Economic Review

November 2004

125

1879

YEARS

BULGARIAN
NATIONAL
BANK

125

YEARS

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November 2004

BULGARIAN NATIONAL BANK

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

The November 2004 *Economic Review* was approved for publication by the BNB Governing Council at its 28 October 2004 meeting. It employs statistical data published by 30 October 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.

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Contents

Abbreviations

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

Summary

In 2004 economic growth in the developed countries was higher than expected, especially in industry, with growth rates reflecting dynamic rises in the international trade. Optimism colored business assessments but rising crude oil prices gave rise to concerns about slowdown in global growth rates throughout 2005. The velocity at which the Federal Reserve will continue interest-rate push will depend on price dynamics and US growth stability. It is hardly to expect the ECB to raise its interest rates until year-end and expectations of a possible increase over the first quarter of 2005 are gradually fading.

International economic situation volatility in 2004 did not affect adversely the Bulgarian economy. Balance of payments financial flows covered the current account deficit and backed Bulgaria's international reserve growth: by end-September international reserves reached EUR 6218.8 million.

Reserve money grew by some 20 percent on an annual basis, with currency in circulation contributing most to this growth. Broad money also sustained its dynamic development, with households providing the bulk of lev resources to the banking system. Dramatic money supply growth reflected increased commercial bank claims on the nongovernment sector: an annual increase of about 48–50 percent by end-September. Rising household income as a result of increased employment, along with business optimism will determine credit demand in the future. Expectations of bank credit resource exhaustion did not come true. Although the relatively high credit growth did not threaten directly the financial stability, banks' credit portfolios may worsen under changed economic situation. Therefore, the BNB undertook measures to intensify the control over the credit quality. They include amendments to BNB Regulation No. 21 effective as of 1 October: only 50 percent of banks' cash shall be accepted as minimum required reserves. October saw rises in commercial bank's money with the BNB which may result in lower funds for lending. Since credit expansion rates remained high, the BNB will effectively apply a set of conventional measures coordinated with the IMF and coupled with additional measures to curtail credit expansion, thus guaranteeing the high quality of banks' credit portfolios.

Sustainable growth at high rates reflected both the active internal demand and export increases in Bulgaria. We expect to see competitiveness continue improving, and particularly manufacturing competitiveness. This will extend foreign markets for the Bulgarian producers and decrease import rates due to greater supply of and demand for domestic goods on the domestic market.

Internal demand for tradable goods did not exert inflationary pressure but worsened the trade balance due to the openness of the Bulgarian economy. Inflation rates were driven by adjustments of administratively controlled prices and partially by international oil price dynamics. We anticipate a 4.2 percent inflation rate at the close of 2004.

1. External Environment

Current Business Situation

Accelerating growth of developed countries' industries was associated with high growth rates of the international trade which stayed at 12.1 percent in the summer months of 2004. On the other hand, a global PMI-based indicator of world manufacturing output shows a slowdown since the second quarter. Expectations remained quite optimistic and the uncertainty reflected mainly rising crude oil prices and concerns that the October historical maximum will affect negatively sales as a result of increased energy expenditure *per* unit output.

According to preliminary data, US growth in the third quarter fell to 3.9 percent on an annual basis. The US economic slowdown was ascribable to increased negative contribution of net exports by 0.9 percentage points and subdued investment in fixed assets and inventories. Private consumption contribution matched its second quarter level.

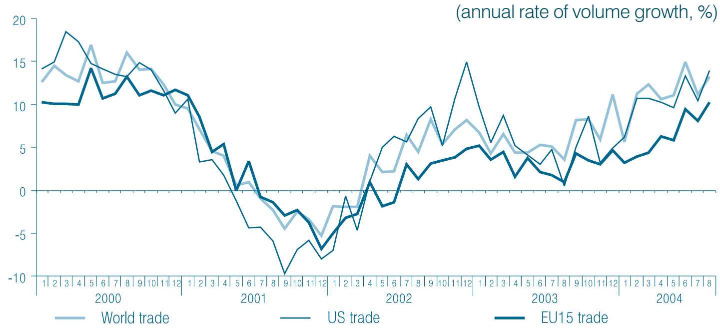
On a quarterly basis, private consumption significantly rose on the prior quarter contributing by 0.8 percentage points in the 0.9 percent overall growth for the third quarter. Purchases of durable goods, especially motor vehicles and their spare parts, contributed most to private consumption growth.

Over the third quarter of 2004 US employment rates decreased, with average new appointments dropping to 103,000 *per* month. In the first two quarters this indicator averaged 200,000 *per* month giving a start to the Federal Reserve policy of raising federal funds interest rates.

According to our forecasts, the US inflation began falling to reach 2.5 percent in September. Transportation prices contributed most significantly to the overall price level. Core inflation measured by consumer expenses fell to 1.46 percent during the third quarter compared to its level of 1.51 percent over the second quarter. At the close of 2004 and in early 2005 we expect retention of the current inflation rate, with a relatively high effect of oil and transportation prices.

...growth rates of the international trade remained stable ...

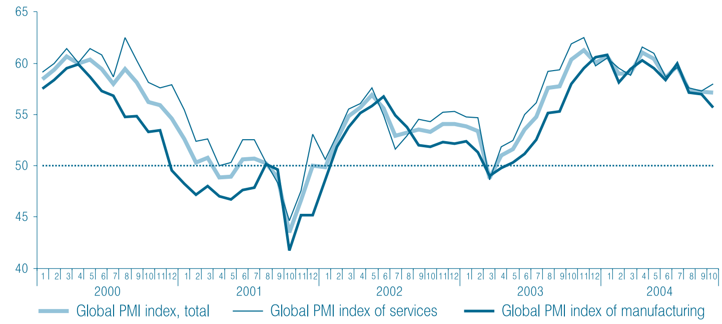
Chart 1
World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis.

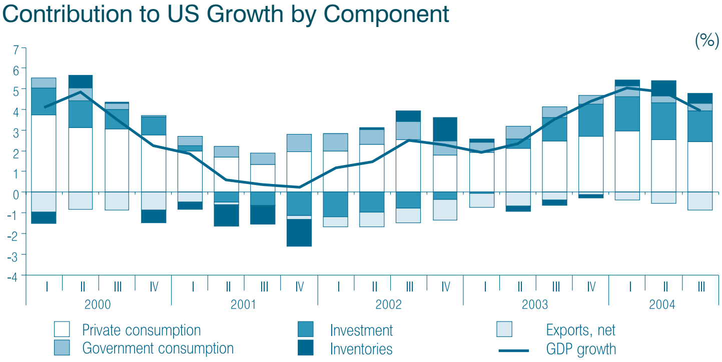
...expectations remained quite optimistic and the uncertainty reflected mainly rising crude oil prices...

Chart 2
Global PMI Indices



Source: NTC Research, JP Morgan.

Chart 3
Contribution to US Growth by Component



Source: Bureau of Economic Analysis.

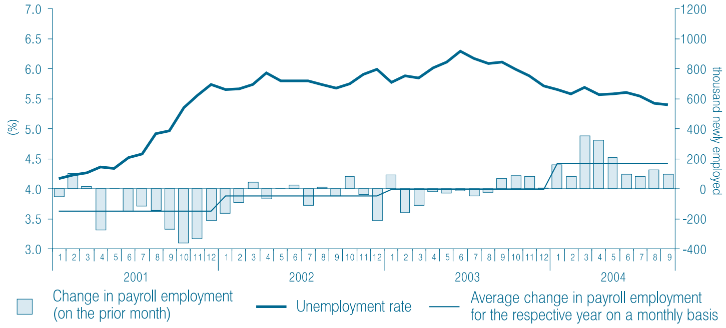
US consumer and manufacturing confidence indicators showed less optimism over the third quarter. Volatility in consumer assessments reflected balanced values of the future and current economic situation indicators. Leading PMIs for both the manufacturing and the services sectors recorded declines on the second quarter but stayed over 50 percent which is an indicator of growth, albeit at slower rates.

In the following two quarters we anticipate the US economy to sustain its moderate growth rates at approximately 3.8–4 percent on an annual basis. The reasons behind growth slowdown on the first half-year include the exhaustion of fiscal stimuli influence on consumption and the slighter effect of low interest rates on housing property. On the other hand, these circumstances will contribute to decreasing household disposable income and respectively private consumption contribution to GDP growth. Petroleum prices, if they exceed USD 50 *per* barrel, pose some risk for the forecast.

Eurozone growth came to two percent in the second quarter, with net exports (0.7 percent) and private consumption (0.6 percent) contributing most to this. Foreign trade was the main driver of growth: exports increased by 8.5 percent on an annual basis and imports by 6.5 percent.

... US consumer and manufacturing confidence indicators showed less optimism over the third quarter...

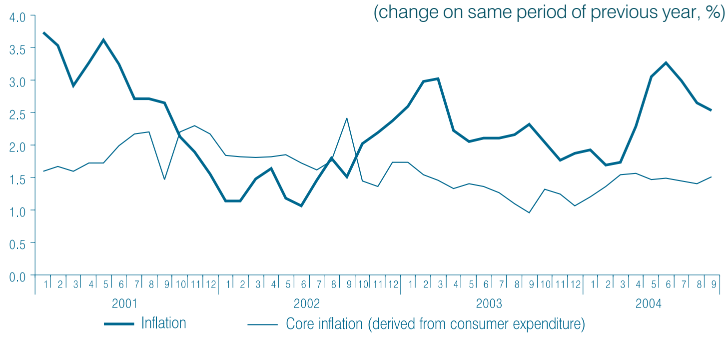
Chart 4
US Unemployment Rate and Change in Payroll Employment



Source: Bureau of Labor Statistics.

Chart 5
US Inflation Rate

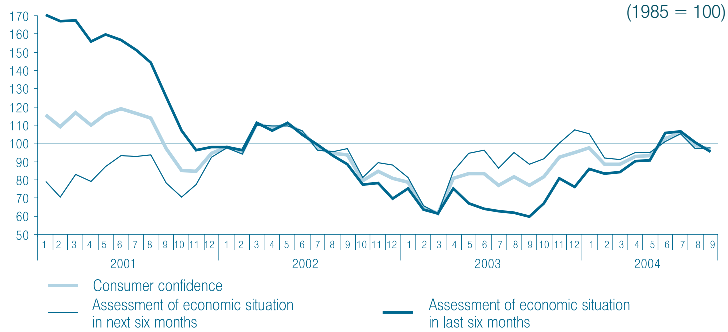
(change on same period of previous year, %)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis.
Note: The US core inflation is measured by personal consumption expenditures index excluding energy and food expenditures.

Chart 6
US Consumer Confidence Indicators

(1985 = 100)



Source: Conference Board.

Eurozone unemployment stayed at nine percent. Employment in manufacturing continued declining which was offset by higher employment in the services sector.

Over the third quarter eurozone inflation went down in line with our expectations and September saw a 2.1 percent inflation rate. Transportation price contribution in the price index stayed at its high level of the second quarter (0.6 percentage points). Food prices indicated a significant decrease, an average of 0.1 percentage points (0.3 percentage points in the second quarter). Communications prices continued falling and their contribution reached -0.1 percentage points. We expect inflation to sustain its level in the third quarter and to reach nearly 2.2 percent over the last quarter of 2004 and first quarter of 2005.

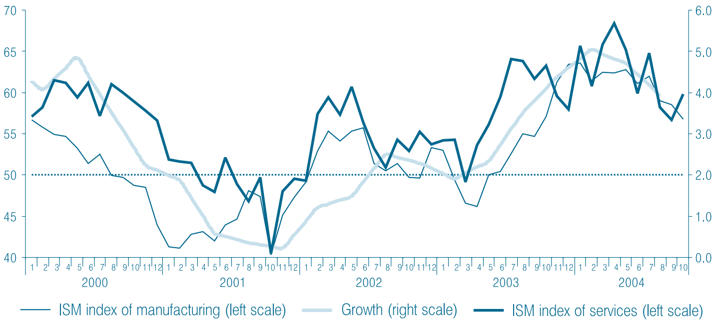
Eurozone manufacturing indicators showed slight declines in economic activity mostly due to lower expectations of export orders. Consumer confidence improved in September: besides greater optimism in expectations of the economic situation over the next 12 months (a trend evolved at the end of the second quarter), optimistic assessments colored the past year. This may be a positive sign of expected consumption acceleration in the eurozone.

In the coming two quarters we expect a two percent growth on an annual basis. Risks are associated with a possible slowdown of economic growth outside the eurozone which will decrease net export growth rates. Rising oil prices increased concerns about a steady retention of inflation above two percent which will negatively affect eurozone internal demand and growth. The ECB revised its inflation prospects for 2004 upwards to 2.1 percent (1.9 percent in the prior year).

...over the third quarter eurozone inflation went down in line with to our expectations ...

Chart 7

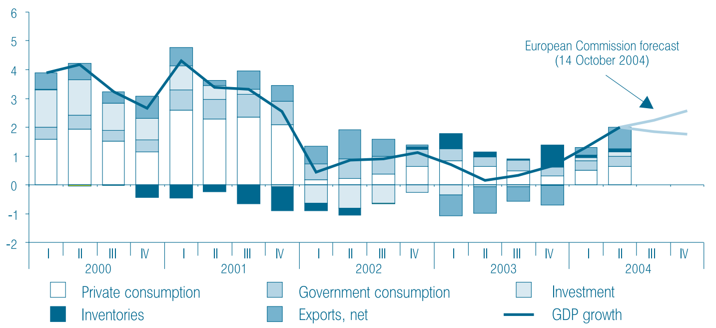
US PMIs and Growth



Source: Institute for Supply Management.

Chart 8

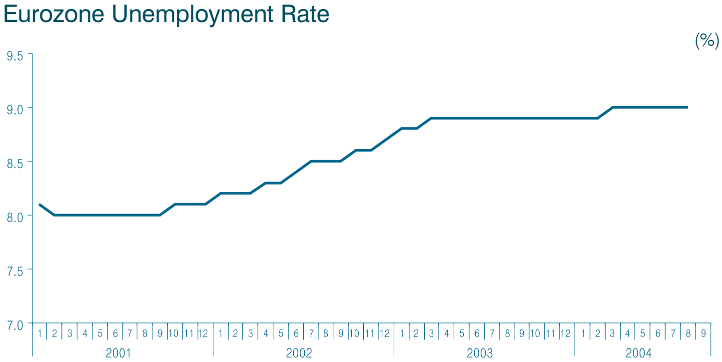
Contribution to Eurozone Growth by Component



Source: Eurostat, European Commission.

Chart 9

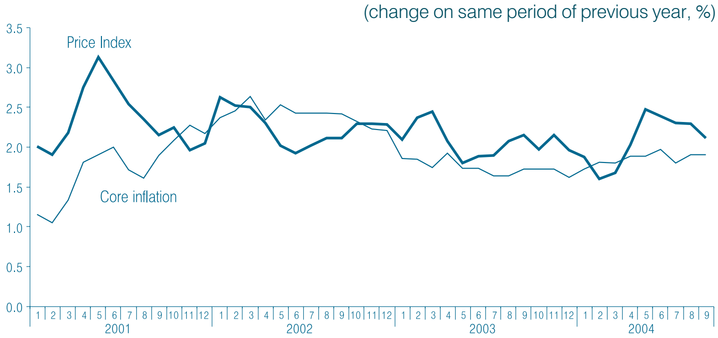
Eurozone Unemployment Rate



Source: Eurostat.

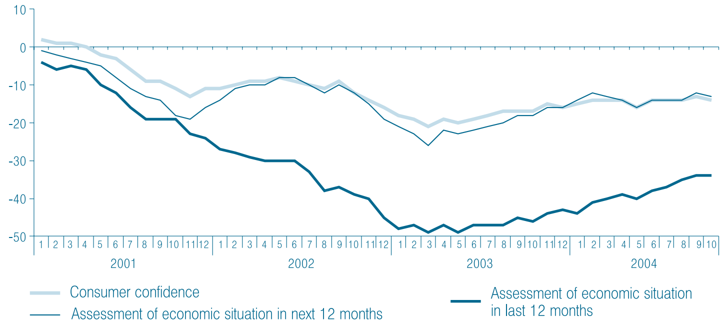
Chart 10
Eurozone Inflation Rate

(change on same period of previous year, %)



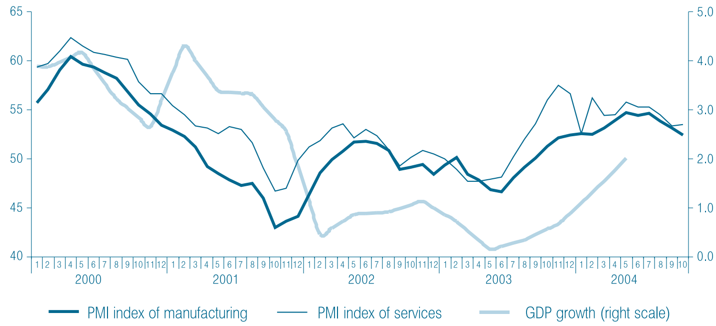
Source: Eurostat.
Note: Eurozone core inflation excludes changes in energy, food, alcoholic drinks and tobacco prices.

Chart 11
Eurozone Consumer Confidence Indicators



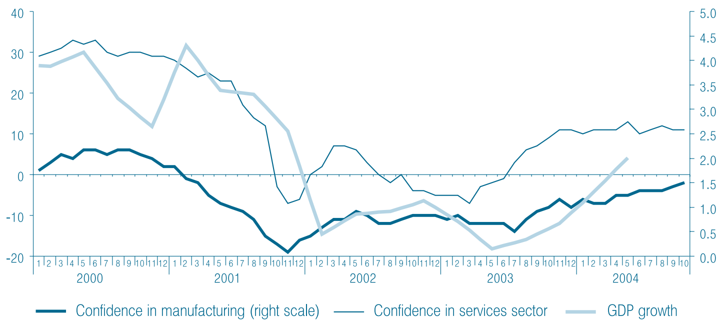
Source: Eurostat.

Chart 12
Eurozone PMIs and Growth



Source: NTC Research.

Chart 13
Eurozone Confidence Indicators and GDP Growth



Source: Eurostat.

EC and IMF Autumn 2004 Forecasts

The IMF* (at the close of September) and the European Commission** (at the close of October) published their autumn forecasts for the world economic development. The two institutions revised up their forecasts for 2004 global growth to five percent compared with the spring projections. The 2005 global growth forecast was revised down compared with spring forecasts as rising oil prices are expected to affect the economic activity in 2005. Continued buoyancy of global growth reflecting the macroeconomic policy pursued by individual countries, the retention of historically low interest rate levels, and especially the strong growth of a few transition economies, among which China, were marked in the outlook. According to EC forecasts, the EU, Japan, the CIS countries, the OPEC, the Asian region (especially China) and Latin America reported higher than expected growth.

The IMF and the EC revised up their forecasts for inflation. The reason behind this was the global expansion resulting in increased global demand for energy and nonenergy raw materials in the first quarter and retention of the levels in the following two quarters. According to the EC and IMF, the high oil price effect and price volatility will impact negatively the 2005 growth, although the economies importing crude oil have significantly reduced their dependence on it and oil real prices were not as high as during the prior oil shocks.

Serious risks for the economic growth will come from: crude oil prices*** and the volatility in other raw materials prices, a possible acceleration of inflation, the social sector reforms and fiscal deficits balancing (especially in the EU), global imbalances and particularly the rising negative balance on the US current account and the positive balances in most countries across the world.

Table 1

Autumn Forecasts: Major Trends

(real percentage change)

			Autumn forecast, 2004		Change on spring forecast, 2004	
	2002	2003	2004	2005	2004	2005
EC						
EU						
GDP growth	1.1	1.0	2.5	2.3	0.4	-0.2
Eurozone						
GDP growth	0.9	0.6	2.1	2.0	0.4	-0.3
Unemployment	8.4	8.9	8.9	8.9	0.1	0.3
Inflation	2.3	2.1	2.1	1.9	0.3	0.3
USA						
GDP growth	1.9	3.1	4.4	3.0	0.2	-0.2
Unemployment	5.8	6.0	5.5	5.5	-0.1	-0.1
Inflation	1.6	2.3	2.6	2.8	1.2	1.6
Japan	**-0.3**	**2.4**	**4.2**	**2.1**	**0.8**	**-0.2**
Latin America	**-0.2**	**3.1**	**4.7**	**3.7**	**1.2**	**-0.6**
Asia (Japan excluded)	**6.1**	**6.4**	**7.5**	**6.9**	**0.2**	**-0.1**
Africa	**0.7**	**-0.6**	**3.3**	**4.4**	**-0.3**	**0.3**
World growth	**2.7**	**3.5**	**5.0**	**4.2**	**0.5**	**-0.1**
IMF						
EU						
GDP growth	1.2	1.1	2.6	2.5	0.4	-0.1
Eurozone						
GDP growth	0.8	0.5	2.2	2.2	0.4	-0.1
Unemployment	8.5	8.9	9.0	8.7	-0.1	-0.2
Inflation	2.3	2.1	2.1	1.9	0.4	0.3
USA						
GDP growth	1.9	3.0	4.3	3.5	-0.3	-0.3
Unemployment	5.8	6	5.5	5.4	0.0	0.0
Inflation	1.6	2.3	3.0	3.0	0.7	0.8
Japan	**-0.3**	**2.5**	**4.4**	**2.3**	**1.1**	**0.5**
Advanced economies	**1.6**	**2.1**	**3.6**	**2.9**	**0.2**	**-0.2**
Western Hemisphere	**-0.1**	**1.8**	**4.6**	**3.6**	**0.7**	**0.0**
Asia	**6.4**	**7.2**	**7.3**	**6.5**	**-0.1**	**-0.5**
Africa	**3.5**	**4.3**	**4.5**	**5.4**	**0.3**	**0.0**
World growth	**3.0**	**3.9**	**5.0**	**4.3**	**0.3**	**-0.1**

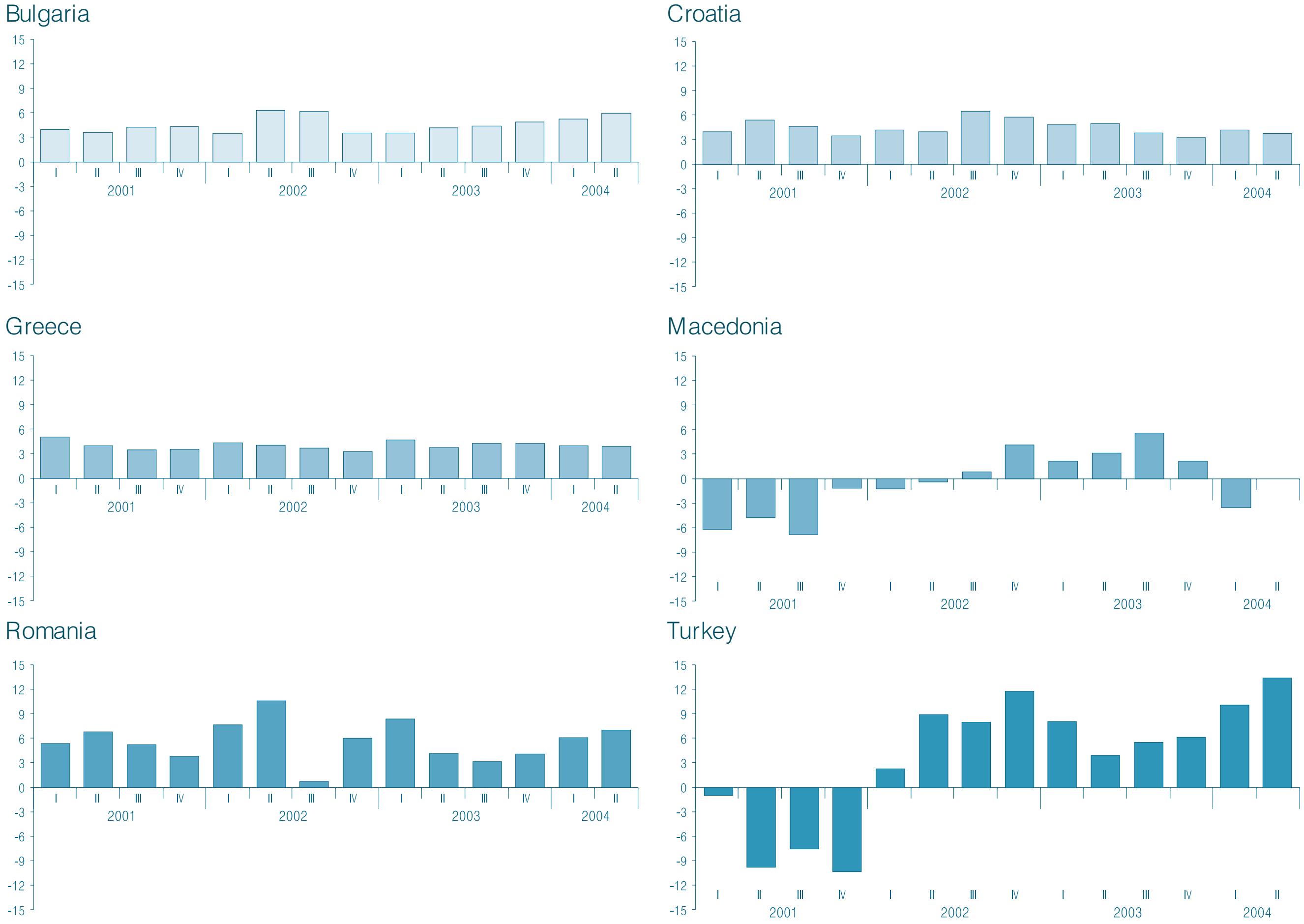
Source: EC and IMF.

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

** *European Commission, Economic Forecasts – Autumn 2004*, October 2004.

*** The IMF projected that a possible pick-up in the oil price by USD 5 *per* barrel will decrease the global growth by 0.3 percentage points. The European Commission predicted that a 25 percent increase of the oil price in US dollars *per* barrel will decrease the global growth by 0.3 percentage points in the first year and by 0.1 percentage points in the second year.

Chart 14
GDP Real Growth Rate in Balkan Countries



Source: Statistical institutes and central banks of respective countries.

During the second quarter Turkey, Romania and Bulgaria reported the highest growths. Growth rates in this region remained high thanks to accelerated internal and external demand aligned with rising investment in fixed assets.

As in the first quarter, Turkey posted the highest growth of 13.4 percent. Manufacturing and trade again backed growth contributing by 4.8 and 4.7 percentage points. Capital investment rates slightly fell on the first quarter but stayed high at 51.7 percent. Private consumption rose to 16.4 percent.[1]

Inflation in the Balkans retained its second quarter levels rising more significantly in Serbia. It slightly fell in Romania, Albania and Croatia.

... growth rates in the Balkans remained high thanks to accelerated internal and external demand aligned with rising investment in fixed assets...

[1] Changes are presented in real terms at constant prices of 1987.

We expect to see growth in this region curtailed in the fourth quarter of 2004 and first quarter of 2005, a result of contracted foreign demand reflecting the projected slowdown of the world economy in the coming year.

Commodity Prices

Energy prices

In the third quarter of 2004 crude oil prices rose by 13.5 percent on average compared with the prior quarter and by 55 percent on an annual basis in US dollar terms *vis-a-vis* September 2003. Brent was traded at USD 41.6 *per* barrel on average, almost USD 3 above the forecast: historically, the highest nominal levels recorded. Emergence of new instability centers – Nigeria and the Gulf of Mexico – hampered further the market and increased uncertainty prior to the winter which had an immediate effect on prices.

Although the Russian Yukos oil company continued its work without serious breaks, uncertainty and the threat of stopping its exports remained. Yukos' tax obligations of USD 14 billion from 2000 to 2002 have not been paid and the government refused to reschedule them.

In late September Hurricane Ivan seriously damaged oil extracting facilities in the Gulf of Mexico. The capacity of this oil field is estimated at 3.3 million barrels *per* day, and losses led to a 25 percent decrease in oil production. Reduced extraction hit US oil reserves which fell below the seasonal minimum.

Additional tension came from Nigeria, an important oil supplier to the US economy. After raising the petrol excise duty, a conflict burst in Nigeria causing a serious disorder which has threatened country's exports. Nigeria exports light oil used primarily by the USA since it is easily and fully reprocessable.

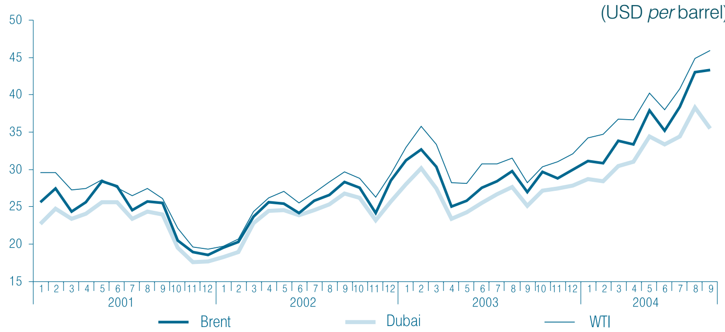
In Norway, which exports three million barrels *per* day, dockers threatened to hit ports. The Venezuelan President's statement that a price of USD 60 *per* barrel is absolutely reasonable with a view to extraction expenses caused additional tension on the market. Simultaneously, Venezuela raised foreign oil companies' extraction taxes from one percent to 16.6 percent.

...crude oil prices reached a historical high...

...emergence of new instability centers – Nigeria and the Gulf of Mexico – hampered further the market and increased uncertainty prior to the winter ...

Chart 15
Crude Oil

(USD *per* barrel)



Source: World Bank.

In addition, terrorist attacks against oil facilities in Iraq hampered extraction and exports.

Concentration of unfavorable circumstances gave rise to market speculations and by mid-October Brent price went up to USD 51.60 *per* barrel, although there were no shortages of supply.

We expect the oil price to range between USD 48 and USD 50 *per* barrel during the fourth quarter and between USD 45 and USD 48 over the first quarter of 2005. If the crisis in Nigeria continues and oil supply stops, the price may be set at between USD 52 and USD 54 *per* barrel in the fourth quarter of the current year.

OPEC basket oil price in euro averaged EUR 31.9 *per* barrel during the whole quarter, staying above the corridor of EUR 22 to EUR 28 *per* barrel which was an appreciation of 12 percent on the prior quarter. Taking into account our forecasts for the EUR/USD exchange rate, in the coming two quarters we expect the twelve-month moving average of the price to jump over the corridor reaching EUR 33 *per* barrel in the first quarter of the coming year.

Other Commodity Prices

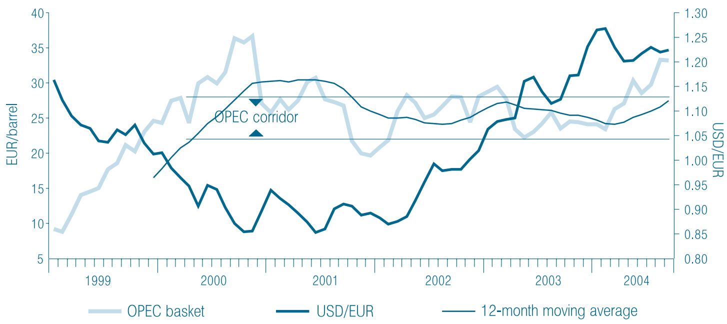
International prices of major food and raw materials stopped rising and stayed at the second quarter levels. Metals registered a slight rise of 2.2 percent. The slight metal price growth over the last two quarters reflected measures undertaken in China which have brought good results in limiting demand.

Food prices continued going down. Food price index fell by eight percent on the prior quarter and for the first nine months the price decrease was 1.3 percent reflecting the good harvest (soya, corn and wheat).

We expect to see downward food price trends and retention of metal price levels to continue in the coming two quarters.

Chart 16

OPEC Basket Price in Euro



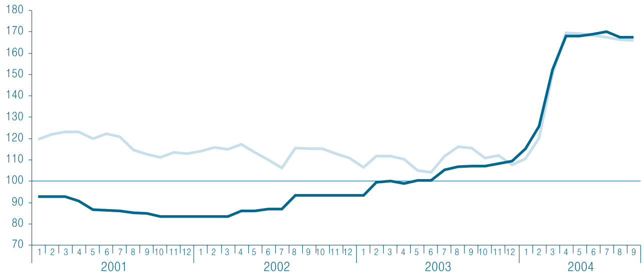
Source: World Bank.

...according to our expectations, international prices of major food and raw materials stopped rising and stayed at the second quarter levels...

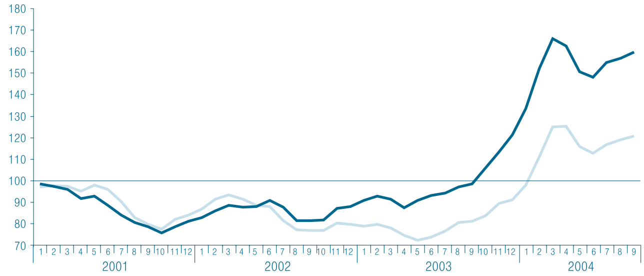
Chart 17

Price Indices of Major Commodities and Commodity Groups

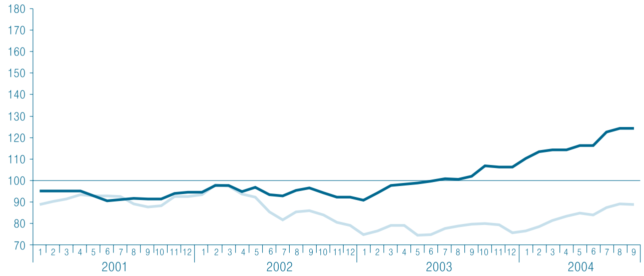
Steel (2000 = 100)



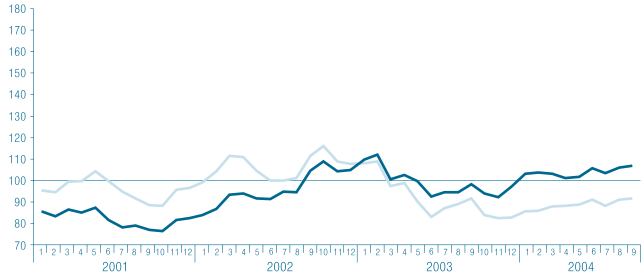
Copper (2000 = 100)



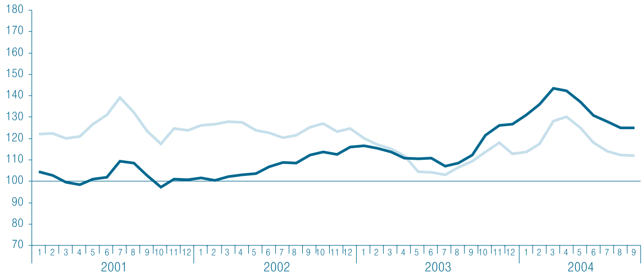
Fertilizers (2000 = 100)



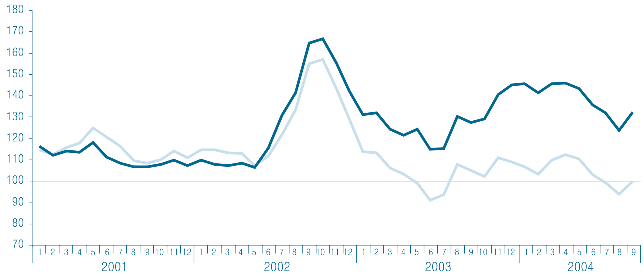
Drinks (2000 = 100)



Food (2000 = 100)



Wheat (USA, HRW) (2000 = 100)



USD EUR

Source: World Bank, ECB, BNB, OPEC.

Although the first half-year saw increased demand for oil, supply fully covered it. The OPEC countries reacted adequately to the difficulties of other major oil suppliers. The high price reflected mostly the volatile supply, while demand receded into the background after signs of decreased demand by China. Thus, the geopolitical uncertainty added further to the rise of oil price risk premium. The concomitant existence of a few risk zones (Russia, Iraq, Nigeria, and the Gulf of Mexico) along with the seasonal nature of demand served as further catalysts for oil futures prices.

Amid a multitude of unexpected factors, the oil price may run at USD 60 to USD 70 *per* barrel in the coming two quarters. However, this is unlikely to continue in the long run. Significant investment in oil extracting over the last year and the launch of new capacities will entirely cover demand. On the other hand, with the new energy-saving technologies dependence of manufacturing on oil is becoming weaker. From this point of view, a crisis like the oil shock in the late 70s and early 80s is unlikely to happen. Furthermore, the crude oil price in real terms is relatively low (Chapter 16). No inflationary shocks are expected and this may be seen in price index dynamics in the developed countries over the last two years (Charts 5 and 10) when oil price rises were significant, while inflation slightly increased. Presently, the difference in prices is offset by reduced profits of transportation companies and to a lesser degree by consumers.

Chart 18

World Oil Demand and Supply

(million barrels *per* day)

Source: International Energy Agency.

Chart 19

OPEC Crude Oil Supply and IEA Estimates of the Quantity Demanded by the Market

(million barrels *per* day)

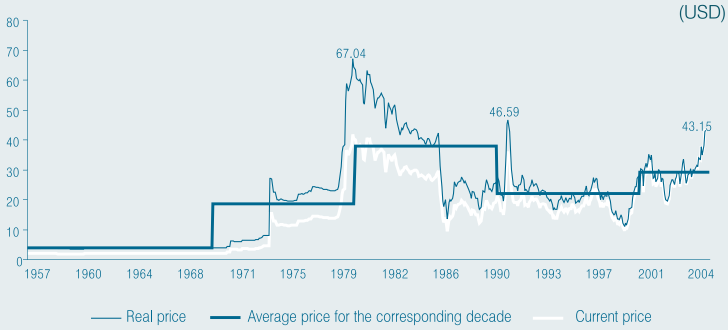
Source: International Energy Agency.

Chart 20

Brent Real Price

(at prices of 2004)

(USD)



Source: IMF, Bureau of Labor Statistics and BNB calculations.
Note: Data as of September 2004. Current prices are deflated using the US CPI to obtain the real price.

Table 2
World Oil Demand and Supply
(million barrels *per* day)

(%)

	January – March 2003		January – March 2004		January – March 2005*	
	Contribution to demand growth	Share in overall growth	Contribution to demand growth	Share in overall growth	Contribution to demand growth	Share in overall growth
Demand						
China	0.9	25.9	1.2	31.2	0.5	29.8
Asia	0.4	13.0	0.7	18.8	0.2	12.4
North America	0.5	15.6	0.7	18.8	0.3	14.1
Middle East	0.7	21.6	0.5	12.3	0.4	19.3
Europe	0.3	8.7	0.4	9.7	0.2	12.1
Former CIS countries	0.2	6.0	0.2	5.6	0.1	5.4
Latin America	-0.2	-4.8	0.2	5.2	0.1	7.5
Africa	0.2	6.4	0.1	1.9	0.1	5.5
Pacific Ocean Region	0.6	16.5	-0.1	-3.4	-0.1	-6.1
Overall demand growth	*3.4*		*3.7*		*1.8*	
Supply						
Former CIS countries	1.2	34.5	1.2	24.6	0.7	81.9
Africa	0.0	-0.6	0.5	10.1	0.5	57.8
Asia	0.2	5.0	0.2	3.3	0.0	1.0
China	0.1	1.6	0.1	1.6	0.0	4.1
Latin America	0.1	2.7	0.1	1.2	0.3	40.3
North America	0.0	0.9	0.1	1.1	0.4	47.7
Pacific Ocean Region	-0.2	-4.7	-0.1	-2.4	-0.1	-6.7
Middle East	-0.1	-3.5	-0.1	-2.7	0.0	-4.9
Europe	-0.3	-9.4	-0.2	-3.3	-0.2	-21.9
Overall supply, excl. OPEC	0.9	26.3	1.6	34.2	1.7	195.3
Crude oil	*2.2*	*60.9*	*2.5*	*52.5*	*-1.4*	*-170.3*
Natural gas	*0.5*	*12.7*	*0.6*	*13.2*	*0.6*	*75.0*
OPEC overall supply	2.6	74	3.1	66	-0.8	-95
Overall supply growth	*3.6*		*4.7*		*0.8*	

* Forecasts.

Source: IEA (September 2004).

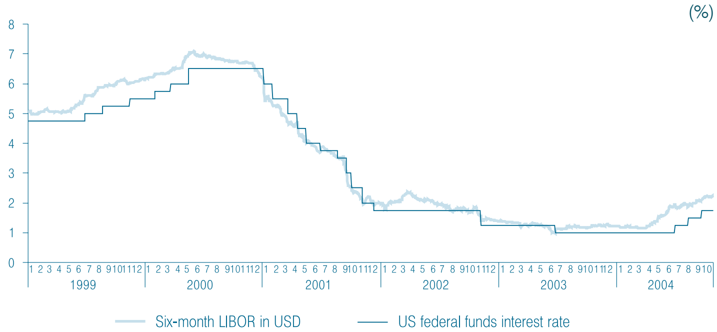
Interest Rates

Over the third quarter six-month USD deposit rates on the London interbank market rose steadily reflecting the US federal funds interest rate increased twice by 25 basis points in August and September. The transparency of the Federal Reserve System's actions significantly reduced the uncertainty and hence future interest rate fluctuations. The range of six-month USD LIBOR movements (from 1.83 percent to 2.2 percent) was considerably narrower than in the prior quarter.

...the US federal funds rate increased twice by 25 b.p. in August and September...

Chart 21
US Federal Funds Rate and Six-month LIBOR in US Dollars

(%)



Source: Bloomberg.

By the close of October futures contracts based on federal funds showed expectations of a two percent interest rate by the year's close and 2.25 percent at the end of the first 2005 quarter. The forward yield curve also showed expectations of a two percent interest rate by end-2004 and a reference interest rate moving between 2.25 percent and 2.5 percent at the close of the first 2005 quarter. This scenario supposes that the six-month LIBOR in USD will move within the 2 percent to 2.5 percent band with an average value of 2.25 percent.

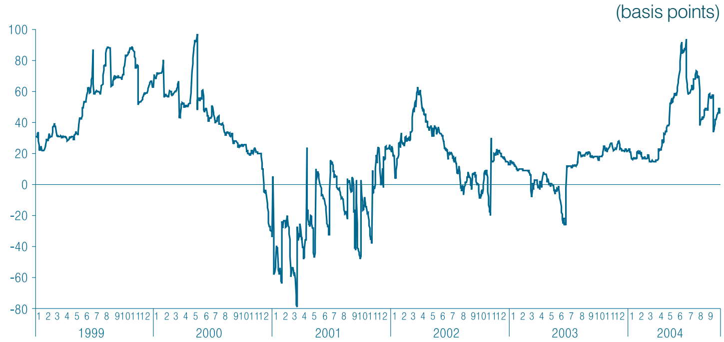
The velocity of tightening the Federal Reserve System monetary policy over the coming months will reflect largely domestic price dynamics and the economic situation. Signals of US growth slowdown gave rise to expectations among most market analysts that the US Federal Reserve System will make a pause before raising gradually interest rates. This will add to narrowing the spread between the federal funds interest rate and the six-month LIBOR. A risk may arise from more rapid than expected interest rate rises, should the high oil prices exert a secondary pressure on inflation.

Over the third quarter the eurozone yield curve reflected divergent factors effect, with receding expectations of repo interest rate changes and sustained movement of the six-month EURIBOR within the narrow 2.15–2.22 percent range.

Futures markets reflected receding expectations of eurozone interest rate rises, with the spread between the December futures and the three-month EURIBOR spot rate showing no probability of change in ECB monetary policy until the year's close. The possible change by 25 basis points incorporated in the March 2005 futures continued falling in October and now it comes to some 38 percent. Market expectations based on the forward curve showed by 6 October 2004 possible eurozone interest rate rises during the first 2005 quarter. This forecast assumes that the six-month EURIBOR will stay at the current level during the fourth quarter of 2004 within the projected 2.15–2.4 percent band.

Chart 22

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

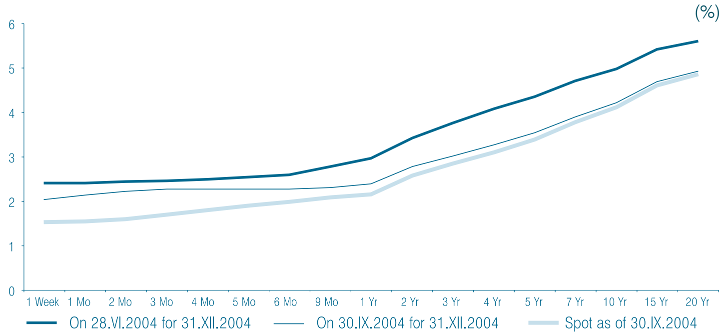


Source: Bloomberg.

... expectations among most market analysts are that the US Federal Reserve System will make a pause before raising gradually interest rates...

Chart 23

Expected US Yield Curve

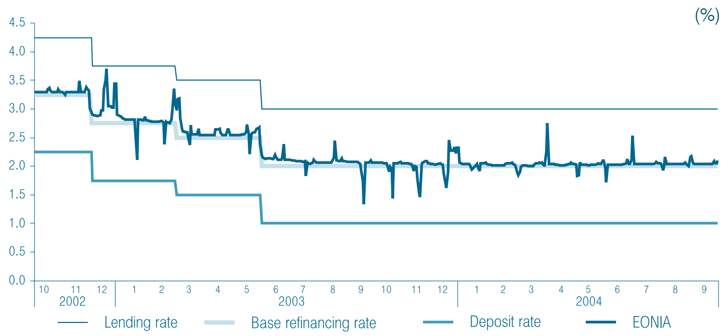


Source: Bloomberg.

...futures markets reflected receding expectations of eurozone interest rate rises...

Chart 24

Eurozone Base Interest Rates

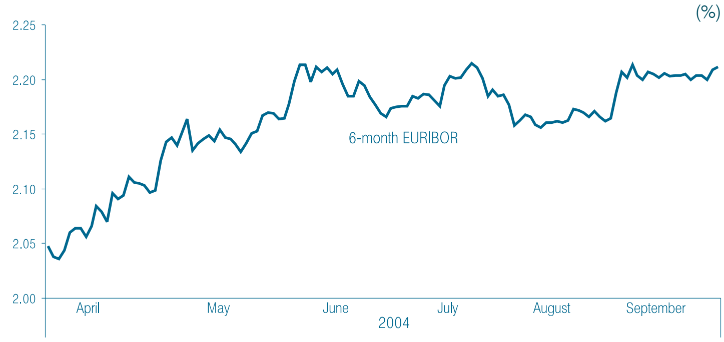


Source: Bloomberg.

A putative retention of oil price upward trends is likely to affect negatively eurozone economic growth and postpone the repo interest rate increase. At the same time, any further consequences of energy price rise effect on the overall price level would induce earlier than expected interest rate rises in the eurozone.

Chart 25

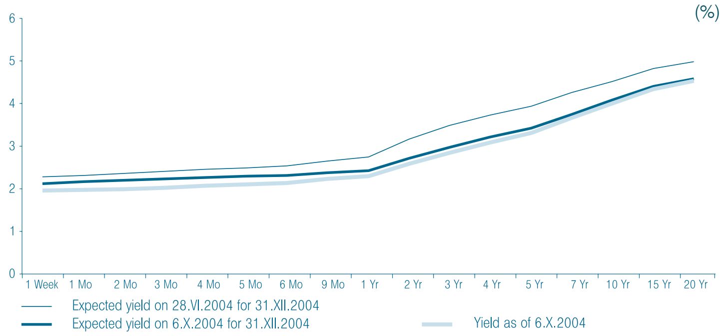
Eurozone Interest Rates on Interbank Deposits with Six-month Maturity



Source: Bloomberg.

Chart 26

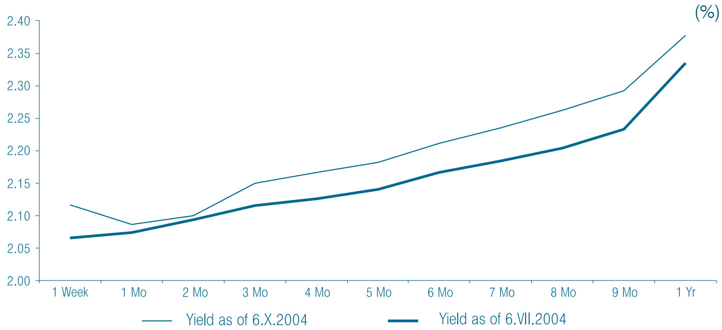
Curve of Expected Eurozone Yield



Source: Bloomberg.

Chart 27

Eurozone Money Market Yield Curve



Source: Bloomberg.

The Stock Markets

Over the third quarter the global stock indices declined reflecting the record high oil prices and world economic growth slowdown. Over the review period the US Dow Jones Industrial Average lost 3.4 percent of its value, and the technological Nasdaq index went down by 7.4 percent. The European DJ Euro Stoxx fell by 3 percent. Crude oil price hikes had a negative effect on investors' preferences causing uncertainty about future consumption and corporate profits. The expensive crude oil hit transportation companies, at the same time

...over the third quarter the global stock indices declined ...

favoring extracting and reprocessing oil companies.

Signals of slowing global economic activity emerged in the summer led to weakening interest in the procyclical sectors, such as technological, telecommunications and media. Technological companies reported serious losses as a result of announced expectations of weakening demand in this sector until the year's close. The slowing US corporate profit growth was accompanied by accumulated finished output in the semiconductors and automobiles sectors. Most European companies' profits showed favorable results over the first half-year, still failing to increase the interest in European stock-exchange indices.

Economic fundamentals will have contradictory effects on market developments in the coming two quarters. Amid sustained upward trends in oil prices, a negative stock-exchange indices movement may be expected.

The slowing US corporate profit growth is expected to continue. After passing the peak in the labor productivity rate and amid increasing employee compensation expenditures, corporate profits will become more dependent on final consumption dynamics. Expectations that the summer economic slowdown may continue over the coming quarters gave pessimistic outlooks for the stock-exchange indices. It should be noted however, that shares occupied relatively attractive levels in terms of a *price to earnings* ratio. This suggests that most negative trends and risks have already been reflected in financial asset prices and upward movements in the markets are quite probable.

Eurozone worsened labor market affected unfavorably personal incomes which may depress final consumption. This may lead to downward movements in the European stock-exchange markets. At the same time, the retention of the current low interest rates by the ECB makes corporate financing less expensive.

Over the coming quarters both the oil market and the global economy through corporate profits will influence stock-exchange indices.

Chart 28

Dow Jones Industrial Average Index Dynamics

Source: Bloomberg.

...the slowing US corporate profit growth is expected to continue...

Chart 29

DJ Euro Stoxx 50 Index Dynamics

Source: Bloomberg.

The US Dollar/Euro Rate

The third quarter saw weakening forex market fluctuations, with the USD/EUR exchange rate staying at the close of the review period at levels close to those at the start of the period. US trade deficit reached USD 55 billion in June and the current account deficit USD 166.2 billion in the second quarter which was reported as an indicator of deepening structural imbalances. On the other hand, however, the expected change in the interest rate differential between the USA and the eurozone backed the US dollar.

Until the end of the year and over the first 2005 quarter the US current account deficit and the signals of slowing economic growth coupled with geopolitical uncertainty will further influence the USD/EUR exchange rate. After the US dollar depreciation in November, its exchange rate is most likely to continue moving in a corridor. By the close of the year, after the US presidential elections and interest rate changes, the USD/EUR exchange rate would return to approximately 1.25. The risk scenario supposes a cheaper US dollar.

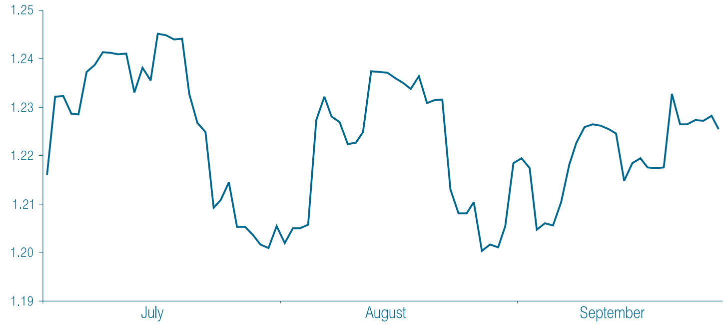
Gold

Over the third quarter three major factors affected the gold price: its technical link with the US dollar, high oil prices, and the geopolitical tension (gold's role of an investment haven). The gold price moved within the USD 385 to USD 414 range *per* 1 troy ounce.

Realized expectations of a gradual increase in US interest rates resulted in the lack of pessimistic forecasts of the gold price since investment in gold is still quite attractive. Oil prices jumping to record highs on the futures markets were among the other factors affecting the gold price. The more expensive oil increased worries about inflation rises which had a positive effect on the gold price (the traditional use of gold as a store of value). Representatives of Newmont Mining, the world's largest gold producer, think that the gold price will move within the USD 380 to USD 450 range *per* troy ounce following the US dollar negative outlooks caused by the large deficits on the balance of payments trade account and government finance. The company did not effect hedging operations but thinks that high prices will worsen producers' financial performance. The bankruptcy of the Australian mining com-

...the third quarter saw weakening forex market fluctuations...

Chart 30
USD/EUR Exchange Rate



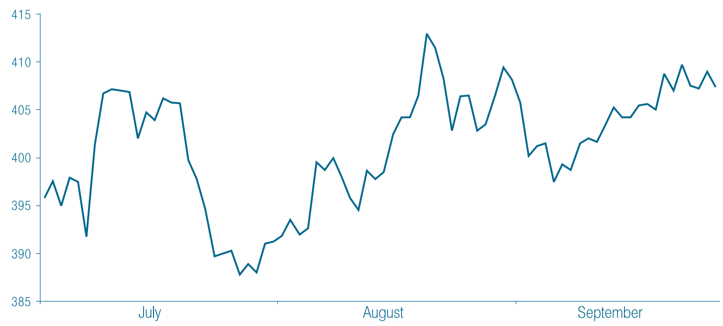
Source: Reuters.

...the risk scenario supposes a cheaper US dollar...

...rising oil prices led to enhanced demand for gold...

Chart 31
Spot Price of Gold

(USD *per* troy ounce)



Source: Reuters.

pany Sons of Gwalia was quite indicative.

We shall see the following factors affecting the gold price: the technical link with the US dollar, geopolitical tension, demand associated with the festivals in India and coming Christmas holidays. The expected price will range between USD 390 and USD 450 *per* troy ounce.

Interest rates on gold deposits will stay at record low levels as supply is absolutely sufficient, chiefly at the official sector.

Bulgarian External Debt

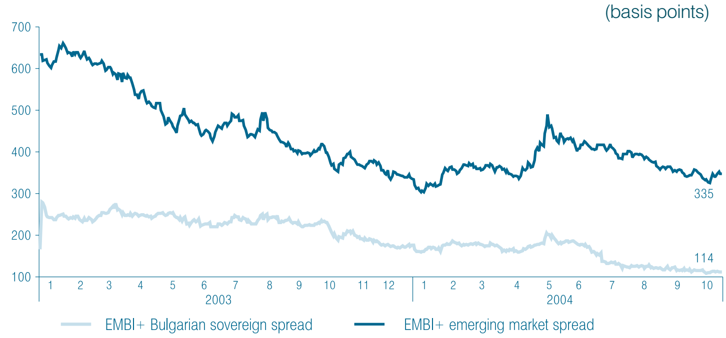
Shortening of Bulgarian government securities spreads measured by the JP Morgan EMBI+ index was evident over the third quarter. Decreased return on investments in the developed countries boosted demand for higher earnings and increased the interest in emerging economies' debts.

Positive economic data on Bulgarian growth over the second quarter along with Brady bond buy-backs of USD 679.3 million boosted investors' interest. Important factors behind the enhanced demand for Bulgarian government securities were the consistent following of low-deficit fiscal policy and the related upgrading of Bulgaria's credit rating by Fitch to BBB-. The 2004 European Commission Report on Bulgaria's progress towards accession confirmed the trends to political and economic reforms stating that Bulgaria is ready to join the European Union in 2007.

The stable macroeconomic situation and continuing efforts to meet the preaccession criteria created expectations of sustained interest in Bulgarian government debt. This will contribute to retention of Bulgarian debt instrument prices at current high levels. At present, the yield spread is extremely low and its further narrowing is unlikely to happen.

...shortening of Bulgarian government securities spreads was evident over the third quarter...

Chart 32
Spread of JP Morgan Index for Emerging Markets



Source: Bloomberg.

2. Financial Flows, Money and Credit

Financial Flows and External Position Sustainability

Following the fall in July due to the external debt buyback transaction, the third quarter saw an increase in foreign reserves. By 30 September 2004 the balance sheet figure of the Issue Department was BGN 12,163 million (EUR 6218.8 million), an increase of 23.1 percent on end-September 2003. The balance of payments financial account surplus continued exceeding the current account deficit. Between January and August 2004 current account deficit totaled BGN 1066.5 million (a decrease of BGN 404.3 million on a year-to-year basis. The trade balance continued worsening (BGN -3139.3 million for the period under review against BGN -2465.3 million between January and August 2003), while improved balances of income, services and current transfers contributed to diminution in the current account deficit.

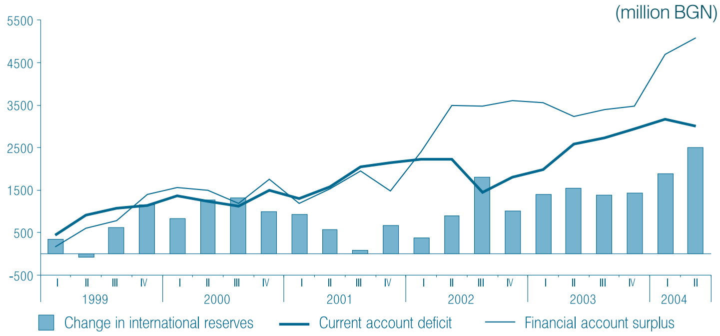
Between January and August 2004 foreign direct investments covered 254 percent of the current account deficit, reflecting their significant rise as a result of privatization of the Bulgarian Telecommunications Company and reporting of the transaction with M-Tel. The quarterly coverage increase (on an annual basis) proved to be more moderate: from approximately 80 percent in recent quarters to 102.3 percent in the second quarter of 2004 (compare with Chart 34).

Between January and September 2004 the major factors behind the increased gross international reserves were purchases and sales of reserve currency by the central bank. Government transactions prompted a fall in reserves over the review period, reflecting mainly the transactions on government debt management.

...BNB international reserves reached EUR 6218.8 million by the end of September...

Chart 33

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

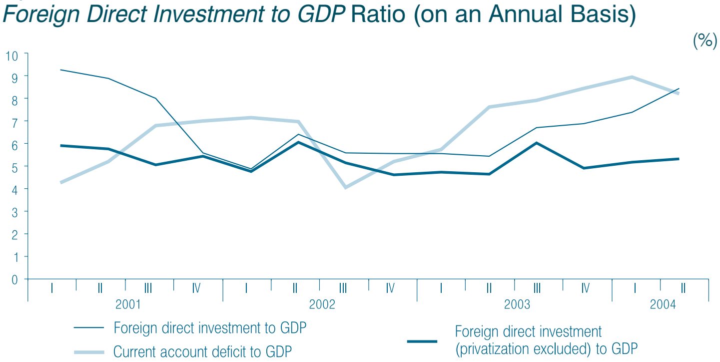


Source: BNB.

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

Chart 34

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



Source: BNB, NSI.

Table 3

Cashflows which Prompted Significant Changes in Gross International Reserves

	Third quarter, 2004	January – September 2004
A) Purchases and sales of reserve currency (million EUR)	+631	+1123
- Net purchases by commercial banks	+633	+1093
- Revenue (outflows) related to net purchases (sales) at tills	-2	+26
B) Changes due to revenue on commercial banks' minimum required reserves accounts in foreign currency	EUR +20 million	EUR +220 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments	***Payments:*** equivalent of about EUR 730 million (USD 827 million, including also repurchase expenditure on Brady bonds, JPY 1.8 billion, SDR 23 million and EUR 14.5 million; ***Revenue:*** a World Bank loan of EUR 102.5 million.	***Payments:*** external and internal debt payments equivalent to approximately EUR 1080 million (including debt payments in US dollars, euro, SDR and Japanese yens); ***Revenue:*** EUR 184 million from the sale of the Bulgarian Telecommunications Company; EUR 182 million new loans; EUR 53 million from government securities issue.

Source: BNB.

The sectoral breakdown of balance of payments flows suggests that the seasonal profile in the second quarter was sustained (Chart 35)[2]. The worsened trade balance was partly offset by the net inflow on the other items of the nongovernment nonfinancial sector current account.

Financial account flows by sector reflect income from privatization of BTC and the specificity in reporting the transaction with M-tel. The two major events determining the changes in the *General government sector* item included payment on BTC sale in June and the transaction on the early repayment of Brady bonds in July (EUR 553.9 million). As a result of these transactions the public sector debt went down at the expense of a certain fall in BNB international reserves due to a decreased government deposit with the Issue Department.

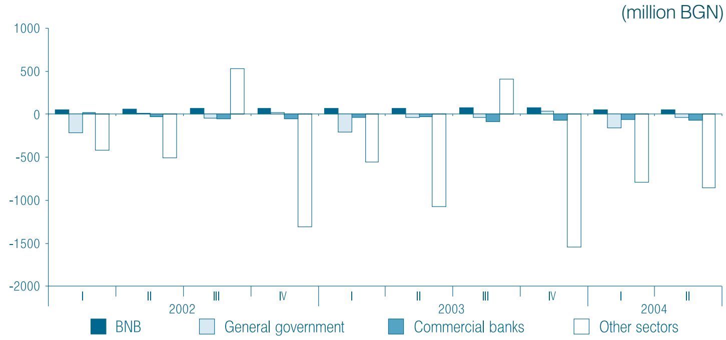
The transaction with M-tel led to a smaller net inflow of financial resources to commercial banks due to the increase in foreign assets recorded in June. The same was the reason behind the higher net inflow of resources to the *Other sectors* item as a portion of the transaction was accounted as direct investment.

The effect of the M-tel transaction on com-

[2] The methodology of sectoral distribution of balance of payments flows is presented in the *Economic Review*, May 2004 issue.

Chart 35

Distribution of Current Account Flows by Sector (Quarterly)

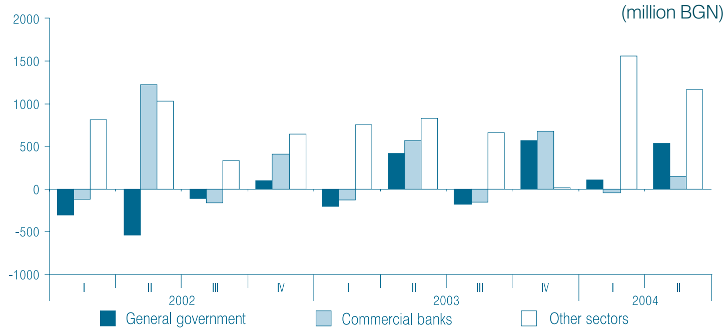


Source: BNB.

...privatization of Bulgarian Telecommunications Company and the transactions with M-tel changed the seasonal profile of the financial account flows...

Chart 36

Distribution of Financial Account Flows by Sector (Quarterly)

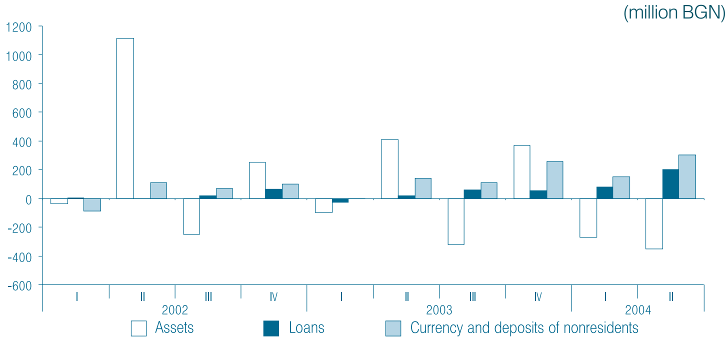


Source: BNB.

mercial bank flows is more clearly displayed on Chart 37 where the increase in commercial bank foreign assets atypical of the second quarter is shown. The bulk of the increase was concentrated in one month (June) when *Other investment: assets, currency and deposits of commercial banks* item rose by BGN 711.5 million (for comparison, see the analysis of monetary and credit aggregates). Both loans to commercial banks disbursed by nonresidents and nonresidents' currency and deposit inflow continued to increase. This was attributable to the positive interest rate differential between domestic market lending rates and international rates which is sufficiently attractive for foreign investment in the Bulgarian economy (Chart 38).

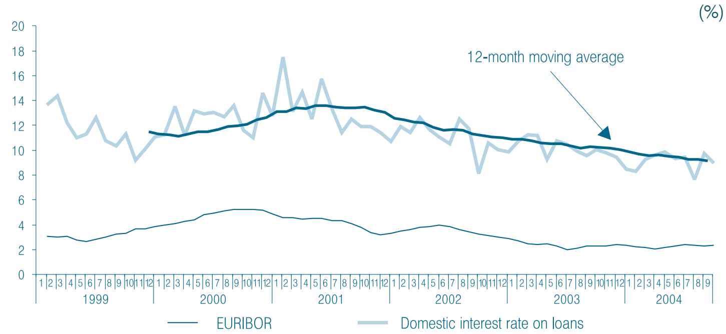
...commercial banks continued to attract loans and deposits from nonresidents...

Chart 37
Commercial Banks' Financial Account Flows (Quarterly)



Source: BNB.

Chart 38
Interest on Long-term Loans and EURIBOR

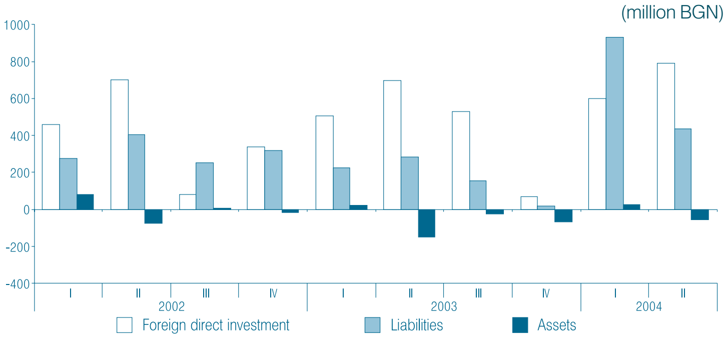


Source: BNB, European Central Bank.

Over the second quarter of 2004 direct investment is the major financing flow for the *Other sectors* item, followed by liabilities (Chart 39). The private nonfinancial sector current account deficit between April and June was covered by direct investments at 102.5 percent. If the *Other capital* subitem is reclassified as an obligation of the sector[3], the cover of *Other sectors* current account deficit is 55.5 percent, reflecting the sustained trend towards financing the private nonfinancial sector by debt, irrespective of the lower absolute amount of obligations than in the second quarter of 2003 (BGN 747 million against BGN 823 million).

...the trend towards financing the nonfinancial sector by debt was sustained...

Chart 39
Other Sectors Financial Account Flows (Quarterly)



Source: BNB.

As a result of the balance of payments financial flows structure the gross external debt continued to increase and by the end of the second quarter the *gross external debt to GDP* ratio reached 64.9 percent.

...the *gross external debt to GDP* ratio reached 64.9 percent...

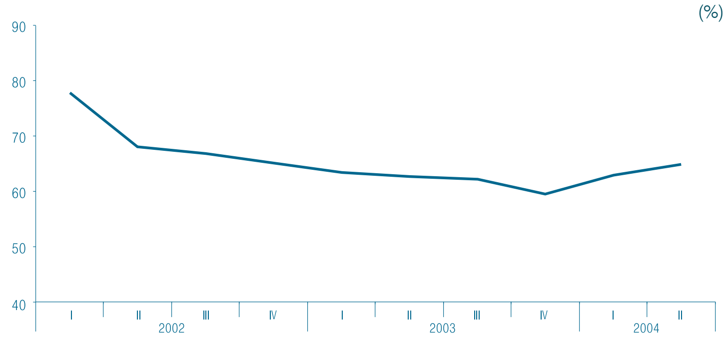
[3] According to the methodology for compiling external debt statistics, this reclassification corresponds to the reporting of intracompany loans as debt.

Following the buy-back of Brady bonds in July, the amount of government debt went down by almost EUR 500 million on December 2003. The higher gross external debt since early 2003 was entirely due to increased private sector liabilities with both private companies (including the transaction with M-tel) and banks contributing to this growth.

...the higher gross external debt was entirely due to the private sector ...

Chart 40

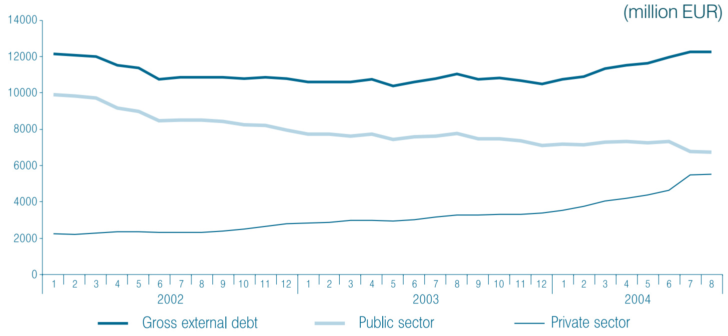
Gross External Debt/GDP on an Annual Basis



Source: BNB, NSI.

Chart 41

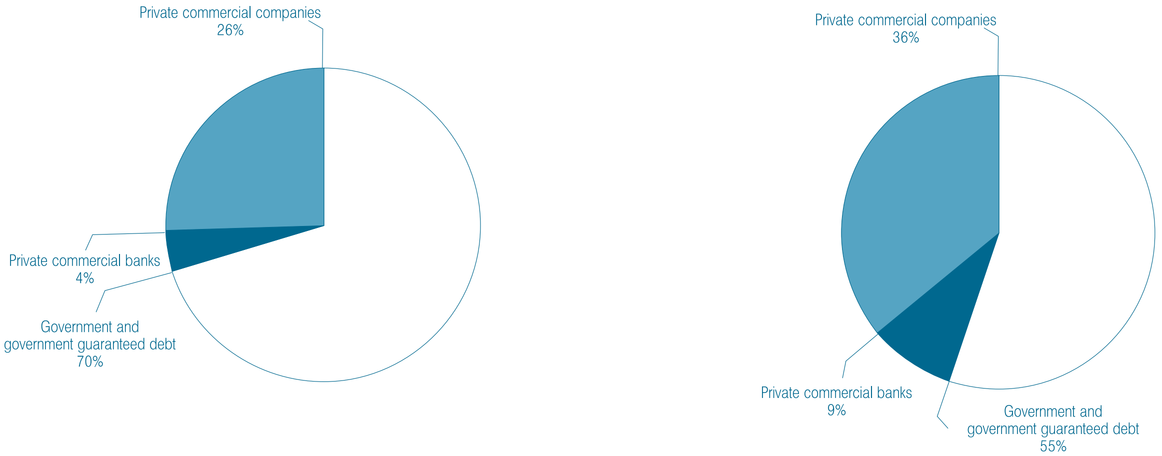
Gross External Debt



Source: BNB.

Chart 42

External Debt Structure



August 2003

August 2004

Source: BNB.

Nonresidents' deposits contributed most to the increase in commercial banks' debt, with resources extended to Bulgarian banks by foreign owners comprising a significant share. The transaction on transferring M-tel ownership contributed most significantly to the increased commercial companies' debt in the *Other loans* item.

Table 4
Debt Dynamics of Private Commercial Banks and Private Commercial Companies

	August 2003 (million EUR)	August 2004 (million EUR)	Change (%)	Contribution (percentage points)
Private commercial banks	**442.8**	**1083.1**	**144.6**	
Loans	156.2	397.4	154.4	54.5
Bonds	0.0	0.0	-	-
Nonresidents' deposits	286.6	685.7	139.2	90.1
Private commercial companies	**2837.2**	**4436.0**	**56.4**	
Intracompany loans	1008.5	1413.5	40.2	14.3
Other loans	805.6	1741.8	116.2	33.0
Commercial loans	1020.3	1277.8	25.2	9.1
Bonds	2.9	2.9	0.0	0.0

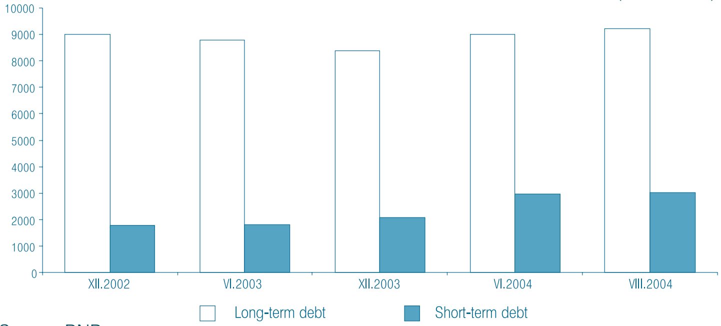
Source: BNB.

More than half of the nominal increase in external debt since early 2004 was attributable to the short-term debt. The increase in the short-term debt of commercial banks and commercial companies was high (40 percent and 30 percent respectively), but the nominal increase in the private nonfinancial sector debt was even higher. Approximately 42 percent of the short-term debt was comprised of trade credits which are supposed to be related to imports of goods. More than 70 percent of the external debt of commercial companies was denominated in euro and it may be assumed that the foreign currency structure of commercial credits is similar. This means that foreign currency risk related to servicing commercial credits was reduced. Commercial credit service will primarily depend on the opportunities for realizing imported goods in the domestic market. According to the NSI business survey as of October the business climate for retail trade proves optimistic and more sales are expected in the following months.

If short-term intracompany loans other than trade credits are added to trade credits, the share of these two categories in the short-term debt will be 62.5 percent. Since short-term intracompany loans are claims on resident companies by their parent companies, there are more opportunities for these obligations to be rescheduled and restructured in case of possible liquidity shortages than for the obligations between unrelated economic agents. Since approximately two-thirds of the short-term debt is comprised of obligations bearing low risk of any possible problems associated with their service, it may be concluded that currently the increase in short-term debt does not threaten the balance of payments sustainability.

Chart 43
Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Since early year credits extended by nonresidents to the nonfinancial sector amounted to USD 2.5 billion, 63 percent with floating interest rate. This could put pressure on the credit servicing in case of faster than expected increase in international interest rates. On the other hand, 85 percent of these newly disbursed credits are denominated in euro which reduces the foreign exchange risk related thereto. In August private sector debt reached 52.5 percent of the annual exports of goods and nonfactor services, while in most of 2003 it ranged within 33 and 35 percent. Gross external debt service as a share of exports of goods and nonfactor services slightly worsened to reach 18.3 percent between January and August 2004 against 16.3 percent for the corresponding period of 2003. The debt service as a share of GDP exhibited similar dynamics. Developments in these indicators suggest that debt dynamics should be carefully monitored due to a possible threat of nonservicing the obligations.

Until 2007 government and government guaranteed debt is expected to remain practically unchanged in nominal terms and to fall as a share of GDP. Over the same period the private sector debt is expected to grow at rates lower than the currently registered ones. Based on the forecast for maintaining economic growth high in the following years (over 5 percent) and the estimates of international market interest rates, it may be concluded that private sector external debt does not threaten the balance of payments stability in the medium-term run.

Based on the forecasts about the international environment, the current account deficit in the fourth quarter is expected to reach approximately EUR 900 million. The current account is expected to worsen in the first quarter of 2005 compared with the corresponding period of 2003 as the trade balance deficit continued to increase. The current account deficit is estimated to amount a little under EUR 600 million. Two-thirds of the total amount of earnings from privatization of energy distribution companies is expected to be received in the fourth quarter of 2004 and the rest in the first quarter of 2005. An inflow of EUR 250 million per quarter is estimated for the nonprivatization component of foreign direct investments. Given the ongoing processes this estimate is characterized as relatively conservative and earnings for the review period may be higher than estimated.

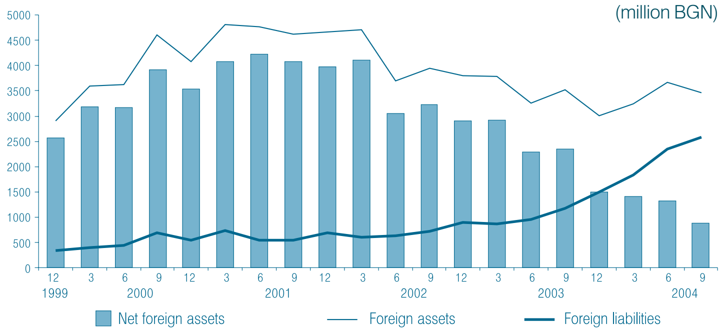
Commercial Bank Intermediation

Over 2004 the structure of financial flows between the external and banking sectors changed. On the one hand, in 2003 banks used the fall in foreign assets to increase their liquid resources, while in 2004 this process has abated and has been losing its role as a source of funds for the banking system. Between January and September 2004 commercial bank foreign assets posted an increase of BGN 464.8 million against a fall of BGN 282.5 million in the corresponding period of 2003.[4]

On the other hand, the external sector started providing resources for the banking sector mostly through borrowed funds from nonresidents. Banks' foreign liabilities significantly increased reflecting to a great extent the high interest rate differential between domestic and international interest rates. Despite the relatively small share of obligations to nonresidents in commercial banks' liabilities, their role as a source of funds substantially rose. Over the third quarter banks' foreign liabilities grew by BGN 230.1 million, a rise of BGN 1081.9 million since the beginning of 2004. The annual growth rate by end-September was 119.9 percent.

Chart 44

Foreign Assets and Foreign Liabilities of Commercial Banks



Source: BNB.

...banks' foreign liabilities significantly increased...

Table 5

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

(million BGN)

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

Source: BNB.

[4] One-off effect as a result of the transaction with M-tel.

The bulk of banks' resources were borrowed in the form of deposits of households and corporations. In addition to higher incomes and confidence in the banking system, the increased deposit base reflected also enhanced lending, insofar a portion of disbursed loans returned back to banks in the form of deposits. Banks used most of borrowed funds to extend lending. Since early 2004 banks' claims on households and corporations increased by BGN 1304.9 million and BGN 1842.2 million respectively and in the third quarter, by BGN 503.8 million and BGN 690.9 million respectively.

Commercial banks' relations with other economic sectors are displayed in Chart 45[5]. Over the third quarter the trends in financial relations of banks with corporations and households were sustained. Corporations' indebtedness went up, while households continued to be a net source of funds for the banking system irrespective of the rapid increase in their obligations. Despite the increased foreign assets, consistent with seasonally high banking liquidity, over the third quarter the external sector was a net source of resources for banks, reflecting the significant rise in funds borrowed from nonresidents.[6]

Redistributive Role of the Consolidated State Budget

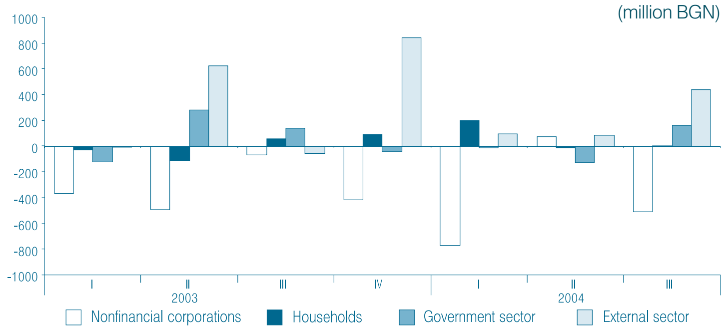
The General government sector redistributes funds between major economic sectors through the consolidated fiscal program.[7]

During the second quarter the government withdrew its deposits from commercial banks[8] and decreased financial sector liquidity given the positive net government securities transactions (BGN 59.8 million). Accumulated budget surplus reflected also the withdrawal of liquidity from the nongovernment nonbank sector.

Deposits of the government and budget-supported organizations at the BNB Issue Department by end-September totaled BGN 4732 million. The decrease by BGN 169 million on June reflected the repurchase of government

Chart 45

Net Financial Flows of Commercial Banks (quarterly)

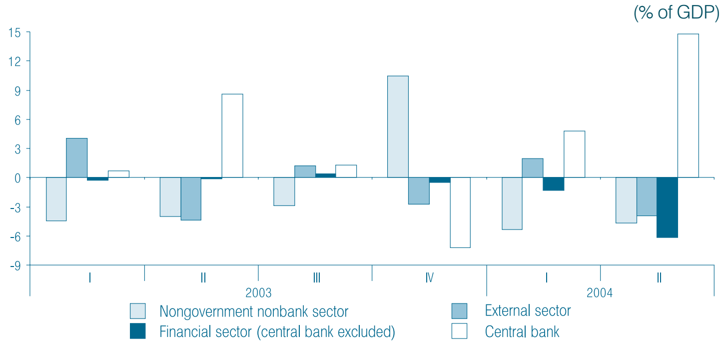


Source: BNB.

...commercial banks' relations with corporations and households were sustained...

Chart 46

Influence of Consolidated State Budget on Other Sectors Liquidity in 2003 and in the January – June 2004 Period (Quarterly)



Source: MF, BNB.

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

[6] For the purposes of the analysis one-off effects of late June 2004 resulting from the ownership restructuring of a telecommunications company are taken into account (see *Economic Review*, August 2004, p. 25, footnote 10).

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

[8] See *Economic Review*, August 2004, p. 27.

securities on Bulgaria's external debt in late July and regular debt interest payments in the same month.

Monetary Aggregates

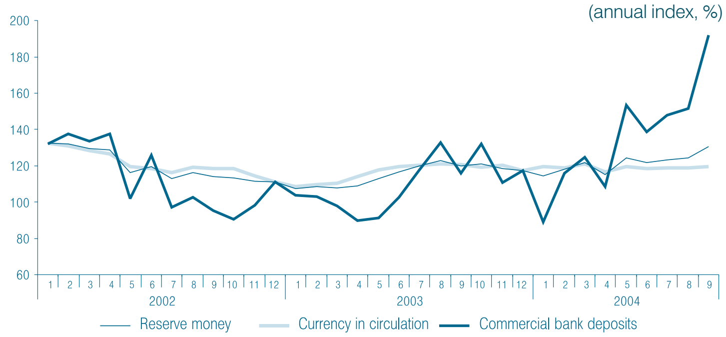
During the third quarter of 2004 reserve money continued to increase at high rates. The reported monetary base increase of 30.5 percent by end-September exceeded by almost nine percentage points that in June. Commercial banks' deposits contributed most significantly to the accelerated reserve money growth. In September alone banks' deposits posted a 92 percent growth on an annual basis. This was partly attributable to the amendments to Regulation No. 21 on the minimum required reserves maintained with the Bulgarian National Bank by banks, effective as of 1 July 2004. In accordance with these changes banks have also to maintain minimum required reserves on long-term borrowed funds (over two years) in the amount of four percent. Chart 8 illustrates the effect of extending the deposit base by including balances on commercial bank accounts with the BNB. Their average monthly amount in July exceeded by approximately BGN 92 million that of June, with BGN 55 million of that amount resulting from the change in the said regulation. However, dramatically increased bank deposits by end-September may not be explained by the requirement to allocate minimum required reserves on long-term deposits.

Bank reserves dynamics displayed a clearly pronounced calendar effect: at the end of the month commercial banks' deposits with the central bank went up. This effect was very strong after June 2004 and was ascribable to the measures enforced in fulfillment of liquidity requirements to banks acting as primary dealers of government securities. A similar high in bank reserves was also reported at the end of August, and after that deposits daily values returned close to average. However, in October bank deposits stayed high reflecting probably the enforcement of another important change in the regulation on minimum required reserves: as of 1 October just 50 percent (instead of 100 percent) of cash balances and ATM funds will be included in determining bank reserves. As shown in Chart 48 the nominal effect of this measure is stronger compared with the four percent required reserves

...in September reserve money rose by 30.5% on an annual basis, reflecting the dramatically increased deposits of commercial banks...

Chart 47

Reserve Money and Its Components



Source: BNB.

on long-term deposits: in October banks kept BGN 152 million more on average on their accounts with the BNB than in September.

Unlike commercial banks' deposits which were strongly volatile, currency in circulation, another component of reserve money, maintained a steady growth rate of about 20 percent on an annual basis. This reflects the enhanced demand for liquidity by households and companies, a result of the favorable macroeconomic conditions.

In September broad money (M3) rose by 3.3 percent on end-June, reflecting entirely M1 growth. Quasi-money contribution in money supply growth was negative due to decreased foreign currency deposits following the finalized transaction on M-tel ownership transfer and the 2003 dividend payment by the Bulgarian Consolidation Company. Overnight deposits retained their prevalent bearing on the increase of money, reflecting the dynamic processes in the banking sector and deepening financial intermediation.

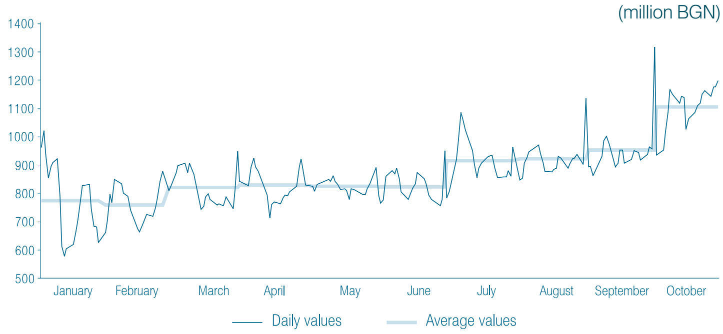
An indicator of the increasing role of banks is the velocity of noncash payments dynamics, measured by the number of newly issued debit cards and installed ATMs and POS terminals. Between January and September 2004, for instance, 886,000 new debit cards were issued, an increase by almost 90,000 than in 2003. As the issue of debit cards requires maintaining current accounts with commercial banks, extensive card payments were a key factor behind increasingly growing overnight deposits.

The share of lev deposits continued increasing in the structure of overnight deposits: from 65 percent by the end of the first half of 2004 to 68 percent at the end of September. Lev overnight deposits were the fastest growing component of the deposit base: by 37 percent on the 2003 third quarter against the average deposit growth rate of 25 percent.

Between July and September the values of money multiplier indicated significant fluctuations. In August the *quasi-money to overnight deposits* ratio dramatically went down, reflecting the decline by BGN 457 million (38 percent on July) in foreign currency deposits of nonfinancial corporations. This was attributable primarily to the transfer of funds by the Bulgarian Consolidation Company, worth BGN 349 million, to the Ministry of Finance accounts. De-

Chart 48

Commercial Banks' Deposits



Source: BNB.

...Quasi-money contribution in money supply growth was negative due to decreased foreign currency deposits ...

Table 6

	2001	2002	2003	1.X.2004
Total number of ATMs	642	829	1222	1653
Total number of POS terminals	1968	2554	3754	5883
Total number of cards issued ('000)	990.4	1614.1	2410.6	3296.7

Source: BORICA.

creased quasi-money as a result of withdrawing a sizable amount of foreign currency deposits had a negative effect on the money multiplier, which went down from 3.39 in July to 3.19 in August. Given the high value of the monetary base by end-September, the money multiplier indicated a new fall to 3.12, a record low from end-2002.[9]

Despite the buoyant economic growth during the second quarter of 2004, the gap between the M3 growth adjusted by GDP real growth on the one hand, and inflation on the other hand, has increased. Faster money supply growth has not prompted high inflation yet, since the bulk of disbursed bank loans (underlying the monetary expansion) were used for imported goods and therefore a potential pressure on the price level may come only from the sector of nontradable goods and services. Such indications have already emerged as a result of the boom in mortgage lending since early year. Based on NSI data the average housing market prices rose by 12 percent from the second quarter. This growth is not reported in the general consumer price index, as it includes rents which stayed relatively stable.

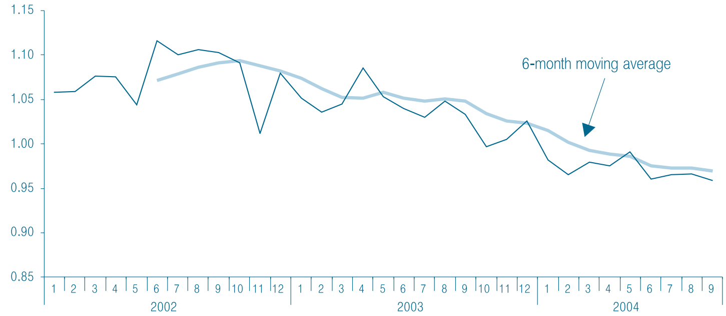
The velocity of money circulation is another important indicator characterizing the state of the financial system. Following the introduction of the currency board this variable has followed a downward trend with clearly pronounced seasonality. If the velocity of currency circulation is considered as a behavioral parameter in the demand for real balances, the fall may be interpreted as an increase in the part of real income which households and corporations prefer to keep in the form of money. Increased preferences to liquidity were clearly pronounced irrespective of the fact whether money is considered in a narrow or broad context. The analysis of velocity of broad money circulation suggests that the downward trend complies with the willingness of households and companies to hold more and more of their income in monetary instruments (cash and bank deposits). This is explained by the fact that deposits are the major form of saving in the Bulgarian economy. Rapid money supply growth over 2004 directly reflects commer-

[9] It should be taken into account that the fall in money multiplier in September and partly in August reflected primarily the specificity of reporting the compliance with the requirement for primary dealers' liquidity.

...money multiplier declined to 3.12 in September...

Chart 49

Currency in Circulation to Overnight Deposits Ratio

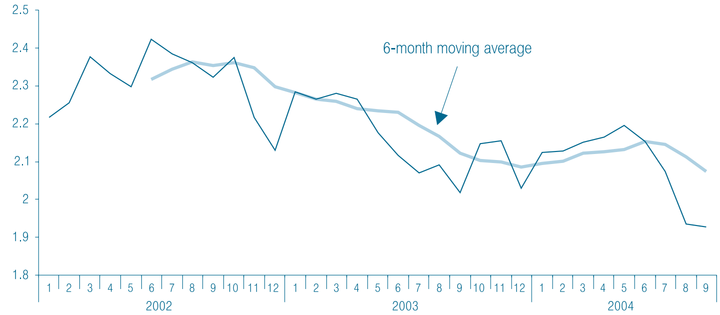


Source: BNB.

...faster money supply growth compared with the real GDP has not exerted inflationary pressure yet...

Chart 50

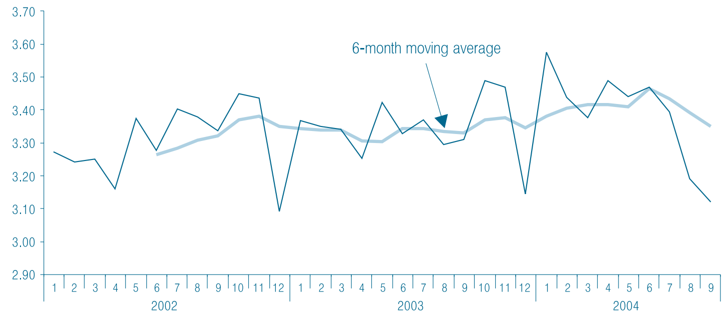
Quasi-money to Overnight Deposits Ratio



Source: BNB.

Chart 51

Money Multiplier (the *M3 to Reserve Money* Ratio)



Source: BNB.

...the *credit to the nongovernment sector to GDP* ratio reached 31.8 percent in the second quarter...

cial bank enhanced lending. Claims on non-government sector as a share of GDP rose from 23.4 percent in June 2003 to 31.8 percent in the same month of 2004.

In contrast to the first half-year when foreign currency deposits contributed most sizably to M3 growth, in the third quarter they affected adversely money supply growth. However, lev deposits continued growing at high rates partly offsetting the negative effect of foreign currency deposits on quasi-money dynamics.

Over the third quarter households provided the bulk of lev resources to the banking system and their contribution to time lev deposits growth accounted for 70 percent and to deposits redeemable at notice, 74 percent. Between July and September household time deposits in foreign currency increased by BGN 140 million and deposits in euro by BGN 177 million. The share of euro-denominated household time deposits in total foreign currency deposits grew from 39 percent (in March) to 45 percent (in September). Low interest rates and declining US dollar exchange rate against euro made investment in deposits denominated in US dollars unattractive and the interest in this currency has seriously subdued.

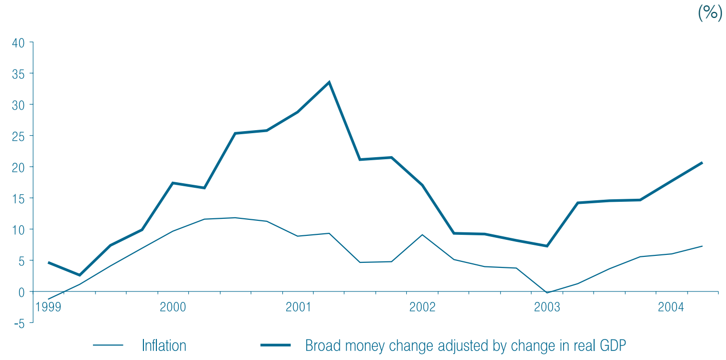
Chart 52

Annual Growth Rate of Reserve Money and M3

Source: BNB.

Chart 53

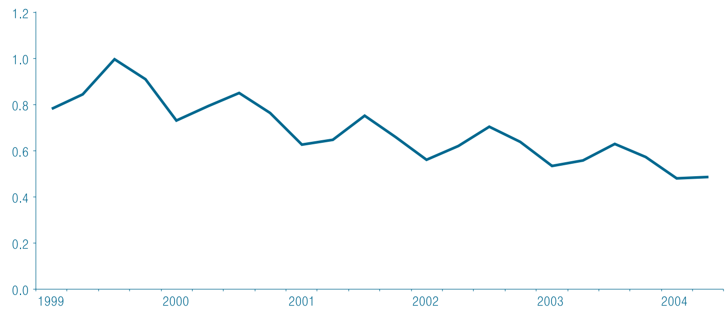
Broad Money Growth Adjusted by GDP Change and Inflation



Source: BNB, NSI.

Chart 54

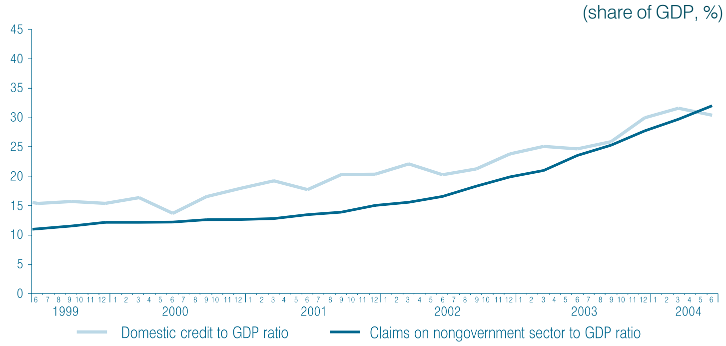
Currency Circulation Velocity



Source: BNB.

Chart 55

Domestic Credit



Source: BNB.

In September interest rates on one-month deposits in levs and US dollars slightly went up compared with June: from 3.11 percent to 3.29 percent and from 1.7 percent to 1.78 percent respectively. In the same period the average interest rate on deposits in euro fell from 2.15 percent to 2.05 percent. The increased interest rates on lev deposits reflect the banks' competition for attracting deposits in national currency. This refers mostly to smaller banks, with some of them offering two or three times higher interest rates than those offered by large banks.

Compared with June the interest rate distribution on household one-month lev deposits experienced two significant changes. First, the differential between the lowest and the highest interest rates increased from 4.5 percentage points to 5.3 percentage points. Second, in contrast to June when most banks offered deposit rates between two and three percent, in September the number of these banks almost equaled the number of banks offering interest rates between three and four percent.

Interest rates offered on deposits denominated in euro and US dollars diverged insignificantly. Raised international interest rates in US dollars have not affected the domestic market yet, consistent with the low demand for loans denominated in US dollars by companies and households, and the lack of banks' interest in attracting funds in US dollars.

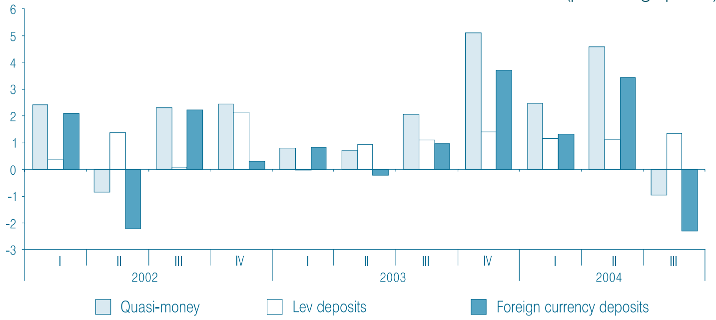
The forecast for the fourth quarter of 2004 and the first quarter of 2005 is for reserve money growth to slow down and for broad money to continue growing by approximately 23–25 percent on an annual basis. This growth will reflect the money multiplier dynamics which is an indicator of the banks' lending. Lev deposits are expected to increase at a faster pace than foreign currency deposits, with overnight deposits again increasing most significantly. Most likely interest rates will stay stable with a slight increase in interest rates on lev deposits.

...deposit rates stayed stable...

Chart 56

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

(percentage points)

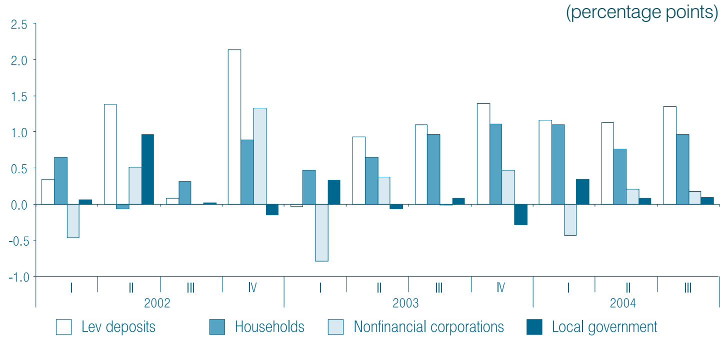


Source: BNB.

Chart 57

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

(percentage points)

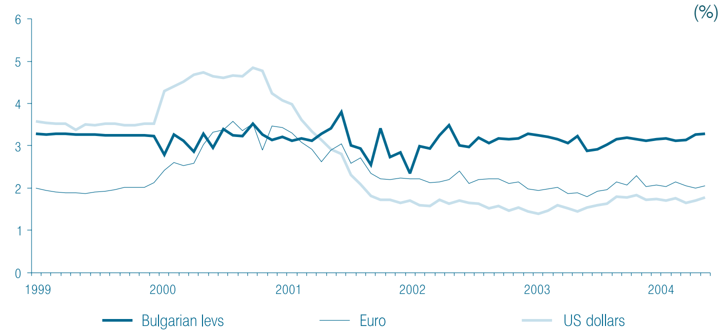


Source: BNB.

Chart 58

Time Deposit Interest Rates

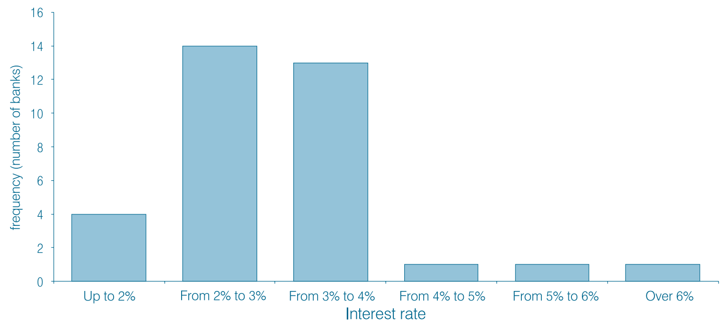
(%)



Source: BNB.

Chart 59

Interest Rate Distribution on Household One-month Lev Deposits



Source: BNB.

Credit Aggregates

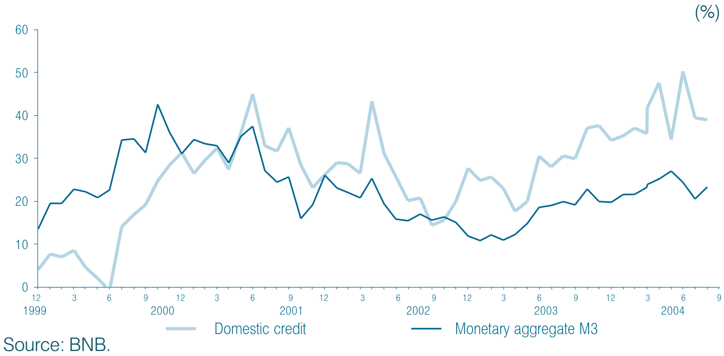
Domestic credit continued to increase at high rates. By the end of September 2004 domestic credit posted an annual increase of BGN 3356.5 million (38.7 percent) to reach BGN 12,037.2 million. This increase was entirely attributable to the claims on nongovernment sector which rose by BGN 4178.9 million (49.3 percent) on an annual basis.

...Domestic credit continued to increase at high rates...

Chart 60

Annual Growth Rate of Money Supply and Domestic Credit

(%)

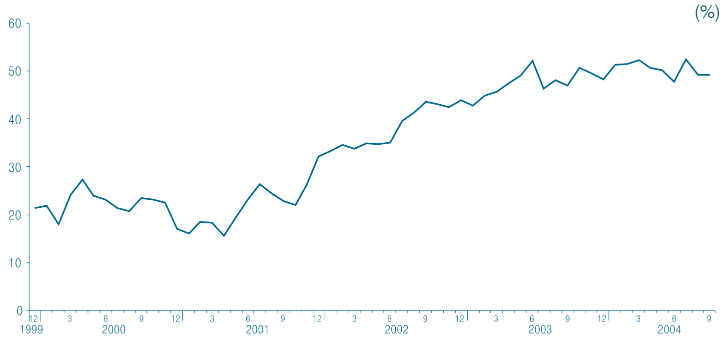


Source: BNB.

Chart 61

Annual Growth Rate of Claims on Nongovernment Sector

(%)



Source: BNB.

Table 7

Claims on Nongovernment Sector (Quarterly)

(%)

	Annual growth rate							Growth on the year's start	Structure as of 30 June 2004
	2003				2004				
	I	II	III	IV	I	II	III		
Claims on nongovernment sector, including	45.7	52.1	47.0	48.3	52.3	47.8	49.3	33.4	
claims on nonfinancial corporations	42.0	46.8	37.7	37.1	41.9	36.3	40.5	27.4	67.7
claims on households and nonprofit institutions serving households	54.4	68.4	73.0	80.7	84.5	79.6	76.4	52.2	30.1
claims on financial corporations	124.8	91.2	150.3	146.8	86.0	107.0	25.8	9.9	2.2

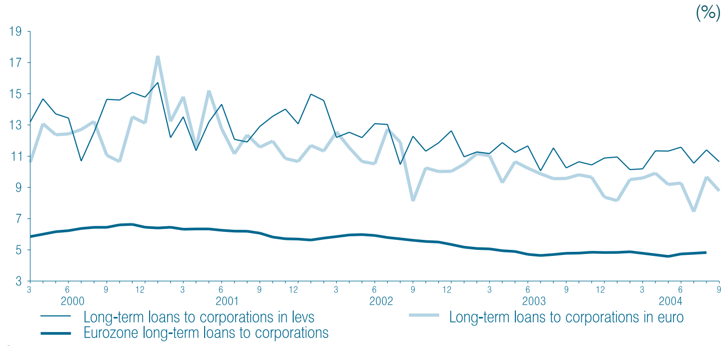
Source: BNB.

Over the third quarter claims on the nongovernment sector continued to increase dynamically, with the annual growth rate almost matching previous months' levels. On the one hand, this resulted from the fact that demand for credit by corporations and households stayed high. Credit supply by banks contributed significantly to this effect, consistent with the stable macroeconomic conditions and enhanced banking competition.

Chart 62

Interest Rates on Long-term Loans in Levs and Euro

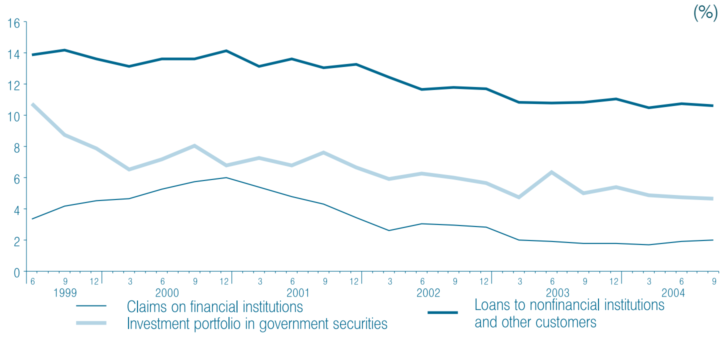
(%)



Source: BNB.

In the following months these factors will be critical for lending, and therefore the loan growth rates are likely to sustain in the short run. The expected depletion of available resources did not entirely realize, associated to a great extent with the inflow of residents' resources. However, in the following months the growth in claims on nongovernment sector may start to gradually slow down due to the exhaustion of the low base effect and to the enforcement of amendments to banking regulations. As a result, the rate of growth is expected to gradually slow down to 45–46 percent by end-2004 and to 43–45 percent by the end of the first quarter of 2005. Since the rates of credit expansion stay high, the BNB will effectively enforce a set of conditional measures coordinated with the IMF, and will seek for additional measures to slow down the speed of extending credits in order to ensure the adequate quality of banks' credit portfolios.

Chart 63
Commercial Banks' Assets Yield



Source: BNB.

No essential changes occurred in lending rates during the third quarter. They varied around the level at which lending rates steadied in early year; in the following months they are expected to sustain their levels. The opportunities for further relax in loan terms are reduced by a possible increase in the cost of borrowed funds and banks' investment expenditures. On the other hand, the enhanced banks' competition is unlikely to allow for a sizable increase in lending rates.

...no essential changes occurred in lending rates...

3. Economic Activity

In the second quarter of 2004 Bulgarian economic growth reached six percent year-on-year. Gross capital formation, including change in inventories, contributed most to this growth. Consumer demand sustained its major role in growth, albeit with slower growth. Foreign trade balance had a negative effect on overall growth, but slower import growth was a positive sign and comparatively high export growth rates were preserved.

...in the second quarter Bulgarian economic growth reached six percent...

Chart 64

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

(percentage points)

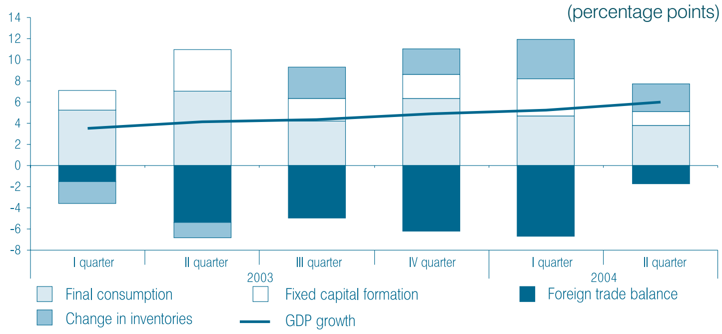


Table 8

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	II quarter
Final consumption	**5.9**	**8.0**	**5.4**	**7.0**	**5.2**	**4.2**
Individual consumption	6.8	8.5	5.4	6.5	4.9	4.3
Final household consumption expenditure	6.3	9.1	5.1	5.4	5.5	4.9
Final consumption expenditure of nonprofit institutions serving households	4.4	4.8	4.9	0.7	4.4	1.5
Final government consumption expenditure	12.4	3.8	8.3	14.7	0.1	-1.2
Collective consumption	-1.9	3.9	5.0	10.2	6.9	3.7
Gross fixed capital formation	11.6	21.2	13.3	10.0	21.4	6.3
Reserve change	-82.4	-52.7	1643.0	213.4	902.8	228.6
Balance (exports – imports)						
Exports of goods and services	13.2	11.7	4.0	5.3	8.0	10.9
Imports of goods and services	13.8	18.3	13.3	14.0	17.7	11.3
Statistical discrepancy						
GDP	3.5	4.2	4.4	4.9	5.3	6.0

Source: NSI.

Behavior of Households

...consumer demand growth rates slowed down...

Between January and August 2004 household budget data show final consumption *per* household member growing by 3.8 percent in real terms on the prior year when the growth was 6.3 percent. Expenditure on food, healthcare and communications contributed most significantly to consumption growth. Spending on furniture and home maintenance increased more slowly compared with the same period of 2003. Growth in spending on clothing and footwear accelerated.

Table 9

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	II quarter	July – August
Consumer expenditure, total	6.7	6.3	5.1	2.9	4.1	3.1	4.2
Food	6.8	2.4	2.8	-0.9	2.4	2.9	1.1
Alcoholic drinks and tobacco products	1.1	8.4	11.7	9.5	-5.9	-10.4	-7.4
Clothing and footwear	0.2	6.1	9.6	7.1	10.7	7.7	13.1
Houses, water, electricity and fuels	-0.9	6.1	5.2	-7.0	-0.3	0.2	2.9
Furniture and home maintenance	2.8	24.6	20.4	25.2	14.2	-0.8	2.8
Healthcare	14.3	7.6	1.2	13.4	9.0	20.1	22.5
Transport	12.0	21.5	2.7	5.8	5.4	-2.2	12.9
Communications	20.2	21.3	18.5	18.8	17.2	9.2	8.4
Leisure, entertainment, education and arts	16.5	10.0	8.3	21.1	10.6	6.1	8.0
Miscellaneous goods and services	8.4	7.9	4.9	12.2	6.2	11.8	12.6

Source: NSI.

Retail trade data show higher consumer demand, retail sales revenue growing by 13 percent between January and August year-on-year. Sales of household goods and equipment grew at high rates. In compliance with the household budget data, trade in clothing and footwear, as well as in medical goods and cosmetics, was reported to intensify.

Table 10

Dynamics of Retail Sale Revenue

(on corresponding period of previous year, %)

	2003				2004		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	July – August
Retail trade, repair of personal items and home equipment	3.9	6.3	6.8	7.5	12.9	13.4	13.8
Food, drink and tobacco products	2.0	5.5	6.3	6.4	11.2	6.4	4.6
Pharmaceutical and medical goods, cosmetics and toiletry	-0.5	-4.4	-2.0	0.1	11.6	15.0	11.0
Textiles, clothing, footwear and leather products	3.6	5.1	4.2	5.4	9.3	15.9	8.1
Household goods and equipment	16.0	18.9	18.3	18.1	15.3	20.3	25.0

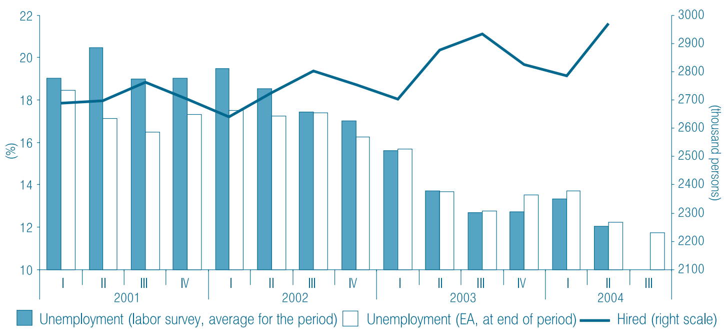
Source: NSI.

Increased employment and credit to households were the main drivers of rising consumer demand. NSI labor force survey data show that in the second quarter employment rose by 3.3 percent compared with the corresponding quarter of 2003, while unemployment dropped from 13.7 percent to 12.3 percent. The bulk of new jobs were created in the private sector. The Employment Agency reported the number of registered unemployed to have dropped to 434,737 persons, or 11.7 percent of the economically active people.

...increased employment and ensuing income growth boosted consumer demand and credit demand by households...

Chart 65

Status of Economically Active People



Source: NSI, Employment Agency.

Table 11
Employment and Income Dynamics

(%)

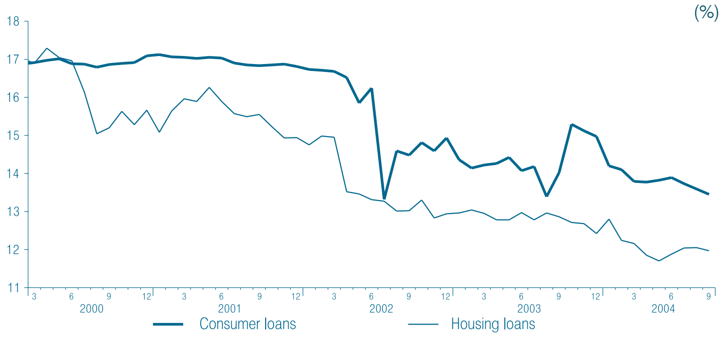
	2003				2004		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Employed							
Share on corresponding quarter of previous year	5.4	7.9	7.8	6.0	5.7	5.3	4.9
Share on previous quarter	3.6	3.6	0.6	-1.9	3.4	3.2	0.2
Hired (labor survey data)							
Share on corresponding quarter of previous year	2.5	5.5	4.7	2.6	2.9	3.3	
Share on previous quarter	-1.8	6.3	2.0	-3.7	-1.5	6.7	
Pay, real increase in purchasing power on the corresponding quarter of prior year	-3.0	6.0	3.1	11.5	14.1	7.7	

Source: NSI.

Personal income continued rising and according to System of National Accounts data, total amount of wages and salaries posted a 7.7 percent increase in real terms on an annual basis. Between January and September 2004 liabilities of households and nonprofit institutions serving households to the banking system grew by BGN 1.305 billion on the corresponding period of 2003, while their claims rose by BGN 1.963 billion, *i.e.* households continued to be net lenders to the economy. By end-August 2004 households' obligations to the banking system amounted to 45 percent of their assets, and as it is known, households have other financial assets of growing importance in recent years.[10] Therefore, credit demand may stay high with a significant volume of new loans in absolute terms. Adequate risk management by banks and prevention from worsening the quality of their claims on households are critically important for the financial stability given the boosted financial intermediacy.[11]

The favorable trends in incomes and employment maintained household loan demand high. Loan demand was additionally boosted by interest rates dynamics of consumer and housing loans which followed a gradual downward trend. On the other hand, banks were try-

Chart 66
Interest Rates on Loans to Households



Source: BNB.

[10] Data from a UniCredit Group survey of 2003, conducted in Central and Eastern Europe, show that foreign currency and deposits comprised some 92.5 percent of Bulgarian households' financial wealth. The remaining 7.5 percent were, *inter alia*, securities, interest in mutual funds and pension funds.

[11] The Central Credit Register system allows the banks to take informed lending decisions. The Central Credit Register includes all loans irrespective of their amount with the exception of: loans to the government, loans to the BNB and overdrafts on debit cards in the amount up to BGN 1000 (provided they are classified as standard).

ing to expand their positions in this credit market segment by offering new credit products and easing noninterest credit terms. The combined effect of these two factors predetermined the high growth rate of claims on households. Despite the slowdown in the last few months, claims on households continued increasing at a fast pace, posting a 76.4 percent growth on an annual basis by September 2004.

Household budget data show that indebtedness of the households from the last decile (*i.e.* those with the highest income *per* household member) grew fastest. Between January and August they received 51.8 percent of all consumer loans. The ratio of debt service to average household income has stayed stable at 2.8 percent since October 2003. Concurrently, the share of borrowed loans and credits in overall household income continued rising, averaging 6.8 percent for July and August.

Extension of housing loans was particularly buoyant. As distinct from consumer loans which slowed down, housing loans increased, posting a 126.3 percent annual rise and their share in the total household loans rapidly grew to some 20 percent.

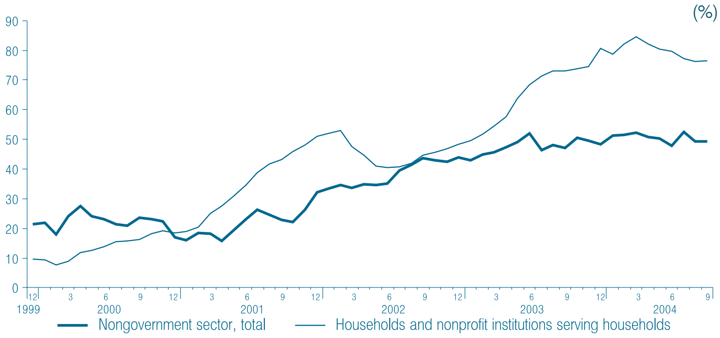
In the last quarter of 2004 and the first quarter of 2005 the enhanced consumer demand is expected to retain its contribution to economic growth. Household consumer expenditure will grow by three to four percent annually.

Government Finance and Consumption

Over the second quarter the contribution of government consumption to GDP growth amounted to 0.27 percentage points. Collective consumption rose by 3.7 percent, while growth in final household consumption spending was negative, -1.2 percent.

Chart 67

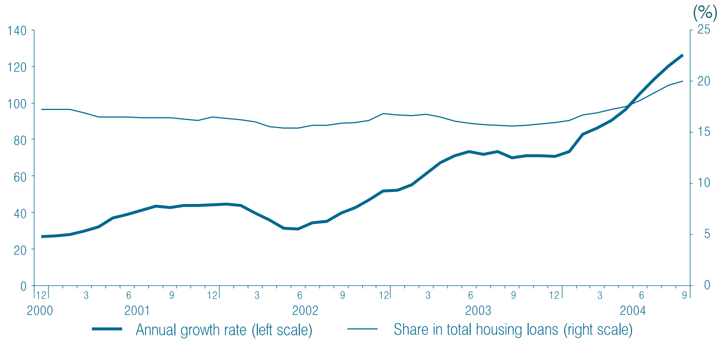
Claims on Households and Nonprofit Institutions Serving Households (Annual Change)



Source: BNB.

Chart 68

Housing Loans



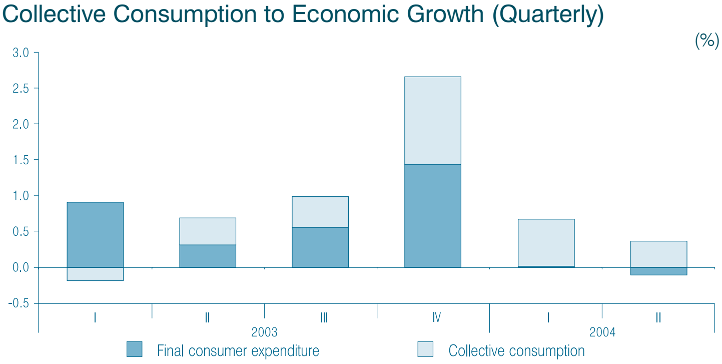
Source: BNB.

...household consumer expenditure will grow by three to four percent in the fourth quarter of 2004 and in the first quarter of 2005...

...contribution of government consumption stayed low...

Chart 69

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



Source: MF, BNB.

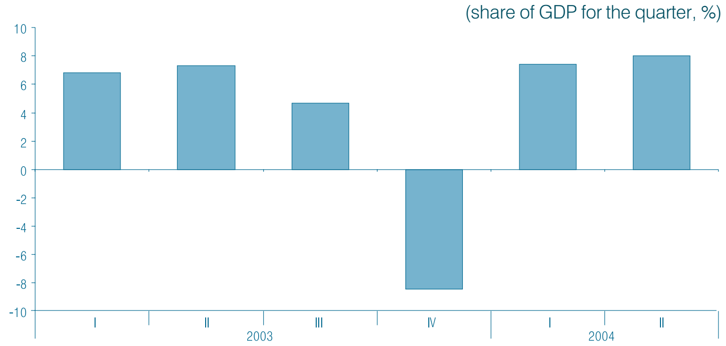
...over the second quarter primary surplus accounted for eight percent of GDP...

Over the second quarter primary surplus accounted for eight percent of GDP and yet, as in the first quarter, it was higher than that in the corresponding period of 2003. This was attributable to the steady and high revenue growth, and to the low noninterest expenditure growth in the first half of the year. Revenue increased by 14.3 percent and expenditure by 7.5 percent on the corresponding quarter of 2003. Execution of the government budget program for the first half of 2004 confirmed our forecast that the government would not face difficulties in implementing the budget by year-end.

Chart 70

Primary Balance in 2003 and 2004

(share of GDP for the quarter, %)



Source: MF.

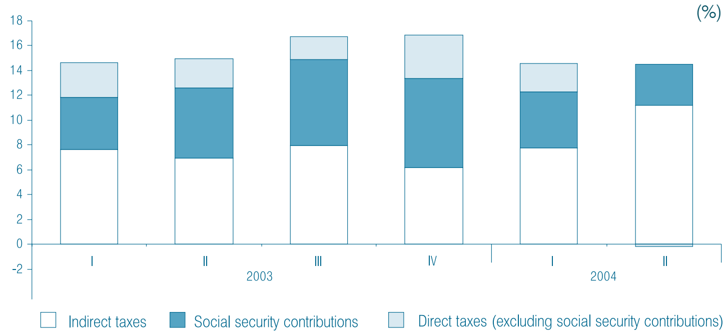
...indirect taxes contributed mostly to the overall revenue growth ...

Indirect taxes contributed mostly to the overall revenue growth (11.2 percentage points), while the effect of social insurance contributions and direct taxes significantly decreased. VAT revenue played a key role (7.6 percentage points) in overall growth of indirect taxes, followed by excise duties (3.3 percentage points). Higher revenue from these two taxes reflected the increase in excise duty on alcohol and fuel at the year’s start, as well as Bulgaria’s increased imports in the second quarter of 2004 (18.6 percent in euro from the corresponding period of the previous year).

Chart 71

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

(%)



Source: MF, BNB.

In the second quarter of 2004 the structure of expenditure changed compared with 2003. Current noninterest expenditure stayed higher than in 2003 tending to increase. The contribution of social and health insurance expenditure continued to rise which is indicative of rising government social commitment.

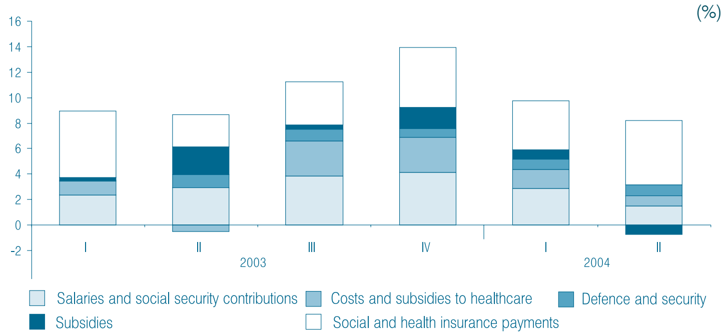
...government expenditure is expected to grow faster in the last two months of 2004...

Government expenditure is expected to grow faster till year-end, retaining a surplus of some one percent of GDP. Consequently, the contribution of government consumption to GDP growth will reach some two percent.

Chart 72

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

(%)



Source: MF, BNB.

Behavior of Firms

Gross capital formation played a major role in economic growth. Fixed capital investment slowed down dramatically; however, this was offset by increased inventory build-up which added considerably to overall growth. Accelerated inventory accumulation did not signal difficulties in output sale or a drop of demand since neither manufacturing, nor trade reported any excess inventories of output and goods. Most likely the change in inventories reflects buoyant construction activity where the gross output increased by seven percent year-on-year. Sizable volume of unfinished construction works are expected to be subsequently reported as fixed capital investment, particularly in the services sector. The April 2004 investment survey shows that industrial managers reported a slowdown in investment, although output and assessments of the economic situation were satisfactory.

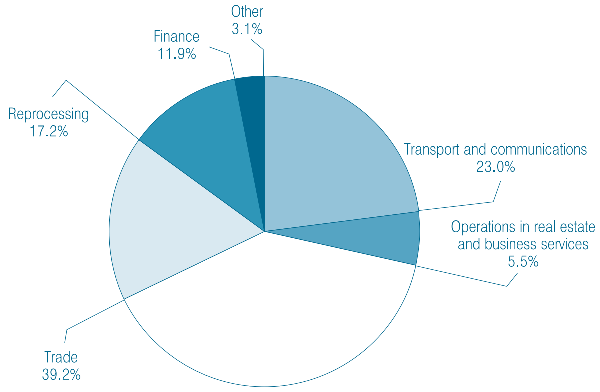
Enhanced investment by corporations was accompanied by rapid lending expansion. Claims on nonfinancial corporations continued rising at high rates (40.5 percent by the end of the third quarter on a year earlier basis. Credit demand by companies stayed high owing to the stable macroeconomic environment and the optimistic expectations associated with favorable corporate prospects consistent with growing orders and the views about the business environment in manufacturing.

...investment contributed mostly to growth...

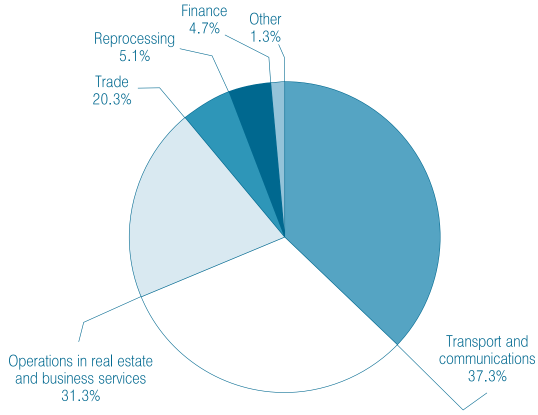
Chart 73

Structure of Foreign Direct Investment by Industry in the First and Second Quarters of 2004

(%)



January – March 2004



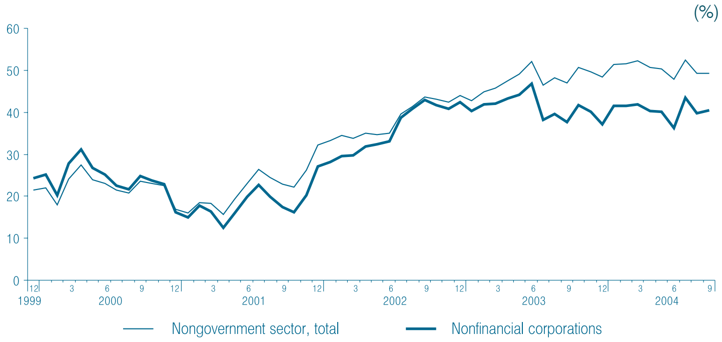
April – June 2004

Source: BNB.

Chart 74

Claims on Nonfinancial Corporations (Annual Change)

(%)



Source: BNB.

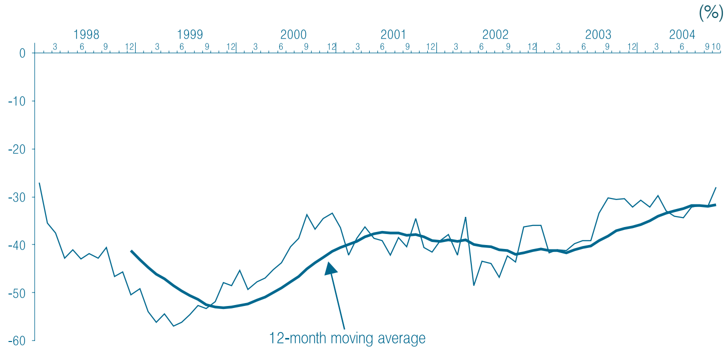
Companies' need for long-term finance and banks' greater willingness to lend for longer periods were the major reasons behind the sustained trend towards extending the maturity of new credits. By end-September long-term credits comprised 66 percent of the total volume of credits extended to nonfinancial corporations against 63 percent a year earlier.

Trade, repair and technical services, and *reprocessing* had the largest share in the structure of commercial banks' claims by industry. The economic conditions in these sectors remained favorable: their fast growth rate and strengthened competitiveness were sustained and there are no threats for the quality of commercial banks' claims.

At the end of 2004 and the beginning of 2005 investment demand will retain its key role for growth. Fixed capital formation is expected to accelerate its growth rates reaching ten to thirteen percent due to the need to improve efficiency in production of goods and services, while the contribution of accumulated inventories is expected to decline.

Chart 75

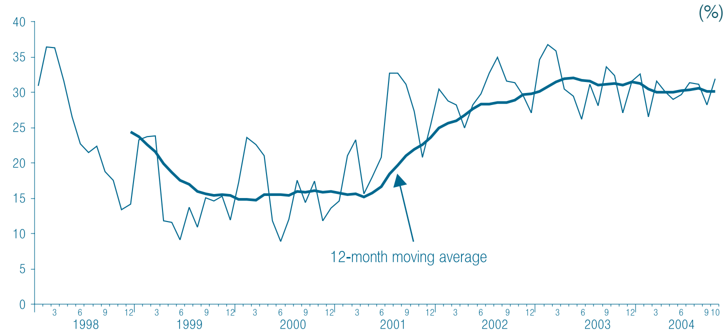
Industrial Orders



Source: NSI, business survey.

Chart 76

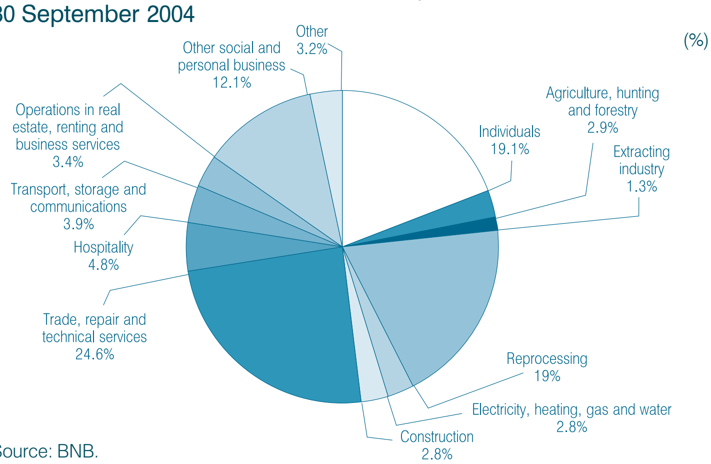
Expectations of the Business Environment in Manufacturing



Source: NSI, business survey.

Chart 77

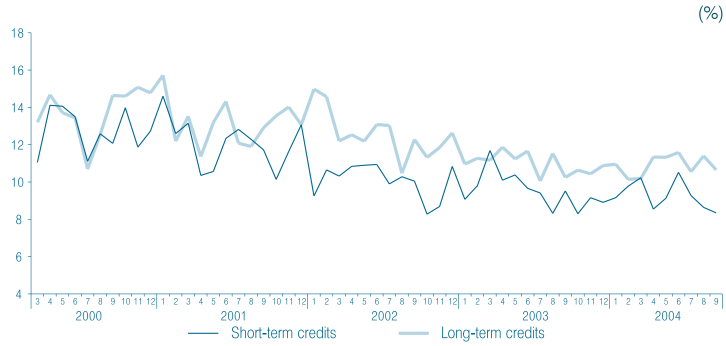
Structure of Commercial Bank Claims by Sector as of 30 September 2004



Source: BNB.

Chart 78

Interest Rates on Credits in Levs Extended to Companies



Source: BNB.

Exports and Imports of Goods and Services

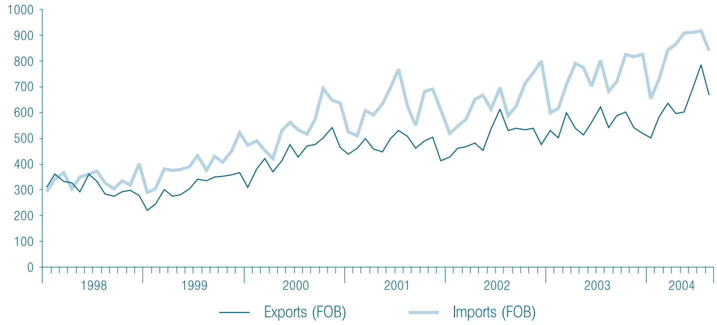
High growth rates of exports in the second quarter of 2004 and their further increase in July and August underlie their rise of 14.8 percent between January and August 2004 on the corresponding period of 2003. Between January and August 2004 imports grew by 17.6 percent. Bulgaria's trade deficit reached EUR 1605.1 million, a decrease of EUR 344.6 million on the corresponding period of 2003.

...exports have increasingly grown, while imports have slightly slowed down...

Chart 79

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

In the review period the trend to a rapid growth in the exports of base metals was sustained. The overall growth of the *base metals and articles thereof* group was 40.3 percent, main subgroups (according to the customs tariff) posting two-digit rises. In this group high metal prices were the major factor underlying sizable growth rates (see Part 1, *External Environment*). Sustained high price levels favored the nominal increase in exports in euro, although, in the second quarter this group's international prices stopped rising in line with our forecast.

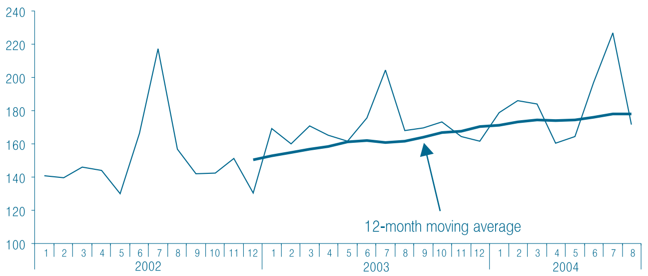
...exports of raw materials have grown at high rates followed by those of consumer goods...

In the second quarter exports of textiles slowed down; however, the 11 percent growth reported in July contributed to the 6.9 percent nominal rise for the January to August period. The slowdown in the growth of textiles exports to the current values may be considered as normal given the demand in the EU, the major market of these goods. The higher base also added to this effect: the group's share in total exports comprised some 30 percent. In the long run, the importance of textiles may subside, although this drop does not signal the emergence of such a process. Liberalization of trade in textiles between the EU and China is unlikely to affect seriously Bulgaria's exports of textiles to the EU. China and Bulgaria specialize in the production of different kinds of textiles which have few substitutes. In addition, the bulk of textiles exported to the EU by Bulgaria are produced with materials supplied by the customer and the geographic proximity supports this type of output organization.

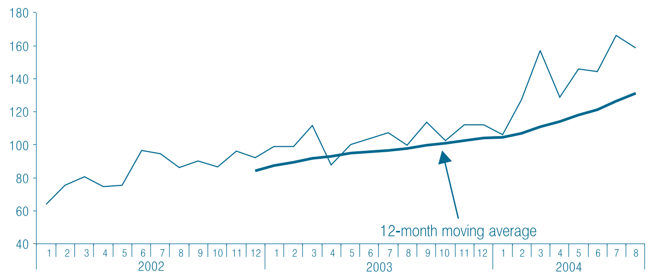
Chart 80
Exports

(million EUR)

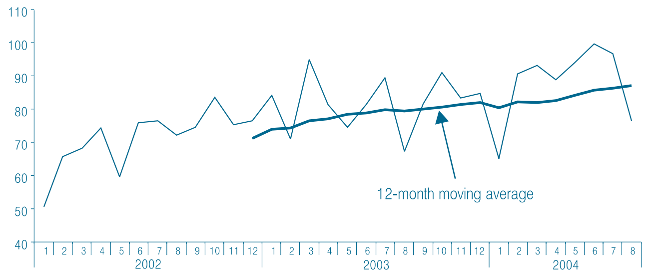
Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods



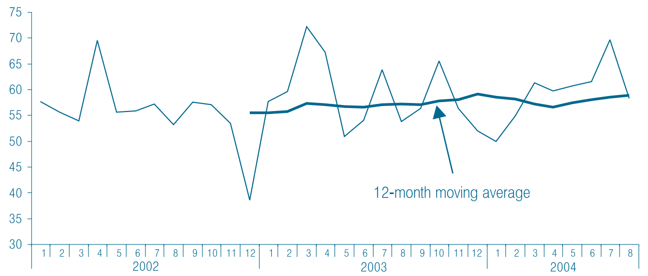
Base Metals and Their Products



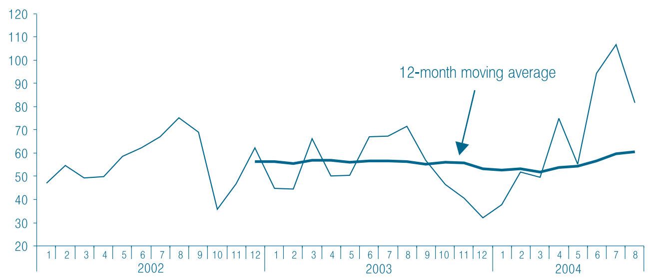
Machines, Vehicles, Appliances, Tools, Weapons



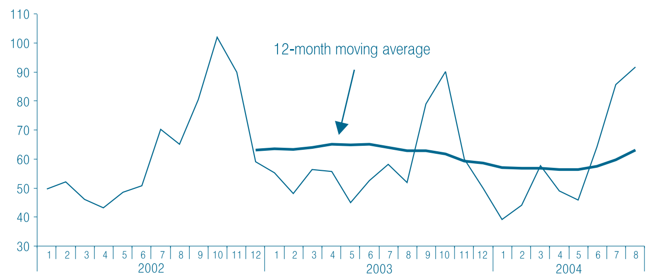
Chemical Products, Plastics, Rubber



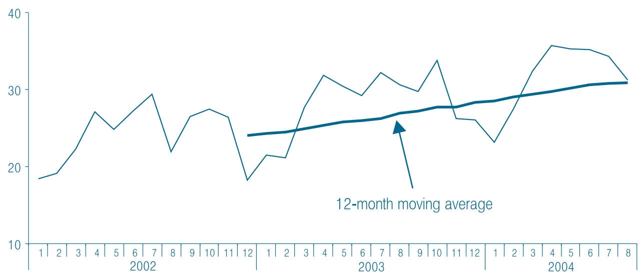
Mineral Products and Fuels



Animal and Plant Products, Food, Drink, Tobacco



Wood, Paper, Pottery, Glass



Source: BNB.

Between January and August exports of mineral products and fuels rose by 19.5 percent on the same period of previous year. Growth rates fluctuated significantly by month: growth was particularly high in June and July (40.8 and 58.8 percent respectively on corresponding months of 2003). In these months international oil prices rose; however, the nominal increase in exports of oil products was prompted mainly by the physical volumes. In the January to August period exports of oil products rose by four percent in real terms on the same period of 2003, while the average prices of these products increased by 13.2 percent.

In the reporting period exports of *machines and transport equipment* rose by 9.4 percent. Monthly fluctuations were considerable, attributable probably to larger transactions effected in various subsectors whose exports are classified in this group. Exports of *chemical products* slightly declined (by -0.7 percent) on the same period of 2003 owing to the weaker exports until April, and rose nominally in the following months. Given the group's heterogeneous nature no conclusions about the factors behind this growth may be drawn, although it may be suggested that the growth reflects the rise in international prices of the products in this group. Exports of agricultural products showed similar dynamics: the growth at the end of the review period resulted from the better harvest in the current year.

The analysis indicates that the growth in the second quarter, and in July and August, was prompted to a great extent by price effects. According to System of National Accounts data, exports of goods' deflator for the first quarter (compared with previous year's average prices) was 2.8 percent, while in the second quarter it reached 7.2 percent. Concurrently, in the first quarter of 2004 the physical volume of export growth amounted to 5.7 percent compared with the same period of 2003, and in the second quarter it comprised 8.3 percent.

Steady export growth in real terms matched the data on the rising competitiveness of Bulgarian output in international markets evaluated through unit labor costs by industry. This trend emerged in the medium run in industries with a big share in exports (textiles, metallurgy). No such interdependence may be observed in the short run, which indicates that a similar comparison could not be used for monitoring the competitive position of exports for the corresponding sectors. Therefore, reduced unit labor costs improve efficiency and have a positive effect on exports in the long run.

The competitive position of Bulgarian exports may be checked by comparing their share in the imports of a major trade partner with the corresponding shares of a country or country groups considered competitors to Bulgaria in the respective market. Provided this share is increasing faster than the shares of the countries subject to the comparison, it can be concluded that Bulgaria's position has been improving. To this end, the ratios of Bulgaria's exports to those of two groups of eurozone countries were calculated for the period starting from the beginning of 2002.[12] The selected country groups included the newly acceded countries to the EU and the *Other trade partners* group of the eurozone.[13] The results are shown in Chart 81 together with the linear trends of respective groups. In both cases it is evident that Bulgaria's competitive positions measured by this indicator have been improving.

Between January and August 2004 the import components posting the highest growth on the same period of 2003 were: consumer goods (28 percent), investment goods (19.1 percent) and raw materials (18.5 percent). Raw materials contributed mostly to the nominal increase in imports (Table 12).

Over the review period *Pharmaceuticals and toiletries* increasing by 38.8 percent and *Automobiles* by 46.6 percent had the largest share in consumer goods growth. The increase in the first group matched household budget data survey which shows that healthcare expenses rose in real terms. Since household budgets have traditionally produced comparatively conservative estimates on household expenditure, compared, for example, with System of National Accounts data, it can be assumed that the increase in the *Pharmaceuticals and toiletries* group resulted to a great extent from the growth of their physical volume in imports. Factors affecting the dynamics of the

Chart 81

Exports of Bulgaria to the Eurozone to Exports of Selected Country Groups to the Eurozone Ratio

Source: BNB, ECB.

...raw materials and investment goods determined import growth...

Table 12

Contribution of Commodity Groups to Trade Growth between January and August 2004

(percentage points)

	Contribution to the growth of	
	exports	imports
Raw materials	8.6	7.5
Investment goods	1.4	4.8
Consumer goods	2.9	4.1
Energy resources	1.8	1.4
Other		-0.3

Source: BNB.

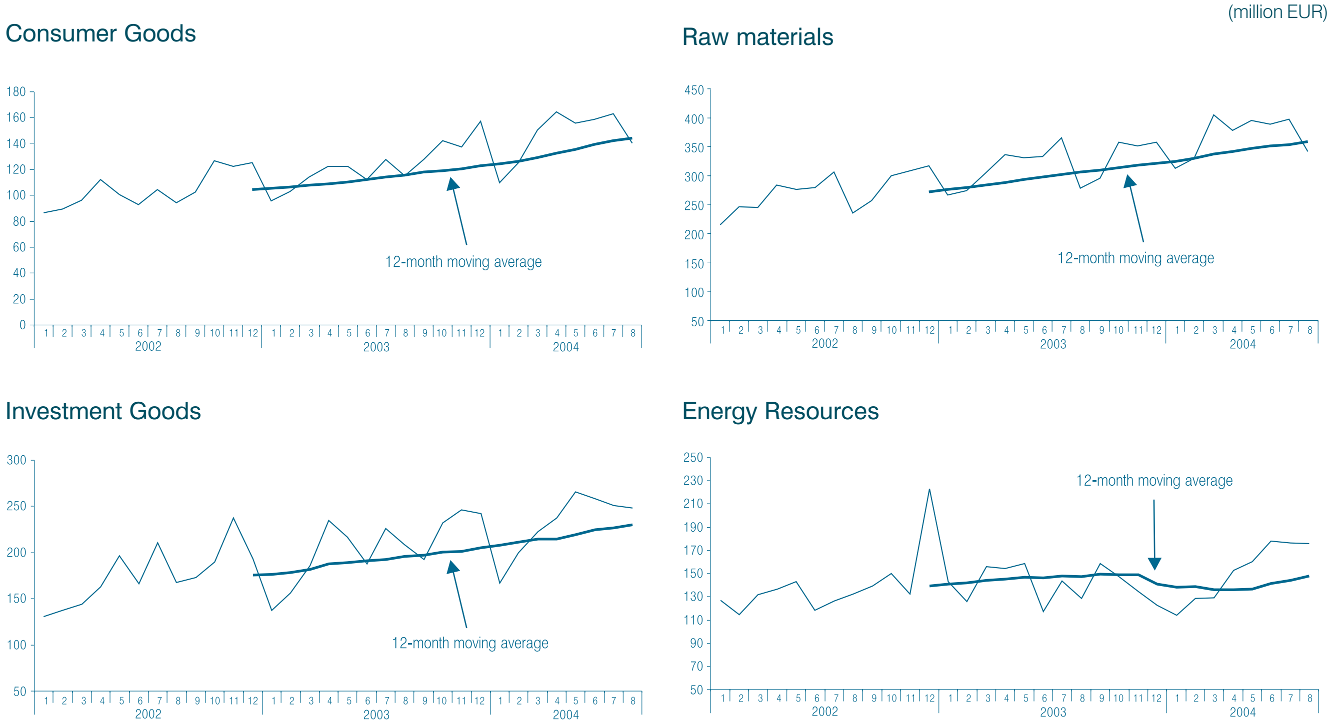
[12] This is an equivalent comparison of the ratios between the shares of the respective (groups of) countries in eurozone's imports.

[13] Asian countries (Japan excluded), Latin America and the *Miscellaneous* group according to the definition in the ECB monthly bulletin.

Automobiles group are more uncertain owing to the considerable price effect of the changed regulations on customs duties imposed on imported automobiles. The latter was confirmed by the NSI data on the prices of imported goods for the second quarter of 2004 where SITC group 78 *Automobiles, motorcycles, trailers and semitrailers* has index 126.3 against the average prices for 2003.

A slight slowdown in the growth of imported investment goods has occurred since the start of 2004; however, it did not replicate considerably decreased nominal growth rates of gross capital formation according to the System of National Accounts in the second quarter compared with the first quarter. In the coming quarters the growth of investment good imports may slow down considerably provided a drop in investment is reported by the System of National Accounts. If this scenario materializes, it will probably last one or two quarters and then import growth rates of investment goods may be expected to start recovering. The latter could be a natural outcome of restored investment growth rates; investment is anticipated to remain high in the medium term due to the need for capital renewal in the economy.

Chart 82
Imports



Source: BNB.

Imports of raw materials followed the same pattern as those of investment goods, reporting a slight fall in growth since the year start. Imports of raw materials were the major driver both of investment (mainly in terms of construction) and of exports since output in some industries is based on a substantial import component. Inasmuch as exports by month indicated an upward trend, it can be assumed that the changes in imports of raw materials were influenced mainly by investment dynamics and to a lesser extent by exports.

The relation between imports of raw materials and exports may be studied for particular commodity groups whose manufacturing is based on a considerable import component. To this end the coefficients of exported output values to imports have been calculated for a set of adequately selected commodity groups.

Table 13

Exported Output to Imported Raw Materials Coefficients (Selected Commodity Groups)

(million EUR)

	2003	May 2004	August 2004
Exports of clothing	1340.2	580.8	981.7
Imports of cloth and materials	920.5	383.1	638.2
Coefficient	**1.456**	**1.516**	**1.538**
Exports of cast iron, iron and steel	541.4	310.5	519.3
Imports of iron ore, cast iron, iron and steel	303.3	182.7	319.4
Coefficient	**1.785**	**1.699**	**1.626**
Exports of nonferrous metals	534.7	263.5	461.9
Imports of nonferrous metal ores	256.4	142.7	262.0
Coefficient	**2.085**	**1.846**	**1.763**

Source: BNB.

The coefficients retained their large values (over 1.5) which show a high value added typical of export output. This in turn could be viewed as an indicator of efficient functioning of respective industries provided that the change in used raw materials prices approximate the change in prices of finished output produced with the said raw materials. The ratios of exports of *clothing to imports of cloth and materials* were rising, while the coefficients of *exports of cast iron, iron and steel, and nonferrous metals to exports of the respective raw materials for their manufacturing* were falling. The downward trend in the last two ratios could be explained by the rising domestic market sales in the *Smelting and casting* and *Metal goods excluding machines and equipment* industry groups.

Since early 2004 imports of crude oil in euro have increased slightly in nominal terms (6.8 percent) decreasing in real terms by 3.3 percent. Figures matched energy balances data which show a downward trend in crude oil gross domestic consumption over the last four years. There have been no indications so far that rises in international prices affect considerably prices at which Bulgaria imports crude oil since this is a result of corporate policies pursued. These trends will limit risks provided oil prices stay high in the medium run. Slight worsening of the trade balance could be expected in the short run.

Since the start of the year imports of natural gas have risen by 11.7 percent in real terms partly due to the 6.5 percent lower price compared with the corresponding period of the prior year. The increase in physical volumes of natural gas is probably attributable to a shift toward the use of this energy resource. This was not confirmed by energy balances data till 2002, when gross consumption of natural gas decreased.

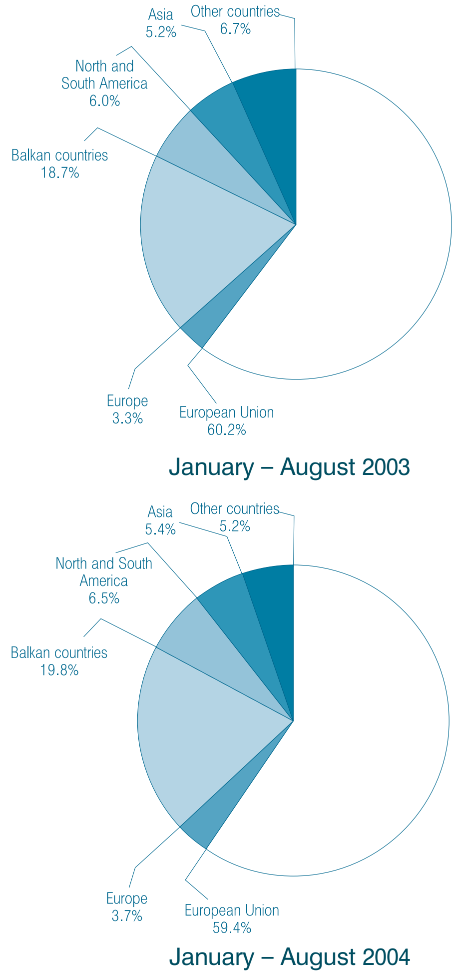
Import dynamics was also influences by price effects. System of National Accounts data indicate an increase in the deflator of the imports of goods: from 1.3 percent in the first quarter (against the 2003 average) it reached 5.7 percent. The percentage increase in imports in real terms versus the respective quarters of the previous year was less in the second quarter of 2004 (11.2 percent) than in the first quarter when it amounted to 19.6 percent. This supported our expectations of a certain slowdown in import growth both in nominal and in real terms.

No substantial changes occurred in the structure of foreign trade by country. Due to the large share of trade with the EU (54.7 percent of imports and 59.4 percent of exports for the eight months since the year's start) foreign trade contributed mostly to the increase both in exports and imports. Exports to the new EU member countries (EU-10) and to the Balkan countries rose faster reflecting high economic growth rates in these country groups.

... oil prices have not affected oil imports significantly...

Chart 83

Structure of Exports by Major Trade Partner

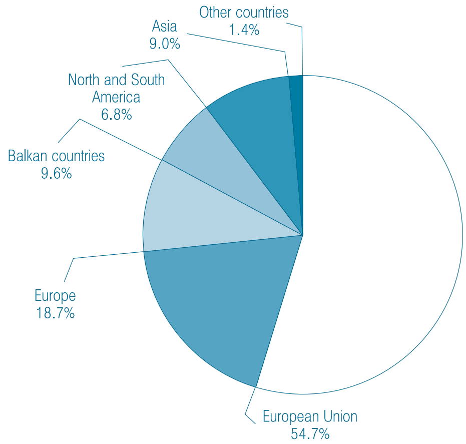


Source: BNB.

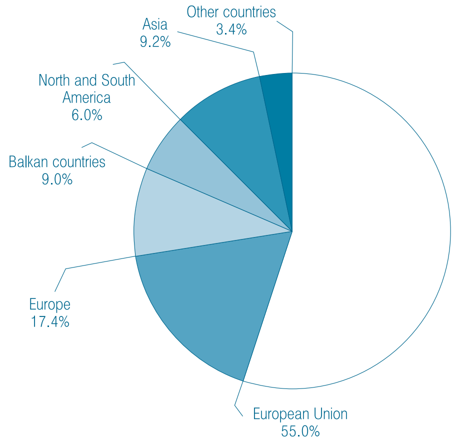
...no substantial changes occurred in the structure of foreign trade by country...

Chart 84

Structure of Imports by Major Trade Partner



January – August 2003



January – August 2004

Source: BNB.

The upward trend in revenue from travel services was sustained. Between January and August the credit side of this item increased by 22.2 percent (EUR 236.6 million), with the summer months (June – August) traditionally contributing most significantly to the growth in the industry. *Travel* expenditure also grew at high rates (21.5 percent for the review period), exhibiting more even distribution by month than revenues.

Export growth data by end-August were better than expected; hence export growth in the fourth quarter of 2004 and the first quarter of 2005 is anticipated to reach 15–16 percent on an annual basis. The estimated import nominal growth for both quarters comes to some 15 percent on an annual basis. Provided these estimates are realized, the trade balance would worsen by some EUR 100 million in the fourth quarter of 2004 and by EUR 80 million in the first quarter of 2005. Our conservative estimates of travel revenues are for growth rates of 12–13 percent in both quarters.

...we expect an increase in exports and a slight slowdown in imports...

Supply and Competitiveness

Manufacturing , trade and communications had the largest share in value added growth in the second quarter of 2004. Agriculture also added to this after the fall reported in 2003.

...competitiveness in the economy sustained and export activity in manufacturing stayed high...

Table 14
Gross Value Added Growth Rate and Sectors' Contribution
(Corresponding Quarter of Previous Year = 100)

(%)

	2003				2004	
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter
Agriculture and forestry	-0.3	-0.3	-1.5	-2.2	1.2	0.9
Industry	5.7	5.9	6.6	10.1	6.4	7.5
Services	2.6	3.8	4.6	3.0	6.2	5.4
At base prices, total	3.4	4.0	4.0	4.4	6.0	5.6
Contribution, percentage points						
Agriculture and forestry	0.0	0.0	-0.3	-0.2	0.1	0.1
Industry	1.8	1.8	1.9	2.8	2.1	2.3
Services	1.6	2.3	2.4	1.9	3.8	3.2

Source: NSI.

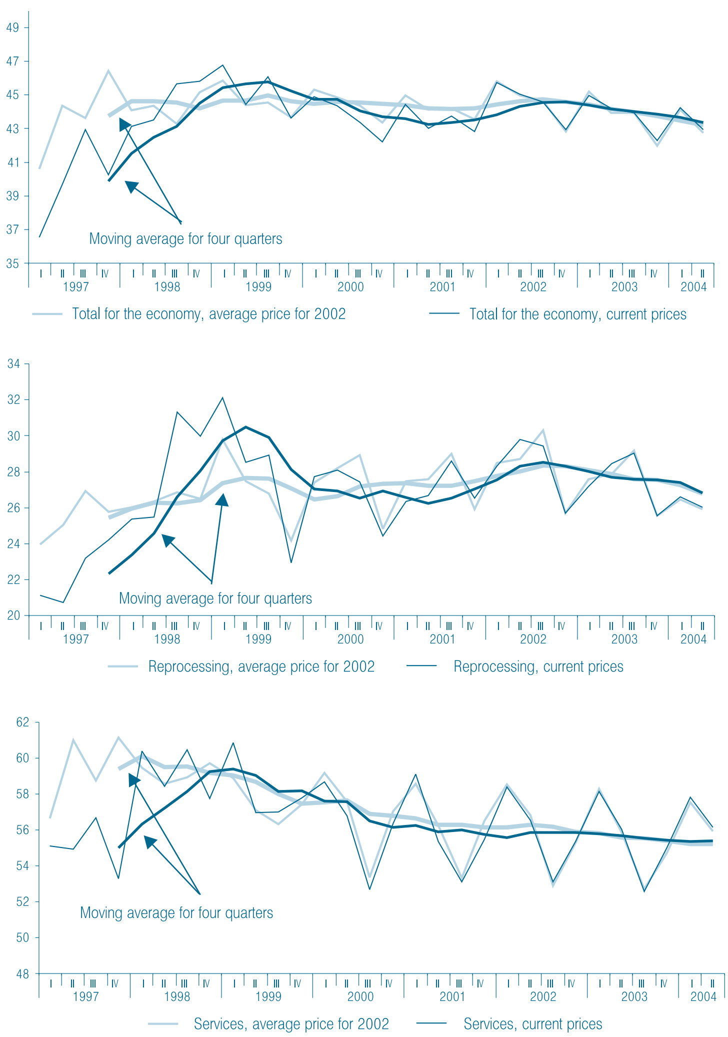
Growth of value added in industry resulted from the sector's rising output and exports. Between January and August industrial sales grew by 21 percent on the corresponding period of 2003, including export sales up 41 percent and home market sales up 6.5 percent. *Metallurgy*, *food and drink*, *machines and equipment*, and *clothing* were the leading industries. According to NSI manufacturing survey data in October production facility utilization reached 63 percent which is considered to be a high value for the Bulgarian economy.

Buoyant output was associated with a faster rise in intermediate consumption and a fall (albeit not substantial) in production efficiency measured by the *value added to gross production* ratio. We expect that in the coming years the need for maintaining production efficiency high by introducing new technologies will be the major incentive of investment demand.

Good cost competitiveness in reprocessing favored economy's exports. Rising productivity and moderately increasing real salary have a suppressing effect on inflation.

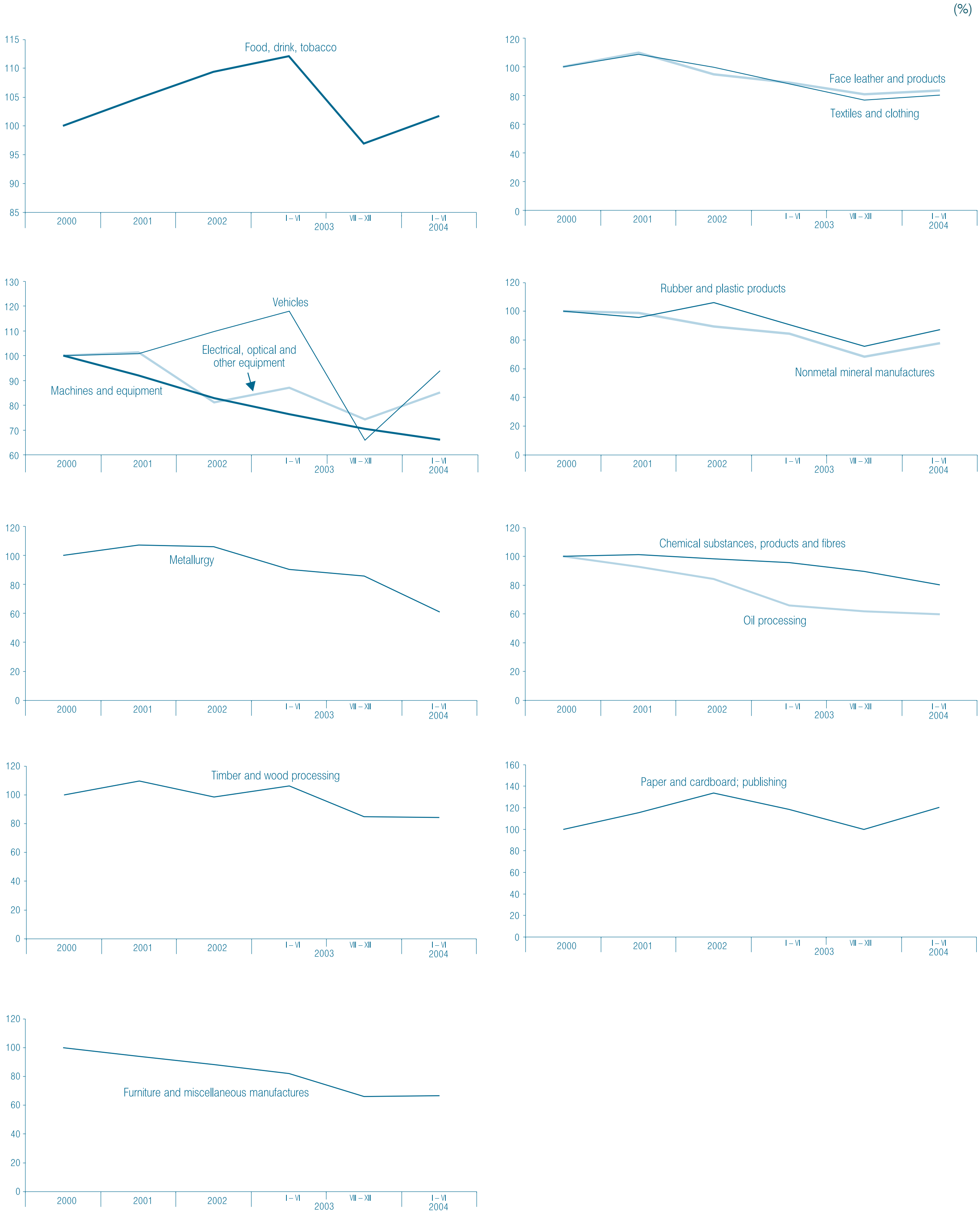
Chart 85
Production Efficiency: *Gross Value Added to Gross Production* Ratio

(%)



Source: NSI.

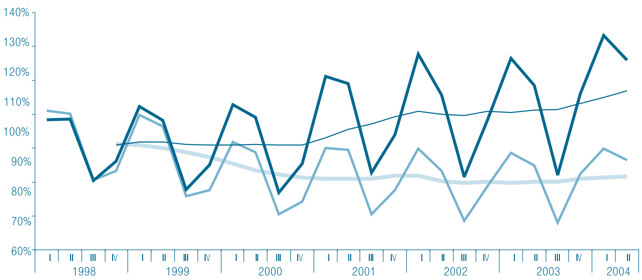
Chart 86
Nominal Unit Labor Cost in Manufacturing Industries
(2000 = 100)



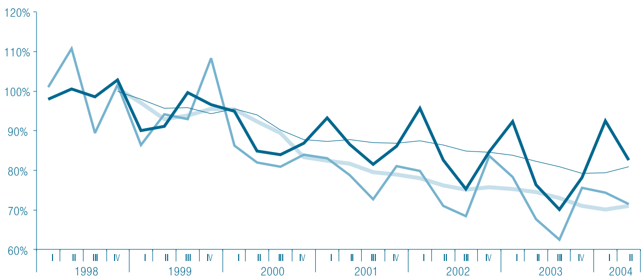
Source: NSI, BNB.

Chart 87
Unit Labor Cost

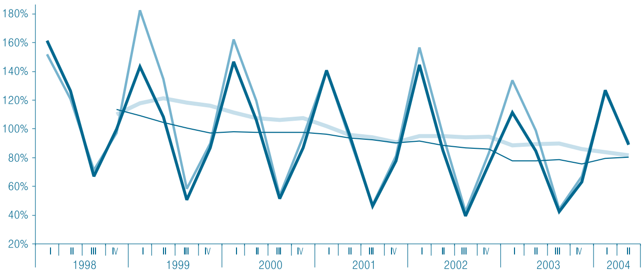
Total for the economy



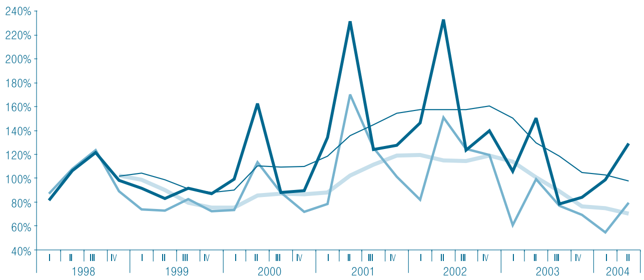
Manufacturing



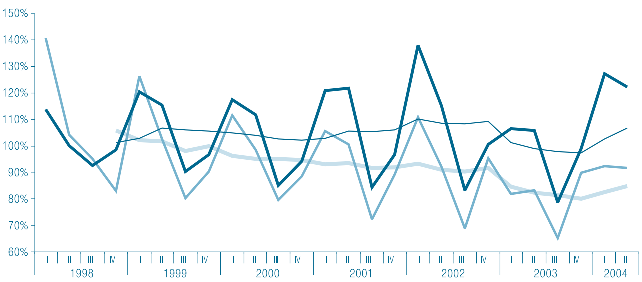
Agricultural sector



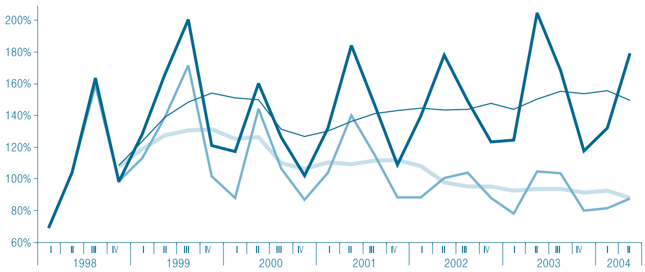
Extracting industry



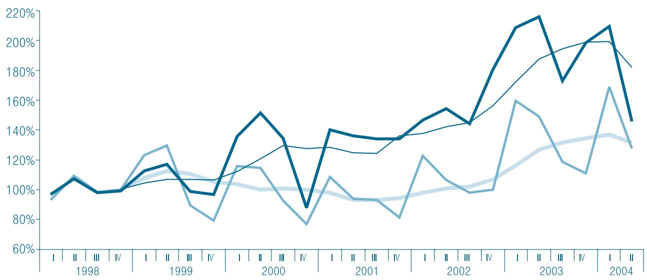
Construction



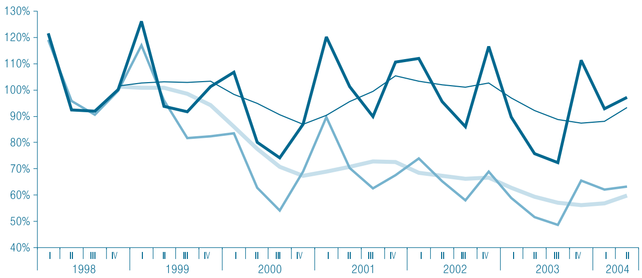
Electricity, gas and water



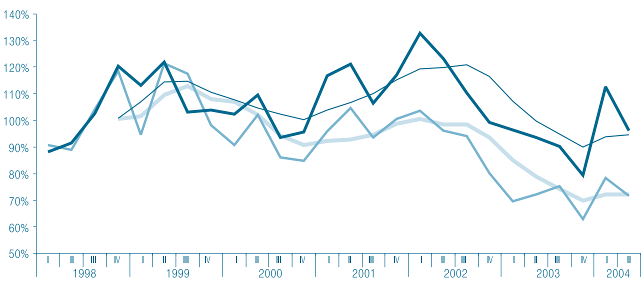
Trade



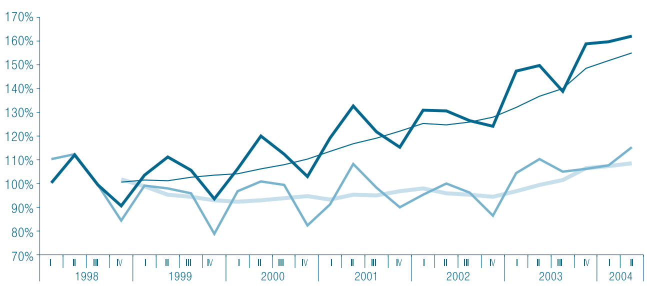
Transport and communication



Financial intermediation



Other sectors



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

Source: NSI, BNB.

Table 15
Industrial Sale Dynamics

(share on corresponding period of previous year, %)

	2003				2004		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	July – August
Industrial sales	21.6	15.8	13.7	19.1	18.1	22	24.2
export sales	50.3	32.1	25.1	39.2	34.5	42.6	47.5
domestic sales	6.3	5.9	6.7	7.7	5.9	6.8	6.9
Contribution, percentage points							
export sales	17.5	12.1	9.6	14.1	14.8	18.4	20.3
domestic sales	4.1	3.7	4.1	4.9	3.4	3.6	3.9

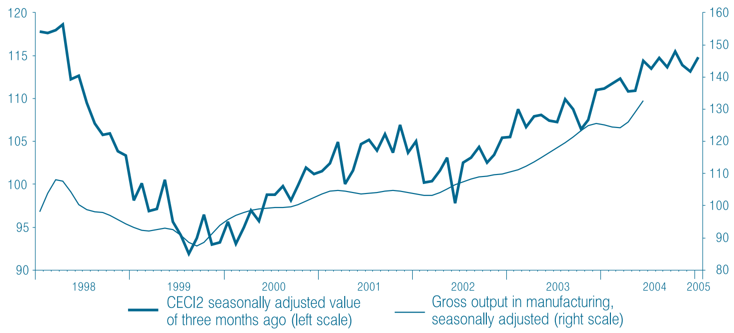
Source: NSI.

Positive dynamics in the production of goods and services is expected to continue in the period ahead. The business climate indicator in manufacturing reached its highest value since its creation and continued to show the favorable cyclic position of manufacturing. CECI2 indicator[14] also showed high values. Hence, manufacturing value added is expected to rise by seven-eight percent. Business climate in trade and services stayed favorable. The bulk of investment was concentrated there; therefore growth in these sectors is expected to accelerate.

...industrial growth will stay at the level of seven-eight percent...

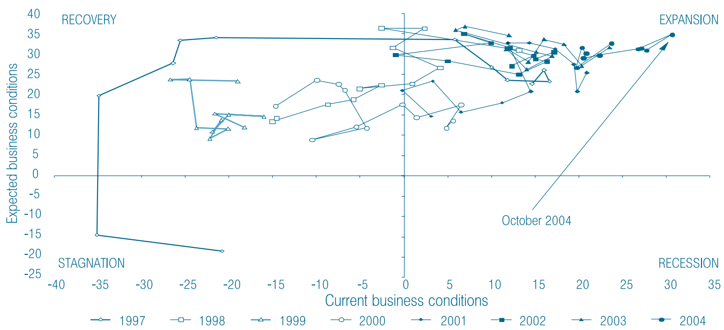
...growth in services will accelerate...

Chart 88
Expected Output



Source: NSI, BNB.

Chart 89
Business Climate in Manufacturing



Source: NSI, business survey in manufacturing.

[14] A composite indicator comprised of the indicators of expected output and business conditions, order books and the evaluations of foreign and domestic demand based on the NSI manufacturing survey.

4. Inflation

Inflation accumulated between December 2003 and September 2004 amounted to 1.9 percent and it was higher compared with the corresponding period of the previous year due to two major factors: higher contribution of government-controlled prices and considerable fluctuations of crude oil prices in international markets.

In the first two months of 2004 tobacco products' prices increased by almost 35 percent as a result of excise duty rises. July saw the last planned rises in power and heating prices by 10.6 percent and 4.5 percent respectively. In the third quarter of 2004 contribution of fuels to inflation stayed at the last quarter's level of some 0.22 percentage points. Indirect effects of high international fuel prices were experienced by transportation services whose prices added to inflation in the second and third quarters by 0.04 and 0.07 percentage points respectively (see the box on p. 58).

Table 16

Contribution to Inflation between January and September

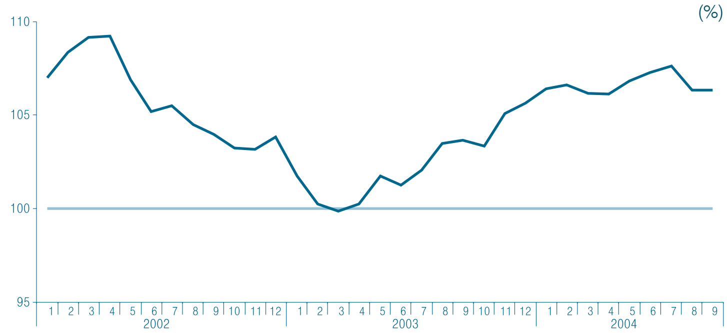
(percentage points)

	2003	2004
Inflation	1.21	1.88
Contribution		
Food	-0.82	-1.31
Nonfood	-0.33	1.25
Fuels	-0.28	0.32
Catering	0.11	0.12
Services	2.15	1.93
Goods and services with administratively set prices	1.82	2.76
Controlled-price goods	0.24	1.16
Tobacco	0.00	1.19
Controlled-price services	1.58	1.60
Electricity and heating	1.407	1.07

Source: NSI.

Chart 90

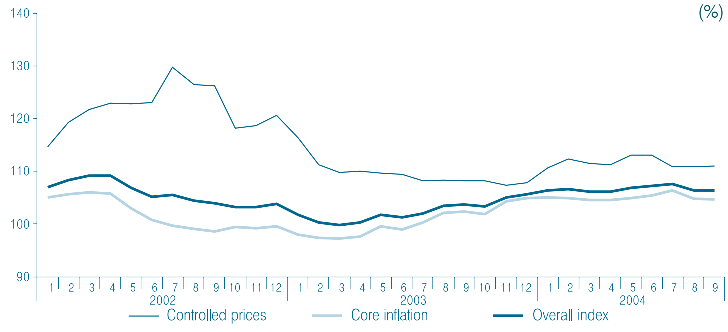
Consumer Price Index on an Annual Basis



Source: NSI.

Chart 91

Price Indices on an Annual Basis



Source: NSI.

The high rates of domestic demand growth did not put pressure on internal commodities' prices due to the economy's openness. Imports met some home demand (mainly for investment and raw materials) at international market prices. In the structure of consumer demand spending on clothing and footwear increased at a high pace: the contribution of this commodity group to overall inflation by end-September 2004 was negative (-0.75 percentage points). Trade in household goods and equipment showed fast growth; the prices of these commodities affected inflation negatively in the last two years.

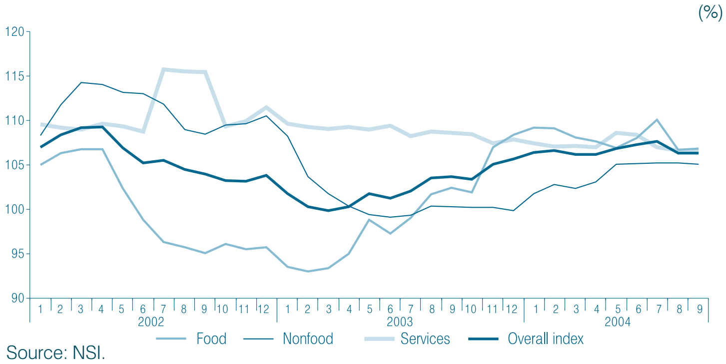
It can be assumed that rising consumption would put pressure on services prices. Data for 2004 indicate that services related to leisure contributed to inflation by 0.068 percentage points (0.18 percentage points for the same period of 2003), and educational services by 0.02 percentage points (0.02 percentage points for the same period of 2003). *Healthcare* services retained their steady contribution to inflation accounting for some 0.06 percentage points.

Bread and cereals prices have been falling gradually since early-2004 after their sharp rises in the third quarter of 2003 although they are unlikely to reach their level of June 2003. Their contribution to inflation over the first nine months of 2004 was negative (-0.72 percentage points).

International fuel prices and their indirect influence on transport will be one of the inflationary factors till the close of 2004. Our forecast of a 4.2 percent end-of-year inflation remains unchanged. In the first quarter of 2005 changed excise duties will be a major factor for inflation: excise duties on beer will be raised with a 7.14 percent overall effect on prices and 0.05 percentage points contribution to inflation, as well as the excise duty on hard liquor with 0.08 percentage points contribution to inflation.[15]

Chart 92

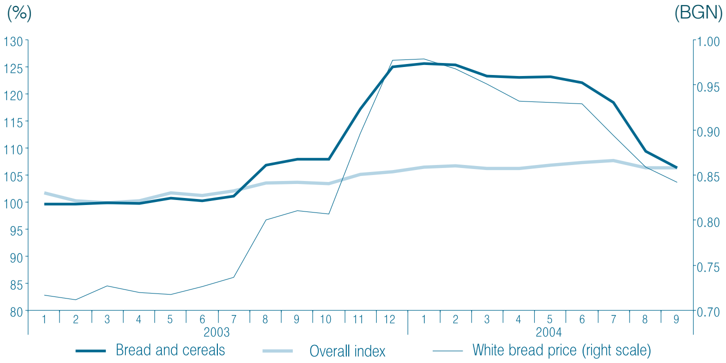
Price Indices by Commodity Group on an Annual Basis



Source: NSI.

Chart 93

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



Source: NSI.

[15] Agency for Economic Analyses and Forecasting estimates.

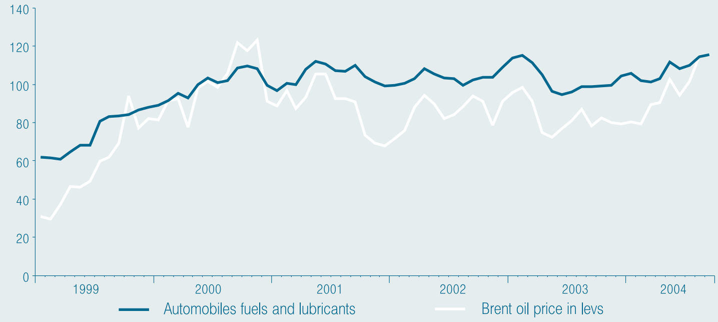
Crude Oil Prices and Inflation in Bulgaria

Dynamics of international crude oil prices directly affected inflation in Bulgaria through fuel prices, and indirectly though transportation services prices. In oil processing crude oil forms some 70 percent of the production cost at basic prices which indicates that a 50 percent raw materials price rise will cause a 35 percent increase in finished goods' prices. The difference between fuel production cost and end-user price is considerable and it consists of the charged indirect taxes and distribution expenses: a component which is relatively constant in nominal terms and does not depend on raw materials prices. Therefore changes in automobile fuel and lubricant prices only partially reflect crude oil price dynamics in international markets. If we assume that the share of indirect taxes and distribution expenses comprises 70 percent of the fuel end price, a 35 percent change in fuel production cost (other conditions being equal) will result in a 10.5 percent increase in the fuel end price. The increase in fuel end price will lead to 0.3 percentage point rise in the consumer price index as the share of fuels in the consumer basket amounts to 3.2 percent.

Road and sea transport sectors are most sensitive to fuel prices: fuels comprise 35 and 30 percent of these sectors' production costs at basic prices, respectively; therefore a 10.5 percent fuel price rise will cause an increase in the transportation services basic price by some 3.2 percent. The share of transportation services in the consumer basket amounts to 2.7 percent; hence, based on the above assumptions, the sector's contribution to consumer price inflation will be 0.09 percentage points.

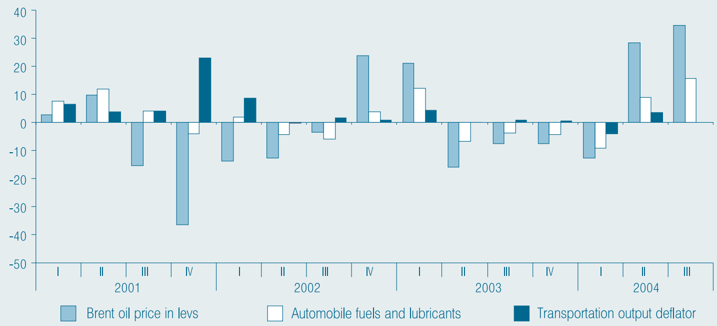
Overall for the economy, the share of oil and natural gas at purchaser's prices in the value of gross output at basic prices come to some five percent, while that of refined oil products, nuclear fuel and coke, to some six percent. Transportation services amount to some four percent. Therefore oil price fluctuations should not affect production costs and end prices seriously, and the negative effect on growth rates and inflation should be fairly limited.

Chart 94
Dynamics of Oil, Automobile Fuels and Lubricants Prices (2000 = 100)



Source: World Bank, BNB, NSI.

Chart 95
Dynamics of Oil Products and Transportation Services Prices
(% on annual basis)



Source: World Bank, NSI, BNB.