

Economic Review

4/2006



BULGARIAN
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Bulgarian monetary policy regime seeks national currency stability with a view to price stability. The BNB quarterly *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 estimates and projections published in this issue should not be regarded as advice or recommendation. Exclusively the information user is liable for any consequences thereof.

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
p. p.	percentage points
PPP	Purchasing Power Parity
WB	World Bank
WTI	West Texas Intermediate

Summary

Global economic indicators recorded expectations of slowing world economic growth in the fourth quarter of 2006 and first quarter of 2007. Lower growth rates are expected in the USA and leading Asian economies. Euro area growth will accelerate over the fourth quarter of 2006, followed by a temporary moderation in the first quarter of 2007 due to the higher VAT rate in Germany. Crude oil prices are projected to hover around USD 60 *per* barrel, pushing down the inflation rate. Market expectations show that US federal funds interest rates will remain at the current levels in the coming two quarters, whereas interest rates on ECB main refinancing operations will rise by 25 basis points over the fourth quarter and most likely by another 25 basis points at the end of the first quarter of 2007.

The high rate of return on investment in Bulgaria and favourable expectations of economic developments after joining the EU on 1 January 2007 attracted significant financial resources in the form of foreign direct investment and external loans boosting the economic development. Investment activity has become an important factor for economic growth, with investment in fixed assets' contribution to growth matching household consumption's contribution. On the other hand, demand for investment goods has been mostly satisfied by imports, thus contributing to an increase in the balance of payments trade balance deficit. In line with capital inflows, some items of the balance of payments current account (i. e. balance on income and balance on other services) further worsened. Rises in international prices of major raw materials (crude oil and metals) also added to trade balance deficit growth over the past year since this group occupied a significant share in overall Bulgaria's imports.

Reflecting all above factors, the balance of payments trade account deficit continued rising between January and September 2006, foreign direct investment covering 135.8 per cent of it. The balance of payments overall surplus was distributed between international reserve growth and IMF loan repayments. The ratio between international reserves and imports of goods and services in months of imports remained constant at approximately five months.

Trends to accelerating growth are expected to continue in the fourth quarter of 2006 and first quarter of 2007. Consumption and investment will maintain high growth rates, with projections of higher export rates underpinned by favourable trends in industry's cost competitiveness and a contracted negative contribution of the foreign trade balance. Capital inflow into Bulgaria will remain high, covering over 100 per cent of the current account deficit. Given the projected growth in international reserves and in the government deposit with the BNB, the reserve money growth rate is expected to approximate 20–22 per cent over the fourth quarter of 2006 and 18–20 per cent over the first quarter of 2007. Broad money growth will also slightly increase to 22–24 per cent annually. Following the BNB decision to lift the administrative constraints on lending growth rates as from 1 January 2007, simultaneously retaining the strict supervisory requirements, the central bank will seek to achieve a moderate and sustainable bank loan growth rate of 20 per cent annually.

The annual inflation rate is expected to further moderate over the fourth quarter of 2006 due to the favourable situation on international energy markets and lack of indirect effects on domestic prices of fuels. In early 2007 inflation will further decrease on an annual basis, with administratively set prices contributing mostly to the fall. The contribution of price effects (resulting from Bulgaria's accession to the EU) to overall inflation is estimated at around 0.48 percentage points, which will not reverse the trend of a declining annual rate of inflation.

1. External Environment

Global economic indicators recorded expectations of slowing world economic growth in the fourth quarter of 2006 and first quarter of 2007. Lower growth rates are expected in the USA and leading Asian economies. Euro area growth will accelerate over the fourth quarter of 2006, followed by a temporary moderation in the first quarter of 2007 due to the higher VAT rate in Germany. Crude oil prices are projected to hover around USD 60 *per* barrel, pushing down the inflation rate. Market expectations show that US federal funds interest rates will remain at the current levels in the coming two quarters, whereas interest rates on ECB main refinancing operations will rise by 25 basis points over the fourth quarter and most likely by another 25 basis points at the end of the first quarter of 2007.

Current Business Situation

Growth in the leading world economies began to slow down in the third quarter of 2006, with the USA, China and India contributing mostly to this. Global PMI indicators and leading OECD indicators remained in the expansion area, still reporting expectations of declining economic activity. After the fall in crude oil prices in the beginning of the fourth quarter, the services sector reported revived optimism. In industry, optimism continued decreasing due to prevailing expectations of lower volumes of new orders and output. World trade accelerated its growth over the third quarter to 9.4 per cent on an annual basis.

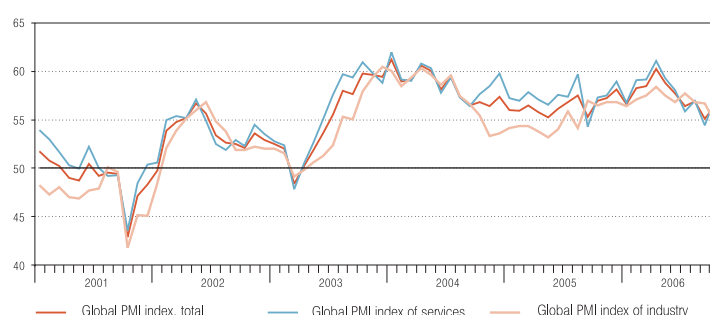
In the last quarter of 2006 and the first quarter of 2007 lower growth rates are anticipated in the USA and the Asian region, whereas euro area growth will accelerate over the last quarter of 2006, followed by a temporary moderation in the first quarter of 2007.

Risks to the projection may arise from unstable crude oil prices and geopolitical uncertainty around nuclear programmes of Iran and North Korea. Greater-than-expected moderation in the US economy will also affect negatively the global growth and world trade.

Euro Area

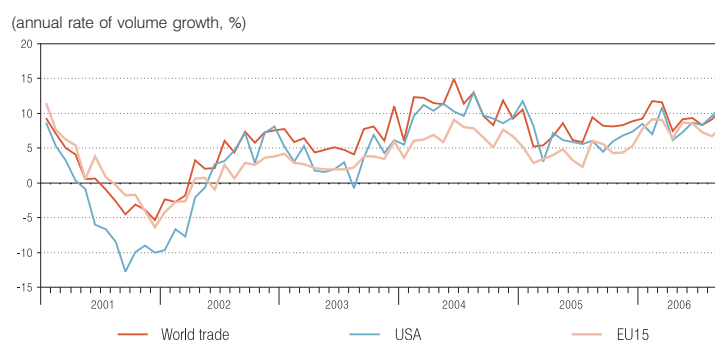
The euro area GDP growth rate was higher than the long-term trend at 2.7 per cent in the third quarter of 2006 (2.8 per

Chart 1
Global PMI Indices



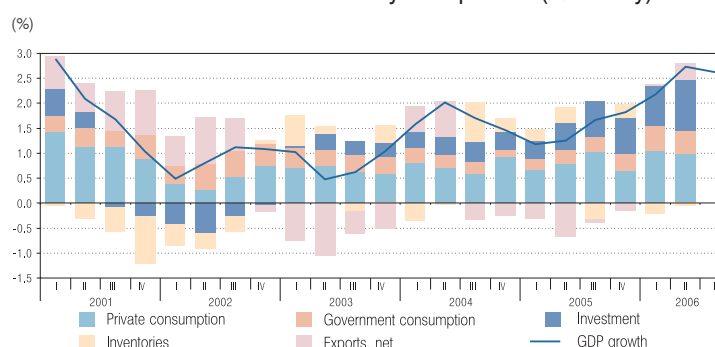
Source: NTC Research, JP Morgan.

Chart 2
World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 3
Contribution to Euro Area Growth by Component (Quarterly)



Source: Eurostat.

cent in the second quarter), with sound domestic demand contributing most significantly to this. The average growth rate of retail sales over the third quarter accounted for 1.7 per cent on an annual basis, from 1.5 per cent over the second quarter of 2006. Industrial production growth accelerated over the same period to reach 4.1 per cent annually, from 3.8 per cent a quarter earlier.

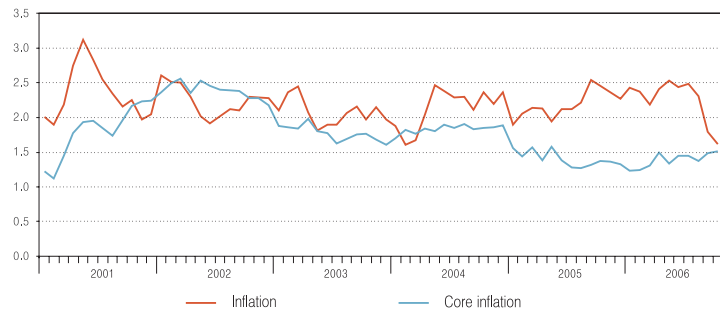
High values of the leading indicators underpinned the view of continuing growth in euro area economic growth in the fourth quarter of 2006. By the end of October PMI indices stayed at the level of 50 which indicated retaining growth rates in services and industry. After the period of volatile developments, the business climate indicator for the euro area and the EU published by the EC increased to reach at the end of the third quarter its highest value for six years. The overall confidence index improved significantly, reaching in October its highest value for the past five years.

ECB projections of September 2006 put euro area economic growth at 2.2–2.8 per cent (against 1.7–2.5 per cent in June) for 2006 and at 1.6–2.6 per cent (1.5–2.5 per cent in June) for 2007. The respective autumn European Commission projections as of the end of 2006 again were revised upwards to 2.6 per cent annually. Both projections point to the increased domestic demand contribution, primarily on the part of households, partially taking into account the effect of intensified consumer and investment activity in Germany at the end of 2006 due to pending rises in VAT rates in early 2007 (for more details see *Effects of the VAT Rate Increase in Germany* on page 9).

By the end of October euro area HICP inflation slowed down on an annual basis to 1.6 per cent, against an average of 2.3 per cent for the January to September 2006 period. The base effect in the price index on the same period of the prior year and decreasing energy prices contributed most significantly to these developments. By contrast, core inflation stayed at low levels, reaching 1.5 per cent annually in October. Core inflation dynamics supports the view

Chart 4
Euro Area Inflation Rate

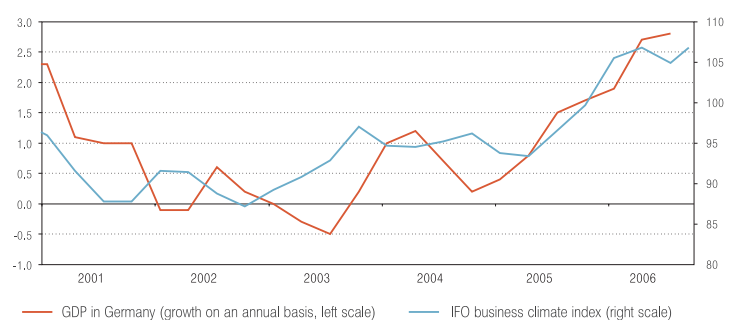
(percentage change on same period of previous year)



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

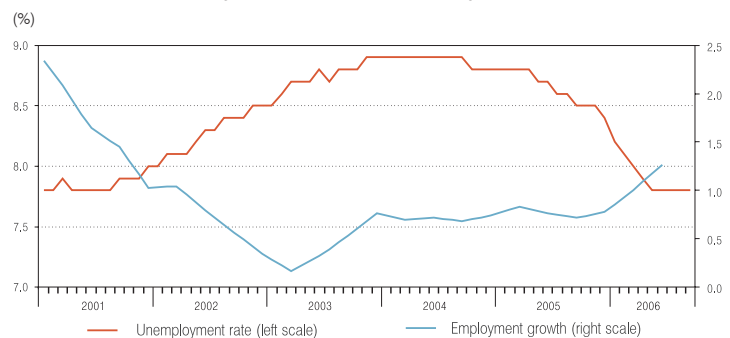
Source: Eurostat.

Chart 5
Economic Growth and Business Climate in Germany



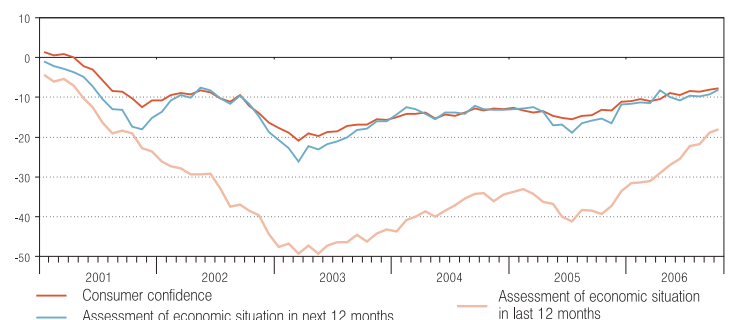
Source: Bloomberg.

Chart 6
Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

Chart 7
Euro Area Consumer Confidence Indicators



Source: Eurostat.

that there are currently no essential second-round effects on prices and salaries.

Market expectations show core inflation values close to current levels, reflecting primarily sustained growth in unit labour costs. In the review quarter, as well as in the following quarter HICP inflation will further reflect petroleum price dynamics. The early 2007 VAT rate increase from 16 to 19 per cent in the largest euro area economy is likely to have a one-off upward effect on HICP inflation.

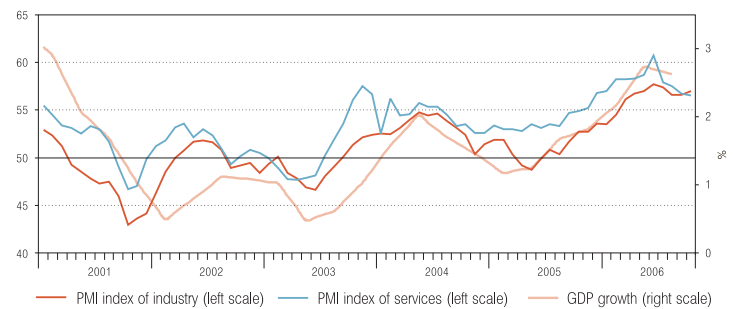
Possible second-round inflationary effects and the uncertainty around oil price movements posed an increased risk to inflation dynamics in the euro area. According to ECB forecasts of September, inflation is expected to move within the 2.3–2.5 per cent band annually in 2006 and within 1.9–2.9 per cent in 2007. EC projections put the inflation rate at 2.2 per cent annually in 2006 and at 2.1 per cent in 2007.

Euro area unemployment remained almost unchanged over the third quarter: 7.8 per cent by end-September. Consumers' expectations of labour market developments, measured by the consumer confidence index, improved further to reach the October peak in the last five years. This indicator supports favourable expectations of future labour incomes in the euro area.

At its meeting on 5 October 2006, the ECB Governing Council increased the interest rate on its main refinancing operations by 25 basis points to 3.25 per cent. The ECB decision rests on robust economic activity in the euro area. The ECB monetary analysis also supported the increase in the rate on main refinancing operations in line with M3 growth in September. Credit growth rates also accelerated to 9.4 per cent annually, from 9.2 per cent in August.

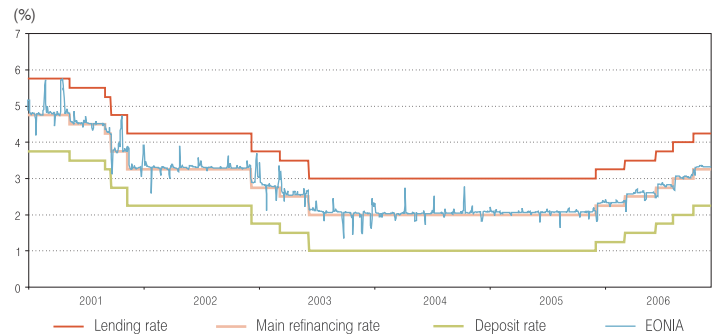
Despite the October fall in inflation, the ECB continued to point to upside risks over the medium term. The low level of interest rates helped generating ample liquidity in the euro area which, coupled with expectations of sustained economic growth above the long-term trend, called for a policy of gradual increasing interest rate levels. As of the beginning of the fourth quarter market

Chart 8
PMI Indices and Euro Area Growth



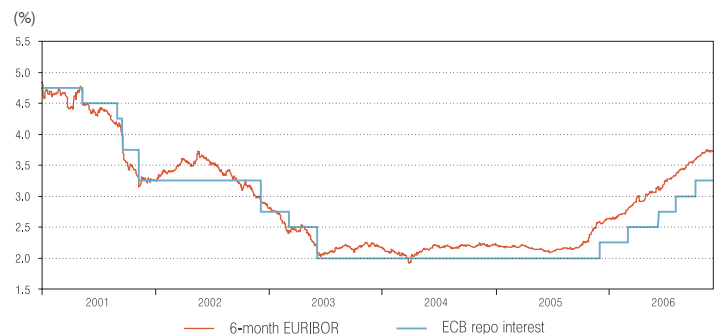
Source: NTC Research.

Chart 9
Euro Area Base Interest Rates



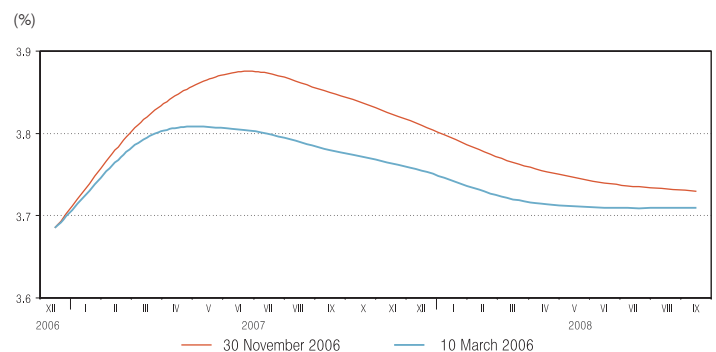
Source: Bloomberg.

Chart 10
Interest Rate on Main Refinancing Operations and Six-month EURIBOR



Source: Bloomberg.

Chart 11
Implied Yield on the Three-month EURIBOR Futures Contracts



Source: Bloomberg.

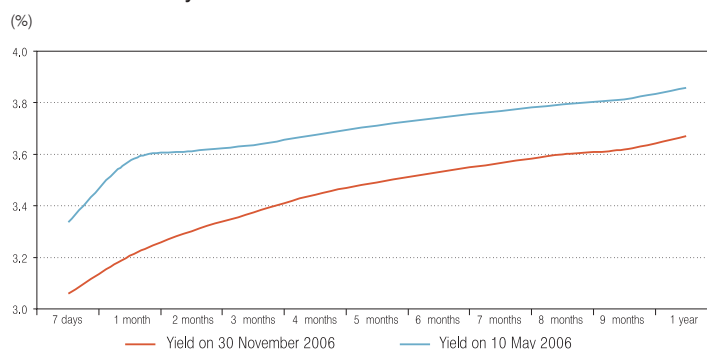
expectations signal an increase in the reference interest rate by another 25 basis points to 3.5 per cent in early December.

Retention of ECB anti-inflationary policy reflected on market expectations of further rises in the rate on main refinancing operations. EURIBOR interest rates on time deposits with maturity of one, three, six and 12 months retained their upward trend. November saw expectations of another increase in the repo rate by the close of the year. If this scenario materializes, EURIBOR interest rates on time deposits and their futures contracts yield are expected to continue increasing in early 2007.

EU-25

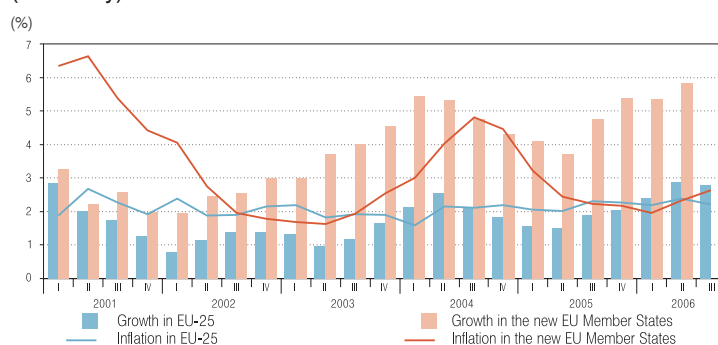
EU-25 growth slowed down to 2.8 per cent on an annual basis, from 2.9 per cent over the second quarter. Average monthly inflation in the newly acceded countries rose to 2.6 per cent in the third quarter of 2006, fuel prices remaining the main driver to this. In October energy prices went down and year-on-year inflation in newly acceded countries fell to 2.2 per cent.

Chart 12
Euro Area Money Market Yield Curve



Source: Bloomberg.

Chart 13
Growth and Inflation in EU-25 and in the New EU Member States (Quarterly)



Source: Eurostat, BNB calculations.

Effects of the VAT Rate Increase in Germany

In February 2006 the German government tabled a proposal to the Parliament to increase the standard rate of VAT from 16 per cent to 19 per cent. The reduced rate of 7 per cent applicable to foods remained unchanged. This measure, which was introduced from 1 January 2007, reflected the need to ensure higher revenue in the federal budget and consistency with the Stability and Growth Pact's requirement to hold EU member countries' budget deficit below 3 per cent of GDP. A part of this increase was intended to compensate lower budget revenue from unemployment insurance contributions which fell from 6.5 to 4.5 per cent. It was estimated that this measure will raise the federal budget revenue by approximately 1 per cent of GDP, prompting a fall in the budget deficit to 1.4–1.6 per cent of GDP in 2007.

Effects of the VAT rate increase on economic growth and inflation in Germany are marked by uncertainty. In a historical perspective, the present 3 percentage point increase was significantly higher than the three VAT rises by 1 percentage point in the last 25 years. Announcing this increase almost a year earlier enabled economic agents to adjust their behaviour and make purchases in 2006.

Comments and analyses of the VAT increase effect show expectations of subsiding economic growth and increasing inflation over the short term in Germany. The EC autumn projections include estimates of a possible increase in demand for durable goods allowing consumers to benefit from lower selling prices at the end of 2006. Higher consumption in Germany at the end of 2006 is expected to further stimulate real GDP growth which, according to the latest estimates of the federal government, may reach 2.3 per cent – one of the highest levels in recent few years. On the other hand, the VAT rate increase may have a negative effect on consumption growth over 2007, the EC projection pointing to a 0.1 percentage point fall on 2006 levels. This will lead to lower growth of 1.2 per cent in real GDP over 2007.

According to consumer attitudes survey in Germany conducted by GfK on 15 November, each fifth German citizen (29 per cent of West Germans and 37 per cent of East Germans) has already made greater purchases, while 11 per cent of consumers have planned to make such purchases until the close of the year. Transferring future consumption on expenses on furniture (growth by 12.5 per cent) and on housing refurbishments (growth by 12.5 per cent) had the strongest effect.

According to preliminary estimates, the VAT increase will exert an essential inflationary pressure in the first quarter of 2007. The EC projections show a 1.5 per cent increase in inflation for the fourth quarter of 2006 and a 2.5 per cent rise in the first quarter of 2007. In 2008 inflation will return to a little above 1 per cent level.

According to forecasts of the six leading economic research institutes in Germany, GDP growth in 2007 will be 1.4 per cent and inflation 2.3 per cent. Some analysts expect that the increased VAT rate will have only a temporary effect on consumer activity due to robust growth of household disposable income and favourable situation on the labour market (EU unemployment fell to 7.7 per cent in October 2006). According to other economists, the negative effect will be longer since no essential growth in employment and consumption is expected. Both groups of analysts think that the negative contribution of higher consumption in 2006 on GDP growth in 2007 will be 0.25 percentage points.

At its latest press conference, the president Jean-Claude Trichet expressed concerns about increased volatility in quarter-on-quarter GDP growth in early 2007, pointing to VAT increases in Germany. At the same time, ECB expectations for 2007 show euro area growth sustaining its rate close to the long-term trend.

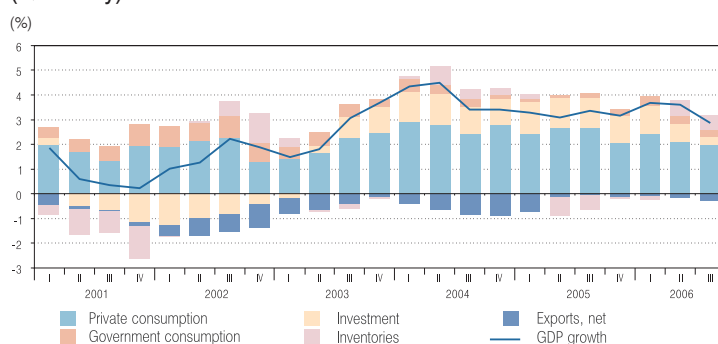
The USA

Moderation in the US growth rate continued in the third quarter of 2006. Gross domestic product rose by 1.6 per cent on an annual basis (2.6 per cent in the previous quarter). Lower economic activity was adversely affected by the 17.4 per cent decline in new residential construction investment. Decreased activity in this sector has not yet impacted the key components of domestic demand (private consumption and business investment). Personal consumer expenditure recorded a robust growth rate of 3.1 per cent, underpinned by favourable conditions on the labour market, real income growth and decreased energy prices.

Over the fourth quarter economic activity rates are expected to slow down and stabilize below the long-term trend. A similar scenario was supported by the economic indicators of production and services whose dynamics recorded expectations of moderation in the fourth quarter. It is projected that low unemployment, favourable conditions on energy markets and stock indices dynamics will positively affect household disposable income and consumption. Main risks to consumer activity stem from possible shifts of negative effects of declines in housing construction on household behaviour and disposable income.

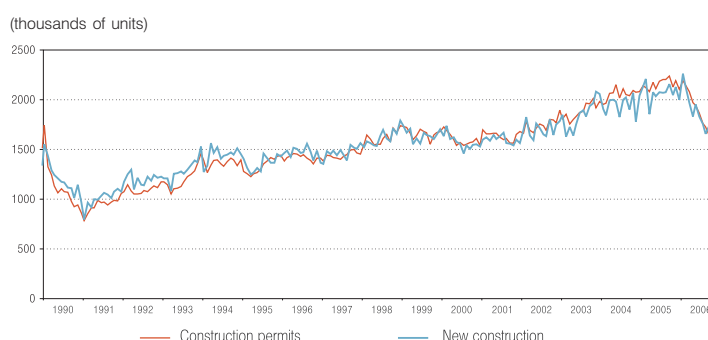
In October consumer price growth rates fell to 1.3 per cent on an annual basis, reflecting deflation of energy resources. Core inflation stayed above 2 per cent and further exceeded the implicit goal of price stability of the Federal Reserve System. The main factor behind the high core inflation is the increase in unit labour costs in line with increased wages and decreased labour productivity.

Chart 14
Contribution to US Growth by Component (Quarterly)



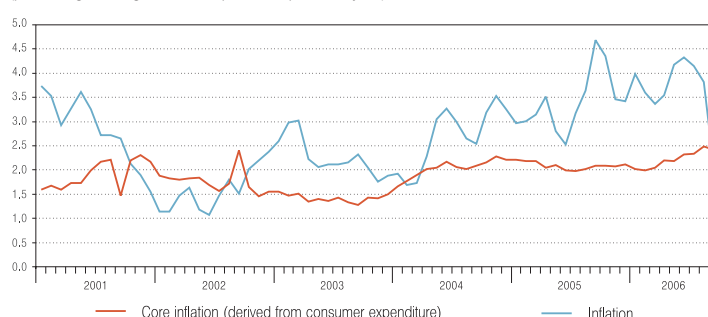
Source: Bureau of Economic Analysis.

Chart 15
New Construction in the USA



Source: Bureau of Economic Analysis.

Chart 16
US Inflation Rate
(percentage change on same period of previous year)



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

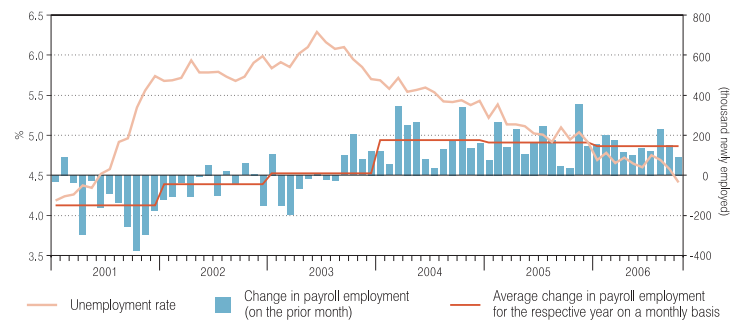
Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

Over the fourth quarter overall inflation will mainly reflect crude oil price dynamics. Core inflation is expected to decrease its growth rates due to contracted domestic demand and the relevant easing of pressure on production capacities.

Unemployment continued falling to reach 4.4 per cent in October – the lowest level in the last five years. Employment growth was sustainable, albeit at slowing rates on an annual basis, reflecting trends in economic activity.

The US Federal Reserve System left federal funds interest rates unchanged over the third quarter. Despite the downward trends in inflation, its underlying component stayed solidly above 2 per cent on an annual basis. This fact, coupled with increased unit labour costs, underpinned the Federal Reserve System's reasons to draw attention to upside risks to price stability. Hence, market expectations signal that the federal funds rate is likely to remain unchanged at 5.25 per cent by the end of the first quarter of 2007. If this projection materializes, the six-month LIBOR deposit rate in USD is likely to range between 5 and 5.5 per cent until the end of March 2007.

Chart 17
US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labor Statistics.

Chart 18
US Productivity and Unit Labour Costs

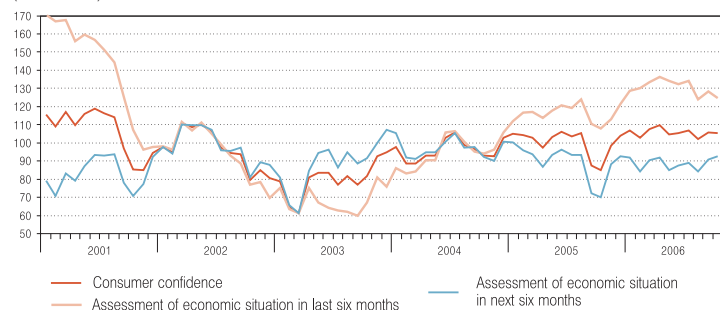
(change on an annual basis)



Source: Bureau of Labor Statistics.

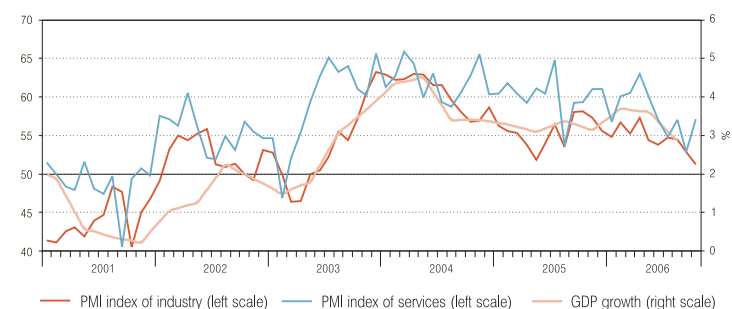
Chart 19
US Consumer Confidence Indices

(1985 = 100)



Source: The Conference Board.

Chart 20
US PMIs and Growth

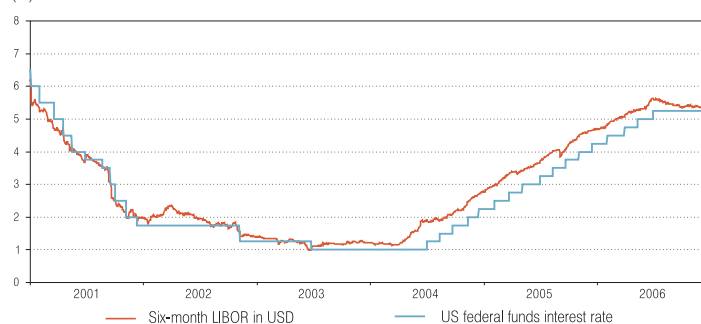


Source: Institute for Supply Management.

The USD/EUR Rate

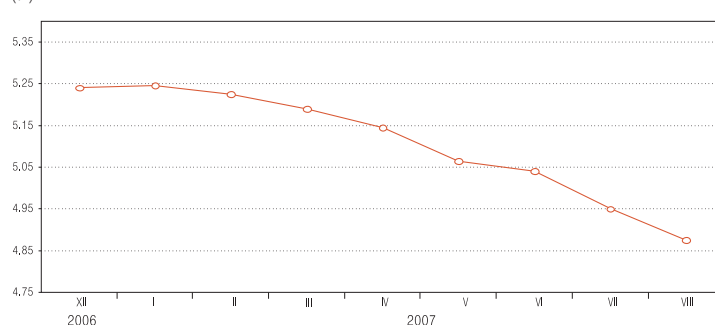
The expected interest rate differential between investment in US dollars and in euro was among the major factors behind the USD/EUR rate volatility between September and the middle of November. In the first half of October the US dollar appreciated to USD 1.2513 per EUR 1 as a result of the latest US economy data pointing to inflationary risks and no further declines in interest rates. In the middle of October the trend reversed and the US dollar started depreciating against the euro. Moderation in US economic growth over the third quarter, coupled with the downward outlook for inflation, consolidated the majority of market participants around coming cuts in interest rates. As regards December, foreign currency markets anticipate retention of US interest rates and a 25 percentage point increase in the euro area. Expectations of the monetary policy in the USA and the euro area will further affect significantly exchange rate developments in the short term and in the first quarter of 2007.

Chart 21
US Federal Funds Rate and Six-month LIBOR in US Dollars (%)



Source: Bloomberg.

Chart 22
Implied Federal Funds Futures Rate as of 29 November 2006 (%)



Source: Bloomberg.

Chart 23
USD/EUR Exchange Rate (USD per EUR 1)



Source: ECB.

The Balkan Region

Over the second quarter of 2006 Balkan countries continued to report high economic growth. Romania and Turkey posted the highest growth in GDP at 7.9 per cent and 7.5 per cent on an annual basis, followed by Bulgaria and Serbia at 6.6 per cent. High private consumption and increased growth rates of investment were the major factors behind the continuing high economic activity in this region. Over the second quarter private consumption growth in Romania and Turkey reached 12.7 per cent and 10.1 per cent annually, while investment growth accounted for 12.2 per cent and 10.9 per cent respectively.

Inflation in this region moderated over the third quarter and the beginning of the fourth quarter due to energy price falls and subsiding effects of increases in some administered prices.

High growth rates are expected to be sustained over the fourth quarter of 2006 and first quarter of 2007, with the robust economic activity of EU countries further affecting favourably the Balkan countries.

Table 1

Real Growth and Inflation in Balkan Countries (Quarterly)

	2005					2006		
	I	II	III	IV	Total	I	II	III
Growth (on the previous year, %)								
Bulgaria	5.9	6.5	4.6	5.5	5.5	5.6	6.6	
Greece	3.4	3.7	3.8	3.7	3.7	4.1	4.1	
Macedonia	2.9	5.0	4.1	3.8	4.0	2.5	2.8	
Romania	5.9	4.1	1.8	4.6	4.1	6.9	7.9	
Turkey	6.6	5.5	7.7	9.5	7.4	6.5	7.5	
Croatia	1.8	5.1	5.2	4.8	4.3	6.0	3.6	
Serbia	6.7	8.0	6.7	5.9	6.8	6.7	6.6	
Inflation (averaged for the period, %)								
Bulgaria	3.8	4.9	4.8	6.6	5.0	8.0	8.3	6.7
Greece	3.4	3.2	3.8	3.5	3.5	3.2	3.4	3.5
Macedonia	-0.4	0.9	0.8	0.8	0.5	2.7	3.4	3.6
Romania	8.9	9.9	8.9	8.5	9.0	8.6	7.1	5.9
Turkey	8.6	8.6	7.9	7.6	8.2	8.1	9.6	10.8
Croatia	3.1	3.0	3.4	3.8	3.3	3.5	3.8	3.2
Serbia	15.9	16.4	15.5	16.6	16.1	14.6	14.2	11.4

Source: Statistical institutes and central banks of respective countries.

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

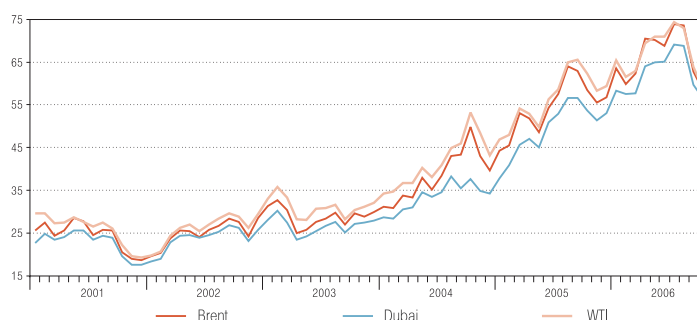
Crude Oil

Subsiding global uncertainty at the end of the third quarter led to lower crude oil prices in September (down 15 per cent on a monthly basis after the July and August highs of over USD 75 *per barrel*). This trend persisted in October, with the risk premium for oil prices falling further as a result of Iran's readiness to resume talks on its nuclear programme and comparatively quiet Atlantic hurricane season. The IEA data on world demand and supply of crude oil in October recorded a positive balance for the sixth consecutive quarter. This contributed to peak values of oil and oil product inventories in OECD countries. Inventories accumulated as of the beginning of the fourth quarter were entirely sufficient to cover the seasonal increase in demand over the winter months in the northern hemisphere.

In response to oil price falls, the OPEC countries took a decision to reduce the supply by 1.2 million barrels *per day* (b/d): from 27.5 million b/d to 26.3 million b/d with effect from 1 November. The OPEC members signaled that a price below USD 50 *per barrel* was unacceptable for the cartel and it would further cut the supply. IEA projections show that world demand will grow in 2007 by 1.4 million b/d, while supply by non-

Chart 24

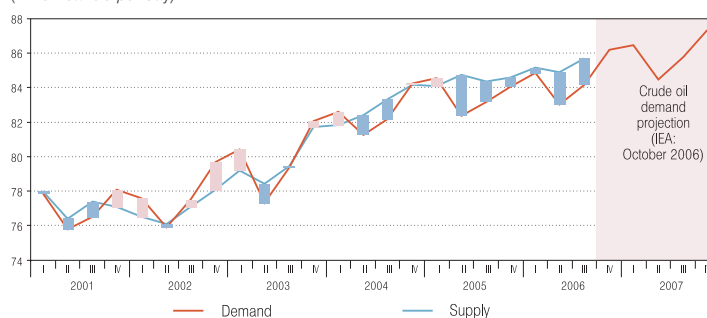
Crude Oil

(USD *per barrel*)

Source: World Bank.

Chart 25

World Crude Oil Demand and Supply (Quarterly)

(million barrels *per day*)

Source: IEA.

OPEC countries is anticipated to rise by 1.7 million b/d, following the introduction of new capacities in Russia, the Caspian region, Africa and Brazil.

The average monthly Brent price is expected to fluctuate within the range of USD 55–65 *per barrel*. Main risks to the projection stem from a possible increase in geopolitical uncertainty around nuclear programmes of Iran and North Korea and greater-than-expected declines in supply by OPEC countries. Frequent terrorist threats and attacks against oil facilities in Nigeria will further impact oil markets.

Major Raw Materials and Commodity Groups

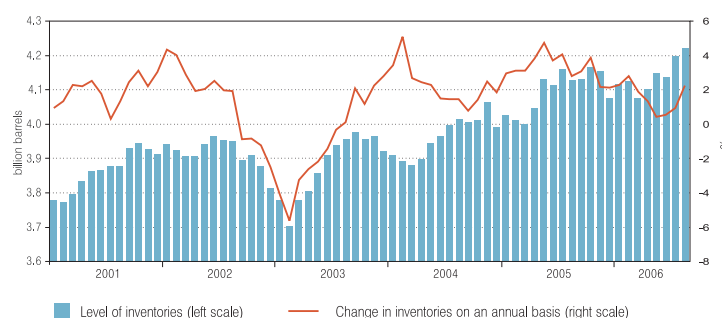
Following the significant increase in the second and third quarters, non-ferrous metal prices stabilized at attained levels. Demand remained high, while inventories of non-ferrous metals were low. However, moderation in world growth rates curbed their prices. Latest available data for October show rises in nickel, zinc, aluminium and lead prices on a monthly basis by 8.5 per cent, 12.3 per cent, 7.3 per cent and 14.1 per cent respectively. For a third consecutive month the copper price fell on a monthly basis (-1.2 per cent in October).

Data on steel output again showed significant growth rates. As of July world output picked up by 14.4 per cent on an annual basis and reached its highest value in the last six years. Steel product prices retained their downward trend, with the prices falling by 3.5 per cent on an annual basis.

Metal prices are expected to slow down their growth rates due to moderation in world economy over the fourth quarter of 2006 and the first quarter of 2007. Low world inventories of non-ferrous metals will not allow their prices to decrease in these two quarters.

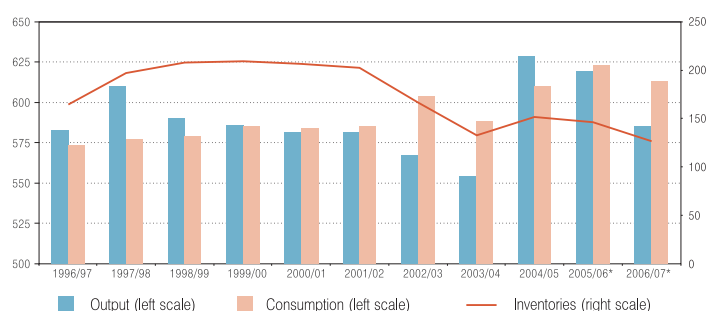
In the third quarter of 2006 food inflation accelerated to 10.1 per cent on an annual basis. Cereal prices rose most significantly, with wheat, corn and rice prices increasing annually by 29.9 per cent, 15.3 per cent and 10.9 per cent respectively over the third

Chart 26
Crude Oil Inventories in OECD Countries



Source: IEA.

Chart 27
World Wheat Output, Consumption and Inventories
(metric tons)



* Projections for 2005–2006 and 2006–2007.

Source: United States Department of Agriculture.

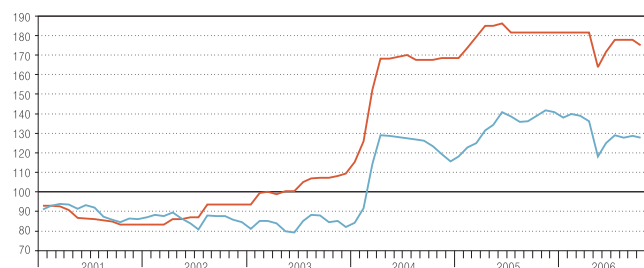
quarter. In the beginning of the fourth quarter the wheat price continued picking up and reached its ten-year high, drought in Australia contributing most to this. The projections for the 2006–2007 season point to a 5 per cent decrease in world crops, resulting in a fall in world inventories to a 25-year minimum. Corn price rises reflected the increase in wheat prices, expected lower crops in the USA and the growing corn demand of ethanol producers.

Expectations for the fourth quarter of 2006 and first quarter of 2007 show food price rises due to expected declines in world production.

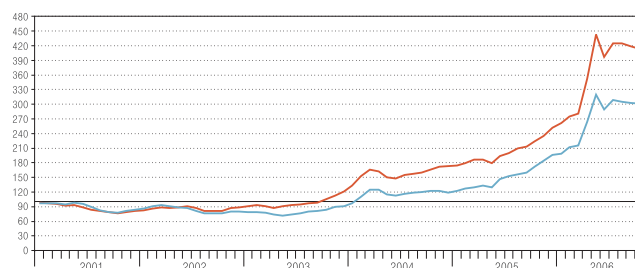
Chart 28

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

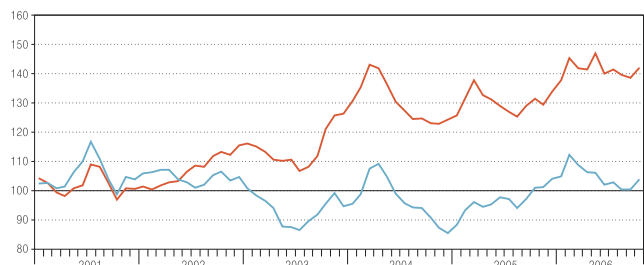
Steel



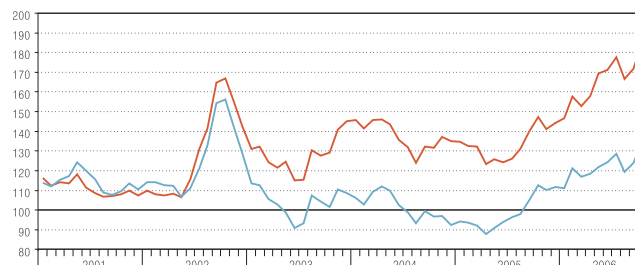
Copper



Food



Wheat



Source: World Bank, BNB.

— USD

— EUR

Gold

During the fourth quarter of 2006 gold price fluctuations subsided and since the start of October the price has been moving within the range of USD 563–633 *per* troy ounce. In the first week of October the gold futures price reached its lowest level for the last six months: USD 566.7 *per* troy ounce. In November the price of a futures contract with a delivery in December rose again. The appreciation of gold was partially under-

pinned by the speculations that China would diversify its international reserves by increasing its purchases of gold. Around 1.3 per cent of China's central bank reserves are invested in gold. The speculative interest in gold was occasionally boosted by the rising geopolitical tension resulting from North Korea's nuclear experiment. The market was further impacted by the close gold/US dollar exchange rate connection.

Gold is expected to gradually appreciate in the fourth quarter of 2006 and the first quarter of 2007. In the fourth quarter of 2006 its price will be determined by seasonal factors owing to its physical demand, while in the first quarter of 2007 the price will be mainly affected by changes in inflationary expectations and by interest rates. Its close connection with the US dollar is likely to be sustained.

Bulgarian External Debt Dynamics on International Financial Markets

In the third quarter of 2006 emerging markets' government debt yield spread measured by the *JP Morgan Euro EMBI Global* index exhibited a gradual downward trend. This movement stemmed from the enhanced global interest of investors in emerging markets' debt instruments in their efforts to achieve higher yield, since the US Federal Reserve System discontinued the cycle of increasing interest rates. Investors were attracted by the improving macroeconomic conditions in a number of emerging economies and gradually subsiding government crises in Hungary, the Czech Republic and Poland.

The yield spread of the Bulgarian government debt measured by the *Euro EMBI Global* index gradually went down in the third quarter and at the start of the fourth quarter, coming to 44 basis points by 17 November 2006 against 53 basis points by mid-year. The favourable macroeconomic environment and pending membership of Bulgaria in the EU were the key factors behind the stable interest in Bulgarian external debt. The upgrading of the Bulgarian long-term foreign currency government debt by the *Standard & Poors* to BBB+ at the close of October affected favourably market risk assessment.

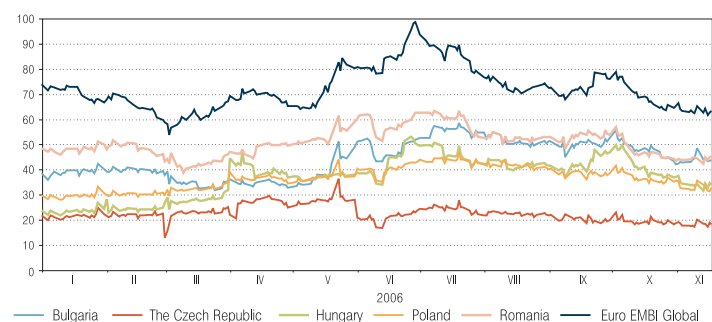
Chart 29
Spot Price of Gold

(USD per troy ounce)



Source: The London Bullion Market Association.

Chart 30
Government Debt Yield Spreads in Bulgaria, Romania, Poland, The Czech Republic and Hungary (*Euro EMBI Global* index)



Source: JP Morgan.

The stable macroeconomic conditions, along with Bulgaria's pending membership in the EU and the reliable and consistent fiscal policy of the Bulgarian government in 2007 will strengthen the trend towards a more positive risk assessment and a less expensive access of economic agents to external financing, thus supporting indirectly long-term economic growth.

2. Financial Flows, Money and Credit

High returns on investment in Bulgaria and positive expectations of economic development stemming from the EU membership from 1 January 2007 attracted large amounts of financial resources – foreign direct investments and external loans boosting Bulgaria's economic growth. Investment activity has become a major factor behind economic growth, and the contribution of investments in fixed assets to growth became equal to that of household consumption. On the other hand, demand for investment goods has been mostly satisfied by imports, thus contributing to the rise in the balance of payments trade balance. In line with capital inflows, some items of the balance of payments current account (i.e. balance on income and balance on other services) further worsened. Rises in international prices of major raw materials (crude oil and metals) prompted an increase in the trade balance deficit during the year, since this group occupied a significant share in Bulgaria's overall imports.

As a result of the above factors, the balance of payments current account continued to grow in the January to September 2006 period, with foreign direct investments covering 135.8 per cent of it. The balance of payments total surplus was distributed between the rise in international reserves and IMF loan repayments. The ratio between international reserves and imports of goods and services in months of imports remained constant at approximately five months.

By September 2006 the Issue Department balance sheet figure reached BGN 16,520.3 million (EUR 8446.7 million). The increase in international reserves in the third quarter by BGN 1118.3 million resulted mainly from net purchases of foreign currency by commercial banks. Unlike the first half year, the change in commercial banks' minimum required reserve accounts impacted adversely

Table 2

Cash Flows Which Prompted Significant Changes in Gross International Reserves

	January – June 2006	Third quarter, 2006
A) Purchases and sales of reserve currency	Total, net: EUR +772 million	Total, net: EUR +788 million
Net purchases from commercial banks	Net purchases from CB: EUR 785 million Bought: EUR 5708 million Sold: EUR 4923 million	Net purchases from CB: EUR 791 million Bought: EUR 3550 million Sold: EUR 2759 million
Outflows related to net purchases at tills	Sold banknotes: EUR 13 million	Sold banknotes: EUR 3 million
B) Changes due to revenue (outflows) on commercial banks' minimum required reserve accounts in foreign currency	Net revenue : EUR 603 million	Net withdrawals : EUR 252 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	Revenue : EUR 113 million USD 17 million SDR 10 million Payments : EUR 929 million USD 141 million JPY 1.1 billion SDR 10 million	Revenue : EUR 166 million USD 9 million SDR 4 million Payments : EUR 127 million USD 85 million JPY 180 million SDR 4 million

Source: BNB.

the increase in reserves during the quarter due to releasing additional minimum required reserves in August. The government's contribution remained neutral. The rise in international reserves under a currency board arrangement leads to a change in the monetary base and affects broad money and credit dynamics through the process of money multiplication.

Financial Flows and External Position Sustainability

Capital inflows into Bulgaria will stay high, underpinning robust domestic demand. The current account deficit will reach some 14 per cent of GDP for 2006 and will move within the range of 13.2 and 13.4 per cent on an annual basis in the first quarter of 2007. Private external debt will come to 59–60 per cent of GDP in the fourth quarter of 2006 and to 60–61 per cent of GDP in the first quarter of 2007.

The flow of financial resources into Bulgaria influenced to a great extent the flows on the balance of payments current account and pushed up the deficits on various current account items. During the first nine months of 2006 foreign direct investment financed over 135.8 per cent of the current account deficit which grew by EUR 867.8 million on the same period of the prior year to EUR 2094.1 million. In terms of current

account items, deficit growth was attributable both to the trade balance with a share of 55 per cent and to all other components, including balance on income, with a share of 20 per cent and net current transfers with a share of 14 per cent.

Exports of goods have accelerated since the year's start, posting 30.9 per cent growth between January and September compared with the respective period of 2005. Exports are expected to preserve their robust growth until the end of the current year driven by the accelerating EU growth and favourable dynamics in international prices of major commodity groups occupying a significant share in Bulgaria's exports. Imports went up by 26.4 per cent in the January to September 2006 period. However, the sizable fluctuations in import growth rates by month (between 16.1 per cent and 36.5 per cent) impeded the identification of a clear trend. A decrease in the import growth is more likely to occur, albeit counteracted by relatively high domestic demand (especially for investment goods and raw materials).

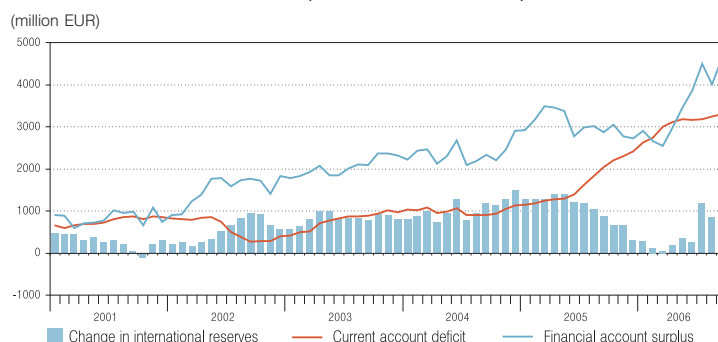
Balance on services totaled EUR 733.4 million by September 2006: down by EUR 95.7 million compared with the same period of the previous year. Foreign trade dynamics affected transportation services. Growth rates of tourism income decreased to 4.5 per cent over the first nine months of 2006, although information is insufficient to estimate if the growth in this indicator will accelerate or retain its attained level. The *Other services* item exhibited a sustainable trend towards a worsening balance in 2005, but at the start of 2006 a more favourable trend emerged: a slowdown in growth from 50.9 per cent in the first quarter to 10.7 per cent on the debit side and an increase of 1.1 per cent in the first quarter and 70.6 per cent in the third quarter, on the credit side. Periods with similar dynamics were observed in the past as well, and provided the current upward trend in the balance is retained, the negative contribution of the *Other services* sector to the current account balance may diminish.

The balance on the *Income* item came to EUR 31.3 million over the first nine months of 2006: a decrease on the level of EUR 173.5 million in the respective period of 2005. The contraction of the positive balance was driven mainly by payments on income from direct investment which went up by 47.7 per cent over the period, reaching EUR 507.5 million. Given the existing trend and sizable foreign direct investment flows into Bulgaria, income payments from direct investments may be expected to retain their high growth rates, thus reducing the surplus on the *Income* item in the coming quarters.

Over the first nine months of 2006 net current transfers totaled EUR 596.9 million against EUR 716.9 million in the same period of 2005. The decrease of EUR 119.9 million was attributable to a fall in the private sector transfers, while the government balance improved. Lower private current transfers resulted probably from the higher disposable income of Bulgarian households underpinned by rising employment and incomes. The veracity of this view can be proved through longer data series which are not available at present.

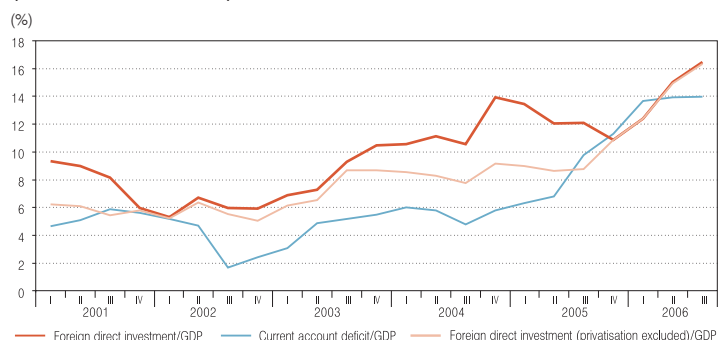
Given the trends in flows on the balance of payments current account and sustained sizable foreign direct investment, the current account deficit for 2006 is expected to be higher than that for 2005, reaching 14 per cent of GDP. During the first quarter of 2007 the current account deficit is anticipated to move within the range of 13.2 to 13.4 per cent of GDP. The forecasts about a relative improvement in the current balance during the first quarter of 2007 is based on expectations of a recovery in the growth of services exports and weaker growth in outflows on the *Income* item. A risk may arise from a slower improvement of the current account deficit in 2007. In view of investors' interest and the concluded privatisation contract for the Varna Thermo-electric Power Plant, it may be expected that in both quarters the foreign direct investment inflow on an annual basis will cover the current account deficit.

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



Source: BNB.

Chart 32
Current Account Deficit to GDP and Foreign Direct Investment to GDP (on an Annual Basis)



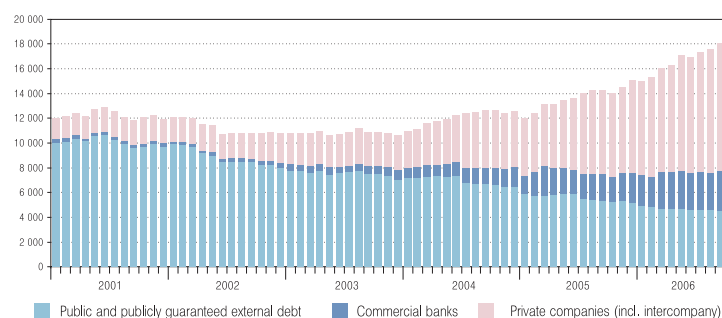
Source: BNB, NSI.

The balance of payments financial account reported a surplus of EUR 3287.8 million for the first nine months of 2006, with a considerable contribution of foreign direct investment which, according to preliminary data, reached EUR 2845.1 million: up by EUR 1552.8 million or 120 per cent on the corresponding period of 2005. The contribution of privatisation revenue to foreign direct investment growth was negligible. Within the total increase in direct investment, EUR 900 million came from the growth of attracted equity, with over EUR 500 million growth in receipts from sales of real property to non-residents. Purchases of real property by non-residents may be interpreted as a sign of enhanced confidence in Bulgarian economy and a lasting interest in Bulgaria. This may result in a future inflow of resources on the balance of payments current account. On the other hand, these investments would hardly add to strengthening economy's production capacities.

Within the framework of foreign direct investment, the net inflow on the *Other capital* item, reporting changes in intercompany indebtedness, amounted to EUR 1236.9 million over the January to September 2006 period. This almost doubled the inflow during the respective period of 2005, thus affecting Bulgarian external debt as well.

In the structure of direct investments by sector, the *Real property, renting and business activities* sector occupied the largest share (35.4 per cent), followed by *Manufacturing* (21.4 per cent) and *Financial intermediation* (12.7 per cent). The leading role of transactions in real property in the structure of direct investments by sector corresponded both to the share of receipts from real property sales in the net share capital and to the structure of direct investments by country where the total share of Great Britain and Ireland came to over 25 per cent during the period. The latter indirectly indicates the importance of transactions with minor investors as part of real estate operations, since in recent few years residents of these countries have invested in Bulgarian personal use property.

Chart 33
Gross External Debt
(million EUR)



Source: BNB.

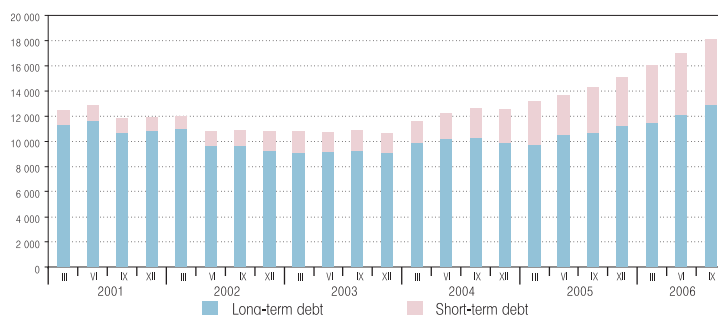
Over the January to September 2006 period substantial financial flows in the form of borrowings entered the Bulgarian economy. The greater portion of them was debt directly covered by companies, while flows allocated to the economy through the banking system ranked second in amount. Over the review period the net increase in the private non-guaranteed external debt comprised EUR 3563.4 million, with debt of commercial banks growing by EUR 695.4 million and that of private companies by EUR 1669.5 million. Debt related to intercompany loans also posted sizable growth (EUR 1228.3 million).

Gross external debt reached EUR 18,083.9 million by end-September 2006: up by EUR 2973.2 million (19.7 per cent) on December 2005. During this period public and publicly guaranteed debt decreased by EUR 589.3 million (11.4 per cent) as a result of debt repayments to the IMF and the World Bank in the first quarter. Thus, the increase in the total gross external debt was entirely ascribable to the 35.8 per cent rise in the private non-guaranteed external debt.

Economic sectors which became indebted most intensively between January and September 2006 were the *Real property, renting and business activities* sector (45.7 per cent of the total growth in real sector external indebtedness, excluding trade credits and bond loans) and the *Electricity, gas and water supply* sector (a 11.7 per cent contribution). The share of the euro (some 77 per cent) in the private non-bank sector's currency structure remained stable, while its share in intercompany loans was even higher (88–89 per cent). This reduced the risks associated with exchange rates fluctuations.

The short-term indebtedness in the period between end-December 2005 and September 2006 went up by EUR 1352.3 million (35.2 per cent), while long-term external debt rose by EUR 1620.8 million (14.4 per cent). Credits on demand increased by EUR 1392.8 million or 78.8 per cent, with EUR 760 million of this increase due to a rise in intercompany loans (reported as foreign direct investment). Therefore, these funds

Chart 34
Long- and Short-term Gross External Debt Dynamics
(million EUR)



Source: BNB.

(albeit potentially payable at any moment from a statistical viewpoint) have been granted by external economic agents with a long-term interest in Bulgarian economy. The remaining part of the increase (EUR 630 million) and the total amount of non-intracompany debt payable on demand (almost EUR 1.2 billion) indicate existent risks associated with the external debt's maturity structure.

Major factors behind the growing private sector's indebtedness were the efforts of Bulgarian companies to ensure a more effective management of liabilities through borrowings from abroad and the BNB's measures for curbing bank lending. These factors will continue to affect the debt's dynamics in the fourth quarter of 2006 and the first quarter of 2007, making possible a certain acceleration in the growth of banks' liabilities due to phasing out BNB restrictions from the start of 2007. As a result, private debt is expected to be at the levels of 59–60 per cent of GDP in the fourth quarter of 2006 and 60–61 per cent of GDP in the first quarter of 2007.

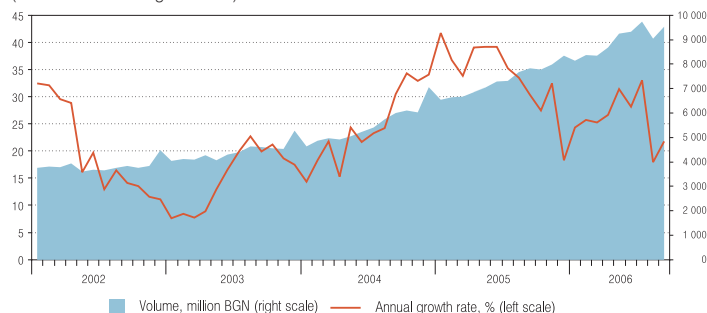
Monetary Aggregates

Given the projected change in international reserves and in the government deposit with the BNB, reserve money is expected to increase by about 20–22 per cent in the fourth quarter of 2006 and by some 18–20 per cent in the first quarter of 2007. Bank reserves will nominally stay high, but their growth will slow down. Growth rates of currency in circulation are anticipated to pick up due to buoyant economic activity and the lower base compared with 2005. Broad money growth is also projected to increase slightly to 22–24 per cent on an annual basis. Interest rates on deposits in US dollars and in euro are likely to increase slightly, while those on lev deposits will match their current level.

Currency in circulation entirely contributed to the increase in the monetary base during the third quarter of 2006, while commercial banks' deposits with the BNB stayed below their June level. Commercial banks' deposits with the BNB went down following the removal of the additional reserves' progressive scale in August 2006. As a result, reserve money growth rates fell to 18 per cent (against 33 per cent in July). September saw an enhanced dynamics of reserve money which rose by 21.8 per cent. Nevertheless, its growth remained below the average for the last five years and is expected to decline in the medium run. Only in Sep-

Chart 35
Reserve Money

(volume and annual growth rate)



Source: BNB.

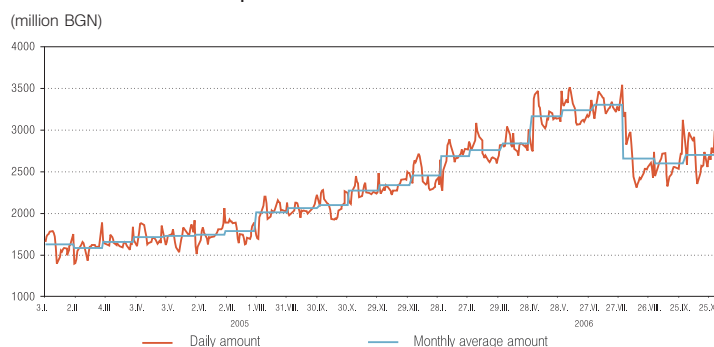
tember, however, bank deposits' contribution dominated due to their unusually high level by the close of the month. On the last business day of September they picked up by BGN 407 million. This growth was in line with the extremely high activity on the inter-bank money market where on the last day of September effected transactions came to BGN 1085 million: five times more than the average amounts on the remaining days of the month. Banks' reserves are anticipated to retain their high levels in the fourth quarter of 2006 and the first quarter of 2007.

BNB's decision to remove the administrative measures curbing non-government sector's credit growth from the start of 2007 will affect the monetary base only in May 2007. Until then, banks will be obliged to maintain additional minimum required reserves in case they have exceeded the limits on loans in the third and fourth quarters of 2006.

In the third quarter of 2006 currency in circulation went up by 14.5 per cent on an annual basis, reporting no change compared with the June growth rate. Since the start of the year a downward trend in the currency growth rates has been observed and this trend is expected to continue in the future, given the high *currency in circulation to GDP* ratio. The driving factor behind this will be the fast growing number of POS terminals and the volume of transactions conducted through them. In the next two quarters, however, slight acceleration in the growth of currency is expected, owing, on the one hand, to the buoyant economic activity and sizable inflow of capital on the balance of payment and, on the other hand, to the base effect of the first quarter of 2006, when the typical seasonal decrease in currency was most clearly pronounced.

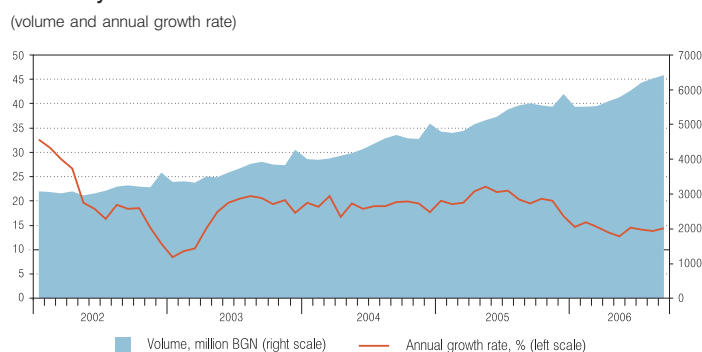
The fiscal policy affects monetary aggregate dynamics through redistribution of liquidity among the other sectors of economy and the change in the level of government and budget organizations' deposits with the BNB. Good revenue implementation in the third quarter of 2006 and moderate growth rates of budget expenditure underlay the withdrawal of liquidity from the non-govern-

Chart 36
Commercial Bank Deposits



Source: BNB.

Chart 37
Currency in Circulation



Source: BNB.

ment non-bank sector. As a result, government and budget organizations' deposits in the Issue Department balance sheet exceeded BGN 5 billion. The inflow of resources from the external sector to the government during the June to September 2006 period reflected mainly received BGN 270 million in the form of grants under the EU pre-accession funds and the EU Solidarity Fund (the lev equivalent was BGN 39.8 million extended for 2005 floods in Bulgaria).

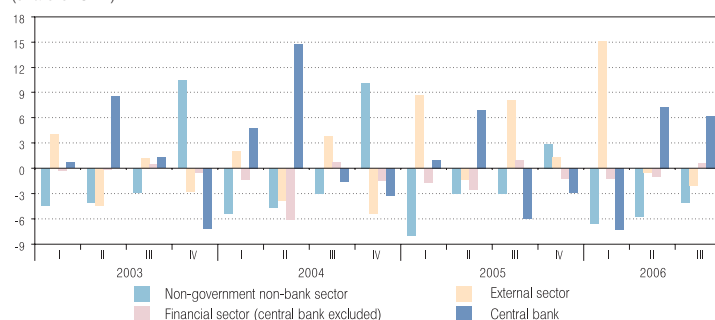
Privatization receipts and traditionally higher payments to the non-government sector will play a decisive role for the budget's redistributive function by the year-end. Receipts from the sale of the Varna Thermo-electric Power Plant to the amount of EUR 206 million in early October will partially offset larger budget transfers at the close of the year, and the government deposit with the BNB is expected to go up on the end of September. In the first quarter of 2007 payments to the external sector will be effected due to global bonds maturity (BGN 500 million), external debt interest payments and the transfer of one-fourth of Bulgaria's contribution to the EU budget. Receipts from privatization of enterprises in the energy sector¹ and EU Structural Funds advance payments are expected. Uncertainty about tax revenue in the budget, as well as inflows from the EU funds and receipts from privatization in early 2007 also reflect on the projections of government and budget organizations' deposits with the BNB, their levels being estimated at around BGN 5 to BGN 5.5 billion.

In September the annual growth rate of M3 rose to 24.7 per cent, from 20.9 per cent in June. Over the third quarter it posted a 7.5 per cent increase. These rates corresponded to the robust economic activity since the year start and especially to rising employment, incomes and asset prices. In the next two quarters money supply growth is expected to stay within the range of

¹ During the last months companies were selected by the Privatisation Agency for the sale of the Bobov Dol Thermo-electric Power Plant and Varna and Plovdiv Thermo-electric Heating Systems. These three contracts totaled BGN 215 million. The execution of payments on these contracts is largely uncertain since an approval by the Supervisory Board of the Privatization Agency is pending.

Chart 38
Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

(share of GDP)



Source: MF, BNB.

23–24 per cent, driven both by internal factors and the continuing capital inflow from abroad.

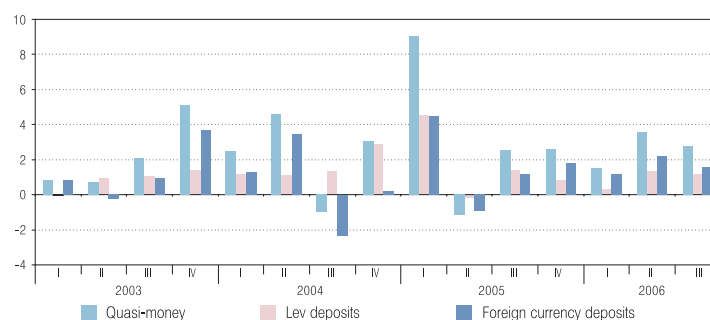
The M1 monetary aggregate again contributed more significantly (by 4.7 percentage points) to the change in broad money. Between September 2005 and September 2006 M1 went up by 27.5 per cent due mainly to the significant rise in overnight deposits (by 39 per cent). Over the review period overnight deposits in levs increased by 35.1 per cent and those in foreign currencies by 48 per cent. Non-financial corporations played a leading role for the change in lev and foreign currency deposits (35.9 per cent and 55.2 per cent respectively). This could be attributed to stronger exports in the last two quarters.

Growth in households' overnight deposits was relatively slower than that in firms' deposits (33.2 per cent and 32.5 per cent respectively on an annual basis), albeit accelerating on the end of June. As a result, the share of overnight deposits in the total amount of households' deposits increased from 17.5 per cent to 20.7 per cent over the last year. Since the relative share of overnight deposits is above 50 per cent on average for the euro area, a much faster increase in these deposits may be expected in the future.

The contribution of quasi-money to the change in M3 in the third quarter was 2.7 percentage points, with foreign currency deposits growing more dynamically than lev deposits. In the time deposits segment, deposits in levs rose by 15.4 per cent on an annual basis and those in foreign currencies by 31.1 per cent. The difference in growth rates is attributable to non-financial corporations which increased their deposits by 79 per cent over the last year, showing a trend towards a more rapid increase in the last three months. The growth rate of households' foreign currency time deposits remained at the level of approximately 20 per cent. The currency structure of households' time deposits remained almost unchanged in the last year, lev deposits occupying around 36.8 per cent of total deposits (against 36.3 per cent in September 2005).

Chart 39
Contribution of Quasi-money and Their Components to M3 Growth (Quarterly)

(percentage points)



Source: BNB.

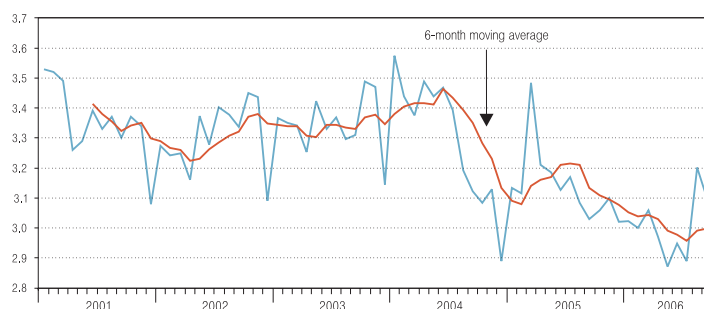
This structure reflects to a great extent the state of savings prior to introducing the currency board, rather than foreign currency risk.

The high level of reserve money after introducing additional required reserves resulted in a dramatic decline of the money multiplier. After releasing bank reserves in August, the multiplier rose abruptly to 3.2 and subsequently dropped again to 3.1 by end-September. The money multiplier is expected to fall further until the close of the year prompted both by higher additional reserves that commercial banks will have to maintain after 4 November 2006 and by seasonal factors. In the first quarter of 2007 its dynamics will depend mainly on banks' credit activity.

Money circulation velocity continued its downward trend with clearly pronounced seasonality owing to the seasonal character of GDP. With M3 growing faster than GDP, the velocity is expected to continue falling in the next two quarters.

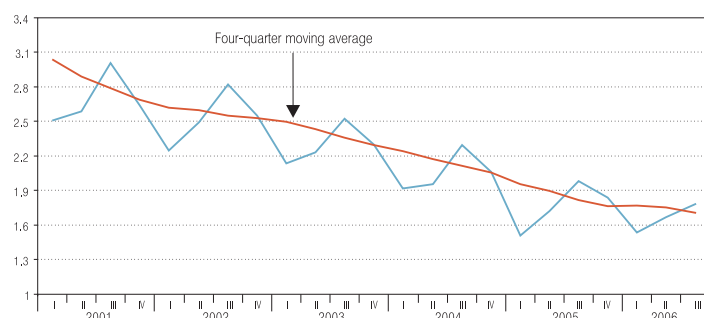
Interest rates on lev time deposits in the third quarter underwent no significant changes compared with the second quarter (3.44 per cent on average for the July to September period, from 3.48 per cent for the April to June period). Thus, following the gradual increase in 2004 and 2005, interest rates on lev deposits became stable in early 2006. Unlike interest rates on lev deposits, those on time deposits in euro and US dollars continued to grow in the third quarter to an average of 2.51 per cent for deposits in euro and 2.60 per cent for deposits in US dollars (2.43 per cent and 2.52 per cent in the second quarter). Given the projected new rise in the ECB repo rate in December, interest rates on deposits in euro are likely to climb again. Similar dynamics may be observed in interest rates on deposits in US dollars, even if we assume that the current policy of the Federal Reserve System will be preserved, since there is a considerable margin between domestic interest rates on USD deposits and the USD LIBOR.

Chart 40
M3 Money Multiplier



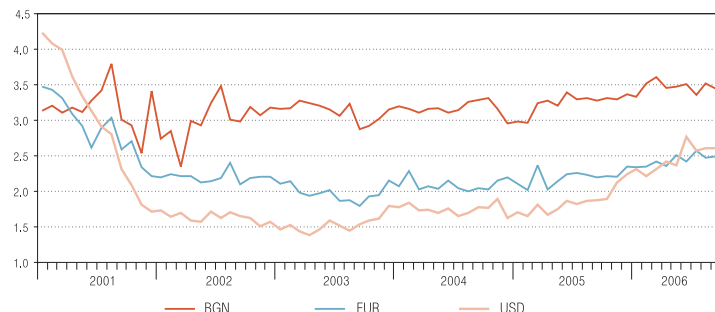
Source: BNB.

Chart 41
Currency Circulation Velocity (Quarterly)



Source: BNB, NSI.

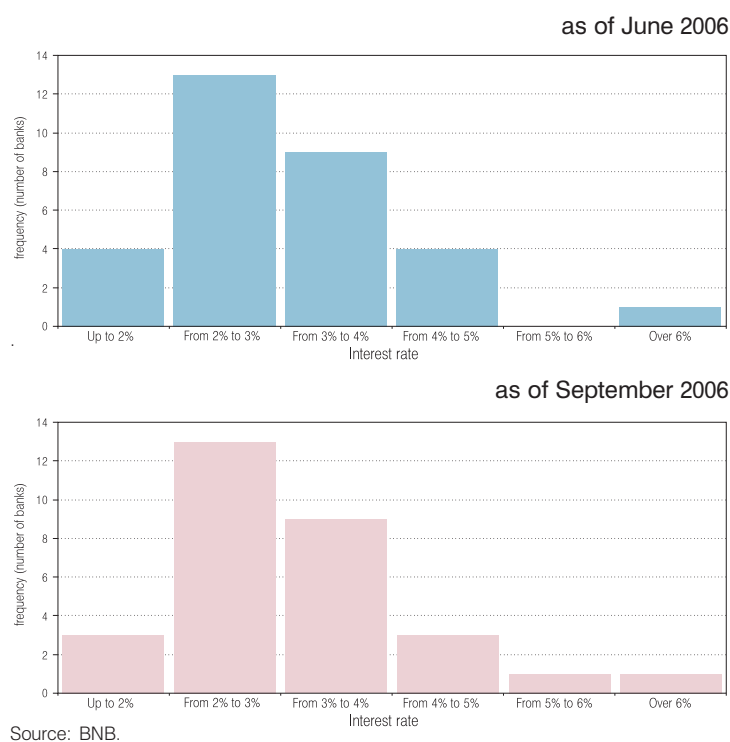
Chart 42
Interest Rates on Time Deposits (%)



Source: BNB.

The distribution of interest rates on household one-month lev deposits by bank remained unchanged in September compared with June. The greatest number of banks offered their customers rates within the 2 to 3 per cent interval. Of the 30 banks that accepted one-month lev deposits of households, seven banks increased their interest rates on June, while eight banks decreased them. The differential between the highest and lowest interest rates decreased from 5.87 percentage points in June to 5.73 percentage points in September. A smaller dispersion in interest rates was also observed.

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



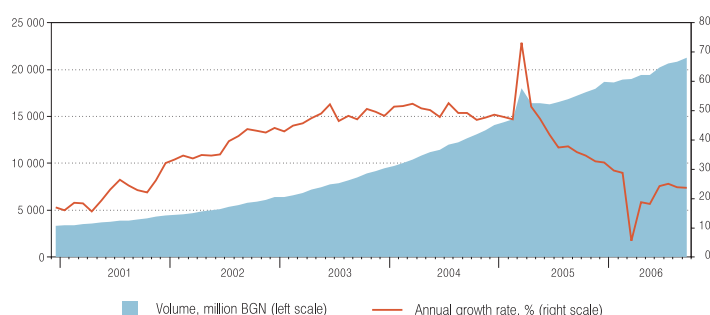
Credit Aggregates

As of 1 January 2007 the BNB has decided to remove all administrative restrictions on credit growth rates. Meanwhile, the central bank will retain the strict supervisory requirements aimed at achieving a moderate and stable bank credit growth within 20 per cent annually.

During the third quarter non-government sector claims increased by BGN 1067.1 million (against BGN 941 million over the same period of the prior year) and by the end of September their annual growth rate fell to 23.6 per cent. Sustained favourable macroeconomic conditions predetermined the robust demand for loans by corporations and households in the third quarter, and hence, the brisk lending. Concurrently, bank lending was strongly influenced by the measures undertaken by the BNB to moderate credit expansion. Credit aggregates dynamics was influenced by credit transfers to foreign banks and non-bank financial institutions, reaching an amount of BGN 691.2 million in the third quarter.

Having declared its intention to abolish the progressive scale used for determining the minimum required reserves in June, in late October the BNB decided to remove the administrative constraints on lending. De-

Chart 44
Claims on Non-government Sector

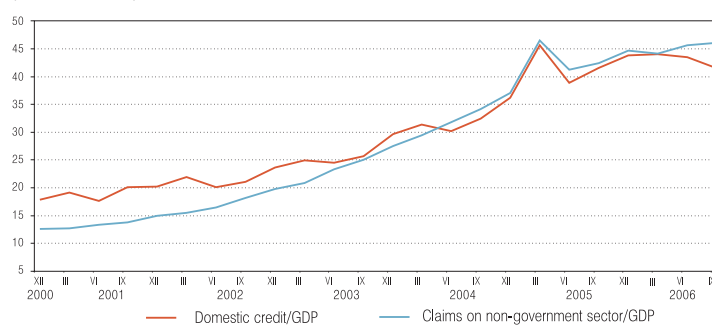


Source: BNB.

spite the change, it is expected that the banks will continue to adhere to the imposed restrictions. Hence, the annual growth rate of claims on the non-government sector will stabilize within 20 per cent.

Chart 45
Domestic Credit

(share of GDP, %)



Source: BNB.

Since June 2006 the BNB has started to gradually remove the effective administrative constraints (i.e. credit ceilings) regulating credit growth rate. With the initial implementation of the additional minimum required reserves, the BNB emphasized the temporary nature of the measures and their short-term effect. Having achieved the desired stability effect in the banking sector as of 1 January 2007, the BNB abolished the restrictions. In addition, to improve credit risk measurement of household loans the term for reclassification from problem into standard loans group, in case of compliance with the set criteria, will be reduced from 6 to 3 months. Meanwhile, the central bank will retain the strict supervisory requirements aimed at achieving sustainable and moderate growth of bank loans within 20 per cent *per annum*. In case of rapid credit growth going beyond these limits, the BNB reserves its right to use additional adequate measures.

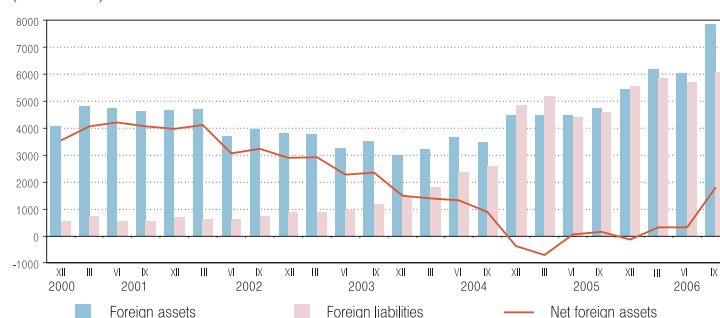
Irrespective of the slowdown in non-government sector credit growth to a more moderate level, the enhanced financial intermediation was sustained. By the end of September 2006 the *claims on the non-government sector to GDP* ratio reached 46.1 per cent, posting a rise of 1.5 percentage points on the year's start and 3.7 percentage points on September 2005.

Measures enforced to moderate credit growth had a significant influence on banks' net foreign assets dynamics. Banks' net foreign assets increased by BGN 1471.5 million in the third quarter of 2006, reaching BGN 1800.1 million in September. This is partly due to the restrictions on banks to finance their lending operations by foreign liabilities. The considerable increase in net foreign assets reflects the foreign assets upward trend resulting from large credit transfers between banks and the release of additional minimum required reserves upon lifting the progressive scale.

Credit demand by enterprises remained high during the third quarter due to robust production and investment activity. Within the quarter claims on non-financial corporations increased by BGN 657.3 million and the annual growth rate stabilized at around 18

Chart 46
Foreign Assets and Liabilities of Commercial Banks

(million BGN)



Source: BNB.

Table 3
Changes in Major Balance Sheet Items of Commercial Banks (Quarterly)
(million BGN)

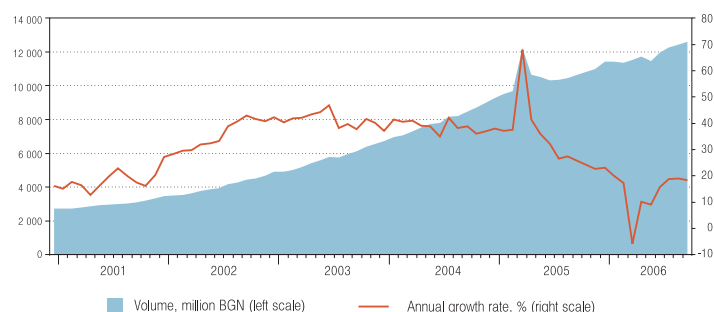
	2005				2006		
	I	II	III	IV	I	II	III
Claims on non-financial corporations	2948.8	-1922.6	334.6	784.9	76.8	434.2	657.3
Deposits of non-financial corporations	1971.2	-1258.6	292.5	710.3	140.8	974.0	1006.7
Claims on households	721.7	590.6	537.5	704.2	188.2	767.9	367.0
Deposits of households	702.9	633.0	575.6	813.0	453.9	565.3	791.3
Foreign assets	-9.3	23.1	251.2	670.0	775.0	-179.2	1845.7
Foreign liabilities	325.7	-752.7	155.6	951.4	319.7	-174.7	374.2
Claims on general government	17.1	209.8	135.4	137.1	14.2	120.0	3.5
Deposits of general government	65.8	105.4	110.6	-112.7	73.7	143.9	138.9
Claims on central government	16.3	203.5	113.9	133.8	-5.7	120.9	-7.0
Liabilities to central government	-95.6	94.7	129.9	11.8	-54.9	81.1	135.7

Source: BNB.

per cent (18.3 per cent as of end-September) over the same period. Although to a lesser extent compared with prior months, non-financial corporation claims dynamics were impacted by banks' credit sales which amounted to BGN 136.5 million in the third quarter.

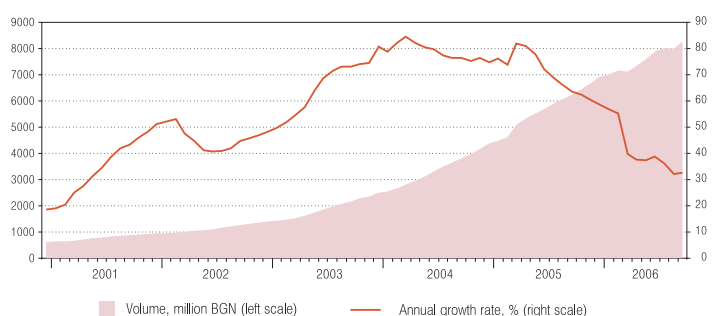
The annual growth rate of claims on households declined somewhat to 32.6 per cent by end-September, from 38.7 per cent in June. This, coupled with the slight increase in lending in nominal terms, contributed to the slower annual growth rate (between July and September claims on households increased by BGN 367 million on BGN 537.5 million in the same period of the prior year). The slighter increase in nominal terms is mainly due to the transfer of credits to foreign banks and non-bank financial institutions (between July and September banks sold credits to households amounting to BGN 539.1 million).

Chart 47
Claims on Non-financial Corporations



Source: BNB.

Chart 48
Claims on Households



Source: BNB.

Table 4
Claims on Non-government Sector (Quarterly)

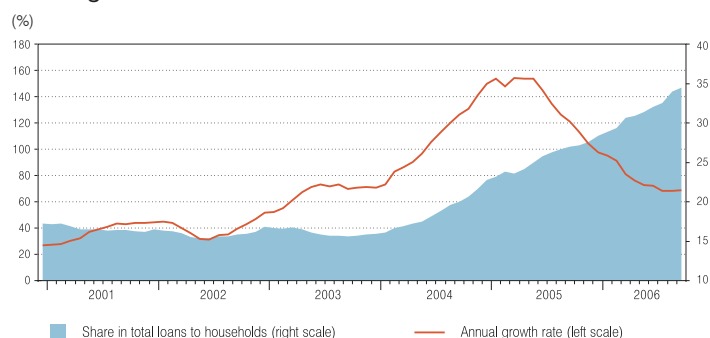
	Annual growth rate, %							Structure as of 30 Sept. 2006
	2005				2006			
	I	II	III	IV	I	II	III	
Claims on non-government sector, incl.:	73.1	41.8	35.9	32.4	5.6	24.2	23.6	
on non-financial corporations	68.0	32.2	25.7	23.1	-5.9	15.8	18.3	59.3
on households and NPISHs	81.8	72.2	63.5	58.4	39.7	38.7	32.6	38.8
on financial corporations	113.4	-27.6	-12.4	-31.1	-44.6	42.7	25.9	2.0

Source: BNB.

Housing loans marked the highest annual growth rates among individual segments of the credit markets. Between January and June they picked up by BGN 315.5 million compared with the increase of BGN 216.1 million in the corresponding period of 2005, while their share in total household loans rose from 32.1 per cent in June to 34.5 per cent as of the end of September.

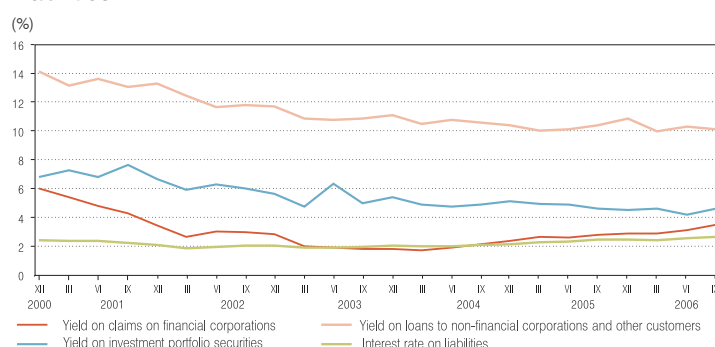
The ECB raised the interest rate on its main refinancing operations by 25 basis points in August and October which had an immediate effect on money market interest rates. Regardless of the increase in the price of borrowed funds, interest rates on loans remained unchanged probably reflecting the enhanced competition in the banking system. In the coming months lending interest rates are unlikely to undergo any significant changes. The forecast was based on the assumption that the competition in the banking system would substantially limit the influence of a putative further tightening of ECB's monetary policy and of the increase in the price of borrowed funds.

Chart 49
Housing Loans



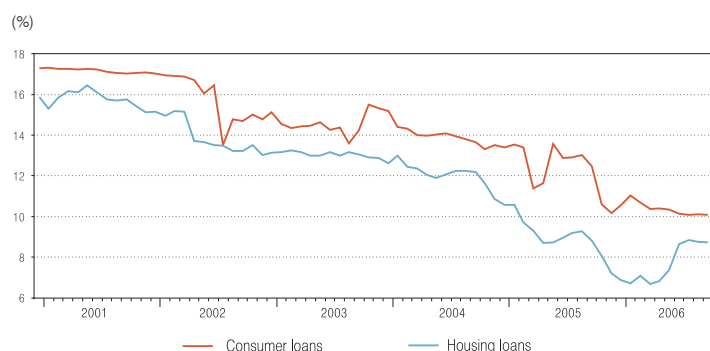
Source: BNB.

Chart 50
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities



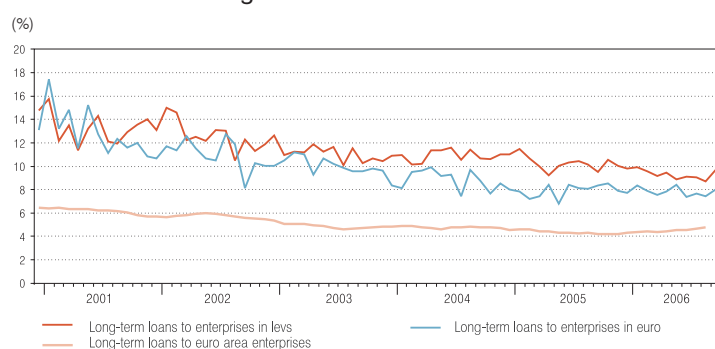
Source: BNB.

Chart 51
Interest Rates on Household Loans



Source: BNB.

Chart 52
Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

Economic growth in the fourth quarter of 2006 and in the first quarter of 2007 is expected to accelerate. Strong growth in consumption and investment will be sustained along with the anticipated higher export growth and a reduction in the negative contribution of foreign trade balance accordingly.

Current data on the development of foreign and domestic trade and industrial output evidenced buoyant economic growth in the third quarter of 2006. Positive signals came from the surveys in industry, construction, retail trade, and services, as well as from consumer surveys reporting optimistic medium-term expectations of development in these sectors.

Household Behaviour

The improving labour market, consistent with the rise in household economic activity ratio, and employment and real salary growth are expected to be major factors for the high consumption at the end of 2006 and early 2007.

In the second half of 2005 household consumption went up and in the second quarter of 2006 reached 8 per cent (on an annual basis) in real terms. Data on retail trade, trade income and household expenditure from household budget surveys indicate an upward trend in consumer demand. Apart from food spending and current home maintenance expenses, the third quarter saw high growth rates in expenditure on furniture, home maintenance, clothing and footwear.

Table 5
Real Change in Consumer Demand

(on corresponding period of previous year, %)

	2005				2006		
	I	II	III	IV	I	II	III
Consumer spending <i>per</i> household member	5.0	4.3	3.6	2.6	3.7	6.3	6.7
Retail sales	13.9	15.7	11.5	9.8	10.9	13.2	14.1
Income from retail trade	12.0	13.2	12.9	12.8	8.6	12.4	14.2
Food, drinks, tobacco	9.5	10.1	8.3	4.0	6.1	5.8	7.3
Pharmaceutical and medical goods, cosmetics and toiletries	3.3	7.3	12.3	10.9	6.2	11.5	7.1
Textile, clothing, footwear and leather	10.0	17.5	24.7	25.9	7.5	12.4	18.1
Household goods and home appliances	20.7	18.7	18.9	24.8	12.9	18.9	20.3

Source: NSI.

Brisk consumption reflected the favourable labour market situation. In the third quarter of 2006 employment continued to rise at a robust pace. The real salary also posted a significant increase. These factors, namely the rise in employment and salary, had a positive effect on consumption, which is expected to continue rising in early 2007.

Table 6
Employment and Income Dynamics (Quarterly)
(% on corresponding period of previous year unless otherwise indicated)

	2005				2006			
	I	II	III	IV	I	II	III	October
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	8.4	8.4
Employed under labour contract	4.3	3.5	1.5	1.6	0.8	0.6	1.0	
Employees (Labour Force Survey data)	2.0	1.3	2.4	2.4	3.6	4.3	3.3	
Real salary	3.3	3.9	3.3	0.8	1.7	1.4	4.7	
Wages and salaries, deflated by CPI	2.6	6.0	7.3	9.6	3.9	4.5		

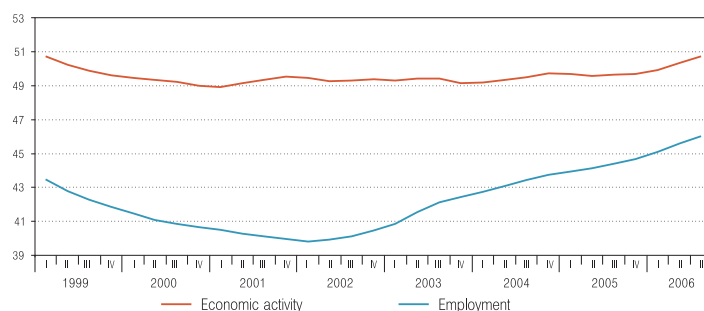
Source: NSI, Employment Agency – Ministry of Labour and Social Policy.

Since the beginning of 2006 an upward trend in the number of employed occurred mainly due to the inclusion of persons who were not actively participating in the labour markets so far. This resulted in an increase in economic activity ratio, a key labour market indicator. Enhanced economic activity is of essential importance for curbing inflationary pressure and overcoming labour force shortage in a fast growing economy. The economic activity ratio in Bulgaria is among the lowest in the European Union and the inclusion of individuals, who were not actively participating in the labour market, indicated that the offered salary level and the working conditions were attractive enough to contribute to employment growth.

The results from October NSI consumer survey show a better financial state of the households due to higher employment and income growth. Both the assessments of their current financial state (including savings and household budget) and the current developments in durable goods spending were positive. The present moment is considered favourable for larger expenditures. Meanwhile, households' expectations for their financial state and savings, as well as for unemployment and economic performance in the coming 12 months are less optimistic.

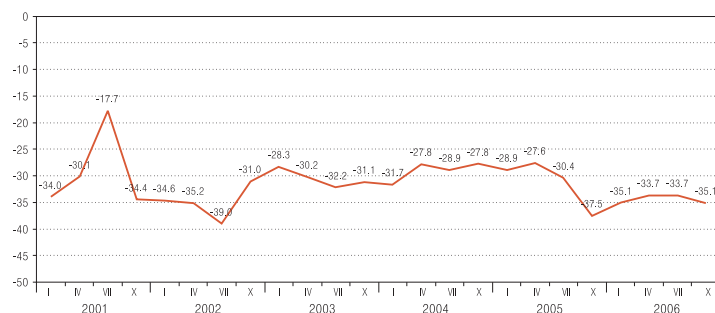
Chart 53
Labour Market Structural Indicators (Quarterly)

(percentage of the individuals over 15)



Sources: NSI, Labour force survey.

Chart 54
Household Confidence Indicator



Sources: NSI, Consumer survey.

The consumer confidence indicator is composed of these indicators and its downward trend reflects their movements. The seasonal factor (the beginning of the winter season) along with the expectations of an increase in current home maintenance expenditure have significantly affected the assessments.

Government Finance and Consumption

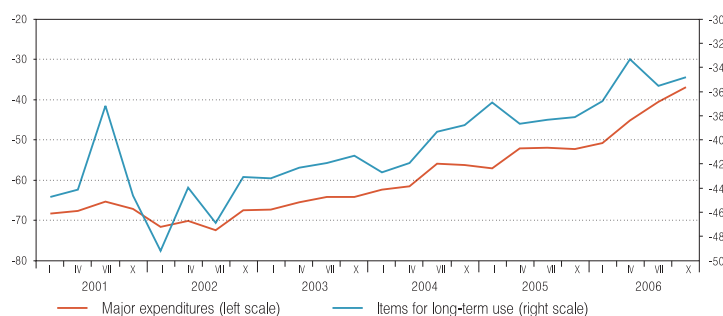
Budget revenue overperformance of the requirement set out in the State Budget Law for 7 per cent savings from non-interest expenditure and subsidies (under the conditions and exceptions provided for by this Law) in case of a current account deficit rise underpinned the assessment that consolidated budgetary cash surplus is expected to account for over 3 per cent of GDP.

Total revenue and aid under the consolidated fiscal programme amounted to BGN 14,508.1 million in September, an increase of BGN 954.1 million over the indicative target set out in the agreement with the IMF. This comprised 79 per cent of the revenue and aid projected in the State Budget Law. Indirect taxes contributed most significantly (by 7.5 percentage points) to the 10 per cent growth in tax revenue. The increase in the VAT ratio revenue to tax base was sustained, reflecting both higher-tax collectability and increased tax credit, which is subject to budget refund. In line with the forecast for sustainable growth in domestic consumption, over the last quarter of 2006 the consolidated state budget revenue may exceed by 6–8 per cent the projected revenue.

The total expenditure amounted to BGN 12,406.3 million or 6 per cent more than expenditure realized between January and September 2005. Spending on social security and healthcare (2.9 percentage points) significantly contributed to current non-interest expenditure growth. This contribution will remain strong as some BGN 115 million will be spent on Christmas benefit payments to pensioners.

Increased salary and social security expenditure is anticipated to accelerate over the period and their contribution to current

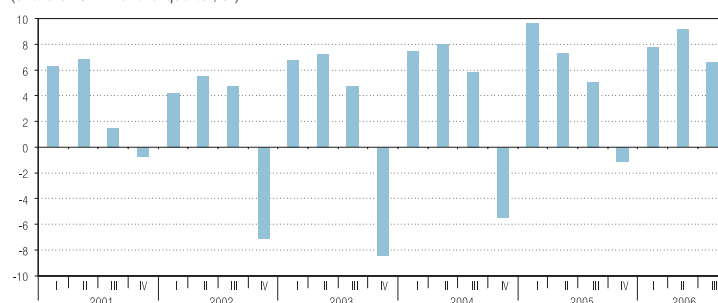
Chart 55
Current Trend of Major Expenditures



Sources: NSI, Consumer Survey.

Chart 56
Primary Balance (Quarterly)

(share of GDP for the quarter, %)



Source: MF.

non-interest expenditure is expected to be more than 5 per cent. The typical end-of-year government consumption concentration will be limited due to the measures set out in the State Budget Law for reducing expenditure in case of current account deficit deterioration and the commitments ensuing from the arrangement with the IMF for saving half of the revenue surplus over the indicative target. Hence, government consumption contribution to GDP growth is expected to remain under 0.9–1 percentage points in the last quarter, with accelerated growth partly reflecting the low collective consumption base by end-2005. In line with projections made, government consumption contribution to the 2006 GDP remained between 0.6–0.8 percentage points. Depending on budget revenue overperformance, the cash surplus is expected to account for more than 3 per cent of GDP.

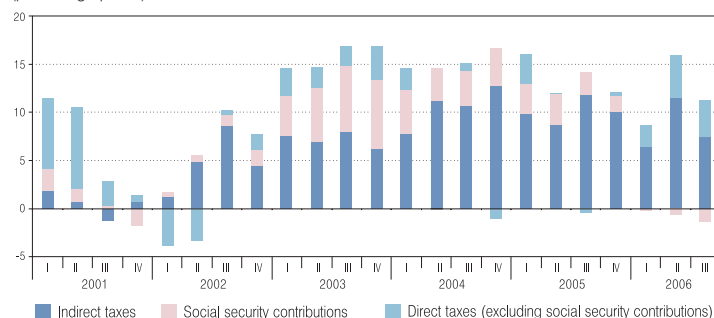
The 2007 draft budget approved by the Parliament at the first reading projects a surplus of at least 0.8 per cent of GDP, and in case of worsening of the current account deficit non-interest expenditure (with the exception of several expenditure items, provided for by the Law) will be within 90 per cent of the projections for achieving a consolidated state budget surplus of 2 per cent. The net effect of Bulgaria's accession to the EU was negative: 1.9 per cent of GDP². The main instrument in implementing the government policy of fostering economic activity and investment in 2007 is the corporate tax rate cut from 15 per cent to 10 per cent. The negative effect of reducing tax revenue rates will be offset by an increase in the tax base. Hence, the decreased share of budget revenue from profit tax in GDP is expected to range between 0.07 and 0.12 per cent. This effect will not be tangible over the first quarter of 2007 when the taxes due for the prior year shall be paid. The expected decline in VAT and customs revenue growth as a result of harmonizing Bulgarian tax legislation with that of the European law will determine tax revenue developments in the beginning of the following year.

² The effect involves all EU funds for financial assistance including the pre-accession ones and expenditure on their utilization, as well as Bulgaria's contribution to the EU budget.

Chart 57

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

(percentage points)

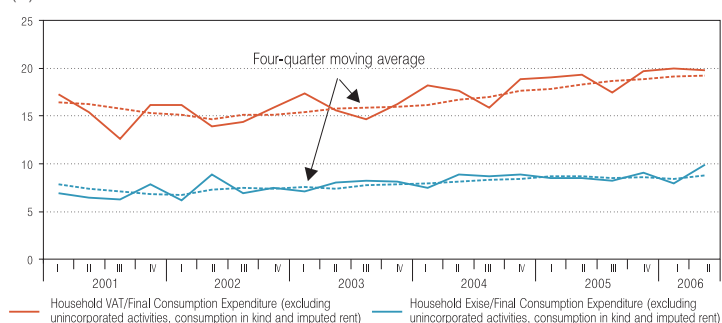


Source: MF.

Chart 58

Indirect Tax Dynamics (Quarterly)

(%)



Sources: MF, NSI.

VAT revenue losses after Bulgaria's accession to the EU will reflect the effect of several factors: exemption from taxation for second-hand vehicles, one-month delay of due tax payments for imported goods and broadening the scope of transactions that allow tax credit. The expected customs revenue slowdown reflects the application of the EU Common Customs Tariff with lower rates than those applied so far in Bulgaria and the removal of customs duties on EU³ imported goods. There is great uncertainty as to the amount of the potential losses for both indirect taxes. Although the fuel excise increase may partly offset the prospective losses from VAT and customs duty payments over the first quarter of 2007, a lower indirect tax contribution to tax revenue growth is expected.

In compliance with the expenditure policy set out in the draft budget, an accelerated growth in capital expenditure and reduced operational expenditure to ensure additional spending on projects financed by EU funds are expected. In conformity with the plan for raising budget-supported salaries and pensions as of 1 July (by 10 and 8.5 per cent respectively) and with the time horizon for subsidy payments under EU funds⁴, the second half of 2007 will see more concentrated government expenditure. It is expected that social expenditure, pension spending in particular, will increase owing to the partial pension indexation due to the rise in insurance income, while the share of current transfers will decrease. Restructuring of social transfers by reducing unemployment benefits at the expense of pregnancy allowances⁵ will continue.

³ According to the assessment of the Ministry of Finance, provided for in the 2007 Report on the State Budget Law, the loss of customs duties paid by third parties due to reduction of customs rates will amount to BGN 180 million. These losses reflect the existing tax base but after 1 January 2007 Bulgaria will be an external EU border and customs duties will be imposed on goods that were subject to transit customs regime and no customs duties were collected. Only 25 per cent of the amount of customs duties collected will be a net income in the budget, and the rest 75 per cent will be in the EU budget.

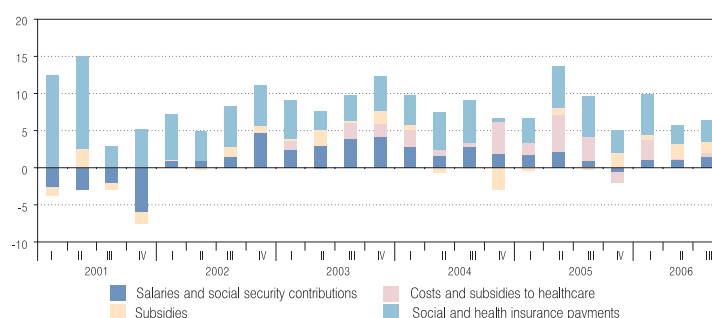
⁴ For example direct subsidies payments provided under the Common Agricultural Policy of the EU as financial assistance to agricultural producers will start in October 2007 at the earliest.

⁵ According to the latest amendments to the Law on Social Assistance, unemployment benefits shall be paid only for a period of 18 months. The new amendments to the Social Insurance Code provide for extension of the time span for payment of benefits for child birth from 135 to 315 calendar days.

Chart 59

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

(percentage points)



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

Sources: MF, BNB.

Based on the projected expenditure policy, government consumption contribution to the GDP growth over the third quarter is expected to remain between 1–1.2 percentage points.

Behaviour of Firms and Competitiveness

The favourable trend in cost competitiveness of Bulgarian producers was sustained. The process of optimising the employment scale and labour costs went on. Capacity utilization boosted. These developments had a positive effect on investment demand. Favourable domestic and foreign environment is expected to foster production activity over the forecast period.

Firms' industrial activity reflected the growing domestic demand and the improved market situation in the EU. Industrial sales went up by 8.6 per cent on the previous years' corresponding period: export sales rose by 10.7 per cent and domestic market sales by 5 per cent. Metallurgy, manufactures of non-metal mineral raw materials, metal manufactures, food, drinks and manufacture of vehicles were among the leading industries. Export sales were critical for metallurgy, while domestic sales for food industry. External and domestic market growth was balanced in the other branches mentioned above. Electric equipment manufacture was also among the leading exporting industries.

The structure and dynamics of domestic market sales indicated strong consumer and investment demand in Bulgaria. Food and drinks, products from non-metal raw materials, machines, equipment and home appliances contributed most substantially to sales growth.

Table 7
Industrial Output Dynamics
(Quarterly)

(% on corresponding period of the previous year)

	2005				2006		
	I	II	III	IV	I	II	III
Industrial output index	6.6	7.3	5.0	7.7	7.3	6.2	6.7
Industrial sales	8.5	6.6	4.5	5.8	8.3	9.9	8.6
exports	10.6	3.7	2.2	6.8	13.5	15.3	11.0
domestic market	6.7	9.4	6.8	5.0	3.5	4.9	6.3
Contribution (percentage points)							
exports	4.9	1.8	1.1	3.0	6.5	7.3	5.3
domestic market	3.6	4.8	3.5	2.8	1.8	2.6	3.3

Source: NSI.

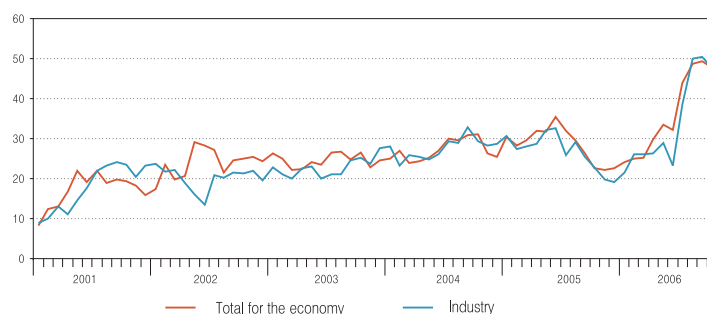
Business survey indicators evidenced a high industrial productivity. The global business climate indicator reached its highest value in August and September. In the beginning of the third and the fourth quarter the capacity utilization indicator followed the same pattern. These developments gave rise to expectations that high industrial growth rates and investment will be sustained over the forecast period.

Investment activity will be further enhanced by the enterprises' own financial resources and by additional finance sources in the form of direct investment and long-term debt securities.

The sizable employment growth recorded over the third quarter impacted employment data. According to the breakdown of the employees under labour contracts by economic activity, trade and construction played a leading role in employment growth over the recent years. Since the beginning of the year real estate operations, lessors activities and business services also contributed to it. This sector has attracted a significant portion of foreign direct investment since the beginning of the year.

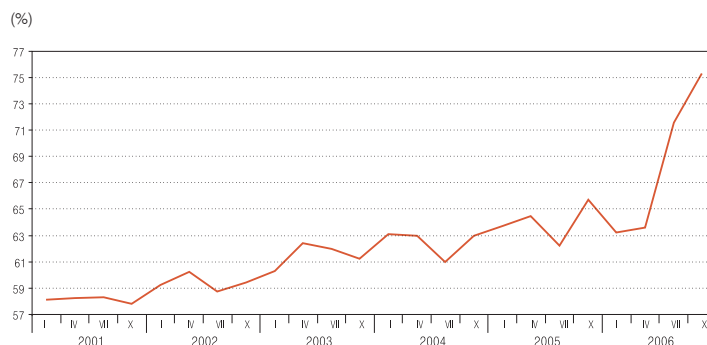
Lower employment was recorded in branches such as manufacturing, mining and quarrying and energy. At the same time, industry is one of the sectors which contributed most substantially to real salary growth since the beginning of the year. It was obvious that the ongoing process of reorganization and optimization of production aims at more efficient use of resources. Regardless of the rise in real labour income, the policy of prudent cost management was retained as evidenced by the favourable unit labour cost dynamics.

Chart 60
Business Climate Assessment



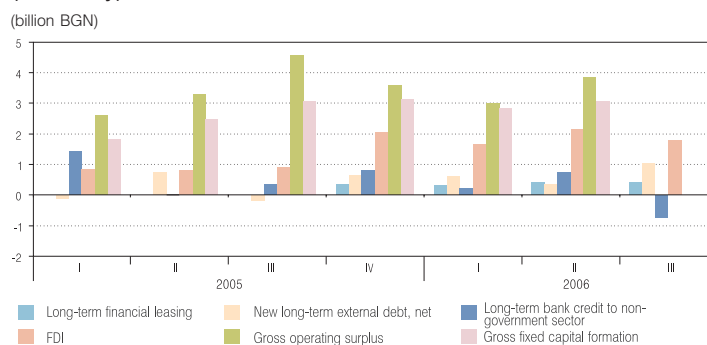
Source: NSI.

Chart 61
Production Capacity Loading in Industry



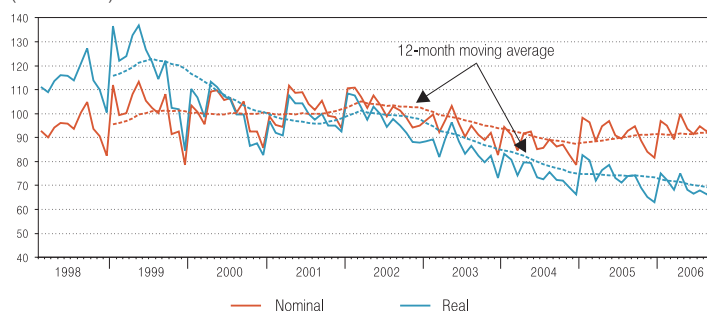
Source: NSI, business survey in industry.

Chart 62
Non-government Sector Investment Funds
(Quarterly)



Sources: NSI, MF.

Chart 63
Unit Labour Cost: Manufacturing
(2000 = 100)



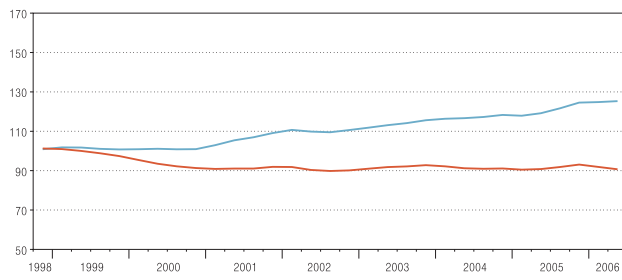
Sources: NSI, BNB.

Chart 64

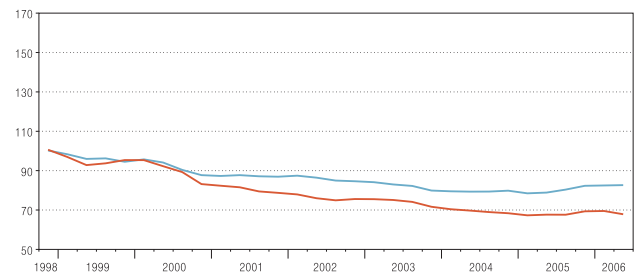
Unit Labour Cost (Quarterly)

(1998 = 100%)

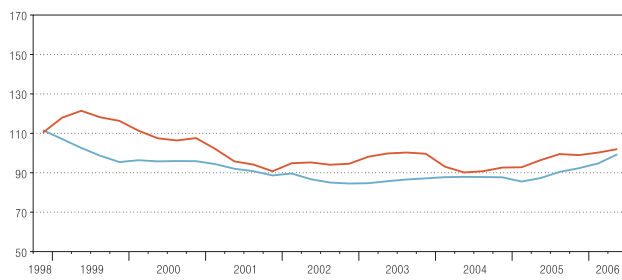
Total for the Economy



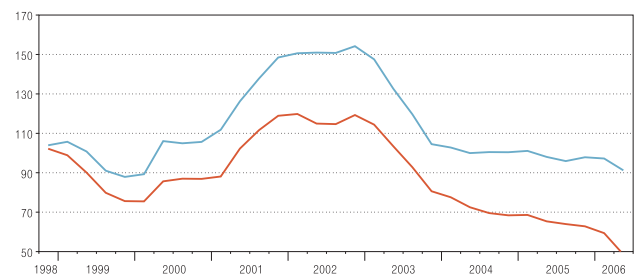
Manufacturing



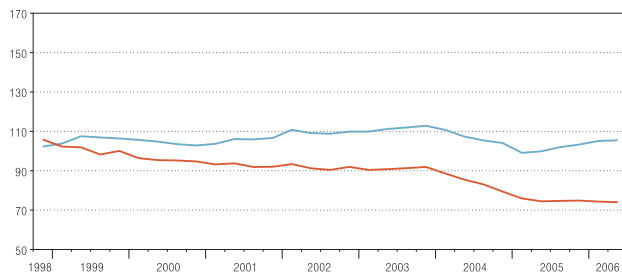
Agricultural Sector



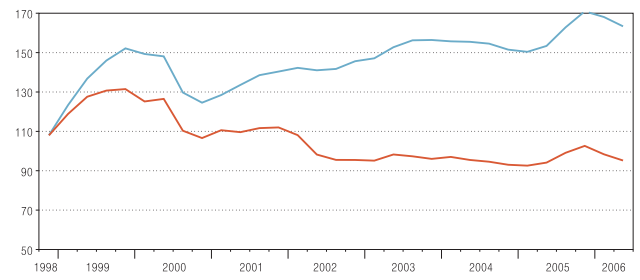
Mining and Quarrying



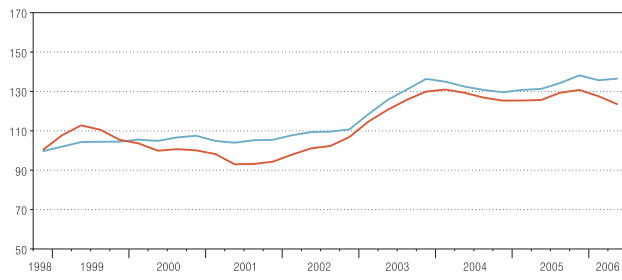
Construction



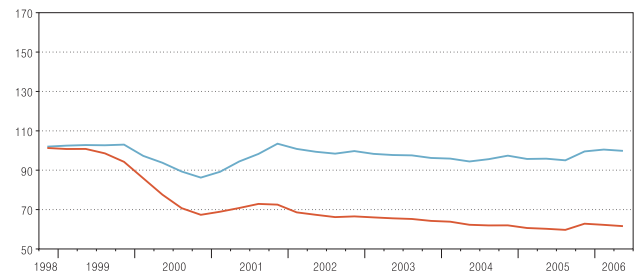
Electricity, Gas and Water Supply



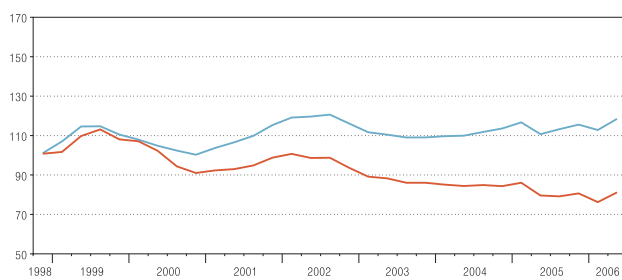
Trade



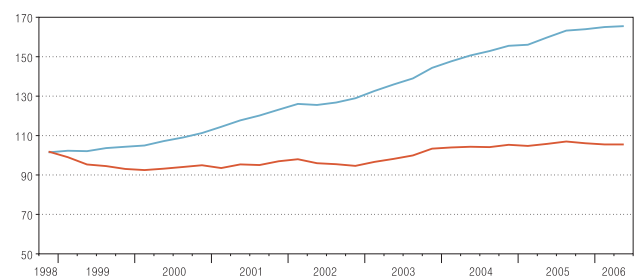
Transport and Communications



Financial Intermediation



Other Sectors



— Four-quarter moving average (nominal)
— Four-quarter moving average (real)

Source: NSI, BNB.

Exports and Imports of Goods

The annual growth rate of nominal goods exports in euro is expected to hover around 22–24 per cent over the fourth quarter of 2006 and 20–24 per cent over the first quarter of 2007. International crude oil prices, which stabilized at the early fourth quarter levels, and moderate domestic demand growth will keep the nominal growth in imports of goods within the 19–21 per cent band in the fourth quarter of 2006 and around 15–19 per cent in the first quarter of 2007.

Given the expected dynamics of exports and imports, the trade balance deficit will reach nearly 20–21 per cent of projected GDP in 2006 and approximately 19–21 per cent of GDP on an annual basis in the first quarter of 2007.

In the fourth quarter of 2006 the negative contribution of foreign trade balance to overall GDP growth will be sustained. Price stabilization will cut the growth in imported goods and services, and the expected domestic demand growth will maintain sustainable real growth in imports. Despite the continued real growth in exports of goods and non-factor services, the physical growth in imported goods and services will be higher than exports growth in the fourth quarter of 2006. In the first quarter of 2007 sustainable real growth in Bulgaria's exports of goods and non-factor services is anticipated, accompanied by slowing imports growth. Continuing upward trends in output and exports of major Bulgarian industries and stable domestic demand growth will be the main drivers of these developments. Bulgaria's competitiveness on international markets will further improve owing to favourable trends in industry's unit labour costs.

High business climate values support entrepreneurs' optimism. Expected developments in foreign trade flows are further driven by the assumption of favourable trade conditions over the projected time horizon and the base effect on imports of goods and non-factor services in the first quarter of 2007. According to the base projection scenario which takes into account the influence of the above factors, the foreign trade balance will positively contribute to real GDP growth over the first quarter of 2007.

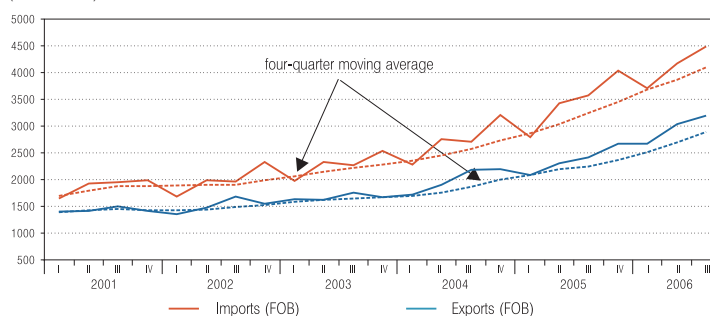
Exports in euro reached EUR 8900.1 million between January and September 2006, up nominally by EUR 2099.7 million, or 30.9 per cent on the corresponding period of 2005. Imports (FOB) amounted to EUR 12,355.7 million, increasing nominally by EUR 2578.4 million (26.4 per cent) on an annual basis.

Over the third quarter goods exports con-

Chart 65

Dynamics of Exports and Imports (Quarterly)

(million EUR)



Source: BNB.

tinued to rise in nominal terms at rates higher than those of imports (32.1 per cent and 25.5 per cent respectively between July and September). Factors behind this growth include slowing imports of energy resources, reflecting crude oil price declines in September, as well as accelerating exports of metals (with a strong effect of non-ferrous metal prices and prevailing real growth in ferrous metals).

International prices of end-2006 are expected to foster trade conditions in Bulgaria and hence foreign trade flows. The exhaustion of the base effect of the third quarter was another factor influencing the projected foreign trade dynamics until the end of 2006.

Forecasts of stabilizing growth rates of Bulgaria's exports at 20–24 per cent in the third and fourth quarters reflect expected rises in international prices of non-ferrous metals and cereals on an annual basis, as well as retention of upward trends in output and export activity of key industries and agriculture.⁶ Expected moderation in external demand in early 2007 will reduce the possibilities for dynamic developments in Bulgarian exports.

In the fourth quarter of 2006 and the first quarter of 2007 our expectations show a gradual moderation in annual growth of imports underpinned by both the assumption of steady crude oil prices at the current levels and projected moderate growth in domestic demand. Nonetheless, high import dependence of some industries with expected high output gives grounds to project sustainable growth rates of goods imports. High imports volume in early 2006, a result of boosted imports of energy resources, was among the factors behind slowing annual growth in imports. The major risks to the projection stem from volatile international prices of raw materials and a possible sudden acceleration in domestic demand which may lead to increased imports of consumer and investment goods.

As regards expectations of export dynamics by group, energy resources, metals and metal products are among the leaders. In

⁶ Bulgarian industries reporting growth in export sales include iron and steel industry, oil processing, glass industry. As regards agriculture, cereal grain growing reported positive trends.

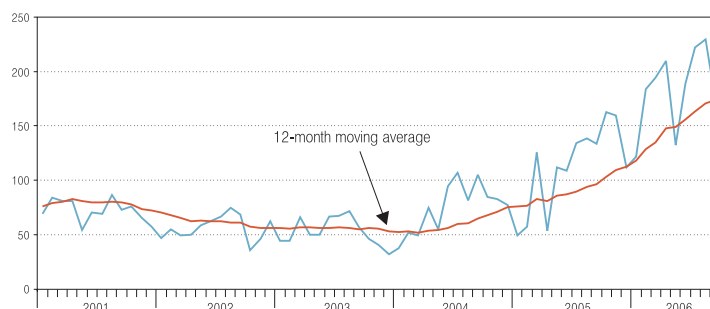
the first nine months of 2006 exports of mineral products and fuels posted the highest growth of 81.3 per cent, followed by base metals (54.9 per cent). Exports of animal and plant products recorded the lowest growth (0.1 per cent). Dynamically developing exports of energy resources over the review period entirely match our projections. Moderation was observed in the third quarter due to price and non-price factors. Exports of petroleum products between January and September 2006 grew annually by 57.2 per cent in physical volume, while the average price (in euro) rose by 22.6 per cent. Oil price hover around the current levels backed our expectations of continued dampening trends in exports of mineral products and fuels. Nevertheless, the increasing production capacity in this industry suggests that sustainable real growth in these exports will be maintained.

Total growth in base metal exports by EUR 814.6 million in the first nine months of 2006 compared with the same period of 2005 is mostly driven by upward price dynamics of non-ferrous metals on international markets. Exports of copper and its products rose by 103 per cent in value and contributed most significantly to overall growth (by 8.4 percentage points). Positive trends in exports of cast-iron, iron and steel continued in the third quarter of 2006, with the nominal growth since early 2006 reaching 9.4 per cent. Given the decrease in the world steel price over the third quarter (on an annual basis), the reported growth in value probably reflected the physical growth in ferrous metals exports. Our expectations of base metal exports until the end of 2006 and in the first quarter of 2007 are for progressive positive trends. Maintained high growth rates in these exports are ascribable to the favourable effect of non-ferrous metal prices and real growth in ferrous metals. Robust investment activity in this industry affects positively its competitiveness on international markets and supports its export orientation.

Exports of animal and plant products, food, drinks and tobacco posted sustainable growth in the summer months. The 14.5 per cent increase in the third quarter offsets the drop in the first half of the year, with the

Chart 66
Exports of Mineral Products and Fuels

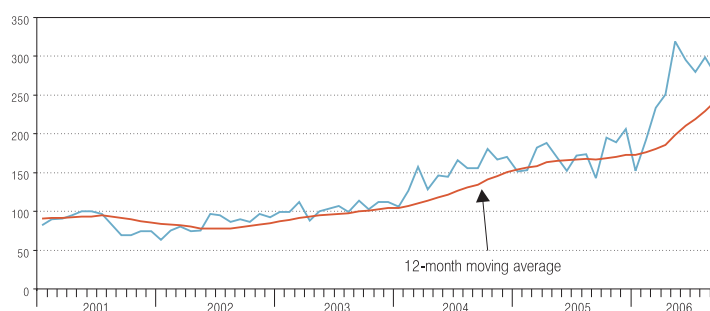
(million EUR)



Source: BNB.

Chart 67
Exports of Base Metals and Base Metal Products

(million EUR)



Source: BNB.

nominal change between January and September turning positive (0.1 per cent) on the same period of 2005. Cereals contributed most significantly to this trend, their exports rising by 70 per cent over the third quarter. Producers' expectations of higher crops in 2006 and upward food price trends on international markets support our projections of positive growth in exports of food, drinks and tobacco in the fourth quarter of 2006 and first quarter of 2007.

Imports (CIF) between January and September 2006 accounted for EUR 13,148.4 million, a nominal increase of EUR 2761 million (26.6 per cent) on the corresponding period of the prior year. In the structure of imports by use, the highest growth was recorded by energy resources (46.6 per cent) and raw materials (26.8 per cent), their contributions to overall imports growth reaching 9.3 and 9.8 percentage points.

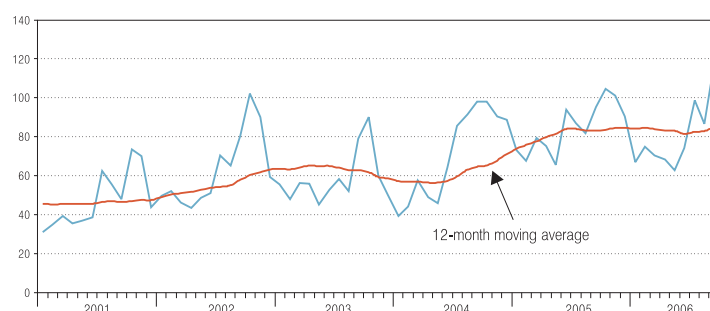
In the third quarter growth in imports of energy resources slowed down to 26.3 per cent on an annual basis, with international oil price declines in September contributing mostly to this development together with imported oils (down 24 per cent in value on the same quarter of 2005). The decrease in international oil prices reduced the price effect. Correspondingly, physical volume growth was predominant in energy resources imports dynamics. In the first nine months of 2006 the physical volume of imported crude oil rose by 27.1 per cent on the corresponding period of the previous year, and its average price (in euro) increased by 25 per cent. Expectations of hovering oil prices at levels close to those of the last two months suggest a declining importance of the price factor for imports of mineral resources over the projected time horizon. On the other hand, the expanding production capacity in oil processing supports the forecast of high real growth in crude oil imports. The combination of both factors will result in sustainable nominal growth in energy resources imports until the end of 2006 and its moderation in early 2007.

Imports of raw materials continued to rise in the third quarter of 2006, growth between January and September reaching 26.8 per cent on an annual basis. The total amount

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 September 2006

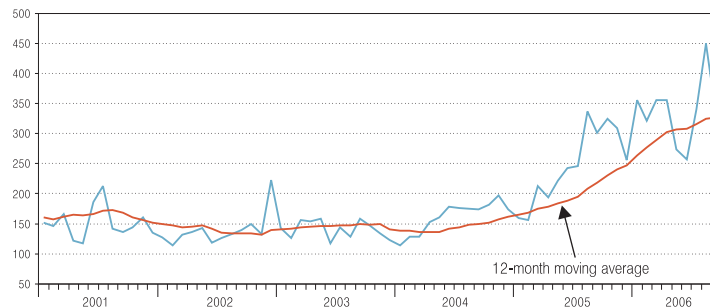
	Exports		Imports	
	growth,%	contribution, p.p.	growth,%	contribution, p.p.
Consumer goods	8.1	2.4	20.2	3.1
Raw materials	35.5	15.3	26.8	9.8
Investment goods	25.0	3.8	17.7	4.9
Energy resources	77.1	9.4	46.6	9.3
Other			-38.5	-0.4

Source: BNB.

Chart 69

Imports of Energy Resources

(million EUR)



Source: BNB.

of imported raw materials was EUR 4800.9 million, up EUR 1015.3 million on the corresponding period of 2005. Imports of ores, non-ferrous metals and cast-iron, iron and steel, increasing by 2.8, 1.4 and 1.4 percentage points respectively, contributed most significantly to total growth in this group. Expected expansion in metallurgy suggests that high rates of physical growth in imports of ores and metal feedstocks will be maintained until the end of 2006 and in the first quarter of 2007. Another factor fostering high growth rates is the assumption of further rises in non-ferrous metal prices on international markets.

Consumer goods imports further declined over the third quarter of 2006, with the nominal growth remaining lower than overall imports growth. These developments matched our expectations of consumer goods imports dynamics: between January and September they grew by 20.2 per cent on the same period of 2005, their relative share falling to 14.3 per cent. The total value of these goods reached EUR 1884.9 million, up EUR 317.3 million on the first three quarters of 2005. Furniture and household equipment had the most significant contribution to overall imports growth (0.9 percentage points), their rate accounting for 29.9 per cent over the review period. Our expectations point to sustainable growth rates of consumer goods imports, albeit lower than in overall imports, in the third and fourth quarters of 2006. A sudden strengthening of domestic demand is most likely to boost imports of consumer goods over the projected time horizon.

Investment goods imports continued to develop at the lowest growth rate both in the third quarter (17.1 per cent) and in the January to September period (17.7 per cent), reflecting lower growth in imports of transportation vehicles (7.3 per cent) in the first three quarters of 2006. The value of imported investment goods between January and September 2006 was EUR 3356.3 million, their nominal growth reaching EUR 505.6 million. Despite some moderation in the first three quarters of 2006, imported investment goods growth rates are expected to accelerate over the third and fourth quarters of 2006. This projection rests on antici-

Chart 70
Imports of Raw Materials
(million EUR)

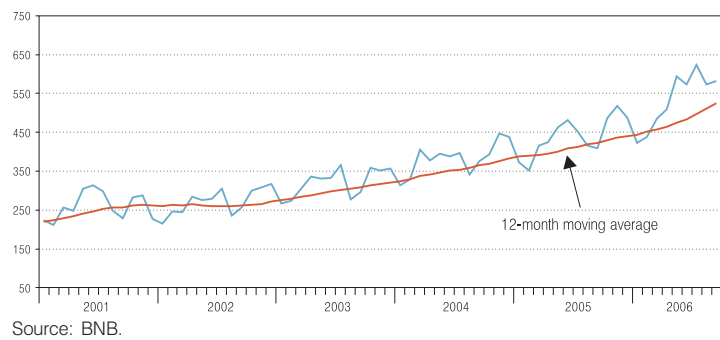
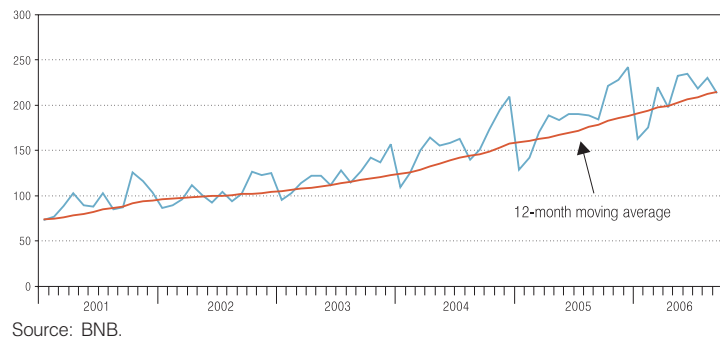


Chart 71
Imports of Consumer Goods
(million EUR)



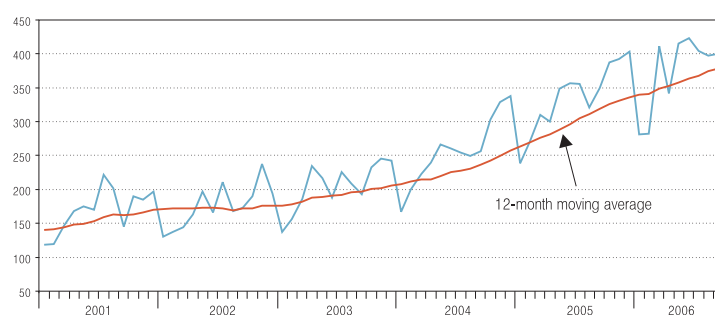
pated sustainable growth in domestic demand and the base effect.

The trade partners which increased their share in Bulgaria's exports over the first nine months of 2006 include Balkan countries, the Asian region and newly acceded EU countries. Balkan countries occupied 23.9 per cent of goods exports (up 2.6 percentage points on the same period of 2005). The Asian region's share was 7.6 per cent (up 1.1 percentage points), and that of the ten new EU Member States reached 5.8 per cent (up 0.8 percentage points). Balkan countries and the Asian region occupied the largest shares in Bulgaria's exports of energy resources, while exports to the new EU countries were almost evenly distributed among various groups of exported goods.

Total Bulgarian exports to EU countries between January and September rose by 25.2 per cent on the corresponding period of 2005. Albeit diverging by country, growth in exports to old and new EU countries accounted for 22.7 and 51.7 per cent respectively. The growing share of Bulgarian exports in total EU imports reflected the increasing competitiveness of Bulgarian economy. Although consumption of Bulgarian goods in the EU is still low, the Bulgaria's share in EU imports increased from 0.45 per cent in 2005 to 0.48 per cent in the first nine months of 2006.

As regards the structure of Bulgarian imports, the weight of goods of Russian origin rose most dynamically to reach 18.8 per cent (up 3.8 percentage points) of total imports between January and September. The large share of Russia in energy resources imports and higher crude oil prices on an annual basis were the main factors behind this trend. Although Germany and Italy sustained their leading role of Bulgaria's main trade partners, their share in imports dropped to 12.1 per cent (down 1.5 percentage points) and 8.4 per cent (down 0.6 percentage points) respectively. China, Serbia and Poland increased their shares, albeit still low, in Bulgaria's imports. Over the projected time horizon no essential changes in the geographical structure of Bulgaria's foreign trade are expected.

Chart 72
Imports of Investment Goods
(million EUR)



Source: BNB.

4. Inflation

The annual inflation rate is expected to further moderate over the fourth quarter of 2006 due to the favourable situation on international energy markets and lack of indirect effects on domestic prices of fuels. In early 2007 inflation will further decrease on an annual basis, with administratively set prices contributing mostly to the fall. Price effects resulting from Bulgaria's accession to the EU are not expected to reverse the downward trend.

Inflation accumulated between January and October came to 3.8 per cent, down 0.74 percentage points on the corresponding period of the previous year. Factors affecting inflation include the increase in the tobacco excise rate (a contribution of 2.72 percentage points) in line with EU minimum rates and the decrease in food prices (a contribution of -0.07 percentage points) following their significant rises in the second half of 2005 due to flood losses.

A global factor pushing inflation since 2004 was the crude oil price dynamics. In the first half of 2006 the average oil price continued to rise rapidly to USD 75 *per barrel*. As of the end of September the trend reversed, the average price falling to around USD 60 *per barrel*. Changes in domestic prices of liquid transportation fuels in September and October resulted in declines in their levels below those of end-2005, and their contribution to inflation accumulated until October was negative at 0.075 percentage points.

Adjustments in administered prices further contributed to inflation over the year. After the approved increase in the heating price by 6 per cent reported partially in July (2.3 per cent, a 0.04 percentage point contribution to July inflation) and given the insignificant adjustments in other administered prices by September, in the third quarter the annual rate of these prices slowed down to 16.2 per cent on average. In October the State Energy and Water Regulatory Commission approved a unified electricity tariff of BGN 0.146 per kWh⁷ for household con-

⁷ This unified tariff abolished different prices of electricity consumption up to 75 kWh (0.098 BGN/kWh) and above 75 kWh (0.174 BGN/kWh).

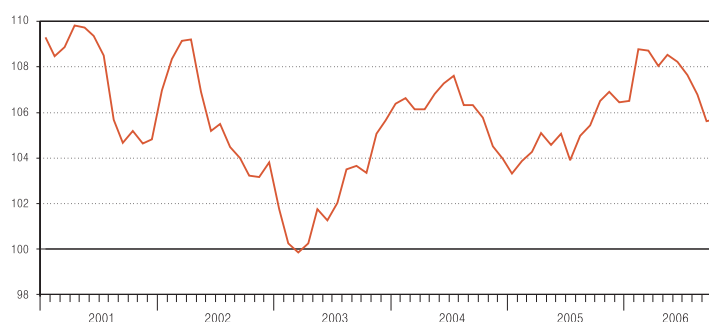
Table 9
Inflation Accumulated since Year's Start

	January – October	
	2005	2006
Inflation, %	4.54	3.80
Contribution, percentage points		
Foods	1.26	-0.07
Non-foods	1.78	3.14
Transportation fuels	0.83	-0.08
Catering	0.28	0.21
Services	1.23	0.56
Goods and services with administratively set prices	1.10	2.89
Controlled-price goods	0.70	2.77
Tobacco	0.25	2.72
Controlled-price services	0.35	0.13
Electricity and heating	0.14	0.03

Source: NSI.

Chart 73
Consumer Price Index

(on an annual basis)



Source: NSI.

sumption. As a result, the electricity price in the consumer basket fell by 0.16 per cent on a monthly basis, and the annual inflation of administered prices reached 14.9 per cent. Since no changes in these prices are planned until the end of 2006, their annual rate is expected to decrease to some 13.8 per cent in the last quarter. Following the base effect of harmonizing the excise-to-bacco rate in 2006, controlled-price inflation will drop significantly to reach nearly 5.4 per cent in early 2007.

Core inflation (excluding administered prices) decreased over the year to reach 4.1 per cent in the third quarter. It reflects mostly food price declines on end-2005 and slower growth in fuel prices (7.6 per cent) under the high base effect. In the coming two quarters core inflation is likely to maintain an annual rate of some 4 per cent. These expectations rest on the exhaustion of the base effect, lack of any inflationary pressure of demand and indirect effects of fuel prices.

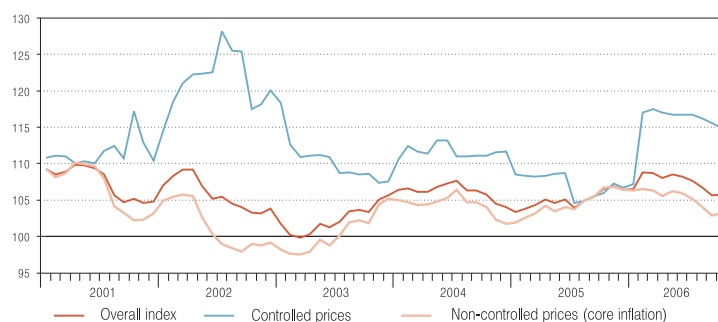
The annual rate of food prices declined substantially from 7.2 per cent in the second quarter to 3.8 per cent in the third quarter, reflecting both unprocessed and processed food prices. Unprocessed food prices fell as a result of growing supply, their annual rate reaching 2.6 per cent. Processed foods experienced similar dynamics. The bread price started falling in early 2006 (a result of the competitive pressure on the domestic market) to reach BGN 0.82 *per* kg as of September. In October bread and cereals prices increased by 4.3 per cent annually following the inclusion of higher transportation expenses in crop's prices and rising international prices.

As of October the annual price change in foods was 3.1 per cent. The decrease in their annual rates will continue until the end of 2006 if domestic demand exerts no pressure. In early 2007 food inflation is likely to increase due to the restored seasonal profile of unprocessed goods and possible price rises in some foods (sugar, meat, milk) after Bulgaria's accession to the EU.⁸

⁸ See *Estimation of Price Effects of Bulgaria's Accession to the EU* on page 50.

Chart 74
Price Indices

(on an annual basis)



Source: NSI, BNB.

Prices of non-food goods (excluding fuels and controlled-price goods) retained their dynamics in the third quarter of 2006 (2.1 per cent growth). The increase in prices of household appliances from 1.8 per cent in the second quarter to 2.1 per cent in the review period reflected primarily the introduction of eco-fees for electric home appliances. Non-food inflation (excluding fuels and controlled-price goods) is expected to reach 2–2.5 per cent until the end of 2006 if the current situation on international fuel markets is sustained. In early 2007 the average customs tariff for industrial goods will decrease from 10.6 per cent to 4.1 per cent as a result of applying the EU Single Market and Customs Policy. This may cut imported prices of non-foods over the year and in the medium term.

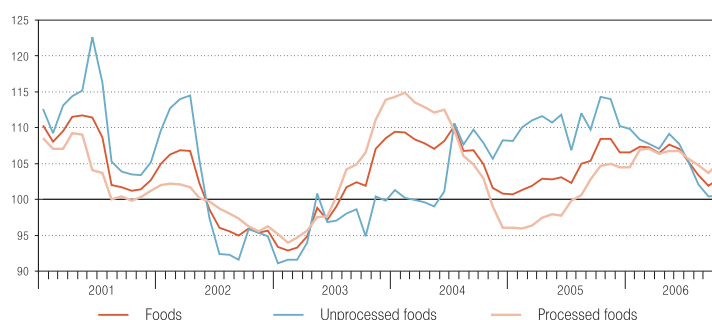
Average prices of various fuels (solid and fluid, household and transportation fuels) included in the consumer basket continued falling on an annual basis to an average of 7.6 per cent in the third quarter. This downward trend is likely to persist in the fourth quarter, consistent with expected favourable developments in international energy prices. In early 2007 an increase in fuel excise is planned in line with harmonizing excise rates with EU minimum rates.⁹ The effect of this increase is estimated at 6 per cent average annual growth in final prices if no significant changes in international crude oil prices occur.

Services price inflation (excluding controlled-price services) fell on an annual basis from 5 per cent in the second quarter to 4.5 per cent in the third quarter, entirely reflecting the base effect of transportation services. Due to higher transportation services in the third quarter of 2005 and no inflationary pressure of fuels in 2006, the annual price increase in transportation services fell from 11.8 per cent in the second quarter to 9.6 per cent in the third quarter.

Following the exhaustion of the base effect, services inflation (excluding controlled-price services) is expected to hover around

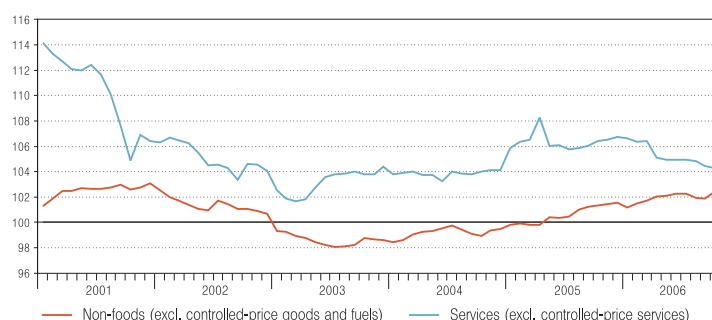
⁹ The estimation is based on the increase in unleaded petrol excise from BGN 530 to BGN 585 *per* 1000 litres and in diesel excise from BGN 430 to BGN 485 *per* 1000 litres.

Chart 75
Price Indices
(on an annual basis)



Source: NSI, BNB.

Chart 76
Price Indices
(on an annual basis)

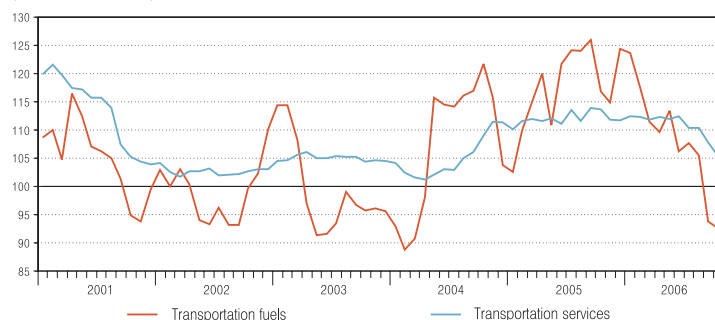


Source: NSI, BNB.

5–5.5 per cent in the coming two quarters. The increase in vignette charges by 10 per cent for light vehicles and by 21 per cent for heavy vehicles in 2007 will have a direct inflationary contribution to transportation services but no significant indirect effects are anticipated.

In the third quarter overall inflation fell to 6.7 per cent on an annual basis and will further decrease in the following two quarters. It will reach 6 per cent until the end of the year, with average annual inflation rising to 7.2 per cent as a result of normalizing its monthly profile. In early 2007 inflation will further decrease on an annual basis, with administered prices contributing most significantly to this. It is not expected price effects resulting from Bulgaria's accession to the EU to reverse the downward trend in annual inflation over the first quarter of 2007. The upper band is estimated at around 5.0 per cent, taking into account the uncertainty around the time of these effects, their duration and ensuing indirect effects.

Chart 77
Price Indices
(on an annual basis)



Source: NSI, BNB.

Estimation of Price Effects of Bulgaria's Accession to the EU

Data on inflation in the ten countries which acceded to the EU in May 2004 point to acceleration in inflation rates a few months prior and after this date. Estimation of the factors affecting the general price level in these countries shows the impossibility to separate the pure effect of EU accession on inflation. For example, from the beginning of 2004 energy prices started to rise rapidly, affecting primarily inflation in the ten new Member States, rather than in other countries, due to lower fuel excise levels. Nonetheless, some factors associated solely with EU accession had a direct effect on inflation. They include adjustments in excise rates and indirect taxes in line with EU minimum rates. With the accession, a great number of factors exerted divergent effects on inflation in the short term. They will also take effect in the long term after applying the Common Agricultural Policy and Single Market and Customs Policy.

With the EU membership and enforcement of the Common Agricultural Policy, food prices in most new Member States increased (except Slovenia and Malta). Sugar prices rose by some 10 per cent on average in the ten countries due to strongly controlled prices in the EU (minimum purchase prices, high import duties and other charges). Average annual growth in sugar prices over 2004 was quite different in individual countries: from 1.6 per cent in Lithuania to 28.6 per cent in Estonia. Meat product prices also picked up significantly (by nearly 15 per cent in Poland, Hungary and Latvia), followed by milk product price rises in Latvia and Estonia resulting from higher purchase prices and larger demand from other EU Member States. Effects of applying the Common Agricultural Policy on inflation were exhausted within a year whereupon food prices followed the same pattern in all Member States.

Applying the Single Customs Policy fosters the trade within the EU. In addition to its direct anti-inflationary price effects, this policy helps strengthen the competition on domestic markets in the medium term. In terms of services, the main long-term pro-inflationary factors include salary formation, high demand for particular services as recreation, hotelry, property and rental services.

What conclusions can be made on possible price effects resulting from Bulgaria's accession to the EU?

Under the government programme on a gradual increase in excise rates between 2005 and 2013, a rise in excise on fuels is planned for 2007 which will push up their final prices by some 6 per cent on average. In early 2007 an excise on electric power, coal and coke will be introduced, excluding consumption of households.¹⁰ The draft State Budget Law for 2007 provides for a 20 per cent VAT on school text-books approved by the Ministry of Education and Science and on lawyer and notary services which will contribute by no more than 0.03 percentage points to overall inflation.

'More than 95 per cent of white sugar consumption in Bulgaria is covered by sugar produced from imported raw cane sugar in national factories.'¹¹ In Chapter 7 – Agriculture, Bulgaria has negotiated 'a production quota (right to produce for maximum delivery output) for white sugar from preferentially imported non-refined cane sugar to the amount of 198,748 tones white sugar.' According to our estimates, customs duties on imported sugar may rise by some 15 per cent under the assumption that 250,000 tones raw cane sugar will be imported under a preferential tariff of 5 per cent of the import price according to the GATT list.¹² The estimation is strongly dependent on international sugar prices since the effect of changes in customs duties decreases in case of price rises. If this increase transfers entirely on final prices of sugar products, the contribution to overall inflation will be 0.3 percentage points.

Comparing the relative price levels of 2004 (EU-15 = 100), we see that the meat price in Bulgaria (45.9) does not differ essentially from the average price in the new Member States (56.4), with the highest prices recorded in Slovenia (78.6), Cyprus (75.1) and Malta (63.2). Excluding them, the average meat price falls to 49.6. No significant increases in meat product prices are expected after Bulgaria's accession due to high similarities to other Central and Eastern European countries. The analogues comparative analysis of milk products as of 2004 shows that their prices in Bulgaria are higher (77.3) than the average relative price in the new Member States (74.4) indicating no upward price pressure on milk products. Effects of applying the Common Agricultural Policy on inflation are expected to be exhausted within a year whereupon food prices will follow the same pattern in all Member States.

The Common Customs Tarrif (CCT) is projected to result in declining prices of tradable goods, with the average customs rate of both agricultural and industrial products imported from non-EU countries decreasing (from 22.4 to 16.1 per cent and from 10.6 to 4.1 per cent respectively). Import duties phasing out within the single market of goods, services and capital will foster EU trade, exerting direct anti-inflationary effects coupled with a second-round effect through strengthening competition on domestic markets in the medium term. In terms of services, the main long-term pro-inflationary factors include salary rises in this sector and higher demand for particular services as recreation, hotelry and rental services.

Estimation of price effects is shown in the following table:

Product/Service	Price changes (%)	Contribution to inflation (p.p.)
Petrol	6.04	0.13
Gas oils	6.27	0.02
Notary fees	20.00	0.01
School text-books	20.00	0.02
Sugar	15.00	0.30
Overall contribution to inflation		0.48

To sum up, the contribution of price effects resulting from Bulgaria's accession to the EU is estimated at 0.48 percentage points to overall inflation, which in turn will not reverse the downward trend in the annual rate of inflation. The actual change in prices will also reflect developments in fundamental factors affecting inflation, such as strengthening demand with accession to the single European market and international price and exchange rate movements.

¹⁰ New excise rates on electric power and coal will result in increases in their producer prices by 3 per cent and 0.12 per cent respectively.

¹¹ Document CONF-BG 7/04 to Negotiation Chapter 7 – Agriculture of 16 April 2004.

¹² Data on imports under Chapter 17 – Sugar and Sugar Products of Bulgaria's Customs Tariff are used in the estimation. An assumption has been made that the annual physical volume of imports will be sustained. The customs rate for the volume above 250,000 tones changed from 50 per cent of the import price to EUR 33.9 per 100 kg.

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