Economic Review

May 2004

125

1879

YEARS

BULGARIAN
NATIONAL
BANK

125

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Bulgarian monetary policy seeks national currency stability with a view to price stability. The new BNB *Economic Review* presents information and analysis of monetary and credit aggregates, their link with the development of the real economy, and their bearing on price stability, as well as the Bank's short-term expectations.

Based on an analysis of trends and assessments of Banks' policies, this *Economic Review* presents expectations of the movements of basic macroeconomic indicators: monetary and credit aggregates, domestic and foreign demand, and growth and inflation during the second and third quarters of 2004.

The May 2004 *Economic Review* was approved for publication by the BNB Governing Council at its 3 June 2004 meeting. It employs data published by 15 May 2004.

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.

This issue includes materials and data received up to 7 June 2004.

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Preface

Dear Reader,

Since mid-1997 the peg to the euro has underpinned Bulgarian National Bank policy. Successful implementation of this basic policy over the past seven years has allowed the Bank to attain stability in prices and in national finance: key factors in economic restructuring and growth. Alongside this, structural changes in the economy and the dynamics of its development determine consumer prices and the quality of commercial bank portfolios, which in turn add to national price and financial stability.

This policy compelled the BNB to invest significant resources in developing its analytical potential and researching the Bulgarian and world economies. The first *Economic Review* quarterly, which you hold in your hands, pursues two major aims: *first*, to render the Bank's analytical function transparent by increasing accountability to the Bulgarian public; and *second*, to present Bank views on short-term (up to six months) trends in national economic development, helping businesses and politicians assess economic performance and anticipate immediate national developments.

Ivan Iskrov

Governor

Abbreviations

bbl	barrel
BCC	Bank Consolodation Company
b/d	barrels *per* day
BIR	Base Interest Rate
b. p.	basis points
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
GDP	Gross Domestic Product
IEA	International Energy Agency
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
M1	narrow money
M2	M1 and quasi-money
M3	broad money
MF	Ministry of Finance
mmbtu	million British thermal units
NPISHs	Nonprofit Institutions Serving Households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PPP	Purchasing Power Parity
WB	World Bank

Contents

Summary

Since mid-1997 Bulgaria has followed the particular monetary policy regimen of a currency board as a way of setting and maintaining price stability. The transparent rules of a currency board, in addition to prudent fiscal policy, as well as imminent Bulgarian accession to the European Union make economic policy easy to anticipate and cut economic uncertainty. This eases the inflow of foreign capital into Bulgaria: a condition for money supply growth and a safeguard of sustainable development.

The world economy influences the dynamics and direction of financial flows in Bulgaria's balance of payments and hence money supply, growth and inflation.

The expected acceleration of global growth in 2004 would back Bulgarian growth, with export growth rates expected to increase in real terms. Global raw material and feedstock demand is growing and pushing up world market prices. These processes will influence Bulgaria in complex ways, but the net effect of raw material and feedstock price growth on the trade balance would sooner be negative. We expect world interest rate hikes which would likely affect domestic lending rates and slow Bulgaria's first quarter credit expansion.

The interplay between the Bulgarian economy and the external environment reflects directly on balance of payments capital flows. The sectoral structure of these flows affects money supply dynamics. The rates of monetary aggregate growth in 2003 hastened, with both reserve money and money multiplier contributing to this. Since early 2004 monetary aggregate dynamics remains fluid, but by the close of the third quarter we expect a slight drop in nominal year-on-year growth rates.

High annual money supply growth rates are accompanied by similar trends in domestic credit. The growth of commercial banks' deposits and the cutback in these banks' foreign assets have freed resources to increase domestic claims. In the short-term horizon, credit growth rates will remain high. The current rapid credit expansion does not entail any worsening in the state of the banking system or the good quality of its credit portfolios. Nevertheless, measures are in hand to limit credit and its attendant risks. As a result of these measures, and of limits to resources, we expect a gradual fall in the rates of credit growth over the third quarter. We expect commercial banks to maintain good revenue, stable liquidity, and capital levels aligned with their risk profiles.

Business activity at the start of the year was buoyant. Businesses expressed intentions to boost investment, managers expressed optimism, and consumers showed growing confidence. This indicates that domestic demand will keep increasing at the highest rates and will contribute most significantly to gross domestic product growth over the coming quarters. It will press the banking system for more credit for the acquisition of imports. The expected growth in the world economy will boost export growth in real terms during the second and third quarters of the year, but by less than imports. As a result, the second and third quarters will see a retention of the trend to a growing trade deficit.

As regards supply, manufacturing and services made the greatest contribution to gross value added in 2003. An important change in industrial sales emerged this year with the growth of domestic demand. We expect to see this continue over the current year. In the first quarter of 2004, buoyant industrial sales and the strong export orientation of manufacturing continued. Industrial productivity is growing and, alongside moderate pay rises, is cutting the unit labor cost and hence boosting manufacturing's export competitiveness.

The effect of supply and demand on prices is analyzed in the last part. The peg to the euro and the openness of the Bulgarian economy mean that domestic inflation levels should approximate eurozone ones. Divergences reflect adjustments to state-controlled prices, and world price fluctuations.

Buoyant domestic demand does not affect inflation directly, but does impact the balance of payments trade balance. The fall in unit labor cost in manufacturing, construction, and transport and communications is an important factor favoring price stability. In the short run, crude oil prices will exert an inflationary pressure.

1. The World Environment

Conditions

Business expectations evolved from marked pessimism in early 2003 to rapidly growing optimism. Optimism also colored business assessments of the economic situation and prospects in early 2004. Consumer confidence increased, too, but took a knock after the March 2004 terrorist attacks in Madrid. Economic data for 2003, and optimism in manufacturing, support expectations of accelerating growth during the second and third quarters of the current year (Chart 1).

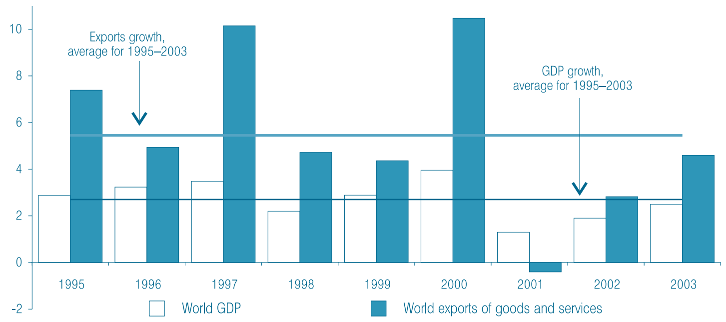
US economic growth led the world in 2003, with major contributors including government consumption (military spending), private services consumption, new housing, and equipment and software investment. The greatest growth, at 8.2 percent on an annual basis, came in the third quarter. Over the last quarter of 2003 and the first quarter of 2004 growth slowed while still remaining above underlying rates. We expect the USA to entrench its world growth lead over the second and third quarters of 2004.

After restructuring corporate balances in 2003 and the cut in labor cost, the USA proved their economic flexibility by rapidly boosting overall factor productivity, with a subsequent slower decline in unemployment. At the close of the first quarter of 2004, unemployment stayed at the 5.7 percent level set in the prior quarter. The same period saw a quarter percent increase in employment: the first sign of a labor market improvement.

Chart 1

Real Growth Rates of World GDP and Exports of Goods and Services, 1995–2003

(%)



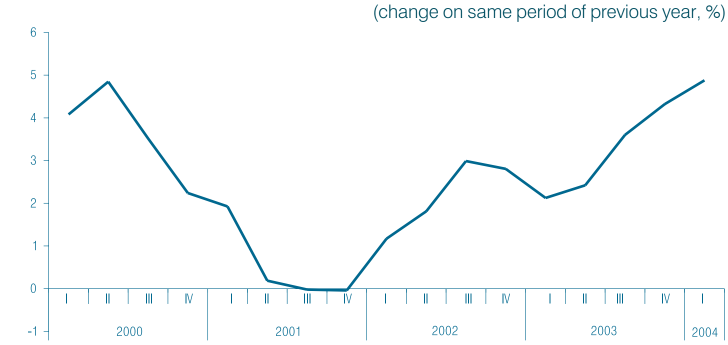
Source: World Bank.

...accelerated world growth is expected

Chart 2

US GDP Real Growth Rate

(change on same period of previous year, %)

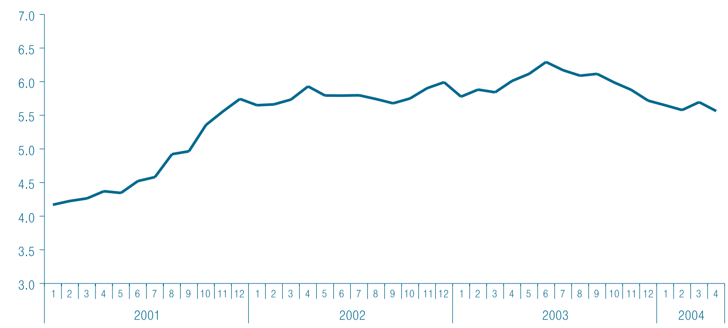


Source: Bureau of Economic Analysis.

Chart 3

US Unemployment Rate

(%)



Source: Bureau of Labor Statistics.

The average US inflation in 2003 was 2.3 percent, with oil prices contributing most to this. An acceleration in the growth of prices for a great many goods and services was noted in the first quarter of 2004, but inflation remained low (at an average of 1.8 percent) due to the effect of the low base from a year earlier. Alongside higher growth and rising oil prices, the tailing-off of this effect creates conditions for a gradual rise in inflation over the coming quarters.

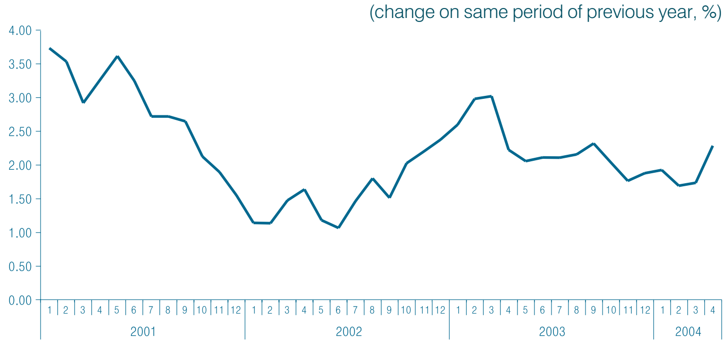
The dynamics of various business indicators gives rise to positive expectations as to the state of the US economy over the short term. The improvements to the labor market over recent months and the expected subsequent inflationary pressure resulting from greater demand suggest a gradual tightening of monetary policy. Any faltering of consumer spending would pose a risk to the expected acceleration of the business cycle, as would budget and balance of payments current account deficits. Tilts in these directions could come from events such as the recent oil price rises, the decline in the effect of tax incentives by the close of 2004, and putative geopolitical complications.

Eurozone growth fell below expectations in 2003, but forecasts point to a boost in 2004. Slow growth was due to weak household consumption on the one hand, and to the strong euro hampering exports, on the other. ECB interest rate adjustments in 2003 failed to speed growth, but were kind to business and consumer expectations.

Chart 4

US Inflation Rate

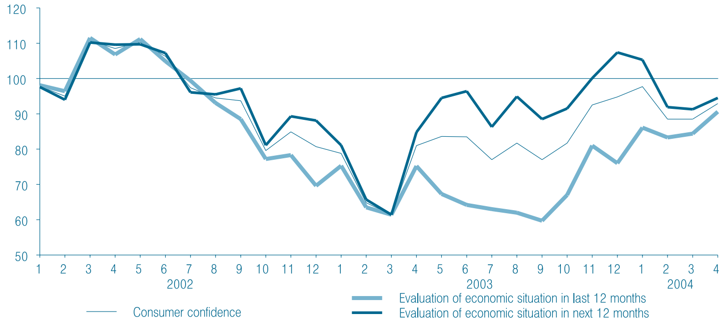
(change on same period of previous year, %)



Source: Bureau of Labor Statistics.

Chart 5

US Consumer Confidence Indices



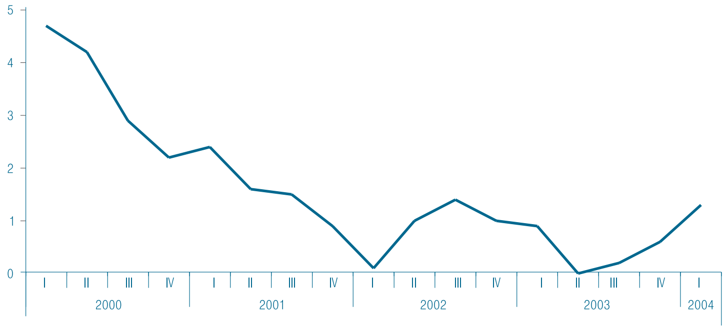
Source: Conference Board.

...the improvements to the US labor market and expected subsequent inflationary pressure suggest a gradual tightening of monetary policy

Chart 6

Eurozone Real GDP Growth Rate

(change on same period of previous year, %)



Source: Eurostat.

Eurozone unemployment has been a steady 8.8 percent for a year. Employment in manufacturing and agriculture is falling, with services taking up the slack. European Commission 2004 unemployment forecasts show no change despite expectations of higher employment during the year's second half.

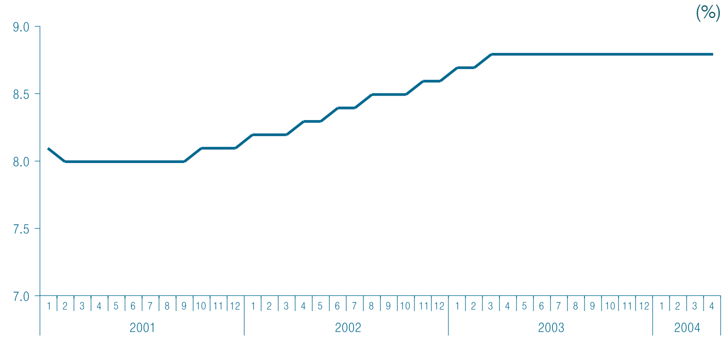
The average annual eurozone inflation was 2.1 percent in 2003. Over the first quarter inflation fell to 1.7 percent due to the fall in communications prices and the less rapid growth in alcohol and tobacco prices, and the high base set in the prior year.

We expect to see tax breaks in large European countries to make themselves felt in 2004 by boosting disposable incomes and hence final consumption.

European Commission forecasts point to a retention of overall eurozone budget deficits to 2.7 percent for the current year, followed by a cut to 2.6 percent in 2005. Structural reform is crucial to improving fiscal discipline in countries expected to breach Stability Pact criteria with budget deficits possibly reaching 3 percent of GDP.

Chart 7

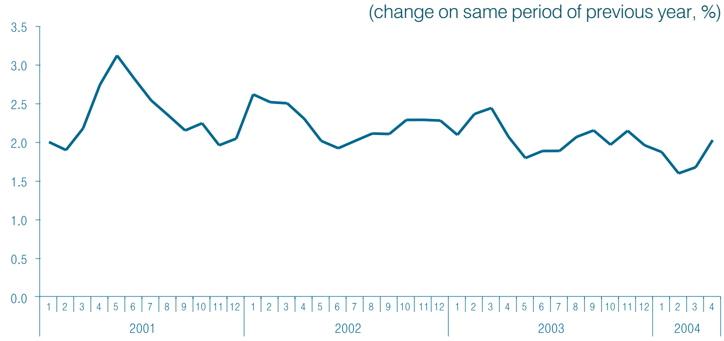
Eurozone Unemployment Rate



Source: Eurostat.

Chart 8

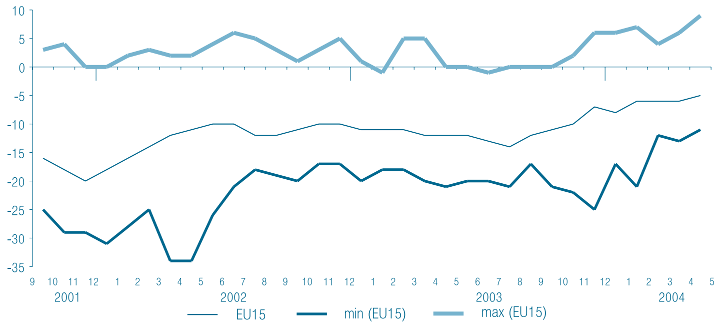
Eurozone Inflation Rate



Source: Eurostat.

Chart 9

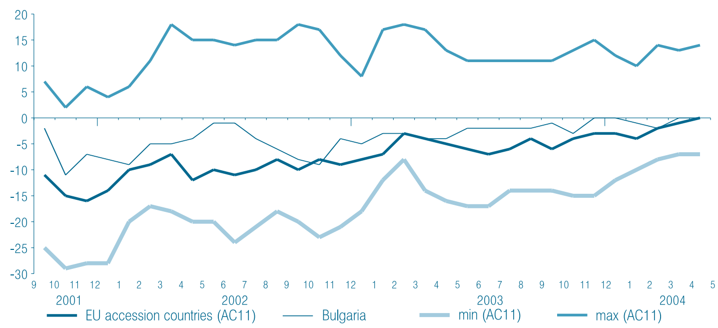
Indicator of Confidence in Industry



Source: Eurostat.

Chart 10

Indicator of Confidence in Industry



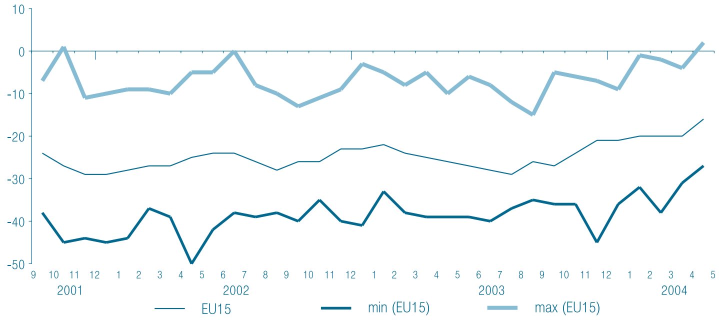
Source: Eurostat.

...eurozone growth fell below expectations in 2003, but forecasts point to a boost in 2004

The accession of ten new member states on 1 May 2004 was a major EU event. The accession states chalked up a 3.6 percent growth during 2003. The Baltic Republics were the leaders, followed by Poland and Slovakia. Investment in accession states was low, yet strong private consumption boosted growth rates compared with 2002. Expectations are for the accession states with the lowest *per* capita incomes to register high growth in 2004.

Chart 11

The Volume of Orders



Source: Eurostat.

Table 1

Basic Trends of Spring Forecasts for Accession Countries

(real percentage change)

			Spring forecasts, 2004		Change on autumn forecasts, 2003	
	2002	2003	2004	2005	2004	2005
GDP growth	2.4	3.6	4.0	4.2	0.2	0.0
Unemployment	14.8	14.3	14.1	13.8	-1.1	-1.0
Inflation	2.7	2.1	3.8	3.3	0.1	0.0
Budget surplus(+)/deficit(-), percentage of GDP	-4.9	-5.7	-5.0	-4.2	0.0	-0.1
Government debt, share of GDP, %	39.4	42.2	44.4	45.2	-0.2	-0.7
Current account, share of GDP, %	-	-3.7	-3.9	-4.1	1.0	0.7

Source: EC.

EU Enlargement[1]

On 1 May ten new member states acceded to the European Union in what was its greatest-ever enlargement. As distinct from previous enlargements, however, the economic contribution of new members was relatively modest. EU macroeconomic data did not change substantially. The greatest change was to the population, which increased by some 20 percent, while GDP grew by 5 percent overall. Over the long term, this enlargement will contribute to general EU growth and welfare. As regards the Four Freedoms (to provide goods and services, and move capital and people), single market expansion will boost competition and create economies of scale. The speed and scope of these processes will, however, depend on a great many factors other than the economic policies of new and established EU member states.

Table 2

	Period	Unit	U-15	U-25	USA	Japan
Population*	2004	million	380.8	454.9	291.4	127.7
GDP (share of world GDP)**	2002	%	26.8	28.1	32.5	12.3
GDP *per capita*	2002	EUR'000	24.0	21.1	37.7	33.2
	2002	PPP EUR'000	23.3	21.4	32.7	24.1

* 1 January 2004; Japan: 1 April 2004.

** The nominal GDP of the countries in US dollars is used as a base.

Source: ECB.

[1] European Central Bank, *Monthly Bulletin,* May 2004.

The IMF and European Commission Spring Forecasts

In April the IMF* and the EC** published spring forecasts, both of which were optimistic about world growth. They noted that internal demand, the major US growth driver, was accompanied by a relatively high current account deficit which unbalanced the world economy and threatened sustainable growth. On the other hand, Asian countries combined high growth with positive current account balances, which further improved their 2004 prospects. Basic factors backing these optimistic forecasts included business-friendly economic policies, progress in structural reform, corporate sector improvements (improved finances, a return to profit, and new growth in high-tech industries), the wealth effect stemming from 2003 share price rises, the return of confidence, the accumulation of reserves, and falling inflation.

* IMF, *World Economic Outlook*, April 2004.

** European Commission, *Economic Forecasts – Spring 2004*, April 2004.

Table 3

Major Trends in Spring Forecasts of EC and IMF

(real percentage change)

			Spring forecast, 2004		Change on autumn forecast, 2003	
	2002	2003	2004	2005	2004	2005
EC						
EU15						
GDP growth	1.1	0.8	2.0	2.4	0.0	0.0
Eurozone						
GDP growth	0.9	0.4	1.7	2.3	-0.1	0.0
Unemployment	8.4	8.8	8.8	8.6	-0.3	-0.3
Inflation	2.3	2.1	1.8	1.6	-0.2	-0.1
USA	2.2	3.1	4.2	3.2	0.4	-0.1
GDP growth	2.2	3.1	4.2	3.2	0.4	0.1
Unemployment	5.8	6.0	5.6	5.6	-0.6	-0.7
Inflation	1.6	2.3	1.4	1.2	0.0	0.2
Japan	-0.4	2.7	3.4	2.3	1.7	0.8
Latin America	0.3	1.7	3.5	4.3	0.1	-0.1
Asia	4.6	6.2	6.5	5.9	0.9	0.3
Africa	0.9	2.8	3.6	4.1	-0.6	-0.4
World growth	2.7	3.7	4.5	4.3	0.4	0.2
IMF						
EU15						
GDP growth	1.1	0.8	2.0	2.4	0.0	-
Eurozone						
GDP growth	0.9	0.4	1.7	2.3	0.0	-0.1
Unemployment	8.4	8.8	9.1	8.9	-0.1	-
Inflation	2.3	2.1	1.7	1.6	-0.1	-
USA						
GDP growth	2.2	3.1	4.6	3.9	0.5	0.7
Unemployment	5.8	6.0	5.5	5.4	0.3	-
Inflation	1.6	2.3	2.3	2.2	1.0	-
Japan	-0.3	2.7	3.4	1.9	0.7	1.9
Advanced economies	1.7	2.1	3.5	3.1	0.3	0.6
Western Hemisphere	-0.1	1.7	3.9	3.7	0.1	0.4
Asia	6.4	7.8	7.4	7.0	1.4	0.9
Africa	3.5	4.1	4.2	5.4	0.4	-0.4
World growth	3.0	3.9	4.6	4.4	0.6	0.6

Source: EC and IMF.

The Balkans developed at relatively high rates in 2003. Strong domestic demand, falling regional tension, and high world industrial product prices favored growth. A trend to growing national trade deficits emerged with rising domestic demand. Prospects for the first half of 2004 remain positive, with foreign direct investment into the region expected to grow. Good industrial growth figures for the first two months of the year confirm expectations of increased growth.

...the Balkans developed at relatively high rates in 2003

Table 4

Balkan Countries Growth

(%)

	2002	2003
Bulgaria	4.8	4.3
Bosnia and Herzegovina	5.5	3.5
Croatia	5.2	4.3
Serbia and Montenegro	3.3	1.0
Macedonia	0.9	3.2
Turkey	7.8	5.8
Albania	4.7	6.0
Romania	4.9	4.9
Greece	3.9	4.7
Balkan countries	5.8	4.9
Balkan countries, Greece excluded	6.7	5.2

Source: Statistical Institutes and central banks of the respective countries.

Commodity Prices

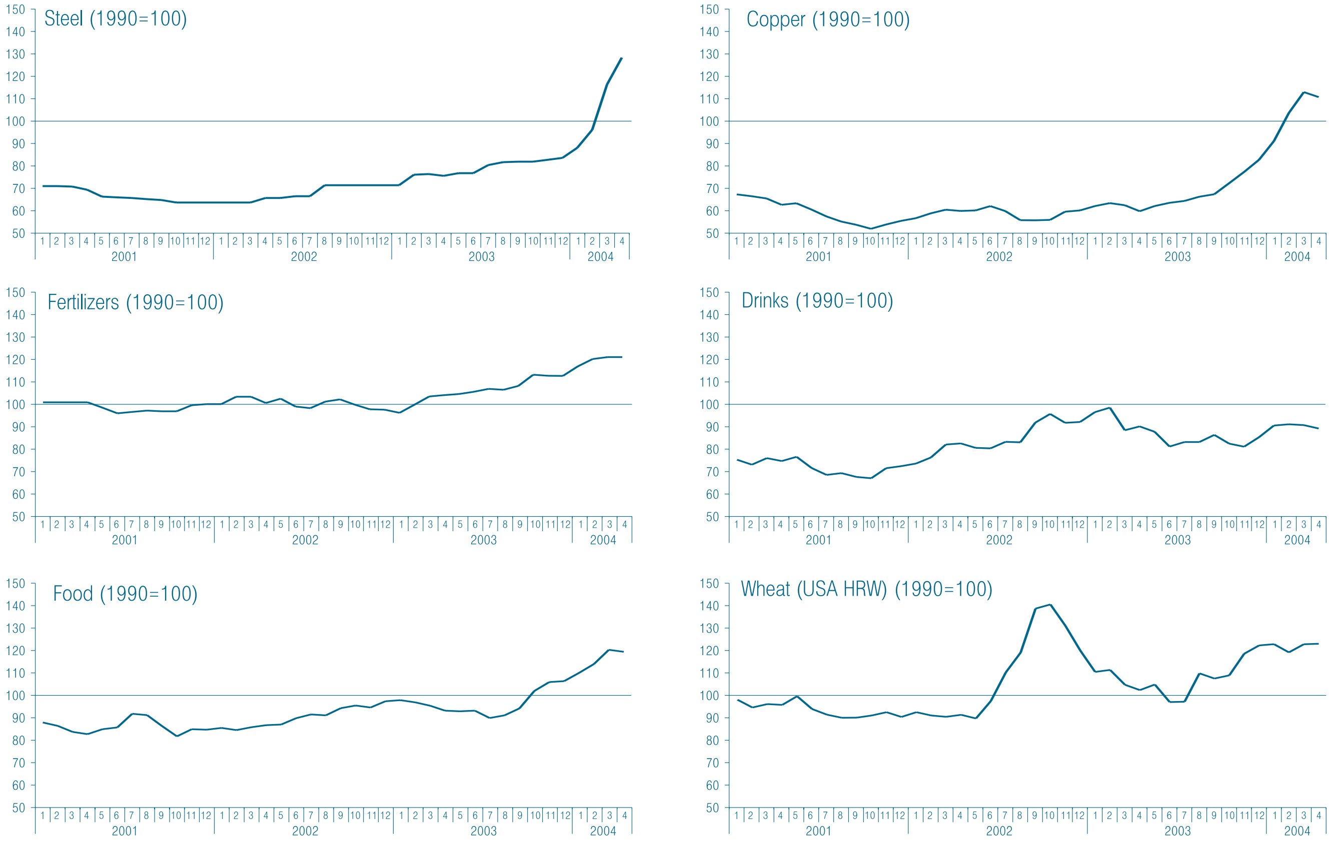
Over the past two years, the US dollar equivalents of major commodity prices have grown steadily. EC, IMF and WB forecasts emphasize that the trend to feedstock material price growth in US dollar terms will continue in 2004.

Metals registered a particularly large jump by an average of 16 percent. In the first months of 2004 metal prices continued climbing. Partly due to US dollar devaluation, this also reflected growing Chinese demand linked to high industrial growth resulting from increasing foreign direct investment and the renminbi yuan peg to the US dollar.

Agricultural produce and feedstock prices grew by 6 percent in 2003, with the trend to dearer cereals continuing into early 2004.

...the US dollar equivalents of major commodity prices have grown steadily

Chart 12
Price Indices of Major Commodities and Commodity Groups



Source: World Bank.

Table 5

Prices and Price Indices of Major Commodities and Feedstock Materials, 1980–2004

		Current prices (USD)							Indices							
		1980	1990	2000	2001	2002	2003	2004*	weight	1980	1990	2000	2001	2002	2003	2004*
ENERGY																
Coal, Australia	$/mt	34.16	39.67	26.25	32.31	27.06	27.84	40.0		109.3	100	68.1	86.4	73.2	70.8	73.1
Crude oil, average price	$/bbl	36.87	22.88	28.23	24.35	24.93	28.9	26.0		204.5	100	127.0	112.8	117.0	127.4	109.8
Natural gas, Europe	$/mmbtu	3.4	2.55	3.86	4.06	3.05	3.91	3.8		169.0	100	155.7	168.6	128.6	154.5	132.5
NONENERGY									100.0	159.2	100	89.4	83.7	89.1	92.1	97.4
Agriculture									69.1	175.2	100	90.3	84.6	92.8	95.3	96.0
Drinks									16.9	230.2	100	90.9	76.4	90.8	87.9	86.4
Cocoa	¢/kg	260.4	126.7	90.6	106.9	177.8	175.1	172.0	3.9	260.8	100	73.6	89.5	150.7	139.4	131.2
Coffee, Arabic	¢/kg	346.6	197.2	192	137.3	135.7	141.5	149.9	8.0	223.0	100	100.2	73.8	73.9	72.4	73.5
Coffee, Robusta	¢/kg	324.3	118.2	91.3	60.7	66.2	81.5	83.8	2.8	348.2	100	79.5	54.5	60.1	69.5	68.5
Food									29.4	176.7	100	87.0	91.2	96.7	97.2	100.4
Corn	$/mt	125.3	109.3	88.5	89.6	99.3	105.4	110.0	1.7	145.4	100	83.4	87.0	97.5	97.2	97.3
Rice, Thailand	$/mt	410.7	270.9	202.4	172.8	191.9	197.6	205.0	2.9	192.4	100	76.9	67.7	76.1	73.6	73.1
Wheat, USA	$/mt	172.7	135.5	114.1	126.8	148.1	146.1	155.0	1.9	161.7	100	86.6	99.2	117.3	108.7	110.5
Sugar	/kg	63.16	27.67	18.04	19.04	15.18	15.63	15.0	7.5	289.6	100	67.1	73.0	58.9	57.0	52.4
Feedstock materials									22.8	132.7	100	94.0	82.0	89.4	98.3	97.4
Cotton	¢/kg	206.2	181.9	130.2	105.8	101.9	139.9	145.5	5.9	143.8	100	73.7	61.7	60.2	77.5	77.3
Rubber, Malaysia	¢/kg	142.5	86.5	69.1	60.0	77.1	105.6	110.2	4.8	209.0	100	82.2	73.6	95.7	123.1	123.2
Timber, Malaysia	$/m^3	396.0	533.0	594.7	481.4	526.5	551.0	560.0	2.9	94.3	100	114.8	95.7	106.1	104.2	101.5
Fertilizers									*2.7*	*163.5*	*100*	*108.8*	*104.7*	*107.9*	*107.0*	*107.5*
Triple superphosphate	$/mt	180.3	131.8	137.7	126.9	133.1	149.3	160.0	0.9	173.5	100	107.5	102	108.4	114.2	117.3
Metals									28.2	119.5	100	85.4	79.6	78.1	82.7	100.0
Aluminum	$/mt	1 456	1 639	1 549	1 444	1 350	1 431	1 650	7.9	112.7	100	97.2	93.4	88.4	88.0	97.2
Copper	$/mt	2 182	2 661	1 813	1 578	1 559	1 779	2 400	9.3	104.0	100	70.1	62.9	62.9	67.4	87.1
Gold	$/toz	607	383	279	271	310	363	380	-	201.1	100	74.9	74.9	86.8	95.6	95.8
Nickel	$/mt	6 519	8 864	8 638	5 945	6 772	9 629	14 000	2.2	93.3	100	100.3	71.1	82.0	109.5	152.6

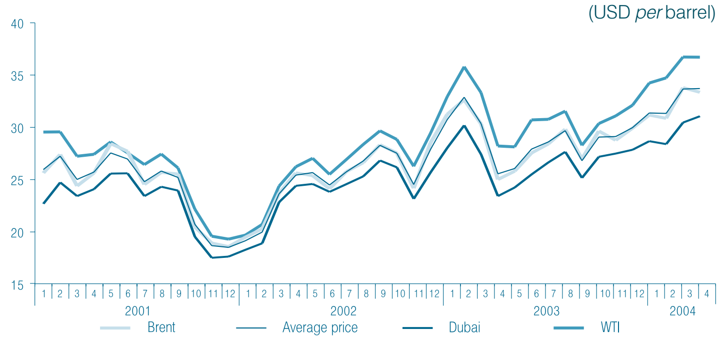
* 2004 projections.
Source: World Bank.

Since mid-2003 crude oil prices in US dollar terms show a pronounced upward trend which continues into 2004. Factors influencing them since the start of the year include data on the depletion of US petroleum reserves, the new OPEC quota reductions, the complex situation in Iraq, terrorist incidents in Saudi Arabia, and growing demand from China and the industrial world. The International Energy Agency (IEA) increased its world oil demand forecast for 2004 to 80.6 million barrels *per* day: up by 2 million b/d on 2003. The IEA sees a need for 26.4 million barrels from OPEC sources in 2004. This would entail quota increases in contravention of current OPEC thinking. Production facility utilization is running at over 88 percent, leaving little slack. We expect to see the second quarter price stay above the upper OPEC target limit (USD 28 *per* barrel), with the average price running at USD 34 to USD 36 *per* barrel. The traditional seasonal build up of petrol reserves will be hampered by both high prices and strong demand. Recent months' trends point to upward revisions of IEA oil demand forecasts, giving rise to concerns about supply. The growing

...high prices of crude oil in early 2004

Chart 13
Crude Oil

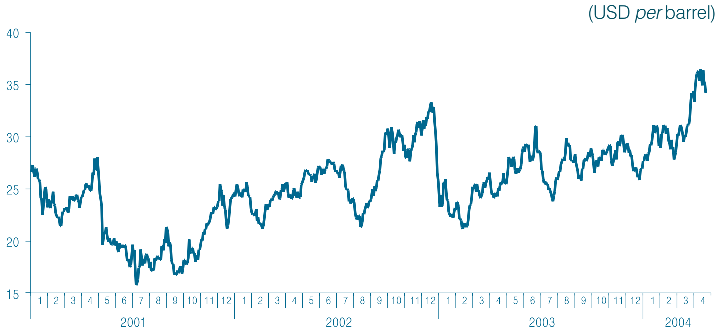
(USD *per* barrel)



Source: World Bank.

Chart 14
Ural Crude Oil
(Shipment to the Mediterranean Sea)

(USD *per* barrel)



Source: Bloomberg.

pressure by the US Congress for the Bush administration to release part of the national strategic oil reserve is one way of handling the situation, but it remains blocked by security considerations. Geopolitical tension and instability in Iraq would also push prices upward. There are no serious grounds to believe that non-OPEC members would increase exports. Demand traditionally grows in the third quarter in line with leisure travel. Strong drives to secure adequate reserves lead to expectations of continuing high prices. An improvement in the Iraq situation could boost deliveries. The IEA sees a need for OPEC members to produce 25.8 million barrels of oil for the period, which would entail quota increases. It is likely, however, that a possible increase in the US dollar rate would deprive OPEC of one reason for maintaining high prices. The cartel's clearly stated concerns about reserves in the second quarter would be tested in practice, possibly leading to a change in mood. This could lead to behavior closer to market expectations, and a fall in prices. Purely technically, the curtailing of the large volume of long speculative positions caused by prevalent expectations of price increases would have a similar effect. We expect a slight price drop, with the average settling at between USD 30 and USD 33 *per* barrel.

...we expect a slight crude oil price drop compared to the May price

Interest Rates

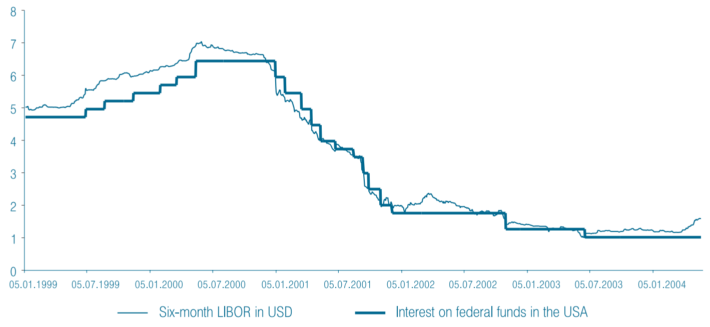
Between April 2003 and March 2004, the US Federal Reserve System kept the federal funds interest rate at the record low of 1 percent. This kept six-month USD deposit rates on the London interbank market within the relatively narrow 0.98 percent to 1.33 percent band. The US reference interest rate and expectations of its change had a basic bearing on yield. The average spread between LIBOR and the federal funds rate over the period was 13.2 basis points.

By the close of March 2004 futures contracts on federal funds showed expectations of a 50 basis point interest rate increase over the fourth quarter. Data derived from the forward yield curve supported these expectations. In April, however, came the publication of macroeconomic data which exceeded expectations and markets changed dynamics in anticipation of a likely earlier rise in interest rates (Chart 17). This caused a rise in the six-month LIBOR in USD.

LIBOR deposit rates will follow a rising curve during the second and third quarters due to the expected tightening of monetary policy by the US Federal Reserve System. The inflation rise observed over the first four months of 2004 (4.4 percent on an annual basis) makes early interest rate rises inevitable. Anything else would throw doubt over the US central bank's resolve to maintain price stability, boosting inflationary pressure. Uncertainty attends only the degree of smoothness with which the US Federal Reserve System will raise rates. This in turn depends on the stability of US economic growth, the degree of labor market improvement, and coming inflation dynamics.

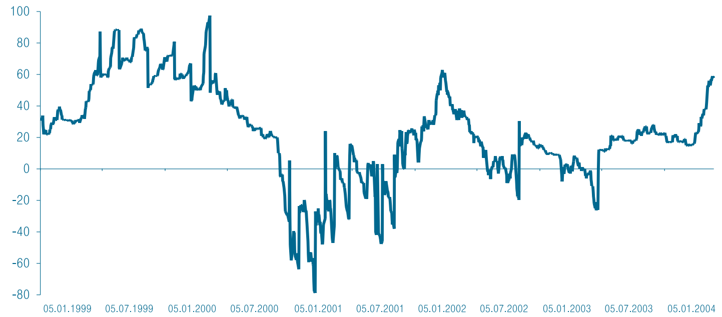
...the US federal funds interest rate stayed at 1 percent

Chart 15
Interest on US Federal Funds and Six-month LIBOR in US Dollars



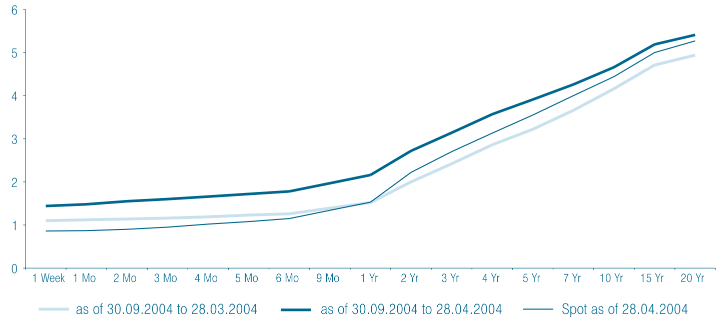
Source: Bloomberg.

Chart 16
Spread between Interest on US Federal Funds and Six-month LIBOR in US Dollars



Source: Bloomberg.

Chart 17
Expected US Curve Yield



Source: Bloomberg.

...we expect interest rate rises

Average eurozone interbank interest levels in 2003 fell to match reference rates. The ECB twice cut interest on basic refinancing operations: by 25 basis points in March, and by 50 basis points in June, to a record low of 2 percent. Over the past year and the first quarter of 2004 interest rates on six-month eurozone interbank deposits (EURIBOR) and on the London interbank market (EURO LIBOR) fluctuated in anticipation of changes in eurozone monetary policy.

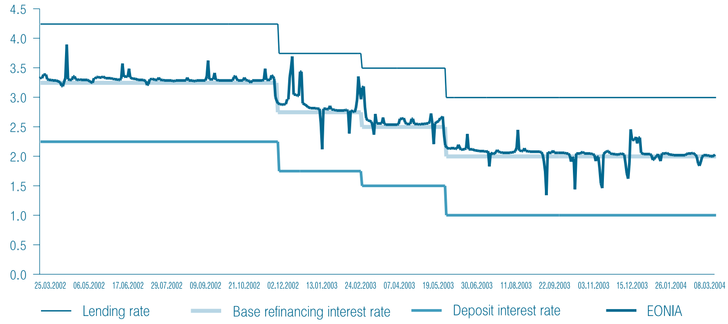
Over the first quarter of 2004 the benchmark interest rate on overnight deposits (EONIA) diverged little from the minimum of 2 percent offered at ECB refinancing auctions.

Three-month EURIBOR futures contracts show that the markets expect eurozone monetary policy change to come in the fourth quarter of this year or early in 2005. Inflation and the stability of growth would be the key influences on eurozone base interest rates. The hike in world fuel prices and its effect on consumer price indices may influence ECB monetary policy decisions.

If current ECB refinancing interest rates stay put, we expect the second quarter six-month EURIBOR and EURO LIBOR to stay within the 2.05–2.25 percent range, rising to 2.15–2.35 percent in the third quarter. In the second and third quarters the money market benchmark yield curve (Chart 21) will get steeper due to expectations of eurozone interest rate rises. On the basis of the forward curve by 28 April 2004, expected European government securities yield by 30 September 2004 will rise over and above levels expected by the markets a month earlier (Charts 20 and 21).

Chart 18

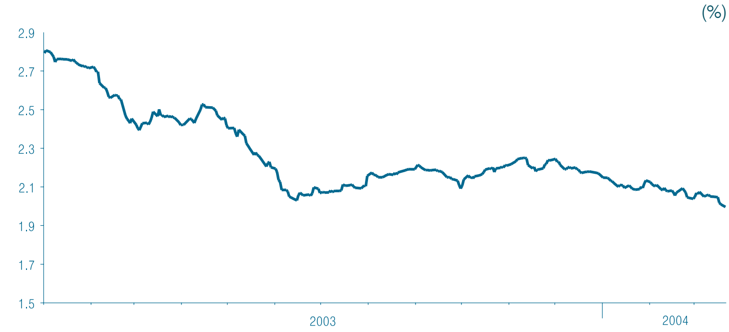
Eurozone Base Interest Rates



Source: Bloomberg.

Chart 19

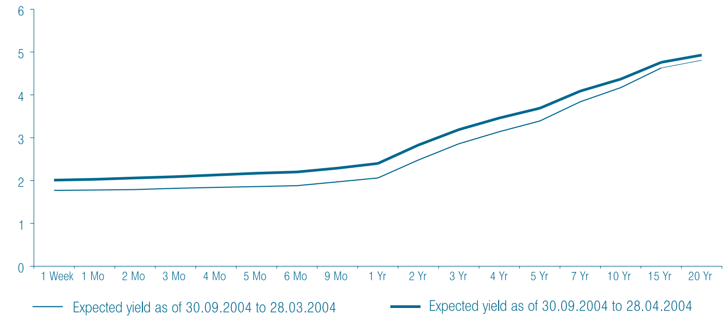
Eurozone Interest Rates on Interbank Deposits with Six-month Maturity



Source: Reuters.

Chart 20

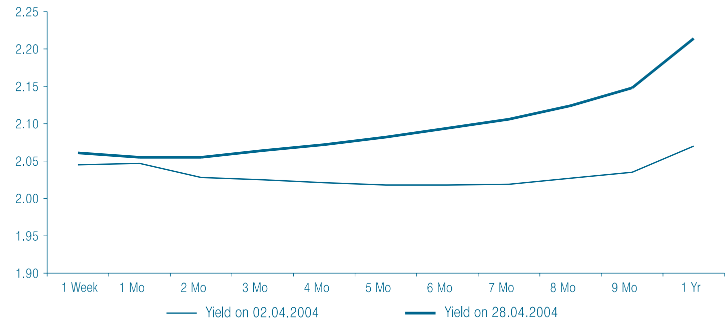
Curve of Expected Eurozone Yield



Source: Bloomberg.

Chart 21

Eurozone Money Market Yield Curve



Source: Bloomberg.

...eurozone interest rate rises are expected

The Stock-exchange Markets

Over most of the past year the major economies' stock-exchange markets kept rising. After three successive years of decline, indices switched direction in March 2003, continuing to climb almost unabated until the start of 2004. Over the period the US Dow Jones Industrial Average and Nasdaq rose by 42 and 69 percent respectively, while the European DJ Euro Stoxx 50 rose by 60 percent.

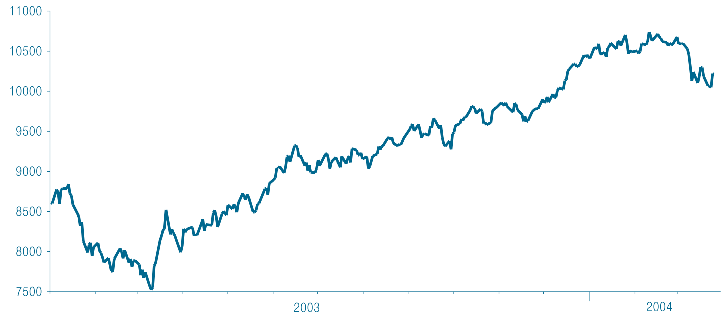
A number of factors showed in this: less uncertainty about corporate scandals and the conflict in Iraq; the completion of US corporate restructuring and expenditure optimization; the relatively low base value of shares after three years of decline; and good corporate prospects amid increasing growth. A strong positive factor was corporate profitability, which in the USA alone rose by 29 percent in the fourth quarter of 2003 over the same period a year earlier. Interest focused on procyclic companies whose shares perform well at the start of the business cycle. This favored technological shares.

After February 2004 stock-exchange indices faltered due to investor concern that macroeconomic fundamentals were lower than reported stock appreciation. This returned the Dow Jones Industrial Average closer to 10,000.

The costly euro and the 11 March Madrid terrorist attacks influenced European *bourses*. Expectations of an early rise in US interest rates, unfavorable developments in Iraq, and oil price rises further depressed the markets in the second quarter.

Prospects before the stock-exchange markets remain good. The recent months' dollar rise has helped European trade with the USA. Any negativity is largely to do with share prices. In all likelihood, the current corrections of US and European indices will end in the second quarter, and markets will resume their rise. Optimistic expectations of corporate profitability and of the economic outlook as a whole back this. The major risk for the markets is retention of the current high oil prices which would hit world growth in the medium term.

Chart 22
Dow Jones Industrial Average Index Dynamics

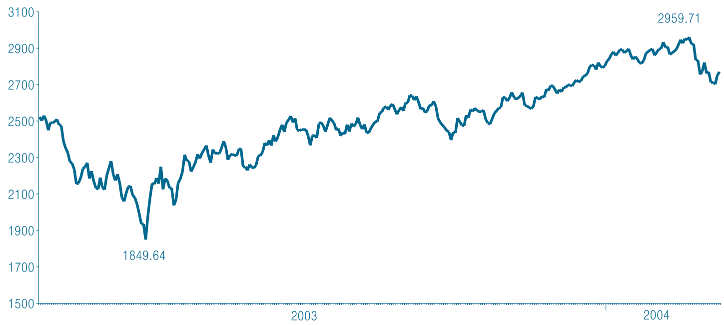


Source: Bloomberg.

...stock-exchange markets kept rising

...a strong positive factor was rising corporate profitability

Chart 23
DJ Euro Stoxx 50 Index Dynamics
(Since Early 2003)



Source: Bloomberg.

...prospects before the stock-exchange markets remain good

The EUR/USD Rate

The EUR/USD exchange rate fluctuated widely within the 1.0800–1.2930 range. The overall trend was to a cheaper US dollar because of global uncertainty and the war on terrorism. This was particularly felt over the first half of 2003. Uncertainty about developments across the Atlantic, the flight to other currencies since early 2004, and not least the low US interest rates which hamper US budget and foreign deficit financing all played a role.

...the overall trend in the previous year was toward US dollar depreciation

Chart 24
EUR/USD Exchange Rate

Source: Reuters.

The euro dropped sharply in late January 2004 after statements by leading EU officials. They attacked the 'brutal' euro appreciation by almost 40 percent over the prior two years, and its deleterious influence on European economies. The repositioning of market participants' portfolios since early 2004 backed the US dollar further. Many investors preferred to cash in the great profits accumulated in prior months and cut their long euro positions. This will likely continue into the start of the subsequent quarter. Assuming the US Federal Reserve System maintains the base rate at 1 percent until the close of the second quarter, we expect to see the US dollar decline against the euro in response to the large trade balance deficit.

...many investors preferred to cash in the great profits accumulated in prior months and cut their long euro positions

...we shall see a US dollar appreciation over the third quarter

We shall see a US dollar appreciation over the third quarter: that is the time when analysts expect a strong US economic rally and a US Federal Reserve System rate rise. By the close of the second and third quarters, the EUR/USD rate would be at the 1.22 and 1.16 levels. Putative signals or interest rate policy changes on both sides of the Atlantic may lead to changes in market mood and participants' behavior. This would likely give rise to clearly expressed and sharply divergent trends.

Bulgarian Foreign Debt on the International Financial Markets

A steady closing of Bulgarian government securities spreads has been evident since early 2003. Over the past year, yield spread measured by the JP Morgan EMBI+[1] index for Bulgaria fell from 280 to 177 basis points by year-end. The trend to greater interest in Bulgarian government debt is in line with Bulgarian eco-

...the trend to greater interest in Bulgarian government debt is in line with Bulgarian economic stability

[1] A JP Morgan-Chase investment bank index monitoring emerging markets securities.

nomic stability, the prospects for growth, political stability, the solid fiscal position, and coming EU accession. In May 2003, Standard & Poor's upped Bulgaria's credit rating to BB+ in response to the above factors. Comparing the EMBI+ index for Bulgaria with the overall index of BBB-rated paper shows similar dynamics. Market valuations include a possible upgrading of the Bulgarian foreign debt credit rating during the current year.

The close of 2003 saw a tightening of spreads on Bulgarian government securities mainly due to wariness about a possible 'contagion' of the problems on the Hungarian forex market, and to 'differentiation.' In late November the Hungarian central bank intervened to back the forint, spreading 'contagion' to Poland and the Czech Republic. Similar issues in the three countries (mainly on budget deficits) lowered investor expectations, weakening interest in government securities issued by their governments. Market interest switched to those second accession wave countries that show stability, causing Bulgarian government securities prices to rise and spreads to tighten. This distinction the market draws between second accession wave countries created the 'differentiation' effect for Bulgaria.

Early 2004 saw a broadening of Bulgarian securities spreads measured by the EMBI+ index: from some 160 basis points to 186 basis points. Basic reason for this was the Brazil corruption scandal and the mass sale of some USD 800 million worth of Brady bonds. The Venezuelan political crisis at the time supplemented the drop in interest in developing economies' foreign debt.

Since early April, spreads on Bulgarian government securities have broadened in line with the overall EMBI+ emerging markets index. Favorable data on the US economy and expectations of US interest rate increases have shifted interest away from emerging market government securities.

We expect to see the moderate widening of Bulgarian government securities spreads to continue, while remaining strongly lined to debt prices for Central and East European EU members with credit ratings higher than that of Bulgaria.

Chart 25

Spread of JP Morgan Emerging Markets Bond Index

Source: Bloomberg.

... we expect to see the moderate widening of Bulgarian government securities spreads to continue

2. Financial Flows, Money and Credit

Since 1997 Bulgaria has held to a regimen requiring the lev equivalent of BNB forex reserves at the pegged exchange rate to cover its monetary obligations. BNB monetary obligations include reserve money, the deposits of the government and other government institutions, and the net value of the Bank's Issue Department. The regimen requires that money issuing (the growth of reserve money) be equal to foreign exchange (euro) purchased by the Bank at the legally fixed rate. The rise in reserve money must thus match BNB international foreign exchange reserves. Yet, due to the specifics of the Bulgarian currency board, the correlation is not directly proportional. For this reason analysis focuses on identifying the behavior of major economic sectors: the BNB, general government, commercial banks, and others, and amending Bank international foreign exchange holdings in line with analytical findings.

Financial Flows and Foreign Position Stability

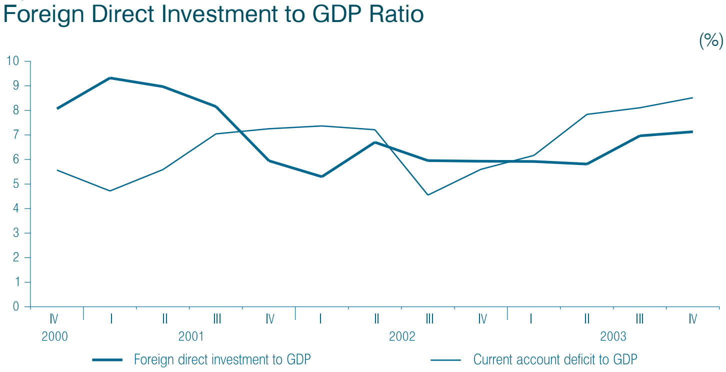
In 2003 BNB international foreign exchange reserves reached BGN 10,382.7 million (EUR 5308.6 million) or 30.2 percent of GDP. The balance of payments current account deficit of BGN 2930.4 million or 8.5 percent of GDP[2] was financed by the net inflow of money into the balance of payments capital and financial accounts, with the Bank's foreign exchange reserves growing by BGN 1597.4 million. A significant part of the current account deficit financing is long-term: foreign direct investment over the year came to BGN 2452.5 million, providing balance of payments stability.

...BNB international foreign exchange reserves by end-2003 reached EUR 5308.6 million

...current account deficit was 8.5 percent of GDP

Chart 26

Dynamics of the Current Account Deficit to GDP Ratio and the Foreign Direct Investment to GDP Ratio



Source: BNB, NSI.

[2] NSI preliminary data put 2003 GDP at BGN 34,410.2 million (EUR 17,593.7 million).

A more detailed analysis of factors with a bearing on the balance of payments financial flows rests on net financial flows in major economic sectors.[3] Determining the position of each sector in its relationship with the outside world involves classifying balance of payments current and financial flows conditionally into groups relevant to each sector (see below).

...current account was mainly financed through foreign direct investment

Classifying Balance of Payments Financial Flows by Sector

Sectors include the central bank, commercial banks, the general government (government sector), and other sectors.

The following classification principles apply:

1. Central bank flows include flows corresponding to the *Income account* of the current account, and flows in the financial account of the *Other investment* item identified as central bank transactions, as well as changes in foreign exchange reserves

2. Commercial bank data take into account only relevant flows in the *Income account* of the current account, the *Portfolio investment assets* item, the *Debt Securities* subitem, and relevant *Other investment* items

3. Government current account flows comprise relevant income and transfer items, and the financial account comprise privatization revenue (as part of foreign direct investment), the *Debt Securities* subitem of the *Portfolio investment liabilities*, and relevant items of *Other investment*, including use of IMF credit (net)

4. the *Other sector*'s current account flows comprise goods and services flows from the *Income* item and from current transfers. Financial account flows attributed to this sector include direct investment abroad, all direct investment inflows except privatization, the *Equity sequrities* subitem portfolio investment flows, relevant subitems of *Other investment*, and *Errors and omissions*.

The above is not an exhaustive institutional classification of balance of payments flows, but rather a categorization which gives a good degree of approximation between each sector and the rest.

[3] Balance of payments analysis uses formal presentation data. This shows government loans from the IMF (and all other exceptional financing in support of the balance of payments such as World Bank loans) under **Financing**, **Other Investment; Liabilities; Loans**.

A negative trade balance of BGN 4295.3 million[4] mainly influenced the balance of payments current account deficit in 2003. The reasons for this lie in the significant increase in domestic investment and consumer demand, some of which satisfied by imports of investment and consumer goods.[5]

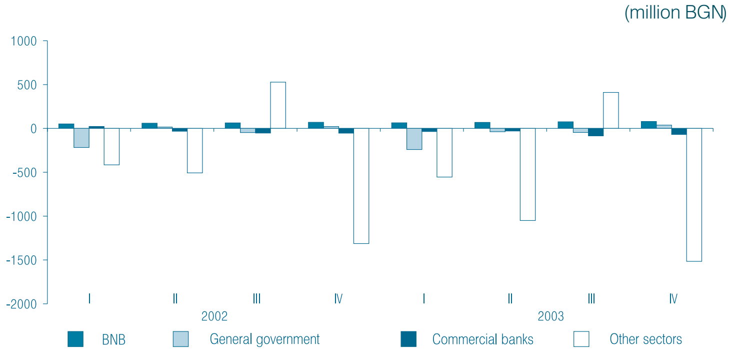
The *Income* item deficit of BGN 858.2 million added to the current account deficit. This resulted from net outflows from all sectors except the central bank (Chart 27). Thanks to low world interest rates, the government sector cut its foreign debt service bill, improving the current account, which however retained a negative net position. The negative balance on the commercial banks' *Income* item was due to dividend payments which were not offset by interest income.

The stability of the balance of payments current account may be assessed by reference to the structure and character of cash flows in the capital and financial accounts by sector.

Privatization revenue was the major financing item in the general government sector. In 2000–2001 net obligations fell, with the state repaying more debt than it assumed. In 2003 the net change in obligations was almost zero: debt repayments were about equal to new loans (a World Bank loan and IMF tranches).[6]

Chart 27

Distribution of Current Account Flows by Sector (Quarterly)



Source: BNB.

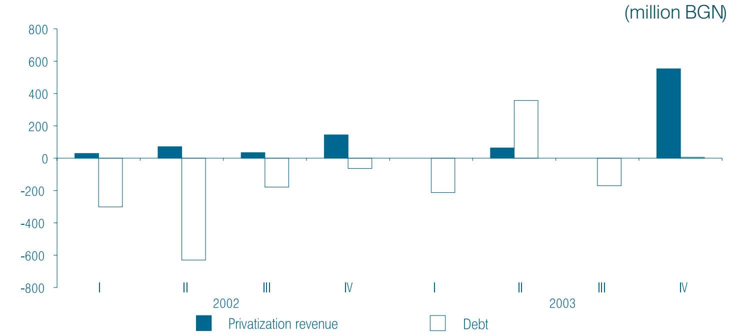
Chart 28

Distribution of Financial Account Flows by Sector (Quarterly)

Source: BNB.

Chart 29

Government Sector Financial Account Flows (Quarterly)



Source: BNB.

...privatization revenue was the major financing item in the general government sector

[4] Over the first two months of this year the current account deficit reached BGN 691.4 million. It was again formed largely by the trade balance deficit of BGN -586.5 million and the negative balance on the *Income* item (BGN -237.1 million). The BGN 174.4 million net revenue from current transfers partly offset the negative values of other major current account components. This deficit was mostly financed by a BGN 290.5 million drop in forex reserves, and by BGN 149.1 million of net revenues into the financial account. Foreign direct investment came to BGN 93.5 million. A detailed analysis of financial sources by sector follows in the next issue of the *Economic Review*.

[5] A detailed analysis of business activity factors and their effects appears in Part 4.

[6] The debt increase in the second quarter of 2003 was due to the World Bank PAL loan, while fourth quarter proceeds from the privatization of the DSK Bank are shown as revenues into general government sector; in practice these proceeds would reach government accounts only in 2004.

As regards commercial banks, a source of income in 2002 and 2003 was the repatriation of foreign assets. The conversion of some foreign assets into domestic ones was prompted by the higher yield offered by the latter (Chart 30). Last year saw very significant growth in nonresidents' deposits (with possible remittances of credit lines from abroad). This was despite the narrowing of differentials between domestic credit rates and LIBOR or EURIBOR[7], and shows rising confidence in the economy.

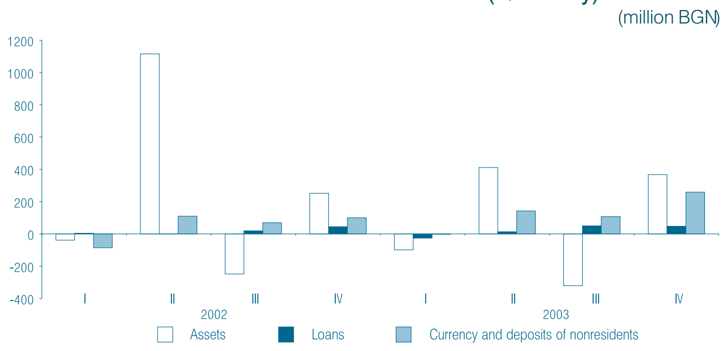
The growth of nonresidents' deposits was also linked with transaction needs in line with the opening of the Bulgarian economy to the world. This also explains the trend to increasing resident deposits abroad[8] (Chart 32).

Foreign direct investment dominated the fiancing of other sectors (Chart 33), covering 66 percent of their current account deficits in 2003.

[7] The dynamics of the two interest differentials is practically identical.

[8] Some of this increase may be due to refined data scope following amendments to the Foreign Exchange Law mandating local legal entities and sole proprietors to report claims on foreign persons with the BNB.

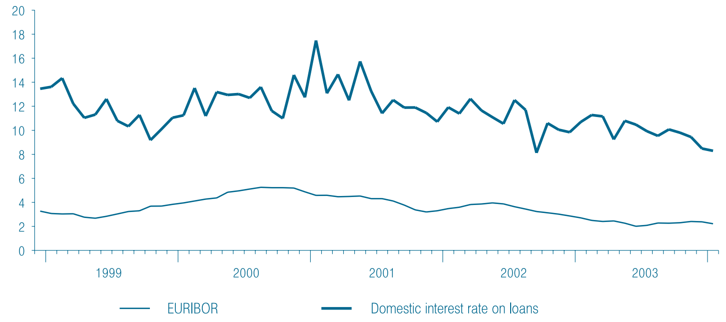
Chart 30
Commercial Banks' Financial Account Flows (Quarterly)



Source: BNB.

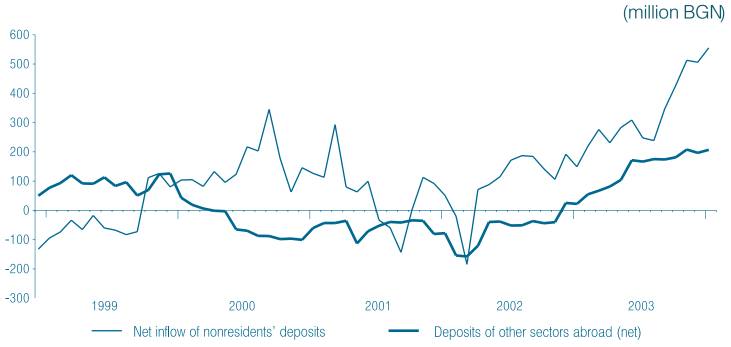
...commercial banks convert some foreign assets into domestic ones to provide higher yield on their investment

Chart 31
Interest on Long-term Loans and EURIBOR



Source: BNB, ECB.

Chart 32
Balance of Payments Deposit Flows



Source: BNB.

The resulting financing pattern shows that the nominal Bulgarian foreign debt is tending to fall (Chart 34). In 2003 gross foreign debt measured in euro fell by 4 percent on 2002, with government debt falling by 7.5 percent. Commercial bank debt grew by 50 percent, and the debt of other sectors by 7.6 percent. Data analyses ought to take into view the contributions of separate debt components, particularly as regards banking and corporate debt. Table 6 shows that bank debt grew mostly due to the increase in nonresidents' deposits (with most terms exceeding two years), while corporate debt grew most due to intercompany indebtedness, reported as part of direct foreign investment in the balance of payments. This allows the conclusion that net capital flows by sector are stable in the medium term.

The dynamics of net capital flows by sector leads to these conclusions on their influence over Bank international forex reserves, and over money supply:

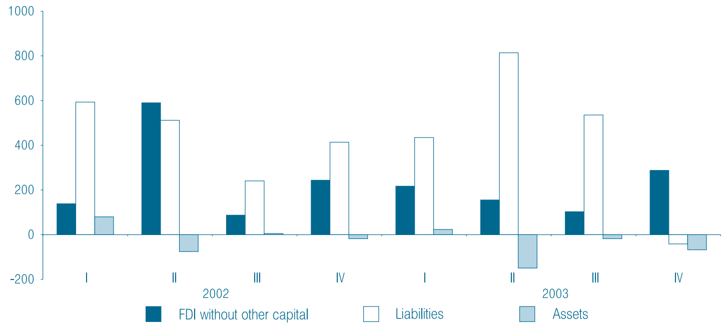
- the relations of other sectors to the external one reflect directly on reserve money through money demand for transactions and the growth of bank deposits; and

- general government policy involves cutting debt and the cost of its service, in tandem with the principle of low budget deficits (under 1 percent of GDP). The growing government deposit with the BNB boosts forex reserves. With regard to reserve money, this forex growth may be neutral. Inasmuch as the budget redistributes money flows by economic sector, budget operations influence money demand for transaction purposes and savings.

Since mid-2002 and throughout 2003 banks restructured their foreign assets, aiming at the higher yields offered at home. Nonresidents' deposits grew considerably in 2003, with most of them acting as a credit resource (thus boosting money multiplier), while a portion directly boosts banks' reserves with the BNB.

Chart 33
Other Sectors Financial Account Flows

(million BGN)

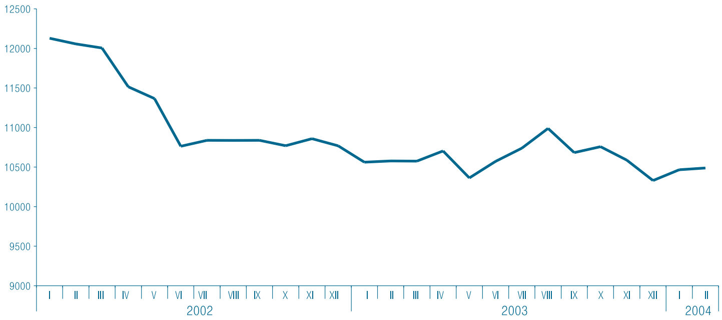


Source: BNB.

...foreign direct investment dominated the financing of other sectors

Chart 34
Gross Foreign Debt

(million EUR)



Source: BNB.

...gross foreign debt measured in euro fell by 4 percent on 2002

Table 6
Debt Structure of Commercial Banks and Companies

	2003	
	Debt growth rate in euro (%)	Contribution (percentage points)
Commercial banks	50.4	
Intracompany loans	-27.2	-2.5
Other loans	35.2	8.6
Nonresidents' deposits	66.7	44.3
Commercial companies	7.6	
Intracompany loans	52.7	13.7
Other loans	17.7	5.1
Commercial loans	-25.3	-11.4

Source: BNB.

Financial Flows in the Economy

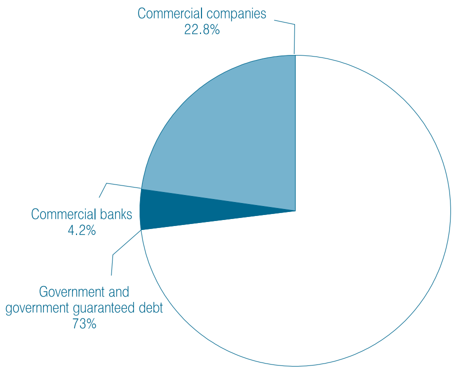
Bank Intermediacy

The analysis of balance of payments financial flows shows a deep and rapid change in the structures of banks' assets and liabilities: the return of assets home and the increase of nonresidents' deposits.[9] In 2003 the cut in banks' foreign deposits came to BGN 800.4 million. The growth of banks' foreign liabilities in 2003 was BGN 604.7 million, including deposits by BGN 545.6 million. By early 2004 the level of banks' foreign assets steadied, but their foreign liabilities continued rising, growing by BGN 339.3 million over the first quarter, with deposits as part of foreign liabilities growing by BGN 398.3 million. In late March the ratio of Bulgarian deposits abroad to nonresidents' deposits in Bulgaria was 1.2: sufficient to cover runs on nonresident deposits. These structural changes influenced money supply directly by accelerating money multiplier because of greater domestic lending (see Part 2 on monetary and credit aggregates).

In 2003 banks also attracted considerable domestic resource, with household and corporate deposits growing by BGN 1686.3 million.

Chart 35
Gross Foreign Debt Structure in 2002

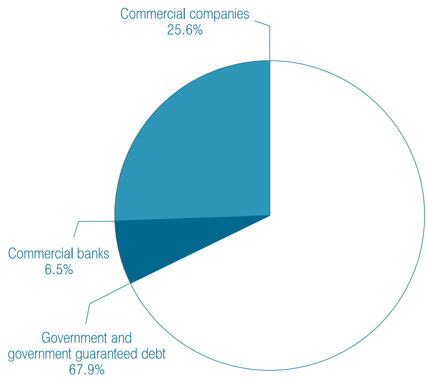
(%)



Source: BNB.

Chart 36
Gross Foreign Debt Structure in 2003

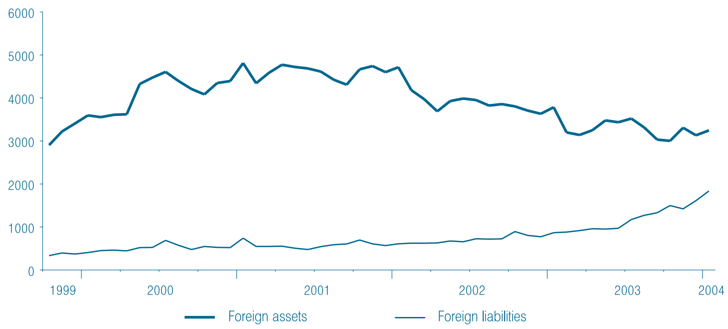
(%)



Source: BNB.

Chart 37
Foreign Assets and Liabilities of Commercial Banks

(million BGN)



Source: BNB.

...nonresidents' deposits have increased

...deposits of households and companies have grown

[9] Analysis uses monetary statistics data, *viz.* monetary statistics, BNB analytical reporting, and commercial bank analytical reporting (see the BNB website).

Table 7
Changes in Major Balance Sheet Positions of Commercial Banks

(million BGN)

	2002	I	II	III	IV	2003
		quarters, 2003				
Claims on nongovernment sector	1883.5	424.5	940.3	717.7	1006.6	3089.2
Deposits	1241.5	58.6	372.7	619.1	636.0	1686.3
Foreign assets	-862.2	-19.0	-533.6	270.0	-517.9	-800.4
Foreign liabilities	196.8	-26.8	92.9	213.4	325.2	604.7
Claims on central government, net	507.6	183.7	-275.9	-160.8	0.1	-252.8
Claims on central government	607.5	201.1	-53.7	-57.0	-12.1	78.4
Liabilities to central government	99.9	17.4	222.2	103.8	-12.2	331.2

Source: BNB.

The banks' role as intermediaries is shown on Chart 38. In 2003 banks' net obligations to the foreign sector grew, with banks transforming them into net claims on nonfinancial corporations. Households continued to be net creditors to banks but their contribution to net resources fell with the expansion of consumer credit.

The 2003 changes in banks' assets and liabilities reflect an important aspect of the economy's ability to develop: credit growth. Money accumulated by banks between 1998 and 2001 and invested abroad is now returning as credit to the Bulgarian economy. The process influences monetary aggregate dynamics, as well as real economic growth.

The Budget's Redistributive Role

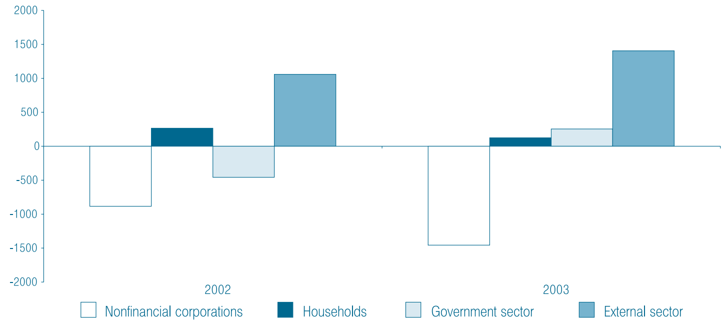
The state budget redistributes finance between economic sectors through the consolidated fiscal program. Budget balances, and the size and makeup of tax revenue, as well as the structure of financing, are important indicators of the character of fiscal policy and its influence on other sectors.

Over the past year the consolidated state budget primary surplus grew by 0.5 percentage points on 2002 to 2.1 percent of GDP. Revenue and expenditure reached 40.9 percent of GDP, up by 2.1 and by 1.5 percentage points on 2002. Major contributors to the nominal revenue growth were indirect taxes and social insurance contributions. Significant import growth boosted duty revenues by 22.8 percent. VAT and excise duty contributed 5.1 percentage points to the growth of all revenue and forms of assistance. This was linked with the increased share of consumer spending in

...households continued to be net creditors to banks

Chart 38
Net Financial Flows of Commercial Banks

(million BGN)

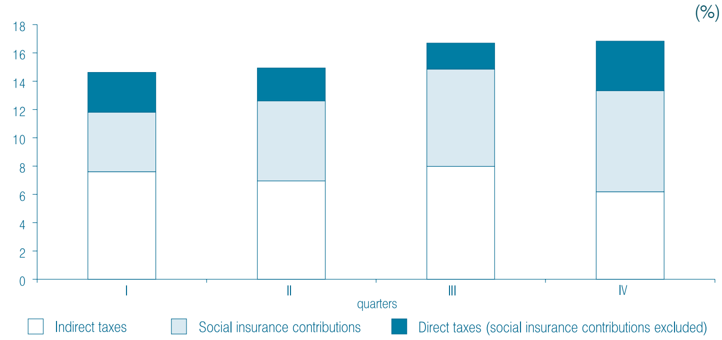


Source: BNB.

Note: A plus sign denotes a net increase in commercial banks' liabilities to the respective sector and a net flow minus sign shows commercial banks' claims on the respective sector.

Chart 39
Contribution of Major Tax Groups' Revenue to the Total Tax Revenue Growth under the Consolidated Fiscal Program in 2003

(%)



Source: MF, BNB.

...major contributors to the nominal revenue growth were indirect taxes and social insurance contributions

GDP, the fall in the share of untaxed consumption in consumer spending, and the increase in excise duty on alcohol and fuel at the year's start.

Significant changes took place in 2003 with regard to social insurance revenues. Employment contracts began to be registered mandatorily, and minimum insurance thresholds were launched for various businesses and trades. This boosted the collectability of social insurance, whose share in employment remuneration is expected to rise by some 2 percentage points to 24 percent. The significant underspend under the Law on Mandatory Social Insurance (unemployment benefits and income support came to BGN 111.7 million against the forecast BGN 192 million) and under the Law on Children's Family Assistance (BGN 125.8 million against BGN 171.8 million), made the state social insurance budget surplus come to BGN 14.2 million, or BGN 12.3 million higher than the law projections.

Corporate tax and income tax revenues retained recent years' trends by growing less rapidly than overall tax revenue, or by 11.5 and 8.4 percent respectively.

Overall budget spend grew nominally by 10.5 percent over the year, mostly due to noninterest spending (a 9.4 percentage point contribution). Capital spending kept its share at 3.5 percent of GDP, and interest spending fell to 2.1 percent of GDP: a 15 year low.

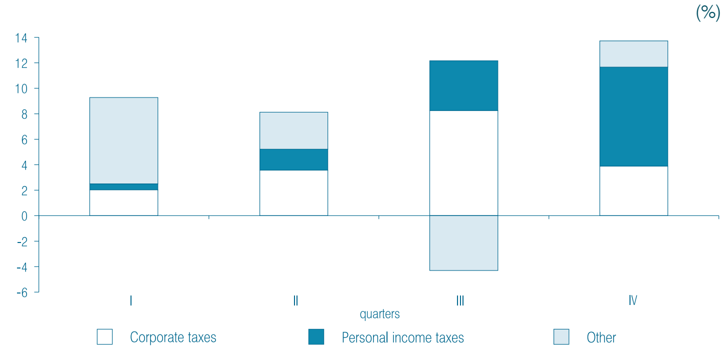
Foreign financing in 2003 remained positive[10] to the tune of BGN 107 million. Domestic financing stood at BGN -508 million, and privatization revenue came to BGN 400 million: under the BGN 550 million target but significantly more than in the two prior years. Net government securities operations were positive to the tune of BGN 197 million, with the growth of deposits and account balances coming to BGN 497 million.

Government and government guaranteed debt fell by 8.3 percentage points to 48 percent of GDP at the close of 2003. US dollar devaluation against the euro was a major contributor to this, along with real GDP growth.

[10] Including the IMF.

Chart 40

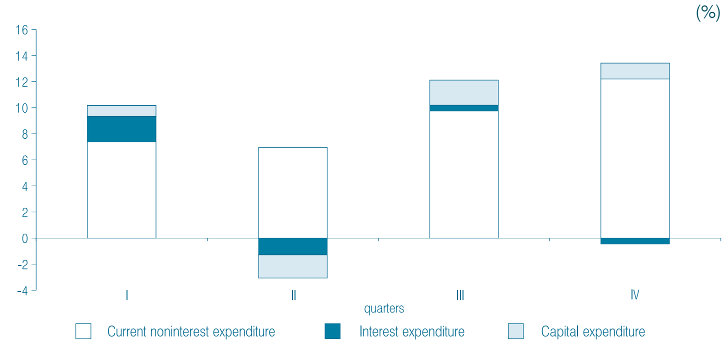
Contribution of Income Tax and Corporate Taxes' Growth to the Growth of Direct Taxes' Revenue (Less Insurance Contributions) in 2003



Source: MF, BNB.

Chart 41

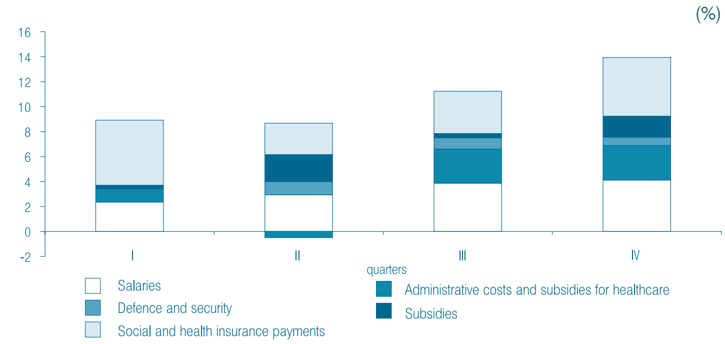
Contribution of Major Group Expenditure Growth to the Total Expenditure Growth under the Consolidated Fiscal Program in 2003



Source: MF, BNB.

Chart 42

Contribution of Major Groups Current Noninterest Expenditure in Their Total Growth in 2003



Source: MF, BNB.

...the major contributor to the total expenditure growth was noninterest expenditure

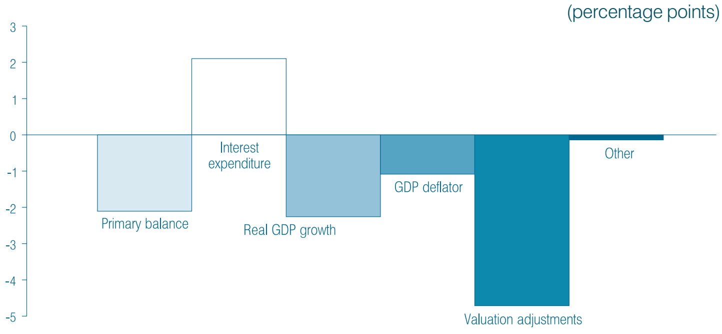
Fiscal policy led to the fiscal reserve growing to BGN 3848.8 million in 2003. The better part of this was down to changes in resources at commercial banks, rather than to the deposit at the BNB Issue Department. Government deposits with commercial banks grew by BGN 331 million over the year, with banks' claims on the central government growing by just BGN 78 million, mainly due to their greater holdings of forex-denominated government securities. This resulted in net claims on the government dropping by BGN 238 million as distinct from 2002, when they grew by BGN 480 million with the significant increase of banks' government securities holdings. The effect of the BGN 185 million of extraordinary government deposits on banks' liquidity in the spring of last year was to offset just 6 percent of the growth of the nongovernment sector's claims over the year. Under the terms of agreements with the IMF, these deposits shall be withdrawn by the middle of this year.

The government may receive net revenue from one sector and redirect it into another through its budget operations. This enables it to affect sectors' liquidity, disposable income, and net wealth (Charts 44 and 45).

Chart 43

Contribution of Individual Factors to the Change in Government Debt to GDP Ratio in 2003

(percentage points)

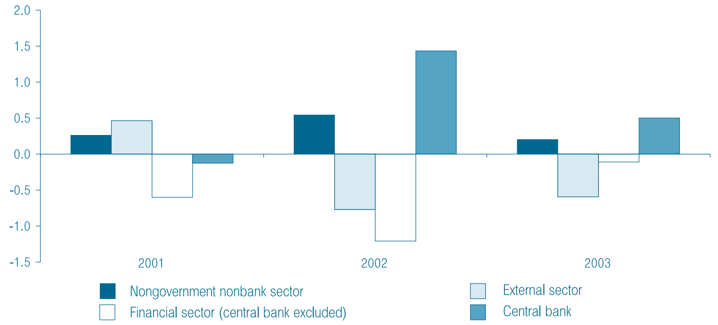


Source: MF, BNB.

Chart 44

Influence of Consolidated Budget on Other Sectors' Liquidity

(share of GDP, %)



Source: MF, BNB.

Financial Flows between the Budget and Other Sectors

The BNB measures the budget's effect on the liquidity of other sectors by monitoring changes in the Issue Department deposits of government and budget-supported organizations with reference to set criteria:

- for the financial sector (without the BNB), by subtracting the interest repayments on domestic loans and changes in government BNB deposits from the sum of financial institutions' corporate tax income, the excess of BNB income over expenditure, interest revenue, and internal bank financing

- for the external sector, by subtracting all interest payments on foreign loans from the sum of income from foreign provident institutions for pension payments under international programs; grants, aid and other monies from abroad; foreign financing and privatization revenue

- for the nongovernment nonbank sector, as the remainder that balances flows in other sectors.

Chart 44 shows assessments of these flows over the last three years. Plus signs shows that the budget has disbursed resources into the relevant sector, while minuses show net budget withdrawals.

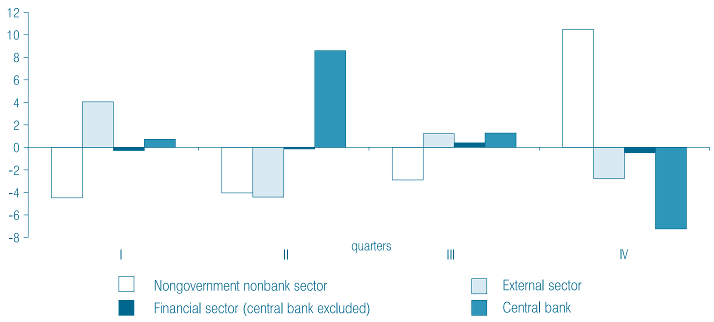
In recent years the financial sector (less the BNB) was a net finance source to the budget, and hence to other sectors. In 2003 the sector (less the BNB) enjoyed an almost balanced position. Nongovernment nonbank sector and the central bank are the two sectors into which the budget has disbursed net resource over the past year. The liquidity source was largely the external sector, mostly through privatization earnings. Within individual quarters of 2003 government influence on financial sector liquidity (without the BNB) was very weak: fiscal policy was largely neutral toward this sector.

...nongovernment nonbank sector and the central bank are the two sectors into which the budget has disbursed net resource over the past year

Chart 45

Influence of Consolidated Budget on Other Sectors' Liquidity in 2003

(share of GDP, %)



Source: MF, BNB.

...source of liquidity was largely the external sector, mostly through privatization earnings

Over the first three quarters of 2003 government drew net liquidity from nongovernment nonbank sector, reversing the process in the last quarter with monies equal to 10.5 percent of the quarter's GDP. This made the financial sector a net recipient of budget money.

Government dealings with the BNB fluctuated greatly through the year as shown by the government's Issue Department deposit, which balances liquidity in the other sectors. This deposit draws money out of the economy: a rise in it signals a cut in money multiplier and hence a cut in the rate of money supply growth.

...drawing of government deposits from commercial banks would decrease domestic lending rates and demand for government securities

Under government agreements with the IMF, over the second quarter of 2004 the sums deposited last spring with commercial banks shall be redeposited into the BNB. This aims to lower the rates of internal credit growth. By the close of March these deposits made up 1 percent of commercial banks' liabilities or 0.5 percent of anticipated GDP. Apart from restricting credit, the measure will likely depress demand for government securities[11] and raise the cost of budget deficit financing.

[11] Government deposits are secured by freezing government securities. Partial withdrawal of deposits will release the security, allowing banks to restructure portfolios and sell parts of them. This would occasion pressure for improved secondary government securities market yields, as well as improved new issue yields.

In 2004 the fluctuations of flows in the budget's financial part are expected to be significantly greater than last year. Foreign financing will be positive both for the year, and for the second and third quarters. Net government securities issue will be positive, but the lack of a longer-term schedule hampers budget financing forecasts for individual quarters, as well as forecasting fluctuations in the government's BNB deposit. At the close of the second quarter we expect financing to mark the dividend the state will receive after liquidating the Banking Consolidation Company (BCC). This is expected to exceed BGN 400 million. Revenue from the Bulgarian Telecommunications Company (BTC) privatization is expected in the third quarter, but this is dependent on the licensing process for a new GSM network which is still in procedure. Overall expectations are for the government's BNB deposit to grow significantly, passing above BGN 4 billion as early as the second quarter.

Monetary Aggregates

The monetary base continued growing rapidly in 2003, marking 17.5 percent or BGN 784 million growth. Money outside banks contributed most to this, growing by BGN 539 million between December 2002 and a year hence. Monetary base growth directly affected narrow money (M1), and later broad money (M3).

The M1 aggregate contributed greatly to the growth of broad money between 2002 and 2003, while overnight deposits boosted M1 most. This indicates the growth of noncash payments and the expansion of banking and financial intermediacy. Commercial banks played a significant role in this by diversifying the services they offer. The debit and credit card expansion is an example of this (Table 8).

...the government's BNB deposit is expected to grow significantly, passing above BGN 4 billion as early as the second quarter

Chart 46

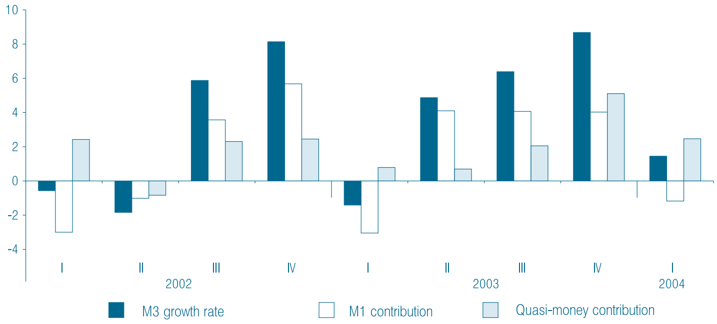
Reserve Money and Its Components

(annual index, %)

Source: BNB.

Chart 47

3 Growth Rate and Contribution by Component (Quarterly)

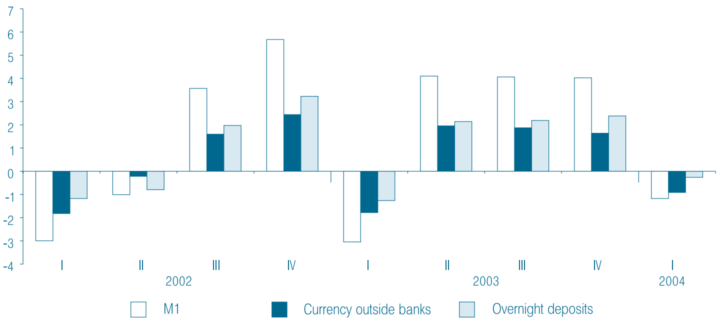


Source: BNB.

Chart 48

Contribution of 1 and Its Components to the Change in 3 (Quarterly)

(percentage points)



Source: BNB.

Table 8

Major Indicators of the System for Payments Initiated by Cards (BORICA)

Indicator	2002	2003	Increase (%)
Debit and credit cards, total	1 614 105	2 410 553	49.3
ATMs (number)	829	1 222	47.4
POS terminals (number)	2 554	3 754	47.0
Number of transactions, total	26 134 129	42 006 384	60.7

Source: BNB.

In the foregoing parts, analyses of relations between sectors in the economy identified processes which influence money multiplier: the inflow of capital in the form of foreign direct investment, changes in banks' assets, and the growth of nonresidents' deposits and those of the government and government institutions with the BNB. With the exception of the last of these, all factors accelerate money multiplier through changing the ratio between money in circulation and overnight deposits, and the ratio between quasi-money and overnight deposits.

Of the two values, the ratio of money in circulation to overnight deposits has a greater effect on money multiplier. If we take the ratio of quasi-money to overnight deposits as constant and cut the money in circulation to overnight deposit ratio by 0.1 units (some 10 percent), we boost money multiplier by some 0.17 units. In short, the faster growth of overnight deposits compared with money in circulation boosts the multiplier.

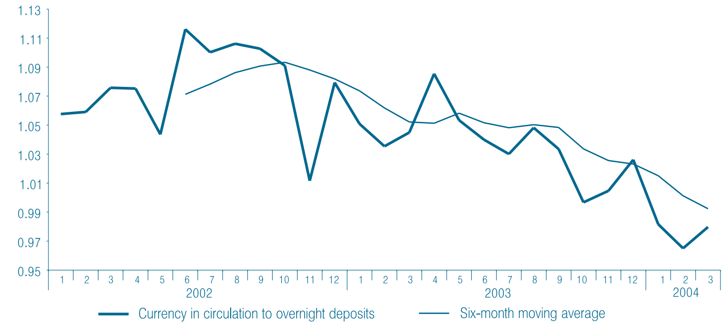
Other conditions being equal, a rise in the quasi-money to overnight deposit ratio by 10 percent or 0.22 units would boost money multiplier by 0.13 units. (This assessment rests on these variables' average values over the last three years.)

A rising trend in money multiplier is in evidence since mid-2003 as a result of changes in its composition. This is an indication of deepening financial intermediacy.

An important indicator of the depth of financial intermediacy is the velocity with which broad money circulates. Over recent years, this has declined, explaining the difference between reported inflation on the one hand, and the difference between the growth of broad money and real GDP growth, on the other (Charts 53 and 54).

Chart 49

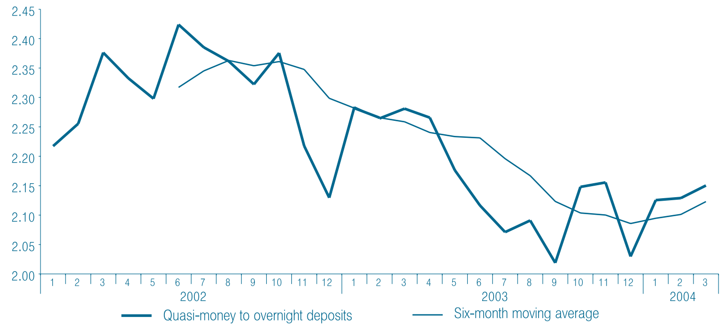
Currency in Circulation to Overnight Deposits Ratio



Source: BNB.

Chart 50

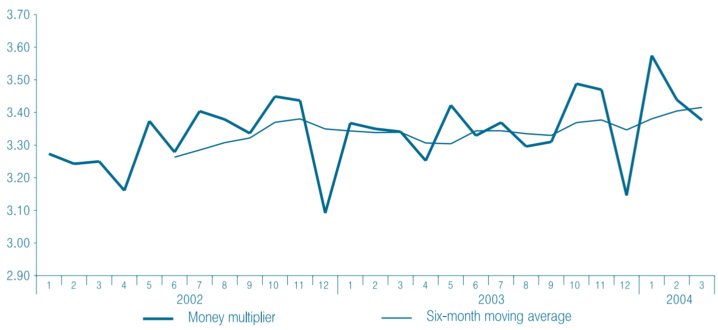
Quasi-money to Overnight Deposits Ratio



Source: BNB.

Chart 51

Money Multiplier (3 to Reserve Money)



Source: BNB.

Because of the credit expansion over the year, the ratio of nongovernment claims to GDP grew from 19.8 percent to 27.6 percent by late 2003: another indicator of deepening financial intermediacy (Chart 55).

Between 2000 and 2002 the contribution of lev deposits dominated quasi-money, but from mid-2002 growth in the contribution of forex-denominated deposits emerged. This could be explained by the continuing opening of the Bulgarian economy to the world, and with the growth of current private transfers and foreign trade. The correlation between the forex to the lev components of quasi-money at the close of 2003 was 57 to 43 percent. If the contribution of lev and forex deposit growth to broad money growth were analyzed, it would show that households save mainly in levs, while nonfinancial corporations are boosting their forex deposits.

As distinct from quasi-money, the structure of overnight deposits did not show any forex component growth. These deposits were largely swayed by lev deposit movements: something linked with transaction needs and the development of noncash bank services.

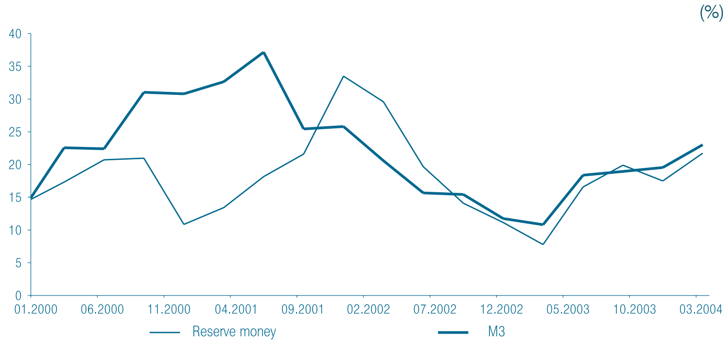
The demand for money is influenced by business activity and by interest rates which represent the alternative to keeping cash. Average 2003 deposit interest rates were steady, with an upward trend. Interest on one-month time deposits which we view as representative of the economy, show several major trends.

Average annual interest rates on one-month lev deposits grew from 3 percent in 2002 to 3.12 percent in 2003, while fluctuations, measured by the standard deviation method, fell from 0.28 to 0.12 percent. Despite the rise of nominal rates in 2003, depositors lost some purchasing power since real interest was negative due to higher inflation at the year's close.

Interest rates on one-month deposits in US dollars and euro also steadied, with a fall from 2.2 to 1.97 percent (euro) and from 1.6 to 1.5 percent (US dollars).

Chart 52

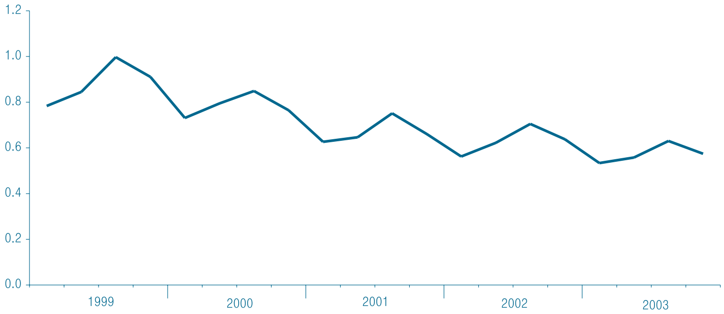
Annual Growth Rate of Reserve Money and Money Supply



Source: BNB.

Chart 53

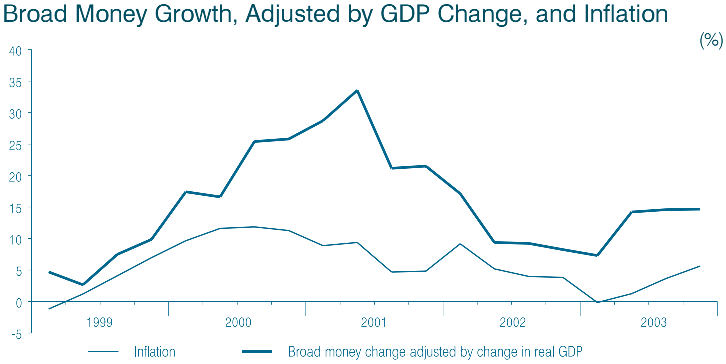
Currency Circulation Velocity



Source: BNB.

Chart 54

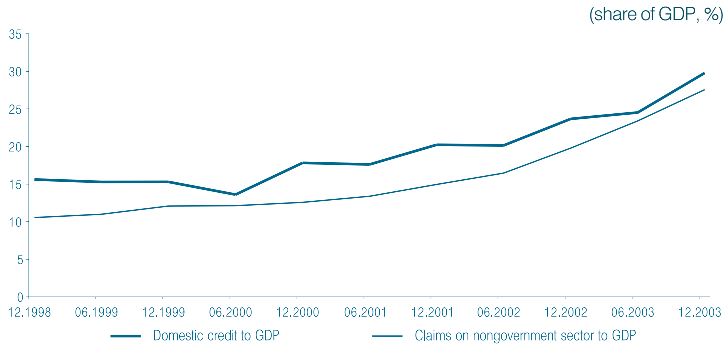
Broad Money Growth, Adjusted by GDP Change, and Inflation



Source: BNB, NSI.

Chart 55

Domestic Credit



Source: BNB.

Overall, monetary aggregate growth rates increased in 2003 due to reserve money growth and a rising money multiplier. The structure of money supply showed a positive trend to greater financial intermediacy, while the growth of forex deposits contributed to money supply growth.

The trend to a rapid growth in money supply continues in 2004. Reserve money has grown by 21.7 percent, while money outside banks is 20.5 percent up on the close of March 2003. Broad money has grown yet more, by 23 percent, due to the growth in the M3 multiplier from 3.3 to 3.4. The M1 aggregate grew by 25 percent mainly due to overnight lev deposits growing four times faster than forex overnight deposits (41 versus 9 percent respectively).

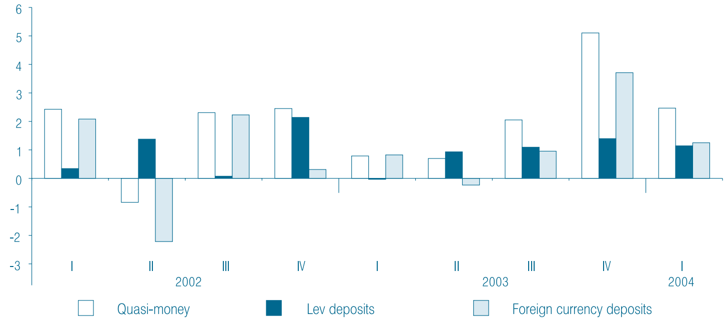
We can expect to see the processes at work since the start of the year continue in the second quarter, with growth rates gradually falling. Thus, the forecast for the end of June is for reserve money to grow by some 14 percent, which, assuming money multiplier retains its early-year high value (adjusted with seasonal factors) suggests that by mid-year broad money will reach BGN 17.3 billion or 21 percent more than in 2003. Third quarter growth rates are likely to be some 13 percent for the monetary base and 22 percent for M3. No significant changes are expected in the structure of monetary aggregates. Most likely the trend for lev overnight deposits to grow faster than other types of deposits will continue in line with the need for liquidity in a buoyant economy.

A positive balance of payments is basic to reserve money dynamics in the period ahead. The rising money multiplier which is particularly evident since the start of the year offers conditions for faster broad money growth compared with other monetary aggregates.

Chart 56

Contribution of Quasi-money and Its Components to the Change in 3 (Quarterly)

(percentage points)

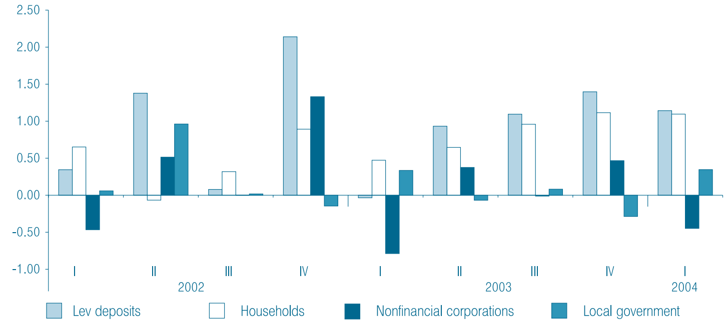


Source: BNB.

Chart 57

Contribution of Deposits by Economy Sector to the Change in 3 (Quarterly)

(percentage points)



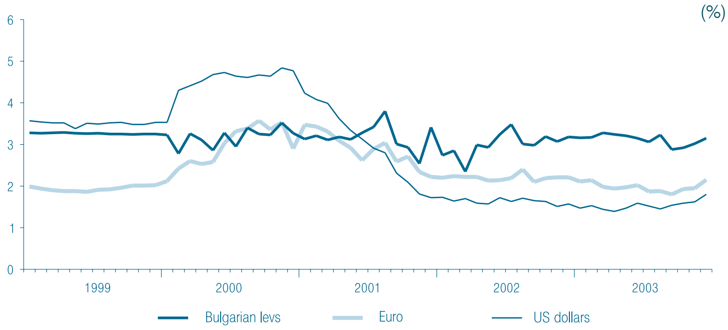
Source: BNB.

... monetary aggregate growth rates increased in 2003 due to reserve money growth and a rising money multiplier

Chart 58

Time Deposit Interst Rates

(%)



Source: BNB.

...the trend to a rapid growth in money supply continues in 2004

Credit Aggregates

The faster annual growth rate of money supply accompanied a similar development in internal credit. The growth of deposits and the repatriation of banks' foreign assets fed rising domestic claims.

Domestic credit dynamics depended mainly on changes in claims to the nongovernment sector. As distinct from 2002 when domestic claims on the government sector also grew (banks then invested some resource into eurobonds issued by the Bulgarian government), over the past year government securities investing stayed relatively steady. The favorable macroeconomic environment and banking competition encouraged banks to put resource into credit which, together with lively credit demand by companies and households, kept credit expanding at high rates. The annual growth of claims from the nongovernment sector remains high, increasing by half as much again year on year.

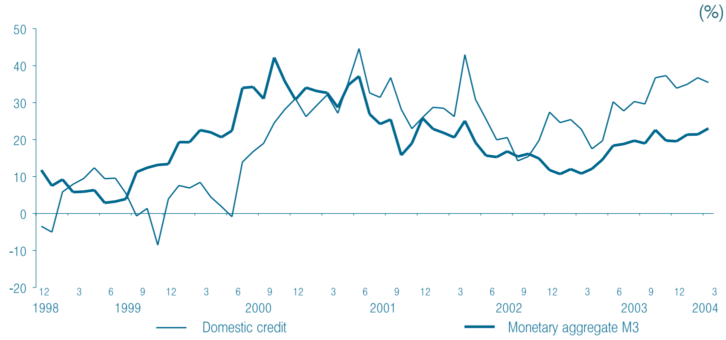
A structural analysis of banking system assets shows that loans are growing fastest at 44.9 percent[12] gross. Taking into account depreciation in the form of provisions set aside, this growth is 47 percent. The continuing expansion of the share of the credit portfolio in assets (from 46.9 percent in February 2003 to 54.8 percent a year hence) indicates active credit promotion.

Though rapid credit expansion has not affected banks so far, measures are in hand to limit it along with its concomitant risks. Amendments to BNB Regulation No. 9 on the evaluation and classification of risk exposures of banks and the allocation of provisions to cover impairment loss are in force from 1 April 2004. They raise thresholds and tighten criteria for calculating impairment of risk exposure. Expert opinion is that part of the accumulated profit will be put aside as extra provisions against loss and impairment.

[12] The analysis employs data methodologically sorted to fit bank supervision needs, and may thus diverge from monetary statistics data.

Chart 59

Annual Growth Rate of Money Supply and Domestic Credit

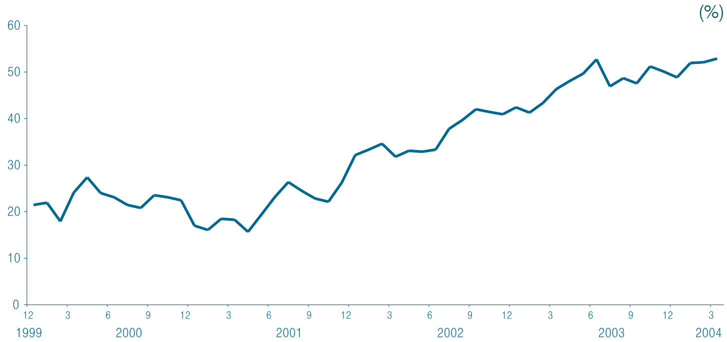


Source: BNB.

...the annual growth of claims from the nongovernment sector remains high

Chart 60

Annual Growth Rate of Claims on Nongovernment Sector



Source: BNB.

...measures are in hand to limit credit expansion

July sees the end of the current BGN 10,000 threshold below which loans are not subject to entry into the Central Credit Register. This will provide banks with complete data on the indebtedness of current and potential customers, and likely limit further credit expansion.

Early June saw amendments to BNB Regulation No. 8 on the capital adequacy of banks come into force pursuant to a Governing Council resolution of 26 April. These remove unaudited current profits from the capital base and are expected to lead to changes in the requirements on the extent of single exposures under BNB Regulation No. 7 on the large exposures of banks.

...in the short term banks will sustain the levels of credit growth

As part of the package of measures aimed at limiting credit expansion, Regulation No. 21 on the minimum required reserves maintained with the Bulgarian National Bank by banks also changed. From 1 July 2004 the base for calculating minimum required reserves broadens to cover deposits and debt instruments with terms of over two years, with banks being mandated to keep minimum required reserves to the tune of 4 percent covering them.

June 2004 also sees the selection of primary government sequrities dealers for the post-1 July 2004 period. The selection criteria include strict minimum permissible primary and secondary liquidity levels. This is another argument in support of opinions that the credit expansion will not exceed levels jeopardizing banking system liquidity.

In the short term banks will sustain the levels of credit growth established over the first quarter of the year. Further along, a gradual slowdown in credit compared with 2003 has to be anticipated, with annual growth expected to be running at 40 percent by the close of the third quarter.

...however, a gradual slowdown of annual credit growth is expected resulting from the exhaustion of asset restructuring and the measures taken by the BNB and the government

Reasons for this are to do with banks' reducing ability to finance new credit by restructuring assets, with the exhaustion of the low base effect, and with effect of the aforementioned measures.

3. Trends in the Banking System

Major reasons for the growth of bank credit during the period under review are restructuring in the banking sector, falling eurozone and US interest rates, and growing domestic demand for credit resulting from the good business climate. Greater competition between banks engendered new banking products and, less markedly, a contraction of interest rate spreads.

The banking system continued to be dominated by the big three: Bulbank, DSK Bank and UBB, which between them held 40 percent of bank assets by February 2004 (from 44 percent a year earlier).[13] Most of the credit expansion came from UBB (BGN 367 million or 48.4 percent), Bulbank (BGN 319.8 million or 53.4 percent) and Biochim (BGN 314.6 million or 63.6 percent).

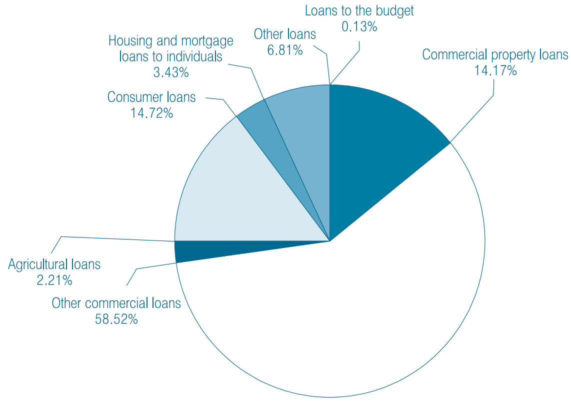
A trend to a market share increase for small and medium-sized banks emerged in the period. These banks are dynamic participants in the system. Credit grew fast at the Economic and Investment Bank (BGN 138.1 million or 156.2 percent) and Procredit Bank (BGN 114.1 million or 195.4 percent). Greater competition between institutions and the opportunities for achieving asset management savings by using economies of scale in placements with large banks are the challenges smaller banks face.

The steady increase of nonfinancial institutions' deposits is a major source of lending capital. The top three are best placed to attract deposits, not least through their large branch networks. Yet their share of overall deposits fell from 44.9 percent in February 2003 to 41.4 percent in favor of medium and small banks. DSK Bank was most active in attracting deposits, drawing almost 15 percent of the overall deposit rise for the system. From a cur-

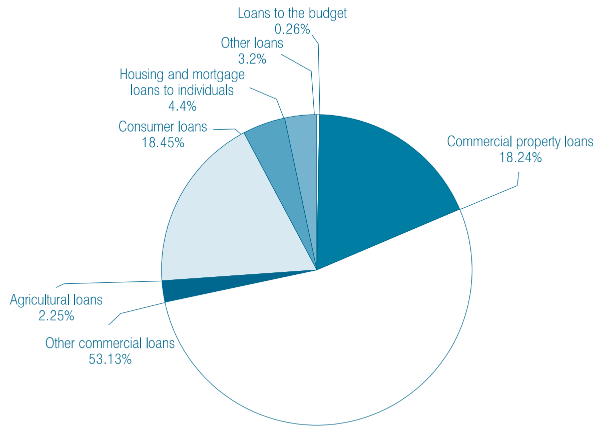
[13] The analysis employs data from commercial banks' financial statements.

...greater competition between banks engendered new banking products

Chart 61
Credit Structure



February 2003



February 2004

Source: BNB.

rency standpoint, more depositors are moving towards euro and lev deposits due to the continuing US dollar slide over the last year (Chart 24). Short-term deposits grew by 74.8 percent or BGN 69 million, with long-term ones rising by 72.6 percent or BGN 286 million. Yet the latter's share of deposit totals remains a relatively low 6 percent. The short-term maturities skew in liabilities limits banks with regard to investment projects and supply of long-term lending.

The restructuring of bank assets followed the best yields obtainable for various assets. Despite falling loan interest rates, credit gives banks much higher yields than any other investment. This led banks to continue expanding their credit portfolios, including doing so at the expense of some other types of asset.

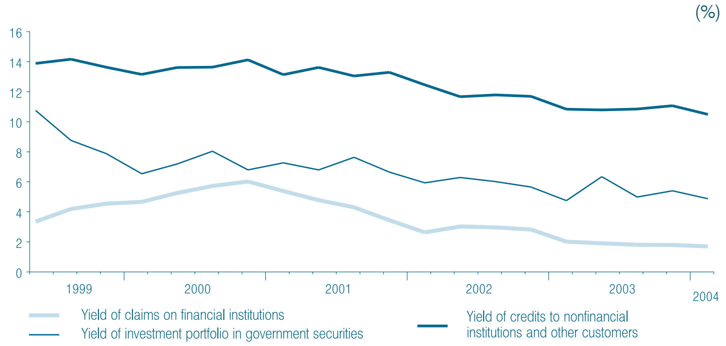
Commercial bank cash grew by 28 percent on February 2003, but its relative share of assets stayed almost put at 7.5 percent *versus* 7.2 percent for the same period last year. This overall banking system level ensures normal functioning of the payments system.

Bank claims fell by 17 percent overall, and their share of assets declined to 14.8 percent against 22.1 percent in February 2003. The current level is enough to ensure banking liquidity at system level, and at most individual banks. Some institutions still have leeway for a future restructuring of assets in the direction of lending, but at system level this resource is exhausted. Deposits at foreign banks came to some 70 percent of all financial institution deposits. The growing demand for lending resource by domestic banks is forcing a reduction in this share.

Trading portfolio assets are slightly up on February 2003, but faster rises elsewhere have depressed their share from 11.3 percent to 9.3 percent of overall assets. Bulgarian government securities predominate here with some 80 percent of the total portfolio's value. Securities in the investment portfolio came to 9.9 percent of assets in February 2004 *versus* 7.2 percent a year earlier. Banks would clearly like to diversify their portfolios by venturing outside government guaranteed securities. A quarter of

Chart 62

Commercial Banks' Assets Yield



Source: BNB.

investments held to maturity and as much again of investments available for sale are in the form of corporate and other debt securities. Yet the circumstance that most banks are primary government securities dealers limits opportunities for increasing holdings of such instruments: dealers are mandated to keep set holdings of government securities.

The banking system's *own funds* grew by 15.4 percent or BGN 317 million mainly due to increased bank reserves and to some equity increases. Some banks show falls due to less buoyant profits in the first two months of 2004 compared with the prior year. The overall banking capital position is stable, but some banks do not have sufficient capital to cover future asset increases. An increase in financial indebtedness may be expected through improved bank access to capital markets and putative asset growth financing through borrowings. A significant number of banks issued mortgage bonds, with others attracting subordinated term debt from abroad.

...credit portfolio quality remains good

An analysis of the currency component over the first two months of this year shows that the euro continues to dominate. It accounted for BGN 5669 million of the BGN 9313 million of forex assets, and for BGN 4274 million of the BGN 8219 million of forex liabilities. No significant change occurred in the forex position, with the system being short in US dollars and long in euro. The aggregate net open forex position remained almost unchanged on 2003. The extent of transforming deposits into credit measured by the *credits to deposits* ratio grew from 60.8 percent in February 2003 to 70 percent in February 2004. In view of the good credit portfolio quality and the stable growth of deposits at most banks, these values may be said not to jeopardize system liquidity.

...banks stand to gain from credit growth

Banks' *profits* by February 2004 came to BGN 78.7 million against BGN 122.8 million over the same period of last year. Revenue for the first two months of 2003 were reported amid a significant effect of reintegrated provisions (BGN 97.7 million) in connection with the application of International Accounting Standards (IAS). Removing this reduces underlying profit considerably. The top ten banks earned more than three quarters of the system's profits.

Despite interest rate falls and tougher competition most banks stand to gain from credit growth, stable fee and commission earnings, improved management and reduced noninterest expenditure resulting from the entry of foreign banks into Bulgaria. An analysis of financial results sources shows that the 2003 trend to a growth in high-yield interest-bearing assets (mainly credit) and in core activity net revenue continues in 2004. *Net interest revenue* for the two early months of 2004 was BGN 144.9 million *versus* BGN 106.5 million last year. This 36.1 percent increase reflects not just expanded credit, but expanded long-term credit offering higher average interest earnings.

Trading portfolio profit fell from BGN 35 million in February 2003 to BGN 16 million this year. Compared with last year, *noninterest revenue* grew significantly (by 32 percent), with bank charges dominating. Low *profit from foreign currency revaluation and extraordinary operations* confirms expectations of a decline in these two items' shares in banks' operating results.

Forecasts for the two coming quarters are that banks will maintain good revenues, stable liquidity and capital levels aligned to their risk profiles. The share of high-yield assets in overall assets will stay within the 25–28 percent band, and provided depositor behavior remains unchanged, this level is expected to be entirely sufficient to cover borrowed funds adequately.

...forecasts for the two coming quarters are that banks will maintain good revenues, stable liquidity and capital levels aligned to their risk profiles

4. Business Activity

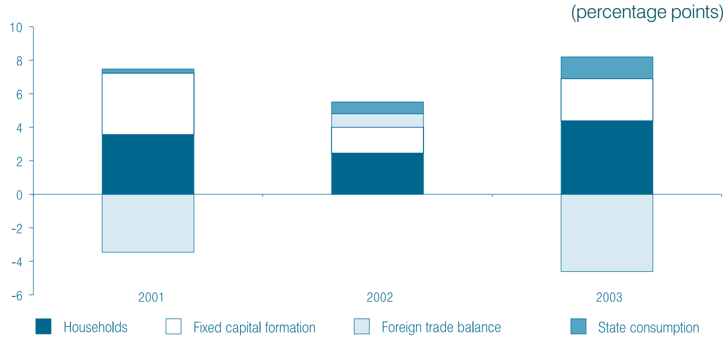
Bulgaria's economy attained a relatively high rate of growth in 2003[14] for the sixth successive year. Growth rates for GDP components by expenditure accelerated. End-user household consumption and investment into fixed capital contributed most. Imports outstripped exports, resulting in a large negative contribution by foreign trade to GDP (Chart 63).

...sustainable economic growth for the sixth successive year

Chart 63

Contribution to GDP Growth by Component of Final Demand

(percentage points)

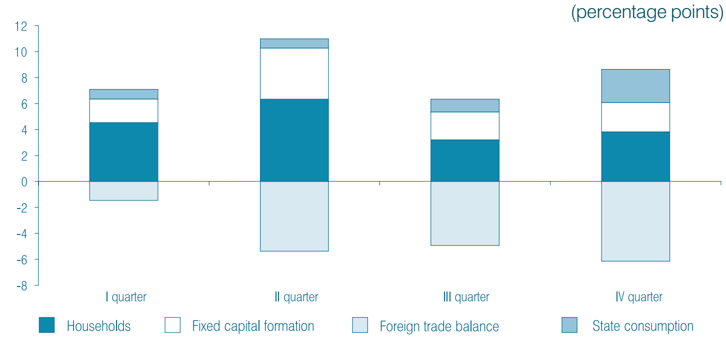


Source: NSI.

Chart 64

Contribution to GDP Growth by Component of Final Demand, 2003

(percentage points)



Source: NSI.

Table 9

Dynamics of Final Consumption Components

(real growth on corresponding period of previous year, %)

	2003				
	I quarter	II quarter	III quarter	IV quarter	total
GDP	3.5	4.2	4.4	4.9	4.3
Final consumption	5.9	8.0	5.4	7.0	6.6
Individual consumption	6.8	8.5	5.4	6.5	6.8
Final household consumption expenditure	6.3	9.1	5.1	5.4	6.4
Final government consumption expenditure	12.4	3.8	8.3	14.7	10.1
Collective consumption	-1.9	3.9	5.0	10.2	4.9
Gross fixed capital formation	11.6	21.2	13.3	10.0	13.8
Exports of goods and services	13.2	11.7	4.0	5.3	8.0
Imports of goods and services	13.8	18.3	13.3	14.0	14.8

Source: NSI.

[14] Preliminary Gross Domestic Product data published by the NSI in April 2004.

Household Behavior

Household budget data show consumption *per* household member growing by 5.1 percent in real terms in 2003. Spending on furniture and home maintenance grew by 19.2 percent. Communications spend grew by 19.6 percent. Spending on free time, entertainment, education and arts grew by 13.6 percent. The last few years show a trend to more positive household spending, indicating a steady rise in living standards. Spending on home improvement and furniture is rising, as is that on free time and communications (Table 11).

Rising consumer demand reflected a 4.8 percent income rise *per* household member, according to household budget data. It also reflected expectations of future income stability and rising consumer confidence according to the NSI survey. This in turn creates greater demand for finance, largely in the form of consumer credit (see below).

...a trend to more positive household spending

Table 10

Real Growth Rate of Consumer Expenditure *per* Household Member

(%)

	2002	2003
Consumer expenditure, total	8.7	5.1
Food	8.6	2.4
Alcoholic drinks and tobacco products	-5.1	8.1
Clothing and footwear	17.0	6.3
Houses, water, electricity and fuels	11.8	0.2
Furniture and home maintenance	19.2	19.2
Healthcare	-8.0	9.2
Transport	10.0	9.9
Communications	31.4	19.6
Free time, entertainment, education and arts	12.6	13.6
Miscellaneous goods and services	10.4	8.3

Note: Consumer indices for the corresponding commodity group are used as deflators.

Source: NSI, household budgets.

Table 11

Structure of Household Consumer Expenditure

(%)

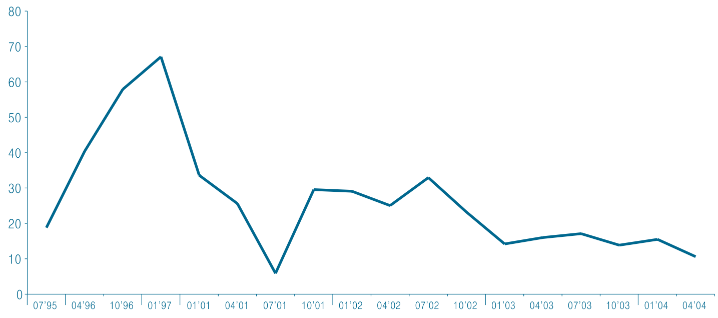
	2002	2003
Necessities of life expenditure	69.4	67.9
Food	49.1	46.7
Houses, water, electricity and fuels	15.7	16.2
Healthcare	4.7	5.0
Expenditure on improving life quality	26.1	27.4
Clothing and footwear	4.2	4.1
Transport	5.9	6.2
Communications	4.9	5.4
Furniture and home maintenance	3.4	3.8
Free time, entertainment, education and arts	3.8	4.1
Miscellaneous goods and services	3.8	3.9
Alcohol and tobacco	4.5	4.7

Source: NSI, household budgets.

Chart 65

Unemployment Expectations

(%)



Source: NSI, user survey.

The consumer confidence survey showed a rising confidence trend in early 2004. Expectation of unemployment reductions are an important consumer mood driver. The Employment Agency put unemployment at the close of March at 13.7 percent: 0.53 points down on February, and 1.99 points down on March 2003. Advertised vacancies are mainly in the private sector.

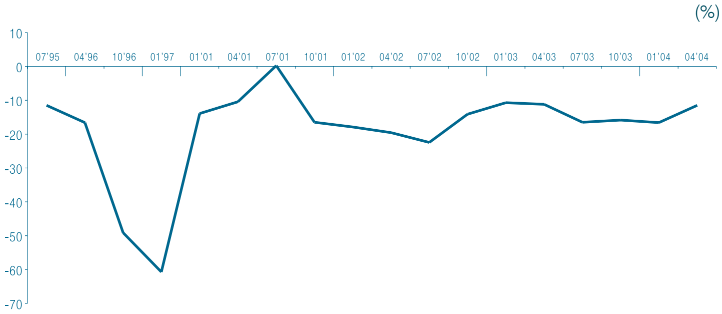
Expectations of household finance are also optimistic.

Questioned on spending on durables, consumers' answers were strongly positive, confirming that households are looking to buy durables by using credit. Overall consumer answers remain negative, but less so than last year.

Employment growth gave an important boost to household incomes and hence consumption in 2003. Growth was due to economic growth and government labor market policy. Data from the workforce survey show that 3.8 percent more people were in work on average in 2003, with full-time employees growing by 4.9 percent. The greatest contribution (3.3 percentage points) came from sectors with predominantly private ownership.[15] Active government measures showed in the employment boost of the *Other social and personal business* category which rose by 63 percent on 2002, contributing 2.1 percentage points to the overall employment rise. Unemployment fell by 4.3 points to 13.7 percent in the last quarter of the year.[16] The rate of registered unemployment reached 13.5 percent or 2.8 percentage points down on the end of 2002.

...rising consumer confidence

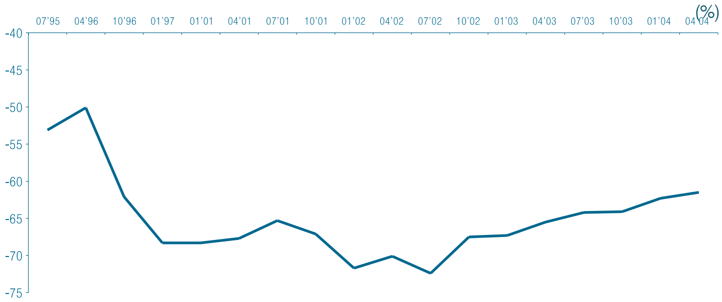
Chart 66
Expectations of Household Finance in the Following Twelve Months



Source: NSI, user survey.

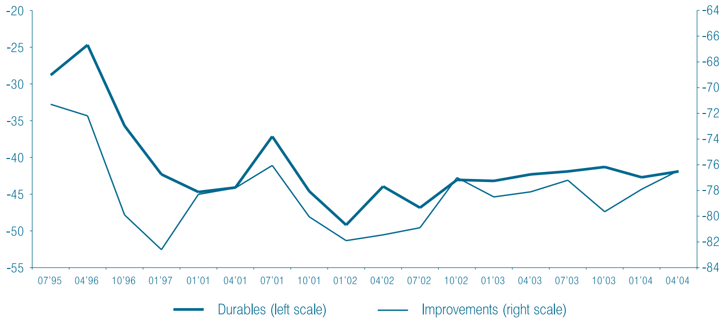
...employment growth

Chart 67
Public Feeling of the Advantage of Spending on Consumer Durables



Source: NSI, user survey.

Chart 68
Trends in Spending on Consumer Durables and Home Improvement in the Following Twelve Months



Source: NSI, user survey.

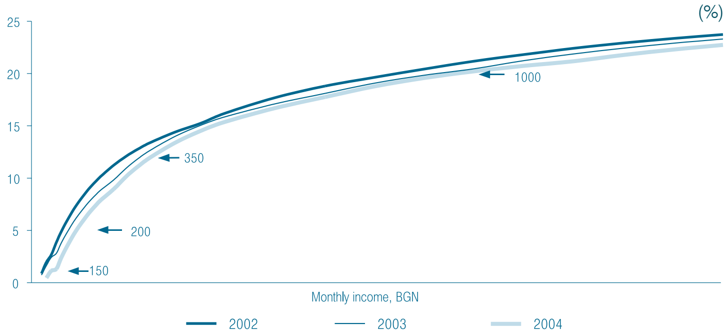
[15] The commerce, reprocessing, real estate and business services, construction, hospitality, transport and finance sectors.

[16] Data from NSI workforce monitoring. This monitoring applies International Labor Office unemployed and unemployment rate definitions.

The rise of employment boosted the proportion of pay in the average household income from 37.4 percent in 2002 to 40 percent in 2003, while cutting the share of unemployment benefit and other social security payments from 2.4 percent to 1.8 percent of overall household income levels.[17] The early-2004 cut in the average tax burden on personal incomes also had an important effect.

...cut in the tax burden

Chart 69
Average Tax Burden



Source: MF, BNB.

Table 12
Dynamics of Household Income

(%)

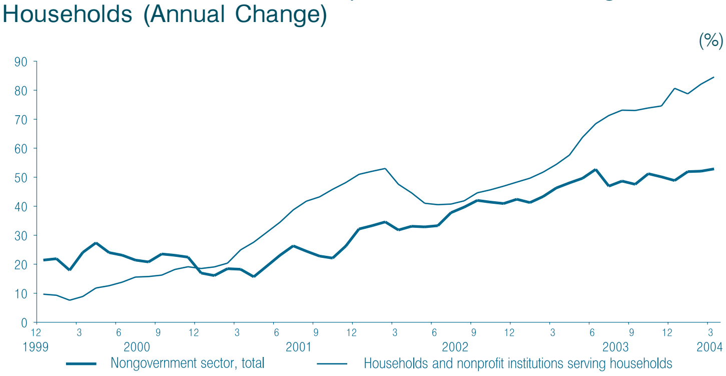
	2002		2003	
	rate	contribution	rate	contribution
Total	18.1		4.8	
Salary	11.1	4.4	12.2	4.6
Extra pay, entrepreneurship and ownership	10.2	1.0	-2.3	-0.2
Budget transfers (pensions, grants)	0.7	0.2	4.8	1.1
Household production	55.7	8.3	-3.3	-0.6
Property sale	21.5	0.1	52.0	0.2
Other	49.9	4.0	-2.3	-0.2

Source: NSI.

The rapid growth of credit (Chart 70) boosted consumer demand. Banks actively promoted consumer credit, with intense selling of household-oriented products. The overall business climate in Bulgaria, and particularly the lending rate fall (Chart 71) boosted take-up of these products. Competition among producers and retailers added to the launch of new financial products in the market, easing the purchase of consumer durables.

...increased supply of, and demand for, credit

Chart 70
Claims on Households and Nonprofit Institutions Serving Households (Annual Change)



Source: BNB.

[17] NSI 2003 household budget data.

Table 13
Dynamics of Retail Sale Revenue

	2001	2002	2003
Retail trade, repair of personal items and home equipment	5.8	8.4	6.2
Food, drink and tobacco products	9.4	11.6	5.2
Pharmaceutical and medical goods, cosmetics and toiletry	8.8	-3.8	-1.7
Textiles, clothing, footwear and leather products	-2.9	8.9	4.6
Household goods and equipment	28.4	20.5	17.9

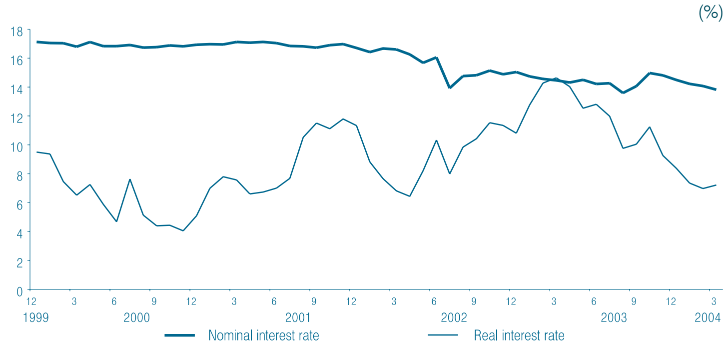
Source: NSI.

High consumption rates boosted real retail revenue by 6.2 percent in 2003, and real retail sales by 4.2 percent in real terms on 2002. This is the successive year to witness the most highest rises in the sale of goods and equipment for the home.

Domestic consumer demand in the first quarter of 2004 remains high. Expectations are for it to retain its leading role in Gross Domestic Product growth over coming quarters. Apart from the emerging rally in consumer confidence, and hardening consumer conviction on future spending on durables and home improvement, this optimistic forecast is backed by retail and service managers. Both sectors forecast growing demand and sales and intentions to boost wholesale orders.

...expectations are for domestic consumer demand to retain its leading role in economic growth

Chart 71
Nominal and Real Interest Rates on Household Loans in Levs



Source: BNB.

Government Finance and Consumption

The effect of government consumption on GDP growth increased in 2003 on the prior year, and analyses of government expenditure by quarter show that procurement peaks late in the year.

...the effect of government consumption on GDP growth rate increased

Though nominal 2003 GDP was lower than initial estimates, tax revenue significantly exceeded expectations with two-figure rises on the prior year. Main factors here were excise duty increases and moves to increase the proportion of taxed consumption.[18] This yielded a 12.3 percent increase in overall revenue and aid, with indirect taxes alone contrib-

[18] Defined as end-user expenditure less notional rents for housing and household consumption of household products.

uting 5.5 percentage points.

Greater tax revenue allowed the government to spend considerably more than in 2002. Current noninterest spending on the Consolidated Fiscal Program grew by 1.4 percentage points to 34.8 percent of GDP. This mostly boosted end-user government spending which grew by 10.1 percent in real terms last year. Yet from the viewpoint of the primary balance, fiscal policy was more restrictive than anything else, rising by 0.5 percentage points to 2.1 percent of GDP.

...in 2003 the primary balance rose by 0.5 percentage points to 2.1 percent of GDP

Government spending is strongly dependent on current quarter noninterest spending under the Consolidated Fiscal Program, which offers a good basis for assessment using the budget implementation data. This spending retained its seasonal pattern: government spending was greatest in the year's closing quarter and lowest in the third quarter.

Despite the projected deficit the government managed to balance the budget last year. This was down to the significant tax revenue surplus. The administration has budgeted a 0.4 percent of GDP deficit in the Consolidated Fiscal Program for 2004. Preliminary Program implementation data for the first quarter again show a likely revenue surplus. By late March the primary balance was BGN 587.6 million, and the cash balance reached BGN 228.4 million or about twice its corresponding 2003 extent. Budget surpluses are likely to be maintained until the year's close.

...by late March the budget showed a surplus, with budget surpluses likely to be maintained until the year's close

Consolidated Fiscal Program inflows have declined since the start of the year due to reduced nontax revenue into the republican budget. Tax revenue continues growing steadily, having increased by 13.6 percent by late February mostly because of growing consumer spending. Growth is expected to decline to some 10 percent in the second and third quarters.

...tax revenue continues growing steadily

Direct tax revenues traditionally fluctuate much more than indirect ones throughout the year. The four percentage point cut in corporate profit tax will cut monthly revenue, but the increased tax base will largely make up for this. As a result, corporate profit tax revenue for each quarter will be higher than in corresponding prior periods. One-off payments under this tax were made into the budget in late March in respect of the Bank Consolidation Company (BCC) accounting profits after bank privatization. They were reported as privatization revenues and did not affect the cash balance.

...with regard to current nonunterest expenditure, the government is expected to continue spending conservatively until the close of the year

Government is expected to continue spending conservatively, with current spending steady until a rise at the very close of the year. This will accumulate a significant primary surpluses, mostly in the first two quarters. Interest payments fall due mainly in the first and third quarters. International interest rates are lower and the euro is stronger than budget projections, leading to economies. Overall interest expenditure will reach some BGN 700 million by the year's close. The quarterly capital expenditure distribution will likely change from last year, moving from the last quarter to the second and third quarters.

Investment Demand

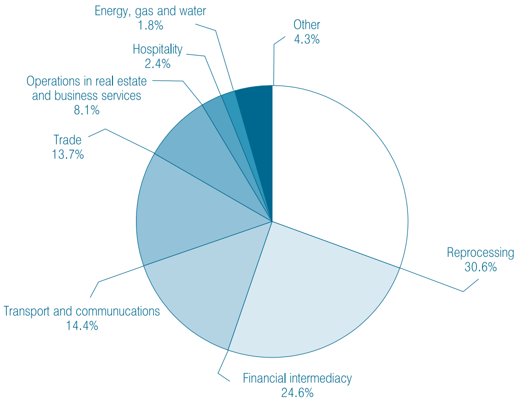
...production facility renewal has been underway intensively since 1997

Production facility renewal as part of economic restructuring has been underway intensively since 1997 in most of the economy. The relatively high growth rates of investing into fixed assets is largely financed by foreign direct investment, bank loans, and retained corporate profit.

Chart 72

Structure of Foreign Direct Investment (Cumulative as of 31 December 2003)

(%)



Source: NSI, BNB.

...a sizeable foreign direct investment and a positive effect on competitiveness

Gross domestic product data show fixed capital investment in 2003 growing by 13.8 percent in real terms and contributing significantly to economic growth. Imports of investment goods grew by almost 17 percent. Bulgaria drew the sizeable foreign direct investment total of USD 1049.3 million, not including privatization revenue. Reprocessing is traditionally among the biggest contributors to growth in fixed capital investment, including foreign direct investment. Last year the sector drew USD 258.7 million of foreign direct investment: a three-fold rise on 2002. Transport and communications attracted USD 188.4 million, and tourism attracted USD 20 million or 144 percent more than in the prior year.

...optimistic expectations about future development and lively demand for credit

Unit labor cost is a good indicator of foreign direct investment by industry (Chart 97). The sectors with the largest cumulative foreign direct investment (reprocessing, financial intermediacy, and transport and communications) show significant falls in costs *per* unit of production, backing views that foreign direct investment enhances competitiveness of these industries.

Credit to the nonfinancial nongovernment sector grew fast in 2003. The lively demand for loans by nonfinancial corporations reflects their optimistic expectations.

NSI business surveys show positive sales trends, and positive expectations on the business environment in industry. The favorable business environment stimulates investment activity and hence the call for finance, boosting bank loan demand. Though the annual rate at which bank claims on nonfinancial corporations were growing stopped rising in recent months, it continues to run high. After peaking at 47.6 percent in June 2003, it stabilized at some 40 percent, reaching 42.6 percent in late March.

Fast-growing credit to the nongovernment sector is accompanied by a change in new loans' maturities. This reflects banks' greater willingness to lend for longer, as well as the real sector's need for long-term finance. Newly extended long-term loans[19] are 77.5 percent more than extended last year, and their share in the overall volume of new loans continued rising to reach 55.4 percent against 43.1 percent in 2002. At the close of 2003 long-term credit comprised 72.6 percent of the total volume of credit to the nongovernment sector *versus* 65 percent at the close of 2002.

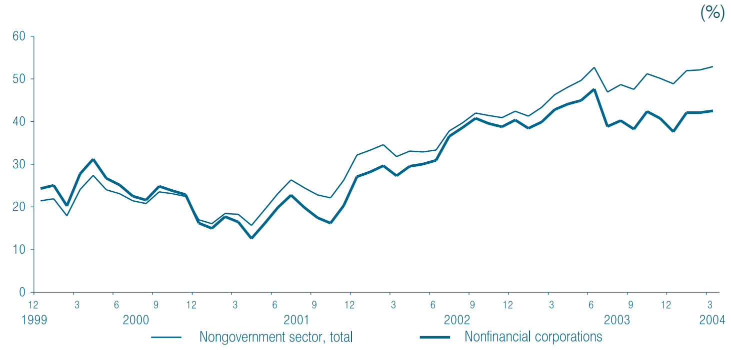
Lending rates continue recent years' downward trend in line with international markets. Low yields on banks' foreign assets, greater banking competition, and the drop of overall economic risk are factors here. These trends will likely continue to affect lending rates in coming periods.

Investment demand will continue to govern demand in 2004. The NSI investment survey

[19] Loans with maturities of over one year.

Chart 73

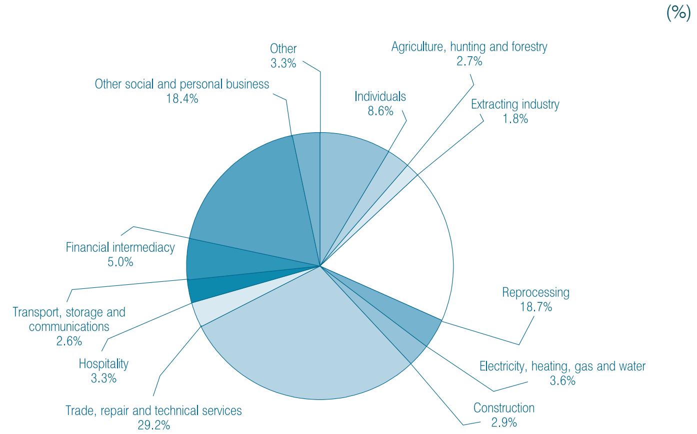
Claims on Nonfinancial Corporations (Annual Change)



Source: BNB.

Chart 74

Structure of Commercial Bank Claims by Sector as of 31 December 2003

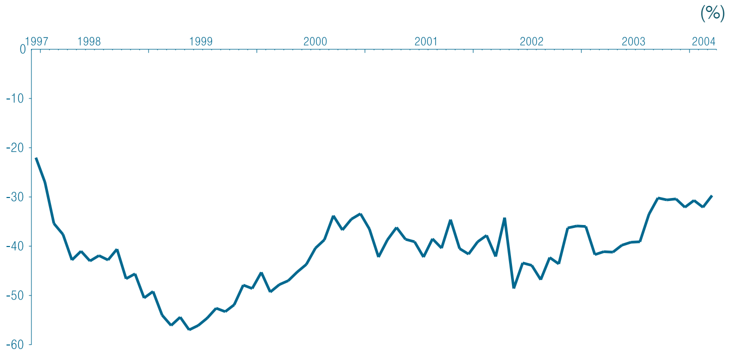


Source: BNB.

...enhanced bank competition and lower risk means longer maturity and lower interest rates

Chart 75

Industrial Orders



Source: NSI.

shows industry anticipating 14.2 percent nominal investment growth.

Energy and water supply industries are expected to dominate 2004 investment by attracting 53 percent of it. Investment into these industries is expected to grow by 56 percent, with intermediate consumption goods following with 24 percent.

The investment priority for 2004 remains replacing old equipment, reducing labor input, and introducing new technology.

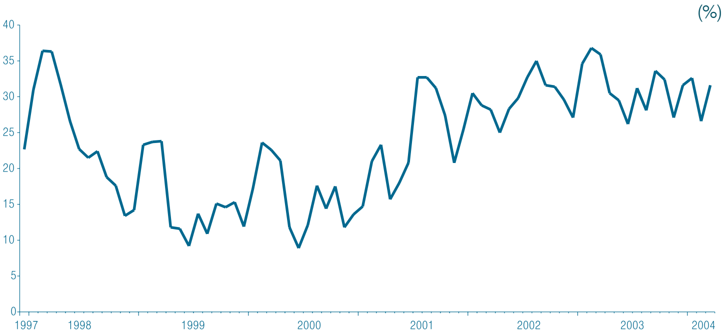
This year's investment decision factors appear favorable. The predominant view is that demand for output, the availability of finance, and anticipated profit will boost investing.

The survey also shows expectations of active investment into construction. Companies report healthy order books and growing expectations.

High construction activity partly reflects growing housing demand, driven in turn by the rapid growth of housing lending.

Chart 76

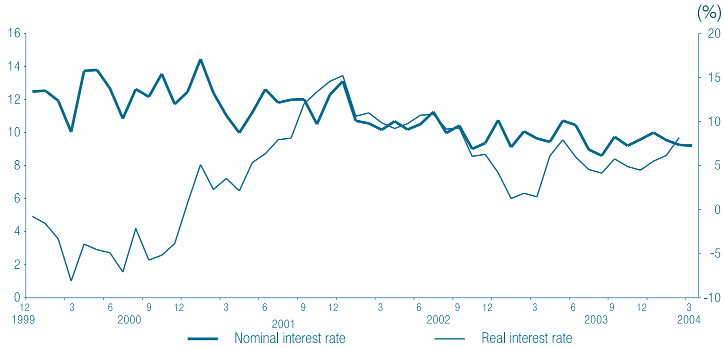
Expectations of Business Environment in Industry



Source: NSI.

Chart 77

Nominal and Real Interest Rates on Lev Loans of Nonfinancial Corporations

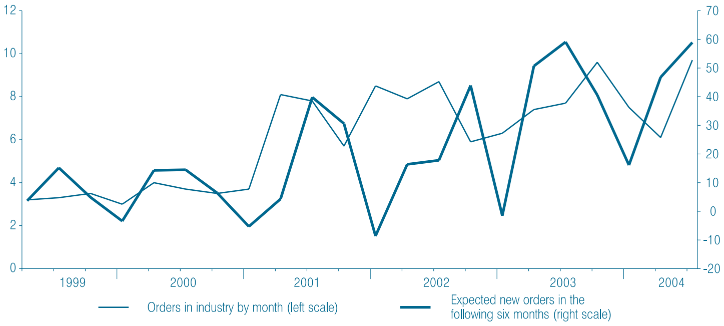


Source: BNB.

...the strong demand, anticipated profit and the expanded access to finance will boost investing

Chart 78

Orders in Construction



Source: NSI.

Exports and Imports of Goods and Services

GDP data show that real export growth rates rose in 2003. Exports contributed as much as household consumption to GDP growth.

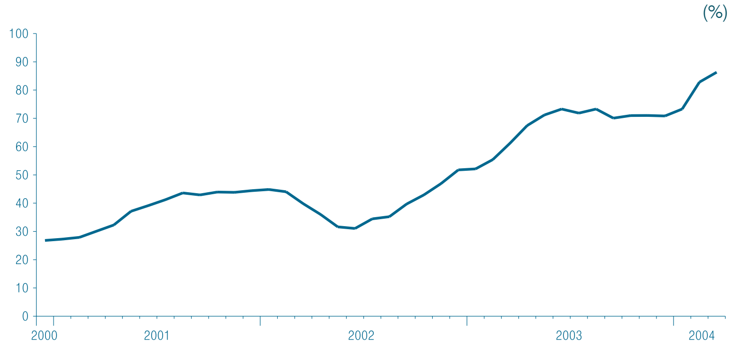
Euro-denominated exports of goods and services grew by 10.7 percent in 2003. Goods exports grew by 9.9 percent. Charts 80 and 81 show EUR-denominated exports by month at constant prices under the National Accounting System. Both charts show relatively high exports in second half of 2002, with growth continuing in 2003. Given the current international conditions, these exports trends suggest that this is due to improvements on the part of supply rather than on increased demand: Bulgarian manufacturers are becoming more competitive abroad.

Export makeup is changing in line with Bulgarian economic restructuring. The textiles, leather, clothing, footwear and miscellaneous consumer goods group leads, with other highly reprocessed items like miscellaneous goods also growing healthily (a 4.3 point contribution), along with machines, equipment, and vehicles (1.9 points).[20] Metal goods and animal and plant husbandry growth fluctuates.

[20] Using the SITC nomenclature.

Chart 79

Housing Loans Growth Rate *per Annum*

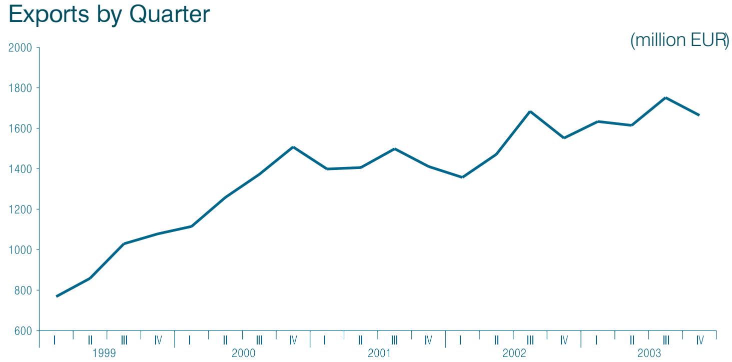


Source: BNB.

...Bulgaria's foreign trade volume has increasingly grown

Chart 80

Exports by Quarter

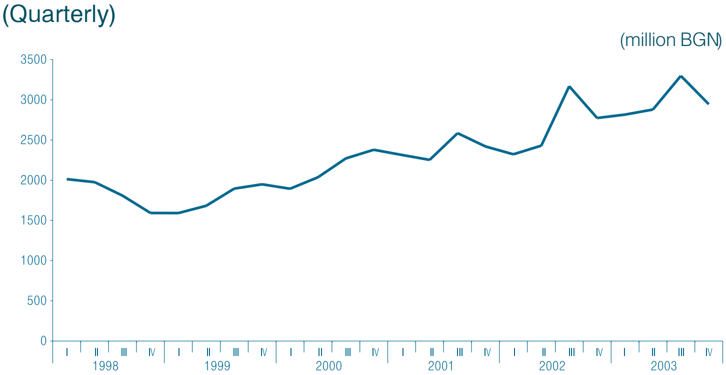


Source: BNB.

...Bulgaria's competitiveness in international markets has improved hence boosting exports

Chart 81

Exports of Goods at Average Prices since 1998 (Quarterly)



Source: NSI.

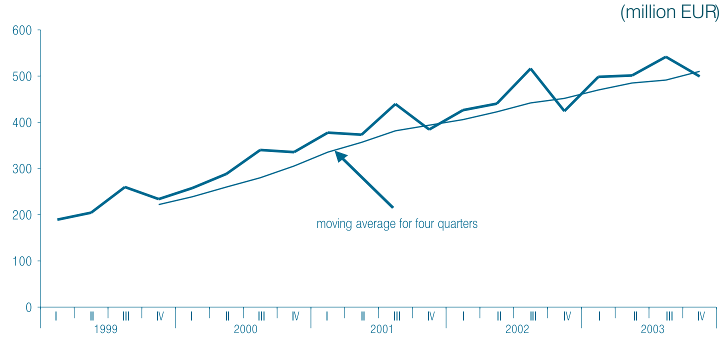
Table 14 shows the competitiveness of Bulgaria and of First Wave countries improving *versus* other countries. Data also show Bulgarian exports to the EU growing faster than those of other accession countries (7.9 percent and 11.6 percent *versus* 5.2 percent and 9.1 percent respectively for 2001 and 2002).

High domestic demand (consumer and investment) stimulated local manufacturers' home market sales, but they could not meet demand. Hence imports grew significantly in real terms in 2003. Greater domestic demand for feedstocks and investment goods stemming from greater production, and growing investment into fixed assets, also boosted imports. Investment goods, feedstocks, commodities, and energy commodities contributed four times more than consumer goods to import growth. Consumer good imports in euro grew by 17.7 percent against an overall end-user demand growth of 6.5 percent, while investment goods' imports in euro grew 16.6 percent against a 13.8 percent overall real growth in gross fixed capital formation. Imports of commodities grew by 17.7 percent.

Chart 82

Exports of Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods (Quarterly)

(million EUR)



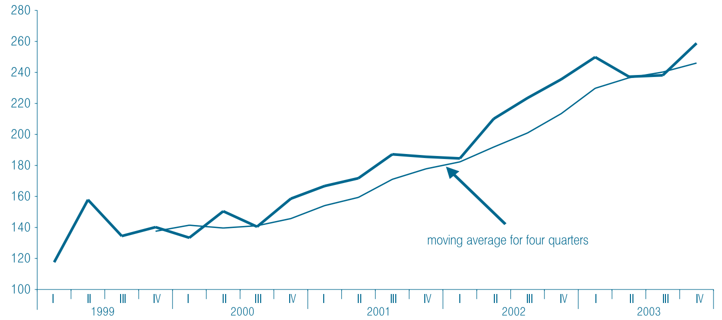
Source: BNB.

...growing investment boosted imports

Chart 83

Exports of Machines, Vehicles, Appliances, Tools, Weapons (Quarterly)

(million EUR)

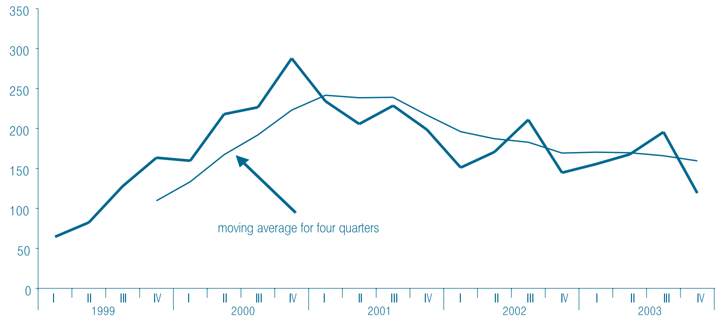


Source: BNB.

Chart 84

Exports of Mineral Products and Fuels (Quarterly)

(million EUR)



Source: BNB.

The major share of commodity and investment goods' imports is from EU and OECD countries, replicating the major sources of foreign direct investment. If we exclude the great imports of energy resources from the CIS, CEFTA and CIS states are primarily feedstock suppliers to Bulgaria (53 percent and 63 percent of nonenergy imports from these regions). As regards consumer goods imports, the EU and OECD are again the major sources at 69 percent, though the rise in consumer goods is across the board, indicating relatively diversified consumer demand.

In principle, stronger imports of investment goods and commodities ought not to create problems since they are likely to improve production facilities and competitiveness.

In view of expected increases in basic capital investment and household consumption, partly financed by continuing credit expansion in the nongovernment sector, and by current transfer revenue, we anticipate imports to continue growing in the second and third quarters, albeit at lower rates than in the corresponding quarters of 2003. The physical volume of imports is likely to continue growing, but slower than in 2003, with actual growth exceeding nominal growth due to the deflator effect of US dollar devaluation.

Chart 85

Exports of Chemical Products, Plastics, Rubber (Quarterly)

Source: BNB.

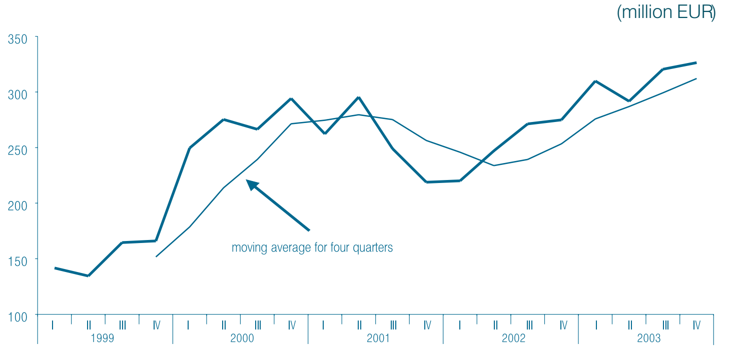
Chart 86

Exports of Animal and Plant Products, Food, Drink, Tobacco (Quarterly)

Source: BNB.

Chart 87

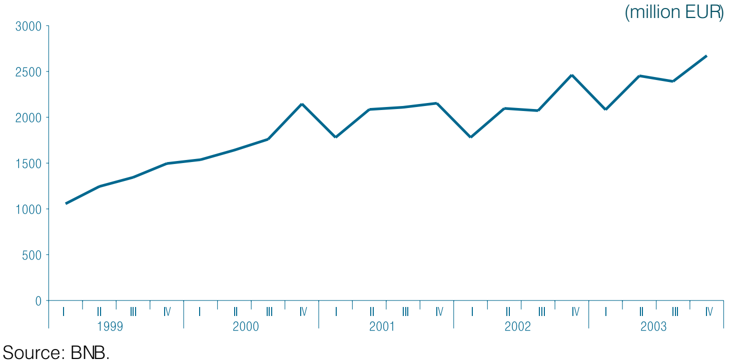
Exports of Base Metals and Their Products (Quarterly)



Source: BNB.

Chart 88

Imports, CIF (Quarterly)



Source: BNB.

The end of the Iraq war and the retention of low world interest rates are helping the world economy grow, boosting foreign demand in a major way. Foreign demand in turn is the basic driver of Bulgarian exports. Hence anticipated world economic growth will maintain second and third quarter export growth, and boost it on 2003. The forecast is for real-terms export growth over the second and third quarters to exceed nominal growth significantly, which (as in imports) depends on the inverse behavior of physical volumes and the price component. Second quarter physical volume growth and price falls should be lower than last year. The third quarter should see export volumes growing significantly more than the same time last year, with the export price component falling.

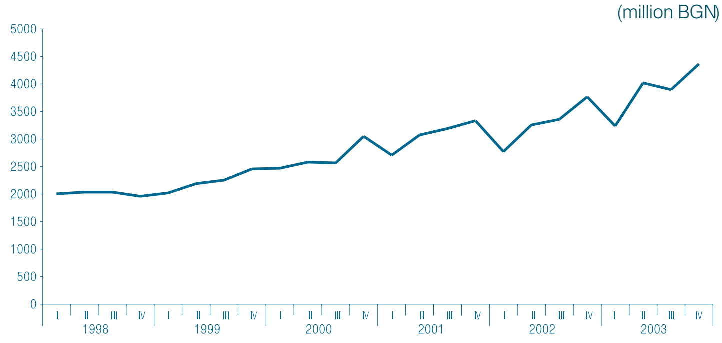
This should maintain the trend to growth in the trade balance deficit in the second and third quarters.

Expected buoyant foreign demand and the growth of investment into tourism should boost revenue from this sector further, but with an anticipated growth rate flattening *vis-a-vis* the prior year.[21]

Chart 89

Imports of Goods at Average Prices since 1998 (Quarterly)

(million BGN)

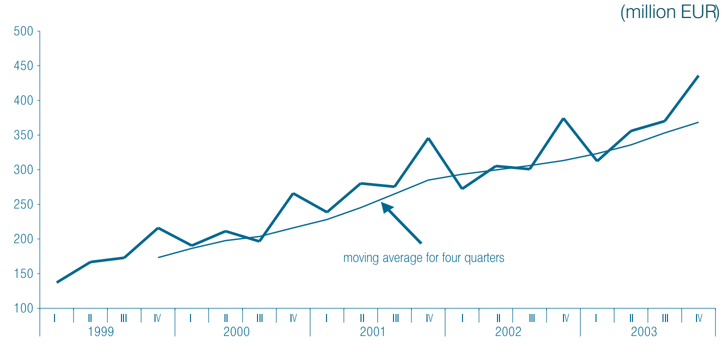


Source: NSI.

Chart 90

Imports of Consumer Goods (Quarterly)

(million EUR)



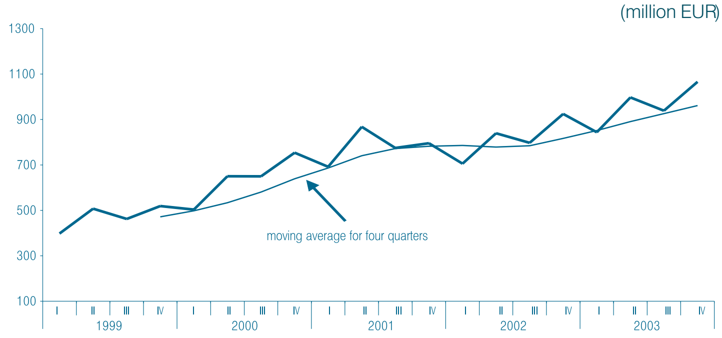
Source: BNB.

...the increase in foreign trade volume and in trade balance deficit is expected to continue

Chart 91

Imports of Feedstocks (Quarterly)

(million EUR)

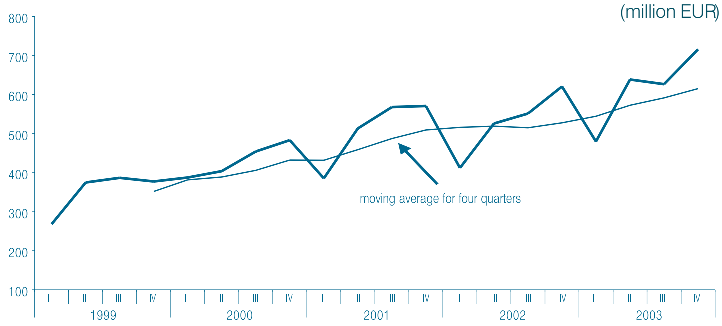


Source: BNB.

Chart 92

Imports of Investment Goods (Quarterly)

(million EUR)



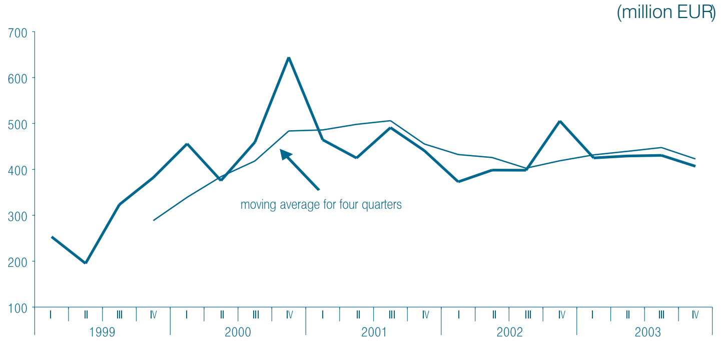
Source: BNB.

[21] The anticipated fall in the rates of revenue growth from tourist services is largely due to 'the base effect.'

Supply and Competitiveness

Manufacturing and services contributed most to gross value added growth in 2003. Farming registered a drop due to poor weather and the poor cereals harvest which pushed up flour and bread prices sharply at the year's close.

Chart 93
Imports of Energy Commodities (Quarterly)



Source: BNB.

Table 14
Bulgaria's Foreign Trade with the European Union

	EU imports, CIF			Bulgaria's exports to the EU		
	Total	from accession countries				
	billion EUR	billion EUR	% of total EU imports	million EUR	% of total Bulgaria's exports	% of total EU imports
2001	1012.5	88.9	8.8	3129.0	54.8	0.31
2002	985.3	93.5	9.5	3376.4	55.7	0.34
2003	983.1	102.0	10.4	3769.3	56.6	0.38
I quarter, 2003	250.3	24.8	9.9	910.2	55.7	0.36
II quarter, 2003	244.1	25.1	10.3	923.5	57.2	0.38
III quarter, 2003	241.4	25.1	10.4	989.9	56.5	0.41
IV quarter, 2003	247.3	27.0	10.9	945.7	56.8	0.38

Source: ECB, BNB.

The relatively high 2003 growth of manufacturing value added was expected, with corporate optimism in the sector rising through the year based on work in hand and order backlogs. Manufacturing sales grew by 17.4 percent in real terms in 2003, with export sales up 35.8 percent. Over 90 percent of sectors reported growth, with food and drink, smelting, confectionery, engineering, equipment and domestic appliances and textiles leading. Production facility utilization ran at 62 percent on average: among recent years' highest values. An important change in industrial sales became evident during the year with the increase of domestic sales.

...manufactoring and services contributed most significantly to the growth

Table 15

Gross Value Added Growth Rate and Sectors' Contribution

	2002		2003	
	real growth, %	contribution, percentage points	real growth, %	contribution, percentage points
Gross value added	5.0	5.0	4.0	4.0
Agriculture	5.5	0.7	-1.3	-0.2
Industry	4.6	1.4	7.1	2.1
Services	5.1	2.9	3.5	2.1

Source: NSI.

Table 16

Industrial Sale Dynamics

(%)

	2001		2002		2003	
	rate	contibution	rate	contibution	rate	contibution
Industrial sales	2.8		1.3		17.4	
export sales	-2.1	-0.8	4.6	1.7	35.8	13.6
domestic sales	5.9	3.6	-0.7	-0.4	6.2	3.8

Source: NSI.

A major factor in industrial goods sales was manufacturing's post-privatization restructuring, with a concomitant rise in efficiency. Manufacturing labor productivity continued rising; together with moderate pay rises this cut unit labor cost, boosting this sector competitiveness in the world markets. This allowed the industry to expand exports and make full use of its enhanced world competitiveness amid an open economy and liberalized trade. The production cost competitivenes is vitally important for the smooth operation of the currency board.

Exports have always been very important to Bulgarian manufacturing. Thanks to them the industry reported an overall sales rise in 2002 despite a home market drop, and 2003 growth came to double figures.

Reprocessing is largely driven by textiles and clothing: export-orientated manufactures. The sector is among the leaders in investment and job creation, with pay levels among the lowest in the economy.

Timber processing, a relatively small industry, has developed dynamically in recent years, with exports growing fast. By comparison with 1999 cost competitivenes has not changed significantly and employment and pay are rising steadily, with pay remaining below the reprocessing average.

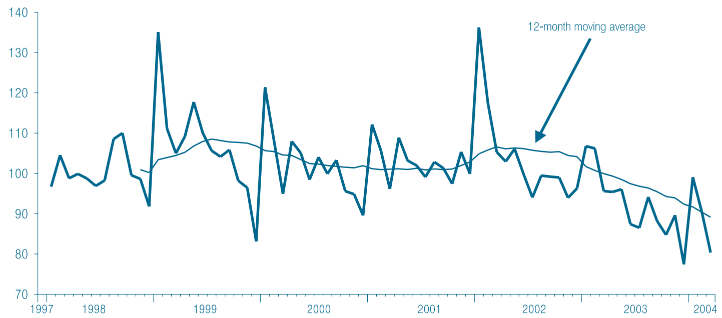
...broad base for manufacturing output growth and significant production facility utilization

...improved competitiveness of manufacturing due to increased productivity and moderate growth of the real pay and employment

Chart 94

Unit Labor Cost in the Reprocessing Industry

(1998 = 100)



Source: NSI, BNB.

Electrical, optical and other equipment is another sector reporting clear sales growth. Exports have driven sales here over the last three years. Real pay is growing while staying well below that in industries like power generation and metals smelting.

Furniture and miscellaneous manufactures are enjoying strong sales growth, but industry figures remain relatively modest. The character of output limits the industry largely to the home market, where most sales have been. The industry's cost competitivenes is also improving despite the relatively fast rise in employment in 2003. Pay levels are low.

...small industries' growth with low labor cost helped diversify manufacturing

Industries with low pay have led recent years' diversification of industrial manufacture, contributing to Bulgaria's overall cost competitivenes.

Cost competitivenes in structurally important industries like food, metals smelting and oil processing results from holding growth back or cutting employment and pay. The food industry overcame its stagnation only in 2003 thanks to the rapid rise of home sales. Metals smelting has fluctuated with world cyclic demand, with overall production growing on 1999.

...home market sales dynamics corresponds to the increased consumer and investment demand and buoyant manufacturing

Home sales comprised some 60 percent of all manufacturing sales. In periods of buoyant home demand such as 2001 and 2003, they have contributed significantly to the growth of overall sales. In 2003 home market sales grew by 6.2 percent. Most industries enjoyed good results, with food and drink manufacture, energy generation, nonmetal manufactures, furniture, rubber and plastics processing, and metals leading. This suggests high consumer and investment demand (for instance in construction) and buoyant manufacturing.

Reprocessing maintained its significant contribution to economic growth, financial intermediacy and transport and communications grew fastest. Both these sectors retained their cost competitivenes in the face of rising pay (particularly in financial intermediacy) by keeping employment in check and raising productivity.

...strong growth and high efficiency in financial intermediacy, communications and transport

Retail trade also contributed to growth. This sector has led recent years' employment growth. Unit labor cost has also risen over recent years due to rising sector pay. Yet its level remains significantly below the average for the economy because of the specifics of sectoral labor relations. Similar conditions apply to sectors like hospitality, property and business services, and other social and personal services listed as Miscellaneous: growing employment and real pay, but continuing low remuneration. These sectors have an important social function, offering opportunities to untrained people and alternatives to people who cannot find employment matching their qualifications.

The economy remained buoyant in the first quarter of 2004. Industrial sales rose by 17.9 percent, with export sales up 33.8 percent.

Metals smelting, engineering , clothing and textiles which contributed most to the 2003 sales boost, continued contributing greatly in early 2004. Manufacturing's export orientation was marked.

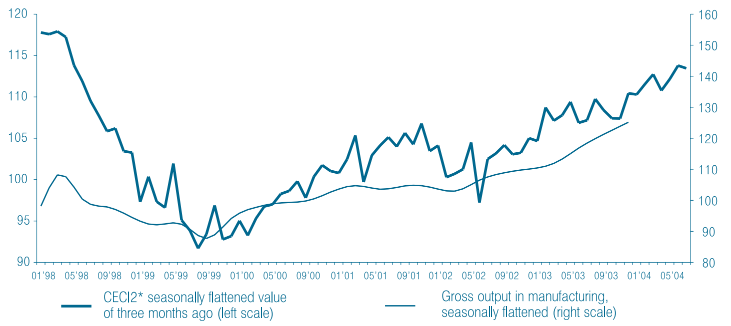
Home market industrial sales are growing at 6 percent, with food and drink contributing most, along with nonmetal and metal goods. Demand for the last two industries' wares reflects buoyant construction and consumer demand.

April saw the good industrial climate continue, with industry poised to continue the favorable cycle. The CECI2 indicator shows favorable trends thanks to foreign demand, order backlogs and work in hand. Facility utilization remains high, with some prospects of employment growth. Economic indicators give grounds for believing that positive manufacturing dynamics will continue.

Retail and services managers also assess the business environment favorably, their assessments continuing to improve through April. Expected demand, sales and order indicators show upward trends. Both sectors register higher employment expectations.

...retail trade, tourism and services provide alternatives to people who cannot find employment matching their qualifications

Chart 95
Expected Output

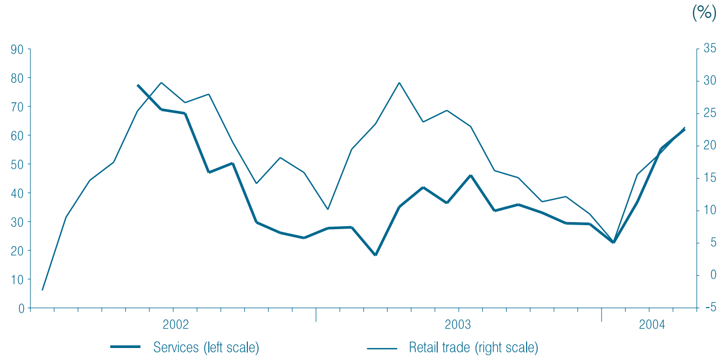


Source: NSI, BNB.

*A composite indicator comprised of the indicators of expected output and business conditions, order backlogs and the evaluations of foreign and domestic demand based on the NSI manufacturing survey. See, Tzalinski, Tz., A Composite Tendency Indicator for Bulgaria's Industry, DP/36/2003, BNB.

...economic indicators signal favorable dynamics of goods and services supply

Chart 96
Expected Demand in Retail Trade and Services (Balance*)



* The share of companies anticipating growth less the share of companies anticipating a fall.
Source: NSI, business surveys.

Chart 97

Unit Labor Cost by Industry

Source: NSI, BNB.

Unit Labor Cost

Indicators of unit labor cost in the agriculture, extracting, reprocessing, construction, power, gas and water, transport and communications, trade, financial intermediacy and miscellaneous sectors rest on data from the Income Formation account. The index of nominal unit labor cost reflects the difference between nominal compensation (the complete labor cost) and real value added. The index of real unit labor cost reflects the difference between nominal compensation and nominal value added, equivalent to the ratio of real values where one deflator (here, the implicit deflator of value added) is applied. The average convergence of the nominal labor cost and real labor cost indices is applied to reprocessing: $\frac{w_t^n N_t Y_0^r}{w_0^n N_0 Y_t^r}$, to real labor cost correspondingly: $\frac{w_t^n N_t Y_0^n}{w_0^n N_0 Y_t^n}$, where ***w*** is remuneration, ***N*** is the number of employees, and ***Y*** is the volume of sales. A subscript **0** indicates a base period, and ***t*** indicates a reporting period. A superior ***n*** means nominal value, and ***r*** means real value. The industrial sales deflator is used.

Source: NSI.

5. Inflation

The Bulgarian monetary regimen aims to maintain price stability by keeping the national currency stable. Data show objective attainment, with inflation since 1997 (currency board launch) largely reflecting changes to government-controlled prices, indirect tax rises in line with minimum EU requirements, sudden changes in international prices of commodities like crude oil, metals, and chemicals, and of farm produce.

The high rates of 2003 growth in home demand did not push prices upward due to the economy's openness. Imports met some home demand (mainly for investment and feedstocks), at international market prices. US dollar prices of major commodity groups in 2003 grew, with euro appreciation against the US dollar making up for this on the home market. A worsened balance of payments trade balance was a negative consequence of rising home demand.

Another part of home demand, mostly consumer-led, was met by rising industrial output sales at home. This marked the year for Bulgarian manufacturers. The fall in unit labor cost was an important factor in maintaining price stability (Chart 97).

The average annual 2003 inflation stood at 2.3 percent, with accumulated inflation by the year's end coming to 5.6 percent, core inflation contributing 3.4 percentage points. The poor cereals harvest which pushed up bread and cereals prices (9.9 percent of the consumer basket) by 25 percent was the major driver of the core inflation in 2003. Flour and cereal prices made up 68 percent of the core inflation.

The year saw rises in electricity and heating prices as part of their alignment with production costs. Excise duty rose as part of harmonization with EU minima, pushing up alcohol prices.

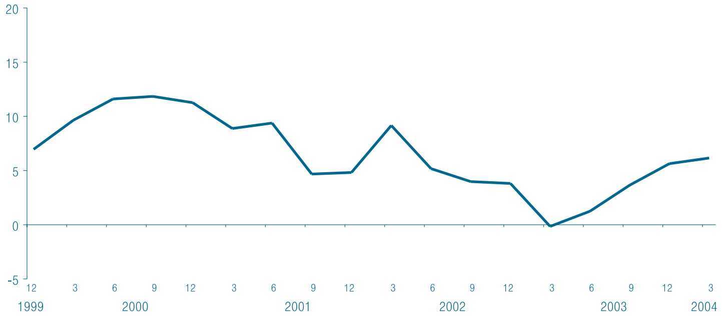
..the high rates of growth in home demand did not push prices upward due to the economy's openness

...industrial output sales increased in the home market

...lower unit labor cost was an important factor in maintaining price stability

Chart 98
Consumer Prices Index

(share on corresponding month of previous year, %)



Source: NSI.

Table 17
Contribution to the 2003 Inflation

(percentage points)

	January – December
Food	3.4
incl. bread and flour	2.3
Nonfood	-0.1
Catering	0.2
Services	2.1
Goods and services whose prices are controlled by the government	2.2
Core inflation	3.4
INFLATION (%)	5.6

Source: NSI, BNB.

Note: Computing the core inflation excludes goods and services whose prices are set administratively (electricity, heating, tobacco, water supply, postal services, fixed telephone tariff, pharmaceuticals).

Crude oil price fluctuations affected monthly inflation but did not push up overall prices for the year.

Excise duty rises drove inflation in early 2004, with tobacco rising by 20.8 percent in January, and another 11.6 percent in February. March saw a 0.07 percent consumer price deflation.

Accumulated first quarter inflation came to 1.65 percent: within anticipated bounds. It largely reflected tobacco price rises and seasonal farm produce price movements. In annual terms, first quarter inflation ran at 6.15 percent, with an average value of 6.4 percent for the quarter. Bearing in mind inflation seasonality, and excluding the effect of fuel, a fall may be anticipated in the second quarter, followed by a rise in the third. The sudden rise of crude oil prices in May will boost second quarter inflation.

...excise duty rises drove inflation in early 2004

...crude oil prices will have the strongest effect on inflation in the short run