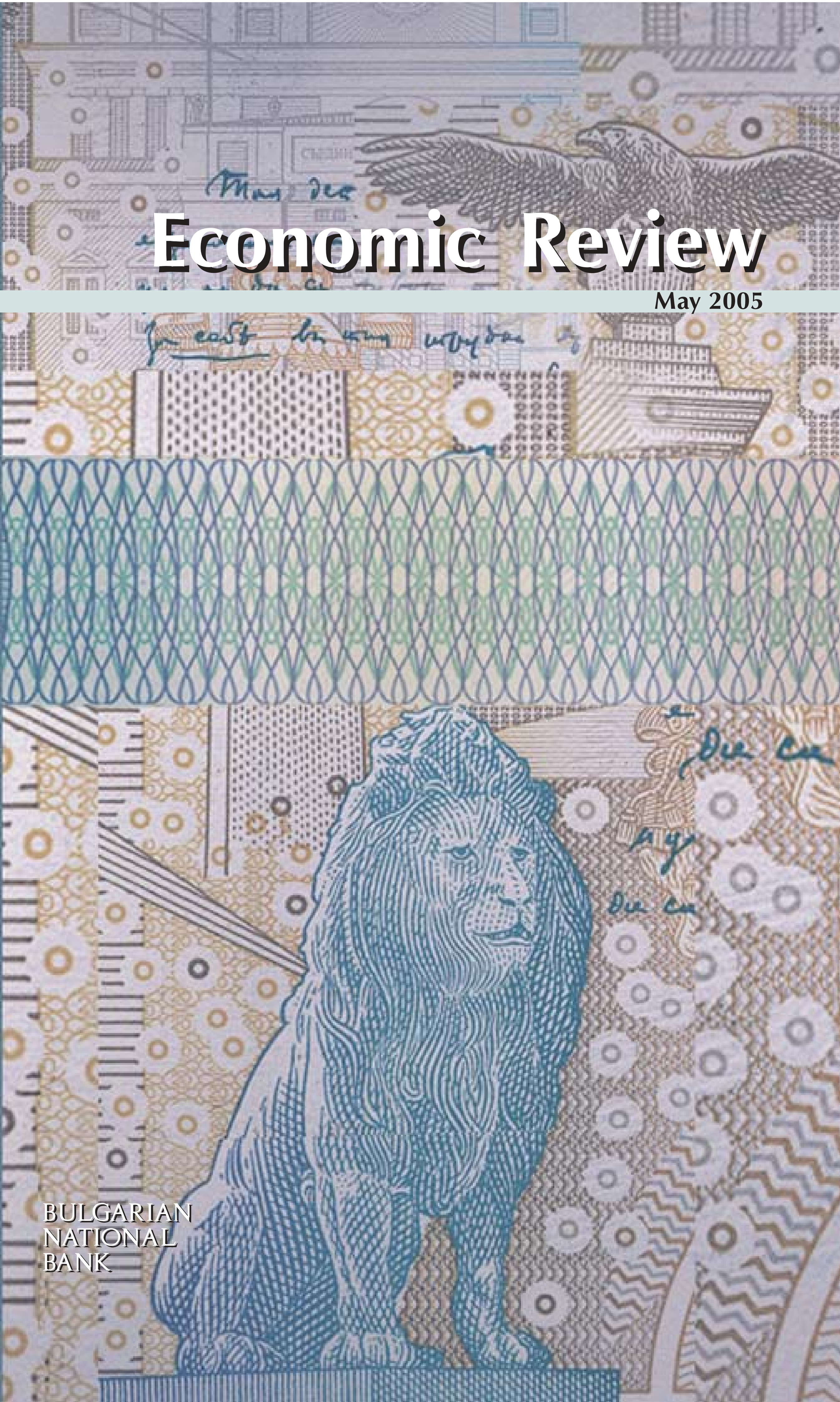
Economic Review

May 2005



BULGARIAN
NATIONAL
BANK

Economic Review

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

The May 2005 *Economic Review* was approved for publication by the BNB Governing Council at its 26 May 2005 meeting. It employs statistical data published by 16 May 2005.

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

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Abbreviations

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

Summary

The Bulgarian economy has been developing at high rates which will sustain throughout 2005 irrespective of the expected overall slowdown in global growth. Public confidence in economy strengthened in line with signing of Bulgaria's Treaty of Accession to the European Union on 25 April 2005. The Japanese JCR upgraded Bulgaria's credit rating for foreign currency long-term senior debts from *BBB-* to *BBB/Stable* and for local currency long-term senior debts to *BBB+/Stable* which was indicative of increasing investor confidence in Bulgaria.

Capital inflow into Bulgaria in the form of foreign direct investment and loans remained significant over the review period. Despite the January government expenditure on Brady bond buybacks of BGN 1406.7 million, the balance of payments financial account closed the first quarter of 2005 with a surplus of BGN 1966.1 million. As of March current account deficit coverage by foreign direct investment was 123.3 per cent on an annual basis. By end-March the international reserve balance sheet value came to BGN 13,197.6 million (EUR 6747.8 million) almost matching the end-2004 level. The current account deficit is expected to worsen over the second quarter both in nominal value and as a share of GDP which will be offset by high travel revenue generated in the third quarter.

In the first quarter reserve money growth rates remained high at 34 per cent on an annual basis. In March commercial bank deposits with the BNB almost doubled the deposit level of March 2004, reflecting deposit stock growth and changed minimum required reserves. This created stimuli for banks to extend loans which were blocked on current and deposit accounts. Due to the significant foreign funds inflow into banks, the BNB measures undertaken in 2004 to cut credit expansion contributed to retention of annual growth rates of credit to the private sector at between 47 and 48 per cent. Therefore, in early 2005 new measures were undertaken by the BNB by amending Ordinance No. 21 on the minimum required reserves maintained with the BNB by banks, Ordinance No. 8 on the capital adequacy of banks and Ordinance No. 9 on the evaluation and classification of risk exposures of banks and the allocation of provisions to cover impairment loss. The amendments were intended to cut growth rates of claims on the non-government sector to 30 per cent annually at the close of 2005.

Since early 2005 domestic demand has remained high. Sustainable upward trends in Bulgarian economy' competitiveness and particularly in industrial competitiveness extended foreign markets for the Bulgarian producers and decreased import rates due to greater supply of, and demand for, domestic goods on the home market. Economic growth is expected to reach approximately 5.8 – 6 per cent in the second quarter and 5 – 5.2 per cent in the third quarter.

Domestic demand for tradable goods did not exert inflationary pressure and the improving cost competitiveness favoured domestic price stability due to the openness of the Bulgarian economy. International crude oil prices affected directly transport fuel prices. Nevertheless, the indirect effect of oil price rises on other prices at the end of 2004 subdued in the beginning of 2005. Inflation rates over the first four months were mostly driven by food prices, but also by the one-off rise in communication, water supply and healthcare prices, adjustments in administratively controlled prices and world crude oil price rises. By end-April inflation accumulated since early 2005 came to 3.05 per cent, followed by expectations of deflation in the second quarter and price stabilization in the third quarter. We anticipate a 0.7 – 1 per cent inflation rate at the end of September.

1. External Environment

Current Business Situation

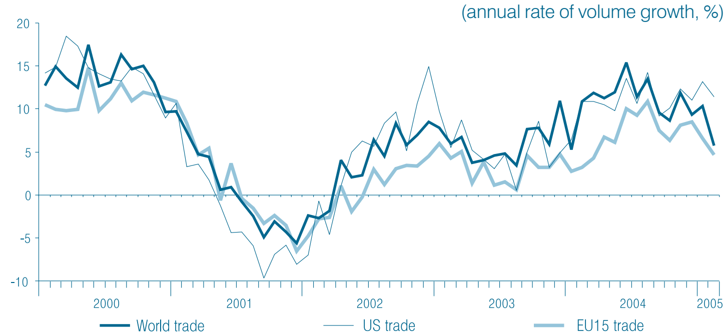
Macroeconomic data and current economic indicators in developed countries show a trend to an expected slowdown in global economic growth. Crude oil price hikes in the first quarter of 2005 also added to growing business and consumer pessimism.

The USA

US GDP growth stayed high over the first quarter due to the active domestic demand and accumulation of inventories. A trend to slowing and approaching potential growth has formed. Due to the high elasticity of imports with respect to domestic demand, the external imbalance worsened and contributed negatively to growth by nearly one percentage point.

High oil prices at the start of the year impacted adversely US economic activity and consumption. Reported declines in capital goods orders and consumer confidence showed expectations of a further growth slowdown in the coming quarters. The expected interest rate rises in response to tightening Federal Reserve's monetary policy will have a similar effect.

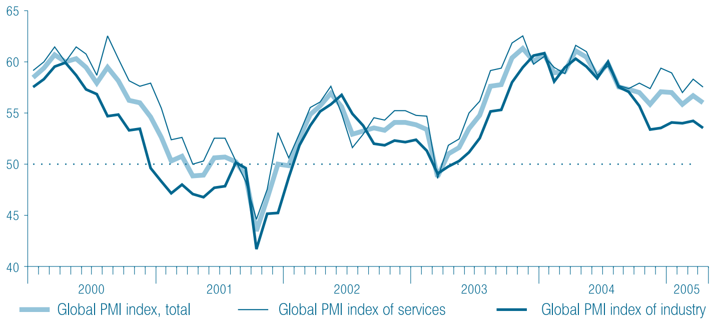
Chart 1
World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis.

...world economic growth will slow down over the first half of 2005...

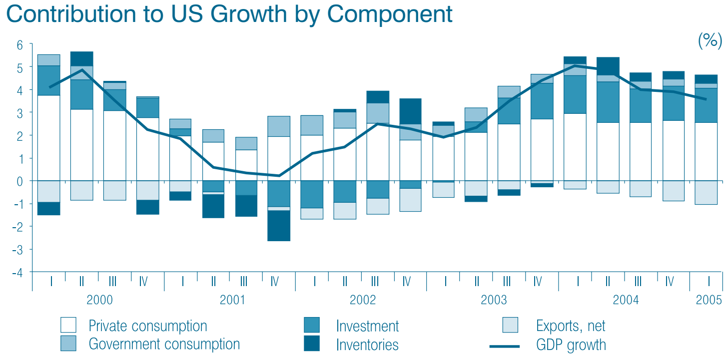
Chart 2
Global PMI Indices



Source: NTC Research, JP Morgan.

...global growth is expected to accelerate at the end of the third quarter at the earliest...

Chart 3
Contribution to US Growth by Component



Source: Bureau of Economic Analysis.

...US GDP continued rising at high rates, albeit the clear trend to slowing of growth to potential levels...

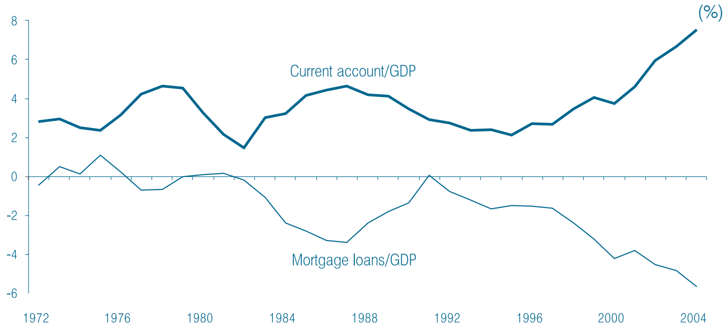
High oil and raw material prices pushed inflation up from 3.3 per cent in 2004 to 4.3 per cent in the first three months of 2005. Inflationary tension affected core inflation which reached its highest values since 2002. Import and producer prices also rose over the recent years and increasing firms' opportunities to transfer rising costs to end-use consumers created expectations of retaining inflationary pressure in the future. Financial markets inflationary expectations increased from 2.6 to 2.7 per cent in the first quarter, prompting declines in fixed income financial instrument prices.

In the second quarter inflation will be driven by crude oil prices. The cyclical increase in unit labour cost will continue exert pressure on core inflation, while the expected monetary policy tightening and slowing domestic demand growth will have a reverse effect. The base effect over the second quarter is likely to retain inflation at around 3 per cent or a bit higher on an annual basis, with higher than expected price rises.

The US labour market continued recovering gradually but steadily. New jobs outside the agricultural sector increased by 570,000 in the first three months (up by 569,000 in the last 2004 quarter). Employment rose by 1.7 per cent on the first quarter of 2004. US unemployment continued falling to reach 5.2 per cent in March 2005 *vis-a-vis* average values of 5.5 and 6 per cent for 2004 and 2003 respectively. Wages picked up on an annual basis: from 2.1 per cent in 2004 to 2.6 per cent in March 2005 (a signal of pressures on inflation).

Chart 4

USA: External Imbalances and Household Indebtedness

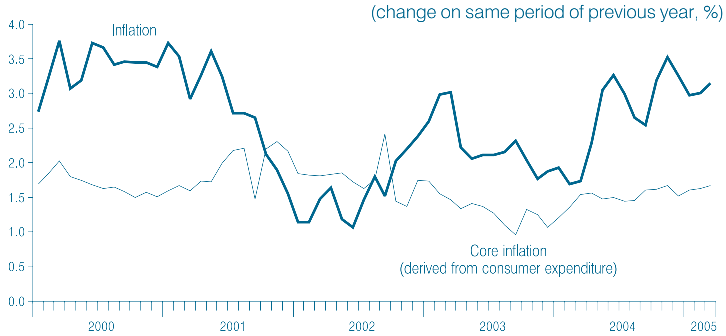


Source: Flow of funds.

...inflationary tension affected core inflation ...

Chart 5

US Inflation Rate



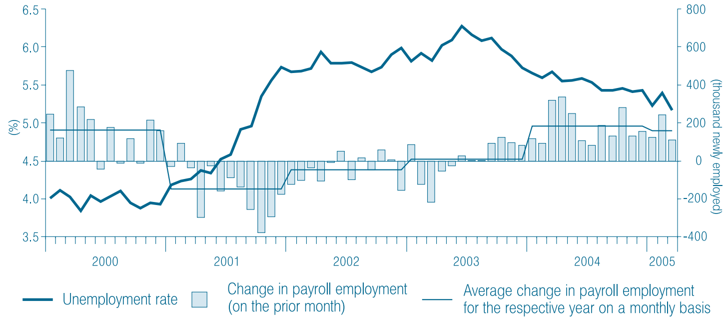
Source: Bureau of Labor Statistics.

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

...the US labour market continued recovering gradually but steadily...

Chart 6

US Unemployment Rate and Change in Payroll Employment



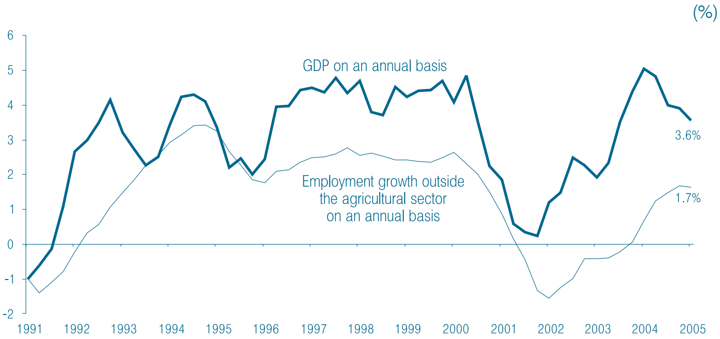
Source: Bureau of Labor Statistics.

The Federal Open Market Committee raised its target for the federal funds by 25 basis points to 3 per cent at its three meetings held since early 2005. Federal Reserve statements on monetary policy changes have been clear enough to all market participants. Spreads between the federal funds rate and the market 6-month and 12-month LIBOR on deposits remained stable. Market expectations foresee another 25 basis point rise in the federal funds rate at the close of June. However, uncertainty on monetary policy stance till year-end remained. As most analyses show that the neutral interest rate level is at between 3.5 and 4 per cent, most market participants forecast another 25 basis point rise at the August meeting.

Based on current expectations of federal funds rate changes, we anticipate the yield on 6-month and 12-month LIBOR on USD deposits to range between 3.50 and 3.75 per cent, and 3.75 and 4 per cent respectively.

Chart 7

US Growth and Labour Market



Source: Bloomberg.

...market expectations foresee another 25 basis point rise in the federal funds rate at the close of June...

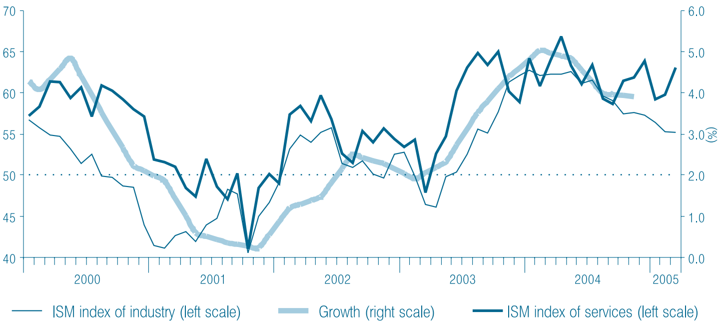
Chart 8

US Consumer Confidence Indicators

Source: Conference Board.

Chart 9

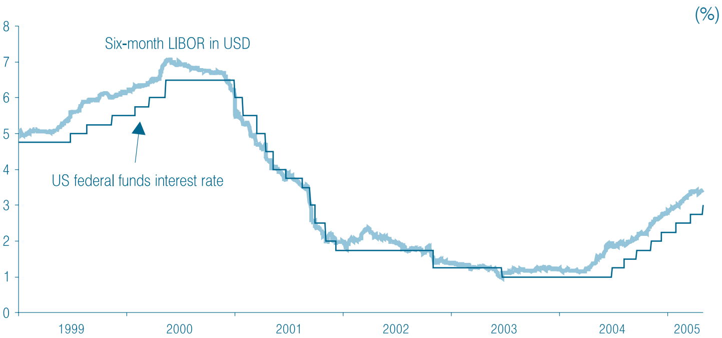
US PMIs and Growth



Source: Institute for Supply Management.

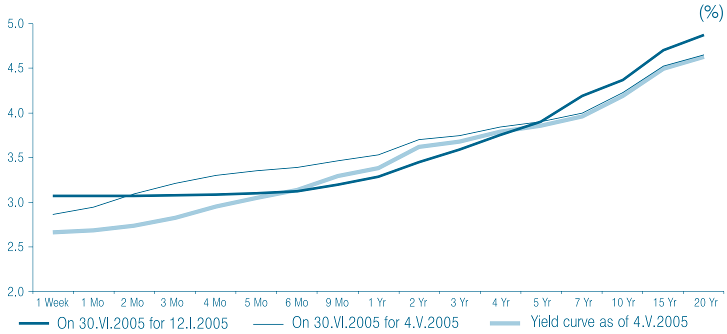
Chart 10

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



Source: Bloomberg.

Chart 11
Expected US Yield Curve



Source: Bloomberg.

...current data show a possible cyclical recovery of economic activity in the euro area...

The Euro Area

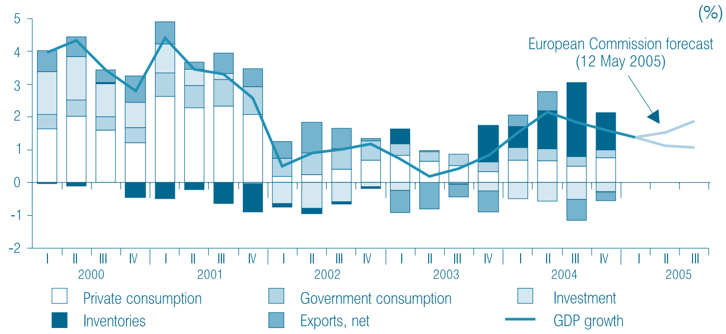
In the fourth quarter of 2004 euro area GDP annual growth dropped to 1.6 per cent (1.8 per cent for the third quarter). This slowdown continued in the first quarter of 2005 when economic growth came to 1.4 per cent according to preliminary data.

Early 2005 inflation averaged 2.1 per cent reflecting energy, fuel and food prices. Core inflation fell to 1.6 per cent on an annual basis compared with the 2004 average level which confirmed lack of factors exerting inflationary pressure. Decreased unit labour costs over the past two and a half years compensated partially the inflationary pressure of oil and major raw material prices. Low consumption predetermined firms' inability to transfer high production costs to end-user consumers prompting further pressure on inflation.

In March euro area unemployment remained relatively high at 8.9 per cent on an annual basis. Unfavourable prospects for employment were retained following increased households' pessimism about the unemployment level over the first quarter.

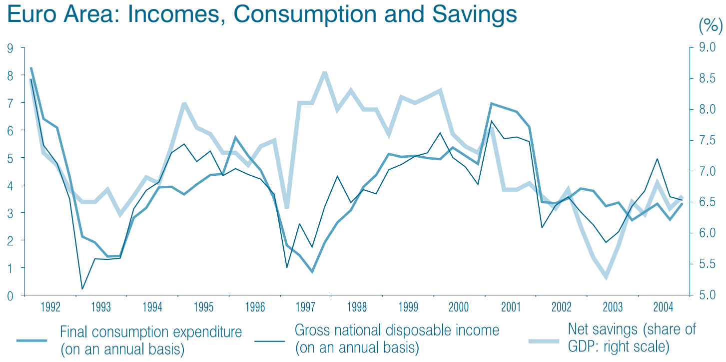
According to May 2005 data, euro area economic indicators (the ZEW indicator of economic sentiment and the IFO business climate index) moved downwards to signal slowing economic activity over the second quarter. The OECD leading indicator index retained its downward trend which suggests further slowdown in euro area economic growth in a six-month horizon. The business climate indicator and the ZEW economic sentiment indicator showed similar trends.

Chart 12
Contribution to Euro Area Growth by Component



Source: Eurostat.

Chart 13
Euro Area: Incomes, Consumption and Savings



Source: Eurostat.

...euro area economic indicators (the ZEW indicator of economic sentiment and the IFO business climate index) moved downwards to signal slowing economic activity ...

European economic forecasts point to low to moderate growth over the second half of 2005. European Commission expectations were revised downwards from 2 per cent to 1.6 per cent for 2005. The ECB also revised its forecast for the current and the following year to 1.2 – 2 per cent on an annual basis for 2005 (prior to revision: 1.4 – 2.4 per cent) and 1.6 – 2.6 per cent for 2006.

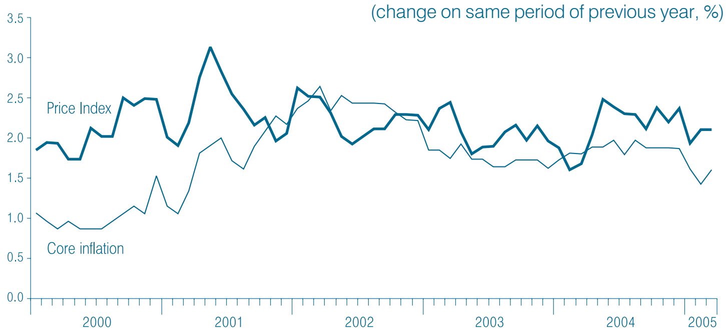
In the first 2005 quarter the ECB did not change its interest rate policy. Nonetheless, market expectations were altered at the end of the period. Until then the outlook that repo rate will be raised by 25 basis points during the third quarter prevailed. Following the announced data on economic growth slowdown and core inflation drops, it is unlikely that monetary policy will change until the end of the year. Consequently, spreads between six-month and 12-month LIBOR on EUR deposits and the ECB repo rate contracted from 40 basis points and 22 basis points in the third week of March to 14 basis points and 18 basis points at the close of April.

The downward trend in core inflation and lower risk stemming from the secondary effect of oil price increases gave rise to expectations of retaining interest rate levels till year-end. The ECB discounted the possibility of a repo rate cut. Recent worsening of leading economic indicators prompted increased pessimism about economic activity which raised market expectations of coming interest rate changes.

According to this view, the spread between futures contracts yield and three-month EURIBOR in early May showed no probability of a significant change in the ECB monetary policy until year-end. Market expectations built into the forward yield curve matched those on the futures market. Based on market expectations, six-month LIBOR on EUR-denominated deposits will probably move within the projected 2.10 to 2.25 per cent band over the second quarter of 2005.

Chart 14

Euro Area Inflation Rate



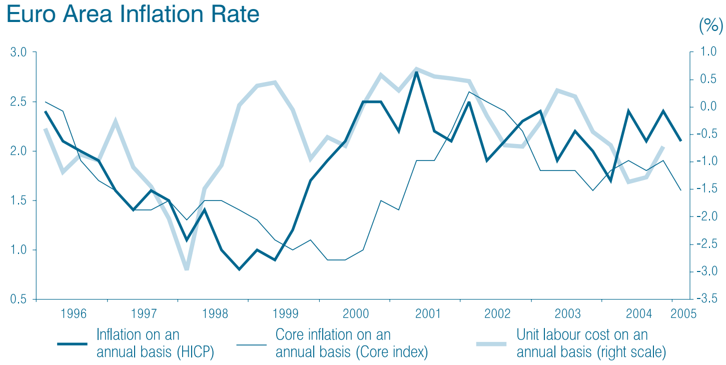
Source: Eurostat.

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

...no direct inflationary pressures in the first quarter...

Chart 15

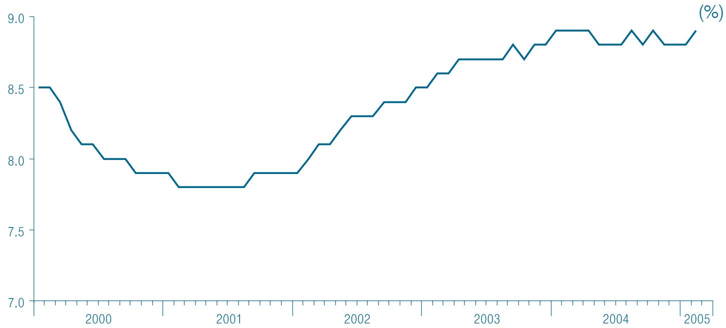
Euro Area Inflation Rate



Source: Bloomberg.

Chart 16

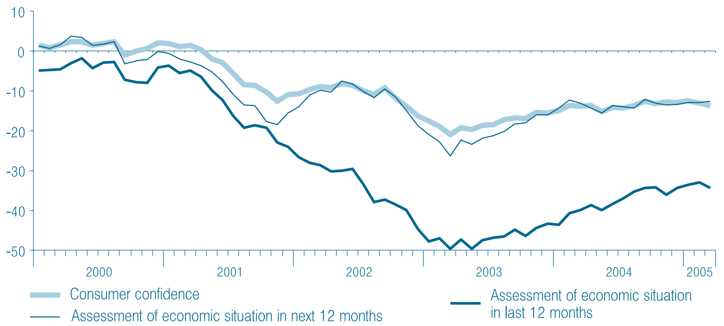
Euro Area Unemployment Rate



Source: Eurostat.

Chart 17

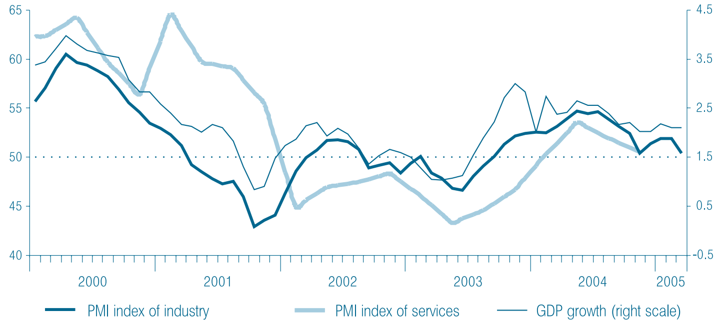
Euro Area Consumer Confidence Indicators



Source: Eurostat.

Chart 18

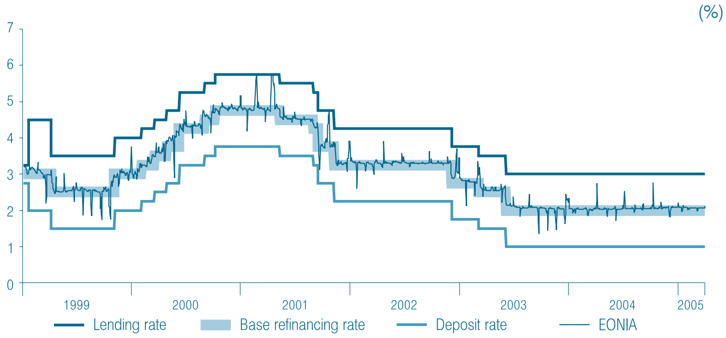
Euro Area PMIs and Growth



Source: NTC Research.

Chart 19

Euro Area Base Interest Rates



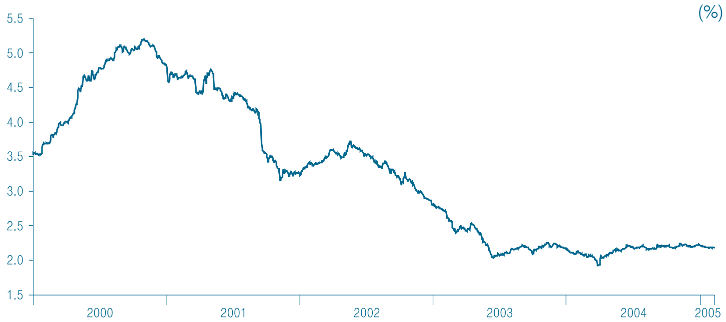
Source: Bloomberg.

EU-25

Weak euro area growth had a negative effect on EU-25 growth (1.9 per cent in the last quarter of 2004). Nevertheless, other EU member countries reported higher growth than that in the euro area. Newly acceded countries' growth came to 4.2 per cent over the fourth quarter of 2004 (4.6 per cent for the third quarter). Slovakia and the countries adopted a currency-board type systems (Lithuania, Latvia and Estonia) reported the highest rates of growth.

Chart 20

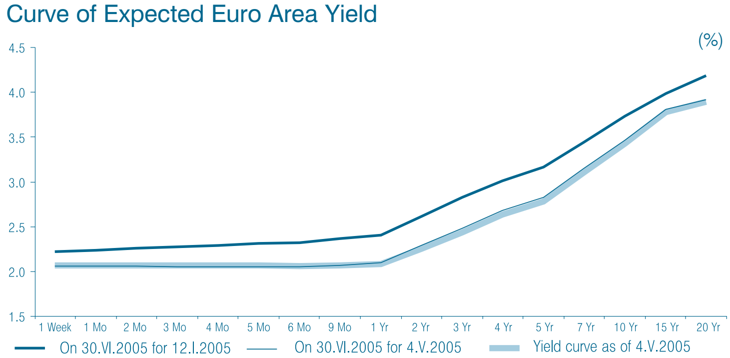
Euro Area Interest Rates on Interbank Deposits with Six-month Maturity (EURIBOR)



Source: Bloomberg.

Chart 21

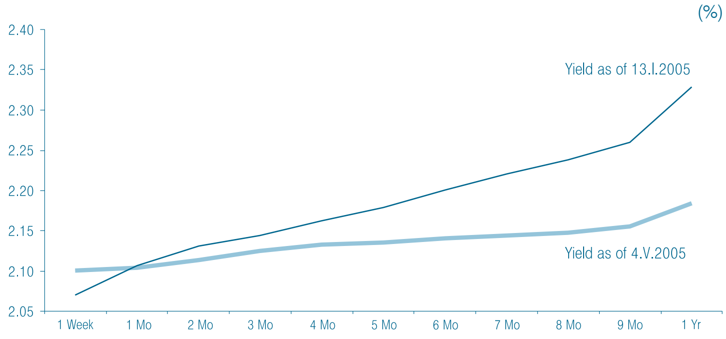
Curve of Expected Euro Area Yield



Source: Bloomberg.

Chart 22

Euro Area Money Market Yield Curve



Source: Bloomberg.

The IMF and European Commission Spring Forecasts

In April the IMF[1] and the EC[2] published their spring forecasts. The global economic slowdown which started in the third quarter of 2004 is expected to subdue over the second 2005 quarter, and growth to accelerate in the second half-year, yet at rates lower than in 2004.

The IMF and EC forecasts of US and euro area 2005 growth are nearly identical. The euro area 2005 and 2006 growth forecasts were revised down due to unexpectedly low growth over the second half of 2004 and crude oil price hikes. US growth is expected to remain above potential in 2005. It is anticipated that the lagging effect of the US dollar depreciation on trade balance will emerge in 2005 and 2006 and export growth will outstrip import growth. The outlook for developing countries remains optimistic, with the highest rates in the Asian Region, the CIS countries and Africa.[3]

The 2005 global inflation is expected to be moderate with a view to the policy of raising interest rates in most developed countries. Risks for accelerating inflation stem from higher unit labour costs which dropped significantly in most industrialized countries over 2004 and are expected to increase in 2005.

Risks to 2005 and 2006 economic growth are associated with imbalances in current accounts globally and in the USA, as well as with high crude oil prices, a result of increasing demand and geopolitical uncertainty.

Table 1

Major Trends in EC and IMF Spring Forecasts

(real percentage change)

			Spring forecast, 2005		Change on autumn forecast, 2005	
	2003	2004	2005	2006	2005	2006
EC						
EU						
GDP growth	1.0	2.4	2.0	2.3	-0.1	-0.3
Euro area						
GDP growth	0.6	2.0	1.6	2.1	-0.1	-0.4
Unemployment	8.7	8.8	8.8	8.8	-0.1	-0.1
Inflation	2.1	2.1	1.9	1.5	0.0	0.0
USA						
GDP growth	3.1	4.4	3.6	3.0	0.0	0.6
Unemployment	6.0	5.5	5.2	5.0	0.0	-0.3
Inflation	2.3	2.7	2.6	2.3	0.1	-0.2
Japan	1.4	2.7	1.1	1.7	-1.5	-1.0
Latin America	1.7	5.6	3.9	3.6	0.9	0.2
Asia (Japan excluded)	7.6	7.8	7.1	7.1	0.3	0.2
Africa	3.8	4.2	5.7	6.1	0.9	1.3
World growth	3.7	5.0	4.2	4.1	0.0	0.0
IMF						
EU						
GDP growth	1.2	2.5	2.1	2.5	-0.1	-0.4
Euro area						
GDP growth	0.5	2.0	1.6	2.3	-0.2	-0.6
Unemployment	8.7	8.8	8.7	8.4	-0.2	0.0
Inflation	2.1	2.2	1.9	1.7	0.1	0.0
USA						
GDP growth	3.0	4.4	3.6	3.6	0.1	0.1
Unemployment	6.0	5.5	5.3	5.4	0.0	-0.1
Inflation	2.3	2.7	2.7	2.4	-0.3	-0.3
Japan	1.4	2.6	0.8	1.9	-1.8	-1.5
Advanced economies	2.0	3.4	2.6	3.0	-0.2	-0.3
Western Hemisphere	2.2	5.7	4.1	3.7	1.1	0.5
Asia	8.1	8.2	7.4	7.1	0.9	0.9
Africa	4.6	5.1	5.0	5.4	0.6	-0.5
World growth	4.0	5.1	4.3	4.4	0.2	0.0

Source: EC and IMF.

[1] IMF, *World Economic Outlook*, April 2005.

[2] European Commission, *Economic Forecasts – Spring 2005*, April 2005.

[3] Developing countries reported favourable growth performance in 2004 since prices of raw materials, especially of crude oil and natural gas rose over the year. Some of these countries attracted significant foreign investments. The World Trade Organization put the share of developing countries in international trade at 31 per cent, the largest since 1950.

The USD/EUR Rate

The USD/EUR exchange rate fluctuated within the relatively broad range of USD 1.27 to USD 1.36 *per* EUR 1 over the first quarter of 2005, reflecting divergent factors. The most important among them include: the expected behaviour of the interest rate differential between the USA and the euro area; putative signals of contracting the US fiscal deficit; US current account dynamics and sustainable financing by capital flows. On individual days, the USD/EUR rate changed due to concerns associated with possible diversification of several Asian central banks' international reserves.

In the second quarter greater fluctuations are possible with a view to increasing uncertainty about the Federal Reserve and ECB policy and slowing rates of global economic growth. Market forecasts put the USD/EUR rate at the 1.20 to 1.32 levels. At the start of the period a slight US dollar appreciation is expected as a result of any further increase in the interest rate differential between USD-denominated assets and EUR-denominated ones, as well as high net capital inflows adequate to cover the US trade deficit.

The assumption still prevails that until the close of the year uncertainty about trade deficit financing will push the dollar's value down.

Chart 23

USD/EUR Exchange Rate

Source: Bloomberg.

...in the second quarter greater fluctuations on foreign exchange markets are possible ...

The Balkan Region

In the fourth quarter of 2004 growth on the Balkans retained its high rates reported over 2004. Turkey posted the highest growth in the region, followed by Romania, Albania, and Bulgaria. Industrial output remained high in the first 2005 months. Signs of enhanced industrial output were registered in Macedonia following the significant drop in the first half of 2004.

Over the first quarter of 2005 inflation rates slightly rose in most countries. A one-off acceleration in inflation is expected over the second quarter due to projected increases in administratively controlled prices in some Balkan countries.

We expect economic growth on the Balkans to stay relatively high in the second and third quarters of 2005 at rates lower than those reported in 2004.

Table 2

Real Growth and Inflation in Balkan Countries

	2003	2004					2005
	Total	I	II	III	IV	Total	I
Growth (on an annual basis, %)							
Bulgaria	4.5	4.5	5.5	5.8	6.2	5.6	
Greece	4.7	4.3	4.1	4.0	4.2	4.2	
Macedonia	2.8	2.4	3.7	3.4	2.1	2.9	
Romania	4.9	6.1	7.1	11.1	8.9	8.3	
Turkey	5.8	11.8	14.4	5.3	6.3	8.9	
Croatia	4.3	4.2	3.8	3.6	3.6	3.8	
Inflation (as of end of period, %)							
Bulgaria	5.6	6.2	7.3	6.3	4.0	4.0	4.3
Greece	3.1	2.9	3.0	2.9	3.1	3.1	2.9
Macedonia	2.6	1.4	-0.2	-1.8	-1.9	-1.9	0.2
Romania	14.1	13.1	12.0	11.1	9.3	9.3	8.7
Turkey	18.4	11.8	8.9	9.0	9.3	9.3	7.9
Croatia	1.7	1.4	2.5	1.5	2.7	2.7	4.0

Source: Statistical institutes and central banks of respective countries.

International Prices of Major Raw Materials, Crude Oil and Gold

Crude Oil

Crude oil prices were extremely dynamic in the first quarter of 2005. By contrast with the previous quarter' developments, trends reversed upwards, with Brent crude trading at USD 47.6 *per* barrel on average. March saw the peak of USD 53.1 *per* barrel: the highest level since October 2004.[4]

The unexpectedly high demand coupled with supply adequate to additional production facilities capacity were the key factors behind price spikes. The end-2004 price drop was accompanied with statements of a decrease in OPEC's output quota which was treated as a clear sign that levels below USD 40 *per* barrel were not acceptable to OPEC. Concurrently, cold weather in the Northern Hemisphere increased fuel demand, thus reducing inventories.

Another factor producing instability was China, the country with the highest contribution to world oil demand growth over 2004, which announced its plans for using international reserves to increase the strategic crude oil reserves.

The OPEC countries reacted adequately by increasing oil supply by 500,000 barrels *per* day to reach 27.5 million barrels, albeit at high prices.

In April 2005 tension on petroleum markets subsided following the announced OPEC forecasts of free resources which may double compared to 2004 (9.5 per cent on average). Announced also were OPEC countries' plans to increase output capacity by 3.5 – 4 million bb/d for the 2006 to 2010 period. The IEA information published in April showed a significant excess of oil supply over demand during the first 2005 quarter.

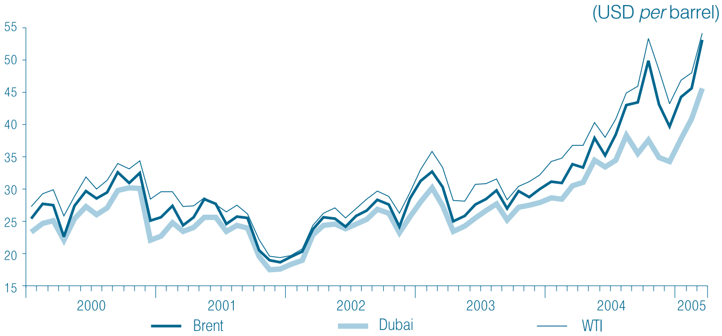
We expect the Brent crude price to retain its high levels of USD 48 – 54 *per* barrel over the coming two quarters. Despite the positive data on petroleum supply, the uncertainty about the free capacity which may satisfy the increasing demand in the short run still remains. As the world's largest oil importer and consumer, the USA affected significantly oil prices on interna-

[4] On 4 April oil futures prices reached record rises on both sides of the Atlantic: Brent was traded at USD 57.65 *per* barrel, while the US market registered a value of USD 58.28 *per* barrel.

...March saw the peak of USD 53.1 *per* barrel: the highest level since October 2004...

Chart 24
Crude Oil

(USD *per* barrel)

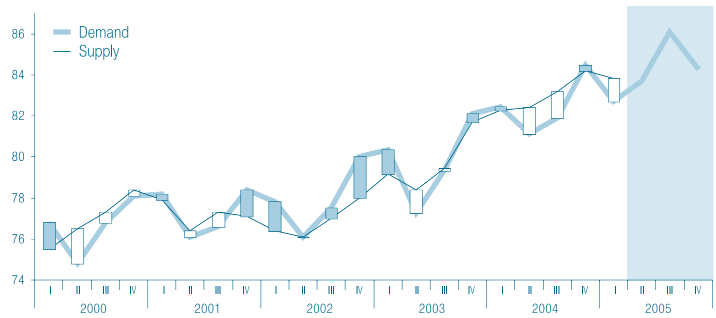


Source: World Bank.

... the unexpectedly high demand coupled with supply adequate to additional facilities capacity were the key factors behind price spikes...

Chart 25
World Oil Demand and Supply

(million barrels *per* day)



Source: International Energy Agency.

...we expect the Brent crude price to retain its high levels of USD 48 – 54 *per* barrel over the coming two quarters...

tional markets. The coming summer months in the USA will see enhanced demand for petrol which explains efforts to accumulate inventories over the second quarter. Large inventories are expected to push oil prices lower. Over the third quarter demand for petrol products will increase prompting price hikes. The expected upper limit of the normal range will be USD 54 *per* barrel.

Calculated in euro, the OPEC basket oil price remained above the corridor of EUR 22 to 28 *per* barrel. The average quarterly value was EUR 33.3 *per* barrel. The oil price rise in USD was higher than the valuation effect of euro appreciation. Given our EUR/USD exchange rate forecasts for the second and third quarters of 2005, we expect the average price to fluctuate in the corridor of EUR 31 to 36 *per* barrel. Furthermore, it is unlikely to expect that the average price will return to the corridor of EUR 22 to 28 *per* barrel.

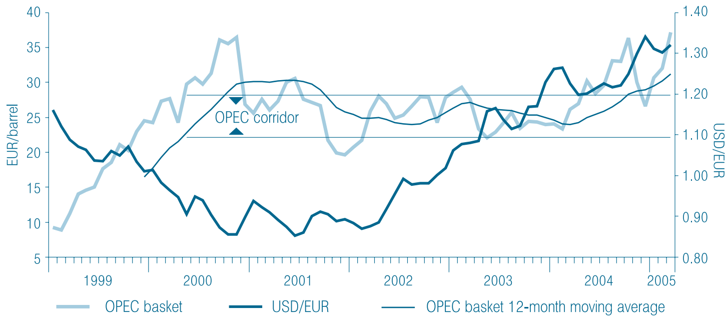
Major Raw Material and Commodity Prices

In the first quarter of 2005 metal prices rose by 17 per cent on the prior quarter. In addition to non-ferrous metals (zinc, aluminium, and lead), steel prices also increased. The high metal demand over 2004 led to significantly decreased inventories in commodity exchanges. Thus, uncertainty in delivering to final customers increased. China, thanks to its high demand, continued to play a key role on the market. Metal prices are expected to rise in the second and third quarters to overcome the imbalance in metal inventories on the world exchanges.

By contrast with metal prices, food prices moved within the anticipated bounds close to the fourth quarter's levels. We expect food prices to increase slightly in the second quarter of 2005 and to fluctuate depending on weather conditions in the third quarter.

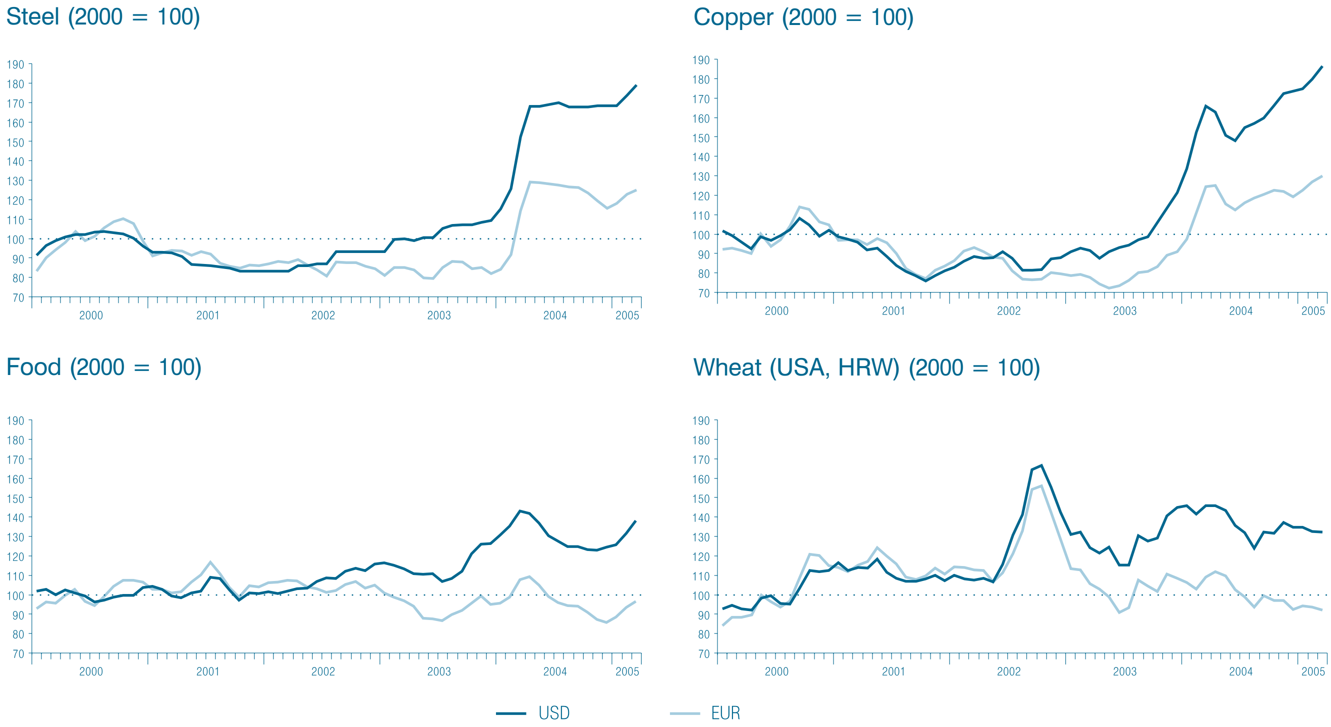
...in the first quarter of 2005 metal prices rose by 17 per cent on the prior quarter...

Chart 26
OPEC Basket Price in Euro



Source: World Bank, ECB, BNB, OPEC.

Chart 27
Price Indices of Major Commodities and Commodity Groups



Source: World Bank, BNB.

Gold

Gold price movements over the first quarter of 2005 reflected mostly the link with the US dollar. On individual days, the traditional role of gold as a store of value intensified. For a short period, the gold price exceeded the level of USD 440 *per* 1 troy ounce.

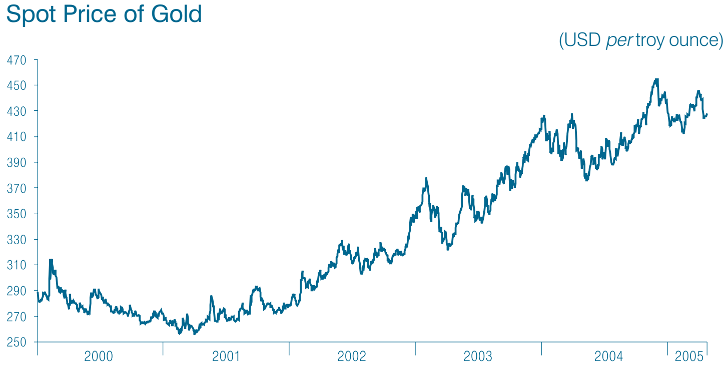
Early February saw a three-month minimum due to closing positions after Iraq's first democratic elections. Another factor involved speculations about IMF gold reserve revaluation at market value which later were denied after the US stiff opposition.

Gold price reached its peak since early 2005 on 3 March when projections of the US dollar depreciation had a significant impact on investors' decisions.

According to the World Gold Council, consumer demand rose by 7 per cent in 2004 (the first increase in recent four years) and jewellery demand by 7.5 per cent.

Until end of third quarter the gold price is expected to move within the range of USD 395 to 460 *per* troy ounce. We will see the following factors affecting the gold price: the technical link with the US dollar and the seasonally high demand in India; the potential for increasing investment demand; reducing hedging posi-

Chart 28
Spot Price of Gold



Source: Bloomberg.

tions and opening new positions primarily by New Zealand and Australian companies.

Bulgarian External Debt Dynamics on International Financial Markets

Debt markets in emerging economies were dynamic in the first quarter of 2005. Until 7 March securities spreads measured by the EMBI+ index contracted steadily. Increased inflationary expectations in the USA prompted long-term interest rate rises which coincided with worsening financial performance of General Motors Corp. (one of the largest corporate debt issuers rated borderline investment grade). Since the risk rating of many emerging economies is close to investment grade, most institutional investors hastened to sell their positions frightened by increasing uncertainty. Hence, the EMBI+ spread picked up by nearly 70 basis points until the close of March. Debt securities of the countries with a credit rating close to BBB were mostly affected by investors' behaviour.

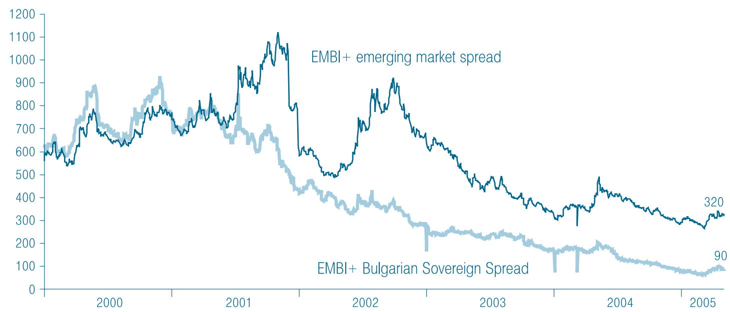
The trend to further declines in Bulgarian government securities spreads measured by the JP Morgan EMBI+ index was evident most of the time in the first quarter of 2005. From early March till the end of the third week of April the Bulgarian government securities spread increased by 35 basis points, a significantly lower than the overall emerging market index rise of 51 basis points.

The current macroeconomic stability and prudent fiscal policy are important factors behind relatively greater interest in Bulgarian government debt. Signing of Bulgaria's Treaty of Accession to the European Union boosted confidence in the national economy. The upgrading of Bulgaria's rating for foreign currency long-term senior debts from BBB- to BBB/Stable and for local currency long-term senior debts from BBB to BBB+/Stable by the Japanese JCR on 9 May was indicative of investors' improved assessments.

Chart 29

Spread of JP Morgan Index for Emerging Markets

(basis points)



Source: Bloomberg.

2. Financial Flows, Money and Credit

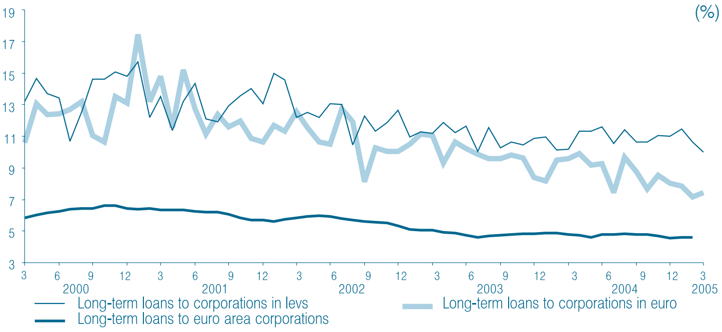
International conditions have a direct effect on the economic activity in Bulgaria reflecting the open nature of the economy and free movement of capital. In recent years favourable internal conditions, enhanced certainty about the sound economic development in the following years, as well as the interest rate differential between internal and international interest rates have been the major factors impacting capital inflow into Bulgaria.

A part of the capital inflow into Bulgaria prompted an increase in BNB international reserves. By end-March 2005 the Issue Department assets totalled BGN 13,197.6 million (EUR 6747.8 million), up 25.8 per cent on March 2004. Cash flows prompting more sizable changes in gross international reserves during the first quarter were associated with commercial banks' liquidity management transactions and demand for national currency (net purchases of reserve currency from commercial banks) and the net result from transactions with state budget funds, reporting the budget revenue from privatization and energy distribution companies, on the one hand, and expenditure on government's buybacks of Brady bonds made in January 2005.

Another part of the capital flow was infused in the banking system and coupled with increasing household deposits formed significant resources for lending to the economy. As a result, since mid-2001 claims on the non-government sector increasingly grew exceeding 50 per cent on an annual basis in mid-2003. In 2004 the BNB initiated more radical measures intended to withdraw liquidity from the banking system, with the direct effect evaluated at 1.7 per cent of GDP.[5]

Chart 30

Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

... BNB international reserves reached EUR 6747.8 million by end-March 2005 ...

[5] The qualitative assessment of measures initiated by the BNB in 2004 may be found in details in BNB Annual Report for 2004 and in previous issues of the Economic Review.

Table 3
Cash Flows Which Prompted Significant Changes in Gross International Reserves

	2004, total	First quarter, 2005
A) Purchases and sales of reserve currency (million EUR)		
- Net purchases from commercial banks	EUR +1428 million	EUR +328 million
- Revenue (outflows) related to net purchases (sales) at tills	EUR +25 million	EUR -3 million
B) Changes due to revenue on commercial banks' minimum required reserves accounts in foreign currency	CHF +233 million EUR +96 million USD +24 million	CHF -52 million* EUR +55 million USD -99 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	**Revenue:** USD +315 million – revenue from released (and sold) collateral on Brady bonds; EUR +184 million – from BTC privatization. **Loans:** EUR +123 million from the World Bank and SDR +52 million from the IMF; government securities issued by the MF in EUR: EUR +53 million. **Payments on external government debt:** USD -1007 million, EUR -205 million, SDR -101 million; JPY -4.2 billion; CAD -10 million.	**Revenue:** 1. From privatization of energy distribution companies: EUR +555 million; 2. From external loans: EUR +18 million; 3. From issue of external debt: EUR +17 million. **Payments:** 1. On the external government debt: USD -1074 million; EUR -168 million, SDR -6 million; JPY -600 million. 2. On the internal government debt: EUR -3 million.

* As a result of the amendments to Regulation No. 21 which do not allow commercial banks to maintain minimum required reserves in currencies other than the lev and euro, during the first quarter CHF 52 million and USD 99 million were withdrawn.
Source: BNB.

The central bank's efforts were also backed up by the government which in 2004 withdrew liquidity through the consolidated state budget accounting for 1.7 per cent of GDP. As a result, progressively accelerating lending growth was discontinued and lending growth rates stabilized around 47 – 48 per cent on an annual basis. As of early 2005 the BNB continued to employ measures aimed at subduing growth of credit to the non-government sector to 30 per cent annually by the end of 2005 (See p. 20).

Amendments to the Ordinance on minimum required reserves prompted reactions of a multiple increase in credit in the last week of March intended to raise commercial bank base for reporting minimum required reserves. Therefore, end-March monetary statistics data and balance of payments data should be cautiously interpreted and changes in monetary and credit flows and in the structure of banks' assets and liabilities reported in April should be taken into account.

BNB Measures Intended to Limit Growth of Credit to the Non-government Sector

Dramatic growth in claims on non-financial corporations and households surveyed as of 2003 increases risks for the banking system and threatens the stability of the balance of payments current account. To this end, in early 2005 the BNB initiated new measures to continue the 2004 policy of stabilizing the increase in private sector credit to a moderate rate which may be maintained in the medium run and will not threaten the financial stability.

Amendments to Ordinance No. 21 of the BNB on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks

Amendments to Ordinance No. 21 are based on the principle of reporting individual banks' risk profiles, with banks implementing the most aggressive policies being required to maintain additional reserves with the BNB to be used as a cushion against accumulated credit risk. A bank has to maintain additional minimum required reserves provided the two conditions are simultaneously satisfied:

1. the percentage growth of total credit exceeds the amount specified in the Ordinance, with end-March 2005 being the reporting base;
2. the amount of extended loans and risk-weighted off-balance-sheet items converted into balance-sheet assets less the amount of banks' own funds exceeds 60 per cent of the funds which banks have attracted from persons other than banks and non-bank financial institutions.

Provided these conditions are satisfied, the bank should maintain additional minimum required reserves to the double amount of the excess of the three-month total credit growth over the statutory allowed. In fact, no constraints on lending are imposed and only additional minimum reserves are required against higher risk.

With the amendments to Ordinance No. 21 the number of currencies in which commercial banks may maintain minimum required reserves with the BNB is reduced. As of 1 April 2005 minimum required reserves are to be maintained in national currency (Bulgarian lev) or in reserve currency (euro).

To inform banks on its decision in due time, on 23 February 2005 the Bank announced the amendments to Ordinance No. 21. Banks reacted by dramatically increasing their credit portfolios in March intended to raise the base for reporting credit growth rates. In March private sector credit posted an increase by BGN 3.28 billion, with the last week's rise alone amounting to BGN 1.7 billion. Dramatic credit growth rates did not allow the BNB to achieve its indicative objective of private sector credit growth of about 30 per cent *per* annum in 2005 and entailed changes in additional reserves under Ordinance No. 21.

On 21 April 2005 the Governing Council of the Bulgarian National Bank approved amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks, Ordinance No. 8 on the Capital Adequacy of Banks and Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss. These amendments are aimed at neutralizing the impact of extremely high rates of private sector credit growth reported in the last week of March according to the reporting basis of credit growth. In accordance with Ordinance No. 21, the amount of loans reported by 31 March 2005 is to be considered the reporting basis of credit growth rates, but for banks whose total loans disbursed by 31 March exceeded by 4 per cent the level of 28 February 2005 the reporting basis will be the amount by 28 February 2005 increased by 4 per cent. The amount of loans and data associated with the conditions for maintaining additional minimum required reserves are to be reported on a daily basis. The three-month rate of growth set by the central bank is computed as an increase in the average value of credit by the end of each business day: the three-month average growth rate is set at 5 per cent, six-month at 12.5 per cent, nine-month at 17.5 per cent and twelve-month at 23 per cent. The higher rates of growth set in the first quarter after the enforcement of the new requirements are intended to help banks easier comply with the constraints following the high growth rates reported in March.

Amendments to Ordinance No. 8 of the BNB on the Capital Adequacy of Banks

According to the amendments to Ordinance No. 8, the current profit is to be excluded from commercial banks' capital in reporting their capital base. Prior to this amendment, commercial banks were allowed to include the audited current profit in the middle of the year in the capital base. With the enforcement of this amendment the opportunity of commercial banks to use the current year profit as a capital support in lending was entirely removed.

In compliance with the amendments, the capital adequacy ratio is to be reported on a monthly basis intended to provide timely information to the BNB and improve supervision of this indicator.

Amendments to Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss

In accordance with the amendments, classified assets may not be reclassified into a lower-risk classification group immediately after the ground for reclassification has been removed. The former provision effective until the end of 2002 has been restored. According to this provision, classified assets may be reclassified upon the expiry of a six-month period. During the six-month period the debtor should prove that he has significantly improved his ability to service the credit.

Financial Flows and External Position Sustainability

Between January and March 2005 the balance of payments current account deficit came to BGN 1383.4 million, an increase of BGN 406.8 million compared with the same period of 2004, reflecting the worsened trade balance by BGN 279.9 million to BGN -1274.3 million and the balance on services by BGN 92.7 million. Over the same period a surplus of BGN 1966.1 million was reported on the balance of payments financial account despite the costs of BGN 1406.7 million on the Brady bonds buyback. The *foreign direct investment to current account deficit* ratio stayed high, with FDI covering by March 2005 123.3 per cent of the deficit on an annual basis.[6]

The current account deficit was primarily financed by flows increasing Bulgaria's external indebtedness. By March 2005 gross external debt totalled EUR 12,854.8 million, up EUR 600 million on end-2004. The purchase of government debt in January, resulting in a decline of EUR 714.7 million in obligations to non-residents on the debt in IAB Brady bonds, had a depressive effect on total debt growth rates.

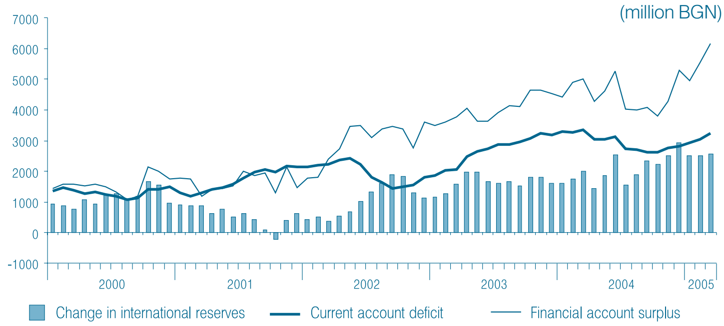
By March 2005 the *General government sector* item accounted for 40.1 per cent of gross external debt against 59.2 per cent in March 2004. This share is expected to go down given the sustained government policy in respect of external debt management. On a year-to-year basis, the share of the external debt of the private non-financial sector[7] (*Other sectors*) rose from 18 per cent to 24.5 per cent (by approximately EUR 1.1 billion).

Between January and March 2005 the share of commercial banks' debt exhibited an increase of 159.2 per cent or EUR 1.5 billion on March 2004, with commercial banks' share in Bulgaria's total external debt rising from 8.2 per cent to 19 per cent in the same period. Non-resident deposits remained the major factor responsible for this growth. A significant portion of these deposits were extended by foreign banks intended to provide resources to

...by March 2005 foreign direct investment covered 123.3 per cent of the deficit on an annual basis...

Chart 31

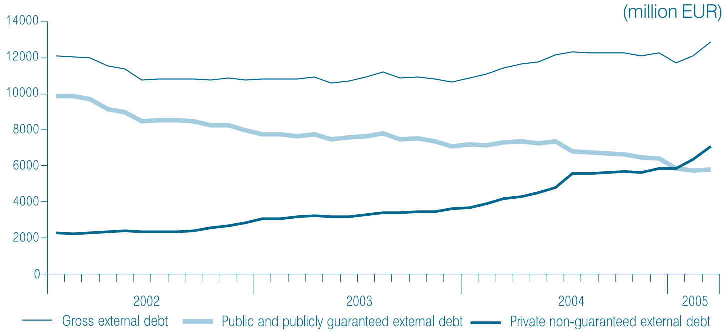
Dynamics of Current Account, Financial Account and International Reserves on an Annual Basis



Source: BNB.

Chart 32

Gross External Debt



Source: BNB.

... since early 2005 commercial banks contributed most significantly to the increased gross external debt...

[6] Within the *Foreign direct investments* item of the September 2004 balance of payments, a subitem indicating merges and acquisitions was included under which the transaction with M-Tel was reported. Given the specificity of mergers and acquisitions, the indicators were computed by using the *Direct investment in the reporting economy* item which did not include the balance on the *Mergers and acquisitions* item.

[7] Intercompany loans excluded.

resident banks, consistent with dramatically risen commercial bank lending by the end of March financed at the expense of increased external liabilities. In March 2005 alone external loans and deposits disbursed to commercial banks totalled EUR 524.2 million.

The increased private non-financial sector debt was entirely attributable to the loans drawn which posted a 56.1 per cent growth in March 2005 on a year earlier basis. Liabilities on trade credits continued increasing reflecting probably the high growth rates in imports.

Table 4

Commercial Bank and Non-bank Non-government Sector's Debt Dynamics

	March 2004 (million EUR)	March 2005 (million EUR)	Change (%)	Contribution (percentage points)
Commercial banks	**941.0**	**2439.2**	**159.2**	
Loans	232.7	602.7	159.0	39.3
Non-residents' deposits	571.8	1712.7	199.5	121.2
Other	136.5	123.9	-9.2	-1.3
Other sectors	**2059.6**	**3149.2**	**52.9**	
Loans	1455.9	2272.2	56.1	39.6
Trade credits	600.7	874.0	45.5	13.3
Bonds	2.9	2.9	0.0	0.0
Other	0.0	0.0		-
Direct investment: intercompany loans	**1673.1**	**2117.0**	**26.5**	

Source: BNB.

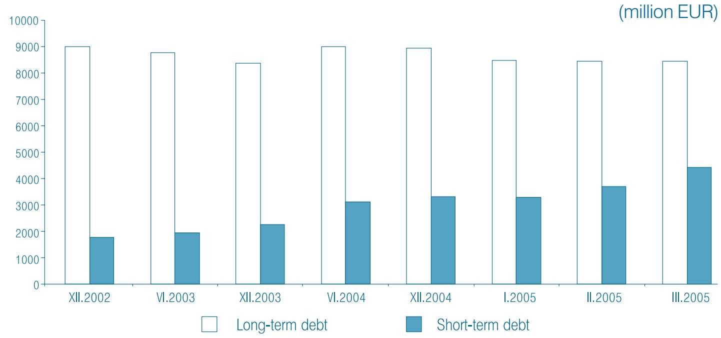
Note: As of early 2005 external debt statistics has been published in accordance with the new classification.

Following the buyback of external government debt (long-term), the share of short-term debt exhibited growth. By March 2005 short-term external debt reached EUR 4435.5 million, posting an increase by EUR 724 million for a month alone, driven primarily by the accelerated growth of commercial banks' debts in the form of non-resident deposits.

Risk assessment associated with gross external debt service is based on the maturity, currency and interest rate structure of the debt. The short-term debt continued increasing, with inetrcompany loans and trade credits comprising 45 per cent of this debt. These liabilities directly reflect the buoyant economic activity and foreign investments in Bulgaria. This type of short-term debt is not considered as high-risk, as it is supposed that despite its short-tem nature this debt reflects long-term interests. Given the confidence in the economic policy pursued and the macroeconomic stability sustained for eight years, there are no internal factors prompting a rapid change in foreign investors' expectations and correspondingly withdrawal of capital from Bulgaria.

Chart 33

Long- and Short-term Gross External Debt Dynamics



Source: BNB.

External debt's currency structure did not presupposed high risks from exchange rate movements. By March 2005, 83.8 per cent of the commercial banks' debt and 74.7 per cent of *Other sectors* debt was denominated in euro. The share of the euro in liabilities on direct investments accounted for 72 per cent. The share of the US dollar in the *Other sectors* debt remained higher (more than 22 per cent), while the commercial banks' debt exposure in US dollars was lower, 6.9 per cent. The share of the US dollar in liabilities of the *General government* sector stayed highest: 31.6 per cent against 48.6 per cent in euro. However, this component diminished due to the transactions in debt restructuring.

More serious threats for debt service are associated with the changes in the interest rate structure of new non-residents' loans extended to the real sector. Between January and March 2005, the newly disbursed loans at a floating exchange rate accounted for 54.2 per cent, and those at a fixed interest rate made up 29.6 per cent[8]. Between January and March 2004 loans extended at a floating interest rate comprised 30.8 per cent of total new loans. The split of newly extended loans coupled with the faster-than-expected rise in international interest rates enhance the risks for debtors and may prompt past due payments, particularly in terms of the US dollar-denominated debt given the expected increase in US Federal Reserve System interest rates.

Table 5

Selected External Debt Indicators

(%)

	XII.2003	XII.2004	I.2005	II.2005	III.2005
Short-term debt/exports of goods and non-factor services	23.9	29.1	28.3	32.0	37.7
Short-term debt/GDP	12.8	17.0	-	-	-
Short-term debt – intercompany loans – trade credits/ exports of goods and non-factor services	9.2	12.3	10.7	13.6	17.5
Private sector debt/exports of goods and non-factor services	38.0	51.3	50.8	55.0	60.3

Note: The above indicators are selected from a broader range of indicators and are sufficiently indicative of the external debt state and dynamics.
Source: BNB.

BY end-March 2005 external debt indicators worsened on the end-2004. Despite there are no signs of difficulties in debt service and forecasts on the international environment do not signal immediate risks, the increasing indebtedness to external creditors, even to parent banks, enhance the banking sector vulnerability.

[8] No interest is accrued on the remaining loans, or special schemes of interest payments are applied on them.

In the second quarter of 2005 the balance of payments current account is expected to worsen by about EUR 150 million compared with the second quarter of 2004. Over the third quarter of 2005 the seasonal surplus on the current account is projected to approximate EUR 530 million, an increase by about EUR 130 million on the corresponding period of 2004. If the flow dynamics on the financial account sustains and there are no government debt management transactions, BNB international reserves in the second and third quarters are expected to increase by approximately EUR 600 million each quarter.

Commercial Bank Intermediation

Over the first three months of 2005 external liabilities of banks rose by BGN 325.7 million, and by end-March their volume reached BGN 5191.8 million, posting a rise by 182.5 per cent on an annual basis.[9] In spite of the fact that deposits of households and corporations dominated the sources of borrowed funds for banks, the significance of foreign liabilities as a source of financing continued increasing. Increased foreign liabilities reflected the banks' ambition to expand credit under the favourable interest rate differential between domestic and international interest rates.

Between January and March 2005 household deposits grew by BGN 702.9 million and those of non-financial corporations by BGN 1971.2 million. Bank claims on these sectors rose by BGN 721.7 million and BGN 2943.6 million correspondingly. The rapidly growing deposit base reflects both the buoyant economic growth in Bulgaria and banks' behaviour prior to the enforcement by end-March of the new measures intended to limit the credit expansion as the bulk of external loans were blocked as deposits.[10]

The structure of net financial flows between banks and other sectors stayed unchanged from the previous reporting periods (Chart 35).[11] The external sector appeared to be a net source of funds for the banking sector, reflecting a significant increase in borrowed funds from non-residents. Non-financial corporations are the net user of funds and their in-

[9] The actual increase in foreign liabilities in the first quarter is larger than the reported one, since the volume of foreign liabilities by the end of 2004 was impacted by a temporary effect. As a result of the privatization of energy distribution companies in December 2004, earnings of about EUR 550 million received on commercial banks' accounts, were transferred to the BNB in the first quarter of 2005.

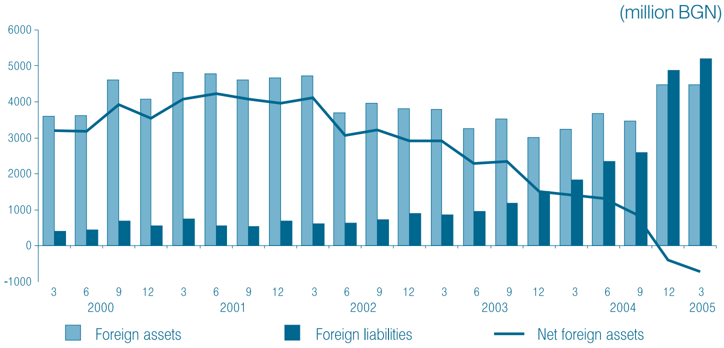
[10] See the *Credit Aggregates* Section.

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

... BNB international reserves are expected to increase in the second and third quarters...

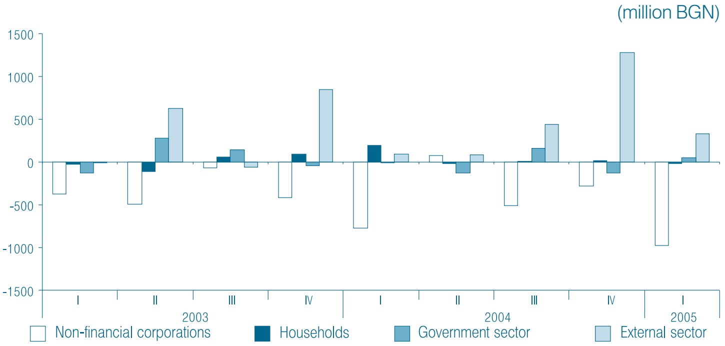
...commercial banks' foreign liabilities continued to increase at a fast rate...

Chart 34
Foreign Assets and Foreign Liabilities of Commercial Banks



Source: BNB.

Chart 35
Net Financial Flows of Commercial Banks (Quarterly)



Source: BNB.

debtedness to banks continued growing, consistent with the faster increasing loans compared with bank deposits. No changes occurred in the financial position of households to commercial banks.

...corporations' indebtedness to banks continued growing, the financial position of households remained comparatively unchanged...

Table 6

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

(million BGN)

	2004				2005
	I	II	III	IV	I
Claims on non-financial corporations	599.9	551.5	690.9	732.6	2943.6
Deposits of non-financial corporations	-170.0	624.6	179.7	449.2	1971.2
Claims on households	300.4	500.7	503.8	567.0	721.7
Deposits of households	498.9	486.7	508.9	580.2	702.9
Foreign assets	243.2	428.5	-206.8	1008.1	-4.1
Foreign liabilities	339.3	512.6	230.1	2285.8	325.7
Claims on government sector	190.5	-108.9	42.6	64.6	17.1
Deposits of government sector	177.8	-239.2	206.1	-64.2	65.8
Claims on central government	188.2	-109.6	42.2	66.9	16.3
Liabilities to central government	57.4	-212.7	189.7	-70.5	-95.6

Source: BNB.

Redistributive Role of the Consolidated State Budget

As in the previous years, during the last quarter of 2004 liquidity accounting for 10 per cent of GDP for this quarter was provided to the non-government non-bank sector through non-interest expenditure of the consolidated state budget. Deposits of the government with the central bank posted a smaller decline than that typical of this period of the year. The positive net issue of domestic debt, worth BGN 130.3 million over the reporting quarter (BGN 43.8 million over the fourth quarter of 2003) and the sale of a security on the Brady bonds purchased in mid-2004 to the amount of over BGN 400 million, funded partly the budget deficit.

Between January and June 2005 deposits of the government and budget-supported organizations with the BNB are expected to grow significantly, with their amount exceeding BGN 5 billion by end-June. As in the previous years, withdrawal of liquidity from the non-government non-bank sector will be the major source for accumulating resources in the government deposit. Net flows to the external sector are expected to be positive, with expenditure on the external debt service exceeding the anticipated earnings from privatization and new loans.[12]

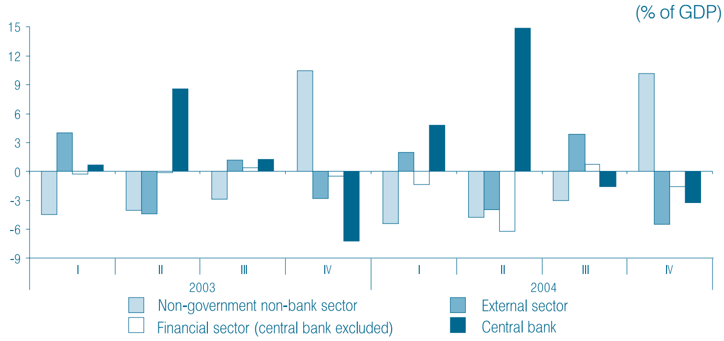
[12] By the end of January the government redeemed in advance bonds on past due interest (IAB) of USD 937.5 million. Earnings from privatization of energy distribution companies were transferred to the budget and reported in the budget statistics in early 2005 despite their reporting in the balance of payments for 2004. This reflects the different principles used in compiling the report on the budget execution and the balance of payments: on cash and accrual basis respectively.

...deposits of government and budget-supported organizations with the BNB are expected to grow in the second quarter...

Chart 36

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

(% of GDP)



Source: MF, BNB.

Monetary Aggregates

The balance of payments financial account surpluses generated in recent years led to a rapid increase in BNB international reserves and cash growth. In accordance with the currency board principle, currency in circulation and international reserves growth are of closest interdependence, while any inconsistencies in these two variables in particular periods reflect the changes in government funds in the Issue Department balance sheet.

During the first quarter of 2005 reserve money growth rate stayed unchanged on end-2004: 34 per cent on an annual basis. The major factor behind dramatically growing monetary base was commercial bank deposits with the BNB which in March almost doubled on a year-to-year basis. The reported increase was ascribable both to the deposit base rise and the measures enforced for limiting the credit expansion[13] in the second half of 2004. By the end of March dramatically increased deposits, consistent with the extensive lending, also had a short-term effect.

Currency in circulation sustained its rate of growth at 20 per cent *per* annum, a trend which occurred in mid-2003. Since the behaviour of currency in circulation is most closely tied to the economic activity in Bulgaria, it is comparatively less volatile.

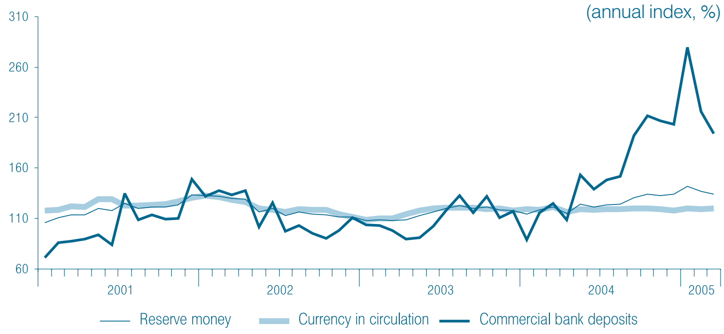
Between January and March 2005 broad money exhibited a high growth rate: 38 per cent on an annual basis. This growth was primarily attributable to the M1 monetary aggregate and overnight deposits alone rose by 66 per cent. Quasi-money went up by 34 per cent, with time deposits in levs posting the largest growth (54 per cent).

However, these changes reflect primarily the new requirements for minimum required reserves (to be enforced as of early April) associated with BNB efforts to subdue lending expansion, rather than the changes in the economic environment. Enhanced lending growth by end-March affected the dynamics of various types of deposits.[14]

Deposits of non-financial corporations and financial institutions moved within a wide range prompting fluctuations in total monetary aggregates. Based on the monetary survey, in

[13] For measures and results, see *Economic Review*, February 2005.
[14] See p. 20.

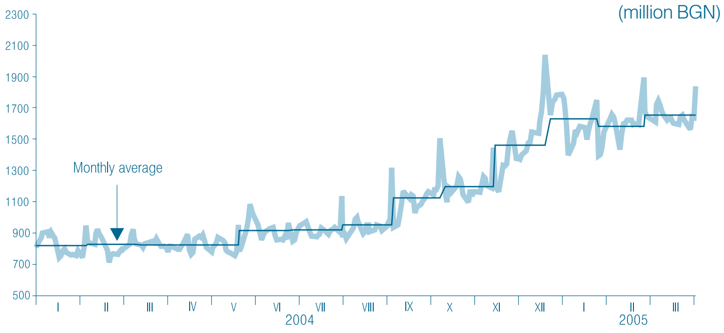
Chart 37
Reserve Money and Its Components



Source: BNB.

...reserve money increased by 34 per cent on an annual basis...

Chart 38
Commercial Bank Deposits



Source: BNB.

...higher growth rates of deposits in the first quarter reflected the banks' reaction to the changes in the Ordinance on the minimum required reserves...

March lev time deposits of non-financial corporations grew by BGN 581 million or 68 per cent on February, lev deposits redeemable at notice by 269 per cent and foreign currency deposits redeemable at notice by 1798 per cent. As regards financial institutions' deposits, overnight deposits exhibited the highest growth rates: 104 per cent in lev deposits and 308 per cent in foreign currency deposits. Enhanced banks' operations in borrowing funds and extending loans by end-March were clearly evidenced by the record high hit on 31 March in the interbank money market trade, worth BGN 383 million. Households stayed unaffected by these processes and household deposits grew at moderate rates.

During the first week of April broad money went down by 4.3 per cent, overnight deposits by 11.2 per cent, time deposits by 1.3 per cent and deposits redeemable at notice by 4.5 per cent. This fall supports the assumption of the speculative nature of the movements in these indicators by the end of March. The decline in broad money and particular types of deposits continued in the second week of April. As a result, monetary aggregates restored their normal dynamics.

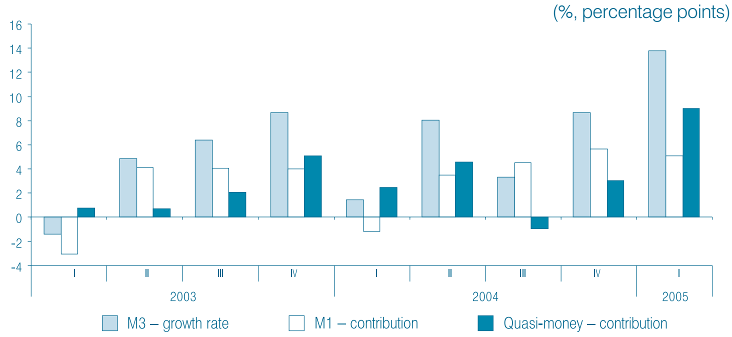
Enhanced commercial bank lending in March prompted a dramatic rise in money multiplier to 3.48 per cent against 3.12 in February. Given the significant increase in deposit base, the *currency outside banks to deposits* ratio fell down from 0.27 to 0.24 and the *bank reserves to deposits* ratio from 0.13 to 0.11. Changes in both ratios contributed to the increase in money multiplier. In April money multiplier values went down but stayed close to 3.3, a value significantly higher than those reported by the end of 2004 and in the first two months of 2005.

Following a slight fall in January and February 2005, in March interest rates on time deposits went up to their normal levels. This probably pertained to the enhanced demand for resources in March, given the intensified bank lending. In addition to the increase in deposits in levs and euro, time deposits denominated in US dollars also rose. This may be partly attributable to the increased international USD interest rates. Time deposits to corporations did not deviate significantly from the typical interest rate levels irrespective of their dramatic growth in March. The March lending rates may sustain in the future, since in ac-

...deposits of non-financial corporations and financial institutions were the major source of money supply growth...

Chart 39

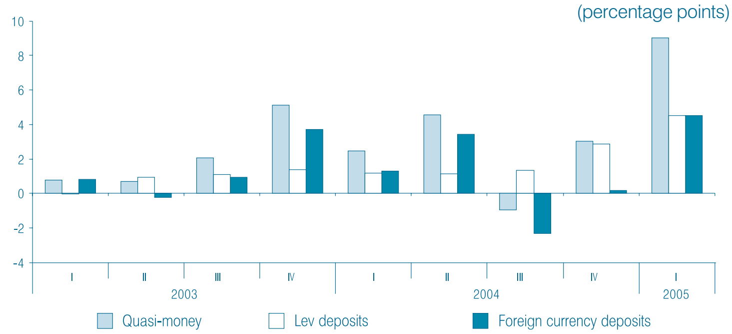
M3 Growth Rate and Contribution of M1 and Quasi-money (Quarterly)



Source: BNB.

Chart 40

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

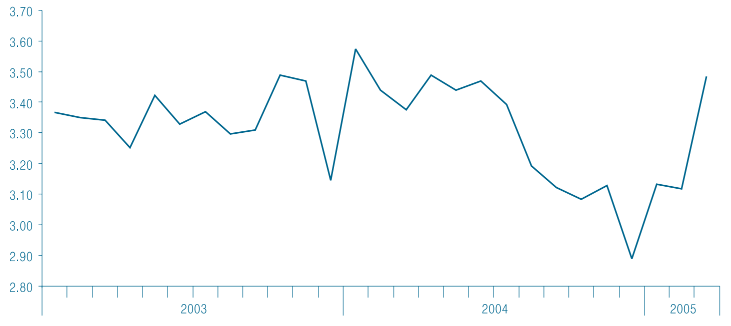


Source: BNB.

...the money multiplier went up to 3.48 per cent in March...

Chart 41

Money Multiplier of M3



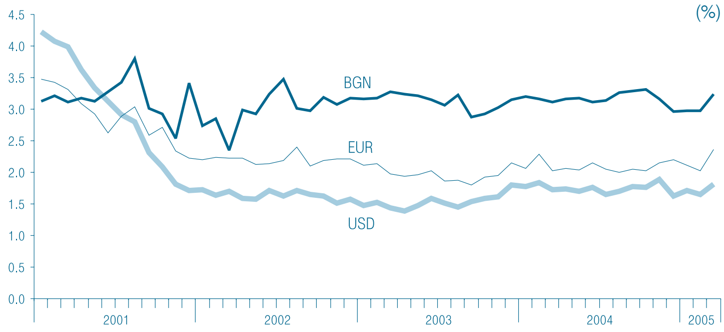
Source: BNB.

cordance with the new provisions banks are strongly encouraged to borrow funds from households and companies for improving the ratio between the sum total of extended loans and risk-weighted off-balance sheet items converted into balance sheet assets (less the amount of own funds) and the amount of funds borrowed from entities other than banks and non-bank financial institutions. Pursuant to Ordinance No. 21 this ratio is set at 60 per cent.[15]

The interest rate split of household one-month lev deposits did not experience significant changes from December 2004. The differential between the highest and the lowest interest rates slightly increased from 5.23 to 5.25 percentage points. The standard deviation went up from 1.08 to 1.19 percentage points.

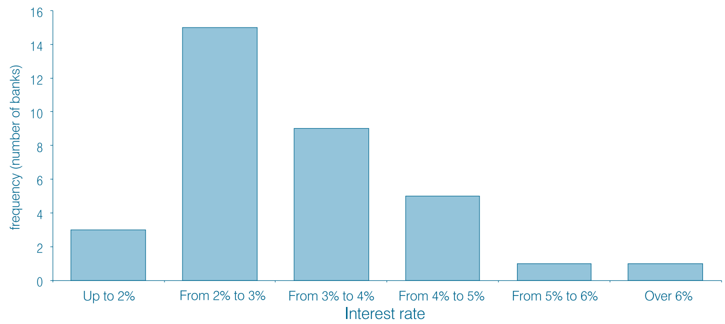
...interest rates on time deposits slightly rose in March...

Chart 42
Time Deposit Interest Rates



Source: BNB.

Chart 43
Interest Rate Distribution on Household One-month Lev Deposits



Source: BNB.

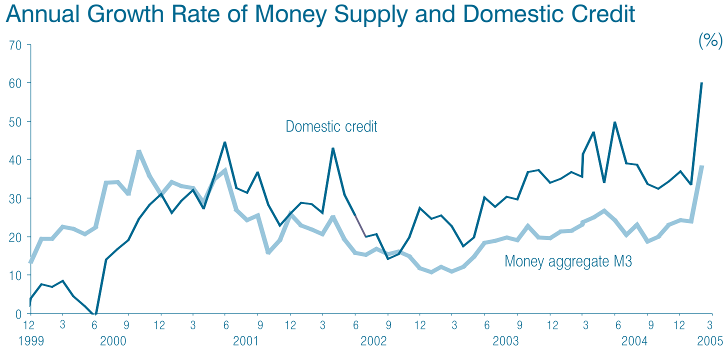
Credit Aggregates

During the first months of 2005 claims on the non-government sector sustained their high annual growth (47 per cent in January and 47.1 per cent in February) reflecting both the enhanced demand for loans by corporations and households, and the aggressive lending policy pursued by banks by launching new credit products and easing the terms and conditions for drawing loans.

...claims on the non-government sector sustained their high annual growth ...

Rapidly growing claims on the non-government sector and the lack of signs of more moderate lending growth encouraged the BNB to initiate additional measures aimed at subduing lending growth rates to a moderate level (see p. 20). Announcement of these measures in advance allowed banks to raise their credit portfolios by the end of March. Consequently, during the first quarter of 2005 claims on the non-government sector grew by 27.5 per cent, an increase of 73.2 per cent on an annual basis. In March alone claims on the non-government corporations went up by 22.3 per cent, on non-financial corporations by 26.2 per cent and claims on households by 10.5 per cent.

Chart 44
Annual Growth Rate of Money Supply and Domestic Credit



Source: BNB.

[15] See p. 20.

Table 7
Claims on Non-government Sector (Quarterly)

(%)

	Annual growth rate									Structure as of 31 March 2005
	2003				2004				2005	
	I	II	III	IV	I	II	III	IV	I	
Claims on non-government sector, including	45.7	52.1	47.0	48.3	52.3	47.8	49.3	48.7	73.2	
Claims on non-financial corporations	42.0	46.8	37.7	37.1	41.9	36.3	40.5	38.3	68.2	68.1
Claims on households and non-profit institutions serving households	54.4	68.4	73.0	80.7	84.5	79.6	76.4	74.8	81.8	28.3
Claims on financial corporations	124.8	91.2	150.3	146.8	86.0	107.0	25.8	69.1	113.4	3.6

Source: BNB.

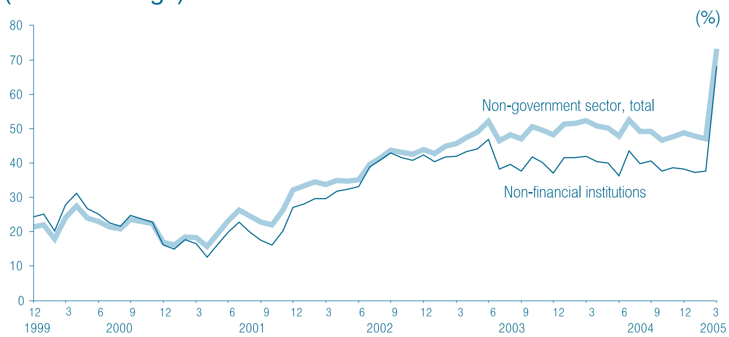
Banks' lending was most intensive between 26 March and 1 April when claims on the non-government sector increased by BGN 1702.6 million. However, credit aggregates data did not provide a clear picture of the credit market state, since this growth reflected to a great extent commercial banks' efforts to raise the amount of the reporting basis, consistent with Ordinance No. 21.

Banks' behaviour was the major reason behind the significantly accelerated claims on households which reached 81.1 per cent by the end of the quarter and claims on non-financial corporations posing a 62.8 per cent increase on an annual basis. The same reason predetermined the end-March increase in the share of loans with a term of over one year to non-financial corporations to 60 per cent against 66.9 per cent by the close of 2004 (if these factors are disregarded, the trend toward extending the term of newly disbursed loans is sustained).

The reasons supposed to cause the dramatic rise in loans by end-March were confirmed by the credit aggregates dynamics in April published in the weekly monetary statistics. Between 31 March and 8 April claims on the non-government sector diminished by BGN 1697.3 million and in April by BGN 1573.8 million. Following the decrease of BGN 1517.8 million in the claims on non-financial corporations in the first week in April, these claims continued to fall and by end-April exhibited a decline of BGN 1565.7 million on end-March. However, claims on households posted a rise: by BGN 56.8 million in the first week of April and by BGN 253.2 million in the whole month. As a result, by the end of April the annual growth rate of the claims on the non-government sector went down to 51.8 per cent and that of non-financial corporations to 41.8 per cent. The annual growth rate of claims on

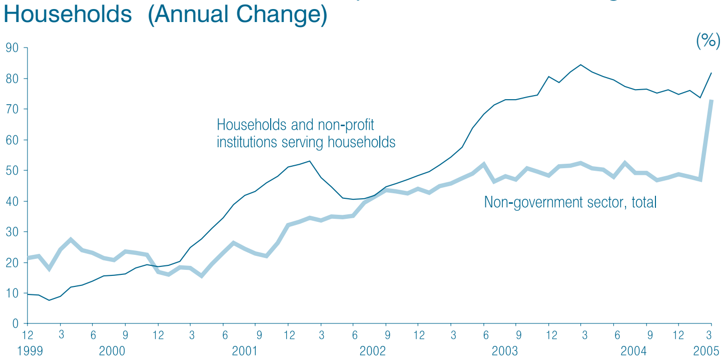
...credit aggregates data did not provide a clear picture of the credit market state by end-March...

Chart 45
Claims on Non-financial Institutions (Annual Change)



Source: BNB.

Chart 46
Claims on Households and Non-profit Institutions Serving Households (Annual Change)



Source: BNB.

households almost matched the end-March level (81.3 per cent).

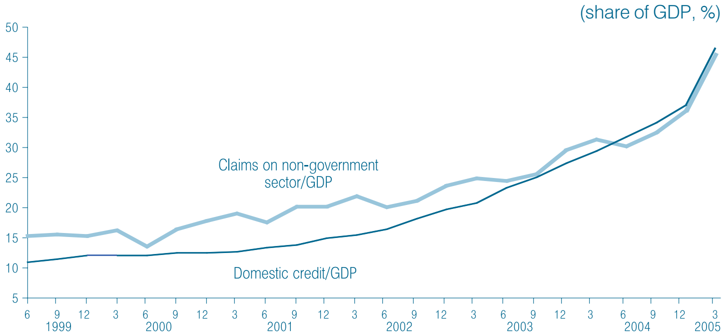
Given the buoyant lending over 2004, the *claims on the non-government sector to GDP* ratio reached 46.5 per cent by the end of March.[16] Despite this indicator remained far under the levels typical of developed countries (about 100 per cent), in Bulgaria credit as a percentage of GDP exceeds the values reported in most Central and Eastern European countries and its rapid growth (by 17 percentage points *per* annum) causes concerns.

Lending rates did not experience dramatic changes and the gradual slowdown in early 2005 continued (Chart 30). If banks opt for a strategy of borrowing domestic funds by raising deposit rates intended to neutralize the constraints under the Ordinance on the minimum required reserves, the possible decrease in the interest rate spread between lending rates and the cost of borrowed funds may lead to a decrease in operational costs for banks and an increase in lending rates.

Competition for expanding banks' market shares is expected to have a stronger effect. This will probably reverse the trend toward a decrease in lending rates and their retention at the existing levels. If the constraints on lending are observed, the annual growth of loans to the non-government sector is anticipated to approximate 30 per cent by the close of 2005.

[16] Based on GDP projections.

Chart 47
Domestic Credit



Source: BNB.

...lending rates exhibited a fall...

3. Economic Activity

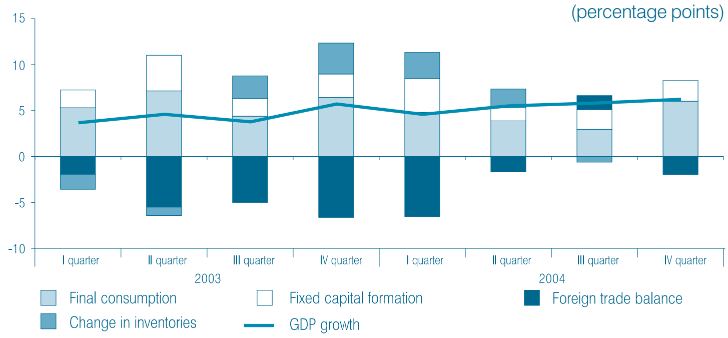
In 2004 economic activity picked up and a buoyant real GDP growth of 5.6 per cent was reported. Rapidly growing exports of goods and services from 8 per cent in 2003 to 13 per cent in 2004, coupled with a slight slowdown in imports, reduced the foreign trade balance negative contribution from -4.9 per cent to -1.9 per cent in absolute terms. Household consumption and investment in fixed assets significantly affected real GDP growth despite its slowing rates throughout the year.

... exports – a factor behind accelerating growth...

Chart 48

Contribution to GDP Growth for 2003–2004 by Component of Final Demand (Quarterly)

(percentage points)



Source: NSI.

Table 8

Dynamics of GDP Components According to Final Consumption Method

(on corresponding period of previous year, %)

	2003				2004			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter
Final consumption	5.8	8.0	5.5	7.0	5.3	4.3	3.7	6.6
Gross fixed capital formation	12.2	21.3	12.1	10.9	22.1	6.9	12.6	9.9
Exports of goods and services	12.6	12.0	4.1	5.3	7.0	10.6	14.1	19.8
Imports of goods and services	14.1	18.8	13.5	14.8	16.7	11.1	11.9	16.9
GDP	**3.6**	**4.6**	**3.8**	**5.7**	**4.5**	**5.5**	**5.8**	**6.2**

Source: NSI.

Economic activity will remain high in the second and third quarters and economic growth is expected to reach 5.9 per cent and 5.1 per cent respectively.

... economic growth is expected to reach 5.9 per cent in the second quarter and 5.1 per cent in the third quarter...

Household Behaviour

In 2004 household consumer expenditure growth decreased by 0.8 points compared with 2003 and reached 5.5 per cent. At average prices, the absolute growth for 2004 was BGN 1.345 billion against the increase of BGN 1.442 billion in the previous year. The greatest contribution to consumption growth came from non-foods and non-produced services[17] in contrast to services related to home maintenance (imputed rent, heating, water supply, electricity) and consumption in

[17] Services satisfying personal needs only.

kinde. According to data on retail sales revenue, trade in household appliances and radio and television sets showed the biggest dynamics.

Table 9
Consumer Demand Dynamics

(share on corresponding period of previous year, %)

	2003				2004				2005
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter	I quarter
Consumer expenditure *per* household member	6.7	6.3	5.1	2.9	4.1	3.1	5.6	1.6	3.2
Retail sales	9.1	11.1	11.8	11.9	12.5	14.6	13.4	14.7	14.1

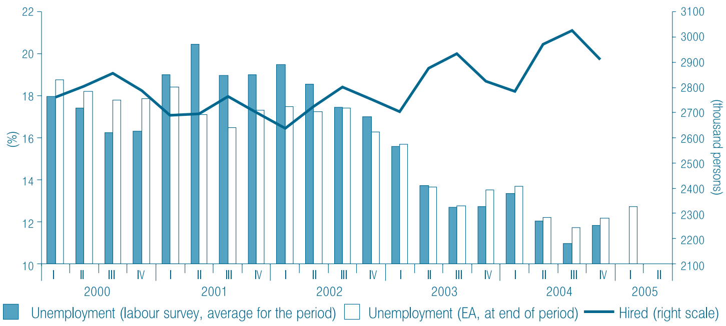
Source: NSI.

Domestic trade and household budget data for the first two months of 2005 indicate that the high consumer activity was sustained. Household consumption growth rates are expected to rise within the 4 to 4.2 per cent range in the second and third quarters.

... high consumer activity at the start of 2005 ...

... household consumption growth rates are expected to rise within the 4 to 4.2 per cent range in the second and third quarters...

Chart 49
Status of Economically Active Population



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

Table 10
Employment and Income Dynamics

(%)

	2003				2004				2005
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter	I quarter
Unemployment at the end of the period (EA data)	15.7	13.7	12.8	13.5	13.7	12.2	11.7	12.2	12.7
Employed									
Share on corresponding quarter of previous year	5.4	7.9	7.8	6.0	6.2	5.1	5.3	5.4	1.0
Share on previous quarter	3.6	3.6	0.6	-1.9	3.9	2.5	0.8	-1.9	-0.4
Hired (labour survey data)									
Share on corresponding quarter of previous year	2.5	5.5	4.7	2.6	2.9	3.3	3.1	3.1	2.0
Share on previous quarter	-1.8	6.3	2.0	-3.7	-1.5	6.7	1.8	-3.7	-2.5
Wages and salaries, real increase in purchasing power on the corresponding quarter of prior year	6.7	7.6	4.5	5.8	-0.6	2.5	5.9	8.2	

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

The main factor behind robust economic activity was rising income prompted by increased employment and real salary. According to revised annual data, in 2003 and 2004 real salary[18] rose by 3.7 per cent and 3 per cent respectively, and wages and salaries reported on national accounts – by 6.1 per cent and 4.1 per cent in real terms.[19] The favourable dynamics of these indicators affected positively consumer confidence and households' willingness to finance themselves by loans. Thus, they ensured resources to boost consumption additionally. As a result, in 2004 the average annual bank claims on households reached 13 per cent of their consumer expenditure.

Sustained high rates of increasing claims on households on an annual basis reflected lively credit demand on the part of households coupled with banks' efforts to expand their market positions in the field of lending to households. The end of March 2005 saw brisk consumer lending with annual consumer credit growth accelerating to 64.5 per cent after a gradual decrease in the previous months.[20]

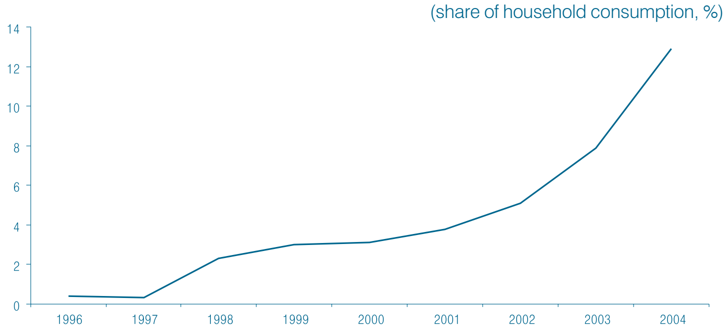
Housing lending remained the most dynamically developing segment of the credit market; by end-March housing loans went up by 154.2 per cent on an annual basis. Housing demand, especially in big cities, put pressure on the prices of houses in 2004 and they began rising fast. They started to stabilize at the end of the same year.

Banks continued to reduce interest rates on household loans as a result of intensified competition. In the last few months this mainly concerned housing loans. However, in March interest rates on consumer loans also fell. Nevertheless, this did not relieve dramatically the burden of real indebtedness since banks tend to announce lower interest rates only for the first year of the credit.

...households' liabilities to the banking system were rising...

Chart 50

Banks' Claims on Households (Average Annual Amount)

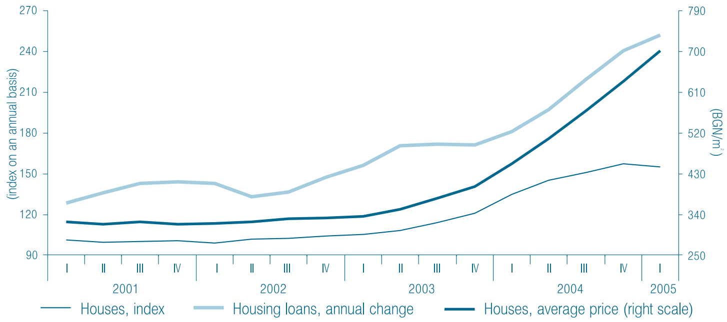


Source: NSI, BNB.

...high growth rates of housing loans were sustained...

Chart 51

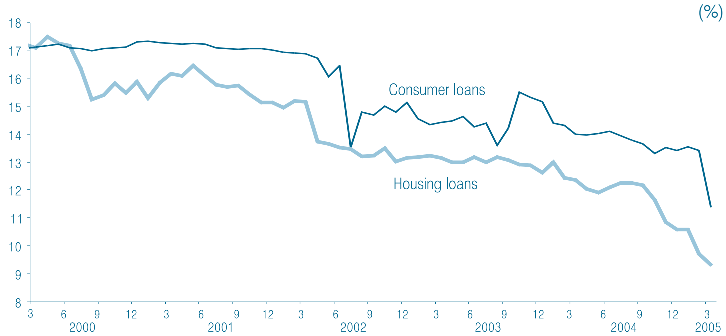
Housing Loans



Source: BNB.

Chart 52

Interest Rates on Loans Extended to Households



Source: BNB.

[18, 19] Deflated by average annual CPI.

[20] See Part 2, Financial Flows, Money and Credit, concerning the one-off effect on lending in March 2005 reflecting commercial banks' reaction prior to the enforcement of the Amendments to Ordinance No. 21.

Government Finance and Consumption

In 2004 contribution of government consumption to GDP growth amounted to 0.7 percentage points, reaching its highest value of 1.4 percentage points in the last quarter of 2004. Government consumption growth reflected mainly the faster increase in salary and operating expenditure than that in GDP.

Household budget survey data show that transfers from the consolidated budget to the households rose reflecting growing pension and child benefit expenditure which comprised 26.1 per cent (a 1.2 percentage point increase for the year) of income *per capita*. Unemployment reduction prompted cutting of unemployment benefit expenditure which came to just 0.5 per cent of average income *per capita*.

Brisk economic growth and rising imports of goods in 2004 led to a dramatic increase in the revenue from indirect taxes which underlay the record high surpluses on the consolidated fiscal programme: cash surplus was 1.7 per cent and primary surplus 3.6 of GDP. By the end of the first half of 2005 we expect high values of the balances on the consolidated fiscal programme with indirect tax revenue still underlying these surpluses.

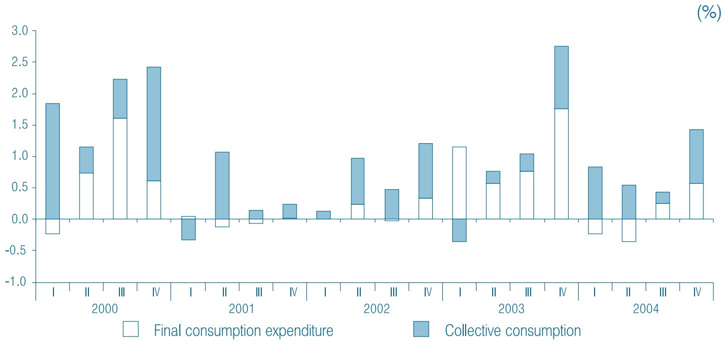
...government consumption growth reflected mainly the increase in salary and operating expenditure ...

...by the end of the first half of 2005 we expect surpluses on the consolidated fiscal programme...

Chart 53

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

(%)

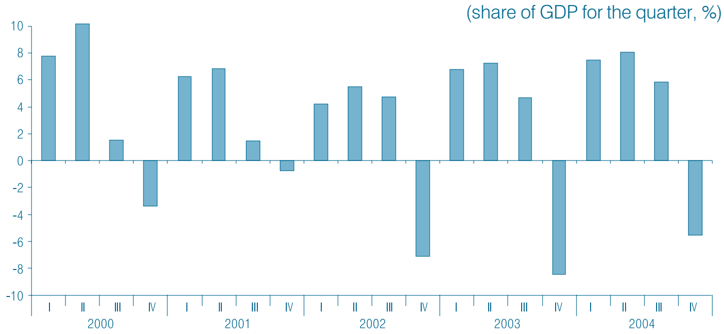


Source: NSI.

Chart 54

Primary Balance (Quarterly)

(share of GDP for the quarter, %)

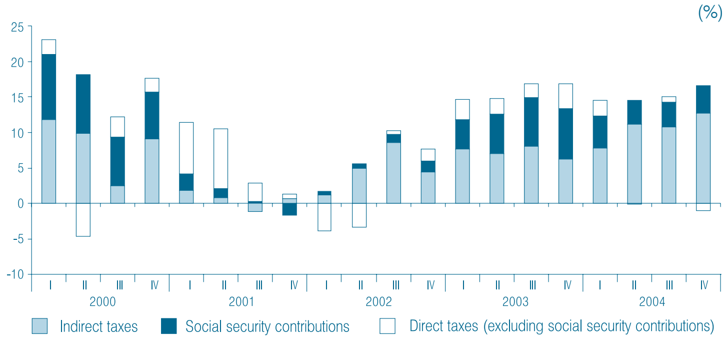


Source: MF.

High growth rates of revenue from indirect taxes makes it uncertain whether they will be sustained in the medium term. In 2004 the ratios between revenue from VAT and from excise duties and fees on liquid fuel and the respective tax base[21] reached their highest values. In 2005 the ratio of excise duties is expected to rise slightly owing to increased excise duties on beer, alcoholic beverages and cigarettes. In the previous year the VAT ratio exceeded the threshold of 16.7 which was equal to the computed ratio at a 20 per cent tax. Since such a level can be maintained in the short run only, in the second half of the year this ratio will probably start to fall.

Chart 55

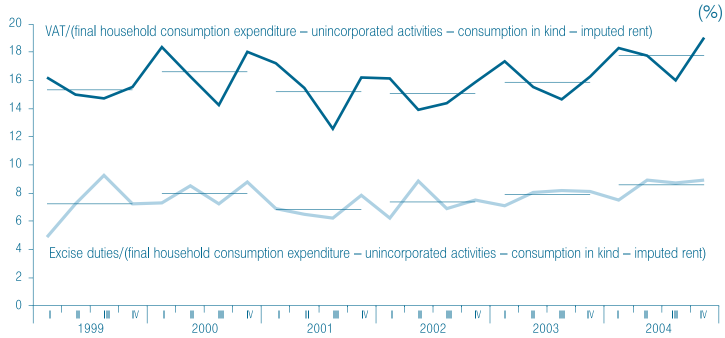
Contribution of Major Tax Groups Growth to Tax Revenue Growth under Consolidated Fiscal Program (Quarterly)



Source: MF, BNB.

Chart 56

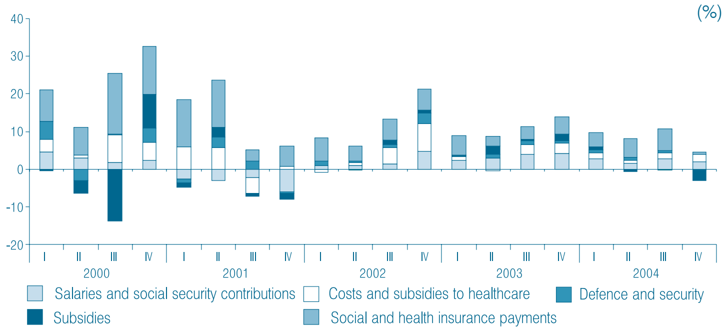
Indirext Tax Dynamics (Quarterly)



Source: MF, BNB.

Chart 57

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



Source: MF, BNB.

[21] The tax base of this tax group is defined by subtracting consumed household economy items (including unincorporated activities and consumption in kind) and imputed rent from final household consumption expenditure according to the internal concept of the System of National Accounts.

Firm Behaviour and Competitiveness

Manufacturing and trade contributed mostly to the value added growth in 2004. Value added growth in industry resulted from high output and exports. *Metallurgy, food manufacture, machines and equipment*, and, not in the last place, *oil processing* played a key role in output increase.

...manufacturing and trade contributed mostly to the 2004 growth ...

Table 11
Gross Value Added Growth by Sector

(corresponding quarter of previous year = 100)

	2003				2004			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter
Agriculture and forestry	-0.1	0.1	-1.2	-2.0	-1.0	-0.4	3.7	3.3
Industry	4.5	6.7	6.4	9.3	4.9	6.1	5.3	4.8
Services	3.5	4.1	3.4	4.8	5.9	5.7	6.5	6.0
At base prices, total	3.6	4.5	3.4	5.3	5.1	5.2	5.6	5.4
Contribution, percentage points								
Agriculture and forestry	0.0	0.0	-0.2	-0.2	-0.1	0.0	0.7	0.3
Industry	1.4	2.0	1.8	2.5	1.6	1.8	1.5	1.4
Services	2.2	2.5	1.8	3.0	3.6	3.4	3.4	3.7

Source: NSI.

Industrial sales continued to grow in the beginning of 2005, with *metallurgy, production of machines* and *energy* being the leading branches. The high export activity and the upward trend in facility utilization were sustained. According to data from the business survey conducted in April, facility utilization run at 64.5 per cent.

Table 12
Industrial Sale Dynamics

(share on corresponding period of previous year)

	2003				2004				2005
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter	I quarter
Industrial sales	21.4	14.3	12.6	16.8	14.5	20.9	23.8	26.8	14.5
export sales	50.3	32.1	25.1	39.2	34.5	42.5	49.1	49.6	23.3
domestic sales	6.3	5.9	6.7	7.7	5.9	6.9	8.1	9.5	6.0
Contribution, percentage points									
export sales	17.2	10.3	8.1	11.3	10.3	16.7	18.8	21.4	11.5
domestic sales	4.2	4.0	4.5	5.5	4.1	4.2	5.0	5.4	3.0

Source: NSI.

Investment in fixed assets went up by 12 per cent in 2004 and is expected to exceed 10 per cent in the second and third quarters of 2005.

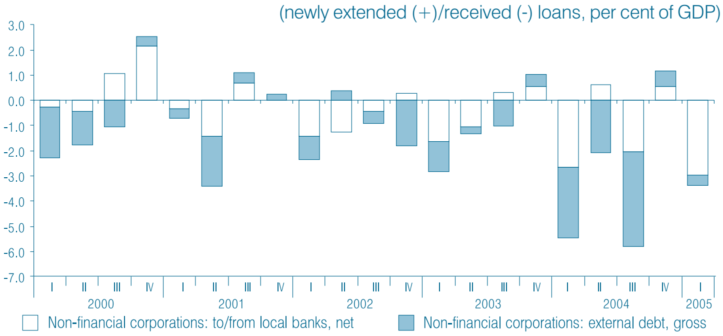
... industrial and export activity stayed high at the beginning of 2005...

The macroeconomic stability and improved business climate were the major factors behind investment demand and companies' tendency to become indebted in order to finance their operations and acquire fixed asset. Non-financial corporations were the major net debtor in the economy, with the banking system being an intermediary between external financial resources and Bulgarian firms.

Chart 58

Indebtedness of Non-financial Corporations

(newly extended (+)/received (-) loans, per cent of GDP)

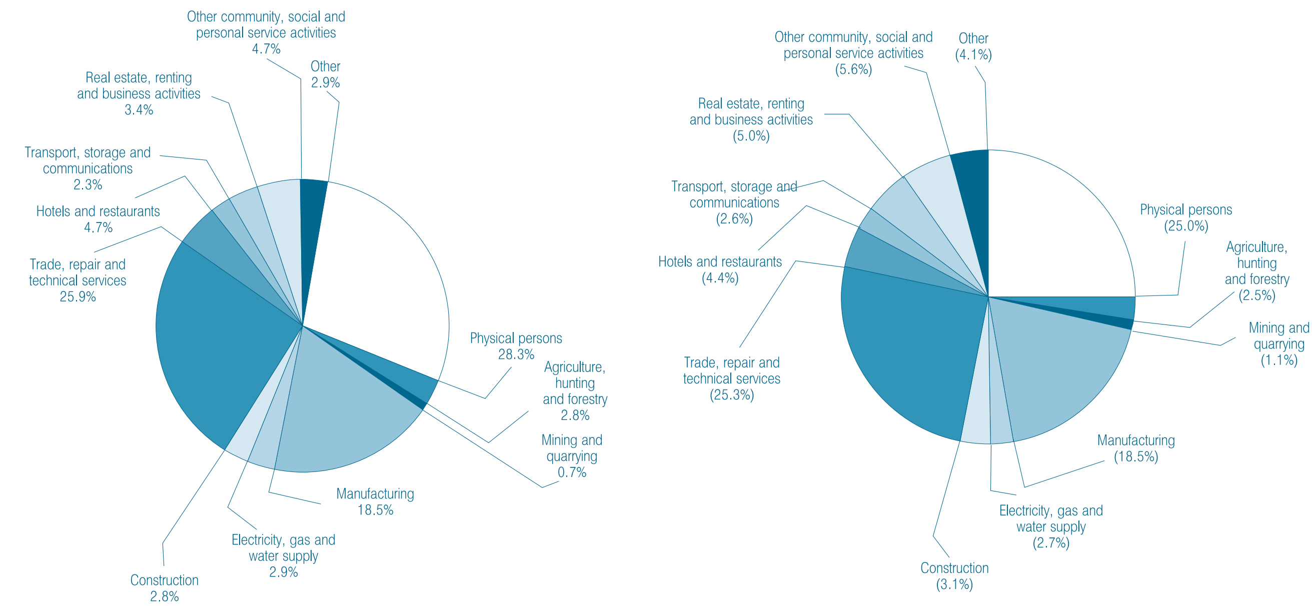


Source: BNB.

Note: The ratio of *newly extended (+)/received (-) loans* to *GDP* is computed as the change in the gross external debt and in the net domestic credit to non-financial corporations to the GDP in the current and the previous three quarter.

Chart 59

Structure of Commercial Bank Claims by Industry



as of 31 December 2004 — as of 31 March 2005

Source: BNB.

...interest rates on loans extended to corporations followed the trends of previous periods...

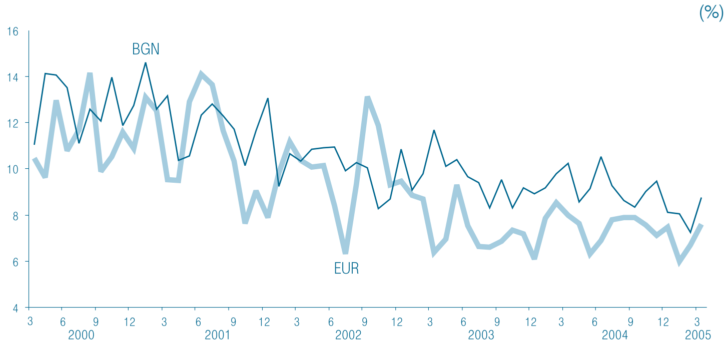
Interest rates on loans extended to corporations followed the trends of previous periods. Conditions of long-term loans in euro were eased more considerably, while those of other loans did not display a clearly expressed dynamics. Lower interest rates on loans in euro determined banks' preferences to borrow mainly in this currency; hence, the dominant position of the euro in the currency structure of loans to non-financial corporations.

Unit labour cost is an important indicator of cometitiveness. In manufacturing, which is directly exposed to international competition, this

Chart 60

Interest Rates on Short-term Loans to Corporations

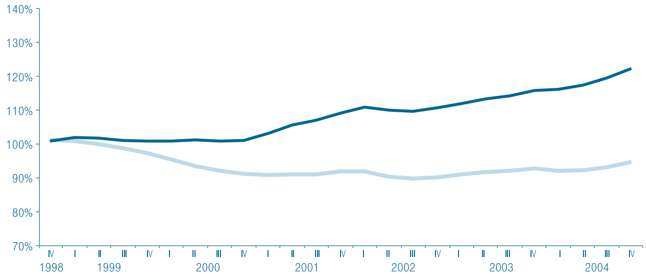
(%)



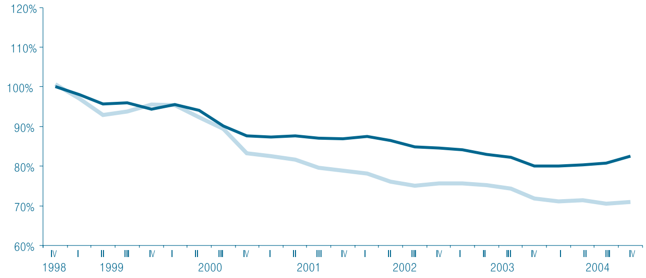
Source: BNB.

Chart 61
Unit Labour Cost (Quarterly)

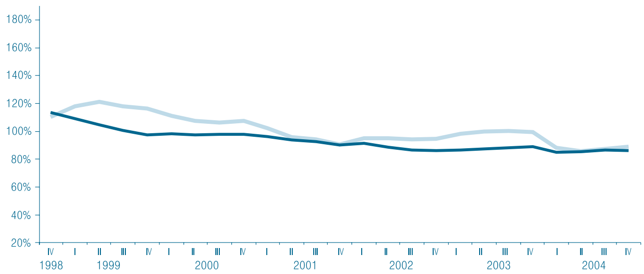
Total for the Economy



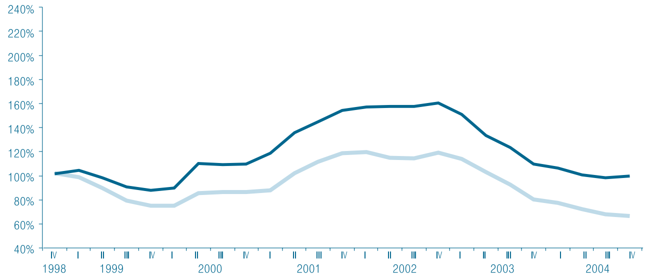
Manufacturing



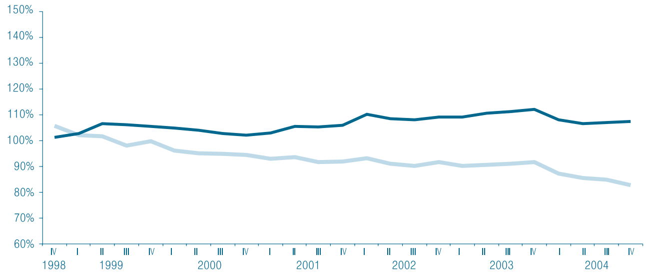
Agricultural Sector



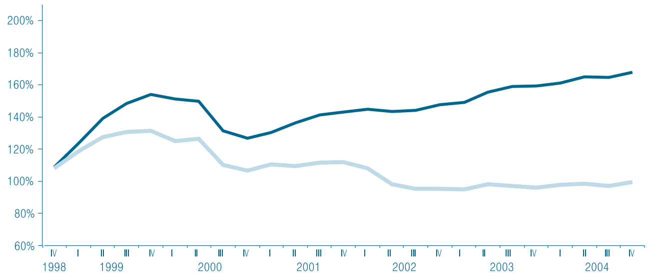
Mining and Quarrying



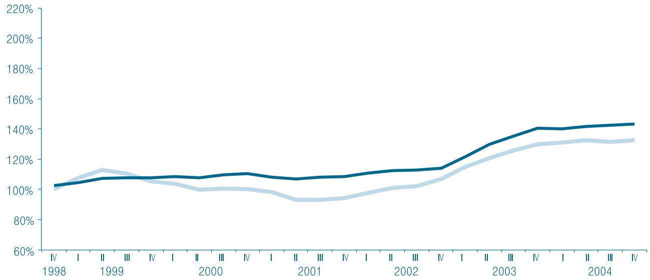
Construction



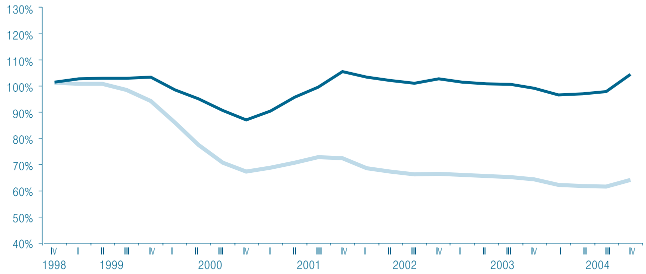
Electricity, Gas and Water Supply



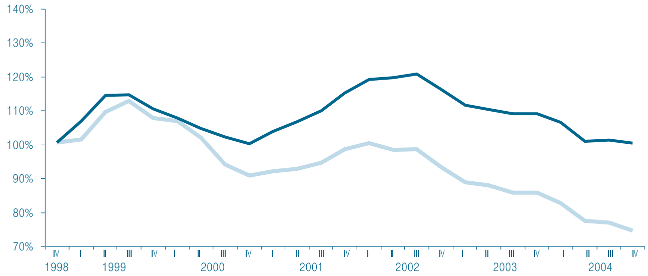
Trade



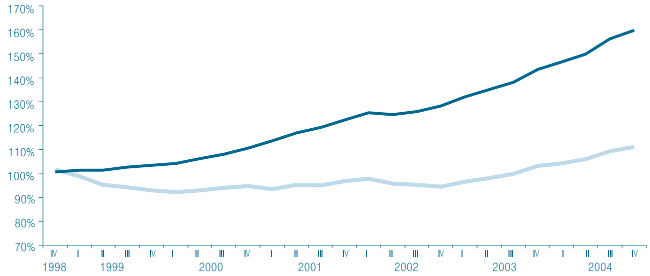
Transport and Communications



Financial Intermediation



Other Sectors



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

Source: NSI, BNB.

indicator continued to improve owing to the faster growth of labour productivity *vis-a-vis* real salary growth. As a result of robust extracting and construction, the indicator in these branches also improved. Services showed diverse trends. Financial intermediation became more effective affecting unit labour cost as well. In trade, owing to the low initial salary, the indicator was revised upward and stabilized in 2004.

... competitiveness of the tradable sector was sustained...

Prospects for industrial activity in the second and third quarters of 2005 are favourable which was confirmed by the NSI business survey on industry, construction and services conducted in April.

... prospects for industrial activity in the second and third quarters are favourable...

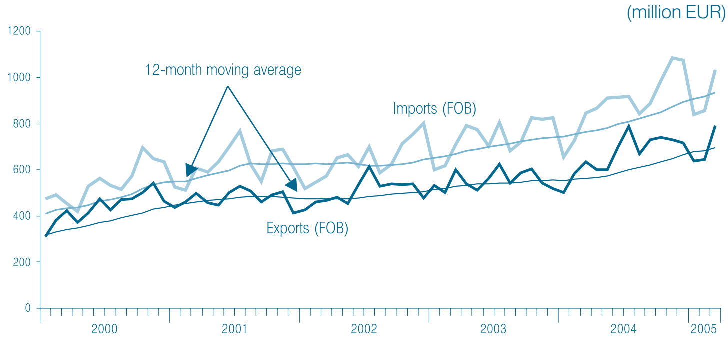
Exports and Imports of Goods and Services

...exports and imports slowed down...

In 2004 exports amounted to EUR 7993.9 million (an increase of 19.9 per cent) and imports to EUR 10,711.8 million (an increase of 20.8 per cent). According to our expectations, at the start of 2005 export and import growth slowed down compared with the last quarter of 2004. Over the January to March 2005 period exports rose by 20.8 per cent on the same period of 2004. Imports increased by 22.5 per cent based on FOB. The trade balance in the first quarter of 2005 was EUR -651.6 million, down EUR 143.2 million on the first quarter of 2004.

Chart 62

Dynamics of Exports and Imports



Source: BNB.

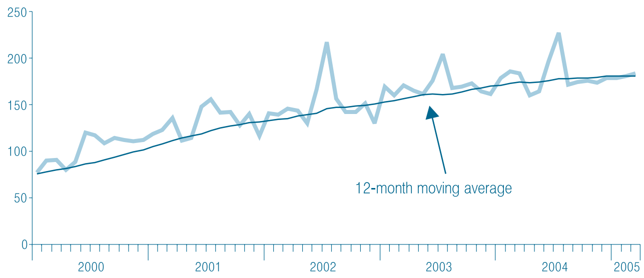
At the start of 2005 exports of base metals and articles thereof continued to grow at high rates (24.6 per cent) which is much slower than the 44.9 per cent growth in 2004. The increase by subgroup (equivalent to a chapter in the Customs Tariff) retained its relatively even distribution. This increase reflected the effect of the higher metal prices. Based on *Commodity Price Data* of the World Bank, the rise in prices of most steel articles in US dollars was within the 20 to 30 per cent range in March 2005 compared with March 2004. Non-ferrous metal prices were also higher in March.

... exports grew slower compared with the fourth quarter of 2004...

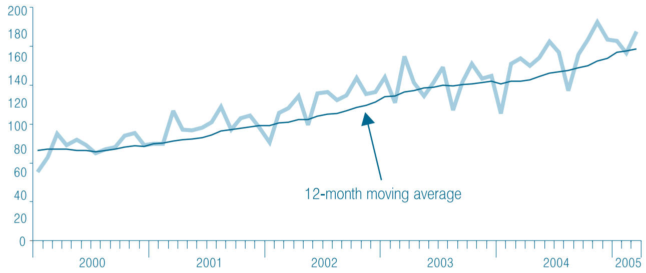
Chart 63
Exports

(million EUR)

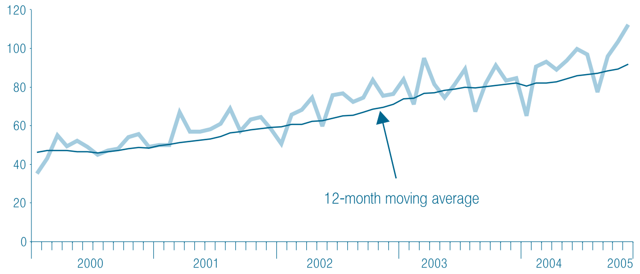
Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods



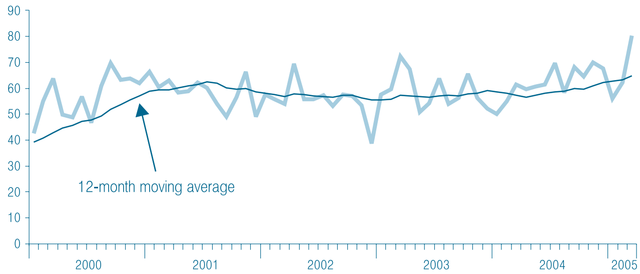
Base Metals and Articles Thereof



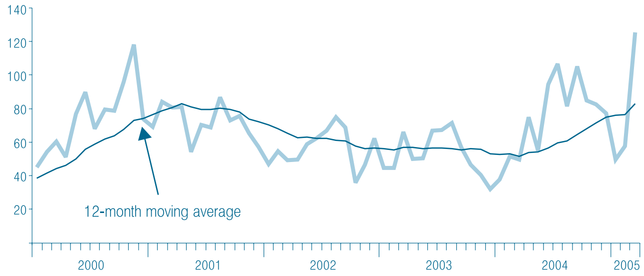
Machines, Vehicles, Appliances, Tools, Weapons



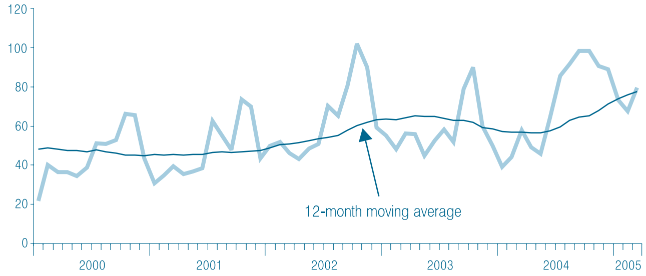
Chemical Products, Plastics, Rubber



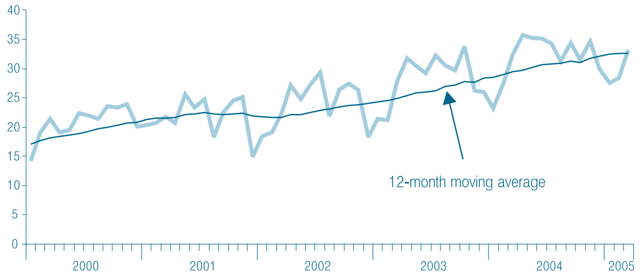
Mineral Products and Fuels



Animal and Plant Products, Food, Drink, Tobacco



Wood, Paper, Pottery, Glass



Source: BNB.

Slowing exports of textiles, leather, clothing, footwear and miscellaneous consumer goods during the second half of 2004 was clearly pronounced at the start of 2005: a decrease of 1 per cent for the group in the first three months of 2005. Exports of clothing from knitwear went down by some 15 per cent compared with the January to March 2004 period. Exports of articles from the other major subgroups grew, albeit at relatively low rates.

Over the January to March 2005 period exports of mineral products and fuels grew by 67.3 per cent on the same period of 2004 owing to higher prices and larger exports in real terms. The average price of exported petroleum products (group 2710, petroleum lubricants) rose by 38.6 per cent and exported physical volumes by 40.3 per cent. The 2004 trend of rising price component contribution to the nominal increase in the exports of mineral products and fuels was preserved.

Exports of machines and vehicles went up by 22.7 per cent over the January to March 2005 period compared with the same period of 2004. However, it had a considerable one-off effect since in January this group's growth was 57.2 per cent, of which the exports' contribution on Customs Tariff Chapter 89, Sea and River Transport, was almost 27 percentage points. Taking into consideration this effect, it could be concluded that the stable dynamics of exports of machines and vehicles was sustained.

In the last months exports of chemical products stabilized. They grew by 16.1 per cent in the fourth quarter of 2004 and by 19.4 in the first quarter of 2005. Major subgroups in the Customs Tariff grew by month on an annual basis between November 2004 and March 2005. In view of this, it can be said that the recovery of chemical product exports is an emerging trend which may be preserved in the following months.

Exports of agricultural produce in the first quarter grew considerably (by 56.1 per cent for the period). The low base at the start of 2004 was the major factor affecting the high growth rates in this group. The increase in exports of cereals in January 2005 amounted to 5001.3 per cent (up from EUR 0.3 million to EUR 17 million), while in February it was 2834.2 per cent (up from EUR 0.3 million to EUR 9.5 million). Similar dynamics was observed in the other major subgroup – oil seeds and fruit – in which the increase in the volumes during first three months of 2005 was 247.9 per cent.

According to GDP data on the fourth quarter of 2004, exports continued to grow in real terms. In line with our expectations of foreign trade developments, the physical change in exports of goods for the fourth quarter of 2004 was 21.1 per cent on the respective period of 2003 and its deflator against the average prices of 2003 came to 7.6 per cent. Based on the export data for the beginning of 2005 and prospects for external environment developments, it is almost unlikely these real growth rates to be sustained in the present year. The physical changes in the exports of goods are expected to slow down by 10 to 12 per cent *per* quarter.

In the fourth quarter of 2004 the nominal growth in imports of goods based on FOB comprised 27.3 per cent which is a further acceleration compared with the third quarter. Fourth quarter GDP data showed a physical volume increase of 16.2 per cent resulting from enhanced domestic demand. The upward trend in the deflator of imported goods by quarter from the start of 2004 was retained reflecting high international prices, and the deflator for the fourth quarter against the average prices of 2003 came to 8.5 per cent.

Over the January to March 2005 period imports (CIF) reached EUR 2959 million posting a 22.7 per cent increase on the same period of 2004. The volumes of imported investment goods and energy resources grew at fastest rates (38.4 per cent and 42.6 per cent respectively). The high growth in investment goods indicates that the slowing growth in gross fixed capital formation (9.9 per cent) in the last quarter of 2004 was probably temporary, and investment growth may recover in the first half of 2005.

Consumer goods imports grew considerably slower at the beginning of 2005. Over the January to March 2005 period imports of consumer goods went up by 14.5 per cent in nominal terms on the respective quarter of 2004. By comparison, throughout 2004 imports of consumer goods rose by 28.4 per cent. The slowdown in imports of consumer goods was attributable mainly to the furniture and home maintenance (5.2 per cent growth) and medical goods and cosmetics (4 per cent growth), while the other groups grew at rates comparable with those for 2004. Similar dynamics

Table 13

Contribution of Commodity Groups to Trade Growth between January and March 2005

(percentage points)

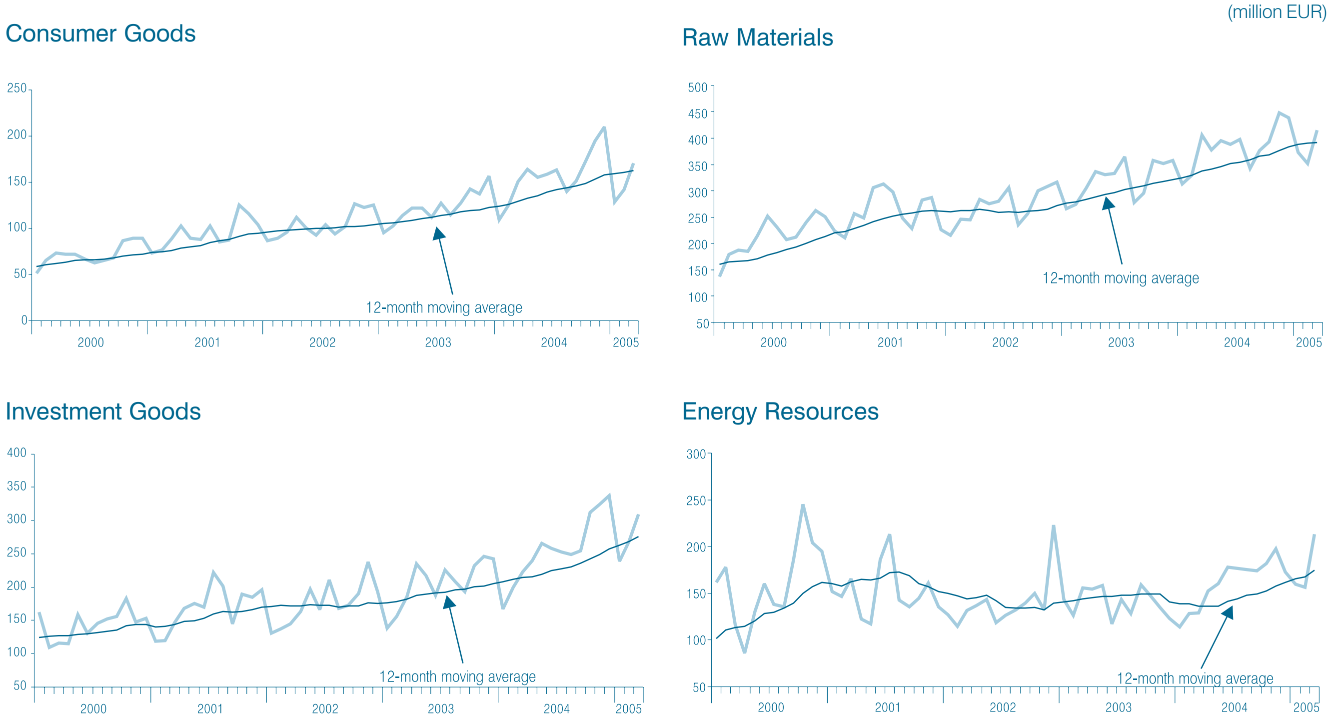
	Contribution to the growth of	
	exports	imports
Raw materials	12.1	3.8
Investment goods	3.4	9.4
Consumer goods	0.4	2.3
Energy resources	5.0	6.5
Other		0.6

Source: BNB.

...import growth rates stayed high...

Chart 64
Imports

(million EUR)



Source: BNB.

shows that the demand for imported goods remained evenly distributed among various groups of goods, and a tangible decrease in this group's growth rates cannot be expected.

The crude oil and natural gas, and oils subgroups contributed mostly to increased imports of energy resources in the first quarter of 2005. The growth in the first subgroup was EUR 101.7 million (by 35.1 per cent) and in the second subgroup EUR 31.6 million (by 89 per cent). In the period under review the average price of imported crude oil in euro was higher by 40 per cent compared with the same period of 2004, while imported volumes grew by 16 per cent. The movement of imported natural gas prices and physical volumes was reversed on 2004. Over the period imported amounts of natural gas decreased by 17.7 per cent, while the average price of imported natural gas in euro rose by 5.2 per cent. The real growth of imported petroleum products increased to 40.8 per cent.

Changes in the export geographic structure reflected the high degree of integration with the EU countries. In the first quarter of 2005 the share of exports to the EU in total exports slightly went down to 61.6 per cent against 62.7 per cent in the respective period of 2004. The share of exports to Turkey grew (comprising 10.5 per cent compared with 9.1 per cent). The share of exports to Europe (excluding the EU) decreased by 0.5 percentage points and that to North and South America fell from 5.2 per cent to 4.5 per cent.

...imports of energy resources grew reflecting high international prices...

The share of the EU in the import structure decreased from 53.3 to 50.9 per cent. The growth rates of exports to the EU stabilized at the level of some 19 per cent in January and February 2005, while growth in March came to 13.4 per cent with the decrease in the relative EU share reflecting stronger import growth. The share of imports to Asia picked up from 8.6 per cent to 11.7 per cent, including the share of China in Bulgaria's imports which rose from 3.1 per cent to 4 per cent. It is an interesting fact that despite the higher imports of crude oil, Russia's share in imports decreased to 12.9 per cent compared with 13.3 per cent in the first quarter of 2004 showing that the trade with Russia is losing its role in the Bulgarian economy.

Revenue from travel services between January and March 2005 rose by 8.3 per cent. The increase in travel expenditure was slighter: 3.8 per cent. Although the balance on travel services in the first quarter is of lesser importance compared with that in the summer months, at the year's start travel had a positive contribution to the balance on services amounting to EUR 55.4 million.

In the second and third quarters of 2005 a further slowdown in the growth of exports and imports is expected stemming from the weaker demand in our major trade partner – the EU – and the anticipated decrease in the growth of the Bulgarian economy. The more modest international price rises will also push down export and import growth. Forecasts for the second quarter point to export growth of 15 per cent and import growth of 16 to 17 per cent. Given these nominal changes, the trade balance for the quarter will worsen on the second quarter of 2004 by some EUR 150 million. In the third quarter of 2005 exports are expected to rise by some 14 per cent and imports by 13 per cent. Similar dynamics indicates that the trade balance for the third quarter will worsen by EUR 50 million on the third quarter of 2004.

...exports and imports are expected to slow down in 2005...

4. Inflation

Inflation started picking up from the year's start and reached 5.1 per cent in April on an annual basis (against 4 per cent at end-2004). Seasonal factors related to fruit and vegetable price rises determined inflation of foods in the review period and contributed to overall inflation by 1.4 percentage points since the beginning of 2005 (3.05 per cent). Prices of seasonal foods are expected to decrease in the next two months offsetting their considerable increase in April.

Specific factors related to the one-off price rises in the infrastructure branches such as communications, water supply and healthcare, affected the overall increase in consumer prices. Between January and April their contribution to inflation was 0.7 percentage points. In healthcare, price rises reflected the higher prices of services set in the National Framework Contract between the National Health Insurance Fund and the Bulgarian Medical Doctors' Union, and The Union of Dentists in Bulgaria signed in February 2005, as well as the increase by 25 per cent of the fee to the general practitioner for primary outpatient healthcare.[22]

Owing to seasonal and specific factors, core inflation increased since the year's start but it also reported the direct and indirect effect of raised international fuel prices. Unlike previous years, in the last twelve months prices of fuels for transportation purposes started to change in line with changes in international crude oil prices. In February and March international crude oil prices started to rise fast; as a result, fuel prices in Bulgaria also rose. During the first four months of 2005 the contribution of fuels for transportation purposes amounted to 0.39 percentage points. The average prices of energy commodities have been falling since the end of 2004 as a result of decreased prices of gas and liquid fuels.

[22] The fee to the general practitioner for primary outpatient healthcare comprises 10 per cent of the minimum salary. At the start of 2005 the minimum salary was raised from BGN 120 to BGN 150, or by 25 per cent.

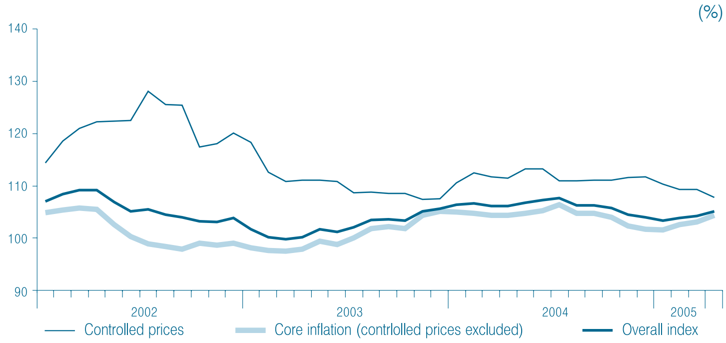
...fruit and vegetable prices have contributed mostly to inflation since the year's start...

Table 14
Inflation Accumulated since Year's Start

	2004	2005
	January – April	
Inflation (%)	1.96	3.05
Contribution (percentage points)		
Foods	0.68	1.50
Non-foods	0.97	0.63
Fuels	-0.03	0.39
Catering	0.09	0.10
Services	0.22	0.82
Goods and services with administratively set prices	1.3	0.45
Controlled-price goods	1.16	0.31
Tobacco	1.18	0.18
Controlled-price services	0.13	0.14

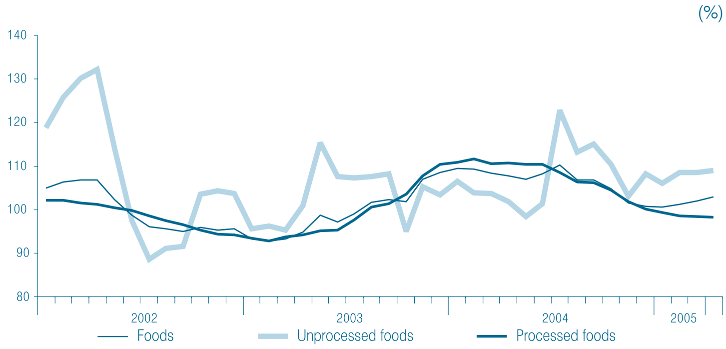
Source: NSI.

Chart 65
Price Indices (on an Annual Basis)



Source: NSI.

Chart 66
Price Indices (on an Annual Basis)



Source: NSI.

The end of 2004 saw the indirect effects of the increased fuel prices in Bulgaria: first on prices of transportation services and later on prices of other services, mainly related to leisure. The weak acceleration of non-food inflation (excluding fuels, tobacco products and medical goods) in 2004 may be explained by an adaptation to the higher fuel prices.

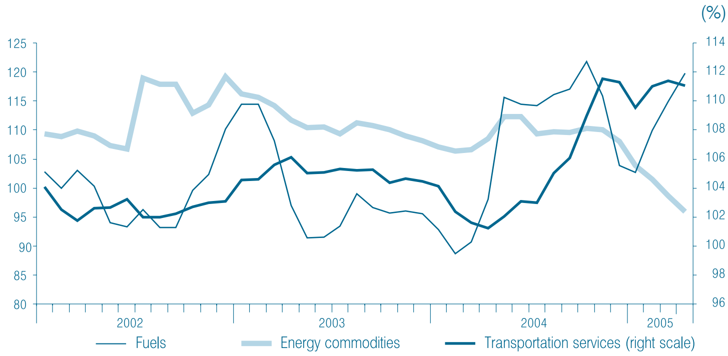
Changes in administratively set prices of electricity and heating, as well as the increased excise duties of alcoholic beverages and tobacco products contributed to inflation by 0.2 percentage points, their influence being much lesser than in 2004.

Domestic demand dynamics and high growth rates of money supply and credit presupposed accumulation of inflationary pressure on domestic prices. The effect of these factors was partially offset by the openness of the Bulgarian economy which allowed satisfying demand for tradable goods by imports, and by the improving cost competitiveness and companies' efficiency.[23]

We expect the seasonal falls in unprocessed foods in the second quarter to compensate the higher-than-projected inflation of the year's start. Unstable crude oil prices in international markets may exert direct inflationary pressure on fuel prices in Bulgaria. However, no indirect inflationary effects are anticipated since we assume that market participants have already adjusted their prices to the higher level of transportation expenses. Inflation accumulated between the year's start and end-September is expected to approximate 0.7 to 1 per cent.

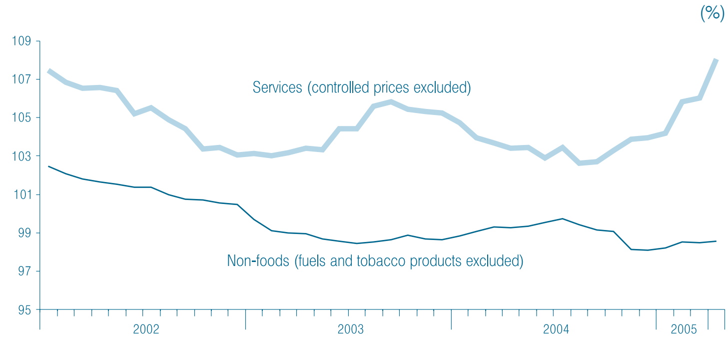
...indirect effects of increased fuel prices started to fade out...

Chart 67
Price Indices (on an Annual Basis)



Source: NSI.

Chart 68
Price Indices (on an Annual Basis)



Source: NSI.

...we expect modest deflation in the second quarter and price stabilization in the third quarter...

[23] See Part 3, *Economic Activity*.