

Economic Review

2/2009

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БЪЛГАРСКА
НАРОДНА
БАНКА

130 YEARS
BULGARIAN
NATIONAL
BANK

Economic Review

2/2009



BULGARIAN
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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.

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

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Abbreviations

BIR	Base interest rate
BOP	balance of payments
BTC	Bulgarian Telecommunications Company
b.p.	basis points
CEECs	Central and East European countries
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
CZK	Czech koruna
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
GFMS	Gold Fields Mineral Services
HICP	Harmonized Index of Consumer Prices
HRW	hard red wheat
HUF	Hungarian forint
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
PLN	Polish zloty
PMI	Purchasing Managers' Index
p.p.	percentage points
PPP	Purchasing Power Parity
CIS	Commonwealth of Independent States
RON	Romanian new leu
WTI	West Texas Intermediate

Summary

Consumer and investment demand in major industrialised economies continued to decrease, albeit at significantly lower rates, which led to market expectations indicating that the global economic cycle would reach its lowest point in 2009. After that a recovery process is anticipated. Global inflation stayed at a low level. Some segments of the financial markets are still not functioning normally. Therefore, central banks continued to apply non-standard measures for providing liquidity to banks.

The effects of the global crisis on the Bulgarian economy became more pronounced from the start of 2009. This was reflected in the decreasing exports of Bulgarian goods and services, falling capital inflows and slowing domestic inflation. Domestic demand also started to decline, pushing down the balance of payments current account deficit (see also *Economic Review*, 2009, issue 1). Over the January to May 2009 period the balance on the balance of payments current and capital accounts improved by EUR 1.7 billion, with trade deficit contraction having the main contribution, underpinned by low international prices and declining domestic demand. The sustainability of the Bulgarian external position was preserved and the coverage of the total deficit on the current and capital accounts by foreign direct investment for the first five months was 67.7 per cent (see also the box entitled *Analytical Indicators for Assessing the Level of International Reserves* in this issue). A positive inflow of external financial resources into Bulgaria's economy, though lower than that in 2008, is expected by the end of 2009. Subdued economic activity and reduced domestic demand will contribute to the further decrease in the balance of payments current and capital accounts.

The real GDP drop, declining inflation and heightened caution on the part of economic agents impacted the monetary and credit aggregate dynamics. Tightening of banks' credit standards and the weaker demand supported the ongoing trend of moderating credit growth. The annual broad money growth continued to slow down. Interest rates on time deposits retained their relatively high levels, and the decline in short-term interest rates on the interbank money market and the fall in money market interest rates in the euro area have not yet spilled over lending interest rates in Bulgaria. In the following months interest rates on time deposits are expected to stabilise, reflecting the improved conditions on international financial markets. The unfavourable macroeconomic environment may entail maintenance of high risk premium, which will not allow a significant cut in the interest rates on loans.

The consolidated fiscal programme balance was positive at BGN 512.9 million in the first quarter of 2009 and at BGN 555.4 million by the end of May. Over the second half of 2009 the budget revenue decline rate is anticipated to stabilize and the nominal revenue to stay lower compared with the same period of the prior year. As a result of applying a restrictive government policy, expenditure on the consolidated fiscal programme is expected to slow down its growth rate registered in the first half of the year. Budget surplus will continue falling and there is a significant risk of a consolidated budget deficit to be reported for the year if no further measures to curb budget expenses are undertaken in addition to those adopted by the government at end-June.

In the first quarter of 2009 real GDP fell by 3.5 per cent on an annual basis, with domestic demand and net exports of goods and services having a negative and a positive contribution respectively. The economic downturn affected the bulk of industries. So far, manufacturing enterprises have been most strongly affected by the weak external demand and they are trying to limit their expenditure with a view to minimizing the negative effect of the crisis on their financial performance and retaining their competitiveness (see also the box entitled *The Global Economic Crisis: Competitiveness and the Role of the Exchange Rate* in this issue).

Over the second half of 2009 the real GDP decline is expected to moderate, although the positive contribution of foreign trade balance will not be sufficient for offsetting the contraction in domestic demand. Over the year the real GDP growth will stay negative.

In the first half of the year the trend towards decreasing inflation on an annual basis was sustained; in June 2009 it reached 2.6 per cent, underpinned mainly by falling food and fuel prices. Annual inflation is expected to decline further in the third quarter; during individual months deflation on an annual basis may be reported. Decreasing consumer demand due to expected higher unemployment and uncertainty concerning incomes will curb price rises. Inflation is anticipated to stay positive at a low level during the fourth quarter and to be within the range of 0–1 per cent at the end of 2009.

1. External Environment

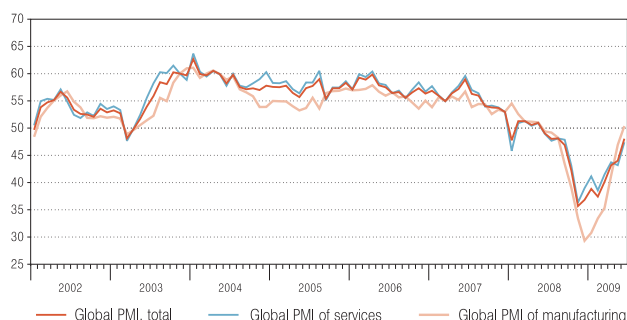
Consumer and investment demand in major industrialised economies continued to decrease, albeit at significantly lower rates, which formed market expectations indicating that the global economic cycle would reach its lowest point in 2009. After that a recovery process is expected. These expectations are supported by the significant fiscal stimulus packages initiated in G-7 countries. However, the process of economic recovery is likely to be slow and volatile due to the structural problems in most of the industrialised countries.

Central banks in industrialised countries retained or cut their interest rate levels and increased the liquidity amount in their extraordinary liquidity provision programmes. The ECB cut the reference rate to 1 per cent and announced new non-standard monetary measures with the aim of stepping up the monetary policy transmission and strengthening banking system stability. After the sizeable interventions, debt markets stabilised, and credit and market risk premia underwent significant downward adjustments. If central banks' programmes for monetary expansion are not withdrawn in time that would give rise to risks for higher inflation in the long run.

Current Business Situation

Major economic indicators reported improvements in corporations' expectations of new orders and output. A probable explanation for this development is that in recent two quarters economic agents overestimated the size of demand slump, cutting their inventories more than required. This creates conditions for strengthening the capacity utilization and relevant output increases in the next quarters. Another factor to improve these expectations is the partial demand recovery over the second quarter of the current year. In the beginning of 2009 the world trade volume fell by 20 per cent and remained at the attained low level.

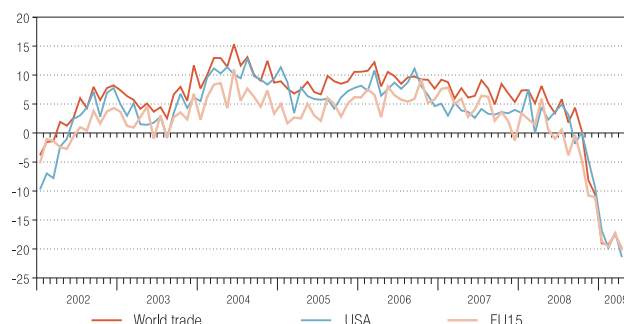
Global PMI



Sources: NTC Research, JP Morgan.

World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Some segments of the financial markets are still not functioning normally. Therefore, central banks not only provided short-term bank liquidity but also increased the transaction maturity to improve the transmission in the banking system.

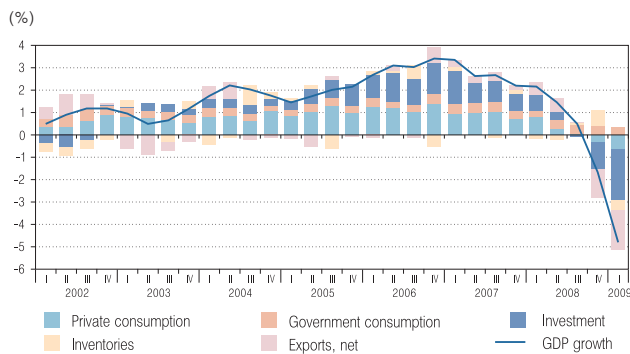
Economic indicator dynamics reflects the economic agent expectations of a gradual recovery in world growth by the end of 2009 and in the beginning of 2010.

Major commodity markets reported a certain recovery and price increases over the second quarter compared with the first one. However, inflation remained low due to the base effect of the previous year. Inflation in the industrialised countries was significantly below the target values of the central banks, but in the context of the weak demand and free production capacity, no reversal of the trend is expected over the next two quarters.

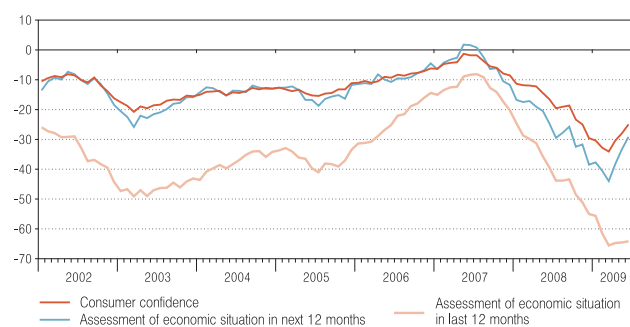
Euro Area

The recession in the euro area intensified further in the first quarter of 2009. Private consumption, investment and exports reported declines, while government consumption sustained its positive growth rates. GDP went down by -4.8 per cent on an annual basis, from 1.7 per cent over the previous period.

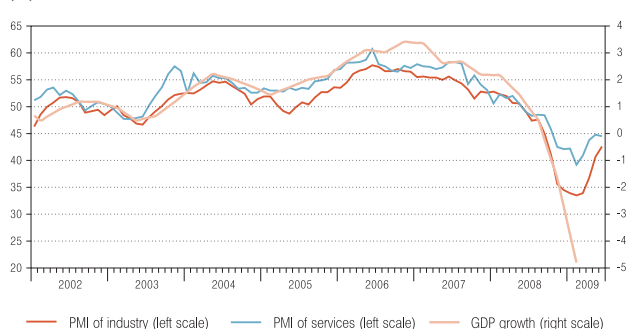
Contribution to Euro Area Growth by GDP Component (Quarterly)



Euro Area Consumer Confidence Indices



PMI of Industry and Services and Euro Area GDP Growth



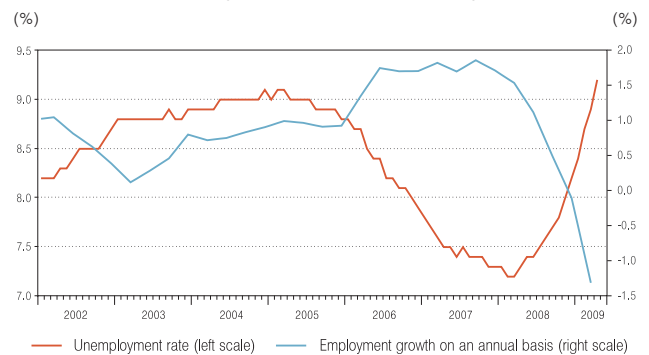
By the end of the first quarter of 2009 the downward trend in euro area economic indicators (PMI, EC indices) was reversed. Most indices have started to increase since the beginning of April. At the same time, all of them remained at

levels below their historical average values. The observed dynamics is a sign of a slowdown in economic activity over the second quarter, rather than of a beginning of an economic recovery cycle.

The outlook for euro area GDP suggests a slowdown in the decline rate of consumption and investment until the end of the year. In the short run, difficulties in monetary policy transmission caused by the financial sector performance will continue which would impede growth rates recovery to the pre-crisis levels.

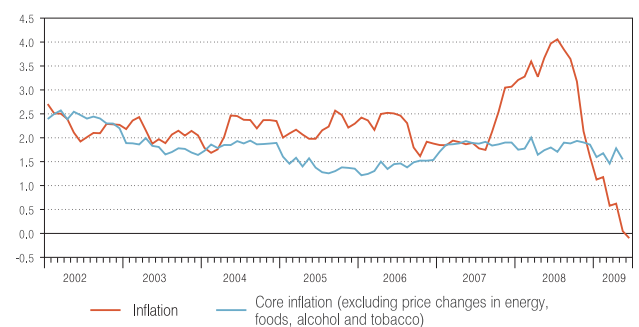
According to the early June ECB forecast, in 2009 euro area GDP will report a decline within the range of 5.1 per cent to 4.1 per cent.

Euro Area Unemployment Rate and Employment Growth



Euro Area Inflation Rate

(percentage change on same period of previous year)



The downward trend in euro area HICP inflation continued. According to Eurostat's flash estimate, in June this indicator reached -0.1 per cent annually. Fuel price decreases on the corresponding period of 2008 played a key role in this downward dynamics. This clearly pronounced trend will continue in the third quarter of 2009. However, its dynamics will start to ease over the fourth quarter of 2009. Core inflation decreased to 1.5 per cent in May possibly due to the declined labour costs.

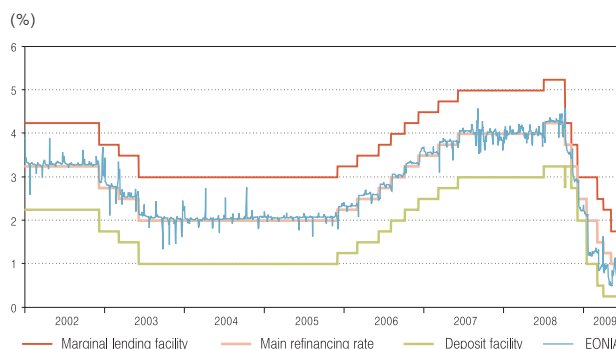
The significant free production capacity in the economy, combined with an outlook for a slow demand recovery, is a precondition for retaining the inflation trend below 2 per cent over the medium term. Over the long term there is a risk inflation expectations to increase in case of fast demand rises and delayed monetary policy reaction. At present, according to the market observations, inflation expectations in the one- to two-year horizon are within the range of 1–1.5 per cent. In accordance with ECB projections, euro area HICP inflation will fluctuate within the range of 0.1 per cent to 0.5 per cent on an annual basis until the year end.

In response to the recession intensification and downward inflation trend, in April and May the ECB gradually decreased repo interest rate by a total of 50 basis points to 1.0 per cent. In addition, the corridor of standing facilities was narrowed to 150 basis points (down 50 basis points) in May, with deposit and credit rates reaching 0.25 per cent and 1.75 per cent respectively.

The review period saw non-standard measures approved by the ECB Governing Council. They include one-year repo operations which provide bank liquidity and an asset purchase programme. The first one-year repo operation took place on 24 June, amounting to EUR 442 billion (about 5 per cent of GDP). The asset purchase programme comes to EUR 60 billion, including purchases of covered bonds issued by European banks. Overall, these measures will help to facilitate the refinancing of bank obligations, which is expected to improve the monetary policy transmission and recover lending activity.

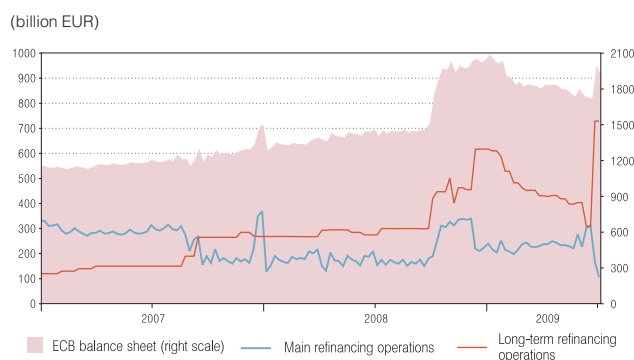
In the context of last signals of market expectation stabilization, the communication of the ECB officials shows that the ECB has already stopped cutting the repo interest rate. Also the ECB will not introduce new non-standard measures. By the end of the year, the Bank will monitor the effects of these operations on banks' refinancing conditions in order to improve the transmission to real sector agents.

Euro Area Interest Rates



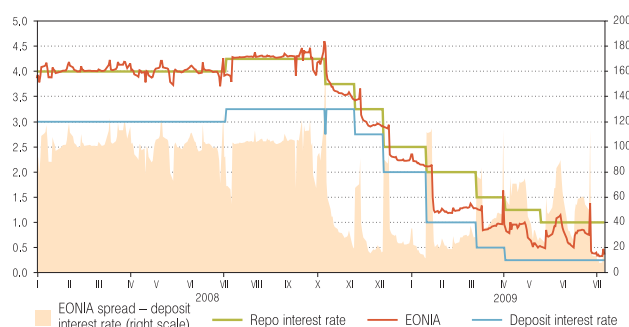
Source: Bloomberg.

ECB Balance Sheet



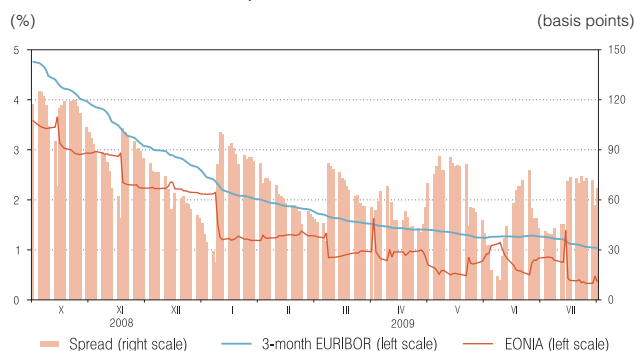
Source: ECB.

Short-term Euro Area Interest Rates



Source: ECB.

Liquidity Risk Premium (Spread between the Three-month EURIBOR and EONIA)

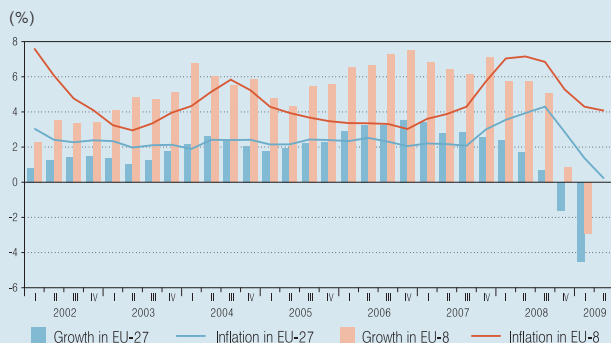


Source: Bloomberg.

EU-8*

Economic growth slowdown in the euro area affected negatively the EU countries outside the Economic and Monetary Union. GDP declines in these countries reached 2.9 per cent on an annual basis over the first quarter of 2009 (against 0.8 per cent growth in the fourth quarter of 2008).

Growth and Inflation in EU-27 and EU-8



Sources: Eurostat, own calculations.

* EU-8 includes the states that joined the EU from 2004 until now, Slovenia, Malta, Cyprus and Slovakia excluded. As of 1 January 2007 Slovenia and as of 1 January 2008 Malta and Cyprus have the status of full members of the Economic and Monetary Union.

All countries except Poland reported GDP declines, with decreases observed most significantly in the Baltic States. Private consumption, investment and export declines were the main factors for the real economic growth slowdown. Inflation continued to moderate over the second quarter of 2009, reaching 4.0 per cent on an annual basis, with fuels having the greatest contribution to this.

Real Goods and Services Trade Volume in the First Quarter of 2009

	(change on an annual basis, %)	
	Exports	Imports
The Czech Republic	-20.9	-19.8
Romania	-20.8	-33.3
Hungary	-18.6	-22.0
Bulgaria	-17.4	-21.1
Latvia	-16.4	-34.3
Estonia	-16.0	-26.7
Lithuania	-14.8	-32.9
Poland	0.5	-7.1

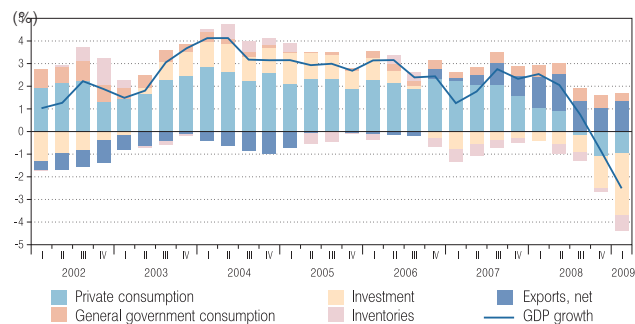
Source: Eurostat.

United States

The decline rate of the US economic activity slowed down in the first quarter of 2009. Over the same period GDP decreased by 1.4 per cent on a quarterly basis after a decline of 1.6 per cent over the previous period. Investments (0.6 percentage points), especially in machines and equipment, had the strongest negative contribution (1.5 percentage points). Falls in profits, combined with the weak demand and restricted access to financial resources, were the driving factors behind this. Given the dramatically reduced consumer demand, output inventories continued to decrease, with their contribution to overall growth estimated at -0.6 percentage points.

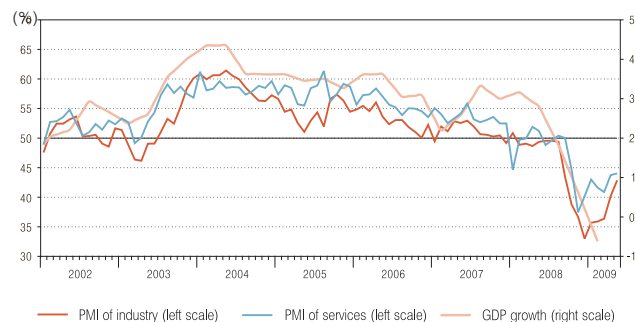
The consumer price decrease over the first quarter contributed to the rise in disposable income, which in turn supported consumption (a 0.2 per cent growth on a quarterly basis). Tax relief introduced by the new administration at the end of February also added to this, reflecting positively on disposable income. With regard to economic agent expectations of unemployment to go beyond 10 per cent at the end of the third quarter and given the continuing decline in the market value of household assets (reflecting housing price decreases), the financial position of this sector will remain unstable.

Contribution to US Growth by GDP Component (Quarterly)



Source: Bureau of Economic Analysis.

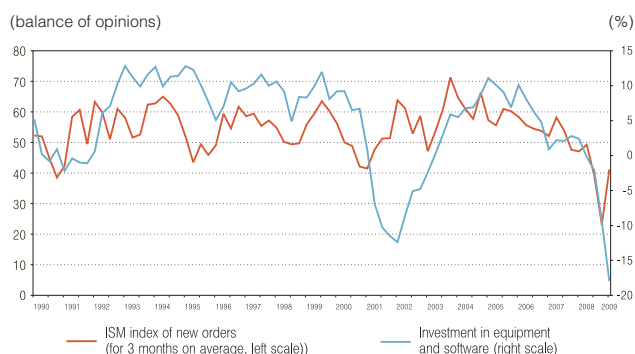
US PMI of Industry and Services and GDP Growth



Sources: Institute for Supply Management, Bureau of Economic Analysis (BEA).

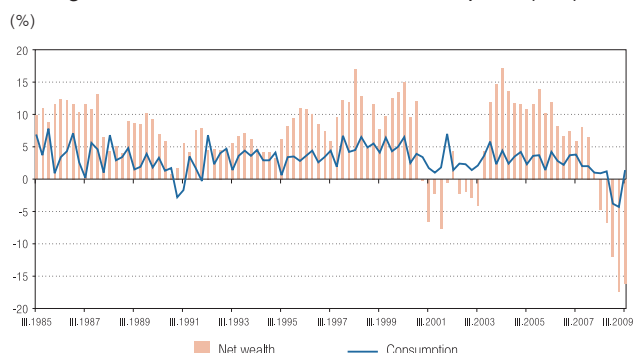
Since the beginning of April, economic indicators have reported increases in consumer confidence and in the level of industry orders, remaining still far below their long-term averages. The improvement in these economic indicators is a sign of a slowdown in the economic decline rate; however, the negative trend is not reversed yet. Given the still high historical levels in the *inventories to sales* ratio, the process of inventory liquidation is likely to continue over the third quarter, impeding economic activity strengthening.

New Orders and Investment



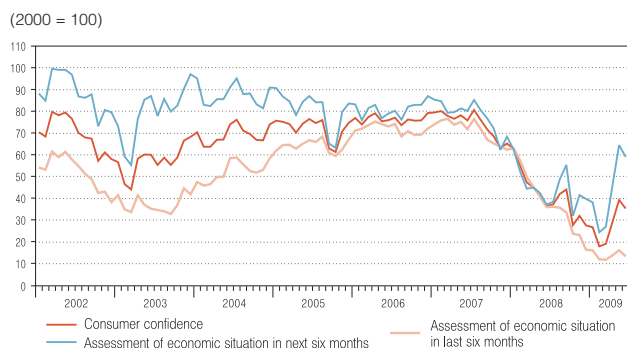
Sources: Institute for Supply Management and Bureau of Economic Analysis (BEA).

Change in Household Wealth and Consumption (Net)



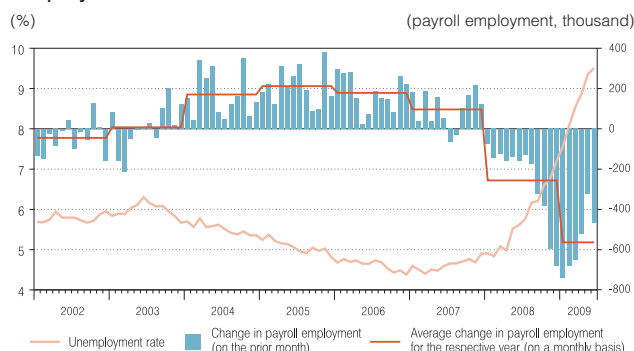
Source: Bloomberg.

US Consumer Confidence Indices



Source: The Conference Board.

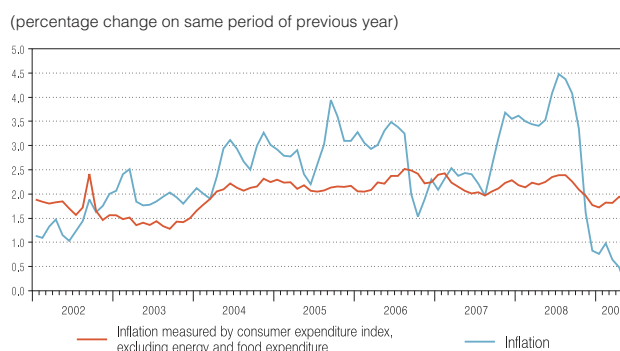
US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labour Statistics.

In the housing market, the selling price decline in April moderated to 18.1 per cent on an annual basis. Sales volume increases are observed in both the existing and new housing. However, the *unsold houses to sales* ratio remained at a historically high level, affecting further downward pressure on selling prices.

US Inflation Rate



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

Dynamics of major price indices is affected by the fluctuations in oil and other commodity prices. As a result of the base effects, deflation was reported over the second quarter. However, core inflation remained steady at positive levels. Low consumer activity and high levels of free production capacity will exercise downward price pressure in the coming months.

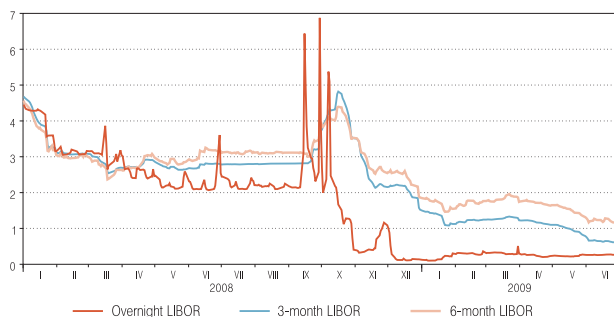
The US money market situation stabilized. Deposit interest rates in three- and six-month segments declined to historical lows, with liquidity risk premium (LIBOR-OIS spread) decreasing at lower rates. The authorities' bail-out plan for the financial sector supported the positive sentiment, which reflected on the equity market revival. The results from stress tests and successful collection of the capital required for some banks decreased significantly the concerns about a new wave of government intervention. Several institutions announced a

recovery of funds received from the government. Nevertheless, the financial sector faces the challenges of falling asset quality.

Over the second quarter the Federal Open Market Committee decisions did not change the interest rate policy, as well as the amount of asset purchases programmes. The US Federal Reserve System is likely to keep the federal funds rate within the current interval (0.00–0.25 per cent) over a longer period of time.

US Dollar LIBOR Deposit Rates

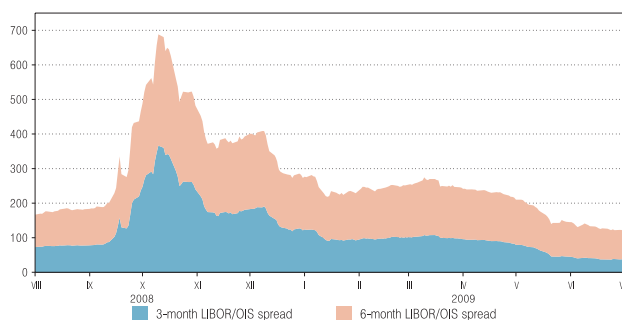
(%)



Source: Bloomberg.

Liquidity Premia (3-month and 6-month)

(b.p.)



Source: Bloomberg.

The USD/EUR Rate

Over the second quarter of 2009 the US dollar depreciated by around 5 per cent against the euro on a quarterly basis. The slight change in April was followed by a significant one-month depreciation by 7 per cent in May and some reverse adjustment in June (around 1.5 per cent). The EUR/USD rate moved within a wide range of 1.29 to 1.43 over the review quarter. In the beginning of the second quarter the US dollar came under pressure due to the increased risk appetite associated with G-20 summit programme to the amount of USD 1.1 trillion. The unfavourable euro area macroeconomic data had an opposite effect

on the US dollar. At the same time, downward revisions in the IMF global economic outlook contrasted to the US official statements signalling a slowdown in the decline rate of economic activity.

USD/EUR Exchange Rate

(USD per EUR 1)



Source: ECB.

In the middle of the period market sentiment improved due to the partial normalization of financial market conditions and expectations that global economy will soon enter a recovery phase. These expectations were supported by US and European officials' statements pointing signs of economic stabilization. The rise in fund indices and oil prices pushed down the demand for US dollars as safe haven. Another negative factor behind the USD rate depreciation involves concerns about US government securities risk increases due to rapidly growing government debt.

Signals for economic stabilization were highlighted in the official statement following the June G-8 summit where anti-crisis strategies were discussed.

The OECD outlook for Member State economic activity was revised upwards. In addition to the increased risk appetite, unfavourable factors affecting the US dollar involve challenges provoked by China and Russia which questioned the role of the US dollar as a world reserve currency. By the end of the review period rapid growth adjustments of the USD/EUR exchange rate were observed.

Over the third quarter market sentiment will continue to have a significant impact on foreign exchange markets. The US fiscal position will continue to affect adversely the US dollar exchange value. On the other hand, the euro will come under pressure due to the EU lagging economic recovery compared with the USA, as well as fears about the banking sector performance.

The Balkan Region

The effects of the deepened global economic crisis became more clearly pronounced in the Balkans. All countries in this region, except Greece, reported GDP declines over the first quarter of 2009. Industrial enterprises' output significantly fell, reflecting cuts in export orders. A significant decline in investment and private consumption was observed. The most severe downturn by 13.8 per cent was registered in Turkey, where private consumption fell by 9 per cent and investment in fixed assets contracted by 30 per cent. The significant contribution of net exports by 7 percentage points was a result of the 32 per cent import decrease. Industrial production in all Balkan countries fell by almost 15 per cent in the first two months of 2008. Over the second quarter inflation continued to decline, with Macedonia reporting deflation of 0.6 per cent on an annual basis.

Recovery in the Balkan countries over the second half of the year will mostly depend on the rates at which euro area growth and imports will recover.

Real Growth and Inflation in Balkan Countries (Quarterly)

	2007	2008					2009	
	Total	I	II	III	IV	Total	I	II
Growth (on the corresponding period of previous year, %)								
Bulgaria	6.2	7.0	7.1	6.8	3.5	6.0	-3.5	
Greece	4.0	3.4	3.3	2.9	2.2	2.9	0.3	
Macedonia	5.9	5.6	6.7	5.8	2.0	4.9	-0.9	
Romania	6.2	8.2	9.3	9.2	2.9	7.1	-6.2	
Turkey	4.7	7.3	2.8	1.2	-6.2	1.1	-13.8	
Croatia	5.5	4.3	3.4	1.6	0.2	2.4	-6.7	
Serbia	6.9	8.5	6.0	4.9	2.8	5.4	-3.5	
Inflation (averaged for the period, %)								
Bulgaria	7.6	12.4	14.0	12.6	9.1	12.0	5.1	3.4
Greece	3.0	4.3	4.8	4.8	3.1	4.2	1.8	0.9
Macedonia	2.3	9.5	9.9	8.4	5.5	8.3	0.9	-0.6
Romania	4.9	8.0	8.6	8.2	6.9	7.9	6.8	6.2
Turkey	8.8	8.8	10.3	11.7	10.9	10.4	8.4	5.7
Croatia	2.9	5.9	6.5	7.4	4.5	6.1	3.8	3.3
Serbia	6.4	13.4	15.8	12.3	10.2	12.9	9.7	8.2

Sources: Statistical institutes and central banks of respective countries.

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

Crude Oil

Market expectations of global economic activity recovery were the major factors for crude oil price rises over the second quarter of 2009. Brent crude oil prices grew by approximately 50 per cent, reaching its highest value of USD 70–72 since last October. In early July, the incoming negative macrodata of leading economies damped market expectations of the growth recovery rate, with oil prices falling to about USD 62–65 *per barrel*.

Crude oil supply in the first half of the year declined and by May 2009 OPEC cut its production by about 5 per cent on an annual basis. This decline was not sufficient to offset world demand slowdown. Therefore, data of the first quarter of

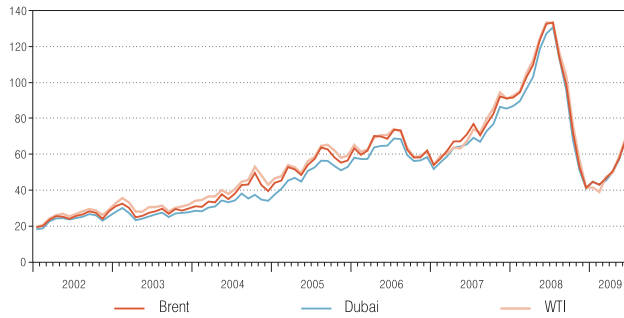
2009 showed an excess of supply over demand. Preliminary data on oil products inventories in OECD countries over the first quarter reported a significant increase by approximately 5 per cent on an annual basis, instead of the traditional seasonal declines. Almost half of the inventories growth was generated in the USA.

International Energy Agency forecasts as of July point to expectations of global declines in crude oil demand by 2.9 per cent in 2009 (almost the same as the March forecast).

Market expectations are for oil price fluctuations within the range of USD 60–80 *per barrel* in the second half of 2009.

Crude Oil Prices

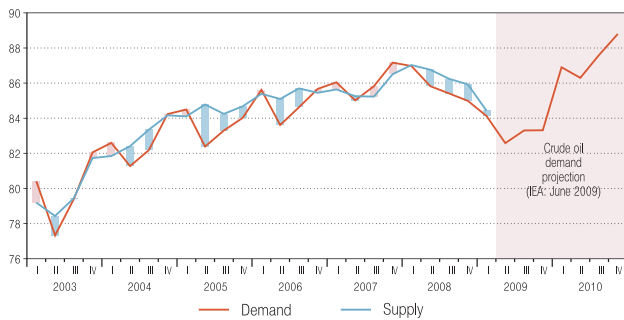
(USD per barrel)



Source: World Bank.

World Crude Oil Demand and Supply (Quarterly)

(million barrels per day)

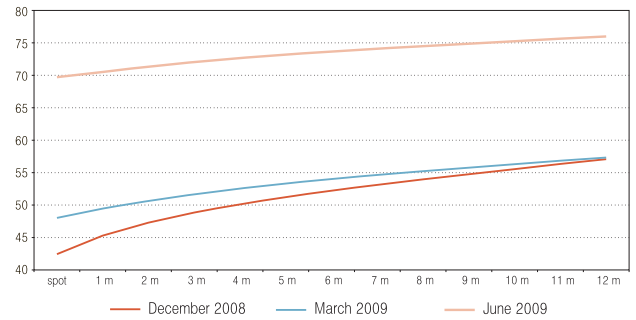


Source: IEA.

WTI Crude Oil Futures Prices

(Average Price of the Contract in the Corresponding Month)

(USD per barrel)



Source: JP Morgan.

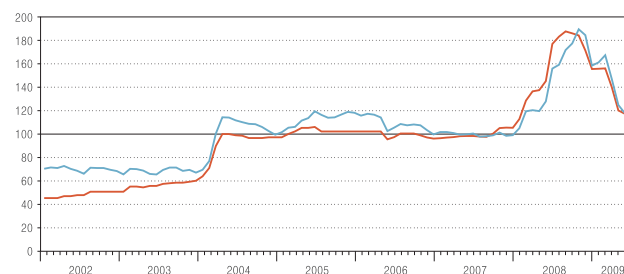
Major Raw Material and Commodity Prices

Over the second quarter of 2009 metal prices went up by 16 per cent on a quarterly basis. Non-ferrous metals' prices increased significantly: copper (36 per cent), lead (30 per cent), zinc (26 per cent) and nickel (23 per cent). This increase was due to the expectations of coming industrial recovery in Asia and the USA. Steel product prices fell by 22 per cent compared with the first quarter due to the raw material price slowdown. Steel production fell by almost 22 per cent in the

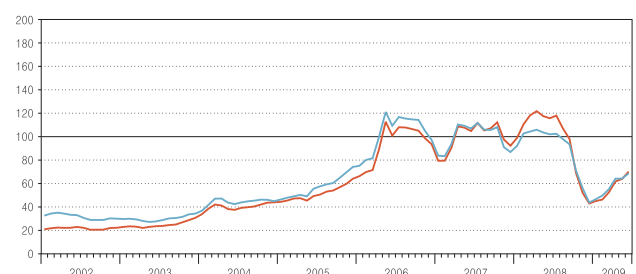
Price Indices of Major Commodities and Commodity Groups

(2007 = 100)

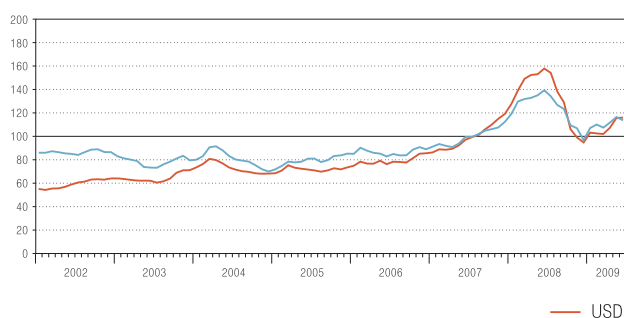
Steel



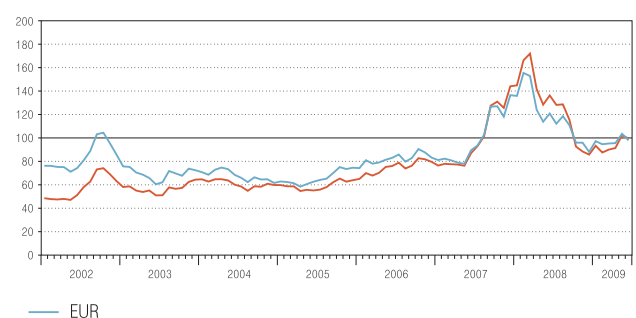
Copper



Food



Wheat



Sources: World Bank, BNB.

first five months of the year compared with the same period of 2008. The output decrease was unevenly distributed across regions. China, India and Iran, occupying 42 per cent of world output, retained their output at the record levels of 2008, while the USA and Europe reported an almost 40 per cent drop. Market expectations suggest rises in metal prices over the third and fourth quarters, reflecting the global economy recovery.

Food indices increased over the second quarter, with a 10 per cent rise on a quarterly basis. Vegetable oil prices contributed most (a 19 per cent growth) to the increases, while cereals reported lower price rises. Corn and wheat prices rose by about 6 per cent, while rice prices fell by approximately 3 per cent. According to the US Department of Agriculture and the International Grains Council, global wheat yields during the 2009 to 2010 period are expected to slow down by approximately 5 per cent after the record levels of the prior season. According to the projections of the US Department of Agriculture, lower yields in the USA and EU will contribute most significantly to the decline (a decline between 20 per cent and 30 per cent is expected in Italy, Spain, Hungary, Romania and Bulgaria). Higher yields in Pakistan, Iran, Argentina, Australia, Kazakhstan and Turkey are expected to compensate to some extent this decrease. Wheat inventories are expected to grow by almost 9 per cent during the season. Price expectations are for a slight increase until the year end due to the forecasts for demand rises.

The sea freight price index (BDI), which is the leading indicator of world trade growth, increased over the second quarter. This is likely to have an effect on raw material and commodity prices over the next quarters.

Gold

Over the second quarter of 2009 the average gold price (one-month futures) went up to USD 922.6 *per* troy ounce (a 1.5 per cent growth on a quarterly basis). Measured in euro, prices reported a decline of 2.6 per cent as a result of the euro appreciation. Price level volatility declined steadily, approaching pre-crisis levels.

Spot Price of Gold



Source: The London Bullion Market Association.

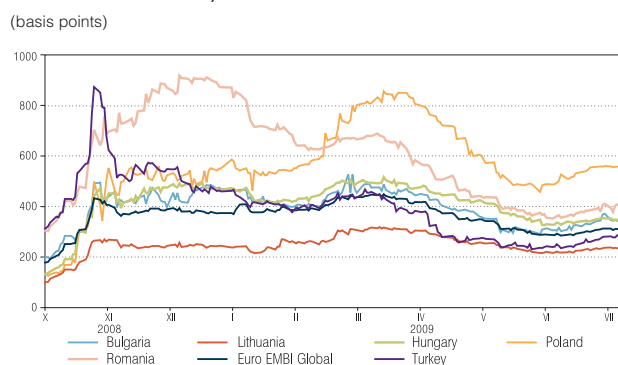
Over the review period the gold price was affected by investors' concerns about the US debt position, accumulation of medium-term inflation tensions and dollar stability as an investment asset. This increased significantly its correlation with the US dollar and commodity and stock market indices, with comparatively high levels reached especially in May and June. The major driver of the precious metal price changes was the investor sentiment of the global economic performance and risk appetite dynamics.

The demand was focused on both physical gold and purchases of ETF assets.

Bulgarian External Debt Dynamics on International Financial Markets

In the second quarter of 2009 the yield spread of the Central and East European countries government debts declined and JP Morgan Euro EMBI Global index fell by 105 basis points. Its fluctuations were within the 286 to 418 basis point range and by the end of the quarter it reached 313 basis points.

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



Source: JP Morgan.

During the first two months of the period the index followed a steady downward trend reaching values below 300 basis points by end-May and in early June. The rise of investor risk appetite and optimism strengthening were the major factors showing that the global recession bottomed out. At the very end of the period, these perceptions were revised which resulted in a slight increase in indices.

Over the review period market participants' perceptions about the Central and Eastern Europe reported partial improvements compared to the first quarter. It is a result of the overall confidence increase in this market group, rather than improvements in the economic outlooks in the short

run. The last months of the year saw the incoming news about reform programmes' performance by the countries which entered agreements with the IMF.

Bulgaria's government external debt spreads, measured by the JP Morgan index, exhibited a downward trend in April and May in line with the general trend. At the end of the quarter an increase related to the external observers' concerns about Bulgarian fiscal position and future results of parliamentary elections was observed. The index fluctuated within a wide range of 291–446 basis points and by the end of June it stood at 346 basis points.

2. Financial Flows, Money and Credit

The balance of payments current account deficit improved since the beginning of 2009 reflecting mainly the decreased trade deficit. According to preliminary balance of payments data for the January to May 2009 period, the overall deficit on the current and capital accounts amounted to EUR 1.7 billion (compared to EUR 3.4 billion deficit in the same period of 2008) and foreign direct investment covered 67.7 per cent of the deficit.

The measures initiated in early 2009 by the central bank and the government to increase liquidity in the economy and counteract the effects of the global crisis of early 2009 helped local economic agents to reduce their foreign liabilities and to boost their foreign assets.¹ Net capital inflow remained positive for the first five months of 2009 but lower than the corresponding inflow in 2008. A surplus of EUR 519.8 million was reported on the balance of payments financial account for the January to May 2009 period and balance of payments total balance recorded a deficit of EUR 1.03 billion.

Cash Flows Which Prompted Significant Changes in Gross International Reserves

(million EUR)

External flows	January–June	
	2009	2008
Total for the period	-1 072	1 089
Purchases and sales of euro	-1 310	1 209
at tills	-22	-22
banks, incl.	-1 288	1 231
bank's purchases	59 877	56 998
bank's sales	-61 165	-55 767
Flows on accounts of banks, the MF, etc.	238	-120
Minimum required reserves	-72	103
Government and other depositors	310	-223

Source: BNB.

The Issue Department balance sheet figure reached BGN 23.27 billion (EUR 11.9 billion) by end-June 2008: a decrease in assets by BGN 1.6 billion (EUR 0.8 billion) since early 2009. The average monthly coverage of imported goods and services by BNB international reserves reached 7.5 months for the January to May 2009 period against 5.5 months a year earlier.²

Financial Flows and External Position Sustainability

According to the balance of payments and external debt data the sustainability of the external position was preserved. A positive net inflow of financial resources into Bulgaria's economy, though lower than that in 2008, is expected in the second half of 2009. Slower economic activity and reduced domestic demand will contribute to the further decrease in the balance of payments current account deficit.

For the January to May 2009 period the balance of payments financial account surplus was EUR 519.8 million, resulting mainly from: 1) attracted foreign direct investment worth EUR 1133.6 million; 2) an increase by EUR 89 million in net financial obligations of the *general government* sector; and 3) a decrease by EUR 80.1 million in foreign currency assets and deposits. Domestic banks repaid external loans

totalling EUR 421.7 million and non-resident deposits in them went down by EUR 62.7 million over the first five months of the year.

BNB international reserves decreased by about EUR 1.03 billion between January and May 2009 (excluding changes due to valuation adjustments) reflecting mostly the measures initiated by the

¹ For further details see the *Financial Flows, Money and Credit* section in this issue and the box entitled *The Principles of Operation of the Currency Board in Bulgaria*, *Economic Review*, issue 1, 2009.

² The indicator is computed as a ratio (in months) of BNB reserve assets by the end of the review month and the average monthly imports of goods and services as from the beginning of the respective year. There are various approaches for computing this indicator (see the box entitled *Analytical Indicators for Assessing the Level of International Reserves* in this issue).

government and the central bank³ which helped enhance the liquidity in the economy and allowed for reducing the external obligations of domestic economic agents.

The balance of payments flows dynamics in the second half of 2009 will depend mainly on the changes in global economic situation and particularly on developments in economic processes in the euro area which are characterised by strong volatility. Based on the data after September 2008, it could be concluded that the net capital inflow in Bulgaria will remain positive in the second half of 2009 but the amount will be lower compared with the corresponding period in 2008. The pursuit of an economic policy intended to maintain macroeconomic stability is a key factor behind the sustained long-term investment interest in Bulgaria and the attraction of capital flows mostly in the form of foreign direct investments.

The sustainability of external position of the economy is based on the structure of financial and capital inflow which posted significant growth in recent years. Capital inflows were mainly in the form of foreign direct investments and external borrowing of intercompany or long-term nature. As a result Bulgaria's economy is characterised by low risk to potential speculative capital withdrawal. The share of portfolio investments continued to decrease in Bulgaria's gross international liabilities falling from 3.5 per cent by the end of 2008 to 3.3 per cent by end-March 2009. The share of short-term external debt relatively stabilised in Bulgaria's total gross foreign debt accounting for 36.1 per cent by April 2009. International reserves ensured a 89.4 per cent coverage of the short-term external debt which to a great extent includes the resources provided by foreign parent banks to domestic banks.⁴

According to preliminary data, foreign direct investment in Bulgaria came to EUR 1133.6 million between January and May 2009.⁵ Over the same period of 2008 foreign direct investment data were revised upwards several times and currently they amount to EUR 2443.9 million. The compari-

³ See footnote 1.

⁴ See the box entitled *Analytical Indicators for Assessing the Level of International Reserves* in this issue.

⁵ Data subject to regular revisions upon receiving additional information from corporations. Recent years have witnessed systematic upward revision of original data on foreign direct investment inflows; therefore the comparison of original 2009 data with the 2008 data that have been revised several times is not correct. With the revision of the total volume of foreign direct investments their original composition by type and industry has changed.

son between the data for the January to May 2009 period and initially reported data for the corresponding period of 2008 points to a decrease in foreign direct investment inflow by 33.5 per cent.

By May 2009 foreign direct investment accounted for 14.1 per cent of annual GDP for the last four quarters. Foreign direct investment net inflow is expected to be sustained during the second half of the year but its share in GDP will fall.

Investments attracted in the first five months of 2009 are mostly in the form of an equity share: EUR 795.6 million (70 per cent of the total inflow). Between January and May 2009 no funds were received from privatization transactions and the equity share investment matched that in the corresponding period of 2008 (EUR 875.4 million). Between January and May non-residents' investment in real property came to EUR 227.5 million (EUR 577.9 million in the same period of 2008). The trend toward lower non-resident investment in acquiring real estate in Bulgaria was sustained. Regardless of the decrease in these investments on an annual basis, they remain at higher than average levels observed over the years up to 2006 when the non-residents' interest in acquiring real estate in Bulgaria sharply intensified.

Between January and May 2009, EUR 191 million were attracted in the form of *other capital* (16.8 of total inflow). Initial estimates of *reinvested earnings* point to a decrease of EUR 64.3 million on an annual basis to EUR 147 million over the review period.

By end-2008 *real estate operations and business services* (22.8 per cent), *manufacturing* (18 per cent), *financial intermediation* (17.5 per cent), and *trade and repairs* (14.3 per cent) occupied the largest shares in the structure of cumulative foreign direct investment structure by industry. These industries retained to a great extent their major significance in the first quarter of 2009, with the largest shares in foreign investment inflow recorded by *financial intermediation* (35.6 per cent), *trade and repairs* (19.2 per cent) and *real property and business services* (13.7 per cent).

The composition of FDI by country in the January to May 2009 period suggests that the foreign direct investments attracted from the Netherlands (17.8 per cent), Luxembourg (11.7 per cent), and Austria (11.4 per cent) accounted for the largest shares.

Bulgaria's gross external debt went down by EUR 174.9 million between January and April 2009. Net repayment of borrowed funds amounted to EUR 589.8 million (revaluations and the net change in trade and revolving loans excluded). Over the four months loans and deposits of EUR 1760.9 million were received, and principal payments of EUR 2350.7 million made. As a result by end-April 2009 Bulgaria's gross external debt reached EUR 36.55 billion or 106.4 per cent of the reported GDP on an annual basis.

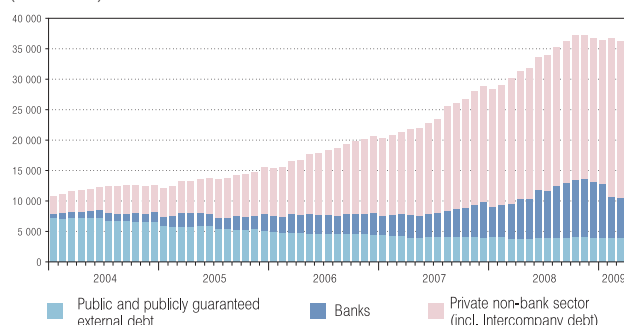
In the first four months of 2009 external debt of the *general government* sector posted a decrease of EUR 64.7 million coming to 7.3 per cent of Bulgaria's total debt. The total amount of public and publicly guaranteed debt fell by EUR 59.1 million.

Private non-guaranteed external debt declined by EUR 115.8 million between January and April, with long-term loans repaid by domestic banks (EUR 462.6 million) and closed non-residents' deposits contributing most significantly (EUR 183.8 million). Banks' debt to foreign parent banks incurred in connection with their activity in Bulgaria occupies a large share in banks' external debt (79.3 per cent by March 2009). Reduced minimum required reserves allowed banks to decrease the amount of their gross external debt by EUR 1.17 million between December 2008 and April 2009 and thus banks' share in Bulgaria's gross external debt fell to 23.2 per cent.

In the first four months of 2009 intercompany loans increased by EUR 368.1 million and their share in total debt rose to 36.3 per cent. This dynamics points to a long-lasting interest of foreign owners of local companies.⁶

Gross External Debt

(million EUR)



Source: BNB.

⁶ Based on the current revisions, it may be expected that the registered volume of intercompany loans will increase in the future.

Gross external debt service in the January to April 2009 period reached EUR 2614.9 million compared to EUR 2874.9 million in the corresponding period of the prior year. For the first four months of 2009 residents declared new loans to be extended by non-residents to the amount of EUR 2047.5 million (new loans declared for the same period of 2008 were EUR 2647.2 million). The largest share in actual borrowings for the January to April 2009 period is occupied by loans related to direct investment (42 per cent) and banks (30 per cent). These data show that local economic agents still have access to international financial markets, but the demand for new debt financing is probably weaker in the context of worsened economic situation.

The average weighted interest rates on new loans declared between January and April 2009 suggest a decrease (on an annual basis) in the cost of external borrowed funds: in euro by 2.2 percentage points to 2.9 per cent.⁷ The differential between interest rates on long-term loans to corporations, extended by domestic banks, and interest rates on external long-term loans remained positive. The interest rate differential on euro-denominated loans was 5.0 percentage points and that on US dollar-denominated loans was 3.1 percentage points respectively. Interest rates on domestic and external loans are not directly comparable due to the different characteristics of corporations with access to both markets. Nevertheless, lower interest rates on external loans preserve the incentives for external borrowing by Bulgarian companies.

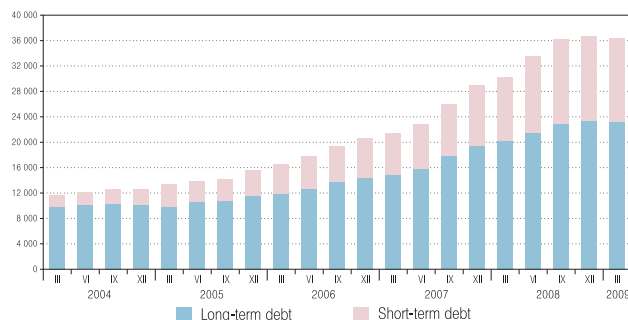
March 2009 saw no notable changes in the structure of private non-bank external debt by industry.⁸ *Real estate operations, lessors activities and business services* retained their relatively large share in the external debt of *other sectors* (18.1 per cent) and in intercompany loans (20.6 per cent). Within the structure of *other sectors'* debt, the *electricity, gas and water supply* (19.5 per cent) and *financial intermediation* (14.9 per cent) had more significant shares, while in intercompany loans, *financial intermediation* (21.9 per cent) occupied the largest share.

⁷ Euro-denominated loans account for 99 per cent of the total amount of declared new loans by non-residents in the first quarter of 2009.

⁸ Excluding trade and bond loan liabilities.

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Gross external debt maturity structure remained relatively stable, with the share of short-term external debt accounting for 36 per cent as of April 2009. The decline in non-residents' deposits with domestic banks by EUR 183.8 million in the first four months of 2009 contributed most substantially to the overall fall in the short-term debt.

By March 2009 the euro retained its leading position (85.8 per cent) in the gross external debt currency structure. The euro occupied the largest share (93.1 per cent) in intercompany loans and the smallest share in the *general government* sector (70.6 per cent). This foreign currency structure significantly reduces risks associated with exchange rate fluctuations in the international markets.

Bulgaria's gross foreign assets went down by EUR 868.8 million between January and April 2009 reflecting mainly the decline in BNB international reserves by EUR 921.3 million. As a result of the gross external assets and gross external debt dynamics, net external debt increased by EUR 693.9 million in the first four months of 2009, reaching 57.8 per cent of the GDP on an annual basis.

In recent years capital inflow on the balance of payments financial account determined to a great extent the current account flows dynamics. This dependence was sustained in the first five months of 2009. Given the lower volume of foreign capital inflow in the January to May 2009 period the total current and capital account deficits contracted to EUR 1675.4 million against EUR 3365 million in the corresponding period of the prior year. By May 2009 current and capital account deficit (on an annual basis) accounted for 19.4 per cent of GDP reported for the last four quarters against 26.5 per cent a year earlier.

In the first five months of 2009 the trade deficit decreased most substantially, by EUR 1287.9 million on the corresponding period of 2008, to reach EUR 2060.5 million. Between January and May 2009 imports marked a decrease of 33.4 per cent on an annual basis and exports fell by 30.7 per cent. The fast declining imports pertain to slower production activity and correspondingly lower demand for commodities, materials and energy resources and the weaker investor and consumer demand in Bulgaria.

In the January to May 2009 period the balance on services, the capital account and balance on income improved by EUR 228.6 million, EUR 94.6 million and EUR 180.1 million respectively as compared to the corresponding period of 2008. Net transfers are the only current account component which worsened in the first five months of the year (by EUR 101.7 million).

The balance on trade in services recorded a deficit of EUR 16.9 million over the January to May 2009 period, while the deficit in the corresponding period of the prior year was EUR 245.5 million. This improvement was mostly attributable to the lower external transport, tourist and other business services costs (coming to a total of EUR 432.4 million), rather than to higher receipts. On the credit side, no improvement was reported in any item, with income from transportation and tourist services exhibiting a decline by EUR 203.7 million on an annual basis.

The improvement in capital transfers was almost entirely attributable to the EU funds inflow. Net capital transfers to the *general government* sector came to EUR 290.8 million, posting an increase of EUR 90.4 million on an annual basis.

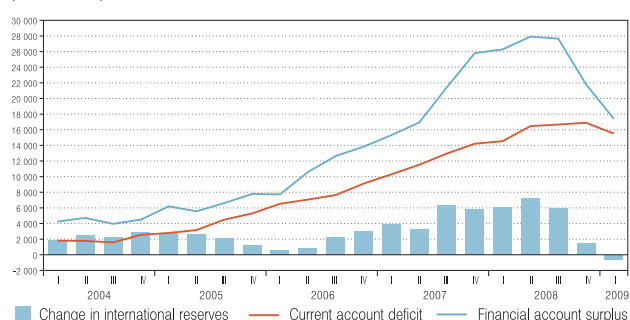
Over the first five months of 2009 the balance on income improved by EUR 180.1 million on an annual basis to a deficit of EUR 191.3 million, with the reported improvement being ascribable mostly to the lower income paid on foreign direct investments in Bulgaria (by EUR 207.1 million) and the increased income on realised portfolio investments abroad (by EUR 57.7 million). Income from compensations to employees exhibited a decline by EUR 97.3 million.

Net current transfers reported for the January to May 2009 period amounted to EUR 297 million: down EUR 101.7 million on an annual basis. This was attributable to the largest extent to the lower

EU funds inflow. The transfers received from the EU exceeded the payments on Bulgaria's contribution to the Community budget and contributed to the positive net transfers of EUR 44.6 million to the *general government* sector. The receipts in the form of private current transfers fell by EUR 20.3 million on an annual basis. Transfers abroad also posted a decline of EUR 40.2 million. As a result net transfers to the private sector increased by EUR 19.9 million.

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

(million BGN)



Source: BNB.

Taking into account the available data on the balance of payments flows and external debt, we may confirm the conclusion that there are no signs of serious risks to the sustainability of Bulgaria's external position amid the global economic crisis. The analysis of major factors which influence the Bulgarian economy external position in recent months reveals that in addition to the global revaluation of risks and the volume of investments directed to emerging markets, the measures taken by the central bank and the government have played a key role in counteracting the effects of the crisis.

Expectations for the third and fourth quarters of 2009 are characterized by high degree of uncertainty due to the unclear horizon and the speed of overcoming the tension in international financial markets and the recession which affected most of Bulgaria's major partner countries. Lower capital inflow and slower economic activity in Bulgaria contributed to the improvement of the balance of payments current and capital account deficit which is expected to range within 12–13 per cent of GDP on an annual basis by the close of 2009.

Analytical Indicators for Assessing the Level of International Reserves

Theoretical and empirical studies of various episodes of financial and macroeconomic instability resulted in the introducing a set of indicators which should play the role of an early warning system in case of possible future problems. These indicators are used for assessing public or private economic agents' vulnerability with a view to their current liquidity and future solvency. Since the system of these indicators has not been unified and provides no reliable risk assessment, its application and interpretation should take into account specific features in each individual case. In addition, many of these indicators, which historically would have been a timely preventive signal of a given crisis episode, are totally unreliable under other circumstances.

The analysis of Bulgaria's sustainable economic development is a good example of how such indicators cannot be used mechanically; they should be considered comprehensively, in the light of the economic system's functioning. In assessing the macroeconomic risks that Bulgaria's economic development is facing, indicators related to the level of the BNB international reserve are widely used. These indicators comprise the ratios between the BNB reserves and the short-term external debt, Bulgaria's external financial needs* or the foreign currency deposits, as well as the average monthly coverage of imported goods and services by BNB international reserves. The need for making an in-depth and comprehensive analysis and reporting of the specific features is well illustrated by the dynamics of the indicators displayed in the chart below.

One of the most frequently cited indicators is related to the short-term gross external debt coverage by BNB international reserves. Since this ratio decreased during the last two years and from end-2008 it became lower than 100 per cent, this may arouse concerns regarding the capacity of meeting the forthcoming external debt obligations in the course of the year. This conclusion, however, does not take into account the main mechanisms in the development of the economic processes in Bulgaria. In the structure of the Bulgarian short-term external debt as of April 2009, external obligation of local banks comprised 51 per cent. The bulk of these resources provided mainly by their foreign parent banks

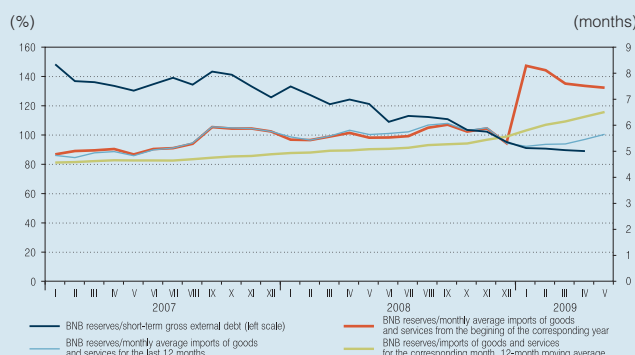
* Analysts define the Bulgaria's external financial needs indicator in various ways with the purpose of taking into account the international payments that have to be made within a year (on, *inter alia*, the short-term external debt and the current account deficit).

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aimed at broadening their scope of operations in Bulgaria. As in the total funds provided to local banks by their foreign parent banks the major portion is in the form of deposits, they are methodologically reported as short-term external obligations, although they reflect a long-lasting interest, rather than being short-term in nature.

Analytical Indicators for Assessing the Level of BNB International Reserves



Source: BNB.

The second indicator, the provided coverage of imported goods and services by BNB international reserves, also calls for tentative interpretation. The indicator measures the time period (the number of months) in which Bulgaria would be able to keep the volume of its imports unchanged in the absence of other international financial inflows and outflows.** On the one hand, the relation between the volume of imports and the change in the central bank's international reserves is indirect, with reserves resulting from all international transactions. On the other hand, the indication is usually computed by means of historical data, and the conclusion about future periods is based on it. Thus, it is implicitly assumed that the reported volume of the imports is a good indicator of their level in the near future as well, which is incorrect, given the current contraction in foreign trade flows. Therefore, it would be more precise if the expected volume of imports during the following 12 months is used in computing this indicator, as is the practice of some of the analysts, rather than the historical volume of previous periods.

Since early year the dynamics of the coverage of Bulgarian imports of goods and services by BNB international reserves has been improving (three different approaches of computing the indicator by means of reported data are presented in the chart). This reflects the severe downturn in the volume of imports, resulting from the reaction of local economic agents to the worsened economic environment. Under these circumstances the interpretation of similar dynamics cannot be unequivocal and it should not be assumed that there is a strong positive development.

In using indicators for assessing the risks to Bulgaria's economic development, their specific features should be taken into account, as well as the overall macroeconomic development. Seen in the context of the general macroeconomic information about Bulgaria, these indicators give no ground to revise the conclusion that the external position of the Bulgarian economy retained its sustainability amid the global economic crisis.

** It is generally assumed that the three-month import coverage by international reserves is the minimal level causing no liquidity problems.

Moreover, it should be noted that as a whole foreign obligations are not serviced mechanically by the central bank's reserves. For example, over the January to April 2009 period an external debt to the amount of EUR 2.6 billion was serviced; nevertheless, due to received new external loans (coming to EUR 1.8 billion) and an inflow of foreign direct investment (EUR 0.96 billion), the net result on Bulgaria's financial account is positive, comprising EUR 0.3 billion for the period. Private economic agents service their external liabilities mainly by their own foreign currency proceeds received from exports of goods and services or from returns attained from foreign asset holdings. Another major mechanism that is used in practice is the re-negotiating and rescheduling of obligations, which essentially facilitates short-term gross external debt servicing.

Monetary Aggregates

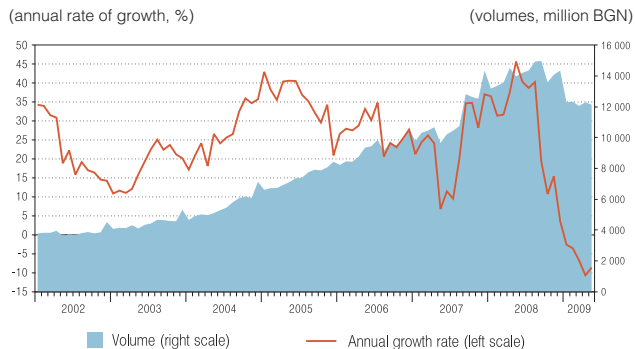
The annual broad money growth continued to moderate impacted by the slower real GDP growth, lower inflation and moderate lending growth. Interest rates on time deposits remained relatively high.

Between April and May 2009 reserve money went on exhibiting a negative growth on an annual basis and by end-May 2009 recorded a decline by 13.1 per cent on the corresponding month in 2008. By end-May banks' deposits with the BNB saw a decline by 26.9 per cent reflecting the lower amount of required reserves after the rate of minimum required reserves to be main-

tained by banks in the BNB had been decreased at the close of 2008 and in early 2009. Concurrently, the annual growth of currency in circulation continued to slow down and in April and May was negative (-3.2 per cent by end-May). The dynamics of the currency in circulation reflects weaker economic activity and sustained high interest rates on time deposits which discourage eco-

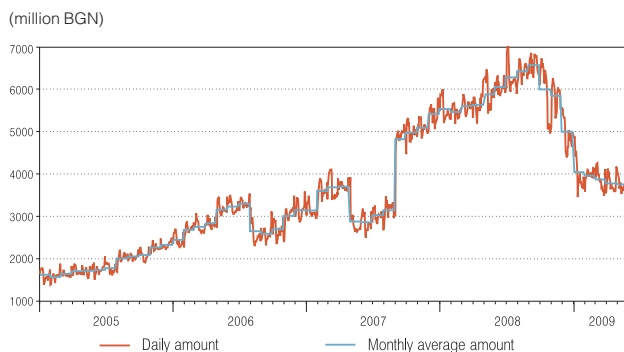
economic agents to hold cash. In the second half of 2009 currency in circulation and banks' deposits with the BNB are expected to further decline on an annual basis (due to a base effect attributable to the higher rate of minimum required reserves until November 2008).

Reserve Money



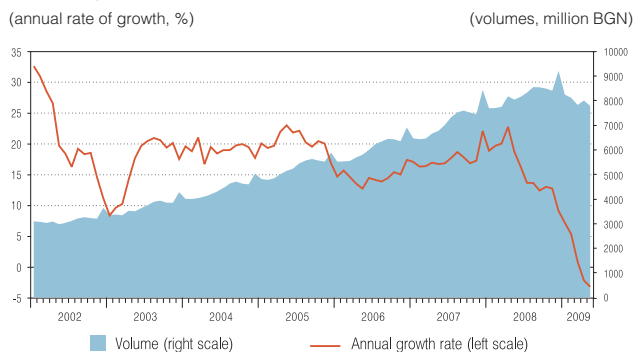
Source: BNB.

Bank Deposits with the BNB



Source: BNB.

Currency in Circulation

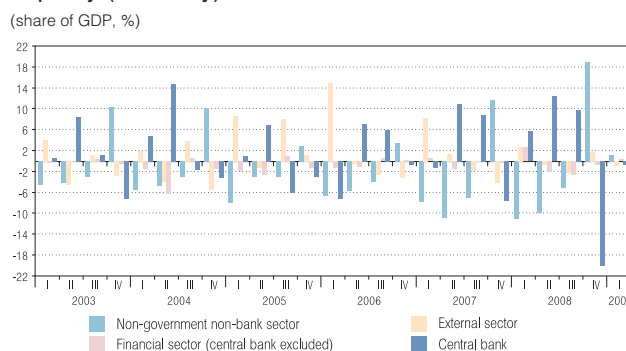


Source: BNB.

In the first quarter of 2009 a slight net transfer of liquidity from the consolidated budget to other economic sectors was carried out. The external sector provided funds to the budget in the amount of 0.8 per cent of GDP mainly due to the inflow of capital and current transfers from abroad (EU funds) and external loans. Another liquidity source for the economy was the reduced govern-

ment deposit with the BNB by BGN 106 million in the first three months of 2009.⁹ Correspondingly, the consolidated budget injected liquidity, accounting for 1.2 per cent of GDP, in the non-government non-bank sector mostly in the form of maintenance costs and social benefits and health insurance payments. The budget rechanneled a portion of withdrawn liquidity from the BNB and the external sector to the financial sector (the central bank excluded). As a result this sector's net liquidity increased by 0.4 per cent of GDP.

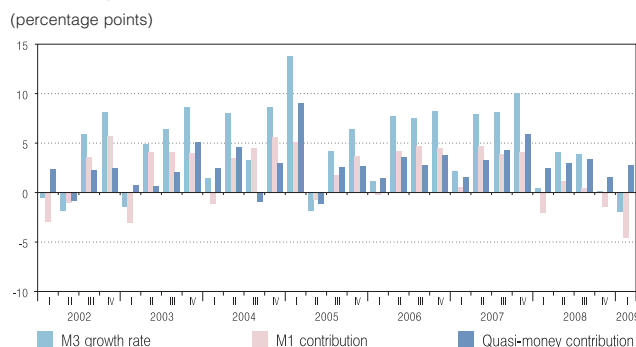
Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)



Sources: MF, BNB.

The annual broad money growth continued to decline impacted by the economic activity slow-down and lower rate of lending growth. As a result of these factors the broad money growth slowed down to 4.6 per cent by end-May and this downward trend in broad money growth is expected to be sustained in the following months.

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



Source: BNB.

M1 monetary aggregate posted an annual decline of 13.7 per cent by the end of May. The major reason behind this fall was the decline in overnight deposits which went down by 19.1 per

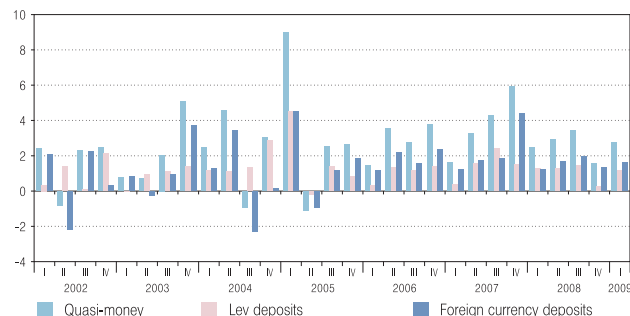
⁹ By the time of preparing this issue of the *Economic Review* data on the consolidated state budget were available only for the first quarter of 2009.

cent on May 2008. Overnight deposits of non-financial corporations in levs and in foreign currency decreased by 12.3 per cent and 39.8 per cent by end-May on an annual basis respectively, while overnight deposits of households in levs decreased by 8.6 per cent and those denominated in foreign currency declined by 38.2 per cent. Factors pushing down overnight deposits were moderate credit operations of banks, ongoing repayment of obligations and shifts from overnight to time deposits driven by high interest rates on time deposits.

Quasi-money continued to grow at relatively high rates, posting an annual increase of 20.9 per cent by the end of May 2009. Deposits with agreed maturity of up to two years still contributed most to quasi-money growth, with household deposits in levs going up by 37 per cent on an annual basis by the end of May and those in foreign currency by 20 per cent. The annual growth rate of non-financial corporations' lev deposits with agreed maturity of up to two years amounted to 9.1 per cent and that of deposits in foreign currencies came to 23.5 per cent.

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

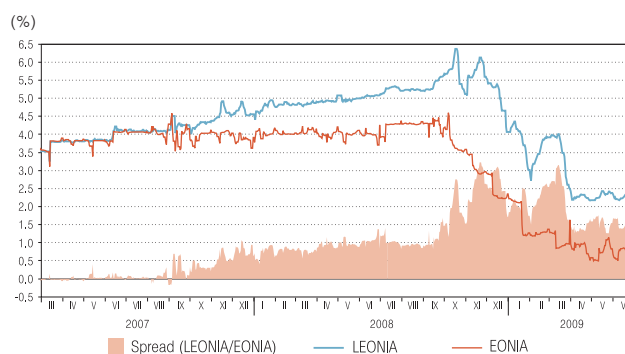
(percentage points)



Source: BNB.

Interbank money market rates posted a decrease from the values reported in the first quarter of 2009. The average interest rate on transactions concluded on the interbank money market went down from 3.63 per cent in March to 2.46 per cent in June. Following a similar trend, LEONIA decreased from 3.53 per cent in March to 2.24 per cent in June, with the spread *vis-à-vis* interest rates on interbank overnight deposits in the euro area falling to 154 basis points in June.

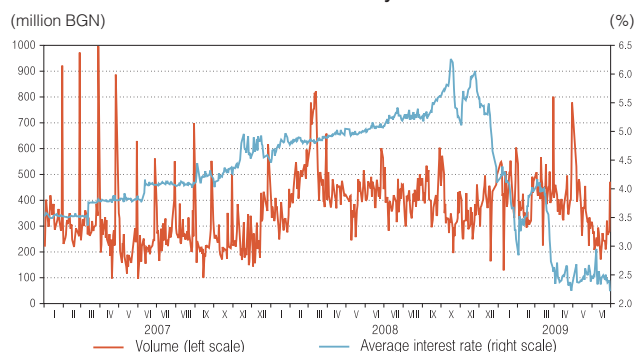
LEONIA/EONIA



Source: BNB.

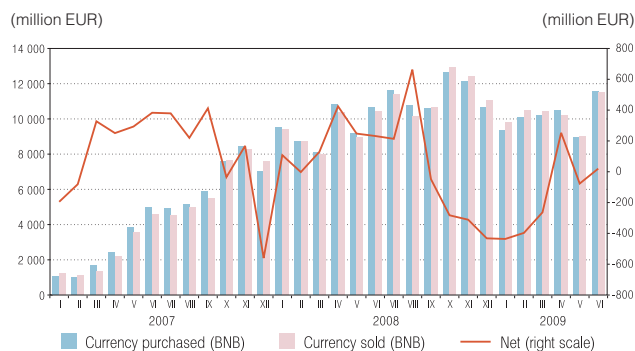
Interbank money market trade remained active although between April and June 2009 the average daily volume of transactions decreased to BGN 348.3 million, from BGN 432.2 million in the first quarter of 2009. Apart from the transactions on the money market, banks also used currency trade with the BNB as a liquidity management instrument. Trade volumes remained high, with banks' net sales of foreign currency bought amounting to EUR 196.3 million between April and June 2009.

Trade Volume and Interbank Money Market Interest Rates



Source: BNB.

Currency Sales or Purchases between Banks and the BNB

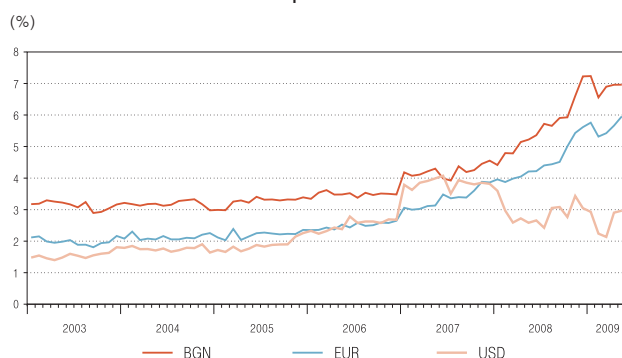


Source: BNB.

Interest rates on time deposits remained high. Following the February decline, the average inter-

est rates on time deposits continued to increase to reach 6.94 per cent on deposits in leva and 5.94 per cent in euro. In the following months interest rates on time deposits are expected to stabilise and probably to gradually fall. These expectations are supported by gradually stabilising international financial markets underpinned by one-year liquidity provided by the ECB and lower lending activity which leads to a weaker demand for resources for financing credit operations.

Interest Rates on Time Deposits

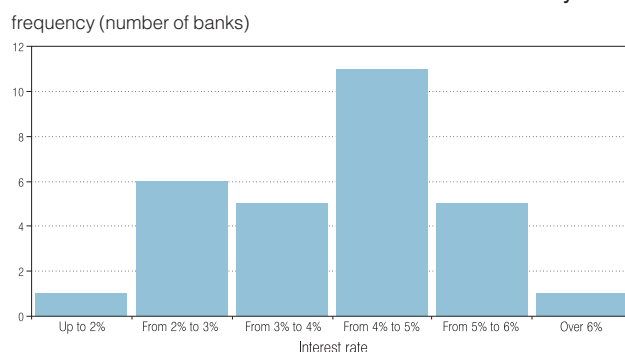


As regards the distribution of interest rates on household lev deposits with maturity of up to one month by bank, the number of banks offering rates within the 5 to 6 per cent and over 6 per cent band increased at the expense of those offering rates within the 2 to 5 per cent band. May

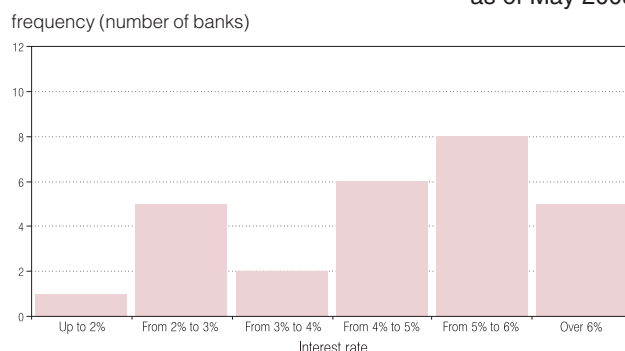
saw a new increase in the average interest rate level compared with February 2009 accompanied by rising dispersion.

Distribution of Interest Rates on Household Deposits with Maturity of up to One Month

as of February 2009



as of May 2009



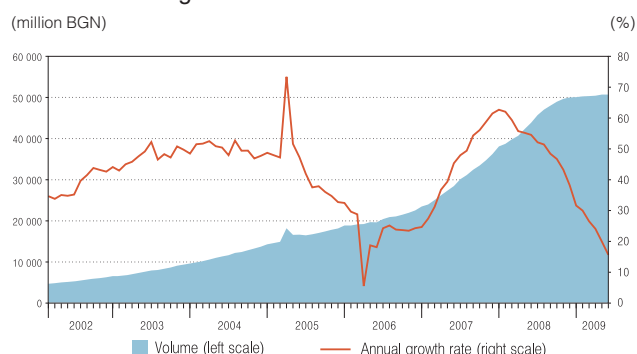
Credit Aggregates

The downward trend in credit growth was sustained due to the slump in demand, weaker economic activity and banks' tightened credit standards. The decline in interest rates on the interbank money market and the fall in money market interest rates in the euro area have not yet spilled over lending interest rates in Bulgaria.

Uncertainty of the macroeconomic environment continued to adversely affect lending, reducing credit demand and acting as a factor for tightening banks' lending policies.

In the first five months of 2009 claims on the non-government sector rose by BGN 636.7 million against BGN 5742.7 million in the same period of 2008. As a result of relatively high price of borrowed funds and banks' tightened lending policies the rate of credit growth slowed down and by end-May the annual growth of claims on the non-government sector fell to 15.7 per cent. The growth rate is expected to moderate in the following months.

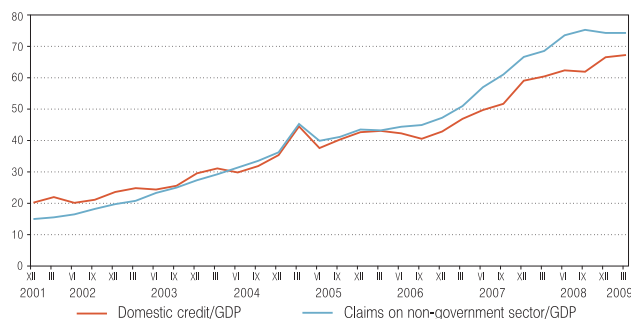
Claims on Non-government Sector



The slowdown in lending growth impacted the dynamics in the *claims on the non-government sector to GDP* ratio. By the end of March 2009 the value of this ratio accounted for 74.5 per cent and remained unchanged from December 2008.

Domestic Credit

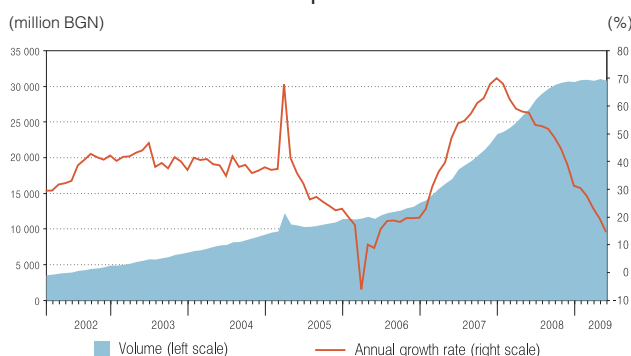
(share of GDP, %)



Source: BNB.

Claims on Non-financial Corporations

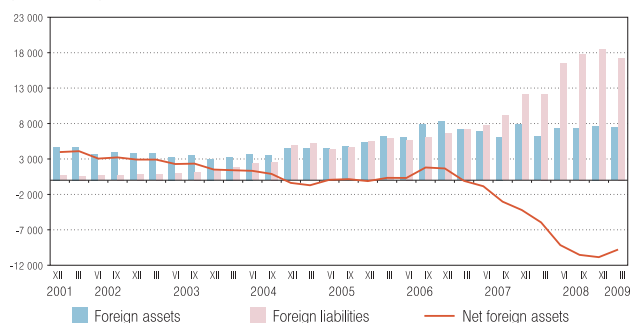
(million BGN)



Source: BNB.

Foreign Assets and Liabilities of Banks

(million BGN)



Source: BNB.

Between January and May 2009 banks' funds attracted from non-residents decreased by BGN 1008.5 million, while their foreign assets grew by BGN 43.6 million.

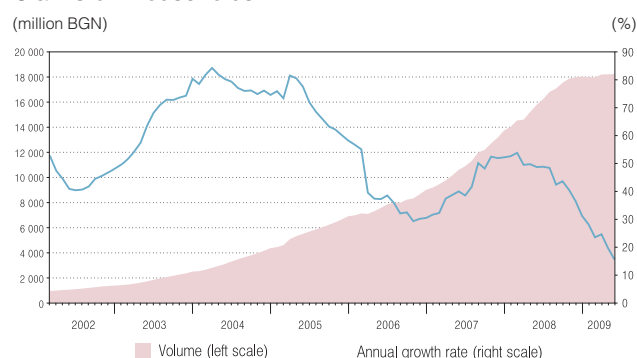
Tightened lending policy and weaker credit demand continued to limit growth in claims on non-financial corporations. Between January and May 2009 claims on non-financial corporations rose by

BGN 183.5 million, up BGN 3553.5 million on the same period of 2008. The annual growth rate of these claims continued to decelerate and by the end of May fell to 14.7 per cent.

Lending to households also decreased, consistent with banks' tightened lending policy and weaker demand for loans due to significant uncertainty as to the employment and income developments. In the first five months of 2009 claims on households rose by BGN 206.5 million (up BGN 2048.1 million on the same period of 2008). Their annual growth rate continued to moderate reaching 15.6 per cent by the end of May. Although residential mortgage loans exhibited comparatively high growth rates compared to the other household borrowing components, their growth rate moderated to 22.1 per cent on an annual basis by the end of May.

Claims on Households

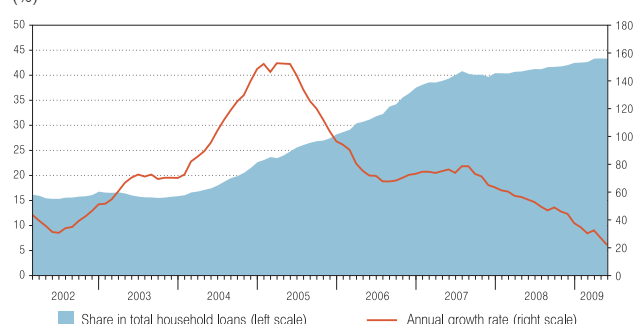
(million BGN)



Source: BNB.

Residential Mortgage Loans

(%)



Source: BNB.

The cut in ECB interest rates on the main refinancing operations by 50 basis points in March and by 25 basis points in April and May 2009, as well as lower cost of interbank market funds, have not spilled yet over lending rates in Bulgaria. The weak response is likely to reflect the following two reasons. First, since lending rates on a portion of loans is determined as a sum total of the cost of

Changes in Major Balance Sheet Items of Banks (Quarterly)

(million BGN)

	2007	2008					2009
	IV	I	II	III	IV	I	April – May
Claims on non-financial corporations	3010.1	1670.7	3190.4	2047.4	408.1	166.1	17.4
Deposits of non-financial corporations	1678.3	-422.9	297.5	62.5	23.1	-1182.6	-323.9
Claims on households	1543.9	867.7	1634.8	1306.7	505.7	167.7	38.8
Deposits of households	1734.7	811.9	954.3	1204.4	122.7	411.6	-1.1
Foreign assets	1764.5	-1681.4	1099.2	-8.9	361.6	-199.2	242.8
Foreign liabilities	2955.8	63.5	4304.6	1361.5	680.6	-1260.7	252.2
Claims on the <i>general government</i> sector	32.4	-103.6	-34.0	21.6	3.8	4.0	-74.7
Deposits of the <i>general government</i> sector	404.6	-200.3	322.8	-31.0	-188.7	-220.6	118.3
Claims on central government	-6.9	-106.2	-34.1	22.1	-17.6	7.3	-89.7
Liabilities to central government	448.6	-310.1	145.2	-36.8	199.3	-356.4	77.3

Source: BNB.

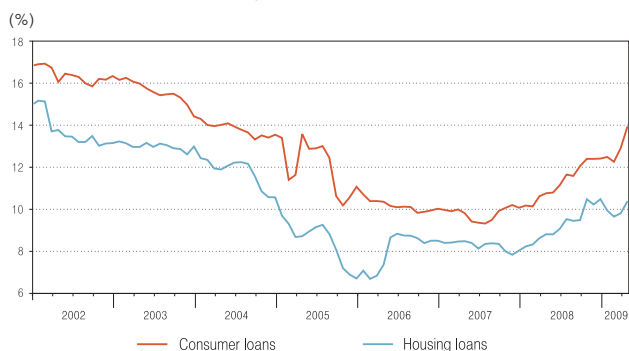
Claims on Non-government Sector (Quarterly)

	Annual growth rate, %							Structure, %	
	2007	2008					2009	2009	2009
	IV	I	II	III	IV	I	May	May	May
Claims on non-government sector, incl.	62.5	55.5	52.0	46.6	31.6	24.0	15.7		
on non-financial corporations	70.2	59.2	53.3	48.8	31.4	23.2	14.7	61.8	61.2
on households and NPISHs	52.4	49.7	49.0	43.7	31.3	24.7	15.6	36.4	36.4
on financial corporations	33.3	56.3	64.7	28.6	44.2	38.8	49.5	1.9	2.4

Source: BNB.

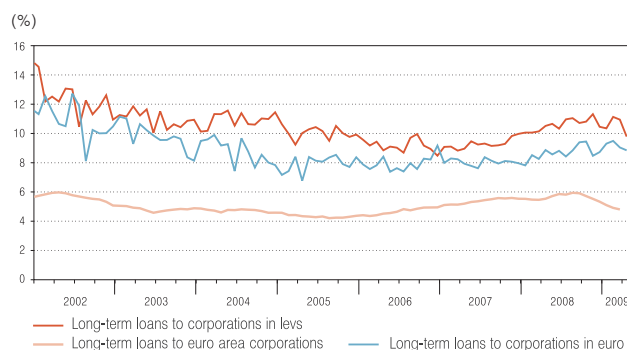
attracted funds and a spread, the upward trend currently observed in deposit rates does not allow for a stronger decrease in the cost of loans. Second, although the decrease in money market interest rate allows for a cut in interest rates based on particular market index (e.g. EURIBOR or SOFIBOR), the dynamics of lending rates depends on the amount of risk premium calculated by banks. The significant uncertainty in macroeconomic environment in recent months contributed to the increase in the premium required for credit risk which offset the effect of the cut in money market rates on lending rates.

Interest Rates on Newly Extended Household Loans



Source: BNB.

Interest Rates on Newly Extended Long-term Loans in Levs and Euro



Source: BNB.

The dynamics of interest rates in the following months will be characterized by a significant uncertainty. On the one hand, the stabilisation and a possible gradual decrease in deposit rates is likely to help lower the cost of borrowed funds. At the same time, the unfavourable macroeconomic environment may entail maintenance of high risk premium in interest rates on loans, which will not allow a significant cut in the cost of borrowed funds.

3. Economic Activity

In the first quarter of 2009 real GDP contracted by 3.5 per cent on an annual basis. The decrease in real terms hit most industries (excluding *financial intermediation, transport and communications, and real estate and business services*). The structure of real economic growth changed, with domestic demand contribution turning negative and the contribution of net exports of goods and services turning positive.

Over the second half of 2009 the real GDP decline is expected to continue, although the rate will begin slowing at the end of the year. Unemployment will continue to increase until end-2009.

In the first quarter of 2009 real GDP registered a 3.5 per cent drop on the corresponding period of the previous year.

The growth structure of the real gross domestic product changed significantly in the first three months of 2009. On the one hand, declines in domestic demand had a strongly negative contribution to GDP dynamics. On the other hand, foreign trade balance which contributed negatively to the economic growth over the recent years had a considerable positive contribution of 8.1 percentage points. The fall in final consumption was 5.4 per cent on an annual basis. This change reflected mostly declines in household consumption by 6.3 per cent. Government consumption fell by 0.38 per cent on the same period of 2008, contributing insignificantly to the decrease in GDP in real terms (-0.06 percentage points), while the contribution of household expenditure was -5 percentage points.

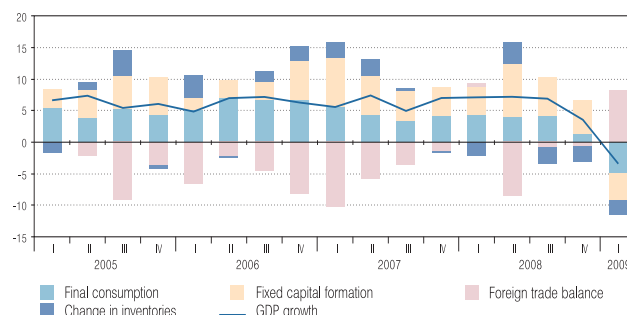
The worsened economic situation and lower credit activity affected negatively investment in fixed capital. Over the first quarter of 2009 real gross fixed capital formation fell by 14 per cent on an annual basis, contributing to real GDP decrease by 4.2 percentage points.

The negative contribution of inventory changes (-2.3 percentage points) to GDP dynamics explained a considerable part of the negative growth. When corporations face contracting domestic and foreign markets, they try to reduce their inventories and purchases, including those of imported goods. This trend is exacerbated by the impeded access to cheap credit resources which limit the available working capital of the firms.

In the fourth quarter of 2008 and the first three months of 2009 imports and exports of goods and services posted declines both in real and nominal terms. Due to the comparatively high import component of investments in fixed assets and in some consumer expenditure, the physical import volume fell by 21.1 per cent which exceeds the decline rate of exports (-17.4 per cent) over the first quarter of 2009. As a result, foreign trade balance had a positive contribution of 8.1 percentage points to GDP dynamics in real terms.

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

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



Source: NSI.

Deepening global economic crisis affected Bulgarian enterprises and since October 2008 sales of industrial production have dropped in international markets and since early 2009 in domestic markets also. Negative trends in industry since the middle of 2008 deepened in the first quarter of 2009 and value added in manufacturing decreased by 17.8 per cent in real terms on an annual basis.

Real value added growth moderation in the sector which had started in the last quarter of 2008 continued in the first three months of 2009 (2.5

per cent), from 6.4 per cent in the third quarter of 2008. The contribution of services to real GDP remained broadly positive (1.6 percentage points in the first quarter). Financial intermediation contributed further to services growth in the first three months as well. Albeit slowing since early 2008, financial services retained their comparatively high real growth at 22.2 per cent on an annual basis.

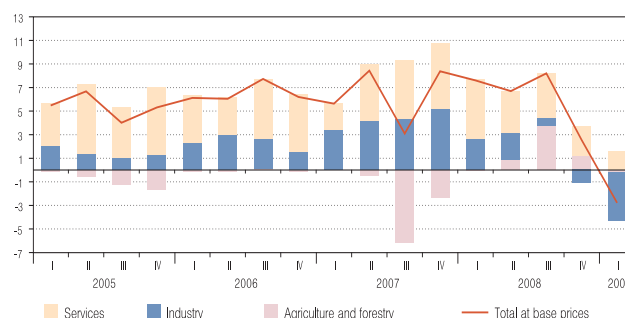
Due to household expenditure falls, trade experienced serious difficulties posting a decrease of 8.5 per cent in real terms on the first quarter of 2008.

Over the second half of the year real GDP is expected to drop on an annual basis, although its rate will start slowing due to more favourable export opportunities. Lower expenditure in economy is anticipated to be reported both by investments and household consumption. Limiting wage expenses and lower employment (higher unemployment) along with the increased uncertainty will reduce consumer demand, especially for durable goods. Government consumption will have an insignificant effect on the dynamics of the GDP physical volume due to the commitment to follow a conservative fiscal policy. The positive contribution of foreign trade balance to economic activity will be sustained. If the recovery of Bulgaria's major trade partners begins over the current year, signs of which are currently observed, this will further increase the positive contribution of net exports. Under a pessimistic scenario involving continuation of the financial and economic crisis in our major partners in the next year as well, the economic activity decline in Bulgaria will be accompanied by a significant rise in unemployment, subdued domestic demand and substantially worsened economic agent expectations.

Unemployment growth and investment expenditure contraction will negatively affect the potential economic growth. The pace of future recovery will depend on overcoming these negative trends and on the degree of Bulgarian enterprises' flexibility in limiting their expenses.

Value Added Growth and Contribution by Sector

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



Source: NSI.

Household Behaviour

The trends toward limiting consumer demand by the end of 2008 continued to deepen in the first months of 2009. Over the first quarter of 2009 final consumption expenditure of households fell in real terms by 6.3 per cent on an annual basis. Most of expenditure components decreased at constant prices *vis-à-vis* their values a year earlier, excluding expenses on food products and some services whose total positive contribution was almost 1 percentage point. Major components contributing negatively to household expenditure dynamics were non-food goods and net expenditure on tourism abroad. These expenditure groups have a strong import component and contributed to improving foreign trade balance.

GDP by Component of Final Consumption (Real Rate)

(%, on corresponding period of previous year)

	2007				2008				2009
	I	II	III	IV	I	II	III	IV	I
Consumption, incl.	6.0	5.0	4.2	4.5	4.7	4.8	5.4	1.4	-5.4
Final government consumption expenditure	-1.2	-1.0	2.3	8.5	-2.9	4.1	-0.3	4.6	-2.1
Collective consumption	-2.7	0.7	-2.5	13.3	-5.8	0.3	0.9	-1.5	1.2
Gross fixed capital formation	35.9	24.7	19.7	14.0	15.5	28.6	22.3	15.8	-14.1
Exports of goods and non-factor services	3.7	5.3	5.4	6.0	9.2	5.1	3.8	-6.0	-17.4
Imports of goods and non-factor services	14.7	11.1	9.3	5.7	5.8	13.7	4.2	-3.2	-21.1
Real GDP growth	5.5	7.3	4.9	6.9	7.0	7.1	6.8	3.5	-3.5

Sources: NSI, BNB.

In the beginning of the second quarter downward trends in demand continued, and the structure of the fall by expenditure group was retained. Based on April and May data, the physical volume of sales in retail trade went down by 9.9 per cent on an annual basis. Food sales retained positive growth of 2.4 per cent and all other components declined on an annual basis. Retail sales of household appliances and furniture, as well as of computer and communications equipment decreased most significantly. Sales of automobiles between January and May 2009 dropped by almost 34 per cent compared with the same period of 2008.

The reason behind lower consumption growth was largely the increased rate of savings by households. The rate of savings is at a much higher level compared with previous years which may be explained by the heightened uncertainty about future incomes.

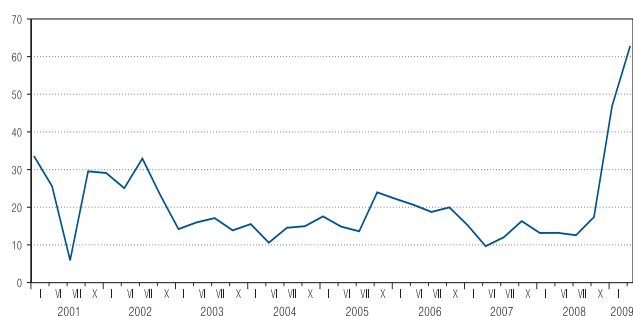
The increased propensity to savings is also evidenced by household budgets survey data. In real terms, incomes for the first five months of the current year rose by 4.9 per cent. On the other hand, real expenditure matched the previous year's levels. Since February 2009 a trend has been formed towards a strongly negative contribution of clothing, footwear, home furnishing and transportation expenditure on the real growth in consumer expenditure.

In the first four months of 2009 wage income was of more limited importance for the real growth in total household budget income. This trend reflected the effort of enterprises to reduce their labour expenditure through limiting employment and labour costs *per* employee. These developments in the coming periods will adversely affect household expenditure.

Consumer perceptions and expectations have worsened since early 2009 in line with the worsening global economic situation. Since early 2009 consumer concerns about the increase in unemployment have heightened. Unemployment fears reflect on expectations of a possible decline in incomes which resulted in deteriorating of household estimates on their future financial performance and overall economic situation. Consequently, consumers postpone some purchases of durable goods and revise their plans for major expenses (furniture, household devices, *etc.*).

Unemployment Expectations

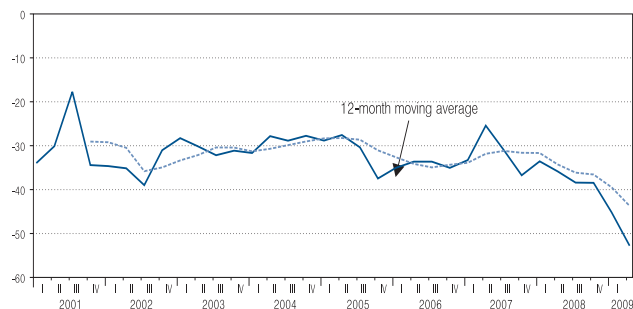
(balance of assessments)



Source: NSI – Consumer Survey.

Households Confidence Indicator

(balance of assessments)



Source: NSI – Consumer Survey.

Household income dynamics depends to a great extent on employment. The employees number fell by 0.8 per cent on an annual basis. This decline did not still induce unemployment growth: in the first quarter the unemployment rate was 6.4 per cent (6.5 per cent a year earlier) according to NSI labour force survey. The reason behind this may be seen in the structure of dismissed employees by sector and status of employment. Half of this decrease was due to lower employment in agriculture and the remaining portion to the reduced jobs in industry. Those who left agriculture, most of them self-employed persons, did not actively look for jobs as employed.

According to Employment Agency data, the number of registered unemployed has increased since early 2009. In April and May 2009 unemployment exceeded the previous year's levels, reaching 7.08 per cent in May. Over the review period the number of offered job vacancies decreased by 4 per cent on an annual basis. The vacancy ratio¹⁰ rose by approximately 5 percentage points in the first five months of 2009 which

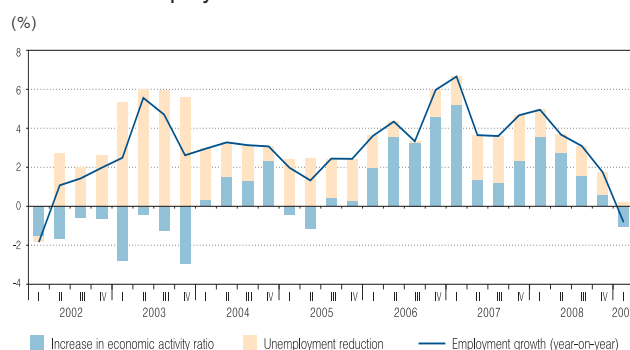
¹⁰ A ratio between the number of vacancies which were occupied in a given month and the number of offered job vacancies in the same period.

indicates lack of difficulties in filling vacancies. The review period saw no deepening of mismatches in the structure of demand for and supply of free labour resources. If these structural characteristics of the market are sustained, the recovery of positive economic growth will be accompanied and supported by improvements in labour market conditions. There is a risk that structural changes in the economy related to re-orientation of economic activity to various economic sectors may result in long-term unemployment. A key factor in avoiding this scenario is the enhancement of professional and geographical mobility and qualification of the labour force.

The effect of major factors limiting consumer demand since early 2009, i.e. higher uncertainty around future incomes, lower employment and limited income growth, as well as tightened con-

sumer lending conditions, will continue in the coming periods. In the next quarters household final consumption expenditure in real terms is therefore expected to stay below its levels of the previous year.

Sources of Employment Growth



Source: NSI – Labour Force Survey.

Employment and Income Dynamics (Quarterly)

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

	2007				2008				2009
	I	II	III	IV	I	II	III	IV	I
Employed	4.9	3	2.1	1.6	3.3	2.9	2.8	2.6	-0.5
Real wage	11.8	14.2	11.6	10.8	10.7	8.9	8.9	10.2	10.6
Wage fund	17	17.2	13.7	12.1	14.1	11.7	11.8	12.7	10.0
Unemployment at the end of the period, % of the labour force	8.9	7.4	6.8	6.9	6.8	6.0	5.8	6.3	6.9

Sources: NSI – Enterprise Survey, Employment Agency.

Real Consumer Demand Dynamics (Quarterly)

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

	2007				2008				2009
	I	II	III	IV	I	II	III	IV	I
Consumer spending <i>per</i> household member	10.6	12.0	8.9	6.5	6.5	1.8	1.7	-0.7	0.1
Retail sales	18.4	18.8	13.8	14.5	11.2	7.8	4.4	-1.7	-9.8
Income from retail trade, incl.	23.4	21.1	17.2	15.7	7.8	5.3	2.2	-1.2	-5.6
Foods, drinks, tobacco	17.8	18.2	11.9	10.0	4.6	0.0	2.4	4.6	3.3
Universal stores offering varied goods	38.9	34.2	32.2	35.7	11.9	13.6	8.1	3.8	-4.4
Automobile fuels and lubricants	17.7	14.1	6.8	2.8	3.4	4.0	0.8	-5.9	-8.3
Pharmaceutical and medical goods, cosmetics and toiletries	10.2	8.7	12.7	10.6	11.8	7.8	5.0	5.6	1.4
Textile, clothing, footwear and leather	22.1	15.0	23.7	23.7	22.9	13.1	2.3	0.1	-5.0
Household goods and home appliances	40.3	38.6	34.0	31.5	10.2	5.8	1.3	-1.7	-8.1
Computers and communication equipment	32.6	23.8	21.4	24.2	13.2	12.2	3.8	-4.5	-15.0
Out of stores	12.0	12.8	11.2	11.4	0.0	-1.6	0.7	-1.5	-4.6
Income from trade in automobiles and repairs	37.7	36.1	34.6	34.4	22.6	13.5	10.5	-4.6	-31.1

Source: NSI Household Budgets and Domestic Trade Survey.

Government Finance and Consumption

The consolidated fiscal programme balance was positive at BGN 512.9 million in the first quarter of 2009 and BGN 555.4 million by the end of May. Over the second half of 2009 the growth rate of consolidated fiscal programme expenditure is expected to start decreasing as a result of applying restrictive government policy. Budget surplus will continue falling and there is a significant risk of a consolidated budget deficit for the year to be reported if no additional measures to curb expenses are undertaken.

Over the first three months of 2009 the consolidated fiscal programme surplus came to BGN 512.9 million. Compared with the first quarter of 2008, this surplus was lower due to a 3.2 per cent decrease in current revenue and a 16.9 per cent increase in total expenditure. Revenue went down mostly owing to the 10.4 per cent drop in indirect taxes on the same period of 2008, reflecting the reduced consumption. Receipts of profit taxes in the first three months of 2009 were 11.7 per cent lower than in the same period of 2008, reflecting the downward economic dynamics after the autumn of 2008 which led to lower annual corporate tax due for payment until end-March. The fact that corporations reporting low net receipts from sales (up to BGN 200,000) or tax losses in the previous year do not owe advance monthly contributions also brought about to the decreased corporate tax receipts.

This downward trend in these revenue items intensified by May, with the government budget registering a 14.5 per cent annual decline in indirect taxes and a 20.5 per cent fall in corporate taxes.

At the same time personal income tax posted an increase of 15.3 per cent and social security revenue went up by 7.1 per cent, reflecting the continuing annual growth in compensation of employees over the first quarter.

The increased total expenditure in consolidated budget over the first quarter was mainly due to wage and remuneration growth at 22.8 per cent on an annual basis, social and health insurance payments at 15.6 per cent and maintenance expenditure at 14.2 per cent (expenditure on hired services which grew by 34.1 per cent had the largest contribution within this group). The reason behind the increased wage expenditure on an annual basis involves public sector remuneration indexation in the middle of 2008. In the group of social and health insurance payments, over the first quarter pensions posted an annual growth of 16.8 per cent which resulted from wage increases

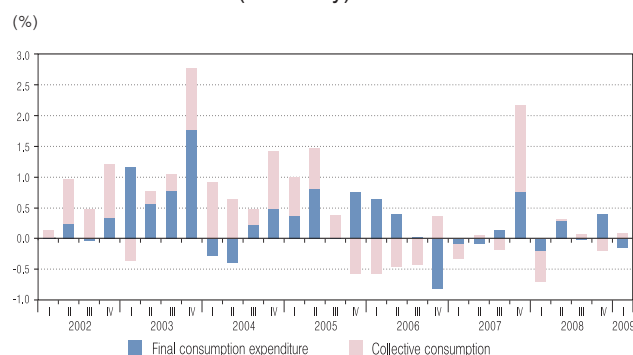
in the second half of 2008, while compensations and social security payments rose by 45.6 per cent, suffering the negative effects of slowing economic activity on the labour market.

Interest payments went down by 5.2 per cent on the same period of 2008.

As of end-May revenue and grants on consolidated fiscal programme totalled BGN 11,044.1 million or 33.9 per cent of annual projections, while expenditure (Bulgaria's contribution to the EU budget included) accounted for BGN 10,488.6 million or 34.5 per cent of annual projections.

The growth rate of expenditure is expected to begin falling over the second half of 2009 as a result of applying the restrictive fiscal policy. The revenue side of the consolidated budget will broadly maintain the annual decline rate of the first quarter. Budget surplus will thus continue falling and there is a significant risk an almost 1 per cent budget deficit of GDP to be reported if no additional measures to curb expenses are undertaken. Under these circumstances, pursuing prudent expenditure policy is of great significance for preserving public finance sustainability.

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



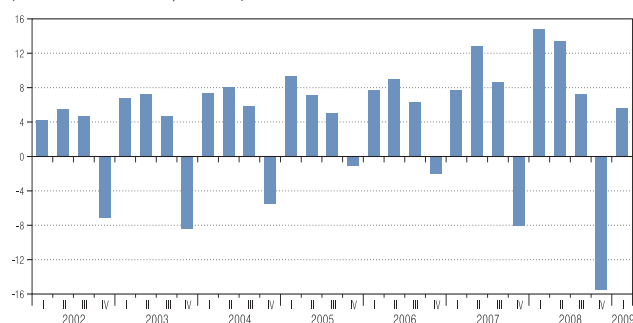
Sources: NSI, BNB.

In the first quarter government final consumption expenditure had an insignificant contribution (-0.15 percentage points) to GDP declines on an annual basis and collective consumption reported a minimal positive contribution (0.1 percentage points).

In 2009 total government consumption is expected to undergo a real annual decline between 2 per cent and 3 per cent which will have a very small contribution to the projected negative growth in real GDP. Despite the nominal anti-cyclical worsening in the budget balance, government consumption will thus have a negligibly weak effect on the decrease in aggregate demand by contrast to the higher contribution of the real decline in private consumption and gross fixed capital formation.

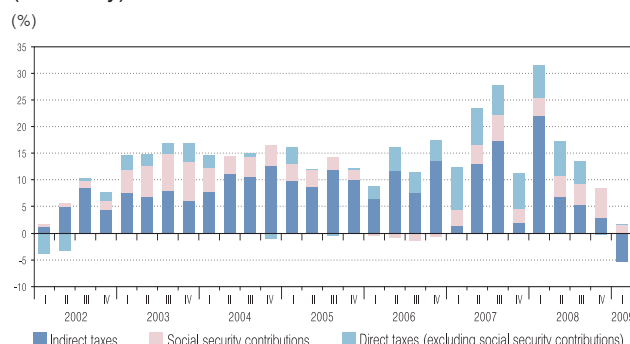
Primary Balance (Quarterly)

(share of GDP for the quarter, %)



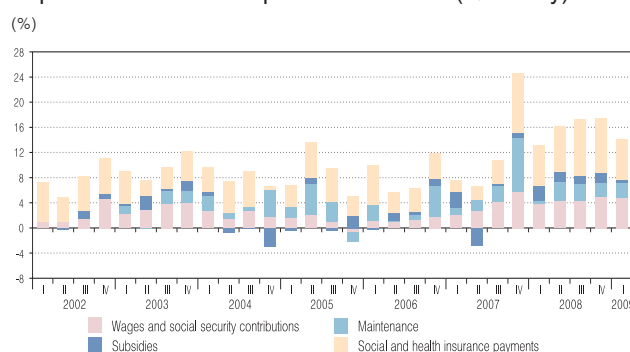
Sources: MF, BNB.

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



Sources: MF, BNB.

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



Sources: MF, BNB.

Behaviour of Firms and Competitiveness

The sharp contraction in external demand at the end of 2008 continued in the first four months of 2009. All economic sectors experienced difficulties due to the economic crisis. Manufacturing enterprises most strongly affected by the weak external demand limited their expenditure to minimize the negative effect of the crisis on their financial performance.

Sharply reduced external demand along with more conservative credit policy of banks, weaker foreign investment inflow and heightened uncertainty impacted adversely the overall development of the economy. Since early 2009 almost all economic sectors have faced difficulties. Economic activity in industry contracted most significantly, reflecting mainly the reduced external demand. Between January and May 2009 the average annual decline in industrial turnover in international markets was 34.4 per cent (-19.4 per cent in the last quarter of 2008). Most industries reported sales declines. Over the first four months of 2009 merely some one-fifth of them reported growth in their export sales on the same period of the previous year. The reduced output and investment activity of foreign corporations limited to a great

extent external demand for investment and energy products, as well as for other intermediate consumption products.

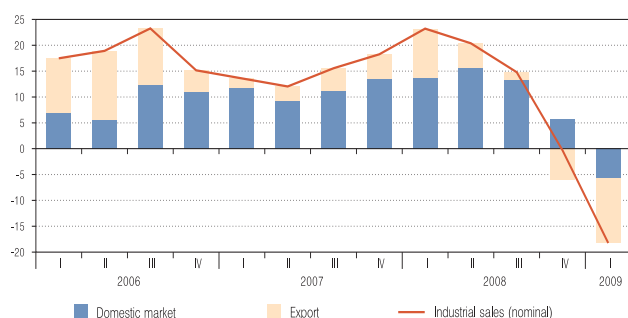
No downward trends in the annual decline rate of nominal industrial turnover abroad were observed in individual months of 2009. The relative retention of the annual change in the first four months suggests that the lowest industrial export values may have already been reached. If demand in Bulgaria's major trade partners improves over the second half of 2009, a gradual recovery in industrial exports may be expected.

Domestic market sales also contributed to the drop in total industrial sales. In the first five months of 2009 annual declines deepened: from -3.8 per cent in January to -21.8 per cent in April.

Similar to export industrial sales, almost one-fifth of the sectors have reported positive annual growth of domestic market turnover since early 2009. Domestic market sales of intermediate industrial and investment goods registered the most sizeable declines on an annual basis. Consumer goods enterprises were affected less hard. The negative external shock gradually widespread in all industrial sectors outside export-oriented firms was expected. On the one hand, part of the goods used for intermediate consumption by export industries are provided by domestic market oriented firms. On the other hand, the overall economic environment deterioration led to lower demand for consumer and investment goods in the domestic market. Thus, domestic market sales recovery will depend on Bulgaria's export capability and the consequent improvement of domestic demand.

Industrial Sales Growth

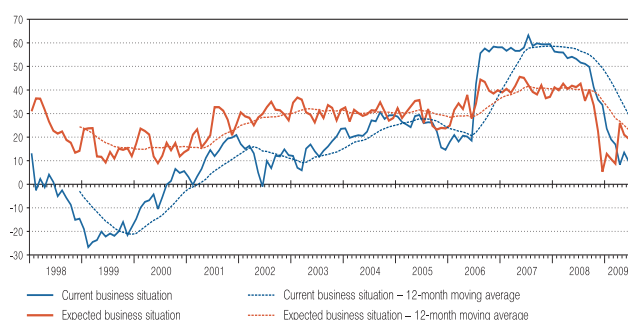
(% on corresponding quarter of previous year)



Sources: NSI, BNB.

Business Climate in Industry

(balance of assessments)



Source: NSI.

The trend toward increasing the number of industries hit by the reduced production activity became evident from the data on capacity utilisation. This indicator fell from comparatively high levels of almost 75 per cent in 2007 and 2008 to 67.4 per cent in April 2009. The share of enterprises assessing their production capacity as

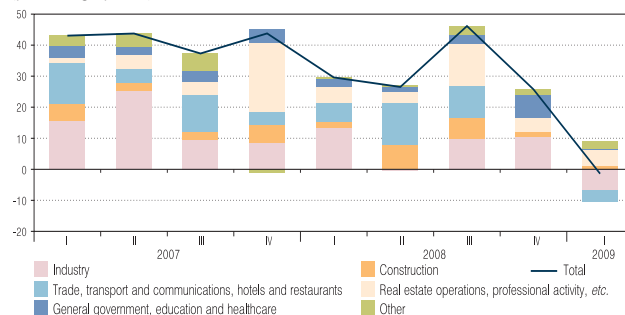
normal decreased to 16 per cent in April (25 per cent on average between October 2006 and January 2009).

The end-2008 trends concerning constraints to business development in industry (see *Economic Review*, issue 1, 2009) were retained in the current year. The increased uncertainty continued to be the main impediment for almost half of the enterprises. A much smaller share (almost one-fifth) of the firms assessed their financial performance as an impediment to expanding activity (against some 15 per cent in 2008).

The decreased utilization of available production capacities and heightened uncertainty predetermine enterprises' cautiousness in continuing their intensive investment activity. In the first quarter of 2009 expenditure on acquiring fixed assets in industry (including electricity production and distribution, water supply and refuse collection) decreased by approximately 17 per cent¹¹ on an annual basis. In case production activity recovers and expectations in industry improve, investment activity is also expected to intensify.

Contribution to Nominal Growth in Costs of Acquiring Fixed Assets

(percentage points)



Source: BNB.

In the context of contracting external and domestic demand, Bulgarian companies faced the need of mitigating the negative impact of lower sales on their financial performance. The main instrument for limiting the negative effects of the worsened external environment is to reduce expenses. Manufacturing enterprises continued to limit their expenditure to minimize the negative effect of the weaker demand. Since the end of 2008 dynamics of the gross production deflator

¹¹ The relative change in costs of acquiring fixed assets is measured by comparing their nominal value for the first quarter of 2009 under the NCEA-2008 (National Classification of Economic Activities – 2008) to the sum total of costs of acquiring fixed assets in the *mining and quarrying* and *manufacturing, electricity, gas and water* sectors under NCEA-2003.

exceeded that of intermediate consumption. In the first quarter of 2009 the gross production deflator was practically equal to the average 2008 level, while intermediate consumption deflator was 1.7 per cent lower than the average 2008 value. As a result, nominal value added in manufacturing posted a nominal decrease by 2.4 per cent in the first quarter (against a 17.6 per cent nominal decline in gross output for the same period). However, if the recent months' upward trend in the prices of major raw materials and energy is sustained, it is possible this source of reducing expenditure to be exhausted in the coming periods. Therefore, enterprises need to use other ways of limiting their production expenses. To keep their cost competitiveness in the short run, industrial enterprises are expected to continue the policy of cutting wage and other labour costs growth.

Real unit labour costs in manufacturing fell on an annual basis in the first quarter. This allowed gross operating surplus to remain at the early 2008 level which suggests that manufacturing maintains its competitiveness positions and relatively stable financial performance.

Reduced labour costs in manufacturing is a result of both employment declines and reduced labour costs *per* employee. The employees number fell by 4.6 per cent, while compensation *per* employee rose on an annual basis by 1.2 per cent (against the average 20 per cent growth in 2008). Rises in the minimum wage and minimum social security thresholds since early 2009 contributed to maintaining positive growth of wage costs *per* employee.

Monthly data on employed persons and wages according to the enterprise survey suggest that downward trends in employment and wage costs progressively intensified over the first quarter. It is therefore expected this trends to deepen in the coming periods, especially in relation to wages which are characterized by a strong base effect due to their accelerated growth in 2008. Industrial enterprises' efforts to optimize labour costs reflect on their intentions to hire additional personnel. Since the start of the year less than 5 per cent of industrial enterprises have planned to expand employment, while in 2008 these enterprises comprised some 10 per cent. Moreover, the share of firms planning lay-offs increased from almost 13 per cent in 2008 to 21 per cent in April 2009.

Industrial managers' opinions support expectations about a possible improvement in economic conditions in the second half of 2009 *vis-à-vis* the current low levels. Following the concurrent dramatic decline in expectations of future production and business activity of industrial enterprises¹² in October 2008, these indicators have recovered somewhat over the recent months. In addition, the downward trend in the balance of opinions, which was formed in the last three months of 2008 and continued in the first five months of 2009, reversed in June. However, these initial positive signals should be interpreted with particular caution since no sustainable recovery in these indicators is still reported.

Construction activity in the first quarter of 2009 posted lower annual growth, with value added decreasing by 6 per cent in real terms. Preliminary data on construction output in April and May show a decline in activity by 11.6 per cent on an annual basis which indicates continuation of the negative trends that started in the beginning of 2009.

Lending for new house purchases also moderated substantially in the first four months of 2009 compared with the same period of 2008. New housing loans extended accounted for one-fifth of the new loans a year earlier. By month, the volume of extended loans has increased since the beginning of the year, which suggests that the decline did not deepen.

Limited labour costs in construction over the first quarter were not sufficient to constrain the increase in unit labour costs. Unit labour costs in real terms rose by 15 per cent on an annual basis and employment remained broadly unchanged on the same period of the previous year. However, part of the real adjustment in wages and the number of employed in construction may not be reported in official data due to the existing shadow employment in the sector. In 2009 labour cost elasticity became more import and owing to real construction activity contraction. This was evidenced by the gross operating surplus dynamics. In 2008 it increased by approximately 20 per cent in contrast to the beginning of 2009 when it fell by 11 per cent.

The economic activity in the services sector retained its positive growth in the first three months

¹² These two indicators showed a strong correlation dependency (0.85) in the previous years.

of 2009. However, by contrast to the previous periods, only three sectors contributed positively to the economic growth: *financial intermediation*, *real estate operations and business services*, and *transport and communications*.

Financial intermediation had the most significant contribution to value added growth in services in the beginning of 2009 and throughout 2008. Value added in this sector increased by 22 per cent in real terms over the first quarter of 2009, contributing around 2 percentage points to physical volume dynamics of economy's value added. Despite these positive developments, gross operating surplus in the sector fell nominally by 7.6 per cent in the first quarter after rising at accelerated rates in seven consecutive years. Lower profitability of the financial sector was due to higher prices of the available financing since the end of 2008 due to the global financial crisis. As a result, growth in the intermediate consumption deflator exceeded final output deflator dynamics in this sector which resulted in a 1.7 per cent decline in the nominal value added over the first quarter of 2009. Despite lower returns since the beginning of the year, financial intermediation is expected to continue intensifying at moderate rates due to the banking system stability and long-lasting strategic interest of foreign banks in the local market.

In the first quarter of 2009 value added in the *real estate operations and business services* sector rose by 4.8 per cent in real terms. Annual growth over the same period was similar to that in 2008 (5.5 per cent). Due to the grouping of both sub-sectors (real estate operations and business services), no direct conclusions about their individual development may be drawn. However, positive growth retention suggests that the negative effect of lower demand in the real estate market was largely seen in construction rather than in the real estate operations sub-sector which continued to develop its intermediation activity. Data about expenditure on acquiring fixed assets in real estate have retained their early 2009 positive trends.

Still, slowing demand and continued downward trends in property prices in the coming periods will set limits to the development of this sector.

Reflecting lower demand in trade, value added growth in the sector became negative (-8.5 per cent in the first quarter of 2009). Value added in nominal terms remained broadly unchanged com-

pared with the previous year. Faster growth of gross output deflator *vis-à-vis* the price index of intermediate consumption costs suggests that firms in this sector retained and even increased the margin over the cost of sold goods.

Notwithstanding the worsened assessments and expectations of the managers in trade and higher unit labour costs, the indicator showing intentions to hire and dismiss personnel did not change essentially.

Current economic data on trade sales in April and May show that demand continued to decline in the beginning of the second quarter as well. In line with consumer expenditure data, the most significant fall was registered by household appliances and furniture, as well as computer and communications equipment. The worsened expectations in retail trade concerning orders to foreign suppliers support expectations of lower consumer demand for imported goods.

The overall decrease in economic activity in Bulgaria along with slowing imports and exports of goods created difficulties for firms in the *transport and communications* sector. Despite the real growth in value added by 5.4 per cent in the first quarter, nominal value added was practically identical to that a year earlier. Following the demand reduction, firms are forced to cut prices of offered services in order to keep their positions in the market. As a result, gross operating surplus fell by 7.4 per cent on an annual basis and the number of employed decreased by 5.3 per cent annually. This industry is sufficiently flexible with respect to prices and labour costs which give grounds to expect that the recovery of total economic activity will have a fast positive effect on this sector.

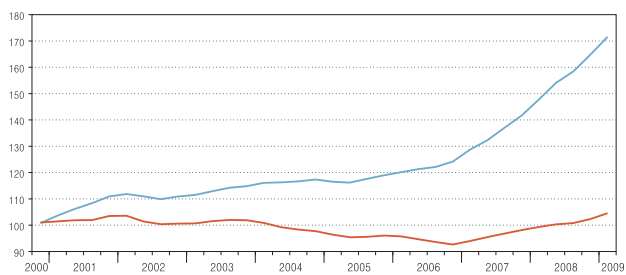
In the first six months, the balance of opinions on the current business state of services remained at its low levels of the end of 2008 and expectations improved moderately. Besides the uncertain economic environment, the insufficient demand was also a serious impediment to the business development of almost 20 per cent of the firms in this industry. The positive growth recovery in the services sector will follow the overall economic recovery.

In early 2009 nominal and real unit labour costs in the economy continued to increase on an annual basis amid the worsened economic condi-

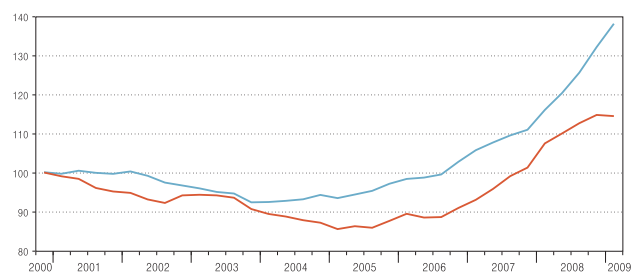
Unit Labour Cost (Quarterly)

(2000 = 100)

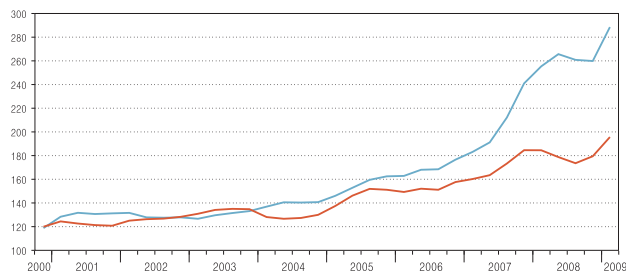
Total for the Economy



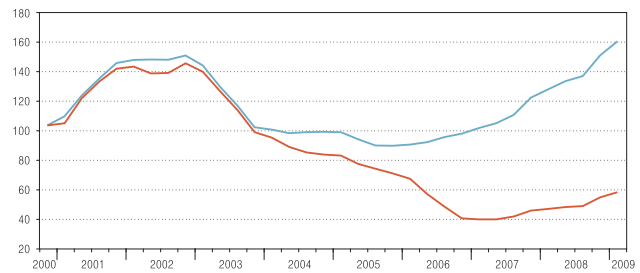
Manufacturing



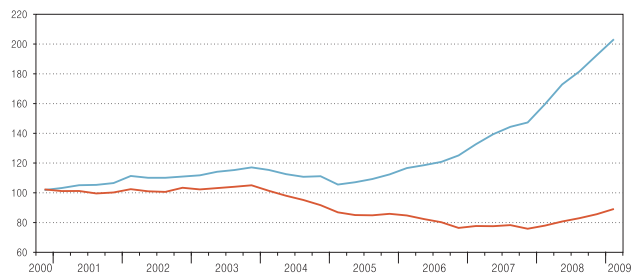
Agricultural Sector



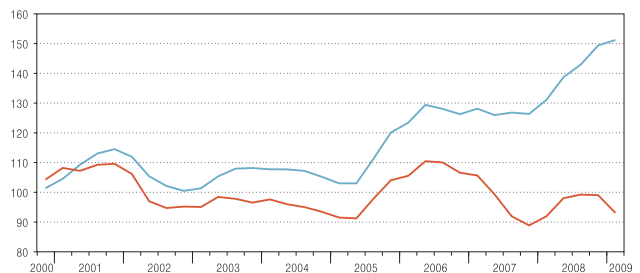
Mining and Quarrying



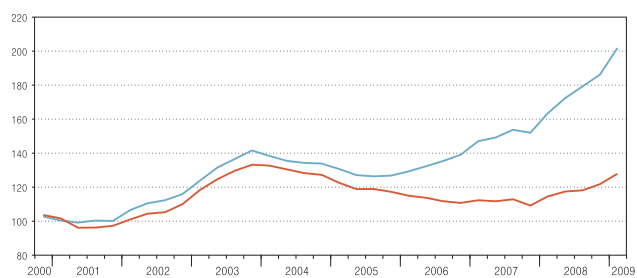
Construction



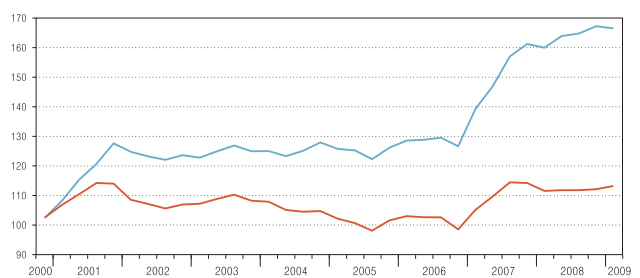
Electricity, Gas and Water Supply



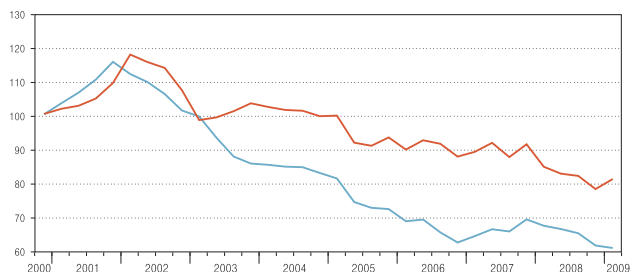
Trade



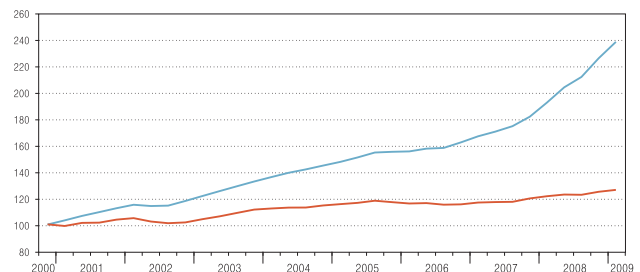
Transport and Communications



Financial Intermediation



Other Sectors



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

Note: The 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.

tions. Rises in the minimum wage and minimum social security thresholds since early 2009 contributed to this. On a chain basis and given the seasonality, wage costs slowed down significantly which suggests that real costs may decline in the coming quarters. In the sectors most severely affected by the worsened external demand, e.g.

Exports and Imports of Goods

In the third and fourth quarters of 2009 negative trends in export and import growth rates are expected to continue, with imports falling faster than exports which will result in trade deficit improvements.

Due to deepening of the global economic crisis in EU countries, Bulgaria's major trade partner, a dramatic slowdown in foreign trade flows to Bulgaria¹³ was registered in the first four months of 2009. Export growth was negative at -30.4 per cent on the first four months of 2008, while imports registered a 32.6 per cent decrease.¹⁴

According to preliminary data, this trend was sustained in May when exports fell by 32 per cent and imports by 36.7 per cent.

In the first four months exports and imports of *mineral products and fuels*, and *raw materials* reported the strongest decrease. The *mineral product and fuel* group traditionally shows a procyclical pattern. In the *raw material* group, exports fell due to external demand contraction and price decreases, while the import fall was driven by both lower prices and reduced domestic demand and exports of investment and consumer goods.

Over the January to April 2009 period *investment goods* and *mineral products and fuels* contributed most (by -17.5 percentage points and -10.5 percentage points respectively) to the decrease in trade deficit (by EUR 929.8 million). Imports of both groups went down, with the overall decline exceeding that of exports. In imports of investment goods, *machines and equipment* and *transportation vehicles* exhibited the most pronounced drop due to the simultaneous reduction of output and investment activity in Bulgaria and the EU which is its major trade partner.

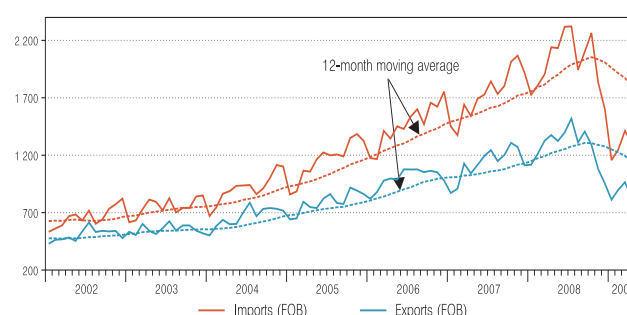
¹³ For a comparative analysis on the other new EU Member States see the box entitled *The Global Economic Crisis: Competitiveness and the Role of the Exchange Rate* in this issue.

¹⁴ The analysis presented in this section is based on data about nominal exports and imports in euro.

manufacturing, firms managed to adjust their wage expenditure so as to retain their cost competitiveness. A considerable portion of the real unit labour cost increase was due to the public sector. In addition, the existing shadow employment in some sectors did not allow real changes in labour costs to be reported.

Dynamics of Exports and Imports

(million EUR)



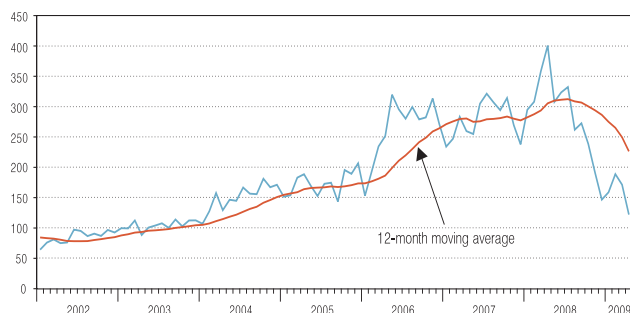
Source: BNB.

Between January and April 2009 all groups excluding *animal and plant products*, *foods*, *drink and tobacco* contributed to the negative growth of exports, with the dynamics of *base metals* (-11.4 percentage points), *mineral products and fuels* (-8.0 percentage points), *textile, clothing and footwear* (-2.6 percentage points) and *machines, transportation vehicles and appliances* (-2.5 percentage points) contributing most to this.

Between January and April 2009 base metal export revenues amounted to EUR 638.7 million, down 53 per cent on the corresponding period of 2008. The group's major negative contribution to the total export dynamics was registered by *copper* (-6.0 percentage points) and *iron and steel* (-3.1 percentage points) due to lower international prices and weaker external demand. Our expectations of base metal exports in the projected horizon are for a continued decline due to external demand contraction and lower prices.

Exports of Base Metals

(million EUR)

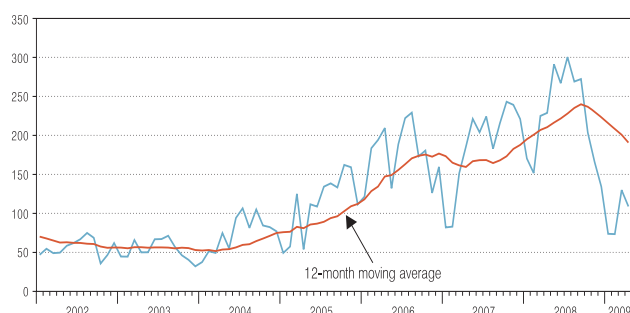


Source: BNB.

Revenue from exports of mineral products and fuels went down EUR 390.2 million (50.2 per cent). Negative developments were reported under all major items in the group, with fuels contributing most significantly to these developments (by -7.5 percentage points) owing to lower prices and external demand contraction. Due to the strong procyclical dynamics of mineral product and fuel exports, our expectations for the third and fourth quarters of 2009 are for retaining the downward trends as a result of the global economic crisis despite some rises in oil prices over the projected period.

Exports of Mineral Products and Fuels

(million EUR)

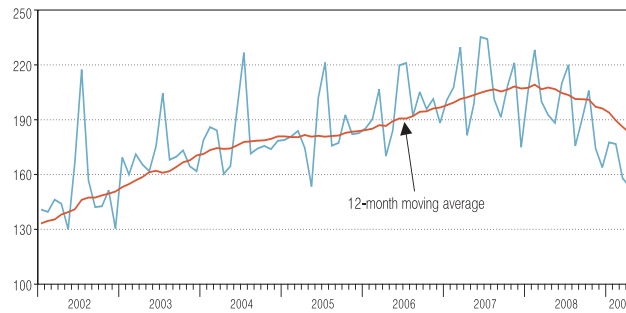


Source: BNB.

Revenue from textile exports decreased by EUR 160.5 million (19.4 per cent) compared with the same period of 2008, with the decrease in clothing exports (a contribution of -1.3 percentage points) having the strongest impact. Over the projected period the downward trend which had started since early 2007 and continued during 2008 and in the first four months of 2009 is expected to be sustained due to restructuring in this industry and the worsened external environment.

Exports of Textile, Clothing and Footwear

(million EUR)

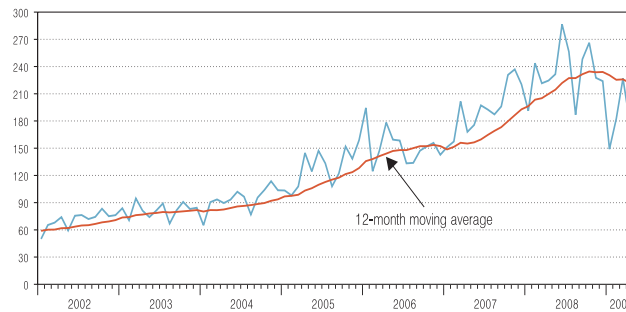


Source: BNB.

Receipts from exports of machines, transportation vehicles and appliances went down by EUR 144.1 million (16.4 per cent). All components of this group reported a decrease with the exception of *transportation vehicles and spare parts for aircraft* which retained their positive growth rates in spite of the worsened international environment. *Nuclear reactors, boilers, machines, appliances and machinery* had a major negative contribution (-1.8 percentage points). Due to the worsened global environment, the negative growth in this group is expected to continue in the projected horizon as well.

Exports of Machines, Transportation Vehicles and Appliances

(million EUR)

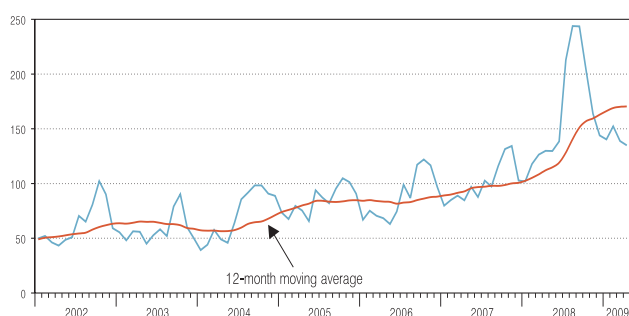


Source: BNB.

The group of animal and plant products, foods, drink and tobacco is the only group reporting a positive contribution to overall exports between January and April 2009. Their revenue rose by EUR 89.9 million (18.9 per cent), with *cereals* (2.1 percentage points) and *tobacco* (0.4 percentage points) contributing most significantly driven by good harvests and strong competitive positions. This trend is expected to continue over the projected horizon with the risks on the downside owing to the uncertain agricultural harvest.

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

(million EUR)



Source: BNB.

Contribution of Commodity Groups to Trade Growth, January – April 2009

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	-6.8	-1.5	-12.5	-2.1
Raw materials	-37.9	-17.9	-38.1	-13.4
Investment goods	-23.8	-3.9	-33.0	-8.9
Energy resources	-51.0	-7.1	-39.3	-8.4
Growth, total	-30.4		-32.6	

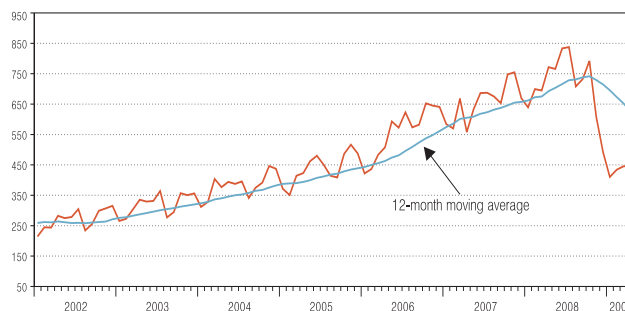
Source: BNB.

Imports (CIF) reached EUR 5374.9 million in the January to April 2009 period: a nominal decrease of EUR 2598.4 million (32.6 per cent) on the respective period of the prior year. In the structure of imports by use, *raw materials* registered the highest negative contribution (-13.4 percentage points), followed by *investment goods* (-8.9 percentage points) and *mineral products and fuels* (-8.4 percentage points).

In the first four months of 2009 payments on imports of raw materials came to EUR 1741.4 million, down 38.1 per cent. All items in this group reported declines, with *iron and steel* (-3 percentage points) and *ores* (-2.3 percentage points) having the major negative contributions due to lower prices, output activity contraction and weaker domestic demand.

Imports of Raw Materials

(million EUR)

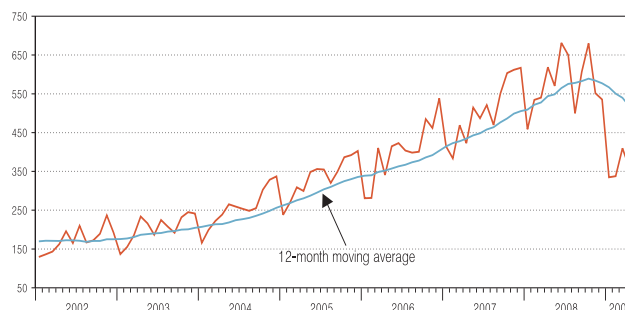


Source: BNB.

Investment goods imports fell by 33 per cent between January and April 2009; these products ranked second in imports (after raw materials) with a share of 26.8 per cent. Their value reached EUR 1443 million. All items in this group reported negative growth, with *transportation vehicles* ranking first (-3.3 percentage points), followed by *machines and equipment* (-2.4 percentage points) due to the reduced investment activity in Bulgaria. Our expectations for the third and fourth quarters of 2009 show further worsening in *raw materials* and *investment goods* due to lower world prices and weakening domestic investment and consumer demand.

Imports of Investment Goods

(million EUR)

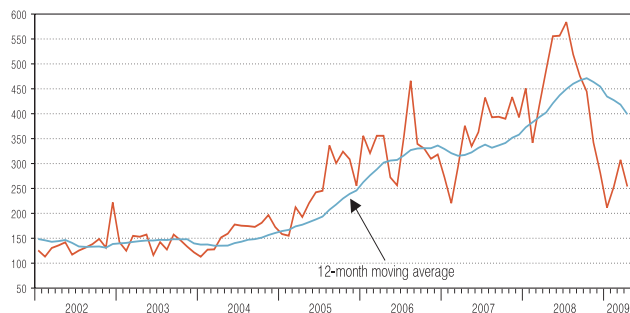


Source: BNB.

Between January and April 2009 payments on imports of mineral products and fuels came to EUR 1029.9 million, down 39.3 per cent. All items reported negative growth, with *fuels* (-7.3 percentage points) and *natural gas* (-7.2 percentage points) registering major negative contributions. Our expectations show that declines in the nominal growth rates of mineral products and fuels in the first four months of 2009 will continue due to lower global prices and reduced domestic demand.

Imports of Energy Resources

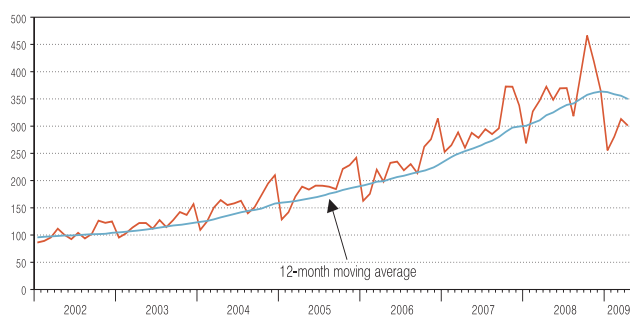
(million EUR)



Source: BNB.

Imports of Consumer Goods

(million EUR)



Source: BNB.

Between January and April 2009 imports of consumer goods went down by EUR 164.1 million (12.5 per cent) on the same period of the prior year, with their value reaching EUR 1148.3 million. All items in this group excluding *foods, drink and tobacco products* and *medicines and cosmetics* reported negative growth. *Automobiles* and *furni-*

ture had the most significant negative contributions (-1.4 and -0.9 percentage points respectively) which is consistent with our expectations of declines in demand for durables and postponement of such purchases. We expect this downward trend in consumer goods imports to continue in the projected horizon due to the contraction in final consumer demand.

According to preliminary data, Bulgaria's exports to other EU Member States between January and April 2009 dropped by 26.5 per cent, while exports to non-EU countries decreased by 36.7 per cent. Goods imported from the Community went down by 30.7 per cent, while those from third countries by 34.6 per cent. Over the forecast horizon no significant changes in Bulgaria's foreign trade geographic structure are expected.

In the context of the world trade decline and the recession in the countries which are Bulgaria's major partners, the market share of Bulgarian goods in total imports of Community Member States decreased to reach 0.55 per cent in the first quarter of 2009 (on an annual basis), from 0.59 per cent a year earlier.

The effect of declining world prices and shrinking external and domestic demand will continue in the third and fourth quarters of the year. Nominal imports are expected to continue decreasing at faster rates than exports which will improve Bulgaria's trade deficit.

The Global Economic Crisis: Competitiveness and the Role of the Exchange Rate

The financial crisis started in the summer of 2007 as a US sub-prime mortgage crisis and since the autumn of 2008, following the Lehman Brothers bankruptcy, significantly deepened, causing a global slowdown in economic activity, which, in turn, further worsened the situation in the financial sector. The unprecedented measures undertaken by the major economies' governments and central banks led to certain stabilization, although the functioning of the international financial markets did not normalize, with distrust among the main institutions on the markets staying high. These trends were coupled with nominal depreciation in the currencies of a number of countries, especially of those in the small and opened economies.

There is a view in the literature that the countries with a fixed exchange rate are in a more unfavourable position during a crisis regarding their competitiveness compared with those with a floating exchange rate. This is explained by the fact that the currencies of the countries with a floating exchange rate may depreciate, which should make their exports more competitive, as well as by the possible conducting of a countercyclical monetary policy. In practice, however, there are channels of impact that can smooth or totally offset the positive effects of currency depreciation and autonomous monetary policy.

The depreciation of the national currency results in appreciation of the production activity import component (imports of raw materials and investment goods), thus leading to higher expenditure of enterprises and deteriorating exports' competitive positions. The higher import price impacts directly the *inflation level* in Bulgaria as well. Higher inflation, in turn, exerts pressure towards nominal wage rises, further pushing up expenditure of enterprises. Therefore, *labour market flexibility* is a more important factor for preserving the economy's competitive positions than the possibility of a nominal change in the exchange rate. Local currency depreciation also has a direct negative effect on the financial performance of enterprises since the service of obligations in foreign currency becomes more costly (a *balance sheet effect*).

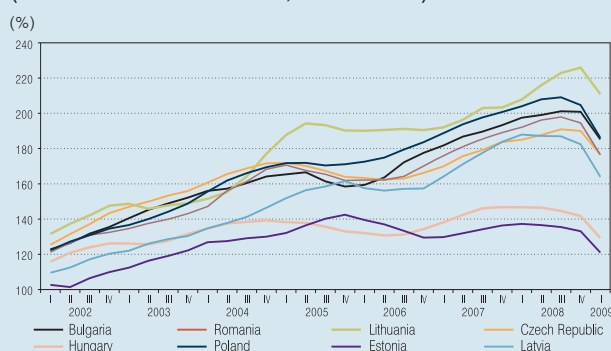
Another conventional argument in support of the exchange rate free-floating regime is the possibility of conducting an *autonomous countercyclical policy* pursuing objectives related to the internal economy. However, the fulfillment of certain conditions (for example the presence of normally functioning financial markets and the lack of currency substitution) is indispensable to the successful monetary policy transmission. In addition, even if these conditions are not fulfilled, monetary policy implementation takes into account the exchange rate dynamics.*

Exports Dynamics and Exchange Rate Regime

Available empirical evidence does not support the advantage of floating exchange rates in the current worsened situation. Data on the exports share of Central and Eastern European countries in the imports of EU-27 in euro show that the countries cannot be grouped by their exchange rate regime (fixed or floating). The share of Lithuania's exports in the imports of EU-27 (annual base index) continued to grow in the first quarter of 2009. The most dramatic decline was reported in Latvia and Poland, followed by the Czech Republic, Bulgaria, Lithuania, Rumania and Hungary.

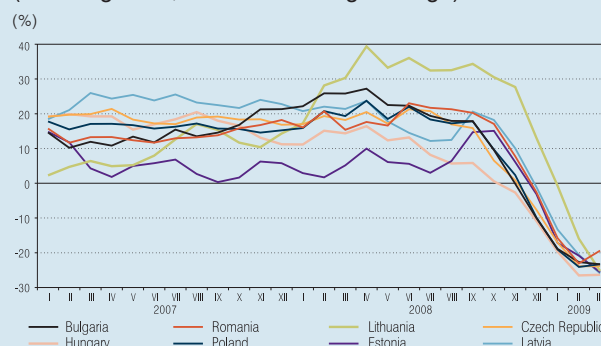
The total exports dynamics in euro of the new EU Member States also does not appear to differ significantly in the countries with fixed and floating exchange rates. International trade in all countries contracted significantly in the last

Share of CEECs Exports in EU-27 Imports
(index on an annual basis, 2000 = 100)



Sources: Eurostat, BNB.

Dynamics of Total Exports in Euro
of the New EU Member States
(annual growth, 3-month moving average)



Sources: Eurostat, BNB.

* The exchange rate could be an intermediate objective of monetary policy. Even if it is not so, its impact on the economic developments in Bulgaria is taken into consideration in formulating and conducting the monetary policy.

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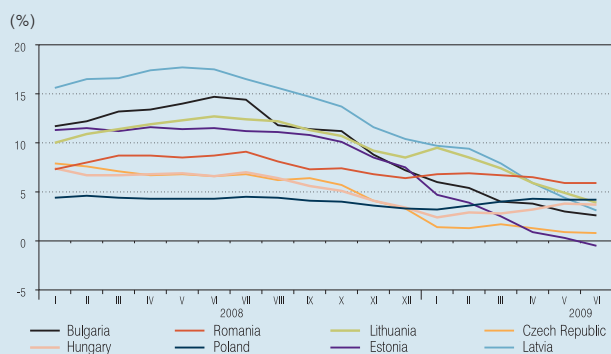
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quarter of 2008; the process is synchronous regardless of whether the exchange rate is fixed or floating and is accounted for by the common shock: the dramatic slowdown in external demand.

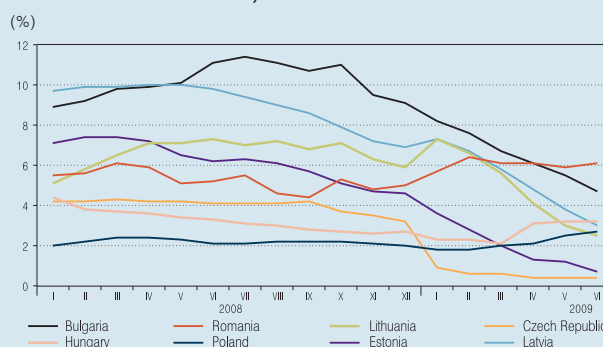
Inflation and Exchange Rate Developments

Currency depreciation in the countries with a floating exchange rate observed between end-September 2008 and the first months of 2009 was one of the main factors behind rising inflation in these countries. During the first half of the present year the annual inflation growth rate in the countries that registered the strongest depreciation (Poland, Rumania and Hungary) grew or stayed relatively unchanged. By comparison, countries with a fixed exchange rate experienced a clearly outlined downward trend of inflation, underpinned by the decline in the economic activity and depreciation in international prices of major raw materials and oil.

Annual Inflation Rate in the New Member States

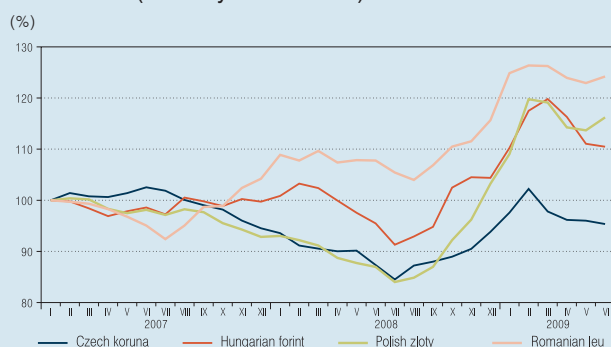


Annual Inflation Rate in the New Member States (Excluding Foods, Energy Products, Alcohol and Tobacco Products)



Labour Market Flexibility

Indices of Average Monthly Nominal Exchange Rates to the Euro (January 2007 = 100)



Share of Loans Denominated in Foreign Currency in Total Loans to Non-financial Corporations and Households

	Non-financial corporations	Households
Bulgaria	73.3	29.8
Estonia	88.5	83.3
Lithuania	-	64.7
Latvia	91.6	88.2
Czech Republic	17.9	0.12
Hungary	60.2	68.3
Poland	26.9	39.6
Romania	57.6	60.1

Note: Data as of April 2009.

Sources: The central banks of the countries and the ECB.

Downward flexibility in wages was an essential prerequisite for retaining competitiveness under worsened external economic conditions.

During the last few years nominal unit labour costs went up in all reviewed countries, reflecting the processes of nominal convergence (rising prices and wages). These developments do not depend on individual countries' exchange rate regimes. In most economies the adjustment of labour costs in the first quarter of 2009 was insufficient to offset the negative economic growth which pushed up unit labour costs. The response of wages resulting from the economic crisis is also independent from the classification by fixed and floating exchange rates.

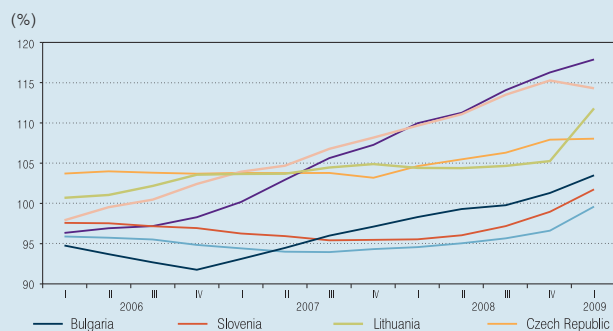
Exchange Rate and the Balance Sheet Effect

Among the countries with a floating exchange rate, in Hungary and Rumania the share of loans to non-financial corporations in foreign currency was some 60 per cent, which implies that the balance sheet effect in these countries was stronger. In Bulgaria and the Baltic states, where the share of loans in foreign currency (mainly reserve currency) was comparatively higher, no balance sheet effect was observed owing to the fixed exchange rate.

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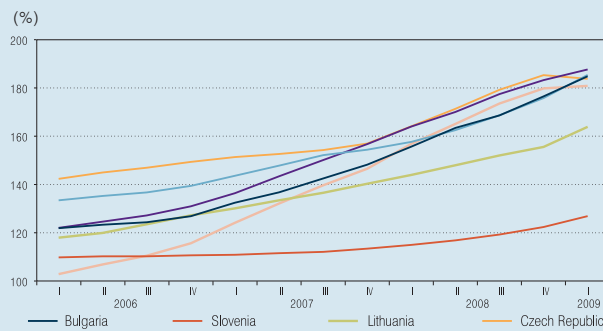
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Real Unit Labour Costs (2000 = 100)



Source: Eurostat.

Nominal Unit Labour Costs (2000 = 100)



Source: Eurostat.

Exchange Rate Regime and Monetary Conditions

The current stage of the global economic crisis illustrates the fact that the choice of an exchange rate regime cannot unequivocally be associated with advantages or disadvantages. As regards the autonomous monetary policy's capabilities to boost the real economic activity, it is sufficient to outline just two of the current problems. First, amid strong lack of confidence in international financial markets and still unrestored normalisation of their functioning, transmission of the conducted monetary policy is largely limited. For instance, despite the series of cuts in ECB interest rates on refinancing operations, the effect on interest rates in the euro area financial markets was small and the spread between them was widening. Despite the significant amounts of liquidity provided by the ECB, the lack of confidence among financial institutions and their high risk aversion disallowed intensified lending. In response, the ECB introduced a number of instruments for longer-term financing, reaching operations with a 12-month maturity, launched in June 2009.

Second, pursuing objective related to the internal economy through autonomous monetary policy is even more difficult in small open economies. For example, in response to the 2008 high inflation and probably to the depreciating currency during the second half of 2008 and early-2009, the Romanian and Hungarian central banks raised dramatically their main rates, which prompted rises in the overnight interbank deposit rates. Thus, notwithstanding the recession in these economies (the reported drop in the GDP for the first quarter was 5.4 per cent in Hungary and 5.7 per cent in Romania), the central banks of these countries were not able to provide monetary stimuli to economic growth.

As regards overcoming the effects of the economic crisis under the conditions of the fixed exchange rate, one of the main arguments in support of abandoning the autonomous monetary policy is related to following the monetary policy of the country whose currency is used as a reserve currency. Thus, due largely to the currency board in Bulgaria, the monetary conditions in the country follow those in the euro area since it ensures stability and predictability of the macro-economic environment.

The Outlook for Recovery from the Crisis

The expectations that the countries with a floating exchange rate will recover faster from the recession are based on the assumption that national currencies will depreciate steadily while the more expensive import will not affect the expenses of enterprises on goods for intermediate consumption and investment goods and, therefore, the wage-price spiral will be avoided. These assumptions are not supported by the above-mentioned data so far. Faster recovery of individual Member States' economies will depend on a number of factors related to the real developments of economic processes, rather than on exchange rate nominal values. Thus, individual economies' structural characteristics, such as labour market flexibility and the opportunity of improving efficiency at firm and sectoral levels will play a key role. Maintaining investor interest and a prudent and consistent fiscal policy will also be of crucial importance.

4. Inflation

Annual inflation is projected to decline further during the third quarter. Decreasing consumer demand due to expectations of higher unemployment and uncertainty concerning incomes will curb price rises. During the third quarter deflation on an annual basis may be reported. Inflation is anticipated to stay positive at a low level during the fourth quarter.

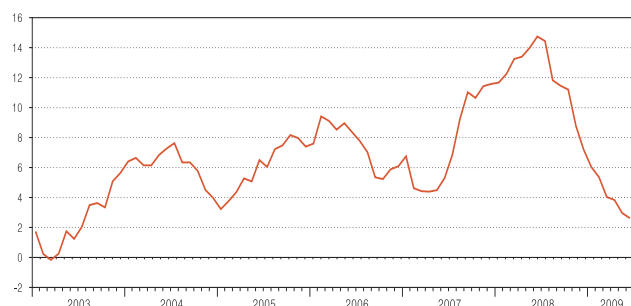
In the first half of the year the trend towards decreasing inflation on an annual basis was sustained; in June 2009 it reached 2.6 per cent (7.2 per cent at the close of 2008).

The two groups with major contribution to inflation slowdown over the second half of 2008, foods and fuels, continued to be the factors behind its clearly outlined downward trend in the first two quarters of the present year. Food and fuel price dynamics reflects both the global trend towards decreasing prices and the ongoing impact of enhanced supply of major agricultural products resulting from the good harvest in Bulgaria during 2008.

From the year start an abrupt drop in inflation of foods is observed, with their June prices staying close to their level a year earlier, contributing by 0.1 percentage points to annual inflation (1.5 percentage points in December). Contribution of fuels to inflation on an annual basis in June continued to be negative (-1.3 percentage points) due to a base effect despite the rises in their prices. By comparison, this group had a -1 percentage point contribution to annual inflation in December.

Harmonized Index of Consumer Prices

(inflation on corresponding month of previous year, %)



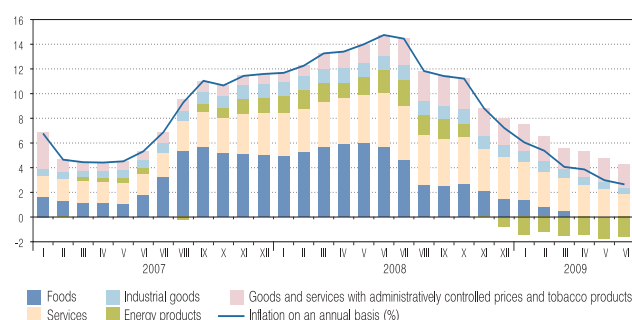
Source: NSI.

The slowdown in consumer demand which registered a 6.3 per cent drop in the first quarter of the current year, in addition to food and fuel price

dynamics, was a key factor behind the moderating overall inflation rate from the fourth quarter of 2008.

Inflation Rate on the Corresponding Month of Previous Year and Contribution of Major Goods and Services Groups*

(on corresponding month of previous year, %)



* This structure corresponds to the Eurostat classification; tobacco products and goods and services with administratively controlled prices are presented separately.

Sources: NSI, BNB.

Heightened economic environment uncertainty led to caution in household behaviour. It was reflected in growing propensity to savings and limiting consumer expenditure despite the still positive real income dynamics (see the *Economic Activity* section in this issue). Increasing unemployment and deteriorating expectations about it, as well as the relatively more difficult access to loans and rising interest rates on deposits also fostered propensity to savings and pushed down demand. The decline in household real consumption was the main factor behind the slowing annual growth rate of services and non-energy industrial goods prices. As of June services contributed to inflation on an annual basis by 1.8 percentage points (3.4 percentage points in December), while non-foods by 0.5 percentage points (1 percentage point at the close of 2008). A base effect triggered by accelerating rises in the prices of certain services (like those of transport and catering) during the

first half of 2008 also contributed to the faster slowdown in inflation of services.

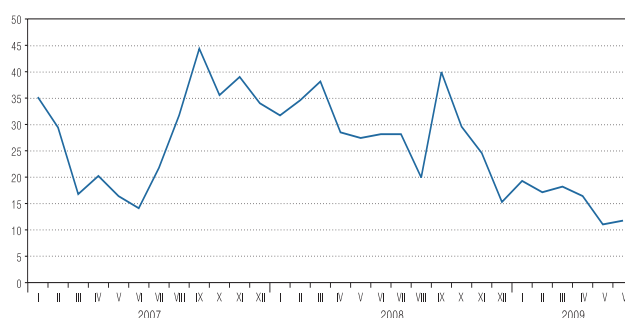
Unlike the previous year, when due to raised excise duty of tobacco products their appreciation materialized gradually over the year, in 2009 this group reported a one-off considerable price rise in April owing to the shorter grace period. As a result of the accelerating annual growth rate of tobacco product prices, at the start of the second quarter of 2009 no faster drop in overall inflation was registered. The total contribution of tobacco products and goods with administratively controlled prices to annual inflation in June was close to that in December 2008: some 2 percentage points.

Between January and June 2009 accumulated inflation came to 1.2 per cent: down 4.5 percentage points on the corresponding period of 2008. Tobacco products, fuels and services had a main contribution to this effect, respectively by 0.7, 0.5 and 0.4 percentage points. The total level of food prices in June was lower by 2 per cent on the end of 2008 (a -0.5 percentage point contribution), while non-food deflation was lower by -0.2 per cent (a -0.03 percentage point contribution). The accumulated inflation (excluding that of to-

bacco products and goods with administratively controlled prices) was minimal (0.3 per cent) and reflected the considerable reduction in inflationary pressure in Bulgaria as a result of contracting economic activity.

The limited increase in consumer prices since the end of 2008 is also evidenced by diffusion index data reporting the share of the groups in the consumer basket with monthly appreciation higher than 1 per cent. According to the index, such price rises were observed in just 12 per cent of the groups in the basket.

Diffusion Index*



* The diffusion index is calculated on the basis of the elementary aggregates in the consumer basket and is a relative share of the aggregates with a monthly growth rate of prices higher than 1 per cent.

Sources: NSI, BNB.

Growth Rate of Major Goods and Services Groups Prices and Their Contribution to Accumulated Inflation

	January – June 2008		January – June 2009		June 2008 – June 2009	
Inflation (%)	5.7		1.2		2.6	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
Foods	3.3	0.83	-2.2	-0.53	0.2	0.07
Processed foods	5.1	0.81	-2.1	-0.33	-2.1	-0.32
Unprocessed foods	0.2	0.02	-2.2	-0.20	4.2	0.39
Services	6.6	1.91	1.2	0.37	6.1	1.80
Catering services	7.1	0.76	2.3	0.27	9.7	1.06
Transportation services	14.0	0.71	-0.9	-0.04	0.8	0.05
Telecommunication services	-0.9	-0.04	-0.7	-0.03	-1.0	-0.04
Other services	5.4	0.48	1.9	0.17	8.2	0.73
Energy products	16.0	1.38	5.5	0.42	-17.6	-1.66
Transportation fuels	16.5	1.28	6.9	0.46	-20.2	-1.34
Industrial goods	2.2	0.38	-0.2	-0.03	3.0	0.51
Goods and services with administratively controlled prices	4.4	0.72	1.6	0.25	7.2	1.14
Tobacco products	12.6	0.43	23.3	0.67	26.1	0.76

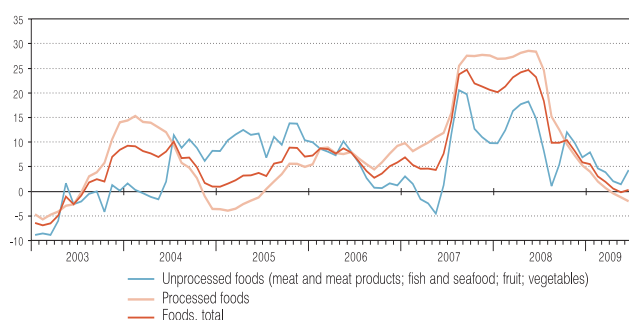
Sources: BNB, NSI.

Food Prices

During the first half of 2009 foods continued to contribute most to the decline in inflation. This reflected the clearly outlined trend towards moderating growth rates of their prices and their relatively large weight in the consumer basket (25 per cent). In June food prices registered a slight increase on the same month of the previous year, with accelerating annual inflation of non-processed foods playing the major role in these developments. At the same time, processed foods recorded deflation on an annual basis.

Harmonized Price Indices of Foods

(inflation on corresponding month of previous year, %)

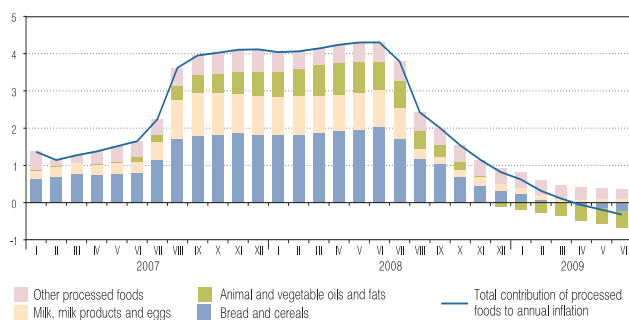


Sources: NSI, BNB.

Growing supply especially of cereals and sunflower as a result of the very good 2008 harvest which went on impacting them during the first half of 2009, put a downward pressure on food prices.

Contribution of Major Groups of Processed Foods to Annual Inflation

(p.p.)



Sources: NSI, BNB.

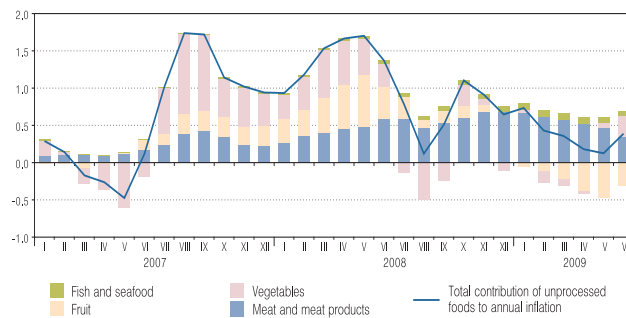
Processed food inflation slowed down very fast and as of June a -2.1 per cent deflation on an annual basis was reported in this group. *Bread and cereals*, and *vegetable oils* contributed most to the moderation of overall consumer price inflation. In the group of non-processed goods, meat and meat products played a decisive role for the

decline in end-2008 overall inflation. At the same time, accelerating annual inflation in vegetables and to a lesser degree in fruit, observed at the close of the second quarter of 2009, had an opposite effect compared with overall inflation.

Producer prices in food industry fell by 5.9 per cent on an annual basis in May, suggesting that additional transferring of lower production prices to end-use prices in the group of foods (excluding vegetables and fruit) may be expected in the following several months.

Contribution of Major Groups of Unprocessed Foods to Annual Inflation

(p.p.)



Sources: NSI, BNB.

Due to a base effect the low inflation in foods during the third quarter will probably be sustained or deflation may be registered as a result mostly of the dynamics in processed foods whose prices will still depend on inventories of commodities from the 2008 harvest. There is uncertainty around food prices for the last quarter due to unpredictability of the harvest during the current year. Some of the processed foods may report a slight increase in their prices on a quarterly basis. Nevertheless, until the end of 2009, food prices are expected to stay close to their last year level.

Energy Products Prices

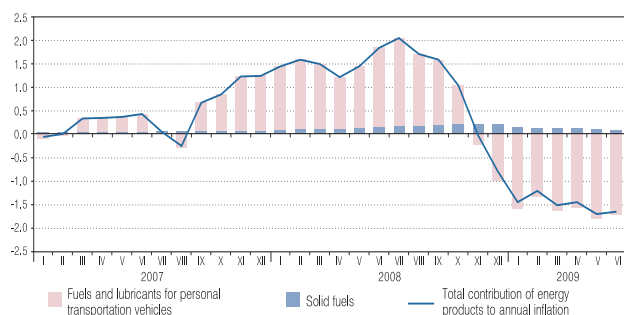
During the first half of the current year the prices of energy products (excluding those with controlled prices) continued to fall on an annual basis, reflecting the sharp drop in the price of oil compared with the same period of the previous year. This contributed to the decline in overall inflation on an annual basis.

The rise in oil prices from EUR 37 *per* barrel in March to some EUR 49 *per* barrel in June was accompanied by rises in fuel prices (the major component in the group of energy products) by around 12 per cent. Nevertheless, owing to a

base effect, the annual change in the prices of energy products in June stayed negative reaching -18 per cent (-20 per cent in fuel prices).

Contribution of Major Groups of Energy Products (Excluding Those with Administratively Controlled Prices) to Annual Inflation

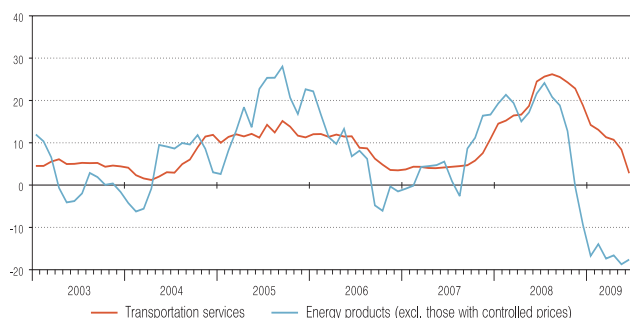
(p.p.)



Sources: NSI, BNB.

Harmonized Price Indices of Energy Products and Transportation Services

(inflation on corresponding month of previous year, %)



Note: 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.

Annual inflation in transportation services (including those with administratively set prices) continued to follow a clearly outlined downward trend, although it was more moderate than that in fuels.

Despite the similar developments in the two sub-groups of transportation services (with market and administratively controlled prices), the trend was more pronounced in the first sub-group. This reflected the deflation in the sub-group that started early in the year and, although insignificant (-0.9 per cent), led to a faster slowdown in annual inflation rate compared with urban and railway transport which reported no reduction in prices owing to their stronger downward rigidity.

Expectations of oil price fluctuations within the range of USD 60–80 during the second half of the year will additionally impact fuel prices. Annual deflation in energy products is anticipated to be

sustained, although more moderate, during the third quarter, thus pushing down overall rate of inflation. At the close of the year the annual growth of energy products prices will become positive as a result of a base effect, triggered by the dramatic fuel depreciation during the same period a year earlier. This specific feature of energy products price dynamics should increase overall inflation by the end of 2009.

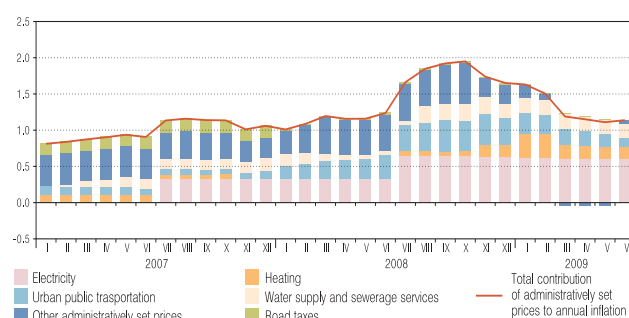
Despite projected fuel appreciation, the prices of transportation services are likely to remain unchanged or to rise slightly as a result of demand downturn. Such developments will lead to a low positive or close to zero annual growth rate of these services prices at the year end.

Administratively Controlled Prices and Tobacco Products Prices

During the first half of the year administratively controlled prices were characterized by a slighter increase compared with the same period of the prior year; as a result, their annual growth rate slowed down from 10.2 per cent at the close of 2008 to 6.9 per cent in May 2009. Appreciation of medicals prescribed under the positive list of the National Healthcare Fund was the main factor behind the increase in the inflation in this group to 7.2 per cent in June. The total contribution of administratively controlled prices to annual inflation in June came to 1 percentage point. Electricity added most to overall harmonized inflation (by 0.6 percentage points), followed by water supply and heating (by 0.2 percentage points each).

Contribution of Major Groups of Goods with Administratively Controlled Prices to Annual Inflation

(p.p.)



Sources: NSI, BNB.

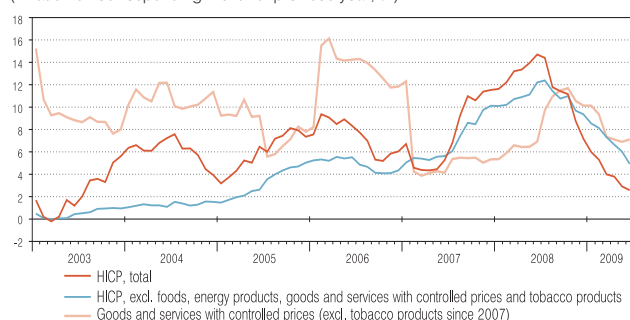
Inflation in administratively controlled prices is anticipated to slow down considerably during the second half of 2009 and to reach a low positive level at the close of the year. A reason for this will be the decreases in certain groups of prices,

as well as a base effect stemming from the previous year's raises.¹⁵ Expectations point to an abrupt decline in inflation in administratively controlled prices since the beginning of July, which will contribute considerably to the moderation in overall inflation annual rates.

Falls in electricity and heating prices, as well as those in wholesale prices of calls between fixed and mobile networks will be of major importance for the anticipated dramatic slowdown in inflation in administratively set prices. Electricity prices were lowered by 1.6 per cent, while heating prices by some 10–11 per cent. Adjustments in the price of electricity will contribute most to the decline in inflation in July, with the base effect, prompted by the 14 per cent appreciation of July 2008, having a strong effect. The lower prices of heating will probably be reflected in the consumer basket over time. Their impact on inflation may be stronger during the last quarter of 2009 due to the relation between reflecting the services prices in the consumer basket and the actual period of their consumption.

Harmonized Indices of Goods 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.

Depreciation of wholesale prices of calls between fixed and mobile networks since 1 July will also result in a slowdown in inflation of administratively controlled prices and, subsequently, of overall inflation.¹⁶ In addition, due to the depreciation

¹⁵ An assumption is made that the prices of the groups about which there is no information about changes in their prices will stay the same.

¹⁶ Adjustments in these prices resulted from the synchronization of the Communications Regulation Commission policy with the recommendations of the European Commission in respect of fixed and mobile services markets. Based on information of the Communications Regulation Commission of 13 March 2009, the introduction of symmetry between the charges of calls from fixed to mobile networks and between mobile networks will push down the prices of calls from fixed to mobile net-

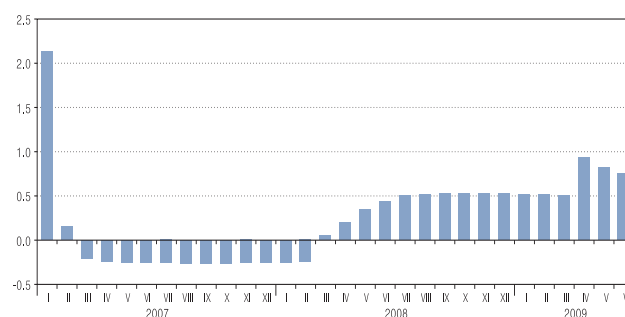
works, which also came into force on 1 July 2009, a certain decrease in the market prices of calls between mobile operators may be expected.

In the absence of substantial adjustments in some of the other controlled prices with a larger weight in the consumer basket, such as public transport and water supply, a base effect stemming from the raises in their prices in the second half of 2008 will exert an additional downward pressure on inflation. A similar effect is anticipated to occur in higher education fees, whose approved increase for the current year is smaller (8 per cent) than that in the prior year (20 per cent). The putative entry into force during the present year of the higher administrative fees for issuing identity documents could put an upward pressure on annual inflation in administratively controlled prices.

Tobacco products contributed most to accumulated inflation since the start of the year. Over the first six months cigarette price rises resulting from raised excise duties in 2009 were higher than had been anticipated earlier (15–16 per cent) and came to about 23 per cent. Compared with 2008, when their appreciation materialized gradually over the year, in 2009 a one-off considerable price rise was reported in April (by 18 per cent) owing probably to the shorter grace period (three months) of sales at the old prices. Provided tobacco product prices retain their level, their annual inflation will slow down to some 23 per cent in December (from 26 per cent in May). Tobacco products, in tandem with fuels, are expected to have a major contribution to inflation at the end of the year.

Contribution of Tobacco Products to Annual Inflation

(p.p.)



Sources: NSI, BNB.

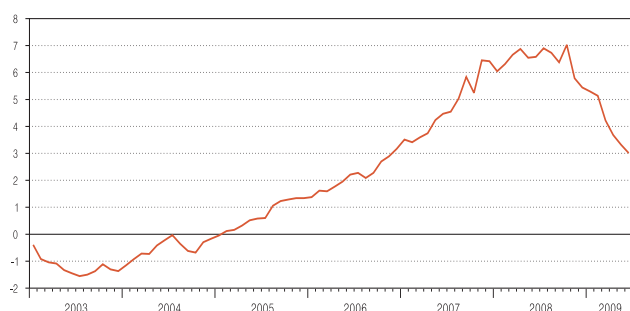
works by 14 per cent for the strong traffic and 24 per cent for the weak traffic.

Non-energy Industrial Goods Prices

Underpinned by contracted consumer demand, the trend towards moderating growth of industrial goods prices, which started in the last few months of 2008, was sustained during the first half of 2009. In June the prices of the goods in this group posted an increase of 3.0 per cent on the same month of the previous year (against an annual growth of 5.4 per cent in December).

Harmonized Price Indices of Industrial Goods Excluding Energy Products and Those with Administratively Controlled Prices

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

The decline in non-foods' contribution to inflation resulted mainly from falls in automobile prices and the slower growth rates of clothing and footwear prices.

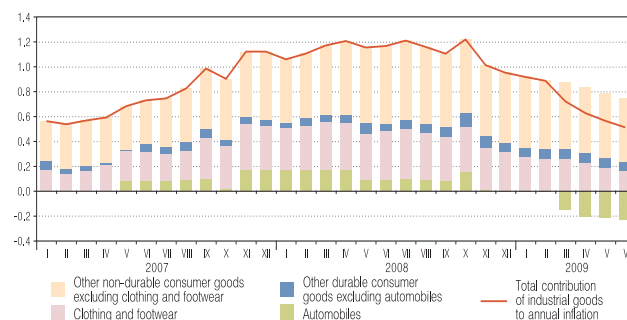
Concurrently, in the other non-foods no similar fast drop in inflation was registered. This, on the one hand, can be explained by the fact that probably the firms do not experience such severe cuts in demand as in the trade in automobiles, clothing and footwear, which may be typical, in particular, of non-durables. Second, it should be taken into account that the relative share of the above-mentioned three groups in the consumer price index is comparatively bigger; therefore, its impact on overall inflation is more clearly pronounced. Third, a different base effect may be of importance in individual groups of goods.

Contracting consumption predominantly of durables, clothing and footwear is seen in the data on industrial sales on the domestic market, retail trade revenues, imports of automobiles and trade in automobiles, and household budgets, as well as in the consumer survey (see the *Economic Activity* section in this issue). Weaker demand predominantly for durables, such as automobiles, is determined to a large extent by the dependence on the financing of purchases by loans. Heightened economic environment uncertainty and

deteriorating expectations of unemployment and incomes constrained credit demand; in addition, tightened bank credit policy also played a role. At the same time, the more permanent nature of the demand for non-durables was the main driver of their more sustainable price dynamics.

Contribution of Major Groups of Industrial Products (Excluding Energy Products and Goods with Administratively Controlled Prices) to Annual Inflation

(p.p.)



Sources: NSI, BNB.

According to recent data on the economic situation in retail trade for June the general opinion in the sector is that the price level should be retained during the following three months. These data may be considered as an indicator that demand slowdown continues to put a pressure on non-food prices.

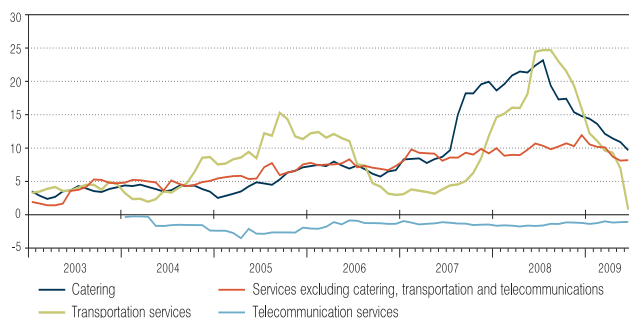
Non-food inflation is expected to continue to gradually moderate till end-2009 reflecting the decline in consumer demand as a result of the higher unemployment and uncertainty regarding incomes. A low positive growth rate of non-food prices is anticipated by the close of the year. The trend towards contracting demand for durables, clothing and footwear will probably be preserved, while consumption of other groups of goods will depend on the degree to which the demand for them will be reduced.

Prices of Services

During the first half of 2009 annual inflation in services (excluding those with administratively controlled prices) continued its downward movement. In June the prices of services posted an increase of 6.1 per cent on the same month of 2008. The annual price growth in this group was by 5.7 percentage points lower than that of previous year's end. Due to the relatively high share of services in the consumer basket (30 per cent), this dynamics brought about a fast decline in overall inflation.

Harmonized Indices of Services Excluding Those with Controlled Prices

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

A base effect triggered by the accelerated rises in the prices of services at the start of 2008 led to a fast fall in inflation on an annual basis during the first half of the current year. This is particularly relevant for the prices of transportation services and public catering on which fuel and food price dynamics put a considerably weaker pressure compared with the same period of 2008.

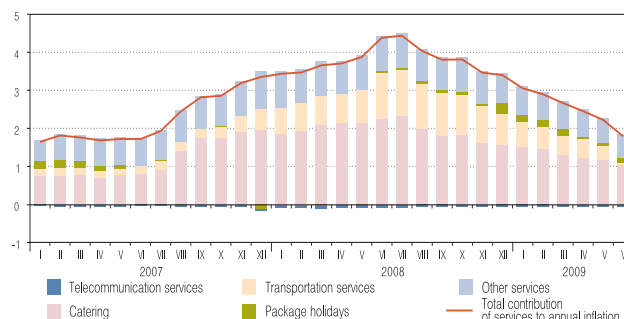
As in non-foods, the strongly subdued price developments in services resulted mainly from the slowdown in economic activity which affected negatively household consumption. Firms in the sector are facing the growing uncertainty in the economic environment; therefore, they are forced to cut their expenditure, including their labour costs. Thus, they achieve better market positions amid enhanced competition in the context of declining demand. Growth in the prices of services between January and June by merely 1.2 per cent (against 6.6 per cent in the prior year) shows that firms' pricing policy is much more cautious compared with 2008.

Amid the continuing economic slowdown, the trend towards decreasing annual growth rate of services prices will be sustained. A more pronounced drop in inflation in this group may be expected at the start of the third quarter as a result of the anticipated smaller seasonal rises in the prices of catering services and package holidays. During this quarter telecommunication services are also expected to contribute to the fall in the services inflation owing to the reduction in wholesale

prices of mobile services with effect from 1 July 2009. At the close of the year services prices are likely to post a low positive growth on the same period of 2008.

Contribution of Major Groups of Services (Excluding Those with Administratively Controlled Prices) to Annual Inflation

(p.p.)



Sources: NSI, BNB.

Inflation Expectations for the Second Half of the Year

Annual inflation is projected to decline further during the third quarter. Decreasing consumer demand due to moderating economic activity and the related higher unemployment and uncertainty concerning incomes will curb price rises. A base effect stemming from the acceleration in the previous year's price rises, as well as the decline in some administratively controlled prices, will further reduce inflation. During individual months inflation may reach close to zero levels or temporary deflation may be reported.

Inflation is anticipated to stay positive at a low level during the fourth quarter and to be within the range of 0–1 per cent at the end of 2009. At the close of the year inflation will be impacted by a base effect related to the dramatic fuel depreciation during the last few months of 2008. Tobacco products, in tandem with fuels, are expected to have a major contribution to inflation at the end of 2009. Projections are facing risks associated with a possible stronger upward dynamics of fuel and food prices as a result of which the degree of transferring higher costs to end-use prices will depend on consumer demand and firms' ability to limit their other costs.

