

Economic Review

4/2007



BULGARIAN
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BANK

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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 4/2007 was presented to the BNB Governing Council at its 7 December 2007 meeting. It employs statistical data published up to 12 December 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* sub-menu. 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
LEONIA	LEv OverNight Index Average
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

External environment in the second half of 2007 was characterized by increased uncertainty and loss of confidence between international financial market participants due to adverse developments of the crisis in the US sub-prime mortgage market. Dramatically increased international fuel and food prices additionally enhanced global uncertainty. Global economic indicators point to growing pessimism in business and consumer sentiment and a moderation in global economic growth rates and expectations for increasing inflation.

In Bulgaria business assessments of the current economic situation and expectations for the following 12 months show continued optimism. Investor interest in Bulgaria's economy remained strong. Based on financial account and international reserve data, a conclusion may be drawn that Bulgaria's external position underwent no significant changes. Between January and October 2007 the balance of payments financial account surplus amounted to EUR 8136.4 billion, foreign direct investments covered the current account deficit by 103 per cent, the overall balance was positive and boosted BNB reserves by EUR 2820.1 million (excluding valuation adjustments). The current information about the market value of international assets (Issue Department balance sheet figure) suggests that BNB international reserves continued to increase, reaching EUR 12,032.6 million by the end of November.

Banks' lending activity accelerated since early 2007. On the one hand, positive expectations about economic growth motivated the strong demand for loans by corporations and households, and on the other hand favourable macroeconomic developments lead to an increase in banks' disposable lending resources. Since early 2007 administrative measures for limiting bank lending growth imposed in the second quarter of 2005, were removed but due to the strong credit expansion the BNB increased minimum required reserves as of 1 September from 8 per cent to 12 per cent which resulted in a significant withdrawal of liquidity from the domestic market. The implemented fiscal policy of a surplus on the consolidated state budget also contributed to decreasing the liquidity in the economy.

The economic activity was strong and the significant contribution of investment in fixed assets to growth is expected to be sustained and the contribution of net exports to improve until the end of the year. Manufacturing industry retained its competitiveness irrespective of increased average nominal wage in this industry. In nominal terms, unit labour costs in the manufacturing industry slightly grew but remained lower than the 1998 level, while in real terms they accounted for 70 per cent compared with the 1998 level. Moderate growth of nominal unit labour costs over the year did not deteriorate the profit rate in the industry since the producer price index rose at a faster pace.

The average annual inflation rate between January and November 2007 was 7.2 per cent with the food and services (mostly catering) price rises contributing most significantly. In the first quarter of 2008 annual inflation is expected to remain high, with food catering and transport fuel prices contributing most significantly to this effect.

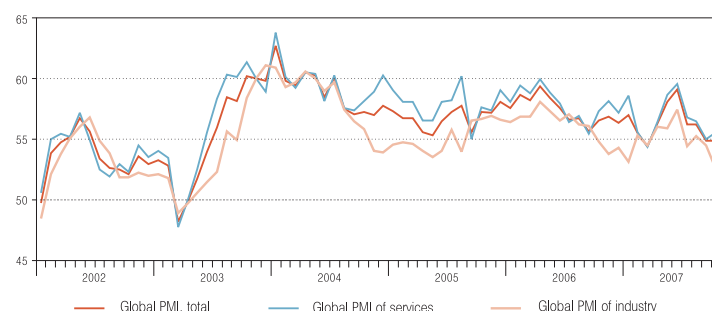
1. External Environment

The crisis in the US sub-prime mortgage market eroded confidence and increased uncertainty of international financial markets which affected adversely business expectations about global economic development.

Current Business Situation

Global economic indicators show expectations of a moderation in industry and services growth. The expected decline in the US consumption and moderation in the economic activity in the EU reflect both the increasing uncertainty in international financial markets caused by the US credit market crisis and the upward trend in fuel and food prices.

Chart 1
Global PMI



Sources: NTC Research, JP Morgan.

Table 1
Major Trends in EC and IMF Autumn Forecasts
(real percentage change)

			Autumn forecast, 2007		Change on spring forecast, 2007	
	2005	2006	2007	2008	2007	2008
EC						
EU						
GDP growth	1.8	3.0	2.9	2.4		-0.3
Euro area						
GDP growth	2.4	1.6	2.3	2.2		-0.3
Unemployment	8.9	8.3	7.3	7.1	0.1	0.3
Inflation	2.2	2.2	2.0	2.1	0.1	0.2
USA						
GDP growth	3.1	2.9	2.1	1.7	-0.1	-1.0
Unemployment	5.1	4.6	4.6	5.3	-0.1	0.3
Inflation	3.4	3.2	2.7	1.9	0.4	
Japan	1.9	2.2	1.9	1.9	-0.4	-0.2
China	10.2	11.1	11.2	10.3	0.7	-0.1
Latin America	4.5	5.4	5.0	4.4	0.5	0.3
Asia (Japan excluded)	8.3	9.1	8.8	8.4	0.5	
Africa	5.9	5.8	6.9	6.5	0.4	0.5
World growth	4.8	5.4	5.1	4.8	0.3	-0.1
IMF						
EU						
GDP growth	2	3.2	3	2.5	-0.1	-0.3
Euro area						
GDP growth	1.5	2.8	2.5	2.1	0.2	-0.2
Unemployment	8.6	7.8	6.9	6.8	-0.4	-0.3
Inflation	2.2	2.2	2.0	2.0		
USA						
GDP growth	3.1	2.9	1.9	1.9	-0.3	-0.9
Unemployment	5.1	4.6	4.7	5.7	-0.1	0.7
Inflation	3.4	3.2	2.7	2.3	0.8	-0.2
Japan	1.9	2.2	2	1.7	-0.3	-0.2
China	10.4	11.1	11.5	10	1.5	0.5
Advanced economies	2.5	2.9	2.5	2.2		-0.5
Western Hemisphere	4.6	5.5	5	4.3	0.1	0.1
Asia	8.7	9.3	9.2	8.3	0.8	0.3
Africa	5.6	5.6	5.7	6.5	-0.5	0.7
World growth	4.8	5.4	5.2	4.8	0.3	-0.1

Sources: EC and IMF.

In the autumn IMF and EC projections about global economic development in 2007 were revised upward due to higher growth reported by the Asian economies.¹ As to the projections about global economic growth in 2008, both institutions took into account the negative effect of the US subprime mortgage market crisis in 2007 and decreased the estimates by 0.1 percentage points. The euro area growth is expected to remain steady within 2.1 and 2.2 per cent. The estimates revised downward reflect the effects of euro appreciation, trade slowdown and tightened financing conditions. US growth was revised downward by 1 percentage point and according to both projections it is expected to range between 1.7 and 1.9 per cent. The mortgage market crisis is anticipated to continue affecting negatively the housing construction investments. On the other hand, private consumption is expected to moderate, consistent with high fuel prices, lower employment growth and depreciation of housing.

Euro Area

In the third quarter of 2007 euro area GDP growth increased to 2.6 per cent on an annual basis against 2.5 per cent in the second quarter. Based on preliminary data growth reflects mostly the domestic demand in France and the net exports and investments in Germany.

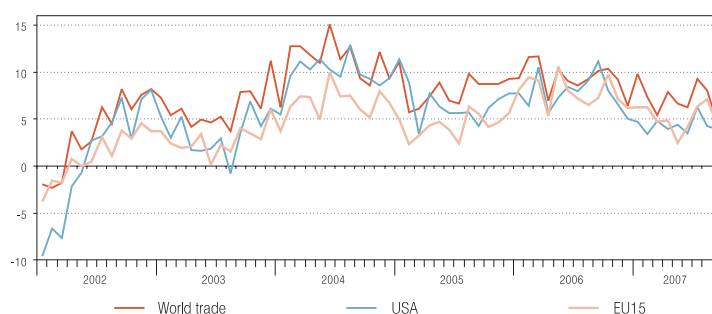
In October the euro area harmonized inflation went up to 2.6 per cent on an annual basis against 2.1 per cent a month earlier due both to the exhaustion of 2006 favourable base effects and to the appreciation of fuels and food in recent months. Nevertheless, the annual core inflation remained relatively stable: at 1.9 per cent against 1.8 per cent in the previous month.

Enhanced uncertainty in international financial markets ascribable to US risk mortgage lending crisis had a negative effect on consumer and investment sentiment in recent months. The downward trend in indicators reflects the expectations for a moderate

¹ As compared with the IMF and EC projections published in spring 2007.

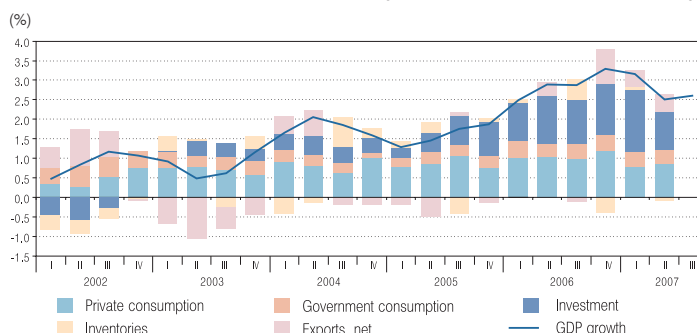
Chart 2
World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

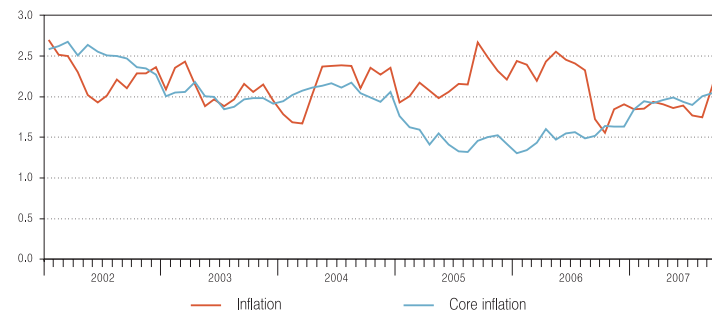
Chart 3
Contribution to Euro Area Growth by GDP Component (Quarterly)



Source: Eurostat.

Chart 4
Euro Area Inflation Rate

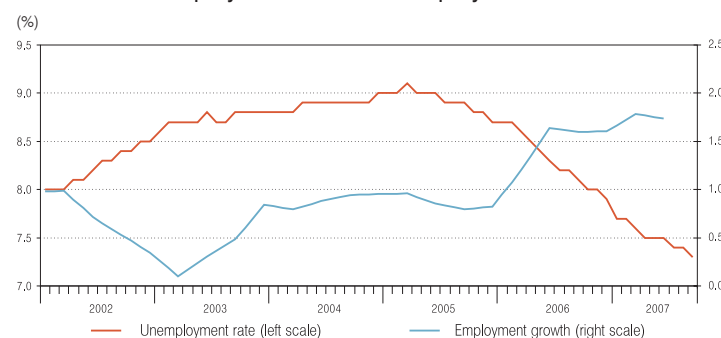
(percentage change on same period of previous year)



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

Source: Eurostat.

Chart 5
Euro Area Unemployment Rate and Employment Growth



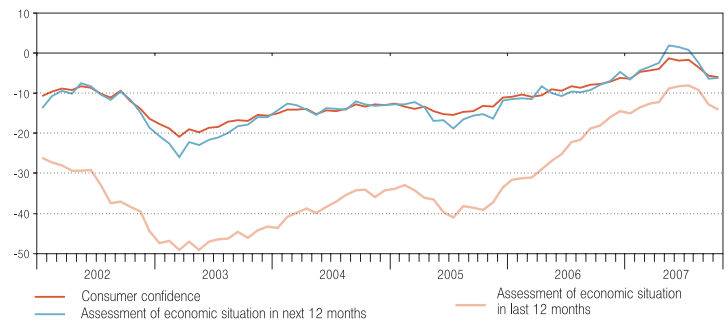
Source: Eurostat.

slowdown close to the long-term euro area economic growth until the end of 2007 and early 2008. Risks to slower euro area economic activity in the medium run are associated mostly with a possible stronger effect of the financial market crisis on the real economy and further appreciation of petroleum and commodities. The increasing fuel and food prices pushed up the inflationary pressure in the euro area and inflation is expected to remain at a level of over 2 per cent until the end of the first quarter of 2008.

The impact of the US sub-prime mortgage market crisis on the euro area financial markets resulted primarily in weaker confidence among participants, and hence a decreased supply of money market resources. Banks preferred to keep liquidity given the increased uncertainty about crisis developments, which led to stronger fluctuations in overnight deposit rates (EONIA) very often deviating from the interest rate on ECB main refinancing operations. The spread between the three-month EURIBOR and the reference rate on overnight deposits (EONIA) increased. Stronger financial market fluctuations led to an increased risk aversion and enhanced demand for zero-risk government securities. This prompted a dramatic fall in the yield of European government bonds. Since the last quarter of 2007 the yield in the sector of two-year bonds lost 37 basis points accounting for 3.66 per cent (by 23 November), while the yield of ten-year bonds declined by 31 basis points to 4.03 per cent (by 23 November).

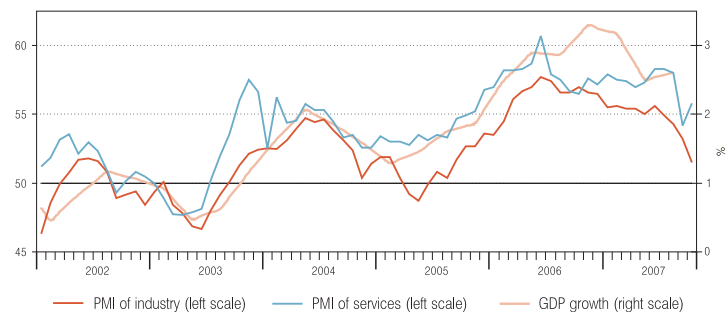
To counterbalance the adverse effect on market liquidity the ECB Governing Council decided to leave the interest rate on ECB main refinancing operations in November and December unchanged at 4 per cent. In addition to its regular weekly refinancing operations the ECB started conducting extraordinary operations for providing liquidity against a three-month collateral. Interest rates on main refinancing operations in the euro area are expected to remain at 4 per cent in the first quarter of 2008.

Chart 6
Euro Area Consumer Confidence Indices



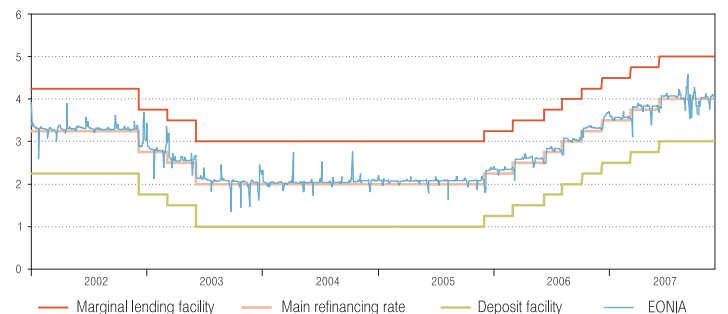
Source: Eurostat.

Chart 7
PMI and Euro Area GDP Growth



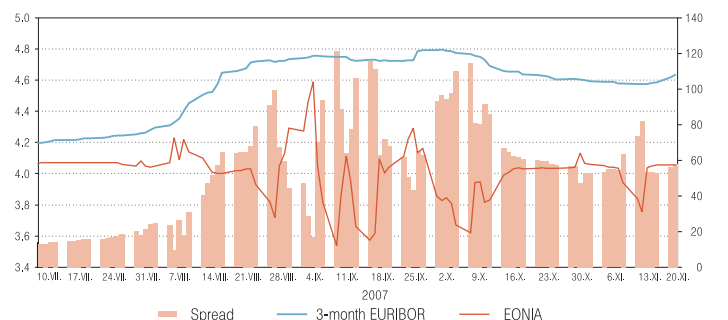
Source: NTC Research.

Chart 8
Euro Area Interest Rates
(%)



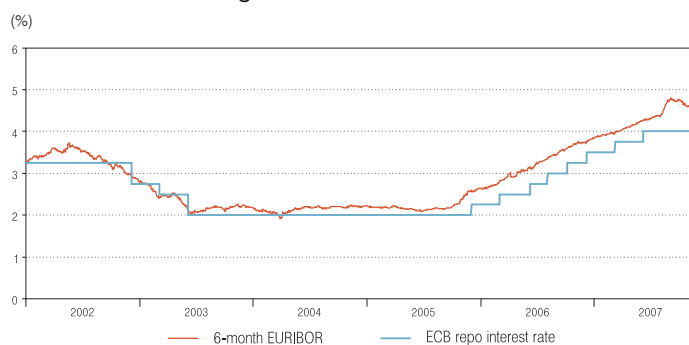
Source: Bloomberg.

Chart 9
Liquidity Premium (the spread between 3-month EURIBOR and EONIA)



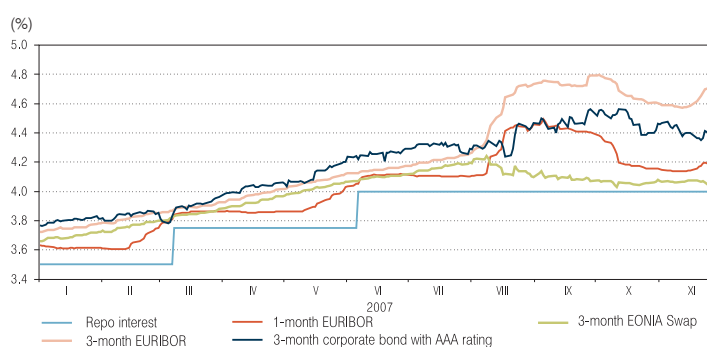
Source: Bloomberg.

Chart 10
ECB Main Refinancing Rate and Six-month EURIBOR



Source: Bloomberg.

Chart 11
Euro Area Short-term Interest Rates



Source: Bloomberg.

EU-11*

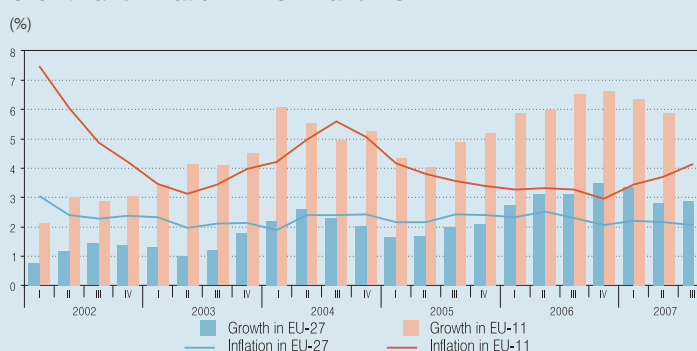
In 2008 growth is expected to moderate in all EU-11 member states with the exception of Hungary and Cyprus. The major factor contributing to this effect will be the decreased private consumption. The average monthly inflation in the new monthly member states reached 4.1 per cent on an annual basis in the third quarter due to accelerated inflation in food and fuels.

Table 2
Forecasts for EU-11 Countries' Growth
(%)

	2007	2008	Change on spring forecast
Bulgaria	6.3	6.0	-0.3
The Czech Republic	5.8	5.0	-0.8
Estonia	7.8	6.4	-1.4
Latvia	10.5	7.2	-3.3
Lithuania	8.5	7.5	-1.0
Hungary	2.0	2.6	0.6
Poland	6.5	5.6	-0.9
Romania	6.0	5.9	-0.1
Slovakia	8.7	7.0	-1.7
Cyprus	3.8	3.9	0.1
Malta	3.1	2.8	-0.3

Source: EC, Autumn forecast 2007.

Chart 12
Growth and Inflation in EU-27 and EU-11



Sources: Eurostat, own calculations.

* EU-11 includes newly acceded EU countries, excluding Slovenia. As from 1 January 2007 Slovenia became a full-fledged member of the European Monetary Union.

USA

In the third quarter of 2007 GDP growth in the USA accelerated. Net exports contributed positively to growth, as well as to government consumer expenditure. The state of housing market continued deteriorating, with the contraction affecting GDP growth.

In the third quarter of 2007 the economic growth rate is expected to be lower than the long-term rate. The decline in consumer confidence will result in a moderation of private consumption dynamics. The crisis in the residential estate sector, where the prices went down and investments in new construction fell, will continue to affect the overall economic activity. A key factor behind the worsened growth outlook was the tightened lending standards and higher cost of financial resources both in the capital markets and in extending loans by banks. The more conservative lending policy pursued will have a negative effect on business investments and consumer expenditure. The intensity and duration of this effect will depend on the credit market crisis developments and the associated losses incurred by financial institutions.

Recent labour market data suggest that unemployment has smoothly increased and employment growth has slowed down. Notwithstanding, employment in the economy was high and remained a source of inflationary pressures due to yet strong wage growth and high unit labour costs.

Personal consumer expenditure deflator accelerated its growth supported by high energy prices. Core inflation, excluding energy and food groups, sustained its downward trend of the last year, decreasing to 1.8 per cent on an annual basis in September. Risks to higher inflation are associated with higher petroleum prices, depreciation of the US dollar (and correspondingly the accelerated growth in import prices) and increasing expectations for higher inflation.

The US Federal Reserve System initiated a number of measures to reduce the losses caused by the US sub-prime mortgage market and to overcome the liquidity fall. Following the cut in the reference rate by 50 basis points on 18 September the US Federal

Chart 13

Contribution to US Growth by GDP Component (Quarterly)

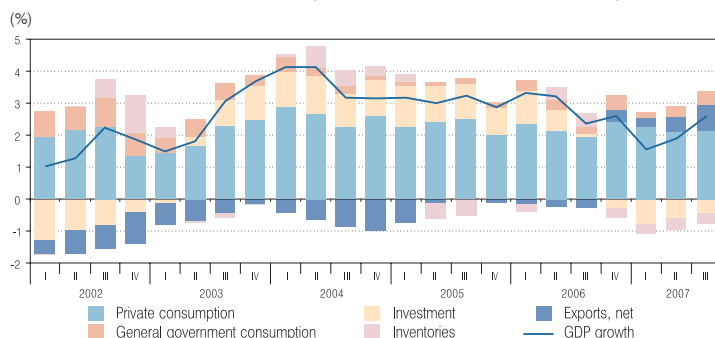


Chart 14

US Consumer Confidence Indices

(1985 = 100)

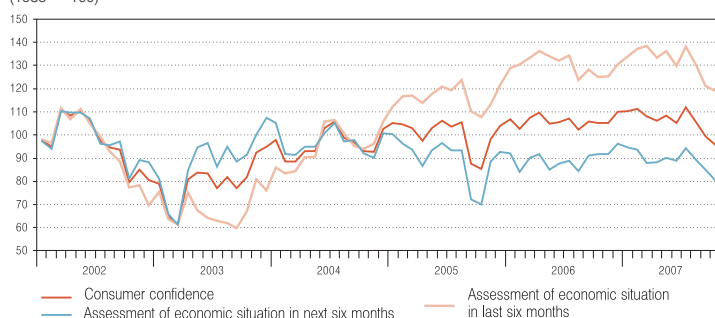


Chart 15

US PMI of Industry and Services and GDP Growth

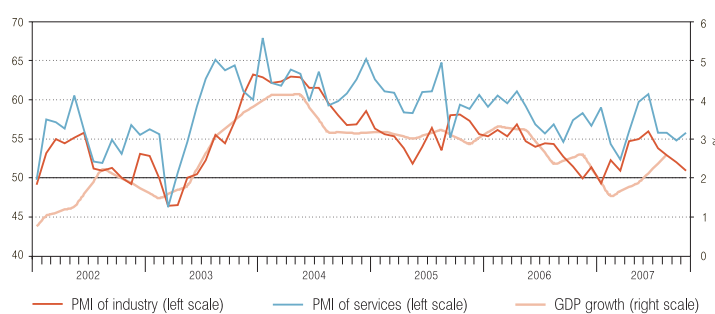
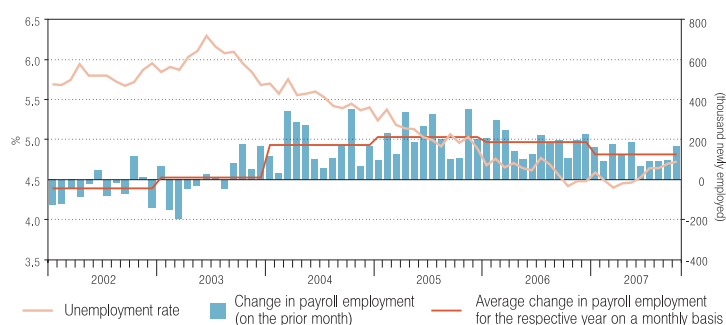


Chart 16

US Unemployment Rate and Changes in Payroll Employment



Open Market Committee (FOMC) initiated two consecutive interest rate decreases by 25 basis points each in October and December to 4.25 per cent. These decisions were supported by the expected economic slowdown in the future due to deteriorated real estate market and the negative trends in financial markets. Financial market expectations are for a further cut in interest rates in the first quarter of 2008.

The USD/EUR Rate

Depreciation of the US dollar continued in most of the fourth quarter of 2007. The movement corridor widened and the fast euro appreciation continued. Due to significant uncertainty about financial crisis developments and the size of losses incurred, market participants continued to expect lower interest rates in US dollars in the future.

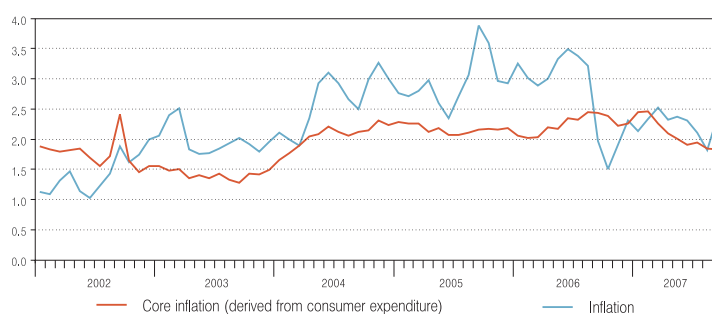
The incoming macroeconomic information failed to support the US dollar as the balance remained on the negative side. The US trade balance improved in the fourth quarter. Concurrently, risks associated with deficit financing increased due to a downward trend in portfolio capital flows, a result of the credit crisis.

External factors exerted downward pressure on the value of the US dollar. China's signals about its intents to diversify its foreign reserves continued, and the Persian Gulf countries announced their intents to review their fixed exchange rate regimes to the US dollar.

In the first quarter of 2008 market expectations are for a broad volatility range of the USD/EUR exchange rate and a sustained upward trend. The short-term expectations about the dynamics of the interest rate differential between the USA and euro area remained in support of the euro. The policy of tightening credit standards in response to the ongoing US housing and financial sector turmoil will continue to have an adverse effect on the economic development.

Chart 17
US Inflation Rate

(percentage change on same period of previous year)

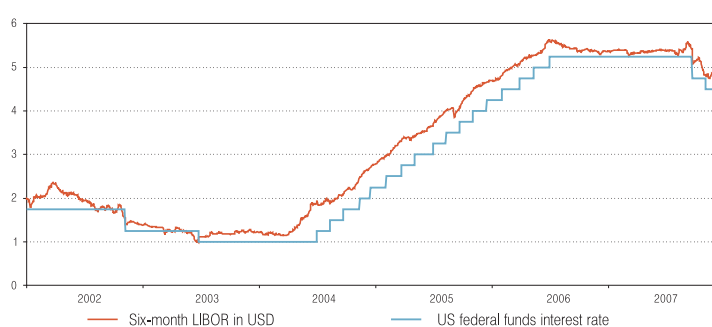


Note: The US core inflation is measured by consumer expenditure index excluding energy and food expenditure.

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

Chart 18
US Federal Funds Rate and Six-month LIBOR in US Dollars

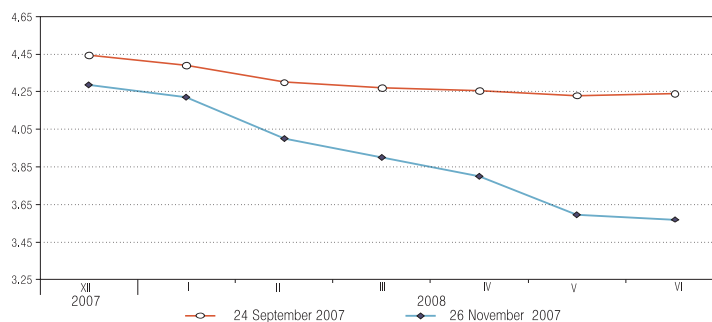
(%)



Source: Bloomberg.

Chart 19
Implied Federal Funds Futures Interest Rate

(%)



Source: Bloomberg.

Chart 20
USD/EUR Exchange Rate

(USD per EUR 1)



Source: ECB.

The Balkan Region

In the third quarter of 2007 economic situation in the Balkans remained favourable. The rate of industrial output slightly slowed down in recent months but retained its relatively high levels. Higher international fuel and food prices pushed up inflation rates in the Balkan region countries.

Expectations in the following months are for a moderation of growth due to worsened international economic conditions.

Table 3

Real Growth and Inflation in Balkan Countries (Quarterly)

	2006					2007		
	I	II	III	IV	Total	I	II	III
Growth (on the previous year, %)								
Bulgaria	5.5	6.4	6.7	5.7	6.1	6.2	6.6	4.5
Greece	4.2	4.2	4.5	4.4	4.3	4.6	4.1	3.6
Macedonia	2.7	4.1	4.7	3.4	3.7	6.8	4.2	4.2
Romania	6.9	7.8	8.3	7.7	7.7	6.0	5.6	5.7
Turkey	6.7	8.3	4.8	5.2	6.1	6.8	4.1	1.5
Croatia	6.0	3.6	4.7	4.8	4.8	7.0	6.6	5.1
Serbia	7.0	6.2	5.1	4.8	5.7	8.1	7.5	7.2
Inflation (averaged for the period, %)								
Bulgaria	8.7	8.6	6.7	5.7	7.4	5.3	4.7	9.0
Greece	3.2	3.4	3.5	3.2	3.3	2.9	2.6	2.8
Macedonia	2.7	3.4	3.6	3.1	3.2	0.7	1.1	2.4
Romania	8.7	7.2	5.9	4.8	6.6	3.9	3.9	5.1
Turkey	8.1	9.6	10.8	9.8	9.6	10.3	9.5	7.1
Croatia	3.5	3.8	3.2	2.2	3.2	1.6	2.1	2.9
Serbia	14.6	14.2	11.4	7.1	11.8	4.8	3.3	6.6

Sources: Statistical institutes and central banks of respective countries.

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

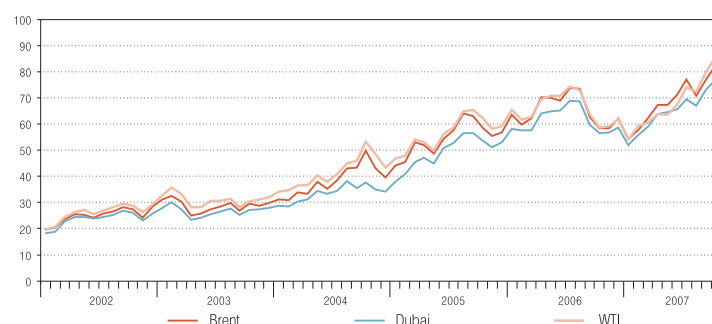
Crude Oil

In the third quarter of 2007 the average monthly Brent crude oil price rose by 9.2 per cent on the previous quarter to USD 75 *per barrel*. Increasing uncertainty about supply prompted a new price increase and in November the Brent crude oil was traded at about USD 92 *per barrel*. The major factor behind the oil appreciation over the review period was the reduced supply by OPEC countries and particularly by Saudi Arabia, Venezuela, Nigeria and Iran. The third quarter saw an annual fall in supply by 0.5 per cent for the first time for the last 5 years. Therefore, industrial inventories fell by 4.1 per cent. Significant US dollar depreciation and speculative demand for short-term crude oil futures contracts from hedging funds also contributed to its appreciation.

Over the fourth quarter of 2007 and the first quarter of 2008 the average monthly Brent price is expected to fluctuate within the range of USD 80–100 *per barrel*. The increased demand by the northern hemisphere countries in the winter will support

Chart 21
Crude Oil Prices

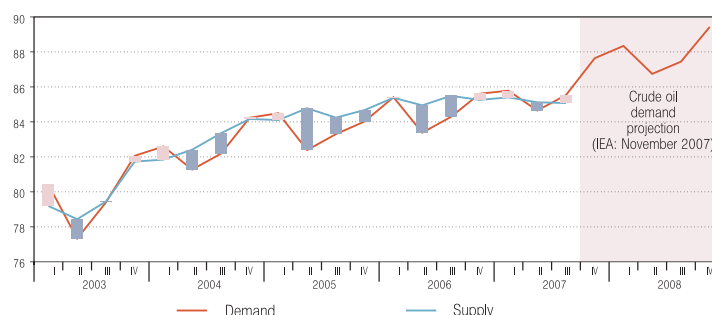
(USD *per barrel*)



Source: World Bank.

Chart 22
World Crude Oil Demand and Supply (Quarterly)

(million barrels *per day*)



Source: IEA.

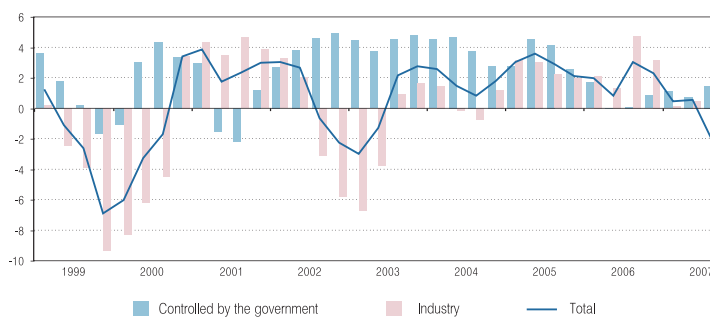
retention of the high oil prices in the fourth quarter of 2007 and the first quarter of 2008. Risks to the forecast continued to be associated with the OPEC decision of 4 December not to increase production and with the geopolitical instability in the Middle East, particularly in Iran. A possible disturbance in supply from any of the large oil exporting countries would prompt a significant price rise. Demand may decrease provided the expectations for a global economic slow-down materialise.

Major Raw Material and Commodity Prices

In the third quarter of 2007 metal prices went down by 6.4 per cent on the previous quarter. Both the fall in supply and increased inventories in most metals exerted downward pressure on prices. The lead price strengthened significantly but the factors impacting it are specific and associated with constraints in supply.

In the third quarter wheat prices went up by 34 per cent on the previous quarter and contributed to the food price increase by 9.5 per cent. Wheat production and inventories in the 2007/2008 agricultural season declined due to unfavourable weather condi-

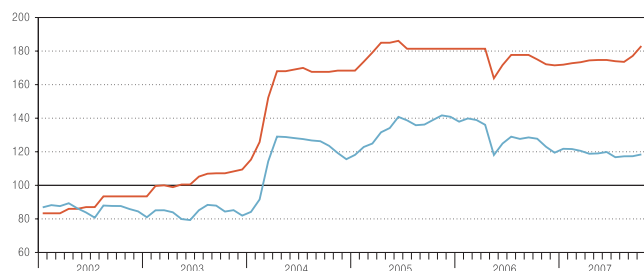
Chart 23
Inventories of Crude Oil Products in OECD Countries
(annual growth, %)



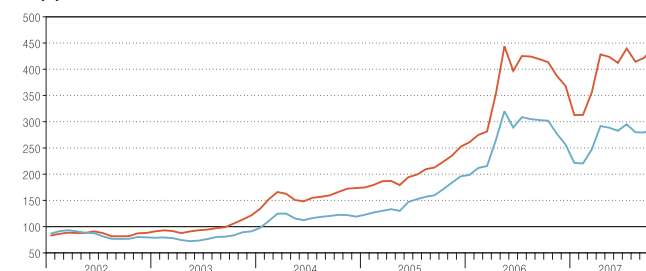
Source: IEA.

Chart 24
Price Indices of Major Commodities and Commodity Groups
(2000 = 100)

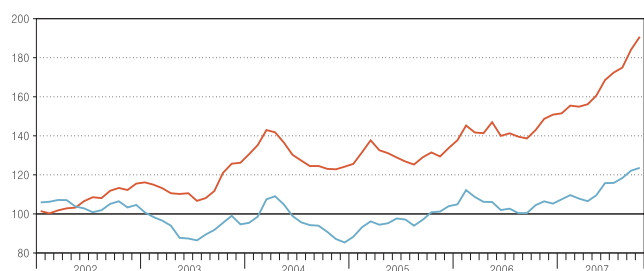
Steel



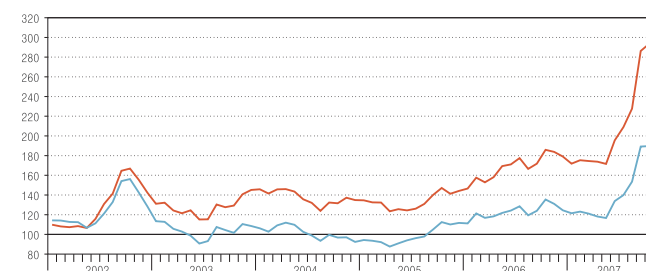
Copper



Food



Wheat



Sources: World Bank, BNB.

— USD — EUR

tions in Australia and Canada. An additional factor concerning supply was the export constraints imposed by some major exporting countries: Ukraine and Argentina.

Gold

Over the fourth quarter of 2007 the gold price varied within a wide range, following a sustainable upward trend. The gold price movement corridor ranged within USD 680–848 *per* troy ounce and after the threshold of USD 750 *per* troy ounce had been exceeded, the gold price increase accelerated. Net long positions in gold hit a record high supporting the expectations for further price increases.

The major factors behind the increased price were US dollar devaluation and higher petroleum prices in international markets.

Investment demand for gold appeared to be stronger than in the previous quarter. In November, Street Gold Tracks, the largest gold investment fund, reported a record high in its assets.

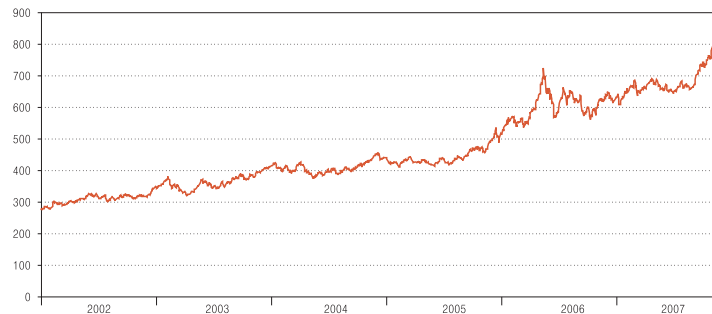
Over the first quarter of 2008 the gold price will continue to fluctuate within a wide range sustaining the upward trend. The major factor impacting gold price developments will remain the technical dependence on the USD/EUR exchange rate. The correlation with major commodity futures is also expected to sustain its high level. Global uncertainty of financial markets and uncertainty about financial crisis developments and the size of incurred losses will continue to influence investment flows dynamics.

Bulgarian External Debt Dynamics on International Financial Markets

During the third quarter of 2007 the yield spread of the emerging markets' government debt in Europe measured by the JP Morgan Euro EMBI Global index varied within a very broad range: between 54 and 88 basis points with an average value of 73 basis points. The total yield increased by 16 basis points to 72 basis points. The US market credit turmoil, prompting a strong global risk aversion, underlied the significant adjustment in the risk premium over the third quarter.

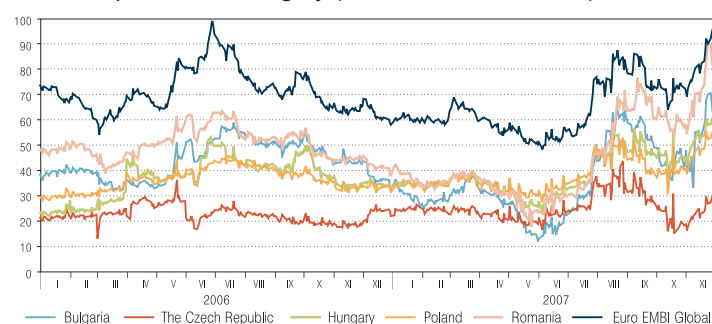
Chart 25
Spot Price of Gold

(USD *per* troy ounce)



Source: The London Bullion Market Association.

Chart 26
Government Debt Yield Spreads in Bulgaria, Romania, Poland, the Czech Republic and Hungary (*Euro EMBI Global index*)



Source: JP Morgan.

The yield spread of the Bulgarian government debt was also affected by the international market volatility, exhibiting an increase by 29 basis points to 51 basis points. The largest spread (64 basis points) since 2004 was recorded on 29 August 2007. The yield spread of the Bulgarian government debt varied within a broad range: between 22 and 64 basis points with an average value of 47 basis points. Debt dynamics followed the general market trend, and the correlation with the Euro EMBI Global index was 0.94.

2. Financial Flows, Money and Credit

Bulgarian economy continued to attract a sizable volume of foreign capital flows against a background of heightened uncertainty on international financial markets. Foreign direct investment and external loans reflecting accelerated restructuring and the high rate of investment return remained the main drivers of economic growth in the first ten months of 2007. According to preliminary data, between January and October 2007 foreign direct investment reached EUR 4670.9 million and covered 103 per cent of the current account deficit. The total balance of payments ended in surplus of EUR 3075.4 million resulting in BNB reserve growth by EUR 2820.1 million (excluding changes due to valuation adjustments). In 2007 the government paid EUR 255.3 million on its debt to the IMF.

Table 4
Cash Flows Which Prompted Significant Changes in Gross International Reserves
(million EUR)

	Third quarter 2007	January – June 2007, total	2006, total
Total for the period	1981	508	1360
Purchases and sales of euro	1 306	1194	1720
1) at tills	-8	-22	-26
2) banks	1 313	1 204	1 746
purchases by banks	15 953	15 015	12 962
sales to banks	14 640	13 811	11 216
Flows on accounts of banks, the MF, etc.	675	-686	-361
incl. minimum required reserves	760	-64	524
Government and other depositors	-85	-622	-884

Source: BNB.

The Issue Department balance sheet figure reached BGN 23,533.8 million (EUR 12,032.6 million) by end-November 2007; up BGN 5977.6 million (EUR 3056.2 million) on November 2006 and BGN 6075.2 million (EUR 3106.2 million) as compared to the years' start.

Financial Flows and External Position Sustainability

The capital flow to Bulgaria is expected to sustain its high levels and BNB international reserves will continue to grow. The long-lasting interest of foreign investors, favourable economic outlook and high rate of return on investment were the main factors behind these trends.

The foreign capital flow remained high with the balance of payments financial account surplus of over EUR 8.1 billion between January and October 2007, mainly due to foreign direct investment (EUR 4670.9 million), loans of other non-resident sectors (EUR 1889.6 million), the rise in non-resident deposits (EUR 993.1 million) and the decrease in deposits of Bulgarian commercial banks abroad (EUR 742.8 million).

The stable and predictable macroeconomic environment, sustainable economic development and projections for high return against a relatively low risk were among the main factors behind the strong investor interest in the Bulgarian economy. The disturbances on international financial markets seen in the summer of 2007 resulting from the US sub-prime mortgage crises had a limited effect on the capital flow to Bulgaria. External financial flows to Bulgaria were driven by the long-lasting investment interest which made them less sensitive to greater volatility on international financial markets. Despite the average increase in credit and interest risk premia of 50–70 basis points, return on investment remained high enough to attract foreign capital. The balance of payments data until October and the increase in international reserves posted in November and in the beginning of December of 2007 show a sustainable flow of external financial resources. This was the main argument in support of the forecasts for relatively large capital flows to Bulgaria over the projection horizon.

Over the first ten months of the review year foreign direct investment picked up by EUR 1167.5 million as compared to the same period of the previous year.² Attracted equity (excluding privatization) totalled EUR 2732.6 million comprising 58 per cent of foreign direct investment. The equity comprised earnings from sales of real estate to

² Preliminary data subject to revision.

non-residents of EUR 1390.4 million for the January–October 2007 period against EUR 890.5 million in the same period of the previous year. Equity from privatization transactions with non-residents came to EUR 86.5 million. Between January and October 2007 reinvested earnings were 9 per cent higher than in the corresponding period of 2006, which was a sign for investors' positive assessment of Bulgarian economy.

Within the structure of foreign direct investment by sector between 1999 and 2006 *Manufacturing* occupied the largest share (24 per cent), followed by *Real estate operations, lessors activities and business services* (16.3 per cent) and *Financial intermediation* (16.1 per cent) reflecting dynamic development and high return in these sectors. In the first nine months of 2007 the largest share was that of *Real estate operations, lessors activities and business services* which occupied 38.3 per cent.³

On the one hand, available data show high investors' interest in acquiring real estates in Bulgaria, on the other one, a part of funds in this sector were invested in construction and acquisition of industrial and commercial buildings, and in companies acting as intermediaries in real estate operations or providing machine and equipment rental services. Hence, a large share of investment resources in the *Real estate operations, lessors activities and business services* sector aimed directly at strengthening the industrial and commercial capacity of local enterprises. In the period under review *Financial intermediation* came second in terms of foreign direct investment (27.4 per cent), followed by *Construction* (12.8 per cent).

The continuous flow of borrowed funds to the balance of payments financial account resulted in an increase of external debt to EUR 24.9 billion by September 2007, including private non-guaranteed external debt of EUR 20,864.5 million. The rise in private

³ According to the system for collecting data from non-financial corporations, current data on foreign direct investment are compiled on a sample basis and are subject to revision. NSI data on this item are exhaustive after the year-end. Both data on the total amount of inflows and on the distribution of investments by sector are subject to revision.

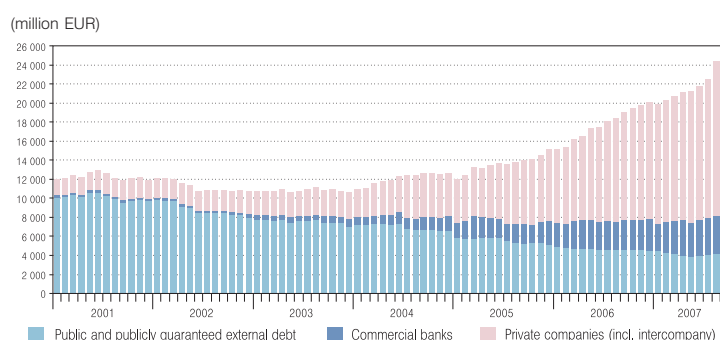
non-guaranteed external debt of EUR 5257.3 million in the first three quarters of 2007 was mostly attributable to intercompany loans (up by EUR 2463 million) and *Other sectors'* borrowed funds (up by EUR 1753.7 million). An intercompany loan received in August 2007 for the acquisition of a company from the telecommunications sector had the greatest contribution to the increase in intercompany loans. Direct investment-related loans were funds provided by foreign economic agents with a long-lasting interest in Bulgaria and their growth reflected investors' confidence in the Bulgarian economy. Commercial banks' foreign liabilities went up by EUR 1129.3 million on end-2006 and reached EUR 4483.5 million. Only in September 2007 banks' liabilities picked up by EUR 420 million, of which EUR 390 million were non-residents' short-term deposits from banks' operations with their foreign bank owners. These flows were mainly due to the increase in the minimum required reserves on banks' borrowed funds from 8 per cent to 12 per cent, effective as of 1 September 2007.

Public and publicly guaranteed external debt fell by EUR 467.9 million on December 2006 and reached EUR 4602.7 million (16 per cent of total external debt).

By end-September 2007, 80.4 per cent of the private non-bank sector debt were denominated in euro. This share was higher than that of intercompany loans (90.3 per cent) and of banks (90.4) per cent. No changes in the currency structure of external debt occurred as compared to the end of 2006, suggesting that the currency denomination structure of private debt remains favourable and reduces the risks associated with exchange rate fluctuations.

The maturity structure of gross external debt remained relatively stable with the share of short-term loans coming to 32.4 per cent. By the end of September 2007 short-term external debt came to EUR 8070 million, posting an increase of EUR 1979 million on end-2006 mainly due to the rise in non-residents' loans and deposits with banks. Most short-term loans were granted to local banks by their foreign bank owners.

Chart 27
Gross External Debt



Source: BNB.

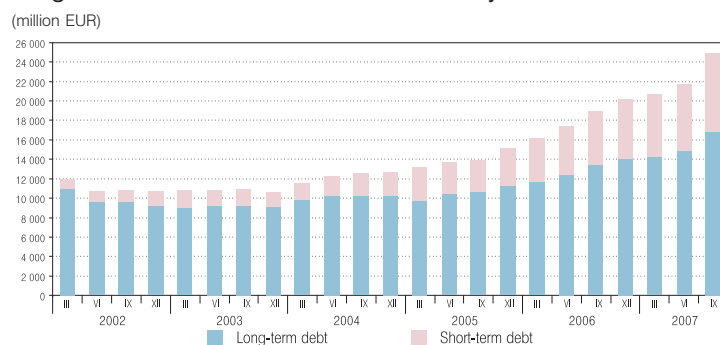
Over the year under review Bulgaria's gross foreign assets also posted an increase, prompted mainly by the growth in BNB international reserves. By September 2007 banks' foreign assets dropped by EUR 1103 million on December 2006. Between January and September 2007 Bulgarian net external debt rose by EUR 3.2 billion, its share of GDP reaching 34.2 per cent, reflecting the dynamics of gross external debt and gross foreign assets.

The inflow of financial resources into Bulgaria determined to a great extent the balance of payments current account. During the January to October 2007 period the current account deficit came to EUR 4.5 billion against EUR 2.6 billion during the same period of 2006. All basic components, excluding *Services*, contributed to the increase in the current account deficit. The deterioration was driven mainly by the balance payments trade deficit which came to EUR 5.8 billion (an increase of EUR 1.6 billion on the corresponding period of 2006). The nominal increase in goods trade deficit was in line with enhanced investment and consumer demand in Bulgaria, as well as with the restructuring of production capacity.⁴

Between January and October 2007 the balance of *Services* improved by EUR 135.4 million, coming to EUR 1111.5 million. Exports of tourist services (11.2 per cent) and other services (16 per cent) retained their high growth rates, with *computer and information services and legal, accounting and managerial services* contributing most significantly to the latter. The dynamic development of the tourist sector over the year under review and the related growth in non-residents' revenue were mainly attributable to the growing capacity of the sector, Bulgaria's membership in the EU and the relatively favourable weather conditions for tourism in the summer. Imports of services posted a moderate increase of 9.4 per cent, with transportation services recording the highest growth. They picked up by EUR 197 million mainly due to high imports of goods over the review period. The downward trend

Chart 28

Long- and Short-term Gross External Debt Dynamics



Source: BNB.

⁴ For a detailed analysis of exports and imports see Section Three, *Economic Activity*.

in the *Other services* imports was sustained (-7.1 per cent) with small payments on *architecture, engineering and consultation services and construction-related services* contributing most significantly to it.

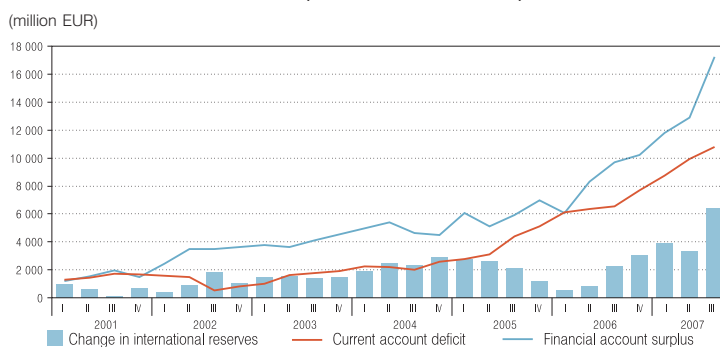
The *Income* balance was negative, comprising EUR 147.1 million, down by EUR 191.1 million on the respective period of the previous year. Growth was reported both in the account's credit side and debit side with *Compensation for employees* having the major contribution to the credit side (up 20 per cent). The deterioration was driven mainly by payments on income from direct investment which went up by 54.5 per cent over the review period, reaching EUR 955 million. Given the sizable foreign direct investment flows into Bulgaria, payments on income from direct investment are expected to retain their high rates in the future and to deteriorate the *Income* balance.

Over the first ten months net current transfers reached EUR 259.5 million against EUR 552.3 million in the corresponding period of 2006. The drop reflected mainly the contribution of BGN 249.1 million paid to EU budget. Net private current transfers fell by EUR 35 million compared with the January–October 2006 period as a result of the decrease in transfers to Bulgaria and the increase in transfers abroad. In the first quarter of 2008 net current transfers are expected to increase due to the substantial inflows from EU funds.

Financial account and international reserve data showed that no substantial changes occurred in Bulgaria's external position; it retained its sustainability consistent with accelerated dynamics and economic restructuring. The sizable inflow of capital into Bulgaria is expected to be sustained in the fourth quarter of 2007 and in the first quarter of 2008. These expectations are supported by the upward trend in international reserves which picked up by EUR 211 million in November compared with October 2007 and by EUR 167 million in the first twelve days of December compared with end-November 2007, reflecting the long-lasing interest of foreign investors in Bulgarian economy. Current account deficit is anticipated to in-

Chart 29

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



crease nominally on the corresponding quarters of 2006 and 2007; this rise is likely to be revised downwards in the coming quarters.

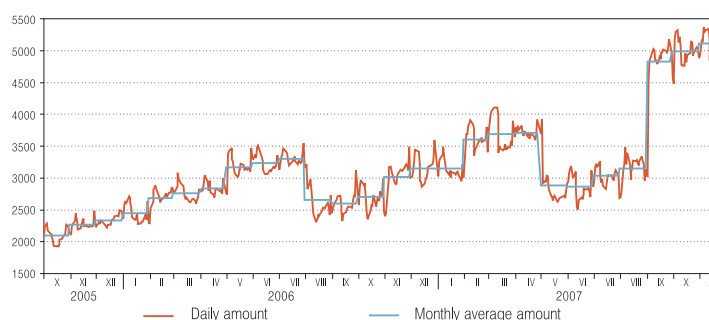
Monetary Aggregates

On 1 September 2007 the BNB raised commercial banks' minimum required reserves rate from 8 per cent to 12 per cent, which would underpin the high rate of reserve money growth (40–50 per cent) by the end of 2007 and the beginning of 2008. The annual growth of currency in circulation is expected to remain stable at around 17–18 per cent and the broad money rate of change at around 28–30 per cent.

Against a background of significant inflows of foreign capital and enhanced economic activity, in the third quarter of the review year the growth rates of currency in circulation picked up to 17.8 per cent, falling slightly to 16.9 per cent in October, a level close to that in June. Growth rates of currency in circulation remained relatively stable since the beginning of the year and this trend is expected to be sustained in the next two quarters.

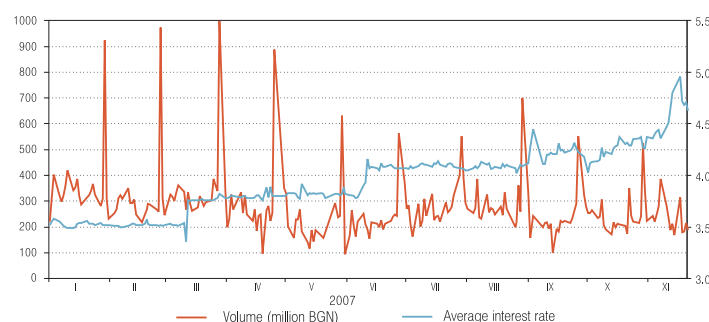
In the third quarter of 2007 the dynamics of the monetary base was mainly influenced by the change in commercial banks' deposits with the BNB, which went up by 64 per cent on an annual basis. The increase resulted directly from the rise in the minimum required reserves' rate from 8 per cent to 12 per cent as of 1 September 2007. By increasing the minimum required reserves' rate the BNB withdrew a lot of liquidity from the banking system. Only in September commercial banks' reserves with the BNB picked up by BGN 1980 million. The need for additional liquidity resulted in a slight increase in the interbank money market interest rates in the last two months. The increase was more pronounced in mid-November when the interest rate on interbank market transactions reached 4.80 per cent. In the first half of November the interest rate on these transactions was 4.46 per cent on average, compared with a 4.24 per cent average interest rate in October. Volumes traded on the money market did not change significantly. The average daily amounts traded in November came to BGN 242 million against BGN 235 million in September and BGN 249 million in October. An important source of banks' lev liquidity was the

Chart 30
Commercial Bank Deposits with the BNB
(million BGN)



Source: BNB.

Chart 31
Trade Volume and Interbank Money Market Interest Rates



Source: BNB.

BNB purchase of leva against euro at the fixed exchange rate. Over the last two quarters the volumes of purchased and sold currency between the BNB and the banks posted an increase, but no significant changes occurred in BNB's net purchases of foreign currency.

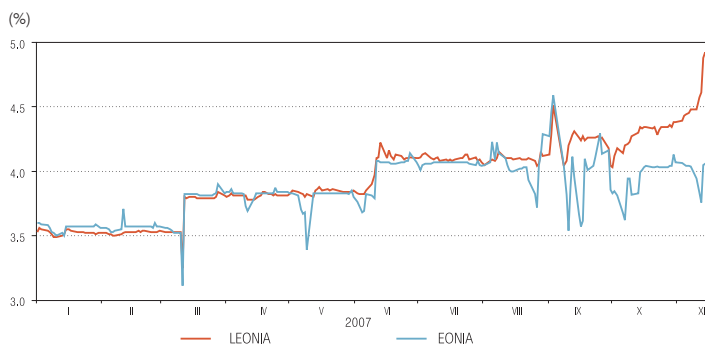
LEONIA marked a more sizable increase in November. Its average rate in the first half of the month was 4.53 per cent against 4.25 per cent in the previous two months. The increase was in line with the widened spread between Bulgarian and European interest rates on overnight transactions concluded on the interbank money market.

As a result of the considerable rise in bank reserves and the sustainable dynamics of currency in circulation, reserve money grew by 32.9 per cent in September 2007. In October reserve money rate of change stood around its September level, while bank reserves accelerated, coming to 67.6 per cent on an annual basis.

During the third quarter of 2007 the budget withdrew a great amount of liquidity from the non-government non-bank sector due to good performance of tax revenue and the conservative expenditure policy. The external sector was another source of liquidity for the consolidated budget which reflected the realization of receipts from privatization transactions with foreign investors, and of the positive net financial flows from the EU budget. As a result, government deposit with the BNB picked up considerably, reaching BGN 7664.6 million by end-September. In the fourth quarter the traditional end-of-year flight of liquidity to the non-government non-bank sector is expected; this will cause a decline in the government deposit on the end of September.

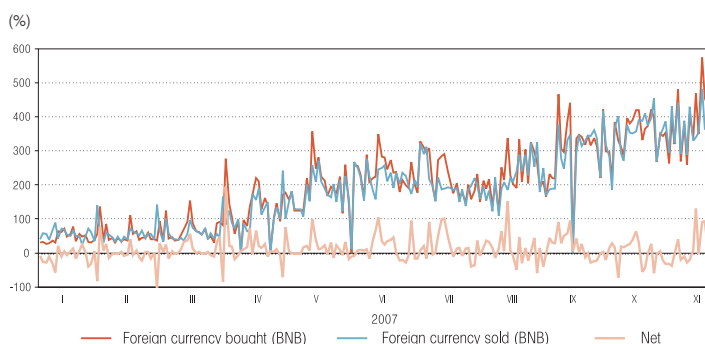
Given the positive external debt financing (BGN 294 million) projected in the 2008 budget and the growing net flows from the EU (BGN 1192 million), a great amount of liquidity will be provided by the external sector to the consolidated budget. The projected surplus of 3 per cent of GDP and the positive domestic financing (BGN 365 million) will be the other major factors behind

Chart 32
LEONIA/EONIA



Source: BNB.

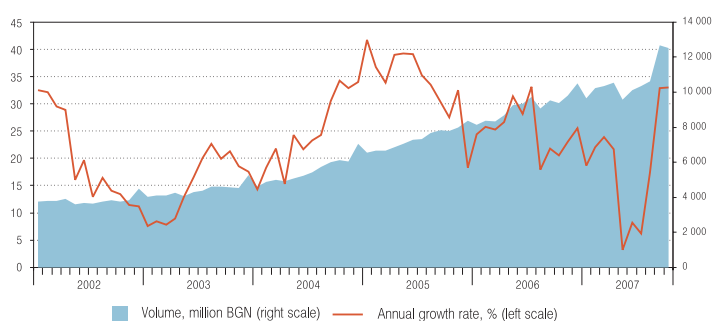
Chart 33
Purchase and Sale of Foreign Currency between BNB and the Banks



Source: BNB.

Chart 34
Reserve Money

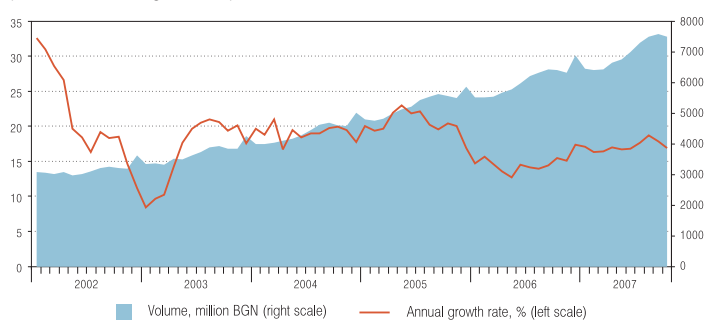
(volume and annual growth rate)



Source: BNB.

Chart 35
Currency in Circulation

(volume and annual growth rate)



Source: BNB.

the expected increase in the fiscal reserve in 2008.

In September the annual growth rate of the M3 monetary aggregate picked up to 29.1 per cent against 28.4 per cent in June, posting an 8.2 per cent increase only in the third quarter. The lev component recorded a greater contribution to broad money change for the first time since 2005. This trend was mainly due to the buoyant economic activity recorded since the beginning of the review year and in particular to the increase in employment and income. Strong demand for loans by the households and firms was another factor behind the faster growth of money supply. In October broad money posted a 28.5 per cent annual increase and the rate of change is expected to remain high in the following two quarters due to domestic factors and continuous foreign investment inflow.

In October quasi-money posted a 28.8 per cent rise on an annual basis and the accelerated growth of foreign currency deposits in levs was sustained. Household deposits with agreed maturity of up to two years went up by 19.2 per cent on an annual basis against a 27.8 per cent increase in foreign currency deposits, while non-financial corporations' lev and foreign currency deposits growth rates were 14.7 per cent and 37.8 per cent respectively.

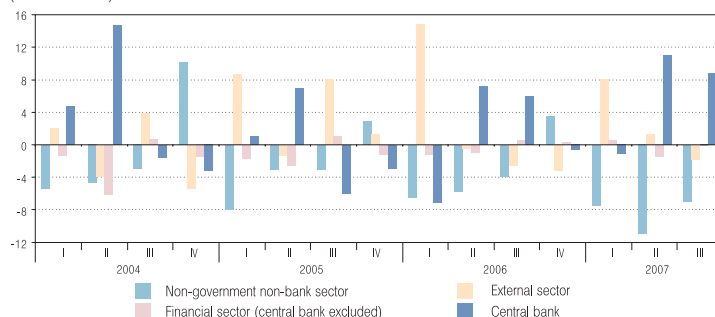
In October the M1 monetary aggregate marked an annual growth of 28.5 per cent mostly due to overnight deposits with an annual growth rate of 36.6 per cent. Over the review period lev overnight deposits went up by 30.9 per cent and foreign currency deposits by 49.0 per cent. Non-financial corporations played a key role for the change in lev and foreign currency deposits (30.7 per cent and 51.0 per cent respectively). The annual growth of household overnight deposits was relatively lower than that of firms, lev deposits going up by 26.2 per cent and foreign currency deposits by 39.8 per cent, with a slight increase in the latter by the end of June.

The average interest rates on time deposits in levs over the third quarter of 2007 retained their levels from the second quarter

Chart 36

Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

(share of GDP)

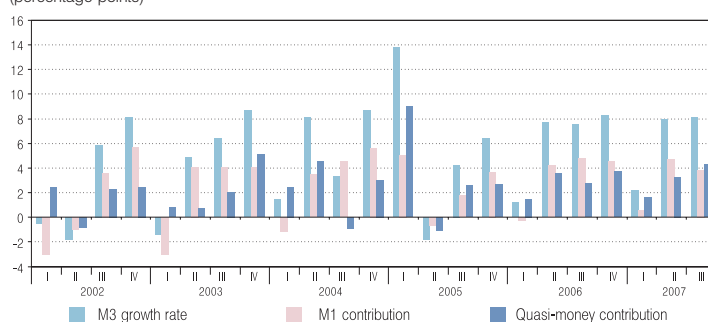


Sources: MF, BNB.

Chart 37

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

(percentage points)

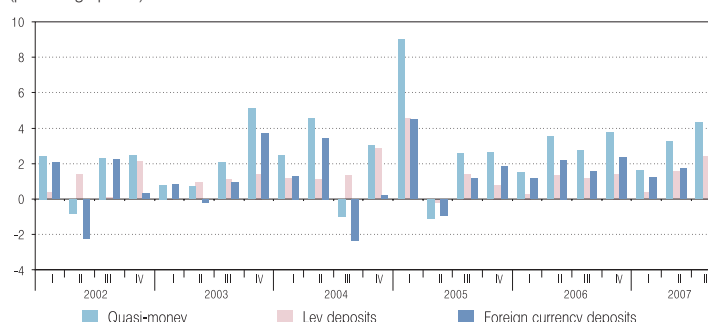


Source: BNB.

Chart 38

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

(percentage points)

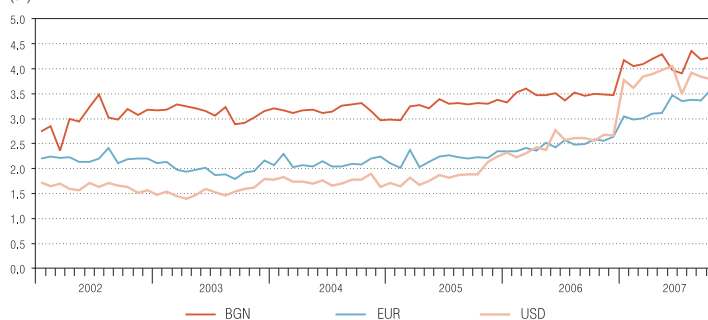


Source: BNB.

Chart 39

Interest Rates on Time Deposits

(%)



Source: BNB.

(4.15 per cent). Unlike interest rates on lev deposits, those on time deposits in euro continued to grow in the third quarter to an average of 3.37 per cent against an average level of 3.23 per cent in the second quarter. Interest rates on time deposits in US dollars fell from 3.98 per cent to 3.75 per cent. Foreign currency interest rate dynamics was influenced mainly by international interest rates' movements. As regards USD-denominated time deposits, the changes resulted from the US Federal Reserve policy aimed at cutting interest rates.

In October interest rates on deposits in levs and in euro increased, while interest rates on USD-denominated time deposits decreased.

As regards the distribution of interest rates on household deposits with maturity of up to one month by bank, in October the number of banks offering rates within 3–4 per cent increased at the expense of those offering rates of up to 2 per cent and within the 5–6 per cent band. In October the average interest rates on deposits with maturity of up to one month was 3.33 per cent, and the differential between the highest and the lowest interest rate came to 2.59 percentage points against 4.16 percentage points in June. A certain fall in interest rate dispersion occurred as well.

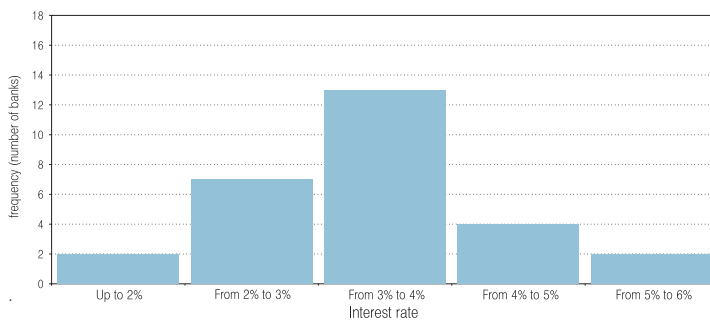
Credit Aggregates

Lending will remain high. Interest rates on loans may slightly increase as a result of the change in the minimum reserve requirement regulation and the rise in interbank money market interest rates.

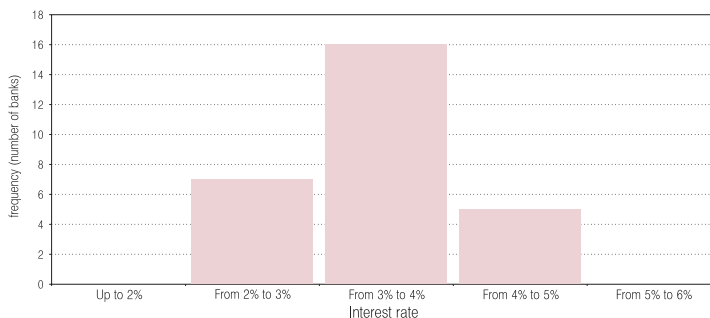
Between July and October 2007 claims on the non-government sector picked up by BGN 4592 million (against an increase of BGN 1521.5 million in the corresponding period of the previous year), and their annual growth rate accelerated from 47.8 per cent by the end of June to 58.6 per cent in October 2007. High lending was driven mainly by the favourable macroeconomic trends enhancing the demand for loans from enterprises and households. Lending is expected to remain robust and the annual growth in claims on the non-government sector is likely to remain over 50 per cent by the end of 2007 and in the beginning of 2008.

Chart 40
Interest Rate Distribution of Household
One-month Lev Deposits

as of June 2007

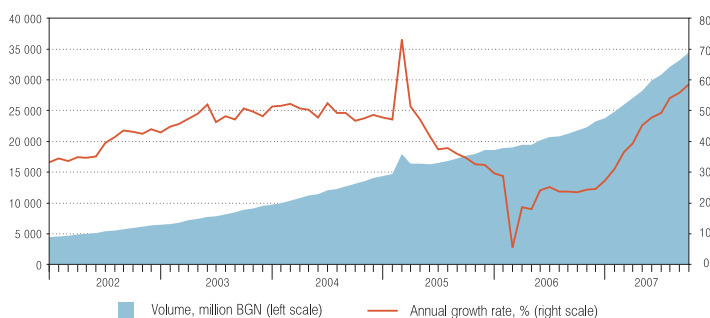


as of October 2007



Source: BNB.

Chart 41
Claims on Non-government Sector



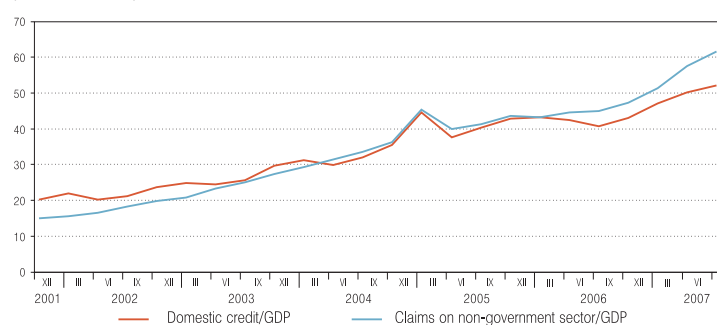
Source: BNB.

Rapidly expanding lending sustained the trend towards deeper financial intermediation. The *claims on the non-government sector to GDP* ratio reached 61.6 per cent by end-September posting a 14.2 percentage points growth compared with early 2007 and a 16.5 percentage points growth compared with September 2006.

Between July and October 2007 foreign bank assets fell by BGN 629.4 million, while funds borrowed from non-residents increased by BGN 1871.7 million which resulted in a decrease in banks' net foreign assets which reached BGN -3347.9 million by end-October. These changes reflected the increase in the minimum required reserves since the start of September 2007 and the use of external resources to expand lending.

Chart 42
Domestic Credit

(share of GDP, %)



Source: BNB.

Table 5
Changes in Major Balance Sheet Items of Commercial Banks
(million BGN)

	2005	2006				2007		
	IV	I	II	III	IV	I	II	III
Claims on non-financial corporations	784.9	76.8	434.2	657.3	1105.4	1995.2	2678.6	1938.1
Deposits of non-financial corporations	710.3	140.8	974.0	1006.7	893.4	-196.4	1123.9	1156.1
Claims on households	704.2	188.2	767.9	367.0	793.6	744.3	1141.8	1308.6
Deposits of households	813.0	453.9	565.3	791.3	1045.4	550.0	908.1	1079.8
Foreign assets	670.0	775.0	-179.2	1845.7	402.2	-1131.0	-236.5	-789.8
Foreign liabilities	951.4	319.7	-174.7	374.2	543.9	627.5	510.4	1384.2
Claims on general government	137.1	14.2	120.0	3.5	30.0	-48.3	172.4	226.5
Deposits of general government	-112.7	73.7	143.9	138.9	135.3	214.8	123.8	113.7
Claims on central government	133.8	-5.7	120.9	-7.0	-0.4	-51.1	154.7	201.7
Liabilities to central government	11.8	-54.9	81.1	135.7	64.5	-15.6	11.9	88.3

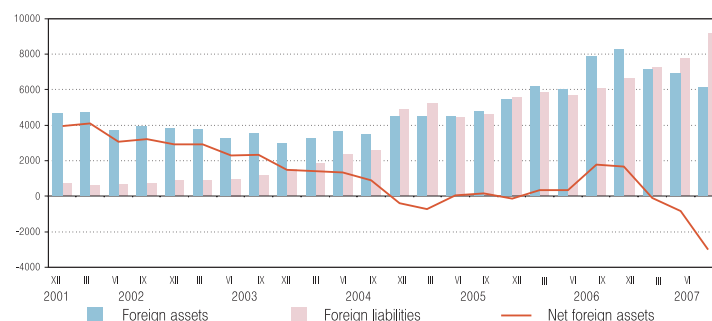
Source: BNB.

Strong production and investment activity fostered high demand for loans by corporations. Between July and October 2007 claims on non-financial corporations went up by BGN 2716.7 million, against an increase of BGN 1000.2 million in the corresponding period of the previous year. As a result their annual growth rate accelerated from 53.9 per cent in June to 63 per cent by the end of October 2007.

Sustained favourable trends in employment and income contributed to the sizable increase in household loans: up by BGN 1818.2 million between July and October 2007 against an increase of BGN 470.3 million in the corresponding period of the

Chart 43
Foreign Assets and Liabilities of Banks

(million BGN)

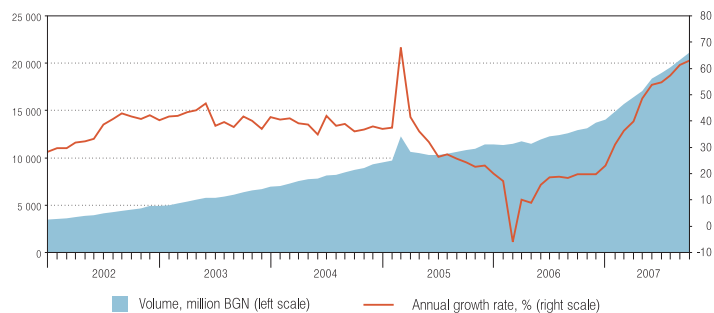


Source: BNB.

previous year. At the same time their annual growth rate reached 52.6 per cent by end-October from 38.6 per cent in June. Despite the fall in housing loans which fell to 71.9 per cent in October from 74.6 per cent in June, they still remained the most rapidly developing segment of household loans.

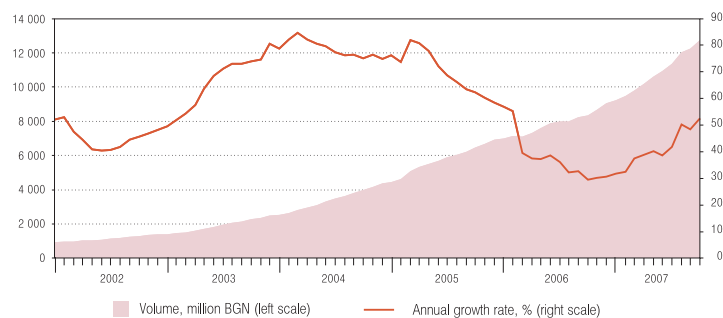
In the third quarter of the review year interest rates on loans did not experience significant changes, and in October 2007 only the interest rates on consumer credits were raised. The price of borrowed funds is likely to increase in the following months reflecting the rise in money market interest rates and the increase in minimum required reserves from the start of September.

Chart 44
Claims on Non-financial Corporations



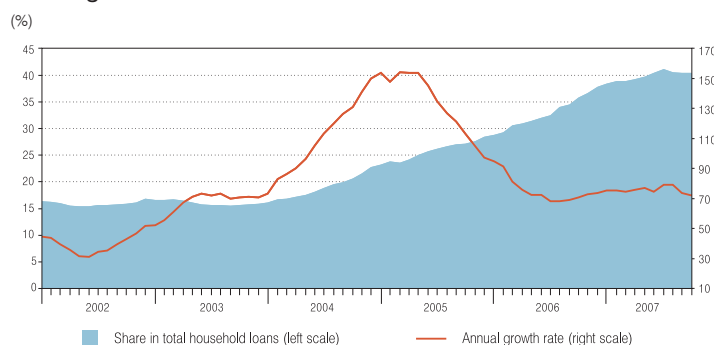
Source: BNB.

Chart 45
Claims on Households



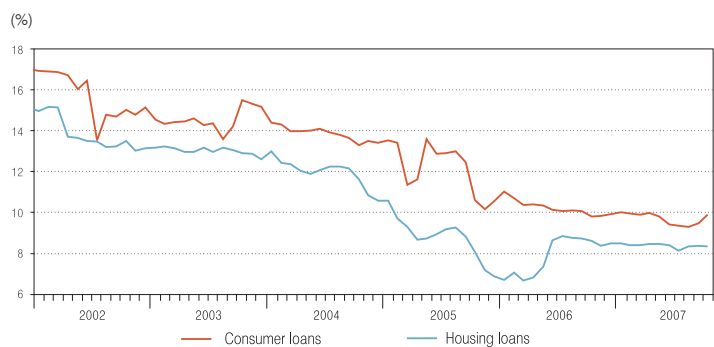
Source: BNB.

Chart 46
Housing Loans



Source: BNB.

Chart 47
Interest Rates on Household Loans



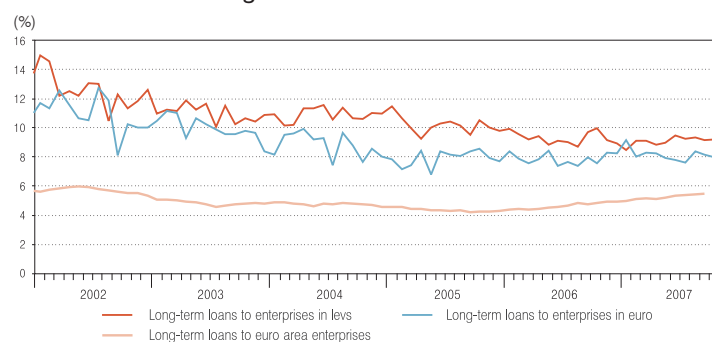
Source: BNB.

Table 6
Claims on Non-government Sector (Quarterly)

	Annual growth rate, %								Structure as of
	2005	2006				2007			
	IV	I	II	III	IV	I	II	III	30 Sept. 2007
Claims on non-government sector, incl.:	32.4	5.6	24.2	23.6	24.6	36.6	47.8	55.9	
on non-financial corporations	23.1	-5.9	15.8	18.3	19.9	36.4	53.9	61.2	61.3
on households and NPISHs	58.4	39.7	38.7	32.6	30.6	37.6	38.6	48.3	36.9
on financial corporations	-31.1	-44.6	42.7	25.9	68.6	26.0	46.0	43.9	1.8

Source: BNB.

Chart 48
Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

Economic growth is expected to sustain its high rate over the fourth quarter of 2007 and the first quarter of 2008, with investment in fixed assets and net exports having the major contributions to the growth.

In the second quarter of 2007 real GDP growth accelerated to 6.6 per cent on an annual basis. The robust investment growth was retained, while household consumption rates decreased to 6.4 per cent in the second quarter, from 9.0 per cent in the first quarter. Accelerated export growth helped increase the net contribution of foreign trade balance to growth.⁵

The information on economic developments in the second half of 2007 shows sustained dynamics: industrial sales retained their high growth rates in real terms consistent with industrial export sales. Business expectations remained optimistic.⁶

High growth rates are expected to be sustained until the end of 2007 and in the beginning of 2008, with investment and net exports contributing further to this growth. The downward trend in household consumption growth will be retained and government consumption will remain neutral to growth throughout 2007.

Household Behaviour

Household consumption has started to moderate since mid-2007 based on data in the household budgets and domestic trade survey. More moderate annual growth in consumption was clearly pronounced in household expenditure on food and household goods and home appliances.

The consumer confidence indicator decreased in November on July 2007 as a result of the growing pessimism in consumer assessments and expectations of both the current economic situation in Bul-

⁵ See *Economic Review*, 2007, issue 3, *Economic Activity* Section.

⁶ See *Economic Conditions. NSI Business Survey*, November, 2007.

Table 7

Consumer Demand Dynamics (Quarterly)

(on corresponding period of previous year, percentage growth in real terms)

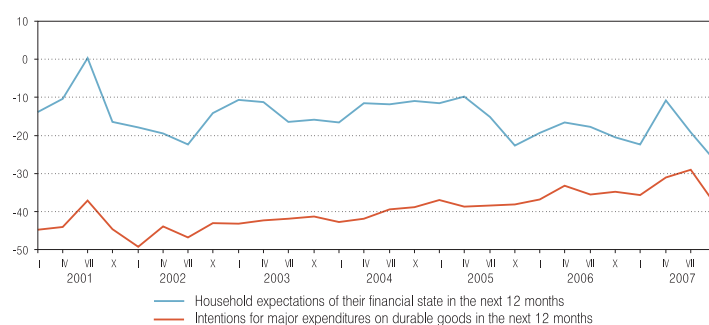
	2006				2007			
	I	II	III	IV	I	II	III	October
Consumer spending <i>per</i> household member	2.9	5.5	7.3	8.1	10.6	12	8.9	5.3
Food	3.4	5.8	4.3	5.5	9.1	8.5	3.9	3.4
Income from retail trade incl.	10	12.6	14.1	15.3	11.8	6.8	3.8	2.3
Food, drinks, tobacco	6.5	5.8	7.4	8.8	9.6	9.9	3.8	1.2
Pharmaceutical and medical goods, cosmetics and toiletries	7.2	11.5	7.2	5.1	7.5	5.6	10.2	10.8
Textile, clothing, footwear and leather	7.3	12.1	17.9	15.7	11.3	5.2	13.8	14
Household goods and home appliances	14.6	18.8	20.2	19.4	18	6.8	2.4	0.2

Source: NSI – household budgets and domestic trade survey.

garia and in the next 12 months.⁷ Inflation was an important factor affecting negatively consumer assessments. Consumer perceptions of purchasing power loss increased and households' expectations for their financial state worsened. Similarly, expectations of future expenditure on durable goods also decreased.

Trends in household behaviour supported the assessment of slower consumer demand, reflecting two major factors. On the one hand, high inflation rates led to lower purchasing power of households which is seen in consumption of goods recording the strongest price hikes. On the other hand, the worsened assessment of the future financial situation coupled with the increased uncertainty reduced that portion of the income which households were ready to spend on durables. Further labour market improvement (employment and wage growth) had a positive effect on household incomes. However, this trend failed to compensate the negative perceptions associated with higher inflation.

Chart 49

Household Expectations for Their Financial State and Major Expenditures

Source: NSI, Consumer survey.

Table 8

Employment and Income Dynamics (Quarterly)

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

	2006				2007		
	I	II	III	IV	I	II	III
Employees (Labour Force Survey data)	3.6	4.3	3.3	5.9	6.6	3.6	3.6
Employed (Enterprise Survey)	0.9	-0.1	-1.8	-1.4	3.4	3.0	2.1
Real wage (Enterprise Survey)	-0.2	0.0	3.0	4.6	11.1	12.6	9.9
Wage Fund (deflated by CPI)	0.4	-0.4	1.0	2.8	14.6	15.6	11.9
Unemployment at the end of the period, % of the labour force	10.8	9.2	8.4	9.1	8.9	7.4	6.8

Sources: NSI, Employment Agency.

⁷ See *Consumer Survey*, October 2007, NSI.

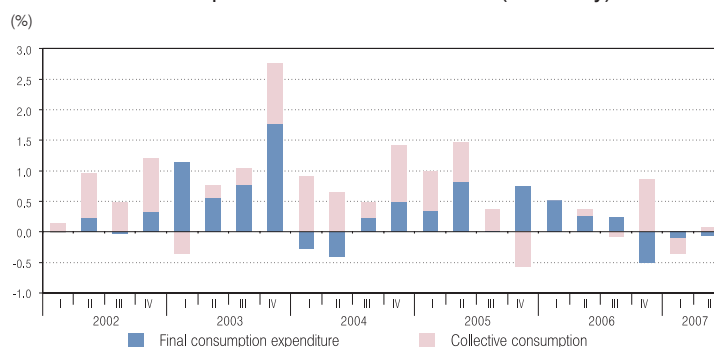
By the end of the third quarter of 2007 the consolidated budget balance reached 5.9 per cent of projected GDP. Given the accelerating growth rate of tax revenue, the budget surplus for 2007 may significantly exceed 3 per cent of GDP.

Strong domestic demand in the third quarter of 2007 underpinned good revenue performance and in particular indirect tax revenue which accounted for two-thirds in overall tax growth (17.1 percentage points). Direct tax revenue also posted considerable growth, reflecting favourable trends in employment and incomes, as well as good financial results of firms in early 2007. The tax revenue overperformance for the first three quarters *vis-à-vis* the State Budget Law projections was 6.3 per cent. As a result, the annual growth rate of tax revenue reached 27.5 per cent in the third quarter, whereas total revenue and grants on consolidated state budget came to BGN 6081.2 million (23.5 per cent annual growth) over the third quarter. Tax revenue growth is expected to be high in the coming two quarters despite the projected decline in social security contributions (due to the 1 and 2 percentage point decrease in Pension and Unemployment Fund contributions as of 1 October 2007). In the first quarter of 2008 indirect taxes are expected to increase their contribution to tax revenue growth, reflecting fuel and tobacco excise changes and the VAT low base effect in the beginning of 2007.

Over the third quarter of 2007 current non-interest expenditure on consolidated budget (excluding the contribution to the EU budget) increased to BGN 3893.6 million, while their annual growth reached 10.7 per cent. By the end of 2007 the expenditure level will further increase, reflecting pension growth of 10 per cent as from 1 October and the approved Christmas bonus to pensions of BGN 100, as well as higher wage and operational expenditure. Accordingly, government consumption is anticipated to rise in the second half of 2007 in line with its contribution to GDP growth. Due to the restrictive expenditure policy pursued, the government consumption contribution to GDP growth is likely to remain moderate (0.4–0.6 percentage points) in the first

Chart 50

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

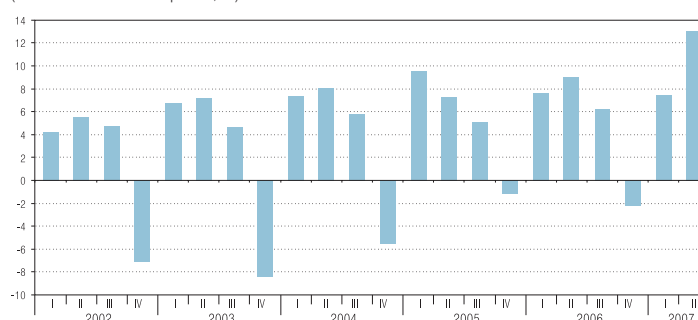


Sources: NSI, BNB.

Chart 51

Primary Balance (Quarterly)

(share of GDP for the quarter, %)

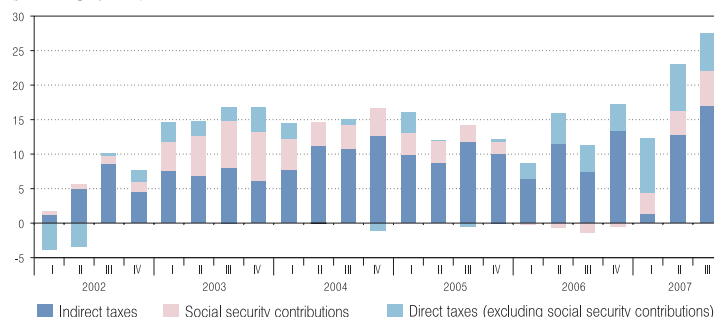


Sources: MF, BNB.

Chart 52

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

(percentage points)



Sources: MF, BNB.

three quarters of 2007 and to be insignificant in the first quarter of 2008. By the end of 2007 capital expenditure is expected to rise significantly which will result in an increased contribution of public investment to gross fixed capital formation.

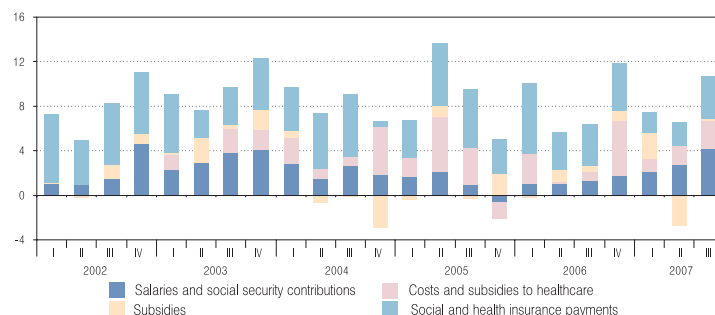
The consolidated budget balance reached 5.9 per cent of GDP at the end of the third quarter of 2007. Good tax revenue performance and restrictive fiscal policy support the expectations of a budget surplus exceeding 3 per cent of GDP.

The first reading of the 2008 draft budget suggests a conservative fiscal policy aimed at preserving the macroeconomic stability, generating a 3 per cent surplus of GDP and reducing budget expenditure (excluding the contribution to the EU budget) to 40 per cent of GDP.

Chart 53

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

(percentage points)



Sources: MF, BNB.

Major Parameters of the 2008 Budget

Tax Policy

- **Income taxation:** introducing a 10 per cent flat-rate tax on individual incomes (without a non-taxable income minimum), lifting most tax alleviations, a 15 per cent tax on sole proprietors' incomes, a 5 per cent dividend tax.
- **A corporate tax:** changes in advance payments taxation – recalculating monthly advance payments for the first quarter of 2008 on the basis of the 2007 tax profits, depositing the fourth quarterly advance payment in 2008 and exempting small firms (turnover of up to BGN 100,000) from making advance payments.
- **Social security:** increasing the amount of the maximum insurance income from BGN 1400 in 2007 to BGN 2000 in 2008 and increasing the minimum insurance income for 'self-insured' persons from BGN 220 to BGN 240. The proportion between employer's and employee's contributions changes to 60:40.
- **Excises:** increasing excise rates on cigarettes, fuels, coal, and industrial electricity; abolishing the excise duty on coffee.
- **Local taxes and charges:** decentralization in determining their amount and including the patent tax within the scope of the Law on Local Taxes and Charges.

Expenditure Policy

- **Fiscal rules** for limiting expenditure to counteract macroeconomic risks of increasing the current account deficit; replacing the existing rule of 90 per cent by a fiscal sustainability reserve to the amount of BGN 300 million.
- **Wage expenditure:** compensation of individuals who are adversely affected by the introduction of flat-rate tax as from 1 January 2008, budget wage indexation by 5 to 10 per cent as from 1 July, reducing the number of all budget structures by at least 12 per cent until 30 June 2008.
- **Pensions:** a 9.5 per cent indexation as from 1 July 2008.
- **Education expenditure:** increasing the expenditure *per* a child and *per* a student.
- **Capital expenditure:** significant growth in their share of total expenditure to 16.8 per cent and in their amount to 6.9 per cent of GDP.

Effects of introducing the 10 per cent tax rate on individual incomes and of the changes in the social insurance tax in 2008 on disposable income and labour price

- Disposable income of taxpayers with gross monthly income less than BGN 450 will be negatively affected, that of taxpayers with gross monthly income between BGN 600 and BGN 1600 will rise by 7 per cent on average and that of persons with income over BGN 2000 by more than 10 per cent.
- The projected changes would result in reducing firms' labour costs in 2008 for employees with gross monthly income of over BGN 325.
- Labour costs of employers which hire employees at a minimum monthly wage will increase from BGN 223 to BGN 264 due to the projected rise of the minimum wage from BGN 180 to BGN 220.

Behaviour of Firms and Competitiveness

Industrial sales posted high growth rates in real terms. Investment activity in industry led to production capacity strengthening and competitiveness improvements.

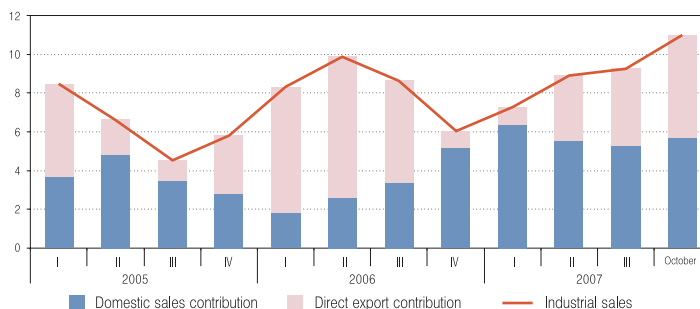
The total business climate indicator slightly fell in November (by 1 percentage point on October), with its level remaining high enough to show sustained optimism for economic growth started in mid-2006. Assessments in industry, construction, trade and services show a rebound in production activity. However, the assessment of economic environment stability has worsened. The assessment of EU industrial firms regarding their competitive position improved in the period under review.

Industrial sales growth between January and October 2007 came to 8.8 per cent on the corresponding period of 2006. Domestic sales of manufacturing industry rose by 10.2 per cent. Manufacture of food, drink and tobacco products (2.9 percentage points) and of other non-metal mineral products (1.5 percentage points) had the most significant contribution to domestic sales growth. An increasing contribution was recorded by machines and equipment, excluding electrical, optical and other equipment (1.3 percentage points).

Growth rates of industrial sales accelerated between January and October mostly as a result of rebounded export dynamics. Manufacturing export sales rose by 9.3 per cent on the same period of 2006. Manufacture of electrical, optical and other equipment (1.9 percentage points), textile and clothing (1.7 percentage points), food, drink and tobacco products (1.7 percentage points) and machines and equipment, excluding electrical, optical and other equipment (1.3 percentage points) contributed most significantly to this growth. Exports were adversely affected by non-ferrous metallurgy restructuring and cuts in power generation. The increased exports of high-value-added goods (machines and equipment) show favourable trends in the manufacturing export structure. Our expectations are for retention of the trend to increasing value

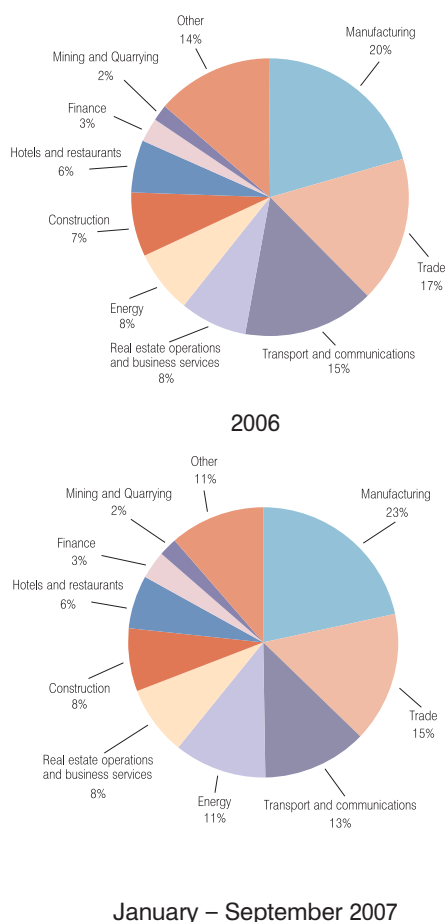
Chart 54
Industrial Sales Growth

(% on corresponding quarter of previous year)



Sources: NSI, BNB.

Chart 55
Structure of Expenditure for Acquiring Fixed Assets by Economic Activity



Source: NSI.

added of exported products and to a gradual restructuring of total export sales of manufacturing.

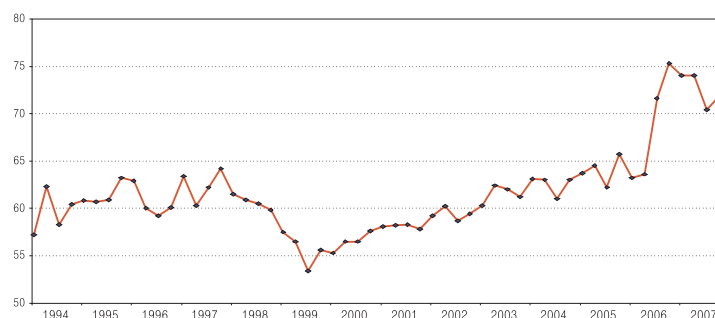
Production capacity expansion reflected high investment activity over the recent years. In the first nine months of 2007 expenditures on acquiring fixed assets of firms rose by nearly 40 per cent on the same period of the previous year. Manufacturing, trade and transportation occupied the largest share in the structure of these expenditures.

High growth rates of industrial investment activity reflected on the degree of capacity utilization measured by the NSI Business Situation Survey. Capacity utilization in industrial firms exceeded 70 per cent, with expectations showing a continued upward trend due to utilizing new capacities.

Labour force supply is a factor which as a result of the negative demographic trends in Bulgaria may limit both economic growth and the capacity utilization rates over the long run. In the short run however, despite the low level of unemployment (6.6 per cent in the third quarter), a significant potential for labour force supply exists: the economic activity rate, which is a ratio between the labour force and population aged 15 and over, has started increasing robustly since 2006 but its level of 53.5 per cent over the third quarter was still low (up 0.7 percentage points, from 52.7 per cent over the third quarter of 2006). The employment rate (number of workers divided by population aged 15 and over) rose by 1.8 percentage points on the third quarter of 2006 to reach 49.9 per cent. Positive trends in economic activity and employment rates are expected to continue in the future due to the current low values of the respective ratios and to improving labour conditions and increased motivation for active labour market participation.

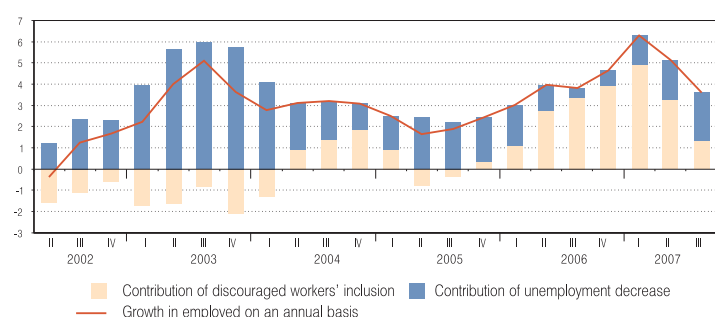
After a several years of moderate growth, since early 2007 wage has started growing at faster rate, increasing by 18.3 per cent between January and October (11.1 per cent in real terms) compared with the average wage in the same period of 2006. Current data are insufficient to make a detailed analysis of the reasons behind the significant increase in the average pay. 2007 saw

Chart 56
Production Capacity Utilization in Industry



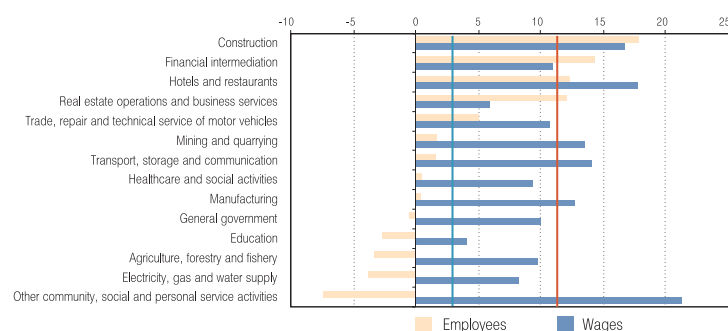
Sources: NSI, Business survey in industry.

Chart 57
Sources of Employment Growth



Sources: NSI, BNB.

Chart 58
Employee and Real Wage Growth between January and October 2007
(relative growth on an annual basis, %)



Sources: NSI, BNB.

two important changes in the legal regulation of the labour market: an increase in minimum wage by 12.5 per cent (from BGN 160 to BGN 180) and a decline in social security contributions by 6 percentage points supporting shadow economy shrinkage. Following these changes, firms' reporting of paid wages will become more correct and lower social contributions will help decrease the share of the shadow economy. Bulgaria's membership in the EU since 2007 and opportunities associated with structural funds will also stimulate better economic reporting.

Another factor affecting wage growth is the rising labour productivity as a result of utilizing new, more productive capacities. Robust wage growth in some economic sectors was also associated with problems in recruiting qualified employees in construction, mining and quarrying, and transportation.

In manufacturing, wage growth since early 2007 pushed up nominal unit labour costs, though their level was significantly below the 1998 level. Over the last two years the wage growth rate in manufacturing matched the labour productivity rate. Consequently, unit labour costs remained constant in nominal terms. In real terms unit labour costs declined to 70 per cent in 2007 compared with 1998. Moderate growth in nominal unit labour costs in 2007 did not affect negatively the profit rate in this industry since the producer price index rose at higher rates. Given the dynamics of both indicators, the competitiveness and good financial performance of firms were retained over the review period.

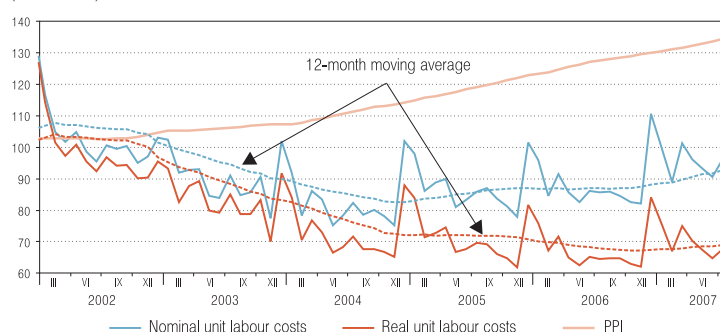
Exports and Imports of Goods

The upward trend in nominal export growth is expected to continue. Domestic demand will influence import dynamics, in particular imports of investment goods and raw materials.

Expectations of exports revenue in the fourth quarter of 2007 and the first quarter of 2008 are for growth acceleration. Current economic data support the view of improving competitiveness of domestic economy. Labour productivity in industry continued to rise robustly (based on the Enterprise Survey), investment activity and provision of

Chart 59
Unit Labour Costs and PPI in Manufacturing

(2000 = 100)



Sources: NSI, BNB.

export orders still remained at high levels. Preliminary data on the share of Bulgarian exports in total EU imports also show sustained competitive positions of the domestic producers on international markets. With regard to the world commodity prices, comparatively high prices of food and crude oil in the third and the beginning of the fourth quarters are expected to be sustained, while metal prices are projected to gradually decrease. Taking into account the structure of foreign trade flows and projections of world price dynamics, a negative change in domestic trade conditions may be expected.

Nominal imports of goods are expected to sustain their growth rate in the fourth quarter of 2007 and the first quarter of 2008, with the price effect gradually increasing its contribution to the overall dynamics. Major factors which will affect import developments are domestic investment and consumer demand and high production activity in import-dependent industries.

According to preliminary data, exports of euro-denominated goods reached EUR 11 billion between January and October 2007, up EUR 1.05 billion nominally or 10.5 per cent on the corresponding period of the previous year. Imports (FOB) came to EUR 16.8 billion for the first nine months, up EUR 2.61 billion nominally or 18.4 per cent on the same period of 2006.⁸ The upward trend in exports continued in October, with their growth rate reaching 23.1 per cent on an annual basis. The corresponding annual growth in imports was 21.3 per cent.

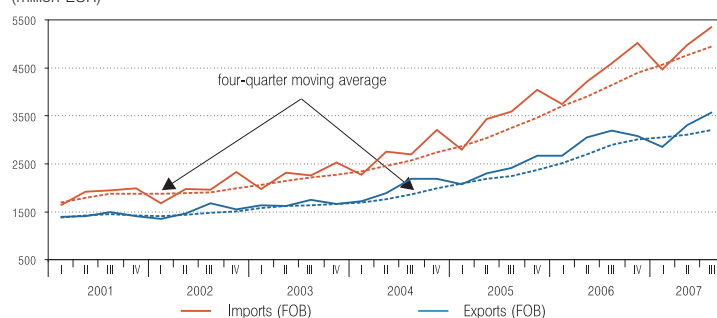
Investment goods and raw materials contributed most significantly to trade deficit growth by EUR 1452.9 million over the January to September 2007 period.⁹ The growing imports of machines, equipment and appliances, and of electrical machines reflected the robust investment activity in Bulgaria, while non-ferrous metals, which are major

⁸ Introducing the Intrastat system in early 2007 led to greater uncertainty and regular revisions of initially published foreign trade statistics (see previous issues of *Economic Review*). In addition, the time limits for receiving, processing and announcing the initial detailed data on the commodity and geographic structure of Bulgaria's foreign trade became longer.

⁹ Data on foreign trade by commodity group are published a month later than those on total exports and imports.

Chart 60
Dynamics of Exports and Imports (Quarterly)

(million EUR)



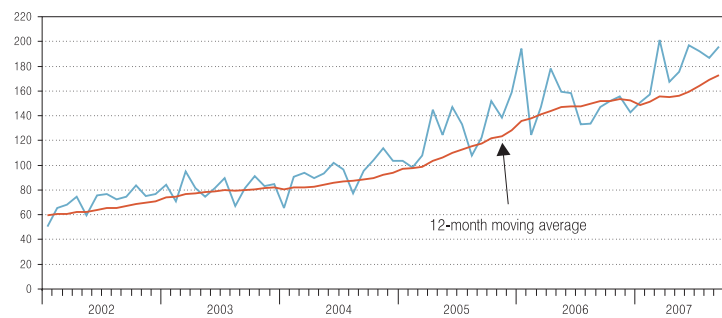
Source: BNB.

raw materials, impacted to a great extent the deficit.

Between January and September 2007 exports picked up by 9 per cent on an annual basis due to a great extent to the dynamics of exports of machines, transportation vehicles and appliances (2.8 percentage points) and of base metals and their products (2.2 percentage points). Export revenue growth in the first category came to EUR 248.2 million, which was attributable mainly to revenue growth from exports of nuclear reactors, boilers and their spare parts (a 2 percentage point contribution to overall growth) and electrical machines and appliances (1.4 percentage points). Despite the positive developments in the last few months, *sea and river transport* and *aeronautics and astronautics* positions preserved their negative contribution to total export growth over the review period. Revenue from base metal exports reached EUR 2.5 billion, rising by 8.7 per cent over the nine months since the start of the year compared with the respective period of 2006. Both the annual growth in the prices of iron, steel and zinc on international markets and the stable production and export activities in ferrous metallurgy had a positive effect. Cast iron, iron and steel, and zinc and its products added most significantly to the overall increase in exports (by 1.7 percentage points and 0.6 percentage points respectively), while exports of copper and its products registered a negative contribution (-1.5 percentage points). During the fourth quarter of 2007 and the first quarter of 2008 exports of machines, transportation vehicles and appliances are anticipated to retain their upward trend realizing a growth exceeding that of total exports. We expect that the good competitive positions of base metals on international markets will back the positive trends of the year start.

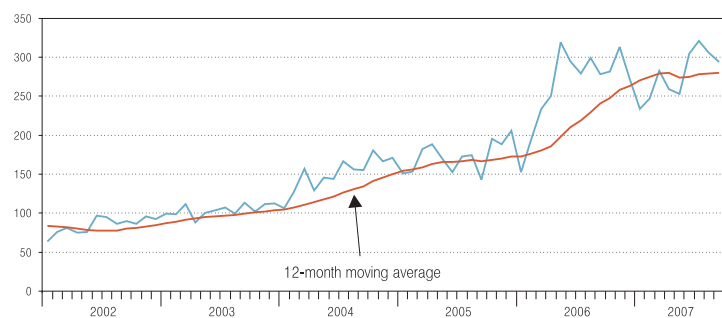
Mineral products and fuels was the only group whose exports impacted negatively total export growth in the first nine months of the year (-1.7 percentage points), while all other groups reported positive results over the period. Revenue from exports of energy resources declined compared with the Janu-

Chart 61
Exports of Machines, Transportation Vehicles and Appliances
(million EUR)



Source: BNB.

Chart 62
Exports of Base Metals and Base Metal Products
(million EUR)



Source: BNB.

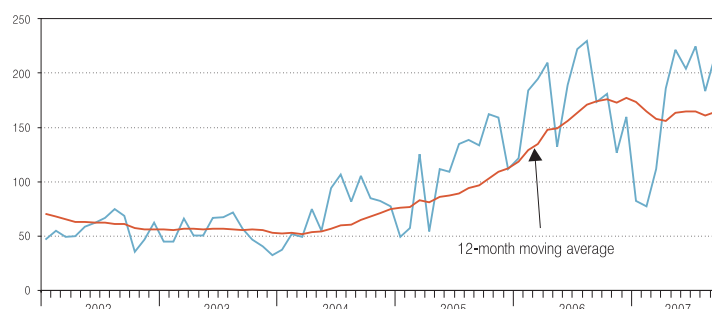
ary to September 2006 period: by 9.5 per cent for petroleum and 10.8 per cent for electricity and other energy resources. The factors responsible for this dynamics were both the lower crude oil average price (in euro) on international markets between January and September 2007 on an annual basis and the real decrease in these products. Electricity exports rebounded between June and September; however, this was insufficient to offset the fall at the year start. Forecasts for the exports of energy resources point to an upward dynamics and growing positive contribution to Bulgarian total exports during the fourth quarter of 2007 and the first quarter of 2008. Higher international oil prices are expected to contribute mostly to the increasing revenue from energy resources exports (on an annual basis). Positive expectations are also supported by the physical growth in exports of petroleum products and the retained trend of the last few months towards increasing revenue from electricity exports.

Revenue from exports of chemical products, plastics and rubber reached EUR 905 million between January and September 2007, rising by 26.2 per cent on the corresponding period of the previous year. All positions of the group reported positive developments over the period, with non-organic chemical products and pharmaceuticals having the strongest effect (contributing to total growth by 0.5 percentage points and 0.6 percentage points respectively). Expectations are for a sustainable upward dynamics of revenue from exports of chemical products over the forecast horizon.

Imports (CIF) reached EUR 15.55 billion between January and September 2007, posting a nominal increase of EUR 2.35 billion (17.8 per cent) on the respective period of the previous year. In the structure of imports by use the largest contribution was reported by raw materials (7.3 percentage points) and investment goods (6.4 percentage points), while energy resources retained their negative contribution (-0.1 percentage points). Total raw material imports came to EUR 5.77 billion during the first nine months of the year: up by EUR 967.1 million on the same period of 2006. Within this group, im-

Chart 63
Exports of Mineral Products and Fuels

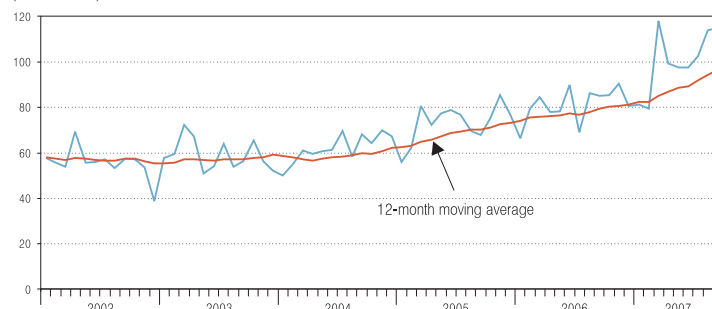
(million EUR)



Source: BNB.

Chart 64
Exports of Chemical Products, Plastics and Rubber

(million EUR)



Source: BNB.

Table 9
Contribution of Commodity Groups to Trade Growth,
January – September 2007

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	9.2	2.2	33.3	4.8
Raw materials	13.6	6.1	20.1	7.3
Investment goods	15.7	2.3	25.2	6.4
Energy resources	-9.7	-1.6	-0.6	-0.1
Other			-100.0	-0.5
Growth, total	9.0		17.8	

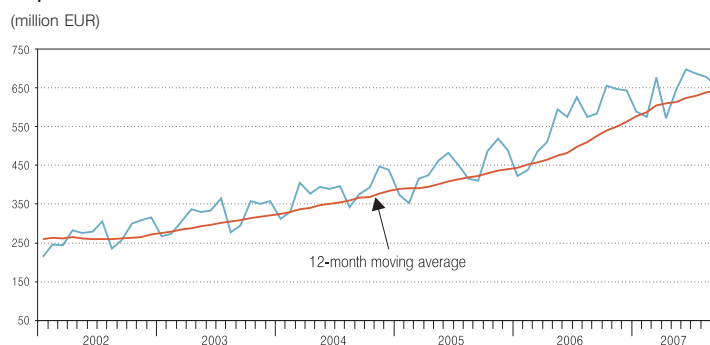
Source: BNB.

ports of *cast-iron, iron and steel, plastics and rubber*, and *non-ferrous metals* contributed most significantly to total growth (by 1.9 percentage points, 1 percentage point and 0.7 percentage points respectively). Imports of investment goods preserved their sustainable development since early 2007, with *machines, tools and appliances* contributing most significantly to overall growth (by 2.9 percentage points). Growth was reported for all kinds of investment goods, their total value reaching EUR 4.2 billion between January and September 2007. These products represented the second largest group in total imports with a share of 27 per cent. Expectations for the fourth quarter of 2007 and the first quarter of 2008 point to retention of the upward trend in imports of raw materials and investment goods resulting both from sustainable industrial output and high investment demand in Bulgaria.

Payments on imports of energy resources totaled EUR 3.06 billion in the January–September 2007 period, sustaining the negative change by EUR 19.8 million compared with the respective period of the previous year. Crude oil and natural gas contributed most substantially to these developments (by -0.7 percentage points). On international markets the average oil price in US dollars posted a minimal change over the first nine months (on an annual basis), while that in euro reported an average drop of 5 per cent. As regards the imported physical volumes of crude oil, since the year start there have been no substantial changes compared with the respective volumes in the previous year. Expectations in the current and next quarters are for sustainable output in the oil processing sector which will result in a real growth of the imported crude oil. Assumptions of the international oil price suggest a significant price effect (on an annual basis) resulting in a dynamic growth of payments on imports.

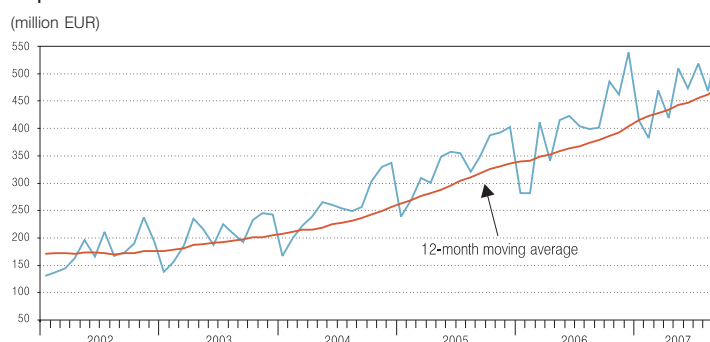
Between January and September 2007 imports of consumer goods rose by EUR 627.8 million on the corresponding period of 2006 to reach EUR 2.5 billion. *Food, drinks and cigarettes* and *furniture and home equipment* contributed most signifi-

Chart 65
Imports of Raw Materials



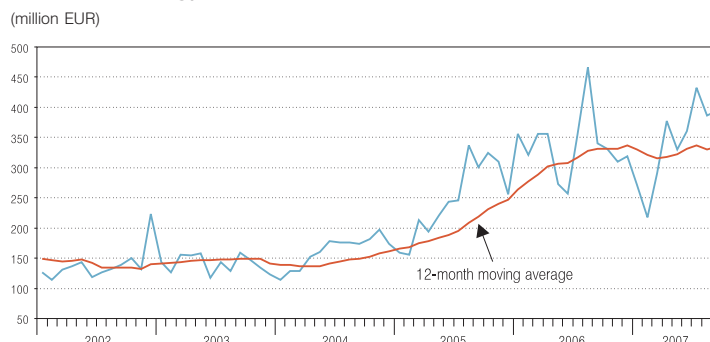
Source: BNB.

Chart 66
Imports of Investment Goods



Source: BNB.

Chart 67
Imports of Energy Resources



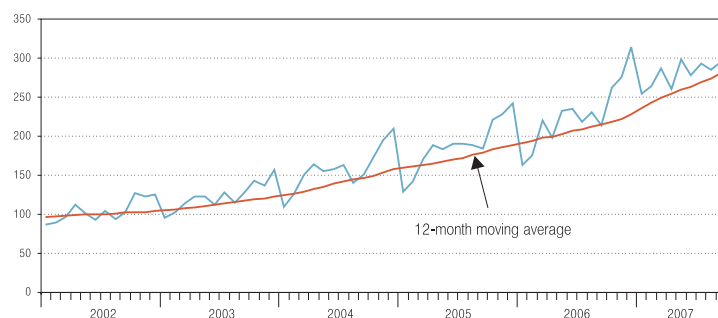
Source: BNB.

cantly to import growth in this commodity group (by 1.7 percentage points and 1.4 percentage points respectively). A decline in this group was reported in imported automobiles, with a contribution of -0.4 percentage points to total imports. In the fourth quarter of 2007 and the first quarter of 2008 imports of consumer goods are expected to retain their steady growth rates supported by stable domestic demand.

During the first nine months of 2007 Bulgarian exports to other EU member states went up by 9.8 per cent based on preliminary data, and exports to countries outside the Community picked up by 7.8 per cent. Imports of goods show a similar trend in terms of regional distribution, with imported goods originating from the Community going up by 20.8 per cent and those from third countries by 14.8 per cent. Although the exports to the Asian region increased in the third quarter, since early 2007 the decline in revenue continued, coming to 6.9 per cent on an annual basis. Exports to other destinations went up between January and September 2007, with the fifteen old EU member states contributing most significantly to the overall dynamics (by 4.6 per cent). Hence, by September 2007 the market share of Bulgarian goods in total imports of the Community member states rose to 0.55 per cent (on an annual basis) against 0.52 per cent in the previous year. No significant changes in the geographical structure of Bulgaria's foreign trade are expected over the forecast horizon, and the share of Intracommunity trade will continue to increase gradually.

Chart 68
Imports of Consumer Goods

(million EUR)



Source: BNB.

4. Inflation

Annual inflation is expected to stay relatively high till the end of the current year and in the first quarter of 2008, attributable mostly to the prices of foods, catering and transportation fuels.

Measured by the Harmonized Index of Consumer Prices (HICP), inflation accumulated between the start of the year and November 2007 reached 10.4 per cent. Average annual inflation during the January–November period came to 7.2 per cent. Food and services (catering in particular) had a major contribution to inflation during the year.

In 2007 food was the group reporting the highest inflationary dynamics on an annual basis. Over the January–November period food prices picked up by 12.6 per cent on average compared with the same period of the previous year. The increase was prompted mainly by processed foods (total contribution of 10 percentage points). *Bread and cereals* and *milk, dairy products and eggs* sub-groups had a leading role for the average annual inflation of food (contributing by 4.9 percentage points and 2.5 percentage points respectively). Vegetable oils were another group with an increasing contribution to food annual inflation rate.

In the unprocessed foods group, vegetables and meat and their products had the largest contribution to the average annual price change (by 1.1 percentage points and 0.9 points respectively). Compared with previous years, in 2007 vegetable prices exhibited a smaller seasonal drop, followed in the third quarter by a sizable rise of 39 per cent on the corresponding quarter of 2006, atypical of the ending summer months. In October vegetable prices reported a decrease, instead of the traditional increase in this period of the year, while in November vegetable price dynamics recovered its seasonal profile.

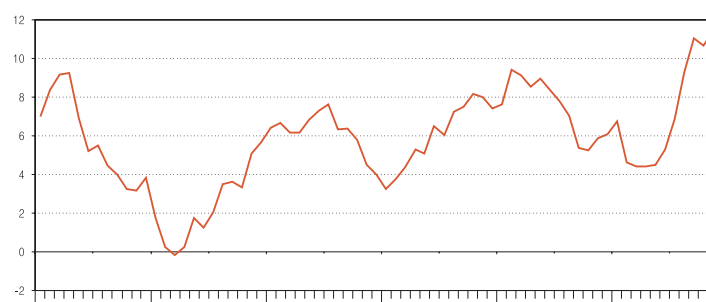
Table 10
HICP Inflation Accumulated since Year's Start*

	2006	2007
	January	– November
Inflation (%)	5.1	10.4
Contribution, percentage points		
Food	0.77	4.50
Processed food	1.07	3.88
Unprocessed food	-0.30	0.62
Services (excl. those with administratively set prices)	1.17	2.81
Public catering	0.52	1.81
Energy products (excl. those with administratively set prices)	-0.13	1.20
Transportation fuels	-0.18	1.14
Industrial goods (excl. energy products and those with administratively set prices)	0.42	1.18
Goods and services with administratively set prices	0.64	0.99
Electricity	-0.01	0.32
Water supply and sewerage services	0.00	0.16
Charges related to personal transportation vehicles	0.02	0.16
Tobacco products	2.25	-0.26

*This structure corresponds to the Eurostat classification used to present in a comparable manner the major components of HICP for euro area and EU countries. These components include: *processed food* (incl. *alcohol and tobacco products*), *unprocessed food* (*meat; fish and seafood; fruits; vegetables*), *energy products* (*electricity; solid, liquid and gaseous fuels for households; heating; fuels and lubricants for personal transportation vehicles*), *non-energy industrial goods and services* (incl. *catering services*). With the purpose of distinguishing the effects of goods and services with administratively set prices and goods whose prices largely depend on changes in excise rates (tobacco products), their prices are excluded from the major HICP groups under Eurostat.

Source: NSI.

Chart 69
Harmonized Index of Consumer Prices
(inflation on corresponding month of previous year, %)



Source: NSI.

Several specific factors determined the food inflation during the year. The continuing drought in Bulgaria decimated cereal crops and led to lower corn and sunflower yields and fodder shortages. The dramatic rises in international prices of cereal and oil-bearing crops caused by the poor harvest in major producer countries and growing demand for these crops worldwide resulted in more expensive imports. Rising bread prices resulted directly from these trends. On the other hand, increasing fodder prices impacted significantly the prices of milk and meat products. Lower crops during the year were reported for vegetables and fruits.

Bulgaria's EU membership also affected food price dynamics. The application of the Common Customs Tariff from the start of 2007 resulted in a change in the imports and exports regime of some foods. Enhanced external demand due to lower prices in Bulgaria compared with those in its neighbour EU countries was another direct effect from Bulgaria's accession to the EU (see the *External Demand and Effects on Prices of Certain Food Products* box in *Economic Review*, issue 3, 2007).

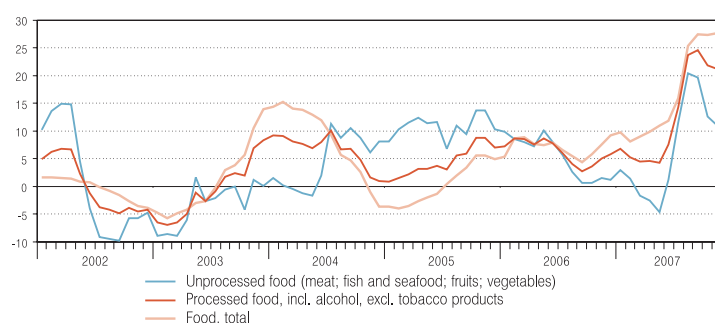
Decreased supply owing to unfavourable weather conditions, dramatic rises in international food prices and significantly growing demand, including external demand, led to higher food prices in 2007 in Bulgaria.

On an annual basis, food inflation is expected to stay relatively high. During the last two months the annual rates of food price rises started to slow down underpinned by the lower contribution of vegetables, meat and dairy products' prices. However, continuing rises in the prices of bread and cereals and of animal and vegetable fats and oils were responsible for the retained high inflation of food. Inflation in this group is likely to stay high till end-2007 and in the first quarter of 2008 due to anticipated high international and domestic food prices. Moderate domestic demand for food products by households, related to slower rises in real wage and respectively in real incomes, may to a certain extent reduce the potential for a considerable increase in retail food prices in the following months. Data on household budgets and

Chart 70

Harmonized Price Indices of Food

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

retail trade revenue from sales of foods, drinks and tobacco products are indicative of the trends in domestic consumer demand (see Section 3 *Economic Activity*).

Rises in the prices of catering, which is crucial to services inflation dynamics due to its large share in the group of services (36.3 per cent in 2007), resulted directly from food prices. Average annual inflation of services reached 8 per cent in November; of this 4.2 percentage points were contributed by public catering.

We expect a relatively high inflation in services owing to the influence of catering and transportation prices. Growing crude oil prices on international markets directly impact the prices of transportation and other services related to personal transportation vehicles. From the start of 2008 bus transportation prices will be affected by the raised prices of buses' vignette charges.¹⁰ The comparatively large share (21 per cent) of transportation services, expenditure on personal transportation vehicles' maintenance and repair and other services related to personal transportation vehicles in the groups of services makes this group second in importance (catering occupies the first place) in identifying services inflation dynamics. The steady transportation expenditure contribution to the real growth in consumer expenditure in the period between the last quarter of 2006 and the third quarter of 2007 shows that this expenditure is considered by households as a constant element of their total expenditure. The trend probably reflects both the expenditure restructuring and the lower elasticity of demand compared with that of prices. The foreseen rise in the civil liability insurance premium will be another factor with a direct inflationary contribution in the services group.

Non-energy industrial goods (excluding those with administratively set prices) reported a relatively low inflation dynamics over the first eleven months of 2007. During this period their prices rose by 4.6 per cent on average on the same period of the previous year.

¹⁰ Rises amounting to BGN 500 and BGN 550 are envisaged in 2007 and 2008 respectively.

The following groups contributed most to the average annual non-food inflation: home furnishings, maintenance and repair (1.3 percentage points), transportation vehicles, including spare parts (1 percentage point) and clothing and footwear (0.9 percentage points and 0.8 percentage points respectively). Growing real income during the first six months and high consumer confidence based on positive expectations of future income and favourable labour market developments boosted consumer demand for various durable goods. The strong demand stimulated these goods' price rises.

Consumer expenditure growth is anticipated to slow down till the year-end and during the first quarter of 2008; this would contribute to moderate inflation dynamics of non-energy industrial goods. These developments are supported by data about slower consumption growth since mid-year and weakening consumer confidence (see Section 3 *Economic Activity*). In line with these trends at the start of the fourth quarter a slowdown in the growth of some industrial goods' prices was observed. The lower real growth of consumer expenditure on home furnishings, maintenance and repair resulted in slower rises in the prices of the goods in this group in October and November. Industrial goods prices dynamics is expected to be influenced by the falling prices of some goods, *inter alia*, computers and television sets. The increase in the product tax on electrical appliances will exert a one-off effect on their prices in early 2008.

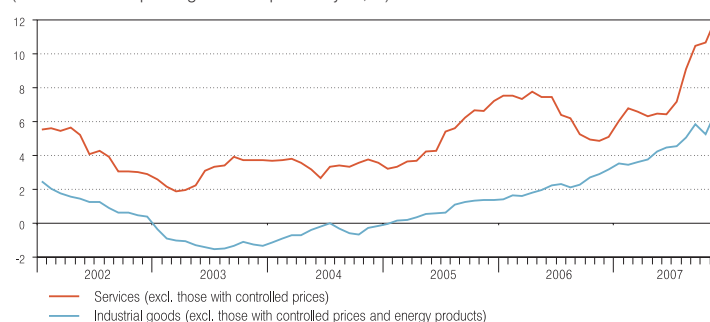
Year-on-year inflation of energy products (mainly transportation fuels) was relatively low in the first eight months of 2007 owing to the high base of crude oil prices during the same period of 2006. Between September and November the annual change in the prices of goods in this group accelerated to some 12 per cent on average again due to the base effect. The average annual inflation of energy products over the January to November 2007 period reached 4.7 per cent.

Till end-2007 and during the first quarter of 2008 the upward trend in inflation of energy products on an annual basis is likely to be

Chart 71

Harmonized Price Indices of Industrial Goods and Services

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

sustained due to several factors. One of them is the continuing rise in crude oil prices on international markets. The increase in the excise duties on fuels since the beginning of the next year will be another pro-inflationary factor; it is expected to contribute to the rise in transportation fuel prices by 0.3–0.4 percentage points.¹¹ The upward annual change in the prices of energy products will also be attributable to the base effect till the end of March 2008.

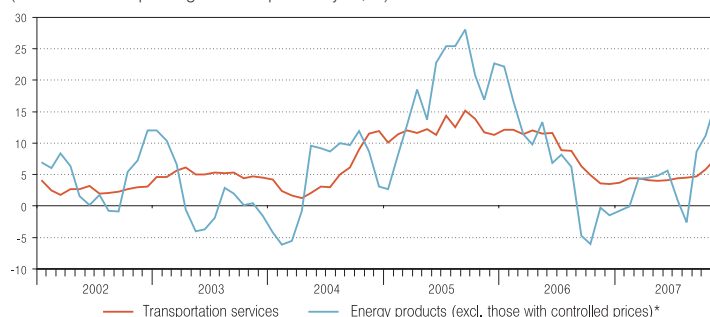
During the year inflation dynamics of controlled prices was directly influenced by several adjustments in these prices which were made mainly at the beginning and in the middle of the period. At the year start changes in the prices of medical and hospital services, higher automobile vignette charges and rises in the price of water supply and sewerage services in several towns of Bulgaria had a major contribution to inflation of administratively set prices on an annual basis. In July the price of electricity for households was raised.¹² Average year-on-year inflation of controlled prices over the January to November 2007 period reached 5.4 per cent. Till the close of the year the only approved adjustment of administratively set prices was the increase in the price of water supply since 1 December 2007, resulting from higher expenditure of water supply companies on electricity. During the first quarter of 2008 the main changes in controlled prices will be related to the rise in the prices of doctors' and hospital services (owing to minimum wage growth) and in the fares of passenger railway transport and urban transport. These adjustments are not expected to change substantially the inflation of administratively set prices which will

¹¹ In compliance with the amendments to the Law on Excise Duties and Tax Warehouses, since the beginning of 2008 excise duties on fuels will be raised as follows: from BGN 635 to BGN 685 per 1000 l of unleaded petrol and from BGN 535 to BGN 600 per 1000 l of diesel. The estimated effect of increased excise rates is an increase in the average end-price of fuels by some 3–4 per cent. It is more difficult to estimate how the requirement for adding a certain amount of bio-mixes to fuels since the start of 2008 will affect fuel prices as this will lead to reduced excise duties. The difficulty stems from the fact that it is not possible to evaluate the practical application of this requirement in the first months of 2008.

¹² Mid-year inflation was also influenced indirectly by the dramatic rise in the price of electricity for companies stemming from increased end-use consumer prices due to higher production costs. For further details see *Economic Review*, issue 3, 2007.

Chart 72
Harmonized Price Indices of Energy Products
and Transportation Services

(inflation on corresponding month of previous year, %)



* Energy products excluding those with controlled prices include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB.

gradually slow down and stabilize at a lower level.

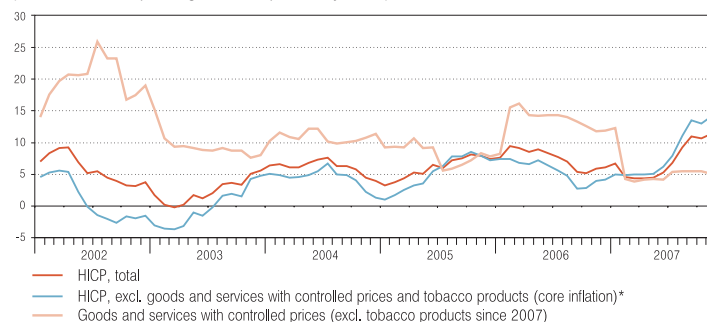
Since early 2007, the prices of tobacco products, whose market was liberalized, dropped by 6.3 per cent. In early 2008 the excise duties of these products will be raised in line with the scheduled harmonization of excise rates with the EU minima. The total contribution of cigarettes to inflation on an annual basis is expected to move within the range of 0.8 percentage points and 1 percentage point in the first quarter of 2008 (against a -0.26 percentage point contribution during the last two quarters of 2007); there is uncertainty about the effects of market competition and the probable inclusion of imported cigarette brands in the consumer basket. Increased contribution of tobacco products will be one of the factors behind the high annual rate of the change in inflation at the start of the next year.

We expect till end-2007 and during the first quarter of 2008 inflation on an annual basis to stay relatively high. Food, public catering and transportation fuels will contribute mostly to inflation. At the beginning of the next year the contribution of tobacco products will increase.

Chart 73

Harmonized Indices of Goods and Services with Controlled and Non-controlled Prices

(inflation on corresponding month of previous year, %)



* Since tobacco product prices depend on administratively set excise rates, they are excluded from the group of goods and services with non-controlled prices (core inflation) despite the liberalization of the tobacco market since early 2007.

Sources: NSI, BNB.

Published by the Bulgarian National Bank
1000 Sofia, 1, Knyaz Alexander I Sq.
Tel.: (+359 2) 9145 1351, 9145 1209, 9145 1231, 9145 1978
Fax: (+359 2) 980 2425, 980 6493
Website: www.bnb.bg