

Economic Review

2/2007



BULGARIAN
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Economic Review

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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.

The *Economic Review*, issue 2/2007 was presented to the BNB Governing Council at its 7 June 2007 meeting. It employs statistical data published up to 23 May 2007.

The estimates and projections published in this issue should not be regarded as advice or recommendation. Exclusively the information user is liable for any consequences thereof.

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

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Abbreviations

BIR	Base interest rate
BOP	balance of payments
BTC	Bulgarian Telecommunications Company
b. p.	basis points
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
EA	Employment Agency
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
FOB	Free on board
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
HRW	hard red wheat
IEA	International Energy Agency
IMF	International Monetary Fund
ISM	Institute for Supply Management
LIBOR	London Interbank Offered Rate
M1	narrow money
M2	M1 and quasi-money
M3	broad money
MF	Ministry of Finance
mt	metric tons
NPISHs	Non-profit institutions serving households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
p. p.	percentage points
PPP	Purchasing Power Parity
WB	World Bank
WTI	West Texas Intermediate

Summary

Global economic indicators show signs of declining optimism which, coupled with lower world trade growth, point to a possible global growth moderation in the second and third quarters of 2007. In Bulgaria, economic growth is expected to retain its high rate over the second and third quarters, domestic demand contributing most significantly to this. Current information on retail sales and revenue supported the expectations of consumer demand sustainability. Labour market situation continued to improve, boosting consumer confidence and driving high consumer activity. Industrial sale statistics of supply show retention of high economic activity. Industrial sales in the first quarter of 2007 rose by 7.3 per cent on the corresponding quarter of 2006. Business optimism also remained high. The above trends give grounds to expect high investment activity in 2007.

Intensive restructuring and high return on investments in Bulgaria attracted a sizable volume of financial resources (foreign direct investments and external loans) which contributed to economic growth acceleration and robust investment activity. The inflow of foreign direct investments into Bulgaria throughout 2006 and high investment and production activity boosted imports of investment goods and raw materials. Despite the relatively high goods export rates, faster import growth led to worsening of the trade balance and balance of payments current account in 2006, with foreign direct investment covering over 100 per cent of its deficit. In early 2007 the external position analysis became more complicated given the changes in foreign trade statistical reporting (the Intrastat system). Since previously published data on goods exports and imports are incomplete, they will undergo essential revisions in 2007 and early 2008.¹ To this end, balance of payments evaluation could be more reliable if it was based on indicators not subject to changes in statistical reporting, such as financial account dynamics and international reserves.

Financial account and international reserve data show no significant changes in Bulgaria's external position. Between January and March 2007 balance of payments financial account surplus was EUR 1548.4 million (an increase of almost EUR 700 million on the first quarter of 2006). Positive overall balance boosted BNB reserves by EUR 31.4 million (excluding valuation adjustments) in the first quarter of 2007. The Issue Department balance sheet figure reached BGN 17,564.7 million (EUR 8980.7 million) as of end-March 2007, up BGN 3841.7 million on March 2006 and BGN 106.2 million on end-2006. Capital inflow into Bulgaria will remain high in the second and third quarters of 2007, with the financial account surplus entirely covering current account deficit and boosting international reserves. Their dynamics within the Issue Department balance sheet shows a BGN 182 million increase in early June compared to March, though in the beginning of May BNB liabilities to commercial banks (and correspondingly international reserves) declined as a result of releasing banks' additional minimum reserves to the amount of BGN 966 million.

Releasing funds after lifting administrative constraints on bank credit growth will lead to a significant moderation in reserve money growth in the coming two quarters. Growth in currency in circulation and broad money will remain at first quarter's levels. In the first quarter claims on the non-government sector rose by BGN 2692.8 million (BGN 327.9 million over the same period of 2006), with annual growth accelerating from 24.6 per cent by end-2006 to 36.6 per cent in March and 39.3 per cent in April 2007. Credit activity reflected favourable macroeconomic trends and robust credit demand by corporations and households, as well as abolishment of BNB constraints on lending growth. Accelerated growth rates of credit to the private sector were partially driven by loans sold during the period of administrative constraints and brought back to banks' balance sheets, as well as by corporate sector's shifts from foreign to domestic credit. Bank lending will remain robust in the coming two quarters. No significant changes are expected in lending interest rates over the second and third quarters.

¹ You can find details on these changes in *Economic Review* (1/2007), p. 42–43, and in this issue on p. 40. Further information on the methodology of collecting data under the Intrastat system is available on the BNB and NSI websites.

Since early 2007 annual HICP inflation has tended to decline, and this trend is expected to continue in the second and third quarters provided favourable weather conditions and stable domestic prices of transportation fuels are sustained. Risks to the projection stem from a new electricity price rise (affecting producers – public suppliers – electric distribution companies – household and industrial consumers) which the State Energy and Water Regulatory Commission may approve, as well as from firms' pricing policies due to energy market liberalization expected in July.

1. External Environment

Leading world economies are expected to post moderate growth in the second and third quarters of 2007. Mid-May expectations point to an increase in interest rates on ECB main refinancing operations by 25 basis points in June and no changes in US federal funds interest rates.

Current Business Situation

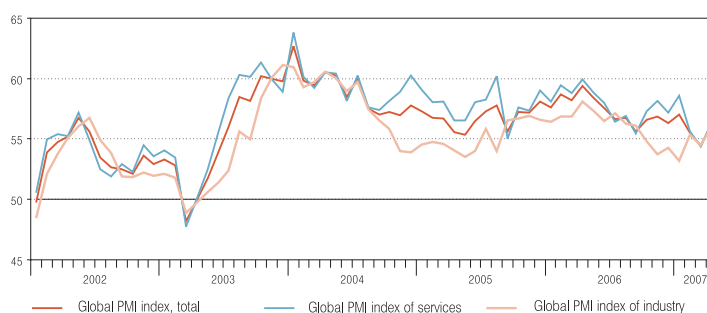
The first quarter saw a further decline in global economic indicators, reflecting mainly significantly decreased optimism in the services sector. In addition to this, the slowing growth rate of world trade is a sign of global growth moderation. Growth rates in the euro area and the USA are expected to slow down, whereas those in Asian economies are likely to remain relatively stable. Risk of greater-than-expected growth moderation may arise from higher energy prices and geopolitical uncertainty around Iran's nuclear programme.

Euro Area

Preliminary data put euro area GDP growth at 3.1 per cent annually in the first quarter of 2007 (3.3 per cent in the prior period). Expectations of a significant negative effect associated with the increased VAT rate in Germany did not materialize. High investment activity in the business sector and exports growth contributed further to overall growth, while household consumption remained still below the long-term median.

Since early March PMI in industry and services have stayed above the level of 50 which supported expectations of relatively high growth rates of these sectors. Positive signals came from business climate indicators and European Commission consumer confidence index, hitting peak values in the second quarter. Consumer confidence growth has not yet materialized in high investment activity but fundamental factors for its growth in the future improved (employment and real income growth). Given the

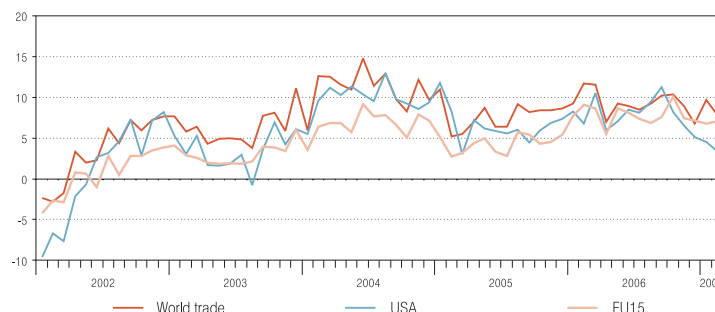
Chart 1
Global PMI Indices



Sources: NTC Research, JP Morgan.

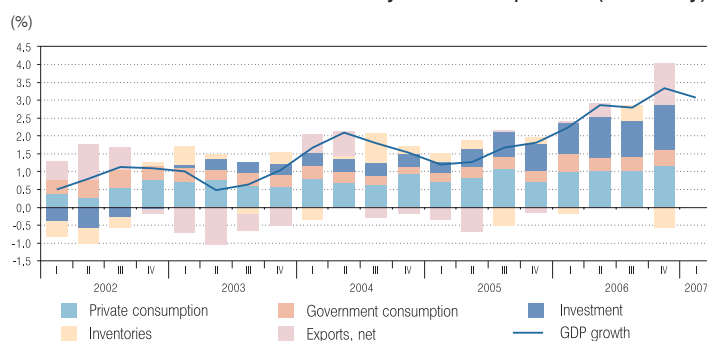
Chart 2
World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

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



Source: Eurostat.

latest data, euro area economy is expected to sustain its expansion trend in the second and third quarters.

Short-term risks to economic growth stem from volatile oil prices and their negative effect on consumer purchasing power, as well as from reduced foreign demand due to moderation in global economic activity.

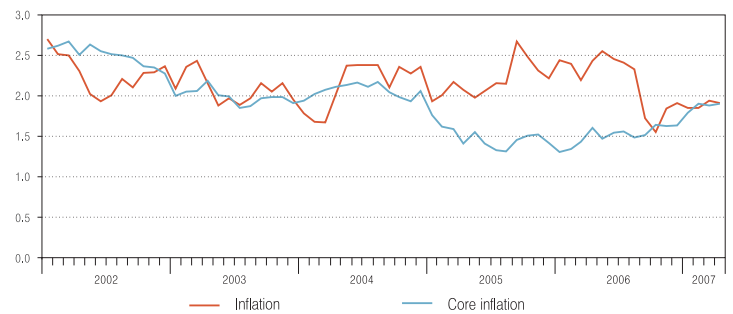
Over the first four months of 2007 euro area HICP and core inflation remained below 2 per cent on an annual basis. The previous year's base effect caused by fuel prices was the major factor behind low inflation rates. This effect is expected to drive inflation dynamics in the second and third quarters.

Continuing downward trends in the annual growth of unit labour costs and robustly rising labour productivity contributed to retaining core inflation at current levels in the coming quarters.

The outlook for euro area HICP inflation shows no essential changes in the first and second quarters and a possible rise above the 2 per cent level in the second half of the year due mostly to the exhausted base effect.

Chart 4
Euro Area Inflation Rate

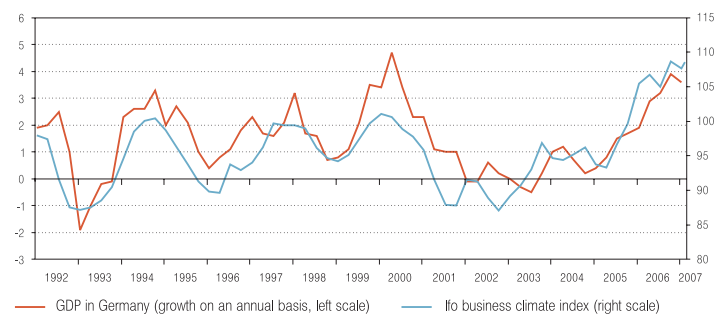
(percentage change on same period of previous year)



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

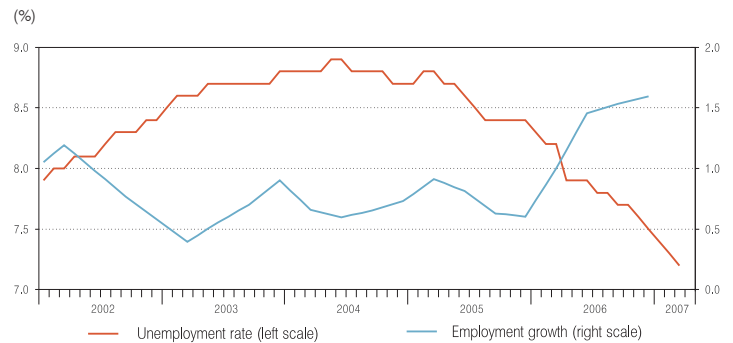
Source: Eurostat.

Chart 5
Economic Growth and Business Climate in Germany



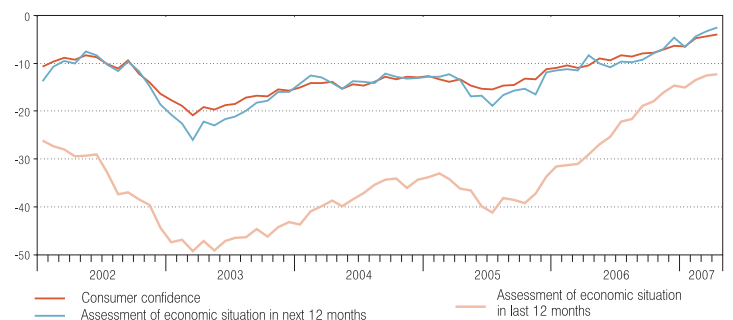
Source: Bloomberg.

Chart 6
Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

Chart 7
Euro Area Consumer Confidence Indices



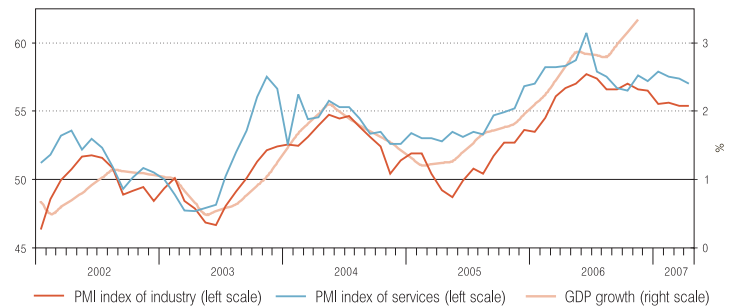
Source: Eurostat.

Upside risks to inflation stem from wage negotiations and the outrunning rise in producer prices which is likely to be spread on consumer prices. Much uncertainty exists about oil price developments, with possible rises threatening medium-term price stability.

At its early May meeting, the ECB Governing Council decided to leave the key interest rates unchanged at 3.75 per cent, expressing intentions to raise it to 4.00 per cent at the June meeting. Despite consumer price growth moderation in the first months of 2007, the ECB warns that risks to the medium-term outlook for price stability remain on the upside.

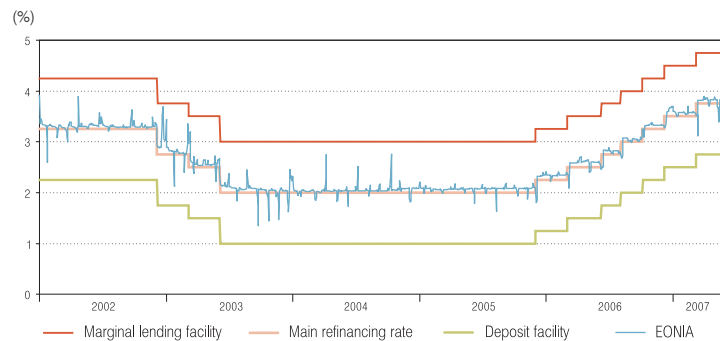
Market expectations as of end of May pointed to a 25 basis point repo rate rise to 4.00 per cent in early June which will be followed by another 25 basis point increase in the third quarter. Provided these expectations are retained until the close of the third quarter, the 6-month EURIBOR is expected to vary within the 4.00 to 4.50 per cent band.

Chart 8
PMI Indices and Euro Area Growth



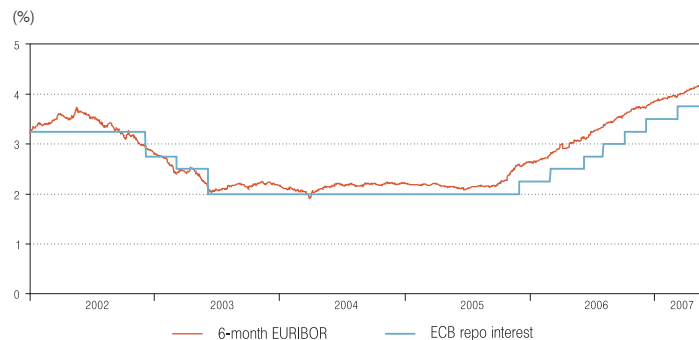
Source: NTC Research.

Chart 9
Euro Area Interest Rates



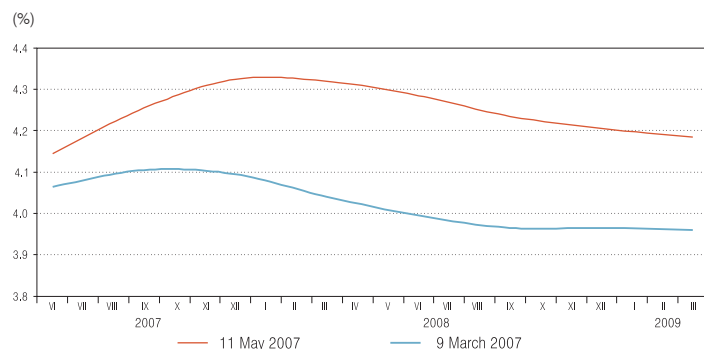
Source: Bloomberg.

Chart 10
ECB Repo Interest Rate and Six-month EURIBOR



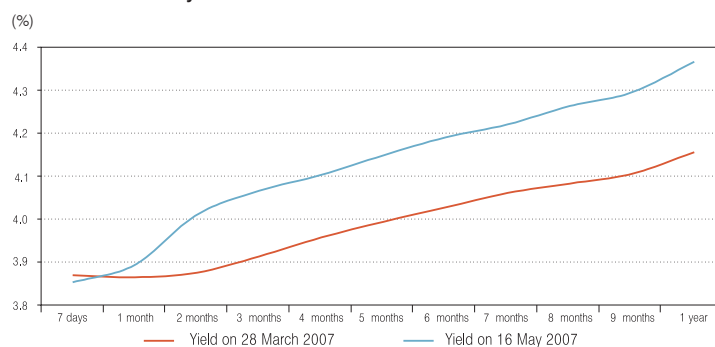
Source: Bloomberg.

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



Source: Bloomberg.

Chart 12
Euro Area Money Market Yield Curve



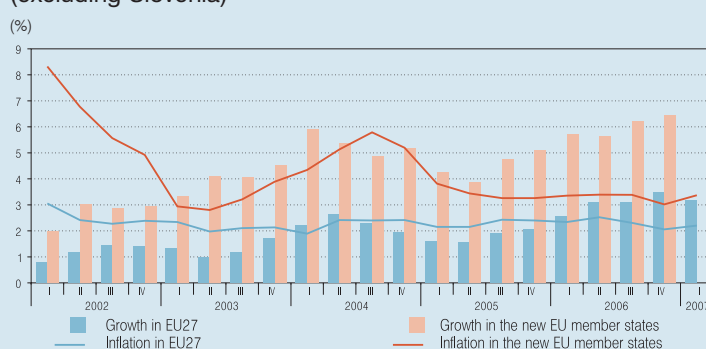
Source: Bloomberg.

EU11¹

In the fourth quarter of 2006 EU11 growth accelerated to 6.5 per cent on an annual basis, from 6.2 per cent in the prior quarter. Average monthly inflation in the new Member States rose to 3.4 per cent, reflecting fuel price rises. As a result of robust economic activity in 2007, most countries reported relatively high current account deficits.

¹ EU11 includes newly acceded EU countries, excluding Slovenia. As from 1 January 2007 Slovenia became a full-fledged member of the European Monetary Union.

Chart 13
Growth and Inflation in EU27 and New EU Member States (excluding Slovenia)

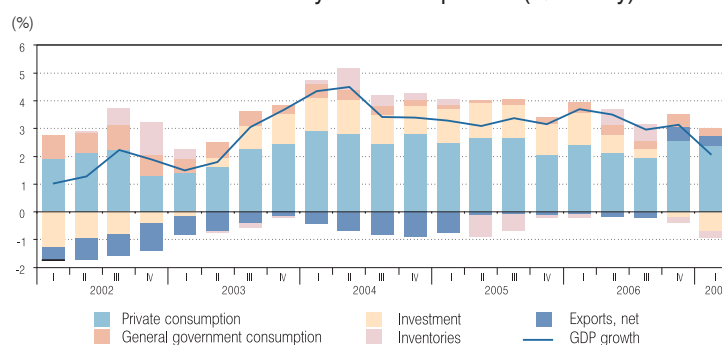


Sources: Eurostat, own calculations.

The USA

US economic expansion moderated further in the first quarter, with GDP posting the lowest growth in the last four years. Economic activity slowdown reflected mainly the continued recession in the real estate sector resulting in a significant fall in housing investment. Trade deficit worsening was due to higher world oil prices and correspondingly higher value of imported oil. The US dollar depreciation since early 2007 and favourable developments of US major trade partners' economies have not yet caused a significant rise in exports. Consumer activity retained its high level, underpinned by employment and disposable income growth and appreciated household assets in the form of shares. Prevailing expectations are for economic growth to stabilize around levels lower than those in the last ten years. The April IMF *World Economic Outlook* re-

Chart 14
Contribution to US Growth by GDP Component (Quarterly)



Source: Bureau of Economic Analysis.

Chart 15
US GDP and Employment Growth



Sources: Bureau of Labor Statistics, BEA.

vised downwards its projections of US economic growth to 2.2 per cent in 2007 against an average growth of 3.5 per cent between 2004 and 2006.

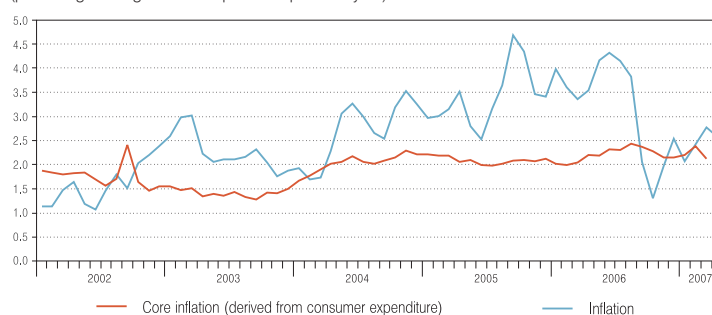
Labour market lags behind the business cycle, still remaining stable amid economic growth moderation. The latest data for April show that unemployment reached 4.5 per cent, close to the lowest values in the previous cycle of economic expansion. Remuneration and labour productivity dynamics show that labour market still exerts inflationary pressure on economy.

Inflation measured by the personal consumption expenditure deflator rose by 0.2 percentage points in the first quarter to 2.4 per cent in March. Core inflation which excludes changes in food and fuel prices came to 2.1 per cent in March, posting a decrease on the previous month. Core inflation is expected to continue falling in the context of moderate economic growth and projected cyclical worsening of labour demand.

Current core inflation levels exceed the Federal Reserve System implicit reference value for price stability. The existing inflationary pressure was the major reason for the FOMC to leave interest rates unchanged over the first quarter. The Federal Reserve System continues to stress that inflation remains a threat to economy and no interest rate cuts are expected in the near future. Mid-May market expectations did not point to a change in the reference rate until the end of the third quarter of 2007. If current market participants' projections are retained, the six-month LIBOR deposit rate in USD will vary between 5.20 and 5.45 per cent until the end of the third quarter.

Chart 16
US Inflation Rate

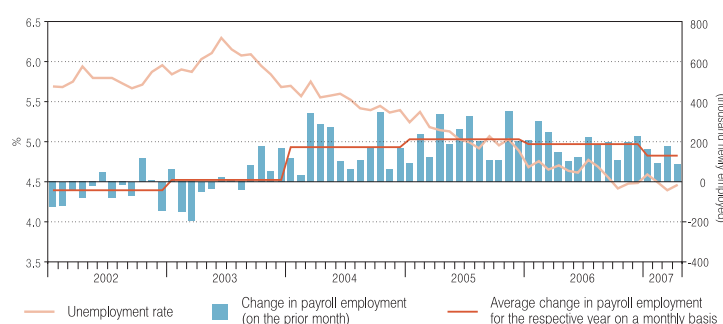
(percentage change on same period of previous year)



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

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

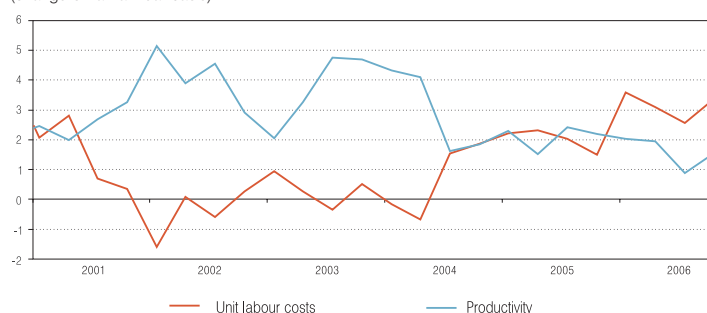
Chart 17
US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labor Statistics.

Chart 18
US Productivity and Unit Labour Costs

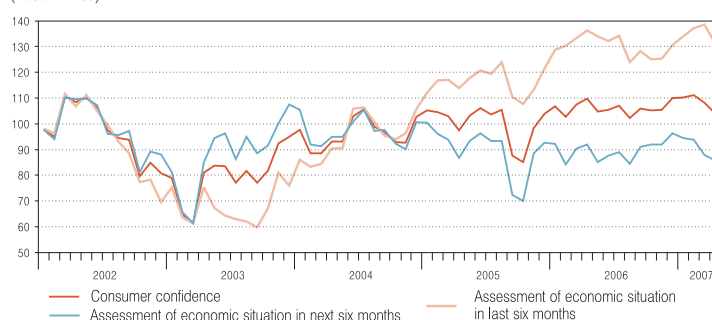
(change on an annual basis)



Source: Bureau of Labor Statistics.

Chart 19
US Consumer Confidence Indices

(1985 = 100)



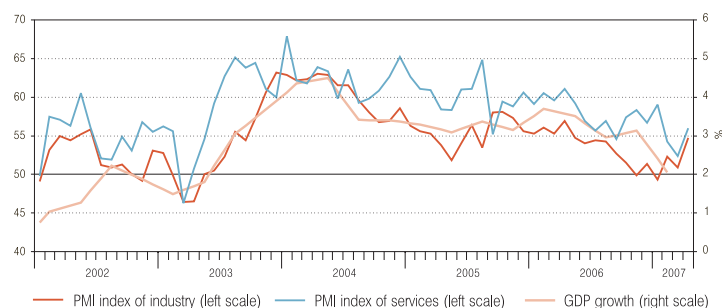
Source: The Conference Board.

The USD/EUR Rate

In the second quarter of 2007 the USD/EUR rate fluctuated within a wide band, with the US dollar tending to depreciate. More and more signs of US economic activity slow-down coupled with euro area interest rate rises were the major reasons behind this. At the end of April net speculative EUR positions reached their peak levels, while the US dollar lost almost 2 per cent of its value against the euro. Market volatility lessened in mid-May when the EUR/USD rate consolidated near 1.35.

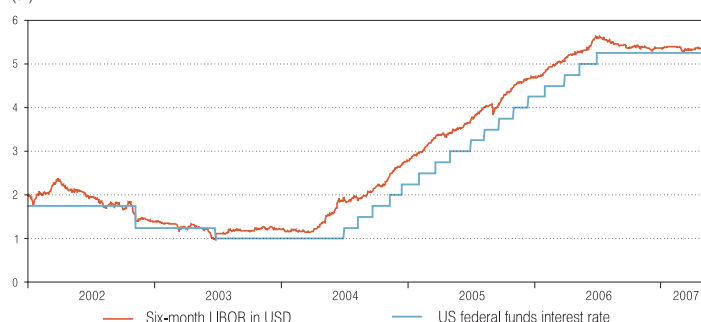
The USD/EUR exchange rate is expected to fluctuate within a wide range over the coming two quarters, with prevailing market expectations of further US dollar depreciation. They are supported by projections of higher short-term interest rates in the euro area which suggests a further narrowing interest rate differential in favour of the euro.

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



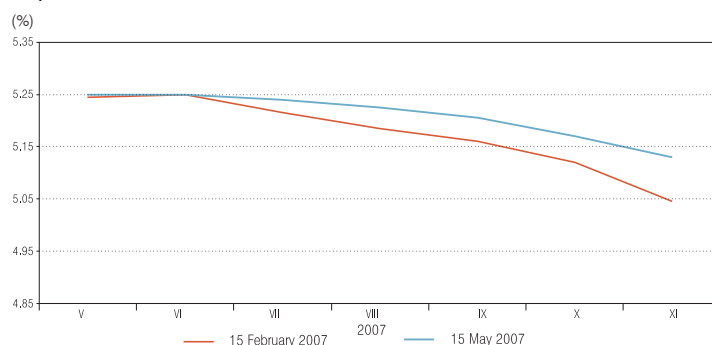
Source: Institute for Supply Management.

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



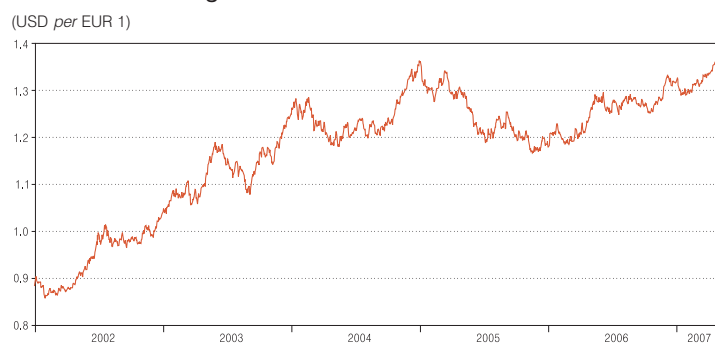
Source: Bloomberg.

Chart 22
Implied Federal Funds Futures Interest Rate (%)



Source: Bloomberg.

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



Source: ECB.

The Balkan Region

Economic growth in the Balkans remained high, reflecting mainly robust foreign investment and vigorous domestic demand. Romania, Turkey, Bulgaria, and Serbia posted the highest GDP growth. Inflation in the region moderated over the first quarter of 2007 due to fuel price deflation. High economic activity rates are expected, with a slight slowdown in the third quarter as a result of expected moderation in external demand.

Table 1

Real Growth and Inflation in Balkan Countries (Quarterly)

	2005					2006					2007
	I	II	III	IV	Total	I	II	III	IV	Total	I
Growth (on the previous year, %)											
Bulgaria	6.6	7.3	5.4	6.0	6.2	5.5	6.4	6.7	5.7	6.1	4.6
Greece	3.5	3.8	3.8	3.8	3.7	4.2	4.2	4.5	4.4	4.3	
Macedonia	2.7	4.8	3.9	3.6	3.8	2.2	3.4	4.0	2.6	3.1	
Romania	5.9	4.5	2.4	4.2	4.1	6.7	7.7	8.2	7.6	7.2	
Turkey	6.6	5.5	7.7	9.5	7.4	6.7	8.3	4.8	5.2	6.1	
Croatia	1.8	5.1	5.2	4.8	4.3	6.0	3.6	4.7	4.8	4.8	
Serbia	4.6	7.8	7.4	5.0	6.2	7.0	5.9	5.3	5.0	5.7	
Inflation (averaged for the period, %)											
Bulgaria	3.8	5.6	6.9	7.8	6.0	8.7	8.6	6.7	5.7	7.4	5.3
Greece	3.4	3.2	3.8	3.5	3.5	3.2	3.4	3.5	3.2	3.3	2.9
Macedonia	-0.4	0.9	0.8	0.8	0.5	2.7	3.4	3.6	3.1	3.2	0.7
Romania	8.9	9.9	9.0	8.5	9.1	8.7	7.2	5.9	4.8	6.6	3.9
Turkey	8.6	8.6	7.9	7.6	8.2	8.1	9.6	10.8	9.8	9.6	10.3
Croatia	3.1	3.0	3.4	3.8	3.3	3.5	3.8	3.2	2.2	3.2	1.6
Serbia	15.9	16.4	15.5	16.6	16.1	14.6	14.2	11.4	7.1	11.8	4.8

Sources: Statistical institutes and central banks of respective countries.

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

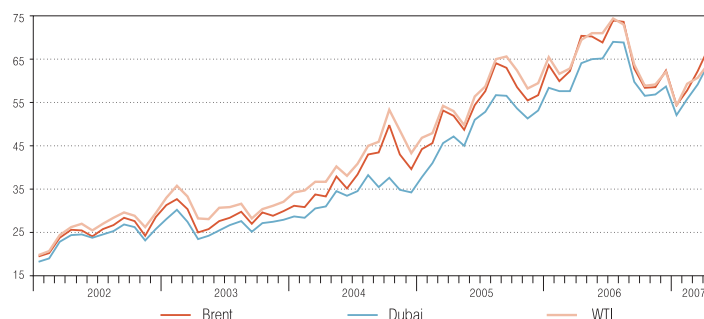
Crude Oil

In the first quarter of 2007 the average monthly Brent crude oil price fell by 2.8 per cent on the previous quarter to USD 57.1 *per barrel*, reflecting the mild winter in the northern hemisphere and lessening geopolitical uncertainty. Lower demand for heating fuels led to much slighter declines in OECD countries' inventories.

Major factors contributing to oil price rises which started at the end of the first quarter include: reduced supply by OPEC countries, technical problems in some large US refineries, terrorist attacks against oil facilities in Nigeria and renegotiations on Iran's nuclear programme. Reflecting these factors, in the middle of the second quarter markets significantly increased the risk premium for a potential supply disruption, with the Brent crude price reaching USD 70 *per barrel*.

Chart 24
Crude Oil

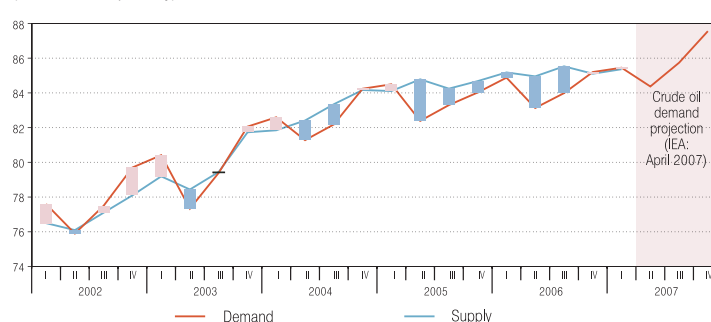
(USD *per barrel*)



Source: World Bank.

Chart 25
World Crude Oil Demand and Supply
(Quarterly)

(million barrels *per day*)



Source: IEA.

The average monthly Brent price is expected to fluctuate within the range of USD 65–70 *per barrel*. Risks to the projection stem from terrorist attacks against oil facilities in Nigeria and increasing geopolitical uncertainty around Iran's nuclear programme.

Major Raw Material and Commodity Prices

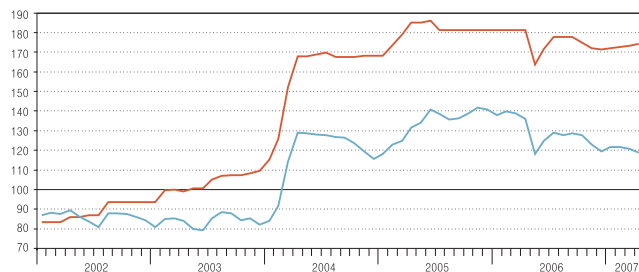
Metal prices growth moderated in the first quarter, reflecting the eased pressure of demand and lower industrial activity. Nonetheless, most metal inventories stayed low in the first five months due to supply problems. After a 16 per cent fall in the first quarter of 2007 on the previous quarter, the copper price rose by 35 per cent in April and May.

Steel output posted high growth rates, thus contributing to price falls by 4.8 per cent on an annual basis.

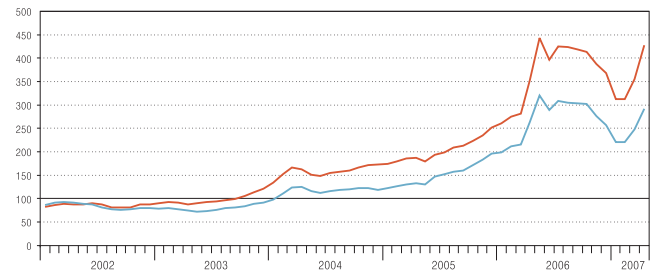
Metal prices are expected to stay high in the second and third quarters of 2007.

Chart 26
Price Indices of Major Commodities and Commodity Groups
(2000 = 100)

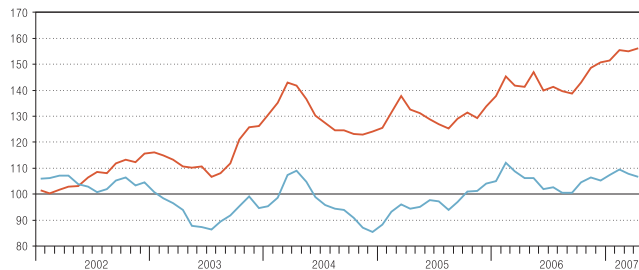
Steel



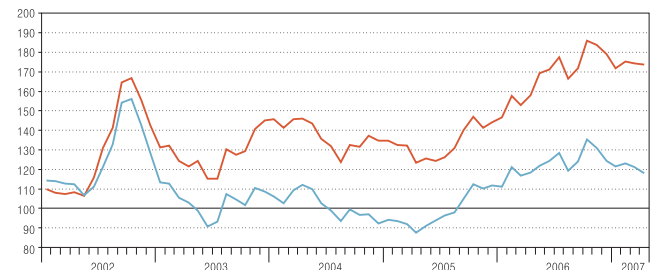
Copper



Food



Wheat



— USD

— EUR

Sources: World Bank, BNB.

Over the first quarter food prices continued to rise, though at lower rates of 7.7 per cent on an annual basis. The upward trend in cereal prices in the previous two quarters was sustained, with corn, wheat and rice increasing by 62.2 per cent, 14.1 per cent and 6.1 per cent on an annual basis. The current season projections point to high crops in the USA, Russia, Ukraine and Australia. However, significant declines in inventories over the previous year will result in lower exports from major export countries since they are expected to earmark a large portion of their production for inventories.

Growing demand for bio-fuels pushed up some food prices. They are expected to rise further in the second and third quarters of 2007. Low crop yields as a result of April droughts and heat will be another factor driving cereal price dynamics in the EU.

Gold

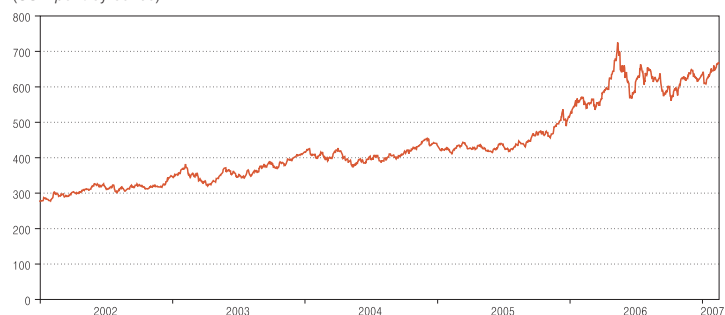
During the first months of 2007 gold's strong technical dependence on the US dollar exchange rate on international markets was sustained. The major factors behind gold price rises in the first quarter were US currency depreciation, petrol price dynamics and global uncertainty.

In the first quarter and at the beginning of the second quarter of 2007 crude oil prices picked up and steadied at levels over USD 60 *per barrel*, backing the increase in the stock exchange gold price to USD 670–690 *per troy ounce* in reply to growing inflationary risks. World Gold Council data show that in the first quarter of 2007 global turnover of the physical gold market came to USD 17.4 billion: up by 22 per cent in US dollar terms on annual basis but by only 4 per cent in physical terms.

In the second and third quarters of 2007 a slowdown in physical demand is expected as a result of seasonal factors. The speculative demand is anticipated to stay high due to the growing popularity of gold ETF funds and still high levels of global liquidity. Gold futures prices will probably fluctuate within the corridor of USD 650 to USD 690 *per troy ounce*.

Chart 27
Spot Price of Gold

(USD *per troy ounce*)



Source: The London Bullion Market Association.

Bulgarian External Debt Dynamics on International Financial Markets

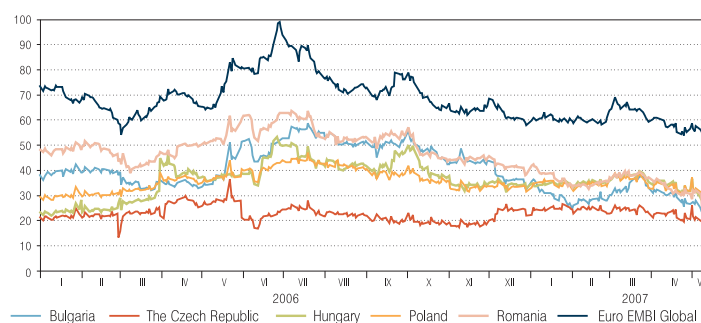
The yield spread of the emerging markets government debt measured by the JP Morgan Euro EMBI Global index remained unchanged in the first quarter of 2007. The short period of instability on stock exchange markets at the start of March resulted in a temporary jump in the risk premium on the global financial markets, and on 5 March 2007 the Euro EMBI Global reached its highest value for the period. Following the global trends, the risk premium of central and eastern European countries' debts stayed close to the previous year's levels.

The yield spread of the Bulgarian government debt measured by the Euro EMBI Global index posted minimum growth of 2 basis points to 34 basis points. By mid-May the spread hit its historically lowest value of 18 basis points. During this period the Bulgarian spread was lower than those of Poland, the Czech Republic, Hungary, Lithuania and Romania.

An important indicator of market expectations about the credit risk of Bulgaria and Romania, the newest EU members, is the credit swap (CDS) on government debt. In the first quarter of 2007 the spread on the five-year liquidity agreement ensuring against insolvency risk fell to the average of 18.5 basis points for Bulgaria and to 19.7 basis points for Romania. Since mid-April the Bulgarian debt risk premium started to drop and on 7 May 2007 the indicator hit its historical low of 13.88 basis points. This fall was underpinned by the overall market dynamics in the segment, the enhanced investor optimism stemming from advance repayment of Bulgarian debt to the IMF, the government's strong commitment to continue structural reforms and a conservative fiscal policy in line with the challenges of integrating Bulgarian economy into the EU.

Chart 28

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



Source: JP Morgan.

2. Financial Flows, Money and Credit

Intensive restructuring and high return on investments attracted a sizable volume of financial resources (foreign direct investments and external loans) which contributed to Bulgaria's economic growth acceleration and robust investment activity. Over the January to March 2007 period the surplus on the balance of payments financial account came to EUR 1548.4 million (up by some EUR 700 million compared with the first quarter of 2006). As a result of the net inflow of funds into the financial account, the overall balance for the first quarter was positive and led to an increase in the BNB reserves by EUR 31.4 million (excluding valuation adjustments).

Table 2
Cash Flows Which Prompted Significant Changes in Gross International Reserves

	2006, total	First quarter, 2007
A) Purchases and sales of reserve currency	Total, net: EUR +1720 million	Total, net: EUR +101 million
Net purchases from commercial banks	Net purchases from CB: EUR 1746 million Bought: EUR 12,962 million Sold: EUR 11,216 million	Net purchases from CB: EUR 113 million Bought: EUR 3732 million Sold: EUR 3619 million
Outflows related to net purchases at tills	Sold banknotes: EUR 26 million	Sold banknotes: EUR 12 million
B) Net changes in commercial banks' minimum required reserve accounts in foreign currency	Net earnings : EUR 524 million	Net earnings : EUR 296 million
C) Changes due to flows on government accounts and other BNB customers' accounts	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	Earnings : EUR 114 million USD 16 million SDR 3 million Payments : EUR 495 million USD 72 million JPY 191 million SDR 3 million CHF 1 million

Source: BNB.

The Issue Department balance sheet figure reached BGN 17,564.7 million (EUR 8980.7 million) by the end of March 2007. The growth amounted to BGN 3841.7 million on end-March 2006 and to BGN 106.2 mil-

lion on the close of 2006. Net purchases of currency from commercial banks comprised EUR 113 million, while net earnings on commercial banks' minimum required reserve accounts came to EUR 296 million, thus contributing to the increase in international reserves. Owing to payments on external government debt and other payments to non-residents, the contribution of the government to the change in international reserves was negative.

Financial Flows and External Position Sustainability

In the second and third quarters of 2007 capital inflow into Bulgaria will remain high enough to entirely finance the current account deficit. Based on the balance of payments financial account and international reserves data, we may conclude that there was no substantial change in Bulgaria's external position – it retained its sustainability consistent with economic restructuring and capacity building.

Capital inflow into Bulgaria stayed high, with the balance of payments financial account surplus coming to over EUR 1.5 billion in the first quarter due mainly to foreign direct investment (EUR 770.8 million), a decrease in deposits of Bulgarian commercial banks abroad (EUR 564.8 million), other sectors' loans from non-residents (EUR 433.7 million) and an increase in non-resident deposits (EUR 275 million).²

Foreign direct investment in Bulgaria reached EUR 770.8 million in the January to March 2007 period.³ In the reporting quarter the attracted equity (excluding privatisation) was EUR 555.3 million, with EUR 309.7 million in receipts from sales of real property to non-residents.⁴ Reinvested earnings were comparable with those in the first quarter of 2006 (EUR 78.4 million against EUR 79.7 million for the respective period of the previous year). The latter is indicative of the high foreign investment effectiveness and investors' positive assessment of prospects for Bulgarian economy.

² Preliminary data.

³ Preliminary data. The source of data on foreign direct investment is the NSI. The different scope of NSI quarterly and annual surveys is the reason for data revisions of foreign direct investment in Bulgaria. The BNB receives the NSI annual survey data a year after the review period; hence, the preliminary data which have been published need serious revisions, especially those in the balance of payments *Equity and Reinvested earnings* subitems. Different periodicity and delays in submitting reports to the BNB also result in revisions of this item.

⁴ Privatisation revenue for the review quarter was minimal (EUR 1.4 million).

Real estate operations, lessors activities and business services continued to occupy the largest share in foreign direct investment sectoral structure (27.5 per cent) owing to notable receipts from sales of real property to non-residents. *Financial intermediation* ranked second (24.1 per cent), followed by *Construction* (13.8 per cent) which might also reflect non-residents' interest in acquiring real property in Bulgaria. The share of investment in *Manufacturing* was 13.6 per cent.⁵

Continuing inflow of borrowings on the balance of payments financial account reflected on the gross external debt level in the first months of 2007. According to preliminary data, by March 2007 external debt totaled EUR 20,261.5 million: up by EUR 591.6 million on December 2006. During the first quarter public and publicly guaranteed debt declined by EUR 291.4 million (as a result of redeeming global bonds in February) to reach 20.8 per cent of total debt. Private non-guaranteed external debt went up by EUR 883 million (5.8 per cent) to EUR 16,052.4 million.

The external debt increase was mainly due to the private non-bank sector (*Other sectors*) whose external obligations went up by EUR 500 million (7.1 per cent) over the first quarter, thus amounting to EUR 7526.2 million by March 2007. Intercompany loans grew by EUR 270.7 million compared with the end-2006 level of EUR 5597.5 million. At the year's start companies continued taking recourse to short-term external financing (*Other sectors'* short-term liabilities increased by 10.5 per cent in the first quarter).

In the first quarter of 2007 commercial banks' external debt rose by EUR 88.4 million (2.6 per cent) on end-2006. Commercial banks' short-term liabilities changed most dynamically due to divergent developments of various components. Non-residents' deposits with commercial banks increased by EUR 274 million over the reviewed quarter,

⁵ Foreign direct investment classification by sector is based on companies' core activities according to their registration. This means that conclusions about the distribution of direct investment among sectors producing tradable and non-tradable goods may be misleading if they are based on these data only. The same applies to putative assessments of the direct investment's share in export-oriented industries.

while commercial banks' short-term loans fell by EUR 207 million. As foreign-owned banks have a considerable share in non-residents' deposits, their dynamics in the next quarters will be influenced by the need for financing related to commercial banks' lending.

The share of the euro in the private non-bank sector's currency structure was 78 per cent at the end of March 2007. The remaining part of the private debt was distributed between the US dollar (between 3 and 11 per cent in the different sectors) and other currencies. As a whole, there were no considerable changes in the external debt currency structure compared with end-2006. This allows the conclusion that as far as such a structure of private debt currency denomination reduces the risks associated with exchange rate fluctuations, it might be considered favourable.

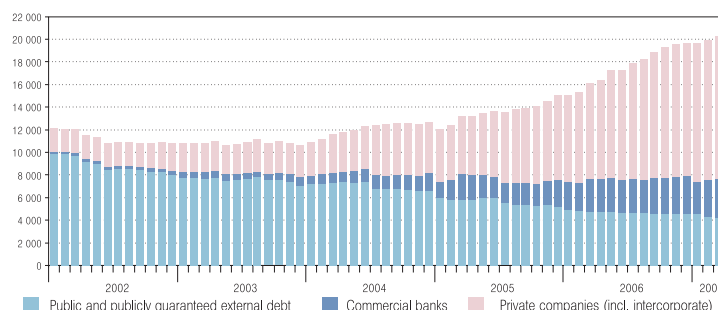
By end-March short-term external debt picked up by EUR 432.4 million (7.2 per cent) on end-2006 and long-term external debt rose by EUR 159.2 million (1.2 per cent). Long-term external debt dynamics was influenced by the redemption of global bonds by the government, with private sector's long-term external debt growing by EUR 426.8 million. Short-term debt included liabilities on trade credits stemming from the rise in imports, as well as non-residents' deposits affected by commercial banks' operations with their foreign owners. Although short-term indebtedness growth may be explained by high investment and adaptation of the private sector to EU requirements, the growth rate and the total amount of short-term debt are indicative of potential risk accumulation.

In 2007 the main factors behind the rise in private sector indebtedness will continue to be the more effective liability management of Bulgarian enterprises through attracting borrowed funds from abroad and the easier access to external financing. Therefore, an increase in private external debt as a share of GDP is anticipated over the year.

Current account dynamics between early January and end-March was determined by

Chart 29
Gross External Debt

(million EUR)



Source: BNB.

Chart 30
Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

the development of the trade balance which worsened by BGN 431.4 million on the first quarter of 2006, reaching EUR -1484.8 million.⁶ The nominal increase in goods trading deficit matched the expectations of economic development. At the same time, since data are preliminary, they call for a cautious interpretation and analysis.⁷

Developments in other current account components (excluding the trade balance) during the first quarter show improvements in the corresponding balances. Over the quarter under review the balance on the *Services* item improved by EUR 48.8 million. All components of services exports rose, with the *Other services – credit* item taking the lead (up by 39.8 per cent on the first quarter of 2006). Exports of tourist services retained their relatively high growth rates (11.1 per cent). Imports of services posted a moderate increase (7.1 per cent) reflecting mostly the drop in the *Other services* (-9.3 per cent) item which registered high growth rates at the beginning of 2006.

In the January to March 2007 period *Income balance* was EUR 34.5 million marking an increase of EUR 16.8 million on the first quarter of 2006. Growth was registered both in the account's credit side and debit side, with *Compensations to employees* having the major contribution (27.8 per cent) to the credit side. The largest flight of funds was in terms of income from foreign direct investment (EUR 165.2 million for the quarter). According to preliminary data, almost half of the exported income from foreign direct investment was reinvested in the economy. As considerable flows of foreign direct investment into Bulgaria would probably be retained in the following years, it might be expected that income payments on foreign direct investment will remain high in the future, thus decreasing the surplus in the *Income* item.

Net current transfers in the first quarter of 2007 reached EUR 76.7 million: down by EUR 42.2 million on the first quarter of 2006.

⁶ Preliminary data.

⁷ For a detailed analysis of exports and imports see Section Three, *Economic Activity*, and the box *Original Data on Commodity Exports and Imports within the Scope of the Intrastat System* on p. 40.

The decrease in the net current transfers reflected entirely the dynamics of *General government sector's* current transfers which reported a net decline of EUR 44 million, due to Bulgaria's contribution to the EU budget. Private current transfers posted an insignificant increase compared with the January to March 2006 period.

The analysis of the data on Bulgaria's external position since the start of 2007 was seriously impeded by the substantial change in statistical reporting. Launching the Intrastat system changed entirely the way of statistically registering export and import data. Hence, these data will undergo significant revisions following their initial publication.⁸ To this end, balance of payments evaluation could be more reliable if it was based on indicators which are to a lesser extent impacted by the revisions or are not subject to revisions, such as financial account dynamics and international reserves.

Data on the financial account and international reserves give grounds to conclude that there were no substantial changes in Bulgaria's external position. It remained steady consistent with economic restructuring and capacity building. The sizable inflow of capital into Bulgaria is expected to continue in the second and third quarters. These expectations are backed by the dynamics of international reserves which rose by BGN 182 million in early June 2007 compared with end-March,⁹ though in the beginning of May BNB liabilities to commercial banks (and respectively international reserves) dropped due to releasing banks' additional minimum required reserves to the amount of BGN 966 million. Current account deficit is anticipated to increase nominally on the corresponding quarters of 2006, this rise likely to be revised down in the coming quarters of 2007.

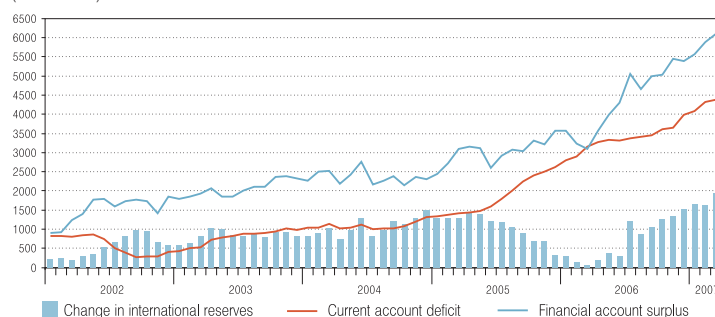
⁸ A detailed description of the changes in statistics is presented in *Economic Review*, 1/2007, pp. 42–43. Information on the methodology of collecting data under the Intrastat system is available on the BNB and NSI websites.

⁹ Issue Department balance sheet data as of 2 June 2007.

Chart 31

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

(million EUR)



Source: BNB.

Monetary Aggregates

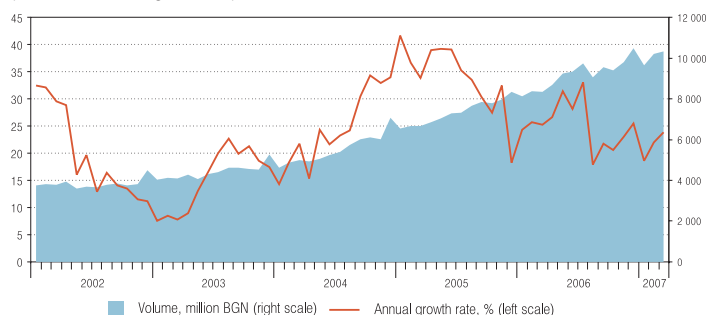
Reserve money growth rates will slow down dramatically in the next two quarters as a result of releasing additional minimum required reserves after removing the administrative measures taken to curb bank credit growth. The growth rates of money in circulation and broad money are expected to stay relatively stable at levels close to the current ones.

In the first quarter of 2007 money aggregate dynamics displayed high growth rates reflecting the notable increase in capital flows into the balance of payments financial account and the rise in domestic credit.

During the January to March 2007 period reserve money annual growth came to 23.9 per cent: a slowdown of some 2 percentage points on end-2006. Bank reserves had a larger contribution to the change in monetary base (13 percentage points) compared with currency in circulation (10.9 percentage points). Between March 2006 and March 2007 commercial bank deposits with the BNB posted a BGN 1085 million (38.5 per cent) growth, while on December 2006 growth comprised 8.6 per cent. This stemmed from the fact that, despite the removal of credit growth ceilings since January 2007, banks which exceeded their limits over the fourth quarter of 2006 had to maintain additional reserves in the three-month period starting on 4 February 2007. A trend of maintaining an increasingly greater portion of bank reserves in foreign currency (euro) was reported. By end-March 2007 monetary financial institutions' lev deposits with the BNB occupied 32.5 per cent of total deposits against 47.4 per cent in the same month of 2006. The average volumes of currency traded between commercial banks and the BNB have doubled since the year's start at the expense of the continuing decline in the trade volumes on the interbank foreign currency market. This reflected the stronger use of euro purchases and sales transactions with the BNB as a liquidity management instrument. On the other hand, interbank money market volumes did not decrease. Over the January to May 2007 period the total amount of transactions was even greater than that in the same period of the previous year. This may also serve as an indicator of the substantial increase in the economy's liquidity.

Chart 32
Reserve Money

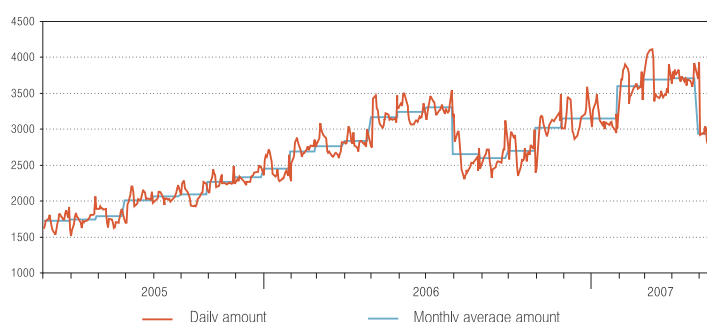
(volume and annual growth rate)



Source: BNB.

Chart 33
Commercial Bank Deposits with the BNB

(million BGN)



Source: BNB.

In the second quarter a dramatic slow-down in the reserve money growth rates is expected owing mainly to the decline in commercial banks' deposits with the BNB after withdrawing the additional minimum reserves deposited in prior periods.¹⁰

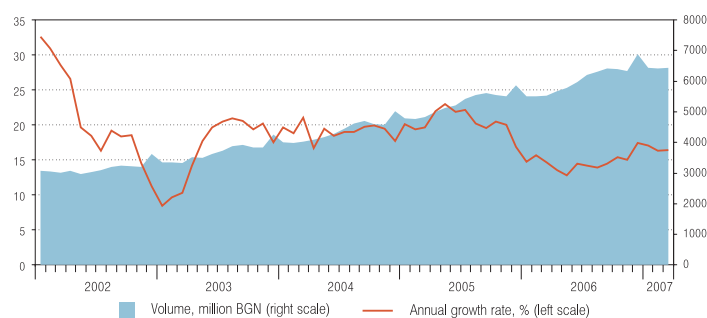
The first quarter of 2007 saw a slightly reduced growth of money in circulation, with banknotes and coins picking up 16.4 per cent against 17.4 per cent on an annual basis in December 2006. The growth rate remained relatively high, and though a more substantial slowdown may be expected in the long run, during the next two quarters money in circulation are likely to continue rising by 15–16 per cent on an annual basis. The major factor behind this will be the high demand for cash balances due to enhanced economic activity.

The fiscal policy affects monetary aggregates through the amount and change in government deposits with the BNB and through redistribution of liquidity among other economic sectors. In the first quarter of 2007 a great amount of liquidity was withdrawn from the non-government non-bank sector owing mainly to the fast growing budget revenues from this sector which were related to the buoyant profits in 2006 and strong domestic demand. The trend will be sustained in the next two quarters, though less pronounced by the end of the third quarter due to the salary and pension rises since 1 July 2007. Principal payments on global bonds (BGN 500 million) played a decisive role for the flows between the consolidated budget and the external sector in the first three months. Flight of liquidity into the external sector will be observed in the second quarter of 2007 as well, reflecting advance debt repayments to the IMF (BGN 449.8 million) at the end of April. Net financial flows from the *General government* sector to the EU budget in the first quarter of 2007 were negative, with the contribution to the overall European budget (BGN 177.6 million) exceeding the grants received (some

¹⁰ The measures taken by the BNB to curb commercial banks' credit activity are described and analysed in the last two years' *Economic Review* issues. These administrative measures were removed in early 2007; as a result, commercial banks which had deposited additional minimum reserves withdrew them from their accounts with the BNB.

Chart 34
Currency in Circulation

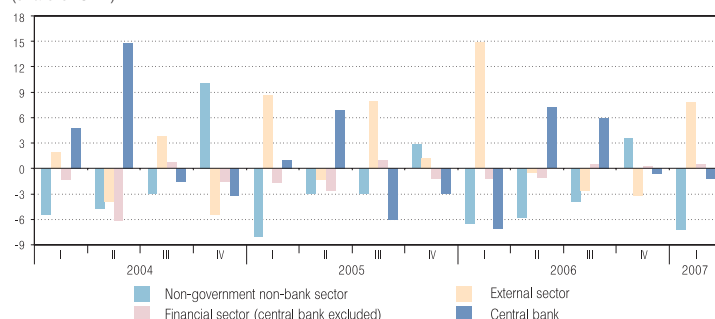
(volume and annual growth rate)



Source: BNB.

Chart 35
Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

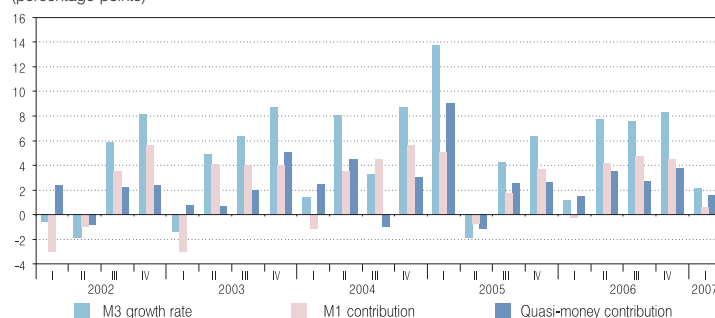
(share of GDP)



Sources: MF, BNB.

Chart 36
M3 Growth Rate and M1 and Quasi-money Contribution (Quarterly)

(percentage points)



Source: BNB.

BGN 116.2 million). The bulk of received funds were intended to support the Schengen Agreement implementation and to facilitate the movement of budget cash flows.

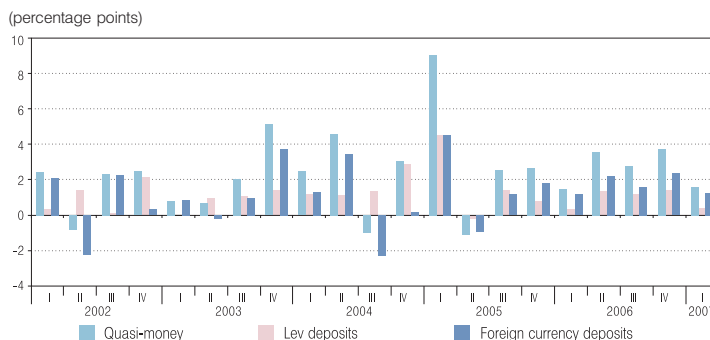
In the first quarter of 2007 broad money measured by the M3 monetary aggregate picked up by 28.2 per cent on the same quarter of the previous year (an annual growth of 26.9 per cent in December). Over the review quarter the monetary base rose by 2.2 per cent. Quasi-money contributed mostly to this growth (1.6 percentage points) with foreign currency deposits rising faster than lev deposits. The M1 monetary aggregate contributed by just 0.6 percentage points to the change in broad money despite the continuing fast growth of overnight deposits. Lev overnight deposits posted an annual increase of 43.2 per cent and those in foreign currency 41.7 per cent. Deposits of non-financial corporations grew faster than those of households. The annual growth of corporate lev overnight deposits accounted for 45.1 per cent against 25.1 per cent for household deposits, while foreign currency deposits posted a 39.4 per cent growth against 37.1 per cent for household deposits.

Most types of deposits included in quasi-money also exhibited high growth rates. Lev-denominated deposits of non-financial corporations with agreed maturity of up to 2 years increased by 17.4 per cent, while household deposits went up by 17 per cent on an annual basis. The annual change in corporate and household foreign currency time deposits was respectively 47.5 per cent and 24.4 per cent.

Provided the first quarter brisk lending is preserved, we may expect in the second and third quarters a change in broad money close to that in March.

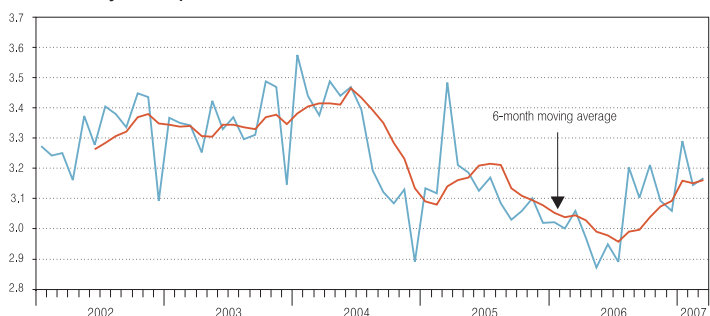
Over the last two years the money multiplier dynamics was greatly influenced by the measures undertaken by the central bank towards curbing credit expansion. The sizable volume of additional required reserves maintained by banks with the BNB had a direct effect on the money supply, most frequently pushing it up, and hence on the

Chart 37
Contribution of Quasi-money and Their Components to M3 Growth (Quarterly)



Source: BNB.

Chart 38
M3 Money Multiplier



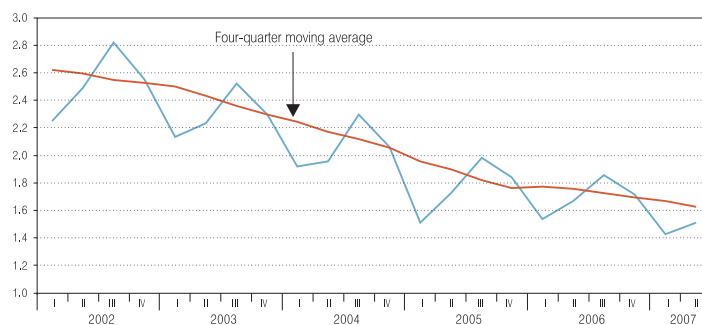
Source: BNB.

multiplier value which was on the downside until July 2006. After releasing additional reserves in August 2006, the money multiplier went up to 3.1–3.2 and decreased again by the close of the year as a result of the seasonal factor effect. Since the year's start it has risen to 3.2–3.3 and the upward trend is expected to be retained in the coming two quarters reflecting the removal of administrative measures and additional minimum required reserves coupled with the fast M3 growth.

Money circulation velocity continued its sustainable decline of the recent years, preserving its clearly pronounced seasonal nature. Given the projected M3 and GDP growth rates, the dynamics of this variable is expected to follow a downward trend in the next two quarters as well.

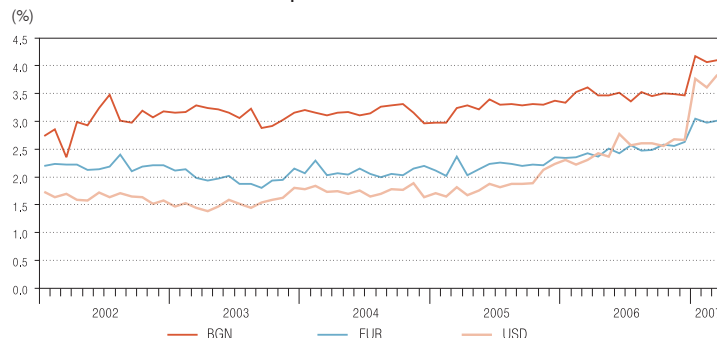
Compared with the prior quarter and the 2006 average levels, the first quarter of 2007 saw a significant rise in average interest rates on time deposits. Some of this growth should be attributed to a change in the accounting methodology (see the box below).

Chart 39
Currency Circulation Velocity (Quarterly)



Sources: BNB, NSI.

Chart 40
Interest Rates on Time Deposits



Note: Data for 2007 are reported under the new methodology of interest rate reporting (see the box below).

Source: BNB.

Change in the Methodology for Reporting Interest Rates on Deposits

Since early 2007 the BNB applies a new methodology for reporting interest rates on deposits in compliance with the requirements of the European Central Bank.

The scope of deposits used as a basis for calculating annual effective interest rates underwent a fundamental change. Until the end of 2006 the definition of new business included new agreements setting out terms and conditions for deposit interest rates for the first time and time deposits whose term to maturity is automatically renegotiated. From the beginning of 2007 interest rates on time deposits whose term to maturity is automatically renegotiated upon expiry of the term set forth in the agreement are excluded from the scope of interest rate statistics.

Since the global upward interest rate dynamics over the recent years result in renegotiating higher interest rates under the new agreements compared to those on existing deposits which are renewed automatically upon expiry of their term, the effect of this methodological change is the one-off increase in interest rates on deposits.

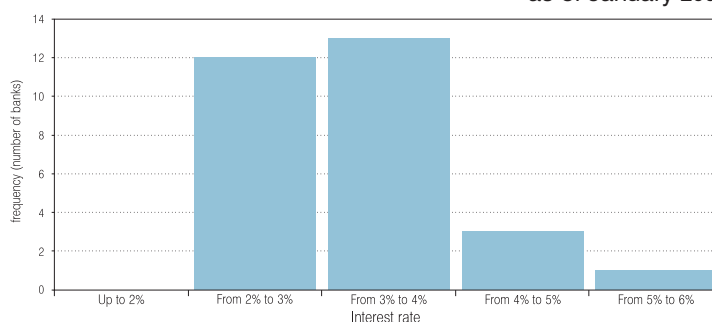
ECB monetary policy was the major economic factor behind the increase in interest rates on deposits in Bulgaria. The several interest rate rises in 2006 and in March 2007 influenced interest rates on deposits and loans in the euro area and hence in Bulgaria. Moreover, due to the need for attracting longer-term resources, commercial banks offered customers more favourable conditions, with growing income deposits

gaining popularity recently. As a result of the aforementioned factors, the average interest rates on time deposits denominated in levs, euro and US dollars picked up to 4.11 per cent, 3.01 per cent and 3.74 per cent respectively.

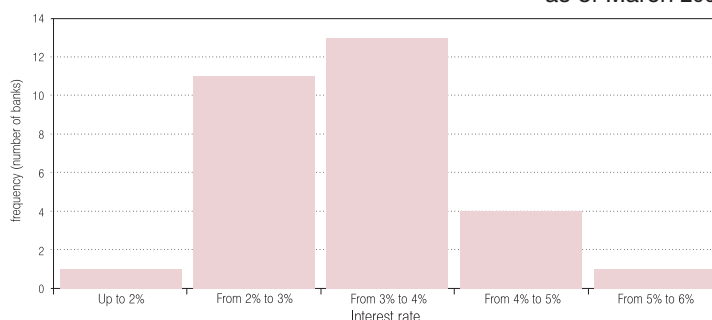
As regards the distribution of interest rates on one-month lev deposits of households, the most sizable change in March compared with January 2007 was the decreased number of banks offering interest rates between 2 and 3 per cent at the expense of those offering interest rates of up to 2 per cent and within the 4–5 per cent band. No change in interest rate dispersion by bank occurred.

Chart 41
Interest Rate Distribution of Household
One-month Lev Deposits

as of January 2007



as of March 2007



Note: Data for 2007 are reported under the new methodology of interest rate reporting (see the box on p. 26).

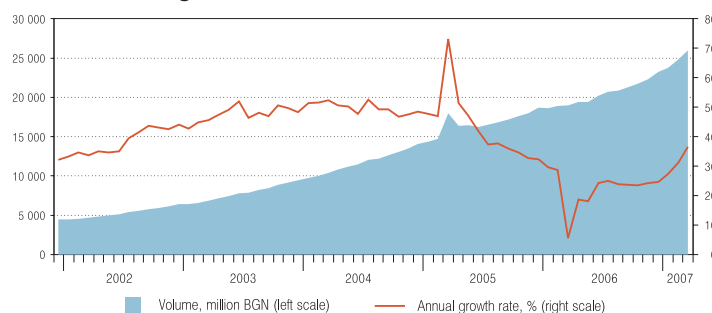
Source: BNB.

Credit Aggregates

Commercial bank credit activity is expected to remain high over the next two quarters. Interest rates on loans were stable and no significant change in their levels is projected over the second and third quarters of 2007.

In the first quarter of the review year claims on the non-government sector rose by BGN 2692.8 million (against an increase of BGN 327.9 million over the same period of the prior year) with their annual growth increasing to 36.6 per cent in March 2007, after 24.6 per cent by end-2006. Robust lending was underpinned by favourable macroeconomic trends and strong demand for loans by corporations and households, as well as by the removal of the additional required reserves in early 2007. Bringing a portion of loans (sold during the period of the administrative constraints) back to commercial banks' balance sheets contributed, although to a limited extent, to the accelerated growth of claims on the non-government sector. At the same time, though the administrative restrictions on lending were lifted, some commercial banks continued to sell loans as in 2006.

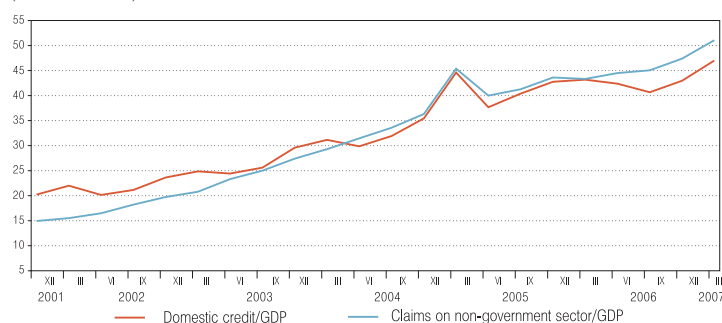
Chart 42
Claims on Non-government Sector



Source: BNB.

Chart 43
Domestic Credit

(share of GDP, %)



Source: BNB.

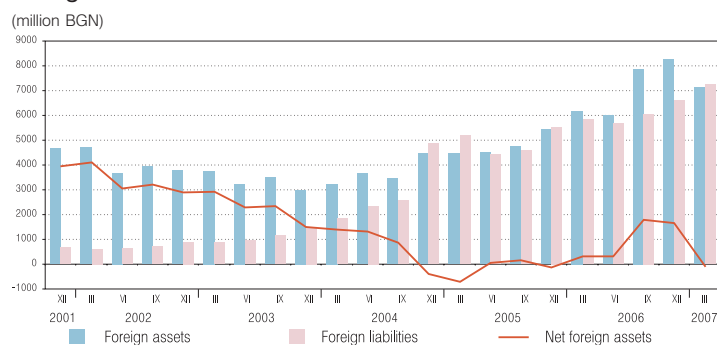
The trend to enhancing financial intermediation was retained. By the end of March the claims on the non-government sector to GDP ratio reached 51.1 per cent posting a 3.7 percentage point increase on the year's start and a 7.7 percentage point rise on March 2006.

In the first quarter of 2007 commercial banks' net foreign assets fell by BGN 1758.5 million and by the end of March reached a negative value (BGN -100 million). The recorded change is mainly attributable to the decrease in foreign assets (BGN 1131 million) and to the increase in funds attracted by non-residents (BGN 627.5 million).

Non-financial corporations had the most clearly pronounced credit activity reflecting enhanced demand for loans driven by high production and investment activity and good liquidity of banks. In the first quarter of 2007 claims on non-financial corporations picked up by BGN 1995.2 million against an increase of BGN 711.8 million in the previous quarter and of BGN 76.8 million in the first quarter of 2006. Consequently, by end-March 2007 their annual growth rate reached 36.4 per cent, from 19.9 per cent at the end of 2006.

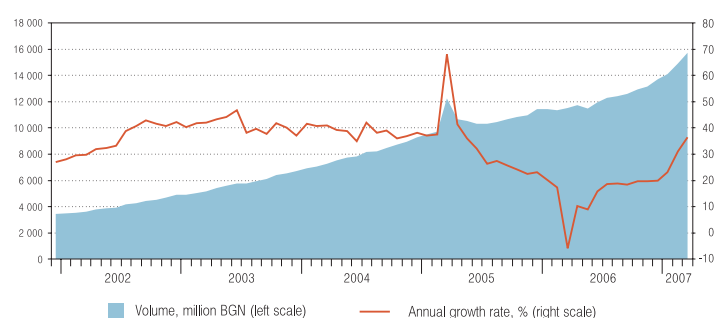
Loans to households also posted a considerable increase in nominal terms, their growth rate accelerating on the prior year. In the first quarter of the review year they picked up by BGN 744.3 million against an increase of BGN 188.2 million in the same period of 2006. Their annual growth rate increased from 30.6 per cent in December 2006 to 37.6 per cent in March 2007. Housing loans were still the most rapidly developing segment on the credit market. During the first quarter of 2007 their growth rate rose from 73.8 per cent to 74.5 per cent and by end-March the share of mortgage loans in total household loans accounted for 38.9 per cent.

Chart 44
Foreign Assets and Liabilities of Commercial Banks



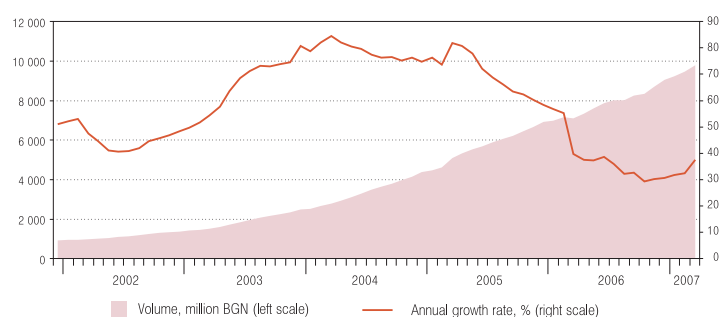
Source: BNB.

Chart 45
Claims on Non-financial Corporations



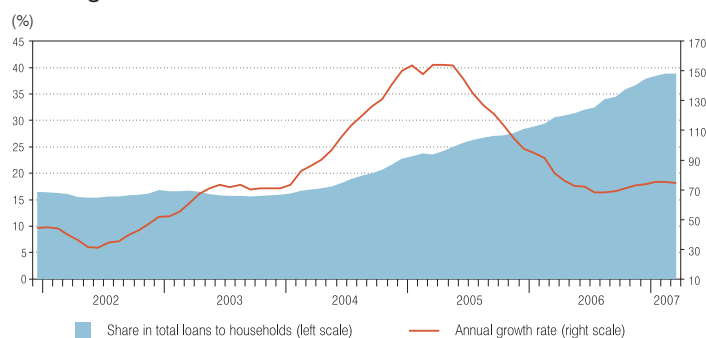
Source: BNB.

Chart 46
Claims on Households



Source: BNB.

Chart 47
Housing Loans



Source: BNB.

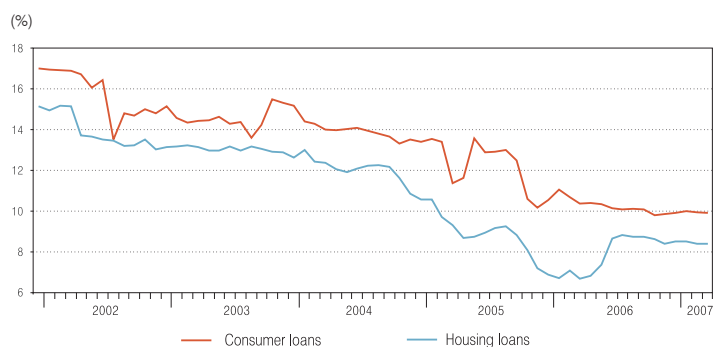
Table 3
Claims on Non-government Sector (Quarterly)

	Annual growth rate, %								Structure as of 31 Mar. 2007
	2005			2006				2007	
	II	III	IV	I	II	III	IV	I	
Claims on non-government sector, incl.:	41.8	35.9	32.4	5.6	24.2	23.6	24.6	36.6	
on non-financial corporations	32.2	25.7	23.1	-5.9	15.8	18.3	19.9	36.4	60.5
on households and NPISHs	72.2	63.5	58.4	39.7	38.7	32.6	30.6	37.6	37.7
on financial corporations	-27.6	-12.4	-31.1	-44.6	42.7	25.9	68.6	26.0	1.7

Source: BNB.

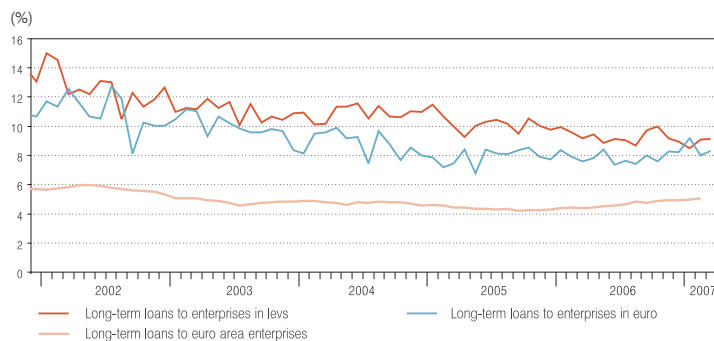
Regardless of the slight increase in inter-bank money market interest rates, lending interest rates remained stable over the first quarter of the review year. In the coming months they are unlikely to undergo any significant changes. A possible further rise in ECB interest rates would have a slight impact on lending interest rates in Bulgaria due to enhanced competition in the banking system.

Chart 48
Interest Rates on Household Loans



Source: BNB.

Chart 49
Interest Rates on Long-term Loans in Levs and Euro



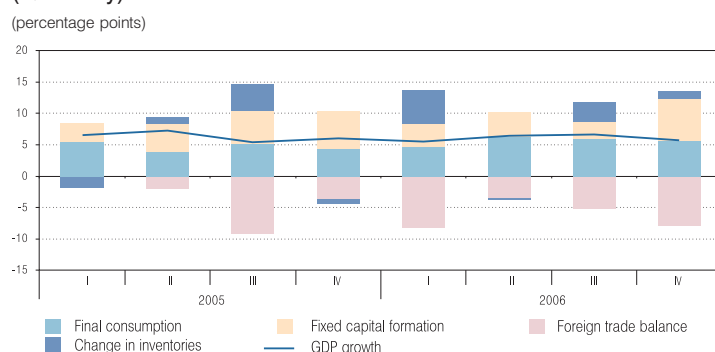
Source: BNB.

3. Economic Activity

Economic growth is expected to remain high over the second and third quarters of 2007 mainly attributable to domestic demand. Bulgarian firms improved their competitive positions regardless of the relatively robust growth in real salaries and employment since early 2007.

The 2006 buoyant economic growth was sustained at relatively high levels reaching an annual rate of 6 per cent according to preliminary data. Household consumption accelerated slightly compared to the previous year. Investment activity recorded high growth (17.6 per cent): a slight downturn compared to 2005 (23.3 per cent).

Chart 50
Contribution to GDP Growth by Component of Final Consumption (Quarterly)



Source: NSI.

Table 4
Final Consumption Dynamics (Quarterly)

(on corresponding period of previous year, %)

	2005				2006			
	I	II	III	IV	I	II	III	IV
Consumption incl.	5.9	4.3	6.6	4.7	5.0	7.2	7.4	6.1
Household consumption	6.3	3.7	8.0	6.3	5.2	8.3	9.1	7.5
Government final consumption expenditure	-0.6	5.0	-4.5	2.0	11.7	8.2	3.5	-5.0
Collective consumption	8.3	8.5	6.3	-2.9	-1.7	-0.6	-1.1	7.8
Gross fixed capital formation	15.1	21.1	28.4	25.9	17.1	16.0	11.7	23.8
Exports of goods and non-factor services	10.5	13.3	2.0	10.7	12.7	10.0	8.4	5.4
Imports of goods and non-factor services	8.3	13.6	17.0	12.9	20.8	12.2	14.7	13.9
GDP, real growth	6.6	7.3	5.4	6.0	5.5	6.4	6.7	5.7

Source: NSI, BNB.

Recent years' trends towards an increase in consumer and investment demand were sustained in the beginning of 2007. Current information on retail sales and revenue support the expectations of consumer demand sustainability. The labour market situation continued to improve, boosting consumer confidence and driving high consumer activity. Industrial sale statistics of supply show retention of high economic activity. Industrial sales in the first quarter of 2007 rose by 7.3 per cent on the corresponding quarter of the previous year. Business optimism also

remained high alongside a high degree of industrial capacity utilization and growing trade turnover. These trends underpinned expectations for high investment activity over the forecast period.

Household Behaviour

The improving situation on the labour market boosted consumer confidence and will be a major factor driving consumer demand.

In early 2007 consumer demand sustained its upward trend as evidenced by domestic trade and household budget data. Transport expenditure (including personal vehicle maintenance and consumables), furniture, home maintenance, clothes and shoes posted accelerated growth. On the one hand, growth in trade investment reflected enhanced demand and prospects for stable consumption growth and, on the other hand, it built capacity for extending the retail trade net and hence the supply of goods.

Table 5
Consumer Demand Dynamics (Quarterly)
(on corresponding period of previous year, %)

	2006				2007
	I	II	III	IV	I
Consumer spending <i>per</i> household member	3.7	6.3	6.7	9.7	11.3
Retail sales	10.9	13.3	14.2	14.0	12.0
Income from retail trade	10.0	12.6	14.1	15.3	11.8
including					
Food, drinks, tobacco	6.5	5.8	7.4	8.8	9.6
Pharmaceutical and medical goods, cosmetics and toiletries	7.2	11.5	7.2	5.1	7.5
Textile, clothing, footwear and leather	7.3	12.1	17.9	15.7	11.3
Household goods and home appliances	14.6	18.8	20.2	19.4	18.0

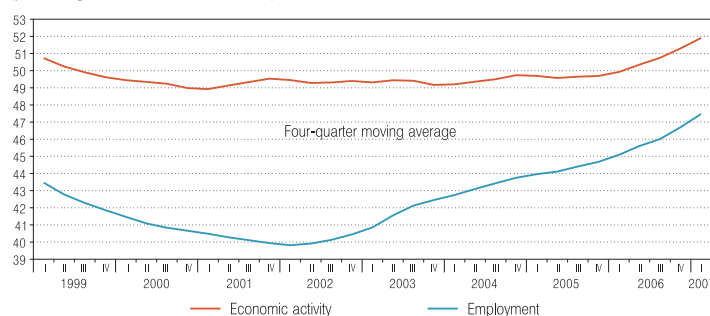
Source: NSI: household budgets and domestic trade survey.

Increasing household incomes and improving situation and prospects on the labour market played a major role for high consumer demand. From mid-2006 real salary and employment growth boosted the Wages and Salaries Fund recorded according to GDP data and in compliance with the income method.¹¹ Employment growth has strengthened and according to the *Work Force Survey* data, in the first quarter of 2007 its rate was 6.6 per cent on the corresponding quarter of the previous year. As a

¹¹ *Generation of Income* account.

Chart 51
Labour Market Structural Indicators (Quarterly)

(percentage of the individuals over 15)

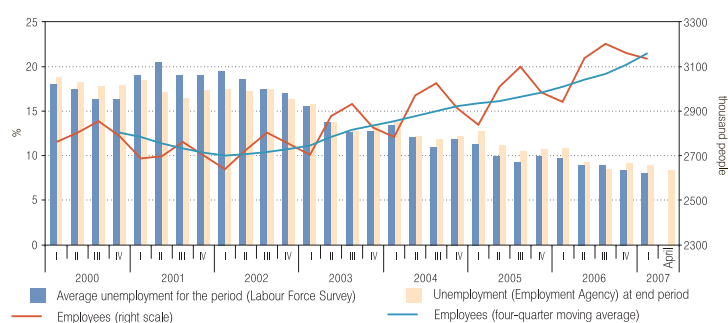


Sources: NSI, Labour force survey.

result of favourable labour market prospects, more people outside the work force started looking for a job which led to an increase in the economic activity ratio. The downward trend in the number and share of long-term unemployed people (over one year) was also a positive one.

Chart 52

Employment and Unemployment Level (Quarterly)

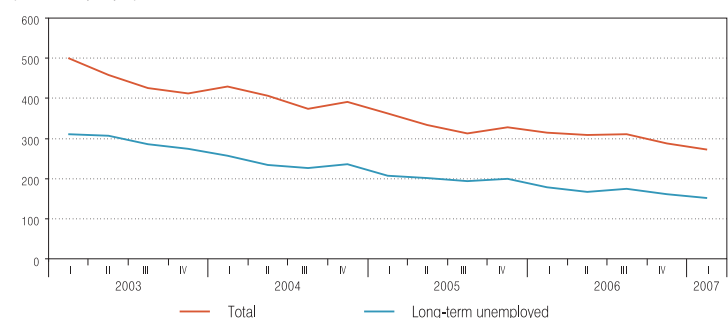


Source: NSI, Employment Agency – Ministry of Labour and Social Policy.

Chart 53

Number of Unemployed People (Quarterly)

(thousand people)



Source: NSI: Labour Force Survey.

Table 6

Employment and Income Dynamics (Quarterly)

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

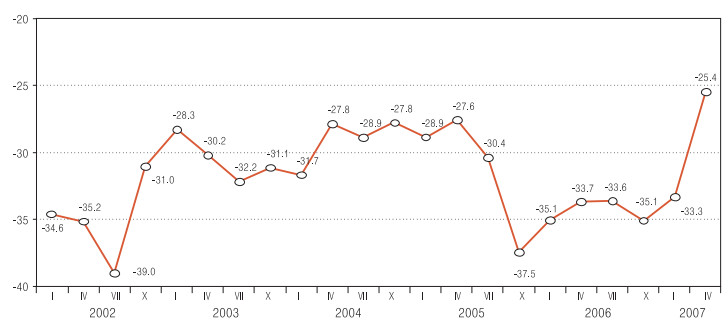
	2005				2006				2007	
	I	II	III	IV	I	II	III	IV	I	April
Unemployment at the end of the period, % of the labour force	12.7	11.1	10.5	10.7	10.8	9.2	8.4	9.1	8.9	8.4
Employed under labour contract	4.3	3.5	1.5	1.6	0.8	0.6	1.0	0.6	3.4	
Employees (Labour Force Survey data)	2.0	1.3	2.4	2.4	3.6	4.3	3.3	5.9	6.6	
Real salary	3.2	3.1	1.1	-0.4	1.4	1.4	5.0	6.9	11.1	
Wages and salaries, deflated by HICP	5.8	8.1	8.8	11.9	0.3	2.3	5.1	7.8		

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

The NSI Consumer Survey conducted on a quarterly basis showed significant improvements in consumer confidence underpinned by positive developments in employment and income in the beginning of the second quarter of 2007. People surveyed express optimism about their savings and financial performance, expected unemployment and overall economic performance. These trends gave rise to expectations of accelerated household consumption.

Chart 54

Household Confidence Indicator



Source: NSI Consumer Survey.

Improved financial performance of the households reflecting income growth had a favourable effect on their solvency and facilitated their access to loans. Banks' claims on households picked up steadily along with the share of income used to cover their liabilities.¹² Higher indebtedness would force households to increase their motivation to save, thus maintaining moderate growth in consumption.

The household budget survey showed comparatively moderate savings rate of above 7 per cent of households' income. On the other hand, according to the BNB monetary statistics, since mid-2006 a new upward trend in household deposits growth outrunning extended loans has started. As a result, the net creditor position of the household sector has recently gained increasing significance.

Government Finance and Consumption

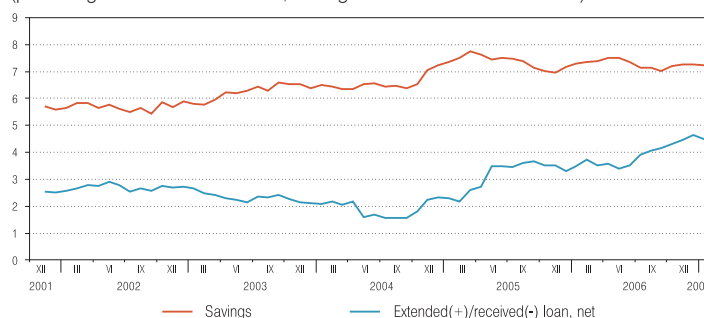
Consolidated state budget surplus for the first quarter of 2007 came to BGN 544.7 million (approximately 1 per cent of projected 2007 GDP). An annual surplus of about 2.3 per cent of GDP and a minimum contribution of government consumption to GDP growth are expected in 2007.

Total revenue and aid under the consolidated state budget amounted to BGN 5055.3 million by the end of March 2007, an increase of 15.4 per cent on the same period of the prior year. Direct taxes contributed most significantly (by almost 8 percentage points) to tax revenue reflecting both the rise in corporations' profit in 2006 and higher employment. January and February saw a sharp fall in revenue from indirect taxes mainly due to the changed VAT taxation regime and the application of the Common Customs Tariff after Bulgaria's accession to the EU. Efficient repayment of past

¹² On the basis of statistics on new bank loans extended to households, interest rates on these loans and maturity structure of the total bank credit to households and according to national accounts data on household income, an (approximate) estimation of the weight of debt servicing has been made. According to it, in 2006 households have set aside around 10 per cent on average of their salaries for servicing liabilities to banks.

Chart 55
Household Financial Performance According to Household Budget Survey

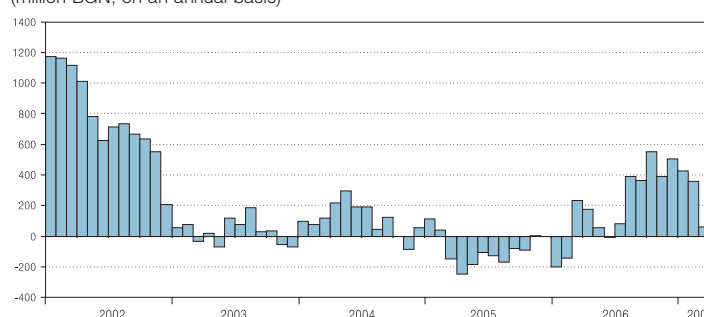
(percentage of household income, average data for the last 12 months)



Sources: NSI, BNB.

Chart 56
Change in Household Net Assets in the Banking System

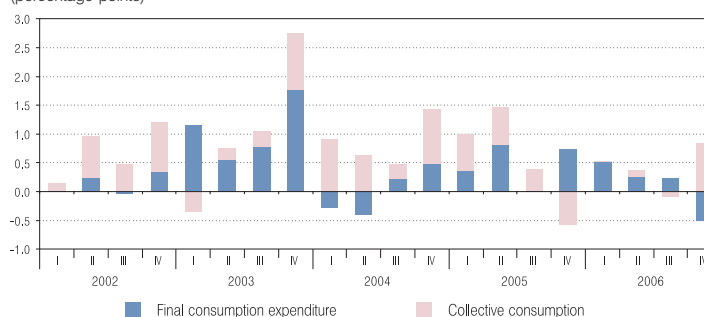
(million BGN, on an annual basis)



Source: BNB.

Chart 57
Contribution of Government Final Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)

(percentage points)



Sources: NSI, BNB.

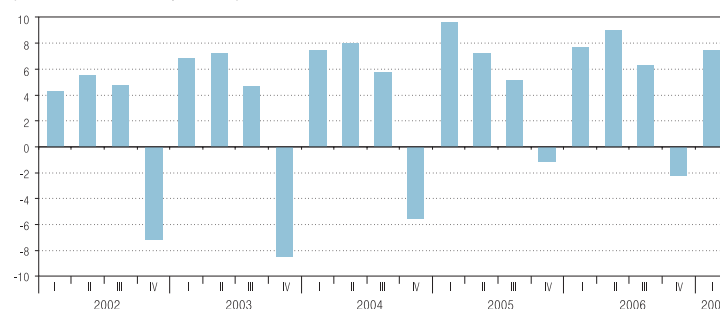
period tax credit was another factor behind lower net VAT revenue. Despite the long lasting decrease in receipts from customs duties of more than 50 per cent annually, expectations for a more sizable contribution of indirect taxes to the overall growth in tax revenue over the following two quarters are based on the rebound in VAT revenue which started in March and April 2007.

Current expenditure on the consolidated fiscal programme picked up by 7.8 per cent excluding Bulgaria's contribution to the EU budget due for the first quarter of 2007 (BGN 177.6 million or almost 4 per cent of total expenditure). This increase was mostly driven by subsidies as the total annual amount of resources was allotted to the Tobacco Fund. The growth rate of current non-interest expenditure is expected to slow down over the second quarter and to accelerate to 9–11 per cent over the third quarter of the review year due to the increase in pensions and salaries in the budget sector.

Current implementation of the consolidated fiscal programme, along with government policy of curbing expenditure in the event of current account deficit deterioration and expected revenue and expenditure dynamics were in support of the forecasts for a cash surplus of about 2.3 per cent of GDP in 2007. Hence, the contribution of government consumption to GDP growth in 2007 is expected to remain close to that in 2006 (0.4 percentage points). In the coming two quarters this contribution will be within the band of 0.3–0.4 percentage points.

Chart 58
Primary Balance (Quarterly)

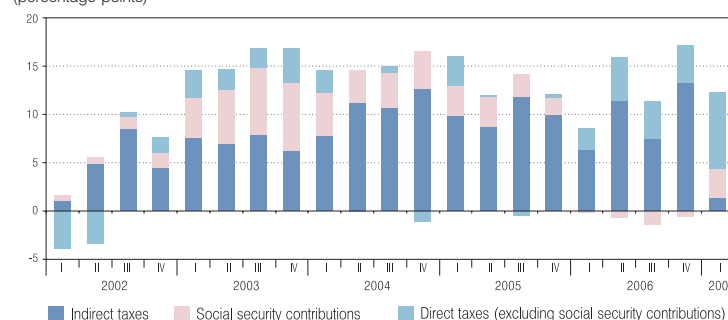
(share of GDP for the quarter, %)



Sources: MF, BNB.

Chart 59
Contribution of Major Tax Groups Growth to Tax Revenue Growth under the Consolidated Fiscal Programme (Quarterly)

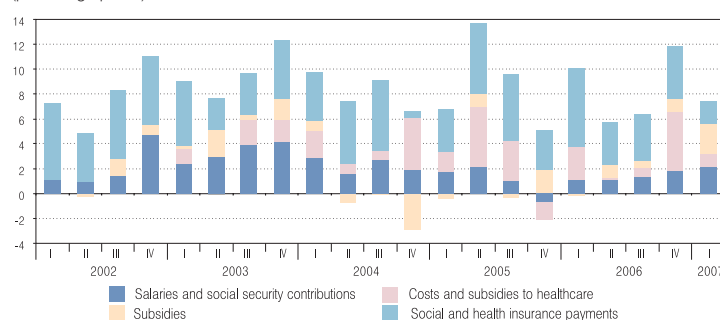
(percentage points)



Sources: MF, BNB.

Chart 60
Contribution of Major Groups of Current Non-interest Expenditure to Total Growth (Quarterly)

(percentage points)



Sources: MF, BNB.

Behaviour of Firms and Competitiveness

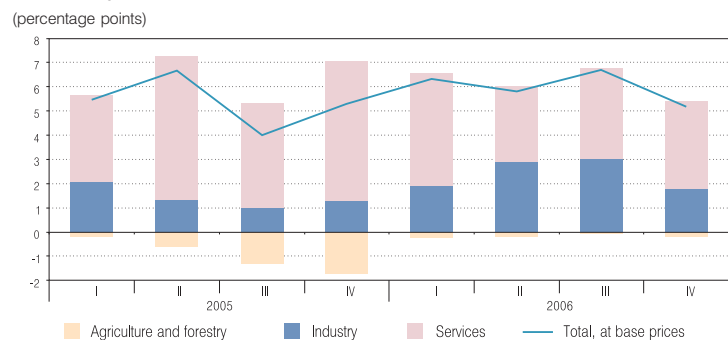
Employment and real salary growth did not entail an increase in unit labour cost due to the accelerating rise in labour productivity; as a result, cost competitiveness was sustained.

Value added picked up by 6 per cent in 2006 posting the highest growth rate ever registered. Manufacturing had a considerable contribution (11.3 per cent growth) followed by trade, financial intermediation and construction. The agricultural sector again reported negative growth.

Operating data as of early 2007 evidenced brisk economic activity. Over the first quarter of 2007 industrial sales increased by 7.3 per cent on the respective quarter of the prior year, including export sales by 1.9 per cent and domestic market sales by 12.9 per cent. The weak export growth resulted from the negative contribution of a limited number of companies in the sectors of oil processing, energy supply and non-ferrous metal-lurgy. The reasons for the decline in these sectors' exports stemmed from the reconstruction of production facilities (used for the production of non-ferrous metals) or the worsened conditions in the sector. Most industrial sectors registered high sales growth including the export sales. In the first quarter of 2007 manufactures of non-metal mineral raw materials and metal products were among the industries which contributed most significantly to the rise in sales, with domestic market sales of raw materials in construction taking the lead.

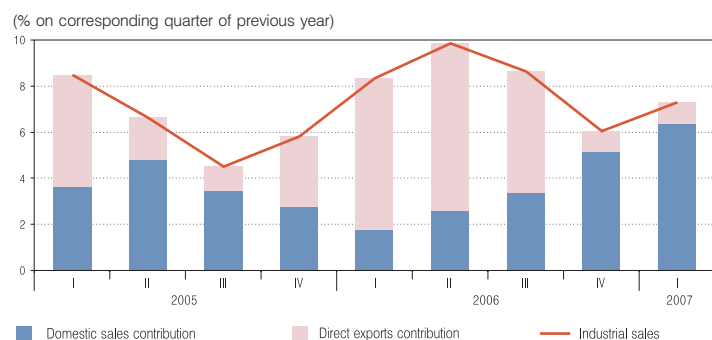
Given the relatively high employment growth rates in 2006, the economy registered an accelerating rise in labour productivity to 4.7 per cent on an annual basis – an expected effect resulting from buoyant investment activity in previous years. Manufacturing was the major industry behind growing labour productivity, although the services sector also reported a significant rise. Data on the industrial production index and the number of employed in the first quarter of 2007 give grounds to conclude that labour productivity growth in this industry and especially in manufacturing remained high at the start of 2007.

Chart 61
Contribution of Economic Sectors to Value Added Growth (Quarterly)



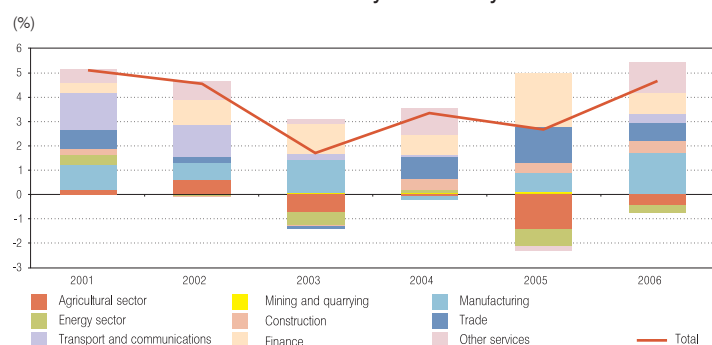
Source: NSI.

Chart 62
Industrial Sales Growth



Source: NSI.

Chart 63
Contribution to Labour Productivity Growth by Sector



Sources: System of National Accounts – NSI, BNB.

The link between growing real salary and labour productivity added to the sustainable trend towards improving unit labour costs. Despite the high salary growth rates, the firms' restrictions on labour remuneration were retained. Cost competitiveness in manufacturing continued to improve.

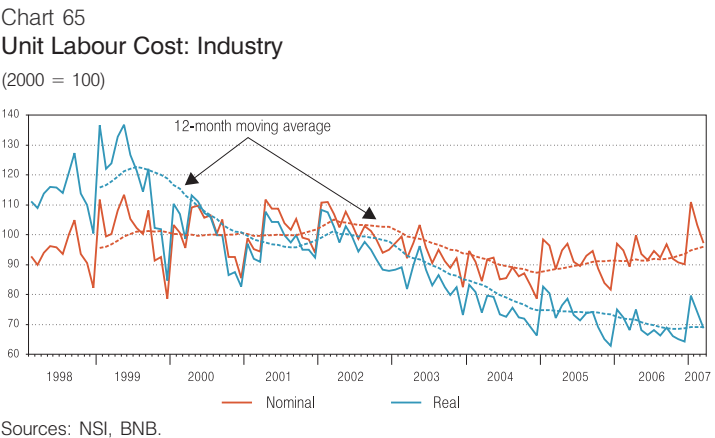
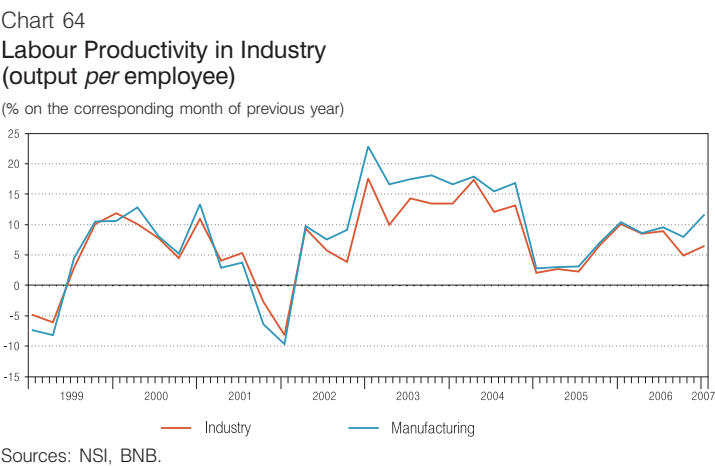
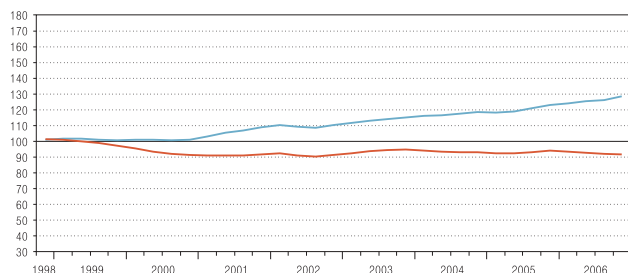
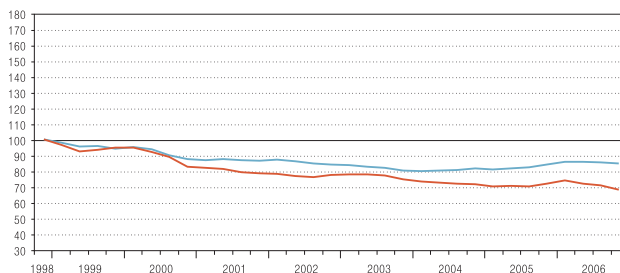


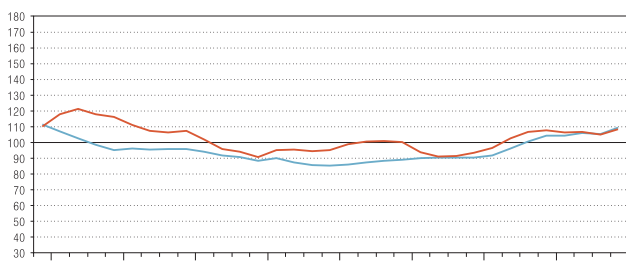
Chart 66
Unit Labour Cost (Quarterly)
(1998 = 100)
Total for the Economy



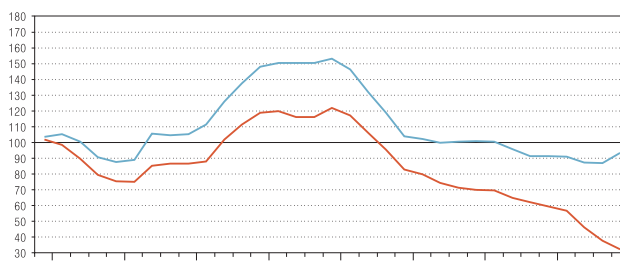
Manufacturing



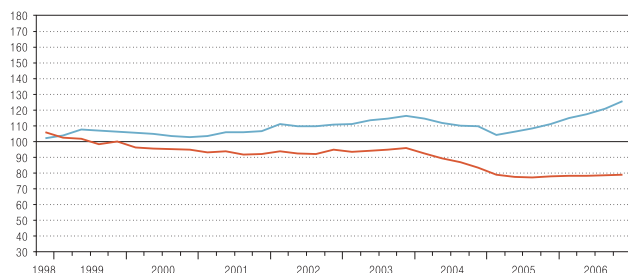
Agricultural Sector



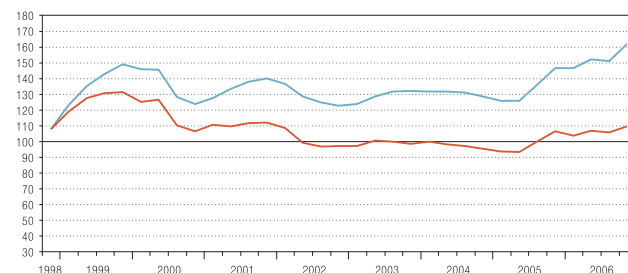
Mining and Quarrying



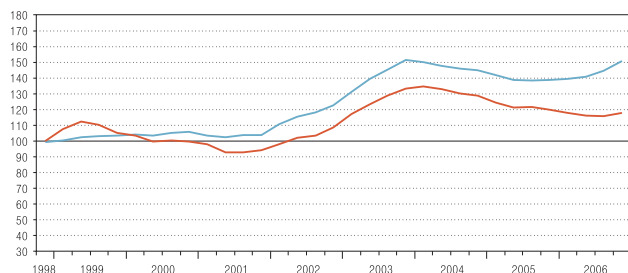
Construction



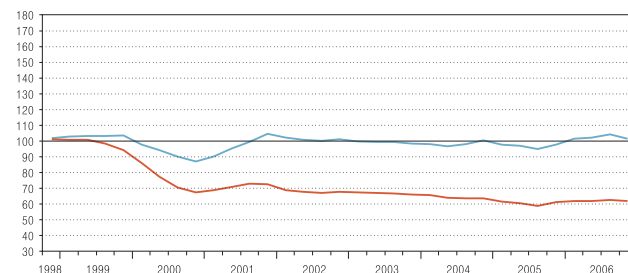
Electricity, Gas and Water Supply



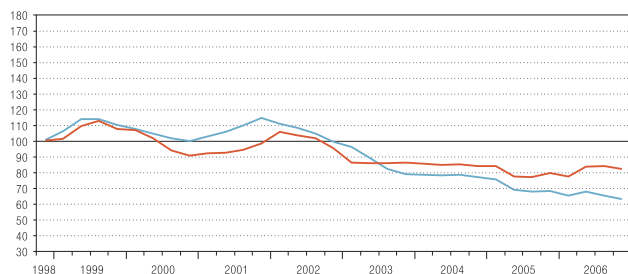
Trade



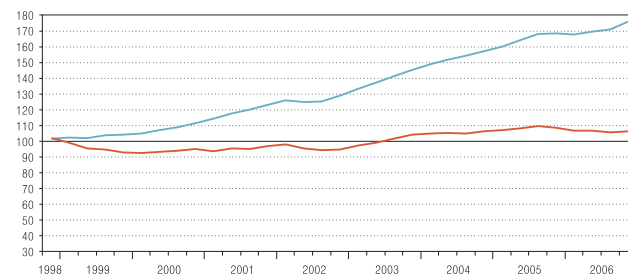
Transport and Communications



Financial Intermediation



Other Sectors



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

Sources: NSI, BNB.

In the second and third quarters of 2007 nominal export growth is expected to increase and relatively sustainable growth in imports of goods to sustain. Major assumptions on which the expectations are based involve the retained stable external demand, improving competitiveness of Bulgarian output and positive changes in Bulgaria's trade conditions.

In terms of value, export growth is expected to accelerate over the forecast horizon supported by the increasing physical volumes, consistent with the improving competitiveness of domestic industry. The faster growth of labour efficiency compared with the compensation *per* employee in industry, high investment activity, positive entrepreneurs' expectations and the increasing share of Bulgaria's exports in total EU imports suggest that competitive positions of domestic output in international markets are retained. Major external assumptions on which the export forecast dynamics are based include: sustained strong consumer activity and a real economic growth higher than the euro area potential growth and positive changes in Bulgaria's trade conditions. A possible moderation in global economic growth will be mostly attributable to lower activity in the USA, and consequently it will have an insignificant effect on the Bulgarian economy. Forecasts on international metal prices point to sustaining the present high levels and moderate growth on an annual basis. International market crude oil prices are expected to move within an interval close to the average monthly values reported in March and April which means insignificant decreases on an annual basis.

Commodity imports are expected to sustain their steady dynamics in the second quarter of the year and to slightly decrease in the third quarter, indicating real growth and an insignificant price change on an annual basis. Major factors determining import growth will be domestic demand growth and dependence of some export oriented industries on imported raw materials.

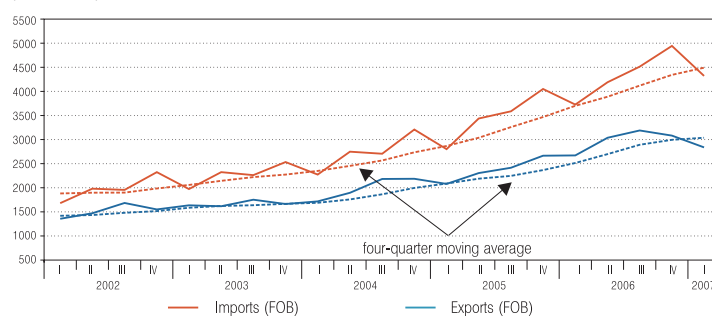
In accordance with the forecasts on export and import dynamics, the negative contribution of foreign trade balance to real GDP growth is expected to increase in the second quarter of the year and to fall in the third quarter. The contribution of exports of goods and non-factor services is projected to stay comparatively unchanged in the two quarters, while imports of goods and non-factor services is expected to moderate to a certain extent due mainly to the base effect.

The new way of collecting information about commodity trade between Bulgaria and other EU Member States used since early 2007 prompted a structural change in the available time series of foreign trade and a stronger uncertainty in exports and imports.¹³ Given the specificity of the new methodology, data revisions will be more profound, which increases uncertainty of currently incoming information both on an aggregate level and in more detailed breakdown by commodity group and partner. The employment of Intrastat system requires more time for collecting, processing and publishing data on Bulgaria's foreign trade commodity structure. Upon balance of payments publication for the reporting month, only aggregate preliminary data on Bulgaria's exports and imports are available. Therefore, the analysis of foreign trade commodity structure is based on the January – February data.

According to preliminary data, exports of goods in euro reached EUR 2837.3 million in the first quarter of 2007 posing a nominal increase by EUR 165 million or by 6.2 per cent on the corresponding period of 2007. Imports (FOB) amounted to EUR 4322.1 million between January and March, a nominal increase by EUR 596.4 million or 16 per cent compared with the first quarter of 2006.

¹³ See the box on the *Original Data on Commodity Exports and Imports within the Scope of the Intrastat System*, p. 40.

Chart 67
Dynamics of Exports and Imports (Quarterly)
(million EUR)



Source: BNB.

Original Data on Commodity Exports and Imports within the Scope of the Intrastat System

With Bulgaria's accession to the EU on 1 January 2007, the Intrastat system for reporting imports and exports of commodities with other EC Member States was introduced. The National Revenue Agency receives and processes Intrastat declarations and provides data to the NSI, where these data are supplemented with information on trade with third parties. The aggregate statistics is made available to users, including the BNB.

The methodology of statistical reporting of trade with other EU Member States was presented and analyzed in details in the *Economic Review* 1/2007. (Changes in Foreign Trade Statistics: Launching the Intrastat System for Reporting Intracommunity Trade, p. 42). The analysis highlights the fact that data are subject to revisions which will be carried out for a comparatively long period pursuant to Article 25, paragraph 2 of the Law on the Statistics of Intracommunity Trade in Goods (Darjaven Vestnik, issue 51 of 2006). Under the provisions of this Law, 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. The first data revision for the January – March 2007 period will be carried out upon publishing on 15 June 2007 the balance of payments for April.

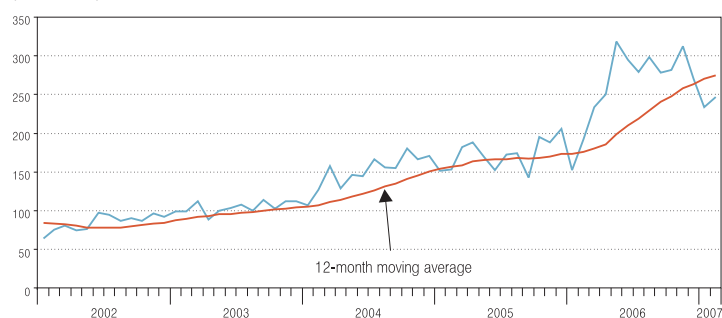
Due to the large share of companies declaring zero values or filing empty declarations for the first three months of the year, the degree of uncertainty of initially published statistics increases and impedes the analysis and forecasting of foreign trade dynamics. In exports (dispatches flow) 42.7 per cent of all filed declarations does not contain information on dispatches, and in imports (arrivals flow) this share accounts for 41.3 per cent. In addition, the share of companies which are obligated but did not file Intrastat declarations on a monthly basis made up about 10 per cent of all companies obligated to prepare export declarations and approximately 11 per cent of those obligated to prepare import declarations.

Consequently, the foreign trade data for the January – March 2007 period, which have already been published, are preliminary and are subject to a number of revisions in the current year and in early 2008.

Investment and consumer goods contributed most significantly to the increase in trade deficit by EUR 302.3 million in January and February 2007. In the first group of goods, imports of machines, equipment and appliances rose significantly, while in the second group, home furniture, clothes and footwear contributed most substantially to the deficit growth. On the other hand, foreign trade dynamics of petroleum products and non-ferrous metals helped decrease the deficit: the negative balance in petroleum went down and Bulgaria's net revenue from non-ferrous metals posted an increase.

Between January and February 2007 exports grew by 4.1 per cent on annual basis reflecting to the largest extent the dynamics of base metals and products made of them, textile, clothing and footwear. In the first category, income from exports rose by EUR 135.3 million supported both by higher prices of non-ferrous metals on international markets and increased production activity in ferrous metallurgy. The increase in cast-iron, iron and steel (by 2.5 percentage points) contributed most significantly to the total growth followed by copper and copper-made products (by 2.1 percentage points) and zinc and zinc-made products (1.6 per-

Chart 68
Exports of Base Metals and Base Metal Products
(million EUR)



Source: BNB.

centage points). Income from exports of textile, clothing and footwear reached EUR 404.1 million over the review period. This group is characterized by relatively even dynamics of individual types of goods. The positive trends in exports of base metals and clothing and footwear as a result of favourable competitive position of these industries in international markets are expected to be sustained in the second and third quarters of 2007.

Mineral products and fuels (falling by 8.6 percentage points) and machines, transportation vehicles and appliances (falling by 0.6 percentage points) contributed negatively to total export growth in the first two months of the year. Export income from mineral products and fuels was lower by 52 per cent from exported petroleum products and by 59.7 per cent from energy and other energy resources compared with the January – February 2006 period. The major factor behind these developments was the physical decline in exports of these products, although international prices of petroleum and petroleum products also went down on an annual basis. Within the group of machines, transportation vehicles and appliances, a negative contribution of 4.3 percentage points was reported in the sea and river shipping. Exports of these products were characterized by a strong base effect as a result of significant income generated in January 2006. The decline is expected to be offset in the following months. Forecasts about export developments in energy resources over the second and third quarters of 2007 are for insignificant changes in income compared with the corresponding periods of 2006. The major hypothesis underlying these expectations is based on the temporary nature of the reported drop in exports of petroleum products since the onset of 2007. Physical growth of exports of petroleum products is expected to partially offset both the lower international petroleum price on an annual basis and the decline in exports of electricity.

Chart 69
Exports of Textiles, Leather, Clothing, Footwear and Miscellaneous Consumer Goods

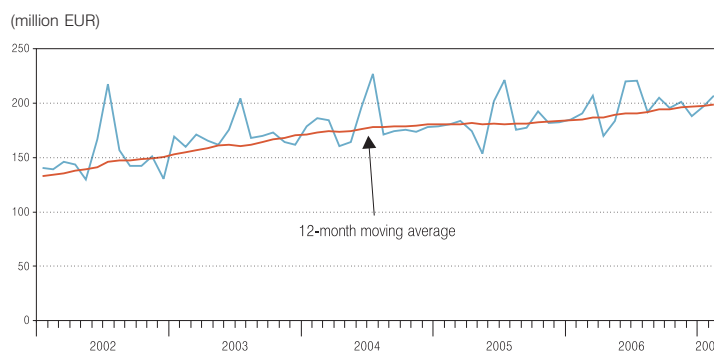


Chart 70
Exports of Mineral Products and Fuels

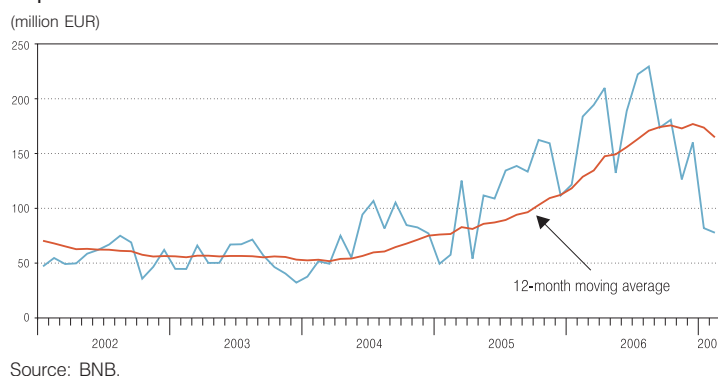


Chart 71
Exports of Machines, Transportation Vehicles and Appliances

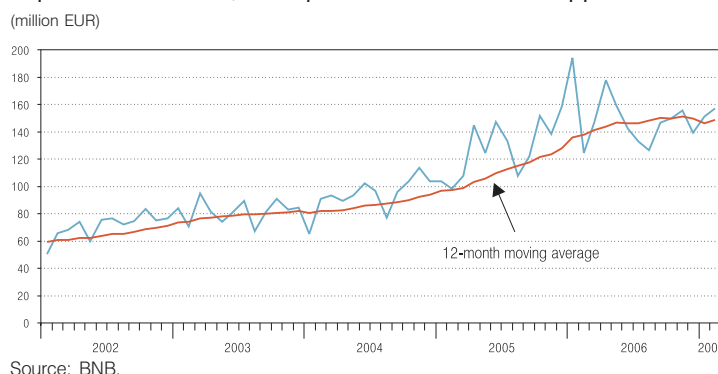


Table 7
Contribution of Commodity Groups to Trade Growth,
January – February 2007

	Exports		Imports	
	growth,%	contribution, p.p.	growth,%	contribution, p.p.
Consumer goods	6.2	1.6	42.9	5.9
Raw materials	31.1	12.2	32.7	11.5
Investment goods	-4.1	-0.7	29.9	6.9
Energy resources	-53.5	-9.0	-27.8	-7.7
Other			-100.0	-0.6
Growth, total	4.1		15.9	

Source: BNB.

Imports (CIF) reached EUR 2848.1 million between January and February 2007, posting a nominal increase by EUR 391.4 million (15.9 per cent) on the corresponding period of 2006. Within the structure of imports by use, raw materials contributed most significantly to import growth (11.5 percentage points) followed by investment goods (6.9 percentage points), while energy resources had a negative contribution (-7.7 percentage points).

Imported raw materials totaled EUR 1143.1 million in the first two months of 2007, an increase by EUR 282 million on the corresponding period of 2006. Imports of cast-iron, iron and steel, plastics and rubber, and ores contributed most significantly to total import growth by 2.8 percentage points, 1.5 percentage point and 1.5 percentage point respectively. Imports of investment goods remained sustainable since early 2007, with machines, equipment and appliances contributing most significantly to total growth: by 3.9 percentage points. A decline was reported in imports of transportation vehicles (-10.1 per cent), and the expectations are for a turnaround in the trend in the following months.

The volume of imported investment goods in the first two months of 2007 reached EUR 732.2 million, with this group ranking second in the structure of imports with a share of 25.7 per cent. In the second and third quarters of 2007 the upward trend in imports of raw materials and investment goods is expected to be retained underpinned by the increasing activity in metallurgy and the high investment activity in Bulgaria. Reconstruction of key non-ferrous metallurgy companies may reduce imports of raw materials in the second quarter.

In the January – February period payments on imported energy resources decreased by EUR 188.4 million on the corresponding period of 2006. Crude oil and natural gas, and fuels contributed most substantially to these developments (-7.5 percentage points and -0.6 percentage points respectively). The negative dynamics in imports of these products were mainly due to

Chart 72
Imports of Raw Materials

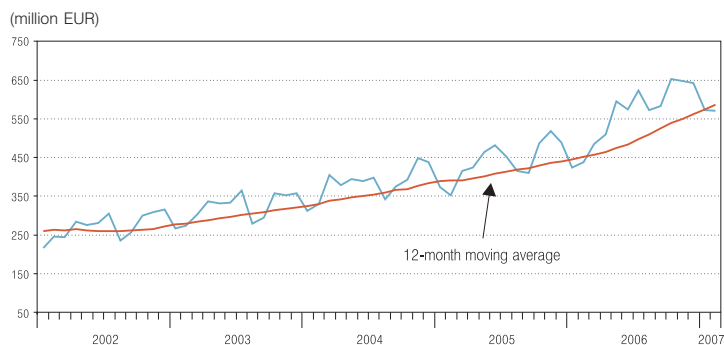
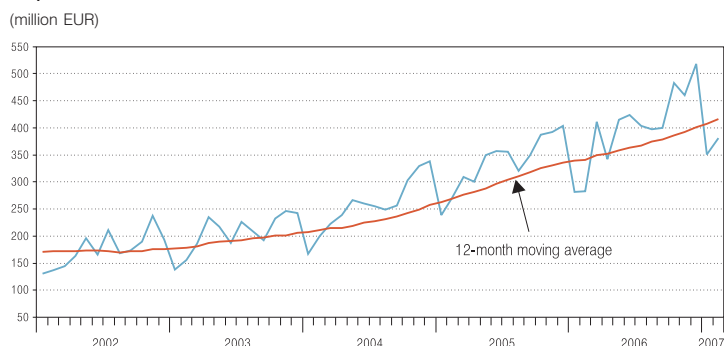


Chart 73
Imports of Investment Goods

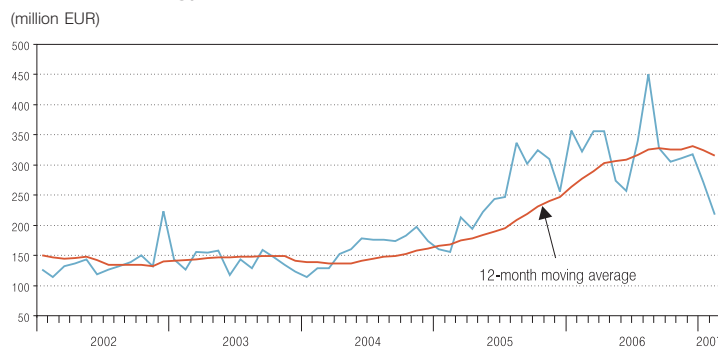


reduced physical volumes. However, lower oil prices in international markets (on an annual basis) also contributed to the lower payments. The downward trend is expected to reverse as the sustainable production activity in oil refining is foreseen to prompt a real growth in imported crude oil. Assumptions on international oil prices suggest a negative price effect (on an annual basis) but expectations are for a dominant role of physical volume growth in the second and third quarters.

Between January and February 2007 imports of consumer goods rose by EUR 145.2 million on the corresponding period of 2006 to reach EUR 483.5 million. Furniture and home equipment contributed most significantly to import growth (by 2 percentage points) in this commodity group and correspondingly to the trade deficit growth. A decline in this group is reported in imported automobiles with a contribution of -0.6 percentage points to total imports. In the second and third quarters imports of consumer goods are expected to retain their steady growth rates supported by the stable domestic demand.

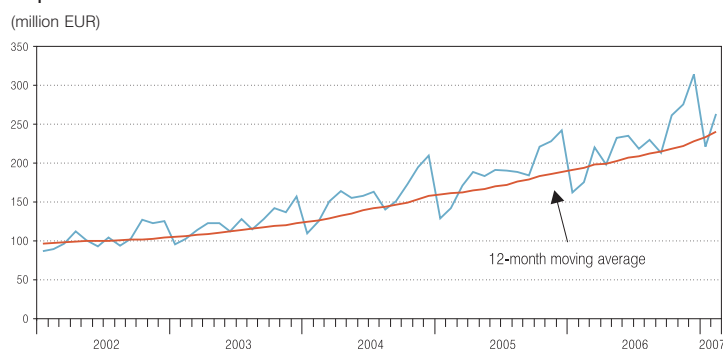
During the first two months of 2007 Bulgarian exports to other EU Member States went up by 9.3 per cent based on preliminary data, while exports to countries outside the Community posted a decline by 4.8 per cent. Imports of goods shows similar trend as to regional distribution, with imported goods originating from the Community going up by 29.4 per cent and those from third countries by 3.8 per cent. Since early 2007 the regional distribution of exports has shown opposite trends compared with 2006. In 2006 Bulgarian goods exported to the Asian region and new EU Member States grew most dynamically, while since early 2007 exports to these two regions exhibited a fall by 42 per cent and 17.9 per cent respectively, with the dynamics in the second group probably also impacted by statistical effects. No significant changes in the geographical structure of Bulgaria's foreign trade are expected over the forecast horizon.

Chart 74
Imports of Energy Resources



Source: BNB.

Chart 75
Imports of Consumer Goods



Source: BNB.

4. Inflation

In April HICP inflation went down to 4.4 per cent on an annual basis.

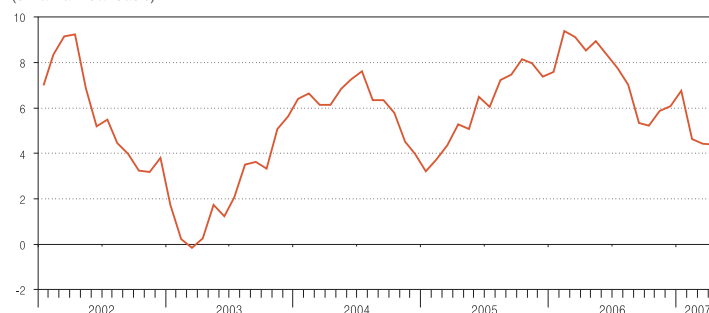
In the second and third quarters of 2007 the downward trend in inflation is expected to continue if the weather conditions are favourable for the crop and the current prices of transport fuels are sustained.

Inflation accumulated since early 2007 is 2.63 per cent: down by 1.66 percentage points on the corresponding period of 2006. In contrast to 2006 when dramatically increased tobacco prices as a result of the rise in excise rates was the major inflationary factor, in early 2007 following the liberalization of cigarette market, tobacco prices decreased by 5.9 per cent and had the most significant negative contribution to the accumulated inflation. Between January and April food and services prices went up by 0.83 percentage points and 1 percentage point (including 0.51 percentage points of administratively set prices) respectively. Higher international crude oil prices in March and April and the early-2007 increase in excise rates of transport fuels in Bulgaria led to a hike in domestic market fuel prices by 7.6 per cent, contributing by 0.5 percentage points to inflation compared with December. In April total inflation went down to 4.4 per cent.

The contribution of administratively set prices to the inflation accumulated since early 2007 reflects the price rises in the following three groups of services: vignette charges (by 60.2 per cent), water supply and sewerage services (by 10.3 per cent and 9.5 per cent on average all over the country) and medical services (hospital services by 12.5 per cent and doctors' services paid to doctors who have concluded a contract with the National Health Insurance Fund, and by 12.5 per cent due to the increased minimum salary as of 1 January 2007. Inflation of administratively set prices went up from an average of 11.8 per cent in November and December 2006 to 12.3 per

Chart 76
Harmonized Index of Consumer Prices

(on an annual basis)



Source: NSI.

Table 8
HICP Inflation Accumulated since Year's Start

	2006	2007
	January – April	
Inflation, %	4.29	2.63
Contribution, percentage points		
Foods	1.10	0.83
Non-foods	2.33	0.43
<i>Transportation fuels</i>	0.04	0.50
<i>Tobacco products</i>	2.25	-0.24
Public catering	0.26	0.38
Services	0.60	0.98
Goods and services with administratively set prices	2.54	0.54
Controlled-price goods	2.23	0.03
<i>Tobacco products*</i>	2.25	-
<i>Medical and other pharmaceutical goods</i>	-0.02	0.03
Controlled-price services	0.31	0.51
<i>Electricity and heating</i>	0.00	0.00
<i>Water supply</i>	0.00	0.10
<i>Medical and hospital services</i>	0.05	0.10
<i>Postal services</i>	0.11	0.00
<i>Vignette charges</i>	0.02	0.16

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

Source: NSI.

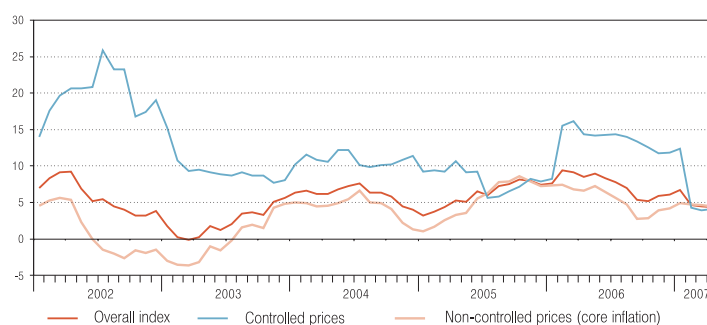
cent in January on an annual basis. The annual growth rate of administratively set prices in the second and third quarters of 2007 is expected to moderate. Risks to the projection stem from a new electricity price rise (affecting producers – public suppliers – electric distribution companies – household and industrial consumers) which the State Energy and Water Regulatory Commission may approve.

Between January and April 2007 core inflation (the inflation rate excluding administratively set prices) rose to 4.7 per cent, up 1.3 percentage point on the last quarter of 2006, a result of the faster increase in food prices on an annual basis (by 5.4 per cent from an average of 3.9 per cent in the previous four months), transport fuel prices (by 4.3 per cent on average in March and April following a six-month deflation period) and services prices excluding administratively set prices (by 5.7 per cent from an average of 4.5 per cent between September and December). If the weather conditions are favourable and the current prices of transport fuels remain unchanged, core inflation is expected to moderate in the second and third quarters. A factor which may have an opposite effect is the occurrence of an indirect impact of higher transport fuel prices at the end of the first and the beginning of the second quarter of 2007 on the prices of goods and services. Firms' pricing policies after the energy market liberalization as of July 2007 may add to the uncertainty.

The annual price rise in food products (excluding soft and alcohol drinks) accelerated from an average of 4.5 per cent in the last quarter of 2006 to 5.3 per cent on average in the first four months of 2007. Faster price rises were reported in the bread and cereals groups (from 8.1 per cent on average in the fourth quarter of 2006 to 15.0 per cent on average in the first four months of 2007) and the milk and dairy product group (from 3.5 per cent to 7.3 per cent respectively). The increase in international and domestic wheat prices, started at end-2006, had a strong effect on the bread price pushing it up by 18.7 per cent on an average annual basis. Similar trends occurred in

Chart 77
Harmonized Price Indices

(on an annual basis)



Sources: NSI, BNB.

the rice price which increased by 22.3 per cent on average in the first four months of 2007 compared with the corresponding period of 2006 (against an average annual growth rate of 10.5 per cent in the previous four months). Sugar and sugar product prices posted an annual decline from 19.1 per cent in the last quarter of 2006 to 6.4 per cent in the first four months of 2007, reflecting the base effect of the higher sugar prices in international and domestic markets in early 2006.

Prices of unprocessed food slowed down. Concurrently, prices of meat and meat products exhibited a relatively small increase on an annual basis (down 2.9 per cent in early 2007 compared with the December 2006 level).

Between January and April non-food inflation (excluding fuels and controlled-price goods) remained at 2.8 per cent on average compared with the corresponding period of 2006, up 1 percentage point on the previous quarter. The decrease in annual prices in this commodity group to 2.1 per cent in March and April reflected the negative contribution of tobacco prices. No significant acceleration in inflation in the non-food group is expected in the following two quarters. Inflation dynamics of prices in this commodity group may be affected by the indirect effect of higher transport fuel prices. The base effect of the high base of tobacco prices in the February – December period of 2006 will have an opposite impact. The increased international market crude oil prices in March and April had a direct effect on domestic market fuel prices. Over these two months annual inflation in transport fuel prices accelerated from negative rates between September and February to reach 4.1 per cent in March and 4.5 per cent in April. Since early 2007 the total price rise of transport fuels has been 7.6 per cent, while that of fuels used by households 0.4 per cent. The annual price increase in transport services experienced no significant changes from the last quarter of 2006 and remained at about 4 per cent on average in the first quarter of 2007. In the absence of additional

Chart 78
Harmonized Price Indices

(on an annual basis)



* Foods, alcohol drinks and tobacco products.

Sources: NSI, BNB.

Chart 79
Harmonized Price Indices

(on an annual basis)



Sources: NSI, BNB.

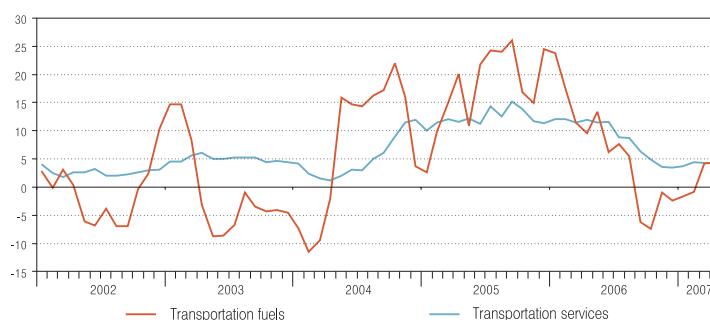
inflationary pressure exerted from international markets, the annual inflation in the transportation fuel commodity group is expected to slow down in the second and third quarters and that in transportation services is anticipated to remain unchanged due to possible secondary effects associated with fuel price hikes.

Services price inflation (excluding controlled-price services) went up by 5.8 per cent annually in April, with the annual growth accelerating from 4.3 per cent on average in the last three months of 2006 to 5.7 per cent in the first quarter of 2007. Compared with the previous quarter, prices of some services exhibited an increase: civil liability insurance (35.9 per cent against 9.3 per cent in the previous three months), tourism and travel (18.3 per cent against 7.2 per cent on an annual basis), cultural services (9.6 per cent against 3.9 per cent). Over the first four months the services group, excluding administratively set prices of services, contributed by 1.89 percentage points on average to total inflation on an annual basis, with the subgroup of restaurants and cafes having the largest contribution (0.73 percentage points). Prices of market services are expected to maintain an annual rate of about 5.4–5.5 per cent in the second and third quarters, a result of the indirect effect of appreciated transport fuels in March and April.

The growth rate of total HICP on an annual basis went down from 5.7 per cent in the October – December period to 5.3 per cent on average in the first quarter of 2007. The average inflation on an annual basis is expected to further decline in the second and third quarters if the weather conditions are favourable for the crop and the current prices of transport fuels remain unchanged following the stabilization of international energy commodity markets.

Chart 80
Harmonized Price Indices

(on an annual basis)



Sources: NSI, BNB.

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