

Economic Review

2/2006



BULGARIAN
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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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Highlights

- Amendments to BNB Ordinance No. 9 and Ordinance No. 21 Adopted in Early 2006 30

Abbreviations

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
mt	metric tons
NPISHs	Non-profit institutions serving households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	Purchasing Power Parity
WB	World Bank

Summary

Global economic indicators continued to improve over the first quarter of 2006, with world trade growth accelerating to 11 per cent on an annual basis. The world economy is expected to continue growing in the second and third quarters, Asian and European economies taking the lead. Growing geopolitical uncertainty posed risks for growth by increasing volatility in crude oil and energy resource prices.

Over the first quarter of 2006 the US economic activity was higher compared with end-2005. According to market expectations, growth will slow down to some 3–3.3 per cent in the second and third quarters, reflecting mostly slowing private consumption. The US Federal Reserve System has raised the federal funds rate three times since early 2006, in increments of 25 basis points, bringing its level to 5 per cent. Expectations are for retaining the current level or a further increase of 25 basis points.

Preliminary euro area GDP data show a 2 per cent increase on an annual basis over the first quarter of 2006, investments in fixed capital contributing most significantly to this effect. Thus, forecasts of euro area growth were revised upwards, the European Commission projecting a 2.1 per cent growth in 2006. At its meeting in early March 2006, the ECB Governing Council raised the repo rate by 25 basis points to 2.5 per cent, reflecting higher inflationary risks. According to current market expectations, the repo rate is expected to rise by 25 basis points in early June and at the end of August.

In the first quarter the US dollar depreciated against the euro. Uncertainty associated with US and euro area monetary policy will affect exchange rate dynamics in the coming two quarters. However, the downward trend for the US dollar is expected to sustain in a long-term horizon.

Increased concerns about shortages in crude oil supply prompted significant fluctuations in its price. Market expectations are for Brent oil average monthly price to range between USD 65 and USD 75 *per barrel*, reflecting primarily geopolitical factors. International raw material prices are expected to retain their upward trends.

Over the first quarter of 2006 BNB international reserves declined by BGN 692.1 million and by March the Issue Department balance sheet figure reached BGN 13,723 million. International reserve dynamics reflected mostly government operations related to early debt repayments to the World Bank and the IMF and making a deposit to purchase equipment for the Ministry of Defence.

In early 2006 the balance of payments current account deficit almost doubled compared to the first quarter of 2005. All major current account components contributed to this growth, with worsening trade balance taking the lead. The current account deficit is expected to rise in the second quarter, whereas projections for the third quarter show an improvement.

Significant foreign direct investment inflows on the balance of payments financial account between January and March 2006 are likely to continue in the coming two quarters. Expected positive flows of borrowings coupled with high foreign direct investments will contribute to international reserve growth. The financial account surplus will exceed the current account deficit and international reserves will rise by approximately EUR 1 billion over the second and third quarters.

Credit limits exceeded by particular banks and deposited additional minimum required reserves were the major reasons behind accelerating growth in reserve money over the first quarter. Bank reserves by end-March 2006 rose by 53.2 per cent on March 2005. Annual growth rates of broad money and credit slowed significantly in the first quarter due mainly to the high March 2005 base. Excluding credit portfolios from banks' balance sheets contributed considerably to the credit slowdown. Comparatively high levels of banks' net foreign assets at the end of the first quarter are partially ascribable to transferring a portion of newly extended loans to non-

residents. The relative share of loans to households in the structure of claims on the non-government sector continued rising to reach 37.5 per cent as of March 2006.

To achieve greater efficiency of BNB restrictive bank credit measures, new statutory amendments were adopted in February 2006 to discontinue the existing practice of transforming and replacing bank loans with other debt instruments. Ordinance No. 8 was also amended with regard to determining risk weight of mortgage loans. Given the assumption that banks will adhere to imposed restrictions, a 22–23 per cent annual growth in claims on the non-government sector may be expected in the second and third quarters of 2006.

Interest rates on time deposits increased in the first quarter as a result of rising international rates, this trend most likely to sustain in the coming two quarters. Lending interest rates are expected to stay at the current levels.

Amid high consumption and investment activity in 2005, gross domestic product rose by 5.5 per cent. Household consumption behaviour continued to be driven by increasing employment and incomes. In 2006 consumption will progressively rise, with a certain slowdown in the third quarter due to the prior year's high base.

Investments in fixed capital grew by 19 per cent in 2005. The increasing share of investments in GDP underpinned Bulgarian producers' competitiveness. Currently, a significant reserve has been accumulated in the economy to ensure sustainable competitiveness in case of short-term growth in unit labour costs. Available data give reason to expect high investment growth with a certain slowdown in the second half of the year. Overall, economic growth will remain high in the second and third quarters.

Export and import growth rates at the end of 2005 matched those in the first quarter of 2006 under the strong influence of high international prices. Goods exports are expected to grow annually by 23–25 per cent in the second quarter and by 25–29 per cent in the third quarter of the year, consistent with recovering euro area growth and the upsurge in key export-oriented sectors of the Bulgarian economy. Retention of energy resource prices at current high levels and expected moderate growth in domestic demand will maintain nominal growth rates of goods imports at 23–25 per cent in the second quarter and approximately 15–19 per cent in the third quarter. The trade balance deficit as a share of GDP will reach some 21.9–22.2 per cent annually in the second quarter and approximately 21–21.5 per cent in the third quarter.

Inflation accumulated between January and April came to 4.6 per cent, reflecting mainly increased excise on cigarettes and sugar price rises on international and domestic markets. If cigarettes are excluded, inflation accumulated in the first four months of 2006 is 1.95 per cent, down 1 percentage point on the same period of the previous year. Over the second quarter of 2006 inflation is anticipated to stay at approximately 8 per cent on an annual basis, reflecting primarily the increased petrol price. In the third quarter consumer price inflation is projected to slightly fall compared with the second quarter. Risks to the projection may arise from world fuel price dynamics and its effect on the domestic market.

1. External Environment

Improving economic indicators underpin expectations of accelerating world growth rates in the second and third quarters of 2006. Due to crude oil price rises, risks of higher inflation increased. In accordance with market expectations, the US federal funds rate may be retained at the current level or may rise by 25 basis points, whereas euro area repo rates are likely to increase twice: by 25 basis points in early June and by another 25 basis points at the end of August.

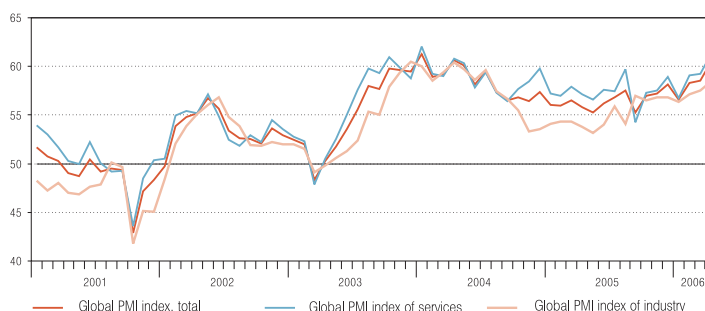
Current Business Situation

Global economic indicators continued improving in early 2006, especially in industry and services. World trade growth accelerated, its annual rate reaching 11 per cent over the first quarter. Asian and European economies are expected to occupy leading positions in accelerating world economic growth in the second and third quarters of 2006. Risks may arise from enhanced global uncertainty associated with Iran's nuclear programme. This leads to a stronger volatility in international crude oil and fuel prices.

The USA

Over the first quarter of 2006 the US economic activity picked up compared with the last quarter of 2005: GDP grew by 3.6 per cent on an annual basis, with private consumption (primarily durables) and investments in business equipment contributing most significantly to growth. Government consumption also added to growth: in the first quarter expenditure went on reconstruction of the regions hit by last summer's hurricanes.

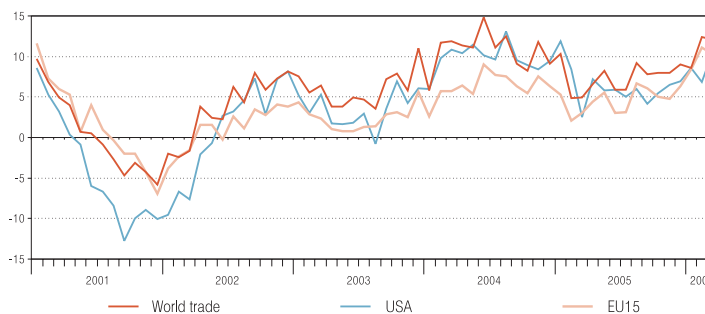
Chart 1
Global PMI Indices



Source: NTC Research, JP Morgan.

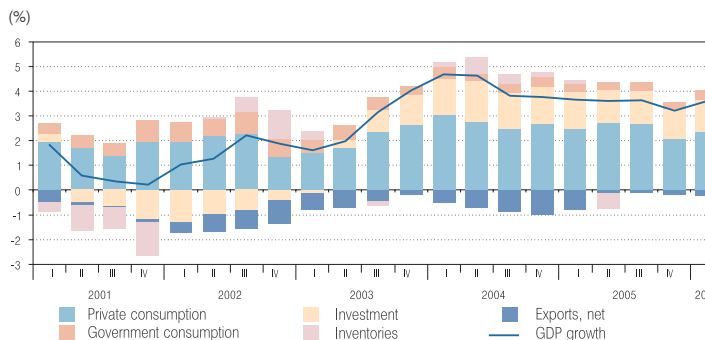
Chart 2
World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 3
Contribution to US Growth by Component



Source: Bureau of Economic Analysis.

According to market expectations, in the second and third quarters of 2006 growth may gradually slow to levels of approximately 3–3.3 per cent which are close to long-term rates. The main force behind this projection may be lower private consumption owing to higher interest rates and gradually subduing activity on the US housing market. Government expenditure will also fall with exhausting the one-off effect of first quarter's reconstruction expenditure. The improving conditions on the labour market (higher incomes and employment) and exports of goods and services are projected to support economic activity. The upward trend in corporate profits over the first quarter is likely to boost the investment activity's positive contribution over the second and third quarters of 2006.

During the first four months of 2006 inflation was driven by fuel price dynamics. Consumer price inflation averaged 3.6 per cent on a year-on-year basis, whereas import price dynamics (disregarding the effect of petrol prices) showed a certain slowdown to 1.5 per cent annually. The upward producer price pace also slowed down. In April core consumer inflation rose to 2.3 per cent annually, still remaining stable at 2.1 per cent over the first four months. Increased housing rents contributed sizably to higher core consumer inflation in March and April.

In the second and third quarters of 2006 the US core inflation is likely to stay at approximately 2 per cent on an annual basis. Albeit increasing on a quarterly basis, the US labour productivity growth in the first quarter reflected cyclically improving economic activity. Consequently, dynamics in this indicator is anticipated to match long-term trends. This supports expectations of stable core inflation.

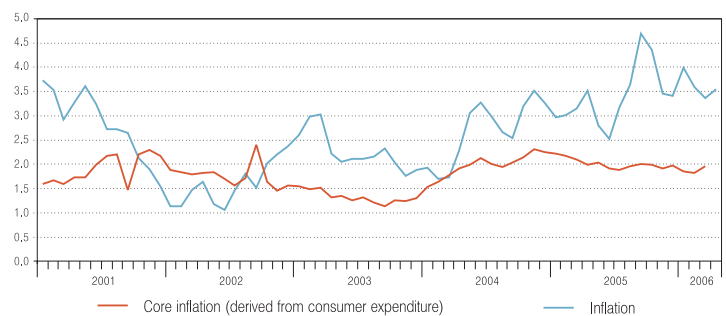
Overall inflation will continue to depend on petrol price movements, with its level in the second quarter likely to exceed the first quarter's level due to high oil prices in April and May.

Major risks to the US price level in the following two quarters are associated both with fuel price rises and robust consumer

Chart 4

US Inflation Rate

(change on same period of previous year, %)

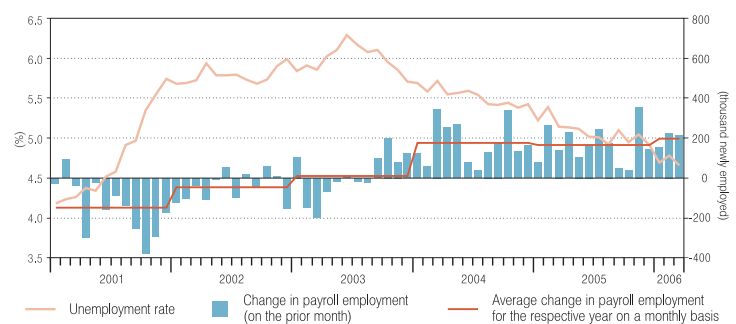


Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

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

Chart 5

US Unemployment Rate and Change in Payroll Employment

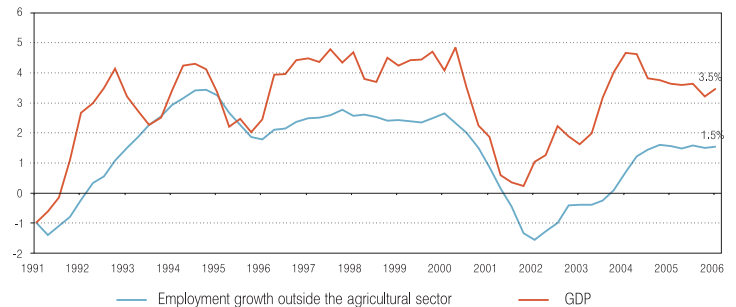


Source: Bureau of Labor Statistics.

Chart 6

US Growth and Labour Market

(on an annual basis, %)

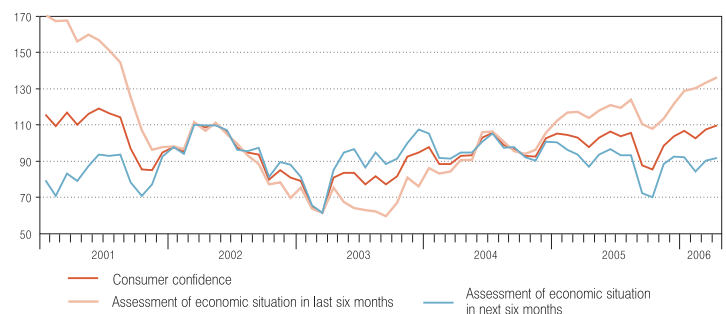


Source: Bloomberg.

Chart 7

US Consumer Confidence Indicators

(1985 = 100)



Source: The Conference Board.

demand. As a result, enterprises may be more inclined to raise prices of products and services offered.

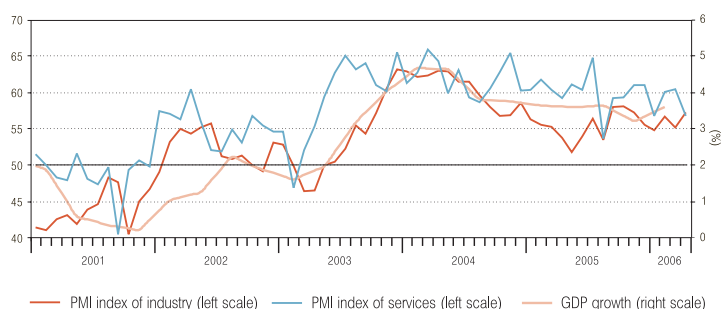
Over the first quarter unemployment went down to 4.7 per cent, with employment rate remaining steady (1.5 per cent on an annual basis).

In line with market expectations, in early 2006 the Federal Reserve System three times raised the federal funds rate by 25 basis points to 5 per cent as of May. Markets expect retention of the current level or a further rise by 25 basis points at the end-June meeting. Given the assumption that the increase to 5 per cent is the last for the current interest rate cycle, the rate on six-month LIBOR deposits in US dollars is likely to fluctuate between 5 and 5.3 per cent until end-September.

Euro Area

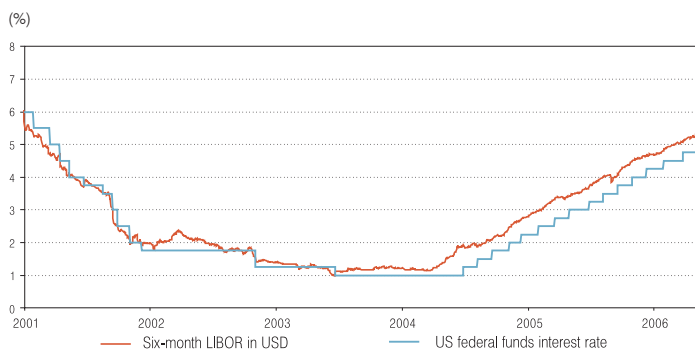
Moderate expansion of economic activity in the euro area continued in 2006. According to preliminary data, over the first quarter of 2006 euro area GDP rose by 2 per cent on an annual basis against 1.8 per cent in the prior quarter. Investments in fixed capital (most of the time stimulated by low interest rates) significantly contributed to economic growth in the reporting quarter. Investment activity was underpinned by robust external demand, reflecting the need to expand and renew production capacity and boost ex-

Chart 8
US PMIs and Growth



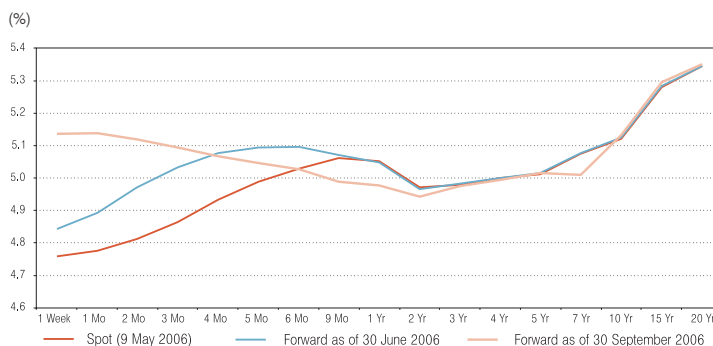
Source: Institute for Supply Management.

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



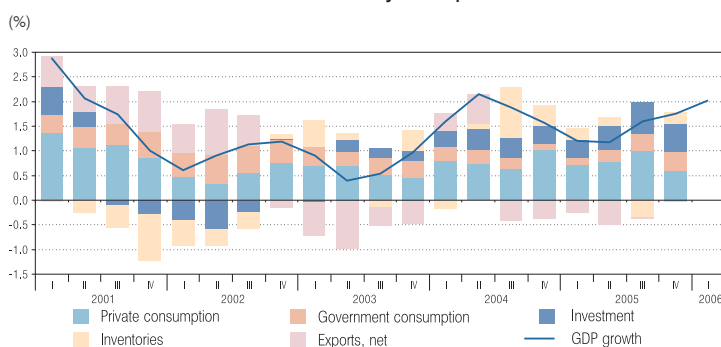
Source: Bloomberg.

Chart 10
Expected US Yield Curve



Source: Bloomberg.

Chart 11
Contribution to Euro Area Growth by Component



Source: Eurostat.

ported production. Simultaneously, low consumption activity was observed owing to stagnated employment, slowing real income growth and high propensity to save. Consumer budgets were also adversely affected by high fuel prices.

The expansion of the European economy is evident in the sustainable rise in leading business climate indicators over the first quarter. The PMI indices measuring the current condition of economic activity also picked up to reach the highest values registered in the last five years. Expectations based on economic indicators show a progressive trend to a moderate upsurge of the euro area economic growth over the second and third quarters of 2006.

ECB latest forecasts (March 2006) of GDP growth in 2006 and 2007 were revised upwards to 1.7–2.5 per cent (the previous forecast: 1.4–2.4 per cent) for 2006 and to 1.5–2.5 per cent (the previous forecast: 1.4–2.4 per cent) for 2007. The EC spring forecasts of euro area economic growth were revised upwards to 2.1 per cent for 2006.

In April consumer price inflation in the euro area came to 2.4 per cent annually (reflecting mainly increased fuel prices) following its moderate decline over the first quarter. The average core inflation was 1.3 per cent on an annual basis for the first four months of 2006. Nevertheless, April saw an increase in core inflation to 1.5 per cent annually. Petrol prices, steadily retaining their high nominal levels, gave rise to concerns about second-round inflationary effects. Market indicators of inflationary expectations showed a similar risk.

Consumer activity is expected to remain low over the coming quarters which may result in a pressure on retail prices. Data on European companies' corporate results for the first quarter show that businesses have reserves to defray increased production costs rather than transfer them on end consumer prices. Slightly increased unit labour costs and the growing labour productivity also will contribute to retaining core inflation at the current level.

Chart 12

Euro Area: Incomes, Consumption and Savings

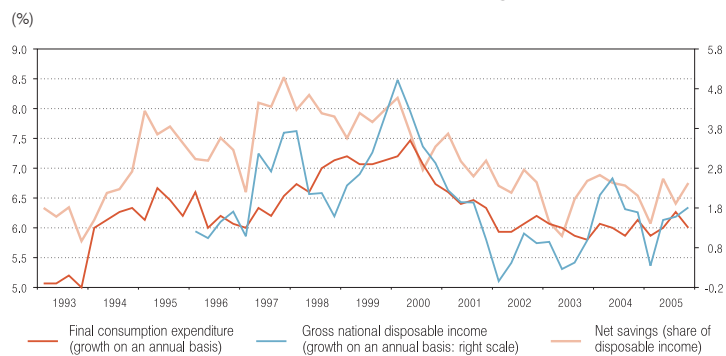
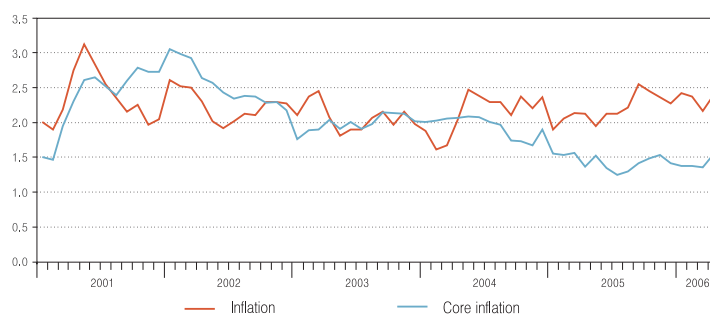


Chart 13

Euro Area Inflation Rate

(change on same period of previous year, %)



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

Chart 14

Euro Area Unemployment Rate

(%)

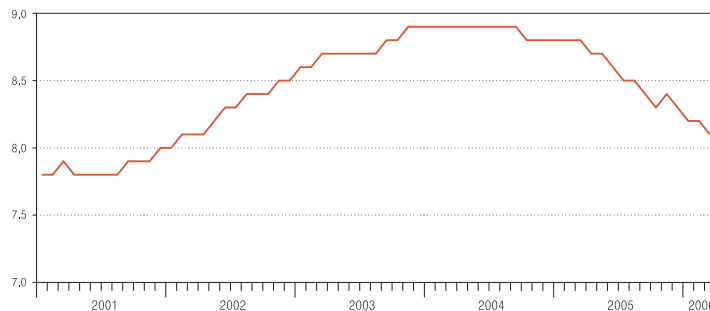
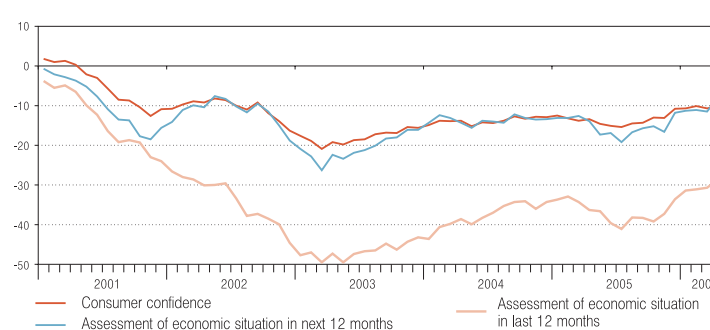


Chart 15

Euro Area Consumer Confidence Indicators

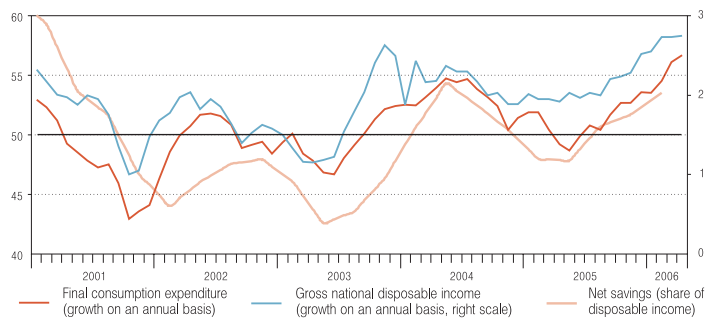


Risks may arise from euro area inflation dynamics in the future. They are associated with further petrol price rises and second-round inflationary effects on end consumer prices and salary negotiation. At the same time, a counteraction may be expected from declining selling prices of imported goods owing to the steady appreciation of the euro against the US dollar in April and May.

The fall in unemployment to 8.1 per cent between January and March is a sign of moderate improvements in the labour market. However, EC economic survey data for March and April show increasing concerns about employment in the following 12 months which corresponds with modest expectations of future consumer activity. In contrast, employment components of the PMI posted growth in services and industry.

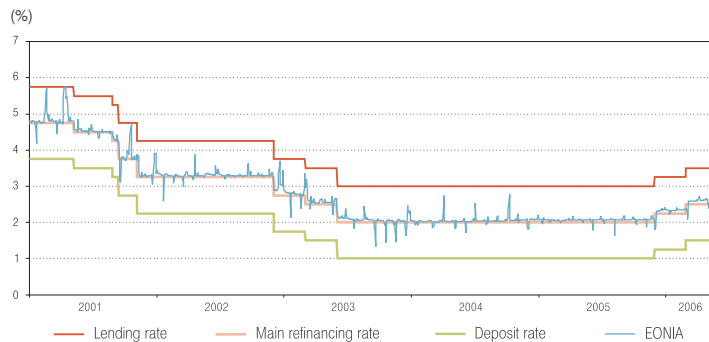
At its early March 2006 meeting, the ECB raised the repo rate by 25 basis points to 2.5 per cent, explaining the change with the need to maintain price stability in response to growing inflationary risks.

Chart 16
PMI Indices and Euro Area Growth



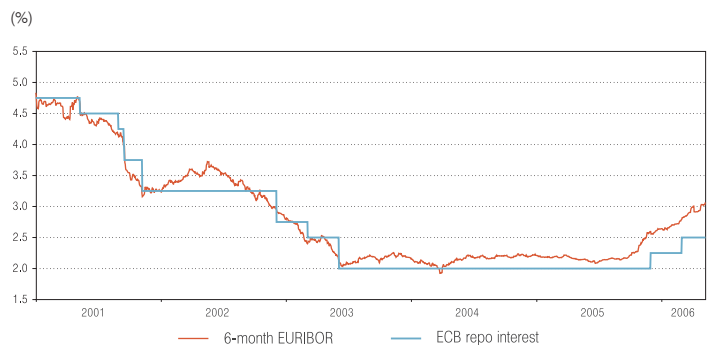
Source: Eurostat.

Chart 17
Euro Area Base Interest Rates



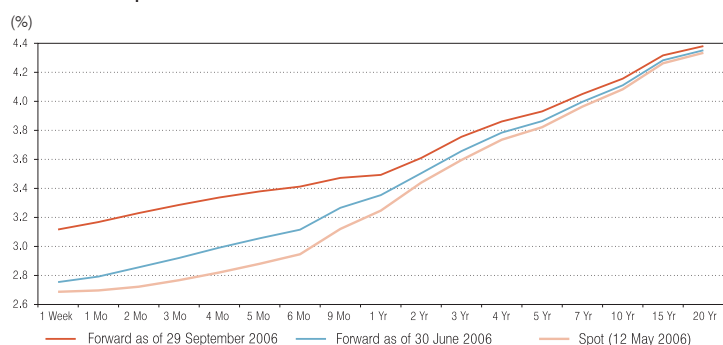
Source: Bloomberg.

Chart 18
BIR on Refinancing Operations and Six-month EURIBOR



Source: Bloomberg.

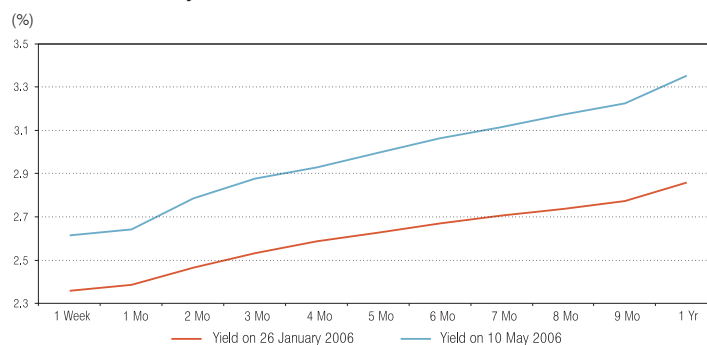
Chart 19
Curve of Expected Euro Area Yield



Source: Bloomberg.

The six-month EURIBOR deposit yield has risen since the beginning of 2006 to reach approximately 3.03 per cent in early May. According to current market expectations of a 25 basis point rise in repo rates in early June and at the end of August, the six-month EURIBOR deposit yield is expected to increase ranging between 3 and 3.5 per cent over the coming two quarters.

Chart 20
Euro Area Money Market Yield Curve



Source: Bloomberg.

The IMF and European Commission Spring Forecasts

In the spring the IMF¹ and the EC² published their latest forecasts of world economic developments between 2006 and 2007. Expectations of 2006 world growth were revised upwards, with most significant revisions to accelerated growth in China, India and Japan.

Expectations of euro area growth in 2006 show sustainable rates of 2 and 2.1 per cent. 2007 may see a slowdown due to the 3 percentage point VAT increase in Germany as from 1 January 2007 which will withdraw a portion of household consumption and investments from 2007 into 2006. Stable private consumption and comparatively high investment activity in industry will be the main motives behind US economic growth.

Economic growth risks for 2006 and 2007 reflected several factors. High and unstable oil prices pose a serious risk despite the lack of dramatic fluctuations in growth and inflation. It is quite possible that fuel price rise effects have not yet been manifested since consumers assess it as short-term. At the same time, free extracting capacities are minimal and each escalation in geopolitical uncertainty results in considerable crude oil price rises. Other risks to world growth stem from further US Federal Reserve System, ECB and Bank of Japan interest rate increases, as well as growing global imbalances, especially in US trade with Asian countries. A possible avian flu spread would have considerable economic and social effects on the world.

Major Trends in EC and IMF Spring Forecasts

(real percentage change)

			Spring forecast, 2006		Change on autumn forecast, 2005	
	2004	2005	2006	2007	2006	2007
EC						
EU						
GDP growth	2.4	1.6	2.3	2.2	0.2	-0.2
Euro area						
GDP growth	2.0	1.3	2.1	1.8	0.2	-0.3
Unemployment	8.9	8.6	8.4	8.2	0.0	0.1
Inflation	2.1	2.2	2.2	2.2	0.0	0.1
USA						
GDP growth	4.2	3.5	3.2	2.7	0.0	0.0
Unemployment	5.5	5.1	4.8	5.1	-0.2	
Inflation	2.7	3.4	2.9	1.6	0.0	
Japan*	2.3	2.7	2.8	2.4	0.6	0.6
China*	10.1	9.9	9.5	9.0	1.3	1.0
Latin America*	5.5	4.3	4.3	3.7	0.7	0.1
Asia (Japan excluded)*	8.1	7.9	7.7	7.5	0.5	0.5
Africa*	4.9	5.0	6.0	5.5	0.0	0.0
World growth	5.1	4.6	4.6	4.3	0.3	0.3
IMF						
EU						
GDP growth	2.5	1.8	2.4	2.3	0.2	-0.2
Euro area						
GDP growth	2.1	1.3	2.0	1.9	0.2	-0.3
Unemployment	8.9	8.6	8.3	8.4	-0.1	
Inflation	2.1	2.2	2.1	2.2	0.3	
USA						
GDP growth	4.2	3.5	3.4	3.3	0.2	-0.3
Unemployment	5.5	5.1	4.9	5.1	-0.3	
Inflation	2.7	3.4	3.2	2.5	0.4	
Japan*	2.3	2.7	2.8	2.1	0.8	0.5
China*	10.1	9.9	9.5	9.0	0.8	0.8
Advanced economies*	3.3	2.7	3.0	2.8	0.2	-0.2
Western Hemisphere*	5.6	4.3	4.3	3.6	0.5	0.1
Asia*	8.8	8.6	8.2	8.0	1.0	0.8
Africa*	5.5	5.2	5.7	5.5	-0.1	0.6
World growth	5.3	4.8	4.9	4.7	0.6	0.3

Source: EC and IMF.

* GDP growth.

¹ IMF, *World Economic Outlook*, April 2006.

² European Commission, *Economic Forecasts – Spring 2006*, May 2006.

EU-25

Over the last quarter of 2005 EU-25 growth accelerated to 2 per cent annually. New member countries' growth increased to 5.1 per cent over the reporting period. Poland (4.1 per cent), the Czech Republic (6.7 per cent) and Slovenia (5.1 per cent) contributed most significantly to overall growth.

Average monthly inflation in the newly acceded countries fell to 2 per cent over the first quarter of 2006, reflecting mainly lower inflation in Poland.

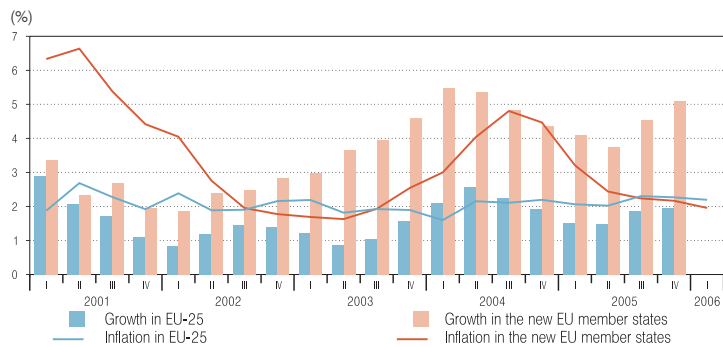
The USD/EUR Rate

During the review quarter the US dollar followed a trend to a gradual depreciation against the euro. This trend deepened after publication of the G-8 meeting's declaration which emphasized on global imbalances and the policy required for their balancing. The change in expectations toward narrowing interest differential between the USA and euro area also contributed to euro appreciation. This effect intensified in early May when the probability of discontinuing US interest rate rises began to dominate market expectations. This prompted the mid-May change in the exchange rate of USD 1.28 against EUR 1.

Over the second and third quarters the USD/EUR rate volatility is likely to increase on the first quarter. Uncertainty associated with future monetary policy in the USA and the euro area will further affect investors' attitudes. The long-term trend to the US dollar depreciation will be driven by the lack of policy of reducing external imbalances in several countries. To this end, financial flows of the US government bond market may be reoriented to other monetary areas and reserve currencies.

Chart 21

Growth and Inflation in EU-25 and in the New EU Member States



Source: Eurostat, BNB.

Chart 22

USD/EUR Exchange Rate



Source: Bloomberg.

The Balkan Region

Over the fourth quarter of 2005 Balkan countries posted comparatively high economic growth. Overall growth rates in 2005 were lower than in 2004 due to subdued external demand. Romania's low growth was mostly ascribable to reduced agricultural produce as a result of summer floods.

In the first quarter of 2006 inflation in this region increased, reflecting food and fuel price rises and increased administratively set prices in some countries (Romania, Turkey, Macedonia, and Bulgaria).

The favourable business climate is expected to sustain and even improve underpinned by enhanced external demand due to global growth acceleration in 2006.

Real Growth and Inflation in Balkan Countries

	2004					2005					2006
	I quarter	II quarter	III quarter	IV quarter	Total	I quarter	II quarter	III quarter	IV quarter	Total	I quarter
Growth (on the previous year, %)											
Bulgaria		4.6	5.5	6.2	6.3	5.7	5.9	6.5	4.6	5.5	
Greece		4.3	4.1	4.0	4.2	4.2	3.5	3.7	3.8	3.7	
Macedonia		3.4	4.8	4.6	3.4	4.1	2.9	5.0	4.1	3.8	
Romania		6.1	7.1	11.1	8.9	8.3	5.9	4.1	1.8	4.6	
Turkey		11.8	14.4	5.3	6.3	8.9	6.6	5.5	7.7	9.5	
Croatia		4.2	3.8	3.6	3.6	3.8	1.8	5.1	5.2	4.8	
Serbia and Montenegro		7.5	5.5	9.5	14.2	9.3	5.3	6.8	5.6	5.9	
Inflation (averaged for the period, %)											
Bulgaria		6.4	6.7	6.8	4.8	6.2	3.8	4.9	4.8	6.6	8.0
Greece		2.9	3.1	3.0	3.2	3.0	3.4	3.2	3.8	3.5	3.2
Macedonia		1.6	-0.5	-1.5	-1.1	-0.4	-0.4	0.9	0.8	0.8	2.7
Romania		13.6	12.3	11.9	10.0	11.9	8.9	9.9	8.9	8.5	8.6
Turkey		14.1	9.3	9.5	9.7	10.7	8.6	8.6	7.9	7.6	8.1
Croatia		1.8	2.3	1.8	2.3	2.1	3.1	3.0	3.4	3.8	3.5
Serbia and Montenegro		8.5	10.2	12.3	13.0	11.0	16.0	16.5	15.6	16.8	15.2

Source: Statistical institutes and central banks of respective countries.

International Prices of Major Raw Materials, Crude Oil and Gold

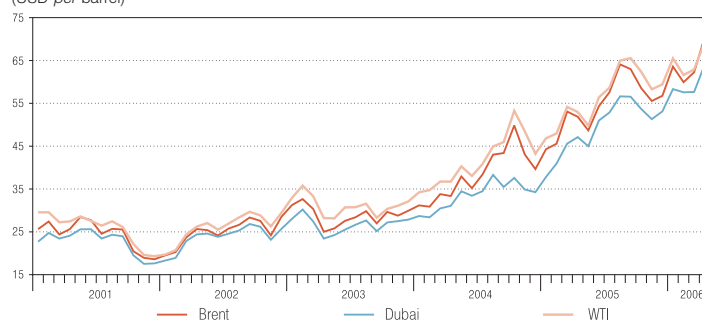
Crude Oil

In the first quarter and the beginning of the second quarter of 2006 concerns about possible shortages in crude oil supply increased, prompting great fluctuations in its price. The average monthly Brent price was USD 61.9 *per barrel* in the second quarter (against USD 56.9 *per barrel* in the previous quarter).

Geopolitical factors dominated market incentives and expectations. Over the first four months of 2006 terrorist attacks in Nigeria damaged oil facilities (those ensured 15 per cent of the country's output) which have not been restored as of May. Growing threats of terrorist attacks against Middle East's refineries (following the attempt to blow up one of the largest Saudi Arabia's and world's refineries) aroused serious concerns.

Chart 23
Crude Oil

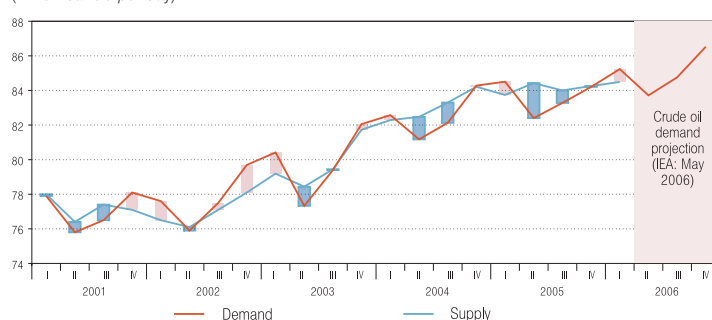
(USD *per barrel*)



Source: World Bank.

Chart 24
World Crude Oil Demand and Supply

(million barrels *per day*)



Source: IEA.

The Iran's nuclear programme and intensified confrontation with the USA predetermined market's ascending dynamics at the close of February. A possible military conflict resumed fears that the United Nations Security Council would impose trade sanctions against Iran. This country produces 3.9 million barrels daily, or 4.7 per cent of the world output. At the same time, the OPEC maintains high volumes of oil production, retaining a reserve capacity which would not be enough to offset a possible Iran's withdrawal from the market. In April and May the Brent price exceeded USD 70 *per barrel* (reaching the absolute maximum of USD 75 *per barrel* on 2 May).

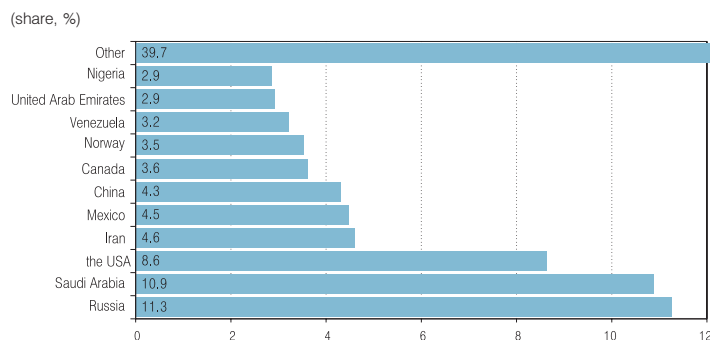
Market expectations put average Brent monthly price at USD 65–75 *per barrel*. Geopolitical factors, such as oil supplies, UN Security Council sanctions and fears of a military conflict, will mainly influence Brent prices. High volumes of OECD petrol product inventories will contribute to price falls. The US petrol inventories jumped to the seven-year high in May.

Risks to this forecast stem from a significant crude oil price rise under unfavourable geopolitical circumstances and poor weather conditions in the Gulf of Mexico over the third quarter (the height of the hurricane season).³

The price of the crude oil OPEC basket, calculated in euro, increased during the first quarter of 2005 up to EUR 47.9 *per barrel* (a 7.7 per cent rise compared with the previous quarter and a 43.9 per cent increase compared with the first quarter of 2005). Based on market expectations of the USD/EUR exchange rate, the price is projected to vary between EUR 49 and EUR 55 *per barrel* over the second and third quarters of 2006.

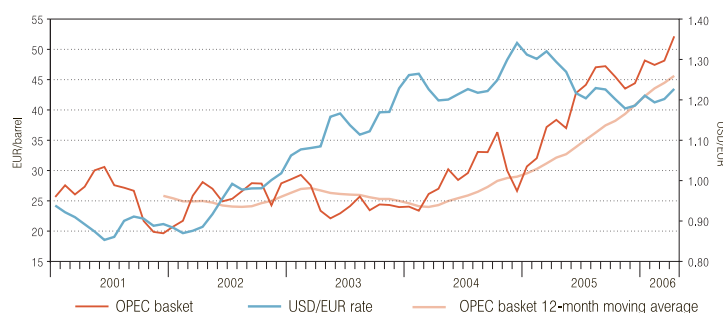
³ In May the US National Hurricane Centre published its forecasts for 2006. It predicted a very active hurricane season. Four to six high-category hurricanes (like Rita and Katrina in August and September 2005) are likely to occur.

Chart 25
World Production of Crude Oil in 2005



Source: IEA.

Chart 26
OPEC Crude Oil Basket Price in Euro



Source: World Bank, ECB, BNB, OPEC.

Major Raw Material and Commodity Prices

Over the first quarter of 2006 non-ferrous metal prices rose significantly. In the first four months zinc, copper and aluminium prices increased most significantly: by 69.3 per cent, 39.6 per cent and 16.6 per cent respectively. Low world inventories and enhanced industrial demand, especially in China and India, as well as speculative hedge fund demand gave grounds to concerns about longer-than-expected non-ferrous metal deficits. Steel prices did not

The Sugar Price

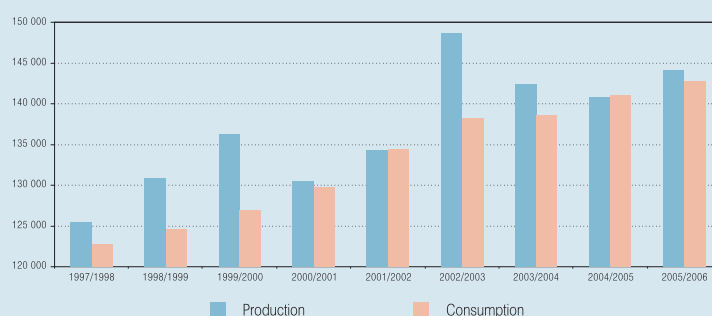
Over the first quarter of 2006 the sugar price in US dollars increased by 91 per cent on an annual basis. Intentions declared by Brazil (world's largest sugar exporter and producer) to use more sugar cane for ethanol production resulting in reduced sugar exports and declining EU sugar exports due to the restriction introduced by the World Trade Organization (partially removing quotas and admitting 49 sugar-producing countries to the EU market as from 2009) were the reasons behind the price hike. As a result of crude oil appreciation, the ethanol production has been rising in recent years with a view to its use as an alternative energy source. Major sugar producers are Brazil, the EU, India, China, and the USA, and major sugar exporters Brazil, the EU, Australia, Thailand, and Guatemala. Brazil's increasing output and its dominating position in sugar trade contributed to falls in international prices at the end of 90ies and their retention until 2005.

No deficits of sugar cane and sugar beet were reported worldwide. Restrictions were imposed on most producer countries by introducing high tariffs and limited import quotas in the USA, the EU, and India. Notwithstanding, continuing high oil prices stimulate the growing interest in alternative fuels in the long run. Brazil is an example of a country introducing new alternative fuel technologies. Ethanol produced in 2004 came to 14 billion litres which was enough to replace 40 per cent of petrol consumption, and 60 per cent of the new automobiles have hybrid petrol and ethanol engines.

Expectations of sugar price dynamics show retaining the appreciation to the level matching the first 2006 quarter's level. Motives behind this forecast are seen in increasing output and exports of smaller exporters as a result of the opening European market. This will compensate greater internal consumption of sugar cane for ethanol production in Brazil.

World Production and Consumption of Sugar

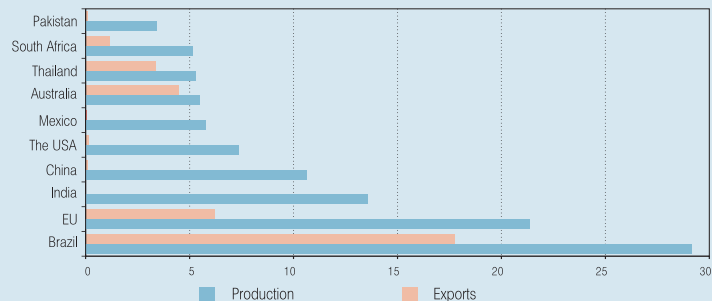
(thousand mt)



Source: United States Department of Agriculture.

Sugar Producers and Exporters

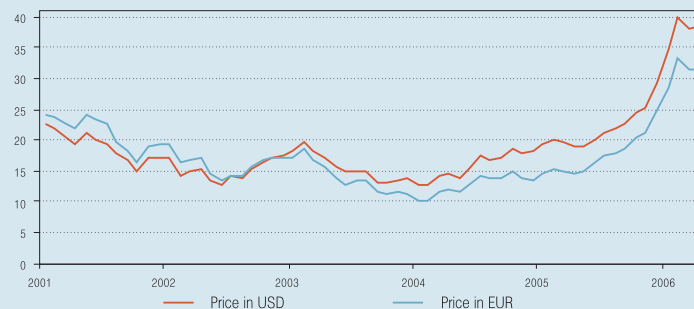
(million t)



Source: Illovo Sugar.

Sugar Price

(price/kg)



Source: World Bank.

change considerably over the first quarter thanks to the high world production growth (6 per cent in the first quarter).

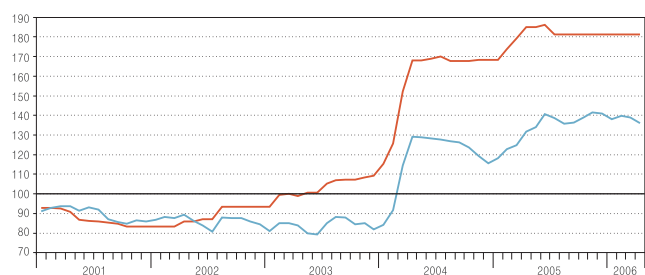
Expectations of metal prices remain unchanged: non-ferrous metals will continue to appreciate over the second and third quarters, and the steel price will retain its current level.

Food prices increased by 7.6 per cent annually over the first quarter. Wheat and sugar prices also grew. Drought in particular regions of the USA pushed wheat prices. The 2006–2007 yields are expected to decline by 11 per cent on the previous period. In contrast to poor crops in the USA, Russia and Ukraine, high yields are forecasted for Argentina, Canada, Australia and the EU. According to the US Department of Agriculture, the wheat price is most likely to rise by some 19 per cent in the case of poor weather conditions.

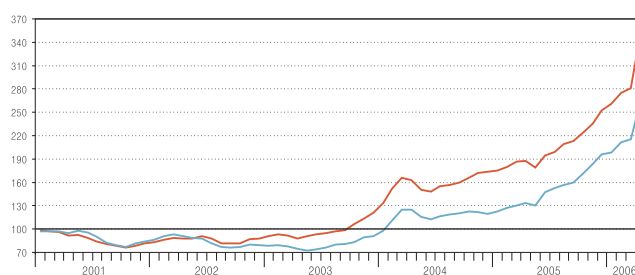
Sugar and corn prices posted growth as a result of increased demand for sugar cane used for ethanol production. In the second and third quarters of 2006 a slight appreciation is expected due to enhanced demand and growing probability of low-quality yields in several large grain exporters.

Chart 27
Price Indices of Major Commodities and Commodity Groups
(2000 = 100)

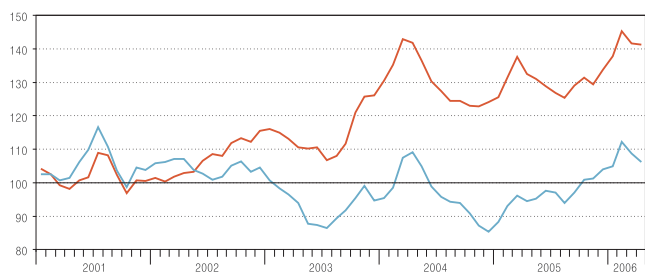
Steel



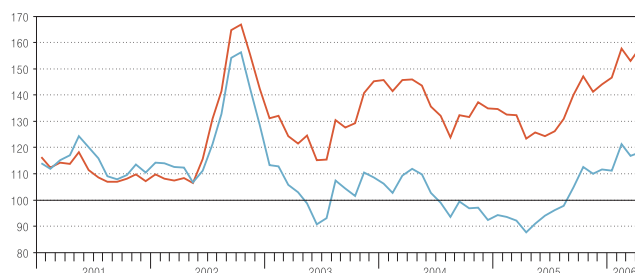
Copper



Food



Wheat



— USD — EUR

Source: World Bank, BNB.

Gold

During the first quarter of 2006 investment demand for gold increased, the gold price reaching record high levels. Gold's strong link with the US dollar, crude oil and non-ferrous metals was sustained, with the correlation between gold and the dollar remaining negative. The enhanced demand counteracted with increased inflationary expectations owing to oil price rises. The Iran's nuclear programme was the geopolitical factor exerting a permanent pressure on the gold price. Simultaneously, the downward trend in gold demand by Asia's jewelry industry was retained due to the high price pressure on this market segment.

Over the second and third quarters of 2006 market expectations show sustained international tension over Iran's nuclear programme which will increase demand for gold as a secure investment haven. The gold's link with the US dollar will probably persist, affecting the exchange rate behaviour. US short-term interest rates reached 5 per cent in tandem with increasing financing costs of gold positions. This will not stimulate some market participants. The announcement of the Bank of Japan that it will stop using monetary stimuli may also impact demand for future contracts. The GFMS (Gold Fields Mineral Services) analysis shows a possible increase in investment demand for gold in China and in physical demand in India, Iran, and Thailand. Despite the high gold price, no significant rise in production is expected. Moreover, the largest South Africa's gold mine announced an expected 50 per cent contraction in production.

Bulgarian External Debt Dynamics

The prior year's trend towards a progressively increasing interest in government debts of emerging markets was sustained in the first four months of 2006. Between January and May the spread on these countries' government debt securities, measured by the JP Morgan EMBI+ index, fell by 67 basis points, fluctuating around 180 basis points in early May. Despite the prospects for global interest rate rises, market partici-

Chart 28
Spot Price of Gold



Source: Bloomberg.

Chart 29
Spread of JP Morgan Index for Emerging Markets



Source: Bloomberg.

pants continued to assume greater risk, underpinning the enhanced demand for high-yield financial instruments. Improved macroeconomic conditions in most emerging countries and favourable fiscal results pushed up their debt securities' ratings.

The Bulgarian government securities spread, measured by the JP Morgan EMBI+ index, stayed stable, moving within the 70 to 90 basis point range. It was underpinned by the sustainable investor interest. Stable macroeconomic conditions, reduction in public sector's external debt and prospects for the pending Bulgaria's membership in the EU contributed most to this. In response to the sound fiscal position and favourable macroeconomic environment, in early March Moody's (after two other rating agencies) upgraded Bulgaria's foreign currency long-term debt rating to an investment grade.

The outlooks are for sustaining the stable investors' interest in Bulgaria's government debt over the second and third quarters of 2006. Factors which will progressively support the interest are the prudent fiscal policy of the government and stable macroeconomic environment boosting economic growth.

2. Financial Flows, Money and Credit

Over the recent years Bulgaria's economic development was determined by capital inflows. The increase in international interest rates in 2005 and the beginning of 2006 caused no changes in the direction and volume of financial inflows due to relatively high investment returns in the country. The worsened trade conditions and slower growth rates of the EU countries contributed to the increase of the trade balance deficit, but the notable inflow of financial resources during 2005 was in excess of the current account deficit. The positive capital inflows continued in 2006 and contributed to the private sector investment growth. The influence of capital inflows is additionally shown in the change in international reserves which through the currency board arrangements leads to a change in monetary base, and through the process of money multiplication it affects broad money and credit dynamics.

In the first quarter of 2006 BNB international reserves decreased by BGN 692.1 million and in March 2006 the Issue Department balance sheet figure reached BGN 13,723 million (EUR 7016.5 million). International reserves dynamics to a great extent reflected the government operations: the early repayment of debt to the World Bank and the IMF, and the deposit made for purchasing equipment for the Ministry of Defence. These outflows prompted a decrease in international reserves during the quarter.

Table 1

Cash Flows Which Prompted Significant Changes in Gross International Reserves

	First quarter, 2006	2005, total
A) Purchases and sales of reserve currency		
- Net purchases from commercial banks	EUR +199 million	EUR +1408 million
	EUR +205 million	EUR +1419 million
- Revenue (outflows) related to net purchases (sales) at tills	EUR - 6 million	EUR - 11 million
B) Changes due to revenue (outflows) on commercial banks' minimum required reserve accounts in foreign currency	EUR +231 million	EUR + 394 million USD - 99 million CHF - 52 million*
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	Revenue: total EUR +67 million, incl. 1) transfer for participation in the tender for Trakia highway: EUR +20 million, and 2) an external credit received from Sofia Airport: EUR +4 million Payments on external debt: total: EUR -785 million; USD -131 million; JPY -647 million; SDR -6 million, incl. on early repayment of debt to: 1) World Bank: EUR -147 million and USD -57 million; 2) IMF: EUR -151 million, and a payment to the Ministry of Defence for delivery of equipment for the Bulgarian army: EUR -240 million	Revenue: 1) EUR 602 million from privatisation; 2) EUR 175 million from external loans; 3) EUR 17 million from domestic debt issues Payments on external debt**: USD 1777 million; EUR 728 million; JPY 2.1 billion; SDR 26 million Payments on domestic debt: EUR 14 million

* Outflows in US dollars and Swiss francs for 2005 resulted from amendments to Ordinance No. 21, under which banks may no longer maintain minimum required reserves in currencies other than levs and euro.

** External debt payments for 2005 include an early repayment of EUR 1.3 billion.

Source: BNB.

The inflow of financial resources, mainly in the form of net currency purchases and changes in commercial banks' minimum required reserve accounts, only partially offset the decrease in international reserves caused by the government operations effected over the first quarter.

Financial Flows and External Position Sustainability

On an annual basis, in the second quarter of 2006 current account deficit is expected to vary within the range of 14.3 and 14.6 per cent of GDP and in the third quarter within 13.2 and 13.4 per cent. The inflow of FDI into the economy will stay high and the private sector will continue borrowing. Private debt is expected to be a bit over 48 per cent of GDP in the second and third quarters of 2006.

International reserves will rise in the second and third quarters of 2006.

The current account deficit picked up reaching EUR 1052.4 million in the first quarter of 2006 against EUR 550.6 million during the same period of 2005. All major current account components contributed to the increase in the deficit during the first quarter of 2006: the trade balance deficit growth accounted for two thirds of the deficit growth, while the remaining 25 per cent reflected the larger deficit reported by the services sector.

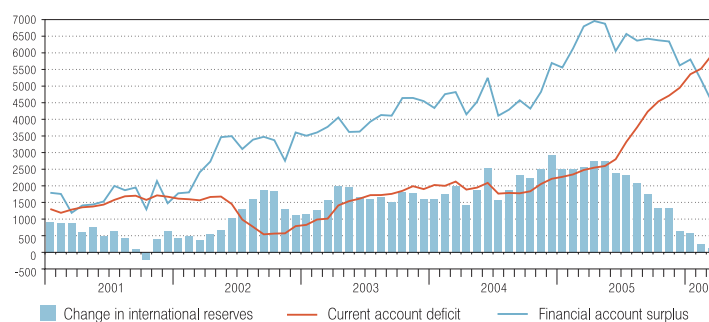
Despite the trade deficit nominal growth, export and import dynamics did not pose any problems to foreign trade. In the first quarter export growth amounted to 28.2 per cent on the corresponding period of 2005 and it was relatively evenly distributed by month, while the increase in imports came to 33 per cent. The bulk of it can be explained by the higher import prices (see the Economic Activity Section). The latter were the factor behind export growth, albeit to a lesser extent. Early 2006 data confirm the expectations expressed in the *Economic Review, issue 1/2006* that strong domestic demand, growing employment, higher real income and rising international prices will retain their significance for foreign trade dynamics in the first half of 2006 as well. The impact of these factors is most likely to sustain in the second half of 2006.

In the first quarter of 2006 the balance of services totaled EUR -198.5 million, the deficit exceeding by EUR 121 million that for the first quarter of 2005. The rise resulted mainly from the great increase in imports on the *Other services* item (50.9 per cent for the quarter) and from the slower export growth rates on the *Travel* and *Other services* items (by 2.2 per cent and 1.2 per cent respectively). Although the former can be partially explained by the growing need for various services (legal and consulting, related to the enhanced investment activity in Bulgaria), such high growth rates could not be maintained over a longer-term horizon. Concurrently, the growth of the items on the liabilities side was lower than the usual values observed in previous periods. Accelerating services growth on the liabilities side accompanied by a certain slowdown in the *Other services: debit* is possible in the next quarters. However, the dynamics of *Other services: debit* is exposed to the risk of sustained high growth rates reported in recent few quarters.

Surpluses on the balances of income and current transfers declined in the first quarter of 2006 compared with the corresponding quarter of 2005 but the effect was negligible since the total worsening of the two items was less than EUR 50 million. In the second

Chart 30
Dynamics of Current Account, Financial Account and International Reserves (on an Annual Basis)

(million BGN)



Source: BNB.

and third quarters the income balance is expected to remain practically unchanged on the corresponding periods of 2005, while net current transfers may show a certain improvement stemming from the recovered growth rates on the liabilities side following the slowdown in 2005.

The trade balance deficit is expected to rise nominally in the second quarter and to result in a greater nominal deficit on the current account compared with the second quarter of 2005. The influence of the balances of services, income and current transfers will practically be neutral; hence, in the second quarter the current account deficit is anticipated to be between 14.3 and 14.6 per cent of GDP on an annual basis. In the third quarter a minimum effect of the trade deficit on the current account is expected due to the high deficit reported in the third quarter of 2005. An improvement in the current account is anticipated in the third quarter owing to the predicted nominal improvement in the balances of services and current transfers. On an annual basis, the current account in the third quarter will probably move between 13.2 and 13.4 per cent of GDP.

The start of 2006 saw a sizable inflow of foreign direct investment into the balance of payment financial account. In the first quarter foreign direct investment in Bulgaria totaled EUR 755.4 million against EUR 392 million for the first quarter of 2005. Since no privatisation transactions were concluded in the comparison periods, it can be assumed that the increase in direct investment reflected the enhanced investor interest in the Bulgarian economy. The foreign direct investment inflow into Bulgaria is expected to continue rising in the next quarters.

Debt flows are an important financing resource of Bulgaria's economic growth. A part of them is used to directly finance companies, and the other part is distributed on the domestic market through the banking system. Debt resources for the non-government sector amounting to EUR 1071.7 million entered the Bulgarian economy in the first quarter of the current year.

Chart 31
Current Account Deficit to GDP and Foreign Direct Investment to GDP (on an Annual Basis)

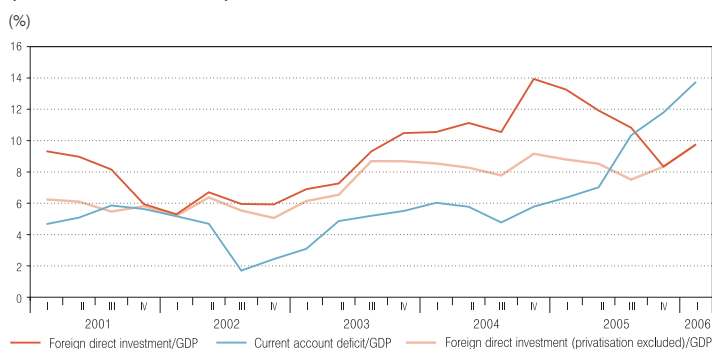
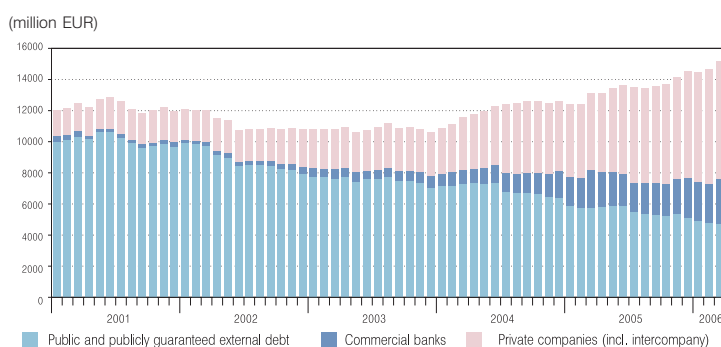


Chart 32
Gross External Debt



Between January and March 2006 gross external debt picked up by EUR 645.6 million on the end of 2005. Short-term external debt grew by EUR 871.2 million mainly due to the increased short-term obligations of commercial banks. The long-term external debt went down by EUR 225.6 million in the first quarter of 2006. The decline resulted entirely from operations of the *General government* sector whose external debt fell by EUR 461.6 million (see Table 1 about repayments on the debt to the IMF and the World Bank).

In the second and third quarters of 2006 positive flows of borrowed funds are expected which coupled with foreign direct investment will boost international reserves' growth. Unlike the first quarter, government operations will affect insignificantly debt dynamics. The financial account surplus is expected to exceed the current account deficit and international reserves to rise by some EUR 1 billion over the two quarters.

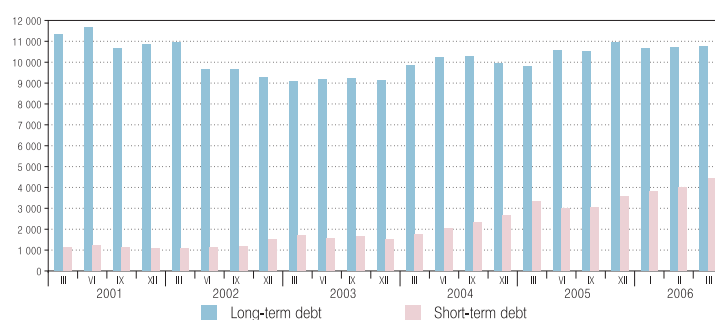
Following the early repayment of obligations to the IMF and the World Bank by the close of 2005 and the start of 2006, public and publicly guaranteed external debt will retain its nominal amount in the second and third quarters of 2006. Forecasts put it at some 21 per cent of GDP on an annual basis by the end of the second quarter. In the third quarter of 2006 public debt is expected to be a little under 21 per cent of GDP on an annual basis.

First quarter data on external debt confirm the hypothesis proposed in the *Economic Review* previous issues that commercial banks' debt will grow more moderately in 2006. Indebtedness of the private non-bank sector is likely to continue going up. Therefore, in the second and third quarters private debt is expected to come to a little over 48 per cent of GDP on an annual basis.

Chart 33

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Given the projected dynamics of international reserves and the government deposit, reserve money are expected to slow down its growth to 23–24 per cent in the second quarter and to 17–18 per cent in the third quarter of 2006. In the second quarter of 2006 banks' reserves will nominally surpass those in the first quarter, but growth rates will gradually slow down. The slowdown will be more significant in the third quarter. Growth rates of currency in circulation are expected to decline slightly to about 13 per cent by the close of the third quarter.

In the second and third quarters of 2006 broad money growth is projected at some 18 to 20 per cent on an annual basis.

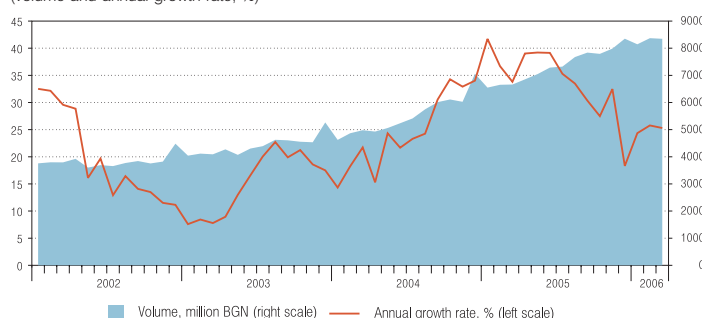
The upward trend in the interest rates on deposits is likely to sustain in the next two quarters.

In the first quarter of 2006 reserve money picked up by 25.3 per cent on an annual basis, their growth accelerating by some 7 percentage points on the end of 2005. The driving factor of this acceleration was the dramatic rise in banks' reserves: by end-March they came to BGN 2817 million, up by BGN 979 million (53.2 per cent) compared with the same period of the previous year. In March 2006 the average commercial banks' reserves with the central bank comprised BGN 2738 million of which BGN 2054 million in minimum required reserves and BGN 683.9 million in additional reserves associated with exceeded credit limits set in BNB Ordinance No. 21. The average monthly minimum required reserves grew by BGN 225 million and additional reserves by some BGN 300 million on December 2005. Despite the fact that some of the banks exceeded the set credit growth rates, as a whole the measures taken by the BNB proved effective and the banking system total credit stayed within the regulation limits. A trend towards maintaining a greater part of reserves in foreign currency (euro) was observed ensuing from the previous year's amendments to BNB Ordinance No. 21 according to which commercial banks may also maintain reserves in euro on funds attracted in levs.

Growth rates of currency in circulation subsided in line with expectations; in the first quarter of 2006 banknotes and coins grew by 14.6 per cent against 16.9 per cent in December 2005. In the next two quarters the increase in currency in circulation is most likely to continue slowing down mainly due to the large base, although it will stay higher than the nominal GDP growth.

Chart 34
Reserve Money

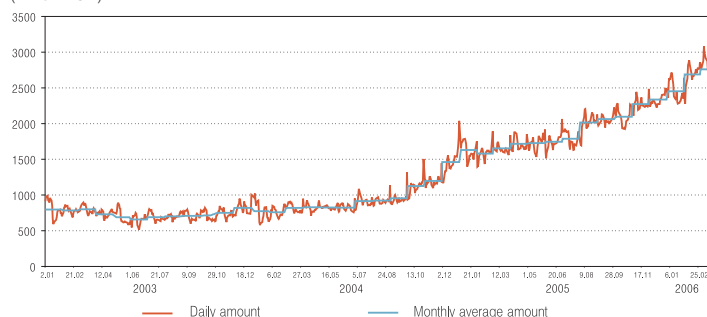
(volume and annual growth rate, %)



Source: BNB.

Chart 35
Commercial Bank Deposits

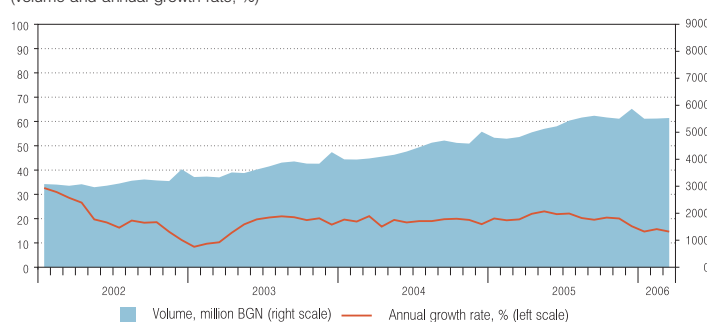
(million BGN)



Source: BNB.

Chart 36
Currency in Circulation

(volume and annual growth rate, %)



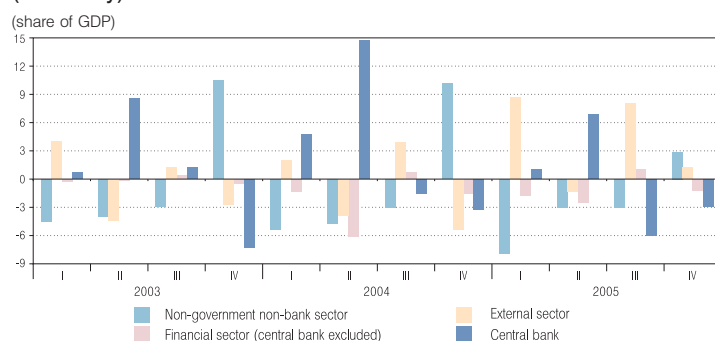
Source: MF, BNB.

Deposits of the government and budget organisations with the central bank limit the fiscal policy effect on liquidity of individual economic sectors and correspondingly on the BNB balance sheet. Curtailed non-interest expenditure and the considerably lower primary deficit on the consolidated state budget in the last quarter of 2005 led to a lower-than-usual level of liquidity flow to the non-government non-banking sector.

Since early 2006 flows from the budget to the external sector have increased owing to the early government debt payments; as a result, government deposits with the BNB decreased. In the second and third quarters no significant changes are expected in the financial flows related to government operations. This will prompt an increase in government deposits with the central bank which is typical of this period of the year and these deposits will again exceed BGN 4 billion.

In the first quarter of 2006 broad money measured by the M3 monetary aggregate, went up by 10.1 per cent on the same quarter of the previous year. The major reason behind the considerable slowdown in annual growth rates was the high March 2005 base when enhanced commercial bank lending caused a sharp rise in deposit base and particularly in deposits of non-financial corporations. Broad money increased by 1.2 per cent in the first quarter compared with the end of 2005. Quasi-money played a key role for this, while the contribution of M1 was negative owing to the seasonal decline in money outside banks. Between December 2005 and March 2006 overnight deposits posted a 3 per cent rise, with households reporting a faster growth in lev deposits and non-financial corporations in foreign currency deposits. March 2006 saw a significant rise in companies' overnight foreign currency deposits: within a month they went up by BGN 212 million or 21 per cent.

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



Source: MF, BNB.

Households reported the greatest increase in lev deposits with agreed maturity of up to two years (5.7 per cent for the first quarter of 2006 and 30.9 per cent on an annual basis), while non-financial corporations registered a decline (4.8 per cent on December 2005 and 16 per cent on March 2005). Time foreign currency deposits of non-financial corporations picked up by 6.2 per cent over the quarter and those of households by 3.9 per cent. The faster rise in euro deposits compared with those in other currencies sustained; thus, as of March 2006 the relative share of euro deposits in total time deposits came to 62.6 per cent against 57.4 per cent by the close of the previous year.

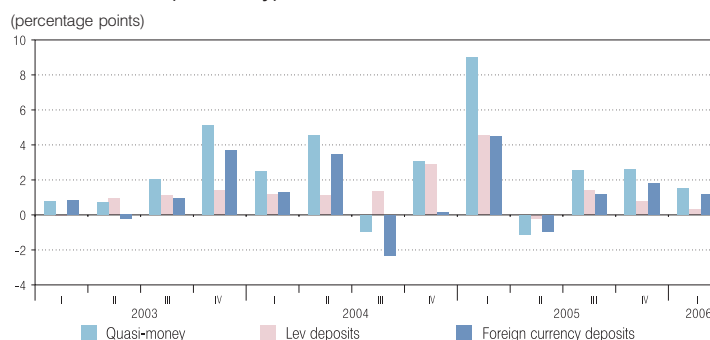
Broad money annual growth rates are expected to increase to some 18–20 per cent in the second and third quarters of 2006 due to the exhaustion of the high base effect and provided the nominal deposit inflow is stronger than in 2005. This assumption is based on the favourable prospects of economic activity and mostly on the positive trends in employment and salaries, on the one hand, and the continuing capital inflow from abroad, on the other one.

Subdued lending as a result of the measures taken by the BNB to limit credit expansion affected the dynamics of money multiplier which declined in the previous year.

The money circulation velocity continued to subside, retaining its clearly pronounced seasonal profile. This downward trend is anticipated to sustain although at lower rates.

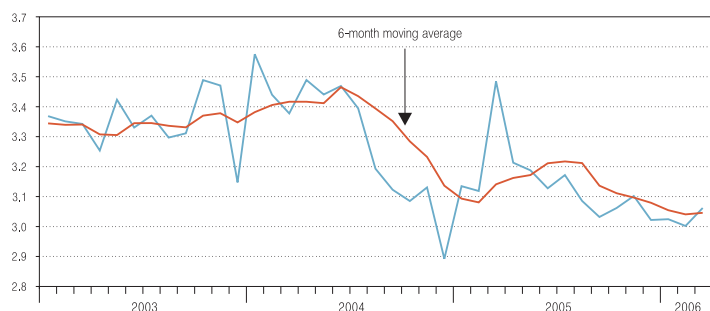
In the first quarter of 2006 banks' rates on time deposits picked up again, especially those on one-month deposits. Overnight deposits and deposits with maturities longer than one month did not show an increase. The average interest rate on time lev deposits grew from 3.37 per cent in December 2005 to 3.61 per cent in March 2006. Time deposits in euro rose from 2.35 per cent to 2.42 per cent and in US dollars from 2.24 per cent to 2.31 per cent. The upward trend in interest rates in recent months most probably stemmed from the change in international interest rates. As it is seen from

Chart 38
Contribution of Quasi-money and Their Components to M3 Growth (Quarterly)



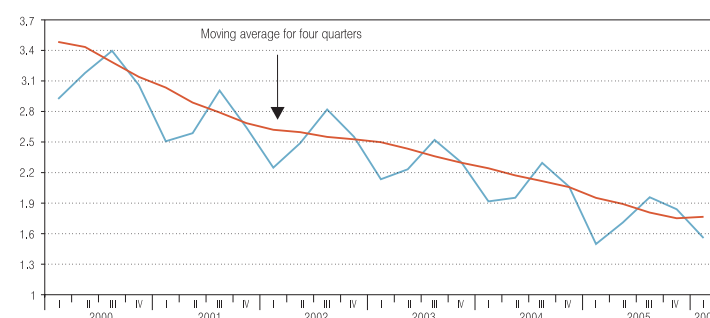
Source: BNB.

Chart 39
M3 Money Multiplier



Source: BNB.

Chart 40
Currency Circulation Velocity (Quarterly)



Source: BNB.

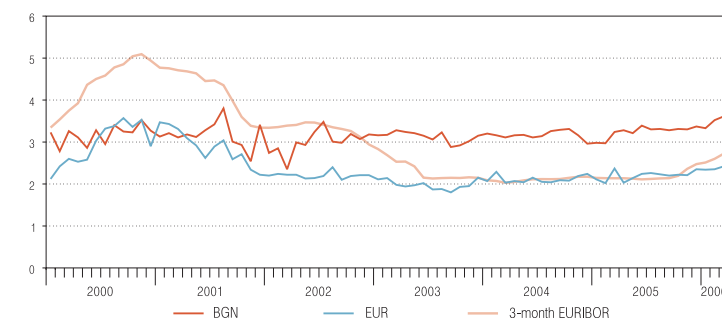
Note: The velocity of circulation for the first quarter of 2006 is based on GDP projections.

Charts 41 and 42, internal interest rates on deposits followed quite closely the dynamics of international reference interest rates in the respective currency. There was a strong dependence between interest rates on USD time deposits and the USD LIBOR: the calculated correlation coefficient of the two series in the January 2000 to March 2006 period came to 0.91. However, this correlation has been weakening in the last few years (in the January 2003 to March 2006 period the correlation coefficient was 0.74).

Vice versa: the correlation between interest rates on time deposits in leva and EURIBOR strengthened considerably: from 0.03 to 0.68 for the whole sample and for the period after 2003 respectively. The dependence remained strong throughout the period after 2000 (the correlation coefficient was 0.87) in internal interest rates on euro deposits, on the one hand, and EURIBOR, on the other one. These indicators display a relatively strong and increasing financial integration of the Bulgarian economy into the euro area economy and a weaker influence of international USD interest rates on internal USD interest rate levels.

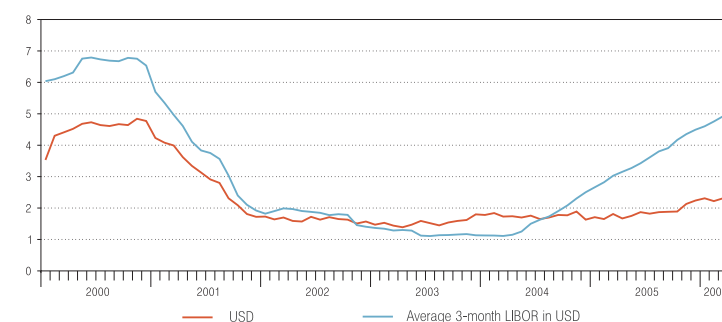
The distribution of interest rates on one-month leva deposits by bank did not display any substantial changes on December 2005.

Chart 41
Interest Rates on BGN- and EUR-denominated Time Deposits and Three-month EURIBOR (%)



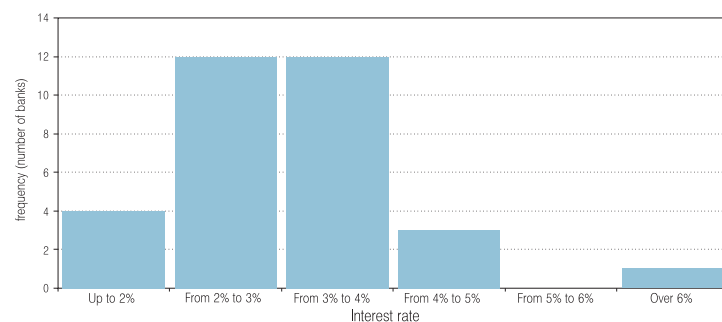
Source: BNB.

Chart 42
Interest Rates on USD-denominated Time Deposits and Three-month LIBOR (%)

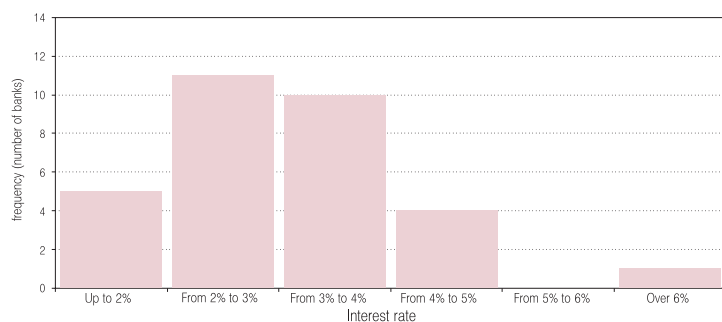


Source: BNB.

Chart 43
Interest Rate Distribution on Household One-month Lev Deposits as of December 2005



as of March 2006



Source: BNB.

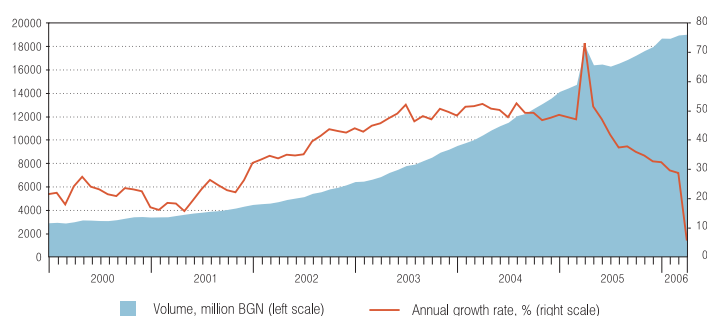
Under BNB-imposed lending constraints, growth rates of claims on the non-government sector will slow down to 22–24 per cent in the second and third quarters of 2006. No significant changes in lending interest rates are expected.

In the first quarter of 2006 the BNB measures continued to curb lending growth parallel to the retained sizable credit demand. The nominal increase in claims on the non-government sector between January and March 2006 was BGN 327.9 million, far less than that reported in the prior quarter (BGN 1454.5 million). The annual credit growth rate came to 5.6 per cent by end-March 2006, the reasons behind the sharp drop at the close of 2005 (32 per cent) being the base effect of the brisk lending in March 2005 and the process of excluding credit portfolios from banks' balance sheets. Assuming that banks will adhere to the imposed restrictions, in the second and third quarters of 2006 a 22 to 23 per cent annual growth in claims on the non-government sector could be expected.

Moderate credit growth at the start of 2006 should be considered a signal of a change in the structure of financing the non-government sector rather than of curbing credit flows into the economy. The change resulted in the decreased relative share of bank credits at the expense of increased leasing and financing from abroad.

In February 2006 new amendments broadening the scope of BNB Ordinance No. 21 were adopted, consistent with improving the efficiency of measures taken by the BNB to limit lending growth. The amendments are aimed at discontinuing the practice of transforming bank loans into, or replacing them with, other debt instruments, thus avoiding the restrictions imposed by the Ordinance. Amendments to BNB Ordinance No. 8 were also adopted providing for changes in determining the risk weights of mortgage loans. Hence, banks are encouraged to be more conservative in determining the level of collateralization on extended credits.

Chart 44
Claims on Non-government Sector



Source: BNB.

Amendments to Ordinance No. 8 and Ordinance No. 21 Adopted in Early 2006

New amendments to Ordinance No. 8 and Ordinance No. 21 in line with the BNB policy of stimulating commercial banks to maintain moderate growth rates of claims on non-financial institutions and to apply a more conservative approach to credit risk evaluation were adopted in March 2006.

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

In order to prevent avoidance of the restrictions provided for in the Ordinance through transferring some of the existing and newly extended loans into other debt instruments, as of March 2006 new amendments came into force under which for the purposes of determining additional minimum required reserves all bonds and other debt securities acquired by the banks after 31 December 2005 were included in the concept 'loan'. Securities issued by other state-owned, central or local banks and other debt instruments with an investment rating are exceptions to this.

Ordinance No. 8 on the Capital Adequacy of Banks

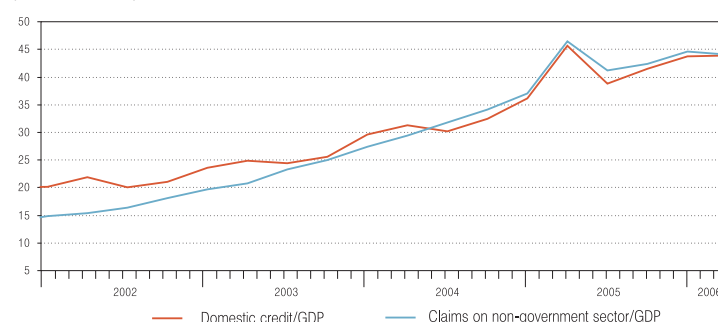
The amendments to this Ordinance aim to apply a more conservative approach in extending mortgage loans and to supplement the amendments on provisioning these loans. Claims secured with real estate and especially housing loans are among the credit aggregates growing at fastest rates and the increasing competitiveness of banks in this market segment presupposes applying lower standards to credit risk assessment. Therefore, the BNB approved changes in determining the risk weights of mortgage loans. In calculating the banks' capital adequacy ratio, only mortgage loans whose amount does not exceed 50 per cent of the mortgaged real estate will be included with a half of their weights in the asset risk component. Until now this method of weighting was applied to all mortgage loans whose amount was up to 70 per cent of the mortgage. A tighter approach applied to determining the risk weights of mortgage loans will be a strong stimulus for banks to extend fewer mortgage loans with a lower degree of collateralizing the claims.

In the first quarter of 2006 financial intermediation measured by the *internal credit to GDP* ratio slowed down partially due to taking credit portfolios out of banks' balance sheets. The moderate growth of credit aggregates over this period could explain the slight decrease in the *claims on the non-government sector to GDP* ratio from 44.6 per cent by end-2005 to 44.1 per cent as of March 2006.

The BNB-imposed measures and the changing structure of credit flows into the economy affected the dynamics of banks' net foreign assets as well. Adherence to a more moderate credit portfolio growth rate could account for the slower growth of foreign liabilities on a quarterly basis: up 5.8 per cent at the close of 2005 (against a 20.7 per cent growth in the prior quarter). On the other hand, transferring a part of the newly extended credits to non-residents could partially be responsible for the fact that by end-March 2006 net foreign assets indicated the highest levels since the enforcement of the measures (BGN 333.3 million).

Chart 45
Domestic Credit

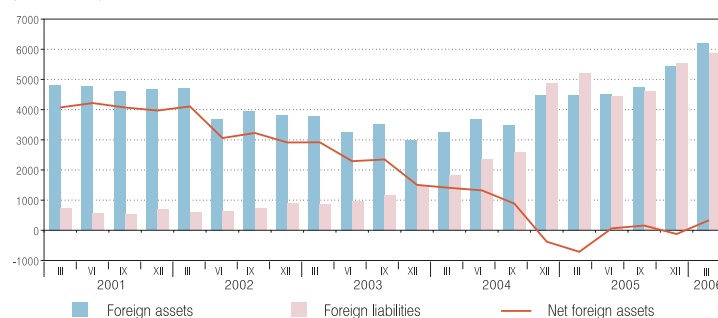
(share of GDP, %)



Source: BNB.

Chart 46
Foreign Assets and Liabilities of Commercial Banks

(million BGN)



Source: BNB.

The first three months of 2006 saw a minimum change in all segments of the credit market; on a quarterly basis the growth rates were considerably lower than those registered in the previous period. Since the year start claims on non-financial corporations have picked up by BGN 76.8 million (against BGN 784.9 million for the fourth quarter of 2005). The slowdown in the corporate loan growth reflected to a certain extent the transfer of portfolios abroad as far as similar practices are realized predominantly in the corporate segment of lending.

In the first quarter of 2006 credits extended to individuals also exhibited moderate growth rates with a relatively low increase in volumes since the beginning of the year: BGN 188.2 million against BGN 704.2 million for the prior quarter of 2005. Nevertheless, claims on households was the credit market segment which grew at the fastest pace contributing to more than a half of the rise in the claims on the non-government sector on a quarterly basis. The annual growth rate of claims on households (39.7 per cent) exceeded several times that on total loans since the base effect of the 2005 dramatic credit growth was significantly weaker.

The most rapidly rising component of credits extended to individuals were housing loans reporting a 7.9 per cent increase on a quarterly basis with their relative share in claims on households picking up from 28.4 per cent to 30.6 per cent. Annual growth rates of housing loans continued to slow down in January and February 2006 reaching 95 per cent and 91 per cent respectively and falling to 81 per cent in March due to the high base of March 2005. The slowdown in housing loans is expected to sustain particularly under the influence of the recent statutory changes associated with provisioning and risk weights of these loans.

Chart 47
Net Financial Flows to Commercial Banks (Quarterly)

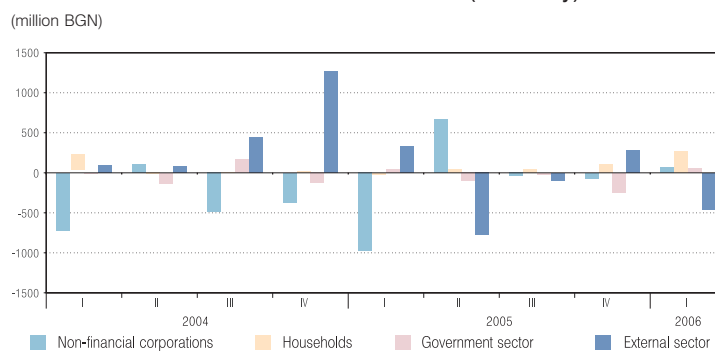


Table 2
Changes in Major Balance Sheet Items of Commercial Banks (Quarterly)

(million BGN)

	2005			2006
	II	III	IV	I
Claims on non-financial corporations	-1922.6	334.6	784.9	76.8
Deposits of non-financial corporations	-1258.6	292.5	710.3	140.8
Claims on households	590.6	537.5	704.2	188.2
Deposits of households	633.0	575.6	813.0	453.9
Foreign assets	23.1	251.2	670.0	775.0
Foreign liabilities	-752.7	155.6	951.4	319.7
Claims on government sector	209.8	135.4	137.1	14.2
Deposits of government sector	105.4	110.6	-112.7	73.7
Claims on central government	203.5	113.9	133.8	-5.7
Liabilities to central government	94.7	129.9	11.8	-54.9

Source: BNB.

Chart 48
Claims on Non-financial Corporations

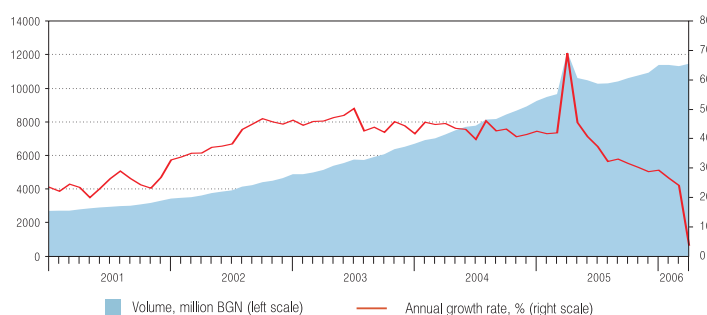
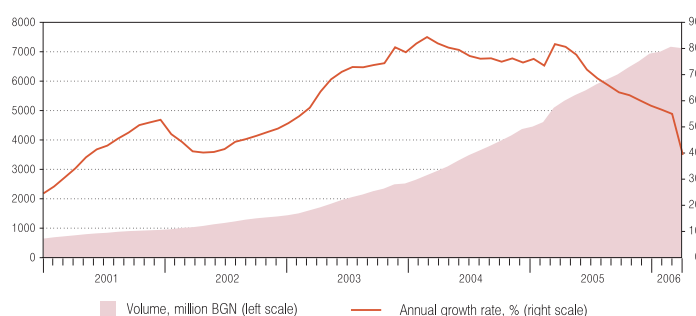
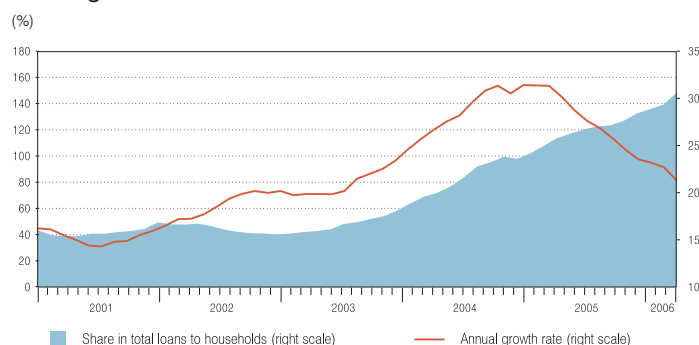


Chart 49
Claims on Households



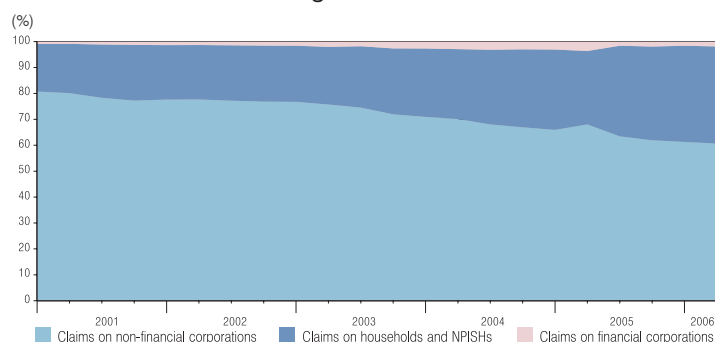
The upward trend in the relative share of loans extended to households in the structure of claims on the non-government sector sustained, their share coming to 37.5 per cent by March 2006. It is normal to observe such a trend at this stage of the banking sector development in Bulgaria since the retail banking potential has not been exhausted yet. In addition, households have no more favourable borrowing alternatives, unlike companies, some of which having access to international financial markets. It could be suggested that measures aimed at limiting lending will affect asymmetrically the credit market segments with various yield, the effect of constraints on retail lending being comparatively weaker than on corporate lending.

Chart 50
Housing Loans



Source: BNB.

Chart 51
Structure of Claims on Non-government Sector



Source: BNB.

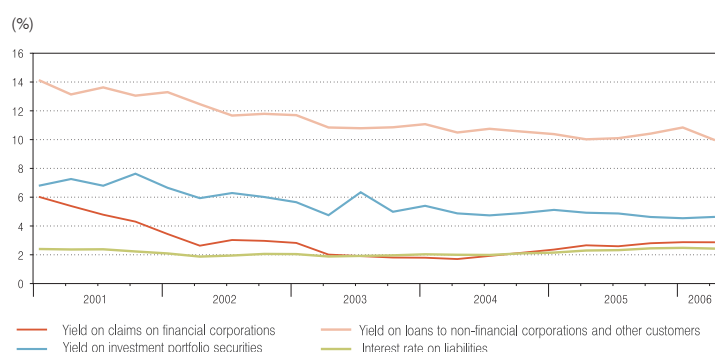
Table 3
Claims on Non-government Sector (Quarterly)

	Annual growth rate, %				Structure as of 31.III.2006
	2005			2006	
	II	III	IV	I	
Claims on non-government sector, incl.:	41.8	35.9	32.4	5.6	
on non-financial corporations	32.2	25.7	23.1	-5.9	60.6
on households and NPISHs	72.2	63.5	58.4	39.7	37.5
on financial corporations	-27.6	-12.4	-32.4	-44.6	1.9

Source: BNB.

The first quarter of 2006 saw a drop in interest rates on credits to companies and households. Data on households credits indicate significant interest rate falls in the last two years. Some of these falls reflected the rising competitiveness on the market of bank services to households which led to credit product structuring in a way that cut interest expenditure in the first few years of the credit. This resulted in an underestimated price of credits to households in the data on interest rate statistics. The interest

Chart 52
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities



Source: BNB.

rate downward trend is likely to reverse upon exhaustion of banks' price strategies potential and the ECB continued policy of increasing reference interest rate in the euro area. These developments would limit banks' opportunities of gaining a market share through decreasing interest rates. Therefore, no sizable changes in lending rates are anticipated in the following months.

Chart 53
Interest Rates on Household Loans

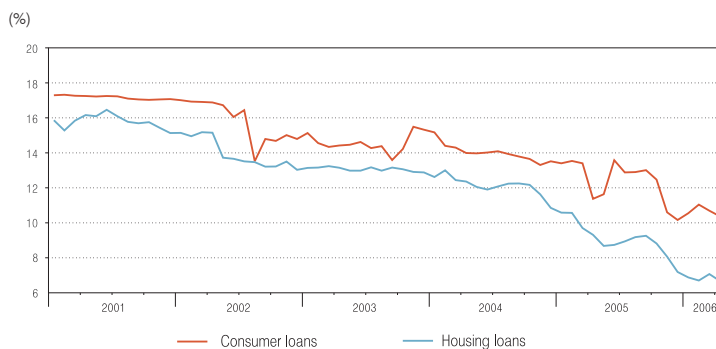
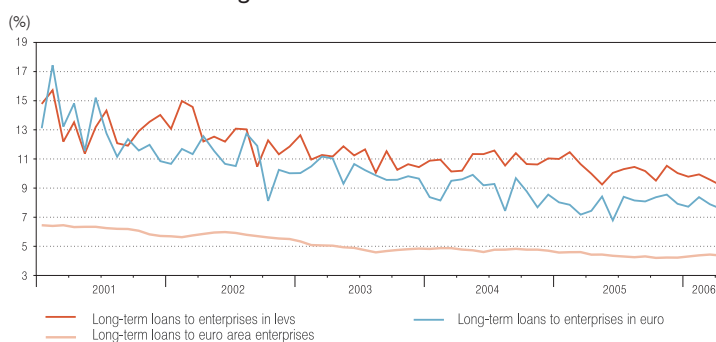


Chart 54
Interest Rates on Long-term Loans in Levs and Euro



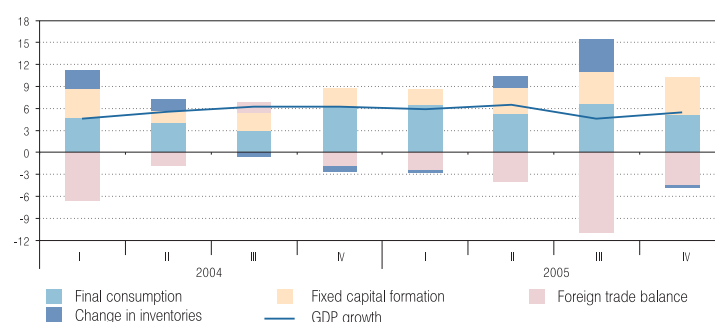
3. Economic Activity

Economic growth is expected to stay high in the second and third quarters. Household consumption and fixed capital investments will contribute most significantly to this growth despite the anticipated slowdown in growth rates attributable to the base effect in the third quarter. Foreign trade balance contribution is expected to be negative in the second quarter and positive in the third quarter. Government consumption contribution will not exceed 0.5 percentage points.

Developments in consumption will depend on income and employment growth. The investment activity will be determined by the improvement of business climate assessments and capacity workload, as well as by sustainable financial inflows on the balance of payments financial account associated with high investment returns in Bulgaria and pending membership in the EU.

The gross domestic product exhibited a 5.5 per cent increase in 2005. Growth rates in private consumption and investment accelerated significantly. Household consumer expenditure growth reached 7.7 per cent and investments in fixed capital 19 per cent. Total economic growth slowed down by 0.2 percentage points on the previous year, consistent with the low growth in exports of goods and non-factor services in the third quarter.

Chart 55
Contribution to GDP Growth by Component of Final Consumption
(percentage points)



Source: NSI.

Table 4
Dynamics of GDP Components According to Final Consumption Method
(on corresponding period of previous year, %)

	2004				2005			
	I quarter	II quarter	III quarter	IV quarter	I quarter	II quarter	III quarter	IV quarter
Consumption, incl.	5.2	4.4	3.8	6.7	7.1	5.9	8.6	5.6
Household consumption	5.7	5.3	4.0	6.8	7.6	5.5	10.4	7.1
Government final consumption expenditure	-3.2	-4.5	3.0	4.5	4.5	10.3	0.2	7.2
Collective consumption	9.8	6.5	2.9	7.8	6.4	6.5	4.3	-4.7
Gross fixed capital formation	23.7	8.4	14.1	11.4	11.2	16.9	24.0	21.5
Exports of goods and non-factor services	7.0	10.5	14.0	19.8	9.2	12.0	1.1	8.9
Imports of goods and non-factor services	16.7	11.1	12.0	16.9	10.8	15.3	18.8	12.9
GDP, real growth	4.6	5.5	6.2	6.3	5.9	6.5	4.6	5.5

Source: NSI, BNB.

Household Behaviour

Household consumer behaviour continued to reflect the clearly pronounced upward trend in employment and income. Income from salary contributed most significantly to the total household income and resources used to finance consumer spending. The significance of income from property and

entrepreneurship was sustained. Labour income and transfers from abroad comprised a significant portion of household financial resources. Data on household consumption and household assets in the banking system on the one hand, and data on finance sources on the other one, were still imbalanced. Provision of a comprehensive scope of various types of income cause a number of difficulties. To ensure a more effective use of available data, the BNB Statistics Directorate introduced a new methodology for assessment of residents' income from employment abroad,⁵ an item of the balance of payments current account. As a result, the statistical data on household income provide a more reliable information about household behaviour.

Chart 56
Sources of Financing Households

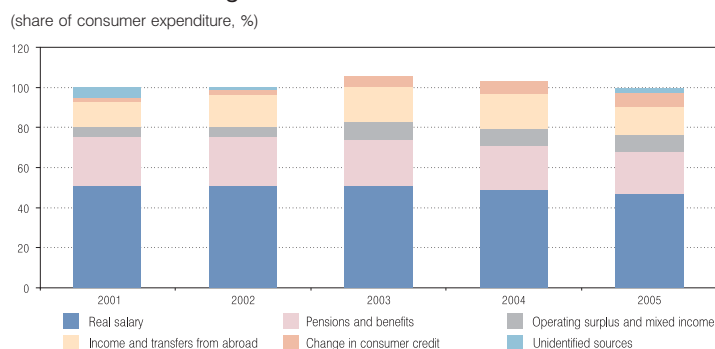


Chart 57
Status of Economically Active Population
(Quarterly)

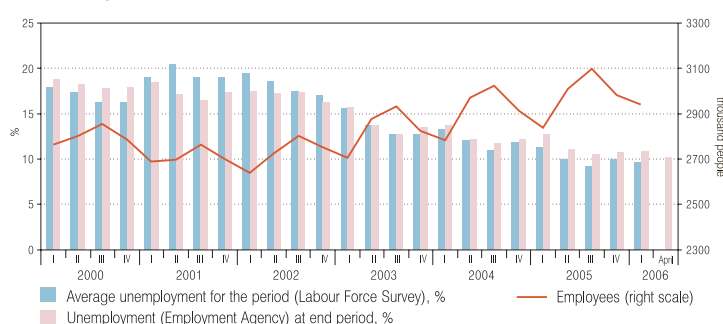


Table 5
Employment and Income Dynamics (Quarterly)
(%)

	2004				2005				2006	
	I	II	III	IV	I	II	III	IV	I	April
Unemployment at the end of the period (Employment Agency data)	13.7	12.2	11.7	12.2	12.7	11.1	10.5	10.7	10.8	10.2
Employed under labour contract										
share on corresponding quarter of previous year	5.8	5.7	5.7	3.4	4.3	3.5	1.5	1.6	0.8	
share on the previous quarter	-1.5	3.0	3.2	-1.2	-0.7	2.2	1.2	-1.1	-1.5	
Employees (Labour Force Survey data)										
share on corresponding quarter of previous year	2.9	3.3	3.1	3.1	2.0	1.3	2.4	2.4	3.6	
share on the previous quarter	-1.5	6.7	1.8	-3.7	-2.5	6.0	3.0	-3.7	-1.4	
Real salary										
share on corresponding quarter of previous year	-0.7	-1.8	-0.2	2.2	3.3	3.9	3.3	0.8	1.7	
share on the previous quarter	-4.8	3.5	1.7	2.1	-3.8	4.1	1.1	-0.4	-2.9	
Wages and salaries , deflated by CPI, an increase on the corresponding quarter of prior year (System of National Accounts data)	1.3	-0.5	1.9	4.3	2.6	6.0	7.3	9.6		

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

⁵ [http://www.bnb.bg/bnb/home.nsf/vPages/S_BP_MNotes_Employment/\\$FILE/CoE%20Meth_bg_rev.pdf](http://www.bnb.bg/bnb/home.nsf/vPages/S_BP_MNotes_Employment/$FILE/CoE%20Meth_bg_rev.pdf)

Growing household income was the major factor behind the increased household solvency and extended access to additional financial resources. Over the recent years the share of consumer expenditure funded by consumer credits went up though smoothly. Based on monetary statistics the net amount of newly extended consumer credits did not exceed 7 per cent of consumer spending. Concurrently, households continued to be a net creditor of the banking system.

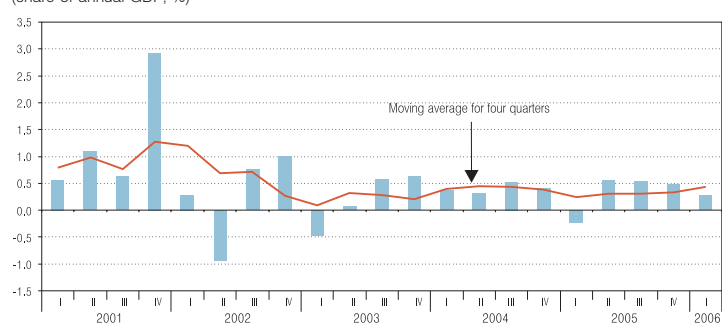
Progressively improving household welfare led to a sustainable change in the structure of expenditure, prompting a growth in the share of expenses related to enhanced consumer and economic activity (non-foods, non-production services, catering, communications, transport) at the expense of food spending and current home maintenance expenses.

The 2006 first quarter current data evidence a reviving household confidence. Consumer surveys conducted by the NSI reported a decline in the expectations about unemployment, improved expectations about the financial state of consumers and their opportunities for saving. The upward trend in income and consumption sustained. Consumption continued to grow over the forecast period. A slowdown is expected in the third quarter given the high growth reported in the 2005 corresponding period.

Chart 58

Net Household Credits Extended (+)/Received (-) to/from the Banking System (Quarterly)

(share of annual GDP, %)

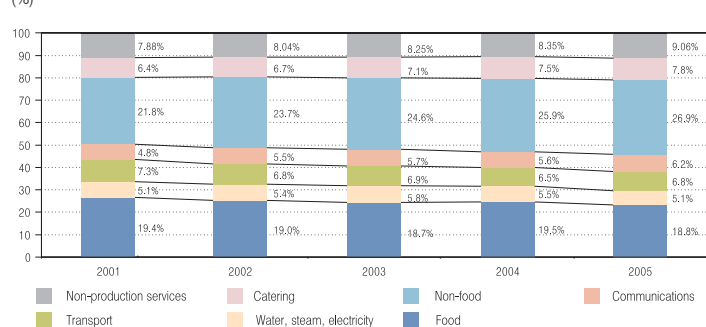


Source: BNB, NSI.

Chart 59

Structure of Household Consumer Expenditure

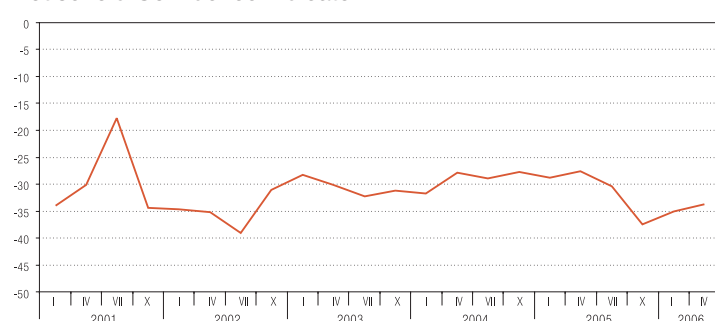
(%)



Source: NSI.

Chart 60

Household Confidence Indicator



Source: NSI, consumer survey.

Table 6

Consumer Demand Dynamics (Quarterly)

(share on the corresponding period of prior year)

	2004				2005				2006
	I	II	III	IV	I	II	III	IV	I
Retail sales	13.3	15.3	14.0	15.2	13.9	15.7	11.5	9.8	10.8
Income from retail trade	19.5	19.1	20.3	22.6	12.0	13.2	12.9	12.8	8.6
Food, drinks, tobacco	13.4	7.8	7.8	10.9	9.5	10.1	8.3	4.0	6.1
Pharmaceutical and medical goods, cosmetics and toiletries	19.8	22.8	18.7	16.8	3.3	7.3	12.3	10.9	6.2
Textiles, clothing, footwear and leather	26.0	27.6	19.9	22.8	10.0	17.5	24.7	25.9	7.5
Household goods and home appliances	32.9	31.4	39.3	39.6	20.7	18.7	18.9	24.8	12.9

Source: NSI.

Government Finance and Consumption

The major elements of the forecast about government finance and consumption remained unchanged. Nominally, cumulative cash balance will probably vary around previous year's levels and total expenditure is anticipated to rise at a rate close to the annual inflation rate, with government consumption contributing insignificantly to the GDP real growth.

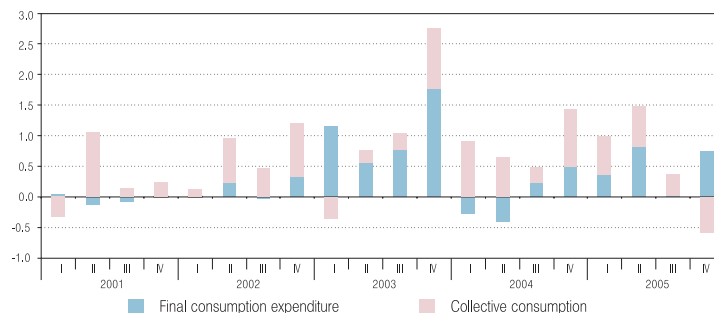
Total revenue and aid over the first quarter matched the indicative target of BGN 4251 million set out in the agreement with the IMF, reflecting mostly the good tax revenue performance. Earnings from indirect taxes remained the major factor behind the total revenue growth. Following the insignificant slowdown in total revenue growth rates since early 2006, consistent with the slower increase in excise revenue, in the second and third quarters it is expected to boost to approximately 10 per cent. Social security institutes' revenue will nominally match the previous year's levels, and growth in employment and social security income will be almost entirely offset by decreased social security contributions.

Accomplishment of the quarterly objectives set in the agreement with the IMF in respect of the consolidated budget cash balance and total revenue implicitly presupposes a reduction in expenditure. The first quarter preliminary data indicate that the surplus over projections was due to the lower expenditure irrespective of their higher growth rate compared with total revenue. Over the following two quarters annual growth rates of expenditure are expected to fall under those of revenue and to stay relatively stable: from 6 per cent to 8 per cent. Salary, operational and subsidy expenditures are anticipated to contribute insignificantly to total expenditure growth. Moreover, some types of expenditure may have a negative contribution to total spending growth in the second quarter. The reasons behind these expectations reflect the high prior year's base due to the extra expenditure made on the 2005 parliamentary elections. This quarterly expenditure profile will lead to government consumption

Chart 61

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

(percentage points)

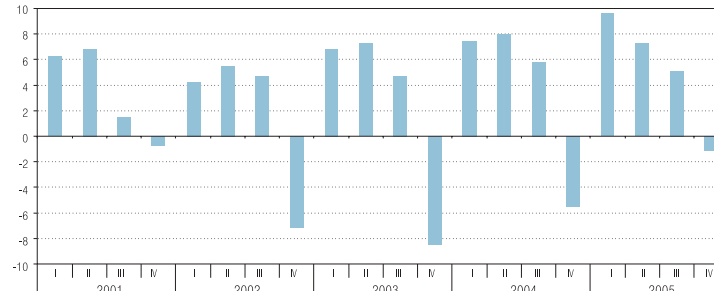


Source: NSI, BNB.

Chart 62

Primary Balance (Quarterly)

(share of GDP for the quarter, %)

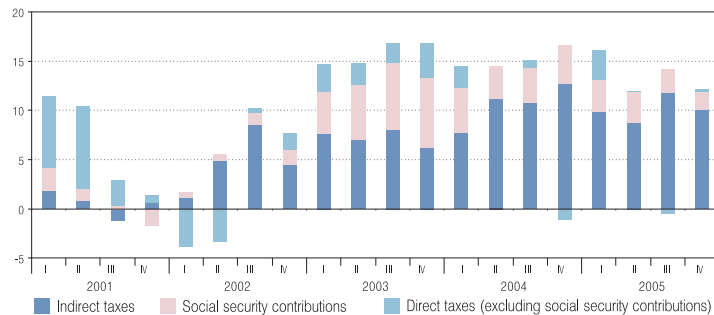


Source: MF.

Chart 63

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

(percentage points)



Source: MF, BNB.

growth rates close to null without affecting significantly households' disposable income.

Behaviour of Firms

In 2005 production activity slowed down compared with the previous year. The major reason behind this was the negative performance of agriculture due to unfavourable weather conditions and the slowdown in the energy industry, a result of lower industrial consumption. In other sectors high value added growth rates sustained and accelerated.

Trade and manufacturing industry contributed most significantly to this growth.

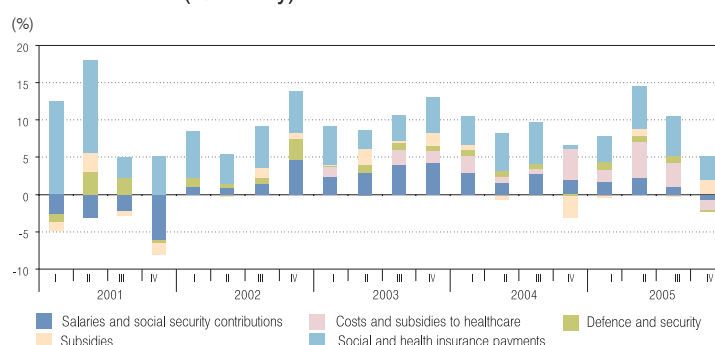
Buoyant consumption helped sustain the value added growth rate in trade at 15 per cent matching the prior year's level. Within the manufacturing industry sales in oil refining, food and drinks, machines and equipment, non-ferrous metallurgy and chemicals increased most significantly. Construction continued to grow dramatically. The value added in this sector rose by 14.1 per cent in 2005 matching the growth reported in 2004. This dynamics evidences the sustained high investment activity in Bulgaria.

Fixed capital investments went up by 19 per cent in 2005 and by approximately 23 per cent in the 2005 second half-year compared with the corresponding periods of the prior year. Similar acceleration in investment demand growth was reported at the initial stage of the Bulgarian economy's recovery between 1998 and 2001. The increasing share of investment in the GDP is the major factor behind the improved technological level and enhanced economic efficiency, an important condition for real salary growth without threatening the competitiveness of Bulgarian producers.

The real unit labour cost index is a key indicator of the corporate competitiveness. It shows the dynamics of the *compensation for employees (the entire labour costs) and value added* ratio. This indicator may be used to check whether the real salary growth corresponds to the labour efficiency growth.

Chart 64

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



Source: MF, BNB.

Table 7

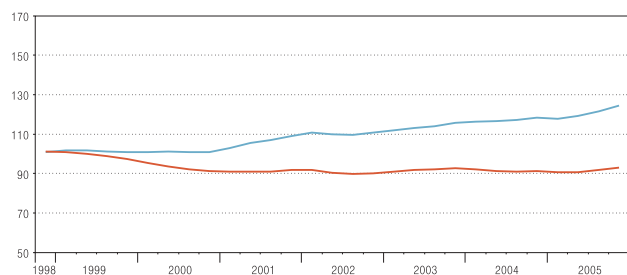
Gross Value Added Growth by Sector

(corresponding quarter of previous year = 100)

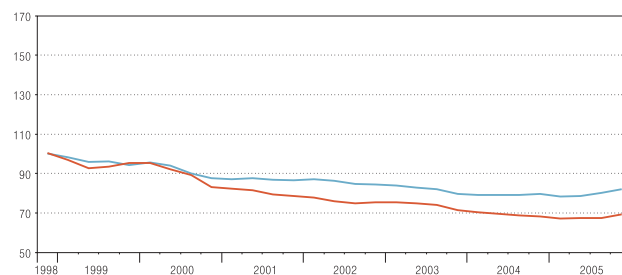
	2004				2005			
	Quarters							
	I	II	III	IV	I	II	III	IV
Agriculture and forestry	-0.3	0.7	4.5	3.8	-1.9	-5.8	-6.9	-17.1
Industry	6.7	6.7	5.3	4.7	11.0	9.2	3.8	5.9
Services	5.0	4.9	7.1	5.8	5.9	7.0	6.2	7.0
At base prices, total	5.2	5.0	6.1	5.3	7.1	6.5	3.3	4.4
Contribution, percentage points								
Agriculture and forestry	0.0	0.1	0.8	0.4	-0.1	-0.5	-1.2	-1.6
Industry	2.1	2.0	1.5	1.3	3.6	2.8	1.1	1.7
Services	3.1	2.9	3.7	3.6	3.6	4.2	3.3	4.4

Source: NSI.

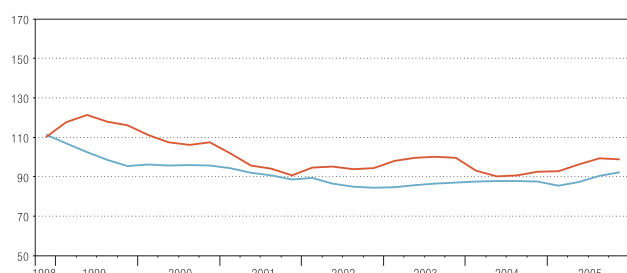
Chart 65
Unit Labour Cost (Quarterly)
(1998 = 100%)
Total for the Economy



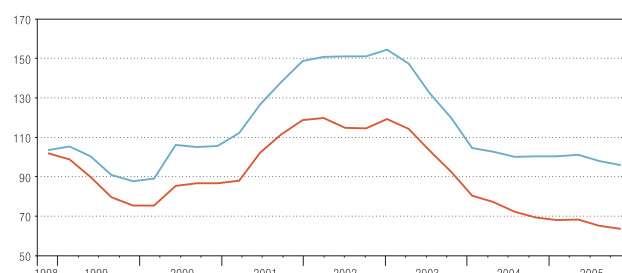
Manufacturing



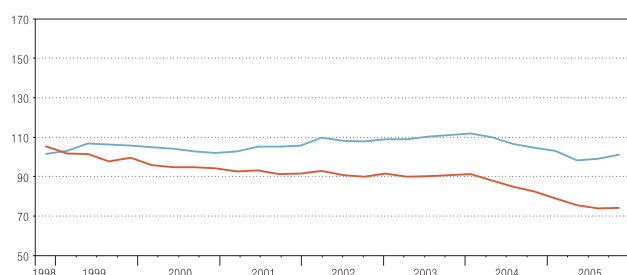
Agricultural Sector



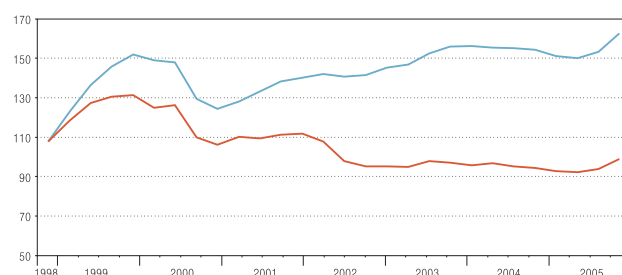
Mining and Quarrying



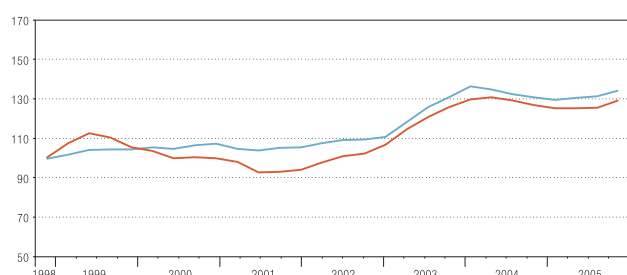
Construction



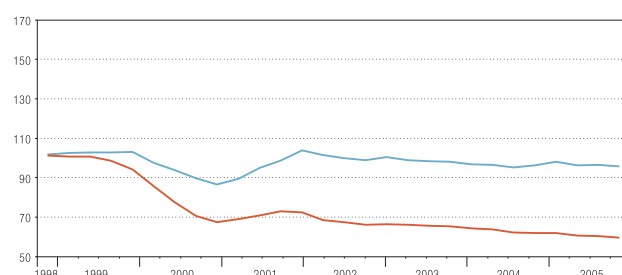
Electricity, Gas and Water Supply



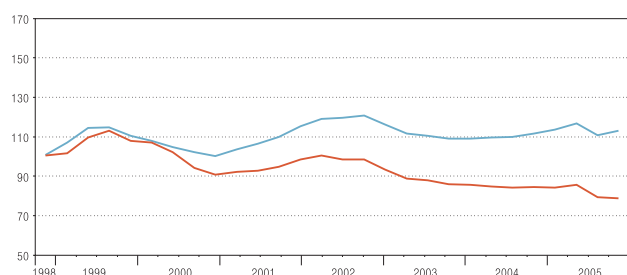
Trade



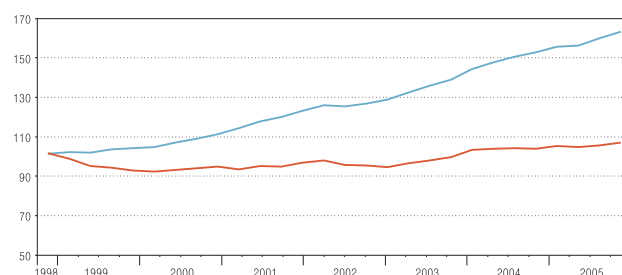
Transport and Communications



Financial Intermediation



Other Sectors



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

Source: NSI, BNB.

As a result of restructuring of the economy after the 1996–1997 crisis the real unit labour cost index fell quickly to approximately 90 per cent of the 1998 average level and around 91 per cent on average in the last five years. In particular sectors (the manufacturing industry, construction, transport and communications) this index fell under 70 per cent, consistent with enhanced labour efficiency, improved human and materials management and moderate real salary growth. Labour efficiency for the entire economy went up by 18 per cent between 2000 and 2005. In most sectors efficiency growth over the period mentioned above exceeded the average growth rate.

Sizable inventories have been accumulated in the economy as a whole and particularly in the manufacturing industry, transport and communications, and construction which are instrumental in preserving competitiveness in case of a short-term rise in unit labour costs. To this end, the increase in this indicator, started in mid-2005, should not be considered as a threat for the competitive position of the economy as a whole and the manufacturing industry, the major exporting industry.

Over the first quarter of 2006 production activity in industry was high. Industrial sales growth rate matched that of the corresponding quarter of the previous year. Oil refining industry benefited from favourable conditions and maintained the rate of export growth high. Metal products output and products from non-metal mineral raw materials were among the leading industries. Domestic market sales played a key role in the reported results, indicating a buoyant activity in construction. Industries manufacturing investment goods, that is production of machines and equipment, including electrical machines, exhibited a substantial growth in export sales.

Information on investments in the first quarter is insufficient. In addition to sales growth in manufacturing industries servicing construction, imports of investment goods, posting a 19 per cent nominal growth, is an indicator of a significant investment activity. The high degree of workload of industrial

Table 8
Index of Value Added per Employee
(2000 = 100)

	2001	2002	2003	2004	2005
Total	107.4	111.1	111.8	114.3	117.8
Agriculture	115.8	117.6	105.3	110.1	105.5
Mining and quarrying	100.1	117.5	107.2	122.2	129.8
Manufacturing	108.3	113.7	123.4	124.5	131.3
Energy and water supply	104.7	101.9	97.3	99.3	89.4
Construction	128.0	123.1	118.0	120.8	123.0
Trade	108.5	112.5	111.7	124.9	139.7
Transport and communications	115.4	124.3	132.0	140.1	148.3
Financial mediation	91.5	103.1	145.5	147.2	153.4
Other sectors	100.3	102.3	101.6	100.6	103.7

Source: NSI, Eurostat.

capacities is also an indirect indicator of the need to expand the production capacity. Available data give ground to expect a two-digit growth rate in investments in the first quarter, with the buoyant investment activity anticipated to retain over the whole year though at a slower rate in the second half of the year.

Based on the surveys conducted in industry, construction, trade and services expectations about production activity in the second and third quarter are optimistic. The favorable upward trend in business climate assessments retains, with services and industry contributing most significantly to improvement. Confidence in construction stays high and conservative assessments of retail trade are probably attributable to the increasing competitiveness within the sector. Notwithstanding, the prospects for the trade sector are favorable, since consumer confidence is tending to strengthen.

Exports and Imports of Goods

Nominal exports of goods in euro is expected to grow on an annual basis by about 23–25 per cent over the second quarter on the corresponding period of 2005, and by approximately 25–29 per cent over the third quarter underpinned by the reviving growth in the euro area and the recovery in production of key export-oriented sectors of the Bulgarian economy. Retained high current prices of energy resources and expected moderate growth of domestic demand will help keep the nominal growth rates of imported goods within 23–25 per cent in the second quarter and about 15–19 per cent in the third quarter.

Based on the forecasts about export and import dynamics, the trade balance deficit in the second quarter of 2006 is anticipated to reach approximately 21.9–22.5 per cent of the GDP on an annual basis and about 21–21.5 per cent in the third quarter.

Exports in euro reached EUR 2666.7 million in the first quarter of 2006, a nominal increase by EUR 586.1 million or by 28.2 per cent on the corresponding quarter of 2005. Imports (FOB) came to EUR 3705.2 million over the review period, up EUR 919.8 million on the first quarter of 2005, or 33 per cent.

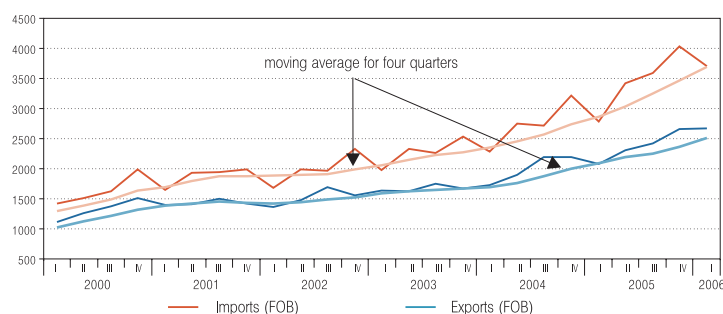
Forecasts about retaining export and import growth rates in the second quarter reflect the expected stabilization of international prices of raw materials of decisive importance for the Bulgarian economy at their currently high levels and a moderate increase in domestic demand. The adverse effect of some factors which occurred in 2005, such as a decline in agriculture

Table 9
Industrial Sales in the First Quarter of 2006
(change on the corresponding period of 2005)

Industries with largest contributions	rate, %			contribution, p.p.	
	total	domestic market	exports	domestic market	exports
TOTAL	8.2	3.2	13.5	1.7	6.5
Metal goods	31.9	35.8	26.4	20.9	11.0
Electrical machines and equipment	33.3	29.1	36.3	12.3	21.0
Energy and water supply	3.9	0.9	16.7	0.7	3.2
Food and drinks	3.4	5.2	-1.8	3.8	-0.5
Goods of non-metal mineral raw materials	10.3	22.6	-11.7	14.5	-4.2
Machines, equipment and home appliances	5.8	-4.1	12.6	-1.7	7.5
Vehicles (car excluded)	35.2	69.3	19.2	22.2	13.1

Source: NSI.

Chart 66
Dynamics of Exports and Imports (Quarterly)
(million EUR)



Source: BNB.

(caused by the floods in Bulgaria) and ongoing post-privatisation renewal of enterprises from metallurgical industry, impeded additionally the acceleration of Bulgarian exports over the second quarter of 2006.

Based on the assumptions about international price dynamics of major raw materials and the base effect of the corresponding quarter of 2005, over the third quarter exports are expected to accelerate and imports to slow down. The forecast is underpinned by the expected expansion of production and export activity in ferrous and non-ferrous metallurgy in the second half of the year and higher agricultural output in 2006. Over the third quarter of 2006 foreign trade dynamics will be also impacted by the anticipated improvement of trade conditions in Bulgaria and the slowdown in total domestic demand.

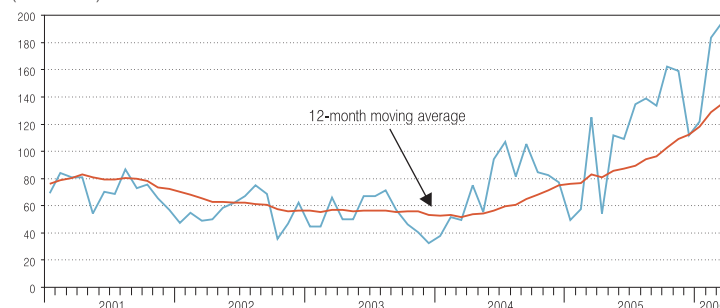
In terms of developments in exports and imports by commodity group and the respective contribution to total foreign trade flows, high growth rates in the group of energy resources is expected to sustain in the second and third quarters, prompting a rise in their weights in foreign trade. No quality changes in the developments of other commodity groups are expected.

Exports of mineral products and fuels posted the largest growth in the first quarter of 2006 (115.1 per cent), followed by machines, vehicles and appliances (48.7 per cent) and base metals (18.9 per cent). In accordance with the expectations exposed in the *Economic Review, issue 1/2006*, the increased physical volume of imported crude oil in the second half of 2005 led to a rise in exported volume of petroleum products in early 2006. The physical volume of exported petroleum products over the first quarter grew by 111 per cent on an annual basis and the increase in the average price (in euro) was 31 per cent. The high crude oil prices are expected to retain in the second and third quarter of 2006⁶, with the price effect on an annual basis anticipated to be stronger than in the second quarter.

⁶ Average Brent price (in US dollars) on international markets rose by 30 per cent over the January to March 2006 period against the prior year.

Chart 67
Exports of Mineral Products and Fuels

(million EUR)



Source: BNB.

The increasing imports of crude oil and more effective workload of production capacities of the local refinery will help sustain the high nominal growth rates of exports in this group.

Between January and March 2006 exports of machines and vehicles rose by EUR 150.8 million on the corresponding period of 2005 and their value reached EUR 460.7 million. Following the exports of mineral products these goods posted the highest growth rates, prompting a 15 per cent increase of these goods in the structure of exports in the first quarter of 2005 and a 17 per cent increase in the first quarter of 2006. The dynamic developments in this group also match the expectations: the trend is anticipated to sustain in the second and third quarters of 2006.

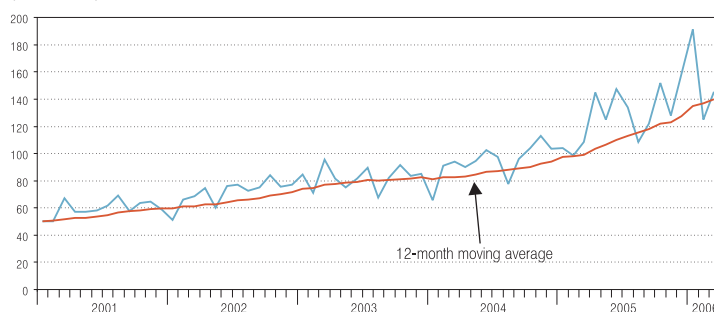
The total increase in exports of base metals was EUR 92 million in the first quarter of 2006 compared with the corresponding quarter of 2005, and to a great extent reflects the upward price dynamics of non-ferrous metals on the international markets. Exports of copper and copper products, which increased by 49 per cent over the review period, contributed most significantly to the total growth, by 4 percentage points. The downward trend in the volume of exported cast-iron, iron and steel which occurred in the second half of 2005, continued. The change in this group over the first three months of 2006 was -12 per cent on an annual basis and its contribution to total commodity exports of Bulgaria is -1.1 percentage point. This trend is expected to sustain in the second quarter and to reverse in the third quarter of 2006 when production and export activity in metallurgy is anticipated to expand.

Only exports of animal and plant products, food, drinks and tobacco exhibited a 4 per cent decline between January and March 2006 compared with the first quarter of 2005, with the export volume amounting to EUR 212 million. Floods in 2005 and lower agricultural output were probably the major reasons behind the lower exports of unprocessed food and tobacco since early 2006. This trend is expected also to sustain

Chart 68

Exports of Machines, Vehicles, Appliances, Tools and Weapons

(million EUR)

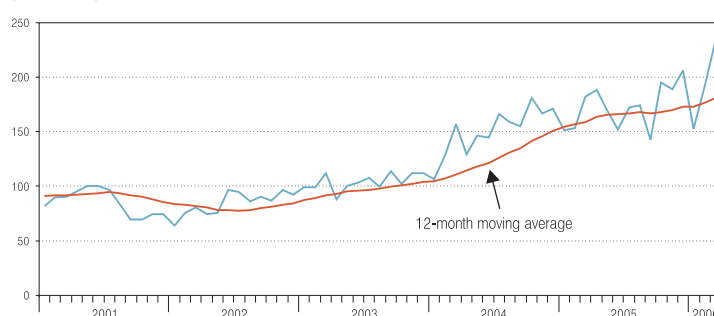


Source: BNB.

Chart 69

Exports of Base Metals and Base Metal Products

(million EUR)

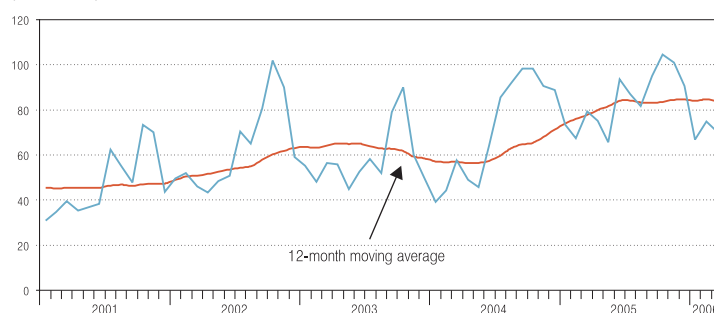


Source: BNB.

Chart 70

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

(million EUR)



Source: BNB.

in the second quarter of 2006, while in the third quarter exports of food are anticipated to recover after gathering the new crop.

Between January and March 2006 imports reached EUR 3933.2 million, a nominal increase by EUR 971.5 million or 32.8 per cent on 2005. Energy resources and consumer goods contributing by 17 and 4 percentage points correspondingly to the total import growth, increased most significantly in the structure of imports by use: 95.4 per cent and 26.6 per cent respectively. Accelerated growth of imported energy resources in terms of value reflected both the larger physical volumes and higher international prices of crude oil and petroleum products. Between January and March 2006 imported crude oil increased by 62.7 per cent compared with the corresponding period of 2005, with the average price (in euro) rising by 43 per cent. Total expenditure on imported crude oil (on an annual basis) rose by EUR 357.3 million over the review period, with EUR 145.4 million attributable to the price factor. High growth rates reported in this group are expected to retain in the second and third quarters, consistent both with the sustained international crude oil prices and increasing physical volumes. International price developments are anticipated to contribute significantly to the value growth (on an annual basis) in the second quarter and to help gradually subdue the price effect in the third quarter.

In contrast to the expectations imported consumer goods in the first quarter of 2006 grew at a faster pace (on an annual basis) compared with the second half of 2005, exhibiting a 27 per cent increase. Notwithstanding, the first quarter growth remained lower than total import growth as its was forecast, and this trend is expected to retain in the following two quarters.

The slowdown of imported investment goods, which started at the end of 2005, continued in January and February 2006, posting a 19 per cent growth in the first quarter. In terms of value, between January and March 2006 imports of investment goods went up by EUR 153.4 million compared with the corresponding period of 2005

Table 10

Contribution of Commodity Groups to Trade Growth between January and March 2006

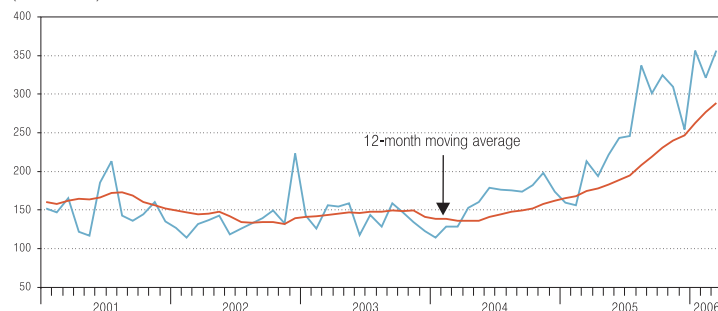
	Exports		Imports	
	growth,%	contribution, p.p.	growth,%	contribution, p.p.
Consumer goods	8.8	2.7	26.6	4.0
Raw materials	14.0	6.3	18.1	6.9
Investment goods	46.2	6.6	18.7	5.2
Energy resources	126.6	12.5	95.4	17.0
Other			-30.2	-0.3

Source: BNB.

Chart 71

Imports of Energy Resources

(million EUR)

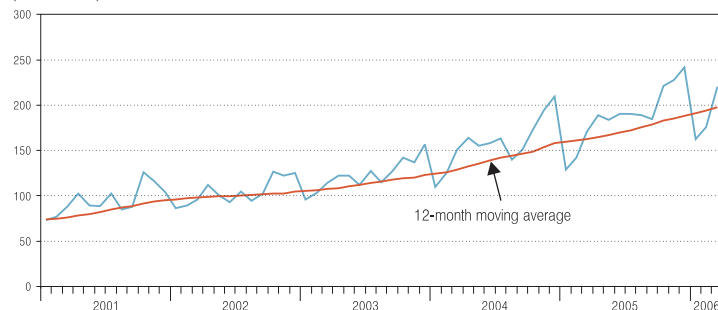


Source: BNB.

Chart 72

Imports of Consumer Goods

(million EUR)



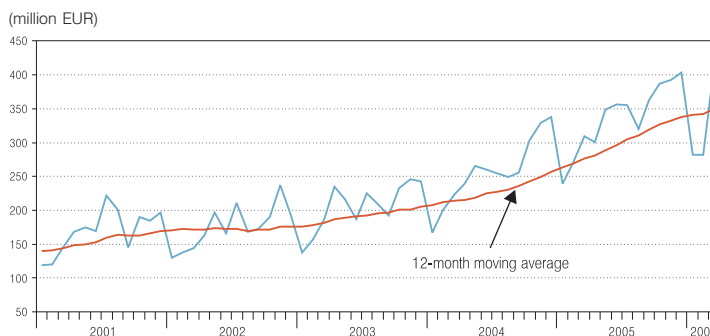
Source: BNB.

when it was EUR 972.5 million. On a disaggregated basis imports of vehicles and imports of machines and appliances contributed most essentially to the total import growth: by 2 percentage points and 1.1 percentage points respectively. In spite of the fact that accelerated imports of investment goods were reported only in March (32 per cent on an annual basis), the expectations are about comparatively high growth rates in the second and third quarters.

Imports of raw materials posted the lowest growth rate in the first quarter, 18.1 per cent on an annual basis, consistent with the previous forecasts. The volume reported between January and June 2006 was EUR 1345.8 million, up EUR 205.8 million on the corresponding period of 2005. Imports of ores and non-ferrous metals, increasing by 1.8 percentage points and 1.6 percentage points respectively, contributed most substantially to total growth, while raw materials for food production exhibited a decline and had a negative contribution of 0.7 percentage points. In the second and third quarters forecasts about imported raw materials are for positive growth rates, though lower than total import growth, tending to moderately accelerate in the third quarter.

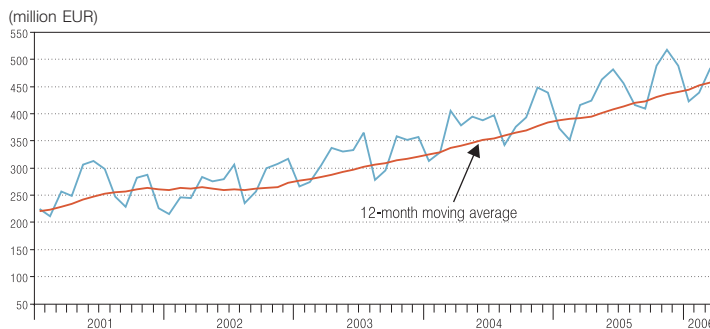
No significant changes are anticipated in the geographical structure of Bulgaria's exports and imports in the second and third quarters of 2006. Improved economic relations between Balkan countries and intensified integration with the ten new EU member states (EU-10) will lead to an increase in the shares of these regions in the Bulgarian exports. Exports to Balkan countries over the first quarter of 2006 accounted for 21.2 per cent (an increase of 0.9 percentage points on the corresponding period of 2005) and exports to EU-10 comprised 7.7 per cent (an increase of 1.7 percentage points). Sizeable imports of energy resources from Russia in the first quarter of 2006 was the major reason behind the 7.4 per cent increase (to 25.4 per cent) in the share of European countries outside the EU in Bulgarian exports under the conditions of a progressive price rise.

Chart 73
Imports of Investment Goods



Source: BNB.

Chart 74
Imports of Raw Materials



Source: BNB.

Based on the reported data under the System of National Accounts, imports of goods and non-factor services grew faster than in 2005 when the growth of physical volumes was 14.6 per cent and 7.2 per cent. This trend is expected to sustain in the first half of 2006 and to change radically in the third quarter. Based on the forecasts the volume of exported goods and non-factor services is expected to increase from 10 to 14 per cent in the following two quarters, with the exports accelerating in the third quarter due to increased euro area demand and the recovery of key industries in the Bulgarian economy. The forecast dynamics of exports is additionally underpinned by the anticipated weaker effect of transitional adverse factors which occurred in the second half of 2005.

The real growth in exported goods and non-factor services is expected to gradually slow down in the first three quarters of 2006 and to post a single-digit growth by the end of the forecast period. These expectations are based on the domestic demand dynamics, where growth rates are expected to decline under the average rates for 2005. The dynamics of the EUR/USD exchange rate is not expected to have a significant effect on Bulgaria's foreign trade balance in the following two quarters.

4. Inflation

In the second quarter of 2006 inflation is expected to stay at about 8 per cent on an annual basis due mostly to the April hike in petroleum prices on international markets. By the end of the review period a slight decrease is anticipated which will also sustain in the third quarter.

Accumulated inflation between January and April 2006 reached 4.6 per cent, pertaining mostly to the increased excise on cigarettes and higher sugar prices on international and domestic markets. Tobacco products contributed most significantly (by 2.72 percentage points) to the inflation rate, reflecting the adjustments in cigarette excise under the program for harmonizing indirect taxes and fees in order to comply with the EC minimum rates. With the exception of the group of cigarettes, the change in prices of consumer goods and services between January and April 2006 was 1.95 per cent, down 1 percentage point on the corresponding period of 2005 due to lower contribution of food, services and fuels. Food prices rose by 3.83 per cent from early 2006, consistent with the sugar price rise on international markets. Despite the increased excise fuels posted a mere 0.8 per cent growth on domestic market and did not reflect higher international prices of energy resources.

Since early 2006 prices of controlled goods and services rose by 12 per cent. In addition to tobacco products price rises were reported by postal services (23.6 per cent), fees related to personal vehicles (7.6 per cent), hospital services (6.7 per cent), passenger railway transport (2.2 per cent), while the prices of pharmaceuticals exhibited a decline of 0.54 per cent. Between January and April 2006 accumulated price rise of tobacco reached 74.8 per cent, with the excess over the initial assessments signaling a depleted excise effect. Given the significant increase in the excise on cigarettes, by April 2006 prices of controlled goods posted a 17 per cent growth on

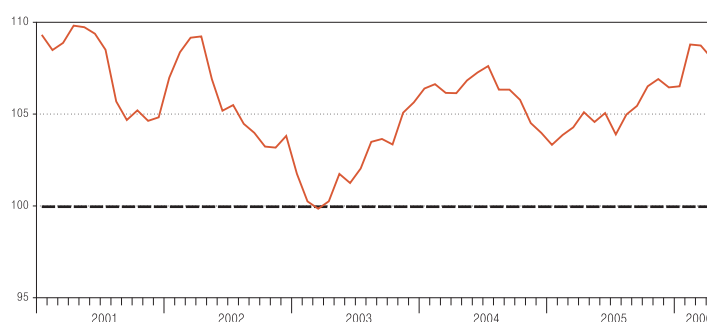
Table 11
Inflation Accumulated since Year's Start

	January – April	
	2005	2006
Inflation, %	3.04	4.60
Contribution, percentage points		
Foods	1.50	1.43
Non-foods	0.63	2.82
Fuels	0.39	0.02
Catering	0.10	0.14
Services	0.82	0.26
Goods and services with administratively set prices	0.45	2.70
Controlled-price goods	0.31	2.69
Tobacco	0.18	2.72
Controlled-price services	0.14	0.01
Electricity and heating	0.08	0.00

Source: NSI.

Chart 75
Consumer Price Index

(on an annual basis)



Source: NSI.

an annual basis. In the following two quarters the growth rate is expected to fall insignificantly to 16 per cent in accordance with the announced adjustments in administratively set prices.

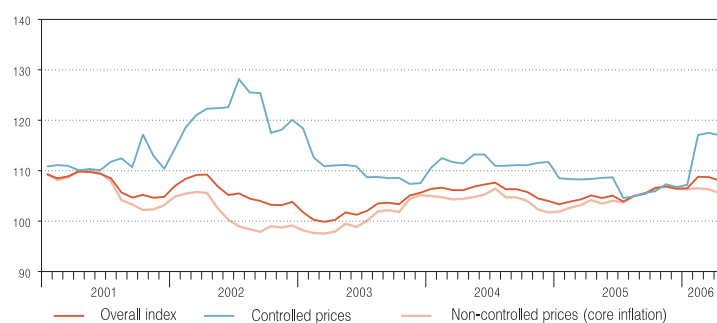
In the first quarter core inflation⁷ slowed down to 6.4 per cent on an annual basis, down 0.2 percentage points on the last quarter of 2005, consistent with the lower inflationary contribution of food and services. The annual rate of core inflation will continue falling in the following two quarters until the effects of the 2005 fuel price rise have been exhausted. In the second quarter of 2006 core inflation rate is expected to vary between 5.2 and 5.7 per cent due to a typical summer recovery in deflationary trend of unprocessed food. Given the lack of inflationary pressure from the prices of energy products and services in the domestic market, core inflation rate may subside to 3.5 per cent in the third quarter.

Sustained high growth rates of food prices reflect both the low base in the first quarter of 2005 and a number of other factors having a divergent effect on price dynamics of processed and unprocessed food. Increased international prices of sugar and sugar products (3 percentage points) contributed most significantly to the price hike of processed food to 6.2 per cent on an annual basis. As a result of enhanced market competition the contribution of bread and cereals went down to 1.2 percentage points, while alcohol drinks contributed by 0.73 percentage points due to the increased excise. Unprocessed food declined on an annual basis from 13 per cent in the fourth quarter of 2005 to 9 per cent on average in the first quarter of 2006, partly attributable to the restored normal fruit and vegetable seasonal price dynamics. Decreased consumption of chicken meat as a result of the information about Avian flu spread in early year had a strong effect for the 2 percentage point lower inflationary contribution by the *Meat* group compared with the fourth quarter of 2005.

⁷ Defined as inflation of goods and services excluding controlled-price ones.

Chart 76
Price Indices

(on an annual basis)



Source: NSI, BNB.

Chart 77
Price Indices

(on an annual basis)



Source: NSI, BNB.

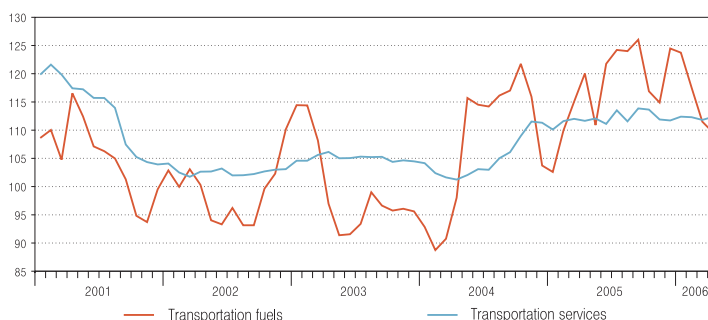
Food prices will continue falling under favourable weather conditions in the summer and with the depletion of adverse effects of the 2005 fuel price rises.

The annual price rise of fuels for transport and household heating subsided to 11.9 per cent on average in the first four months of 2006. Similar trend occurred in international prices of energy raw materials in US dollars on an annual basis (32 per cent for crude oil Brent type). The significant slowdown in the annual retail fuel prices on the domestic market could hardly be explained by the international situation where crude oil prices rose by 43 per cent in levs on an annual basis, taking into account the effect of the BGN/USD exchange rate. Between January and March 2006 fuel prices went down by 0.97 per cent on the domestic market despite the increased excise by 7.11 per cent on average. The impact of international prices on the domestic market subsided and fuel prices has decreased since early 2006 reflecting probably the high domestic market prices attained in 2005 and the higher excise rate. The dynamic market developments of energy raw materials over the recent months and occurrence of specific internal factors which have a divergent effect, make forecasts about fuel price dynamics in Bulgaria uncertain. In the following two quarters the annual inflation of this commodity group is expected to decline progressively.

The annual growth rate of services prices (controlled prices excluded) in the first quarter averaged 6.5 per cent, exhibiting a fall to 5 per cent in April owing to the base effect of the 2005 price rise in fixed telephone services. As a result of the planned restructuring of fixed telephone services prices in the second quarter, prices of these services will increase by approximately 8 per cent. This coupled with early 2006 effects of raised minimum salary, which directly affects medical services, pre-determines the expected annual inflation rate of market services to vary between 5 and 5.5 per cent in the following two quarters.

Chart 78
Price Indices

(on an annual basis)

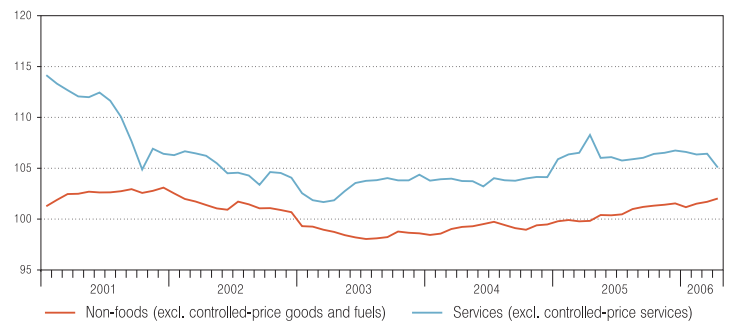


Source: NSI, BNB.

The annual price rise in non-food (fuels and controlled-price goods) went up to 1.5 per cent on average in the first quarter, a result of the indirect effect of sustained high growth rates of transportation expenditure and stable domestic demand. In the following two quarters inflation of non-foods is expected to stay at about 2.5 per cent.

Given the expected changes in the external environment and the velocity at which they impact the domestic market, the annual inflation rate in the second quarter is likely to stay at 8 per cent and may start subsid-ing to approximately 7.8 per cent. The lack of inflationary pressure from energy goods and services coupled with the typical summer recovery in deflationary trend of unprocessed food may prompt an inflation decline to about 6 per cent in the third quarter. Forecasts are challenged by the movements in international fuel prices and their effects on the domestic market which may indirectly push domestic prices up.

Chart 79
Price Indices
(on an annual basis)



Source: NSI, BNB.

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