

# Economic Review

2/2011



BULGARIAN  
NATIONAL  
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 2/2011* was presented to the BNB Governing Council at its 21 July 2011 meeting. It employs statistical data published up to 18 July 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.

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

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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

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In the second quarter of 2011 signs of a slowdown in global economic recovery appeared. They reflected lower economic growth in the USA and also in Japan which was hit by a disastrous earthquake. Economic activity in the euro area accelerated in the first quarter of 2011, but slight decreases in the growth rates are expected in the second and third quarters. Inflation in the euro area also slowed down, but remained at relatively high levels, with market expectations showing that it will remain at levels above the ECB benchmark of 2.0 per cent until end-2011.

In the first quarter of 2011 the real GDP growth rate in Bulgaria reached 0.6 per cent compared with the fourth quarter of 2010. Now, just like during most of 2010, net exports contributed most substantially to growth. Exports of goods and services increased in real terms by 4.6 per cent on the fourth quarter of 2010 while imports fell by 1 per cent. On a chain basis gross fixed capital formation increased in real terms by 0.9 per cent, but due to the sizeable fall in inventories gross capital formation contracted by 3.7 per cent in real terms and had a negative contribution to GDP growth. Final consumption of households rose marginally. Recovery was uneven across economic sectors. In the first quarter of 2011 gross value added in the industrial and construction sectors went down in real terms compared to the fourth quarter of 2010, while in the agricultural and services sectors it saw an increase.

In the first half-year the overall business climate remained more favourable than at the end of 2010, which gives grounds to expect that the process of gradual economic recovery will continue in the second half-year.

Between January and May 2011 the balance of payments current account balance was positive (EUR 412.4 million). Preliminary data show that the total balance of payments current and capital account for the first five months of 2011 was a surplus of EUR 428.5 million. In the third quarter of 2011 the current account balance is expected to remain positive, while in the fourth quarter it is likely to show an insignificant deficit of 0.3–0.6 per cent of GDP. Bulgaria's external position remained sustainable with the positive current and capital account balance. Gross external debt gradually declined reaching 98 per cent of GDP in April. International foreign currency reserves covered more than 100 per cent of Bulgaria's short-term obligations.

Between January and May 2011 exports (euro-denominated) rose nominally by 47.2 per cent on the same period of 2010. Imports also reported a positive growth rate (25.5 per cent). In the second half-year exports growth rates are expected to moderate, while imports rates are expected to accelerate and as a result the trade balance deficit will remain small.

By the end of May broad money growth accelerated to 7.9 per cent on an annual basis compared to 7.4 per cent in March. In the second half of 2011 the upward trend is expected to be retained at rates slightly above the current ones. Residents' deposits contributed most to broad money growth. Deposits with agreed maturity of up to two years rose by 9.8 per cent on an annual basis. Higher reserves maintained by banks with the BNB reflect deposit base growth and showed a 13.2 per cent increase on an annual basis. Bank deposits with the BNB are expected to rise at a rate close to the current one, but moderating.

The gradual recovery in industry and services resulted in higher demand for loans from corporations and contributed to the gradual increase in bank claims on non-financial corporations. Bank loans to households reported a decline due to the lower growth rate of loans for house purchase and mortgage loans and to the negative growth in consumer loans. Household behaviour was determined by the continuing uncertainty about future income and the slow improvement in labour market conditions. House-

holds maintained a relatively high savings rate and as a result their deposits in the banking system increased. Banks also pursued cautious lending policy.

After a surplus of BGN 189.9 million in April and a small deficit of BGN 45.5 million in May, the cash budget deficit in the first five months of 2011 increased to BGN 597.5 million (0.8 per cent of the projected GDP for the current year).

In the first quarter of 2011 the real individual and collective consumption changed by 0.2 per cent and -0.2 per cent on a chain basis respectively, which led to a zero per cent contribution of government consumption to GDP growth. The dynamics of wage and intermediate consumption expenditure reported in April and May confirmed our expectations for a small positive real growth in the second quarter. In the following two quarters the growth rate of government consumption will tend to slightly accelerate, but as a whole the annual contribution of government consumption to GDP growth is expected to be close to zero.

In June 2011 annual inflation came to 3.5 per cent. Food and transport fuel price rises reflecting international price dynamics contributed most to inflation. Global commodity market developments will continue to significantly affect inflation in the second half of 2011 as well. We expect a slight increase in inflation by end-2011 compared with its current level. Decline in annual inflation is only possible if international food and fuel prices stabilise their levels.



# 1. External Environment

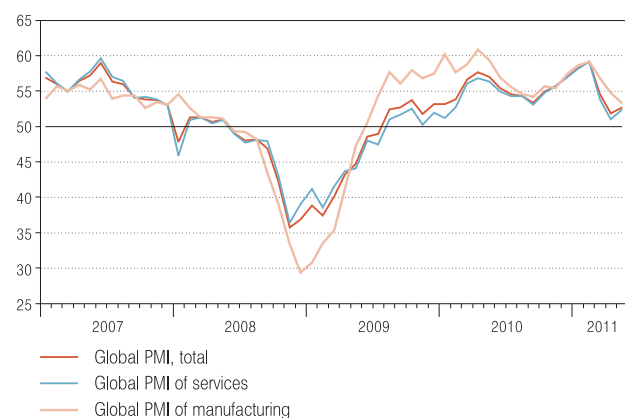
Signs of a slowdown in global economic recovery were observed in the second quarter of 2011. They reflect lower economic growth in the USA and Japan which was hit by a catastrophic earthquake. Economic growth in the euro area accelerated in the first quarter of 2011. However, decreases in the growth rates are expected in the second and third quarters. The rise in the euro area consumer price index also slowed down, while inflation sustained its high levels, with market expectations showing that it will remain over the ECB target level of 2.0 per cent until end-2011.

## Current Business Situation

In May 2011 global economic indicators decreased but remained at a level suggesting positive economic growth. This decrease reflects lower economic growth in the USA and Japan which was hit by the catastrophic earthquake and the Fukushima nuclear accident. The April slowdown in the global industrial output growth from 4.5 to 2.4 per cent also contributed to the decrease in expectations of the global economic activity.<sup>1</sup> Expectations of slowing economic growth in China based on the policy of raising reference interest rates and bank minimum required reserves pursued by the central bank of China also affected global economic indicators.

Based on economic indicators, it may be expected that global economic growth will slow down in the second half of 2011 but global economy will return to the path of sustainable economic development by the end of the year.

### Global PMI



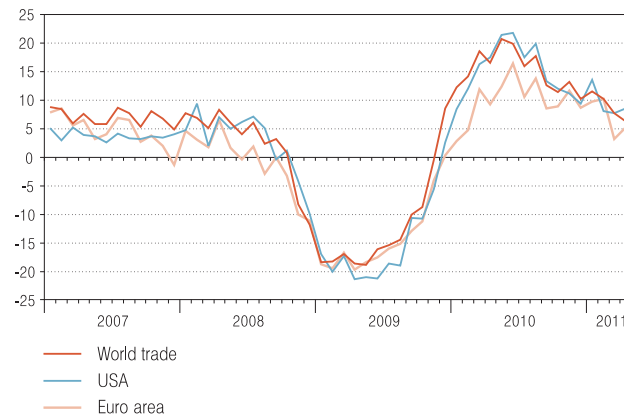
Source: JP Morgan.

<sup>1</sup> Based on the World Bank data by 29 June 2011.

On an annual basis, world trade growth moderated to 6.3 per cent in April 2011, with a pronounced trend to approaching the pre-crisis growth levels.

### World Trade

(annual rate of volume growth, %)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Food and energy product prices in international markets led to acceleration in global inflation which reached 4.5 per cent on an annual basis in April. Inflation has accelerated in all developing and developed countries unlike 2010 inflation developments which were more pronounced in developing and only in some developed countries.

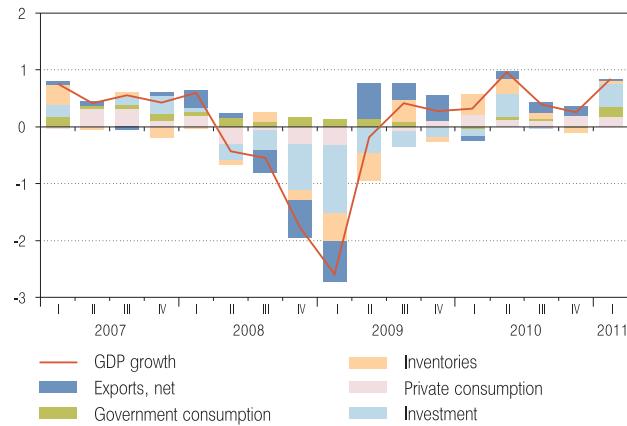
### Euro Area

In the first quarter of 2011 real GDP in the euro area grew by 2.5 per cent on an annual basis against 1.9 per cent growth in the previous quarter. The quarterly GDP growth accounted for 0.8 per cent which exceeded significantly the previous 0.3 per cent value. Investments (0.4 percentage points), household consumption (0.2 percentage points) and government

consumption (0.2 percentage points) contributed most significantly to quarterly GDP growth.

### Contribution to Real GDP Growth in the Euro Area by Component (Quarterly)

(%, percentage points)

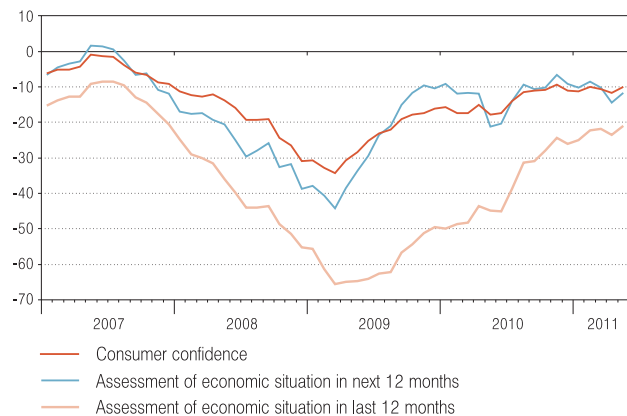


Source: Eurostat.

Following the first quarter's high levels, leading euro area indicators experienced a decline. This dynamics supported the expectations that the economic growth in the second quarter of 2011 will be lower than that in the first quarter.

The European Commission's economic sentiment index for the euro area declined to 105.1 in June, from 105.5 in May, while the business climate indicator fell to 0.92 from 0.98.

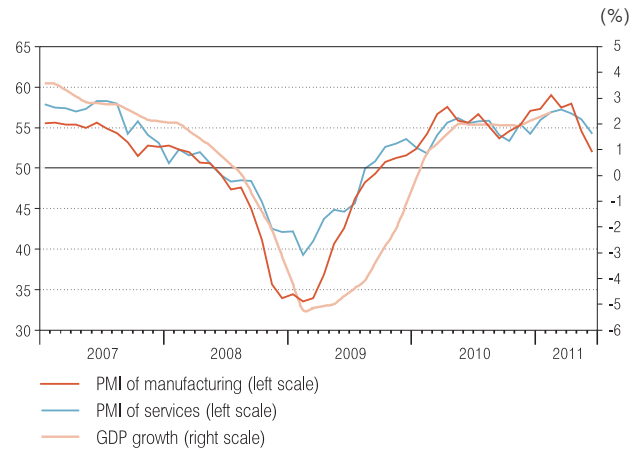
### Euro Area Consumer Confidence Indices



Source: European Commission.

The European Commission's consumer confidence index in the euro area increased in June to -9.8 against -9.9 in May and -11.6 in April. In the second quarter its average value slightly rose on the previous period.

### PMI of Industry and Services and Euro Area GDP Growth



Source: European Commission.

Over the second quarter of 2011 the euro area PMI remained above the level of 50 indicating that the economy continued to grow. In June the overall index declined to 53.6 against 55.8 in May. Output and services subindicators also decreased in June: to 52 (previous value: 54.6) and to 54.2 (previous value: 56). In the second quarter the average value of these indicators was lower than that in the first quarter.

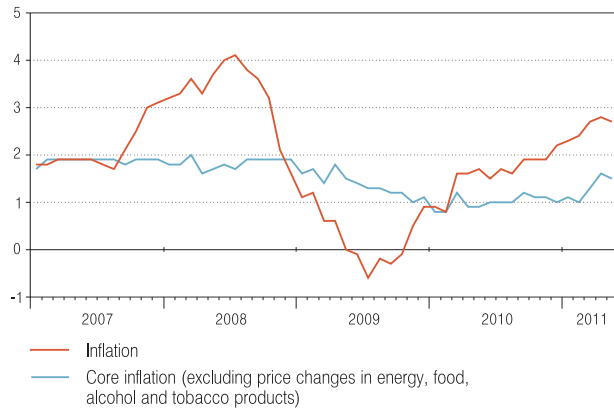
The European Commission, the ECB and the IMF revised upwards their projections of euro area growth in 2011. In its April 2011 projections, the European Commission points to an increase in euro area real GDP growth of 1.6 per cent over 2011: up 0.1 percentage points compared with the autumn 2010 projections. The EC expectations for 2012 remained unchanged at 1.8 per cent. According to ECB forecasts of June 2011, annual GDP growth in 2011 will range between 1.5 per cent and 2.3 per cent and in 2012 between 0.6 per cent and 2.8 per cent. Compared to March 2011, expectations for 2011 were revised upwards; for 2012 the lower limit was cut by 0.2 percentage points and the upper one remained unchanged. The latest IMF forecast of June 2011 points to euro area real GDP growth of 2 per cent for 2011 and 1.7 per cent growth for 2012 on an annual basis (previous forecasts: 1.6 per cent and 1.8 per cent respectively).

In May 2011 euro area inflation went down to 2.7 per cent on an annual basis, from 2.8 per cent in April 2011. On a monthly basis, the HICP remained unchanged. The annual inflation acceleration is mainly associated with a continuous increase in energy product prices: 11.1 per cent

and 12.5 per cent on an annual basis in May and April respectively. In May core inflation declined on an annual basis to 1.5 per cent, from 1.6 per cent in April.

### Euro Area Inflation Rate

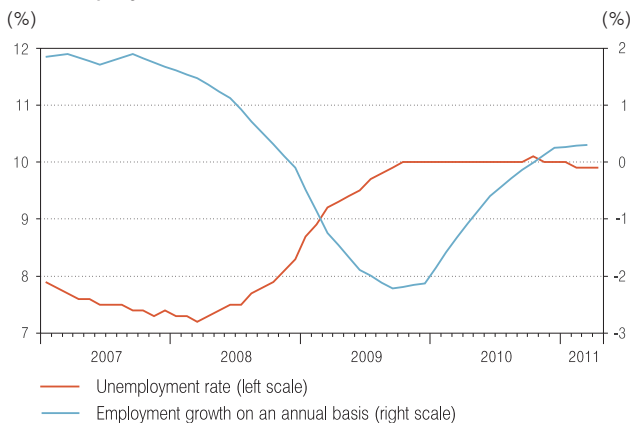
(percentage change on same period of previous year)



Source: Eurostat.

In May the European Commission revised upwards its projections for euro area inflation in 2011 to 2.6 per cent (up 0.4 percentage points compared with the February 2011 projections). According to ECB projections of June 2011, the increase in euro area HICP will move between 2.5 per cent and 2.7 per cent in 2011 (an upward revision compared with the March 2011 projection) and between 1.1 per cent and 2.3 per cent in 2012 which indicates a downward shift in the limits.

### Euro Area Unemployment Rate and Employment Growth



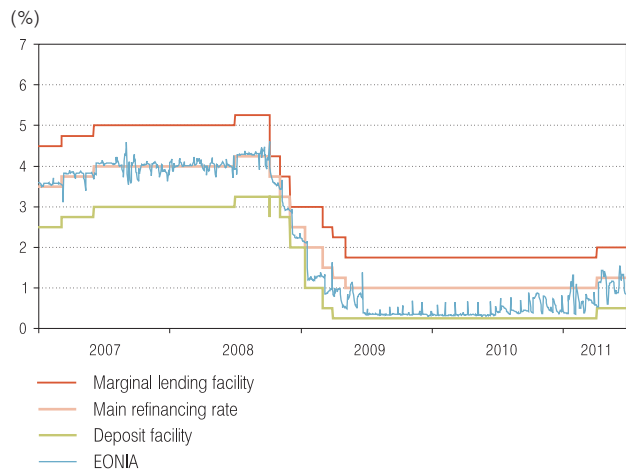
Source: Eurostat.

The latest Eurostat data on euro area unemployment in April 2011 point to a retention of its level at 9.9 per cent for a third consecutive month. The indicator of the expected euro area unemployment over the following twelve months included in the EC consumer confidence index

declined to 13.9 in May, from 16.6 in the previous period.

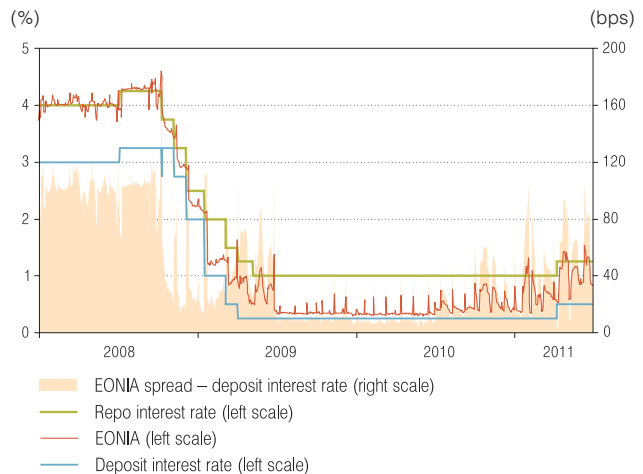
In April the Governing Council of the ECB decided to increase the interest rate on main refinancing operations of the Eurosystem by 25 basis points to 1.25 per cent, with effect from 13 April 2011. Moreover, the interest rates on the deposit facility and on the marginal lending facility were also increased by 25 basis points to 0.50 per cent and 2 per cent respectively.

### ECB Interest Rates



Source: Bloomberg.

### Short-term Interest Rates

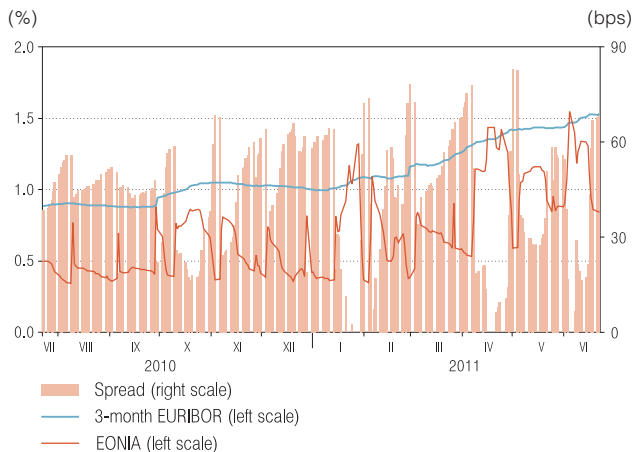


Source: Bloomberg.

In June the ECB took a decision to continue its policy of unlimited liquidity allotment on main and one-month refinancing operations for as long as needed and at least until the end of this year's ninth maintenance period on 11 October 2011. The ECB announced that three three-month longer-term refinancing operations would be carried out on 27 July, 31 August and 28 September 2011. The average interest rate on main

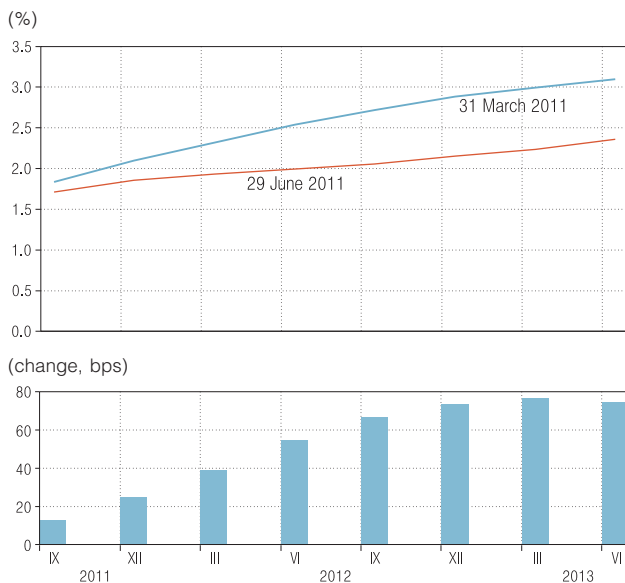
refinancing operations for the review period will be applied to these operations.

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



Source: Bloomberg.

### Expected Reference Interest Rate in the Euro Area Based on EURIBOR Futures



Source: Bloomberg.

Market expectations show that the ECB interest rate on main refinancing operations will come to 1.75 per cent by the end of the year following the rises in the third and fourth quarters.

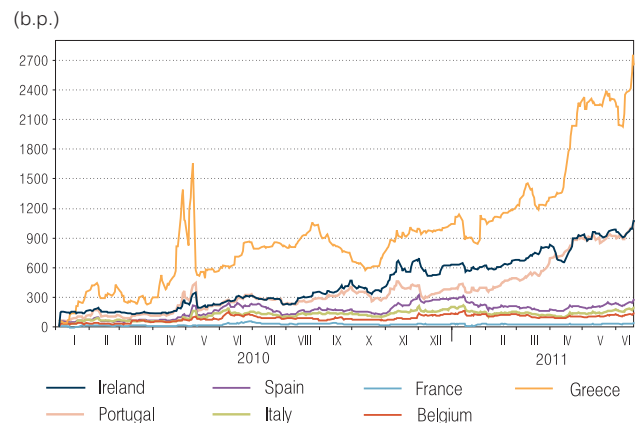
Over the second quarter of 2011 Portugal became the third euro area Member State (after Greece and Ireland) which sought financial support from the European Union and the International Monetary Fund. On 3 May an agreement was reached to provide financial aid to Portugal, with payments under it bound by a reform programme aiming to stimulate economic growth and employment. This programme was based on three strategic priorities: recovery of economy's competitive-

ness, fiscal consolidation (budget deficit under 3 per cent of GDP until end-2013) and financial sector stabilization. At its meeting of 16 May 2011, the ECOFIN Council approved the provision of financial assistance to Portugal to the amount of EUR 78 billion comprising equal amounts of funds provided by the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Facility (EFSF) and the IMF.

At the end of the second quarter it was established that in the spring of 2012 Greece could not return to financial markets and would need a new bail-out plan after the expiry of the current agreement with the EU and the IMF. This fed the concerns of a possible restructuring of the Greek sovereign debt and led to increases in credit risk premia. Uncertainty about debt crisis resolution increased further due to differing views of euro area Member States on the way by which private investors holding Greek government debt would take part in the new bail-out plan for Greece as well as to the internal political instability.

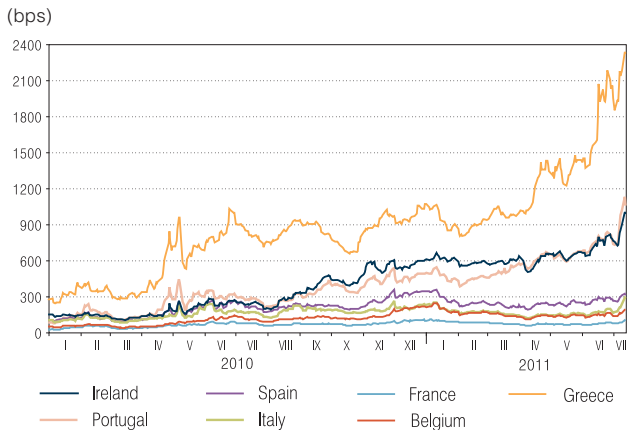
On 21 June the Greek Parliament gave a confidence vote to the Georgios Papandreou government and approved new measures for fiscal consolidation. In early July the EU and the IMF extended the next tranche of the financial aid for Greece to the amount of EUR 12 billion. By end-June the euro area financial ministers also agreed that the maturity of Greek government bonds held by private investors could be lengthened on the basis of voluntary participation by these investors. After the Eurogroup meeting on 11 July, a working group was established to explore possible ways of additional financing and improving Greece's debt structure.

### Five-year Government Bond Yield Spreads in Euro Area Countries



Source: Bloomberg.

## Five-year Credit Default Swaps of Euro Area Countries



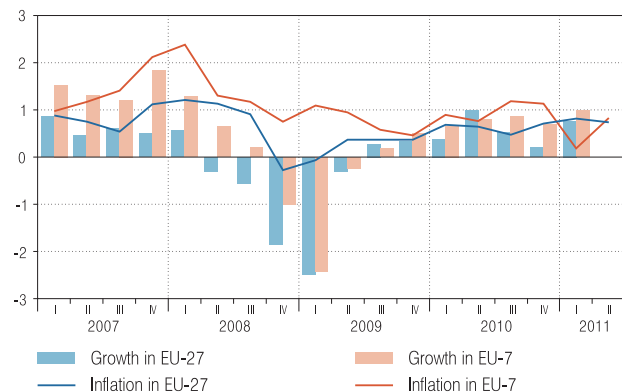
Source: Bloomberg.

### EU-7<sup>2</sup>

During the first quarter of 2011 economic recovery continued in EU-7 countries. All these countries reported positive economic growth, with total real GDP rising on a quarterly basis by 1.0 per cent, from 0.7 per cent in the previous quarter.

### Quarter-on-Quarter Growth Rate of Real GDP and Inflation in EU-27 and EU-7

(%; seasonally adjusted data)



Sources: Eurostat, own calculations.

Major growth factors varied across countries in the group: in some of them, growth was due to exports, while in other (Latvia and Lithuania) it was a result of final consumption growth. Gross fixed capital formation growth concealed some-

<sup>2</sup> EU-7 includes Member States that have joined the EU since 2004, excluding those that are full-fledged members of the Economic and Monetary Union. Slovenia (since 1 January 2007), Malta and Cyprus (since 1 January 2008), Slovakia (since 1 January 2009) and Estonia (since 1 January 2011) are euro area members. EU-7 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 economic growth, while in measuring inflation, the weights of EU-27 countries in HICP as calculated by Eurostat have been used.

what divergent developments by country, stabilizing at 1.1 per cent for the group. Domestic consumption in EU-7 improved by 2.5 per cent (from 0.5 per cent in the previous period). Exports rose by 5.0 per cent on a quarterly basis (2.7 per cent in the previous period) and imports growth rates accelerated to 4.6 per cent compared to 1.5 per cent in the fourth quarter of 2010.

Measured by the average-weighted HICP, inflation in April–May 2011 increased by 0.8 per cent on a chain basis (0.2 per cent in the previous quarter). The main factors behind this were the continued increases in energy product and food prices.

### Real GDP Growth on a Quarterly Basis

(%; seasonally adjusted data)

	2010				2011
	I	II	III	IV	I
Lithuania	1.3	1.0	0.3	1.8	3.5
Poland	0.6	1.1	1.2	0.8	1.0
Czech Republic	0.8	0.6	0.8	0.5	0.9
Hungary	1.1	0.1	0.8	0.5	0.7
Romania	-0.2	0.2	-0.7	0.1	0.7
Bulgaria	0.9	1.7	0.7	0.5	0.6
Latvia	0.6	0.4	1.5	0.9	0.3
EU-7	0.7	0.8	0.9	0.7	1.0

Source: Eurostat.

### Real Exports Growth on a Quarterly Basis

(%; seasonally adjusted data)

	2010				2011
	I	II	III	IV	I
Romania	7.6	3.4	0.2	5.8	10.6
Czech Republic	8.4	2.7	2.6	2.2	7.4
Hungary	3.5	2.4	2.9	2.7	5.5
Bulgaria	0.3	7.1	11.6	-3.9	4.6
Poland	3.6	4.1	-2.9	2.5	2.1
Latvia	0	1.8	7.7	3.6	1.2
Lithuania	1.0	10.4	4.3	7.8	-3.7
EU-7	4.9	3.5	1.3	2.7	5.0

Sources: Eurostat, ECB.

## The Balkan Region

In the first quarter of 2011 GDP growth patterns were mixed in the Balkan countries: still negative in some countries and showing increases in others. The major factor behind economic activity acceleration in this region was the external demand, with private consumption remaining weak. One exception was Turkey whose real GDP growth accelerated on an annual basis to reach 11 per cent, from 9.2 per cent in the previous quarter. Industrial output showed no clear trends, remaining broadly unchanged. In the first quarter of 2011 inflation continued to increase as

## Real GDP Growth and Inflation in the Balkan Countries

(%; non-seasonally adjusted data)

	2008	2009	2010					2011	
	Total	Total	I	II	III	IV	Total	I	II*
<b>Growth</b>									
Bulgaria	6.2	-5.5	-4.8	1.0	0.3	3.1	0.2	1.5	
Greece	1.0	-2.0	0.7	-4.0	-4.8	-8.8	-4.5	-8.1	
Macedonia	5.0	-0.9	-0.5	1.5	2.1	3.8	1.8	5.1	
Romania	7.3	-7.1	-2.2	-0.4	-2.2	-0.6	-1.3	1.7	
Turkey	0.7	-4.8	12.0	10.3	5.2	9.2	8.9	11.0	
Croatia	2.4	-5.8	-2.5	-2.5	0.2	-0.6	-1.2	-0.8	
Serbia	5.5	-3.1	-0.6	0.8	2.0	1.4	1.0	3.4	
<b>Inflation</b>									
Bulgaria	12.0	2.5	2.0	2.8	3.3	4.0	3.0	4.5	3.4
Greece	4.2	1.3	3.0	5.1	5.6	5.1	4.7	4.5	3.4
Macedonia	8.3	-0.8	0.5	1.1	1.8	2.9	1.6	4.1	5.0
Romania	7.9	5.6	4.6	4.3	7.5	7.8	6.1	7.5	8.4
Turkey	10.4	6.3	9.3	9.2	8.4	7.4	8.6	4.3	5.7
Croatia	5.8	2.2	1.1	0.8	1.0	1.4	1.1	2.2	2.4
Serbia	12.5	8.2	4.5	4.0	6.5	9.6	6.1	12.6	14.1

\* Average inflation for April and May.

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

a result of high international energy product and food prices.

Though this region's economies were further affected positively by world economic recovery, their structure remained fairly heterogeneous. GDP of Turkey continued to grow at high rates due to enhanced investment activity, and in Macedonia and Serbia, it started to accelerate. Solely in Greece and in Croatia, economic activity declined as a result of the weak domestic demand. Prevailing forecasts show a gradual recovery in this region, with exports expected again to be the main driving factor.

### USA

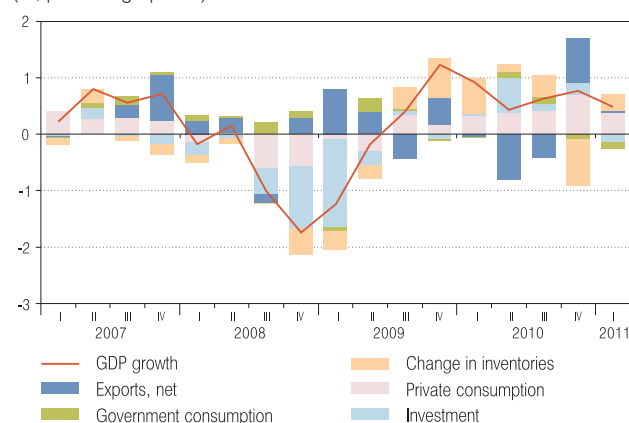
Since the start of the second quarter the US macroeconomic indicators have worsened. Economic situation worsening was mainly due to external shocks.

Rises in oil and other commodity prices over the review period pushed up energy and food prices, these goods having a large weight in the consumer basket. This exerted a strong pressure on the purchasing power of households. The growth rate of retail sales which form around 60 per cent of the household consumption component in GDP has decreased since the end of the first quarter, indicating in May a 0.2 per cent drop on a monthly basis. In nominal terms, households' disposable income increased by around USD 170 billion in the first two quarters

of 2011, its real terms growth reaching almost USD 1.4 billion.

### Contribution to US GDP Growth by Component (Quarterly)

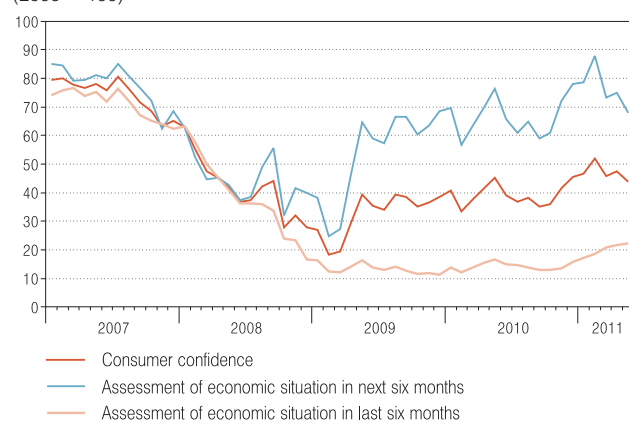
(%; percentage points)



Source: Bureau of Economic Analysis.

### US Consumer Confidence Indices

(2000 = 100)

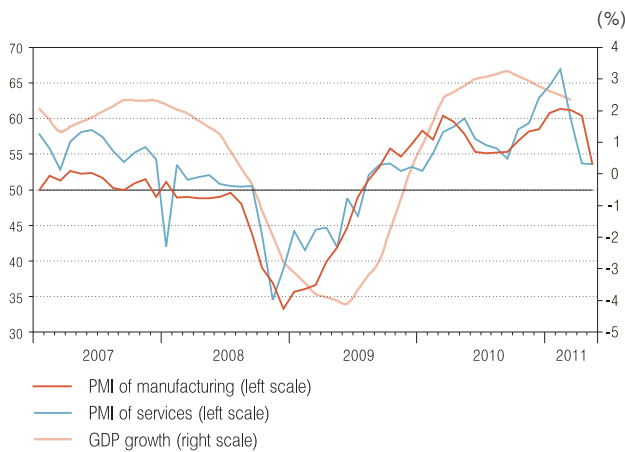


Source: The Conference Board.

Food and fuel price rises coupled with slower labour market recovery had a negative effect on consumer sentiment and in June consumer confidence indices reached their lowest levels since the end of 2010. The possible drop in commodity prices over the second half of the year may underpin confidence and correspondingly domestic demand in the third quarter.

Another external factor affecting the US economic activity was the natural disaster which hit Japan in mid-March. Halting of deliveries along the supply chain from Japan led to a decline in production activity due to the shortage of key components imported from Japan. In April and May car production declined on a chain basis by 6.5 per cent (to 9.7 per cent on an annual basis) and by 1.4 per cent (to 2.2 per cent) respectively. The number of traded cars decreased significantly, with the inventories to sales ratio falling in May to 49 days against 71 days in early 2011. The recovery in Japan's industrial output and deliveries to the USA by leading Japanese producers, as well as the total recovery of car production in the North America are expected to result in strengthening the economic activity in the US industry.

#### US PMI of Manufacturing and Services and GDP Growth



Source: The Conference Board.

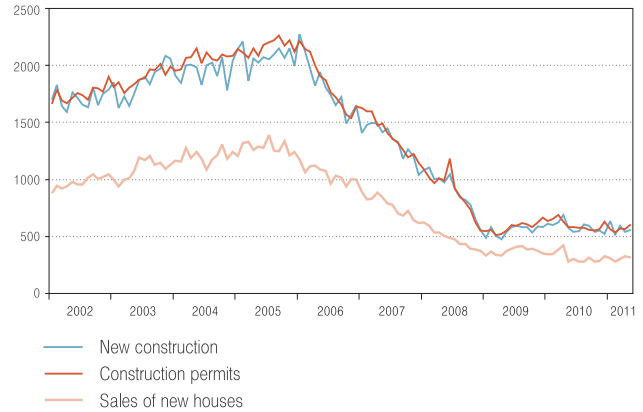
Reflecting the recent developments, leading output indicators decreased strongly driving expectations that the economic activity will continue declining in the coming months. We believe that this decrease is temporary and in the third quarter of 2011 output growth rates will accelerate.

Low investment activity in the housing sector will continue to exert pressure on gross fixed

capital formation in the second and third quarters. Our expectations are supported by the homebuilder confidence index (the NAHB index) which in June reached its lowest level in the last nine months.

#### Sales of Houses in the USA

(number, in thousands)



Source: Bloomberg.

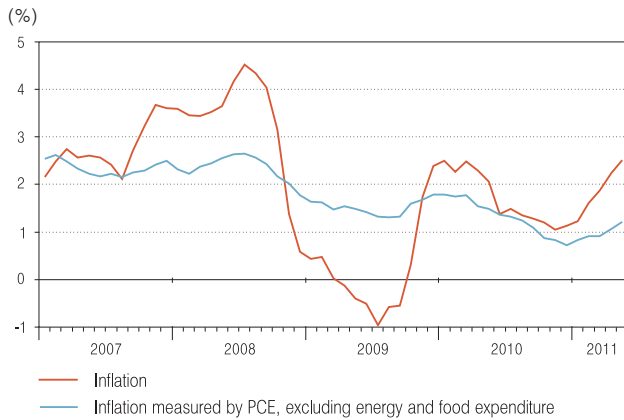
New construction in the USA remained weak due to the large number of unsold houses in the market, and sales continued to decline despite the drop in real estate prices and favourable mortgage interest rates. This decline was due to the existing uncertainty about labour market recovery, on the one hand, and to the still limited access to credit, on the other. Uncertainty resulted also from the decline in house prices observed in the last eight months which was driven by the increased number of real estate acquired by banks in the market of collateralised bad loans.

The negative effect of the factors outside the USA on the economy was stronger than initially expected. Therefore, official institutions revised significantly downside their forecasts of economic growth in the first half which reflected on the annual GDP projections. In the June World Economic Outlook, the IMF revised its expectations of the US economic growth for 2011 to 2.5 per cent, from 2.8 per cent in April. The Federal Reserve System also revised downwards the US growth projections in 2011 to 2.7–2.9 per cent against 3.1–3.3 per cent in the April 2011 projection.

In May US inflation as measured by personal consumption expenditure (PCE) deflator rose to 2.5 per cent, from 2.2 per cent in April and 1.2 per cent in January. On an annual basis, data on the consumer price index showed growth of 3.4

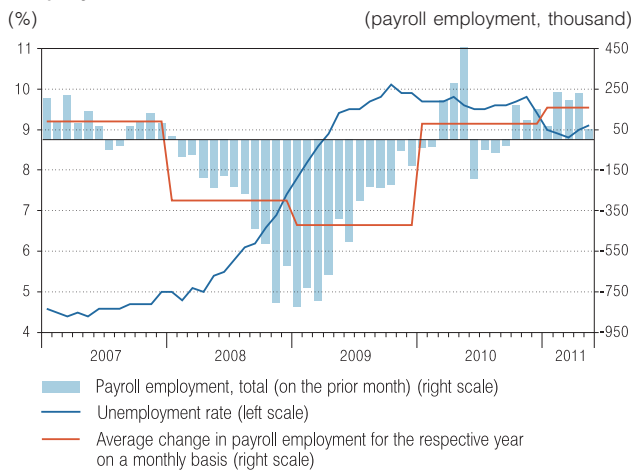
per cent in May against 3.1 per cent in April. On a monthly basis, this growth moderated reflecting declines in fuel prices. Over the last two months short-term expectations of consumer price inflation declined as a result of the same reason, while long-term expectations remained stable. Further weakening in the external pressure on price levels in the third quarter will likely contribute to slower increases in major price indices on an annual basis.

### US Inflation Measured by the PCE Index



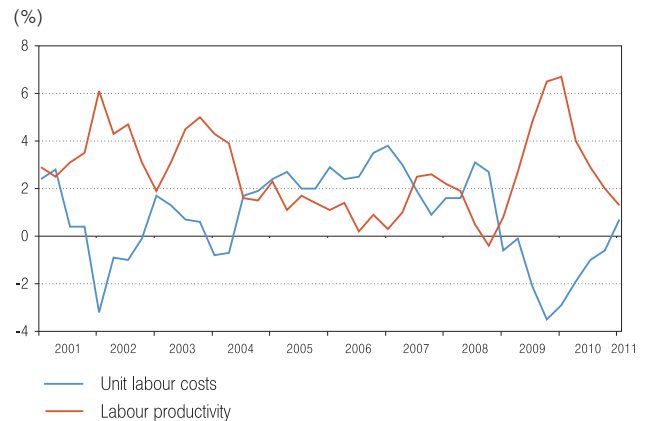
Indices excluding the fuel and food components have so far reported a slight increase staying below the 1.7–2.0 per cent band that is deemed to be compatible with price stability. In May 2011 the base index of personal consumption expenditure increased on an annual basis by 1.2 per cent against 1.1 per cent in April, while that of consumer prices rose by 1.5 per cent in May against 1.3 per cent in April.

### US Unemployment Rate and Changes in Payroll Employment



Labour market was again marked by under-utilisation of labour resources which will further limit its potential regarding the emergence of second-round effects on final wage formation. In May non-farm payrolls increased by 54,000. This was significantly lower than the average growth rate in the last seven months (around 160,000 persons). In addition, the unemployment level increased for two consecutive months reaching 9.1 per cent in May. With more people seeking jobs and given the low job creation rate, no declines in unemployment levels and no wage increases are expected until the end of the year.

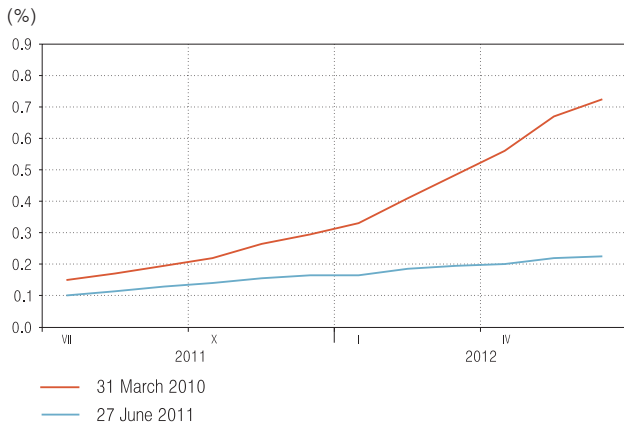
### Unit Labour Costs and Non-farm Labour Productivity



Given the sustained moderate rates of economic recovery and still low core inflation, at its 21–22 June meeting, the US Federal Open Market Committee (FOMC) announced no intentions of forthcoming monetary policy change. The US reference interest rate on federal funds stayed unchanged within the range of 0.00–0.25 per cent. FOMC representatives pointed out that the current growth rate had proved to be inadequate and amid high unemployment and inflation below 2.0 per cent complying with the definition of price stability, it would be necessary to retain the reference rate within the above mentioned range for a long period. Market participants expect no rises in the money market reference rate until the end of the second quarter of 2012.



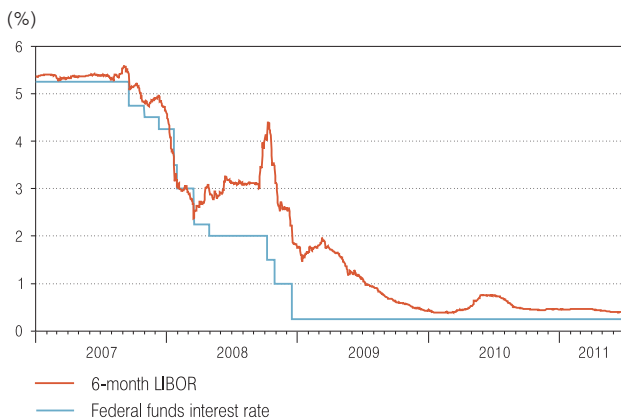
### Expected Reference Interest Rate on US Federal Funds Based on Futures Contracts



Source: Bloomberg.

The expectations of sustaining the reference market rate coupled with the excess liquidity in the banking system will continue to retain the cost of short-term financing at the levels close to the current values until the end of 2011.

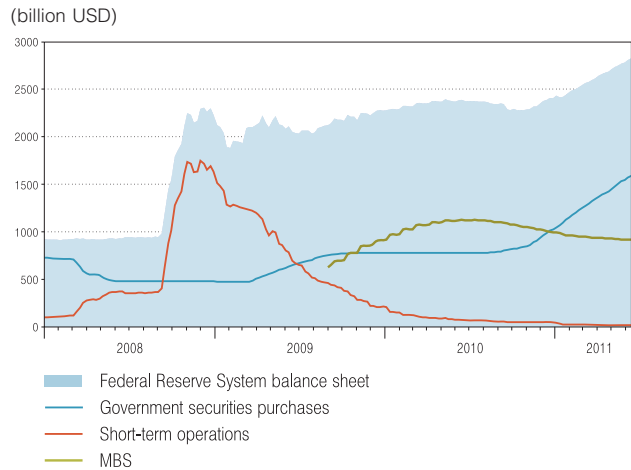
### US Federal Funds Interest Rates and Six-month LIBOR in US Dollars



Source: Bloomberg.

At the 21–22 June meeting on monetary policy, it was confirmed that securities purchase operations would be terminated. As a result, the US Federal Reserve balance sheet figure reached a new maximum of USD 2.83 trillion by end-June. In the following months, the Federal Reserve System will continue to maintain its balance sheet figure through reinvesting earnings of previously purchased maturing financial assets into government securities while leaving open the option to respond to incoming macroeconomic information.

### US Federal Reserve Balance Sheet



Source: Bloomberg.

### Brazil, Russia, India and China

Over the first quarter of 2011 this group's countries continued to report high growth rates. GDP growth in each of these countries showed a slight moderation on the fourth quarter, albeit remaining at high levels.

Inflation tensions in Brazil, China and Russia did not only remain high, but increased in the second quarter of 2011. Only in India, inflation pressures began slightly to decrease.

In addition to raising their reference rates, the central banks of these countries actively used the increases in the minimum required reserve rate to counteract the inflation tensions. In response to the increasing inflationary pressure, Russia also raised its reference interest rates.

The Chinese central bank raised the reference rate twice by 25 basis points: on 4 May and on 6 July. Simultaneously, in the second quarter of 2011 bank minimum required reserves were raised on three occasions by 50 basis points to 21.5 per cent. Nevertheless, in June the M2 monetary aggregate rose by 15.9 per cent on an annual basis. Inflation was also above the expectations reaching in June 6.4 per cent on an annual basis compared to the expected value of 6.2 per cent.

In the second quarter of 2011 economic growth data show retention of the high growth rate which reached 9.5 per cent on an annual basis (projected growth at 9.2 per cent).

## Real GDP Growth and Inflation in BRIC

(%)

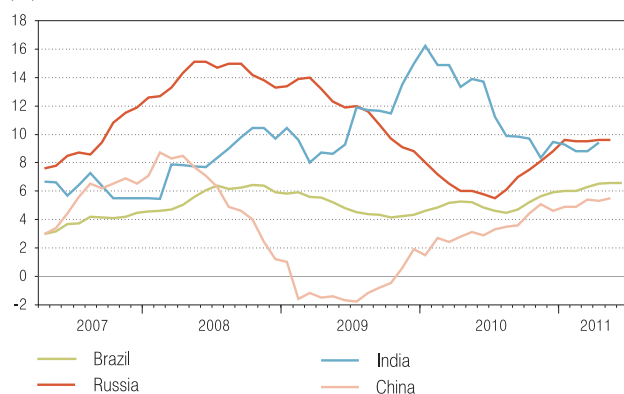
	2009					2010					2011
	I	II	III	IV	Total	I	II	III	IV	Total	I
<b>Growth (on previous year)</b>											
Brazil	-3.0	2.8	-1.8	5.0	-0.6	9.3	9.2	6.7	5.0	7.5	4.2
Russia	-9.3	-11.0	-8.6	-2.9	-7.8	3.1	5.2	3.1	4.5	4.0	4.1
India	5.8	6.3	8.6	7.3	6.8	8.6	8.9	8.9	8.2	8.8	7.8
China	6.5	7.9	9.1	10.7	9.2	11.9	10.3	9.6	9.8	10.3	9.7
<b>Inflation (on an annual basis)</b>											
Brazil	5.6	4.8	4.3	4.3	4.9	5.2	4.0	4.7	5.9	5.0	6.3
Russia	14.0	1.9	10.7	8.8	10.7	6.5	5.8	7.0	8.8	6.9	9.5
India	8.0	9.3	11.6	15.0	10.9	14.9	13.0	9.8	9.5	13.2	8.8
China	-1.2	-1.7	-0.8	1.9	-0.7	2.4	2.9	3.6	4.6	3.3	5.4

Sources: IMF, Bloomberg.

Industrial output also increased its annual growth rates to 15.1 per cent in June. Solely PMI data showed moderation to 50.9 in June, from 52.0 in May.

### Annual Inflation

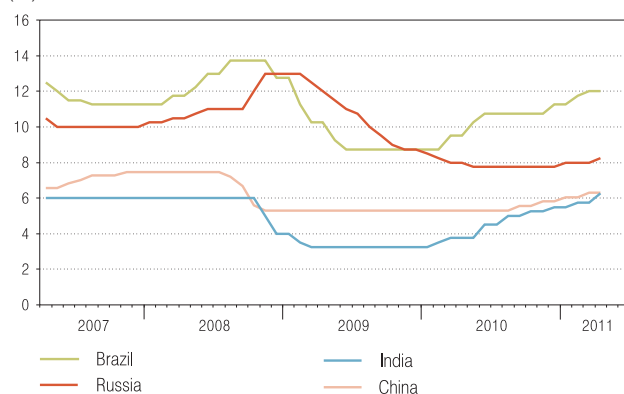
(%)



Source: Bloomberg.

### Reference Interest Rates of Central Banks

(%)



Source: Bloomberg.

## International Prices (Crude Oil, Major Raw Materials, and Gold) and the EUR/USD Exchange Rate

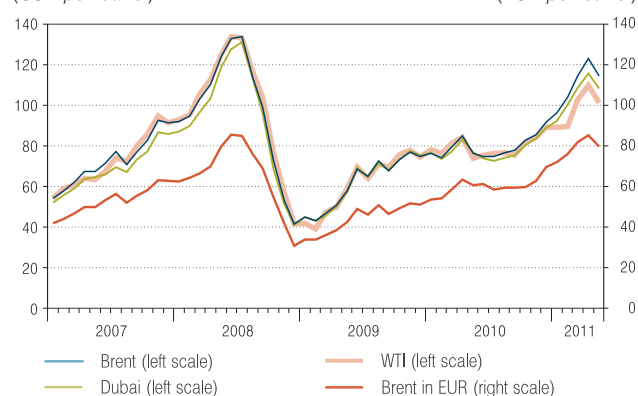
### Crude Oil Prices

In the second quarter of 2011 Brent crude oil prices rose slightly, with trading averaging USD 117.3 or EUR 81.5 *per* barrel. The uncertainty around supply stemmed from the war in Libya and political tensions in the Middle East countries led to oil price rises despite the measures taken by the other oil-producing countries. Lower oil supply by Libya was partially compensated by the increased production in the OPEC member countries. Non-OPEC producers also increased crude oil production and supply in international markets.

### Crude Oil Prices

(USD per barrel)

(EUR per barrel)



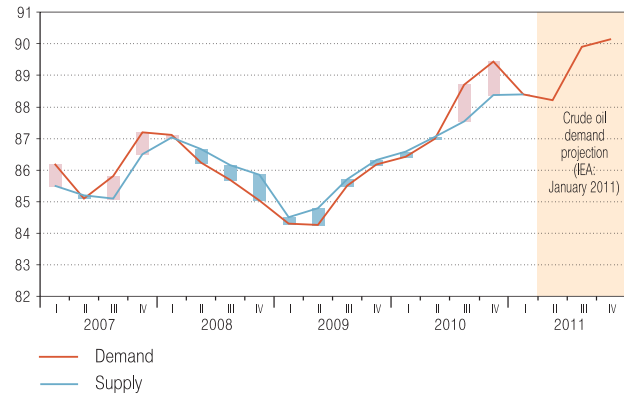
Source: World Bank.

Reflecting the high oil price, demand began contracting. This was taken into account by the

IEA which revised downwards its June projection on oil demand by OECD countries. It is expected to rise by almost 1.3 per cent on 2010.

### World Crude Oil Supply and Demand (Quarterly)

(million barrels per day)

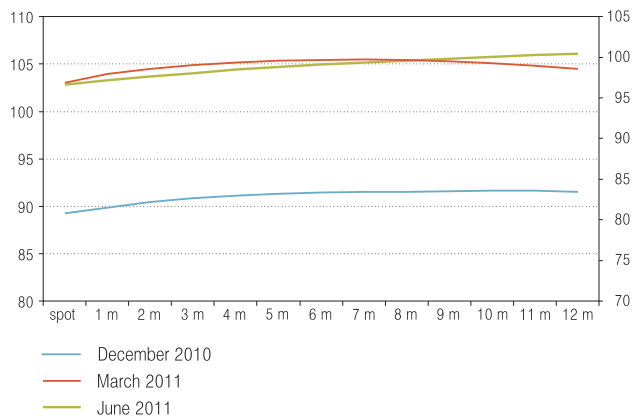


Source: IEA.

In June the IEA announced that in order to support supply, 60 million barrels would be unblocked from the strategic crude oil reserves. This affected market expectations of oil prices, with Brent oil expected to be traded at USD 90 to 110 per barrel based on futures contracts.

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

(USD per barrel)



Source: JP Morgan.

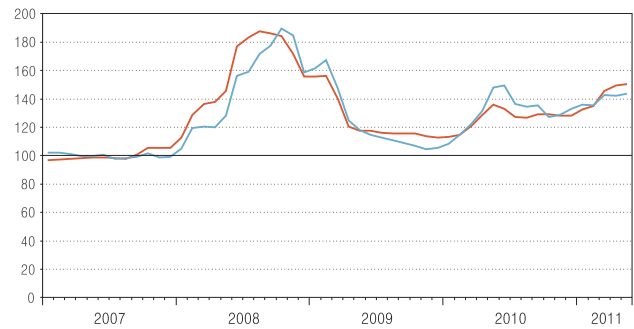
### Major Raw Material and Commodity Prices

In April and May the steel output growth rate continued to increase on the corresponding period of the previous year, reaching 9.4 per cent, from 9 per cent in the first quarter of 2011. The North America and the European Union reported the most significant growth at 16.2 per cent (previous period: 9.2 per cent) and 8.3 per cent (previous period: 7.3 per cent) respectively, while Asia registered a slowdown to 6.0 per cent (previous period: 7.8 per cent). In April and May

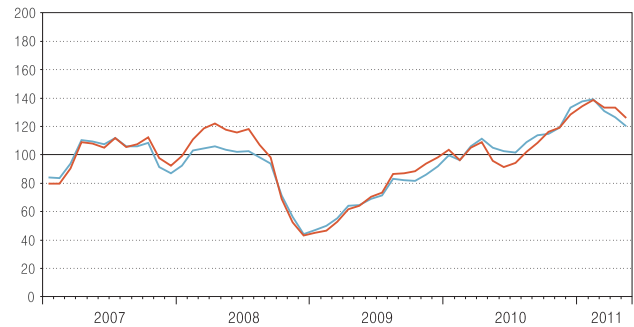
### Price Indices of Major Raw Materials and Commodity Groups

(2007 = 100)

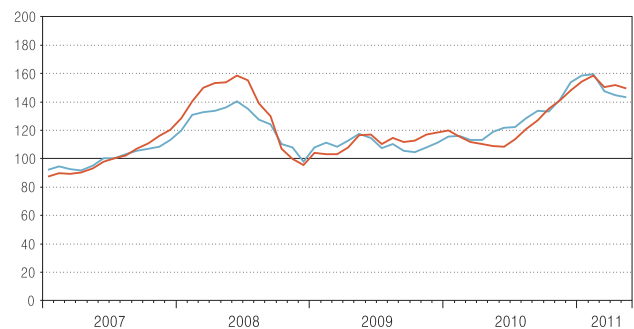
#### Steel



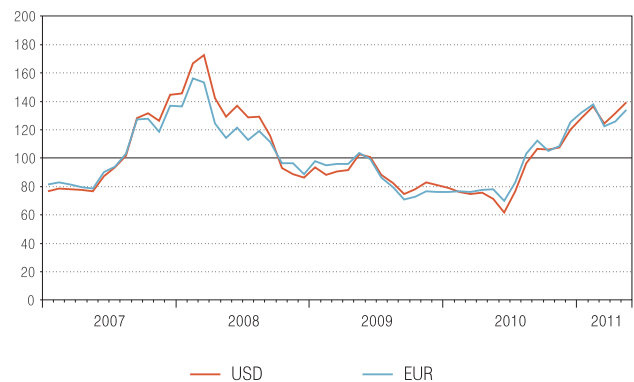
#### Copper



#### Food



#### Wheat



Sources: World Bank, ECB and BNB.

2011 steel product prices fell by 5.5 per cent on average compared with the first quarter, and the overall index measuring metal prices remained unchanged. Non-ferrous metal prices decreased, with nickel, zinc and copper prices falling most significantly (by -9.1, -6.0 and -5.1 per cent respectively).

Most expectations about metal prices point to retention of their levels in the second half of 2011.

The strong upward price dynamics in food prices slowed down, with the index measuring food prices increasing slightly in April and May by 1.3 per cent on average compared with the first quarter of 2011. The major contribution to slower food price rises was recorded by sugar (-19.6 per cent), rice (-6.6 per cent) and wheat (-1.6 per cent), while the prices of corn (13.8 per cent) and vegetable oils (6.7 per cent) continued to increase. According to the US Department of Agriculture and the International Grains Council data of May 2011, world grain yields in the 2011–2012 season are expected to rise by approximately 2.5–2.8 per cent compared with the 2010–2011 season, while its consumption is expected to increase by around 1.2–1.7 per cent. Over the same period wheat inventories may decrease by 0.5–1.5 per cent on average. In the second half of 2011 food prices are expected to decline.

### Gold Prices

Over the second quarter of 2011 the average gold price (one-month futures) went up to USD 1500.5 *per troy ounce* (8.1 per cent growth on a quarterly basis). Gold price in euro posted a slight increase (4.4 per cent) due to the stronger performance of the single currency against the US dollar over the review period.

Foreign currency market dynamics and tensions in the euro area government bond market had the most significant effect on the gold demand and price over the review period. Tensions around Greece and Portugal, tense geopolitical situation in the Middle East and speculations with the US debt led to a new nominal peak in the gold price at USD 1577.6 *per troy ounce* on 2 May. The decision of the CME Group to raise five times the margin for silver positions proved to be crucial for the increase. This fact coupled

with a strong US dollar caused adverse chain effects which led to closures of commodity positions, including in gold and oil. The dramatic fall in gold prices enjoyed the strong interest of Asian investors. As a result, the gold price returned again to the level of USD 1500 *per troy ounce*.

Gold demand by physical gold exchange-traded funds (ETFs) fully collateralized by gold increased in early 2011 but the closure of positions reversed this trend and led to a dramatic decline in fund assets. Despite investor interest recovery in June, demand for physical gold by ETFs did not return to early April levels. In 2010 ETFs demand for physical gold comprised more than one fifth of the global investment demand for gold. At the end of the review period gold assets of the SPDR Gold Trust, the largest gold fund, declined by 0.2 per cent, and as of 24 June this fund managed over 1209.1 tonnes of gold. As a result, the SPDR has become the world's sixth largest holder of gold before China and Switzerland.

### One-month Futures of Gold

(USD *per troy ounce*)



Source: The London Bullion Market Association.

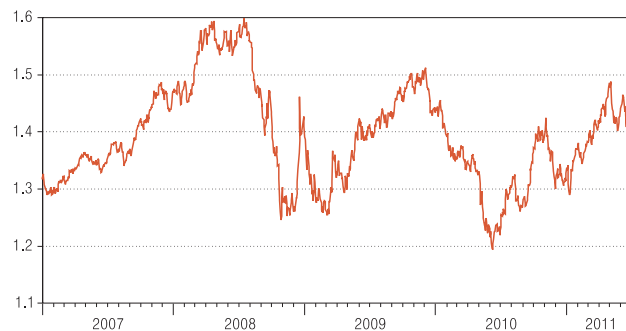
The most recent data for the first quarter of 2011 published by the major gold market survey organizations, the World Gold Council and the GFMS consultant company show strengthened investor interest in direct investment in physical gold in the form of gold bullion bars and coins. India and China enjoyed the strongest demand, both countries reporting 57 per cent of world demand for physical gold. Of note is the 47 per cent rise in physical gold demand in China and the 128 per cent growth in direct gold investment to 91 tonnes of gold.

## The EUR/USD Rate

Over the second quarter of 2011 the average value of the US dollar decreased by -5.1 per cent against the euro and by -3.8 per cent against the basket of six currencies. Over the review period the US currency traded within the 1.40–1.48 band. From the beginning of the second quarter to 27 June, the single currency registered considerable fluctuations, though cumulatively remaining broadly unchanged (a 0.8 per cent decline). Over the review period foreign currency dynamics reflected investor expectations of the monetary policies pursued by the US Federal Reserve System and the ECB, the sustainability of euro area periphery countries' debt positions and worsened US macroeconomic data.

### The EUR/USD Rate

(USD per EUR 1)



Source: ECB.

Risk appetite and interest rate differential between the United States and the euro area were among the most essential factors behind foreign currency rate dynamics. Investor perceptions concerning the euro appreciation were sustained in the futures markets despite the Greek debt crisis effect. In practice, the ECB statement of forthcoming interest rate rises had a stronger effect, and investors retained their long positions in euro.

## Bulgarian External Debt Dynamics in International Financial Markets

Over the second quarter of 2011 the downward trend in the spreads on yields of the Central and East European countries' government debts was reversed, with spreads gradually starting to expand. The JP Morgan Euro EMBI Global index increased by 10 basis points to

194 basis points at the end of the review quarter. It fluctuated within a relatively wide range of 157 to 204 basis points.

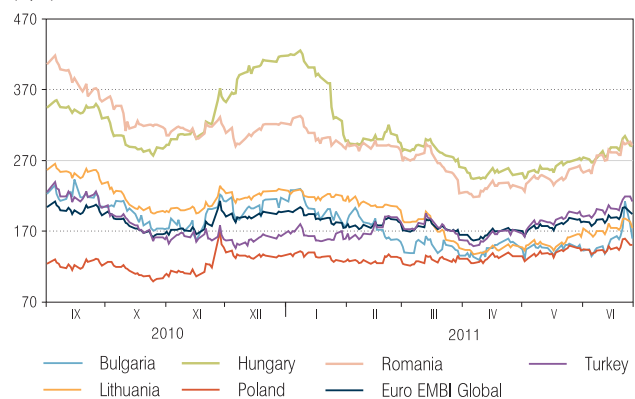
The downward trend in spreads continued until mid-April, with spreads starting to expand thereafter. The major factor for this was the change in investor risk appetite as a result of the widening in euro area sovereign yield spreads and investor concerns about Greek debt restructuring. The US data showing worsening macroeconomic situation exerted an additional effect.

The recovery rate in CEE counties was sustainable in the first and second quarters despite the dominated concerns about a possible slowdown in global recovery. Developments in the Greek debt crisis had the most considerable effect on the spreads.

Bulgaria's government debt spreads, measured by the JP Morgan index, followed the general market trend throughout the whole period, reporting a 2 basis point cumulative increase to 160 basis points by the end of the quarter.

### Government Debt Yield Spreads in Bulgaria, Lithuania, Hungary, Poland and Turkey (Euro EMBI Global index)

(bps)



Source: Bloomberg.

## 2. Financial Flows, Money and Credit

Between January and May 2011 the balance of payments current account was positive, amounting to EUR 412.4 million. Over the same period the total balance of the current and capital accounts was also positive and reached EUR 428.5 million *vis-à-vis* a deficit of EUR 717.5 million in the corresponding period of 2010.

The Issue Department balance sheet figure was BGN 24.13 billion (EUR 12.34 billion) by end-June 2011: up by BGN 255.9 million (EUR 131 million) on March 2011. The increase in government deposit of BGN 458.2 million (EUR 234 million) in the second quarter contributed most to this development. By May 2011 the average monthly coverage of imported goods and services by BNB international reserves was 6.4 months<sup>1</sup>.

### Financial Flows and External Position Sustainability

Between January and May 2011 the balance of payments current account was positive, amounting to EUR 412.4 million. On an annual basis the current account exhibited a surplus of EUR 888.1 million (2.4 per cent of GDP). In the third quarter of 2011 the current account balance is expected to remain positive, while in the fourth quarter it is likely to turn negative reaching around 0.3–0.6 per cent of GDP, with the positive inflow of foreign direct investments covering entirely this deficit.

Between January and May 2011 the balance of payments financial account recorded a deficit of EUR 1284.2 million. Transactions of domestic banks, which increased their foreign assets in the form of deposits abroad worth EUR 620.9 million and reduced their foreign liabilities due to the closure of non-residents' deposits in domestic banks worth EUR 660.3 million, contributed most substantially to the deficit of the financial account.

<sup>1</sup> The average value of imports of goods and services for the last 12 months and BNB reserves by the end of May 2011 were used in the calculation of this indicator.

### Monetary Flows Which Prompted Significant Changes in Gross International Reserves

(million EUR)

External Flows	2010		2011	
	I Q	II Q	I Q	II Q
<b>Total for the period</b>	-860	-374	-672	171
<b>Purchases and sales of euro</b>				
at tills	-6	-3	-3	-3
banks, incl.	-764	29	-704	-28
banks' purchases	18 011	15 991	7 902	8 066
banks' sales	-18 775	-15 962	-8 606	-8 094
<b>Flows on accounts of banks, the MF, etc.</b>				
Minimum required reserves	-14	-283	73	-153
Government and other depositors	-75	-117	-38	355

Source: BNB.

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 increase in gross international reserves in the first quarter of 2011 amounted to EUR 171 million. Banks' net purchases of euro from the BNB came to EUR 28 million and banks' reserves denominated in euro decreased by EUR 153 million.

Based on preliminary data between January and May 2011 foreign direct investment in Bulgaria amounted to EUR -26.9 million<sup>2</sup> due to the negative net *other capital* (EUR -373 million)<sup>3</sup>.

<sup>2</sup> Preliminary data that are subject to revision upon receipt of additional information from direct investment enterprises.

<sup>3</sup> An explanation for the negative net value of the other capital item is provided in the BNB July 2011 Balance of Payments Monthly Bulletin. Matching the preliminary data, the difference between the flows for the reporting period and for the previous year resulted mainly from intercompany loans and the repayments thereon in accordance with the repayment schedules of corporations.

Foreign direct investments comprise mainly of equity capital of EUR 265.2 million and reinvested earnings in the banking sector of EUR 80.8 million. Between January and May 2011 non-residents' investment in real estate came to EUR 72.9 million against EUR 73.2 million in the corresponding period of 2010. Earnings from real estate acquired by non-residents in Bulgaria were close to the levels typical of the years prior to 2006 when the interest of non-residents in acquiring real estate in Bulgaria sharply intensified.

Turning to the sectoral structure, in the first quarter of 2011 foreign direct investment inflows were directed mainly to transport (EUR 235 million) and construction (EUR 69.1 million). Consequently, real estate operations and business services (23.5 per cent), financial intermediation (17.9 per cent) and manufacturing (16.5 per cent) contributed most significantly to the stock of foreign direct investment as of March 2011.

The composition of FDI by country in the January–May 2011 period suggests that foreign direct investment attracted from Austria (EUR 122.7 million) and Cyprus (EUR 44.6 million) accounted for the largest shares. Net payments related to revolving intercompany loans were made to Germany (EUR -99.6 million), and the UK (EUR -122.7 million).

By May 2011 net foreign direct investment accounted for 2.9 per cent of the annual GDP for the last four quarters. The positive net foreign direct investment inflows are expected to gradually stabilise in the third and fourth quarters of 2011. As a result, the foreign direct investment to GDP ratio will range between 2.5–3.0 per cent on an annual basis.

In the January and April 2011 period Bulgaria's gross foreign debt went down by EUR 664.7 million and by the end of the review period amounted to EUR 36.01 billion or 98 per cent of GDP reported for the last four quarters. Net repayment of borrowed funds amounted to EUR 2511.6 million (revaluations and changes in trade and revolving loans excluded). Between January and April 2011 new loans and deposits came to EUR 1578.2 million, of which loans received from banks occupied 17 per cent and intercompany loans comprised 49 per cent. Principal payments amounted to EUR 2319.7 million against EUR 2312.6 million in the corresponding period of the previous year.

In the maturity structure of gross external debt the share of short-term external debt in total debt declined. It decreased by EUR 833.5 million and its share fell to 29.6 per cent compared to 31.3 per cent earlier. These developments in the first four months of 2011 were largely attributable to the closure of deposit accounts of non-residents with banks (EUR -636.6 million).

In the currency structure of gross external debt the euro retained its high relative share which by end-March 2011 reached 88.3 per cent. The euro occupied the largest share in intercompany loans (92.9 per cent), and the smallest share in the general government sector (74.2 per cent).

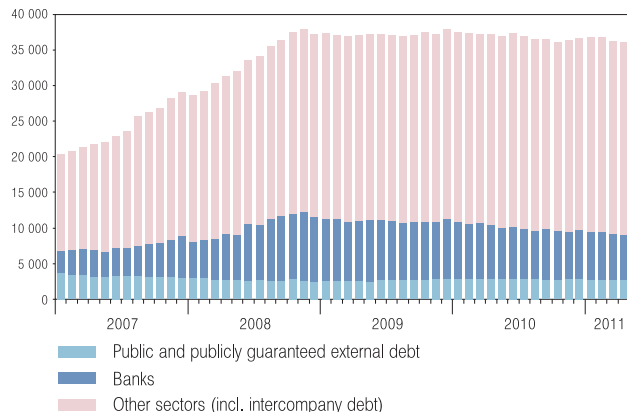
Between January and April 2011 private non-guaranteed external debt decreased by EUR 501.3 million mainly due to the deposits of non-residents with local banks. Banks' debt to foreign parent banks incurred in connection with their activity in Bulgaria occupied a large share in banks' external debt (75 per cent as of March 2011). Changes in banks' external debt between 2009 and the end of April 2011 were due to the ample liquidity of local banks against the background of weak demand for loans, which allowed them to use the free resources to reduce their net external indebtedness.

Between January and April 2011 non-bank sector enterprises increased their external liabilities by EUR 193.2 million while intercompany loans decreased by EUR 142.7 million. The share of intercompany loans in the total amount of external debt stabilised at around 41 per cent by April 2011 compared with 40 per cent a year earlier. This dynamics underlines the long-term interest of foreign owners of local companies in Bulgaria's economy.

Over the same period general government external debt decreased by EUR 122.5 million. The total amount of public and publicly guaranteed debt went down by EUR 163.4 million and came to 11.4 per cent of Bulgaria's total debt. New deposits and loans disbursed to the general government sector amounted to EUR 98.5 million: up EUR 22.7 million on the previous year. New loans were mainly investment loans from the World Bank and the European Investment Bank provided to finance infrastructure projects.

## Gross Foreign Debt by Institutional Sector

(million EUR)



Source: BNB.

According to the average weighted interest rates on new loans declared between January and April 2011 there is an appreciation (on an annual basis) in the cost of external borrowed funds in euro by 0.9 percentage points to 4.3 per cent. The cost of new loans in US dollars reported a decrease of 2.3 percentage points to 3.6 per cent.

By March 2011 there were no notable changes in the structure of private non-bank external debt by industry. The largest share in the external debt of other sectors was occupied by *real estate operations and business services* (22.4 per cent), followed by *electricity, gas and water* (20.6 per cent) and *financial intermediation* (11.4 per cent). The largest share in intercompany loans was occupied by *telecommunications* (19.5 per cent), *real estate operations and business services* (14.9 per cent) and *financial intermediation* (13.3 per cent).

## Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Bulgaria's gross foreign assets decreased by EUR 140.6 million between January and

April 2011. BNB international reserves fell by EUR 1011.2 million and banks' foreign assets went up by EUR 343.1 million. As a result of gross foreign asset and gross external debt dynamics, the net external debt decreased by EUR 524 million, reaching EUR 17.8 billion by end-April 2011, or 47 per cent of GDP reported for the last four quarters.

The interdependence between the capital inflows on the balance of payments financial account and the current account dynamics was retained in the January–May 2011 period. The improvement of the current and capital account balance continued, reporting a surplus of EUR 428.5 million against a deficit of EUR 717.5 million in the corresponding period of 2010. The balance of payments current and capital account balance ended in surplus on an annual basis, accounting for 2.9 per cent of GDP reported for the last four quarters, while a year earlier the balance was negative: -3.9 per cent of GDP.

Between January and May 2011 all current account components improved compared with the corresponding period of 2010. Trade balance improved by EUR 880.5 million, services balance by EUR 206.1 million, income balance by 108.3 million and net current transfers increased by EUR 49.5 million.

In the first five months of 2011 the net inflow on the capital account decreased by EUR 98.4 million on the corresponding period of 2010.

Over the same period trade balance increased most significantly: a deficit of EUR 318.5 million. In nominal terms exports increased by 47.2 per cent and imports by 25.5 per cent on an annual basis<sup>4</sup>. Imports and exports are expected to increase on an annual basis in the third and fourth quarters of 2011 at similar rates as exports growth rate is likely to moderate.

The services balance reported a surplus of EUR 333 million for the January–May 2011 period compared with a surplus of EUR 126.9 million in the corresponding period of the prior year. The improvement was mainly a result of increased transport and other services (communication and other business services) earnings and reduced external services costs (other business services). Earnings on the credit side (as-

<sup>4</sup> More detailed analysis of exports and imports is presented in Section 3.



sets) increased by EUR 182.6 million and earnings on the debit side (liabilities) increased by a total of EUR 23.4 million.

Between January and May 2011 the deficit on the income account amounted to EUR 392 million: down by EUR 108.3 million on the corresponding period of 2010. This reflects mainly the lower income paid on foreign direct investments (improvement of EUR 89.9 million).

Over the first eight months of 2011 net current transfers amounted to EUR 789.8 million: up EUR 49.5 million on an annual basis, mainly due to the increase in transfers to the general government sector (up EUR 39.9 million). The receipts in the form of private current transfers increased by EUR 14.9 million on an annual basis. Transfers abroad declined by EUR 6.2 million. As a result, net transfers to the private sector increased by EUR 21.1 million.

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 amounted to EUR 13 million.

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

(million BGN)



\* Data as of May 2011.

Source: BNB.

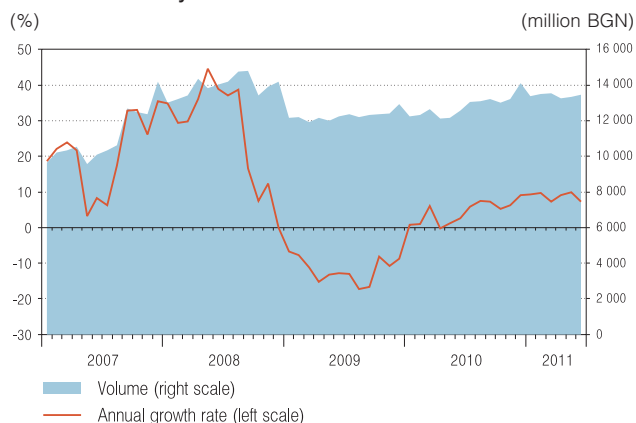
As regards balance of payments components we expect the deficit on the current account to range between 0.3 and 0.6 per cent of GDP in the second quarter of 2011; the latter will be due to the increase in trade deficit which will be covered entirely by foreign direct investment.

Bulgaria's external position remained sustainable with a positive current account balance reflecting the favourable developments in all its components.

## Monetary Aggregates

By June 2011 banks' deposits with the BNB rose by 13.2 per cent on an annual basis as a result of retained high growth of funds attracted from residents. Currency in circulation retained its positive trend and increased by 3.3 per cent. In the next two quarters banks' deposits with the BNB are expected to gradually slow down while currency in circulation is likely to experience a slight increase. By end-2011 interest rates on time deposits are expected to remain broadly unchanged.

### Reserve Money



Source: BNB.

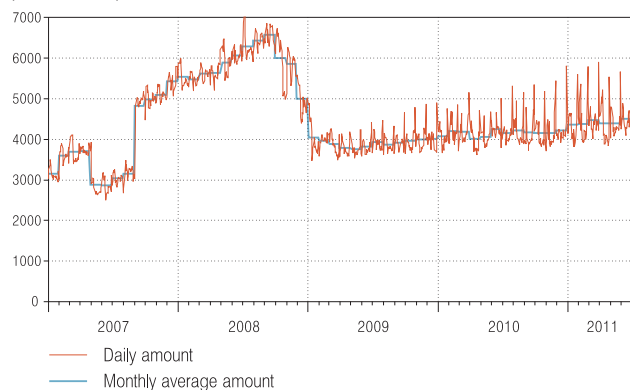
By the end of June 2011 on an annual basis reserve money went up by 7.2 per cent and banks deposits with the BNB by 13.2 per cent contributing by 5.3 percentage points to reserve money growth.

The average daily volume of funds attracted from residents continued to increase at relatively high rates: by approximately BGN 960 million in June compared with March 2011. Over the same period the average daily volume of funds attracted from non-residents went up by about BGN 160 million. As a result of the dynamics and structure of attracted funds, the effective implicit rate of minimum required reserves main-

tained with the BNB<sup>5</sup>, continued to grow slightly. On the other hand, in the second quarter of 2011 banks reduced their excess reserves and their share in the total reserves by banks declined to around 2.1 per cent from 3.7 per cent in the first quarter.

### Bank Deposits with the BNB

(million BGN)



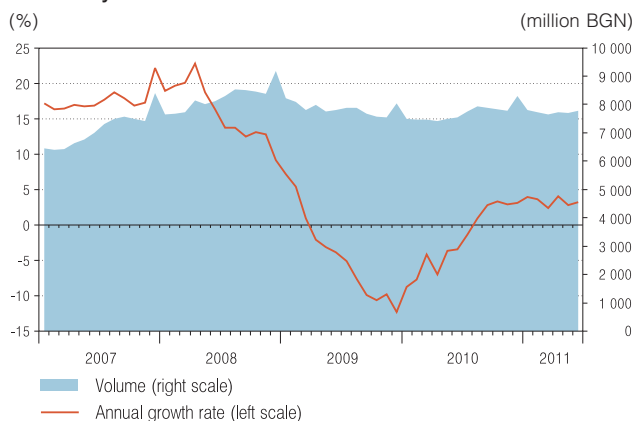
Source: BNB.

The annual growth rate of currency in circulation reached 3.3 per cent in June. Determinants of cash in circulation dynamics relate to the gradual recovery of economic activity.

In the second half of 2011 currency in circulation is expected to further increase at a moderate rate slightly above the current one 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, but with slightly moderating growth rates.

### Currency in Circulation

(%)



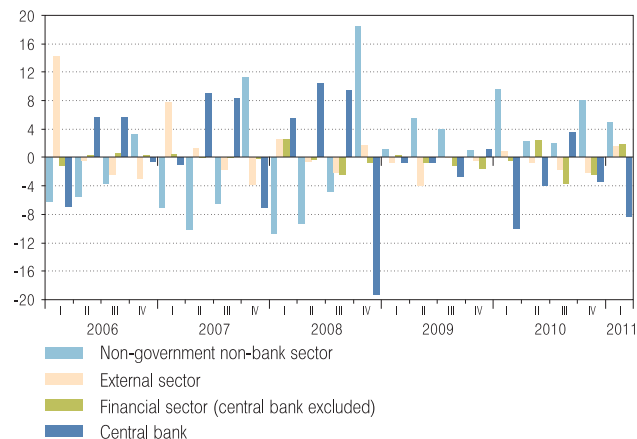
Source: BNB.

<sup>5</sup> 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, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

Fiscal policy affects the allocation of liquidity between economic sectors. In the first quarter of 2011 consolidated budget continued to withdraw a significant amount of liquid funds from the government deposit with the BNB which declined by BGN 1323.7 million over the review period. Most of these funds were re-channelled to non-government non-bank sector but in contrast to the previous quarter the net flows from the budget to the external and financial sectors were also positive. This was mainly attributable to the accumulation of significant payments on debt service in the beginning of the year including interest payment on government global bonds to the external sector and amortisation payments on maturing government securities issued on the domestic market. In March and April direct payments to farmers were made from the government deposit with the BNB under the common agricultural policy of the EU, amounting to BGN 356.2 million and BGN 180.1 million respectively<sup>6</sup>. Most of these funds (BGN 349.4 million) were reimbursed in May by the EU which resulted in an inflow of funds from the external sector to the budget.

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

(share of GDP, %)



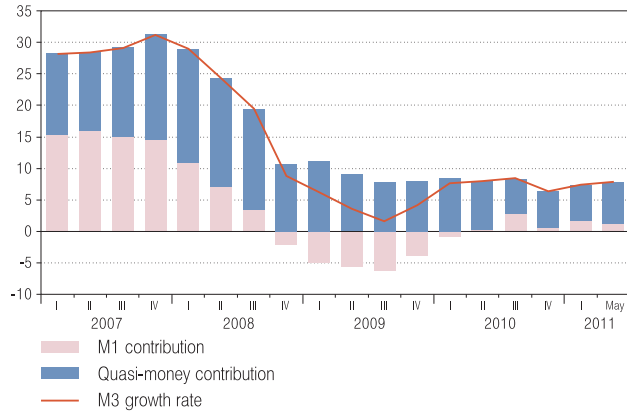
Sources: MF, BNB.

By the end of May broad money growth accelerated to 7.9 per cent on an annual basis compared to 7.4 per cent in March. The annual growth of broad money is expected to moderately increase to a level slightly above the current levels in the second half of 2011.

<sup>6</sup> The sums refer only to that part of the budget which is financed at the expense of the EU.

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

(%, percentage points)



Source: BNB.

Quasi-money contributed most to accelerated broad money growth in May, while the contribution of the narrow aggregate, M1, declined. Annual M1 growth moderated to 3.5 per cent. This dynamics resulted from overnight deposits which on an annual basis grew by 3.8 per cent in May compared with 6.4 per cent at the end of the first quarter. The slowdown was mainly attributable to the decline in overnight deposits of social security funds on an annual basis by 92.2 per cent by end-May.<sup>7</sup> Overnight deposits of financial corporations also reported a decline. The local government overnight deposits increasing by 44.7 per cent<sup>8</sup>, overnight deposits of non-financial corporations, posting an increase of 10.1 per cent on an annual basis by end-May (9.6 per cent in March), as well as overnight deposits of households<sup>9</sup>, increasing by 7.7 per cent (6.6 per cent in March) had a positive contribution.

Growth in money outside banks retained the trend observed in the last quarter of 2010 towards a low but positive annual growth rate (3.0 per cent as of end-May).

By May 2011 quasi-money grew by 10.4 per cent on an annual basis against 8.9 per cent by the end of the first quarter, with lev-denominated deposits contributing most significantly to this: 8.0 percentage points by the end of the month. Concurrently, the contribution of foreign currency

<sup>7</sup> For further details on this decline see Economic Review, 4/2010.

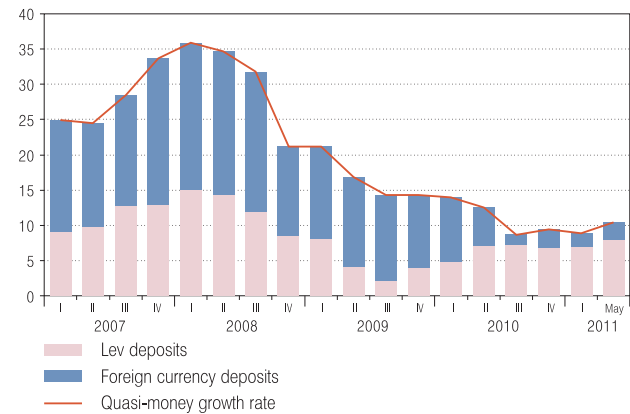
<sup>8</sup> For further details on municipalities' deposits see below Chapter 3, Government Finance and Consumption.

<sup>9</sup> The cited data on deposits and loans of households include also deposits and loans of NPISHs in line with the classification used in monetary statistics.

deposits went up from 1.8 percentage points in March to 2.4 percentage points in May.

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

(%, percentage points)

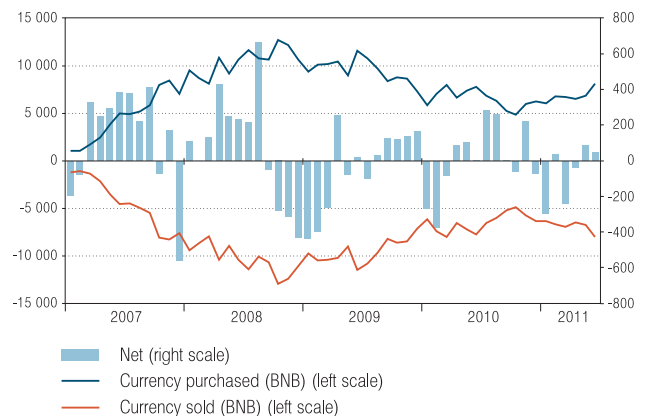


Source: BNB.

Deposits with agreed maturity of up to two years went up by 9.8 per cent on an annual basis, mainly due to household deposits (7.8 percentage points). By end-May household deposits in lev increased by 24.9 per cent on an annual basis and those in foreign currencies by 4.1 per cent. Non-financial corporations also increased their deposits with agreed maturity of up to two years with lev-denominated deposits going up by 16.6 per cent by May and foreign currency deposits going down marginally (by 0.9 per cent).

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

(million EUR)



Source: BNB.

Banks' foreign exchange transactions with the BNB served as a major lev liquidity management tool. It is used to perform the main function of the Currency Board to buy and sell on demand national currency against euro.

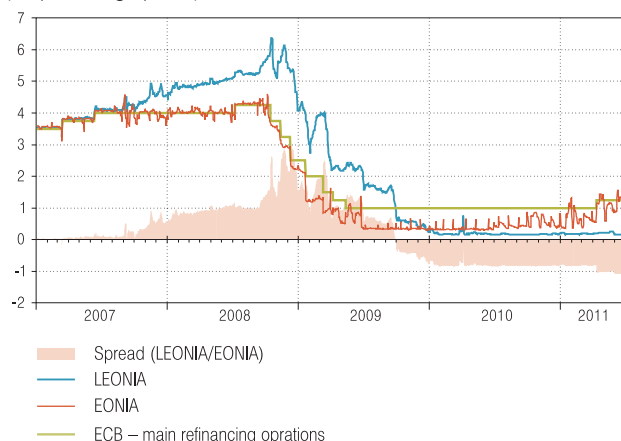
Between April and June 2011 the average daily volume of currency trade of banks with the BNB came to around EUR 700 million against almost EUR 630 million in the first quarter. Over the same period banks realised net sales of euro to the amount of EUR 90 million (compared to net purchases of EUR 500 million in the first quarter of 2011).

As a result of the retained ample liquidity in the Bulgarian banking system in the second quarter interbank money market interest rates saw no sizeable changes compared with the previous quarter and the average interest rate on concluded transactions remained at the level of 0.25 per cent.

LEONIA index increased by 1 basis point to 0.20 per cent compared with the previous quarter. The negative spread between LEONIA and EONIA continued to expand, the average value being 84 basis points in the second quarter against a negative spread of 49 basis points in the first quarter of 2011. The widening of the spread was entirely due to the increase in European interest rates as a result of ECB liquidity absorption operations. In contrast to the euro area, interest rates in Bulgaria were again characterised by very low volatility. The ample liquidity of banks resulting from the higher savings rate of households and the cautious lending policy were the factors behind this dynamics.

#### LEONIA/EONIA

(%, percentage points)



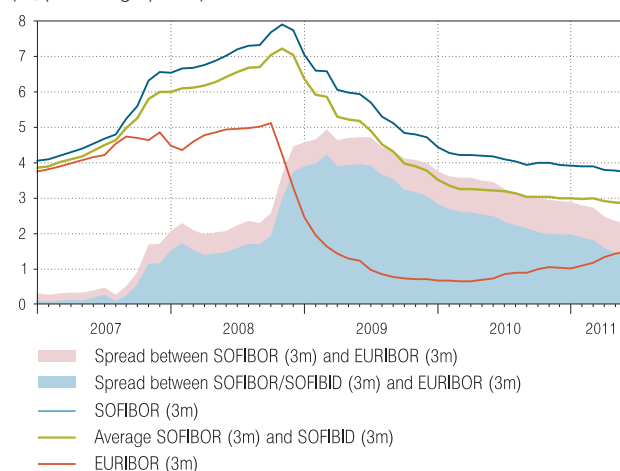
Source: BNB.

In the second quarter the SOFIBOR reference rate (3m), used as an indicator for short-term interest rates, went down by 13 basis points on the previous quarter reaching 3.7 per cent. The spread between the three-month SOFIBOR and EURIBOR continued to follow its downward trend

reaching 225 basis points in June (48 basis points lower than its March level). The narrowed spread reflects the 31 basis point rise in the EURIBOR between April and June and the 17 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 correct to compare this value with EURIBOR which is the closest rate to the actual market price at which transactions are concluded<sup>10</sup>. The average SOFIBOR/SOFIBID reference rate in the interbank market in Bulgaria over the three-month horizon declined by 14 basis points by end-June 2011 (reaching 2.9 per cent) compared with March and the spread between the average quotation and EURIBOR (3m) decreased to 137 basis points compared to 182 basis points in March 2011.

#### SOFIBOR, EURIBOR and Average SOFIBOR/SOFIBID (Three-month Horizon)

(%, percentage points)



Source: BNB.

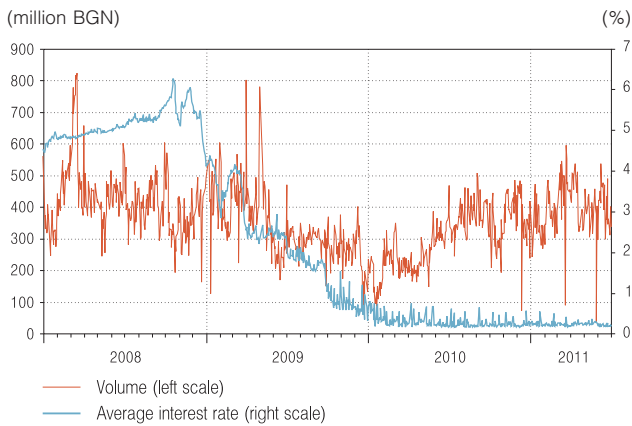
Between April and June the average daily volumes traded in the interbank market amounted to BGN 403 million, an increase of 2.3 per cent on the previous quarter. These trade levels were typical of the period prior to the global economic crisis. Correspondingly, this is indicative of the improvement of the interbank market and the confidence among participants.

The yield curve also shows positive signs of the domestic interbank market development. In the second quarter the downward trend in the long end continued. By June a fall of 94 basis

<sup>10</sup> 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, 2/2010.

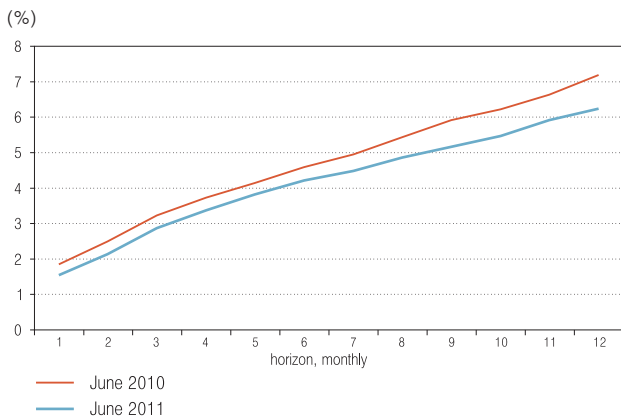
points on an annual basis was reported in the 12-month horizon against 30 basis points in the one-month horizon.

### Trade Volume and Interbank Money Market Interest Rates



Source: BNB.

### Interbank Money Market Yield Curve (Based on Average SOFIBOR/SOFIBID Quotations)



Source: BNB.

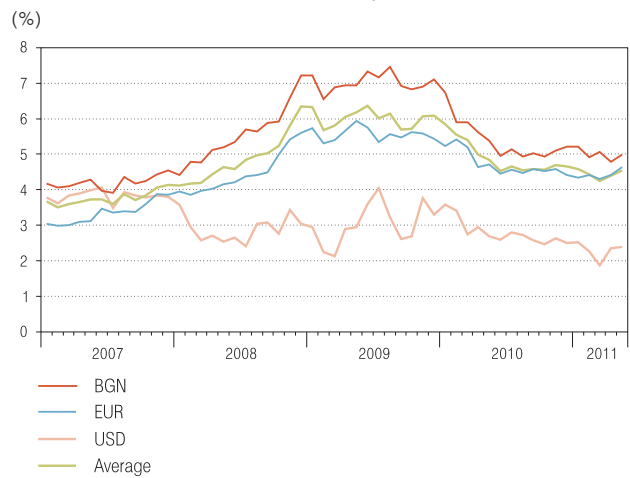
Between April and May 2011 the average weighted interest rate on new<sup>11</sup> deposits remained broadly unchanged compared with the first quarter (4.5 per cent) but there was a varying interest rate dynamics by currencies. By May the average interest rate on new time deposits denominated in levs reached 5.0 per cent (against 5.1 per cent in March) and the average interest rate on time deposits denominated in euro increased to 4.6 per cent. At the same time, the average weighted deposit rate declined by 28 basis points to 4.55 per cent on an annual basis.

Interest rates on time deposits are expected to remain broadly unchanged in the second half of 2011. These expectations are underpinned by

<sup>11</sup> The term *new deposits* refers to the statistical category *new business*.

the projections of high banking system liquidity<sup>12</sup>, expected low lending activity and persistent high savings rate of households. The ECB's policy of interest rate rises by the end of 2011 will also contribute to this.<sup>13</sup>

### Interest Rates on New Time Deposits

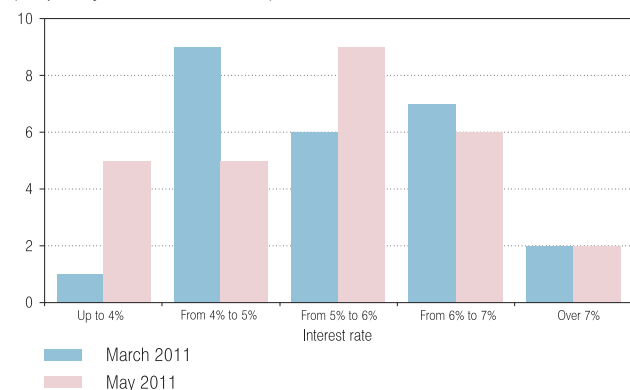


Source: BNB.

As regards the distribution of interest rates on time lev deposits of households by bank, the number of banks offering rates between 4 and 5 per cent, and between 6 and 7 per cent band decreased at the expense of those offering rates of up to 4 per cent and from the 5 to 6 per cent band. The average interest rate level<sup>14</sup> in May decreased by 36 basis points to 5.19 per cent on March, while the dispersion coefficient went up by 66 basis points reaching 1.76 percentage points.

### Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



Source: BNB.

<sup>12</sup> The liquid assets to total liabilities ratio remained at the remarkable 23.7 per cent level in May 2011.

<sup>13</sup> See here, Chapter 1, sub-section Euro area.

<sup>14</sup> The average interest rate level is a simple average value not weighted by volumes.

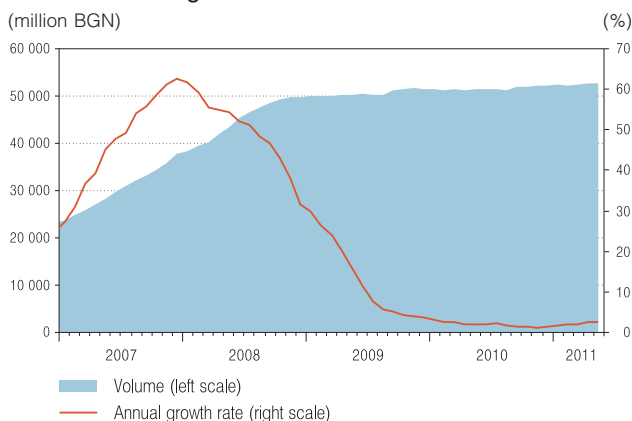
## Credit Aggregates

The gradual recovery in industry and services contributes to the smooth increase in claims on non-financial corporations. The decline in loans to households reflects both the weak consumption and the higher savings rate, as well as the cautious bank lending policy. Interest rates on loans to non-financial corporations and on housing loans to households reported an increase in May compared with the first quarter of 2011. Lending rates are expected to recoup their downward dynamics in the second half-year.

The gradual recovery in export-oriented industry and in the services sector contributed to the moderate increase in claims on non-financial corporations. Meanwhile, private consumption remains weak as the households retained their high savings rate, which contributed to the decline in claims on households. The cautious bank lending policy is also a key factor which continued to influence credit growth. The growth rate of claims on the non-government sector accelerated slightly and reached 2.6 per cent on an annual basis by end-May (compared to 1.9 per cent in March).

Between April and May 2011 claims on non-government sector rose by BGN 365.5 million (against a decrease of BGN 9.3 million in the same period of 2010). In the April–May 2011 period banks reported minimum net sales of loans to the amount of BGN 10.3 million.

### Claims on Non-government Sector



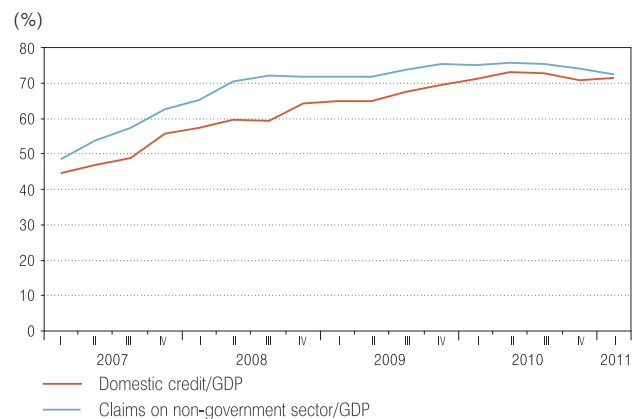
Source: BNB.

As a whole the demand for loan financing remained low, but there are some signs of an increased demand from corporations in the short-term horizon to cover their needs of working capital and inventories. Banks expect a slight easing of credit standards in the second half of the year and a gradual increase in claims on non-government sector.

The higher nominal GDP growth than that of claims observed in the first quarter influenced

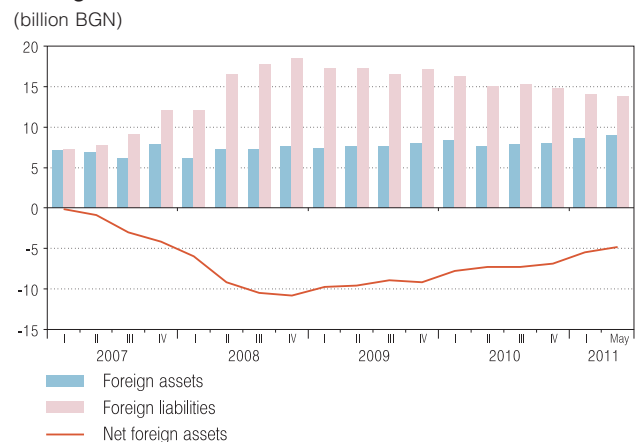
the dynamics of the *claims on the non-government sector to GDP ratio*. By the end of March 2011 this ratio was 72.6 per cent: down 1.6 percentage points on the previous quarter.<sup>15</sup>

### Domestic Credit



Source: BNB.

### Foreign Assets and Liabilities of Banks



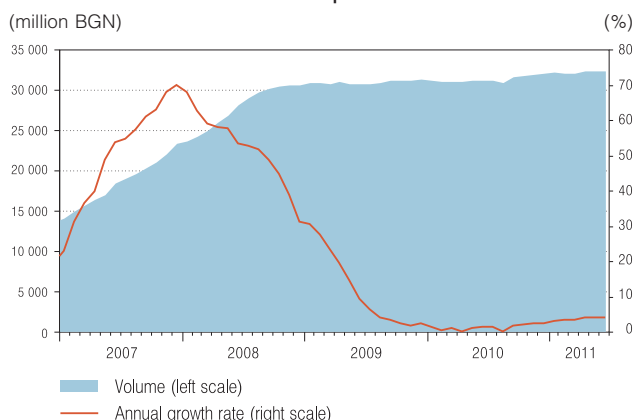
Source: BNB.

Between April and May 2011 banks' funds attracted from non-residents decreased by BGN 252.4 million, while their foreign assets grew by BGN 408.7 million. As a result, banks' net foreign liabilities declined by BGN 661 million reflecting banks preference for reducing their external obligations in the context of ample liquidity and still low domestic demand for loans. No significant change in the banks' policy is ex-

<sup>15</sup> The ratio is calculated using the annual GDP.

pected in respect of foreign assets and liabilities in the following two quarters of the review year.

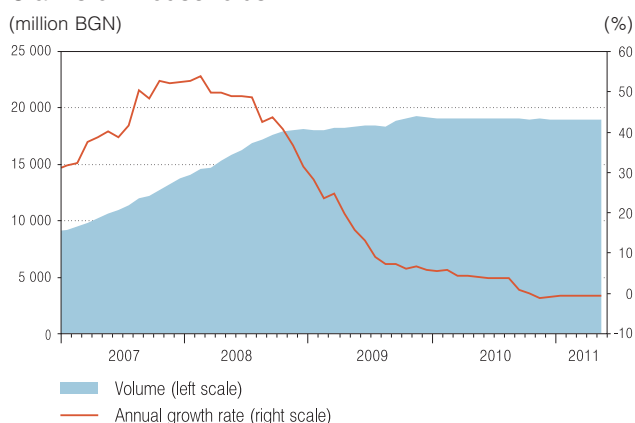
### Claims on Non-financial Corporations



Source: BNB.

As a result of improved external environment and the recovery of the services sector the annual growth rate of claims on non-financial corporations started slightly to accelerate from the fourth quarter of 2010 to reach 4.0 per cent by the end of May 2011. Claims on non-financial corporations increased by BGN 291.6 million between April and May 2011 (an increase of BGN 43.4 million compared with the same period in 2010). Over the same period new loan agreements for non-financial corporations went up by BGN 1085 million on the corresponding period of the previous year which is an increase of 84.2 per cent.

### Claims on Households

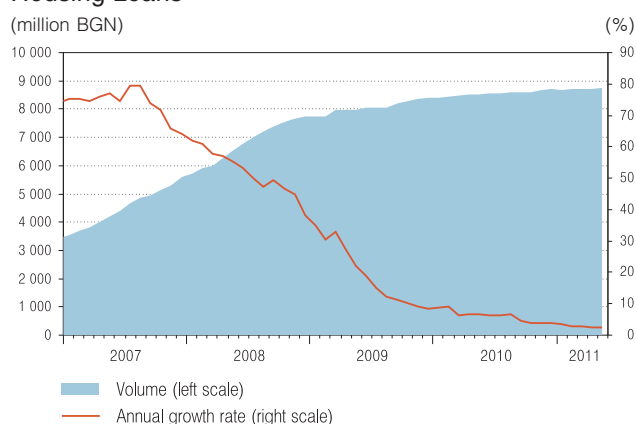


Source: BNB.

Lending to households remained weak. Despite the signs of gradual economic recovery unemployment retained its level, a factor creating uncertainty about future income, thus limiting household consumption. Between April and May 2011 claims on households increased

by BGN 19.6 million against a decrease of BGN 16.5 million in the corresponding period of 2010. Their annual growth rate remained negative, reaching -0.5 per cent by the end of May 2011. Except for housing loans, all other household loans reported declines on an annual basis (overdrafts: 10.7 per cent; consumer loans: 1.2 per cent; and other loans: 2.6 per cent). Though positive, annual growth in housing loans continued to moderate and reached 2.6 per cent by the end of May 2011. Now it is not sufficient to offset the decline in the other loan categories. Between April and May 2011 new housing loan agreements amounted to BGN 197.7 million: down 7.2 per cent on the same period of the prior year.

### Housing Loans



Source: BNB.

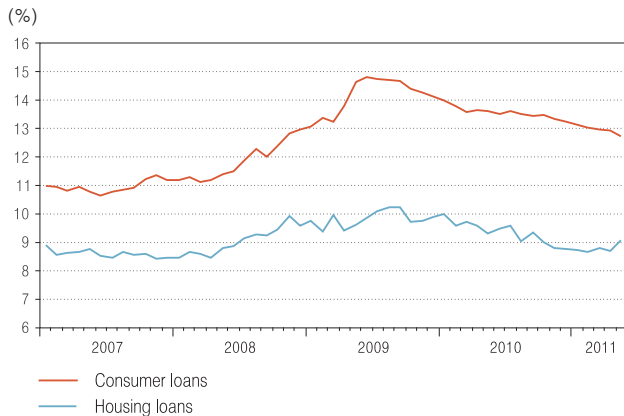
Between April and May 2011 interest rates on consumer loans declined compared with the previous quarter and interest rates on housing loans increased.

The average annual percentage rate of charges (APRC) on new consumer loan agreements amounted to 12.7 per cent in May (against 13.0 per cent in March) and the average interest rate on these loans fell by 25 basis points to 11.2 per cent on March<sup>16</sup>.

In May the annual percentage rate of charges on housing loans increased by 27 basis points on March, reaching 9.1 per cent. By end-May interest rates on housing loans accounted for 8.3 per cent, an increase of 20 basis points compared with March.

<sup>16</sup> The annual percentage rate of charges is the total amount of credit to the credit borrower expressed as an annual per cent of the total sum of extended credit (Directive 87/102/EEC on Consumer Credit amended by Directive 90/88/EEC and Directive 98/7/EC).

### The Annual Percentage Rate of Charges on New Household Loans\* (Average Weighted by Currency) (%)

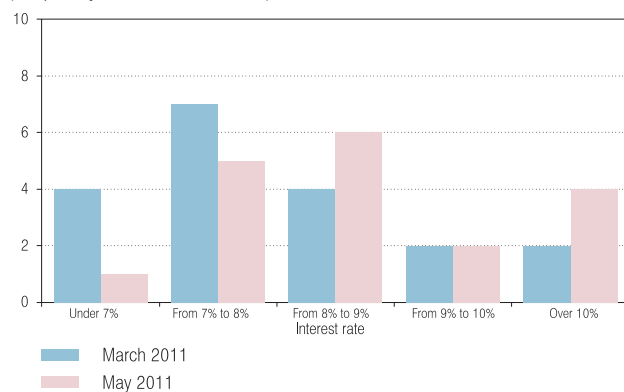


\* The term *new loans* refers to the statistical category *new business*.  
Source: BNB.

As regards the distribution of interest rates on housing loans in euro<sup>17</sup> by bank in May, the number of banks offering rates within the 8 to 9 per cent and over 10 per cent band at the expense of those offering rates under the 7 per cent and from 7 to 8 per cent increased compared with March. Over the same period the average interest rate level increased by 108 basis points and the dispersion coefficient went up by 24 basis points to 2.02.

### Distribution of Interest Rates on New Housing Loans in Euro

(frequency – number of banks)

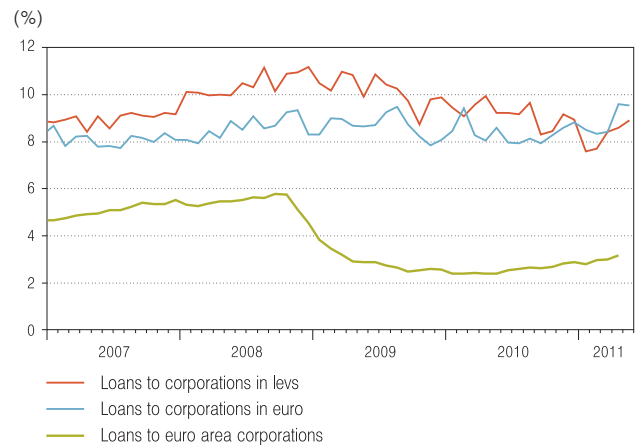


Source: BNB.

In May the average interest rate on bank loans to non-financial corporations increased by 87 basis points to 9.3 per cent on March. Interest rates on loans in levs went up by 49 basis points and those on loans in euro by 111 basis points.

Lending rates are expected to fall insignificantly in the second half of 2011. Ample liquidity in the interbank market may not be a decisive factor for the reduction of lending rates, since this market's role in bank liquidity management is just auxiliary. On the other hand, the expected stabilisation of deposit rates, which are a major resource for banks and the increase in ECB interest rates on its main refinancing operations, will be factors limiting the possible decrease in lending rates.

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



Sources: BNB and ECB.

<sup>17</sup> Housing loans in euro comprise the largest share in the new housing loans over the last three years.



# 3. Economic Activity

In the first quarter of 2011 the real GDP growth rate was 0.6% on the previous quarter, net exports contributing most to this. We expect that the strengthening of the economic activity in the second half of 2011 will be mainly due to the recovery in domestic demand.

During the first quarter of 2011 real GDP continued to gradually recover and on a chain basis growth accounted for 0.6 per cent<sup>1</sup>. Similar to 2010 exports of goods and services contributed most substantially to the enhanced economic activity. In real terms, exports of goods and services rose by 4.6 per cent on the fourth quarter of 2010. Exports of goods continued to rise at faster rates (6.2 per cent) than exports of services which increased by 1.5 per cent. Dynamics of imports of goods and services remained unstable. Following the accelerated growth in the fourth quarter of 2010, the first quarter of 2011 saw a real fall in imports by 1 per cent on a chain basis, with imports of services contributing most significantly. Imports of goods increased by 4.9 per cent, while imports of services decreased by 11.1 per cent.

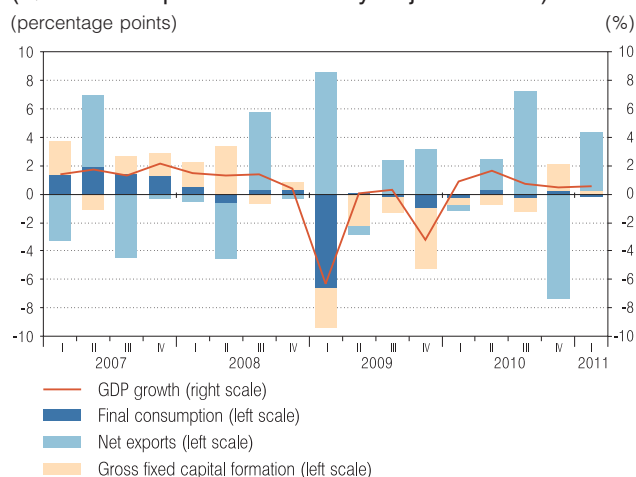
Investment in fixed capital continued recovering in the first quarter of 2011 albeit at a slower pace (0.9 per cent on a chain basis). Decreases in inventories had a significant negative contribution to growth of total investment: for the first time since early 2011 inventories in the economy reported a decline in nominal terms. As a result of inventories dynamics gross fixed capital formation went down in real terms by 3.7 per cent and had a negative contribution to GDP growth.

Final consumption of households rose by 0.1 per cent in real terms, that is it remained close to its 2010 fourth quarter's level. Labour market conditions have improved at very slow rates. This impacted households' perceptions

<sup>1</sup> The analysis in this section employs seasonally adjusted data, unless otherwise indicated. For indicators on which the NSI or Eurostat do not officially publish seasonally adjusted data, adjustment was made via the TRAMO SEATS programme by using automated set-up for diagnostics and optimization of adjustment parameters.

and they remained cautious in increasing their spending although real income from remuneration increased.

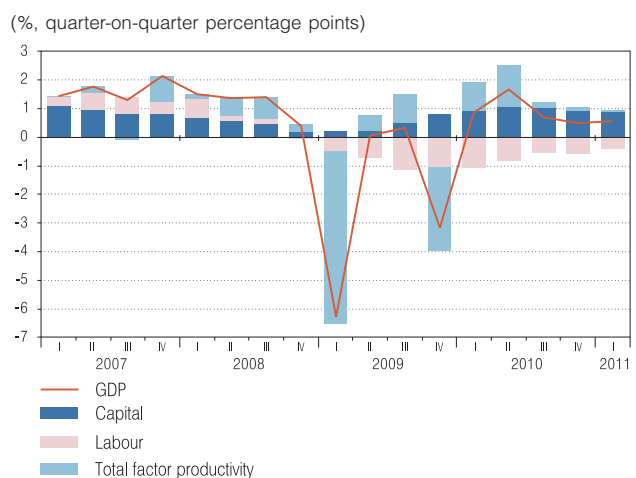
**Contribution to GDP Growth by Component of Final Consumption**  
(Quarter-on-quarter Seasonally Adjusted Data)



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

Sources: NSI, BNB.

**Contribution of Changes in Factors of Production to GDP Growth**



Sources: NSI, BNB.

The growth breakdown by factors of production shows a stabilisation of contribution of the capital<sup>2</sup> used in GDP growth around 1 percentage point since 2010, reflecting both higher capacity utilisation and slower decline in net investment.

The labour factor measured by hours worked in economy has gradually decreased its negative contribution to output growth to -0.4 percentage points since mid-2010. The contribution of total factor productivity also contracted to reach 0.1 percentage points in the first quarter of 2011.

### Value Added Growth and Contribution by Sector

(%; quarter-on-quarter percentage points)



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

Sources: NSI, BNB.

In the first quarter of 2011 gross value added in real terms matched the previous quarter's level. Industrial sector contributed negatively to

<sup>2</sup> Calculations are based on the capital estimated through seasonally adjusted accumulated capital corrected for the capacity utilisation rate in manufacturing according to the Industry Trend Survey. The HP bandpass filter ( $\lambda = 10$ ) is applied to the capacity utilization indicator.

### GDP by Component of Final Consumption

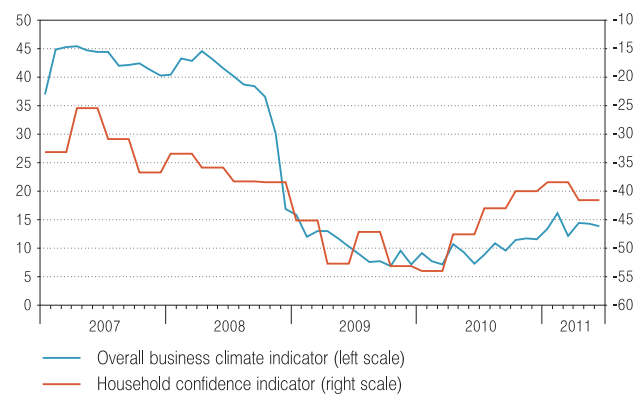
(%, real growth on the previous quarter; seasonally adjusted data)

	2008				2009				2010				2011
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Consumption incl.	0.6	-0.6	0.4	0.4	-7.6	0.1	-0.2	-1.1	-0.3	0.4	-0.3	0.3	-0.3
Household consumption	1.9	-1.6	-0.6	-1.6	-3.3	-1.6	-1.2	-1.3	0.2	0.6	-0.4	0.3	0.1
Final government consumption expenditure	-4.8	2.1	-1.8	7.0	-14.1	2.4	2.2	-3.0	2.8	2.1	0.2	-0.3	0.2
Collective consumption	-1.5	0.6	0.3	1.4	-1.0	0.1	-1.4	-16.1	13.4	-2.2	-1.8	-2.5	-0.2
Gross capital formation	-0.7	29.8	-9.5	-8.1	-11.5	-4.4	-7.2	-10.9	1.2	-2.9	-5.7	2.7	-3.7
Gross fixed capital formation	5.5	10.6	-2.0	1.6	-8.2	-6.9	-3.5	-14.1	-1.8	-3.0	-3.7	7.9	0.9
Exports of goods and non-factor services	2.7	-0.3	-3.2	-5.0	-6.6	-2.6	1.8	6.5	0.3	7.1	11.6	-3.9	4.6
Imports of goods and non-factor services	2.4	4.0	-7.9	-3.1	-15.0	-1.3	-1.8	0.8	0.9	3.1	0.5	5.9	-1.0
<b>Real GDP growth</b>	<b>1.5</b>	<b>1.4</b>	<b>1.4</b>	<b>0.4</b>	<b>-6.3</b>	<b>0.0</b>	<b>0.3</b>	<b>-3.2</b>	<b>0.9</b>	<b>1.7</b>	<b>0.7</b>	<b>0.5</b>	<b>0.6</b>

Sources: NSI, BNB.

it, with value added in construction decreasing by 1.8 per cent and in manufacturing by 1.2 per cent. Agriculture and services reported growth, while *trade and repair, hotels and catering, transport and communications*, posing a 2.4 per cent increase, contributed most substantially.

### Business Climate and Household Confidence Indicator



Sources: NSI, BNB.

In the first half of 2011 the overall business climate was more favourable since end-2010, and by May industrial turnover retained its high growth rate in the domestic and world markets. We anticipate that the economy will continue to recover gradually in the second half of 2011 as domestic demand contribution to growth continues to increase. The contribution of net exports is likely to become negative due to the increased imports of goods and services. Retention of the financial performance of firms and increasing capacity utilisation will help maintain a positive rate of change in investment expenditure. Consumer demand is likely to continue growing at slow rates, consistent with the slow improvement in the labour market situation.

## Gross Value Added Growth

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

	2008				2009				2010				2011
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Agriculture and forestry, hunting and fishing	43.6	1.8	-6.0	2.2	-4.3	-2.1	0.9	-0.1	2.0	0.2	-0.7	-3.8	1.1
Mining and quarrying, production and distribution of electricity, gas and water	0.6	-0.8	-2.7	-2.6	-4.4	0.7	-0.2	-1.0	3.5	0.2	-0.2	3.5	-1.2
Construction	1.6	2.1	3.3	2.3	-8.3	-0.4	-0.2	-0.3	1.3	0.0	0.1	0.9	-1.8
Trade, repair; hotels and restaurants; transport and communications	1.1	0.9	0.9	-1.0	-0.1	-1.8	-0.9	1.2	-1.6	0.4	0.1	0.3	2.4
Finance, credit, insurance; operations in real estate and business services	2.9	0.4	2.8	0.3	-0.1	-0.1	-1.5	-1.4	2.7	2.7	1.6	0.9	1.2
General government; education; healthcare; other services	-0.3	0.1	0.5	1.1	0.2	0.1	-0.2	-0.4	-0.9	0.0	-0.7	-0.6	1.0
<b>Total for the economy</b>	<b>1.5</b>	<b>1.1</b>	<b>1.7</b>	<b>0.3</b>	<b>-4.4</b>	<b>0.3</b>	<b>0.0</b>	<b>0.1</b>	<b>0.0</b>	<b>0.6</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.0</b>

Sources: NSI, BNB.

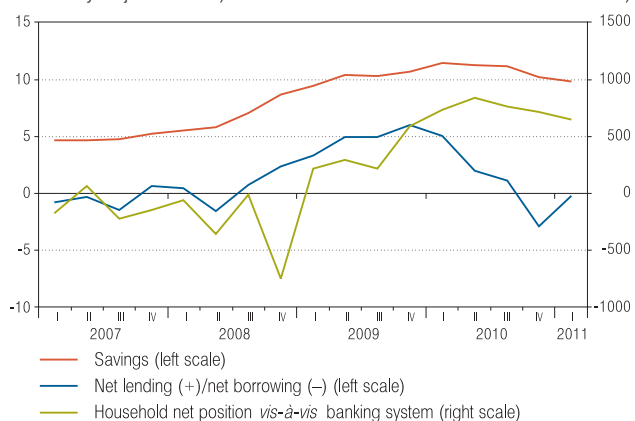
## Household Behaviour

In the first quarter of 2011 household consumption posted slight growth. Consumer demand is expected to recover slowly but the growth rate of household final consumption expenditure will depend on the rate at which labour market conditions improve.

In the first quarter of 2011 household consumption posted a slight increase by 0.1 percentage points on a chain basis, following the 0.3 per cent increase in the last quarter of 2010. Slow improvement in labour market conditions influenced household perceptions and uncertainty in expectations and cautiousness regarding changes in consumption were sustained.

### Household Savings Propensity

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



Sources: NSI Household Budget Survey, BNB.

In the first quarter of 2011 households' savings represented as the net assets of households in the banking system, continued to increase albeit at a lower rate than in early 2010. The share of savings in household disposable income indicated a certain decline but remained at a relatively

high level. Factors behind the relatively lower rate of household saving were the lower nominal interest rate on deposits and the higher inflation.

According to national accounts data, household expenditure on food service activities increased, while that on food products, transportation and purchased non-production services decreased.<sup>3</sup> Between January and May 2011 retail trade volumes moderately recovered, particularly *information and communication equipment* and *automobile fuels and lubricants*. On the other hand, the January–May 2011 period saw a decrease in the turnover of retail trade in food, beverages and tobacco products, following the rise exhibited in the previous quarters.

The relatively low household investment demand is evidenced by the available indicators related to housing supply. Since early 2010 and particularly in the first quarter of 2011 the number of building permits continued to decline albeit at lower rates. The indicator on residential buildings remains low showing no signs of growth. Unsold houses and slow demand were probably the factors behind comparatively constant annual decline of average market prices of houses in the fourth quarter of 2010 and the first quarter of 2011 (by -5.6 per cent).

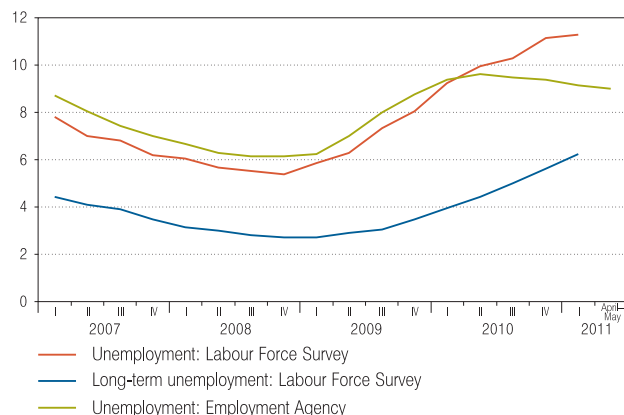
<sup>3</sup> Purchased non-production services include services other than food service activities, water supply, heat energy and electricity, transportation and communications.

Based on national accounts employment data, the downward trend in the number of employed continued in the first quarter of 2011, albeit at a slower pace. On a chain basis the decline accounted for 0.7 per cent against 0.8 per cent in the fourth quarter of the previous year. According to seasonally adjusted data of the Labour Force survey, unemployment of individuals at and above the age of 15 reached 11.3 per cent in the first quarter of 2011 and based on non-seasonally adjusted data it increased to 12 per cent. Registered unemployment measured by the Employment Agency corrected for seasonal factors, gradually decreased, reaching 8.9 per cent in May 2011 which matched the non-seasonally adjusted monthly data.

In 2010 and particularly in the fourth quarter long-term unemployed (over 12 months) contributed most substantially to unemployment growth, while in the first quarter of 2011 the unemployed from 6 to 11 months and unemployed for 2 and over two years had the major contribution. Concurrently, the number of unemployed people who lost their jobs in the last 5 months went down. The share of long-term unemployed remained relatively high and the share of discouraged persons also went up. In the first quarter of 2011 seasonally adjusted economic activity ratio of persons between 15 and 64 years of age decreased insignificantly to 66.3 per cent against an average of 66.4 per cent in the preceding two quarters. These data show a relative stabilisation of the economic activity coefficient.

### Unemployment

(%; seasonally adjusted data)

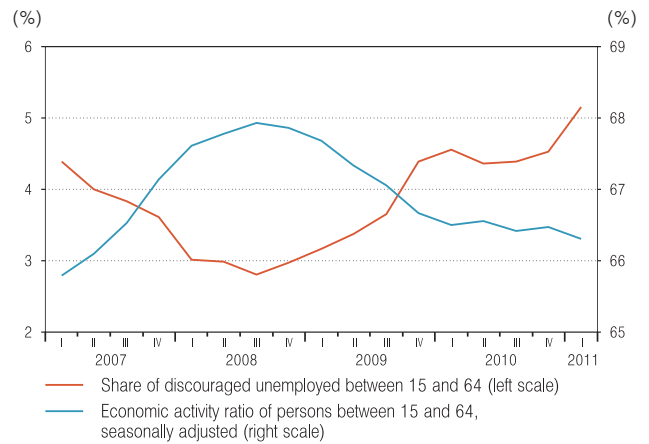


Sources: NSI, Employment Agency, BNB.

Employment Agency data show that competition for occupying vacancies was a little bit lower than in the second half of 2010, with the

number of unemployed applying for a vacant position averaging 15 persons. The vacancy absorption ratio<sup>4</sup> between January and May 2011 indicates no signs of deepening the inconsistencies of the structure of demand for and supply of labour resources.

### Economic Activity and Share of Discouraged Unemployed

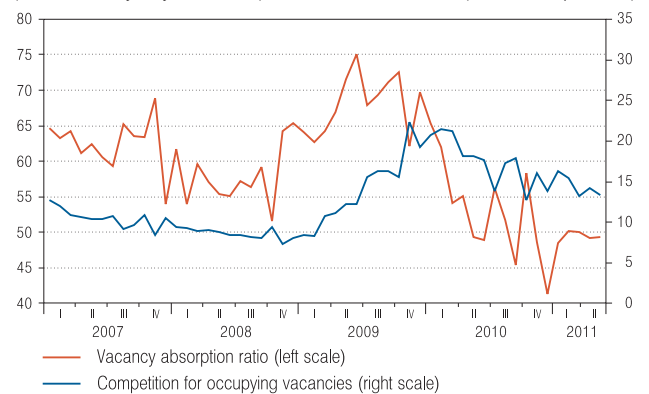


Sources: NSI, BNB.

### Competition and Vacancy Absorption Rates

(%; seasonally adjusted data)

(number of persons)



Sources: Employment Agency, BNB.

Total for the economy on a chain basis the nominal wage per employee rose by 1.5 per cent in the first quarter of 2011, a rate close to that reported in the fourth quarter of 2010. This fact may reflect various reasons, one of them involving the change in the composition of employed by criteria such as age and level of education. In the last quarter of the previous year and in the first three months of 2011 persons aged up to 34, who are probably lower-paid employees, contributed most significantly to the employment decline.

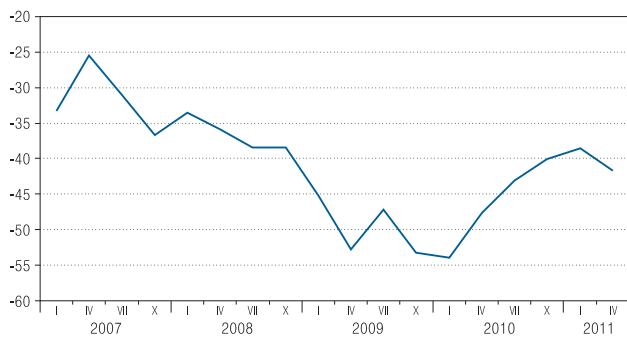
<sup>4</sup> A ratio between the number of vacancies in a particular month which were occupied in a given quarter and the number of offered job vacancies in the same quarter.

In the first quarter of 2011 the average household income from wages per household member increased by 1.3 per cent nominally on an annual basis following the declines reported in the previous quarters (based on NSI household budget survey data).

Real income in total economy, measured by the wage per employee deflated by the HICP, posted positive chain growth in the first quarter of 2011. Over this period, the wage bill in total economy increased on a chain basis both in real and nominal terms irrespective of the continuing decline in the number of employed persons.

### Households Confidence Indicator

(balance of opinions; %)



Source: NSI Consumer Survey.

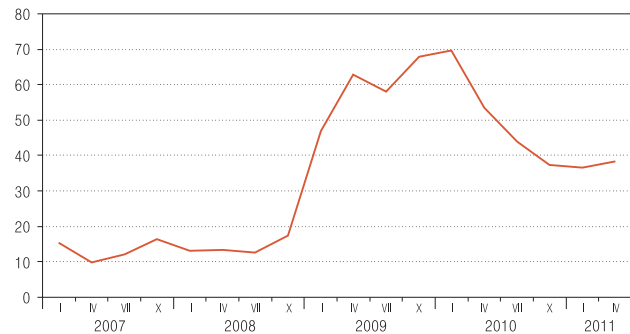
In 2010 and in early 2011 consumer confidence survey data showed positive trends, while April saw a certain deterioration. Households' expectations were more pessimistic regarding their financial performance and the future economic situation. The survey reported a deterioration in household budgets, retention of the upward trend in perceived inflation, and uncertainty surrounding labour market outlook. Based on the business survey firms' expectations about

personnel in the second quarter of 2011 suggest that labour market recovery is likely to be slow. We expect a moderate nominal increase in wages in 2011 consistent with the slow recovery in employment. Consumer demand is also likely to continue rising at moderate rates in line with these trends.

In parallel with the improvement in economic situation consumer sentiment is expected to become more optimistic in the following quarters.

### Unemployment Expectations in the Next 12 Months

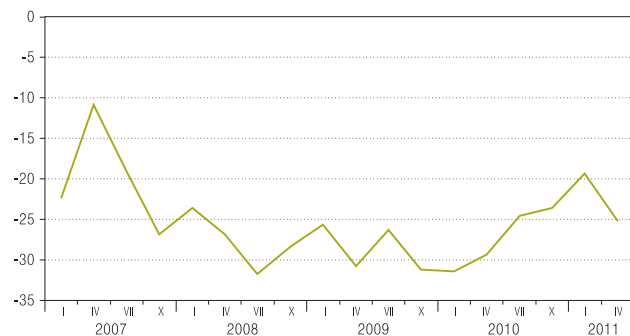
(balance of opinions; %)



Source: NSI Consumer Survey.

### Expectations of Households' Financial Performance in the Next 12 Months

(balance of opinions; %)



Source: NSI Consumer Survey.

### Retail Trade Turnover

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

	2008				2009				2010				2011	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	April-May
Retail trade turnover (excluding cars and motorcycles) incl.	2.8	1.9	-0.8	-0.9	-2.3	-3.5	-2.6	-2.1	-2.4	-0.9	-0.4	-1.2	2.4	0.3
Foods, drinks and tobacco	0.2	0.0	1.0	1.4	7.5	-0.8	0.6	0.0	-0.2	0.5	0.1	0.2	-0.4	-0.9
Textile, clothing, footwear and leather	9.0	0.0	0.3	0.8	-4.2	-4.0	-5.1	0.9	-1.8	-2.3	-1.2	-0.9	2.0	-2.8
Household goods and home appliances	2.0	1.2	-0.6	-2.0	-15.6	-5.0	-5.0	-2.9	-2.8	-1.6	-0.7	-2.2	-1.4	0.6
Computers and communication equipment, etc.	5.5	2.6	-0.2	-1.5	-18.7	-3.9	-5.9	-5.0	-4.6	-2.6	0.1	0.2	1.2	1.6
Pharmaceutical and medical goods, cosmetics and toiletries	6.3	7.0	4.3	3.3	4.6	0.1	2.8	2.7	-15.1	3.4	2.6	3.5	-4.6	3.5
Unspecialized shops with different kinds of goods	8.9	5.7	2.4	0.2	65.9	-3.6	-4.2	-3.7	-4.1	-2.4	-1.7	-2.3	11.9	-0.6
Automobile fuels and lubricants	4.1	1.3	-4.0	-2.7	-1.3	-4.3	-0.5	-1.6	-4.2	-0.2	0.5	-1.8	4.9	1.6

Source: NSI Domestic Trade Survey.

## Employment and Income Dynamics

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

	2008				2009				2010				2011
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Employed	1.0	0.2	0.4	-0.3	-0.6	-1.2	-1.8	-1.8	-1.8	-1.2	-0.9	-0.8	-0.7
Real wage*	-4.0	3.0	0.1	6.1	0.9	3.6	2.6	-2.4	4.8	-1.3	-0.1	0.3	2.8
Wage bill in real terms	-0.4	3.3	-0.4	5.0	0.8	1.2	0.5	-2.2	0.0	-2.1	0.7	-0.4	1.6
Unemployment, average for the period, % of the labour force	6.0	5.7	5.5	5.4	5.9	6.3	7.3	8.1	9.2	10.0	10.3	11.1	11.3

\* Data deflated by HICP.

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

## Government Finance and Consumption

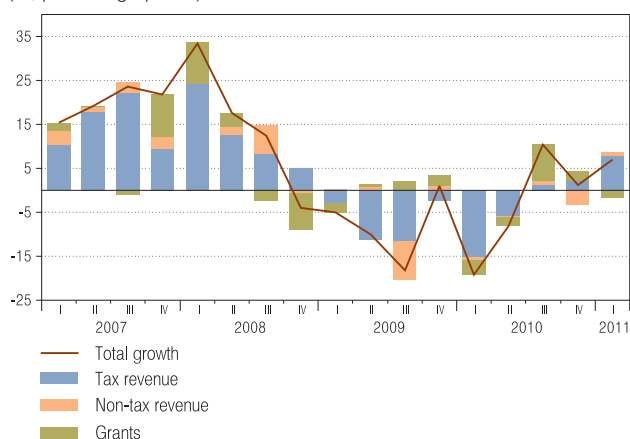
Following a surplus of BGN 189.9 million in April and a small deficit of BGN 45.5 million in May, the cash budget deficit for the first five months of 2011 decreased to BGN 597.5 million (0.8 per cent of the projected GDP for the present year).

In the first quarter of 2011 the real individual and collective consumption changed by 0.2 per cent and -0.2 per cent on a chain basis respectively, which led to a zero per cent contribution of government consumption to GDP growth. The dynamics of wage and intermediate consumption expenditure reported in April and May confirmed our expectations for a small positive real growth in the second quarter. In the following two quarters the growth rate of government consumption will tend to slightly accelerate, but as a whole the annual contribution of government consumption to GDP growth is expected to be close to zero.

In the first quarter of 2011 total budget revenue in the consolidated fiscal programme (CFP) amounted to BGN 5529.8 million, which is 6.9 per cent higher when compared with the corresponding period of 2010 and accounts for 21.1 per cent of the annual estimates in the 2011 Republic of Bulgaria State Budget Law. The increase in total revenue was entirely attributable to the effective tax revenue collection which offset the delayed receipts under EU programs.

### Contribution of Major Groups of Revenue to the Growth in Total Revenue and Grants (Quarterly, on an Annual Basis)

(%; percentage points)



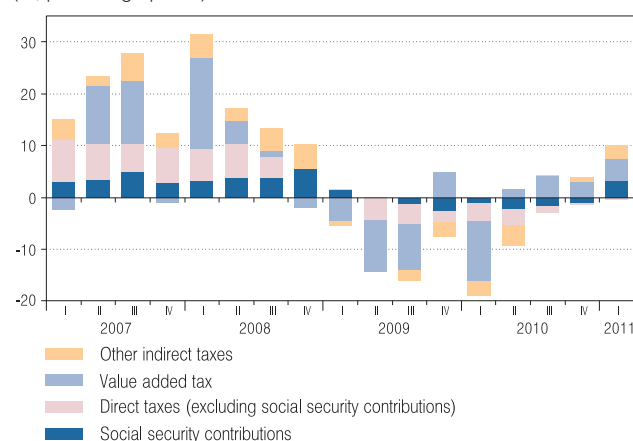
Sources: MF, BNB.

Indirect taxes (up 6.7 percentage points) had the largest contribution to the strong recovery of tax revenues. Their dynamics reflects the in-

creased household consumption both in real and nominal terms in the last quarter of 2010 and the first quarter of 2011. Between January and March a number of one-off divergent factors<sup>5</sup> occurred but they had a net positive effect on receipts from indirect taxes.

### Contribution of Major Tax Groups to Tax Revenue Growth under the Consolidated Fiscal Programme (Quarterly, on an Annual Basis)

(%; percentage points)



Sources: MF, BNB.

At the same time direct tax contribution to the increase in tax revenue remained almost zero. Despite the significant nominal increase in gross operating surplus in the first quarter (by 16.9 per cent), corporate tax receipts continued

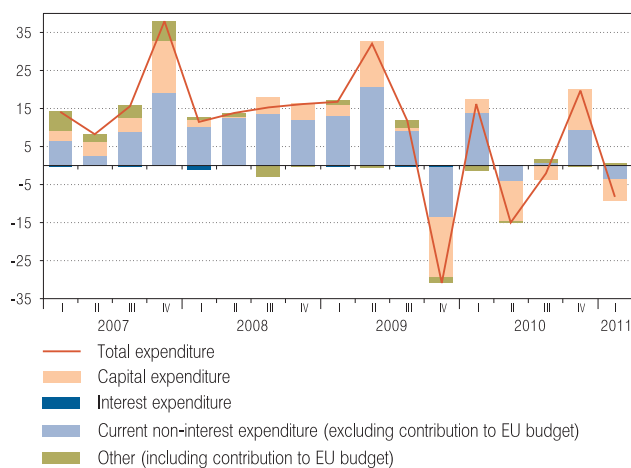
<sup>5</sup> For more details, see also Economic Review, 1/2011.

to decrease. The significant mismatch between the dynamics of this tax and the respective macroeconomic base was primarily due to delays in depositing current profit taxes due and the legal ability of the firms to deduct previous periods' losses from the current taxable profit. On the other hand, implementation of revenue from personal income tax (up 1.2 per cent on an annual basis) reflected the rate of change in the wage fund in total economy (by 1 per cent on an annual basis). Higher remuneration paid at the end of 2010 offset to a large extent the indirect effect of the shortened taxable base as a result of raised social security rates since early 2011.

Data on the implementation of the consolidated fiscal programme for the first quarter of 2011 do not support the estimates set in the National Social Security budget for a two-digit growth rate of revenue from social and health insurance contributions. This revenue posted a mere 2.3 per cent annual increase after the one-off amount of BGN 109.6 million transferred by the Professional Pension Funds in March is deducted. The gap between the current implementation and the targets may pertain to worsened collectability accompanying the changes in legislation.

#### Contribution of Major Groups of Expenditure to Total Expenditure Growth (Quarterly, on an Annual Basis)

(%; percentage points)



Sources: MF, BNB.

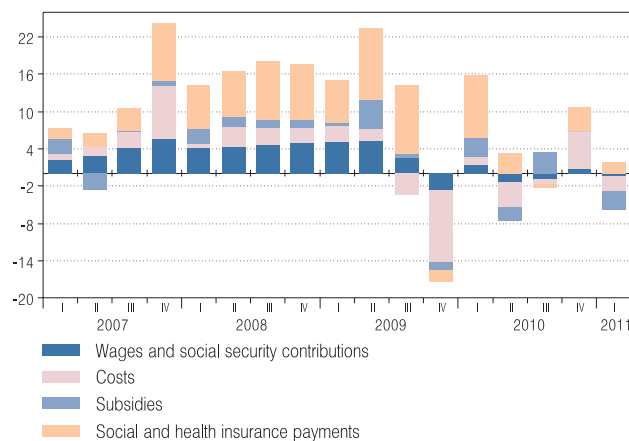
In the first quarter of 2011 total budget expenditure (including also Bulgaria's contribution to EU budget) amounted to BGN 6272.3 million, accounting for 22.3 per cent of the annual projections in the Republic of Bulgaria State Budget Law.

The annual rate of decline in consolidated government expenditure by 8.3 per cent was

mainly due to the lower capital expenditure (by 48.0 per cent), subsidies (38.9 per cent) and current operating expenditure (14.3 per cent). One-off factors that pushed up the expenditure in the beginning of 2010 were also important.<sup>6</sup> Social expenditure rose substantially in the first quarter (by 4.0 per cent), which was attributable to the increase in health insurance payments by 25.6 per cent compared with the corresponding period of 2010. Pension expenditure almost matched the 2010 first quarter's level, indicating an insignificant annual increase of 0.2 per cent, consistent with the fiscal consolidation measures announced by the government.

#### Contribution of Major Groups of Current Non-interest Expenditure to Total Expenditure Growth (Quarterly, on an Annual Basis)

(%; percentage points)



Sources: MF, BNB.

Based on Ministry of Finance preliminary monthly data by the end of May total revenue and grants under the consolidated fiscal programme rose by 6.8 per cent<sup>7</sup> reflecting mainly the continuing recovery of revenue from indirect taxes. Between January and May revenue from VAT and excise duties went up annually by 18.3 per cent and 17.8 per cent respectively. However, it should be noted that high revenue growth from excise duties reflects to some extent the refunded excise duty which was lower by about BGN 200 million compared with the corresponding period of 2010. The MF monthly data show that social and health insurance posted an increase by 11.1 per cent by the end of May, but deducting the one-off amount transferred by Professional Pension Funds in March,

<sup>6</sup> For more details, see also Economic Review, 1/2010.

<sup>7</sup> Based on preliminary data for June revenue growth accelerated to 7.6 on an annual basis.

the reported annual change was 5.6 per cent. Non-tax revenue and revenue from grants had the largest contribution to the change in government revenue (by -1.22 and -1.87 percentage points respectively). Revenue from indirect taxes are expected to slow down in the following two quarters after the effect of one-off factors, affecting the dynamics of this revenue in the first months of the year, phases out. Concurrently, the revenue from personal income tax and social security contributions are anticipated to accelerate as a result of the expected labour market recovery. Following a decline of 39.2 in revenue from grants in the first five months this revenue item is expected to increase as a result of reimbursement by the European Commission of funds spent on EU programmes (BGN 515 million in the January-June period).

Between January and May 2011 government expenditure (including Bulgaria's contribution to the EU budget) continued to decrease but the annual rate of change slowed down considerably to -1.1 per cent<sup>8</sup>. Compared to the corresponding period of the previous year in April and May only expenditure went up by 14.2 per cent and 8.7 per cent respectively. Subsidies, operating expenditure and investments contributed most significantly to higher expenditure over these two months. Dynamics of subsidies may be explained by delayed direct payments to farmers, as most of the co-financing related to these payments were made from the national budget in April<sup>9</sup>. The increase in capital expenditure in April and May was probably attributable to the acceleration in payments under EU programmes. Notwithstanding, investment expenditure in the first five months of 2011 were 26.6 per cent lower than in the corresponding period of the previous year, when the utilisation of EU funds was more pronounced. Similar to the end of the first quarter cumulative social expenditure by the end of May again had the largest contribution (by 1.74 percentage points) to the change in total expenditure. Wage and maintenance expenditure growth is expected to accelerate somewhat in the following two quarters due mainly to the lower base. Given the signs of accelerated implementation of EU programmes, capital ex-

<sup>8</sup> Based on preliminary data for June total expenditure declined further to 0.1 on an annual basis.

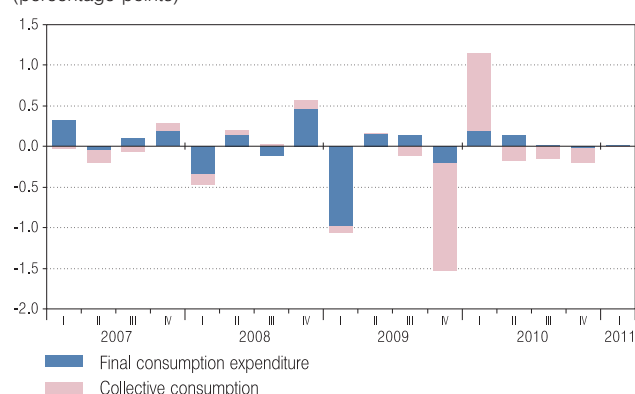
<sup>9</sup> In the preceding campaign of direct payments agricultural subsidies were transferred between December 2009 and February 2010.

penditure should also exhibit higher growth in the following two quarters.

The dynamics of wage and maintenance expenditure and healthcare payments reported in April and May confirmed our expectations for positive but close to zero real growth of government consumption in the second quarter. In the following two quarters the growth rate of government consumption will tend to slightly accelerate but as a whole the annual contribution of government consumption to GDP growth is expected to be close to zero.

#### Contribution of Government Consumption to Economic Growth (Quarter-on-quarter Contribution to Seasonally Adjusted GDP Growth)

(percentage points)



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

Sources: NSI, BNB.

Following a surplus of BGN 189.9 million in April and a small deficit of BGN 45.5 million in May, the cash deficit in the first five months of 2011 decreased to BGN 597.5 million.<sup>10</sup> The negative balance was entirely financed by the accumulated fiscal reserve funds amounting to BGN 4986.4 million as of the end of May<sup>11</sup> (a decrease by BGN 1025.4 million on end-2010). Concurrently, deposits of municipalities not included in the fiscal reserve scope went up by BGN 222.0 million as a result of surpluses, worth BGN 203.2 million, accumulated in the first five months of the year. In addition to budget balance financing, the decline in fiscal reserve was also due to payments made for the account of EU in the amount of BGN 574.2 million reflecting mainly payments to agricultural producers

<sup>10</sup> Based on MF preliminary data the deficit on the consolidated fiscal programme reached BGN 652.1 million by the end of June.

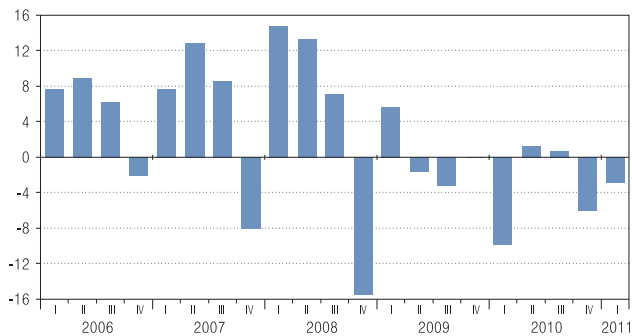
<sup>11</sup> Based on MF preliminary data the fiscal reserve amounted to BGN 5.2 billion by the end of June.



in March and April. A portion of these funds (BGN 349.4 million) was refunded by the European Commission in May.

### Primary Budget Balance (Quarterly)

(% of GDP)



Note: Data for the first quarter of 2011 are based on GDP projections for this period.

Sources: MF, BNB.

Between January and May 2011 the net financing by government securities issued on the domestic market was positive amounting to BGN 6.7 million. In May alone it was BGN 55.1 million. Between January and May the total amount of government securities issued reached BGN 353.2 million, and repayments totalled BGN 346.5 million. Over the same period net foreign financing was negative amounting to BGN 3.7 million and financing by privatisation funds came to BGN 7.3 million.

### Government Securities Market

Investors' activity in the primary market of government securities was sustained in the second quarter of 2011. Over the review period the bid-to-cover ratio (the average ratio between the total nominal value of the bids admitted to the auction and the total nominal value of the government securities offered) was 2.35<sup>12</sup> against 1.79 for the corresponding period of 2010. As in the first quarter investors were mostly interested in reopening of 5-year government securities issue<sup>13</sup> in May 2011 with their bids exceeding approximately 3.36 times the quantity offered by the Ministry of Finance. The maturity of offered issue and its currency de-

<sup>12</sup> The average bid-to-cover ratio for the period includes the bid-to-cover ratio of the the auction for the sale of three-month government securities held on 18 April 2011, when the MF did not approve the bids of primary dealers and their customers.

<sup>13</sup> At the primary auction of 16 May 2011, the Ministry of Finance offered for sale treasury bonds denominated and payable in euro with a maturity of five years and an annual coupon interest of 4.0 per cent. The nominal value of offered government securities amounted to EUR 35 million and primary dealers' bids came to about EUR 118 million.

nomination allowed to include a wider range of participants in the auction: a number of non-bank institutions such as the National Insurance Institute, the Deposit Insurance Fund, insurance companies, pension funds, etc. In line with buoyant investors' demand, the average-weighted annual yield at the auction went down to 4.10 per cent against 4.16 per cent at the opening of the issue in March. The average annual yield of the remaining primary market government securities issues in May and June stabilised around the previous auctions' levels. The yield attained at the auction of government securities with maturity of 3 years and 6 months held on 6 May was 3.54 per cent against 3.51 per cent at the last opening of the issue in the beginning of April, and the yield attained at the auction of 10-year government bonds held on 20 May was 5.42 per cent against 5.39 per cent at the auction held at end-April when the MF approved 92 per cent of total amount of government securities offered for sale. Approving the results of the auction of 6-month discount bills held on 9 May, the MF set a minimum price at which just 7.2 per cent of the quantity initially offered for sale was sold (BGN 1.8 million). The average annual yield of the issue was 1.38 per cent, or 1 basis point less than the yield attained at the previous auction of government securities with the same maturity in January. The low offered-to-approved bids ratio reflects the narrow scope of investors participating in the auction. In addition to bids of credit institutions, only bids of the Deposit Insurance Fund were submitted.

### Ten-Year-and-Six-Month Government Bond Primary Market Dynamics

(%)



Source: BNB.

The activity on government securities secondary market remained significantly higher in April and May compared with the corresponding period of 2010. The intensified trade reflects

mainly the increase in the volume of repo agreements with their share in total secondary market volume continued growing in April to reach its highest value since early 2011 (94.7 per cent or BGN 5083.4 million). To some extent this was due to the progressive increase in the average daily amount of blocked government securities by banks since early 2011 intended to comply with the statutory requirement for securing cash deposits on budget entities' accounts with them<sup>14</sup>. In May the average daily volume of government securities blocked for this purpose reached BGN 1297 million, accounting for approximately one-third of outstanding government securities, issued on the domestic market. Long-term bonds remained the most actively traded among transactions concluded for purchase and sale of government securities. The active trade in this segment and investors' confidence in government debt instruments had a positive effect on the dynamics of the average annual yield of

the long-term reference issue (10 years and 6 months) on the secondary market which continued falling to reach 5.33 per cent in April (a decrease by 5 basis points compared to March).

According to the MF preliminary calendar, in the third quarter issues of 5-year and 15-year treasury bonds denominated in euro are expected to be reopened, while lev-denominated government securities offered will be with a maturity of 3 years and 6 months and 10 years and 6 months. The projected total nominal value of government debt instruments to be issued in the third quarter of 2011 is approximately BGN 344.5 million, up BGN 147.2 million on the corresponding period of the previous year. If the issues included in the calendar are successfully sold, the total nominal value of government securities issued since the beginning of 2011 will reach approximately BGN 900 million, up about BGN 160 million compared to the January-September 2010 period.

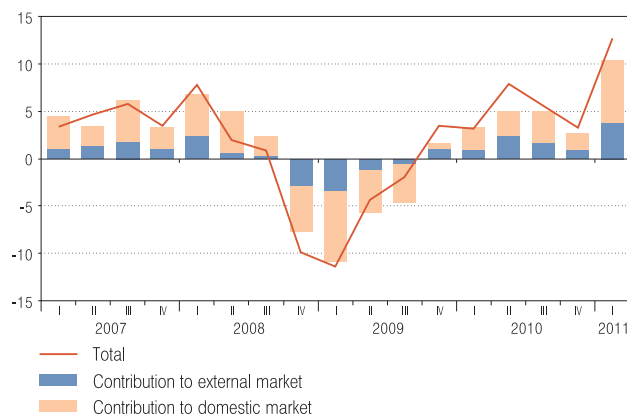
## Behaviour of Firms and Competitiveness

Sound external demand coupled with a gradual recovery of domestic demand contributed to real growth in gross output. As a result of the effective policy of labour expenditure management, the financial performance of firms remained almost unchanged compared with the previous quarters.

Sound external demand coupled with a gradual recovery of domestic demand contributed to the increase in gross output in the first quarter of 2011 compared with the last three months of 2010.

### Industry Turnover Dynamics

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



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

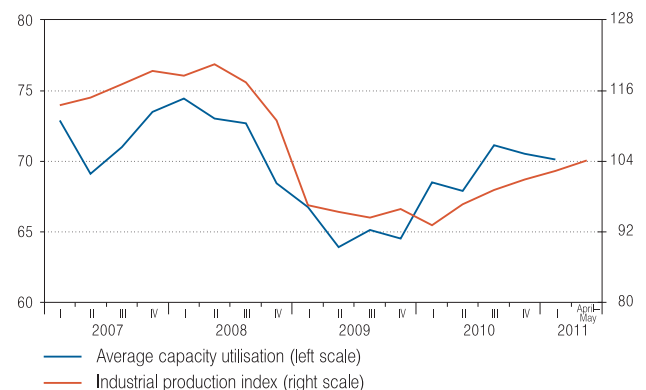
Sources: NSI, BNB.

<sup>14</sup> Repo agreements are the major instrument used by banks to meet this statutory requirement.

The value added produced in the first quarter of 2011 remained unchanged on a chain basis following the 0.6 per cent increase in the last quarter of 2010.

### Production Capacity Utilisation in Industry

(%)



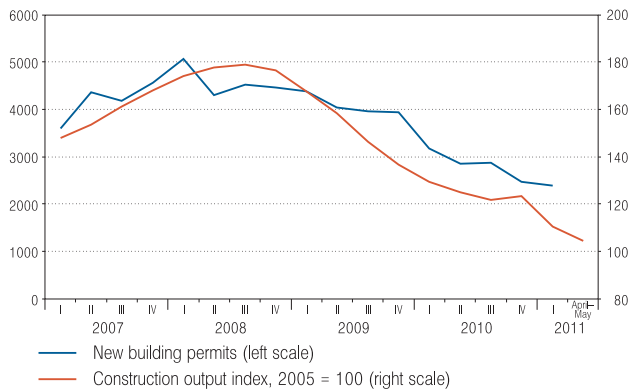
Source: NSI, Industry Trend Survey.

Value added in industry declined on a chain basis due to the increase in resource-intensive industries such as production of energy and non-durable consumer goods. On the other hand,

gross output of firms in the sector continued to recover reflecting the enhanced domestic and external market demand. This trend was also confirmed by the data on the nominal volume both on the domestic and external market which continued to grow.

### Construction Output Dynamics, Buildings Permits Issued and Construction of New Buildings

(number of buildings; seasonally adjusted data)

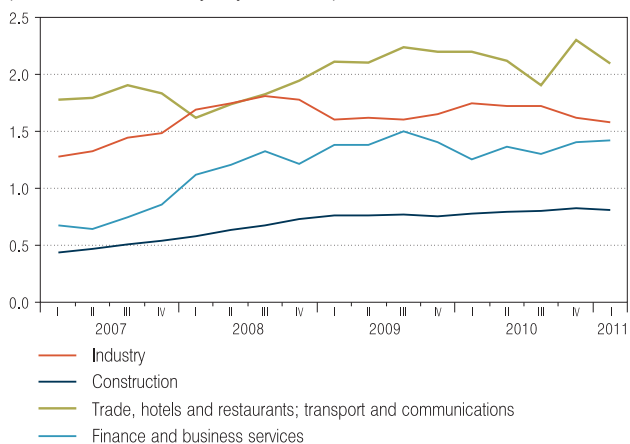


Sources: NSI, BNB.

Following the two consecutive quarters of positive growth rates in construction the value added in this sector slowed down on a chain basis. The production volumes of various sector activities contracted further, with the most significant decline observed in the civil and engineering construction. In the first quarter of 2011 the downward trend in the number of building permits issued for construction of new buildings was sustained. On the other hand, the stabilised fall in the number of newly built houses and more favourable data about started construction of new buildings prove to be a positive signal of the activity in the industry. However, no serious recovery is expected in this industry in the short run.

### Gross Operating Surplus at Current Prices

(billion BGN; seasonally adjusted data)

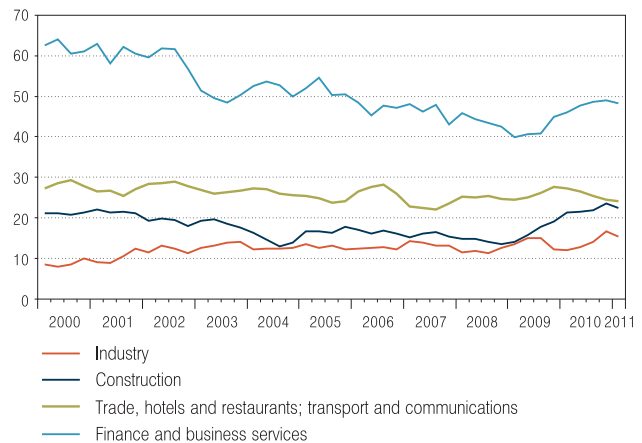


Sources: NSI, BNB.

Gross value added in the services sector increased by 1.7 per cent on a quarterly basis compared with 0.3 per cent in the preceding quarter. This is probably attributable to the replaced consumption of imported goods by domestic ones. The assessment is based on the strong downturn of imported services and increased gross output in the sector. The economic situation in transport and communications remained favourable and that in domestic trade started gradually to improve.

### Operating Surplus to Gross Output

(%; seasonally adjusted data)

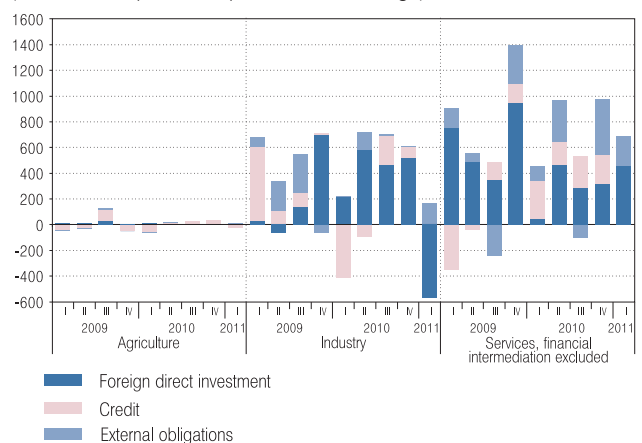


Sources: NSI, BNB.

In the first quarter of 2011 corporations' financial performance remained unchanged on the previous quarters, with gross operating surplus in most sectors slightly improving in nominal terms due to reduced labour expenditure. Output profitability, as measured by the *operating surplus to output* ratio in industry and trade remained close to previous quarters' levels, while that in business services and construction exhibited an improvement.

### Financing Sources

(million BGN, quarter-on-quarter volume change)

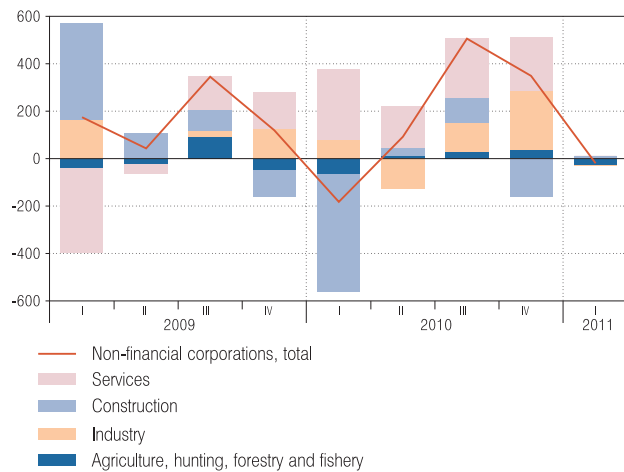


Sources: NSI, BNB.

In the first quarter of 2011 a source for financing firms, other than the net operating surplus, was foreign direct investment in services and external loans in industry. Compared with the previous quarter the share of loans decreased unlike the other sources of financing.

### Loans to Non-financial Corporations

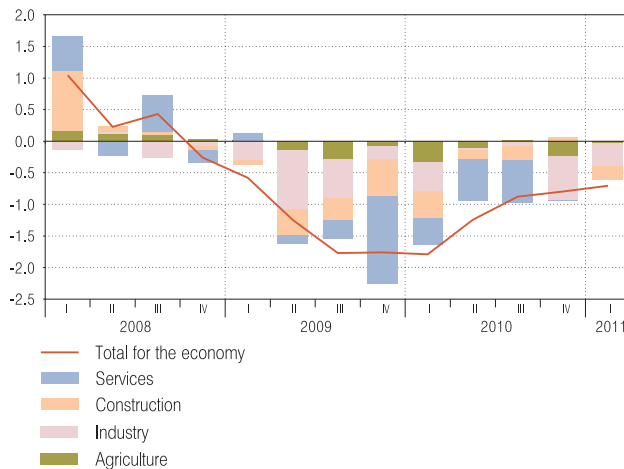
(million BGN, quarter-on-quarter volume change)



Source: BNB.

### Contribution to Changes in the Number of Employed by Economic Sector

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



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

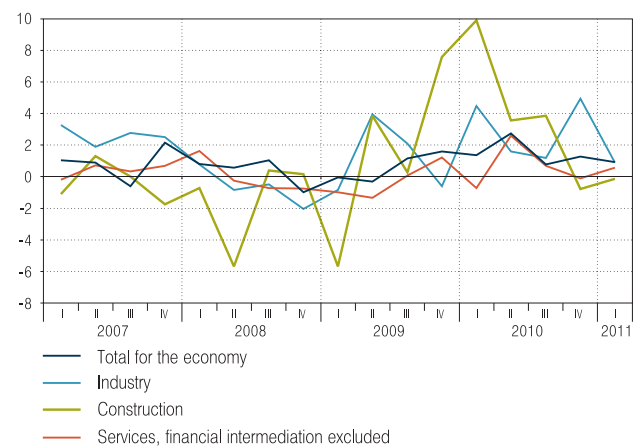
Sources: NSI, BNB.

Compared with the fourth quarter of 2010 in general firms continued to contract their labour expenditure reducing their staff at a slower rate. Industry contributed most substantially to the fall in employment.

Over the first quarter of 2011 staff was reduced primarily by dismissing relatively lower-paid workers to optimise unit labour costs. As a result labour productivity per employee in industry and in the overall economy significantly improved.

### Labour Productivity Developments (Value Added per Employee)

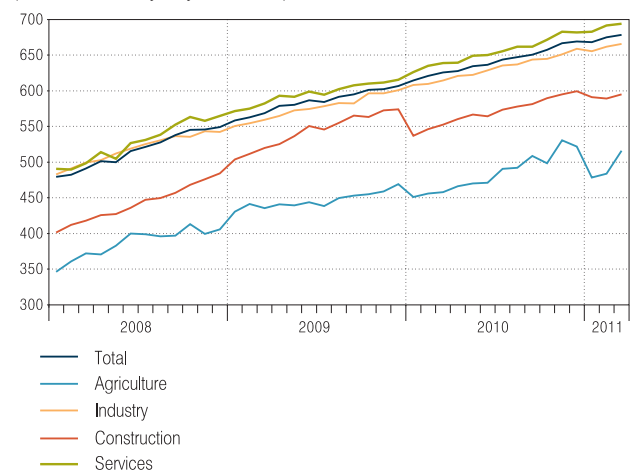
(%, quarter-on-quarter; seasonally adjusted data)



Sources: NSI, BNB.

### Average Nominal Wage by Economic Employment Sector

(BGN; seasonally adjusted data)



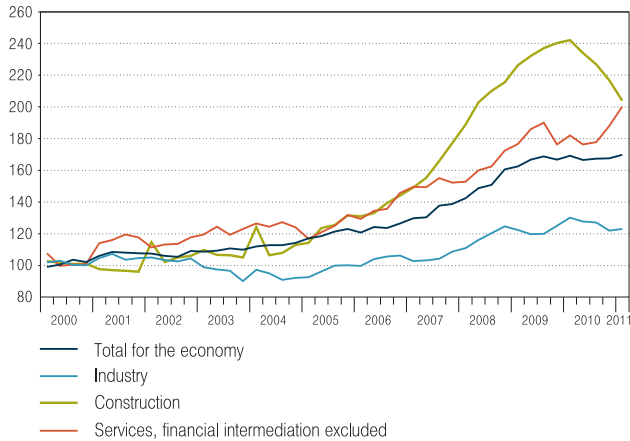
Sources: Short-term statistics of employment and labour costs, NSI.

Despite the fact that the average wage continued to rise smoothly according to the short-term statistics on employment and labour costs, firms managed to improve their cost competitiveness. The reduced compensation per employee in industry allowed corporations to cut their nominal and real unit labour costs. In construction unit labour costs continued to decrease prompting a decline in nominal unit labour costs. In real terms these costs remained comparatively constant.

The increased gross output in industry and more optimistic expectations of economic activity dynamics boosted investment in real terms by 0.9 per cent on a chain basis in the first quarter of 2011.

### Nominal Unit Labour Costs

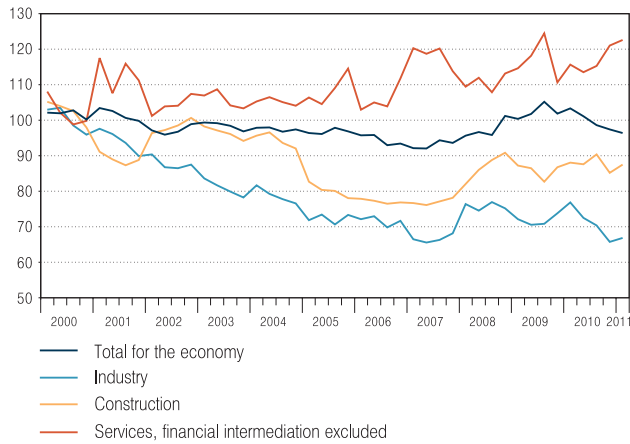
(2000 = 100; seasonally adjusted data)



Sources: NSI, BNB.

### Real Unit Labour Costs

(2000 = 100; seasonally adjusted data)

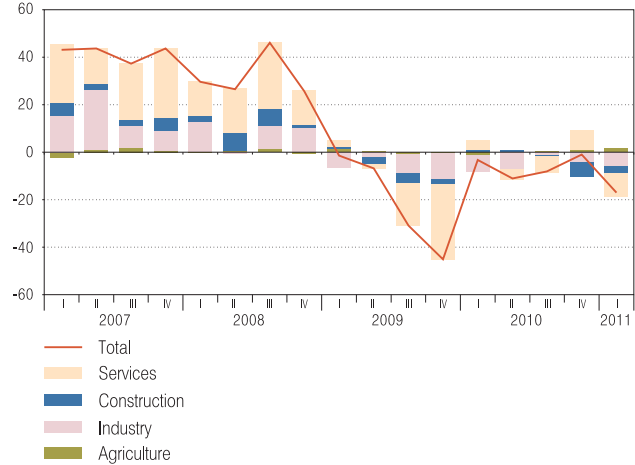


Sources: NSI, BNB.

Based on the NSI data on the first quarter of 2011 nominal expenditure on acquiring fixed assets went down by 17 per cent on the first quarter of the previous year. Similar dynamics was observed in national accounts data based on which gross fixed capital formation contracted nominally by 1.9 per cent. Expenditure on acquiring fixed assets in industry continued to fall (by 22.5 per cent). In the services sector these costs posted an increase by 14 per cent in the last quarter of 2010 later falling again by 15.9 per cent. Public services, real estate operations, trade, hotels and restaurants reported the strongest decline, while information technologies and financial and insurance activities posted an increase. In the first quarter of 2011 and in April and May the real interest rate based on projected inflation decreased. This trend will probably have a positive effect on investments and in the second half of 2011 they will continue growing.

### Contribution to the Annual Rate of Change in Expenditure on Acquiring Fixed Assets by Industry

(%, percentage points, growth on an annual basis)

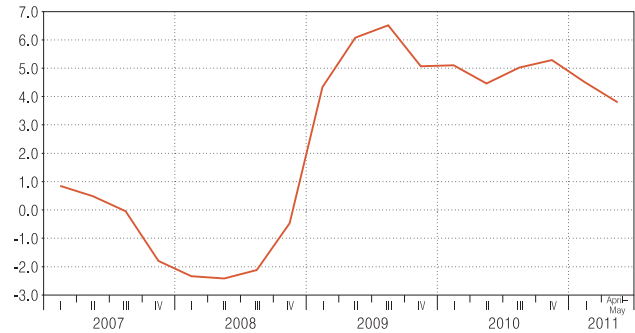


Note: Due to the lack of final data, the quarterly data are preliminary.

Sources: NSI, BNB.

### Real Interest Rate (based on expectations)

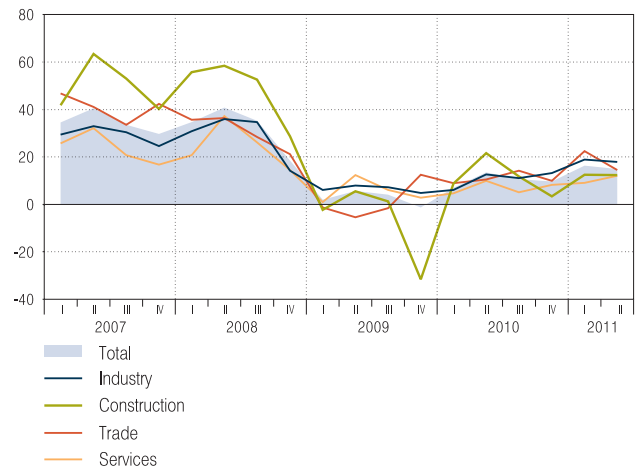
(%)



Sources: NSI, BNB.

### Expectations about Future Economic Activity

(balance of opinions, %)



Sources: NSI, BNB.

Trends derived from the available information for the second quarter of 2011 remained divergent, showing no clear signs of a strong enhancement in firms' economic activity. The upward trend in industrial output was sustained

with domestic demand increasing its importance. New orders both for domestic and external market continued to increase. Following the strong increase in January and February, in March the trade volume index went down and in May again picked up. The total output index in construction continued to decrease.

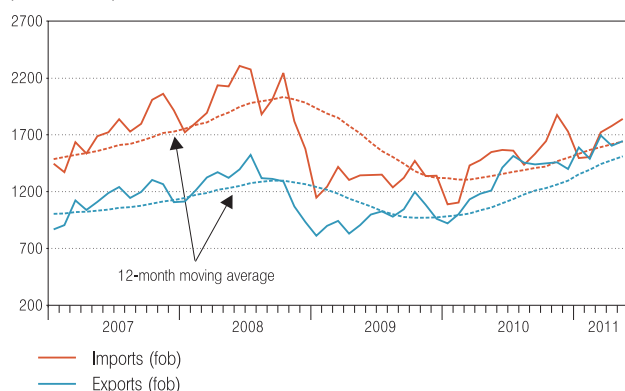
## Exports and Imports of Goods

Between January and May 2011 the trade balance contracted to EUR -318.5 million against EUR -1198.9 million in the corresponding period of the prior year. Growth rates in imports are expected to approach those of exports in the second half of the year and the trade balance is anticipated to remain negative.

Between January and May 2011 exports continued to grow at high annual rates (47.2 per cent) due to the stronger external demand and higher international prices. The growth rate of imports remained much lower than that of exports (25.5 per cent) but also accelerated due mainly to high international prices.<sup>15</sup>

### Dynamics of Exports and Imports

(million EUR)



Source: BNB.

In the second half of 2011 the exports growth rate is expected to moderate due to lower external demand on an annual basis and a slower increase in international prices. Imports are expected to continue growing, gradually moderating its rate, due to a slower increase in international prices. Growth rates of exports and imports will be similar which will prompt a gradual increase in the trade deficit.

Between January and May 2011 the trade balance contracted to EUR -318.5 million against EUR -1198.9 million in the corresponding period of the prior year.

<sup>15</sup> The analysis presented in this section is based on nominal export and import data in euro.

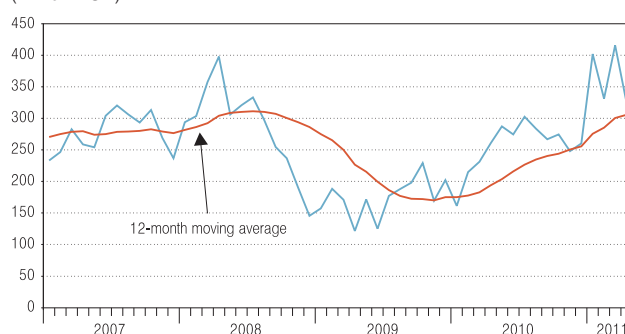
Survey data from the second quarter of 2011 show that the economic situation in industry and services improved, while in trade and construction it worsened. Firms' expectations about future dynamics of economic activity remained broadly unchanged.

Therefore, economic activity on the supply side is expected to gradually recover.

In the January–April 2011 period all commodity groups contributed to the total growth of exported goods. *Base metals and their products* (14.3 percentage points), followed by *mineral products and fuels* (10.5 percentage points), *animal and plant products, foods, drinks and tobacco* (7.3 percentage points) and *machines, transportation vehicles, appliances, instruments and weapons* (7.2 percentage points) had the major contribution to this growth.

### Exports of Base Metals and Base Metal Products

(million EUR)

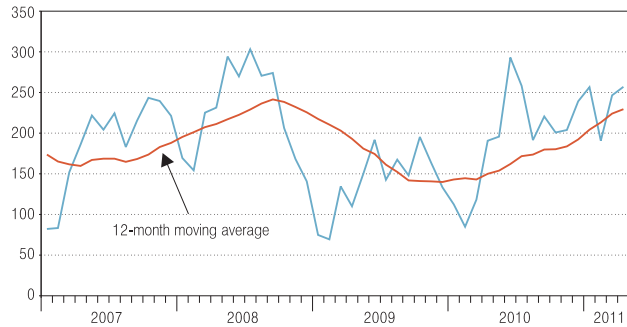


Source: BNB.

Exports of base metals and their products increased by 69.7 per cent in the first four months of the current year compared with the corresponding period of 2010 and totalled EUR 1474.0 million. The items contributing mostly to this effect were *copper and articles thereof* (49.4 percentage points) and *cast iron, iron and steel* (11.4 percentage points) reflecting high international metal prices. In the second half of 2011 the export growth rate in this group is expected to moderate due to the slowing growth rate of metal prices and weaker external demand on an annual basis.

### Exports of Mineral Products and Fuels

(million EUR)

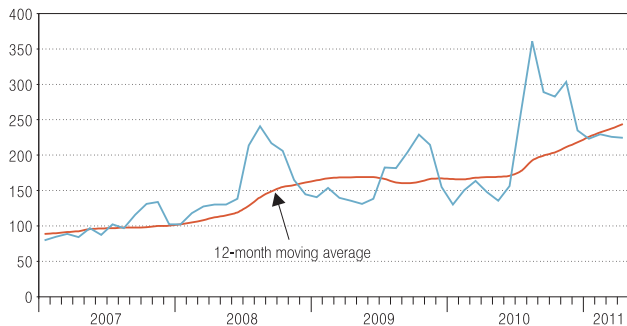


Source: BNB.

Exports of mineral products and fuels between January and April amounted to EUR 950.8 million, an increase by 87.8 per cent on the corresponding period of 2010. *Mineral fuels, mineral oils and distilled products* (82.6 percentage points) contributed most significantly to this growth, reflecting primarily high international oil prices. In the second half of 2011 the growth rate of this group's exports is expected to moderate due to weaker external demand and also to the slower growth rate of international fuel prices by the end of the year.

### Exports of Animal and Vegetable Products, Foods, Drinks and Tobacco

(million EUR)

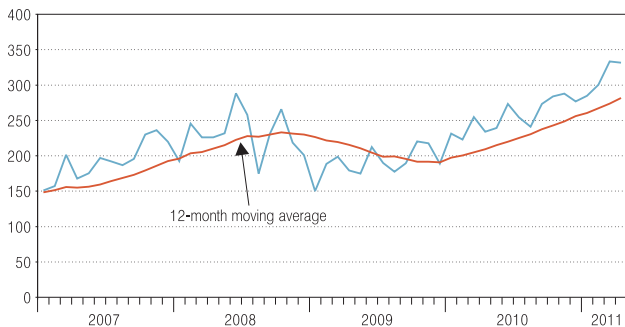


Source: BNB.

Between January and April 2011 exports of animal and vegetable products, foods, drinks and tobacco amounted to EUR 903 million: an increase of EUR 310.4 on the corresponding period of the previous year. *Oil seeds and fruit, different types of seeds* (18.7 percentage points) and *cereals* (11.5 percentage points) had the major contribution to this growth. This increase reflects primarily the price effect. In the second half of 2011 exports of this group's goods are expected to moderate reflecting both the weaker external demand and the slower rise in international food prices.

### Exports of Machines, Transportation Vehicles, Appliances, Instruments and Weapons

(million EUR)



Source: BNB.

Between January and April 2011 exports of machines, transportation vehicles, appliances, instruments and weapons amounted to EUR 1250.7 million: an increase of 32.6 per cent on the corresponding period of the previous year. *Nuclear reactors, boilers, machines, appliances and machinery* (11.5 percentage points), *electrical machines and appliances* (11.2 percentage points) and *automobiles and spare parts* (8.3 percentage points) contributed substantially to this increase. In the second half of 2011 export growth rates in this group are expected to moderate due to weaker external demand.

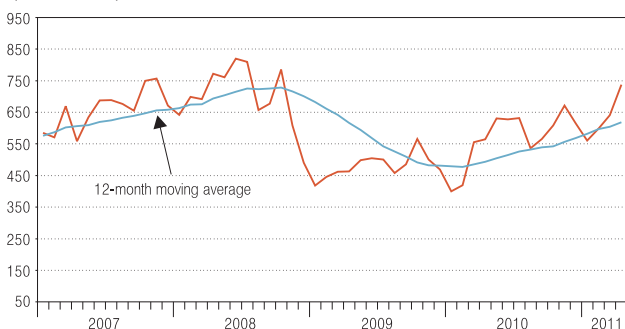
### Contribution of Commodity Groups to Trade Growth in the January–April 2011 Period

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	19.8	5.4	14.3	3.0
Raw materials	64.3	27.5	30.8	11.0
Investment goods	38.7	7.3	12.9	3.0
Energy resources	94.6	10.2	53.3	10.6
<b>Growth, total</b>	<b>50.5</b>		<b>27.6</b>	

Source: BNB.

### Imports of Raw Materials

(million EUR)



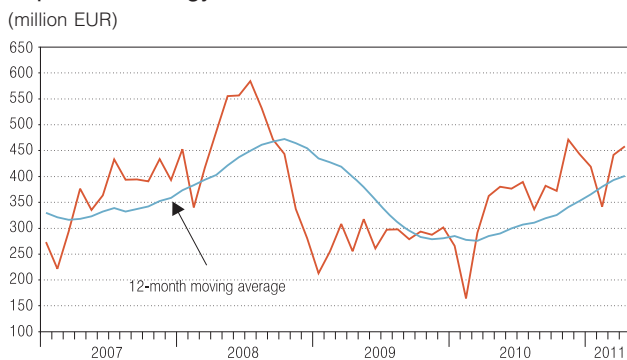
Source: BNB.

Between January and April 2011 imports (*cif*) reached EUR 6922.8 million, an increase by 27.6 per cent (EUR 1499.4 million on an annual basis). The groups of *raw materials* (11.0 percentage points) and *energy resources* (10.6 percentage points) contributed most substantially to this increase, and *investment goods* and *consumer goods* also added to this effect (3.0 percentage points each).

Imports of raw materials between January and April totalled EUR 2538.2 million: a 30.8 per cent increase on the same period of the previous year. This growth was mostly attributable to *cast iron, iron and steel* and *other raw materials* (6.7 percentage points each) and *non-ferrous metals* (5.4 percentage points). The increase in imports of metals reflected higher metal prices in international markets. In the second half of 2011 the export growth rate in this group is expected to moderate due to the slower growth rate of metal prices and food commodities.

Between January and April 2011 exports of energy resources amounted to EUR 1660.6 million, an increase by 53.3 per cent on the corresponding period of 2010. The group of crude oil and gas contributed most significantly to this growth (32.8 percentage points). This rise was mainly due to higher international oil prices. In the third quarter of 2011 the import rate in this group is expected to stay high due to domestic demand recovery and high oil prices and in the fourth quarter to moderate due to slower rise in fuel prices.

### Imports of Energy Resources

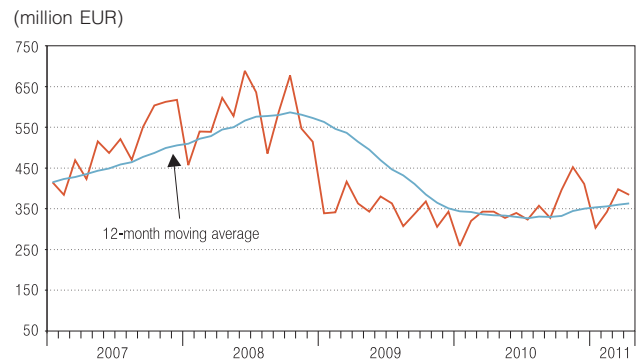


Source: BNB.

Between January and April 2011 exports of investment goods amounted to EUR 1427.4 million, posting an increase by 12.9 per cent on the corresponding period of 2010. *Transportation vehicles* and *spare parts and equipment* had the largest contribution (6.8 percentage points each).

*Other investment goods* had a negative contribution (-5.0 percentage points). In the second half of 2011 growth is expected to remain positive due to strengthened investment activity in Bulgaria.

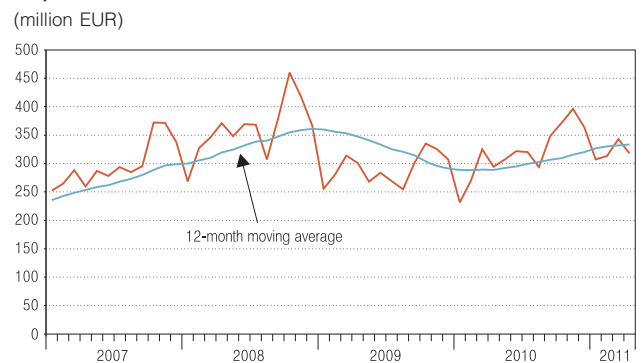
### Imports of Investment Goods



Source: BNB.

Over the review period imports of consumer goods recorded nominal growth of 14.3 per cent, reaching EUR 1281.6 million. This growth rate almost matched the rates of the previous two quarters. This dynamics reflects mainly the contribution of *food, drink and tobacco* (6.2 percentage points), *medicines and cosmetics* (3.7 percentage points), *automobiles* (2.2 percentage points) and *other consumer goods* (1.8 percentage points). Consumer goods imports is expected to continue to grow in the second half of 2011 due to stronger domestic demand.

### Imports of Consumer Goods



Source: BNB.

Between January and April 2011 Bulgaria's exports to other EU Member States rose by 51.8 per cent on an annual basis, and exports to non-EU countries by 48.6 per cent. Imports from EU Member States rose by 20.9 per cent, while imports from non-EU countries grew by 35.0 per cent.

The market share of Bulgarian goods in total EU imports came to 0.67 per cent by March 2011 *vis-a-vis* 0.62 per cent in March 2010.

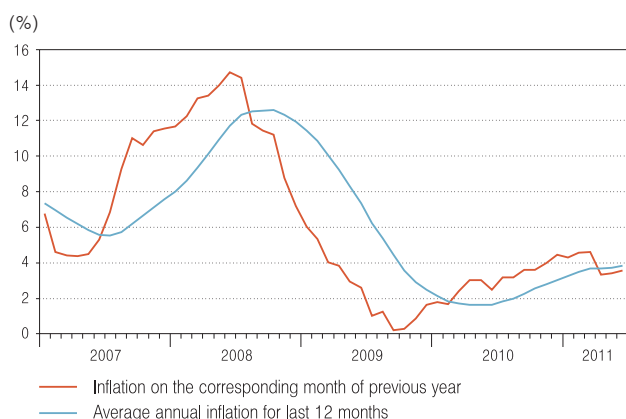


# 4. Inflation

In June 2011 annual inflation came to 3.5 per cent. Food and transport fuel price rises reflecting international price dynamics contributed most to inflation. International commodity market developments will continue to significantly affect inflation in the second half of 2011 as well. We expect a slight rise in inflation by end-2011 compared with its current level. Decline in annual inflation is only possible if international food and fuel prices stabilise their levels.

In the first half of 2011 the main driving factors of inflation were the increase in international commodity and food prices and their pass-through to consumer prices<sup>1</sup>. In June an annual inflation of 3.5 per cent was reported (against 4.4 per cent in December 2010) and the average annual inflation came to 3.8 per cent over the last 12 months.

## Inflation



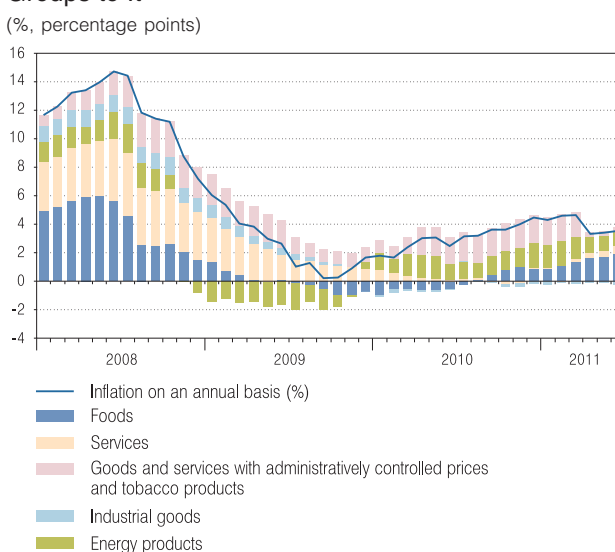
Source: NSI.

In June food and energy prices contributed most to annual inflation by 1.9 and 1.0 percentage points respectively. Administered prices inflation decelerated somewhat on the end of 2010, and by June contributed 0.3 percentage points to the annual inflation. Tobacco prices had a negative contribution<sup>2</sup>. By June core inflation contributed 0.3 percentage points to the overall annual inflation.

<sup>1</sup> The analysis in this Section is based on NSI data on HICP.

<sup>2</sup> In line with our expectations, over the second quarter of 2011 overall annual inflation decreased mainly as a result of a base effect related to the unchanged tobacco excise rates. In 2011 smoking tobacco excise duties were raised. However, this product is not included in the consumer basket and has no effect on consumer price inflation.

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



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 at elementary aggregates level in the consumer basket.

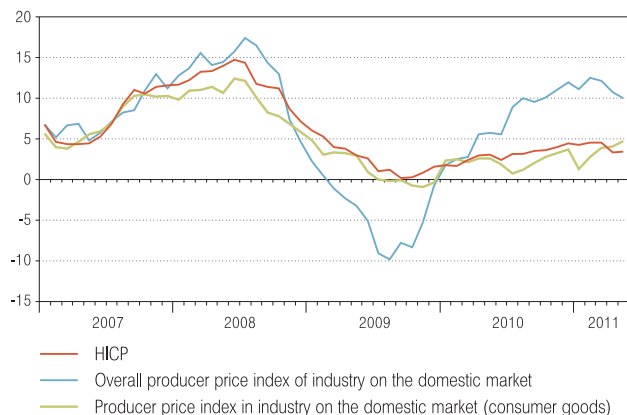
Sources: NSI, BNB.

The impact of international price dynamics on domestic prices may be seen in the change of the import deflator of goods and services and in producer prices. Over the first quarter the import deflator of goods and services posted 13.8 per cent annual growth (against 10.4 per cent in the fourth quarter of 2010), including the import deflator of goods growing by 16 per cent. The strong impact of international prices on domestic prices reflects both the high share of imported raw materials and energy resources in the overall intermediate consumption of the economy and the relatively high weight of foods and fuels in the consumer basket. Therefore, the producer price index in industry reflected the upward dynamics in international prices, posting a 12 per

cent growth on an annual basis in the first quarter and slowing to 10.0 per cent in May, while the PPI in consumer goods production rose by 4.7 per cent in May.

### Rate of Change in PPI in Industry and HICP

(on corresponding month of previous year, %)



Source: NSI.

International oil prices have a direct effect on inflation. The annual growth rate of transport fuel consumer prices increased to 19.2 per cent in the first quarter, with latest June data showing lower prices in most fuels in line with the downward dynamics in international oil prices.

Reflecting international commodity price dynamics, since early 2011 food inflation has continued to accelerate, though in May and June monthly inflation was lower, with some goods'

prices slightly falling. Food price developments are likely to reflect a comparatively more stable situation in international commodity markets over the recent months.

Core inflation (excluding the prices of foods and energy products, administered prices and tobacco prices), which fell slightly on an annual basis at the end of 2010, began to gradually increase and reached 0.7 per cent on the corresponding period of the previous year in June.

Firms' price-setting policy reflecting the specific conditions in individual goods and services markets is an important factor for consumer price developments. The higher rate of growth in the value added deflator *vis-à-vis* that of the nominal unit labour costs shows that firms succeeded in transferring these costs on consumers and in increasing their profit margins. The increased share of gross operating surplus in gross value added indicates the improving profitability of the economy. The slow recovery in consumer demand may also be a factor which is likely to drive consumer price inflation, especially core inflation dynamics. At this stage, no such effect has been seen. In trade which is the link between producer prices and final prices for most consumer goods, data show declines in profit margins. Hence, firms' pricing policy in this sector has so far limited consumer price growth.

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

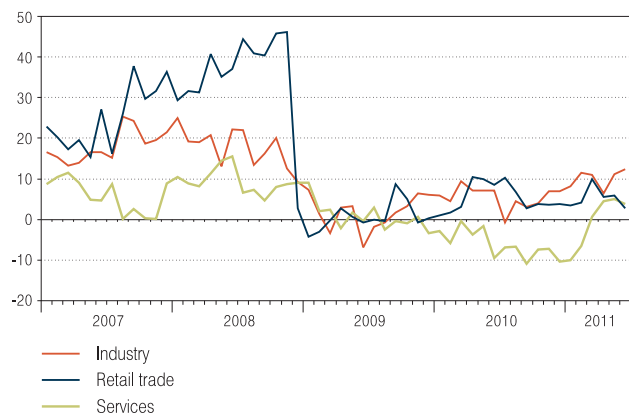
	Accumulated inflation as of June 2010 (December 2009 = 100)		Accumulated inflation as of June 2011 (December 2010 = 100)		Annual inflation as of June 2011 (June 2010 = 100)	
Inflation (%)	2.0		1.1		3.5	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
<b>Foods</b>	-1.8	-0.38	2.9	0.70	8.9	1.92
Processed foods	-1.5	-0.20	4.2	0.66	11.8	1.59
Unprocessed foods	-2.1	-0.18	0.6	0.05	3.9	0.32
<b>Services</b>	-1.3	-0.41	0.2	0.05	1.8	0.53
Catering services	1.2	0.15	1.9	0.09	2.9	0.21
Transport services	-1.7	-0.08	3.7	0.13	4.6	0.18
Telecommunication services	-0.4	-0.01	-0.9	-0.04	-1.9	-0.08
Other services	-4.8	-0.47	-1.1	-0.13	2.7	0.22
<b>Energy products</b>	11.2	1.04	4.0	0.29	11.1	0.99
Transport fuels	12.4	1.04	4.3	0.30	11.6	0.80
<b>Industrial goods</b>	-0.2	-0.04	-0.2	-0.05	-1.0	-0.20
Goods and services with administratively controlled prices	2.9	0.44	0.8	0.13	2.2	0.34
<b>Tobacco products</b>	34.4	1.35	-0.2	-0.02	-0.5	-0.03

Sources: NSI, BNB.

Since early 2011 expectations of selling price rises over the following months have broadly increased. Industry remained the sector with comparatively stronger expectations of price rises, while trade, services and construction reported more moderate expectations. Since end-2010 the share of firms expecting more rapid selling price rises compared with the current rates has increased in the retail trade sector.

### Selling Prices Expectations in Industry, Retail Trade and Services in the Following Three Months

(balance of opinions)



Source: NSI.

International commodity market developments will continue to determine inflation dynamics over the second half of 2011. If international prices stabilise, we may expect a decline in annual rates of food and fuel price rises. Overall annual inflation dynamics, especially in services prices, will also reflect to a certain extent the rate of recovery in consumer demand and the pass-through of last years' raw materials price hikes on final prices. We expect inflation to slightly increase above its current level by end-2011.

### Food Prices

In the first half of 2011 the annual rate of food inflation continued to increase and reached 8.9 per cent in June.

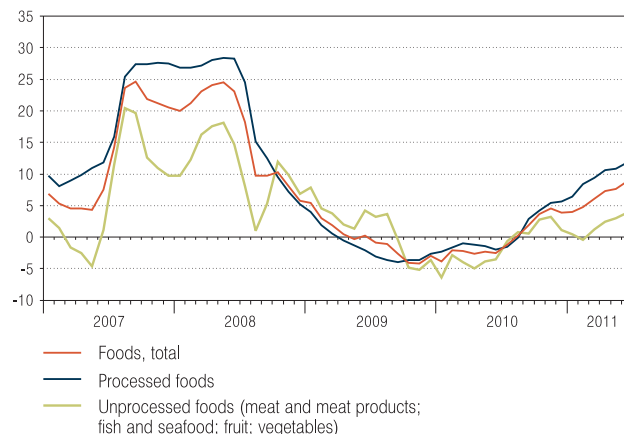
Processed food inflation rose substantially to 11.8 per cent (5.7 per cent in December 2010) and played a key role for the upsurge in food prices, while unprocessed food (meat and meat products, fruit and vegetables, and fish) inflation remained at a lower level (3.9 per cent). Bread and sugar had the most significant contribution to overall inflation acceleration. In June the contribution of processed foods to the annual rate

of inflation was 1.6 percentage points (bread and cereals at 0.6 percentage points, milk, dairy products and eggs at 0.3 percentage points, animal and vegetable oils at 0.3 percentage points, other foods at 0.4 percentage points). In June unprocessed foods contributed 0.3 percentage points to annual inflation, with fruit and meat product prices having the major importance for this.

The increase in agricultural product prices in international markets remained the main driver behind food inflation. The significant increase in international food prices from the second half of 2010 to the first quarter of 2011 is reflected in the upward dynamics in Bulgarian agricultural producer prices. In the first three months of 2011 the most significant annual increases were reported in sunflower seeds (by 100.6 per cent), wheat (by 77.2 per cent), fruits (by 27.9 per cent) and milk (by 24.6 per cent).

### Rate of Change of Food Price Index

(on corresponding month of previous year, %)



Sources: NSI, BNB.

On a monthly basis, food price data for the second quarter show lower growth rates and even slight price falls in some foods (vegetable oil and flour). These developments are likely to reflect the comparatively more stable situation in international commodity markets over the recent months.

In the second half of 2011 food inflation will still be driven by international market developments, though weather conditions will also play a key role for the farming yields in Bulgaria. Under the assumption of stabilization in international prices, a gradual decline in annual food inflation is projected.

## Energy Products Prices

Over the first quarter of 2011 the annual inflation rate of transport fuels accelerated to 19.2 per cent and had the major contribution to consumer price inflation<sup>3</sup>.

The strong increase in oil prices over the first quarter and its comparatively fast pass-through to end-use fuel prices remained the key factors behind the increase in fuel prices in Bulgaria. The increase in excise duties on diesel and unleaded petrol since the beginning of 2011 had a lower impact on fuel prices than the oil price rises did.

### Rate of Change of Energy Product Price Index and of Transport Services Price Index

(on corresponding month of previous year, %)



\* Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB.

Between April and May annual transport fuel inflation moderated to 13 per cent, with its dynamics by month being different from that of oil prices (taking also into account the appreciation of the euro against the US dollar). A possible explanation for this is the agreement achieved between the government and LUKOIL Bulgaria on freezing retail fuel prices. Unlike the other transport fuel prices whose falls in April were offset by increases in May, diesel prices declined in both months. This decline may be associated with the decision to postpone until early 2012 the obligation of fuel retailers to include bio-components into fuel mixes, though this effect cannot be precisely determined.

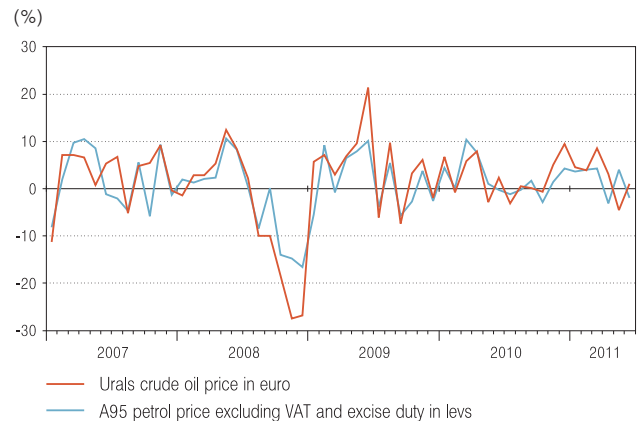
June data on retail fuel prices show price falls in line with the downward dynamics of oil prices.

<sup>3</sup> Transport fuels have the largest relative share in the group of energy products; hence, their price developments determine the overall price dynamics of energy products.

Only diesel prices remain unchanged from the previous month.

If assumed that oil prices will gradually stabilise in the second half of 2011, a further deceleration of annual transport fuels inflation may be expected.

### Monthly Rate of Change in the Prices of Urals Crude Oil and A95 Petrol



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

## Administratively Controlled Prices and Tobacco Products Prices

In the first half of 2011 annual inflation in administratively controlled prices declined on its December 2010 level (4.3 per cent), reaching 2.2 per cent by June and contributing 0.3 percentage points to overall inflation. The base effect of the increase in the fees for issuing identity documents implemented in 2010 was a key factor behind this dynamics.

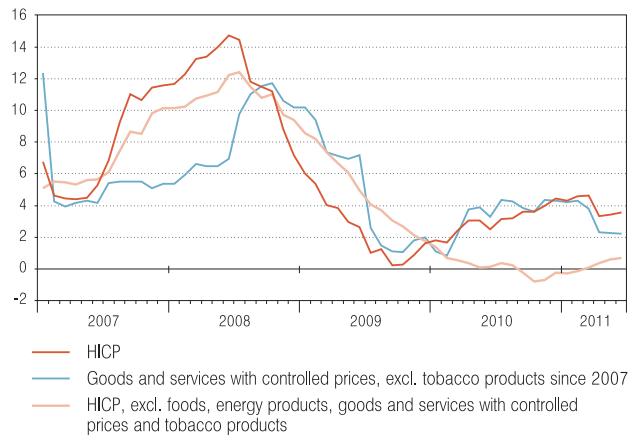
Since early 2011 the main adjustments in administratively controlled prices included higher user charges for visits to GPs (up 19.4 per cent), higher urban transport fares (up 6.4 per cent) and lower heating prices (down 4.8 per cent).

The decisions on the increase in electricity for households, natural gas and heating prices in force as of 1 July 2011 will influence inflation in administratively controlled prices in the second half of 2011. The increase in the minimum wage from 1 September 2011 will have a direct effect on hospital services prices and on user charges for visits to GPs<sup>4</sup>.

<sup>4</sup> The impact on the latter might be lower in case the proposal tabled with the National Assembly to set this charge to 1 per cent of the minimum old age pension for the people over 60 years (for women) and over 63 years (for men) is approved.

## Rate of Change in the Overall CPI, Administratively Controlled Price Index and Core Inflation

(on corresponding month of previous year, %)



Note: Given the relation between tobacco product prices and administratively controlled excise rates, 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 at the elementary aggregates level in the consumer basket.

Sources: NSI, BNB.

Tobacco product prices reported an annual increase of 27.1 per cent in March, contributing 1.1 percentage points to inflation as a result of higher excise duties introduced in 2010. In line with our expectations, this group of goods contributed most to the decline in overall inflation in the second quarter due to the base effect of the increase in prices in 2010 and unchanged excise duties in 2011. As of June tobacco products contributed -0.03 percentage point to annual inflation.

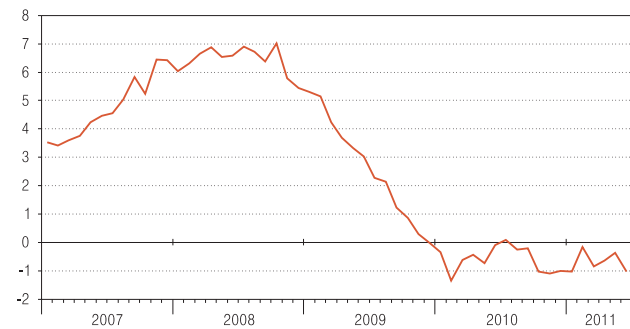
### Industrial Goods Prices

In the first half of 2011 the index of the prices of industrial goods retained a negative year-on-year rate of change (-1.0 per cent in June, contributing -0.2 percentage point to overall inflation).

The fall in industrial goods prices continued to be driven mainly by the decrease in durables prices. Car prices remained with the largest negative contribution. Other groups with a relatively high negative contribution to inflation in the first half-year were personal computers and televisions. Meanwhile, inflation in most of the other consumer goods has remained slightly positive, tending to increase gradually.

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

(on corresponding month of previous year, %)



Sources: NSI, BNB.

Economic data on retail trade turnover signal a gradual increase in consumer demand although still uneven in individual groups of goods and at relatively low levels as a whole. Current price developments in non-food goods also point to a similar trend. We expect low inflation in this component by the end of 2011.

### Services Prices

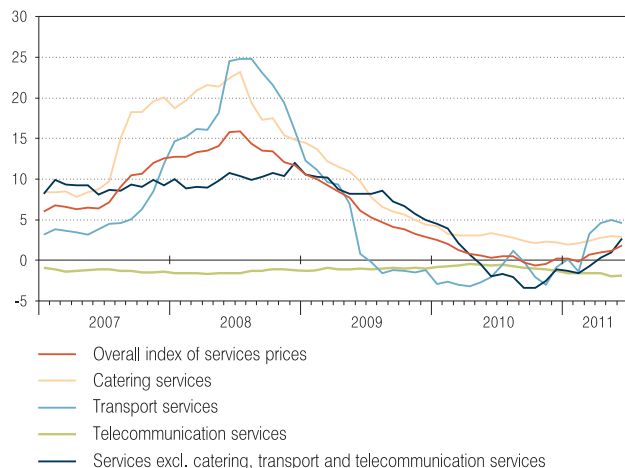
Since early 2011 annual inflation in services (excluding administratively controlled prices) followed a trend toward a gradual increase reaching 1.8 per cent in June from 0.2 per cent in January (a contribution of 0.5 per cent to overall consumer price inflation).

The gradual increase in services inflation was mainly due to the upward dynamics in transport services prices (automobile and air transport), where there is an indirect effect through fuel prices reflecting oil price rises. The catering price index also trended upwards, although in a less clearly pronounced manner than in transport services prices. These developments can be attributed to the inflationary pressure stemming from the increase in food prices over the last year. However, the contribution of catering services prices to overall annual inflation started to decline since the beginning of 2011 due to the relatively lower weight of this group in the consumer basket in the current year<sup>5</sup>.

<sup>5</sup> See Economic Review, 1/2011, Chapter 4.

## Rates of Change of Services Price Index Excluding Those with Controlled Prices

(on corresponding month of previous year, %)



Sources: NSI, BNB.

Services inflation excluding catering, transport and communication services reported an increase from -1.3 per cent in January to 2.7 per cent by the end of the first half-year<sup>6</sup>. Regardless of the fact that inflation in most of these services remained

relatively low, the overall increase in inflation in this group was underpinned by the more sizeable change in the annual rate of change in prices of several types of services. Accommodation services prices saw a distinct trend towards a slowing down annual rate of decline, while in June they reported an increase of 3.1 per cent. Package holidays prices declined marginally in June on an annual basis compared with the decline of 9.8 per cent reported in January 2011. Insurances connected with transport reported a higher annual growth rate of their prices in early 2011 coming to 9.0 per cent (compared with 4.2 per cent by end-2010) and this growth rate increased further to 9.6 per cent in June.

In the second half of the review year services prices inflation is projected to continue to rise gradually. Firms' pricing policy in the services sector is expected to reflect the gradual recovery in consumer demand and the firms are likely to continue to pass on the price hikes in raw materials prices on final services prices.

<sup>6</sup> A clearly pronounced trend towards a decrease in the prices of telecommunication services is observed. As of June 2011 prices in this group were 1.9 per cent lower compared with the corresponding period of the prior year against a reported average annual fall in prices of 0.8 per cent in 2010.