

Economic Review

1/2013



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

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

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Abbreviations

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

The 2012 recession in the euro area contributed to global economic activity slowdown. The improvement of the global composite PMI indicator in the second half of 2012 was followed by its decline in early 2013, though remaining at a level showing a positive rate of economic growth. Global economic indicators showed divergent dynamics across sectors: expectations for developments in manufacturing started to improve in the first months of 2013, while confidence in the services sector posted a decline on the end of the previous year. By region, global indicator dynamics was also divergent in early 2013. Euro area indicators continued to deteriorate, while the expectations for new orders, employment and production in the USA and China continued to increase. Signals of an improvement of the business environment were reported in emerging economies as well. Projections point to a gradual increase in the global economic activity over the second and third quarters. Euro area growth is expected to recover in the second half of the year, but at a low rate, which will have a negative impact on the growth of Bulgarian exports. However, the increased demand in emerging economies is likely to continue supporting Bulgarian exports.

Global inflation continued to slow down on an annual basis over the first four months of 2013, reflecting lower economic activity in most regions of the world, as well as weaker dynamics of international commodity prices. These developments also exert downward pressure on domestic inflation. Reflecting the price dynamics in global commodity markets, the terms of trade for the Bulgarian economy are expected to further improve over the projection horizon, thereby boosting nominal exports of the country.

As a result of the interaction between external and domestic economic factors and of the resulting financial flows, Bulgaria's international foreign exchange reserves continued to increase on an annual basis. In March the overall current and capital account balance remained in surplus on an annual basis. The relatively high savings rate maintained in the economy against the background of weak investment growth contributed to the improvement of the current account balance in the second half of 2012 and in early 2013. In the second and third quarters of 2013 households' propensity to save is expected to remain at its current level and the overall current and capital account balance to remain positive.

In the context of growing deposits and weak lending, banking system liquidity remained high. Banks continue to hold a large part of their liquidity as excess reserves on their accounts with the BNB and as funds on their accounts in the national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2-BNB). Banks have used another part of their available resources to manage their net external assets by increasing foreign assets and reducing external indebtedness. Another part of the available liquidity is invested in government securities, primarily of the Bulgarian government.

Non-government sector credit growth rate has slowed even further, a trend since the second half of 2012, driven mainly by the increase in claims on non-financial corporations, while bank claims on households have recorded a slight decline. Households' deposits are expected to grow further in the second and third quarters of 2013 and banks to preserve their high liquidity level. Monetary aggregate M3 will continue to rise at relatively high rates, with a slight tendency of deceleration. The current rates of private sector credit growth are anticipated to be sustained over the projection horizon.

Economic activity in Bulgaria continued to slow down in the fourth quarter of 2012 influenced by the unfavourable factors stemming from the euro area recession. The deterioration of the external environment and the enhanced level of uncertainty affected the behaviour of households, which retained their

high propensity to save and decreased the consumption growth. Firms continued to invest cautiously mainly to improve effectiveness due to the lack of clear signs of rapid recovery of economic activity both in the euro area countries and in Bulgaria. Firms' flexibility and ability to penetrate the new markets partly offset the negative impact of euro area recession on exports. The downward trend in domestic demand growth affected adversely imports which declined at a rate stronger than the rate of exports. As a result, net exports contributed positively to economic growth in the fourth quarter of 2012.

The still depressed labour market had a negative impact on consumer confidence, which remained below its long-term average. Although the nominal wage *per* employee continued rising, the firms' conservative policy of labour cost optimisation contributed to a slight decline in the overall wage bill. The decline in the latter indicator coupled with households' high propensity to save adversely affect consumption demand, resulting in lower retail trade turnover (at constant prices) and lower industrial turnover on the domestic market. Despite these unfavourable trends since early 2013, external demand started to recover and contribute to the upturn in the economic activity of industry measured by industrial production index.

Based on current information, domestic demand is expected to remain close to its levels as of the first quarter of 2013 and to start recovering at slow rates along with the strengthening of external demand in the second half of the year. The spare production capacity available and the still subdued managers' expectations about the future economic activity would have a dissuasive effect on the dynamics of private sector investment activity. On the other hand, the planned increase in government capital expenditure in 2013 is projected to contribute positively to the overall investment activity. The simultaneous improvement of domestic and external demand is anticipated to accelerate real GDP growth in the second and third quarters of 2013 against the background of currently low economic activity. Risks to this outlook are broadly balanced. However, if the growth rates of exports reported at the end of 2012 and in early 2013 are sustained, a faster-than-expected recovery of exports in 2013 may be anticipated. On the other hand, in case of further deterioration of economic agents' confidence due to lack of clear recovery prospects for the euro area, the probability of slower domestic demand recovery in the second and third quarters of 2013 will increase.

The downward trend in inflation which occurred in the beginning of the fourth quarter of 2012 was sustained in the first four months of 2013. In April an annual inflation rate of 0.9 per cent was reported (against 2.8 per cent in December), and the average annual inflation for the last 12 months came to 2.4 per cent. Fuel prices and the decrease in the administered end-user price of electricity for households of March 2013 contributed most to the deceleration of inflation. Deflationary trends were observed in prices of telecommunication services and non-energy industrial goods. Food prices, affected by the strong increase in international food prices in the second half of 2012 and by internal factors associated with higher costs of food production, had the largest positive contribution to inflation since early 2013.

Core inflation, comprising services and non-food goods, remained relatively low since the beginning of the year and did not seriously contribute to overall inflation of consumer prices. The lack of internal pro-inflationary factors to influence core inflation reflects the weak household consumption and firms' policy of increasing efficiency and reducing costs.

The downward trend in inflation is expected to continue in the second and third quarters of 2013 largely due to the negative contribution of administratively controlled prices and retained weak energy and core inflation dynamics.

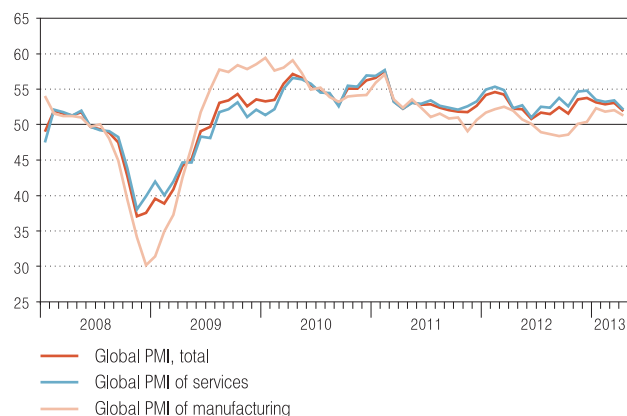
1. External Environment

The 2012 recession in the euro area contributed to global economic activity slowdown. Inflation in the euro area and in the United States remained stable, with the consumer price index reporting a decrease. The euro area economic activity is expected to start recovering slowly in the second half of 2013 and to support global economic recovery.

Current Business Situation

Following the increase in the second half of 2012 the global economic indicator (global PMI) posted a minimum decline in the first quarter of 2013. Economic indicators showed divergent dynamics across sectors: expectations of manufacturing developments started to improve in the first months of 2013, while confidence in the services sector posted a decline on the end of the previous year. Global economic indicators continued to stay over 50 which suggests a positive rate of economic growth (including across sectors).

Global PMI



Source: JP Morgan.

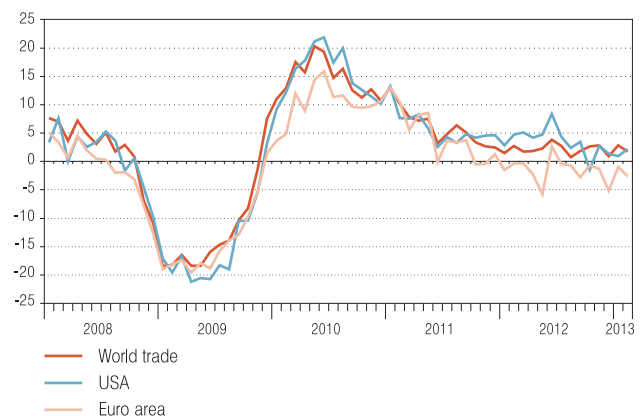
By region, global indicator dynamics was also divergent in early 2013. Euro area indicators continued to worsen, while the expectations of new orders, employment and production in the USA and China continued to increase. Signals of an improvement of the business environment were also reported in emerging economies.

The volume of world trade rose in early year, with emerging economies contributing most significantly to growth. The US foreign trade also

continued to increase while the euro area foreign trade turnover continued to slow down, though at a lower rate.

World Trade

(annual rate of volume growth, per cent)



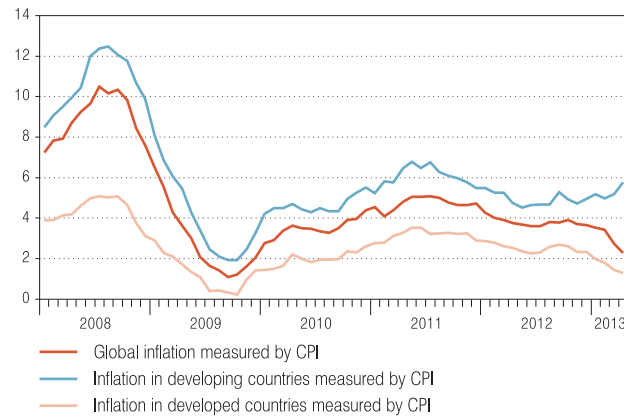
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Expectations point to a gradual increase in the global economic activity over the second and third quarters of 2013. Euro area growth is projected to recover in the second half of the year, though at a low rate. Therefore, the weak economic activity in the euro area will have a dampening effect on growth of Bulgarian exports. However, the increased demand in emerging economies is expected to have a positive effect on Bulgarian exports growth.

Global inflation continued to slow down on an annual basis over the first three months of 2013, reflecting lower economic activity in most regions of the world, as well as the weaker dynamics of commodity prices traded in international markets. By region, inflationary pressure subsided significantly in advanced economies and weaker in developing countries. These developments had a downward effect on domestic inflation.

Inflation Measured by CPI

(per cent, annual rate of change, seasonally adjusted data)



Source: World Bank

Euro area

According to Eurostat data the euro area recession deepened in the fourth quarter of 2012 and the real GDP declined by 0.9 per cent on an annual basis against 0.7 per cent in the third quarter.

On a quarterly basis the real GDP decline came to 0.6 per cent (against -0.1 per cent in the previous quarter). GDP components with a negative contribution to growth were household consumption (-0.2 percentage points), investment (-0.2 percentage points) and inventories (-0.1 percentage points). Net exports and government consumption remained neutral in terms of growth with zero contribution to GDP. Factors adversely affecting domestic demand were high unemployment, continuous uncertainty of financial markets and fiscal consolidation.

Based on preliminary data euro area GDP decline intensified in the first quarter of 2013 to 1 per cent on an annual basis and accounted for 0.2 per cent on quarterly basis.

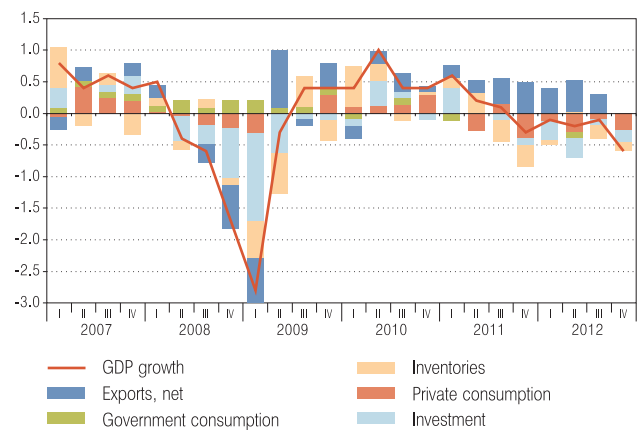
GDP data by country for the fourth quarter of 2012 suggest strongly divergent growth rates in euro area countries. On an annual basis economic growth in Germany moderated significantly to 0.3 per cent (against 0.9 per cent in the previous period). Over the same period the real GDP in France fell by 0.3 per cent on an annual basis (against 0 per cent in the previous period). In Spain the decline accelerated to 1.9 per cent on an annual basis (against -1.6 per cent in the previous period) and in Italy to 2.8 per cent (against -2.6 per cent in the previous period). Estonia reported the largest GDP growth on an

annual basis (+3 per cent), while Greece¹ and Portugal reported the strongest decline: -5.7 per cent and -3.8 per cent respectively.

In the fourth quarter of 2012 a quarter-on-quarter decline in real GDP was reported in Spain (-0.8 per cent), Italy (-0.9 per cent), Cyprus (-1.2 per cent), the Netherlands (-0.4 per cent), Austria (-0.1 per cent), Belgium (-0.1 per cent), Portugal (-1.8 per cent), Finland (-0.6 per cent), Malta (-0.2 per cent) and Slovenia (-1 per cent)². In Germany and France GDP declined from the previous quarter by 0.7 per cent and 0.2 per cent respectively (against a previous increase of 0.2 per cent and 0.1 per cent).

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

(per cent; percentage points)



Source: Eurostat.

The euro area economic confidence index in April 2013 decreased to 88.6 against 90.1 in March, while the business climate indicator went down to -0.93 (against -0.75 in March). With the March decline the upward trend in these indices observed since November 2012 reversed. The deterioration in the indices was attributable to a decline in sub-indices for all sectors. On the other hand, the euro area consumer confidence index of the European Commission improved to -22.3 (against -23.3 in March).

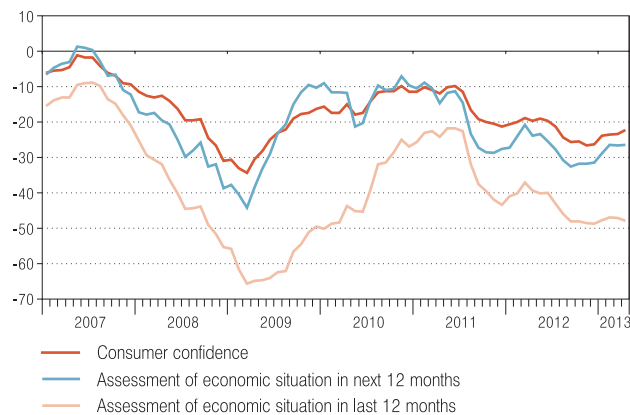
Over the first quarter of 2013 euro area PMI remained below 50, signalling contraction in the economic activity and worsened expectations about the economy. In March the composite PMI was 46.5 (against 47.9 in February) and manufacturing and services PMIs declined to 46.8 and 46.4 respectively (against 47.9 for

¹ Data have not been seasonally adjusted.

² No data published about Greece.

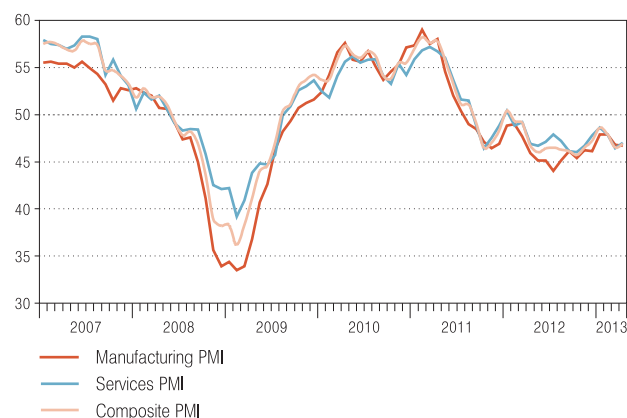
both indices in February). In April services PMI and the composite PMI went up to 47 and 46.9 respectively, while the manufacturing PMI decreased to 46.7.

Euro Area Consumer Confidence Indices



Source: European Commission.

Manufacturing and Services PMIs



Source: Markit.

Based on leading indicators dynamics, a decrease in euro area economic activity may be expected in the first months of 2013, while in the second half of the year (most likely in the fourth quarter) economic growth will start recovering.

According to the ECB March 2013 forecast, the GDP change will range between -0.9 per cent and -0.1 per cent in 2013 (previous forecast: -0.9–0.3 per cent) and between 0 per cent and 2 per cent in 2014 (previous forecast: 0.2–2.2 per cent). In May 2013 the EC forecasts pointed to a decline in euro area GDP by 0.4 per cent in 2013 and growth by 1.2 per cent in 2014 (previous estimates: -0.3 per cent and 1.4 per cent respectively).

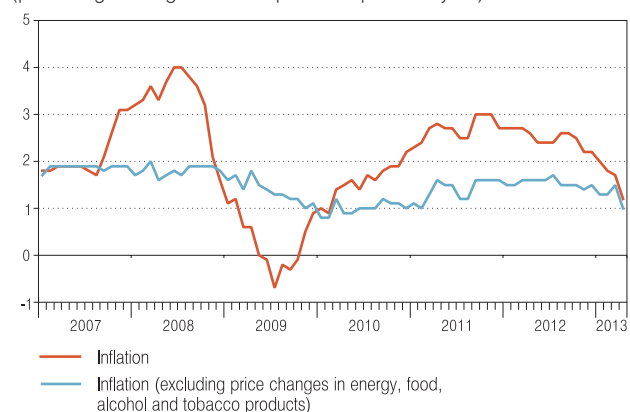
In April euro area inflation decreased to 1.2 per cent against 1.7 per cent in March and 1.8 per cent in February. On a monthly basis, HICP went down by 0.1 per cent compared with 1.2 per cent growth in March. The major factor behind the inflation decline was the fall in energy prices with lower domestic demand also contributing to this effect.

By index constituent, energy prices declined most in April by 0.4 per cent on an annual basis (against 1.7 per cent growth in March). Food prices rose by 2.9 per cent on an annual basis in April against 2.7 per cent growth for the previous two months. In March euro area core inflation slowed to 1 per cent on an annual basis against 1.3 per cent in February.

By country the lowest annual inflation in April 2013 was reported in Greece (-0.6 per cent), Cyprus (0.1 per cent) and Portugal (0.4 per cent). Estonia and the Netherlands were the countries with the highest inflation rates: 3.4 per cent and 2.8 per cent respectively. The annual rate of HICP in Germany showed to 1.1 per cent (against 1.8 per cent in March) and in France it moderated to 0.8 per cent (against 1.1 per cent in March). Lower inflation rates were also reported in Spain and Italy: 1.5 per cent and 1.3 per cent on an annual basis respectively (against previous values of 2.6 per cent and 1.8 per cent respectively).

Euro Area Inflation Rate

(percentage change on same period of previous year)



Source: Eurostat.

According to ECB forecasts of March 2013 euro area inflation will range between 1.2–2 per cent (previous estimate: 1.1–2.1 per cent) in 2013 and between 0.6–2 per cent (previous estimate: 0.6–2.2 per cent) in 2014. According to the latest EC forecasts of May 2013 inflation in the

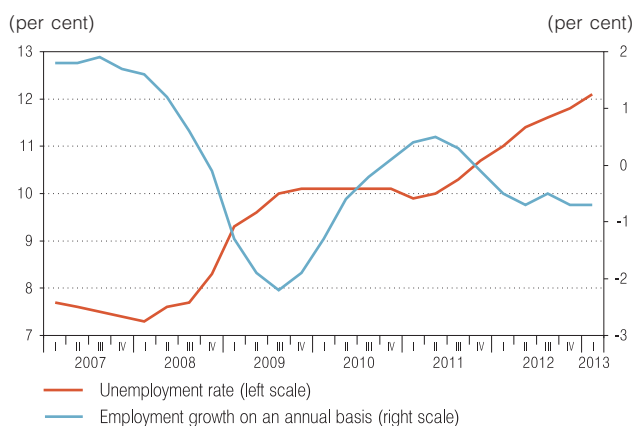
euro area will slow down to 1.6 per cent in 2013 and to 1.5 per cent in 2014 (previous estimates: 1.8 per cent and 1.5 per cent respectively).

The contraction of euro area economic activity continued to adversely affect the labour market. According to the data for the last quarter of 2012 employment in the region contracted by 0.7 per cent. The highest number of redundancies was recorded in construction (-4.8 per cent), agriculture (-1.4 per cent) and industrial production (-1.4 per cent).

In March 2013 unemployment in the euro area reached 12.1 per cent against 12 per cent in the previous two months. The indicator's level is high and continued to follow the upward trend in Greece³ (27.2 per cent), Spain (26.7 per cent) and Portugal (17.5 per cent). The lowest and most stable unemployment level was reported in Austria (4.7 per cent) and Germany (5.4 per cent).

Based on the business confidence survey data in March companies have not changed their plans on employment with the exception of construction sector companies where the expectations point to a slight decline. Households insignificantly improved their expectations about unemployment rate.

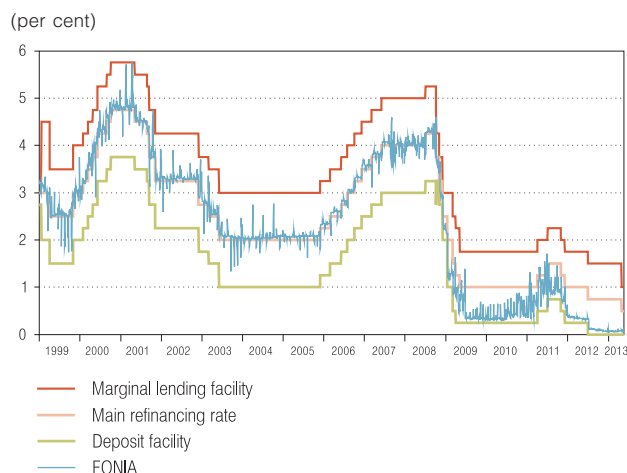
Euro Area Unemployment Rate and Employment Growth



The annual growth rate of unit labour costs in the fourth quarter of 2012 slowed down to 1.6 per cent (previous value 2 per cent) and productivity went down by 0.2 per cent on an annual basis (previous value -0.1 per cent).

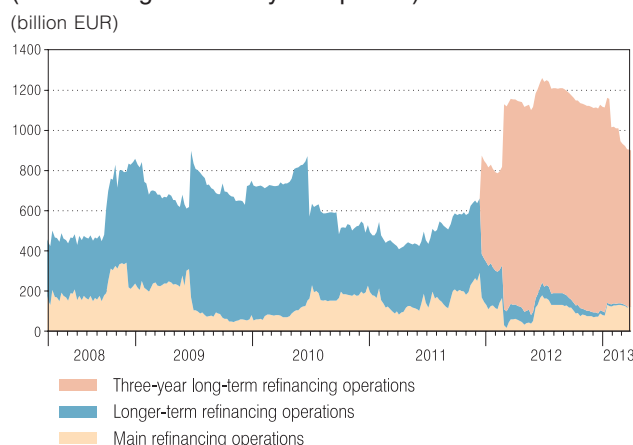
³ The latest available data are for January 2013.

ECB Interest Rates



Between January and April 2013 the ECB made no changes to its monetary policy and interest rates on the main refinancing operations, the deposit facility and the marginal lending facility which remained at 0.75 per cent, 0 per cent and 1.50 per cent respectively. ECB decisions were based on a comprehensive analysis of all available information about the dynamics of macro-economic indicators and monetary and credit aggregates. As there is a risk of overestimating the economic activity in the ECB projections, *i.e.* the expected recovery of growth in the second half of 2013 may not materialise or may have a lower than projected rate, the Bank is committed to keep the accommodative monetary policy for as long as needed. Risks to the annual inflation indicating a decrease to 1.2 per cent in April, were seen as balanced in the medium run.

ECB Refinancing Operations (outstanding amount by end-period)

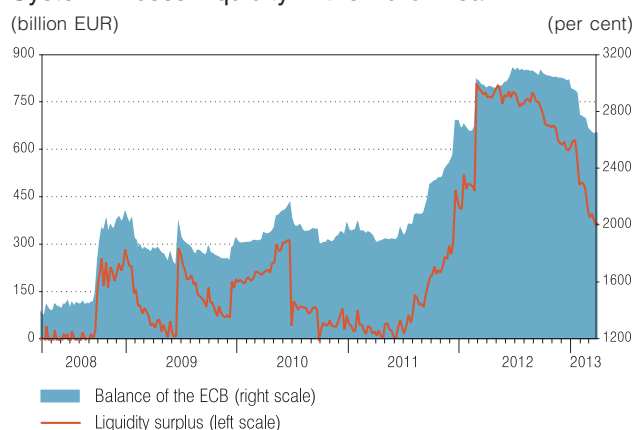


In the first quarter of 2013 the early repayment by euro area banks of the ECB longer-term refi-

financing operations started. Until the end of the quarter the repayments on the three-year operation of December 2011 amounted to EUR 158.6 billion (outstanding amount: EUR 330.6 billion), and that on the three-year operation of February 2012, EUR 79.1 billion (outstanding amount: 450.4 billion). In net terms, almost half of the funds provided under these longer-term operations were recovered. In addition, national central banks' data suggest that between January and March 2013 the amount of long-term refinancing provided by the ECB decreased most dramatically at Spanish⁴, French and German banks by EUR 69.5 billion, EUR 55.1 billion and EUR 48.1 billion respectively.

Early repayment of liquidity on the ECB three-year operations contributed to a significant decrease of excess liquidity in the euro area banking system. By the end of March 2013 the amount of excess liquidity decreased to EUR 359 billion (against EUR 597 billion by the end of December 2012). The ECB balance sheet declined by 12.3 per cent compared with December 2012 and reached EUR 2.648 trillion by end-March 2013. Refinancing operations declined to EUR 902 billion (against EUR 1.125 trillion by the end of December 2012) in the balance sheet assets and the funds on the deposit facility to EUR 145 billion (against EUR 262 billion by the end of December 2012) in the balance sheet liabilities.

The ECB Balance Sheet Figure and the Banking System Excess Liquidity in the Euro Area



Source: ECB.

⁴ Data on Spain are based on the average value for the period, while those on France and Germany are based on the end of period value. Source: central banks of the respective countries.

On 21 February 2013 the ECB published data on securities holdings acquired under the Securities Markets Programme (SMP) as at 31 December 2012. Based on the published data the outstanding amounts of Italian and Spanish government debt accounted for the largest share of total: 47.4 per cent and 20.9 per cent respectively.

Eurosystem's SMP Holdings as at 31 December 2012

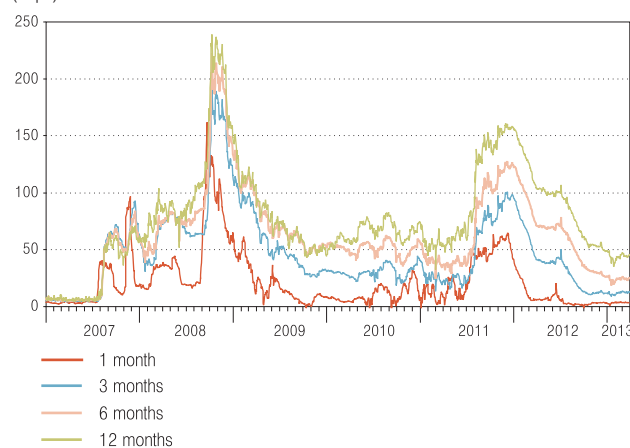
Issuer	Nominal amount (billion EUR)	Book value (billion EUR)	Relative share (per cent)	Average maturity (years)
Ireland	14.2	13.6	6.5	4.6
Greece	33.9	30.8	14.8	3.6
Spain	44.3	43.7	20.9	4.1
Italy	102.8	99.0	47.4	4.5
Portugal	22.8	21.6	10.3	3.9
Total	218.0	208.7	100	4.3

Source: ECB.

By the end of March 2013 the cumulative amount of the programme came to EUR 205.5 billion (against EUR 208.7 billion by end-December 2012), with reported decrease on end-December 2012 reflecting government securities with maturity at the end of January (Spanish) and in early February (Italian) amounting to EUR 3.35 billion.

Credit and Liquidity Risk Premium (Spread between EURIBOR and OIS)

(b.p.)



Source: European Banking Federation.

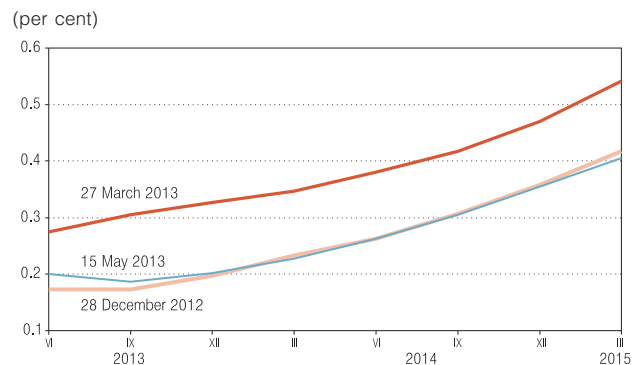
In the first quarter of 2013 euro area money market interest rates experienced a slight change. The EONIA reference overnight interest rate moved within the interval of 0.06 per cent and 0.13 per cent, with the average value for the period accounting for 0.07 per cent (against 0.08 per cent for the fourth quarter of 2012). EURIBOR interest rates on interbank

market deposits slightly increased. By the end of March 2013 interest rates with maturity of one month were at 0.12 per cent (an increase by 1 basis point on the end of December 2012), and those with maturity of six and 12 months at 0.34 per cent (2 basis points against the end of December 2012) and 0.55 per cent respectively (1 basis point against the end of December 2012). Risk premium for credit and liquidity risk measured by the spread between EURIBOR and overnight index swap (OIS) in the three-month and six-month maturity segment ended at 13 basis points (an increase by 1 basis point against the end of December 2012) and 25 basis points. (a decrease by 1 basis point against the end of December 2012).

By the end of March 2013 the market expectations based on the prices of 3-month EURIBOR futures contracts were for an unchanged money market interest rate. In April, however, markets started to incorporate a possible interest rate

decrease after the ECB signalled its readiness to intervene in case the worse than expected macroeconomic scenario materialises.⁵

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



Source: European Banking Federation.

⁵ At its meeting on the monetary policy of 2 May 2013 the ECB Governing Council cut the interest rate on main refinancing operations by 25 basis points to 0.50 per cent and on the marginal lending facility by 50 basis points to 1.00 per cent and left the interest rate on the deposit facility unchanged at 0 per cent.

The Crisis in Cyprus

Since the accession to the EU in 2004 the growth rate of real GDP in Cyprus has accounted for 4.0 per cent on average (on an annual basis) with growth in tourism and construction contributing most substantially. These two sectors were strongly impacted by the 2009 global economic and financial crisis. As a result, earnings from tourism and investment activity in construction significantly subsided. The real GDP in Cyprus decreased by 1.9 per cent in 2009. Property prices in 2009 went down by over 16 per cent and investment in new properties by more than 50 per cent and continued to gradually decline. By the end of 2012 the share of non-performing exposures in banks' portfolios increased to 15.5 per cent compared with 3.6 per cent by the end of 2008. As a result of the economic slowdown the state of public finances worsened with the budget surplus of 0.9 per cent of GDP in 2008 turning into a deficit of 6.1 per cent of GDP in 2009. Following a period of low economic growth in 2010 and 2011 the economy of Cyprus fell again in recession in 2012 and the real GDP declined by 2.4 per cent.

Between 2004 and 2008 the favourable tax regime of Cyprus attracted a sizeable amount of foreign capital, mostly from non-EU countries, with non-residents' deposits comprising 30 per cent of total deposits in Cypriot banks and rising from about 87 per cent of GDP in 2005 to 120 per cent of GDP in 2012. Relaxed lending practices were the major reason behind increasingly growing bank exposures to sectors as construction and real estate operations. The increase in mortgage loans prompted a rapid increase in property prices based on the Central Bank of Cyprus data residential property prices went up by 53 per cent between the first quarter of 2006 and reached a peak in the third quarter of 2008.

An important specificity of the Cypriot banking system is its close linkage with Greece. As a result Greek financial problems quickly spilled over to the banking system of Cyprus. The high dependence of Cyprus on Greece resulted from the high share of Greek government bonds in the banks' balance sheets and intensive operation of Cypriot credit institutions in Greece which are not autonomous legal entities (subsidiaries) subject to local capital and supervisory requirements but branches with a significant market share in deposits and loans in the banking system and the economy of Greece. Financial problems of Cyprus sharpened after restructuring of the Greek debt which was accompanied by losses suffered by Cypriot banks and significantly higher cost for servicing Cyprus' debt.

The need of financial support to the banking system of Cyprus was a result of the negative effect of the Greek crisis on Cypriot banks and of the sizeable amount of the Cyprus' banking sector. The specific tax regime in Cyprus and the application of particular business practices aimed at attracting foreign capital was a catalyst for

the inflow of foreign deposits in the period prior to the global crisis, mostly from non-EU countries, and led to an expansion of the banking system to a size exceeding many times that of the national economy. By the close of 2009 the banking system assets to GDP ratio of Cyprus reached 827 per cent. Given the amount of the banking sector assets and the significant losses incurred at the end of 2011 and in 2012 by several institutions from exposures to Greek debt, funds from the national budget turned out to be insufficient to support the banking system. This required an external assistance and in March 2013 the EU and IMF took a decision on providing financial support to Cyprus.

Following the negotiations with the Eurogroup on 25 March 2013 an agreement was reached on providing financial assistance to Cyprus of EUR 10 billion with

mandatory private sector involvement amounting to EUR 10.6 billion and provided the required macroeconomic and structural reforms are implemented to generate additional budget revenue. The agreement expires in 2016 and is based on two major pillars: structural reforms in the banking and public sectors and measures to stabilise the economy and the public debt. To ensure sustainable growth and a sound fiscal position in the long run, Cyprus committed to use the financial package of EUR 10 billion (the IMF participation is projected to amount to EUR 1 billion) for providing refinancing of maturing government debt, newly issued government debt and recapitalisation of banks (with the exception of Laiki Bank and Bank of Cyprus). In order to receive financial assistance to stabilise its public finances and implement the necessary structural reforms, Cyprus has to implement a number of measures such as putting a ceiling in the budget deficit, increase in the tax on capital gains and the statutory corporate income tax rate, as well as the implementation of other structural reforms and privatisation of state enterprises.

The plan for reform of the banking sector includes:

- restructuring of Laiki Bank, the second largest Cypriot bank with full involvement of shareholders, bondholders and holders of uninsured deposits (above EUR 100,000);
- splitting the bank into a 'good' and 'bad' bank. The good bank will be folded into the Bank of Cyprus which will take up Laiki Bank's obligation to repay the financing already extended under the ECB Emergency Liquidity Assistance (ELA), worth EUR 9 billion. Insured deposits up to EUR 100,000 will be fully protected;
- recapitalisation of the Bank of Cyprus through a conversion of uninsured deposits (above EUR 100,000) to equity and with the full involvement of equity shareholders and bondholders.

To avoid the risk of a bank run, banks in Cyprus were closed in the second half of March for more than a week and opened again on 28 March at reduced working hours. This was accompanied by capital controls and measures to limit the maximum amount of withdrawals from banks. The constraints were imposed with the approval of the European Commission and they were gradually eased. In early April the Greek Piraeus Bank will acquire all Greek branches of Laiki Bank and Bank of Cyprus for the amount of EUR 0.5 billion.

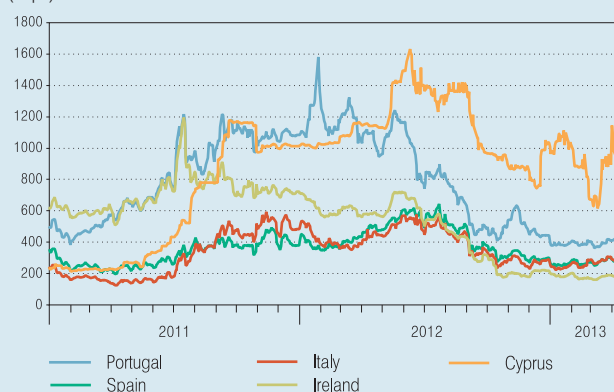
Based on the November 2012 estimate the involvement of depositors, creditors and shareholders in the rescue plan was expected to amount to EUR 7.5 billion. In the initial EC assessment of Cyprus' public finances sustainability published on 9 April this amount was revised upwards to EUR 13.3 billion due to expected worsening of macroeconomic environment and withdrawal of funds from the banking sector in the intermediate period. The measures implemented in Cyprus were non-conventional and entirely reflected the specificity of the national banking system. The Council of Finance Ministers of the euro area countries (the Eurogroup), the EC and the ECB explicitly stated that insured deposits in EU credit institutions in the amount of up to EUR 100,000 would remain protected and would not be subject to any similar actions upon initiating measures for restructuring and transformation of credit institutions.

Concerns about spill-over effect to other euro area countries proved unwarranted. The market effect was short-lived and reduced to an increase in sovereign and liquidity risk premia in mid-March.

After the announcement of the Financial Assistance Facility Agreement for Cyprus market expectations and risk premia started returning to previous levels.

Five-year Credit Default Swap (CDS) Spreads

(b.p.)



Source: Markit.

Economic Development of EU-7 Countries

In the fourth quarter of 2012 economic activity of EU 7 countries¹ started to decline. The real growth rate in Latvia remained high while the Czech Republic and Hungary reported a sizeable fall in real GDP. The real GDP of the EU-7 group totalled 0.1 per cent on a quarter-on-quarter basis (the same as in the previous quarter). Inflation in the group moderated reaching 0.6 per cent on average compared to 0.9 per cent in the third quarter. Falling international food and energy prices contributed most to this. The unemployment rate in most of these countries went up in the last quarter of the year.

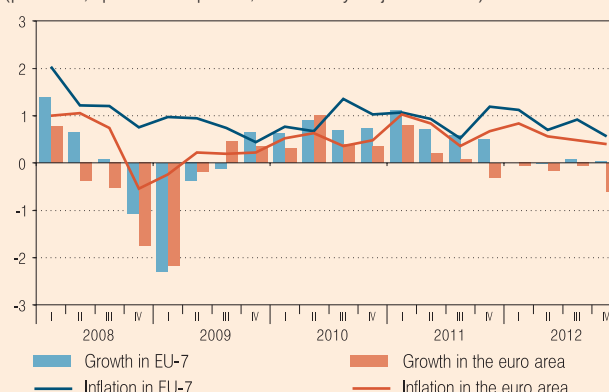
Latvia continued to report a relatively high growth rate in the fourth quarter of 2012 largely due to the higher domestic demand, in particular for investment. Net exports' contribution to growth was negative. Trade contributed most to the increase in gross value added by sector. Only the financial and insurance services sectors and the public administration sector reported negative contribution to growth. The seasonally adjusted unemployment rate declined marginally to 14.3 per cent. The downward trend in inflation observed since early 2011 continued in the fourth quarter of 2012 largely as a result of the falling international commodity prices. The central bank of Latvia did not change its reference interest rates over the last quarter of 2012 and in early 2013.

Real growth in **Lithuania** moderated over the last quarter of 2012 but remained relatively high. Net exports contributed most to this while investment reported a decline. All sectors of the economy except construction reported growth. Manufacturing and trade enjoyed high growth rates. The moderation in the last quarter of 2012 resulted in a decline in employment and a slight increase in the rate of unemployment. The less pronounced increase in administratively controlled prices and international fuel prices resulted in a decline in inflation over the last quarter of the year.

Economic growth in **Poland** slowed down in the fourth quarter of 2012. Net exports and government consumption had a positive contribution to growth. Private consumption and investment reported a decline. Business conditions in all sectors of the economy deteriorated. The financial and insurance services sector increased at the highest rates while construction and industry saw a decline. Inflation moderated further in the fourth quarter

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

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



Sources: Eurostat, own calculations.

Real GDP Growth

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

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

Source: Eurostat.

Contribution to Real GDP Growth

(per cent; percentage points)

Country	GDP growth, fourth quarter of 2012	Private consumption	Government consumption	Investment	Exports, net
Bulgaria	0.0	-0.5	-0.1	-0.1	1.2
Czech Republic	-0.2	0.4	0.2	-0.9	-2.2
Hungary	-0.9	0.2	0.0	-0.3	-1.4
Latvia	1.4	0.4	0.0	0.7	-0.1
Lithuania	0.7	0.7	0.0	-0.5	3.8
Poland	0.2	-0.1	0.1	-0.1	0.2
Romania	0.4	0.4	-0.8	-1.3	1.6

Sources: Eurostat, own calculations.

¹ EU-7 comprises the following countries: Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.

Inflation

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

Country	2010				2011				2012			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Bulgaria	0.7	1.4	0.7	1.2	1.1	0.4	0.4	0.6	0.4	0.5	1.4	0.5
Czech Republic	0.5	0.6	0.6	0.4	0.3	0.7	0.7	1.1	1.4	0.4	0.5	0.6
Hungary	1.0	1.0	1.2	1.1	0.7	0.9	0.9	1.6	2.0	1.0	1.4	1.0
Latvia	-0.7	0.6	1.0	0.9	1.3	1.3	0.9	0.6	0.6	0.4	0.4	0.3
Lithuania	0.8	0.3	0.8	1.0	1.0	1.7	0.7	0.5	0.6	0.9	1.1	0.3
Poland	0.5	0.4	0.9	1.0	1.3	0.8	0.7	1.4	1.1	0.6	0.6	0.3
Romania	1.7	1.0	3.4	1.5	1.4	1.6	-0.4	0.7	0.8	0.9	1.7	1.2
Average	0.8	0.7	1.4	1.0	1.1	0.9	0.5	1.2	1.1	0.7	0.9	0.6

Source: ECB.

Unemployment

(per cent; quarterly, seasonally adjusted data)

Country	2010				2011				2012			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Bulgaria	9.3	10.0	10.4	11.3	11.3	11.2	11.1	11.5	12.0	12.3	12.3	12.5
Czech Republic	7.7	7.2	7.1	7.0	6.9	6.8	6.6	6.5	6.8	6.9	7.0	7.2
Hungary	11.2	11.3	11.2	11.0	11.0	10.9	11.0	10.9	11.1	10.9	10.7	11.0
Latvia	21.2	20.5	19.4	18.2	17.1	16.7	16.0	15.6	15.4	15.2	14.4	14.3
Lithuania	17.4	18.3	18.4	17.8	16.7	15.6	14.9	13.8	13.6	13.3	13.0	13.2
Poland	9.8	9.6	9.5	9.5	9.5	9.6	9.7	9.9	10.0	10.0	10.2	10.4
Romania	7.5	7.2	7.2	7.2	7.2	7.4	7.5	7.4	7.3	7.1	7.0	6.7

Source: Eurostat.

quarter of 2012 inflation slowed down. The factors restraining inflationary pressure were international food and oil prices and the appreciation of the Romanian Leu on the euro. On the other hand, higher administratively controlled prices had a pro-inflationary effect. The Romanian central bank maintained its reference interest rate at 5.25 per cent taking into account the risks to a higher than projected inflation due to the inflationary pressure coming from international prices.

Over the last quarter of 2012 **Hungarian** economy contracted further on a chain basis and the rate of decline accelerated again. The main negative contributors to GDP by sector were agriculture, construction and manufacturing while by expenditure components net exports ranked first. The quarter saw unfavourable labour market dynamics, higher rate of unemployment and falling employment. Inflation declined as a result of the lower fuel prices, weak domestic demand and stronger Hungarian forint. The Hungarian central bank gradually lowered its main policy rate in several successive steps by 25 bps each and in April 2013 it reached 4.75 per cent.

Economic activity in the **Czech Republic** contracted further and the country reported a real fall in the GDP for a fourth consecutive quarter. These developments were largely due to the decline in net exports and decreasing investment on a quarter-on-quarter basis. All sectors of the economy reported declines or insignificant growth. Weakening economic activity had a negative effect on labour market and the unemployment rate continued to increase in the fourth quarter of 2012. Over the same period inflation in the Czech Republic remained low due to the weak economic activity and the moderate price rise of some imported goods. At its November 2012 meeting the Governing Council of the central bank of the Czech Republic cut its main policy rate (the two-week repo rate) by 0.2 percentage points to 0.05 per cent due to expected low inflation.

of 2012 largely due to weaker domestic demand and lower fuel prices. The economic slowdown in Poland over the same period has been accompanied by an increase in the rate of unemployment. Fears that the weak economic growth will result in inflation lower than the target level were the reason behind the central bank's decision to cut its benchmark interest rates by 1.5 percentage points between October 2012 and March 2013 when the reference rate fell to 3.25 per cent.

Net exports reported the strongest positive contribution to economic growth in **Romania** in the fourth quarter of 2012. Domestic demand contracted with a sizeable fall in investment. Agriculture had the largest negative contribution to growth by sector while the information and communication services sector reported the highest growth. Over the quarter employment remained unchanged while the rate of unemployment declined slightly. Over the last

United States

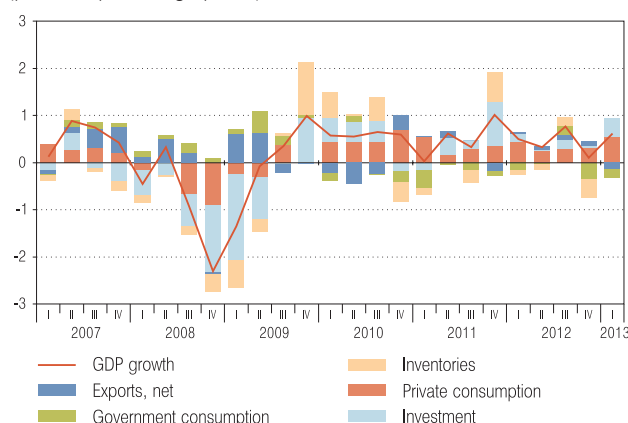
Economic growth in the USA slowed down on an annual basis to 1.7 per cent in the fourth quarter of 2012 against 2.6 per cent in the third quarter and 2.1 per cent in the second quarter. The US real GDP growth reached 2.2 per cent in 2012 against 1.8 per cent in 2011.

In the fourth quarter of 2012 growth slowed down to 0.1 per cent on a quarterly basis from 0.8 per cent in the previous quarter. A temporary factor which affected growth was Hurricane Sandy that impeded the supply of firms and had a strong negative contribution to the change in inventories (by 0.4 percentage points). Government expenditure and exports also contributed negatively to growth on a quarterly basis. The contribution of net exports was positive due to a significant decline in imports in the fourth quarter. On the other hand, the contribution of household consumption and household investments increased from the previous quarter and that of business investments changed from negative into positive.

Based on preliminary data in the first quarter of 2013, US real GDP increased by 0.6 per cent on a quarterly basis and by 1.8 per cent on an annual basis. Major factors behind the increase compared with the fourth quarter were the higher household consumption and the recovery in inventories.

Contribution to US GDP Growth by Component (Quarterly)

(per cent; percentage points)



Source: Bureau of Economic Analysis.

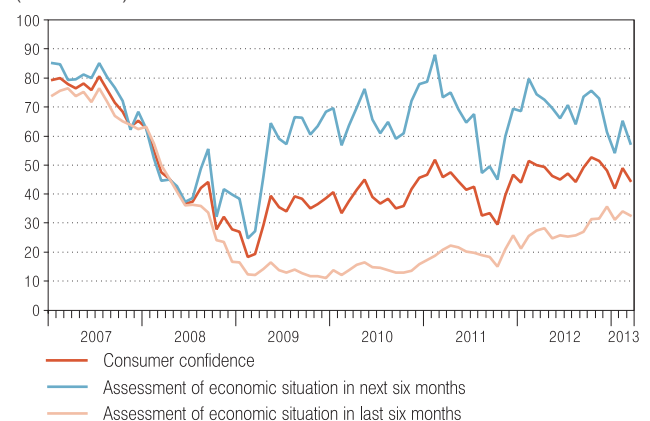
In the first quarter of 2013 US economic activity and consumer confidence indicators displayed volatile and divergent developments, reflecting mainly the lack of a consensus in the Congress between democrats and republicans about

fiscal policy priorities and the ways of reducing the US budget deficit and government debt. Automatic measures, effective as of early March, for reducing budget expenditure of about USD 85 billion for the financial 2013, on the restructuring and possible rescheduling of which no compromise was reached in the Congress, adversely impacted business and household economic expectations. The compromise reached in March between democrats and republicans on the adoption of a law providing for financing of government expenditure until 30 September, when the current fiscal year ends, smoothed to a certain degree the unfavourable effect on consumer and business sentiment after the implementation of the said measures. With the adoption of this law the threat of interrupting government administration operation at the end of March was avoided.

Consumer confidence measured by the University of Michigan consumer confidence index increased in the first quarter, and in March reached 78.6 percentage points against 77.6 percentage points in February. The April estimate however suggested a decline in the indicator to 76.4 percentage points. The Conference Board Consumer Confidence Index in March indicated a significant fall to 61.9 percentage points against 68 percentage points in February. In April the indicator increased to 68.1 percentage points.

US Consumer Confidence Indices

(2000 = 100)

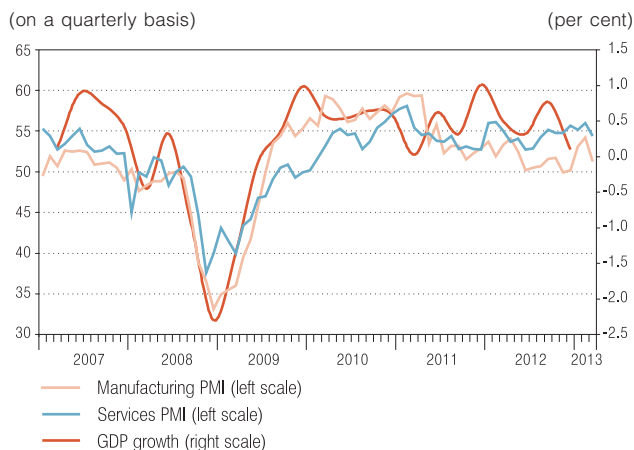


Source: Conference Board.

Worsened consumer confidence by the end of the first quarter impacted the demand for goods and services. Retail sales in March posted a decline by 0.5 per cent on a monthly basis against an increase by 1.1 per cent in the previous month, and the annual growth rate slowed

down to 2.8 per cent against 4.4 per cent in February.

US Manufacturing and Services ISM-PMI and GDP Growth



Source: Institute for Supply Management.

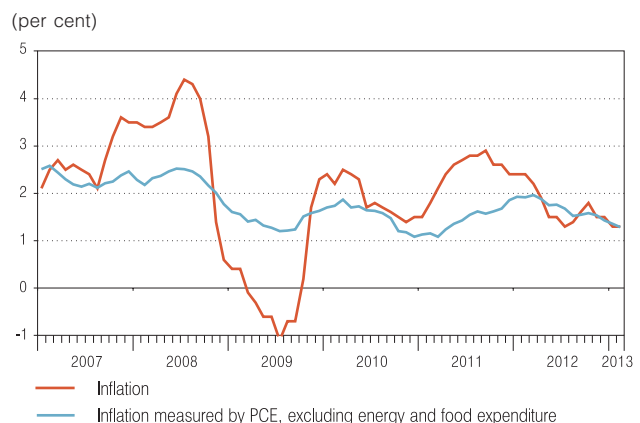
In early 2013 changes in conjunctural industrial and services indicators were volatile. Following three consecutive months of growth in March 2013 manufacturing ISM-PMI declined significantly to 51.3 percentage points against 54.2 percentage points in February. In April the indicator decreased to 50.7 percentage points. In April services ISM-PMI for the services sector posted a fall for a second consecutive month to 53.1 percentage points against 54.4 percentage points in the previous month. However, both indicators remained higher than the limit of 50 percentage points, over which the economic activity indicates an acceleration.

The recovery in the housing sector continued in the first quarter of 2013. The annual growth rate of house price index in the 20 largest cities in the USA (S&P/CaseShiller 20), which in mid-2012 reported a positive value for the first time since September 2010, in February 2013 accelerated to 9.3 per cent against 8.1 per cent in January. Employment in construction continued to increase in March and the annual growth rate of newly started construction reached 44.4 per cent against 35.9 per cent in February. In the same month, however, the building permits received went down by 6.5 per cent on a monthly basis, and their annual growth slowed down to 13.4 per cent against 28.8 per cent in February. A downward trend also occurred in the National Association of Home Builders (NAHB) index, indicating a decline for a third consecutive month in April. This was mainly attributable to higher prices of building materials and to a

deficit of qualified workers. On the other hand, the sub-index of building entrepreneurs' expectations in the following six months continued to increase.

The annual inflation rate measured on an annual basis by personal consumption expenditure deflator (PCE) decreased to 1 per cent in March against 1.3 per cent in the previous month. The core index, excluding food and energy, also posted a decline, falling to 1.1 per cent in March against 1.3 per cent in February. The annual growth rate is expected to slightly accelerate in the following two quarters.

US Inflation Rate



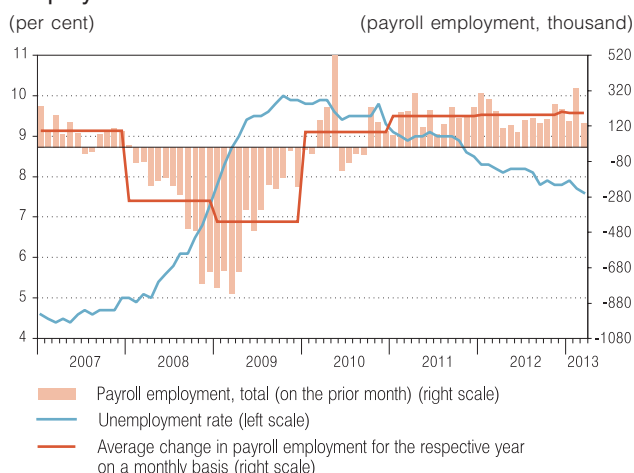
Note: Inflation is measured by the personal consumption expenditure deflator.

Source: Bureau of Labor Statistics.

The annual growth rate of consumer price index, the other measure of the US inflation, posted a decline to 1.1 per cent on an annual basis in April against 1.5 per cent in March and 2 per cent in February. The major reason behind the significant slowdown of the indicator was the fall in fuel prices. The annual growth rate of the core CPI in April declined more slowly to 1.7 per cent against 1.9 per cent in March.

The expected consumer price inflation in the period of one to five years, which is a component of the University of Michigan consumer confidence index, reported divergent developments in April. Short-term inflationary expectations slowed down to 3.1 per cent against 3.2 per cent in March, while long-term inflationary expectations increased to 2.9 per cent against 2.8 per cent in March. In the following two quarters inflation in the USA is expected to slightly increase but to remain below 2 per cent on an annual basis.

US Unemployment Rate and Number of New Employees in the USA



Source: Bureau of Labor Statistics.

Unemployment rate in the first quarter of 2013 decreased to 7.6 per cent and reached its lowest rate since 2009. Despite the reported positive developments, over the quarter fewer jobs were opened compared with the fourth quarter of 2012. Average monthly growth of employment in the non-agricultural sector over the review quarter was 206,000 persons, down 3000 compared with the average number of jobs opened in the previous quarter. Uncertainty associated with the measures of fiscal consolidation, which was the major reason behind opening of 138,000 new jobs in March (against 332,000 in February) will continue to have a negative effect on the US labour market. Serious risks of new high unemployment rates in the USA stem mainly from the continuous polarisation of positions in the Congress as to the fiscal consolidation and the possible delay in reaching a consensus for overcoming the constraints associated with legally set limit on the US government debt.

At its meeting held on 19 and 20 March the US Federal Open Market Committee (FOMC) took a decision to keep the current policy of the Committee, implementing further the programmes adopted in the second half of 2012 for purchasing mortgage bonds in the amount of USD 40 billion on a monthly basis and US government securities to the amount of USD 45 billion on a monthly basis.

The range of interest rates on federal funds of 0–0.25 per cent remained unchanged. FOMC representatives stated that the interest rates will be maintained within the set range at least until

the unemployment rate in the USA reaches or falls under 6.5 per cent and unless the expected inflation within the one to two year horizon exceeds the threshold of 2.0–2.5 per cent and long-term inflationary expectations remain within stable limits.

At the meeting it was decided that the revenue from maturing government securities of the US Federal Reserve balance sheet will continue to be invested back in US government securities. Revenue from mortgage loans of government sponsored agencies in the US Federal Reserve balance sheet will also continue to be reinvested in mortgage bonds.

China

At a session of the Congress of the Communist Party of China in March 2013 the targets for China's macroeconomic indicators in 2013 were announced.

Macroeconomic Indicators (on an Annual Basis)

	2012 (target)	2012 (realised)	2013 (target)
GDP, rate of change, per cent	7.5	7.8	7.5
Inflation, per cent	4.0	2.7	3.5
Monetary aggregate M2 – rate of change, per cent	14.0	14.3	13.0
Budget deficit, billion RMB	800	850	1200
Budget deficit, per cent of GDP	-1.5	-1.6	-2.0
Investment, rate of change, per cent	16.0	20.6	18.0
Foreign trade, rate of change, per cent	10.0	6.2	8.0
Retail sales – rate of change, per cent	14.0	13.8	14.5

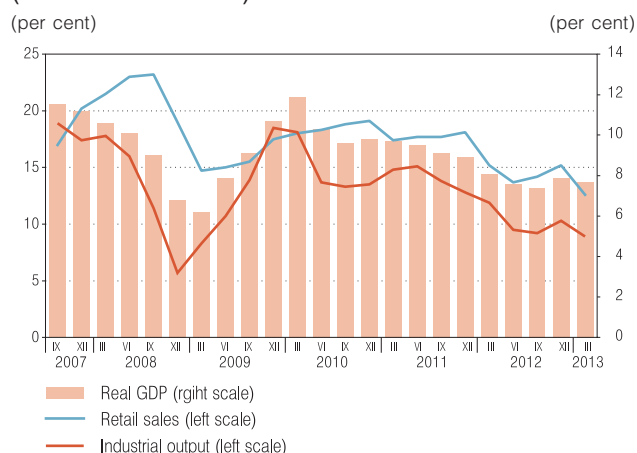
Target growth of real GDP on an annual basis remained unchanged at 7.5 per cent but target inflation measured by CPI was lowered to 3.5 per cent on an annual basis. Changes to the economic policy pursued may be expected (based on the analysis of authorities' behaviour) in case of lower real than target growth and higher than target inflation. The increase in the target of the budget deficit from RMB 800 billion to RMB 1200 billion shows an intent to increase investment in the infrastructure by 18 per cent on an annual basis against target growth set at 16.0 per cent in 2012 and realised rate of 20.6 per cent.

Worsened global environment is the major reason behind the decrease in the targets set for the rate of change in foreign trade to 8 per cent on an annual basis in 2013 against 10.0 per cent in 2012 and the realised 6.2 per

cent. The authorities' intent to rebalance the growth structure is reflected in the target levels of retail sales that are expected to grow by 14.5 per cent on an annual basis in 2013 against a target of 14.0 per cent in 2012 and the realised rate of 13.8 per cent.

In the first quarter of 2013 real GDP growth in China slowed down to 7.7 per cent on an annual basis from 7.9 per cent in the fourth quarter of 2012 due to slower growth of industrial output and consumption.

GDP, Consumption and Industrial Output (on an Annual Basis)



Source: National Bureau of Statistics of China.

In the first quarter of 2013 economic growth accounted for 1.6 per cent on a quarterly basis compared with 2.0 per cent in the fourth quarter of 2012.

GDP on an Annual and Quarterly Basis

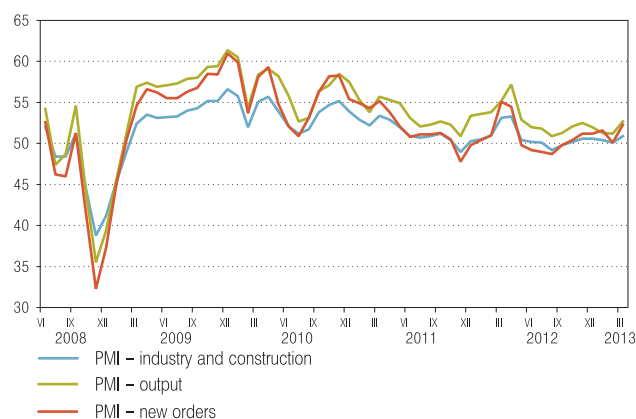


Source: National Bureau of Statistics of China.

According to manufacturing PMI in March the economic activity in the sector increased to 50.9 (previous value: 50.1). The dynamics of Individual components is also favourable. The sub-index of the current production increased to 52.7 (previous value: 51.2), new orders rose

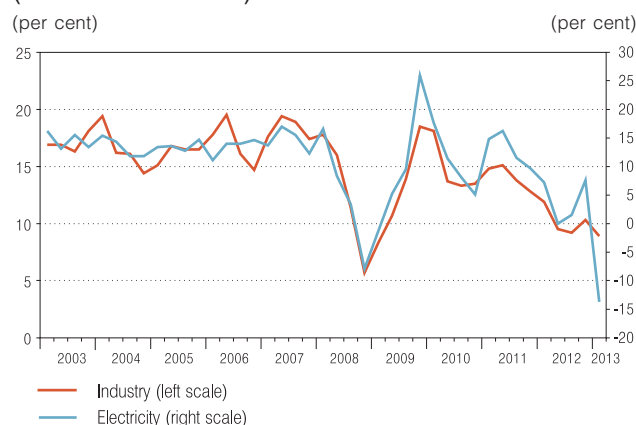
to 52.3 (previous value: 50.1), and employment went up to 49.8 (previous value: 47.6).

Manufacturing PMI, Output and New Orders



Source: China Federation of Logistics and Purchasing.

Industrial Output and Electricity Generation Indices (on an Annual Basis)



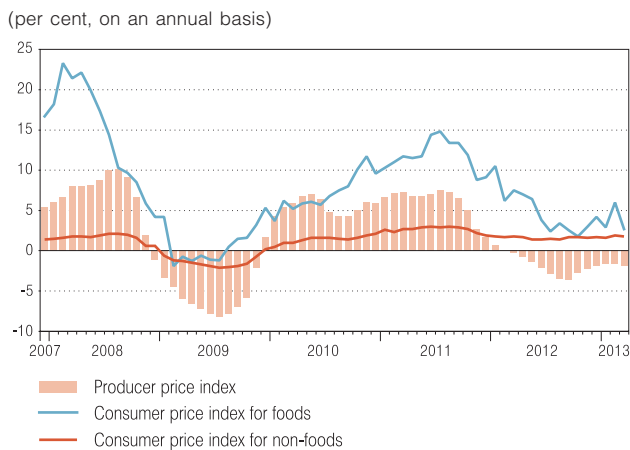
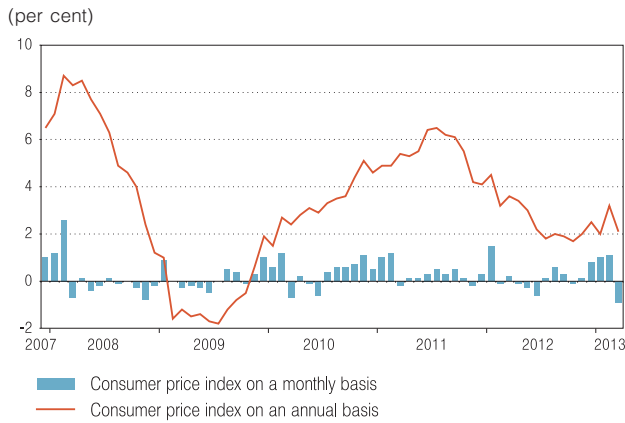
Source: National Bureau of Statistics of China.

In March PMI for the services sector posted an increase reaching 55.6 compared with 54.5 in February.

Inflation in March slowed down to 2.1 per cent on an annual basis against 3.2 per cent in February. The dynamics of food prices, increasing to 2.7 per cent on 6.0 per cent in February, contributed most significantly to the decline.

Consumer price index posted a monthly decrease of -0.9 per cent in March against an increase of 1.1 per cent in February and 1.0 per cent in January.

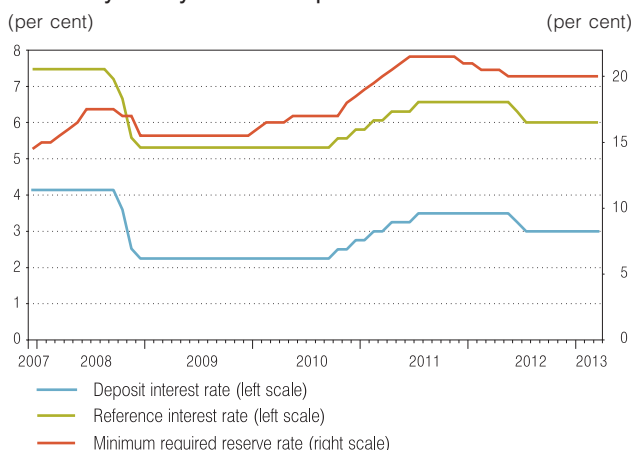
Price Indices (Rate of Change)



Source: National Bureau of Statistics of China.

No changes to the monetary policy implemented by the People's Bank of China occurred since early 2013, the reference rates on one-year deposits and loans remaining unchanged at 3 per cent and 6 per cent respectively. The rate of minimum required reserves also remained unchanged at 20 per cent.

Monetary Policy of the People's Bank of China

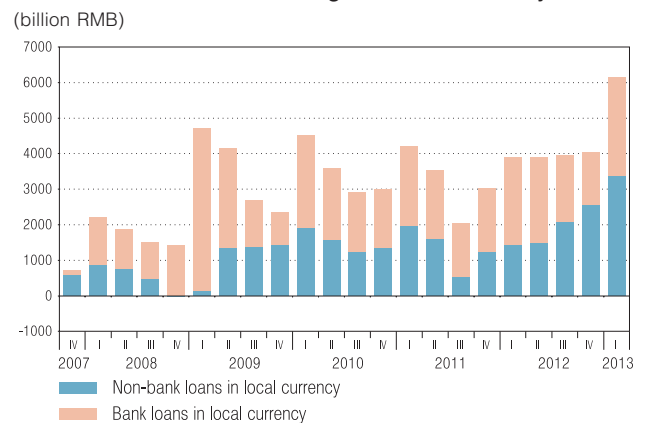


Source: People's Bank of China.

In the first quarter new bank loans in national currency increased to RMB 2760 billion against RMB 1482 billion in the previous quarter. Usually

each first quarter of the year is characterised by higher lending due to the advance use of planned and approved lending programmes mostly by corporate customers. Data also suggest a steady increase in non-bank financing of the economy. Based on central bank's data on the so-called total social financing (TSF), in the first quarter total financing to the economy (bank and non-bank) in national currency amounted to RMB 6150 billion, posting an increase of 52 per cent on a quarterly basis and 58 per cent on annual basis.

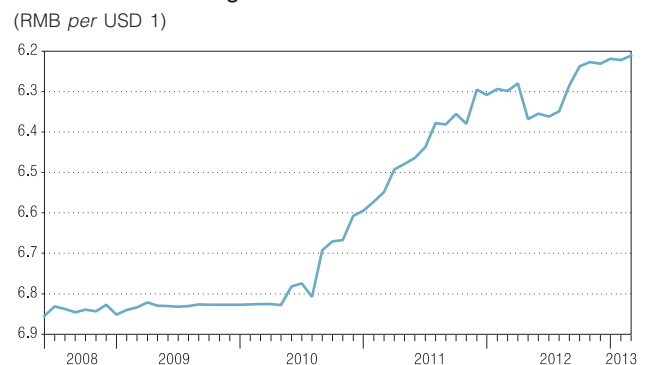
Bank and Non-bank Lending in Local Currency



Source: National Bureau of Statistics of China.

In the first quarter of the year the Chinese currency appreciated by 0.3 per cent, with the rate of growth following a sustainable trend.

RMB/USD Exchange Rate



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

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

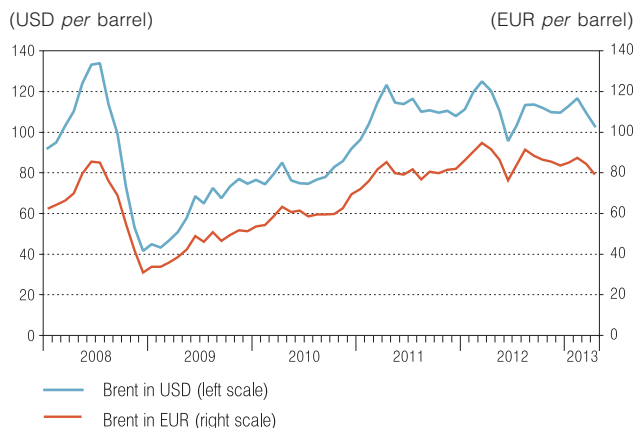
Crude Oil Prices

The price of Brent crude oil rose in early 2013 on the end of 2012, with the appreciation followed by a downward trend after mid-February.

Brent crude oil was traded at USD 112.9 per barrel (EUR 85.5) on average in the first quarter. On an annual basis this points to a decrease by 4.8 per cent. In April the oil price continued to decrease but by mid-May the downward trend was reversed and the price stabilised at slightly over USD 100 per barrel.

The oil price fall in March and April was a result of a faster decline in demand (having to a large degree a seasonal nature) compared with the rate of decrease in supply which reflected riots in Nigeria, Libya and Iraq.

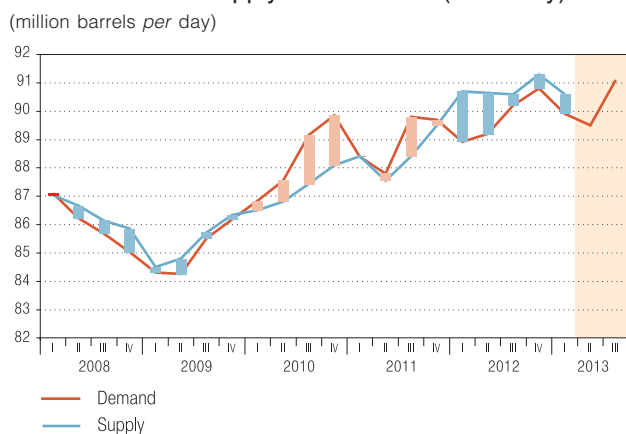
Crude Oil Prices



Source: World Bank.

According to the International Energy Agency (IEA) data the world oil supply still exceeds the demand. The IEA forecast on demand and supply developments is for retaining this trend in 2013. Supply is expected to increase as a result of restored oil extraction in non-OPEC countries.

World Crude Oil Supply and Demand (Quarterly)



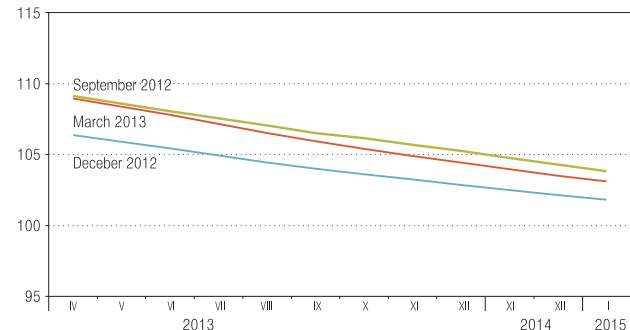
Source: IEA.

According to the market sentiment measured by the futures prices Brent crude oil will trade in the USD 103-109 range per barrel in the follow-

ing twelve months. This marks an increase in the expected price as compared with December. On the other hand, the expected slower recovery of global economic growth and weaker demand may result in a lower than projected oil price.

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

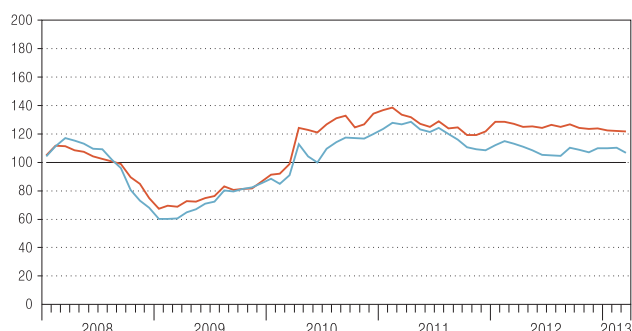
In the first half of 2013 the general metal price index published by the ECB continued to decrease (by 1.4 per cent) against the fourth quarter of 2012. Copper price also continued to decline (by 1.6 per cent). The price of other non-ferrous metals also decreased and the general index of non-ferrous metals went down by 1.4 per cent on a quarterly basis. An appreciation was also reported on an annual basis: metals by 4.6 per cent, copper by 5.5 per cent and the general non-ferrous metal index by 6.1 per cent. The downward trend in metal prices, which started in mid-2012, is expected to remain sustained in the second and third quarters of 2013.

Wheat and cereals prices continued to decrease in international markets, developments observed since September 2012. Cereals depreciated by 8 per cent in the first quarter of 2013 on a quarterly basis, the wheat price falling most dramatically (by 12.4 per cent). The general index of food also retained its downward trend falling by 5.3 per cent. An annual increase in the price of cereals was reported as a whole (by 13.9 per cent) and of wheat in particular (by 17 per cent). The forecast of the International Grains Council is for a faster increase in demand for cereals compared with supply. This is likely to result in an increase of prices of these goods in the second and third quarters of 2013.

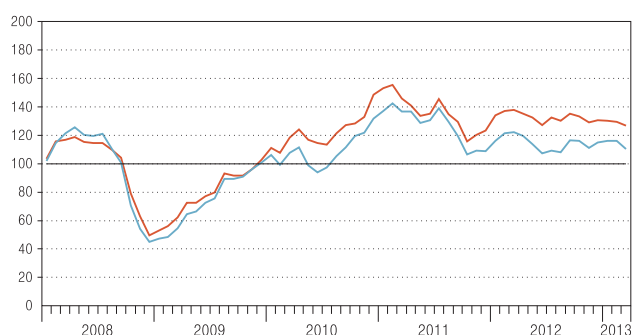
Price Indices of Major Raw Material and Commodity Groups

(2008 = 100)

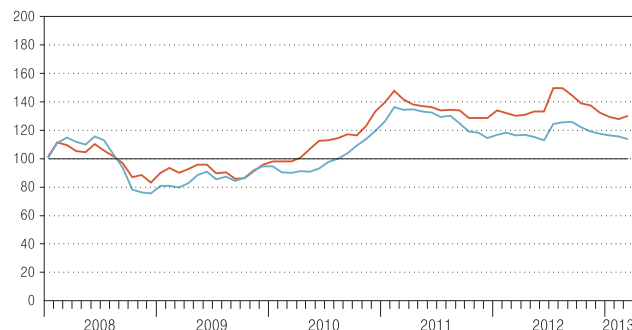
Metals



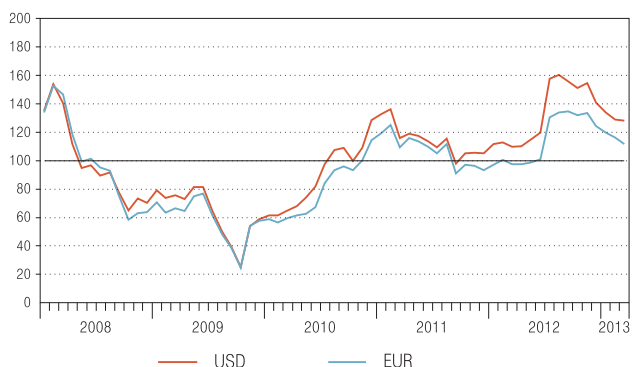
Copper



Food



Wheat



Sources: ECB and BNB.

The international market commodity price dynamics continued to help improving the terms of trade for the Bulgarian economy in the forecast horizon. This will have a favourable effect on Bulgaria's nominal export growth.

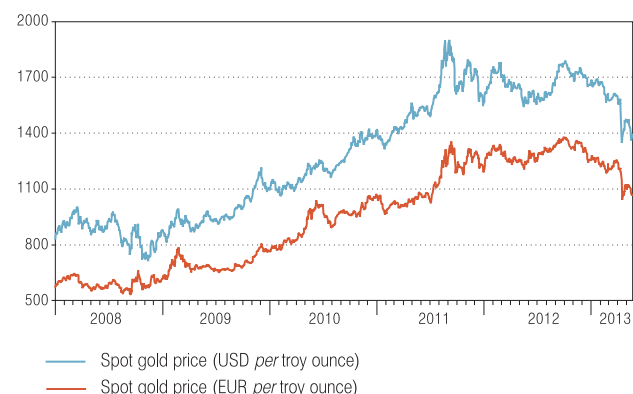
Gold Prices

Over the first quarter of 2013 the spot price of gold went down by 4.6 per cent on a quarterly basis to USD 1598.8 per troy ounce by the end of the period. The euro gold price declined by 2.1 per cent to EUR 1243.8 per troy ounce.

Positive data on the US economy, prompting rechanneling of investors to higher risk assets and weakening the flight to security through gold investments, impacted most strongly the gold price over the quarter.

In the beginning of the second quarter the gold price fell by over 20 per cent against the maximum historical value of USD 1892 per troy ounce reported in August 2011. The depreciation reflected the closure of items of exchange-traded funds (ETF) collateralised by gold and strengthening of expectations that the central bank of Cyprus will sell a portion of its gold reserves to provide EUR 400 million for the Cyprus rescue plan, expectations that did not materialise but impacted the gold price, causing concerns that such a measure may be initiated also by other euro area countries. Panic sales after the price fell under USD 1500 per troy ounce led to the strongest daily gold price decline since 1980: USD 1361 per troy ounce (a decline by 9.4 per cent) on 15 April stabilising at USD 1380 per troy ounce on the same day.

Spot Price of Gold



Source: London Bullion Market Association.

Gold price fall was accompanied by a significant decline in physical demand for gold by

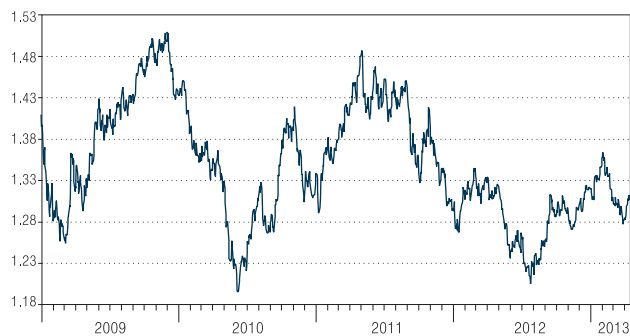
exchange-traded funds (ETF) collateralised by gold. By the end of the quarter funds' total assets decreased to 2450 tonnes of gold, down by 6.9 per cent compared with the end of the previous quarter. The decline in assets of SPDR Gold Trust, the largest fund collateralised by gold was even stronger, falling by 9.6 per cent on a quarterly basis to 1221 tonnes of gold, the lowest value registered in the last three years.

The USD/EUR Exchange Rate

In the first quarter of 2013 the US dollar appreciated against the euro by 2.5 per cent. Over the period nominally the US currency traded within a range of 1.28–1.36 per euro. The volatility of foreign currency markets increased as a whole, while risk appetite moved around its long-term average.

The USD/EUR Exchange Rate

(USD per EUR 1)



Source: ECB.

The USD/EUR exchange rate was strongly volatile in early year influenced by data of various nature. In January the exchange rate was impacted by the news on postponing the so-called fiscal cliff for several months, but most strongly by subsiding concerns about European financial markets, after the ECB reported at the first conference for the year a stabilisation of euro area financial conditions and announced moderately optimistic expectations of economic recovery later in the year. The latter was interpreted by financial markets that the ECB is unlikely to cut interest rates in the first quarter. The euro was strongly supported by the larger than expected early payment of liquidity by European banks on long-term refinancing operations. This helped the USD/EUR exchange rate to reach 1.3641 on 1 February.

The euro's upward trend was reversed in early February when the ECB announced that the euro appreciation was a result of the restored confidence and directly tied a possible further appreciation of the single currency to euro area price stability. This changed market expectations which started to incorporate a decrease in ECB reference rates, provided the inflation decline is further accompanied by negative economic data. Following a period of euro depreciation, since end-March the USD/EUR exchange rate fluctuated within USD 1.28–1.32 per EUR 1.

2. Financial Flows, Money and Credit

On an annual basis, the financial flows resulting from the interaction between external and domestic economic factors supported the continued rise of Bulgaria's international foreign exchange reserves. As of March 2013 the overall current and capital account balance remained in surplus on an annual basis. The relatively high savings rate maintained in the economy against the background of weak investment growth contributed to the improvement of the current account balance in the second half of 2012 and in early 2013.

The financial account dynamics in the beginning of the year was largely driven by banks' financial flows and the repayment of global bonds of the Bulgarian government maturing in January.

Banking system liquidity remained high in the context of growing deposits and weak lending. As a result, banks have managed their net external assets by increasing the foreign assets and reducing external indebtedness. Banks increased their investment in government securities (mainly Bulgarian government securities).

In the second and third quarters of 2013 households' propensity to save is expected to remain at its current level and the overall current and capital account balance to remain positive on an annual basis, while banks are expected to continue to operate amid ample liquidity.

The worsening of economic conditions in the EU observed since 2012 continued to affect the economic activity of firms and households in Bulgaria in the first quarter of 2013. The uncertainty related to economic activity and household employment curbed consumption and boosted savings. This trend contributed to the improvement of the current account balance. The financial account dynamics in the beginning of the year was largely driven by banks' financial flows reporting an increase in foreign assets and foreign liabilities, albeit a less pronounced one, as well as by the repayment of global bonds of the Bulgarian government maturing in January.

Banking system liquidity remained high in the context of growing deposits and weak lending. Banks continue to hold a large part of their liquidity as excess reserves on their accounts with the BNB and as funds on their accounts in the national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2-BNB). Banks have used another part of their available resources to manage their net external assets. A third part of the available liquidity has been invested in government securities, primarily of the

Bulgarian government and as of March the amount of Bulgarian government securities in the banking system continued to increase on an annual basis.

Non-government sector credit growth rate has slowed even further, a trend since the second half of 2012, driven mainly by the increase in claims on non-financial corporations, while bank claims on households recorded a slight decline.

External Cash Flows in Foreign Currency

(million EUR)

External flows	2012	January–March	
		2012	2013*
Total for the period	1527	-255	-1292
Purchases and sales of euro	-317	-725	-870
at tills	-10	-2	-5
banks, incl.	-307	-722	-865
banks' purchases	46 550	10 343	7 309
banks' sales	-46 856	-11 065	-8 174
Flows on accounts of banks, the MF, etc.	1844	470	-422
Minimum required reserves	40	163	164
Government and other depositors	1804	307	-585

Note: The table shows only foreign currency inflows and outflows to the Issue Department balance sheet. Flows in levs from and to the Issue Department, and transactions between accounts in foreign currency and levs in the Issue Department balance sheet are not reported, as they do not prompt changes in gross international reserves.

* Preliminary data.

Source: BNB.

As a result of the interaction between external and domestic economic factors and of the resulting financial flows, Bulgaria's international reserves continued to increase on an annual basis. The market value of international reserves⁶ (an asset in the Issue Department balance sheet) increased on an annual basis by EUR 1470.8 million and by the end of April 2013 came to BGN 29.1 billion (EUR 14.9 billion). Analogous trend was observed in the balance of payments, the international reserves going up and reaching EUR 1291.7 million by the end of March (excluding valuation adjustments and price revaluation).

The repayment of maturing Bulgarian global bonds contributed to the decrease in international reserves in January and February. Banks' deposits with the BNB contributed most to the annual increase of the Issue Department balance sheet figure; their dynamics reflecting mainly banks' policy related to maintaining excess reserves and the increased funds available on their accounts in the TARGET2-BNB system.

In April the Issue Department balance sheet figure continued to increase on an annual basis. On the one hand, this was due to the income from the recovery of the farmers subsidies from the European Commission after their advance payment from the national budget in February⁷, and, on the other hand, it reflected the sizeable fall in the price of gold.

External currency flows related to the change in international reserves reflected the economic agents' need for foreign currency or lev holdings. In the first quarter of 2013, as in the previous two years, banks realised net purchases of currency from the BNB. This trend continued largely due to the ongoing bank and firm policy aimed at reducing external indebtedness.

In the second and third quarters of 2013 we expect a gradual improvement in domestic demand and enhanced external demand dynamics. As a result, the current and capital account balance is expected to remain positive. Households' propensity to save is expected to remain high and banks are likely to preserve

their high liquidity level. Monetary aggregate M3 will continue to rise at relatively high rates, with a slight tendency of deceleration. The current rates of private sector credit growth are anticipated to be sustained over the projection horizon.

External Financial Flows

The trend towards reducing the balance of payments current and capital account deficit observed since the second half of 2012 continued in early 2013.⁸ The main drivers behind this dynamics were the current account flows, while the role of the capital account was insignificant. The improved current account reflected largely the positive balance between savings and investment resulting from the higher propensity to save and the lower investment activity.⁹

The contracting trade balance deficit followed by the improved income account balance contributed most to the improvement of the current account in early 2013. At the same time, the surplus in the current transfers and services balances declined. The current transfer balance decreased sizeably in the first quarter compared with the same period of the previous year reflecting the recovery of farm subsidies from the EC in March 2012, while in 2013 it was made in April.

Narrowing trade deficit reflected the successful diversion of exports to third countries and enjoying more favourable trading conditions over the recent months.¹⁰ The improved trade deficit in the first quarter of 2013 was the result of the higher exports of goods: up 12.9 per cent on an annual basis compared with a decline over the corresponding period of the previous year. Between January and March 2013 imports of goods reported a 2.4 per cent increase on an annual basis: significantly lower compared with the corresponding period of 2012.

⁶ The market value of international reserves includes changes stemming from transactions, valuation adjustments and price revaluation.

⁷ See the Public Finance and Government Consumption section in Chapter 3.

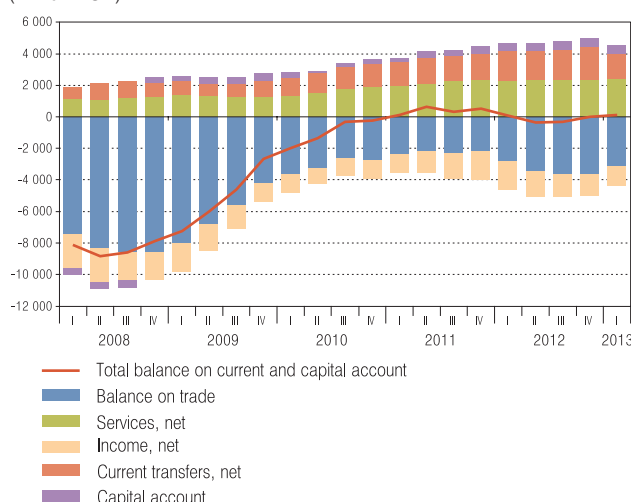
⁸ Preliminary data subject to revision.

⁹ For more details, see Chapter 3.

¹⁰ For a more detailed analysis of exports and imports of goods see Chapter 3.

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

(million EUR)



Source: BNB.

Flows on Balance of Payments Main Accounts

(million EUR; cumulative as of early 2013)

	as of 31.III.2012	as of 31.III.2013
Current account	-561.6	-420.7
Trade balance	-941.6	-477.9
Services balance	90.4	73.1
Income account	-312.2	-210.7
Current transfers, net	601.7	194.8
Capital account	11.3	-9.5
Financial account	28.9	-1 013.5
FDI in Bulgaria	672.8	257.1
Changes in reserves	175.6	1 044.8

Source: BNB.

Services balance worsened insignificantly in the first quarter of 2013 due to the more pronounced exports than imports fall. The decline in computer and information services, as well as in other business services contributed most to the decrease in exports of services. The lower imports of services reflected the decline in construction, computer and information services and in other business services contributed most to the decrease in exports of services. Maintaining positive rate of growth in tourist services which play a dominant role for the services dynamics by mid-year, gives enough grounds to expect a slight improvement on an annual basis of the trade in services balance in the second and third quarters.

The downward trend in the Income Account deficit observed throughout 2012 continued in the first months of 2013. Lower outward flows in the investment income from direct investment,

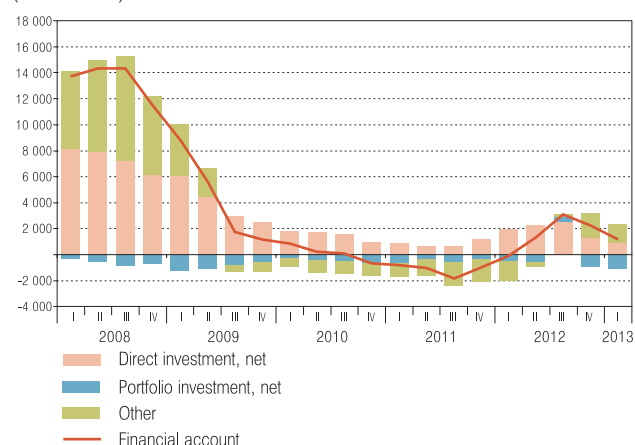
followed by other investment, income from loans in particular, contributed most to this. In the event of gradual recovery of economic activity observed throughout 2013 these developments in the Income Account may be discontinued.

Net current transfers in early 2013 worsened compared with the corresponding period in 2012 as a result of lower government inflows (largely due to the later recovery of the farm subsidies by the European Commission) and the unusually high outward flow on other private transfers in February. It may be presumed that the latter has a one-off effect.

Given the trends observed in the current account dynamics and if our assumptions for the international environment development materialise, the balance on the current and capital account is expected to remain positive on an annual basis in the second and third quarters of 2013. Factors that would contribute to lower values of this balance are the expected utilisation of the EU funds and the possible acceleration of imports as a result of international price dynamics or enhanced domestic demand. On the other hand, if the strong recovery of new emerging economies is retained, exports may grow faster, thus improving trade and current account balances.

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

(million EUR)



Source: BNB.

The balance of payments financial account dynamics for the first two months of 2013 was driven by the financial flows from government and bank activities. The euro denominated Bulgarian global bonds issue of EUR 818.5 million maturing in January (in particular the part

held by non-residents) was reflected in the balance of payments flows and in the external debt amount. As a result, the portfolio investment in the general government liabilities reported an outward flow of EUR 301.4 million and the external debt of the sector contracted by EUR 309.2 million. In February an additional repayment of liabilities of EUR 92.8 million was reported.

Banks increased their foreign assets between January and March 2013. Against the background of ample liquidity and still limited demand for loans in the national economy, the banking system is looking for investment alternatives outside the country and is reducing its liabilities to non-residents. These trends are likely to remain sustained in the second and third quarters of 2013.

The latest publications on the balance of payments show a decrease in the FDI inflow to Bulgaria in the first three months of the year compared with the year before. As data are preliminary and subject to revisions, it is difficult to make any conclusions on FDI dynamics. The comparison between the January to March 2013 data and the original release of the data for the same period of 2012 points to a positive difference (*i.e.* the FDI flow in the January–March 2013 period is EUR 20.3 million higher) while the revised data point to a decrease of EUR 415.7 million. On the basis of these preliminary data it may be expected that in the second and third quarters of 2013 the positive FDI flow to Bulgaria will decrease slightly on an annual basis compared with the corresponding periods in 2012.

Banks' Flows on Balance of Payments Financial Account

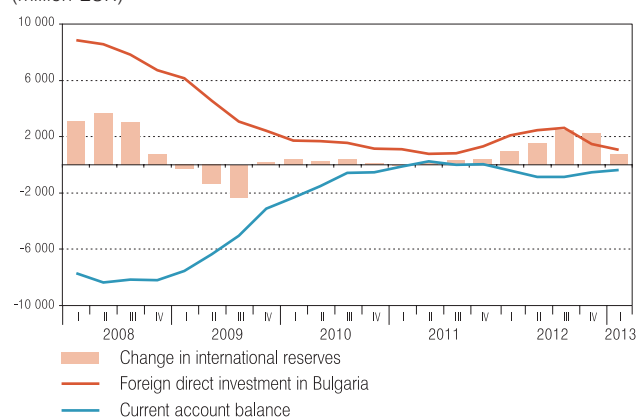
(million EUR; cumulative as of early 2013)

	as of 31.III.2012	as of 31.III.2013
Net direct investment	50.5	40.2
abroad	-0.1	0.0
in Bulgaria	50.6	40.2
Net portfolio investment	-220.6	-132.1
assets	-217.7	-158.6
liabilities	-2.9	26.5
Other investment	-152.5	-752.2
assets	-325.2	-681.9
liabilities	172.7	-70.3
<i>Portfolio and other investment</i>	<i>-373.1</i>	<i>-884.3</i>
Total	-322.6	-844.1

Source: BNB.

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

(million EUR)

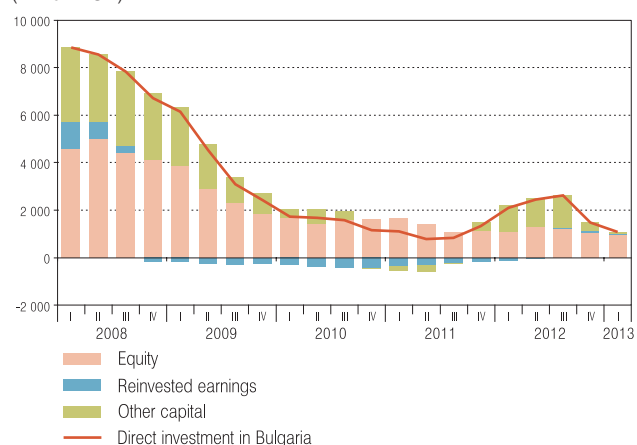


Source: BNB.

As a result of the inflows on the major balance of payments accounts, the international reserves of the BNB (excluding valuation adjustments and price revaluation) in the first quarter of 2013 dropped on the end of the previous year. By March they reported an increase of EUR 1291.7 million on an annual basis. The international reserves coverage of the average nominal imports of goods and non-factor services over the last 12 months came to 6 months in March.

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

(million EUR)



Source: BNB.

Balance of payments flows dynamics in early 2013 was reflected in the gross external debt amount. In the first two months of 2013 gross external debt declined on end-2012 largely due to the reduced government and bank debt. Long-term external debt and short-term external debt contracted by 1.4 and 1.5 per cent respectively.

Gross External Debt as of February 2013

(million EUR)

	Amount	January – February 2013*	Last 12 months*
General government	2 992.6	-381.7	276.3
Central bank	0.0	0.0	0.0
Banks	6 291.5	-163.1	798.4
Other sectors	12 103.0	-36.9	-119.5
FDI: Intercompany loans	15 662.9	39.7	-149.7
Total	37 050.0	-542.1	805.4

* Change for the corresponding period.

Source: BNB.

In early 2013 Bulgaria's external position remained sustained. There were no changes in entities' behaviour and indebtedness of major economic sectors. Payments on external debt servicing in the January-February 2013 period totalled EUR 1060.7 million (of which EUR 442.3 million from general government) compared to EUR 896.3 million (of which EUR 125.2 million from the general government) in the January-February 2012 period.

Loans and deposits disbursed in the first two months of 2013 amounted to EUR 457.9 million compared to EUR 514.4 million in the corresponding months of the previous year. Some 13 per cent of them were intercompany loans.

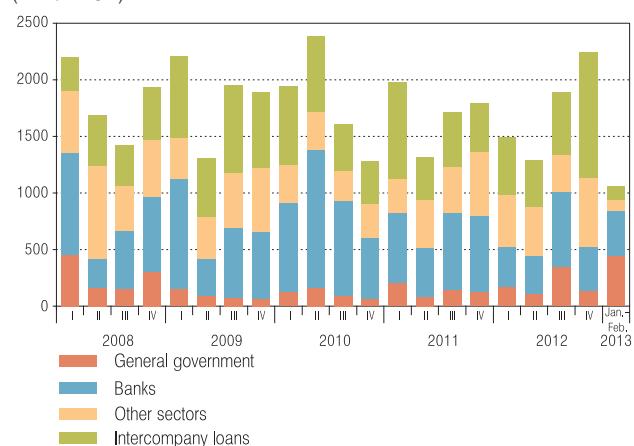
According to the data on new loans declared during the first two months, the share of long-term loans is almost 70 per cent. The average weighted maturity on new loans contracted slightly on the corresponding period of 2012 reaching 4 years and 11 months.

The relative share of loans in euro in the total amount of declared loans remained high for the January to February 2013 period (97.2 per cent). Over the recent years this share hovered around 95 per cent.

The downward trend in interest rates on declared new loans continued. In the first two months of 2013 the average weighted interest rates on loans in euro was 3.5 per cent (down 0.6 percentage points compared to the year before). The average weighted interest rate on loans in USD was 2.9 per cent: down 0.7 percentage points on the same period of 2012.

Gross External Debt Service by Institutional Sector

(million EUR)



Source: BNB.

Loans and Deposits Received by Institutional Sector

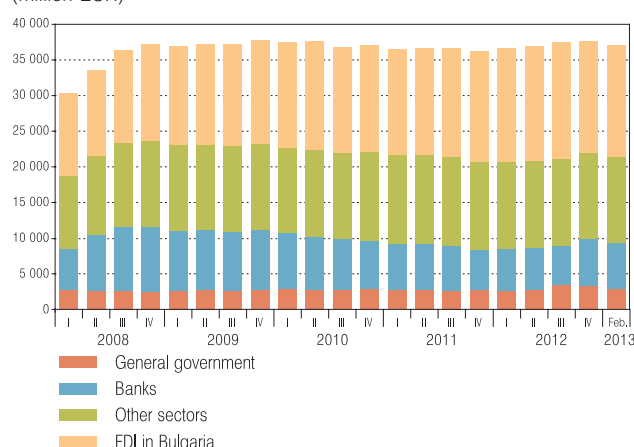
(million EUR)



Source: BNB.

Gross External Debt by Institutional Sector

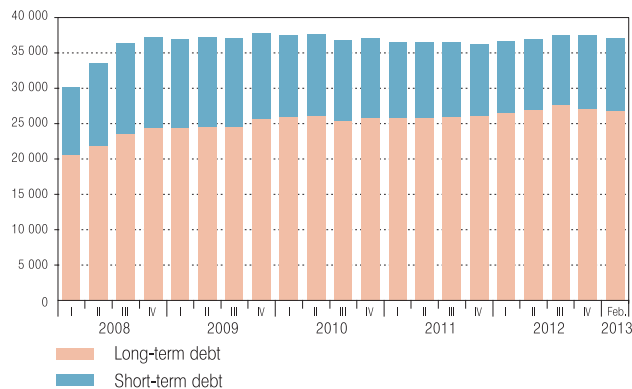
(million EUR)



Source: BNB.

Against the backdrop of stable external position in Bulgaria and no shocks in the external environment, a further drop in the cost of financial resource over the second and third quarters of 2013 may be expected.

Long- and Short-term Gross External Debt Dynamics (million EUR)



Monetary Aggregates

Over the review quarter the upward dynamics in reserve money was still driven mainly by banks' reserves with the BNB and the less pronounced currency in circulation contribution. Banks continued to maintain high excess reserves on their accounts to meet the minimum reserve requirements, as well as increased funds on banks' settlement accounts in TARGET2-BNB system. The rising minimum required reserves with the BNB resulting from the higher deposit base were reflected, although to a lesser extent, in the total amount of banks' deposits with the BNB. By the end of April the annual reserve money growth remained relatively high reporting a more sizeable contribution of currency in circulation and a less pronounced one of banks' deposits with the BNB compared with the end of the first quarter.

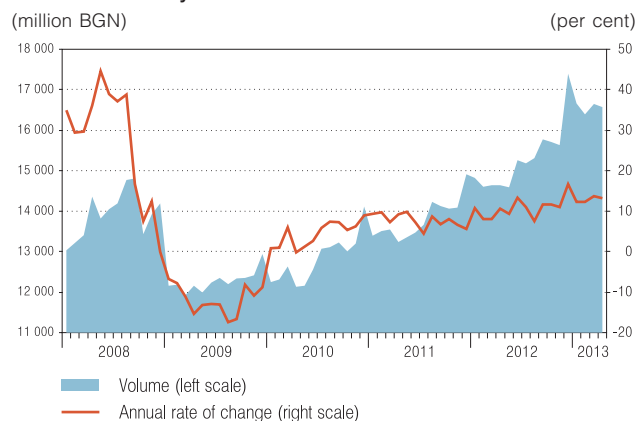
The average daily volume of funds attracted from residents¹¹ continued to increase, their growth coming to BGN 894 million on December 2012. The average daily volume of funds attracted from non-residents contracted by BGN 514 million as of April, funds from non-resident banks going down BGN 457 million and from non-residents (banks excluded) – BGN 57 million. Reflecting the developments and structure of attracted funds, the effective implicit rate of minimum required reserves maintained with the BNB was 8.83 per cent¹², with banks' reserves with

¹¹ The definition of residents other than state and local government budgets under BNB Ordinance No 21 on the Minimum Required Reserves Maintained with the BNB by Banks is used in the analysis.

¹² Under Article 3, paragraph 1 of BNB Ordinance No 21, the rate of minimum required reserves 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.

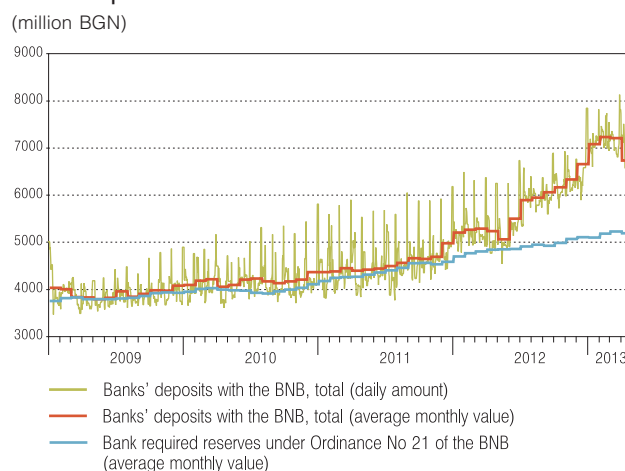
the BNB forming 7.77 percentage points, and the remaining 1.07 percentage points formed by cash and funds on banks' settlement accounts in the TARGET2-BNB national system component.¹³ The excess of banks' funds on minimum reserve requirements accounts with the BNB under Ordinance No 21 remained unchanged from the previous year coming to an average daily volume of 8.7 per cent in the first quarter of 2013 and 5.7 per cent in April.

Reserve Money



In the second and third quarters of 2013 deposits in the banking system are expected to grow further and to contribute to an increase in the minimum required reserve level maintained by banks with the BNB. On the other hand, the total amount of banks' deposits with the BNB will continue to reflect mainly their policy related to maintaining excess reserves and increased funds available on their accounts in the TARGET2-BNB system.

Bank Deposits with the BNB

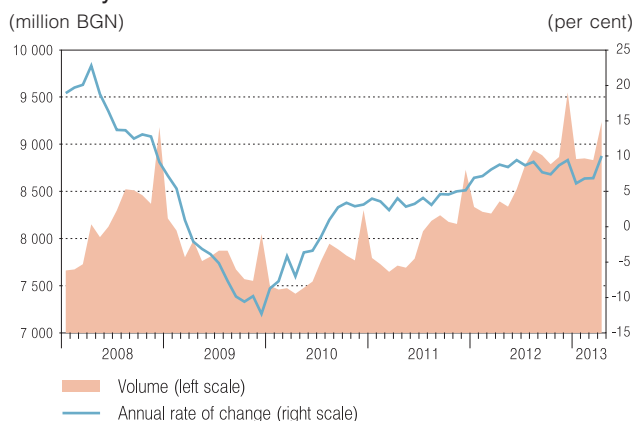


¹³ See Article 4 of Ordinance No 21 of the BNB.

The growth of currency in circulation moderated in the first quarter of 2013 reaching 6.9 per cent on an annual basis by end-March. This slow-down reflected the still high saving rate in the economy and the trend toward a weaker domestic demand observed in the second half of 2012 which according to the data on industrial sector turnover and retail turnover remained sustained in early 2013. By end-April the annual growth rate of currency in circulation was 10.0 per cent.

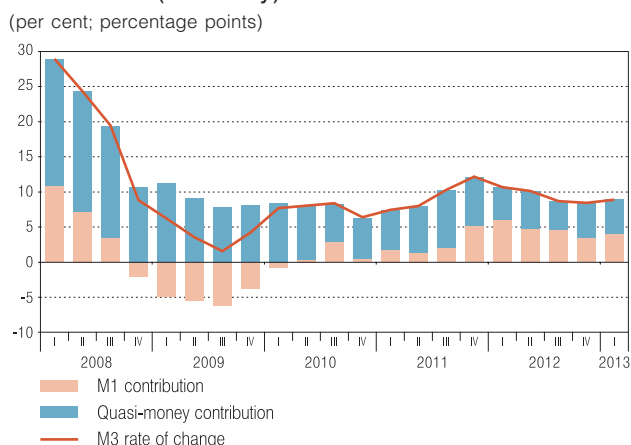
In the second and third quarters of 2013 currency in circulation is expected to increase further at rates close to those observed in the first quarter of the year. We expect their dynamics to be driven by a slow recovery of economic activity and a slight increase in private consumption.

Currency in Circulation



Source: BNB.

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



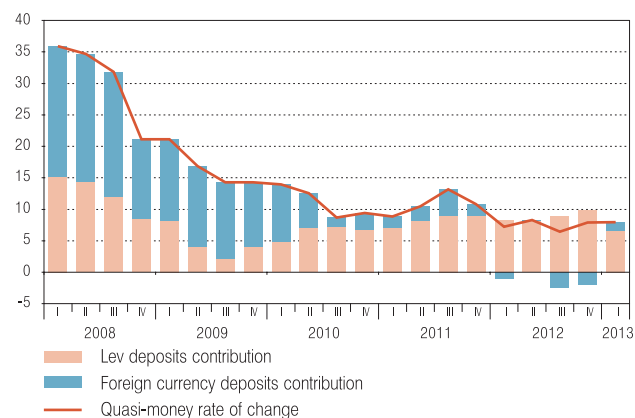
Source: BNB.

In January 2013 the annual broad money growth continued to follow the downward trend observed in 2012. In February and March the broad monetary aggregate M3 enhanced its growth reaching 8.9 per cent by the close of

the first quarter largely due to the accelerated growth of the M1 monetary aggregate and the stable quasi-money growth. Household deposits remained the main contributor to the increase in deposits in the banking system.¹⁴

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

(per cent; percentage points)



Source: BNB.

In the first quarter of 2013 foreign currency deposits of firms and households¹⁵, included in the *quasi-money* aggregate, reported an increase following the decline recorded in 2012. At the same time, growth of lev-denominated deposits moderated. This trend was reflected also in the share of lev-denominated deposits in quasi-money which contracted to 52.4 per cent by end-March compared with 53.5 per cent at the end of 2012.

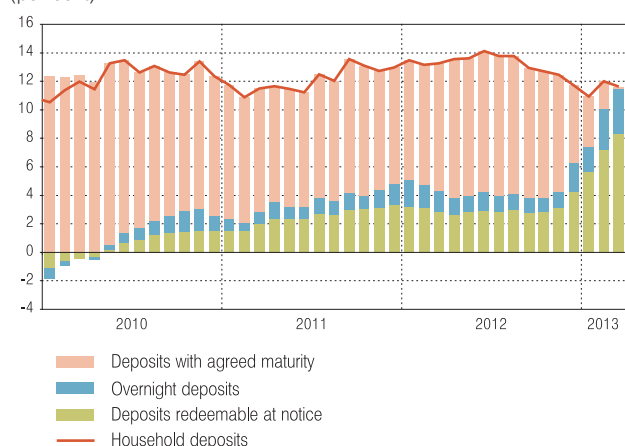
The changes in the structure of household deposits which started in the fourth quarter of 2012 continued over the review period. They reflected the more sizeable contribution of deposits redeemable at notice and overnight deposits to the total annual growth of household deposits and the weaker contribution of deposits with agreed maturity. These changes are probably the result of the change in the preferences of households driven by the taxation of natural persons' interest income from time deposits with banks introduced in early 2013.

¹⁴ See Chapter 3.

¹⁵ 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.

Annual Growth of Household Deposits and Contribution by Type of Deposit

(per cent)



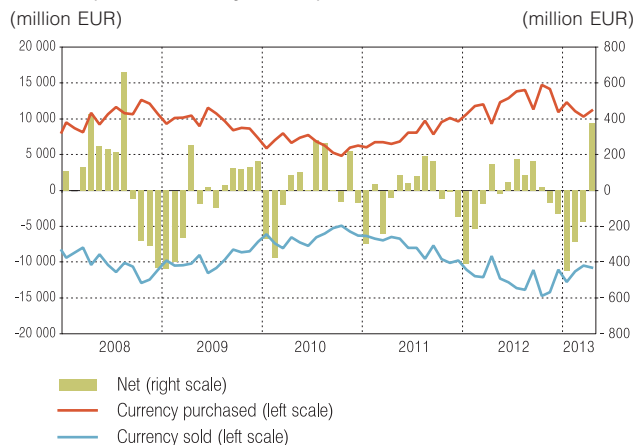
Source: BNB.

The relatively high annual broad money growth is expected to remain sustained in the second and third quarters of 2013 as a result of the moderate income growth amid the retained high household propensity to save. The M3 growth is expected to moderate in the second half year.

Transactions in reserve currency (euro) with the BNB are the major tool used by banks to manage their lev liquidity. Thus, the main function of the Currency Board is performed: buying and selling on demand national currency against euro.

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

(million EUR)



Note: Net means currency purchased minus currency sold by the BNB. Data refer to all bank transactions in foreign currency including liquidity management operations related to the transfer of own funds from lev accounts with the BNB to own accounts with the BNB in euro and *vice versa*.

Source: BNB.

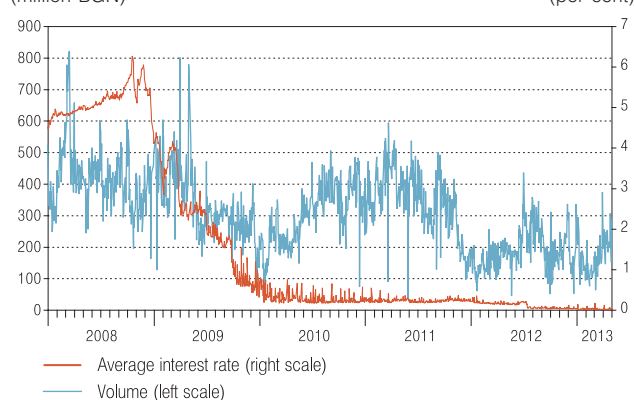
In the first quarter of 2013 banks realised net purchases of currency from the BNB. On the one hand, this trend was related to seasonal factors, and on the other hand, to the sustained policy of both banks and, to a lesser extent, of firms

aimed at reducing their external indebtedness. In April BNB reported net purchased of foreign currency.

Trade Volumes and Interbank Money Market Interest Rates

(million BGN)

(per cent)

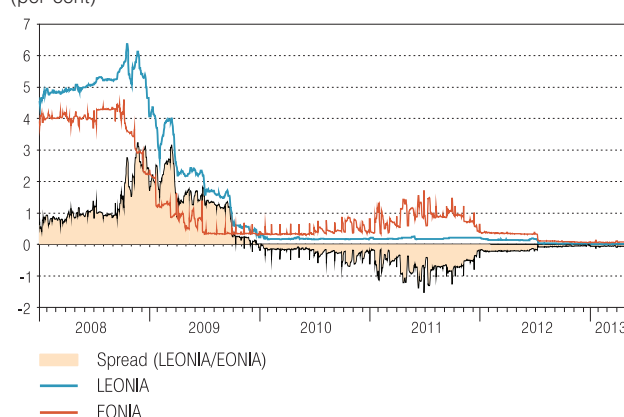


Source: BNB.

The downward trend in interest rates on the interbank money market in Bulgaria continued in early 2013. By April the average interest rate on transactions concluded in the interbank money market went down reaching a historical low of 0.03 per cent. At the same time, the average daily volumes traded in the interbank money market in the first four months of 2013 remained relatively low. High banking liquidity and ECB policy for maintaining low interest rates and provision of unlimited liquidity were the main factors behind interbank money market developments in Bulgaria.

LEONIA and EONIA, and Spread between Them (Daily Data)

(per cent)



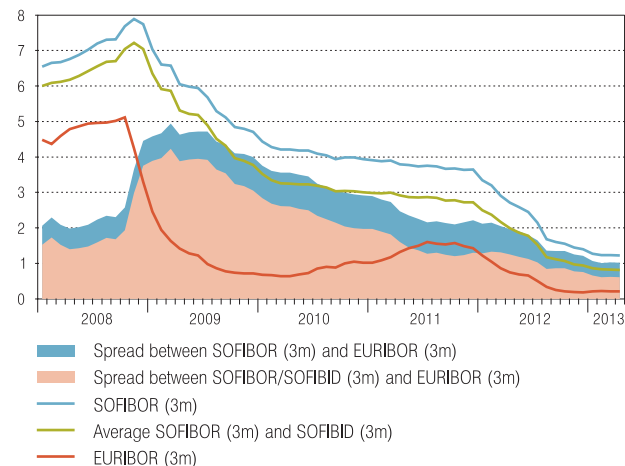
Source: BNB.

LEONIA continued to fall reaching 0.01 per cent in the first quarter of 2013. The average value of the negative spread between LEONIA and EONIA continued to fluctuate within a narrow range around 6 basis points over the same

period. In April LEONIA came to 0.02 per cent and the spread between LEONIA and EONIA remained negative, hovering around 6 basis points.

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

(per cent; percentage points)

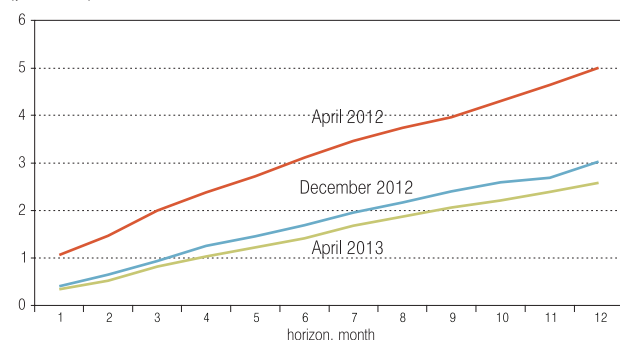


Source: BNB.

SOFIBOR reference rate (3m) used as an indicator for short-term interest rates tended downwards reaching 1.22 per cent in April. This trend was observed also in the spread between SOFIBOR (3m) and EURIBOR (3m) which narrowed to 102 basis points. The average three-month SOFIBOR/SOFIBID reference rate¹⁶ declined to 0.82 in April and the spread with EURIBOR came to 61 basis points.

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

(per cent)



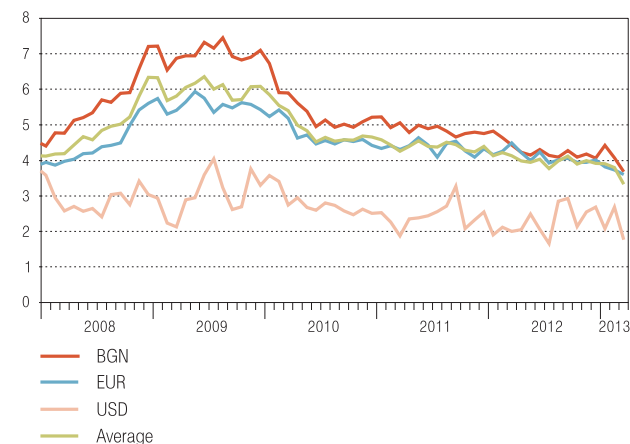
Source: BNB.

¹⁶ The average SOFIBOR/SOFIBID index gives a better picture of the interest rates in Bulgaria. Correspondingly, it is more accurate to compare this value with EURIBOR as the closest rate to the actual price at which transactions are concluded. 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.

The downward trend in quotations and in long-term maturity sectors of the interbank money market yield curve continued in the first four months of 2013. In April a year-on-year fall of 170 basis points was reported in the 6-month horizon, while in the 12-month horizon, it was 242 basis points.

Interest Rates on New Time Deposits in Relevant Currencies

(per cent)



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

Source: BNB.

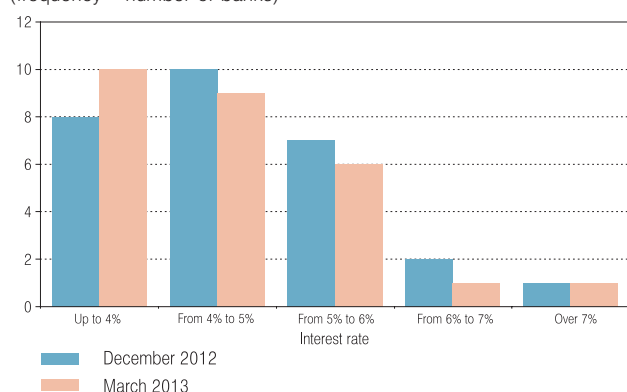
The gradual downward trend in interest rates on new¹⁷ time deposits remained sustained over the first quarter of 2013. The main factors behind it were still related to the sustained sizeable growth of attracted funds from residents and the relatively low demand for bank loans. Over the period the average weighted interest rate declined to 3.7 per cent, the interest on euro denominated deposits posting a more sizeable decline than the interest on lev denominated deposits. Interest rates on USD deposits marked an increase.

A comparison between the December 2012 and March 2013 breakdown of interest rates on household time lev deposits showed that the number of banks offering rates in the up to four per cent band increased and that of banks offering rates within the four to seven per cent band decreased. The average interest rate level on time lev deposits dropped by 49 basis points to 4.39 per cent and the dispersion coefficient declined by 17 basis points to 1.43 percentage points.

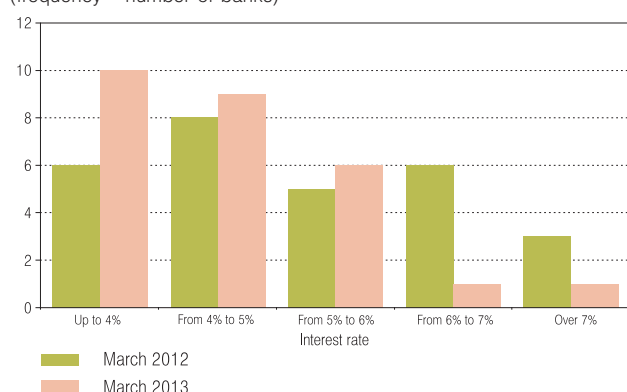
¹⁷ The terms *new*, *new contracted* and *new disbursed loans and deposits* refer to the *new business* statistical category.

Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



(frequency – number of banks)



Source: BNB.

The downward trend in the average cost of financing in the banking system¹⁸ remained sustained. On the one hand, it was underpinned by the lower interest rate levels on the inter-bank market in Bulgaria and the fact that they remained low on the euro area money market, and, on the other hand, by the gradual fall in interest rates on attracted deposit.

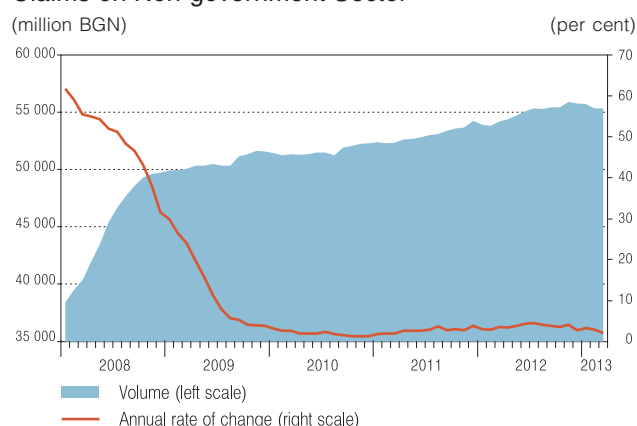
The gradual reduction in interest rates on time deposits is expected to continue in the second and third quarters of 2013 reflecting the limited investment alternatives and the high propensity to save in the economy. The ECB's non-standard monetary policy measures for providing unlimited liquidity to euro area banks and maintaining low reference interest rates will continue to put downward pressure on interest rates.

¹⁸ The indicator is calculated ex post using data of the BNB Banking Supervision Department as the ratio between interest payments on attracted funds over the last 12 months and the average volume of attracted funds over the same period.

Credit Aggregates

The moderation in the growth of claims from the non-government sector observed since August 2012 continued over the review quarter. By March 2013 claims from the non-government sector went down by BGN 435 million on December 2012 posting an annual increase of 2.1 per cent (2.8 per cent by end-2012). The dynamics in the claims on the non-government sector was largely driven by the moderation in the growth rate of non-financial corporations' borrowing and, to a lesser extent, by the minimum decline of banks' claims from households in the context of weakening economic activity in Bulgaria. The moderate annual growth of lending was reflected in the claims from the non-government sector to GDP ratio reaching 71.9 per cent by end-2012.

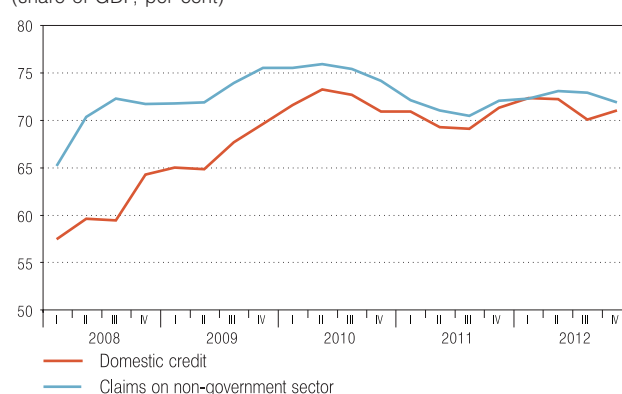
Claims on Non-government Sector



Source: BNB (monetary statistics: monetary survey).

Domestic Credit

(share of GDP, per cent)



Source: BNB.

According to the results of the BNB quarterly lending activity survey, banks reported a minimum increase in demand for loans from corporations in the January–March 2013 period compared to the previous quarter. More opportunities

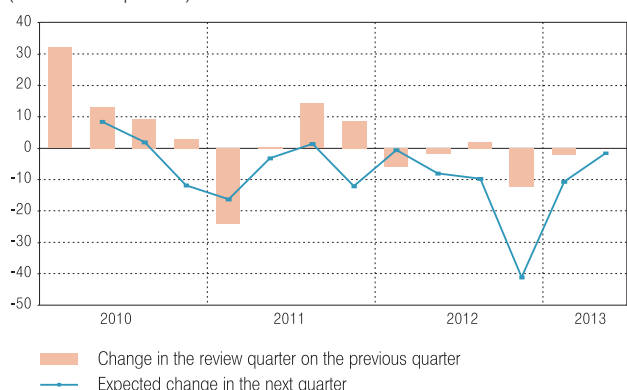
Changes in Credit Standards Applied to Corporate Loans

(balance of opinions)



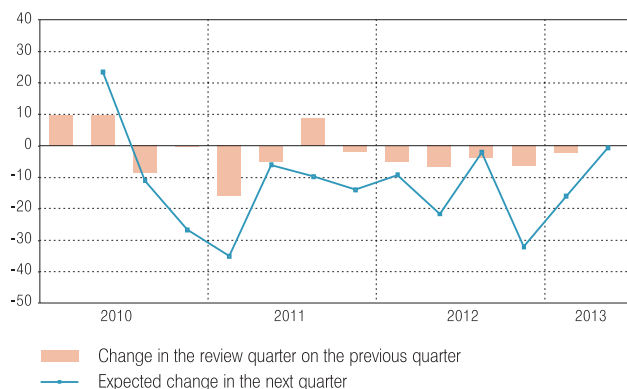
Changes in Credit Standards Applied to Consumer Loans

(balance of opinions)



Changes in Credit Standards Applied to Housing Loans

(balance of opinions)



Note: The charts present banks' balance of opinions as the difference in percentage points between the percentage of banks that answered 'tightened' ('significantly' and 'to some extent') and percentage of banks that answered 'eased' ('significantly' and 'to some extent'). All the answers are weighted by banks' market share in the respective credit segment. The expectations are shown in the charts by shifting the data a quarter forward.

Source: BNB, Banks' lending activity survey.

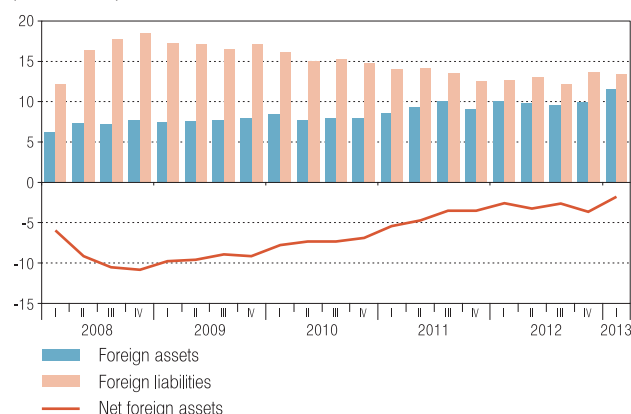
for non-bank financing of corporations and inter-company sources of funding contributed most to lower demand. Household loans reported a stable upward trend in consumer loans demand, while housing loans demand was weaker compared to the previous quarter. Banks have more optimistic expectations of demand for loans in the second quarter of 2013 both by households and corporations.

In the first quarter of 2013 banks reported easing in lending to corporations and, to a lesser degree, in loans to households. Competition from other banks, lower price of attracted resources and the amount thereof were the factors behind the easing of the lending policy. The macroeconomic environment, collateral risk, the business climate in the sectors occupying large shares in banks' credit portfolios and credit risk were the factors contributing to a tighter bank lending policy. In the second quarter of 2013 banks expect easing of credit standards for loans for corporations and relatively unchanged credit standards for housing and consumer credit.

The continuous growth in attracted resources in the first quarter of 2013 allows banks to increase their foreign assets and at the same time to repay foreign liabilities. In the second and third quarters of 2013 bank liquidity is expected to remain high providing opportunities for boosting the domestic credit amount and contributing to the ongoing trend toward lower negative values of banks' net foreign assets.

Foreign Assets and Liabilities of Banks

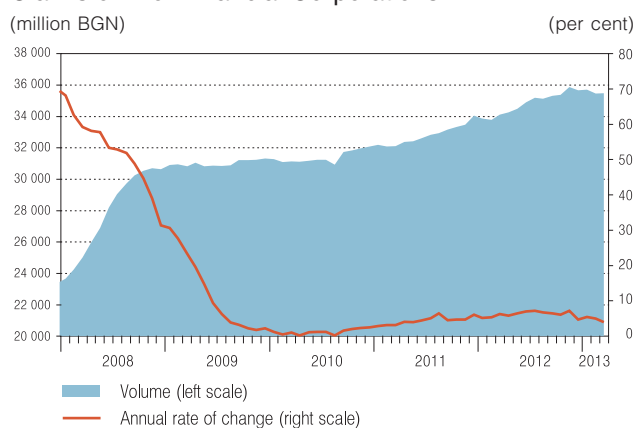
(billion BGN)



Source: BNB.

The moderation in the growth of claims from non-financial corporations which started in the first quarter of 2012 continued in the first three months of 2013. Claims on non-financial corporations had a moderate annual growth and by end-March increased by 4 per cent compared with 4.7 per cent at the close of the prior year. Weaker demand for loans reflected the uncertainty related to economic activity and the decreased estimate of the current economic situation according to early 2013 survey observations. An additional factor that might contribute to the weaker demand of borrowed funds from non-financial corporations is the possibility of funding by using their gross operating surplus and external sources including foreign direct investment.¹⁹

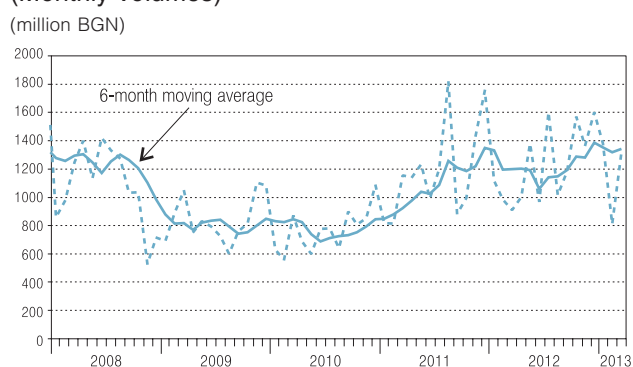
Claims on Non-financial Corporations



Source: BNB.

In the first quarter of 2013 the volume of new loans to NFCs remained high following the upward trend observed in the second half of the previous year.

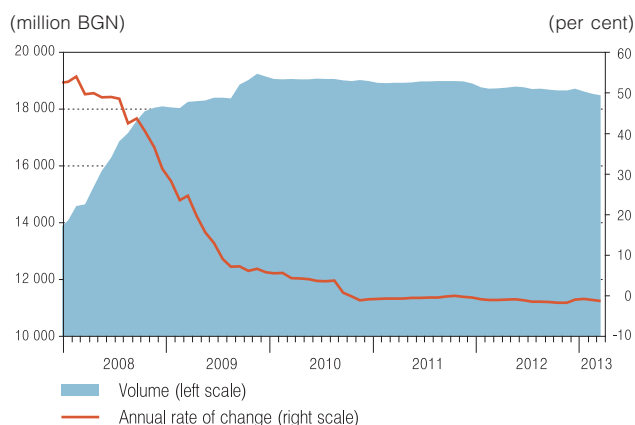
New Loans to Non-financial Corporations (Monthly Volumes)



Source: BNB.

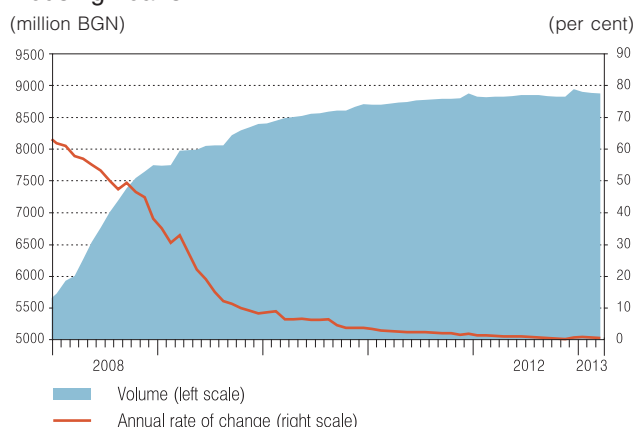
Lending to households remained weak over the review quarter. At the end of March the total amount of banks' claims on households fell by 1.0 per cent on an annual basis (1 per cent on an annual basis by end-2012). Deposit growth and lending fall point to household cautiousness against the background of a continuous uncertainty related to economic environment developments and unfavourable labour market trends. Since early 2013 housing loans growth rate moderated slightly and by end-March reached 0.62 per cent on an annual basis. Overdraft and other loans reported a more sizeable decline on December 2012. By the end of March 2013 the amounts of new loans for house purchases showed a stable upward trend for the last six months while consumer credit reported a slight decline by mid-2012 as a result of seasonal factors.

Claims on Households



Source: BNB.

Housing Loans

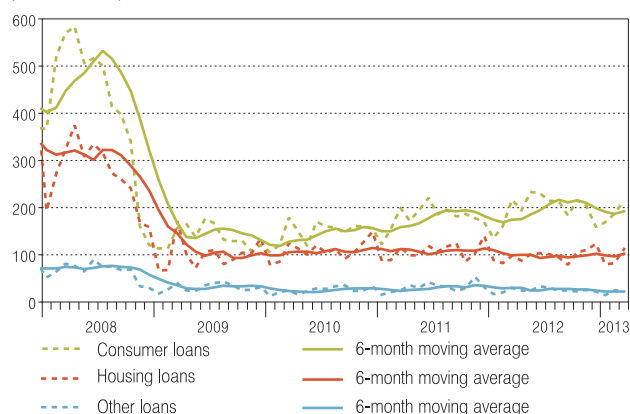


Source: BNB.

¹⁹ For more information see the Behaviour of Firms and Competitiveness section in Chapter 3.

New Loans to Households (Monthly Volumes)

(million BGN)



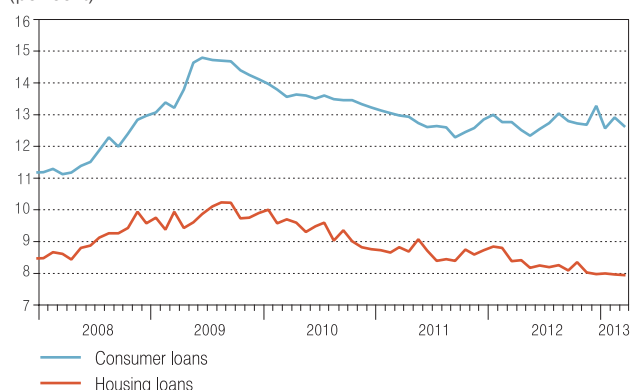
Source: BNB.

The current growth rates of lending for corporations are anticipated to remain sustained over the second and third quarters of 2013 due to the gradual improvement of the domestic economic activity against the background of enhanced domestic demand dynamics. The decline in loans for households is expected to remain low on an annual basis and be less pronounced reflecting our expectations of gradual recovery in consumption in this sector.

The new EC and European Investment Fund programme for funding investment projects of small- and medium-sized enterprises which was launched in early 2013 and offers much better credit conditions than market ones is likely to contribute to the enhanced demand for borrowed funds.

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

(per cent)



* See footnote 17 on page 34.

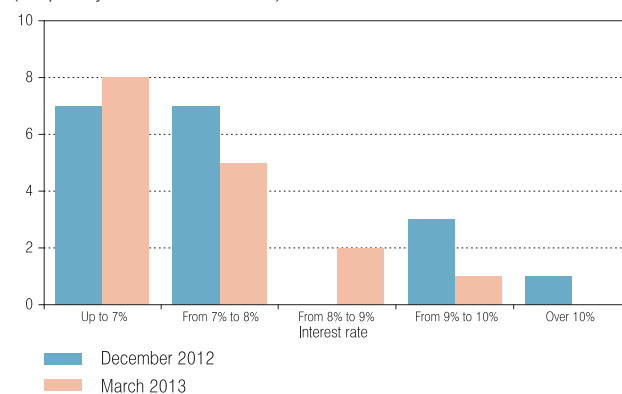
Source: BNB.

By March 2013 the slight decline in interests on loans continued. Interest rates on new loans to non-financial corporations denominated in

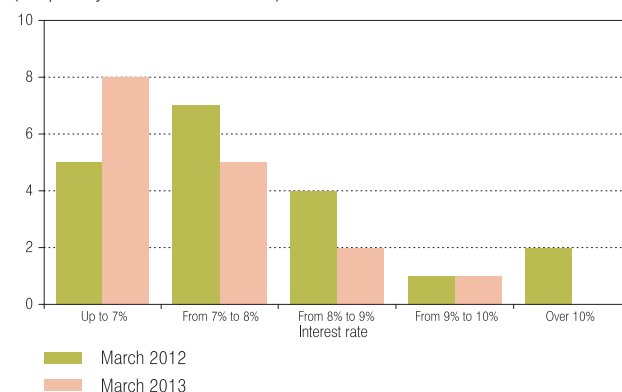
euro and leva came to around 8.2 per cent.²⁰ The annual percentage rate of charge (APRC) on new housing loans declined to 8.0 per cent, while the interest rate on consumer loans went up slightly to some 12.6 per cent on end-2012. Interest rate dynamics reflected mainly the ample liquidity in the banking system and the reduction of financing costs.

Distribution of Interest Rates on New Housing Loans in Euro

(frequency – number of banks)



(frequency – number of banks)



Source: BNB.

As regards the distribution of interest rates on housing loans in euro by bank, in March 2013 compared to December 2012 the number of banks offering rates up to 7 per cent and from 8 to 9 per cent increased at the expense of those offering rates within the other bands. Over the same period the average interest rate level fell by 11 basis points and the dispersion coefficient went down by 50 basis points to 0.97 percentage points.

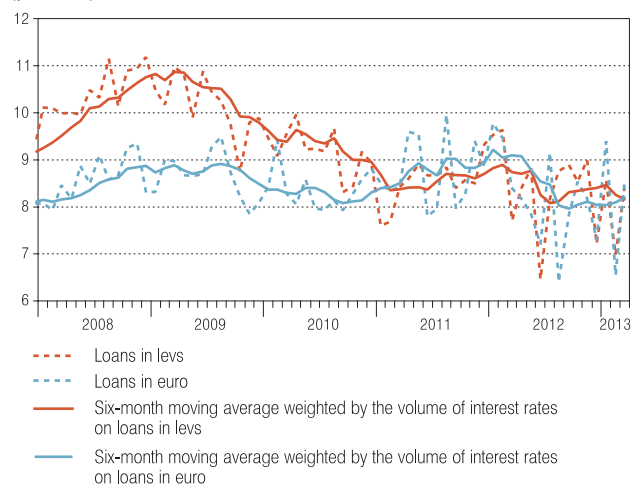
The gradual reduction in interest rates on loans is expected to continue in the second and third quarters of 2013. The projection is based both

²⁰ The figures below are the weighted average of the interest rates on a six-month basis.

on high bank liquidity and our expectations of a further slight decline in deposit interest rates.

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

(per cent)



Source: BNB.

Financial Flows between the General Government and the Other Sectors of the Economy

The government's fiscal policy affects the allocation of liquidity between economic sectors.²¹ In the fourth quarter of 2012 the net inflow from the external sector to the government came to some BGN 965 million and a large part of this flow was formed by current and capital grants received under the EU Structural Funds. Over the review period the net inflow of resources from the external sector reached around 4.6 per cent of the GDP for the quarter.

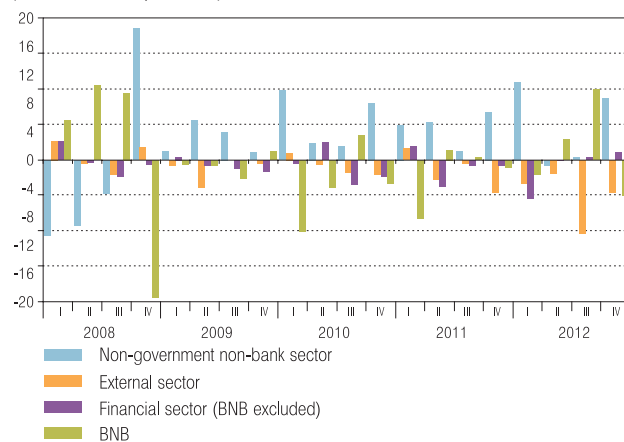
In the second and third quarters of 2012 the government's fiscal policy had no significant impact on the distribution of liquidity resources to the non-government non-bank sector, but at the close of the year significant portion of the budget liquidity was distributed to this sector (8.6 per cent of GDP). Financial flows to the non-government non-bank sector reflected mainly higher investment expenditure, social payments and operating expenditure. In addition to the liquidity flow from the external sector the government provided funds for these financial flows by

²¹ For more details on the financial flows between the budget and other sectors see Economic Review, May 2004, p. 28. The sign '+' of the respective financial flow indicates that as a result of its operations the budget provided net funds to the respective sector, while the sign '-' means that the budget withdrew net funds from the respective sector.

a decrease in the government deposit with the BNB (5 per cent of GDP for the quarter).

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

(share of GDP, per cent)



Sources: MF, BNB.

Based on data available as of the first quarter of 2013 it may be concluded that due to the redemption of euro denominated global bonds worth BGN 1546 million maturing in January 2013 the government paid net funds to non-residents and residents (excluding the BNB). The allotment of liquidity to the financial sector in Bulgaria was due to the fact that by end-2012 slightly over 70 per cent of these global bonds were held by residents. Over the review quarter the non-government non-bank sector also received additional liquidity due the advance payment of around BGN 840 million – farmer subsidies *per ha* of agricultural land. Over the same period the government realised a net issue of government securities worth BGN 939 million²² and positive net financing with external loans (BGN 17.5 million) reducing the amount of the deposit withdrawn from the BNB.

²² Including the unscheduled issue of six-month lev treasury bills worth BGN 800 million nominally, maturing in February 2013.

Analysis of the Indebtedness of Non-financial Corporations in Bulgaria

On 28 November 2012 the European Commission published its second Alert Mechanism Report in compliance with the procedure for prevention and correction of macroeconomic imbalances in the EU Member States, and on 10 April 2013 it published in-depth reviews carried out into the following Member States: Belgium, Bulgaria, Denmark, Spain, France, Italy, Hungary, Malta, the Netherlands, Slovenia, Finland, Sweden and the United Kingdom. The in-depth reviews have found macroeconomic balances in each of the analysed 13 Member States but the European Commission has concluded that these imbalances are excessive only in Spain and Slovenia. The in-depth review for Bulgaria points to risks ensuing from the high external indebtedness of the economy, high non-financial corporations' indebtedness and labour market recovery as major challenges for the country.

The BNB presented details (Economic Review, 2011 issue 3, p. 11–14 and issue 4, p. 63–70) on the procedure for detection of macroeconomic imbalances, supplemented by an analysis of some of the main weaknesses of the scoreboard of indicators relevant to the detection of macroeconomic imbalances used in preparing Alert Mechanism Reports. Special attention was also paid to some characteristics of Bulgaria's economic development insufficiently analysed by the EC such as the impact of real and nominal convergence processes, specific trends in the balance of payments current account and in the net international investment position, dynamics of exports and competitive position of the Bulgarian economy as well as labour market flexibility.

This analysis presents the results of the BNB study on the indebtedness of non-financial corporations (NFCs) in Bulgaria based on the available public information. It aims at identifying possible risks to the economic activity stemming from the level of indebtedness and the capacity of NFCs to service their debts.

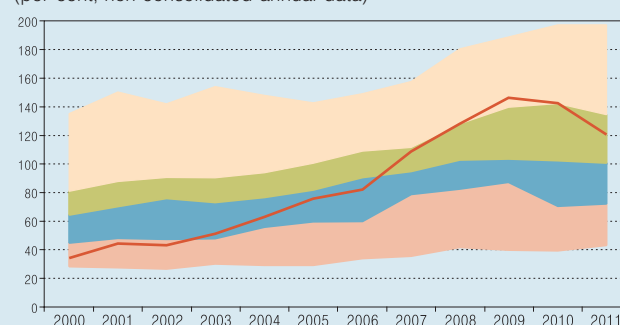
The indebtedness of NFCs¹ in Bulgaria amounted to 120.4 per cent of GDP by 2011 based on non-consolidated data, with loans comprising the bulk of indebtedness (118.1 per cent of GDP). Between 2000 and 2009 NFCs' indebtedness increased rapidly and Bulgaria was among the EU countries reporting the fastest growth of indebtedness in this period. The 2009 global crisis affected indebtedness dynamics, with growth rates slowing down in the following years.² Comparison of this indicator with other Member States in 2011 suggests that Bulgaria is among the countries with relatively high indebtedness. The highest level of indebtedness is reported by Ireland (197.1 per cent), Belgium (183.4 per cent) and Sweden (174.8 per cent).

A large part of the indebtedness of Bulgaria's non-financial corporations is formed by foreign funding sources mostly as a result of intercompany lending in the form of FDI. Concurrently, bank loans extended in Bulgaria comprise a relatively smaller portion of total loans of NFCs compared to other EU countries. By 2011 the share of bank loans extended in Bulgaria in total non-financial corporations' loans amounted to 37.6 per cent compared to approximately 50 per cent on average for the EU.

In the economic literature, higher indebtedness is considered to have a negative effect on growth³, but there is no common view on the threshold for debt level beyond which debt poses risks of depressing growth. Moreover,

Non-financial Corporations Debt to GDP in EU Member States

(per cent; non-consolidated annual data)



Notes: The chart shows a quartile distribution of the indicator for EU Member States. Each segment contains 25 per cent of the member states: the one at the lowest end presents the first 25 per cent with the lowest values of the indicator, the second segment presents the next 25 per cent of countries with higher values of the indicator and the top 25 per cent segment covers the countries with the highest values. The values for Bulgaria are presented with a line.

Sources: Eurostat, BNB calculations.

¹ Non-financial corporations' indebtedness is measured by 'loans and securities other than shares' on a non-consolidated basis from financial accounts. The loans category does not include transactions in trade credits and advances, and other accounts payable (as taxes, social security contributions, wages and remunerations, dividends, interest, etc.). According to ESA'95 the non-financial corporations sector comprises all private and public corporate enterprises that produce goods or provide non-financial services. It includes private and public enterprises, holding structures, sole proprietors, cooperatives and some non-profit organisations.

² In 2012 the NSI made changes to the methodology for computing the indicator by means of a re-classification of short-term loans representing usual trade practices/transactions of corporations from the loans item to the other accounts payable item. As the changes affected only 2011 data (without a corresponding historical data adjustment), a significant decline in non-financial corporations' indebtedness was reported compared to the previous year. Due to a lack of compatibility with data from previous periods, the trends in the 2011 indebtedness dynamics cannot be explicitly assessed.

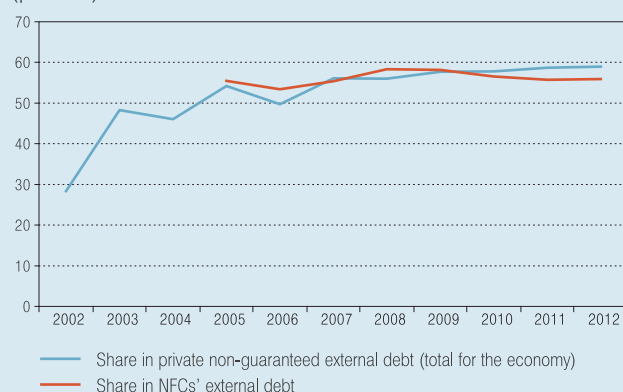
³ Reinhart, C. and K. Rogoff, 'This time is different. Eight centuries of financial folly', Princeton University Press, 2008. Cecchetti, S. G., M. S. Mohanty and F. Zampolli, 'The real effects of debt', Working Paper Series, BIS, No 352, September 2011.

there is no clear conclusion in the literature on the acceptable level of debt that may be maintained by economies undergoing real and nominal convergence⁴, where real growth depends to a large extent on foreign capital inflows. Therefore, the analysis of potential risks to economic activity stemming from indebtedness dynamics and the assessment of NFCs' capacity to service their debts should take into account the specific situation in a particular country depending on the stage of its development.

Comparatively fast growth of non-financial corporate indebtedness in Bulgaria in the period before the global financial and economic crisis was driven by fundamental factors for the economy related to real and nominal convergence processes, high return on capital, favourable macroeconomic situation as well as the low base. Macroeconomic stabilisation after 1997, structural reforms, the simplified tax regime and legislative harmonisation to prepare the country for EU membership created favourable conditions for investments as an instrument to increase the potential for economic growth in Bulgaria. FDI inflows are indicative of the long-term investor interest in the Bulgarian economy which supports the development of local firms and provides a stable source of financing compared to borrowing in international financial markets characterized by high volatility in setting the cost of financing. Attracted foreign direct investment contributed to acceleration of the economy's restructuring and entailed modernisation and build-up of production capacities in all major sectors, as well as development of the infrastructure. Financial integration with other EU Member States is another important factor for the increase of bank lending to NFCs in the period before the global economic crisis, with growth rates starting from low initial levels (the ratio of loans to NFCs to GDP increased from 14 per cent at the end of 2002 to 44 per cent at the end of 2008).

Share of Foreign Direct Investment in Bulgaria's External Debt

(per cent)



Source: BNB.

In 2012 and the first two months of 2013 the share of FDI in the private non-guaranteed external debt (excluding banks' debt) was around 60 per cent for the total economy⁵ (against 30 per cent in early 2003). In 2012 FDI comprised 55.9 per cent of NFCs' external debt.⁶ Due to the high share of intercompany lending of Bulgarian corporations from foreign parent companies in their total liabilities, it is important to note that countries like Bulgaria with large FDI inflows may have higher levels of indebtedness.

In addition to the debt to GDP ratio, more comprehensive indebtedness analysis requires a broad set of indicators to be employed with a view to making a more adequate evaluation of the capacity for repayment of accumulated debt. The debt to GDP ratio, the most commonly used indicator, should be analysed together with the ratios of debt to gross operating surplus, gross output or total assets (financial and non-financial) of corporations since these indicators provide

a better insight into possible resources available for servicing corporate liabilities. Available data on the ratios of debt to gross operating surplus and gross output of NFCs shows that Bulgaria is close to EU average values. The lack of data on firms' non-financial assets makes it difficult to calculate the debt to total assets ratio. However, it is not justified to use only the debt to financial assets ratio since a large part of non-financial corporations' assets may comprise fixed assets. Comparing non-financial corporate indebtedness among EU countries, it should be also taken into account that data is not fully comparable due to national specificities in applying the common methodology of financial accounts – ESA95.

From the perspective of servicing non-financial corporate debt, national sector accounts for 2009 and 2010 point to a decline in the ratio of total interest paid (on external and internal debts) to gross operating surplus of corporations. The latest available data for Bulgaria shows that in 2010 this ratio remained lower than euro area average levels. A similar conclusion may be drawn from gross external debt statistics which shows that implicitly estimated interest rates⁷ on external debt of other sectors (excluding the general government sector and banks) and on intercompany lending have decreased after 2008. The decline in interest rates contributes to easing the servicing of non-financial corporate external debt.

⁴ Cuerpo, C., I. Drumond, J. Lendvai, P. Pontuch and R. Raciborski, 'Indebtedness, Deleveraging Dynamics and Macroeconomic Adjustment', European Economy. Economic Papers No 477, April 2013.

⁵ The share is calculated for the total economy due to the lack of detailed information on non-financial corporations' institutional sector.

⁶ The estimate for non-financial corporations is based on external debt data on intercompany lending (FDI-related) and external debt of other sectors, with financial intermediation and households excluded from economic activities.

⁷ Interest rates are calculated as a ratio of actual interest payments per year and the average amount of debt in the relevant year.

At the same time, the maturity structure of NFCs' external debt also has an important role in assessing the risks related to debt service. The share of short-term debt to total debt of NFCs (according to financial accounts data) has shown a trend toward a gradual decrease following the general EU countries' trend and the indicator for Bulgaria reached about 23.2 per cent in 2011 compared to 39.6 per cent in 2001. The decline in short-term external debt lowers the risk of refinancing NFCs' indebtedness.

As regards the impact of intercompany indebtedness⁸ on the servicing of bank loans and the business activity of corporations, the results of the survey conducted by the BNB among Bulgarian banks point to a negative effect of arrears on intercompany loans. However, banks pointed to sizeable differences across sectors. According to the assessments, the construction sector suffers most severely from problems related to intercompany indebtedness, while the impact on bank loan servicing and business activity of the corporations in the other sectors is relatively lower. The impact on the construction sector can be explained by the substantial contraction of activity in this sector reflecting weak demand and resulting in a continuous decline in the sector's profits. These results are also confirmed by the data on the non-financial corporations by economic activity which shows that NFCs, excluding the construction sector, retained their good financial performance in the period of the economic crisis.

Since 2008 the gross operating surplus of NFCs has been their main source of financing. Furthermore, there has been a recovery in foreign direct investment inflows and a relatively more gradual recovery in bank lending. However, unlike most EU Member States, there has been no decline in bank lending to the overall sector of NFCs in Bulgaria.⁹

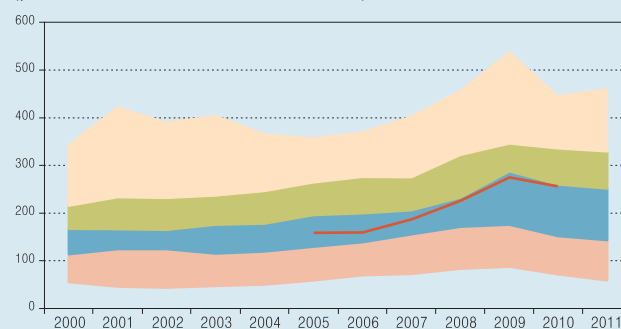
The analysis presented above, given the available information, leads to the conclusion that there are fundamental factors determining the fast growth of NFCs' indebtedness in the period before the global financial and economic crisis and binding the level of indebtedness with the processes related to the building of economic development potential. A large part of the indebtedness of Bulgarian NFCs is formed by foreign sources of financing. These comprise mainly intercompany lending (in the form of FDI), instead of loans, which lowers the risks related to a possible volatility on international capital markets. The downward trend in the interest rates on servicing non-financial corporations' external debt and in the share of short-term debt in their total debt are additional factors mitigating the risks related to the servicing of indebtedness. This analysis shows that firms' indebtedness, as a whole, has no dampening effect on their growth.

⁸ The quantitative analysis of the part of NFCs' indebtedness covering intercompany loans in Bulgaria would have a very low informative value due to the lack of detailed information and a number of shortcomings related to the data collection, such as the the existence of double-counting practices. Such an analysis would be incomplete and methodologically incorrect – hence, it could not be used for well-grounded and credible conclusions about the real economic relevance of this type of indebtedness.

⁹ National accounts, monetary statistics, external debt and balance of payments data.

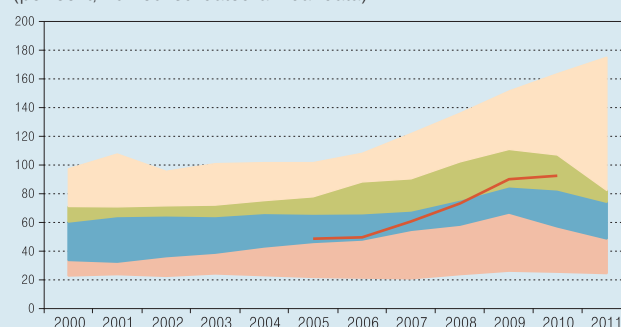
Debt to Gross Operating Surplus of Non-financial Corporations

(per cent; non-consolidated annual data)



Debt to Gross Output of Non-financial Corporations

(per cent; non-consolidated annual data)

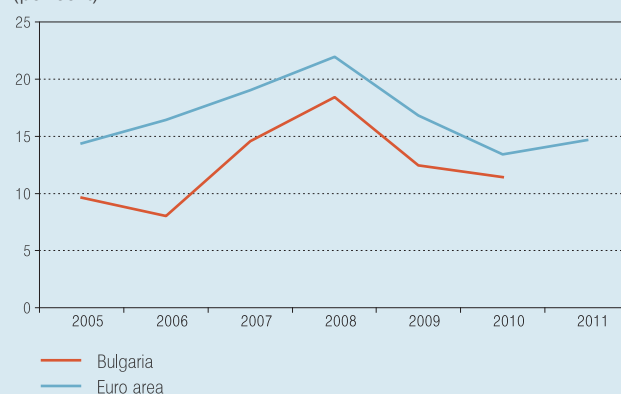


Notes: The Charts show a quartile distribution of the two indicators for EU Member States. Each segment contains 25 per cent of the Member States: the one at the lowest end presents the first 25 per cent with the lowest values of the indicator, the second segment presents the next 25 per cent of countries with higher values of the indicator and the top 25 per cent segment covers the countries with the highest values. The corresponding values for Bulgaria are presented with a line.

Sources: Eurostat, BNB calculations.

Interest Paid to Gross Operating Surplus of Non-financial Corporations

(per cent)



Sources: Eurostat, BNB calculations.

3. Economic Activity

The recession in the euro area affected Bulgaria's economic activity as exports declined and the confidence of economic agents deteriorated. Households sustained their high propensity to save and further restrained their consumption. Firms continued to invest cautiously mainly to improve effectiveness and reduce their labour costs through layoffs. Growth in the economy is expected to remain weak in the first quarter of 2013 and in the second and third quarters it is likely to increase slightly as a result of the simultaneous improvement in domestic and external demand.

Economic activity^{23, 24} in Bulgaria continued to slow down in the fourth quarter of 2012 influenced by the unfavourable factors stemming from the euro area recession. The deterioration of the external environment and the enhanced level of uncertainty affected the behaviour of households, which retained their high propensity to save and decreased consumption growth. Firms continued to invest cautiously mainly to improve effectiveness due to the lack of clear signs of rapid recovery of economic activity in euro area countries and in Bulgaria. Firms' flexibility and ability to penetrate the new markets²⁵ partly offset the negative impact of euro area recession on exports. The downward trend in domestic demand growth affected adversely imports which declined at a rate stronger than the rate of exports. As a result, net exports contributed positively to GDP growth in the fourth quarter of 2012. Changes in inventories also had a positive contribution to growth over the last quarter of 2012, which corresponds to the slowing rates of domestic demand.

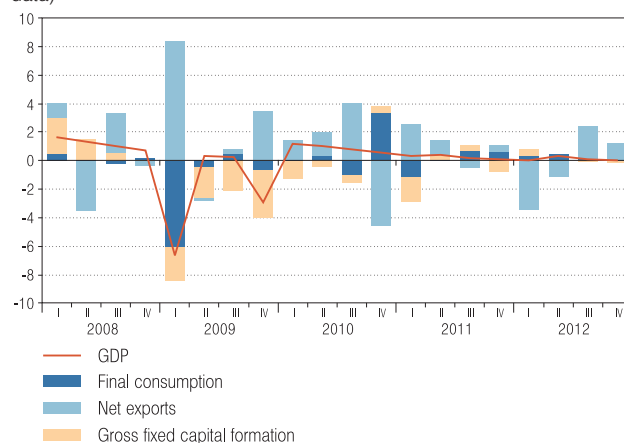
²³ The quarter-on-quarter analysis in this section employs seasonally adjusted data, unless otherwise indicated. For indicators on which the NSI or Eurostat do not officially publish seasonally adjusted data, adjustment was made via the TRAMO SEATS or OxMetrics programmes by using automated set up for diagnostics and optimisation of adjustment parameters.

²⁴ GDP estimates for the first quarter of 2013 became available after the publication of the present issue. In accordance with our expectations, seasonally adjusted real GDP grew by 0.1 per cent compared with the previous quarter.

²⁵ See the Exports and Imports of Goods section in this Chapter.

Contribution to GDP Growth by Component of Final Use

(per cent, quarter-on-quarter percentage points, seasonally adjusted data)

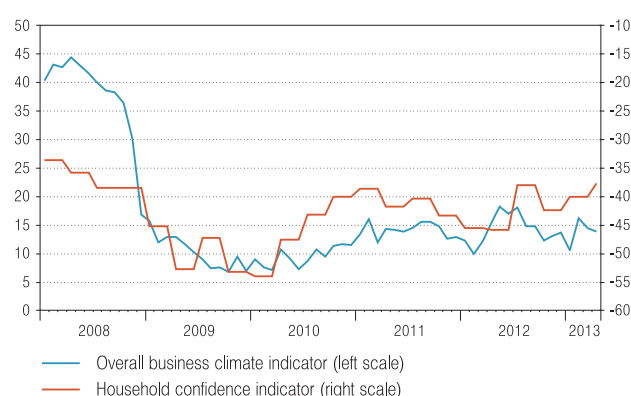


Note: Non-additive data due to direct chain-linked and seasonal adjustment of GDP and its components; the contribution of the change in inventories has not been included.

Sources: NSI, BNB calculations.

The still depressed labour market had a negative impact on households' confidence and their consumption. Although the nominal wage *per* employee continued rising, the firms' conservative policy of labour cost optimisation contributed to a slight decline in the overall wage bill. The decline in the latter indicator coupled with households' high propensity to save adversely affected consumption demand. This assumption is supported by lower retail trade turnover (at constant prices) and decreased industrial turnover on the domestic market. Despite these unfavourable trends, since early 2013 external demand has started to recover, thus contributing to the upturn in the economic activity of industry measured by industrial production index.

Business Climate and Household Confidence Indicator

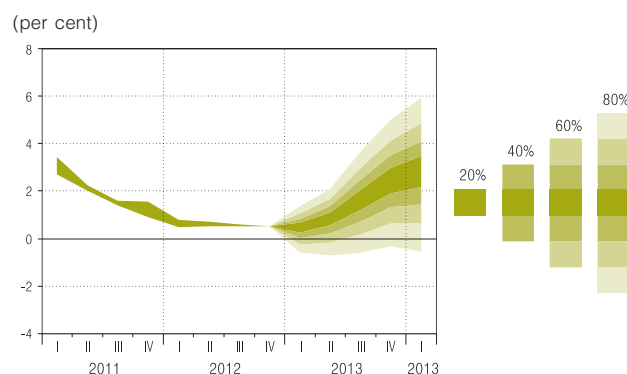


Sources: NSI, BNB calculations.

Based on current information, domestic demand is expected to remain close to its levels in the first quarter of 2013 and to start recovering at slow rates along with external demand strengthening. Programmes to stimulate employment are likely to ease temporarily the unfavourable labour market situation which would further support the recovery of household confidence and consumption. Nevertheless, labour market is expected to improve with a delay by the end of 2013. The spare production capacity and still subdued managers' expectations about the future economic activity would have a dissuasive effect on the dynamics of private sector investment activity. On the other hand, the planned increase in government capital expenditure in 2013 is projected to contribute positively to the overall investment activity. The simultaneous improvement of domestic and external demand is anticipated to push up real GDP growth in the

second and third quarters of 2013 against the background of currently low economic activity.

Fan Chart of the Expected Annual Rate of Change of GDP



Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The reporting period includes revised GDP growth estimates. 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.

Risks to this outlook are broadly balanced. However, if the growth rates of exports reported at the end of 2012 and in early 2013 are sustained, a faster-than-expected recovery of exports in 2013 may be anticipated. On the other hand, in case of further deterioration of economic agents' confidence due to the lack of clear recovery prospects for the euro area, the probability of a slower domestic demand recovery in the second and third quarters of 2013 will increase.

GDP Growth by Component of Final Use

(per cent real growth on the previous quarter; seasonally adjusted data)

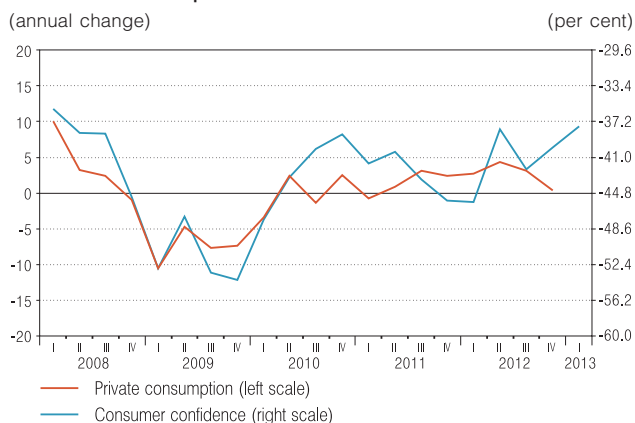
	2009				2010				2011				2012			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Consumption	-7.2	-0.5	0.6	-0.8	0.0	0.4	-1.2	4.1	-1.4	0.2	0.8	0.8	0.4	0.6	0.2	-0.1
incl.																
Household consumption	-6.8	-0.8	0.3	-0.6	0.2	0.4	-1.0	1.1	1.2	0.2	1.3	0.7	0.6	0.7	0.3	0.2
Final government consumption expenditure	-12.0	1.6	2.4	-0.8	2.1	0.9	1.6	1.0	-0.5	2.1	-2.3	0.6	-0.8	-0.2	-0.4	-3.0
Collective consumption	-0.8	0.6	-0.6	-13.2	12.6	-1.5	-0.4	-1.8	2.0	-0.5	-0.7	0.3	-0.4	0.2	0.0	0.1
Gross fixed capital formation	-7.1	-6.5	-7.0	-11.5	-4.9	-1.7	-2.2	2.2	-7.2	1.3	1.9	-3.4	2.4	-0.1	-0.4	-0.4
Exports of goods and non-factor services	-5.9	-2.5	0.2	6.7	1.2	6.8	8.4	-3.2	6.3	1.3	3.0	1.5	-5.7	4.7	-0.2	-0.6
Imports of goods and non-factor services	-15.7	-1.7	-0.3	-0.2	-1.2	3.4	1.3	3.8	1.8	-0.3	3.6	0.7	-0.6	5.8	-3.2	-2.3
Real GDP growth	-6.7	0.3	0.3	-2.9	1.2	1.0	0.8	0.6	0.3	0.4	0.2	0.1	0.0	0.4	0.1	0.0

Source: NSI.

Household Behaviour

The uncertainty stemming from external environment and economic situation in Bulgaria, as well as the unfavourable labour market situation remained driving factors behind comparatively low consumer confidence,²⁶ affecting household behaviour in the second half of 2012. With the retained high household propensity to save, decreased employment and low labour income dynamics, household consumption recovery slowed down in the second half of 2012.

Private Consumption and Consumer Confidence



Sources: NSI Consumer Survey and BNB calculations.

According to seasonally adjusted national account data, in the fourth quarter of 2012 household consumption rose by 0.2 per cent on a quarterly basis (0.3 per cent in the third quarter). In the second half of 2012 consumer expenditure growth moderated in public catering and non-food goods groups. Food consumption, however, decreased throughout the whole year. Purchased non-production services had an essential contribution to the change in consumption over the fourth quarter. No substantial changes occurred in the other groups.

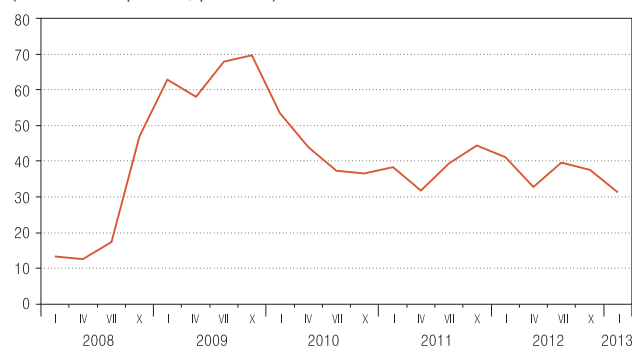
Slowing consumption in the second half of the year corresponds to the retail trade turnover, posting a slight decline in the same period (see the *Retail Trade Turnover* table). In the first quarter of 2013 retail trade volumes slightly fell, which gives grounds to project that consumption will stay at levels close to those of end-2012. In

²⁶ Final results of the Consumer Survey represent balances of opinions calculated as a difference between the relative shares of positive and negative consumer opinions on raised issues. The composite consumer confidence indicator is calculated as the arithmetic mean of expectation balances in the following twelve months for the development of: financial position and savings of households, the overall economic situation in the country and unemployment (the latter with the sign reversed).

addition, consumption recovery in the second and third quarters of 2013 is expected to be weak. Low employment will continue to have an unfavourable influence and its stable revival is likely to begin at the end of the year. The uncertain economic environment will have a similar effect, as reflected in comparatively low consumer confidence and high saving rates of households.

Unemployment Expectations in the Following Twelve Months

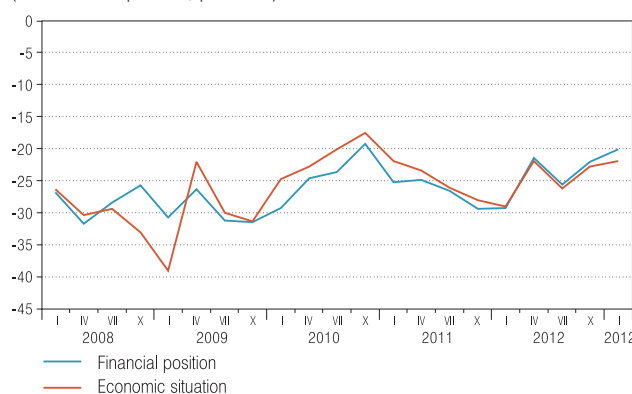
(balance of opinions; per cent)



Source: NSI Consumer Survey.

Expectations about the Financial Position and Economic Situation in the Following Twelve Months

(balance of opinions; per cent)



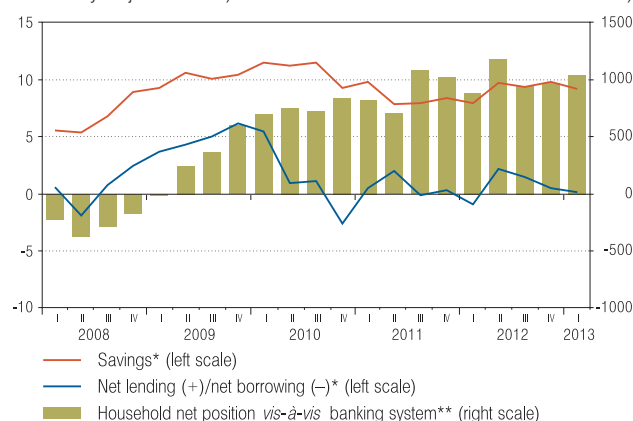
Source: NSI Consumer Survey.

In the fourth quarter of 2012 total employment continued to decline, posting a 1.5 per cent fall on a quarterly basis (seasonally adjusted data of national accounts), retail trade and industry having stronger negative contributions. Growth of employed on a quarterly basis was reported for the second consecutive quarter in the information and communication sector. However, its contribution to total employment growth remained insignificant. The labour force survey data show that in the first quarter of 2013 employment increased slightly by 0.2 per cent on a quarterly basis. At the same time, conjunctural indicators of firms' sentiment concerning personnel employ-

ment in April 2013 show a certain improvement in all sectors compared to end-2012. Our expectations for the second and third quarters point to retention of total employment at a level close to the current low level. Labour income measured by the average wage *per* employee continued to increase at comparatively low rates in both real and nominal terms over the fourth quarter of 2012. Higher real growth was reported on a quarterly basis in the sectors with lower-than-average remuneration, as construction (6 per cent) and culture, sports and entertainment (7.1 per cent). In the context of an ongoing fall of employment in most industries and comparatively low average wage growth rates in the fourth quarter of 2012, the wage bill in total economy declined by 1.5 per cent quarter-on-quarter in nominal terms. Due to the fact that labour income is the main source for household expenditure financing, the wage growth gives additional cause to expect retention of consumption at its current levels of early 2013.

Household Propensity to Save

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



* NSI data.
** BNB data.

Sources: NSI Household Budget Survey, BNB.

Low consumer confidence is evidenced by first quarter's household expectations about their financial situation, the general economic situation and unemployment level, as well as expected inflation acceleration in the following 12 months. Rather negative household sentiment is likely to contribute to a relatively high propensity to save, as reflected in both the increased share of savings in disposable income²⁷ and the excess of

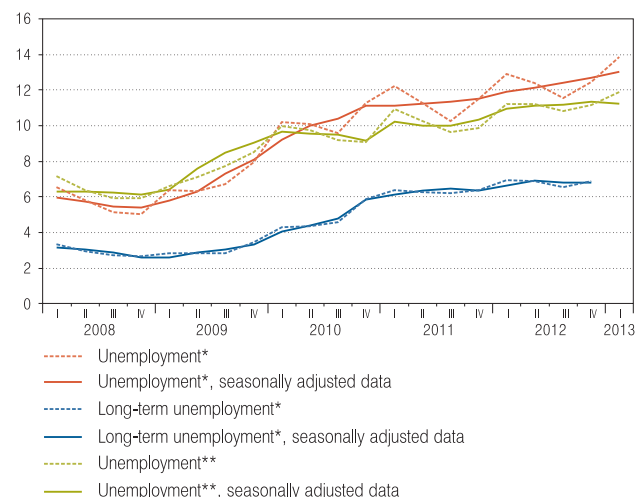
²⁷ Disposable income (based on the household budget survey) is obtained by subtracting tax expenditure, social contributions and transfers from the total income.

net lending over net borrowing.²⁸ BNB monetary statistics show a rise in net assets of households (net position of households, seasonally adjusted data) in the banking system over the first quarter of 2013. Household intentions to increase savings in the following 12 months (Consumer Survey data for the first quarter of 2013) signal a retention of higher rates of savings over 2013 and a slower recovery of consumption in the second and third quarters of the year.

Over the recent quarters some changes have occurred in the number of persons outside the labour force – from inactive to actively seeking jobs – and their inclusion in labour force (mainly as unemployed) signalling an increasing labour supply by households. This contributed to the slight rise in the level of unemployment (seasonally adjusted data) over the first quarter of 2013 based on NSI Labour Force Survey (13.0 per cent) and Employment Agency (11.2 per cent). This rise was accompanied by a decline in labour force on a quarterly basis. Employment Agency data of April 2013 indicate stabilisation of seasonally adjusted unemployment at a level close its current value (11.2 per cent). Labour Force Survey data point to a continued slight rise in the number of long-term unemployed (for more than a year) over 2012.

Unemployment

(per cent of labour force; seasonally adjusted data)



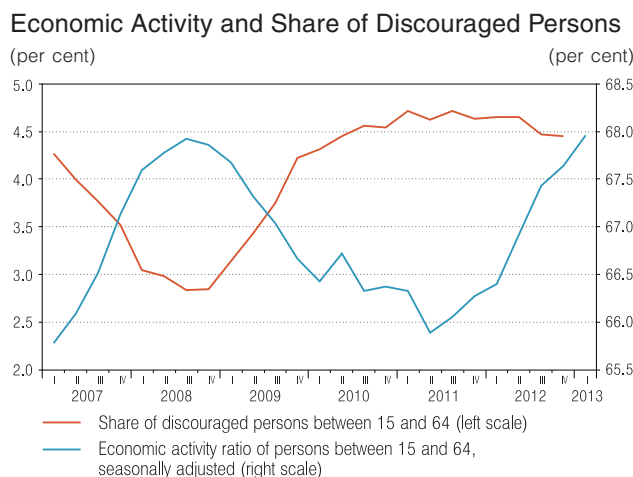
* NSI data.

** Employment Agency data.

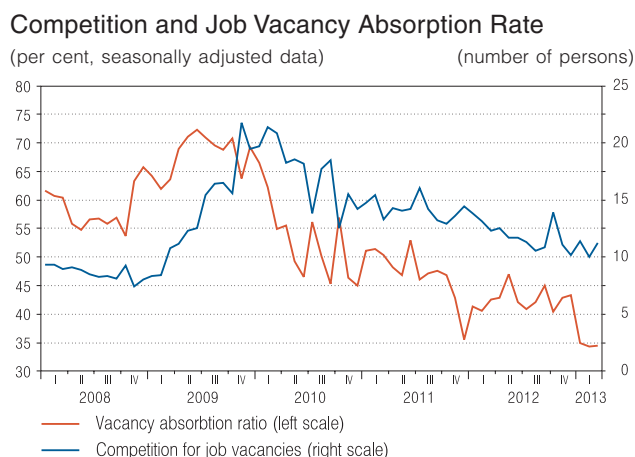
Sources: NSI Labour Force Survey, Employment Agency, BNB calculations.

²⁸ This indicator is based on NSI household budget data and is derived as the difference between deposit amounts, foreign currency and bond purchases and repaid debt and granted loans, on the one hand, and the amount of withdrawn savings, loans and credits, on the other hand.

Dynamics of the economic activity rate, measuring the *labour force* to *working-age persons* ratio, until the third quarter of 2012 also reflected the increased labour supply by households. The upward trend in quarter-on-quarter economic activity since 2011 is largely due to the decreased number of working-age persons and increased labour force in the first quarter of 2013. After declining in the third quarter, the share of discouraged persons in total working-age population remained comparatively constant over the fourth quarter.



Sources: NSI Labour Force Survey, BNB calculations.



Sources: Employment Agency, BNB calculations.

Data releases on vacancy absorption²⁹ published by the Employment Agency for the first quarter of 2013 give somewhat mixed signals. On the one hand, the vacancy absorption rate outside employment programmes remained comparatively constant, unlike that under employment programmes which declined due to significant

job vacancies not occupied in previous months. The overall increase in vacancies determines the downward trend in competition for occupying a vacancy in 2012. Given the signs of relatively low labour demand by corporations³⁰ and low vacancy absorption under EA employment programmes, it appears that the increased labour supply by households was reversed in the fourth quarter of 2012, as confirmed by Labour Force Survey data releases.

According to the Employment Agency, the expected low labour demand by firms and stabilisation of the number of unemployed are likely to reflect in the retention of employment at its current levels over the second and third quarters of 2013. Employment is expected to gradually rise only towards the end of the year. These expectations will in turn maintain a more moderate increase in nominal wages over 2013, with the strong link between real wage growth and labour productivity being sustained.

Between January and March 2013 household consumer demand is likely to remain at close to current levels and its recovery in the second and third quarters will be weak. Risks to the projection relate mainly to factors affecting consumer confidence, such as employment and income developments. They largely depend on firms' propensity to hire personnel and enhance investment activity. On the other hand, the active policy to stimulate employment and to retrain staff is expected to somewhat mitigate the unfavourable labour market situation.

Housing market data by region give initial signals about a reversal of the 2010 downward trend in average prices and a possible recovery of household investment demand in individual regions. Though declining continuously on both annual and quarterly basis, average housing price rates slowed down in the first quarter of 2013. In addition, prices stabilised in some cities (Russe, Veliko Tarnovo, Gabrovo, Targovishte). The reversed downward trend and increased housing prices in some cities of Northern and Central Bulgaria give grounds to suggest that household investment demand is strengthening in this region.

²⁹ This is the ratio between the number of newly occupied vacancies in a given month and the total number of vacancies in this month (unoccupied posts in the previous month and posts offered in the current one).

³⁰ In the Household Behaviour section, labour market situation is analysed in the context of labour supply by households. Labour demand by firms is discussed in greater detail in the Behaviour of Firms and Competitiveness section.

Employment and Income Dynamics

	2009				2010				2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Seasonally adjusted data (per cent on the previous quarter)																
Employed	-0.7	-1.1	-1.9	-1.5	-0.9	-1.3	-0.3	-1.9	-0.2	-0.7	-1.2	-0.4	-1.4	-1.5	-0.8	-1.5
Nominal wage per employee*	1.6	2.4	2.5	-2.7	16.0	-2.6	-0.6	2.0	4.7	2.3	0.6	1.4	-0.4	2.5	2.0	2.2
Real** wage per employee	2.1	1.4	2.3	-3.0	15.2	-4.3	-1.2	1.0	3.6	1.6	0.3	1.0	-0.9	1.9	0.6	1.9
Wage bill, nominal terms	2.9	0.7	-0.7	-5.5	17.1	-4.1	-2.2	0.2	5.6	1.4	-0.5	0.1	-1.1	1.7	0.9	-1.5
Wage bill, real terms*	3.3	-0.2	-0.9	-5.7	16.4	-5.8	-2.9	-0.7	4.4	0.7	-0.8	-0.3	-1.6	1.0	-0.5	-1.8
Non-seasonally adjusted data (per cent on the corresponding period of the previous year)																
Employed	0.0	-1.5	-3.4	-5.5	-5.9	-5.7	-3.4	-3.6	-3.7	-3.7	-3.5	-2.6	-3.8	-4.8	-3.9	-4.9
Nominal wage per employee*	18.4	15.6	14.8	2.6	19.4	13.4	9.1	12.9	3.4	9.3	10.3	8.8	3.6	4.2	5.8	6.2
Real** wage per employee	12.6	12.1	13.8	1.7	17.1	10.3	5.6	8.6	-1.0	5.7	6.9	6.1	1.7	2.3	2.7	3.3
Wage bill, nominal terms	18.2	13.3	9.6	-4.2	11.2	5.9	4.0	8.9	-0.8	5.6	7.2	6.3	-0.6	0.3	2.0	0.0
Wage bill, real terms**	12.4	9.9	8.7	-5.1	9.1	2.9	0.6	4.7	-5.0	2.1	4.0	3.6	-2.4	-1.5	-1.0	-2.8

* Wage is calculated on the basis of NSI (SNA) data by deducting social security contributions paid by employers from compensation of employees and dividing the difference by the number of employed.

** Data deflated by HICP.

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

Retail Trade Turnover

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

	2009				2010				2011				2012				2013
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Retail trade turnover, excluding cars and motorcycles incl.	-2.3	-3.3	-2.8	-2.4	-2.8	-1.3	-0.4	-0.9	3.7	-1.0	-1.3	-0.3	-1.8	1.2	-0.9	-1.8	-0.6
Foods, drinks and tobacco	6.9	0.1	0.7	0.2	0.2	1.0	0.5	0.7	1.0	0.1	0.5	0.6	0.3	0.0	-0.5	-0.9	-1.1
Textile, clothing, footwear and leather	-4.3	-2.8	-3.7	-1.2	11.5	-0.9	-1.1	-2.3	13.6	-4.4	-6.3	-2.0	-7.8	-2.1	0.5	-0.6	1.0
Household goods and home appliances	-16.8	-5.3	-4.1	-1.7	-13.0	-0.9	1.3	-0.8	-1.3	-2.4	-1.0	-1.7	-6.7	3.6	-4.5	-4.4	-4.9
Computers and communication equipment, etc.	-23.2	-2.0	-2.6	-2.9	-1.1	-1.4	7.7	0.4	-2.5	-0.5	-0.3	0.6	0.3	-0.5	-1.0	-3.2	-1.0
Pharmaceutical and medical goods, cosmetics and toiletries	6.8	-1.4	2.0	2.2	3.1	1.3	0.9	2.8	-0.1	3.4	1.8	5.2	-0.8	0.0	0.9	-4.5	-1.6
Unspecialised shops with different kinds of goods	41.2	2.6	2.9	3.4	6.2	4.7	5.5	3.5	1.6	0.3	-2.1	-2.0	-3.5	-1.5	-0.6	-0.4	1.4
Automobile fuels and lubricants	-2.2	-4.0	0.2	-0.4	-29.6	0.4	2.7	-1.1	-0.3	-2.1	-2.6	-0.4	-0.1	1.0	0.2	-2.3	1.6

Source: NSI Domestic Trade Survey.

Public Finance and Consumption

In 2012 the consolidated fiscal programme deficit came to BGN 357.4 million, or -0.5 per cent of GDP,³¹ which is significantly lower than the government programme ceiling of BGN 1092 million (-1.3 per cent of GDP).³² This result reflects primarily lower investment and operational expenditure.

In 2012 total budget revenue on consolidated fiscal programme amounted to BGN 27,470 million, posting annual growth of 8.2 per cent driven by tax revenue (3.7 percentage point contribution), grants (3.6 percentage point contribution) and non-tax revenue (1 percentage point contribution). The quarterly breakdown shows

³¹ According to final quarterly data.

³² The MF programme and estimate of GDP are set out in the report to the State Budget Law of the Republic of Bulgaria for 2012.

that funds under EU programmes gradually increased their contribution at the expense of the decreasing tax revenue contribution.

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

(per cent, percentage points)

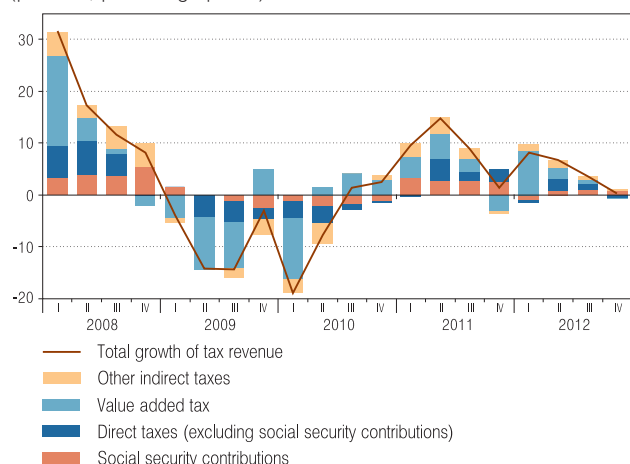


Sources: MF, BNB.

VAT revenue and to a less degree excise duties had the major contributions to tax revenue growth in 2012. Unlike excise revenue which retained its comparatively stable growth throughout the year, VAT receipts showed moderation in their annual growth, reflecting early 2012 measures to improve tax collection and differences in tax credit refunding over 2011 and 2012. Indirect tax developments were additionally impacted by the slowing growth in private consumption. In the fourth quarter budget revenue from corporate tax declined significantly, mostly reflecting the base effect of one-off October 2011 receipts by Kremikovtsi AD. If this effect is removed, annual growth in corporate tax revenue would be 1.5 per cent, corresponding to the growth of the relevant tax base. At the same time, revenue from personal income tax retained its stable growth throughout the whole year.

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

(per cent, percentage points)

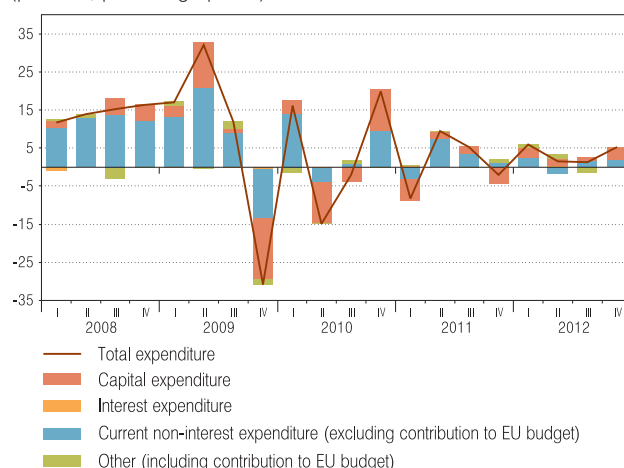


Sources: MF, BNB.

In 2012 grants revenue rose approximately 62 per cent on 2011 and their contribution to total government revenue growth increased to 3.6 percentage points compared to the negative contribution of 0.6 percentage points a year earlier. This change was broadly due to the increased EU structural and cohesion fund absorption rate to 34.1 per cent by end-2012, from 18.8 per cent by end-2011. Irrespective of the higher rate, the implementation of revenue from grants *vis-à-vis* the State Budget Law was 61 per cent (66 per cent in 2011).

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

(per cent, percentage points)

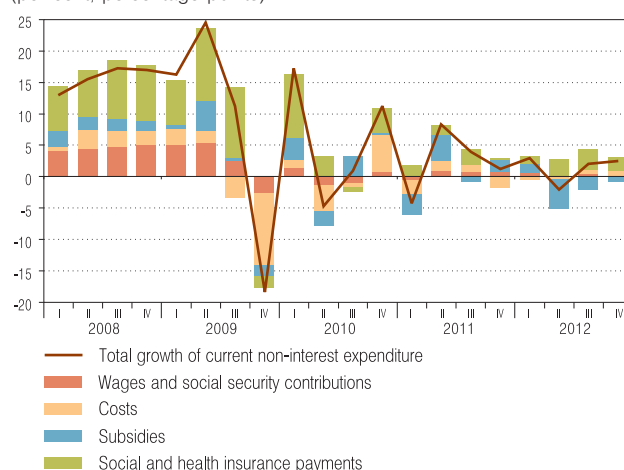


Sources: MF, BNB.

In 2012 total consolidated fiscal programme expenditure³³ came to BGN 27,828 million. The annual expenditure growth was 3.6 per cent, with higher capital and social security, assistance and care expenses contributing most significantly to it. Growth was additionally curbed by lower expenses on subsidies which declined by some 23 per cent on an annual basis.

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

(per cent, percentage points)



Sources: MF, BNB.

After declining in the third quarter of 2012, the growth rate of capital expenditure accelerated in the fourth quarter to reach levels close to those of the first half year. This acceleration was broadly due to higher payments on projects financed by EU structural and cohesion funds. Social expenditure growth remained stable, driven mainly by

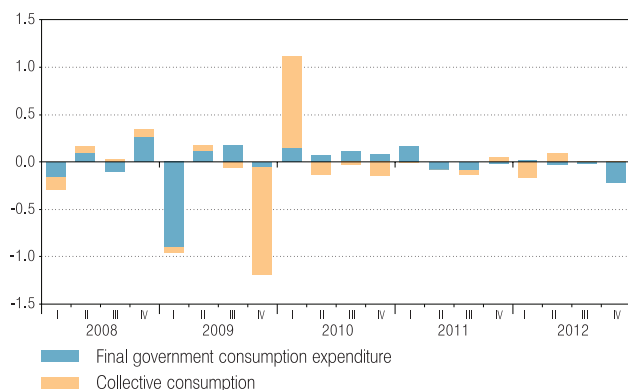
³³ Including Bulgaria's contribution to the EU budget.

higher current transfers, compensations and aids for households which posted around 10 per cent growth in 2012, while pension expenses retained their comparatively constant annual growth of approximately 1.8 per cent.

Reflecting the continued process of fiscal consolidation in 2012, the contribution of government consumption to economic growth was negative in the fourth quarter at -0.2 percentage points,³⁴ this rate being sustained throughout the whole year. Fiscal consolidation in the review year was achieved through operating expenditure and wage restraints in the public sector. Unlike the first six months of 2012 marked by declines in operating expenditure on an annual basis, its second half's growth was positive, while wage and social security contribution growth in the public sector remained constant at a low level during the whole year.

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

(percentage points)



Sources: NSI, BNB.

On an accrual basis (under ESA'95 methodology), the general government deficit reached BGN 624 million or 0.8 per cent of GDP in 2012. The deficit level under ESA'95 was 0.8 percentage points lower than the value set in Bulgaria's Convergence Programme for the 2012–2015 period. Structurally, the deficit comprised 0.4 per cent of GDP,³⁵ which is below Bulgaria's medium-term budgetary objective of 0.5 per cent of GDP.³⁶ At the end of 2012 nominal consolidated

debt of the general government sector was BGN 14,390 million (18.5 per cent of GDP), an increase of 2.2 percentage points of GDP compared to 2011.

According to the Budget Forecast for the 2014–2016 period adopted by the Council of Ministers on 17 April 2013, the budget cash deficit on consolidated fiscal programme is projected to remain nominally unchanged at BGN 1100 million (1.4 per cent of projected GDP) compared to the planned 2012 deficit of BGN 1092.3 million or 1.3 per cent of GDP. Planned revenue and grants (BGN 30,192 million) were 9.9 per cent higher than 2012 receipts, while projected growth of total budget expenditure (including the contribution to EU budget) *vis-à-vis* the previous year's implementation was 12.4 per cent (BGN 31,292 million). The planned high growth of total budget revenue was mainly due to the grants revenue which is projected to increase by 50.4 per cent on the previous year. Tax revenue is expected to grow by 7.7 per cent mainly because of the projected high growth of VAT revenue (9.3 per cent) and social and health insurance contributions (8.5 per cent).³⁷ The anticipated growth of total non-interest expenditure by 11.6 per cent driven mostly by pension and operating expenditure will have the largest contribution to the overall budget expenditure rise. The expected high EU fund absorption rate was the main reason behind the 35.9 per cent excess of the planned 2013 capital expenditure over the previous year's value.

In line with medium-term budget projection parameters, the updated 2013–2016 Convergence Programme forecasts a general government deficit of 1.3 per cent of GDP for 2013. After 2014 this deficit is projected to gradually decrease until reaching a balanced budget in 2017. After a temporary deviation within the programme period, the medium-term budgetary objective of Bulgaria is also anticipated to be implemented in 2017.

The MF monthly data for the first quarter of 2013 show a budget deficit on consolidated fiscal

³⁴ Operating expenditure and compensation of employees in the public sector are the two major components of government consumption.

³⁵ Under Bulgaria's Convergence Programme for the 2013–2016 period.

³⁶ Under the Law on Public Finance (published in the Darjaven Vestnik, issue 15 of 15 February 2013), the medium-term budgetary objective of general government sector'

structural deficit should not exceed 0.5 per cent of GDP on an annual basis.

³⁷ The increase in social and health insurance contributions results mainly from the 20 per cent rise of social security contributions to the Pension Fund paid by special bodies' employees. This increase is also associated with the relevant growth in social security expenses of special bodies and therefore has no bearing on the overall consolidated fiscal programme balance.

programme of BGN 795.6 million generated by the national budget deficit of BGN 474.7 million and EU programme deficit of BGN 320.9 million.

Growth in total budget revenue and grants was 3.3 per cent on an annual basis, with tax revenue (2.8 percentage points), and especially VAT receipts, contributing most significantly to this.

Direct tax revenue was negative at -0.6 percentage points after first quarter's corporate tax declines of 10.5 per cent compared with the same period of 2012. This decrease can be explained by the extended term for depositing monthly advance payments for the first three months of the year which causes problems for data comparability.³⁸ Between January and March the annual growth rate of revenue from personal income tax comprised 3.1 per cent, including income from the new tax on time deposit interest estimated at BGN 15.5 million. March data show that there is a serious risk of underperformance of new tax revenue estimated at BGN 132 million³⁹ for 2013. However, if interest tax income is deducted, growth of budget revenue from personal income tax would be 0.1 per cent by end-March.⁴⁰ Over the same period, social security contributions increased merely 1.2 per cent. If the effect of increased security contributions paid by special bodies' employees is eliminated, this revenue would decrease by 3.0 per cent on an annual basis.

In March the annual growth rate of indirect tax revenue was broadly driven by the increase in VAT receipts (15.1 per cent). In turn, this growth was mainly due to higher VAT revenue from domestic and intra-Community transactions (net⁴¹) and to a lesser degree to VAT on imports. In the first quarter of 2013 excise revenue declined on an annual basis, reflecting mostly lower fuel excise receipts. However, the MF monthly data show that their decline rate slowed down to -5.6 per cent by end-March, from -15.4 and -7.5 per cent in January and February.

³⁸ From 1 January 2013 monthly corporate tax advance payments for January, February, March and April are due by the end of April. For further information on early 2013 changes in tax legislation, see the box Major Tax Legislation Amendments Effective since 1 January 2013, p. 53.

³⁹ Under Bulgaria's Convergence Programme for the 2013–2016 period.

⁴⁰ According to the March MF bulletin, over the review period undesignated liabilities of BGN 143.3 million were allocated into revenue from personal income tax on the basis of estimates.

⁴¹ Net revenue, less VAT refunded to exporting companies.

Growth in revenue from grants remained negative in March, though it is expected to accelerate given the anticipated increase of the EU fund absorption rate.

Preliminary data of the Ministry of Finance for the first three months of the year show that the annual growth of total expenditure (4.6 per cent) was mainly driven by compensation of employees in the public sector (2.3 percentage points⁴²) and current operating expenditure (1.0 percentage points). Preliminary monthly data point to some 7.0–7.5 per cent growth in public sector wages over 2013, above the 2 per cent⁴³ level projected by the government. First quarter's expenditure was affected by a one-off factor associated with the higher amount of the last interest payment on global bonds maturing in January. This was due to the difference between the original nominal amount of the issue (EUR 835.5 million) and the price of its sale in the market (0.9962). Lower subsidy expenditure (-15.8 per cent) and investment (-6.3 per cent) had the major contribution to limiting the annual growth in total budget expenditure.

The contribution of government consumption to GDP growth is expected to increase in the second and third quarters of 2013 based on monthly data on consolidated fiscal programme implementation in March and the expenditure policy set out in the 2013 budget. Social expenses will also rise following the 9.3 per cent pension increase in April and the measures initiated by the caretaker cabinet to support the most vulnerable groups in the society. Our expectations show a continuous rise in the EU structural and cohesion fund absorption rate given the progress in launching major infrastructure projects financed by operating programmes. This will also boost capital expenditure over the following quarters.

In the first three months budget was mainly financed by fiscal reserve funds and a positive net issue of domestic government securities. The major part of the fiscal reserve change (BGN -1865 million) since early 2013 was due to Eurobond principal payments maturing on 15 January 2013 (BGN 1546 million) and farmer

⁴² If the effect of increased security contributions paid by special bodies' employees is eliminated, this contribution would be 1.5 percentage points.

⁴³ Based on data about implementation of the consolidated fiscal programme in 2012 and projected wage expenditure in the report to the 2013 State Budget Law.

Revenue and Expenditure on Consolidated Fiscal Programme for 2012 – 2013 (percentage changes and contributions to growth)

Consolidated fiscal programme	2012								2013	
	I quarter		II quarter		III quarter		IV quarter		I quarter*	
	Annual rate of change on the same period of the previous year (per cent) and contributions to total revenue/expenditure (percentage points)									
	per cent	percent- age points	per cent	percent- age points	per cent	percent- age points	per cent	percent- age points	per cent	percent- age points
Total revenue and grants	7.7		11.6		7.1		6.6		3.3	
Tax revenue	8.2	6.8	6.7	5.4	3.6	3.0	0.4	0.3	3.3	2.8
Corporate tax	-9.7	-1.0	19.5	1.1	9.2	0.4	-18.8	-0.8	-10.5	-0.9
Personal income tax	4.1	0.4	8.6	0.8	6.1	0.5	2.7	0.2	3.1	0.3
Value added tax	33.4	7.0	6.7	1.8	2.3	0.7	-0.5	-0.1	15.1	3.9
Excise	6.3	0.9	7.9	1.1	3.1	0.6	2.9	0.4	-5.6	-0.8
Customs duties	-2.4	0.0	13.7	0.1	-20.8	-0.1	-21.8	-0.1	14.4	0.1
Social and health insurance contributions	-3.2	-0.8	2.8	0.6	3.9	0.8	2.6	0.6	1.2	0.3
Other taxes	7.2	0.2	0.3	0.0	6.7	0.2	4.7	0.1	-1.9	-0.1
Non-tax revenue	4.7	0.7	15.0	2.3	13.9	1.6	-5.1	-0.6	6.6	0.9
Grants	9.1	0.3	104.9	3.8	49.0	2.5	64.9	6.8	-11.6	-0.3
Total expenditure (incl. the contribution to EU budget)	6.0		1.5		1.3		5.3		4.6	
Wages and social security contributions	2.0	0.4	1.1	0.2	2.1	0.4	1.7	0.3	12.7	2.3
Operating expenditure	-1.4	-0.2	-2.3	-0.4	2.8	0.4	3.1	0.6	6.9	1.0
Interest	1.8	0.1	44.1	0.3	1.4	0.0	-5.6	0.0	10.5	0.5
Social security, assistance and social care	2.7	1.2	6.0	2.6	5.9	2.6	4.8	1.8	4.3	1.9
Subsidies	24.4	1.1	-52.6	-4.2	-31.6	-1.7	-12.1	-0.7	-15.8	-0.9
Capital expenditure and state reserve growth	38.3	2.5	23.7	2.3	-3.4	-0.4	27.3	4.3	-6.3	-0.5
Contribution to EU budget	22.7	0.9	36.1	0.7	1.1	0.0	-28.1	-0.9	6.9	0.3

* Based on preliminary data on CFP implementation for 2013, relative to the final data on CFP implementation for 2012.

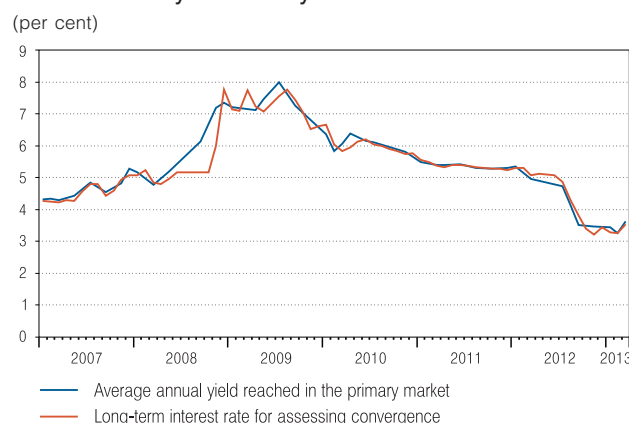
Source: MF.

subsidies paid in advance in February (BGN 840 million⁴⁴). The fiscal reserve increase was fuelled by a positive net issue of domestic government bonds of BGN 1077.7 million⁴⁵ and positive net external financing to the amount of BGN 276.0 million.

After a prolonged decline in 2012, government bond yields in the primary market slightly increased in the first three months of 2013⁴⁶ which reflected on bond prices in the secondary market. Bulgaria's long-term interest rate⁴⁷ stabi-

lised at a level of about 3.5 per cent in March and April, up 25 basis points compared to its lowest value achieved in November 2012.

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



Source: BNB.

The price of five-year Bulgarian Eurobonds issued in international markets in 2012 remained high, with a temporary decline in February (108.5) and a rise to some 110.4 at the end of April. This value corresponds to an annual yield

⁴⁴ Refunded by the EC in April.

⁴⁵ On 20 February the MF held an unscheduled auction of six-month short-term treasury bills worth BGN 800 million in nominal value. This issue was intended to temporarily meet advance subsidy payments to farmers before their refunding by the EC in April. The attained average annual yield was 1 per cent and bid-to-cover ratio 1.45. This unscheduled issue prompted no revisions to the MF issuing policy for 2013 since its maturity is in the same year.

⁴⁶ For details on individual issues of domestic government securities, see *Government Debt Management* monthly bulletin of the Ministry of Finance.

⁴⁷ 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.

of 1.65 per cent, which is a significant decrease compared to the 4.44 per cent yield attained at their initial sale in July 2012.

As a result of the MF issuing policy, in the first quarter of the year the amount of domestic gov-

ernment securities debt rose by BGN 1080.0⁴⁸ million on end-2012 to BGN 6061.0 million.⁴⁹

⁴⁸ Including the unscheduled issue of six-month lev treasury bills worth BGN 800 million nominally, maturing in August 2013.

⁴⁹ Including government bonds issued for structural reform (BGN 189.6 million).

Major Tax Legislation Amendments Effective since 1 January 2013

Amendments to the conditions for calculating obligations and their payment time limits under the Corporate Income Tax Law, Income Taxes on Natural Persons Law and Social Security Code were introduced in early 2013. These amendments change the monthly profile of tax revenue and are one of the factors behind lower receipts on some tax items in early 2013. In the beginning of 2013 certain conceptional changes in the manner of paying tax obligations and in the basis for calculating some taxes were adopted with a view mainly to increase tax revenue and collection.

Major amendments to the monthly profile of tax revenue include:

- Projected tax profit for the current year is used as a basis for calculating advance payments on corporate tax instead of declared tax profit for the previous year. The threshold of net revenue from sales for the previous year under which taxable persons are exempt from advance payments is raised from BGN 200,000 to BGN 300,000. Quarterly advance payments are made by persons whose net revenue from sales is between BGN 300,000 and BGN 3 million, while persons with sale volumes of over BGN 3 million are obliged to pay monthly contributions. Tax profit for the previous year is no longer a criterion for setting advance payments which will depend solely on net revenue from sales.
- The time limits for advance corporate tax payments are changed as follows:
 - monthly payments for January, February and March are due altogether prior to 15 April instead of the 15th day of the month they relate to. Time limits for the rest monthly advance payments remain unchanged.
 - the last quarterly payment for the year is made prior to 15 December instead of 15 October. Time limits for the rest quarterly advance payments remain unchanged.
- Expenditure tax and tax on the activity from operation of vessels become annual taxes to be paid prior to 31 March of the following year. Thus far, taxes have been paid on a monthly basis.
- Final tax and advance tax on rental income and other economic activity under the Income Taxes on Natural Persons Law are due on a quarterly basis prior to the 25th day of the month following the quarter during which the tax event occurs. Thus far, these taxes have been paid on a monthly basis.
- Uniform time limits are introduced for payment of social security contributions under labour contracts and for self employed persons: prior to the 25th day of the month following the month in which work is actually done. Until the end of 2012 social security contributions under labour contracts were paid together with labour remunerations.

Amendments to tax legislation affecting revenue and its collection:

- In January 2013 important changes to the manner of paying tax and insurance obligations in the National Revenue Agency* became effective. From 1 January 2013 tax and social security contributions (excluding supplementary compulsory pension insurance) will be paid on one bank account. The major difference compared to the past procedure for repaying public claims is that received payments are automatically linked to the obligations in the order of their occurrence and each payment is allocated to the oldest obligation.
- Natural persons' interest income from time deposits with banks is taxed at a 10 per cent rate. Banks and foreign bank branches in Bulgaria withhold a 10 per cent final tax of gross interest income from time deposits of resident persons and deposit it until the end of the month following the month of interest income acquisition.
- The maximum amount of social security income is raised from BGN 2000 to BGN 2200.
- Penalty interest rates imposed for inconsistencies between advance contributions and due annual corporate taxes are reduced along with interest rates for overdue payments of social security contributions.

* Source: National Revenue Agency.

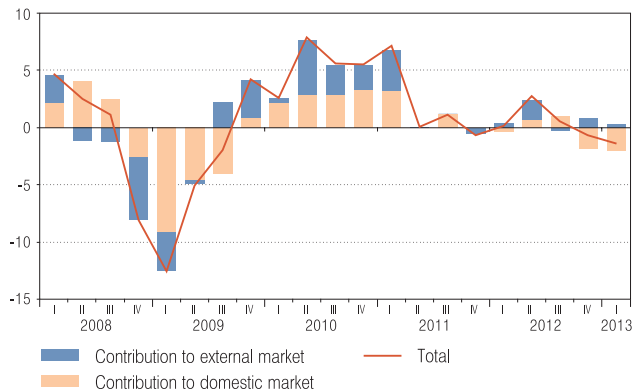
Behaviour of Firms and Competitiveness

Industrial firms' economic activity reflected two diverse trends in the last quarter of 2012. Domestic demand decelerated, while exports to non-EU countries increased. These trends may be seen through the conjunctural indicators of sales turnover and industrial production index. The growth of external sales revenue was offset by declines in domestic sales. This trend persisted over the first three months, though the positive contribution of the external market decreased.

The reported rise in industry's sales on external markets referred to all groups of goods except for non-durable consumer goods. Energy products, like coke and refined petroleum products, had the strongest contribution to this. On the other hand, the group of energy products had the major contribution to the decreased sales of industry on the domestic market. External demand growth in the last quarter of 2012 affected positively the industrial production index, a trend being sustained in the first three months of 2013.

Industry Turnover Dynamics

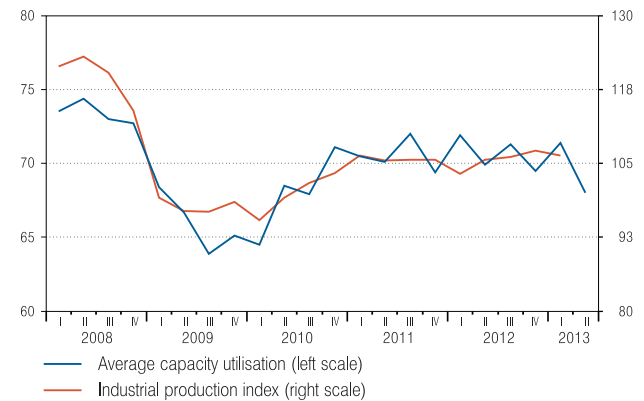
(per cent, quarter-on-quarter percentage points, seasonally adjusted data)



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

Production capacity utilisation went down in the second quarter of 2013 which is indicative of available free capacities in industry. This affected the low investment activity in the sector.

Production Capacity Utilisation in Industry (per cent)



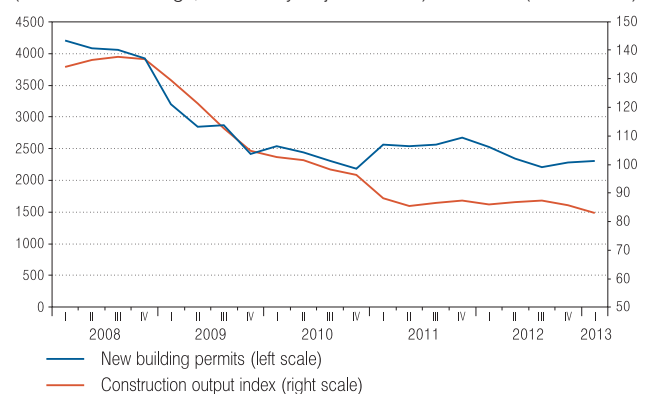
Source: NSI, Industry Business Survey, BNB calculations.

While the last quarter of 2012 saw positive developments in industry in terms of external demand, economic activity of construction firms dropped at the end of the year, affecting both building and civil engineering construction. The fall in construction output index was most pronounced in December, reflecting most likely temporary factors, since it was entirely offset in the first quarter of 2013. The tendency among companies to postpone the implementation of construction investment plans was sustained. Issued building permits for new buildings remained at a low level and data on started construction of new buildings and newly launched houses continued to show negative trends.

Construction Output Dynamics and New Buildings Permits Issued

(number of buildings; seasonally adjusted data)

(2010 = 100)



Sources: NSI, BNB calculations.

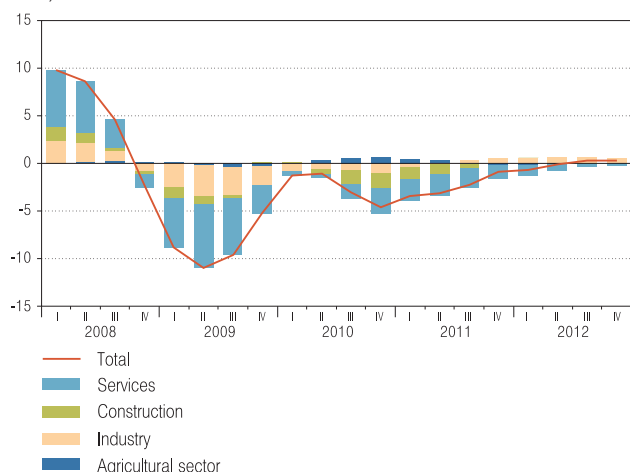
Trade volumes⁵⁰ went down as a result of the reduced household consumption. Data show that households decreased their demand for all groups of goods, with sales of durable consumer goods posting the strongest decline at constant prices. In the sectors providing business ser-

⁵⁰ See the Retail Trade Turnover table in this Chapter, p. 48.

vices, demand was sustained and corporations' trade volumes continued to pick up, albeit at slowing rates.

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

(per cent, quarter-on-quarter percentage points, seasonally adjusted data)

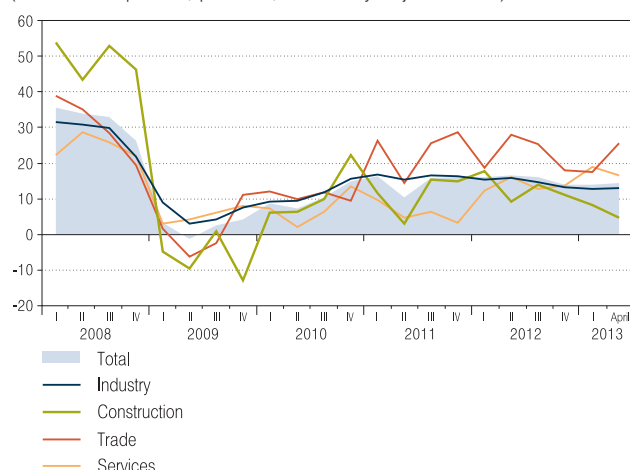


Note: Preliminary quarterly data due to the lack of final data.

Sources: NSI, BNB calculations.

Expectations about Future Economic Activity

(balance of opinions, per cent; seasonally adjusted data)



Sources: NSI, BNB calculations.

Due to the heightened uncertainty, firms' investment policy remained comparatively unchanged at the end of 2012. In the fourth quarter real gross fixed capital formation posted a slight decline of 0.4 per cent on a quarterly basis. Expenditure on acquiring fixed assets in nominal terms retained its weak positive growth rate, with industry and agriculture contributing most positively to this. However, construction and services reported a quarterly decrease in fixed asset acquisition expenditure, though at significantly lower rates than those in 2011. The moderation in the weak rate of investing in physical assets

is likely to reflect the decreased expectations of managers about future economic activity. In early 2013 expectations slightly improved, though remaining at relatively low levels which will result in a slow rate of recovery in gross fixed capital formation over the first three quarters of 2013.

Reflecting the slack in Bulgaria's economic activity, gross operating surplus rose slightly on a quarterly basis in the fourth quarter of 2012, with industry contributing most positively, driven by improved economic activity of corporations. The downward trend in construction was retained due to the still dampened economic activity rate in this sector.

Developments in gross operating surplus and other financing sources show that firms initiated measures to improve their financial wealth. In addition to gross operating surplus, firms used bank loans and external funds, including foreign direct investment, to finance their operations. In the second half of 2012 foreign financial flows into corporations decreased, especially FDI. This information is preliminary, subject to revisions, but the increased uncertainty in the EU is likely to affect the capital inflows into Bulgaria.

Gross Operating Surplus at Current Prices

(billion BGN; seasonally adjusted data)

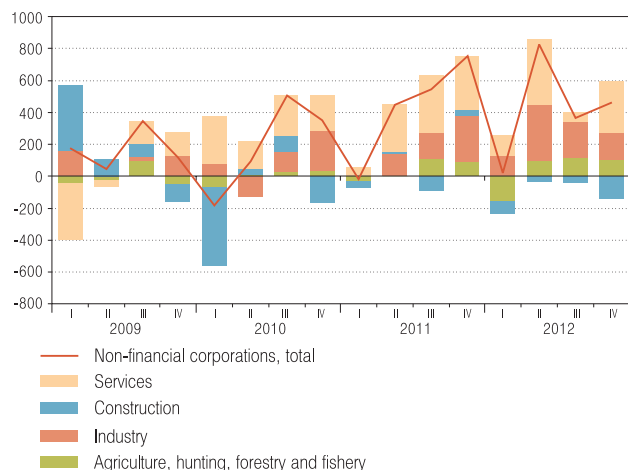


Sources: NSI, BNB calculations.

By sector, financial flows were equally distributed between industry and services. Financial flow dynamics slowed down in both sectors.

Bank Loans to Non-financial Corporations

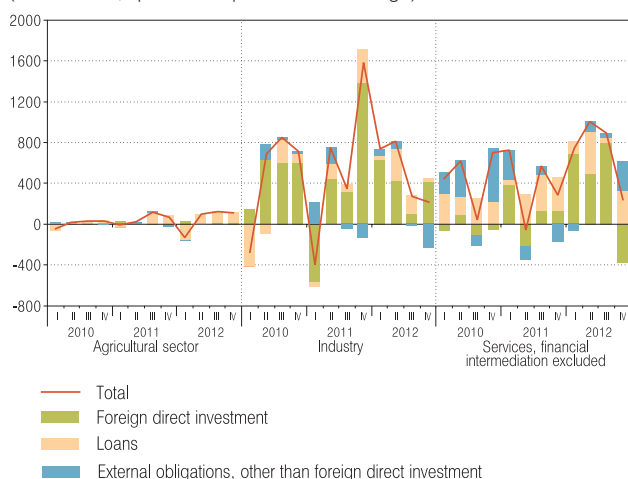
(million BGN, quarter-on-quarter stock change)



Source: BNB.

Financing Sources*

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

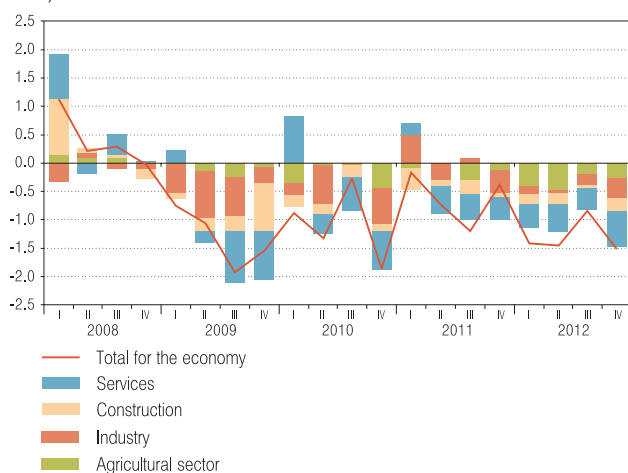


* The chart displays financing sources other than gross operating surplus.

Source: BNB.

Contribution to Changes in the Number of Employed by Economic Sector

(per cent, quarter-on-quarter percentage points, seasonally adjusted data)



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

Sources: NSI, BNB calculations.

Labour Productivity Developments

(Value Added *per Employee*)

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

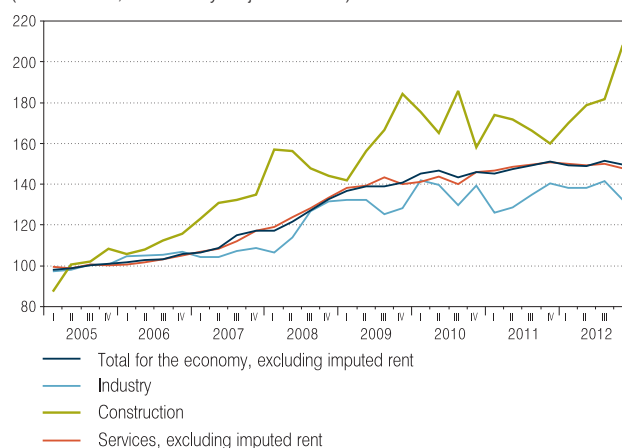


Sources: NSI, BNB calculations.

The overall trend to a slack in internal economic activity created conditions for firms to continue optimising their investment and labour expenditure. All economic sectors recorded declines in employment over the last quarter of 2012, with services posting the largest and most continuous fall. Given the sustained demand for services in Bulgaria, shown in the data on stocks in other services, employment decreases are most likely to reflect optimisation of labour costs by corporations.

Nominal Unit Labour Costs

(2005 = 100; seasonally adjusted data)



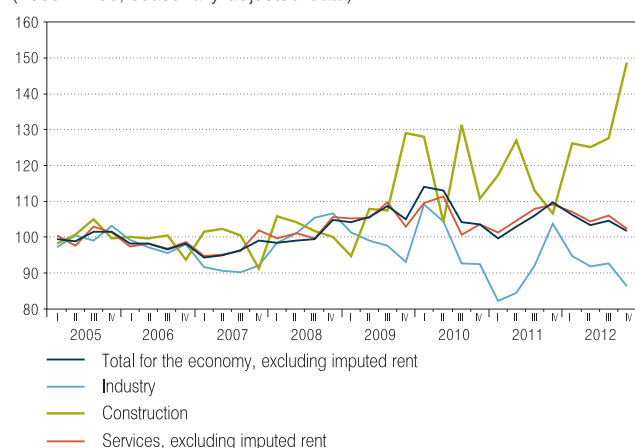
Sources: NSI, BNB calculations.

As a result of the continued policy to optimise labour costs and the retained economic activity rate, labour productivity in total economy continued to increase over the fourth quarter of 2012, with industry and services reporting the major positive contribution. In parallel, compensation of employees accelerated nominally in total economy at a rate lower than that of labour productivity. Hence, nominal unit labour costs

declined on a quarterly basis. In industry where optimisation processes develop at faster rates due to its export-oriented structure, nominal unit labour costs posted the strongest decline in 2012. In real terms, the downward trend in unit labour costs has prevailed since early 2012, with the industrial and services sectors recording the most essential declines. The upward tendency in construction continued over the review period.

Real Unit Labour Costs

(2005 = 100; seasonally adjusted data)



Sources: NSI, BNB calculations.

Reflecting a slight deterioration of domestic demand dynamics and a positive trend in external demand, over the fourth quarter value

added in economy rose by 0.2 per cent on a quarterly basis compared to the previous quarter. Industry and services had the largest positive contribution, while construction registered a negative contribution. In this context, corporations continued to pursue a policy directed at efficiency improvements and prudent expenditure management. Such indications can be found in total factor productivity during the whole year. It continued to have the largest positive contribution to real GDP growth.

Value Added Growth and Contribution by Sector

(per cent, 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 calculations.

Gross Value Added Growth

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

	2009				2010				2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Agriculture and forestry, hunting and fishing	-2.9	-4.5	-3.4	-3.7	-2.7	0.5	-0.4	-1.9	2.8	1.3	2.7	0.5	4.7	-2.1	-0.4	0.1
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	2.4	1.8	-1.2	1.5	-0.7	1.9	0.4	2.1
Construction	5.2	-8.4	2.8	-22.4	0.0	1.1	-2.2	0.2	-4.2	-1.5	12.1	-10.5	1.4	2.1	2.1	-17.2
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	1.4	2.2	0.3	-1.1	1.0	0.8	0.8	1.2
Creation and dissemination of information and author products; telecommunications	-1.5	1.9	-2.7	0.9	0.9	1.8	-0.9	-0.5	2.7	-1.4	0.8	-0.7	-2.2	-0.4	0.3	-0.2
Finance and insurance activity	9.2	-2.7	-4.4	5.8	4.9	-8.8	4.6	-2.3	-0.2	1.6	3.6	-1.1	-3.7	2.0	-0.1	0.0
Real estate activities	0.8	-2.2	-3.5	-0.1	3.4	0.4	0.2	0.0	-1.7	1.0	0.5	2.2	-1.5	0.9	-0.7	-0.4
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	11.6	-9.5	5.3	6.7	-6.8	0.7	-1.1	-3.4
General government; education; healthcare and social services	-2.8	4.3	1.2	-0.1	0.8	-1.6	-2.7	-0.7	0.6	-0.3	0.0	-1.6	0.9	0.1	0.5	1.4
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	1.0	-5.6	-1.9	-4.8	-5.1	4.7	4.2	5.1
Gross value added, total for the economy	-4.1	-0.1	-0.2	-0.7	0.1	0.4	0.8	0.9	0.4	0.6	-0.2	0.0	-0.3	0.6	0.1	0.2

Source: NSI.

Contribution of Changes in Production Factors to GDP Growth

(per cent, quarter-on-quarter percentage points)



Sources: NSI, BNB calculations.

Given the slowdown in both household consumption and investment activity of corporations, economic activity in Bulgaria is expected to remain low in the second and third quarters of 2013. In this context, firms are likely to continue optimising their expenditure policy, which will be reflected in a labour market slack and slow investment activity growth.

Exports and Imports of Goods

In early 2013 exports increased significantly, with nominal growth rate reaching 12.9 per cent in the first quarter on the corresponding period of the prior year. The increase in exports was mainly driven by several factors: the economic growth in non-EU countries to which part of exports of Bulgarian goods is directed, the stabilisation of major commodity prices on international markets and the improvement in the terms of trade. Between January and March 2013 imports grew at a lower rate of 2.4 per cent on an annual basis due to weaker domestic demand. As a result of nominal exports and imports dynamics, trade balance deficit continued to improve, a trend which evolved in the fourth quarter of 2012 and in the first quarter of 2013 it decreased to EUR 420.7 million (improvement by EUR 140.9 million on an annual basis). The unfavourable terms of trade dynamics between the last quarter of 2011 and the third quarter of 2012, contributed to the increase in trade deficit. Only in the fourth quarter of 2012 terms of trade improved, following the drop in annual inflation of energy products and the rise in metal prices.

Net Exports of Commodity Groups by Use, January–February 2013

	Balance, million EUR	Change*, million EUR	Exports growth**, per cent	Imports growth**, per cent
Consumer goods	104.8	-0.9	10.1	12.0
Raw materials	-69.5	-159.0	8.3	21.5
Investment goods	-171.3	197.9	25.4	-9.1
Energy resources	-406.2	145.2	65.2	9.2
Total	-553.2	178.9	18.5	9.8

* Balance change on same period of previous year.

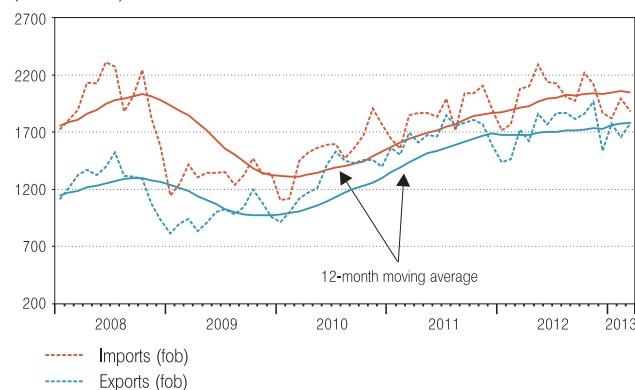
** Exports and imports growth for the period on an annual basis.

Source: BNB.

In the second and third quarters of 2013 exports and imports are expected to grow nominally at a moderate pace. The increase in external demand mainly from non-EU countries will be the main driver behind exports dynamics in real terms, while imports dynamics will depend on the expected moderate recovery in domestic demand. Terms of trade are expected to remain favourable as a result of the fall in fuel prices and the metal and commodity price rise. Against this background trade deficit is likely to remain close to its current level of 7.5 to 8.5 per cent of GDP.

Exports and Imports Dynamics

(million EUR)

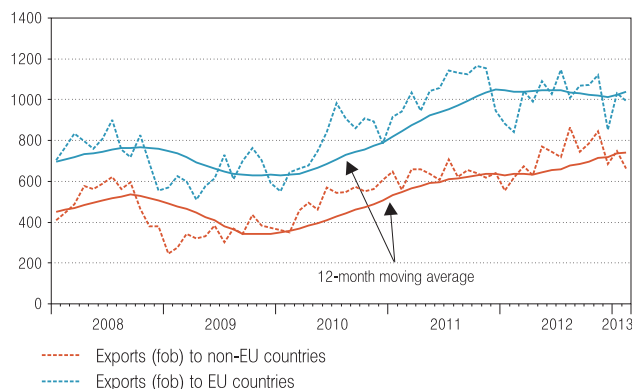


Source: BNB.

Exports of mineral products and fuels are expected to contribute further to exports growth over the projection horizon, as the bulk of them is exported to non-EU countries, but the fall in their prices may curb nominal growth. All groups by use are likely to contribute to the moderate growth of imports and the expected falls in petrol prices will probably be reflected in the weaker dynamics of the mineral products and fuels group.

Dynamics of Exports to EU and non-EU Countries

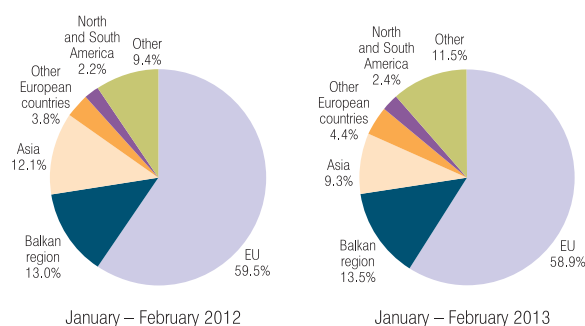
(million EUR)



Source: BNB.

Risks to higher-than-expected trade deficit relate to the lower-than-expected external demand, as well as to the faster recovery of domestic demand and higher import growth rates. International price dynamics of major commodities affecting adversely terms of trade may also result in a larger trade deficit, *e.g.* in case of higher-than-expected oil prices and fall in metal prices.

Geographical Distribution of Exports



Source: BNB.

In the second half-year of 2012 exports to non-EU countries increased greatly, while exports to EU-countries decreased due to the differences between EU and non-EU countries economic growth and redirection of exports to trading partners from faster developing regions. Between January and February 2013 an increase in exports to the EU occurred together with the strong growth in exports to third countries. Over the second half of 2012 exports of base metals and related products picked up. In the last quarter of 2012 and January 2013 exports of machines, vehicles, appliances, instruments and weapons also reported an increase. If the trend towards a reorientation of exports to non-EU countries persists, a higher-than-expected export growth may be anticipated.

Over the January to February 2013 period exports to EU Member States rose by 17.3 per cent on an annual basis, while exports to non-EU countries increased by 20.2 per cent. Germany (inside EU) and Turkey (outside EU) contributed most to the exports growth.

The market share of Bulgarian goods in total EU imports decreased marginally by 0.01 percentage point on an annual basis as of December 2012, while Bulgaria's share of world trade (excluding intra EU trade) slightly rose.

Exports of all groups grew on an annual basis. Mineral products and fuels, as well as machines, vehicles, appliances, instruments and weapons, and base metals and related products contributed most to this growth.

Exports by Commodity Groups in the January–February 2013 Period

	million EUR	Change*	Growth**, per cent	Contribution**, percentage points.
Mineral products and fuels	676.9	249.7	58.5	8.6
Machines, vehicles, appliances, instruments and weapons	649.5	115.4	21.6	4.0
Base metals and related products	673.2	51.0	8.2	1.8
Chemical products, plastics and rubber	339.2	43.9	14.9	1.5
Animal and vegetable products, foods, drinks and tobacco	509.2	49.7	10.8	1.7
Wood products, paper, ceramics and glass	142.2	21.5	17.8	0.7
Textiles, leather, clothing, footwear and other consumer goods	445.7	4.6	1.0	0.2
Total exports	3435.8	535.8	18.5	

* Change on corresponding period of previous year, million EUR.

** Growth/contribution to total export growth over the period on an annual basis.

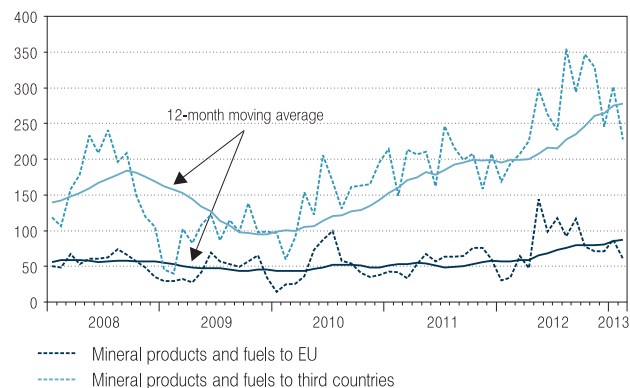
Source: BNB.

Exports of mineral products and fuels continued to grow at high rates (58.5 per cent on an annual basis between January and February 2013), with mineral fuels, mineral oils and distilled products contributing most (8.2 percentage points). This increase was due to the continued upward trend in exported quantities of these products to non-EU European countries and Balkan countries, which were the main export destination of the group. In the second and third quarters of 2013 exports of mineral products and fuels are expected to continue rising, reflecting the accelerating growth in non-EU countries and

higher demand for this group's products. On the other hand, the expected fall in international fuel prices on an annual basis will curb nominal export growth of these products.

Exports of Mineral Products and Fuels

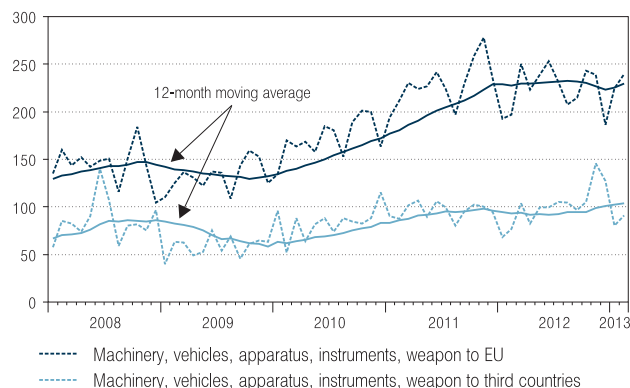
(million EUR)



Source: BNB.

Exports of Machines, Vehicles, Appliances, Instruments and Weapons

(million EUR)



Source: BNB.

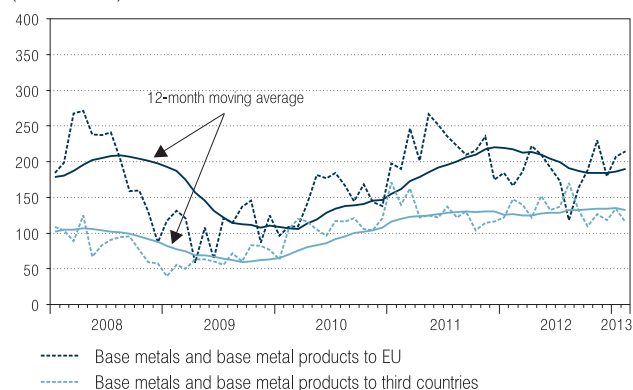
Exports of machines, vehicles, appliances, instruments and weapons started to grow again at the end of the prior year, rising nominally by 21.6 per cent in January and February 2013. Electrical machines and appliances had the largest contribution: 2.4 percentage points. The major partners in these commodities' exports are EU Member States, primarily from the euro area. In 2012 weak euro area demand led to a decline in exports of machines. Concurrently, in the last quarter of 2012 and the January–February 2013 period the exports of these commodities to third countries accelerated, which indicates the reorientation of exports to regions with higher demand growth, but it is still early to talk about a sustainable trend. In the second and third quarters of 2013 this group's exports are expected to increase slightly owing to the euro area recession. If the redirection of exports to economies with higher

growth continues, a stronger increase in this commodity group may be expected.

In late 2012 and early 2013 exports of base metals and related products started to rise again, with copper and copper products contributing most by 0.8 percentage points to the 1.8 per cent growth. Growth in exports of these products to the EU recovered, while that in exports to third countries decreased. In the second and third quarters of 2013 exports of this group are expected to continue recovering due to the enhanced external demand and higher international metal prices on an annual basis.

Exports of Base Metals and Related Products

(million EUR)



Source: BNB.

Imports of Commodity Groups by Use, January–February 2013

	million EUR	Change*	Growth** per cent	Contribution**, percentage points
Consumer goods	686.7	73.5	12.0	2.0
Raw materials	1538.3	272.0	21.5	7.5
Investment goods	767.2	-77.1	-9.1	-2.1
Energy resources	982.9	82.5	9.2	2.3
Imports, total (cif)	3989.1	356.9	9.8	

* Change on corresponding period of previous year, million EUR.

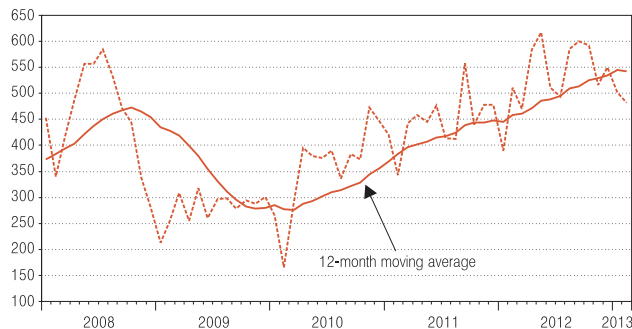
**Growth/contribution to total import growth over the period on an annual basis.

Source: BNB.

Imports (CIF) increased by 9.8 per cent on an annual basis in the January–February 2013 period. By end use, raw materials, energy resources and consumer goods contributed to this growth. Only investment goods posted a decline.

Imports of Energy Resources

(million EUR)

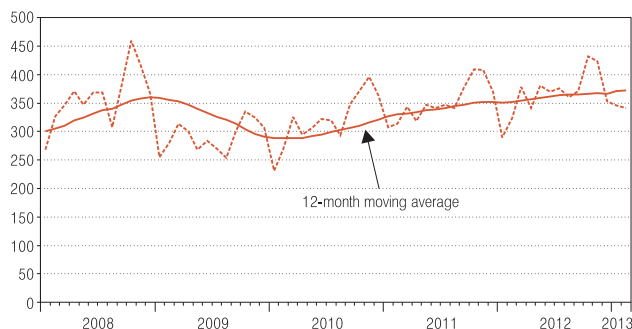


Source: BNB.

The growth in energy resources imports moderated to 9.2 per cent between January and February 2013. Crude oil and natural gas had a major positive contribution (1.7 percentage points). In the first months of 2013 the decrease in international oil prices on an annual basis entails real import growth. In the second and third quarters the nominal growth rate of this group's imports is expected to moderate due to the gradual recovery in domestic demand and fuel price falls on an annual basis.

Imports of Consumer Goods

(million EUR)



Source: BNB.

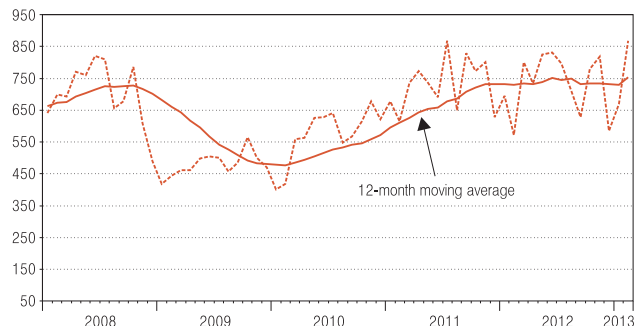
In January and February 2013 imports of consumer goods reported nominal growth of 12 per cent on an annual basis. Foods, drinks and tobacco (0.6 percentage points) and medicines and cosmetics (0.7 percentage points) contributed greatly. In late 2012 imports of this group's commodities were driven by the slowdown in Bulgarian consumption. The higher growth rate in January and February 2013 was attributable to a base effect. Over the projection horizon imports of consumer goods are expected to remain positive due to the progressive improvement in domestic demand.

Between January and February 2013 imports of raw materials grew by 21.5 per cent on an annual basis. The ores item had the most pronounced positive contribution: 4.7 percentage

points. In the second and third quarters of 2013 the growth rate of imports in this group is expected to remain positive due to the improving domestic demand and the slight increase in international metal prices.

Imports of Raw Materials

(million EUR)



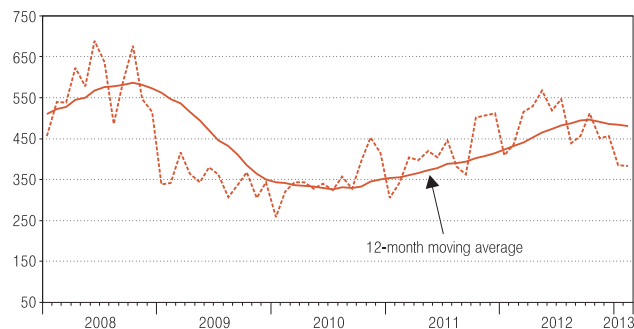
Source: BNB.

Following strong growth rates in the first half of 2012, imports of investment goods moderated gradually and started to exhibit a downward trend at the end of the last year. The trend was sustained in the January to February 2013 period when investment goods imports declined by -9.1 per cent in nominal terms. This reflected mainly the impact of Bulgarian weak investment activity, with spare parts and equipment contributing most to this decline (5.1 percentage points). This item's imports fell due to the base effect related to their significant increases in early 2012. Over the projection horizon, imports of investment goods are expected to gradually increase as a result of the improving investment activity.

Imports from EU Member States rose by 10.1 per cent and that from countries outside the European Community grew by 9.6 per cent.

Imports of Investment Goods

(million EUR)



Source: BNB.

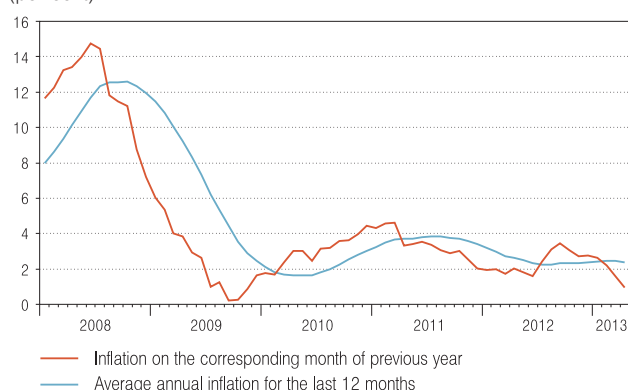
4. Inflation

The deceleration in inflation from the beginning of the fourth quarter of 2012 was sustained in the first four months of 2013. Fuel prices and the decrease in the administered end-user price of electricity for households as of March 2013 contributed most to lower inflation. The downward trend will continue in the second and third quarters of 2013 largely due to the negative contribution of administratively controlled prices and weak energy and core inflation dynamics.

The downward trend in inflation which occurred in the beginning of the fourth quarter of 2012 was sustained in the first four months of 2013.⁵¹ In April an annual inflation rate of 0.9 per cent was reported (against 2.8 per cent in December), and the average annual inflation over the last 12 months came to 2.4 per cent.

Inflation

(per cent)



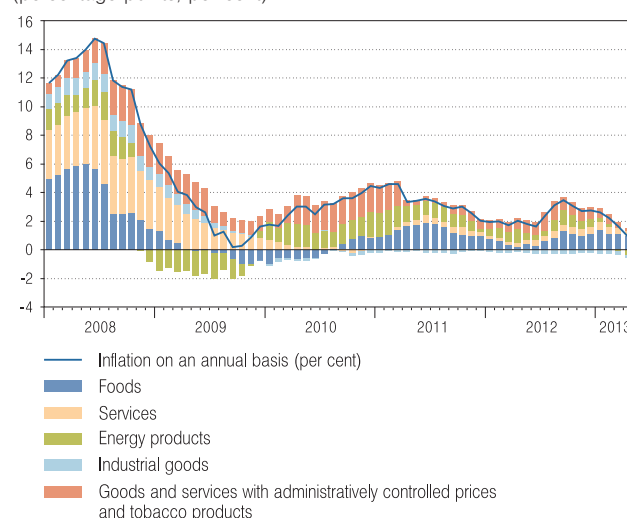
Source: NSI.

Lower price of crude oil on international markets contributed to the significant slowdown in the growth rate of transport fuel prices, which even fell by 4.4 per cent on an annual basis in April. Downward trends were observed in prices of telecommunication services and industrial goods. The March decrease of 6.1 per cent in the controlled price of electricity for households also contributed to inflation moderation in early 2013.

Food prices, impacted by the strong increase in international food prices in the second half of 2012 and by internal factors, had the largest positive contribution to inflation since early 2013.

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

(percentage points, per cent)



Notes: This structure corresponds to the Eurostat classification; tobacco products and goods and services with administratively controlled prices are presented separately. Administratively controlled price index is calculated through the elementary aggregates level in the consumer basket.

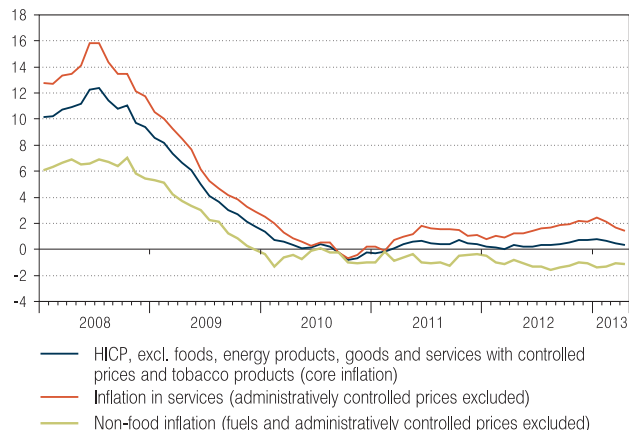
Sources: NSI, BNB calculations.

Core inflation, comprising non-food goods and services prices, remained relatively low since the beginning of the year and had no substantial effect on overall consumer price inflation. It reached 0.3 per cent in April (0.7 per cent in December 2012). The lack of internal pro-inflationary factors to influence core inflation reflects the weak household consumption and firms' policy of increasing efficiency and reducing costs. According to the national account data, in the fourth quarter of 2012 final household consumption moderated on a quarterly basis. Household behaviour was reflected in the data on retail trade where the turnover at comparable prices continued to decrease on an annual basis in the first three months of 2013.

⁵¹ The analysis in this Section is based on NSI data on HICP.

Core Inflation

(per cent on corresponding month of previous year)

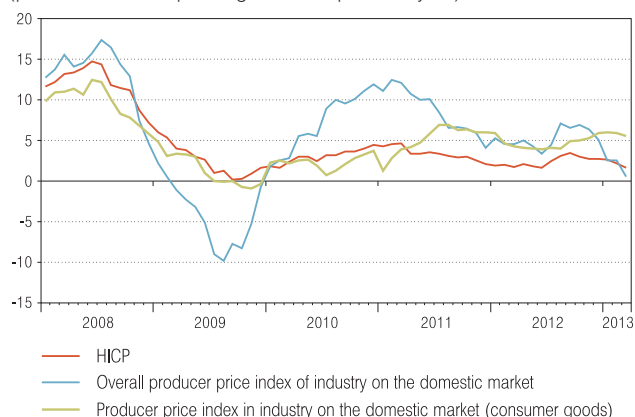


Sources: NSI, BNB calculations.

The price setting policy of the trade firms, which are the link between producer prices and end-use prices for most consumer goods, aims at retaining profit margins in this sector by limiting labour and investment costs. In this context, the current price policy in the trade sector cannot be taken as a source of pro-inflationary pressure. A similar conclusion may be drawn about the impact of producer price index (PPI) on the domestic market, exhibiting a downward trend to 0.6 per cent on an annual basis over the first quarter (5.1 per cent in December 2012). The main drivers behind this trend were lower producer prices in energy products and the drop in natural gas and heating prices from 1 January 2013.

Rate of Change in HICP and Industrial PPI

(per cent on corresponding month of previous year)



Source: NSI.

The NSI updates the weights of goods and services in the consumer basket on an annual basis⁵², affecting the dynamics of consumer

price inflation. In 2013 the weights of unprocessed foods, energy products and goods and services with administratively controlled prices are higher than last year. The weights of processed foods, services, industrial goods and tobacco products are lower. Data show that in early 2013 weight developments contributed to inflation by 0.02 percentage points compared with the inflation that would have been measured with the weights from 2012.

Comparison of the Structure of the Consumer Basket According to the HICP between 2012–2013

(per cent)

	2012	2013
Foods	25.8	25.4
Processed foods	17.5	16.4
Unprocessed foods	8.4	9.1
Services	25.3	24.7
Catering services	5.0	5.1
Transport services	4.4	3.5
Telecommunication services	5.2	5.0
Other services	10.8	11.1
Energy products	8.7	9.3
Industrial goods	19.4	18.6
Goods and services with administratively controlled prices*	16.1	18.2
Tobacco products	4.6	3.8

* The weights of goods and services with administratively controlled prices are calculated at an elementary aggregates level in the consumer basket.

Sources: NSI, BNB calculations.

The change in the weights in consumer basket does not support a definitive conclusion about their eventual effect on inflation level throughout the year, but it may be expected that international fuel price movements, adjustments in administratively controlled prices and agricultural economic processes will have a stronger impact on inflation.

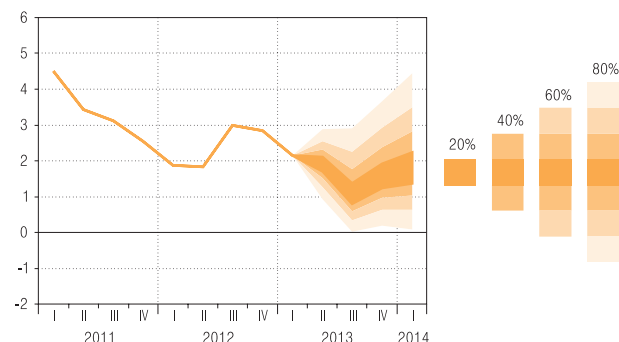
Our inflation expectations for the following two quarters and the associated uncertainty are presented in the fan chart on quarter-on-quarter annual inflation rate.⁵³ We expect a moderate decrease in inflation on its current levels of between 1.5 and 2.3 per cent in the second quarter of 2013 and 0.6 and 1.8 per cent in the third quarter.⁵⁴

⁵³ For further details, see the box entitled Measurement and Presentation of Uncertainty in Forecasting Economic Indicators, Economic Review, 1/2012.

⁵⁴ Thus presented ranges of the expected annual 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

(per cent)



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 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.

The low inflation is likely to be mainly driven by the group of administratively controlled prices, which is anticipated to contribute negatively to overall inflation in the third quarter as a result of the base effect compared to the corresponding quarter of the prior year when the price was raised significantly. The forecast is based on the assumption that oil prices in euro will fall slightly, which creates conditions for low and likely negative contribution of energy products (excluding administratively controlled prices of energy and heating) to overall inflation over the projection horizon. On the other hand, the assumption for a slight rise in international cereal prices⁵⁵ sets up our expectations that the group of food will remain relatively constant, close to its current levels. Core inflation is expected to remain low, given the relatively sluggish domestic demand and the lack of a pro-inflationary international price pressure.

The main risks for expected inflationary dynamics relate to the international commodity market developments and the decision on the administered electricity price for households in the third quarter of the year, which should be announced by the State Energy and Water Regulatory Commission at the end of June.

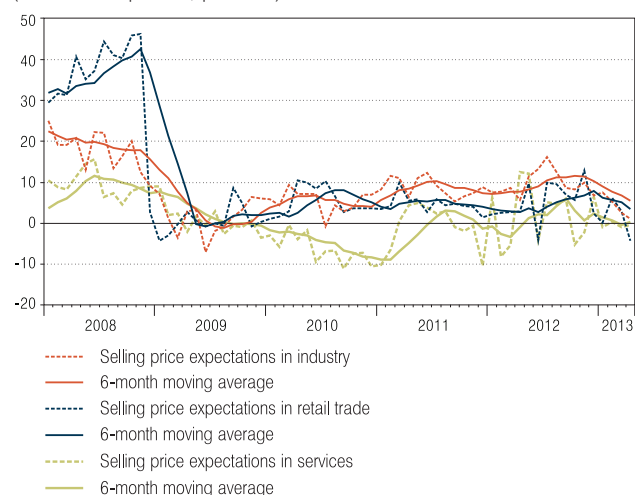
⁵⁵ See the Major Raw Materials and Food Prices section in Chapter 1.

In case of lower-than-expected food price rises and more sizeable fall in oil prices a lower overall inflation in consumer prices in Bulgaria is to be expected. Current data on the annual inflation rate in April and the stabilisation of oil and transport fuel prices on domestic market in May show higher probability of a relatively low inflation in the second quarter of 2013.⁵⁶

The business situation survey data in early 2013 supported the projected decrease in inflation. Data suggest that managers' selling price expectations in the economy decreased in the following three months compared to end-2012.

Selling Price Expectations in Industry, Retail Trade and Services over the Next Three Months

(balance of opinions, per cent)



Source: NSI.

In industry where the impact of international prices is more pronounced, a significant downward revision of the expectations was observed. Projections for selling price rises in retail trade also decreased, while managers' sentiment in the services sector points to retention of prices at their current levels, following the prevailing expectations of price rises at the end of the prior year.

Food Prices

In the first four months of 2013 annual food inflation retained its upward trend observed since mid-2012, reaching 4.4 per cent (4.1 per cent in the fourth quarter of 2012). The annual growth rate of the food price index went down on international markets in the first quarter of 2013 after recording an increase in the second

⁵⁶ According to updated information on retail fuel prices published by LUKOIL Bulgaria.

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

	Inflation accumulated as of April 2012 (December 2011 = 100)		Inflation accumulated as of April 2013 (December 2012 = 100)		Annual inflation rate as of April 2013 (April 2012 = 100)	
Inflation (per cent)	1.3		-0.5		0.9	
	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points
Foods	1.5	0.37	1.2	0.31	4.0	1.01
Processed foods	-0.1	-0.02	-0.3	-0.05	2.1	0.36
Unprocessed foods	4.7	0.40	4.0	0.36	7.5	0.65
Services	-0.2	-0.05	-0.9	-0.22	1.4	0.36
Catering services	0.5	0.03	1.0	0.05	4.0	0.20
Transport services	3.0	0.13	-1.3	-0.04	-0.4	-0.01
Telecommunication services	-0.4	-0.02	0.0	0.00	-0.7	-0.04
Other services	-1.8	-0.19	-2.0	-0.22	2.0	0.21
Energy products	10.9	0.95	0.2	0.02	-4.0	-0.37
Transport fuels	11.3	0.92	0.0	0.03	-4.4	-0.39
Industrial goods	-0.8	-0.15	-0.8	-0.15	-1.1	-0.21
Goods and services with administratively controlled prices*	1.3	0.20	-2.5	-0.45	1.1	0.14
Tobacco products	0.0	0.00	0.2	0.01	0.3	0.01

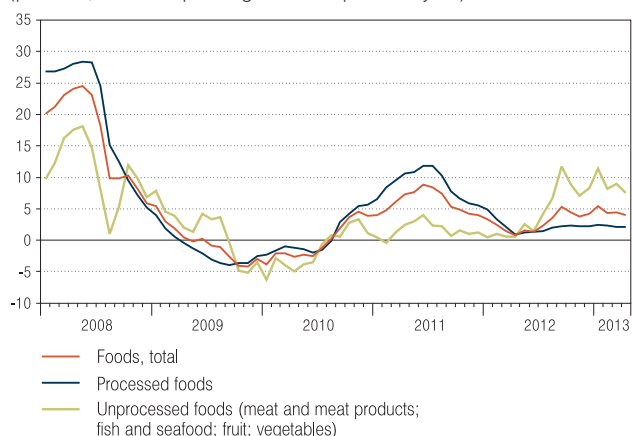
* Administratively controlled prices are calculated at an elementary aggregates level in the consumer basket.

Sources: NSI, BNB.

half of the previous year.⁵⁷ However, in the first four months of this year annual growth rates of some groups as cereals stayed at relatively high levels, though moderating. In addition to the impact of external factors, some structural changes on the domestic market leading to higher expenditure on food production played a crucial role for food price dynamics. Over the first quarter of 2013 annual growth rate in producer prices of foods, drinks and tobacco products increased to 8.2 per cent (7.6 per cent in the fourth quarter of 2012).

Rate of Change of Food Price Index

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

Unprocessed food inflation (meat and meat products, fruit, vegetables and fish) was 7.5 per cent in April 2013, slightly moderating on the close of the previous year (8.3 per cent in December 2012). This group was the key factor behind the sustained relatively high inflation of food prices in the first four months. Higher growth rates in vegetable prices, whose price developments over the recent years showed a growing dependency on international market trends due to increasing imports coupled with reduced domestic production, had the most sizeable contribution to this trend in unprocessed foods. According to NSI preliminary data, vegetable physical volumes reported a reduction of 8.6 per cent and an increase in prices of 2.1 per cent on 2011.

Meat and meat products contributed significantly to annual unprocessed food inflation. This can be attributed to production cost increases in farming of animals associated with higher fodder and energy prices together with sector's restructuring in line with the new farming requirements introduced on 1 January 2013.⁵⁸ On the other hand, the high level of domestic demand for meat and meat products cannot be satisfied

⁵⁷ Based on food price indices denominated in euro (source ECB).

⁵⁸ Red meat: a situation and outlook analysis in 2011 and 2012, Ministry of Agriculture and Food, February 2013.

only by Bulgarian output, with pork and chicken dominating the imported agricultural products.⁵⁹

Between January and April 2013 annual inflation rate of processed foods stabilised at its 2012 fourth quarter level, reaching 2.2 per cent. Bread and cereals contributed most to the inflation in this group, with their price dynamics reflecting the continued rise in cereal prices on international and domestic markets in late 2012 and early 2013. According to NSI data on agricultural producer prices, in the third and fourth quarters of 2012 cereals rose by 28.4 per cent and 34.8 per cent on 2011. Price rises in mineral water, soft drinks, fruit and vegetable juices, and beer from the beginning of the year had lower positive contribution to overall processed food inflation. In other groups (such as milk, dairy products and eggs) inflation tended downwards on an annual basis, contributing 0.01 percentage point to the annual inflation in April.

In the first half of 2013 food inflation is projected to retain its current level and to moderate gradually in the second half. Factors that are likely to influence most strongly food prices over the period are international market developments and the quality of the harvest in Bulgaria.

Energy Product Prices

In the first four months of 2013 a significant deceleration of annual transport fuel inflation was observed⁶⁰. In April annual rate of change of energy products came to -4.0 per cent (6.3 per cent in December 2012), contributing negatively to overall inflation (-0.37 percentage points). Excise duties on fuels were raised in early 2013 (from BGN 630 to BGN 645 per 1000 litres), with a slight effect of this change on annual inflation rate of energy product prices.

This group is expected to have a comparatively low and likely negative contribution to overall inflation in the second and third quarters of 2013. Major risks to this projection relate to the possibility of significant oil price fluctuations on international markets, which could lead to analo-

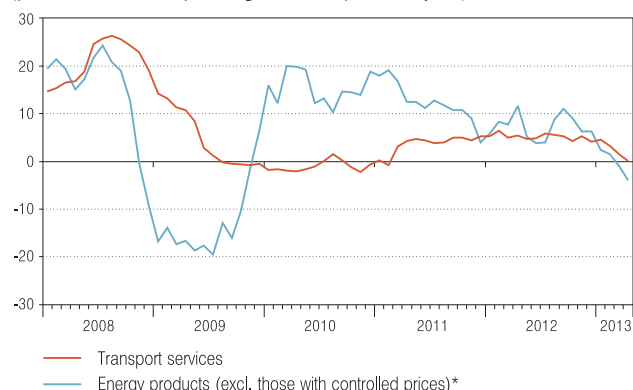
⁵⁹ Prospects for agricultural commodity market development: an analysis of external trade with agrarian goods, Ministry of Agriculture and Food, March 2013.

⁶⁰ In the group of energy products (excluding administratively controlled prices of energy and heating) transport fuels occupy the largest relative share; hence, their price developments determine the price dynamics of energy products in general.

gous dynamics in the rates of change in fuel end-use consumer prices in Bulgaria.

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

(per cent, on corresponding month of previous year)

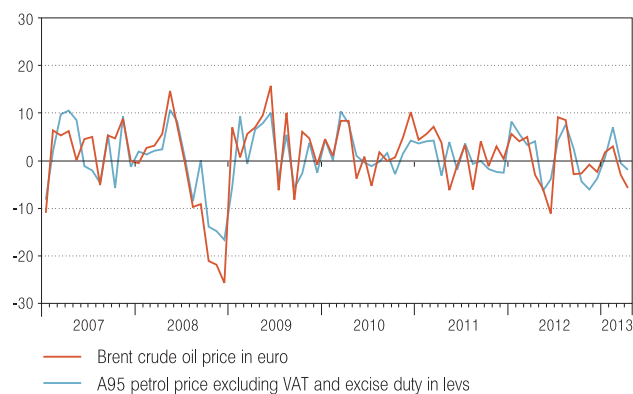


* Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB calculations.

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

(per cent)



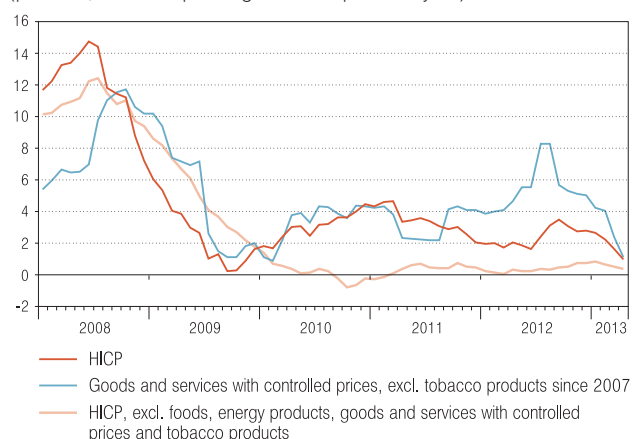
Sources: ECB, NSI, BNB calculations.

Administratively Controlled Prices and Tobacco Product Prices

In the first four months of 2013 annual inflation in administratively controlled prices came to 2.9 per cent (5.1 per cent in the fourth quarter of 2012). The 6.1 per cent decrease in the end-use price of electricity for households since early March had the strongest impact on inflation moderation. Price falls of heating (6.9 per cent) and central gas supply (7.2 per cent) since the start of 2013 resulting from the lower wholesale gas prices had weaker effect on the inflation due to their relatively low weight in the consumer basket.

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

(per cent, on corresponding month of previous year)



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

Sources: NSI, BNB calculations.

In early April a new decrease in heating prices (3.8 per cent) and central gas supply (2.9 per cent) became effective: a result of the further fall in wholesale gas prices.

If the level of the controlled price of electricity remains unchanged in the third quarter, controlled prices are expected to have a negative contribution to the inflation in the second half of 2013. Eventual adjustments in other administratively controlled prices are not included into the projection since there is currently no information about concrete changes.

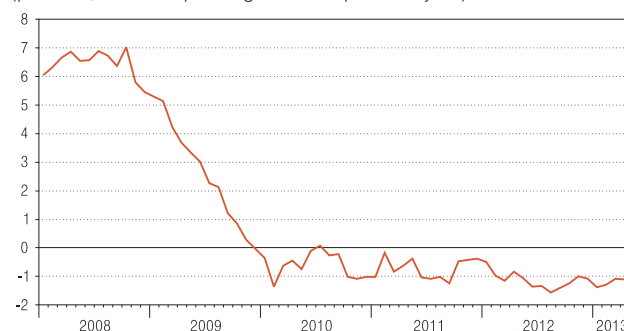
Industrial Goods Prices

In early 2013 the recent three years' trend toward a slight decline in the index of non-food prices (excluding fuels and controlled prices) was sustained. As of April the annual rate of change in the prices of industrial goods was -1.1 per cent, contributing by -0.2 percentage points to overall inflation.

As in 2012, deflation in this group was driven mainly by the depreciation of automobiles and other durables such as audio equipment, computers and televisions. Meanwhile a slight increase in most non-durable consumer goods was observed.

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

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

Particularly in the car market, price falls continued to be driven by the dampened demand for passenger cars and commercial vehicles in the EU.⁶¹ Data on Bulgaria suggest that car demand measured by the number of new vehicle registrations contracted by 9.8 per cent in the first quarter of 2013 on the corresponding period of the prior year. On the other hand, global trend toward a depreciation of computer and television equipment prices is another factor behind the lower prices in this group.

In the second and third quarters of 2013 global trends in demand developments and manufacturing firms' potential for further decreases in price falls will play a key role for industrial goods prices.

Services Prices

Over the first four months of 2013 annual inflation in services (excluding those with administratively controlled prices) posted a decline, reaching 1.4 per cent in April (2.5 per cent in January).

The different groups of services saw divergent inflation dynamics, with transport services and catering contributing most to the inflation.⁶² The gradual moderation in services inflation since the beginning of the year was mainly due to the lower inflation of automobile transport ser-

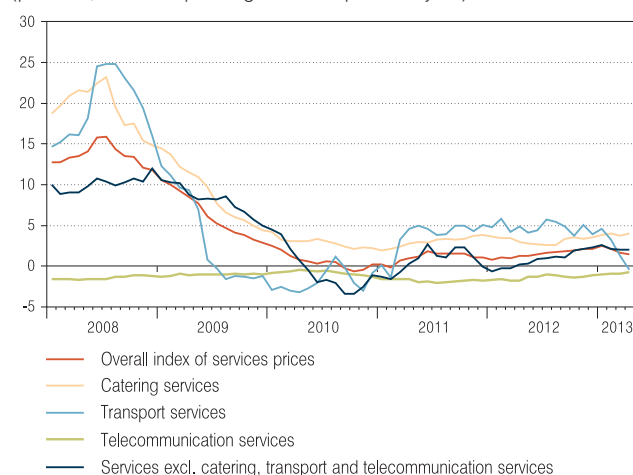
⁶¹ Based on data published in the European Automobile Manufacturers' Association press releases on the registrations of passenger cars in March 2013 and commercial vehicles in February 2013.

⁶² In 2012 the services group (excluding administratively controlled prices) included the following components with relatively high weight: catering (5 per cent), transport services (4 per cent), telecommunication services (5 per cent), other services (11 per cent).

vices and the decline reported in air transport prices. As of April the annual rate of change in the prices of transport services was -0.4 per cent (3.9 per cent as of December 2012). In early 2013 catering inflation followed a slight upward trend observed since the second half of 2012. This was driven by the continued rise in the prices of food products, a part of the expenses on intermediate consumption. Demand also creates conditions for moderate inflation in this group, as catering expenses continued contributing positively, albeit slightly declining to household consumption growth.

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

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

Deflation in telecommunication services (phone services, apparatus and internet services) which occurred in recent years was sustained in the first four months of 2013. As of April 2013 the index of the prices in this group reported a 0.7 per cent decline on an annual basis.

Inflation in services, excluding catering, transport and telecommunication services continued to contribute positively to overall services inflation, but it moderated somewhat from the beginning of the year. Lower inflation in this group can be ascribed to both demand-side factors and moderation in household final consumption.

Current data give grounds to expect that services inflation will follow consumer demand dynamics and will increase slightly in the second and third quarter of 2013.