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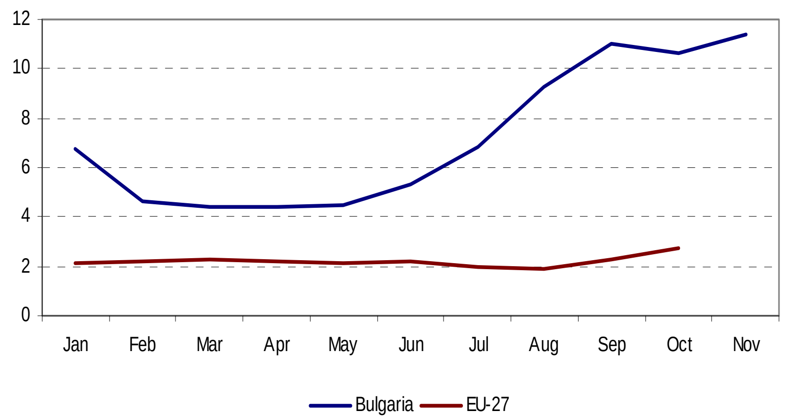
RISING INLFATION IN BULGARIA – REASONS AND EFFECTS

According to the data of the National Statistical Institute of Bulgaria, in September 2007 the annual rate of change of HICP in Bulgaria reached a two-digit level (11%) for the first time in the last seven years and it has remained above 10% since then (it was 10,6% in October and 11,4% in November). The current peak has been preceded by a sharp increase in the value of the index throughout this year's third quarter (see Chart 1.).

CHART 1. HICP IN BULGARIA AND IN THE EU IN 2007 (ANNUAL CHANGE, %)



Source: NSI, Eurostat

Although in the first half of 2007 the inflation rate has at least started to approximate the EU-27 average (which is even higher than the Maastricht criterion) and it has been in line with the government's initial target of 4.4% for this year, in the last five months an unfavourable tendency has emerged. The government has already modified its estimate for the annual inflation rate to 8%, just like the IMF, which raised its end-year inflation forecast to the same value in September. However some analysts expect that the annual inflation rate will reach 12%.

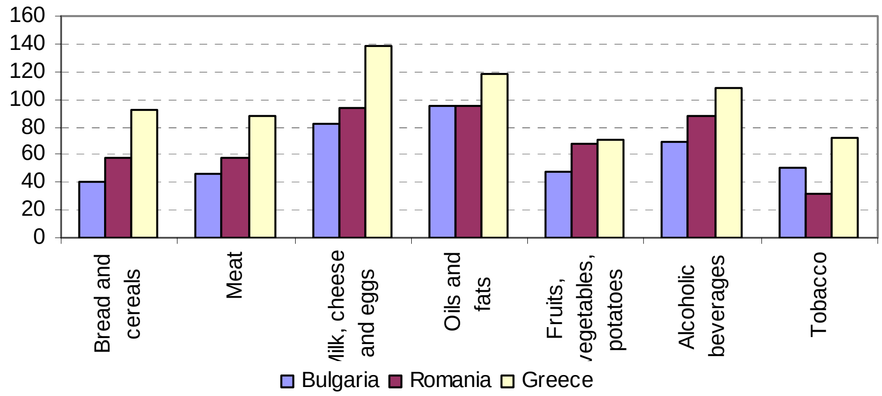
The current situation is even more alarming as in Bulgaria in July 1997 a currency board was introduced under the BNB act, pegging the Lev to the DEM as 1:1 and with the introduction of the Euro in the EU, the legislation was amended and the ratio was changed to 1 Euro equalling 1.95583 Levs. Operating under this system, the central bank has no direct control over the inflation rates in the country. In the lack of monetary tools, in order to avoid further price increases, alternative policies are needed to make the economy capable of responding to changes in the external environment (e.g. rising raw material prices on the world market) and in the demand for domestic products (e.g. external demand for Bulgarian products increased after the country's accession to the EU). However the range of alternative tools is also limited as in the presence of a fixed exchange rate regime the government has to pursue a very conservative fiscal policy in order to meet the inflation criterion (e.g. in 2006 by practising one of the tightest fiscal policies in Europe, the government reached a budget surplus of 3.3%). Among these circumstances promoting the competition and improving the business environment are considered as main policy aims.

Thus pegging the exchange rate makes the remedying of the current situation even more difficult, especially in view of the reasons which have led to the evolvement of the high inflation rates. Among the causes there are one-off shocks, but also such processes like the acceleration of wage increases in the private sector, which are results of the tightening labour market conditions. On the whole numerous external and internal inflationary effects can be distinguished.

EXTERNAL INFLATIONARY FACTORS

Bulgaria's integration into the Single European Market is reflected in stronger external demand and a process of price level convergence, especially evident for food products. After introducing the common Customs Tariff as from 1 January 2007 and applying the Common Agricultural Policy, higher demand and higher import duties on certain food products pushed up their prices. According to the Commodity Exchange and Wholesale Markets State Commission data, sales of domestic fruits and vegetables increased by 93% on an annual basis between January and August 2007, whereas sales of imported fruits and vegetables increased by 38%.

CHART 2. INDICES OF COMPARATIVE PRICE LEVELS (EU25=100, 2006)



Source: Eurostat

As Chart 2. shows in 2006 the price level in Bulgaria was significantly lower in the case of several commodities than the EU25 level. Bread and cereals (40,4%), meat (46%), fruits and vegetables (48,2) had the lowest levels of relative prices, this year significant upward price dynamics could be perceived in the case of these products. As there are significant differences with Bulgaria's neighbouring EU members Romania and Greece in the price-level of several commodities, after the EU accession exports of certain products (e.g. milk, fruits) to these countries have significantly increased.

After the EU accession, not only the external demand increased, but also the manufacturing costs of the food enterprises, as investments had to be implemented in the factories in order to meet the EU requirements. Bad climatic conditions had a negative effect on the supply of food not only in Bulgaria but also in the major producer countries, thus the world market prices of agricultural products also increased, which resulted in limited and expensive import possibilities for Bulgaria. These factors significantly boosted the price levels of both processed and unprocessed foods in Bulgaria throughout this year. Within the former group *bread and cereals* and *milk, cheese and eggs* groups had the largest contribution to overall annual inflation, their average inflation in the beginning of the third quarter coming to 31% and 22% respectively on the same period of 2006. Prices of unprocessed foods also posted a significant increase in annual growth, with the prices of *vegetables* and *meat* (by 38% and 7.2% y-o-y) contributing most sizably to overall inflation. The average rise in *fruit* prices in July and August was 16.8% year-on-year.

Another external inflationary factor is the indirect effect of rising world crude oil prices. This phenomenon had been reflected in an average increase of 5.2% y-o-y in the prices of energy products (primarily transportation fuels) over the May to June period. However in Q3 2007 fuel prices decreased their annual growth rates reflecting the base effect of the surge in oil prices in the beginning of the summer of 2006. The Bulgarian National Bank expects an average y-o-y inflation of 11% for Q4 2007, the possible acceleration would also imply the base effect of the relatively low oil prices in the last four months of 2006.

INTERNAL INFLATIONARY FACTORS

As it had been already indicated before, the summer was characterized by bad climatic conditions (hot and dry weather at the end of June and in July, which was then followed by floods) which caused a reduced supply of food on the domestic market. The inflationary effect of the shortage in domestic products was aggravated by the limited and expensive imports.

The rising administratively set prices are another significant group of internal inflationary factors. Inflation in this group accelerated on the corresponding periods of 2006 from 4.2 % on average in Q2 2007 to 5.5% in the first two months of Q3 2007. Electricity (0.32 percentage points), vignette charges (0.16 percentage points) and water supply and sewerage prices (0.15 percentage points) contributed most significantly to the overall inflation accumulated until August. The increase of electricity prices for households became effective on 1 July and had a direct effect on inflation, while there was also an unexpected rise in prices for the firms on the same day, which had an indirect effect on inflation, through the increasing manufacturing costs. The latter meant a price increase of 20% for the SMEs (up to 50 employees and an annual turnover of up to BGN 19.5 million) and price rises after this date varied between 34% and 41% for the large consumers, which – after the liberalization of the electricity market on 1 July 2007 – are able to negotiate directly prices with the National Electric Company.

High transportation expenditures over the year had contributed on the one hand to the price increase of industrial goods (industrial goods contributed by 0.56 percentage points to the overall inflation accumulated by August) and to the price increase of the catering services (catering services contributed by 1.12 percentage points to the overall inflation accumulated by August). The latter was one of the major driving factors for services inflation and its high growth rates had been also the result of the high food prices and the robust consumption.

TABLE 1. MAIN LABOUR MARKET INDICATORS (2007)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Employed (1000)	2 282	2 289	2 308	2 320	2 331	2 343	2 354	2 353	2 337
Unemployed (1000)	358	351	330	310	290	275	268	259	251
Unemployment (%)	9,7	9,5	8,9	8,4	7,8	7,4	7,3	7,0	6,8
Average monthly wages and salaries (BGN)	377	380	396	400	411	408	420	419	434

Source: NSI

High growth in household consumption is also among the main internal inflationary factors, which resulted from real salary growth and employment growth over the first half of the year. The wage rates have been increasing fast since the start of 2004 and they have been accelerating rapidly as this year has progressed: the average monthly salary increased from 377 BGN in January to 434 BGN in September.

On the one hand this process shows that the Bulgarian economy is getting closer to the more developed economies in this respect (e.g. the higher percentages in salary increases for qualified specialists is due to exact estimation of the difference between the labour productivity of the latter compared to that of other employees). On the other hand, similarly to other new EU member states, the shrinkage of labour supply can be also perceived in the case of Bulgaria, which emerges as a result of the ageing population (the old-age dependency ratio increased from 22.2% in 1995 to 24.9% in 2005 and it is expected to reach 29% by 2015) and the significant migration of the working labour to other countries (157000 active working citizens are residents in another EU member state in 2007, which is 0,1% of the resident active working age population[1]). As a result of the above-mentioned factors decreasing unemployment has been coupled with growing wage rates in 2007. Among these circumstances demands for massive wage hikes in the public sector raise concerns that further domestic overheating could trigger a wage-price spiral.

Conclusions

The increasing price levels and salaries, together with the high current account deficit (14.5% in Q3 2007) and the significant credit growth (annual growth rate of claims on non-government sectors increased from 36,6% in Q1 2007 to 55,9% in Q3 2007 and claims on households and NPISHs from 37,6% in Q1 2007 to 48,3% in Q3 2007) pose risks for the overheating of the economy. However as a negative repercussion of the high inflation rate the increase in interest rates has already begun (the long-term interest rate increased from 4.24% in Q1 2007 to 4.67% in Q3 2007) which may curb credit demand and it can have a negative impact on the increase in investments in production output, thus it may have a negative impact on growth.

According to experts fixed exchange rates can be blamed for accelerating inflation and current account deficits (similarly to the situation in the Baltic countries) because the currency board system limits the disposable monetary tools of the central bank. In turn breaking the peg may cause problems for Bulgaria because of the balance sheet consequences of all the foreign currency (largely Euro) denominated debt, which the citizens have been acquiring throughout the years. On the whole as Bulgaria has set its target rate for entering the Euro zone in 2010, in the light of the recent developments, it has to reconsider the possible advantages and drawbacks of the fixed exchange rate system.

[1] Source: Eurostat LFS 2007

ROAD TO THE EUROPEAN UNION: THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

The former Yugoslav Republic of Macedonia (fYR of Macedonia) submitted an application for European Union (EU) membership on 22 March 2004. The European Commission was tasked by the European Council to prepare an assessment on the application. Its recommendation to the Council was to grant candidate status to the country as recognition of a closer relationship, consequently, the fYR of Macedonia obtained the status of candidate country on 16 December 2005. In addition, the fYR of Macedonia was requested to show further progress and achievements concerning the effective implementation of the Stabilisation and Association Agreement. The Commission presented its second Report to the Council on the progress achieved by the country on 6 November 2007, besides presenting a proposal for an Accession Partnership. The proposal concludes the main objectives that the country should address in preparing for the opening of the forthcoming negotiations. The Accession Partnership inspires the country's government to focus on the most important reform issues to meet the criteria.

TABLE 2. PROGRESS OF EU – MAIN STEPS TOWARDS ACCESSION

fYR Macedonia becomes eligible for funding under EU Phare programme	**1996**
Regional Approach. The EU Council of Ministers establishes political and economic conditionality for the development of bilateral relations	**1997**
The Stabilisation and Association Agreement is signed in Luxembourg	**9 Apr. 2001**
Under the Co-operation Agreement, fYR Macedonia benefits from asymmetric trade preferences with the EU	**1 Jun. 2001**
Launch of EU's Emergency Assistance Programme managed by the European Agency for Reconstruction, Operational Centre Skopje	**Sep. 2001**
Second Annual Report on the Stabilisation and Association process by the European Commission	**26 Mar. 2003**
EU takes over the international military presence in fYR Macedonia from NATO	**31 Mar. 2003**
'EU – Western Balkans Summit' was held in the framework of the summit. In this way the European Union is sending a positive political signal for the future European perspective of the Western Balkans	**Jun. 2003**
fYR Macedonia submits an application for EU membership	**22 Mar. 2004**
The European Commission approves the first ever European Partnerships for the Western Balkans	**30 Mar. 2004**
The Stabilisation and Association Agreement between the European Union and fYR Macedonia, signed on 9 April 2001, enters into force	**1 Apr. 2004**
The Stabilisation and Association Committee between fYR Macedonia and the EC, established after the Stabilisation and Association Agreement enters into force	**3 Jun. 2004**
The Stabilisation and Association Council between fYR Macedonia and the EC is established	**14 Sep. 2004**
The European Council recognizes the country as a candidate for EU membership	**16 Dec. 2005**
The Republic becomes the fourth member of the Central European Free Trade Agreement (CEFTA), joining Croatia, Bulgaria and Romania.	**Feb. 2006**
The European presents its second Report to the European Council on the progress achieved by the country	**6 Nov. 2007**

Source: Mission of the European Union to the Former Yugoslav Republic of Macedonia

Progress Reports

On 6 November 2007 the European Commission adopted its annual strategy document explaining policy on EU enlargement. The document also includes a progress report, referring to the achievements of each of the candidate and potential candidates over the last year; Croatia, the former Yugoslav Republic of Macedonia, Turkey, as well as Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo (under UN Security Council Resolution 1244). The report concludes the significant progress in the Western Balkans, however, it also highlights the fact that each country has its own weaknesses such as, for example the malfunctioning governance in the former Yugoslav Republic of Macedonia, Albania and Montenegro. The region as a whole faces challenges in the building of modern democracies and the development of political dialogue. Specifically in the case of fYR Macedonia, the European Union urges the country to improve political dialogue and intensify fight against corruption, which are considered as the largest unresolved problems up to this day. As EU Enlargement Commissioner, Olli Rehn said, “we need to see more concrete results, especially as regards the judiciary and the police reform, the public administration and the fight against corruption.”

Meeting the Criteria

Although further steps have been taken in political, economic and legal criteria throughout the past years, the country still needs to make additional efforts to meet the needs of EU accession. On 1 January 2007 a new Instrument for Pre-accession Assistance (IPA) was introduced to provide a coherent framework for assistance to the candidate and potential candidate countries. Under IPA, the intention was that the European Commission concentrates on the following areas:

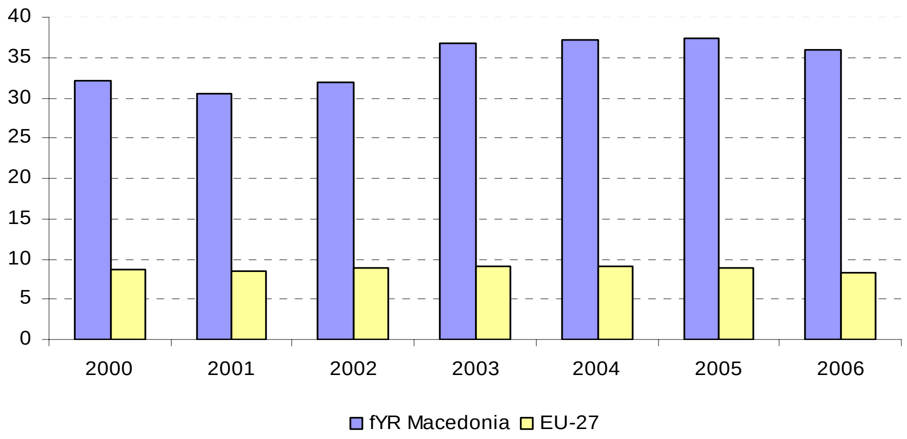
- Support to democratic institution building
- Improvement in cross-border cooperation
- Preparation for participation in the Community's cohesion and rural development policy
- Preparation for decentralised management of EU funds

According to Michael Leigh, - Director-General for Enlargement at the University “Sv. Kiril I Metodij,” Skopje – “the basic condition for membership is the stability of institutions, which guarantees the rule of law, democracy, human rights and protection of minorities.”

The commitments undertaken in the Stabilisation and Association Agreement (SAA) are being successfully implemented, although, unfortunately some slowdown could be seen in the pace of reforms in recent months. Besides the consolidation of democracy and the rule of law, the reform of the judicial system has been started. The problem of the lack of efficiency in the courts and the independence of the system, - which are key European Partnership priorities - needs to be solved urgently. The fYR of Macedonia still faces challenges in the implementation of a well-functioning, fully effective legislation. Due to continuous political tensions in the country, such changes could not be realised yet as the improvement in the electoral process or the implementation of reforms in the police system. Nonetheless, the problem of the delaying reforms could be solved in the future with the cooperation of all political stakeholders, to ensure an effective democratic process. Namely, the poor quality of cooperation between the President and the Prime Minister hinders effective functioning of the political institutions.

Concerning the economic criteria, the former Yugoslav Republic of Macedonia has been successful in the progress of a functioning market economy. Needless to mention, that a well performing legislation would fully support the progress, since the protection of the contracts of the business community, the potential investors is indispensable. Structural weaknesses still remain a major problem and have to be reduced in the fYR of Macedonia, otherwise its economic policy contributed to macroeconomic stability, solid growth and low inflation. The country showed great results in its current account balance recently, and such factors as price and trade liberalisation led to better economic performance, while increase in privatisation has also proved to have positive effects on the economy. All in all, economic integration with the EU is well advanced. Property registration has been accelerated, however, one of today's largest issues, the fight against corruption and organised crime could not prevail. Actions were taken to achieve better results but still, corruption and the lack of property registration constitute very serious problems. Another significant issue is the persistence of unemployment that has remained very high due impediments to employment creation and poor functioning of labour markets.

Chart 3. Development of the unemployment rate in the former Yugoslav Republic of Macedonia and the EU-27, 2000-2006 (%)



Source: Eurostat

Regarding regional issues and international obligations, fYR Macedonia has continued to participate actively in regional co-operation. The country gave its support to the South East Europe Co-operation Process (SEECP), the Regional Co-operation Council and the Central European Free Trade Agreement (CEFTA) in February 2006.

Concluding Remarks

The former Yugoslav Republic of Macedonia has yielded great results concerning the criteria of European Union accession, but still, unemployment, corruption and legislation remain three major problems in the eye of the European Commission. According to Olli Rehn, the institutional settlement has been given so much priority because in order to receive new Member States, strong institutions and effective functioning of decision-making should be preserved. The majority of the citizens in the country demonstrate a strong confidence in the European institutions, which is a reflection of the consensus in the public that the EU membership would bring benefits to the country.

President Branko Crvenkosvski said that fYR Macedonia will get a date for the accession talks in 2008, while the EU Enlargement Commissioner pointed out, that the 27-nation European Union is committed to starting accession talks with fYR Macedonia. However, the question is not whether Macedonia will become an EU member, but when will the membership criteria be met.

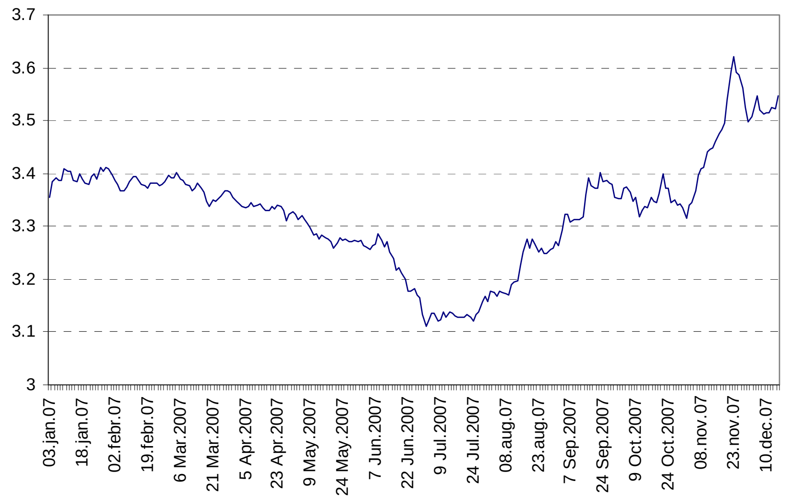
Depreciating Romanian Currency

During the second half of the year the Romanian currency depreciated significantly against the euro. While the RON/EUR exchange rate reached its bottom (3.11) at the beginning of July, it increased to above 3.60 (3.62 was the peak) at the end of November. It means the Romanian currency depreciated by 16% in the last five months. The RON/EUR exchange rate has not been that high since mid-2006.

Development of Exchange rate

The pattern of exchange rate development in Romania was similar to a rollercoaster this year. In the first six months the RON kept on appreciating against the euro. The appreciation was fuelled by EU membership and inflowing speculative capital, accordingly, RON/EUR exchange rate came down from 3.40 to 3.11 in the first half of the year. However, this exchange rate has not reflected the real ratio, the appreciation was artificial and it helped disinflation.

Chart 4. RON/EUR Exchange Rate, 2007



Source: BNRO

In the second part of the year the sentiment changed and RON started to depreciate against the euro. The main reasons for that was the worrisome external imbalance of the economy, while external negative tendencies had a limited impact on the currency.

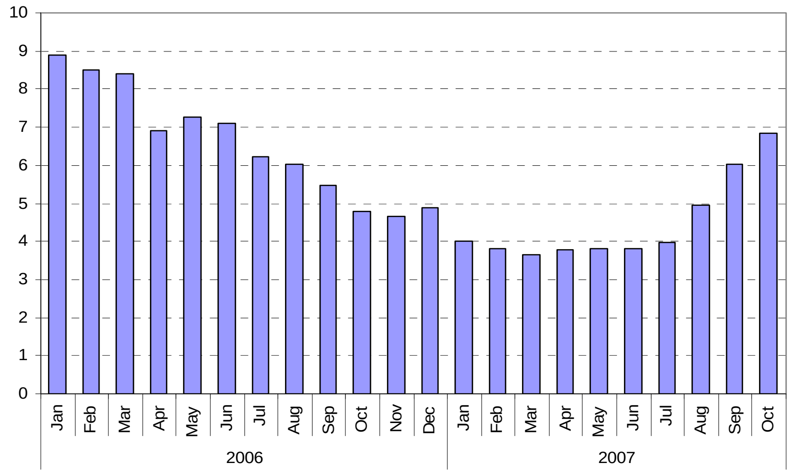
Current account deficit has skyrocketed since the beginning of the year, accordingly, at the end of September current account (CA) deficit exceeded EUR 10 billion due to the deterioration of the trade balance. In the corresponding period of 2006 CA deficit reached EUR 5.5 billion or the deficit almost doubled compared to the previous year. Consequently, current account deficit is expected to reach EUR 16.2 billion or 13.8% of GDP in 2007 against 10.3% in last year. Besides, foreign direct investments represent a decreasing share in financing current account deficit.

The worsening external balance was the result of the growth pattern based on domestic factors. The Romanian economy developed rapidly in last years fuelled by private consumption and investments. Wages increased significantly due to loose public sector wage policy, while foreign direct investments represented a large part of investments and contributed to economic growth. However, these factors boosted import of goods and services which deteriorated current account considerably.

Besides, fiscal developments were also worrying since the government planned to increase fiscal expenditures and apparently neglected growing external imbalance. The aforementioned loose public sector wage policy and other measures (such as increase of pensions) pointed to that direction, which has not helped to improve the sentiment.

As a consequence of the aforementioned developments, the Romanian currency started to depreciate and RON/EUR ratio reached 3.6 again. Together with the significant increase in agriculture product prices, the uncertainties over Leu exchange rate made the Romanian National Bank to modify its inflation target for 2007. It was increased from 3.9% to 5.7% (the original target band was 3-5%), and policy rate was also increased by 50 base points to 7.50%.

CHART 5. EVOLUTION OF CPI, 2006-2007 (%, COMPARED TO THE SAME PERIOD OF PREVIOUS YEAR)



Source: BNRO

CONSEQUENCES

The depreciation of the Leu against the euro may have a few positive consequences in next period. First, the depreciation of the currency resulted in increasing prices of imported goods. It may lead to the gradually decreasing growth of consumption; however a significant decline is not expected.

Second, the export companies welcome the depreciation of the Romanian currency since the appreciation in the first half of the year was disadvantageous for their sales at foreign markets. Their competitiveness worsened at foreign markets while wages increased considerably, now at least they can sell their products cheaper abroad.

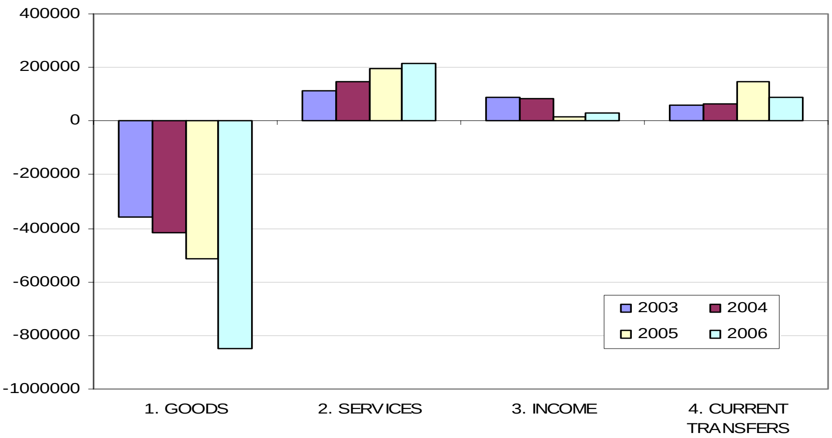
Third, the depreciation of the Romanian currency may have an impact on credit developments as well. Foreign currency denominated credits increased rapidly in last years, therefore the depreciation and policy rate increase may limit the rapid credit expansion.

Fourth, current developments may ring the bell for the government to limit its plans to increase expenditures, even if parliamentary elections will be held in 2008. Romania should avoid any pro-cyclical pressures, in accordance with IMF's policy recommendations.

CURRENT ACCOUNT DEFICIT IN MONTENEGRO

Estimates for 2007 suggested a sharp increase in the deficit to around 30 per cent of GDP in Montenegro. This forecast seemed too pessimistic in 2006, but not that in the end of 2007. According to central bank data, the current account recorded a deficit of 50.3% of projected GDP in H1 of 2007, and this is 42.8% more than in the same period of the previous year. The imbalance of goods and services deteriorated, while the small surplus of current transfers declined. On the other hand the high current account deficit was financed by foreign investments. The sum of net foreign direct investments and other investments reached 58% of GDP in this period.

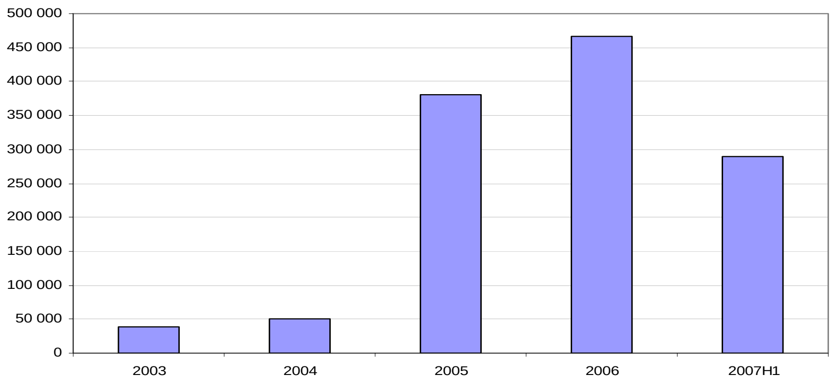
CHART 6. CURRENT ACCOUNT OF MONTENEGRO (MILLION EUR)



Source: Central Bank of Montenegro

This seemingly dramatic widening of external imbalances should be seen in the context of the extraordinary inflow of FDI in recent years. In 2005 it was EUR 375 million, or nearly 20% of GDP, and it rose further in 2006 to about EUR 500 million, on the back of further privatisations and investments in the banking sector and strong greenfield investment in tourism. Montenegro has privatized its large aluminium complex - the dominant industry - as well as most of its financial sector in recent years. The direct investment could reach the EUR 600 million in 2007.

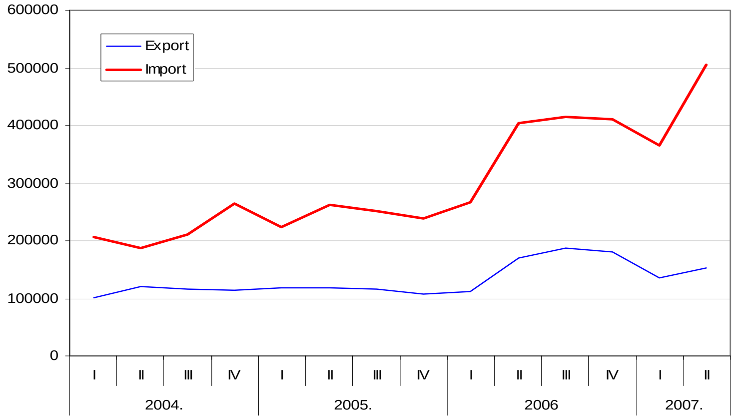
CHART 7. FOREIGN DIRECT INVESTMENT INFLOWS, 2003 - H1 2007 (MILLION EUR)



Source: Central Bank of Montenegro

The deteriorating current account balance is mainly due to surging import growth, which is fuelled by soaring private consumption and investment. A significant increase of foreign direct investments (and also in deposits to domestic sectors) reflected on a growth of domestic consumption through which the imported goods are mainly purchased. The import increased by more than 25% in the second quarter based on the same period of the previous year, and it seems to growth further in the future, while the export of goods will increase more slowly.

CHART 8. EXTERNAL TRADE, 2004 - Q2 2007 (MILLION EUR)



Source: Central Bank of Montenegro

As a transition economy, Montenegro has experienced typical problems due to the robust economic growth, and one of these problems is the large current account deficit. The widening current account seems manageable. Looking ahead, the size of the current account deficit is likely to remain very high in the short-term but decline gradually thereafter. Montenegro has a relatively liberal trade regime and exports and services are forecast to rise sharply over the medium-term. In short term only the tourism sector could compensate the large deficit of goods balance in the current account. The question is if the financial sector of Montenegro could tolerate the high increase of the monetary base, especially the accelerated credit growth in short term.