

Economic Review

November 2005



BULGARIAN
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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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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

World economic growth started to pick up gradually. These processes, coupled with the improving Bulgarian tradable sector competitiveness, are expected to prompt a 20 to 23 per cent increase in the nominal exports of goods in euro in the fourth quarter of 2005 and a 17 to 20 per cent rise in the first quarter of 2006. Imports will stay high since the favourable economic conditions in Bulgaria attract capital in the form of foreign direct investment and loans which contribute to a sustainable high domestic demand for investment goods and raw materials.

The current account deficit in the last quarter of 2005 and first quarter of 2006 is projected at 13.5 to 14 per cent of GDP on an annual basis. The financial account surplus formed by the large foreign direct investment inflows followed in amount by loans extended to the private sector will cover this deficit allowing for an increase in the central bank's international reserves. As a result of financial inflows from abroad, by end-September 2005 the Issue Department balance sheet figure came to EUR 7298.8 million, up by EUR 1080 million on September 2004 despite government expenditure on external debt buybacks amounting to approximately EUR 2 billion. The upward trend in Bulgarian international reserves will sustain in the next two quarters. Debt of private corporations will continue to rise and its ratio to GDP is expected to reach some 38.5 to 40 per cent by the end of the first quarter of 2006, while public and publicly guaranteed debt will fall below 25 per cent of GDP over the same period.

The steady foreign currency inflow into Bulgaria maintained a relatively high and sustainable growth rate of currency in circulation (about 20 per cent on an annual basis). A slight slowdown (up to 23–25 per cent) in broad money is expected in the fourth quarter of 2005, while in the first quarter of 2006 the M3 percentage increase will be considerably lower: about 10–12 per cent (due to the high March 2005 base). Interest rates on deposits are expected to remain stable.

Provided the restrictions on credit expansion are observed, growth rates of claims on the non-government sector will slow down to some 30 per cent by the year-end, while the annual growth rate will be about 5–7 per cent by the end of the first quarter of 2006 owing to the base effect of the dramatic increase in loans at end-March 2005. If the effect of the March 2005 high base were disregarded, the annual growth rate of loans to the non-government sector is anticipated at about 25 per cent by the end of the first quarter of 2006 (23 per cent on average for the period) in compliance with the restrictions under Ordinance No. 21.

We expect economic growth of some 6 per cent on an annual basis in the fourth quarter of 2005 and an accelerated increase of up to 6.5 per cent in the first quarter of 2006. Fixed capital investment went up at high rates: by some 17 per cent in the fourth quarter of 2005 and by 14 per cent in the first quarter of 2006.

Household consumption growth rates in the fourth quarter of 2005 and first quarter of 2006 are projected at over 6 per cent. Household consumption will preserve its greatest contribution to GDP growth in the future. Improved financial state of households led to an increase in their savings in the form of banking system deposits. Households' access to bank loans is facilitated. Hence, the *banking system consumer loans to household consumption* ratio came to some 16 per cent. Concurrently, the rise in households' deposits and cash in the second and third quarters exceeded considerably their liabilities in the form of bank loans, and households remained net creditors to economy.

Inflationary expectations accumulated in anticipation of agricultural produce supply shortage due to damages caused by floods and declared intentions of electricity and heating price rises and rises in excise duties, as well as fluctuations in international fuel prices posed risks of increased inflation to 5.4–6.5 per cent by year-end and to some 8.2–8.4 per cent on an annual basis by the close of the first quarter of 2006. In compliance with commitments assumed in negotiations on Chapter 10, *Tax Policy*, Bulgaria follows a schedule of harmonizing excise rates with a view to reaching EU minimum ones: in 2006 cigarette prices will grow by some 65 per cent and prices of alcoholic drinks by 17 per cent. Rises in petrol and gas oil excise duties will push up the prices of these fuels by 4.6 per cent and 4.9 per cent respectively. The overall effect of harmonizing excise rates is estimated at 2.5 percentage point contribution to overall inflation, with the bulk of this inflation evolving in the first quarter of 2006.

1. External Environment

World economic rates started to pick up gradually. Inflation slowed down following its acceleration in September. The ECB increased the repo interest rate in early December by 25 basis points. Market expectations are for US federal funds interest rates to rise in December and January to 4.5 per cent. The anticipated widening of the interest rate differential between the USA and the euro area will prompt the US dollar appreciation.

Current Business Situation

Economic indicators for industry reported a global recovery of this sector, thus supporting the expectations of a gradual increase in world economic growth rates. Accelerating trade growth rates in the third quarter of 2005 also were a driving factor. Major projection risks arise from the possible effect of high fuel prices and global uncertainty about avian flu spread.

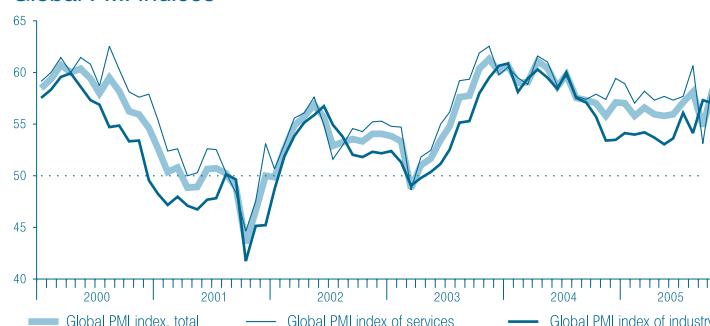
By end-August and early September crude oil appreciated dramatically. This brought about inflation rises in most developed countries. Nevertheless, no secondary effects have been observed.

The USA

Preliminary assessments of US GDP for the third quarter show a 3.7 per cent growth on an annual basis. Private consumption of durable goods (purchases of automobiles in particular) contributed most about this. Falls in inventories continued in the third quarter and had a negative effect on growth. Investment in housing property started to decrease due to high housing prices and gradually rising interest rates on mortgage loans (following the minimum reached in June 2005).

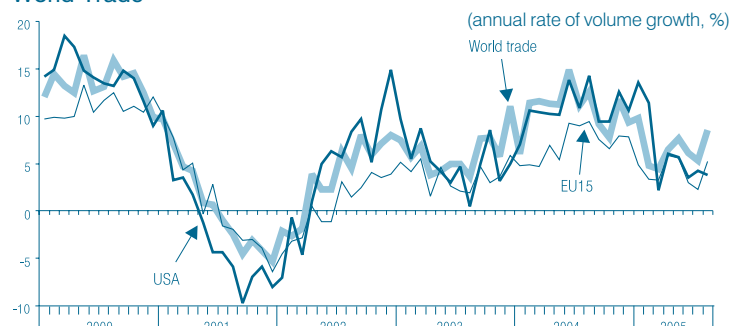
Market expectations foresee a gradual slowdown in economic activity in the fourth quarter of 2005 and first quarter of 2006 to levels close to the potential ones. This reflects projections for weaker consumer expenditure growth stemming from higher energy prices in winter months and a possible low contribution of durable goods purchases. Rising federal funds interest rates are expected to impact adversely consumption and investment. Inventories are expected to recover gradually.

Chart 1
Global PMI Indices



Source: NTC Research, JP Morgan.

Chart 2
World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 3
Contribution to US Growth by Component



Source: Bureau of Economic Analysis.

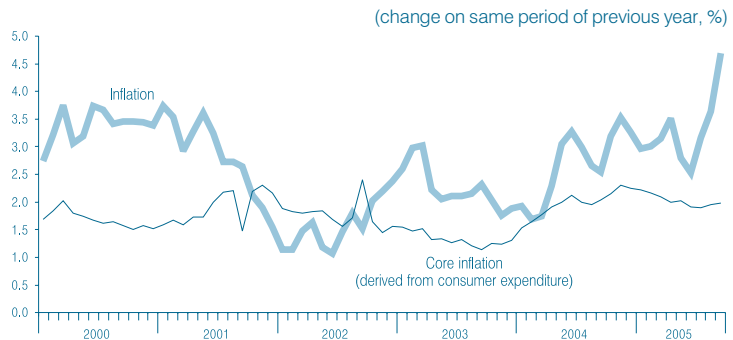
In the third quarter US inflation increased considerably as a result of higher energy prices and strong domestic demand. In September the consumer price index went up by 4.7 per cent on an annual basis, while June saw a 2.5 per cent inflation. Producer prices also rose dramatically in August and September. Core inflation over the same period was relatively stable at levels of some 2 per cent on an annual basis which indicates that higher production costs have not been transferred to end-use consumers yet.

Forecasts for the fourth quarter of 2005 and first quarter of 2006 are for falling inflation under the influence of stabilizing petrol prices and weaker consumer demand. Imported goods and the appreciating US dollar are likely to exert an additional pressure on US consumer prices. Risks of inflation are related to possible secondary effects of raw material price rises and higher labour costs in the third quarter of 2005.

Steady economic growth in the third quarter and stronger inflationary expectations after the devastating calamities were arguments in favour of the higher Federal Reserve interest rates. At the two meetings of the Federal Open Market Committee held until the end of November, federal funds interest rates were raised in two steps to 4 per cent.

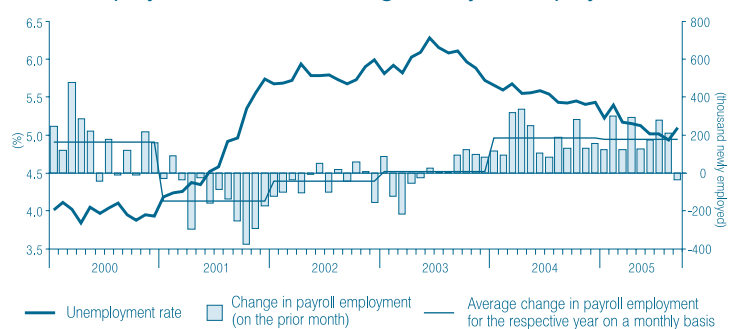
Market expectations for December and the first quarter of 2006 incorporated into financial instrument prices foresee two additional rises in the reference interest rate to 4.5 per cent. Forecasts of policy after end-January when the term of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, will expire are cautious. However, according to most market analysts, approximation of the reference interest rate to the neutral level will lead to retention of the reached level over a period of several months.

Chart 4
US Inflation Rate



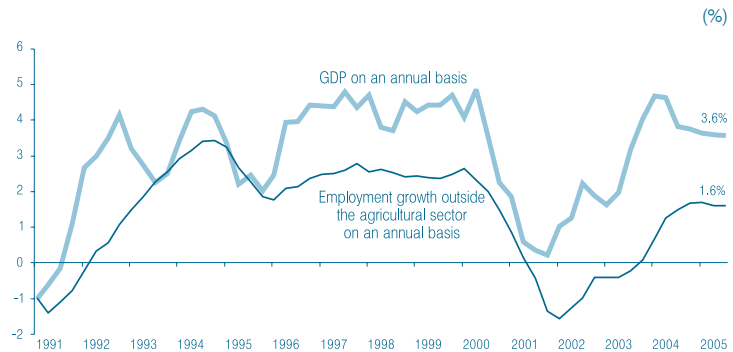
Note: The US core inflation is measured by personal consumption expenditures index excluding energy and food expenditures.

Chart 5
US Unemployment Rate and Change in Payroll Employment



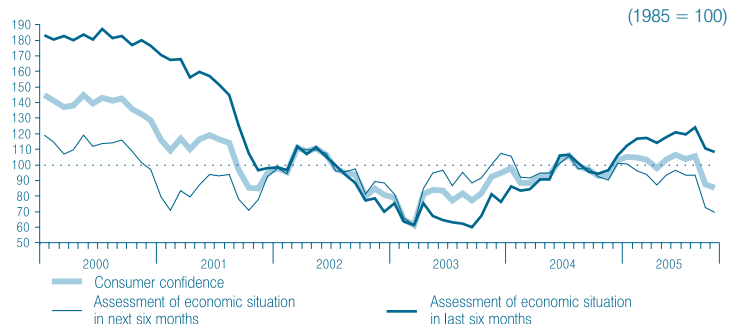
Source: Bureau of Labor Statistics.

Chart 6
US Growth and Labour Market



Source: Bloomberg.

Chart 7
US Consumer Confidence Indicators



Source: The Conference Board.

In the last few months the spread between the interest rate on six-month LIBOR deposits in US dollars and that on federal funds was steady within the range of 30 to 70 basis points. Provided the policy of rising interest rates is discontinued by the end of the first quarter of 2006, the spread will decrease. Based on this projection and current market expectations, the interest rate on six-month LIBOR deposits in US dollars will move between 4.75 and 5 per cent in the first quarter of 2006, and these levels will be sustained until mid-2006.

Chart 8
US PMIs and Growth

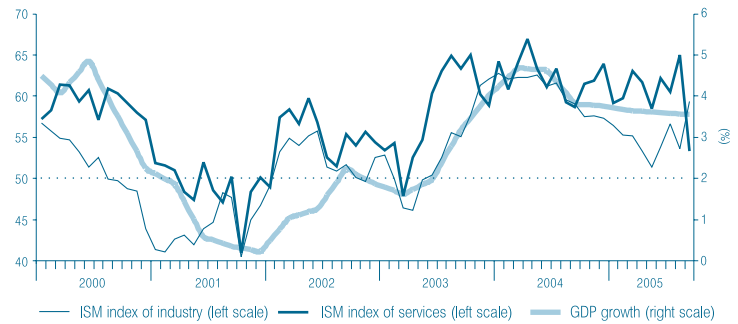


Chart 9
US Federal Funds Rate and Six-month LIBOR in US Dollars

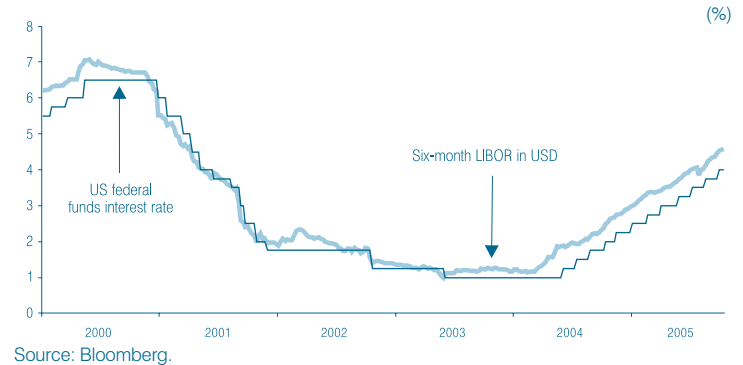
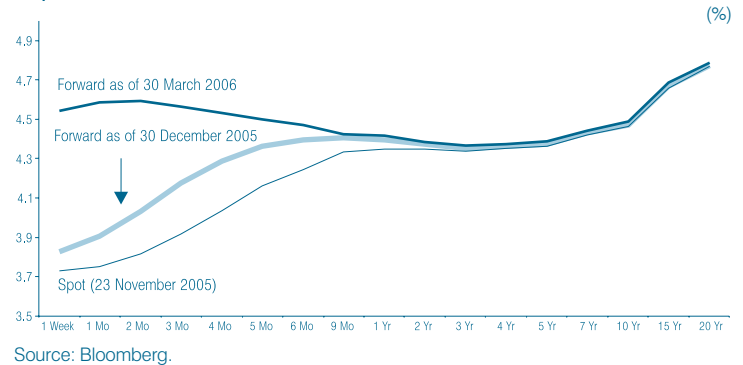


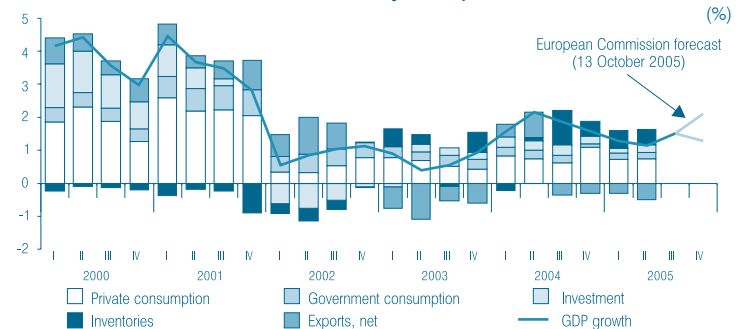
Chart 10
Expected US Yield Curve



Euro Area

Euro area economic activity posted a moderate growth in the third quarter of 2005, with GDP increasing to 1.5 per cent (1.1 per cent in the second quarter). Relatively high growth rates were reported by the largest euro area economies: France (1.8 per cent) and Germany (1.4 per cent). Increasing GDP growth in France resulted from enhanced consumption in the third quarter stemming from government measures to increase short-term employment, while strong export growth and brisk invest-

Chart 11
Contribution to Euro Area Growth by Component



ment activity were the drivers of economic growth in Germany. By the close of 2005 and the start of 2006 we expect European economy to develop at moderate rates affected positively by rising exports and a moderate increase in consumer and investment activity.

In September 2005 the ECB cut the 2005 euro area projected GDP growth interval to 1–1.6 per cent on an annual basis (June 2005 projection: 1.1–1.7 per cent) owing to the lower than expected EU and euro area growth rates in the first half of 2005. The European Commission also revised its 2005 projected growth to 1.3 per cent on an annual basis (April 2005 projection: 1.6 per cent).

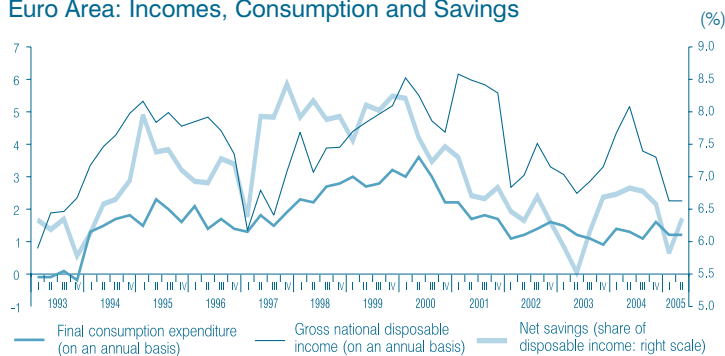
High inflation was reported in September 2005 both in the USA and in the euro area as a result of rising crude oil prices. Nevertheless, no significant effect of high energy prices on core inflation was observed, and in September it ran at 1.3 per cent on an annual basis against the 2.6 per cent overall inflation. The reversed oil price upward trend and the subsequent gradual decline in October and November contributed to the fall of inflation to 2.4 per cent by end-November. Crude oil price stabilization gave rise to expectations that the price pressure will continue to subside in the next few months.

The prospects of moderately rising consumer activity and companies' limited opportunities to transfer their larger feedstock expenditure to end-use selling prices backed expectations of moderate inflation. Putative high inflationary expectations related to another oil price rise which might give rise to secondary effects would pose a risk to price stability.

A trend to improving euro area labour market showed in the third quarter, with unemployment coming to 8.4 per cent. Enterprises' optimism about employment expressed in PMI indices of industry and services rose, thus predetermining favourable prospects for euro area labour market until the end of 2005.

Chart 12

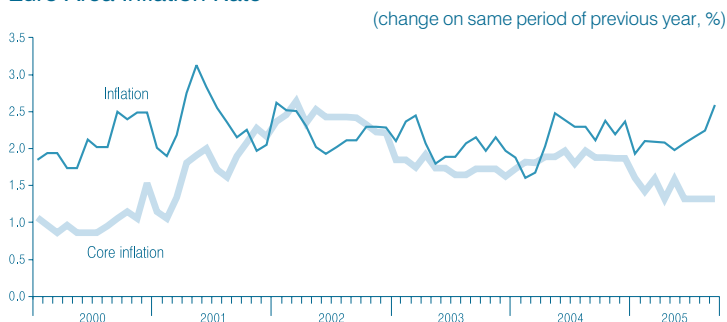
Euro Area: Incomes, Consumption and Savings



Source: Eurostat.

Chart 13

Euro Area Inflation Rate

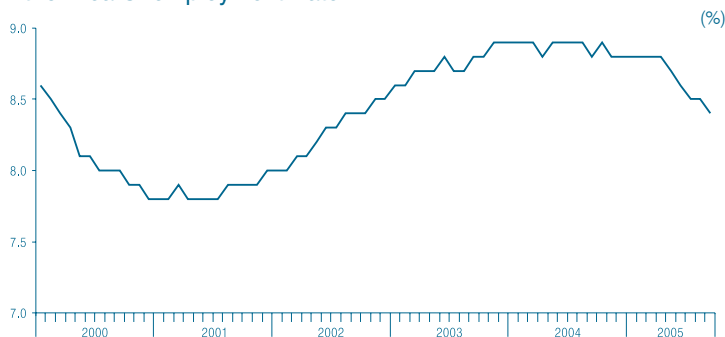


Source: Eurostat, ECB.

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

Chart 14

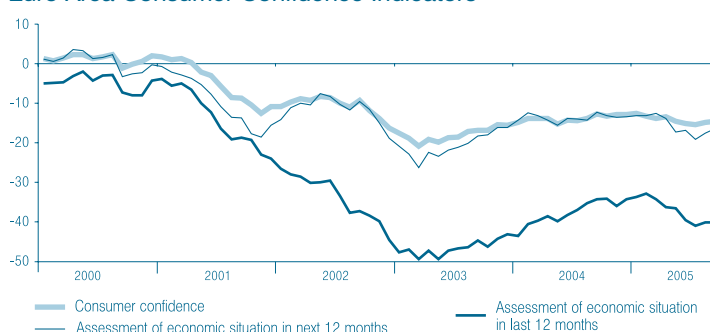
Euro Area Unemployment Rate



Source: Eurostat.

Chart 15

Euro Area Consumer Confidence Indicators



Source: Eurostat.

The trend to gradually improving business confidence leading indicators sustained in the third quarter. Indicators of economic activity in the sectors of services and industry also picked up. The sustainability of this trend supported expectations of euro area economic activity moderate dynamics until the end of 2005.

The ECB did not change its monetary policy until the close of the third quarter. Favourable macroeconomic information about the European economy in the last few months revised market expectations considerably. The probability of an imminent increase in ECB interest rates is growing. As a result, the spread between the repo interest rate and the yield of six-month LIBOR on euro deposits rose to some 50 basis points by mid-November.

At the start of December, in response to the growing risks to price stability, the ECB raised the repo interest rate by 25 basis points. According to a statement of the ECB President, the Bank has no plans for a series of increases. He pointed out that the Bank's next steps would be determined by the development of the economy. Prospects for the future monetary policy based on market expectations indicate a further increase in interest rates by another 25 basis points until the end of the first half of 2006.

Chart 16
Euro Area PMIs and Growth

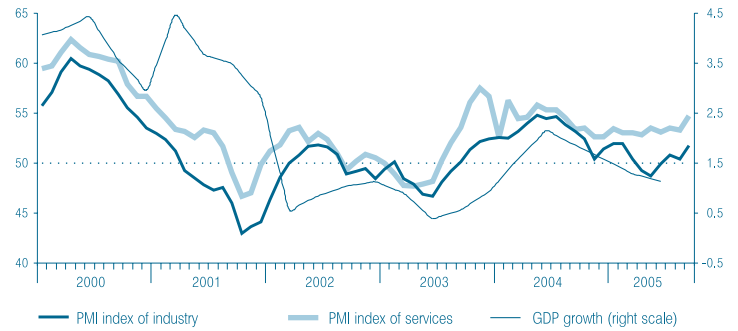


Chart 17
Euro Area Base Interest Rates

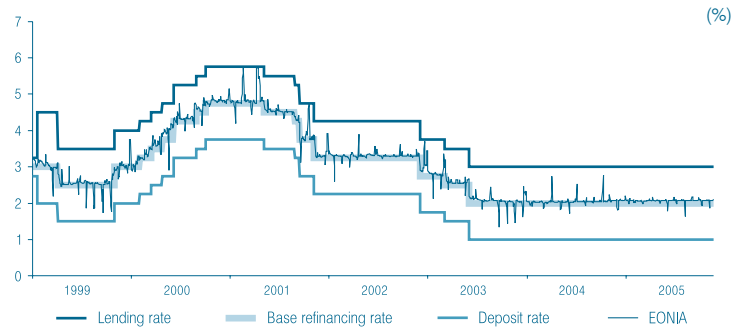


Chart 18
BIR on Refinancing Operations and Six-month EURIBOR

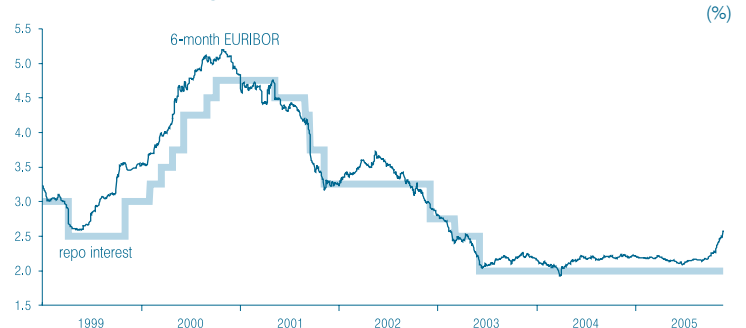
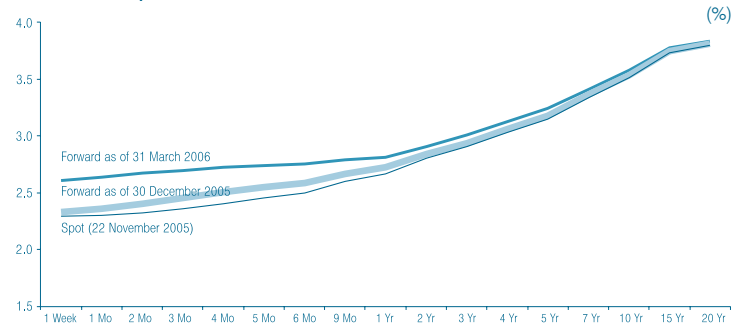


Chart 19
Curve of Expected Euro Area Yield



Autumn Forecast of the IMF and the European Commission

The new IMF¹ and EC² forecasts were released in the autumn. The high growth in 2004 is expected to be followed by a two-year period of stabilizing growth rate at 4.3 per cent. The main factors affecting this will continue to be the low interest rates, the impact of the higher real estates prices, as well as the steady growth of China, India and almost all of petroleum exporting countries.

The expectations of growth in the euro area in 2005 and 2006 are revised downward due to the low growth rates maintained during the first half of 2005, the delay of the world growth rate and the high price of crude oil. In 2006 the growth rate of the USA is expected to remain close to potential and will be the highest one amongst the G-7 countries.

The risks affecting the economic growth until the end of 2005 and in 2006 are connected with the unstable crude oil prices regardless of the fact that presently they have not caused significant variation in the growth and inflation rates. The emerging protectionism in the USA and EU following the removal of textile import quotas could significantly impede the growth of the developing countries; there exists a risk associated with a shift in moods on the financial markets, if the inflationary expectations take a pessimistic turn.

¹ IMF, *World Economic Outlook*, September 2005.

² European Commission, *Economic Forecasts – Autumn 2005*, November 2005.

Table 1

Major Trends in EC and IMF Autumn Forecasts

(real percentage change)

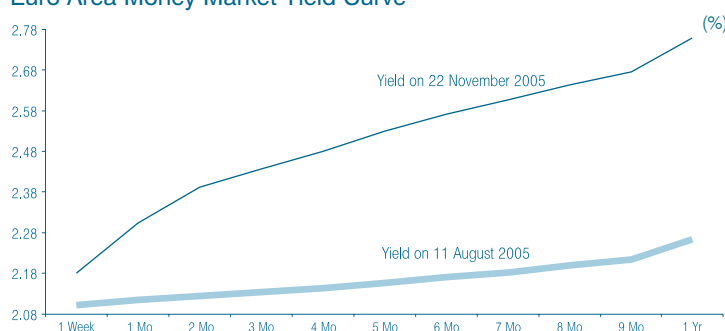
			Autumn forecast, 2005		Change on spring forecast, 2005	
	2003	2004	2005	2006	2005	2006
EC						
EU						
GDP growth	1.2	2.4	1.5	2.1	-0.5	-0.2
Euro area						
GDP growth	0.7	2.1	1.3	1.9	-0.3	-0.2
Unemployment	8.7	8.9	8.6	8.4	-0.2	-0.1
Inflation	2.1	2.1	2.3	2.2	0.4	0.7
USA						
GDP growth	2.7	4.2	3.5	3.2	-0.1	0.2
Unemployment	6.0	5.5	5.1	5.0	-0.1	0.0
Inflation	2.3	2.7	3.3	2.9	0.7	0.6
Japan	1.4	2.7	2.5	2.2	1.4	0.5
Latin America	1.9	5.5	4.0	3.6	0.1	0.0
Asia (Japan excluded)	7.5	7.8	7.2	7.2	0.1	0.1
Africa	3.0	4.3	5.0	6.0	-0.7	-0.1
World growth	3.8	5.2	4.3	4.3	0.1	0.2
IMF						
EU						
GDP growth	1.3	2.5	1.6	2.1	-0.4	-0.4
Euro area						
GDP growth	0.7	2.0	1.2	1.8	-0.4	-0.5
Unemployment	8.7	8.9	8.7	8.4	0.0	0.0
Inflation	2.1	2.1	2.1	1.8	0.2	0.1
USA						
GDP growth	2.7	4.2	3.5	3.3	-0.2	-0.3
Unemployment	6.0	5.5	5.2	5.2	-0.1	-0.2
Inflation	2.3	2.7	3.1	2.8	0.4	0.4
Japan	1.4	2.7	2.0	2.0	1.2	0.1
Advanced economies	1.9	3.3	2.5	2.7	-0.1	-0.3
Western Hemisphere	2.2	5.6	4.1	3.8	0.0	0.1
Asia	8.1	8.2	7.3	6.9	-0.1	-0.2
Africa	4.6	5.3	4.5	5.9	-0.5	0.5
World growth	4.0	5.1	4.3	4.3	0.0	-0.1

Source: EC and IMF.

Based on market expectations, by the end of the first quarter of 2006 the six-month LIBOR on deposits in euro will move within the range of 2.45 to 2.95 per cent.

Chart 20

Euro Area Money Market Yield Curve



Source: Bloomberg.

EU-25

In the second quarter of 2005 the EU posted a 1.3 per cent growth on an annual basis (1.5 per cent for the first quarter of 2005). The average growth rates of the new member states slowed down to 3.3 per cent (3.9 per cent in the first quarter of 2005) owing solely to the low rates reported by Poland (1 per cent according to preliminary data). In the remaining newly acceded countries growth rates accelerated compared with the first quarter of 2005, with Estonia, Lithuania and Latvia sustaining their growth of 9.9 per cent, 8.4 per cent and 11.6 per cent respectively.

Inflation in the newly acceded countries continued to go down and in the third quarter of 2005 it amounted to an average of 2.2 per cent (an average of 2.5 per cent in the prior quarter). In September inflation rates went up to 2.4 per cent reflecting fuel price rises.

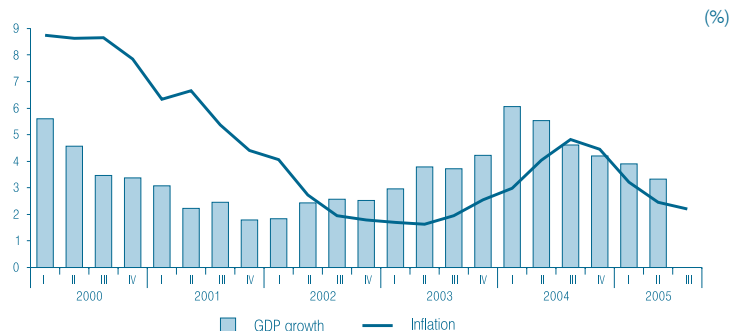
The USD/EUR Rate

Between August and November the movement of the USD/EUR was in the margin of USD 1.16 to USD 1.26. Conforming to the market expectations, the USD was backed up by the broadening interest rate differential and the USA benefiting from it. At times, the fears of worsening trade and fiscal deficits of the USA and the speculations for diversification of central banks currency reserves exerted pressure on the US dollar.

Sizable fluctuations are expected during the next two quarters on the currency markets. One of the factors causing this are the expectations of a possible discontinuation of the policy of rising interest rates on US federal funds. Another factor is the noticeable uncertainty about ECB monetary policy. This sets a wide range for the expected exchange rate, varying from USD 1.14 to USD 1.25. By the end of 2005 the USD will probably appreciate under the influence of the widening interest rate differential and the favourable macroeconomic results of the USA. An alternative development could be achieved if the ECB increases the repo rate over the currently implemented market expectations. In the medium run market assessments suggest appreciation of the euro against the US dollar.

Chart 21

GDP Growth and Inflation in the New EU Member States



Source: Eurostat, BNB.

Chart 22

USD/EUR Exchange Rate



Source: Bloomberg.

The Balkan Region

Over the second quarter of 2005 Balkan countries continued reporting comparatively high growth reflecting the stable private consumption and favourable industrial development. By the end of the third quarter inflation picked up as a result of high fuel prices. However, price growth slowed down, especially in high inflation countries: Turkey and Romania.

In the following two quarters growth in the region is expected to stabilize at levels close to the current ones, with the economic activity supported by expectations of enhanced external demand.

Table 2
Real Growth and Inflation in Balkan Countries

	2003	2004					2005		
	Total	I quarter	II quarter	III quarter	IV quarter	Total	I quarter	II quarter	III quarter
Growth (on an annual basis)									
Bulgaria	4.5	4.5	5.5	5.8	6.2	5.6	6.0	6.4	-
Greece	4.7	4.3	4.1	4.0	4.2	4.2	3.5	3.7	3.7
Macedonia	2.8	2.4	3.7	3.4	2.1	2.9	2.7	4.7	-
Romania	4.9	6.1	7.1	11.1	8.9	8.3	5.9	3.9	-
Turkey	5.8	11.8	14.4	5.3	6.3	8.9	4.8	4.2	-
Croatia	4.3	4.2	3.8	3.6	3.6	3.8	1.8	5.1	-
Inflation (as of end of period)									
Bulgaria	5.6	6.2	7.3	6.3	4.0	4.0	4.3	5.1	5.4
Greece	3.1	2.9	3.0	2.9	3.1	3.1	2.9	3.2	3.8
Macedonia	2.6	1.4	-0.2	-1.8	-1.9	-1.9	0.2	1.4	1.1
Romania	14.1	13.1	12.0	11.1	9.3	9.3	8.7	9.7	8.5
Turkey	18.4	11.8	8.9	9.0	9.3	9.3	7.9	9.0	8.0
Croatia	1.7	1.4	2.5	1.5	2.7	2.7	4.0	2.8	3.8

Source: Statistical institutes and central banks of respective countries.

International Prices of Major Raw Materials, Crude Oil and Gold

Crude Oil

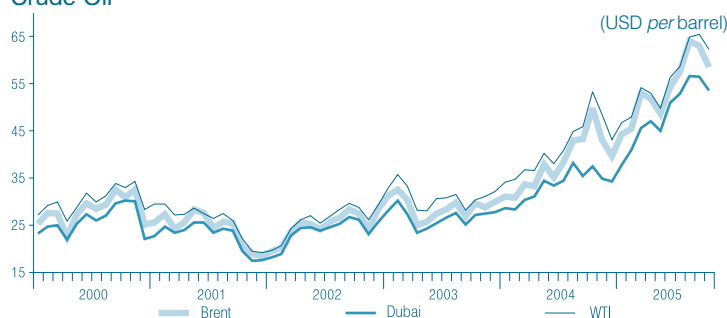
The price of crude oil reached high levels in the middle of the third quarter, and on 30 August Brent price reached its high of USD 68.80 *per barrel*. The average daily price in August was USD 64.10 *per barrel*, while the third quarter average daily price was USD 61.6 *per barrel* (up USD 10 *per barrel* on the previous quarter).

The main factors causing price increases were the Katrina and Rita hurricanes, which caused serious damages to the oil rigs in the Gulf of Mexico and the sea-port terminals on the US coastline. The unfavourable weather conditions extended the time needed for production recovery and caused further loss of production resources.³ Regardless of the difficulties, the increase in prices was quickly tackled by coordinated actions between IEA and OPEC.⁴ Additional 2.1 million barrels *per day*

³ Oil production in the Gulf of Mexico is estimated at 1.6 million barrels: 25 per cent of total US oil production (12 per cent a decade earlier).

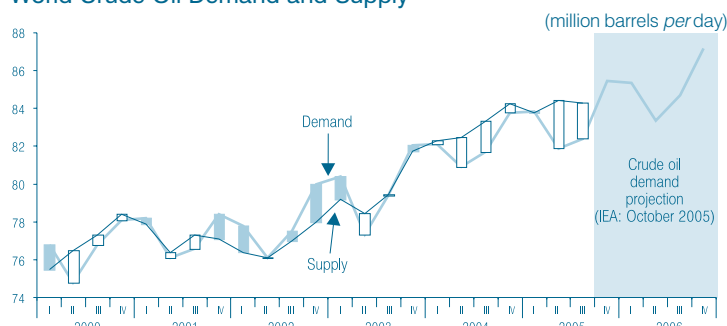
⁴ On 2 September the IEA member countries agreed to make available 60 million barrels of crude oil for an initial period of one month. They agreed to provide 2.1 million barrels daily, of which 2 million barrels from the countries' strategic reserve stocks and 0.1 million barrels extra output. This agreement was extended on 20 October until utilization of initially set 60 million barrels. At the September OPEC meeting member states decided to discontinue temporarily adherence to quotas and increase supply by 2 million barrels between October and December.

Chart 23
Crude Oil



Source: World Bank.

Chart 24
World Crude Oil Demand and Supply



Source: International Energy Agency.

were released on the market from the IEA countries and 2 million barrels *per* day from OPEC countries, which were sufficient to compensate for the production losses in the Gulf of Mexico and to decrease the uncertainty on the market.

In the summer demand for transportation fuel increased. Therefore, refineries' attempts to speed up production led to an increased demand for light oil, as it has a shorter processing time. During the upcoming season it is unlikely to face a shortage of end-use oil products, namely heating fuel. Crude oil inventories of OECD countries are substantial; the technological production time is shorter and is associated with larger production capacity compared to refining of transportation fuel. According to the November IEA assessment of the raw material demand, growth for 2005 and 2006 will be 1.2 per cent and 1.7 per cent respectively due to expected lower demand in China, the USA and Latin American countries.

The expected movement in the price of crude oil is within USD 56–64 *per* barrel, and the expected trend is for the price to go down. Price dynamics will mostly depend on time necessary to restore oil rigs and terminals operations in the Gulf of Mexico and on the southern coastline of the USA.

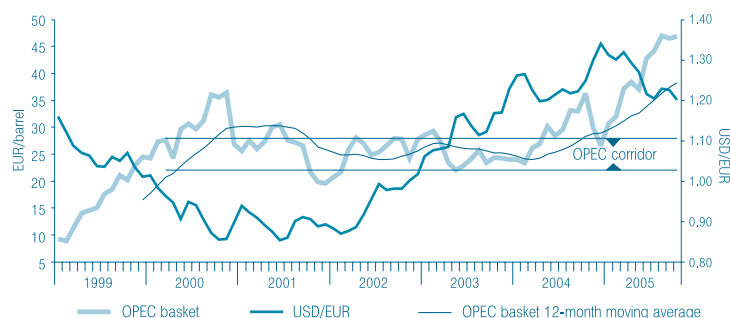
Calculated in euro, the price of the OPEC basket crude oil seized its rise at levels of EUR 47 *per* barrel. Its average price for the third quarter was EUR 47.1 *per* barrel, an increase of 14 per cent against the previous quarter and 37.9 per cent compared with the third quarter of 2004. While forming market expectations for the USD/EUR currency exchange rate, the price of crude oil will fluctuate within EUR 39 and EUR 43 *per* barrel until the end of 2005 and the beginning of 2006.

Major Raw Material and Commodity Prices

Metals kept the upward trend during the third quarter of 2005, while the prices of ferrous and non-ferrous metals tended to diverge. Non-ferrous metals continue to become more expensive, while ferrous metals marked a slight decline (steel marked a 2.1 per cent price decline compared with the previous quarter). The reported overproduction of steel during 2004 gradually began to affect the prices by lowering their levels, and the larger ore extracting plants started reducing production. During the third quarter the non-ferrous metals which

Chart 25

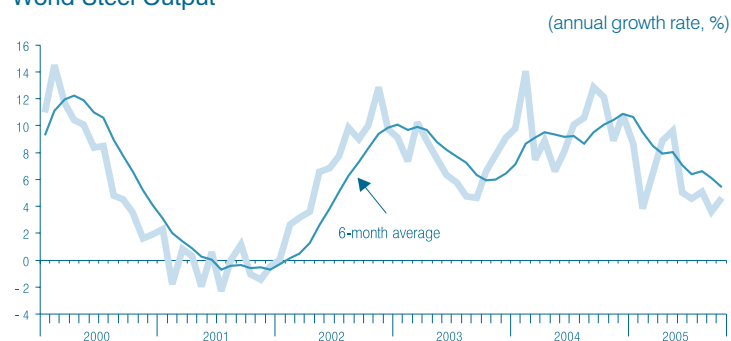
OPEC Basket Price in Euro



Source: World Bank, ECB, BNB, OPEC.

Chart 26

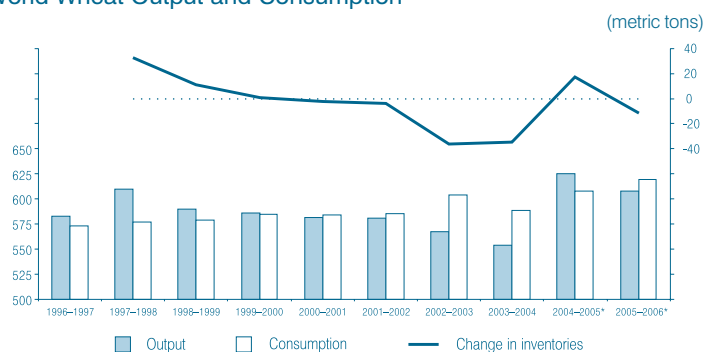
World Steel Output



Source: International Iron and Steel Institute (IISI), BNB.

Chart 27

World Wheat Output and Consumption



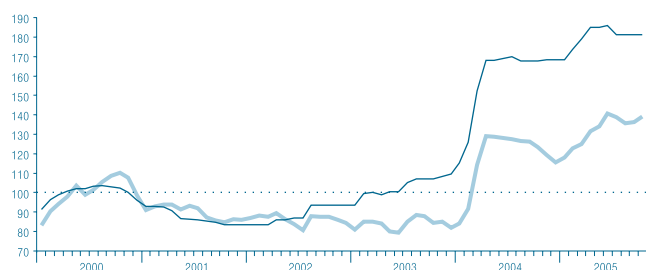
* Projections.

Source: Economic Research Service (U.S. Department of Agriculture).

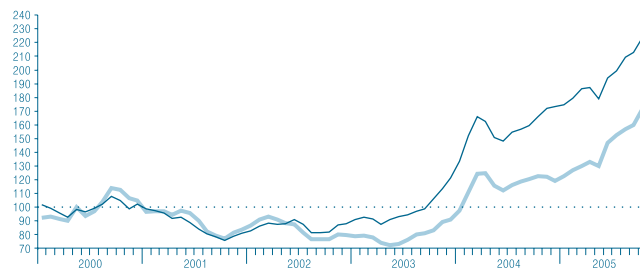
reached high prices were copper, zinc, lead and aluminum. A major factor for the price increases remains the demand of China for non-ferrous metals and the low inventories, mainly of copper which is a basic raw material in the high-tech industry (the price of copper is affected by low extracting levels, which are likely to increase in 2006).

Chart 24
Price Indices of Major Commodities and Commodity Groups

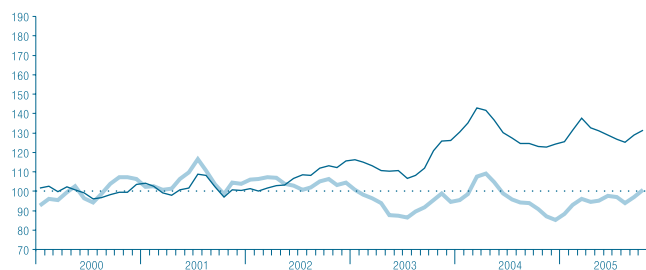
Steel (2000 = 100)



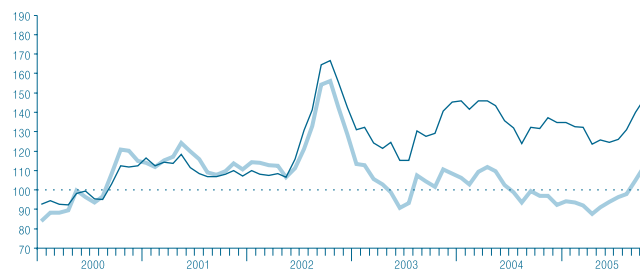
Copper (2000 = 100)



Food (2000 = 100)



Wheat (USA, HRW) (2000 = 100)



— USD

— EUR

Source: World Bank.

The metal price increase is expected to continue until the end of 2005, though at slower rates, and during the first quarter of 2006 this trend is expected to reverse.

Food prices during the third quarter of 2005 marked an 1.2 per cent increase against the third quarter of 2004. An upward trend is also observed among most of the cereals. During the last quarter of 2005 and the first quarter of 2006 a slight increase is expected, consistent with the unfavourable weather conditions which impeded the sowing of grain crops in Ukraine and in Russia. The forecasts for grain consumption were revised upward mainly due to the poor quality of the grain production in some regions.

Gold

Between August and November the gold price marked a sizable increase. The range of the movement was USD 415–480 *per* troy ounce, and the technical link between the exchange rate of USD/EUR was broken in most of the period. The main factors affecting the price of the precious metal were its properties of a secure asset and a means of security against inflation.

Under the pressure of increased speculative interest and larger real demand related to seasonal factors, the gold market price exceeded the USD 500 threshold *per* troy ounce at the end of November. This is the highest gold price level for the last 22 years and it is unlikely to sustain in the medium run.

Bulgarian External Debt Dynamics on International Financial Markets

The increasing interest in government debts of emerging markets was sustained in most of the third quarter of 2005. In the beginning of October this trend was reversed reflecting the fears of increasing inflation, caused by rising crude oil prices and expectations of a global interest rate increase.

In October the yield spread of the Bulgarian external debt increased in accordance with the general interest decline in the emerging markets financial instruments. This trend was also sustained in November. The yield spread measured by the JP Morgan EMBI+ index gradually increased to 94 basis points by 16 November 2005.

The prospects for a global interest rate increase formed expectations for relatively lower investors' interest in government debt securities of emerging markets at the expense of financial assets of the developed countries. The maintenance of macroeconomic stability and the conduct of a prudent fiscal policy will be the main factors determining the international investors' interest in the Bulgarian government debt.

Chart 29
Spot Price of Gold



Source: Bloomberg.

Chart 30
Spread of JP Morgan Index for Emerging Markets



Source: Bloomberg.

2. Financial Flows, Money and Credit

Changes in the world economic situation, prompting fluctuations in external demand, exchange and interest rates, had a significant effect on Bulgaria's economy *via* foreign trade dynamics and balance of payments financial account flows. Financial flows prompting changes in international reserves are formed in the process of interaction between domestic and external economic agents. Changes in international reserves under a currency board arrangement leads to a change in monetary base and correspondingly in broad money through the process of money multiplication. Thus, domestic economic activity is financed.

Table 3

Cash Flows Which Prompted Significant Changes in Gross International Reserves

	July – September 2005	January – September 2005
A) Purchases and sales of reserve currency (million EUR)		
- Net purchases from commercial banks	EUR +384 million	EUR +1195 million
- Outflows related to net sales at tills	EUR -2 million	EUR -8 million
B) Changes due to revenue (outflows) on commercial banks' minimum required reserve accounts in foreign currency	EUR +108 million	EUR +401 million CHF -327 million* USD -100 million*
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	Revenue: Payments: On external government debt: USD -685 million; JPY -610 million; EUR -154 million; SDR -7 million.	Revenue: From privatization: EUR +602 million; From external loans: EUR +59 million; From external debt issues: EUR +17 million; Payments: On external government debt: USD -1775 million; JPY -1663 million; EUR -421 million; SDR -19 million.

* Outflows in USD and CHF between January and September reflect amendments to BNB Ordinance No. 21 according to which banks are not allowed to maintain minimum required reserves in currencies other than levs and euro.

Source: BNB.

Between January and September 2005 BNB international reserves continued to increase, reflecting the bulk of financial inflows. By the end of September 2005 the Issue Department balance sheet figure came to EUR 7298.8 million, up by EUR 1080 million on September 2004. State budget transactions continued to play a dominating role in reserve dynamics

over the third quarter when Brady bonds worth EUR 506.9 million were bought back, prompting a decline in BNB international reserves by EUR 154.4 million. Between January and September 2005 external debt payments totaled almost EUR 2 billion (Table 3). The sale of energy distribution companies was reported as privatization revenue on the balance of payments at the end of 2004, with the funds transferred on state budget accounts with the BNB in early 2005.

Financial Flows and External Position Sustainability

The worsening balance of payments current account in the first half-year went ever deeper into deficit during the third quarter. Between January and September 2005 the current account balance came to EUR -1837.4 million (EUR -697.6 million in the corresponding period of 2004). The trade balance followed by the balance on services contributed most significantly to current account deficit worsening. The worsening of the balance on goods and services was so significant over the third quarter, that the quarterly current account went into an EUR 420.9 million deficit instead of the expected seasonal surplus.

Approximately two-thirds of the trade balance worsening between January and September 2005 was generated in the third quarter (a negative balance of EUR -1100 million against EUR -467.5 million in the third quarter of 2004). Increased physical imports of crude oil at high international prices were the one-off driving factor. It may be assumed that the significant investment goods imports in the third quarter also had a one-off effect due to implementing large-scale investment projects.

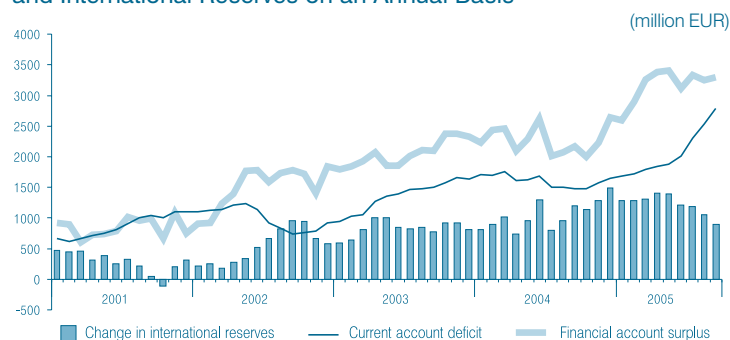
Clothing exports retaining its dynamics since early 2005 are likely to sustain in a medium-term horizon (rates close to zero since early 2005). Grounds for expected low growth rates may be found in increased nominal labour costs and enhanced competitiveness of Asian producers on international markets.

The trade deficit has worsened since early 2005 due mostly to accelerated imports rates (22.7 per cent in the first quarter, 24.2 per cent in the second quarter and 32.6 per cent in the third quarter) amid high international prices and strong domestic demand. Exports rose at high rates (17.3 per cent) though slowing in the

In the last 2005 and first 2006 quarters the current account deficit is expected to account for around 13.5–14 per cent of GDP on an annual basis, with the financial account surplus covering the deficit and boosting international reserves of the central bank.

The foreign direct investment inflow (excluding privatization revenue) will remain high. Private corporations' debt will progressively increase, with its ratio to GDP reaching some 38.5–40 per cent by the end of March 2006. Public and publicly guaranteed debt is projected to drop under 25 per cent of GDP over the same period.

Chart 31
Dynamics of Current Account, Financial Account and International Reserves on an Annual Basis



Source: BNB.

third quarter to reach 10.6 per cent.⁵ The trade balance reached EUR -2791.4 million over the review period (up by EUR 1 billion on the January – September 2004 period).

Given the expectations of sustaining high domestic demand by the end of 2005 and in early 2006, import growth rates are likely to remain high. Exports are expected to restore their growth rates since factors prompting the third quarter slowdown were transitory. Trade balance dynamics will further determine the current account deficit.

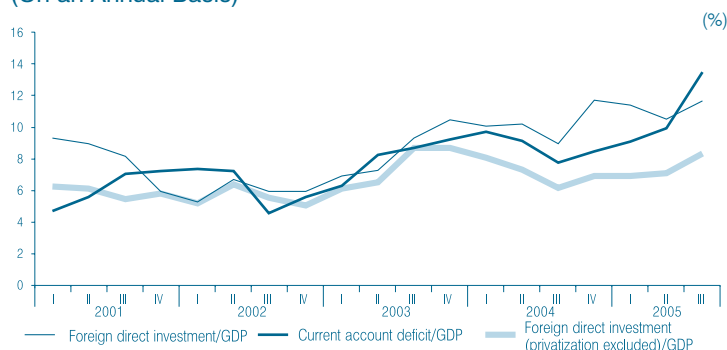
Since early 2005 trade in services was marked by comparatively low export rates and dynamically increased imports of services. The difference in growth rates of *Transportation, credit* (12 per cent) and *Transportation, debit* (21.2 per cent) items reflected mostly relevant differences in growth of goods exports and imports. Changes in the *Travel* item matched the expectations, with no significant movements in growth rates being anticipated. The *Other services* dynamics were atypical both in its credit and debit part. Between January and September flows on the *Other services, credit* item dropped by 11.4 per cent on the corresponding period of 2004. Simultaneously, the *Other services, debit* item went up at high rates (22.5 per cent between January and September 2005 and 17.9 per cent over the third quarter). Similar declines in the *Other services, credit* item occurred in the past, with relatively fast recovery of its growth rates. This gives grounds to expect a compensating increase in flows on this item in 2006. The high growth in the *Other services, debit* item was partially ascribable to the robust domestic demand in 2005. However, this growth was quite high and unlikely to continue over the long-term horizon at similar rates. Thus, growth is projected to slow in late 2005/early 2006.

Such dynamics will probably result in worsening current account deficit and hence an annual deficit of some 14 per cent of GDP. In the first quarter of 2006 the current account balance is expected to reach nearly 14 per cent of GDP on an annual basis.

⁵ The *Economic Activity* Section presents a detailed analysis of export and import dynamics and expectations of exports for the fourth quarter of 2005 and first quarter of 2006.

Chart 32

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



Source: BNB, NSI.

Despite the rapid rise in the current account deficit, its values remained within sustainable levels based on GDP and investment growth rates. Therefore, the increase in the current account deficit should be considered a trend associated with the need to modernize the Bulgarian economy and increase investor confidence in Bulgaria's economic policy on the eve of EU membership, rather than a sign of imbalances within the economy. Nonetheless, risks stemming from the current account deficit should not be disregarded. The sustainability of flows financing deficits is shown in investor attitudes. Hence, sources of financing of the current account deficit and debt flow dynamics have been comprehensively analyzed.

Based on the January to September 2005 data, the BOP current account deficit was covered by the financial account (EUR 1963.7 million for the January – September 2005 period) with rising international reserves. A significant portion of financing came from foreign direct investment: EUR 1322.9 million over the review period (72 per cent of the current account deficit) with the non-privatization portion increasing by EUR 378.9 million on the corresponding period of 2004.

The September external debt data confirm our expectations that commercial banks' obligations will change at comparatively low rates in the second half-year. As of September the overall debt of commercial banks rose by EUR 356.7 million on the end of 2004.⁶ Since the bulk of commercial banks' debt was short-term, this affected overall short-term debt dynamics. Non-residents' deposits, the major external source for the credit expansion, increased by EUR 21.2 million on December 2004. In July and August they decreased by EUR 135.6 million and EUR 41.8 million respectively on the previous month. September saw a slight rise of EUR 9.5 million. This shows that the compensating decrease in non-residents' deposits has been exhausted and rises are expected in the last quarter of 2005 and first quarter of 2006.

⁶ September saw a decline of EUR 371 million compared with the March 2005 maximum of EUR 2420.2 million.

Chart 33
Gross External Debt



Source: BNB.

In the second quarter external obligations of the private non-bank sector increased, with the rates slowing during the third quarter. In some components of the private non-bank sector's debt, for instance commercial loans, deviations from overall trends were reported. However, small amounts and short-term periods allow no definite conclusion. Nevertheless, amid liberalized balance of payments financial account and large foreign borrowings, domestic demand remains the major factor determining the amount of external financing. Thus, the private non-bank sector is most likely to run farther into debts in late 2005/ early 2006.

Consequently, private external debt is expected to reach some 38.5 per cent of GDP by the close of 2005. Our forecast shows a further increase in private external debt to a bit under 40 per cent of GDP in the first quarter of 2006.

Net government debt repayments in July affected both public and publicly guaranteed debt and long-term external debt. Public and publicly guaranteed debt is expected to be under 26 per cent of GDP over the fourth quarter and to fall under 25 per cent of GDP in the first quarter of 2006.

If our expectations of balance of payments flow dynamics materialize, international reserves will further increase in the fourth quarter of 2005 and first quarter of 2006. The expected growth in international reserves by the end of 2005 will be within the EUR 200 to EUR 350 million range and up to EUR 50 million in the first quarter of 2006.

Monetary Aggregates

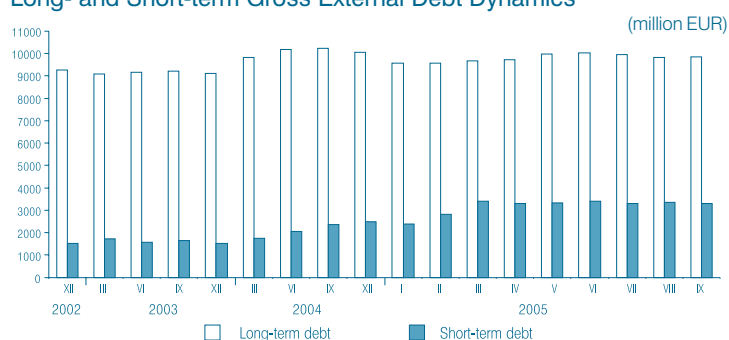
Amendments to the statutory framework of minimum required reserves enforced by the BNB in 2004 and early 2005 changed reserve money dynamics on an annual basis: an effect which will evolve in the coming year.⁷ Over the third quarter of 2005 reserve money rose by 30.3 per cent, some 9 percentage points down from the prior quarter rate of growth. Growth rates slowed further in October when reserve money increased by 27.5 per cent on a year-on-year basis.

Commercial bank deposits with the BNB grew by 69 per cent by the end of the third quarter: a significant decline on the second quarter (117 per cent). At the end of November

⁷ For more details see previous issues of the BNB *Economic Review*.

Chart 34

Long- and Short-term Gross External Debt Dynamics



Source: BNB.

Currency in circulation is expected to rise further by nearly 20 per cent on an annual basis. A slight slowdown in broad money growth to 23–25 per cent is likely to occur in the fourth quarter, while in the first quarter of 2006 the M3 percentage growth will be significantly lower due to the high March 2005 base: around 10–12 per cent. Deposit interest rates are expected to stay stable.

growth slowed down to 49 per cent on an annual basis, albeit deposited additional reserves by banks under Ordinance No. 21.⁸ Due to the high base at the end of 2004, growth rates of commercial banks' deposits with the BNB are expected to fall additionally to nearly 20 per cent on an annual basis. Since this reserve money component is strongly volatile and its dynamics reflect seasonal or one-off factors, more significant deviations from projected values are possible.

Over the third quarter of 2005 currency in circulation rose by 19.5 per cent on an annual basis according to our expectations (20.4 per cent in October). This rate is close to the average value of the recent two years (19.8 per cent). Sustained high growth rates reflect mostly the strong consumer and investment activity associated with the increasing need for liquidity. The negative balance on overall balance of payments in the third quarter and the respective fall in BNB international reserves as a result of Brady bonds buybacks did not affect money supply. Since external debt operations are effected through the government deposit in the BNB Issue Department, they have no direct effect on currency board functioning. Generally, the fiscal policy may affect currency in circulation through government revenue and non-interest expenditure and their distribution over time. The consolidated fiscal programme performance results in redistributing liquidity among economic sectors and thus indirectly affects demand for currency in circulation.

In the first quarter significant liquidity was withdrawn from households and enterprises through the state budget. Between April and June non-interest government expenditure increased and in the second quarter levels of withdrawn liquidity from these two sectors were lower than usual. The fiscal expansion in the second quarter affected the level of the primary surplus which was lower than in the first quarter for the first time since 1999.

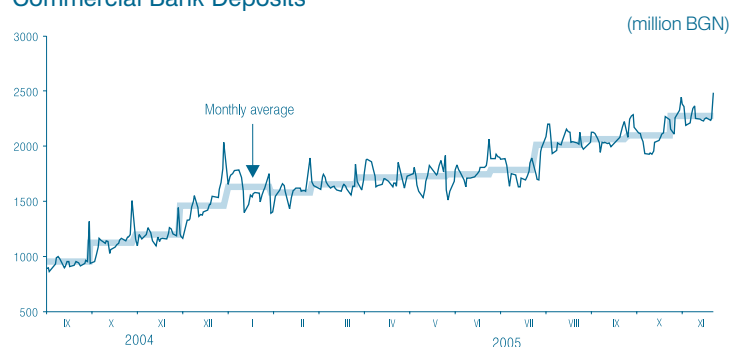
⁸ Due to higher lending rates compared with the limits under Ordinance No. 21, in August four commercial banks deposited additional reserves of BGN 236 million. In the following reporting period eight banks exceeded the set rates and paid additional reserves in November to the amount of BGN 383 million. In response to the increasing number of institutions violating the statutory provisions, the BNB Governing Council adopted further amendments to Ordinance No. 21 which introduced a progressive scale of additional reserves depending on the percentage of excess of extended loans over the set limits.

Chart 35
Reserve Money and Its Components



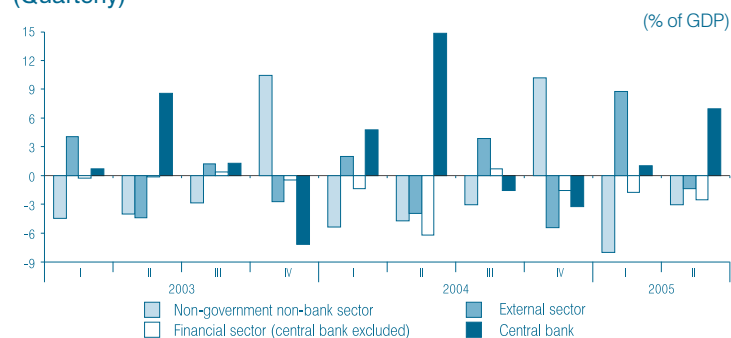
Source: BNB.

Chart 36
Commercial Bank Deposits



Source: BNB.

Chart 37
Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)



Source: MF, BNB.

In late 2005/early 2006 the non-government non-bank sector is expected to retain its liquidity position (formed in its interaction with consolidated budget) at the level of the corresponding quarter of the previous year. Flows from and to financial institutions are expected to be almost balanced. Most likely, changes in government deposits with the BNB will be significant due to the large budget expenditure and expected privatization revenue at the end of the year. Under these assumptions on fiscal policy stance and favourable economic projections for the last quarter of 2005 and first quarter of 2006, currency in circulation is expected to rise by approximately 20 per cent annually. In nominal value, the increase will be higher than in the same period of the previous year which corresponds to the larger consumer expenditure of households over the fourth quarter of 2005.

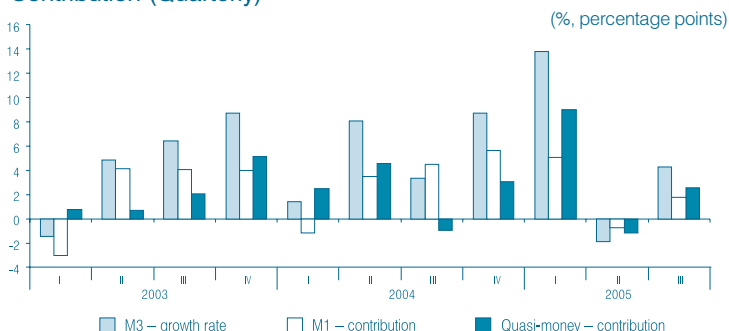
In the third quarter broad money measured by the monetary aggregate M3 rose by 4.3 per cent on June and 26.6 per cent on the third quarter of 2004. Expectations of slowing growth rates of broad money did not materialize, since deposits continued growing at high rates. Overnight deposits increased by 29.7 per cent and time deposits 32.7 per cent. In both types of deposits, the lev component demonstrated an outstripping growth: 32.7 per cent and 46.8 per cent respectively. Between July and September the annual growth rate of non-financial corporations' deposits outstripped that of households' deposits. Lev overnight deposits (13.8 percentage points) followed by lev time deposits (13.5 percentage points) contributed most significantly to growth (32.5 per cent) in corporations' deposits.

In March 2005 non-financial corporations' deposits rose dramatically⁹ and stayed at levels significantly exceeding the prior year's values despite the April decline. These rates coupled with slowing credit activity led to higher growth rates of deposits compared with loans (not observed in previous periods).

In terms of households' deposits, lev time deposits rose most significantly (43.7 per cent) followed by lev overnight deposits (34.5 per cent). As a result, the lev deposits' share in total households' deposits increased from 43 per cent to 45 per cent over the last year, an indicator of the increasing confidence in the national currency. Within the deposit structure,

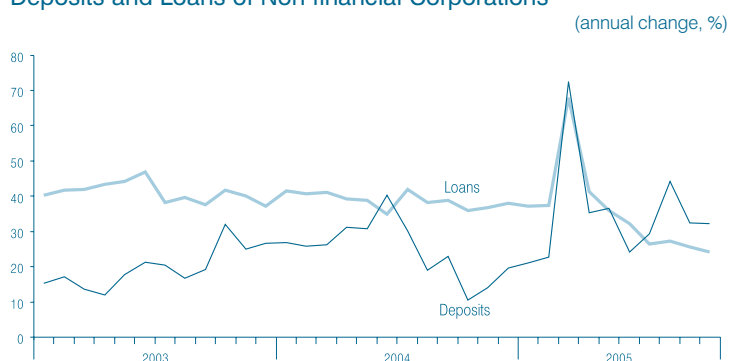
⁹ See *Economic Review*, May and August 2005 issues.

Chart 38
M3 Growth Rate and M1 and Quasi-money Contribution (Quarterly)



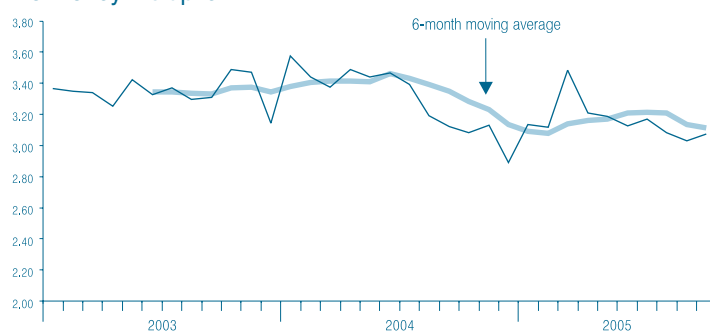
Source: BNB.

Chart 39
Deposits and Loans of Non-financial Corporations



Source: BNB.

Chart 40
M3 Money Multiplier



Source: BNB.

those in foreign currencies dominated in the review period, with a two-fold increase in time deposits. In recent years the currency structure of foreign currency deposits have dynamically changed. The share of EUR-denominated deposits rose by 45 per cent in September 2004 to 53 per cent in September 2005. Larger share of EUR-denominated deposits was due to their higher interest rates compared with those on USD-denominated deposits and to risks stemming from unfavourable US dollar rate movements.

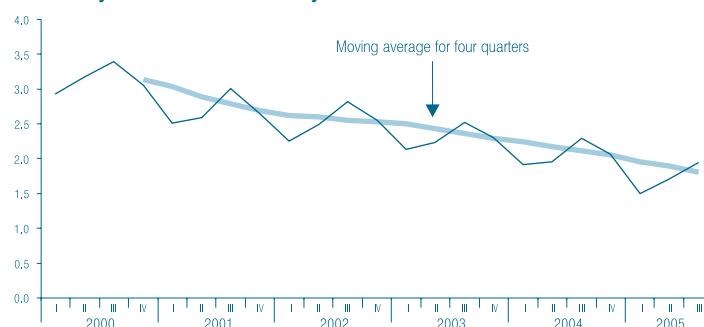
In the coming two quarters broad money rates are expected slightly to decrease to 23–25 per cent in December 2005 and to nearly 10–12 per cent in March 2006. The significant drop in March was entirely due to the high base in March 2004 and was not associated with real money supply contraction. As a whole, broad money is projected to grow at comparatively fast rates in absolute terms despite the slowing credit. This is a result of high economic rates and growing income and savings, whilst firms may occasionally use foreign direct financing instead of bank lending.

Declining lending rates following the enforcement of amendments to BNB Ordinance No. 21 affected money multiplier dynamics which decreased to 3.03 in September. However, M3 growth rates are likely to pick up slightly in early 2006.

Expectations of the broad money behaviour reflect also trends in money circulation velocity. Its dynamics over the last five years showed a stable downward trend with clearly pronounced seasonality. This reflects households' and firms' propensity to hold larger cash balances.

In the third quarter of 2005 average interest rates on lev time deposits matched the second quarter's level. Projections of slight rises did not materialize. More significant growth was reported in interest rates on USD-denominated deposits, a result mostly of external factors and especially of Federal Reserve policy of increasing US dollar interest rates. These changes, however, affected slightly the domestic market of USD-denominated deposits. Following the two percentage point increase in federal funds' interest rates between September 2004 and September 2005, interest rates offered by Bulgarian banks on time USD-denominated deposits rose by merely 0.1 percentage points on average. This reflected

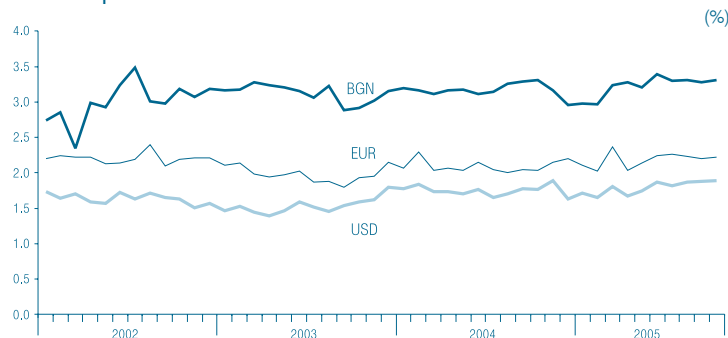
Chart 41
Currency Circulation Velocity



Source: BNB.

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

Chart 42
Time Deposit Interest Rates



Source: BNB.

largely the weaker demand for USD-denominated loans and the significant amount of deposits in US dollars.

Interest rates on time euro-denominated deposits stayed stable at nearly 2.2 per cent: by one percentage point lower than those on lev-denominated deposits.

When comparing interest rate distribution on lev time deposits among banks in September with that in June, an increase in interest rates offered by banks needing to attract more deposits is seen. In June two banks offered deposit rates between four and five per cent and two banks between five and six per cent, while in September three banks offered rates between four and five per cent and two banks over six per cent. Thus, the differential between the lowest and the highest interest rates rose from 4.9 to 5.1 percentage points, while the standard deviation went up from 1 to 1.1 percentage points.

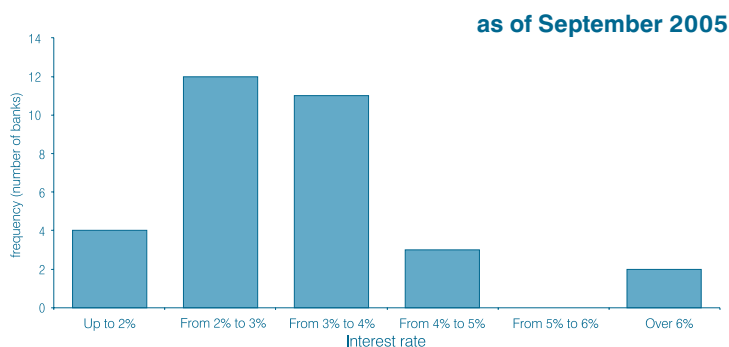
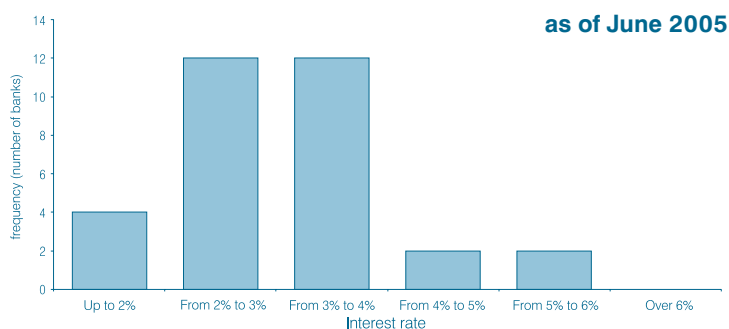
In the coming two quarters no significant changes in interest rate levels are expected, with the exception of slight increases in USD deposit rates.

Credit Aggregates

High credit demand and BNB measures to curb bank lending were the main drivers for credit aggregate dynamics in the third quarter of 2005. Claims on the non-government sector rose by BGN 941.1 million (against BGN 1188 million in the same period of 2004), their annual growth falling to 35.9 per cent by the end of September. October saw a further fall to 34.7 per cent. If BNB restrictions on lending are observed, the growth rate of claims on the non-government sector is expected to drop to 30 per cent in late 2005. At the end of the first quarter of 2006 domestic credit is projected to rise by 5–7 per cent on a year-on-year basis, a result of the significant increase in credit at the end of March 2005. If the high base effect is disregarded, the annual growth rate of the credit to the non-government sector is estimated at some 25 per cent by the end of the first quarter of 2006 (23 per cent on average) consistent with BNB Ordinance No. 21 restrictions.

Chart 43

Interest Rate Distribution on Household One-month Lev Deposits



Source: BNB.

Under BNB-imposed lending restrictions, the growth rate of claims on the non-government sector will slow to some 30 per cent in late 2005. Due to the base effect of credit growth by end-March, the annual growth rate is estimated at some 5–7 per cent by the end of the first quarter of 2006. If the high base effect of March 2005 is disregarded, the annual growth rate of the credit to the non-government sector is estimated at some 25 per cent at the end of the first quarter of 2006 (23 per cent on average) consistent with BNB Ordinance No. 21 restrictions.

Chart 44

Claims on Non-government Sector (Annual Growth Rate)

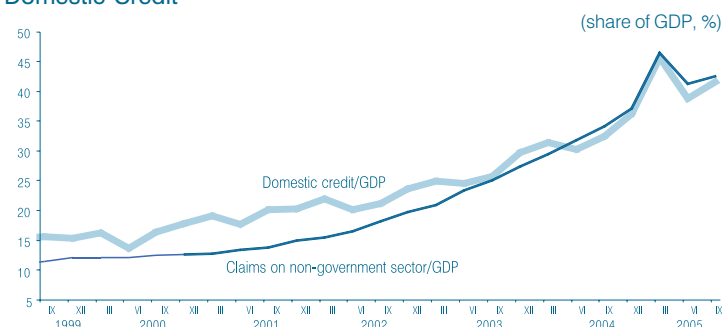


Source: BNB.

Over 2005 the upward trend in financial intermediation was sustained, with the *claims on the non-government sector to GDP* ratio reaching 42.5 per cent by the end of the third quarter, up 8.3 percentage points on the corresponding period of 2004.

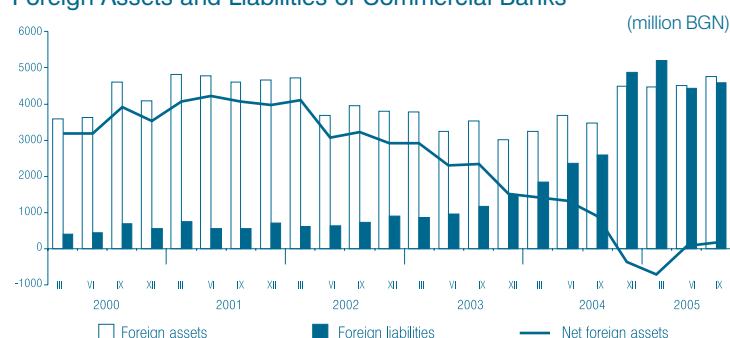
BNB restrictive measures set limits for banks to borrow funds from non-residents for their credit activities. This affected commercial banks' foreign liabilities which rose during the third quarter by BGN 155.6 million, significantly less than in previous periods.

Chart 45
Domestic Credit



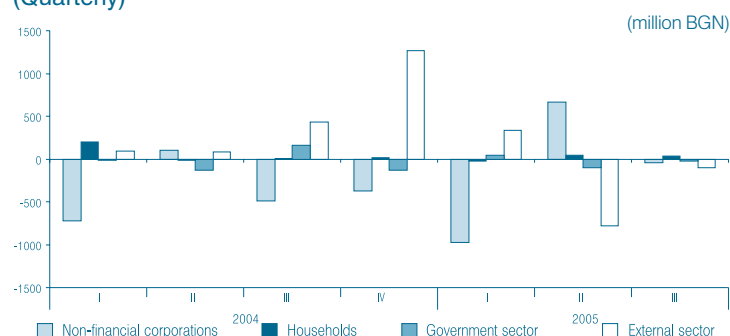
Source: BNB.

Chart 46
Foreign Assets and Liabilities of Commercial Banks



Source: BNB.

Chart 47
Net Financial Flows of Commercial Banks
(Quarterly)



Source: BNB.

Table 4
Changes in Major Balance Sheet Items of Commercial Banks (Quarterly)

	2004				2005		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Claims on non-financial corporations	553.6	522.1	668.1	817.8	2948.8	-1922.6	334.6
Deposits of non-financial corporations	-170.0	624.6	179.7	449.2	1971.2	-1258.6	292.5
Claims on households	300.4	500.7	503.8	567.0	721.7	590.6	537.5
Deposits of households	498.9	486.7	508.9	580.2	702.9	633.0	575.6
Foreign assets	243.2	428.5	-206.8	1021.4	-9.3	23.1	251.2
Foreign liabilities	339.3	512.6	230.1	2285.8	325.7	-752.7	155.6
Claims on government sector	190.5	-108.9	42.6	64.6	17.1	209.8	135.4
Deposits of government sector	177.8	-239.2	206.1	-64.2	65.8	105.4	110.6
Claims on central government	188.2	-109.6	42.2	66.9	16.3	203.5	113.9
Liabilities to central government	57.4	-212.7	189.7	-70.5	-95.6	94.7	129.9

Source: BNB.

Annual growth rates in all credit market segments slowed down. Although demand for loans by enterprises stayed high, reflecting buoyant production and investment activity, the annual growth rate of claims on non-financial corporations dropped to 25.7 per cent by the end of September and 24.2 per cent by the end of October.

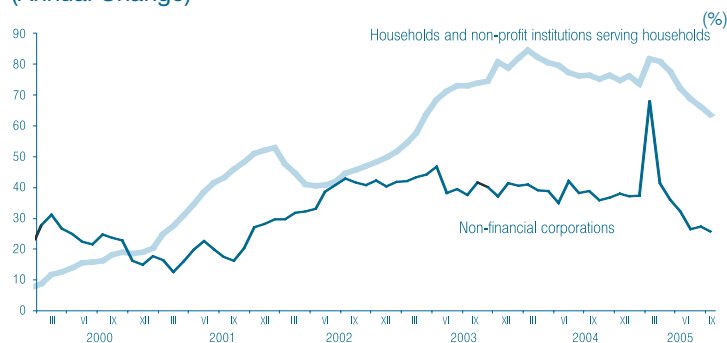
Claims on households increased by BGN 537.5 million during the third quarter, with the absolute lending volumes remaining unchanged. The annual growth rate of claims on households continued decreasing to reach 63.5 per cent by the end of September (62.4 per cent in October). Although the annual rate of housing loans decreased from 145.2 per cent to 121.1 per cent during the third quarter (113 per cent in October), they remained the most dynamic segment of the credit market, with their share in total claims on households reaching 27 per cent.

Consumer loans are a source of funds for the bulk of household consumption which contributes to the change in the consumption structure: an increase in the share of non-food goods.

The access of corporations to external sources of financing and the greater potential for developing household lending gave rise to changes in the structure of claims on the non-government sector. As a result, the share of loans to households continued rising to reach 36.2 per cent of claims on the non-government sector by the end of September.

Chart 48

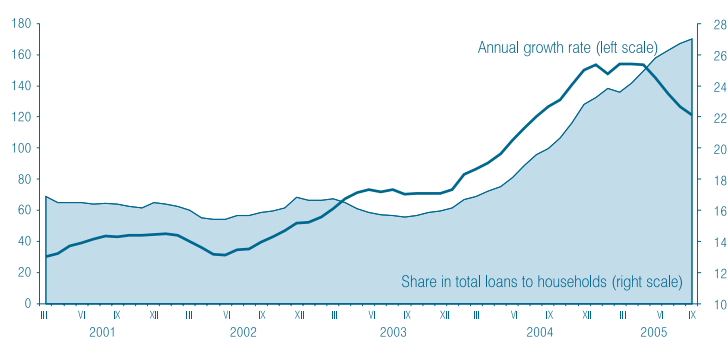
Claims on Non-financial Corporations and Households (Annual Change)



Source: BNB.

Chart 49

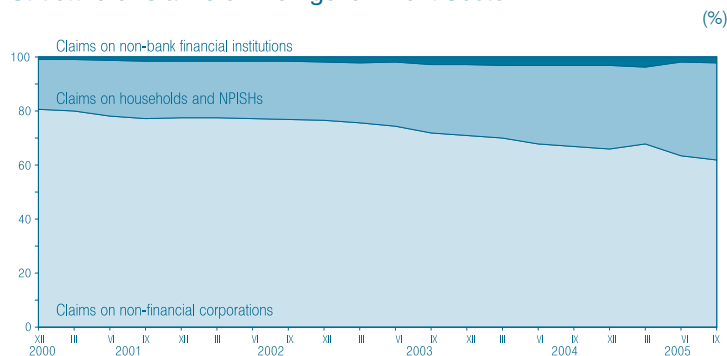
Housing Loans



Source: BNB.

Chart 50

Structure of Claims on Non-government Sector



Source: BNB.

Table 5

Claims on Non-government Sector

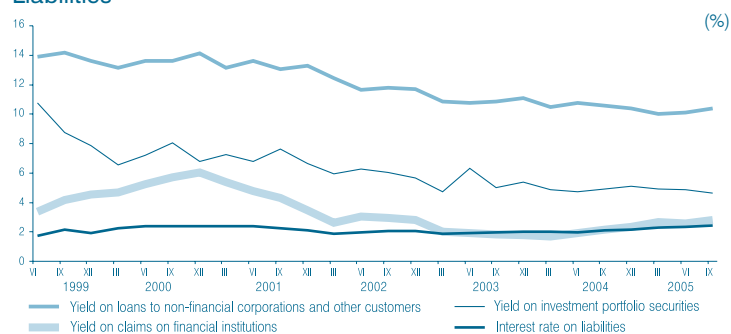
	Annual growth rate, %							Structure as of 30.IX.2005
	2004				2005			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	
Claims on non-government sector, incl.	52.3	47.8	49.3	48.6	73.1	41.8	35.9	
Claims on non-financial corporations	41.0	35.0	38.9	38.1	68.0	32.2	25.7	61.9
Claims on households and NPISHs	84.5	79.6	76.4	74.8	81.8	72.2	63.5	36.2
Claims on financial enterprises	119.5	161.7	70.2	69.1	113.4	-27.6	-12.4	1.9

Source: BNB.

Most likely, domestic lending rates will remain relatively unchanged in the following months. For now, measures to curb credit activity have no clear effect on the price of borrowings due to the strong competition among banks to expand their market shares. The spread between lending and deposit rates is still high which allows banks to keep lending rates unchanged even in case of more expensive borrowings.

Chart 51

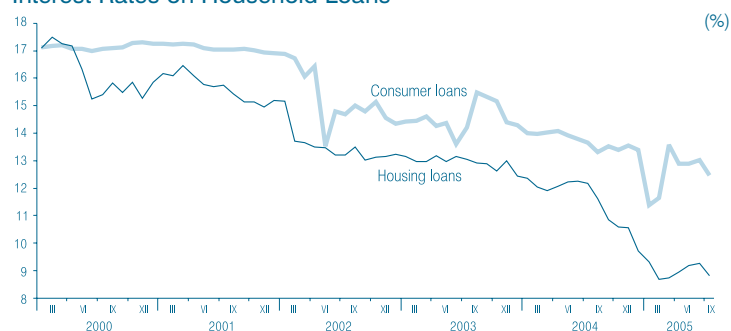
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities



Source: BNB.

Chart 52

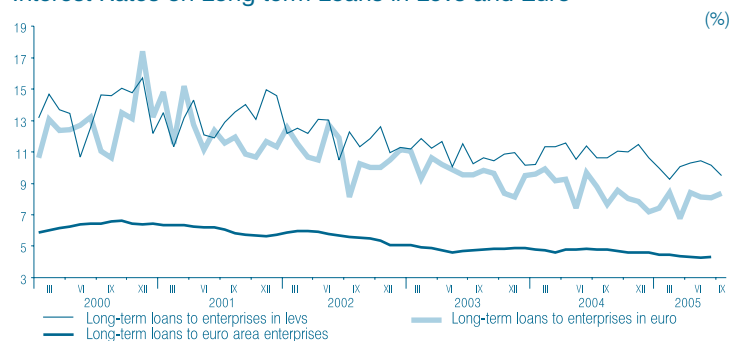
Interest Rates on Household Loans



Source: BNB.

Chart 53

Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

Accelerated economic activity, resulting in a 6.4 per cent growth, continued in the second quarter of 2005. Year-to-year growth rate increased by 0.9 percentage points reflecting accelerated growth in investment in fixed assets and government consumption. Accelerated growth of these end-use components offset the absolute growth of the negative foreign trade balance contribution.

Economic activity remained high. Year-on-year growth is expected to reach 6 per cent in the fourth quarter of 2005 and 6.5 per cent in the first quarter of 2006. Investment activity and household consumption will contribute to this effect.

Chart 54
Contribution to GDP Growth for 2003–2004 by Component of Final Demand (Quarterly)

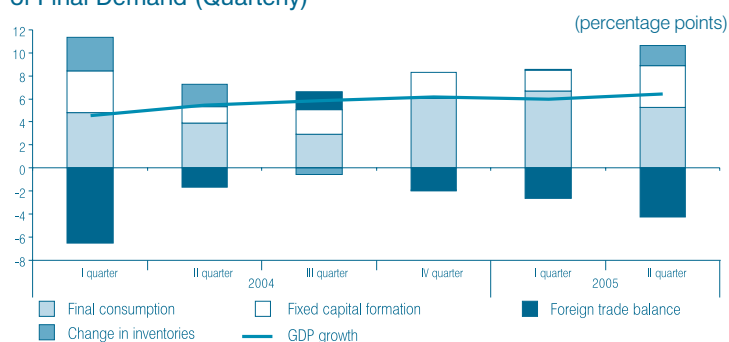


Table 6
Dynamics of GDP Components According to Final Consumption Method

(on corresponding period of previous year, %)

	2004				2005	
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter
Final consumption	5.3	4.3	3.7	6.6	7.3	5.9
Gross fixed capital formation	22.1	6.9	12.6	9.9	9.2	16.8
Exports of goods and services	7.0	10.6	14.1	19.8	8.8	12.0
Imports of goods and services	16.7	11.1	11.9	16.9	10.8	15.5
GDP	4.5	5.5	5.8	6.2	6.0	6.4

Source: NSI.

Household Behaviour

Over the second and third quarters of 2005 households' financial state continued improving, consistent with the increasing employment and real income growth. Based on the NSI labour force survey, over the first six months of 2005 employment increased by 1.6 per cent on an annual basis; and according to the sample statistics employed under labour contracts during the third quarter rose by 1.3 per cent on the corresponding period of 2004. Wages and Salaries Fund reported under Income Formation account of the System of National Accounts (deflated by the consumer price index) posted a 3.8 per cent growth in the first quarter of 2005 compared with the

Household consumption will further add to growth over the fourth quarter of 2005 and first quarter of 2006, with expected rates exceeding 6 per cent. Enhanced consumer demand will affect growth rates in imports of consumer goods.

same period of 2004. The reported real salary¹⁰ growth in the third quarter of 2005 was 3.1 per cent. Employment growth led to a decrease in unemployment. By the end of the third quarter the number of registered unemployed reached 388,548, a record low since July 1996.

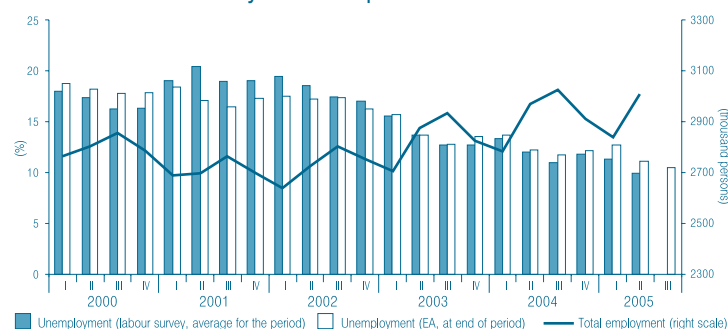
Table 7
Employment and Income Dynamics

	2004				2005		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Unemployment at the end of the period (EA data)	13.7	12.2	11.7	12.2	12.7	11.1	10.5
Employees							
Share on corresponding quarter of previous year	6.2	5.1	5.3	5.4	1.0	0.7	1.3
Share on previous quarter	3.9	2.5	0.8	-1.9	-0.4	2.2	1.4
Total employment (labour survey data)							
Share on corresponding quarter of previous year	2.9	3.3	3.1	3.1	2.0	1.3	
Share on previous quarter	-1.5	6.7	1.8	-3.7	-2.5	6.0	
Real salary							
Share on corresponding quarter of previous year	-0.4	-1.2	-0.3	1.5	5.5	4.3	3.1
Share on previous quarter	-5.4	3.4	2.0	1.8	-1.7	2.2	0.8
Wages and salaries , real increase on the corresponding quarter of prior year	-0.6	2.5	5.9	8.2	4.6	3.0	

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

The structure of household income sources experienced changes attributable to the increased shares of transfers and labour income from abroad (based on household budget surveys). Salaries and pensions continued to provide more than half of the financial resources for market and consumer spending.

Chart 55
Status of Economically Active Population



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

Table 8
Ratios of Household Financial Fund Sources and Consumer Expenditure*

	2000	2001	2002	2003	2004	VII.2004–VI.2005
Salaries	42.4	42.3	42.5	41.8	41.5	40.7
Pensions	19.4	18.4	18.0	17.6	17.5	17.2
Benefits	5.8	9.0	6.2	5.6	4.7	4.6
Labour income and transfers from abroad	5.6	8.3	7.4	7.4	9.1	9.2
Loans	3.7	4.4	5.8	8.8	13.6	18.9

* Imputed rent, consumption in kind and non-market consumption excluded.

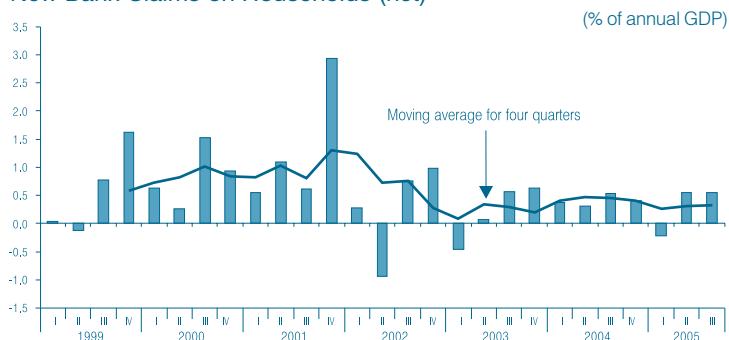
Source: NSI, MF, BNB.

¹⁰ Deflated by consumer price index.

With the improvement of households' financial state, savings in the form of household deposits exhibited an increase. Easier access of households to bank loans was provided. As a result, the share of consumer credit from the banking system in household consumption accounted for about 16 per cent. Concurrently, the volume of deposits and cash of households in the second and third quarters significantly exceeded their liabilities in the form of bank loans. Households remained a net creditor of the economy or a net saver correspondingly. The trend of concentrating loans in higher-income groups was sustained suggesting that the extended access to consumer loans reflected household demand for goods suitable for longer use rather than for consumer goods. Based on the household budget surveys conducted by the NSI, the above five deciles comprised almost three-fourths of loans.

Over the second quarter of 2005 household expenditure growth rate matched that of the corresponding period in 2004 (5.3 per cent), consistent with growing household income. Consumption of non-foods, rising by approximately 13 per cent in real terms on the corresponding period in 2004, contributed most substantially to growth (accounting for more than half of the reported growth). In recent years the growth rate of non-food consumption has significantly exceeded total consumption growth, resulting in approximately a 7 percentage point increase in the share of non-foods since 1998. This reflected both the improved financial state of households and better conditions for drawing bank loans.

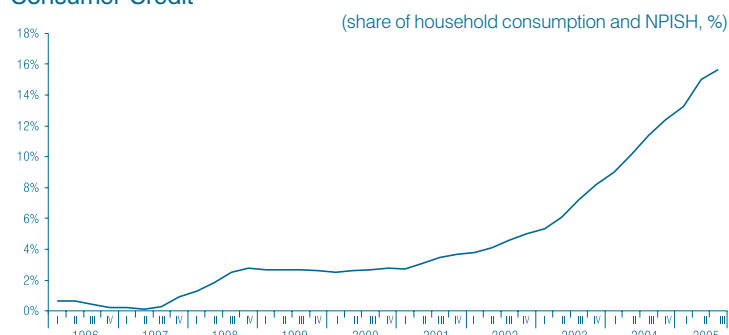
Chart 56
New Bank Claims on Households (net)



Note: The difference between growth of household assets in banks (deposits and 50 per cent of currency outside banks) and the increase in bank claims on households.

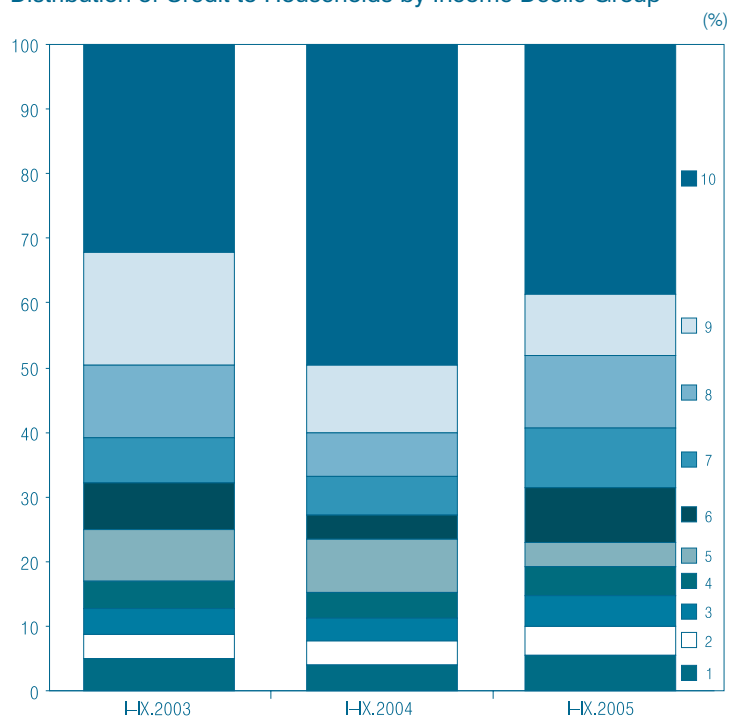
Source: BNB, NSI.

Chart 57
Consumer Credit



Source: NSI, BNB.

Chart 58
Distribution of Credit to Households by Income Decile Group



Source: NSI, household budgets.

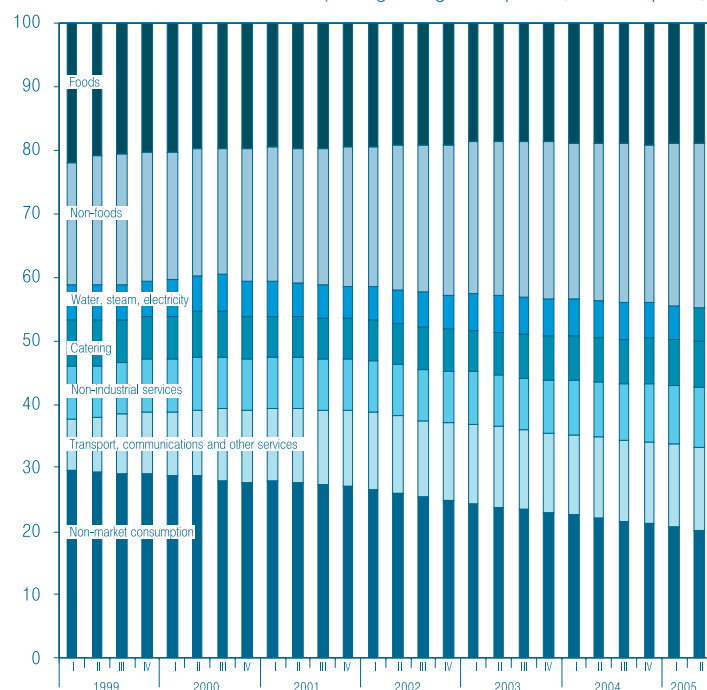
Retail trade data confirmed the trends in household expenditure: during the third quarter of 2005 the sizable increase in earnings from trade in household appliances sustained, and the growth of earnings from trade in clothing and footwear accelerated. Thus, the structure of household consumption continued changing, with the share of market-based consumption going up and the share of non-foods, including durable goods, increasing.

At the onset of the fourth quarter the consumer confidence indicator revealed a sharper slowdown compared with the previous consumer survey conducted in the beginning of the third quarter. The indicator summarizes the expectations of households included in NSI survey about general economic situation, unemployment, consumer financial status and opportunities to save. With the exception of indicators displaying expectations about savings and expenditure on home refurbishment which worsened slightly, the remaining indicators experienced a significant fall in October. Probably, the factors influencing consumer expectations involved damages caused by the July–September floods, pending rises in electricity and heating prices and higher excises to be introduced from early 2006. Consumer surveys suggest dramatically increased inflationary expectations which affect the general confidence indicator. Consumer expectations are also influenced by a number of subjective factors which are not necessarily related to household welfare.

Chart 59

Structure of Household Consumption

(moving average for 4 quarters, at current prices, %)



Source: NSI.

Table 9

Consumer Demand Dynamics

(share on corresponding period of previous year, %)

	2004				2005		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Retail sales	12.5	13.6	13.5	13.8	14.1	16.3	11.7
Revenue from retail trade	11.5	12.2	12.9	15.6	12.0	12.9	13.0
Food, drink, tobacco	10.6	5.1	5.1	8.1	10.4	10.7	9.2
Pharmaceutical and medical goods, cosmetics and toiletry	6.0	8.7	5.0	3.4	3.3	7.4	12.3
Textiles, clothing, footwear and leather products	9.0	15.9	7.6	12.0	12.0	17.1	25.7
Household goods and equipment	15.7	18.6	25.0	27.1	19.3	17.3	18.6

Source: NSI.

Government Finance and Consumption

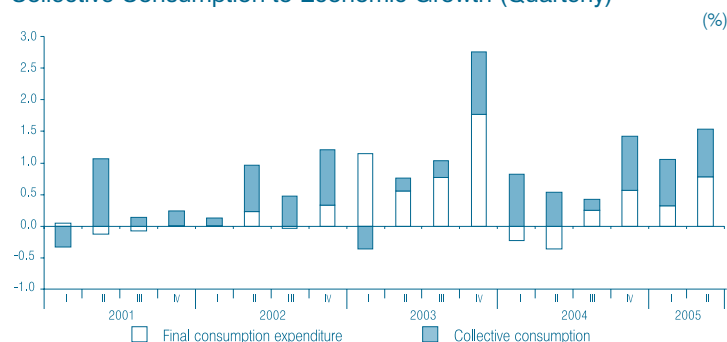
Over the second quarter the government contribution to GDP growth increased to come to 1.5 percentage points. Final consumer expenditure of the government and collective consumption displayed a two-digit nominal growth rates and their real growth of 9.7 per cent and 7.4 per cent respectively exceeded household consumption growth. By year-end real growth rates of government consumption are expected to slow down. However, they will stay relatively high at approximately 5–6 per cent. Extra expenditure will be made to cover damages caused by the floods, on the one hand, and commitments under the agreement with the IMF are to be fulfilled, on the other hand. Dependant on the amount of tax revenue, cash balance is expected to account for 2 and 2.2 per cent of GDP.

The 2006 draft budget filed in the Parliament projects a zero deficit. Based on the government expenditure policy presented in the draft budget, the higher growth of salary and operating expenditure is expected to sustain in the first quarter of 2006. As a result, the real growth of government consumption may reach 2 per cent. Despite the expected faster growth of social expenditure, social transfers will not affect seriously household disposable income, since it is planned to increase at rates close to those of the average income *per* a household member, thus sustaining the share in it relatively unchanged. However, these transfers will continue restructuring and the lower unemployment compensation payments will be offset by higher family allowances and other social benefits.

Real growth rates of government consumption are expected to remain comparatively high at nearly 5–6 per cent. Extra expenditure will be made to cover flood damages, on the one hand, and commitments under the agreement with the IMF are to be fulfilled, on the other hand. Dependent on the amount of the tax revenue, the cash balance is expected to account for 2–2.2 per cent of GDP.

Chart 60

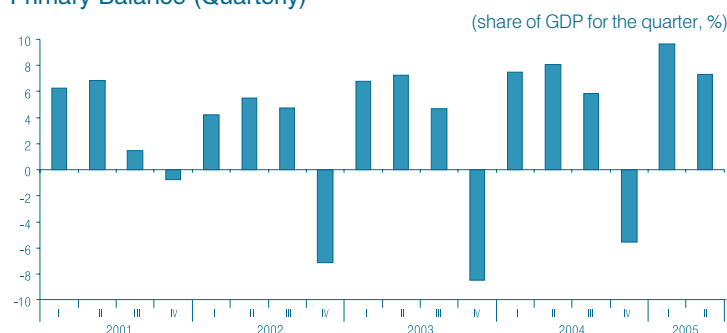
Contribution of Final Government Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)



Source: NSI, BNB.

Chart 61

Primary Balance (Quarterly)



Source: MF.

Chart 62

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



Source: MF, BNB.

Behaviour of Firms and Competitiveness

Production activity accelerated in the second quarter of 2005. Gross value added for the January–June period exceeded by 1.5 percentage points that in the corresponding period of 2004 and reached 6.6 per cent in a one-year horizon.

Table 10
Gross Value Added Growth by Sector

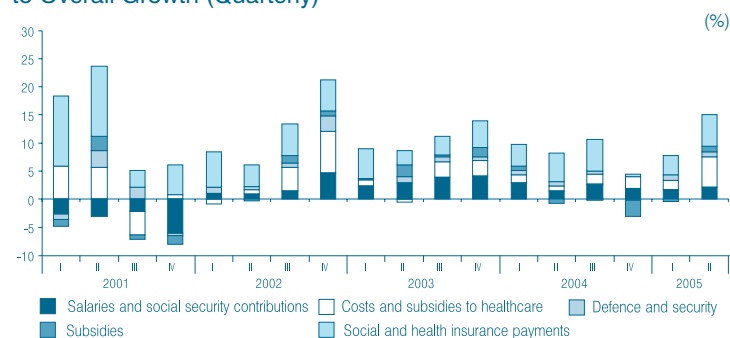
	2004				2005	
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter
Agriculture and forestry	-1.0	-0.4	3.7	3.3	-1.7	-5.2
Industry	4.9	6.1	5.3	4.8	8.2	9.3
Services	5.9	5.7	6.5	6.0	7.4	6.4
At base prices, total	5.1	5.2	5.6	5.4	7.1	6.2
Contribution, percentage points						
Agriculture and forestry	-0.1	0.0	0.7	0.3	-0.1	-0.5
Industry	1.6	1.8	1.5	1.4	2.6	2.8
Services	3.6	3.4	3.4	3.7	4.6	3.9

Source: NSI.

Industry exhibited positive dynamics. Oil processing, metallurgy, manufacture of machines and equipment, manufacture of food and drinks, chemical products and electrical machines have been the leading industries. Metallurgy again contributed significantly to growth despite the slowdown in sales between January and September 2005, including exports due to about a double increase in output in 2004. Concurrently, the structure of industrial output continued diversifying. Manufacture of machines and equipment sustained its leading position from 2004, and manufacture of electrical machines and chemical products boosted in 2005. In addition to traditional chemical industry output, manufacture of paint and var-

Chart 63

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

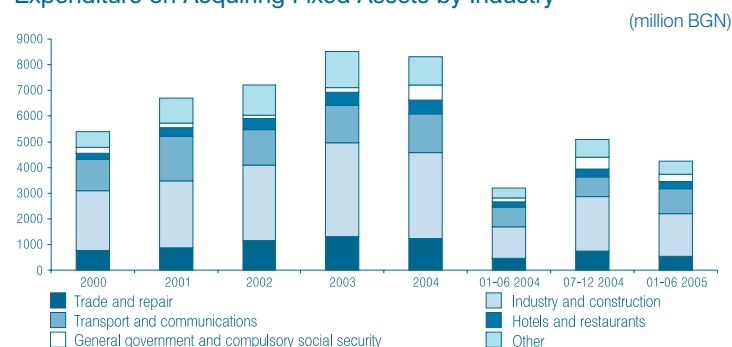


Source: MF, BNB.

Fixed capital investment rates will accelerate to nearly 17 per cent in the fourth quarter of 2005 and 14 per cent in the first quarter of 2006.

Chart 64

Expenditure on Acquiring Fixed Assets by Industry



Source: NSI.

nish, intended to meet the enhanced demand in construction, progressively increased, as well as manufacture of pharmaceuticals which gradually went up.

Table 11
Industrial Sale Dynamics

(share on corresponding period of previous year)

	2004				2005		
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter
Industrial output index	14.8	19.3	17.1	19.4	11.1	9.4	5.1
Industrial sales	14.5	20.9	23.8	26.8	14.8	11.9	8.6
export sales	34.5	42.5	49.1	49.6	23.7	14.7	10.8
domestic sales	5.9	6.9	8.1	9.5	6.3	9.2	6.5
Contribution, percentage points							
export sales	10.3	16.7	18.8	21.4	11.6	7.2	5.4
domestic sales	4.1	4.2	5.0	5.4	3.2	4.7	3.3

Source: NSI.

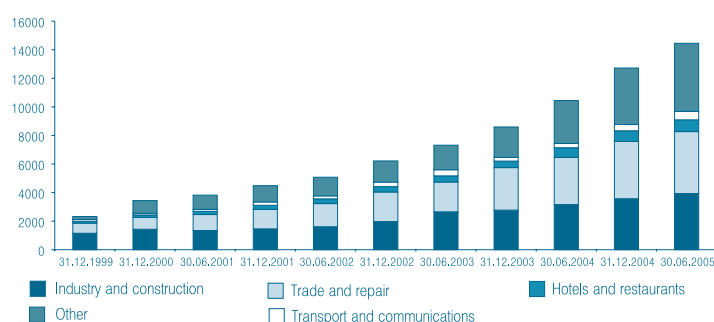
Value added and gross output in construction exhibited high growth rates in the first half of 2005: 14 per cent and 25 per cent respectively.

Trade, indicating a value added growth of 15.4 per cent (by 3.4 per cent higher than in the corresponding period of 2004) contributed most significantly to value added growth in the services sector. Financial sector growth also accelerated. Over the forecasting period positive dynamics is expected in communications, consistent with the launch of the third GSM operator.

Transport and communications, industry and trade were determined as leading in investment by sector measured by costs for acquiring fixed assets. Along with accelerated growth and increased investment in trade, banks' net claims on trade tended to increase. Medium-term claims (between 1 and 5 years) accounted for the largest share: 40 per cent. Intensified investment demand was one of the major factors determining the potential for future economic growth of these sectors as a whole.

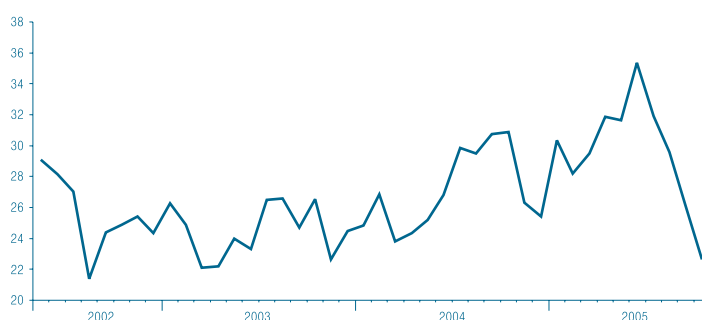
Against the background of buoyant economic activity over the first six months of 2005 and improving international economic conditions, dramatically worsened managers' assessments and expectations about the business climate could hardly be explained. One of the reasons may be related to damages on transport infrastructure caused by the floods. A seasonal slowdown of some indicators included in the general business climate indicator occurred in trade and construction. Man-

Chart 65
Claims on Banks and Non-financial Corporations by Branch
(million BGN)



Source: BNB.

Chart 66
Business Climate Indicator

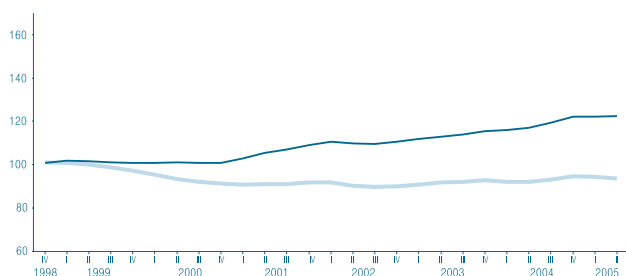


Source: NSI, business survey.

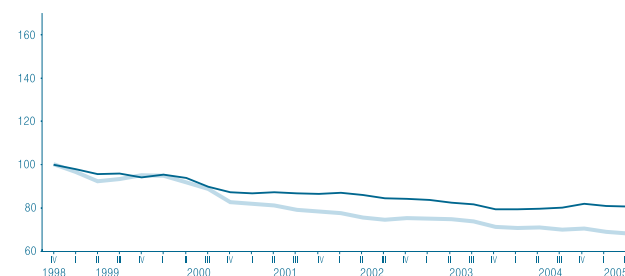
Chart 68

Unit Labour Cost (Quarterly)

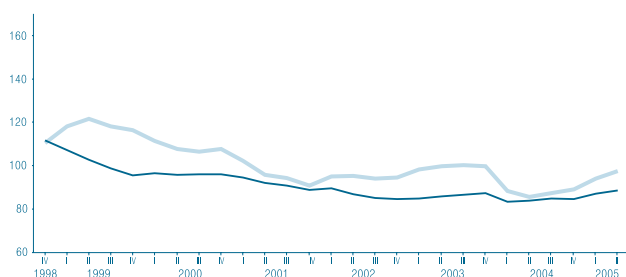
Total for the Economy



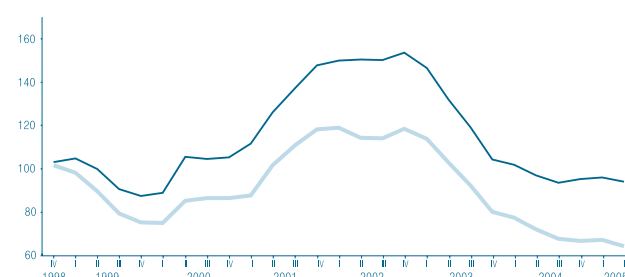
Manufacturing



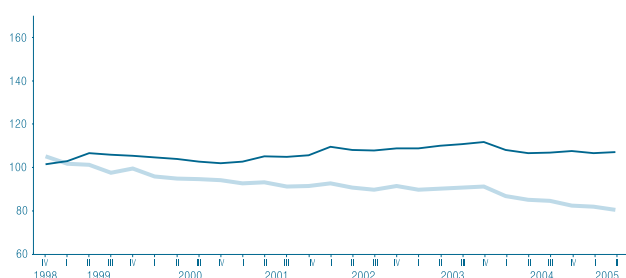
Agricultural Sector



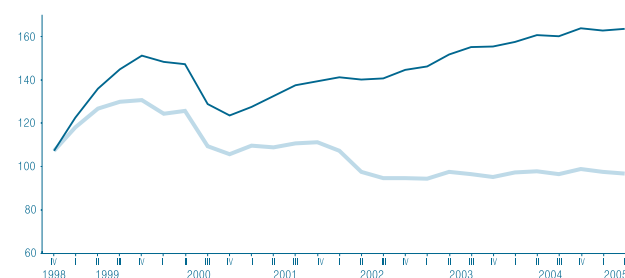
Mining and Quarrying



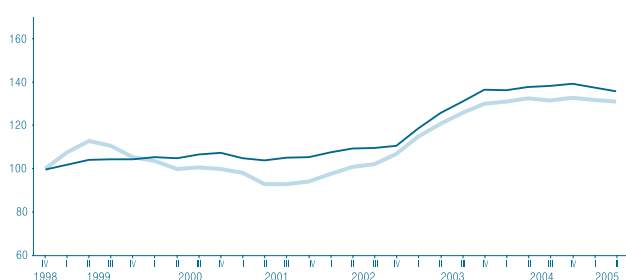
Construction



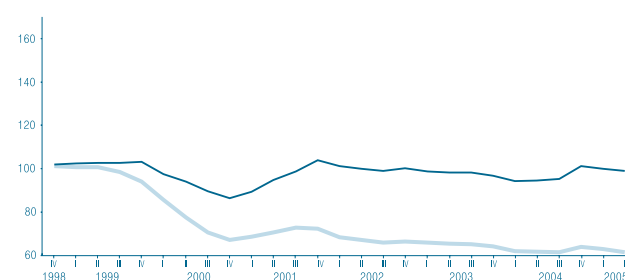
Electricity, Gas and Water Supply



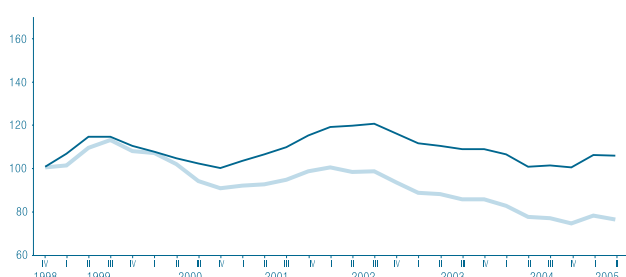
Trade



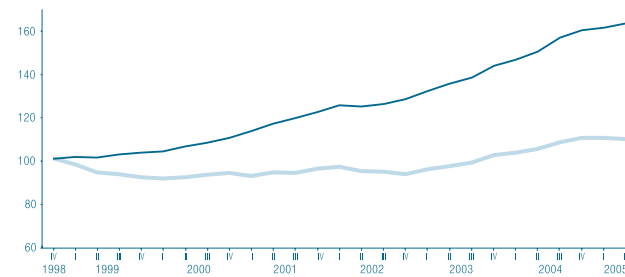
Transport and Communications



Financial Intermediation



Other Sectors



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

Source: NSI, BNB.

agers in trade and services sector have traditionally been conservative and prudent in assessments about economic conditions. As a result, the level of economic activity in these sectors is often underestimated. Concurrently, assessments about order backlogs in construction and industry prove to be stable which is an important positive sign.

Cost competitiveness measured by the *unit labour cost* indicator in the tradable sector (manufacturing) continued improving. This trend is expected to sustain in the following years as a result of the new investment in the sector. In real terms, this indicator for the whole economy measured by the gross value added deflator, sustained at a level well under the average for 1998. This is an important factor for maintaining the export capacity of the economy and the stability of the fixed exchange rate.

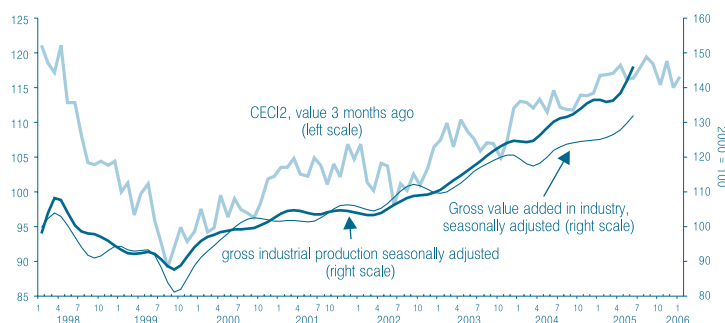
Exports and Imports of Goods

Between January and September 2005 exports in euro reached EUR 6800.3 million, a nominal increase of EUR 1002.1 million, or 17 per cent on the corresponding period of 2004. Imports (FOB) amounted to EUR 9591.7 million, rising nominally by EUR 2020.7 million on the corresponding period of 2004, or 27 per cent. Forecasts for accelerating export growth in the fourth quarter of 2005 and the first quarter of 2006 reflect expectations of increasing external demand (particularly in the euro area) in the respective periods and improving competitiveness of the Bulgarian economy. Import growth is expected to slow down compared with the 33 per cent growth rate in the third quarter of 2005¹¹ primarily as a result of keeping international prices of raw materials unchanged until year-end and improving terms of trade in Bulgaria. Domestic demand is anticipated to stay high in the following two quarters reflecting the expectation for a nominal import growth of 22–24 per cent on an annual basis in the fourth quarter and 18–21 per cent in the first quarter of 2006.

No dramatic changes are expected in growth rates by commodity group and in commodity group contributions to total exports until year-end and in the first quarter of 2006.

¹¹ Over the third quarter import nominal growth (on an annual basis) hit a record high for the last five years.

Chart 67
Expectations of Industrial Production

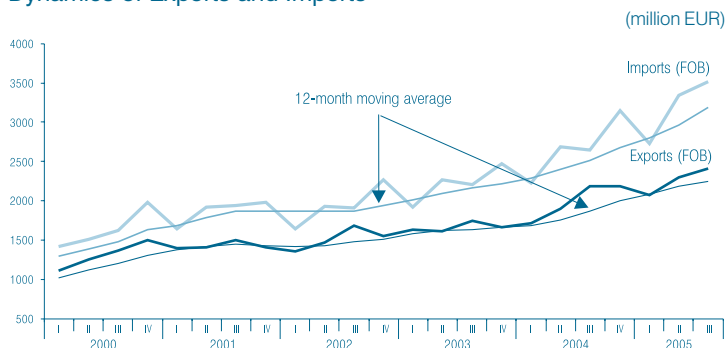


Source: NSI, BNB.

The improving competitiveness of the Bulgarian economy and accelerating euro area growth supported the expectations of annual growth rates of nominal exports in euro at 20–23 per cent for the fourth quarter of 2005 and 17–20 per cent for the first quarter of 2006. Domestic demand will retain high nominal rates of imports at 22–24 per cent for the fourth quarter of 2005 and 18–21 per cent for the first quarter of 2006.

According to projected export and import dynamics, the trade balance deficit will reach nearly 17–19 per cent of GDP in 2005. On a year-to-year basis, it will sustain its level in the first quarter of 2006.

Chart 69
Dynamics of Exports and Imports



Source: BNB.

Between January and September 2005 mineral products and fuels rose most dramatically (by 39 per cent on an annual basis), followed by machines, vehicles, appliances, instruments, guns (35 per cent) and animal and vegetable food products, food, drinks tobacco (25 per cent).

Among the factors behind the sizable growth in imports of mineral products and fuels were high petroleum prices. The average price of exported petroleum products (in euro) went up by 37.8 per cent and the physical volume of these products increased by 4.2 per cent.¹² The sizable growth in the physical volume of imported crude oil in the third quarter of 2005 is probably associated with enhanced exports of oil products at the end of 2005 and early 2006, consistent with the export-oriented nature of this industry. Consequently, the high nominal growth rates of exported petroleum products are expected to sustain and physical volumes to increase in the following two quarters.

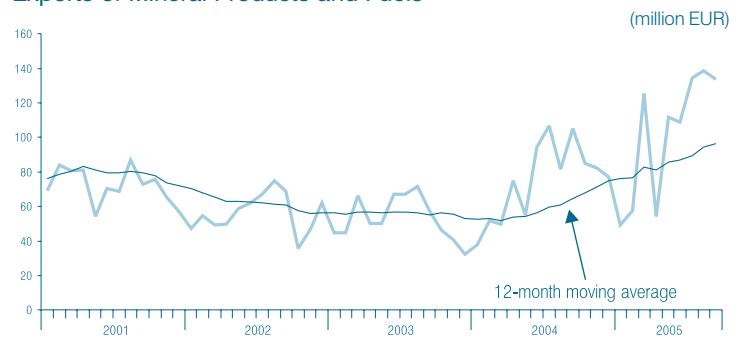
Exports of machines and vehicles between January and September 2005 increased by EUR 284.2 million, with the value reaching EUR 1089.4 million. Growth in machines and vehicles has ranked second after mineral products in recent years, and the share of this commodity group rose from 13.9 per cent between January and September 2004 to 16 per cent in the same period of 2005. Comparatively high growth rates are expected to sustain in the following two months.

In the first three quarters of 2005 exports of animal and vegetable products, food, drinks and tobacco rose by EUR 143 million on the corresponding period of 2004 to reach EUR 719 million. However, reported growth over the review period pertains to the positive developments in the first two quarters of the year, while in August and September exports in this commodity group slowed down by 11 and 3 percent respectively on an annual basis. Floods may be one of the reasons behind the slower growth in exported food. Based on a more detailed disaggregation, oil seeds and fruit (contributing to growth by 10 percentage points each) and cereals (contributing to growth by 9 percentage points) added most significantly to export growth, while tobacco and live animals had a negative contribution of -3 percentage points and -1 percentage point

¹² The average price of Brent type petroleum (in US dollars) increased by 47.5 per cent between January and September on the corresponding period of 2004.

Chart 70

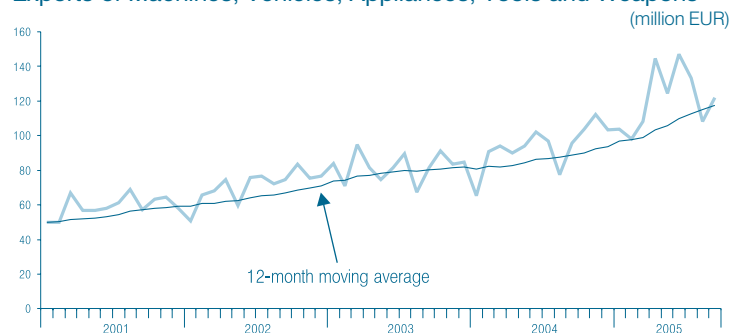
Exports of Mineral Products and Fuels



Source: BNB.

Chart 71

Exports of Machines, Vehicles, Appliances, Tools and Weapons



Source: BNB.

respectively. Following a 4 per cent decline in exports of food and drinks in the third quarter of 2005, expectations are for recovering positive growth rates in the following two quarters. However, the rates will lag behind total export growth.

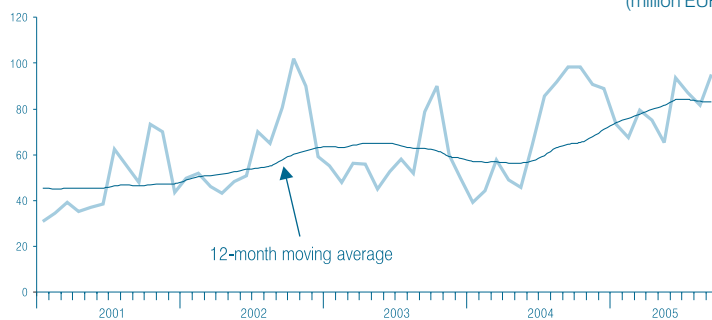
Solely, exports of textile, leather, footwear and miscellaneous consumer goods remained almost unchanged between January and September, with an insignificant increase of 0.2 per cent on an annual basis. Available data show reorientation of domestic manufacturers to internal markets (where sales in real term increased insignificantly in the first eight months of 2005) at the expense of exports. This reorientation is realized through a policy of limiting producer price rises which is expected to improve price competitiveness of these producers in the domestic market. The reason behind this reorientation could reflect the competition of foreign manufacturers, as well as limited practice of work with materials supplied by the customer and orientation of local companies to a higher income segment of the market. Forecasts about accelerated EU-25 growth in the following two or three quarters give grounds to expect a small positive growth in exports of textile, leather, clothing, footwear and other consumer goods.

Between January and September 2005 imports (CIF) reached EUR 10,404 million, a nominal increase of EUR 2195 million (26.7 per cent) on the corresponding period of 2004. Energy resources and investment goods displayed the largest growth (49 and 36 per cent respectively) in the structure of imports by use, with the latter contributing most significantly to import growth (9.2 percentage points). Accelerated growth of the value of imported energy resources reflected primarily high international prices of crude oil and petroleum products. The average price of imported crude oil rose by 45 per cent between January and September 2005 (in euro on an annual basis), while the physical volume growth for the same period was 13 per cent. Imported petroleum products over the review period increased by 23 per cent on the corresponding period of 2004. Over the fourth quarter of 2005 and the first quarter of 2006 these goods are expected to grow nominally at a slower rate than in the first nine months of 2005. The forecasts are based both on the expected movements in international prices of crude oil and the high base attained as a result of accelerated

Chart 72

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

(million EUR)

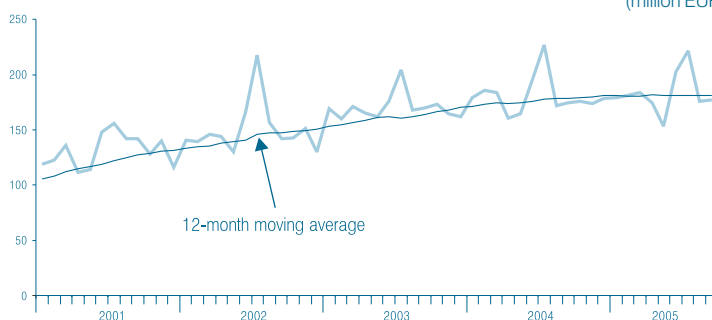


Source: BNB.

Chart 73

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

(million EUR)



Source: BNB.

Table 12

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

(percentage points)

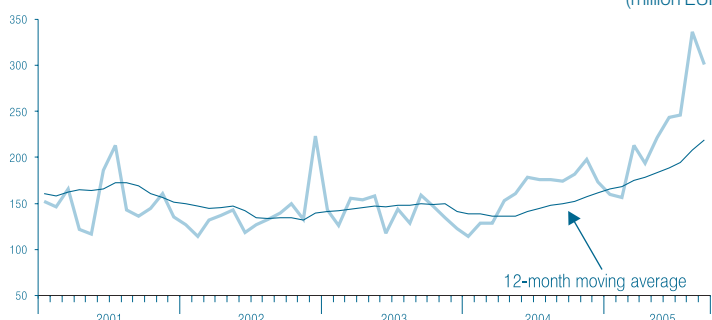
	Exports		Imports	
	growth	contribution	growth	contribution
Consumer goods	2.6	0.9	19.0	3.0
Raw materials	17.6	7.6	14.0	5.7
Investment goods	35.8	4.7	35.6	9.2
Energy resources	41.2	4.2	49.3	8.3
Other			70.4	0.6

Source: BNB.

Chart 74

Imports of Energy Resources

(million EUR)



Source: BNB.

growth at the end of 2004 and early 2005. International petroleum prices will probably stay at the level attained in the third quarter of 2005. However, imports in this group will continue to exceed total import growth.

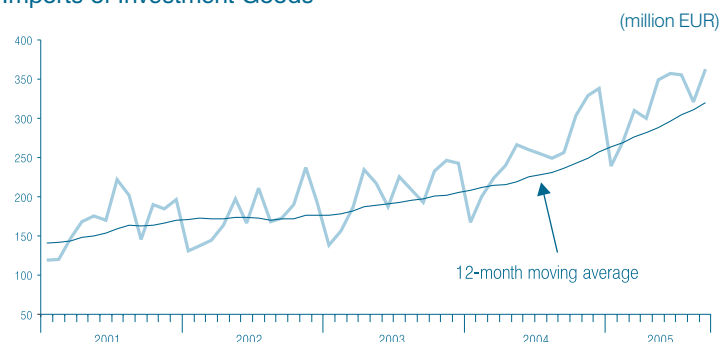
Imports of investment goods sustained its relatively fast growth rate in the third quarter of 2005 (37 per cent on an annual basis) posting a 36 per cent nominal growth between January and September. The value of imported investment goods grew by EUR 750 million over the review period to reach EUR 2861 million corresponding to GDP data (the nominal gross fixed capital formation increased by 22 per cent). The sustained high rate of imported investment goods in the third quarter of 2005 and the expectations for retaining the trend in the following quarters are the main factors behind the forecasts for the highest real growth in gross fixed capital formation to be attained until year-end.

The upward trend of accelerated imports of investment goods which started in 2004 is unlikely to sustain in the medium run. Therefore, the growth rates are expected to gradually subdue in the following two quarters sustaining total imports higher than the average.

Growth rates of imported consumer goods attained in the last quarter are foreseen to sustain in the following months. Imports of these goods boosted over the last three quarters to grow by 19 per cent in nominal terms. Imported consumer goods amounted to EUR 1568 million between January and June, up EUR 250 million on the corresponding period of 2004. Growth of these goods in the following two quarters is expected to stay around or under total import growth.

Raw material imports had a dominant share in overall commodity imports, weighting some 37 per cent since early 2005. Imported raw materials exhibited the lowest annual growth since early 2005 (just 14 per cent nominal increase between January and September 2005), the value reaching EUR 3790 million. Over the previous quarter growth rates slowed down (to approximately 15 per cent on an annual basis) after comparatively high growth of 18 per cent in the second quarter. In the following two quarters the dynamics of end-2004 and early 2005 is expected to sustain showing positive growth rates though under the growth rate of total imports. Forecasts are based on expected favourable economic development.

Chart 75
Imports of Investment Goods

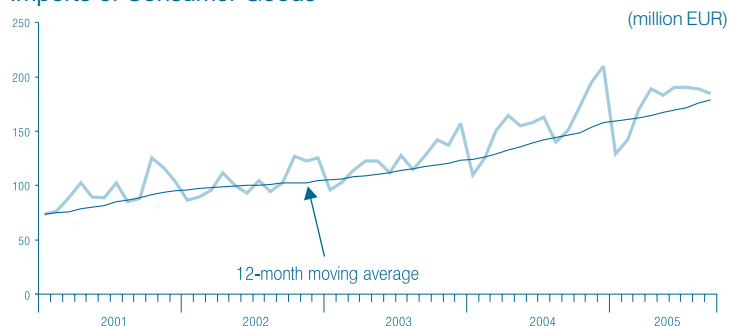


Source: BNB.

No changes in export and import geographic structures are expected until end-2005. 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 58 per cent of the nation's commodity exports for the first nine 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 50 per cent of overall imports between January and June 2005, with no signs of a change in the EU-10 share. The share of EU-25 is expected to stabilize at around 60 per cent by end-2005 and early 2006.

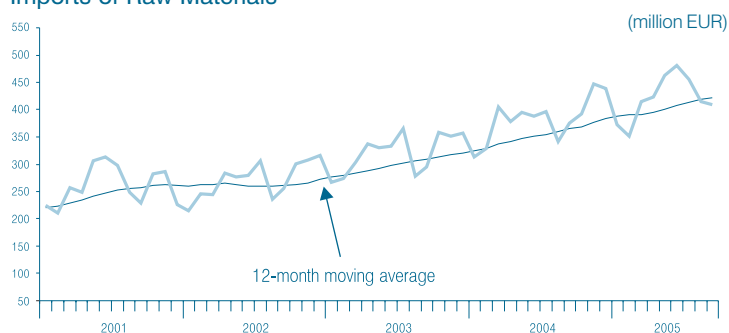
In the first half of 2005 growth rates in imports of goods and non-factor services was higher than export growth rates in real terms (according to the System of National Accounts data). This trend is expected to sustain in the following quarters. Exports of goods and non-factor services are foreseen to grow between 6 and 10 percent (in terms of physical volume), consistent with strengthening competitiveness of Bulgaria's industry and improved terms of trade until year-end. As regards imports of goods and non-factor services, growth ranging from 9.6 to 13 per cent is foreseen for the fourth quarter of 2005 and first quarter of 2006, consistent with the projected dynamics of domestic demand, which following the reported slowdown in the third quarter, is likely to accelerate. No significant effects of the EUR/USD exchange rate on foreign trade volumes is anticipated.

Chart 76
Imports of Consumer Goods



Source: BNB.

Chart 77
Imports of Raw Materials



Source: BNB.

4. Inflation

Inflation accumulated between January and October came to 4.5 per cent, up nearly 2.5 percentage points on the corresponding period of the previous year. High crude oil prices affected directly fuel prices on the domestic market and indirectly prices of other goods and services. Fears of shortages in farm production supply due to the summer floods impacted expectations and pushed prices of unprocessed foods. On an annual basis, inflation accelerated to 6.5 per cent in October.

Growth in administratively set prices was lower than in the previous year, with their contribution to end-year inflation expected to reach 1.3 percentage points. Pharmaceuticals contributed most significantly to inflation growth (0.5 percentage points). Heating prices are expected to rise by some 8 per cent by the end of the year as a result of fuel price rises. In October, 50 kWh night charge at preferential prices for homes without central heating was removed. As a result, no traditional October decline in average monthly electricity prices by nearly 1 per cent occurred. A significant increase in excise rates is expected in the first quarter of 2006, with the contribution to inflation by 2.5 percentage points (see the box). In early 2006 rises in administratively set prices (16 per cent on annual basis) will be of key significance to overall inflation, with prices of uncontrolled goods and services staying at nearly 6 per cent.

As of October core inflation¹³ came to 6.8 per cent on an annual basis, thus exceeding overall inflation as a result of significant food and fuel price rises. This trend will continue until the end of the year, reflecting both the expected seasonal increase in food prices and direct and indirect effects of fuel price hikes on the prices of other goods and services.

¹³ Defined as inflation in uncontrolled-price goods and services.

Inflationary expectations accumulated in anticipation of agricultural produce supply shortage due to damages caused by floods and declared intentions of electricity and heating price rises and rises in excise duties, as well as fluctuations in international fuel prices posed risks of increased inflation to 5.4–6.5 per cent by year-end and to some 8.2–8.4 per cent by the close of the first quarter of 2006 on an annual basis.

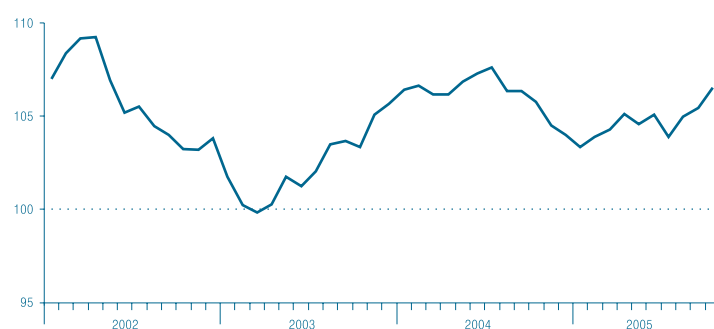
Table 13
Inflation Accumulated since Year's Start

	January – October	
	2004	2005
Inflation	2.05	4.54
Contribution		
Foods	-1.49	1.26
Non-foods	1.52	1.78
Fuels	0.46	0.83
Catering	0.13	0.28
Services	2.02	1.23
Goods and services with administratively set prices	2.76	0.90
Controlled-price goods	1.16	0.70
Tobacco	1.19	0.25
Controlled-price services	1.60	0.20
Electricity and heating	1.07	0.14

Source: NSI.

Chart 78
Consumer Price Index

(on an annual basis)



Source: NSI.

Change in Excise Rates in 2006

In line with the commitments assumed under Chapter 10, Tax Policy, Bulgaria is in the process of harmonizing excise duty rates with the minimum ones in the European Union. To decrease the inflationary burden of excise goods in the years when Bulgaria is expected to join ERM II, the following adjustments were made. The initially planned increases in excise rates on alcohol for 2007 and on tobacco for 2008 were rescheduled for the beginning of 2006. Thus, tobacco prices are expected to rise by some 65 per cent in the coming year, and alcohol prices by 17 per cent. In addition, adjustments in excise duty on petrol and gas oil will prompt 4.6 and 4.9 per cent rises in their prices. The overall effect of harmonizing excise duty rates is estimated at 2.5 percentage point contribution to inflation, with the bulk of this inflation evolving in the first quarter of 2006 due to the way of introducing new excise rates.

Table 14
Excise Price Goods Effect on Overall Inflation

Excise goods groups	Weights in consumer basket for 2005	Price rise, 2006 (%)
Alcohol drinks	0.36	17.20
Tobacco	3.60	65.00
Petrol	2.11	4.64
Gas oil	0.21	4.89
Total contribution to inflation (percentage points)		2.51

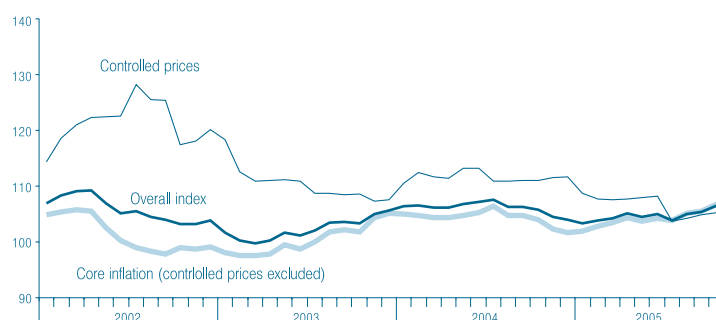
Source: Agency for Economic Analysis and Forecasting.

In October domestic transportation fuel prices fell for the first time on a monthly basis. Thus, the annual price rise in this consumer group accounted for 16 per cent. Household fuel prices rose by 4.4 per cent on a year-on-year basis consistent with the price increase in gaseous and liquid fuels in the autumn. Sustained high prices of crude oil and appreciated US dollar pushed year-on-year transportation prices up to 14 per cent, with their indirect effect evolving until the end of the year (an 8 per cent rise in passenger railway and airplane prices). Since early 2006 adjustments in excise rates on petrol and gas oil (see the box) are expected to push these fuels' prices by 4.6 and 4.9 per cent respectively. This indirect effect will be increased by expected rises in road charges and insurance services.

In October prices of non-food goods (excluding controlled-price ones) and fuels rose by 1.3 per cent on a year-on-year basis, most likely reflecting the appreciating US dollar since mid-2005 and price adjustments to higher fuel and transportation prices. Until the close of the year no significant increase in this consumer group's prices is expected due to the Bulgarian economy's openness and imported goods competition. Inflation in market services (excluding controlled-price ones) will retain its annual growth rate of nearly 7 per cent by the year's end, with a slight increase in early 2006 reflecting the indirect effect of high fuel prices.

Chart 79
Price Indices

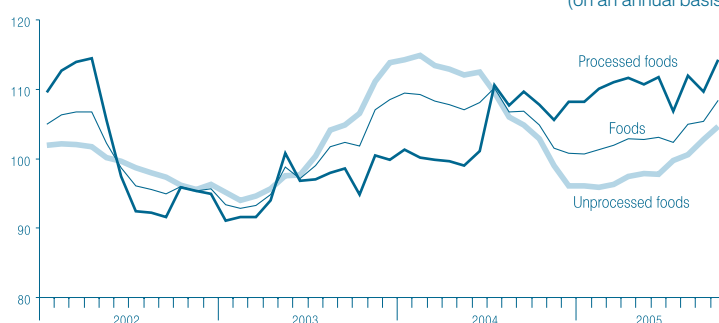
(on an annual basis)



Source: NSI, BNB.

Chart 80
Price Indices

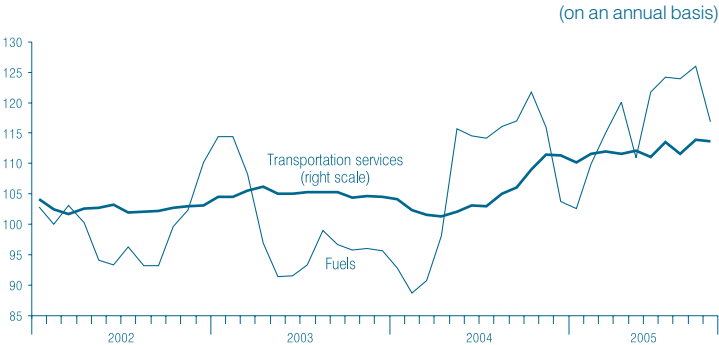
(on an annual basis)



Source: NSI, BNB.

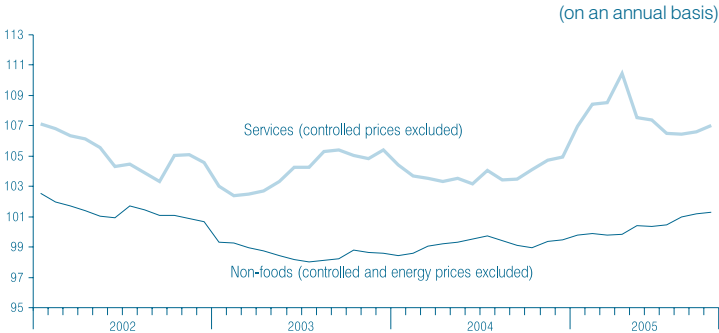
Estimates put end-2005 inflation at 5.4–6.5 per cent, a result of the accumulated inflationary pressure over the second half of the year. The average annual inflation for 2005 is likely to reach 5 per cent. In early 2006 administratively set prices will increase significantly, reflecting primarily excise duty changes. This will push the annual inflation rate up to approximately 8.2–8.4 per cent.

Chart 81
Price Indices



Source: NSI, BNB.

Chart 82
Price Indices



Source: NSI, BNB.