

Economic Review

1/2007



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.

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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

Bulgaria's economy enjoys a period of robust economic growth and creation of a sustainable growth potential in the long run. Investment activity, an important factor for economic growth, remained strong in 2006 and between January and September the real growth rate of gross fixed capital formation reached 18.9 per cent on the corresponding period of 2005. The favourable economic outlook associated with Bulgaria's membership in the EU as of 1 January 2007, intensive restructuring and high rate of return on investments attracted a sizable volume of financial resources (foreign direct investments and external loans) which contributed to Bulgaria's economic growth. The inflow of foreign direct investments in Bulgaria throughout 2006 went up by EUR 1 billion and reached EUR 4104.5 million or 16.8 per cent of GDP based on preliminary data.

Foreign direct investments covered 108.1 per cent of the deficit on the balance of payments current and capital account which grew in 2006 reflecting the increased trade balance deficit and lower balances on current account other balances such as income balances and other services balances. The balance of payments financial account surplus in 2006 reached EUR 5395.6 million, up EUR 1835.4 on 2005. Approximately three-fourths are attributable to the net inflow of foreign direct investments and the remaining one-fourth to the inflow of borrowed funds used for increasing international foreign currency reserves and loan payment to the IMF. The ratio of international foreign currency reserves to the monthly average imports of goods and services remained comparable at a level of a little bit over 5 months.

Given the favourable balance of payments financial flows developments by the end of 2006, the balance sheet figure of the Issue Department (currency board) reached BGN 17,458.6 million (EUR 8926.4 million). Banknotes and coins in circulation went up by 17.4 per cent.

Between January and June 2007 broad money growth is expected to stay between 24–26 percent on an annual basis, with the annual growth rate of cash in circulation remaining stable within 15–17 percent. Commercial banks' behaviour in respect of lending management in the first half of 2007 will be impacted by the removal of additional required reserves and the introduction of capital adequacy standards under Basel II. No significant changes are expected in lending and deposit rates.

Strong economic growth will be sustained in 2007. Consumer and investment demand will contribute to this growth. The negative contribution of net exports is expected to decrease. Improved labour market conditions have a positive effect and help strengthen consumer confidence, a factor stimulating consumption. Liquidity and industrial sector efficiency stayed high adding to the robust investment activity of enterprises. The economy's cost competitiveness displays favourable trends and assessments of companies' managers on their competitiveness on external markets is improving. The growth of nominal exports of goods (in euro) is expected to range between 21 and 23 per cent in the first quarter of 2007 and to moderate in the second quarter due to anticipated slowdown in global economic growth. Stabilisation of international crude oil prices at the early year's level combined with moderate domestic demand growth will maintain the nominal growth of imports of goods within 16–18 per cent in the first quarter of 2007 and 14–18 per cent in the second quarter.

Annual HICP is expected to retain its downward trend provided the expectations for developments of international prices of major goods and fuels materialize and no changes occur in domestic administratively set prices of goods and services.

1. External Environment

The leading world economies are expected to post moderate growth between January and June 2007. Lower industrial activity results in a decreased demand for raw materials and correspondingly weakened pressure on prices. Mid-March expectations point to an increase of interest rates on ECB main refinancing operations by 25 basis points in June and no changes of interest rates on US federal funds.

Current Business Situation

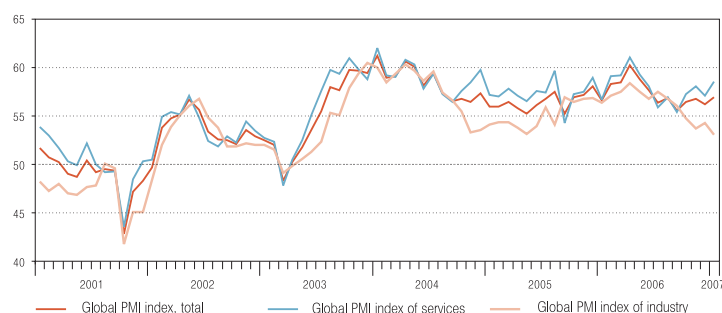
Over the second half of 2006 optimism in industry significantly went down but PMI general economic activity indicator retained its level due to increased optimism in the services sector. Growth rates of world trade accelerated in the second half of 2006 following the slowdown in the second quarter. Leading world economies are expected to post moderate growth in the first half of 2007. Growth rates in the euro area are expected to remain stable, while those in the US and Asian economies to slow down. Major risks to growth reflect geopolitical tensions related to the nuclear programmes of Iran and North Korea.

Euro Area

According to preliminary data in the fourth quarter of 2006 GDP growth in euro area countries was 0.9 per cent on a quarterly basis. Over the same period economic growth in Germany was 0.9 per cent, in France 0.6 per cent, in Italy 1.1 per cent and in Spain 1.2 per cent. The analysts' forecast median of euro area growth in 2007 published by the ECB¹ was revised from 2.0 per cent to 2.1 per cent. The change reflects improved outlooks for private consumption and investments, as well as favourable expectations for external demand. As a result of lower crude oil prices at the end of 2006 and early 2007 inflation forecast decreased to 2 per cent. According to the analysts changes to the value added tax in Germany made short-term inflation developments uncertain to a large extent. Expected unemployment in the euro area in 2007 and

¹ ECB Monthly Bulletin, January 2007.

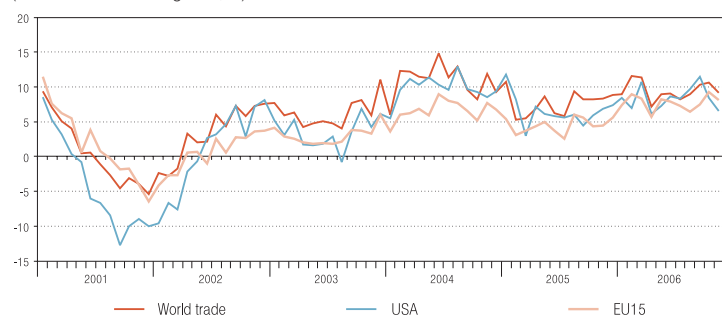
Chart 1
Global PMI Indices



Source: NTC Research, JP Morgan.

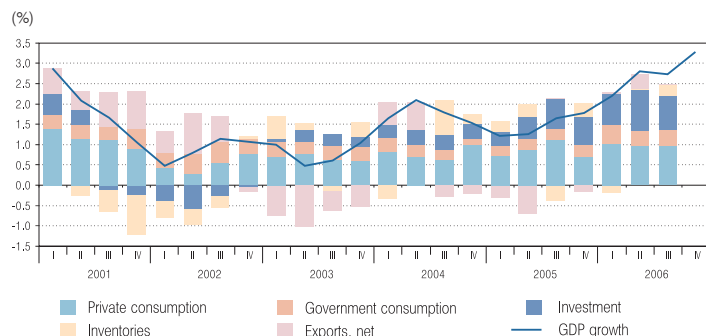
Chart 2
World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

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



Source: Eurostat.

2008 was also revised downward: to 7.5 per cent and 7.3 per cent respectively.

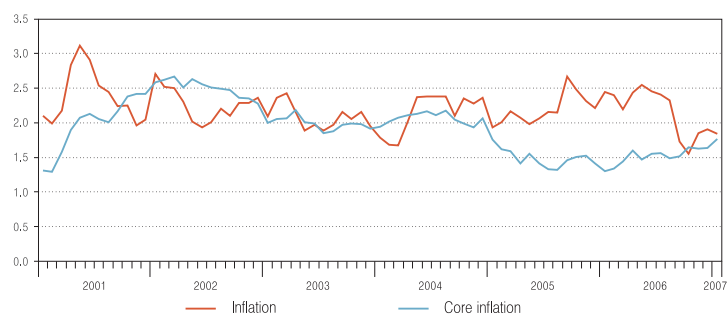
By the end of 2006 euro area economic activity indicators exhibited high values which slightly declined in early 2007. In January PMI in industry went down to 55.5 against 56.5 in the previous month. The decline in the euro area aggregate index reflects the worsened business climate in Germany, France, Italy and Spain. Business climate in the services sector continued to improve, with PMI increasing to 57.9 in January against 57.2 a month earlier.

In January Ifo, the business climate index in Germany, decreased following a 15-year record high hit in December. Consumer confidence in January also weakened, with GfK index falling from 8.5 in December to 4.8 in January. The change pertains mostly to the dramatic fall in the component measuring the propensity to purchase. The investment climate measured through ZEF index displayed a positive trend in early 2007: the ZEF index rose from -19 to -3.6 in January and reached 2.9 in February. The investment climate was supported by continuously rising stock exchange indices, historically low values of corporate risk premiums and record profits. In general, January data indicate that fears for a strong adverse effect on the economic activity as a result of increased value added tax has not materialized.

In February consumer price inflation in the euro area remained unchanged at 1.8 per cent on an annual basis compared with January. In contrast to the expected inflation rise due to increased value added tax rate from 16 per cent to 19 per cent since early 2007, the inflation rate in Germany indicated a fall by 0.2 percentage points in January. No one-off price rise due to increased value added tax is expected to be initiated by merchants and the full effect is likely to gradually reflect on prices during the first three months of the year. This was confirmed by the February survey, indicating a monthly price rise by 0.4 per cent in the largest euro area economy. Movements in oil prices had a repressive effect on prices in the first two months of 2007, while upside

Chart 4
Euro Area Inflation Rate

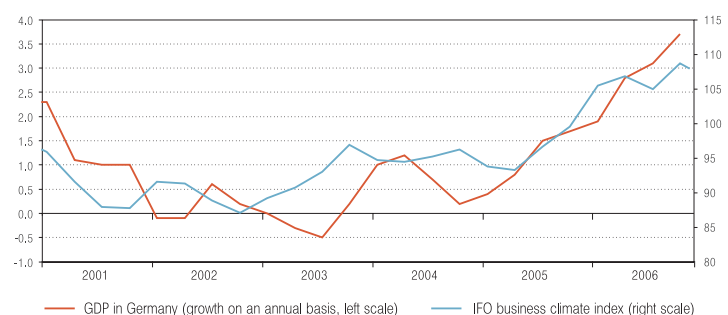
(percentage change on same period of previous year)



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



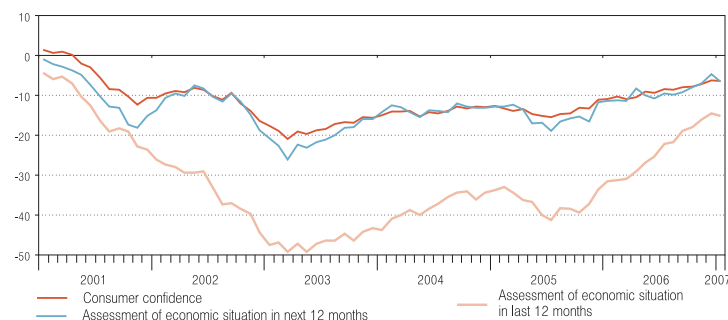
Source: Bloomberg.

Chart 6
Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

Chart 7
Euro Area Consumer Confidence Indices



Source: Eurostat.

risks to future inflation stem from pending wage agreements in particular key economic industries.

Improvement in labour market conditions in the euro area continued in early 2007, with unemployment decreasing to 7.5 per cent. Significant labour market improvement was reported over 2006, a result of steadily generated employment. Required higher wages may have a negative effect on efficiency of some key sectors of the European economy and may threaten the sustainable employment growth.

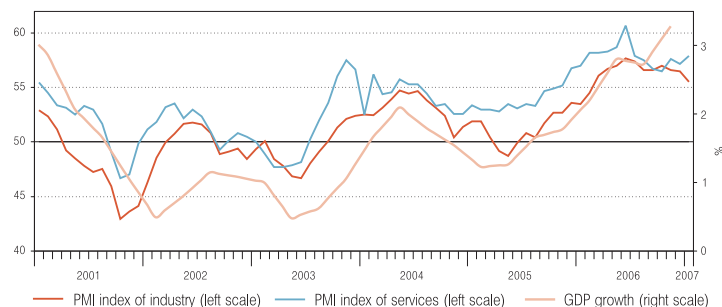
As of early March the ECB raised interest rates on its main refinancing operations by 25 basis points to 3.75 per cent. This decision was motivated by the expected short-term fall in the consumer price index, a result of the favourable base effect prompted by crude oil price decline, and upside risks to price stability in the euro area over the medium term. According to the ECB major risks to inflation are associated with the expected wage rise and the possible full spread of fuel price increases on prices of other goods and services. The excess liquidity in the euro area (in December M3 grew to 9.7 per cent compared with 9.3 per cent in November) was also a source of inflationary concerns in the short term.

Consolidated expectations for an increase of repo interest rate in March impacted the euro area money market dynamics. EURIBOR on time deposits with maturity of 1, 3, 6 and 12 months displayed an upward trend. If the current market expectations for a new rise in repo interest rate in the euro area are retained in the second quarter, the 3-month EURIBOR is expected to vary within 3.80 and 4.10 per cent.

EU-25

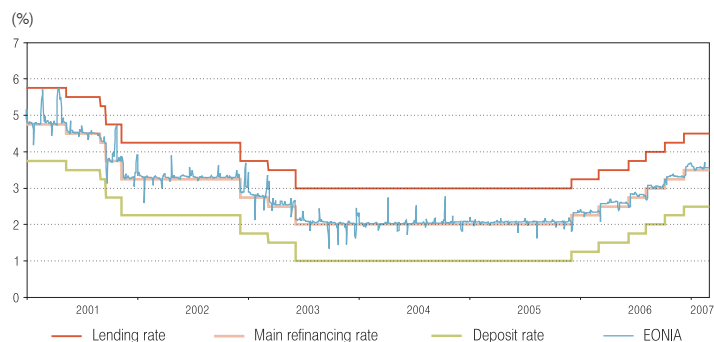
Based on preliminary data growth rate in the EU-25 accelerated to 3.4 per cent on an annual basis in the fourth quarter against 3 per cent in the third quarter. The average monthly inflation in the newly acceded countries fell to 2.4 per cent on an annual basis over the fourth quarter. The inflation rate slowed down most significantly in the Czech Republic, Poland and Slovakia, while it went

Chart 8
PMI Indices and Euro Area Growth



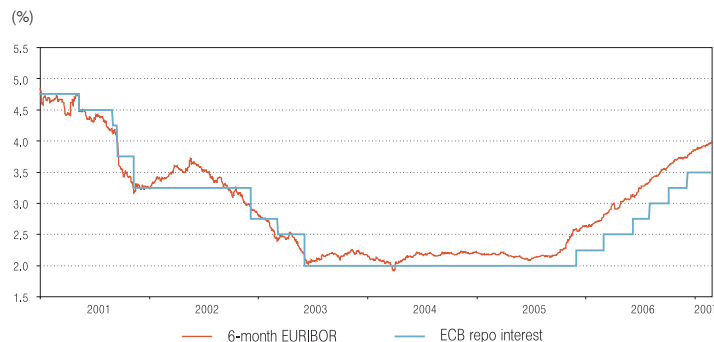
Source: NTC Research.

Chart 9
ECB Interest Rates



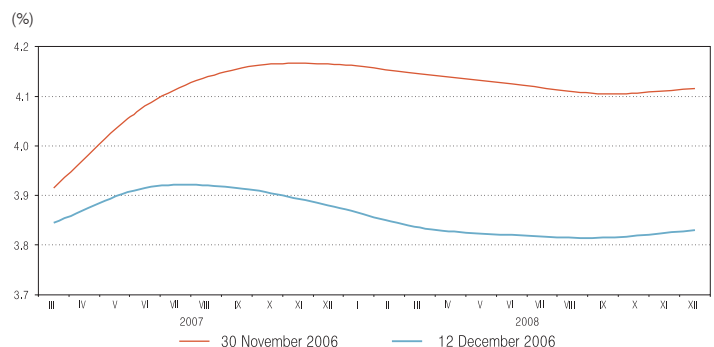
Source: Bloomberg.

Chart 10
ECB Repo Interest Rate and Six-month EURIBOR



Source: Bloomberg.

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



Source: Bloomberg.

up in Hungary. Lower inflation rates reflect primarily the lower fuel prices and correspondingly their contribution to inflation.

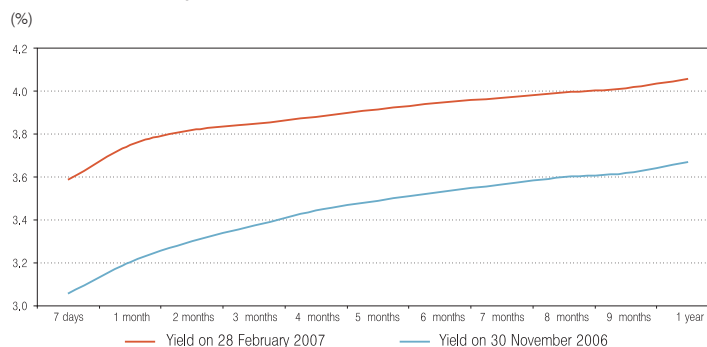
The USA

In the fourth quarter of 2006 US economy posted a 2.2 per cent growth on an annual basis attributable mostly to the robust private consumption and the positive contribution of net exports. Consumption was supported by increased income, favourable effects due to lower fuel prices and the aggressive price discount campaign initiated in the retail sale sector by the end of the year. Consumer confidence retained high, particularly in the component related to current state assessment. On the other hand, investments in housing construction remained a negative factor for GDP growth reflecting the continued recession in this sector. Slower growth was due to a large extent to the negative contribution of inventories which indicated that internal demand was met primarily through finished produce and not through output growth or imports of goods.

Forecasts of official institutions and market analysts are consolidated around the view that economic growth will gradually slow down to levels slightly under the long-term trend. Consumer activity is likely to moderate, consistent with the effects of the restrictive monetary policy, sizable household indebtedness and negative savings. The expected stabilisation of the housing and real estate sector is likely to support growth dynamics in the following quarters. In recent months signals of this sector's bottoming out from the recession increased.

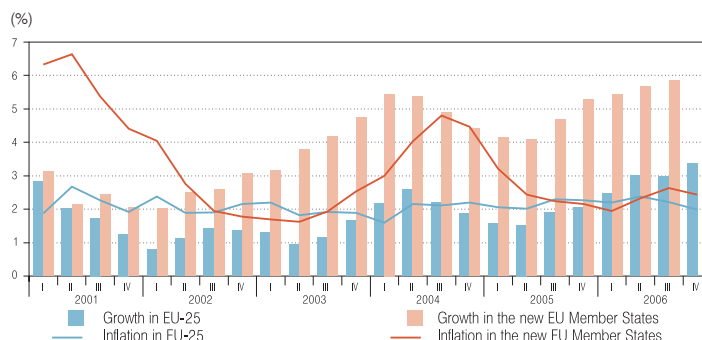
Consumer price inflation remained volatile in recent months reflecting the changes in oil prices. Disregarding the impact of food and oil components, core inflation exhibited a downward trend, though it stays relatively high yet: over 2 per cent. The recent decline in unit labour costs coupled with the forecast for a lower domestic demand supported the expectations for a further price slowdown in the future.

Chart 12
Euro Area Money Market Yield Curve



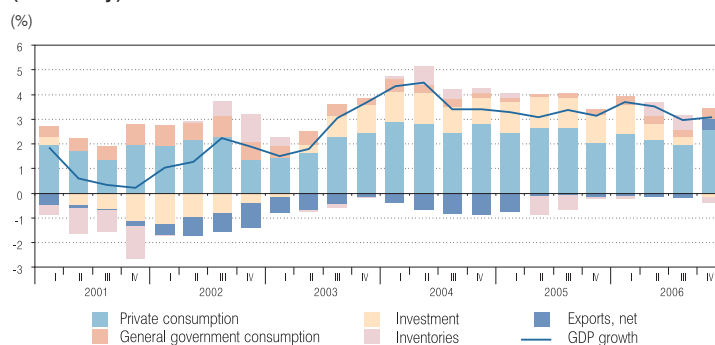
Source: Bloomberg.

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



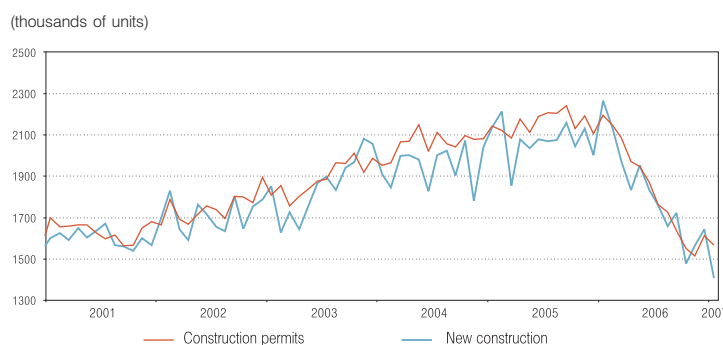
Source: Eurostat, BNB calculations.

Chart 14
Contribution to US Growth by Component (Quarterly)



Source: Bureau of Economic Analysis.

Chart 15
New Construction in the USA



Source: US Department of Commerce.

Labour market developments evidenced a slight increase in unemployment from the five-year low of 4.4 per cent registered three months ago to 4.6 per cent in January 2007. Employment growth remained robust though tending to moderate in recent months, a trend typical of this stage of the business cycle. If these trends are retained inflation pressure ensuing from wage increases in the labour market is likely to be weaker. This trend is supported by slower growth of hourly wages and unit labour cost index. It is of note that corporate sector profits remained sufficiently high to absorb higher output cost, thus reducing the effects of final pricing.

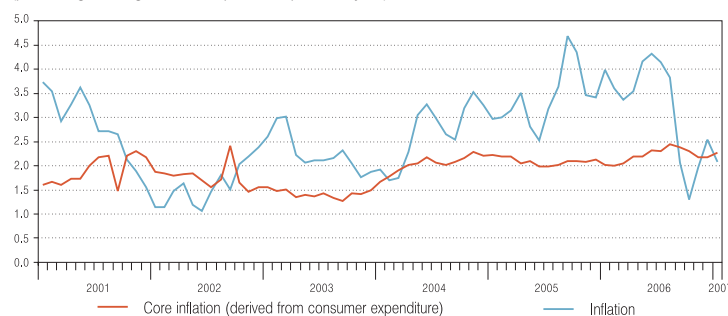
In the context of a moderate economic growth and declining but still high core inflation the US Federal Reserve System did not signal any intentions to make changes in its monetary policy.

As a result of positive macroeconomic data about the US economy published in December 2006 and January 2007, market expectations about future interest rate levels were revised and consolidated around the view that the central bank would not change the interest rate until mid-2007. In this setting, the six-month LIBOR on deposits denominated in US dollars is expected to vary between 5.10 and 5.50 per cent until the end of the second quarter.

Chart 16

US Inflation Rate

(percentage change on same period of previous year)

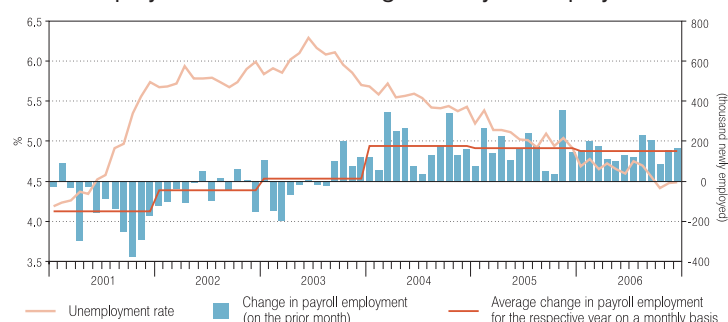


Note: The US core inflation is measured by consumer expenditure index excluding energy and food expenditure.

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

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)

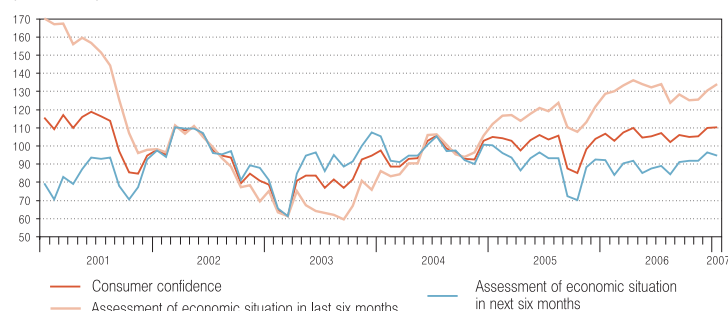


Source: Bureau of Labor Statistics.

Chart 19

US Consumer Confidence Indices

(1985 = 100)



Source: The Conference Board.

The USD/EUR Rate

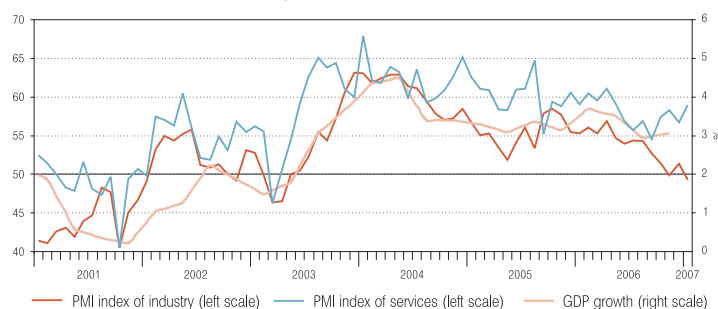
In early December 2006 the US dollar reached its lowest exchange rate vis-a-vis the euro for the last 20 months, reflecting the prevailing expectations for a pending decrease in the US interest rates. In early 2007 the downward trend in the US dollar exchange rate was reversed due to a revision of the expected US Federal Reserve System policy prompted by surprisingly strong data on the US economic activity. The increasing demand for assets issued by US residents associated with portfolio shifts in early 2007 also supported the US dollar.

Until end-February foreign currency trade experienced no significant fluctuations and remained in a narrow band. Gradually subsiding inflationary risks partly changed the balance of expectations in favour of shortening the interest rate differential with the euro and prompted an increase in market fluctuations by mid-February.

By the end of February and early March 2007 foreign exchange market volatility increased, with the euro appreciating against the US dollar and exceeding the level of 1.32. Increased uncertainty about the US economy related to the reports about the growing amount of non-performing mortgage loans in some sectors brought about a total decline in investors' risk appetite which also reflected on foreign exchange markets.

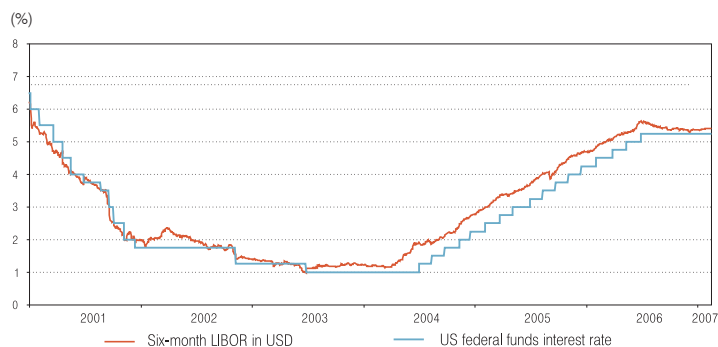
Interest rate dynamics in the USA and the euro area and investment preferences will remain the factors determining the EUR/USD exchange rate until the end of the first half of 2007.

Chart 20
US PMI Indices of Industry and Service and GDP Growth



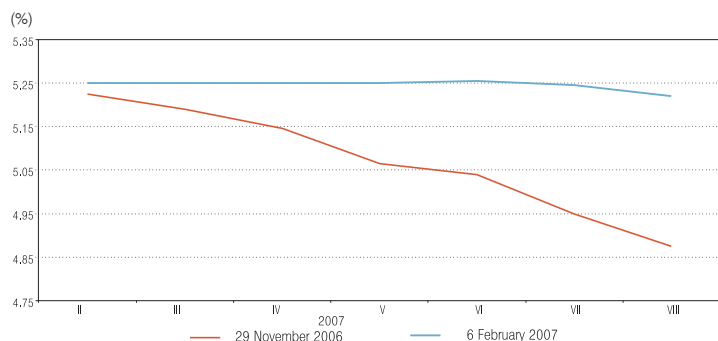
Source: Institute for Supply Management.

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



Source: Bloomberg.

Chart 22
Implied Federal Funds Futures Interest Rate



Source: Bloomberg.

Chart 23
USD/EUR Exchange Rate



Source: ECB.

The Balkan Region

Over 2006 Balkan countries reported comparatively high rates of economic growth, reflecting robust investment and consumption activity. Romania and Bulgaria posted the highest real growth in the third quarter: 8.3 per cent and 6.7 respectively. Inflation in the Balkan region continued moderating due mostly to lower inflation rate of energy.

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

	2005					2006				
	I	II	III	IV	Total	I	II	III	IV	Total
Growth (on the previous year, %)										
Bulgaria	5.9	6.5	4.6	5.5	5.5	5.6	6.6	6.7		
Greece	3.5	3.8	3.8	3.8	3.7	4.1	4.1	4.4		
Macedonia	2.9	5.0	4.1	3.8	4.0	2.5	2.6	3.0		
Romania	5.9	4.1	1.8	4.6	4.1	6.9	7.9	8.3		
Serbia	4.6	7.8	7.4	5.0	6.8	6.2	5.6	4.6		
Turkey	6.6	5.5	7.7	9.5	7.4	6.5	7.8	3.4		
Croatia	1.8	5.1	5.2	4.8	4.3	6.0	3.6	4.7		
Inflation (averaged for the period, %)										
Bulgaria	3.8	4.9	4.8	6.6	5.0	8.0	8.3	6.7	6.1	7.3
Greece	3.4	3.2	3.8	3.5	3.5	3.2	3.4	3.5	3.2	3.3
Macedonia	-0.4	0.9	0.8	0.8	0.5	2.7	3.4	3.6	3.1	3.2
Romania	8.9	9.9	8.9	8.5	9.0	8.6	7.1	5.9	4.8	6.6
Serbia	15.9	16.4	15.5	16.6	16.1	14.6	14.2	11.4	7.1	11.8
Turkey	8.6	8.6	7.9	7.6	8.2	8.1	9.6	10.8	9.8	9.6
Croatia	3.1	3.0	3.4	3.8	3.3	3.5	3.8	3.2	2.2	3.2

Sources: Statistical institutes and central banks of respective countries.

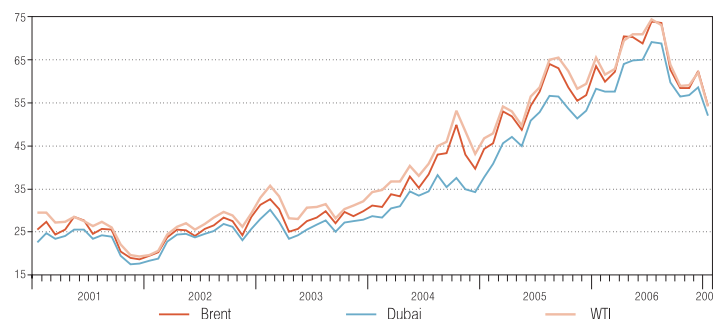
International Prices of Crude Oil, Major Raw Materials, and Gold

Crude Oil

Subsided global uncertainty at the end of the third quarter helped stabilize crude oil prices over the fourth quarter of 2006. The average monthly Brent crude oil price was USD 59.7 *per barrel*, down 14.8 per cent on the previous quarter. In January and February 2007 crude oil prices exhibited a new fall and by mid-January it reached USD 50 *per barrel*. The major factor impacting crude oil price dynamics in recent months was unusually mild winter in the northern hemisphere and consequently much lower seasonal demand for heating fuels. Concurrently, the lower consumption allowed for accumulation of inventories irrespective of the cuts in supply by 1.7 million barrel daily undertaken by OPEC countries in November 2006 and February 2007. Reduced supply by OPEC countries prompted a decrease in the risk premium on the low spare capacity of global output. Spare capacities of refineries are crucially important in the event of unexpected disturbance in deliveries of major oil producers. The IEA data on world demand and supply of crude oil in January

Chart 24
Crude Oil

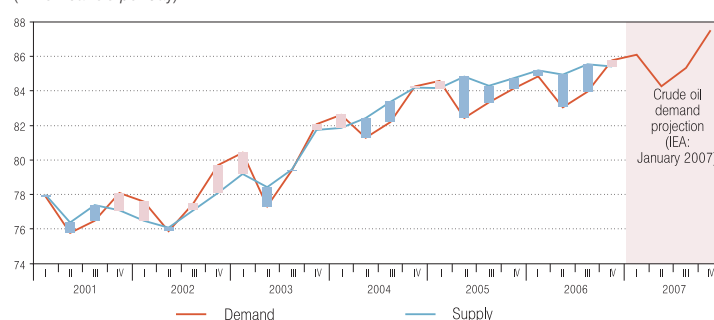
(USD *per barrel*)



Source: World Bank.

Chart 25
World Crude Oil Demand and Supply (Quarterly)

(million barrels *per day*)



Source: IEA.

recorded a negative balance in the fourth quarter of 2006. Traditionally, the demand in the second quarter of 2007 is expected to be lower and this will contribute to subsiding price volatility.

The average monthly Brent crude oil price is expected to fluctuate within the range of USD 50–60 *per* barrel. Main risks to the projection stem from a possible increase in geopolitical uncertainty associated with nuclear programmes of Iran and North Korea, frequent terrorist attacks against oil facilities in Nigeria and a possible new cut in supply by OPEC countries making attempts to limit falling oil prices.

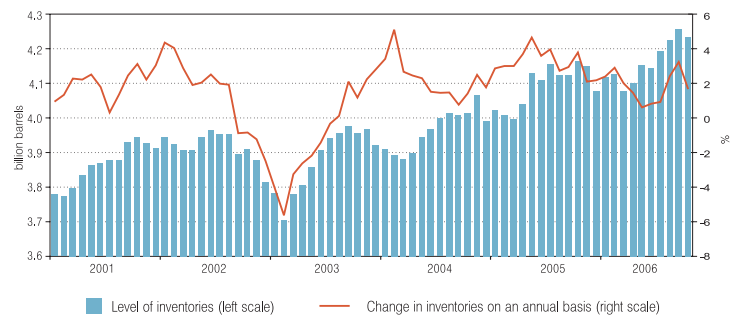
Prices of Major Raw Materials and Commodity Groups

Global decline in industrial activity over the second half of 2006 helped ease the pressure of demand on metal prices and gradually accumulate inventories. In January 2007 copper, zinc, lead and aluminium prices went up by 15.1, 14, 3.4 and 0.2 per cent respectively. Market expectations point to stabilizing prices at levels close to current ones, with prices tending to slow down until the end of 2007.

Similar to non-ferrous metals steel prices also posted a decline. Over the fourth quarter of 2006 prices of steel-made articles went down by 4.7 per cent on annual basis. Increased supply was the major factor behind the price fall. Global output growth accelerated to reach 8.8 per cent on an annual basis in 2006. China's share in world output continued to increase steadily and accounted for 33.8 per cent over 2006.

Over the fourth quarter of 2006 food prices continued to rise, with the growth rate accelerating to 12 per cent on an annual basis. As in the previous quarter cereals prices rose most dramatically: corn by 56 per cent, wheat by 26.9 per cent and rice by 6.8 per cent on an annual basis. The major reason behind the price increases was the dry in Australia whose crops are expected to drop by 60 per cent on the previous season. Wheat projections in the 2006/2007 agricultural season are for a 4.5 decrease in world crop and a fall in con-

Chart 26
Crude Oil Inventories in OECD Countries

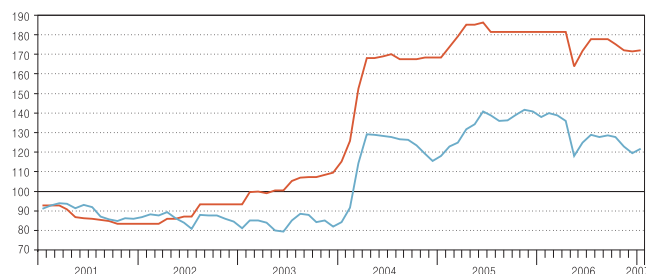


Source: IEA.

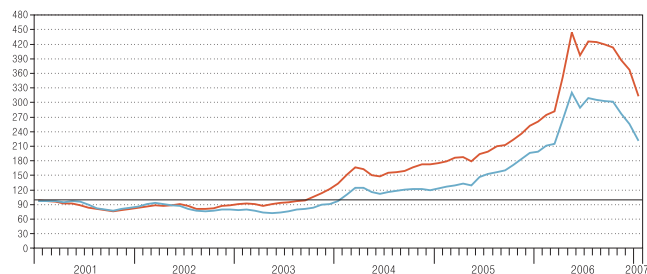
sumption by 1 per cent. This will prompt a 17 per cent decrease in global inventories. The corn price rise consistent with growing demand for corn used as an input for ethanol production pushed wheat price up due to the close technical interdependence between them. In November and December 2006 data on unexpectedly good crops of cereals in Argentina and Brazil helped stabilize corn prices and decrease wheat prices. However, in the medium run expectations are for steady demand and a gradual rise in food prices.

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

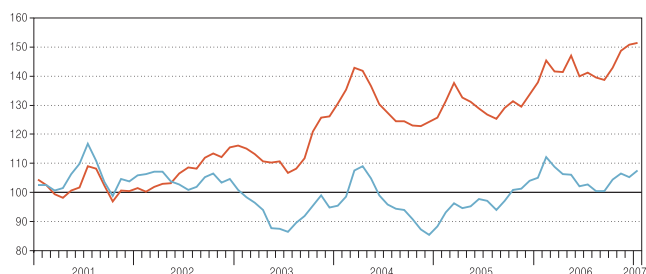
Steel



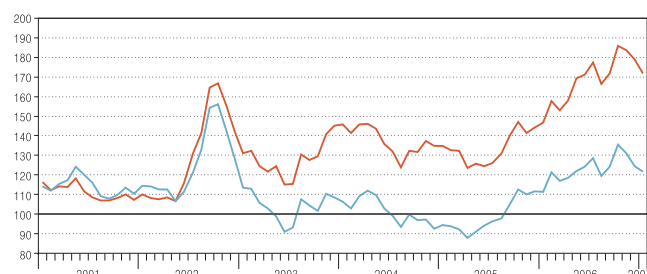
Copper



Food



Wheat



— USD

— EUR

Sources: World Bank, BNB.

Gold

As a result of the strong technical dependence on the US dollar exchange rate, in early December the one-month gold futures reached a two-month high of USD 650.90. By end-December gold price stabilized slightly under this level.

In early 2007 the gold price continued to be impacted mostly by the US dollar exchange rate but the sudden price drops in crude oil and base metals exerted downward pressure.

The short-term downward trend was reversed after the expectations for an increase in physical demand for gold on Asian markets became prevailing. Restored oil prices and postponed increase in the Japanese reference rate also added to this effect. Low short-term interest rates in Japan are considered to be used as a cheap source for financing speculative positions. The Final Report of the Committee² announced in early February in which the IMF is recommended to sell about 400 million ton of its gold reserves for financing its operations will have a medium-term effect on gold market supply at a time when the European banks lagged behind the announced sale schedule.

Bulgarian External Debt Dynamics on International Financial Markets

The yield spread of the emerging markets government debt measured by the JP Morgan *Euro EMBI Global* index dramatically went down in the fourth quarter of 2006 (by approximately 18 basis points), exhibiting one of its lowest historical levels (53 basis points) by the close of the year. A deviation from the general trend occurred in the beginning of 2007, reflecting the traditionally stronger seasonal financial market volatility in this period. However, the period of volatile dynamics was short and prices stabilized around the general trend. Indicators of global risk inclination displayed comparatively high values supported by the favourable dynamics of economic fundamentals in most emerging economies and also by the high global liquidity. The risk premium of central and eastern European countries' debts also exhibited a decline, reflecting the positive signs of economic development and subdued political risks in some countries of the region.

The yield spread of the Bulgarian government debt measured by the *Euro EMBI Global* index posted a steady downward trend in the fourth quarter of 2006 and early 2007, reaching 25 basis points on 1 February, the lowest value for the last 18 months. The overall market dynamics of the segment, increased investor optimism associated with

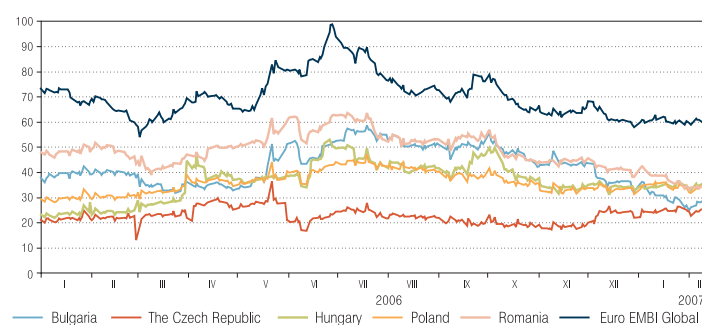
² Final Report of the Committee to study the sustainable long-term financing of the IMF, January 2007 (www.imf.org)

Chart 28
Spot Price of Gold



Source: The London Bullion Market Association.

Chart 29
Government Debt Yield Spreads in Bulgaria, Romania, Poland, The Czech Republic and Hungary (*Euro EMBI Global* index)



Source: JP Morgan.

Bulgaria's membership in the EU and government's resolve to continue structural reform and pursuit of a tight fiscal policy were the major determinants in the 2007.

In the long run advantages of Bulgaria's membership in the EU and positive effects of opening financial markets help reduce the market risk evaluation and firmly attract investor interest in debt issues.

2. Financial Flows, Money and Credit

Bulgarian economy saw a robust growth. In 2006 investment activity, which has been a major factor behind economic growth over the recent years, remained high. Over a nine-month period in 2006 real fixed capital formation growth reached 18.9 per cent compared to the respective period of the previous year. Positive expectations of economic development stemming from Bulgaria's membership in the EU from 1 January 2007, intensive restructuring and high returns on investment attracted large amounts of financial resources, with foreign direct investments and external loans boosting Bulgaria's economic growth. Foreign direct investment inflow in 2006 increased by EUR 1 billion and according to preliminary data reached EUR 4104.5 million or 16.8 per cent of GDP.

Foreign direct investments entirely cover the total balance of payments current and capital account deficit³ which due to the rise in trade balance deficit and the lower balances of particular items of the balance of payments current account, such as the *income* and *other services* items, marked an increase over the year under review. Balance of payments current and capital account deficit reached EUR 3798.4 million. The sizable inflow of financial resources resulted in a balance of payments total surplus which was distributed between the rise in international foreign reserves and loan payments to the IMF. The ratio between international foreign reserves and the average monthly rate of imports of goods and services matched the 2005 level at slightly over 5 months.

³ Since the beginning of 2007 the inflow of EU resources to the balance of payments is classified as *current and capital transfers*. Due to the large amount of these resources the total balance of payments capital and current accounts will be analyzed.

Table 2

Cash Flows Which Prompted Significant Changes in Gross International Reserves

	Fourth quarter, 2006	2006, total
A) Purchases and sales of reserve currency	Total, net: EUR +159 million	Total, net: EUR +1720 million
Net purchases from commercial banks	Net purchases from CB: EUR 170 million Bought: EUR 3704 million Sold: EUR 3534 million	Net purchases from CB: EUR 1746 million Bought: EUR 12,962 million Sold: EUR 11,216 million
Outflows related to net purchases at tills	Sold banknotes: EUR 11 million	Sold banknotes: EUR 26 million
B) Changes resulting from earnings (outflows) on commercial banks' minimum required reserve accounts in foreign currency	Net earnings : EUR 173 million	Net earnings : EUR 524 million
C) Changes due to flows on government accounts (only the largest cash flows: revenue and payments)	Earnings : EUR 322 million USD 42 million SDR 3 million Payments : EUR 213 million USD 88 million JPY 1.4 billion SDR 3 million CHF 2 million GBP 1 million	Earnings : EUR 601 million USD 69 million SDR 16 million CHF 2 million Payments : EUR 1270 million USD 314 million JPY 2.7 billion SDR 17 million GBP 5 million CHF 6 million

Source: BNB.

By the end of 2006 the Issue Department balance sheet figure reached BGN 17,458.6 million (EUR 8926.4 million), an increase by BGN 3043.5 million compared with the end-2005. Commercial banks behaviour and the strong demand for national currency for transaction purposes underpinned the rise in international reserves over the reviewed year. In 2006 net purchases of foreign currency by commercial banks amounted to EUR 1746 million and net earnings on commercial banks' minimum required reserve accounts were EUR 524 million. Banknotes and coins in circulation increased by 17.4 per cent. The general government's contribution to the changes in international reserves was negative as a result of debt payments to foreign creditors.

Financial Flows and External Position Sustainability

Capital inflow into Bulgaria will remain high in the first half of 2007. On an annual basis, current account deficit as a percentage of GDP is expected to improve on the corresponding period of 2006.

The balance of payments financial account surplus reached EUR 5395.6 million in 2006, up EUR 1835.4 million on 2005. Nearly three-fourths of it were due to the net for-

eign direct investment inflow and the remaining one-fourth resulted from the increase in net borrowings.

Gross foreign direct investment grew by EUR 1 billion and according to preliminary data reached EUR 4104.6 million in 2006. The share of annual earnings from privatization was insignificant amounting to EUR 212.3 million and was mostly due to the sale of Varna Thermo-electric Power Plant. The attracted equity was EUR 1885.8 million in 2006 (excluding privatization), with EUR 1372.5 million in receipts from sales of real property to non-residents. The increase in such flows may be interpreted as a sign of enhanced confidence in the economic growth outlook and a long-lasting interest in Bulgaria.

Within foreign direct investment, the *Other capital* item increased by EUR 677.7 million on 2005 and reached EUR 1689.9 million over the year. Intercompany loans provided by local companies with foreign ownership are recorded under this item. Hence the amount of earnings and the increase recorded under this item are indicative of robust activity of such companies in Bulgaria. According to preliminary data, the amount of reinvested profit for 2006 was EUR 316.5 million compared with EUR 301.8 million in the prior year which was a clear sign of foreign investment effectiveness and investors' positive assessment of economic prospects for Bulgaria.

Owing to sizable earnings from the sale of real property to non-residents, the largest share in the structure of direct investment (33.4 per cent) was occupied by *Real property, renting and business activities* followed by *Manufacturing* (19.2 per cent) and *Financial intermediation* (18.0 per cent). The share of *Construction* (10.5 per cent) probably also reflects the non-residents' interest in acquiring real property in Bulgaria. When interpreting the data on the structure of direct investments it should be noted that the classification made by companies' main activity defined upon registration may not correspond to their real activities. Therefore, conclusions about direct investment distribution among sectors producing marketable or non-mar-

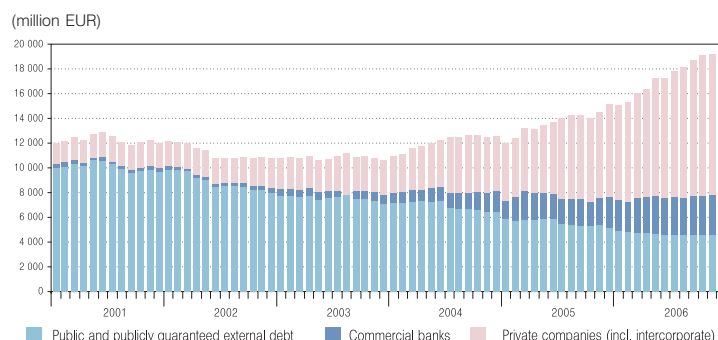
ketable goods based solely on these data might be misleading. The same applies to possible evaluations of the share of direct investments in export-oriented industries.

Net borrowings inflow on the balance of payments financial account in 2006 reflected gross external debt growth. According to preliminary data the total external debt amount by December 2006 was EUR 19,194.6 million: up EUR 4083.8 million on December 2005. In 2006 the public and publicly guaranteed external debt decreased by EUR 671.1 million as a result of debt payments to the IMF and the World Bank and reached 23.4 per cent of the total debt. Private non-guaranteed external debt went up by EUR 4755 million (47.8 per cent) and reached EUR 14,694.1 million.

The increase in total external debt was mainly due to the private non-bank sector (*Other sectors*) whose external debt went up by EUR 2506.4 million (59.5 per cent) over the review year thus amounting to EUR 6719.1 million by December 2006. Intercompany loans saw sizable growth: EUR 1490.7 million above the level of EUR 4013.6 million by end-2005. On the basis of indicators such as dynamics of national accounts' gross fixed capital formation and optimistic estimates and expectations based on business situation surveys, it might be assumed that the bulk of these debt resources were used to increase production capacity and to prepare the enterprises to operate under the conditions of the single European market. The necessity for fulfilling a number of regulatory requirements and standards stemming from the EU membership might be seen as a possible explanation of the companies' recourse to short-term external financing (*Other sectors* short-term liabilities increased by 64.4 per cent in 2006).

In 2006 commercial banks' external debt rose by EUR 840.7 million (34.1 per cent) on end-2005 which was mainly attributable to the EUR 503.5 million increase in non-residents' deposits with commercial banks. As foreign-owned banks have a considerable share of non-residents' deposits, their dynamics was influenced by banks' operations related to the measures undertaken by the

Chart 30
Gross External Debt



Source: BNB.

BNB for curbing credit such as attracting resources as additional required reserves.

The share of the euro in the private non-bank sector's currency structure was 76.6 per cent at the end of 2006. This share was higher in intercompany loans (88.4 per cent) and in commercial banks (82.8 per cent). The remaining part of the debt was distributed between the US dollar (between 5 and 2 per cent in the different sectors) and other currencies. As far as such currency denomination structure of private debt reduces the risks associated with exchange rate fluctuations it might be considered favourable.

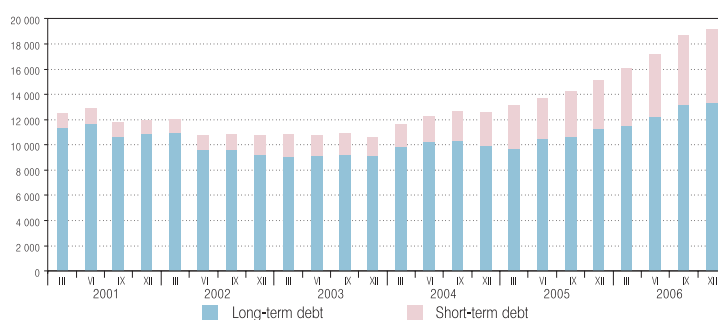
By end-December 2006 short-term external debt rose by EUR 1987 million (51.7 per cent) on end-2005, while long-term external debt increased by EUR 2096.8 million (18.6 per cent). Short-term debt includes liabilities on trade credits stemming from the rise in imports and non-residents' deposits affected by commercial banks' operations related to measures aimed at credit moderation. Short-term debt increase less the one in these two components was nearly EUR 1.3 billion. Although such an increase in short-term indebtedness is understandable having regard to high investment and firms' preparation to match the EU requirements, short-term debt growth rate and its total amount point at potential risks associated with external debt's maturity structure.

The main factors behind the rise in private sector indebtedness in 2006 proved to be the more effective liability management of Bulgarian enterprises achieved by attracting borrowed funds from abroad and the easier access to external financing. In the first half of 2007 these factors will continue to impact debt dynamics. Therefore, a slight increase in private external debt as a share of GDP is anticipated over the above-mentioned period.

The flow of financial resources into Bulgaria influenced to a great extent the flows on the balance of payments current account. In 2006 the balance of payments current and capital account deficit went up by EUR 1385.2 million on 2005 and the deficit to GDP ratio reached 15.6 per cent. Nearly two-thirds of capital and current account deficit deterioration was ascribable to

Chart 31
Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

the increased trade deficit by EUR 980.3 million partly due to higher energy prices and to the growing imports of investment goods⁴.

In 2006 the balance on *Services* amounting to EUR 720 million was positive although down by EUR 98.9 million compared with the prior year. The balance on *Transportation* also remained positive but marked a decrease of EUR 56.7 million on 2005 reflecting the dynamics of foreign trade in goods. The income from tourist services increased moderately by 5.4 per cent in 2006 and the balance on *Travel* went down by EUR 11.8 million. The balance on *Other services* decreased by EUR 30.4 million. The *Services* components' dynamics was indicative of the balance deterioration resulting primarily from the worsened trade balance and partly (*Other services* item) from the increase in services related to foreign direct investment.

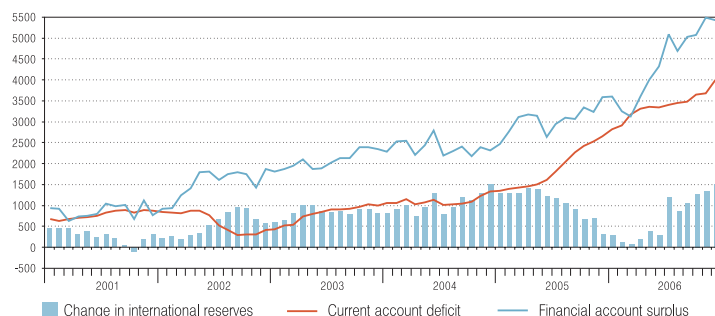
In 2006 the *Income* balance was EUR 40.7 million marking a decrease of EUR 110.3 million on 2005. Income from foreign direct investment saw the most sizable out-flight of resources (EUR 777.2 million in 2006). According to preliminary data EUR 316.5 million, or 40 per cent of exported income from foreign direct investment were reinvested in the economy. Since the changes in the other components under the *Income* item were insignificant and hence offset each other, the decrease in the positive balance was due to payments on income from direct investment. As considerable flows of foreign direct investment into Bulgaria would probably be retained in the following years, it might be expected that payments on income from direct investment will remain high in the future thus worsening the balance on the *Income* item.

Net transfers (current and capital) in 2006 reached EUR 830.9 million: down by EUR 195.7 million on 2005. In 2006 earnings from current transfers to the general government increased by nearly EUR 30 million, while in the private sector they decreased by almost EUR 220 million. This underpinned the over-

⁴ For a similar analysis of export and import dynamics by group of goods see Section 3 *Economic activity*.

Chart 32
Dynamics of Current Account, Financial Account and International Reserves (on an Annual Basis)

(million EUR)



Source: BNB.

all dynamics of net current transfers since in 2006 payments on current transfers went down by EUR 10 million compared with the prior year. This development may be due to statistical or economic reasons but the current available information is insufficient to determine the influence of specific factors.

On the basis of the current and capital account components' analysis it might be concluded that deficit growth in 2006 was largely attributable to factors related to economic growth and inflow of foreign direct investment. Gross foreign direct investment financed 108.1 per cent of the current and capital account deficit. Therefore, the deficit rise can be interpreted as a temporary effect relating to the restructuring of the economy and capacity building for its development rather than as a sign of imbalance threatening the balance of payments sustainability. In the first and the second quarter of 2007 the *current account deficit to GDP* ratio is expected to improve.

Bulgaria's net international investment position is a major indicator reflecting the dynamics and the direction of balance of payments flows. In the recent years the *total net indebtedness to GDP* ratio increased and according to preliminary data made up 40 per cent of GDP by September 2006 which was mainly due to the increase in indebtedness on foreign direct investment (50.9 per cent of GDP). Net debt position covering net trade credits, net loans and other net debt (nearly 20 per cent of GDP) including the net foreign assets of the banking system (excluding the central bank), were positive.

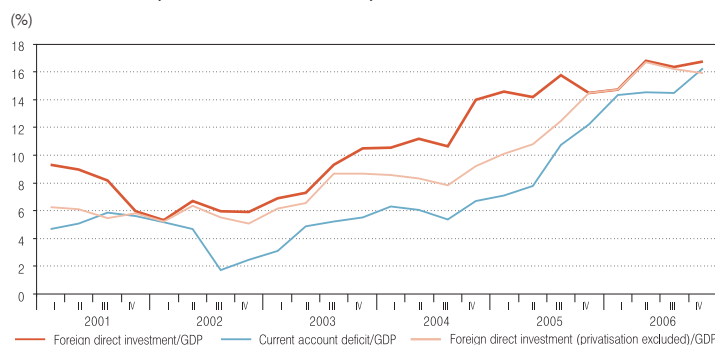
Monetary Aggregates

In the first half of 2007 broad money growth is projected to stay at a level of 24–26 per cent on an annual basis with a stable annual growth rate of currency in circulation between 15 and 17 per cent. No substantial changes in deposits rate dynamics is foreseen.

The last quarter of 2006 saw accelerated growth in all main monetary aggregates. Reserve money grew by 25.5 per cent on an annual basis: up 3.7 percentage points compared with the September growth. In 2006 banks' reserves and currency in circulation contributed equally to the change in

Chart 33

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



Source: BNB, NSI.

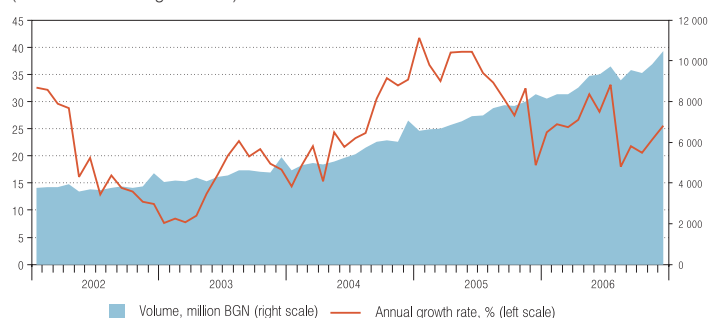
the monetary base with 13.3 and 12.2 percentage points respectively. Between December 2005 and December 2006 commercial bank deposits with the BNB saw an increase of BGN 1.1 billion or 44.7 per cent reflecting mainly additional required reserves' maintenance in relation to BNB Ordinance No. 21 in the part for curbing credit growth in the banking system. Since the beginning of 2007 credit growth ceilings were removed but the banks that exceeded the limits over the fourth quarter of 2006 should maintain additional reserves for a quarterly period starting from 4 February 2007. The total amount of these additional reserves was BGN 996 million. Consequently, commercial bank deposits with the central bank will remain high in the first quarter of 2007.

Currency in circulation saw enhanced growth reaching 17.4 per cent in the fourth quarter of 2006 after maintaining annual growth rate of around 14 or 15 per cent during the whole year. Since demand for banknotes and coins was mostly driven by transactions, the acceleration of this monetary aggregate at the end of 2006 probably indicated a stronger consumption over the period under review. Currency in circulation is expected to sustain its high growth rates (between 16–17 per cent) in the following two quarters of 2007 underpinned mainly by robust economic growth. In the short term book-entry payments are expected to affect the dynamics of the most liquid monetary component, while in the longer term robust growth of banknotes and coins in circulation will probably be limited by e-money developments. According to the BORIKA national card operator data, in 2006 the total number of POS transactions increased by 24 per cent on the prior year. The number of payments conducted *via* ATM went up by 21 per cent and that *via* the internet (using the *ePay.bg* system) increased by more than 78 per cent. In 2006 these transactions totaled nearly BGN 900 million.

The fiscal policy affects monetary aggregate dynamics through deposits of the general government and other budgetary organizations with the BNB and through redistribution of liquidity among other economic sectors. In the fourth quarter deposits of the

Chart 34
Reserve Money

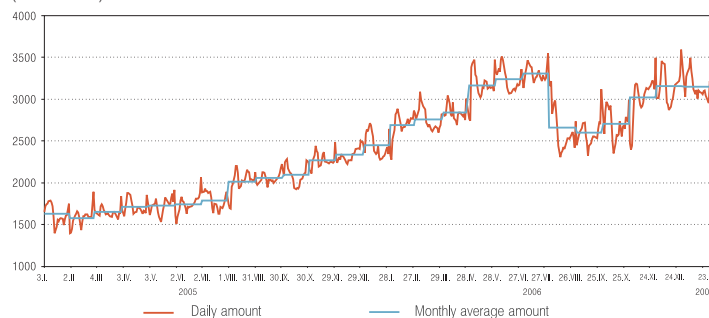
(volume and annual growth rate)



Source: BNB.

Chart 35
Commercial Bank Deposits

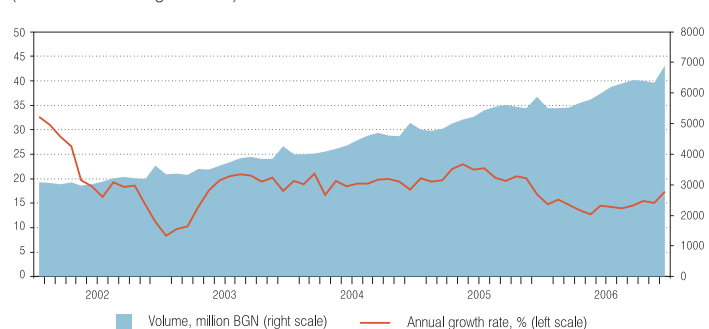
(million BGN)



Source: BNB.

Chart 36
Currency in Circulation

(volume and annual growth rate)



Source: BNB.

general government and budgetary organizations with the BNB decreased by BGN 85.4 million and by the end of the year reached BGN 4981.7 million. Good budget revenue implementation helped non-government non-bank sector to withdraw liquidity, while traditionally higher payments to the non-bank sector had the opposite effect by the end of the year. Net government debt repayment and revenue from Varna Thermo-electric Power Plant privatization reflected the flows between the general government and the external sector, the latter being the main liquidity source for the general government in the fourth quarter of 2006.

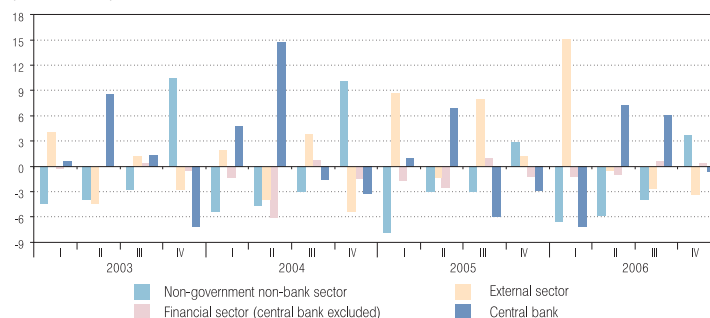
In the fourth quarter of 2006 broad money, measured by the M3 monetary aggregate, increased by 26.9 per cent on the same quarter of the prior year compared to an annual growth rate of 24.7 per cent in September. Money supply went up by 8.3 per cent over the quarter. The M1 monetary aggregate contributed greatly to the changes in M3 (4.5 percentage points). The contribution of quasi-money to broad money growth was 3.8 percentage points, with foreign currency deposits growing faster than lev deposits.

Lev overnight deposits within the M1 monetary aggregate saw an annual growth rate of 38.3 per cent. As a whole non-financial corporations' deposits increased faster than household deposits (37.8 per cent against 28.5 per cent). Overnight deposits in foreign currency rose by 47 per cent in 2006, with firms' deposits growing by 50.7 per cent to 68 per cent. Household overnight deposits in foreign currency also posted comparatively strong growth: 41.6 per cent.

Most types of deposits included in quasi-money also exhibited an increase. Lev denominated deposits of non-financial corporations with agreed maturity of up to 2 years increased by 40.1 per cent, while households' deposits went up by 17.6 per cent. The annual change in corporate and household foreign currency time deposits was respectively 60.7 per cent and 23.9 per cent. The largest increase in corporations' foreign currency time deposits was in December with their absolute growth amount-

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

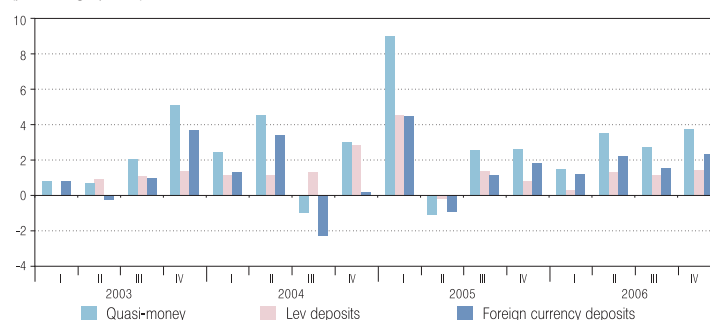
(share of GDP)



Source: MF, BNB.

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

(percentage points)



Source: BNB.

ing to BGN 278 million which made up almost half of the annual growth.

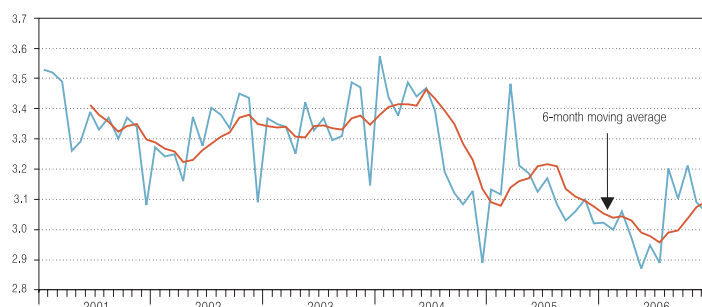
Assuming that there will be a sizable inflow of deposits (especially of overnight deposits) in the banking system, broad money growth rate is expected to remain high (between 24 and 26 per cent) in the first and the second quarter of 2007. This assumption is based on the favourable expectations for the economic activity owing to the positive developments in employment and wages on the one hand, and to the continuing capital inflow from abroad, on the other hand.

Over the last two years the money multiplier dynamics was greatly influenced by the measures undertaken by the central bank towards curbing credit expansion. The sizable volume of additional required reserves maintained by banks with the BNB had a direct effect on the money supply, most frequently pushing it up, and hence on the multiplier value that was on the downside until July 2006. After releasing additional reserves in August, the money multiplier rapidly went up to 3.1–3.2 and decreased again by the close of the year as a result of seasonal factor effect.

The seasonal nature of money circulation velocity, which marked a sustainable decline over the recent years, was also clearly pronounced. The downward trend in money circulation velocity that may be interpreted as an increase in the share of income, preferably held by firms and households in a liquid form, may be sustained as the *broad money to GDP* ratio in Bulgarian economy is significantly lower than that in developed countries.

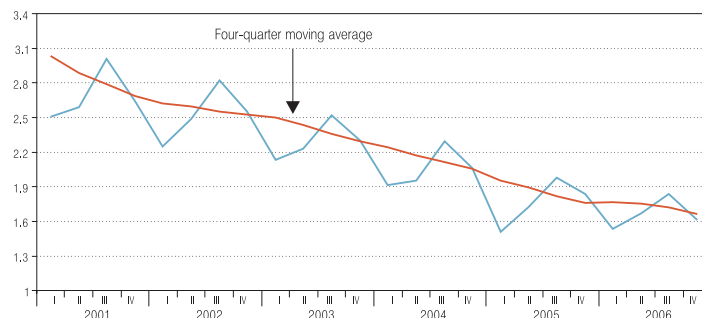
The fourth quarter of 2006 saw an insignificant rise in the interest rates on time deposits in all foreign currencies. The average quarterly interest rates on lev deposits rose from 3.44 per cent in the third quarter to 3.49 per cent in the fourth quarter. Interest rates on euro-denominated deposits rose from 2.51 per cent to 2.59 per cent and those on US dollar denominated deposits from 2.60 per cent to 2.63 per cent. After a period of moderate growth in 2005, interest rates on lev deposits remained fairly stable. Having unlimited access to resources of-

Chart 39
M3 Money Multiplier



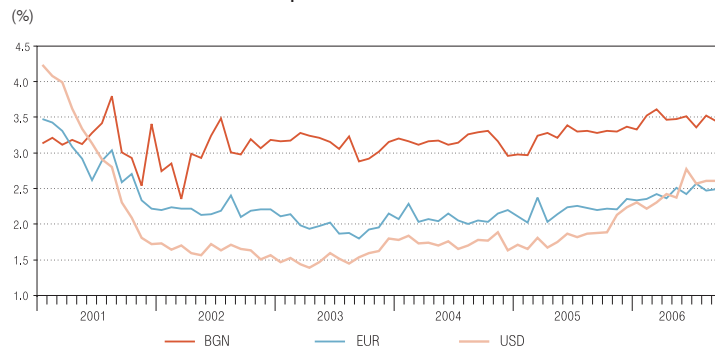
Source: BNB.

Chart 40
Currency Circulation Velocity (Quarterly)



Source: BNB, NSI.

Chart 41
Interest Rates on Time Deposits (%)



Source: BNB.

ferred from abroad there were no incentives for most local banks to offer higher interest rates for attracting more deposits. Interest rates on time deposits in euro and US dollars saw a clear upward trend mainly due to international interest rates' movements. The rise of ECB interest rates on repos in March will probably reflect on local market rates and the various instruments will need different time and degree of transmission. The increase in interest rates on repos by 0.25 percentage points will have a relatively limited effect. The upward trend in time deposits in US dollars may be sustained although no change in the US Federal Reserves System's policy is expected in the following two quarters. The increase may be due to the large difference between domestic interest rates on the US dollar deposits and the US dollar LIBOR. On the other hand, the still great amount of US dollar deposits in the Bulgarian banking system and low credit demand in this currency will limit the process.

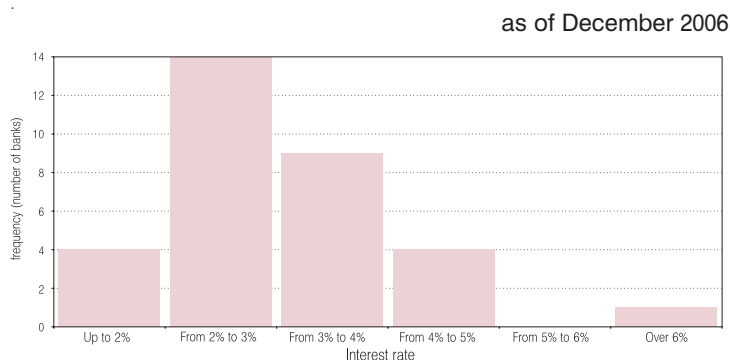
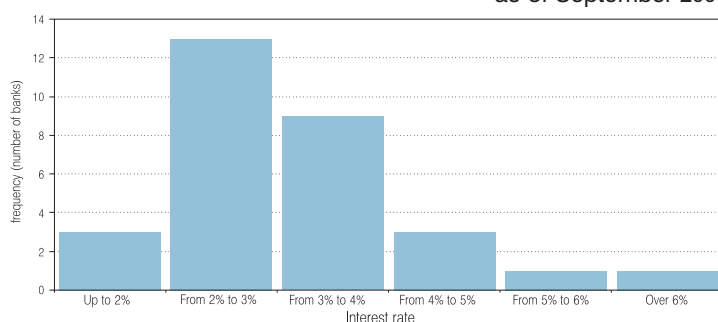
The distribution of interest rates on deposits in levs with maturity of up to one month in December is characterized by lower interest rates variation compared to the previous two quarters. The difference between the highest and the lowest offered interest rate was reduced to 5.66 per cent in December against 5.73 per cent in September 2006.

Credit Aggregates

Commercial bank behaviour in managing credit activity over the first half of 2007 will reflect the removal of additional required reserves and introduction of capital adequacy standards under Basel II. No significant changes in lending rates are expected.

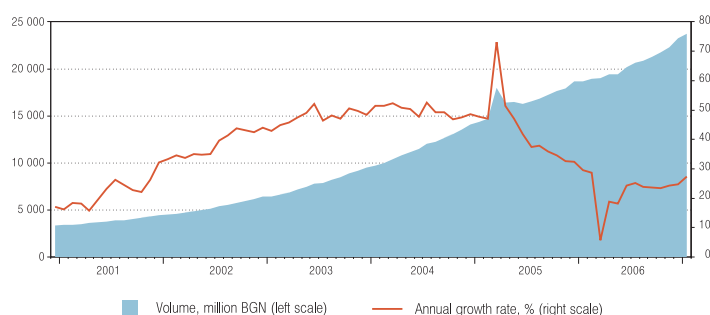
In the fourth quarter of 2006 bank claims on the non-government sector rose by BGN 1981.7 million (against an increase of BGN 1454.5 million in the same period of the prior year), whereas their annual growth rate reached 24.6 per cent by end-December. Robust lending reflected the sustained favourable macroeconomic trends which continued to underpin the strong demand for loans by corporations and households. At the same time, BNB measures made lending more moderate. Banks continued selling loans to foreign banks and non-bank

Chart 42
Interest Rate Distribution on Household One-month Lev Deposits
as of September 2006



Source: BNB.

Chart 43
Claims on Non-government Sector



Source: BNB.

financial institutions, their volume coming to BGN 902 million over the fourth quarter.

The first half of 2007 saw a significant uncertainty in assessing credit aggregate dynamics. The removal of additional required reserves in early 2007 may provoke banks to partially restore sold loans in their balance sheets which in turn will push up growth in claims on the non-government sector. Factors which would limit this process are associated with the capital adequacy requirement, securitization of loans by some banks and redemption of a portion of these loans in the meantime. The restoration of some sold loans in banks' balance sheets is not associated with generating a new debt in the economy and will bring no changes from the macroeconomic point of view. At the same time however, this process would impact the level of risk in banks' credit portfolios.

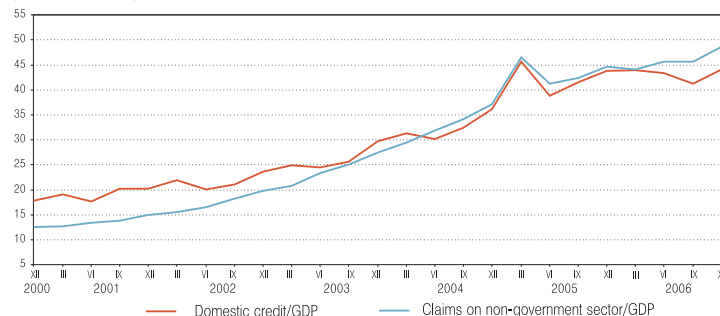
The trend to enhancing financial intermediation was sustained. By end-December the *claims on the non-government sector to GDP* ratio comprised 48.6 per cent, posting a 3.9 percentage point rise in 2006.

Demand for loans by corporations remained strong in the fourth quarter of 2006, driven by high production and investment activity. Despite the loan sales of BGN 515 million effected in the fourth quarter of 2006, claims on non-financial corporations posted considerable growth in nominal terms. In the last quarter of 2006 they rose by BGN 1105.4 million (BGN 784.9 million in the same period of the previous year), with their annual growth remaining relatively constant at approximately 20 per cent (19.9 per cent by the end of December).

The annual growth rate of the claims on households declined somewhat compared with the end of the third quarter (from 32.6 to 30.6 per cent), reflecting mainly the increasing base effect. Simultaneously, loans grew robustly in nominal terms: in the fourth quarter of 2006 claims on households increased by BGN 793.6 million against an increase of BGN 704.2 million in the corresponding period of the previous year. Albeit lower compared to the prior quarter, sales

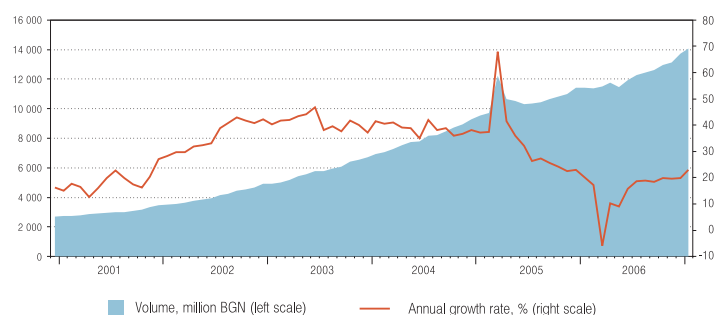
Chart 44
Domestic Credit

(share of GDP, %)



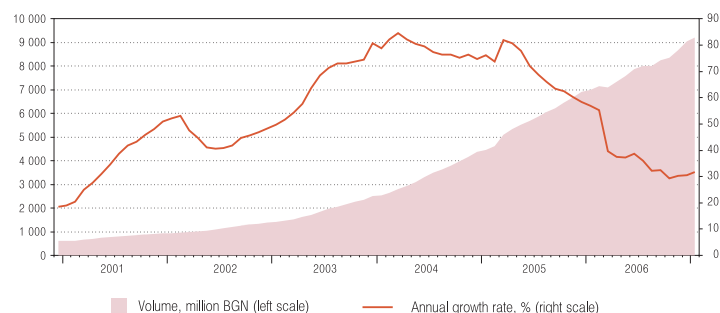
Source: BNB.

Chart 45
Claims on Non-financial Corporations



Source: BNB.

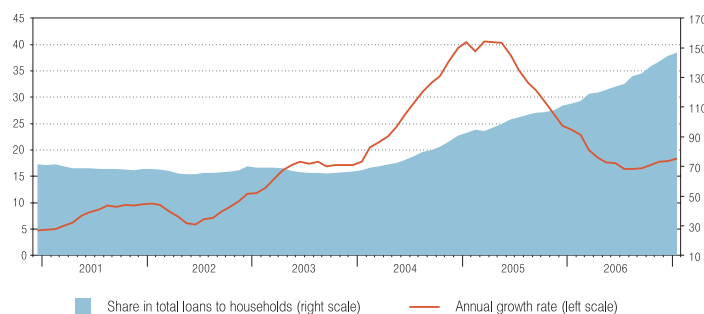
Chart 46
Claims on Households



Source: BNB.

Chart 47
Housing Loans

(%)



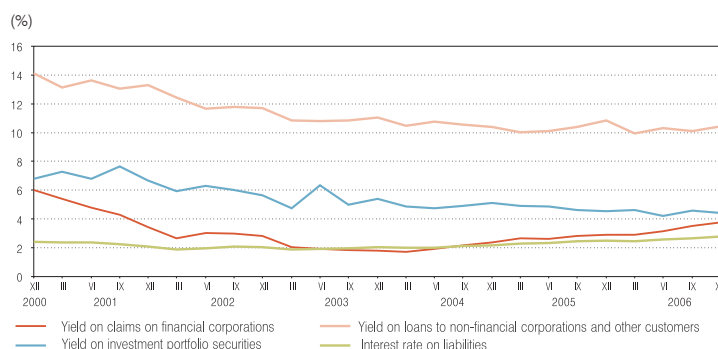
Source: BNB.

of loans (BGN 387 million in the fourth quarter) affected the dynamics of claims on households.

The annual growth rate of consumer loans continued decreasing in the fourth quarter of 2006: from 13.1 per cent in September to 6.3 per cent as of end-December. Housing loans still were the most rapidly developing segment of the credit market. In the fourth quarter they rose by BGN 576.9 million (against BGN 284.9 million in the same period of the prior year), with their annual growth accelerating from 69 per cent in September to 73.8 per cent in December and their share in total household loans rising from 34.5 to 37.8 per cent over the review quarter.

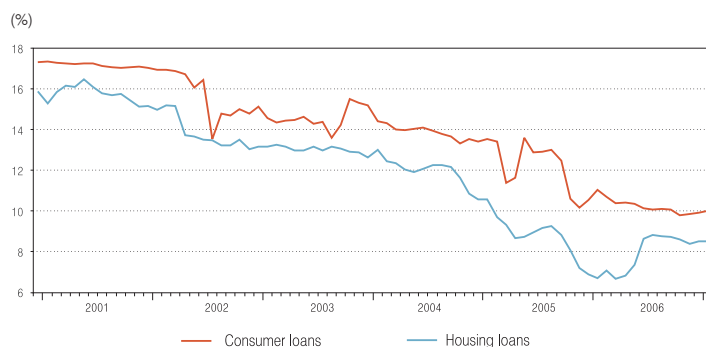
Despite the slight increase in the cost of borrowings, lending rates remained relatively unchanged, most likely due to the strong competition within the banking system. Interest rates on loans will probably undergo no significant changes over the coming months, reflecting the assumption that competition within the banking system will reduce the effect of possible ECB monetary policy tightening and increased costs of borrowed funds.

Chart 48
Yield on Assets and Interest Expenditure on Commercial Bank Liabilities



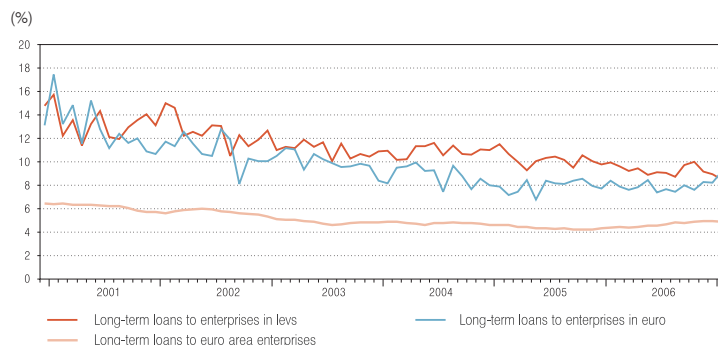
Source: BNB.

Chart 49
Interest Rates on Household Loans



Source: BNB.

Chart 50
Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

Table 3
Claims on Non-government Sector (Quarterly)

	Annual growth rate, %								Structure as of 31 Dec. 2006
	2005				2006				
	I	II	III	IV	I	II	III	IV	
Claims on non-government sector, incl.:	73.1	41.8	35.9	32.4	5.6	24.2	23.6	24.6	
on non-financial corporations	68.0	32.2	25.7	23.1	-5.9	15.8	18.3	19.9	59.0
on households and NPISHs	81.8	72.2	63.5	58.4	39.7	38.7	32.6	30.6	38.9
on financial corporations	113.4	-27.6	-12.4	-31.1	-44.6	42.7	25.9	68.6	2.1

Source: BNB.

3. Economic Activity

Economic growth will retain its high rates, with consumer and investment demand contributing steadily to this growth and net exports contribution relatively improving.

Economic situation estimates in early 2007 signal favourable trends. Optimism in managers' expectations in the services sector continued to increase along with the sustained favourable situation in industry and construction. In 2006 industrial firms increased significantly the assessment of their competitive position on foreign markets. In early 2007 high capacity utilization was reported by this sector. Consumer confidence tended to improve owing to more favourable assessments of the labour market situation and overall economic performance in Bulgaria.

In the third quarter of 2006 economic growth reached 6.7 per cent on the corresponding period of the previous year. Consumption and investment retained their high contributions to growth, with restored exports and lower negative contribution of foreign trade balance compared with the third quarter of 2005 acting as main drivers to growth acceleration. In terms of supply, manufacturing was the leading sector.

Household Behaviour

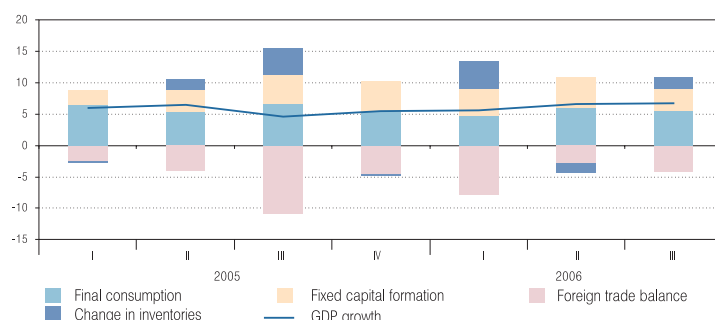
The improving situation on the labour market boosted consumer confidence and will be the main factor driving consumer demand growth over the first half of 2007.

In the third quarter of 2006 household consumption reported high growth at 8.4 per cent, irrespective of the high base of the corresponding quarter of 2005 (10.4 per cent). Household expenditure on non-food goods grew at an outstripping growth rate of approximately 20 per cent.

Domestic trade and household budget data evidenced consumer activity acceleration in the last quarter of 2006. Consumer spending *per* household member rose by 9.2 per cent and retail sales income by 15.8

Chart 51
Contribution to GDP Growth by Component of Final Consumption (Quarterly)

(percentage points)



Source: NSI.

per cent. Furniture, home maintenance and transportation expenditure (including personal vehicle maintenance) had the largest contribution to overall consumer expenditure. The increased trade supply capacity was another factor behind the robust consumer activity.

Table 4
Consumer Demand Dynamics (Quarterly)

(on corresponding period of previous year, %)

	2005				2006			
	I	II	III	IV	I	II	III	IV
Consumer spending <i>per</i> household member	5.0	4.3	3.6	2.6	3.7	6.3	6.7	9.2
Retail sales	13.9	15.7	11.5	9.8	10.9	13.2	14.1	14.0
Income from retail trade	12.0	13.2	12.9	12.8	8.6	12.4	14.2	15.8
including								
Food, drinks, tobacco	9.5	10.1	8.3	4.0	6.1	5.8	7.3	8.7
Pharmaceutical and medical goods, cosmetics and toiletries	3.3	7.3	12.3	10.9	6.2	11.5	7.1	4.2
Textile, clothing, footwear and leather	10.0	17.5	24.7	25.9	7.5	12.4	18.1	15.8
Household goods and home appliances	20.7	18.7	18.9	24.8	12.9	18.9	20.3	19.7

Source: NSI.

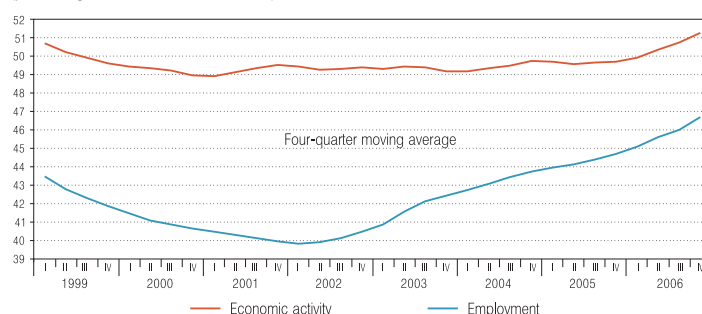
Increasing incomes and improving situation and prospects on the labour market played a major role for household consumption growth. Over the third and fourth quarters real salary growth accelerated to 4.7 and 6.1 per cent respectively on an annual basis. Employment continued to increase and reached almost 6 per cent in the last quarter of 2006. Trade and construction were the sectors offering the most employment opportunities.

Employment increased at high rates, while the unemployment rate slowed down in 2006, reflecting the gradual rise in the economic activity rate. This trend may be seen as favourable since, on the one hand, the economic activity rate is relatively low in Bulgaria and on the other hand, the influx of people looking for a job will raise labour market flexibility and reduce risks of labour force shortages at the macro level and of a potential inflationary pressure arising from salary increases.

The favourable labour market situation resulted in improving households' expectations of unemployment and overall economic situation in Bulgaria. These indices form the consumer confidence indicator and have a major contribution to its upward rebound in early 2007.

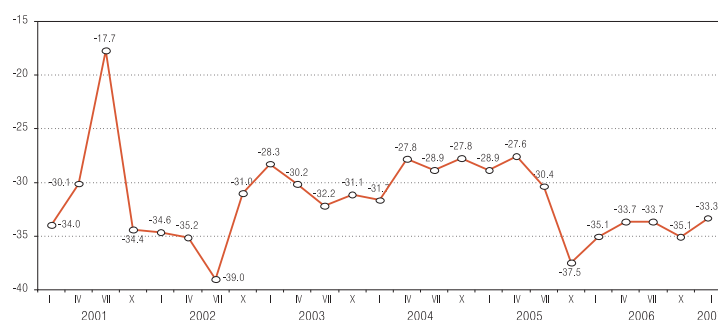
Chart 52
Labour Market Structural Indicators (Quarterly)

(percentage of the individuals over 15)



Sources: NSI, Labour force survey.

Chart 53
Household Confidence Indicator



Sources: NSI, Consumer survey.

Table 5

Employment and Income Dynamics (Quarterly)

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

	2005				2006			
	I	II	III	IV	I	II	III	IV
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	9.1
Employed under labour contract	4.3	3.5	1.5	1.6	0.8	0.6	1.0	0.6
Employees (Labour Force Survey data)	2.0	1.3	2.4	2.4	3.6	4.3	3.3	5.9
Real salary	3.2	3.8	3.2	0.7	1.8	1.4	4.7	6.1
Wages and salaries, deflated by CPI	2.6	6.0	7.3	9.6	3.9	4.5	8.1	

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

Government Finance and Consumption

Good revenue performance and measures to curb expenditure led to a consolidated budget surplus of 3.7 per cent of GDP.

Consolidated budget balance for 2006 reached BGN 1747.6 million or 3.7 per cent of GDP. The surplus was formed by saving most of the revenue overperformance, along with the State Budget Law measures to cut expenditure in case of current account deficit worsening.

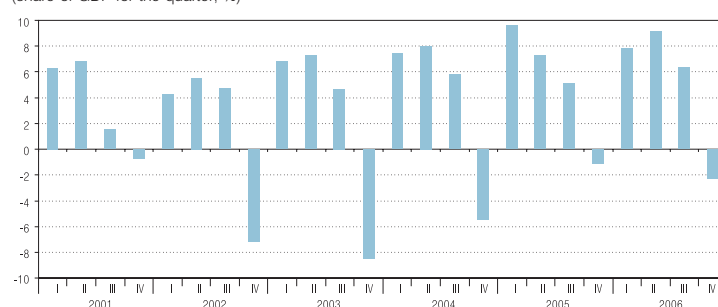
By the end of December total revenue and aid under the consolidated fiscal programme came to BGN 20,034 million, an increase of BGN 2021.8 million (11.2 per cent) on the previous year, outstripping by BGN 1580 million the indicative target set out in the agreement with the IMF (BGN 18,454 million). This comprised 9.7 per cent of the revenue and aid projected in the State Budget Law. The growth rate of tax revenue accelerated in the fourth quarter to 17 per cent on an annual basis, indirect tax earnings contributing most significantly to this. Their annual growth exceeded 25 per cent, with their contribution to tax revenue growth reaching 13 percentage points. In the first half of 2007 tax revenue growth is expected to slow down to around 7 per cent annually, reflecting lower contribution of indirect taxes to tax revenue growth as a result of expected moderation in VAT earnings and duties growth after accession to the EU.

Consolidated fiscal programme expenditure for 2006 accounted for BGN 18,286.3 million, up 9.6 per cent on the prior year but close to the value projected in the State

Chart 54

Primary Balance (Quarterly)

(share of GDP for the quarter, %)



Sources: MF, BNB.

Chart 55

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

(percentage points)



Sources: MF, BNB.

Budget Law. The level of expenditure is affected by quarterly targets set out in the agreement with the IMF with regard to cash balance and total consolidated budget revenue whose achievement implicitly involves expenditure reduction. The fourth quarter saw the highest expenditure, including additional operating expenditure, salaries and pensions. Over the last quarter of 2006 current non-interest expenditure posted an increase of 13 per cent on an annual basis, this accelerated growth on the previous quarters reflecting the base effect. Accordingly, the contribution of general government consumption to economic growth in the fourth quarter is estimated at around 1 percentage point. In the first half of 2007 a moderate government consumption contribution to economic growth is expected. In line with the expenditure reduction policy, the general government consumption contribution to GDP growth in the first two quarters of 2007 is projected to be within a 0.3–0.4 percentage point band.

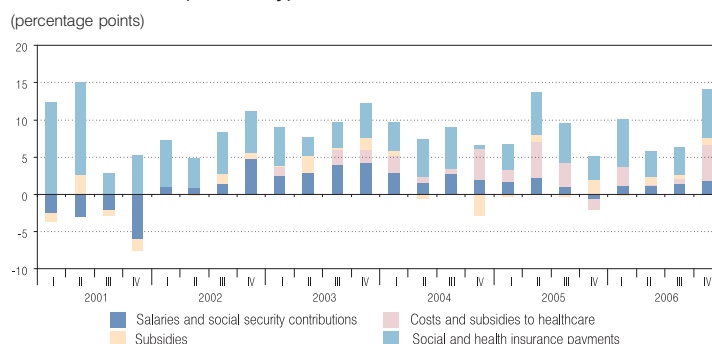
Behaviour of Firms and Competitiveness

Liquidity and profitability of the production sector remained high, fostering high investment activity.

In the third quarter of 2006 firms' production activity continued rising, with manufacturing acting as a major driver to growth and its value added growing by some 14 per cent. Agriculture also posted positive growth, still failing to compensate for declines stemming from natural disasters in the second half of 2005. High export activity in industry was the main factor behind sales and value added growth since early 2006.

According to industrial sales data in the fourth quarter, production activity remained high due to the essential slowdown in direct export sales which rose by merely 2.2 per cent on the corresponding quarter of the previous year. Most industrial sectors reported a significant increase in export sales, with ferrous metallurgy, manufacture of electrical machines and appliances, textile and clothing, products from non-metal mineral raw materials, machines, equipment and home appliances being among the leading

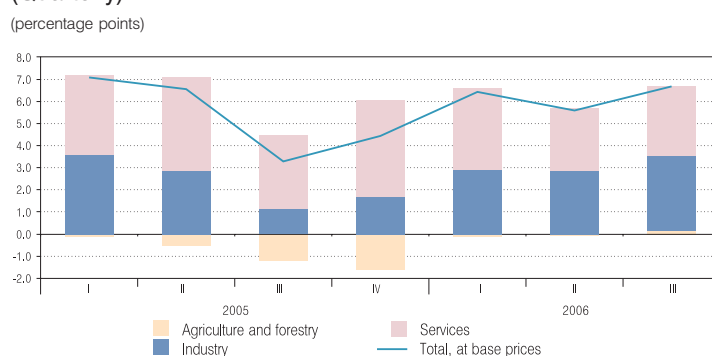
Chart 56
Contribution of Major Groups of Current Non-interest Expenditure to Total Growth (Quarterly)



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.

Chart 57
Contribution of Economic Sectors to Value Added Growth (Quarterly)



Source: NSI.

exporters. Export declines were registered by few sectors: non-ferrous metallurgy and manufacture of energy and fertilizers. Most likely, declines reflect the economic situation, rather than the competitiveness of the relevant industries. In 2006 industrial firms essentially raised the assessment of their competitive position on foreign markets.

Despite the slowing exports, total sales growth over the fourth quarter was a bit higher than that in the fourth quarter of 2005. This was due to dynamic internal market sales which rose by some 10 per cent. Domestic sales had a decisive role for industries contributing most significantly to sale growth in the last quarter of 2006: foods and drinks, non-metal mineral materials, machines, equipment and home appliances, furniture, textile.

Economy's cost competitiveness retained its favourable trend over the third and fourth quarters of 2006 despite accelerating growth in real salary. Robust growth was seen in few industries, mainly in trade, but even here salary growth matched labour productivity growth. Real unit labour costs in major economic sectors remained stable, even tending to fall in several industries. Preliminary operating monthly data on salaries, employment and output in industry point to sustaining favourable trends over the last quarter of 2006.

Production capacity innovation, a result of the increasing share of GDP in fixed capital investment, played a key role in rising labour productivity. The analysis of available statistical data on national accounts, foreign direct investment, external debt, non-government sector's credit and leasing firms' activity intended to establish links between incoming capital flows, investment and economic growth shows the following favourable trends. On the one hand, real sector profitability and liquidity were high at a macro level. Overall, firms generated a high gross operating surplus⁵ which was enough to finance investment using own funds. High

⁵ Gross operating surplus less corporate income taxes, less estimates of interest expenditure based on indirectly measured services of financial intermediaries, but not adjusted for consumption of fixed capital.

Chart 58

Assessment of Industrial Firms' Competitive Position

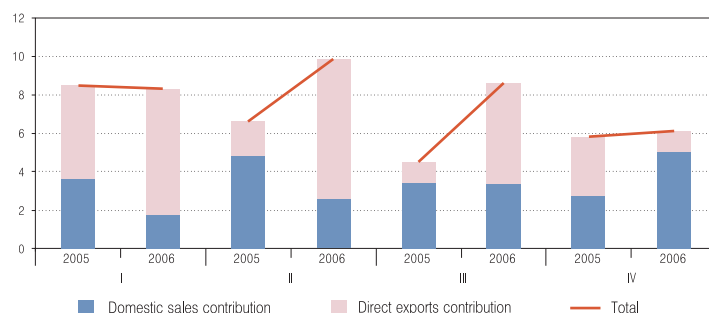


Sources: NSI, Business survey in industry.

Chart 59

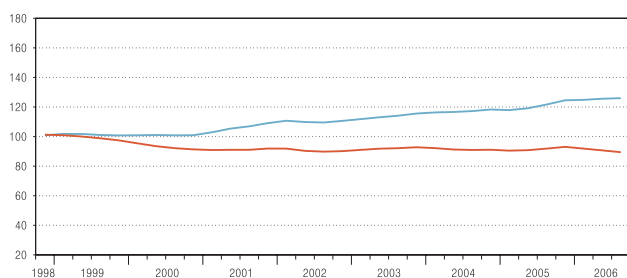
Industrial Sales Growth

(% on corresponding quarter of previous year)

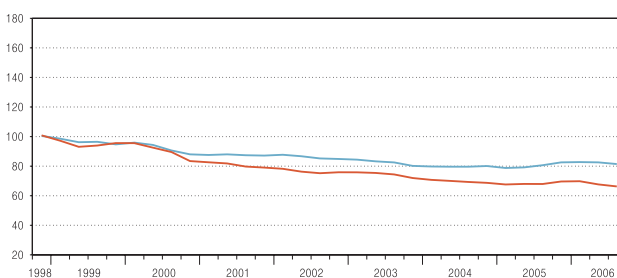


Source: NSI.

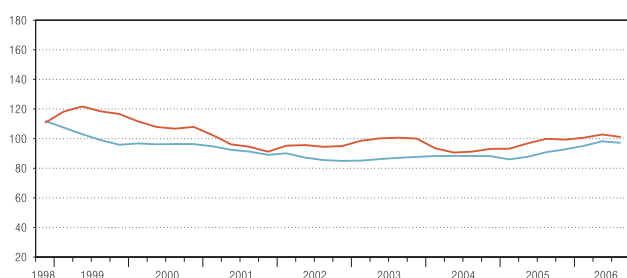
Chart 60
Unit Labour Cost (Quarterly)
(1998 = 100%)
Total for the Economy



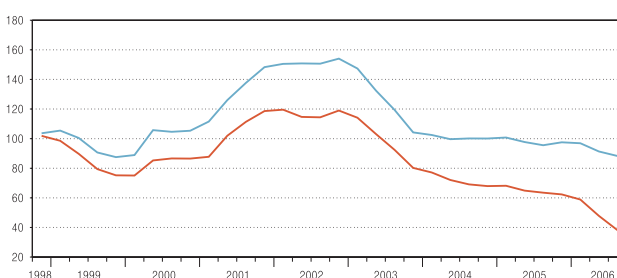
Manufacturing



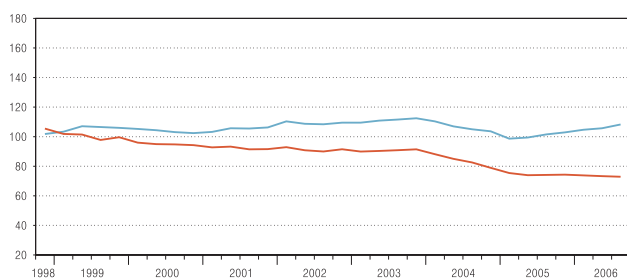
Agricultural Sector



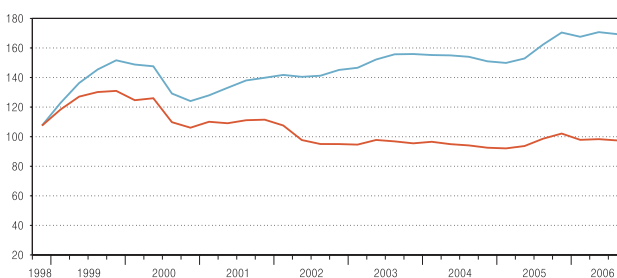
Mining and Quarrying



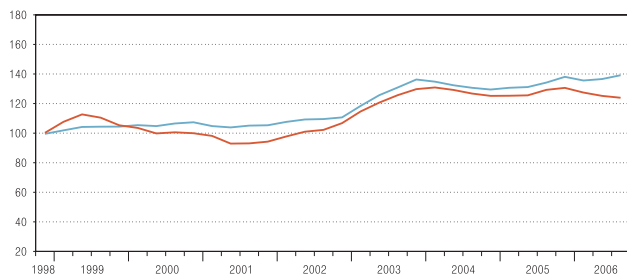
Construction



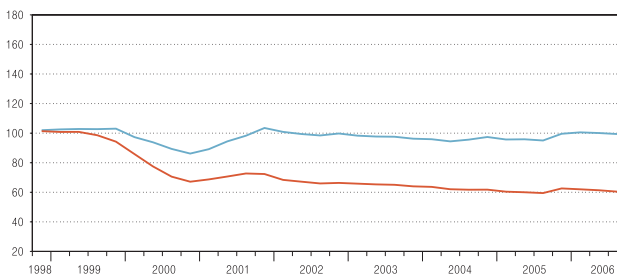
Electricity, Gas and Water Supply



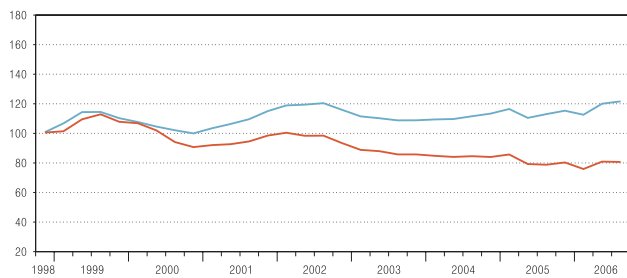
Trade



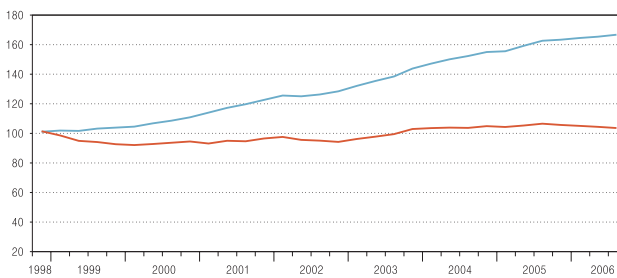
Transport and Communications



Financial Intermediation



Other Sectors

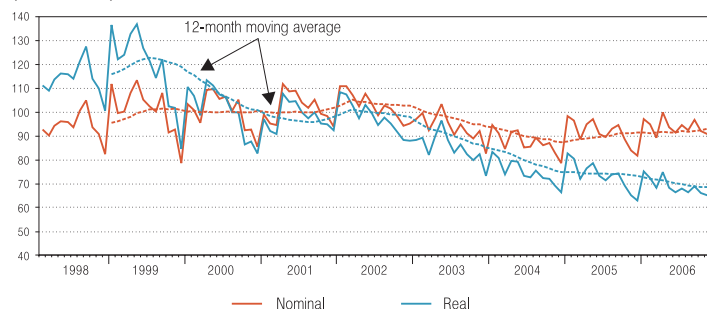


— Four-quarter moving average (nominal)
— Four-quarter moving average (real)

Source: NSI, BNB.

profitability and liquidity of the firms underpinned their credibility and stimulated foreign capital inflow into Bulgaria's economy. Additional sources of external and internal non-debt and debt financing in the form of foreign direct investment, long-term external debt, long-term bank credit and financial leasing play as catalysts for diversification of the economy's structure. They accelerate the emergence of new economic agents and new product and technology utilization.

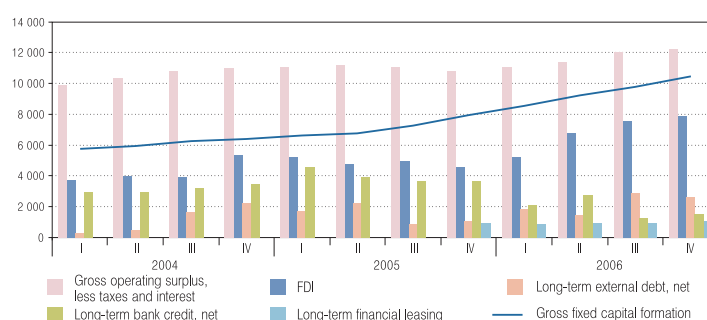
Chart 61
Unit Labour Cost: Industry
(2000 = 100)



Sources: NSI, BNB.

Chart 62
Firms' Investment Resources
(Quarterly)

(million BGN, four-quarter moving amount)



Note: This chart displays data on fixed capital investment of the non-government sector; gross operating surplus of the non-government sector less corporate and patent taxes and sole proprietorship taxes, as well as interest expenditure based on indirectly measured services of financial intermediaries; foreign direct investment flows; changes in long-term external debt of firms and banks, long-term bank credit of the non-government sector and long-term financial leasing.

Sources: NSI, MF, BNB.

Exports and Imports of Goods

Nominal goods exports in euro are expected to grow by approximately 21–23 per cent in the first quarter of 2007 and to slightly moderate to 14–18 per cent in the second quarter of 2007. Stabilizing crude oil prices on international markets at the early 2007 levels along with moderate growth in domestic demand will maintain nominal goods imports growth within the 16–18 per cent band over the first quarter and around 14–18 per cent over the second quarter of the year.

The international situation analysis implies expectations of moderation in global economic growth which may impact Bulgaria's foreign trade. The improving competitiveness of the Bulgarian economy is a main factor for overcoming the foreseen slowdown in external demand which will be more clearly pronounced in the second quarter. High investment activity in major export-oriented industries over 2006 and the positive trend in industry's unit labour costs underpinned the view of sustained competitive positions of domestic output. Consequently, goods exports are expected to retain high real growth in the first half of 2007, while imports

will experience a slowdown in the first quarter, followed by robust growth in the second quarter.

The negative contribution of foreign trade balance to real GDP growth is expected to decrease significantly in the first quarter of 2007 and to rise in the second quarter. Retention of strong investment activity and high import dependence of exports will maintain sustainable growth in real imports.

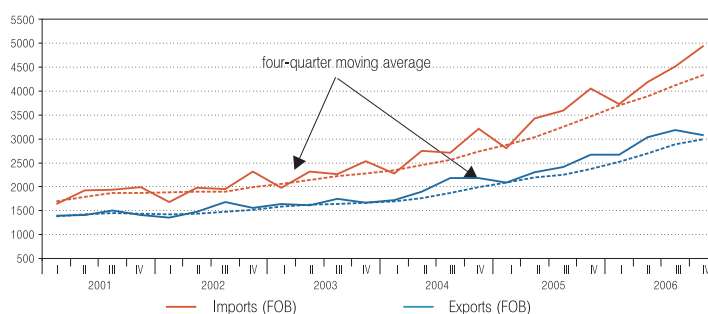
Goods exports in euro reached EUR 11,982.6 million, a nominal increase of EUR 2516.3 million, or 26.6 per cent on the previous year. Imports (FOB) came to EUR 17,372.7 million over the period, up nominally EUR 3496.6 million or 25.2 per cent on 2005.

Investment goods and energy resources had the largest contribution to the trade deficit increase in value over 2006. Within investment goods, imports of machines, transportation vehicles and appliances rose significantly along with crude oil imports. Following oil and oil product price changes over the year, trade deficit rose by EUR 251.1 million. On the other hand, foreign trade dynamics of non-ferrous metals, clothes and shoes which pushed up net revenue in 2006 helped reduce the deficit.

In the fourth quarter of 2006 goods exports slowed down to 15.6 per cent nominally on an annual basis, while imports (FOB) continued its robust growth at 22.1 per cent. Transportation vehicles (an annual decline of 67.3 per cent) and non-oil energy resources (down 18.4 per cent) had the largest contribution to the downward dynamics of exports.

Our expectations for the first quarter of 2007 show a sustainable increase in the volumes of both exports and imports. On the one hand, our forecasts point to moderate growth in total demand in Europe and in other major regions of the world. In addition to this, high import values in the corresponding quarter of 2006 had a curtailing effect on import nominal dynamics. On the other hand, the expected dynamics of international prices show improved trade conditions in Bulgaria over the review quarter owing to a relative moderation in prices of metals, foods and agricultural raw materials.

Chart 63
Dynamics of Exports and Imports (Quarterly)
(million EUR)



Source: BNB.

Our assumptions for the second quarter show a more substantial moderation in external demand and more clearly pronounced fall in base metal prices. These factors will contribute to lower exports revenue over the review quarter and a negative change in domestic trade conditions. International crude oil prices are expected to stabilize around the average values of early 2007. Changes introduced since early 2007 in reporting trade with other EU Member States caused further statistical uncertainty about projected foreign trade dynamics in the first half of 2007.

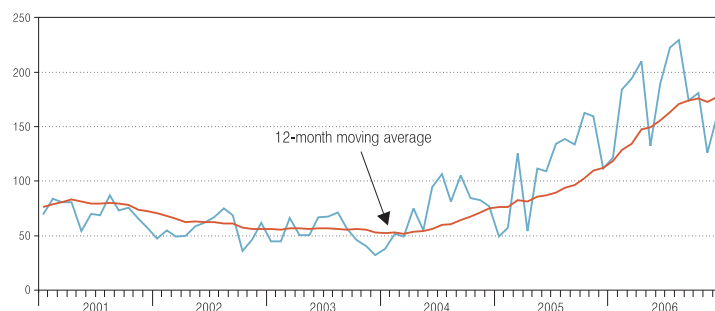
Our expectations of export dynamics by group point to high growth in raw materials over the first quarter of 2007 and in investment goods over the second quarter. Projected real growth in exports of base metals is the main factor in the former group, while exports of machines, transportation vehicles and appliances are expected to retain their upward trends within the latter group.

In 2006 exports of mineral products and fuels posted the highest nominal growth of 57.6 per cent, followed by base metals (52.5 per cent), while animal and plant products recorded the lowest growth (3.9 per cent). Exports of energy resources slightly fell over the fourth quarter (0.2 per cent annually) owing to the lower average price of exported petroleum products and lower revenue from exports of electricity and other products. Exports of petroleum products in 2006 grew annually by 41.6 per cent in physical volume, while the average price (in euro) rose by 15.1 per cent. Our expectations for the first half of 2007 show slight changes in revenue from exports of energy resources compared to the corresponding period of the prior year. Main assumptions underpinning the projected dynamics involve oil price hover around the average levels of early 2007 and offsetting lower revenue from electricity exports by physical growth in exported petroleum products.

Exports of base metals and their products rose by EUR 1089.4 million over 2006, reflecting mostly higher base metal prices on international markets. Exports of copper and its products rose by 82.8 per cent in value and contributed most significantly to overall growth (by 7.3 percentage points). Positive

Chart 64
Exports of Mineral Products and Fuels

(million EUR)



Source: BNB.

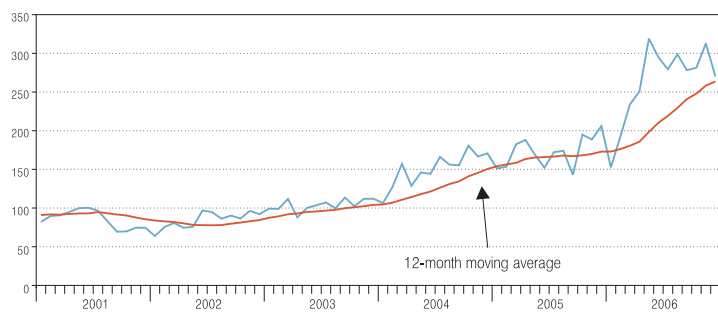
dynamics in exports of cast-iron, iron and steel continued in the fourth quarter of 2006, with the nominal growth over 2006 reaching 16.1 per cent (a contribution of 1.3 percentage points). Our expectations of base metals exports in the first two quarters of 2007 are for progressive positive trends due to favourable competitive positions of this industry on international markets. If the assumptions about metal price declines (on an annual basis) materialize, growth in revenues from exports of these products will slow down. The expanding production capacity which involves an increase in exported physical volumes is a positive driving factor.

In 2006 exports of machines, transportation vehicles and appliances rose by 16.8 per cent, nuclear reactors and boilers (1.3 percentage points) and electrical machines and appliances (1.2 percentage points) contributing most significantly to overall growth. Over the fourth quarter a 1 per cent decline was reported in this group's revenue owing to the negative contribution of sea and river shipping exports. The first half of 2007 will see robust growth in revenue from machines and transportation vehicles exports, with stronger dynamics reported most likely in the second quarter.

Exports of animal and plant products, food, drinks and tobacco continued to increase over the fourth quarter of 2006, with nominal annual growth reaching 3.9 per cent. In the last three months of 2006 oil seeds and fruits had the largest contribution (1.4 percentage points) to overall growth, while cereals' contribution was negative at 0.9 percentage points. Our projections for the first half of 2007 are for moderate growth in revenues from food, drinks and tobacco exports. They are supported by the assumption of relatively stable prices of foods on international markets in the first quarter of 2007 and a slight decrease in the second quarter, along with expectations of physical growth in exports of these products.

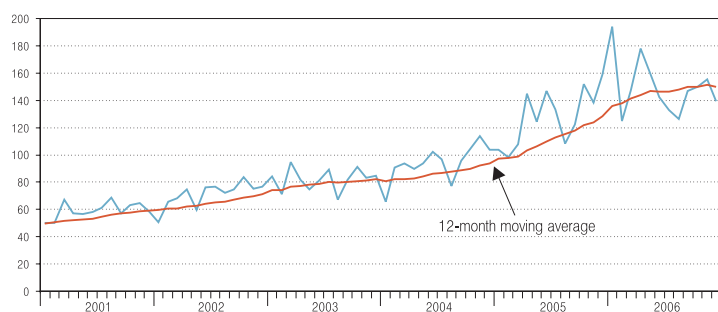
In 2006 imports (CIF) accounted for EUR 18,375 million, a nominal increase of EUR 3707.3 million (25.3 per cent) on the prior year. In the structure of imports by use, the highest growth was recorded by energy resources (34.1 per cent) and raw materials

Chart 65
Exports of Base Metals and Base Metal Products
(million EUR)



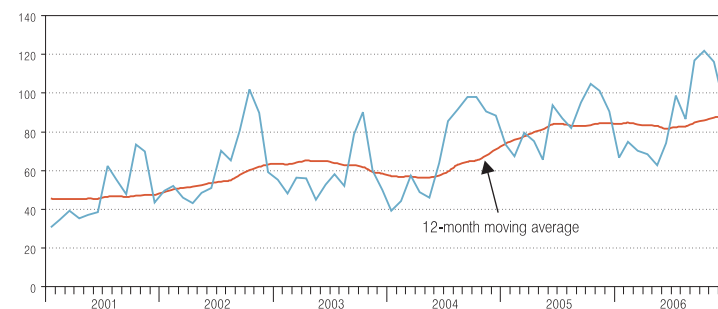
Source: BNB.

Chart 66
Exports of Machines, Transportation Vehicles and Appliances
(million EUR)



Source: BNB.

Chart 67
Exports of Animal and Plant Products, Food, Drinks and Tobacco
(million EUR)



Source: BNB.

(27.7 per cent), their contributions to overall imports growth reaching 6.9 and 10 percentage points.

Imports of energy resources slowed down to 4.8 per cent in the fourth quarter of 2006 reflecting both a decline in oil prices on international markets and lower payments on coal imports. Nevertheless, fuels contributed most significantly (by 6.4 percentage points) to the total increase in nominal imports. The physical growth dominated in Bulgarian crude oil imports as a result of world oil price dynamics. In 2006 the average price of the imported crude oil (in euro) picked up by 17 per cent and its physical volume by 21.3 per cent. Our expectations of stabilizing oil prices on international markets at levels close to those in early 2007 suggest a negative price effect (on an annual basis) of crude oil imports which will be more clearly pronounced in the second quarter. Based on the assumption of a moderate rise in imported oil physical volumes, forecasts indicate nominal payments on imports of energy resources in the first half of the year comparable with those in 2006.

High nominal growth in raw material and feedstock imports was preserved in the fourth quarter of 2006, reaching 27.7 per cent over the year. Total raw material and feedstock imports came to EUR 6742.6 million, with payments exceeding those in 2005 by EUR 1463 million. Within this group, imports of ores, cast-iron, iron and steel and non-ferrous metals contributed most significantly to total growth (by 2.8 percentage points, 1.5 percentage points and 1.4 percentage points respectively). Expectations for the first half of 2007 show a sustainable upward trend in metallurgy's production activity resulting in the steady real growth in imports of ores and metal raw materials. As regards price dynamics, a decline in metal prices is anticipated in the second quarter of the year which will curtail the nominal imports increase.

Imports of consumer goods went up by 23 per cent in the fourth quarter and by 21.1 per cent over the year. Within this group, durable goods (furniture and household equipment, and automobiles) made a major contribution

Table 6

Contribution of Commodity Groups to Trade Growth in 2006

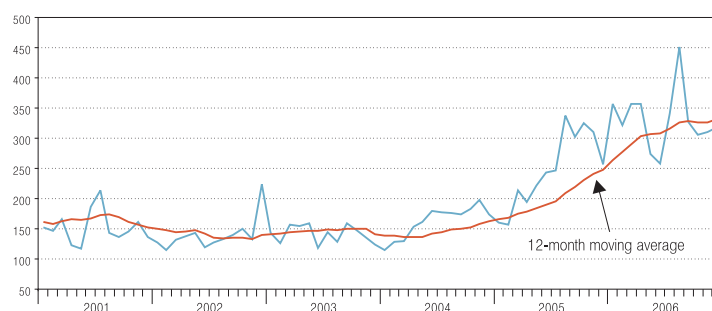
	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	8.0	2.3	21.1	3.2
Raw materials	34.8	14.9	27.7	10.0
Investment goods	17.1	2.6	19.5	5.4
Energy resources	52.2	6.7	34.1	6.9
Other			-19.6	-0.2

Source: BNB.

Chart 68

Imports of Energy Resources

(million EUR)

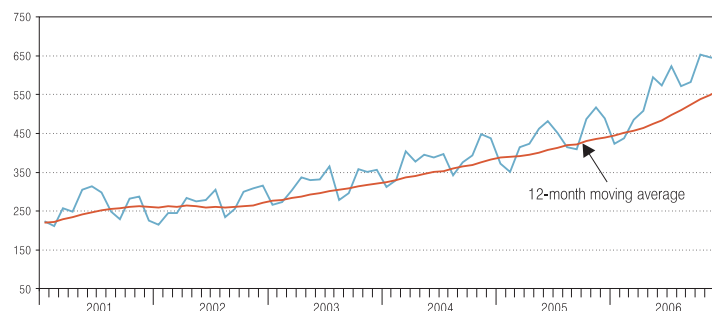


Source: BNB.

Chart 69

Imports of Raw Materials

(million EUR)



Source: BNB.

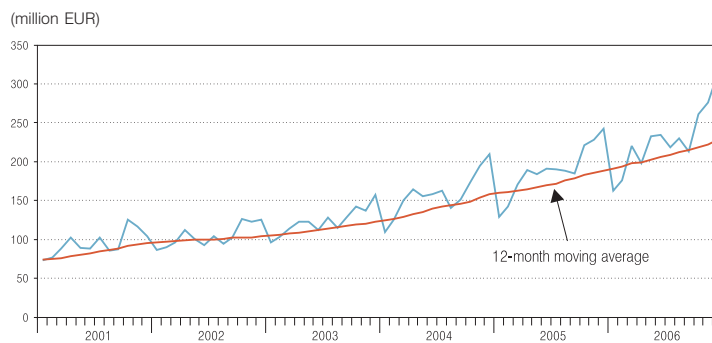
(by 0.9 percentage points and 0.6 percentage points respectively) to annual import growth and correspondingly to trade deficit growth. Total imports of consumer goods came to EUR 2735.3 million: up EUR 476.5 million on 2005. Imports of consumer goods are expected to retain their steady growth rates similar to those of total imports.

Imports of investment goods continued their steady growth in the fourth quarter of 2006, annual growth reaching 19.5 per cent. Following the third-quarter slowdown, imports of transportation vehicles accelerated in the fourth quarter and their annual growth came to 27.3 per cent. Machines, tools and appliances, and transportation vehicles were the investment goods with major contributions to total import growth in 2006 (by 1.6 percentage points and 1.1 percentage points respectively). During 2006 the volume of imported investment goods reached EUR 4818.4 million, these products occupying the second position in imports with a share of 26.2 per cent. Our expectations for the first half of 2007 point to sustainable growth in investment goods imports backed by sustainable enhanced investment activity in Bulgaria.

During the fourth quarter of 2006 Bulgaria's foreign trade geographic structure underwent no substantial changes. The Balkan countries and the Asian region were the trade partners which increased most significantly their shares in Bulgarian exports over the year. Consequently, the Balkan countries occupied 24.3 per cent of goods exports (up 2.6 percentage points on 2005) and the Asian region's share was 7.5 per cent (up 1.1 percentage points). The Balkan countries and the Asian region occupied the largest shares in Bulgaria's exports of energy resources.

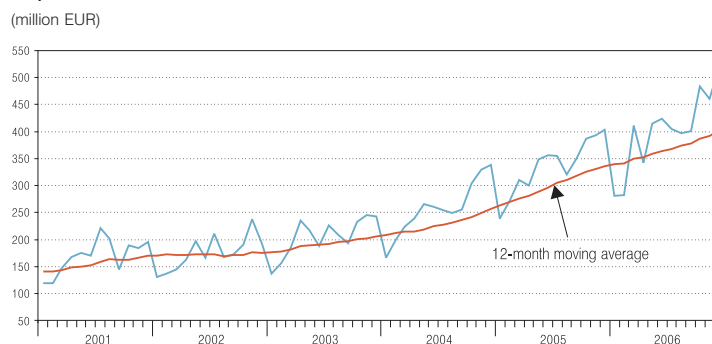
In 2006 exports of goods to the EU countries increased by 23.4 per cent. Comparison between the two major groups shows a significant variation in growth distribution: the old EU members reported a 21.4 per cent growth and the newly acceded ones 44 per cent. Sustained competitive positions of local producers on the European markets underlay the dynamics of the Bulgarian goods' share in EU imports. Bulgarian ex-

Chart 70
Imports of Consumer Goods



Source: BNB.

Chart 71
Imports of Investment Goods



Source: BNB.

ports to the EU countries increased as a share in total imports of these countries from 0.45 per cent in 2005 to 0.49 per cent in 2006.

As regards the structure of Bulgarian imports, the weight of goods of Russian origin registered the most dynamic rise: they comprised 17.3 per cent of total imports in 2006 and reported a 1.6 percentage point increase on the previous year. This trend reflected largely higher average annual prices of crude oil in 2006. Germany and Italy sustained their leading role of Bulgaria's main trade partners, although their share dropped to 12.4 per cent (down 1.2 percentage points) and 8.7 per cent (down 0.3 percentage points). Over the projected time horizon no essential changes in the geographical structure of Bulgaria's foreign trade are expected. A gradual increase in the share of intracommunity trade with the other EU Member States is anticipated in the long run.

Changes in Foreign Trade Statistics: Launching the Intrastat System for Reporting Intracommunity Trade

Following Bulgaria's accession to the European Union on 1 January 2007, the regime of trade with the other Community members (intracommunity trade) and correspondingly the manner of collecting information on these transactions were changed. The current methodology for statistical reporting of exports and imports in 2006 will be applied to foreign trading with third countries (those outside the European Community), while in early 2007 the Intrastat system for statistical reporting of Bulgaria's trade with the other EU countries will be launched. The change in the statistical reporting of external trade (namely the intracommunity trade) will cause structural changes in the available macroeconomic time series and greater uncertainty about projected foreign trade dynamics.

The Intrastat System

Following the accession date, freely tradable goods in an acceding or a member state become freely tradable goods within the expanded Community, and collecting statistical information on goods trading in the Community by the Customs Agency is discontinued. With a view to collecting data on intracommunity dispatches and arrivals, the Intrastat system, designed and maintained by the National Revenue Agency, was launched (in compliance with the Law on Statistics of Intracommunity Merchandise Trade published in Darjaven Vestnik, issue 51 of 2006). Validation and aggregation of data on Bulgaria's intracommunity and foreign trade are carried out by the NSI.

Analysing a Traders' Sample According to Definite Thresholds

One of the major differences between the methodology of reporting exports and imports, applied until the end of 2006 to trade with all countries, and as of early 2007 only with third countries, and the Intrastat system is that the latter is based on an analysis of incomplete data (a sample) instead of aggregated data. In conducting transactions (exports or imports) with third countries, traders are obliged to submit declarations to the Customs Agency and this information is used for statistics purposes. Within the Intrastat system, the parties carrying out intracommunity trade in goods are obliged to provide declarations upon reaching annual physical volumes exceeding definite thresholds. These thresholds are set up by the NSI annually; for the current year exports to the Community (dispatches) total BGN 150,000 and imports from the Community (arrivals) BGN 100,000. Therefore, all transactions with accumulated volumes lower than these thresholds are not subject to declaring by the traders that have no annual obligations.

Launching Further Expert Estimates

The NSI is starting to assess unreported flows in line with the sample principle of collecting data on intracommunity trade. In view of analyzing the character and the anticipated volume of uncovered transactions, the Intrastat system was launched in September 2006. Until the end of December 2006 it was in force together with the exhaustive reporting pro-

vided by the Customs Agency. The NSI is expected to work out a model of further estimating the missing data which will be applied to reporting intracommunity trade as of early 2007. The sample of traders (Intrastat operators) obliged to declare their transactions will be updated on a monthly basis.

Changes in Publication Schedule and Data Revision

The application of the Intrastat system prompted changes in the schedule of collecting, processing, aggregating and publishing data on Bulgarian intracommunity and foreign trade. Preliminary aggregated data will be published within 43 days after the expiry of the reporting month, while preliminary comprehensive data will be prepared not earlier than 74 days after the expiry of the month. A new practice of revising preliminary data has also been introduced. Intrastat operators will be able to send data for adjusting monthly declarations accepted in the current year and until 30 April – declarations accepted in the previous year. This information will require verifying and aggregating. As a result, changes might be made to the new estimates. Thus, our expectations are for regular revisions of aggregated data: data on the previous month are most likely to be revised monthly and data on the current and (probably) the prior year – quarterly. This practice will additionally impede short-term and medium-term analyses.

Uncertainty of Projected Dynamics and Experience of Other EU Member States

Reporting intracommunity trade *via* the Intrastat system from the start of 2007 will cause structural changes in Bulgaria's foreign trade time series and, correspondingly, significant uncertainty about the projected dynamics at the present moment. Analysing comparatively the dynamics of newly acceded countries' trade flows over the 2004 to 2006 period does not allow for explicit conclusions about the effect of the change in reporting. The major problem is that trade flows are impacted more significantly by economic rather than statistical factors, and the two effects cannot be set apart.

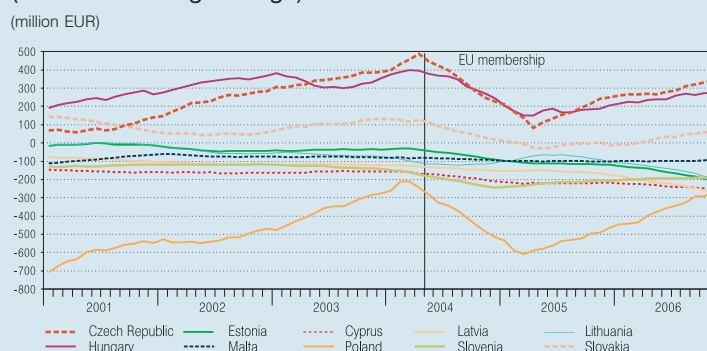
On the one hand, analysing the effect of the new system for reporting intracommunity trade, most new EU countries emphasize lower reliability and higher uncertainty of external trade statistics. Similarly, some of the reports underestimate imports and, to a certain extent, underrecord trade deficit. Thus, according to the August 2005 report of the Hungarian Central Bank on inflation¹, the registered improvement in the external position of the country in the first half of 2005 may reflect an underestimated import volume. Contrary to this hypothesis, one-off factors related to EU membership which caused sizable increases in imports in the second quarter of the year are analysed in present developments in foreign trade in 2004.² Another example of initial underestimation of intracommunity acquisitions and subsequent revision of import data has been provided by Great Britain.³ In the August 2003 report on inflation, a VAT-related fraud is presented which led to underrecording total imports of the other EU countries. Accordingly, the revision of initial data led to an increase in the current account deficit by 0.7 per cent of GDP for 2001 and by 1 per cent for 2002.

On the other hand, available data on the trade of the newly acceded countries with the other EC countries point to worsening trade balances in 2004 and prevailing improvement in the 2005 to 2006 period. This trend is characteristic of almost all new Member States, most clearly pronounced in Poland, the Czech Republic, Hungary, Slovakia and Slovenia, while worsening started in the April to May 2004 period. Countries like Estonia, Latvia, Lithuania and Cyprus also reported worsening, but in contrast to the first group, it was not followed by improvement in the next two years.

Of note is the fact that such a worsening in the period close to the accession was not reported by the newly acceded countries' trade with third countries. In some of the new members (Poland, the Czech Republic and Hungary) improvements in the balances of trade with third countries were registered in the months immediately following their accession. As a result of the divergent dynamics, the total trade balance showed no clearly outlined and systematic effect of the countries' membership in the EU.

With regard to methodological changes, there is no answer to the question to what extent the worsening in the balances of trade with the other EU Member States was underpinned by the changed reporting system and to what extent by the ongoing economic factors during the year, including one-off factors and/or those related to the EU membership.

Chart 72
Trade balance compared with the other EU Member States
(12-month moving average)



Sources: Eurostat (13 February 2007), BNB calculations.

¹ Magyar Nemzeti Bank, *Quarterly Report on Inflation: August 2005*, p. 61.

² Magyar Nemzeti Bank, *Quarterly Report on Inflation: November 2004*, p. 28.

³ Bank of England, *Inflation Report: August 2003*, p. 18.

4. Inflation

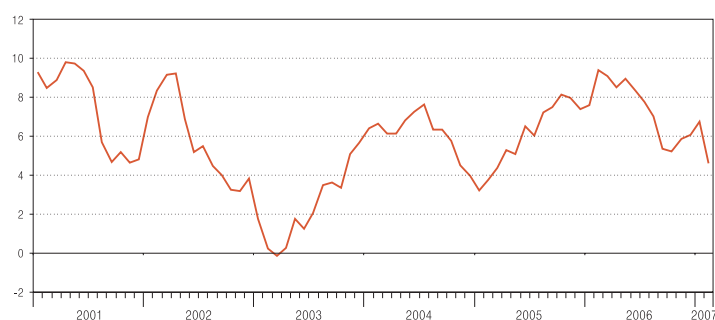
Since the start of 2007 the National Statistical Institute started publishing data on the Harmonized Index of Consumer Prices (HICP) according to the Eurostat methodology. The HICP is the reference criterion for price stability assessment adopted by the ECB and all EU countries which are not members of the euro area. According to the Law on the Bulgarian National Bank, the primary BNB objective is to maintain price stability. The Bulgarian Government and the BNB have set out, presented to the public and follow a clearly outlined strategy of Bulgaria's accession to the euro area in the shortest time. The inflation level measured by the HICP is one of the five criteria for Bulgaria's readiness to adopt the euro.

In compliance with a resolution of the BNB Governing Council of 15 February 2007, the BNB will start using the HICP as a main indicator of the price level in Bulgaria in implementing its primary objective and strategy.

Inflation accumulated in 2006 came to 6.1 per cent: up by 1.31 percentage points on 2005. Tobacco products' price rises stemming from the harmonization of the excise with that in the EU and food price rises had a major contribution to inflation in 2006 (by 2.25 percentage points and 1.38 percentage points respectively). Between early 2007 and end-February a 2 per cent inflation was registered, with foods and services reporting the greatest contributions of 0.82 percentage points and 0.8 percentage points.

The contribution of administratively set prices to overall inflation in 2006 was considerable owing to harmonization of tobacco

Chart 73
Harmonized Index of Consumer Prices
(on an annual basis)



Source: NSI.

Table 7
HICP Inflation Accumulated since Year's Start

	2005	2006	2006	2007
	January – December		January – February	
Inflation, %	7.39	6.08	3.41	2.0
Contribution, percentage points				
Foods	1.68	1.38	0.91	0.82
Non-foods	2.26	2.60	1.98	0.07
<i>Transportation fuels</i>	1.45	-0.18	-0.16	-0.04
Public catering	0.64	0.61	0.13	0.30
Services	2.82	1.49	0.39	0.80
Goods and services with administratively set prices				
Controlled-price goods	1.97	2.91	2.29	0.38
<i>Tobacco products*</i>	0.61	2.28	2.09	0.02
<i>Medical and other pharmaceutical goods</i>	0.22	2.25	2.09	-
Controlled-price services	0.39	0.03	0.00	0.02
<i>Electricity and heating</i>	1.36	0.63	0.21	0.36
	0.38	0.10	0.00	0.00

* As of 1 January 2007 administrative control over tobacco products was discontinued.

Source: NSI.

excise rates with those in the EU. Tobacco products' contribution to accumulated inflation came to 2.25 percentage points. Approved rises in the prices of heating and postal services and in the fares of urban transport had lower contributions (the first two by 0.11 percentage points each and the third by 0.10 percentage points).

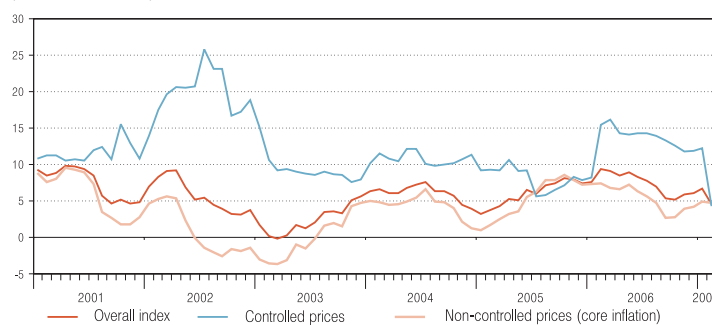
During the fourth quarter of 2006 the contribution of administratively set prices was 0.17 percentage points and it stemmed from the approved 2.8 per cent rise in heating prices on the previous quarter, 1.1 per cent rise in urban transport fares, 0.6 per cent rise in some administrative fees and 8.8 per cent rise in civil liability insurance premiums. A slight depreciation was reported by some medical goods (0.3 per cent) and electricity (0.2 per cent) prompted by the unified electricity tariff adopted by the State Energy and Water Regulatory Commission.

During the first two months of 2007 administratively set prices contributed to overall inflation by 0.38 percentage points owing mainly to the approved rises in the vignette charges (by 60.2 per cent), the prices of medical and hospital services (by 12.5 per cent), medical goods (by 0.57 per cent) and water (by 2.8 per cent), as well as in the fees for setting up a telephone post (by 2.6 per cent). The slight decline in the refuse collection levies (by 0.16 per cent) and in fixed telephone services (by 1.42 per cent) had an opposite effect. Annual inflation of administratively set prices slowed down from 12.1 per cent on average in the fourth quarter of 2006 to 4.3 per cent in February 2007.

During the first half of the year inflation of administratively set prices is expected to moderate due to the exhausted base effect of harmonizing tobacco excise rates in 2006. Projections do not contain any possible rises in heating and electricity since there were no approved price rises by the time the projections were made. In 2007 tobacco products will be excluded from the goods with administratively set prices as a result of the changed trade regime.

Chart 74
Harmonized Price Indices

(on an annual basis)



Source: NSI, BNB.

Core inflation (excluding administratively set prices) declined in the last quarter of 2006, averaging 3.7 per cent on an annual basis. In December 2006 and the first two months of 2007 core inflation rates accelerated owing mainly to rising prices of foods (vegetables and bread). Over the first half of 2007 core inflation is anticipated to hover around 4.5 per cent on an annual basis.

The annual change in food prices averaged 4.8 per cent in the fourth quarter of 2006. Prices of processed foods were impacted by rising international prices of cereals. Higher inflation of 8.1 per cent was reported by the *bread and cereals* group. The annual inflation of sugar products stayed relatively high: 19.1 per cent on average in the last quarter of 2006 (24.3 per cent in the third quarter).

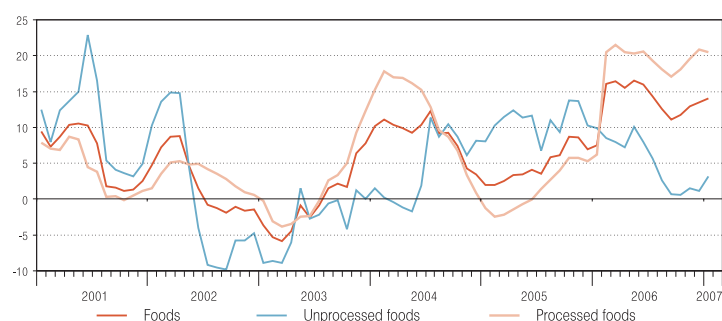
Food inflation accumulated in January and February 2007 came to 3.3 per cent. Accelerating food inflation stemmed from the rise both in cereals and sugar (by 2.1 per cent and 10 per cent respectively) and in vegetables (by 14.6 per cent) since the year start. The group of meat products (mainly pork and chicken meat) contributed negatively to inflation (by 2.5 per cent). Food inflation will retain its rates in the first half of 2007 prompted by possible rises in prices of some food products following Bulgaria's accession to the EU.

Non-food inflation (excluding fuels and controlled-price goods) did not undergo any significant changes, reaching in the fourth quarter of 2006 2.6 per cent on average. It is expected to retain its rates due to decreasing customs tariff rates, on the one hand, and increasing prices of international goods, on the other hand.

Crude oil depreciation in the third quarter and more considerably in the fourth quarter of 2006 resulted in a 2.4 per cent drop in transportation liquid fuel prices and a 0.18 percentage point negative contribution to accumulated inflation. On an annual basis, growth in prices of household fuels (solid, liquid and gaseous) also slowed down, reaching an average of 7.2 per cent in the fourth quarter. The expected stabilization of

Chart 75
Harmonized Price Indices

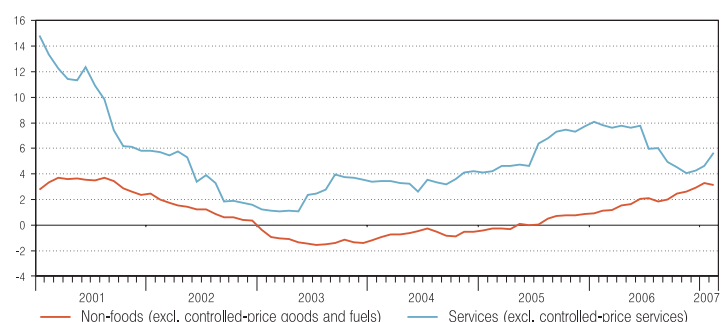
(on an annual basis)



Source: NSI, BNB.

Chart 76
Harmonized Price Indices

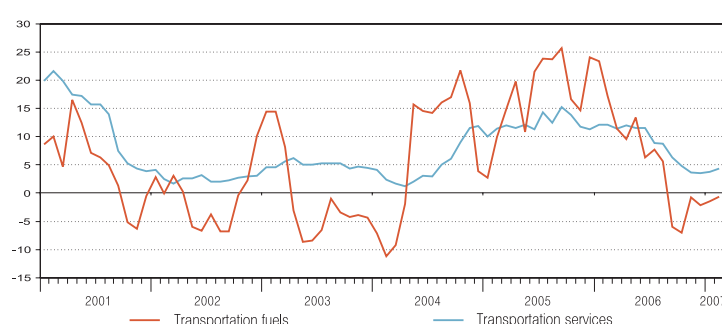
(on an annual basis)



Source: NSI, BNB.

Chart 77
Harmonized Price Indices

(on an annual basis)



Source: NSI, BNB.

crude oil prices on international markets in the first half of 2007 will probably lead to a low negative annual contribution of transportation fuels to inflation in the first and especially in the second quarter of 2007. The fall in oil prices on international markets will be partially offset by higher rises in fuel excise rates in 2007 compared with the scheduled harmonization of excise rates with the EU minima (the unleaded petrol excise picked up from BGN 530 to BGN 635 *per* 1000 l and the diesel excise from BGN 430 to BGN 535 *per* 1000 l).

Services price inflation (excluding controlled-price services) fell to an average of 3.9 per cent on an annual basis in the fourth quarter of 2006. The factor behind this was the slowdown in inflation of transportation services to 4.3 per cent on average in the reporting quarter.

Total inflation dropped to an average of 5.7 per cent on an annual basis in the fourth quarter of 2006 and a further slowdown is anticipated in the next two quarters. Administratively set prices and especially prices of tobacco products will have the greatest contribution to this fall. In 2006 the average HICP inflation was 7.4 per cent. The price effects of Bulgaria's accession to the EU are not expected to reverse the downward trend in average annual inflation over the first quarter of 2007.

Harmonized Index of Consumer Prices¹

The Harmonized Index of Consumer Prices (HICP) measures the general relative change in the price level of goods and services used by households for final consumption on the territory of Bulgaria. Its purpose is to measure inflation in EU Member States on a comparable basis, taking into account differences in national definitions.

Unlike the national Consumer Price Index (CPI), the HICP is computed by the so called 'domestic concept' of measuring the CPI which includes the effect of consumption of non-residents in Bulgaria on consumer price dynamics; it also includes second-hand cars in the consumer basket. Sources of data for weight construction are also different, and hence, the time period of HICP weights and CPI weights. National accounts are the main data source for computing HICP weights. The computation of HICP in the current year t is based on national account weights for the last three years, $t-3$. The main data source for computing CPI weights is the household budget survey. The computation of CPI in the current year t is based on weights of household expenditure under the household budget survey for the previous year, $t-1$.

NSI will continue to compute and publish the CPI together with the HICP. The divergent dynamics of the CPI and HICP will be defined by the different weights of individual commodity groups used in computing the two price indices. The main changes in the structure for 2006 are related to *Foods and soft drinks* (the weight in the HICP declined by 13.7 per cent compared with that in the CPI) and *Transport* (the weight in the HICP rose by 12.4 per cent). A decrease was also reported by *Housing (rents, current repair and maintenance)*, *water, electricity, gas and other fuels* (-6 per cent), while the weight of the *Restaurants and hotels* group went up (+6.1 per cent). The annual HICP inflation for 2006 came to 6.08 per cent and the national CPI to 6.49 per cent. In January 2007 HICP inflation comprised 1.62 per cent and CPI inflation 1.47 per cent.

	January – December 2006								
	weight	CPI Infla- tion	contri- bution	weight	HICP Infla- tion	contri- bution	weight	Change Infla- tion	contri- bution
TOTAL		6.49			6.08			-0.41	
Foods and soft drinks	35.9%	5.20	1.90	22.2%	5.45	1.23	-13.7%	0.25	-0.67
Alcoholic drinks and tobacco products	4.9%	57.31	2.78	4.3%	56.25	2.40	-0.6%	-1.06	-0.38
Clothing and footwear	4.3%	4.90	0.21	4.2%	4.99	0.21	-0.1%	0.10	0.00
Housing (rents, current repair and maintenance), water, electricity, gas and other fuels	17.4%	2.98	0.52	11.5%	2.89	0.33	-6.0%	-0.09	-0.19
Home furnishings, household appliances and accessories	4.2%	3.43	0.14	4.0%	3.58	0.14	-0.2%	0.14	0.00
Healthcare	6.0%	1.81	0.11	5.2%	2.48	0.13	-0.7%	0.67	0.02
Transport	7.2%	1.44	0.11	19.6%	1.38	0.27	12.4%	-0.06	0.17
Communications	6.4%	-0.23	-0.01	7.8%	1.01	0.08	1.4%	1.24	0.09
Leisure, entertainment and recreation	3.9%	2.91	0.11	5.3%	3.35	0.17	1.4%	0.44	0.06
Education	0.7%	6.39	0.04	1.3%	6.40	0.08	0.6%	0.00	0.04
Restaurants and hotels	5.0%	6.91	0.35	11.2%	7.28	0.82	6.1%	0.37	0.47
Miscellaneous goods and services	4.2%	6.12	0.25	3.5%	6.62	0.23	-0.7%	0.51	-0.02
Foods	37.2%	5.37	2.03	23.4%	5.79	1.38	-13.7%	0.42	-0.65
Non-foods	30.0%	11.35	3.38	30.9%	8.51	2.60	0.9%	-2.84	-0.77
Catering	4.7%	6.75	0.32	9.1%	6.75	0.61	4.3%	0.00	0.29
Services	28.1%	2.75	0.76	36.6%	3.93	1.43	8.5%	1.18	0.67

Sources: NSI, BNB.

Cumulatively, changes in the consumer basket reflected lower inflation for 2006 (6.5 per cent in CPI and 6.1 per cent in HICP respectively). Foods and excise goods (cigarettes and tobacco products) were the main factors behind this, with a total 1.0 percentage point decrease in the contribution to overall inflation, thus offsetting the total 0.6 percentage point increase in the contribution of the *Restaurants and hotels* and *Transport* groups.

Lower HICP inflation for 2006 should not imply that the HICP will report slower inflation rates than the CPI. The smaller weight of foods will make the index less sensitive to changes in food prices and monthly fluctuations in inflation, while the sensitivity of the HICP to changes in prices of fuels and transportation services will increase in line with their growing weight in the consumer basket.

¹ The methodology of computing the HICP is available on the NSI website (www.nsi.bg).