

Economic Review

4/2010

BULGARIAN
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BANK

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

The *Economic Review*, issue 4/2010 was presented to the BNB Governing Council at its 17 February 2011 meeting. It employs statistical data published up to 14 February 2011.

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

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Abbreviations

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
FRS	Federal Reserve System
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
MFIs	Monetary Financial Institutions
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

In the second half of 2010 the rate of world economic recovery remained stable but regional differences were sustained. Global inflation started to increase as a result of higher food and fuel prices. Inflation accelerated mostly in developing economies, while in advanced economies it remained relatively stable. The world economy will continue to recover at moderate rates in the first half of 2011, and prices of commodities are also expected to rise more moderately. The US and euro area monetary policies remained unchanged.

Bulgaria's economy is recovering slowly from the recession in 2009. In the third quarter of 2010 real GDP growth rate increased, posting 0.7 per cent on the previous quarter. The major factor behind growth was exports, while domestic demand continued to decrease due to a fall in household consumption. Lower household consumer expenditure was impacted by income dynamics, associated with the decline in employment and higher rate of household savings. In the third quarter government consumption continued to have an insignificant negative contribution to GDP growth on a chain basis.

The economic activity is expected to continue recovering in the first half of 2011, with domestic demand also contributing to this effect.¹ Increased production capacity utilisation and improved financial performance of firms is likely to result in recovery of investment activity yet from the end of 2010. The negative labour market trends which were responsible to a great extent for the decline in consumer demand are expected to gradually subside. A slight improvement is expected in the first half of 2011. Furthermore, household consumption will also recover and this will probably happen from the beginning of 2011 due to improving consumer sentiments.

For the January–December 2010 period the balance of payments current and capital account recorded a deficit of EUR 23 million according to preliminary balance of payments data. On an annual basis, the current account ended in a deficit of 0.8 per cent of GDP which was entirely covered by the inflow of foreign direct investment (3.8 per cent of GDP). In the first half of 2011 the current and capital account balance is expected to be positive as a percentage of GDP on an annual basis and the inflow of foreign direct investment to remain positive and to stabilise as a percentage of GDP.

Exports of goods recorded a positive nominal growth rate of 33.0 per cent in 2010 on the previous year reflecting the higher external demand and international prices. The nominal growth rate of imports of goods was also positive (13.1 per cent) due mainly to increased international prices. In the first and second quarters of 2011 exports and imports are expected to continue growing on an annual basis. The growth rate of exports will moderate due to weaker external demand and a lower increase in international prices. Export growth rates will again outstrip those of imports and the trade deficit will remain close to nil.

Broad money went up by 6.2 per cent in 2010. Household deposits in MFIs (the BNB excluded) continued to increase. In 2010 household deposits grew by BGN 3 billion, including BGN 1.4 billion solely in the fourth quarter. In the last quarter of 2010 interest rates on new time deposits stabilised around the levels of the end of the third quarter. No significant changes are expected to occur in the first half of 2011.

The annual growth rate of claims on the non-government sector continued to slow down (1.3 per cent by December 2010) impacted by the slow recovery of economic activity, the negative trends in the labour market and the cautious policy by banks. Over the projection horizon interest rates on loans will likely undergo no significant changes.

¹ The NSI flash estimates on GDP for the fourth quarter of 2010 confirm this assessment.

The deficit on the consolidated fiscal programme for 2010 amounted to BGN 2783.4 million, which is BGN 478.7 million lower as compared with the deficit target in the Amendment to the State Budget Law for 2010. The bulk of the deficit was financed by the fiscal reserve, which went down by BGN 1661 million, and by net issue of government securities in the domestic market (in the amount of BGN 850 million). Total revenue and expenditure were 2.5 per cent and 3.9 per cent respectively lower as compared with the projections in the Amendment to the State Budget Law for 2010.

In 2010 inflation tended to increase and by the end of the year accumulated inflation reached 4.4 per cent (against 1.6 per cent by the end of 2009). The major factors behind this dynamics were the significant increase in international prices of energy products and farm produce, which affected the final consumer prices of fuels and foods in Bulgaria, and the raised tobacco product excise duties this year.

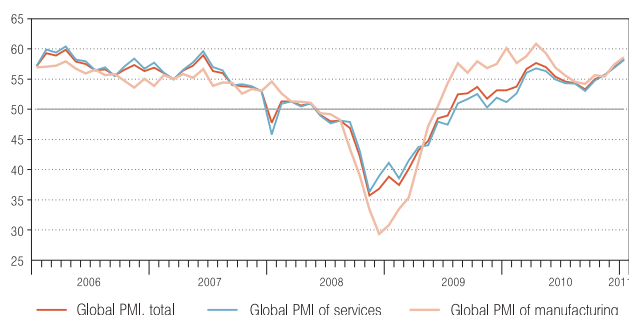
If the oil price remains under USD 100 *per* barrel, a gradual slowdown in the annual rate of overall inflation may be expected in the first half of 2011 which will be also underpinned in the second quarter by the drop in inflation in tobacco prices due to unchanged excise duties. Based on preliminary data for January 2011, the annual inflation was 4.3 per cent (4.4 per cent by December 2010). The current upward dynamics in international oil and food prices poses risks of higher annual inflation.

1. External Environment

In the second half of 2010 the US and euro area economies retained their moderate growth rates and the economic recovery continued. As a result of the rises in fuel and food prices in the international commodity markets, global inflation started increasing and developing economies were affected most strongly, while inflation in developed countries remained relatively stable. US and euro area monetary policies remained unchanged. The US Federal Reserve System launched a programme for a purchase of government securities and ECB continued phasing-out the non-conventional measures on the money market. The recovery of the global economy is expected to continue at a moderate rate in the first half of 2011.

Global economic indicators went up in the last quarter of 2010. The rate of global economic recovery proved stable but regional differences remained significant. The expected moderate economic recovery is confirmed by the leading indicators of output, employment and new orders.

Global PMI



Source: JP Morgan.

The development of the world economy at present remains favourable for the improvement in economic activity in 2011 though at a more moderate rate compared with 2010. Industrial output is anticipated to remain the main driver, while services sector is expected to recover at a slower pace. In January 2011 the IMF revised upward its forecast of the global economic growth in the current year, retaining the expectation of a strongest contribution by developing economies.

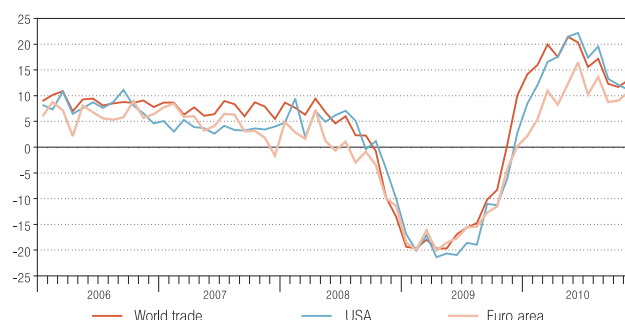
By November 2010 the volume of world trade growth accounted for 13.1 per cent on an annual basis. World industrial output growth accelerated to 6.9 per cent¹ on an annual basis compared with 6.6 per cent by September 2010. Global inflation increased to reach 3.5 per cent on an

¹ Based on the World Bank data by 24 January 2011.

annual basis.² The highest inflation rates were recorded in developing economies, while inflation in developed countries remained relatively stable.

World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Euro area

The euro area GDP increased by 1.9 per cent on an annual basis over the third quarter of 2010 against 2 per cent growth in the previous quarter. The quarterly growth of GDP accounted for 0.3 per cent against 1 per cent in the second quarter. Final consumption of households (+0.1 percentage points) and the government (+0.1 percentage points), as well as net exports (+0.2 percentage points) contributed most significantly to quarterly GDP growth.

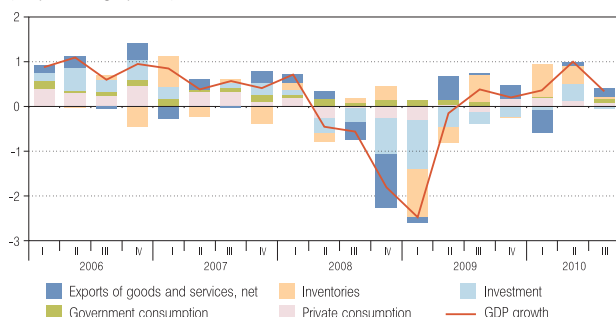
Leading euro area indicators posted an increase in the last quarter of 2010. Although the average value of some indicators remained slightly below the average value for the previous quarter, the current level of indicators suggests that the economic growth in the fourth quarter of 2010

² Based on the IMF data by 24 January 2011.

will almost match the growth reported in the third quarter. Preliminary Eurostat data on the real GDP in the last quarter of 2010 reported an increase by 0.3 per cent on a quarterly basis.

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

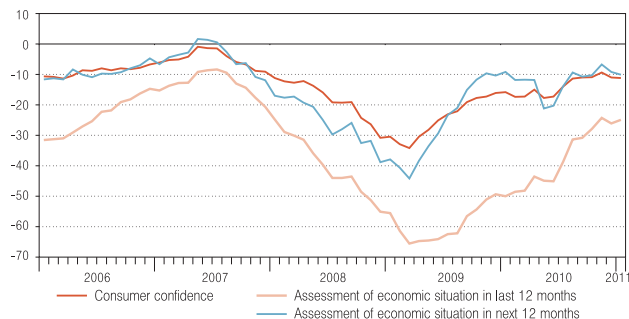
(%, percentage points)



Source: Eurostat.

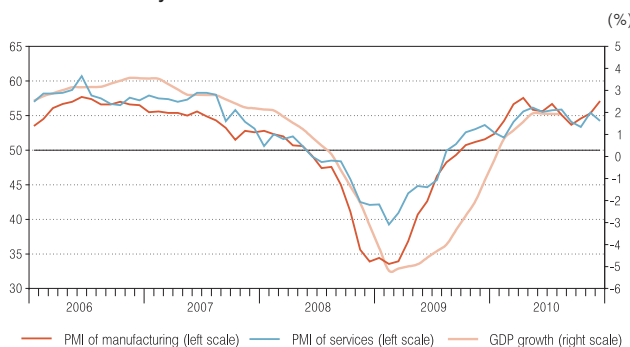
The euro area economic sentiment index recorded a seventh successive monthly rise in December 2010 reaching 106.2 (against 105.1 in the previous month). The EC business climate indicator also continued improving to 1.31 (against 0.91 in the previous month). The average values of the indicators for the fourth quarter of 2010 were higher than those for the third quarter of 2010.

Euro Area Consumer Confidence Indices



Source: EU Commission

PMI in Industry and Services and Euro Area GDP Growth



Source: European Commission.

During the fourth quarter the PMI remained above the level of 50 indicating that the economy

continued to grow. Following the decline in three consecutive months the composite index in November posted a monthly increase, second by size for the year, to 55.5 (an increase by 1.7 percentage points) and in December remained unchanged. The output sub-index (PMI in industry) increased to 57.1 in December (against 55.3 a month earlier) while that of services decreased to 54.2 (against 55.3 a month earlier).

In the autumn EU Commission forecast of 29 November 2010 the anticipated euro area real GDP growth of 1.7 per cent for 2010 was sustained. Based on EC forecast the economic activity in the euro area will slow down to 1.5 per cent on an annual basis in 2011, while in 2012 it will accelerate to 1.8 per cent. Real GDP growth in the first and second quarters of 2011 is expected to be 0.3 per cent on a quarterly basis which corresponds to 2 per cent and 1.3 per cent growth on an annual basis. The European Commission attributed the euro area economic growth slowdown in the second quarter of 2010 and the first quarter of 2011 mainly to the uncertainty about the recovery of consumption and investments, the expected slowdown in global economy over the said period, as well as the fiscal consolidation in most euro area countries.

According to the ECB forecast of December 2010 the annual real GDP growth in the euro area for 2010 will range between 1.6 per cent and 1.8 per cent (the previous revision was within the range of 1.4 to 1.8 per cent) and for 2011 between 0.7 and 2.1 per cent (the previous revision was within the range of 0.5 to 2.3 per cent). The ECB projected euro area economic growth between 0.6 per cent and 2.8 per cent on an annual basis in 2012. The latest IMF forecast of January 2011 points to euro area annual real GDP growth of 1.5 per cent for 2011 and 1.7 per cent growth for 2012.

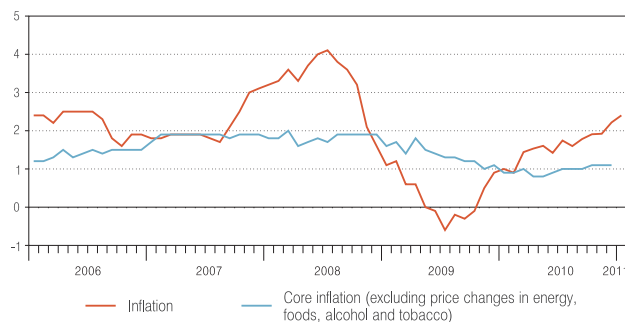
The December data showed acceleration³ of inflation in the euro area to 2.2 per cent on an annual basis against 1.9 per cent in November 2010. Monthly inflation was 0.6 per cent. The higher inflation rate was a result of accelerated price rise in energy products which was 11 per cent on an annual basis in December compared with 7.9 per cent in November 2010. The food component also posted an increase by 1.8 per

³ Preliminary data on the January 2011 inflation rates suggest a rise in HICP by 2.4 per cent on an annual basis.

cent compared with 1.4 per cent in November. In December euro area core inflation stayed at the level of 1.1 per cent on an annual basis reporting no change on November 2010.

Euro Area Inflation Rate

(percentage change on same period of previous year)



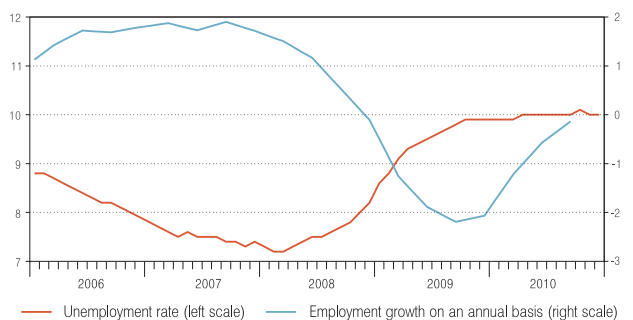
Source: Eurostat.

Euro area inflation level anticipated by the European Commission in 2011 was raised to 1.8 per cent on an annual basis (against the previous projection of 1.7 per cent). According to the ECB forecast of December 2010, the increase in HICP in 2011 will range between 1.3 per cent and 2.3 per cent which was a revision upwards on the previous forecast of September 2010.

The latest Eurostat data on euro area unemployment in December 2010 point to a 10 per cent level, reporting no change on the previous month. The indicator of the expected unemployment during the following twelve months included in the EC consumer confidence index went up in December. Unit labour costs decreased in the third quarter of 2010 by 0.5 per cent on an annual basis (-0.6 per cent during the previous quarter). Over the same period compensation *per* employee picked up by 1.5 per cent (against 1.9 per cent) and labour productivity by 2.1 per cent on an annual basis (against the previous value of 2.5 per cent).

Euro Area Unemployment Rate and Employment Growth

(%)

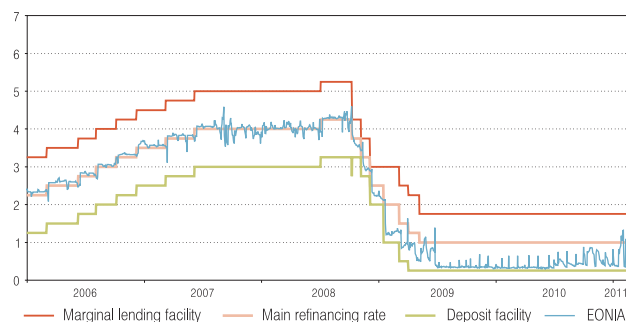


Source: Eurostat.

At its monetary policy meetings in October, November and December 2010, the ECB Governing Council left unchanged the repo interest rate at 1.00 per cent. The interest rates on deposit and lending facilities also remained unchanged. The decision to retain the current conditions was motivated by the ECB regular economic and monetary analysis which reported further recovery in the euro area economy under the conditions of heightened uncertainty and preserved price stability in the medium term. According to the ECB results of the analysis, the current euro area interest rate level corresponds to the monetary policy objectives. The ECB will continue to monitor very closely consumer price developments and in case of second-round inflationary effects, measures to preserve price stability will be undertaken.

ECB Interest Rates

(%)

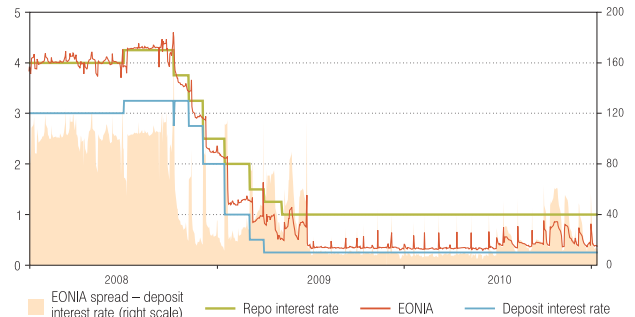


Source: Bloomberg.

Due to the tensions associated with the financial problems in Ireland and renewed euro area financial market tensions in December, it was decided the term of the measures for unlimited liquidity allotment on main and long-term refinancing operations to be extended as long as needed and at least until 12 April 2011.

Short-term Euro Area Interest Rates

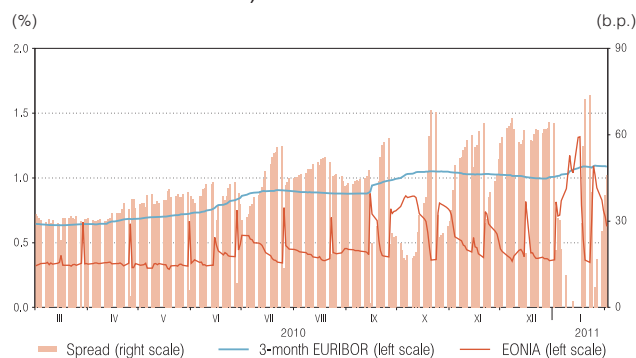
(%)



Source: Bloomberg.

The ECB announced that three three-month long-term refinancing operations will be held on 26 January, 23 February and 30 March 2011. The average interest rate on main refinancing operations for the review period will be applied to these operations.

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



Source: Bloomberg.

EU-8¹

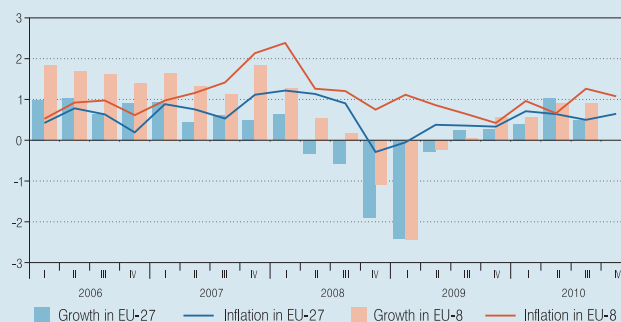
The economic recovery of the EU member countries outside the euro area remained stable. Their total real GDP went up by 0.9 per cent on a quarterly basis in the third quarter of 2010 (against 0.9 per cent growth in the second quarter). All countries except Romania reported positive economic growth.

Exports remained the main driving factor behind the improvement in economic activity over the third quarter of 2010 with a positive trend occurring in domestic consumption. Exports rose by 2.6 per cent on a quarterly basis (against 2.2 per cent in the previous quarter) while domestic consumption by 2.2 per cent (against 1.3 per cent in the previous quarter). At the same time, gross fixed capital formation in EU-8 moderated, rising by 0.8 per cent against 6.0 per cent in the second quarter. Imports growth rates increased to 3.7 per cent against 2.7 per cent on a quarterly basis in the second quarter.

In the fourth quarter of 2010 inflation in EU-8 countries measured by the average-weighted HICP accelerated by 1.1 per cent on a quarterly basis compared with 1.3 per cent in the previous quarter. The main factors behind this were energy product and food price rises in international markets.

Real GDP Growth and Inflation in EU-27 and EU-8 on a Quarterly Basis

(%; seasonally adjusted data)



Sources: Eurostat, own calculations.

Real GDP Growth on a Quarterly Basis

(%; seasonally adjusted data)

	2009		2010		
	III	IV	I	II	III
Poland	0.4	1.4	0.7	1.2	1.3
Czech Republic	0.5	0.4	0.6	0.8	1.0
Latvia	-4.2	-0.6	1.0	0.4	0.8
Hungary	-0.8	0.0	1.0	1.9	0.7
Estonia	-1.3	1.4	1.0	0.4	0.8
Bulgaria	-0.1	-0.2	-0.5	0.5	0.7
Lithuania	-0.5	-0.2	-0.1	0.5	0.6
Romania	0.1	-1.5	-0.3	0.3	-0.7
EU-8	0.1	0.6	0.6	0.9	0.9

Source: Eurostat.

Exports Growth on a Quarterly Basis

(%; seasonally adjusted data)

	2009		2010		
	III	IV	I	II	III
Estonia	4.8	-2.0	6.3	8.0	10.1
Bulgaria	3.6	2.9	1.7	3.9	8.9
Latvia	1.6	6.8	-1.8	1.2	8.9
Czech Republic	5.2	1.9	4.5	1.4	5.6
Hungary	4.0	4.2	4.5	2.2	2.2
Romania	4.0	0.7	12.0	2.0	1.3
Lithuania	3.3	4.1	1.6	9.2	1.2
Poland	2.8	3.7	3.8	3.8	-2.0
EU-8	4.1	3.9	4.5	2.2	2.6

Sources: Eurostat, ECB.

¹ EU-8 includes the states that joined the EU from 2004, excluding Slovenia, Malta, Cyprus and Slovakia. 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. EU-8 indicators are calculated by weighing the time series; the weights of the relevant countries in total GDP of the group have been used in calculating the growth, while in measuring inflation, the weights of EU-27 countries in HICP as calculated by Eurostat have been used.

The Balkan Region

Real GDP growth accelerated in most Balkan countries in the third quarter of 2010 on an annual basis. Exports of goods were the main factor behind the improvement in the economic activity of the region. Domestic consumption started to recover in most countries although the trend remained divergent by country. The strongest economic growth was registered in Turkey due to an increase in private consumption and investments. In almost all Balkan countries, industrial output continued to grow in the third quarter as well, albeit at lower rates. Over the fourth quarter of 2010 inflation in this region accelerated, with energy product and food price rises in international markets contributing most significantly to this.

Real GDP Growth and Inflation in the Balkan Countries

(%; non-seasonally adjusted data)

	2008	2009					2010			
	Total	I	II	III	IV	Total	I	II	III	IV
Growth (on the corresponding period of previous year)										
Bulgaria	6.2	-5.3	-3.8	-4.9	-5.8	-4.9	-4.0	0.5	1.0	
Greece	1.3	-1.0	-1.9	-2.4	-2.5	-2.3	-2.4	-4.0	-4.7	
Macedonia	5.0	-0.6	-1.2	-1.4	1.6	-0.7	-1.1	0.4	1.3	
Romania	7.3	-6.2	-8.7	-7.1	-6.5	-7.1	-2.6	-0.5	-2.5	
Turkey	0.4	-14.6	-7.6	-2.7	6.0	-4.5	11.8	10.2	5.5	
Croatia	2.4	-6.7	-6.3	-5.7	-4.5	-5.8	-2.5	-2.5	0.2	
Serbia	5.5	-4.1	-4.2	-2.3	-1.6	-3.1	0.4	2.0	2.7	
Inflation (average for the period)										
Bulgaria	12.0	5.1	3.1	0.8	0.9	2.5	1.9	2.9	3.3	4.0
Greece	4.2	1.8	0.8	0.8	2.0	1.4	3.0	5.1	5.6	5.1
Macedonia	8.3	0.9	-0.6	-1.4	-2.1	-0.8	0.5	1.1	1.8	2.9
Romania	7.9	6.8	6.1	5.0	4.5	5.6	4.6	4.3	7.5	7.8
Turkey	10.4	8.4	5.7	5.3	5.7	6.3	9.3	9.2	8.4	7.4
Croatia	5.8	3.8	2.8	1.2	1.6	2.4	0.9	0.7	1.1	1.4
Serbia	12.9	9.7	8.1	7.7	5.8	7.8	4.3	3.9	5.9	9.5

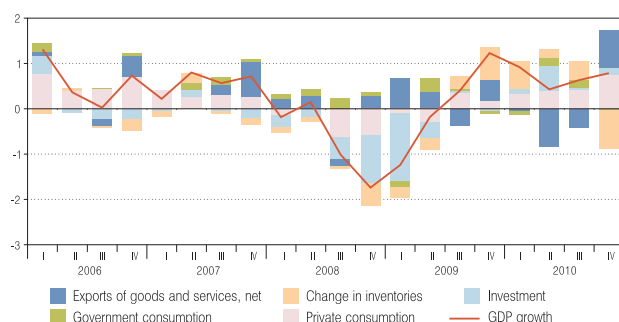
Sources: Statistical institutes and central banks of respective countries, Eurostat.

United States

In the fourth quarter the rate of economic activity in the USA accelerated to 0.8 per cent on a quarterly basis against 0.6 per cent in the previous quarter. Annual GDP growth moderated to 2.8 per cent (from 3.2 per cent). Household consumption and net exports were the main drivers of reported growth.

Contribution to US Growth by GDP Component (Quarterly)

(%, percentage points)

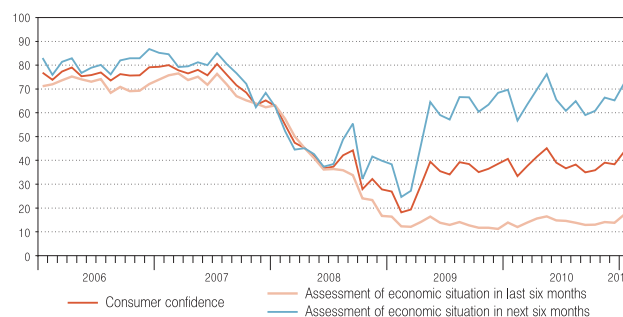


Source: Bureau of Economic Analysis.

Economic indicators published in the last quarter of 2010 underpinned the positive sentiment about the economic recovery in the USA. Output and services economic indicators posted an increase and consumer confidence improved by the end of 2010.

US Consumer Confidence Indices

(2000 = 100)

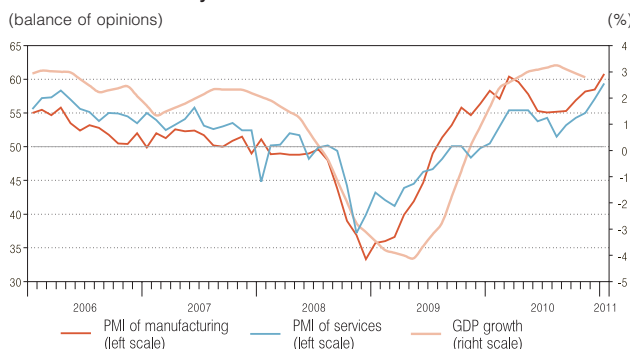


Source: The Conference Board.

The growth in retail sales which account for almost half of the US private consumption confirmed the expectations that the consumption ac-

tivity will be the main driver of economic growth in the following months. The indicator showed sustainable growth in each of the last three months of 2010, in December accounting for 0.6 per cent against November (0.8 per cent).

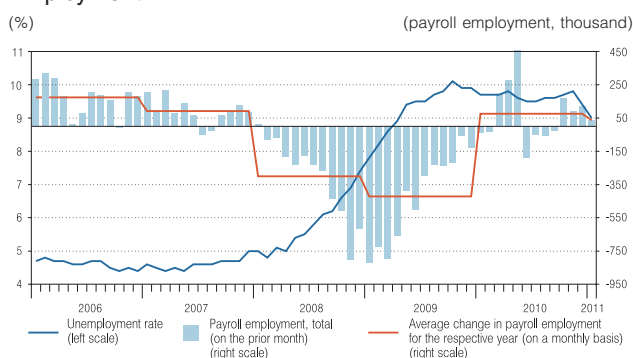
US PMI of Industry and Services and GDP Growth



Source: The Conference Board.

The new Barack Obama's fiscal package is expected to have a favourable effect on the household disposable income, consumer activity and investment decisions in the business sector. The plan adopted at the end of 2010 is evaluated at about USD 900 billion and is based on several pillars which include an extension of the tax relief term introduced in 2001 by President George Bush by two more years, as well as an extension of the term of unemployment benefits by 13 months. The business sector will benefit from the depreciation relief for purchasing new production capacities which are expected to generate investments for about USD 50 billion during 2011.

US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labour Statistics.

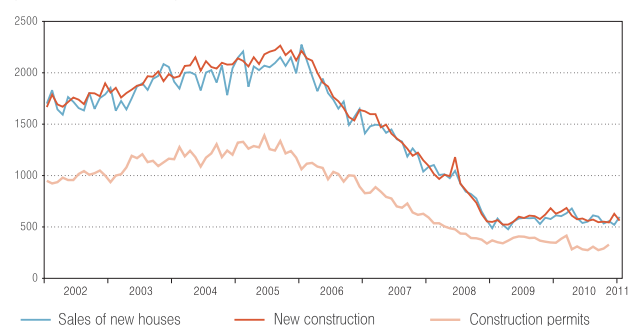
Despite the positive developments, there are factors which will probably continue to hamper domestic supply growth. The difficult access to credit funds is one of these factors, which is evidenced by the results of the latest US Federal Reserve credit survey. The continued decrease

in household indebtedness also may limit private consumption growth.

Labour market stabilisation plays a key role in recovering confidence and consumer activity. The employment in non-agricultural sector went up by 36,000 persons in January 2011 (against 121,000 persons). Surprisingly, unemployment went down to 9.0 per cent on an annual basis (from 9.4 per cent). Employers are still reluctant to substantially increase labour force. This is evidenced by the increasing number of long-term unemployed and further extension of the average period for finding a new job. In January 2011 it took 36.9 weeks on average for an unemployed person to find a job against 34.2 weeks in December 2010.

Sales and Construction of New Houses in the USA

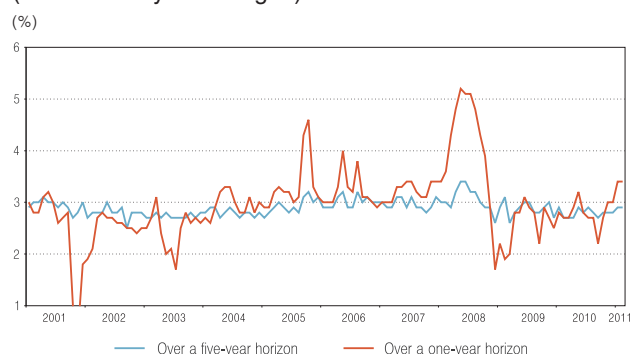
(number, in thousands)



Source: Bloomberg.

Low demand and significant number of unsold houses in the market will continue to exert downward pressure on construction activity and real estate prices. The total amount of investments is expected to remain subdued reflecting the continued adjustments in the housing sector.

Expectations about Consumer Price Inflation (the University of Michigan)



Source: Bloomberg.

Long-term consumer inflation expectations for a five-year period, which are a component of the University of Michigan consumer confidence index, remained unchanged in the last three

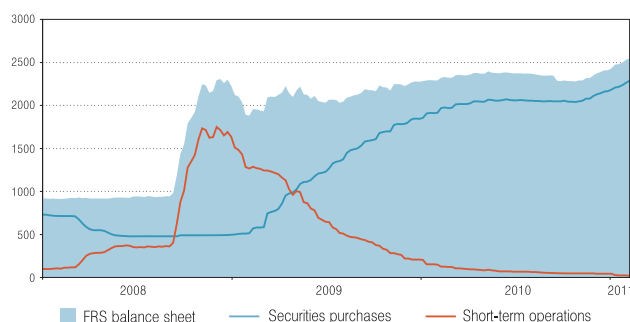
months of 2010. Short-term expectations for a period of one year posted an increase by the close of the year but for the time being this is not considered to be a threat to the price stability.

In the context of sustained high unemployment and subdued inflationary expectations, the Federal Open Market Committee renewed purchases of government securities in November retaining the ability to react depending on the newly incoming macroeconomic information. The total amount of operations on purchasing government bonds was fixed at USD 600 billion, with the term of conducting these operations until the end of the first half of 2011. The Federal Reserve Bank of New York, in charge for the execution of the open market operations, will purchase, on average, USD 75 billion monthly. In parallel, the institution will continue to re-invest the earnings from previously purchased maturing financial instruments (e.g. mortgage-backed securities). Until the end of the second quarter of 2011 total receipts are expected to total be USD 300 billion or USD 35 billion on a monthly basis.

In cumulative terms, by the end of the fourth quarter of 2010 government securities of approximately USD 250 billion were purchased, including re-investment in securities. The US Federal Reserve System balance sheet figure by 31 December reached USD 2.48 trillion, up USD 120 billion compared with the end of the third quarter.

Federal Reserve Balance Sheet

(billion USD)

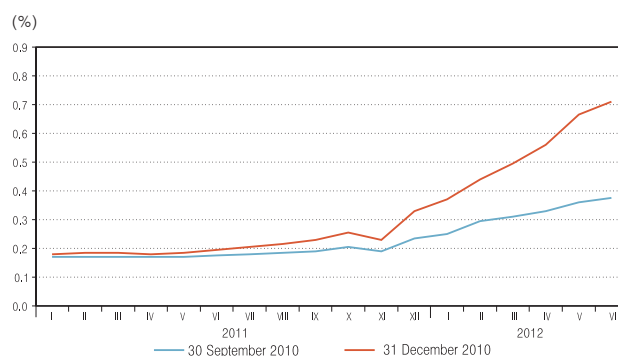


Source: Bloomberg.

Depending on the rates of recovery of the economic activity and labour market in the USA the programme for purchase of government securities may be discontinued at the end of the first half of 2011 or extended after the initially specified term has expired. It is apparent from US Federal Reserve announcement that most of the members of the Federal Open Market Committee do not support an early change in the programme.

As regards the interest rate policy, the market expectations until the end of 2011 do not include a view for an increase in the reference market rates.

Expected Reference Interest Rate on US Federal Funds Based on Futures Contracts



Source: Bloomberg.

Improved macroeconomic indicators and monetary and fiscal measures initiated to support the economic recovery buoyed US financial markets in the last quarter of 2010. Fluctuations in the stock-exchange markets and government securities secondary markets subdued and investors' risk appetite significantly increased.

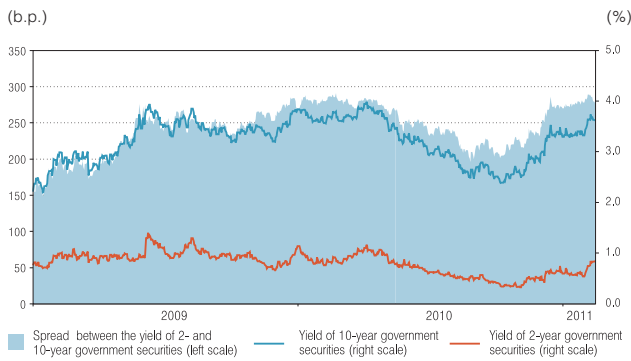
US Stock-Exchange Indices



Source: Bloomberg.

Stock-exchange indices reached a record high since mid-2008 with credit premium on the corporate debt for a term of 5 years indicating a decline by 21 basis points to 85 basis points by the end of December. This trend was accompanied by a substantial increase in government debt yield. By the end of the year the yield of securities with a maturity of two years went up by 18 basis points to 0.60 per cent and that of securities with a maturity of 10 years by 79 basis points, exhibiting a significant rise from the end of the previous quarter level. Despite the reported growth, historically the yield remained at relatively low levels.

US Government Securities Yield



Source: Bloomberg.

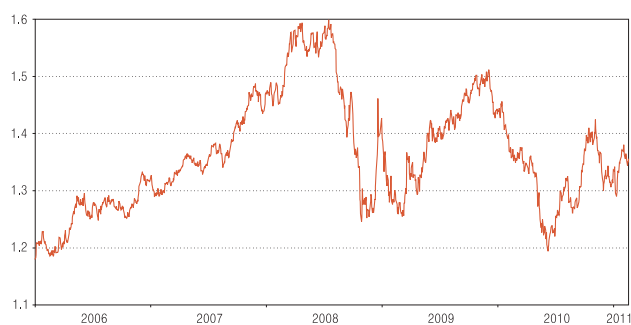
Money market conditions normalised to a great extent at the end of the year. During the quarter interest rates and risk premiums varied within narrow intervals. The expectations of sustaining the US Federal Reserve monetary policy stance coupled with the ample money market liquidity will continue to hold short-term interest rates and risk premiums at levels close to those in the first quarter of 2011.

The USD/EUR Exchange Rate

Over the fourth quarter of 2010 the euro depreciated cumulatively by 2.7 per cent against the US dollar. Over the reporting period the foreign currency dynamics was impacted by the changes in the investors' risk appetite, US Federal Reserve's purchases of government securities and the launch of the tax stimulus programme by the Barack Obama's administration. In November widening of credit premium on government securities of peripheral euro-area countries again dominated in the foreign currency markets. Tensions escalated dramatically after it had become clear that Ireland also needed a financial aid from the EU and IMF.

The USD/EUR Exchange Rate

(USD per EUR 1)



Source: ECB.

The volatility in the sovereign debt markets was behind the weakened correlation between investors' risk appetite measured by the US stock market volatility index and the EUR exchange rate in the foreign currency markets. Positive euro area macrodata and the gradual recovery of the global economy strengthened investors' risk appetite in foreign currency markets but due to the tense euro area government securities market, the euro depreciated further *vis-à-vis* the US dollar.

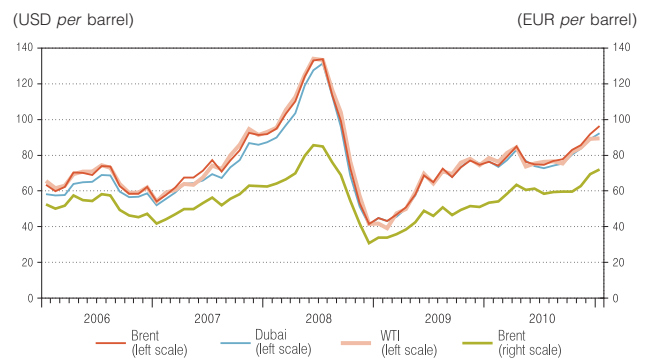
Consistent with the non-standard measures introduced by the US Federal Reserve in the amount of USD 600 billion, the interest rate differential between the yield of US long-term government securities and European benchmark government securities widened prompting an appreciation of the euro against the US dollar.

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

Crude Oil

During the fourth quarter of 2010 the price of Brent crude oil rose, with trading around USD 90 or EUR 70 *per barrel*. Higher than expected economic activity in the Asian countries and the high level of global industrial output were the major factors behind the increased petroleum prices.

Crude Oil Prices



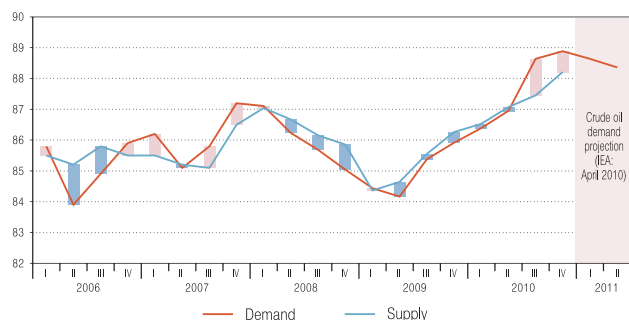
Source: World Bank.

International Energy Agency data of January 2011 on crude oil market suggest that oil demand in the third and fourth quarters of 2010 exceeded supply which was the main factor behind petroleum price rise. OECD Member States and Asian countries contributed most significantly to the enhanced oil demand. Between January and August 2010 inventories of petroleum products in the OECD member states increased by 17.3 per

cent on an annual basis on the corresponding period in 2009. The International Energy Agency forecast of January 2011 points to an increase in oil demand by 1.6 per cent on average in 2011 compared with 2010 due mostly to developing countries of the Asian region.

World Crude Oil Supply and Demand (Quarterly)

(million barrels *per day*)

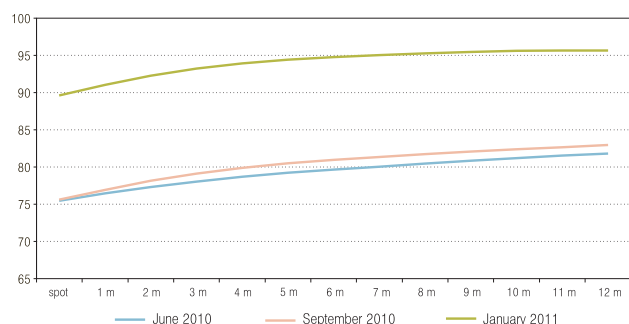


Source: IEA.

The projections about oil demand growth and positive macroeconomic data changed upwards market sentiments about oil price dynamics. Oil prices are expected to move within the interval of USD 90–110 *per barrel* in the first and second quarters of 2011.

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

(USD *per barrel*)



Source: JP Morgan.

Major Raw Materials and Commodity Groups

During the fourth quarter of 2010 world steel production restored its growth rate and by December reached 7.8 per cent on an annual basis against 1.4 per cent by September 2010. In 2010 world steel production increased by 16.7 per cent on 2009, with the increase in North America, the European Union and Asia being most sizable, by 34 per cent, 24.5 per cent and 11.8 per cent respectively. During the last quarter of 2010 the metal price index went up by 3.8 per cent on average on a quarterly basis due mainly to the rise in the prices of copper (by 18.9 per cent), lead (by 17.0 per cent) and zinc (by 14.9 per cent). In 2010 the general metal price index rose by 62 per cent on 2009. In the last quarter of 2010 steel product prices stayed relatively unchanged increasing by 1.3 per cent compared with the third quarter of 2010, though they are 57 per cent higher compared with 2009. Most expectations about metal prices point to moderate growth in 2011.

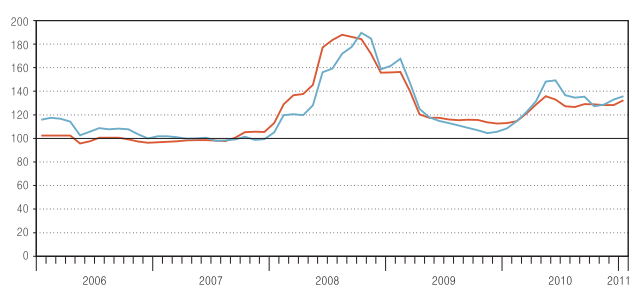
In the fourth quarter of 2010 the food price index went up by 13.1 per cent on a quarterly basis, an increase by 15.4 per cent on average on 2009. Price rises compared with the third quarter of 2010 were mostly attributable to the higher prices of sugar (34 per cent), vegetable oils (24.3 per cent) and cereals (19 per cent). Compared with 2009, the prices of cereals and vegetable oils have risen by 20.6 per cent and 30.7 per cent respectively. According to the US Department of Agriculture and the International Grains Council data of January 2011, global wheat yields in the 2010 to 2011 period are expected to decline by approximately 4.6–5.4 per cent on an annual basis, while its consumption is expected to increase by around 1.7–2.1 per cent. Over this period wheat inventories are expected to drop by an average of 8.2 per cent on an annual basis. The lower wheat supply in the Black Sea region countries and Australia was partly offset by better than expected yields in the countries of South America and the European Union.

Food prices are expected to retain their upward trend in the first and second quarters of 2011, though at a slower pace.

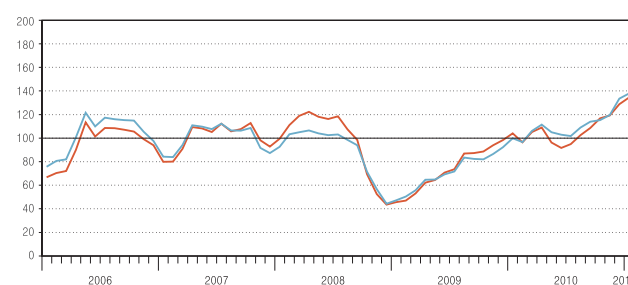
Price Indices of Major Commodities and Commodity Groups

(2007 = 100)

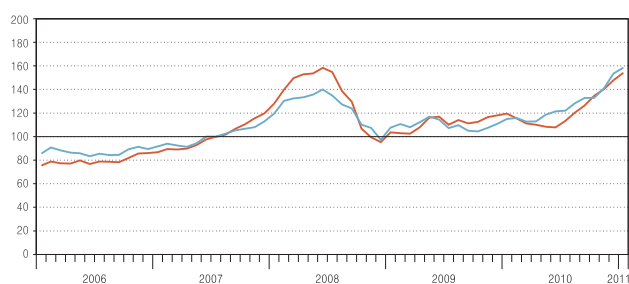
Steel



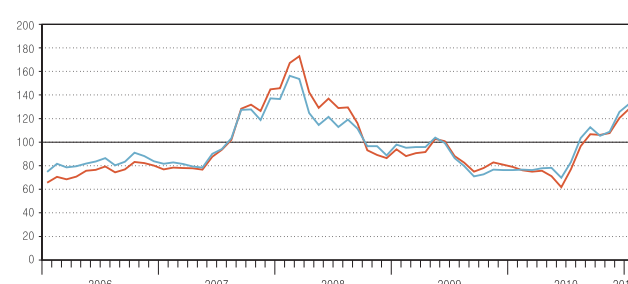
Copper



Food



Wheat



— USD

— EUR

Sources: World Bank, ECB and BNB.

Developments in the International Prices of Major Commodity Groups

The increase in global inflation stemmed from the direct impact of rising food and fuel prices, although it was underpinned indirectly by the prices of other commodity groups traded in international commodity exchanges.

The prices of main farm produce and metals posted strong growth in 2010 as a result of the impact of fundamental factors that determined the rising demand for and the falling supply of raw materials in world markets, as well as owing to the liquidity available globally in money markets. The higher consumption of farm produce stemming from the changing nutritional habits of emerging economies' population (namely in China and India) and the larger output of biofuels put an upward pressure on prices. Natural calamities (e.g. the floods in Australia) pushed down agricultural yields and contributed to a drop in industrial metal output. Speculative commodity exchange positions also influenced significantly raw material prices. As a result, the S&P GCSI spot index comprising the 24 major commodities traded on leading commodity exchanges posted a 20.4 per cent increase for 2010. Farm produce was the index component reporting the highest growth at 44.5 per cent. Precious and industrial metals have also risen substantially (by +35.5 per cent and +20.0 per cent respectively) since the year's start.

The rise in the prices of cereals which are the main raw materials for food industry was the main driver of the farm produce component's strong dynamics. The price of the one-month wheat futures went up by 79.4 per cent to EUR 337.5 *per tonne* at the end of the year following the ban on wheat exports in August 2010 imposed by Russia and Ukraine which are their leading world exporters. The price of wheat on international commodity exchanges increased as a result also of the negative impact of the weather phenomenon called *La Niña*.¹ *La Niña* was one of the major factors behind the record rises in the price of maize to EUR 314.1 *per tonne* (62.4 per cent) and of soybeans to EUR 574.8 *per tonne* (43.7 per cent) at the close of 2010 since it jeopardized the yield and the quality of the crops in Argentina, one of the leading world exporters of maize and soybeans. The change in the nutritional habits of emerging economies' population resulting in greater consumption of meat, dairy products and fish also played a key role in the upward movement of the price of maize. The larger worldwide output of biofuels exerted an upward pressure on the formation of maize and sugar prices over the year. Since mid-2010 CFTC² data point to an increase in the number of speculative positions taken by the trade in farm produce. The greater interest of commodity market participants entailed additional fluctuations in cereals futures prices.

¹ *La Niña* is an ocean-atmosphere *phenomenon* causing abrupt weather changes in various parts of the planet.

² U.S. Commodity Futures Trading Commission.

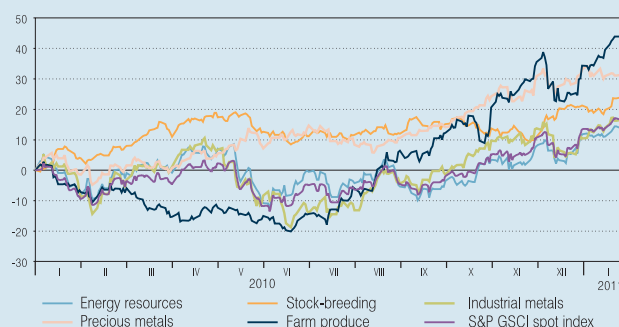
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The precious metals component of the S&P GSCI spot index was impacted mainly by the record high rise in the price of gold by 29.7 per cent to USD 1421.4 *per troy ounce* by end-2010. Industrial metals also attracted investor interest with prices of copper posting record growth to USD 9644 *per tonne* (31.2 per cent), of nickel USD 24,715 *per tonne* (33.8 per cent) and of tin USD 26,932 *per tonne* (59.4 per cent). The main factor behind the rise in the price of copper was the demand on the part of China, the greatest importer of the metal which is used for meeting the needs of the country's industrial output. The 24.8 per cent decrease in copper inventories registered on the London Metal Exchange (LME) in 2010, as well as the report of the International Copper Study Group (ICSG) forecasting a shortage of 435,000 tonnes in copper supply in 2011 also put an upward pressure on the price of this metal. Recovering demand for stainless steel for the industrial production and the rising shortage in the supply of this raw material were the main drivers of the nickel price rise. Heavy rains in Indonesia, the greatest tin producer, made the extraction of the metal difficult which led to a shortage in global supply. The increase in demand on the part of Asian economies and the decrease in the inventories registered on the London Metal Exchange by 39.2 per cent also prompted the rise in the price of nickel in international markets. The imbalance between increasing demand for raw materials by the recovering industrial economies and lagging supply as a result of contracted investments and out-of-date technologies in the agrarian and extracting sectors will continue to push up food and metal prices in international markets. Price levels will continue to experience an additional pressure caused by the enhanced interest of financial investors and speculators since they see in commodity exchanges an opportunity for higher return on their invested capital.

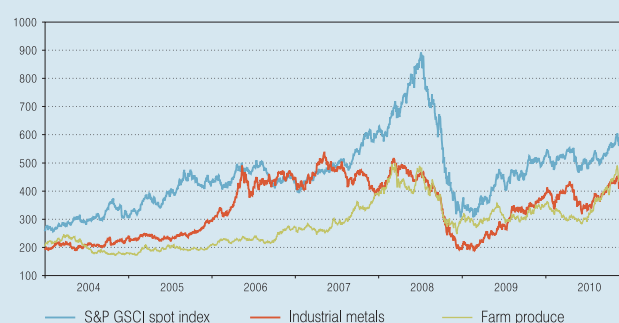
S&P GSCI Spot Index and Components, January 2010 – January 2011

(%; normalized data)



Source: Bloomberg.

S&P GSCI Spot Index and Some Components, 2004–2010



Source: Bloomberg.

Gold

Over the fourth quarter of 2010 the average gold price (one-month futures) went up to USD 1369.8 *per troy ounce* (12.2 per cent on a quarterly basis). A weaker rise was reported in euro (6.5 per cent on a quarterly basis).

Over the review period the gold price reflected mainly Ireland's debt problems and concerns associated with spillover effects of the crisis on other peripheral euro area countries. The new non-conventional monetary measures initiated by the US Federal Reserve to stimulate growth and employment in the US economy also contributed significantly to gold price rises. The typically strong physical demand for gold in the fourth quarter by the jewellery industry retained the upward trend in gold price.

Gold supply by the European central banks under the Central Bank Gold Agreement reached

its lowest level in 2010 since the conclusion of the first agreement in 1999. In 2010 European central banks sold 1.8 tonnes of gold, with the strong demand by the Asian central banks met mainly by the IMF. On 22 December the IMF announced the completion of the programme for a sale of 403.3 tonnes of gold started in September 2009 (13 per cent of IMF gold reserves), with the news having a positive effect on the gold price and on investor expectations of future investment demand.

Demand for gold by physical gold exchange-traded funds (ETFs) remained strong in the review period, with the assets of the largest fund, SPDR Gold Trust, posting a slight decline to 1280.7 tonnes or approximately 4.2 per cent of the world inventories of gold. Notwithstanding, SPDR Gold Trust remained the world's sixth largest holder of gold before China and Switzerland.

The permission to launch a mutual fund in China which will invest USD 500 million in physical gold exchange-traded funds (ETFs) also supported the gold price and had a positive effect on investor long-term expectations.

One-month Futures of Gold

(USD per troy ounce)



Source: The London Bullion Market Association.

Bulgarian External Debt Dynamics in International Financial Markets

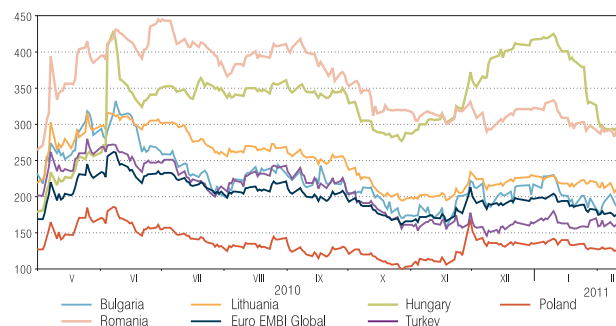
During the fourth quarter of 2010 the spreads of the yield on the Central and East European countries' government debt widened. The *JP Morgan Euro EMBI Global* index slightly increased, by 4 basis points to 197 basis points at the end of the quarter. The index fluctuated within relatively wide range from 161 to 213 basis points.

In the beginning of the review period the spreads tended to decline but the escalated crisis in Ireland at the end of November and early

December had a negative effect also on credit premium of Central and Eastern European countries. Over the review period the flow of macroeconomic data had rather a positive effect. Only Hungary's index exhibited an increase due to the effect of the factors specific for the country. In early December Moody's downgraded Hungary's credit rating by two steps to Baa3 from Baa1 and retained the negative prospect due to unsatisfactory progress in the country's fiscal consolidation. In December the Hungarian Central Bank increased the reference rate by 25 basis points consistent with higher inflationary expectations.

Government Securities Yield Spreads in CEE Counties (Euro EMBI Global index)

(b.p.)



Source: Bloomberg.

Bulgaria's government debt spreads, measured by the *JP Morgan* index, followed the general market trend throughout the period, reporting a 12 basis point increase to 217 basis points by the end of the year.

2. Financial Flows, Money and Credit

The balance of payments current account balance continued to improve between January and December 2010. Preliminary data show that the overall balance of the balance of payments current and capital accounts for 2010 was negative at EUR -23.0 million *vis-à-vis* a deficit of EUR 2999.8 million for 2009.

Between January and December 2010 the balance of payments financial account reported a deficit, with the fall in banks' foreign liabilities contributing most substantially to it. Under the conditions of increasing residents' deposits and reduced demand for loans, the banking system was characterised by high liquidity. Attracted resources allowed banks to pay their foreign obligations with no adverse impact on Bulgaria's economy.

The Issue Department balance sheet figure came to BGN 25.38 billion (EUR 12.98 billion) by end-December 2010, with assets increasing by BGN 113 million (EUR 58 million) on 2009.

The analysis of the Issue Department liabilities suggests that bank deposits with the BNB (growth of EUR 467.7 million) and Banking Department deposit (growth of EUR 294.7 million) contributed most significantly to this rise. The increase in bank reserves is driven by the growth in residents' deposits in the banking system, while the growth in the Banking Department deposit is a result of valuation adjustments, primarily in gold, and of BNB gross asset management yield.

In addition to bank deposits with the BNB and the Banking Department deposit, circulating banknotes and coins (up by EUR 129.5 million) contributed also to the increase in BNB's international reserves in 2010. The government and other budgetary organisation's deposits with the BNB decreased by EUR 895.3 million as these reserves were a major source for financing the budget deficit.

Cash Flows Prompting Significant Changes in Gross International Reserves

(million EUR)		
External flows	2010	2009
Total for the period	-463	-265
Purchases and sales of euro	-321	-1 282
at tills	-16	-35
banks, incl.	-306	-1 247
banks' purchases	57 241	112 527
banks' sales	-57 547	-113 774
Flows on accounts of banks, the MF, etc.	-141	1 018
Minimum required reserves	-385	159
Government and other depositors	243	859*

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

Source: BNB.

The average monthly coverage of imported goods and services by BNB international reserves was 7.4 months by December 2010.¹

Cash flows, which prompted stronger changes in gross international reserves, provided additional information about the major operations of the central bank. On a cash basis, the decrease in gross international reserves in 2010 amounted to EUR 463 million. Included are banks' net purchases of euro from the BNB which came to EUR 306 million and bank reserves denominated in euro which decreased by EUR 385 million.

¹ The average value of imports of goods and services for the last 12 months and BNB reserves by the end of December 2010 were used to calculate this indicator.

Financial Flows and External Position Sustainability

The balance of payments current account continued to improve, with a deficit of EUR 282.7 million reported between January and December 2010. On an annual basis, the current account ended in a deficit of 0.8 per cent of GDP which was entirely covered by the annual flows of foreign direct investment. Over the first and second quarters of 2011 exports are expected to continue growing at a faster rate than imports and the balance of the current and capital account to turn positive on an annual basis. Our expectations show retention of the net inflow of foreign direct investment.

Between January and December 2010 the balance of payments financial account recorded a deficit of EUR 403.1 million. The inflow of foreign direct investment, worth EUR 1359.5 million, was insufficient to offset the repayment of banks' loans in the amount of EUR 918.0 million and the closure of non-resident deposits with local banks, worth EUR 642.0 million. Major balance of payments outflows reflect high liquidity used by banks operating in Bulgaria amid low credit demand for a partial repayment of their foreign obligations. To this end, outgoing financial resources were not associated with negative effects on Bulgaria's economy.

Between January and November 2010 short-term external debt contracted by EUR 936.8 million and therefore its share in Bulgaria's gross external debt fell, reaching 31.6 per cent (32.5 per cent a year earlier). The share of portfolio investment in Bulgaria's gross international liabilities remained stable at 2.7 per cent by September 2010. In November 2010 BNB international reserves provided a 111.2 per cent cover of the short-term external debt. This gives grounds to claim that 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.

Foreign direct investment in Bulgaria came to EUR 1359.5 million for 2010 against EUR 3281.9 million in 2009.

By December 2010 net foreign direct investment accounted for 3.4 per cent of GDP. Net foreign direct investment inflows are expected to gradually increase in the first and second quarters of 2011. As a result, the foreign direct investment to GDP ratio will rise on an annual basis.

Direct investments attracted in 2010 were mostly in the form of *equity* (EUR 1280.2 million), while those to the banking sector were in the

form of *reinvested earnings* (EUR 205.1 million). *Other net capital* was EUR -125.9 million, matching the preliminary data on intercompany loans received and repayments thereon in accordance with the repayment schedules of corporations.

In 2010 non-residents' investment in real estate came to EUR 238.9 million (against EUR 551.1 million in 2009). As a result of the declines in 2009 and 2010, the earnings from real estate acquired by non-residents in Bulgaria were close to the levels typical of the years prior to 2006.

Trends in the structure of foreign direct investment were sustained in 2010 when flows were directed mainly to *manufacturing* (33.3 per cent), *transport, storage and communication* (16.8 per cent), and *production and distribution of electricity and heating* (15.5 per cent). Consequently, *real estate operations and business services* (22.7 per cent), manufacturing (18.3 per cent) and *financial intermediation* (17.4 per cent) contributed most significantly to the total accumulated foreign direct investment as of the end of the third quarter of 2010.

The composition of FDI by country suggests that in 2010 foreign direct investment attracted from the Netherlands (EUR 1408.5 million), Germany (EUR 159.1 million) and Belgium (EUR 124.2 million) accounted for the largest shares. Net payments related to revolving intercompany loans were made to Austria (EUR -684.0 million), the United Kingdom (EUR -187.4 million) and the Netherlands Antilles (EUR -100.4 million).

Between January and November 2010 Bulgaria's gross external debt went down by EUR 1643.2 million. Net repayment of borrowed funds amounted to EUR 6548.5 million (revaluations and changes in trade and revolving loans excluded). In the first eleven months of 2010 loans and deposits of EUR 4589.4 million were received, and principal payments of EUR 6076.6 million serviced (compared to EUR 6199.0 million

in the corresponding period of the prior year). As a result, by end-November 2010 Bulgaria's gross external debt reached EUR 36.2 billion or 101.2 per cent of GDP.

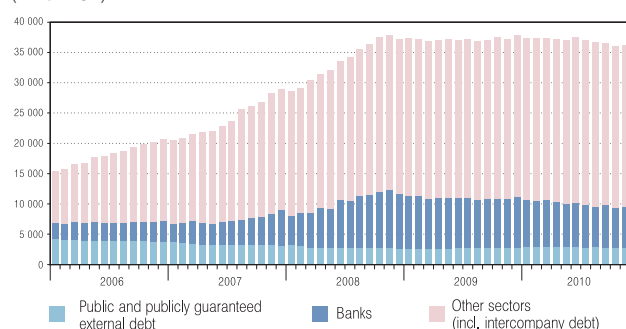
Between January and November 2010 private non-guaranteed external debt decreased by EUR 1681.9 million, mainly due to the decline in bank debt by EUR 1592.6 million. Banks' debt to foreign parent banks incurred in connection with their activity in Bulgaria occupied a large share in banks' external debt (78 per cent as of September 2010). Changes in banks' external debt in 2009 and in the first eleven months of 2010 were due to the ample liquidity of local banks and the efforts to reduce their net external indebtedness. Non-bank sector enterprises reduced their external liabilities by EUR 35.5 million in the January to November 2010 period. Intercompany loans increased by EUR 23.5 million in the same period of 2010. The share of intercompany loans in the total amount of external debt increased to 40 per cent by November 2010 against 38 per cent a year earlier. This dynamics underlines the long-term interest of foreign owners of local companies in Bulgaria's economy.

Between January and November 2010 *general government* external debt decreased by EUR 38.6 million. The total amount of public and publicly guaranteed external debt decreased by EUR 38.7 million and occupied 11.6 per cent of Bulgaria's total external debt.

Gross external debt service in the January to November 2010 period reached EUR 6548.5 million compared to EUR 6818.5 million in the corresponding period of the prior year. Between January and November 2010 new borrowings and deposits came to EUR 4.6 billion, of which loans received from banks occupied 42 per cent and intercompany loans comprised 37 per cent.

Gross External Debt

(million EUR)



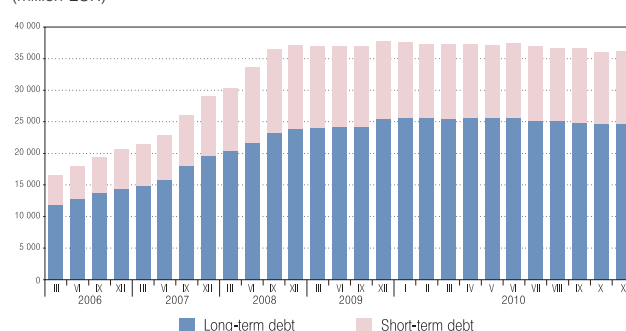
Source: BNB.

The average weighted interest rates on new loans declared between January and November 2010 suggest a minimum increase of 0.5 percentage points to 3.5 per cent (on an annual basis) in the cost of external borrowings. The cost of new loans in US dollars reported a decrease of 0.1 percentage points to 5.6 per cent.

By November 2010 there was no notable change in the sectoral structure of private non-bank external debt. The largest share in the external debt of *other sectors* was occupied by *real estate operations and business services* (21.6 per cent), followed by *electricity, gas and water* (20.2 per cent) and *financial intermediation* (11.6 per cent). The largest share in intercompany loans was occupied by *telecommunications* (15.9 per cent), *financial intermediation* (15.7 per cent) and *real estate operations and business services* (15.0 per cent).

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

In the maturity structure of gross external debt, short-term external debt trended downwards. It decreased by EUR 936.8 million and its share fell to 31.6 per cent compared to 32.5 per cent a year earlier. These developments in the first eleven months of 2010 were largely attributable to the closure of deposit accounts of non-residents with banks (EUR 576.3 million) and declines in banks' short-term loans (EUR 375.1 million).

As regards gross external debt currency structure, the euro retained its leading position at 89.0 per cent by September 2010. It occupied the largest share in intercompany loans (92.7 per cent) and the smallest share in the general government sector (72.9 per cent).

Between January and November 2010 Bulgaria's gross foreign assets fell by EUR 300.7 million. Over the same period BNB's foreign reserves decreased by EUR 221.5 million and foreign as-

sets of domestic banks by EUR 35.0 million. As a result of gross foreign asset and gross external debt dynamics, the net external debt decreased by EUR 1342.5 million to EUR 18.2 billion by end-November 2010, or to 50.8 per cent of GDP.

The interdependence between the capital inflows on the balance of payments financial account and the current account dynamics was retained in the January–December 2010 period. The trend toward improving the current and capital account balance continued in 2010 and a deficit of EUR 23.0 million was reported against a deficit of EUR 2999.8 million in 2009. The balance of payments current and capital account balance still ended in a deficit on an annual basis accounting for 0.1 per cent of GDP against a deficit of 8.6 per cent of GDP a year earlier.

In 2010 all current account components improved on 2009 as follows: the trade balance by EUR 1772.5 million, the balance on services by EUR 594.9 million, the income account by EUR 206.1 million, and net current transfers by EUR 620.8 million. In 2010 the capital account surplus decreased by EUR 217.5 million on 2009.

Trade deficit in 2010 came to EUR 2401.0 million. Over the same period nominal exports and imports in euro increased by 33.0 per cent and 13.1 per cent respectively on an annual basis.² Exports and imports are expected to rise on an annual basis in the first and second quarters of 2011, with exports growth rates exceeding those of imports.

The balance on services reported a surplus of EUR 1892.3 million throughout 2010 against a surplus of EUR 1297.4 million in the previous year. The increase in the surplus was mainly due to reduced expenditure on travelling and external services (construction services), as well as improved transport and travel earnings.

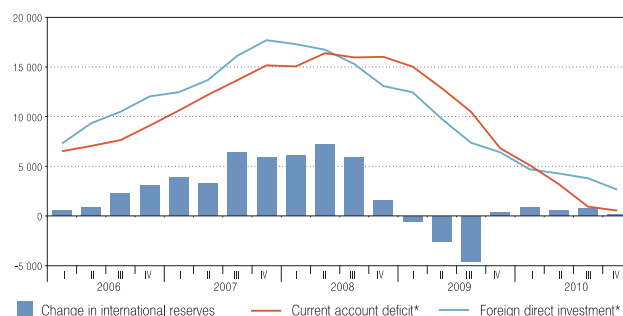
For the January–December 2010 period the income account deficit was EUR 1326.3 million: an improvement of EUR 206.1 million on the corresponding period of 2009. The improvement was largely ascribable to lower income payments on direct investments (by EUR 193.8 million) and on other investments (by EUR 154.7 million).

² More detailed analysis of exports and imports is presented in Section 3.

Net current transfers amounted to EUR 1552.3 million in 2010 and the improvement on an annual basis was mainly due to increased transfers to the general government sector (by EUR 596.8 million). The receipts in the form of private current transfers fell by EUR 4.8 million on an annual basis. Transfers abroad also posted a decline (EUR 56.9 million). As a result, net transfers to the private sector increased by EUR 52.1 million on an annual basis.

Dynamics of International Reserves, Foreign Direct Investment and Current Account (on an Annual Basis)

(million BGN)



* Data as of December 2010.

Source: BNB.

The decline in capital transfers on the corresponding period of the previous year reflects lower net receipts from EU funds. Capital transfers from the EU to the *general government* sector came to EUR 396.3 million and capital transfers to the EU amounted to EUR 149.3 million. As a result, net capital receipts from EU funds totalled EUR 247 million in 2010, down by EUR 228.3 million on an annual basis.

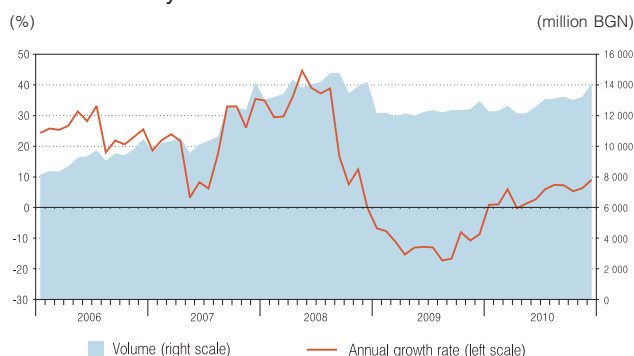
Our expectations for the developments in balance of payments components over the first and second quarters of 2011 point to a minimum (as a percentage of GDP) positive balance on the current and capital accounts. The net inflow of foreign direct investment is expected to be retained over the same period.

Monetary Aggregates

As of December 2010 broad money growth moderated to 6.2 per cent on an annual basis. The annual growth of broad money is expected to remain close to its current levels in the first two quarters of 2011. Over the projection horizon interest rates on time deposits will undergo no significant changes.

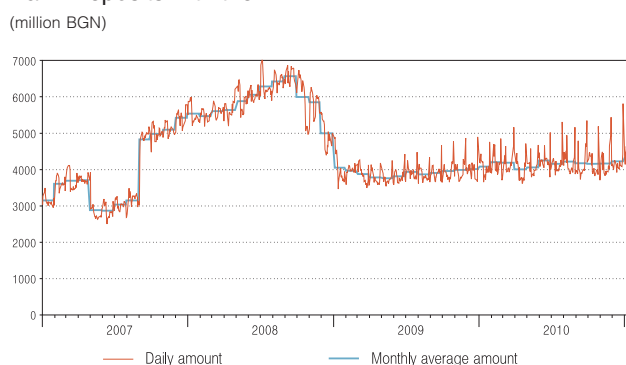
Reserve money retained their upward dynamics from the last two quarters, posting annual growth of 9 per cent as of December. Banks' deposits with the BNB increased by 18.7 per cent on an annual basis and contributed by 7.1 percentage points to reserve money growth. Accelerated growth in bank reserves over the fourth quarter was largely due to the increased amount of funds attracted from residents (up BGN 1 billion on average). As a result, the average amount of the minimum required reserves maintained by banks with the BNB posted an increase.³ On the other hand, given the high liquidity of the banking system, the share of excess reserves in the total amount of reserves maintained by banks reached 6 per cent on average in December 2010 and 4.6 per cent in the review quarter.

Reserve Money



Source: BNB.

Bank Deposits with the BNB

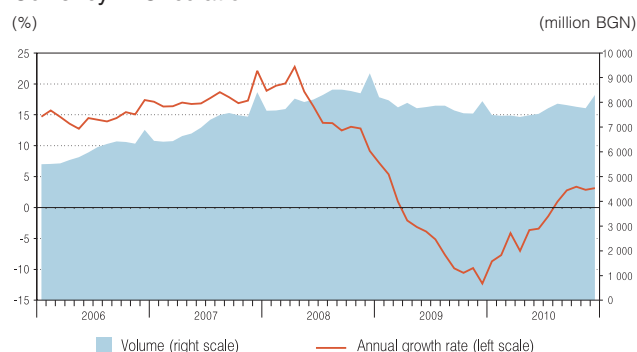


Source: BNB.

³ According to Article 3, paragraph 1 of Ordinance No 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks, the rate of funds attracted from residents is 10 per cent.

For a second consecutive quarter, currency in circulation posted positive growth which was 3.1 per cent at the end of December. Determinants of cash in circulation dynamics are the gradual recovery of economic activity, end-of-year inflation acceleration and stabilisation of private consumption.

Currency in Circulation



Source: BNB.

In the first two quarters of 2011 currency in circulation is expected to further increase on an annual basis which will reflect the gradual recovery of household consumption. Banks' deposits with the BNB are anticipated to further contribute to reserve money growth, posting growth rates close to the current values.

Fiscal policy affects the allocation of liquidity between economic sectors. The Ministry of Finance active issuing policy in the government securities market over the third quarter of 2010 resulted in a transfer of liquidity to the amount of 3.5 per cent of GDP from the financial sector (the BNB excluded) to government and budget organizations' accounts with the BNB. Reallocation of these resources is largely due to the difference in the amount of funds raised by the MF in the domestic government securities market (BGN 755.7 million) and the low level of the budget deficit in the review quarter (BGN 11.3 million). As a result, the bulk of the net issuance of government securities contributed to the growth in government and budget organizations' deposits with the BNB between July and September 2010.

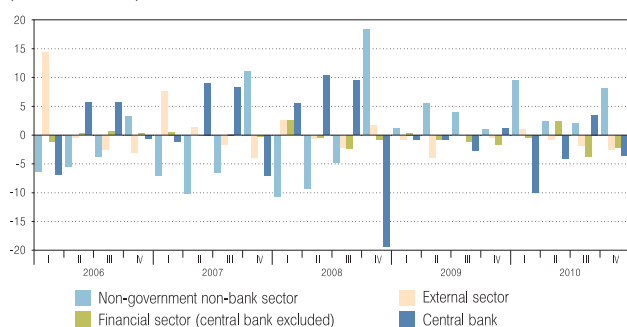
The external sector was also a source of liquidity for the consolidated budget (-1.8 per cent of GDP in the third quarter) mainly due to the funds reimbursed by the European Commission to the National Fund under JEREMIE (Joint European Resources for Micro to Medium Enterprises) initiative.

The MF preliminary data show that in the last three months of 2010 consolidated budget had a stronger effect on liquidity of the non-government non-bank sector. Over the same period the government used liquid funds from its deposit with the BNB in the amount of approximately 3.5 per cent of GDP to finance the budget deficit for this period. Owing to the absence of significant interest and amortization payments on the government debt in this period, most resources were directed to the non-government non-bank sector.

In the first quarter of 2011 our expectations show that consolidated budget continue to withdraw liquid funds from MF accounts with the BNB with the aim to use them in interest payments on government global bonds to the amount of BGN 192 million along with amortization payments of some BGN 336 million on maturing domestic government securities. Consequently, government and other budgetary organisations' deposits are expected to fall and liquidity to be allocated to the external and financial sector (the BNB excluded).

Influence of Consolidated Budget on Other Sectors' Liquidity (Quarterly)

(share of GDP, %)



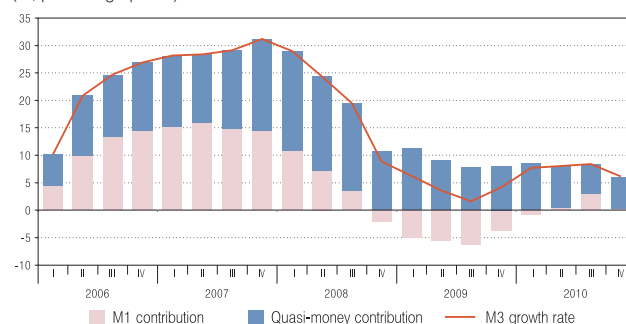
Note: Data for the fourth quarter of 2010 are based on GDP projections for this period.

Sources: MF, BNB.

In December broad money growth slowed down to 6.2 per cent on an annual basis *vis-à-vis* 8.4 per cent in September. The annual growth of broad money is projected to remain close to its current levels in the first two quarters of 2011.

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

(%; percentage points)



Source: BNB.

The narrow aggregate, M1, contributed to moderation in broad money growth in December. It posted a minimum increase of 0.8 per cent at the end of December against 7.7 per cent at the end of the third quarter. The main factor driving M1 dynamics involves overnight deposits which declined by 0.9 per cent by December on an annual basis against an increase of 11.3 per cent by end-September. This decline stemmed almost entirely from a decrease in overnight deposits of social insurance funds by some BGN 1 billion on the end of the third quarter of 2010.⁴ According to the methodology of preparing the monetary survey, monetary liabilities of MFIs excluding those to the central government and the MFI sector are included in money supply. Liabilities to the central government are presented separately in the monetary survey, since this sector is money-neutral.

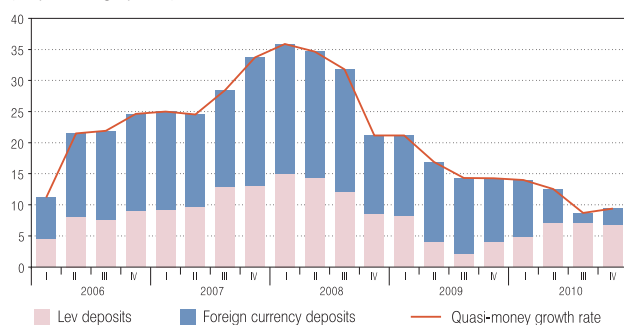
The annual growth rate of overnight deposits of non-financial corporations accelerated from 4 per cent in the third quarter to 5.7 per cent at the end of December and that of households' deposits was 8.7 per cent.⁵ Growth in money outside banks also exhibited a gradual acceleration and by December it was 3.4 per cent compared to 2.2 per cent by the end of September.

⁴ Under § 27, paragraph 1 of the Transitional and Final Provisions of the Republic of Bulgaria 2010 State Budget Law, effective as of 17 December 2010, end-2010 cash holdings in the National Health Insurance Fund's bank and deposit accounts with the BNB are transferred *ex officio* to the central budget's account until 31 December 2010.

⁵ Presented data on deposits and loans of households include also deposits and loans of NPISHs under the classification used in monetary statistics.

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

(%; percentage points)



Source: BNB.

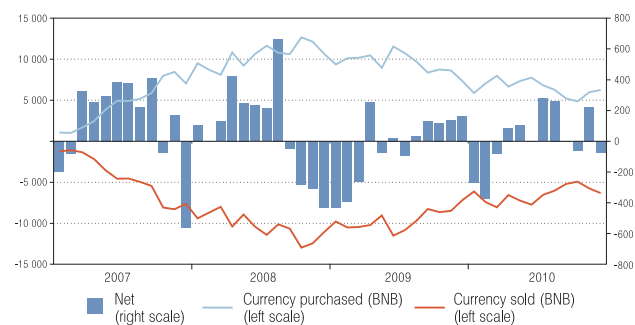
In December the annual growth rate of quasi-money accelerated slightly to 9.4 per cent on an annual basis. Lev-denominated deposits (6.8 percentage points) continued to have a major contribution to quasi-money growth along with foreign currency denominated deposits whose contribution increased (2.6 percentage points in December compared to 1.5 percentage points in September). Deposits with agreed maturity of up to two years rose by 9.5 per cent on an annual basis, with household deposits contributing most significantly (9.4 percentage points). By end-December household deposits in levs increased by 26.2 per cent on an annual basis and those in foreign currency by 7.7 per cent. Non-financial corporations reported a decrease of 4.4 per cent in deposits with agreed maturity of up to two years. Their lev deposits went up by 7.8 per cent on annual basis by December and the annual decline in their foreign currency deposits was 13 per cent.

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.

In the fourth quarter of 2010 the average daily volume of currency trade of banks with the BNB came to EUR 524 million against EUR 564 million in the third quarter. Over the same period banks realised average daily net sales of euro to the amount of EUR 86.9 million (compared to average daily net purchases of euro of about EUR 542.5 million in the third quarter of 2010).

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

(million EUR)



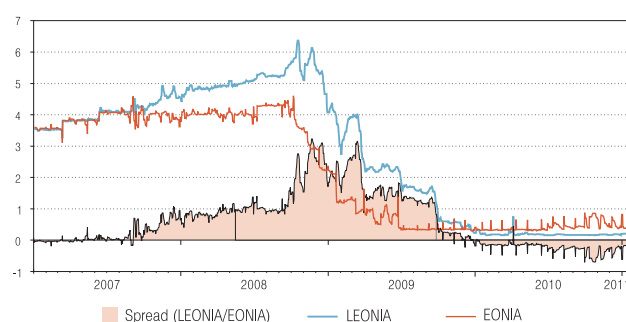
Source: BNB.

Between October and December interest rate levels in the interbank money market remained unchanged from the third quarter of 2010. The average interest rate on transactions concluded in the interbank money market remained at the level of 0.25 per cent.

The LEONIA index exhibited a similar trend retaining its level of the third quarter (0.17 per cent). The negative spread between LEONIA and EONIA expanded to 41 basis points in the fourth quarter against a negative spread of 28 basis points in the third quarter. This expansion was entirely due to the increase in European interest rates. Unlike the euro area, interest rates in Bulgaria were marked by very low volatility which further signals the availability of free bank resources in the interbank market and the existing confidence between individual market participants.

LEONIA/EONIA

(%; percentage points)



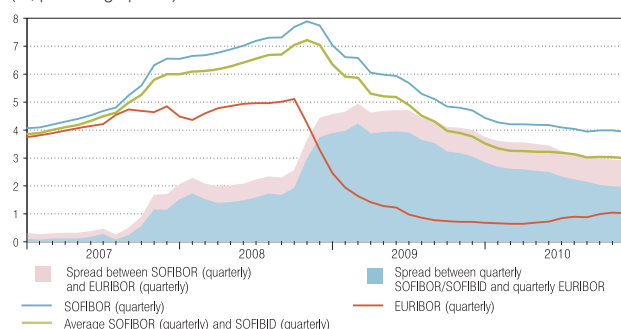
Source: BNB.

The SOFIBOR reference rate (quarterly), used as an indicator of short-term interest rates, stabilised at approximately 4 per cent in the last three months. The spread between SOFIBOR (quarterly) and EURIBOR (quarterly) continued to follow the downward momentum to come to 291 basis points by December (down 15 basis points compared to its September level). The spread reduc-

tion was a result of the 14 basis point rise in the EURIBOR between October and December and the 1 basis point fall in SOFIBOR over the same period. The average value between SOFIBOR and SOFIBID gives a better picture of the market interest rate level in Bulgaria. Correspondingly, it is more correctly to compare this value with EURIBOR which is the closest rate to the actual market price at which transactions are concluded.⁶ The average SOFIBOR/SOFIBID reference rate in the interbank market in Bulgaria over the quarterly horizon remained at 3 per cent in December 2010 and the spread between the average quotation and EURIBOR (quarterly) decreased to 198 basis points compared to 215 basis points in September.

SOFIBOR, Average SOFIBOR/SOFIBID and EURIBOR (quarterly horizon)

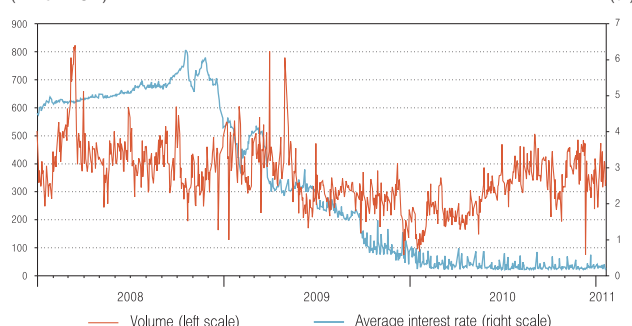
(%; percentage points)



Source: BNB.

The average daily volumes of interbank money market transactions for the October to December 2010 period (BGN 361 million) remained broadly unchanged from the third quarter (BGN 371 million) and were at a level close to pre-crisis levels. This is another indicator of improved conditions in the interbank market and of existing confidence among individual participants.

Trade Volume and Interbank Money Market Interest Rates (million BGN) (%)



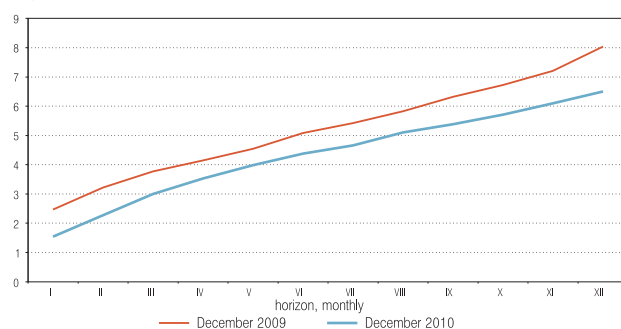
Source: BNB.

⁶ For further methodological notes see the box *Differences between the Methodology for Calculating Money Market Indices in the Euro Area and in the New EU Member States*, Economic Review, 2010, issue 2.

The yield curve also gives a positive signal of the domestic interbank market development. The end-2009 downward trend in the long end of the yield curve in annual terms continued in the fourth quarter of 2010. The decline in the long end of the yield curve was already more pronounced than in the short end, with the fall in the 12-month horizon reaching 153 basis points against 93 basis points in the one-month horizon.

Interbank Money Market Yield Curve (based on average SOFIBOR/SOFIBID quotations)

(%)

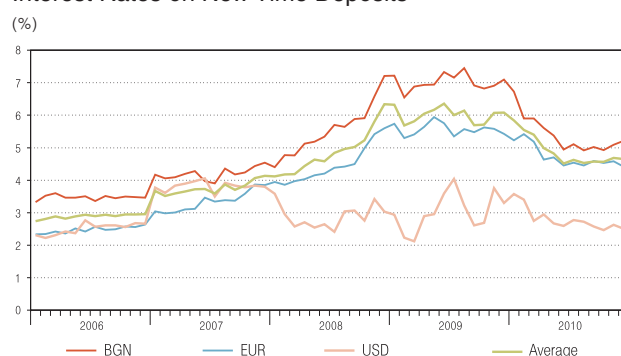


Source: BNB.

In the fourth quarter the average interest rate on new time deposits stabilised at the third quarter's level. In December the average interest rate on new time deposits denominated in leva reached 5.2 per cent (5 per cent in September) and the average interest rate on time deposits denominated in euro fell to 4.4 per cent (from 4.6 per cent in September). In 2010 the average deposit rate declined by 143 basis points to 4.65 per cent.

Interest rates on time deposits are expected to remain almost unchanged in the first half of 2011. This is supported by the high banking system liquidity (the *liquid assets to total liabilities* ratio was 24.4 per cent in December) and still low lending activity of banks.

Interest Rates on New Time Deposits (%)

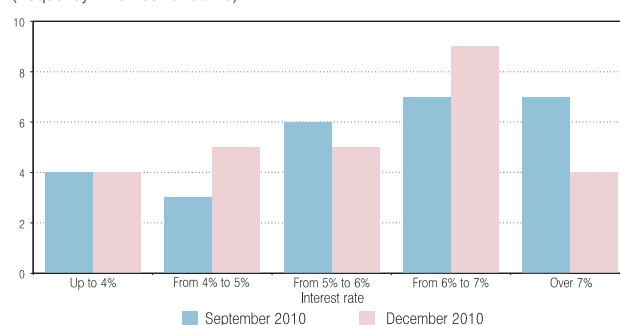


Source: BNB.

As regards the breakdown of interest rates on time household lev deposits by bank, the number of banks offering rates within the 5 to 6 per cent and over 7 per cent interval decreased at the expense of those offering rates within the 4 to 5 per cent and 6 to 7 per cent band respectively. The average interest rate level in December increased by 12 basis points to 5.92 per cent on September, while the dispersion coefficient fell by 20 basis points to 1.48 percentage points.

Breakdown of Interest Rates on Household Lev Time Deposits

(frequency – number of banks)



Source: BNB.

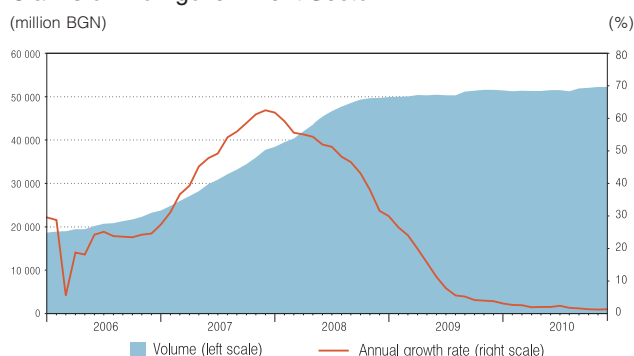
Credit Aggregates

The downward trend in credit growth rates was sustained due to slow recovery of economic activity and high uncertainty which limited demand for loans. Cautious bank lending policy also contributed to the lower credit growth rates. Over the projection horizon interest rates on loans will probably undergo no significant changes.

Cautious bank policy and uncertainty about the rate of macroeconomic environment recovery in Bulgaria had a negative effect on credit demand and correspondingly on credit activity also in the fourth quarter of 2010. Low credit demand⁷ and retained tendency of applying tighter lending standards by banks limited credit growth. By the end of December the annual growth of claims on the non-government sector accounted for 1.3 per cent.

In the fourth quarter claims on the non-government sector increased by BGN 340.4 million against an increase of BGN 432.3 million in the corresponding period of 2009. Since early 2010 claims rose by BGN 695.4 million. The increase reflected mainly higher net purchases of loans by banks amounting to BGN 548.8 million in 2010.

Claims on Non-government Sector



Source: BNB.

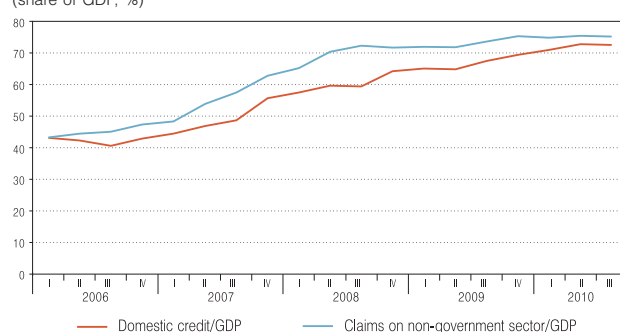
⁷ Based on the lending activity survey conducted by the BNB.

Banks' credit standards are expected to be broadly sustained and claims on the non-government sector to gradually increase in the first half of 2011.

Growth in nominal GDP (by 4.2 per cent on an annual basis) in the third quarter of 2010 and that in claims by 1.5 per cent over the same period contributed to a slight decline in the *claims on non-government sector to GDP* ratio. By the end of September this ratio was 75.2 per cent: down 0.3 percentage points on the previous quarter.

Domestic Credit

(share of GDP, %)



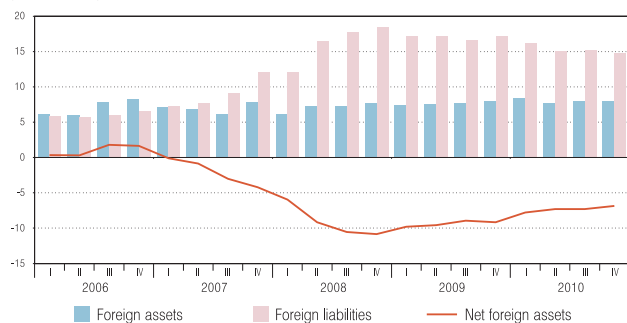
Source: BNB.

Between October and December 2010 banks' funds attracted from non-residents went down by BGN 435.3 million and their foreign assets posted a minimal increase of BGN 17.1 million. As a result, net foreign liabilities of banks declined by BGN 452.3 million. The 2009 downward trend in net foreign liabilities was retained, their value

falling by BGN 2.3 billion in 2010. Bank policy directed at reducing foreign liabilities reflects the conditions of ample liquidity, weak domestic demand for loans and cautious credit policy. No significant change in the banks' behaviour is expected in respect of foreign assets and liabilities over the projection horizon.

Foreign Assets and Liabilities of Banks

(billion BGN)

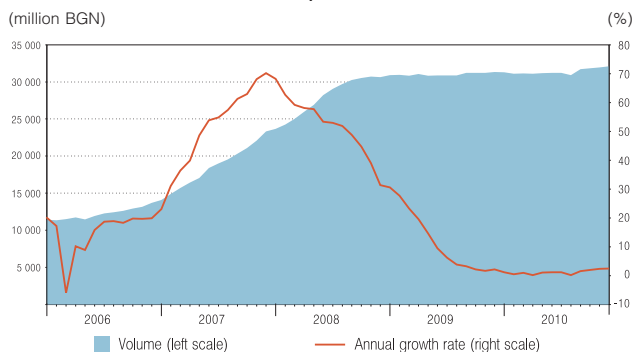


Source: BNB.

As a result of improved external environment and higher trade volumes in the last quarter of 2010, corporations' demand for borrowing intensified. The annual growth rate of claims on non-financial corporations accelerated slightly to reach 2.5 per cent by end-December. Claims on non-financial corporations increased by BGN 367.6 million between October and December. In 2010 newly extended loans to non-financial corporations (overdrafts excluded) went down 9 per cent on 2009 at the expense mainly of long-term loans which decreased by 13.3 per cent, while the volume of newly extended short-term loans rose by 15.2 per cent.

Claims on Non-financial Corporations

(million BGN)



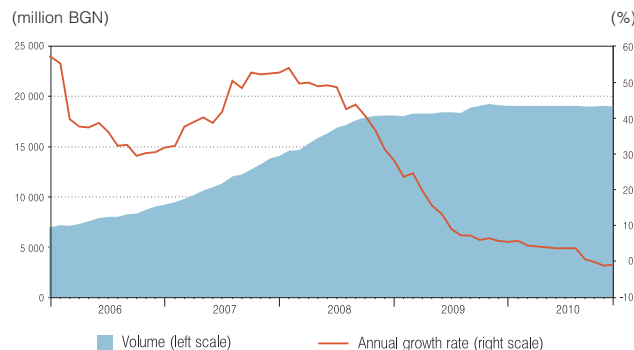
Source: BNB.

Lending to households remained relatively weak. Factors behind this trend were the continued decline in household consumption as a result of declines in employment, low wage growth, uncertainty, the cost of consumer credit, as well as

tightened credit policy of banks. Between October and December claims on households posted a slight decline of BGN 27.9 million against an increase of BGN 272 million in the corresponding period of 2009. On an annual basis, claims on households decreased in the last three months of the year to reach 0.8 per cent by end-December. Except for housing loans, all other loans reported declines on an annual basis (overdrafts: 10.2 per cent; consumer loans: 2.8 per cent; and other loans: 5 per cent). Though positive, annual growth in housing loans continued to moderate and reached 3.8 per cent in December.

Claims on Households

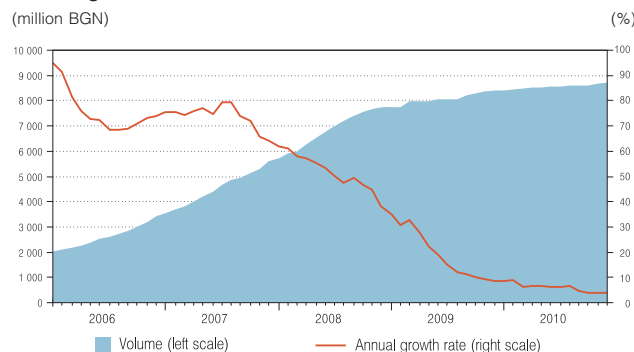
(million BGN)



Source: BNB.

Housing loans

(million BGN)



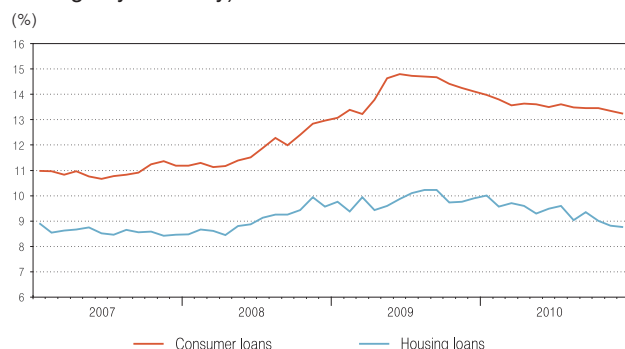
Source: BNB.

In the fourth quarter the levels of interest rates on housing and consumer loans declined compared to the previous quarter of 2010. The average annual percentage rate of charges (APRC) on newly extended *consumer loans* amounted to 13.2 per cent in December (against 13.5 per cent in September) and the average interest rate on these loans accounted for 11.9 per cent by December, declining by 19 basis points on September.

Newly extended *housing loans* between October and December 2010 came to BGN 379.9 million. Overall, in 2010 they were 8.4 per cent higher

than in the previous year. The annual percentage rate of charges on housing loans declined by 59 basis points on September and reached 8.8 per cent in December. By end-year interest rates on housing loans accounted for 8 per cent, a decrease of 42 basis points compared with September.

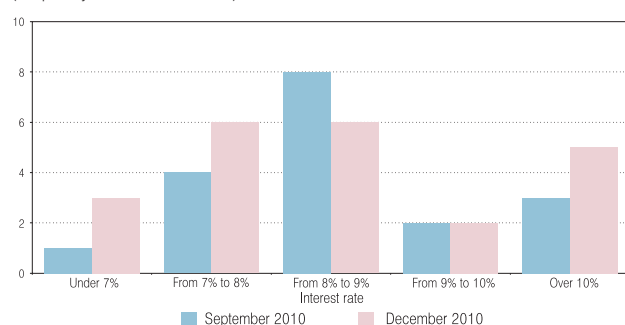
APRC on Newly Extended Household Loans (weighted average by currency)



Source: BNB.

Breakdown of Interest Rates on Housing Loans with Original Maturity of over 10 Years

(frequency – number of banks)



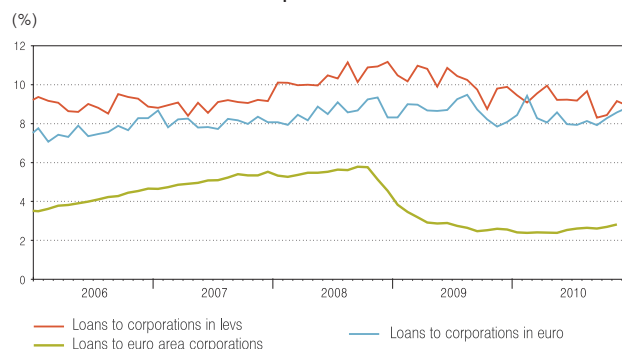
Source: BNB.

As regards the breakdown of interest rates on housing loans by bank⁸, in December the number of banks offering rates under 7 per cent, within the 7 to 8 per cent and over 10 per cent interval increased compared with September at the expense of those offering rates within the 8 to 9 per cent band. The average interest rate level in December remained at the September level (7.9 per cent), while the dispersion coefficient in this credit segment rose by 47 basis points to 1.87.

⁸ Housing loans in euro which comprise the largest share in the newly extended housing loans in the last three years.

The average interest rate on loans to non-financial corporations accounted for 8.8 per cent by December, up 74 basis points on September and 69 basis points on the end of the prior year. High bank liquidity and lower cost of deposits passed through more slowly on lending rates due to higher risk on the part of borrowers.

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



Sources: BNB and ECB.

Lending rates are expected to fall insignificantly over the coming two quarters. The high degree of uncertainty surrounding interest rate developments in the short-term horizon remains. The interbank money market has only a supporting role in bank liquidity management and we cannot expect that the high liquidity of this market will have a significant impact on the fall in lending rates. Stabilisation of interest rates on deposits likely to restrict the decrease in lending rates in the first half of 2011. The spread between deposit and lending rates will be further affected by the increasing bank provisions due to impairment of overdue loans, as well as by banks' efforts to maintain reasonable profitability levels.

3. Economic Activity

In the third quarter of 2010 real GDP increased by 0.7 per cent on the previous quarter. Exports continued to accelerate their growth rate and domestic demand declined further due to reduced household consumption. In the first half of 2011 increased production activity and improved consumer sentiment are expected to result in an increase in investment and consumer expenditure.

In the third quarter of 2010 real GDP registered an increase of 0.7 per cent on a chain basis for a second consecutive quarter¹, with the positive contribution of net exports offsetting the fall in final consumption. Overall, the seasonally adjusted GDP for the first nine months remained 0.2 per cent below its level in the corresponding period of 2009.

Since mid-2009 exports of goods and services positively contributed to GDP dynamics. Its growth rate in real terms increased to 8.9 per cent on a chain basis in the third quarter of 2010. Overall, in the first nine months exports picked up by 12.2 per cent on an annual basis, while imports of goods and services remained close to their levels of the corresponding period in the previous year (up by 0.1 per cent). As a result of reduced domestic demand imports decreased by 1.3 per cent on a chain basis in the third quarter of 2010, after a continuous increase in the first two quarters of the review year (4 per cent in the first quarter and 2.7 per cent in the second quarter).

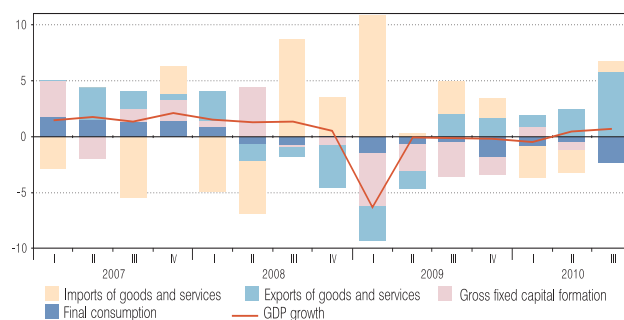
The fall in final consumption accelerated to 2.7 per cent on a chain basis in the third quarter of 2010, reflecting mostly the decline in household consumption. The trend toward an increase in the savings rate and the decline in households' labour income resulted in a decrease in consumer expenditure of 1.5 per cent and 0.5 per cent respectively in the first two quarters of the year to 2.9 per cent in the third quarter. Government consumption over the first nine months in real terms also remained below its levels for the correspond-

ing period of the prior year due to the decline in collective consumption of 6.9 per cent.

The trend toward a reduction in investment expenditure was discontinued as a result of the improved external demand and the gradual rebound in economic activity. On a quarterly basis, since the year start gross fixed capital formation dynamics was divergent which was largely attributable to the changes in public investment over the review period. However, in the third quarter of 2010 the seasonally adjusted real amount of gross fixed capital formation was 0.7 per cent more than in the last quarter of 2009. Managers' assessments² about the enhanced negative effect of materials and/or equipment shortages on the activity of undertakings and about the increase in capacity utilization signal an increase in the need of investment in the economy. On the other hand, higher gross operating surplus creates good potential for materializing entrepreneurs' investment plans.

Contribution to GDP Growth by Component of Final Consumption

(%; quarter-on-quarter percentage points, seasonally adjusted data)



Note: Non-additive contributions due to direct chain-linked volumes and seasonal adjustment of GDP and its components.

Sources: NSI, BNB.

¹ The analysis in the summary of this chapter and in the *Household Behaviour and Behaviour of Firms* sections employ seasonally adjusted data unless otherwise indicated. Where there are no officially published seasonally adjusted data, adjustment was made via the *TRAMO SEATS* programme by using automated set up for diagnostics and optimization of adjustment parameters.

² NSI business survey data.

Gross Value Added Growth

(%, real growth on the previous quarter; seasonally adjusted data)

	2007				2008				2009				2010		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Agriculture and forestry, hunting and fishing	-3.8	-6.2	-30.1	14.9	19.0	9.6	-1.7	0.4	-5.3	1.0	2.8	-0.6	3.6	-0.4	0.5
Mining and quarrying, production and distribution of electricity, gas and water	5.2	1.6	3.7	2.9	0.6	-0.8	-2.7	-2.6	-4.4	0.7	-0.2	-1.0	2.2	0.0	0.1
Construction	3.3	4.0	2.8	3.1	1.6	2.1	3.3	2.3	-8.3	-0.4	-0.2	-0.3	0.0	1.4	-12.7
Trade, repair; hotels and restaurants; transport and communications	1.2	2.2	1.4	1.4	1.1	0.9	0.9	-1.0	-0.1	-1.8	-0.9	1.2	-0.4	1.2	-5.6
Finance, credit, insurance; operations in real estate and business services	1.5	4.2	3.4	2.5	2.9	0.4	2.8	0.3	-0.1	-0.1	-1.5	-1.4	-1.4	-1.4	4.5
General government; education; healthcare; other services	1.6	1.0	0.6	-0.2	-0.3	0.1	0.5	1.1	0.2	0.1	-0.2	-0.4	0.3	0.6	-0.2
Total for the economy	1.3	1.9	1.1	2.5	1.5	1.1	1.7	0.3	-4.4	0.3	0.0	0.1	-0.3	0.5	-0.4

Sources: NSI, BNB.

GDP by Component of Final Consumption (Real Rate)

(%, real growth on the previous quarter; seasonally adjusted data)

	2007				2008				2009				2010		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Consumption incl.	2.0	1.6	1.5	1.6	1.0	-0.7	-0.9	0.1	-1.8	-0.8	-0.6	-2.2	-1.0	-0.6	-2.7
Household consumption	2.1	2.7	1.7	1.6	1.7	-1.6	-0.6	-0.4	-1.4	-0.4	-0.7	-1.7	-1.5	-0.5	-2.9
Final government consumption expenditure	4.7	-1.3	1.3	1.3	-2.4	1.1	-2.4	4.2	-10.5	1.2	2.5	-3.1	3.5	0.3	-0.2
Collective consumption	1.5	-3.6	-2.2	4.2	-4.6	2.6	0.6	0.5	0.1	1.4	-2.2	-23.4	26.5	-3.9	-1.1
Gross capital formation	7.1	-1.5	3.1	2.7	-3.8	31.9	-7.6	-3.6	-28.4	-1.9	-8.1	-1.8	-1.2	-1.3	-0.7
Gross fixed capital formation	11.4	-6.4	4.0	6.4	1.6	14.5	-0.4	-2.3	-14.1	-8.0	-10.8	-6.0	3.8	-3.0	0.0
Exports of goods and non-factor services	0.2	4.6	2.5	0.8	4.2	-2.3	-1.4	-6.1	-5.2	-2.6	3.6	2.9	1.7	3.9	8.9
Imports of goods and non-factor services	3.2	0.0	6.2	-2.7	5.6	5.1	-9.1	-4.1	-13.3	-0.5	-3.8	-2.3	4.0	2.7	-1.3
Real GDP growth	1.5	1.7	1.3	2.1	1.5	1.3	1.4	0.6	-6.3	0.0	-0.1	-0.2	-0.5	0.5	0.7

Sources: NSI, BNB.

Real gross value added in the economy decreased by 0.4 per cent on a chain basis in the third quarter of 2010 mostly as a result of the decline in construction (-12.7 per cent) and the group of trade, hotels and restaurants, transport and communications (-5.6 per cent). Over the first nine months of 2010 the economy as a whole saw an increase in value added of 0.2 per cent in real terms. Manufacturing reported the most significant improvement as the increase in exports resulted in a faster recovery and in an increase of 1.4 per cent on an annual basis.

In the beginning of the fourth quarter manufacturing turnover retained its high growth rates from the third quarter, but the contribution of domestic

market sales increased at the expense of the international market turnover. We expect that economic activity will continue to recover in the first half of 2011 with a growing contribution of the domestic demand. The increase in production capacity utilization and the improved financial performance of firms will probably result in recovery in investment activity from end-2010. Unfavourable labour market developments which were the main driver of the fall in consumer demand are expected to gradually phase out and to start improving moderately in the first half of 2011. Household consumption is also expected to recover which is likely to happen in early 2011, reflecting improved consumer expectations.

Household Behaviour

Household consumption declined further as a result of the negative income and employment dynamics. Its growth recovery is likely to begin in early 2011 in the context of the gradual improvement in the labour market situation and the formation of somewhat more optimistic expectations.

Over the third quarter of 2010 household consumption declined by 2.9 per cent on the second quarter. The intensification of consumer expenditure decrease was influenced by income dynamics related to the decline in employment and higher household savings rate.

According to the national system of accounts data, the decline in employment moderated further on a chain basis in the third quarter of 2010 reaching -0.7 per cent compared to -2 per cent and -1.6 per cent in the first and the second quarter respectively. Most of the dismissed persons were people with primary and secondary education, as well as skilled workers and analysts. As long-term unemployed (more than 12 months) contributed most to unemployment dynamics in the third quarter of 2010, risks related to losing labour skills and discouragement are still present. This is confirmed also by the seasonally adjusted economic activity coefficient of persons between 15 and 64 years of age which in the third quarter of 2010 declined and reached 66.3 per cent on a chain basis. The higher number of discouraged persons contributed most to this. Their number, corrected for seasonal effects, increased since mid-2008 and moderated somewhat since early 2010.

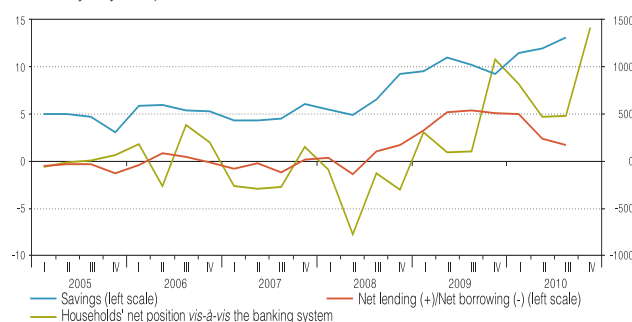
Wage dynamics contributed most to the intensified decline in consumer expenditure. Total for the economy, the nominal compensation *per* employee increased more slowly on a chain basis at a rate of 0.2 per cent in the third quarter compared to 3.6 per cent and 0.4 per cent in the second and first quarter of 2010 respectively. Positive growth was seen only in the general government, education, healthcare and finance, and credit. In the other sectors, particularly in manufacturing, compensations declined in nominal terms. In the third quarter of 2010 the average household income from wages also went down by 4.3 per cent on an annual basis (based on NSI household budget survey data). As a result of the gradual improvement in employment, wages are expected to increase moderately in nominal terms by end-2010 and in early 2011.

Real income (total for the economy) measured by the compensation *per* employee, deflated by the

HICP, saw positive growth of 0.1 per cent on the second quarter, regardless of the upward trend in prices. Only remunerations in the general government, education and healthcare saw a real increase. On the other hand, the wage bill in the economy went down both in real and in nominal terms. While in the second half of 2010 households reduced mainly their spending on non-food and durable goods, in the third quarter of 2010 there was a decline in all groups of expenditure, including essential commodities, such as household expenditure, water, energy, fuels, transport and food. Meanwhile, precautionary savings represented as the net assets of households in the banking system, increased in December 2010, reflecting households uncertainty about their income.

Households Savings Propensity

(%, share of disposable income, average *per* household member, seasonally adjusted) (quarterly change, million BGN)



Sources: NSI – Household Budget Survey, BNB.

According to seasonally adjusted data of the Labour Force survey, unemployment of individuals at and above the age of 15 increased from 5.4 per cent at the end of 2008 to 10.3 per cent in the third quarter of 2010. Registered unemployment measured by the Employment Agency corrected for seasonal effects, remained relatively high, reaching 9.2 per cent as of December 2010 (9.24 per cent according to non-seasonally adjusted data). Based on Employment Agency data, the competition for occupying one vacancy weakened in the second quarter of 2010, with the number of unemployed applying for a vacant position decreasing from 19 persons in the first half-year to 16 on average in the second half of 2010. Compared with the first quarter of 2009 (9 persons), competition remained at relatively high

Retail Trade Turnover

(% on the previous quarter; seasonally adjusted data at constant prices)

	2008				2009				2010			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Retail trade turnover (excluding cars and motorcycles) incl.	3.0	1.8	-1.1	-1.1	-2.9	-3.8	-2.8	-2.6	-2.2	-0.7	-0.6	-1.2
Foods, drinks and tobacco	0.8	-0.2	0.8	1.3	1.2	-0.9	0.5	0.2	-0.4	0.3	0.1	0.9
Textile, clothing, footwear and leather	11.3	-0.3	0.1	-0.7	-4.4	-3.9	-4.5	-0.1	-2.5	-1.8	0.2	-1.5
Household goods and home appliances	2.6	0.8	-1.2	-2.8	-5.4	-5.7	-5.7	-3.6	-2.1	-1.5	0.0	-2.8
Computers and communication equipment, etc.	5.5	2.5	-0.2	-1.6	-12.2	-4.1	-6.1	-5.0	-5.0	-2.5	-0.3	2.2
Pharmaceutical and medical goods, cosmetics and toiletries	12.1	5.2	1.9	0.7	-1.1	-2.8	0.4	0.7	-8.6	0.9	-0.5	1.3
Unspecialized shops with different kinds of goods	21.5	2.1	0.2	-1.6	-3.9	-4.6	-4.9	-4.1	-2.9	-2.4	-2.7	-1.4
Automobile fuels and lubricants	2.8	0.4	-2.6	-2.3	0.3	-5.2	-1.3	-2.0	-2.5	-1.0	-1.3	-1.7

Source: NSI – Domestic Trade Survey.

Employment and Income Dynamics

(% on the previous quarter; seasonally adjusted data unless otherwise indicated)

	2008				2009				2010		
	I	II	III	IV	I	II	III	IV	I	II	III
Employed	1.0	0.3	0.4	-0.2	-0.6	-1.3	-1.6	-1.8	-2.0	-1.6	-0.7
Real wage*	1.1	1.7	0.7	4.1	0.7	2.7	2.2	0.2	2.1	-0.1	0.1
Wage bill*	1.6	2.1	0.8	4.2	0.1	0.9	0	-2.6	0.8	-1.7	-1.0
Unemployment. average for the period, % of the labour force	5.9	5.7	5.4	5.4	5.8	6.3	7.1	8.2	9.1	9.9	10.3

* Real wage dynamics is approximated by compensation of employees under the System of National Accounts, deflated by HICP.

Sources: NSI – SNA, BNB calculations, NSI – Labour Force Survey.

levels. In the third quarter of 2010 the vacancy³ ratio was lower than in 2009. According to data in the fourth quarter, the vacancy ratio improved again; therefore, no deepening of inconsistencies in the structure of demand for and supply of labour resources.

Although the increase in income was dampened by the more serious decline in consumption and the fall in employment, October 2010 and the January 2011 NSI Consumer Surveys send positive signals. The consumer confidence indicator still shows more optimistic expectations about households' financial state, general economic performance and unemployment, while inflation expectations pointed to some upside risks since mid-2010. Data from the survey of business developments in the industrial sector, services and trade show that the share of managers expecting staff reductions in the following months gradually declines.

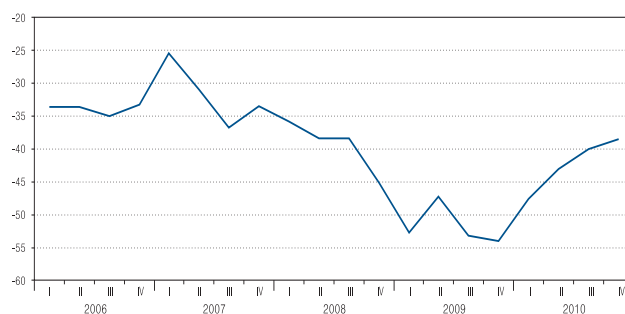
Available data on short-term statistics of employment and labour costs for the fourth quarter showed no further decline in the number of employed, and the increase in the average wage

³ A ratio between the number of employed and all offered job vacancies for the period.

remained relatively low (comparable with that of the recent quarters).

Households Confidence Indicator

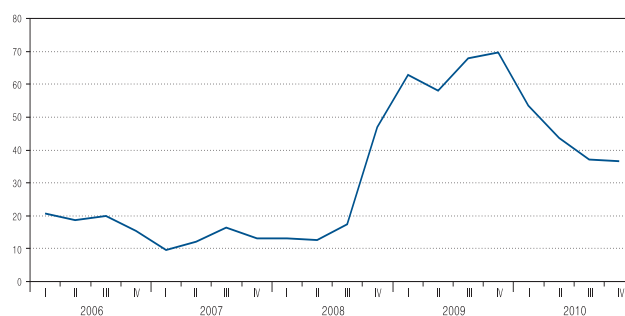
(%, balance of opinions)



Source: NSI – Consumer Survey.

Unemployment Expectations in the Next Twelve Months

(%, balance of opinions)



Source: NSI – Consumer Survey.

Analysis of the Current Situation Based on Seasonally Adjusted Data

As from September 2010 the National Statistical Institute started publishing seasonally adjusted GDP series, including the components of final use and value added by economic activity. Moreover, the set of short-term business statistics indicators (e.g. output, sales or turnover in industry, construction, trade, transport, *etc.*) has been expanded in phase, for which seasonally adjusted data is published. This is an important step to improve the statistical infrastructure and to bring it in line with the established world practices. This provides new opportunities for the analysis of the current situation.

The most important advantage of seasonally adjusted economic indicators is the provision of timely information on the changes in the economic environment. Therefore, this type of data is used in current economic analysis and primarily by institutions responsible for the development, implementation and assessment of the economic policy in the short run.

The seasonality of data on economic series results from factors of non-economic nature which affect the economic activity and act each year during each of the seasons of the year. Based on the historical values of the respective indicator, it may be expected that these factors will continue to act in the same way in the future if the circumstances remain unchanged. Besides seasonal factors, estimates of economic indicators were also impacted by calendar effects associated with the different number of working days in a particular month or quarter.

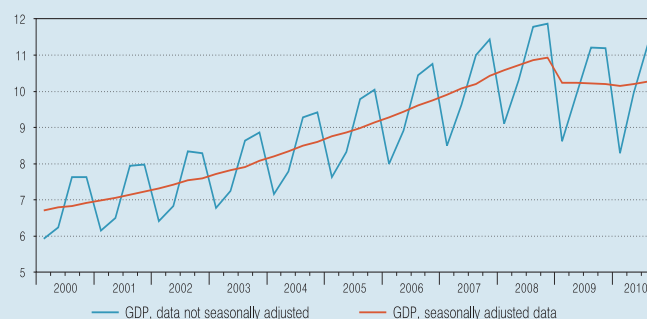
A typical example of seasonality is the higher GDP value in the third quarter of the year which reflects the favourable weather conditions for construction works, main agricultural activities and the active tourist season (see Figure 1). Disregarding the seasonality, it could be wrongly assumed that GDP drop in a given quarter compared with the previous quarter is due to weaker economic activity or that the increase in GDP in another quarter compared with the previous one exhibits an economic expansion.

In case of lack of seasonally adjusted data for offsetting the effect of seasonality, usually the change of the indicator on an annual basis against the respective period of the previous year is used. This comparison, though important in itself, conceals an important information about the dynamics of the indicator on a monthly basis and does not provide an unequivocal assessment of the economic performance. This problem may be illustrated using the example in Figure 2. It suggests that one and the same profile of the rate of change against the corresponding period of the previous year (the Chart on the right side at the bottom) may be a result of singularly radical trends in the monthly dynamics of the indicator (these changes are shown in the other three charts).

Seasonally adjusted series allow for a direct comparison of the dynamics between successive or random periods. From the point of view of the economic policy, the comparison with the preceding period (month or quarter) is most interesting because this way the latest information about current dynamics of the said indicator is obtained and correspondingly the timely information about trends in the economic development. After the NSI started publishing seasonally adjusted data, the current macroeconomic analysis at the BNB is based on these data due to their significant advantages.

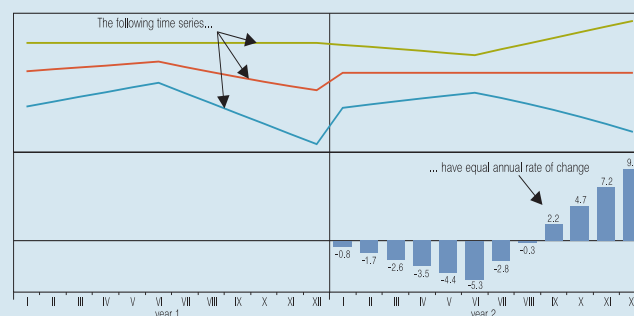
Figure 1
Adjusted and Non-adjusted GDP Data

(billion BGN; constant prices from 2000)



Source: NSI.

Figure 2
Interpretation of Changes (on an annual basis)



Government Finance and Consumption

The cash balance on the consolidated fiscal programme amounted to BGN -2783.4 million in 2010 which is BGN 478.7 million lower as compared to the deficit target in the Amendment to the State Budget Law (BGN 3262.1 million). The general government cash deficit, planned by the government for 2011, is 2.5 per cent of GDP.

Government consumption in the third quarter of 2010 had a close to zero contribution to GDP growth (seasonally adjusted data on the previous quarter) with a real change in individual and collective consumption of -0.2 per cent and -1.1 per cent respectively. In the last quarter of 2010 we expect considerable positive growth in government consumption given the high operating and healthcare expenditure. In line with the government spending policy approved for 2011, we expect negative real growth in government consumption in the first quarter of 2011 and positive, but close to zero, real growth in the second quarter.

The cash-based budget balance for the January – December 2010 period came to BGN -2783.4 million⁴. The budget deficit was financed mainly by drawing from the fiscal reserve (BGN 1661 million) and by net issue of government securities on the domestic market of BGN 850 million. Despite the stronger increase in operating costs and capital expenditure in December 2010, the deficit was BGN 478.7 million less than the targeted level in the Amendment to the State Budget Law (BGN 3262.1 million).

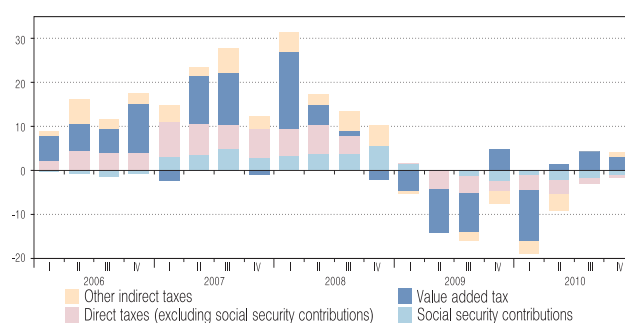
The total general government revenue came to BGN 23 932 million in 2010, which was 2.5 per cent less than the targeted level in the Amendment to the State Budget Law. Revenue declined by 4.4 per cent compared with 2009.

In the last two quarters of 2010 the downward trend in the annual rate of decline in revenue was retained in line with our expectations. After tax revenues have been declining since early 2009, it was only in the third quarter of 2010 when their annual growth turned positive. VAT revenue saw the strongest recovery, exceeding by 6.9 per cent the amount provided for in the Amendment to the State Budget Law for 2010 and completely offsetting the weaker performance of excise revenue, which reached 91.5 per cent of the annual target. Value added tax revenue contributed most (4.3 percentage points) to the increase in tax revenue already in the third quarter. This tax revenue saw the most pronounced increase in the last two months of 2010, possibly reflecting not only the increase in companies' turnover, but also somewhat slower VAT refund. Provided that such an assumption is relevant, the monthly volatility in VAT due to be refunded would result in relatively lower net receipts from VAT in the first several

months of 2011, despite the expected higher gross receivables.

Contribution of Major Tax Groups to Tax Revenue Growth under the Consolidated Fiscal Programme (quarterly on an annual basis)

(percentage points)



Sources: MF, BNB.

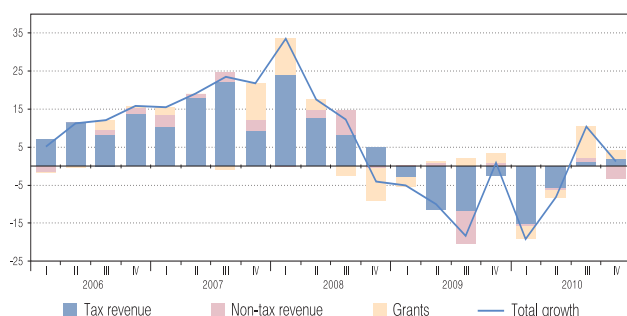
The rebound of direct taxes was weaker. In the third and fourth quarters of 2010 they saw a negative rate of change, but with a smaller negative contribution to the increase in tax revenue compared to the first half year. Overall, in 2010 profit taxes saw a sizeable decline of 23.2 per cent compared to the receipts in 2009. There was a significant deviation between corporate tax and gross operating surplus developments. The latter has traditionally been used as a macroeconomic basis for the respective tax. On the one hand, receipts from profit taxes are determined on the basis of the financial results of the corporations for the previous year and, hence, reflect gross operating surplus developments with a significant lag. On the other hand, gross operating surplus in the economy is not a very precise proxy for the taxable profit of corporations due to the inclusion of mixed income and depreciation costs in its scope, the different treatment of provisions for arrears and the possibility to write off past losses when estimating the financial result for tax purposes. These differences are more pronounced in periods of turndown in economic activity.

⁴ The analysis is based on preliminary monthly data of the Ministry of Finance about the implementation of the consolidated fiscal programme by end-December 2010.

The annual fall in receipts from income tax for individuals was marginal (-0.8 per cent). The improvement in the financial state of corporations observed mainly in export oriented sectors of the economy will contribute to the rebound of direct taxes. Receipts from social and health insurance contributions went down by 5.9 per cent in 2010, mostly as a result of the lower pension contributions (down 2 percentage points) and the fall in employment.

Contribution of Major Groups of Revenue to the Growth in Total Revenue and Grants (quarterly on an annual basis)

(%, percentage points)



Sources: MF, BNB.

Revenue from grants in 2010 reached BGN 1602 million (83 per cent of the levels provided for in the revised State Budget Law for 2010), reporting a sizeable increase of around 21 per cent compared to 2009.

In the third quarter of 2010 consolidated budget expenditure declined by 2.1 per cent on an annual basis, with capital expenditure contributing most significantly to this effect. This trend changed at the end of the last quarter of 2010. Total monthly expenditure in December 2010 was 57 per cent higher than the 2010 monthly average due to the significant rise in operating expenditure and investments. As a result, between January and December 2010 government expenditure (including also Bulgaria's contribution to the EU budget) increased by 4.6 per cent on an annual basis. Yet, budget expenditure for 2010 was 3.9 per cent lower than the target in the Amendment to the State Budget Law and contributed to the realization of lower than envisaged cash deficit.

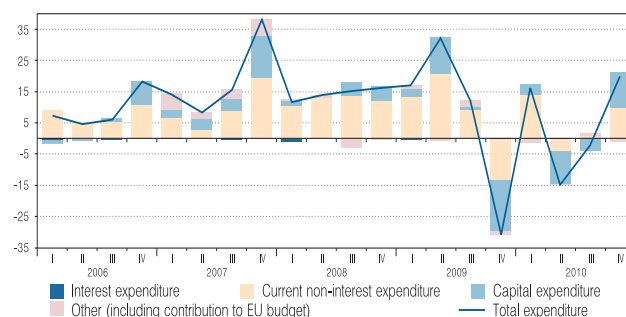
However, better than expected outturn in the cash balance should not necessarily be associated with an improvement in the projected deficit on an accrual basis⁵.

⁵ The first estimate of ESA'95 deficit will be available in April 2010. Its level for the first nine months of 2010 was BGN 1.3 billion or around 1.9 per cent of GDP.

Assuming that most of the unused budget funds in 2010 are part of the contingency reserve in the expenditure on covering prior year liabilities, they will not contribute to the improvement of the accrued balance. The sharp increase in VAT revenue in the last two months of 2010 might not be reflected in the 2010 accrued deficit, if it is associated with delayed VAT refunds.

Contribution of Major Groups of Expenditure to Total Expenditure Growth (quarterly, on an annual basis)

(%, percentage points)



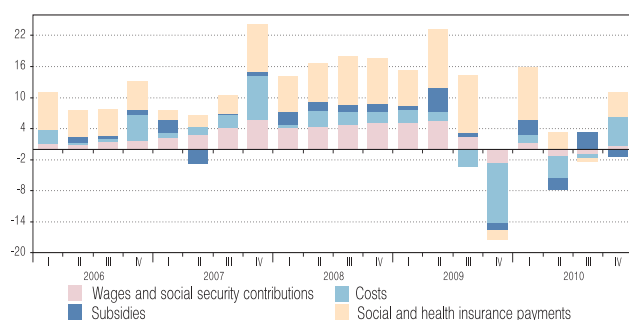
Sources: MF, BNB.

Compensation of employees in the government sector for 2010 exceeded the levels provided for in the Amendment to the State Budget Law for 2010 by 7.1 per cent and 6.4 per cent respectively. While in the third quarter of 2010 operating costs had a marginal negative contribution to non-interest expenditure growth, in the last months of the year their growth accelerated (37.2 per cent for the October – December 2010 period). Social and health insurance payments exhibited an opposing trend. This type of expenditure contributed most to the increase in current government expenditure in the first two quarters of the year, but once the base effect of pension indexation made in April and July 2009 was exhausted, they reported negative growth in the third quarter of 2010. In the fourth quarter of 2010 the downward trend in pension payments was sustained, while other social benefits and compensation funds, as well as healthcare expenditure marked a sizeable increase by the end of the year. This increase was largely attributable to the need for additional payments to cover the obligations of the National Healthcare Fund to hospitals. The increase in these expenses was underpinned also by the removal of the ceiling for unemployment benefits. As a result, social benefits and transfers for 2010 exceeded by more than 10 per cent the levels projected in the Amendment to the State Budget Law for

2010. The temporary measure of transferring the payment for the first three days of the employees' sick leave from the National Social Security Institute to the employers (to the amount of 70 per cent of their daily salary) will remain in force during 2011. Meanwhile, since early 2011 the periods on the basis of which the daily remuneration in the event of sickness or maternity leave is calculated shall be extended to 12 and 18 months respectively in order to limit abuses, upon receipt of such a compensation. Given the policy of pension and salary freezes, the increase in contributions of 1.8 percentage points and stricter eligibility criteria for receiving social benefits in 2011, net transfers from the general government to households will probably be less compared to those in 2010. Thus, the budget would have a more restrictive role on household disposable income in 2011.

Contribution of Major Groups of Current Non-interest Expenditure to Total Expenditure Growth (quarterly, on an annual basis)

(percentage points)

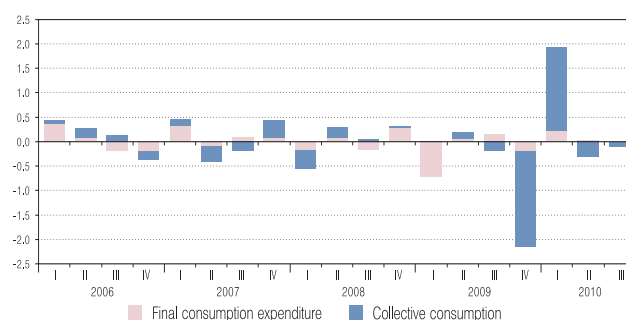


Sources: MF, BNB.

Despite the weak growth in current non-interest expenditure of 1 per cent on an annual basis in the third quarter of 2010, government consumption had a negative, albeit marginal, contribution to GDP growth compared to the previous quarter. The contribution of government consumption to GDP growth (0.04 percentage points in the third quarter of 2010) was largely determined by collective consumption developments. Given the higher maintenance and healthcare costs, we expect a sizeable positive increase in government consumption over the last quarter of 2010. In line with the government spending policy for 2011, we expect negative real growth in government consumption in the first quarter and a positive, but close to zero, real growth in the second quarter of 2011.

Contribution of Government Final Consumption Expenditure and Collective Consumption to Economic Growth

(percentage points)



Note: Quarter-on-quarter contribution to seasonally adjusted GDP Growth

Sources: MF, BNB.

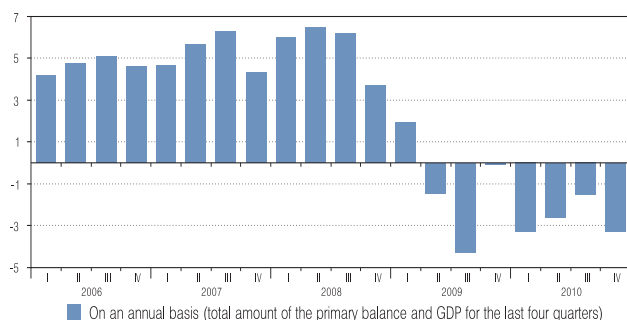
The low level of budget deficit in the third quarter of 2010 and the positive net government bond financing to the amount of BGN 755.7 million resulted in an increase in the fiscal reserve by BGN 682 million to a level of BGN 6711.0 million by end-September. This might have contributed to the government's decision to cancel the auction of 15-year government securities, scheduled for 22 November 2010 and not to approve bids above the bidding limit set for all auctions by the end of 2010. In the fourth quarter of 2010 investors preserved their interest in government securities market. The bid-to-cover ratio (the ratio between the total nominal value of the bids admitted to the auction and the total nominal value of the government securities offered) for the period reached 4.6. The demand for 10-year government securities⁶ picked up at the auction of 8 November 2010, when investors' bids exceeded six-and-a-half times the quantity offered by the Ministry of Finance.

The positive net issue of government securities to the amount of BGN 173.7 million in the fourth quarter of 2010 was not enough to finance the negative budget balance for the period (BGN -1266 million) which resulted in a decrease in the fiscal reserve of BGN 6012 million at the end of the review year.

⁶ On 8 November 2010 the Ministry of Finance offered for sale treasury bonds with a maturity of ten years and six months and an annual coupon of 5 per cent. The nominal value of bids submitted by investors reached BGN 162.4 million, but the bids approved by the Ministry of Finance amounted to BGN 25 million.

Primary Balance (Quarterly)

(percentage of GDP)



Note: Data for the fourth quarter of 2010 are based on GDP projections for this period.

Sources: MF, BNB.

The second half of 2010 and early 2011 saw a downward trend in the average annual yield of government securities with a maturity of 10 years and six months issued at the primary market and used as a basis for calculating the long-term interest rate for assessing the degree of convergence, which is one of the Maastricht criteria for adopting the euro. At the primary auctions of June, July and November 2010, this yield was 6.15 per cent, 6.10 per cent and 5.81 per cent respectively, while the level reached at the auction in January 2011 was 5.49 per cent.

Investor interest in domestic government bond market and respectively the decline in the average yield attained at primary auctions enabled the government to finance budget deficit by funds generated in the domestic government securities market. At the end of the first quarter net domestic government securities financing was around BGN -87.8 million, while at the end of 2010 it reached nearly BGN 850 million. Government bonds issued in the domestic market totalled BGN 1508.1 million for 2010.

The primary market developments also affect the ever increasing liquidity on the secondary government securities market. In November the ratio between the volume (in levs) of registered government securities transactions and those in circulation reached its peak since the beginning of the year: 1.91 against an average level of approximately 0.6 in the first three months of 2010.

The issuing policy of the Ministry of Finance for 2011⁷ projects a positive net domestic financing

⁷ Please refer to *Issuing policy of the Ministry of Finance for 2011* available on the website of the Ministry of Finance.

of around BGN 430 million, with the gross amount of the government securities issued in the domestic market coming to around BGN 1 billion.

The share of government securities issued in the domestic market in banks' portfolios continued to increase in the fourth quarter of 2010. At the end of 2010 credit institutions owned government securities of BGN 2176 million, which is 24.3 per cent more compared to end-2009 and 4.3 per cent more compared to end-September 2010. Higher demand for government securities was not due to the needs of budget servicing banks to have sufficient government securities holdings to secure budget balances on these accounts. This was confirmed by the analytical reporting of Monetary Financial Institutions (excluding BNB), which showed that by the end of 2010 bank holdings of Bulgarian government securities, including global bonds, were around BGN 1.62 billion or 48.8 per cent higher than the amount required to secure cash on budget entities' accounts with them.

The third and fourth quarters of 2010 saw no signs of the effect of crowding out of the private sector from the credit market as a result of the active issuing policy of the government. Credit institutions liquidity ratio continued to improve in the third quarter of the review year, with banks using their free resources mainly to repay foreign liabilities and invest in government bonds issued by the Bulgarian government.

In the first quarter of 2011 we expect higher VAT revenue compared to the corresponding period in 2010 due to higher government expenditure in December 2010. The increase in the contribution to the Pension Fund by 1.8 percentage points will have a favourable effect on the revenue from social contributions in the first two quarters of 2011. We do not expect significant changes in the other revenue items compared to the first half of 2010.

In the first and second quarters of 2011 government expenditure is expected to remain close to its level of the corresponding period in 2010. Social payments will probably be lower than last year's levels due to the stricter eligibility criteria for limiting social fund abuses in force since early 2011.

Overview of 2011 Budget Laws

On 2 December 2010 the Parliament approved the 2011 State Budget Law of the Republic of Bulgaria, which provides for a cash deficit on the consolidated fiscal programme amounting to BGN 1963 million or 2.5 per cent of the nominal GDP projected by the Ministry of Finance. On an accrual basis, the deficit for 2011 expected by the Ministry of Finance is 2.5 per cent of GDP: down by 1.1 percentage points compared with the preliminary estimate of this indicator for 2010¹.

In 2011 the government plans no significant changes in its tax policy. Tax revenue included in the 2011 State Budget Law of the Republic of Bulgaria is 8.8 per cent higher than that received in the previous year. The main contributor to this are the expected higher revenue from social and health insurance contributions (by 15.6 per cent) due to a great extent to the increase in pension contributions by 1.8 percentage points. Significant increases in corporate and indirect tax revenue by 25.8 per cent and 4.5 per cent respectively are also anticipated compared with the implementation of the 2010 budget. Almost a quarter of the projected total government revenue growth (9.5 per cent) results from BGN 623 million higher grants.

During the current year total government expenditure (including the contribution of Bulgaria to the EU budget) is projected to rise by BGN 1.5 billion on 2010, while as a percentage of GDP it is expected to decrease by 0.7 percentage points. The most significant increase is that of operating expenditure and subsidies which are expected to be higher by 7 per cent and 19.6 per cent respectively on the previous year. Social expenditure and scholarships are close to their levels in the implementation of the BNB budget for 2010. Among current non-interest expenditure, only government wages are projected to be BGN 182 million lower as compared to 2010.

According to the 2011 State Budget Law of the Republic of Bulgaria, the deficit of the consolidated fiscal programme should be financed mainly by issuing government securities in international markets to the amount of BGN 2000 million. This would allow to maintain the fiscal reserve at its end-2010 level. However, the additional parameters laid down in the Law, provide for financing of the deficit without resorting to government securities issuance in international markets. One of the funding sources is the fiscal reserve with a set minimum of BGN 4.5 billion as of 31 December 2011 which enables the government to use some BGN 1.5 billion for budget deficit financing. Another source is the foreseen realisation of receipts from privatisation coming to BGN 450 million. A third source is the net issue of government securities in the domestic market which in accordance with the document 'Issuing Policy of the Ministry of Finance in 2011' is planned to come to around BGN 430 million.

In the 2011 State Budget Law of the Republic of Bulgaria, the government debt maximum amount for 2011 is envisaged to come to BGN 14.6 billion (against 12.5 billion in 2010) while new debt issuance throughout 2011 should not exceed BGN 3.9 billion. The amount of the new government guarantees that can be undertaken by the government is BGN 0.46 billion, while the minimum amount of the fiscal reserve as of 31 December 2011 is projected at BGN 4.5 billion.

For the first time, the Law on the State Budget provides for a maximum level of outstanding liabilities to suppliers to the amount of BGN 556.4 million (0.7 per cent of projected nominal GDP) by end-2011 (Article 17 of the 2011 State Budget Law of the Republic of Bulgaria). These obligations are included in the consolidated deficit under ESA'95 methodology and are one of the main factors explaining the difference between the budget cash balance and the balance on an accrual basis. Consequently, upon realisation of the cash deficit set at 2.5 per cent of GDP, at the end of the year the undertaken but unpaid obligations to suppliers will not contribute to the size of the cash accrual deficit adjustment.

Under the 2011 State Budget Law of the Republic of Bulgaria, at the end of 2010 deposits of the National Health Insurance Fund with the BNB were transferred *ex officio* by the Bank to the central government's budget account. The operation was reported as a transfer to the central budget that does not affect the budget balance under the consolidated fiscal programme².

With the changes in the Social Security Code adopted on 9 December 2010, as of 1 January 2011 the funds available in professional pension funds in the name of individuals engaged in first and second category labour and subject to retirement over the 1 January 2011 to 31 December 2014 period shall be transferred to the Pension Fund of the National Social Security Institute until 31 March 2011. The transfer of the funds of the professional pension funds will most probably be reported as a one-off capital income under the ESA'95 methodology that should be excluded when calculating Bulgaria's structural deficit. As a result of the change, there will be additional revenue from the social insurance contributions of those who will retire over the 2011–2014 period. NSSI's expenditure on pen-

¹ A preliminary budget deficit estimate for 2010 of the Ministry of Finance according to ESA'95 has been used. The first official statistics will be published by the NSI in April 2011.

² For details about the effect of the transfer on the money, see here the *Monetary Aggregates* and *Credit Aggregates* subsections of Section 2.

(continued)

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sions will increase by the expenditure on the pensions of these individuals till they reach the general retirement age (three years and eight years for first and second category labour respectively) and by the one-off payments, receivable in cases of death before retirement or in cases when the option for retirement was not used.

On 29 November 2010 the Parliament adopted the 2011 Law on the Social Security Budget which envisages revenue from social insurance contributions amounting to BGN 4043 million: up by BGN 373 million compared to the projected revenue in the report to the draft of the 2011 State Budget Law of the Republic of Bulgaria. The projected higher receipts result from the 1.8 percentage point increase in pension contributions since 1 January 2011.

The temporary measure of transferring the obligation of the payment for the first three days of the employees' sick leave from the National Social Security Institute to the employers was retained. In compliance with the Amendments to the Social Security Code, the employer has to pay to the ensured employee for the first, second and third business days of his temporary disability 70 per cent of his average daily gross remuneration for the month in which the disability occurred but not less than 70 percent of the average daily agreed remuneration. Being temporary, this measure is unlikely to be included in estimating the structural deficit under ESA'95.

According to the 2011 State Budget Law of the Republic of Bulgaria, total government revenue is expected to increase by 0.6 percentage points of the nominal GDP, projected by the Ministry of Finance, as compared to actual revenue performance in 2010. The expected revenue growth reflects mainly the projected higher receipts from social and health insurance contributions, corporate tax and grants. There exists, however, a certain risk to the implementation of this revenue. The expected effect of the increased contribution to the Pension Fund by 1.8 percentage points does not usually incorporate the concomitant worsening of tax collection which is likely to lead to non-performance of the envisaged 15.6 per cent higher revenue from health and social insurance contributions compared with the previous year. The projected rise in the corporate tax revenue could also turn out to be too optimistic given the moderately improved economic activity and gross operating surplus and the legally provided opportunity of firms to deduct their accumulated losses from their profits for the next five years. Despite the anticipated significant increase in the revenue from grants in 2011, the risks of non-performance of the estimates are moderate, assuming that the government will be able to preserve the accelerating rate of EU funds absorption that was observed in 2010. There is a risk of exceeding or revising the funds planned in the 2011 State Budget Law of the Republic of Bulgaria *vis-à-vis* investment expenditure that is expected to report a minimum rise on 2010. The foreseen increase in absorption of EU funds for infrastructure projects would lead to a rise in government expenditure on project co-financing and, hence, in budget capital expenditure.

Consolidated Fiscal Programme

(million BGN)

	Implementation 2010	Budget 2011	Annual change, %	Difference, million BGN
Total revenue	23 931.9	26 208.5	9.5	2276.6
Tax revenue	19 008.8	20 687.7	8.8	1678.9
Corporate taxes	1 353.4	1 702.6	25.8	349.2
Income tax for individuals	2 012.7	2 092.4	4.0	79.7
Value added tax	6 267.1	6 480.0	3.4	212.9
Excise duties	3 567.9	3 800.0	6.5	232.1
Customs duties	119.2	100.0	-16.1	-19.2
Insurance premia tax	0.0	20.0	-	20.0
Revenue from social insurance and health insurance	4 964	5 740.3	15.6	776.0
Other taxes	724.2	752.3	3.9	28.0
Non-tax revenue	3 320.6	3 306.1	-0.4	-14.5
Grants	1 602.5	2 214.7	38.2	612.2
Total expenditure and contribution to the EU budget	26 715.4	28 171.5	5.5	1456.2
Current non-interest expenditure	22 011.4	22 476.8	2.1	465.4
Salaries	4 064.6	3 882.0	-4.5	-182.6
Social and health insurance contributions	982.8	1 001.3	1.9	18.4
Operating expenditure	4 470.5	4 783.1	7.0	312.7
Subsidies	1 490.6	1 782.3	19.6	291.7
Social expenditure and scholarships	11 002.9	11 028.1	0.2	25.2
Capital expenditure and growth in reserves of the general government sector	3 548.2	3 694.8	4.1	146.6
Reserves for contingent and urgent expenses	0.00	527.4	-	-
Interest	486.0	661.1	36.0	175.1
Contribution to the EU budget	669.7	811.5	21.2	141.7
Budget balance (+/-)	-2 783.4	-1 963.0		820.4
GDP (MF forecast)	71 726.4	77 076.7		

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Share of GDP	2010, %	2011, %	Difference, p.p.
Total revenue	33.4	34.0	0.6
Tax revenue	26.5	26.8	0.3
Non-tax revenue	4.6	4.3	-0.3
Grants	2.2	2.9	0.6
Total expenditure and contribution to the EU budget	37.2	36.5	-0.7
Current non-interest expenditure	30.7	29.2	-1.5
Capital expenditure	4.9	4.8	-0.2
Interest	0.7	0.9	0.2
Contribution to the EU budget	0.9	1.1	0.1
Budget balance, on a cash basis	-3.9	-2.5	1.3

Source: MF.

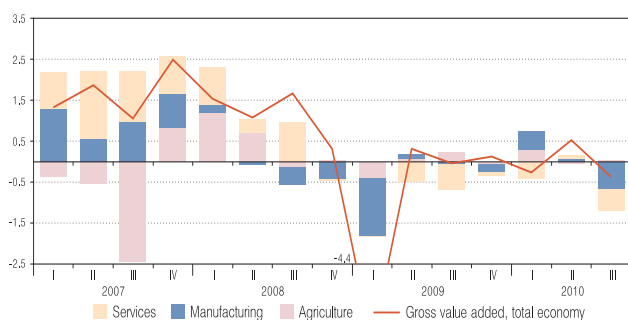
Behaviour of Firms and Competitiveness

Despite the strong export activity, the economic recovery was still hampered by some factors related to domestic demand. The financial performance of companies remained favourable from macroeconomic point of view. Recovery processes had a key role to this development in industry, while in the other sectors, the effective policy of inventories and labour expenditure management was of great importance.

Value added generated in the third quarter of 2010 fell by 0.4 per cent on the previous quarter. These developments should be interpreted as a sign for a continuous standstill in economic activity, reflecting the still negative balance between domestic and external demand.

Value Added Growth and Contribution by Sector

(%; quarter-on-quarter percentage points)



Note: Non-additive contributions due to direct chain-linked volumes and seasonal adjustment of gross value added and its components.

Sources: NSI, BNB.

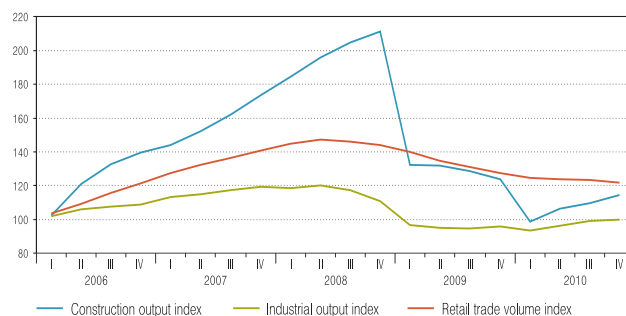
Value added growth in industry remained weak, despite the stronger export sales and the recovery in the positive growth in domestic market sales. This was due to manufacturing with large intermediate consumption such as energy, metallurgy, oil processing, foods, beverages and tobacco products, at the expense of those with higher value added such as the production of investment and durable consumer goods where domestic demand remains subdued.

After the positive growth in the second quarter, in the value added in construction there was another decline, despite the overall favourable dy-

namics in construction output. There were divergent developments in the sector. Production activity in civil and engineering construction continued to improve, while building construction reported further contraction, which might be the reason behind the decrease in value added. Building permits issued in the third quarter of 2010 are still for a relatively small unfolded build-up area compared to the pre-crisis levels. Since there is still no trend of recovery, there are no reasons to expect significant revival in building construction in the near future.

Indices of Industrial Production, Construction and Retail Trade Volume

(2005 = 100 at constant prices; seasonally adjusted data)



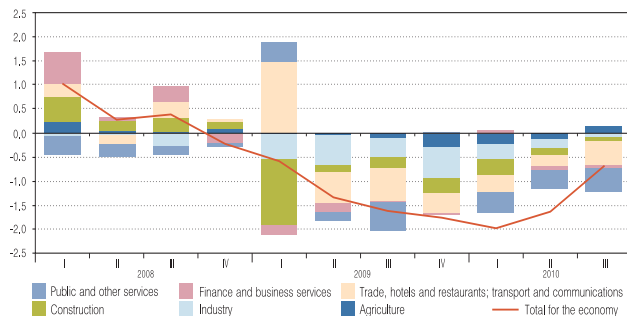
Sources: NSI, BNB.

The subdued domestic demand continued to adversely affect trade, hotels and restaurants, transport and communications. Short-term business statistics data gave a more detailed sector information and showed an improvement in transport and communications. In contrast, in hotels and restaurants, as well as in domestic trade, the turnovers continued to be in a standstill or continued to fall.

In the third quarter of 2010 the companies continued to cut employment, but at a significantly lower rates. The group of trade, hotels and restaurants, transport and communications, where the rate of decline of employment accelerated, was an exception.

Contribution to Changes in the Number of Employed by Economic Sector

(%; quarter-on-quarter percentage points, seasonally adjusted data)



Note: Non-additive contributions due to direct seasonal adjustment of the total amount and its components.

Sources: NSI, BNB.

The increasing level of unemployment over the recent months made it possible for the firms to reduce their labour costs not only by staff redundancies but also by wage cuts. Given the decline or the moderation in productivity growth, measured with the value added *per* employee, this is a justified strategy. This trend is observed mainly in industry and construction, as well as in some services.

Labour Productivity Developments (value added *per* employee)

(%, quarter-on-quarter; seasonally adjusted data)



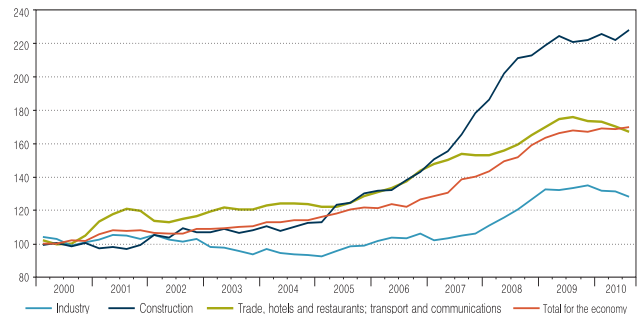
Sources: NSI, BNB.

Thus, in industry and services there was no deterioration in cost competitiveness, and the gradual downward trend in nominal unit labour costs remained sustained. Flexible labour costs management in industry even allowed manufacturers to reduce also real labour costs, i.e. to increase the share of value added, which remains in the firm as an operating surplus and strengthens its

financial standing. The wage cuts in construction were insufficient to prevent the worsening in cost competitiveness against the background of weak production results and the strong deflation in the sector.

Nominal Unit Labour Costs

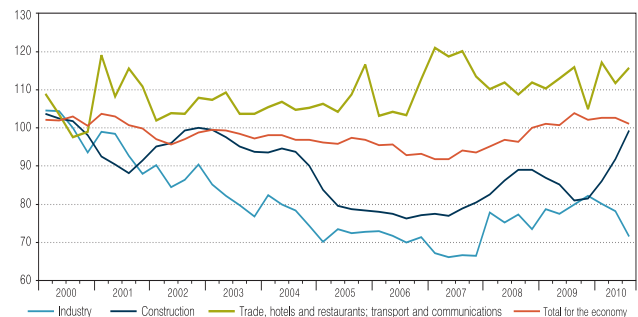
(2000 = 100; seasonally adjusted data)



Sources: NSI, BNB.

Real Unit Labour Costs

(2000 = 100; seasonally adjusted data)



Sources: NSI, BNB.

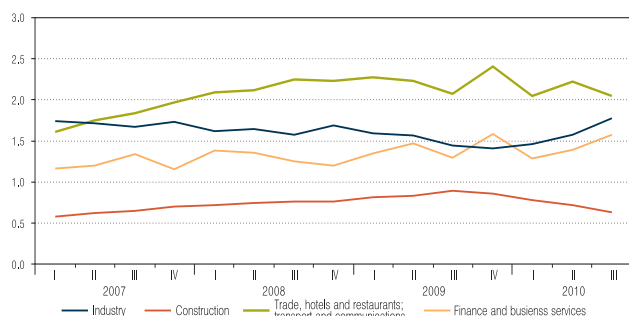
Overall, firms managed to keep their financial performance stable. The gross operating surplus in manufacturing continued to increase in value. Financial and business services also saw favourable developments. Gross operating surplus in trade, hotels and restaurants, transport and communications remained relatively unchanged, while in construction it continued to decline. Despite the divergent developments in gross operating surplus in value by economic activity, output profitability, as measured by the gross operating surplus/output ratio, remained favourable and stable in all sectors.

Available data for the fourth quarter of 2010 do not show sharp changes in companies' economic activity. The upward trend in manufacturing was sustained, driven not only the enhanced export growth, but also by a gradual increase in domestic demand mainly for intermediate consumption products. Total output in construction also recovered moderately with a levelling in the decline in building construction in the fourth quarter. The

turnover index in retail trade continued to decline, mostly due to the trade in durable non-food goods such as clothes, equipment and household appliances.

Gross operating surplus at current prices

(billion BGN; seasonally adjusted data)



Sources: NSI, BNB.

Exports and Imports of Goods

In the first and second quarters of 2011 exports and imports are expected to continue growing on an annual basis. The growth rate of exports will moderate due to slower external demand and a lower increase in international prices. Export growth rates will again outstrip those of imports and trade deficit will remain close to nil.

Exports of goods recorded a positive growth rate of 33.0 per cent in 2010 compared with 2009, reflecting the higher external demand and international prices. The growth rate of imports was also positive (13.1 per cent) due mainly to higher international prices. In December 2010 exports increased by 45.0 per cent and imports by 28.3 per cent on an annual basis.⁸

In the first and second quarters of 2011 exports are expected to sustain its positive growth on an annual basis, although somewhat moderate due to slower external demand and a lower increase in international prices. Imports are also expected to continue to report positive growth as a result of the recovery in domestic demand.

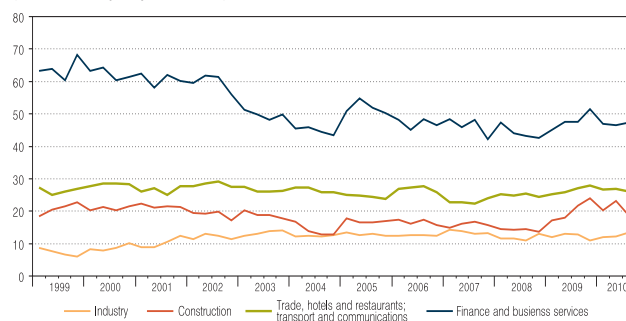
Trade deficit contracted by EUR 1772.5 million in 2010. This dynamics was largely due to the increase in net exports of investment goods and raw materials between January and November 2010. Exports of investment goods increased on January to November 2009, while imports reported a negative growth rate, moderating gradually and reaching positive territory in October and

⁸ The analysis presented in this section is based on data on nominal exports and imports in euro.

Survey data on the different sectors show an improvement in the business climate in industry and services at the end of 2010 and in early 2011. The estimates in trade and construction stabilized, but at relatively unfavourable levels, which indicates significant risks related to the velocity of business activity recovery.

Operating Surplus/Gross Output

(%; seasonally adjusted data)



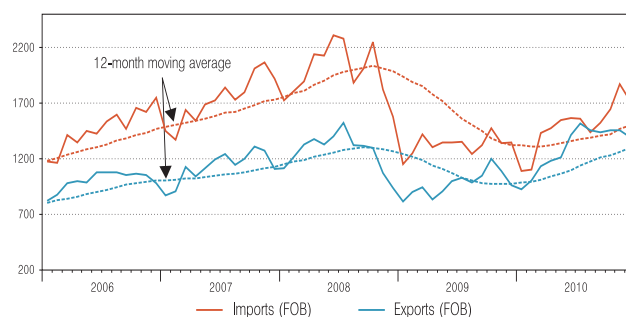
Sources: NSI, BNB.

November. In the raw material group, both exports and imports reported positive annual growth rates, though the exports growth rate was higher than that of imports.

Between January and November 2010 all commodity groups contributed to the positive growth of exports, with *base metals and their products* (8.4 percentage points), *machines, transport facilities and appliances* (6.4 percentage points), *mineral products and fuels* (4.9 percentage points), *animal and vegetable products, foods, drink and tobacco* (4.9 percentage points) and *chemicals, plastics and rubber* (3.4 percentage points) contributing most significantly to this.

Dynamics of Exports and Imports

(million EUR)

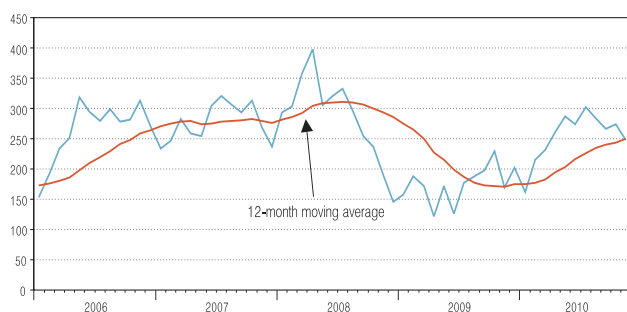


Source: BNB.

Over the review period exports of base metals and their products increased by EUR 906.3 million: up 47.8 per cent on an annual basis. Most items in this group reported an increase reflecting mainly high international metal prices. The items contributing most significantly to this dynamics were: *copper and articles thereof* (26.9 percentage points), *iron and steel* (10.1 percentage points) and *aluminium and articles thereof* (3.7 percentage points). In the first two quarters of 2011 exports of base metals and their products are expected to continue to report positive growth, albeit moderating as a result of the lower external demand and the slowdown of the upward price dynamics.

Exports of Base Metals

(million EUR)

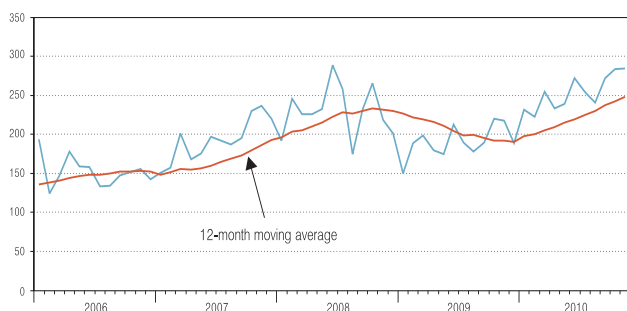


Source: BNB.

Between January and November 2010 exports of machines, transportation vehicles and appliances reached EUR 2788.1 million: an increase of 32.8 per cent on the corresponding period of the previous year. *Nuclear reactors* (10.3 percentage points), *electrical machinery and equipment* (10.1 percentage points), *vehicles* (5.6 percentage points) and *optical measuring and control instruments* (2.2 percentage points) contributed to the increase. Over the projection horizon export growth rate is expected to moderate due to weaker external demand.

Exports of Machines, Transportation Vehicles and Appliances

(million EUR)

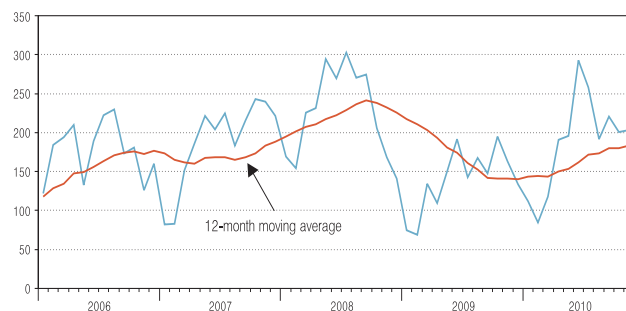


Source: BNB.

Over the review period exports of mineral products and fuels increased by EUR 521.8 million (33.7 per cent) on the corresponding period of the previous year. *Mineral fuels and mineral oils* (32.3 percentage points) contributed most to this increase, reflecting the increase in international fuel prices. In the first and second quarters of 2011 this trend is expected to slow down both as a result of weaker external demand and the moderate increase in fuel prices.

Exports of Mineral Products and Fuels

(million EUR)

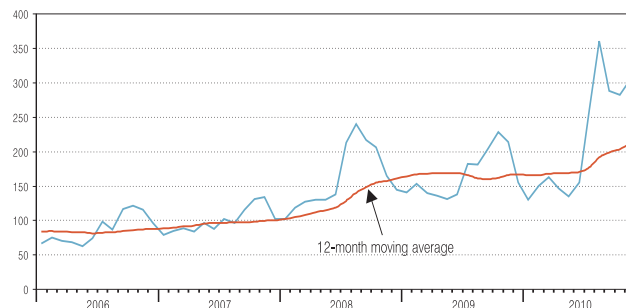


Source: BNB.

Between January and November exports of *animal and vegetable products* reported an increase of EUR 525.5 million: up 28.4 per cent compared with the same period of 2009, due mainly to the rise in *cereals* (9.7 percentage points) underpinned by the growth in export volumes between July and November. The items contributing most significantly to this dynamics were: *oil seeds and fruit* (5.6 percentage points), *sugars and sugar confectionary* (2.1 percentage points) and *cocoa* (1.9 percentage points). Exports of goods from this group are expected to increase further over the projection horizon.

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

(million EUR)



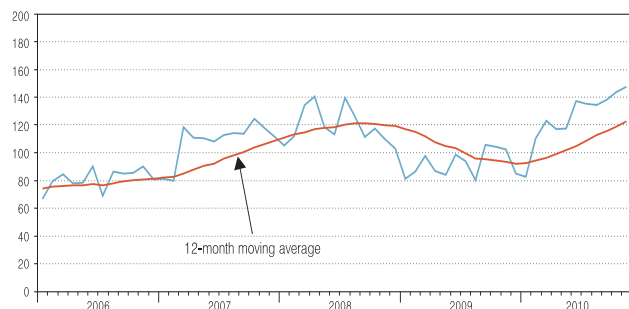
Source: BNB.

Exports of chemicals, plastics and rubber came to EUR 1386.7 million, posting an increase of 35.8 per cent on the January – November 2009

period. *Pharmaceutical products* (11.2 percentage points), *fertilizers* (6.9 percentage points), *plastics and articles thereof* (5.2 percentage points), *inorganic products* (5.1 percentage points) and *rubber and articles thereof* (3.0 percentage points) contributed most to this growth. In the first two quarters of 2011 we expect lower export growth in this group due to weaker external demand.

Exports of Chemical Products, Plastics and Rubber

(million EUR)



Source: BNB.

Contribution of Commodity Groups to Trade Growth, January – November 2010

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	19.1	5.4	8.9	1.8
Raw materials	36.2	15.4	17.0	5.8
Investment goods	38.2	6.2	-2.4	-0.6
Energy resources	37.4	4.8	23.7	4.7
Growth, total	31.9		11.8	

Source: BNB.

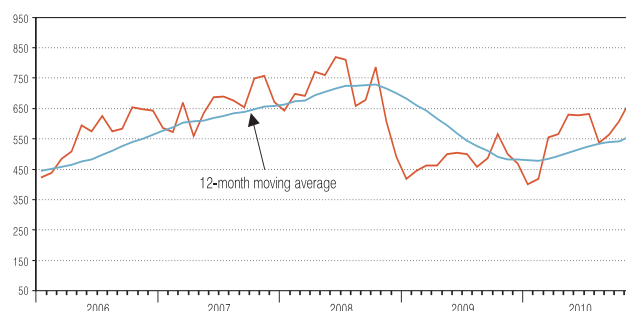
Between January and November 2010 imports (CIF) reached EUR 17 278.6 million: an increase of 11.8 per cent (EUR 1826.9 million) on an annual basis. The individual groups by end use with positive contribution to this increase were *raw materials* (5.8 percentage points), *mineral fuels, oils and electricity* (4.7 percentage points) and *consumer goods* (1.8 percentage points). Investment goods had a negative contribution of -0.6 percentage points.

Over the review period imports of raw materials increased by 17.0 per cent on the corresponding period of the previous year, reaching EUR 6202.7 million. This development reflected the contribution of *other metals* (3.6 percentage points), *ores* (3.6 percentage points), *plastics and rubber* (2.8 percentage points), *iron and steel* (2.2 percentage points) and *chemicals* (1.8 percentage points). The only item with negative contribution was that of *textiles* (-0.3 percentage points). The increase

reflected higher metal prices. Over the projected horizon growth is expected to remain positive due to domestic demand recovery.

Imports of Raw Materials

(million EUR)

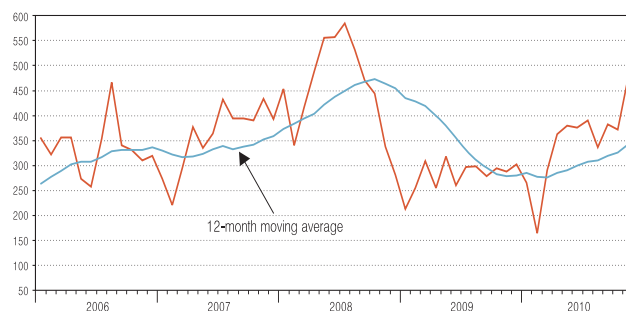


Source: BNB.

As a result of higher international fuel prices, imports of mineral fuels, oils and electricity went up by EUR 726.1 million (23.7 per cent) compared to the January – November 2009 period. *Crude oil and natural gas* (14.3 percentage points) and *oils* (9.4 percentage points) contributed most to this increase. *Coal* (-0.4 percentage points) had a negative contribution. As a result of higher domestic demand, we expect that the imports of this group will continue to increase, but this growth will be limited somewhat by the easing in the upward fuel price dynamics.

Imports of Energy Resources

(million EUR)



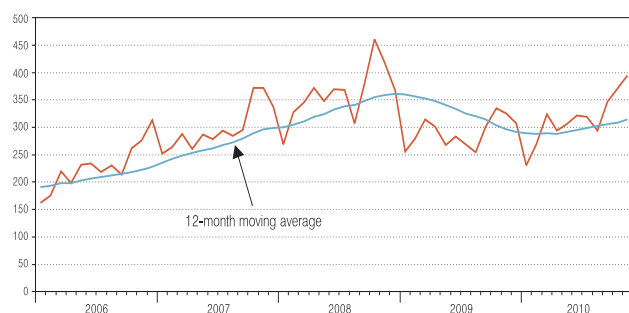
Source: BNB.

Over the January to November 2010 period imports of consumer goods saw an increase of 8.9 per cent, reaching the nominal value of EUR 3470.0 million. Clothing and footwear whose imports increased despite the lower prices compared to the corresponding period in 2009 contributed most significantly to this dynamics (4.8 percentage points). *Medicines and cosmetics*, as well as *others* also had a strong contribution of 2.0 and 1.7 percentage points respectively. Growth in consumer goods imports is expected

to continue to improve in the first two quarters of 2011 due to the rise in domestic demand.

Imports of Consumer Goods

(million EUR)



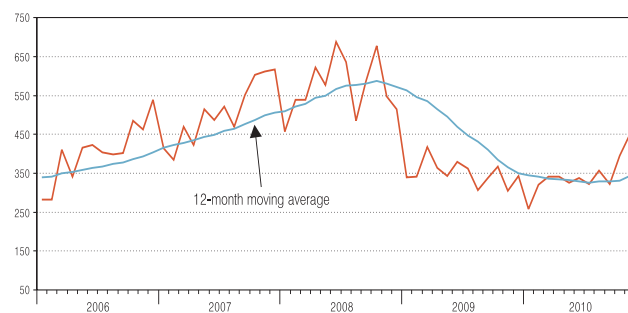
Source: BNB.

Over the review period imports of investment goods went down by EUR 92.8 million (-2.4 per cent), reaching EUR 3770.2 million. The pace of decline gradually decelerated on an annual basis, turning positive in October and November. The largest contribution in absolute value was that of *machines and equipment*: -4.6 percentage points. The items *others* and *vehicles* had a negative contribution of -2.2 and -0.5 percentage points respectively. *Spare parts and equipment* had the most pronounced positive contribution of 4.1 percentage points. Over the projection horizon their growth rate is expected to improve as a result of

the positive rate of increase in investment activity in Bulgaria.

Imports of Investment Goods

(million EUR)



Source: BNB.

Over the January to November 2010 period Bulgarian exports to other EU Member States picked up by 23.9 per cent on an annual basis, while exports to non-EU countries increased by 46.7 per cent. Imports from EU Member States increased by 8.0 per cent and that from non-EU countries by 8.3 per cent.

Between January and November 2010 the market share of Bulgarian goods in total imports of EU Member States came to 0.64 per cent compared to 0.69 per cent in the corresponding period of the prior year.

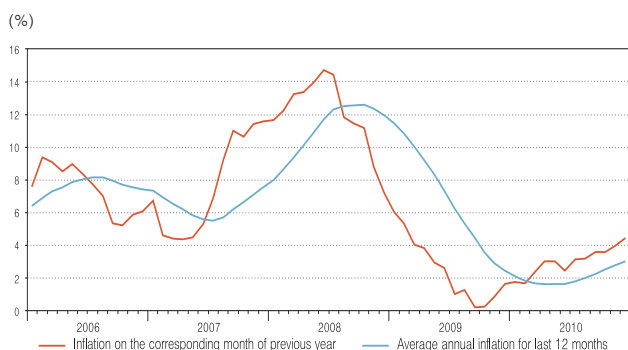
4. Inflation

In 2010 a trend towards accelerating inflation was observed, with accumulated inflation reaching 4.4 per cent by end-year (1.6 per cent in 2009). Significant world energy and farm produce price rises which directly affected fuel and food end-use consumer prices in Bulgaria and the raised tobacco products excise duties were the main factors behind this dynamics.

During the first half of 2011 a gradual slowdown in the overall inflation rate is expected (provided oil price remains under USD 100 *per barrel*) that will be underpinned in the second quarter by a decrease in tobacco prices inflation due to retained excise duties this year. The current upward dynamics of world oil and food prices poses risks of higher annual inflation.

In 2010 a trend towards accelerating annual inflation was observed: by end-year accumulated inflation reached 4.4 per cent (up 3 percentage points on December 2009). The average annual inflation in 2010 accounted for 3 per cent.¹

Inflation



Source: NSI.

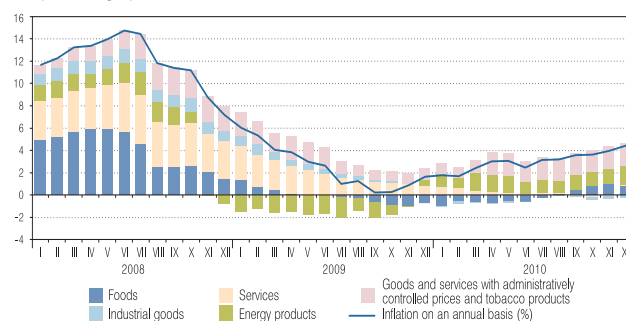
The main driver of this upward inflation dynamics were external factors related to the international commodity market developments. Over the year oil and farm produce prices reported significant rises that directly affected transport fuel and food end-use consumer prices and thus impacted inflation in Bulgaria. Raised tobacco products excise duties and the increase in some administratively controlled prices were also key pro-inflationary factors during the year. Energy products, tobacco products, foods and administratively controlled prices were the components with the highest contribution to inflation as of end-2010 by 1.7 percentage points, 1.3 percentage points, 0.8 percentage points and 0.7 percentage points respectively.

¹ The analysis in this section is based on NSI data on HICP.

Core inflation including non-food prices (fuels excluded) and services prices had no significant effect on overall inflation (a total contribution of -0.1 percentage points by end-2010 and a 0.1 percentage point contribution to average annual inflation). These groups' price dynamics was impacted by reduced consumption and the measures of firms aimed at cutting expenditure (e.g. salary spending). On the other hand, raw materials price falls at the close of 2008 and in 2009 did not push down the prices of non-foods (excluding fuels) and services which probably shows that during this period producer firms accumulated financial resources that allowed them to keep prices unchanged in 2010. As a result, core inflation dynamics was not affected by the accelerating rises in producer prices on the domestic market, and no significant indirect effects of food and fuel appreciation on the rest of the components in the consumer basket were observed.

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

(%, percentage points)



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 elementary aggregates in the consumer basket.

Sources: NSI, BNB.

Given that in the first half of 2011 oil price remains under USD 100 *per barrel*, a gradual moderation in annual overall inflation rate is expected. During the second quarter this moderation will be underpinned by the decrease in inflation of tobacco products prices stemming from their retained excise rates this year. The current upward dynamics of world oil and food prices poses risks of higher annual inflation. The increase in the price of electricity for households since the start of the third quarter of 2011, which is being discussed by the State Energy and Water Regulatory Commission, related to inflation accumulated during the previous year as well, creates additional inflation expectations in Bulgaria.

Core inflation is projected to start going up slowly with the anticipated gradual recovery in domestic demand in the first half of 2011; however, it will remain relatively low.

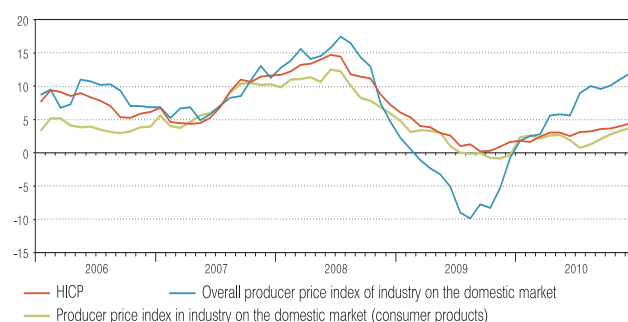
Producer prices in industry in the domestic market and the business situation survey data provide current information about the change in the consumer prices in the next months.

The pronounced upward price dynamics in international commodity markets over the past year played a key role in accelerating producer price inflation that reached 12.0 per cent by end-2010 against -0.7 per cent on an annual basis in December 2009. The increase in the prices of electricity, heating and gas production and distribution also contributed to the rise in producer price inflation in Bulgaria. Inflation in the producer prices of consumer products (3.7 per cent as of De-

cember 2010 against 0.3 per cent at end-2009) stayed substantially lower than overall inflation in producer prices. At the same time the business situation survey data as of January 2011 show that, despite prevailing expectations of higher prices in industry, selling prices expectations in trade stay at relatively low levels, while those in the services sector are about price decreases.

Rate of Change of Producer Price Index in Industry and of Harmonised Index of Consumer Prices (HICP)

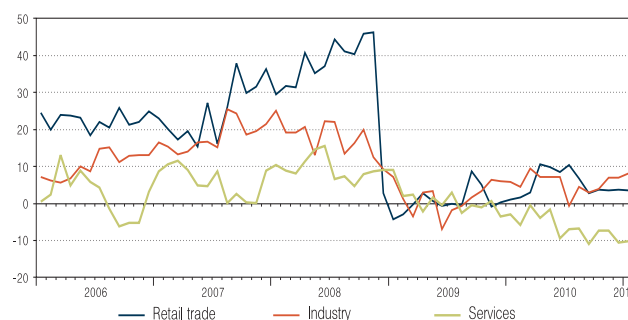
(on corresponding month of previous year, %)



Source: NSI.

Expectations of Selling Prices in Industry, Retail Trade and Services during the Next Three Months

(balance of opinions)



Sources: NSI, BNB.

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

	Accumulated inflation as of December 2009 (December 2008 = 100)		Accumulated inflation as of December 2010 (December 2009 = 100)		Annual inflation for 2010 (2009 = 100)	
Inflation (%)	1.6		4.4		3.0	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
Foods	-3.0	-0.73	3.9	0.84	-0.3	-0.09
Processed foods	-2.6	-0.39	5.7	0.74	0.6	0.07
Unprocessed foods	-3.6	-0.33	1.1	0.10	-1.6	-0.15
Services	2.9	0.88	0.2	0.07	0.6	0.19
Catering services	4.4	0.52	2.2	0.27	2.9	0.35
Transport services	-1.2	-0.06	-0.8	-0.04	-1.8	-0.09
Telecommunication services	-1.0	-0.04	-1.3	-0.05	-0.8	-0.03
Other services	4.9	0.46	-1.1	-0.11	-0.5	-0.05
Energy products	6.4	0.49	18.7	1.74	15.3	1.33
Transport fuels	8.2	0.54	20.5	1.71	17.3	1.45
Industrial goods	0.0	-0.01	-1.0	-0.19	-0.6	-0.11
Goods and services with administratively controlled prices	2.0	0.31	4.3	0.65	3.3	0.51
Tobacco products	23.9	0.69	33.9	1.33	32.8	1.21

Sources: BNB, NSI.

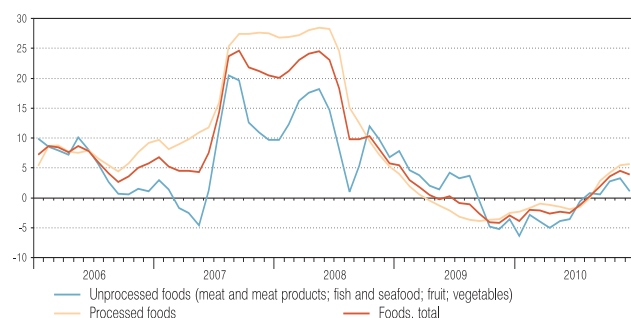
Food Prices

Food prices inflation accumulated by end-2010 came to 3.9 per cent: 5.7 per cent and 1.1 per cent for processed and unprocessed foods (meat and meat products, fruit, vegetables and fish) respectively. Vegetable oils, dairy products, bread and cereals, and vegetables had the highest contribution to overall inflation by the end of the year.

During the year food price dynamics was determined mainly by the significant rise in international farm produce prices and the increase in domestic agricultural prices, and their pass-through to end-use consumer prices. The highest price rises were registered by the products with a comparatively smaller degree of processing that are characterized by comparatively lower elasticity of demand. The increase in dairy products prices probably reflects an additional factor as well, related with the demand for higher quality products following the announced introduction of government quality standards; however, due to insufficient information, this effect cannot be evaluated precisely.

Rate of Change of Food Prices

(on corresponding month of previous year, %)



Sources: NSI, BNB.

Processed food price dynamics shows gradual moderation of monthly price growth rates (from 1.4 per cent and 2.5 per cent in August and September respectively to 1.1 per cent and 0.6 per cent in November and December respectively) with the downward trend being preserved for seasonally adjusted data as well.

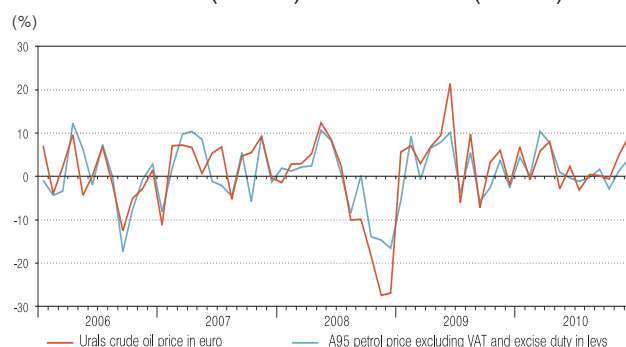
Provided the current trend towards increasing food prices is sustained, their annual inflation is anticipated to post a further rise in the first half of 2011. A base effect related to the lower food prices over the same period of the prior year will contribute to this. However, according to the State Commission on Commodity Exchanges and Market-places data, in January 2011 an acceler-

ating trend towards a rise in major food prices was observed which probably reflects the ongoing increase in farm produce prices in international markets or, for some products, it may result from a lag in the pass-through of the higher farm produce prices during the previous year. This information points to existing risks of a more significant increase in food price inflation.

Energy Products Prices

The upward trend in the price of oil, that started in 2009, continued in the last year as well. Oil price upward dynamics and the relatively fast pass-through to fuel prices in Bulgaria impacted considerably the increase in inflation in 2010.² By the close of the year energy products prices reported a rise of 18.7 per cent on the corresponding period of the prior year and had the largest contribution to accumulated inflation (1.7 percentage points).

Monthly Rate of Change in the Prices of Urals Crude Oil (in EUR) and A95 Petrol (in Levs)



Sources: U.S. Energy Information Administration, NSI, BNB.

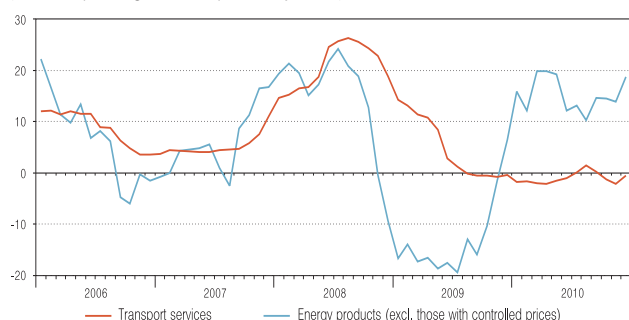
The dynamics of the prices of transport services (excluding those with administratively controlled prices) stayed significantly more moderate compared with the rising fuel prices. Accumulated inflation in passenger automobile transport by end-2010 was minimal (0.4 per cent) but in comparison with 2009, when a decline by some 1 per cent was reported, a gradual increase in the prices was observed in the course of the year. The relative downward rigidity of transport services prices in the case of fuel price probably allows firms to respond more slowly to the substantial rises of fuel prices over the last two years (see the box entitled *Food and Fuel Price Dynamics between 2007 and 2010*, Economic Review, 2010, issue 3).

² Transport fuels have the largest relative share in the group of energy products; hence, their price developments determine the overall price of energy products.

Assuming that oil price stabilizes during the first half of 2011 at levels below USD 100 *per barrel*, the annual inflation rate in energy products is expected to gradually moderate and overall inflation is anticipated to slow down. The increase in diesel and unleaded petrol excise rates during the present year is not expected to have a significant effect on these developments. Nevertheless, the continuing oil price upward dynamics poses a risk of a further increase in the annual rate of transport fuel price rises and, hence, of higher overall inflation.

Rate 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 transport vehicles, and solid, fluid and gaseous fuels for household consumption.

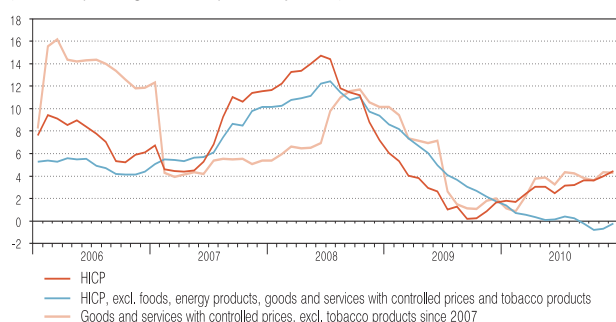
Sources: NSI, BNB.

Administratively Controlled Prices and Tobacco Products Prices

Accumulated inflation of goods and services with administratively controlled prices came to 4.3 per cent by end-2010 with a 0.7 percentage point contribution to inflation.

Rate of Change in Controlled and Uncontrolled Prices

(on corresponding month of previous year, %)



Note: Given the strong effect of administratively controlled excise rates on tobacco products prices, tobacco products are discussed separately from the group of goods and services with non-controlled prices regardless of the liberalization of the market of tobacco products in early 2007. Administratively controlled prices are calculated on the basis of elementary aggregates in the consumer basket.

Sources: NSI, BNB.

The higher fees for issuing identity documents (by 90 per cent) and the rises in the prices of heating, electricity and water supply (by 27 per cent, 2 per cent and 5 per cent respectively) contributed most to overall inflation.

In the first half of 2011 inflation in administratively controlled prices is expected to gradually slow down to around 2 per cent by June. The 5 per cent drop in the price of heating announced in January and the rise in the price of water supply services are included in the projections.

Tobacco products contributed significantly to inflation in 2010. As a result of their raised excise rates, these products appreciated by 34 per cent, adding by 1.3 percentage points to inflation by the close of the year. With this increase, excise duties in Bulgaria are now 20 per cent higher than the minimum for the EU. Owing to the unchanged excise duties in 2011, tobacco products inflation will be zero, thus contributing to the decline in overall annual inflation. The strongest effect on overall inflation will be observed in the second quarter since the appreciation of these products in 2010 was registered mostly in the second quarter following the three-month grace period of sales at 2009 prices.

Industrial Goods Prices

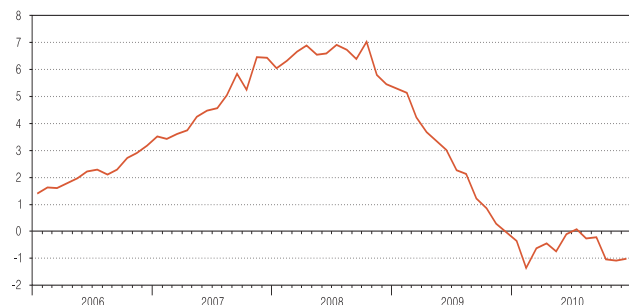
The index of the prices of industrial goods (excluding fuels) during the last year displayed a negative dynamics, with a 1 per cent annual fall as of December.

The prices of automobiles had the greatest negative contribution to overall consumer price inflation falling by some 10 per cent at the close of the year on the corresponding period of 2009 after a decrease by 11 per cent in February and 1 per cent in July. Automobile price dynamics probably reflects the remaining low consumer demand for this group of goods and the related active price policy of the firms in this sector. Unlike automobiles, the other two groups with a higher relative share in the consumer basket – clothing and footwear – showed a moderating annual decline rate and the inflation in these goods accumulated by end-2010 came to 0.3 per cent and -0.4 per cent respectively. The prices of the remaining groups of industrial goods registered low inflation or an insignificant decrease on an annual basis with a slight trend towards an in-

crease in inflation, respectively a slowdown in the decline rates of these goods' prices in the end of the year.

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

(on corresponding month of previous year, %)



Sources: NSI, BNB.

In the first half of 2011 non-food price dynamics will depend on the recovery in domestic demand and by the end of the projection period inflation in this component is expected to be at a low positive level.

Services Prices

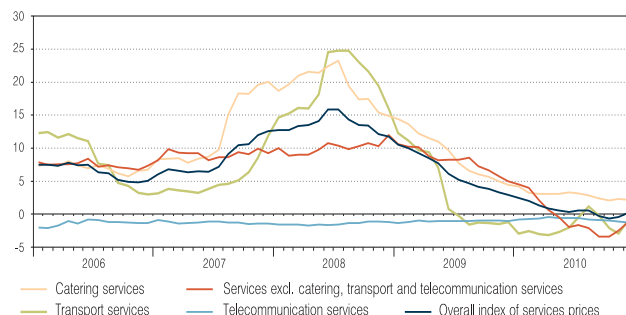
In 2010 the growth rate of services prices followed a downward trend reaching 0.2 per cent in December: a 2.7 percentage point fall on end-2009.

Overall inflation in services went down by almost 1 per cent on an annual basis in October and by the end of the year an insignificant positive rate of price rises was registered; in December this dynamics pushed up overall accumulated inflation. Temporary deflation of services and the subsequent price rises should be considered with

caution owing to the impact of the strongly pronounced seasonality in the price dynamics of two services included in the 2010 consumer basket for the first time – holiday resorts accommodation services and low-tariff flights. These two groups contributed significantly to the change in overall annual inflation of services during the last year. Excluding these components, the annual rate of the change in the prices of services stayed positive over the year with a clearly pronounced, albeit gradually moderating, downward trend. The sustained positive inflation of services prices is indicative of the relatively low downward flexibility of these prices; this is probably characteristic to a greater extent of the sectors with lower competition or relatively lower price elasticity of demand (e.g. barber's and hairdresser's services).

Rate of Change of Services Prices Excluding Those with Controlled Prices

(on corresponding month of previous year, %)



Sources: NSI, BNB.

The major factor behind services inflation dynamics during the first half of 2011 will be the gradual increase in domestic demand which is likely to be associated with a slight acceleration of inflation in this group.

