# Economic Review

3/2006

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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The *Economic Review* is available at the BNB website, *Periodical Publications* submenu. Please address notes, comments and suggestions to the BNB Economic Research and Projections Directorate at 1000 Sofia, 1 Alexander Battenberg Square, or to econreview@bnbank.org.

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# Abbreviations

| | |
|---|---|
| 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 |
| EURIBOR | Euro Interbank Offered Rate |
| FDI | foreign direct investment |
| FOB | Free on board |
| GDP | Gross Domestic Product |
| HRW | hard red wheat |
| 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 |
| WTI | West Texas Intermediate |

# Summary

In the first half of 2006 world economic growth accelerated to 5.2 per cent, with the USA, Asian and euro area countries playing the major role. In mid-year global business indicators showed a possible moderation in world economy, especially in the USA in the second half of 2006, while growth rates of European and Asian economies are expected to retain their current levels.

US GDP grew by 2.6 per cent on an annual basis in the second quarter of 2006 (below the long-term growth rate) with private consumption and investments in business equipment contributing most significantly to this. Market expectations continued to indicate a gradual slowdown in economic activity in the third and fourth quarters of 2006 due to a weaker private consumption. In the second quarter US inflation preserved its upward trend and by June it reached 4.3 per cent on an annual basis. By end-June the US federal funds interest rate was increased by 25 basis points to 5.25 per cent. The opinion of most market participants is that it will keep its current level by the close of the year.

Euro area economic activity picked up in the second quarter of 2006, with GDP growth rising to 2.6 per cent on an annual basis affected by stronger investment activity and stable external demand. Most euro area forecasts put year-end economic growth within the range of 2.2 and 2.8 per cent. In August the Governing Council of the European Central Bank raised the interest rate on main euro area refinancing operations by 25 basis points to 3 per cent due to growing inflationary pressure and concerns about second-round effects. Market expectations point to another two rises of 25 basis points by the close of the year.

By mid-July the US dollar came to 1.25 against the euro. However, after the change in expectations of interest rate differential, it started to depreciate. Until the close of 2006 the exchange rate will fluctuate within a wider band, reflecting uncertainty about the US economic activity dynamics and future monetary policy of the ECB and the Federal Reserve System.

By end-September the Brent price came to USD 59 *per* barrel. We expect the average monthly Brent price to fluctuate in the corridor of USD 60 to USD 75 *per* barrel in the fourth quarter.

In the second quarter of 2006 BNB international reserves went up by BGN 1679 million. Between January and July 2006 they grew by BGN 1862.7 million and by July the Issue Department balance sheet figure reached BGN 16,277.7 million (EUR 8322.7 million). Unlike the first quarter, the amount of government operations directed at decreasing its deposit with the BNB was considerably smaller and had no sizable effect on international reserve dynamics.

Over the January to July 2006 period the current account deficit comprised EUR 1822.8 million against EUR 1065.7 million over the same period of 2005. All major current account components brought about the rise in the deficit during the period under review. Current account deficit is anticipated to show a minimum nominal improvement in the third quarter. Throughout 2006 estimates of current account deficit moved between 13.4 and 13.6 per cent of GDP.

Between January and July 2006 balance of payments financial account was positive, amounting to EUR 1999.5 million, of which EUR 1586.2 million were direct investments in Bulgaria. Foreign direct investment inflow into Bulgaria is expected to sustain its growth in the next quarters, matching the rise in BNB reserves. In the January to July 2006 period the net increase in non-government sector external debt was EUR 2107.8 million, including net liabilities of commercial banks of EUR 564.8 million and of private corporations of EUR 1543.9 million. This trend is likely to be sustained in the second half of 2006. As a result, in the fourth quarter private debt will reach 54–55 per cent of GDP.

The reserve money growth rate went up to 33 per cent on an annual basis by end-July 2006, underpinned by the behaviour of commercial banks' deposits with the BNB. In July 2006 growth rates of banks' claims on the non-government sector slowed down to 25.1 per cent on an annual basis. The more moderate increase in these claims reflected to a great extent transferring bank loans to non-resident financial institutions. Given the favourable credit aggregate dynamics in the last few months and decreasing efficiency of the administrative measures, in June 2006 the BNB Governing Council decided to gradually lift the restrictions on private sector credit growth. As a first step, the progressive scale of determining additional minimum required reserves was abolished. As a result, in August the average monthly amount of bank deposits decreased by some BGN 650 million on July. Adherence to the established restrictions on credit growth will lead to a fall in the annual growth rate of the claims on the non-government sector to 20–22 per cent by the close of the year.

As a whole, in the second quarter of 2006 interest rates on time lev deposits retained their first-quarter levels and those on foreign currency deposits continued to rise following the international interest rate dynamics. Lending interest rates also exhibited no significant changes.

In the first six months of 2006 economic growth stayed high. GDP went up by 6.6 per cent in the second quarter compared with the respective period of the prior year, driven by household consumption and investments in fixed capital. During the second quarter household consumption accelerated to 8 per cent on an annual basis and again contributed mostly to GDP growth. Enhanced consumer activity reflected mainly increasingly rising employment. During the first two quarters growth in investments in fixed capital exceeded 20 per cent. Macroeconomic stability, prospects of intensifying integration with European economies and increasing purchasing power of the domestic market were the major factors affecting positively investment activity.

High economic growth is expected to be sustained in the second half of 2006, slightly accelerating on the same period of the previous year. Investments and consumption will maintain high growth rates. However, the recovered growth of goods exports will play a leading role, resulting in a lower negative contribution to foreign trade balance.

Consolidated budget revenue overperformance by end-June above the indicative target set out in the agreement with the IMF pushed the fiscal surplus target from 3 per cent to 3.2 per cent of GDP, thus backing our forecasts of cash balance levels close to those of 2005. Contribution of government consumption to GDP real growth by end-2006 will also match that observed in the prior year. The prospects for growth rates of total expenditure similar to those of annual inflation are preserved.

During the January to July 2006 period exports went up to 29.1 per cent on an annual basis, while imports rose to 26.6 per cent. We expect the annual growth rate of nominal exports of goods in euro to reach some 28 to 30 per cent in the third quarter against the respective quarter of 2005 and approximately 24 to 28 per cent in the fourth quarter of 2006. The major factors behind this are the anticipated acceleration in EU growth in the second half of the year and expected upsurge in some key export-oriented sectors of the Bulgarian economy, stemming from recovery in metallurgy and agriculture. High prices of energy resources coupled with a slowdown in domestic demand in comparison with the respective quarters of 2005 will keep nominal import growth at 22–24 per cent in the third quarter and at approximately 20–24 in the fourth quarter. Based on the expected dynamics of exports and imports, the trade balance deficit will reach approximately 20 to 22 per cent of GDP for the year.

Inflation accumulated between January and August reached 2.21 per cent. Tobacco products contributed most significantly (by 2.72 percentage points) to the inflation rate, reflecting the increased excise rate which lead to a 74.9 per cent rise in their price. Restored seasonality of unprocessed foods whose prices fell by 12.1 per cent by end-August coupled with international energy price dynamics curbed the consumer price index growth.

We expect the annual inflation growth rate to moderate in the third quarter of 2006, reflecting the base effect of the previous year's respective period and restored seasonality of unprocessed food products. Based on expectations of international markets' developments, inflation will continue to subside on an annual basis in the fourth quarter as well. The upper bound of inflation growth is estimated at 6.6 per cent by the end of the year.

# 1. External Environment

World economic growth is expected to slow down in the second half of 2006. Euro area growth rates will accelerate, while those of the US economy will subside. Decreasing geopolitical uncertainty will result in a decline in crude oil prices and in subsiding inflationary expectations. By September market expectations were for retaining the US interest rates until the year-end and for increasing the euro area rates in two steps by 25 basis points.

## Current Business Situation

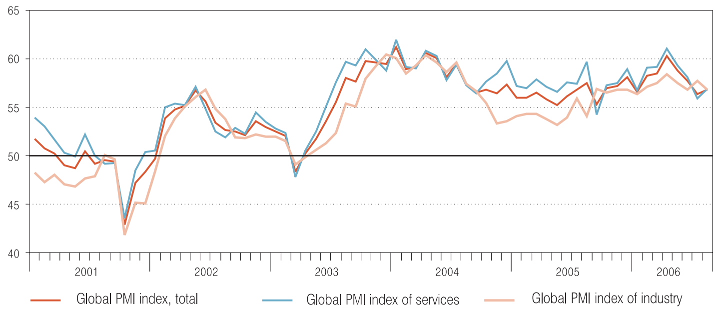
In the first half of 2006 world economic growth picked up to 5.2 per cent, especially in the USA, the Asian region and the euro area. The end of the second quarter and the start of the third quarter saw signs of moderation in world economy. Global business climate indicators reported a decline in optimism, and leading OECD indicators pointed to downward trends in world economy. Following the acceleration in the first quarter, world trade growth went down to 8.3 per cent in the second quarter. We expect economic growth to decrease during the second half of 2006, particularly that of the USA, while European and Asian economies growth will stay at the levels of the first six months of the year.

Risks to the projection are still associated with volatility in the prices of energy resources stemming from geopolitical uncertainty. Retained current levels of crude oil supplies and accumulated oil inventories are most likely to prompt a further fall in energy prices and gradual moderation in inflation across the world.

### The USA

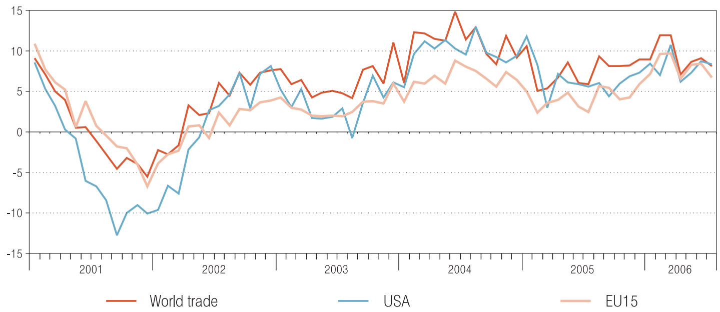
During the second quarter of 2006 US economic activity growth rates decreased below the long-term level. Since the Federal Reserve System continued to pursue its policy of raising interest rates and real interest rates stayed positive over a period of more than six months, consumer and investment demand started to signal a decline. According to the second revised estimate, in the second quarter of 2006 GDP increased

Chart 1
**Global PMI Indices**



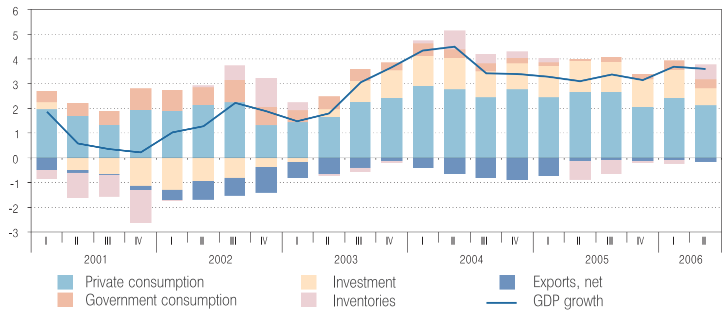

Source: NTC Research, JP Morgan.

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 (Quarterly)**
(%)




Source: Bureau of Economic Analysis.

by 2.6 per cent on an annual basis (5.6 per cent in the prior quarter) with private consumption, investments in business equipment, and raw material and output inventories contributing mostly to this growth by 1.8, 0.45 and 0.44 percentage points respectively. As a result of decreased demand for imported goods, the external sector also had a positive contribution to GDP growth (by 0.42 percentage points) for the first time in the last year.

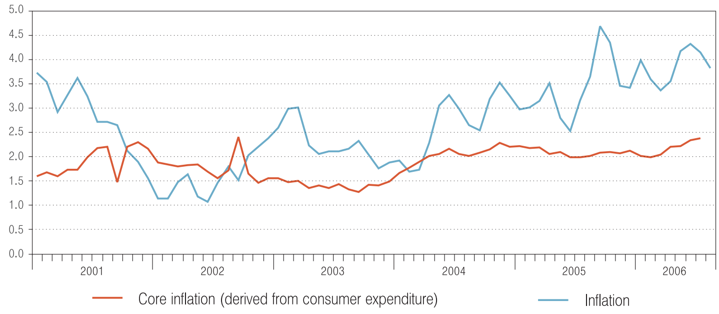
Consensus market expectations continued to indicate a gradual slowdown in economic activity in the third and fourth quarters of 2006 to levels lower than the long-term trend (3–3.3 per cent). Private consumption dynamics is anticipated to be the main force behind this projection. Owing to the rising indebtedness of households, their consumption was adversely impacted by higher real interest rates. Subdued activity on the housing market limited the opportunities of refinancing mortgage loans, thus reducing the effect of deriving value from property. This is likely to exert an additional pressure on consumer activity. As far as managers closely monitor the state of households, investments in the business sector will follow the slowdown in final sales to households.

In the second quarter US inflation sustained its upward trend underpinned by oil price dynamics, high consumer demand and decreasing labour productivity. It peaked by end-June at 4.3 per cent on an annual basis reaching its highest level in the last fifteen years.[1] Core inflation followed the same trend coming to 2.4 per cent on an annual basis by end-July.

Although US labour productivity increased in the first quarter, it was entirely due to the cyclically improving economic activity and in the second quarter the indicator registered growth lower than the long-term trend. In the second half of 2006 growth in this indicator is expected to remain lower but close to the long-term trend.

[1] September and October 2005 data have been disregarded due to the one-off effect of Katrina and Rita hurricanes.

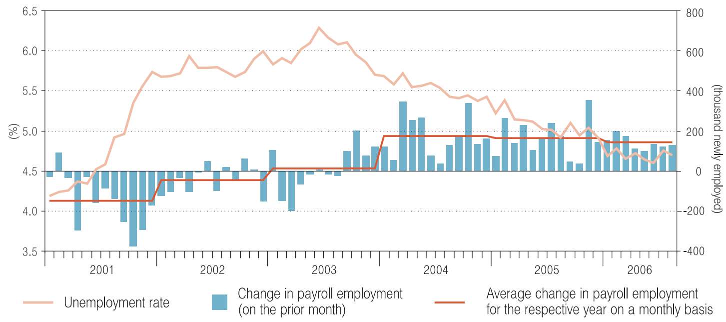
Chart 4
**US Inflation Rate**
(change on same period of previous year, %)




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

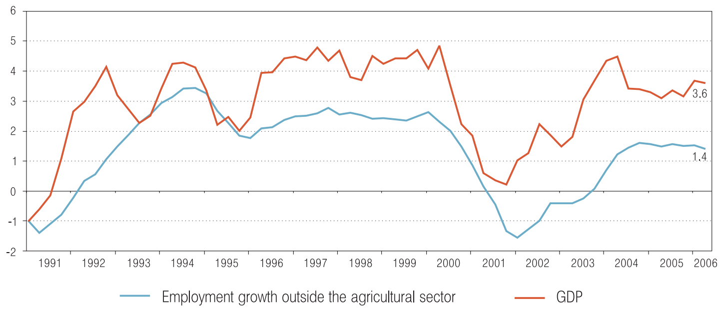
Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

Chart 5
**US Unemployment Rate and Change in Payroll Employment**



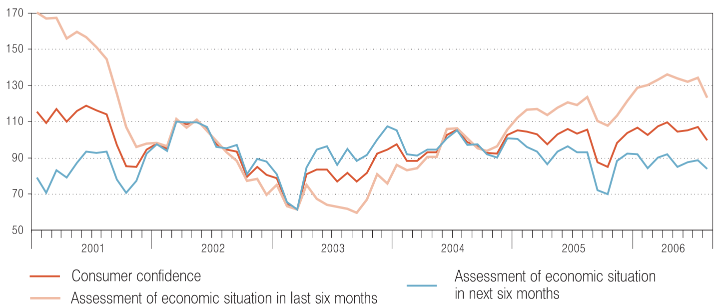

Source: Bureau of Labor Statistics.

Chart 6
**US Growth and Labour Market**
(on an annual basis, %)




Source: Bloomberg.

Chart 7
**US Consumer Confidence Indices**
(1985 = 100)




Source: The Conference Board.

US core inflation is anticipated to follow a downward trend in the third and fourth quarters of 2006. It will be determined by falling final consumer demand and weakening pressure of import prices. Decreasing labour productivity and rising unit labour costs will have opposite effects.

Overall inflation will further depend on oil price dynamics. In the third quarter it is more likely to fall below the first half-year levels. Oil prices will pose the major risk to the increasing US price level. Another risk stems from wage rises which, under the conditions of a weaker labour productivity growth, will increase the prime cost of products and services.

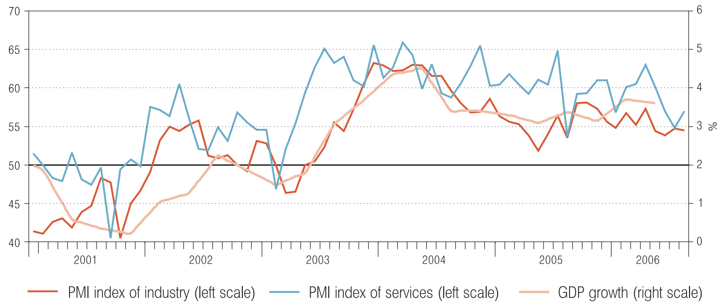
By the end of the half-year unemployment declined to 4.6 per cent and employment growth rates started to gradually subside, reaching 1.3 per cent on an annual basis by end-August.

At the end-June meeting of the Federal Open Market Committee, the federal funds interest rate was raised by 25 basis points to 5.25 per cent. After the July and August reduction in the annual inflation growth rate, at its August meeting the Federal Reserve System retained the reference interest rate. The opinion of most market participants is that the federal funds interest rate will stay at its current level. Provided this expectation comes true, the interest rate on six-month LIBOR deposits in US dollars is likely to move within the 5 to 5.5 per cent range until the close of the year.

## The Euro Area

The second quarter of 2006 saw a robust upsurge in euro area economy, with GDP growth rising to 2.6 per cent on an annual basis against 2.1 per cent in the first quarter. High economic growth was mostly ascribable to enhanced investment activity and stable external demand. Subsiding unemployment and respectively rising employment in the last few months contributed to higher incomes, which according to expectations, will boost consumer activity in the short run.

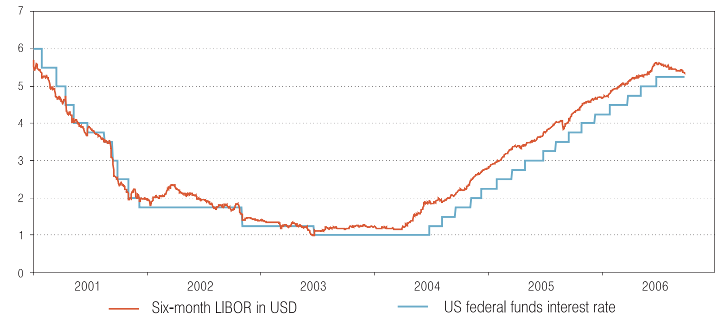
Chart 8
US PMIs and Growth




Source: Institute for Supply Management.

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

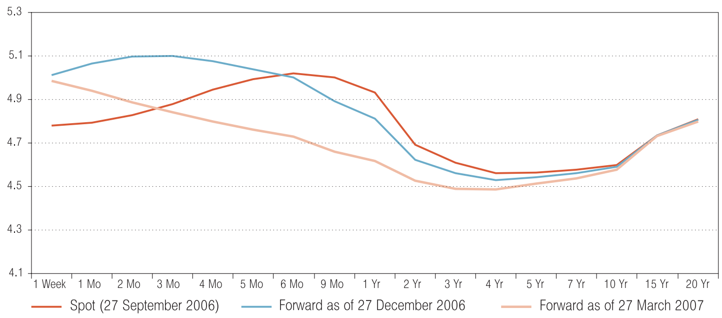
(%)




Source: Bloomberg.

Chart 10
Expected US Yield Curve

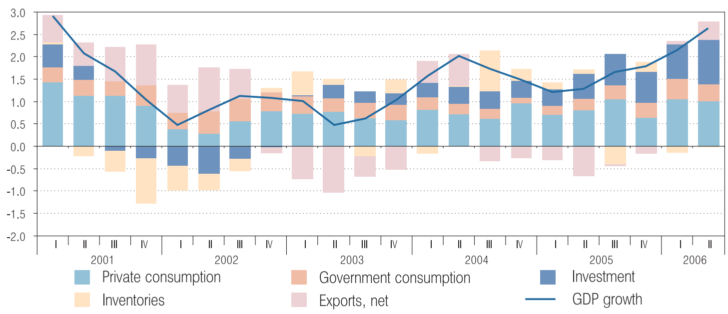
(%)




Source: Bloomberg.

Chart 11
Contribution to Euro Area Growth by Component

(%)




Source: Eurostat.

Leading business climate indicators and economic confidence dramatically improved to reach by mid-year their highest levels in the last five years. PMIs also rose steadily over most of the current year signalling brisk economic activity in industry and services. Although major leading indicators moderately dropped in July and August, their values stayed considerably higher than the average historical levels, showing economic agents' sustained optimism. Overall, economic indicators support expectations of an upsurge in European economy by the close of the current year.

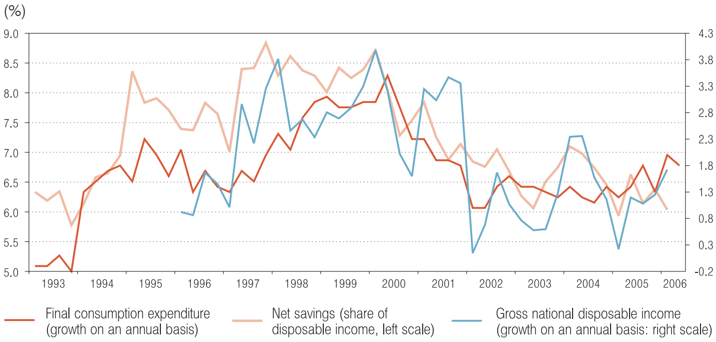
ECB latest forecasts published in September 2006 predict economic growth within the range of 2.2–2.8 per cent for 2006 (1.7–2.5 per cent in the previous quarter) and 1.6–2.6 per cent (1.5–2.5 per cent) for 2007. Consensus expectations of experts[2] put GDP growth at 2.2 per cent on an annual basis in 2006 and at 1.8 per cent on an annual basis in 2007. According to EC interim forecasts of September 2006, euro area growth expectations were revised upwards to 2.5 per cent against the previous forecast of 2.1 per cent. This change in the EC forecasts is ascribable to stronger economic indicators in the first half of the current year and expectations of a sizable domestic demand contribution to growth associated mainly with withdrawal of consumption and investments in Germany into 2006 reflecting VAT increase in 2007.

Euro area inflation behaviour was mostly driven by oil price dynamics in the current year's second quarter and early third quarter. After peaking at 2.5 per cent on an annual basis in May and June, harmonized inflation dropped to 2.3 per cent on an annual basis in August. Core inflation continued to vary at considerably lower levels coming to 1.3–1.5 per cent on an annual basis in the period between April and end-July.

[2] Source: ECB Survey of Professional Forecasters, Q3 2006.

Chart 12

Euro Area: Incomes, Consumption and Savings

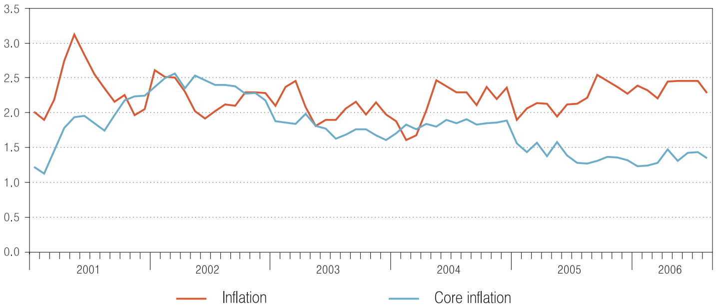



Source: Eurostat.

Chart 13

Euro Area Inflation Rate

(change on same period of previous year, %)

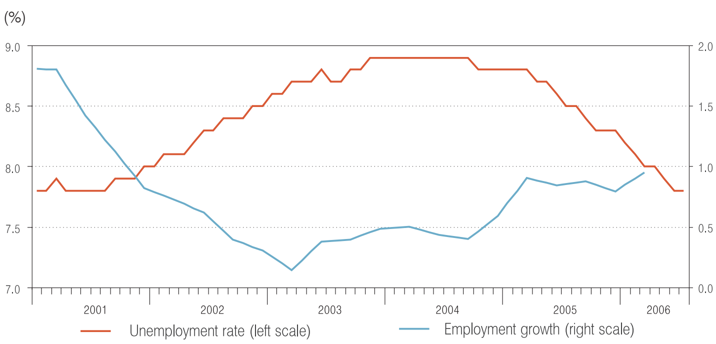



Note: Euro area core inflation excludes changes in energy, food, alcohol and tobacco prices.

Source: Eurostat.

Chart 14

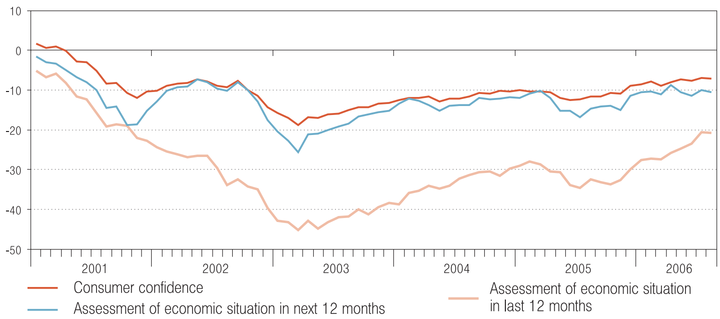
Euro Area Unemployment Rate and Employment Growth




Source: Eurostat.

Chart 15

Euro Area Consumer Confidence Indicators



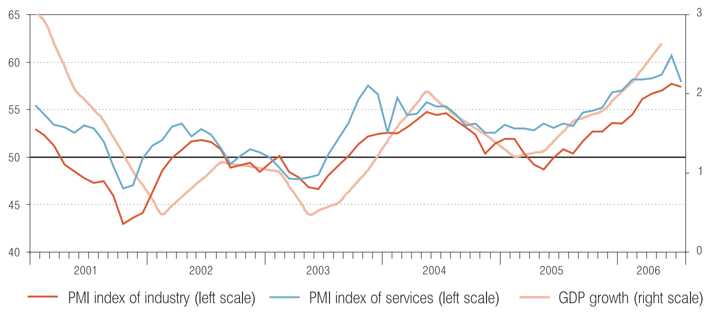

Source: Eurostat.

Euro area inflation is anticipated to fluctuate close to the ECB indicative target of 2 per cent. This assumption is backed by the prospects of moderate unit labour cost growth. Latest data on European corporate profit show that rising production costs could be defrayed by the profit of enterprises without affecting significantly final consumer prices. Uncertainty about oil price dynamics and putative second-round inflationary pressures will be the factors associated with inflationary risks in the euro area. VAT increases in Germany may exert a one-off inflationary pressure in early 2007. Consistent with this measure, a portion of consumer expenditure in the biggest European economy is expected to be withdrawn into the fourth quarter of 2006 which may result in an inflationary pressure exerted by enhanced consumer demand.

Since early 2006 unemployment in the euro area has been subsiding steadily and by July it came to 7.8 per cent. Employment components of PMIs varied at a level of over 50 showing positive growth of employment in the services and manufacturing sectors. Expectations of the future labour market dynamics in the next twelve months based on an economic survey conducted by the EC are favourable and point to a possible decline in unemployment.

At its meeting in early August, the ECB Governing Council raised the interest rate on main refinancing operations in the euro area by 25 basis points to 3 per cent. The decision was influenced by growing expectations of inflation in the medium run and the risk of arising second-round effects. At its meeting of end-August, the ECB Governing Council announced that it would most probably raise the repo rate by 25 basis points in early October. Developments in euro area macroeconomic indicators, as well as public statements by members of the ECB Governing Council gave rise to market expectations of a repo rate increase by the close of the year.

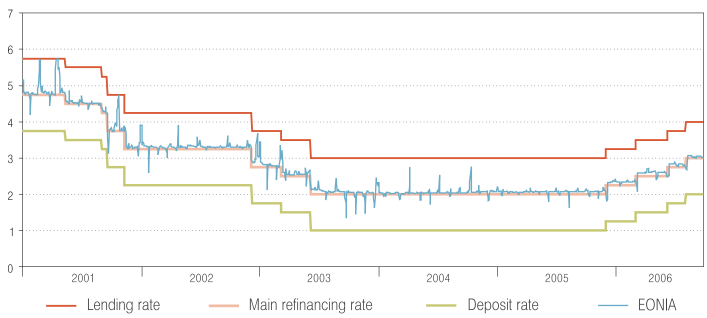
Chart 16
PMI Indices and Euro Area Growth




Source: Eurostat.

Chart 17
Euro Area Base Interest Rates

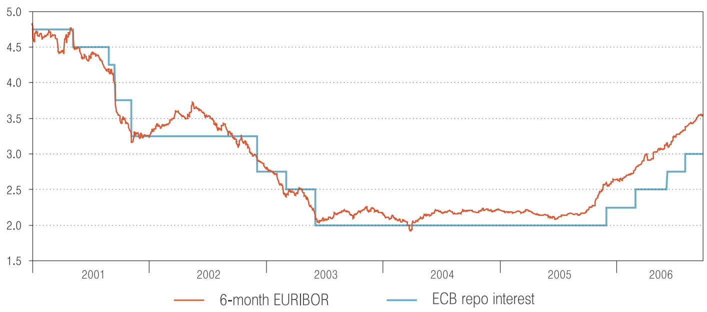
(%)




Source: Bloomberg.

Chart 18
BIR on Refinancing Operations and Six-month EURIBOR

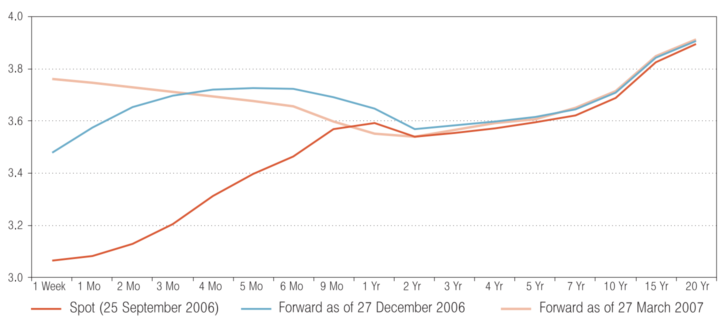
(%)




Source: Bloomberg.

Chart 19
Curve of Expected Euro Area Yield

(%)




Source: Bloomberg.

If the ECB raises the repo rate at the current pace once or twice until the year-end, we may expect the six-month EURIBOR on time deposits to be between 3.409 and 3.976 per cent in the fourth quarter of 2006.

## EU-25

EU-25 growth continued to accelerate, reaching 2.8 per cent in the second quarter of 2006. New member countries' growth also increased to 5.7 per cent over the same period owing to Poland's buoyant growth.

Average monthly inflation in the newly acceded countries went up to 2.3 per cent over the second quarter of 2006, reflecting mainly the rises in the prices of fuels and transportation services.

## The *USD/EUR* Rate

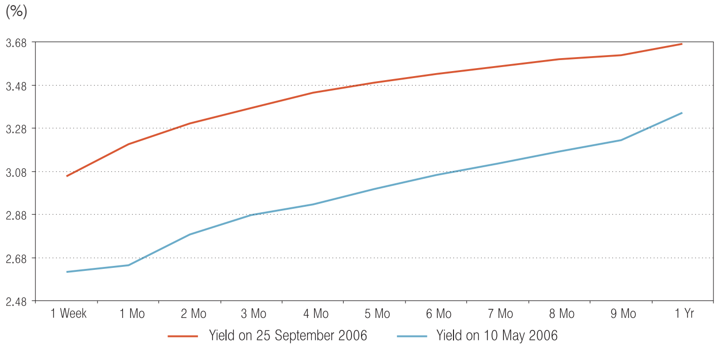
Until mid-July the US dollar appreciated against the euro to the level of 1.25 underpinned by investment outflows from emerging markets. The appreciation resulted from the rise in risk premiums pushed by escalation in geopolitical uncertainty in the Middle East. These levels appeared to be the highest ones in the third quarter when the USD/EUR rate moved within the relatively narrow 1.25 to 1.29 band displaying no clear trend.

During the next few months foreign currency market will fluctuate in a wider interval owing to the uncertainty about US economic activity dynamics and future monetary policy. By September foreign currency markets expect a retained interest rate in the USA until the close of the year and two rises of 25 basis points in the euro area.

In the long run concerns about external imbalances will further add to the weakening of the US dollar to which in the short run stronger than expected data on economic growth in the world's biggest economy may be opposed.

Chart 20

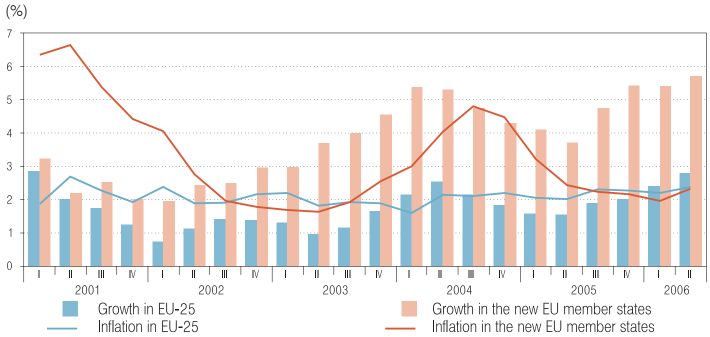
Euro Area Money Market Yield Curve




Source: Bloomberg.

Chart 21

Growth and Inflation in EU-25 and in the New EU Member States (Quarterly)




Source: Eurostat, BNB.

Chart 22

USD/EUR Exchange Rate


Source: ECB.

## The Balkan Region

Economic developments in the Balkan Region stayed favourable. In the second quarter of 2006 economic growth of Balkan countries continued to accelerate. Macroeconomic data in the second and the beginning of the third quarter of 2006 show sustainable high growth rates. Inflation dynamics in the second quarter reflected mainly rises in the price of fuels and transportation.

We anticipate that high economic activity prompted mainly by expectations of EU growth and respectively by strong foreign demand in these countries will be retained in the second half of 2006 as well.

Table 1
**Real Growth and Inflation in Balkan Countries (Quarterly)**

| | 2004 | | | | | 2005 | | | | | 2006 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | I | II | III | IV | Total | I | II | III | IV | Total | I | II |
| **Growth** (on the previous year, %) | | | | | | | | | | | | |
| Bulgaria | 4.6 | 5.5 | 6.2 | 6.3 | 5.7 | 5.9 | 6.5 | 4.6 | 5.5 | 5.5 | 5.6 | 6.6 |
| Greece | 4.3 | 4.1 | 4.0 | 4.2 | 4.2 | 3.5 | 3.7 | 3.8 | 3.7 | 3.7 | 4.1 | 4.1 |
| Macedonia | 3.4 | 4.8 | 4.6 | 3.4 | 4.1 | 2.9 | 5.0 | 4.1 | 3.8 | 4.0 | 2.6 | |
| Romania | 6.1 | 7.1 | 11.1 | 8.9 | 8.3 | 5.9 | 4.1 | 1.8 | 4.6 | 4.1 | 6.9 | 7.9 |
| Turkey | 11.8 | 14.4 | 5.3 | 6.3 | 8.9 | 6.6 | 5.5 | 7.7 | 9.5 | 7.4 | 6.5 | 7.5 |
| Croatia | 4.2 | 3.8 | 3.6 | 3.6 | 3.8 | 1.8 | 5.1 | 5.2 | 4.8 | 4.3 | 6.0 | |
| Serbia | 7.5 | 5.5 | 9.5 | 14.2 | 9.3 | 5.3 | 6.8 | 5.6 | 5.9 | 6.3 | 6.3 | |
| **Inflation** (averaged for the period, %) | | | | | | | | | | | | |
| Bulgaria | 6.4 | 6.7 | 6.8 | 4.8 | 6.2 | 3.8 | 4.9 | 4.8 | 6.6 | 5.0 | 8.0 | 8.3 |
| Greece | 2.9 | 3.1 | 3.0 | 3.2 | 3.0 | 3.4 | 3.2 | 3.8 | 3.5 | 3.5 | 3.2 | 3.4 |
| Macedonia | 1.6 | -0.5 | -1.5 | -1.1 | -0.4 | -0.4 | 0.9 | 0.8 | 0.8 | 0.5 | 2.7 | 3.4 |
| Romania | 13.6 | 12.3 | 11.9 | 10.0 | 11.9 | 8.9 | 9.9 | 8.9 | 8.5 | 9.0 | 8.6 | 9.6 |
| Turkey | 14.1 | 9.3 | 9.5 | 9.7 | 10.7 | 8.6 | 8.6 | 7.9 | 7.6 | 8.2 | 8.1 | 7.1 |
| Croatia | 1.8 | 2.3 | 1.8 | 2.3 | 2.1 | 3.1 | 3.0 | 3.4 | 3.8 | 3.3 | 3.5 | 3.8 |
| Serbia | 8.6 | 10.3 | 12.2 | 12.9 | 11.0 | 15.9 | 16.4 | 15.5 | 16.6 | 16.1 | 15.2 | 14.2 |

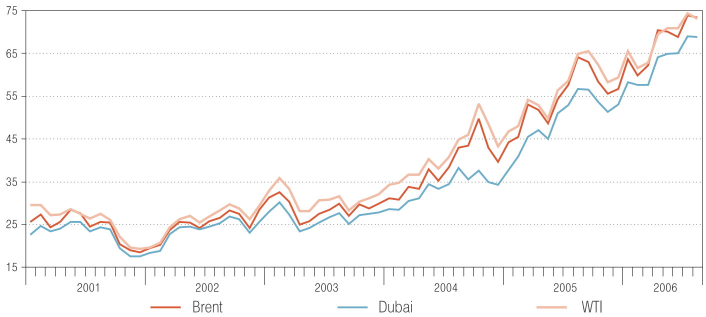
Source: Statistical institutes and central banks of respective countries.

## International Prices of Major Raw Materials, Crude Oil and Gold

### Crude Oil

In the second quarter of 2006 global uncertainty continued to be a major factor behind crude oil price dynamics. The average monthly Brent price came to USD 69.8 *per* barrel during the quarter under review. Volatility persisted in the third quarter as well, and in mid-July the price reached USD 78 *per* barrel. The major factors behind the third quarter price rises were the Middle East conflict and declared intentions of repairing a main oil pipeline which would halve oil supply by the biggest platform of British Petroleum in Alaska (with a capacity of 850,000 barrels *per* day, 17 per cent of the US oil extraction). On the other hand, developments in Iran's nuclear programme were and still are dynamic and uncertain. Only by end-August the steps undertaken by Iran for a dialogue with the EU eased

Chart 23
**Crude Oil**
(USD *per* barrel)




Source: World Bank.

somewhat the tension on the market and, in tandem with some other factors, contributed to a decline in crude oil prices. Market supply remained stable at high levels thanks to the OPEC countries' production. Thus, high inventories of oil products in OECD countries were preserved. Expectations of an active season of the hurricanes in the Atlantic Ocean did not realize and oil supplies from Alaska were resumed since the oil pipeline repairs caused no serious difficulties in crude oil transportation. Hence, the Brent price came to USD 59 *per* barrel by end-September.

The Brent average monthly price is projected at USD 60 to USD 75 *per* barrel. It will be mostly affected by geopolitical factors related to the supply and especially the putative UN sanctions against Iran provided that the country changes its position. Another obstacles to greater decrease in oil prices are enhanced demand with the coming winter in the Northern Hemisphere and clearly pronounced unwillingness of some OPEC countries to lower the price below USD 60 *per* barrel.

### Major Raw Materials and Commodity Groups

High demand and reduced inventories of non-ferrous metals continued to be the main drivers behind their appreciation. Over the January to August 2006 period the rise in prices of nickel, zinc, copper and aluminum came to 128.9 per cent, 83.7 per cent, 68.1 per cent and 9.5 per cent respectively.

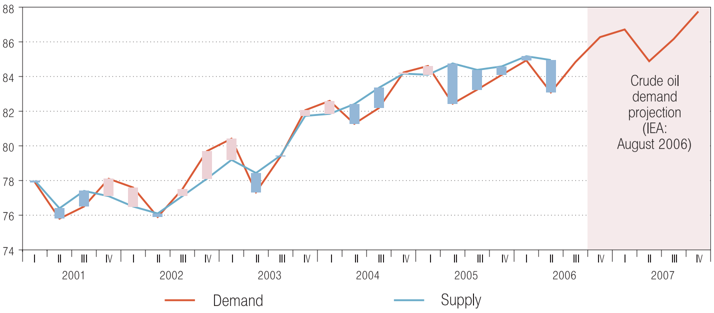
Steel production increased, meeting strong world demand which kept steel prices almost unchanged in the second and third quarters of 2006. Between January and August production growth was 9.5 per cent higher than that in the same period of 2005. By August the Chinese share in world production reached 36 per cent (32 per cent for 2005).

Metal price growth is projected to fall in line with expectations of world economy moderation in the second half of 2006.

Chart 24

World Crude Oil Demand and Supply

(million barrels *per* day)




Source: IEA.

Food prices went up by 9.1 per cent in the second quarter of 2006 on the same period of 2005, while in July and August the appreciation came to 11.4 per cent. Cereal prices which rose by 15.9 per cent in the second quarter and by 18.3 per cent in the first two months of the third quarter contributed mostly to the acceleration in food inflation. Although North America' yields exceeded the expected ones, the robust demand in the EU, India and Egypt created conditions for retaining the prices after their rise in the first quarter of the year.

The sugar price dropped in the second and third quarters as a result of anticipated higher yields which would be sufficient to satisfy rising demand for sugar cane used in ethanol production.

Food prices are expected to undergo no significant changes in the second half of 2006 which will reflect, on the one hand, stable demand and, on the other one, forecasts of good autumn crops.

Chart 25
Price Indices of Major Commodities and Commodity Groups
(2000 = 100)


Source: World Bank, BNB.

## Gold

In the third quarter fluctuations in the price of gold stayed relatively high despite their subsiding amplitude. During the July to mid-September period the average value of gold stayed close to the one registered in the second quarter: around USD 628 *per* troy ounce.

The main factors affecting the gold price behaviour were the geopolitical uncertainty in the Middle East, changes in inflationary expectations among market participants, the Federal Reserve System's decision to retain the reference interest rate at 5.25 per cent, the USD rate's volatility and the speculative interventions of hedging funds and other institutional investors. In the summer months market participants balanced their positions using the gold price and following the crude oil price dynamics. The close correlation between gold and the USD/EUR exchange rate also was sustained.

According to market expectations, in the next months the gold price will continue to reflect oil prices and its technical link with the US dollar will still be in force. The main drivers behind the gold price will be the inflationary expectations in the USA and the Federal Reserve System's interest rate policy. Stronger investor interest in gold may be expected in case of deepening problems of the US economy. The traditional autumn demand of the jewellery industry will probably be lower given the relatively high prices.

## Bulgarian External Debt Dynamics

The second quarter of the current year saw a subsiding investor interest in government debts of emerging markets. The total government spread measured by the JP Morgan EMBI+ index increased to 238 basis points by end-June after the record low of 174 basis points reached in May. The rise in the risk premium registered in mid-May resulted from the growing concerns about inflation and global cycle of increasing interest rates. This proved to be of temporary nature as there has been a steady decline in the spread since early July.

Chart 26

Spot Price of Gold

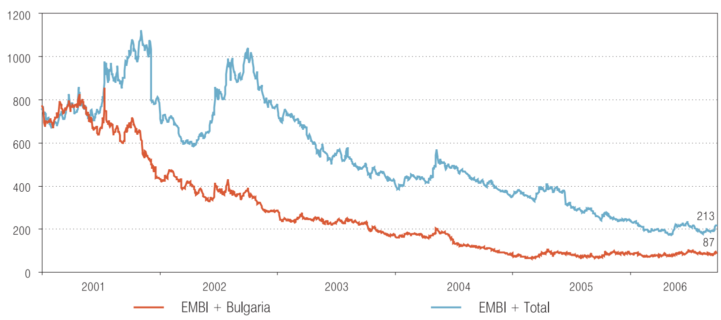
(USD *per* troy ounce)


Source: World Gold Council.

Chart 27

Spread of JP Morgan Index for Emerging Markets

(basis points)




Source: Bloomberg.

The Bulgarian government securities spread measured by the JP Morgan EMBI+ index was also affected, albeit on a smaller scale, by the global trend, and as of end-June it came to 105 basis points. The subsequent return to higher-risk assets on the part of market participants contributed to the decrease in the yield spread to some 85 basis points in early September.

Favourable macroeconomic conditions in Bulgaria, its upcoming membership in the EU and expectations of a sustained conservative fiscal policy were among the major factors of importance for maintaining further investor interest in Bulgarian government debt and low risk premium.

# 2. Financial Flows, Money and Credit

Over the recent years Bulgaria's economic development has been 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 balance of payments current account deficit continued to grow in the first half of 2006 as well. It was covered by the positive capital inflow into the financial account which continued in 2006, adding to the increase in investments in the private sector. The influence of capital inflows is additionally shown in the change in international reserves which through the currency board arrangement leads to a change in monetary base, and through the process of money multiplication it affects broad money and credit dynamics.

Table 2

Cash Flows Which Prompted Significant Changes in Gross International Reserves

| | First half, 2006 | Second quarter, 2006 | July 2006 |
|---|---|---|---|
| **A) Purchases and sales of reserve currency**<br>- Net purchases from commercial banks | Total, net: EUR +772 million<br>Net purchases from commercial banks: EUR 785 million<br>Bought: EUR 5708 million<br>Sold: EUR 4923 million | Total, net: EUR +574 million<br>Net purchases from commercial banks: EUR 580 million<br>Bought: EUR 3714 million<br>Sold: EUR 3134 million | Total, net: EUR +333 million<br>Net purchases from commercial banks: EUR 334 million<br>Bought: EUR 1143 million<br>Sold: EUR 809 million |
| - Revenue (outflows) related to net purchases at tills | Sold banknotes: EUR 13 million | Sold banknotes: EUR 6 million | Sold banknotes: EUR 1 million |
| **B) Changes due to revenue (outflows) on commercial banks' minimum required reserve accounts in foreign currency** | Net revenue: EUR 603 million | Net revenue: EUR 373 million | Net revenue: EUR 30 million |
| **C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)** | **Revenue**:<br>EUR 113 million<br>USD 17 million<br>SDR 10 million<br>**Payments**:<br>EUR 929 million<br>USD 141 million<br>JPY 1.1 billion<br>SDR 10 million | **Revenue**:<br>EUR 46 million<br>USD 10 million<br>SDR 3 million<br>**Payments**:<br>EUR 189 million<br>USD 10 million<br>JPY 474 million<br>SDR 4 million | **Revenue**:<br>EUR 117 million<br>USD 4 million<br>SDR 4 million<br>**Payments**:<br>EUR 31 million<br>USD 77 million<br>JPY 170 million |

Source: BNB.

In the second quarter of 2006 BNB international reserves increased by BGN 1679 million. Between January and July they picked up by BGN 1862.7 million and by July the Issue Department balance sheet figure reached BGN 16,277.7 million (EUR 8322.7 million). Unlike the first quarter, the amount of government operations was considerably smaller and they did not affect significantly the international reserves dynamics. Net currency purchases and changes in commercial banks' minimum required reserve accounts played a key role for the reserves growth.

## Financial Flows and External Position Sustainability

**On an annual basis, current account deficit is expected to vary within the range of 13.2 and 13.4 per cent of GDP in the third quarter of 2006 and within 13.4 and 13.6 per cent for the year. The FDI inflow into the economy will stay high and the private sector will continue borrowing. Private debt is expected to be between 52 and 53 per cent of GDP in the third quarter of 2006 and between 54 and 55 per cent of GDP in the fourth quarter.**

Over the January to July 2006 period the current account deficit came to EUR 1822.8 million against EUR 1065.7 million for the same period of 2005. All major current account components contributed to the increase in the deficit during the period, the trade balance deficit growth accounting for 58.8 per cent of the worsening followed by the income balance which accounted for another 17.5 per cent of it.

Exports of goods picked up by 29.1 per cent on the respective period of 2005, accelerating in the second quarter. Over the January to July 2006 period import growth totaled 26.6 per cent; in the second quarter it slowed down compared with the first quarter. Based on the System of National Accounts data, it may be concluded that a positive change in trade conditions emerged: the goods exports deflator was 13.9 per cent at average prices for 2005, while the analogous imports deflator was 7.9 per cent. Similar dynamics was observed for the first time after several quarters of worsened trade conditions. In the third and fourth quarters export growth is likely to continue rising underpinned by external demand and international prices. Concurrently, certain moderation in import growth rates is anticipated but it will be subdued by domestic demand.

Between January and July the balance of services comprised EUR 337.9 million, down EUR 95.5 million on the January to July 2005 period. The trend towards high growth rates of imports on the *Other services* item was retained (28.7 per cent in the period under review). Returns on the *Travel* item also remained low (4.6 per cent), albeit accelerating on the first quarter. The *Other services: credit* item reported more sizable growth (29.7 per cent against 1 per cent in the first quarter). The latter confirms the hypothesis that exports and imports of services' growth rates will start converging.

Income balance went down by EUR 132.8 million in the first seven months of 2006 compared with the respective period of 2005 reaching EUR -14.4 million. The fall could be explained almost entirely by higher outflows on the income from direct investments which rose by 48.9 per cent (EUR 123 million) over the period. A similar rise, although higher than usual, corresponds to the trend towards increasing direct investments in the country. Therefore, such flows may be expected in the future as well.

Between January and July net current transfers declined by EUR 83.8 million on the corresponding period of 2005. Smaller flows were registered both on the credit side and the debit side. A possible explanation for the current transfers' dynamics is that rising employment and incomes in the country limit the needs for transferring external resources into Bulgarian economy; hence, flows on the current account decrease.

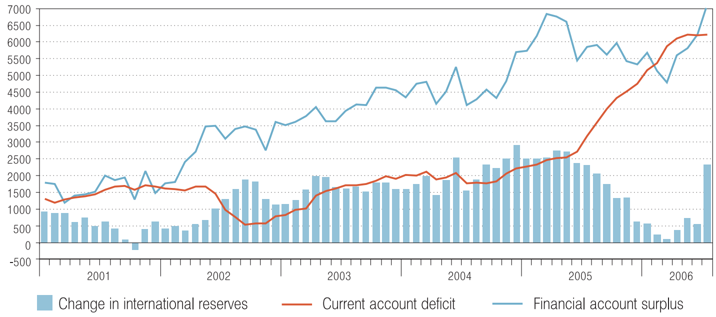
In the third and fourth quarters income balance is not expected to change substantially in comparison with the respective periods of 2005. Net current transfers are projected to stay close to those of the third and fourth quarters of 2005 and a greater credit side improvement is unlikely to happen in the second half of 2006.

Current account deficit is expected to post a minimum nominal improvement in the third quarter of 2006 against the third quarter of

Chart 28

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

(million BGN)




Source: BNB.

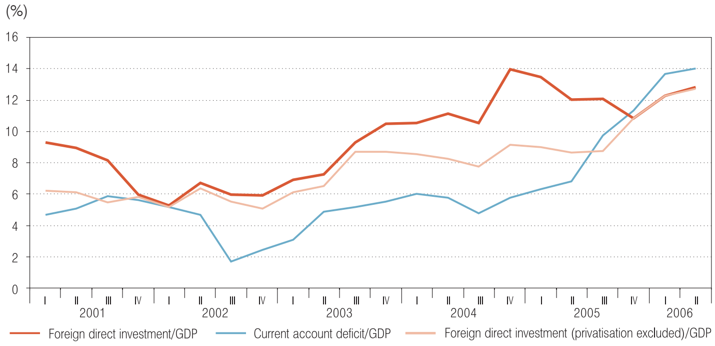
2005 as a result of better balance of services. The third-quarter current account deficit will be within the 13.2 to 13.4 per cent band on an annual basis. Throughout 2006 the current account deficit will worsen in comparison with that for 2005 both nominally and as a share of GDP. All major current account components are anticipated to add to this. The current account deficit for 2006 is assessed to vary between 13.4 and 13.6 per cent of GDP.

Over the January to July 2006 period the balance of payments financial account was positive and amounted to EUR 1999.5 million, of which EUR 1586.2 million were direct investments in Bulgaria. Compared with the respective period of 2005, foreign direct investment inflow picked up considerably (126.5 per cent). The effect of earnings from privatisation on direct investment in the periods subject to comparison was minimal (EUR 25 million until July 2006 and no earnings in 2005) which supports the assumption that the increase in direct investments reflects enhanced investor interest in the Bulgarian economy. Foreign direct investment inflow is expected to continue rising in the next quarters backing the BNB reserves' growth.

The greater part of financial inflows into Bulgaria in the first seven months of 2006 include borrowed funds. Attracted debt capital plays a key role for financing the investment process in the country and for maintaining high economic growth. The bulk of these resources was used to directly finance companies and the remaining part was distributed through the banking system. Over the January to July 2006 period the net increase in the non-government external debt came to EUR 2108.7 million, with commercial banks' net liabilities rising by EUR 564.8 million and those of private corporations by EUR 1543.9 million. Economic sectors which became indebted most intensively in the first half of 2006 were real property, renting and business services (41 per cent of the total growth in the external indebtedness of the real sector, excluding commercial credits and bond loans), and wholesale trade and commercial intermediation (19 per cent of the growth).

Chart 29

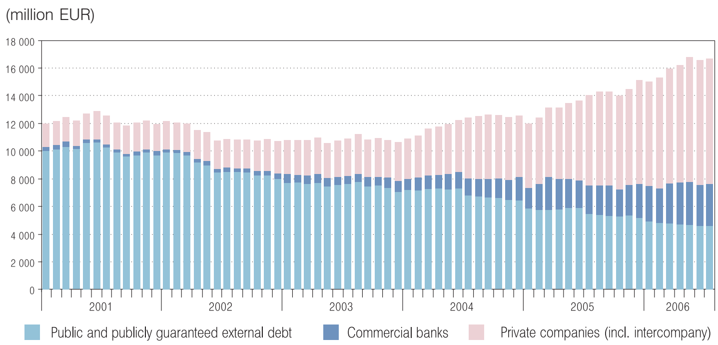
*Current Account Deficit to GDP* and *Foreign Direct Investment to GDP* (on an Annual Basis)




Source: BNB, NSI.

Chart 30

Gross External Debt




Source: BNB.

By end-July gross external debt reached EUR 16,659.6 million, up by EUR 2654.8 million (19 per cent) on July 2005. The increase was entirely attributable to the private sector whose foreign liabilities picked up by EUR 3538.9 million (42 per cent), while public sector's liabilities dropped by EUR 884.1 million (16 per cent) in line with the policy of reducing government external debt.

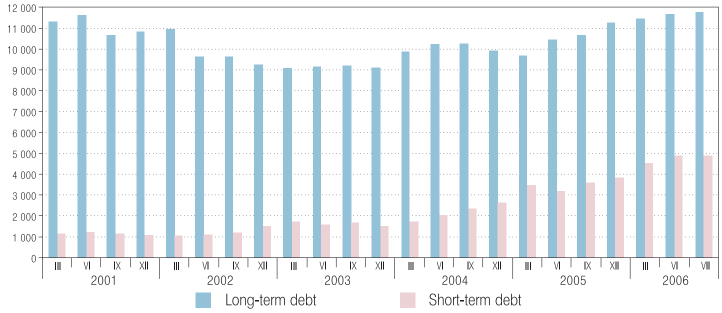
Changes in the external debt maturity structure since early 2006 are associated with increasingly growing short-term indebtedness and more moderately rising long-term debt. The January to July period saw net growth of EUR 1043 million (27 per cent) in external debt with a maturity of up to one year and of EUR 506 million (4 per cent) in liabilities with an original maturity of over one year (including liabilities on direct investments). Short-term external debt growth was mostly ascribable to financial loans received from the real sector (up by EUR 564 million) and to non-residents' deposits with local commercial banks (a net increase of EUR 200 million). The change in the gross external debt on an annual basis is more evenly distributed by maturity structure, with short-term and long-term liabilities growth amounting to EUR 1379.1 million and EUR 1275.7 million respectively.

Current gross external debt dynamics confirmed the expectations about increasing indebtedness of the private non-bank sector. The trend towards more extensive direct external borrowing on the part of the private sector stemmed from the orientation of Bulgarian companies to more effective liabilities management through borrowing funds from abroad, and partially from the measures taken by the BNB to curb bank credit. The growing share of local corporations' foreign ownership and their inclusion in multinational companies furthered the process of using external financing resources for satisfying investment and current needs. This trend is expected to continue in the second half of 2006, pushing the private debt to 52–53 per cent of GDP in the third quarter of 2006 and to 54–55 per cent of GDP in the fourth quarter.

Chart 31

Long- and Short-term Gross External Debt Dynamics

(million EUR)




Source: BNB.

## Monetary Aggregates

**Given the projected change in international reserves and government deposit dynamics, reserve money is expected to slow down its growth to about 18 per cent in the third and fourth quarters of 2006. Bank reserves will nominally be lower than those in July and their growth rates will also moderate to 20–22 per cent in the third quarter and to 16–18 per cent in the fourth quarter. Growth rates of currency in circulation are likely to accelerate slightly to 17–18 per cent by the close of the year. Broad money growth is also projected to increase to 22–24 per cent in the coming two quarters.**

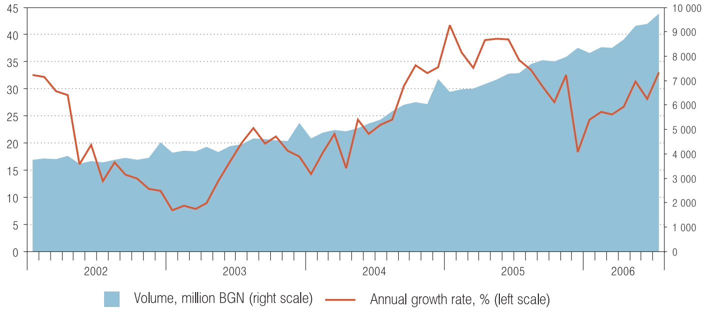
**Interest rates on deposits in US dollars and in euro are anticipated to slightly go up in the next two quarters, while those on lev deposits will match their current level.**

By end-July 2006 reserve money growth rates picked up to 33 per cent on annual basis (25 per cent in March) driven by the behaviour of commercial banks' deposits with the BNB. Individual banks exceeded the limits on credit portfolio growth rates and they were sanctioned to deposit additional minimum required reserves under the Amendments to Ordinance No. 21 of November 2005.[3] In accordance with these amendments, as of the first quarter of 2006 a progressive scale of determining additional reserves for banks violating the regulation was introduced, with the maximum penalty reaching 400 per cent of the excess of the extended loans over the set limit. Since the first maintenance period started on 4 May 2006, the effect became evident in the May to July period. Thus, in July bank deposits totaled BGN 3.3 billion, of which additional minimum reserves of BGN 997 million.

Against the background of the favourable credit aggregate dynamics in the last few months and decreasing efficiency of administrative measures, in June 2006 the BNB Governing Council decided to gradually lift the restrictions on private sector credit growth. As a first step, the progressive scale of determining additional minimum required reserves was abolished. Thus, in August the average monthly amount of bank deposits decreased by some BGN 650 million on July (Chart 33).

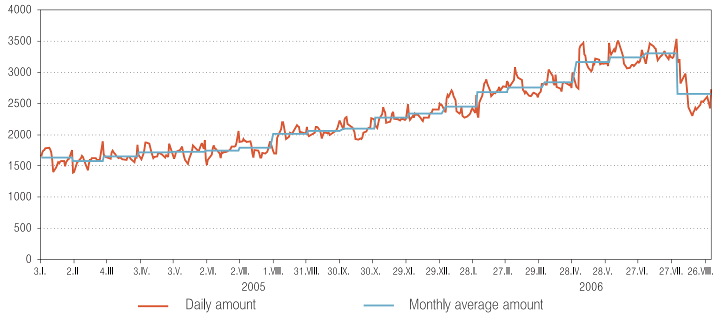
Growth rates of currency in circulation continued to gradually slow down , posting an annual increase of 14.2 per cent in July. This growth rate was slower than the nominal increase in GDP (almost 17 per cent in the second quarter) for the first time in the

Chart 32
**Reserve Money**
(volume and annual growth rate, %)



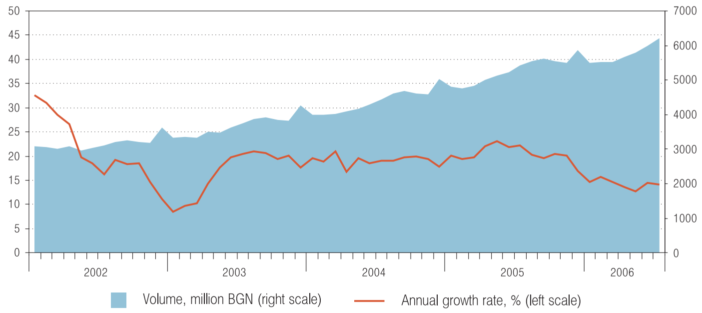

Source: BNB.

Chart 33
**Commercial Bank Deposits**
(million BGN)




Source: BNB.

Chart 34
**Currency in Circulation**
(volume and annual growth rate, %)




Source: BNB.

[3] See *Economic Review,* issue *1/2006.*

last six years. Given the fact that the *currency in circulation to GDP* ratio for the Bulgarian economy is considerably higher than that in the developed countries, we expect this ratio to decline in a medium term.

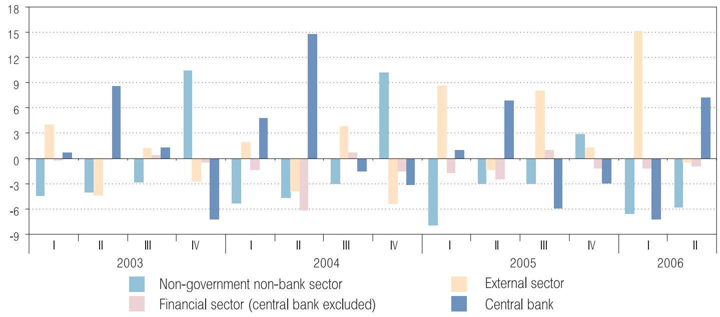
Fiscal policy affects monetary aggregate dynamics through deposits of the government and budget organisations with the BNB, as well as through redistribution of liquidity among the other economic sectors. Following the sizable increase in the flows to the external sector due to the early repayment of debt at the start of the year, the second quarter of 2006 saw a rise in government deposits with the BNB, which is typical of this period. The main factor behind this was the withdrawal of liquidity by the non-government non-bank sector. Its volume was higher than that in the same period of the last three years. Buoyant economic growth in the second quarter and especially the faster increase in consumption underlay the budget revenue implementation by this sector which was better than expected.[4] Curtailed non-interest expenditure led to relatively small flows to the non-bank non-government sector and further contributed to net withdrawal of liquidity from it.

Government's activity in the second quarter was almost neutral as regards liquidity of the financial sector (excluding the BNB) and the external sector, this trend most likely to be sustained in the third quarter when no significant changes in the flows from the government to other economic sectors are expected. This will lead to an increase in the government deposit with the BNB within the range of BGN 5–5.2 billion. The last quarter of 2006 may see a decline in the deposit at the expense of higher cash flows to the non-government sector which are typical of this period. This decline will be curbed by inflows of funds from the external sector due to the new loan of EUR 124 million extended by the World Bank.

Chart 35

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

(share of GDP)




Source: MF, BNB.

[4] According to the revenue indicative target set out in the agreement of the government with the IMF.

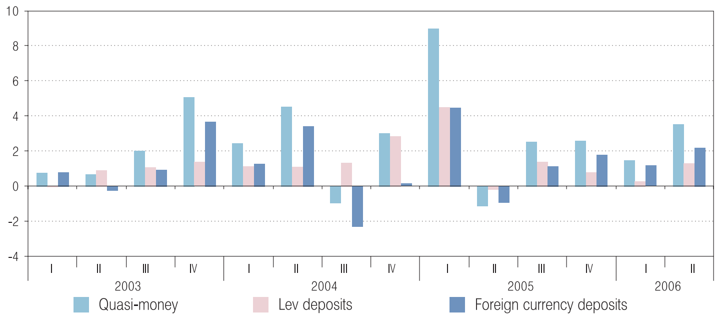
In the second quarter of 2006 broad money recovered their growth rates following the temporary slowdown in March prompted by the 2005 high base effect. However, the 21 per cent rise in the M3 monetary aggregate in June and July stayed below the December 2005 level. Money supply growth is anticipated to be between 22 and 24 per cent in the coming two quarters, approximating the projected change in bank credit. Brisk economic activity, and especially growing employment and incomes, as well as continuing capital inflow from abroad will be the main factors affecting money dynamics.

Broad money increased by 7.7 per cent on a quarterly basis in June, with the M1 monetary aggregate contributing mostly to the growth (4.2 percentage points). The fastest growing components in the structure of M1 were foreign currency overnight deposits (10 per cent) and lev overnight deposits (9 per cent). Regarding quasi-money, foreign currency deposits also reported faster growth as a whole. In the time deposits segment, deposits in levs of up to two years rose by 5.9 per cent in the second quarter and those in foreign currencies by 9.1 per cent. The difference in growth rates is attributable to non-financial corporations which increased their foreign currency deposits by 34 per cent, while household deposits in levs and in foreign currencies went up at approximately same rates (3.7 per cent and 3.5 per cent respectively). In the second quarter the share of the euro in foreign currency deposits retained its upward trend reaching 66 per cent in time deposits against 63 per cent in the first three-month period.

Fast accumulation of bank reserves prompted by the BNB measures for curbing credit activity and the respective reserve money growth caused a dramatic drop in money multiplier in the last year. By July 2006 the M3 multiplier fell to 2.9. However, the August reduction in commercial banks' deposits with the BNB led to a sharp rise in money multiplier to the level[5] of 3.2 which is close to the long-term average. Moderate credit rates maintained by commercial

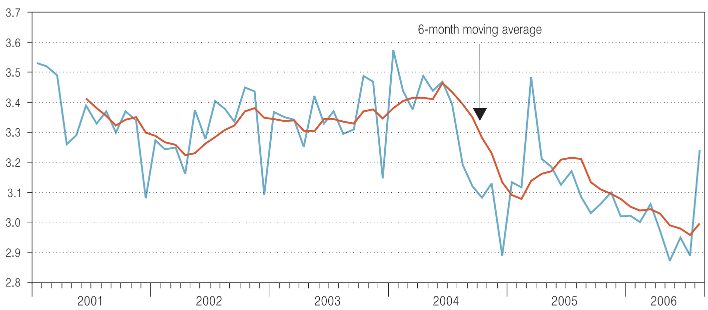
[5] Weekly monetary statistics data as of 25 August.

Chart 36
**Contribution of Quasi-money and Their Components to M3 Growth (Quarterly)**
(percentage points)




Source: BNB.

Chart 37
**M3 Money Multiplier**




Source: BNB.

banks are likely to bring about retention of multiplier's current levels in the next two quarters.

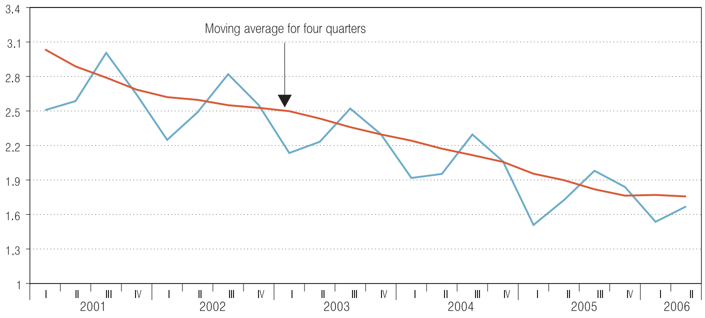
The money circulation velocity continued to subside, preserving its clearly pronounced seasonal profile. It reflects households and companies' preferences to keep an increasing portion of their incomes in financial assets. Based on projected M3 and GDP growth rates, dynamics of this variable will continue its downward trend in the next two quarters.

In the second quarter banking systems' average interest rates on time lev deposits stayed at their first-quarter levels (3.5 per cent) while in July they registered a slight fall (3.4 per cent). However, interest rates on foreign currency deposits continued to grow following international interest rates dynamics. Over the April to July period the average interest rates on EUR time deposits came to 2.47 per cent (against 2.37 per cent over the January to March period) and on USD deposits to 2.53 per cent (against 2.28 per cent over the January to March period). While interest rates on lev deposits are unlikely to experience any substantial changes in the coming two quarters, those on foreign currency deposits are expected to continue climbing.

The distribution of interest rates on household one-month lev deposits by bank in July 2006 (compared with March 2006) showed an increased number of banks offering rates within the 2 to 3 per cent interval at the expense of those offering up to 2 per cent and between 3 and 4 per cent. In July the differential between the highest and the lowest interest rates was 5.71 percentage points against 5.25 percentage points in March. A bigger dispersion in interest rates was also observed.

Chart 38

Currency Circulation Velocity (Quarterly)

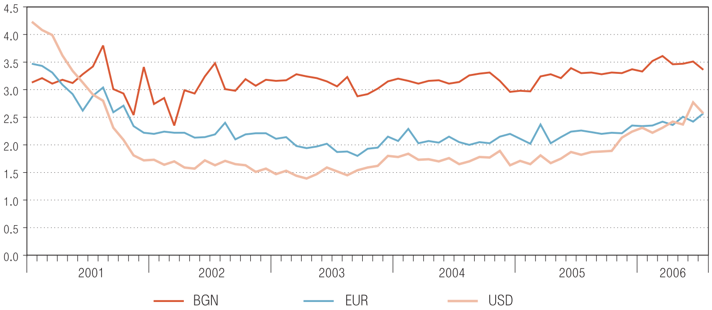



Source: BNB, NSI.

Chart 39

Interest Rates on Time Deposits

(%)

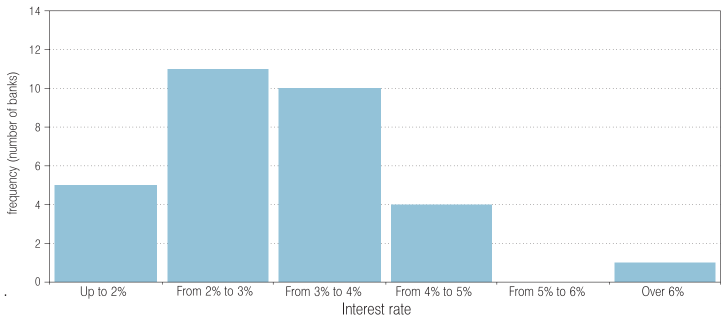



Source: BNB.

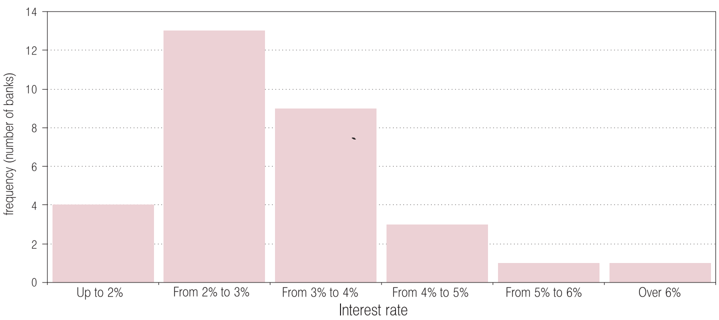
Chart 40

Interest Rate Distribution on Household One-month Lev Deposits

as of March 2006




as of July 2006




Source: BNB.

## Credit Aggregates

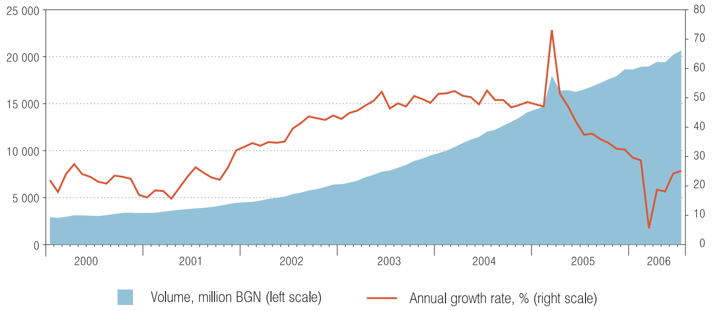
**Under BNB-imposed lending constraints, annual growth rates of claims on the non-government sector will slow down to 23–25 per cent by the end of the third quarter of 2006 and to 20–22 per by the end of the year. No significant changes in lending interest rates are expected.**

The sustained favourable macroeconomic conditions continued to predetermine the robust demand for loans by corporations and households, and hence the brisk lending. Concurrently, banks' credit activity was strongly impacted by the measures taken by the BNB to make lending more moderate. Between January and July claims on the non-government sector went up by BGN 2016.1 million (against BGN 2432.5 million over the same period of the prior year) and their annual growth reached 25.1 per cent by end-July. The more moderate increase in claims on the non-government sector reflected to a great extent banks' transfers of loans to foreign banks and non-bank financial institutions, with the amount of sold loans reaching BGN 1861 million in the first seven months of 2006.

In early June 2006 the BNB Governing Council declared its intention to gradually lift the requirement for additional minimum reserves. As a first step, it would abolish the progressive scale used for determining these reserves. Despite the change, banks are expected to continue adhering to the imposed credit restrictions. As a result, the annual growth of claims on the non-government sector will decline to some 23–25 per cent by the end of the third quarter and to 20–22 per cent by the end of the year.

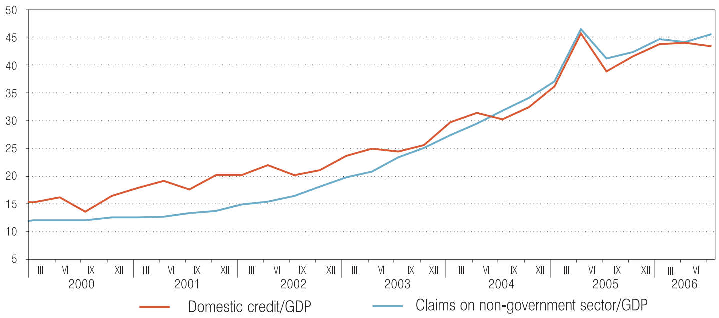
Irrespective of the more moderate credit growth, the trend to enhancing financial intermediation was sustained. By June 2006 the *claims on the non-government sector to GDP* ratio comprised 45.6 per cent, posting a rise of 1 percentage point on the year's start and of 4.4 percentage points on June 2005.

Chart 41
Claims on Non-government Sector




Source: BNB.

Chart 42
Domestic Credit
(share of GDP, %)



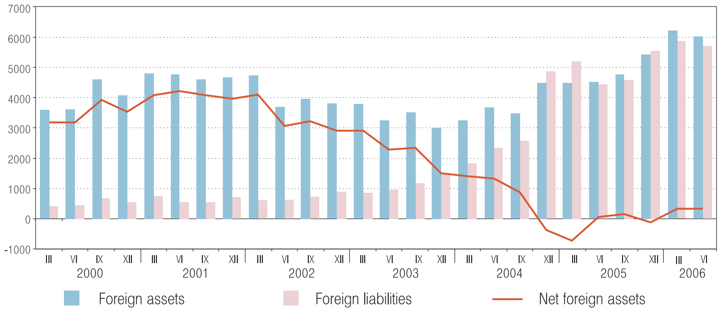

Source: BNB.

Measures to moderate the pace of credit growth affected further dynamics of banks' net foreign assets. These measures restrict banks in using foreign liabilities to finance their credit activity. Therefore, banks' net foreign assets already have sustainable positive values.

Chart 43

Foreign Assets and Liabilities of Commercial Banks

(million BGN)

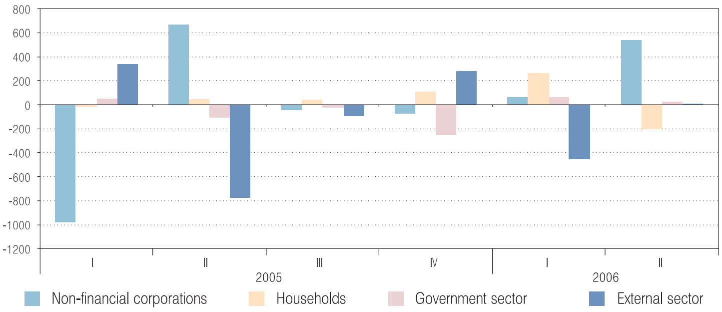



Source: BNB.

Chart 44

Net Financial Flows to Commercial Banks (Quarterly)

(million BGN)




Source: BNB.

Table 3

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

(million BGN)

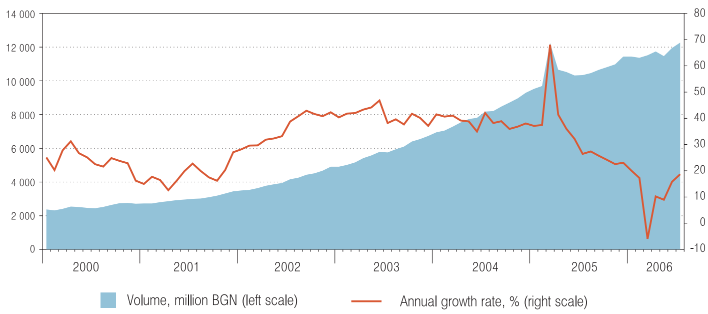
| | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II |
| Claims on non-financial corporations | 2948.8 | -1922.6 | 334.6 | 784.9 | 76.8 | 434.2 |
| Deposits of non-financial corporations | 1971.2 | -1258.6 | 292.5 | 710.3 | 140.8 | 974.0 |
| Claims on households | 721.7 | 590.6 | 537.5 | 704.2 | 188.2 | 767.9 |
| Deposits of households | 702.9 | 633.0 | 575.6 | 813.0 | 453.9 | 565.3 |
| Foreign assets | -9.3 | 23.1 | 251.2 | 670.0 | 775.0 | -179.2 |
| Foreign liabilities | 325.7 | -752.7 | 155.6 | 951.4 | 319.7 | -174.7 |
| Claims on government sector | 17.1 | 209.8 | 135.4 | 137.1 | 14.2 | 120.0 |
| Deposits of government sector | 65.8 | 105.4 | 110.6 | -112.7 | 73.7 | 143.9 |
| Claims on central government | 16.3 | 203.5 | 113.9 | 133.8 | -5.7 | 120.9 |
| Liabilities to central government | -95.6 | 94.7 | 129.9 | 11.8 | -54.9 | 81.1 |

Source: BNB.

Moderation in annual growth rates of claims continued to involve all segments of the credit market. Between January and July claims on non-financial corporations rose by BGN 831.8 million (against BGN 1045.9 million in the same period of 2005), while their annual growth fell to 18.7 per cent by end-July. This was ascribable to banks' sales of loans to non-financial corporations, accounting for BGN 1135 million in the first seven months of 2006.

Chart 45

Claims on Non-financial Corporations

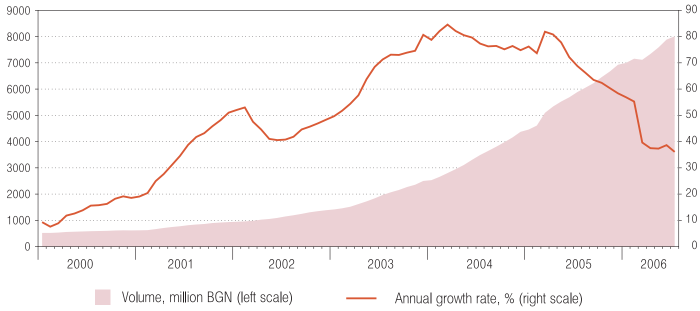



Source: BNB.

Between January and July claims on households rose by BGN 1083.2 million against BGN 1513.8 million in the respective period of 2005. The weaker increase in nominal terms ensued mainly from banks' transfers of loans to foreign banks and non-bank financial institutions. Since early 2006 transferred loans to households amounted to BGN 725.2 million. The annual growth of claims on households continued falling, affected by the increasing base, to reach 36.1 per cent by end-July. The biggest slowdown was observed in housing loans: from 97.4 per cent at the year-start to 72.4 per cent by the close of the second quarter and to 68.4 per cent by end-July. Nevertheless, housing loans still are the most rapidly developing segment of the credit market: between January and July they picked up by BGN 636.2 million compared with the increase of BGN 549.8 million in the respective period of 2005, while their share in total household loans continued to expand to 32.5 per cent.

Loans to households still form a growing share in banks' claims on the non-government sector, reaching 38.7 per cent by end-July. Changes in the structure of claims on the non-government sector continued to reflect both higher potential of lending to individuals and extended access of non-financial corporations to external financing sources.

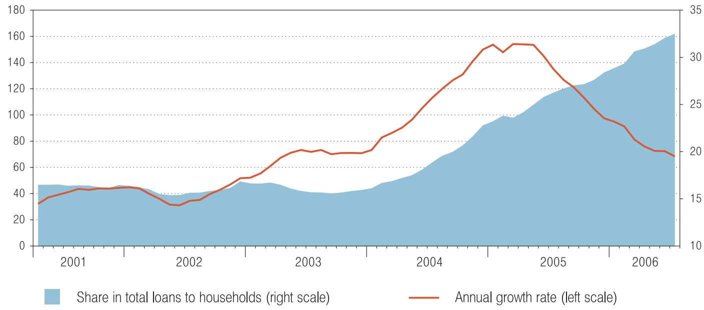
Chart 46
Claims on Households




Source: BNB.

Chart 47
Housing Loans

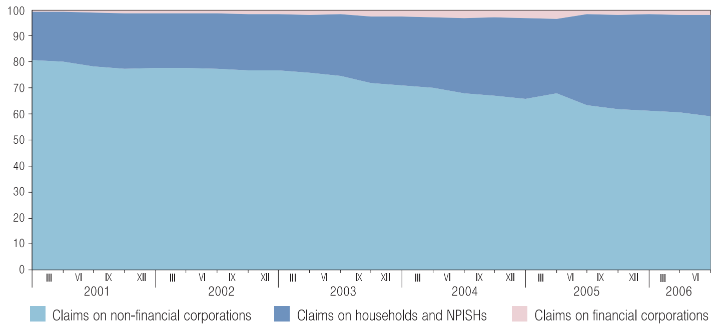
(%)




Source: BNB.

Chart 48
Structure of Claims on Non-government Sector

(%)




Source: BNB.

Table 4
Claims on Non-government Sector (Quarterly)

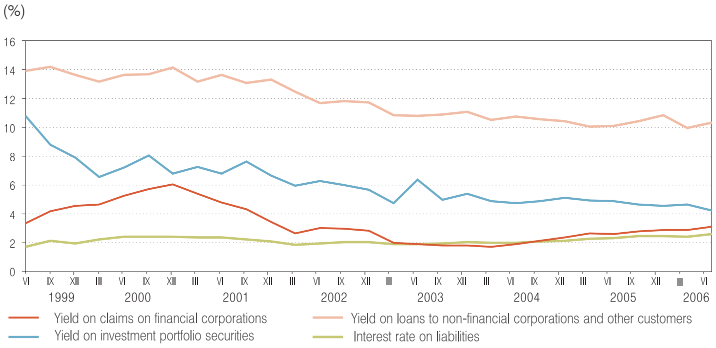
| | Annual growth rate, % | | | | | | Structure as of 30 June 2006 |
|---|---|---|---|---|---|---|---|
| | 2005 | | | | 2006 | | |
| | I | II | III | IV | I | II | |
| Claims on non-government sector, incl.: | 73.1 | 41.8 | 35.9 | 32.4 | 5.6 | 24.2 | |
| on non-financial corporations | 68.0 | 32.2 | 25.7 | 23.1 | -5.9 | 15.8 | 59.1 |
| on households and NPISHs | 81.8 | 72.2 | 63.5 | 58.4 | 39.7 | 38.7 | 39.0 |
| on financial corporations | 113.4 | -27.6 | -12.4 | -31.1 | -44.6 | 42.7 | 1.9 |

Source: BNB.

The ECB raised the interest rate on its main refinancing operations by 25 basis points in June and August which had an immediate effect on money market interest rates. Although it has probably affected interest rates on loans tied to the financing costs on the money market, this effect cannot be established due to the strong monthly fluctuations of credit interest rates. In the coming months lending interest rates are unlikely to undergo any significant changes. The increased price of borrowed funds and putative further tightening of ECB's monetary policy would exert pressure for increasing interest rates. However, enhanced competition among banks considerably weakens the influence of these factors.

Chart 49

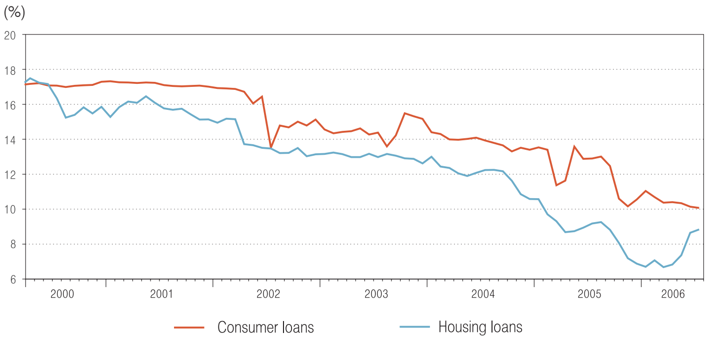
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities




Source: BNB.

Chart 50

Interest Rates on Household Loans

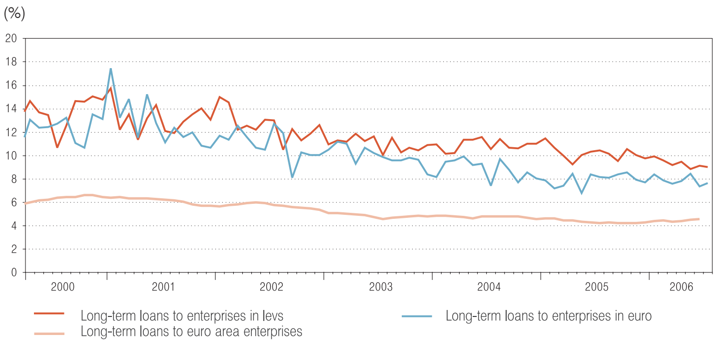



**Note:** Interest rates include promotional interest rates offered by banks.

Source: BNB.

Chart 51

Interest Rates on Long-term Loans in Levs and Euro




Source: BNB.

# 3. Economic Activity

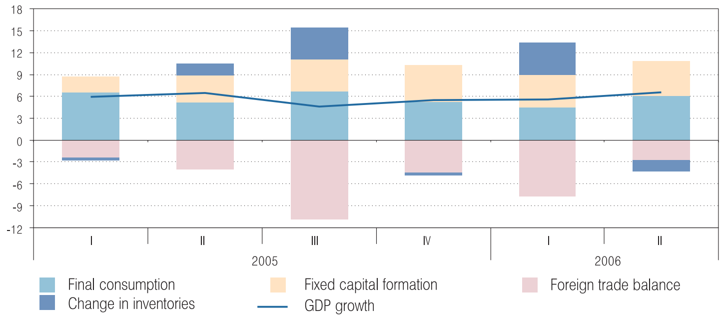
**In the second half of 2006 high economic growth is expected to be sustained, slightly accelerating on the corresponding period of the prior year. Investments and consumption will maintain strong growth rates, recovery of goods export growth being the leading factor. This will reduce the negative contribution of the foreign trade balance.**

Buoyant economic growth was sustained in the first half of 2006. GDP picked up by 6.6 per cent in the second quarter compared with the respective quarter of the previous year, posting the highest quarterly economic growth. Investments in fixed capital played a leading role. Their contribution was comparable with that of the traditionally biggest end-use component, the household consumption, which also recorded high growth rates.

Chart 52

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

(percentage points)




Source: NSI.

Table 5

Dynamics of GDP Components According to Final Consumption Method (Quarterly)

(on corresponding period of previous year, %)

| | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II |
| Consumption | 7.1 | 5.9 | 8.6 | 5.6 | 4.8 | 6.7 |
| incl. | | | | | | |
| Household consumption | 7.6 | 5.5 | 10.4 | 7.1 | 5.3 | 8.0 |
| Government final consumption expenditure | 4.5 | 10.3 | 0.2 | 7.2 | 6.3 | 3.0 |
| Collective consumption | 6.4 | 6.5 | 4.3 | -4.7 | 0.1 | 1.2 |
| Gross fixed capital formation | 11.2 | 16.9 | 24.0 | 21.5 | 21.4 | 20.3 |
| Exports of goods and non-factor services | 9.2 | 12.0 | 1.1 | 8.9 | 12.9 | 10.2 |
| Imports of goods and non-factor services | 10.8 | 15.3 | 18.8 | 12.9 | 20.0 | 11.4 |
| GDP, real growth | 5.9 | 6.5 | 4.6 | 5.5 | 5.6 | 6.6 |

Source: NSI, BNB.

Enhanced investment and consumption activity, as well as foreign capital inflows were related to the increased negative contribution of foreign trade balance in the first half-year. This trend was more clearly pronounced in the first quarter, while in the second quarter the foreign trade balance deficit started to contract due to slowing imports. Net exports are anticipated to continue improving until the year-end boosted by the recovered high growth in exports of goods.

## Household Behaviour

In the second quarter of 2006 household consumption accelerated to 8 per cent on an annual basis, again contributing mostly to GDP growth. The growth of bought non-foods went up to 15.8 per cent and they retained their key role in consumption dynamics. According to the System of National Accounts statistics, during the last three quarters (from the fourth quarter of 2005 to the second quarter of 2006) net tourism tended to contribute positively to overall household consumption. Although Bulgaria's travel balance is positive, in value terms, travel of residents abroad, including that at comparable prices, grew faster than travel of non-residents to the country. This could be ascribable both to intensified short-term labour migration and to shifts of Bulgarian tourists to foreign destinations since they are becoming more accessible.

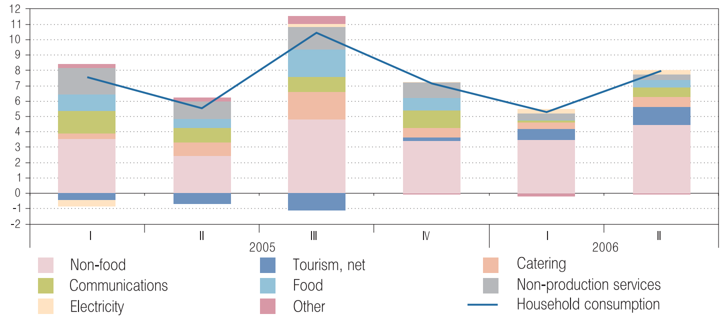
Rising employment played a major role for enhanced consumer activity. In the first half-year the number of employed picked up by 4 per cent on the previous year's corresponding period. The bulk of new jobs were created in trade, construction and in the *Real estate and business services* industry. By end-August unemployment dropped by 2 points on the same period of the prior year.

Real salary grew moderately (1.5 per cent) in the first six months compared with the respective period of 2005. Concurrently, consumer lending stabilized its level and slowed down its growth, and households continued to be a net creditor of the banking system. These circumstances evidenced further diversification of households' financing sources, some of which proved difficult to identify and assess.

Chart 53

**Contribution on Consumer Expenditure to Household Consumption Growth (Quarterly)**

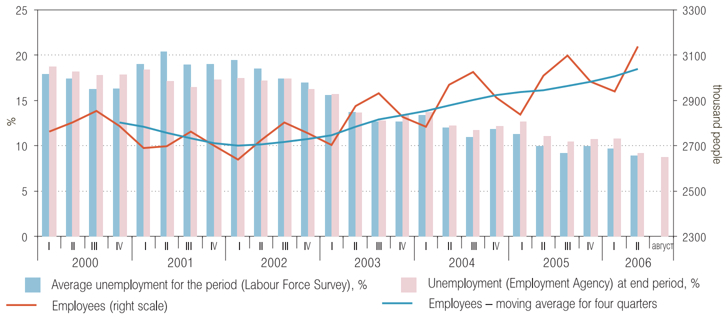
(percentage points)




Source: NSI.

Chart 54

**Status of Economically Active Population (Quarterly)**

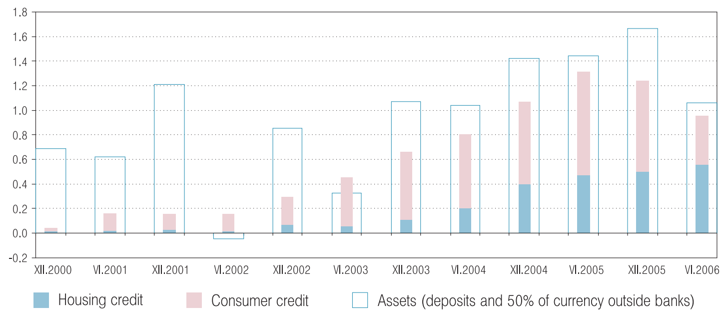



Source: NSI, Employment Agency – Ministry of Labour and Social Policy.

Chart 55

**Growth in Household Assets and Liabilities**

(billion BGN)




Source: BNB.

Table 6

**Employment and Income Dynamics (Quarterly)**

(% on corresponding period of previous year, unless otherwise indicated)

| | 2005 | | | | 2006 | | |
|---|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II | August |
| **Unemployment** at the end of the period, per cent of the labour force | 12.7 | 11.1 | 10.5 | 10.7 | 10.8 | 9.2 | 8.7 |
| **Employed under labour contract** | 4.3 | 3.5 | 1.5 | 1.6 | 0.8 | 0.6 | |
| **Employees** (Labour Force Survey data) | 2.0 | 1.3 | 2.4 | 2.4 | 3.6 | 4.3 | |
| **Real salary** | 3.3 | 3.9 | 3.3 | 0.8 | 1.7 | 1.4 | |
| **Wages and salaries,** deflated by CPI | 2.6 | 6.0 | 7.3 | 9.6 | 3.9 | 4.5 | |

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

## Government Finance and Consumption

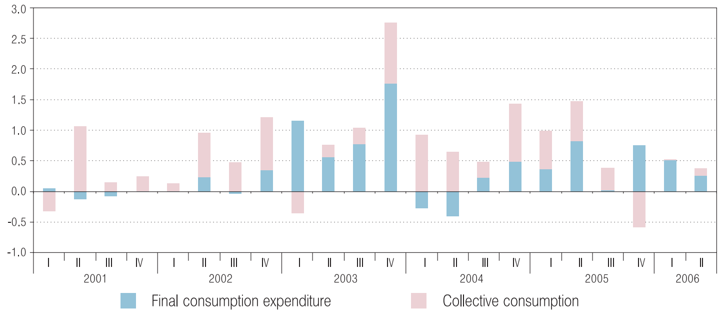
**Consolidated budget revenue overperformance by end-June above the indicative target set out in the agreement with the IMF called for a revision of the fiscal surplus target from 3 per cent to 3.2 per cent of GDP, thus backing our forecasts of cash balance levels close to those of 2005. The contribution of government consumption to GDP real growth by end-2006 will also be close to that observed in the prior year. The prospects for growth rates of total expenditure similar to those of annual inflation are sustained.**

By the close of June 2006 total revenue and aid under the consolidated fiscal programme came to BGN 9579.8 million, outstripping by BGN 528.8 million the indicative target of BGN 9051 million set out in the agreement with the IMF. Pursuant to this agreement, 50 per cent of the revenue surplus should be saved and this called for a revision of the consolidated budget target performance from 3 per cent to 3.2 per cent of GDP. High indirect tax earnings exceeding 20 per cent in the second quarter again underlay good revenue performance. The fastest growing components of indirect taxes were earnings from value added tax on imports and from excise duties, reflecting high import prices and growing volumes of fuels and other imported raw materials. Indirect taxes' contribution to the growth of tax earnings is expected to stay around 10 percentage points in the second half of 2006 as well.

During the first six months of 2006 social security funds' revenue was some 1.4 per cent lower in nominal terms than that of the last year's respective period, comprising 69 per cent of projected revenue from contributions to the state social security budget. Losses of revenue caused by reduced security contributions are expected to be offset by rising employment and remuneration. Nevertheless, social security revenue contribution to overall tax revenue will stay close to zero.

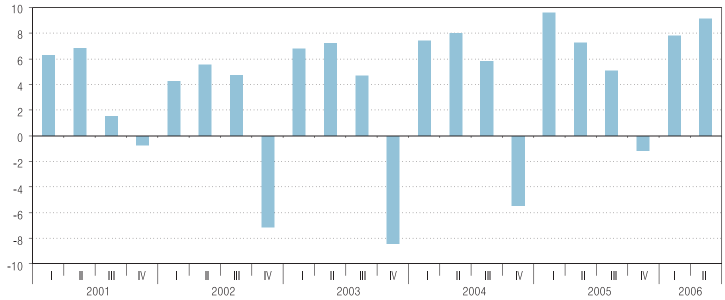
The agreement with the IMF implicitly presupposes reduction in consolidated programme expenditure ensuing from the consolidated programme surplus criterion and from the indicative revenue target. Exceeding the fiscal surplus lower limit by over BGN 600 million as of the end of June results both from revenue overperformance and lower expenditure. Salary and opera-

Chart 56
Contribution of Government Final Consumer Expenditure and Collective Consumption to Economic Growth (Quarterly)
(percentage points)



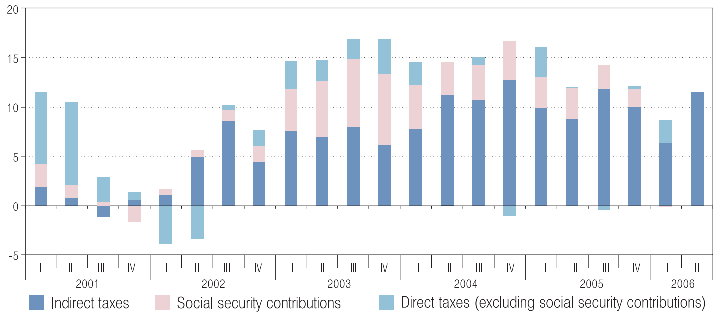

Source: NSI.

Chart 57
Primary Balance (Quarterly)
(share of GDP for the quarter, %)



Source: MF.

Chart 58
Contribution of Major Tax Groups Growth to Tax Revenue Growth under the Consolidated Fiscal Programme (Quarterly)
(percentage points)




Source: MF.

tional expenditures affected by the higher base in the second quarter of 2005 had a minimum contribution to overall expenditure growth. We expect this contribution to be higher in the second half of the year owing to base effects again.

July 2006 saw a new rise in pensions. This referred only to the minimum pensions (below BGN 150) received by about 1,600,000 pensioners. Similar to the previous rise in pensions at the year-start, there was differentiation of pension indexation: pensions from BGN 90 to BGN 120 were raised by 5 per cent and those from BGN 120 to BGN 150 by 4 per cent. The increase amounted to BGN 30 million *per* quarter; July and August rises were paid in September.

As a result of curtailed expenditure in the first six months of 2006, government consumption contributed to GDP growth by just about 0.5 percentage points in the first quarter and by 0.4 percentage points in the second quarter. In the coming two quarters this contribution will go up boosted mostly by the 2005 low base. However, annually it will match the previous year's growth (within the band of 0.6–0.8 percentage points).

## Behaviour of Firms

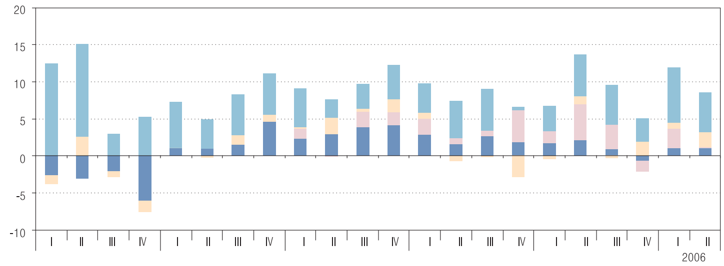
During the second quarter gross value added rose by 5.6 per cent in real terms on the previous year's corresponding period. High growth rates in industry were sustained, parallel to recovered growth in energy and mining and quarrying prompted by brisk external demand for non-ferrous metals. Construction also played a leading role for rising production activity stimulated by accelerating investment demand. Trade continued to register two-digit growth rates typical of the period from 2004 on. Increased supply capacity of this sector was one of the factors favouring high consumer activity.

In the second quarter growth of value added in manufacturing slowed down on the same period of 2005. Sales growth decreased in about half of the branches owing to weaker dynamics of domestic demand. Business climate assessments were also conservative. However, latest business sur-

Chart 59

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

(percentage points)




**Note:** In early 2006 the way of reporting defence and security's current expenditure was changed. This expenditure should not be reported separately but under the other expenditure items (salary and remuneration expenditure, social security and operating expenditure). For the purposes of compatibility, in calculating contributions the former classification has been used, with contributions of salary and remuneration, social security and operating expenditure computed, excluding defence expenditure.

Source: MF.

Table 7

Gross Value Added Growth by Sector (Quarterly)

(corresponding quarter of previous year = 100)

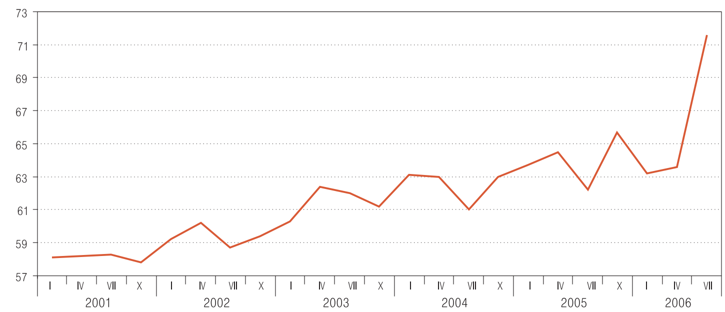
| | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II |
| Agriculture and forestry | -1.9 | -5.8 | -6.9 | -17.1 | -2.7 | -1.1 |
| Industry | 11.0 | 9.2 | 3.8 | 5.9 | 8.8 | 9.0 |
| Services | 5.9 | 7.0 | 6.2 | 7.0 | 6.0 | 4.7 |
| **At base prices, total** | 7.1 | 6.5 | 3.3 | 4.4 | 6.4 | 5.6 |

Source: NSI.

Chart 60

Production Capacity Loading in Industry

(%)




Source: NSI, business survey in industry.

veys (of July and August) clearly signal a sizable improvement in this sector and in the economy as a whole. Business climate indicators for industry and for the entire economy reached their highest values. At the start of the third quarter industrial capacities utilization recorded a historical maximum. Favourable dynamics of economic indicators gives grounds to expect acceleration in production activity over the second half of the year.

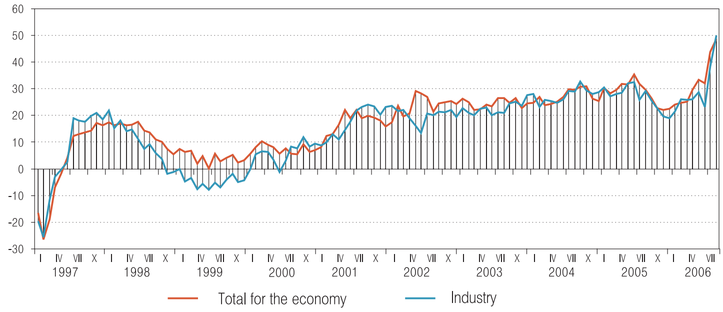
During the first two quarters growth in investments in fixed capital exceeded 20 per cent. Manufacturing, trade, transport and communications accounted for the intensified investment activity. Since early 2006 foreign direct investment inflows into the country picked up, with acquisition of shares in local companies contributing mostly to this growth. Confidence in Bulgaria, associated with macroeconomic stability, favourable prospects of intensified economic integration with European economies and increasing purchasing power of the domestic market brought about a sustained investment interest and a trend towards improving and expanding production and trade capacities. The positive contribution of the change in inventories during the last three years and the first six months of 2006 is an indicator of this. Net inventory accumulation should be considered a means of servicing enterprises' expansion and development, rather than a signal of difficulties in realizing production.

High capacity utilization and managers' optimism are signs of relatively sustained high rates of fixed capital formation in the second half of 2006.

The rising share of fixed capital formation is the main force behind the improved production capacities and competitiveness of the Bulgarian economy. During the first half-year the trend towards moderately rising nominal unit labour cost was preserved. The real-term indicator showing dynamics of the employees' compensation relative share in value added remained practically unchanged. Thus, Bulgarian exporters retained their favourable cost competitiveness.

Chart 61

Business Climate Assessment

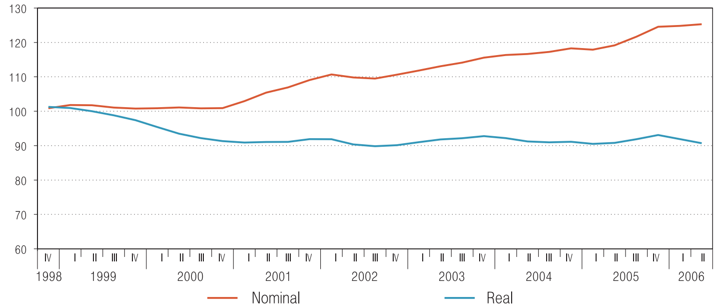



Source: NSI.

Chart 62

Unit Labour Cost: Total for the Economy (Quarterly)

(moving average for 4 quarters)

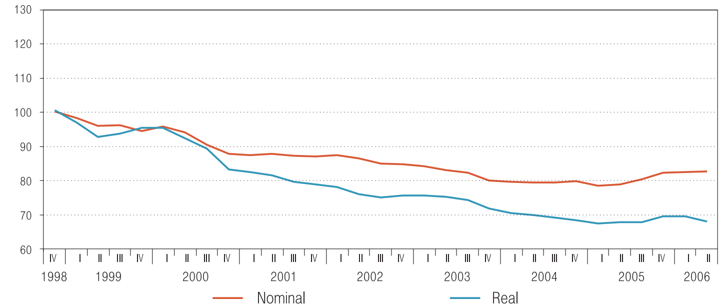



Source: NSI, BNB.

Chart 63

Unit Labour Cost: Manufacturing (Quarterly)

(moving average for 4 quarters)




Source: NSI, BNB.

## Exports and Imports of Goods

**Nominal exports of goods in euro are expected to grow on an annual basis by about 28–30 per cent over the third quarter on the corresponding quarter of 2005 and by approximately 24–28 per cent over the fourth quarter, underpinned mostly by projected acceleration in EU growth in the second half of the year and the upsurge in the production of key export-oriented sectors of the Bulgarian economy. High prices of energy resources coupled with moderate slowdown in domestic demand will help keep the nominal growth rates of imported goods at 22–24 per cent in the third quarter and at about 20–24 per cent in the fourth quarter.**

**Based on the forecasts about export and import dynamics, the trade balance deficit in the third quarter of 2006 is anticipated to reach approximately 20–21 per cent of projected GDP on an annual basis and about 20–22 per cent of GDP for the year.**

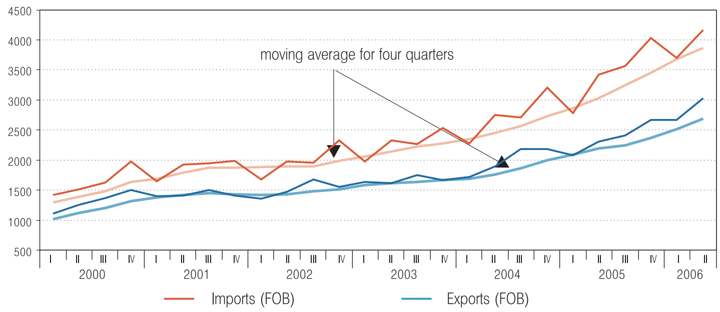
Exports in euro reached EUR 6769.6 million between January and July 2006, indicating a nominal increase by EUR 1524.4 million or by 29.1 per cent on the corresponding period of 2005. Imports (FOB) came to EUR 9366 million over the review period, rising nominally by EUR 1966.8 million (26.6 per cent) on an annual basis.

The second quarter saw favourable trends in foreign trade. Exports of goods registered a nominal increase which was faster than that of imports: 31.6 per cent and 21.8 per cent respectively on an annual basis. The factors behind the better-than-expected dynamics were slowing imports of energy resources and consumer goods and accelerating exports of raw materials (non-ferrous and ferrous metals contributing most significantly).

Forecasts about sustained high export rates and decreasing growth of imports in the third quarter reflect the expected increasing growth in our major trade partners, stabilizing international raw material prices and moderately decreasing domestic demand. The base effect, related to the dynamics in the corresponding quarter of 2005, is another factor for the projected annual changes. In the fourth quarter we expect a moderate slowdown in export and import annual growth rates based on the outlook for international price dynamics and the foreseen external and domestic demand dynamics.

Projected foreign trade growth in the second half of the year is another indicator of anticipated expansion of production and export activity in key branches of the Bulgarian industry, as well as expectations about higher yields of agricultural producers. Forecasts about improved trade conditions in the country will also affect positively foreign trade

Chart 64
Dynamics of Exports and Imports (Quarterly)
(million EUR)




Source: BNB.

dynamics in the third and fourth quarters of 2006.

As regards exports by group, energy resources and raw materials are expected to retain their highest growth. Over the first seven months of 2006 exports of mineral products and fuels posted the highest increase of 95.3 per cent followed by base metals (47.5 per cent) and machines, vehicles and appliances (24 per cent). Dynamic developments in exports of energy resources over the review period completely match the expectations. Physical growth in exports of petroleum products between January and July rose by 71.6 per cent on the corresponding period of 2005, while the rise in the annual price (in euro) came to 30.3 per cent. The assumptions about sustained relatively high international oil prices until the year-end backs the anticipated high nominal growth rates of exports in this group.

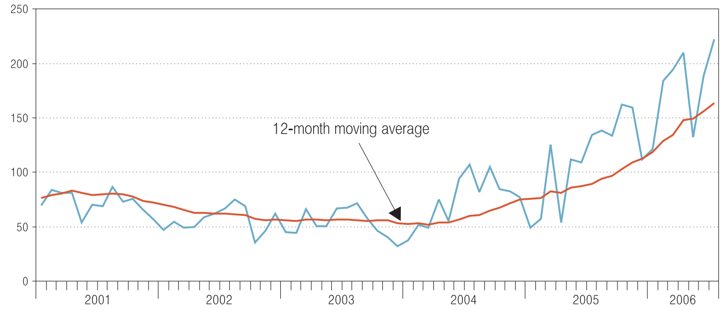
Total growth in exports of base metals by EUR 554.6 million in the current year's first seven months compared with the respective period of 2005 stems predominantly from the upward dynamics of non-ferrous metal prices on international markets. Exports of copper and copper products which increased by 94.2 per cent over the review period contributed most significantly to the total growth, by 7.7 percentage points. The downward trend in the value of exported cast-iron, iron and steel reversed in the second quarter of 2006. Increasing exports of these goods in the last months resulted in a positive nominal change of 2.8 per cent on an annual basis over the January to July 2006 period. We expect exports of base metals to retain their positive trends in the second half of the year and the group to remain among the most dynamically developing ones.

Between January and July 2006 exports of machines and vehicles rose by EUR 206.4 million (24 per cent) on the corresponding period of 2005, their value reaching EUR 1066 million. Despite the expected high growth rates, exports of these goods fell in the last two months owing mostly to the reported drop in the *Sea and river transport* item. The outlook is for sustaining the moderate growth in the nominal exports of machines and vehicles, albeit at rates lower than those of total goods exports.

Chart 65

Exports of Mineral Products and Fuels

(million EUR)

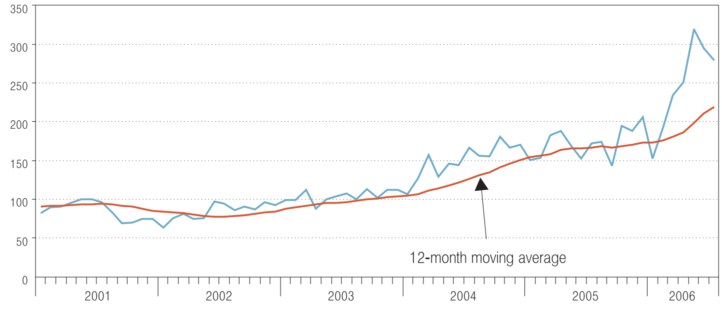



Source: BNB.

Chart 66

Exports of Base Metals and Base Metal Products

(million EUR)

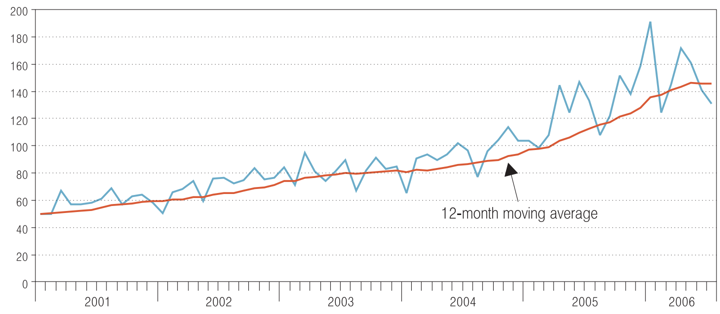



Source: BNB.

Chart 67

Exports of Machines, Vehicles, Appliances, Tools and Weapons

(million EUR)



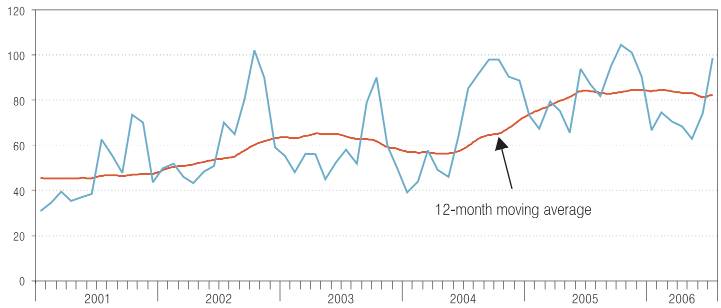

Source: BNB.

In line with our projections published in the *Economic Review, issue 2/2006*, the downward trend in exports of animal and plant products, foods, drinks and tobacco was sustained in the second quarter of 2006. During the first seven months of 2006 these exports decreased by EUR 25.6 million (4.7 per cent) on the corresponding period of the prior year, their value amounting to EUR 516.1 million. Irrespective of the negative dynamics reported over the period, in July exports of foods and drinks rose by 13.4 per cent on an annual basis, with cereals contributing mostly to the growth. We expect this positive signal to turn into a sustainable trend by the year-end, with anticipated growing exports of these products underpinned by the new crop.

Between January and July 2006 imports (CIF) totaled EUR 9956.9 million, posting a nominal increase of EUR 2093.2 million (26.6 per cent) on the respective period of 2005. Energy resources and raw materials displayed the largest growth (57.7 and 23 per cent respectively) in the structure of imports by use, contributing to import growth by 10.5 and 8.7 percentage points.

Crude oil remained one of the fastest growing products in Bulgarian imports. Its value rose by 69.6 per cent on an annual basis during the first seven months of 2006 and its real contribution came to 9.4 percentage points. The physical volume of imported crude oil went up by 28.9 per cent on the prior year's corresponding period and the average price (in euro) of the imported oil increased by 36 per cent. Despite the high nominal growth of imported energy resources over the period, the second quarter of 2006 saw a slowdown in their dynamics to 34.6 per cent on an annual basis owing mainly to the moderate growth of imported crude oil and natural gas (by 38.6 per cent). Crude oil prices matched our expectations which means that the physical volume of imported crude oil in the second quarter was lower than that in the second quarter of 2005. Since exports of petroleum products did not record a considerable slowdown in the last months, some of the available inventories might have been used in production. Their recovery in the next months and the maintenance of normal facility utilization sup-

Chart 68
Exports of Animal and Plant Products, Food, Drinks and Tobacco
(million EUR)




Source: BNB.

Table 8
Contribution of Commodity Groups to Trade Growth between January and July 2006

| | Exports | | Imports | |
|---|---|---|---|---|
| | growth,% | contribution, p.p. | growth,% | contribution, p.p. |
| Consumer goods | 7.5 | 2.2 | 20.7 | 3.1 |
| Raw materials | 28.4 | 12.5 | 23.0 | 8.7 |
| Investment goods | 24.6 | 3.8 | 17.2 | 4.8 |
| Energy resources | 95.9 | 10.5 | 57.7 | 10.5 |
| Other | | | -41.2 | -0.5 |

Source: BNB.

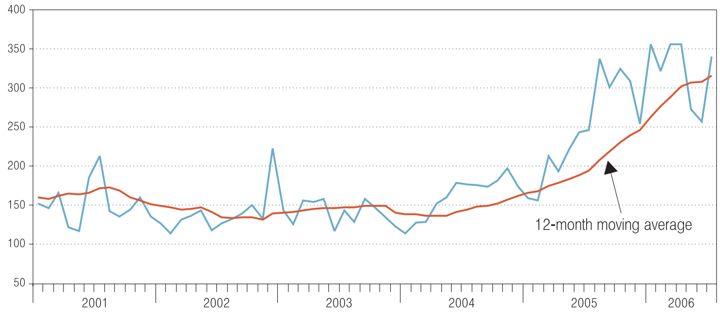
port expectations about high nominal growth in crude oil and natural gas imports, and in energy resources as a whole, in the second half of 2006.

During the second quarter of 2006 raw material imports growth picked up to 22.5 per cent on an annual basis, while over the first seven months their value rose by 23 per cent. The total value of imported raw materials reached EUR 3645.6 million over the period, up by EUR 681.2 million on the same period of 2005. In this group, ores and non-ferrous metals retained their highest contribution to total imports: 2 percentage points and 1.6 percentage points respectively. Owing to the high share of imported raw materials in exported metallurgy output, the earlier-than-expected upsurge in output prompted an earlier acceleration in raw material import growth rates. Based on positive expectations about industrial developments, the upward trend in raw material imports is foreseen to be sustained in the second half of the year.

In line with the projections published in the *Economic Review, issue 2/2006*, imports of consumer goods decelerated in the last months, with the second quarter nominal growth being lower than the total import growth. Between January and July 2006 consumer goods to the value of EUR 1441.6 million were imported, up by EUR 247.1 million or 20.7 per cent on the respective period of 2005. The *Furniture and household equipment* group contributed mostly to the growth of imports in this category (by 0.9 percentage points) rising by 30.2 per cent over the period. The outlook is for moderate growth of imported consumer goods in the second half of 2006, albeit at rates lower than those of total imports.

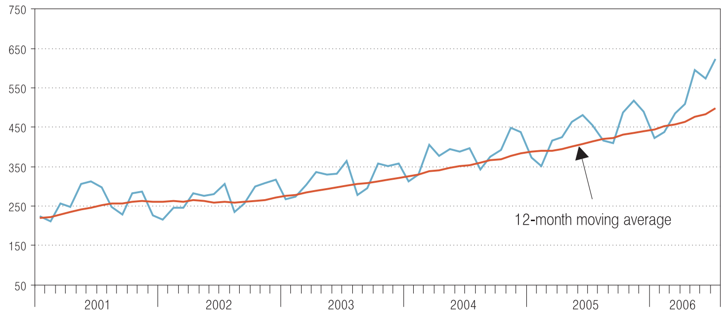
Imports of investment goods recorded the lowest growth rates over the January to July 2006 period: 17.2 per cent on the corresponding period of the previous year. Their value went up by EUR 375.2 million to reach EUR 2555.6 million in the first seven months. In contrast to our expectations, imports of investment goods slowed down in the second quarter, a result mostly of the fall registered by the *Vehicles* item. Forecasts for the third and fourth quarters are for moderate positive growth rates of imported investment goods.

Chart 69
**Imports of Energy Resources**
(million EUR)




Source: BNB.

Chart 70
**Imports of Raw Materials**
(million EUR)



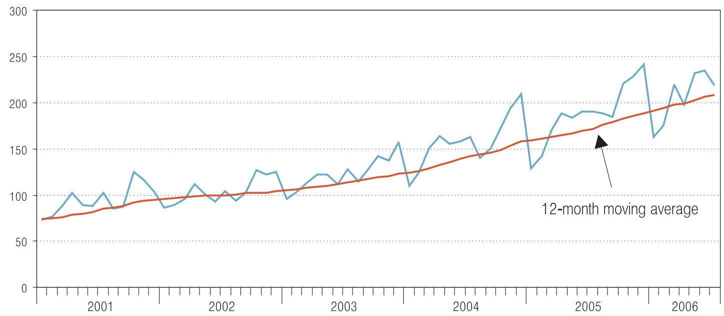

Source: BNB.

No significant changes in exports and imports' geographic structures are expected in the second half of 2006. During the first seven months the Balkan countries and the Asian region were the destinations with the fastest growing shares in total exports. The share of the former came to 23.5 per cent (2.8 percentage points higher than in the corresponding period of 2005), while the share of the latter was 8 per cent of the exports (a 2.4 percentage point increase). Russia increased its share in the structure of Bulgarian imports most dramatically, occupying 18.3 per cent between January and July 2006 and reporting a 4.7 percentage point rise on the same period of the prior year. The major reasons behind this trend are the country's dependence on imported energy resources and rising prices on international markets.

During the first six months dynamics of exported and imported physical volumes was retained: according to the System of National Accounts data, the real growth in imports of goods and non-factor services remained higher than that in their exports in the first and second quarters of 2006. In the first half-year physical volumes growth of imported goods and non-factor services comprised 15.3 per cent and that of exported goods and non-factor services 11.4 per cent.

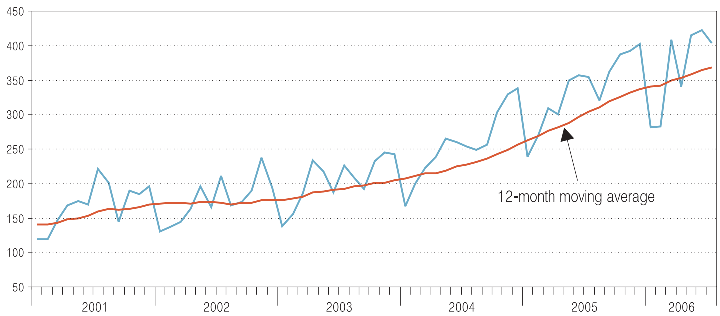
In the third and fourth quarters of 2006 we anticipate converging real growth rates of exported and imported goods and non-factor services and a lower negative contribution of foreign trade compared with the respective periods of 2005. Due to the considerable excess of imported goods and services over exported ones, the similar growth in physical volumes makes positive contribution of foreign trade balance to total growth of GDP impossible. The major factors underlying the expected dynamics are: accelerating EU growth (accompanied by a moderate slowdown of demand in the rest of the world), upsurge in key export-oriented sectors of the Bulgarian economy, stabilizing international prices of energy resources and gradually slowing domestic demand.

Chart 71
Imports of Consumer Goods
(million EUR)



Source: BNB.

Chart 72
Imports of Investment Goods
(million EUR)



Source: BNB.

# 4. Inflation

**In the third quarter of 2006 the annual growth rate of inflation is expected to moderate, reflecting the base effect of the previous year's respective period and the recovering seasonal profile of unprocessed foods. Against the background of favourable international conditions, inflation will continue to subside in the fourth quarter as well, with its end-year upper bound coming to 6.6 per cent.**

Inflation accumulated between January and August 2006 reached 2.21 per cent, pertaining to the opposite effects of three main factors. Tobacco products contributed most significantly (by 2.72 percentage points) to the inflation rate. Harmonization of their excise rate in order to comply with the European Community minimum rates resulted in a 74.9 per cent rise in their price since the year-start. The second factor was the recovery of the unprocessed foods' seasonal profile. By August their prices fell by 12.1 per cent and had a negative contribution of 1.9 percentage points. The behaviour of international energy prices also favoured the weaker growth in fuel prices on the domestic market, their contribution dropping by 0.52 percentage points compared with the same period of 2005.

In the second quarter of 2006 the annual rate of change in administratively set prices reached 16.8 per cent. This resulted mainly from raised excise duties on cigarettes (13 percentage points) and to a lesser degree from rises in the price of pharmaceuticals and some transportation services since the year-start. By August inflation of administratively set prices slowed down to 16.2 per cent and we expect it to retain this annual growth in the third quarter. Following the approved 6 per cent increase in the price of heating, part of which (2.3 per cent) was reported in July, and if the planned 14.5 per cent[6] adjustments in the prices of electricity are made, the annual change in the administratively set prices will reach about 19.1 per cent in the last quarter of the year.

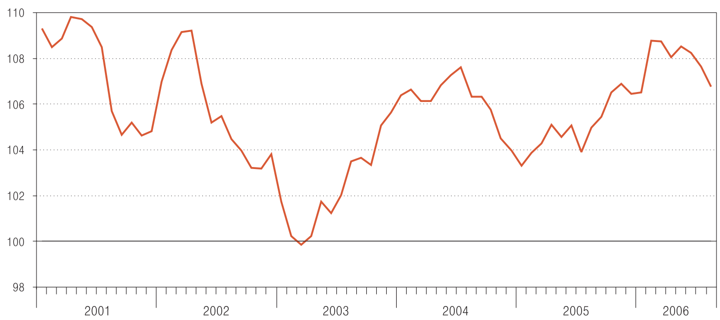
[6] A revised assessment reflecting the abolished cheaper charge for part of the daytime electricity consumption (9.8 stotinkas *per* kWh) and established unified daytime tariff (17.4 stotinkas *per* kWh).

Table 9
Inflation Accumulated since Year's Start

| | January – August | |
|---|---|---|
| | 2005 | 2006 |
| ***Inflation**, %* | ***1.90*** | ***2.21*** |
| ***Contribution, percentage points*** | | |
| Foods | -0.62 | -1.67 |
| Non-foods | 1.25 | 3.20 |
| Fuels | 0.85 | 0.34 |
| Catering | 0.18 | 0.16 |
| Services | 1.12 | 0.58 |
| Goods and services with administratively set prices | 0.80 | 2.86 |
| Controlled-price goods | 0.48 | 2.74 |
| Tobacco | 0.24 | 2.72 |
| Controlled-price services | 0.32 | 0.13 |
| Electricity and heating | 0.14 | 0.04 |

Source: NSI.

Chart 73
Consumer Price Index
(on an annual basis)




Source: NSI.

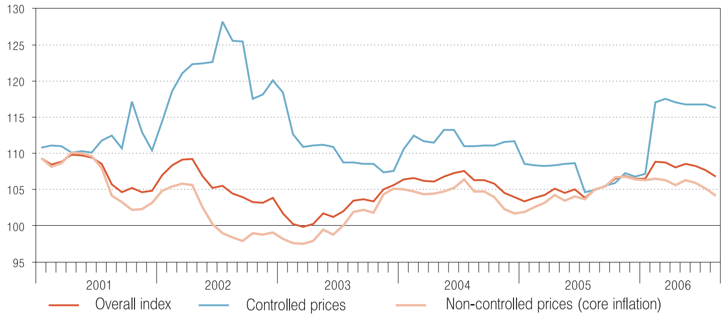
In the second quarter core inflation[7] dropped to 5.9 per cent as a result of slower growth in the prices of fuels (11.2 per cent) and non-controlled services (5 per cent). In the third and fourth quarters core inflation will continue subsiding due to the recovering seasonal profile of unprocessed foods and the exhausted effects of increased fuel prices in the second half of 2005. We expect it to stay around 4 per cent in the coming two quarters.

In the second quarter food prices sustained their high growth rate of 7.2 per cent, reflecting divergent movements in processed and unprocessed food prices. The growth in the annual inflation of processed foods from 6.2 per cent in the first quarter to 6.6 per sent in the second quarter came primarily from appreciating diary products (from 3.1 per cent to 5.6 per cent) which led to a difference of some 0.14 percentage points in the group's contribution to overall inflation. The price of unprocessed foods continued to decline from 8.6 per cent at the year-start to 8 per cent in the second quarter underpinned by the recovery in the typical dynamics of agricultural food prices. During the summer months the meat price decreased, reducing the inflationary contribution of meat products by 0.1 percentage points compared with the first quarter of the year. Food inflation is expected to start decreasing in the third quarter due to the exhausted base effect of bread price rises in the second half of 2005 and the growing supply of agricultural foods favoured by weather conditions. Slowdown in this group's annual inflation rate may continue till the year-end provided there is no inflationary pressure from fuels and major food prices.

In the second quarter the growth of fuels prices in the consumer basket went down to 11.2 per cent on average. Prices of fuels for transportation purposes rose by 9.7 per cent on an annual basis, while the price of fuels for household heating posted higher growth (12.6 per cent) largely owing to the rise in the gas price in October 2005. The downward trend in the annual growth of fuel

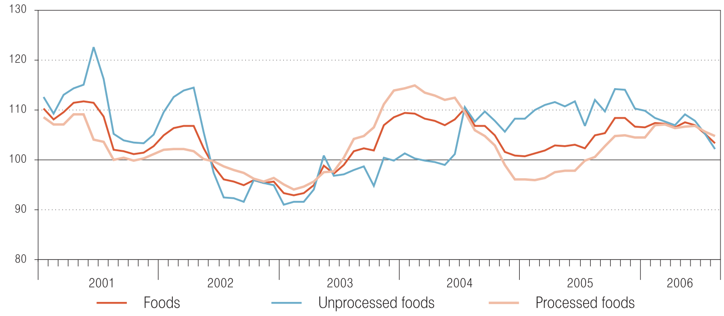
[7] Defined as inflation of goods and services excluding controlled-price ones.

Chart 74
Price Indices
(on an annual basis)




Source: NSI, BNB.

Chart 75
Price Indices
(on an annual basis)



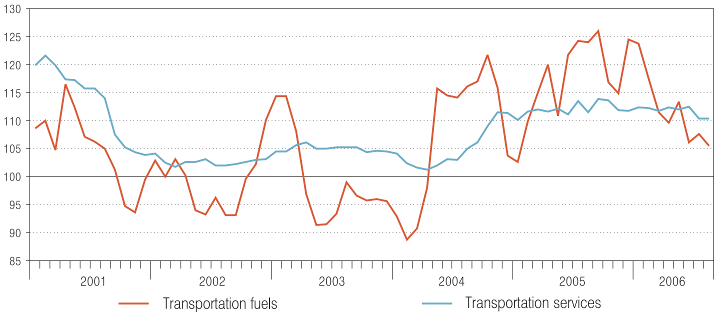

Source: NSI, BNB.

prices is likely to be sustained in the next two quarters in line with the expected favourable developments in the international prices of energy resources. By August the annual inflation rate of fuel prices dropped to 9.5 per cent. However, the trend may reverse with the upcoming heating season and the possible offsetting of greater moderation in domestic fuel prices in the second half-year compared with the international conditions in the first six months of 2006.

Inflation in services (excluding the controlled-price ones) on an annual basis declined from 6.5 per cent in the first quarter to 5 per cent in the second quarter, reaching 4.9 per cent in August. The major factor behind the annual slowdown in inflation of services with market prices is the decision of the Communications Regulation Commission to reject the proposal for restructuring prices of fixed telephone services which, according to preliminary assessments, was expected to push up the price of this service by 8 per cent in June. Thus, in the second quarter average annual growth in the prices of fixed line calls was negative (-0.67 per cent). Besides the *Communications* group, a certain slowdown on an annual basis was registered in the prices of housing rents, furniture and home maintenance, as well as in prices of leisure services. In the next two quarters the annual inflation rate of market services is expected to stay at about 5–5.5 per cent as a result of the higher demand for leisure services and the slowing annual change in the price of transportation services which came to 10.3 per cent by August.

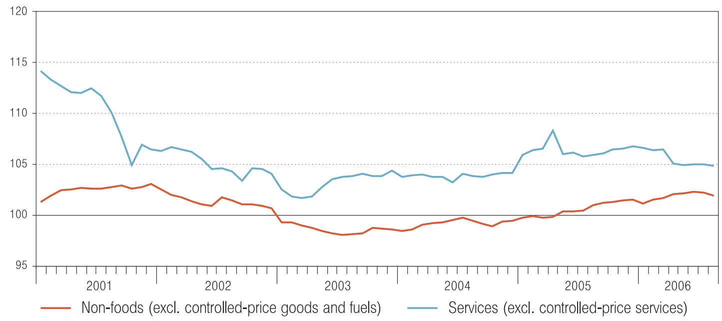
On an annual basis, the price rise in non-foods (fuels and controlled-price goods excluded) went up from 1.5 per cent in the first quarter to 2.1 per cent in the second quarter. Within this group, personal belongings and clothing and footwear posted the highest growth (4.42 per cent on average in the second quarter and 3.29 per cent respectively). This rise is most probably attributable to the influence, with a certain lag, of the US dollar appreciation in the second half of 2005,[8] as well as to the high trans-

Chart 76
**Price Indices**
(on an annual basis)




Source: NSI, BNB.

Chart 77
**Price Indices**
(on an annual basis)




Source: NSI, BNB.

[8] Since these are tradable goods, domestic demand is mostly satisfied by imported goods.

portation expenses during the year. Based on the forecasts of a weaker US dollar till the year-end, non-food inflation is anticipated to retain its growth of about 2.1 per cent in the third and fourth quarters.

Annually, inflation is likely to fall in the third quarter prompted by recovered typical dynamics of unprocessed food prices and exhaustion of the base effect of fuel and major food price rises in the prior year's respective period. Provided the planned adjustments in electricity prices are made and there is no inflationary pressure from the prices of energy resources in the fourth quarter which might otherwise cause second-round effects, inflation will continue to subside. The upper bound of inflation by the year-end is estimated at 6.6 per cent. Average annual inflation is expected to rise to 7.4 per cent due to the normalizing of the monthly profile of inflation during 2006 and the sustainable high price level backed by stable demand.