Economic Review

August 2005

BULGARIAN
NATIONAL
BANK

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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.

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This publication should not be regarded as advice or recommendation. Exclusively the information user is liable for any consequences thereof.

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

Global economic indicators continued to show a slight decrease in world growth rates. This trend was determined primarily by euro area developments. The remaining economic zones are expected to retain their current growth rates. In compliance with assessments of major economic indicator dynamics, expectations of financial markets are for a 50 basis point increase in US federal funds interest rate by the end of the third quarter. No change in monetary policy is anticipated in the euro area. The expected widening of the interest rate differential between the USA and the euro area will prompt the US dollar appreciation.

The Bulgarian economy is stable, with GDP growth rate reaching 6 per cent in the first quarter of 2005. High growth rates will sustain in the coming quarters. The slight decline in absolute GDP growth rates reflected the base effect and the more moderate inventory build-up compared with the previous year. Annual growth rates are anticipated to move within the range of 5.4 to 5.8 per cent.

Favourable economic conditions in Bulgaria continued to attract capital in the form of foreign direct investment and loans. The financial account surplus for the first five months of 2005 amounted to BGN 2423.8 million and the reported in January 2005 government expenditure on repurchases of Brady bonds totaled BGN 1406.7 million. By end-June the BNB international reserve balance sheet value came to BGN 14,577.1 million (EUR 7453.2 million). We expect to see a balance of payments current account surplus in the third quarter of 2005 and a deficit in the fourth quarter due to seasonal factors against preserved structure of financing. As a result, the BNB international reserves will grow in both quarters despite the end-July government debt buyback. Following the repurchase of Brady bonds, the *government debt to GDP* ratio will fall to 32 per cent. At present, only six of the twenty-five EU member states report a lower level of this ratio.

The initial results of the measures taken by the BNB in early 2005 to make lending to the private sector more moderate began to show in the second quarter. By end-June claims on the non-government sector went up by 41.8 per cent year on year (47 per cent at the close of May), the annual growth of the claims on non-financial corporations comprised 32.2 per cent (35.8 per cent at the close of May) and that of claims on households 72.2 per cent (77.8 per cent at the close of May). At end-May commercial banks' external debt decreased by EUR 282.5 million compared with March. Commercial banks' net international reserves turned positive reaching some EUR 100 million by end-June. Banks' behaviour after March 2005 gives grounds to conclude that the growth rates of the claims on the non-government sector will move within the 30 to 35 per cent band by the end of 2005.

Domestic demand stayed high, with household consumption growth picking up in the first quarter of 2005. Sustainable upward trends in Bulgarian economy's competitiveness and particularly in industrial competitiveness favoured the extension of foreign markets for Bulgarian producers and the maintenance of relatively high export growth rates irrespective of the global growth slowdown.

Inflation accumulated since early 2005 came to 1.2 per cent at the close of June. So far, there have been no reasons to change the projected end-year inflation of about 3.5 per cent. The major risks for these projections could arise from a slightly higher inflation rate. High crude oil prices in June and July were an external factor which impacted risk assessment. Fluctuations in crude oil prices were so dramatic that even insignificant events could affect their dynamics. Damages caused by floods were an internal factor affecting inflation and economic growth projections. At present, there is no reliable information which allows us to quantitatively assess the effects of floods on the Bulgarian economy.

1. External Environment

Global economic indicators continued to show a slight decrease in world growth rates. This trend was determined primarily by euro area developments. The remaining economic zones are expected to retain their current growth rates. In compliance with assessments of major economic indicator dynamics, expectations of financial markets are for a 50 basis point increase in US federal funds interest rate by the end of the third quarter. No change in monetary policy is anticipated in the euro area. The expected widening of the interest rate differential between the USA and the euro area will prompt the US dollar appreciation.

Current Business Situation

Consumer and business confidence indicators show expectations of a slight global growth slowdown in the second half of 2005 despite the sustainable high growth rates. Services retained their leading role in economic growth. June saw signs of recovery in industry based on anticipated higher domestic demand.

The USA

According to preliminary assessments, US annual growth in the second quarter came to 3.6 per cent reflecting increased private consumption prompted by favourable labour market conditions. Low long-term interest rates were still the major factor behind high consumption: they allowed the households to derive income from real estate by refinancing mortgage loans under more favourable conditions.

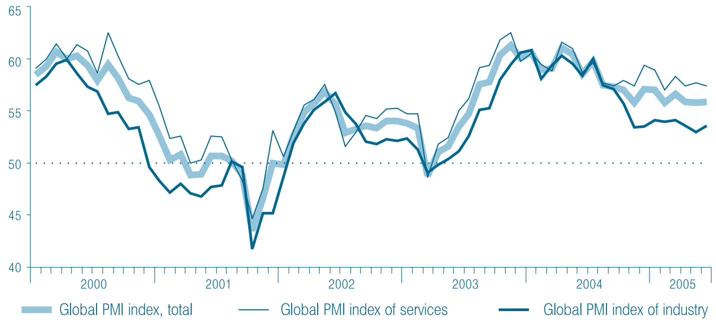
Second quarter data indicate that net exports have improved for the first time in the last four and a half years. GDP growth was lower compared with the previous quarter, the slowdown being most clearly expressed in industry as a result of corporations' efforts to curtail inventories built up in previous quarters.

Economic activity in the third and fourth quarters of 2005 is expected to be high, although its gradual slowdown to levels closer to the potential growth will be preserved.

External imbalances as well as growing real estate prices (partly due to speculative factors) may pose risks to the economy.

Chart 1

Global PMI Indices

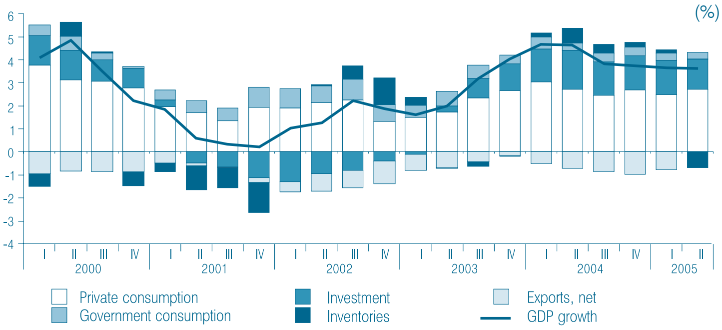


Source: NTC Research, JP Morgan.

Chart 2

Contribution to US Growth by Component

(%)

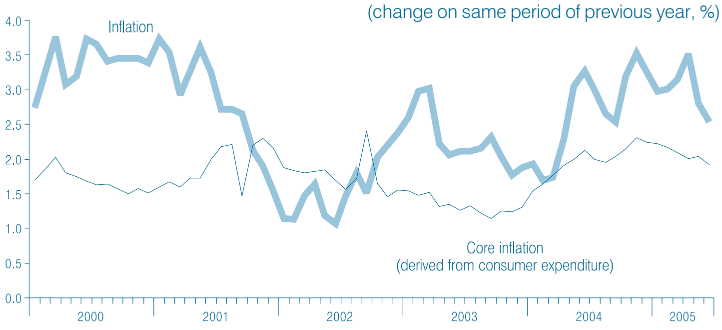


Source: Bureau of Economic Analysis.

Chart 3

US Inflation Rate

(change on same period of previous year, %)



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

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

In the second quarter inflation decreased reflecting the lower growth rates of fuel prices and their smaller contribution to the consumer price index. This stemmed from the base effect in 2004 when a fuel price jump was registered in the domestic market. In June 2005 inflation measured by the change in the consumer price index amounted to 2.5 per cent on a year-on-year basis while in the first months of 2005 it was over 3 per cent. Core inflation also fell to 2 per cent. Inflation projections based on quotations of inflation-indexed ten-year government securities followed a downward trend in the second quarter and by the end of the period they came to some 2.4 per cent.

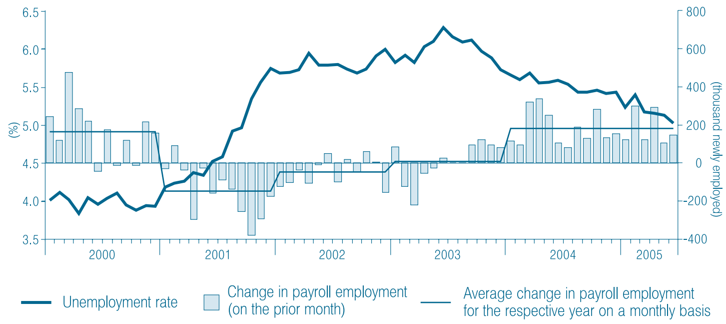
Inflation may accelerate in the second half of 2005 due to the high crude oil prices, rising labour costs and the 2004 base effect. The decision of China to revalue its currency against the US dollar could boost inflationary pressure through raised prices of imports from China.

Unit labour cost dynamics will be the key influence on consumer prices in the coming quarters. The typical slowdown in productivity growth in the business cycle upward phase prompted a rise in labour costs which with a certain lag affected consumer prices. This factor, coupled with enhanced domestic consumption and the high capacity utilization coefficient in the economy, gave rise to expectations that price pressure will be preserved in the future.

Based on stable macroeconomic conditions, the Federal Reserve continued to raise interest rates: as of 9 August 2005 federal funds interest rates were successively increased to 3.25 per cent.

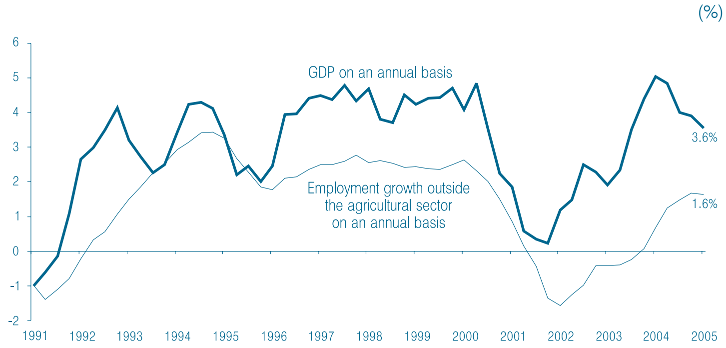
Market expectations foresee an increase in the reference interest rate to 4 per cent. The opinion of most market participants is that there will be at least another 25 basis point increase. The spread between the interest rate on six-month LIBOR deposits in US dollars and that on federal funds was steady in the last few months at average levels within the range of 50 to 75 basis points. Provided the interest rate growth is discontinued at the start of 2006, the spread will be shortened.

Chart 4
US Unemployment Rate and Change in Payroll Employment



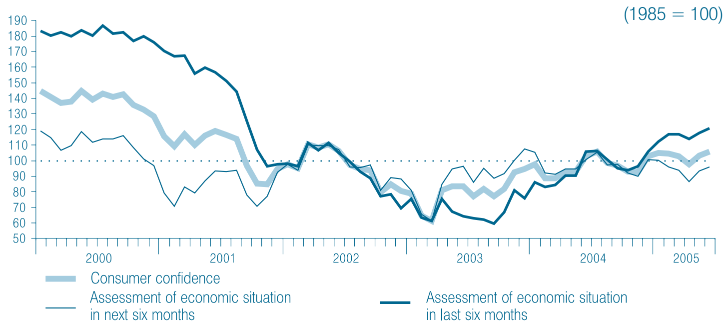
Source: Bureau of Labor Statistics.

Chart 5
US Growth and Labour Market



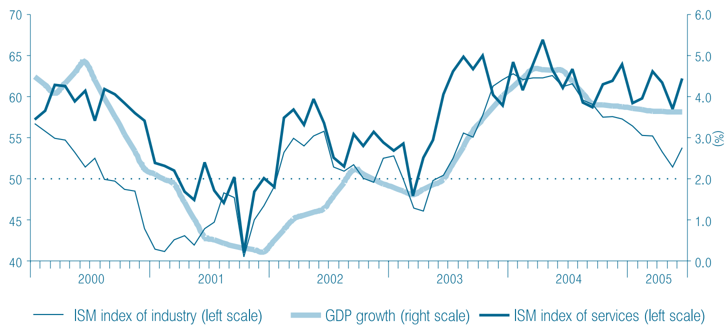
Source: Bloomberg.

Chart 6
US Consumer Confidence Indicators



Source: The Conference Board.

Chart 7
US PMIs and Growth

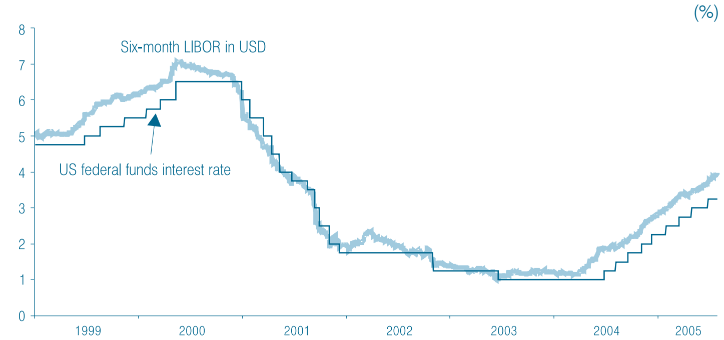


Source: Institute for Supply Management.

Based on current market expectations about the reference interest rate and on the aforementioned spread dynamics, the interest rate on six-month LIBOR deposits in US dollars will fluctuate, ranging between 3.70 and 4.30 per cent in the third quarter and between 4 and 4.50 per cent in the fourth quarter.

Chart 8

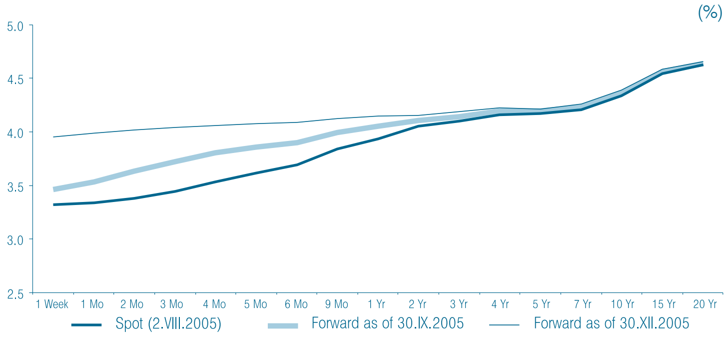
US Federal Funds Rate and Six-month LIBOR in US Dollars



Source: Bloomberg.

Chart 9

Expected US Yield Curve



Source: Bloomberg.

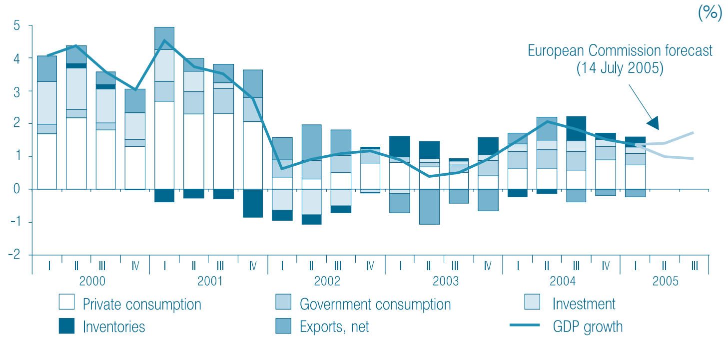
The Euro Area

In the first quarter of 2005 euro area growth rate dropped to 1.3 per cent on an annual basis (1.5 per cent in the last quarter of 2004), although an increase to 0.5 per cent was reported on a quarterly basis (0.2 per cent in the previous quarter).

Inflation stayed close to ECB target values from the start of the second quarter and in June it amounted to 2.1 per cent on a year-on-year basis. Energy and food price dynamics continued to determine the overall price level. Core inflation remained low (1.4 per cent on an annual basis in June) which proves the assumption that higher petrol price secondary effects did not exert any significant inflationary pressure. Weak consumer activity limited producers' opportunities to transfer rising production costs to end-use consumer prices. Despite faster unit labour cost annual growth in the first quarter, most likely the indicator's trend will be reversed in the second half of the year which presupposes weaker pressure on inflation. The major risks for price stability are the depreciation of the euro against the US dollar and the rise in crude oil prices which will result in higher production costs.

Chart 10

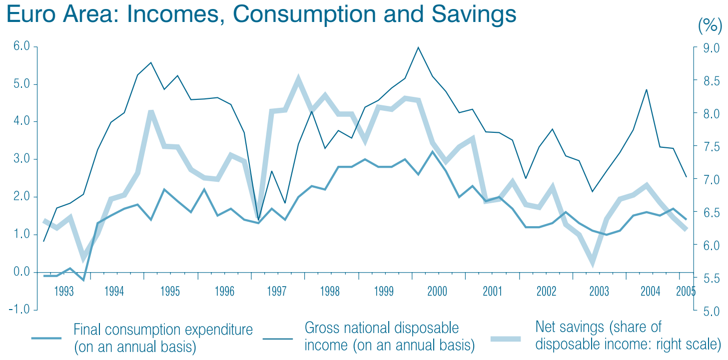
Contribution to Euro Area Growth by Component



Source: Eurostat.

Chart 11

Euro Area: Incomes, Consumption and Savings



Source: Eurostat.

During most of the second quarter euro area labour market data showed a favourable trend of rising employment and unemployment falling to 8.7 per cent in June. Optimistic expectations arise from data on Germany and France for June when a drop in the number of registered unemployed was reported. Major European Commission indicators for June are more optimistic about future employment.

By the close of the second quarter and the start of the third quarter most indicators of the economic situation in industry and services picked up upsetting the trend of the first half of 2005. Provided this change sustains in August and September, the euro area will report faster economic growth in the third quarter.

In June the ECB revised the 2005 projected GDP growth interval to 1.1–1.7 per cent on an annual basis (1.2–2 per cent prior to revision). Major factors behind this were the negative trends emerging in the first half of the year. The August ECB forecasts are for GDP growth within the 0.2–0.6 per cent band in the third quarter compared with the previous quarter and within the 0.4–0.8 per cent band in the fourth quarter.

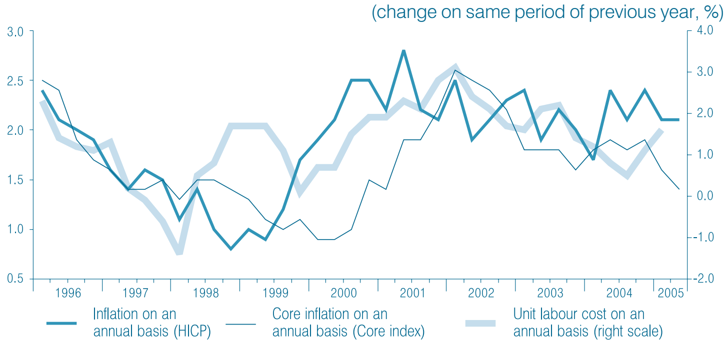
In the second quarter of 2005 ECB monetary policy remained unchanged. Financial markets reported possible interest rate cuts by the ECB in the fourth quarter based on data showing a decline in economic activity by mid-June. As a result, the spread between the interest rate on six-month LIBOR deposits in euro and the repo interest rate narrowed to 8.4 basis points. The subsequent improved current economic indicators supported the yield on six-month LIBOR deposits in euro, and the interest rate spread went up to 15 basis points by end-July.

ECB monetary policy corresponds to the lack of a substantial upward trend in consumer inflation and the relatively low euro area economic activity. Given the current macroeconomic trends, financial markets do not anticipate any changes in interest rates.

Based on market expectations, the six-month LIBOR on deposits in euro for the third quarter of 2005 is foreseen to move within the 2.10 to 2.25 per cent range.

Chart 12
Euro Area Inflation Rate

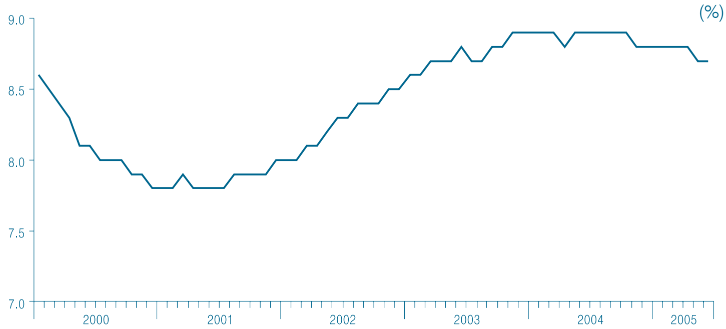
(change on same period of previous year, %)



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

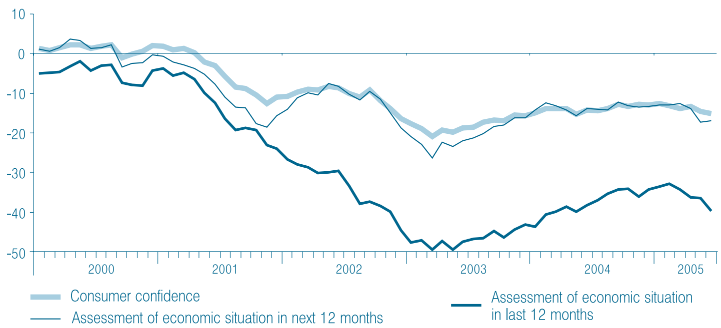
Chart 13
Euro Area Unemployment Rate

(%)



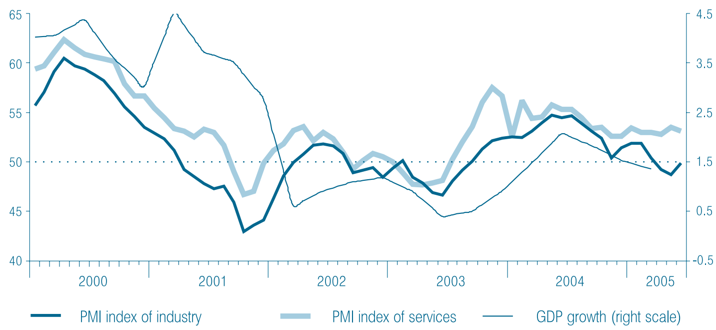
Source: Eurostat.

Chart 14
Euro Area Consumer Confidence Indicators



Source: Eurostat.

Chart 15
Euro Area PMIs and Growth



Source: NTC Research.

EU-25

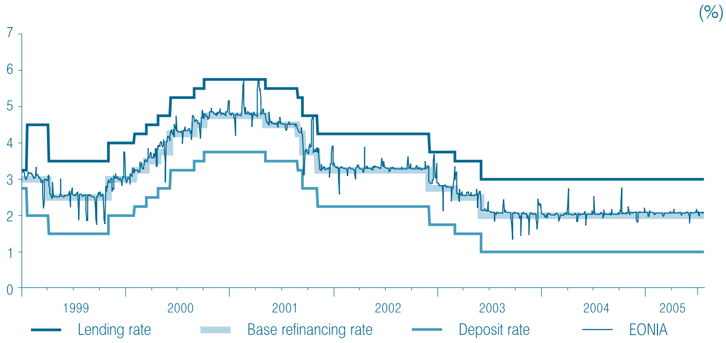
In the first quarter of 2005 EU-25 decreased its GDP growth rate to 1.6 per cent on a year-on-year basis. The growth in the new EU member states amounted to 3.9 per cent in the first quarter (4.2 per cent in the last quarter of 2004). Its lower level resulted from the slowdown in Hungary and Slovenia. Lithuania, Latvia, Estonia and Slovakia reported the highest growth rates.

In the second quarter inflation rates in the newly acceded countries fell to an average of 2.4 per cent (in the previous quarter rates averaged 3.2 per cent). This was caused to a great extent by the base effect of 2004 when a one-off temporary acceleration in inflation was reported (mainly through increased indirect taxes on consumption) owing to accession of the new countries to the EU.

The *EUR/USD* Rate

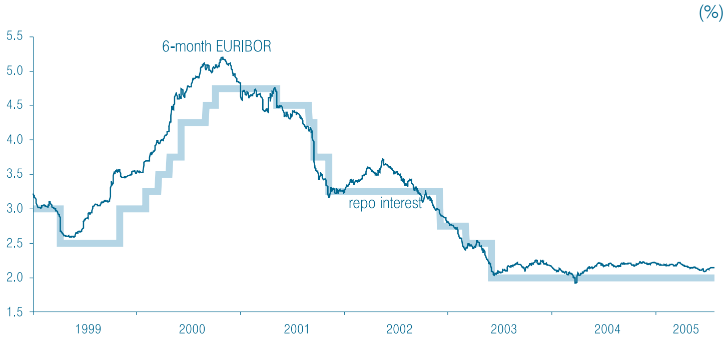
In the second quarter of 2005 a clearly outlined trend to depreciating euro against the US dollar was evident, with the exchange rate moving in a relatively wide corridor of USD 1.19 to USD 1.31. The series of ten monthly *EUR/USD* rate minimums reflected the expected interest rate policy of the ECB and the Federal Reserve (broadening of the interest rate differential and projections concerning decisions). By the end of the second quarter the effect of US news subsided at the expense of growing importance of euro area news.

Chart 16
Euro Area Base Interest Rates



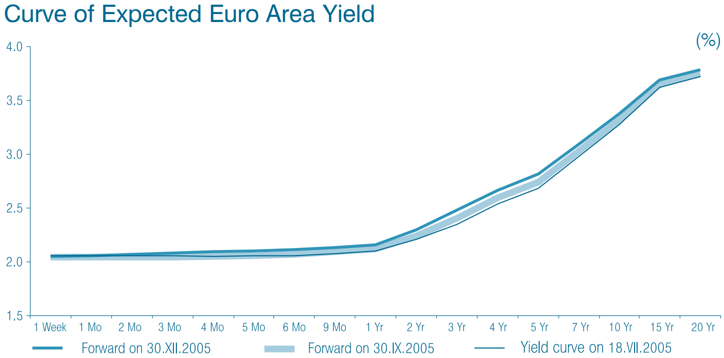
Source: Bloomberg.

Chart 17
BIR on Refinancing Operations and Six-month EURIBOR



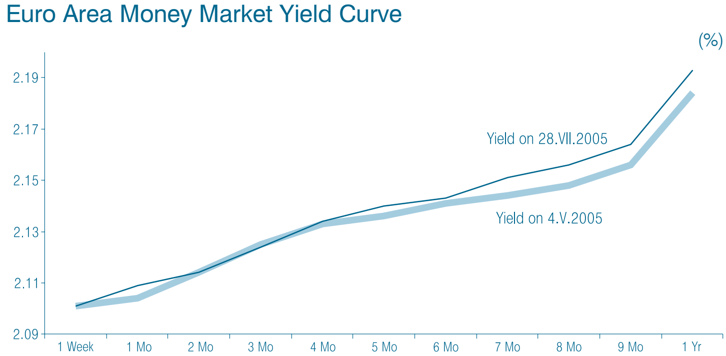
Source: Bloomberg.

Chart 18
Curve of Expected Euro Area Yield



Source: Bloomberg.

Chart 19
Euro Area Money Market Yield Curve



Source: Bloomberg.

Widening US interest rate differentials compared with the remaining developed countries will back the US dollar. In the summer exchange rate fluctuations usually subside, although this is not very likely to happen in the current year provided divergent signals come from the ECB and the Federal Reserve. The *EUR/USD* rate will probably move within the USD 1.17 to USD 1.25 band, with technical factors showing sustainable trends toward US dollar appreciation.

Chart 20

EUR/USD Exchange Rate

Source: Bloomberg.

The Balkan Region

In the first quarter of 2005 growth on the Balkans slowed down slightly. Industrial output growth rates in the Balkan states weakened in the second quarter, especially in Romania and Turkey, which signals steadying of last year's high growth rates and going through a cycle of moderate expansion.

By the end of the first half of 2005 inflation in the region remained relatively low without secondary effects from high crude oil and fuel prices.

Our expectations for the second half of 2005 are still optimistic. Growth rates will probably slow down due to lower foreign demand. However, economic conditions will lead to expansion stemming from the sustainable high domestic demand growth.

Table 1

Real Growth and Inflation in Balkan Countries

(%)

	2003	2004					2005	
	Total	I quarter	II quarter	III quarter	IV quarter	Total	I quarter	II quarter
Growth (on an annual basis)								
Bulgaria	4.5	4.5	5.5	5.8	6.2	5.6	6.0	
Greece	4.7	4.3	4.1	4.0	4.2	4.2	3.5	
Macedonia	2.8	2.4	3.7	3.4	2.1	2.9	2.7	
Romania	4.9	6.1	7.1	11.1	8.9	8.3	5.9	
Turkey	5.8	11.8	14.4	5.3	6.3	8.9	4.8	
Croatia	4.3	4.2	3.8	3.6	3.6	3.8	1.8	
Inflation (as of end of period**)**								
Bulgaria	5.6	6.2	7.3	6.3	4.0	4.0	4.3	5.1
Greece	3.1	2.9	3.0	2.9	3.1	3.1	2.9	3.2
Macedonia	2.6	1.4	-0.2	-1.8	-1.9	-1.9	0.2	1.4
Romania	14.1	13.1	12.0	11.1	9.3	9.3	8.7	9.7
Turkey	18.4	11.8	8.9	9.0	9.3	9.3	7.9	9.0
Croatia	1.7	1.4	2.5	1.5	2.7	2.7	4.0	2.8

Source: Statistical institutes and central banks of respective countries.

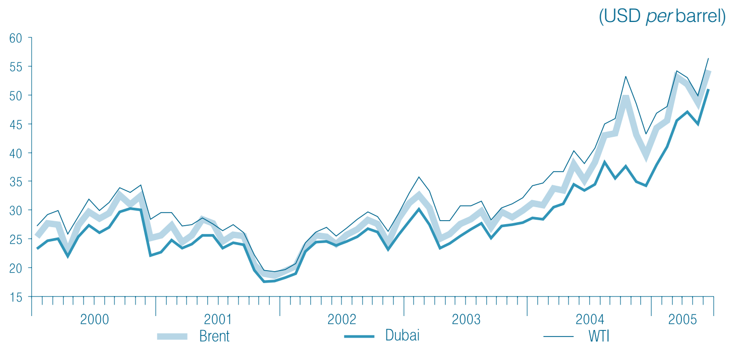
International Prices of Major Raw Materials, Crude Oil and Gold

Crude Oil

Enhanced crude oil demand, coupled with limited extraction facilities capacity, continued to dominate prompting higher prices of the crude oil. The steady rise in demand did not indicate that this high price affected consumer behaviour. Hence, in July Brent average price rose to USD 57.7 *per* barrel.

Chart 21

Crude Oil



Source: World Bank.

The IEA revised its projections of the 2005 raw material demand growth from 2.2 to 1.9 per cent due to the lower expectations of demand in China and the USA until end-year. This will partially ease market tension. However, cautiousness and speculations prevail. The crude oil reserves in OECD countries reached a six-year peak and OPEC supply hit the record highs in the last 25 years.

The upward trend in the crude oil price will be supported by the expected great demand in the second half of 2005 and seasonal factors, including active travel in the summer and accumulation of inventories for the winter. Brent price may continue to move dynamically in a wide range of USD 54 to USD 66 *per* barrel (although the risk here comes from underestimating this borderline). Hurricanes in the Atlantic Ocean whose number is expected to hit a record high additionally affected market fluctuations. High facilities utilization in the USA and the shortage of free capacities also contributed to the upward trend in international fuel prices.

Futures markets showed an intensive activity in the 'non-trade' segment prompted by participation of investment funds whose business activity is not directly related to crude oil extraction and processing. The change in their positions caused stronger-than-usual market fluctuations.

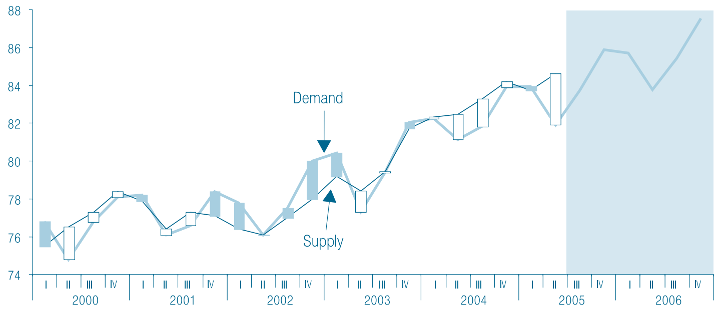
Calculated in euro, the OPEC basket crude oil price stayed above the corridor of EUR 22 to EUR 28 *per* barrel. Its average value in the second quarter was EUR 41 *per* barrel: an increase of 12.9 per cent on the previous quarter and 39.2 per cent on the second quarter of 2004. Unlike the valuation effect of the previous three quarters when oil appreciation in US dollars was partially offset by the appreciation of the European currency against the US dollar, in the second quarter of 2005 both effects pushed up oil prices in euro. On a quarterly basis, exchange rate contribution amounted to 3.9 per cent and that of oil price rise in US dollars to 8.3 per cent.

Given the *EUR/USD* rate forecasts for the third and fourth quarters of 2005, the twelve-month average price may exceed EUR 40 *per* barrel in November (by the end of the second quarter it came to EUR 33.8 *per* barrel).

Chart 22

World Crude Oil Demand and Supply

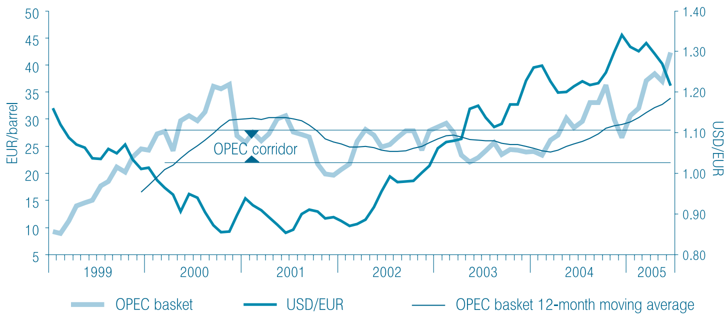
(million barrels *per* day)



Source: International Energy Agency.

Chart 23

OPEC Basket Price in Euro



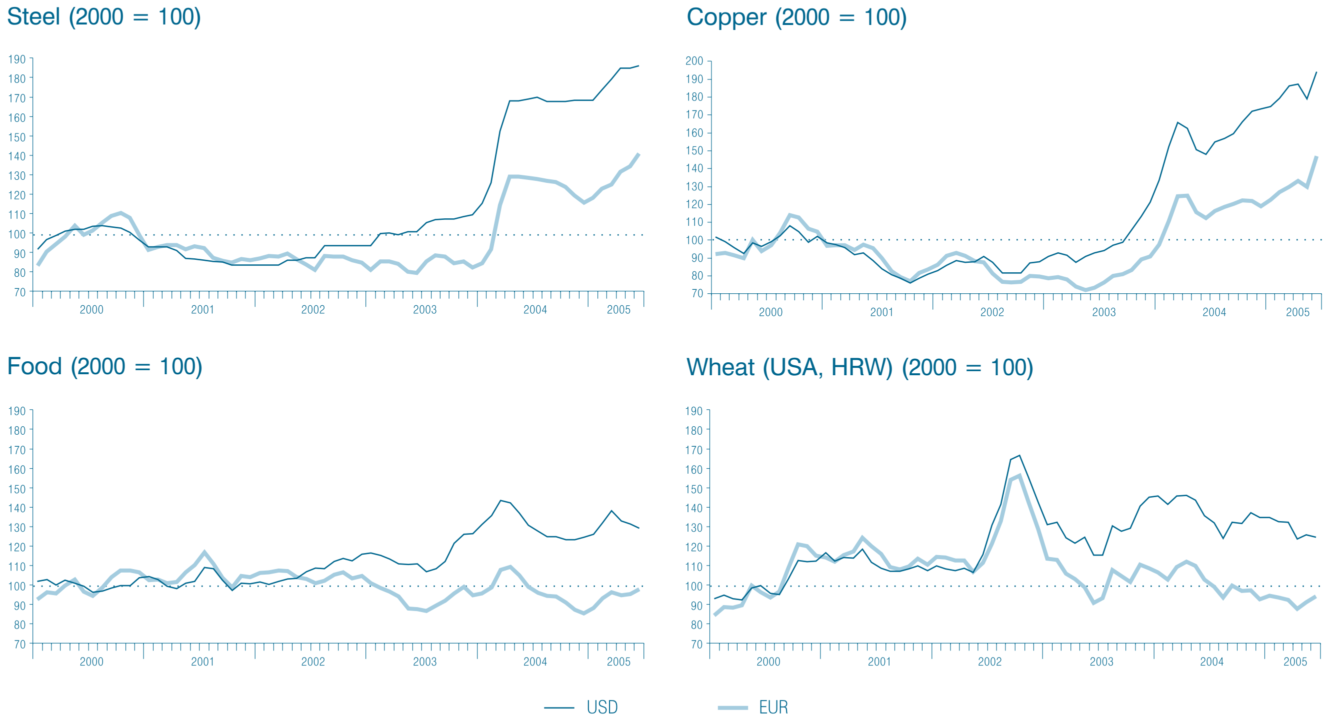
Source: World Bank, ECB, BNB, OPEC.

Major Raw Material and Commodity Prices

In the second half of 2005 metal prices will probably continue to rise slightly.[1] Latest forecasts of China's metal demand were revised downwards. As a result, some non-ferrous metals' prices (aluminium, zinc and lead) slightly fell in the second quarter. The low copper and nickel inventories in world exchange warehouses furthered their upward trend. According to expectations, steel price rose by 6.7 per cent compared with the previous quarter.

In the second quarter of 2005 food prices continued to move within anticipated bounds. Declines are possible in the second half of the year. There have been no indications of poor world cereals harvest so far, which is likely to prevent the pressure of bread and dough products on domestic inflation, provided grains have to be imported.

Chart 24
Price Indices of Major Commodities and Commodity Groups



Source: World Bank, BNB.

[1] Growth rates reflect dynamics in prices in US dollars.

According to International Grains Council forecasts, in July 2005 world wheat harvest will be close to the record highs of 2004 and wheat consumption will be met almost entirely by the new harvest with a minimum decrease in inventories. European Commission projections based on weather forecasts as of July put the 2005 EU cereals harvest at 10 per cent less than that of 2004. This reflects the droughts in France, Spain and Portugal, and the unusually heavy rainfalls on the Balkan Peninsula.

Gold

Gold price remained under the influence of the technical link with the *EUR/USD exchange rate* during most of the second quarter fluctuating within the range of US 415 to USD 442. Widening interest rate differentials between the USA and the euro area made investment in US dollars more attractive affecting adversely the price of this precious metal. In June the dependence on the exchange rate was discontinued due to: raised petroleum prices, silver appreciation leading to increased gold price, enhanced jewelry investment demand and consumption (marking the end of intensified purchases in Asia and mostly in India for the first half of 2005), rising physical demand at levels below USD 420, technical factors related to gold price calculated in euro, uncertainty on international markets.

In the third quarter of 2005 the technical link between the gold price and the exchange rate will gradually start recovering. Widening interest rate differentials will exert pressure on gold price. Purely seasonal factors will add to this. In the fourth quarter they will affect gold price through greater jewelry demand. Concerns have arisen about supply since the output in the three largest gold producers (the Republic of South Africa, the USA and Australia) is declining. At present, the central banks refrain from selling gold, thus limiting the major supply source: the official sector. The gold price will fluctuate between USD 385 and USD 460 *per* troy ounce until year-end.

Chart 25
Spot Price of Gold

(USD *per* troy ounce)

Source: Bloomberg.

Bulgarian External Debt Dynamics on International Financial Markets

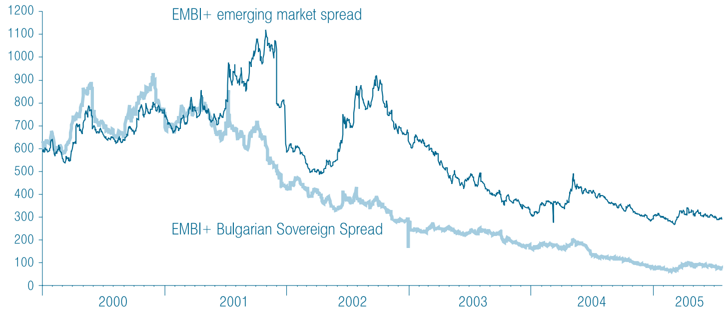
Emerging markets government debt yield spread has been following a steady trend towards a gradual decrease since early May. Recovery of investors' interest in high-risk assets after the crisis of the end of the first quarter resulting from *General Motors'* downgraded rating was an important factor behind this dynamics. Long-term interest rates of government securities in developed economies decreased over most of the second quarter boosting the interest in financial assets offering relatively high yield being a government debt of developing countries.

In compliance with the general trend to stronger interest in emerging markets, the yield spread of Bulgarian external debt measured by the JP Morgan EMBI+ index decreased to 73 basis points by the close of the second quarter prompted by the final repurchase of Brady bonds amounting to USD 607.64 million effected in July.

The stable macroeconomic environment and the prudent fiscal policy continued to be the factors behind the sustaining interest of international investors in Bulgarian government debt.

Chart 26
Spread of JP Morgan Index for Emerging Markets

(basis points)



Source: Bloomberg.

2. Financial Flows, Money and Credit

Changes in international conditions, prompting fluctuations in external demand, exchange rates and interest rates, had a significant effect on Bulgaria's economy *via* foreign trade dynamics and balance of payments financial account flows. The interaction of domestic and external economic agents formed financial flows which determined the direction and the change in international reserves. The change of international reserves under a currency board arrangement leads to a change of monetary base and correspondingly to a change in broad money through the process of money multiplication.

The first half of 2005 saw a relatively high capital inflow and a progressive increase in BNB international reserves. By the end of June the Issue Department assets reached EUR 7453.2 million, an increase of EUR 1341.9 million on 2004). The bulk of financial flows between the Bulgarian economy and non-residents over the review period reflected transac-

Table 2

Cash Flows Which Prompted Significant Changes in Gross International Reserves

	January – March 2005	January – June 2005
A) Purchases and sales of reserve currency (million EUR) - Net purchases from commercial banks - Revenue (outflows) related to net purchases (sales) at tills	EUR +328 million EUR -3 million	EUR +811 million EUR -6 million
B) Changes due to revenue on commercial banks' minimum required reserves accounts in foreign currency	CHF -52 million EUR +55 million USD -99 million	CHF -327 million* EUR +293 million USD -100 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	**Revenue:** 1. From privatization of energy distribution companies: EUR +555 million; 2. From external loans: EUR +18 million; 3. From issue of internal debt: EUR +17 million. **Payments:** 1. On external government debt: USD -1074 million; EUR -168 million, SDR -6 million; JPY -600 million. 2. On domestic government debt: EUR -3 million.	**Revenue:** 1. From privatization of state-owned companies: EUR +602 million; 2. From external loans: EUR +55 million; SDR +4 million; USD +1 million; 3. From domestic debt issues: EUR +17 million; **Payments:** 1. On external government debt: USD -1087 million, EUR -267 million, SDR -12 million; JPY -1053 million; 2. On domestic government debt: EUR -6 million.

* As a result of the amendments to Ordinance No. 21 which do not allow commercial banks to maintain minimum required reserves in currencies other than the lev and euro, during the first half of 2005 CHF 327 million and USD 100 million were withdrawn.

Source: BNB.

tions of commercial banks and the state budget. The January purchase of Brady bonds by the government led to a decline in BNB reserves over the first quarter which was entirely offset until end-June, and international reserves rose by EUR 682.8 million on the end of December 2004.

Commercial Banks' Behaviour in the First Half of 2005

Following the publication of the BNB Governing Council's resolution in February 2005 on introducing additional required reserves, banks tried to raise the reporting basis of the growth rate of loans by significantly increasing their credit portfolios in March. As a result, claims on the non-government sector grew by BGN 3888.7 million (by 27.6 per cent) in the first quarter, with the increase in March alone amounting to BGN 3276.6 million. These changes affected broad money dynamics prompting a rise by BGN 2466.2 million in March (by 11.9 per cent on February) and by BGN 2811 million (by 13.8 per cent on December 2004) in the first quarter of 2005.

Commercial banks' behaviour entails new amendments to Ordinance No. 21 in April, one of them providing for credit growth reporting by averaging daily volumes. Between April and June claims on the non-government sector went down by BGN 1718.2 million and broad money by BGN 427.7 million. This may not be interpreted as an indication of subdued lending and decreased money supply, since annual growth rates of both indicators stayed high. By the end of June claims on non-financial corporations fell by BGN 1922.6 million on March as a result of writing off a part of loans extended by the end of March and another part of loans was transferred to non-resident banks. Claims on households continued to progressively increase (by BGN 590.6 million in the second quarter of the year).

Note: For more details about measures for limiting credit growth initiated by the BNB in early 2005, see *Economic Review*, May 2005, p. 20.

Commercial banks' behaviour, instigated by the amendments to BNB Ordinance No. 21 on Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks (see the above box) affected significantly the dynamics of a number of macroeconomic indicators over the first half of 2005. During the first quarter most of banks started extensively to borrow external resources, mostly in the form of non-residents' deposits, and to raise the volume of extended loans intended to increase the base provided for in the amendments to Ordinance No. 21. During the second quarter following the additional amendments to the Ordinance adopted in April, a fall both in banks' external debt and in monetary and credit aggregates occurred compared with the previous quarter without any indications that it affected Bulgaria's economic activity.

Financial Flows and External Position Sustainability

Since early 2005 the balance of payments current account deficit was progressively increasing to reach by end-June approximately EUR 1.86 billion on an annual basis. This increase was primarily attributable to the trade balance growth which as a result of high growth rates of imports rose by EUR 392.8 million compared with the January – June 2004 period and reached EUR 1693 million over the review period.

We expect to see a current account surplus in the third quarter and a deficit in the fourth quarter, with the annual current account deficit reaching approximately 8.7–8.8 per cent of GDP. Over the third quarter foreign direct investment inflows will come to some 9 per cent on an annual basis, and 6.3–6.4 per cent of GDP over the fourth quarter.

External government debt at the end of the third quarter was nearly 27 per cent of GDP and at the end of the year almost 26 per cent. Private external debt is expected to rise during the third quarter to 39–40 per cent of GDP and to nearly 42 per cent of GDP in the fourth quarter of 2005.

Worsening current account impacted by the trade balance dynamics will be sustained in the second half of 2005. Growth rates of exports and imports are expected to stay relatively high but lower than that registered since early 2005. Trade balance will continue worsening (see the Economic Activity Section). The major factor responsible for the increase in trade balance deficit will be the relatively high growth rate of imports determined by domestic demand.

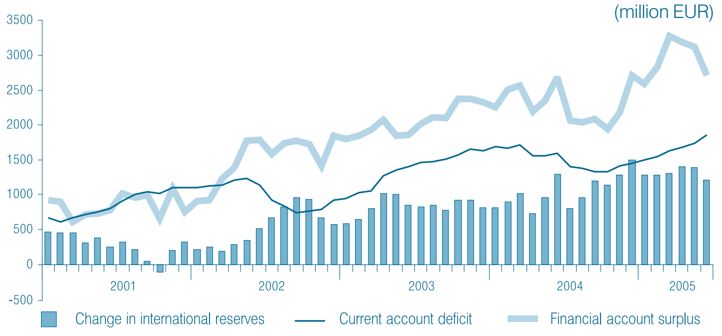
Current account dynamics in the third and fourth quarters significantly diverged due to larger revenue from tourism concentrated in summer months. In recent years summer tourist seasons were favourable for the Bulgarian economy and the summer 2005 is also expected to be good. According to NSI data, foreign travelers who visited Bulgaria numbered 2.7 million in the first half of 2005, an increase of 7 per cent on the same period of 2004. Tourist visits accounted for the bulk of all visits. According to the forecasts based on these data, travel revenue is expected to increase by more than 10 per cent in the third quarter on the corresponding period for 2004. The balance on *Services* again will be the determining factor in current account surplus formation in the third quarter. The nominal growth of travel revenue over the third quarter of 2005 is expected to be lower than that in 2004 reflecting the high volume realized in the third 2004 quarter. The amount of the current account surplus in the third quarter is estimated at nearly EUR 500 million, an increase of approximately EUR 100 million compared with the corresponding period in 2004 but risks are associated with lower surplus.

The deficit on the *Income* item may worsen due to increasing international interest rates and the larger amount of repatriated profit. Balance of payments data by June 2005 confirm these expectations with the income paid on direct investments since early year almost matching that for first half of 2004. Over the same period total income paid on portfolio and other investments rose by 15 per cent on the corresponding period of 2004. The balance on income slightly deteriorated between January and June 2005 and it is anticipated to continue worsening in the second half-year.

Net current transfers increased insignificantly in early 2005 (EUR 414.7 million by June against EUR 354 million between January and

Chart 27

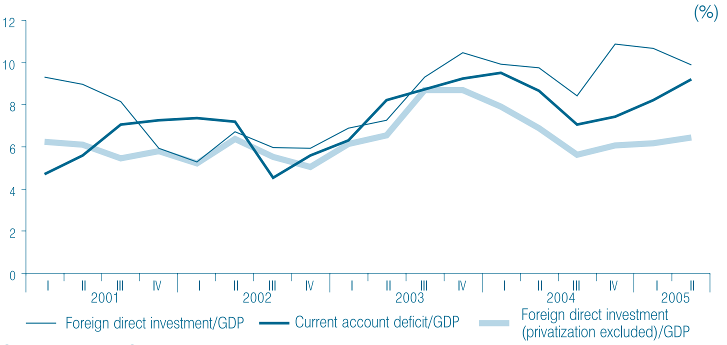
Dynamics of Current Account, Financial Account and International Reserves on an Annual Basis



Source: BNB.

Chart 28

Current Account Deficit to *GDP* and *Foreign Direct Investment* to *GDP* (On an Annual Basis)



Source: BNB, NSI.

June 2004), and no factors prompting accelerated growth are expected to occur in the second half-year. The increase in net current transfers over 2005 is estimated at about EUR 50 million, the bulk of it expected in the fourth quarter.

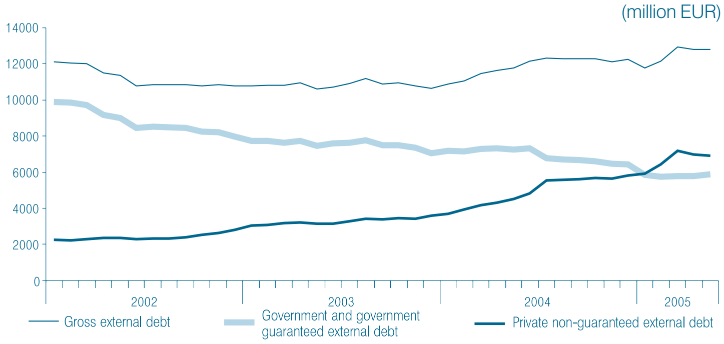
Given the expected dynamics of the current account, the deficit in the fourth quarter will increase by approximately EUR 100 million on the same period of 2004 to reach about EUR 1 billion. The current account deficit is forecasted at approximately EUR 1.8 billion (8.7–8.8 per cent of GDP).

Between January and June 2005 foreign direct investment inflow was slower than in the corresponding period of 2004, reflecting the lack of privatization transactions until June 2005. Over the second half-year the inflow of foreign direct investment is expected to be lower on a year earlier basis, as in the second half of 2004 sizable receipts came from privatization transactions. However, non-privatization component of foreign direct investment is expected to grow compared with the second half of 2004, a prerequisite for a stable current account deficit financing. Anticipated receipts from direct investment over the third quarter are estimated at about EUR 230 million and almost match the 2004 third quarter's level. An inflow of about EUR 500 million is expected in the fourth quarter. The forecasts for 2005 point out an increase in the non-privatization component of foreign direct investment and an insignificant privatization revenue, with the cover provided on the current account deficit by direct investment exceeding 70 per cent.

Private sector's net external borrowing has been stable in recent years and it is expected to sustain in the second half of 2005. Measures initiated by the BNB for limiting credit expansion will mostly affect the structure of balance of payments debt flows. The inflow of debt resources into commercial banks on the balance of payments financial account is expected to be lower than in 2004 at the expense of increasing indebtedness of the private nonbank sector.

By end-May 2005 gross external debt totaled EUR 12,799.1 million, an increase of approximately EUR 550 million on the end of 2004. Debt of the *General government* sector decreased by about EUR 600 million, while that of the private sector rose by over EUR 1.1 billion. The policy of reducing external government

Chart 29
Gross External Debt



Source: BNB.

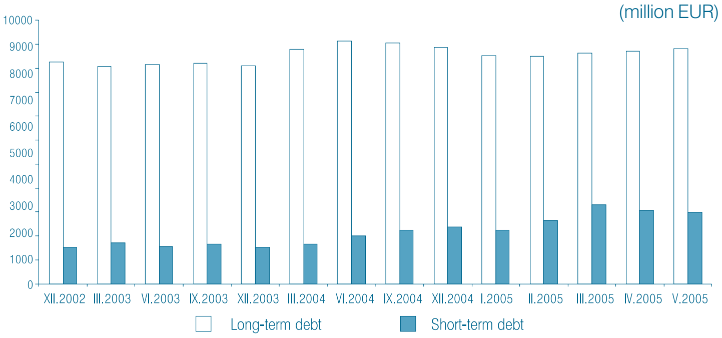
debt pursued by the government and the low probability for negotiating new loans support our expectations for a decrease in the external government debt to about EUR 5500 million in the third quarter (a fall by approximately EUR 1400 million on the third quarter of 2004 if the buyback of Brady bonds effected in July is reported). Over the fourth quarter the amount of the external government debt is expected to amount about EUR 5400 million, a decrease of approximately EUR 1200 million on the corresponding quarter of 2004.

By March 2005 private debt growth was mostly impacted by the behaviour of commercial banks which intensively borrowed funds for lending from their foreign owners, primarily in the form of non-resident deposits. This led to a dramatic increase in short-term external debt. Following the amendments to Ordinance No. 21, commercial banks changed their behaviour and their foreign obligations in the form of non-resident deposits went down by almost EUR 400 for two months. Thus, one of the objectives for limiting external banking system indebtedness, provided for by the amendments to Ordinance No. 21, was achieved.

Over the second half of 2005 the total private sector debt is expected to increase, and debt flows will shift to the private non-bank sector instead of the banking system.

The expected rechanelling of external obligations to the private non-bank sector indicates that commercial banks' debt will gradually increase, while the debt of non-bank economic agents will rise at faster rates . As a result, the private external debt may reach approximately 39–40 per cent of GDP on an annual basis in the third quarter and about 42 per cent of GDP on an annual basis in the fourth quarter of 2005. These expectations about the private external debt dynamics have a short-term nature: until the end of 2005. The trend toward extensive external borrowing of funds for financing the private sector pertains to the favourable internal situation and good prospects for economic growth. The bulk of external obligations are infused in the economy in the form of foreign direct investment (intercorporate loans). In the medium run, growth rates of the private sector foreign debt are expected to fall due to the exhaustion of the base effect, and the debt service expenditure to exports ratio to decline due to the increased export capacity of the firms.

Chart 30
Long- and Short-term Gross External Debt Dynamics



Source: BNB.

If the effect of the buyback of Brady bonds, worth USD 607.64 million, is reported and the expected balance of payments flow dynamics realizes, the increase in the BNB international reserves is estimated at about EUR 60 million in the third quarter and approximately EUR 160 million in the fourth quarter.

Monetary Aggregates

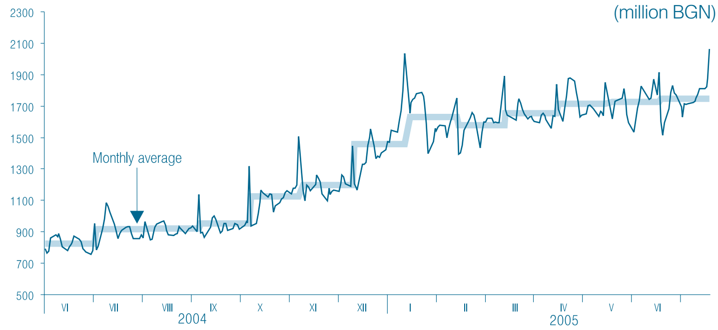
During the second quarter of 2005 reserve money increased to 39 per cent year on year, reflecting mostly the significant 117 per cent rise in commercial banks' deposits by end-June. In absolute terms, bank deposits rose more than twice: from BGN 965 million to BGN 2065 million, reflecting changes in the basis of calculating minimum required reserves in the second half of 2004 and exclusion of banks' cash from these reserves. In the third and fourth quarters of 2005 bank deposits will progressively rise nominally as a result of the increased deposit base and additional required reserves deposited by banks for non-compliance with the provisions of Ordinance No. 21 under the latest amendments thereto.[2] Additional minimum reserves to the amount of BGN 236 million were deposited for the first time in early August. Having in mind the high base in September and especially in December 2004, deposit growth rates are expected to slow to around 60 per cent in the third quarter and 20 per cent in the fourth quarter. These rates are likely to change since bank reserves appear to be one of the most dynamic components of money supply, with one-off factors affecting their daily dynamics.

Currency in circulation is expected to maintain its growth rates at the current levels of 20 to 22 per cent. Over the last two years currency in circulation grew steadily (19.8 per cent with a standard deviation of 1.4 percentage points). Second quarter of 2005 saw growth above the average (22–23 per cent) which is indicative of a significant inflow of funds on the balance of payments, with sustained high demand for cash balances in support of transactions needs. Assuming demand for cash is sustained and BNB international reserves increase, in the third and fourth quarters no significant deviations from above growth rates are projected.

In the third and the fourth quarters of 2005 reserve money growth rates are expected to stabilize at nearly 20–22 per cent on an annual basis. Broad money will progressively change at a rate of between 23 and 25 per cent year on year, with a slight downward trend. No significant changes in deposit interest rates are anticipated, with a possible slight rise over the coming two quarters.

Chart 31

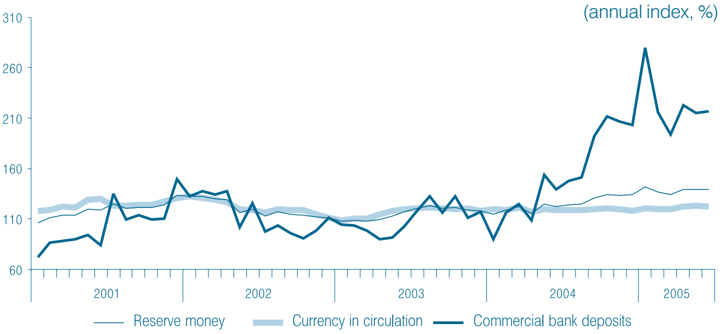
Commercial Bank Deposits



Source: BNB.

Chart 32

Reserve Money and Its Components



Source: BNB.

[2] For more details see *Economic Review*, May 2005, p. 20.

Currency dynamics reflects government fiscal policy which affects demand for currency in circulation through income and non-interest budget expenditure, on the one hand, and money multiplier, on the other, through the amount and changes in government deposits with the BNB. According to the first quarter data, the budget withdrew a significant amount of liquidity from the non-government non-bank sector (budget revenue from this sector picked up steadily as a result of the strong economic growth and outstripping consumption growth). This trend is expected to sustain in the second and third quarters of the year, while in the fourth quarter, as in previous years, the non-government non-bank sector will be a net recipient of budget funds. Over the second half of 2005 negative net financial flows from the consolidated budget to the external sector of some 2 per cent of GDP (resulting mostly from advance external debt repayments at end-July)[3] are projected.

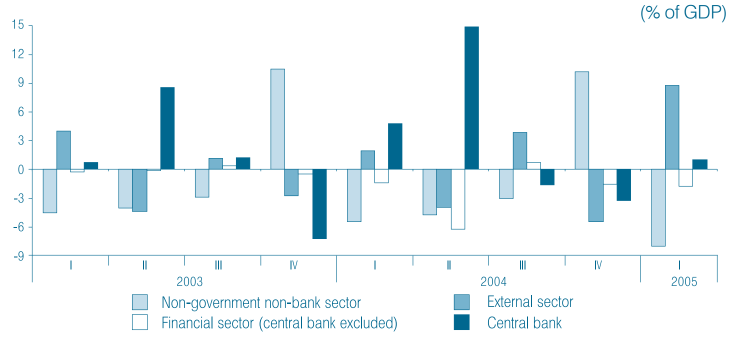
As a result of expected dynamics in financial flows from and to the budget until year-end, deposits of the government and budget organizations with the BNB will exceed BGN 4 billion. After the July FLIRB buybacks, worth USD 607.64 million, government deposits declined to BGN 4.3 billion. However, the expected considerable budget surpluses will prompt a further increase to BGN 5 billion over the third quarter prior to their decline in the last month of the year.[4]

Following the unusually high March growth, in the second quarter of 2005 broad money went down compared with the first quarter. Overnight deposit declines reflected mostly falls in non-financial corporations' deposits in levs and foreign currency which were the main source of growth in the first quarter. Owing to the one-off nature of the March rise which was associated with enhanced lending of commercial banks, in April firms' overnight deposits fell significantly, with lev deposits falling by 17 per cent and foreign currency deposits by 21 per cent. Solely households' overnight deposits picked up in the second quarter *vis-à-vis* first quarter. Over the same period lev time deposits of non-financial corporations dipped by 16 per cent, and foreign currency time deposits

[3] Following this transaction, we anticipate government and government guaranteed debt to reach approximately 32 per cent of GDP.
[4] This projection does not involve possible one-off expenses to be made until the end of the year on damages caused by the summer floods.

Chart 33

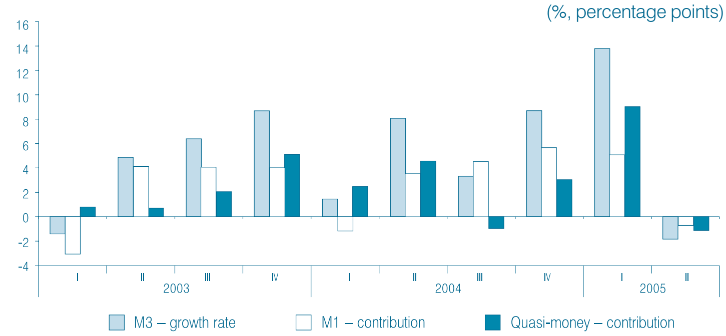
Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)



Source: MF, BNB.

Chart 34

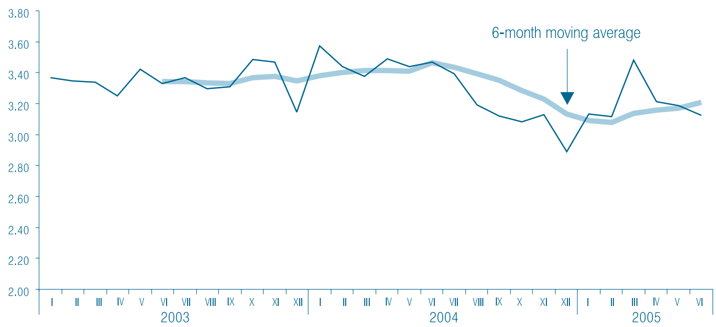
M3 Growth Rate and M1 and Quasi-money Contribution (Quarterly)



Source: BNB.

Chart 35

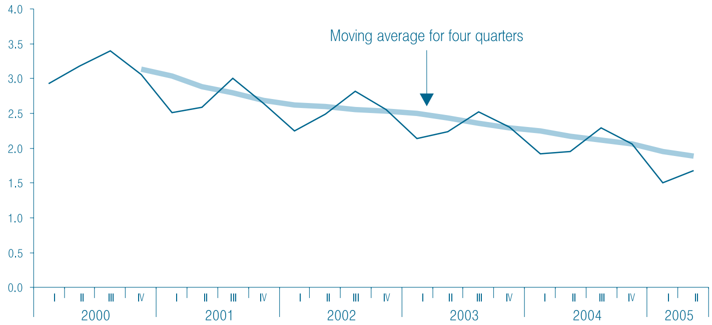
M3 Money Multiplier



Source: BNB.

Chart 36

Currency Circulation Velocity



Source: BNB.

Note: The velocity of circulation for the second quarter of 2005 is based on GDP projections.

by 30 per cent. In June households' lev deposits rose by 6 per cent and foreign currency deposits by 8 per cent on March 2005.

Although broad money (M3) declined in the second quarter compared to the first quarter, it continued to rise on an annual basis at comparatively high rates (25 per cent as of June). Normal deposit dynamics after significant March and April fluctuations and the stable growth in currency outside banks give grounds to expect retention of M3 rates in the coming two quarters at between 23 and 25 per cent, with a slight downward trend.

The expected slowdown in broad money growth rates reflected money multiplier falls stemming from regulations restricting commercial bank lending. After the dramatic rise in March reflecting the lending boom, money multiplier values returned to average in April, May and June. Provided claims on the non-government sector do not deviate significantly from the requirements under Ordinance No. 21, the money multiplier will further decrease in both the third and fourth quarters of 2005.

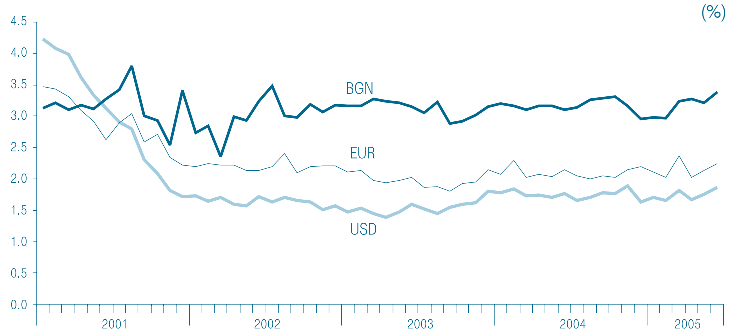
Projections of the broad money behaviour cover also the trends in the velocity of currency circulation. Its dynamics in the last five years showed a stable downward trend with clearly pronounced seasonality, which reflected households' and firms' willingness to hold larger cash balances.

In April in May interest rates on time deposits remained relatively stable, while June saw an increase in interest rates of lev-denominated deposits (from 3.21 per cent to 3.39 per cent), of euro-denominated deposits (from 2.14 per cent to 2.24 per cent) and of USD-denominated deposits (from 1.75 per cent to 1.87 per cent). This could be explained by banks' attempts to attract more funds from firms and individuals in order to improve the *loans to borrowed funds from non-financial corporations* ratio.

Between March and June the interest rate distribution on lev time deposits changed. The differential between the lowest and the highest interest rates contracted from 5.25 to 4.87 percentage points, while the standard deviation fell from 1.09 to 1.03 percentage points.[5] In contrast to previous periods, in June no bank

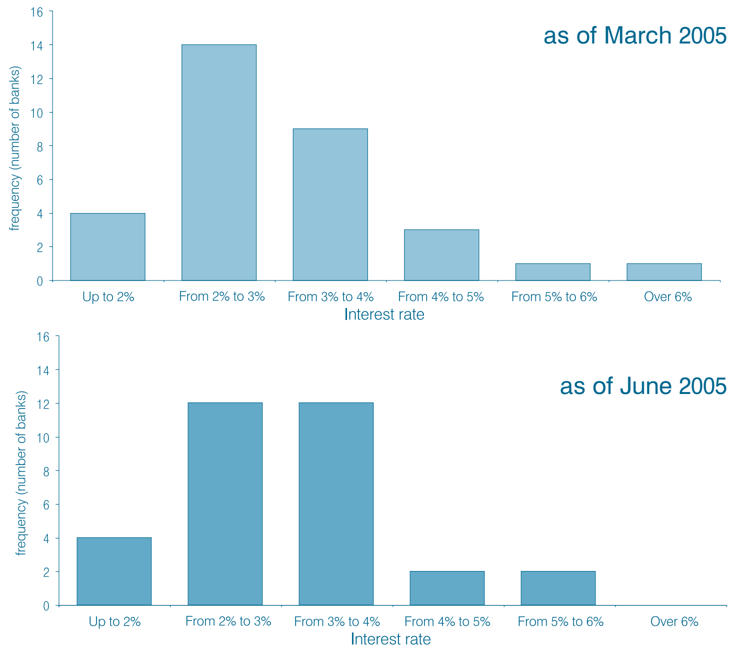
[5] To achieve compatibility between the March and June data, the *International Bank for Trade and Development* (license revoked on 14 June 2005 by the BNB Governor due to insolvency) was excluded from the analysis.

Chart 37
Time Deposit Interest Rates



Source: BNB.

Chart 38
Interest Rate Distribution on Household One-month Lev Deposits



Source: BNB.

offered higher than 6 per cent interest rate on one-month lev deposits. Two banks offering deposit rates between two and three per cent moved to the group of banks offering rates between three and four per cent. One bank offering rates between four and five per cent moved to the group offering deposit rates between five and six per cent. These shifts indicate some banks' attempts to attract more deposits by offering more favourable conditions for potential depositors.

Most likely, the reported level of average deposit interest rates in June will be sustained over the coming quarters. However, a slight increase is possible, with the most active banks being those whose *loans to borrowed funds from non-financial corporations* ratio is close to the threshold of 60 per cent under Ordinance No. 21.

Credit Aggregates

The rapid money supply growth reflected mostly the brisk lending activity. As a result of the active credit policy pursued by banks, the *claims on the non-government sector to GDP* ratio came to 41 per cent in the second quarter: an almost 10 points increase on June 2004.[6]

Trends in credit demand and BNB measures to curb credit activity were the main drivers behind credit aggregate dynamics. The second quarter processes on the credit market are expected to play a decisive role in credit aggregate developments over the coming months. On the one hand, credit demand, staying high under the favourable economic situation and firms' and households' optimistic expectations, created conditions for expanding lending activity. Concurrently, in early 2005 the BNB enforced measures for limiting credit activity which predetermined lower than registered rates of growth. Following the April amendments to BNB Ordinance on minimum required reserves, in the second quarter claims on the non-government sector dropped by BGN 1718.2 million and as of end-June their annual growth rates went down to 41.8 per cent.[7] If the BNB restrictions are observed, the annual growth rate of the claims on the non-government sector is expected to gradually fall to some 30–35 per cent by end-2005.

[6] Based on GDP projections for the second quarter of 2005.

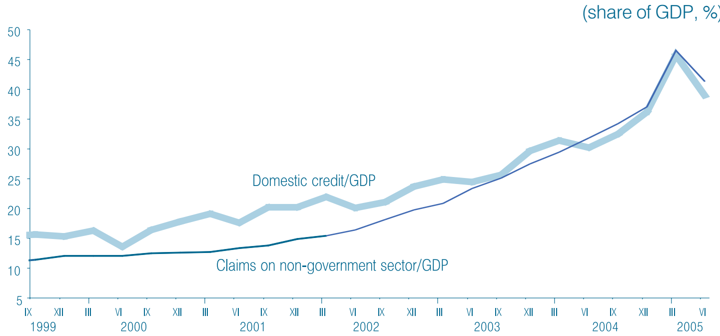
[7] This drop did not reflect weakening credit activity and was rather due to writing off fictitious loans registered at the end of March, and to transferring claims on loans to non-resident banks.

Banks are expected to observe credit growth restrictions. As a result, by end-year growth rates of claims on the non-government sector will slow to 30–35 per cent. No significant changes in lending interest rates are projected.

Chart 39

Domestic Credit

(share of GDP, %)

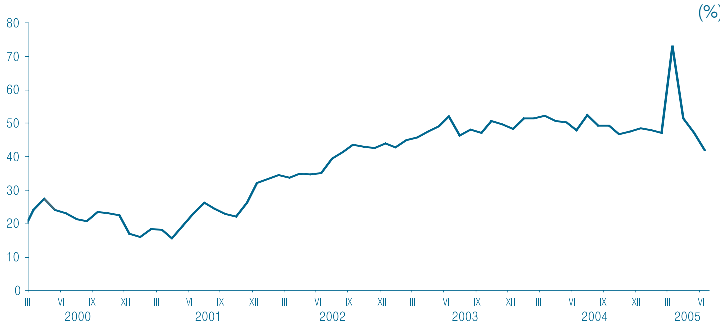


Source: BNB.

Chart 40

Claims on Non-government Sector (Annual Growth Rate)

(%)

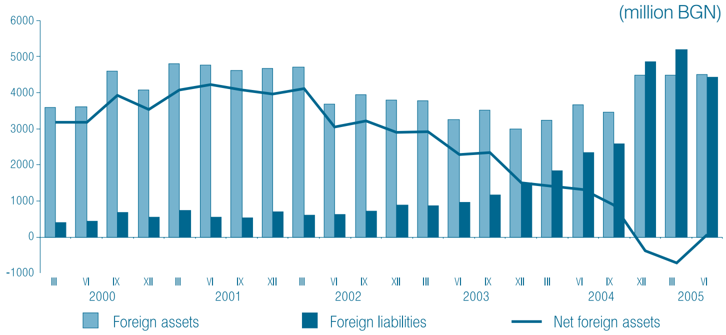


Source: BNB.

Chart 41

Foreign Assets and Foreign Liabilities of Commercial Banks

(million BGN)



Source: BNB.

In the past year bank funds borrowed from non-residents increased sizably driven by prospects of robust credit activity and the wide interest rate differential between domestic lending rates and external lending rates. Introduced restrictive measures, however, set limits to banks' stimuli to borrow funds from abroad in order to finance their lending. This impacted foreign liabilities dynamics which fell by BGN 752.7 million in the second quarter after the rapid growth in 2004. Hence, net foreign assets of commercial banks turned positive at the close of June.

Chart 42

Net Financial Flows of Commercial Banks (Quarterly)

Source: BNB.

Table 3

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

(million BGN)

	I	II	III	IV	I	II
	2004				2005	
Claims on non-financial corporations	553.6	522.1	668.1	817.8	2948.8	-1922.6
Deposits of non-financial corporations	-170.0	624.6	179.7	449.2	1971.2	-1258.6
Claims on households	300.4	500.7	503.8	567.0	721.7	590.6
Deposits of households	498.9	486.7	508.9	580.2	702.9	633.0
Foreign assets	243.2	428.5	-206.8	1021.4	-9.3	23.1
Foreign liabilities	339.3	512.6	230.1	2285.8	325.7	-752.7
Claims on government sector	190.5	-108.9	42.6	64.6	17.1	209.8
Deposits of government sector	177.8	-239.2	206.1	-64.2	65.8	105.4
Claims on central government	188.2	-109.6	42.2	66.9	16.3	203.5
Liabilities to central government	57.4	-212.7	189.7	-70.5	-95.6	94.7

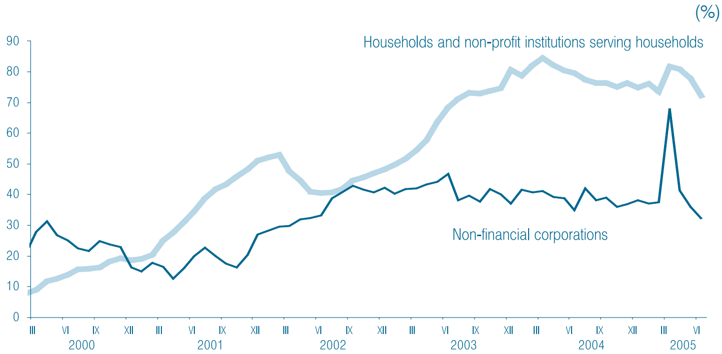
Source: BNB.

In June the annual growth rate of claims on non-financial corporations declined to 32.2 per cent. Although demand for loans by enterprises stayed high, reflecting buoyant production and investment activity, in the second quarter claims on non-financial corporations dropped by BGN 1922.6 million. Besides high values reported by banks by end-March, this was also ascribable to transferring loans to non-resident banks intended to adhere to credit growth rates under Ordinance No. 21.

Despite the second quarter slowdown, annual growth rates of claims on households stayed at high levels (72.2 per cent as of end-June). Favourable trends in income and employment, as well as optimistic expectations prompting enhanced demand for loans by households contributed mostly to this growth. Housing loans continued to be the most dynamic segment in household lending, with annual growth of 145.2 per cent by end-June. These loans' share reached 25.8 per cent of claims on households.

Chart 43

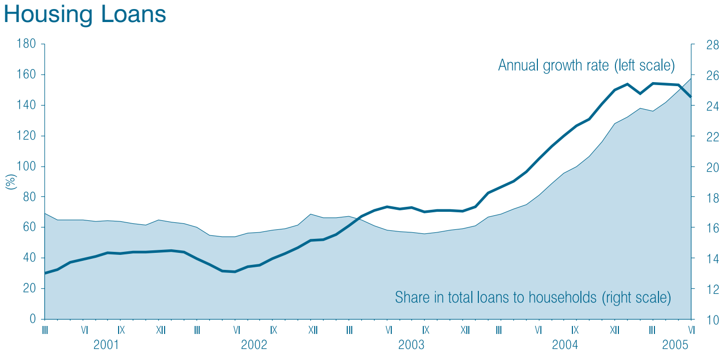
Claims on Non-financial Corporations and Households (Annual Change)



Source: BNB.

Chart 44

Housing Loans



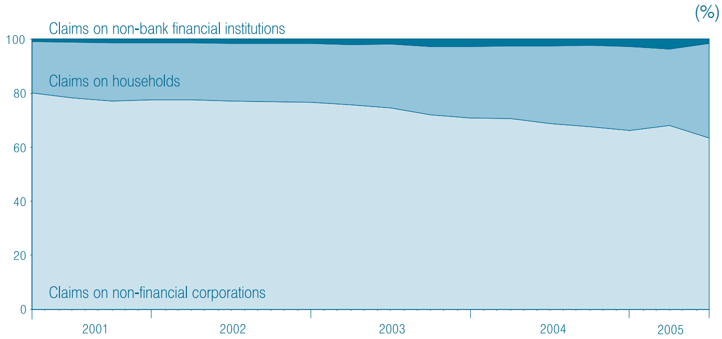
Source: BNB.

Faster growth in loans to households led to their increased share in the claims on the non-government sector: 35 per cent as of end-June. This reflected both the greater potential for developing household lending and the opportunities for enterprises to use more actively foreign financing sources.

Prospects for more moderate credit growth in the coming months are backed by expectations of lending rates dynamics. If banks try to increase the volume of attracted deposits by offering higher interest rates, this would increase the price of borrowed funds and decrease the possibility of further lending rate cuts. However, a sizable increase in lending rates is most unlikely. On the one hand, the spread between lending and deposit rates is still high (Chart 17) which allows banks to raise deposit rates on the account of the spread, thus avoiding growth in lending rates. In addition to this, prospects for sustained euro area interest rates give no grounds to expect significant changes in domestic lending rates.

Chart 45

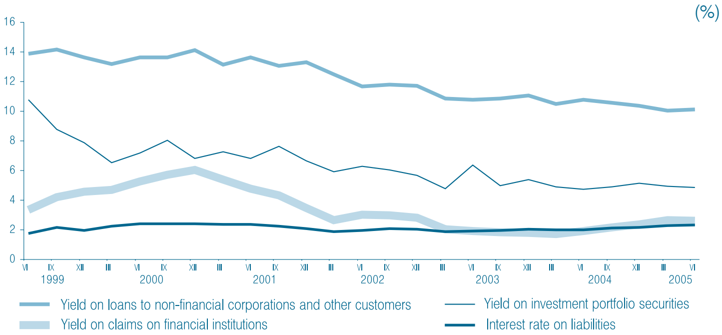
Loan Structure



Source: BNB.

Chart 46

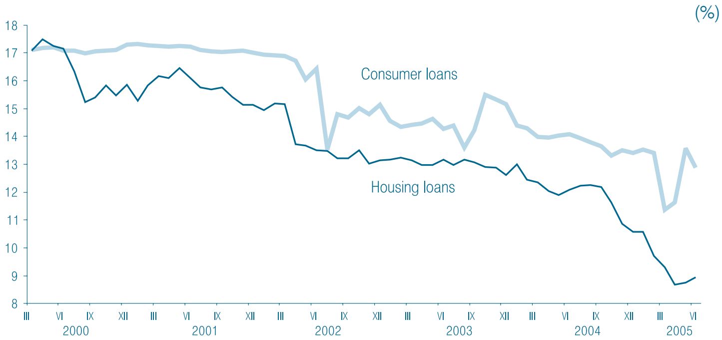
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities



Source: BNB.

Chart 47

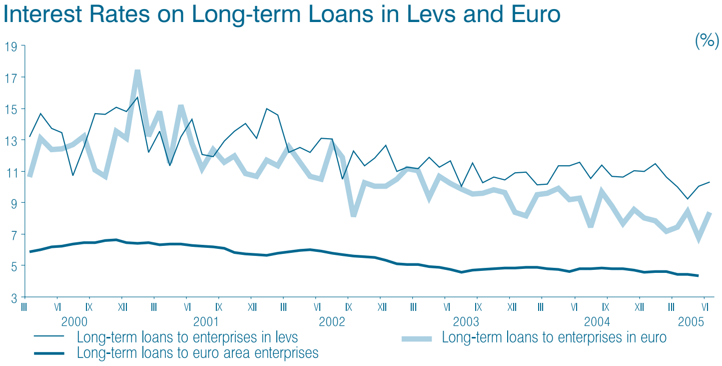
Interest Rates on Household Loans



Source: BNB.

Chart 48

Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

The trend to accelerating economic growth, which started at the end of 2003, continued in the first quarter of 2005. Household consumption growth was surprisingly high, while investment growth posted a stronger-than-expected slowdown. Increasing exports and slowing imports compared with the first quarter of 2004 contributed most.

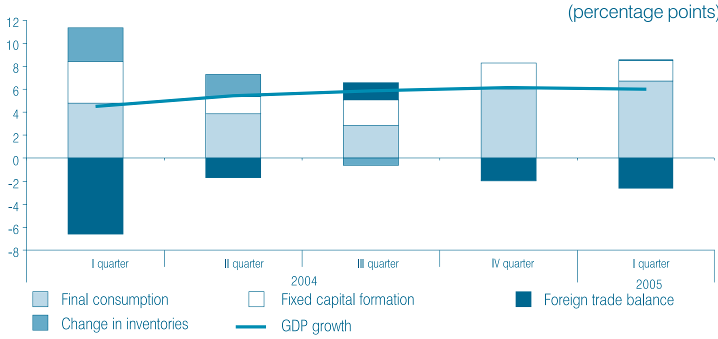
Damage caused by the July floods was recently estimated to exceed BGN 300 million. Yet, the August flood damages will be estimated. Household property, infrastructure, plants and cattle were badly affected . There are no data currently available on damaged industrial enterprises. According to the Ministry of Agriculture and Forestry, harvested wheat as of the beginning of August is sufficient to ensure the nation's grain balance. Based on current data, the agriculture and transport are expected to be among the most affected industries.

Over the third quarter economic growth is expected to remain comparatively high (5.4 per cent) and to slow down slightly in the fourth quarter (to some 4.8 per cent on a year-on-year basis). For 2005 economic growth is estimated at 5.4–5.8 per cent. Risks for delays in Bulgaria's economic growth are associated with damages caused by the July/August floods and the speed of disaster recovery.

Chart 49

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

(percentage points)



Source: NSI.

Table 4

Dynamics of GDP Components According to Final Consumption Method

(on corresponding period of previous year, %)

	2004				2005
	I quarter	II quarter	III quarter	IV quarter	I quarter
Final consumption	5.3	4.3	3.7	6.6	7.3
Gross fixed capital formation	22.1	6.9	12.6	9.9	9.2
Exports of goods and services	7.0	10.6	14.1	19.8	8.8
Imports of goods and services	16.7	11.1	11.9	16.9	10.8
GDP	**4.5**	**5.5**	**5.8**	**6.2**	**6.0**

Source: NSI.

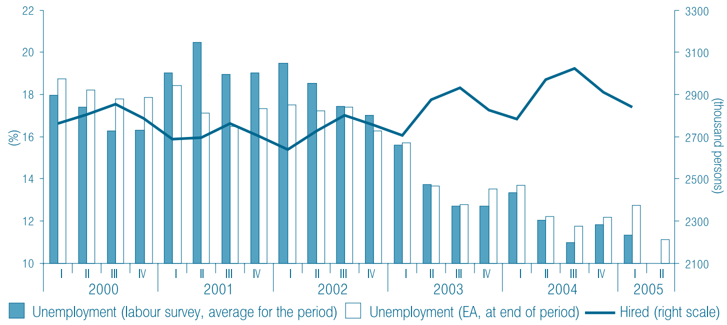
Household Behaviour

Over the first quarter of 2005 household consumer expenditure rose by 7.7 per cent on the corresponding quarter of 2004. Non-food expenditure posted the highest growth, contributing more than twice to overall growth. Spending on foods, communications and catering increased at accelerating rates. Household budget and retail trade data confirmed high economic activity over the first and the beginning of the second quarters.

Household consumption contributed mostly to GDP growth. In the third quarter it is expected to grow in real terms by almost 5.4 per cent on an annual basis and by 3.6 per cent in the fourth quarter. Slowing consumption growth in the fourth quarter is associated with the high base in the corresponding period of the previous year.

Employment and income growth continued to be among major factors behind the buoyant consumption. Labour force survey shows that the number of employed rose by 2 per cent during the first quarter. The Employment Agency reported unemployment to have dropped by one percentage point in the first and second quarters on an annual basis. Wages and salaries increased by 4.6 per cent in real terms.[8]

Chart 50
Status of Economically Active Population



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

Table 5
Consumer Demand Dynamics

(share on corresponding period of previous year, %)

	2004				2005	
.	I quarter	II quarter	III quarter	IV quarter	I quarter	April – May
Consumer expenditure *per* household member	4.1	3.1	5.6	1.6	4.8	4.0
Retail sales	12.5	13.6	13.5	13.8	14.1	
Revenue from retail trade	11.5	12.2	12.9	15.6	11.6	12.8
Food, drink, tobacco	10.6	5.1	5.1	8.1	9.3	11.1
Pharmaceutical and medical goods, cosmetics and toiletry	6.0	8.7	5.0	3.4	3.3	6.3
Textiles, clothing, footwear and leather products	9.0	15.9	7.6	12.0	12.0	15.2
Household goods and equipment	15.7	18.6	25.0	27.1	19.3	18.5

Source: NSI.

Table 6
Employment and Income Dynamics

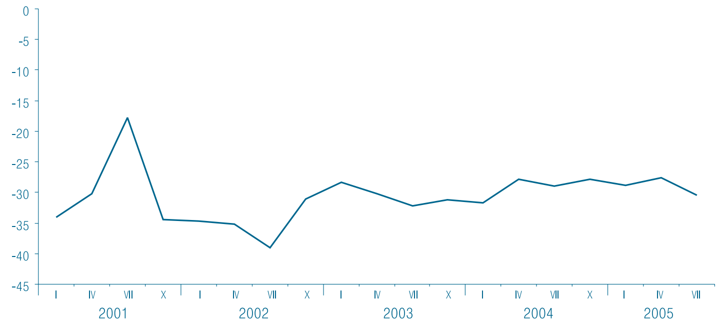
(%)

	2004				2005	
.	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter
Unemployment at the end of the period (EA data)	13.7	12.2	11.7	12.2	12.7	11.1
Employed						
Share on corresponding quarter of previous year	6.2	5.1	5.3	5.4	1.0	
Share on previous quarter		3.9	2.5	0.8	-1.9	-0.4
Hired (labour survey data)						
Share on corresponding quarter of previous year	2.9	3.3	3.1	3.1	2.0	
Share on previous quarter		-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	-0.6	2.5	5.9	8.2	4.6	

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

Since early 2005 the significance of state budget transfers to households intended to finance consumption has decreased. Between January and May these transfers dropped by 0.1 percentage points on the corresponding period of 2004 to reach 29.3 per cent of the average income *per* household member. Individual types of transfers showed divergent dynamics. Owing to the decline in unemployment, unemployment compensations' share in

Chart 51
Household Confidence Indicator



Source: NSI, consumer survey.

[8] Deflated by CPI.

total income *per* capita fell from 0.7 per cent to 0.6 per cent. Pension income decreased by 0.5 percentage points to 25.9 per cent of total income, this fall being offset by a rise in family allowances and other social benefits from 2.3 per cent to 2.9 per cent.

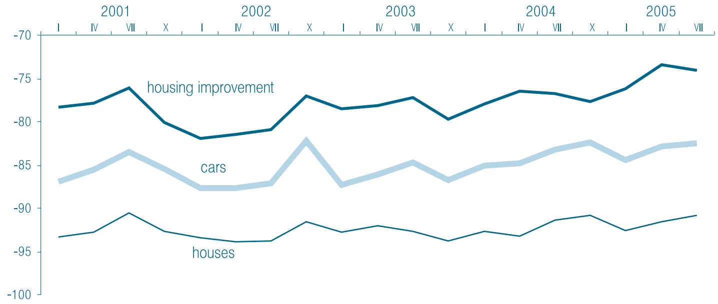
Favourable employment and income dynamics had a positive effect on households' optimism about their financial status, increasing the propensity to borrow funds in order to finance consumption. Households continued to be a net creditor of the banking system. However, the excess of household deposits over loans gradually contracted due to outstripping growth rates of loans as compared to deposits. At the same time, the share of household consumer expenditure financed by credit demonstrated upward trends.

Household optimism reflected in the NSI consumer survey data underlies household consumption growth. Over the third quarter its rate is expected to reach 5.4 per cent on an annual basis. Simultaneously, consumption growth is likely to slow down to 3.6 per cent in the fourth quarter of 2005 due to the high base attained in the fourth quarter of 2004.

The July survey shows worsening expectations of the economic situation in Bulgaria and households' financial position. Undoubtedly, this attitude reflected mostly damages caused by July floods. Still, household optimism about declining unemployment and some types of core expenditure persisted in the survey.

Chart 52

Trends in Major Expenditures in the Coming Two Years

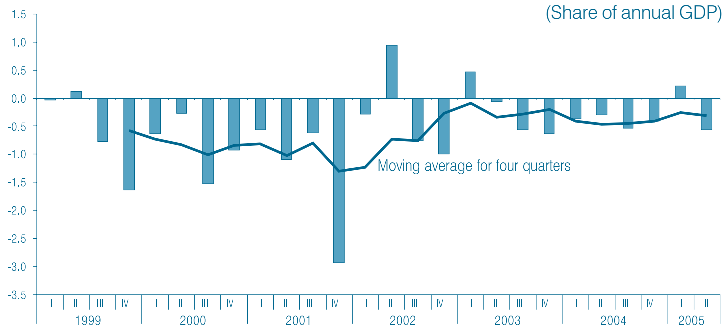


Source: NSI.

Chart 53

New Bank Claims on Households and Non-profit Institutions Serving Households (NPISH)

(Share of annual GDP)



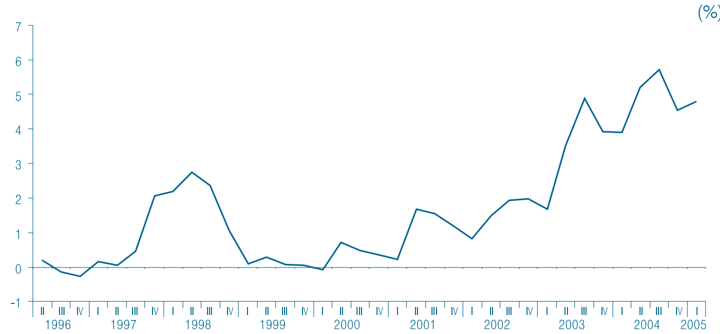
Note: The change in bank claims on households and NPISH less the change in household and NPISH deposits less 50 per cent of the change in currency outside banks divided by GDP for the period of four quarters finishing in the corresponding quarter. GDP projections for the second 2005 quarter.

Source: BNB.

Chart 54

Share of Household and NPISH Consumer Expenditure Financed by Bank Credit

(%)



Note: Change in consumer loans and overdraft to households and NPISH divided by final consumer expenditure of households and NPISH for the corresponding quarter.

Source: BNB.

Government Finance and Consumption

Over the first quarter the contribution of government consumption to GDP growth came to 1.1 percentage points. This reflected mostly large expenditure of collective consumption which rose by 7.3 per cent in real terms, increasing its share in GDP by 0.2 percentage points to 10.2 per cent. Preliminary data on consolidated fiscal programme performance in the second quarter show that further increases in government consumption are expected. Public investment's contribution to gross fixed capital formation growth is expected to rise in the second quarter in view of increased capital expenditure on consolidated budget by 79 per cent on the same quarter of 2004.[9] However, over the second half of 2005 more moderate growth in non-interest budget expenditure and lower growth rates of government consumption are expected based on the assumption that overall annual expenditure as a share of GDP will remain unchanged *vis-à-vis* 2004 (approximately 40 per cent of GDP).

Data on consolidated fiscal programme performance as of end-June and expected economic activity show that the cash surplus on consolidated budget as of end-year will amount to 1.8–2.5 per cent of GDP[10] depending on expenditure policy scenarios by the close of the year. Ambiguity about possible changes in the expenditure policy of the newly formed government gave rise to uncertainty. Therefore, budget surplus estimates may vary within a fairly wide range.

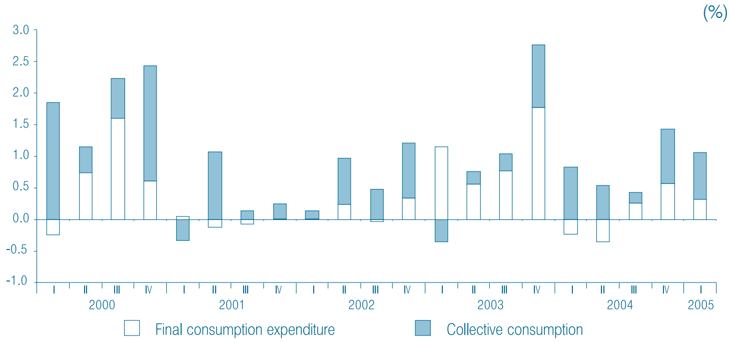
[9] Similar dynamics in capital expenditure was observed in 2001, the year of parliamentary elections.

[10] According to the agreement with the IMF, the annual surplus should be at least 1 per cent of GDP. The excess of revenue is distributed equally between extra expenditure and budget surplus.

Based on consolidated fiscal programme performance data by end-June and expected high economic activity, the cash surplus on consolidated budget is expected to account for 1.8–2.5 per cent of GDP depending on expenditure policy scenarios until the end of the year. The contribution of government consumption to economic growth is estimated at nearly 1 percentage point for the year.

Chart 55

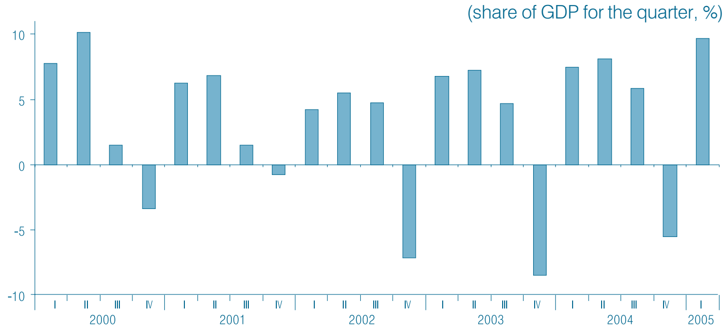
Contribution of Final Government Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)



Source: NSI.

Chart 56

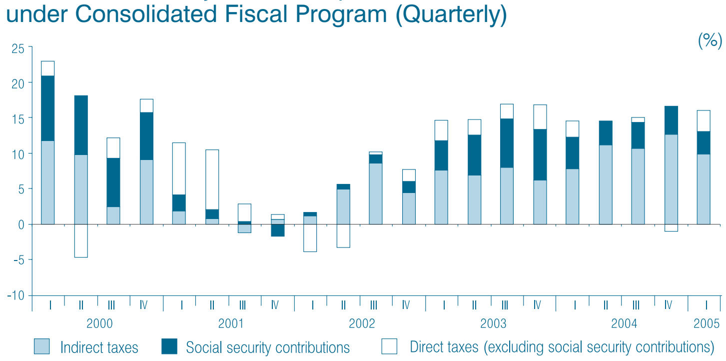
Primary Balance (Quarterly)



Source: MF.

Chart 57

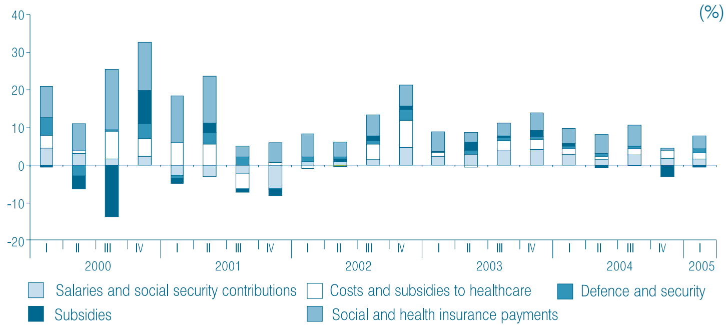
Contribution of Major Tax Groups Growth to Tax Revenue Growth under Consolidated Fiscal Program (Quarterly)



Source: MF, BNB.

Chart 58

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



Source: MF, BNB.

Behaviour of Firms and Competitiveness

Production activity in industry and services accelerated in the first quarter. Metallurgy, manufacture of machines, equipment and household appliances, chemical industry and oil processing have been the leading industries and major exporters since early 2005.

Firms adjusted their estimates of economic situation until the end-year in anticipation of slowing growth rates of exports and domestic demand compared with the second half of the

Downward changes in managers' expectations of the business environment, as shown in the July NCI business survey, and the brisk economic activity in the second half of 2004 give grounds to project a slowdown in production and investment activity and more moderate growth rates compared to those in the corresponding period of the prior year. Fixed capital investment is expected to reach nearly 9 per cent in the second half of 2005 and 10 per cent in 2005. The absolute nominal increase will match the prior year's level.

Table 7

Gross Value Added Growth by Sector

(corresponding quarter of previous year = 100)

	2004				2005
	I quarter	II quarter	III quarter	IV quarter	I quarter
Agriculture and forestry	-1.0	-0.4	3.7	3.3	-1.7
Industry	4.9	6.1	5.3	4.8	8.2
Services	5.9	5.7	6.5	6.0	7.4
At base prices, total	5.1	5.2	5.6	5.4	7.1
Contribution, percentage points					
Agriculture and forestry	-0.1	0.0	0.7	0.3	-0.1
Industry	1.6	1.8	1.5	1.4	2.6
Services	3.6	3.4	3.4	3.7	4.6

Source: NSI.

Table 8

Industrial Sale Dynamics

(share on corresponding period of previous year)

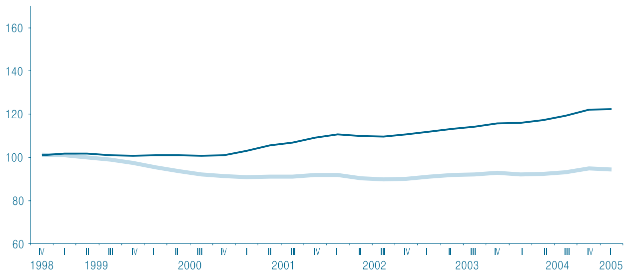
	2004				2005	
	I quarter	II quarter	III quarter	IV quarter	I quarter	April – May
Industrial sales	14.5	20.9	23.8	26.8	14.8	13.8
export sales	34.5	42.5	49.1	49.6	23.7	18.2
domestic sales	5.9	6.9	8.1	9.5	6.3	9.6
Contribution, percentage points						
export sales	10.3	16.7	18.8	21.4	11.6	8.9
domestic sales	4.1	4.2	5.0	5.4	3.2	4.9

Source: NSI.

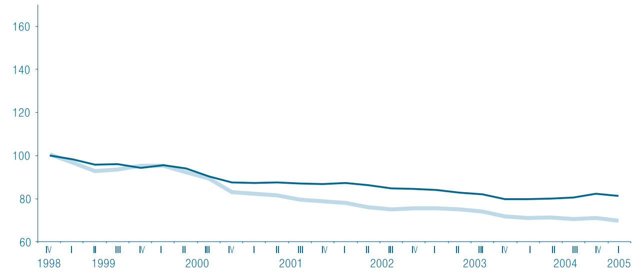
Chart 59

Unit Labour Cost (Quarterly)

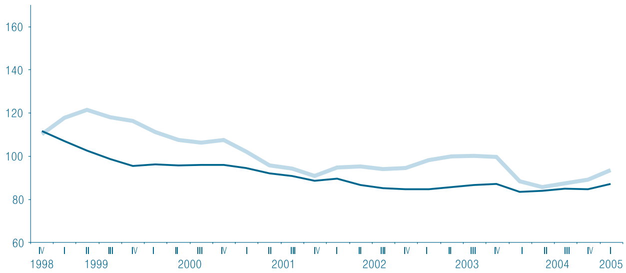
Total for the Economy



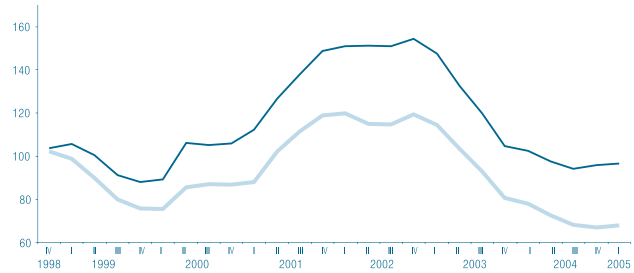
Manufacturing



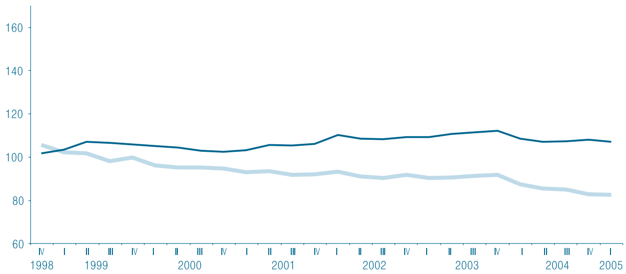
Agricultural Sector



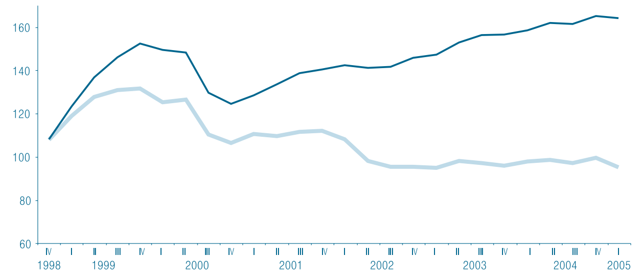
Mining and Quarrying



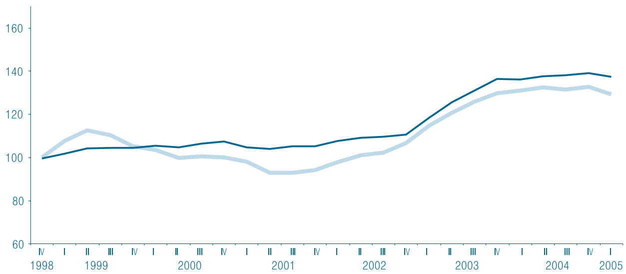
Construction



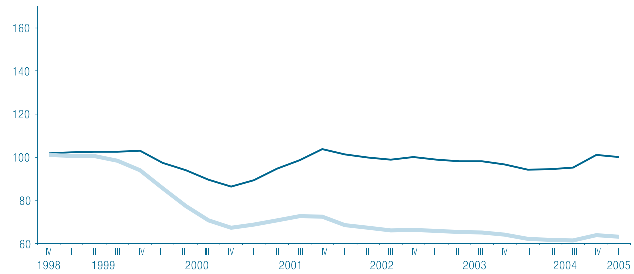
Electricity, Gas and Water Supply



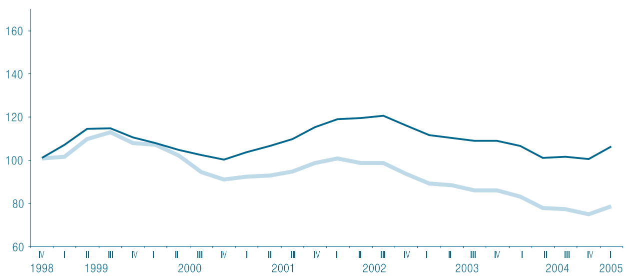
Trade



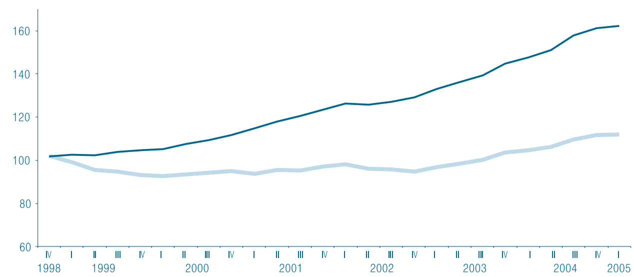
Transport and Communications



Financial Intermediation



Other Sectors



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

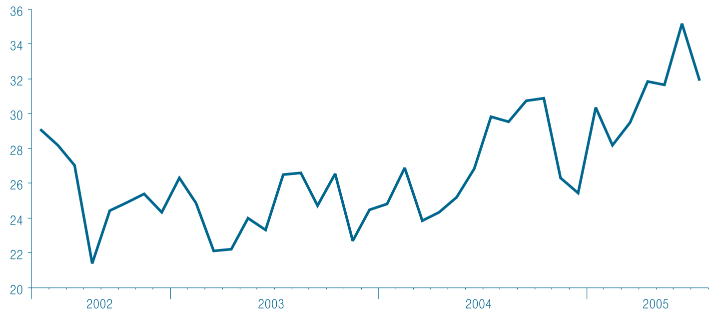
Source: NSI, BNB.

previous year. The improving competitiveness will help industrial enterprises to boost their exports, albeit at lower growth rates.

The high nominal growth rate of investment goods imports (in euro) was a sign of accelerating firms' investment activity over the second quarter. This, coupled with government capital expenditure growth, will result in a 14 to 15 per cent increase in fixed capital investment. In the second half investment growth will be strongly tied to the need and ability to recover the infrastructure and property of firms and households. Public sector's investment expenditure will contribute mostly to growth. Thus, fixed capital investment may exceed the expected 9 per cent.

Chart 60

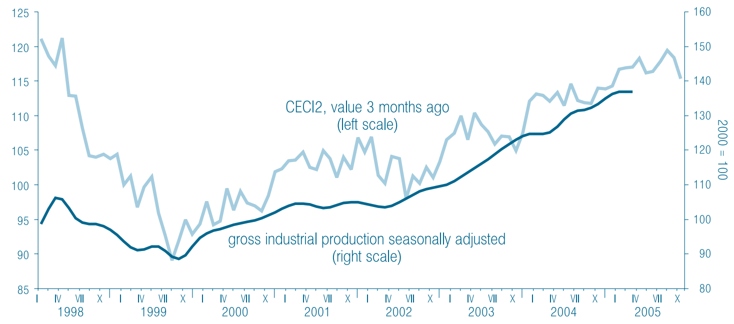
Business Climate Indicator



Source: NSI, business survey.

Chart 61

Expectations of Industrial Production



Source: NSI, BNB.

Exports and Imports of Goods and Services

Between January and June 2005 exports in euro reached EUR 4381.7 million, a nominal increase of EUR 763.7 million (21.1 per cent *vis-à-vis* the first half of 2004). Imports (FOB) accounted for EUR 6074.7 million over the review period, rising nominally by EUR 1156.4 million on the corresponding period of 2004 (23.5 per cent). Forecasts of slowing export and import growth rates for the second half of 2005 reflect expectations of lower growth in foreign and domestic demand until the close of the year. Prices had a secondary effect on projected volumes following the expectations of retaining or slightly increasing international prices.

Growth by commodity group for the first half of 2005 and commodity contribution to overall exports are likely to retain their dynamics in the second half of the year. Animal and plant products, food, drink, tobacco posted the greatest rise between January and June (51.5 per cent on an annual basis), followed by mineral products and fuels (39.6 per cent) and machines, vehicles, appliances, tools and weapons (34.6 per cent). The low base from the previous year

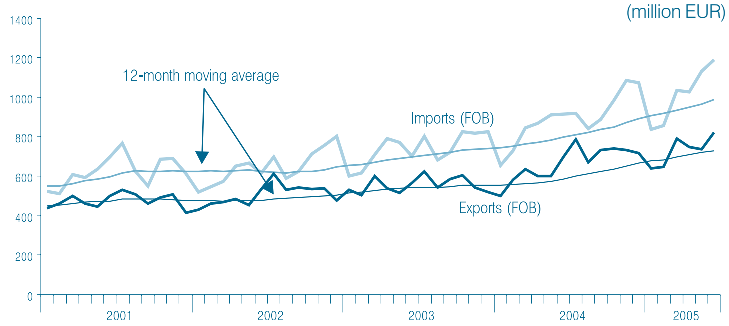
The annual growth rate of goods exports is expected to reach 18 per cent in the third quarter on the same period of 2004 and approximately 17 per cent in the fourth quarter, reflecting primarily the improving competitiveness of the Bulgar5ian economy. Domestic demand will maintain high growth rates of goods imports: 18 per cent in the third quarter on the same period of 2004 and 17 per cent in the fourth quarter of 2005.

Given the projected export and import dynamics, the trade deficit balance will reach 15 per cent of GDP on an annual basis in the third quarter and approximately 15.5 per cent in 2005.

Chart 62

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

and increasing competitiveness of domestic food and agricultural production were among the major factors behind the sizeable increase in food and drink exports. A breakdown analysis indicates that cereal exports grew by 3912 per cent (from EUR 1.9 million to EUR 74.2 million), while oil seeds and fruit exports rose by 189 per cent (from EUR 28.1 million to EUR 81.2 million). Expectations of food and drink exports for the third and fourth quarters include: moderate growth rates on an annual basis (below overall export rates) reflecting the dramatically increased base over the second half of 2004. Food export rates are expected to diminish due to the July and August flooding.

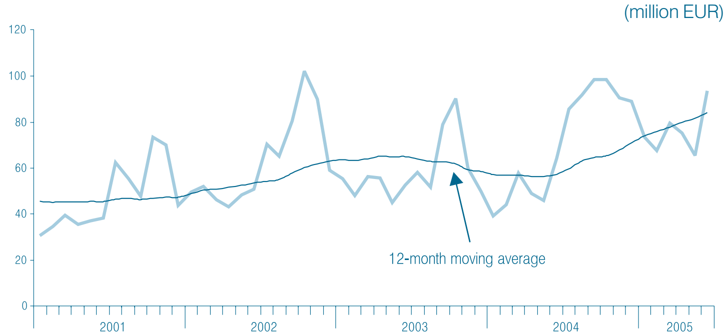
Exports of mineral products and fuels reached EUR 507 million over the first half of 2005, reflecting both high international prices and larger physical volumes. As compared with the corresponding period of the previous year, the average Brent oil price (in US dollars) rose by 47.2 per cent on international markets. The average price of exported oil products in euro grew by 31.2 per cent and their physical volume by 6.9 per cent. The expected retention of oil prices at the current high levels was among the major reasons behind projected highest growth in this commodity group for the third and the fourth quarters *vis-à-vis* the same period of 2004.

Exports of machines and vehicles between January and June 2005 rose by EUR 186 million on the corresponding period of 2004 to reach EUR 722 million. We expect growth lower than overall export average until the end of the year. Our projections are based on reported progressive growth over the second half of 2004 which set a high base and slighter relative changes.

Solely, exports of textiles, leather, clothing footwear and miscellaneous consumer goods remained almost unchanged in year-on-year value for the first six months (a slight rise of 0.2 per cent). Yet, in the second quarter of 2005 (following the 1 per cent drop in the first quarter) positive trends to outstripping the 2004 levels evolved in this group's exports. Available data show no significant competition effect of other countries' producers on this group's exports. The traditionally strong third quarter and projected slight acceleration of EU-25 growth in the fourth quarter give grounds to expect a minimum increase in exports of textiles,

Chart 63

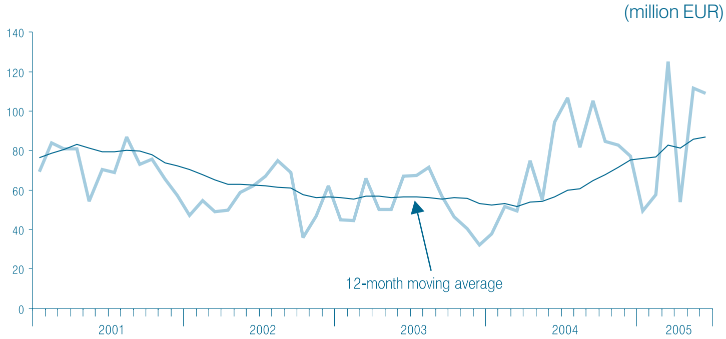
Exports of Animal and Plant Products, Food, Drink, Tobacco



Source: BNB.

Chart 64

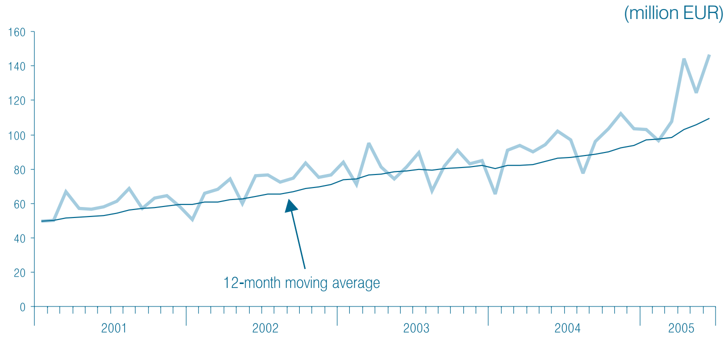
Exports of Mineral Products and Fuels



Source: BNB.

Chart 65

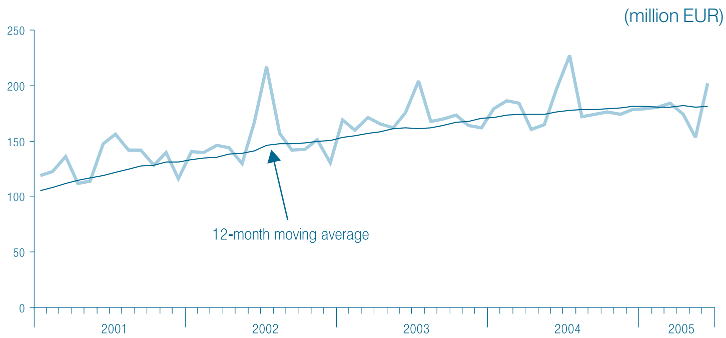
Exports of Machines, Vehicles, Appliances, Tools, Weapons



Source: BNB.

Chart 66

Exports of Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods



Source: BNB.

leather, clothing, footwear and miscellaneous consumer goods.

In the first half of 2005 imports (CIF) reached EUR 6588.7 million, a nominal rise of EUR 1258.9 million (23.6 per cent) on a year earlier basis. In the structure of imports by use, energy resources (37.8 per cent) and investment goods (34.6 per cent) posted the greatest growth, with the latter contributing mostly to import growth. Accelerated growth in volumes of imported energy resources resulted primarily from high international prices of crude oil and its products. The average price of the imported crude oil increased by 35.5 per cent over the reporting period (in euro on an annual basis), while the rise in physical volumes was 14.6 per cent. The year-on-year growth in imported petroleum products was 31.7 per cent. Nominal growth in this group is expected to be lower than in the previous four quarters. These projections are based on the expected dynamics of crude oil international prices and the high base attained in the previous two quarters which had a downward effect on the relative changes in 2005. In the second half of 2005 oil prices are expected to remain high or gradually fall from their current peaks. Nonetheless, import growth in this group is projected to exceed the overall import growth in the second half-year.

In the first quarter of 2005 investment goods imports posted the highest annual growth for the past five years: 38.4 per cent. The growth rate remained comparatively high in the first half of 2005, with a nominal year-on-year increase of 34.6 per cent. This corresponds to GDP data, with a 17 per cent nominal increase in gross fixed capital formation for the first quarter. Retaining comparatively high growth rates of investment goods imports over the second quarter of 2005 backed expectations of real growth in gross fixed capital formation over the same period.

This progressive growth in investment goods imports which started in the previous year is not sustainable in the medium term. Therefore, a gradual decrease in growth rates below the average import rates is expected in the third and fourth quarters of 2005.

Table 9

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

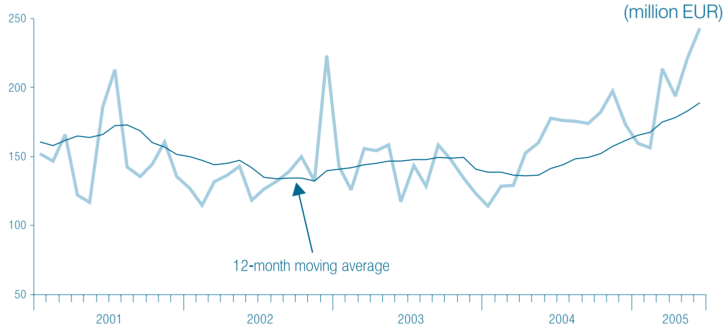
(percentage points)

	Exports		Imports	
	growth	contribution	growth	contribution
Consumer goods	3.1	1.1	16.3	2.6
Raw materials	26.6	11.3	13.6	5.6
Investment goods	35.6	5.0	34.6	8.8
Energy resources	42.5	3.7	37.8	6.1
Other			58.9	0.5

Source: BNB.

Chart 67

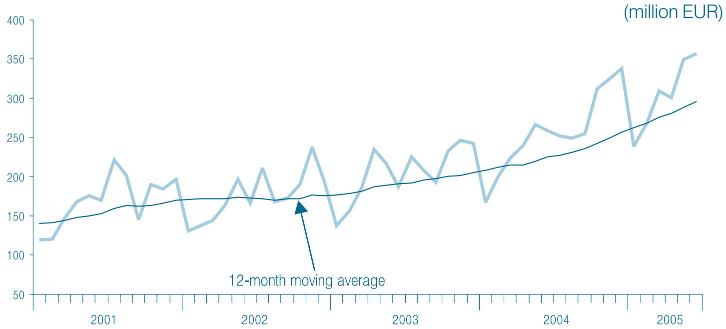
Imports of Energy Resources



Source: BNB.

Chart 68

Imports of Investment Goods



Source: BNB.

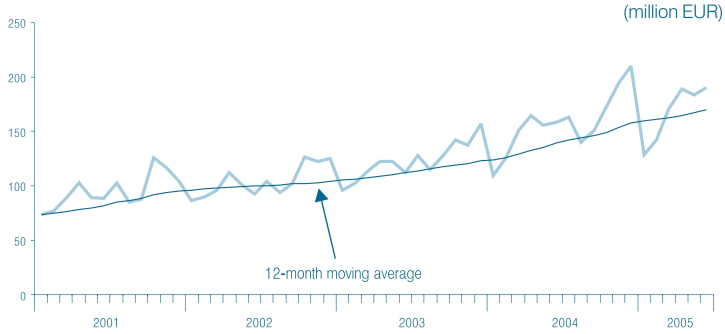
Projections of consumer goods import dynamics show a gradual year-on-year acceleration until the end of 2005. Following the comparatively low growth in this group for the first quarter (14.5 per cent on an annual basis), imports of consumer goods started accelerating, with the second-quarter nominal growth reaching 17.7 per cent on the corresponding period of 2004. We anticipate growth rates to stay a bit above the average import rates until the close of 2005. These rates, however, will be significantly lower than the quarterly changes registered in 2004.

Raw material imports had a dominant share in overall commodity imports, weighting some 40 per cent over different periods. After reporting the lowest annual growth among all groups by use for the first quarter of 2005 (8.9 per cent), year-on-year growth rates in volumes hastened to 17.9 per cent in the second quarter. Such dynamics is expected to match the 2004 rates in the third and fourth quarters. Forecasts of recovering growth rates of raw material imports are also based on favourable assessments of the economic situation and firms' positive expectations. They reflect a certain compensating effect from lower growth registered since early 2005. Nevertheless, year-on-year growth rates in this group will be a bit lower than overall import rates.

No sizeable changes in export and import geographic structures are expected by year-end. The high level of Bulgaria's integration with the EU-25 countries and improving relationships between the Balkan countries are evidenced by the large shares of these regions in Bulgaria's foreign trade. The EU member states occupied nearly 59 per cent of the nation's commodity exports for the first six months of 2005. Exports to the EU-10 countries comprised approximately 5 per cent of overall exports for the review period, rising by around 1 percentage point on 2004, which is likely due to greater domestic demand in the new member countries. Imports from the European Union came to 51 per cent of overall imports between January and June 2005, with no clearly pronounced trends to a change in the EU-10 share. The share of EU-25 is expected to stabilize at around 60 per cent by the year-end. As growth rates of imports from the EU hastened in recent months, a slight increase in the share of this region may be expected.

Chart 69

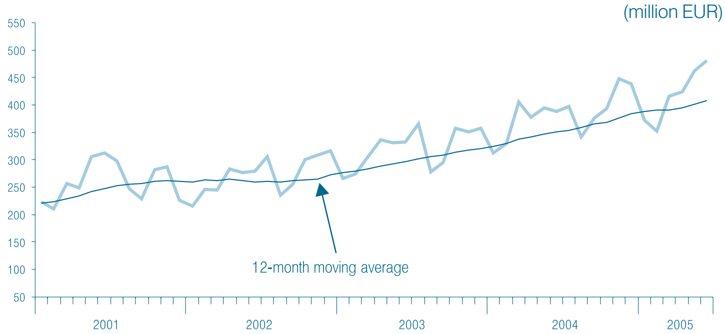
Imports of Consumer Goods



Source: BNB.

Chart 70

Imports of Raw Materials



Source: BNB.

Based on current expectations of export and import dynamics, projections put trade balance at 15.1 per cent of GDP for the third quarter of 2005 (on an annual basis) and at 15.5 per cent for the entire year.

In the first quarter of 2005 growth rates in imports of goods and non-factor services was higher than export growth rates in real terms (according to the System of National Accounts data). Higher real rates of export growth compared with import growth are expected by the end of the year, excluding the fourth quarter when a slight excess of imports by 0.5 percentage points is predicted. The highest growth in physical volumes of exports of goods and non-factor services is projected for the third quarter (nearly 17 per cent on an annual basis) after which rates are expected to dip in the fourth quarter (growth of about 9 per cent). Expectations about future dynamics rest on a good tourist season and increasing competitiveness of the Bulgarian industry.

As regards the imports of goods and non-factor services, the highest real growth is foreseen for the second quarter of 2005 (about 16 per cent) after which a gradual slowdown is possible over the third and fourth quarters (physical volume growth of around 9.5 per cent for the last quarter of 2005). The expected slowing growth at the close of the year is based on domestic demand dynamics, with projections of a gradual drop in GDP growth for the third and the fourth quarters of 2005. No significant effects of the EUR/USD exchange rate on foreign trade volumes is anticipated.

4. Inflation

During the first half of 2005 inflation reached 1.2 per cent on December 2004, a 1.04 percentage point increase on inflation accumulated during the same period of 2004. The greater portion of the increase reflected adjustments in prices of telephone and healthcare services, the greater-than-expected growth in unprocessed foods, and unfavourable international situation on crude oil markets. Hence, the relative change in consumer prices as of June stayed at 5 per cent on a year-on-year basis.

Adjustments in administratively set prices over 2005 were smaller, with their contribution since early 2005 falling by 1.2 percentage points on the corresponding period of 2004. Their smaller inflationary contribution was partially due to a change in the structure of administratively set prices after excluding the prices of fixed telephone services.[11] Although some of controlled prices (heating, healthcare) will further increase in the second half of the year, the overall contribution of this group to inflation will reach 0.75 percentage points if no additional unplanned adjustments are made.

Overall inflation behaviour was mostly driven by prices of goods and services whose annual growth of 4.1 per cent by end-June (excluding controlled prices) was stimulated by enhanced domestic demand. Core inflation[12] reflected strong fluctuations in food and fuel prices. In June food price indices rose to 3.2 per cent on an annual basis due primarily to the high annual growth in unprocessed foods of 15 per cent by end-June. Given their seasonality, fruit and vegetable prices are expected to fall over the second half of the year, thus offsetting price hikes at the start of 2005. Poor harvest prospects reveal a possible price rises in other major foods (bread) which may add significantly to overall CPI growth.

[11] Following the Bulgarian Telecommunication Company privatization finalized by end-2004, prices of fixed telephone services were excluded from the controlled-price group in the beginning of 2005.

[12] Defined as a relative change in uncontrolled prices of the consumer basket.

Higher-than-expected inflation was reported in the first half of 2005. Given this fact and the significant fluctuations in major proinflationary factors, inflation forecasts at the end of the third quarter move within a wide band of 1.8 to 2.8 pert cent.

Uncertainty in inflation estimates increased significantly after the summer floods which hit Bulgaria causing severe damages to agriculture, transport and other economic sectors. Presently, the BNB staff projections put inflation at 3.5 per cent by end-2005. However, given the insufficient information, it is possible risks of surpassing this level to increase.

Table 10

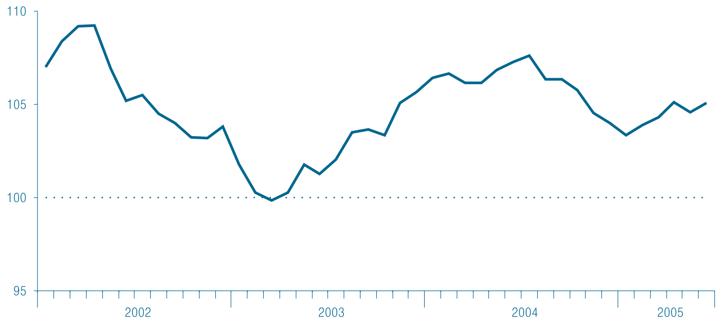
Inflation Accumulated since Year's Start

	2004	2005
	January – June	
Inflation	0.17	1.21
Contribution		
Foods	-1.51	-0.64
Non-foods	0.99	0.86
Fuels	0.11	0.59
Catering	0.08	0.16
Services	0.73	0.86
Goods and services with administratively set prices	1.75	0.84
Controlled-price goods	1.16	0.38
Tobacco	1.19	0.21
Controlled-price services	0.59	0.46
Electricity and heating	0.07	0.09

Source: NSI.

Chart 71

CPI (on an Annual Basis)



Source: NSI.

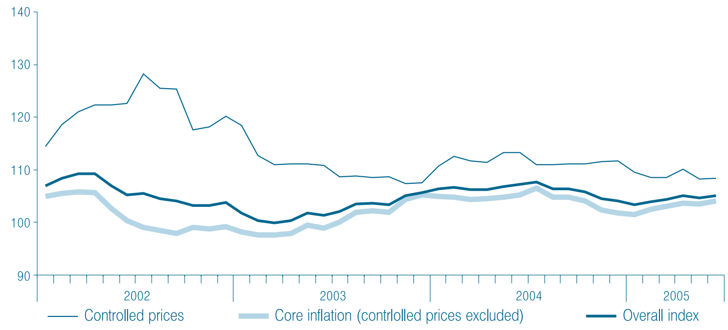
Fuels were another factor responsible for the high inflation since early 2005. Their dynamics reflected directly the crude oil price on international markets which reached USD 60 *per* barrel. This factor, in tandem with the rising US dollar above USD 1.20 *per* EUR 1, resulted in a fuel price increase of 21 per cent on an annual basis. The 11 per cent annual increase in transportation prices was partially due to the secondary effect of fuel price hikes and changed road taxes and fees (a fourfold increase in road tax and a 45 per cent rise in civil liability insurance since early 2005). If the average crude oil price hovers around USD 50 *per* barrel, despite attained high levels, and the US dollar appreciates for a short time, the overall effect on consumer inflation will account for 0.65 percentage points.

Despite the stable domestic demand for non-foods, their annual price rise is expected to remain slightly negative (-0.5 per cent) due to the low international prices and comparatively cheap US dollar. The effective restrictions on banks' credit expansion are likely to push down inflationary pressures on real estate prices which posted a 143.8 per cent annual growth in the second quarter. Compared with the first quarter when the growth rate was 154.9 per cent, this was an absolute drop of 7 per cent. Hence, prices of household goods and services were sustained which contributed to sustaining household willingness to invest in durables. Services prices (excluding controlled ones) are expected to retain their annual growth rate at about 7 per cent which is ascribable to moderate growth rates of disposable income and increased demand for services related to leisure.

As a result of the large short-term instability of the factors driving inflation, the expected inflation by the end of the third quarter will move into a wide range of between 1.8 to 2.8 per cent. Based on current data, July prices will contribute mostly to inflation. Besides the seasonal behaviour of particular goods and services, heating (0.25 percentage points), fuels (0.1 percentage points), and bread (0.2 percentage points) will further add to overall inflation. Although the fourth quarter is also characterized by a positive contribution to the accumulated inflation, this contribution may be weaker than in previous years provided risks of poor harvest, further oil price spikes and US dollar rises are neutralized.

Chart 72

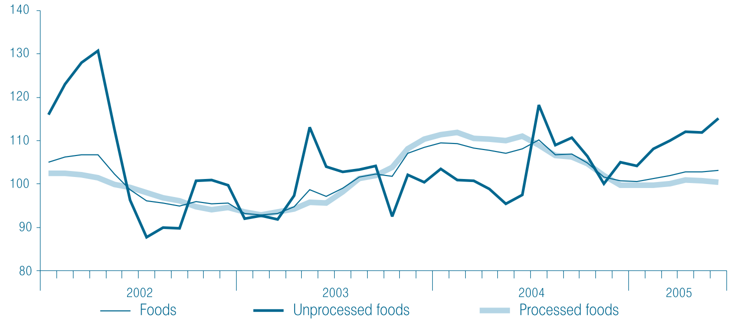
Price Indices (on an Annual Basis)



Source: NSI, BNB.

Chart 73

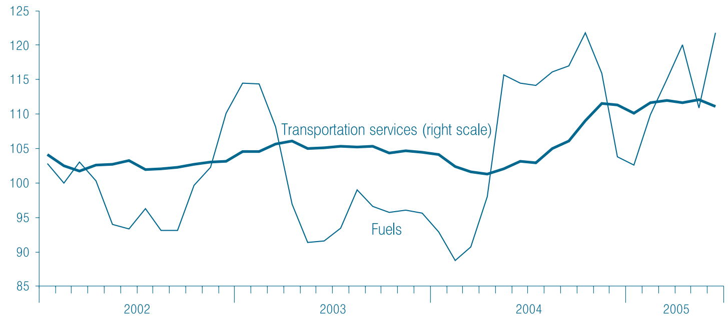
Price Indices (on an Annual Basis)



Source: NSI, BNB.

Chart 74

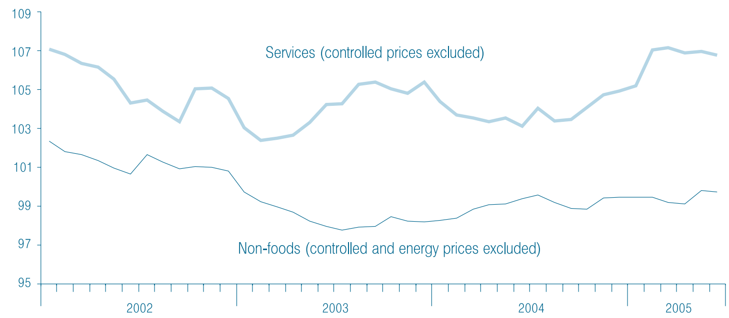
Price Indices (on an Annual Basis)



Source: NSI, BNB.

Chart 75

Price Indices (on an Annual Basis)



Source: NSI, BNB.

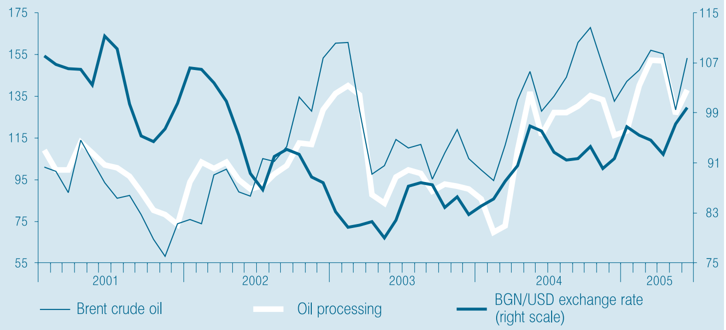
Crude Oil Price Effect on Inflation

In Bulgaria, crude oil prices directly affect inflation through fuel prices, and indirectly through transportation services prices and producer prices. The effect of the oil international price on inflation may increase or decrease depending on the EUR/USD exchange rate fluctuations. This analysis is based on econometric study of the link between annual changes in the crude oil price and the exchange rate, on the one hand, and the producer price index and consumer inflation, on the other hand. Monthly data for the 2001 to 2004 period are used in the analysis.

Crude oil price effect on inflation in Bulgaria may be estimated by analyzing the effects of chain price indices starting from wholesale producer prices of refined oil products. Based on econometric assessments, in oil processing 40 per cent of the annual change in production costs could be explained by fluctuations in crude oil prices in USD, while nearly 30 per cent by the EUR/USD rate movements. Since these variables have independent dynamics, their combination has a significant influence on oil price fluctuations on the domestic market. Econometric assessments put the effect of Brent crude oil price in levs on oil products wholesale prices at a coefficient of 0.6. Limiting the effect only on prices, certain inertia in oil product prices is estimated, which may pertain both to overstocking of oil and the specificity of pricing. This indicates that the price of processed oil products in Bulgaria will rise by 30 per cent if the crude oil price in levs increases by 50 per cent. In case attained crude oil prices in levs are sustained for a longer period and economic agents accept them as long-term (or balanced), price increases in processed oil products could be higher.

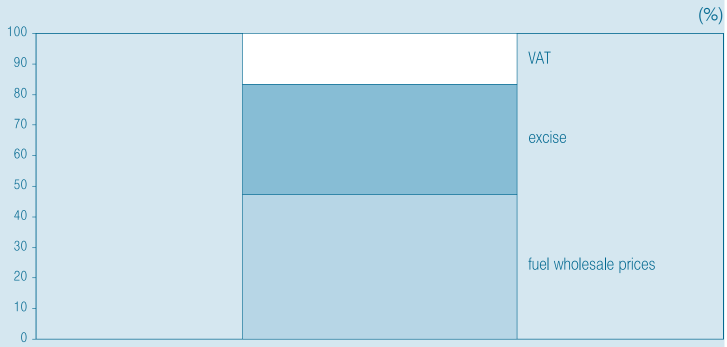
Prices of processed oil products directly affect the overall producer price index, since their weight in calculating PPI is 11.7 per cent. Thus, a hypothetical rise in this sector's prices by 30 per cent (according to our consumptions) will cause a 3.5 percentage point increase in overall producer price index. The secondary effect on producer prices is insignificant: just 0.05 per cent of the change in the crude oil price in levs is transferred on the overall index of industry excluding oil processing industry, or a 0.04 percentage point contribution to producer price inflation. A change in oil international prices by 50 per cent and exchange rate fluctuations may lead to a 3.54 percentage point rise in producer price inflation.

Chart 76
Annual Change (Indices)



Source: NSI, BNB, World Bank.

Chart 77
Structure of Fuel Prices



Source: Lukoil, Bulgaria.

Besides the domestic wholesale price, indirect taxes (the fuel excise) affect directly end-use prices of transportation fuels. The fuel excise tax forms nearly 35 per cent (BGN 495 for 2005) of the consumer price, together with VAT comprising 55 per cent of the end price. Indirect taxes distort the link between fuel wholesale and retail prices. In recent years, the fuel excise was changed and further changes are in progress in order to achieve the minimum levels in the European Community. Indirect taxes and other permanent expenses (i.e. distribution expenses) comprise a significant share of the permanent expenses (70 per cent) in fuel retail prices. Therefore, the fuel retail price changes insignificantly in response to short-term international price or exchange rate fluctuations, with oil international prices affecting end fuel prices not so strongly but for a longer period than exchange rate fluctuations. If another assumption is made, a change in wholesale fuel prices by 30 per cent will cause a 9 per cent growth in retail fuel prices, with a 0.3 percentage point contribution to overall consumer price inflation.

The secondary effect on consumer prices based on the crude oil price effect on domestic transportation services is comparatively weak. The link between transportation services prices and wholesale oil price movements reflects some other indirect effects, such as road insurance and taxes changed administratively and included in the services price. In Bulgaria, the secondary effect of the hypothetical wholesale fuel price increase by 30 per cent amounts to 0.03 percentage points.

Therewith, the overall effect of international fuel price fluctuations by 50 per cent will be a 0.33 percentage point change in inflation.