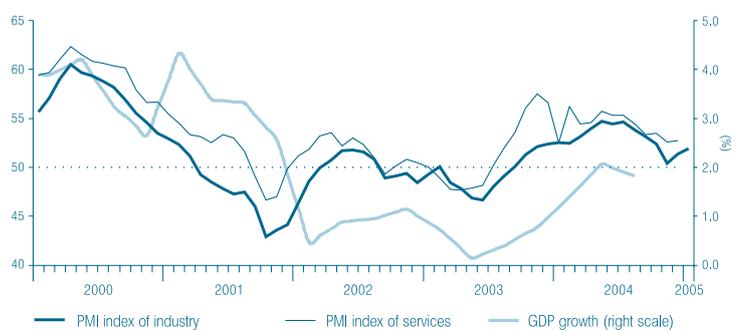
... euro area economic activity is expected to decline ...

Chart 18
Euro Area Consumer Confidence Indicators



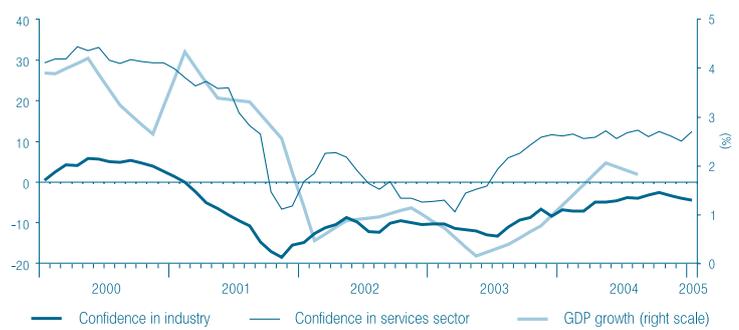
Source: Eurostat.

Chart 19
Euro Area PMIs and Growth



Source: NTC Research.

Chart 20
Euro Area Industry Confidence Indicators and Growth



Source: Eurostat.

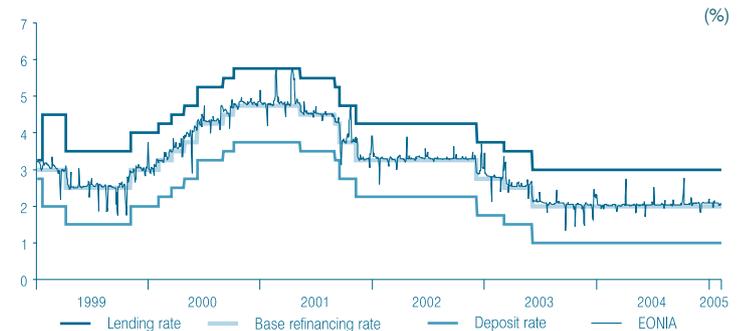
In the fourth quarter of 2004 the securities yield curve reflected the accumulated pessimism concerning economic activity and retention of ECB interest rates at their present levels for a long period. Therefore, the yield on six-month EURIBOR contracts moved within the relatively narrow 2.17 to 2.24 per cent band. Futures markets reflected receding expectations of a change in euro area repo interest rate. The spread between the March futures and the three-month EURIBOR spot showed no probability of a change in the ECB monetary policy until the first quarter of 2005. Market expectations incorporated in the forward yield curve showed by 12 January no possible change in the ECB monetary policy till end-March 2005. The possibility of a euro area interest rate change by mid-2005 measured by futures contracts continued to decrease gradually amounting to some 47 per cent at the present moment. Six-month EURIBOR fluctuations based on market expectations will probably be within the narrow 2.15 to 2.3 per cent band in the first quarter of 2005.

The risks of an unexpected change in monetary policy on the part of the ECB will be influenced by the prospects for generating inflationary pressure. A new rise in oil prices would contribute to inflation growth and secondary pressure on the prices of other commodities and services. Concurrently, the sustained downward trend in unit labour cost keeps inflation low.

Growth in the other EU countries stayed higher than that in the euro area countries, with EU-25 growth coming to 2.1 per cent in the third quarter of 2004 (2.4 per cent in the second quarter). Growth in all newly acceded countries considerably exceeded that in the euro area countries, with Latvia, Lithuania and Estonia reporting the highest growth. EU-25 inflation moved at the same rate as that in the euro area. Inflation in the newly acceded countries was above the average for the euro area. However, it was offset by the low inflation in Denmark, Sweden and Great Britain.

Chart 21

Euro Area Base Interest Rates

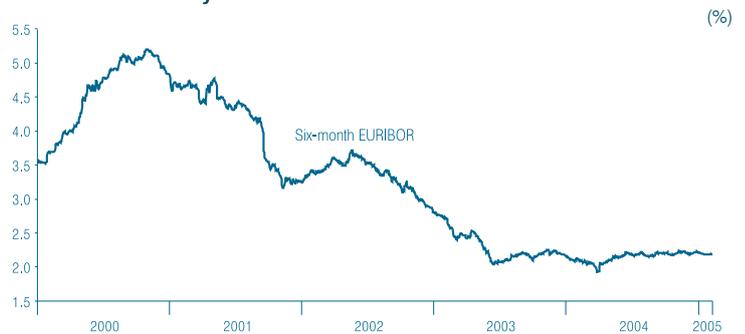


Source: Bloomberg.

...market expectations incorporated in the forward yield curve showed by 12 January no possible change in the ECB monetary policy till end-March 2005...

Chart 22

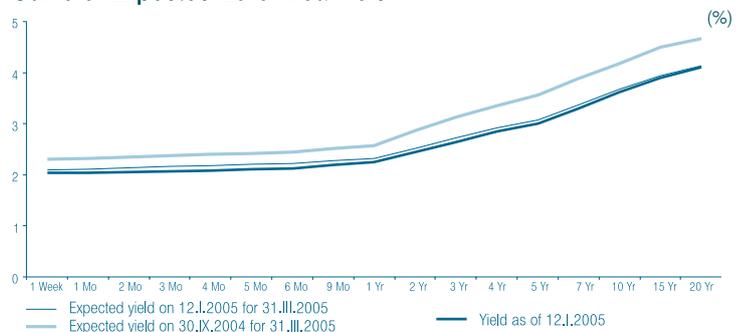
Euro Area Interest Rates on Inter-bank Deposits with Six-month Maturity



Source: Reuters.

Chart 23

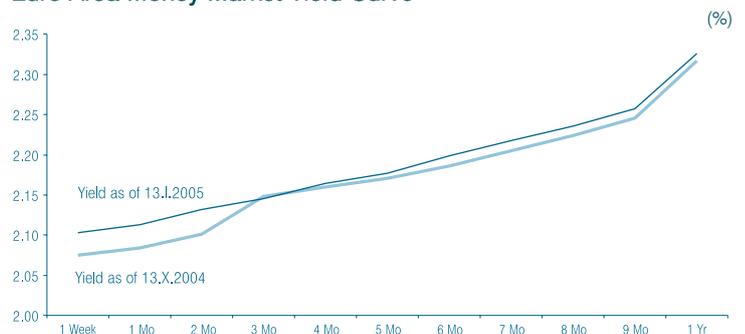
Curve of Expected Euro Area Yield



Source: Bloomberg.

Chart 24

Euro Area Money Market Yield Curve



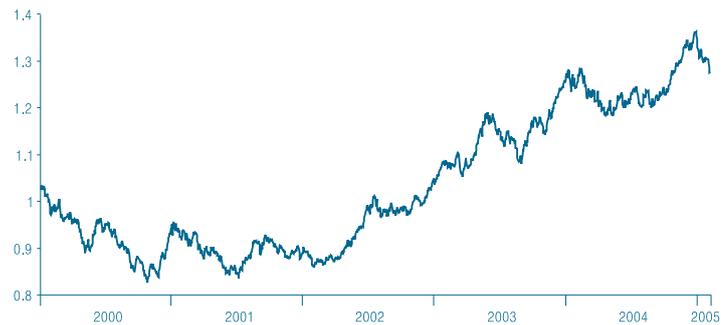
Source: Bloomberg.

The USD/EUR Rate

The fourth quarter of 2004 saw a significant change in exchange rates: the *USD/EUR* rate hit a series of historical maximum values closing the period at higher levels. *USD/EUR* rate fluctuated within the range of USD 1.2280 to USD 1.3470 *per* EUR 1. Concerns about worsening US deficits (fiscal and foreign trade) were the major factors impacting exchange rates. Breaking technical levels and speculations about sales of assets in US dollars by major central banks further backed the euro. At the same time, improving labour market and expectations of higher US interest rates coupled with concerns about possible ECB interventions slowed down the US currency depreciation at moments.

Since the start of 2005 the euro has depreciated, the major factors behind this being high unemployment, reduced investment activity and slower euro area growth. The US dollar appreciation, however, will be limited provided US deficits and capital inflows continue to come as unpleasant surprises.

Chart 25
USD/EUR Exchange Rate



Source: Reuters.

...concerns about worsening US deficits (fiscal and foreign trade) were the major factors impacting exchange rates...

The Balkan Region

In the third quarter of 2004 Romania posted the highest growth in the region. Agricultural sector was the major contributor to Romanian economic growth (19 per cent real growth over the nine months). Turkey reported moderate economic growth rates after the slowdown in the leading sectors (industry and trade). Data on industrial output of the countries in the region indicated enhanced industrial growth following the weaker third quarter.

Inflation rates accelerated over the last months of 2004. However, in December the trend started reversing. As a whole, the region reported moderate inflation.

We expect economic activity on the Balkans to stay high in the first half of 2005.

Table 1

	2003				2004				(%)
	I	II	III	IV	I	II	III	IV	
Growth (on the previous year)									
Bulgaria	3.5	4.2	4.4	4.9	5.3	6.0	5.8	:	
Croatia	4.9	5.0	3.9	3.3	4.2	3.8	3.6	:	
Greece	4.7	3.8	4.3	4.3	4.0	3.9	3.8	:	
Macedonia	2.1	3.1	5.6	2.1	-3.6	:	:	:	
Romania	8.4	4.2	3.2	4.1	6.1	7.1	11.1	:	
Turkey	8.1	3.9	5.5	6.1	10.1	13.4	4.5	:	
Inflation (as of end of quarter)									
Albania	1.9	3.8	2.8	2.9	4.0	2.9	2.0	2.2	
Bosnia and Herzegovina	0.0	1.5	1.4	1.1	0.6	-0.5	-1.5	-1.0	
Bulgaria	-0.2	1.2	3.6	5.6	6.2	7.3	6.3	4.0	
Croatia	2.2	1.6	2.0	1.7	1.4	2.5	1.5	2.7	
Greece	3.9	3.6	3.3	3.1	2.9	3.0	2.9	3.1	
Kosovo	0.0	1.2	0.5	1.6	0.2	1.1	-1.4		
Macedonia	-0.3	0.8	2.0	2.6	1.4	-0.2	-1.8	-1.9	
Serbia and Montenegro	11.4	13.1	7.6	8.1	8.7	10.7	13.2	13.3	
Romania	17.1	14.0	15.9	14.1	13.1	12.0	11.1	9.3	
Turkey	29.4	29.8	23.0	18.4	11.8	8.9	9.0	9.3	

Source: Statistical institutes and central banks of respective countries.

International Prices of Major Raw Materials, Crude Oil and Gold

Crude Oil

Brent was traded at USD 44.2 *per* barrel on average in the last quarter of 2004, some USD 4 below the forecast. Price fluctuations were quite dynamic: after reaching USD 49.8 *per* barrel in October, the price dropped to USD 39.6 *per* barrel in December.

Major factors affecting oil prices at end-2004 were large fuel reserves in the USA and OECD, and mild weather at the close of 2004 which weakened the pressure of raw material demand on prices.

The fourth quarter of 2004 saw a dramatic drop in risk premiums due to global uncertainty. The risk of irregular deliveries from Russia decreased significantly since Yukos' restructuring did not lead to a slump in associated production facilities and hence to serious losses for the company's exports. Market tension subsided following the end of the strikes in Nigeria and Norway, while petroleum platforms in the Gulf of Mexico, damaged by Hurricane Ivan, recovered a great part of their capacities in relatively short terms.

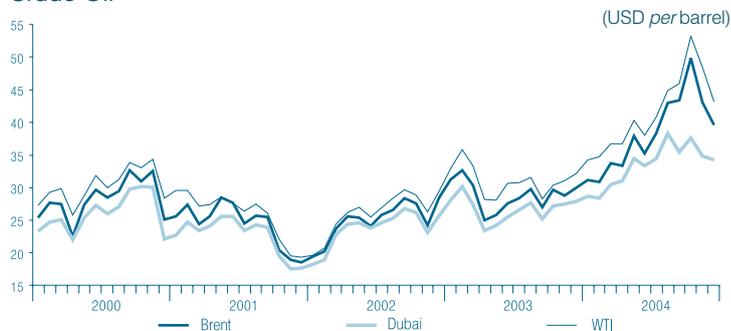
In January 2005 oil prices rose again and Brent reached USD 46 *per* barrel, the major reasons being the cold spell in the Northern Hemisphere and the statements of some OPEC members about their decision to decrease supply.

We expect Brent to start depreciating gradually and its price to fluctuate in the corridor of USD 40 to USD 44 *per* barrel in the first quarter and USD 38 to USD 41 *per* barrel in the second quarter of 2005.

OPEC basket crude oil price in euro averaged EUR 31 *per* barrel in the fourth quarter of 2004, staying above the corridor of EUR 22 to EUR 28 *per* barrel for a second consecutive quarter. The slight depreciation on the previous quarter reflected considerable appreciation of the European currency against the US dollar whose impact was stronger than the appreciation of this raw material in US dollars. Given our *USD/EUR* exchange rate forecasts for the first half of 2005, we expect the average price to return to the corridor of EUR 22 to EUR 28 *per* barrel in the second quarter of 2005 and to be some EUR 28 to EUR 30 *per* barrel in the first quarter.

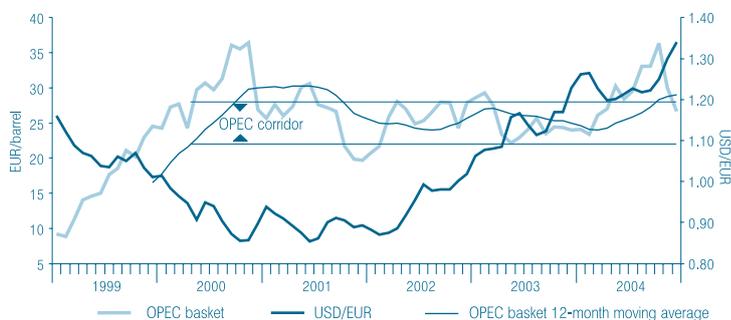
...crude oil prices decreased at the close of 2004 after the October historical maximum...

Chart 26
Crude Oil



Source: World Bank.

Chart 27
OPEC Basket Price in Euro



Source: World Bank, ECB, BNB, OPEC.

...given our *USD/EUR* exchange rate forecasts for the first half of 2005, we expect the average price to return to the corridor of EUR 22 to EUR 28 *per* barrel in the second quarter of 2005 ...

Major Raw Material and Commodity Prices

At end-2004 steel prices remained stable in line with our expectations. Enhanced demand for this raw material led to a record high in steel production in 2004: 1.05 billion metric tons, which exceeded production in 2003 by 8.9 per cent. China was the major contributor (5.2 percentage points) followed by the USA, Russia, Turkey and Japan. Over the last quarter non-ferrous metals (aluminium, lead and zinc) also appreciated, their prices reaching values above the March peaks. Metal prices are expected to retain their October to December 2004 levels in the first quarter of 2005 and to start falling gradually in the second quarter.

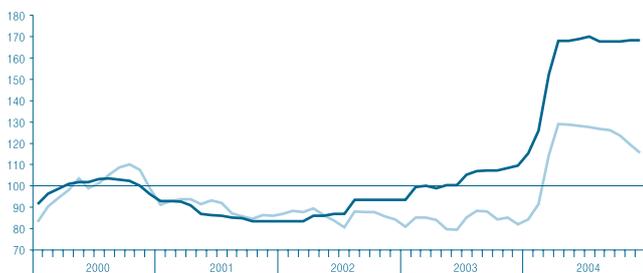
Food prices also moved within the anticipated bounds staying at third-quarter levels. The effect of good cereals harvest was gradually exhausted and their prices slightly rose by the close of 2004. We anticipate no significant changes in food prices over the first half of 2005.

...food and metal prices moved within the anticipated bounds staying close to third-quarter levels...

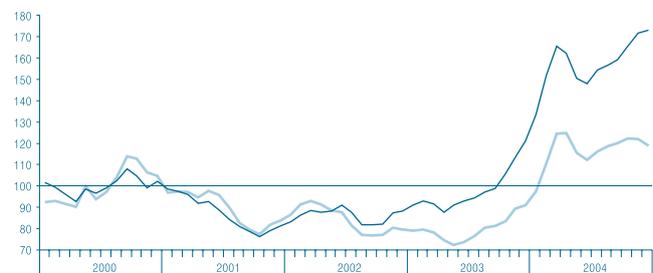
Chart 28

Price Indices of Major Commodities and Commodity Groups

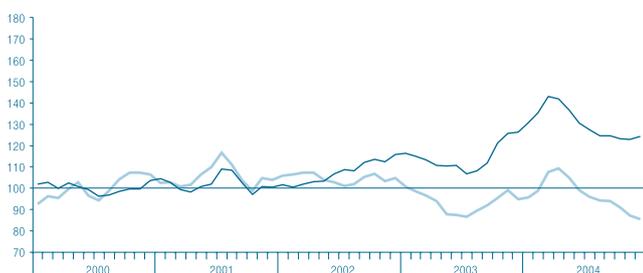
Steel (2000 = 100)



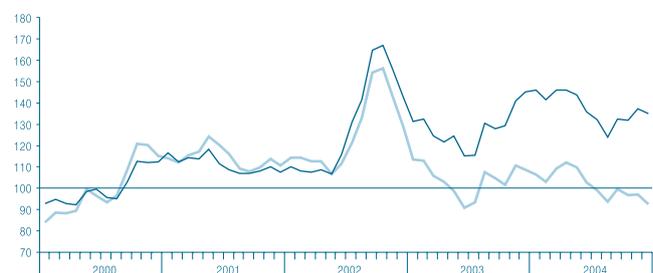
Copper (2000 = 100)



Food (2000 = 100)



Wheat (USA, HRW) (2000 = 100)



— USD

— EUR

Source: World Bank.

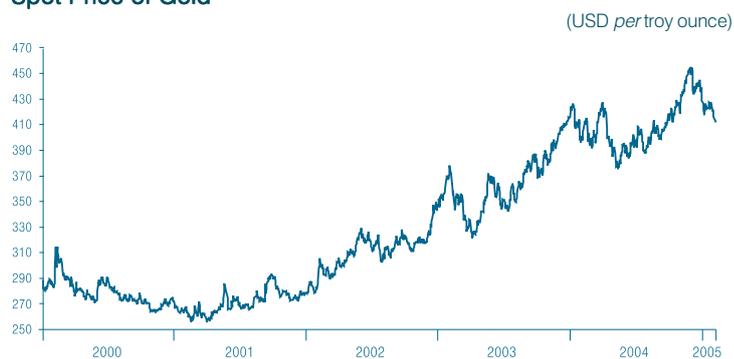
Gold

In the last quarter of 2004 the gold price rose, posting a series of 16 annual highs. The price moved within the quite wide range of USD 413 to USD 456 *per* 1 troy ounce showing a pronounced upward trend till end-November.

Retail investors' interest in gold was boosted by the starting on the New York Stock Exchange of the trade in investment instruments collateralised by gold whose price matches closely the gold price. The new instruments broadened the range of market participants, including more individual investors and pension funds. A set amount of gold (one tenth of an ounce) deposited at a financial institution shall be allocated to each security. Thus withdrawal of a certain amount of physical gold from the market and decreased supply are expected. In addition, this instrument will be much more convenient to end-use consumers. According to market analysts, institutionalization of investment in gold was the major reason for the gold price rise.

In the coming quarters the gold price will be affected by its technical link with the US dollar, the revaluation of the IMF gold reserves and the reduced supply on the part of gold production companies. The gold price is expected to move within the range of USD 410 to USD 470 *per* 1 troy ounce. Interest rates on gold deposits will stay at their record low levels as market supply is absolutely sufficient and comes chiefly from the official sector. The trend to reducing hedging positions by producers continues.

Chart 29
Spot Price of Gold



Source: Bloomberg.

...interest rates on gold deposits will stay at their record low levels as market supply is absolutely sufficient ...

Bulgarian External Debt on the International Financial Markets

Narrowing of the Bulgarian external debt spread measured by EMBI+ emerging market spread continued in the last quarter of 2004. The strong interest in Bulgarian government securities was boosted by the stable macroeconomic environment in Bulgaria and the officially declared intention of the Bulgarian government to buy back bonds to the amount of USD 937 million. The fall in the *government debt to GDP* ratio to 38.9 per cent (41.3 per cent in the previous quarter), prompted by this operation, was assessed positively by international investors.

In the first quarter of 2005 market participants' interest in Bulgarian government securities will be supported by both the prospects of global and local economic activities, and the local political situation. The sustained trend of rising interest rates in the USA will contribute to the weakening of the interest in emerging markets and broadening of their government securities spreads. According to analysts, the fact that debt is traded very expensively signals the decreasing of the risk in these countries. At the present moment it is difficult to assess to what extent this was caused by fundamental factors, albeit existing concerns. As for Bulgaria, the risk of a reversal will be restricted owing to the investment credit rating and the stable economic basis.

Current Bulgarian external debt prices are high, hence their further appreciation is most unlikely.

...narrowing of the Bulgarian external debt continued...

Chart 30
Spread of JP Morgan Index for Emerging Markets



Source: Bloomberg.

2. Financial Flows, Money and Credit

In Bulgaria, the economic development reflects complex interaction between external and internal factors. The external environment directly affects the economic activity through foreign trade and indirectly through foreign investor interest which drives balance of payments financial flow dynamics. Internal structuring of financial flows depends on commercial bank intermediation and budget's influence on banking system liquidity. Flows prompting changes in international reserves are formed in the process of interacting between external and internal economic agents.

Table 2
Cash Flows Which Prompted Significant Changes in Gross International Reserves

	October – December, 2004	Total, 2004
A) Purchases and sales of reserve currency (million EUR)		
- Net purchases by commercial banks	EUR +331 million	EUR +1428 million
- Revenue (outflows) related to net purchases (sales) at tills	EUR -3 million	EUR +25 million
B) Changes due to revenue on commercial banks' minimum required reserves accounts in foreign currency	CHF +20 million EUR +88 million USD -70 million	CHF +223 million EUR +96 million USD + 24 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	Revenue: USD +315 million – revenue from released (and sold) security on Brady bonds. Payments on government external debt: SDR -29 million.	Revenue: USD +315 million – revenue from released (and sold) security on Brady bonds; EUR +184 million – from BTC privatisation; loans: EUR +123 million from the World Bank and SDR +52 million from the IMF; government securities issued by the Ministry of Finance in EUR: EUR +53 million. Payments on government external debt: USD -1007 million, EUR -205 million, SDR -101 million; JPY -4.2 billion; CAD -10 million.

Source: BNB.

Over the fourth quarter of 2004 BNB international reserves picked up and by end-year Issue Department's assets reached BGN 13,241.7 million (EUR 6770.4 million), an increase of 27.5 per cent on end-2003.

...BNB international reserves reached EUR 6770.4 million by end-2004...

Financial Flows and External Position Sustainability

Between January and November 2004 the balance of payments current account deficit came to BGN 2202.3 million (down BGN 184.4 million on a year-on-year basis), with the financial account surplus reaching BGN 3706.2 million.

The *foreign direct investment to current account deficit* ratio remained high, with FDI covering 117.1 per cent of the deficit¹ between January and November. Over the third quarter the quarterly deficit coverage went up to 107.5 per cent on an annual basis, after being below 100 per cent in prior quarters.

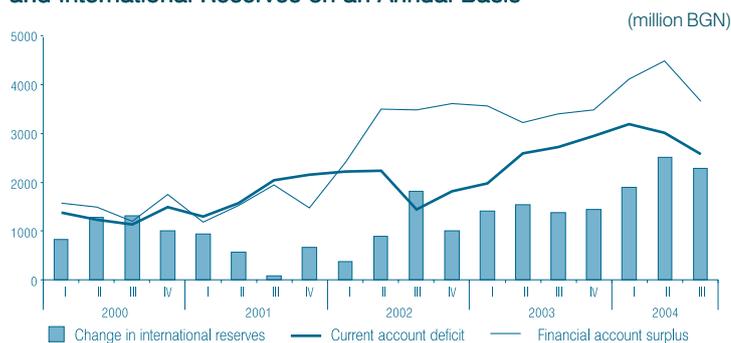
Current account deficit financing by foreign direct investments proved to be a stable source of finance. Insofar as a portion of FDI forms obligations included in the external debt, gross external debt dynamics became another important indicator of Bulgaria's external position assessment.

Over the second half of 2004 gross external debt stabilised at EUR 12,100 – 12,200 million following its high rate over the first half-year. This upward trend coupled with high GDP growth prompted a slight fall in the *Gross external debt to GDP* ratio during the third quarter of 2004 to 63.8 per cent. Simultaneously, external debt components have shown divergent dynamics since early 2004: public sector debt has steadily decreased while private sector debt has increased at high rates.

¹ In the balance of payments published in September 2004, a sub-item indicating mergers and acquisitions (i.e. the transaction with M-Tel) was included within *Foreign direct investments*. Due to the specificity of merger and acquisition transactions, current indicators are calculated on the basis of the *Foreign direct investments* item excluding the balance on the *Mergers and acquisitions, net* item. The transaction with M-Tel mostly affected the *Other sectors* item. Such merger and acquisition transactions affect net foreign direct investment: in this case a significant outflow was reported (foreign direct investment of BGN -1132.9 million over the third quarter). For this reason, it is hard to interpret indicators such as current account deficit coverage by foreign direct investments for the *Other sectors* item. The third quarter saw a negative coefficient of coverage. At the same time, new loans drawn by this sector exceeded BGN 1.2 billion, with over 80 per cent of them related to this transaction.

Chart 31

Dynamics of Current Account, Financial Account and International Reserves on an Annual Basis

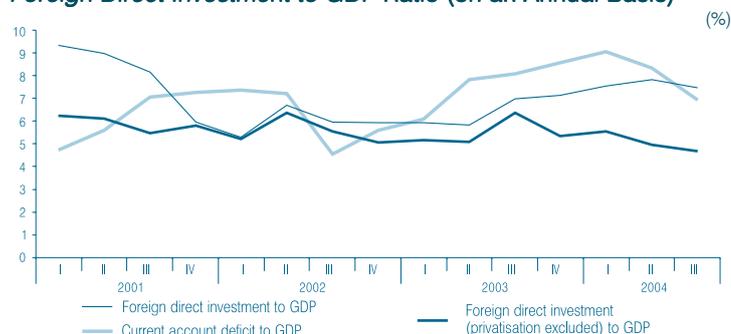


Source: BNB.

...foreign direct investments covered the current account deficit...

Chart 32

Dynamics of the Current Account Deficit to GDP Ratio and the Foreign Direct Investment to GDP Ratio (on an Annual Basis)

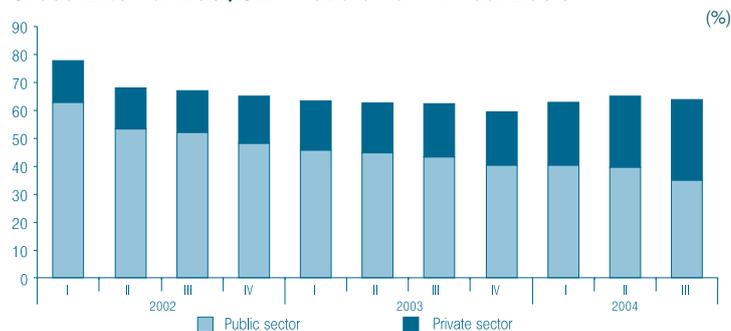


Source: BNB, NSI.

...gross external debt stabilised over the second half of 2004...

Chart 33

Gross External Debt/GDP Ratio on an Annual Basis



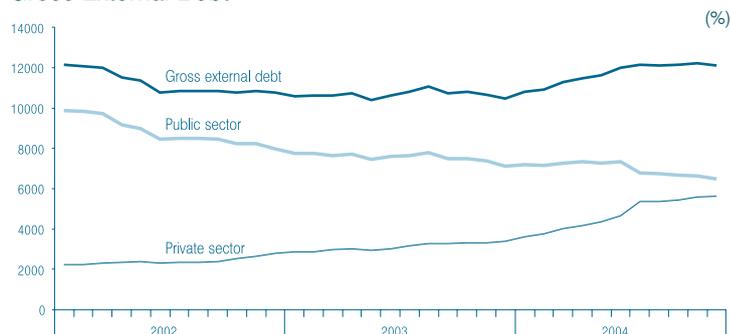
Source: BNB, NSI.

As of November 2004 public sector occupied the largest share of 53 per cent in the external debt structure. Yet, it fell by some 16 percentage points on a year-on-year basis as a result of the policy targeted at government debt reduction. Increased private debt's share in gross external debt reflected larger debt of private commercial banks (from 6 per cent to 11 per cent between November 2003 and November 2004) and of private commercial firms (from 25 per cent to 36 per cent).

Banks' external obligations rose most dynamically over 2004, with their share in private sector's gross external debt increasing from 18.2 per cent in November 2003 to 23.6 per cent a year later. Non-residents' deposits contributed most to this increase, with resources extended to resident banks by foreign owners comprising the significant share. The increased debt of private commercial firms (by 59.4 per cent on an annual basis) is due to largely to the intra-company loans, a portion of foreign direct investments. However, the *Other loans* item contributed most significantly to this growth. Obligations on trade credits also grew in line with buoyant internal activity and increasing imports of goods.

...private sector's external obligations continued to rise...

Chart 34
Gross External Debt



Source: BNB.

Table 3

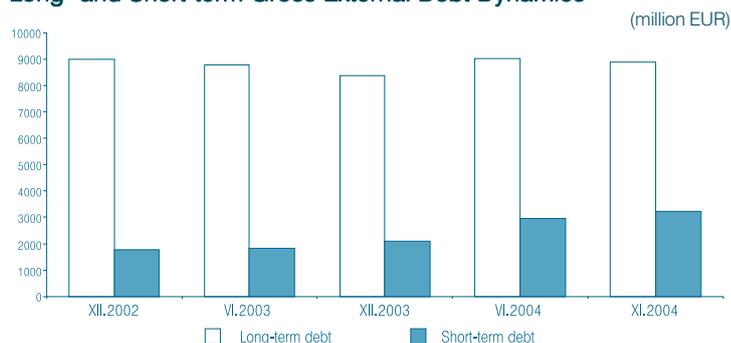
Debt Dynamics of Private Commercial Banks and Private Commercial Firms

	November 2003 (million EUR)	November 2004 (million EUR)	Change (%)	Contribution (percentage points)
Private commercial banks	601.5	1331.3	121.3	
Loans	165.9	476.9	187.4	51.7
Non-residents' deposits	435.6	854.4	96.1	69.6
Private commercial firms	2702.5	4309.0	59.4	
Intra-company loans	1024.9	1646.7	60.7	23.0
Other loans	816.8	1500.6	83.7	25.3
Trade credits	858.0	1158.8	35.1	11.1

Source: BNB.

Risk assessments associated with external debt are based on the following indicators: the debt term, interest rate structure, foreign exchange structure. The increase in short-term debt reported since early 2004 continued during the second half-year. Approximately 70 per cent of the overall debt growth in November on end-2003 was attributable to the short-term debt. Over 40 per cent of it was comprised of trade credits and intra-company loans which are supposed to be related to the robust economic activity and more intensive foreign trade turnover.

Chart 35
Long- and Short-term Gross External Debt Dynamics



Source: BNB.

According to data on non-guaranteed external debt's interest rate structure by financial instrument, long-term loans with floating interest rates comprised 42 per cent and those with fixed rates 14.4 per cent as of September 2004. Short-term loans showed a similar interest rate structure: loans with floating interest rates occupied 16.5 per cent and those with fixed rates 8.5 per cent. The remaining 18.6 per cent of loans (long-term and short-term) were non-interest-bearing and unclassified. The interest rate structure of financial loans bears some risk for their servicing in case of fast and dramatic rises in international interest rates.

External debt's currency structure was a factor driving risk diminution. As of November 77.5 per cent of private commercial banks' debt and 73.6 per cent of private commercial firms' debt were denominated in euro. The share of USD-denominated debt of commercial firms was larger (24.5 per cent) while private banks' debt was diversified, with 7.9 per cent of it denominated in US dollars. Hence, under the existing currency board regime the private sector is relatively protected against foreign exchange risk stemming from external obligations.

Table 4
Selected External Debt Indicators

	XII	XII	VI	VII	VIII	IX	X	XI
	2002	2003	2004					
Short-term debt/exports of goods and non-factor services	20.7	22.1	29.6	29.2	28.5	28.5	29.4	29.0
Short-term debt/GDP	10.7	11.9	16.1	-	-	16.1	-	-
Short-term debt – intra-company loans – trade credits/exports of goods and non-factor services	5.5	8.4	12.3	12.5	11.8	11.7	12.7	12.6
Private sector debt/exports of goods and non-factor services	32.9	35.7	46.4	52.0	51.1	50.9	51.4	50.8

Source: BNB.

In 2004 selected debt indicators presented in the Table worsened on previous years. The slight increase in November is still early to present as a trend toward a long-term improvement in these indicators. They are assessed only in a comparative perspective, and no conclusions about external debt sustainability (an indicator linked to the country's ability to service its debt in medium and long term) could be made on this basis. According to current forecasts of the Bulgarian economic development and international environment, no concerns about the normal service of Bulgaria's external debt in short and medium term exist.

Over the first quarter of 2005 the current account deficit is expected to improve or at least to remain close to first quarter 2004 levels. Following the January 2005 Brady bond buy-back, the government deposit and BNB international reserves went down by nearly BGN 1.5 billion. Over the second quarter the current account deficit is anticipated to range between BGN 500 and 550 million, down EUR 50–70 million on a year-on-year basis. If the trends in financial account flows sustain, the change in BNB international reserves will match that reported in the second quarter of 2004.

Commercial Bank Intermediation

Net financial resources on the balance of payments are distributed between economic sectors through the banking system and affect monetary and credit aggregate dynamics and structure. Over the last three months of 2004 commercial banks' investment in foreign assets posted an increase of BGN 1008.1 million, up BGN 1473 million since early 2004. Meanwhile, funds borrowed from non-residents continued to rise dynamically. During the fourth quarter of 2004 banks' obligations to non-residents grew by BGN 2285.8 million, with the increase reaching BGN 3367.8 million annually. In December a portion of the increase in foreign liabilities and assets came from energy distributing companies' privatisation and had a temporary effect.²

Despite dynamically increased foreign liabilities, deposits of households and corporations dominated banks' sources of funding. Deposit growth reflected robust economic activity, confidence in the banking system, as well as enhanced lending. Deposits of households and non-financial corporations rose by BGN 580.2 million and BGN 449.2 million respectively over the fourth quarter and by BGN 2074.8 million and BGN 1083.6 million respectively since early 2004. Banks used their borrowed funds primarily for expanding credit activity. Claims on non-financial corporations rose by BGN 732.6 million over the fourth quarter and by BGN 2574.8 million since early 2004 and claims on households by BGN 567 million and BGN 1872 million respectively.

² In December commercial bank accounts were credited by approximately EUR 550 million coming from energy distributing companies' privatisation. In early 2005 these funds will be transferred on government accounts with the BNB.

... funds borrowed from non-residents continued to rise dynamically...

Chart 36

Foreign Assets and Foreign Liabilities of Commercial Banks



Source: BNB.

Table 5

Changes in Major Balance Sheet Items of Commercial Banks (Quarterly)

	(million BGN)							
	I	II	III	IV	I	II	III	IV
	2003				2004			
Claims on non-financial corporations	255.6	620.2	315.0	630.3	599.9	551.5	690.9	732.6
Deposits of non-financial corporations	-113.6	125.8	245.0	216.6	-170.0	624.6	179.7	449.2
Claims on households	133.6	320.3	318.9	344.2	300.4	500.7	503.8	567.0
Deposits of households	104.4	207.8	375.8	433.8	498.9	486.7	508.9	580.2
Foreign assets	-19.0	-533.6	270.0	-517.9	243.2	428.5	-206.8	1008.1
Foreign liabilities	-26.8	92.9	213.4	325.2	339.3	512.6	230.1	2285.8
Claims on government sector	200.6	-52.6	-47.0	-7.9	190.5	-108.9	42.6	64.6
Deposits of government sector	76.5	226.7	94.2	-50.7	177.8	-239.2	206.1	-64.2
Claims on central government	201.1	-53.7	-57.0	-12.1	188.2	-109.6	42.2	66.9
Liabilities to central government	17.4	222.2	103.8	-12.2	57.4	-212.7	189.7	-70.5

Source: BNB.

No significant changes occurred in the structure of financial flows between banks and other sectors (Chart 37).³ The sizeable increase in borrowed funds by non-residents made the external sector a net source of funds for the banking system. Non-financial corporations were the main net consumer of funds: their indebtedness continued to increase indicating faster growth of their loans compared with deposited funds. Even though loans to households also grew rapidly, households' financial position toward commercial banks remained relatively unchanged.

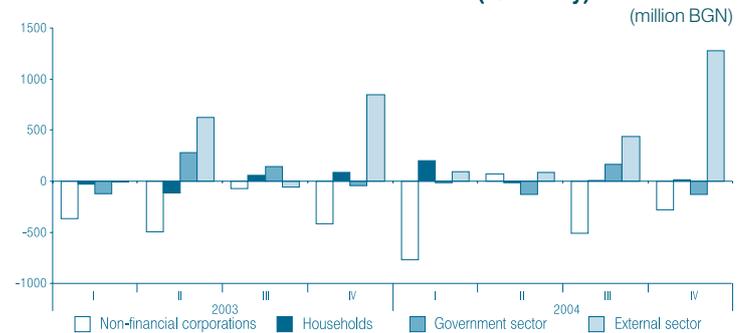
Redistributive Role of the Consolidated State Budget

The state budget affects overall liquidity in the economy through primary balance and depositing budget surpluses and receipts with the BNB. Between January and September 2004 net cash flows between the consolidated budget and the non-government non-bank sector accounted for -3 per cent of GDP, i.e. the budget continued to withdraw liquidity from households and firms. The seasonal character of these flows remained unchanged on the prior year. However, fiscal restriction was higher over the first half-year. In the second half of 2004 over-performance of tax revenue (primarily from indirect taxes) and Council of Ministers' decision to make additional expenditure on the account of the republican budget, worth BGN 263 million, decreased restriction to the average level reported in recent years. At the outset of 2005 fiscal restriction is expected to stay at relatively high levels based

³ Financial flows are determined on the basis of differences in the balances on the corresponding banks' balance sheet items.

Chart 37

Net Financial Flows of Commercial Banks (Quarterly)



Source: BNB.

on the assumption that the undertaken and expected discretionary measures of the Government regarding non-interest expenditure would be insufficient to offset the increasing cyclical growth of tax revenue.⁴

The pre-term repayment in July of DISC principal in the amount of USD 679.3 million changed the profile of flows between the budget and external sector. This transaction affected budget organisations' deposits with the BNB prompting a fall over the third quarter. This fall would be greater if some BGN 464 million were not transferred to budget organisations' accounts from other depositors' accounts as a result of commencing voluntary liquidation of the Bank Consolidation Company. The pre-term repayment of IAB principals scheduled for January together with revenue from energy distributing companies' privatisation⁵ are the major factors which are expected to influence both budget interaction with the external sector and government deposits with the BNB.

Monetary Aggregates

Over the fourth quarter reserve money growth accelerated further to reach 34 per cent on an annual basis. Commercial bank deposits with the BNB contributed most significantly to monetary base growth posting an increase of 103 per cent on end-December 2003. Reasons for this growth stemmed from banks' behaviour: 1) a dramatic rise in their funds with the BNB associated with reporting liquidity requirements to banks acting as government securities primary dealers, and 2) amendments to Regulation No. 21 on the minimum required reserves adopted by the BNB and enforced over the second half-year.⁶ Following these measures, the BNB continued withdrawing liquidity from the banking system with the intention to limit lending growth.

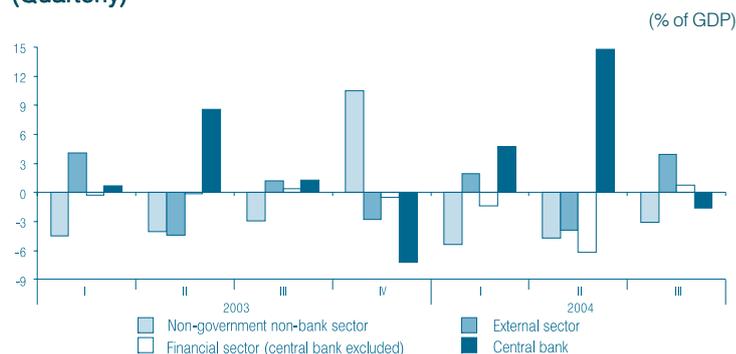
⁴ At the close of 2004 a new Public Investment Projects company (with a capital of BGN 340 million) was established for capital expenditure financing. The transactions of this company will be quasi-fiscal and will hamper the precise assessment of the fiscal position over 2005.

⁵ On 30 November 2004 government deposit with the BNB was credited by USD 266 million from the sale of US Treasury securities serving as collateral on DISCs. In the beginning of January 2005 a portion of contracted payments on transactions of energy distributing companies' privatisation was transferred to the BNB. By end-January the whole principal on IABs, worth USD 937.5 million, was repaid before the term set.

⁶ The latest amendments to this Regulation entered into force in December providing for eight per cent minimum required reserves (instead of four per cent) on long-term borrowed funds. Furthermore, cash balances and ATM funds shall be excluded from reserve assets.

Chart 38

Influence of Consolidated State Budget on Other Sectors Liquidity (Quarterly)



Source: MF, BNB.

...in December reserve money growth accelerated further to reach 34 per cent on an annual basis due to the increase in commercial bank deposits...

Table 6

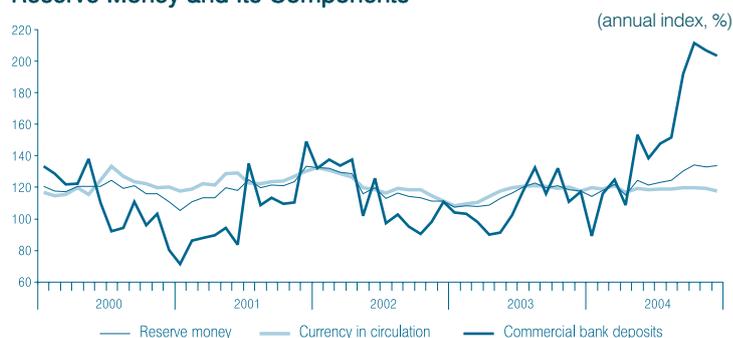
Change in Average Daily Deposits of Commercial Banks with the BNB between June and December 2004 by Source

	(million BGN)
Change in minimum required reserves	657
of which	
Effect of exclusion of cash balances from reserve assets	323
Effect of introduction of eight per cent rate on deposits of over two years	144
Effect of the change in deposit base	190
Change in excess reserves	34
Change in commercial banks' deposits with the BNB, total	691

Source: BNB.

Chart 39

Reserve Money and Its Components



Source: BNB.

At the close of 2004 the average daily amount of minimum required reserves maintained with the BNB by banks rose by BGN 657 million on June, with the bulk of this growth (BGN 467 million) reflecting amendments to Regulation No. 21. Enforced measures did not lead to expected results by end of year: credit growth was high despite the significant resources withdrawn from the banking system. Since demand for credit remained high, banks compensated higher reserves effect by attracting funds mostly from abroad.

Growth rate of currency in circulation, another component of reserve money, slowed down on prior months to 17.7 per cent, or by two percentage points. Nonetheless, demand for currency in circulation remained high in line with robust economic activity.

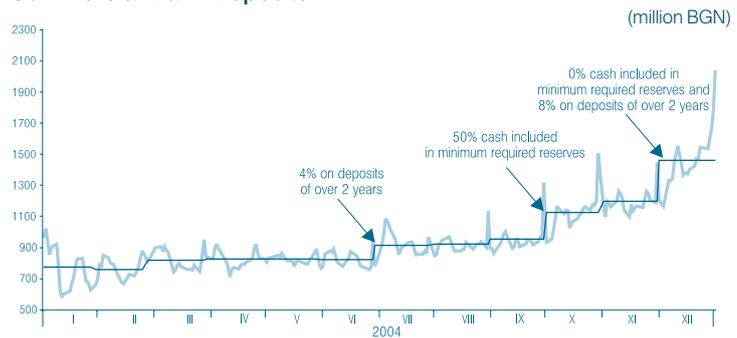
Increased preferences for liquidity are shown in overnight deposit dynamics (an increase of 36.4 per cent on an annual basis) with lev overnight deposits growing by 40.8 per cent. Trends to outstripping growth of these deposits compared with other components of broad money reflected changes both in the financial sector and economy as a whole. The stable macroeconomic environment and the upsurge in domestic demand involved higher nominal cash balances of households and firms due to the transaction motive behind the demand for money. Chart 41 displays the positive (albeit not so strong) correlation between the change in the nominal GDP and the increase in M1, the most liquid component of money supply.

Relatively low interest rates on time and savings deposits also backed the strong growth of highly liquid money. As far as investments in securities remained low (despite the sizeable increase in stock exchange turnover in 2004), holding cash or non-interest-bearing deposits had a low opportunity cost and this certainly prompted portfolio shifts to these assets.

An important factor behind lev overnight deposit dynamics was the extended scope of the BORICA card payment servicing system.

The increased number of issued cards and effected transactions are comparable with lev overnight deposit growth. Newly installed POS terminals almost doubled which is indicative of the increasing role of non-cash payments in the economy.

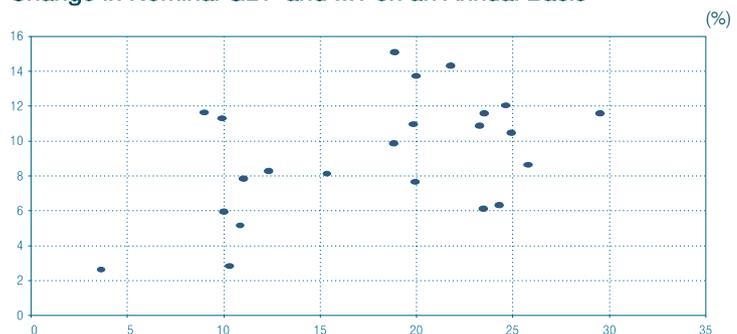
Chart 40
Commercial Bank Deposits



Source: BNB.

...lev overnight deposits rose by 40.8 per cent on an annual basis...

Chart 41
Change in Nominal GDP and M1 on an Annual Basis



Source: BNB.

Table 7
Number of ATMs, POS Terminals, Cards and Transactions

	2003	2004	Change (%)
Total number of ATMs serviced by BORICA	1222	1753	43.5
Total number of installed POS terminals	3754	6837	82.1
Total number of cards issued through BORICA ('000)	2411	3480	44.4
Total number of transactions serviced by BORICA ('000)	42 006	60 504	44.0
Total amount of transactions (million BGN)	3 630	5 048	39.0

Source: BORICA.

Over the fourth quarter broad money (M3) increased by 8.7 per cent on September, with the M1 monetary aggregate contributing most significantly (5.6 percentage points) to this growth. Quasi-money growth reflected mainly changes in lev deposits, while foreign currency deposits contributed just 0.2 percentage points to money supply growth.

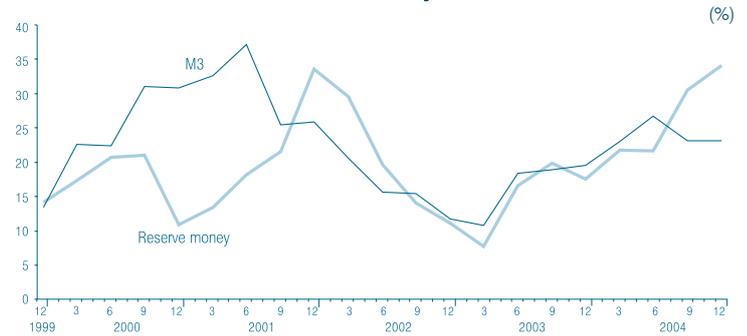
By end-December the annual broad money growth stayed at 23 per cent, almost unchanged compared with the September rate. However, significantly faster growth of reserve money over the last two quarters prompted a fall in the money multiplier to 2.89: the lowest value since April 2000.

Chart 43, together with the published money multiplier values based on monetary aggregates by end-month, displays three alternative multipliers in the assessment of which an attempt has been made to eliminate the calendar effect of bank deposits and excess reserves on monetary base. The alternative multiplier values were higher on the whole, but a clear downward trend emerged in the second half of 2004. The multiplier decline was due to the rise in bank deposits with the BNB following amendments to Regulation No. 21.

Chart 44 exhibits broad money dynamics adjusted by real GDP growth, on the one hand, and inflation. The correlation between the two variables has been relatively high and sustainable. The decline in the M3 growth rate in the third quarter given sustained high GDP growth was accompanied by a fall in the annual inflation. Under the pegged exchange rate and economy's openness, monetary expansion may worsen trade balance and also prompt rises in non-tradable goods and services' prices. Data, however, indicate a weak correlation between money dynamics and prices of services included in the consumer basket (excluding those with controlled prices). When calculating the consumer price index, not all goods and services have been included, especially fast growing prices of houses which rose at a two-digit rate (according to NSI data: 47.5 per cent for 2004).

...broad money increased by 23 per cent on an annual basis, with the M1 monetary aggregate contributing most significantly to this growth...

Chart 42
Annual Growth Rate of Reserve Money and M3



Source: BNB.

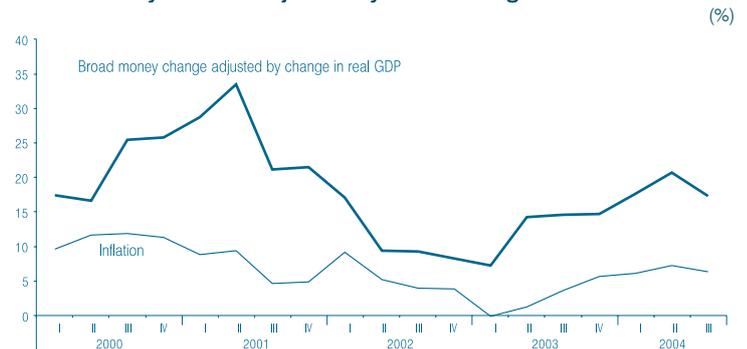
Chart 43
Money Multiplier



Source: BNB.

...withdrawal of liquidity from commercial banks by using changes in minimum required reserves prompted significant declines in money multiplier...

Chart 44
Broad Money Growth Adjusted by GDP Change and Inflation



Source: BNB, NSI.

The velocity of money circulation continued falling with clearly pronounced seasonality. This downward trend may be interpreted as an increase in the part of real income which households and corporations prefer to keep in the form of money. It can be interpreted as a catch up process following the dramatic decline in the *Broad money to GDP* ratio after the financial crisis and may be considered an adjustment to the equilibrium level of this ratio for the Bulgarian economy.

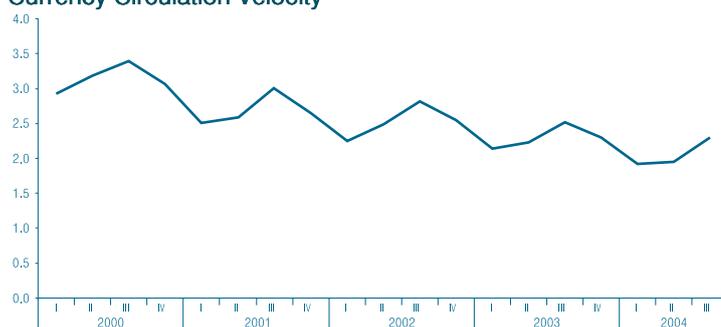
Time and savings lev deposits were the main contributors to changes in quasi-money which rose by six per cent on September. Time lev deposits, the main savings instrument in national currency, increased by 12 per cent over the fourth quarter and deposits redeemable at notice by 15.7 per cent. Over the last three years these were the largest percentage increases on a quarterly basis. Foreign currency deposits showed just the opposite trend. Time foreign currency deposits rose by a mere one per cent and deposits redeemable at notice dropped by 0.9 per cent. This was partially due to revaluation effects stemming from the US dollar depreciation since almost 45 per cent of foreign currency deposits are denominated in US dollars. Summing up, the last year saw significantly faster growth of lev deposits with their share in quasi-money reaching 47 per cent, up five percentage points on end-2003. This is a signal of enhancing confidence in the Bulgarian economy.

Over the fourth quarter households provided the bulk of lev resources to the banking system and their contribution to broad money growth accounted for 1.7 percentage points. Non-financial corporations also increased their funds on accounts with Bulgarian banks. By contrast with previous periods, non-financial corporations' contribution almost matched that of households. Government's deposits decreased due to greater budget expenditure over the fourth quarter.

Interest rates underwent no significant changes during the fourth quarter, save for December when interest rates on time deposits in levs and US dollars slightly fell on November. The fall in deposits in US dollars may be explained by weaker demand for loans in US dollars. Hence, the necessity of attracting deposits in US dollars decreased.

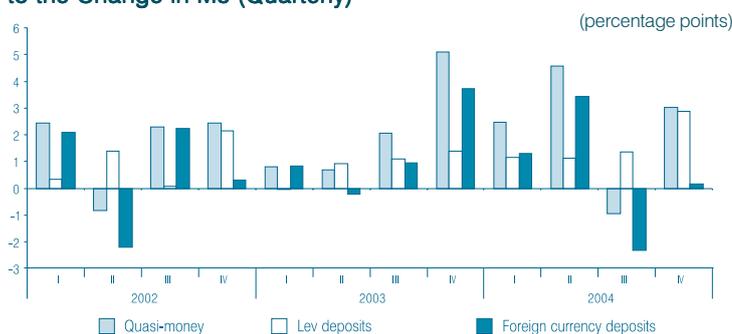
...the velocity of money circulation continued falling ...

Chart 45
Currency Circulation Velocity



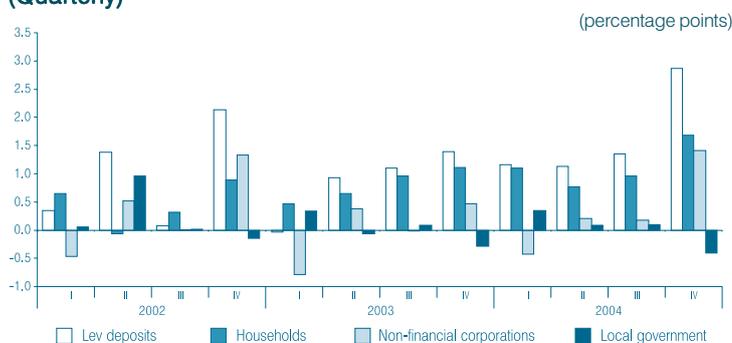
Source: BNB.

Chart 46
Contribution of Quasi-money and Its Components to the Change in M3 (Quarterly)



Source: BNB.

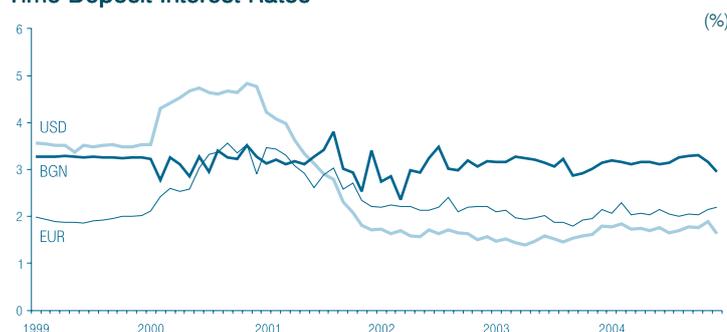
Chart 47
Contribution of Deposits by Economic Sector to the Change in M3 (Quarterly)



Source: BNB.

...interest rates remained stable...

Chart 48
Time Deposit Interest Rates



Source: BNB.

The distribution of interest rates on new one-month lev deposits offered by banks to their customers⁷ changed more significantly. In contrast to September when 27 banks offered deposit rates between two and four per cent, in December such banks numbered 23. On the other hand, four banks (instead of one) offered interest rates between four and five per cent. The variance of the lev deposit rates picked up which is indicative of intensified competition between smaller banks in their striving to attract more customers. As regards deposits in US dollars and especially in euro, differences between individual banks were slighter. No significant changes occurred in long-term deposits' dynamics compared with previous quarters.

Over the first and second quarters of 2005 high growth rates of reserve money (reported in December) are expected to sustain. Broad money may fall slightly: to 22 and 20 per cent over the first and second quarters respectively. Most likely, interest rates on deposits will remain at the current levels.

Credit Aggregates

The rapid growth of borrowed funds in the banking system created conditions for retention of credit aggregates dynamics trends. As a result of banks' active credit policy, the *Claims on non-government sector to GDP* ratio reached 34 per cent over the third quarter, up nearly two percentage points on the second quarter.

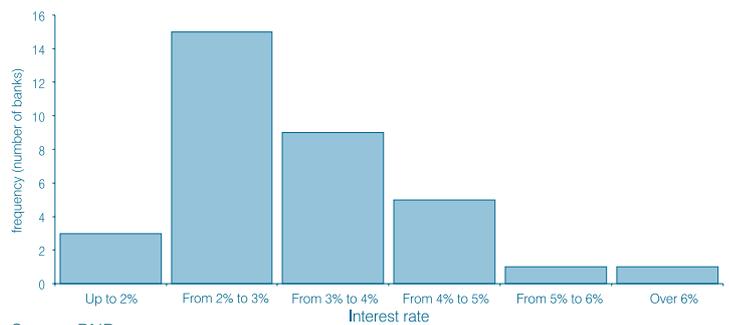
During the fourth quarter domestic credit rose by BGN 1733.4 million (14.4 per cent). Since early 2004 it has increased by BGN 3519.3 million (34.3 per cent) reflecting entirely claims on non-government sector. At the same time, the negative contribution of the government sector to domestic credit changes reflected limited needs for financing by the government.

Claims on non-government sector continued to rise at high rates matching prior months' values. Over the fourth quarter claims on non-government sector increased by BGN 1450.1 million (11.5 per cent). Their annual growth reached BGN 4622.4 million (48.7 per cent). The rapid credit expansion reflected both sustaining high demand for loans by corporations

⁷ Data refer to interest rates applied *vis-à-vis* households and non-profit organisations serving households.

Chart 49

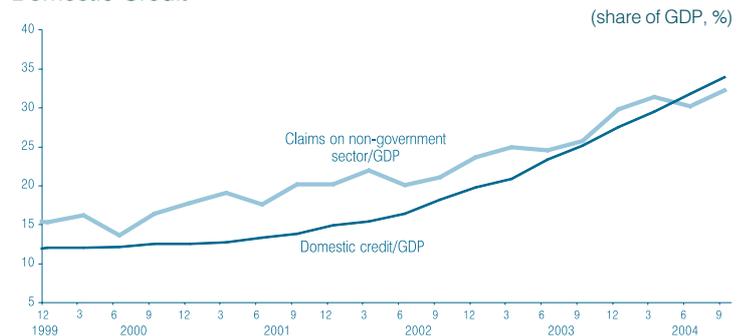
Interest Rate Distribution on Household One-month Lev Deposits



Source: BNB.

Chart 50

Domestic Credit



Source: BNB.

...claims on non-government sector reached 34 per cent of GDP...

Chart 51

Annual Growth Rate of Money Supply and Domestic Credit



Source: BNB.

...claims on non-government sector continued to rise at high rates ...

and households and commercial banks' ambition to expand their market positions by launching new credit products and easing credit conditions.

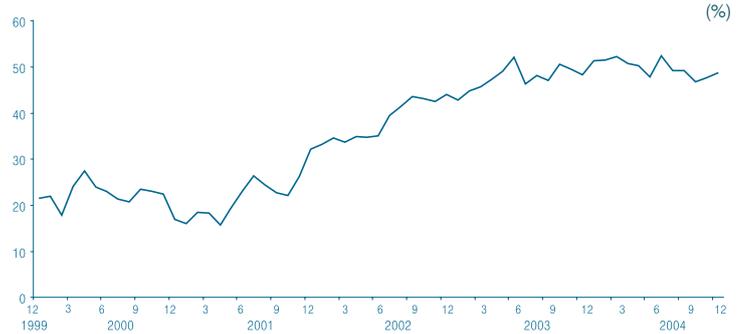
During the fourth quarter no essential changes occurred in lending rates which stayed at their early-year levels. In the following months no significant changes are expected to happen. The opportunities for essential declines in interest rates are reduced by a possible increase in the cost of borrowed funds and banks' investment expenditures. On the other hand, the enhanced bank competition is unlikely to allow for a sizable increase in lending rates.

Amendments to Regulation No. 21 and banks' increased deposits with the BNB, as well as significant external resources attracted by the banking system did not influence banks' cost of funding. This enables them to decrease some of the lending rates or to increase offered deposit rates for expanding their lending.

Over the first half of 2005 claims on non-government sector are expected to increase by some 45 per cent on an annual basis. Although the financial stability is not currently threatened, the retention of high growth rates gives rise to concerns about increasing indebtedness and worsening credit portfolio quality in case of unfavourable movements in the economic environment. A special attention will be paid to lending growth rates. If they do not slow down, the BNB will enforce additional measures to restrict further credit expansion.

Chart 52

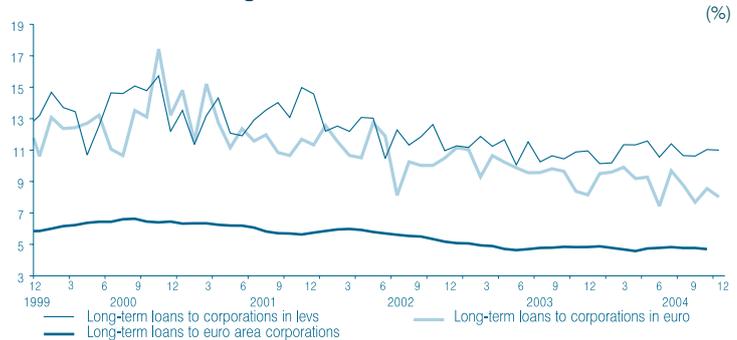
Annual Growth Rate of Claims on Non-government Sector (%)



Source: BNB.

Chart 53

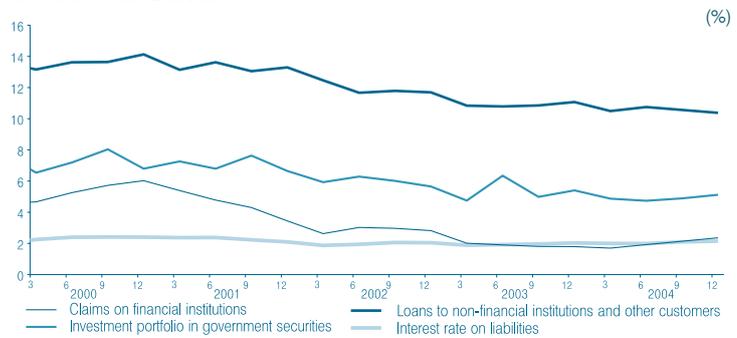
Interest Rates on Long-term Loans in Levs and Euro (%)



Source: BNB.

Chart 54

Assets Earnings and Interest Expenditure on Liabilities of Commercial Banks (%)



Source: BNB.

Table 8
Claims on Non-government Sector (Quarterly)

	Annual growth rate								Growth on the year's start	Structure as of 30 June 2004
	2003				2004					
	I	II	III	IV	I	II	III	IV		
Claims on non-government sector, including	45.7	52.1	47.0	48.3	52.3	47.8	49.3	48.7	48.7	
Claims on non-financial corporations	42.0	46.8	37.7	37.1	41.9	36.3	40.5	38.3	38.3	66.0
Claims on households and non-profit institutions serving households	54.4	68.4	73.0	80.7	84.5	79.6	76.4	74.8	74.8	31.0
Claims on financial corporations	124.8	91.2	150.3	146.8	86.0	107.0	25.8	69.1	69.1	3.0

Source: BNB.

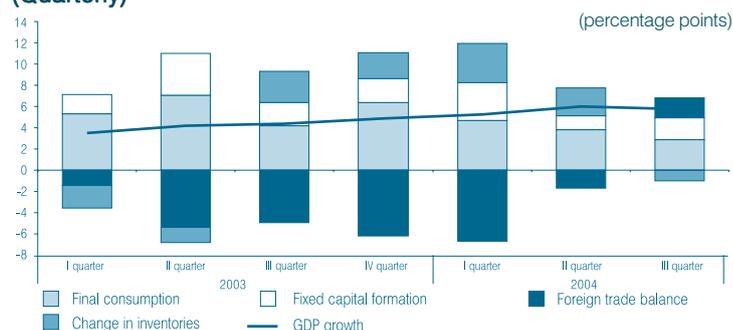
3. Economic Activity

In 2004 the economic activity accelerated, with economic growth reaching 5.8 per cent in the third quarter of 2004. An important factor contributing to this growth was the foreign trade balance of goods and services. According to the expectations, investments in fixed capital posted a real increase by 12.2 per cent and the change in inventories contributed negatively to the growth, thus confirming our statement that accumulation of inventories of unfinished output in construction will result in an increase in long-term tangible assets.

...foreign trade and investments were the factors behind the accelerated growth...

Chart 55

Contribution to GDP Growth by Component of Final Demand (Quarterly)



Source: NSI.

Table 9

Dynamics of GDP Components According to Final Consumption Method

(on corresponding period of previous year, %)

	2003				2004		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Final consumption	5.9	8.0	5.4	7.0	5.2	4.2	3.7
Individual consumption	6.8	8.5	5.4	6.5	4.9	4.3	4.1
Final household consumption expenditure	6.3	9.1	5.1	5.4	5.5	4.9	3.9
Final consumption expenditure of non-profit institutions serving households	4.4	4.8	4.9	0.7	4.4	1.5	0.1
Final government consumption expenditure	12.4	3.8	8.3	14.7	0.1	-1.2	6.6
Collective consumption	-1.9	3.9	5.0	10.2	6.9	3.7	0.2
Gross fixed capital formation	11.6	21.2	13.3	10.0	21.4	6.3	12.0
Exports of goods and services	13.2	11.7	4.0	5.3	8.0	10.9	15.5
Imports of goods and services	13.8	18.3	13.3	14.0	17.7	11.3	12.5
GDP	3.5	4.2	4.4	4.9	5.3	6.0	5.8

Source: NSI.

Behaviour of Households

Households' final consumer expenditure went up by 3.9 per cent compared with the corresponding quarter of 2003. The trend of a slower consumer demand growth was sustained, reflecting to a great extent the progressively increasing comparison base. Non-food items and catering contributed most significantly to consumption growth, and consumption of services appeared to be very dynamic. Accelerated market-based consumption at the expense of declining consumption through unincorporated activities and own production occurred as a new trend in consumer expenditures.

... a slight slowdown in consumer demand...

Table 10
Dynamics of Household Final Consumption Expenditure

	2003												2004					
	I quarter		II quarter		III quarter		IV quarter		I quarter		II quarter		III quarter					
	rate	contri- bution	rate	contri- bution	rate	contri- bution	rate	contri- bution	rate	contri- bution	rate	contri- bution	rate	contri- bution				
Household final domestic consumption expenditure including non-foods	6.0	6.0	8.9	9.6	5.6	6.5	5.4	5.5	5.6	5.7	6.0	6.4	5.6	6.5				
foods	7.1	1.7	13.7	3.4	7.6	1.9	9.8	2.6	13.0	3.1	14.2	3.6	15.3	3.9				
purchased non-produced services	7.9	1.5	11.2	2.4	8.7	1.8	5.6	1.1	4.6	0.9	2.6	0.5	4.3	0.9				
communications	17.5	1.6	15.1	1.2	10.7	1.0	4.9	0.4	3.0	0.3	10.5	0.9	8.5	0.8				
	23.0	1.3	13.4	0.8	12.9	0.8	11.4	0.7	15.0	1.0	11.7	0.7	6.7	0.4				

Source: NSI.

Household budget surveys between October and November and retail trade data confirmed the high rates of consumer demand and structural changes indicating a decline in the share of spending on food and an increase in non-food and services expenditure.

Table 11
Real Growth Rate of Consumption Expenditure *per Household Member*

	2003				2004			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	October–November
Consumption expenditure, total	6.7	6.3	5.1	2.9	4.1	3.1	5.6	4.2
Food	6.8	2.4	2.8	-0.9	2.4	2.9	1.7	1.1
Clothing and footwear	0.2	6.1	9.6	7.1	10.7	7.7	4.3	13.1
Health	14.3	7.6	1.2	13.4	9.0	20.1	20.7	22.5
Transport	12.0	21.5	2.7	5.8	5.4	-2.2	18.7	12.9
Communications	20.2	21.3	18.5	18.8	17.2	9.2	9.1	8.4
Recreation, education and culture	16.5	10.0	8.3	21.1	10.6	6.1	7.2	8.0

Source: NSI.

Table 12
Dynamics of Retail Sale Revenue

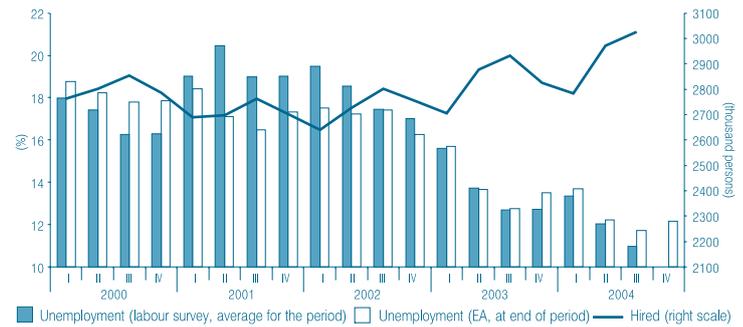
	2003				2004			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	October–November
Retail trade, repair of personal and household goods	3.9	6.3	6.8	7.5	12.9	13.4	13.8	15.9
Food, drink and tobacco products	2.0	5.5	6.3	6.4	11.2	6.4	5.2	7.8
Pharmaceutical and medical goods, cosmetics and toiletry	-0.5	-4.4	-2.0	0.1	11.6	15.0	11.3	9.7
Textiles, clothing, footwear and leather goods	3.6	5.1	4.2	5.4	9.3	15.9	7.4	8.3
Household appliances and radio and television sets	16.0	18.9	18.3	18.1	15.3	20.3	25.4	29.1

Source: NSI.

Increased income prompted a sizable consumer demand. Household incomes rose mostly at the expense of progressively increasing number of employed rather than as a result of an increase in the individual income. Based on NSI labour force survey, employment rose by 3.1 per cent in the third quarter on an annual basis and unemployment went down from 12.7 per cent to 11 per cent for one year.⁸ The bulk of jobs were in *trade, hotels and restaurants, business services, construction and manufacturing* industries, i.e. in sectors where private business prevailed and the salary rose moderately. Based on the System of National Accounts, in the third quarter of 2004 the wage bill posted a rise by approximately ten per cent in real terms on the corresponding quarter of 2003 exceeding significantly the average salary increase (0.2 per cent in the same period).

Chart 56

Status of Economically Active (Population)



Source: NSI, Employment Agency.

Table 13
Employment and Income Dynamics

	2003				2004			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter
Unemployment at the end of the period (Employment Agency data)	15.7	13.7	12.8	13.5	13.7	12.2	11.7	12.2
Employed								
Share on corresponding quarter of previous year	5.4	7.9	7.8	6.0	5.7	5.3	4.9	
Share on previous quarter	3.6	3.6	0.6	-1.9	3.4	3.2	0.2	
Hired (labour survey data)								
Share on corresponding quarter of previous year	2.5	5.5	4.7	2.6	2.9	3.3	3.1	
Share on previous quarter	-1.8	6.3	2.0	-3.7	-1.5	6.7	1.8	
Wage fund, real increase in purchasing power on the corresponding quarter of prior year								
	-3.5	5.4	0.8	7.0	9.8	4.6	9.8	

Source: NSI, Employment Agency – Ministry of Labour and Social Policy.

Increased employment and higher incomes were the factors underlying household optimistic expectations which had a positive effect on households' decision to use loans for financing consumption. Between December 2003 and November 2004 liabilities of households and non-profit institutions serving households to the banking system grew by BGN 1.801 billion, while their assets (including currency outside banks) increased by BGN 2.404 billion.⁹ Irrespective of rapidly increasing household indebtedness, the household sector continued to be a net lender of the economy.

⁸ Developments of registered unemployed followed a similar pattern. By the end of 2004 the Employment Agency reported unemployment to have dropped by 1.3 percentage points on an annual basis to 12.2 per cent.

⁹ We assume that currency outside banks is entirely held by households. Households have also other financial assets which are not reported by the banking statistics but their significance has gradually increased.

Table 14

Liabilities of Households to Banks

(million BGN)

	2000	2001	2002	2003	2004*
Households consumption	18396	20511	22099	23625	25603
Loans, average annual	588	802	1185	1983	3235
Share in consumption	3.2	3.9	5.4	8.4	12.6

* Forecasts.

Source: NSI, BNB.

Based on the household budget surveys, liabilities of households from the last income decile, that is those with the highest income *per* household member, increased at the fastest pace. The share of these households in total loans disbursed in the January – November 2004 period exceeded 50 per cent.

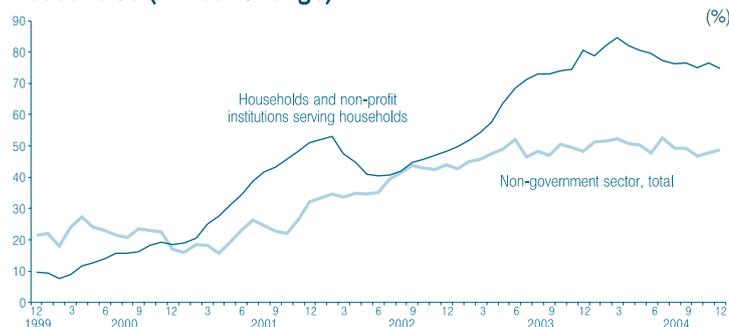
Banks continued to improve their instruments for expanding their positions in lending to households by offering a greater variety of credit products and decreasing interest rates on some types of loans. Growth of household lending stayed relatively high despite the slowdown in recent months. By the end of December loans to households posted a 74.8 per cent increase on an annual basis.

Housing lending remained buoyant. In the last few months consumer loans tended to slow down (on an annual basis), while housing loans appeared to be the most dynamically developing segment of the credit market: the growth rate of these loans accelerated from 126.3 per cent in September to 149.9 per cent by end-December. Rapidly growing housing loans led to an increase in the share of these loans in total claims on households from 15.9 per cent to 22.8 per cent over 2004. Lower interest rates on loans and the buoyant real estate market contributed significantly to the extensive housing lending. However, the high growth rates reflected to a great extent the effect of low base as this credit market segment started intensively developing just in the past year.

Interest rates on loans to households continued to decrease, particularly in housing lending. This is attributable mostly to enhanced competition in the banking system which forces banks to cut lending rates in order to strengthen their market positions in household lending.

The enhanced consumption is expected to sustain its contribution to economic growth in the first half of 2005. Consumer expenditures of households are expected to increase by approximately 4.5 per cent on an annual basis.

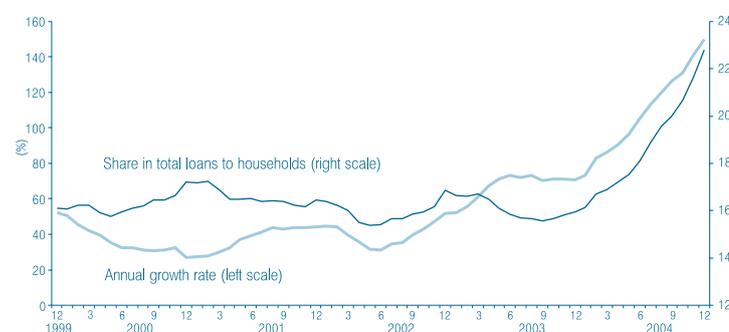
Chart 57

Claims on Households and Non-profit Institutions Serving Households (Annual Change)

Source: BNB.

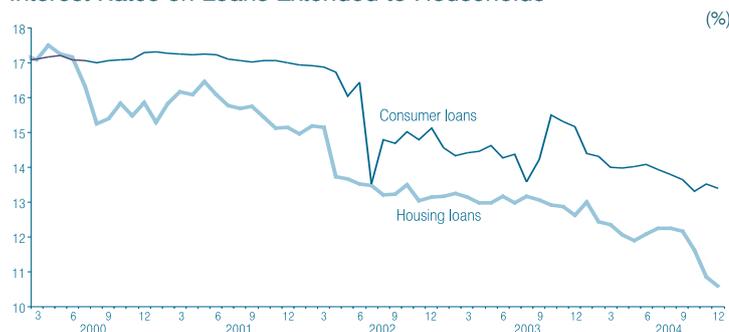
...housing lending remained buoyant...

Chart 58

Housing Loans

Source: BNB.

Chart 59

Interest Rates on Loans Extended to Households

Source: BNB.

Government Finance and Consumption

Since early 2004 government consumption tended to decline within overall economic growth: in the third quarter it went up by 0.5 percentage points. This result matched the dynamics of non-interest expenditures of the consolidated budget which stayed below the previous year's levels. During the first half of 2005 a minimal increase in government consumption contribution to economic growth is expected.

Over the third quarter the primary balance reached BGN 1357 million (3.6 per cent of the 2004 projected GDP). The expected significant cash surplus came true by the end of the year.¹⁰ The overperformance of tax revenue underlying the reported surplus was mostly attributable to significant revenues from consumption taxation. The effective tax and social security burden on the average salary remained unchanged in 2004 and taxes on corporate incomes went down due to decreased corporate tax rate.

The trend of shifting the effective tax burdens, which will lead to an additional cut in the revenue from corporate income taxation and a new rise in the revenue from indirect taxes, is expected to sustain in 2005. During 2005 the tax policy will contribute to curbing the increase in household consumption spending.

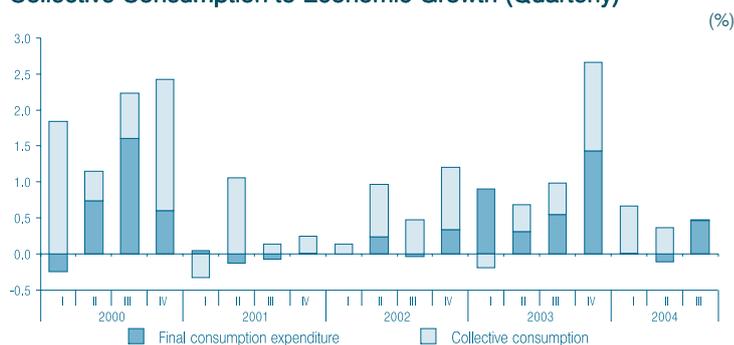
The tax and social security burden¹¹ on the average salary will stay unchanged but in contrast to previous years it will rise for incomes lower than the average salary.

¹⁰ According to preliminary data, the cash surplus of the consolidated budget amounted to BGN 659.7 million (approximately 1.7 per cent of the projected 2004 GDP).

¹¹ Tax and social security burden undertaken by employed persons under the conditions of third category labour is considered, without taking into account the concessions in the event of donation, voluntary pension insurance, voluntary unemployment insurance and tax concessions for children.

Chart 60

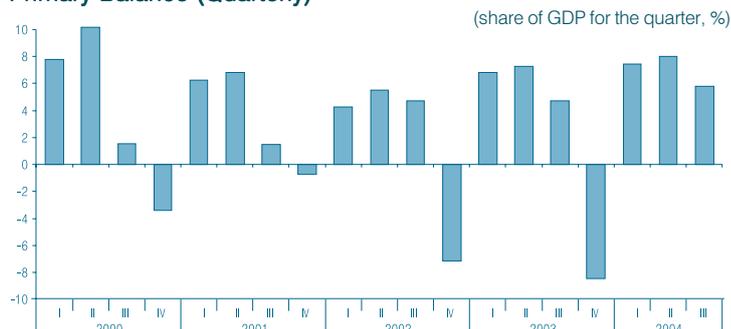
Contribution of Final Government Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)



Source: NSI.

Chart 61

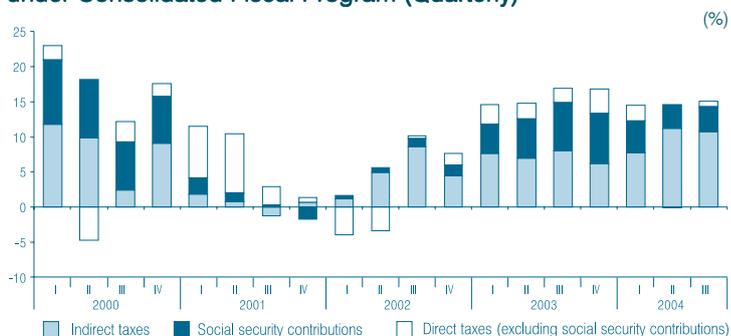
Primary Balance (Quarterly)



Source: MF.

Chart 62

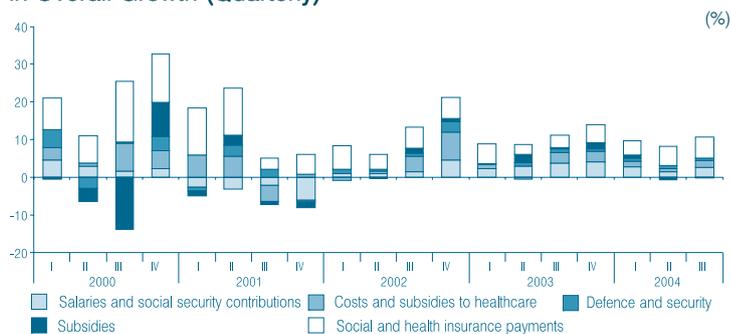
Contribution of Major Tax Groups Growth to Tax Revenue Growth under Consolidated Fiscal Program (Quarterly)



Source: MF, BNB.

Chart 63

Contribution of Major Groups of Current Non-interest Expenditure in Overall Growth (Quarterly)



Source: MF, BNB.

Behaviour of Firms

Manufacturing industry, agricultural sector and trade contributed most significantly to the value added in the third quarter of 2004. Value added growth in industry reflects the high productive and export activity in the sector. Between January and November industrial sales grew by 23 per cent, including for exports by 45 per cent. *Metallurgy, manufacture of food and beverages, machines and home appliances, articles of non-metal materials, clothing* were the leading industries. Data published by the NSI give ground to think that oil processing also contributed significantly to the dynamic developments of industrial sales and production. Based on NSI business surveys, industrial capacity utilisation in January will come to 63.7 per cent, a relatively high value in recent years.

The investment activity in Bulgaria stayed high, reflecting the favourable macroeconomic environment and optimistic expectations for development of enterprises.

Over the third quarter of 2004 fixed capital investment increased by 12 per cent. In 2004 the investment activity was concentrated in the services sector. Industrial managers expected a slowdown of planned investments¹² despite the favourable situation in industry and improvement in enterprises' financial performance.

Enhanced requirements for funds to finance production and investments continued to add to the buoyant credit demand by enterprises. Banks borrowed funds, including from other countries, to expand lending. Rapid credit growth was sustained due to the two major factors: enhanced demand and supply. By end-December claims on non-financial corporations posted an increase by 38.3 per cent on an annual basis. The maturity of newly extended loans continued to grow: by the end of December 2004 loans with maturity of over one year accounted for 66.9 per cent of total loans to non-financial corporations (against 65.5 per cent in early year and 66 per cent in September 2004).

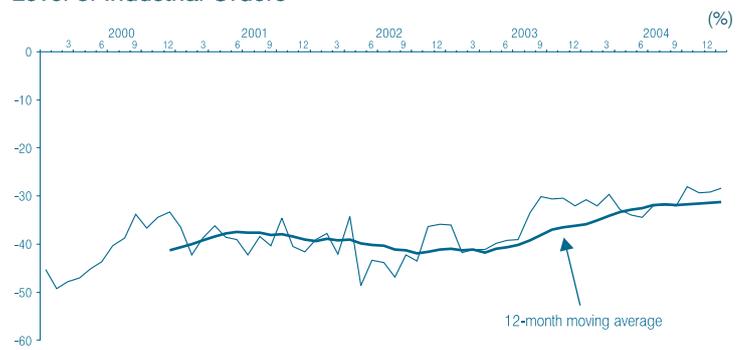
Interest rates on loans to corporations did not exhibit a clear trend and continued to vary around early year's levels. Lower euro lending rates compared with those in levs determined the corporations' choice to borrow funds mostly in euro. This interest rate structure re-

¹² According to the NSI investment survey in industry.

...high activity in industry, agricultural sector, construction and trade...

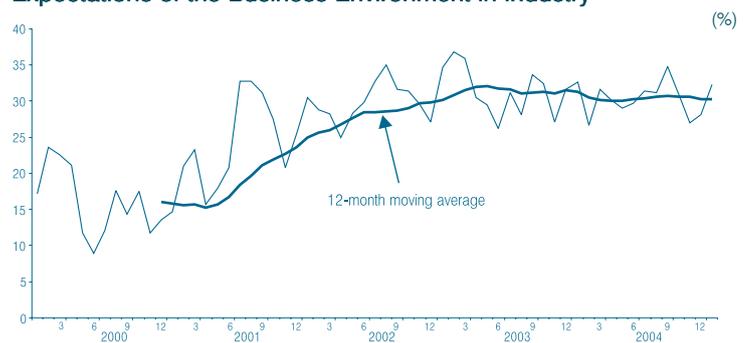
...high export activity in the industry...

Chart 64
Level of Industrial Orders (%)



Source: NSI, business survey.

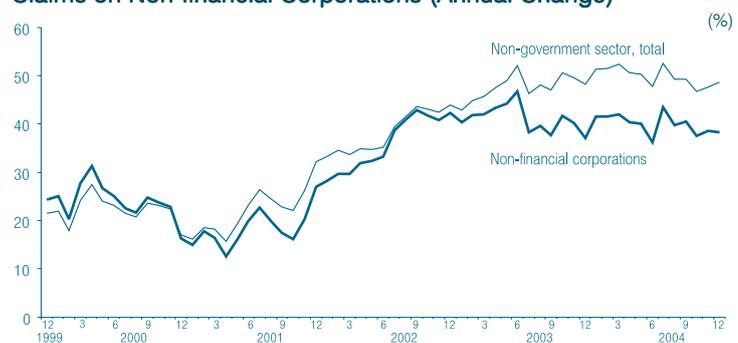
Chart 65
Expectations of the Business Environment in Industry (%)



Source: NSI, business survey.

...claims on non-financial corporations continued to rise at high annual rates...

Chart 66
Claims on Non-financial Corporations (Annual Change) (%)



Source: BNB.

reflects the currency structure of loans to non-financial corporations where the bulk of loans were denominated in foreign currency: the share of these loans went up from 55.3 per cent in early year to 65.3 per cent in December. EUR-denominated loans dramatically rose and by the end of 2004 their share reached 56.6 per cent. The small portion of lev loans to corporations and higher interest rates on them are probably indicative of the risk profile of the respective customers.

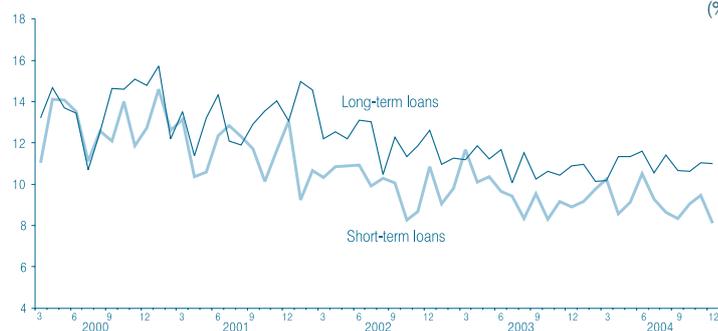
No essential changes occurred in the structure of loans by economic activity: *Trade and repair* and *Manufacturing industry* had the largest shares. The economic situation in these industries remained favourable. Consequently, there are no direct risks as regards the quality of banks' credit portfolios.

Given the rapid credit growth and with a view to assessing non-financial corporations' performance, estimates based on the monetary statistics, balance of payments and the System of National Accounts were made for the *net extended to the net received loans* indicator.¹³ Based on the results, non-financial corporations appeared to be a net debtor to the banking sector and a net debtor in the economy. The financial position of non-financial corporations corresponds to the external debt data which reveal the firms' major contribution to external debt growth. Financial indebtedness of corporations progressively rose as a proportion to GDP, particularly in 2004. Debt to non-residents and loans borrowed from local banks, accounting for 71 per cent and 43 per cent of new obligations (net) for 2004, contributed most significantly to the increased corporations' liabilities. The net financial position of the banking sector as an intermediary between the external sector and local non-financial corporations comprised about one per cent of GDP (Chart 69).

Chart 67

Interest Rates on Lev Loans Extended to Corporations

(%)

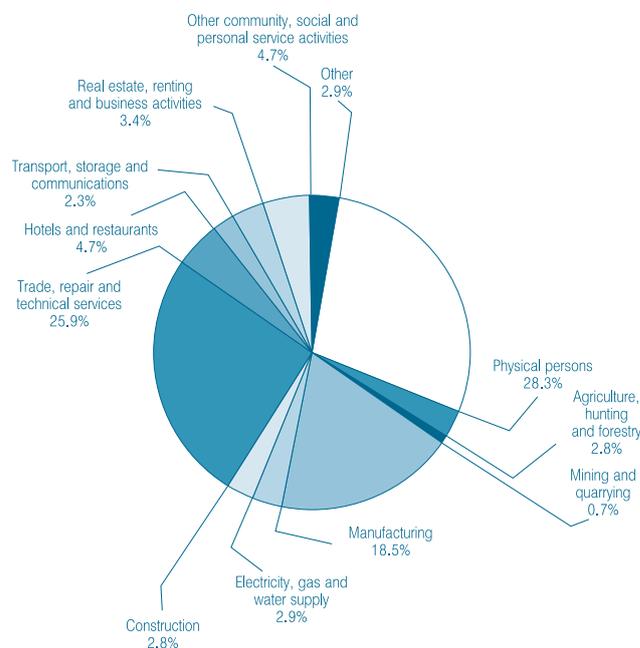


Source: BNB.

Chart 68

Structure of Commercial Bank Claims by Industry as of 31 December 2004

(%)



Source: BNB.

Table 15

Liabilities of Non-financial Corporations

(per cent of GDP)

	2000	2001	2002	2003	2004
Net liabilities to local banks	-1.1	1.2	4.2	6.4	11.4
Gross external debt	13.6	13.3	14.9	15.8	22.7

Source: BNB, NSI.

¹³ The indicator is equivalent to the *surplus/deficit of savings to investments* ratio and reflects the net acquisition of assets/undertaking of obligations over the year.

Provided the optimistic expectations come true, increasingly growing indebtedness of non-financial corporations will not threaten debt service. However, in case of an unexpected adverse shock large debtors may experience financial difficulties.

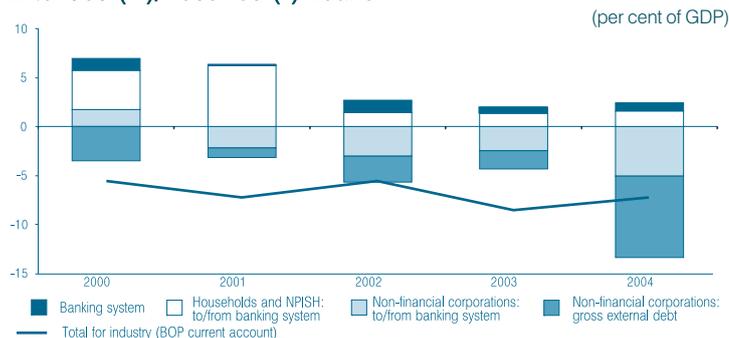
A positive trend was the improved financial performance of industrial enterprises. High productivity in industry reflected the progressively increasing cost competitiveness and efficiency of production which allowed Bulgarian firms to extend their market shares domestically and abroad and helped improve this sector's financial position. Decreased losses accumulated in previous years and growing profitability (return on equity) of industrial enterprises are an important consequence of this process.

Given the positive trends in enterprises' development, credit demand in 2005 is expected to stay high.

Exports and Imports of Goods and Services

Export growth rates continued to increase in the second half of 2004. Between January and November exports calculated in euro posted an increase of 18.3 per cent on the corresponding period of 2003, and November saw the record high of 34.7 per cent. Imports also increased at a fast pace in the review period (19.9 per cent between January and November 2004 and 33 per cent in November compared with November 2003). The trade balance in the period under review was EUR -2359.6 million, worsening by EUR 467 million compared with the January – November 2003 period.

Chart 69
Extended (+)/Received (-) Loans



Source: NSI, BNB.

...financial performance of industrial enterprises improved...

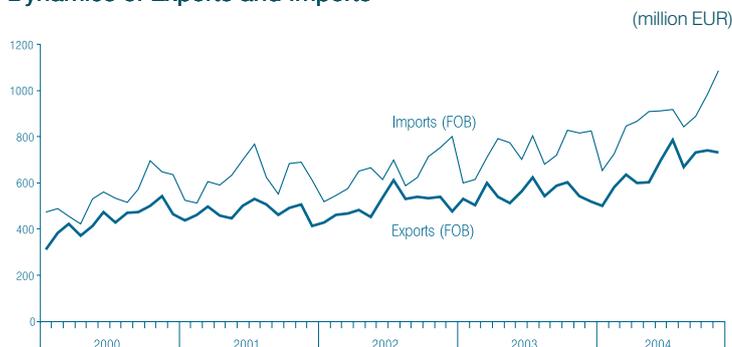
Table 16
Financial Result in Industry

	2002	2003
Profit	753 618	1 211 863
Loss	-603 282	-643 318
Net	150 336	568 545
Accumulated financial result	-2 178 578	-1 585 343
Equity	7 741 263	10 081 141
Liabilities	13 427 069	15 220 953
to banks	2 279 775	2 806 172
related corporations, suppliers and customers	6 025 970	6 716 896
budget and social security	1 285 042	1 552 248
Personnel	386 351	436 203
Equity profitability	1.9%	5.6%

Source: NSI.

...exports and imports continued to rise...

Chart 70
Dynamics of Exports and Imports



Source: BNB.

Over the second half of 2004 the trends in export dynamics by commodity group, which had formed by mid-year, sustained. Between January and November exports of base metals and articles thereof grew at fastest rates (44.1 per cent). Growth in this group was evenly distributed by sub-group (equivalent to a chapter in the Customs Tariff) and high growth rates continued to cause significant price consequences: based on NSI data compared with the 2003 average prices, over the third quarter the export price index of SITC group 67 *Cast-iron and steel* was 135.1 and that of SITC group 68 *Precious and non-ferrous metals*, 134. Taking into account the expectations about international metal price movements, this effect is likely to be exhausted just in the second quarter of 2005.

Over the review period exports of goods from the *Textiles, leather, clothing, footwear and miscellaneous consumer goods* group rose by 5.9 per cent. These figures confirm the slowdown in this group's growth which occurred in the first half of 2004. In August, September and October export growth of goods from this group was less than three per cent on the corresponding month of the previous year (in November it was 5.9 per cent). Based on the information, there is no reason to change the conclusion that slower export growth in this group is natural and reflects to a great extent the higher base (the share of this group in total exports comprises 27.4 per cent).

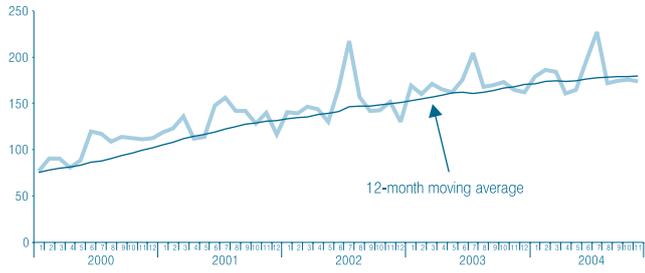
High oil prices affected export growth of petroleum products. Between January and November 2004 the average price of exported petroleum products increased by 22.8 per cent and exported physical volumes by 23.3 per cent. In recent months the contribution of high international prices of petroleum products was more clearly pronounced while until mid-year the nominal rises had reflected mostly the increased physical volumes.

Between January and November the year-on-year increase in exports of machines and vehicles was 13.6 per cent, with the two-digit growth rate being sustained in the August – November 2004 period. In general, the increase in these months was lower than that of total exports. However, taking into account that fluctuations in this group growth are traditionally lower than in total exports, it may be asserted that the stable dynamics in exports of machines and vehicles sustained.

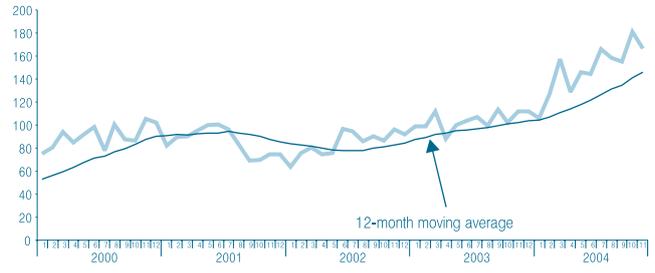
Chart 71
Exports

(million EUR)

Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods



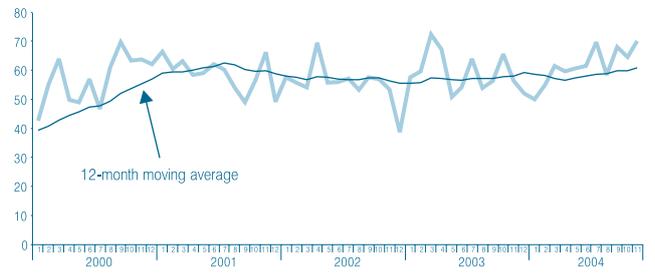
Base Metals and Articles Thereof



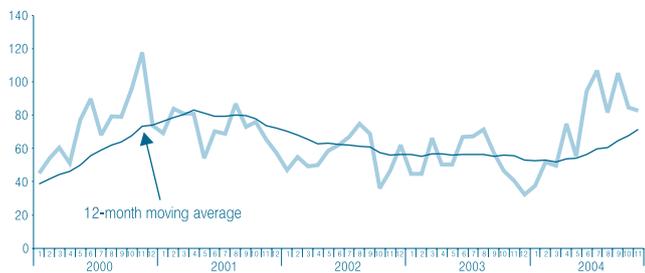
Machines, Vehicles, Appliances, Tools, Weapons



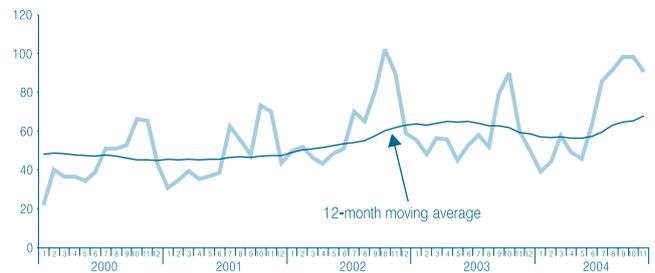
Chemical Products, Plastics, Rubber



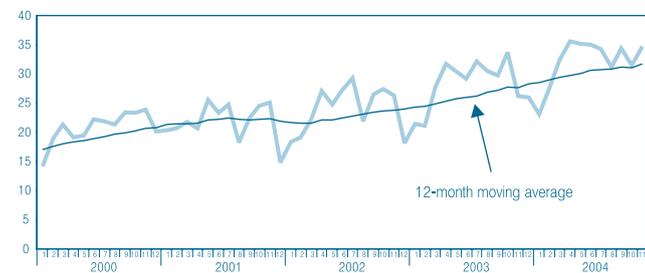
Mineral Products and Fuels



Animal and Plant Products, Food, Drink, Tobacco



Wood, Paper, Pottery, Glass



Source: BNB.

Exports of chemical products continued to fluctuate, with growth rates ranging between 20.7 per cent and -1.7 per cent for the various months in the second half of 2004. As a result, exports of chemical products grew by 3.1 per cent in the January – November 2004 period.

Exports of agricultural produce posted a rise, consistent with the good crops. Over the third quarter exports in euro went up by 46 per cent on the same period of 2003, with the value added rising in real terms by 5.3 per cent in the *Agriculture and forestry* sector. Between January and November 2004 exports in this commodity group increased by EUR 112.7 million.

Compared with the first half of 2004, the System of National Accounts (SNA) data for the third quarter showed a significantly greater contribution of real export growth to the overall nominal increase in exports. The year-on-year physical change in commodity exports over the third quarter of 2004 was 16.9 per cent and the export deflator against the 2003 average prices was 6.9 per cent. Given the external demand over the year, the figures reported for the third quarter revealed also a supply-side effect. Taking into account the international price movements and nominal export growth in October and November, it may be expected that real exports will increase at a high pace in the fourth quarter of 2004.

In the second half of 2004 the nominal increase in imports of goods continued, with growth rates accelerating from 15.8 per cent and 18.7 per cent in the first two quarters to 20.2 per cent in the third quarter. In October and November growth rates reached 19.2 per cent and 33 per cent and the upward trend is expected to sustain in the last quarter of 2004. GDP data indicate a slowdown in the growth of physical volume of imports: the comparatively high growth rate of 19.6 per cent reported in the first quarter went down to 11.2 per cent in the next two quarters. Consequently, the relatively high rates of import growth reflected the strong effect of the price component. The SNA data indicates clearly a trend toward an increase in the deflator of imports of goods since early year: compared with the average prices for 2003, this indicator rose to 7.1 per cent in the third quarter against 1.3 per cent and 5.7 per cent in the first and second quarters respectively.

Table 17
Contribution of Commodity Groups to Trade Growth between January and November 2004

(percentage points)

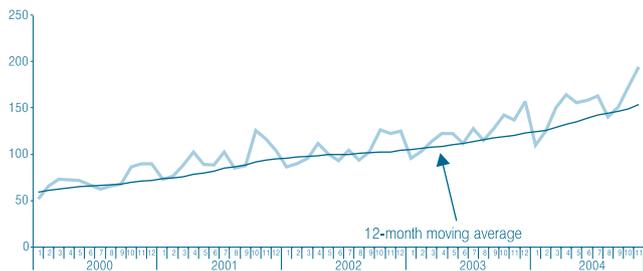
	Contribution to the growth of	
	exports	imports
Raw materials	10.0	7.7
Investment goods	2.3	6.0
Consumer goods	2.7	4.2
Energy resources	3.4	2.3
Other		-0.3

Source: BNB.

Chart 72

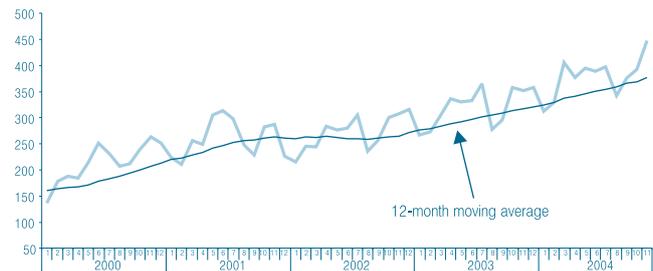
Imports

Consumer Goods

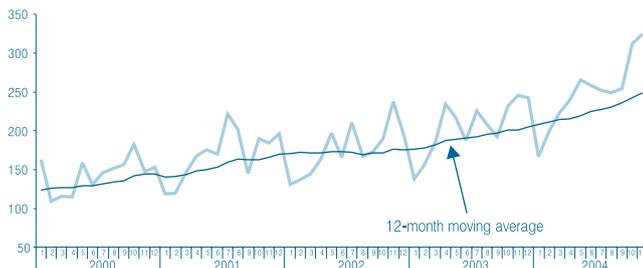


Raw Materials

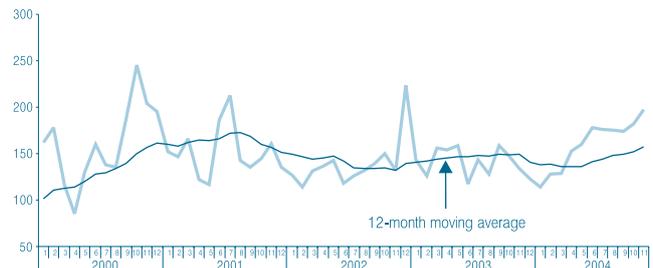
(million EUR)



Investment Goods



Energy Resources



Source: BNB.

Between January and November 2004 imports (CIF) increased by EUR 1735.9 million (19.9 per cent) on the same period of 2003. Consumer and investment goods posted the highest growth rates (27.8 per cent and 23.5 per cent respectively) corresponding to the increased consumer expenditure reported in the SNA (particularly non-food expenditures) and gross fixed capital formation in real terms. Raw materials and investment goods continued to dominate the structure of total imports and contributed most significantly to import growth (7.7 percentage points and six percentage points respectively). The dynamics of these goods matched the high investment and production rates in Bulgaria.

Among major commodity sub-groups, imports of automobiles and vehicles (included in consumer and investment groups respectively), cast iron, iron and steel, ores and non-ferrous metals (included in the group of raw materials) posted the highest growth rates. Import dynamics reflected largely the effect of the price component: the international market prices of steel and non-ferrous metals rose significantly and customs duties rules applied to automobiles were changed.

...import growth reflected imports of investment goods and raw materials...

Crude oil and natural gas and oils accounted for the largest share in imports of energy resources, with the first sub-group increasing most significantly in absolute terms (EUR 129.6 million or 10.6 per cent) and the second one showing the fastest growth rate (41.6 per cent). Enhanced imports (FOB) of crude oil (by EUR 131 million) was entirely attributable to the higher average price (by 17.2 per cent) which offset the 0.9 per cent decrease in the physical volume of imported fuel. This matches the downward trend in gross internal consumption of crude oil (according to the country's energy balance sheets) which has occurred in recent years. Imports of natural gas showed divergent movements of the price component and the physical volume: the first factor posted a decline of 7.4 per cent, while the second indicated an increase by 2.7 per cent. As a result, overall expenditures on imports of natural gas decreased by EUR 12.9 million. A significant increase of 44.2 per cent is reported in imports of petroleum products.

No significant changes in the structure of foreign trade by country occurred between January and November 2004. The EU dominated Bulgaria's exports comprising 58.5 per cent of total exports, followed by the group of Balkan countries, 20.3 per cent. Exports to Balkan countries increased most dramatically (by 28.6 per cent) consistent with high growth rates and enhanced demand in the Balkan region. Exports to the EU rose slower reflecting the EU weaker demand and the high base effect due to the EU large share in Bulgaria's total exports. Over the review period exports to Europe, North and South America and Asia¹⁴ posted growth of over 20 per cent but their contribution to export growth was lower due to their small share in trade.

The EU continued to contribute most substantially to import growth (9.9 percentage points), accounting for the largest share in imports (54.1 per cent). This confirmed the role of the EU as Bulgaria's major trading partner. A substantial portion of investment goods were imported from the EU (73 per cent in the third quarter of 2004) consistent with the fact that the bulk of foreign investment was provided by the EU member states. Imports from North and South America, and the Balkan countries exhibited the highest growth rates: 39 per cent and 28.5 per cent respectively.

¹⁴ According to the definition of regions used in the foreign trade statistics published by the BNB.

Revenue from travel services continued to increase at a high rate to reach 20 per cent (EUR 276.9 million) in the January – November period. These services are characterized by clearly pronounced seasonality and concentration in summer months due to domination of sea tourism in the structure of the travel sector. Travel expenditure also went up (by 17.4 per cent or EUR 105.7 million) with the third quarter contributing mostly to the increase, irrespective of the fact that expenditures were more evenly distributed than revenues.

Expectations for the first quarter of 2005 are for export and import dynamics similar to that in the last quarter of 2004. Slightly worsened international environment will be probably compensated by the lower base reported in the first quarter of 2004. The nominal export growth for the first quarter is expected to approximate 25 per cent and import growth 18 per cent. As a result of these increases, the trade balance for the quarter will slightly improve (by some EUR 30 million) on the first quarter of 2004. Over the second quarter of 2005 exports are expected to grow by approximately 17 per cent and imports by approximately 15 per cent. Such dynamics would result in worsening the trade balance for the quarter by some EUR 100 million compared with the second quarter of 2004.

Competitiveness

Robust production, particularly in industry, and dynamic exports are indicative of improving competitiveness of the Bulgarian economy. Volatile international economic conditions and low growth rates of the European Union, Bulgaria's major trading partner, did not affect Bulgaria's growth rates and Bulgarian producers have progressively expanded their market shares. These conclusions prove to be important for the Bulgarian economy characterized by a fixed exchange rate.

Unit labour cost in real terms is an important competitiveness indicator.¹⁵ This indicator for the manufacturing industry, which is exposed to the strongest international competition, is 70 per cent compared with 1998. The indicator reflects the radical restructuring of the economy and adjustment to the competitive environ-

¹⁵ The higher value of this indicator means that the employed persons receive a larger portion of generated value added, while the lower value indicates that firms retain the larger portion of value added as operating surplus.

...we expect import and export growth to slow down in 2005 ...

...cost competitiveness was retained...

ment of international markets which results in labour efficiency growth, improved human resources management and more effective use of renewed equipment. A positive trend is the progressive improvement of cost competitiveness of the agricultural sector. The industries included in the services sectors showed divergent trends dependant on the starting salary in individual industries. The increased value of this indicator in sectors as *Trade and other services*¹⁶ was attributable to the enhanced aggregate demand and intensifying economic activity which allowed for an increase in salary.

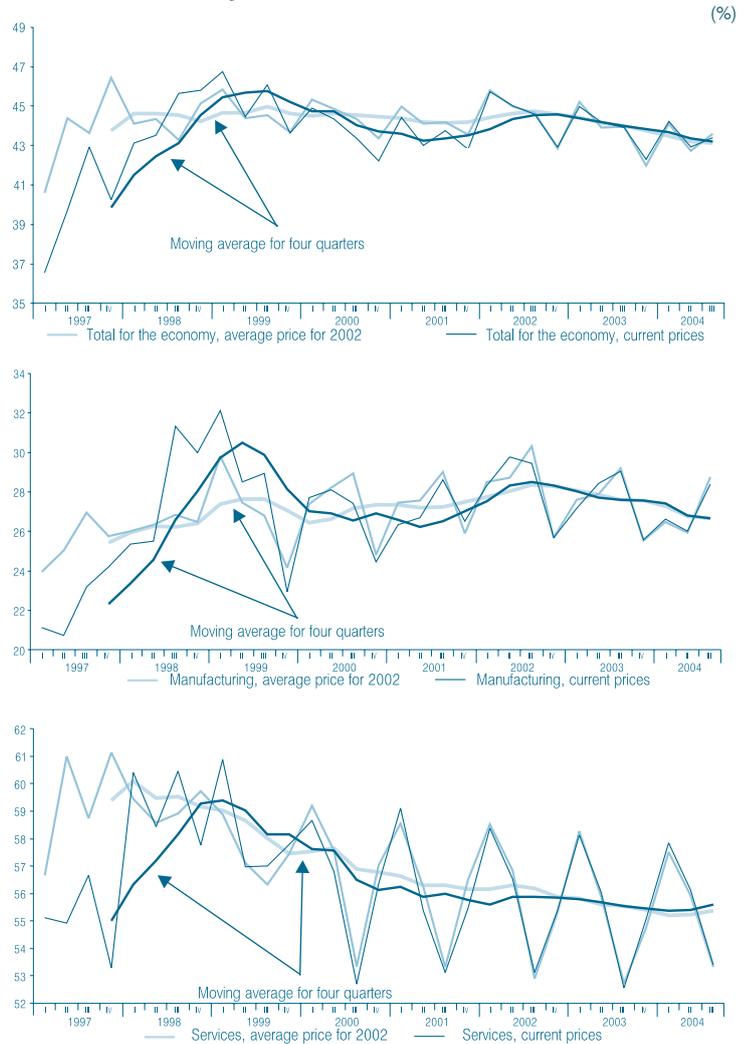
The *value added to gross production* ratio is another economic efficiency ratio. Over the third quarter of 2004 the level of this indicator stabilised. It is crucially important for companies' efficiency to maintain this ratio within acceptable levels. This requires continuous improvement of production and management technologies.

Favourable developments in the real sector, including improved financial performance of corporations as a result of increased production efficiency give grounds to expect economic growth of 5.2 to 5.3 per cent in the first half of 2005. The positive dynamics in production of goods and services is anticipated to sustain over the forecast period. Industry CECI12 indicator retained its upward trend. Consequently, value added growth of about seven to eight per cent is expected to sustain in this sector. Robust investment in the services sector is also indicative of favourable conditions and growth is anticipated to be significant.

¹⁶ Including general government, transactions in property and business services, etc.

Chart 73

Production Efficiency: Value Added to Gross Production Ratio (%)

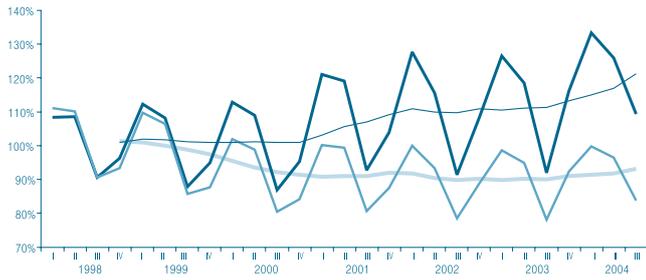


Source: NSI.

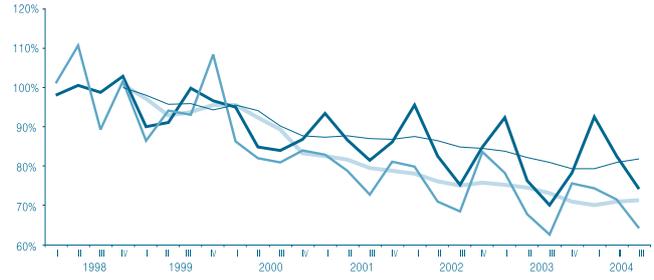
...the positive dynamics in production of goods and services will sustain...

Chart 74
Unit Labour Cost

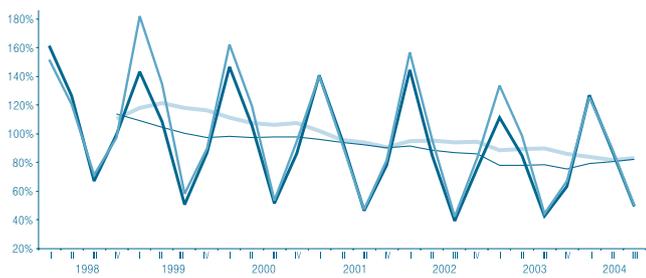
Total for the economy



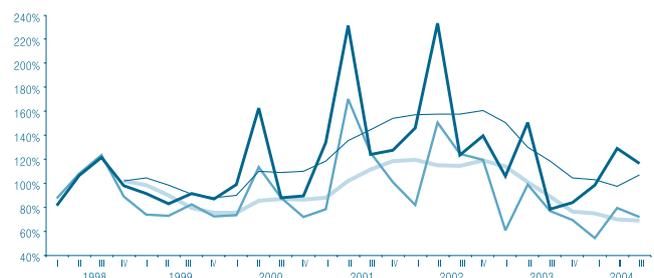
Manufacturing



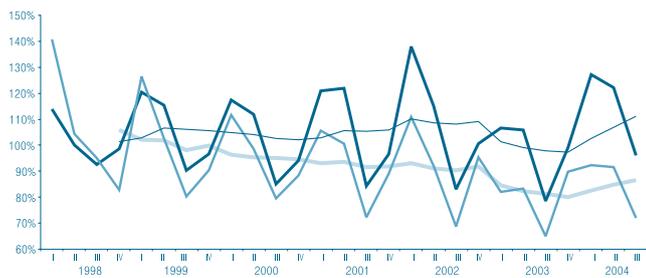
Agricultural sector



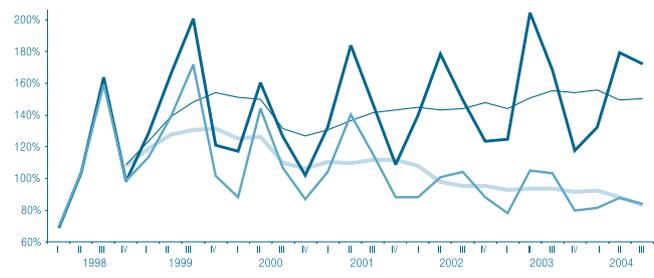
Mining and Quarrying



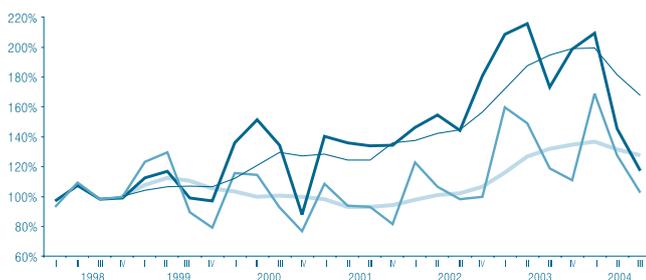
Construction



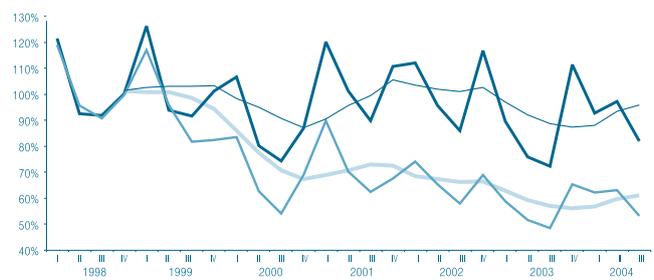
Electricity, gas and water supply



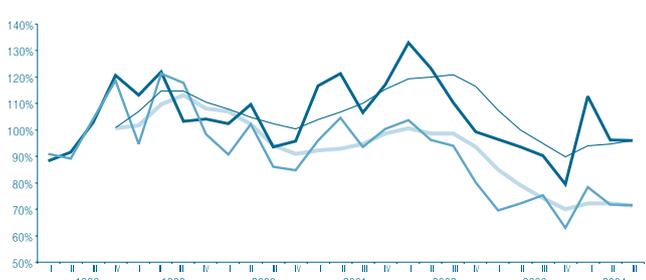
Trade



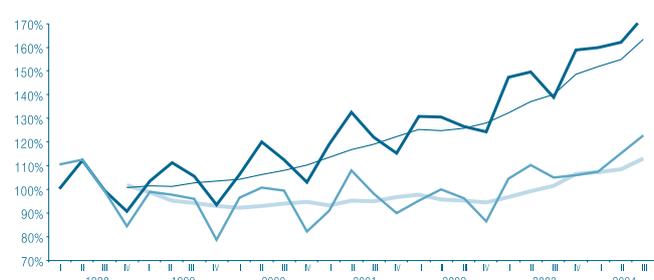
Transport and communications



Financial intermediation



Other sectors



— Nominal — Moving average for four quarters (nominal)
— Real — Moving average for four quarters (real)

Source: NSI, BNB.

4. Inflation

Domestic demand dynamics and high growth rates of money supply and credit pre-supposed accumulation of inflationary pressure on domestic prices. The effect of these factors was partly offset by the open nature of the Bulgarian economy which allowed satisfying demand for tradable goods by imports, by the improving cost competitiveness and companies' efficiency. Under the divergent effect of these factors, the inflation rate in 2004 was primarily determined by the administrative measures: adjustment of administratively set prices of goods and services, international crude oil prices and prices of bread and cereals which rapidly went up at the end of 2003 due to the poor crops. As a result of the effect of these factors, inflation accumulated in 2004 was four per cent, a decrease compared with the previous year, and the average annual inflation was 6.1 per cent.

In 2004 inflation was seriously impacted by prices of bread and cereal products which were progressively declining until year-end. In October bread prices stabilised at a level exceeding by approximately ten per cent that of July 2003 (prior to the rapid price rises due to poor crops).

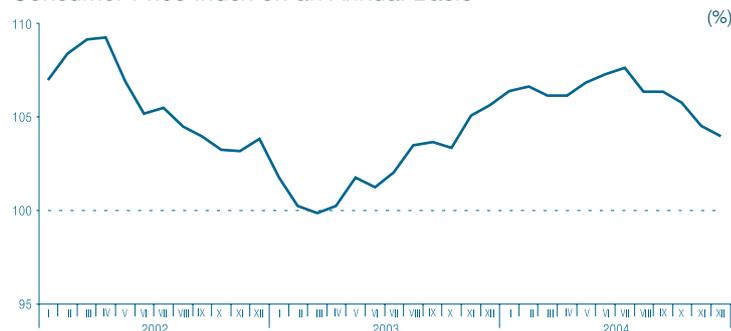
Due to the openness of the Bulgarian economy, the high rates of domestic demand did not exert pressure on domestic prices of tradable goods. Imports met some demand, mainly for investment and raw material, at international prices. In the structure of consumer demand, spending on clothing and footwear increased at a higher pace while the contribution of this commodity group to overall inflation by September 2004 was insignificant (0.02 percentage points). Trade in household goods and equipment grew increasingly but prices remained almost unchanged (a negative contribution to inflation of 0.008 percentage points). The general non-food price index (excluding fuels) stayed stable.

Table 18
Contribution to Inflation by End-2004

	2003	2004
Inflation(%)	5.64	3.98
Contribution (percentage points)		
Foods	3.42	0.35
Non-foods	-0.07	1.36
Fuels	-0.13	0.11
Catering	0.18	0.15
Services	2.09	2.17
Goods and services with administratively set prices	1.69	2.89
Controlled-price goods	0.22	1.28
Tobacco	0.02	1.19
Controlled-price services	1.47	1.60

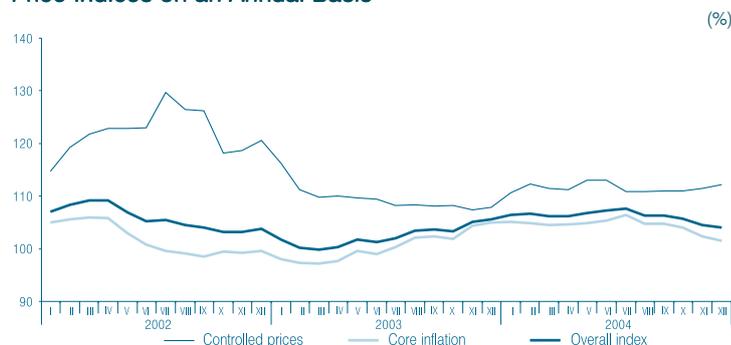
Source: NSI.

Chart 75
Consumer Price Index on an Annual Basis



Source: NSI.

Chart 76
Price Indices on an Annual Basis



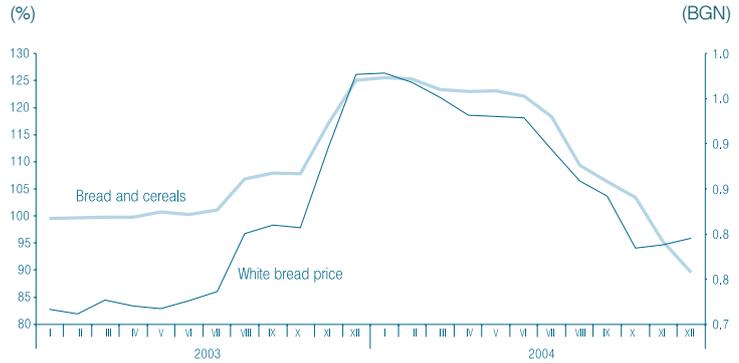
Source: NSI.

It can be assumed that rising domestic demand would put pressure on services prices. Data for 2004 indicate that services related to recreation contributed to inflation by 0.1 percentage points (against 0.2 percentage points for the same period of 2003) and educational services by 0.03 percentage points (against 0.03 percentage points for 2003). *Healthcare* services retained their steady contribution to inflation accounting for about 0.06 percentage points. The general services price index (excluding services' controlled prices) tended to decline since mid-2003. As of October 2004 the trend reversed due to the indirect effect of fuel prices on services (particularly on transportation services).

International crude oil prices were an inflationary factor which had a direct effect on fuel prices in Bulgaria. With a certain lag, the higher crude oil prices also affected other price indices: transportation services index and then non-food price index (excluding fuels) and services index (with the exception of controlled-price services).

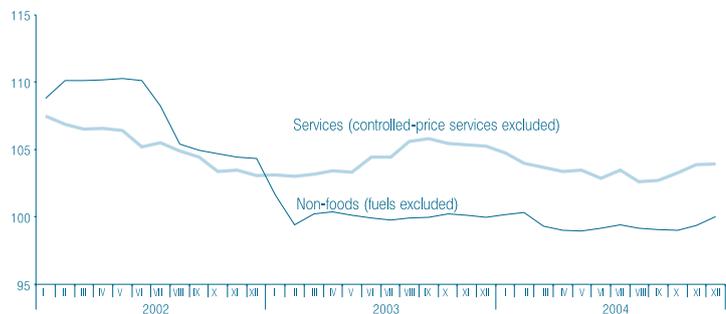
Adjustment of excise duties on beer and strong alcoholic beverages and some brands of cigarettes will affect the general price index in the first months of 2005. Over the first quarter of 2005 the increased excise duties on beer by 7.14 per cent will have a 0.05 percentage point contribution to inflation, and higher excise duties on strong alcoholic beverages contributing by 0.08 percentage points¹⁷ will be major inflationary factors. Inflation accumulated in the first quarter of 2005 is expected to reach two per cent and the deflation processes to compensate for the increase in the second quarter.

Chart 77
Bread and Cereals Price Index on an Annual Basis



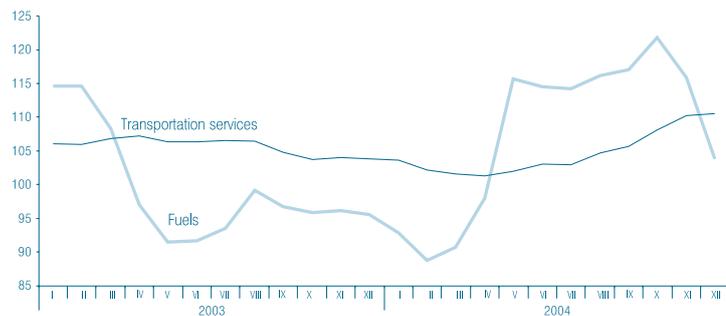
Source: NSI.

Chart 78
Price Indices of Non-foods (Fuels Excluded) and Services (Controlled-price Services Excluded) on an Annual Basis



Source: NSI.

Chart 79
Price Indices of Fuels and Transportation Services on an Annual Basis



Source: NSI.

¹⁷ Agency for Economic Analyses and Forecasting estimates.