Economic Review

3/2012

BULGARIAN
NATIONAL
BANK

Economic Review

3/2012

BULGARIAN
NATIONAL
BANK

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

The *Economic Review, issue 3/2012* was presented to the BNB Governing Council at its 22 November 2012 meeting. It employs statistical data published up to 15 November 2012.

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

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

ISSN 1312 – 420X

This issue includes materials and data received up to 27 November 2012.

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

Published by the Bulgarian National Bank
1000 Sofia, 1, Knyaz Alexander I Sq.
Tel.: (+359 2) 9145 1351, 9145 1209, 9145 1231
Fax: (+359 2) 980 2425, 980 6493

Website: www.bnb.bg

Contents

Abbreviations

APRC	Annual percentage rate of charge
BIR	Base interest rate
BOP	balance of payments
BTC	Bulgarian Telecommunications Company
b.p.	basis points
CEECs	Central and East European countries
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
CZK	Czech koruna
DXY	an index measuring the exchange rate of the US dollar against the basket of six major currencies
EA	Employment Agency
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
FOB	Free on board
FRS	Federal Reserve System
GDP	Gross Domestic Product
GFMS	Gold Fields Mineral Services
HICP	Harmonized Index of Consumer Prices
HRW	hard red wheat
HUF	Hungarian forint
IEA	International Energy Agency
IMF	International Monetary Fund
ISM	Institute for Supply Management
LEONIA	LEv OverNight Index Average
LIBOR	London Interbank Offered Rate
M1	narrow money
M2	M1 and quasi-money
M3	broad money
MF	Ministry of Finance
MFIs	Monetary Financial Institutions
mt	metric tons
NPISHs	Non-profit institutions serving households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PLN	Polish zloty
PMI	Purchasing Managers' Index
p.p.	percentage points
PPP	Purchasing Power Parity
CIS	Commonwealth of Independent States
RON	Romanian new leu
WTI	West Texas Intermediate

Summary

In the third quarter of 2012 the global composite PMI indicator slightly increased compared with the previous quarter, reflecting favourable expectations of world economic growth. The overall trend masks notable differences across regions and sectors. Euro area economic indicators of business and consumer confidence continued to deteriorate. This trend has been particularly pronounced since early 2011. US consumer confidence started to rise at the end of the third quarter. Economic indicators of business confidence also improved, but still remained at low levels due to the uncertainty about economic prospects. The dynamics of global conjunctural indicators shows differences across sectors. In the third quarter improved expectations for economic developments in services were observed, while confidence in industry registered a significant drop. World trade accelerated its pace of growth in the second quarter, with divergent developments across regions. The slowdown in euro area external trade deepened, while the foreign trade turnover in the United States and some East Asian and Middle East developing countries accelerated. Based on the trends in conjunctural indicators and short-term developments in world trade, it may be expected that global economic growth will remain low by the end of 2012 and in the beginning of 2013. The economic development in the USA and China will have a positive effect on growth (if a political decision is achieved on the fiscal consolidation planned for 2013 in the USA), while in the euro area, a decrease in real growth may be expected in the fourth quarter of 2012 and slow growth in 2013.

In the second quarter of 2012 real GDP in Bulgaria went up by 0.3 per cent on the first quarter and reached 0.5 per cent on an annual basis for the first half of the year (seasonally adjusted), with domestic demand contributing most. The worsening of the global economic environment had a negative effect on exports of goods and services, their rate falling by 2.9 per cent in real terms on a quarterly basis in the first quarter of 2012. Reflecting the increased exports to non-EU countries, in the second quarter exports of goods and services rose by 3.4 per cent in real terms on the previous quarter. Overall, exports of goods and services for the first half of 2012 grew by 1.9 per cent on an annual basis in real terms. Over the same period imports of goods and services increased by 4.3 per cent due to domestic demand recovery, with imports of investment goods having the largest contribution. Household consumption continued to accelerate over the second quarter, rising by 2.8 per cent on an annual basis in the first half-year. On a quarterly basis, investments in fixed assets increased by 0.4 per cent in the first quarter and accelerated their growth to 1.5 per cent in the second quarter. As a result of the positive quarterly dynamics, the real decline of gross fixed capital formation moderated to 3.8 per cent for the first half of 2012 on an annual basis.

The worsening international environment is expected to further dampen the recovery of Bulgaria's economic activity. External demand is projected to begin increasing slowly and exports of Bulgarian goods and services to rise accordingly at the end of 2012 and in the first quarter of 2013. Over the same period the positive private consumption growth will be sustained, although at a slower pace than that observed in the first half-year. The gradual recovery of investment demand in Bulgaria is likely to continue over the fourth quarter of 2012 and the first quarter of 2013, underpinned by international financial market developments and foreign direct investment inflow. Higher capacity utilisation and retention of firms' operating surplus at its current level will be the major factors positively affecting the investment demand. The uncertainty surrounding this outlook remains high, with the expected growth rate mainly reflecting euro area recession developments.

Between January and August 2012 the overall current and capital account balance was positive at EUR 227.0 million. The balance of payments financial account balance was also positive with a surplus of EUR 1062.7 million, reflecting mainly the foreign direct investment inflow (FDI). In the first eight months of 2012, FDI inflow in Bulgaria rose by EUR 356.7 million on the respective period of 2011 to reach EUR 873.1 million. The structure of foreign direct investment was dominated by equity capital (62.1 per cent) and other capital (30 per cent), the bulk of which comprised of intercompany loans.

In the fourth quarter of 2012 and first quarter of 2013 the balance of payments current and capital account balance is expected to remain close to its current levels, while as a ratio to GDP to move within the band of -1 to -0.2 per cent. In the last quarter of 2012 and early 2013 FDI inflow is expected to range between 4.0 and 5.0 per cent of GDP.

Deposits of banks with the BNB went up 17.2 per cent on an annual basis in the third quarter due to comparatively large reserves maintained by banks in an environment of high liquidity and a significant amount of attracted deposits of residents, a result of the maintained high household savings rate. The upward dynamics of currency in circulation was sustained and by the end of September the annual growth rate was 7.7 per cent. Over the same period broad money growth slightly moderated to 8.8 per cent (10.2 per cent by June), with the slowdown in the pace of quasi-money growth to 6.5 per cent (8.4 per cent by June) contributing the most significantly. Lower growth in household savings and reduction in deposits from non-financial corporations were the main drivers behind quasi-money developments. The trend to a slight decline in interest rates on time deposits is expected to persist in the fourth quarter of 2012 and first quarter of 2013. The annual growth of broad money is projected to gradually slow down as a result of moderate income growth amid the persistent high savings rate and declining deposit interest rates. In the short-term horizon, introduction of the tax on time deposit interest earnings in early 2013 is not expected to affect household behaviour, since deposits have no alternative in terms of level of risk and security. Over a longer horizon, however, this tax will probably push down the household savings rate and broad money growth (unless new banking products not covered by this tax are offered to depositors).

The investment activity of corporations in the second quarter had a positive effect on lending growth, but the worsened expectations of the business situation contributed to the slowdown in dynamics of lending over the third quarter, reflecting the lower demand for loans. As of September 2012 the annual growth of claims on the non-government sector moderated to 3.9 per cent (4.3 per cent as of June), while that of claims on non-financial corporations slowed down to 6.6 per cent (7.1 per cent as of June). Households' caution in assuming new obligations and preferences for saving were the main drivers behind the downward trend in banks' claims on households, their rate falling by 1.6 per cent on an annual basis in September. In the third quarter data on new loans reported an increase in average interest rates on corporate and consumer loans. As regards the new bank loans to non-financial corporations, this increase was mainly due to the specific transactions in the third quarter, while in a longer historical horizon, the downward trend in interest rates can still be observed. Interest rates on housing loans continued to decrease. In the fourth quarter of 2012 and the first quarter of 2013 lending rates are expected to slowly decrease consistent with the projected decline in deposit rates.

In the first half of 2012 consumer price inflation remained relatively low, while in the third quarter it accelerated driven mainly by price dynamics in unprocessed foods and an increase in the regulated price of electricity for households. In October the annual inflation rate was 3.0 per cent (2.0 per cent in December 2011), with foods (1.1 percentage points), services and goods with administratively set prices (0.9 percentage points) and energy products (0.8 percentage points) contributing most significantly to it. Core inflation remained at low levels (0.5 per cent in October), tending to slightly rise since the beginning of the year as a result of the increased inflation in services.

In the fourth quarter of 2012 inflation is expected to slightly increase from the current levels due mainly to the rises in international food and petroleum prices (in euro terms). Slow growth of core inflation against the background of gradually recovering consumer demand will be another key factor influencing the inflation dynamics until year-end. Given the expected moderate developments in international food and petroleum prices in the beginning of 2013, inflation is likely to slightly slow down in the first quarter of 2013 compared with end-2012.

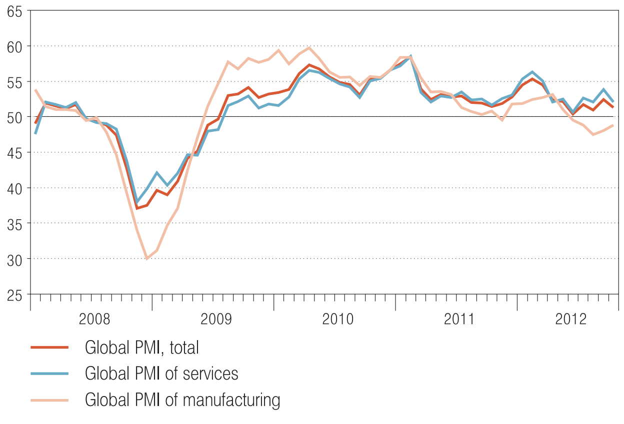
1. External Environment

The euro area real GDP went down in the second quarter of 2012, while in the USA and China a slow-down of economic growth was reported due to worsened economic environment. The global composite PMI slightly increased in the third quarter compared with the previous one but remained above the level of 50 reflecting an improvement of business climate assessments and expectations for accelerating economic growth.
Based on the trends in conjunctural indicators and short-term developments in world trade, it may be expected that global economic growth will remain low by the end of 2012 and in the beginning of 2013. The economic development in the USA and China will have a positive effect on growth (if a political decision is achieved on the fiscal consolidation planned for 2013 in the USA), while in the euro area a decrease in real GDP may be expected in the fourth quarter of 2012 and slow growth in 2013.

Current Business Situation

In the third quarter of 2012 the global composite PMI indicator slightly increased compared to the second quarter to reach the end-2011 level. In the first two quarters of 2012 overall global PMI decreased after falling to 50 in June. It started to rise thereafter, suggesting an improvement of business climate assessments and expectations for accelerating economic growth.

Global PMI



Source: JP Morgan.

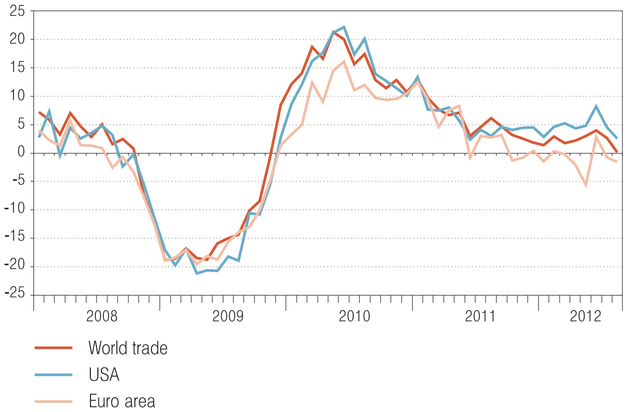
Indicator dynamics by industry was divergent. The levels of major business activity indicators in the services sector went up significantly between July and September 2012 compared with the previous quarter. Concurrently, a considerable decline in manufacturing was observed. Its indicator dropped below the neutral level of 50, reflecting the deterioration of economic conditions in the sector.

Dynamics of global conjunctural indicators shows differences across regions. Since the middle of 2011 the euro area composite PMI has declined below the neutral level of 50, indicating a contraction of economic activity and deterioration in the economic outlook. China's economic indicators also declined in the third quarter to levels close to 50. Over the same period the composite PMI in the United States slightly rose.

In the second quarter of 2012 world trade volumes grew faster than in the January to March period. In annual terms, trade posted a 2.9 per cent increase against 2.0 per cent in the previous quarter, with divergent developments across regions. The slowdown in euro area foreign trade deepened to -1.9 per cent on an annual basis (against -0.6 per cent in the first quarter of 2012), while the external trade growth in the United States accelerated significantly to reach 5.8 per cent in the second quarter, from 4.2 per cent in the first quarter. The rise in external trade turnover in the USA was mainly driven by the higher turnover of goods and services with the developing economies in Asia, Latin America and Middle East, which are less affected by the euro area crisis. Between July and August external trade in the euro area fell by 1.2 per cent on an annual basis, while in the USA this indicator posted a 3.5 per cent increase.

World Trade

(annual rate of volume growth, per cent)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Based on the trends in conjunctural indicators and short-term developments in world trade, it may be expected that global economic growth will remain low at the end of 2012 and the beginning of 2013. The economic development in the USA and China will have a positive effect on growth (if a political decision is achieved on the fiscal consolidation planned for 2013 in the USA), while in the euro area a further decrease in real GDP may be expected in the fourth quarter of 2012 and slow growth in 2013.

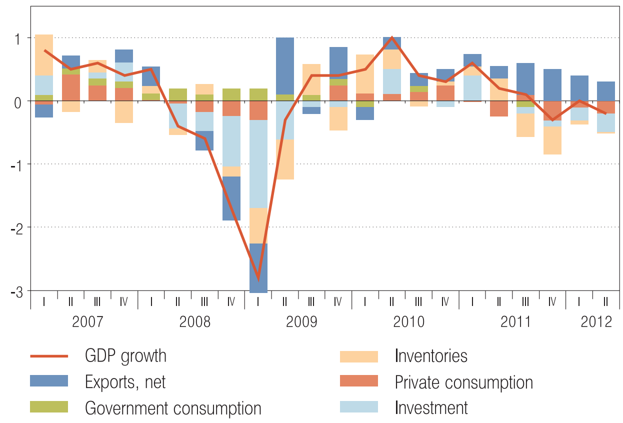
In the second quarter of 2012 the average global inflation was 3.5 per cent, down by 0.4 percentage points on the previous quarter. In July the downward trend in inflation was sustained, reaching 3.2 per cent on an annual basis. This trend was observed in both developed and developing countries.

Euro area

According to the Eurostat data, in the second quarter of 2012 euro area GDP fell by 0.4 per cent on an annual basis (*vis-à-vis* zero annual growth between January and March). On a quarterly basis, it went down by 0.2 per cent (against 0 per cent in the first quarter).[1] By GDP component, only net exports made a positive contribution of 0.3 percentage points. Internal demand had an adverse effect on growth, with investment and household consumption contributing negatively by -0.3 and -0.2 percentage points, respectively. Government consumption and inventories had a zero contribution to GDP changes in the second quarter of 2012 on the prior quarter. Rising food and energy prices and high euro area unemployment rate were the main factors dampening private consumption. The uncertainty caused by the debt crisis in some euro area countries and unfavourable lending conditions had a negative impact on companies' investment. The weakening euro and higher third party foreign demand contributed to export growth. The trends towards positive contribution to net export growth and negative contribution to domestic demand growth are expected to retain until the end of 2012.

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

(per cent; percentage points)

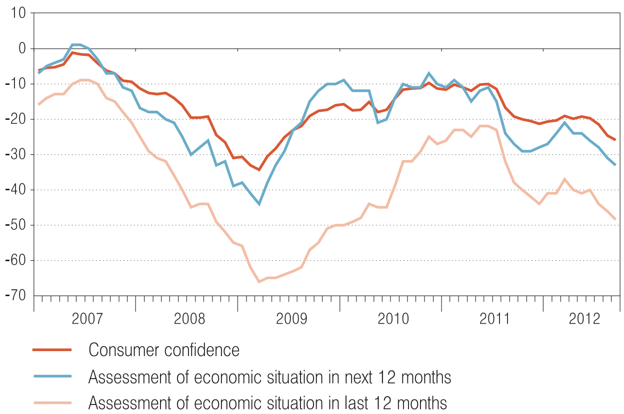


Source: Eurostat.

Data on GDP in the second quarter across countries pointed to significant differences and heterogeneity of economic growth in the euro area. On an annual basis, economic growth in Germany slowed to 1 per cent against 1.2 per cent in the previous quarter, while in France it moderated to 0.3 per cent against 0.4 per cent in the first three months. In Italy and Spain, GDP declines deepened to -2.6 per cent and -1.3 per cent respectively on an annual basis in the second quarter (previous value: -1.4 per cent and -0.6 per cent). Compared with the previous quarter, GDP continued to fall in Italy (-0.8 per cent), Spain (-0.4 per cent), Portugal (-1.2 per cent) and Cyprus (-0.7 per cent).

[1] According to preliminary data, in the third quarter euro area GDP contracted by 0.1 per cent on a quarterly basis and by 0.6 per cent on an annual basis. On a quarterly basis, GDP continued to decline in Italy (-0.2 per cent), Spain (-0.3 per cent), Portugal (-0.8 per cent) and Cyprus (-0.5 per cent). The real GDP went down also in Netherlands (-1.1 per cent), while in France (+0.2 per cent) and Germany (+0.2 per cent) GDP growth was stronger than expected.

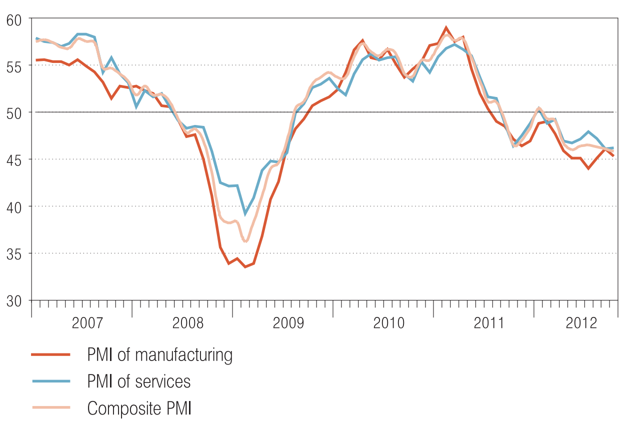
Euro Area Consumer Confidence Indices



Source: European Commission.

Over the third quarter of 2012 the average values of euro area leading indicators were lower than their averages in the second quarter. According to the European Commission's data, the euro area economic sentiment index declined to 84.5 in October (against 85.2 in September), while the business climate index fell to -1.62 (against -1.34 in September). The euro area consumer confidence index of the European Commission remained unchanged in October at -25.7. The euro area PMI was below the neutral level of 50, indicating a contraction of economic activity and deterioration in the economic outlook. In September the composite PMI coincided with manufacturing and services sub-indices, reaching the level of 46.1 (in August the composite PMI came to 46.3, while manufacturing and services sub-indices were 45.1 and 47.2 respectively). According to preliminary data from October, the composite PMI dropped to 45.8 and manufacturing sub-indices to 45.3, while services sub-indices remained almost unchanged at the level of 46.2.

PMI of Manufacturing and Services



Source: Markit.

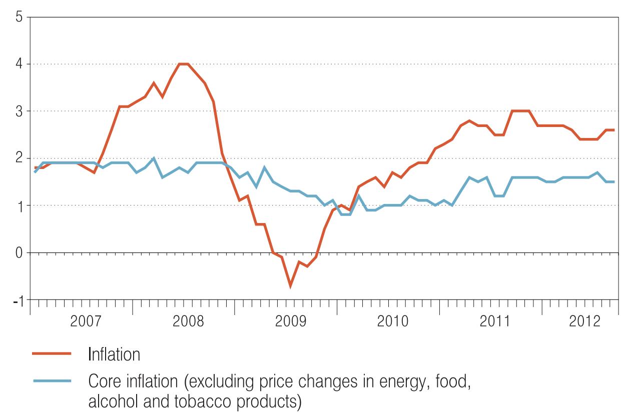
Conjunctural indicator dynamics gives grounds to expect a decline in the euro area real GDP which may start moderating in the fourth quarter of 2012. The euro area real GDP is anticipated to slightly grow in 2013, with increasing competitiveness of exports and expected recovery in global economy contributing most.

According to the latest ECB forecast of September 2012, annual real GDP growth for 2012 will range between -0.6 per cent and -0.2 per cent (the previous revision of June: from -0.5 to 0.3 per cent) and that for 2013 between -0.4 and 1.4 per cent (the previous estimate of growth: from 0 to 2 per cent). The IMF projections of October point to euro area GDP decline of 0.4 per cent for 2012 and 0.2 per cent growth for 2013 (the previous revision: from -0.3 per cent to 0.7 per cent).

Euro area annual inflation rates accelerated to 2.6 per cent in August and September after stabilising at 2.4 per cent in the previous quarter. Based on preliminary data, it moderated to 2.5 per cent on an annual basis. On a monthly basis, HICP increased by 0.7 per cent in September against 0.4 per cent in August. Clothing (0.66 percentage points) and footwear price sub-indices (0.14 percentage points) contributed most significantly to monthly HICP growth in September. Annual inflation dynamics largely reflected the changes in energy prices, rising by 9.1 per cent on an annual basis in September *vis-à-vis* 8.9 per cent in August and 6.1 per cent in July. In September the annual rate of euro area core inflation remained unchanged from the previous month at 1.5 per cent.

Euro Area Inflation Rate

(percentage change on same period of previous year)

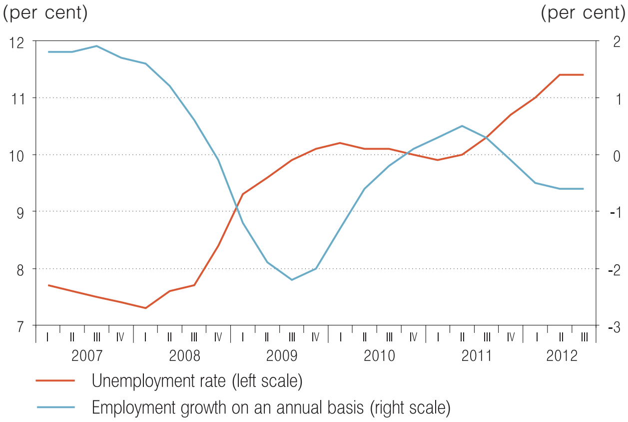


Source: Eurostat.

In September 2012 the annual HICP inflation rate in Germany slowed to 2.1 per cent against 2.2 per cent in August, while in France it moderated to 2.2 per cent against 2.4 per cent in the prior month. In Italy and Spain, consumer prices rose at a faster pace to 3.4 per cent and 3.5 per cent respectively compared to 3.3 per cent and 2.7 per cent in August.

In the October 2012 World Economic Outlook, the IMF revised upward its forecast for euro area inflation in 2012 to 2.3 per cent (compared to the April projection of 2 per cent) and left unchanged its outlook of 1.6 per cent inflation for 2013. According to the ECB forecast of September 2012, the increase in the euro area HICP is expected to move between 2.4 per cent and 2.6 per cent in 2012 (the previous revision of June: from 2.3 to 2.5 per cent) and between 1.3 and 2.5 per cent in 2013 (the previous estimate: from 1 to 2.2 per cent).

Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

According to the Eurostat data, euro area unemployment remained at a relatively high level in September 2012, rising to 11.6 per cent from 11.5 per cent in August. The indicator of the expected unemployment rate during the following twelve months, included in the EC consumer confidence index, increased significantly in the third quarter to reach 43.1 in September against 43 and 36.5 in August and July. It indicates consumer pessimism and expectations about deterioration of labour market conditions. The annual growth rate of unit labour costs was 1.5 per cent in the second quarter of 2012, as in the previous quarter. Over the same period compensation per employee picked up by 1.6 per cent (against 1.9 per cent) and labour productivity by 0.2 per cent on an annual basis (against the previous value of 0.4 per cent).

At its monetary policy meeting in July 2012, the ECB cut interest rates on its main refinancing operations. The interest rates on the main refinancing operations, deposit facility and marginal lending facility were decreased by 25 basis points to 0.75 per cent, 0 per cent and 1.5 per cent respectively. The ECB kept its interest rates unchanged in August, September and October.

At its September meeting, the ECB announced the specific parameters of a new Outright Monetary Transactions (OMTs) programme in the secondary sovereign bond market. It was aimed to support narrowing of government securities yield spreads of some euro area countries, which deviate significantly from fundamentally warranted levels. OMTs will be available to countries implementing a programme for financial assistance from the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) and the IMF within which the EFSF/ESM could intervene in the primary government securities market. OMTs may be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access. OMTs provide for purchases in short maturity sectors and in particular between one and three years (including by residual maturity). The ECB will fully sterilise the liquidity created through OMTs. The existing Securities Markets Programme (SMP) was terminated. Related liquidity-absorbing operations will continue, and securities purchased by the ECB will be held to maturity.

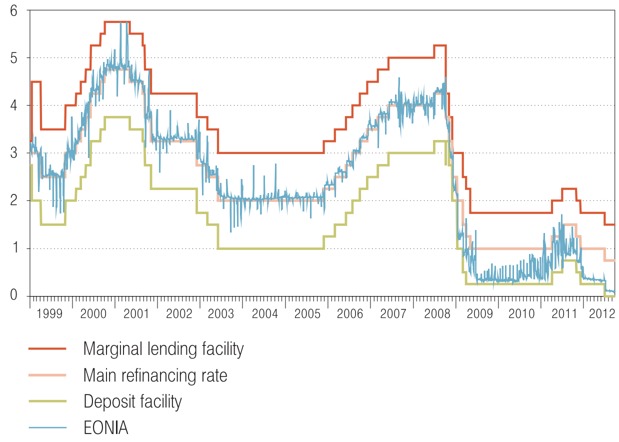
At the September meeting, the ECB decided to additionally widen its framework of instruments eligible to be used as collateral in the refinancing operations in order to maintain the access to the Eurosystem's liquidity-providing operations. The ECB agreed to suspend the application of the minimum credit rating requirement in the case of marketable debt instruments issued or guaranteed by countries that comply with OMTs or are involved in EU/IMF programmes. The ECB has also decided that marketable debt instruments denominated in currencies other than the euro, namely the US dollar, the pound sterling and the Japanese yen, and issued and held by euro area institutions, are eligible to be used as collateral in Eurosystem credit operations.

Subsequently, on 12 September 2012 the ECB announced the prolongation of the liquidity swap agreement with the Bank of England until the end of September 2013, allowing the ECB to provide sterling liquidity to euro area banks, when needed.

These measures aimed at giving banks easier access to funding as a part of the ECB measures adopted to restore the normal functioning of the monetary policy transmission.

ECB Interest Rates

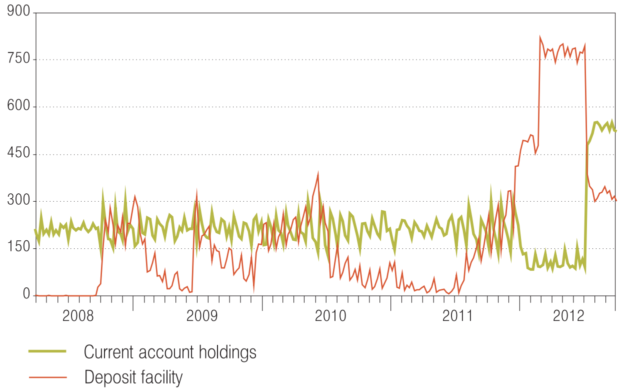
(per cent)



Source: ECB.

Deposit Facility and Banks' Current Accounts with the ECB

(billion EUR)



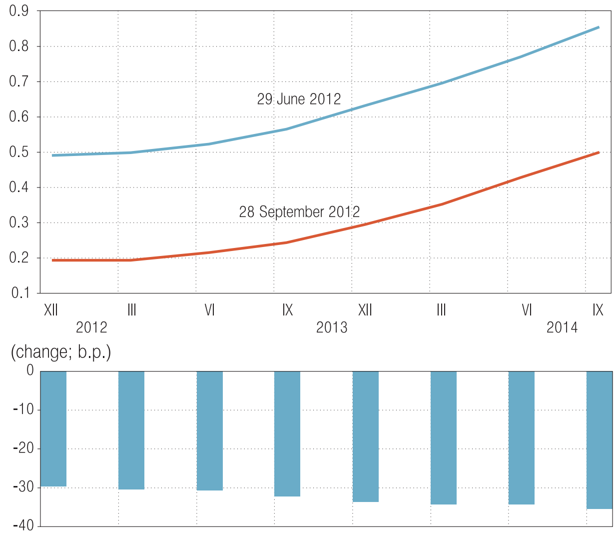
Source: ECB.

ECB deposit facility funds decreased considerably, after the ECB cut its interest rate on deposit facility to 0 per cent. Some banks' overnight deposit rates in the money market were even negative. By the end of September the residual value of deposit facility funds came to EUR 316 billion against EUR 773 billion at the end of June 2012. Concurrently, banks' current account holdings at the ECB (including banks' funds on minimum reserve requirements) rose to EUR 526 billion by end-September, from EUR 117 billion by end-June 2012. The net effect in the ECB balance sheet resulted in absorption of liquidity and some EUR 50 billion decline in the liquidity surplus[2] of euro area banks. As a result, the liquidity surplus decreased to EUR 730 billion at the end of September.

At the end of September 2012 market expectations derived from the prices of three-month EURIBOR futures contracts pointed to a decline in the money market reference interest rate to 0.5 per cent in the fourth quarter of 2012, retaining this level in 2013.

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

(per cent)



Source: European Banking Federation.

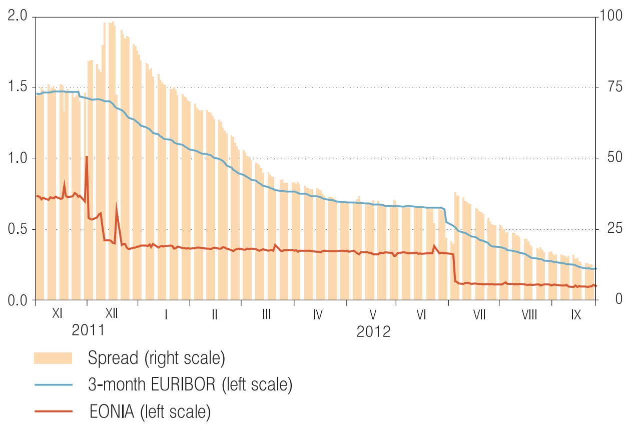
In the third quarter a decline in interbank deposit rates in the euro area was reported, reflecting ECB interest-rate cuts and continued implementation of its policy of unlimited liquidity allotment. The slope of the yield curve went down due to the stronger decline in interest rates in long maturity sectors. At the end of September 2012 EURIBOR interest rates with a maturity of one month stood at 0.12 per cent (-26 basis points on the end of June 2012), while those with a maturity of six and 12 months at 0.44 per cent and 0.68 per cent respectively (-49 basis points and -53 basis points on the end of June). Credit risk and liquidity premia measured by the EURIBOR-OIS spread narrowed to 13 basis points (-29 basis points on end-June) and 37 basis points (-34 basis points) in the three-

[2] The liquidity surplus is the difference between the volumes of the refinancing operations and the two ECB covered bonds programmes and the amount of required reserves and autonomous factors.

and six-month segments at the end of the review period.

The ECB actions contributed to the improvement of market environment. The launch of Outright Monetary Transactions programme led to a drop in the yield on government securities of euro-area periphery countries and thus to a narrowing of the spreads *vis-à-vis* German benchmark government bonds. Portuguese and Irish government securities spreads narrowed most significantly, Irish bonds yield falling below that of Spanish bonds. The yield of Spanish government securities remained higher than that of Italian bonds. Market participants took advantage of the opportunity for additional assistance for the country to make it eligible for OMTs.

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



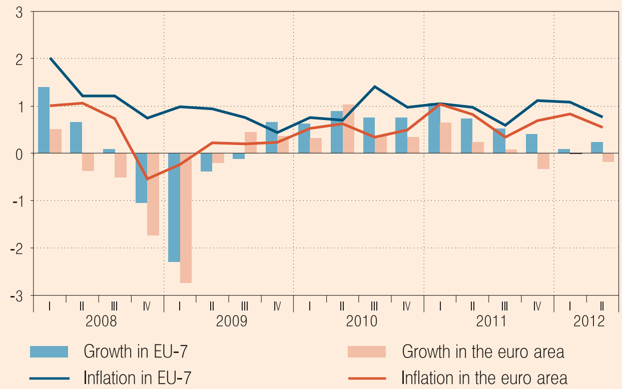
Sources: ECB, European Banking Federation.

Economic Development of EU-7[1]

In the second quarter of 2012 the real growth rate of EU-7 economies slightly accelerated compared to the January – March period, with solely the Czech Republic and Romania reporting a negative rate of growth. Quarter-on-quarter real growth of the EU-7 group was 0.2 per cent between April and June, against 0.1 per cent in the previous quarter. Overall inflation moderated to reach 0.8 per cent in the second quarter against 1.1 per cent in the first quarter.[2] Global food and energy prices had the most significant effect on inflation.

Dynamics of the growth and inflation indicators measured on average for EU-7 displayed divergent trends by country.

Growth Rate of Real GDP and Inflation in Euro Area and EU-7



Sources: Eurostat, own calculations.

In **Romania**, the recovering domestic demand had a positive contribution to economic growth in the second quarter, with private consumption and investments rising significantly. At the same time, net exports had a negative contribution to growth. In terms of supply, agriculture and construction affected positively economic activity, while growth in industry and services declined. Though employment slightly increased, the level of unemployment (seasonally adjusted data) underwent no changes in the second quarter. Over the review period the depreciation of the Romanian leu had the major contribution to the overall price increases, while falling global food prices retained the inflation pressure at low levels. In the second and third quarters the central bank of Romania left unchanged the base interest rate at 5.25 per cent.

In the second quarter **Hungary**'s economic growth continued to decline on a quarterly basis, albeit at a lower rate than in the previous quarter. Net exports continued to have the largest contribution to growth, while domestic demand decreased further. By sector, manufacturing had the largest contribution, followed by information and communication services. Agriculture and construction reported the greatest declines. Employment slightly increased, as reflected also in the declining unemployment rate which reached its end-2011 level. The weak domestic demand and low growth rates of energy prices contributed to the slowdown of inflation. In the third quarter the base interest rate was cut by 25 basis points in two steps to 6.50 per cent in September.

[1] EU-7 includes the newly acceded states, excluding Estonia, Slovenia, Malta, Cyprus and Slovakia. As of 1 January 2007 Slovenia, as of 1 January 2008 Malta and Cyprus, as of 1 January 2009 Slovakia and as of 1 January 2011 Estonia are members of the euro area. 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 growth, while in measuring inflation, the weights of EU-27 countries in HICP as calculated by Eurostat have been used.

[2] Harmonised indices of consumer prices for the respective countries are used in the analysis.

Real GDP Growth on an Annual Basis
(per cent; quarter-on-quarter, seasonally adjusted data)

Country	2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	1.3	1.0	0.8	0.6	0.4	0.3	0.1	0.1	0.0	0.3
Czech Republic	0.7	1.0	0.7	0.6	0.5	0.3	0.0	-0.2	-0.6	-0.2
Hungary	1.2	0.4	0.4	0.2	1.4	-0.3	0.0	0.1	-1.0	-0.2
Latvia	-0.3	0.4	0.7	1.0	1.5	2.0	1.4	0.8	1.1	1.2
Lithuania	0.6	0.9	0.8	2.0	1.6	1.7	1.2	1.0	0.1	0.5
Poland	0.6	1.2	1.3	0.9	1.1	1.3	0.7	0.8	0.6	0.4
Romania	-0.2	0.4	-0.8	0.9	1.2	0.0	1.1	-0.1	0.1	0.5
Average	*0.6*	*0.9*	*0.7*	*0.7*	*1.1*	*0.7*	*0.5*	*0.4*	*0.1*	*0.2*

Source: Eurostat.

Contribution to Real GDP Growth
(per cent; percentage points)

Country	GDP growth, second quarter of 2012	Private consumption	Government consumption	Investments	Exports, net
Bulgaria	0.3	2.7	0.0	0.3	-3.1
Czech Republic	-0.2	-0.5	-0.2	1.6	-1.6
Hungary	-0.2	0.0	-0.2	-0.2	1.0
Latvia	1.2	1.8	0.0	0.0	0.6
Lithuania	0.5	-0.1	0.0	-0.6	3.3
Poland	0.4	0.2	0.1	0.1	0.7
Romania	0.5	1.1	0.4	1.3	-1.6

Sources: Eurostat, own calculations.

Inflation
(per cent; quarter-on-quarter, seasonally adjusted data)

Country	2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	0.7	1.3	0.8	1.1	1.1	0.4	0.5	0.5	0.4	0.4
Czech Republic	0.4	0.7	0.6	0.4	0.2	0.6	0.8	1.1	1.3	0.5
Hungary	1.0	1.0	1.2	1.1	0.7	0.9	0.9	1.6	2.0	1.0
Latvia	-0.7	0.6	1.0	0.9	1.3	1.3	0.9	0.6	0.6	0.4
Lithuania	0.8	0.3	0.8	1.0	1.0	1.7	0.7	0.5	0.6	0.9
Poland	0.4	0.4	0.9	0.9	1.2	0.9	0.7	1.3	1.1	0.8
Romania	1.7	1.0	3.6	1.3	1.4	1.7	-0.2	0.5	0.7	1.1
Average	*0.8*	*0.7*	*1.4*	*1.0*	*1.0*	*1.0*	*0.6*	*1.1*	*1.1*	*0.8*

Source: ECB.

Unemployment
(per cent; quarter-on-quarter, seasonally adjusted data)

Country	2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	9.3	10.0	10.4	11.3	11.2	11.2	11.1	11.6	12.0	12.3
Czech Republic	7.8	7.2	7.1	7.0	6.9	6.8	6.6	6.6	6.8	6.8
Hungary	11.2	11.3	11.2	11.0	11.0	10.9	11.0	10.9	11.1	10.9
Latvia	21.2	20.6	19.4	18.1	17.1	17.0	15.7	15.4	15.4	15.9
Lithuania	17.3	18.1	18.2	17.7	16.7	15.7	15.0	14.1	13.6	13.3
Poland	9.8	9.6	9.5	9.6	9.4	9.5	9.7	10.0	10.0	10.0
Romania	7.5	7.2	7.2	7.2	7.1	7.5	7.5	7.5	7.2	7.2

Source: Eurostat.

Real GDP in **Poland** continued to rise in the second quarter, though at a declining rate. All GDP components had positive contributions to growth. In terms of industry, the financial and insurance sector recorded the largest growth, followed by real estate operations and information and communication. Gross value added in construction rose moderately, while economic activity in manufacturing decreased. In the second quarter inflation in Poland declined on a quarterly basis, with all major price groups reporting slowing growth rates. Over the same period unemployment remained at its end-2011 level. In May the central bank of Poland raised the base interest rate by 25 basis points to 4.75 per cent.

In the second quarter **Latvia** reported positive growth of its real GDP, though the previous quarters' downward trend was sustained. Private consumption and net exports affected positively real GDP growth, while government consumption and investments reported no changes from the previous quarter. On the supply side, construction and information and telecommunication services had significant positive contributions to growth. Gross value added in the financial and insurance sector and in industry also increased, while real estate operations recorded a negative growth rate. The seasonally adjusted level of unemployment rose to reach the high level of 15.9 per cent. The downward trend in inflation continued in the second quarter, with low global food and energy prices contributing mainly to the weaker inflationary pressures. In the third quarter the central bank of Latvia cut in two steps the base interest rate to 2.5 per cent in September.

Real GDP of the **Czech Republic** decreased for the fourth consecutive quarter. Between April and June only investments had a positive contribution, while net exports fell significantly. By sector, agriculture had a positive contribution to growth, while information and telecommunication and financial and insurance services reported declines. Despite the reported data on slowing economic activity, the Czech labour market recorded no significant changes, with unemployment remaining at the region's lowest level of 6.8 per cent. Inflation in this country slowed down substantially over the second quarter following the decline in global food and energy prices. By end-September the central bank of the Czech Republic took a decision to cut the base interest rate to 0.25 per cent as from 1 October.

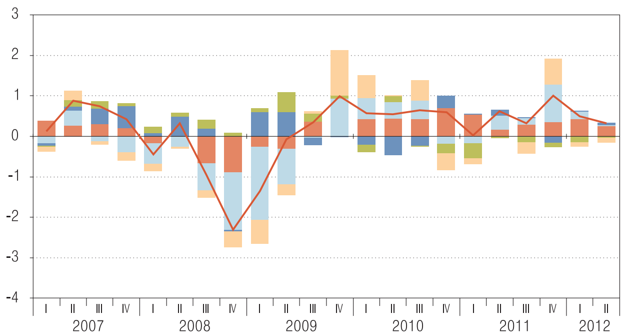
The growth rate of real GDP in **Lithuania** accelerated in the second quarter compared with the previous quarter. Net exports made the major contribution to growth, while investments reported the largest decline. Economic activity accelerated in financial and insurance services, agriculture and real estate operations, unlike the industrial production which decreased over the review period. The continuous increase in economic activity affected further the labour market, boosting employment and depressing the level of unemployment. The price rises in goods and services with administratively controlled prices had the major contribution to the increased price level, while international food prices subdued its future rise.

United States

In the fourth quarter of 2012 the US real GDP growth moderated to 0.3 per cent on a quarterly basis, down from 0.5 per cent in the previous quarter. On an annual basis, it declined to 2.1 per cent, from 2.4 per cent over the first quarter. The slowdown in GDP growth on a quarterly basis between April and June was due to the low contribution of private consumption, exports and gross fixed capital formation. Over the review period household consumption registered a 0.26 percentage point contribution to GDP growth (0.43 percentage points in the first quarter), while exports came to 0.18 percentage points (0.15 percentage points in the previous three months). The contribution of gross fixed capital formation fell to 0.14 percentage points (against 0.29 percentage points between January and March). Over the period under review the change in inventories (-0.12 percentage points against -0.10 percentage points in the prior quarter) and government expenditure (-0.04 percentage points against -0.15 percentage points in the previous three months) had the largest negative contribution to the growth.

Contribution to US GDP Growth by Component (Quarterly)

(per cent; percentage points)

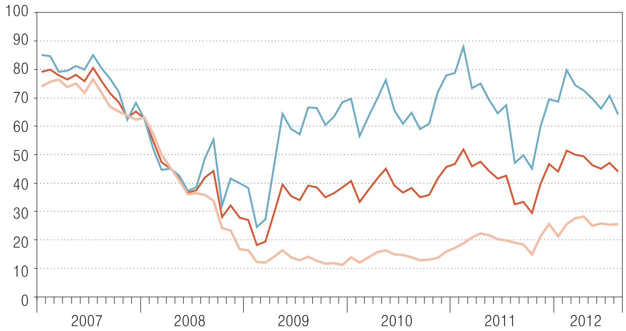


Source: Bureau of Economic Analysis.

Based on initial data, real GDP growth in the USA accelerated to 0.5 per cent in the third quarter, reaching 2.3 per cent on an annual basis (2.1 per cent in the second quarter).

US Consumer Confidence Indices

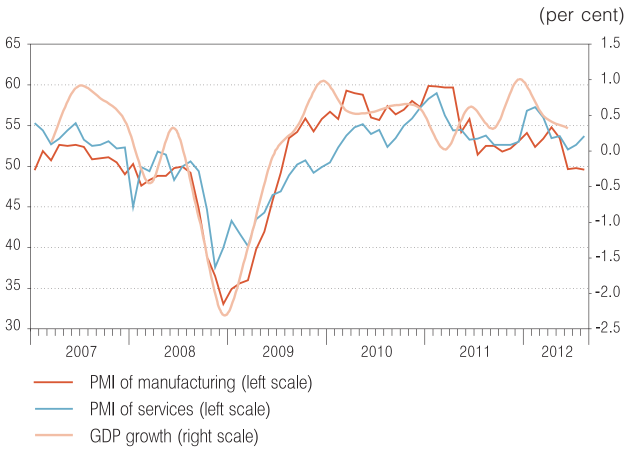
(2000 = 100)



Source: Conference Board.

In the third quarter of 2012 the upward trend in US consumer confidence indicators reflected mainly the prevailing positive economic signals. After falling to 72.3 points in July (the lowest value since the beginning of 2012), the University of Michigan Consumer Sentiment Index rose greatly to reach 78.3 points in September. The leading Conference Board Consumer Confidence Index also recorded an improvement of consumer sentiment at the end of the quarter. Consumer perception improved in participants' assessments of both the current economic situation and economic prospects in the coming six months.

US ISM Manufacturing and Services PMI and GDP Growth



Source: Institute for Supply Management.

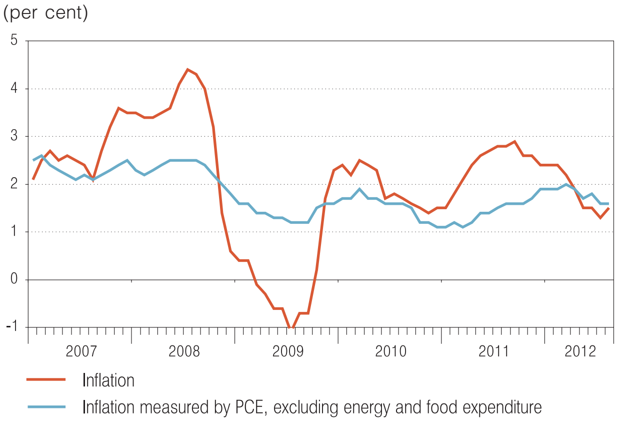
Demand for goods and services picked up in line with the rising consumer confidence. In September retail sales rose by 1.1 per cent on a monthly basis, following the significant increase of 1.2 per cent in August.

In the third quarter of 2012 the change in conjunctural indicators for manufacturing and services was divergent, a sign of uncertainty that continued to affect the assessment of the outlook for the US economic activity. In September 2012 the ISM manufacturing PMI grew to 51.5 points against 49.6 in August and 49.8 in July. After falling in June to its lowest level since February 2010 (52.1 points), the ISM services PMI grew steadily in the next three months to reach 53.7 points in September. Despite the positive quarterly dynamics, low index levels and moderate growth rate indicate considerable uncertainty, which affect the expected US economic recovery.

Over the third quarter of 2012 investment activity in the housing sector continued to improve. In September, the NAHB Builder Confidence Index has reached its peak since 2006, reflecting the support from the US Federal Reserve. However, the improving expectations of the building entrepreneurs were not underpinned by the sentiments of households which currently prefer to postpone a home purchase according to the latest confidence survey by the Conference Board. Still high unemployment, tight credit conditions and uncertainty about restrictive fiscal measures, which will take effect in January 2013, further impeded home sales growth despite the low mortgage rates. The resumption of mortgage-backed securities purchases announced by the US Federal Reserve will mitigate the effect of the drag and will affect favourably the housing market situation in the USA. The necessary adoption of a balanced plan for achieving fiscal consolidation and sustaining economic growth played a crucial role for the future economic development.

Inflation measured on an annual basis by personal consumption expenditure deflator (PCE) rose to 1.5 per cent in August against 1.3 and 1.5 per cent in July and June. In August core inflation (excluding food and fuel items) of personal consumer expenditure retained its level of 1.6 per cent for the second consecutive month, after reaching 2.0 per cent in June. The annual growth rate of the personal consumption expenditure index is anticipated to remain close to its current level in the following two quarters.

US Inflation Rate



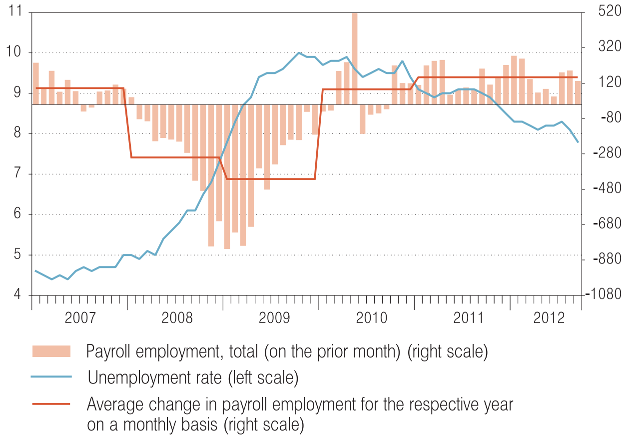
Note: Inflation is measured by the personal consumption expenditure deflator.

Source: Bureau of Labor Statistics.

Consumer price index, the other indicator of the US inflation, accelerated to 2.0 per cent on an annual basis in September against 1.7 per cent in August. The core PCE index also rose to 2.0 per cent against 1.9 per cent a month earlier.

Expected domestic consumer price inflation up to one year, which is a component of the University of Michigan consumer confidence index, posted a 3.3 per cent decline in September from 3.6 per cent in August, long-term inflation expectations also decreasing slightly. In the next two quarters the US consumer price inflation is expected to gradually stabilise at about 2 per cent.

US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labor Statistics.

The unemployment rate fell significantly in the third quarter of 2012, reaching 7.8 per cent in September, the lowest value recorded since early 2009. The number of new jobs created in the third quarter was larger than in the second quarter, new jobs coming to 114,000 in September (142,000 in the prior month). The monthly average number of persons employed in non-agricultural sector increased by 146,000 between July and September against 67,000 on average in the previous quarter. Unemployment rate is expected to hover around 8 per cent until the end of 2012.

In order to encourage moderating economic growth and to prevent negative effects of uncertainty in financial markets caused by the euro area debt crisis, signals of slowing world economy and absence of an agreement to avoid 'fiscal cliff'[3], the Federal Open Market Committee (FOMC) adopted several important decisions at its September meeting. The first one, already reflected in market participants' expectations, was the resumption of mortgage-backed securities purchase programme. The Committee will purchase securities at a pace of about USD 40 billion per month. The programme was launched on 14 September and has no definite expiration date.

[3] A sharp reduction of government spending combined with discontinuance of a number of tax reliefs that are expected to push the US economy into a renewed recession. For further details, see the box on page 20.

Besides the resumed asset purchases, the Committee also will continue through the end of 2012 its programme to extend the average maturity of its holdings of securities by reinvesting earnings from maturing securities and those from short-term bonds in government securities with a maturity of over 6 years (Operation Twist). In addition, the Committee is maintaining its existing practice of reinvesting the yield from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. According to the assessment of the Federal Reserve, these actions will result in an increase of about USD 85 billion in the Committee's holdings of securities each month through the end of the year.

The effect of the operations conducted by the US Federal Reserve implies significant reduction of longer-term interest rates on which the calculation of long-term monetary resources is based. The improvement of funds availability and of loan refinancing possibilities affected favourably the housing market and led to enhanced demand for residential properties. However, there has not been larger investment for the business to create new jobs. Ongoing recovery of the labour market is considered to be one of the conditions necessary for the withdrawal of US Federal Reserve measures to support the US economic activity.

The Committee also decided to keep the existing range for the federal funds rate within 0.00–0.25 per cent through mid-2015. Committee members emphasised the need to maintain the policy of keeping low levels for the federal funds rate for a considerable time after the economic recovery strengthens. Thus, the US Federal Reserve practically aimed at keeping the yields on two-year US government securities close to 0.25 per cent, while those on US medium- and long-term bonds are likely to remain under the pressure of the Operation Twist programme for securities purchases at least through the end of the year.

US Fiscal Position

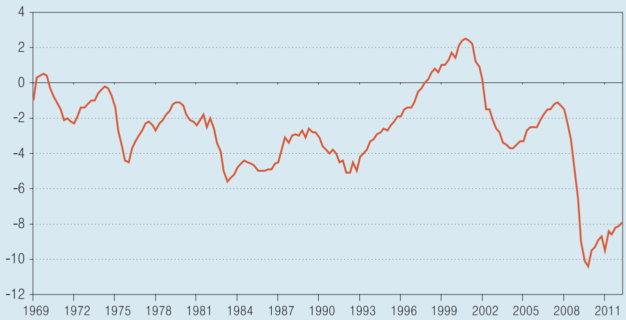
In a number of developed countries, the 2007–2008 financial crisis turned into an economic crisis at the end of 2008, resulting in the introduction of significant fiscal measures to support growth. In the United States, the government measures to stimulate domestic demand led to a dramatic rise in budget deficit and government debt. US budget deficit reached USD 1.4 trillion in 2009 (10.0 per cent of GDP) and USD 1.3 trillion in 2010 (8.9 per cent of GDP), the highest levels since 1945. In comparison, the 2008 budget deficit came to 4.8 per cent of GDP. According to the Congressional Budget Office data, US budget deficit is projected to be 7.0 per cent of GDP in 2012.

To finance the rising budget deficit, the government increased significantly government debt issues. The net amount of securities placed in the market was slightly above 80.3 per cent of GDP in 2011 compared to 53.8 per cent of GDP in 2008.

The adoption of fiscal consolidation measures in the United States was delayed as a result of the concerns that they would jeopardise the economic recovery in the short term, despite the understanding that maintaining large budget deficit destroys the soundness of fiscal policy in the longer term. The renewed increase in statutory debt limit over 2011 highlighted the need for stabilising the US fiscal position.[1] Thus, at the beginning of August 2011 the increased debt ceiling, approved by lawmakers, was accompanied by the adoption of the Budget Control Act of 2011. A budget deficit reduction of USD 2.1 trillion was envisaged for a ten-year period (between 2012 and 2021) in the Act, specifying that USD 917 billion of cuts shall be carried out by imposing reductions in government spending. The Joint Select Committee on Deficit Reduction was established to develop a balanced plan for cutting the remainder of the deficit at USD 1.2 trillion by November 2011. The proposal should be passed and approved by Congress until 15 January 2012. In the event of default of Committee's obligations, automatic procedures to cut spending proportionally in almost every programme, financed by the government, will take effect in January 2013.

US Budget Deficit

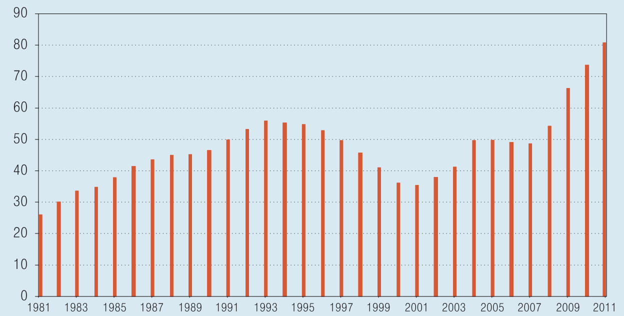
(share of GDP, per cent)



Source: US Department of the Treasury.

US Statutory Debt

(share of GDP, per cent)



Source: IMF.

Due to the existing differences in the views of the two parties' representatives, the Committee failed to achieve its objectives, as had been anticipated. This triggered the automatic cuts.

The *US Fiscal Consolidation Plan in 2013* table displays information about the measures effective until the end of the current year and directed at enhancing economic activity and reductions on government programmes projected in the Budget Act for 2013.

Concerns about a sharp decline in economic activity in the short and long run, caused by such reductions in tax relief and government spending, have increased since early 2012 despite the undisputed benefits related to the need for reducing long-term budget deficits. When presenting the semi-annual monetary policy report to the Congress at the end of February, Ben Bernanke, the Chairman of the Board of Governors of the US Federal Reserve System, called the situation a 'fiscal cliff', emphasising that the US government is likely to prompt a risk of renewed recession, if it fails to adopt a more balanced approach to achieve a stable deficit reduction in the long term.

The table below shows three scenarios, presented in the Congressional Budget Office report.

[1] See Economic Review, issue 3/2011, p. 20.

Fiscal Consolidation Plan in 2013

	Amount (billion USD)	Share of GDP, per cent
Reliefs, expiring at the end of 2012		
Income tax reliefs (so-called Bush tax cuts)	295	1.8
Payroll tax cuts	127	0.8
Other reliefs	87	0.5
Tax reliefs under the Affordable Care Act, aiming at better access to health care of all social groups in the United States	24	0.1
Changes in unemployment benefits	35	0.2
Reductions effective as of January 2013		
Automatic spending cuts under the Budget Control Act of 2011	87	0.5
Suspension of additional Medicare payments	15	0.1
Tax reliefs (total amount)	**532**	**3.2**
Budget spending reductions (total amount)	**136**	**0.8**
Total	**668**	**4.0**

Source: Congressional Budget Office.

In 2011 the complicated negotiations over raising the debt ceiling and unsatisfactory deficit-reduction measures were the main factors behind the S&P downgrade of the US credit rating by one step to AA+ with the argument that the adopted fiscal consolidation plan is insufficient to stabilise the US fiscal position in the medium run, as well as due to the lack of political will to act in this direction, as confirmed by the prolonged period of decision-making. The agency signalled its readiness to downgrade further the US sovereign rating, if the governing bodies of the United States do not demonstrate determination to address the fiscal challenges.

In September 2012 Moody's Investor Service expressed the same concerns, highlighting that it will continue to maintain the negative outlook regarding the US credit rating. If the Congress fails to reach an agreement on the fiscal position stabilisation and a medium-term reduction in the government debt to GDP ratio over 2013, the agency will downgrade the credit rating by one step to Aa1 (from Aaa).

Scenarios for Real GDP Growth and Changes in Employment in 2013, Produced by the Congressional Budget Office

	2013					
	First half		Second half		Total	
	Growth (per cent)	Changes in employment rate (million)	Growth (per cent)	Changes in employment rate (million)	Growth (per cent)	Changes in employment rate (million)
Scenario 1*	-1.3		2.3		0.5	
Projected range						
Scenario 2**	5.3	1.3	3.4	3.3	4.4	2.3
Projected range	1.0 – 9.6	0.5 – 2.1	1.9 – 5.0	1.0 – 5.7	1.4 – 7.3	0.7 – 3.9
Scenario 3***	1.7	1.1	2.5	2	2.1	1.5
Projected range	-0.4 – 3.8	0.4 – 1.8	2.0 – 3.0	0.6 – 3.4	0.8 – 3.4	0.5 – 2.6

* Upon the entry of automatic cuts into force.
** An assumption is made that all measures that have been adopted to stimulate economic activity since the beginning of the crisis will be extended, while scheduled budget cuts will be repealed.
*** All tax reliefs, excluding those on social insurance payments, are assumed to be extended after 2012.

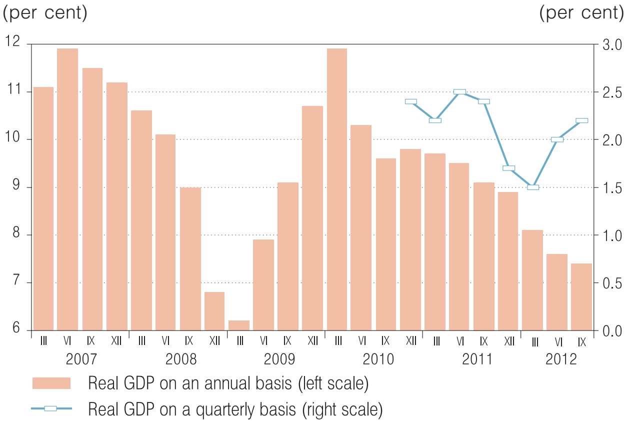
Source: Congressional Budget Office.

The worst-case scenario for the US economy in the absence of an agreement between the government and the Congress on overcoming the 'fiscal cliff' would adversely affect the world economic growth and to a large extent the euro area growth due to the ongoing public finance problems. A possible global economic activity slowdown would have a negative effect on the Bulgarian economy as well.

China

China's economic growth continued to slow in the third quarter, reaching 7.4 per cent on an annual basis against 7.6 per cent in the previous quarter.

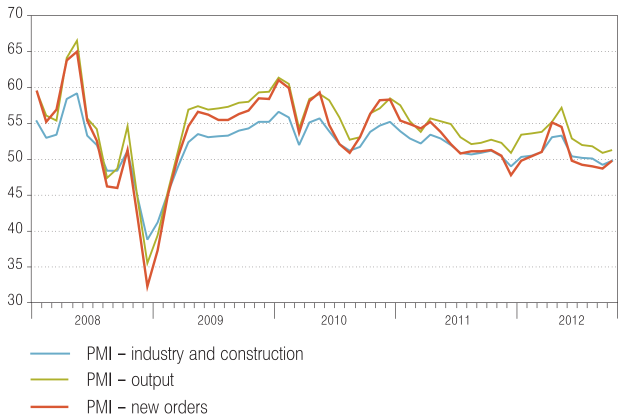
GDP real growth



Source: Bloomberg.

On a quarterly basis, economic growth accelerated to 2.2 per cent compared to 2.0 per cent in the second quarter. If this trend is sustained, China's real GDP growth in 2012 will stabilise close to its current levels at about 7.5 per cent.

Manufacturing PMI, Output and New Orders

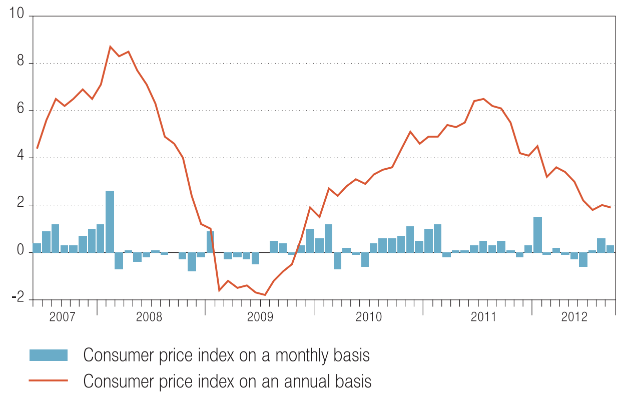


Source: Bloomberg.

The latest manufacturing PMI data pointed to a change in the slowing economic activity of this sector, rising to 50.2 in October (previous value: 49.8), which is a signal of the economic recovery. The major factors behind this rise were the sub-indices of current production and new orders, rising to 52.1 (previous value: 51.3) and 50.4 (previous value: 49.8) respectively.

In September PMI in services unexpectedly declined, falling to 53.7 against 56.3 in August. In October the index increased to 55.5 in line with the general improvement of expectations.

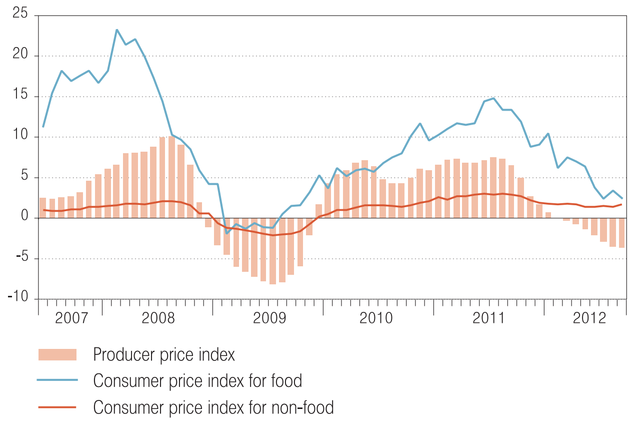
Consumer Price Index



Source: Bloomberg.

The inflation in China was 1.9 per cent in September, down slightly from 2.0 per cent in August and 1.8 per cent in July. Food prices contributed greatly, their rises abating to 2.5 per cent against 3.4 per cent in August.

Inflationary Indices (on an Annual Basis)

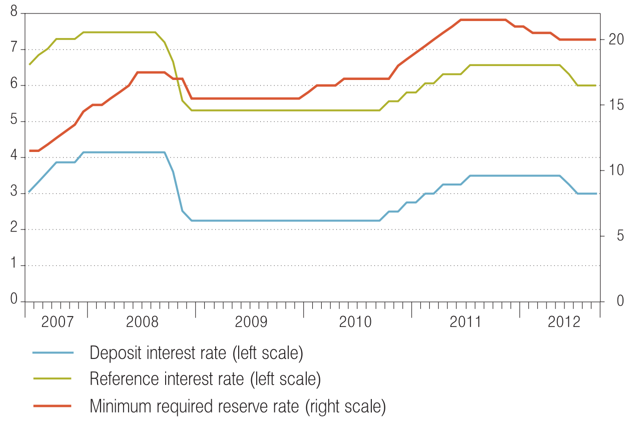


Source: Bloomberg.

On a monthly basis, the consumer price index went up by 0.3 per cent in September compared to 0.6 per cent in August and 0.1 per cent in July.

Producer prices fell further to reach -3.6 per cent on an annual basis in September, from -3.5 per cent in August and -2.9 per cent in July.

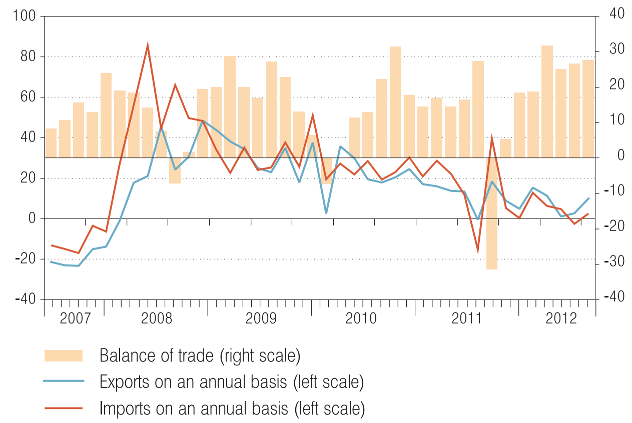
Monetary Policy of the People's Bank of China



Source: Bloomberg.

In early July the People's Bank of China reference interest rate on one-year deposits was reduced by 25 basis points to 3.00 per cent and interest rates on loans by 31 basis points to 6.00 per cent. Reasons for the cut are related to ongoing deceleration in consumer price rises and worsening in global situation.

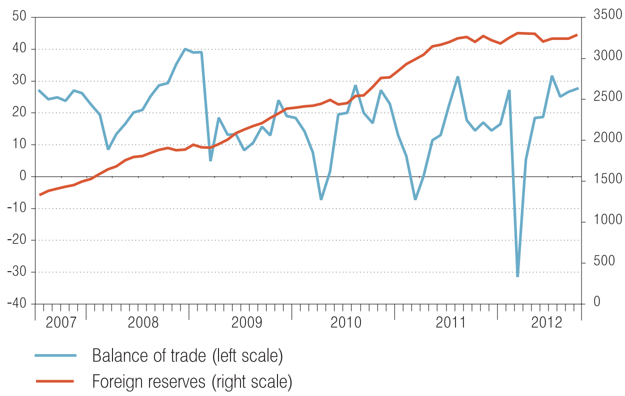
Foreign Trade and Trade Balance



Source: Bloomberg.

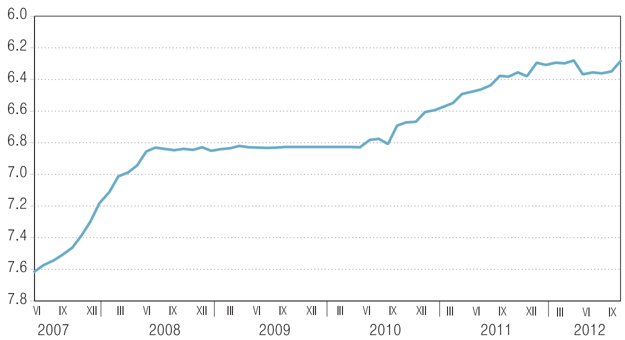
The trade surplus grew to USD 27.7 billion in September, exceeding the expectations for USD 20.5 billion positive balance, somewhat higher than the values recorded in August (USD 26.7 billion) and July (USD 25.2 billion). The increase in China's trade surplus reflected the faster rise in exports to its major trading partners: the United States, Japan and emerging Asian markets. China's exports to the euro area were weaker. On an annual basis, exports accelerated to 9.9 per cent and imports increased by 2.4 per cent.

International Foreign Exchange Reserves and Trade Balance



Source: Bloomberg.

RMB/USD Exchange Rate



Note: The chart scale is inverted, the upward movement shows an appreciation.

Source: Bloomberg.

In July and August the exchange rate of the Chinese renminbi depreciated against the US dollar as a result of the moderating exports and worsening economic situation. In September the movements of the Chinese currency were mixed. It appreciated *vis-à-vis* the US dollar by 1.0 per cent, after China's foreign exchange reserves increased by 1.5 per cent.

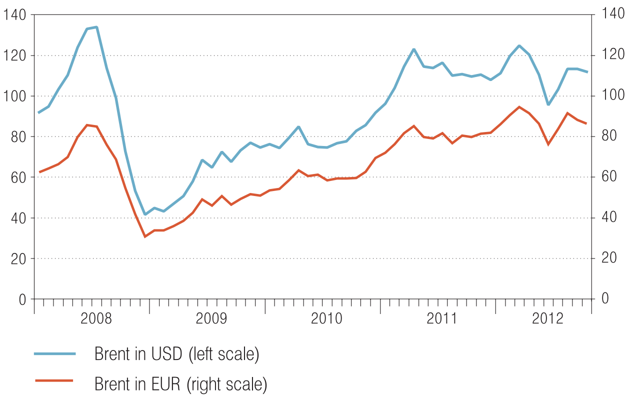
International Prices (Crude Oil, Major Raw Materials, and Gold) and the EUR/USD Exchange Rate

Crude Oil Prices

Between July and September 2012 the price of Brent crude oil rose to USD 110 *per* barrel on average (EUR 87.8 *per* barrel) compared with the second quarter. After a considerable decline by end-June, oil prices picked up again in the third quarter due to the usual for this season rise in demand. Concurrently, crude oil production decreased, reflecting unintended interruption of the operation in some oil refineries because of the safeguards against hurricane Isaac in the Gulf of Mexico, political tension, causing problems with Sudan's oil exports, and repair activities of oil platforms in the North Sea. The effect of the USA and EU-imposed sanctions (regarding Iran's oil exports and Iranian oil operations abroad) on the price of crude oil was estimated as weak amid relatively limited demand for energy products in advanced economies. Higher production in Iraq and Libya in August and September was not sufficient to offset the lower production in other regions. Ongoing military conflict in Syria and resulting risk for its exports were the major reasons behind the rise in crude oil prices. At the same time, developed countries' policies for fostering economic growth had a favourable effect on the market sentiment, pushing up the demand and thus the oil prices on international markets.

Crude Oil Prices

(USD *per* barrel) (EUR *per* barrel)



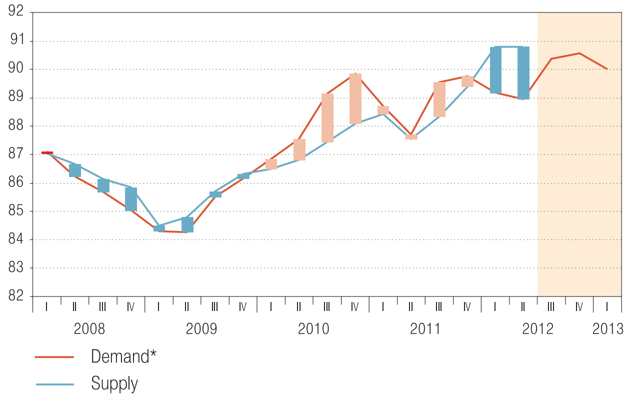
Source: World Bank.

In October 2012 the International Energy Agency (IEA) revised downwards its crude oil demand data for 2012.

IEA expectations for the fourth quarter of 2012 and early 2013 show that oil demand will continue to rise in line with stabilisation in global economy. Until the end of 2012 and the beginning of 2013 supply is also expected to grow, as non-OPEC countries' oil production is projected to increase.

World Crude Oil Supply and Demand (Quarterly)

(million barrels *per* day)



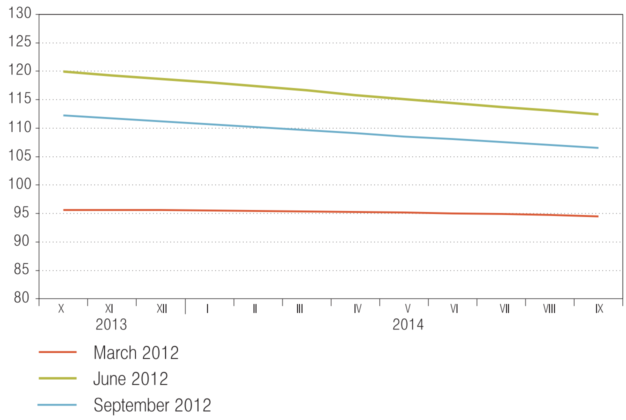
* The International Energy Agency projections of October 2012 for crude oil demand between the third quarter of 2012 and the end of the first quarter of 2013 is also included.

Source: IEA.

According to the market sentiment measured by futures prices as of 30 September 2012, Brent crude oil will be traded in the range between USD 105–112 per barrel in the next twelve months. Price expectations increased on June 2012.

Brent 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

According to ECB data, in the third quarter the general metal price index slightly grew (0.9 per cent) on the April to June period. On a quarterly basis, non-ferrous metal prices also increased marginally by 0.4 per cent, lead (3.0 per cent) and copper (0.7 per cent) posting the most significant increase. Tin and zink declined by 3.6 per cent and 2.3 per cent respectively. Metal prices are expected to stabilise in the fourth quarter of 2012 and early 2013.

Over the first half of 2012 the index recording the global food price level slightly went down. Due to the depreciation of European currency, the prices in euro remained almost unchanged. However, in July and August food prices rose sharply which brought about an 11.6 per cent increase in the index on the second quarter, owing to the marked rise of 28.8 per cent in cereal prices over the review period. The price of wheat rose by 37.4 per cent, following much-weaker-than-expected yields in Australia, the Black Sea Region and North America. Maize and rice also posted an increase, their prices rising by 28.5 per cent and 6.9 per cent respectively.

In September 2012 the International Grains Council revised downwards its global cereal production forecast. The crop is foreseen to fall by around 4.5 per cent between 2012 and 2013 compared with a year earlier. Concurrently, consumption is also expected to decrease by 2.1 per cent.

On the basis of developments in the third quarter, a slight rise in cereal prices is expected on international commodity markets in the fourth quarter of 2012 and early 2013.

Gold Prices

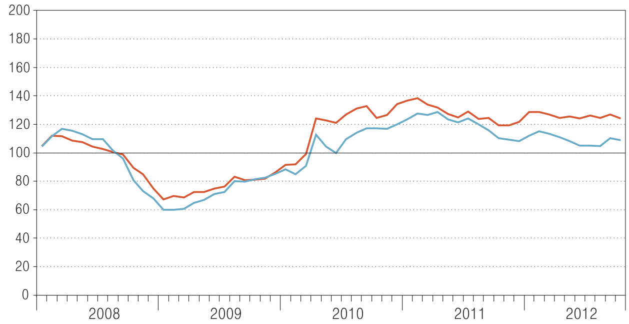
Over the third quarter of 2012 the average spot price of gold went up by 2.6 per cent on a quarterly basis to USD 1654.0 *per* troy ounce. In euro terms, gold prices rose by 5.2 per cent to EUR 1321.2 *per* troy ounce.

The gold price in the third quarter reflected mainly the enhanced demand for gold as a hedge against inflation, as a result of subsequently justified investor expectations that the US Federal Reserve would initiate new monetary measures to stimulate the US economy. After the trade within a relatively narrow range in July and most of August, the gold started to appreciate following the publication of the minutes from the FOMC meeting held on 31 July – 1 August. FOMC minutes signalled the higher willingness of the US Federal Reserve to introduce new non-conventional monetary policy measures. Gold price rose after the Chairman of the Federal Reserve Board stated on 31 August a willingness to introduce economic stimulus. Data on lower number of people employed in US non-

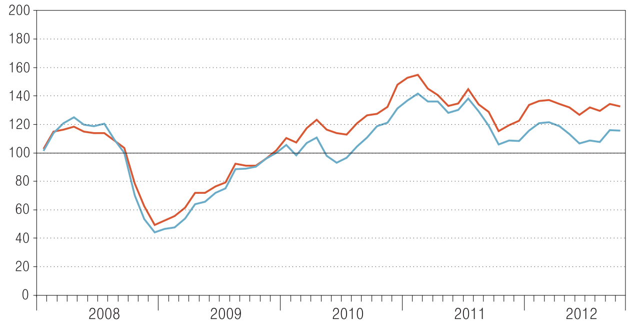
Price Indices of Major Raw Material and Commodity Groups

(2008 = 100)

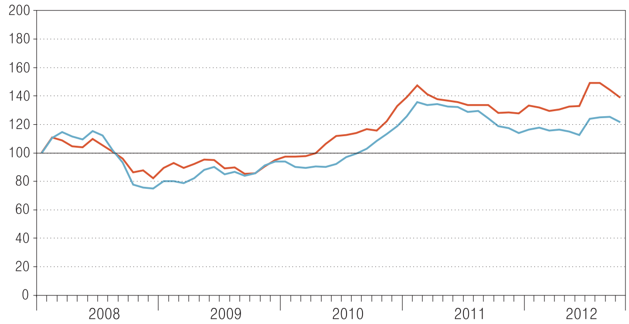
Metals



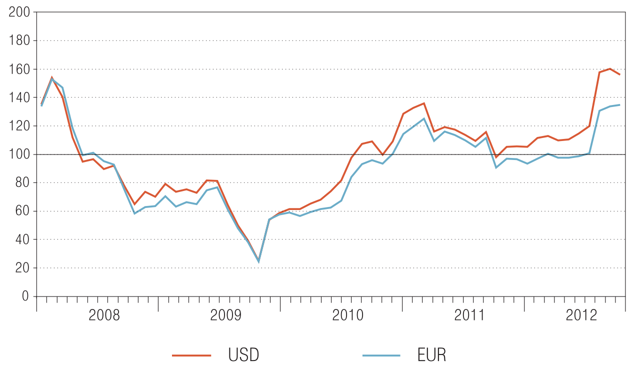
Copper



Food



Wheat



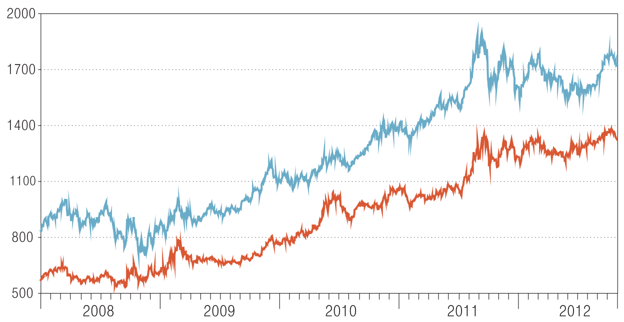
Sources: ECB and BNB.

agricultural sector in August also contributed to the increased expectations of new US Federal Reserve non-conventional monetary policy measures and this in turn led to an appreciation of gold. The decision taken on 19 September by the Bank of Japan to increase the amount of its asset purchase programme by JPY 10 trillion also pushed up the gold price.

Demand for physical gold by exchange-traded funds (ETF), collateralised by gold, increased markedly in the third quarter. At the end of the review period the funds managed assets amounting to 2545 tonnes of gold.

Based on World Gold Council's data in its latest Gold Demand Trends report (August 2012), central banks continued to be net purchasers of gold, their purchases accounting for 157.5 tonnes in the second quarter. Central banks added 254.2 tonnes to their holdings since early 2012. More significant gold purchases were made by central banks of Russia, South Korea, Ukraine and Kazakhstan.

Spot Price of Gold



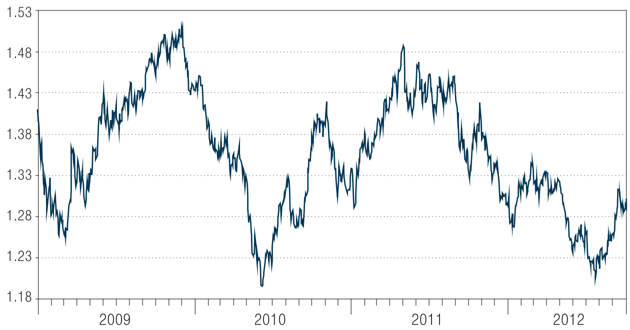
Source: London Bullion Market Association.

The EUR/USD Exchange Rate

In the third quarter of 2012 the average value of the US dollar appreciated by 2.5 per cent against the euro. For comparison purposes, over the second quarter of 2012 the single currency depreciated by 2.2 per cent on average against the US dollar. Over the period the US currency traded within a range of 1.21–1.31 *per* euro. In the review quarter foreign exchange markets were affected by the information related to the stance and actions of the major central banks.

The USD/EUR Exchange Rate

(USD *per* EUR 1)



Source: ECB.

At the beginning of the third quarter the trend towards depreciation of the euro against the US dollar was sustained underpinned by the decline in ECB interest rates. The statement by the President of the ECB at the end of July that the central bank of the EU will do 'whatever it takes' to preserve the euro was a milestone in breaking the downward trend. Later on, in August and September, interest rate differential between the euro area and the USA was the main factor determining the exchange rate fluctuations, with investors monitoring the monetary policy decisions of the Federal Reserve and the ECB. The announced Outright Monetary Transactions (OMTs) programme of the ECB that will be available to countries implementing a programme for financial assistance from the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) and IMF helped restore the confidence in the euro. The actions of the ECB led to a significant appreciation in the single currency at the end of the review period, coming to 1.5 per cent between 1 July and 30 September. The Federal Reserve's decision to initiate new non-conventional monetary policy measures had an additional effect on the depreciation of the US dollar against the euro.

2. Financial Flows, Money and Credit

By August 2012 the balance of payments current account recorded a deficit of EUR 738.9 million, and the overall current and capital account balance amounted to a deficit of EUR 188.3 million.

Between January and August 2012 the overall current and capital account balance was positive at EUR 227.0 million. The balance of payments financial account balance was also positive with a surplus of EUR 1062.7 million, reflecting mainly the foreign direct investment inflow (FDI). According to balance of payments data, foreign exchange reserves, excluding valuation adjustments and changes related to the price of gold, increased by EUR 1554.3 million in the first eight months of 2012.[1]

By end-September 2012 the market value of international foreign reserves (an asset in the BNB Issue Department balance sheet) which includes changes stemming from transactions and revaluation adjustments came to BGN 30.3 billion (EUR 15.5 billion): up BGN 4220.6 million (EUR 2157.9 million) on end-2011.

The change in the market value of international reserves is mainly driven by liabilities developments in the BNB Issue Department balance sheet.[2] Liabilities to the government and other budget organisations contributed most to the rise in the balance sheet value. Government deposit dynamics – an essential part of the Issue Department's liabilities – is determined by the fiscal policy and budget deficit financing policy. Over the first nine months the government deposit with the BNB increased by BGN 2523.1 million (EUR 1290.0 million), largely due to the issue of 5-year government securities with a nominal value of EUR 950 million in the international capital markets. Therefore, in September 2012 the government deposit with the BNB reached BGN 6882.3 million (EUR 3518.9 million). Since the year start bank deposits with the BNB also went up BGN 712.8 million (EUR 364.4 million) against the background of increasing residents' deposits and higher banking system liquidity.

Monetary Flows Which Prompted Significant Changes in Gross International Reserves

(million EUR)

External flows	2011	January – September 2011	January – September 2012*
Total for the period	-24	-225	1413
Purchases and sales of euro	-543	-512	-213
at tills	-11.1	-9	-8
banks, incl.	-532	-504	-205
banks' purchases	33 698	24 103	35 897
banks' sales	-34 230	-24 607	-36 102
Flows on accounts of banks, the MF, ***etc***.	520	288	1626
Minimum required reserves	-128	-31	85
Government and other depositors	647	319	1541

Note: The table shows only currency inflows and outflows to the Issue Department balance sheet. Lev flows to and from the Issue Department balance sheet and transactions between foreign currency and lev accounts in this balance are not reported as they do not result in a change in gross international reserves.

* Preliminary data.

Source: BNB.

Information about the major operations of the central bank provides additional data on cash flow developments which led to more significant changes in gross international reserves.

On a cash basis, disregarding valuation adjustments and changes in the price of gold, gross international reserves increased by EUR 1413 million in the first nine months of 2012. Banks' net purchases of euro from the BNB came to EUR 205 million and banks' reserves denominated in euro went up by EUR 85 million.

In August 2012 the average monthly coverage of imported goods and services by BNB international reserves was 6.6 months.[3]

[1] The errors and omissions item was positive at EUR 264.6 million between January and August 2012.

[2] According to Article 28, paragraph 1 of the Law on the BNB, 'the aggregate amount of monetary liabilities of the BNB shall not exceed the lev equivalent of gross international reserves,' with the lev equivalent determined on the basis of the fixed exchange rate. Pursuant to Article 28, paragraph 2 of the Law on the BNB, the Bank's monetary obligations include all circulating banknotes and coinage issued by the BNB, and all BNB account balances held by other persons with the Bank except those of the IMF. For further details see The Principles of Operation of the Currency Board in Bulgaria box, Economic Review, 1/2009, p. 18.

[3] The average value of imports of goods and services for the last 12 months and BNB reserves by the end of August 2012 were used in the calculation of this indicator.

Financial Flows and External Position Sustainability

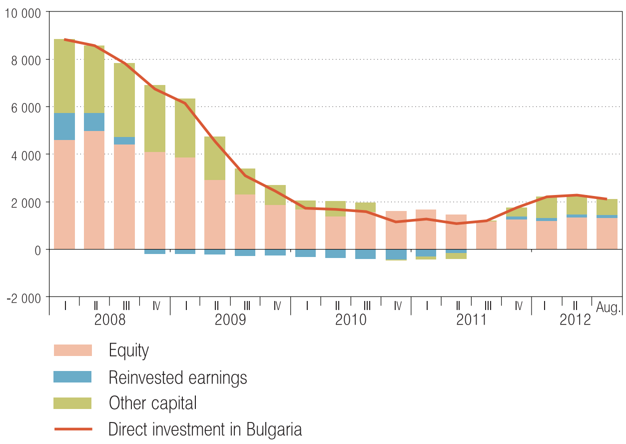
The balance of payments current account balance in the January to August 2012 period was positive at EUR 34.2 million, and the total current and capital account balance also recorded a surplus of EUR 227.0 million.
In the fourth quarter of 2012 and in the first quarter of 2013 the balance of payments current and capital account balance is expected to move within the band of -1 to -0.2 per cent of GDP.

The balance of payments financial account reported a surplus of EUR 1062.7 million for the January–August 2012 period, reflecting mainly the foreign direct investment (FDI) inflow. The high banking system liquidity over the review period contributed to the increase in banks' foreign assets (up by EUR 310.2 million) and to the decrease in their foreign liabilities of EUR 207.9 million.

Bulgaria's external position remained sustainable, with last quarter's trends matching our expectations. Our estimate is based on the structure of capital inflows, mainly in the form of foreign direct investments, on the structure of incurred liabilities, mainly in the form of intercompany loans, and on the gradual decrease in the current account deficit which turned into a surplus in the June–August period.

In the first eight months of 2012 foreign direct investment flow to Bulgaria rose by EUR 356.7 million to EUR 873.1 million.[4] The bulk of this investment was in the form of equity (62.1 per cent) and other capital (intercompany loans) – 30.0 per cent.

FDI in Bulgaria by Type of Investment (on an Annual Basis)
(million EUR)

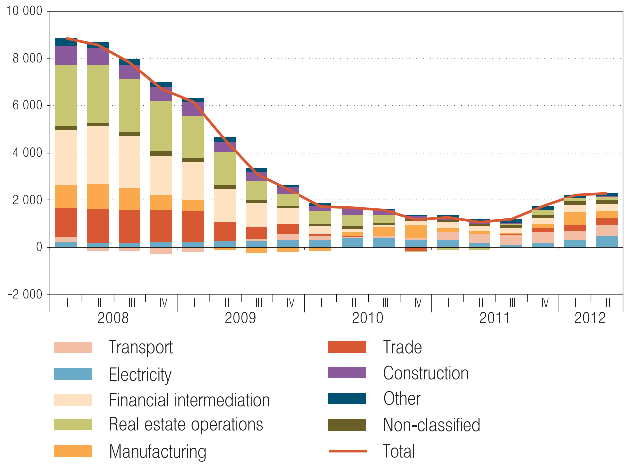


Source: BNB.

[4] Preliminary data subject to revision upon receipt of additional information from direct investment enterprises.

According to preliminary data for the second quarter of 2012, foreign direct investment inflow was directed mainly to the *electricity* and *transport* sectors. In total stock of FDI, *real estate operations, financial intermediation* and *manufacturing* occupied the largest shares.[5]

FDI in Bulgaria by Economic Sector (on an Annual Basis)
(million EUR)



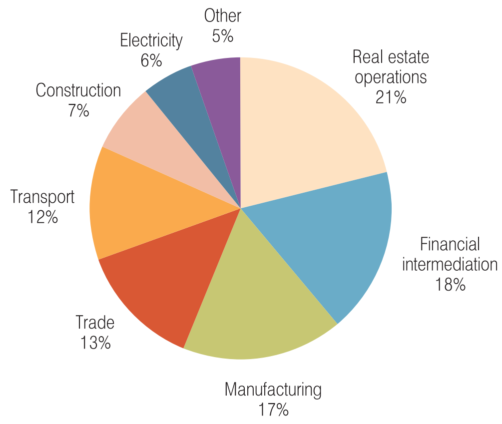
Source: BNB.

By August 2012 net foreign direct investment came to EUR 768.6 million. In the last quarter of 2012 and in early 2013 FDI inflow is expected to decline slightly, still ranging between 4.0 and 5.0 per cent of GDP. Risks to the projection relate to a possible lower foreign direct investment flow to Bulgaria in case of unfavourable debt crisis developments in the euro area and higher instability and uncertainty in international financial markets.

[5] In this section, the headings of the economic sectors should read, as follows: *real estate operations* – real estate operations, lessors activities and business services; *electricity* – production and distribution of electricity, heating, gaseous fuels and water; *transport* – transport, storage and communications; *trade* – trade, repair of motor vehicles and motorcycles, personal belongings and household goods; *healthcare* – healthcare and social activities; *agriculture* – agriculture, forestry and fishery.

Sectoral Structure of FDI Stock in Bulgaria as of June 2012

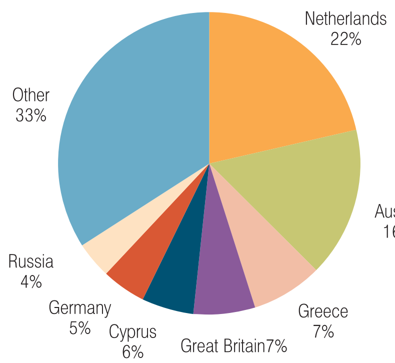
(per cent)



Source: BNB.

Geographic Structure of FDI in Bulgaria as of June 2012

(per cent)

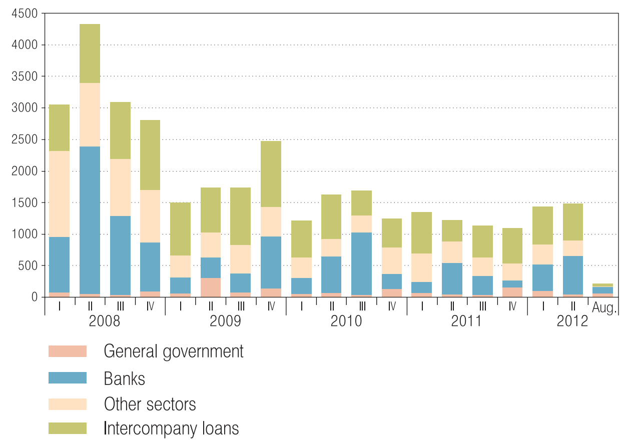


Source: BNB.

Gross external debt rose by EUR 681.5 million in early 2012 to reach EUR 36.5 billion in August, or 94.7 per cent of GDP for the last four quarters. The most sizeable increase was reported in the long-term obligations of the general government sector due to the five-year euro-denominated bonds of EUR 950 million issued in international capital markets. This issue aimed to provide funding for repayment of global bonds maturing in January 2013 which will be reflected in a decrease of general government debt in the following year. Between January and August 2012 net repayment of borrowed funds totalled EUR 4103.7 million (revaluations and changes in trade and revolving loans excluded) compared to EUR 4541.3 million over the same period of 2011. Principal payments were EUR 3696.9 million compared to EUR 4093.3 million in the corresponding period of the prior year. In the first eight months of the year loans and deposits amounted to EUR 4249.0 million (EUR 3404.6 million in the corresponding period of 2011), the bulk of which comprised of intercompany loans (30.5 per cent).

Loans and Deposits Received by Institutional Sector

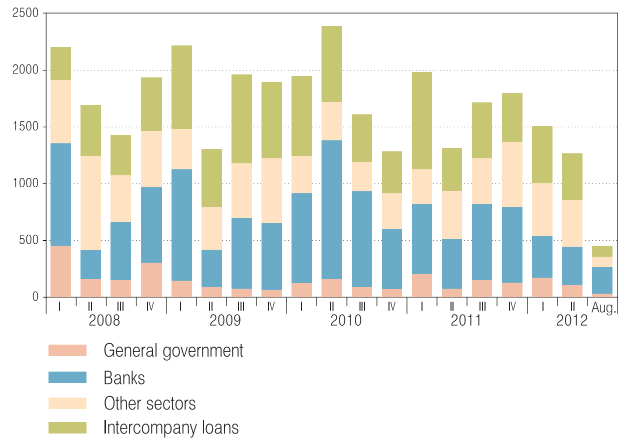
(million EUR)



Source: BNB.

Gross Foreign Debt Service by Institutional Sector

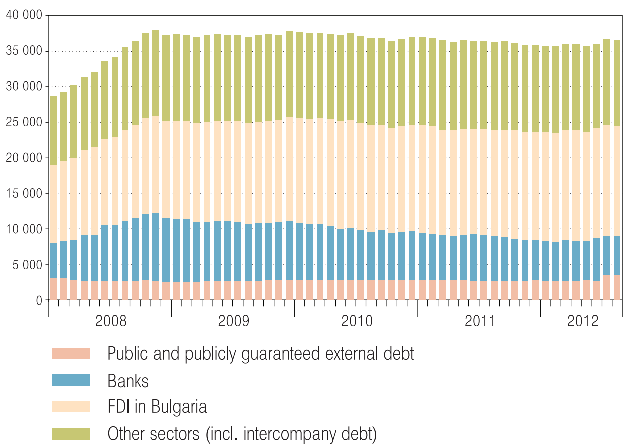
(million EUR)



Source: BNB.

Gross Foreign Debt by Institutional Sector

(million EUR)

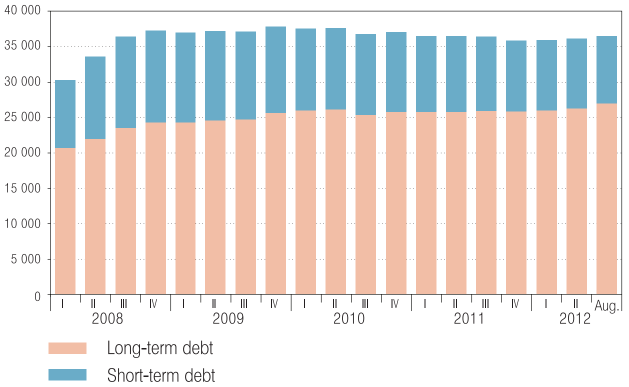


Source: BNB.

In the maturity structure of gross external debt, short-term external debt continued to tend downwards. It decreased by EUR 941.9 million on an annual basis, with its share contracting to 26.0 per cent of gross external debt (28.8 per cent a year earlier).

Long- and Short-term Gross External Debt Dynamics

(million EUR)

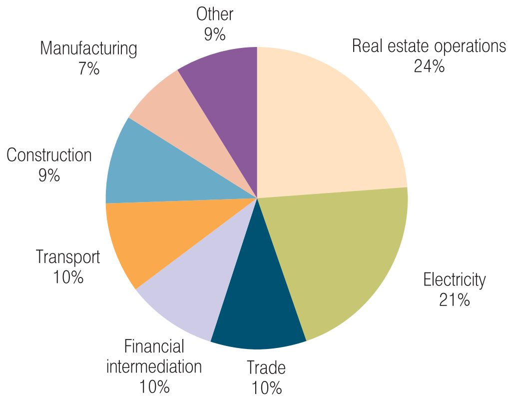


Source: BNB.

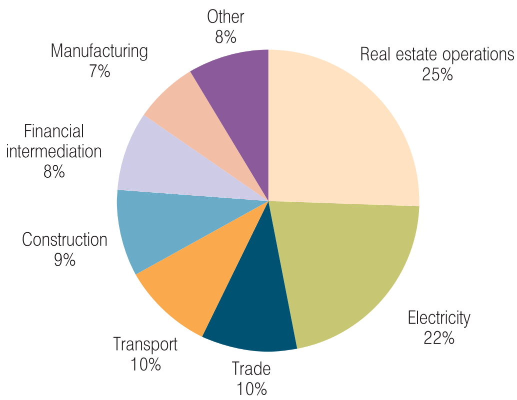
In the currency structure of gross external debt, the euro retained its high relative share which by end-June 2012 reached 88.8 per cent. The euro occupied the largest share in *intercompany loans* (92.2%) and the smallest share in the general government sector (76.7 per cent).

The relatively high bank liquidity made banks less dependent on external financing. According to balance of payments data, banks foreign assets increased by EUR 310.2 million and their foreign liabilities decreased by EUR 207.9 million over the January–August 2012 period. Banks external debt came to EUR 5480.9 million in August: more than two-thirds of it comprised of deposits and short-term loans. Most of the latter two were obligations to foreign parent banks incurred as a result of the funding of their operations in Bulgaria.

Sectoral Structure of the Gross External Debt of Other Sector



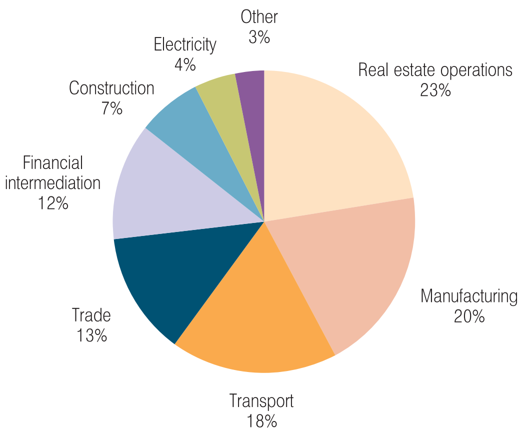
as of December 2011



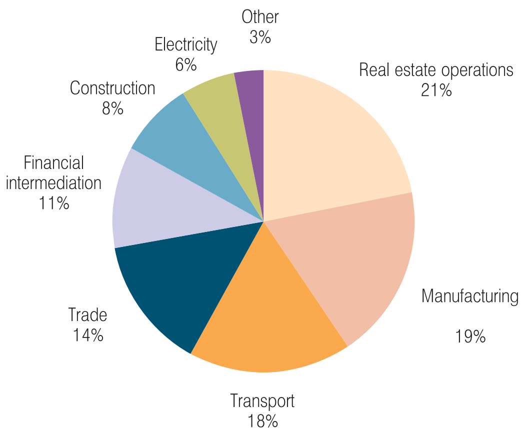
as of June 2012

Source: BNB.

Sectoral Structure of the Gross External Debt by Intercompany Loans



as of December 2011



as of June 2012

Source: BNB.

Gross external debt sectoral decomposition shows an increase in the real estate operations, still having the largest share in the private external debt of other sectors.

Real estate operations and manufacturing still occupied the largest share in the total volume of intercompany loans which are part of the private external debt. Electricity reported the most sizeable increase due to the relatively high foreign direct investment inflow targeting projects related to electricity generation from renewable energy sources.

In the first eight months of 2012 external debt of the general government sector went up EUR 681.5 million. Total public and publicly guaranteed external debt increased by EUR 573.3 million, occupying 13.2 per cent of Bulgaria's gross external debt. Over the same period new loans and deposits disbursed to the general government sector amounted to EUR 1135.4 million: up EUR 1013 million on the previous year, including the 5-year government securities issue in the international capital markets of BGN 950 million.

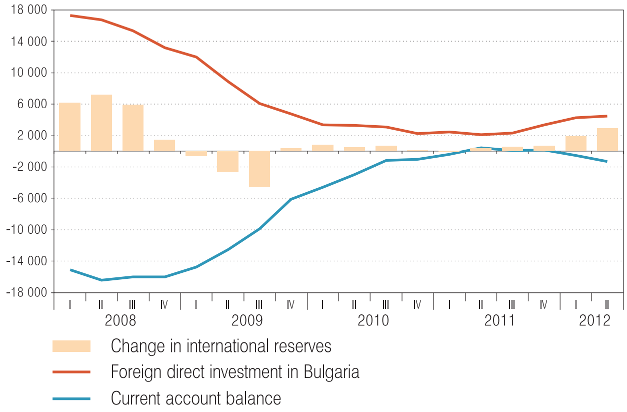
The average weighted interest rates on new loans declared between January and August 2012 suggested a decline (on an annual basis) in the cost of external borrowed funds in euro of 0.3 percentage point on euro-denominated loans and 2.9 percentage points on US dollar denominated loans reaching 3.8 per cent and 0.4 per cent respectively.

Over the same period Bulgaria's gross foreign assets increased by EUR 1997.1 million, with BNB gross international reserves rising by EUR 1700.7 million and local banks' foreign assets growing by EUR 433.6 million. As a result of gross foreign asset and gross external debt dynamics, net external debt decreased by EUR 1392.3 million, reaching EUR 14.8 billion in August 2012.

The surplus on the total current and capital account balance between January and August 2012 fell to EUR 227.0 million compared to EUR 1015.6 million over the same period of 2011. On an annual basis in August 2012 it reported a deficit of EUR 188.3 million.

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

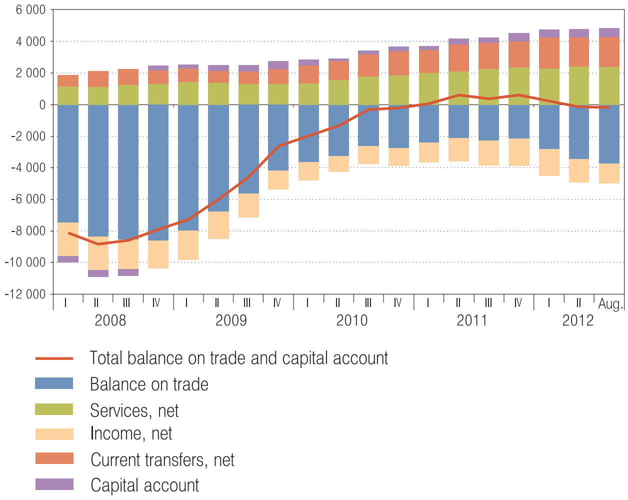
(million BGN)



Source: BNB.

Current and Capital Account Dynamics and Contribution by Component (on an Annual Basis)

(million EUR)



Source: BNB.

Between January–August 2012 the current account balance dynamics continued to be driven by foreign trade developments. The lower current account surplus reflected the higher trade deficit, while the balances of other current account components reported an improvement.

Trade deficit went up EUR 1555.3 million reaching EUR 2563.6 million for the first eight months of 2012. That was underpinned by the lower annual nominal growth of exports (2.3 per cent) and the higher nominal growth of imports (13.0 per cent). The factors behind this dynamics were, on the one hand, related to the contraction in external demand from the euro area and the lower international prices of some major groups of goods exported by Bulgaria. On the other hand, the higher foreign direct investment inflow contributed to a higher imports of investment goods in Bulgaria.[6]

Between January and August 2012 services balance increased, reaching EUR 1914.7 million (EUR 1860.2 million between January and August 2011). Tourist and transport services retained their largest share in exports of services, but the higher balance on services surplus was mainly due to the increase in exports of construction services.

Over the same period the income account deficit went down on an annual basis due to lower income payments by corporations related to foreign direct investment. According to preliminary balance of payments data, the deficit was EUR 759.4 million (EUR 1217.8 million between January and August 2011). Part of this income represents reinvested earnings and was reported in the balance of payments financial account as foreign direct investment.

Between January and August 2012 current transfers accounted for EUR 1442.5 million (EUR 1242.5 million in the corresponding period of the prior year). This was largely due to the increase in government receipts comprising of both EU funds payments and other receipts.

Over the same period the balance of payments capital account reported an increase on the corresponding period of the previous year, reaching EUR 192.8 million (EUR 139 million between January and August 2011). The more sizeable capital transfers from EU funds to the government contributed most to this.

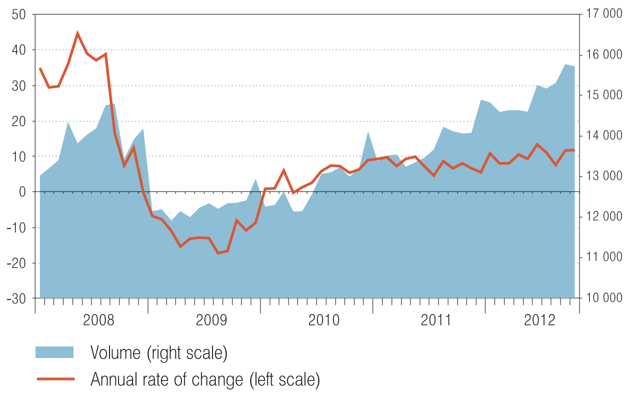
By end-2012 and early 2013 the balance of payments current and capital account deficit is expected to move within the band of -1 to -0.2 per cent of GDP. Risks of a higher-than-expected deficit relate to the intensification of the debt crisis in the euro area which is likely to result in a lower-than-expected exports. On the other hand, the higher degree of EU fund utilisation is likely to increase capital account inflows.

Monetary Aggregates

Deposits of banks with the BNB went up by 17.2 per cent on an annual basis in the third quarter of 2012 due to comparatively large amount of reserves maintained by banks in an environment of high liquidity and a significant amount of attracted deposits of residents, a result of maintained comparatively high household savings rate. Currency in circulation increased by 7.7 per cent as of end-September on an annual basis. Currency in circulation is expected to grow at levels close to current ones and the rates of growth in banks' deposits with the BNB to gradually moderate in the fourth quarter of 2012 and the first quarter of 2013. As regards interest rates on time deposits, the slight downward trend is expected to be sustained over the projection horizon.

By the end of the third quarter of 2012 reserve money went up 11.7 per cent on an annual basis. Banks' deposits with the BNB, reporting an annual increase of 17.2 per cent, contributed most to reserve money growth (7.2 percentage points). The dynamics of banks' deposits with the BNB over the review period reflected the relatively large reserves maintained by banks against the background of excess liquidity in the banking system and a sizeable amount of attracted funds from residents: a result of the maintained high household savings rate.

Reserve Money



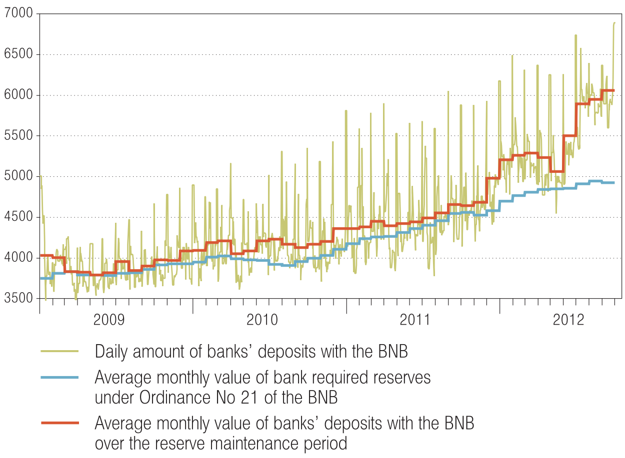
Source: BNB.

[6] For a more detailed analysis of exports and imports of goods see Section 3.

The average daily volume of funds attracted from residents[7] continued to increase at high rates, with their growth reaching BGN 993 million between July and September 2012. (against BGN 744 million in the previous quarter). Over the same period the average daily volume of funds attracted from non-residents decreased by BGN 160 million. Reflecting the developments and structure of attracted funds, the effective implicit rate of minimum required reserves maintained with the BNB was 8.97 per cent[8], with banks' reserves with the BNB coming to 7.82 percentage points, and the remaining 1.16 percentage points were formed by cash and funds on banks' settlement accounts in the TARGET2 national system component[9]. The increase in banks' deposits with the BNB resulted in an excess of the required reserves under Ordinance No 21 of 21.1 per cent compared to an average of 8.6 per cent in the second quarter.

Bank Deposits with the BNB

(million BGN)



Source: BNB.

The upward dynamics of cash in circulation was sustained and by the end of September the annual growth rate was 7.7 per cent. By end-2012 and early 2013 the annual rate of increase in cash in circulation is projected to remain close to its current levels. The projection is based on expectations of low positive GDP growth and a slight decline in deposits' interest rates.

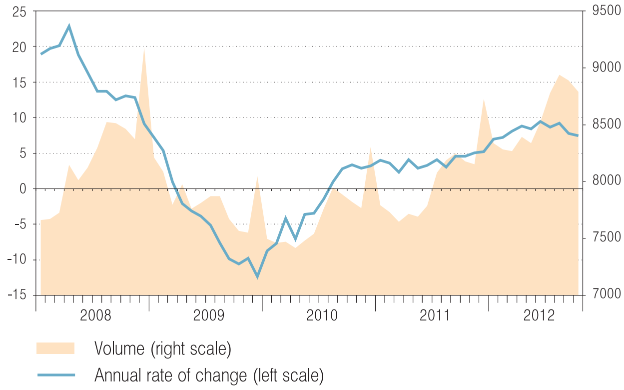
[7] The definition of residents other than state and local government budges under BNB Ordinance No 21 on the Minimum Required Reserves Maintained by Banks with the Bulgarian National Bank is used in the analysis.

[8] According to Article 3, paragraph 1 of BNB Ordinance No 21, the rate of funds attracted from residents is 10 per cent of the deposit base, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

[9] See Article 4 of Ordinance No 21 of the BNB.

Currency in Circulation

(per cent) (million BGN)

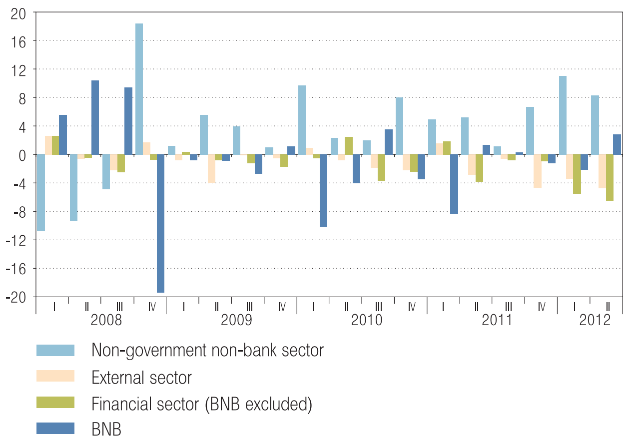


Source: BNB.

As regards banks' deposits with the BNB, a gradual slowdown is expected in the fourth quarter of 2012 and in the first quarter of 2013, reflecting expectations of moderation in the growth rates of resident deposits. The savings rate of the private sector which reflects the expectations of the overall economic performance will affect the risks to the projection. If it increases due to a possible worsening of business expectations, a higher rate of growth in household deposits and hence in bank reserves may be expected.

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

(share of GDP, per cent)



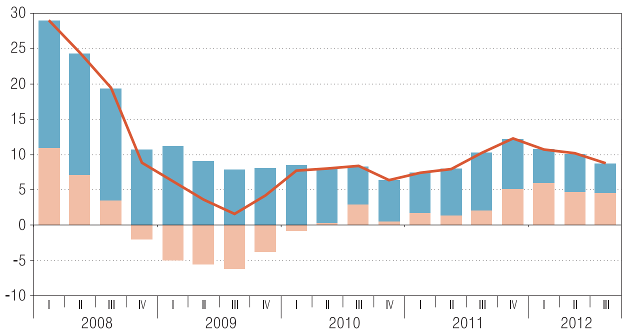
Sources: MF, BNB.

The government's fiscal position affects the allocation of liquidity between economic sectors. The aid of BGN 488 million received by the government, mostly coming from EU funds, resulted in reallocation of liquidity from the external sector to government accounts and budget organisations with the BNB. Net liquidity received by the central bank over the review period came to around 2.8 per cent of GDP largely due to the reported surplus of BGN 753 million. Over the same period the government absorbed liquidity from the financial sector (BNB excluded) by realising a net positive issue of government securities of BGN 67.3 million and due to corporate tax receipts from financial institutions of BGN 57.8 million. At the same time, interest payments on domestic and external loans (including interest on government securities) used by the government to allocate liquidity to the financial and external sector reached BGN 29.2 million and BGN 41.4 million respectively. As a result, the bulk of the free funds was redirected to government and other budgetary organisations' deposit with the BNB which marked an increase of BGN 721.5 million.

In the third quarter of 2012 the government reallocated liquidity to the financial sector as the amount of government securities maturing in August[10] and the interest on domestic debt instruments paid by the government was higher than the amount of the new government bonds issued. The funds from the Bulgarian government securities issued in July in international markets to finance the global bonds maturing in 2013 were invested abroad and have no impact on liquidity in Bulgaria.

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

(per cent; percentage points)



Source: BNB.

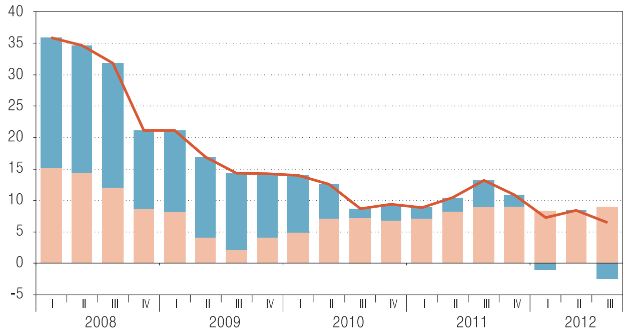
Annual broad money growth moderated slightly to 8.8 per cent in September compared to 10.2 per cent by the end of the second quarter, largely due to lower quasi-money growth. In September M1 growth was 12.6 per cent on an annual basis, with overnight deposits contributing 9.3 percentage points. Overnight deposits increased in all sectors, with those of non-financial and financial corporations contributing most to the overall growth by 5.6 and 5.3 percentage points respectively.

Money outside banks retained the relatively high growth rates from early 2012 and in September reported an increase of 9.0 per cent on an annual basis.

By September quasi-money growth moderated to 6.5 per cent on an annual basis compared to 8.4 per cent by end-June reflecting, on the one hand, the lower increase in household deposits and, on the other hand, the decrease in non-financial corporations deposits.

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

(per cent; percentage points)



Source: BNB.

By the end of the third quarter of 2012 the contribution of lev-denominated deposits to quasi-money growth came to 8.9 percentage points, while that of deposits in foreign currency was negative (2.4 percentage points). The year-on-year dynamics of foreign currency deposits continued to be driven largely by the decrease in deposits from financial corporations. This trend reflected also on the share of lev-denominated deposits in quasi-money which continued to increase steadily to 52.2 per cent by end-September compared with 46.6 per cent a year earlier.

Deposits with agreed maturity of up to two years went up 4.8 per cent on an annual basis, primarily due to household deposits[11] (contributing by 7.8 percentage points) which continued to increase as a result of the high savings rate.

[10] In August EUR 147.9 million (BGN 289.2 million) were repaid on government securities issued in the domestic market in 2010.

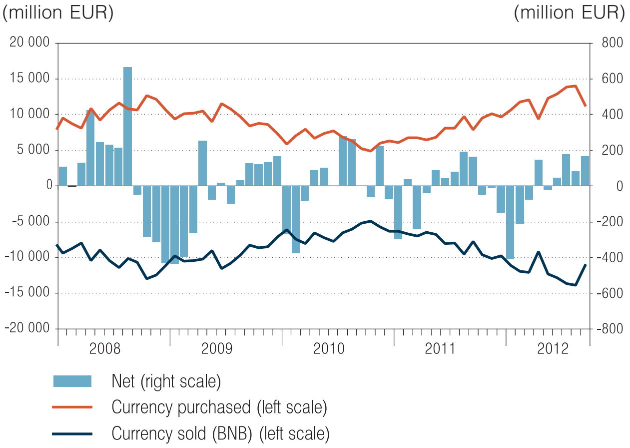
[11] Thus indicated data on deposits and loans of households include also deposits and loans of NPISHs in line with the classification used in monetary and interest rate statistics.

By end-September household deposits in levs increased by 28.1 per cent on an annual basis while those in foreign currencies decreased by 0.6 per cent. Non-financial corporations saw an annual decrease in deposits with agreed maturity of up to two years, with lev-denominated deposits and foreign currency deposits reporting a decline of 6.1 per cent and 9.2 per cent respectively.

In the fourth quarter of 2012 and in the first quarter of 2013 the annual growth of broad money is expected to gradually slow down as a result of moderate income growth amid the persistent high savings rate and reduced deposit interest rates. In the short-term horizon, the introduction of the tax on time deposit interest earnings in early 2013 is not expected to affect household behaviour, since deposits have no alternative in terms of level of risk and security. Over a longer horizon, however, this tax will probably push down household savings rate (unless new banking products not covered by this tax are offered to depositors).

Bank reserve currency (euro) transactions with the BNB served as a major lev liquidity management tool. It is used in performing the main function of the Currency Board, namely to buy and sell on demand national currency against euro.

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



Note: Data refer to all currency transactions of the bank including liquidity management operations related to the transfer of own funds from lev-denominated accounts in BNB to its own accounts with the BNB in euro and *vice versa*.

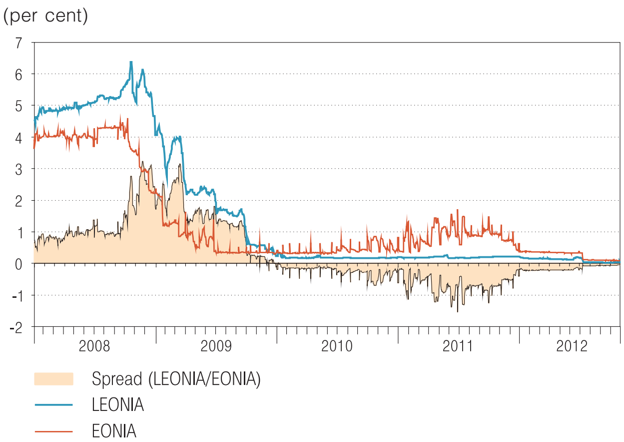
Source: BNB.

In the third quarter of 2012 the average daily volume of euro purchases and sales between the banks and the BNB came to EUR 1216 million against EUR 1129 million in the second quarter. Over the same period banks realised net sales of EUR 427 million (compared to EUR 171 million in the previous quarter).

As a result of the still ample liquidity in the Bulgarian banking system, in the July to September 2012 period interbank money market interest rates decreased compared to the end of the previous quarter. The average interest rate on concluded transactions reached 0.05 per cent in September.

LEONIA decreased to 0.03 per cent in September: down 13 basis points compared to June 2012. The average negative spread between LEONIA and EONIA narrowed further reaching 7 basis points in September compared to a negative spread of 17 basis points in June 2012. This was largely due to the lower euro area interest rates reflecting the decrease in interest rates on the main refinancing operation of the ECB in early July which resulted in a decrease in EONIA.[12] Since early 2012 in both euro area and Bulgaria, interest rates have been characterised by very low volatility. The factors behind this dynamics in Bulgaria relate to the banks' ample liquidity reflecting the increase in non-residents' deposits, weaker demand for loans and high credit standards.

Spread between LEONIA and EONIA (Daily Data)



Source: BNB.

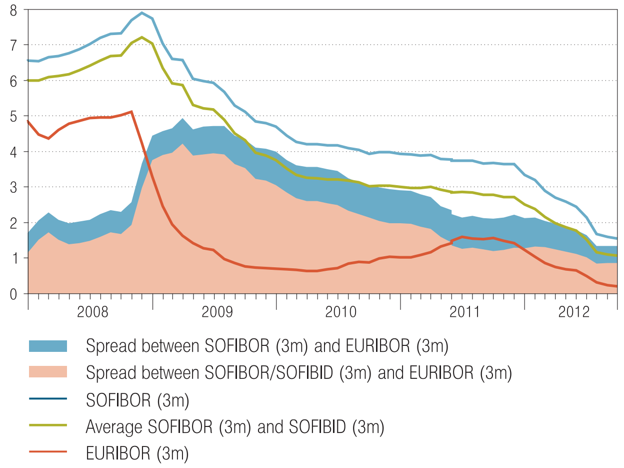
By the end of the third quarter SOFIBOR reference rate (3m)-used as an indicator for short-term interest rates, fell by 85 basis points from its June level to 1.60 per cent. Over the same period, the spread between the three-month SOFIBOR and the three-month EURIBOR fluctuated within a narrow range, coming to 135 basis points by September: down 44 basis points from

[12] See Sub-section Euro Area of Section 1.

its June level. The spread contraction resulted from the more significant decline (by 41 basis points) in SOFIBOR compared with EURIBOR over the same period. The average SOFIBOR/SOFIBID index gives a better picture of the interest rates in Bulgaria. Correspondingly, it is more proper to compare this value with EURIBOR as the closest rate to the actual price at which transactions are concluded.[13] In June the average SOFIBOR/SOFIBID reference rate in the interbank money market in Bulgaria over the three-month horizon declined by 67 basis points compared to June.

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

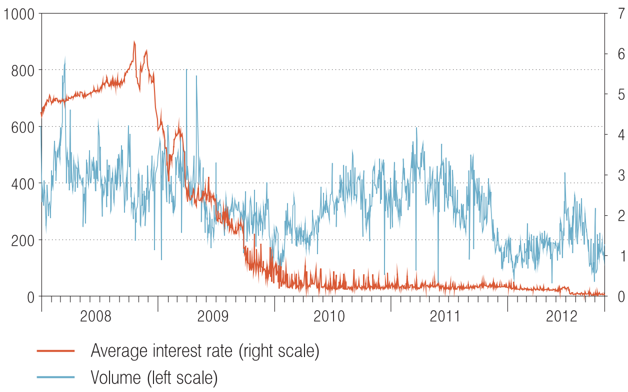
(per cent; percentage points)



Source: BNB.

Trade Volume and Interbank Money Market Interest Rates

(million BGN) (per cent)



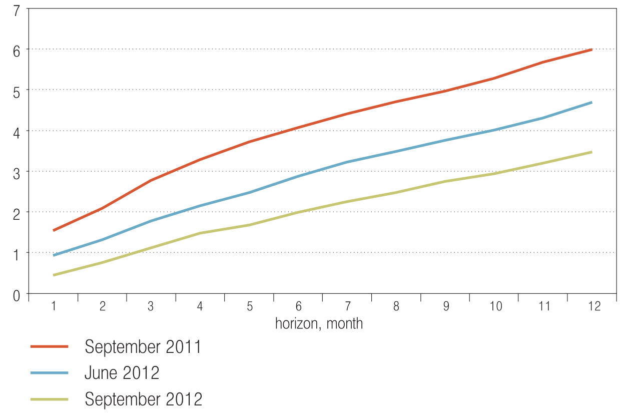
Source: BNB.

Between July and September 2012 the average daily volumes traded in the interbank market amounted to BGN 222 million: an increase of 17.4 per cent on the previous quarter.

Over the same period the downward trend in quotations in all maturity sectors of the interbank market yield curve observed in the previous quarter remained sustained. In September a year-on-year 252 basis point decline was reported in the 12-month horizon along with a 110 basis point decrease in the one-month horizon.

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

(per cent)

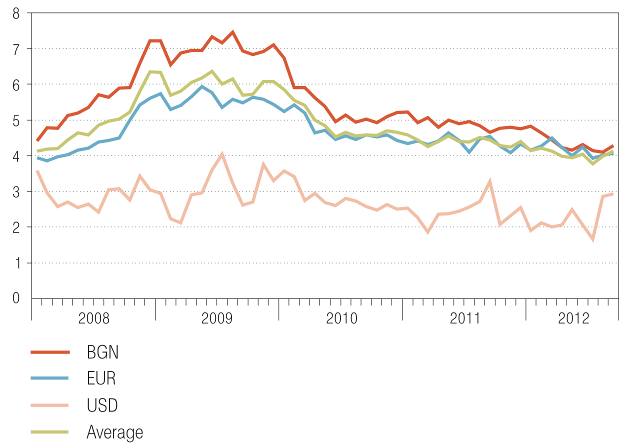


Source: BNB.

In the third quarter of 2012 the average weighted interest rate on new[14] time deposits fell by 5 basis points on the previous quarter to 3.94 per cent.

Interest Rates on New Time Deposits in Relevant Currencies

(per cent)



Note: The average interest rate is calculated using the interest rates in all sectors, maturities and currencies weighted at their respective new deposit volumes.

Source: BNB (interest rate statistics: interest rates and volumes of new business on time deposits of the non-financial corporation and household sectors).

[13] 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 p. 27.

[14] The terms 'newly agreed', 'new loans and deposits' and 'new' refer to the *new business* statistical category.

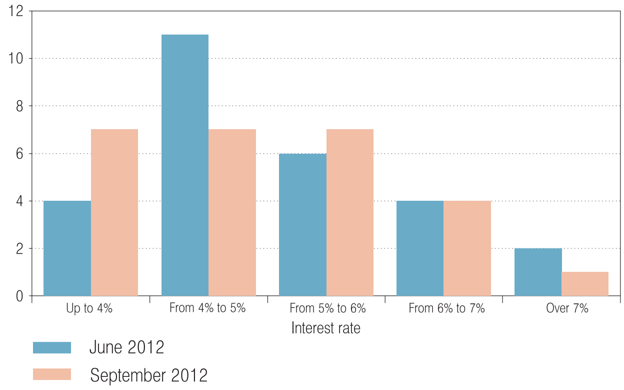
The average weighted interest rates on lev-denominated deposits for the review quarter declined by 6 basis points to 4.17 per cent and those on euro-denominated deposits by 15 basis points to 4.00 per cent respectively. Interest rate levels in USD deposits rose by 3 basis points to 2.22 per cent. In September the average weighted deposit rate reported a decline of 32 basis points on an annual basis. Downward trends in deposit interest rates were associated with the ample liquidity in the banking system and relatively low demand for bank loans.

In September the breakdown of interest rates on household time lev deposits by banks showed that the number of banks offering rates within the up to four per cent and in the five and six per cent band increased and those offering rates within the four to five per cent and over seven per cent bands decreased. The average interest rate level in September decreased by 2 basis points on June coming to 4.93 per cent and the dispersion coefficient fell by 18 basis points to 1.62 percentage points.

The trend to a slight decline in interest rates on time deposits is expected to persist in the fourth quarter of 2012 and the first quarter of 2013. These expectations are underpinned by the increase in private sector deposits and high liquidity in the banking system[15] in the context of low demand for loans.

Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



Source: BNB.

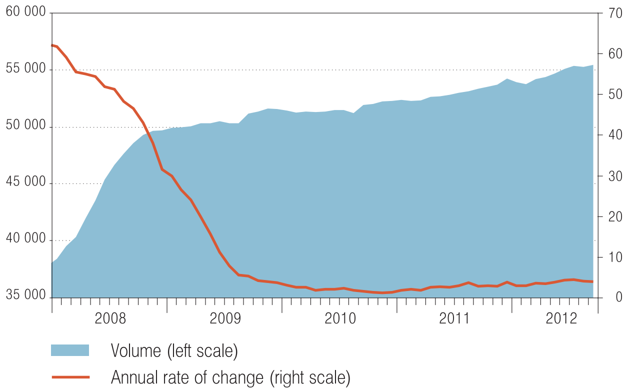
Credit Aggregates

The investment activity of corporations in the second quarter had a positive effect on lending growth, but given the worsened expectations for business performance and lower demand for loans, the dynamics of lending started to slow down in the third quarter. Concurrently, banks' claims on households continued to be driven by the households' uncertainty about their future income, reflecting the persistent unfavourable situation in the labour market.
Based on current developments growth in the following two quarters may be expected mostly in corporate loans, while loans to households are anticipated to continue decreasing at rates similar to the currently observed ones. In the fourth quarter of 2012 and the first quarter of 2013 lending rates are expected to slowly decrease consistent with the projected decline in deposit rates.

Between July and September 2012 claims on non-financial corporations rose by BGN 341.0 million reporting an increase of BGN 535.1 million during the same period of the previous year and by September 2012 the annual rate of growth reached 3.9 per cent. The third quarter saw a more moderate dynamics following the acceleration to 4.3 per cent in the second quarter.

Claims on Non-government Sector

(million BGN) (per cent)



Source: BNB (monetary statistics: monetary survey).

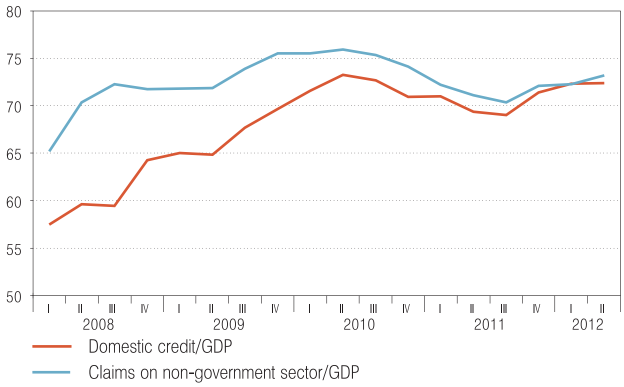
[15] The liquid assets to liabilities ratio retained its high levels reaching 26.11 per cent in September.

According to the summary of the results of the BNB quarterly bank lending survey, in the third quarter of 2012 the demand for corporate loans fell slightly after the sizeable increase in the previous quarter reflecting mainly the higher demand for investment loans. Households reported a continuous decrease in the demand for housing loans and an increase in the demand for consumer loans, although less pronounced compared to the previous quarter. Corporations' demand for short-term loans to cover their needs for working capital fell slightly less compared to the demand for long-term loans needed for investments. Over the review period banks applied tighter credit standards to corporations compared with the previous quarter. Banks reported a slight tightening of credit standards for consumer loans for households and further easing for housing loans. As key factors for the tightening of credit standards credit institutions outlined: collateral risk, the business climate in the sectors occupying large shares in banks' credit portfolios, macroeconomic environment, and credit risk. Banks share optimistic views for higher demand for loans reported by corporations and to a lesser extent by households. Expectations of credit standards over the fourth quarter of 2012 show further easing in lending to households and, to a lesser extent, in that to corporations.

In the second quarter of 2012 the claims on the non-government sector to GDP ratio increased to 73.2 per cent[16]: up 1.0 percentage point *vis-a-vis* the previous quarter, reflecting mostly the higher growth in claims than that in nominal GDP.

Domestic Credit

(share of GDP, per cent)



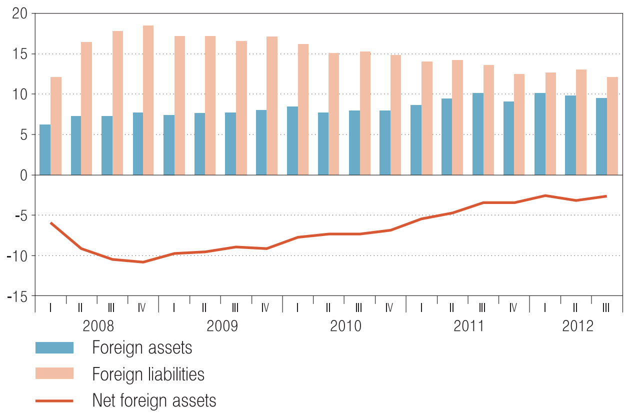
Source: BNB.

[16] The ratio is calculated using the annual GDP.

Over the third quarter bank liquidity remained high largely reflecting the continued inflow of funds attracted from residents (up BGN 1225.1 million).[17] Banks used the attracted resources to increase the volume of new loans and further reduce their net foreign liabilities. Over the review period banks' foreign liabilities decreased by BGN 892.4 million and their foreign assets went down by BGN 323.6 million. As a result, banks' net foreign liabilities decreased by BGN 568.8 million. The current trends are expected to remain sustained in the fourth quarter of 2012 and in the first quarter of 2013 and banks are likely to further reduce their foreign liabilities. Despite the expected moderation in the growth rate of residents' deposit base, its growth is projected to provide enough resources to banks for increasing the volume of domestic credit.

Foreign Assets and Liabilities of Banks

(billion BGN)



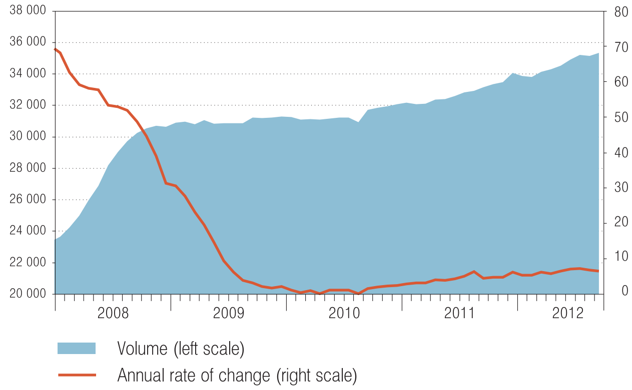
Source: BNB.

The annual growth of claims on non-financial corporations moderated before increasing 6.6 per cent by end-September (7.1 per cent by end-June). Corporations investment activity in the second quarter had a positive effect on lending growth, but worsened expectations of business situation contributed to the slowdown in lending dynamics over the third quarter, reflecting the lower demand for loans. In the third quarter claims on non-financial corporations rose by BGN 420.1 million (up BGN 553.5 million in the same period of 2011).

[17] See Sub-section Monetary Aggregates of Section 2.

Claims on Non-financial Corporations

(million BGN) (per cent)

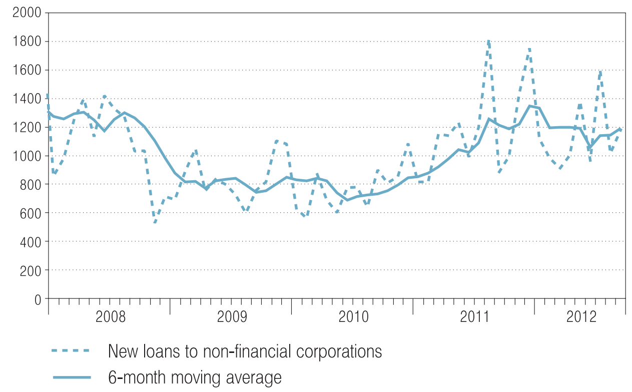


Source: BNB.

Over the review period new loans to non-financial corporations totalled BGN 3797.8 million (BGN 3901.5 million in the same period of 2011).[18] The high month-to-month volatility in the volumes of new loans to corporations remained sustained. Nevertheless, the six-month moving average pointed at a stabilisation around the levels before the global financial and economic crisis regardless of the tighter bank credit standards.

New Loans to Non-financial Corporations (Monthly Volumes)

(million BGN)

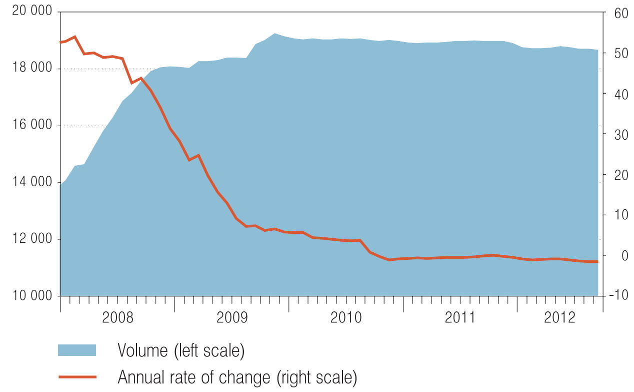


Source: BNB (interest rate statistics: interest rates and volumes of new business: breakdown of loans to the non-financial corporation and household sectors by original maturity).

[18] Part of these volumes are renegotiated loans which signals that the banking system has reacted adequately to the difficulties experienced by corporations and households.

Claims on Households

(million BGN) (per cent)



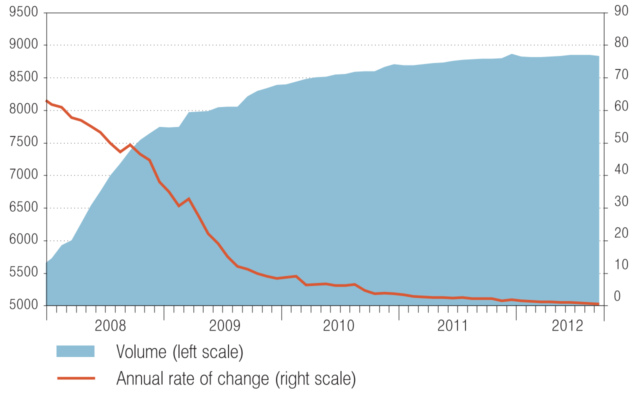
Source: BNB (interest rate statistics: interest rates and volumes of new business: breakdown of loans to the non-financial corporation and household sectors by original maturity).

Bank claims on households retained their downward trend and their total volume contracted to 1.6 per cent on an annual basis by end-September. Households remained cautious to new liabilities and preferred to save. A key factor behind this was the uncertainty about their future income, reflecting the persistent unfavourable situation in the labour market.

Between July and September 2012 claims on households decreased by BGN 75.1 million against an increase of BGN 5.1 million in the corresponding period of 2011. Housing loans and other loans increased by 0.5 per cent and 5.1 per cent respectively on an annual basis while overdrafts and consumer loans decreased by 7.4 per cent and 3.3 per cent respectively.

Housing Loans

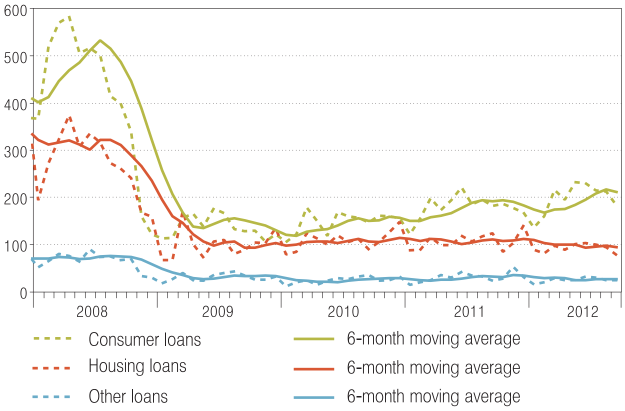
(million BGN) (per cent)



Source: BNB (monetary statistics: loans to non-financial corporations, households and NPISHs).

New Loans to Households (Monthly Volumes)

(million BGN)



Source: BNB (interest rate statistics: interest rates and volumes of new business: breakdown of loans to the non-financial corporation and household sectors by original maturity).

The statistics of new loans[19] still reports higher agreed volumes of consumer loans compared to housing loans. In the third quarter of 2012 new consumer loans came to BGN 609.9 million: up 8.6 per cent on the corresponding period of the previous year. New housing loans came to BGN 272.4 million (down 21.5 per cent on an annual basis). Over the review period new loans to households totalled BGN 961.4 million.

All in all, credit growth is expected to moderate as a result of worsened external environment and due to a base effect in the third quarter of 2011 when loan volume was changed due to some one-off factors.[20] Based on current developments, by the end of the year and in the first quarter of 2013 growth may be expected mostly in corporate loans, while loans to households are anticipated to continue decreasing at current rates.

In the third quarter interest rates on new housing loans and other loans reported a decline while those on new consumer loans increased. Thus, the average interest rate on loans to households[21] over the same period remained unchanged compared to the previous quarter at 9.9 per cent.

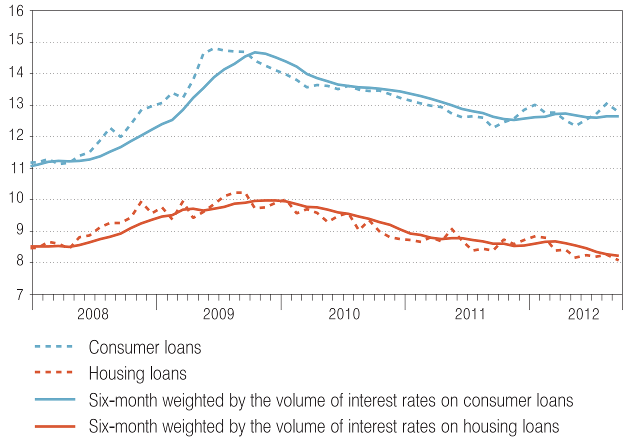
[19] See footnote 18 in this section.

[20] For more details, see also *Economic Review*, 2011, issue 4.

[21] The average interest rate is calculated using the interest rates on loans by category, maturities and currencies weighted by the relevant new loan volumes for the quarter.

Annual Percentage Rate of Charges on New Household Loans (Average Weighted by Currency)

(per cent)



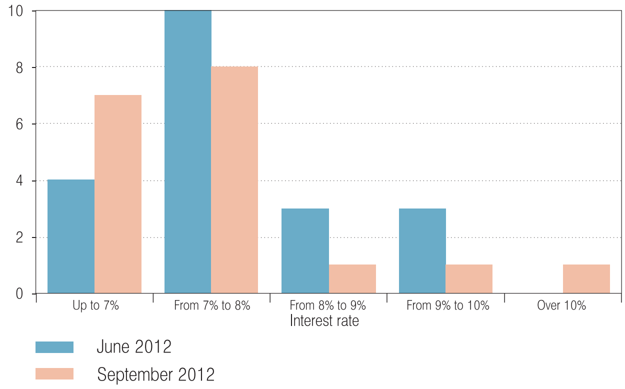
Source: BNB (interest rate statistics: annual percentage rate of charges on new business: breakdown of loans to the household sector by original maturity).

Over the third quarter of 2012 the average annual percentage rate of charges (APRC)[22] on new consumer loans amounted to 12.86 per cent (against 12.46 per cent in the second quarter) and the average interest rate on these loans went up by 22 basis points on the previous quarter reaching 11.10 per cent.

The average annual percentage rate of charges on new housing loans fell to 8.19 per cent in the third quarter of 2012. Over the same period the average interest rate on housing loans went down 18 basis points reaching 7.40 per cent.

Distribution of Interest Rates on New Housing Loans in Euro

(frequency – number of banks)



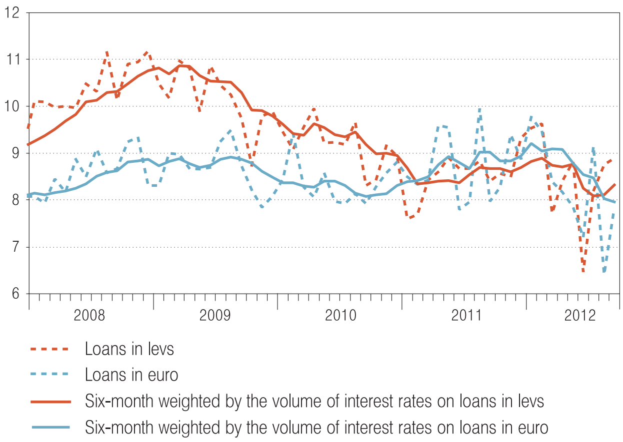
Source: BNB.

[22] The average 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).

As regards the distribution of interest rates on housing loans in euro by bank, in September the number of banks offering rates within the 7 to 8 per cent, 8 to 9 per cent and 9 to 10 per cent band increased at the expense of those offering rates in the up to 7 per cent and over 10 per cent. Over the same period, the average interest rate level declined by 16 basis points and the dispersion ratio rose by 13 basis points to 1.11.

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

(per cent)



Sources: BNB (interest rate statistics: interest rates and volumes of new business on loans to non-financial corporation and household sectors by original maturity).

Over the review quarter the average interest rate on new bank loans to non-financial corporations increased by 45 basis points to 8.35 per cent. All three currencies – lev, euro, and US dollar – reported an increase of 64, 35 and 69 basis points respectively. The increase was rather the result of specific transactions made over the period, while the long-term downward trend (on the basis of volumes and interest rates over the last 6 months) was sustained.

Over the last quarter of 2012 and in the first quarter of 2013 the moderation in lending rates is expected to continue at a slow pace. Our expectations are based on the foreseen further decline in deposit interest rates. We view the risks to this outlook as balanced. On the one hand, both the ample liquidity provided by the ECB to euro area banks and the decrease in ECB interest rates with effect from 11 July 2012 will continue to contribute to this end. The lower risk premium of Bulgaria observed in September and October will probably have a favourable effect. On the other hand, a possible intensification of the debt crisis may bring about further instability and uncertainty on international financial markets and the effect thereof on Bulgaria's risk premium may push interest rates upwards.

Structural Changes in Bulgaria's Banking System Balance Sheet in the Period of the Global Financial and Economic Crisis

Credit cycles both in global economy and individual countries relate to economic cycle phases. Usually, during the boom phase lending activity accelerates, economic agents' indebtedness increases and banks' balance sheets expand. In the phase of a downturn in economic activity an opposite process is observed: low lending activity, a decrease in economic agents' indebtedness and downsizing of banks' balance sheets.

A specific feature of the financial crisis which outbroke at the close of 2008 was that it started in mid-2007 as a local US sub-prime mortgage crisis and following the Lehman Brothers bankruptcy, it quickly spread over financial markets in most advanced countries, causing a significant decline in the prices of securities in banks' portfolios and exerting pressure on their capital. The impact of this process depended on the specificity of individual banking systems. The write-down of assets, which lost their value, forced banks with high leverage ratios[1] and large exposures in instruments with high market and credit risk to raise their capital. The subsequent capital increase along with the continued balance sheet reductions resulted in a decrease of the banking system *asset-to-equity* ratio (*i.e.* deleveraging) and strengthened the banks' capacity to assume risk. The negative effects associated with deleveraging deepened for euro area banks in 2010, reflecting the impact of sovereign debt crisis, which caused additional capital and liquidity difficulties for a number of banks.[2] The weakened ability of banks to increase attracted funds and to raise additional equity was accompanied in some cases by forced liquidation of assets which further decreased the price of their assets. The shortage of capital buffers in some EU banks challenged the stability of their capital positions.[3] Thus, the capital pressure and the financing difficulties had an influence over the processes of reduction and restructuring of banks' balance sheets.

The unprecedented measures for strengthening liquidity of the banking systems initiated by the US Federal Reserve System, the ECB, the Bank of England and other central banks were intended to avoid the negative effects from deleveraging on banks' financial stability, on providing loans to the non-financial sector and on the economic activity in general. On the other hand, the deleveraging by euro area banks posed a potential risk for the stability of the banking systems in Central and Eastern Europe.

Against the background of negative processes in the banking systems of the USA and the euro area as a result of the global financial and economic crisis, Bulgaria's banking sector remains stable and continues to contribute to maintaining the total macroeconomic stability in the country. In contrast to other EU Member State banks, the Bulgarian banking system has not received any government aid in the form of a liquidity or capital financial support and preserves its assets growth by keeping a stable asset-to-equity ratio. The banking system assets continue to increase, a managed restructuring of liabilities is underway reflecting a continuous increase in attracted funds from local sources (including from individuals and households) and a decrease in the share of non-residents' funds; interest rates are gradually decreasing. The *asset to equity* ratio is stable and low compared with the banking systems in other EU Member States.[4]

The significant buffers built by the Bulgarian banking system in the years of economic upswing and the low leverage helped it to face the global crisis. The BNB conservative and anti-cyclical policy played an important role for this. The banking system has a limited exposure to instruments implying market risk, maintains a stable capital position and a high share of liquid assets. Reacting to the unfavourable economic situation in the last several years, banks in Bulgaria tend to be flexible and effective in order to preserve their capital and liquidity buffers. The financial stability indicators of the Bulgarian banking system significantly exceed the regulatory minimum values for Bulgaria and those currently effective in the euro area. As of September 2012 total capital adequacy of the banking system was 16.6 per cent, tier one capital adequacy ratio came to 15.12 per cent and the liquid assets ratio 26.11 per cent.[5]

---

[1] One way of measuring the leverage is through the banking system *asset to equity* ratio. In case of a high leverage ratio any volatility in the value of assets has a negative effect on equity. Shareholders benefit from higher leverage, but during a financial crisis there is a risk for the stability of banks and the entire banking system. The negative consequences associated with assets revaluation lead to serious turbulences and loss of equity value.

[2] Financial deleveraging and the international transmission of shocks, Devereux M. and James Yetman, BIS Papers No 52, July 2010, p. 274.

[3] Special Features: EU Bank Deleveraging – Driving Forces and Strategies, ECB Financial Stability Review, June 2012, p. 105–115.

[4] Monitoring the dynamics of this ratio, the BNB applies a maximum conservative approach, that is, the ratio between balance sheet assets and equity is calculated. In many cases (in EU banking systems as well) the leverage ratio is computed using the risk-weighted component of assets which technically improves the ratio.

[5] See BNB Annual and Semi-annual Reports for 2008–2011.

Unlike developed countries' banking systems, dominated by investment credit institutions, Bulgarian banks focus on traditional lending to economy (64.9 per cent of total banking system assets)[6] and investments in securities other than shares (7.9 per cent, the bulk of which in Bulgarian government securities). Deposits and cash occupied a relatively large share of 19.0 per cent as of September 2012, indicating high banking system liquidity. This business model significantly limits the unfavourable effects of the global financial crisis. As a result, unlike US and euro area banks' balance sheets, the balance sheets of banks in Bulgaria underwent no capital and market pressures due to asset price declines.

The comparison between assets dynamics in the Bulgarian banking system and in the banking systems of other EU Member States shows a sustainable upward trend in assets growth in Bulgaria, while the share of the countries within the EU with increasing assets (diffusion index) significantly decreased in some periods (for example 2009 and 2010–2011).

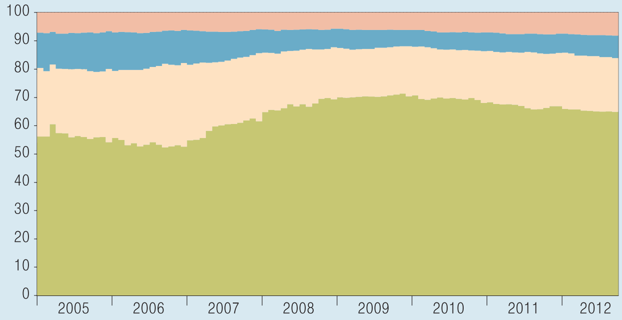
The global financial and economic crisis had an indirect effect on the Bulgarian banking system through the negative impact of the worsened external conditions on the Bulgarian economy and business cycle, as reflected in the growth of non-performing loans in bank portfolios. Compared with the fluctuations in the value of securitised bank assets in developed countries, especially after the bankruptcy of Lehman Brothers, there is a gradual increase in non-performing loans in Bulgaria, showing no self-sustaining dynamics. An important feature of the Bulgarian banking system and supervisory regulations is the ongoing provisioning of non-performing loans and allocation of specific provisions to cover credit risk. Thus, a high coverage ratio and consistently maintained capital buffers are achieved without putting pressure on the capital at the system level.

Bulgaria is among the few EU countries which have not so far reported declines in bank lending despite the changes in lending dynamics by economic sector that have taken place since the beginning of the global financial and economic crisis. After 2008 households have been cautious to take on new loans and have preferred to save and repay their existing loans. Hence, banking system claims on households began to decrease. The growth rate of loans to the non-financial corporate sector slowed down as a result of the unfavourable economic situation and uncertain external economic environment. Corporations offered less high-quality financing projects which along with higher credit standards of banks contributed to the moderation in the growth of loans to non-financial corporations. In September 2012 claims on the private sector increased by 3.9 per cent on an annual basis, with claims on non-financial corporations rising by 6.6 per cent and claims on households falling by 1.6 per cent.[7]

As in the pre-crisis period, resident deposits remain the main source of financing for Bulgaria's banking sector (76 per cent in the fourth quarter of 2007 and 83 per cent in the third quarter of 2012). Their high share determines the stability and sustainability of financial resources attracted by the banking system in Bulgaria, unlike other EU banking systems where the structure of attracted funds is dominated by short-term financing sources

Structure of Assets of the Bulgarian Banking System

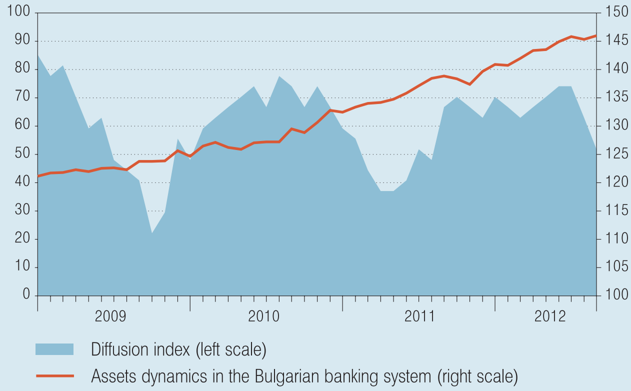
(per cent)



Source: BNB.

Assets Dynamics in the Bulgarian Banking System *vis-à-vis* Banking Systems of Other EU Member States, and Diffusion Index

(per cent) (January 2008 = 100)



Note: The diffusion index measures the share of the EU countries with increasing assets *vis-à-vis* all countries.

Sources: ECB, BNB calculations.

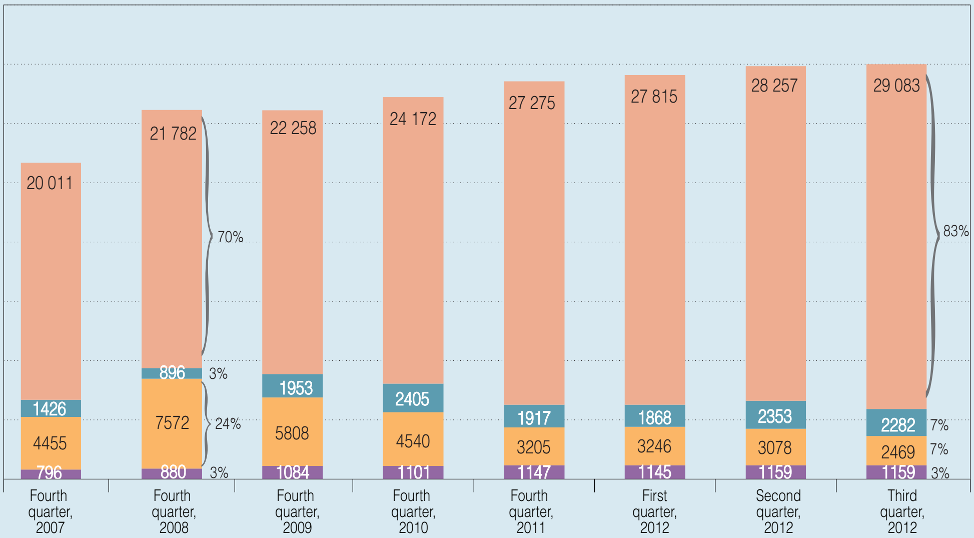
[6] BNB data as of September 2012.

[7] For more information on these indicators' dynamics, see Chapter 2 of this issue.

characterised by higher volatility (*e.g.* interbank money market financing). Bulgarian banking system obligations to parent banks have a small share in total liabilities. This share remained comparatively low even in 2007 and 2008 when an increase was observed in financial resources provided by parent banks to their subsidiary banks and their branches in Bulgaria, intended to boost their market share in the region where banking profits were significant.

Structure of Attracted Funds of the Bulgarian Banking System

(EUR billion)



Source: BNB.

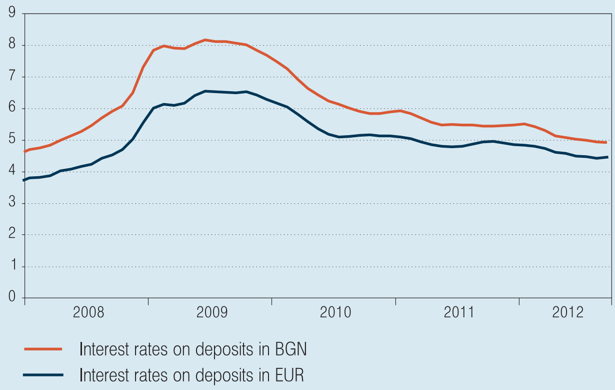
In the context of the global financial crisis, domestic banks began to restructure their liabilities in order to counteract the potential negative effects on financing. As early as the end of 2008 banks increased their interest rates on new deposits, maintaining them at these levels until end-2009. The growth rate of household and corporate deposits has started to accelerate since the middle of 2009 as a result of several factors: the increased interest rates, the higher household savings rate and confidence in the banking system. Overall, between the end of 2008 and September 2012 resident deposits rose by BGN 13.8 billion, of which BGN 11.3 billion household and NPISH deposits. The liquid assets ratio of the banking system increased from 20.7 per cent in the first quarter of 2009 to 26.1 per cent in 2012. Growth in domestic resources entirely covered financial needs of the Bulgarian economy, with part of excess liquidity used by bank groups to reduce exposures to parent banks.

The anti-cyclical BNB policy also contributed to the stability and high liquidity of the banking system. To curb possible negative effects of the global financial and economic crisis on the banking system, in the last quarter of 2008 the BNB took measures to facilitate banks' liquidity management using liquidity buffers created in previous years. Bank minimum reserve requirements were changed, their rate and coverage being reduced. This gave a considerable amount of liquid resources to the banking system.[8]

Liquid resource inflow allowed banks to start repaying their foreign obligations. The restructuring of liabilities, reflecting an increase in resident deposits and a decline in obligations to parent banks, also continued after the reduction of deposit interest rates since the end of 2009. The downward trend in banks' funding costs indicates lack of external pressure for restructuring bank liabilities. The reduced liabilities to parent banks resulted from decisions taken by subsidiaries, rather than from withdrawal of funding by parent

Interest Rates on New Time Deposits

(per cent)



Note: Interest rates on deposits in BGN and EUR, weighted on a quarterly basis by relevant volumes.

Source: BNB.

[8] For further details see Economic Review, 4/2008, p. 26, and BNB Annual Reports, 2008 and 2009.

banks. Bank policy intended to decrease dependence on external financing, maintaining high levels of liquidity, is continuing without deleveraging.

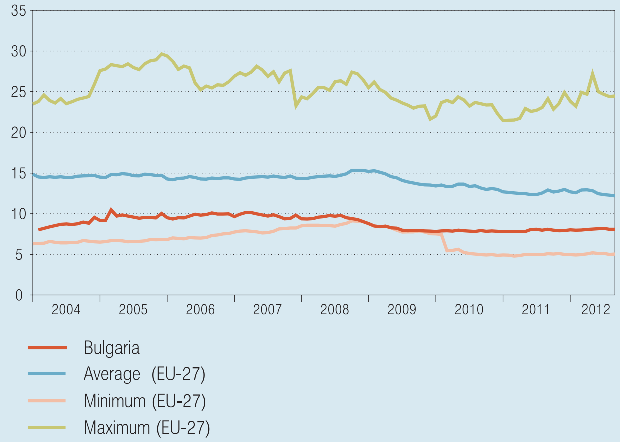
The low leverage is another important characteristic of Bulgaria's banking system. Even in the years of fast lending growth and enhanced financial intermediation before the global financial crisis outset, the *asset-to-equity* ratio did not exceed 10, which makes Bulgaria one of those 25 per cent of the Member States with the lowest banking system leverage. Most banking systems report leverage close to and significantly above 15. As noted above, highly-leveraged banking systems were put under a serious pressure to raise capital.

The analysis of the trends in assets, liabilities and interest rates in Bulgaria confirms the fact that deleveraging that characterised the banking systems of developed countries did not show up in the Bulgarian banking system. In the first year of the crisis, the *asset to equity* ratio slightly declined by approximately 2 percentage points which was due to the increase in capital from reinvesting bank profits amid the sustained level of bank assets.

Since mid-2009 the *asset to equity* ratio has stabilised within the narrow range of 7.3 to 7.6. These developments reflect the sound and sustainable growth of banking system deposits and equity. Bank policy directed at boosting assets in line with capital and resident deposits growth shows a new business model, which limits the negative effect of the unfavourable external environment and guarantees the banking system stability by maintaining moderate lending growth rates.

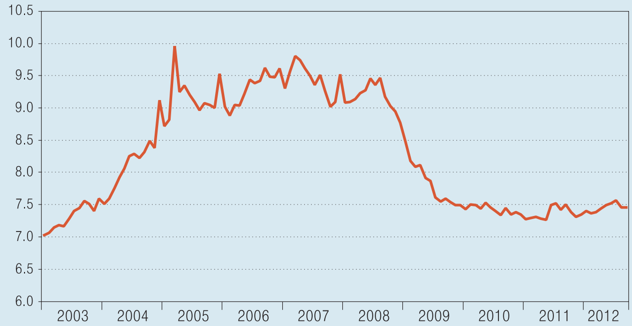
In summary, a conclusion may be drawn that the process of bank deleveraging that is underway in developed countries is not taking place in the Bulgarian banking system. The decrease in the external indebtedness of the banking sector as reflected in the decline of banks' net foreign liabilities shows the ability of Bulgarian banks to decrease their exposure to foreign parent banks in the context of ample liquidity and growth in funds attracted from residents, preserving the main source of sound and sustainable financing – local deposits. This process has been developing gradually, without deleveraging and additional bank expenses, thereby leading to strengthening of banks' balance sheets. In the long run, this process will have a positive effect by reducing the impact of unfavourable external shocks on the Bulgarian banking system. Concurrently, bank liabilities restructuring does not put pressure on Bulgaria's economy which is clearly expressed in the downward trend in deposit and lending interest rates and in growth of loans to non-financial corporations.

Asset to Equity Ratio of the Bulgarian Banking System *vis-à-vis* EU-27 Banking Systems



Source: BNB.

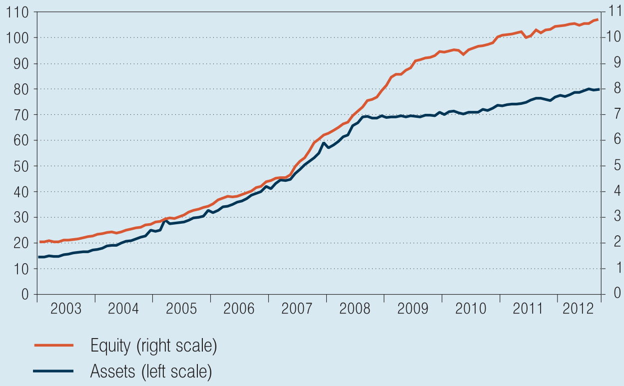
Asset to Equity Ratio of the Bulgarian Banking System



Source: BNB.

Assets and Equity of the Bulgarian Banking System

(BGN billion)



Source: BNB.

3. Economic Activity

In the second quarter of 2012 the real GDP grew by 0.3 per cent on the background of a slight increase in domestic demand and under the conditions of enhanced uncertainty of international environment. Economic activity is expected to remain weak until the end of 2012, while GDP growth may slightly accelerate in the beginning of 2013 provided euro area debt crisis does not further intensify, which will affect domestic demand through the propensity of households to spend and corporations to invest. Household consumption is projected to continue increasing in the second half of the year and in early 2013 though at a lower rate compared with that in the first half of 2012.

Real GDP rose by 0.3 per cent on a quarterly basis[1] in the second quarter of 2012, following a zero increase in the first quarter.[2] Growth in the first half totalled 0.5 per cent on an annual basis based on seasonally adjusted data, with domestic demand contributing mostly to it.

The contribution of net exports remained negative in the first half of 2012. In the first quarter of the year exports of goods and services went down by 2.9 per cent in real terms due to lower euro area foreign trade turnover, while the second quarter saw an increase by 3.4 per cent, with exports to third countries contributing most to this growth[3]. Overall exports rose by 1.9 per cent on an annual basis in the first half of 2012 according to seasonally adjusted data. Increased domestic demand had a positive effect on imports of goods and services and their real growth rate reached 4.3 per cent in the same period. Investment goods followed by raw materials contributed most sizeably to this growth.

Household consumption continued to increase in the second quarter at a quarter-on-quarter growth rate of 2.9 per cent, following an increase by 0.7 per cent in the previous quarter. Although it is hard to explain the significant increase in real consumer expenditure in the second quarter, the gradual consumption recovery was driven by the improved consumer expectations, reported by the July survey and the continuing increase in labour income.[4] Overall household consumption rose by 2.8 per cent on an annual basis in the first half of 2012 according to seasonally adjusted data.

Government consumption expenditure posted slow quarter-on-quarter growth by 0.1 per cent in the second quarter of 2012. Total government consumption went down by 1.2 per cent in the first half-year and contributed negatively to growth by 0.2 percentage points on an annual basis according to seasonally adjusted data.

In the first half of 2012 the downward trend in fixed asset investment on an annual basis was sustained (-3.8 per cent according to seasonally adjusted data), while since the beginning of the year fixed asset investment growth on a quarterly basis accelerated compared with the end of 2011. In real terms, fixed asset investment growth reached 1.5 per cent in the second quarter from 0.4 per cent in the first quarter. Both higher government capital expenditure and larger foreign direct investment inflow in Bulgaria had a positive contribution to investment activity. The change in inventories continued to contribute positively to half-year growth.

[1] The quarter-on-quarter analysis in this section employs seasonally adjusted data, unless otherwise indicated. For indicators on which neither the NSI nor Eurostat publishes seasonally adjusted data, adjustment was made *via* the TRAMO SEATS or OxMetrics programme using automated set up for diagnostics and optimization of adjustment parameters.

[2] GDP flash estimates for the third quarter of 2012 became available after the publication of the present issue. In accordance with our expectations growth of seasonally adjusted GDP in real terms is 0.1 per cent compared with the previous quarter.

[3] See Sub-section Exports of goods and services of Section 3.

[4] Conducting the household budget survey and household consumption accordingly the sample surveyed has been changed once a year which may contribute to more significant changes than expected in the consumption indicator.

GDP Growth by Component of Final Use

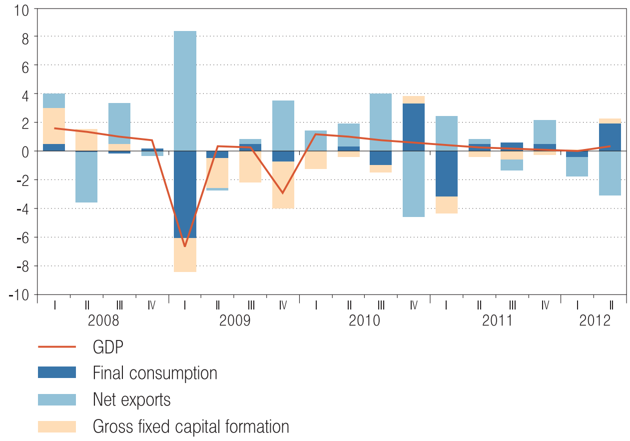
(%, real growth on the previous quarter; seasonally adjusted data)

	2009				2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Consumption	-7.2	-0.5	0.6	-0.8	0.0	0.4	-1.2	4.1	-3.7	0.7	0.7	0.6	-0.5	2.4
incl.														
Household consumption	-6.8	-0.8	0.3	-0.6	0.2	0.4	-1.0	1.1	-1.3	0.7	0.7	-0.3	0.7	2.9
Final government consumption expenditure	-12.0	1.6	2.4	-0.8	2.1	0.9	1.6	1.0	2.2	-1.1	-1.1	-0.2	0.2	-0.5
Collective consumption	-0.8	0.6	-0.6	-13.2	12.6	-1.5	-0.4	-1.8	-0.1	0.0	-0.6	0.6	-2.1	1.2
Gross fixed capital formation	-7.1	-6.5	-7.0	-11.5	-4.9	-1.7	-2.2	2.2	-5.0	-2.0	-2.7	-1.2	0.4	1.5
Exports of goods and non-factor services	-5.9	-2.5	0.2	6.7	1.2	6.8	8.4	-3.2	8.8	-0.6	0.5	2.8	-2.9	3.4
Imports of goods and non-factor services	-15.7	-1.7	-0.3	-0.2	-1.2	3.4	1.3	3.8	4.3	-0.9	1.5	0.2	-0.8	7.6
Real GDP growth	**-6.7**	**0.3**	**0.3**	**-2.9**	**1.2**	**1.0**	**0.8**	**0.6**	**0.4**	**0.3**	**0.1**	**0.1**	**0.0**	**0.3**

Sources: NSI.

Contribution to GDP Growth by Component of Final Consumption

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



Note: Non-additive data due to direct chain-linked and seasonal adjustment of GDP and its components; the contribution of the change in inventories has not been included.

Sources: NSI, BNB.

Based on the structure of growth by input cost the higher total factor productivity contributed most significantly to quarter-on-quarter GDP growth. Due to continued redundancies the labour factor[5] had a negative contribution to growth in the second quarter of 2012 irrespective of the fact that the rate of average hours worked per employee slightly increased over the said period. The contribution of the used capital[6] also increased from 0.2 percentage points in the first quarter to 0.4 percentage points in the second quarter impacted both by the rise in investment and higher capacity utilisation.

[5] The contribution of the labour factor is measured by hours worked per person in the economy.

[6] 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 (parameter =10) is applied to the capacity utilization indicator.

Contribution of Changes in Production Factor to GDP Growth

(%, quarter-on-quarter percentage points)

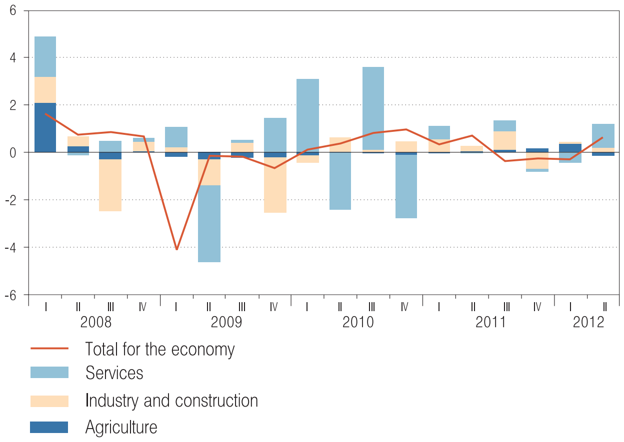
Sources: NSI, BNB.

Gross value added in the economy went up by 0.6 per cent in real terms on a quarterly basis in the second quarter of 2012 after the contraction at rates between 0.3 per cent and 0.4 per cent started since mid-2011. Some services sectors as financial and insurance activities, professional and scientific activities[7], culture, sports and entertainment and other activities contributed positively to to the increase in value added. Value added in industry rose by 0.6 per cent in the second quarter after the slow growth of 0.1 per cent in the previous quarter.

[7] The full name of the sector is professional activities, and scientific research, administrative and ancillary activities.

Value Added Growth and Contribution by Sector

(%, quarter-on-quarter percentage points)

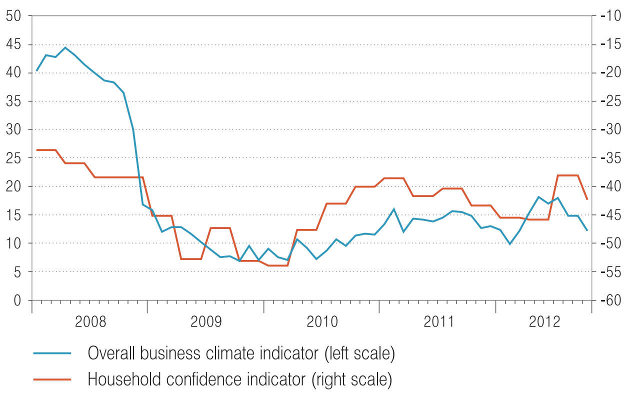


Note: Non-additive data on contributions due to direct seasonal adjustment of value added and its components.

Sources: NSI, BNB.

In the third quarter of 2012 current economic indicators deteriorated compared with the previous quarter. This was a result of increased managers' pessimism in all sectors (except for trade) about future business situation. Although the uncertain economic environment remained the major factor hampering corporations' activity, the share of firms in trade and services sectors, pointing to insufficient demand and increasing competition in the respective industries as limiting factors, posted a decrease. The composite consumer confidence indicator recorded a temporary increase in July, while in October the increase in the indicator and its components was partially offset.

Business Climate and Household Confidence Indicator



Sources: NSI, BNB.

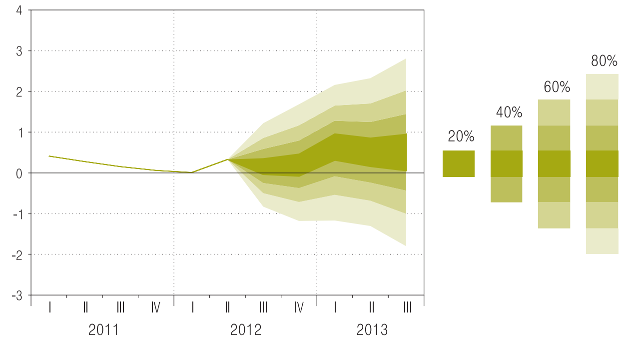
Worsening international economic conditions are expected to further dampen the recovery of Bulgaria's economy. External demand will start to slightly recover and exports will continue to increase until the end of the year and in early 2013 but at very low rates.

Worsened consumer expectations in October and continuing decline in employment will depress consumer demand. Until the end of the year and in the first quarter of 2013 private consumption is expected to continue recovering at lower rates than in the first half of the year.

Investment demand in Bulgaria is likely to continue recovering at a slow rate over the fourth quarter of 2012 and the first quarter of 2013, underpinned by international financial market developments and foreign direct investment inflow. Higher capacity utilisation and retention of firms' operating surplus at its current level will be the major factors affecting positively the investment demand.

Fan Chart of the Expected Quarter-on-quarter Rate of Change of GDP

(%)



Note: The fan chart shows the expert views on the uncertainty around the projected value based on probability distribution. The middle band of the chart, depicted in the darkest colour, includes the central projection. Probability distribution shows 20 per cent probability for the actual value to fall in this band in each of the quarters. If neighbouring bands (in the same brighter colour) are added to the middle band, there would be 40 per cent coverage of the probability mass. Thus, by adding each same colour couple of bands, the probability for the value to fall there would be increased by 20 percentage points to reach 80 per cent. The probability for the value to remain outside the coloured part of the chart is 20 per cent based on the distribution chosen.

Source: BNB.

Our expectations of the real GDP dynamics in the coming quarters and associated uncertainty are presented in the fan chart of the quarter-on-quarter GDP growth rate[8].

[8] For further details, see the box entitled Measuring and Presenting Uncertainty in Projections of Economic Indicators, Economic Review, 1/2012, p. 58.

Gross Value Added Growth

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

	2009				2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Agriculture and forestry, hunting and fishing	-2.9	-4.5	-3.4	-3.7	-2.7	0.5	-0.4	-1.9	-1.0	0.5	2.4	2.9	6.4	-2.3
Mining and quarrying, manufacturing production and distribution of electricity, gas and water	-0.9	-1.5	0.9	-1.8	-1.4	2.4	1.1	1.9	3.3	1.1	-0.6	1.3	0.1	0.6
Construction	5.2	-8.4	2.8	-22.4	0.0	1.1	-2.2	0.2	-3.0	-0.1	14.3	-14.1	0.8	1.0
Trade, cars and motorcycles repair; transport, storage and mail services; hotels and restaurants	1.8	-18.7	4.8	5.2	12.7	-7.8	18.6	-10.2	0.0	2.0	0.1	-0.4	0.9	0.4
Creation and dissemination of information and author products; communications	-1.5	1.9	-2.7	0.9	0.9	1.8	-0.9	-0.5	2.2	-2.3	1.8	0.0	-1.9	-1.1
Finance and insurance activity	9.2	-2.7	-4.4	5.8	4.9	-8.8	4.6	-2.3	0.4	1.4	0.9	-0.1	-1.3	3.7
Real estate activities	0.8	-2.2	-3.5	-0.1	3.4	0.4	0.2	0.0	-1.2	1.7	0.7	1.2	-0.7	0.9
Professional activities and scientific research; administrative and ancillary activities	2.5	6.4	2.8	-1.7	-5.2	7.0	-2.8	1.4	9.2	-6.8	3.8	4.3	-3.2	8.2
General government; education; healthcare and social services	-2.8	4.3	1.2	-0.1	0.8	-1.6	-2.7	-0.7	0.7	-0.6	0.5	-1.2	0.0	-0.6
Culture, sport and entertainment; other activity; activities of households as employers; non-identified activities of households producing goods and services for own use; activities of extraterritorial organisations and bodies	0.2	9.0	-4.2	1.0	-0.8	-2.3	-2.8	-0.7	-0.2	-5.7	-1.2	-6.2	-7.5	12.7
Gross value added, total for the economy	-4.1	-0.1	-0.2	-0.7	0.1	0.4	0.8	0.9	0.3	0.7	-0.4	-0.3	-0.3	0.6

Sources: NSI.

Based on our assessment real GDP until the end of 2012 will increase at a low rate slightly over zero due to the unfavourable impact of the worsened international environment. In the fourth quarter the quarter-on-quarter growth will remain between -0.4 per cent and 0.8 per cent and it will slightly accelerate within -0.1 per cent and 1.3 per cent[9] in the first quarter of 2013.

The uncertainty surrounding this outlook remains high, with the growth rate depending to a large extent on euro area recession developments. A possible debt crisis intensification in the euro area may prompt a decline in exports and investment activity in Bulgaria, which will lead to worsening of the labour market and a decline of GDP.

However, it is very likely that growth will be higher. Factors that may contribute to this are the more favourable external environment developments and stronger export growth on the one hand; on the other hand, the inflow of foreign direct investment in Bulgaria may increase which would boost investment activity. The significant acceleration of the use of funds on EU Cohesion and Structural Funds would have a positive effect on investment.

[9] Thus presented ranges of the expected growth rate of real GDP correspond to 40 per cent probability according to our expert specification of the probability distribution for the relevant quarter.

Household Behaviour

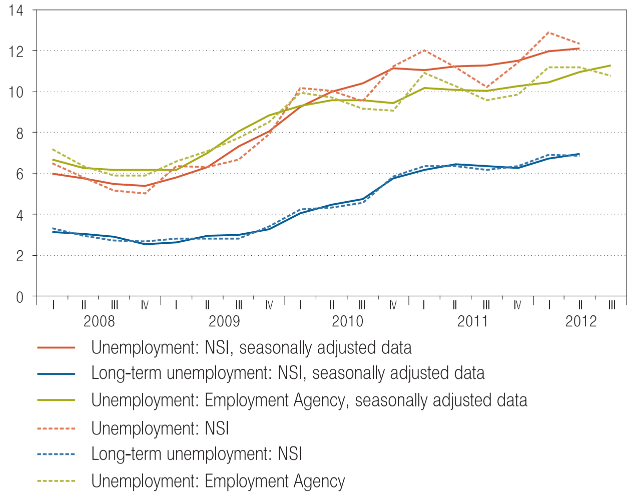
In the second quarter of 2012 household consumption rose quarterly by 2.9 per cent against an increase of 0.7 per cent in the previous quarter of 2012. Consumer demand recovery is expected to continue at slower rates in the second half of 2012, mainly due to continuing unfavourable labour market developments.

In the second quarter of 2012 household consumption rose quarterly by 2.9 per cent against an increase of 0.7 per cent in the previous quarter of 2012. Following the relatively strong increase in the April–June period the recovery of consumption is likely to slow down in the second half of 2012 г. The continuing decline in unemployment which is expected to be sustained in the second half of the year and still negative expectations of corporations about the number of personnel will possibly affect household sentiment and will limit their propensity to consume. On the other hand, the increase in employment in some economic sectors and retained low growth of wage bill may be factors favouring the recovery of consumption.

According to national accounts data, household consumption in the non-food and catering groups continued to improve in the second quarter of 2012. Water supply, heat energy, electricity and transport costs posted a decline. Data on retail trade also indicate an increase in consumption in the second quarter. However, indications for the third quarter tended to be negative, with the retail trade volumes decreasing on a quarterly basis. From the second quarter of 2011 until September 2012 the volumes continued to increase in pharmaceutical and medical goods, cosmetics, and from the beginning of 2012 the turnover in the computer and communication equipment group posted an increase. In the second and third quarters of 2012 the turnover in the textile, clothing, footwear and leather articles group also went up.

Unemployment

(%, share of labour force; seasonally adjusted data)

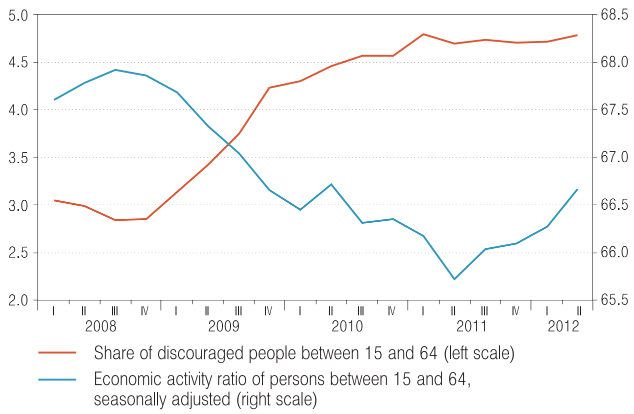


Sources: NSI – Labour Force Survey, Employment Agency, BNB.

Employment dynamics remained negative in the second quarter of 2012 and is likely to further limit household propensity to consume. Employment in the second quarter continued to decline on a quarterly basis at a rate of -1.3 per cent against -0.6 per cent in the first quarter. Firms' employment expectations about the number of employees continued to be pessimistic reflecting uncertainty surrounding the international situation and the speed of economic activity recovery in Bulgaria. The fall in employment in the second quarter of 2012 was attributable to a large extent to the lower number of employed (mainly self-employed) in agriculture, forestry and fishing. The Labour Force Survey showed that unemployment of individuals at and above the age of 15 continued to increase on a quarterly basis in the second quarter of 2012 reaching 12.1 per cent according to seasonally adjusted data. According to non-seasonally adjusted data the ratio accounted for 12.3 per cent. Employment Agency data indicate a continuing slight increase in the level of seasonally adjusted unemployment in the third quarter of 2012. In September unemployment accounted for 11.1 per cent in seasonally adjusted terms (10.6 per cent according to non-seasonally adjusted data for September) and almost matched its June and July levels. Further unemployment growth in the third quarter is confirmed by the preliminary unemployment data by the Labour Force Survey (11.5 per cent according to non-seasonally adjusted data).

Detailed Labour Force Survey data on unemployment duration showed that the number of long-term unemployed (over 12 months) increased more significantly in the second quarter of 2012. As a result the share of longer-term unemployed in the total number of unemployed went up in the second quarter against the first quarter to reach 56 per cent. In contrast to the first quarter of 2012 and the end of 2011, in the April–June period first-time job seekers (persons with no job experience) contributed stronger to unemployment growth, while unemployed due to the close of temporary and seasonal work to a lesser extent.

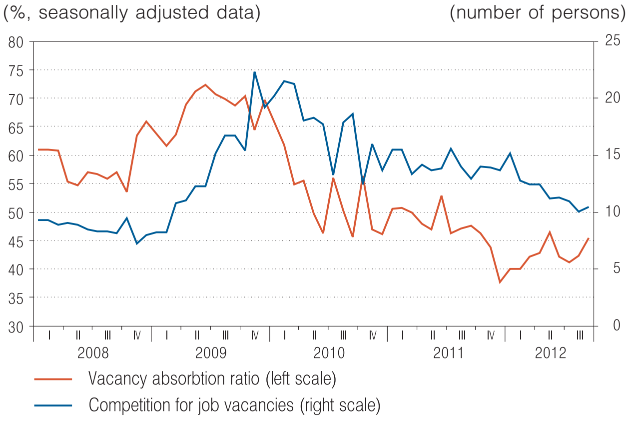
Economic Activity and Share of Discouraged Persons



Sources: NSI, BNB.

Employment dynamics impacted the household behaviour in terms of labour supply. An increasing number of discouraged people indicates potential problems in labour supply. Their number remained at its relatively high level that was reached in 2011, with their share in the total number of the 15–64 age group being sustained at 4.8 per cent. On the other hand, based on seasonally adjusted data the economic activity rate slightly rose to about 66.7 per cent in the second quarter of 2012. Despite the recovery of active labour supply, labour demand is expected to remain weak mainly due to pessimistic expectations of firms in most sectors regarding the number of personnel.

Competition and Job Vacancy Absorption Rate



Sources: Employment Agency, BNB.

The degree of mismatch between labour demand and supply would affect household sentiment associated with consumption and labour supply. The indicators available for measuring this match include the competition for occupying vacancies and vacancy absorption based on Employment Agency data. Currently the signals from both indicator are negative. They show a stronger labour demand/supply mismatch under Employment Agency programmes which stemmed to a large extent from the accumulation of unoccupied vacancies under employment programmes from previous months rather than from the increase in the offered job vacancies in a particular month. Based on the Employment Agency data in early 2012 the competition for occupying vacancies continued to decline on its 2011 average of 14 persons per vacancy, reaching 10.4 persons on average per vacancy (in seasonally adjusted terms) in the third quarter of 2012. On the other hand, the vacancy absorption rate for the vacancies offered by the Employment Agency[10] as an intermediary remained lower than the 2011 average.

Income dynamics impacted the household behaviour in terms of labour supply. According to national accounts data in the second quarter nominal wage growth per employee slightly accelerated its rate of growth on the first quarter of 2012 and the second half of 2011 (the nominal quarter-on-quarter growth rate came to 2.1 per cent in the second quarter against 0.6 per cent in the first quarter of 2012 and 0.6 per cent

[10] The job vacancy rate is the percentage ratio between the number of newly occupied vacancies in a given month and the sum of vacancies in the reference month (unoccupied posts in the previous month and posts offered in the current one).

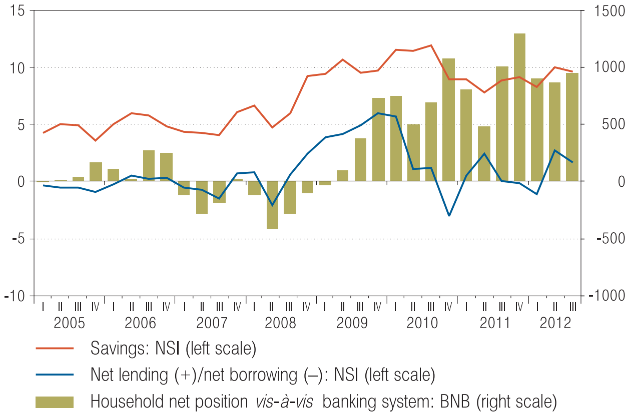
and 1 per cent in the third and fourth quarters of 2011 respectively). In real terms the quarter-on-quarter wage growth rate slowed down to 0.7 per cent in the second quarter of 2012 against 1.1 per cent in the first quarter. Non-seasonally adjusted wage did not exhibit an acceleration in growth rate within the first half-year and it remained at an average level of 4.3 per cent in nominal and 2.4 per cent in real terms and slowed down against the second half of 2011 when it was 7.4 per cent and 4.4 per cent respectively.

In the context of an ongoing fall in employment and low wage growth rates per employee in the first and second quarters of 2012, the wage bill in total economy also retained its moderate quarter-on-quarter growth rates in nominal terms but recorded a decline in real terms.

Household Propensity to Save

(%, share of disposable income, average *per* household member, seasonally adjusted data)

(quarterly change, seasonally adjusted data, million BGN)



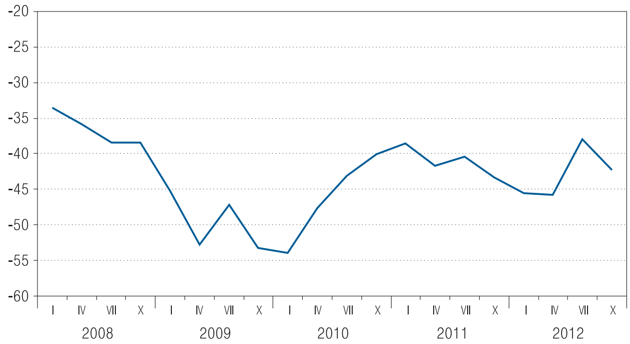
Sources: NSI Household Budget Survey, BNB.

The household savings rate is expected to continue limiting the consumption in the third quarter. During the second and third quarters of 2012 the household savings rate remained relatively high. This is evidenced by both the share of savings in disposable income[11] and the net lending to net borrowing ratio[12] based on the data from the household budget survey. Net household assets in the banking system continued to increase according to the BNB monetary statistics.

Based on consumer survey data following the worsening of the total household confidence indicator in 2011 and its retention on low levels in the beginning of 2012, in July all components of the indicator temporarily increased. In October 2012 the increase in the indicator and its components was partially offset.

Household Confidence Indicator

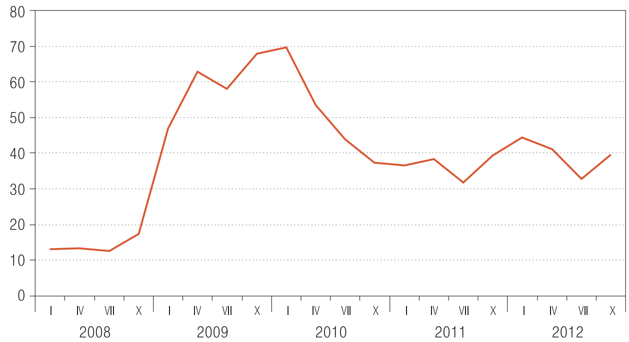
(balance of opinions; %)



Source: NSI Consumer Survey.

Unemployment Expectations in the Next Twelve Months

(balance of opinions; %)



Source: NSI Consumer Survey.

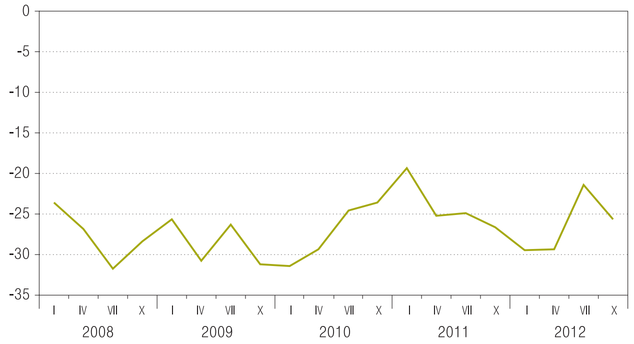
The latest consumer survey data also suggest a retention of the estimate for the current inflation and an increase of expected inflation in the following 12 months.

[11] Disposable income (based on NSI data from the household budget survey) is obtained by subtracting tax expenditure, social insurances and transfers from the total income.

[12] This indicator is based on NSI household budget survey data as a difference, on the one hand, between deposit amounts, foreign currency and bond purchases and repaid debt and granted loan, and, on the other hand, the amount of withdrawn savings, loans and credits.

Expectations about the Financial Situation of Households over the Next Twelve Months

(balance of opinions; %)



Source: NSI Consumer Survey.

Based on the business situation survey from the early year, firms' employment expectations remained negative. Still negative values of this indicator by sector, its instability and our economic activity projection give grounds to expect that only in 2013 a trend to employment recovery may be formed. The decline is expected to gradually subside until the end of 2012.

In the fourth quarter of 2012 the change in employment is expected to vary between -0.5 per cent and 0.2 per cent and in the first quarter of 2013 between -0.4 per cent and 0.4 per cent, with risks to the outlook related mostly to firms' sentiments and euro area public debt crisis developments. Since most of labour cost optimisation through personnel reductions has been completed since 2009, any decreases in employment are expected to be limited.

Expectations of a slow employment recovery and comparatively high level of unemployment will probably result in a more moderate increase in nominal wages until the end of 2012, with the strong link between real wage growth and labour productivity being sustained.

In line with these developments, the gradual recovery of consumer and investment demand of households is likely to continue.

Retail Trade Turnover

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

	2009				2010				2011				2012		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Retail trade turnover (excluding cars and motorcycles) incl.	-3.0	-3.4	-2.0	-1.6	-5.6	-0.4	0.9	-0.4	-0.5	-0.7	-1.3	-1.1	-1.2	2.1	-0.7
Foods, drinks and tobacco	6.8	-0.4	0.8	0.1	0.8	0.9	0.0	0.1	-1.5	-0.5	0.1	-0.1	1.0	1.1	-0.7
Textile, clothing, footwear and leather	-6.4	-2.4	-3.3	1.2	6.9	0.2	1.3	-0.2	-1.0	-2.9	-3.7	1.0	-17.4	1.6	3.8
Home appliances, furniture and other household goods	-16.1	-4.6	-4.9	-3.8	-11.1	0.5	-0.3	-2.1	-2.9	-1.4	-2.4	-2.5	-5.4	4.6	-4.4
Computers and communication equipment, etc.	-23.4	-1.9	-2.5	-2.7	-1.7	-0.8	8.2	1.5	-8.7	0.5	0.3	-0.9	0.4	1.8	0.7
Pharmaceutical and medical goods, cosmetics and toiletries	6.3	-0.9	2.2	1.8	3.3	1.4	1.1	1.7	-1.4	3.1	2.4	3.0	0.9	0.6	1.2
Unspecialised shops with different kinds of goods	52.4	-0.3	-0.5	0.1	16.9	1.8	3.4	2.3	1.6	-0.2	-2.1	0.0	-6.6	-1.8	-1.1
Automobile fuels and lubricants	-2.6	-3.7	0.1	-0.1	-30.2	1.2	2.7	-0.4	1.1	-0.8	-1.8	-1.4	-2.0	2.5	1.1

Source: NSI Domestic Trade Survey.

Employment and Income Dynamics

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

	2009				2010				2011				2012	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Employed	-0.7	-1.1	-1.9	-1.5	-0.9	-1.3	-0.3	-1.9	-1.2	-0.7	-0.9	0.3	-0.6	-1.3
Nominal wage *per* employee	1.8	2.3	2.4	-2.7	16.1	-2.7	-0.8	2.2	3.0	2.2	0.6	1.0	0.6	2.1
Real* wage *per* employee	1.0	3.1	3.3	0.0	6.3	-0.6	1.3	0.8	-1.1	2.3	0.4	0.2	1.1	0.7
Wage bill, nominal terms	2.7	2.5	1.8	-8.2	13.3	-1.1	-0.2	-0.3	0.2	1.8	1.0	0.5	0.6	0.6
Wage bill, real terms*	1.4	3.3	2.2	-11.2	15.9	-3.5	-1.2	-1.3	-1.3	1.7	0.3	-0.6	0.6	0.0
Unemployment (15+), average for the period, % of the labour force	5.8	6.3	7.3	8.1	9.3	10.0	10.4	11.1	11.0	11.2	11.3	11.5	12.0	12.1

* Data deflated by HICP.

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

Government Finance and Consumption

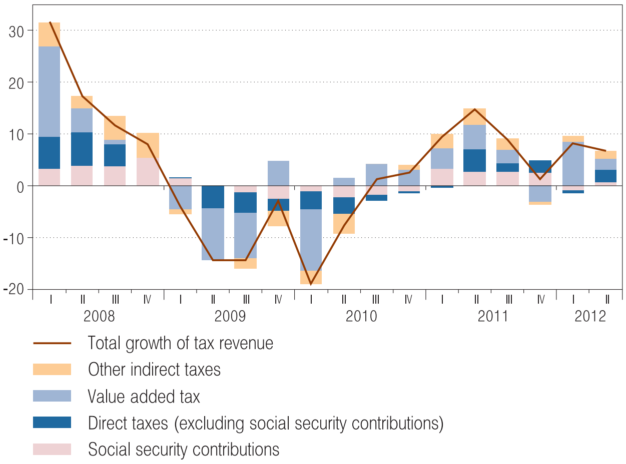
By the end of the first half of 2012 Bulgaria's fiscal position significantly improved, with fiscal consolidation in the second quarter of the year resulting in an effective decrease in current non-interest expenditure and improved tax revenue collection. Over the first six months of 2012 the consolidated fiscal programme surplus came to BGN 61.9 million (0.1 per cent of GDP). According to preliminary data of the Ministry of Finance the budget balance remained positive as of the end of the third quarter, worth BGN 248.1 million. In the second quarter of 2012 government consumption had a low contribution (0.1 percentage points) to quarter-on-quarter GDP growth. By year-end the contribution of government consumption to GDP growth is expected to remain slightly positive and to increase in the first quarter of 2013.

According to quarterly data on the implementation of the consolidated fiscal programme, the budget balance came to BGN 752.9 million in the second quarter of 2012: an improvement of more than BGN 660 million compared with the reported surplus in the same period of the prior year.

Over the second quarter of 2012 total budget revenue on the consolidated fiscal programme amounted to BGN 7268.3 million, their annual growth accelerating to 11.6 per cent. In contrast to the first quarter of the year when the increase in government revenue was almost entirely due to higher tax income on consumption, in the second quarter direct taxes (including social security contributions) and indirect taxes had similar contributions to growth of total budget revenue (of 2.5 percentage points and 3.0 percentage points respectively).

Contribution of Major Tax Groups to Tax Revenue Growth (Quarterly, on an Annual Basis)

(%, percentage points)

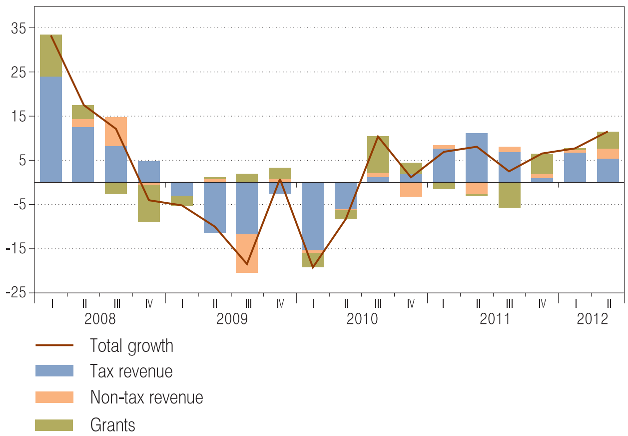


Sources: MF, BNB.

There was a recovery in the structure of indirect taxes during the second quarter shown by the improved performance of excise revenue, while the annual growth rate of receipts from VAT slowed down to 6.7 per cent compared to 33.4 per cent in the first three months of the year. The continuing increase in receipts from VAT was attributable to a large extent to higher fuel prices in international markets, the strong increase in exports and improved tax collection.

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

(%, percentage points)



Sources: MF, BNB.

Between April and June growth of revenue from direct taxes (including social insurance contributions) posted a recovery after the first quarter when it was close to zero. The improvement in this revenue group was determined mostly by the corporate tax revenue. Following a strong decline in the first quarter, by the end of June receipts from non-financial corporations' profit tax[13] reported positive growth while that of revenue from financial institutions accelerated further. Once the base effect of the March 2011 one-off transfers of professional pension funds faded the positive growth rate of revenue from social insurance contributions also recovered and reflected the dynamics of compensation of employees in

[13] Based on Monthly Bulletin data of the Ministry of Finance on the consolidation budget performance.

the economy in the second quarter of the year. However, revenue from income tax for individuals continued to increase at rates faster than those of the respective macroeconomic base.

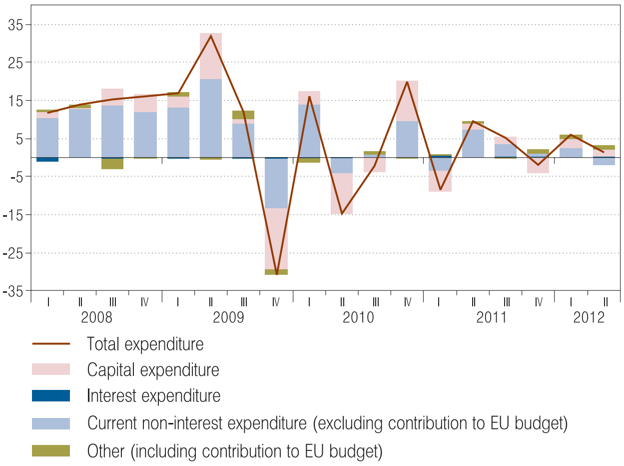
Between April and June receipts form grants and non-tax income also made a sizeable contribution to the increase in total budget revenue. Growth in non-tax revenue was mostly due to much higher revenue from dividends of firms with government participation that were transferred to the central budget in May (approximately BGN 280 million).

Over the second quarter of 2012 total budget revenue (including Bulgaria's contribution to the EU budget) amounted to BGN 6515.4 million, its annual growth limited to 1.5 per cent.

The significant decline in the subsidy expenditure and the limited wage and maintenance expenditure were among the major factors behind the negative annual growth of current non-interest expenditure in the second quarter. The increased social and health insurance payments had an opposite effect, with the positive change in consolidated expenditure being mostly the result of the significantly higher investment expenditure.

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

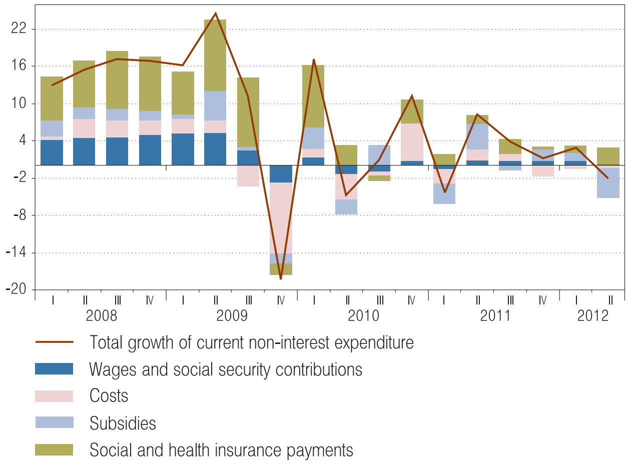
(%, percentage points)



Sources: MF, BNB.

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

(%, percentage points)

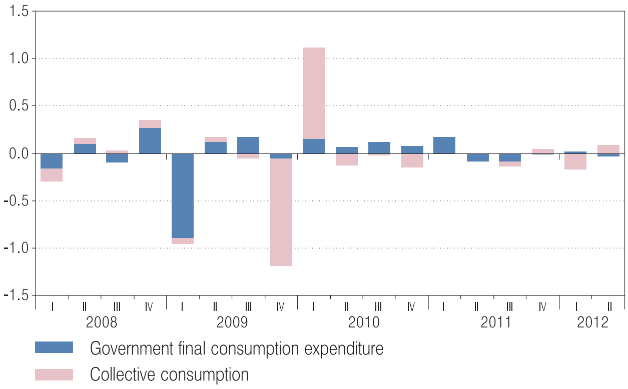


Sources: MF, BNB.

The small contribution (0.1 percentage points) of government consumption to quarter-on-quarter GDP growth in the second quarter pertained mostly to the operating expenditure and compensation of employees in the public sector limited by the government. By year-end these expenditure items are expected to increase somewhat and the contribution of government consumption to GDP growth to remain positive but close to zero and to increase in the first quarter of 2013. The projected increase in expenditure on compensation of employees in the public sector and the increased minimum wage will be a factor for the expected higher contribution of government consumption to economic growth in the beginning of the following year.

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

(percentage points)



Sources: NSI, BNB.

As a result of the budget surplus on the Consolidated Fiscal Programme in the second quarter of 2012 and the positive net financing of the budget by government securities, by the end of June the fiscal reserve funds rose by approximately BGN 530 million since end-March to BGN 5062 million.

Based on the notification tables published by Eurostat in October 2012 the deficit planned by the government for the general government sector in 2012 will amount to BGN 1022 million, or 1.3 per cent of the nominal GDP projected by the Ministry of Finance. The budget balance is expected to be higher by 0.3 percentage points of GDP than the estimated deficit in the revised Bulgaria's Convergence Programme of April 2012.

According to preliminary data of the Ministry of Finance for the January–September period the surplus on the Consolidated Fiscal Programme reached BGN 248.1 million. The end of the third quarter of 2012 saw a surplus on the national budget of BGN 735.3 million and a deficit on the EU programmes of BGN 487.1 million. The positive balance on municipalities' budget by end-September (BGN 202 million[14]) was mostly due to limited investment expenditure reaching 48 per cent of allotted investment expenditure in the 2012 State Budget Law.

By the end of September growth of total budget revenue and grants under the Consolidated Fiscal Programme slowed down slightly (to 8.9 per cent on an annual basis) compared with the first half of the year (9.8 per cent), with the change in the structure of total growth, which occurred in the second quarter, being sustained in the July–September period. The contribution of tax revenue to growth of total budget receipts continued to decrease (to 6.0 percentage points) reflecting mostly the lower growth rate of VAT revenue (11.7 per cent). Receipts from excise duties also exhibited slower growth (to 5.5 per cent) but the decrease was moderate.

Following the sizeable annual decline in the first quarter and low growth in the second quarter, by the end of September the corporate tax revenue[15] reported a certain improvement, the annual increase of 3.3 per cent reflecting mostly the recovered receipts from non-financial corporations. Total revenue from direct taxes rose by 5.5 per cent, but the major factor behind this remains the sustainable growth of receipts from income tax for individuals (6.5 per cent). Receipts from custom duties (-0.03 percentage points), corporate income tax (0.21 percentage points) and social security contributions (0.24 percentage points) had the lowest contributions to government revenue growth among major revenue groups.

By the end of September non-tax income and receipts form grants continued to make a sizeable contribution to the increase in total budget revenue. Although revenue from grants increased significantly (58.7 per cent) on an annual basis, the utilisation rate by end-September 2012 was hardly 29.4 per cent of that projected in the 2012 Government Programme.

By the end of the third quarter budget expenditure growth on the Consolidated Fiscal Programme (including Bulgaria's contribution to the common EU budget) was reduced to 2.9 per cent on an annual basis and no significant change occurred in its structure. As in the second quarter the increase in government expenditure continued to be entirely determined by the annual rise in capital expenditure (14.2 per cent) and social and healthcare expenditure (4.8 per cent). Lower subsidy expenditure (-26.5 per cent) and maintenance (-0.03 per cent) had the major contribution (-1.6 percentage points and -0.0 percentage points) to the limited annual growth of budget expenditure. The compensation of employees in the public sector retained its steady low growth from the beginning of the year (1.7 per cent), while interest expenditure recorded a significant decline in the rate of growth (to 5.9 per cent) due to the very low level of interest payments on government debt instruments in September (just BGN 2 million).

By the end of the third quarter fiscal reserve funds amounted to BGN 7171.7 million. The change since the end of 2011 (BGN 2172.9 million) was due mainly to the funds received from the Eurobonds sold on international markets (BGN 1842.8 million). The surplus accumulated on the Consolidated Fiscal Programme over the review period (BGN 248.1 million) and the positive net financing of the budget by government securities issued on the domestic market (BGN 337.2 million) were also factors behind the increased fiscal reserve funds.

[14] Including target transfers provided from other budgets.

[15] Including revenue from taxes on dividends and liquidation interests of resident and non-resident legal entities and income tax of non-resident legal entities.

Government Securities Market

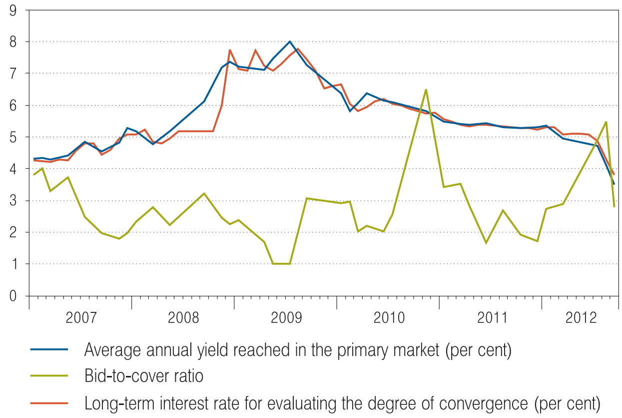
Between January and October the nominal value of government securities sold on the domestic market totalled BGN 1047.5 million: an increase of BGN 144.6 million compared to the corresponding period of 2011. In the third quarter the bid-to-cover ratio increased significantly and by the end of September reached 2.84. Among the auctions held since the beginning of the year the highest bid-to-cover ratio was recorded in the sale of government securities with an original maturity of ten years and six months (issue of 13 August 2012): 5.47. A reason behind the stronger demand for government securities in the domestic market is the pending maturity of the external issue of Eurobonds in January 2013, since by 31 July 2012 based on the Ministry of Finance[16] data about 75 per cent of securities (the total volume of the issue maturing in January 2013 amounted to EUR 818.5 million) are held in residents' investment portfolios.

In the January–October period a total of 23 auctions for the sale of government securities in the domestic market offered seven issues with diverse maturity and currency denomination, worth BGN 1140.5 million nominal value (including the lev equivalent of EUR 215 million). The residual term to maturity of primary market government securities over the review period varied between two years and ten years and six months, with most reopenings of the following issues: ten-year lev-denominated issue of 2012 (5 times), ten-year lev-denominated issue of 2007 (5 times), two-year lev-denominated issue of 2012 (5 times) and seven-year euro-denominated issue of 2012 (4 times).

The increased demand for government securities in the third quarter by a broad range of investors led to a new rise in the price of government debt instruments in all maturity segments. The price of ten-year government securities of 2012 recorded the largest increase. As a result the yield of these bonds in the primary market fell from 4.95 per cent in March to 3.51 per cent at the last auction by the end of September. The average-weighted yield of euro-denominated seven-year government securities exhibited a significant decline: from 4.21 per cent in March to 2.91 per cent at the auction held on 10 September.

Based on data published by the European Central Bank in September the long-term interest rate[17] in Bulgaria went down by 127 basis points on the end of the second quarter to 3.80 per cent. This is the lowest value of this indicator since February 2006. The yield of Bulgarian benchmark government securities was lower than that of the nine euro area Member States and five EU Member States outside the Economic and Monetary Union. As a result the long-term interest rate in Bulgaria was just 1 basis point higher than the euro area average interest rate (3.79 per cent).

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



Source: BNB.

In the first months the trade in newly issued five-year Bulgarian Eurobonds in international markets enjoyed high investor interest. Prices of Bulgarian bonds in the secondary market increased significantly and by the end of October reached 109.2. The yield to maturity of these debt instruments went down to 2.16 per cent against 4.436 per cent upon their initial sale.

According to the indicative issue calendar of the Ministry of Finance, in the last quarter of the year domestic government securities issues are projected to reach a total nominal value of BGN 257.1 million. Provided the issues in the calendar are sold, the nominal value of the gross issue for the whole 2012 will reach BGN 1229.6 million.

[16] Government Debt Management Monthly Bulletin, published by the Ministry of Finance.

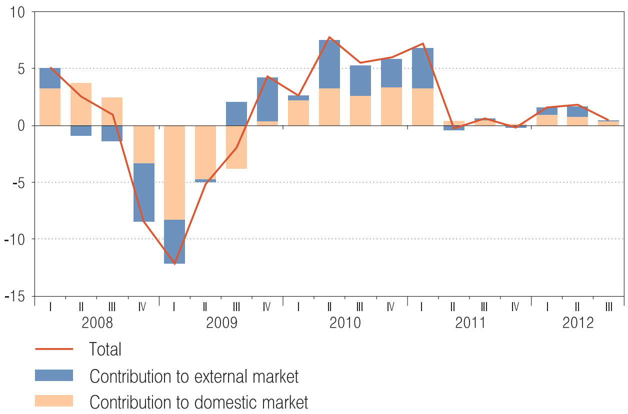
[17] The long-term interest rate for assessing the degree of convergence is based on the yield to maturity on the secondary market according to a long-term security (benchmark) issued by the Ministry of Finance (central government) and denominated in national currency.

Economic activity of firms improved driven by strengthening domestic demand and increased exports of goods and services in the second quarter of 2012. Optimization of firms' labour costs through staff reductions intensified. As a result, the quarter-on-quarter labour productivity increased while real unit labour costs decreased.

Economic activity of corporations strengthened driven by improving domestic demand and increased exports of goods and services in the second quarter of 2012.
Household consumption and investment in fixed capital continued to increase on a quarterly basis and retained their positive effect on the economic activity in Bulgaria in the first quarter of 2012. As a result gross value added for the economy increased on a quarterly basis by 0.6 per cent against -0.3 per cent in the first quarter.
The external environment remained unfavourable in the second quarter of 2012 and continued to dampen the growth rate of exports of raw materials and investment goods. However, in the second quarter exports went up by 3.4 per cent in real terms compared with the first quarter of 2012. On the other hand, domestic demand had a positive effect on industrial production. As a result the value added growth rate in the sector accelerated from 0.1 per cent to 0.6 per cent on a quarterly basis.

Industry Turnover Dynamics

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



Note: Additive data on contributions due to multi-factor seasonal adjustment of the total amount and its components.
Sources: NSI, BNB.

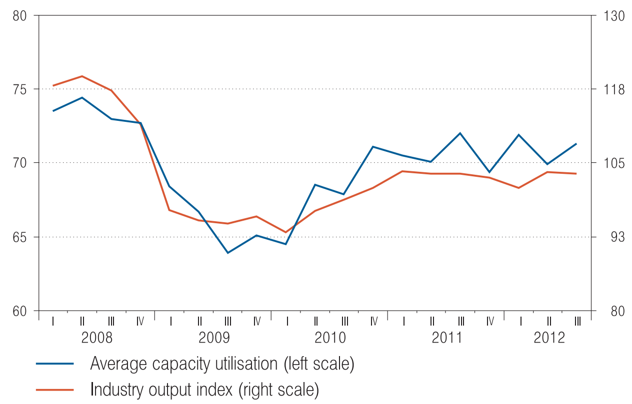
The growth rate of income from sales of enterprises in industry slightly accelerated in the second quarter compared with the first quarter of 2012. This was mainly attributable to the higher contribution of external market sales, while that of domestic market sales remained unchanged. The annual turnover of industrial enterprises on the external market went down in the intermediate consumption goods and investment goods groups, while the turnover of consumer goods continued to increase. This pertained to a lower decline in EU household demand as compared with that of corporations in industry and construction which is evidenced by the data on turnovers in EU trade and industrial output.

In the second quarter of 2012 industrial production index in Bulgaria increased on a quarterly basis and data on output by major industrial group suggest that the strengthened investment activity in Bulgaria and household consumption (both inside and outside the country) contributed significantly to this effect. The annual turnover of industrial enterprises on the domestic market went up due mostly to the sales of general and special purpose machines and equipment and computer and communication equipment, electronic and optical products.

Production capacity utilisation as a whole followed industrial production developments exhibiting a slight increase.

Production Capacity Utilisation in Industry

(%)



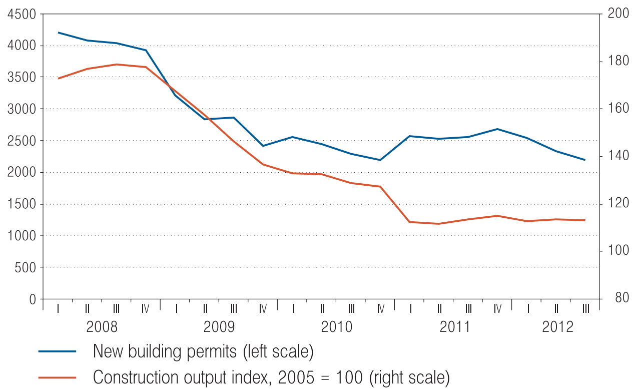
Source: NSI, Industry Tendency Survey.

The civil engineering construction in Bulgaria continued to increase and had the major positive contribution to the economic activity in construction due to the implementation of projects related to building and improving the infrastructure. As a result the gross value added in the sector went up by 1 per cent on a quarterly basis in the second quarter of 2012.

On the other hand, the output in building construction posted a quarter-on-quarter decline due to still uncertain economic environment and weak household investment demand. Registry Agency data suggest that estate sales decreased in the second quarter compared with the first quarter of 2012. Leading indicators as started construction of new buildings, issued building permits and new buildings launched, confirmed the downward trend in this sub-sector, with the strongest decline recorded in residential buildings.

Construction Output Dynamics and New Buildings Permits Issued

(number of buildings; seasonally adjusted data)



Sources: NSI, BNB.

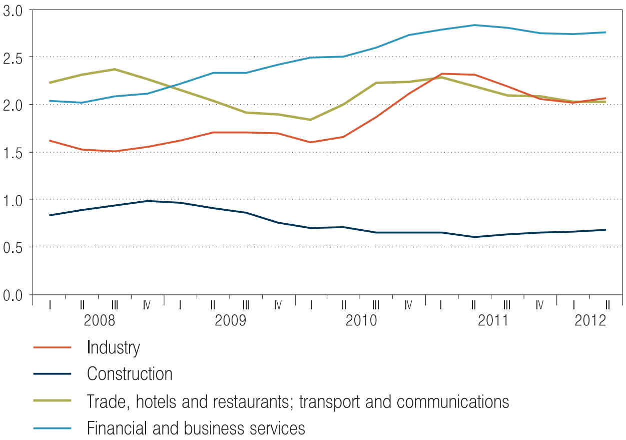
The gross value added in the services sector posted a quarter-on-quarter increase by 1.5 per cent in the second quarter of 2012. Services sectors providing business services as financial and insurance activities, real estate operations and professional activities, as well as culture, sports and entertainment and other activities contributed most significantly to the increase in value added. Based on data on nominal turnover in services the demand for services associated with architectural and engineering activities, technical tests and analyses, activities on labour recruitment and provision and IT activities significantly improved.

Gross value added in trade increased by 0.4 per cent on a quarterly basis in the second quarter of 2012. Firms' enhanced economic activity in the sector was due to higher private consumption in Bulgaria. Despite the quarter-on-quarter increase in the retail trade turnover in all major commodity groups at constant prices, automobile fuels and lubricants and household appliances, furniture and other household goods groups contributed most significantly to the increase in the turnover index.

The gross operating surplus whose dynamics may be used to evaluate firms' financial performance, started recover in the second quarter of 2012, following the quarter-on-quarter decline started since the second quarter of 2011 due to a decrease in the indicator mostly in industry and trade. However, non-seasonally adjusted data point to a slight deterioration in firms' financial performance compared with the second quarter of 2011. The increase in the gross operating surplus in industry contributed most substantially to the quarter-on-quarter improvement in the second quarter of 2012. This reflects both the improved economic activity in the sector and the firms' continued policy of labour cost optimisation. At the onset of the crisis industrial enterprises limited the wage bill mostly by laying off employees, while in the first and second quarters of 2012, signs of a quarter-on-quarter fall also occurred in the nominal compensation per employee. Notwithstanding, the annual growth rate of compensation per employee in the sector remained positive.
In construction and in the sector providing business and financial services gross operating surplus also increased on a quarterly basis but at a lower rate than in industry. Despite the reported quarter-on-quarter improvement of firms' financial performance overall in the economy in the second quarter of 2012, the growth rate of employees' compensations continued to slow down on an annual basis. As a result their share in value added remained unchanged compared with the first quarter of 2012.

Gross Operating Surplus at Current Prices

(billion BGN; seasonally adjusted data)

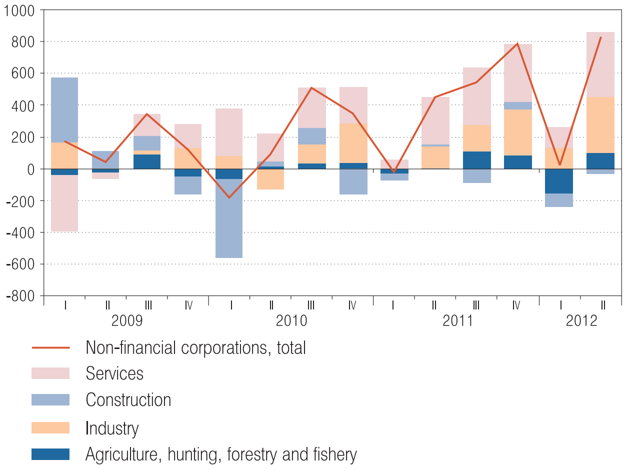


Sources: NSI, BNB.

With the strengthening of corporations' total economic activity in Bulgaria bank loans to non-financial corporations posted a quarter-on-quarter increase in almost all sectors. Construction was the only sector indicating a decline due to a significant uncertainty in the expectations of future economic activity in the sector.

Bank Loans to Non-financial Corporations

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

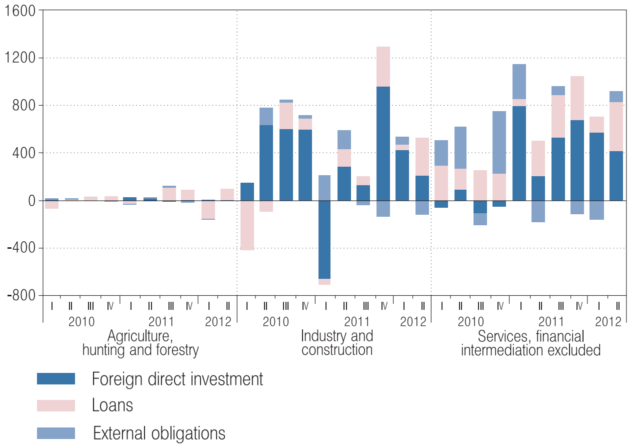


Source: BNB.

In addition to the gross operating surplus and bank loans the inflow of foreign direct investment was an additional source for financing enterprises in the second quarter of 2012. Foreign direct investment dynamics improved further. As a result firms continued to decrease their external obligations. The industry sector followed by trade contributed most significantly to this decrease. Notwithstanding, the total indebtedness of firms slightly went up due to the recovering economic activity in Bulgaria.

Financing Sources

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

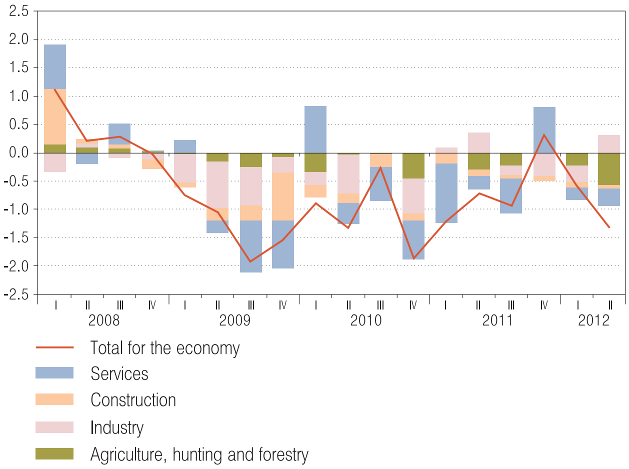


Source: BNB.

Firms continued to reduce their labour costs by reducing labour force in the second quarter of 2012, with the trend strengthening compared with the first quarter of the year. Agriculture and the services sector had the largest contribution to the quarter-on-quarter decrease in employment. Following the decline in the last three quarters, employment in industry increased mostly due to the higher number of self-employed. The uncertain external economic situation is likely to continue affecting negatively firms' propensity to hire personnel. Business surveys reflected the pessimism of firms' managers in respect of hiring staff.

Contribution to Changes in the Number of Employed by Economic Sector

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



Note: Non-additive data due to direct quarter-on-quarter seasonal adjustment of the total turnover amount and its components.
Sources: NSI, BNB.

The reduced number of employees and more rational use of employees hired by firms had a favourable effect on the real labour productivity overall in the economy, which continued to increase from mid-2009. The second quarter of 2012 saw a relative quarter-on-quarter acceleration of the growth rate of labour productivity which was also due to recovering economic activity in Bulgaria.

Labour Productivity Developments (Value Added *per* Employee)

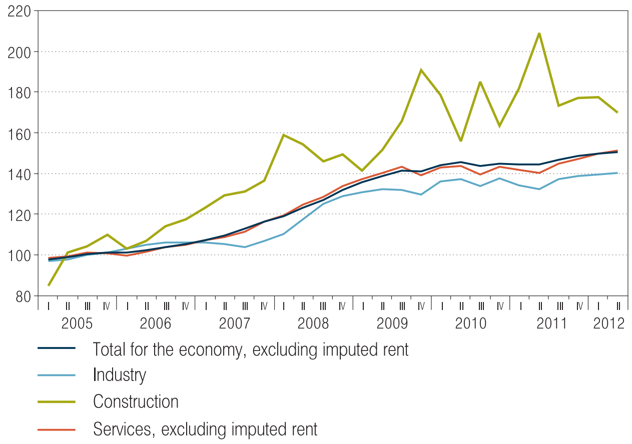
(%, quarter-on-quarter; seasonally adjusted data)

Sources: NSI, BNB.

The wage rate of growth realigned with that of productivity on a quarterly basis in the second quarter. This helped keep nominal unit labour costs in the total economy at a level close to that in the first quarter of 2012, while in real terms the expenditure went down in all sectors.

Nominal Unit Labour Costs

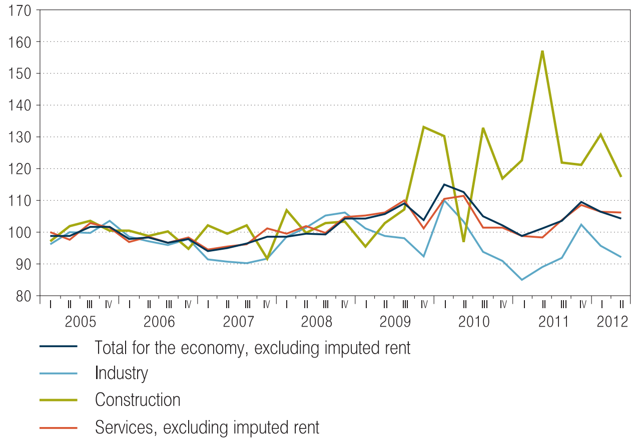
(2005 = 100; seasonally adjusted data)



Sources: NSI, BNB.

Real Unit Labour Costs

(2005 = 100; seasonally adjusted data)

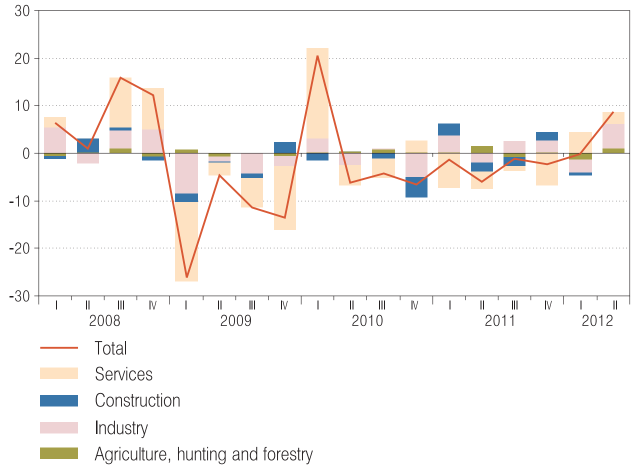


Sources: NSI, BNB.

Investment activity of corporations measured by expenditure on acquiring fixed assets at current prices improved in the second quarter compared with the first quarter of 2012.

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

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



Note: Due to the lack of final data, the quarterly data are preliminary. Additive contributions due to multi-factor seasonal adjustment of the total amount and its components.

Sources: NSI, BNB.

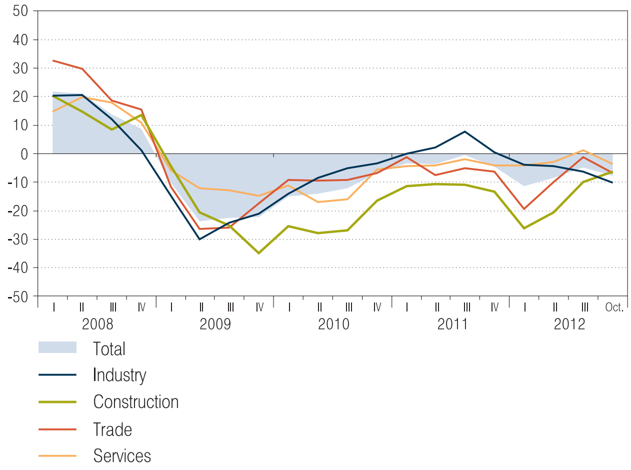
Industry reported the most sizeable increase in expenditure on acquiring fixed assets. Higher capacity utilisation since end-2010 has most likely increased the need to restore amortised capital. This assumption may be supported by the imports data of the balance of payments. These data show that imports of investment goods rose in the second quarter mainly due to the increased imports of machines and spare parts thereof. In the services sector, the increase in expenditure on acquiring fixed assets was broadly concentrated in the business activities, reflecting the positive trends thereof. In the second quarter of 2012 the seasonally adjusted real amount of gross fixed capital formation rose by 1.5 per cent on a quarterly basis.

Corporations' investment activity is expected to remain under the strong influence of the uncertain economic environment. Under a more favourable situation, by the end of 2012 investment activity is likely to retain its positive development of early 2012 and even to increase its growth rate in the beginning of 2013.

The worsened economic activity of Bulgaria's major trading partners is expected to further dampen the exports and economic activity in Bulgaria. The uncertainty and pessimism about euro area growth reflected also on the expectations of Bulgaria's future economic activity. As a result, they decreased in October 2012. In addition, short-term conjunctural indicators show worsening of the economic activity in the third quarter, consistent with second quarter's decreased expectations. Data on trade volumes in the third quarter show that households reduced their demand for goods. The index measuring income from sales of industrial enterprises also decreased its growth rate mainly due to the weaker demand on the domestic market. The construction output index continued to increase thanks to the civil-engineering construction. However, data on building permits and construction of new buildings point to a sustainable decline in building construction.

Current Economic Activity

(balance of opinions, %; seasonally adjusted data)

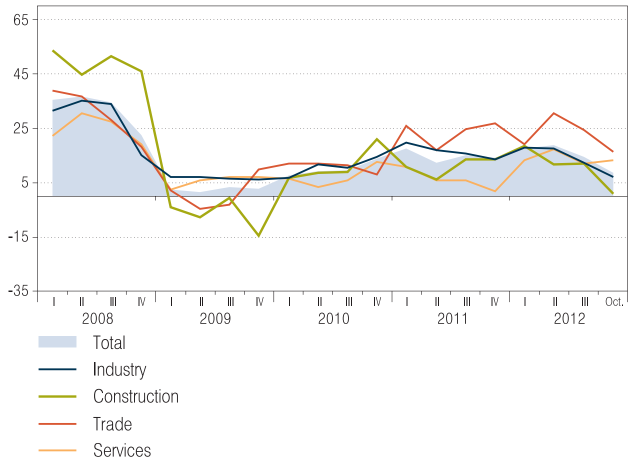


Sources: NSI, BNB.

Firms' economic activity is expected to improve further, though remaining low in the fourth quarter of 2012 and first three months of 2013, given the uncertainty surrounding external environment recovery.

Expectations about Future Economic Activity

(balance of opinions, %; seasonally adjusted data)



Sources: NSI, BNB.

Exports and Imports of Goods

Between January and August 2012 the nominal growth rate of exports was positive but remained lower compared with 2011. This was a result of growth recovery on an annual basis following the reported decrease in the first quarter. Import growth accelerated over the review period due to a domestic demand recovery. As a result, the trade deficit increased by EUR 1555.3 million.
In the fourth quarter of 2012 and the first quarter of 2013 exports and imports are expected to grow due mainly to gradually recovering external and domestic demand. Trade balance deficit is expected to be between 7.5 and 9.5 per cent of GDP.

Between January and August 2012 nominal exports increased, though their rate remained moderate (2.3 per cent), while import rates accelerated (13.0 per cent). As a result, trade balance deficit increased compared to the corresponding period of 2011 (deterioration by EUR 1555.3 million) and reached EUR 2563.6 million.[18] The difference in the rates of nominal change of exports and imports was due both to their divergent dynamics in real terms (a -1.2 per cent decline in exports and 6.4 per cent growth in imports on an annual basis for the first half-year, non-seasonally adjusted data) and continued deterioration of the terms of trade.

The increase in the market share of Bulgarian goods in total imports of the EU (8 per cent on an annual basis in July 2012) indicates the sustainable competitive positions of Bulgarian exporters in the European market. Major factors behind the slowdown in exports growth are related to the more moderate growth rates of external demand mainly in the EU countries, a base effect associated with the high export growth rates in early 2011 and declines in global commodity prices.

In the first two quarters of 2012 deterioration of the terms of trade was broadly due to declines in metal prices which have more weight in the value of exports rather than in the value of imports.

In the fourth quarter of 2012 and first quarter of 2013 nominal exports and imports are expected to increase on an annual basis. Export growth will reflect acceleration in the growth rates of external demand and a gradual improvement of the terms of trade, while import growth will be fuelled by the continued improvement of domestic demand. Trade balance deficit is expected to range between 7.5 and 9.5 per cent of GDP.

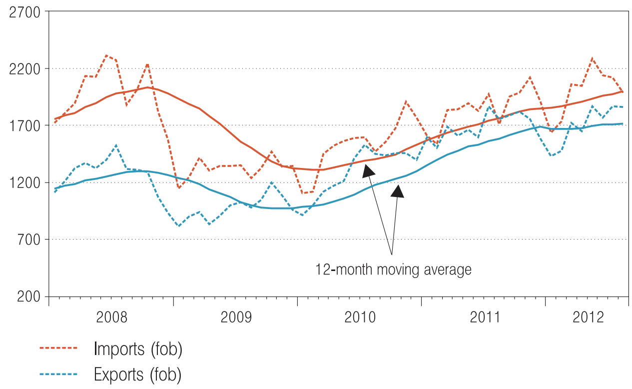
Risks for a higher-than-expected trade deficit are associated with a possible worsening of the external environment beyond our expectations and higher increases in domestic demand which will contribute to accelerated growth of imports.

Global commodity price developments also pose some risks. Trade deficit would be boosted by a new decline in metal prices and higher increases in oil prices.

The trade deficit increase between January and July 2012 reflects the higher growth of imports compared to exports in investment goods (EUR 773.0 million), energy resources (EUR 407.4 million) and raw materials (EUR 398.5 million). The surplus in the consumer goods group increased by EUR 119.3 million.

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

The low nominal growth rate of exports between January and July 2012 (1.7 per cent) reflects divergent export dynamics by commodity group. Mineral products and fuels (3.2 percentage points), and animal and plant products, foods, drink and tobacco (1.1 percentage points) contributed most significantly to export growth.

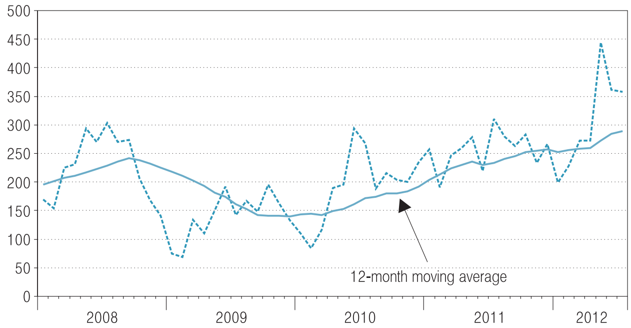
[18] The analysis presented in this section is based on data of nominal exports and imports in euro. Data in real terms by commodity group are derived from deflators published by the NSI under the Standard International Trade Classification (SITC).

Base metals and their products (-2.3 percentage points), textiles, leather, clothing, footwear and other consumer goods (-1.0 percentage points), and machines, transportation vehicles, appliances, instruments and weapons (-0.1 percentage points) had a negative contribution to this growth.

In the first seven months of 2012 exports of mineral products and fuels rose by 21.3 per cent on an annual basis to EUR 2135.3 million. Unusually, ores, slag and ash had the largest contribution (11.5 percentage points) to the exports of this group. Their growth was fuelled also by traditionally most important item, mineral fuels, mineral oils and distilled products (8.9 percentage points), reflecting mainly higher export prices of these products. In the fourth quarter of 2012 and first quarter of 2013 the export growth rate in this group is expected to be moderate due to the gradual rise in external demand and weak dynamics of international fuel prices.

Exports of Mineral Products and Fuels

(million EUR)

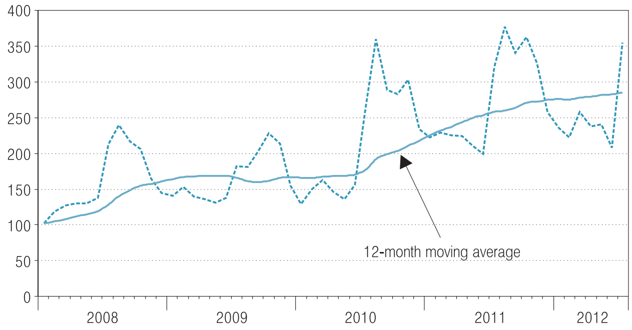


Source: BNB.

Between January and July 2012 exports of animal and plant products, foods, drink and tobacco came to EUR 1762.2 million, growth of 7.7 per cent on an annual basis. Cereals had the major contribution to this growth (10.9 percentage points), while oil seeds and fruit, different types of seeds occupied the largest negative contribution of -7.9 percentage points. Good harvests in 2011 were the main factor for the accelerating growth of cereals both in nominal and real terms. The annual decline in exports of oil seeds and fruit reflects a base effect since exports of these products reported very high growth in the first half of 2011[19]. In the fourth quarter of 2012 and first quarter of 2013 exports of this group are expected to be positive, reflecting both the external demand increase and recovered growth of international food prices.

Exports of Animal and Vegetable Products, Foods, Drink and Tobacco

(million EUR)

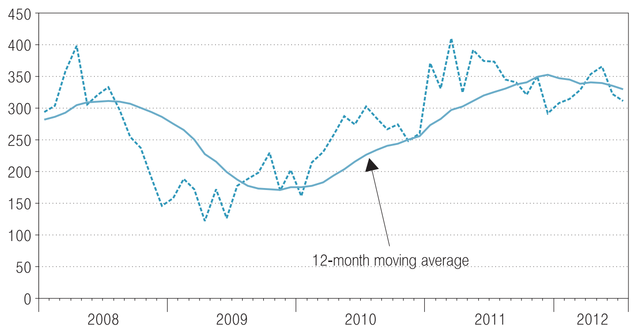


Source: BNB.

In the first seven months of 2012 exports of base metals and their products fell by 10.5 per cent on an annual basis to EUR 2304.4 million. The items contributing mostly to this decline were copper and articles thereof (-5.8 percentage points) and cast iron, iron and steel (-2.7 percentage points). Factors behind the decline include lower growth in external demand and decreased global metal prices on an annual basis[20]. The negative dynamics was also a result of a base effect stemming from the high growth rate in the first quarter of 2011. In the last quarter of 2012 and first quarter of 2013 the export growth rate in this group is expected to be low due to the gradual acceleration of external demand growth and continuing decline of international metal prices.

Exports of Base Metals and Base Metal Products

(million EUR)



Source: BNB.

---

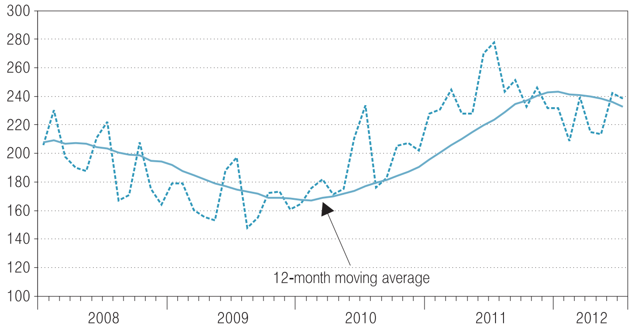
[19] The export deflator for the animal or vegetable fats and oils, and waxes group under SITC was used to estimate the price effect for the item fats and oils of animal or vegetable origin and the export deflator for cereals and grain mill products under SITC was used for the item cereals in the first and second quarters of 2012.

[20] The export deflator for the precious metals and other nonferrous metals and iron and cast iron items under SITC was used to estimate the price effect in the first and second quarters of 2012.

Between January and July exports of textiles, leather, clothing, footwear and other consumer goods totalled EUR 1590.4 million: a 6.9 per cent decrease on the same period of the previous year. Natural or cultured pearls, precious stones and precious metals contributed most significantly (-7.5 percentage points) to this decline. This item has a comparatively low share in exports of the textiles, leather, clothing, footwear and other consumer goods group and its dynamics has no significant effect on this group's exports. They are expected to recover gradually over the projection horizon.

Exports of Textiles, Leather, Clothing, Footwear and Other Consumer Goods

(million EUR)



Source: BNB.

Contribution of Commodity Groups to Trade Growth in the January–July 2012 Period

	Exports		Imports (CIF)	
	growth, %	contribution, p.p.	growth, %	contribution, p.p
Consumer goods	10.0	2.2	5.8	1.0
Raw materials	-4.2	-2.0	3.4	1.3
Investment goods	-0.2	0.0	28.3	5.8
Energy resources	10.4	1.5	19.2	4.4
Growth, total	**1.7**		**12.6**	

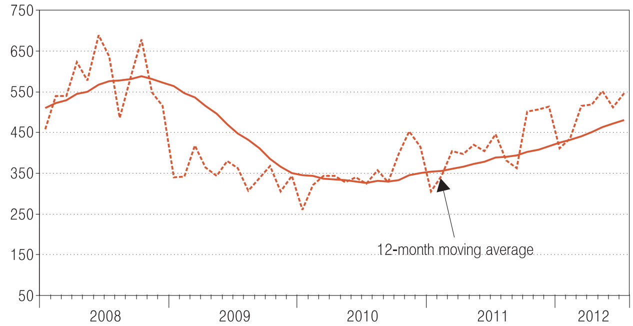
Source: BNB.

Between January and July 2012 imports (CIF) reached EUR 14,815.9 million: an increase of 12.6 per cent on an annual basis. All import groups (by use) contributed to it. The groups of investment goods (5.8 percentage points) and energy resources (4.4 percentage points) had the largest contribution to import growth. Imports of raw materials (1.3 percentage points) and consumer goods (1.0 percentage points) posted a more moderate increase.

Imports of investment goods between January and July totalled EUR 3486.7 million: a 28.3 per cent rise on the same period of the previous year. Spare parts and equipment (17.0 percentage points) had the largest contribution to this rise. The stable nominal growth rate of investment goods imports since early-2012 reflected the positive trends in Bulgaria's investment activity. In the last quarter of 2012 and first quarter of 2013 imports of investment goods are expected to further increase due to the continuing gradual acceleration of investment activity.

Imports of Investment Goods

(million EUR)

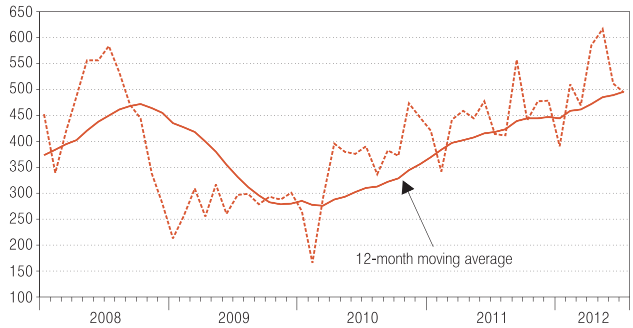


Source: BNB.

In the first seven months of 2012 imports of energy resources amounted to EUR 3576.4 million: an increase of 19.2 per cent on the corresponding period of the previous year. The crude oil and gas item had the major contribution (17.9 percentage points) to the increase, their imports rising both in nominal and real terms. Over the projection horizon import growth rates in this group are expected to remain positive, driven mainly by domestic demand.

Imports of Energy Resources

(million EUR)



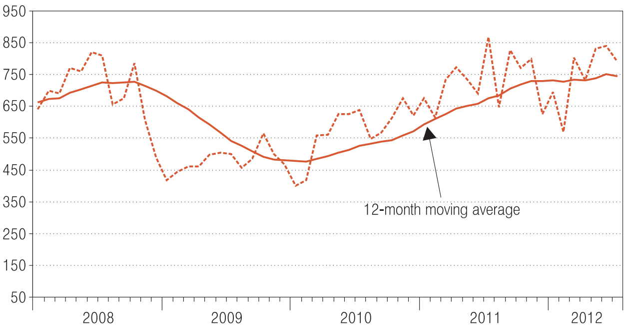
Source: BNB.

Between January and July 2012 imports of raw materials amounted to EUR 5268.1 million: an increase of 3.4 per cent on the corresponding period of the previous year. Most items in this group contributed to the growth, with the item othes contributing most significantly

(1.2 percentage points). The only exceptions are cast iron, iron and steel with a contribution of -1.0 percentage points, which is likely to reflect a price effect, and textiles contributing -0.4 percentage points. In the fourth quarter of 2012 and first quarter of 2013 the import growth rates in this group are expected to remain positive due to the improving domestic demand and gradually recovering increases in global commodity prices.

Imports of Raw Materials

(million EUR)

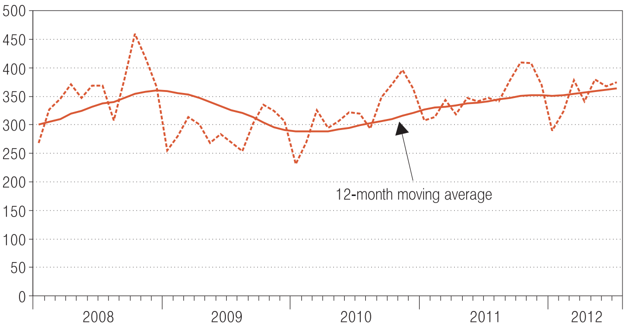


Source: BNB.

Imports of consumer goods recorded nominal growth of 5.8 per cent in the first seven months of 2012, reaching EUR 2455.1 million. Food, drink and tobacco contributed most significantly (4.4 percentage points) to this. The increased imports of this group was driven by rising consumption.[21] Over the projection horizon, imports of consumer goods are expected to remain positive due to the gradual improvement of domestic demand.

Imports of Consumer Goods

(million EUR)

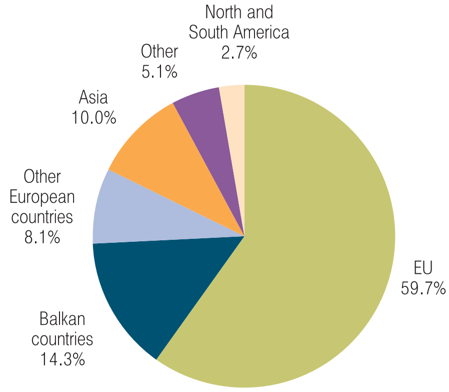


Source: BNB.

[21] To estimate the price effect of the food, drink and tobacco item, the import deflators for the foods and live animals, soft and alcohol beverages, and tobacco groups were used; for furniture and home equipment – the import deflator for furniture, bedding and similar furnishings under SITC in the first two quarters of 2012.

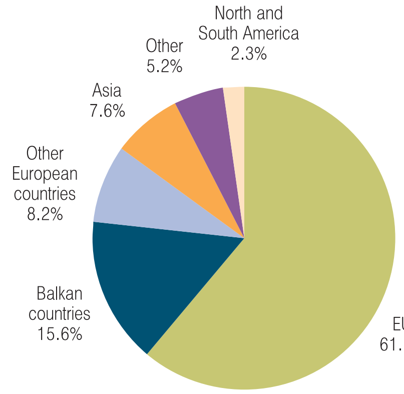
The geographical breakdown of exports between January and July was driven mostly by different rates of economic growth in EU and non-EU countries. Over the January to July 2012 period Bulgarian exports to other EU Member States fell by 0.7 per cent on an annual basis. Exports to Belgium contributed most significantly to this (by -2.1 percentage points), most of this decline reflecting the decreased exports of copper and copper products. Exports to non-EU countries increased by 5.3 per cent, with all major trading partners in this group contributing to this growth. Exports to China contributed most significantly (by 6.9 percentage points), with the main portion of this rise reflecting the increased exports of copper and copper products.

Geographical Breakdown of Exports between January and July 2012



Source: BNB.

Geographical Breakdown of Exports between January and July 2011



Source: BNB.

Imports from EU Member States increased by 9.1 per cent and that from non-EU countries by 15.8 per cent.

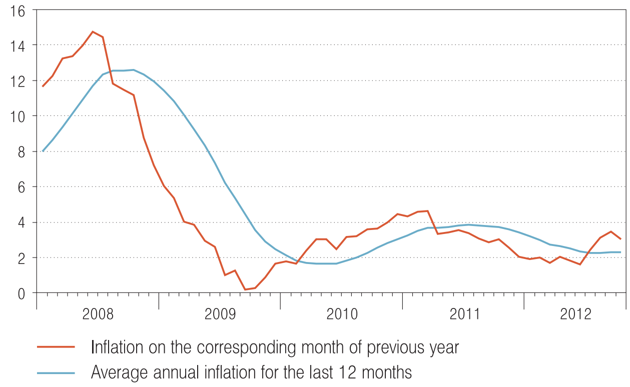
4. Inflation

In the first half of 2012 consumer price inflation remained relatively low, while in the third quarter it accelerated driven mainly by price dynamics of unprocessed foods and the increase in the price of electricity for households. In October the annual inflation rate was 3.0 per cent (2.0 per cent in December 2011) with foods (1.1 percentage points), administratively set prices (0.9 percentage points) and energy products (0.8 percentage points) contributing most significantly to it. Core inflation remained at low levels (0.5 per cent in October), tending to slightly rise since the beginning of the year as a result of increased inflation in services.
In the fourth quarter of 2012 inflation is expected to slightly increase from the current levels due mainly to the rises in international food and petroleum prices (in euro terms). Slow growth of core inflation against the background of gradually recovering consumer demand will be another key factor influencing the inflation dynamics until year-end. Given the expected moderate developments in international food and petroleum prices in the beginning of 2013, inflation will probably slightly slow down in the first quarter of 2013 compared with end-2012.

In the first half of 2012 consumer price inflation remained at a comparatively low level of 1.9 per cent annual rate of change (2.0 per cent in December 2011). In the third quarter inflation accelerated, with the HICP annual rate of change rising to 3.4 per cent in September, driven mainly by price dynamics of unprocessed foods and increased prices of electricity for households.

Inflation

(%)



Source: NSI.

As of October annual inflation accounted for 3.0 per cent. For the fifth consecutive month average annual inflation for the last 12 months remained unchanged at 2.3 per cent (3.4 per cent in December 2011).

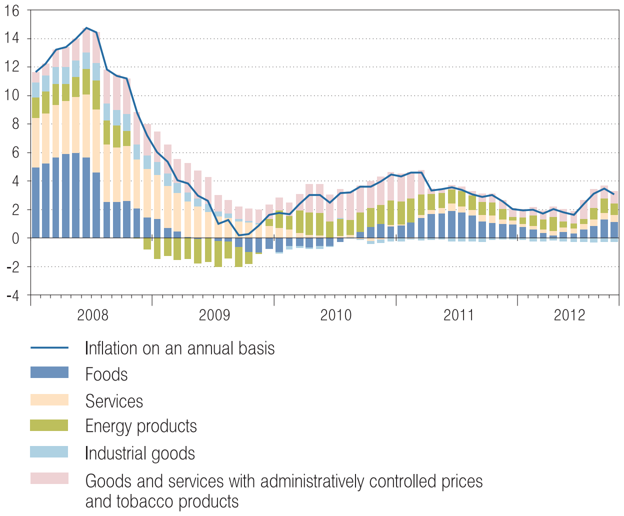
Price dynamics since early 2012 reflects the global commodity market situation, changes in some administratively controlled prices and the slight acceleration of core inflation (excluding the prices of food and energy products, goods and services with administratively controlled prices and tobacco prices). After the significant fluctuations in the first half year, oil prices increased over the third quarter. The downward trend in international food prices observed in the second half of 2011 was sustained in the first months of 2012. However, third quarter's poor cereals harvest in the North America and Eastern Europe led to higher inflation of global food prices (see Section 1).

Energy product inflation followed the prices in international markets, accelerating in August and September after a period of moderation in mid-year. In October, a slight inflation decrease was recorded in this group. In the context of decreasing annual inflation of processed foods in the first half year, unprocessed foods recorded strong dynamics following international market prices in the third quarter of the year. Core inflation stayed at a low level, with a slight upward dynamics affected by the gradual acceleration of services inflation since the beginning of 2012.

In October food products (1.1 percentage points), goods and services with administratively controlled prices (0.9 percentage points) and energy products (0.8 percentage points) had the largest contribution to the annual inflation. Services and non-food goods (excluding energy products) contributed 0.5 and -0.2 percentage points respectively in October.

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

(percentage points, %)



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

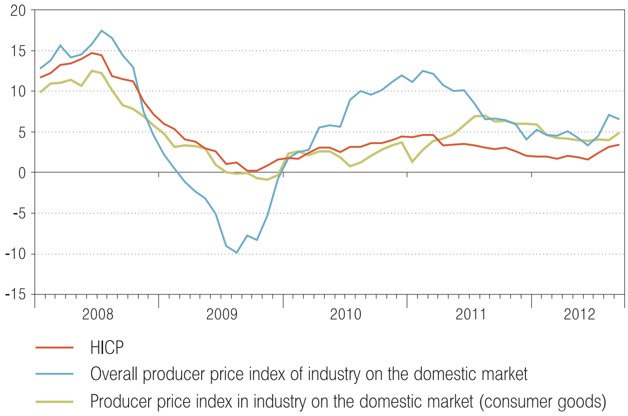
Sources: NSI, BNB.

The effect of external factors on consumer price dynamics in Bulgaria may be seen in the data on the import deflator and domestic industrial producer prices. Over the first and second quarters of 2012 the goods and services import deflator increased on an annual basis by 7.7 and 6.6 per cent respectively. The producer price index (PPI) in industry for the domestic market maintained relatively constant rates in the first half of 2012 unlike September when its annual growth rate was 6.6 per cent (4.5 per cent on average between January and June 2012). Manufacturing and production and distribution of electricity and heating, gaseous fuels and water had the largest contribution to the annual inflation of producer prices in September. The price dynamics in these two groups observed since July was due to the rise in producer price inflation of energy products and increased electricity in the regulated market. In September food output contributed significantly to the rise in manufacturing industry. In the group of energy products, producer prices followed petroleum price developments.[1]

[1] The Major Industrial Groupings classification was used to cover the following sectors: intermediate consumption goods, energy product production and water related activities, investment product manufacturing and consumer goods production. The energy products group calculations exclude production and distribution of electricity and heating, gaseous fuels and water supply, sewerage, waste management and remediation activities (energy products excluding E and F sectors).

Rate of Change in PPI in Industry and HICP

(% on corresponding month of previous year)



Source: NSI.

Core inflation, comprising industrial goods prices (excluding energy) and services prices was marked by slight upward dynamics, though remaining comparatively low since early 2012.[2] Over the first and second quarters of 2012 core inflation was 0.1 and 0.2 per cent on an annual basis against an average annual increase of 0.3 per cent in 2011. In the third quarter it reached 0.4 per cent, accelerating to 0.5 per cent in October. Among core inflation components, non-food prices continued to decrease modestly on an annual basis, reflecting mainly durable goods dynamics. On the other hand, the annual rates of change in services prices (excluding those with administratively controlled prices) have increased gradually since early 2012, which led to relatively stronger dynamics of core inflation.

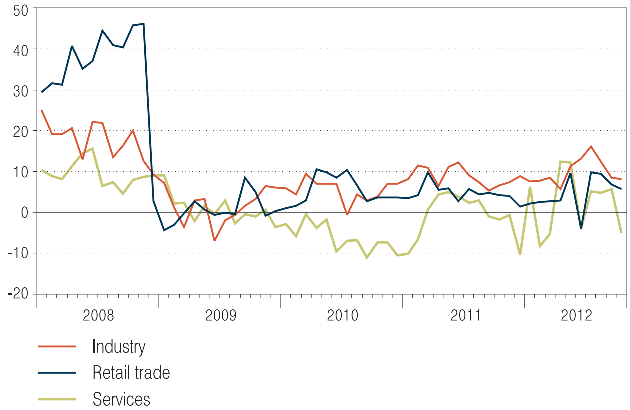
In the context of continuing uncertainty about the economic situation, firms maintained their cautious policy as regards employment and investment expenditure, which is also reflected in their pricing policy. Limited labour costs reflected on the slowing annual growth of unit labour costs in the first half of 2012 *vis-à-vis* the second half of 2011. Data on gross operating surplus in economy evidenced a slight decrease in firms' profit margins on an annual basis. Developments in these indicators show comparatively low effects of internal factors on overall inflation, which may be seen in the retention of core inflation at a low level.

[2] In 2012 the weight of goods and services whose prices are included in core inflation was 45 per cent in the consumer basket (46 per cent in 2011).

The business climate survey between January and July recorded slightly increased expectations of selling prices in industry, retail trade and services. At the end of the third and beginning of the fourth quarter, these three sectors reported declines in the balance of opinions on the assessments of selling price increases in the following months, with the balance in industry remaining highest since 2011.

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

(balance of opinions, %)



Source: NSI.

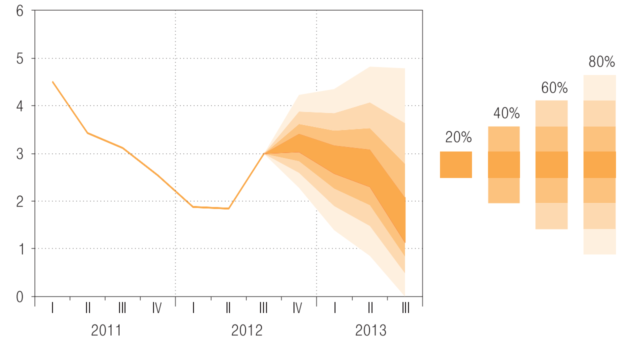
Our inflation expectations for the following quarters and the associated uncertainty are presented in the fan chart on the annual inflation rate.[3] We project a moderate inflation increase *vis-à-vis* the current levels between 2.8 and 3.6 per cent in the fourth quarter of 2012 and a slight decrease to close to current levels of 2.2 to 3.5 per cent in the first quarter of 2013.[4] The projected overall inflation dynamics reflects a slow rise in core inflation in the context of a gradual improvement in consumer demand. Annual food inflation rates are projected to follow an upward trend in the fourth quarter of 2012 and the first quarter of 2013 driven by rising international food prices and a base effect of lower growth in this group over the first quarter of 2012. Our expectations for the fourth quarter are for an upward trend in energy product price dynamics unlike the first quarter of 2013 when this group's inflation is projected to slow down under oil price stabilisation assumptions.

[3] For further details, see the box entitled *Measuring and Presenting Uncertainty in Projections of Economic Indicators*, Economic Review, 1/2012.

[4] Thus presented ranges of the expected annual growth rate of inflation correspond to 40 per cent probability distribution according to our expert forecast of the probability distribution for the relevant quarter.

Fan Chart of the Expected Annual Inflation Rate

(%)



Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The middle band of the chart, depicted in the darkest colour, includes the central projection. Probability distribution assigns 20 per cent probability for the actual value to fall in this band in each of the quarters. If neighbouring bands (in the same brighter colour) are added to the middle band, there would be 40 per cent coverage of the probability mass. Thus, by adding each same colour couple of bands, the probability for the value to fall there would be increased by 20 percentage points to reach 80 per cent. The probability for the value to remain outside the coloured part of the chart is 20 per cent based on the distribution chosen.

Source: BNB.

Major risks for the expected inflation dynamics in the following two quarters stem from the uncertainty around global oil and food price developments. Lower effects are estimated to come from internal factors, *i.e.* economic activity performance and possible rises in administratively controlled prices.

Higher than expected increases in global oil and food prices may lead to higher than expected overall consumer price inflation in Bulgaria. However, the significant oil price fall would be a factor for comparatively low overall inflation. Similarly, lower than expected core inflation, as a result of slower than projected increase in consumer demand, may also apply downward pressure. International commodity market situation by mid-November gives grounds for our projection of relatively balanced risks to inflation in the fourth quarter of 2012 and the first quarter of 2013.

Food Prices

The trend of the second half of 2011 towards annual food inflation slowdown as a result of the weakening dynamics of processed food prices continued in the first months of 2012. In the context of rising international food prices, inflation in this group accelerated due mainly to the significant increase in unprocessed food prices. In October annual food inflation accounted for 4.4 per cent (4.0 per cent in December 2011). The total

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

	Inflation accumulated as of October 2011 (December 2010 = 100)		Inflation accumulated as of October 2012 (December 2011 = 100)		Annual inflation rate as of October 2012 (October 2011 = 100)	
Inflation (%)	1.7		2.7		3.0	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
Foods	**3.3**	**0.78**	**3.7**	**0.96**	**4.4**	**1.13**
Processed foods	4.9	0.76	1.7	0.30	2.3	0.39
Unprocessed foods	0.3	0.02	7.9	0.66	8.9	0.74
Services	**-0.1**	**-0.03**	**0.7**	**0.18**	**1.9**	**0.48**
Catering services	3.0	0.15	2.7	0.14	3.5	0.18
Transport services	3.6	0.13	2.3	0.10	3.7	0.15
Telecommunication services	-1.3	-0.06	-0.9	-0.04	-1.4	-0.07
Other services	-2.0	-0.25	-0.1	-0.01	1.9	0.22
Energy products	**6.1**	**0.44**	**11.3**	**0.98**	**9.1**	**0.83**
Transport fuels	6.3	0.44	11.4	0.93	9.0	0.73
Industrial goods	**-0.2**	**-0.05**	**-1.1**	**-0.22**	**-1.3**	**-0.25**
Goods and services with administratively controlled prices*	**3.7**	**0.57**	**4.9**	**0.80**	**5.3**	**0.86**
Tobacco products	**-0.3**	**-0.02**	**0.0**	**0.00**	**0.0**	**0.00**

* Administratively controlled prices are calculated at an elementary aggregates level in the consumer basket.

Note: To compare the structure of consumer basket in the 2010–2012 period, see Economic Review, issue 1/2012.

Sources: NSI, BNB.

contribution of food prices to the annual consumer price inflation was 1.1 percentage points in October, with unprocessed foods contributing most significantly to it (0.74 percentage points).

The annual inflation of unprocessed foods (meat and meat products, fruit, vegetables and fish) which maintained comparatively low rates in the first months of 2012 posted a sizable increase to 11.7 per cent in September and 8.9 per cent in October (1.1 per cent on average between January and June 2012). Vegetables, meat and meat products, and fruit had the major contribution to this increase. On the one hand, price rises in the group of meat and meat products, of which pork had the largest contribution, reflect poor cereals harvest in the North America and Eastern Europe due to the long period of drought which led to higher animal feed prices and greater pork producers' costs. On the other hand, price rises in the other two groups with major contributions to unprocessed food inflation (fruit and vegetables) were a result of the stronger dependence of the Bulgarian market on imports over the recent years. From 2008 to October 2012 imports of vegetables and fruit increased by approximately 11 per cent, while domestic output declined by around 64 per cent.[5] Lower domestic harvests due to the prolonged drought in the summer was an additional factor which affected Bulgarian agricultural firms and unprocessed food prices.

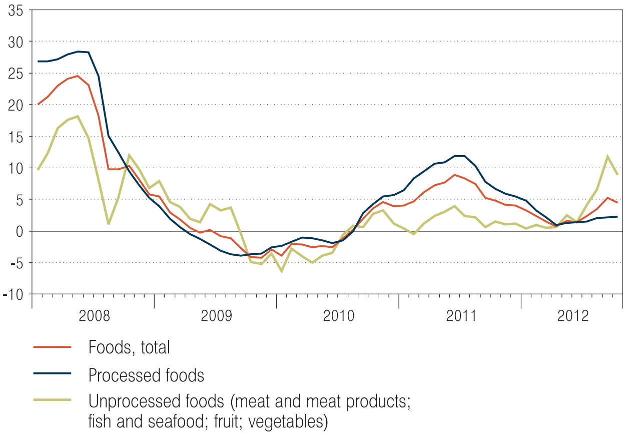
After the slowdown observed from mid-2011 to April 2012, annual inflation of processed foods has increased since May. This in turn also contributed to the higher overall food inflation, though significantly less than the prices of unprocessed foods. The annual growth in processed foods prices was 2.3 per cent in October. Data evidence comparatively high dependence of the processed food group on the overall situation on external markets.[6]

[5] NSI data on external trade and agricultural production are used.

[6] See the box entitled *Food and Fuel Price Dynamics between 2007 and 2010,* Economic Review, 3/2010.

Rate of Change of Food Price Index

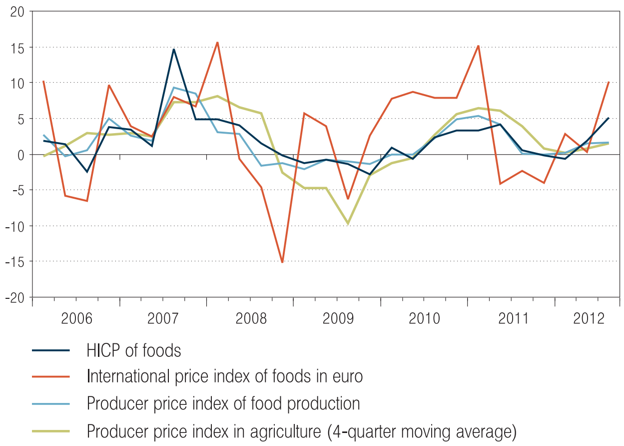
(%, on corresponding month of previous year)



Sources: NSI, BNB.

Dynamics of Producer Prices in Agriculture, International Food Prices, Producer Prices in Food Production and Consumer Food Prices

(% quarter-on-quarter)



Note: Data are seasonally adjusted *via* the TRAMO SEATS programme by using automated set up for diagnostics and optimisation of adjustment.

Sources: NSI, ECB, BNB.

International food price developments signal a possible additional acceleration in food product inflation over the fourth quarter of 2012 and the first quarter of 2013 (see Chapter 1, Section *International Prices*). Inflation in this group will also reflect a spillover, with a certain lag, of still materialised food price rises in international markets over the third quarter. Higher unprocessed food price rises may have an indirect effect on some other prices in the group of foods.

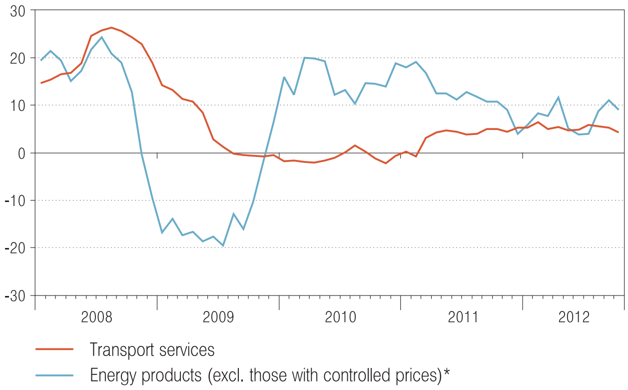
Energy Product Prices

Over the first months of 2012 the annual inflation rate of transport fuels accelerated to 11.9 per cent in April.[7] Following the essential moderation over the second quarter of 2012, fuel inflation accelerated again in the third quarter. In September annual transport fuel inflation was 11.2 per cent (4.0 per cent in December 2011). In October it slowed down, with its annual rate of change reaching 9.0 per cent and the contribution to overall inflation 0.7 percentage points.

The significant fluctuations in transport fuel prices between January and October 2012 followed with a delay of one month the movements of euro oil prices in international markets.

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

(%, on corresponding month of previous year)

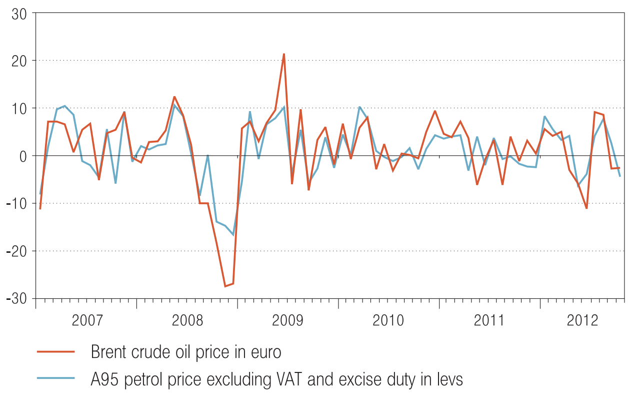


* Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB.

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

(%)



Sources: ECB, NSI, BNB.

[7] Transport fuels have the largest share in the group of energy products (excluding administratively controlled prices of electricity and heating); hence, their price developments determine the overall price dynamics of energy products.

Based on assumptions of rising oil prices in December, energy product price dynamics are expected to follow an upward trend. If assumed that oil prices will stabilise in the first quarter of 2013, a further deceleration of this group's inflation is expected.

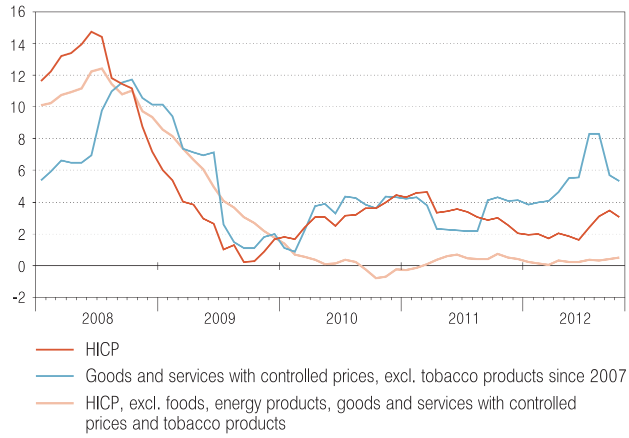
Administratively Controlled Prices and Tobacco Product Prices

Between January and October 2012 administratively controlled prices rose by 5.5 per cent on average compared with the corresponding period of the previous year. Inflation in this group accelerated most significantly in July (to 8.3 per cent on an annual basis against 5.5 per cent in June) reflecting the increase in the regulated price of electricity for households. In September and October inflation of administratively controlled prices slowed down and the year-on-year rate of change reached 5.3 per cent in October, contributing 0.9 percentage points to overall inflation.

Household electricity price rises in July and healthcare services price increases in May had the most significant contribution to overall consumer price inflation between January and October. As from July marginal electricity prices for households were changed which led to a 13.2 per cent average rise on the previous month. In October their contribution to the annual inflation was 0.52 percentage points. The increase in healthcare prices was due to the growth in minimum wage in May, accounting for 7.4 per cent in hospital prices and GP fees. Changes in marginal heating prices by region were approved in April and average prices rose by 7.8 per cent compared with the previous month. The State Energy and Water Regulatory Commission approved a second change in early July. As a result, average heating prices rose slightly by 0.6 per cent on a monthly basis. Heating prices are expected to affect inflation in administratively controlled prices in the last quarter of 2012. However, since their weight in the consumer basket is comparatively low (about 0.9 per cent in 2012), the effect on the overall inflation is estimated as weak. Increases in water supply prices, railway and urban transport fares, refuse levies and central gas supply prices (due to natural gas price changes) had a comparatively smaller contribution to overall inflation. The moderation in administered price inflation in September and October was mainly due to the base effect of the increased healthcare prices reflecting the September minimum wage rise.

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

(%, on corresponding month of previous year)



Note: Given the fact that tobacco product prices are largely dependent on administratively controlled excise rates, tobacco products are discussed separately from the group of goods and services with non-controlled prices, regardless of the liberalisation 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.

No final information on possible adjustments of administratively set prices is available for the next two quarters. Hence, we expect certain moderation in the annual growth rate of regulated prices in the fourth quarter of 2012 and the first quarter of 2013.

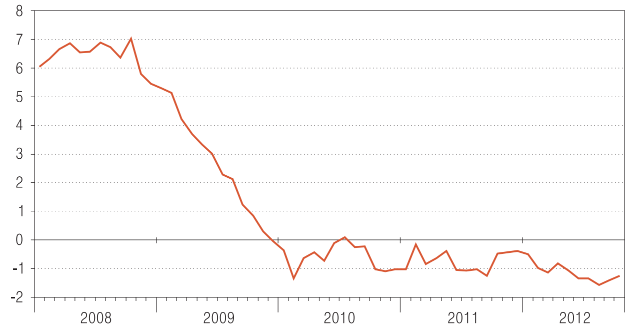
In the January to October period prices of tobacco products whose excise duties remained unchanged in 2012 decreased slightly on an annual basis (-0.1 per cent on average). In the absence of changes in excise duties of tobacco products in 2013, their prices are expected to stay close to the current levels in the first quarter of 2013.

Non-energy Industrial Goods Prices

The previous two years' trend towards a slight deceleration in the non-food price index (excluding fuels) was sustained between January and October 2012. In October the annual rate of change in the prices of industrial goods was -1.3 per cent (-0.4 per cent in December 2011), contributing -0.2 percentage points to overall inflation.

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

(%, on corresponding month of previous year)



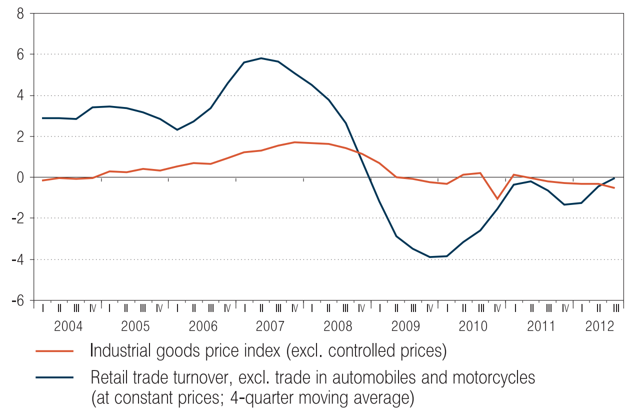
Sources: NSI, BNB.

The decrease in the overall price index in this group over the review period was mainly driven, as in the previous year, by the price falls in durable goods, such as automobiles, audio equipment, computers and TV sets. This trend reflects both the weak consumer demand in this segment and enhanced competition in retail trade.[8]

Non-durable goods were marked by low positive inflation with a slight downward trend in its rates over the review period.

Rate of Change of Retail Trade Turnover (at Comparable Prices) and of Industrial Goods Prices

(% quarter-on-quarter change)



Note: Data are seasonally adjusted *via* the TRAMO SEATS programme by using automated set up for diagnostics and optimisation of adjustment.

Sources: NSI, BNB.

The anticipated consumer demand recovery in the following two quarters may exert an upward pressure on the prices of some goods in this group.

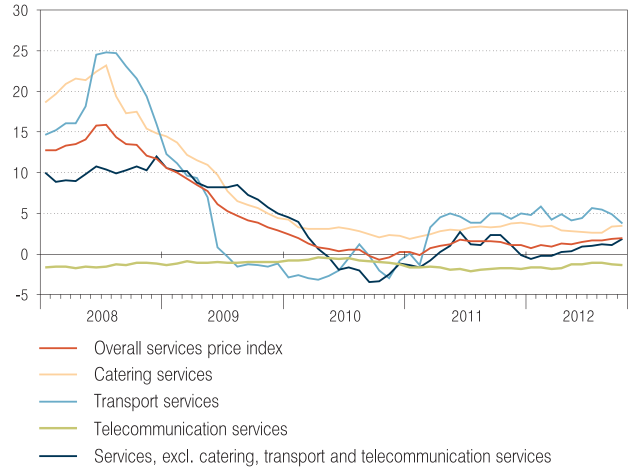
[8] For the analysis of trade developments in the new Member States, see *Structural Features of Distributive Trades and Their Impact on Prices in the Euro Area*, ECB Occasional Paper Series, No. 128, September 2011, the box *The Distributive Trades in the New Member States*, p. 55–59.

Services Prices

Between January and October 2012 a slight upward inflation drift was observed in the services prices (excluding administratively controlled prices). In October annual services inflation was 1.9 per cent (1.1 per cent in December 2011) and the services group contributed 0.5 percentage points to overall consumer price inflation.

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

(%, on corresponding month of previous year)



Sources: NSI, BNB.

Inflation in transport services (excluding railway and urban transport fares) retained its relatively constant level of the last ten months. On an annual basis, it averaged 4.8 per cent for the January to October period, with this group contributing 0.2 percentage points to overall inflation. Comparatively higher inflation in transport services compared with the overall services inflation was driven by external factors (mainly oil prices).

Between January and October 2012 catering inflation remained at relatively constant levels, slightly falling in the summer months. In October annual inflation in this group came to 3.5 per cent (3.8 per cent in December 2011) with a 0.2 percentage point contribution to overall inflation.

The index of telecommunication services prices (telephone services, apparatus, internet services) which has been following a continuous downward trend over the recent years declined on an annual basis by 1.4 per cent in October 2012 (a 1.8 per cent fall in December 2011).

Services inflation, excluding catering, transport and telecommunication services, was marked by an insignificant upward trend observed since April. In October annual inflation in this group was 1.9 per cent, an increase compared to the end of the previous year (-0.1 per cent in December 2011). The main driving factor was the inflation in the group of accommodation services and package holidays which increased in October on an annual basis for the first time since early 2011. The gradual recovery in consumer demand over the fourth quarter of 2012 and first quarter of 2013 is expected to exert inflationary pressure on the prices of services, boosting further inflation in this sector.