

Economic Review

3/2008



BULGARIAN
NATIONAL
BANK

Economic Review

3/2008



BULGARIAN
NATIONAL
BANK

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 3/2008 was presented to the BNB Governing Council at its 7 October 2008 meeting. It employs statistical data published up to 30 September 2008.

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.

ISSN 1312 – 420X

© Bulgarian National Bank, 2008

This issue includes materials and data
received up to 13 October 2008.

The contents of the *BNB Economic Review* may be quoted or
reproduced without further permission. Due acknowledgment is
requested.

Elements of the 1999 issue banknote with a nominal value of
20 levs are used in cover design.

Contents

Summary	5
1. External Environment	6
The USD/EUR Rate	10
International Prices of Crude Oil, Major Raw Materials, and Gold	12
Bulgarian External Debt Dynamics on International Financial Markets	14
2. Financial Flows, Money and Credit	15
Financial Flows and External Position Sustainability	15
Monetary Aggregates	19
Credit Aggregates	22
3. Economic Activity	25
Household Behaviour	26
Government Finance and Consumption	28
Behaviour of Firms and Competitiveness	29
Exports and Imports of Goods	33
4. Inflation	38

Highlights

- China's Economy in 2008 11
- Dynamics of Sovereign Credit Default Swap (CDS) Spreads 14

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

Global financial markets, which relatively stabilized at the end of the second quarter of 2008, were shaken by the failure of several large financial institutions in September. The continuous tension coupled with tightening of lending standards and rising cost of financing led to deepening business pessimism which was visible in rapid worsening of global indicators of economic activity. Economic activity dampening in developed countries and expectations of global growth slowdown affected world prices of major raw materials, foods and fuels which started falling. In an unprecedented coordinated action, on 8 October the European Central Bank and central banks of the USA, Canada, United Kingdom, Switzerland, Sweden and China lowered interest rates on main refinancing operations. Governments also took extraordinary measures to stabilize financial markets and restore global economic agent confidence.

In Bulgaria, over the first seven months of 2008 global financial market turmoil was mostly reflected in the rising cost of financing on the domestic money market, increasing deposit and credit interest rates and stock index declines. Foreign capital inflow in Bulgaria remained strong but highly uncertain international environment after September created risks for the future. The balance of payments financial account surplus (preliminary data) exceeded EUR 6 billion between January and July 2008 and foreign direct investment accounted for EUR 2.8 billion. BNB international reserves continued rising to reach EUR 14.7 billion at the end of September. The ratio between international reserves and average monthly imports of goods and services between January and July came to 5.7 months, from 5.2 months a year earlier.

Real GDP growth over the first half of 2008 accelerated to 7.1 per cent, with real growth in fixed asset investment contributing 6.5 percentage points to overall growth (over the first half of the year real growth in fixed asset investment was 22.7 per cent compared to the corresponding period of the previous year). Government consumption contribution to overall economic growth in the first half of 2008 was negative following the conservative fiscal policy pursued. The policy of moderate growth in government expenditure is intended to limit external demand growth and mitigate its pressure on inflation and current account deficit growth.

Although the strong economic activity and foreign capital inflow continued to create conditions for comparatively rapid growth in monetary aggregates, the high base of 2007 and credit growth slowdown contributed to a gradual decline in monetary aggregate growth rates. Increases in deposit interest rates and cost of financing on money markets both in Bulgaria and the euro area continued to spill over into lending interest rates.

Economic growth is expected to remain high until the end of 2008 though rapidly deteriorating international environment may result in moderation of economic growth until the end of the current year and especially in the coming year. Economic situation in Bulgaria has remained favourable so far and competitive positions of the economy have been sustained. Due to the dramatic worsening in the international situation in September, business expectations in Bulgaria may undergo fast changes. Firms will face the challenge to more flexibly manage their expenditure, especially on wages, so that they could retain their competitive positions amid the global slowdown in economic activity.

Credit activity will continue to moderate, with the growth rate of bank claims on the non-government sector expected to reach 40 per cent on an annual basis by year-end. The rising cost of attracted funds is likely to push further lending interest rates. Still strong competition in supplying loans will be a limiting factor to this.

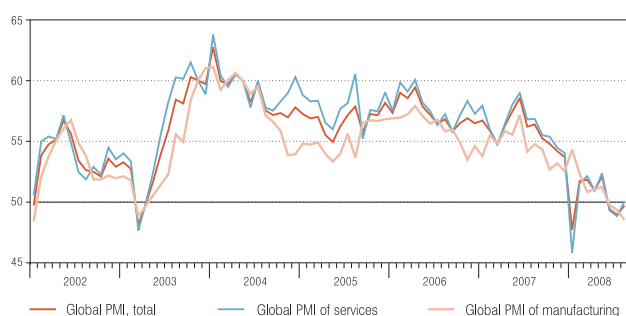
Inflation started to moderate in the second half of 2008. This trend is expected to continue until the end of the year, and declines in world fuel and commodity prices will push down domestic prices by contrast with direct and indirect effects of increased natural gas prices.

1. External Environment

Global financial crisis deepened further in September 2008 when risks to global economic growth increased. Raw material prices started falling due to reduced demand from developed countries and several leading emerging economies. Efficiency of the measures taken by central banks and government institutions will largely predetermine the success in restoring normal functioning of financial markets and counteracting downside risks to global economic growth.

Prospects for the leading economies of the USA and the euro area worsened significantly over the third quarter of 2008. Current economic indicators reached their lowest values since 2001, with pessimism rising further both in industry and services. Expectations of new orders and production significantly decreased.

Global PMI



Sources: NTC Research, JP Morgan.

The US sub-prime mortgage crisis continued to deepen. The collapse of US leading financial institutions affected large European banks. Stock market collapse at the end of September was the largest one since 1987. Only in two weeks at the close of September and early October S&P 500 lost 18 per cent, DJIA 17 per cent, and DJ STOXX 50 euro area 20 per cent of their value. Uncertainty around the efficiency of the measures undertaken to provide liquidity on the interbank market contributed to the increase in stock market volatility.

While trying to overcome the financial market crisis, central banks injected considerable amounts of liquidity into the markets. In an unprecedented coordinated action, on 8 October the European Central Bank and central banks of the USA, Canada, United Kingdom, Switzerland, and Sweden lowered interest rates on main refinancing

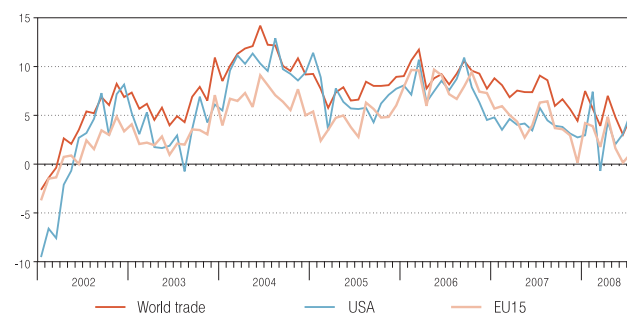
operations by 50 basis points. Coordinated intervention of the six central banks was underpinned by the central bank of Japan, and the central bank of China cut its interest rate by 27 basis points. The significant instability and rising risks to the world financial system created high uncertainty about future actions of monetary institutions in the coming quarterly periods.

Expectations of slowing economic growth in the USA and the euro area spilled over into key emerging economies. China's latest business indicators recorded worsening and expectations of economic growth moderation. Major commodity markets also reacted to changed expectations, with energy and metal prices decreasing significantly.

Global trade rates moderated further, with growth falling to 5.2 per cent on an annual basis between January and July (against 7.1 per cent on average in 2007).

World Trade

(annual rate of volume growth, %)



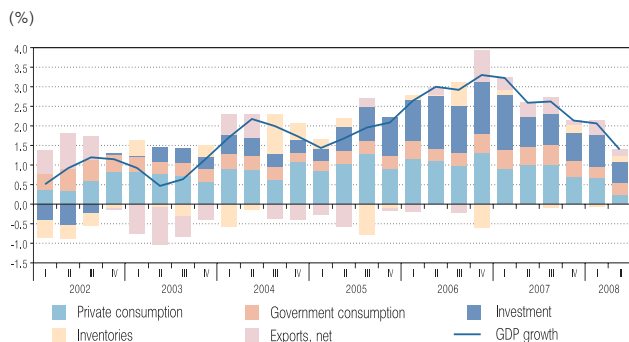
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Euro Area

In the second quarter of 2008 euro area economic growth declined to 1.4 per cent on an annual basis (2.1 per cent in the first quarter). Eco-

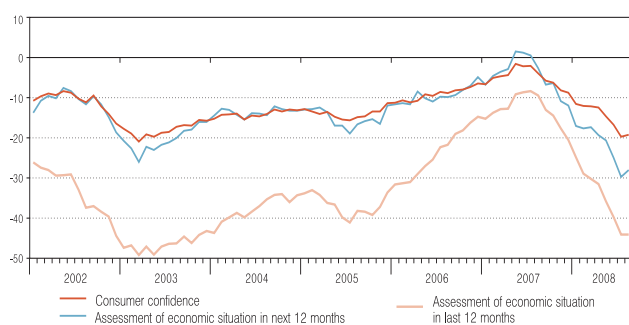
economic activity moderation was due to declines in investment and consumption growth. Slowing economic growth in key trading partners of the euro area led to net exports declines.

Contribution to Euro Area Growth by GDP Component (Quarterly)

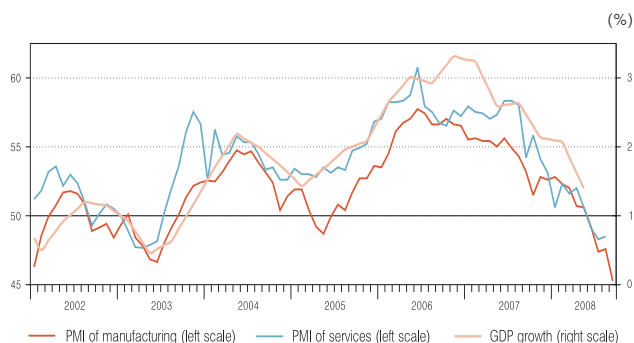


Over the third quarter of 2008 negative trends in leading economic indicators (IFO, EC indicators) and macroeconomic data in real terms (retail sales, industrial output, consumption) deepened further. These trends signal a possible significant moderation in economic growth to a level below the potential over the second half of 2008. The expanding global financial crisis increased the probability of recession in the euro area over the coming quarterly periods.

Euro Area Consumer Confidence Indices

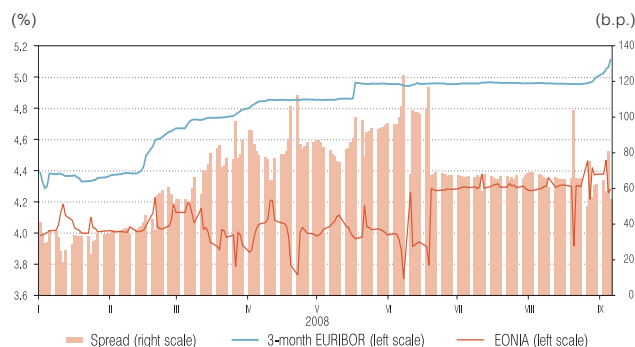


PMI and Euro Area GDP Growth



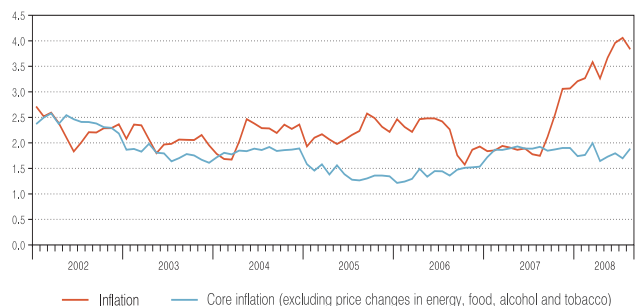
The significant credit spread increase reported recently along with market capitalization reductions in the financial sector will cause further tightening of lending standards and rises in the cost of financing. This will limit private sector's access to financing and have an adverse effect on consumption and investment. Worsening prospects for employment and corporate profits are likely to exert an additional pressure on consumer and investment decisions.

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



Euro Area Inflation Rate

(percentage change on same period of previous year)

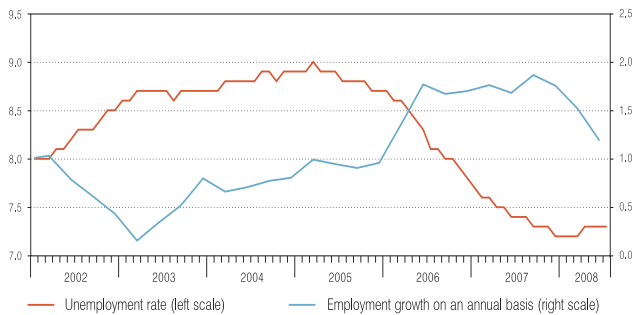


According to preliminary data, in September HICP declined to 3.6 per cent on an annual basis, after reaching 4.0 per cent in previous months. Fuel price declines and food inflation moderation had the major contribution to this decline. Core inflation stayed at low levels and in August reached 1.9 per cent on an annual basis.

The outlook for the last quarter of 2008 shows a gradual slowdown in inflation compared with the current level, with its dynamics reflecting the expected favourable base effect and subsiding pressure of final consumer demand and commodity and energy prices. Upside risks to price stability were associated with volatility of oil and major commodity prices, as well as with possible sec-

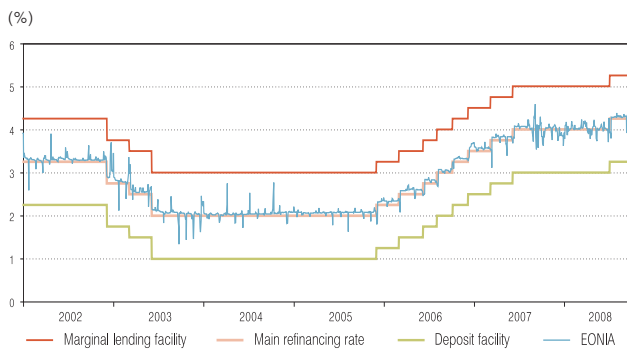
ond-round inflationary effects in the price and wage formation.

Euro Area Unemployment Rate and Employment Growth (%)



Source: Eurostat.

Euro Area Interest Rates (%)

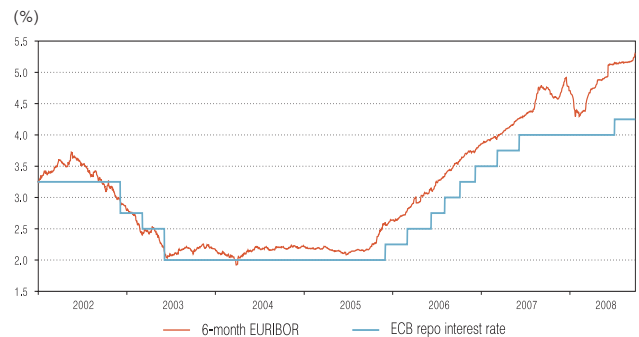


Source: Bloomberg.

In early July the ECB raised the repo interest rate by 25 basis points to 4.25 per cent. At its monetary policy meetings in August and September,

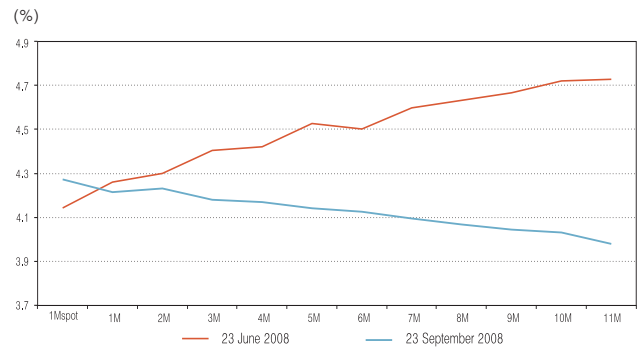
the ECB left unchanged the repo interest rate. At the 8 October meeting, the ECB jointly with other leading central banks cut the interest rate on main refinancing operations by 50 basis points to 3.75 per cent.

ECB Main Refinancing Rate and Six-month EURIBOR (%)



Source: Bloomberg.

Forward Rates Based on the Fixed Swap Yield on Overnight Interest Rate (OIS) (%)



Source: Bloomberg.

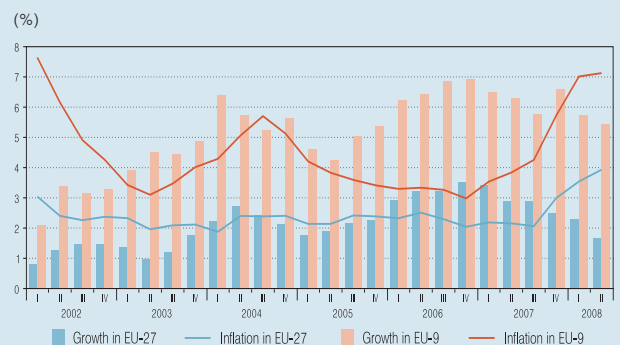
EU-9*

In the second quarter of 2008 EU-9 economic growth continued to moderate and came to 5.4 per cent on an annual basis (against 5.7 per cent in the first quarter). The highest rates of growth were reported by Romania, Slovakia and Bulgaria (9.3, 7.6 and 7.1 per cent respectively). Inflation in EU-9 countries accelerated in the second quarter to 7.1 per cent on an annual basis, foods and fuels contributing again most significantly to this.

Expectations based on leading OECD indicators for Central and Eastern Europe countries are for growth moderation in the second half of the year.

* EU-9 includes the countries which have acceded the EU since 2004, excluding Slovenia, Malta and Cyprus. As from 1 January 2007 Slovenia and as from 1 January 2008 Malta and Cyprus became full-fledged members of the Economic and Monetary Union.

Growth and Inflation in EU-27 and EU-9 (%)

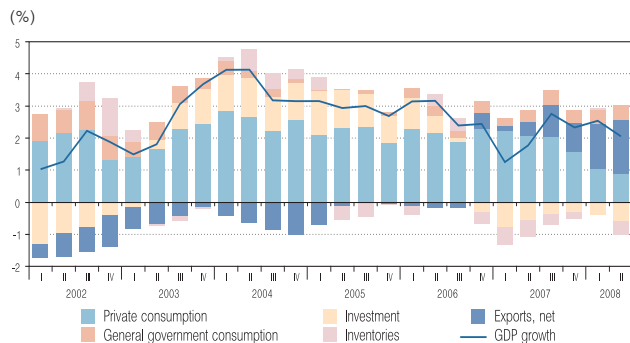


Sources: Eurostat, own calculations.

USA

Final data show that economic activity accelerated in the second quarter of 2008 to 0.7 per cent on a quarterly basis, 0.1 percentage point less than in the preliminary estimate. The downward revision refers mainly to consumption and net exports data. Investment had a negative contribution to GDP, with housing construction and investment in production equipment recording the strongest decrease.

Contribution to US Growth by GDP Component (Quarterly)

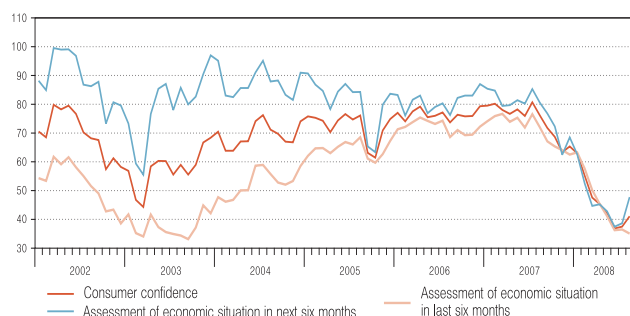


Source: Bureau of Economic Analysis.

In the second quarter of 2008 economic indicators in industry worsened further. The services sector slightly stabilized. Significant oil price falls affected consumer confidence favourably which rebounded in August and September after the record minimum values reached in recent months. Labour market employment declined significantly, resulting in an increasing unemployment to 6.1 per cent at the end of August. Employment outlook remains negative for the following several quarters.

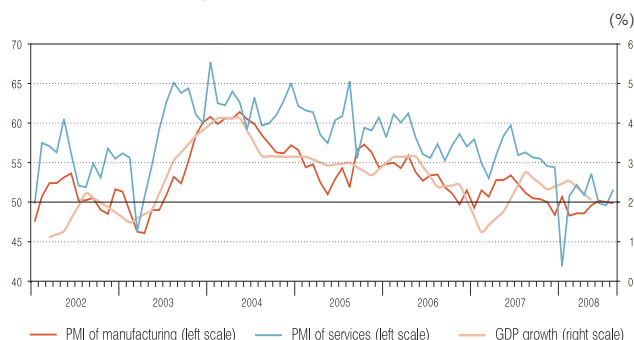
US Consumer Confidence Indices

(2000 = 100)



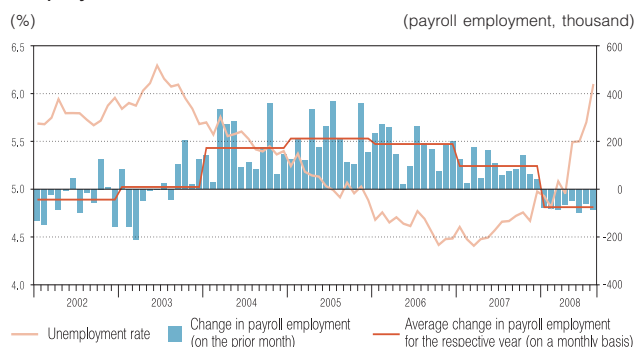
Source: The Conference Board.

US PMI of Industry and Services and GDP Growth



Source: Institute for Supply Management.

US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labour Statistics.

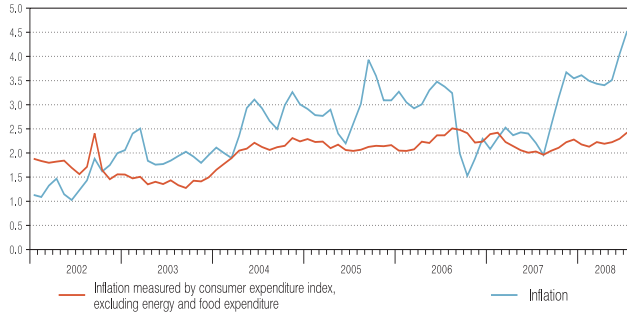
The sizable number of unsold houses is expected to put downward pressure on prices and to repress investment activity in this sector. Tightened standards in extending bank loans and worsening conditions for financing through capital markets continued to create prerequisites for slower investment activity in other sectors as well. In the last three months financial institutions tightened standards for extending consumer loans which will have a negative effect on consumer activity in the last months of the year.

In the coming months net exports contribution to economic growth is likely to decrease due to lower demand in major trading partners of the USA and comparatively higher value of the US dollar.

In August 2008 US inflation as measured by personal consumption expenditure (PSE) deflator rose to 4.5 per cent on an annual basis. Core inflation reached 2.6 per cent over the same period. Inflationary expectations of the markets decreased significantly following the oil price declines. The risk of secondary effects related to labour expenditure subsided considerably and this downward trend is likely to be sustained in the future given the labour market developments.

US Inflation Rate

(percentage change on same period of previous year)

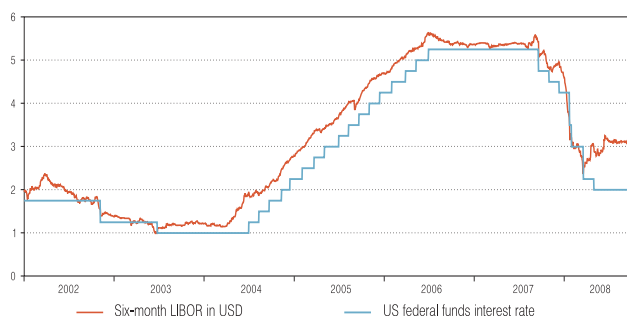


Sources: Bureau of Labour Statistics, Bureau of Economic Analysis.

Housing market imbalances continued to have a negative effect on financial markets due to mortgage asset revaluation. The negative outlook for the financial sector was leading in identifying investment sentiment. Volatility of the stock and government securities secondary markets increased markedly, resulting in severe flight-to-quality episodes. High uncertainty continued to dominate money markets, and credit risk premium was sustained. Seizure of Fannie Mae and Freddie Mac under government control and the subsequent Lehman Brothers bankruptcy put additional pressure. System risk concerns led to shaky confidence among interbank market participants using various Federal Reserve System programmes as a major source of liquidity. The fact that non-US banks were short of US dollar liquidity was the reason for significant increases in the existing Federal Reserve swap lines with other central banks. In response to this, the main government bodies responsible for supervising and controlling the US financial sector took a decision for intervention through stimulating purchases of unstable financial institutions by better capitalized companies. The following step includes adoption of the 700-billion-dollar plan by the US Treasury to bail out troubled assets.

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

(%)

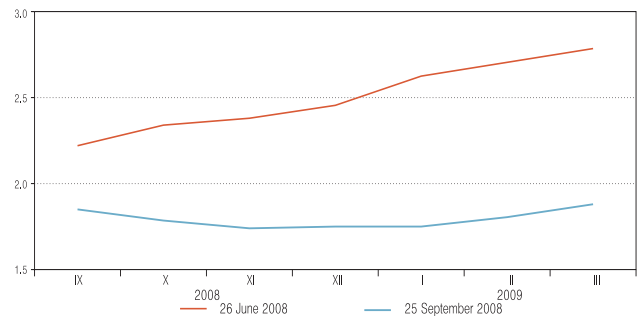


Source: Bloomberg.

On 6 October the Federal Reserve System raised the volume of additional liquidity provided to banks from USD 75 billion to USD 150 billion, with the credit term increasing from 28 to 85 days. Two days later the Federal Reserve System jointly with other leading central banks cut the interest rate on main refinancing operations by 50 basis points to 1.50 per cent.

Implied Federal Funds Futures Interest Rate

(%)



Source: Bloomberg.

The USD/EUR Rate

Over the third quarter of 2008 the US dollar appreciated significantly (around 8 per cent) against the euro. Data on spreading the unfavourable effect of the US financial crisis to Europe and possible interest rate cuts by the ECB predetermined negative sentiment towards the euro.

USD/EUR Exchange Rate

(USD per EUR 1)



Source: ECB.

However, at the end of the third quarter market participants' attention was focused again on the problems of the US financial sector. The decision for taking control over the US mortgage finance companies by the Federal Housing Finance Agency (FHFA) along with the collapse of the fourth largest US investment bank and troubles in other financial institutions caused tension in financial markets.

China's Economy in 2008

Data on China for the second quarter show the most significant slowdown in GDP growth for the last three years: 10.1 per cent on an annual basis (against 10.6 per cent for the same period of the previous year). The slowdown is associated with declines in external demand and investment activity, as well as measures undertaken by the central bank to curb credit expansion in particular sectors of the economy. Though reporting slower rates, the Chinese economy is the most rapidly growing among the 20 largest world economies. According to IMF data, as of the end of 2007 the China's share of the world GDP was between 5 and 6 per cent, while that of the USA was slightly above 26 per cent.

Due to concerns about a total slowdown in economic activity, in the middle of September monetary authorities in Beijing cut the main interest rate for the first time in six years (to 7.20 per cent, from 7.47 per cent) and lowered the reserve ratio (to 16.5 per cent, from 17.5 per cent). The authorities took not only monetary but also fiscal and foreign exchange measures. In support to exports, tax incentives were given to textile and clothing exports and simultaneously the renminbi appreciation rate slowed down. Currently, a new plan on additional government expenditure is discussed.

The government introduced a number of administrative measures intended to limit the flow of speculative foreign capitals in China. Chinese regulatory authorities announced that control over foreign direct investment will be strengthened to prevent creation of fictitious companies. The main reason is the risk of a sudden capital withdrawal which could threaten financial system stability. A requirement was introduced for exporters to prove that their incomes come from real trade transactions registered by customs authorities. In early August a new structure was established to the central bank to manage the exchange rate reform and monitor cross-border short-term capitals.

The Chinese ICBC, CCB, and Bank of China are among the largest banks in terms of market capitalization. Despite some transactions in 2007, these banks have reported small exposure to US sub-prime mortgage products. This was due to the strict government regulation of foreign portfolio investment. In 2008 the Chinese authorities did not permit any large investment in foreign financial institutions. On the other hand, the central bank of China is a major holder of US government securities of nearly USD 1 trillion and of bonds issued by the nationalized Freddie Mac and Fannie Mae agencies. Since China is one of the major external creditors of the US financial system, government's policy is of key significance for global stability.

The Balkan Region

During the first half of 2008 Balkan countries reported comparatively high growth rates despite the worsened international conditions. Domestic demand in this region remained stable. Private consumption and investment continued to increase at high rates. Between January and July 2008 industrial output rates in most countries of the region remained strong compared with the corresponding period of 2007. In the third quarter the upward inflation trend came to an end. Food and fuel price rises continued to have a major contribution to overall price increases in this region.

Expectations show continuous high rates of growth in the third quarter and a probable slight moderation in the fourth quarter of 2008. The worsened international situation is likely to have an adverse effect on economic growth in 2009. However, growth in this region will benefit from high yields of agricultural production.

Real Growth and Inflation in Balkan Countries (Quarterly)

	2007					2008		
	I	II	III	IV	Total	I	II	III*
Growth (on the corresponding period of previous year, %)								
Bulgaria	5.5	7.3	4.9	6.9	6.2	7.0	7.1	
Greece	4.3	4.1	3.8	3.6	4.0	3.6	3.4	
Macedonia	6.7	3.9	4.4	5.1	5.0	5.4	6.5	
Romania	6.1	5.7	5.7	6.6	6.0	8.2	9.3	
Turkey	8.1	4.1	3.3	3.6	4.6	6.7	1.9	
Croatia	7.0	6.6	5.1	3.7	5.6	4.3	3.4	
Serbia	7.8	7.7	6.6	6.4	7.1	8.4	6.2	

(continued)

(continued)

	2007					2008		
	I	II	III	IV	Total	I	II	III*
Inflation (averaged for the period, %)								
Bulgaria	5.3	4.7	9.0	11.2	7.6	12.4	14.0	13.1
Greece	2.9	2.6	2.8	3.6	3.0	4.3	4.8	4.9
Macedonia	0.7	1.1	2.4	4.9	2.3	9.5	9.9	9.1
Romania	3.9	3.9	5.1	6.8	4.9	8.0	8.6	8.6
Turkey	10.3	9.5	7.1	8.2	8.8	8.8	10.3	11.9
Croatia	1.6	2.1	2.9	4.9	2.9	5.9	6.5	7.9
Serbia	4.8	3.3	6.6	10.8	6.4	13.4	15.8	13.2

* July and August inflation data.
Sources: Statistical institutes and central banks of respective countries.

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

Crude Oil

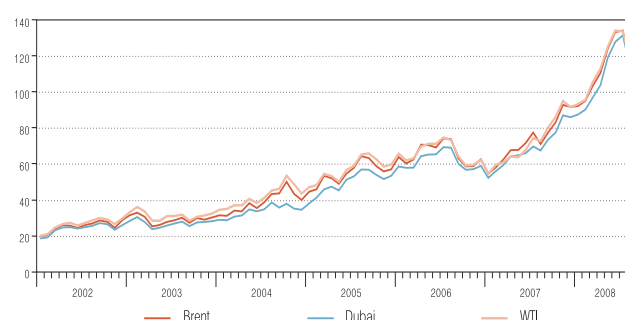
In the beginning of the third quarter crude oil prices reached USD 140 *per barrel*, reflecting high demand and expectations that the US economy will not suffer a significant downturn. In August and September signals of slowing world economy became clearer, and crude oil prices fell to about USD 96 *per barrel*. The slowdown of demand both in OECD countries and in emerging economies coupled with expectations of introducing new oil production capacities in non-OPEC countries contributed to the decrease in supply uncertainty. Latest International Energy Agency forecasts point to expectations of global growth in oil demand by 0.8 per cent in 2008 and 1 per cent in 2009, less 0.2 percentage points than in the second quarter forecast.

In response to the dramatic fall in oil prices, OPEC countries cut supply quotas by 520 million barrels *per day*. However, no changes in the price were registered. According to IEA data, in August the OPEC supply accounted for 30.4 million barrels *per day*, 700,000 barrels more than in the projected member state quotas.

Over the fourth quarter oil prices are likely to stay at the current levels and based on market expectations, the average price will range between USD 70 and USD 90 *per barrel*.

Crude Oil Prices

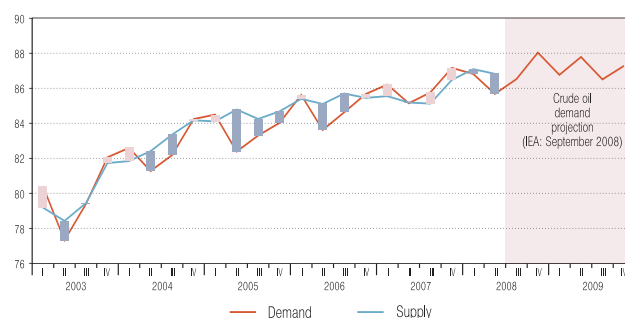
(USD *per barrel*)



Source: World Bank.

World Crude Oil Demand and Supply (Quarterly)

(million barrels *per day*)



Source: IEA.

Major Raw Material and Commodity Prices

Over the third quarter of 2008 metal prices started to decline due to the world industry slowdown and decreased new orders. The metal price index shows a decrease of about 5 per cent on the previous quarter. Nickel prices fell most significantly (25 per cent) followed by zinc and lead prices (16 per cent). Copper and aluminium prices posted a decrease by 6.5 per cent and 2.5 per cent respectively. Unlike non-ferrous metal prices, steel prices continued to

rise, their rate coming to 22 per cent on the previous quarter. Expectations are for retaining the downward trend in non-ferrous metal prices and a slight fall in steel prices until the end of the year.

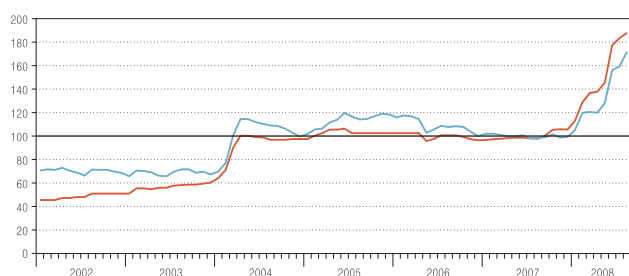
Over the third quarter food prices fell by 6.7 per cent on the previous quarter. Wheat prices dropped by about 12 per cent in July and August due to high yields in EU-27, Russia, Ukraine and Canada, which offset the lower-than-ex-

pected production in Australia, Argentina and Kazakhstan. Thanks to high yields, an 18 per cent increase in world wheat inventories is expected after significant declines in the last two years. Corn prices also posted a decrease (about 7 per cent) along with rice (17 per cent) and vegetable oils (9.2 per cent).

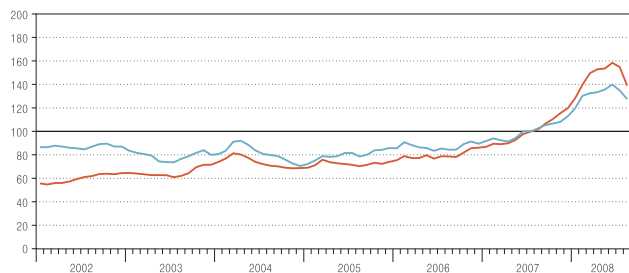
Food prices are expected to decline until the end of the year due to higher yields and increased exports from major exporting countries.

Price Indices of Major Commodities and Commodity Groups
(2007 = 100)

Steel

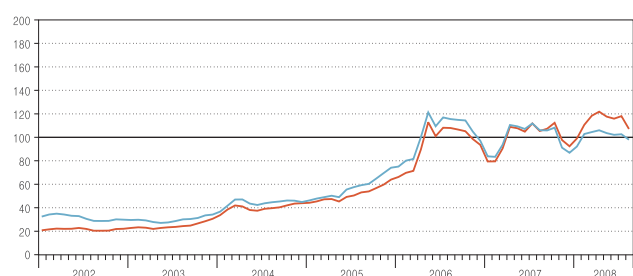


Food

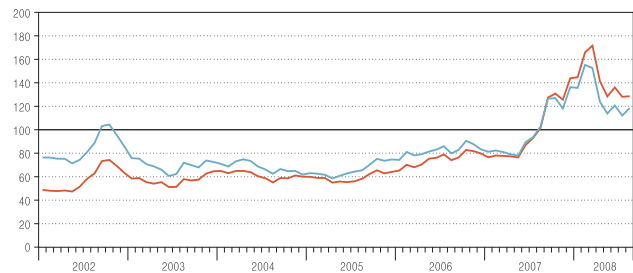


— USD

Copper



Wheat



— EUR

Sources: World Bank, BNB.

Gold

Over the third quarter of 2008 gold prices (one-month futures) fluctuated between USD 740 and USD 980 per troy ounce: a significantly broader range compared with the previous quarter. Over the review period the average price in euro remained almost unchanged on the second quarter. In September gold price fluctuations intensified significantly as a result of the increased instability in the world financial markets.

In July and August the USD/EUR exchange rate and mostly oil prices were the two most important factors behind gold price dynamics. In September

the situation changed significantly, with gold being actively used as a safe haven.

Spot Price of Gold

(USD per troy ounce)



Source: The London Bullion Market Association.

Based on recent GFMS data, demand for physical gold in the second quarter declined by 19 per cent on the same period of 2007 and reached 735.6 tons (an increase of 9 per cent in value to USD 21.2 billion). The decrease continued to reflect mostly the reduced demand in India (-45 per cent in the second quarter) where the use of gold for jewellery production accounted for a quarter of global gold consumption. Gold demand posted an increase only in China and Egypt (by 7 per cent on an annual basis for the second quarter).

Bulgarian External Debt Dynamics on International Financial Markets

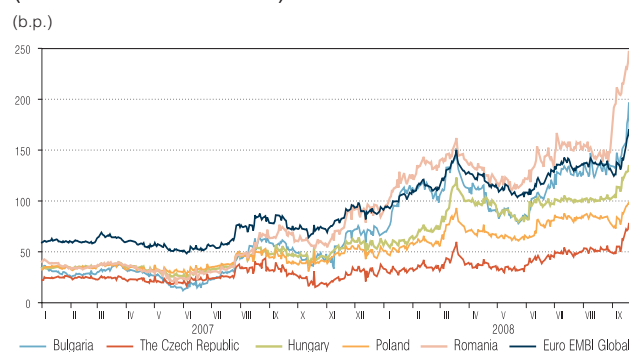
In the beginning of the third quarter of 2008 sovereign risk spreads fluctuated in a comparatively narrow band, approaching the level of the end of the previous period. Temporary stabilization of financial markets and partly restored investor risk appetite contributed to this. In September sovereign risk spreads of emerging markets, as measured by JP Morgan Euro EMBI Global index, increased to a maximum of 170 basis points (on 18 September).

Following the general market trend, in July and August Bulgaria's government debt spread meas-

ured by the JP Morgan index stabilized at around 130 basis points (a minimum of 116 basis points and a maximum of 147 basis points). In early September sovereign risk spreads started to widen and reached the maximum value of 197 basis points on 18 September.

Over the last quarter of 2008 sovereign risk spread volatility is expected to stay at high levels due to great uncertainty around developments of world financial markets, reduced risk appetite of investors and prospects for a slowdown in global economic growth.

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



Source: JP Morgan.

Dynamics of Sovereign Credit Default Swap (CDS) Spreads

The premium charge paid for insurance principals of debts issued by emerging markets have recorded a significant rise since the end of July. This change reflects shifts in the attitude toward emerging markets which have been so far considered untouched by the US financial crisis. However, the outlook changed after signs of slowing economic activity emerged in Europe and Asia. In this context, European countries are already considered riskier than Asian countries due to their higher exposure to developed markets and dependence on financing from bank groups. Credit risk premiums in countries like Hungary, Romania, Bulgaria, Latvia, Estonia and Lithuania posted a significant increase over the third quarter of 2008.

Since risk premiums should be seen as a protection against the risk of non-payment on government securities, they should take into account the macroeconomic situation in a particular country, its public finance performance and the level of government debt. In the case of Bulgaria, the macroeconomic environment was stable, budget surplus exceeded 3 per cent, government's fiscal reserves came to BGN 11.5 billion at the end of August and government debt was 15.5 per cent of GDP. Thus, it is obvious that the increase in CDS premiums for Bulgarian government securities did not reflect the nation's economic conditions but is driven by global negative trends in world financial markets.

Given the ongoing international finance developments, market participants did not take into account differences in the current and future performance of economic fundamentals and fiscal positions of individual countries. High risk premium for emerging markets was reached in the middle of September thereby exceeding the level of March. However, an adjustment occurred after the announcement of the US bail-out plan for the financial sector.

Sovereign CDS Spreads for Bulgaria, Romania, Estonia, Latvia and Lithuania



Source: World Bank.

2. Financial Flows, Money and Credit

Foreign capital inflow in Bulgaria remained strong between January and July 2008 despite enhanced uncertainty in international financial markets. According to preliminary data, by mid-2008 foreign direct investment inflow accounted for 20.3% of the GDP on an annual basis. The total balance of payments current account and capital account balance went down by EUR 1.3 billion to EUR 4.3 billion in the first seven months of the year reflecting mainly the higher trade deficit (by EUR 1.4 billion). The balance of payments reported a surplus of EUR 1.7 billion over the same period, with BNB reserves increasing by an equivalent amount (excluding changes due to valuation adjustments).

The Issue Department balance sheet figure reached BGN 28,793.8 million (EUR 14,722 million) by end-September 2008: up by BGN 5.9

Cash Flows Which Prompted Significant Changes in Gross International Reserves

(million EUR)

	Jan.–June 2008	Jan.–June 2007	2007, total
Total for the period	1108	508	2545
Purchases and sales of euro	1 209	1 194	2 410
at tills	-22	-22	-60
banks, incl.	1 231	1 204	2 458
bank's purchases	56 998	15 015	54 467
bank's sales	-55 767	-13 811	-52 008
Flows on accounts of banks, the MF, etc.	-101	-686	135
Minimum required reserves	103	-64	827
Government and other depositors	-204	-622	-691

Source: BNB.

billion (EUR 3 billion) on September 2007. The average monthly coverage of imported goods and services by BNB international reserves reached 5.7 months between January and July 2008 against 5.2 months a year earlier.

Financial Flows and External Position Sustainability

The net external funds inflow into Bulgaria is expected to continue in the second half of 2008. The uncertainty and instability on international financial markets, as well as the increased cost of financial resources may cause difficulties for domestic economic agents in borrowing external financial resources.

The flow of foreign capital in Bulgaria has stayed high since early 2008. The balance of payments financial account surplus of EUR 6117.9 million for the January – July 2008 period reflected mainly the following factors: 1) attracted foreign direct investment worth EUR 2847.3 million; 2) an increase by EUR 1574.3 million in net external obligations of the private non-bank sector; 3) deposits of non-residents with domestic banks totaling EUR 1294.8 million.

Capital flows in Bulgaria were mainly in the form of acquired equity stakes in domestic companies, extended intercompany loans, provision of additional resources for crediting domestic banks (in the form of deposits) or direct crediting of domes-

tic non-financial corporations. The major factor predetermining external capital flows is the high profitability rate in Bulgaria (attained and expected) at evaluated relatively low risk. The attractiveness of the Bulgarian economy pertains to the implemented consistent policy intended to improve the business environment and competitiveness of the economy under the conditions of macroeconomic stability ensured by the currency board. Sustained restrictive fiscal policy and continued structural reforms give grounds to anticipate that investors' interest will stay high, and capital inflow in Bulgaria will remain strong over the forecast horizon.

Foreign direct investments and long-term debt resources are among major flows financing investment demand in Bulgaria, which accelerated in the second quarter of the year. The contribution of gross capital formation to economic growth reached 8.3 percentage points in the second quarter of 2008 against 4.3 percentage points in the first quarter. Entrepreneurs' positive sentiments are an additional factor in support of expectations for sustaining capital flows in Bulgaria over the second half of the year.

Bulgaria's international current, capital and financial transactions dynamics between January and July 2008 remained stable. The small share of portfolio investments in Bulgaria's gross liabilities under the international investment position (4.3 per cent) suggests a low degree of vulnerability as to the potentially speculative capital withdrawal.

According to preliminary data foreign direct investment in Bulgaria came to EUR 2847.3 million between January and July 2008.¹ According to the current statistical information foreign direct investment for the first seven months of 2007 came to EUR 3325.9 million. Since these data have been revised upwards several times, a comparison between the January – July 2008 flow and initially reported data for the January – July 2007 period points to an increase in foreign direct investment by 6.7 per cent. By mid-2008 foreign direct investment inflow accounted for 20.3 per cent of the GDP on an annual basis. As there are no reasons to consider that the direction of subsequent revisions will change we expect that the reported inflow over the current year will increase due to the additional information from corporations and data revision.

The share of equity accounted for 71 per cent (EUR 2 billion) of total attracted investments. There were no receipts from privatization transactions in the review period. Although the foreign investors' interest in acquiring real estate in Bulgaria remained high, a certain slowdown has occurred in resources invested in this sector since early 2008. Foreign investments in real estate over the review period totaled EUR 874.3 million, a decrease by EUR 205.2 million compared with the corresponding period in 2007.

¹ Data are subject to regular revisions upon provision of additional information by enterprises. The practice of several recent years suggests a systematic revision of initial data on foreign direct investment flow upwards, which makes the mechanical comparison of the 2008 initial data with the revised (several times) 2007 data incorrect.

In the first seven months of 2008 the *other capital* item within the framework of foreign direct investment reached EUR 562.7 million. Despite the reported decrease by EUR 761.6 million on an annual basis, it should be taken into account that this item is subject to significant revisions.² Data on reinvested earnings show an increase of EUR 45.6 million on an annual basis coming to EUR 255.2 million between January and July 2008.³

By end-2007 real estate operations and business services (19.4 per cent), financial intermediation (18.4 per cent), manufacturing (17.9 per cent) and transport and communications (17.9 per cent) occupied the largest shares in the structure of cumulative foreign direct investment by industry. In the first half of 2008 these sectors retained their key role, with the shares of real estate operations and business services, financial intermediation and manufacturing accounting for 25 per cent, 23.3 per cent and 22.1 per cent respectively.⁴ As it has been already mentioned, a certain slowdown in foreign direct investments to real estate and business services has occurred since early 2008, while other sectors (e.g. manufacturing) posted an increase in investments on an annual basis. The composition of foreign direct investment by country in the first half of 2008 suggests that the foreign direct investments attracted from Austria (17.7 per cent), the Netherlands (12.3 per cent), and the United Kingdom (11.8 per cent) accounted for the largest shares.

The statistics on Bulgaria's gross external debt between January and June 2008 supports the thesis that no direct negative effects on the Bulgarian economy were registered over the said period as a result of the international financial market turbulence. The normal access of the domestic business to external financial markets is sustained. Between January and July 2008 the net transfer of borrowed funds from other countries was positive, worth EUR 3.1 billion, reflecting

² Intercompany loans extended by local companies' foreign owners are reported under this item, with initial data usually underestimating the actual amount of funds provided.

³ Currently available information reports only reinvested earnings of banks for 2008 and 2007. We expect that the amount of funds reported under this item would be revised significantly upwards as a result of additional information received on reinvested profit by foreign owners of local companies from the non-financial sector.

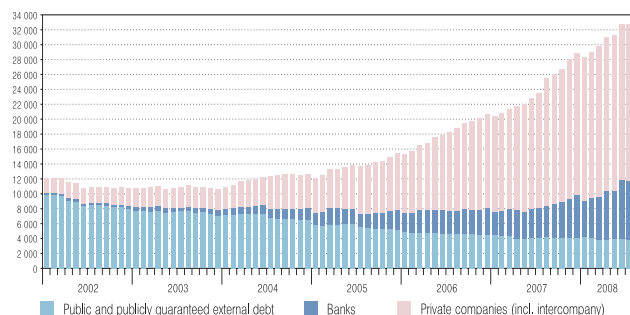
⁴ It should be noted that when additional information is received from non-financial sector enterprises the revision of data on foreign direct investment will affect not only the total amount of inflows but also their sectoral structure.

the excess of received loans and deposits over the total amount of payments for servicing gross foreign debt. As a result Bulgaria's gross foreign debt reached EUR 32.7 billion⁵ by end-July.

Between January and July 2008 public and publicly guaranteed debt declined by EUR 180.4 million (mainly due to an advance loan repayment to the World Bank in March 2008), coming to 12.2 per cent of Bulgaria's total debt. Private non-guaranteed external debt rose by EUR 4 billion over the period, boosted mostly by deposits and loans attracted by banks (up EUR 2 billion), as well as by the increase in other sector liabilities (up EUR 1.6 billion).⁶ Domestic banks' external debt increased mainly at the expense of deposits (EUR 1.3 billion) and long-term loans (EUR 459.4 million). The bulk of this debt (over 75 per cent) is to foreign-owned banks and is aimed at broadening their scope of operations in Bulgaria. Intercompany loans decelerated in June and stayed relatively unchanged in July, reflecting primarily the transformation of loans into equity, with the share of these loans decreasing to 32.9 per cent of the total debt. The volume of intercompany loans will be revised upwards in the following revisions due to quarterly reporting of corporations.

Gross External Debt

(million EUR)



Source: BNB.

Gross external debt service payments came to EUR 4.3 billion between January and July 2008 (47 per cent of receipts from commodity imports over this period) against EUR 3.6 billion in the corresponding period of the prior year (48.5 per cent of exports). Borrowings and deposits amounted to EUR 7.4 billion, up by EUR 1.8 million as compared to the corresponding period of

2007. Banks and other sectors contributed most substantially to the total volume of borrowings and deposits: by EUR 3.9 billion and EUR 2.2 billion respectively.

The average weighted interest rate levels on new loans declared between January and July 2008 suggest an increase in the cost of external borrowed funds both in euro (by 0.4 percentage points on an annual basis to 5.3 per cent) and in US dollars (by 2.2 percentage points to 6.3 per cent). Within long-term euro-denominated loans the interest rate differential between corporate loans extended by domestic banks (with the average-weighted interest rate of 8.4 per cent) and external loans (5.4 per cent) remained positive. Long-term USD-denominated loans exhibited an opposite trend. As a result of the sharp rise in the cost of new loans extended from other countries, the average-weighted interest rate is higher by 1.1 percentage points than that on the corresponding domestic loans. Although the interest rate levels on domestic and external loans are not directly comparable due to different characteristics of corporations with access to both markets, the positive interest rate differential of euro-denominated loans (accounting for the bulk of newly registered loans, as well as of the gross foreign debt) retained the incentives for direct external borrowing in the future.

The first half of 2008 saw no notable changes in the structure of private non-bank external debt by industry,⁷ with real estate operations, lessors activities and business services retaining their relatively large shares in the external debt of other sectors (27 per cent) and in intercompany loans (19.4 per cent). The bulk of borrowed funds in this sector went to companies providing legal, accounting, audit and other business services. Within the structure of intercompany loans, transport and communications occupied a large share (20.5 per cent), while in other sectors the electricity, gas and water supply (15.6 per cent), financial intermediation (11.3 per cent) and trade and repairs (10.5 per cent) had larger external debt shares. The increase in these debt resources reflects the restructuring of domestic companies, their integration into the single European market and the easier access to external financing.

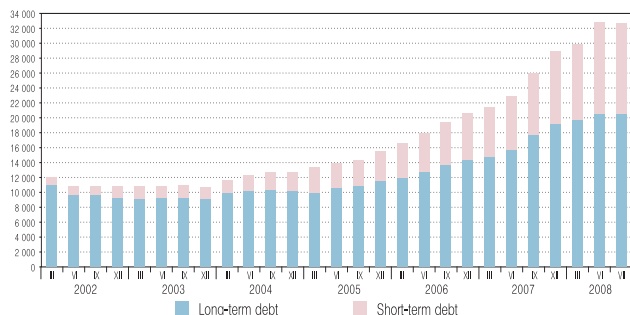
⁵ Compared with December 2007 the growth was EUR 3.8 billion, including EUR 3.1 billion in net transfer of borrowed funds, as well as revaluations and net change on trade and revolving loans.

⁶ Intercompany loans increased by EUR 0.6 billion and publicly guaranteed debt by EUR 0.2 billion.

⁷ Excluding obligations on trade credits and bond loans.

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Gross external debt maturity structure remained relatively steady between January and July 2008, with short-term external debt increasing to 37.3 per cent of total debt by July 2008 against 33.7 per cent by end-2007. The increase in short-term debt of EUR 2.5 million in the January – July 2008 period was primarily attributable to the newly opened non-residents' deposits with domestic banks.

By the end of the second quarter of 2008 the euro retained its leading position (87.6 per cent) in the gross external debt currency structure. The euro occupied the largest share (91.3 per cent) in banks, followed by intercompany loans (90.7 per cent), while the General government sector had the smallest share (70.7 per cent). This foreign currency structure of gross foreign debt significantly reduces risks associated with exchange rate fluctuations in the international markets.

Bulgaria's gross foreign assets rose by EUR 1.1 billion between January and July 2008, with BNB international reserves growth of EUR 1.7 billion partially offset by the fall in banks' foreign assets (EUR 395.4 million) and in the non-financial sector (EUR 222.6 million). As a result of Bulgaria's gross foreign assets and gross external debt dynamics the net external debt increased by EUR 2.7 billion in the first seven months of 2008, reaching EUR 47.4 per cent of GDP in the second quarter of 2008 on an annual basis.

The country's external current and capital transactions matched to a great extent the inflow of financial resources into the Bulgarian economy. The current and capital account deficits between January and July 2008 comprised EUR 4.34 billion against EUR 3 billion in the corresponding period of the prior year.

The trade balance contributed most substantially to the increased net external borrowing by the Bulgarian economy, with trade deficit rising by EUR 1.4 billion to reach EUR 5.19 billion over the review period. The faster growth of imports (nominal growth of 27.4 per cent between January and July 2008 on an annual basis) compared with exports (growth by 22.5 per cent) reflects both lower demand by Bulgaria's major trading partners in recent months and the strong investment activity in the country. Higher international prices of energy resources and raw materials also contributed to the nominal deficit increase.⁸

Net current transfers improved between January and July 2008: by EUR 342.3 million (on an annual basis) and EUR 128.1 million on the balance of payments current and capital account respectively. Net current transfers reported for the January – July 2008 period amounted to EUR 515.9 million. The improvement was almost entirely attributable to the EU funds inflow. A portion of the EU funds disbursed in advance are reported under the balance of payments capital account. In the period under review they amounted to EUR 213.8 million. The transfers received from EU funds exceeded the payments on Bulgaria's contribution to the EU budget and helped the realisation of the positive net transfers of EUR 468.2 million to the *General government* sector. The inflows from private current transfers picked up by EUR 51.5 million on an annual basis, while transfers abroad went up by EUR 48.4 million. As a result, net transfers to the *General government* sector improved by EUR 3.1 million.

The income and services balance exhibited a decline on the corresponding period of 2007 by EUR 302.3 million and EUR 97.8 million respectively. The income balance for the first seven months of 2008 was negative (EUR 514.4 million). The reported fall on the corresponding period of 2007 was mostly attributable to larger payments on income from foreign investments (by EUR 354.5 million). Growth was reported on all components of income from direct investments, with dividends paid accounting for the largest amount (EUR 189.4 million). As regards the income received from residents over the review period income on compensations to employees posted an increase by EUR 102.8 million.

⁸ For a detailed discussion of factors and dynamics of exports and imports, see the *Economic Activity* section.

The balance on services in the first seven months of 2008 was positive, comprising EUR 632.5 million, with higher expenditure on transportation related to imports (up EUR 205.9 million) and higher payments on travel of residents abroad (up EUR 184.2 million) contributing most significantly to its annual deterioration. Improvements were recorded under all items of the earnings from exported services, the most sizable one being that of tourist services (EUR 157.4 million), as well as transport services (EUR 124.4 million) and other business services (EUR 71.6 million). Our expectations for the development of international trade in services point to a turnaround of the negative trend in the net flows which started in the beginning of the year and to an improvement of the balance over the forecast horizon, consistent with the steady growth in exports of tourist and other business services.

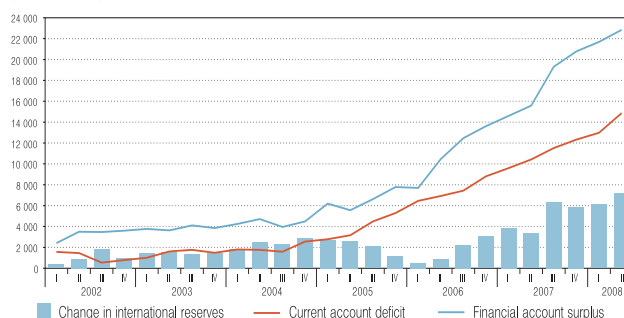
Based on the available macroeconomic data on international current, capital and financial transactions, it may be concluded that Bulgaria's external position remained steady. The analysis of major factors responsible for the changes in the external position of the Bulgarian economy reveals the significance of investment activity and of the process of restructuring and integration into the single European market.

Monetary Aggregates

Although the strong economic activity and foreign capital inflow continued to create conditions for comparatively rapid growth in monetary aggregates, the high base and credit growth moderation prompted a gradual decline in monetary aggregate growth rates. Interest rates on time deposits denominated in leva and in euro continued to rise due to banks' increased needs for funds to finance lending.

Between April and August 2008 reserve money continued to grow at high pace to reach 38.8 per cent by the end of August 2008 on an annual basis. Bank reserves growth, accelerating dramatically after May due to a base effect associated with the released additional minimum required reserves in May 2007, contributed most significantly to the strong growth of reserve money. By the end of August bank reserves grew by 99 per cent on annual basis, with half of the growth pertaining to the increased rates of minimum required reserves from 8 per cent to 12 per cent in September. Concurrently the annual growth rate of currency in circulation was charac-

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



Source: BNB.

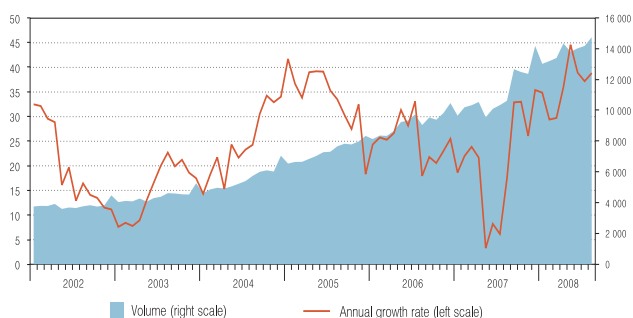
Capital inflows are anticipated to stay strong in the second half of 2008, prompted by the prevailing long-lasting interest of foreign investors and by the consistent and prudent macroeconomic policy pursued. According to the underlying forecast on the balance of payments current and capital account deficit until the close of 2008 it will remain commensurable as a share of GDP with the latest reported data, namely within 22–22.5 per cent of the GDP, and entirely financed by external capital inflow.

terized by a descending trend despite the fast income growth and the price level which went down to 13.7 per cent by the end of August. The slower annual growth in money in circulation was probably attributable to the high base, as well as to the increased deposit rates which affected negatively the preference for holding cash. In the next two quarters no significant changes in currency in circulation growth rate are expected, while bank reserves growth rate is anticipated to substantially slow down by the end of the third quarter, consistent with the increase in minimum required reserves in September 2007.

Reserve Money

(annual rate of volume growth, %)

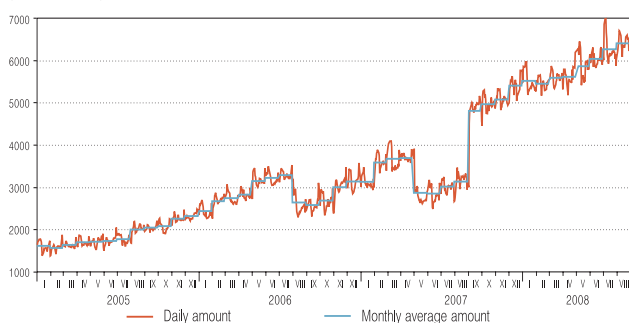
(million BGN)



Source: BNB.

Bank Deposits with the BNB

(million BGN)

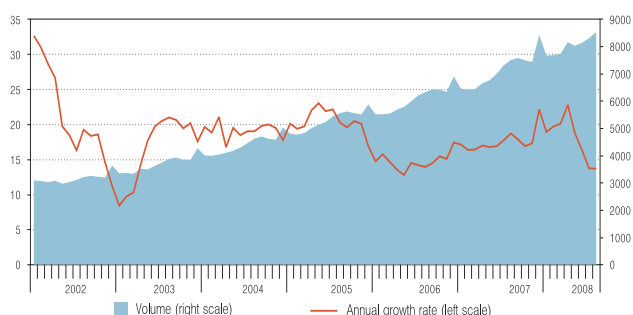


Source: BNB.

Currency in Circulation

(annual rate of volume growth, %)

(million BGN)

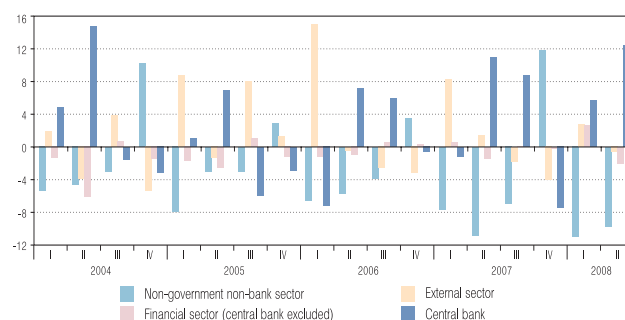


Source: BNB.

In the second quarter of 2008 a significant amount of liquidity was withdrawn from the non-government non-bank sector in favour of the budget associated with the good tax revenue implementation. The external sector was also a source of funds to the budget though to a far lower degree. The aid received from other countries amounted to BGN 339.9 million and the contribution paid in favour of the EU totaled BGN 130.4 million. Government deposit with the BNB posted a significant increase, rising by BGN 1977.1 million to BGN 9192.2 million by the middle of 2008.

Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

(share of GDP, %)

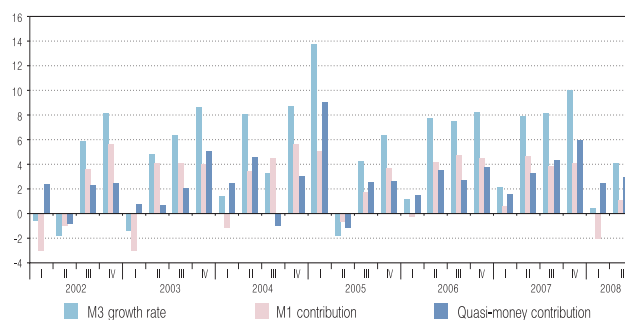


Sources: MF, BNB.

In the second quarter of 2008 the M3 monetary aggregate rose by 4.1 per cent on March, reporting an annual increase of 24.4 per cent in June and 21 per cent in August. In spite of the fact that foreign capital inflow and income and employment growth created conditions for relatively fast broad money growth, it tended to gradually slow down since early 2008, reflecting the high base and slower loan growth rates.

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

(percentage points)



Source: BNB.

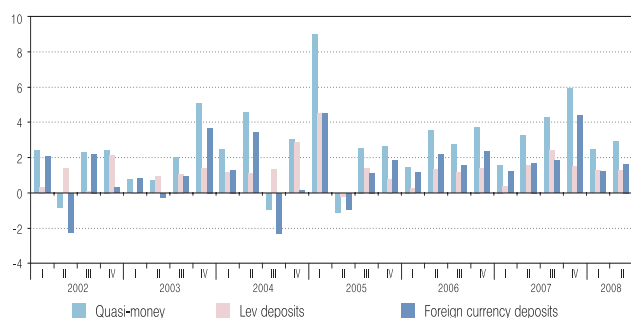
M1 rose by 10.2 per cent on an annual basis by the close of August 2008 against 28.9 per cent in early year, with overnight deposits growth slowing down from 35 per cent to 8.3 per cent. By the end of August overnight deposits of non-financial corporations in levs and foreign currency increased by 5.5 per cent and 2.2 per cent (on an annual basis) respectively, while overnight deposits of households denominated in levs decreased to 15.1 per cent and those denominated in foreign currency to 1 per cent.

Quasi-money growth also moderated (on annual basis), growing by 31.6 per cent by the end of August. Household deposits in levs with agreed maturity of up to two years rose by 19.2 per cent by the end of August on an annual basis and

those in foreign currency by 35.9 per cent. The annual growth rate of non-financial corporations' lev denominated deposits with agreed maturity of up to two years amounted to 44.9 per cent and that of deposits in foreign currencies came to 37.7 per cent.

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

(percentage points)



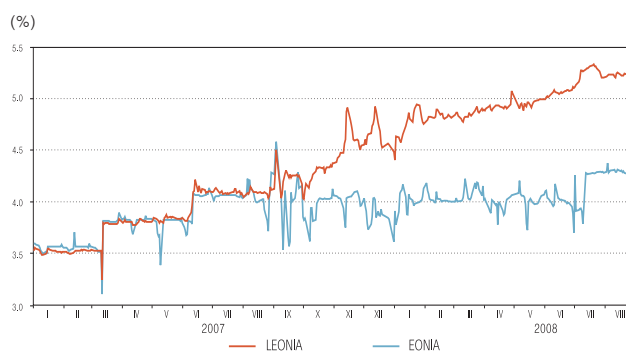
Source: BNB.

Between April and August 2008 interbank money market rates continued rising influenced by enhanced demand for lev resources by some banks and the ECB decision of July to raise the interest rates on main refinancing operations by 25 basis points. The average interest rate on transactions concluded on the interbank money market increased from 4.86 per cent in March to 5.27 in August 2008. Following a similar trend, LEONIA picked up from 4.85 per cent in March to 5.23 per cent in August, with the spread *vis-à-vis* interest rates on interbank overnight deposits in the euro area widening by 93 basis points in August.

The average daily volume of interbank money market transactions between April and August 2008 reached BGN 414.7 million against BGN 265.1 million in the corresponding period of 2007. Apart from the money market, banks used currency trade with the BNB as a liquidity management instrument. The currency trade volumes between banks and the BNB remained high, without net purchases in foreign currency by the BNB.

The international financial crisis has not seriously affected the money and foreign currency market in Bulgaria yet. However, tightened money market conditions in the euro area due to global uncertainty may impact Bulgaria's money market interest rate levels, which in turn will prompt a rise in lending rates resulting in a slower credit aggregates growth.

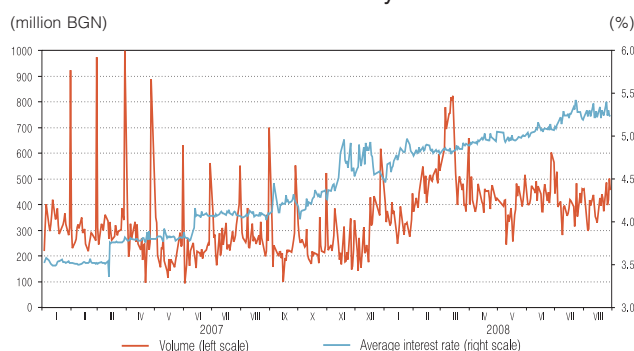
LEONIA/EONIA



Source: BNB.

Trade Volume and Interbank Money Market Interest Rates

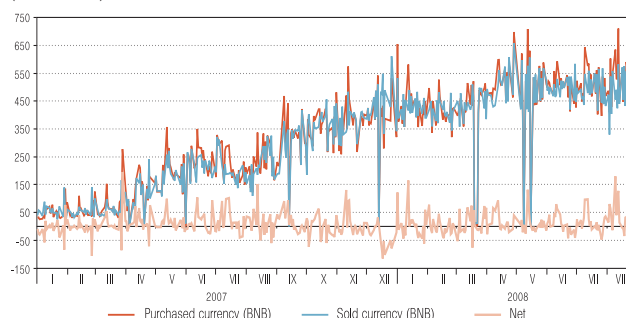
(million BGN)



Source: BNB.

Currency Sales or Purchases between Banks and the BNB

(million EUR)

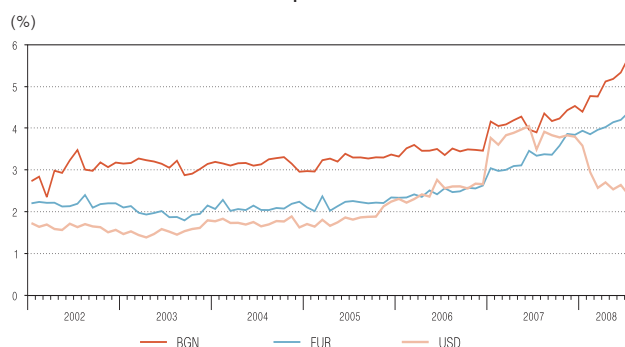


Source: BNB.

Interest rates on time deposits denominated in levs and in euro continued to rise fuelled by banks' increased needs for funds to finance lending. During the second quarter of 2008 average interest rates on lev time deposits rose by 57 basis points to 5.22 per cent, while euro time deposits registered growth of 20 basis points to 4.13% per cent. In July interest rates on time deposits denominated in levs and euro picked up to reach 5.70 per cent and 4.39 per cent respectively.

As regards the distribution of interest rates on household deposits with maturity of up to one month by bank, the number of banks offering rates within the 3 to 4 per cent interval increased at the expense of those offering rates within the 2–3 per cent band. Along with the increased average interest rates the difference between the highest and lowest interest rate narrowed and the dispersion of interest rates decreased.

Interest Rates on Time Deposits

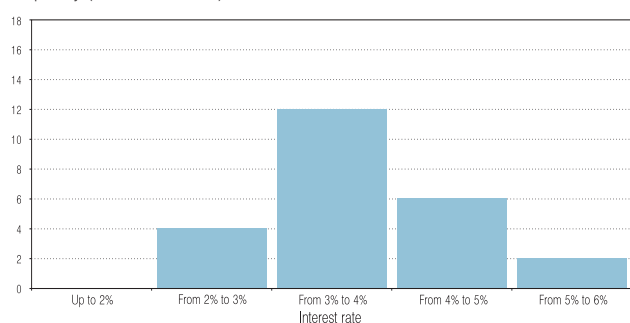


Source: BNB.

Interest Rate Distribution of Household One-month Lev Deposits

as of April 2008

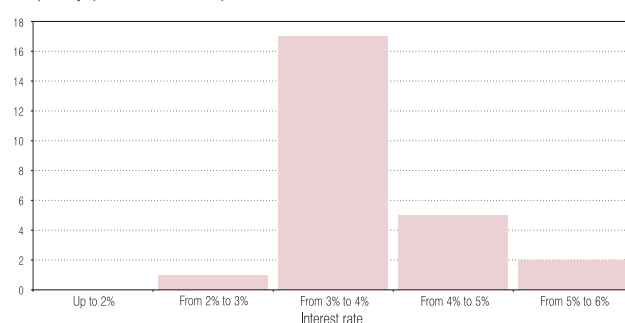
frequency (number of banks)



Source: BNB.

as of July 2008

frequency (number of banks)



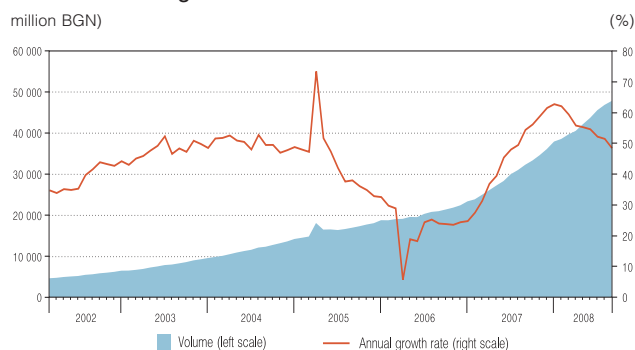
Credit Aggregates

Lending remained robust despite the downward trend in the growth rate of claims on the non-government sector started in early 2008. Increases in deposit interest rates and cost of financing on money markets both in Bulgaria and the euro area continued to spill over into lending interest rates.

Favourable macroeconomic environment and strong demand for loans by corporations and households continued to foster lending expansion. Between January and August claims on the non-government sector rose by BGN 9872.8 million against BGN 8887.9 million in the same period of 2007. However, the high base and increased lending rates led to a gradual decrease in the growth rate of loans, with the annual increase in claims on the non-government sector falling to 48.3 per cent. By the end of June 2008 the claims on the non-government sector to GDP ratio reached 73.8 per cent, up 5 percentage points on the end of the previous quarter and 16.6 percentage points on June 2007. Over the following months the annual growth rate of claims on the

non-government sector will continue to moderate and by the close of the year it is expected to reach 40 per cent.

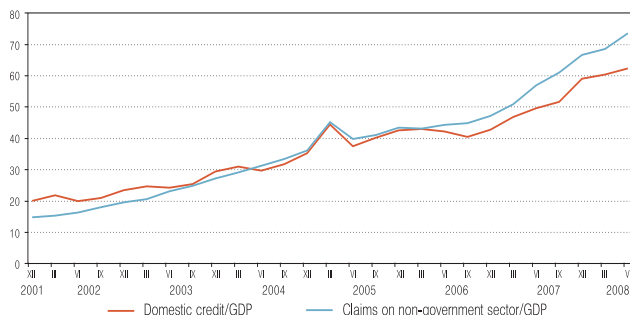
Claims on Non-government Sector



Source: BNB.

Domestic Credit

(share of GDP, %)

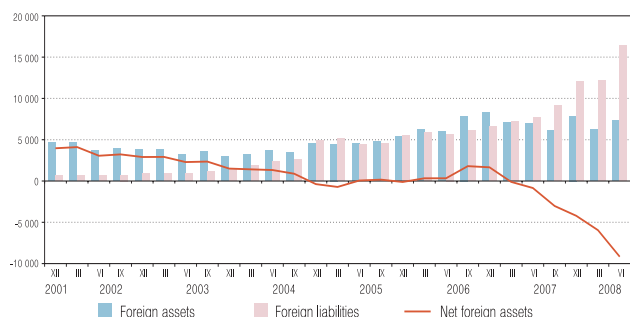


Source: BNB.

Net foreign asset decreases played an essential role in fuelling credit activity. Between April and August 2008 banks' funds borrowed from non-residents grew by BGN 5566.9 million, which due to the increased foreign assets by BGN 1670.5 million resulted in a decline in banks' net foreign assets by BGN 3896.4 million to BGN -9853.3 million.

Foreign Assets and Liabilities of Banks

(million BGN)

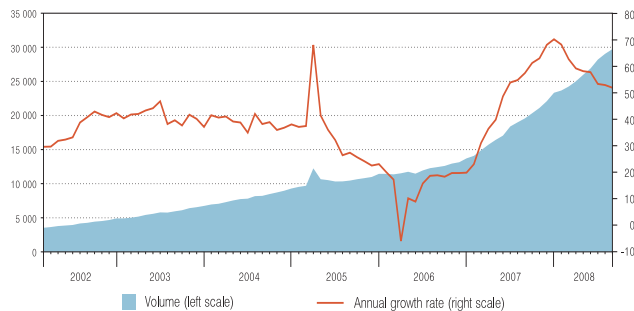


Source: BNB.

Enhanced production and investment activity stimulated the demand for loans by corporations which led to comparatively strong lending to non-financial corporations. Between January and August 2008 claims on non-financial corporations rose by BGN 6393.2 million (up BGN 5858.1 million in the same period of 2007). Though strong the annual growth rate of claims on non-financial corporations tended to moderate and by the end of August reached 51.9 per cent against 70.2 per cent in early 2008.

Claims on Non-financial Corporations

(million BGN)

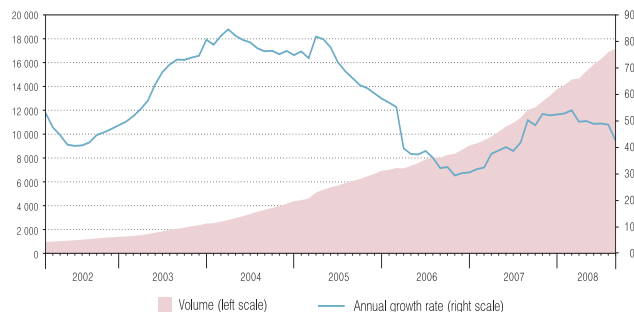


Source: BNB.

Positive trends in income and employment continued to be the factor responsible for the high growth rates of household claims. Between January and August 2008 banks' claims on households rose by BGN 3367.9 million (up BGN 2986.4 million in the same period of 2007). The annual growth rate of these claims tended to moderate reaching 42.6 per cent by the end of August against 52.4 per cent in early 2008. Residential mortgage loans continued rising at comparatively high rates, though their annual growth rate fell to 47.3 per cent at the end of August 2008.

Claims on Households

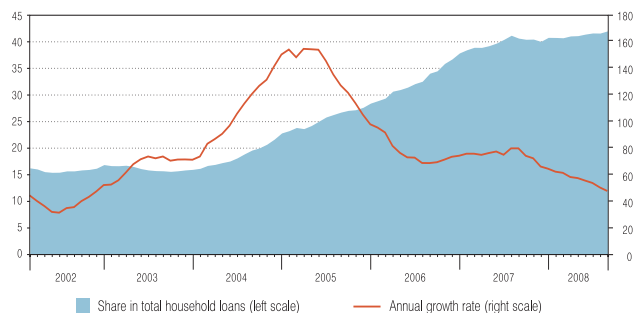
(million BGN)



Source: BNB.

Housing Loans

(%)



Source: BNB.

Changes in Major Balance Sheet Items of Banks (Quarterly)

(million BGN)

	2007				2008		
	I	II	III	IV	I	II	July–August
Claims on non-financial corporations	1995.2	2678.6	1938.1	3010.1	1670.7	3190.4	1532.1
Deposits of non-financial corporations	-196.4	1123.9	1156.1	1678.3	-422.9	297.5	230.3
Claims on households	744.3	1141.8	1308.6	1543.9	867.7	1634.8	865.4
Deposits of households	550.0	908.1	1079.8	1734.7	811.9	954.3	976.7
Foreign assets	-1131.0	-236.5	-789.8	1764.5	-1681.4	1099.2	571.3
Foreign liabilities	627.5	510.4	1384.2	2955.8	63.5	4304.6	1262.3
Claims on general government	-48.3	172.4	226.5	32.4	-103.6	-34.0	-5.0
Deposits of general government	214.8	123.8	113.7	404.6	-200.3	322.8	49.2
Claims on central government	-51.1	154.7	201.7	-6.9	-106.2	-34.1	-9.7
Liabilities to central government	-15.6	11.9	88.3	448.6	-310.1	145.2	-6.7

Source: BNB.

Claims on Non-government Sector (Quarterly)

	Annual growth rate, %						Structure as of 30 June 2008
	2007				2008		
	I	II	III	IV	I	II	
Claims on non-government sector, incl.:	36.6	47.8	55.9	62.5	55.5	52.0	
on non-financial corporations	36.4	53.9	61.2	70.2	59.2	53.3	62.1
on households and NPISHs	37.6	38.6	48.3	52.4	49.7	49.0	35.9
on financial corporations	26.0	46.0	43.9	33.3	56.3	64.7	2.0

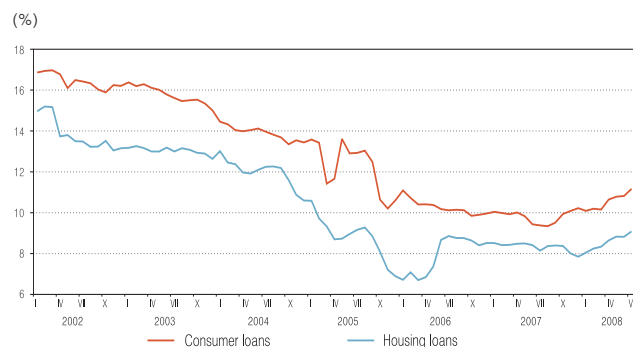
Source: BNB.

Increases in deposit interest rates and higher cost of financing on money market continued to spill over into lending interest rates. The ECB decision taken in early July to raise the interest rate on main refinancing operations by 25 basis points to 4.25 per cent also added to this effect.

The dynamics of interest rates in the following quarters will be characterized by a significant uncertainty. On the one hand, the coordinated cut in the base interest rates of major central banks by 50 basis points in early October is expected to have a dissuasive effect on further interest rate rise in Bulgaria. On the other hand, if market interest rates do not respond to the change in monetary policy, the price at which domestic banks are funded may increase, and correspondingly reflect on lending rates.

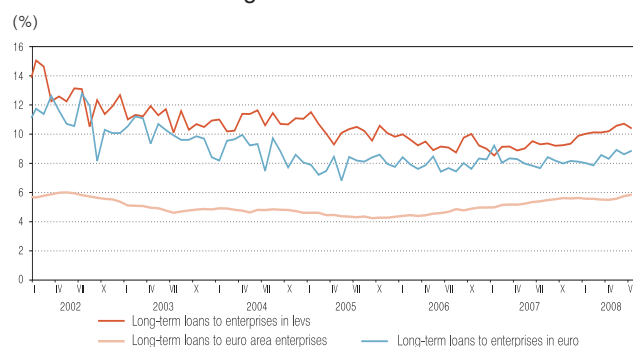
Higher credit cost may lead to slower growth of domestic demand and the effect is likely to be stronger on the investment demand.

Interest Rates on Household Loans



Source: BNB.

Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

In the first half of 2008 real GDP growth rate accelerated to 7.1 per cent on the corresponding quarter of 2007. Economic growth is expected to remain high over the year. Value added growth in the third quarter will be further prompted by the recovery of agriculture.

Real GDP growth rate accelerated to 7.1 per cent in the first half of 2008 compared with the respective quarter of 2007. In the structure of growth by final consumption the 2007 trend of investment in fixed capital towards contributing most to growth (by 6.5 percentage point) was sustained. Strong investment activity helped renovate and extend current production capacities, thus ensuring the maintenance of high economic growth.

Over the review period final consumption growth accelerated slightly by 0.3 percentage points compared to the rates in the second half of 2007 and reached 4.7 per cent. As in previous years, during the first half of 2008 government expenditure stayed neutral as regards growth, reflecting the conservative fiscal policy of high surplus.

GDP by Component of Final Consumption (Real Rate)

(on corresponding period of previous year, %)

	2006				2007				2008	
	I	II	III	IV	I	II	III	IV	I	II
Consumption incl.	5.5	8.0	8.3	7.3	6.0	5.0	4.2	4.5	4.7	4.8
Household consumption	6.7	10.2	10.9	10.2	7.8	6.1	5.1	2.7	6.5	5.4
Final government consumption expenditure	8.2	4.9	0.3	-7.9	-1.2	-1.0	2.3	8.5	-2.9	4.1
Collective consumption	-5.7	-4.6	-5.1	3.4	-2.7	0.7	-2.5	13.3	-5.8	0.3
Gross fixed capital formation	8.5	11.6	12.8	22.1	35.9	24.7	19.7	14.0	15.5	28.6
Exports of goods and non-factor services	12.7	9.5	8.4	5.0	3.7	5.3	5.4	6.0	9.2	5.1
Imports of goods and non-factor services	18.6	10.3	14.0	14.0	14.7	11.1	9.3	5.7	5.8	13.7
Real GDP growth	4.8	6.9	7.1	6.2	5.5	7.3	4.9	6.9	7.0	7.1

Sources: NSI, BNB.

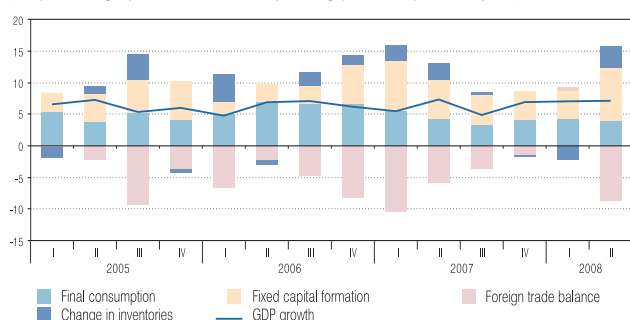
Household consumption picked up by 6 per cent during the first six months of 2008. Consumer demand dynamics was determined by rises in employment and wages; this resulted in growing income of individuals, thus underpinning consumption. On the other hand, fast rising prices during the previous year led to worsened consumer sentiments and expectations, arresting consumer expenditure growth.

Net exports of goods and non-factor services retained their negative contribution to GDP growth over the half-year due to the faster real growth in goods and services imports in comparison with exports. Dynamics by quarter was divergent. Between January and March 2008 high GDP growth

was underpinned by the positive contribution (0.5 percentage point) of foreign trade balance, reflecting buoyant growth in exports of goods (11.7 per cent in real terms on the first quarter of 2007), while the real growth rates of goods and services imports were close to those for the fourth quarter of 2007 (5.8 per cent). In the second quarter exports of goods continued to increase at a relatively high rate of 7 per cent; however, the growth in exports of services fell close to zero. At the same time imports of goods and services went up by 13.7 per cent in real terms. For these reasons the contribution of net exports of goods and services to GDP real growth became negative.

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

(%, percentage points on the corresponding period of previous year)



Source: NSI.

Household Behaviour

The real growth in final household consumption expenditure during the first half of 2008 reached 6 per cent (3.9 per cent in the second half of 2007). The second quarter saw a certain slowdown in household consumption growth: from 6.5 per cent in the first three months to 5.4 per cent in the second quarter. The growth of most household consumption components slowed down during the second quarter with the exception of communications and other services.

The dynamics of real revenue and of sales' physical volumes in retail trade also displayed a certain moderation in consumer demand: it dropped from 10.4 per cent in the first quarter to 7 per cent in the second quarter. The more moderate growth also stemmed from the weaker growth rates in all remaining groups of goods, with foods' realized volumes being almost equal to those in the previous year's respective period. According to July data, the trends that occurred during the second quarter were sustained.

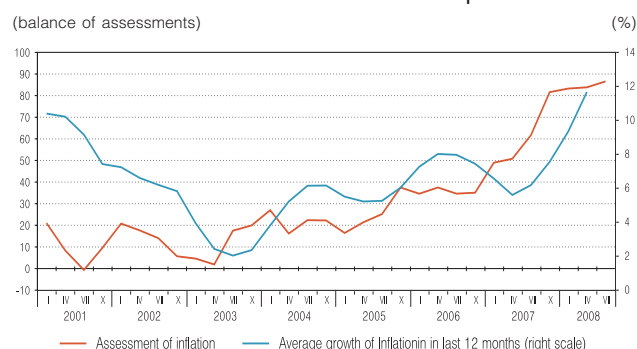
Household budget data also provide information about a slowdown in household expenditure real growth from 6.8 per cent during the first quarter to 1.3 per cent during the second quarter of 2008. The group of foods had a considerable negative contribution (-2 percentage point) to consumption: a trend that showed in the second half of the previous year. Similar to the structure of consumer expenditure, reported in national accounts, household budgets showed a slowdown in the growth of most commodity groups. According to household budget data, household income real growth also moderated during the second quarter (2.8 per cent). The

contribution of wages to income growth remained steady (4.3 percentage point), reflecting higher wages and employment. The other types of income had no significant contribution to the growth in households' total income. For instance, grants to unemployed contributed negatively to real income growth due to accelerating inflation rates and declining unemployment in Bulgaria. The contribution of pension revenue also dropped from 2.1 percentage points in the first quarter of 2008 to 1.1 percentage points in the second quarter. Current data show that the trend towards a weaker income and expenditure real growth was sustained at the start of the review year's third quarter.

Data on consumer sentiment in July also support the trend towards a slower consumption growth. Expectations of the households' financial state and the economic situation within a one-year horizon are more pessimistic than those from October 2007 when consumer confidence declined sharply to -36.7 per cent reflecting the higher inflation. Negative consumer sentiment is related to the assessment of inflation. The higher current inflation assessment values gave rise to expectation of accelerating inflation in the future as well.

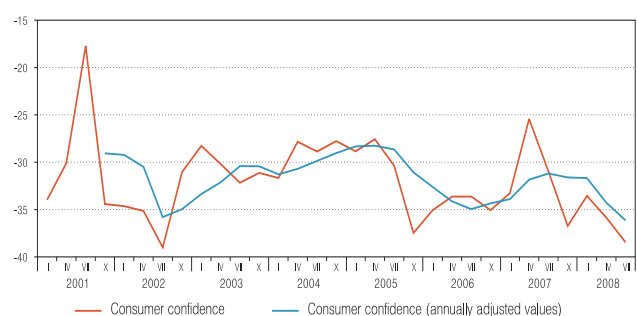
Consumer Assessment of Inflation and Reported Inflation

(balance of assessments)



Source: NSI Consumer Survey.

Household Confidence Indicator



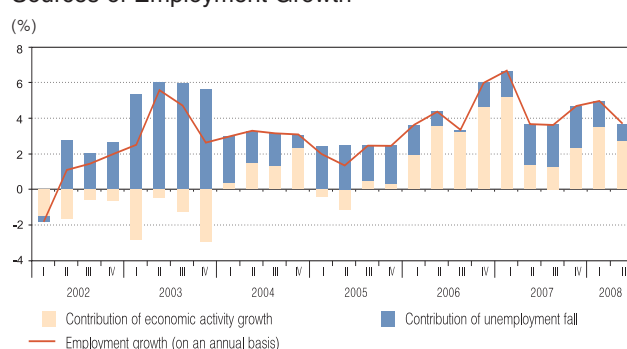
Source: NSI Consumer Survey.

All available data on the first six months of the current year show a certain slowdown in consumption over the half-year. On the one hand, consumer demand dynamics was determined by employment and wage rises which resulted in growing income of individuals, thus stimulating consumption. Another factor prompting consumption by the close of the year will be the planned additional social transfers of the government that will bring about a one-off rise in households' disposable income. On the other hand, fast rising prices during the previous year led to worsened consumer sentiments and expectations, arresting consumer expenditure growth. We expect the total impact of the above-mentioned divergent effects on consumer expenditure to cause a real increase in consumption at rates that are close to the ones reported during the second quarter.

According to the Labour Force Survey data, the number of employed increased by 4.3 per cent on an annual basis in the first half of 2008. Labour supply continued to improve, with the economic activity rate for the population aged 15–64 reaching 67.9 per cent during the second quarter of 2008 (against 66.1 per cent during the same period of 2007). The inclusion of part of the economically inactive population in the labour market

is an important factor for boosting employment given the relatively low levels of unemployment reached in the first half of 2008 (6.1 per cent). The downward trend in the number of long-term unemployed people on the labour market is also a positive one. This allows for the continuation of the trend towards a reduction in the unemployment rate in the future. On the other hand, under tightening labour market conditions the measures taken by the Employment Agency to improve the unemployed people's qualifications with a view to decreasing the disparity between the employers' qualification requirements and the educational level of the spare labour resources are gaining in importance.

Sources of Employment Growth



Source: NSI – Labour Force Survey.

Employment and Income Dynamics (Quarterly)

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

	2006				2007				2008	
	I	II	III	IV	I	II	III	IV	I	II
Employed	2.4	3.6	2.2	2.9	4.9	3	2.1	1.6	3.3	2.9
Real wage	0.5	-0.4	2.1	5.5	11.8	14.2	11.6	10.8	10.7	8.9
Wage fund	2.5	2.8	4.1	8.2	17	17.2	13.7	12.1	14.1	11.7
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	6.9	6.8	6.0

Sources: NSI – Enterprise Survey, Employment Agency.

Real Consumer Demand Dynamics (Quarterly)

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

	2006				2007				2008	
	I	II	III	IV	I	II	III	IV	I	II
Consumer spending per household member	2.9	5.5	7.3	8.1	10.6	12.0	8.9	6.5	6.5	1.8
Retail sales	11.0	13.3	14.2	14.1	13.8	13.1	8.4	9.0	11.3	7.7
Income from retail trade	9.9	12.5	14.1	15.3	15.3	13.4	10.9	10.6	10.4	7.0
incl.:										
Food, drinks, tobacco	6.7	5.7	7.4	8.7	7.6	8.1	2.3	0.6	4.7	0.0
Pharmaceutical and medical goods, cosmetics and toiletries	11.9	15.4	12.1	10.3	7.8	6.0	10.2	9.0	12.2	8.5
Textile, clothing, footwear and leather	18.1	23.8	29.9	27.6	18.3	11.4	20.8	22.1	25.5	14.7
Household goods and home appliances	21.5	26.0	27.5	26.7	27.7	26.2	22.1	19.7	12.1	8.9

Source: NSI Household Budgets and Domestic Trade Survey.

Government Finance and Consumption

Between January and June 2008 the consolidated fiscal programme balance was positive, coming to 5.7 per cent of the year's projected GDP. The government continued its policy of a moderate government expenditure growth, accompanied by good budget revenue implementation.

Between January and June 2008 the consolidated fiscal programme balance was positive, reaching BGN 3777.5 million or 5.7 per cent of the year's projected GDP. Compared with the same period of the prior year, surplus went up by BGN 1616 million. The major factor behind the realized surplus growth was good budget revenue implementation, accompanied by a sustained conservative expenditure policy. During the half-year tax revenue grew by 21.9 per cent on an annual basis, with receipts from VAT and profit tax reporting the highest growth rates (31.6 per cent and 28.7 per cent respectively). The high growth in revenue from VAT over the half-year was due entirely to the results registered in the first quarter. Then, owing to the low base ensuing from the one-off effects that were related to Bulgaria's accession to the EU, revenues from this tax increased by almost 63 per cent. The second quarter of 2008 saw a considerable slowdown and the reported growth was just 12.2 per cent on an annual basis. Another important source of budget revenue, excise duties, picked up by 19.3 per cent over the half-year as a result of the increased rates of some fuels, electricity and tobacco products.

Favourable dynamics of revenue from corporate taxes reflected mainly the high profits of non-financial corporations. Receipts from the income tax for individuals between January and June 2008 were by 17.3 per cent higher than those in the first half of 2007. The second quarter of the current year saw certain acceleration compared with the first quarter due to the faster growth of revenue from the economy.

The received aid amounting to BGN 946 million also contributed to the high revenue growth of the consolidated budget. The bulk of it were advance payments from the EU Cohesion and Structural Funds, as well as advances related to the Common Agricultural Policy.

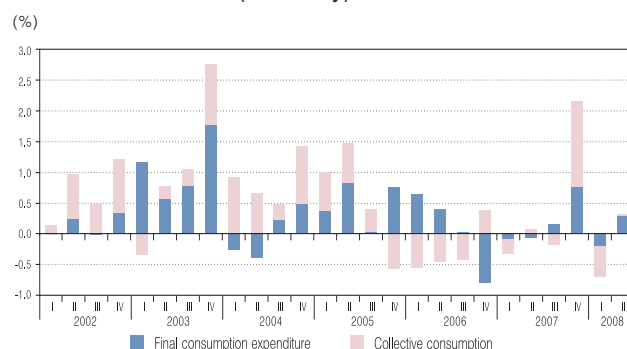
Consolidated fiscal programme expenditure during the first six months of 2008 picked up by 12.7 per cent on the same period of the previous year. Expenditure on wages and pensions posted a higher than the average increase (19.5 per cent

and 19.6 per cent respectively) following the indexation in the second half of 2007. Subsidy payments were 51.9 per cent higher due mainly to advance payments to tobacco producers in the first quarter of 2008. During the second quarter a considerable slowdown in capital expenditure was reported which was by just 1 per cent higher compared with the second quarter of 2007. The portion of Bulgaria's contribution to the EU budget amounted to BGN 359 million by June 2008. Total expenditure on consolidated budget (EU budget contribution included) comprised 40.4 per cent of annual projections.

The policy of moderate growth in government expenditure counteracted the trends towards accelerating growth of wages in the economy which put pressure on consumption and prices. The collective consumption negative contribution (-2.5 per cent) partially offset strong domestic private demand, preventing the economy from overheating.

Revenue growth rates are likely to slow down slightly during the second half of 2008 due to the higher base and the decline in inflation rates. Concurrently, consolidated budget expenditure is expected to increase. Indexation of pensions and wages in the budget sector, and the planned additional social and capital expenditure will have a significant effect in the third quarter and the fourth quarter respectively. As a result, we expect collective consumption to have a positive contribution to GDP growth and consolidated budget surplus to shrink below 4 per cent of GDP.

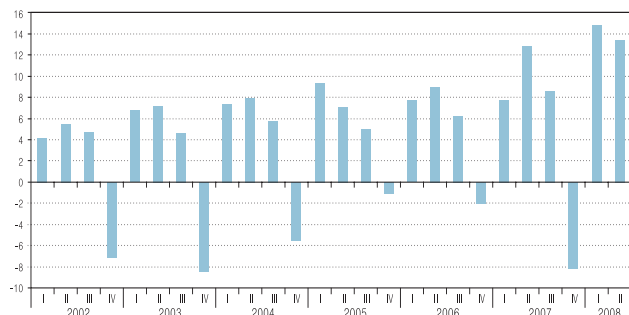
Contribution of Government Final Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)



Sources: NSI, BNB.

Primary Balance (Quarterly)

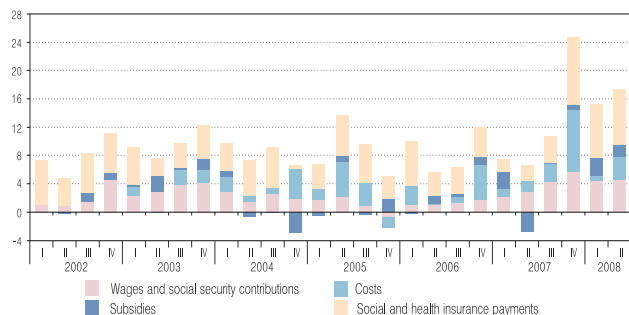
(share of GDP for the quarter, %)



Sources: MF, BNB.

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

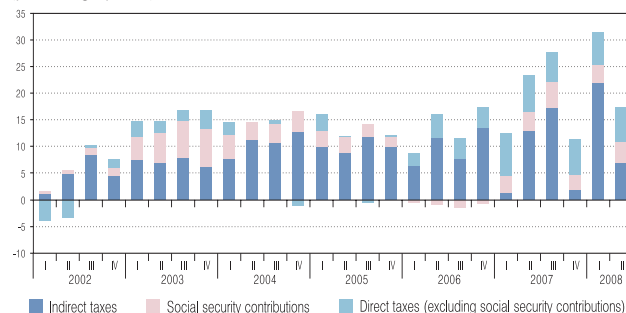
(percentage points)



Sources: MF, BNB.

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

(percentage points)



Sources: MF, BNB.

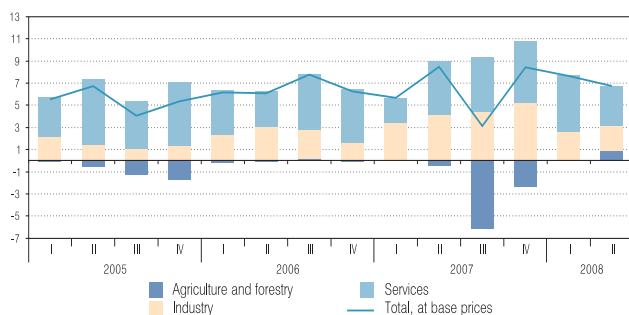
Behaviour of Firms and Competitiveness

According to business surveys of August the economic situation in Bulgaria stayed relatively stable. The abrupt deterioration in the international situation that has been observed since September may change dramatically business expectations. Firms will face the challenge to more flexibly manage their expenditure, especially on wages, so that they could retain their competitive positions on international markets.

During the first half of 2008 corporations' production and investment activity stayed high and expectations about the future development of major economic sectors are favourable. These trends reflect the brisk demand for additional labour resources and the sustained high growth in the compensations to employees.

Value Added Growth and Contribution by Sector

(%, percentage points on corresponding quarter of previous year)



Source: NSI.

Value added continued to grow fast in real terms during the first six months of 2008 (7.1 per cent). The services sector, prompted by buoyant financial intermediation, contributed most to value added growth (by 4.2 per cent). The financial sector registered a considerable improvement in labour productivity.

The operations in real estate and business services sector also developed dynamically during the first six months of the present year, reporting a 7.5 per cent real growth rate on an annual basis. Its accelerating growth since 2004 resulted from the foreign direct investment in the sector and the increased availability of bank credit. Expenditure on acquiring fixed assets in the sector rose, with its share in total expenditure on fixed assets in the economy coming to some 9 per cent. The growth of value added in real estate operations

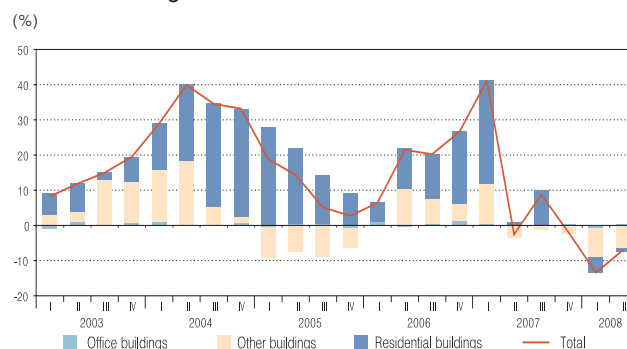
and business services was accompanied by a significant increase in employment: 7.8 per cent in the first six months of the year compared with the same period of 2007. Preliminary data on foreign direct investment in the sector show a slowdown in the flows during the first half-year. These trends signal the expected more moderate annual growth in the sector during the next periods.

The real growth rate of value added in trade since the year's start stayed at the relatively high levels of the previous year (6.2 per cent over the first six months). Expenditure on acquiring fixed assets picked up in the first six months of 2008 by 72 per cent in nominal terms on an annual basis, which will help improve the network of shops and expand the shopping areas; regarding this indicator Bulgaria is lagging behind the other EU countries. The sector reported an increase in employment during the first half of 2008 compared with the corresponding period of the prior year.

During the second quarter agriculture registered a considerable positive growth in value added (11.6 per cent). During the third quarter a positive contribution of agriculture to value added in economy is expected due to the anticipated good harvest.

Construction activity remained strong reflecting the continued brisk demand and real estate price rises. Around 10 per cent of the expenditure on fixed assets during the first half of 2008 were made in construction. Employment in the sector also increased considerably. Over the January to June 2008 period the number of employed picked up by 12.2 per cent on an annual basis. Surveys on current economic situation show that contractors expect to hire additional workers in the following months. As a whole economic managers' sentiment is positive. Provisioning of orders also stayed high. In September 2008, as a result of the trend towards more moderate expectations of economic managers, assessments of business climate in construction were lower by 4.9 points on average compared with the previous month's level. The number of issued construction permits continued to follow its slight descending trend of end-2007, suggesting a slowdown in the sectors' brisk development in the future.

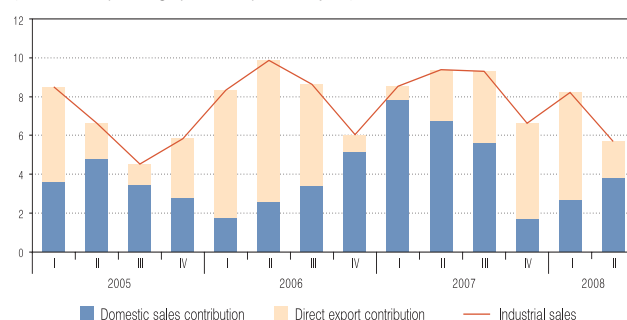
Annual Growth of Permits Issued for Construction of New Buildings



Source: NSI.

Industrial Sales Growth

(% on corresponding quarter of previous year)



Sources: NSI, BNB.

Manufacturing also had an important contribution (1.34 percentage point) to the higher real growth of value added. Compared with 2007, real growth of manufacturing slowed down, with this trend occurring in all sub-sectors. Following the buoyant growth in engineering during 2007, from the start of 2008 the rate became more moderate. As a result of the investments made in 2007, growth in metallurgy accelerated and in the second quarter the contribution of this industry to total value added growth comprised almost 0.5 percentage points. Growth rates of energy supply and construction slowed down in comparison with 2007: from 17.2 per cent to 6.9 per cent and from 16.9 per cent to 10.3 per cent respectively. On the other hand, growth in food industry, textile and clothing and oil processing was close to zero.

During 2007 and the first quarter of 2008 industrial export sales real growth picked up due to rapidly developing engineering industries and the recovery of metal exports.

Industrial enterprise survey data show that during the second quarter of the current year industrial sales' growth in real terms resulted to a great

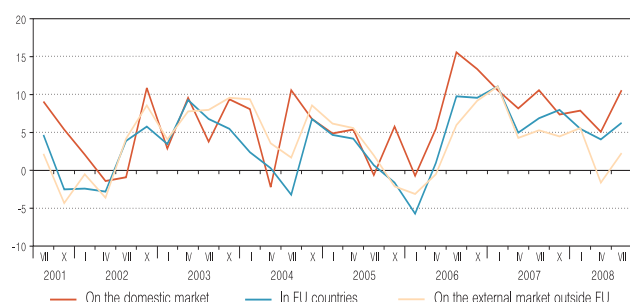
extent from domestic sales rather than from export sales. *Manufacture of non-metal mineral products* and *manufacture of plastics* (industries, which are related to *construction*) contributed considerably to domestic sales by 1.7 percentage points and 1.3 percentage points over the first and second quarters of 2008 respectively. Metallurgy and engineering also contributed considerably to the higher levels of domestic sales, especially during the second quarter when the contribution came to 1.5 percentage points.

The trend to restructuring of manufacturing with a view to gradual reorientation from lower value added and productivity industries to higher-technology ones was sustained. Production of machines and equipment continued accelerating: it went up by some 20 per cent on average over the first seven months of the current year. The share of this group in exports rose by almost 30 per cent during the first half-year, bringing about higher volumes of industrial exports.

According to the survey on current economic situation, the assessment of industrial enterprises' competitive position is improving and the levels of export orders have increased since end-2007. Data indicate that the levels of orders and realized volumes of industrial exports during the current period and the following three quarters are statistically related. The balance of opinion about expectations of exports lightly worsened in July; however, their values stayed close to the ones reported during the previous year. Over 18 per cent of the managers taking part in the survey anticipate higher exports in the future. The dramatic worsening in the international situation may change firms' expectations and slow down the growth rates of industrial sales, particularly those of export sales.

Assessment of Industrial Enterprises' Competitive Position

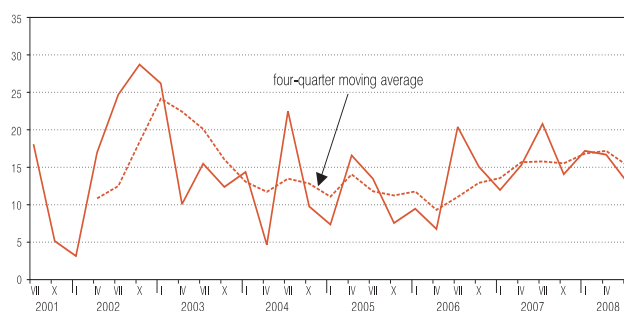
(balance of assessments)



Source: NSI, Business Survey in Industry.

Export Expectations

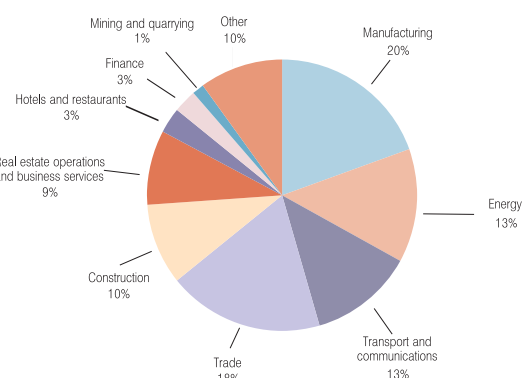
(balance of assessments)



Source: NSI.

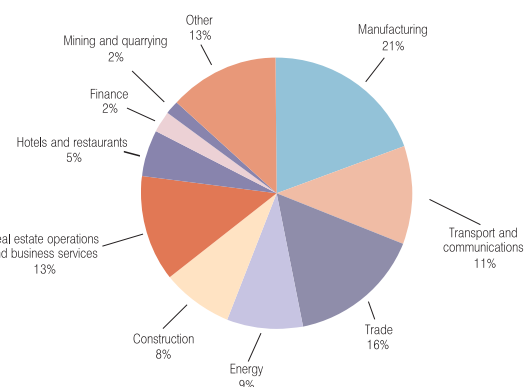
Dynamic development of most manufacturing sectors helped maintain a high average level of production capacity utilization (74.4 per cent in July). Investment activity also stayed high. Manufacturing occupied the largest share (20 per cent) in the distribution of expenditure on acquiring fixed assets by industry. Investments in trade, construction, real estate and energy posted a dynamic growth, reflecting these industries' brisk development.

Structure of Expenditure on Acquiring Fixed Assets by Economic Activity in the First Half of 2008



Source: NSI.

Structure of Expenditure on Acquiring Fixed Assets by Economic Activity in 2007

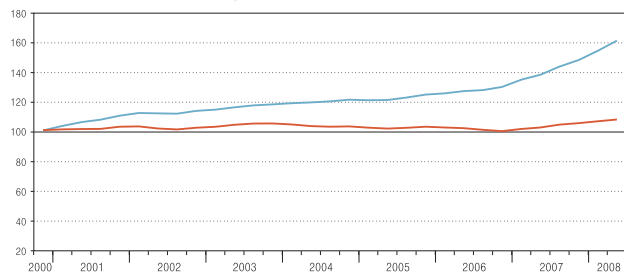


Source: NSI.

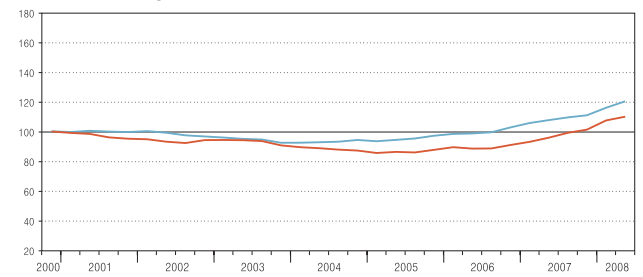
Unit Labour Cost (Quarterly)

(2000 = 100)

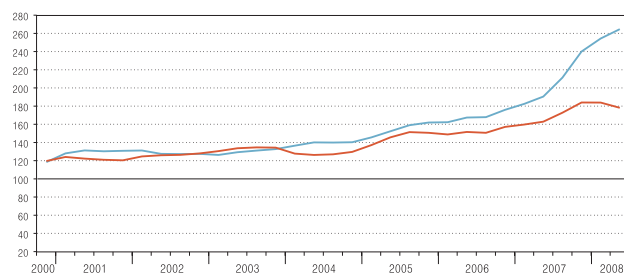
Total for the Economy



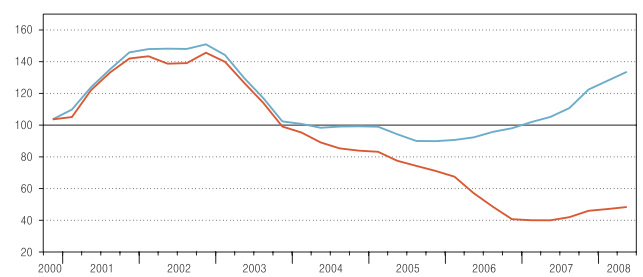
Manufacturing



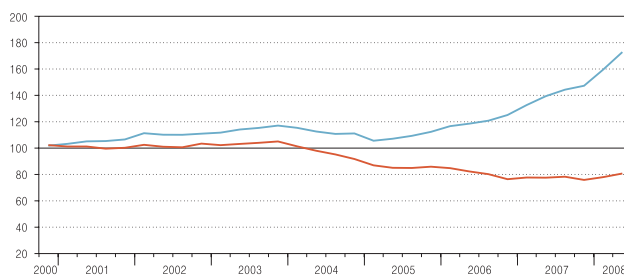
Agricultural Sector



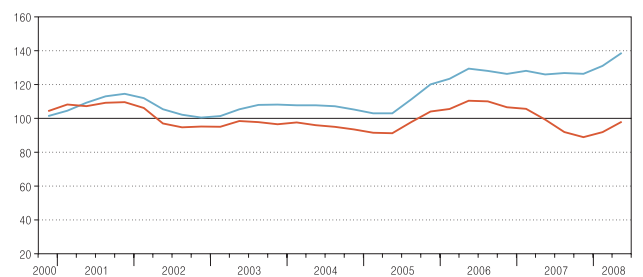
Mining and Quarrying



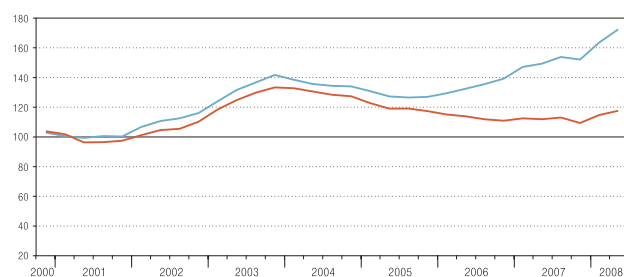
Construction



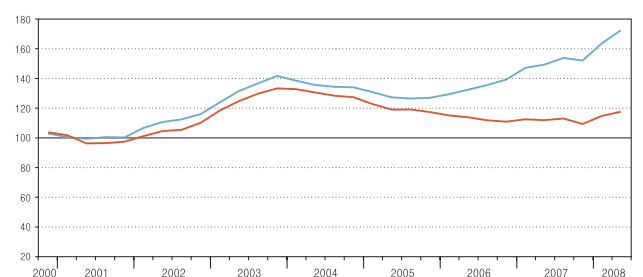
Electricity, Gas and Water Supply



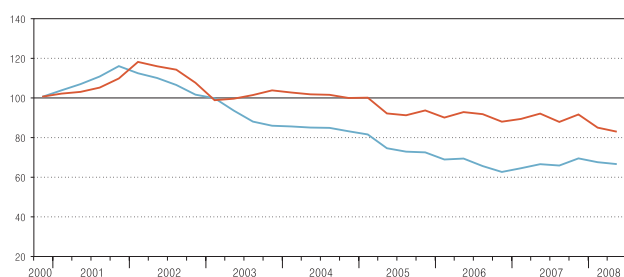
Trade



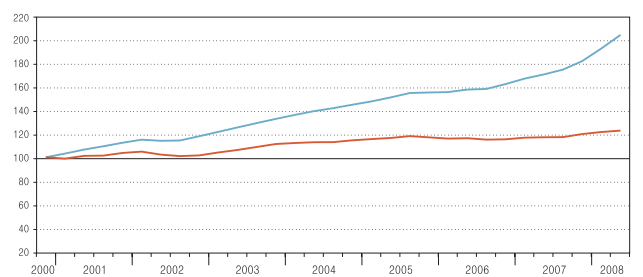
Transport and Communications



Financial Intermediation



Other Sectors



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

Note: Methodology of computing unit labour costs has been changed and complies with ECB methodology. Nominal unit labour costs are computed as a ratio of compensation per employee and labour productivity (real value) per employee. Real unit labour costs are computed using the same formula but labour productivity *per* employee is based on nominal value added.

Sources: NSI, BNB.

Foreign direct investment also contributed to the restructuring of economy as a source of new technologies and managerial practices. Between 2003 and 2006 annual flows of foreign direct investment in manufacturing and energy grew constantly in nominal terms. Following the 2007 slowdown in these flows indicated by the preliminary data on foreign direct investment, the first half of 2008 saw an inflow of foreign direct investments into manufacturing coming to BGN 575.1 million.

During the first six months of 2008 wages continued to rise at high rates, growing nominally by 24.3 per cent (9.8 per cent in real terms). As a result of the faster wage rises compared with labour productivity, unit labour costs went up in nominal and real terms by 17.3 per cent and 4.3 per cent respectively. Owing to the comparatively low share of labour costs in value added and the good financial state of firms, the latter could raise wages while preserving the high levels of their profits.

Exports and Imports of Goods

During the third and fourth quarters of 2008 Bulgarian foreign trade dynamics is expected to help preserve its market share in international trade, attained in the last few years. Risks of a slowdown in Bulgarian export rates due to the weakening growth in the countries that are major trade partners of Bulgaria have increased.

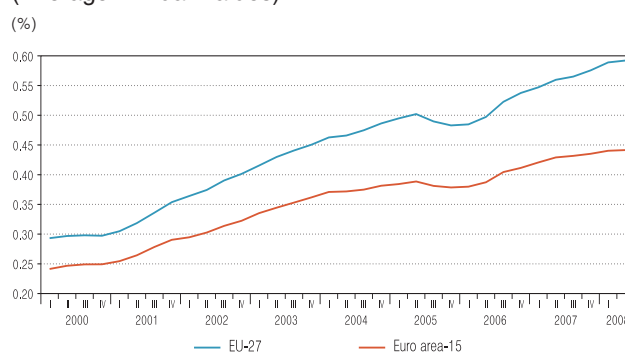
Expectations in the forecast horizon are for a sustainable nominal export growth in terms of value. Available economic indicators support the conclusion that the local industry competitiveness has been preserved. Labour productivity in industry posted a robust growth, investment activity and provisioning of export orders (according to the opinion of firms' managers as of August 2008) stayed at high levels and the share of Bulgarian exports in total imports of EU countries continued increasing.

The decomposition of the sector's gross production deflator provides an indirect assessment of the industrial firms' behaviour regarding their adaptation to the higher prices of major raw materials and feedstocks and fuels, and rising wages. During the last few years the deflator of intermediate consumption in manufacturing registered values that were higher than those of the gross production deflator; therefore enterprises did not transfer entirely to final consumers their increased expenditure stemming from the growing prices of raw materials, energy and wages. This process was most clearly seen in 2007 and the first quarter of 2008 when the deflator of the value added in industry was negative.

In services wage rises were faster transferred to final consumer prices due to the bigger share of labour costs in the gross production value.

Due to the dramatic worsening in the international situation firms will face the challenge to more flexibly manage their expenditure, especially on wages, so that they could retain their competitive positions on international markets.

The Share of Bulgarian Exports in EU Imports (Average Annual Values)



Source: BNB.

Since the economic outlook for the European and global market developments deteriorated and a decrease in the GDP growth in the euro area is expected, there are risks of lower export growth owing to the putative negative impact of external demand.

Imports of goods are anticipated to preserve their steady dynamics in the third and fourth quarters of 2008, underpinned mainly by strong investment activity, stable domestic demand and dependence of some export-oriented industries on imported raw materials.

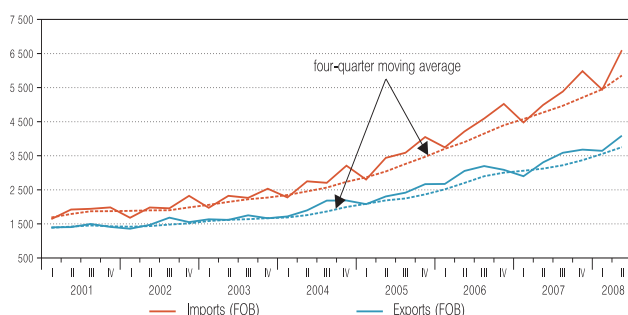
Regarding international prices of commodities and raw materials over the forecast horizon, food, crude oil and metal prices are expected to stay at their current levels or to fall further; nevertheless, the positive price contribution will be sustained on an annual basis. Taking into account the structure of foreign trade flows and the assumptions about international prices of major raw materials, we anticipate minimal changes in trade conditions during the third and fourth quarters of 2008.

Over the January to June 2008 period energy resources and investment goods contributed most (by EUR 1125 million) to trade deficit growth in terms of value (14.4 percentage points and 10.9 percentage points respectively). In the first category, oil product imports rose, reflecting high petrol international price. In the second category, imports of transportation vehicles went up considerably as a result of enhanced investment activity in Bulgaria. The dynamics of foreign trade in raw materials added to the deficit decrease, with non-ferrous metals, whose exports picked up by 49.8 per cent on an annual basis, playing the major role.

According to preliminary data, from January to June 2008 exports of goods in euro reached EUR 7736.7: a nominal growth of EUR 1494.1 million (23.9 per cent) on the corresponding period of the previous year. Imports (FOB) comprised EUR 12,043.7 million for the first six months of 2008 and the nominal increase came to EUR 2618.8 million (27.8 per cent) compared with the same months of 2007.

Dynamics of Exports and Imports

(million EUR)

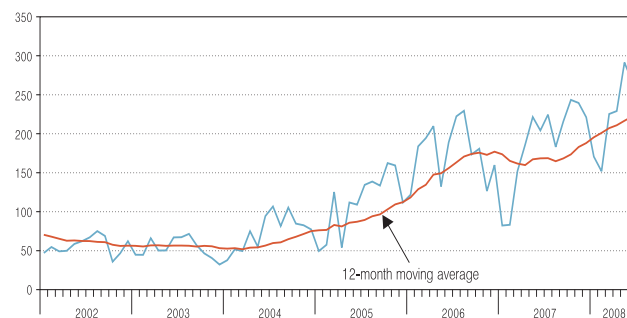


Source: BNB.

Between January and June 2008 all groups excluding *textile, leather, clothing, footwear and other consumer goods* affected positively export growth, with the dynamics of *mineral products and fuels, base metals and their products, and machines, transportation vehicles and appliances* contributing most by 6.5 percentage points, 6.5 percentage points and 5.5 percentage points respectively. Receipts from exports in the first category amounted to EUR 1335.5 million during the January to June 2008 period: up by 43.8 per cent on the corresponding period of the prior year. This resulted from the higher exports of oil products (up by 6.1 per cent on the January to June 2007 period) and higher oil price (the average price in euro went up by 44.4 per cent over the review period of 2008). The group's major positive contribution to the total export dynamics was registered by *mineral fuels, mineral oils and distilled products* (6.7 percentage point) while *ores* had a negative contribution (-0.4 percentage point). Exports of mineral products and fuels are expected to show an upward dynamics and a rising positive contribution to Bulgaria's total exports. The physical growth in the exports of oil products, as well as the retained trend of the last few months towards rising receipts from electricity exports, also supported positive expectations.

Exports of Mineral Products and Fuels

(million EUR)

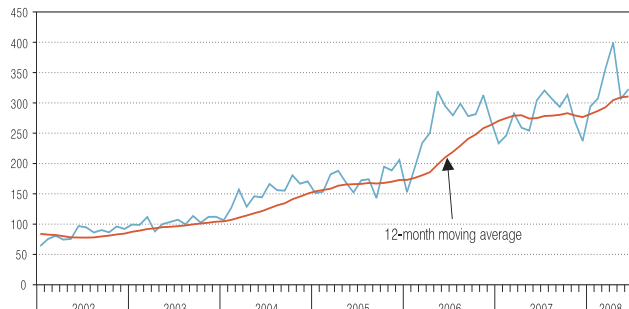


Source: BNB.

Receipts from exports of *base metals and base metal products* went up by EUR 408.3 million (25.8 per cent), affected favourably by stable production and export activity in non-ferrous metallurgy. *Copper and copper products* had a major contribution to total growth (5.9 percentage point), while *zinc and zinc products* had a negative contribution (-0.8 percentage point). The physical volumes of non-ferrous metals exports that have been growing since early year are expected to follow the positive trends in the forecast horizon as well.

Exports of Base Metals and Base Metal Products

(million EUR)

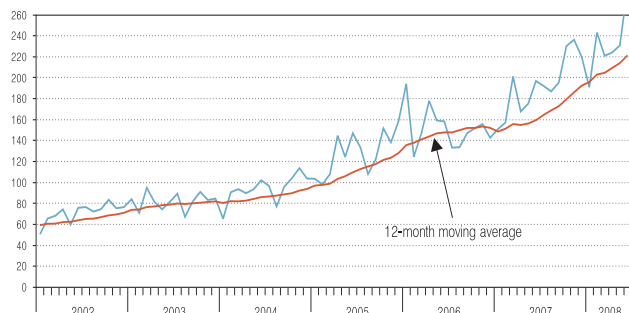


Source: BNB.

Receipts from exports of *machines, transportation vehicles and appliances* went up by EUR 346.4 million (33 per cent). Positive developments for the period were reported by all major positions of the group excluding *railway appliances* (-0.1 percentage point), with *nuclear reactors, boilers, machines, appliances and machinery*, and *electrical machines and appliances* contributing most to total growth (by 2.6 percentage points and 1.5 percentage points respectively). In the third and fourth quarters of 2008 exports of machines, transportation vehicles and appliances are anticipated to retain their upward trend and to report faster dynamics, compared with that of total exports as a result of industry reorientation towards higher value added products.

Exports of Machines, Transportation Vehicles and Appliances

(million EUR)



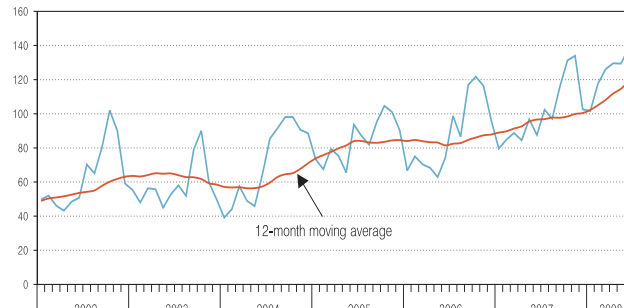
Source: BNB.

Receipts from exports of *food, drink and tobacco products* reached EUR 742.6 million (42.3 per cent) for the first six months of 2008. These positive developments were underpinned mainly by *oil seeds and fruit* (1.2 percentage points), *cereals* (0.7 percentage points) and *milk and dairy products* (0.4 percentage points), while exports of *meat*

had a negative contribution (-0.1 percentage point). Positive trends are expected to continue during the third and fourth quarters of 2008 as a result of good yields in agriculture; expectation will materialise provided that an increasing number of producers meet the EU standards and have a free access to the single European market.

Exports of Animal and Plant Products, Food, Drinks and Tobacco

(million EUR)

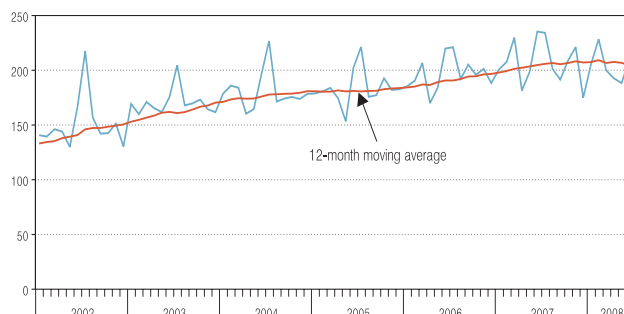


Source: BNB.

Exports of *textile, clothing and footwear* is the only group with a negative contribution (-0.5 percentage point) to total export growth during the first six months of 2008. Receipts from exports of textile were less by EUR 29.3 million (2.3 per cent) compared with the January to June 2007 period, with the decrease in clothing exports (a contribution of -0.5 percentage points) having the strongest impact. The slowdown most likely reflects the losses of the competitive advantages based on low production costs (of energy and labour) of the firms manufacturing clothing and textile.

Exports of Textile, Clothing and Footwear

(million EUR)



Source: BNB.

Contribution of Commodity Groups to Trade Growth, January – June 2008

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	10.4	2.6	24.4	4.0
Raw materials	20.6	9.6	19.1	7.1
Investment goods	31.9	5.0	26.4	7.2
Energy resources	52.6	6.7	50.7	9.6
Growth, total	23.9		27.9	

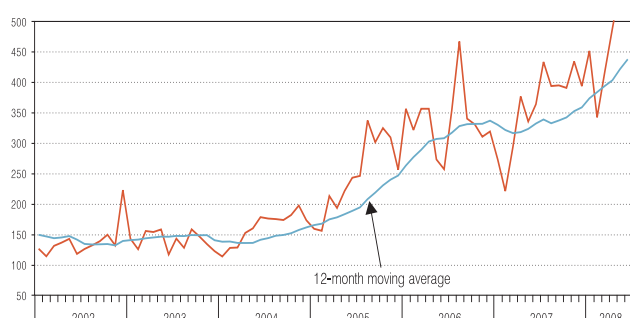
Source: BNB.

Imports (CIF) reached EUR 12,656.3 million in the January to June 2008 period; a nominal increase of EUR 2761.3 million (27.9 per cent) on the respective period of the prior year. In the structure of imports by use mineral products and fuels registered the highest positive growth (9.6 percentage points), followed by investment goods (7.2 percentage points) and raw materials (7.1 percentage points).

Payments on imports of mineral products and fuels in the first six months of 2008 came to EUR 2810.1 million, with fuels and crude oil and natural gas having a major contribution (8.1 percentage points and 7.8 percentage points respectively). Over the January to June period the average price in euro of imported crude oil picked up by 52.3 per cent, while imported oil products increased by 24.3 per cent compared with the January to June 2007 period. Crude oil imports are expected to increase during the third and fourth quarters of 2008 as a result of the sustained production activity in the oil processing sector.

Imports of Energy Resources

(million EUR)



Source: BNB.

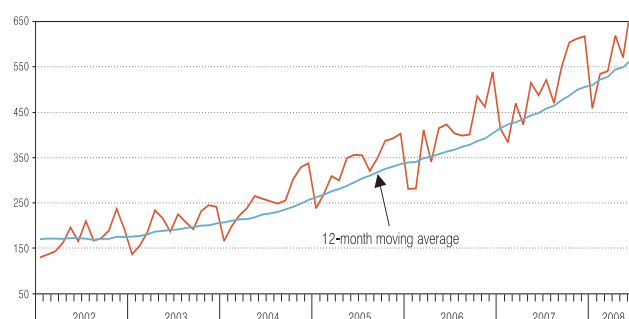
Investment goods imports preserved their sustained developments in the first six months of 2008; they were the second largest group of imports with a share of 26.9 per cent. Their value reached EUR 3404.3 million (26.4 per cent), with transportation vehicles contributing most to total growth (by 1.7 percentage points), followed by

machines and equipment (by 1.6 percentage points). The total value of imported raw materials comprised EUR 4413.5 million during the first six months of 2008: up by EUR 706.3 million (19.1 per cent) on the corresponding period of 2007. In this group *cast iron, iron and steel, ores* and *food feedstocks* had the largest contribution to total growth (1.7 percentage point, 1.2 percentage point and 0.9 percentage point respectively). The upward

trend in imports of investment goods and raw materials is anticipated to be sustained during the third and fourth quarters of 2008 owing to high domestic investment demand and stable production activity in metallurgy.

Imports of Investment Goods

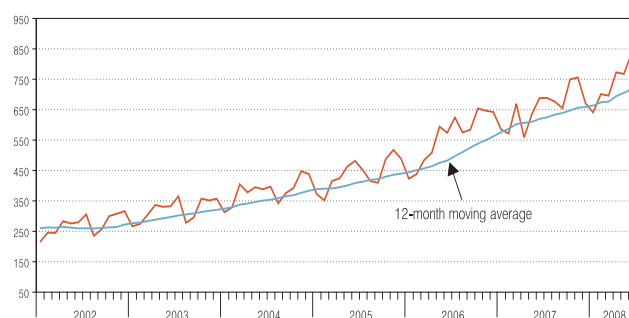
(million EUR)



Source: BNB.

Imports of Raw Materials

(million EUR)

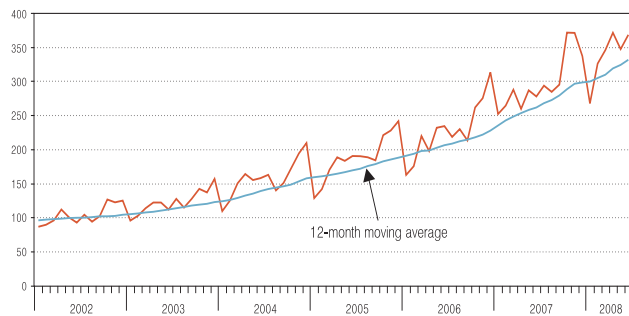


Source: BNB.

Imports of consumer goods picked up during the first six months of 2008 by EUR 398.5 million (24.4 per cent) on the same period of the prior year, with their value reaching EUR 2028.8 million. In this group *food, drink and tobacco products* and *furniture* had a main contribution to total imports (by 1.6 percentage points and 0.6 percentage points respectively). Expectations over the forecast horizon are for preserved sustainable growth rates of consumer goods imports, prompted by stable domestic demand.

Imports of Consumer Goods

(million EUR)



Source: BNB.

According to preliminary data, during the first six months of 2008 Bulgarian exports, directed to the other EU member states, went up by 17.6 per cent, while those directed to countries outside the Community reported a 35 per cent increase. Goods imported from the Community picked up by 23.2 per cent, while those from third countries by 33.2 per cent. The market share of Bulgarian goods in total imports of Community member states rose to 0.59 per cent by June 2008 (on an annual basis) against 0.56 per cent a year earlier. Over the forecast horizon no significant changes in Bulgarian foreign trade geographic structure are expected.

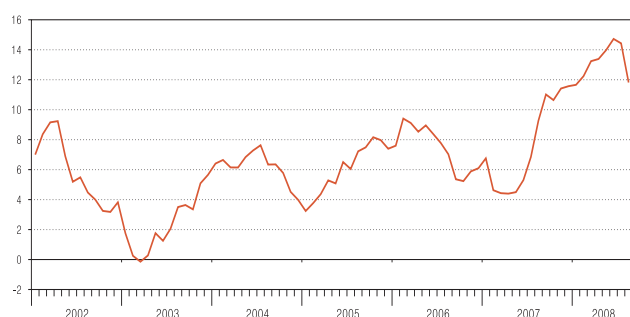
4. Inflation

The downward trend in annual inflation is expected to be sustained by the end of 2008. Possible direct and indirect effects resulting from the sizable increase in the price of natural gas in the fourth quarter of 2008 (between 0.6 and 1 percentage points) pose risks for higher inflation at the end of the year. The fall of international fuel and commodity prices reflecting global economic activity moderation may result in a more pronounced inflation slowdown in Bulgaria as well.

The significant rise in international food and fuel prices from mid-2007 prompted a global acceleration of inflation. Beside the impact of external factors, the general price level in Bulgaria was affected by the insufficient food supply attributable to the drop in agricultural output by 44.1 per cent in the third quarter of 2007 due to unfavourable weather conditions. Increased external demand on behalf of neighbouring EU Member States posed additional pressure on food prices. The rise in certain administratively controlled prices and increased fuel and tobacco excise duties also contributed to the upsurge in prices in 2007, with this contribution being even more pronounced in 2008. In addition to growing company expenditure reflecting higher fuel, energy and commodity prices, the rise in unit labour costs also put upward pressure on prices especially in the services sector.

Harmonized Index of Consumer Prices

(inflation on corresponding month of previous year, %)



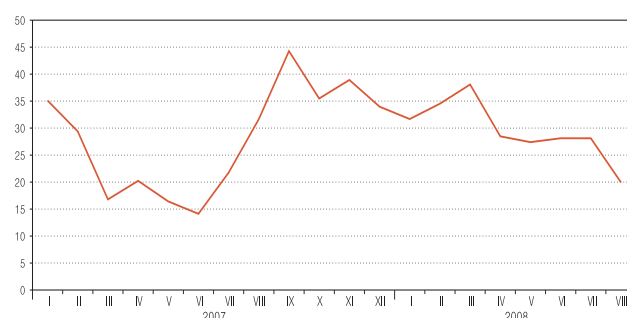
Source: NSI.

The increase in inflation continued until June 2008 when inflation reached 14.7 per cent on an annual basis. In the second half of 2008 it started to moderate and in August the annual growth rate of prices reached 11.8 per cent. The diffusion index, measured

as the relative share of the groups in the consumer basket with monthly inflation over 1 per cent, is an example of how fuel and food price leaps from mid-2007 broadly affected the prices of other goods and services, while subsequently there was a deceleration in the diffusion index due to the gradual reduction in the share of goods and services with a high monthly inflation rate.

Diffusion Index (Share of the Groups in the Consumer Basket with Monthly Inflation of over 1%)

(%)



Note: The diffusion index is calculated on the basis of the elementary aggregates in the consumer basket.

Sources: NSI, BNB.

Inflation went down slowly due to the higher than expected inflation dynamics of certain foods, services and non-foods and to the more sizable contribution of administratively controlled prices. The relatively high growth rates of processed food, services and non-food prices probably reflect lagged second-round effects of the considerable rise in food and fuel prices over the last year, as well as the increase in fuel prices by more than 10 per cent only during the May – June 2008 period. Growing wages in the services sector put upward pressure on consumer prices fuelled by the surge in unit labour costs.

HICP Inflation Accumulated and Contribution of Major Goods and Services Groups to It

	January – August		August 2007 – August 2008
	2007	2008	
Inflation (%)	6.8	7.1	11.8
<i>Contribution, percentage points</i>			
Services	2.05	2.71	4.05
Catering services	1.12	1.17	2.00
Transportation services	0.18	0.79	1.19
Services excluding catering and transportation services	0.75	0.75	0.85
Administratively set prices	0.89	1.64	1.85
Energy products	0.70	1.16	1.70
Transportation fuels and lubricants	0.69	1.03	1.52
Food	3.03	0.58	2.54
Processed food	2.71	1.05	2.42
Unprocessed food	0.32	-0.47	0.12
Fruit	0.34	0.16	0.09
Vegetables	-0.14	-1.02	-0.50
Meat and meat products	0.12	0.36	0.48
Tobacco products	-0.26	0.51	0.52
Non-energy industrial goods	0.42	0.47	1.16

Note: This structure corresponds to the Eurostat classification, with tobacco products and goods and services with administratively set prices presented separately.

Sources: NSI, BNB.

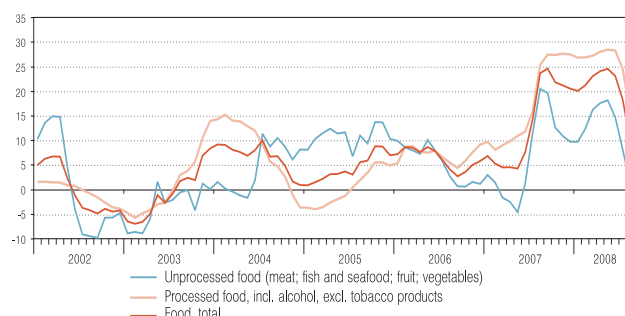
During the first quarter of 2008 food price inflation remained relatively high due to a base effect and to the continuous rise in international food and commodity prices pushing up intermediate consumption costs in food industry. Labour costs growth in this sector was another factor supporting high food inflation. Meanwhile, unlike other manufacturing sectors where companies partially cover higher production costs, food industry companies managed to transfer to end-use consumers the costs related to intermediate consumption and wages. The increase in prices of transportation fuels by 21 per cent over the last twelve months also had an indirect effect on retail food prices.

The annual growth rate of food prices slowed down in the beginning of the second quarter falling to 9.8 per cent in August from 25 per cent in May. Meanwhile, food prices contributed less to inflation (2.5 percentage points on an annual basis in August compared to 6 percentage points in May). In the third quarter unprocessed food (fruit and vegetables in particular) contributed most to the downward trend in food price inflation on an annual basis due to the usual summer deceleration reflecting the good harvest. In August fruit and vegetable prices went down by 14.3 per cent and 36.6 per cent respectively, as compared to those in April 2008. During the same month fruit

prices posted an annual growth of 6.2 per cent, and vegetable prices went down by 17 per cent as compared to those in August 2007.

Harmonized Price Indices of Food

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

The annual rate of inflation in the other food groups also moderated due to a base effect resulting from the sizable increase in their prices in the second half of 2007, but still remained higher than expected as compared to that of fruit and vegetables. This is probably attributable to lagged effects of the hikes in agricultural products prices and the significant rise in international food prices on end-use food prices recorded over the last year.

Higher production costs in food industry and agriculture together with the international price increase had a pronounced indirect effect on the group of meat and meat products. Inflation accumulated in this group since December 2007 is around 9 per cent.

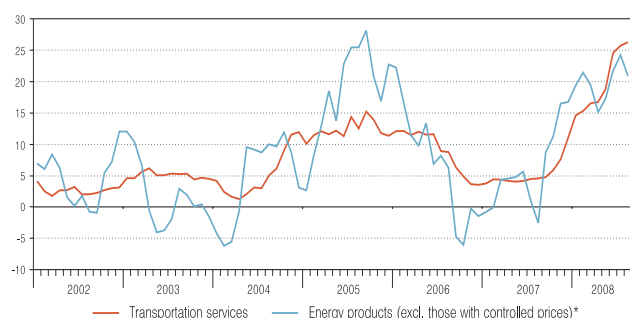
High wheat and sunflower yields in 2008 resulted in less expensive commodities (such as flour and vegetable oil) since mid-year. This development was supported by the fall of these products' international prices which started during the same period (see Section One, *External Environment*). The decrease in flour and vegetable oil prices resulted in a fall in the retail prices of these products, with that of the flour being more pronounced. By August, however, vegetable oil price saw a sizable rise of over 17 per cent since early 2008. The second-round effects of the decrease in flour and vegetable oil prices on food, in the production of which they are used, are still less pronounced. Concurrently, in the group of bread and cereals, rice marked a significant price rise (up by almost 83 per cent from the year-start) as a result of its sizable price leap on international markets.

Annual growth rate of food prices is expected to sustain its downward trend till the end of 2008 mainly due to processed food dynamics. Given the downward trend in agricultural product prices in Bulgaria and abroad which started in the second half of the review year and the fall in fuel prices and hence in transportation costs, we might expect moderate growth rates in processed food prices till the end of 2008. Fruit and vegetable prices are expected to get back to their seasonal profile and to report a certain rise in the last months of 2008.

Between January and August 2008 domestic prices of energy products followed the sizable international oil price fluctuations. Raised excise duties on unleaded petrol and on diesel (by 8 per cent and 12 per cent respectively) also affected domestic fuel prices since early 2008. In July the annual inflation of energy products (excluding administratively controlled prices) reached 24.2 per cent, registering higher-than-expected rates. As a result of fuel price hikes intermediate consumption costs in transport increased sizably. The bulk of higher transportation fuel costs were transferred to consumer prices and the annual growth rate of transportation services prices (including services with administratively controlled prices) reached 25.7 per cent in July.

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.

The downward trend in oil prices which started in the second half of 2008, together with the US dollar appreciation against the euro, contributed to the decrease in fuel prices by 4.7 per cent in August. During the same month energy products contributed 1.7 percentage points to annual inflation. Provided oil prices stabilise or their down-

ward trend is sustained, annual inflation of energy products will slow down. This will reduce the upward pressure on transportation services prices and the decrease in transportation costs should have an indirect effect on the price dynamics of all goods and services which is expected to be more moderate in the coming months.

Administratively controlled prices and tobacco products had a marked contribution to high overall inflation since early 2008. By contrast with end-2007, when the contribution of these two groups to annual inflation was below 1 percentage point, in August 2008 the overall contribution of goods and services with administratively set prices and that of tobacco products picked up to 2.4 percentage points (1.85 percentage points for controlled prices and 0.52 percentage points for tobacco products).

Raised international and domestic prices of energy products (petrol, coal and natural gas) were the main factor behind the high inflation of goods and services with administratively controlled prices since early 2008. The greatest contribution to inflation accumulated since the beginning of the year under review was that of electricity (0.6 percentage points), urban public transport (0.3 percentage points) and water supply and sewerage services (0.2 percentage points).⁹ The increase in the price of heat energy by 13 per cent since July was partially reflected in end-use consumer prices during the same month and, due to its relatively small share in the consumer basket did not contribute significantly to inflation (0.06 percentage points). The increase in medical and hospital services prices (aggregate contribution of 0.15 percentage points) resulting from the minimum wage rise in 2008 was another key factor behind accelerated inflation dynamics of goods and services with controlled prices since early 2008. Other administratively set fees included in the consumer basket marking an increase since the year start were those for legal services with a contribution of 0.15 percentage points.

Most probably new hikes in administratively set prices are to be expected by end-2008. The increase in the price of heat energy from July not included in that month, is anticipated to be reflected in these hikes. The overall increase in the

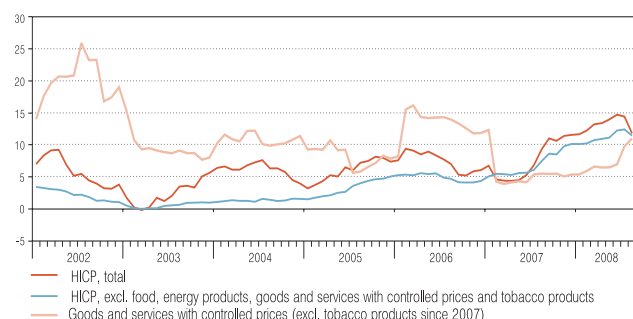
⁹ Water price increase was fuelled mainly by higher electricity prices and investment necessary to improve the water supply network.

price of heating for 2008 may reach some 25 per cent due to the 24 per cent rise in the price of natural gas in the fourth quarter of 2008, provided the previously discussed additional increase of heat energy prices of 10–12 per cent is approved. Apart from its direct effect on inflation through the price of heat energy, the sizable rise in the price of natural gas is expected to have an indirect effect through higher intermediate consumption costs of industrial enterprises. The overall effect of the increase in the price of natural gas on inflation at the end of 2008 is estimated between 0.6 and 1 percentage points (direct effect of 0.2 percentage points and indirect effect between 0.4 and 0.8 percentage points). By the end of 2008 higher education fees will most probably be reflected in the consumer basket, thus making the contribution of administratively controlled prices to inflation even more significant.

By August tobacco products marked an overall increase in prices of 14.7 per cent since early 2008 due to their excise duty rise from January 2008. The contribution of tobacco products to inflation is expected to remain around 0.5 percentage points by end-2008.

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

(inflation on corresponding month of previous year, %)



Note: Given the relation between tobacco product prices and administratively set excise rates, tobacco products are excluded from the group of goods and services with non-controlled prices despite the liberalization of the tobacco market in early 2007.

Sources: NSI, BNB.

Between January and August 2008 average annual inflation of non-foods (excluding those with administrative prices and fuels) was 6.6 per cent, remaining at a level higher than that in end-2007 (6.4 per cent). Due to the relatively low inflation rate in this group as compared to the groups in the consumer basket, their contribution to inflation accumulated since the year-start (0.47 percentage points) and to annual inflation in August (1.16 percentage points) is comparatively low.

The increase in non-food prices was driven by a number of factors. On the one hand, production costs increased as a result of the price hikes in fuel and transportation services. The inclusion of product fees in the prices of electrical appliances also contributed to the rise of non-food prices. Household income growth changed consumption patterns, pushing up the demand for non-foods. At the same time, higher consumer requirements to quality result in an increase in the supply of high-quality and more expensive goods. National accounts data show that during the first half of 2008 final consumer expenditure on non-foods posted an 8 per cent growth on the same period of the prior year against an annual growth rate of 6.6 per cent in 2007. According to the data on revenues from retail trade in textile, clothing, footwear and leather and those on retail sales of industrial goods, the accelerating trend of non-food consumption was sustained with a certain slowdown reported in the second quarter.

The increase in the amount of various types of consumer loans also contributed to the enhanced consumer demand for non-foods. For example, between early-2006 and mid-2008 newly extended household consumer loans (including leases) were used to finance around 37 per cent of consumer expenditure on this group of goods. Non-food inflation is expected to remain relatively high until the end of 2008.

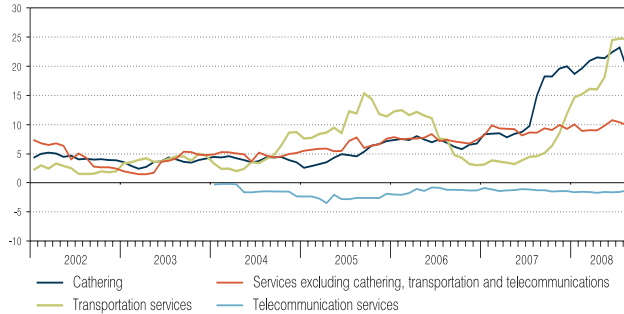
Services (excluding those with administratively set prices) contributed most to inflation accumulated since the year-start (by 2.7 percentage points), with average annual inflation reaching 14 per cent between January and August 2008. Higher inflation rates in the group of services seen in 2008 were largely attributable to enhanced annual growth in transportation and catering services prices reflecting the ongoing impact of the second-round effects resulting from the upsurge in fuel and food prices in 2007.

Sustained high wage growth was another factor supporting high inflation in certain services sectors (such as catering and services excluding catering, transport and telecommunications). Between January and August 2008 the inflation of services excluding catering, transport and telecommunications continued to increase at relatively high rates (around 9–10 per cent on an annual basis). Higher fuel, energy and food commodity prices put further upward pressure on services prices.

By-end 2008 services inflation is expected to gradually moderate mostly on account of reduced pressure from food and fuel prices which will result in lowering growth rates of catering and transport services prices.

Harmonized Price Indices of Services Excluding Those with Controlled Prices

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

Inflation is expected to retain its downward trend till the end of the year underpinned by the moderating annual growth in the prices of food, fuels and some services. Declines in world fuel prices will push down domestic prices, whereas direct and indirect effects of increased natural gas prices will exert an upward pressure.

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