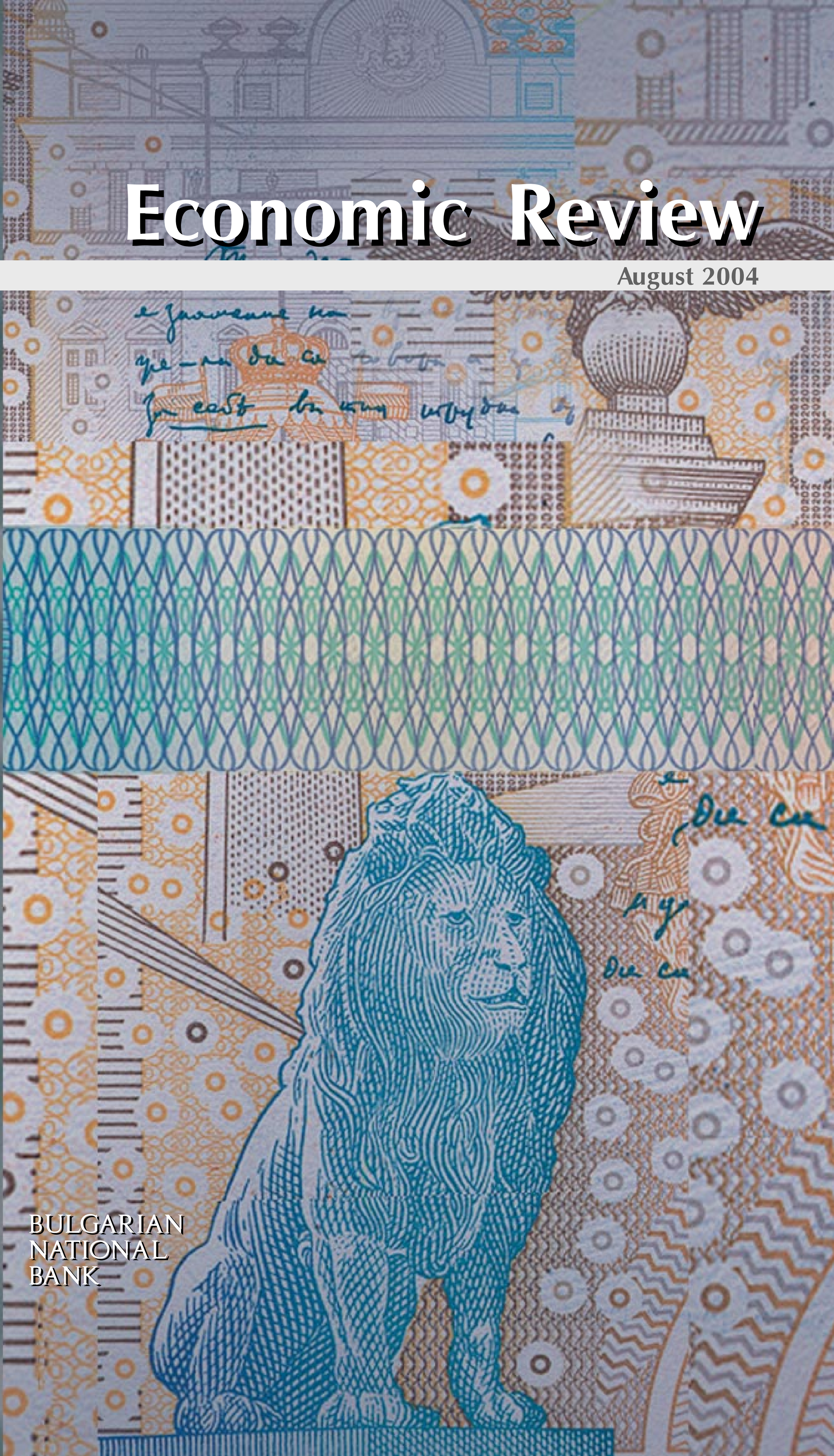
Economic Review

August 2004



BULGARIAN
NATIONAL
BANK

YEARS

125

YEARS

Economic Review

August 2004

BULGARIAN
NATIONAL
BANK

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.

The August 2004 *Economic Review* was approved for publication by the BNB Governing Council at its 22 July 2004 meeting. It employs data published by 30 July 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.

ISSN 1312 – 420X

This issue includes materials and data received up to 5 August 2004.

Elements of the 1999 banknote with a nominal value of 20 levs are used in cover design.

Published by the Bulgarian National Bank
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Abbreviations

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
EA	Employment Agency
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
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

Summary

Over the first half of 2004 economic growth hastened across the world. The US economy remained the leader of world growth and eurozone growth accelerated. Petrol prices continued to exert inflationary pressure, while other basic commodity prices (except that of steel) have tended to fall since the year's start. The Federal Reserve raised federal funds interest rates by 25 basis points in late June. Current market expectations are for federal funds interest rates to rise to between 2 and 2.25 percent in several steps over the balance of the year. The European Central Bank did not change its interest rate in the second quarter, with this policy expected to continue until the year's close. The interest rate differential between the two currencies will be insufficient to make up for investor risk assumed in financing the structural imbalance in US foreign trade amid a presidential election campaign. Therefore, we expect to see a slight depreciation of the US dollar against the euro.

The Bulgarian economy's interaction with the external world was directly mirrored by the intensity and direction of balance of payments flows, with the ultimate result of changes in Bulgarian international reserves. Over the first half of 2004, international reserves continued growing, reaching EUR 6111.3 million. Foreign direct investment made an important contribution to the balance of payments financial account surplus, with its contribution expected to keep rising towards the year's end. We expect international reserves to grow by some EUR 900 million in 2004.

Reserve money grew relatively fast in the second quarter, which – along with money multiplier rises – led by June to 26.75 percent growth in broad money on an annual basis. We expect broad money growth to decline by the end of the year, mainly due to the expected credit cutback and the associated fall in multiplier values.

Favorable macroeconomic conditions and bank competition, along with strong credit demand by businesses and households, stimulated a credit expansion. Nevertheless, the second quarter saw signs of a gradual fall in the annual growth of bank claims on the nongovernment sector. This fell from 52.9 percent in March to 48.2 percent in late June. Regardless of the pressure for more credit and of the slight rise in credit in July, we expect to see its rise curtailed in coming months, with year's end figures down to some 30 to 35 percent. This fall in claims on the nongovernment sector will also reflect government and BNB measures to limit the credit expansion, as well as a higher base effect.

Growth increased over the first quarter of 2004. Over the year's second half, we expect to see household demand rise by some 3 or 4 percent, with investment rising by some 10 to 13 percent on the prior year.

Administratively controlled prices (such as tobacco prices affected by excise duty rises) exerted great inflationary pressure, as did service prices. Annual inflation grew weakly over the second quarter due to rises in postal and telephone charges, and to fuel price rises in response to world crude oil price rises. These inflation rises were largely offset by falls in food prices. We expect to see annual inflation to begin falling by the year's close. The 10 percent July hike in power and domestic heat prices will contribute 1.05 percentage points to inflation for the month, largely offset again by food price falls. Bread and cereal price drops are likely over the year's second half provided the harvest remains good, but great world price fragility forces us to retain an end-of-year inflation forecast of 4.2 percent.

1. The World Environment

Conditions

Between January and June 2004 economic growth hastened across the world. In Asia, Japan, India and Singapore posted significant growth. China continued developing rapidly at over 9 percent despite cooling-off measures in the second quarter.

According to preliminary data, US growth in the second quarter reached 4.8 percent on the earlier year, a slight slowdown compared to a 5 percent growth for the first quarter. Private and government consumption rose at lower rates than in the first quarter. Growth rates of private investment in fixed assets remained high, with exports accelerating.

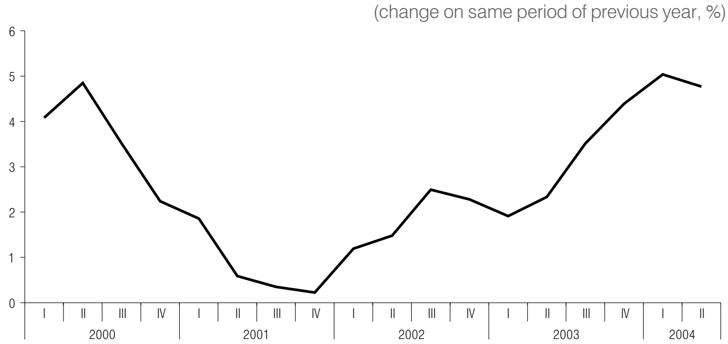
Over the first half of 2004 US employment continued rising with average new appointments reaching 211,000 *per* month: the record high over the last three years. Services contributed most to new vacancies. In the second quarter manufacturing for the first time since 2000 registered positive employment growth on an annual basis.

The second quarter saw the US inflation accelerating, and in June it stood at 3.3 percent on an annual basis, with higher oil and transportation prices contributing most to this. Core inflation over the first quarter was 1.3 percent on average, and 1.8 percent in the second quarter. We do not expect higher inflation in the coming two quarters. The policy of increasing interest rates will contribute to an inflation fall.

Chart 1

US GDP Real Growth Rate

(change on same period of previous year, %)



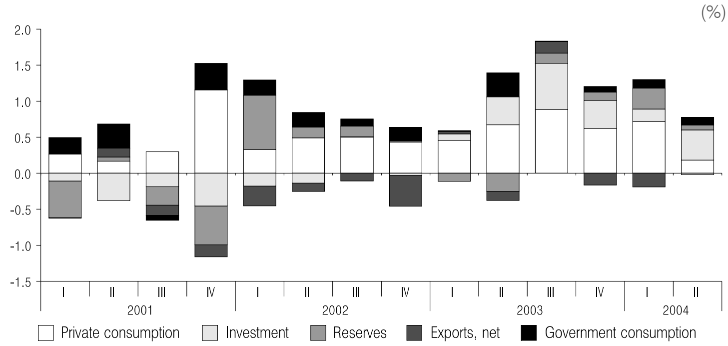
Source: Bureau of Economic Analysis.

...accelerated growth across the world...

Chart 2

Contribution to US Growth by Component

(%)

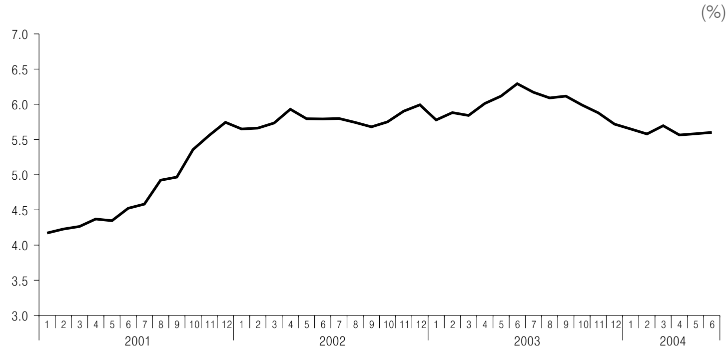


Source: Bureau of Economic Analysis.

Chart 3

US Unemployment Rate

(%)



Source: Bureau of Labor Statistics.

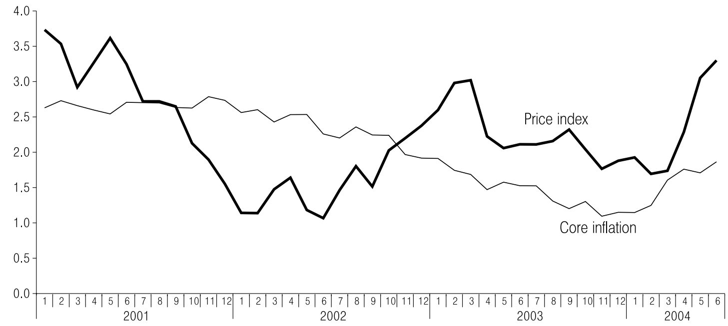
We anticipate the US economy to develop faster than its potential until the close of 2004. US consumer confidence remains the best economic indicator of the last two years. The positive assessment of the current economic situation, in tandem with the optimism for the coming months, gives rise to expectations of a greater contribution by consumption to growth in the coming two quarters.

Eurozone growth accelerated in the second quarter, private consumption and net exports contributing most. However, unemployment in March and April 2004 remained high at 9 percent.

In the first quarter eurozone inflation was low, accelerating during the second quarter to reach 2.4 percent on an annual basis in June.

Chart 4
US Inflation Rate

(change on same period of previous year, %)

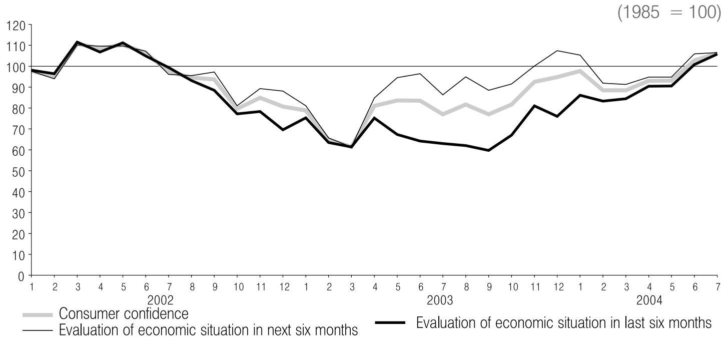


Source: Bureau of Labor Statistics.

...by June the US consumer confidence indicator has posted the best values for the last two years...

Chart 5
US Consumer Confidence Indices

(1985 = 100)



Source: Conference Board.

EU Excessive Budget Deficit Procedures

According to the Stability and Growth Pact, the EU member countries shall achieve balanced budgets in the medium term. Budget deficits shall not excess three percent of GDP in order to achieve steady public finance, price stability and sustainable economic growth. A special procedure under Article 104 of the EU Treaty is envisaged for countries breaching this requirement. At present ten countries (six of them in the last enlargement wave) are at different stages of this procedure.[1] Despite obstacles in the way of the Stability and Growth Pact, and contradictions between the Commission and the Council of Finance Ministers (ECOFIN),[2] achieving low budget deficits continues to be of key importance for sustainable growth. Observance of a strict fiscal discipline by the member states is confirmed by all statements by the European Central Bank.[3] Sustainable public finance is deemed one of the necessary conditions for maintaining price stability and European Monetary Union stability.

[1] Cyprus, the Czech Republic, France, Germany, Greece, Hungary, Malta, the Netherlands, Poland, and Slovakia. On 28 April 2004 the European Commission decided to send an early warning to Italy about the threat of breaching the budget deficit criterion. On 11 May the Council of ECOFIN put off discussions on this issue, and on 5 July it repealed the warning against Italy.

[2] On 25 November 2003 ECOFIN decided to suspend temporarily the excessive deficit procedure against France and Germany. This decision was appealed by the Commission before the Court of Justice of the European Communities in January 2004. On 13 July the Court decided to repeal the November ECOFIN recommendations.

[3] See the Statement of the ECB Management Board on the Stability and Growth Pact dated 24 October 2002 and the Statement of the ECB Management Board on the ECOFIN decision concerning excessive budget deficit procedure against France and Germany of 25 November 2003.

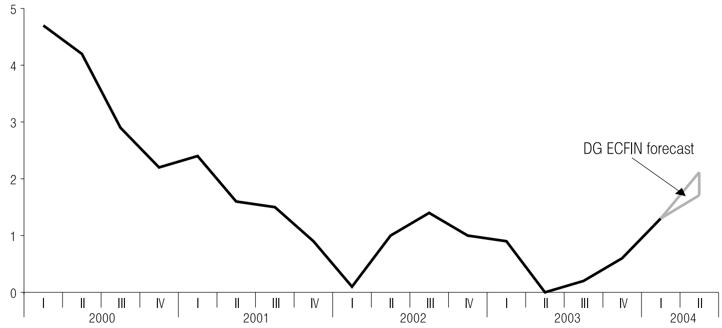
The major reasons for this include the exhaustion of the 2003 base effect, which according to the EC cut inflation by 0.2 percentage points,[1] and high oil and transportation prices responsible for the consumer price index rise. Alcohol and tobacco prices, as well as healthcare prices also contributed to inflation. By the year's close we expect inflation to fall below the first half's level.

[1] European Commission, *Quarterly Report on the Euro Area*, II/2004.

...prices of consumer goods reflected mostly high oil prices...

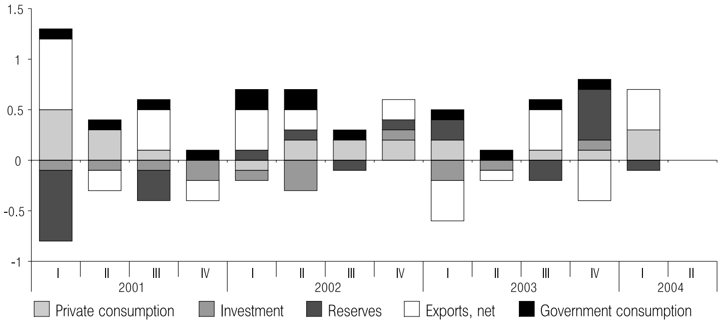
Chart 6
Eurozone Real GDP Growth Rate

(change on same period of previous year, %)



Source: Eurostat.

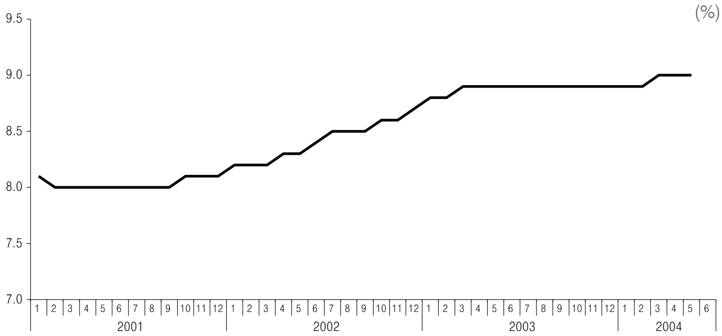
Chart 7
Contribution to Eurozone Growth by Component



Source: European Commission.

Chart 8
Eurozone Unemployment Rate

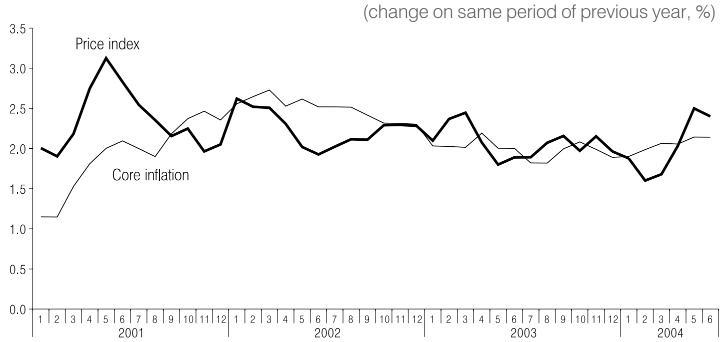
(%)



Source: Eurostat.

Chart 9
Eurozone Inflation Rate

(change on same period of previous year, %)



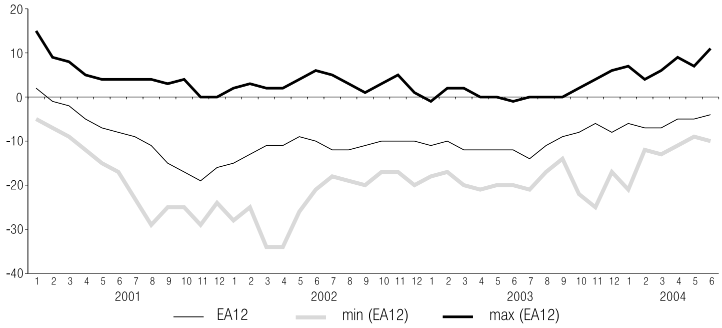
Source: Eurostat.

Eurozone manufacturing indicators accelerated at moderate rates of growth. We expect to see private consumption and rising exports to back this growth (as in the first quarter). Favorable conditions will boost investment.

...eurozone manufacturing indicators accelerated at moderate rates of growth...

Chart 10

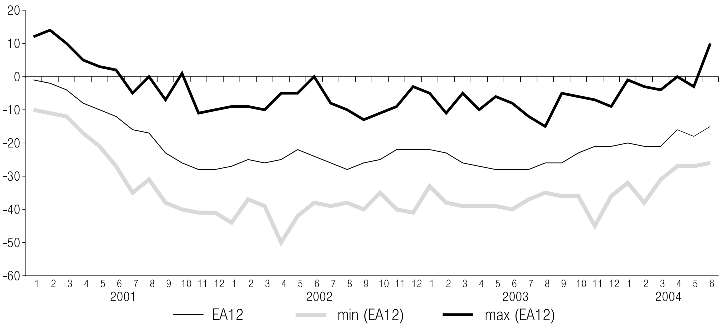
Indicator of Confidence in Industry



Source: Eurostat.

Chart 11

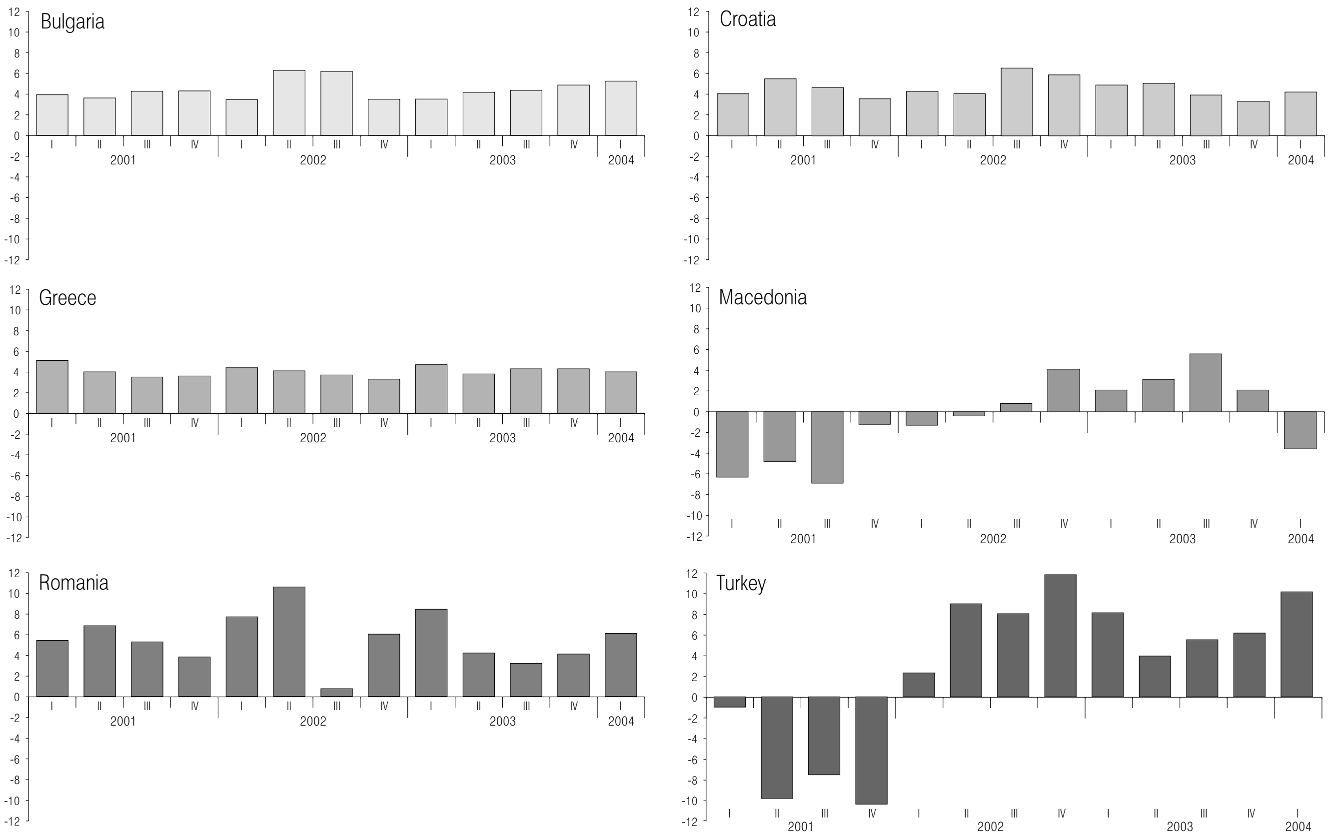
The Volume of Orders



Source: Eurostat.

Chart 12

GDP Real Growth Rate in Balkan Countries



Source: Statistical institutes and central banks of respective countries.

The Balkans developed at high rates, except for Macedonia which reported a 3.6 percent drop during the first quarter. Turkey posted the highest growth of 10.1 percent, followed by Romania with 6.1 percent. Manufacturing was the leading sector in both countries. The very rapid growth in Turkey reflected increased investment in machines and equipment (52.6 percent) and private consumption of durable goods (49.7 percent).

A drop in manufacturing impacted growth in Macedonia, with the most significant declines in ore output, power supply, and textiles. On the other hand, high unemployment resulted in lower household consumption, hitting the trade of home producers.

Inflation retained its downward trend in the Balkan countries showing high growth rates (Turkey and Romania). In the other Balkan countries it rose slightly due to high fuel and transportation prices.

...macroeconomic data for the Balkan countries were extremely favorable...

Commodity Prices

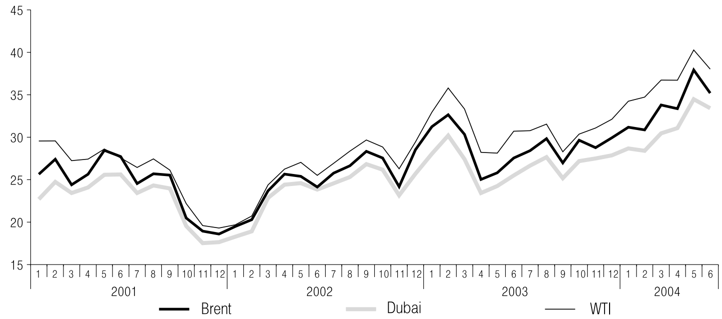
World growth acceleration pushed the prices of energy commodities and feedstocks upward. In addition to growing demand, crude oil prices rose due to geopolitical instability and serious problems in some large refineries.

May saw a record high oil price (Brent at USD 38 *per* barrel) as a result of enhanced demand, terrorist attacks against major petroleum facilities, and market speculation. The price varied within the expected range: from USD 34 to USD 36 *per* barrel (USD 35.5 per Brent barrel).[2] The OPEC countries' decision of 3 June to increase supply by 2 million barrels *per* day as of 1 July, and by another 500,000 barrels as of 1 August, contributed to this. The crude oil daily supply rose from 23.5 to 26 million barrels.

At the start of the third quarter crude oil prices began rising again, the major reason being that Yukos,[3] one of the biggest oil companies in Russia, was threatened of stopping work. Markets reacted immediately and Brent price reached USD 40 *per* barrel in late July. Our assessments are that Yukos' exports are not likely to stop,[4] and that other Russian oil companies are ready to compensate any export shortage.

Chart 13
Crude Oil

(USD *per* barrel)



Source: World Bank.

...the highest crude oil price jump since the crisis in early 80s...

[2] See *Economic Review* (May 2004), p. 13.
[3] Yukos' share in Russian oil production came to 19 percent and as a share of world production it was estimated at 3.6 percent.
[4] Russian authorities explained that the distraint had affected only the company's assets, not its business.

We expect factors influencing the crude oil market over the coming two quarters to include the EUR/USD exchange rate, possible terrorist incidents, the level of reserves, and consumption in China and the USA. In July US reserves exceeded significantly the minima, as well as those in 2002 and 2003. It is still early to state that the USA do not suffer from reserve shortage, but the trend since early 2004 points to entering a normal cyclic corridor. At the present moment it is not likely that Brent crude oil price will stay within the projected range for the third quarter: between USD 30 and USD 33 *per* barrel.[5] In view of the geopolitical instability and the Yukos problems, we anticipate the average price to move between USD 37 and USD 39 *per* barrel over the third quarter. During the fourth quarter our expectations are for the average price to range between USD 36 and USD 38 *per* barrel, since an OPEC quota increase is possible (most likely in September) if the oil price in euro continues exceeding EUR 28 *per* barrel. According to optimistic IEA forecasts for a gradual oil price fall, demand growth in 2005 will be significantly less due to subsiding economic growth.

...the upward trend in metal prices reversed...

Metal prices rose suddenly in the year's first quarter as a result of demand pressure. In the second quarter they sustained their higher levels, falling in some metal groups, since on the one hand, demand in China decreased in line with price movements, and on the other, market opinion was that attained prices were very high and the margin for further increase was quite limited. We expect to see a price retention and a possible slight fall by the close of 2004.

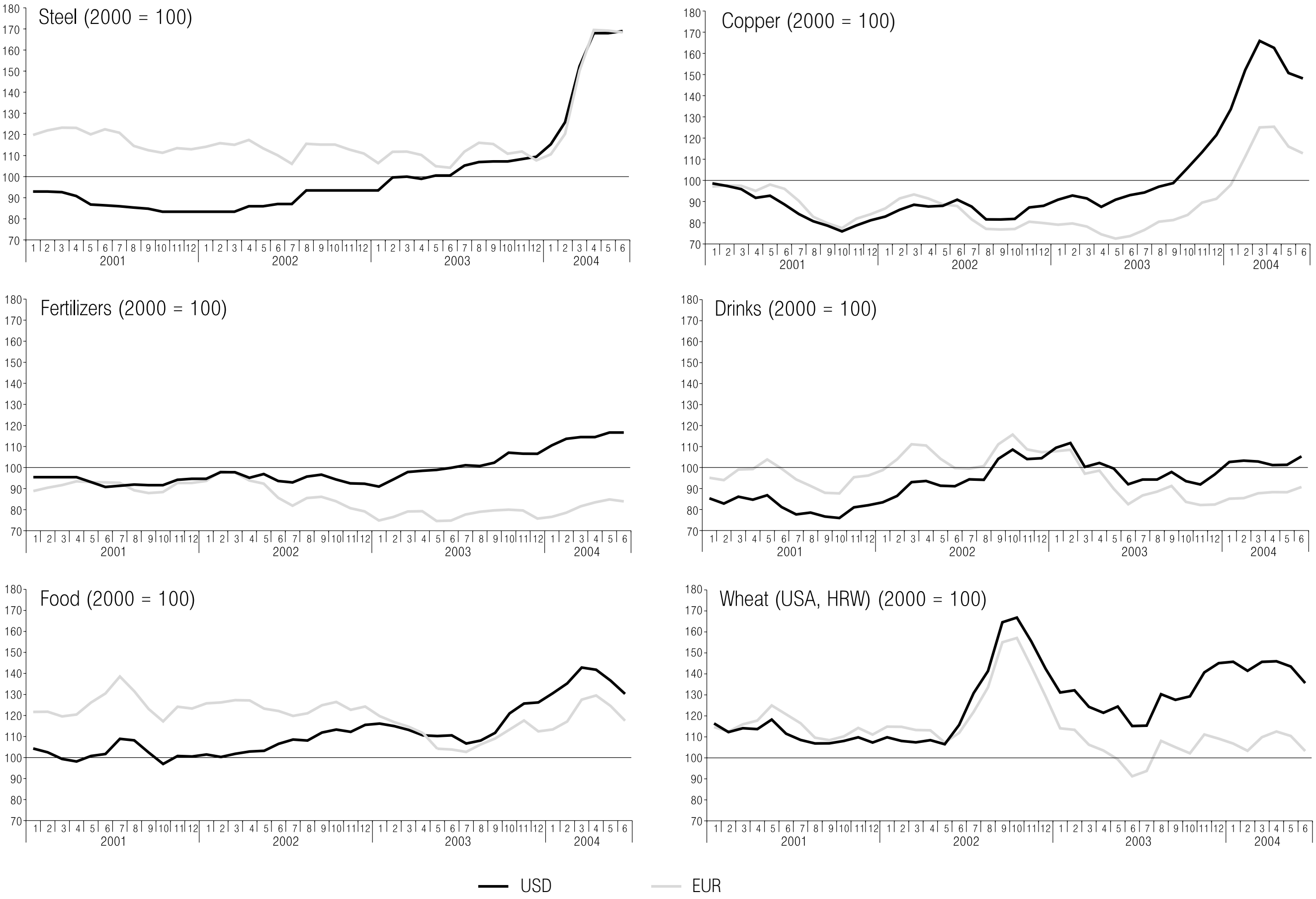
Food prices registered a moderate downward trend in the second quarter, with cereals contributing thanks to the expected good harvest.

...prices of major commodity groups in euro changed at more moderate rates...

Chart 14 shows price indices of selected goods in US dollars and in euro. Obviously, prices in euro changed more gradually compared to the respective indices in US dollars, except metal prices. Prices in euro are important for the Bulgarian economy, their dynamics influencing domestic inflation.

[5] See *Economic Review* (May 2004), p. 14.

Chart 14
Price Indices of Major Commodities and Commodity Groups



Source: World Bank.

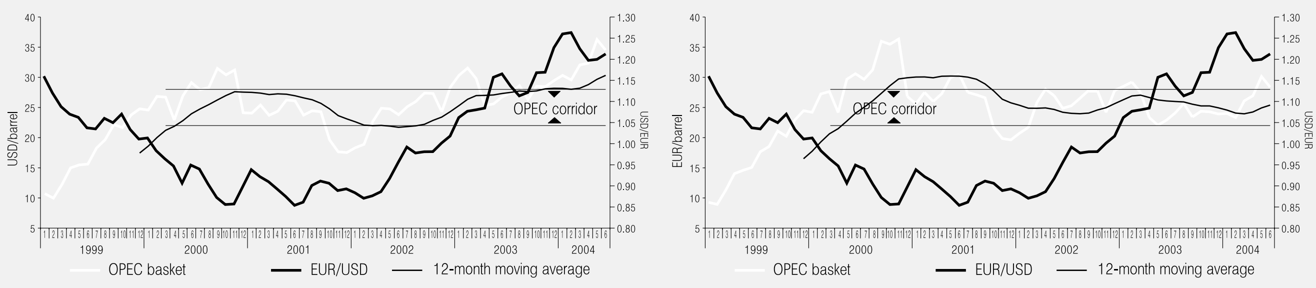
The OPEC Reaction to Crude Oil Price Movements

In March 2000 OPEC introduced a corridor for crude oil price movements, setting them at between USD 22 and 28 *per* barrel. Initially the reaction to price deviations was automatic but later it became a matter of consensus between the member states in view of achieving greater precision.

Price index data from the euro-denominated OPEC basket show that in most periods of the four years after the corridor was introduced, the price moved between EUR 22 and 28 *per* barrel. This suggests that OPEC has stuck to its 2000 decision when the USD/EUR exchange rate was nearly at a unity, taking into account EUR/USD exchange rate dynamics. US dollar depreciation cut member states' profits, and a strategy of an exchange rate peg to the euro became absolutely reasonable. If this assumption were true, OPEC would be expected to react should the crude oil prices continue exceeding EUR 28 *per* barrel.

Chart 15
OPEC Basket Crude Oil in US Dollars

OPEC Basket Crude Oil in Euro



Source: World Bank, ECB, BNB, OPEC.

Interest Rates

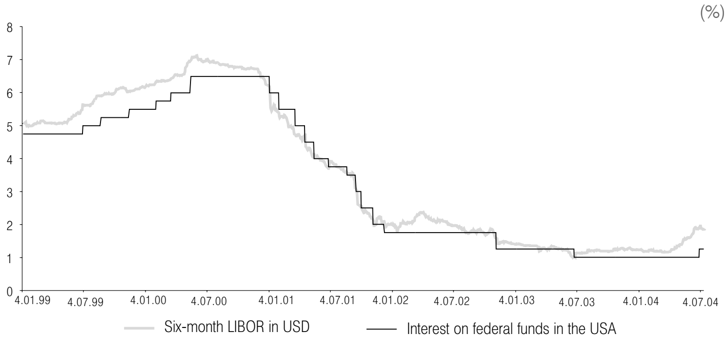
At the close of June the US Federal Reserve System raised federal funds' interest rates by 25 basis points to 1.25 percent. Good indicators of growth and employment, as well as inflation growth in the second quarter backed this step. It was expected by the stock exchanges and caused no surprise. In anticipation of this rise, in the second quarter six-month USD deposit rates on the London interbank market moved within a wider band compared to the first quarter: from 1.33 percent to 1.95 percent. In early April the yield curve moved upward with the two to five years' sector outstripping the 10 to 30 years' sector. Stable expectations of a federal funds' interest rate increase predetermined the upward change in six-month LIBOR which reached by the end of the period its highest value for the last two years.

By the close of July futures contracts on federal funds showed expectations of a 50 basis point interest rate increase over the third quarter and a 25 to 59 basis point increase over the fourth quarter. Data derived from the forward yield curve by the close of July also showed federal funds interest rates rising to between 2 and 2.25 percent. These expectations transformed into an expected three percent six-month LIBOR by the year's close.

Federal funds interest rate increase in coming months will reflect factors governing inflation (mainly unit labor costs, import prices, and inflationary expectations), and US economic growth rates. If the inflation exceeds the current market consensus, it would cause a more rapid increase in interest rates owing to projected current levels of the yield curve and futures contracts.

...US Federal Funds interest rates were raised by 25 basis points at the close of June...

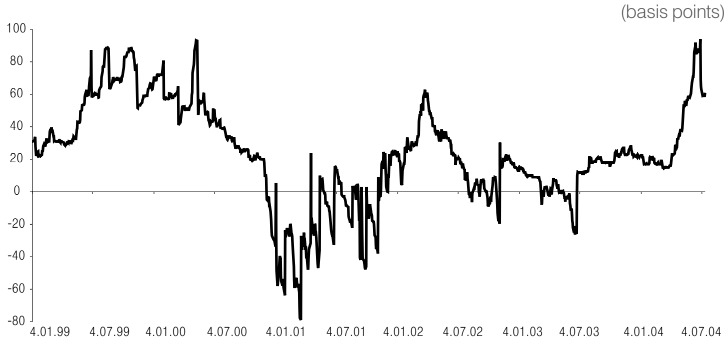
Chart 16
Interest on US Federal Funds and Six-month LIBOR in US Dollars



Source: Bloomberg.

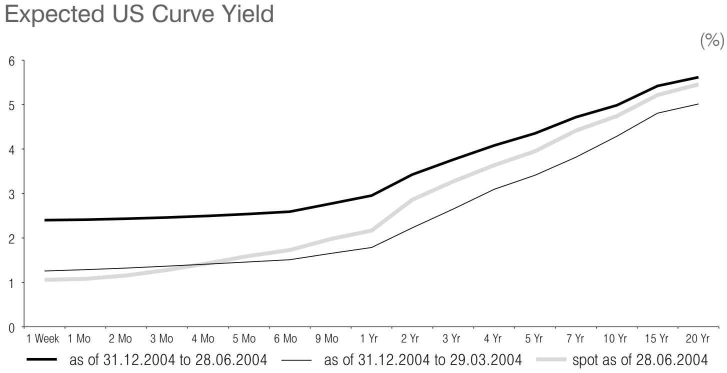
...more rises are expected till the end of the year...

Chart 17
Spread between Interest on US Federal Funds and Six-month LIBOR in US Dollars



Source: Bloomberg.

Chart 18
Expected US Curve Yield



Source: Bloomberg.

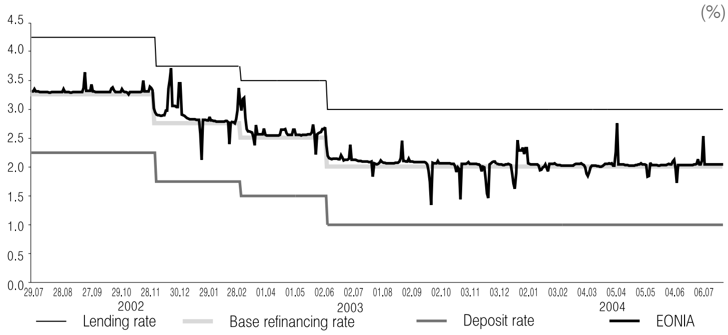
At the start of the second quarter the euro appreciation and a possible economic slowdown gave rise to concerns among market participants that the ECB may cut its interest rates by 25 basis points. After data analysis showing no grounds for concerns, and taking into account the upward revision of expected 2004 economic growth, it was assumed that ECB interest rates had bottomed out. June saw a change in ECB inflation forecasts: the projected band threshold was raised from 1.3 percent to 1.9 percent. The ECB expects annual inflation to stay over the target limit of 2 percent in the coming months. This, coupled with accelerated economic growth, stimulated expectations of interest rate rises and caused a steepening of the yield curve. In mid-June the spread between the six-month and one-month EURIBOR expanded, reaching 12 to 13 basis points.

By the end of the second quarter eurozone futures markets decreased their expectations of the interest rate rise on major refinancing operations but the spread between the December futures and EURIBOR continued to show a possible moderate increase by 25 basis points at the year's close. Eurozone interest rate expectations computed on the basis of the forward curve as of 13 July 2004 signaled a possible eurozone interest rate rise in early 2005.

Our expectations are for the ECB to keep interest rates at their current level until the beginning of 2005. The main risk scenario of maintaining eurozone inflation at the current high levels into the long term would threaten eurozone price stability. Hence, the ECB may enter a cycle of restrictive monetary policy with the interest rate rising by 25 basis points at the end of the current year. Higher than expected GDP growth may also add to earlier changes in eurozone monetary policy. In the third and fourth quarters we shall see the six-month EURIBOR continue rising within the projected 2.15–2.25 percent range for the third quarter, and the 2.20–2.40 percent range for the fourth quarter.

Chart 19

Eurozone Base Interest Rates

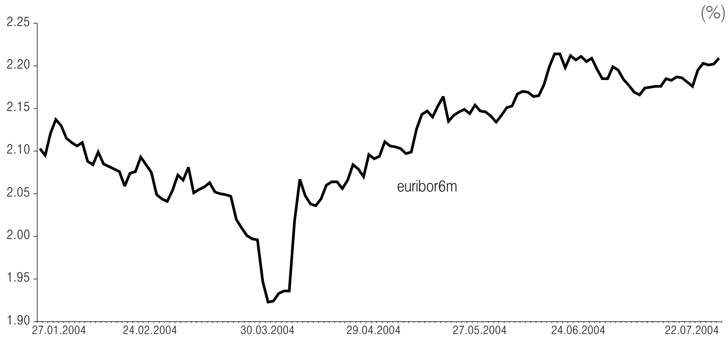


Source: Bloomberg.

...the base interest rate on ECB refinancing stayed at two percent...

Chart 20

Eurozone Interest Rates on Interbank Deposits with Six-month Maturity

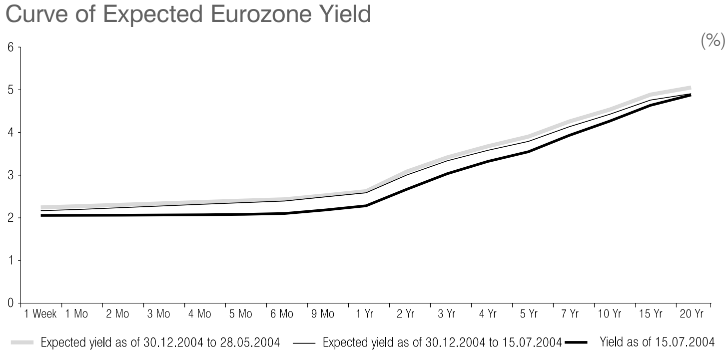


Source: Reuters.

...the ECB may raise its interest rates in the fourth quarter...

Chart 21

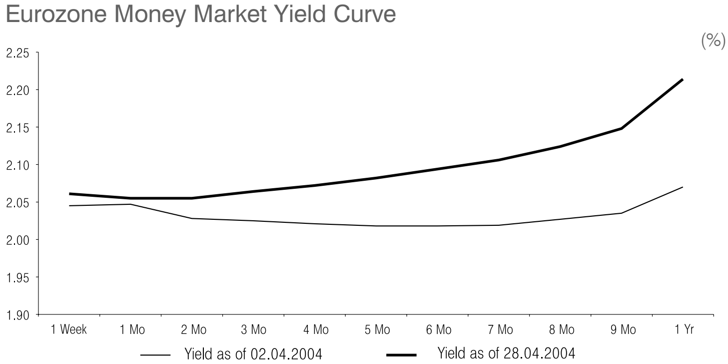
Curve of Expected Eurozone Yield



Source: Bloomberg.

Chart 22

Eurozone Money Market Yield Curve



Source: Bloomberg.

The Stock-exchange Markets

In the second quarter of 2004 investors in shares reported profits. Measured in euro, Morgan Stanley's investment bank overall index of world stock market dynamics, had a yield of 3.15 percent. Within this period, most successful was the US technology sector, summarized by NASDAQ index dynamics, which had a yield of 3.32 percent in euro. This was owing to the slight appreciation of the US dollar against the euro. Between the year's start and the end of the second quarter the Japanese stock market performed best, measured by the Topix index, followed by the US S&P 500.

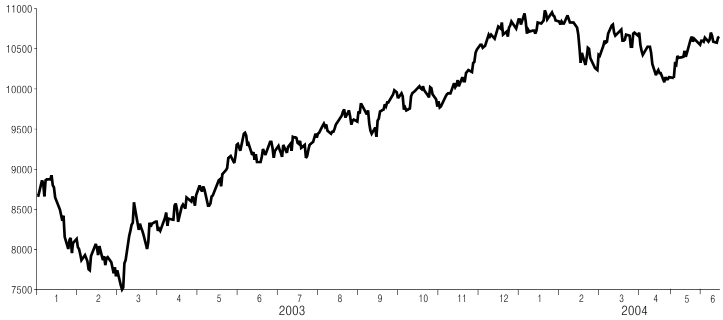
Major factors prompting positive global stock market performance were the cyclic profit rises resulting from buoyant economic growth and the good prospects for the second half of 2004. This refers to a greater extent to the economies of the eurozone and Japan.

After the second half of June a gradual fall in the EU economic growth rate started to show, resulting in worsened expectations of public companies' efficiency in the third and fourth quarters of 2004. This reversed the stock market's upward trend. In the following six months the anticipated rise in interest rates on the part of the Federal Reserve will add to the downward trend of stock exchange indices. In the second quarter the yield in euro of S&P 500 was 2.76 percent, and that of the technological index NASDAQ 3.32 percent.

European stock markets fluctuated in the second quarter, with falling basic indices at its start. Major factors behind this were the expectations of an imminent rise in interest rates, and the expectation that raised petrol prices would have a negative effect on corporate income. As a result, rising demand for shares of petrol companies and of companies from noncyclic economic sectors was noted. The subsequent rise in the second half of the quarter was based on the view that most shares were cheap enough to offer a good value. This was boosted by some fall in the tension related to petroleum production, good figures of US economic growth, and investors' rising willingness to take risks. In the second quarter the Dow Jones Stoxx 50 showed income rises of 1.76 percent, while the more comprehensive Dow Jones Stoxx 600, showed 2.09 percent rises.

...in the second quarter the upward trend of major economies' stock markets was sustained...

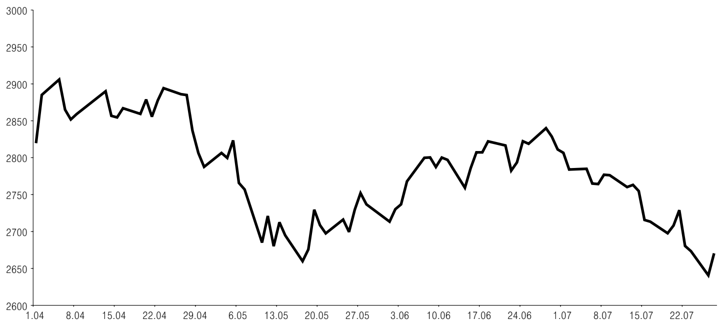
Chart 23
Eurozone Money Market Yield Curve



Source: Bloomberg.

...rising corporate profits were strongly influenced by the upward trend in the business cycle...

Chart 24
DJ Euro Stoxx 50 Index Dynamics



Source: Bloomberg.

In Europe a decrease in stock exchange indices is expected in the third quarter, although initial rises are likely to occur prompted by purely technical factors. Seasonal reporting on corporate profits in Europe shows higher than expected revenue in the second quarter of 2004: a factor supporting the interest in stock markets. Provided European economic growth is surprisingly positive, European stock-exchange indices are also likely to rise.

...stock markets face contradictory prospects for the second half of 2004...

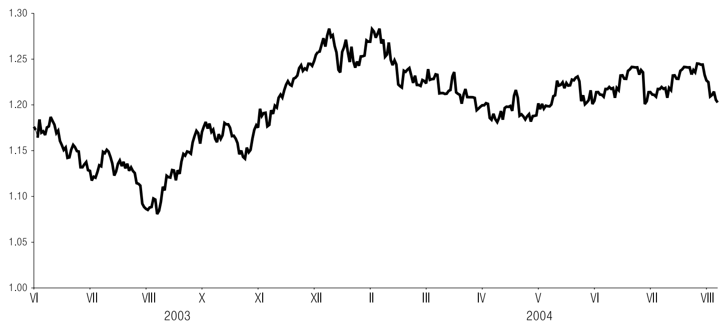
Concurrently, in Europe and across the ocean the business climate reflected worsened prospects of corporate profit growth in the coming quarters, which is backed by expectations of global interest rate growth. A great part of sales by companies whose shares play a leading role in European stock-exchange indices dynamics, depends on external demand and particularly US demand. Therefore, any slowdown in US economic growth would cause a decrease of stock exchange indices in Europe. Retention of high petrol prices and geopolitical uncertainty expose stock exchange markets to additional risks.

The US Dollar/Euro Rate

...the US dollar strengthened against the euro...

In the previous quarter forex market fluctuations were close to the long-term average and the US dollar/euro rate closed the review period 1.4 percent lower than at the beginning of April. Forex market fluctuation subsided compared with the first quarter of 2004, going below the long-term 200 day average in June. US macroeconomic data, expected changes in Federal Reserve interest rate policy, and fluctuations in petrol prices and stock-exchange markets affected markets.

Chart 25
EUR/USD Exchange Rate in 2003 and 2004



Source: Reuters.

...the US dollar/euro rate fluctuations subsided compared with previous quarter...

In the following two quarters the US dollar/euro rate will be influenced mainly by the anticipated changes in short-term interest rates on both sides of the Atlantic. The other two factors of great importance to the market are high petrol prices and possible terrorist attacks.

...a slight US dollar depreciation is likely to occur...

A slight US dollar depreciation is likely to occur by the end of 2004 despite prevalent expectations of a faster rise in interest rates in the USA than in the eurozone. Interest rate differential between the two currencies will not be sufficient to offset investors' risk in financing the existing structural imbalance in US foreign trade against the interest rates trajectory anticipated by the financial markets. Expectations of a comparatively better performance of stock-exchange markets outside the USA will prompt market participants to direct their investment elsewhere. The election campaign and the ensuing political uncertainty, as well as the existing fiscal deficit, will put additional pressure on the US currency.

The Gold Price

In the previous quarter three major factors impacted the gold price: its technical link with the US dollar, speculative positions, and geopolitical tension (affecting gold's role of an investment haven). The gold price moved within the USD 370 to USD 430 *per* 1 troy ounce range.

Favorable data on US economic rally, the cutting of long speculative positions in gold, and the news that NM Rothschild & Sons was withdrawing from gold trading in London contributed to gold's depreciation at the beginning of the period. NM Rothschild & Sons felt that low income and high risk volatility in gold operations had not ensured a good return over the last five years.

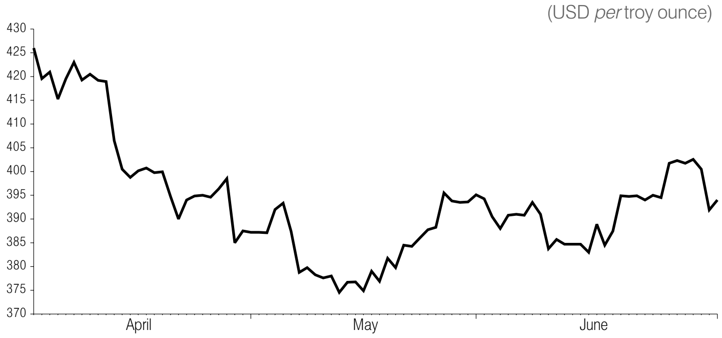
At moments gold has provided a safe haven. More frequent terrorist attacks across the world, enhanced demand for gold in the Middle East and oil high-price pressure pushed up its price. The above factors coupled with the gold/US dollar connection, geopolitical tension, and greater demand for gold will further add to gold price rises in the coming two quarters.

Bulgarian Foreign Debt on the International Financial Markets

A broadening of Bulgarian government securities spreads was evident at the start of the past quarter in line with the overall emerging markets trend (Chart 27). This broadening reflected economic agents' improved expectations of the US economy resulting in weaker interest in emerging economies' assets. The quarter high was reached on 7 May followed by increased US employment outside the agricultural sector for the second month in a row. The start of May saw a tightening of Bulgarian government securities spreads with a clear distinction from the overall EMBI+ emerging markets index in early June. The upgrading of Bulgaria's credit rating, and the declared in-

Chart 26
Spot Price of Gold

(USD *per* troy ounce)

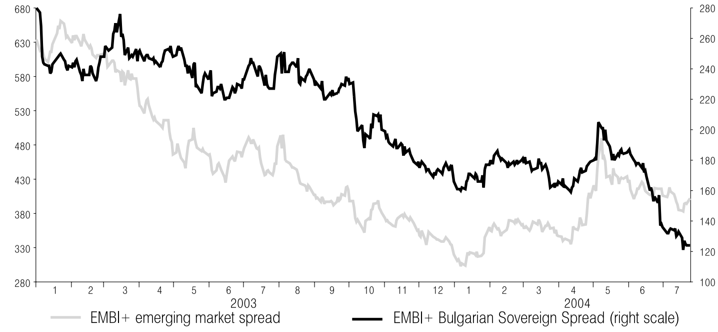


Source: Bloomberg.

...the gold price fluctuated dramatically...

Chart 27
Spread Dynamics of Bulgarian Government Securities

(basis points)



Source: Bloomberg.

tention of Brady bond reverse repurchase contributed further to a closing of Bulgarian foreign debt spreads at the quarter's end.

We expect to see a retention of investors' interest in Bulgarian foreign debt, and a continuing trend to a tightening of Bulgarian government securities spreads. Prospects of US and eurozone interest rate increases and enhanced demand for financial assets by developed economies are expected to have just the opposite effect. Favorable prospects for Bulgarian economic growth and the balanced fiscal position predetermine a relatively stronger interest in Bulgarian government securities than in those of most transition economies.

2. Financial Flows, Money and Credit

Financial Flows and Foreign Position Stability[6]

In the first half of 2004 BNB international reserves retained their upward trend and the Issuing Department balance sheet figure reached BGN 11,952.7 million (EUR 6111.3 million): a 26.5 percent increase on June 2003. The change in international reserves resulted directly from the balance of payments flows dynamics. Over the January to May 2004 period the current account deficit comprised BGN -1796.1 million, posting an improvement of BGN 68.5 million on the same period of 2003. The trade balance deficit continued to increase reaching BGN 2122.1 million (an increase of BGN 550 million on a year earlier basis).[7] Balances of services, income and current transfers improved prompting a decrease in the current account deficit. Foreign direct investment covered almost 50 percent of the current account deficit which favored financial flows' relatively sustained stability (Chart 28). Deficit coverage on an annual basis by quarter was considerably higher: an average of about 80 percent (Chart 29).

Balance of payments flows dynamics and the direction of changes in the central bank's international reserves were determined by businesses' actions (and their interests). In the first half of 2004 the major factor behind international reserve growth were net purchases of reserve currency by the central bank which was indicative of sustained demand for the reserve currency by businesses. Government transactions related to foreign debt service and privatization also boosted international reserve growth.

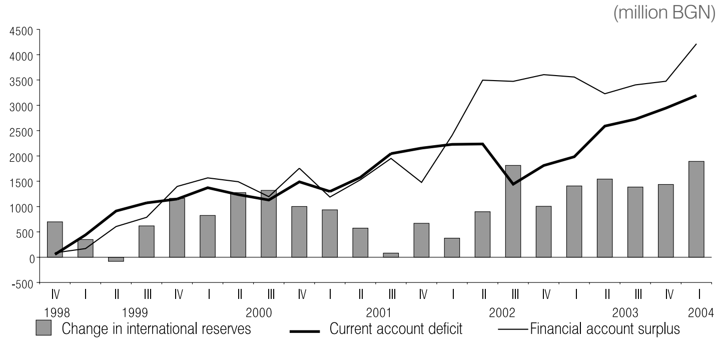
...BNB international reserves reached BGN 11,952.7 million (EUR 6111.3 million) by the end of June...

...over the January to May 2004 period the inflow of foreign direct investment covered almost 50 percent of the current account deficit...

Chart 28

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

(million BGN)

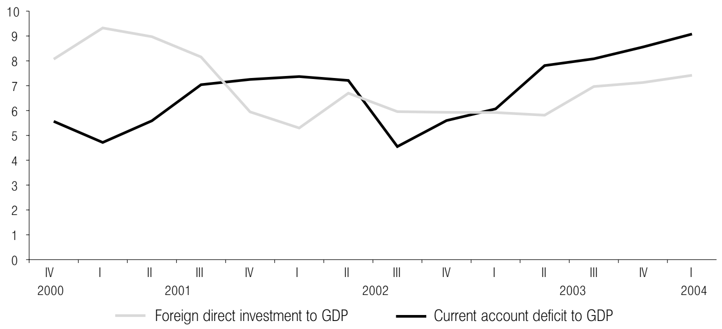


Source: BNB.

Chart 29

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

(%)



Source: BNB, NSI.

[6] Balance of payments analysis uses standard presentation data unless any other data are cited.

[7] A detailed analysis of foreign trade is included in Part Three, The Business Climate.

Table 1
Cashflows which Prompted Significant Changes in Gross International Reserves

	2004 (second quarter)	2004 (first half)
A) Purchases and sales of reserve currency (million EUR)	+560	+492
- Net purchases by commercial banks	+534	+464a
- Revenue from net purchases at tills	+24	+28
B) Changes resulting from revenue on commercial banks' minimum required reserves forex accounts	Received approximately EUR 34 million	Received approximately EUR 200 million
C) Changes resulting from flows on government accounts (only the largest cashflows – revenue and payments)	EUR 184 million revenue from the sale of Bulgarian Telecommunications Company; approximately EUR 70 million payments on domestic and foreign debt	Approximately EUR 80 million new loans received; EUR 53 million revenue from government securities issues; EUR 184 million from the sale of Bulgarian Telecommunications Company; approximately EUR 350 million payments on domestic and foreign debt

Source: BNB.

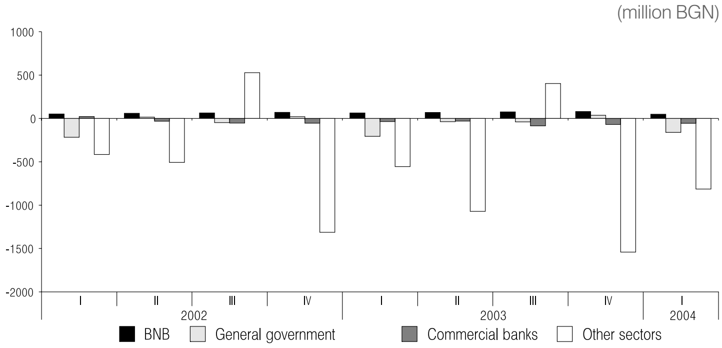
A more detailed analysis of the factors behind the changes in the international reserves is based on classifying balance of payments financial flows by major economic sector: the central bank, general government, commercial banks, and other sectors.[8]

The nongovernment nonfinancial sector (Other sectors) added mostly to the current account worsening in the first quarter of 2004. This is because following classification methodology goods, flows pertain entirely to this sector and trade deficit is the key factor influencing the current account negative balance. Accordingly, during the same period foreign direct investment reported in the financial account of Other sectors prevailed in the structure of financial flows.

The major financial flows which influenced the foreign position sustainability estimate in the review period were related to transactions in two sectors: Commercial banks and Other sectors. In the first quarter of 2004 commercial banks made a net investment of BGN 268 million in foreign assets as a result of seasonally high liquidity in this part of the year (Chart 32).

Chart 30
Distribution of Current Account Flows by Sector (Quarterly)

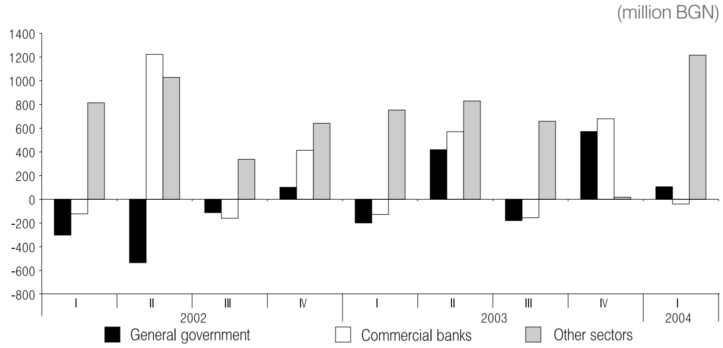
(million BGN)



Source: BNB.

Chart 31
Distribution of Financial Account Flows by Sector (Quarterly)

(million BGN)



Source: BNB.

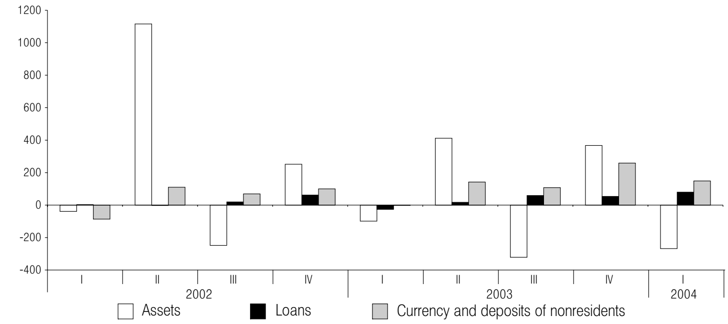
[8] See *Economic Review*, May 2004, p. 21, Classifying Balance of Payments Financial Flows by Sector.

The growth of nonresidents' deposits continued prompting the rise in the sector's foreign indebtedness. The positive interest rate differential between domestic credit rates and interest rates on international financial markets attracted foreign financing in the form of loans, currency and deposits (Chart 33).

The coverage of the Other sector's current account deficit by foreign direct investment was 78 percent. Intracompany loans classified as debt in GDP statistics were prevalent in the structure of foreign direct investment. This gives grounds to conclude that the private nonbank sector was financed predominantly by debt (Charts 34 and 35).

Chart 32
Commercial Banks' Financial Account Flows (Quarterly)

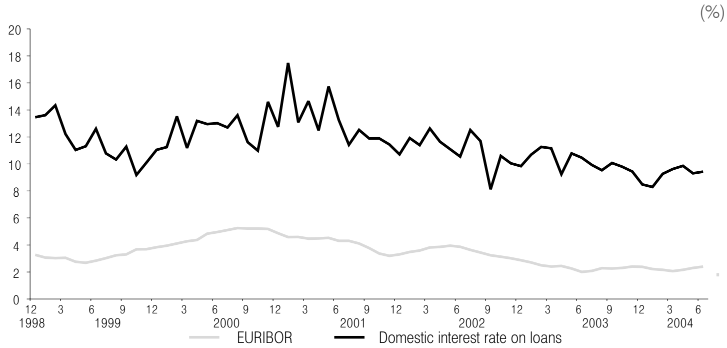
(million BGN)



Source: BNB.

Chart 33
Interest on Long-term Loans and EURIBOR

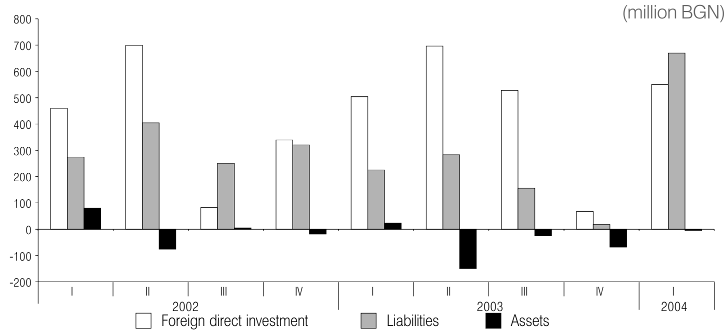
(%)



Source: BNB, European Central Bank.

Chart 34
Other Sectors Financial Account Flows (Quarterly)

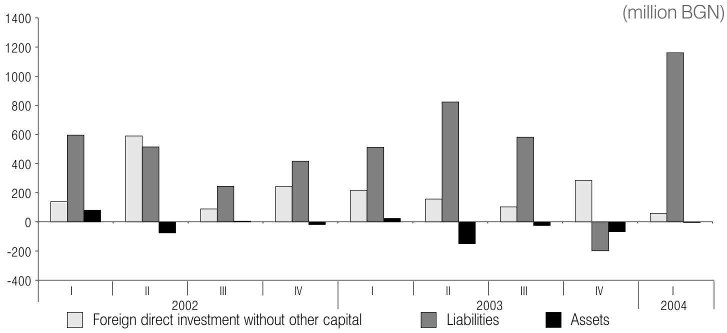
(million BGN)



Source: BNB.

Chart 35
Other Sectors Financial Account Flows (Quarterly)

(million BGN)



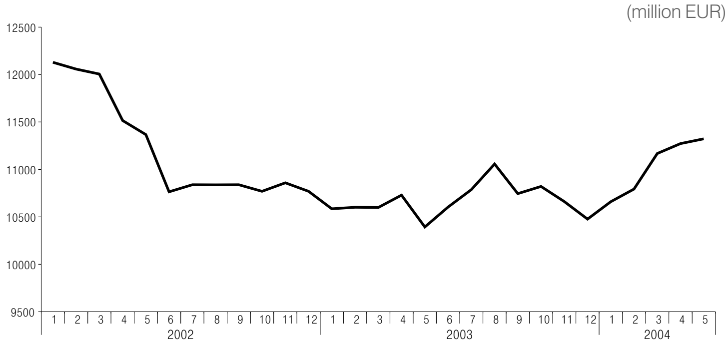
Source: BNB.

Financial flows as described above influenced the level and structure of gross foreign debt which started rising in nominal terms in early 2004. By the end of the first quarter of 2004 total debt exceeded 60 percent on an annual basis as a share of GDP. The private sector, whose debt rose by nearly EUR 700 million, contributed most significantly to foreign debt increase compared with the end of May 2003. Government sector foreign debt increased in nominal terms since the beginning of 2004; however, the sector is implementing a policy of decreasing public debt which has a favorable suppressing effect on total foreign debt. This was evidenced by the reverse repurchase of debt amounting to USD 679.1 million conducted on 28 July 2004.

...the private sector contributed most significantly to foreign debt increase...

Chart 36

Gross Foreign Debt

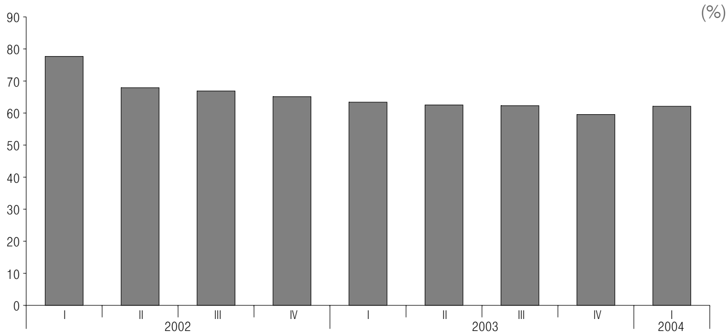


Source: BNB.

...the government sector is implementing a policy of decreasing public debt which has a favorable effect on gross foreign debt level...

Chart 37

Gross Foreign Debt/GDP on an Annual Basis

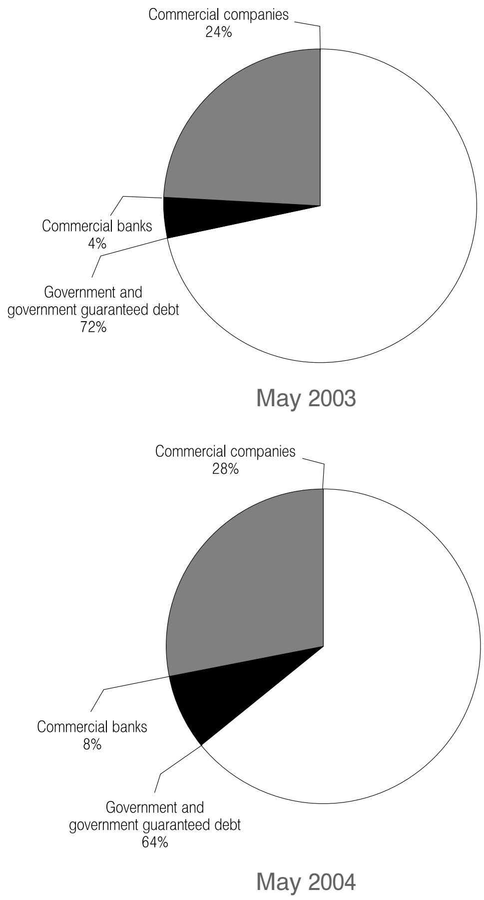


Source: BNB, NSI.

The growth of nonresidents' deposits contributed mostly to the increase in commercial banks' debt followed by other loans, while intracompany loans added to commercial companies' debt (see Table 2). Data on the dynamics and structure of foreign debt by sector prompt the conclusion that net capital flows in the balance of payments were sustainable in the medium term.[9]

Chart 38
Foreign Debt Structure

(%)



Source: BNB.

Table 2
Debt Dynamics of Commercial Banks and Companies

	May 2003 (million EUR)	May 2004 (million EUR)	Change (%)	Contribution (percentage points)
Commercial banks	432.6	895.7	107.0	
Intracompany loans	35.5	35.6	0.3	0.0
Other loans	95.1	196.1	106.2	23.3
Bonds	0.0	0.0	-	-
Nonresidents' deposits	302.0	663.9	119.8	83.7
Commercial companies	2514.3	3161.2	25.7	
Intracompany loans	815.2	1251.3	53.5	17.3
Other loans	751.0	988.9	31.7	9.5
Commercial loans	945.2	918.1	-2.9	-1.1
Bonds	2.9	2.9	0.0	0.0

Source: BNB.

[9] See *Economic Review*, May 2004, p. 21.

We expect a current account surplus of nearly EUR 160 million in the third quarter, and a deficit of over EUR 800 million in the fourth quarter of 2004 entirely due to seasonal factors. Owing to debt reverse repurchase, at the end of July there will be a one-off decrease in BNB international reserves which by end-2004 will be offset by financial inflows on the balance of payments and particularly by privatization revenue. In the second half of the year an increase in foreign direct investment (less privatization revenue) by at least EUR 100 million is anticipated, compared with the second half of 2003 at a conservative estimate. As a result of these inflows, the 2004 forecast was for an increase of over EUR 900 million in balance of payments international reserves, given the effect of the debt transaction in July and the expected revenue from privatization of the electricity companies and the liquidation of the Banking Consolidation Company (BCC) by the end of 2004.

Financial Flows in the Economy

Bank Intermediacy

Monetary aggregates are influenced by balance of payments flows through commercial banks and their relations with customers. Since 2003 commercial banks have been converting their foreign assets into domestic claims due to the low yield on international financial markets; however, since early 2004 the process has been slowing down. In the first six months of 2004 commercial banks' foreign assets rose by BGN 671.7 million.[10] On the other hand, funds attracted by nonresidents increased rapidly by BGN 851.9 million between the year's start and the end of June. The differential between foreign and domestic credit rates attracted foreign capital. This was not a key factor for credit expansion, financed as it was mainly by the increase in household and company deposits, but it did boost credit activity.

Household deposits which grew by BGN 985.6 million in the first half of the year (and by BGN 486.7 million in the second quarter) were the main source of funds for com-

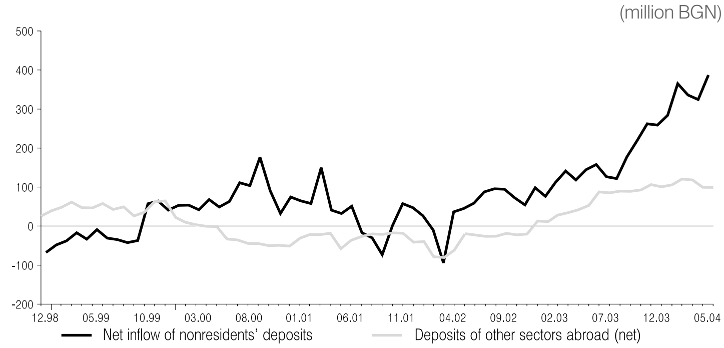
[10] At the end of June a transaction on ownership restructuring of a telecommunications company caused a significant temporary increase in the foreign assets and deposits of nonfinancial corporations. Although the increase lasted only several days, it was reported in the monetary statistics for June. According to weekly monetary statistics as of 25 June 2004 the growth of foreign assets since early 2004 amounted to BGN 295.1 million.

...in the second half of 2004 we expect an increase in foreign direct investment and international reserves...

Chart 39

Balance of Payments' Deposit Flows on an Annual Basis

(million BGN)

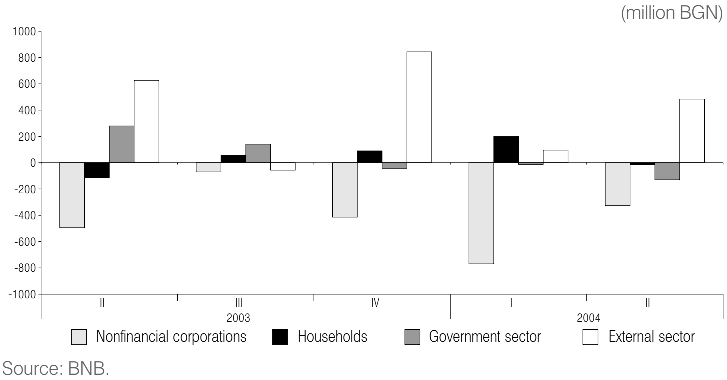


Source: BNB.

Chart 40

Net Financial Flows of Commercial Banks

(million BGN)



Source: BNB.

mercial banks. These funds were used predominantly to finance lending. In the first half of the year claims on nonfinancial corporations rose by BGN 1151.3 million and claims on households by BGN 801.1 million. (The increase for the second quarter was BGN 551.1 million and BGN 500.7 million respectively.)

Table 3

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

(million BGN)

	I	II	III	IV	I	II
	2003				2004	
Claims on nonfinancial corporations	255.6	620.2	315.0	630.3	599.9	551.5
Deposits of nonfinancial corporations	-113.6	125.8	245.0	216.6	-170.0	624.6
Claims on households	133.6	320.3	318.9	344.2	300.4	500.7
Deposits of households	104.4	207.8	375.8	433.8	498.9	486.7
Foreign assets	-19.0	-533.6	270.0	-517.9	243.2	428.5
Foreign liabilities	-26.8	92.9	213.4	325.2	339.3	512.6
Claims on government sector	200.6	-52.6	-47.0	-7.9	190.5	-108.9
Deposits of government sector	76.5	226.7	94.2	-50.7	177.8	-239.2
Claims on central government	201.1	-53.7	-57.0	-12.1	188.2	-109.6
Liabilities to central government	17.4	222.2	103.8	-12.2	57.4	-212.7

Source: BNB.

Relations between commercial banks and other sectors are presented in Chart 40.[11] Changes in the second quarter of 2004 were related to the slower growth of commercial banks' net claims on nonfinancial corporations, and to households' becoming net borrowers despite the fact that this sector was the banking system's main provider of resources. The influence of the general government sector on commercial banks' available resources reflected to a great extent the withdrawal of previous years' government deposits with commercial banks. Although the external sector financial position stayed negative compared with the banking system, it preserved its key role of a net source of funds for commercial banks. Unlike the previous year, when this was possible mainly owing to decreased foreign assets, in 2004 funds attracted by nonresidents proved to be the major source of funds for the banking system provided by the external sector.

... in the second quarter households became net borrowers despite the fact that they were the banking system's main provider of resources...

[11] Values used in the analysis are free of the one-off effects of late June resulting from the ownership restructuring of a telecommunications company (see Footnote 10).

The Consolidated State Budget's Redistributive Role

The General government sector redistributes finance between major economic sectors through the consolidated fiscal program.[12]

The seasonal pattern of budget flows' influence on the major economic sectors' liquidity continued to act in the first quarter of 2004. Significant payments on the foreign debt in January traditionally made the foreign sector a net recipient of budget resources. The flight of funds from the budget to the external sector almost halved compared with the first quarter of 2003 due to decreased net foreign financing.[13] External sector is expected to be the major net source of funds for the budget as a result of privatization revenue despite pending payments on foreign debt and reverse repurchase of Brady bonds at the end of July.[14]

The dynamics of relations between the budget and the financial sector (less the central bank) reflected corporate tax paid by financial institutions, net government securities transactions, and changes in deposits and funds on budget accounts with commercial banks. In the first quarter the financial sector was a net source of funds for the budget as a result of the considerable amount of government securities transactions (BGN 178.3 million). In the second quarter a greater flight of liquidity from the sector is expected, prompted by withdrawal of government deposits from commercial banks. By the year's end fluctuations of flows between the two sectors will subside and their net levels will stabilize at a value below one percent of GDP for the respective quarter.

Deposits by the government and budget-supported organizations at the BNB grew significantly in the second quarter of 2004 reaching BGN 4.9 billion. External sector (privatization revenue) and the withdrawal of government deposits from commercial banks contributed most to this. We expect that following a temporary decline of these deposits, as a result of repurchased debt in July, they will grow again reaching by the end of the third

[12] For details on the calculation of these relations see *Economic Review*, May 2004, p. 28.

[13] A one-off payment of debt to Bulgaria contributed to reduced foreign financing.

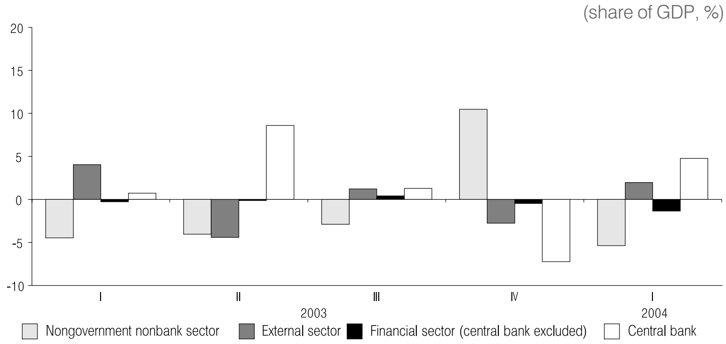
[14] Expected realization of revenue from the Bulgarian Telecommunications Company (BTC) privatization for the third quarter of 2004 did not materialize. The precise time when privatization revenue would be effectively remitted into the budget remains a matter of conjecture.

...cashflows on consolidated state budget stayed within the anticipated bounds...

Chart 41

Influence of Consolidated Budget on Other Sectors Liquidity in 2003 and early 2004 (Quarterly)

(share of GDP, %)



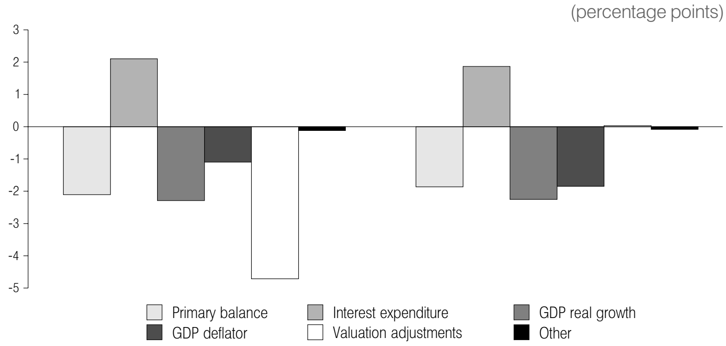
Source: MF, BNB.

...external sector will be a net source of liquidity for the budget mostly as a result of considerable privatization revenue...

Chart 42

Contribution of Individual Factors to the Change in Government Debt to GDP Ratio in 2003 and 2004

(percentage points)



Source: MF, BNB.

quarter over BGN 5 billion: a level they will sustain until the end of 2004.[15]

For the fifth successive year the ratio of government and government guaranteed debt to GDP continued falling, albeit at lower rates than in previous years. Repurchasing of Brady bonds will make the greatest contribution to the anticipated fall of the debt ratio in 2004. As distinct from 2003, in 2004 currency fluctuations are not likely to affect the debt ratio significantly. Interest expenditure and new government guarantees assumed will boost this ratio's upward trend.

Short-term Effects of the Partial Withdrawal of the Government Deposits from Commercial Banks

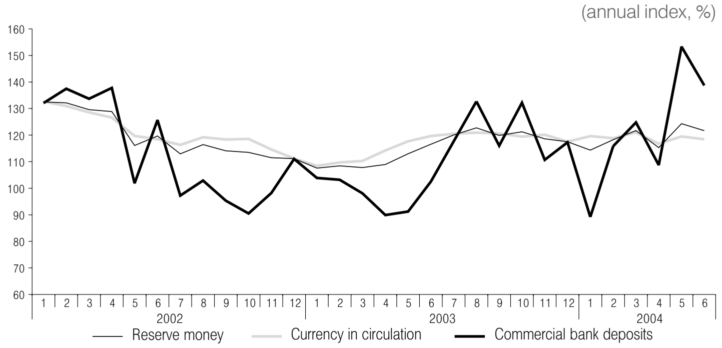
Under the terms of government's agreements with the IMF, in the second quarter of 2004 the Ministry of Finance withdrew from commercial banks the sums deposited in the spring of 2003. Expectations that the measure would favor the government securities' market were confirmed (see *Economic Review*, May 2004, p. 29). The need for additional lev resources to cover all payments to the budget (including the deposits withdrawn by the Ministry of Finance) and the release of blocked government securities boosted the supply of government securities on the secondary market and depressed their demand on the primary market. The yield on all traded maturities increased within a month. Simple annual yield on three-month government securities grew by 124 basis points at the auction held at the end of May. With the abolition on 7 June 2004 of the BNB's commission on noncash transactions for the purchase and sale of euro against levs trade started to cool since dramatically reduced transaction expenses considerably eased the conversion from positions in one currency to positions in another. At the three-month government securities auction held at the end of June the yield on these securities decreased by 139 basis points reaching its levels prior to government deposits withdrawal.

Monetary Aggregates

Currency board functioning put money supply in Bulgaria into a close relation with international reserves. In the first half of 2004 the monetary base was growing steadily as a result of increased international reserves. Over the June 2003 to June 2004 period reserve money rose by 21.7 percent reaching BGN 5.2 billion. A particularly high growth rate was registered by commercial banks' deposits with the BNB: in the review period they posted an increase of 38.8 percent. This increase reflected mostly the low base effect of the previous year, but bank reserves were influenced by the withdrawal of government funds from the banking system as a part of the measures aimed at limiting credit expansion.

...monetary aggregates continued to grow rapidly...

Chart 43
Reserve Money and Its Components



Source: BNB.

[15] The forecast is based on the expected privatization of electricity companies within the quarter, and on the liquidation of the Banking Consolidation Company (BCC) until the end of 2004.

Money outside banks, the most liquid component of money supply, increased by 18 percent on an annual basis: a slowdown in growth compared with March when the increase amounted to 20.5 percent. In terms of demand, income rises and accelerated economic growth since early 2004 comprised the main factors affecting money outside banks.

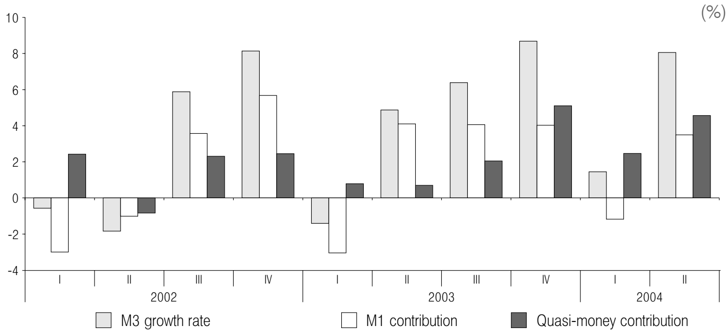
In June money supply, measured by monetary aggregate M3, grew by 8.1 percent on March, quasi-money contribution being higher than that of monetary aggregate M1, as distinct from the second quarter of 2003 when M1 was the leading component in M3 change (Chart 44).

Overnight deposits retained their prevalent bearing on the increase of the M1 monetary aggregate compared with money outside banks: an indication of the growth of noncash payments and financial intermediacy. Lev deposits were nearly twice as high as foreign exchange deposits in the structure of overnight deposits. However, between March and June overnight foreign currency deposits growth increased which can be attributed to intensified trading with the outside world.

Money multiplier links reserve money to broad money. In June the money in circulation to overnight deposits ratio and the quasi-money to overnight deposits ratio fell. Since the first effect was stronger, money multiplier grew to 3.47 in June.[16] Money multiplier's upward trend indicated increasing financial intermediacy.

Chart 44

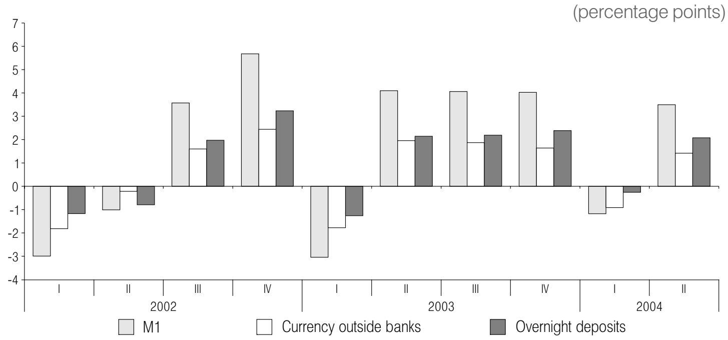
M3 Growth Rate and Contribution by Component (Quarterly)



Source: BNB.

Chart 45

Contribution of M1 and Its Components to the Change in M3 (Quarterly)

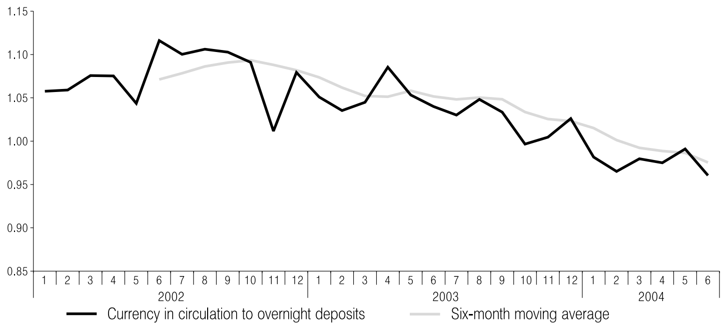


Source: BNB.

...financial intermediacy expanded...

Chart 46

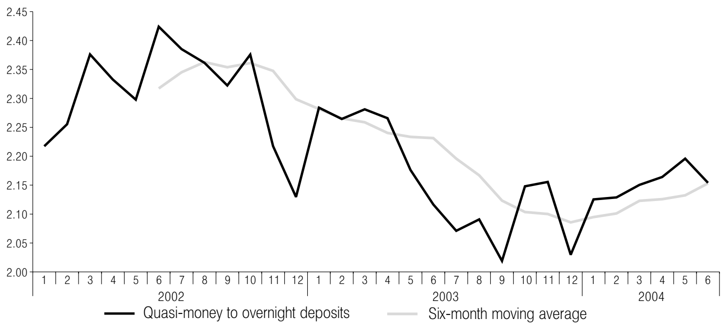
Currency in Circulation to Overnight Deposits Ratio



Source: BNB.

Chart 47

Quasi-money to Overnight Deposits Ratio



Source: BNB.

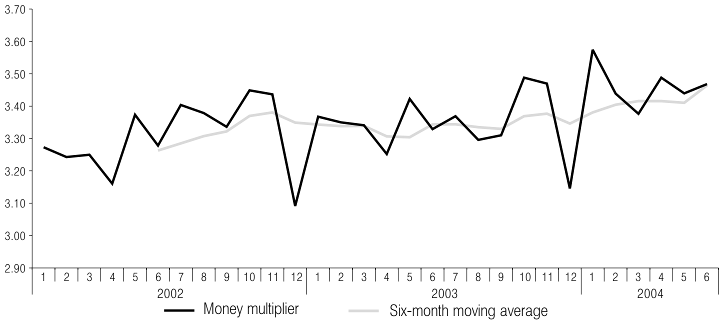
[16] See *Economic Review*, May 2004, pp. 31–32.

An important indicator of the changes in the financial system is the velocity of money circulation. Over recent years, this has declined, reflecting remonetization of the economy following the currency board launch. As a result of the fast growth of money supply in the previous year, the M3 to GDP ratio grew from 43 percent in 2002 to 48 percent in 2003, staying however far below the levels of the 1996 to 1997 financial crisis (by comparison, in 1995 broad money comprised 67 percent of GDP). Since mid-2003 broad money growth has fluctuated at around 20 percent on an annual basis, substantially exceeding real GDP growth. Owing to the slowdown in money circulation, faster money supply growth was not accompanied by inflationary pressure.

Another indicator of deepening financial intermediacy in the economy was the claims to the nongovernment sector to GDP ratio which rose from 20.9 percent in the first quarter of 2003 to 29.5 percent in the first quarter of 2004 (Chart 52). This indicator's fast rise resulted mainly from two factors: the low credit level following the financial crisis, and the rapid growth in financial sector influenced by macroeconomic stability and economic growth.

Chart 48

Money Multiplier (M3 to Reserve Money)

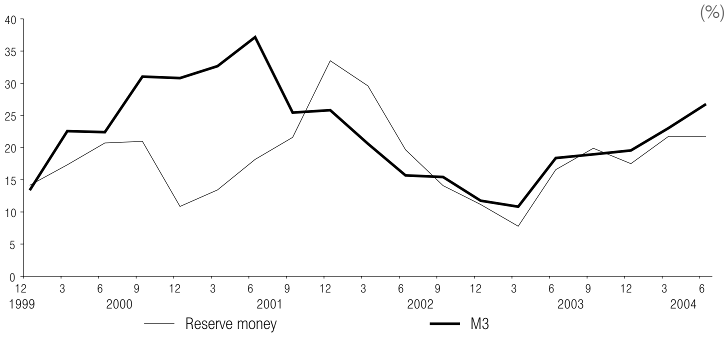


Source: BNB.

Chart 49

Annual Growth Rate of Reserve Money and M3

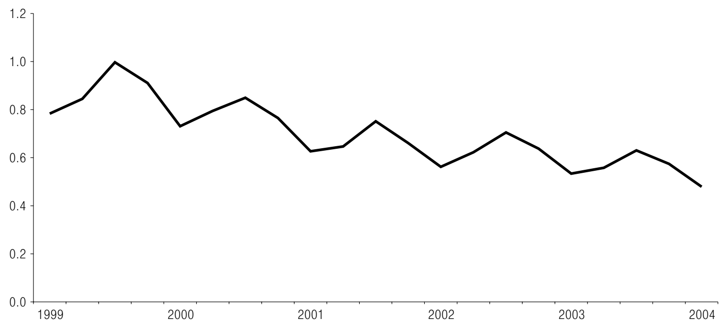
(%)



Source: BNB.

Chart 50

Currency Circulation Velocity

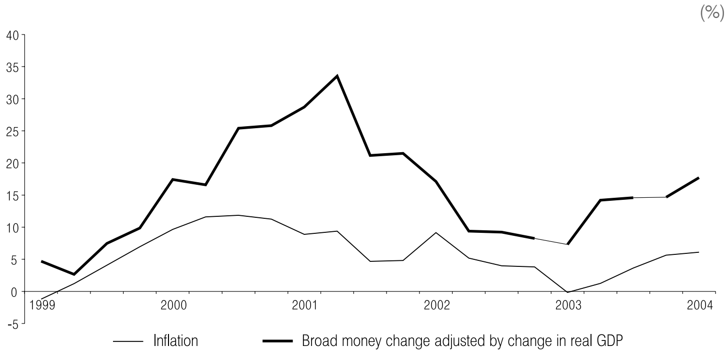


Source: BNB.

Chart 51

Broad Money Growth Adjusted by GDP Change and Inflation

(%)



Source: BNB, NSI.

Confidence in the Bulgarian banking system underlies deepening financial intermediacy. Since the start of 2004 foreign currency time and savings deposits have been growing at higher rates and comprising a bigger relative share in quasi-money. They contributed more to the change in M3 than to lev deposits. Between May 2003 and May 2004 nonfinancial corporations' foreign currency time deposits increased by 79 percent, while lev deposits grew by 20 percent. The trend to a more rapid growth of foreign currency company deposits is probably attributable to easier conditions for extending credits provided foreign currency deposits are pledged. In June 2004 alone an additional increase in these deposits amounting to BGN 329 million was reported compared with May 2004, mainly as a result of funds from a transaction on ownership restructuring of a telecommunications company, remitted into the banking system at the end of the month.[17]

In the second quarter households' foreign currency deposits grew by 18 percent and time lev deposits by 44 percent on an annual basis – a doubling on June 2003. The faster growth of lev deposits was closely connected with enhanced lending inasmuch as part of the extended credits were returned to the banking system in the form of deposits (Chart 55).

Deposit dynamics was also affected by interest rate as an alternative cost of keeping cash, since time deposits are individuals' major saving instrument in Bulgaria. Interest rates steadied in the last two years. Interest rates on deposits in euro and US dollars followed interest rate behavior in the eurozone and the USA. For instance, interest rates on deposits in euro and US dollars quoted by Bulgarian banks were affected directly by the increase in the federal funds interest rate and by the ECB's basic rate hike of 2000 and cuts of 2001 and 2002. The interplay between international and internal interest rates on deposits denominated in foreign currency reflects the opportunities of banks (particularly larger ones) to seek financial resources outside Bulgaria.

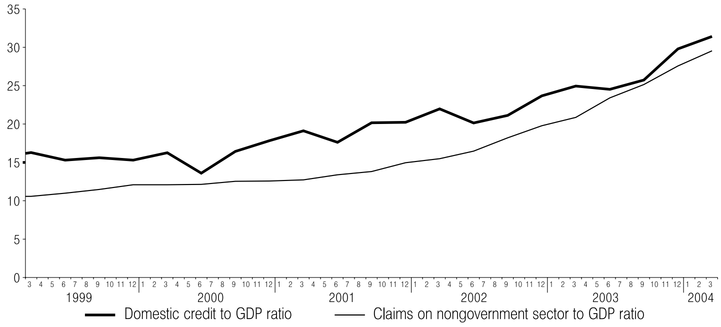
[17] See Footnote 10.

...foreign currency deposits and households' time deposits in levs increased more rapidly...

Chart 52

Domestic Credit

(share of GDP, %)

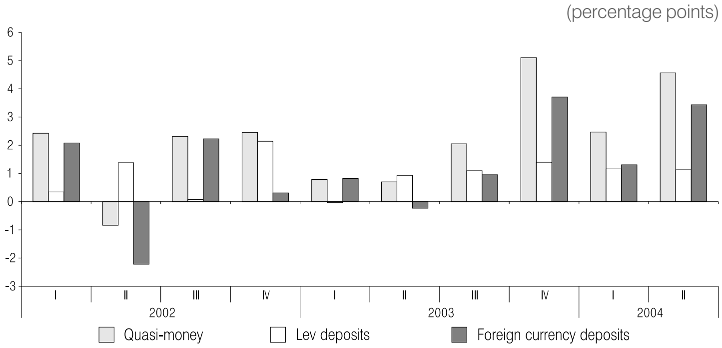


Source: BNB.

Chart 53

Contribution of Quasi-money and its Components to the Change in M3 (Quarterly)

(percentage points)

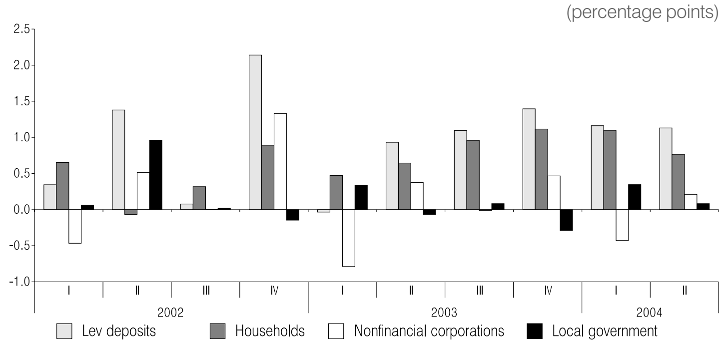


Source: BNB.

Chart 54

Contribution of Deposits by Economy Sector to the Change in M3 (Quarterly)

(percentage points)



Source: BNB.

Dynamics of average interest rate on time lev deposits did not show any definite trend. Following a period of strong fluctuations between 2001 and 2002, it steadied at levels of about 3 percent. However, interest rates on new deposits extended by individual commercial banks to their customers varied considerably (Chart 57). In June 2004 the difference between the lowest and the highest interest rates on one-month deposits extended to households was 4.5 percentage points. Small resident banks pursued a more aggressive policy offering higher interest rates in order to attract depositors. Interest rate distribution shows that more than half of the banks accepted one-month lev deposits at interest rates between two and three percent and about one third of the banks at interest rates between three and four percent respectively. Companies' deposits were characterized by a lower average interest rate and bigger dispersion.[18]

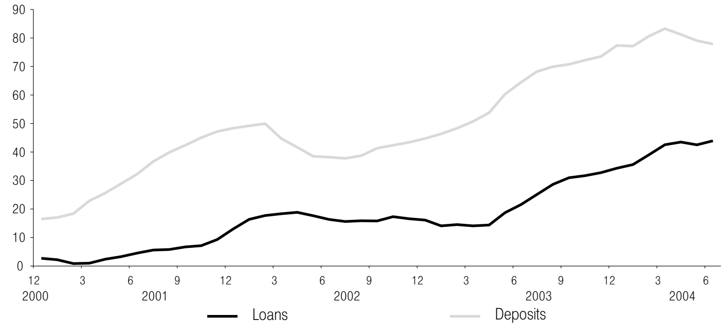
In the following six months broad money growth rates are expected to start falling gradually, staying at about 18 percent at the year's end. This slowdown will be at the expense of money in circulation and foreign currency deposits while lev deposits will not change substantially. Money multiplier is forecast to fall to 3.45 and 3.40 in the third and fourth quarters respectively due to the measures taken to limit lending expansion and the impact of seasonal factors. Interest rates on deposits will remain stable while those on deposits in US dollars are likely to grow slightly as a result of the increased interest rates in the USA.

[18] Excluding banks which did not accept one-month deposits in June.

Chart 55

Change in Time Lev Deposits and Loans to Households

(on an annual basis, %)

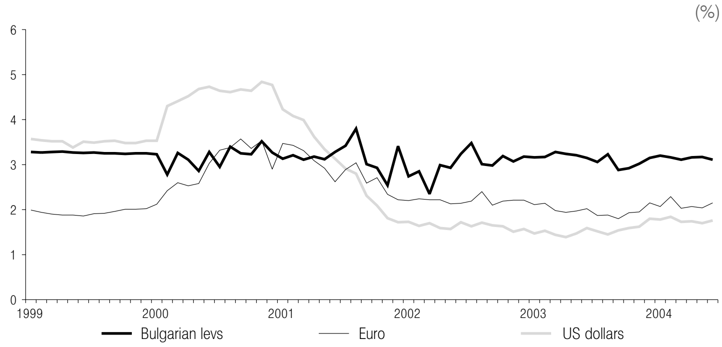


Source: BNB.

Chart 56

Time Deposit Interest Rates

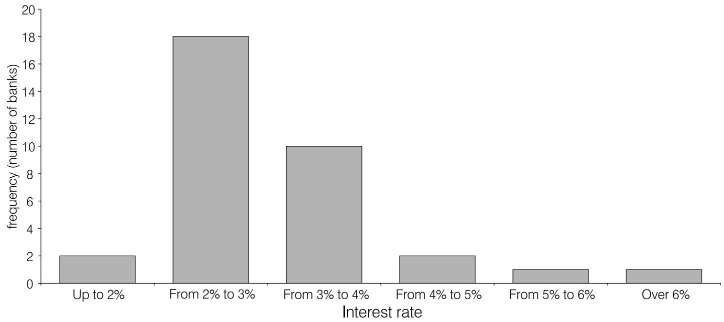
(%)



Source: BNB.

Chart 57

Distribution of Interest Rates
on Household One-month Lev Deposits



Source: BNB.

...broad money growth rates are expected to start falling gradually, staying at about 18 percent by the year's end...

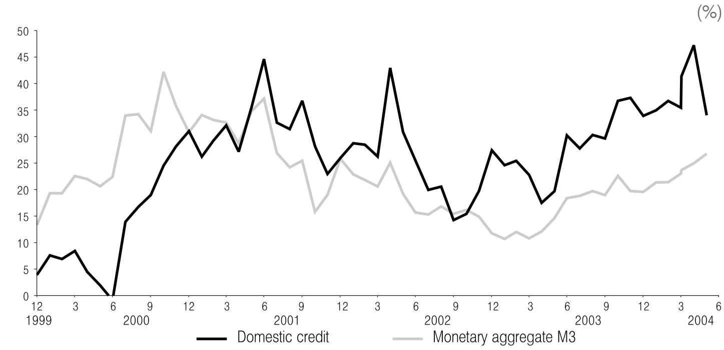
Credit Aggregates

The high annual rates of money supply growth were accompanied by a similar development in internal credit dynamics. The growth of deposits together with foreign liability dynamics fed the rise in banks' domestic claims.

Domestic credit performance depended mainly on claims to the nongovernment sector which maintained their fast annual growth. The favorable macroeconomic environment and banking competition encouraged banks to turn resource into credit which, together with lively credit demand by companies and households, reflected the high annual growth of claims to the nongovernment sector. Despite the high annual growth of such claims, signs of a gradual slowdown started to emerge and within the second quarter annual growth dropped from 52.9 percent in March to 48.2 percent by the end of June.

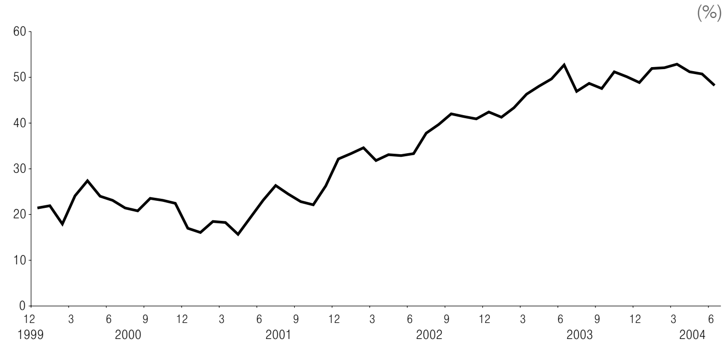
... claims on the nongovernment sector maintained their fast annual growth...

Chart 58
Annual Growth Rate of Money Supply and Domestic Credit



Source: BNB.

Chart 59
Annual Growth Rate of Claims on Nongovernment Sector



Source: BNB.

Table 4
Change in Major Balance Sheet Positions of Commercial Banks (Quarterly)

(%)

	Annual growth rate						Growth on the year's start	Structure as of 30 June 2004
	2003				2004			
	I	II	III	IV	I	II		
Claims on nongovernment sector, including	46.3	52.7	47.5	48.8	52.9	48.2	21.1	
Claims on nonfinancial corporations	42.8	47.6	38.2	37.6	42.5	36.7	17.3	68.5
Claims on households and nonprofit institutions serving households	54.4	68.4	73.0	80.7	84.5	79.6	32.0	29.0
Claims on financial corporations	120.8	87.8	148.9	150.4	87.6	108.9	12.6	2.5

Source: BNB.

Despite lively credit demand, the slowdown is likely to continue and annual growth of claims to the nongovernment sector is expected to decrease to some 30 to 35 percent by the end of 2004. Reasons for this are to do with expectations of gradual exhaustion of resources that can be invested into credit. The role of banks' asset repatriation as a source of credit financing weakened and since early-

...a gradual slowdown in the growth rates of loans to nongovernment sector has occurred and it is expected to continue until the year's end...

2004 the level of banks' foreign deposits has steadied. Though foreign liabilities are rising fast, it is not clear whether this trend is sustainable (increased external interest rates would cause a decrease in these flows). Changes in bank regulations which came into force in the middle of 2004 offer argument supporting expectations of a slower rise in claims to the nongovernment sector.

Loan interest continues recent years' downward trend, albeit at lower rates. This results from higher operational effectiveness, a favorable macroeconomic environment, and improved banking competitiveness. Decreased external interest rates prompted banks' assets repatriation and lending growth, another reason for dropping loan rates.

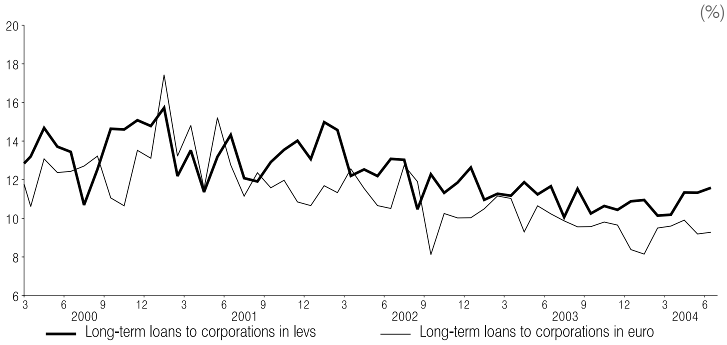
In the short run no dramatic changes in domestic loan rates are anticipated owing to the mutual balance of factors acting in both directions. On the one hand, the increased cost of attracted funds and growing investment by banks would reduce the opportunities for cutting loan rates. On the other hand, the spread between loan and deposit interest rates is relatively high, allowing banks to keep loan rates unchanged at the expense of interest rate spreads in the short term.

Despite fluctuations in individual months, interest rates on credits in levs and euro followed similar trends, and the difference between their levels may be considered a premium for currency risk. Compared with the difference in the yield of government securities denominated in levs and euro, this spread is higher, which indicates that banks maintain an adequate premium for currency risk.

Within the previous three months yield levels of banks' basic assets remained unchanged.[19] Interest rates on credits were much higher than the yield of claims on nonfinancial institutions and the government securities investment portfolio.

Chart 60

Interest Rates on Long-term Loans in Levs and Euro

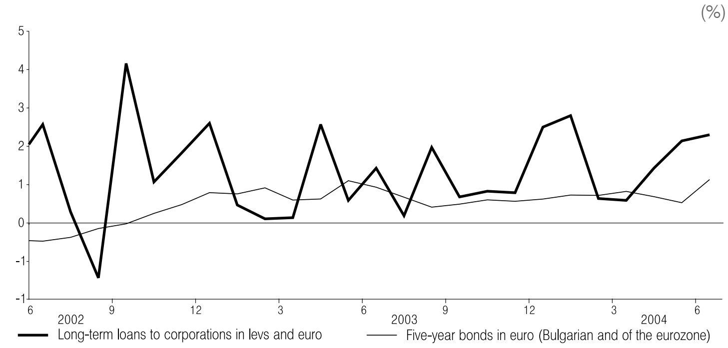


Source: BNB.

... no dramatic changes in interest rates on loans are expected in the short run...

Chart 61

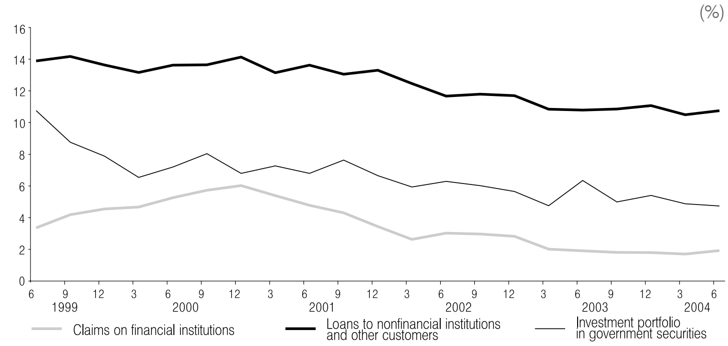
Spreads between Interest Rates on Loans and Government Securities in Levs and Euro



Source: BNB.

Chart 62

Commercial Banks' Assets Yield



Source: BNB.

Short-term Effects of the Abolition of the 0.5 percent Commission on All BNB's Noncash Transactions for the Sale of Euro against Levs

The commission on all noncash transactions for the sale of euro against levs charged by the BNB was abolished by a resolution of the BNB Governing Council of 3 June 2004 which came into force on 7 June 2004. This contributed most substantially to commercial banks' liquidity management and to the steady trade on the interbank money market. The enforced resolution resulted in a dramatic decrease in turnover on the interbank lev money market and a stable interest rate level close to that on the eurozone money market.

[19] A detailed analysis of the state of commercial banks is presented in the *Commercial Banks in Bulgaria* quarterly bulletin.

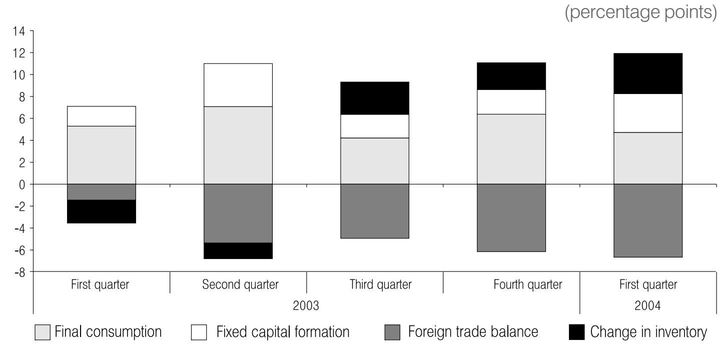
3. The Business Climate

In the first quarter of 2004 Bulgarian economic growth accelerated, reaching 5.3 percent on the earlier year. Investment, including accumulated reserves, contributed most to this growth. Consumer demand also grew strongly, though less than in the same period of 2003. Imports outstripped exports, resulting in a negative foreign trade contribution to GDP growth.

...in the first quarter economic growth reached 5.3 percent...

Chart 63
Contribution to GDP Growth by Component of Final Demand (Quarterly)

(percentage points)



Source: NSI.

Table 5
Dynamics of GDP Components According to Final Consumption Method

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

	2003				2004
	I quarter	II quarter	III quarter	IV quarter	I quarter
GDP	**3.5**	**4.2**	**4.4**	**4.9**	**5.3**
Final consumption	5.9	8.0	5.4	7.0	5.2
Individual consumption	6.8	8.5	5.4	6.5	4.9
Final household consumption expenditure	6.3	9.1	5.1	5.4	5.5
Final consumption expenditure of nonprofit institutions serving households	4.4	4.8	4.9	0.7	4.4
Final government consumption expenditure	12.4	3.8	8.3	14.7	0.1
Collective consumption	-1.9	3.9	5.0	10.2	6.9
Gross fixed capital formation	11.6	21.2	13.3	10.0	21.4
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	17.7

Source: NSI.

Household Behavior

Between January and May 2004 household budget data show end-user consumption *per* household member growing by 4.1 percent in real terms on the corresponding period of the prior year. Growth in spending on furniture and home maintenance slowed down to 9.3 percent and communications spending to 13.2 percent. Spending on clothing and footwear grew by 7.2 percent.

...enhanced consumer demand at a slightly lower rate...

Table 6
Real Growth Rate of Consumer Expenditure *per* Household Member

(on corresponding period of previous year, %)

	2003				2004	
	I quarter	II quarter	III quarter	IV quarter	I quarter	April – May
Consumer expenditure, total	6.7	6.3	5.1	2.9	4.1	4.0
Food	6.8	2.4	2.8	-0.9	2.4	3.9
Alcoholic drinks and tobacco products	1.1	8.4	11.7	9.5	-5.9	-10.5
Clothing and footwear	0.2	6.1	9.6	7.1	10.7	4.0
Houses, water, electricity and fuels	-0.9	6.1	5.2	-7.0	-0.3	0.6
Furniture and home maintenance	2.8	24.6	20.4	25.2	14.2	4.1
Healthcare	14.3	7.6	1.2	13.4	9.0	21.7
Transport	12.0	21.5	2.7	5.8	5.4	-1.0
Communications	20.2	21.3	18.5	18.8	17.2	7.6
Free time, entertainment, education and arts	16.5	10.0	8.3	21.1	10.6	11.8
Miscellaneous goods and services	8.4	7.9	4.9	12.2	6.2	15.2

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

Source: NSI, household budgets.

Rising consumer demand boosted retail trade revenues between January and May resulting in 13 percent growth on the earlier year. Household budget data show high rates of increase in household goods and equipment sales, and also in clothing and footwear.

Table 7
Dynamics of Retail Sale Revenue

(on corresponding period of previous year, %)

	2003				2004	
	I quarter	II quarter	III quarter	IV quarter	I quarter	April – May
Retail trade, repair of personal items and home equipment	103.9	106.3	106.8	107.5	112.9	112.9
Food, drink and tobacco products	102.0	105.5	106.3	106.4	111.2	106.9
Pharmaceutical and medical goods, cosmetics and toiletry	99.5	95.6	98.0	100.1	111.6	114.5
Textiles, clothing, footwear and leather products	103.6	105.1	104.2	105.4	109.3	116.2
Household goods and equipment	116.0	118.9	118.3	118.1	115.3	119.0

Source: NSI.

Growing consumer demand reflected the continuing increase in employment and bank lending to households. NSI workforce monitoring showed employment up by 2.9 percent on the first quarter of 2003 and unemployment down from 15.6 percent to 13.3 percent.[20] The Employment Agency put unemployment at the close of June at 12.2 percent on an annual basis: 1.5 points down. Occupied vacancies were mainly in the private sector.

...rising employment and income boosted consumer demand and bank lending to households...

[20] Data from NSI workforce monitoring. This monitoring applies the International Labor Office's definition of unemployed.

Table 8
Employment Dynamics

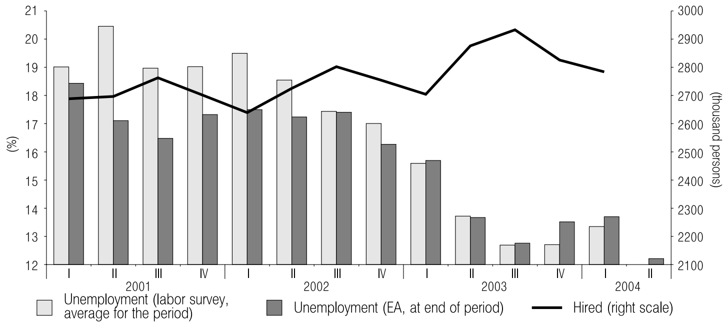
(%)

	2003				2004
	I quarter	II quarter	III quarter	IV quarter	I quarter
Employed					
Share on corresponding quarter of previous year	5.4	7.9	7.8	6.0	5.7
Share on previous quarter	3.6	3.6	0.6	-1.9	3.4
Hired*, share on corresponding quarter of previous year	2.5	5.5	4.7	2.6	2.9

* Labor survey data.
Source: NSI.

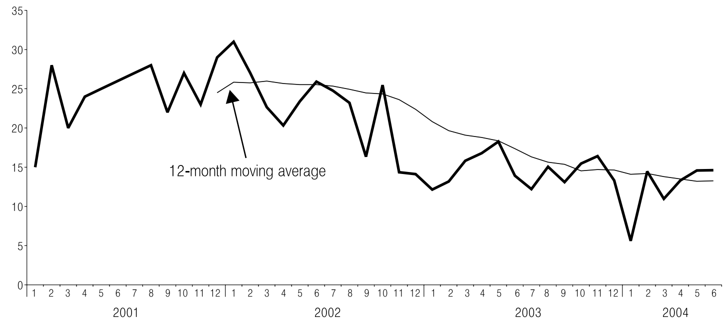
Household incomes also continued rising. According to the National Accounting System, real pay increased on an annual basis by 9.8 percent[21] over the first quarter. This resulted in consumer expenditure growth and boosted household credit worthiness, stimulating demand for credit by households.

Chart 64
Status of Economically Active People



Source: NSI, Employment Agency.

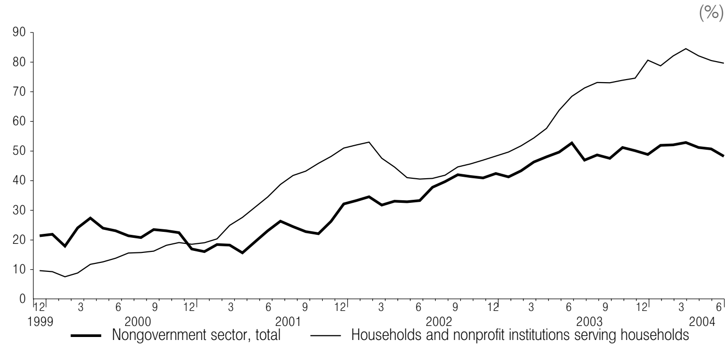
Chart 65
Number of Unemployed *per* a Vacancy



Source: Employment Agency.

Chart 66
Claims on Households and Nonprofit Institutions Serving Households (annual change)

(%)



Source: BNB.

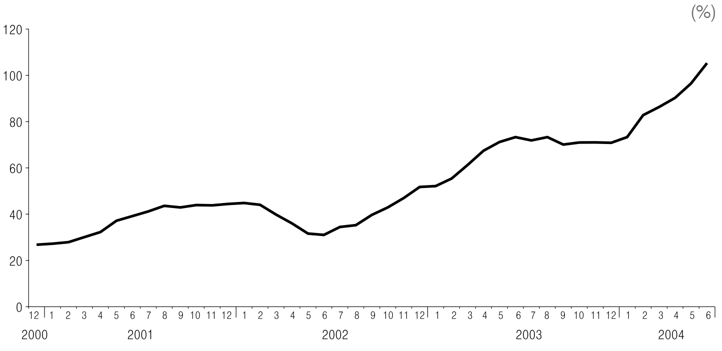
[21] Deflated by CPI.

Household credit demand also reflected relatively low interest rates with a downward trend, especially in housing loans. Though slightly lower over the last months, the annual growth rate of household credit remained high reaching 79.6 percent by late June. Buoyant construction reflected housing demand financed by the rapid growth of housing loans.

Enhanced consumer demand is expected to retain its importance for economic growth over the second quarter. Increased pensions and budget sector pay will not accelerate consumer expenditure growth (as in 2003). Since the increase is expected, it has been taken into account in consumer decisions. The second half of 2004 will see household consumer expenditure growing by 3 to 4 percent on an annual basis.

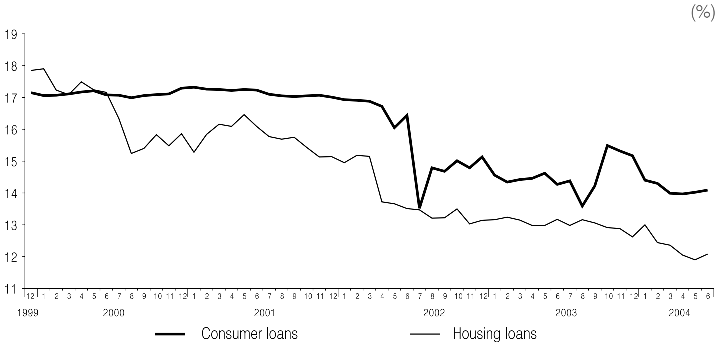
...annual growth rate of household credit continued to be high...

Chart 67
Housing Loans Growth Rate *per Annum*



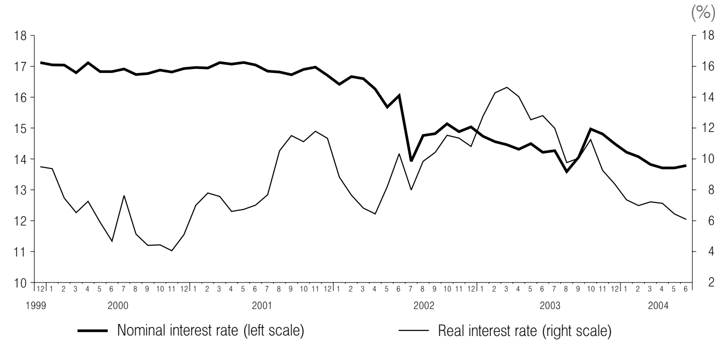
Source: BNB.

Chart 68
Interest Rates on Loans to Households



Source: BNB.

Chart 69
Nominal and Real Interest Rate on Household Loans in Levs



Source: BNB.

...the second half of 2004 will see household consumer expenditure growing by three to four percent on an annual basis...

Government Finance and Consumption

Over the first quarter the effect of government consumption on GDP growth decreased on the corresponding period of 2003. End-user government spending grew insignificantly, while collective consumption rose by 6.9 percent.

The primary balance over the first quarter reached 7.4 percent of GDP thanks to high rates of revenue increase. In early 2004 expenditure policy remained traditionally conservative: current noninterest expenditure, as a share of GDP, rose on a year earlier basis. Amid increasing employment and rising consumer demand, a portion of the accumulated surplus had a cyclic character.

Recent years saw a stable upward trend in budget revenue share of GDP. In the first quarter of 2004 budget revenue came to 45.2 percent of GDP. Consumption and labor tax revenue continued outstripping corporate profit tax.[22] We anticipate that the good revenue implementation over the first half of 2004 will support Ministry of Finance intentions to balance the budget at the close of the year without tension and restrictions.

The structure of expenditure has changed since the start of the year: spending on salaries and social security contributions increased at the expense of lower interest spending. If this trend continues, it will deprive fiscal policy of some flexibility in the future.

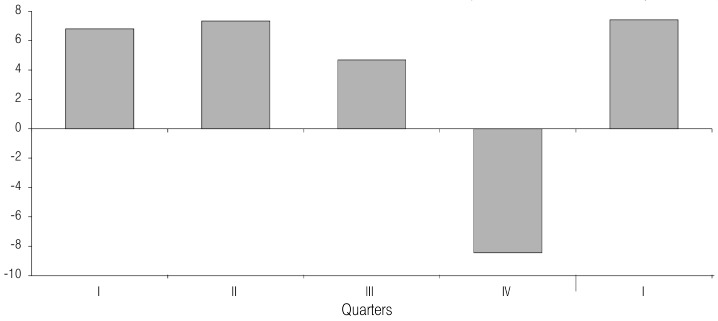
...the effect of government consumption on GDP growth decreased...

...the primary balance over the first quarter reached 7.4 percent of GDP...

Chart 70

Primary Balance in 2003 and 2004

(share of GDP for the quarter, %)

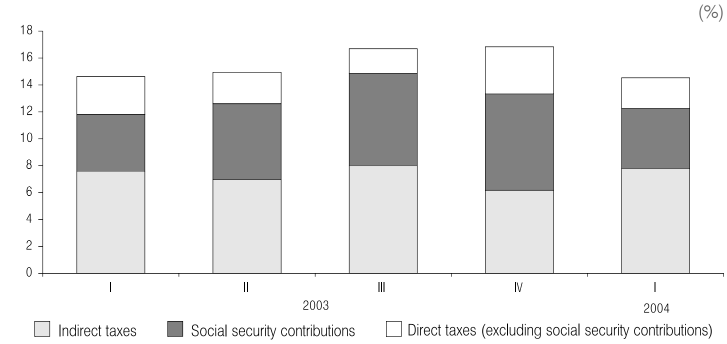


Source: MF.

Chart 71

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

(%)



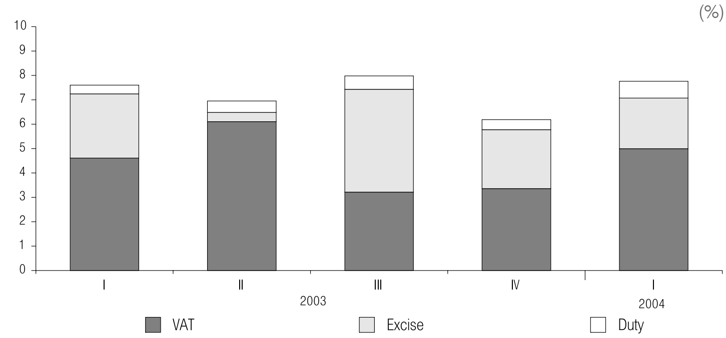
Source: MF, BNB.

...balancing of the budget at the close of the year may be achieved without tension...

Chart 72

Contribution of VAT, Excise and Duty Growth to Indirect Tax Growth (Quarterly)

(%)



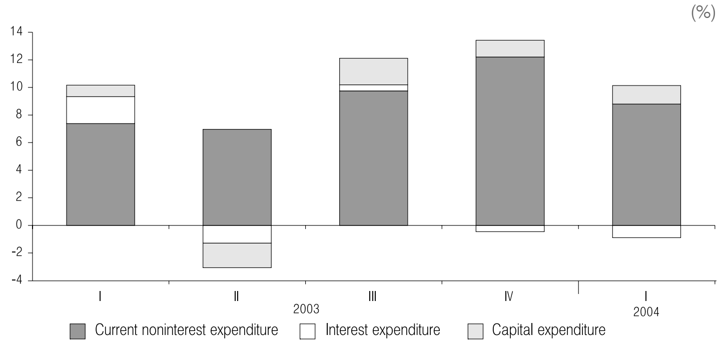
Source: MF, BNB.

[22] You will find more information in the coming BNB Discussion Paper *Effective Taxation of Labor, Capital and Consumption in Bulgaria,* 2004.

Until the close of the year we expect moderate expenditure growth aligned with growth in collective consumption and end-user government spending. Over the second and third quarters government consumption will contribute one percentage point to GDP growth. The last quarter will see the largest current noninterest expenditure, and government consumption contribution to GDP growth will double.

Chart 73

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

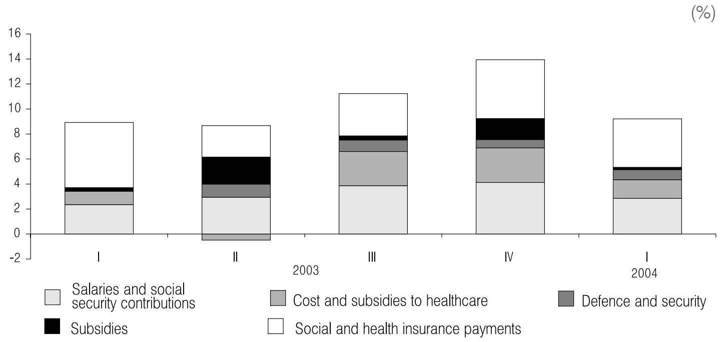


Source: MF, BNB.

...moderate expenditure growth is expected...

Chart 74

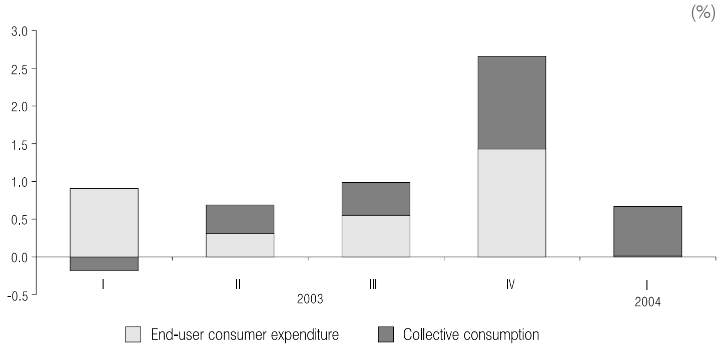
Contribution of Major Groups of Current Noninterest Expenditure in Overall Growth (Quarterly)



Source: MF, BNB.

Chart 75

Contribution of End-user Government Spending and Collective Consumption to Economic Growth (Quarterly)



Source: MF, BNB.

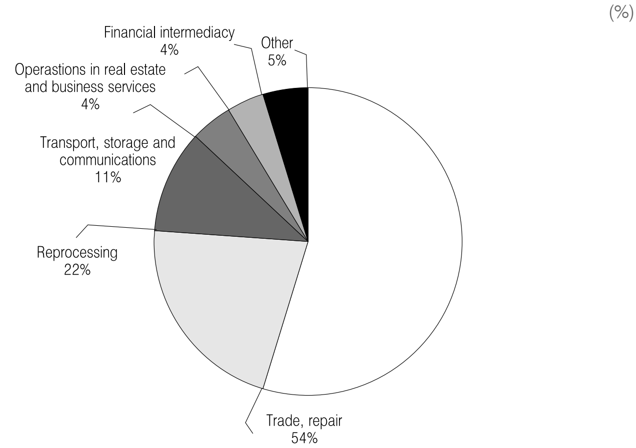
Company Behavior

Over the first quarter of 2004 fixed capital investment growth accelerated to 21.4 percent annually. Enhanced investment demand reflected buoyant construction with gross output increasing by seven percent on a year earlier basis. Foreign direct investment data by industry show that in the first quarter investing concentrated on the trade sector, followed by reprocessing. Imports of investment goods for the January to May period rose by 17.3 percent annually.

Reserves accumulation contributed most to economic growth over the first quarter. Data show that this was not due to decreased demand, and thus hampered sales. Business surveys in manufacturing and trade did not report accumulations of significant reserves of finished goods but rather accumulation of unfinished output. This may be a side effect of buoyant construction. We expect this accumulation to be offset over coming quarters.

...investment growth accelerated over the first quarter...

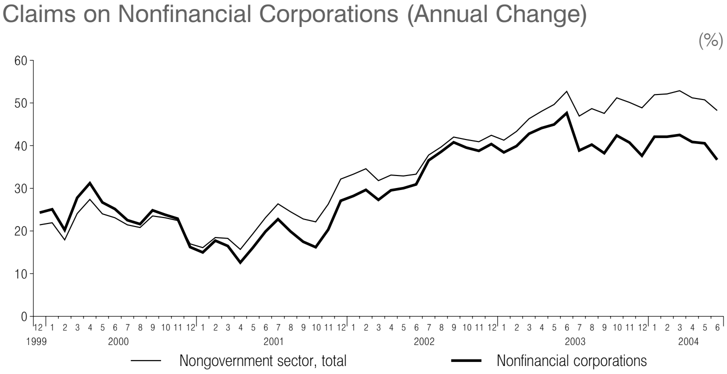
Chart 76
Foreign Direct Investment by Industry (First Quarter of 2004)



Source: BNB.

...reserves accumulation (unfinished output) contributed most to economic growth ...

Chart 77
Claims on Nonfinancial Corporations (Annual Change)

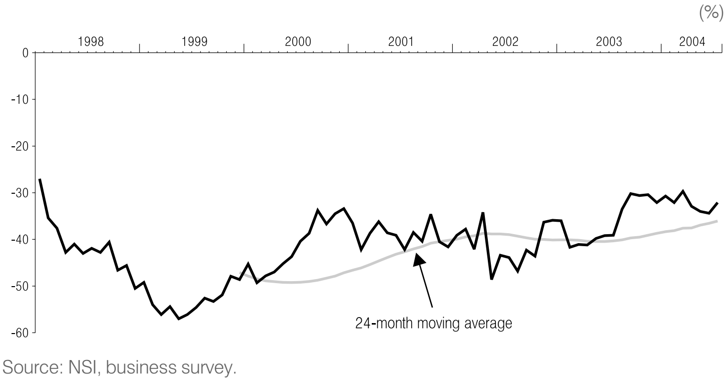


Source: BNB.

Bank loan demand by companies was further driven by rising investment and output backed by favorable economic conditions and optimistic expectations reflecting positive trends in orders and expectations of future business conditions in manufacturing (Charts 78 and 79). Though the second quarter saw slower annual growth of bank claims on nonfinancial corporations (from 42.5 percent in March to 36.7 percent in June), its values continued to be high as a result of fast-growing loan demand and supply by banks.

...loan demand by companies continued rising...

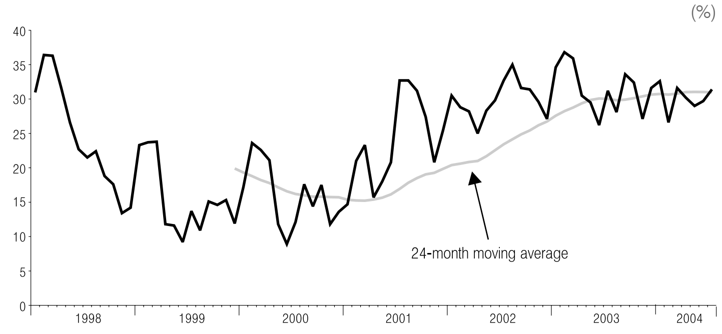
Chart 78
Industrial Orders



Source: NSI, business survey.

Chart 79

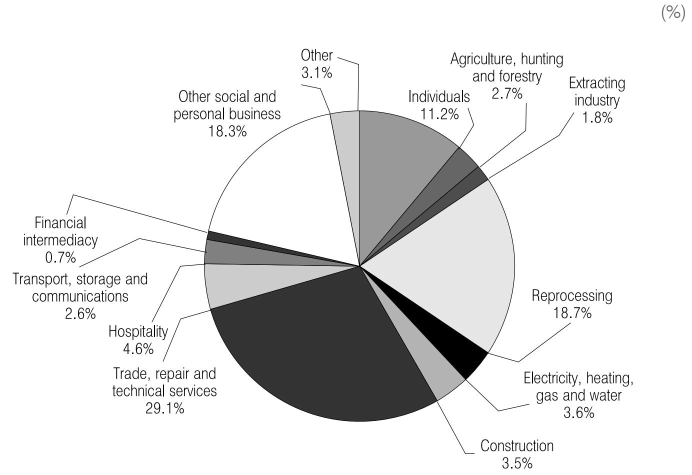
Expectations of Business Environment in Industry



Source: NSI, business survey.

Chart 80

Structure of Commercial Bank Claims by Sector as of 31 May 2004



Source: BNB.

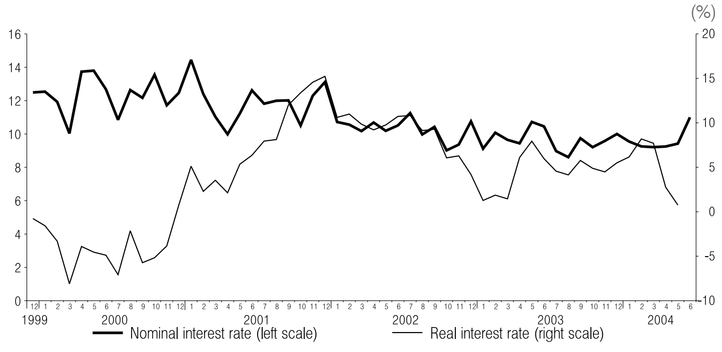
Fast-growing credit to nonfinancial corporations was accompanied by a change in new loans' maturities. This reflected banks' greater willingness to lend for longer, as well as companies' need for long-term finance. At the close of June long-term loans (over one year) comprised 64.9 percent of the total volume of credit to nonfinancial corporations *versus* 58.9 percent a year earlier.

In the coming months credit demand by companies will remain high. The drop of overall economic risk and greater banking competition are factors for lending rates to keep unchanged in the short run, even if banks increase their spending. Yet in the coming months banks will likely tighten loan approval requirements which, combined with the gradual exhaustion of disposable resources, would hamper the growth of lending to companies.

...we expect interest rates on loans to stay unchanged in the short run...

Chart 81

Nominal and Real Interest Rates on Lev Loans to Nonfinancial Corporations



Source: BNB.

Investment demand will continue to govern growth in the second half of 2004, though at rates significantly lower than in the first quarter. We expect fixed capital investment to increase by 10–13 percent. The need to improve output quality and raise production efficiency will be the major incentives here.

...investment demand will continue to govern growth...

Exports and Imports of Goods and Services

Between January and May 2004 Bulgaria's trade deficit reached EUR 1085.1 million, an increase of EUR 282.8 million on the corresponding period of 2003. Exports retained the upward trends growing nominally by 8.5 percent for the January to May period. Imports developed at higher rates picking up by 14.7 percent over the same period.

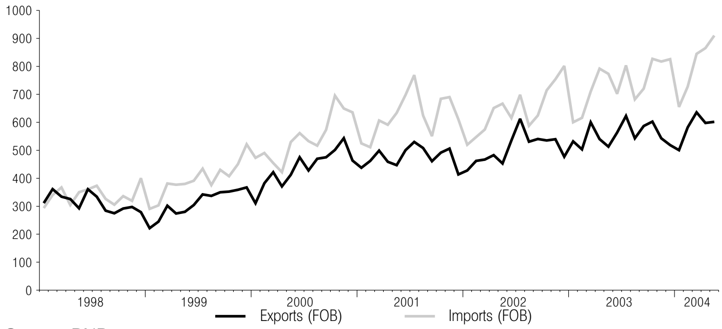
...foreign trade growth and trade deficit deepening were sustained...

Between January and May 2004 exports of base metals (33.7 percent) indicated the highest rate of growth reflecting international prices (see below). Exports of textiles continued growing nominally though at slower rates (5.7 percent). April and May saw values close to zero. Slower rates reflected partly the higher base effect and the effect of economic conditions in recent months. Between January and May 2004 the upward trend in exports of machines continued, though at slower rates (6.4 percent). Exports of mineral products and fuels also rose (5.1 percent), growth rates fluctuating significantly by month. Exports of chemical and agricultural products declined, with the latter tending to fall from the prior year.

The effect of international price movements on exports may be exactly established only for relatively homogeneous commodity groups of the exports breakdown, such as mineral products and fuels, base metals and their products, and to a lesser degree chemical products and plant and animal products.

Chart 82
Dynamics of Exports and Imports

(million EUR)

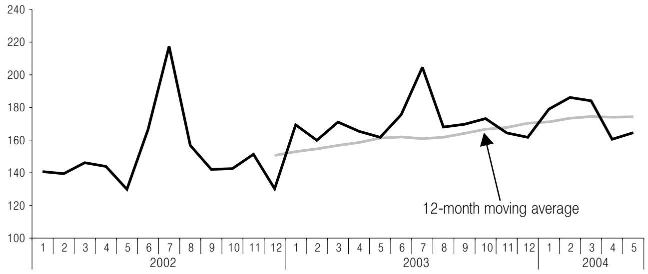


Source: BNB.

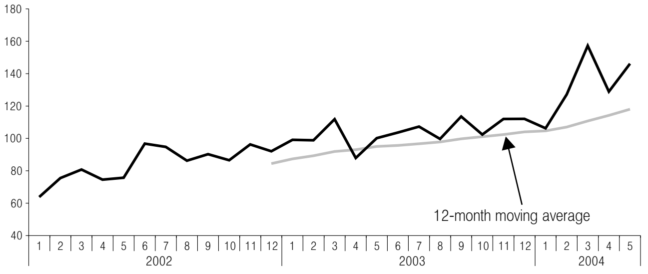
Chart 83

Exports

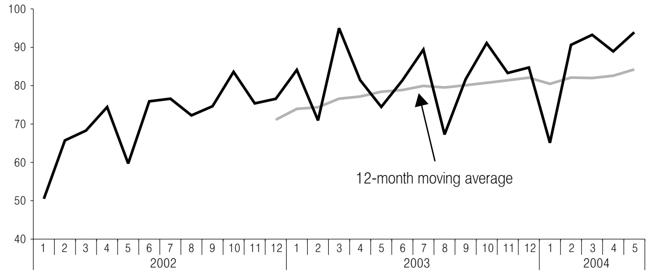
(million EUR)



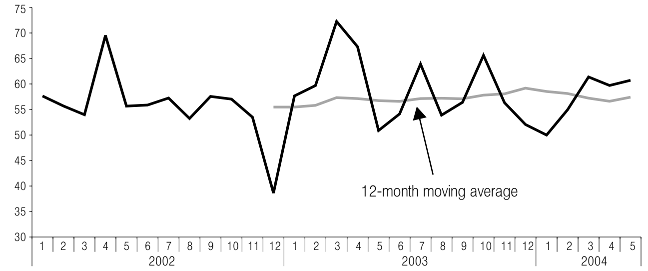
Exports of Base Metals and Their Products



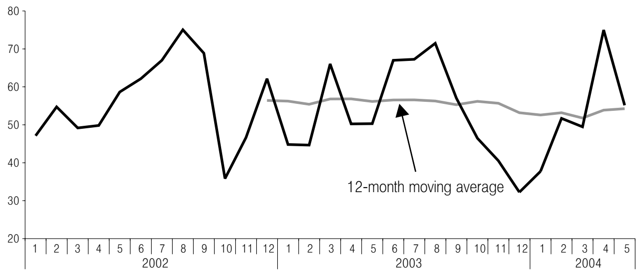
Exports of Machines, Vehicles, Appliances, Tools, Weapons



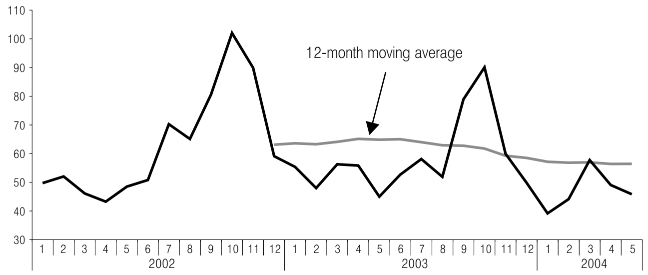
Exports of Chemical Products, Plastics, Rubber



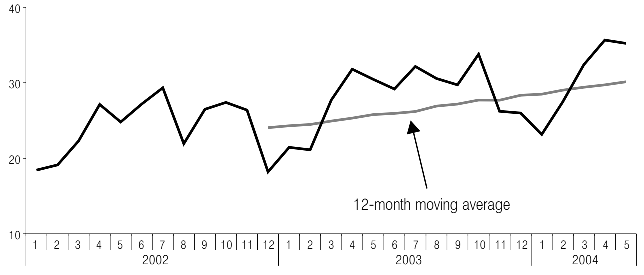
Exports of Mineral Products and Fuels



Exports of Animal and Plant Products, Food, Drink, Tobacco



Exports of Wood, Paper, Pottery, Glass



Source: BNB.

International prices of selected commodity groups show that export dynamics of mineral products and fuels did not reflect crude oil price movements adequately. Since early 2004 significant rises and drops have been reported by month compared to 2003 (amid constantly high international prices). This suggests that changes in the nominal exports of mineral products are likely determined by exported physical volumes which in turn are dependent mainly on individual companies' policies in this industry.[23]

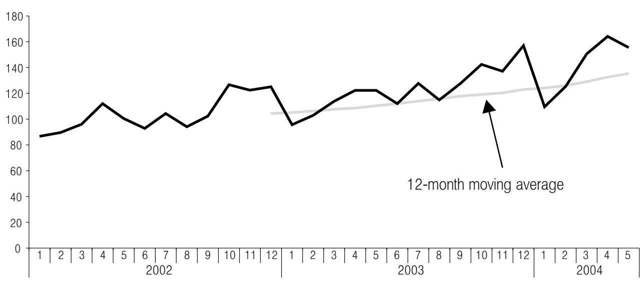
Exports of metal products remained traditionally dependent on international metal prices. Data between January and May did not show any let up in price rises registered over the last months but this effect may be seen in coming months.

Exports of chemical and agricultural products were not correlated to international price indices for the corresponding groups. Since concentration is not so strong in these industries, and Bulgarian export prices should follow international prices, such changes in nominal values reflect mostly downward movements in physical volumes.

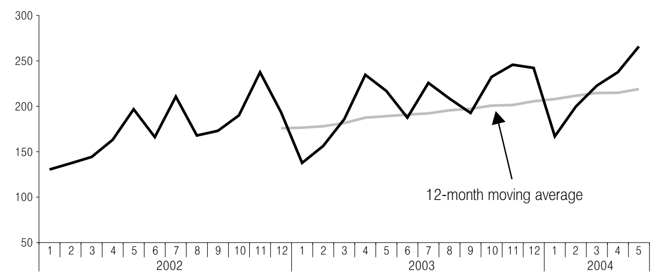
Chart 84
Imports

(million EUR)

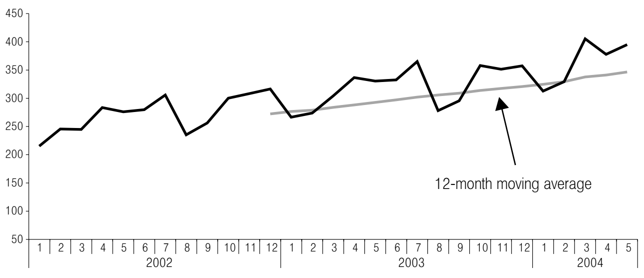
Consumer Goods



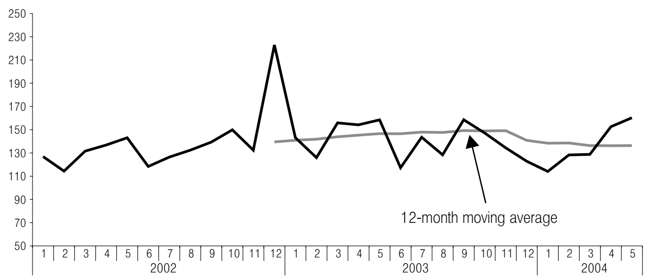
Investment Goods



Feedstocks



Energy Commodities



Source: BNB.

[23] Due to high concentration in this branch, some intracompany price fixing between the branch companies and their foreign owners may exist.

Imports of all commodity groups, except for energy commodities, experienced high growth rates. Pharmaceuticals and toiletries (EUR 57.1 million or 44.3 percent) contributed mainly to import growth, followed by automobiles (EUR 34.5 million or 39 percent) and furniture and household equipment (EUR 32.4 million or 30 percent). Increased imports of feedstocks were largely attributable to the cast iron, iron and steel (EUR 72.9 million) with a significant increase in their international prices, and to food feedstocks (90.7 percent). A slight drop occurred only in leather imports. However, this drop did not affect significantly total feedstock imports due to the low share of leather in this commodity group. Higher investment goods imports were attributable to the significant increase in transportation facilities (EUR 105.1 million or 56.5 percent) offsetting lower volume of electrical machine imports (EUR 9.3 million). Despite the continuing growth in fuel imports (EUR 21.6 million), the overall imports of energy resources decreased on the corresponding period of the prior year as a result of lower (by EUR 75.4 million) fuel imports, mainly due to crude oil and natural gas (EUR 64.2 million) and less to coal and other fuels. Lower crude oil imports reflected lesser imported volumes (by 318,000 tonnes or 14.8 percent) and lower (by 1.4 percent) euro prices. Decreased natural gas imports were due to the price drop in euro by 7.2 percent (the physical volume of imported natural gas rose by 160.6 million cubic meters or 11.3 percent).

...imports continued rising as a result mostly of output growth in Bulgaria...

Imports growth reflected mainly increased imports of feedstocks and investment goods and was dependent on output growth.

Table 9
Contribution of Commodity Groups to Trade Growth

(percentage points)

	January – May 2004	
	Exports	Imports
Consumer goods	2.3	3.9
Feedstocks	4.8	8.2
Investment goods	1.0	4.3
Energy resources	0.3	-1.4
Other		-0.2

Source: BNB.

...a significant portion of feedstock imports resulted from increased exports of finished goods...

Between 1999 and 2003 Bulgarian exports exceeded feedstocks and energy commodities imports. Data for the first quarter of 2004 indicate that nominally increased imports of feedstocks and energy commodities exceeded overall export growth by EUR 65 million. In principle, a putative negative balance may occur within a particular quarter but until now it has been compensated within the year.

The negative balance over the first quarter reflected the extremely high growth of feedstock imports for the food industry: up almost three times from EUR 43 million in the first quarter of 2003 to EUR 119.6 million over the first quarter of 2004. Imports of wheat for government reserves replenishment and duty-free imports of flour were the main contributors to this. Over the first quarter food and drink sales grew on the corresponding period of 2003.

Accelerated imports of cast iron, iron and steel contributed significantly to the negative balance. Cast iron, iron and steel are used in the ferrous metallurgy and other highly reprocessed products, but also in fast-growing construction. Higher ferrous metal prices contributed also to import growth.

A more detailed analysis indicates a close relation between the imports of feedstocks and the exports of their reprocessed products. Higher imports of textiles corresponded directly to increased output of textiles and clothing for foreign and domestic markets. Increased imports of ores were due mostly to iron ores and nonferrous metals occupying the highest share in their structure and were associated with increased exports of cast iron, iron, steel and nonferrous metals. Overall imports of textiles, food feedstocks, ores, cast iron, iron and steel comprised over 57 percent of the total imports of feedstocks.

The large values of the ten commodity groups' coefficients presented in Table 10 show that export-oriented finished output is marked by high value added which may be used as an indicator of industrial efficiency.[24] Lower coefficients between January and May 2004 compared to 2003 are likely to reflect increased home market sales.

The long lasting upward trend in investment goods imports is associated with buoyant investing (increased foreign and domestic investment) resulting in the increase, renewal and modernization of production capacity, hence stimulating growth and export potential. Increased exports in all commodity groups may be deemed a result of previously imported investment goods. This suggests that the current imports of investment goods will boost future exports.

[24] Assuming that changes in prices of feedstock input are approximately equal to the change in prices of finished products.

Table 10

Exported Output to Imported Feedstocks Coefficients (Selected Commodity Groups)

(million EUR)

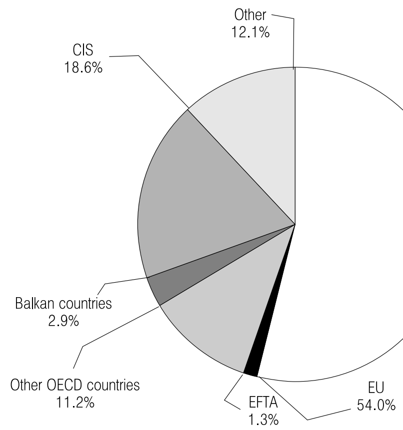
	2003	January – May 2004
Exports of clothing	1340.2	580.8
Imports of cloth and materials	920.5	383.1
Coefficient	1.456	1.516
Exports of cast iron, iron and steel	541.4	310.5
Imports of iron ore, cast iron, iron and steel	303.3	182.7
Coefficient	1.785	1.699
Exports of nonferrous metals	534.7	263.5
Imports of nonferrous metal ores	256.4	142.7
Coefficient	2.085	1.846

Source: BNB.

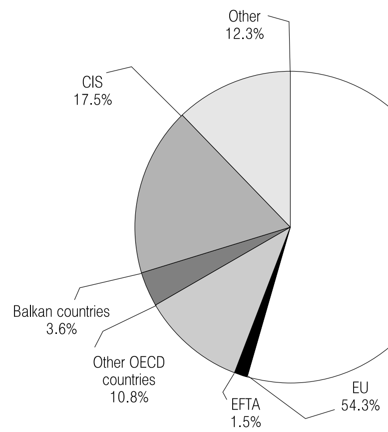
Chart 85

Structure of Imports by Major Trade Partner

(%)



January – May 2003



January – May 2004

Source: BNB.

EU countries were the major contributor to increased Bulgarian imports and exports, representing the largest share in foreign trade.

The accession of ten new member states to the EU in May 2004 will not entail any worsening of trade with these countries, or any decrease in foreign trade turnover or its redirection to other regions. Industrial goods mostly determine the level and dynamics of foreign trade turnover with the EU and CEFTA as a result of their domination (over 85 percent for trade with the CEFTA and nearly 90 percent with the EU). Bulgaria's trade in industrial goods both with the EU and CEFTA is duty-free. As regards agricultural goods and reprocessed agricultural wares, negotiations were held with the EU to adapt preferences applied within the CEFTA to commercial contracts between Bulgaria and the EU. Thus, the net effect of ten countries' accession to the EU on the trade conditions with Bulgaria will be neutral.

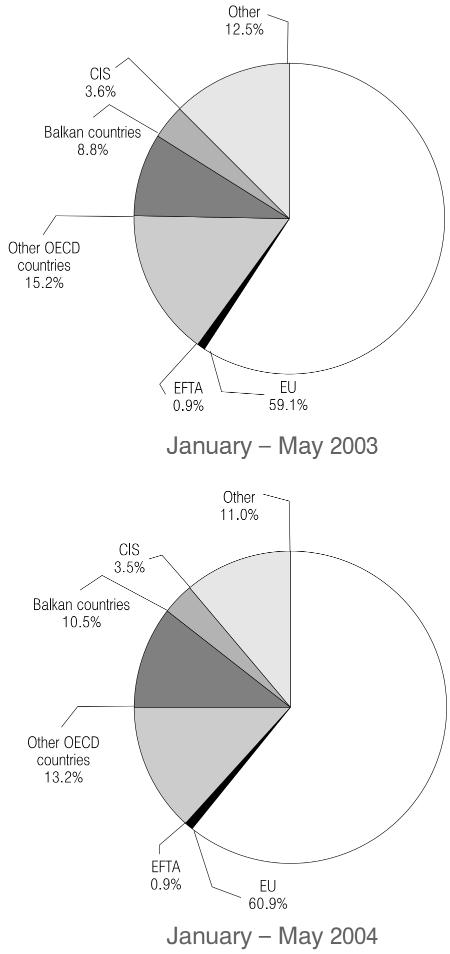
Available data show that projected upward trends in foreign trade turnover and trade balance deficit are likely to continue over the second quarter. Contrary to expectations, since early 2004 the nominal increase of exports has been slower than in 2003, since expected rapid improvements in the world environment and enhanced foreign demand have not materialized. April and May saw a certain recovery of import growth rates and we expect this trend to continue in the third and fourth quarters, reaching nominally 10–11 percent annually (if prices of metals and chemical products stay at current levels).

Our expectations are for a concomitant increase in exports' physical volumes and price components, the first factor contributing more significantly to the nominal increase. We expect in the third and fourth quarters export rise in real terms to exceed the reported values in 2003. In the third quarter we anticipate rising export prices against a negative deflator over the same period of 2003. The price component increase expected in the fourth quarter will be lesser than in the prior year.

According to our expectations, since early 2004 import growth rates have been lower than in 2003. May saw an acceleration in these rates which, if continues into June, would result in nominally higher imports during the second quarter compared to the corresponding period of 2003. In view of the ex-

Chart 86
Structure of Exports by Major Trade Partner

(%)



Source: BNB.

...we expect the accession of ten new member states to the EU to have a neutral effect on Bulgaria's trade with them...

...our expectations are for rising exports and increased trade balance deficit...

pected retention of the trend to growing investment and consumer expenditures, we anticipate the rates of nominal import growth to remain high until the close of the year, reaching 13 to 14 percent annually. In the third quarter we anticipate lower values of this indicator on the same quarter of 2003, entirely due to the lower physical growth of imports with a projected positive deflator (against a negative deflator in the corresponding period of 2003). In the fourth quarter the nominal growth of imports will exceed that of the prior year, entirely reflecting price rises. We anticipate actual imports growth (similar to the third quarter) to decrease considerably on the respective base period.

In view of this forecast of foreign trade dynamics, trade balance deficit will rise by approximately EUR 100 million both in the third and fourth quarters.

Revenue from services continued rising, most significantly in travel (EUR 95.8 million or 30.2 percent). However, balance on the services item was negative mainly due to reported net expenditure on transportation (debit and credit volumes under this item are directly linked to imports and exports). The forecast is that increased investment in travel and expected growing foreign demand will sustain the trend to growing revenues in the long run. Our forecast for the current year is for 11 percent growth in this indicator. Summer months are traditionally strong for travel, hence we expect seasonally increased revenues to cause positive balance formation in the services item over the second and third quarters.

...we expect to see revenue from travel services to continue rising...

Supply and Competitiveness

Reprocessing and communications contributed most to gross value added growth in the first quarter of 2004. Industries in the services sector were dynamic and agriculture posted positive growth after its 2003 drop.

...reprocessing and communications contributed mostly to growth...

Manufacturing value added growth reflected high production and exports in this sector. Between January and May industrial sales grew by 18.7 percent, with export sales up 37 percent and home market sales up 5.3 percent. Smelting, food and drink, engineering, equipment and domestic appliances, confectionery and metal goods were the leading industries here. As shown in the previous part, the high activity in these industries boosted imports of

...sustained competitiveness and high export activity in manufacturing...

Table 11
Gross Value Added Growth Rate and Sectors' Contribution

(%)

	2003				2004
	I quarter	II quarter	III quarter	IV quarter	I quarter
Agriculture and forestry	-0.3	-0.3	-1.5	-2.2	1.2
Industry	5.7	5.9	6.6	10.1	6.4
Services	2.6	3.8	4.6	3.0	6.2
At base prices, total	3.4	4.0	4.0	4.4	6.0
Contribution					
Agriculture and forestry	0.0	0.0	-0.3	-0.2	0.1
Industry	1.8	1.8	1.9	2.8	2.1
Services	1.6	2.3	2.4	1.9	3.8
At base prices, total	3.4	4.0	4.0	4.4	6.0

Source: NSI.

particular feedstocks. Export sales were the main contributor to overall sales growth. In the July business survey managers put production facility utilization at 61 percent. Albeit comparatively high, it dropped on 2003. This most likely reflects production facility renewal.

Buoyant export sales of manufacturing are driven by the retention of cost competitiveness measured by the unit labor cost[25] indicator (Chart 87). Manufacturing labor productivity continued rising coupled with moderate pay rises which did not cause inflationary pressures.

Table 12
Industrial Sale Dynamics

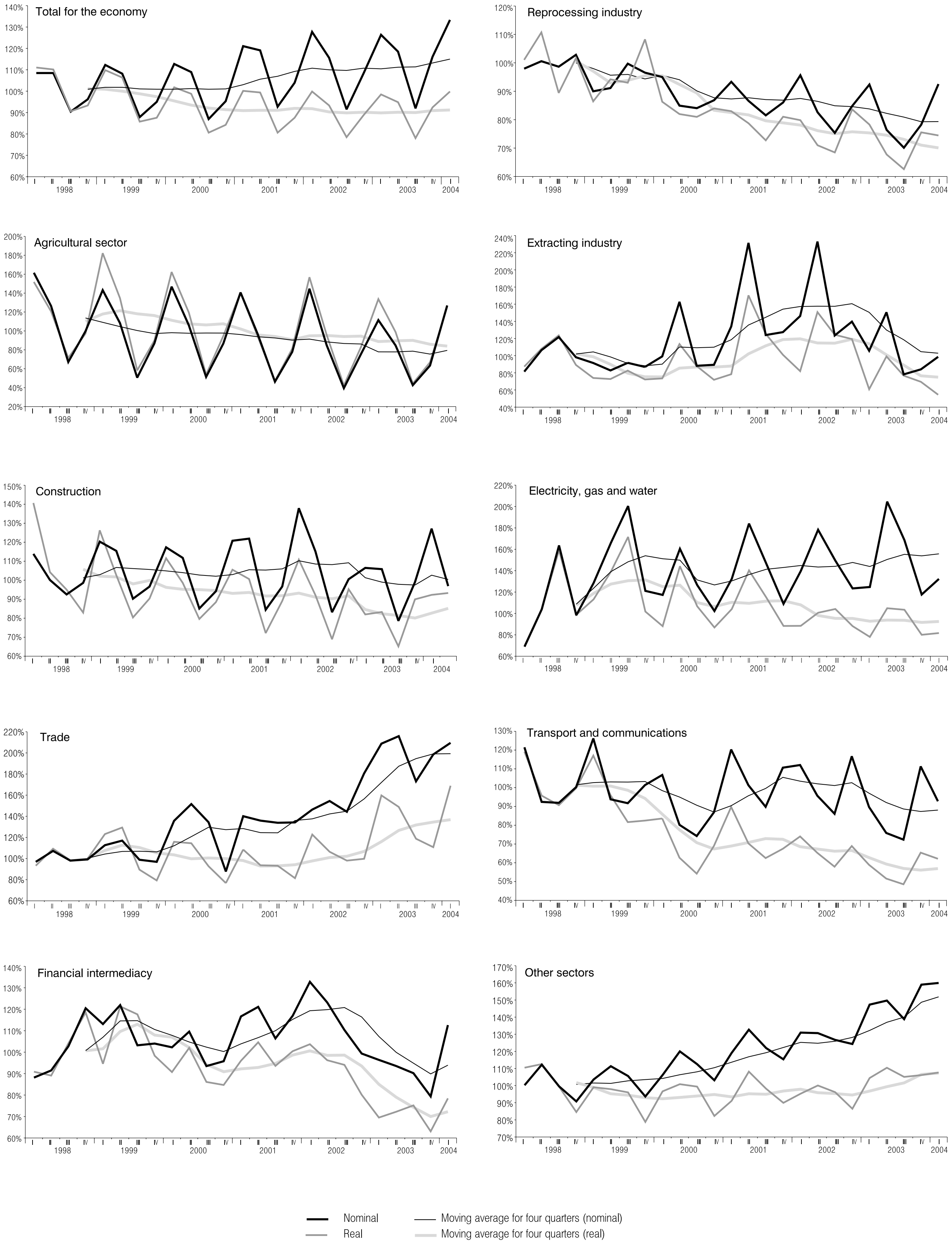
(share on corresponding period of previous year, %)

	2003				2004	
	I quarter	II quarter	III quarter	IV quarter	I quarter	April – May
Industrial sales	21.6	15.8	13.7	19.1	18.1	19.6
export sales	50.3	32.1	25.1	39.2	34.5	40.7
domestic sales	6.3	5.9	6.7	7.7	5.9	4.4
Contribution, percentage points						
export sales	17.5	12.1	9.6	14.1	14.8	17.0
domestic sales	4.1	3.7	4.1	4.9	3.4	2.6

Source: NSI.

[25] Details on this indicator are available in the *Economic Review*, May 2004.

Chart 87
Unit Labor Cost



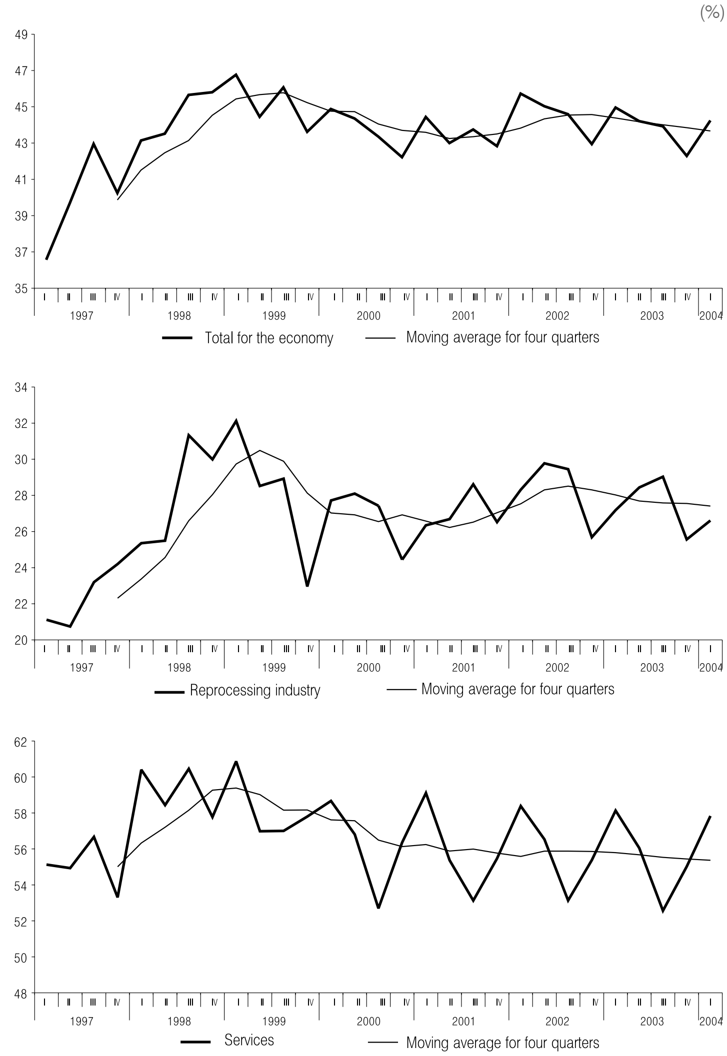
Source: NSI, BNB.

The gross value added to gross output ratio is another indicator of production efficiency. It sharply improved in the first quarters after currency board introduction and since then a gradual downward trend has evolved. It may be said, however, that this indicator did not change negatively. Obviously, given the current state of production facilities, information technologies and managerial skills, and with a buoyant economy, the law of decreasing marginal return comes into force: increasing volume and quality of offered goods and services call for more feedstocks and extra expenditure. Thus, a permanent technological improvement of goods and services production will remain one of the most vital drivers of investment demand in coming years.

...increased intermediate consumption and accelerated imports of feedstocks...

Chart 88

Production Efficiency: Gross Value Added to Gross Production Ratio at Current Prices



Source: BNB.

In the year's second half we will see a retention of the positive dynamics in goods and services output. The business climate indicator in manufacturing sustained its positive trends demonstrating the favorable cyclic position of this industry. The CEC12[26] indicator also showed high values thanks to its components. Expected manufacturing value added will rise by 7–8 percent. Business climate in trade and services also showed upward trends.

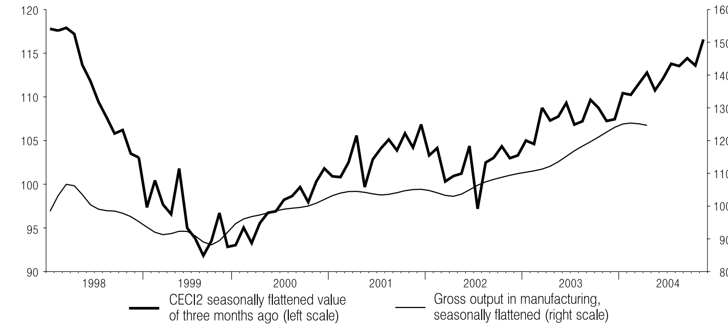
[26] A composite indicator comprised of the indicators of expected output and business conditions, order backlogs and the evaluations of foregn and domestic demand based on the NSI manufacturing survey. See Tzalinski, Tz. *A Composite Tendency Indicator for Bulgaria's Industry*, BNB DP/36/2003.

...the need of technological improvement of production remains an important driver of investment demand...

...a retention of the positive dynamics in supply...

Chart 89

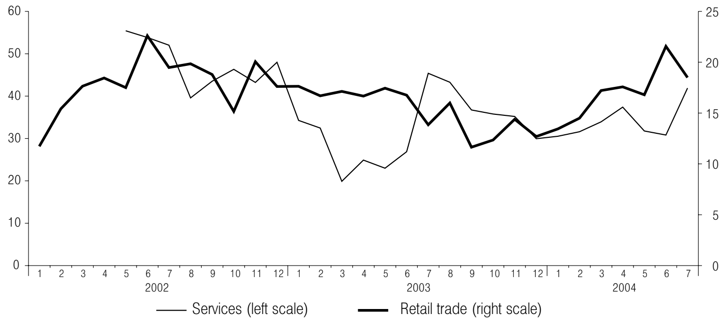
Expected Output



Source: NSI, BNB.

Chart 90

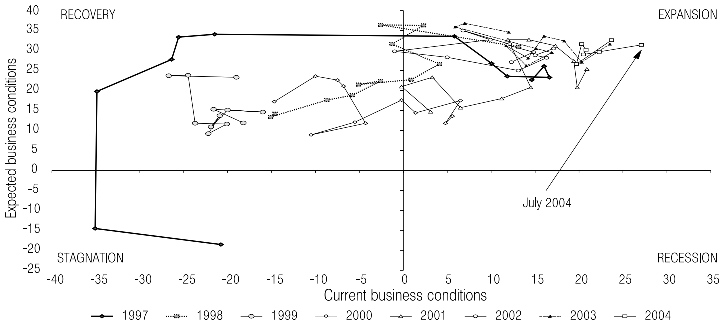
Business Climate in Retail Trade and Services



Source: NSI, business surveys in trade and services.

Chart 91

Business Climate in Manufacturing



Source: NSI, business survey in manufacturing.

4. Inflation

Since 1997 (currency board launch) inflationary factors have included changes to government-controlled prices, indirect tax movements aligned with minimum EU requirements, and sudden changes in international prices of commodities like crude oil, metals, chemicals and farm produce. Accumulated first half inflation completely reflected these factors.

In the second quarter inflation accelerated reflecting crude oil price hikes (contributing 0.21 percentage points to second quarter inflation) and rises in local telephone charges (contributing 0.42 percentage points).

Table 13
Contribution to First Half Inflation

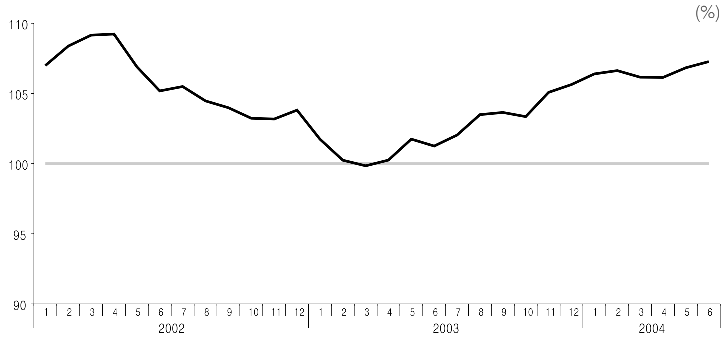
(percentage points)

	2003	2004
Inflation	-1.36	0.17
Contribution		
Food	-1.46	-1.51
Nonfood	-0.58	0.90
Fuels	-0.40	0.12
Catering	0.12	0.08
Services	0.56	0.70
Goods and services with administratively set prices	0.46	1.62
Goods	0.30	1.06
Tobacco	0.00	1.10
Alcoholic drinks	0.03	0.02
Controlled-price services	0.20	0.60

Source: NSI.

Chart 92
Consumer Price Index on an Annual Basis

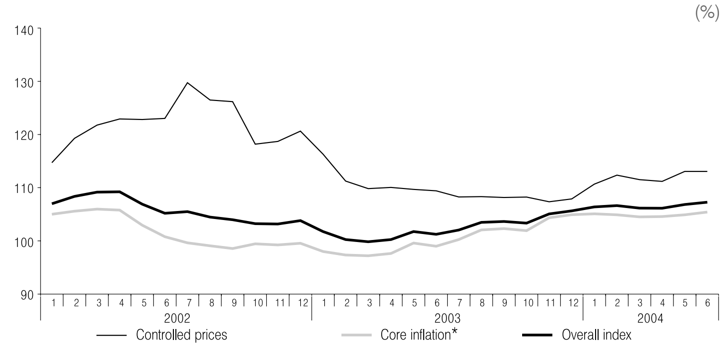
(%)



Source: NSI.

Chart 93
Price Indices on an Annual Basis

(%)



* Consumer price index excluding goods and services with controlled prices.
Source: NSI.

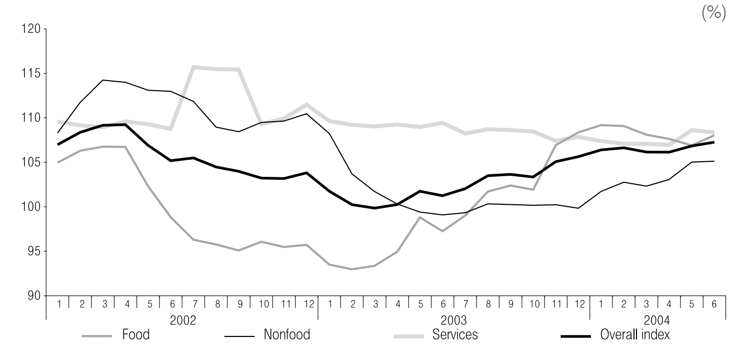
The high rates of home demand growth did not push prices up due to the economy's openness. Imports met some home demand (mainly for investment and feedstocks) at international market prices. A worsened balance of payments trade balance was a negative consequence of rising home demand.

An analysis of data shows that inflation fluctuations by month reflected significant changes in the prices of some goods whose weight in the consumer basket ranged between 10 and 20 percent. At the close of 2003 flour and cereal prices rose dramatically, pushing up food prices and the total annual inflation index during the first half of 2004. In early 2004 tobacco excise duty rose and crude oil price dynamics on international markets pushed up home market fuel prices.

Accumulated first half inflation came to 0.17 percent: within anticipated bounds. Second quarter deflation was 1.46 percent, with fuel prices contributing positively by 0.21 percentage points. Due to the high share of food in the consumer basket, miscounts in inflation forecast for the year's second half are more probable than in the first six months. In case of significant deviations in forecast assumptions, expectations for price dynamics may not be confirmed. Present data show that cereals prices are likely to fall in the second half of the year. This may result in a fall of projected inflation for the end of the year by 1.8 percentage points. Rises in electricity and heating prices by 10 percent in July will have a one-off effect on inflation by 1.05 percentage points. Great world price fragility forces us to retain an end-of-year inflation forecast of 4.2 percent.

Chart 94

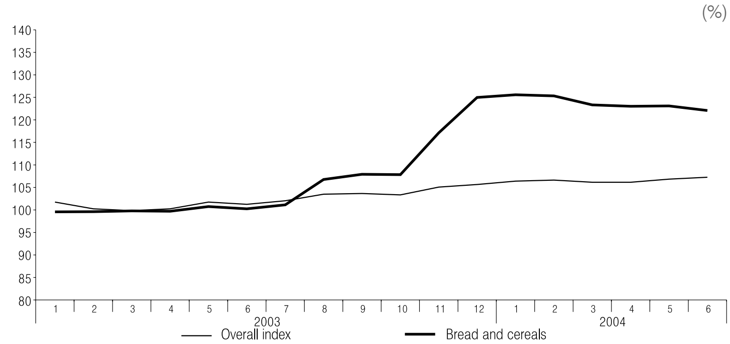
Price Indices by Commodity Group on an Annual Basis



Source: NSI.

Chart 95

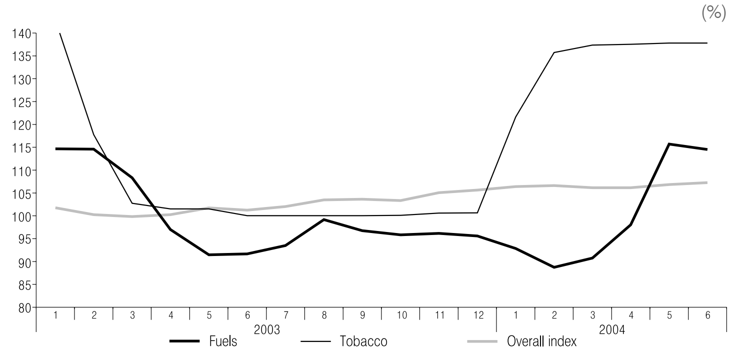
Consumer Price Index and Price Index of Bread and Cereals on an Annual Basis



Source: NSI.

Chart 96

Consumer Price Index and Price Indices of Commodity Groups



Source: NSI.