Economic Review

1/2010

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Bulgarian monetary policy regime seeks national currency stability with a view to price stability. The BNB quarterly *Economic Review* presents information and analysis of balance of payments dynamics, monetary and credit aggregates, their link with the development of the real economy, and their bearing on price stability. External environment is also analyzed since the Bulgarian economy is influenced by international economic fluctuations. This publication contains quantitative assessments of the development in major macroeconomic indicators in the short run: inflation, economic growth, monetary and credit aggregate dynamics and interest rates.

The *Economic Review, issue 1/2010* was presented to the BNB Governing Council at its 21 April 2010 meeting. It employs statistical data published up to 19 April 2010.

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

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

ISSN 1312 – 420X

This issue includes materials and data received up to 21 April 2010.

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

Published by the Bulgarian National Bank
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Abbreviations

APRC	Annual percentage rate of charge
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
DXY	an index measuring the exchange rate of the US dollar against the basket of six major currencies
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

The external environment continued to improve in the last quarter of 2009 and in early 2010 and as a result of the anti-crisis measures taken by governments and monetary authorities of leading world economies, the upward trend in economic growth was sustained. The world business climate improved in the first quarter of 2010, with an increased optimism about output, employment and new orders observed both in the industrial sector and services sector. The US and euro area central banks retained the main refinancing rates unchanged at 0.0–0.25 per cent and 1.0 respectively, yet giving a clear signal that in 2010 they will pursue a policy of withdrawing the additional liquidity in the money markets.

In Bulgaria, real GDP decreased by 5 per cent driven by the declining external demand, consumption and investment. Labour market conditions worsened throughout 2009 and this trend was sustained in early 2010. The level of registered unemployment reached 10.3 per cent in February. Despite the unfavourable conditions, companies maintained expenditure discipline and did not allow serious deterioration of their financial performance and competitiveness.

The production activity will recover slowly and gradually, with exports playing a leading role. In the second and third quarters of 2010 exports are expected to post further positive growth and to gradually accelerate along with the sustainable growth in external demand. Import dynamics is projected to continue lagging behind the export growth rate which will lead to further improvement in the trade deficit. Real economic growth is expected to begin recovering in the second half of 2010 thanks to the improved external demand of enterprises. It is only towards the end of the year that positive labour market signals are expected to emerge.

The trend toward improvement in the balance of payments current account balance was sustained in the first two months of 2010. The overall current and capital account deficit in January and February came to EUR 156.4 million (EUR 700 million in the corresponding period of 2009), with foreign direct investment covering the deficit by 123.4 per cent on an annual basis. Retention of annual growth of exports of goods and services in the second and third quarters of 2010 is the major factor for sustaining the trend to improvements in the current account. The current and capital account deficit is projected to decrease and to range between 3 and 5 per cent of GDP on an annual basis, with FDI flows expected to completely cover the deficit.

The annual growth in broad money accelerated in the first two months of 2010 mostly as a result of the growth in overnight deposits of financial corporations. The annual growth of broad money is expected to remain close to its current levels in the second and third quarters of 2010. Interest rates on time deposits gradually decreased in January and February compared with end-2009, this trend expected to continue over the projection horizon as well. This projection is based on the stabilization of world financial markets, the high liquidity of the banking system and the expected comparatively low lending activity, a factor of lower demand for loanable funds.

The downward trend in credit growth was sustained due to the deteriorated macroeconomic environment and the high degree of uncertainty which reduced credit demand and led to tightening of banks' credit standards. The reduction in interest rates on deposits has not yet passed through to lending interest rates. We expect a relative stabilization of the cost of borrowing in the coming months and a certain fall in lending rates may be expected if the downward trend in deposit interest rates is retained.

The general government cash balance ended the year with a deficit of 0.9 per cent of GDP. Keeping of the deficit below 1 per cent of GDP was mainly a result of the restrictive expenditure policy over the fourth quarter of the year which led to a significant negative contribution of the government consumption to GDP growth (3.9 percentage points in the fourth quarter). In the second and third quarters of 2010 government expenditure is expected to be restrained with the aim of preventing further worsening of the general government deficit which was BGN 1.4 billion in February. Consequently, the contribution of government consumption to GDP growth will remain negative at 1 percentage point.

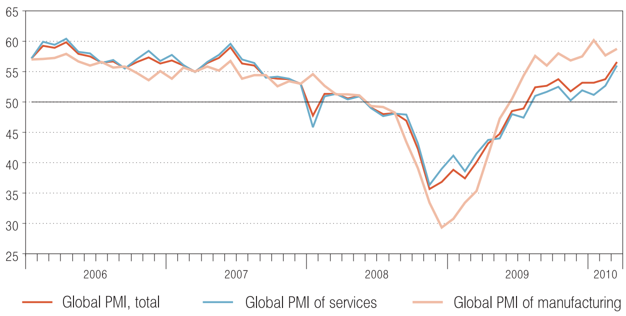
In the second and third quarters of 2010 annual inflation is expected to remain low. Tobacco price increases and dynamics of world energy product prices will contribute to inflation acceleration. The positive contribution of transport fuels to inflation will gradually decline in line with crude oil price dynamics, while the weak domestic demand and wage moderation will curb mainly rises in prices of non-food goods and services.

1. External Environment

The external environment in the last quarter of 2009 and the first quarter of the current year continued to improve. As a result of the anti-crisis measures of the governments and the central banks in the developed and in some of the developing countries the trend towards a recovery in economic growth was sustained. The US and euro area central banks kept their interest rates on refinancing operations unchanged at 0.0–0.25 per cent and 1.0 per cent respectively, though signalling clearly that in 2010 they will start pursuing a policy of absorbing the liquidity provided by them on money markets.

The global business climate continued to improve over the first quarter of 2010. Both in the industry sector and in the services sector considerably enhanced optimism about output, employment and new orders was observed.

Global PMI



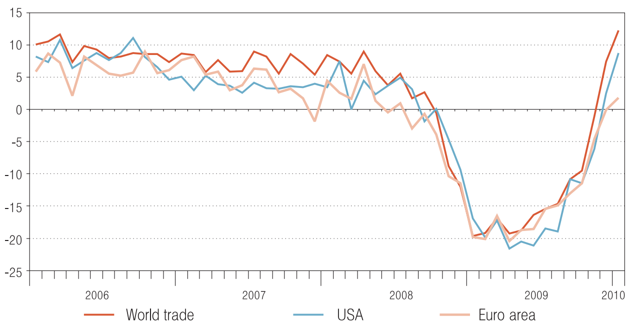
Source: JP Morgan.

During the first quarter of 2010 economic conditions in the United States improved faster compared with the remaining developed economies, while the countries in the Asian Region retained their high growth rates.

In January 2010 world industrial output picked up by 8.3 per cent[1] and world trade was recovering at a fast rate of 12 per cent on an annual basis. Inflation started to accelerate globally since end-2009 and in January 2010 it reached 3.3 per cent on an annual basis.[2] The prices of major commodities preserved their upward trend, albeit at moderating growth rates. The prices of energy resources picked up slightly owing to the more optimistic perceptions of US economic recovery and the high demand in the Asian Region.

World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Euro Area

According to euro area real GDP data the decline rate in the fourth quarter of 2009 slowed down to -2.2 per cent on an annual basis (against -4.1 per cent in the third quarter). The last year saw a GDP fall of -4.1 per cent, the greatest reported since 1999. On a quarterly basis GDP remained unchanged, with the breakdown by component showing that investment had a negative contribution, while the contribution of net exports and inventories was positive. As regards private and public consumption, no changes were registered compared with the prior quarter level.

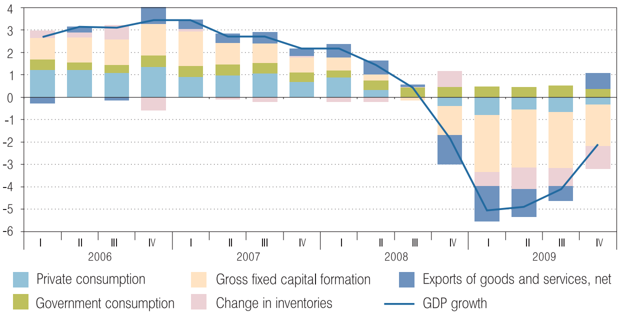
During the first quarter of 2010 major euro area indicators went on increasing, while the economic sentiment index and the EC business climate indicator increased to 97.7 (prior value of 95.9) and -0.32 (prior value of -0.65) respectively in March. PMI were above the threshold of 50, signalling an expansion of economic activity. During the same month the PMI Composite came to 55.9 (prior value of 53.7), the indicator's highest value for the last two and a half years.

[1] World Bank data as of 12 April.

[2] IMF data as of 12 April.

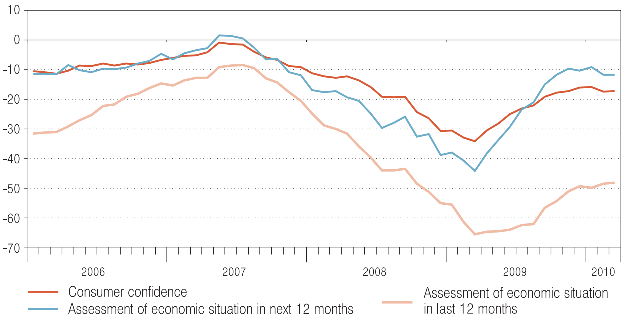
Contribution of GDP to Euro Area Growth by Component (Quarterly)

(%, percentage points)



Source: Eurostat.

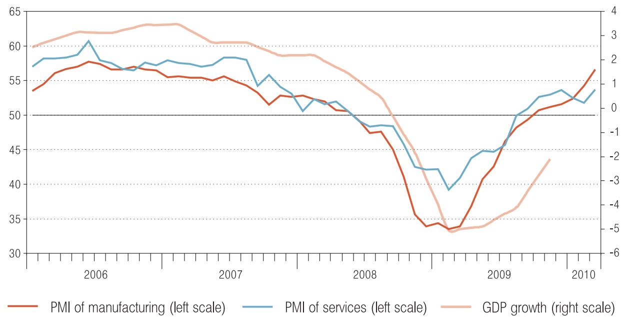
Euro Area Consumer Confidence Indices



Source: European Commission

PMI of Industry and Services and Euro Area GDP Growth

(%)



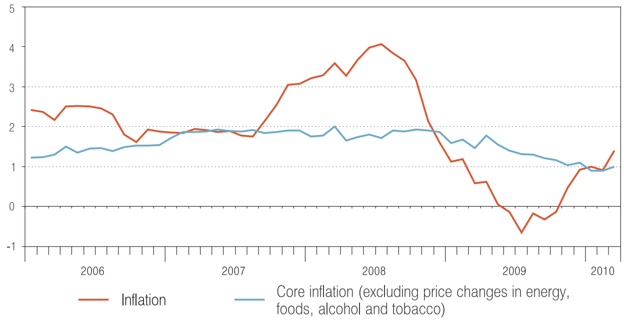
Sources: EC, Eurostat.

As a result of the anti-crisis measures and the gradual improvement in external environment, a moderate recovery in euro area economic activity was observed. According to the ECB forecast of March 2010, this year's GDP growth is expected to move within the range of 0.4–1.2 per cent, while in 2011 within the range of 0.5–2.5 per cent. Expectations about the next year underwent a minor upward revision reflecting the global improvement in economic activity.

March data show HICP growth in the euro area by 1.4 per cent on an annual basis (0.9 per cent as of December 2009). A 0.9 per cent inflation was reported on a monthly basis. Core inflation stabilized relatively, reaching by March 1 per cent on an annual basis (against 1.1 per cent in December 2009).

Euro Area Inflation Rate

(percentage change on same period of previous year)



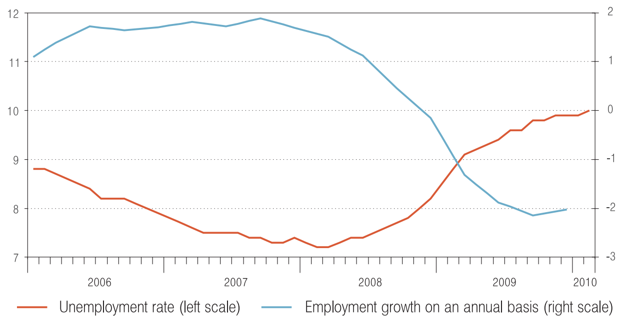
Source: Eurostat.

Weak private consumption due to the worsened state of labour and credit markets went on repressing core inflation in the short run. In the medium term euro area harmonized inflation is likely to stay under the ECB target level of 2 per cent.

According to ECB forecasts the increase in HICP will be within the range of 0.8–1.6 per cent (previous December 2009 forecast: 0.9–1.7 per cent) in 2010 and within the range of 0.9–2.1 per cent (previous forecast: 0.8–2.0 per cent) in 2011.

Euro Area Unemployment Rate and Employment Growth

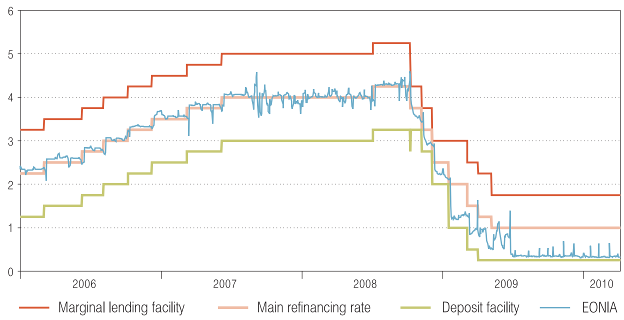
(%) (%)



Source: Eurostat.

ECB Interest Rates

(%)



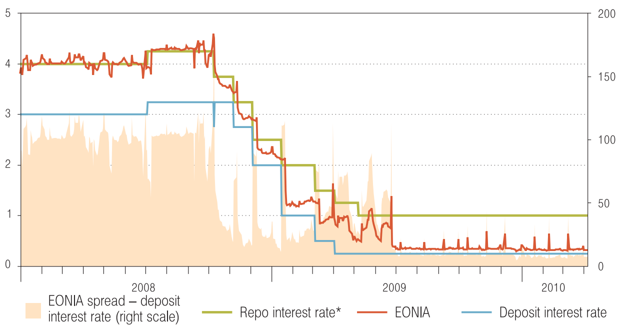
Source: Bloomberg.

During the first quarter of 2010 the ECB kept the interest rate on its main refinancing operations unchanged at the level of 1.00 per cent. The statements of most members of the ECB's Governing Council indicate that the current level is still considered relevant and that at present no change in the monetary policy is necessary.

In relation to the need for a recovery in the money markets' normal functioning, the withdrawal of the monetary stimuli provided by the ECB is a priority in the institution's strategy, which it continued to carry into effect according to the pre-set timetable. An important step in this respect was the resumption of the floating rate auctions and the partial satisfaction of the orders in conducting three-month refinancing operations, starting with the auction on 28 April. The ECB will continue to provide unlimited refinancing to the banking system through the weekly main operations and the special one-month operations till the end of the ninth maintenance period for the year, ending on 12 October. The ECB will effect an additional six-day operation at a fixed interest rate and complete allotment of bids with a view to mitigating the putative negative effects on 1 July, the maturity date of the biggest twelve-month operation.

At the end of March 2010 the last auction for providing unlimited refinancing for a six-month period was held. The ECB will fix the interest rate on this operation on its maturity date as an average of the minimum interest rates on main refinancing operations over the period. There was little interest in this operation; 62 bank institutions submitted bids for the auction and a resource of EUR 17.8 billion was allocated.

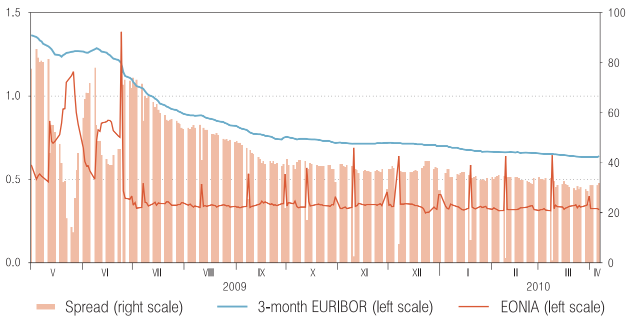
Short-term Euro Area Interest Rates



*Interest rate on the ECB's one-weak repo operations.

Source: Bloomberg.

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



Source: Bloomberg.

ECB's programme for purchasing covered bonds in euro continued to be implemented regularly. By end-March cumulative purchases came to EUR 44.9 billion or 75 per cent of the target volume. As a measure for additional increase in liquidity on the euro area secondary market, the ECB announced that securities purchased under the programme may be lent by the respective national banks in the Eurosystem.

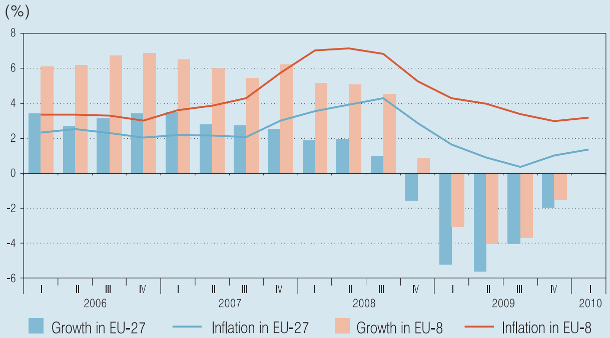
EU-8*

GDP decline in EU countries, non-members of the monetary union, moderated in the fourth quarter of 2009 and the reported overall drop came to 1.5 per cent on an annual basis (against 3.7 per cent during the previous quarter).

GDP growth in Poland during the fourth quarter picked up to 3.3 per cent on an annual basis, while in the rest of the countries in the group reported a deceleration of negative growth rates. The Baltic States reported the most considerable GDP drop in 2009.

Investment in fixed capital continued their strong negative contribution to growth, although this effect tends to subside during the year. Private consumption also exhibited a slight improvement. Positive signals were also seen in terms of exports which increased on an annual basis in Romania, Hungary, the Czech Republic and Bulgaria.

Growth and Inflation in EU-27 and EU-8



Sources: Eurostat, own calculations.

EU-8 inflation stayed at 3.0 per cent on an annual basis in the first quarter of 2010.

* EU-8 includes the states that have joined the EU since 2004, Slovenia, Malta, Cyprus and Slovakia excluded. As of 1 January 2007 Slovenia, as of 1 January 2008 Malta and Cyprus, and as of 1 January 2009 Slovakia have the status of full members of the Economic and Monetary Union.

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GDP Growth on an Annual Basis

	I	II	III	IV	2009
Poland	0.9	1.2	1.2	3.3	1.7
Czech Republic	-3.9	-5.2	-5.0	-2.8	-4.8
Bulgaria	-3.5	-4.9	-5.4	-5.9	-5.0
Hungary	-6.7	-7.5	-7.1	-4.0	-6.3
Romania	-6.2	-8.7	-7.1	-6.5	-7.1
Estonia	-15.0	-16.1	-15.6	-9.5	-14.1
Lithuania	-13.3	-19.5	-14.2	-12.8	-15.0
Latvia	-17.8	-18.4	-19.0	-16.9	-18.0

Source: Eurostat.

Exports Growth on an Annual Basis

	I	II	III	IV	2009
Romania	-9.6	-10.4	-3.7	3.9	-5.5
Hungary	-17.8	-13.9	-6.9	3.1	-9.1
Poland	-15.2	-15.4	-11.3	-0.6	-9.1
Bulgaria	-17.4	-15.8	-6.7	0.8	-9.8
Esonia	-16.5	-11.1	-9.6	-7.9	-11.2
Latvia	-16.4	-17.9	-14.7	-6.3	-13.9
Czech Republic	-18.5	-16.1	-7.7	3.0	-16.5
Lithuania	-13.1	-23.4	-16.5	-8.0	-20.6

Source: Eurostat.

The Impact of the Crisis on the Fiscal Positions and Interest Rates in Leading World Economies

The financial market crisis following Lehman Brothers' bankruptcy in September 2008 which transformed into a global economic crisis, contributed to a worsening of fiscal positions across industrialized countries. Imbalances resulted from reduced budget revenue and increased spending related to the measures taken to support the financial sector and to stimulate the economy. Expenditure on government debt servicing picked up considerably in individual countries.

In 2009 the budget deficit to GDP ratio in fourteen of the sixteen euro area countries infringed substantially the requirement that the deficit should not exceed 3 per cent and the trend will be sustained in 2010. In the euro area this indicator went up to 6.2 per cent against 2 per cent in 2008, with anticipated deficits of 6.6 per cent and 5.2 per cent for 2010 and 2011 respectively. The ECB and the European Commission called for a return to the recommended levels of the Stability and Growth Pact with respect to the budget deficit and emphasized on fiscal consolidation as a key priority in the context of economic recovery. In line with an ECOFIN council recommendation, an excessive deficit procedure was opened by the EU Council for most of the EU member states and the respective advisable deadlines for fiscal consolidation were fixed. In its March 2010 report the European Commission pointed out that the major risks the implementation of the stability programs is faced with are the optimistic macroeconomic assumptions about the member states and the lack of specific action plans concerning individual consolidation measures. Programmes are aimed predominantly at reducing the expenditure side of the budget and in most countries their implementation should start in the current year.

The US budget deficit reached 9.9 per cent of GDP in 2009 and it is expected to exceed 10 per cent in 2010 and to decrease moderately in 2011. Despite the accumulated fiscal imbalances the country is perceived as a trustworthy debtor with good abilities to finance itself from international markets. In the short term no specific measures for decreasing budget expenditure are envisaged since stimulation of the economic activity continued to be a priority of the government.

Fiscal Positions by Country

(share of GDP, %)

Country	Fiscal deficit/surplus				Government debt			
	2007	2008	2009	2010	2007	2008	2009	2010
USA	-1.2	-3.2	-9.9	-10.3	63.9	69.2	83.3	94.3
Euro area	-0.6	-2	-6.2	-6.6	65.9	69.3	78.7	83.9
United Kingdom	-2.7	-5	-12.1	-12.9	44.2	52	68.6	80.3
Japan	-2.5	-5.8	-10.5	-10.2	187.7	196.6	218.6	227.0
China	0.9	-0.3	-3.9	-3.9	20.2	17.7	20.2	22.2

* Projections for 2009 and 2010.

Sources: Congressional Budget Office, ECB, EC, IMF.

During the crisis period leading central banks globally reduced their key interest rates almost to zero levels. The US Federal Reserve cut the interest rate on the federal funds by 500 basis points to 0.00–0.25 per cent, while the ECB and the United Kingdom central bank reduced their reference interest rates to 1.00 per cent (-325 basis points) and 0.50 per cent (-525 basis points). Non-standard monetary measures were adopted leading to substantial expansion of central banks' balance sheets. By end-2009 the ECB balance sheet considerably exceeded

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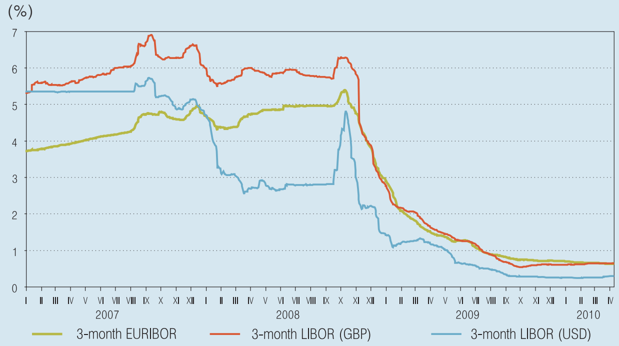
EUR 1900 billion while the balance sheets of the Federal Reserve and the United Kingdom reached USD 2200 billion and GBP 237.7 billion respectively. Measures taken by the US central bank and the ECB included, *inter alia*, increasing the supply of liquidity and broadening the scope of counterparties in open market operations, establishing swap lines for providing resources in foreign currency, direct purchases of assets.

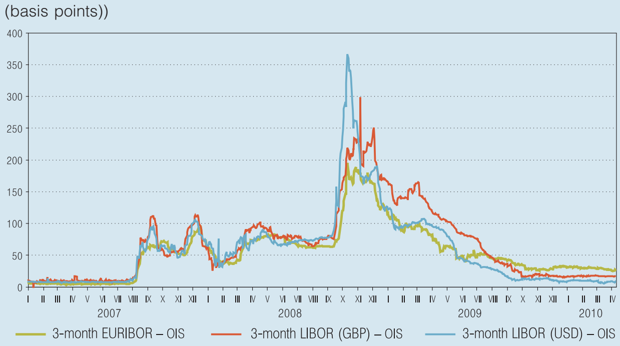
As a result of the central banks' interference, short-term interest rates started to drop, reaching historically low levels by end-2009. In the euro area interest rates on unsecured deposits with a maturity of up to seven months declined below the interest rate on main refinancing operations, while in the United States and the United Kingdom a similar effect was observed in the maturity sectors up to one month. On the money market the credit and liquidity risk premia on interest rates on unsecured deposits compared to secured deposits, measured by the LIBOR/OIS spread,* went over 350 basis points in the United States following Lehman Brothers' bankruptcy. After the measures adopted by the central banks, the premia started to fall and in early 2010 it was at pre-crisis levels in the United States, while in the euro area and the United Kingdom it came close to them, albeit staying higher.

Three-month Interbank Money Market Interest Rates



Source: Bloomberg.

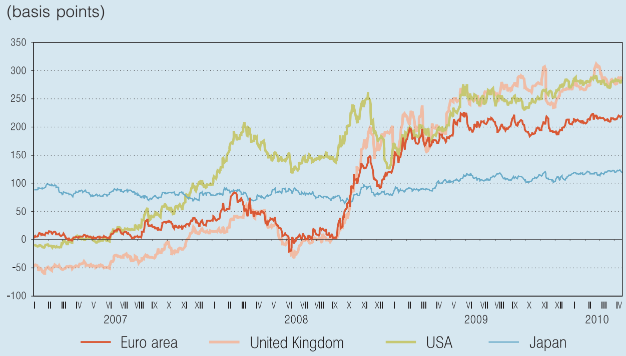
Spreads between the Three-month Interbank Money Market Interest Rates on the OIS Fixed Leg



Source: Bloomberg.

Global monetary policy and the deteriorating macroeconomic indicators in individual countries were the factors behind the substantial drop in the yield of government securities on the secondary market. The trend was more clearly outlined in the short end of the yield curve. As a result, steepening of the yield curves in the United States, the United Kingdom and the euro area was observed, with the spread between the yields in the two- and ten-year sectors widening above 200 basis points.

Spread between the Two- and Ten-year Bonds Yeld



Sources: Bloomberg, European Commission.

Since early 2010 financial markets in the euro area displayed a considerable widening of the spreads on government bonds, measured by the credit premium on credit default swaps (CDSs) in the five-year sector. The investor attention was focused on the risks to fiscal consolidation of the countries and their ability to serve their fast growing government debts. According to the OECD forecast the gross amount of the government debt of Germany, Japan, the United Kingdom and the United States will come to USD 31,500 billion till the close of 2011: up 22 per cent on 2009.

During the second half of 2009 signals of the starting economic recovery appeared, and the trend will continue in early 2010 as well. At the close of the prior year leading central banks announced that in the present year they would discontinue the unconventional measures and begin absorbing the excess liquidity provided by them on the money market. Provided the steady growth rates are sustained and inflation is on the rise in 2010, we may expect the US Federal Reserve System and the ECB to resort to an increase in the reference interest rates at the close of the year or during the first half of 2011. This will put an upward pressure on short-term interest rates and government securities yields. Entering into the cycle of restrictive monetary policy is generally characterized by flattening of the yield curve, measured by the spread between two- and ten-year government bonds, as a result of the greater

* The spread between the 3-month LIBOR and the OIS fixed leg.

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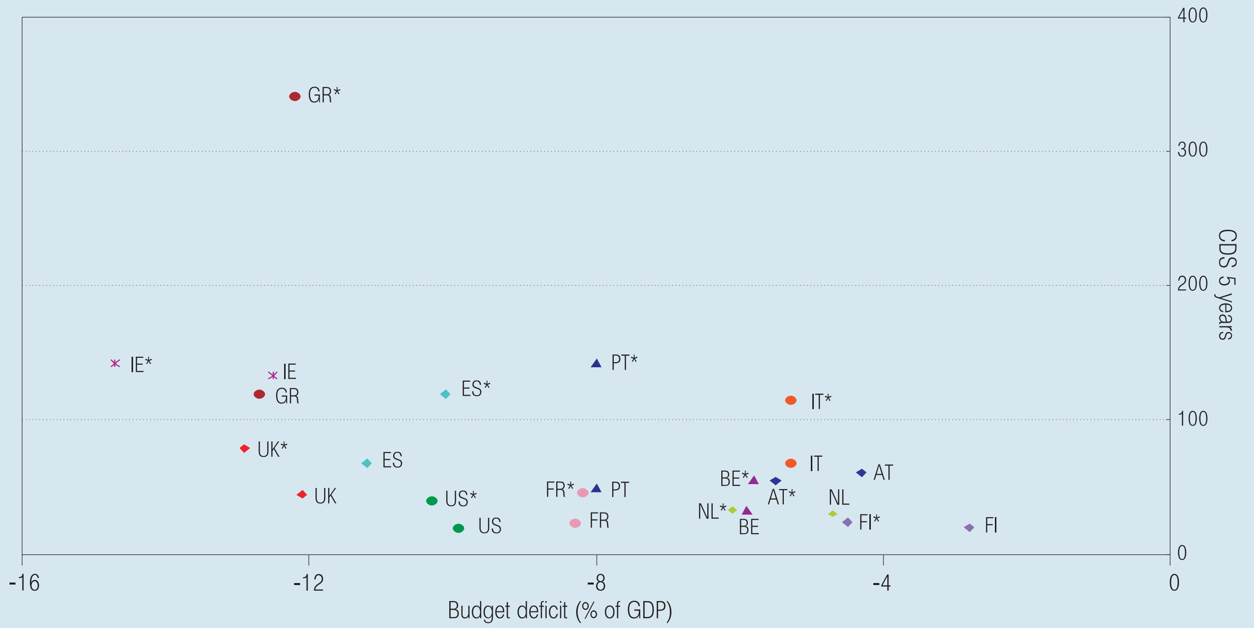
rise in the short end of the yield curve. There are, however, many risks to the realization of this scenario. The crisis in Greece showed that financial market participants have focused their attention primarily on the countries' budget positions and government debt sustainability and require a larger credit premium in the absence of fiscal discipline.

CDS Spread and Budget Deficit (% of GDP)

(first monitoring: CDS on 30 September 2009 and budget deficit for 2009; second monitoring (*): CDS on 31 March 2010 and budget deficit for 2010)



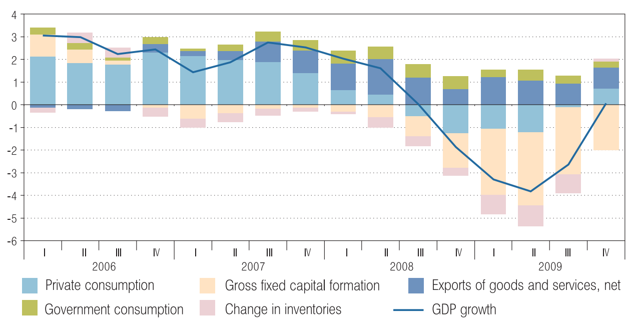
Sources: Bloomberg, European Commission.

United States

During the last quarter of 2009 a 0.1 per cent real GDP growth on an annual basis was reported in the United States (against -2.6 per cent in the third quarter) as a result of the enhanced household demand, slower liquidation of output inventories, housing investment and business investment. Net exports also had a weak contribution. Over the year economic growth was negative, totaling -2.4 per cent.

Contribution to US Growth by GDP Component (Quarterly)

(%, percentage points)

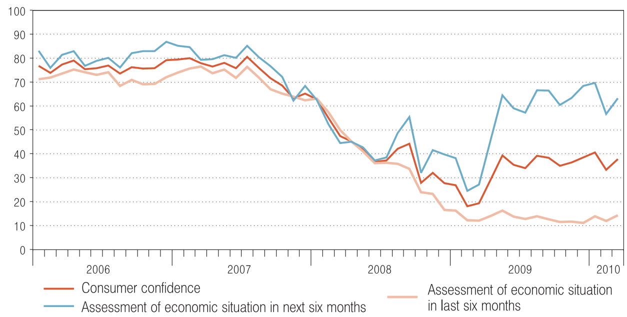


Source: Bureau of Economic Analysis.

The dynamics of economic indicators at the start of 2010 was divergent, with market expectations showing that till the end of the first half-year economic growth will be weaker and unstable compared with the previous two quarters of 2009.

US Consumer Confidence Indices

(2000 = 100)

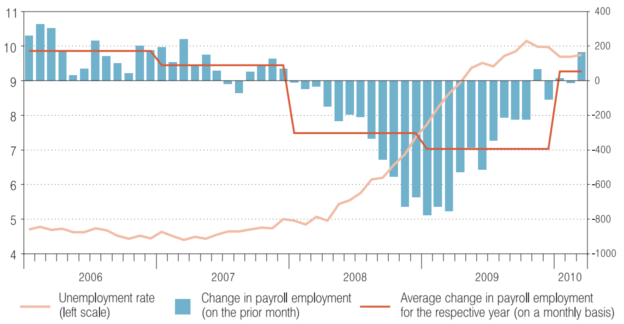


Source: The Conference Board.

Since the beginning of 2010 retail sales picked up moderately. This suggests a positive contribution of consumption to GDP growth during the first quarter of 2010. Excessive household indebtedness and the high level of unemployment continued to pose the main risk factors for the recovery in consumer activity.

US Unemployment Rate and Changes in Payroll Employment

(%) (payroll employment, thousand)



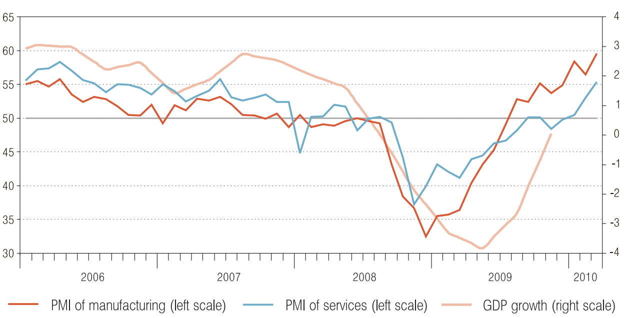
Source: Bureau of Labour Statistics.

During the second half of 2009 business sector investment grew reflecting the growing need for staying competitive on international markets. Banks' willingness to extend credit resources to large non-financial institutions rose and the access to funding through capital markets was extended. During the last few months a substantial narrowing of spreads on the corporate debt was observed, suggesting business investment growth. This was supported by the increase in orders of capital goods in the last few months, indicating future business investment.

Housing investment is expected to have a negative contribution to growth. Demand for real estate dropped drastically at the end of 2009 leading to a contraction in investment in housing construction. Bad loans and the great number of non-performing ones over a long period of time are a prerequisite for deterioration in the state of the sector.

US PMI of Manufacturing and Services and GDP Growth

(%)



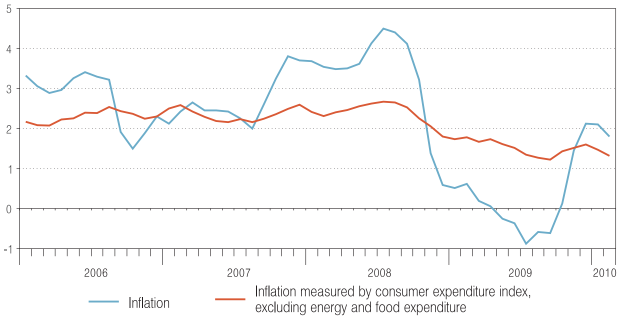
Sources: Institute for Supply Management, Bureau of Economic Analysis (BEA).

Industrial output posted a moderate growth during the first two months of 2010, with the values of industrial sector's activity major indicators continuing to rise. The trend may be preserved in the following quarters as a result of the need for a recovery of the inventories in the economy.

The subsiding base effect of oil prices led to an interruption in the upward trend in major price indices. Core inflation also slowed down. Against the background of high unemployment and low capacity utilisation we can expect the price indices to stay below the levels reporting an existence of inflationary tensions.

US Inflation Rate

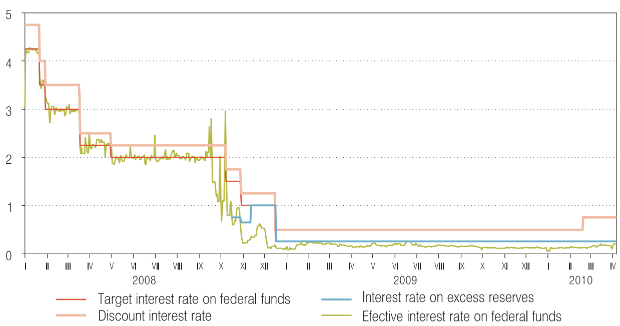
(percentage change on same period of previous year)



Source: Bureau of Labour Statistics.

Amidst weak economic activity and no inflationary pressures the US Federal Reserve System retained its reference interest rate on the money market within the range of 0.00–0.25 per cent in the first quarter of 2010. The central bank took measures aimed at the normal functioning of the mechanisms for monetary policy implementation. Since the beginning of February all programmes for short-term liquidity provision were discontinued, while at the end of March purchases of securities were terminated. Since early July the Federal Reserve will continue to provide financial resources under the TALF-programme only. The term of loans under the non-standard facility was shortened from 90 to 28 days, while the cost of the borrowed funds was risen by 25 basis points to 0.75 per cent.

Short-term US Interest Rates



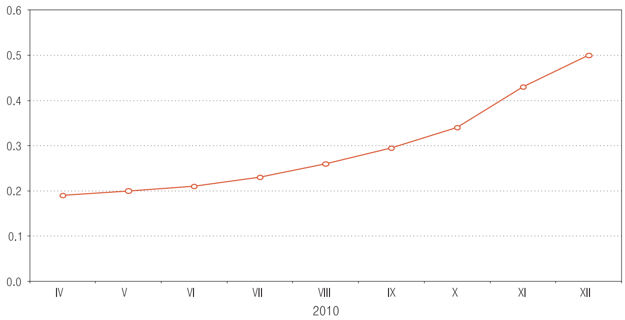
Source: Bloomberg.

During the review period the main emphasis in the statements of the Federal Reserve representatives was laid on the measures for absorbing excess liquidity from the banking system. In the six-month report on monetary policy to the Congress of February 2010 B. Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, outlined the consistency of applying these measures.

1) increasing the volume of reverse repurchases;
2) providing a fixed-term deposit facility;
3) payment of interest on excess reserves.

Expected US Reference Interest Rate Based on Futures on Federal Funds

(%)



Source: Bloomberg.

The last step will be a rise in the reference interest rate on federal funds. The reason for this is the substantial volume of liquidity concentrated in non-deposit institutions that limits the effect of a possible rise in the other interest rates on the money market. Market expectations derived from the yield of the futures on federal funds support the prospects for an increase in the main interest rate at the close of the year.

The USD/EUR Exchange Rate

During the first quarter of 2010 the US dollar appreciation[3] came to 6.2 per cent against the euro and to 4.6 per cent against the basket of the six most traded currencies in the DXY index. Over the review period the US currency moved within a relatively wide range of 1.43–1.33 against the euro.

The state of Greek public finance was the main driver behind the fluctuations on foreign exchange markets and contributed to the depreciation of the single European currency. The interest rate differential between the yields on European and US government securities, coupled with expectations about the future state of the spreads between reference rates in US dollars and euro, had a limited effect on the USD/EUR exchange rate in the first quarter of 2010. The change in nvestors' risk appetite and the dynamics of stock market indices that determined the EUR/USD exchange rate over the second half of 2009 also had a slighter effect. This weakened the attractiveness of speculative transactions related to arbitrage between interest rates in various currencies (carry trades) that played a key role for exchange rate fluctuations in the previous quarters.

USD/EUR Exchange Rate

(USD *per* EUR 1)

Source: ECB.

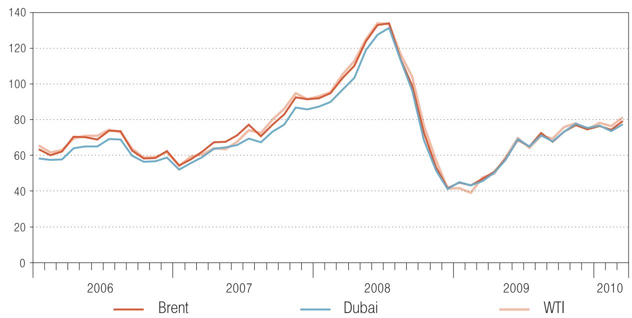
International Prices of Crude Oil, Major Raw Materials, and Gold

Crude Oil

During the first quarter of 2010 the price of Brent crude oil continued to fluctuate within the range of USD 70–80 *per* barrel. At the close of March and in early April oil price went up to USD 85 *per* barrel as a result of enhanced optimism about the recovery of the US economy.

Crude Oil Prices

(USD *per* barrel)



Source: World Bank.

[3] Average price for the first quarter of 2010 against the average price for the fourth quarter of 2009.

The Balkan Region

During the last quarter of 2009 most Balkan countries reported a slowdown in GDP decline, while Turkey and Macedonia were the first ones with positive growth on an annual basis. In Turkey private consumption, government consumption and inventories contributed most to the positive 6 per cent growth in the fourth quarter of 2009 (by 3.3 percentage points, 2.3 percentage points and 2.5 percentage points respectively). Macedonia also posted growth in consumption (1.5 per cent on an annual basis). Unlike Turkey, where investment had a negative contribution, in Macedonia low growth of 0.3 per cent on an annual basis was reported. Inflation kept accelerating in the first quarter of 2010, due mainly to the base effect of fuels.

Economies in the region are expected to recover gradually in the second and third quarters of 2010. Enhanced external demand, predominantly on the part of leading European economies, will remain the major factor behind this.

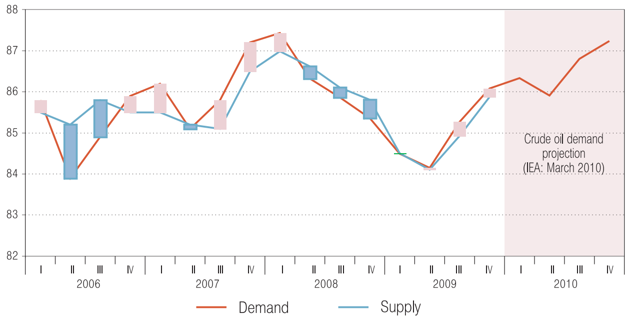
Real GDP Growth and Inflation in Balkan Countries

	2008					2009					2010
	I	II	III	IV	Total	I	II	III	IV	Total	I
Growth (on the corresponding period of previous year, %)											
Bulgaria	7.0	7.1	6.8	3.5	6.0	-3.5	-4.9	-5.4	-5.9	-5.0	
Greece	2.7	2.7	2.0	0.7	2.0	-1.0	-1.9	-2.4	-2.5	-2.0	
Macedonia	6.4	7.9	6.4	1.2	4.8	-0.9	-1.4	-1.8	1.2	-0.7	
Romania	8.2	9.3	9.2	2.9	7.3	-6.2	-8.7	-7.1	-6.5	-7.1	
Turkey	7.0	2.6	0.9	-7.0	0.7	-14.5	-7.7	-2.9	6.0	-4.7	
Croatia	4.3	3.4	1.6	0.2	2.4	-6.7	-6.3	-5.7	-4.5	-5.8	
Serbia	8.8	6.3	4.6	2.9	5.5	-4.1	-4.2	-2.3	-1.6	-3.0	
Inflation (averaged for the period, %)											
Bulgaria	12.4	14.0	12.6	9.1	12.0	5.1	3.1	0.8	0.9	2.5	1.7
Greece	4.3	4.8	4.8	3.1	4.2	1.8	0.8	0.8	2.0	1.4	2.6
Macedonia	9.5	9.9	8.4	5.5	8.3	0.9	-0.6	-1.4	-2.1	-0.8	0.5
Romania	8.0	8.6	8.2	6.9	7.9	6.8	6.1	5.0	4.5	5.6	4.8
Turkey	8.8	10.3	11.7	10.9	10.4	8.4	5.7	5.3	5.7	6.3	9.3
Croatia	5.5	6.3	7.1	4.3	5.8	3.5	2.6	1.2	1.6	2.2	1.1
Serbia	13.4	15.8	12.3	10.2	12.9	9.7	8.1	7.7	5.8	7.8	4.3

Sources: Statistical institutes and central banks of respective countries.

World Crude Oil Demand and Supply (Quarterly)

(million barrels *per* day)

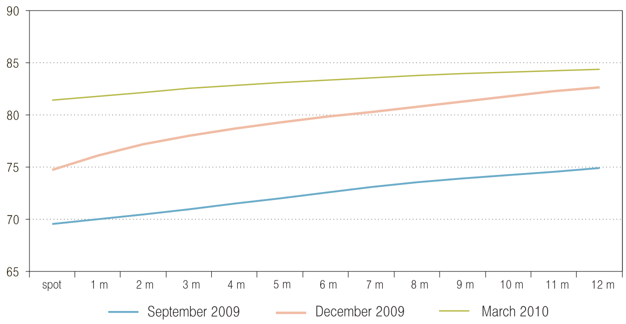


Source: IEA.

IEA data on crude oil market continued to report a rise in demand over supply during the last quarter of the prior year. The major factor behind the imbalance was the OPEC's limited supply and China's increased demand. Data on inventories also reflected this trend, with growth in inventories of oil product in OECD countries falling to 1.5 per cent on an annual basis during the fourth quarter (from an average of 3.9 per cent for the January

WTI Crude Oil Futures Prices (Average Price of the Contract in the Corresponding Month)

(USD *per* barrel)



Source: JP Morgan.

to September 2009). According to March 2010 IEA estimates, in 2009 world crude oil demand contracted by 1.4 per cent (compared with the January estimate of -1.7 per cent). IAE projections for 2010 indicate 1.8 per cent growth in demand.

Market expectations for oil prices remained within the range of USD 70–90 *per* barrel in the second and third quarters of 2010.

Major Raw Materials and Commodity Groups

During the first two months of 2010 world steel output picked up by 27.6 per cent.[4] Unlike the previous year, all leading steel-exporting countries reported a substantial output growth with capacity utilisation coming to some 80 per cent. Metal prices continued rising, albeit at lower rates. During the first quarter of 2010 the rise in metal price index slowed down to 6.1 per cent on a quarterly basis and growth was observed mainly in prices of non-ferrous metals: copper (8.7 per cent), aluminum (8.0 per cent) and nickel (14.1 per cent). The prices of steel products increased by 2.8 per cent on the fourth quarter of 2009 due predominantly to the raised scrap price. In March changes occurred in the iron ore market where major producing companies managed to impose three-month contracts in the pricing of the raw material. So far, the contracts have been fixed on an annual basis. The change is anticipated to evoke a greater volatility in the price of steel products and to lead to possible rises in their prices.

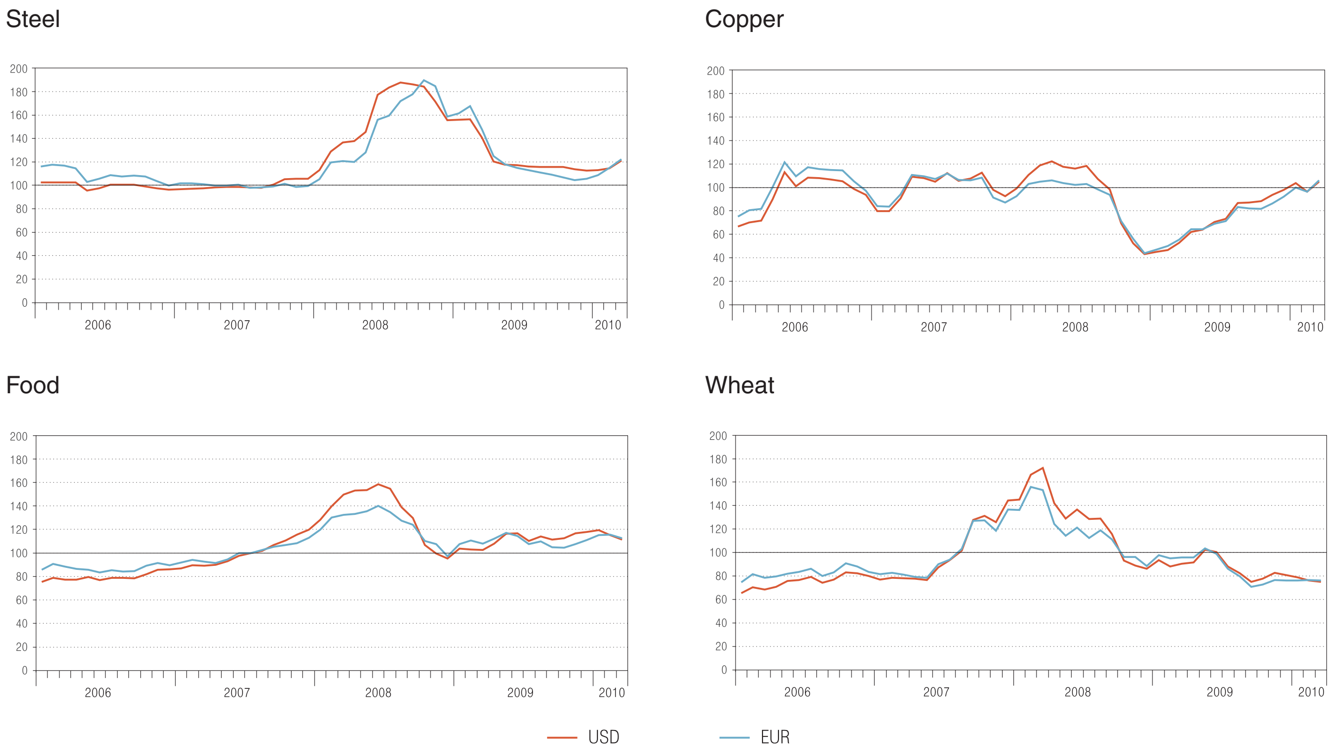
[4] World Steel Association data.

In the second and third quarters of 2010 metal prices are expected to stay close to the levels of the year's start.

The food price index rose insignificantly in the first quarter of the year by 0.6 per cent on a quarterly basis. The prices of wheat and maize fell by about 3 per cent, while those of vegetable oils went up by approximately 10 per cent. According to the US Department of Agriculture and the International Grains Council, world wheat production during the 2009–2010 season is expected to drop by some 0.7–1.6 per cent on an annual basis: an upward revision of about 0.3 percentage points compared with the projection as of January 2010. During the season wheat inventories are anticipated to grow by almost 19 per cent on an annual basis: an increase of almost 2 percentage points on the previous projections.

Food prices are expected to retain their present levels. A slight decrease in the prices of individual products might be observed as a result of the expansion in the areas for the growing of certain crops, such as maize and soybeans.

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



Sources: World Bank, ECB, BNB.

Gold

Over the first quarter of 2010 the average gold price (one-month futures) went up to USD 1110.1 *per* troy ounce (by 0.9 per cent on a quarterly basis). A significantly higher increase was registered in euro (by 7.6 per cent on a quarterly basis) owing to European currency depreciation. Within the said period gold price was impacted mainly by investors' concerns about the EUR/USD exchange rate fluctuations.

At the start of 2010 demand for physical gold and investment in exchange-traded funds covered by physical gold decreased, picking up again subsequently. In addition to the situation in Greece, a considerable influence was exerted by the growing demand in India in the first months of 2010.

Markets reacted to the IMF gold sales: 200 tons to the central bank of India, 10 tons to Shri Lanka and 2 tons to Mauritius, which is half of the planned sales of 403 tons. According to the data of Gold Fields Mineral Sevices Ltd., in the fourth quarter of 2009 physical gold supply fell by 2 per cent on an annual basis. Lower mining production (-12 per cent on an annual basis) proved to be the key factor behind the decline. In contrast to this trend, more active supply and recycling of gold scrap were observed (+3 per cent on an annual basis).

Spot Price of Gold

(USD *per* troy ounce)

Source: The London Bullion Market Association.

The central banks participating in the agreement for gold sales of 7 August 2009 (CBGA 3[5]) did not offer gold during the period. Apart from the agreement, the central banks of Mexico and the Philippines sold small quantities, while the Russian Central Bank was one of the major purchasers on the gold market during the period.

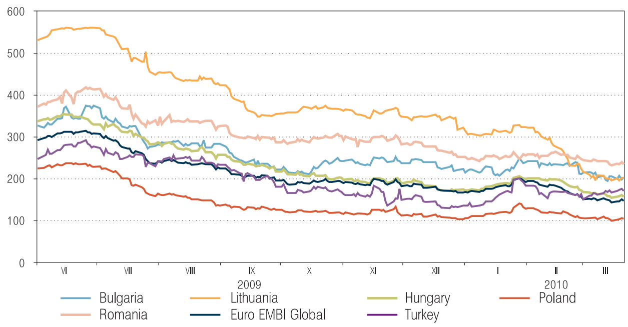
[5] Central Bank Gold Agreement.

Bulgarian External Debt Dynamics on International Financial Markets

During the first quarter of 2010 the spread on the yields of the Central and East European countries' government debts continued to contract. The JP Morgan's Euro EMBI Global went down by 21 basis points to 151 basis points by end-March. The index moved within a narrow band of 144–202 basis points.

Government Securities Yield Spreads (Euro EMBI Global index)

(basis points)



Source: Bloomberg.

The downward dynamics was determined mostly by investors' subsiding risk aversion and the stronger expectations about an improvement in the state of the economies in the region. During the period the outlook for the Baltic Region countries' credit ratings was raised.

In mid-February the decreased credit rating of Greece impacted negatively the spreads on the government debts of most countries in the region. Concerns about the indirect effect of the country's problems on the region dissipated relatively quickly and the economic development of each country was assessed individually. Bulgaria's government debt spread, measured by the JP Morgan index, followed the overall downward market trend over the entire period, reporting a decline of 30 basis points to 199 basis points.

2. Financial Flows, Money and Credit

In the first two months of 2010 Bulgaria's external position remained stable and the trend toward an improvement of the balance of payments current account was sustained. According to preliminary data for the January to February 2010 period, the overall deficit on the current and capital accounts amounted to EUR 156.4 million (compared to EUR 700 million in the corresponding period of 2009). Foreign direct investment covered 123 per cent of the deficit on an annual basis.[1]

The Issue Department balance sheet figure came to BGN 23.94 billion (EUR 12.24 billion) by end-March 2010, with assets decreasing by BGN 1.33 billion (EUR 679.9 million) in the review quarter. The average monthly coverage of imported goods and services by BNB international reserves reached 7.7 months by February 2010 against 5.4 months a year earlier.[2]

Cash Flows Prompting Significant Changes in Gross International Reserves

(million EUR)

External flows	2009	I quarter 2009	I quarter 2010
Total for the period	-265	-1 123	-860
Purchases and sales of euro	-1 282	-934	-770
at tills	-35	-9	-6
banks, incl.	-1 247	-925	-764
bank's purchases	112 527	29 591	18 011
bank's sales	-113 774	-30 516	-18 775
Flows on accounts of banks, the MF, *etc.*	1018	-189	-89
Minimum required reserves	159	-197	-14
Government and other depositors*	859*	8	-75

* A total of SDR 610.9 million (EUR 665.7 million) received on 28 August and 9 September 2009 have been included in the government and other depositors item.

Source: BNB.

Financial Flows and External Position Sustainability

The external position of Bulgarian economy remained stable. The balance of payments current account deficit contracted further, but it was covered on an annual basis by foreign direct investment. A positive net flow of capital to Bulgaria's economy and further improvement of the balance of payment current account deficit to GDP ratio on an annual basis are expected in the second and third quarters of 2010 reflecting the positive growth in the exports of goods and services.

For the January–February 2010 period the balance of payments financial account deficit was EUR 980.7 million, the main flows for the period being from: 1) a reduction in non-resident deposits with local banks of EUR 487.8 million; 2) an increase of EUR 285.4 million in local banks' deposits abroad; and 3) a decrease in banks' net credit obligations of EUR 197 million.

In the first quarter of 2010 BNB gross international reserves fell by EUR 679.9 million. This change was driven mainly by the decrease in deposits of the government and other budgetary organisations by EUR 728.6 million. Banknotes and coins in circulation saw a serious decline of EUR 294 million. BNB Banking Department and banks' deposits went up by EUR 155.7 million and EUR 135.6 million respectively.

The balance of payments dynamics in the second and third quarter of 2010 will largely depend on euro area and global economic developments, where a trend toward a recovery of economic growth and normalization of money market conditions is observed. On the basis of the analysis of existing economic factors and trends our baseline scenario foresees sustaining of the positive net foreign investment inflow to Bulgaria. The pursuit of prudential macroeconomic policy remained

[1] The amount of foreign direct investment for the last 12 months and the deficit on the current and capital accounts for the same period were used in the calculation of this indicator.

[2] The average value of imports of goods and services for the last 12 months and BNB reserves by the end of February 2010 were used in the calculation of this indicator.

the key factor behind the foreign capital inflows to Bulgaria and the efforts to overcome the economic crisis quickly.

Bulgaria's economy is characterised by low risk of potential speculative capital withdrawal. The share of portfolio investment in Bulgaria's gross international liabilities for 2009 was around 3 per cent. In January 2010 short-term external debt contracted by EUR 461.2 million and its share in Bulgaria's gross external debt fell to 33.3 per cent respectively (35.2 per cent a year earlier). International reserves provided a 100.8 per cent cover of the short-term external debt by January 2010. The sustainability of Bulgaria's external position is largely based on the structure of capital inflows, mainly in the form of foreign direct investment and external borrowing of intercompany or long-term nature.

According to preliminary data, foreign direct investment in Bulgaria came to EUR 28 million between January and February 2010.[3] By February 2010 foreign direct investment financed 108 per cent of the current account deficit on an annual basis (86 per cent as of February 2009) and 123 per cent of the balance of payments current and capital account deficit (91 per cent as of February 2009)[4].

Annual net foreign direct investment for February 2010 accounted for 8.2 per cent of projected annual GDP by the first quarter of 2010. Net inflows of foreign direct investment as a percentage of GDP are expected to decline in the second and third quarters of 2010, although staying close to that level.

Direct investments attracted in the first two months of 2010 were mostly to the non-banking private sector in the form of *equity*: EUR 35.9 million, and to the banking sector in the form of *reinvested earnings:* EUR 45.7 million. *Other net capital* (the change in net obligations between companies with foreign interest and direct foreign investors on financial, bond and trade credits) was negative and accounted for EUR 53.6 million. Between January and February non-residents' investment in real estate came to EUR 25.2 million (EUR 85.1 million in the same period of 2009). As a result of the correction in the receipts from real estate acquisition in Bulgaria by non-residents in 2009 and early 2010 their current levels are close to those observed in the years up to 2006.

Data as of end-2009 show that *real estate operations and business services* (22.5 per cent), *manufacturing* (18.1 per cent), *financial intermediation* (18.1 per cent), and *trade and repairs* (13.7 per cent) occupied the largest shares in the structure of the accumulated foreign direct investment by industry. Foreign direct investment inflow in 2009 was reported mainly in *financial intermediation* (22.9 per cent), *real estate and business services* (20.3 per cent), *manufacturing* (18.3 per cent), *transport, storage and communication* (9.4 per cent).

The composition of FDI by country in the January–February 2010 period suggests that foreign direct investment attracted from Hungary (EUR 19 million), Austria (EUR 10.5 million) and Spain (EUR 9.6 million) accounted for the largest shares.

Bulgaria's gross external debt went down by EUR 414.2 million in January 2010. Net repayment of borrowed funds amounted to EUR 476.6 million (revaluations and the net change in trade and revolving loans excluded). In the first month of 2010 loans and deposits of EUR 141.9 million were received, and principal payments of EUR 618.6 million remitted (compared to EUR 695.1 million in the corresponding month of the prior year). As a result, by end-January 2010 Bulgaria's gross external debt reached EUR 37.3 billion or 110.1 per cent of GDP for 2009.

Private non-guaranteed external debt decreased by EUR 476.3 million in January, mainly due to the decline in banks' short-term loans (EUR 469.7 million). Banks' debt to foreign parent banks incurred in connection with their activity in Bulgaria occupied a large share in banks' external debt (81.3 per cent as of December 2009). The changes in banks' external debt in 2009 and early 2010 resulted from the higher liquidity of local banks and their efforts to reduce net external debt. Non-banking sector corporations slightly reduced their external debt by EUR 4.7 million in the first month of the year.

Intercompany loans increased by EUR 26.4 million, with the share of loans related to direct investment rising to 38.9 per cent of Bulgaria's

[3] These data shall be subject to several revisions upon receipt of information from non-financial corporations and the NSI and shall be revised in line with the methodology for collection of statistical information.

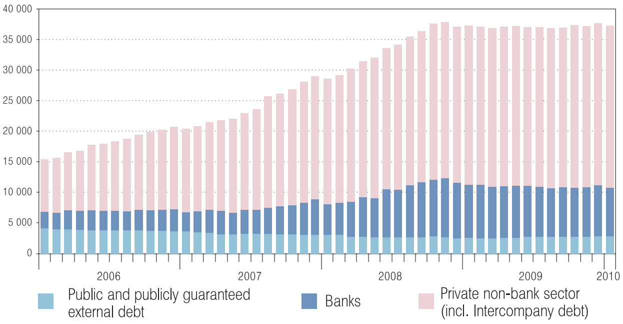
[4] Practice shows that original data on foreign direct investment are usually revised upwards, which may result in an increase in the balance of payments current account deficit coverage.

external debt. This development points to the long-term interest of foreign owners of local companies in Bulgaria's economy.

In January 2010 *general government* external debt increased by EUR 50.3 million, driven mainly by government investment loans. The total amount of public and publicly guaranteed external debt increased by EUR 62.1 million, reaching 11.3 per cent of Bulgaria's total external debt.

Gross External Debt

(million EUR)



Source: BNB.

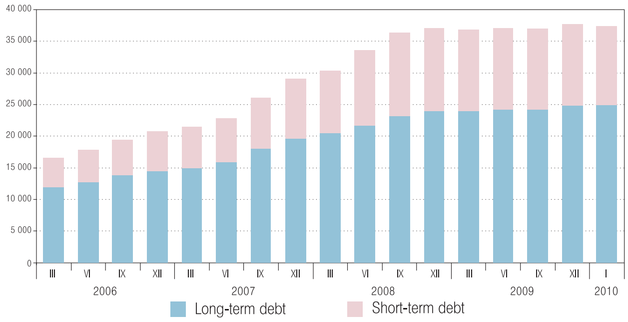
Gross external debt servicing in January 2010 reached EUR 693.9 million compared to EUR 849.7 million in the corresponding month of the prior year. New loans declared in January 2010 were EUR 425.3 million of which EUR 279.3 million intercompany loans (65.7 per cent of all non-declared loans).[5]

The average weighted interest rates on new loans declared in January 2010 suggest that the cost of external borrowed funds has decreased on an annual basis: by 0.8 percentage points to 2.9 per cent in euro and by 0.2 percentage points to 1.5 per cent in US dollars. The interest rate differential between long-term loans to corporations extended by local banks and external long-term loans remained positive. The interest rate differential on euro-denominated loans was 6.3 percentage points and that on US dollar-denominated loans – 8 percentage points.

By December 2009 there was no notable change in the structure of private non-bank external debt by industry. The largest share in the external debt of *other sectors* was occupied by *electricity, gas and water* (20.6 per cent), followed by *real estate operations and business services* (20.3 per cent) and *financial intermediation* (12.4 per cent). The largest share in intercompany loans was occupied by *real estate operations and business services* (22 per cent) and *financial intermediation* (18.7 per cent).

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

In the maturity structure of the gross external debt short-term external debt trended downwards. It decreased by EUR 461.2 million and its share fell to 33.3 per cent. These developments in the first month of 2010 were largely attributable to the closure of non-residents' deposit accounts with banks (EUR -452.1 million).

The euro retained its leading position within the gross external debt currency structure: 88.7 per cent by December 2009. It occupied the largest share (93 per cent) in intercompany loans and the smallest share in the *general government* sector (73.5 per cent).

Between January and February 2010 Bulgaria's gross foreign assets fell by EUR 387 million. BNB foreign reserves decreased by EUR 747 million and foreign assets of local banks increased by EUR 359.9 million. As a result of Bulgaria's gross foreign assets and external debt dynamics, the net external debt increased by EUR 120.9 million, reaching EUR 19.7 billion by end-January 2010, or 58.1 per cent of GDP for 2009.

The strong interdependence between the capital flows on the balance of payments financial account and the current account balance was retained in the first months of 2010. Between January and February 2010 the overall deficit on the current and capital accounts contracted further to EUR 156.4 million against EUR 700 million in the corresponding period of 2009. By February 2010 balance of payments current and capital accounts deficit (on an annual basis) accounted for 6.5 per cent of projected GDP for the first quarter of 2010 and a year earlier it was 20.9 per cent of GDP. As a result of the developments in the

[5] On the basis of previous revisions, it may be expected that the registered volume of intercompany loans will increase in the future.

main components of the balance of payments the deficit on the current account financed by foreign direct investment came to 108 per cent on an annual basis as of February 2010.

In January and February 2010 all current account components improved on the corresponding period of 2009 as follows: trade balance by EUR 383.3 million, income account by EUR 224.7 million, net current transfers by EUR 73.1 million and balance on services by EUR 28.5 million respectively.

The trade balance recorded the most sizable annual improvement between January and February 2010, while over the same period trade deficit contracted by EUR 383.3 million to EUR 310.6 million. Over the first two months imports increased by 10.4 per cent on an annual basis and exports decreased by 8.5 per cent. From the second half of 2009 some positive trends were recorded in exports dynamics – the negative annual growth rate gradually improved and a positive and accelerating annual growth has been observed since November 2009. The trend toward deficit contraction in 2009 pertained to reduced investment and production activity in the course of the year and hence, to lower imports of investment goods, commodities, materials and energy resources. Imports and exports are expected to increase on an annual basis in the second and third quarters of 2010, with higher exports growth rate than that of imports.

The balance on services reported a surplus of EUR 41.9 million over the January–February 2010 period against EUR 13.3 million in the corresponding period of the prior year. The improvement reflected mainly reduced travel and external services costs (mostly construction services). These two items improved by a total of EUR 68.1 million, with lower costs offsetting the decrease in receipts on the credit side (an overall decline of EUR 48.8 million).

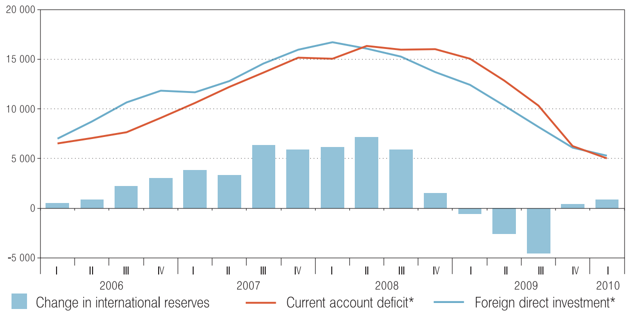
As of February 2010 the income deficit was EUR 136.5 million or EUR 224.7 million less than in the corresponding period of 2008. The improvement was largely due to lower interest payments on direct investments (down EUR 137.1 million) and lower income paid on other investments (down EUR 73 million).

Over the first two months of 2010 net current transfers amounted to EUR 250 million: up EUR 73.1 million on an annual basis, mainly as a result of the increase in transfers to the *general government* (up EUR 96.5 million). The receipts in the form of private current transfers fell by EUR 18.5 million on an annual basis. Transfers abroad also declined by EUR 6.9 million. As a result, net transfers to the private sector decreased by EUR 11.6 million on an annual basis.

The balance of payments capital account was EUR -1.1 million for the January–February 2010 period against EUR 164.9 million in the corresponding period of 2009, which is mainly due to the *general government* sector.

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

(million BGN)



* Data as of February 2010.

Source: BNB.

The uncertainty surrounding the pace of euro area and global economic recovery in the first half of 2010 remained high. Our expectations for the developments in the balance of payments point to a stabilization of the net capital flows to Bulgaria and continuous improvement in the current account balance, mainly as a result of higher exports of goods and non-factor services on an annual basis. The current and capital account deficit is projected to remain between 3 and 5 per cent of GDP on an annual basis in the first half of 2010 and FDI flows are expected to cover it completely.

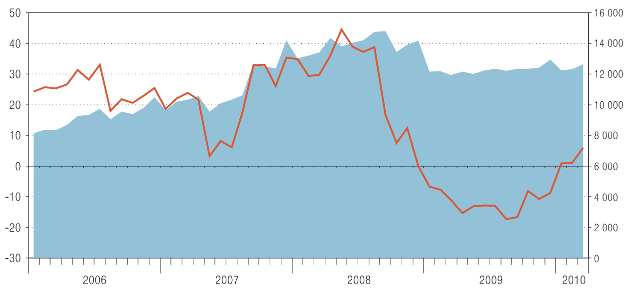
Monetary Aggregates

The annual growth of broad money accelerated due to the increase in overnight deposits of financial corporations. Interest rates on time deposits posted a decrease in January and February 2010 on end-2009.

After reporting negative dynamics throughout 2009, as of early 2010 reserve money started to increase on an annual basis in line with our expectations. By end-March they increased by 6.0 per cent on the corresponding month of 2009. Banks' deposits with the BNB increased by 25.2 per cent and contributed by 8.7 percentage points to reserve money growth. The rate of decline in currency in circulation continued to moderate and reached 4.2 per cent as of March against 12.3 per cent at the end of 2009. Determinants of currency in circulation dynamics relate to weaker demand for currency in circulation due to the contraction of private consumption and the downward trend in inflation. Interest rates on time deposits remained relatively high providing incentives for the economic agents to save in the form of bank deposits thus contributing to the reduced demand for cash.

Reserve Money

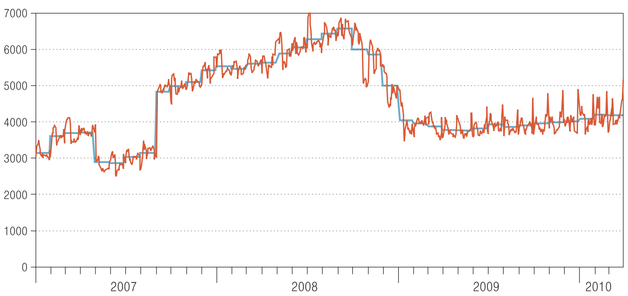
(annual rate of growth, %) (volumes, million BGN)



Source: BNB.

Bank Deposits with the BNB

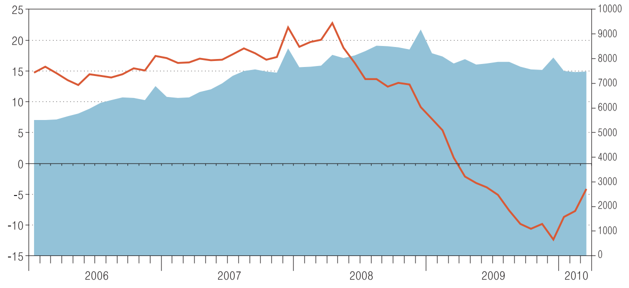
(million BGN)



Source: BNB.

Currency in circulation

(annual rate of growth, %) (volumes, million BGN)



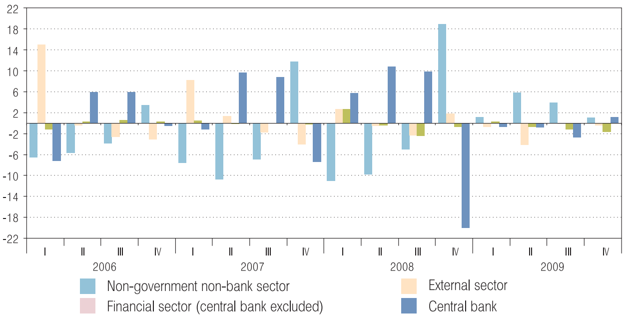
Source: BNB.

In the second quarter of 2010 the downward trend in currency in circulation is expected to come to a halt, reporting moderate growth by the end of the third quarter of 2010. Banks' deposits with the BNB are expected to continue to contribute to the increase in reserve money in the economy over the projection horizon.

Fiscal policy affects monetary aggregates' dynamics through the change in government and other budgetary organisations' deposits with the BNB and through the reallocation of liquidity between the other sectors of the economy. Amid a slowdown in economic activity and limited access to financial resource the impact of budget reallocation on liquidity, disposable income and net wealth of the sectors is even more significant. The consolidated budget position as regards the liquidity of the other sectors of the economy in the fourth quarter of 2009 was almost neutral compared to previous years when a strong provision of liquidity to the non-government non-banking sector was recorded at the year-end at the expense of a decrease in the government deposit with the BNB. Between October and December 2009 a slight withdrawal of liquidity from the external and financial sector (the central bank excluded) of 2.2 per cent of GDP for the quarter was observed and these funds were almost equally distributed between the non-government non-banking sector and the central bank.

Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

(share of GDP, %)

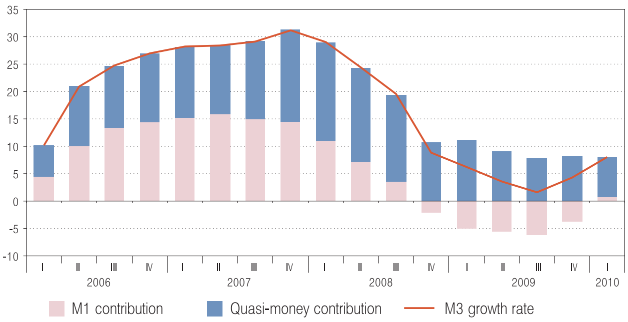


Sources: MF, BNB.

By February 2010 broad money sustained the upward trend from the last quarter of 2009, posting an increase of 8.1 per cent on an annual basis. The annual growth of broad money is projected to remain close to its current levels in the second and third quarters of 2010.

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

(%, percentage points)



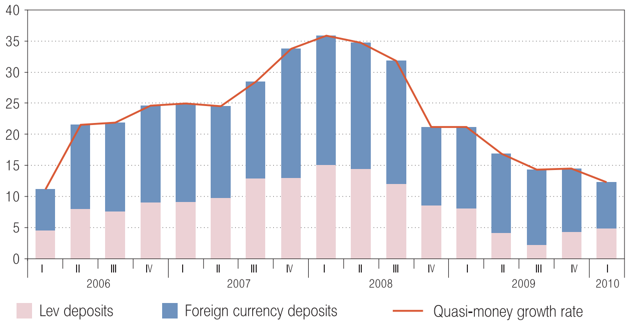
Note: 2010 data as of February.

Source: BNB.

The M1 monetary aggregate was the main factor behind accelerated broad money growth which by end-February was 1.8 per cent on an annual basis against a decrease of 8.8 per cent in 2009. M1 growth developments reflected mainly the increase in overnight deposits: up 8.3 per cent on an annual basis. Overnight deposits of financial corporations reported a sizable increase of around BGN 918 million (almost all were denominated in euro) on February 2009. They contributed by 8.6 percentage points to the overall increase of overnight deposits. Non-financial corporations and households reported a more moderate decrease on an annual basis to -5.4 per cent and -2.3 per cent respectively. Money outside banks also exhibited a gradual moderation in the pace of decline, going down by 7.8 per cent by February against a decrease of 11.4 per cent by end-2009.

Annual Quasi-money Growth Rate and Contribution of its Components (Quarterly)

(%, percentage points)



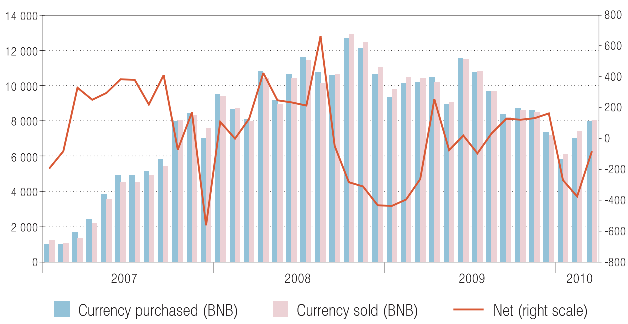
Note: 2010 data as of February.

Source: BNB.

The annual growth rate of quasi-money came to 12.3 per cent by end-February 2010, and a trend toward a gradual increase of lev-denominated deposits at the expense of those denominated in foreign currency was observed. Deposits with agreed maturity of up to two years went up by 15.4 per cent on an annual basis, with household deposits having the largest share – 13.5 percentage points. By end-February household deposits in levs increased by 25.2 per cent on an annual basis and those in foreign currencies by 19.5 per cent. Non-financial corporations reported a decrease of 1.0 per cent in deposits with agreed maturity of up to two years. The downward trend in their lev deposits moderated to 3.0 per cent on an annual basis as of February (against -10.5 per cent as of December 2009) and the annual growth of their foreign currency deposits slowed down to 0.6 per cent. On the one hand, the tight lending policy of banks is likely to have limited the growth of time deposits of the corporations and, on the other hand, current interest rates on time deposits continued to promote the opening of new household deposits.

Currency Sales and Purchases between Banks and the BNB (on a Monthly Basis)

(million EUR) (million EUR)



Source: BNB.

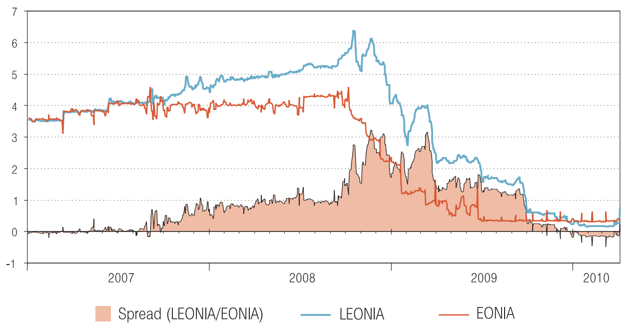
Foreign currency trade with the BNB is the main tool used by banks to manage their lev liquidity. It is used to perform the main function of the Currency Board to buy and sell on demand national currency against euro. Currency trade volumes (purchases and sales) exceeded interbank money trade nearly six times. The average daily volume of currency trade in the BNB came to EUR 685 million. Between January and March 2010 banks realised net purchases of foreign currency to the amount of EUR 727 million (compared to net sales of foreign currency of EUR 416.8 million in the fourth quarter of 2009).

Interbank money market rates posted a decrease from the values reported in the fourth quarter of 2009. The average interest rate on transactions concluded on the interbank money market fell from 0.64 per cent in December to 0.29 per cent in March 2010.

Over the same period the LEONIA index exhibited a similar trend posting a decline from 0.39 per cent to 0.17 per cent. Since early 2010 the spread between LEONIA and EONIA remained in the negative territory, fluctuating around 15 basis points. The spread levels signalled normalisation of interbank trade and corresponded to the average levels before the autumn of 2007 when the first signs of the global financial crisis appeared.

LEONIA/EONIA

(%, percentage points)

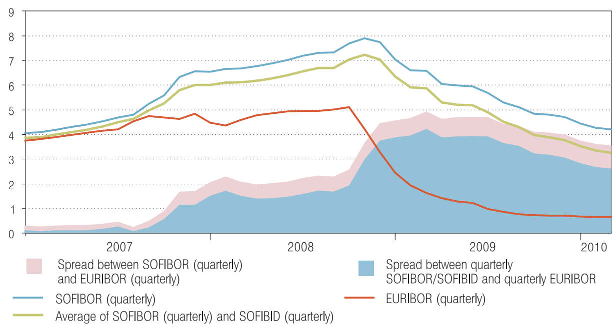


Source: BNB.

The SOFIBOR reference rate (quarterly) – used as an indicator for short-term interest rates – followed a downward trend similar to that observed in EURIBOR (quarterly) since November 2008, reaching 4.2 per cent by March 2010. This SOFIBOR value (in a quarterly horizon) was close to the levels that prevailed before the onset of the global financial crisis. However, euro area interest rates marked a sharp fall, reaching a record low largely due to the unprecedented ECB operations intended to provide the banking system with liquidity. As a result, the spread between SOFIBOR[6] (quarterly) and EURIBOR (quarterly) widened at the end of 2008 and in early 2009. In the first quarter of 2010 this spread retained the downward momentum observed since mid-2009, reaching 356 basis points by March 2010. It declined, mainly owing to the sharp fall in SOFIBOR of around 50 basis points in early 2010, while EURIBOR remained relatively unchanged at exceptionally low levels. The average SOFIBOR/SOFIBID reference rates on the interbank market in Bulgaria for the quarterly horizon declined to 3.3 per cent in March 2010, and the spread between the average quotation and EURIBOR (quarterly) decreased to 261 basis points.[7] By March 2010 the average rate formed by the SOFIBOR and SOFIBID was already lower than the respective average quotation that prevailed in Bulgaria before the first signs of the global financial crisis in the summer of 2007.

SOFIBOR, average SOFIBOR/SOFIBID and EURIBOR (Quarterly horizon)

(%, percentage points)



Source: BNB.

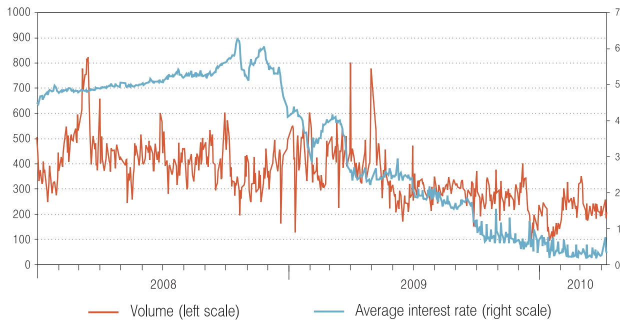
The average daily volumes of transactions on the interbank money market for the January–March 2010 period decreased to around BGN 212 million, from BGN 258 million in the last quarter of 2009.

[6] In interpreting the spread between SOFIBOR and EURIBOR due account should be taken as to the fact that the indices are calculated using different formulas. SOFIBOR is the average of the ask quotes provided by a representative panel of banks. As regards EURIBOR participating banks must offer the best price between the best banks on the market, which means that they are obliged to quote other bid offers if they are better than their ask quotes. In this respect EURIBOR is the most representative rate for the price at which deals are concluded on the interbank market. From this perspective, the average quote between SOFIBOR (ask offers) and SOFIBID (bid offers) better illustrates the interest rate level in Bulgaria, as the statistics in Bulgaria, as well as in the rest non-euro area new Member States, presents both quotes: ask and bid.

[7] See footnote 6.

Trade Volume and Interbank Money Market Interest Rates

(million BGN) (%)

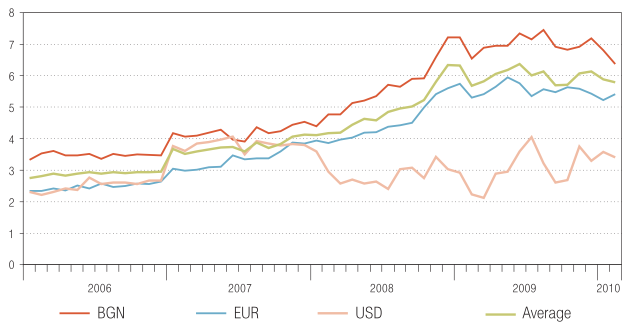


Source: BNB.

Interest rates on new time deposits declined on end-2009. The reported decrease was mainly in interest rates on lev-denominated deposits. By February 2010 the average interest rate on time deposits in levs reached 6.4 per cent and the average interest rate on time deposits in euro came to 5.4 per cent. The average interest rate on deposits fell by 35 basis points to 5.8 per cent.

Interest Rates on New Time Deposits
(average weighted by maturity)

(%)



Source: BNB.

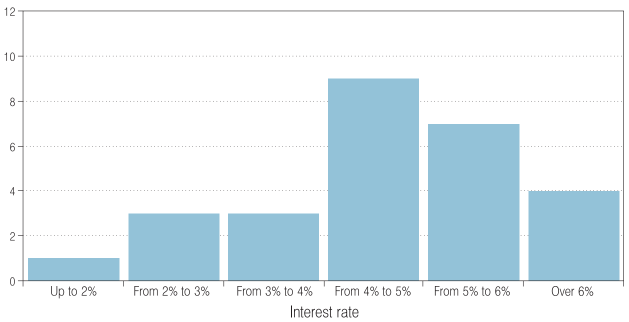
Our expectations point to a gradual reduction in interest rates on time deposits in the second and third quarters of 2010 and are supported by the stabilization in international financial markets, high banking system liquidity (the liquidity ratio went up to 23.0 per cent as of February 2010) and lower expected lending activity resulting in a weaker demand for resources for financing credit operations.

As regards the distribution of interest rates on household deposits in levs with maturity of up to one month by bank, the number of banks offering rates within the 3 to 4 per cent band increased at the expense of those offering rates within the 4–5 per cent band. In February the average interest rate level and the dispersion coefficient decreased on December 2009.

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

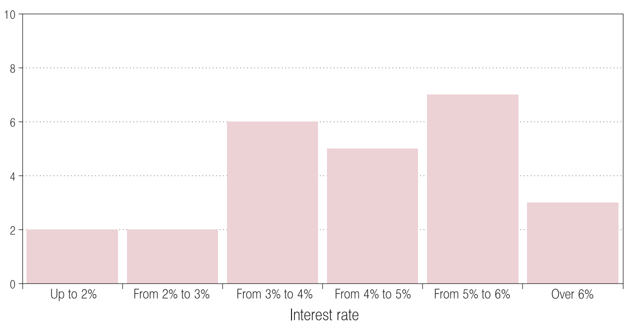
as of December 2009

frequency (number of banks)



as of February 2010

frequency (number of banks)



Source: BNB.

Credit Aggregates

The downward trend in credit growth was sustained due to the worsened macroeconomic environment and the high degree of uncertainty reducing credit demand and tightening banks' credit standards. The reduction in interest rates on deposits has not yet passed through to lending interest rates.

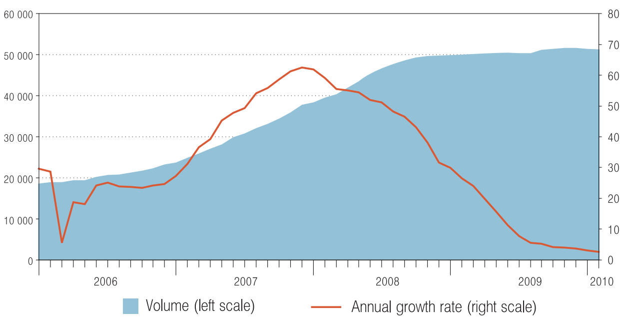
Worsened macroeconomic environment and the uncertainly surrounding the economic recovery continued to adversely affect lending by reducing credit demand and acting as a factor for tightening banks' lending policies. As a result of the moderate credit demand and banks' tightened lending policies, the rate of credit growth slowed down further and by end-February the annual growth of claims on the non-government sector fell to 2.6 per cent.

Between January and February 2010 claims on the non-government sector decreased by BGN 318.5 million against an increase of BGN 259.4 million in the same period of 2009. The impairment of loans by banks also affected the amount of claims on non-government sector. In the first two months of 2010 banks reported minimum net sales of loans to the amount of BGN 4 million.

Our expectations point to a relative stabilization of the growth rate of claims on the non-government sector in the second and third quarters of 2010 at levels close to its current values.

Claims on Non-government Sector

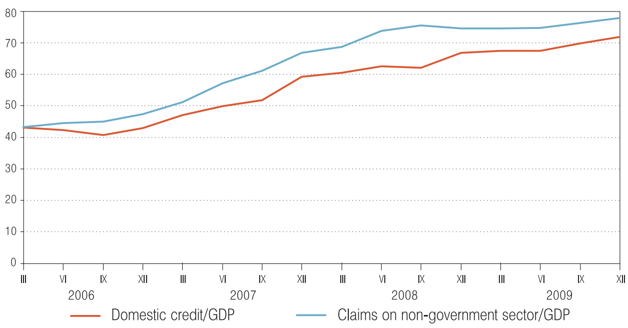
(million BGN) (%)



Source: BNB.

Domestic Credit

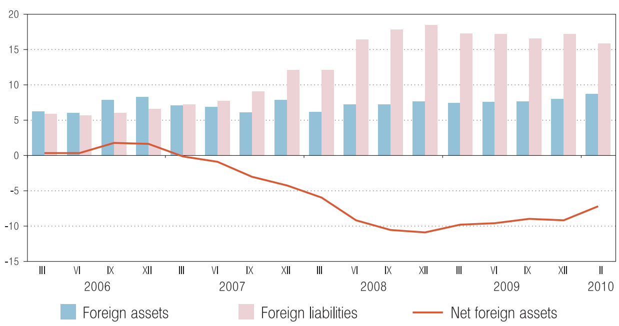
(share of GDP, %)



Source: BNB.

Foreign Assets and Liabilities of Banks

(billion BGN)



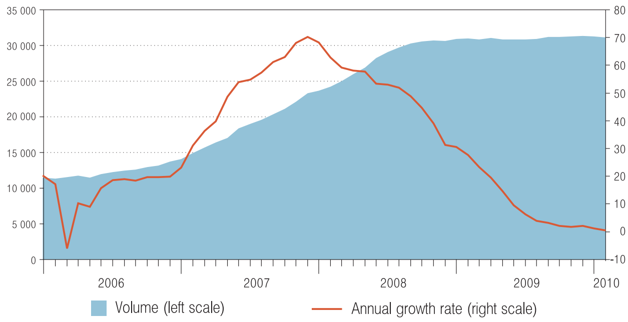
Source: BNB.

The positive lending growth observed in the previous quarter and the decline in GDP impacted the dynamics in the *claims on the non-government sector to GDP* ratio. By the end of December 2009 this ratio continued to increase reaching 77.9 per cent: up 1.5 percentage point on the previous quarter.

Between January and February 2010 banks' funds attracted from non-residents decreased by BGN 1309.3 million, while their foreign assets grew by BGN 704.0 million. As a result, net foreign liabilities declined by BGN 2013 million reflecting banks preference for reducing their external obligations in the context of ample liquidity and prudent lending policy.

Claims on Non-financial Corporations

(million BGN) (%)

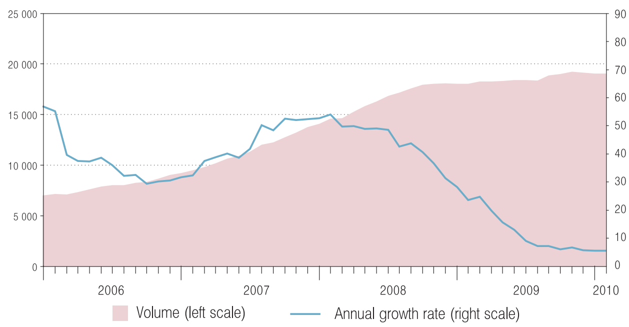


Source: BNB.

Tightened lending policy and weaker credit demand resulting from the worsened macroeconomic environment continued to curb growth in claims on non-financial corporations. Their annual growth rate continued to moderate reaching 0.4 per cent by end-February. Claims on non-financial corporations decreased to BGN 222.4 million between January and February 2010.

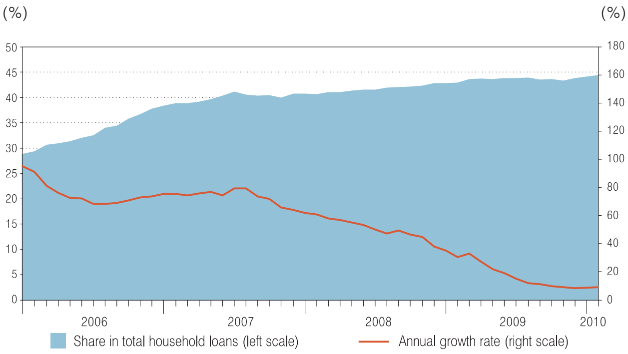
Claims on Households

(million BGN) (%)



Source: BNB.

Housing loans



Source: BNB.

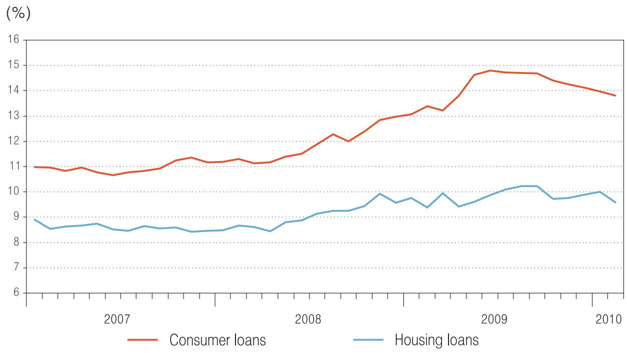
Lending to households was also relatively weak. This trend was underpinned by the tightening of banks' lending policy and the weaker demand for loans reflecting higher uncertainty related to employment and income developments. Between January and February claims on households declined by BGN 99.7 million against a decrease of BGN 64.4 million in the same period of 2009. Their annual growth rate followed a downward trend, reaching 5.6 per cent by end-February. The annual growth rate of housing loans was 9.1 per cent by end-February 2010, owing to the declining house prices and the reduction of interest rates on this kind of long-term loans.

In the first two months of 2010 a gradual decline in the average annual percentage rate of charge (APRC) on consumer and housing loans was observed, which by February went down by 0.32 percentage points to 13.8 per cent and by 0.33 percentage points to 9.6 per cent respectively. The new housing loans between January and February 2010 were 23 per cent more than in the corresponding period of the prior year.

The average interest rate on bank loans to non-financial corporations went up by around 1.3 percentage points to 9.4 per cent owing to the increase in interest rates on loans in euro to 9.43 per cent.

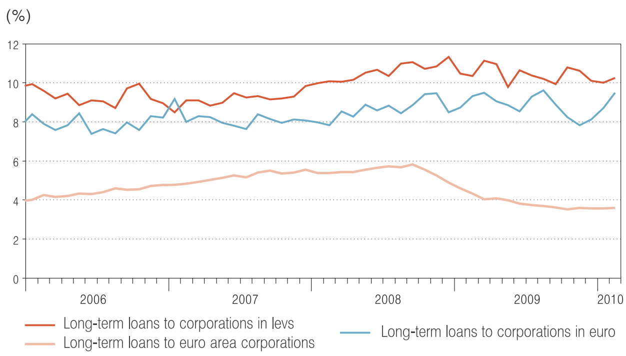
The fall in the cost of financing in the interbank money market in the euro area and in Bulgaria started to spill over to the cost of deposits very slowly and hence, has not resulted in a sizable reduction in lending rates in Bulgaria. There is a high degree of uncertainty surrounding the developments in interest rates in the following months. Since the onset of the crisis banks started to rely largely on resources attracted from residents – a trend underpinned by the reduced external capital inflow. Hence the average cost of bank resources increased, as the share of external attracted funds, which are cheaper, declined. The interbank money market has only a supporting role in bank liquidity management and we cannot expect that changes on this market will significantly affect the decrease in interest rates on deposits. Provided that a gradual decrease in interest rates on deposits was observed in the first two months of 2010 and that there were no significant external capital inflows, a slow decline in interest rates on loans might be expected over the projected horizon.

APRC on New Household Loans
(weighted average by currency)



Source: BNB.

Interest Rates on New Long-term Loans in Levs and Euro to Non-financial Corporations



Source: BNB.

3. Economic Activity

Real GDP went down by 5 per cent in 2009. Real economic growth is expected to recover due to the improved export opportunities of enterprises.

Labour market conditions continued to worsen and the number of registered unemployed increased in early 2010. Positive labour market signals are expected at the end of the year.

In 2009 the real GDP fell by 5 per cent[1]. The global financial and economic crisis impacted all sectors resulting in worsened export opportunities, eroded consumer and business confidence, lower inflow of foreign capital.

Investment was the most strongly affected component of final use by the crisis. Following the accelerated investment growth in recent years, in 2009 fixed capital investment fell down by 27 per cent in real terms on an annual basis, with the decrease reaching 36 per cent in the second half.

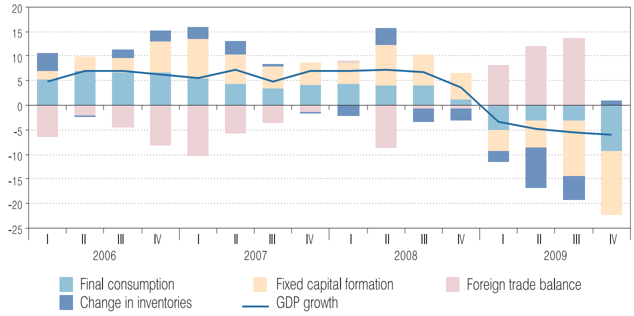
Nominal expenditure on acquisition of fixed assets in 2009 fell down by 28 per cent compared with the previous year. The strongest drop was recorded in the real estate-related sectors: construction (-48%) and real estate operations (-42%).

With the first signals for a declined external demand and lower value added in industry since mid-2008, companies started to reduce their stocks of materials, goods and output. This trend was sustained until the last quarter of 2009 when the physical change in inventories posted an increase on an annual basis.

In 2009 final demand went down by 6.2 per cent in real terms with a negative contribution of 5.2 percentage points. Increasing unemployment and significant uncertainty over the whole year affected adversely household consumer expenditures and they declined by 6.3 per cent in real terms. The last quarter of 2009 saw the strongest fall in final demand: by -10.5 per cent. Over the said quarter household consumption declined by 8 per cent consistent with the fall in real income (see *Households' Behaviour*) and government spending by 19 per cent on an annual basis.

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

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



Source: NSI.

Due to weaker domestic demand imports decreased by 22 per cent in real terms. The decrease in exports was lower which resulted in a positive contribution to the foreign trade balance. Over 2009 the negative growth rate in exports slowed down. Over the fourth quarter exports increased by 0.8 per cent in real terms compared with the last quarter of 2008 which is indicative of the gradual recovery in the international environment.

Gross value added in the economy went down by 3.8 per cent in 2009 at constant prices. The fall in industry was 8.1 per cent and had the largest negative contribution of 2.5 percentage points. The services sector exhibited a slower decline (1.7 per cent) due mostly to delayed effects of the crisis on the sector.

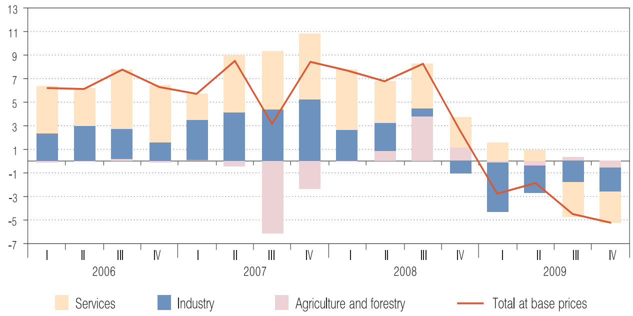
The annual rate of GDP decline is expected to slow down in the second quarter of 2010 and real economic growth in the second half of the year is anticipated to be positive. The increase

[1] The annual GDP decrease by 5 per cent in Bulgaria matches the average fall in the economic activity in the EU (-4.2 per cent).) Forecasts of a number of international analysts for a stronger effect of the global crisis on Bulgaria's economy and for an economic decline of about 7 per cent did not materialise.

in exports is expected to contribute significantly to the economic recovery. The real investment demand is anticipated to continue to decrease, albeit at lower rates. The fall in employment and retention of wages at the end-2009 level will continue to depress consumer demand. The downward trend in imports (in real terms) typical of 2009 will continue over 2010 due to lower domestic demand.

Value Added Growth and Contribution by Sector

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



Source: NSI.

GDP by Component of Final Consumption (Real Rate)

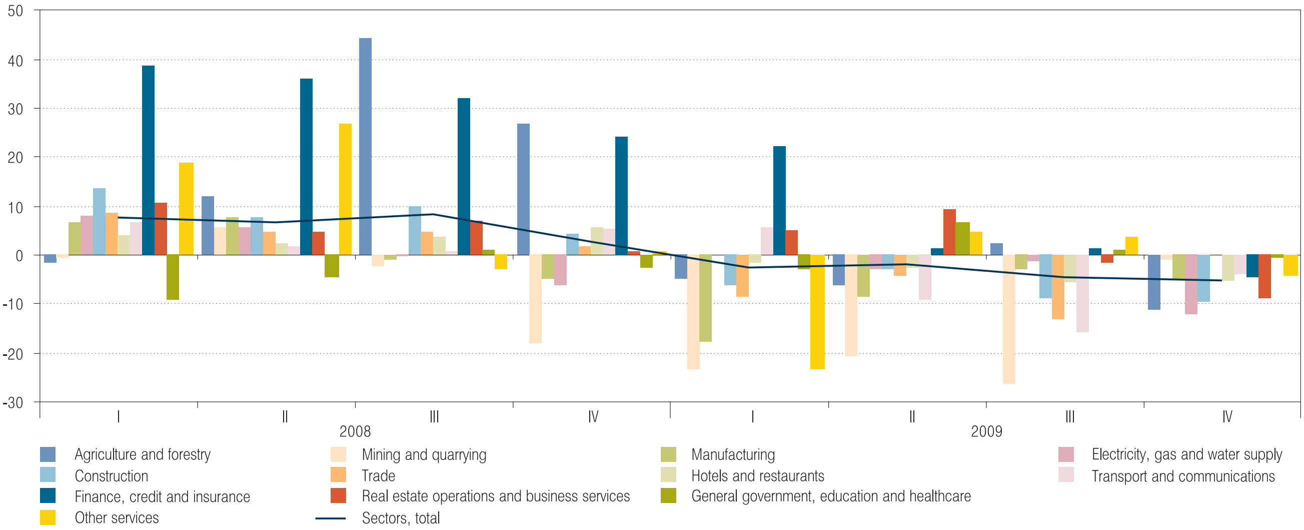
(%, real growth on the corresponding period of previous year)

	2007				2008				2009			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Consumption	6.0	5.0	4.2	4.5	4.7	4.8	5.4	1.4	-5.4	-3.7	-4.2	-10.5
incl.												
Household consumption	7.8	6.1	5.1	2.7	6.5	5.4	6.5	1.5	-6.3	-5.6	-5.3	-8.0
Final government consumption expenditure	-1.2	-1.0	2.3	8.5	-2.9	4.1	-0.3	4.6	-2.1	-0.4	0.4	-14.2
Collective consumption	-2.7	0.7	-2.5	13.3	-5.8	0.3	0.9	-1.5	1.2	8.1	1.4	-22.6
Gross fixed capital formation	35.9	24.7	19.7	14.0	15.5	28.6	22.3	15.8	-14.1	-16.3	-36.5	-35.4
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	-15.8	-6.7	0.8
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	-24.3	-23.4	-20.0
Real GDP growth	5.5	7.3	4.9	6.9	7.0	7.1	6.8	3.5	-3.5	-4.9	-5.4	-5.9

Sources: NSI, BNB.

Dynamics by Value Added by Economic Activity

(%, on corresponding quarter of previous year)



Sources: NSI.

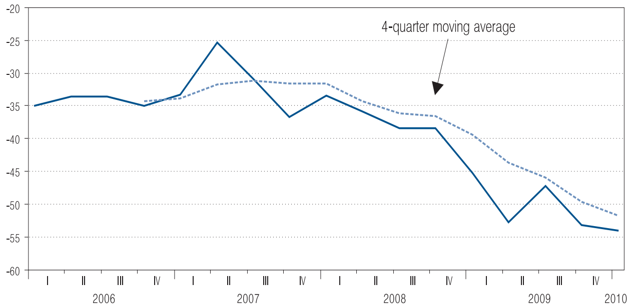
Household Behaviour

The decline in economic activity affected negatively current income and consumer expectations which increased uncertainty as to the future economic development. As a result, household final consumer expenditure in 2009 decreased by 6.3 per cent in real terms on the previous year, with expenditure on durable goods and transport posting the strongest decline. Based on data on retail trade volumes *computer and communication equipment*, and *household appliances and furniture* contributed most significantly to decreased sales in 2009. Consumption of transport services and fuels also went down substantially.

Households changed their expectations about their future financial performance and general economic situation by the end of 2008 and early 2009 irrespective of continuously increasing real disposable income. Consequently, the negative expectations stimulated higher savings to offset a possible freezing or decline in household income in the future. Deposit rate dynamics also impacted household decisions on consumption and savings. The higher interest rate encouraged a higher rate of household savings. Against the background of a declining inflation the real deposit interest rate[2] in 2009 increased compared with pre-crisis levels to reach approximately 4 per cent.

Households Confidence Indicator

(balance of opinions)



Source: NSI Consumer Survey.

Over the second half of 2009 unfavourable labour market processes deepened as a result of the economic crisis and affected adversely the dynamics of household disposable income. Between July and December 2009 employment decreased by 4.7 per cent on an annual basis and wage growth slowed down to 6.5 per cent on a year earlier basis. In the fourth quarter annual household income declined both in nominal and real terms due mostly to lower labour income.

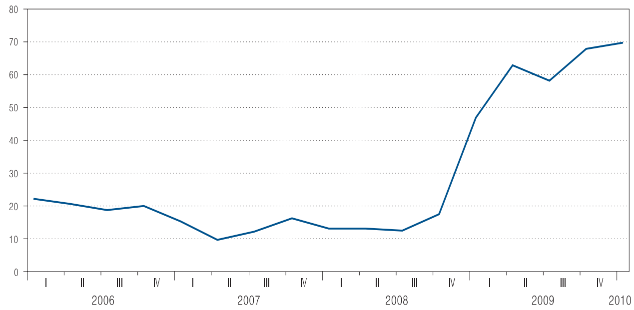
Over the first three months of 2010 the upward trend in the number of registered unemployed in labour offices continued. The unemployment level announced by the Employment Agency reached 10.1 per cent in March[3]. This dynamics led to an additionally weakened of consumer confidence in the first three months of 2010.

[2] The indicator is computed deflating the average annual nominal interest rate on deposit balances obtained as an average weighted value of the interest rates in the three currencies (Bulgarian levs, euro and US dollars) by the average annual inflation for the respective year.

[3] The published Eurostat seasonally adjusted unemployment ratio constructed in accordance with the methodology of the International Labour Organisation gradually increased to reach 8.7 per cent in February 2010 (8.3 per cent by the end of 2009).

Unemployment Expectations (Quarterly)

(balance of opinions)



Source: NSI Consumer Survey.

Labour market trends will predetermine to a great extent the household consumption profile over the current year both through disposable income and the formation of expectations about future economic situation and financial performance.

Weaker labour demand and limited job supply impeded the active participation of working-age population in labour market. The economic activity rate of the persons between 15 and 64 fell by 0.6 percentage points to 67.2 percentage points in 2009 and the share of discouraged population within the composition of working-age persons increased by 0.7 percentage points over the same period. Participation in the labour market continued to weaken over 2009 consistent with the lower labour demand by enterprises.

Employment Agency data suggest that higher unemployment in 2009 pertained to the inflow of newly registered unemployed. Against the background of weaker labour demand the announced job vacancies were quickly occupied due to the increased number of unemployed per vacant position. The high educational level of the persons seeking a new job also helped the unemployed persons to quickly find a new job. Within the structure of the persons dismissed in 2009 the share of persons with professional qualification, who had easily found a new job in the previous years, went up. The current data do not indicate any structural problems in the labour market due to the economic crisis. Therefore, we expect that gradually recovering labour demand will not cause a shortage of labour in the medium run.

Employment and Income Dynamics

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

	2008				2009			
	I	II	III	IV	I	II	III	IV
Employed	4.8	3.4	3.0	2.1	-0.3	-1.8	-3.7	-5.8
Real wage	8.2	10.5	7.3	10.5	9.6	8.1	8.9	2.9
Wage fund	14.1	14.8	10.6	13.2	9.0	5.5	3.5	-4.3
Unemployment at the end of the period, % of the labour force	6.8	6.0	5.8	6.3	6.9	7.3	8.0	9.1

Sources: NSI – SNA, Employment Agency.

Consumer Demand Dynamics

(% on corresponding period of previous year)

	2008				2009				2010
	I	II	III	IV	I	II	III	IV	Jan.-Febr.
Consumer spending per household member	6.7	1.8	1.7	-0.7	0.1	-0.1	2.6	-2.28	n.a.
Retail sales	14.2	10.7	7.2	0.9	-9.5	-14.6	-15.7	-14.9	n.a.
Retail trade turnover	13.5	11.3	8.0	4.3	-5.3	-10.2	-9.2	-10.5	-12.4
Retail trade excluding trade in automobile fuels and lubricants	15.5	12.1	8.7	6.0	-4.4	-9.1	-11.0	-12.4	-12.6
Retail trade in food, drink, tobacco	3.3	-1.0	1.3	3.0	3.2	2.2	2.1	1.0	-0.6
Retail trade in non-food goods	16.7	15.1	9.9	4.6	-7.8	-13.5	-12.2	-13.5	-16.0
Retail trade in textile, clothing, footwear and leather	35.9	25.2	13.3	10.9	-5.1	-8.6	-13.6	-13.2	-12.7
Retail trade in household goods and home appliances	14.1	9.5	4.9	1.9	-7.6	-16.4	-19.0	-19.7	-20.0
Retail trade in computers and communication equipment and other consumer goods	26.3	25.2	15.7	6.3	-15.1	-17.5	-20.0	-23.0	-22.3
Retail trade in pharmaceutical and medical goods, cosmetics and toiletries	20.3	23.5	21.8	21.8	6.9	-2.1	-3.2	-2.6	-7.8
Retail trade in automobile fuels and lubricants	8.4	9.0	5.8	-1.3	-8.3	-13.4	-3.8	-4.2	-11.9

Source: NSI – Household Budgets and Domestic Trade Survey.

Government Finance and Consumption

By the close of 2009 the general government cash balance came to BGN -576.4 million (0.9 per cent of the GDP). The restrictive budget spending policy in the fourth quarter resulted in a significant negative contribution of the government consumption to GDP growth (3.9 percentage points for the quarter and 0.9 percentage points for 2009). After the deterioration of the budget position in the first two months of 2010 the government is expected to reduce its spending over the following two quarters in order to limit the deficit which amounted to about BGN 1.4 billion by February. Consequently, the contribution of government consumption to GDP growth will remain negative and it is expected to be under 1 percentage point.

The general government balance on a cash basis came to BGN -576.4 million (0.9 per cent of the GDP) in 2009.[4] In response to lower budget revenue reflecting the slowdown in economic activity, by the end of 2009 the government initiated measures to limit budget expenditure which were practically frozen at their previous year's levels. Correspondingly, the worsening of the budget position on 2008 (by approximately 4 per cent of the GDP) was mainly due to the effect of automatic stabilisers.

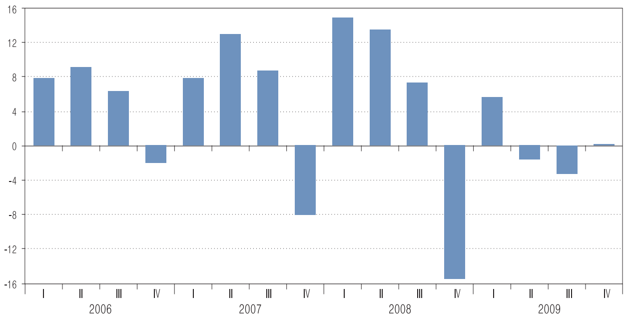
[4] The analysis in this section is based on the statistical information according to the national methodology (on a cash basis) published on the website of the Ministry of Finance.

Total revenue and grants on the consolidated fiscal programme decreased by 8.3 per cent compared with the previous year. The value added tax and corporate income taxes contributed most substantially to the fall in the budget revenue in 2009 (by -14.1 per cent and -20.9 per cent respectively). However, in the last quarter indirect taxes posted a marginal increase (3.6 per cent) despite decreasing household consumption, which reflected to a large extent the lower value of effectively refunded VAT by the tax administration in December[5] and partly the measures intended to improve the collectability.

Social security contributions and personal income taxes responded less noticeably and with a significant lag to the economic activity slowdown, and personal income taxes even increased by 4 per cent in 2009. However, between October and December 2009 revenue from social security contributions and income taxes already had a negative contribution to the growth of tax revenue (-2.5 percentage points).

Primary Balance (Quarterly)

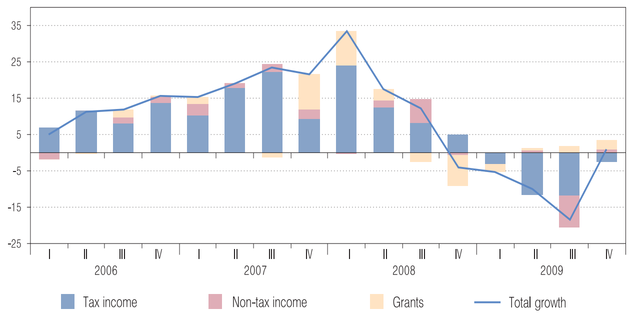
(share of GDP for the quarter, %)



Sources: MF, BNB.

Contribution of Major Groups of Current Revenue to Total Growth of Revenue and Grants (Quarterly)

(%)



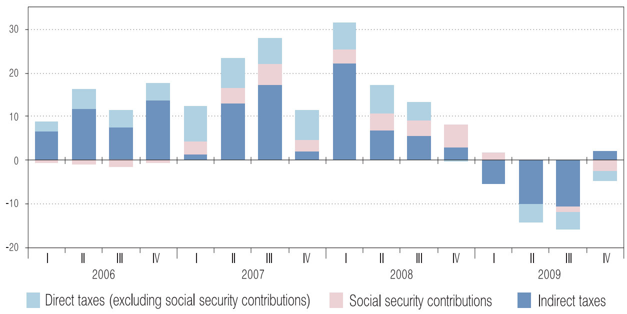
Sources: MF, BNB.

[5] The entities registered under the Law on the Value Added Tax have the right to use a tax loan by deduction or effective refunding after a certain period. Based on MF Monthly Bulletin data for November and December 2009 the tax refunded in December totalled BGN 135.9 million accounting for mere 3.1 per cent of the VAT refunded in 2009 (BGN 4320.7 million).

The fourth quarter of 2009 saw a significant decrease in budget expenditure (by 31.3 per cent) which may be explained to a large extent by the high 2008 base and the postponement of some budget payments from end-2009 for the early 2010. Current operating expenditure contributed most substantially (-45.8 per cent against the forth quarter of 2008) to the negative growth of current non-interest expenditure. A significant fall was also recorded in capital expenditure which went down by 67.4 per cent on an annual basis in the last quarter. Capital spending in 2009 decreased by 17.3 per cent compared with 2008. An increase was reported only in social and health insurance contributions (13.8 per cent) compared with the previous year, reflecting mainly the significant increase in pensions (15.8 per cent). However, this expenditure also posted negative growth (-4.7%) in the fourth quarter of 2009, a result of reduced and postponed traditional Christmas bonuses to pensions and the delay of other social payments.

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

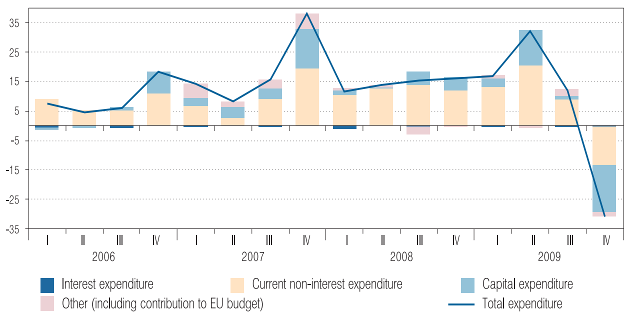
(%)



Sources: MF, BNB.

Contribution of Growth in Major Expenditure Groups to Total Expenditure Growth (Quarterly)

(%)



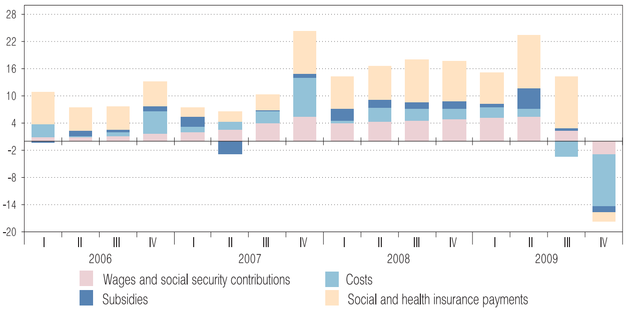
Sources: MF, BNB.

The contraction in government current non-interest expenditure affected the government consumption contribution to the change in the GDP.

While in the third quarter of 2009 this contribution was slightly positive (0.13 percentage points), in the last three months of the year it reached -3.9 percentage points, consistent with restrictive fiscal policy pursued by the government in the second half of 2009.

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

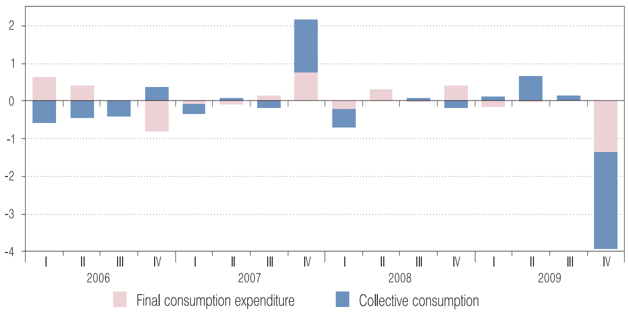
(%)



Sources: MF, BNB.

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

(%)



Sources: MF, BNB.

In January and February 2010 the downward trend in total budget revenue and grants was sustained (-27.4 per cent on an annual basis). Along with the negative effect of the economic cycle, the fall could be explained by the impact of some additional factors. The negative one-off factors had the strongest effect on indirect taxes, exhibiting a decline by 34.9 per cent on the corresponding period of 2009. The significantly contracted government consumption and investment by the end of 2009 against the same period of 2008 prompted a decline in indirect taxes payable by the public sector[6]. The accelerated refund of VAT offsetting the delayed payments by tax authorities in December also contributed to the decline in revenue from VAT. A number of one-off factors impacted also the excise revenue: refunds on unused excise labels, lower revenue from the excise on fuels due to planned overhauls, *etc*.

Another key factor behind the fall in total revenue and grants was the delay in incoming funds under EU programs (the revenue from EU funds totalled BGN 31.5 million for the January – February period against BGN 391.5 million for the same period of 2009). Based on Ministry of Finance data receipts in the amount of BGN 118.4 million from Structural Funds and Cohesion Fund were reported in March.

Total budget expenditure increased in early 2009 by 22.7 per cent compared with the same period of 2009. Social expenditure and wage and remuneration expenditure also posted an increase: by 27.7 per cent and 13.8 per cent respectively. This dynamics was mostly attributable to the increased costs on pensions and payment of postponed remuneration from end-2009 to employees in some spheres of the government sector. The settlement of postponed payments under contractual obligations from 2009 also added to the increase in budget expenditure. In addition, the government made serious efforts to increase the utilization of resources under EU funds, with the expenditure made in the first two months of the year amounting to BGN 408.5 million against BGN 87.4 million for the same period of the previous year. Capital expenditure comprised the bulk of this spending (94 per cent) and explained to a large extent the growth of budget spending on investment during the first two months of 2010 (by 34.7 per cent).

In the first two months of 2010 the government cash deficit reached BGN 1398.1 million. Due to lack of receipts from EU funds in the first months of the year and given the increased costs on utilising the resources under these funds, the accumulated deficit on the programmes financed by EU funds contributed by approximately 27 per cent to the general government deficit.

There is still uncertainty as to the particular measures to be initiated by the government to limit the deterioration of the budget position. In general, it is expected that in the second and third quarters the bulk of the budget consolidation will be at the expense of current non-interest expenditure (excluding social payments). Consequently, the contribution of government consumption to GDP growth will remain negative but it will not exceed 1 percentage point.

[6] Since a certain period of time is required (1–2 months) between the accrual and cash payment of VAT, the effect of expenditure contraction affects tax revenue with a lag.

Behaviour of Firms and Competitiveness

The production activity will recover moderately with exports playing the leading role. Despite the unfavourable conditions companies maintained expenditure discipline and did not allow serious deterioration of their financial performance and competitiveness.

Since the end of 2008 production activity in Bulgaria has been strongly impacted by the world economic and financial crisis the effects of which will be sustained in 2010. The contracted external demand directly affected output by the fall in exports, on the one hand. On the other hand, the limited capital flows, banks' more conservative lending policy and enhanced business pessimism had a negative effect on the investment activity resulting in a contraction of the domestic market for a number of industrial enterprises. The weak domestic consumer demand was also a key factor for the negative dynamics in production of goods and services.

Gross value added produced in industry over 2009 went down by 3.8 per cent in real terms compared with the previous year. Manufacturing declined by 8.1 per cent contributing 1.2 percentage points to the total value added decrease. The sector was impacted by the worsened external conditions but weak domestic demand had even a stronger adverse effect on it. The total nominal fall in manufacturing value added in 2009 was 26 per cent with domestic market contributing 16 percentage points to this decline. The negative growth in industry was prompted by the decline in construction (by -7.2 per cent, -0.6 percentage points), which ensured market for the bulk of intermediate consumption output, and in trade (by -6.1 per cent, -0.6 percentage points). The contracted foreign trade was one of the major factors behind the drop in the *transport and communications* sector where value added fell by 7 per cent (-0.8 percentage points).

Faced with decreasing sales revenue enterprises initiated measures to counterbalance the effects of the unfavourable economic environment on their financial performance by reducing their expenditure on commodities, materials and labour. The improvement in the value added to gross output ratio observed in all industries over 2009 reflects the effect of the measures launched to reduce intermediate consumption, that is the outlays on commodities, materials, hired services, *etc*.

Enterprises made efforts to reduce also their labour costs by decreasing jobs and limiting wage growth. Employment went down by 2.9 per cent from 2008 and layoffs intensified in the course of the year: employment contracted by 1.1 per cent in the first half of 2009 on an annual basis to 4.7 per cent in the second half of 2009. The crisis impacted employment with a certain lag. On the one hand, this lag was attributable to the sound financial performance of enterprises and their ability to reduce current profits expecting a recovery of demand. On the other hand, the gradual transmission of the initial external shock from export oriented industries to those servicing the domestic market also impacted the employment dynamics by sector. In the first half of 2009 employment in services continued to increase on an annual basis, while in the second half of the year the number of employed in the sector went down by 6.2 per cent compared with the corresponding period of 2008.

The nominal growth of labour remuneration slowed down to 9.4 per cent in 2009 (from 22 per cent in 2008) impacted by the negative trends in the labour market and weaker production results. The annual growth of the compensation per employee was more substantially limited in the second half of 2009, particularly in the fourth quarter (to 3.5 per cent on annual basis) when enterprises did not pay or reduced the amount of annual bonuses. The relatively high wage growth rate in the first half of the year was attributable to a large extent to the increase in the minimum wage by 9 per cent and the rise in minimum social security thresholds by more than 20 per cent since early 2009.

Labour productivity worsened by 3.1 per cent on an annual basis in the first six months of 2009 due to delayed employment reduction. Between July and December 2009 the decreasing production activity and fears associated with the decline in profits forced enterprises to start layoffs. As a result the fall in labour productivity slowed down to 1 per cent in 2009 (against 0.1 per cent in the fourth quarter). Due to staff shedding and gradual recovery of industrial output in manufacturing (the real growth in the second half of 2009 was 5.6 per cent compared with the first half), the labour productivity went up by 6.1 per cent between July and December 2009 on the corresponding period of the previous year.

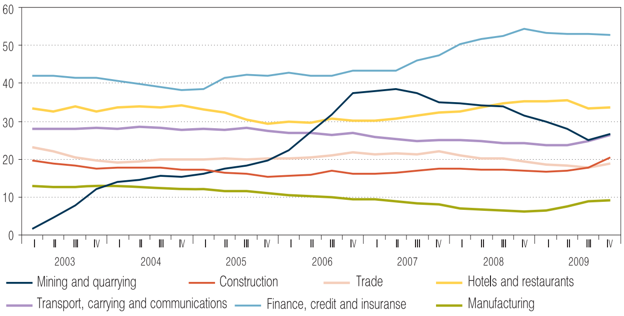
Economy-wide unit labour costs continued to increase in 2009: by 10.6 per cent in nominal terms and 5.8 per cent in real terms. In contrast to the 2007–2008 period when the unit labour cost growth was accompanied by an increase in profits of enterprises, in 2009 this growth was attributable to the significantly contracted demand and delayed staff reductions. During the fourth quarter of 2009 the growth rate of unit labour costs significantly slowed down and reached 3.7 per cent and 1.8 per cent in nominal and real terms respectively.

In 2009 trade and agriculture contributed most significantly to the unit labour cost growth by sector: approximately 4.2 percentage points in nominal terms and about 1.5 percentage points in real terms. Data on unit labour costs in the agricultural sector, should be interpreted cautiously because of the significant share of self-employed whose income is combined: compensation and rents.

Manufacturing contributed most significantly (-0.7 percentage points) to limiting real unit labour cost growth. Developments of unit labour costs in manufacturing have direct effect on the external competitiveness of the economy since this industry is export oriented to a great extent. Manufacturing is the only sector posting positive growth in the operating surplus in 2009. The fall in the value added entirely pertained to the contraction in labour costs which helped improve the competitive positions of enterprises. The unfavourable trends in unit labour costs in trade are associated with the weaker domestic demand and restructuring of the industry resulting in a reduced activity of wholesale traders which do not have a direct effect on Bulgaria's external competitive positions.

Profitability of production (12-month moving average)

(%)



Note: The gross operating surplus to gross produce ratio

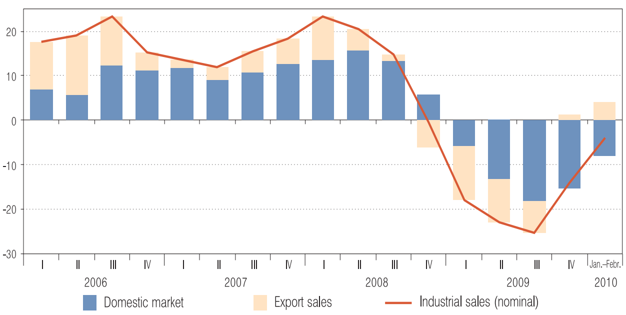
Sources: NSI, BNB.

Despite the worsened market conditions in 2009 the gross operating surplus to gross produce ratio rose in a number of sectors (manufacturing, construction, energy, transport and communications) compared with 2008. In the financial sector the ratio indicated a slight fall to 52.7 per cent (from 54.3 per cent in 2008) but stayed highest compared with other sectors. The decline in trade profitability was also insignificant (from 19.5 per cent to 18.8 per cent) and was due to the increase in the minimum wage in the beginning of 2009, on the one hand, and the stronger competition in the sector, on the other hand.

The quarterly data on economic activity point to a slack since early 2009 rather than to a clear positive dynamics. Managers' estimates and expectations about the business situation in all sectors are at low levels and the same refers to consumer confidence. In early 2010 production capacity utilisation in industry went down from 75 per cent in early 2009 (a level typical of the 2007–2008 period) to its level prior to mid-2006: under 65 per cent. These trends give no grounds to expect a significant contribution of domestic demand to the recovery of the economy in the near future.

Growth Rate of Nominal Industry Turnover

(percentage change on same period of previous year)

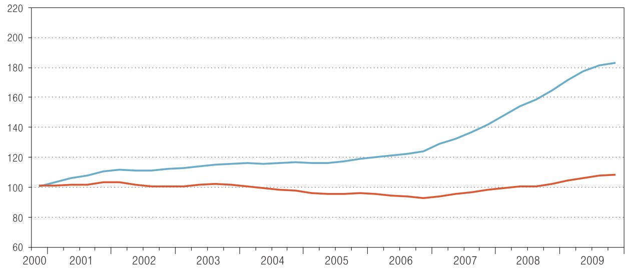


Sources: NSI, BNB.

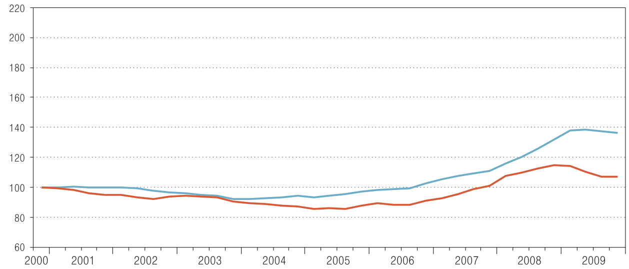
Unit Labour Cost (4-quarter moving average)

(2000 = 100%)

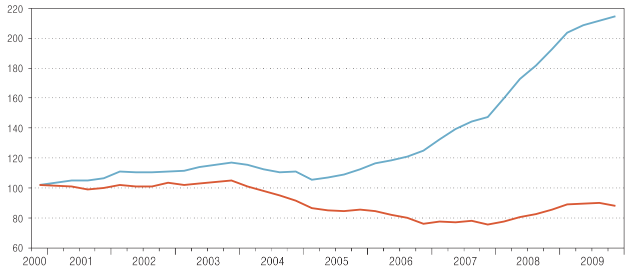
Total for the Economy



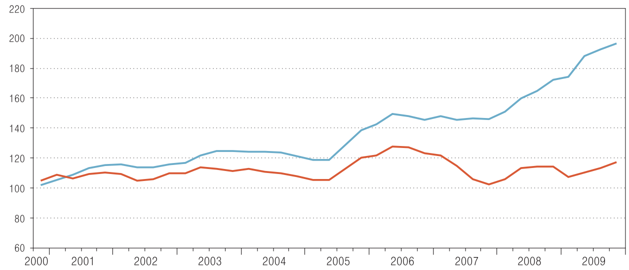
Manufacturing



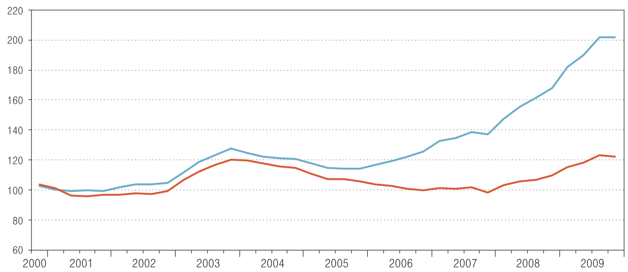
Construction



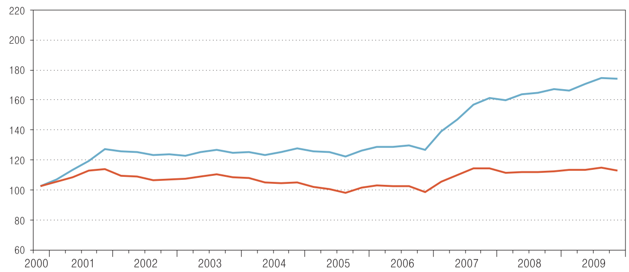
Electricity, Gas and Water Supply



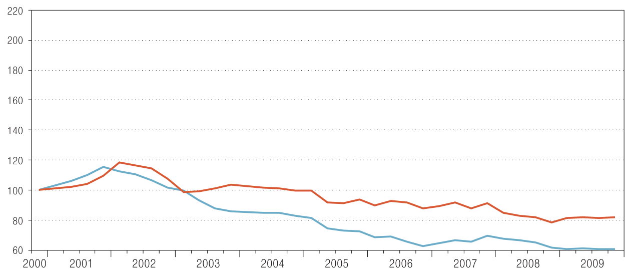
Trade



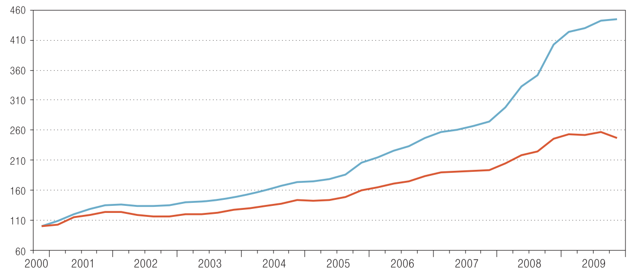
Transport and Communications



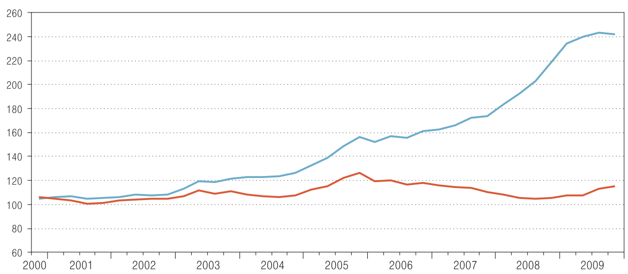
Financial Intermediation



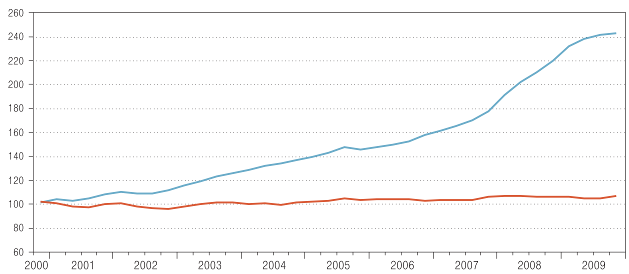
Real Estate Operations



Hotels and Restaurants



Public Services



Nominal unit labour cost

Real unit labour cost

Sources: NSI, BNB

Exports are expected to play a key role in the recovery of output growth. Over 2009 the negative export growth rates moderated and the fourth quarter saw an increase by 0.8 per cent in real terms (exports of goods increased by 2.8 per cent) compared with the last quarter of 2008. Exported industrial goods also posted a nominal increase by 4.5 per cent on an annual basis in the fourth quarter of 2009 and by 15 per cent in January and February 2010. Investment goods and intermediate consumption goods occupied leading export positions which is indicative of sustained competitiveness of these industries and their ability to benefit form the gradually recovering world economy.

Survey of Price and Wage Setting Mechanisms in Non-financial Corporations in Bulgaria

Between September and October 2009 a representative survey of wage and price setting mechanisms in non-financial corporations in Bulgaria was conducted.[1] This survey covered 504 enterprises in industry, trade and services (about 20,000 employed).

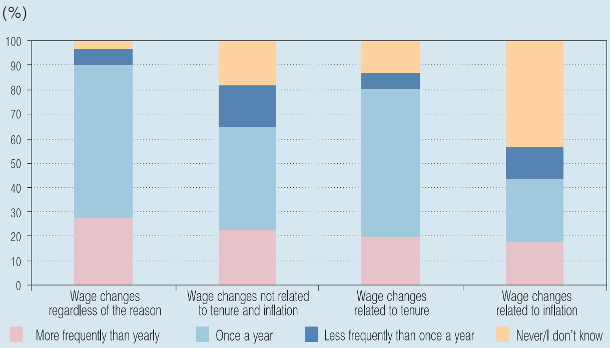
The conclusions drawn from the major survey topics are as follows:

- there is a comparatively high flexibility in wage setting;
- price setting in enterprises is flexible due to the competitive environment;
- the most significant factor for price increases is the raw materials prices;
- the link between wages and prices is comparatively weak.

Wage Flexibility

In Bulgaria, 63 per cent of firms change wages at least once a year while around 30 per cent do it more frequently. In the EU, wages are also changed once a year (approximately 60 per cent of the firms), while the share of the firms which adjust wages more often is only 12 per cent on account of the higher share of those changing wages less frequently than once a year. The results show comparatively higher flexibility of wages in Bulgaria than in the EU. This implies a rapid reaction of firms in case of negative economic shocks. Firms in Bulgaria more often have recourse to cuts in the flexible components of wages compared with the summarized data for the EU which contribute to more effective management of expenditure under negative shocks.

Wage Change Frequency (Bulgaria)



Note: Firms' relative share. The variable 'wage changes regardless of the reason' is constructed by taking the answer with the highest frequency among the three reasons: inflation, tenure and not related to tenure and inflation.

Source: BNB.

Wage Change Frequency (EU average)

Note: Firms' relative share. The variable 'wage changes regardless of the reason' is constructed by taking the answer with the highest frequency among the three reasons: inflation, tenure and not related to tenure and inflation.

Source: ECB.

Nominal and real convergence processes limit the need for a nominal decrease in wages, and no effects of a possible downward rigidity of wages occur. The share of firms with pay freezes in the last five years is 11.7 per cent and of those with pay cuts 6.3 per cent. The relative shares of corporations which use one of the two strategies in Bulgaria differ less than those in the EU. Therefore, obstacles to wage cuts are not more significant than those to their freeze.

[1] The survey was commissioned by the Bulgarian National Bank and carried out by the ESTAT agency.

(continued)

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Price Setting and the Interaction between Wage and Price Adjustments

The data from the survey show that the major pricing practice in Bulgaria involves following of the competitors' policy. This strategy is used by 40 per cent of corporations, while 34 per cent of them set the prices on the basis of their expenditure and profit margin which they have chosen themselves. Following the policy of competitors is a possible explanation of the higher frequency of price changes in Bulgaria compared with other EU Member States and especially euro area countries.

Pricing in the Bulgarian firms does not normally take place on a regular basis at specified intervals of time. Almost one-third of the firms which follow a regular scheme change prices once a month or more frequently. These results show that price flexibility in Bulgaria is significantly higher in time than in the EU.

Price Change Frequency

(Firms' relative share)

	Monthly or more frequently	Once a quarter/ a half year	Once a year	Less frequently than once a year	No fixed scheme
EU	9.2	15.4	39.2	7.4	28.5
Euro area countries	9.0	12.9	40.8	5.1	32.1
Non-euro area countries	9.9	22.5	35.0	13.6	18.6
Bulgaria	16.5	7.5	17.0	6.7	52.3

Sources: BNB and ECB.

The cost of raw materials and the improved quality of offered goods and services had the most significant contribution to the increase in prices in Bulgaria over the last years. Labour costs had significantly lower contribution to price rises, while in the euro area, they were one of the major factors.

Contribution of Various Factors to Price Rises

(average estimates)

Factors	Euro area (industry)	Bulgaria (industry)	Bulgaria (all sectors)
Wage increase	3.0	2.4	2.2
Higher prices of purchased raw materials	3.1	3.3	3.4
Financial expenditure increase (investment expenses/interest rate)	2.2	2.6	2.5
Increase in demand for output	2.2	2.8	2.7
Price rises by competitors	2.4	2.4	2.6
Quality improvements	-	2.8	2.9
Price increase set by a government regulatory authority	-	2.1	2.4
Price indexation to inflation	-	2.1	2.2
Changes in projections of inflation and/or business activity	-	2.0	2.1

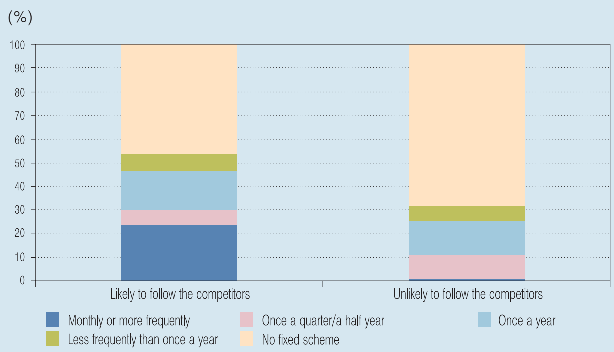
Note: Firms' estimates of individual factor contributions vary between 1 (without any contribution) and 4 (with a very significant contribution).

Sources: BNB and ECB.

In Bulgaria, the wage/price link is weaker than in the other countries included in the survey. In Bulgaria, 25 per cent of the firms pursue a wage indexation policy, while in the euro area and outside it this share is respectively 35 per cent and 38 per cent. The degree to which wage changes spill over into prices may be estimated through firms' reaction to various shocks. When asked how they will react to an unexpected permanent increase in wages (*i.e.* due to a minimum wage rise) affecting all corporations in the market, 43 per cent of the firms reply that they will raise prices, while such a reaction is declared by 60 per cent of the corporations in the EU. The weak link between prices and wages decreases inflation momentum and enables the economy to sustain its competitive positions in the event of negative shocks.

The survey results show that the high competition determines price flexibility in Bulgaria. Hence, measures directed at improving the competitive environment and retaining the labour market flexibility are major factors for boosting the economy's competitiveness.

Link between the Frequency in Price Changes in Bulgaria and the Following of Competitors' Price Policy in the Event of Price Cuts



Source: BNB

Exports and Imports of Goods

In the second and third quarters of 2010 exports are expected to post again positive growth and to gradually accelerate consistent with the strengthened external demand. In nominal terms imports are anticipated to recover slowly. Trade deficit will continue to improve.

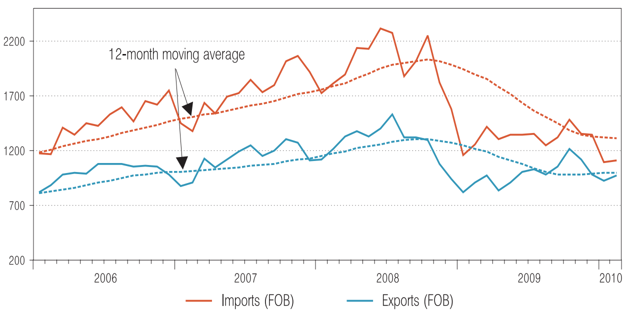
In 2009 the global economic crisis and the crisis in EU countries, our major trading partner, prompted a dramatic slowdown in foreign trade flows to Bulgaria[7]. Export growth rates were negative at -22.5 per cent on 2008 and imports registered a 33.4 per cent decrease. Between January and February 2010 imports continued to decline (by 8.5 per cent), while exports went up by 10.4 per cent on an annual basis.

In the second and third quarters of 2010 exports are expected to post again positive growth and to gradually accelerate consistent with the improved external demand as a result of the recovery in the global economy, particularly in the EU member states – Bulgaria's major trading partner.

Imports are expected to recover slowly in nominal terms reflecting the lower slowdown in domestic investment and consumer demand and the positive increase in international prices.

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

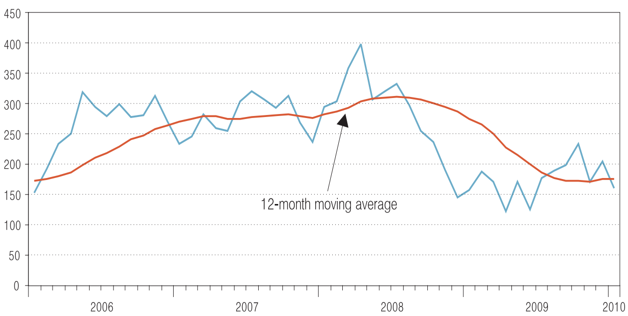
Investment goods and energy resources contributed most significantly (by -19.8 and -11.5 percentage points respectively) to the trade deficit decrease (by EUR 4.49 billion) in 2009. Imports of both groups went down on all items, with the overall decline exceeding that of exports. The most pronounced drop in the imports and exports of both groups was recorded by *machines, vehicles and appliances, spare parts* and *fuel and natural gas* due to the simultaneous reduction of output and investment activity in Bulgaria and in EU member states.

Over 2009 all groups excluding *animal and vegetable products, food, drink and tobacco* contributed to the negative growth of exports, with the dynamics of *base metals* (-8.5 percentage points), *mineral products and fuels* (-6.0 percentage points), *machines, transport vehicles and appliances* (-2.4 percentage points) and *textile, clothing and footwear* (-1.8 percentage points) contributing most to this effect.

In 2009 base metal export revenue amounted to EUR 2110.1 million, down 38.6 per cent on the corresponding period of 2008. The group's major negative contribution to the total export dynamics was exhibited by *copper* (-3.7 percentage points) and *iron and steel* (-3.2 percentage points) due to lower international prices and weaker external demand. In January 2010 this group reported positive growth (2.1 per cent on an annual basis) due mainly to higher international prices and strengthened external demand. Over the forecast horizon the increase in external demand and international prices of base metals are expected to continue which will boost the positive export growth.

Exports of Base Metals

(million EUR)



Source: BNB.

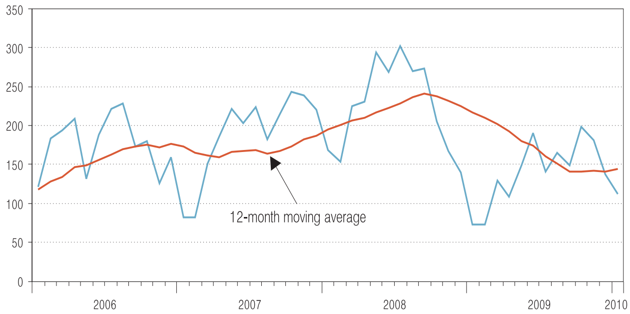
Revenue from exports of mineral products and fuels went down by EUR 1004.3 million (37.1 per cent). Negative developments were reported

[7] The analysis presented in this section is based on nominal export and import data in euro.

under all major items in the group, with fuels contributing most significantly to these developments in 2009 (-5.7 percentage points) owing to lower prices and external demand contraction. In January 2010 this group reported positive growth totalling 52.7 per cent on an annual basis. The recovery is expected to continue in the second and third quarters of 2010 given the improvement in the international environment.

Exports of Mineral Products and Fuels

(million EUR)

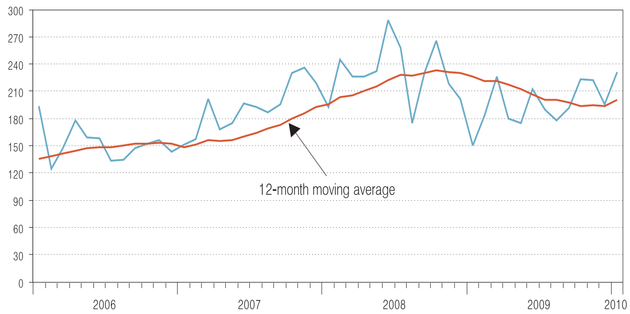


Source: BNB.

In 2009 receipts from exports of *machines, transport vehicles and appliances* went down by EUR 431.8 million (15.6 per cent). *Nuclear reactors, boilers, machines, appliances and machinery* had a major negative contribution (-1.8 percentage points) followed by ships (-0.3 percentage points). In January 2010 this group reported positive growth accounting for 54.3 per cent on an annual basis. Over the forecast horizon a recovery in this group is expected consistent with the recovery of production activity in the EU member states, Bulgaria's major trading partner.

Exports of Machines, Transport Vehicles and Appliances

(million EUR)

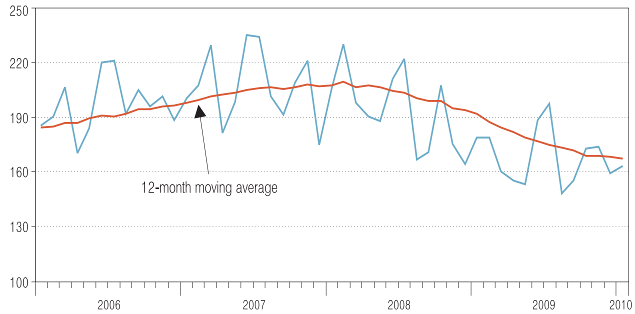


Source: BNB.

Revenue from exports of textiles decreased by EUR 308.2 million (13.2 per cent) compared with 2008, with the decrease in clothing exports (a contribution of -0.9 percentage points) having the strongest impact. This group has registered negative growth since the beginning of 2008, *i.e.* before the Bulgarian economic crisis. In January 2010 it continued to report a negative growth rate, albeit gradually declining (-8.7 per cent on an annual basis). Despite the improved international environment, the downward trend is expected to be sustained over the projection period due to the necessary restructuring in this industry under the pressure of the strong international competition.

Exports of Textile, Clothing and Footwear

(million EUR)

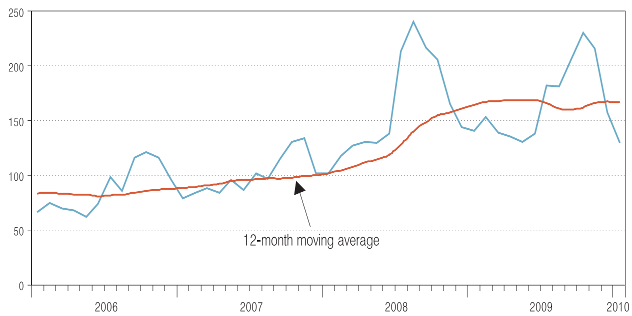


Source: BNB.

The group of *animal and vegetable products, food, drinks and tobacco* is the only group reporting a positive contribution to overall exports in 2009. Their revenue rose by EUR 77.2 million (4.0 per cent), with *tobacco* (0.3 percentage points) and *sunflower seed* (0.2 percentage points) contributing most significantly due to the good harvest and strong competitive positions. In January 2010 this group reported negative growth (-7.8 per cent on an annual basis) due mainly to declines in cereals exports. The positive growth is expected to be restored over the projected horizon with the risks on the downside owing to the uncertain agricultural harvests.

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

(million EUR)



Source: BNB.

Contribution of Commodity Groups to Trade Growth in 2009

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p..
Consumer goods	-3.5	-0.8	-19.5	-3.4
Raw materials	-25.7	-11.4	-32.9	-11.0
Investment goods	-23.1	-3.8	-39.2	-10.7
Energy resources	-39.3	-6.5	-38.4	-8.4
Growth, total	-22.5		-33.4	

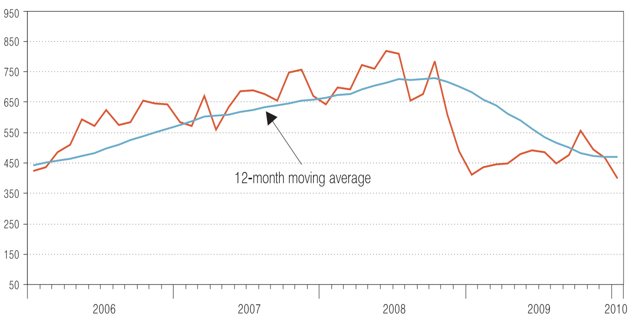
Source: BNB.

Imports (CIF) reached EUR 16,712.5 million in 2009; a nominal decrease of EUR 8381 million (33.4 per cent) on the prior year. In the structure of imports by use, *raw materials* registered the highest negative contribution (-11.0 percentage points), followed by *investment goods* (-10.7 percentage points) and *mineral products and fuels* (-8.4 percentage points) due to lower production and investment activity in Bulgaria.

In 2009 payments on imports of raw materials came to EUR 5648.1 million, down 32.9 per cent. All items in this group with the exception of *tobacco* reported declines, with *iron and steel* (-3.3 percentage points) and *plastics* (-1.3 percentage points) having the major negative contributions due to lower prices and output contraction. In January 2010 imports in this group continued to register negative growth which slowed down by 3.2 per cent on an annual basis.

Imports of Raw Materials

(million EUR)

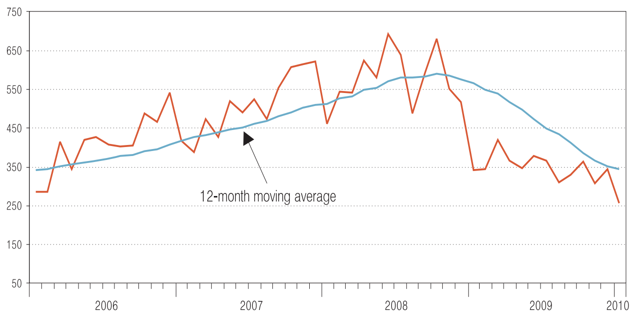


Source: BNB.

Investment goods imports fell by 39.2 per cent in 2009; these products ranked second in imports (after raw materials) with a share of 25 per cent. Their value reached EUR 4180.4 million. All items in this group had negative growth, with *transport vehicles* having the largest negative contribution (-4.2 percentage points), followed by *machines and equipment* (-3.5 percentage points) due to the reduced investment activity in Bulgaria. In January 2010 imports continued to report negative growth (25 per cent on an annual basis) which slowed down on the previous months of 2009. In the second and third quarters of 2010 the positive growth in *raw materials and investments goods* is expected to be restored due to the lower investment and consumer demand contraction in real terms and the rise in the prices of raw materials over the projection period of 2010.

Imports of Investment Goods

(million EUR)

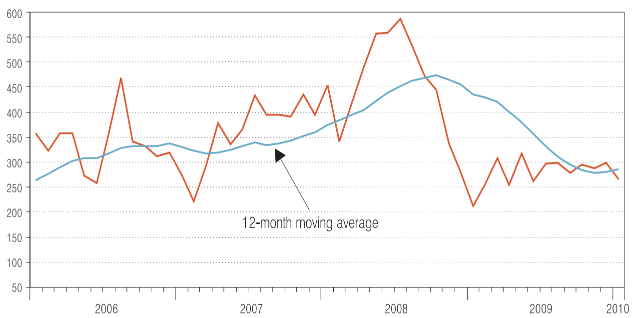


Source: BNB.

In 2009 payments on imports of mineral products and fuels came to EUR 3361.2 million, down 38.4 per cent. All items reported negative growth, with *fuels* (-7.7 percentage points) and *natural gas* (-6.8 percentage points) registering major negative contributions. In January 2010 imports in this group posted positive growth (24.8 per cent on an annual basis) which is likely to reflect the base effect of the previous year due to the gas crisis in Bulgaria. Our expectations of the imports of mineral products and fuels are for a recovery in the positive growth due to lower declines in domestic demand and higher oil prices.

Imports of Energy Resources

(million EUR)

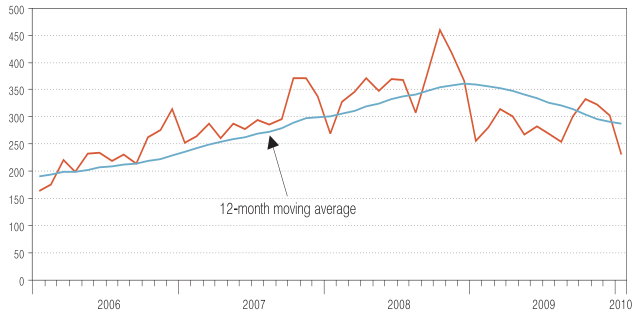


Source: BNB.

In 2009 imports of consumer goods went down by EUR 846.5 million (19.5 per cent) on the previous year, with their value reaching EUR 3484.5 million. All items in this group excluding *food,* *drink, tobacco,* and *medicines and cosmetics* reported negative growth. *Automobiles* and *furniture* had the most significant negative contributions (-1.5 and -1.0 percentage points respectively) which is consistent with our expectations of declines in demand for durables and postponement of such purchases. In January 2010 imports of consumer goods continued to report negative growth (9.6 per cent on an annual basis) which slowed down on the previous months of 2009. We expect this positive growth in consumer goods imports to be restored in the projected horizon due to the expected lower contraction in final consumer demand.

Imports of Consumer Goods

(million EUR)



Source: BNB.

According to preliminary data, Bulgaria's exports to other EU Member States between January and December 2009 dropped by 16.8 per cent, while exports to non-EU countries decreased by 31.0 per cent. Goods imported from the Community went down by 29.5 per cent, while those from third countries by 37.3 per cent.

The market share of Bulgarian goods in total imports of EU Member States rose to 0.63 per cent in 2009 *vis-à-vis* 0.59 per cent a year earlier. This market share is expected to continue increasing over the projection horizon.

4. Inflation

In the second and third quarters of 2010 annual inflation is expected to remain low. Tobacco price increases and dynamics of world energy prices will contribute to inflation acceleration.

Inflation accumulated in the first three months of 2010 was 1.3 per cent, fuels contributing mainly to it as their prices are directly related to oil prices in international markets. Commodity groups characterized by strong seasonality (unprocessed foods) also contributed to this.[1] In March inflation accelerated to 2.4 per cent on an annual basis (from 1.6 per cent at the end of 2009), fuel prices contributing most significantly to it.

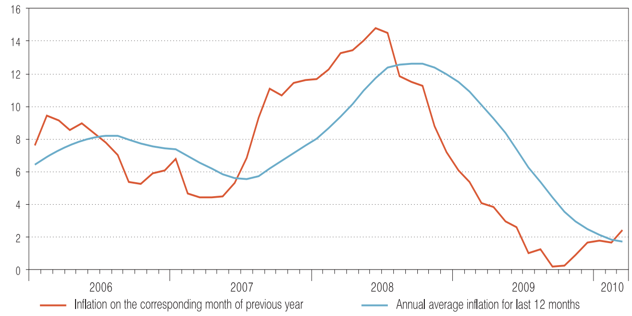
Compared with the first quarter of the previous year when growth rates of prices of all major commodities and services slowed down, excluding tobacco products, over the same period of 2010 inflation dynamics by component was rather diverse. Fuel price increases contributed significantly to the rise in annual inflation, while the strong decrease in services inflation and non-food price falls (excluding fuels) had just the opposite effect. In the first quarter of 2010 food prices continued to decrease on an annual basis and tobacco product prices posted a slightly higher rise compared with the same period of 2009, thus contributing to the increase in annual inflation.

Inflation dynamics remained under the strong effect of international price volatility. Oil price rises continued to be crucially important for overall inflation dynamics. This trend started in the beginning of the fourth quarter of 2009, with the annual rate of change in transport fuel prices accelerating from -18 per cent in September 2009 to 23 per cent in March 2010. Concurrently, there was a significant easing of upward pressure on prices of services and non-food goods from intermediate goods prices. Domestic demand declines also affected the prices in these groups. The annual inflation in services followed a clearly pronounced downward trend and in March 2010 it was 1.3 per cent (2.9 per cent by end-2009), while the price index of non-food goods (fuels excluded) has fallen since early 2010 on an annual basis, this fall reaching -0.6 per cent (0 per cent in December 2009).

1 The analysis in this section employs NSI data on HICP.

HICP Inflation

(%)

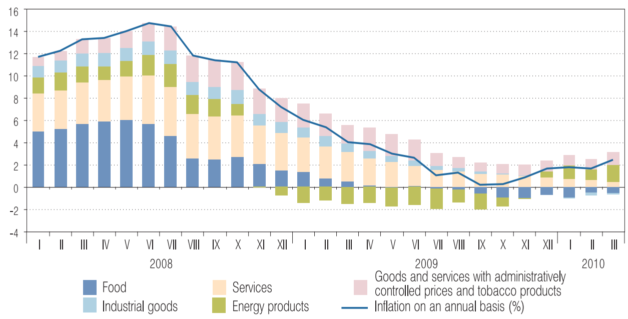


Source: NSI.

In the second and third quarters of 2010 annual inflation is expected to remain low ranging between 2.0 per cent and 2.5 per cent. Tobacco price increases and energy price dynamics will contribute to inflation acceleration. The positive contribution of transport fuels will gradually decrease in line with the assumptions about slowing annual growth rates of oil prices.

Inflation Rate on Corresponding Month of Previous Year and Contribution of Major Goods and Services Groups to It

(p.p.; %)



Note: This structure corresponds to the Eurostat classification; tobacco products and goods and services with administratively controlled prices are presented separately. Administratively controlled prices are calculated on the basis of commodity groups in the consumer basket.

Sources: NSI, BNB.

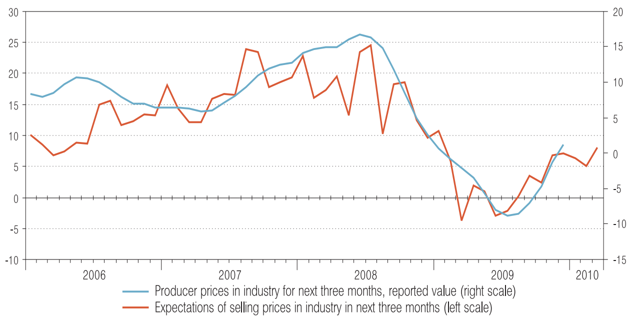
Non-food goods and services price dynamics was characterized by uncertainty. Assuming that import prices will be higher than in 2009, it is expected that firms' pricing policy will reflect both a possible rise in intermediate input costs and a weak domestic demand. The price setting behaviour of firms will take place under conditions different from those in previous years when higher raw materials prices (including imported) could be transferred to end-use prices due to the increasing consumer demand. The pricing policy of firms will also depend on their ability to continue to react to the demand contraction through limiting expenditure and/or profit margin. We expect that the weak domestic demand and wage moderation will subdue price increases in non-food goods and services.

Various economic indicators, as the March 2010 business survey and producer price dynamics in the domestic market in February, support the expectations that annual inflation rate will remain low.

Manager expectations in industry concerning the selling prices in the following three months show a comparatively slight acceleration in price dynamics. Domestic producer prices moved in line with the expectations, and after the steady downward trend on an annual basis in 2009, they increased by 2.5 per cent on an annual basis in February. Oil processing and metallurgy (sectors strongly dependent on international price dynamics) and manufacture of tobacco products (following higher excise duties since the beginning of the year) contributed most significantly to this.

Expectations of the Industrial Sector Producer Prices
and Industrial Producer Prices

(balance of opinions) (on corresponding month of previous year, %, 3-month moving average)

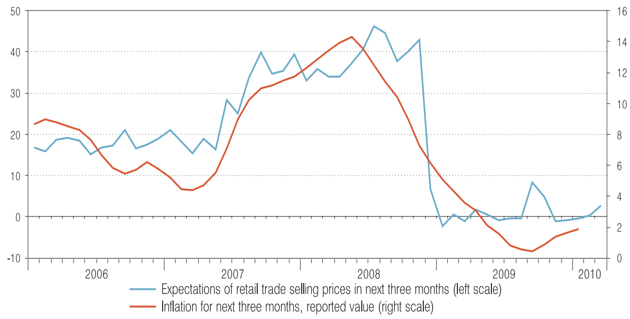


Sources: NSI, BNB.

March 2010 business survey in retail trade shows a slight increase in selling price expectations in the following three months. Nevertheless, the balance of entrepreneurs' opinions in this sector remained close to its lowest level in the last ten years.

Expectations of Retail Trade Selling Prices
and Reported Inflation

(balance of opinions) (on corresponding month of previous year, %, 3-month moving average)



Sources: NSI, BNB.

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

	Accumulated inflation as of March 2009 (December 2008 = 100)		Accumulated inflation as of March 2010 (December 2009 = 100)		Annual inflation as of March 2010 (March 2009 = 100)	
Inflation (%)	0.5		1.3		2.4	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
Food	1.1	0.26	1.9	0.42	-2.1	-0.57
Processed food	-1.4	-0.21	0.2	0.03	-1.0	-0.16
Unprocessed food	5.1	0.48	4.6	0.39	-4.0	-0.41
Services	1.2	0.36	-0.4	-0.12	1.3	0.39
Catering services	1.9	0.22	0.6	0.07	3.1	0.37
Transport services	-0.2	-0.01	-2.0	-0.10	-3.0	-0.14
Telecommunication services	-0.3	-0.01	0.1	0.00	-0.7	-0.03
Other services	1.8	0.17	-1.0	-0.09	2.1	0.20
Energy products	-4.4	-0.34	7.7	0.72	19.9	1.55
Transport fuels	-4.6	-0.31	8.5	0.71	23.2	1.94
Industrial goods	-0.2	-0.03	-0.8	-0.14	-0.6	-0.12
Goods and services with administratively controlled prices	0.9	0.14	1.1	0.17	2.2	0.34
Tobacco products	3.3	0.09	5.3	0.21	26.4	0.80

Sources: BNB, NSI.

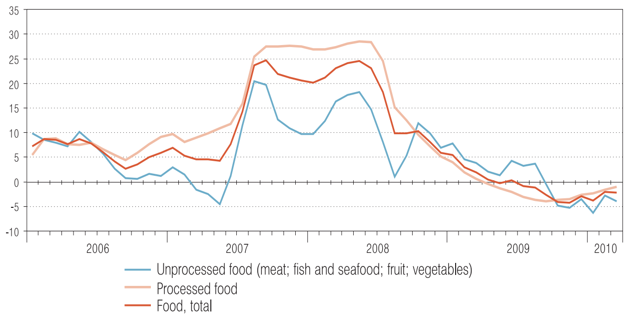
Food Prices

In the first quarter of 2010 food prices decreased less significantly on an annual basis compared with the fourth quarter of 2009. This trend is a result mainly from processed food prices.

In March processed food prices were 1 per cent lower than in the corresponding month of the previous year (in the third quarter of 2009 their decline was 3.6 per cent on an annual basis, while in the fourth quarter it was 3.3 per cent). Vegetable oil prices, which followed the pick-up in international prices, and slighter declines in bread and cereal prices due to a strong base effect of lower prices in early 2009, were crucial for these developments. The annual rate of decline in unprocessed food prices was 4 per cent (close to the level of the last quarter of 2009), with meat and meat products continuing to contribute most significantly to this effect.

Rate of Change of Food Prices

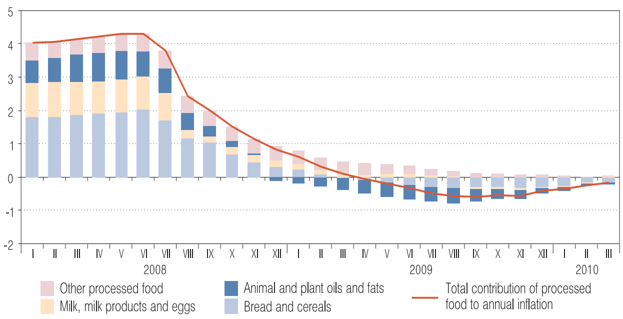
(on corresponding month of previous year, %)



Sources: NSI, BNB.

Contribution of Major Groups of Processed Foods to Annual Inflation

(p.p.)

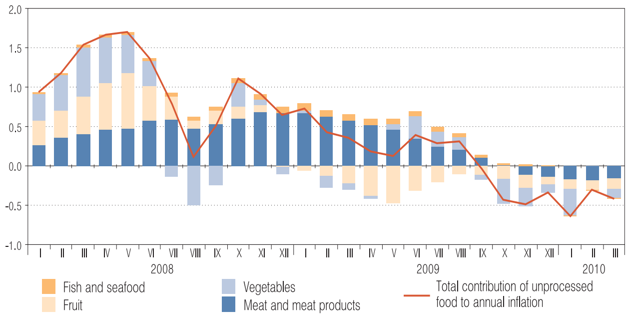


Sources: NSI, BNB.

Food price dynamics in early 2010 remained under the influence of world price dynamics and the base effect of the increased supply as a result of the high farming yields in Bulgaria in 2008. Consumer demand had no effect on food prices when normalization of yields started in Bulgaria. Data on retail and wholesale prices of major food products show retention or an increase in the markups in 2009 compared with 2008. The comparison between the annual rate of growth of food prices in the last years and that of retail trade turnover in food, drink and tobacco products at comparable prices shows no clear dependence.

Contribution of Major Groups of Unprocessed Foods to Annual Inflation

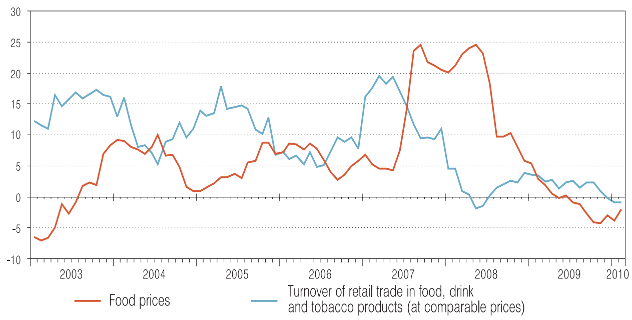
(p.p.)



Sources: NSI, BNB.

Growth Rate of Food Prices and of Turnover of Retail Trade in Food, Drink and Tobacco Products (at comparable prices)

(on corresponding month of previous year, %)



Sources: NSI, BNB.

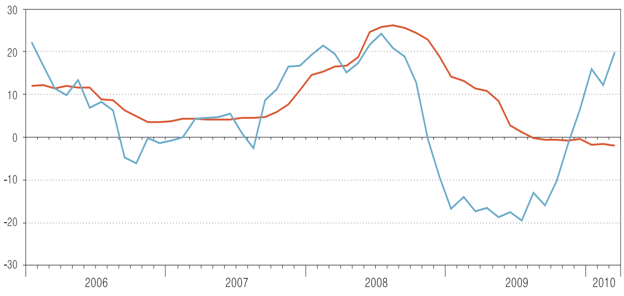
The trend to a gradual slowdown in the annual rate of decline in food prices is expected to be retained in the second and third quarters of 2010.

Energy Products Prices

Since early 2010 energy product prices (automobile fuels and lubricants; fuels for households) have risen by 7.7 per cent. Following the 6.4 per cent price rise in December 2009, the prices of goods in this group rose by 20 per cent in March compared with the same period of 2009. The upward oil price dynamics along with the depreciation of the euro against the US dollar were the major factors behind energy product price increases.

Rates of Change of Energy Products
and Transport Services Prices

(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.

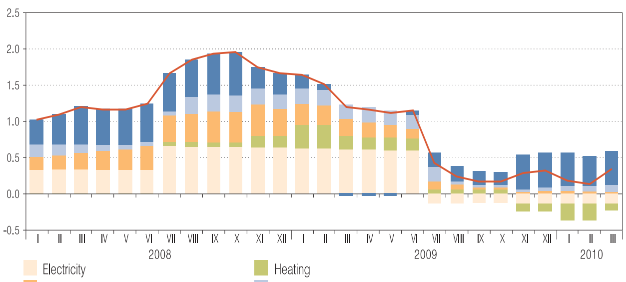
The contribution of fuels to inflation is expected to begin decreasing in the second and third quarters of the year. This projection is based on the assumption of oil prices moving between USD 70 and 90 per barrel which shows a slowdown in the annual growth rate to around 26 per cent.

Administratively Controlled Prices and Tobacco Products Prices

In the first quarter of 2010 accumulated inflation of goods with administratively controlled prices was 1 per cent, with administrative fees for issuance of identity documents, water supply services and heating contributing most significantly to this. Compared with the corresponding period of 2009, inflation of goods with administratively controlled prices was 1.4 per cent (close to that in the last quarter of 2009).

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

(p.p.)

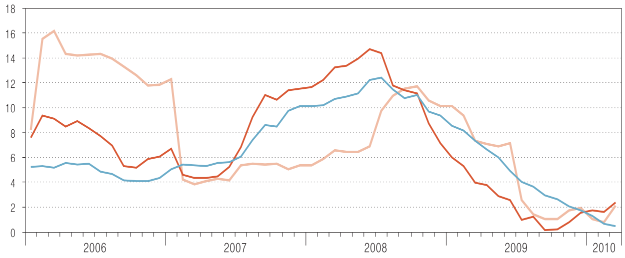


Sources: NSI, BNB.

Natural gas prices have increased by 6 per cent since the beginning of the second quarter and heating prices by around 4 per cent on average in Bulgaria. We expect the effect of these adjustments to lead to a slight increase in the annual inflation of goods with administratively controlled prices to around 2 per cent.

Rates of Change in Controlled and Uncontrolled Prices

(on corresponding month of previous year, %)



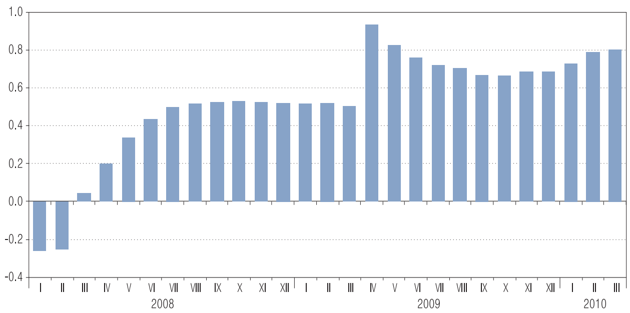
Note: Given the relation between tobacco product prices and administratively set excise rates, tobacco products are discussed separately from the group of goods and services with uncontrolled prices regardless of the liberalization of the market of tobacco products in early 2007. Administratively controlled prices are calculated on the basis of commodity groups in the consumer basket.

Sources: NSI, BNB.

Since early 2010 tobacco product prices have risen by 5.3 per cent. Current prices have not yet fully reflected the higher excise duties in 2010 due to the grace period for selling tobacco products at 2009 prices effective until the end of the first quarter. Our expectations are for a 30 per cent increase in tobacco products throughout 2010, with their contribution to the average annual inflation projected at about 1 percentage point. The effect on overall inflation will be most pronounced in the second quarter when the contribution of this group to annual inflation is expected to rise from 0.8 percentage points on average in the first three months to around 1.0–1.2 percentage points.

Contribution of Tobacco Products to Annual Inflation

(p.p.)



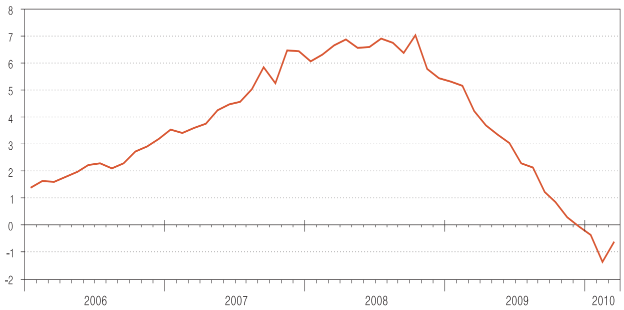
Sources: NSI, BNB.

Industrial Goods Prices

In the first two months of the year the price index of non-food products (excluding fuels) decreased by 0.8 per cent compared with December 2009. Non-food price dynamics remained on a declining trend, with the annual rate of change of these prices slowing from 4.1 per cent in the first half of 2009 to 1.1 per cent in the second half, while in March 2010 they decreased by 0.6 per cent on the same period of the previous year.

Rates of Change of Industrial Goods Prices Excluding Energy Products and Goods with Administratively Controlled Prices

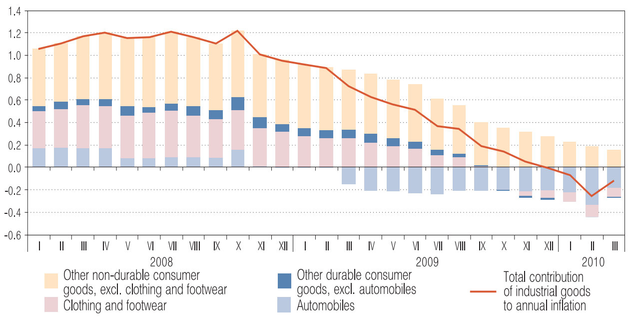
(on corresponding month of previous year, %)



Sources: NSI, BNB.

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

(p.p.)



Sources: NSI, BNB.

Consumer demand contraction and declining on raw materials prices (intermediate consumption costs) were the main factors driving non-food goods price dynamics. Decreases in prices of automobiles and clothing and footwear (including on an annual basis) had the most sizable contribution to the trend observed in non-food prices over 2009. In the first quarter of 2010 non-durable consumer goods prices (*e.g.* home maintenance goods) slightly fell on December 2009, contributing significantly to the downward trend in the prices of the industrial goods group. The annual decline rate in the prices of non-food goods is expected to be retained in the second and third quarters of 2010.

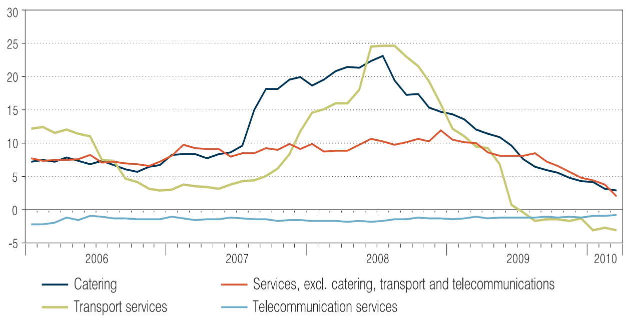
Services Prices

Since early 2010 the services price index (excluding administratively set prices) declined by 0.4 per cent on December 2009. The downward trend in services inflation continued in the first months of 2010, with the annual inflation falling to 1.3 per cent in March from 3.3 per cent on average in the last quarter of 2009. Services prices developments are associated with the significant ease of the pressure from intermediate goods prices (especially in catering and transport services).

Compared with the first quarter of 2009 when most services reported low positive growth rates in prices, in 2010 two groups have registered decreases since the beginning of the year: airline tickets and accommodation services whose prices fell by 8.4 per cent and 5.8 per cent respectively. These groups had the biggest contribution to the fall in services price index compared with the end of the previous year. The consumer demand decline put downward pressure on the prices of airline tickets and accommodation services. It should be noted that the significant fall in services inflation in 2010 reflects holiday accommodation services and low-cost flights included in the consumer basket in 2010. In the projection horizon, services inflation rates are expected to remain close to the current levels.

Rates of Change of Services Prices (Excluding Those with Controlled Prices)

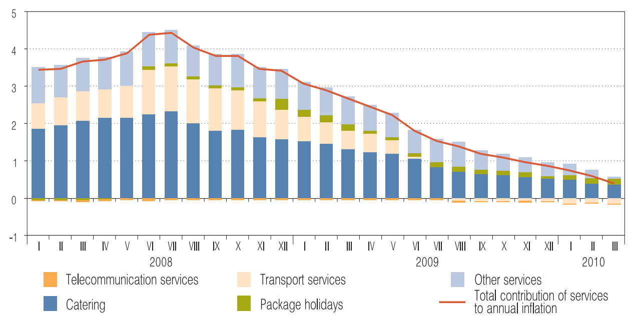
(on corresponding month of previous year, %)



Sources: NSI, BNB.

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

(p.p.)



Sources: NSI, BNB.