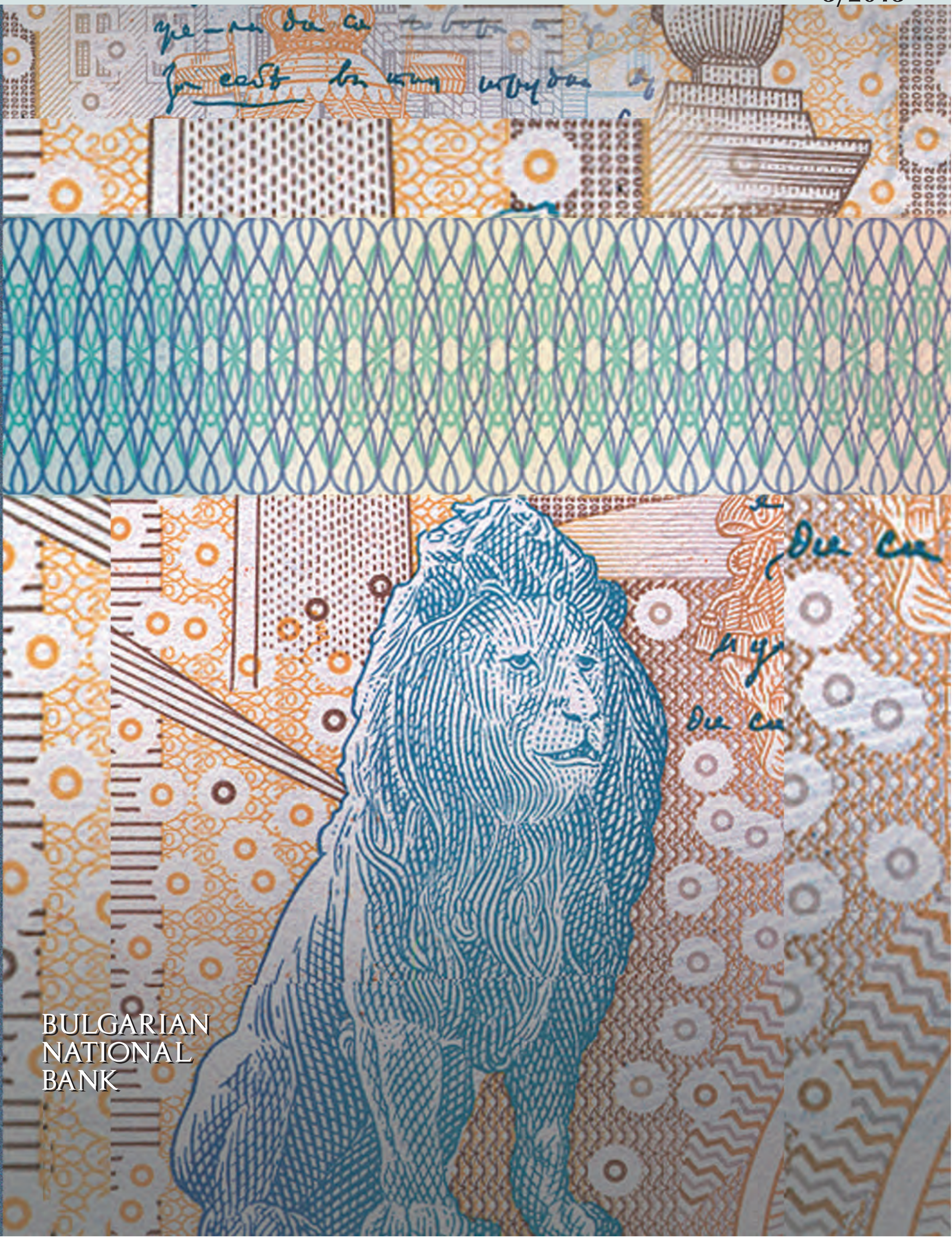
Economic Review

3/2013



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.

The *Economic Review, issue 3/2013* was presented to the BNB Governing Council at its 14 November 2013 meeting. It employs statistical data published up to 6 November 2013.

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

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

ISSN 1312 – 420X

This issue includes materials and data received up to 15 November 2013.

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

Published by the Bulgarian National Bank
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Contents

Charts

Tables

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
RON	Romanian new leu
WTI	West Texas Intermediate

Summary

Between July and September global conjunctural indicators improved on the first half of 2013. The global PMI rose, recording expectations for increasing economic activity over the third quarter. In the second quarter euro area real GDP grew by 0.3 per cent compared with the first quarter, following a six-month decrease. This growth proved to be a positive signal of consumer and business sentiment. US economic growth accelerated to 0.6 per cent on a quarterly basis in the second quarter of 2013, from 0.3 per cent in the previous quarter. Economic activity in China also accelerated over the third quarter, its quarter-on-quarter growth reaching 2.2 per cent. Global inflationary pressures subsided significantly, reflecting price declines in most commodity groups on international markets.

After falling substantially in the second quarter of 2013, Brent crude oil prices increased in the third quarter due to temporary supply constraints and seasonal oil demand rises. Over the projection horizon, the world oil supply is expected to exceed global demand, which may lead to a decline in international oil prices on an annual basis. Between July and September 2013 international prices of most commodity groups in euro continued to fall. In late 2013 and early 2014 these prices are expected to decline further, though at a slower pace, in line with the expected global economic recovery.

Financial flows resulting from the interaction between external and domestic economic factors contributed to the annual increase in Bulgaria's international foreign exchange reserves. Between January and August 2013 a gradual rise in the surplus of BOP current and capital account balance was observed on an annual basis. This trend was largely driven by the strong trade deficit contraction, stemming from the accelerated growth of exports and a slight decline of imports. Flows on balance of payments financial account reflected mainly bank financial operations oriented towards an increase in their foreign assets. Financial account dynamics in the beginning of the year was also driven by financial flows related to repayments on Bulgarian global government bonds maturing in January. The overall current and capital account balance is expected to remain unchanged on an annual basis at the end of 2013 and in the first quarter of 2014.

The uncertainty in expectations of economic agents around external and internal environment developments remained relatively high, thus maintaining the high savings rate in Bulgaria. Growing household deposits and relatively low credit demand in economy contributed to the sustained high bank liquidity. Banks continued to maintain a large portion of their liquidity in the form of excess reserves with the BNB and funds on their accounts in TARGET2-BNB. The April to October period saw a downward trend in the funds on TARGET2-BNB accounts compared to the first quarter. Concurrently, banks continued to use a significant part of their free resources to increase external assets and, to a lesser extent, to repay foreign liabilities.

In the third quarter the non-government sector credit growth moderated further as a result of firms' decreased demand for credit due to their conservative investment expenditure policy. Bank claims on households continued to decline slightly on an annual basis. Hence, households' credit demand is insufficient to increase the volume of borrowings in this sector due to the higher amount of repaid maturing loans that are not renewed. Household deposits are expected to grow further at comparatively high rates, thus maintaining high banking system liquidity. Monetary aggregate M3 will continue to rise at comparatively high rates, with a slight tendency of deceleration over the fourth quarter of 2013 and first quarter of 2014. Relatively low investment activity and household consumption will have a dampening effect on credit activity in Bulgaria, which is expected to slowly increase in early 2014.

Despite the improvement in global economic environment, the uncertainty about future economic activity remained comparatively high and continued to dampen Bulgaria's economic growth in the second quarter of 2013. After growing by 0.1 per cent on a quarterly basis in the first quarter of 2013, GDP fell by 0.1 per cent in the second quarter. Firms opted to remain cautious to their fixed capital investments. As a result, investments decreased by 2.4 per cent on a quarterly basis in the second quarter. Households sustained their high propensity to save, with private consumption rising by 0.9 per cent quarter on quarter. Total employment dynamics is expected to have a favourable effect on household consumption. Employment has started to stabilise since the second half of 2012, following a protracted period of declines since early 2009. In the second quarter of 2013 it rose by 0.3 per cent on a quarterly basis. According to seasonally adjusted data of the NSI Labour Force Survey, between April and June unemployment retained its first quarter's level of 12.8 per cent.

Exports are expected to continue growing, reflecting the improvement in global economic environment observed since early 2013, albeit at a slower pace than in the first half year. This, in turn, is likely to support domestic demand in the second half of 2013 and first quarter of 2014. In the same period, imports growth is projected to exceed that of exports, following domestic demand dynamics. Private consumption is likely to broadly retain its growth rate of the second quarter of 2013, while investment activity will grow due to firms' improved expectations about future economic activity. Exports of goods and services may increase at higher-than-expected rates in case of faster recovery of Bulgaria's major trade partners or more flexible reorientation of Bulgarian exporters to fast-growing markets. On the other hand, household propensity to save may increase further due to still high unemployment rates which will hold up consumer demand recovery in the fourth quarter of 2013 and first quarter of 2014.

In August the Parliament adopted Amendments to the State Budget Law for 2013. The amended Law provides for an increase in consolidated government budget deficit to BGN 1593.4 million (2 per cent of GDP), which is the maximum level allowed under the effective fiscal rules, against an initial projection of BGN 1100 million (1.3 per cent of GDP). Between January and September total budget revenue on consolidated fiscal programme accounted for BGN 21,308 million, or 70.1 per cent of projected budget revenue. Over the same period, total government expenditure, including Bulgaria's contribution to the EU budget, amounted to BGN 21,668 million, or 67.8 per cent of the amended annual projection. As a result, consolidated fiscal programme balance ended the January to September period with a deficit of BGN 360.5 million. Government expenditure is expected to increase until the end of 2013, though the consolidated fiscal programme deficit will not exceed the projected 2 per cent of GDP. In the fourth quarter of 2013 and the first quarter of 2014 government consumption is likely to have a low positive contribution to GDP growth.

In the first nine months of 2013 annual inflation tended to decrease, with an accelerating rate of decline in the third quarter to a negative value of 1.3 per cent in September. Major driving factors involved the decreased electricity price for households and, to a lesser extent, cuts in other administratively controlled prices along with downward developments in international prices of food and energy products. Comparatively low household consumption and indirect effects of global price dynamics on the prices of other goods and services groups in the consumer basket were the major factors behind maintaining low core inflation which recorded a 0.4 per cent year-on-year fall in September.

In the fourth quarter of 2013 slight deflation is anticipated as a result primarily of the continuous negative contribution of administratively controlled prices. Our expectations for the first quarter of 2014 are for a slow increase in inflation under the influence mainly of low growth rates in food and energy prices. It is not expected that core inflation will have a sizeable contribution to overall inflation.

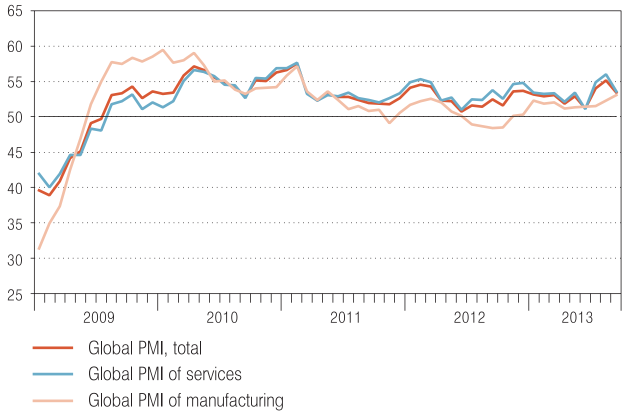
1. External Environment

Between July and September global conjunctural indicators improved on the first half of 2013. The global PMI rose, recording expectations for increasing economic activity over the third quarter. In the second quarter euro area real GDP grew by 0.3 per cent compared with the first quarter, following a six-month decrease. This growth proved to be a positive signal of consumer and business sentiment. US economic growth accelerated to 0.6 per cent on a quarterly basis in the second quarter of 2013, from 0.3 per cent in the previous quarter. Economic activity in China also accelerated over the third quarter, its quarter-on-quarter growth reaching 2.2 per cent. Global inflationary pressures subsided significantly, reflecting price declines in most commodity groups on international markets.

Current Business Situation

Between July and September global composite PMI indicators improved on the first half of 2013. The global PMI rose, signalling an increase in economic activity over the third quarter. Expectations of manufacturing developments gradually improved, with the increase recorded in new orders and export orders contributing most significantly to this effect. The improvement of the indicator in the services sector reflected the expectations of new businesses.

Global PMI

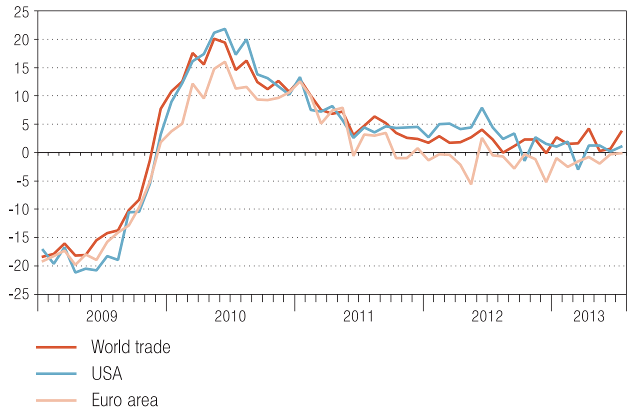


Source: JP Morgan.

Conjunctural indicator dynamics differed across regions since early 2013. The improvement of PMI indices in the euro area started in April and this trend was sustained in the following months, whereas in the July–September period the indicators exceeded the level of 50, signalling a positive rate of economic growth. In the USA expectations about future economic activity significantly improved in the third quarter following the temporary fall in May and June. The dynamics of China's PMI indices was similar where the slight decline in the second quarter was followed by an increase in the July–September period.

World Trade

(annual rate of volume growth, per cent)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

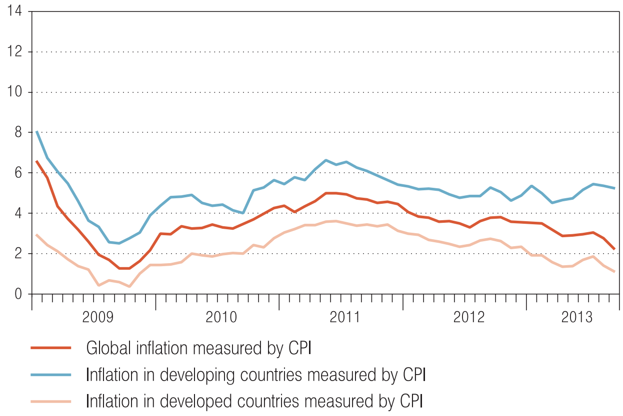
The world trade volume rose in the second quarter and in the beginning of the third quarter of the year, with emerging economies contributing most positively to growth. Accelerated foreign trade growth was recorded in the USA, while the euro area annual foreign trade turnover continued to moderate at a slower rate.

Based on leading economic indicators and global trade trends we may expect a gradual increase in global economic activity in the fourth quarter of 2013 and the first quarter of 2014 and further gradual recovery of economic growth in the euro area.

In the third quarter of 2013 global inflation continued to slow down on an annual basis, reflecting mainly the weak price dynamics of commodities traded in international markets. Inflationary pressure subsided significantly in developed economies, while depreciation of national currencies in some developing economies was the major reason behind the inflation rise in these countries in the third quarter of 2013.

Inflation Measured by CPI

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



Note: The World Bank computed the change in consumer price indices of individual groups as an weighted median of changes in consumer price indices in the countries of the group. Real GDP at purchasing power parity is used to construct country weights. The groups include only World Bank member states, with the classification of 'developing' and developed countries made by the World bank.

Source: World Bank.

Euro area

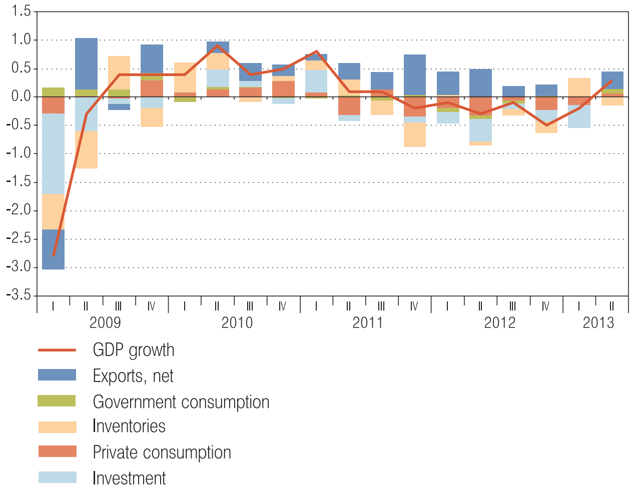
In the second quarter of 2013 euro area real GDP decreased by 0.6 per cent year on year against a fall of 1.2 per cent in the first quarter.[1] Growth rates diverged significantly across countries. Year-on-year economic growth in Germany amounted to 0.5 per cent (against a fall of 0.3 per cent in the previous quarter) and in France to 0.4 per cent (against a fall of 0.5 per cent in the previous quarter). The annual decline in real GDP was -1.6 per cent in Spain (against -2.0 per cent in the previous quarter) and -2.2 per cent in Italy (against -2.5 per cent in the previous quarter). The year-on-year GDP reported the strongest decline in Cyprus (-5.8 per cent against -5 per cent in the first quarter) and in Greece[2] (-4.6 per cent against -5.6 per cent in the first quarter of 2013).

Euro area real GDP increased on a quarterly basis in the second quarter showing signs of overcoming the recession that lasted 18 months.

Economic growth in the euro area accounted for 0.3 per cent against -0.2 per cent in the previous quarter. GDP components with a positive contribution to growth were net exports (0.24 percentage points), household consumption (0.06 percentage points) and government consumption (0.09 percentage points). Inventories contributed negatively to growth (-0.15 percentage points) and investments in fixed assets were close to neutral (contributing by 0.03 percentage points) in respect to growth.

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

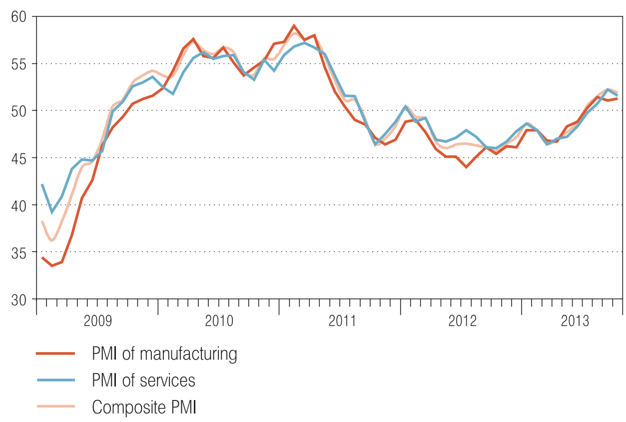
(per cent; percentage points)



Source: Eurostat.

Despite the positive quarterly growth rate reported in the euro area in the second quarter the recession continued in Spain (a fall in real GDP by -0.1 per cent), Italy (-0.3 per cent), Cyprus (-1.8 per cent), the Netherlands (-0.1 per cent), Estonia (-0.2 per cent) and Slovenia (-0.3 per cent).[3]

Manufacturing and Service PMIs



Source: Markit.

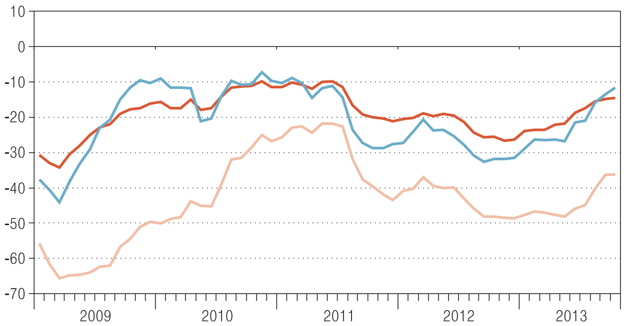
[1] Eurostat data.

[2] Growth by country is calculated on the basis of non-seasonally adjusted data.

[3] No data published about Greece.

In the third quarter of 2013 the euro area PMI rose and exceeded the neutral level of 50, signalling an increase in economic activity. In September the composite PMI was 52.2 (against 51.5 in August) and manufacturing and service PMIs reached 51.1 and 52.2 respectively (against 51.4 and 50.7 in August). October saw a decline in the total indicator to 51.9 and that of the services sector to 51.6, while the sub-index of manufacturing slightly increased to 51.3.

Euro Area Consumer Confidence Indices



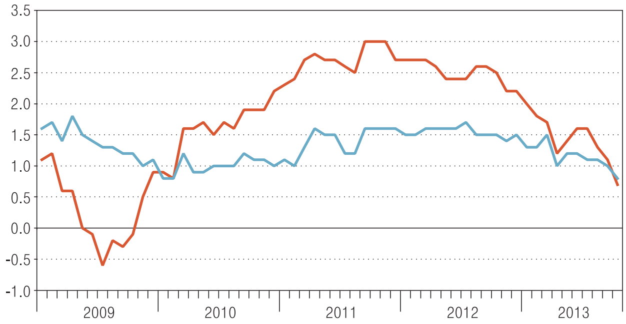
Source: European Commission.

The euro area economic sentiment index published by the European Commission increased in September and October 2013 to 96.9 and 97.8 (against 95.3 in August), while the business climate indicator improved to -0.19 and -0.01 (against -0.22 in August). The EC consumer confidence index in the euro area also increased in September and October to -14.9 and -14.5 respectively (against -15.6 in August).

The EC economic indicator dynamics and PMI indices give grounds to expect a recovery of economic activity in the euro area in the second half of 2013 and in the first quarter of 2014. According to the latest ECB projections published in the beginning of September 2013 the change in the real GDP is expected to vary between -0.6 and -0.2 per cent in 2013 (the previous projection: between -1 and -0.2 per cent) and between 0 and 2 per cent (the previous projection: between 0 and 2.2 per cent) in 2014. In the EC autumn projections (November 2013) the assessment of the spring projections for a decline in real GDP by 0.4 per cent in 2013 was sustained and the projections for real GDP growth in 2014 was decreased by 0.1 percentage point to 1.1 per cent.

Euro Area Inflation Rate

(percentage change on same period of previous year)



Source: Eurostat.

In September euro area inflation decreased to 1.1 per cent against 1.3 per cent in August and 1.6 per cent in July. On a monthly basis, HICP rose by 0.5 per cent in September, *vis-à-vis* 0.1 per cent growth in August. Energy and food prices contributed to the fall in inflation on an annual basis. In September the annual euro area core inflation came to 1 per cent compared with 1.1 per cent in the previous two months.

A decline in inflation is recorded recently in all euro area countries. In September a deflation on an annual basis was reported in Greece: -1 per cent. In Ireland no price rises were observed (0 per cent inflation). In Cyprus and Portugal the inflation rate also remained low: 0.3 per cent. The highest inflation rates were reported in Estonia (2.6 per cent) and the Netherlands (2.4 per cent), although June saw a decrease in this indicator.

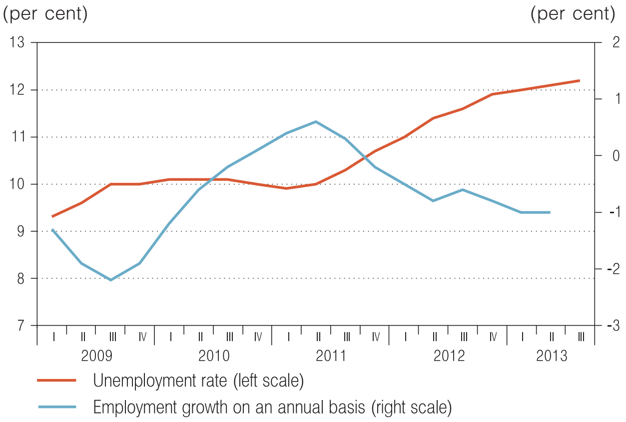
According to the ECB projections published in September 2013 the euro area inflation rate is expected to average 1.5 per cent (the previous projection: 1.4 per cent) in 2013 and 1.3 per cent (the previous projection: 1.3 per cent) in 2014. Based on the EC autumn projections the euro area inflation is expected to be 1.5 per cent in 2013 (1.6 per cent in the EC spring projections) and 1.5 per cent in 2014 (1.5 per cent in the spring projections).

According to the flash estimate published by Eurostat on 31 October 2013 the euro area inflation rate in October was 0.7 per cent, that is the downward trend was sustained and the euro area inflation rate may remain at a very low level until the end of 2013 and early 2014.

The unemployment rate in the euro area remained at relatively high level, since April exceeding

12 per cent. According to Eurostat data in August and September 2013 unemployment was 12.2 per cent (seasonally adjusted data) against 12.1 per cent in the previous three months. The indicator of the expected unemployment in the following twelve months included in the EC consumer confidence index decreased in the third quarter, reaching 28.6 in September and 29.3 in October against 30.4 in July and August. Consequently, consumer expectations about labour market developments slightly improved.

Unemployment Rate and Employment Growth in the Euro Area



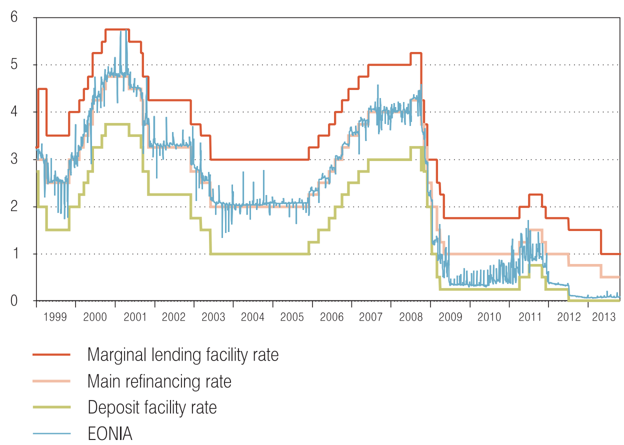
Source: Eurostat.

In some countries with high unemployment rates[4] by September 2013 such as Spain (26.6 per cent) and Portugal (16.3 per cent), a downward trend in this indicator has been observed since June. Unemployment remained high in Slovakia (14 per cent) and slightly increased in Croatia (17.2 per cent in September against 16.9 per cent in August) and Cyprus (17.1 per cent in September against 16.9 per cent in August). The lowest unemployment was reported in Austria (4.9 per cent) and Germany (5.2 per cent).

Between July and October ECB interest rates on the Bank's main refinancing operations, the marginal lending rate and the deposit facility rate remained unchanged at 0.5, 1.00 and 0 per cent respectively[5]. At the session held on 4 July the ECB announced for the first time forward guidance of its interest rate policy, stating that interest rates are expected to remain unchanged or at lower levels for a long period of time. These expectations were confirmed at each session on the ECB monetary policy in August, September and October and were based on the projections of low inflation in the medium run in the context of weak economic activity and low rate of monetary aggregates growth. The public disclosure of ECB expectations about changes in interest rates aims to increase the predictability of the monetary policy pursued and to help decrease fluctuations in money market interest rates. In addition, at the October session the ECB announced that money market conditions were closely monitored and the Bank was ready to employ all monetary policy tools available, including a new long-term refinancing operation (LTRO).

After the first public disclosure of ECB expectations about changes in interest rates on 4 July the money market yield curve went down significantly. As of 6 November 2013 market expectations derived from the prices of three-month EURIBOR futures contracts pointed to a decrease in the euro area reference interest rate under the current level of 0.50 per cent until the end of 2013. The change in the expectations was driven by the fall of consumer price inflation in the euro area in October far below the ECB target of 2.0 per cent.

ECB Interest Rates



Source: ECB.

The EONIA reference overnight interest moved within the interval of 0.07 per cent and 0.23 per cent from July until 6 November, with the average value accounting for 0.09 per cent (against 0.08 per cent in the second quarter of 2013).

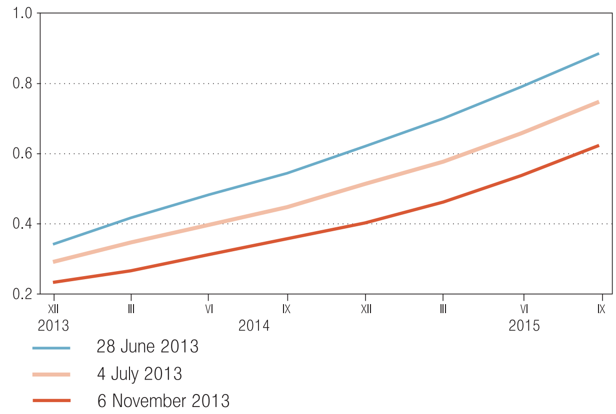
[4] The highest unemployment rate was recorded in Greece but the latest data (27.6 per cent) are from July 2013.

[5] At its session held on 7 November 2013 the ECB decided to cut interest rates on its main refinancing operations by 25 basic points to 0.25 per cent and the interest rates on the marginal lending facility to 0.75 per cent. The deposit facility rate was left unchanged at 0.0 per cent. Since the cut-off date for publication of this issue was 6 November, the analysis of the effect of the ECB decision on financial markets will be published in the following issue of the Economic Review.

The expanded interval was due to the one-off EONIA increase to 0.23 per cent in the last day of October due to technical reasons. EURIBOR interest rates on interbank market deposits slightly increased. On 6 November 2013 one-month interest rates were 0.13 per cent (+1 basis point on end-June 2013), and those with maturities of six and 12 months reached 0.34 per cent (+1 basis point on end-June) and 0.54 per cent (+1 basis point on end-June). Credit and liquidity risk premia measured by the spread between EURIBOR and OIS recorded a minimal increase. As of 6 November risk premia in the three- and six-month segments ended the period at a level of 12 basis points (+1 basis point against the end of June 2013) and 22 basis points (+1 basis point against the end of June).

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

(per cent)

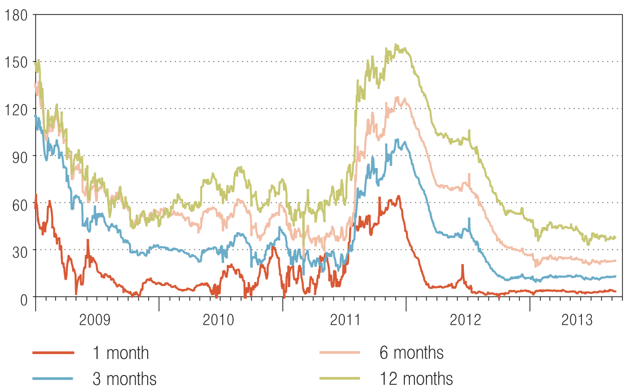


Source: European Banking Federation.

Excess liquidity in the euro area banking system continued to decline as a result of the early repayment of liquidity on ECB long-term operations.

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

(basis points)

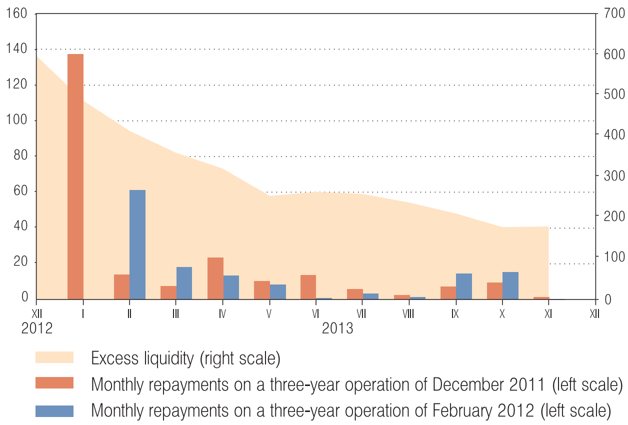


Source: European Banking Federation.

As of 1 November 2013 repayments on the December 2011 three-year operation accounted for EUR 232.3 billion with a residual refinancing value of EUR 254.3 billion. In addition, EUR 136.4 billion were repaid on the February 2012 three-year operation with a residual value of EUR 393 billion. In net terms, 74 per cent of the funds allotted through the two long-term operations were refunded. On 1 November 2013 the excess liquidity in the euro area banking system fell to EUR 179 billion (from EUR 263 billion at the end of June 2013).

Repayments on Three-year Refinancing Operations of the ECB and Excess Liquidity

(EUR billion) (EUR billion)



Source: ECB.

National central banks' data suggest that between July and September 2013 the amount of long-term refinancing provided by the ECB decreased most dramatically at Italian, French and Spanish banks: by EUR 10.4 billion, EUR 6.3 billion and EUR 3.3 billion respectively.

Participation of Banks (by Country) in ECB Three-year Refinancing Operations

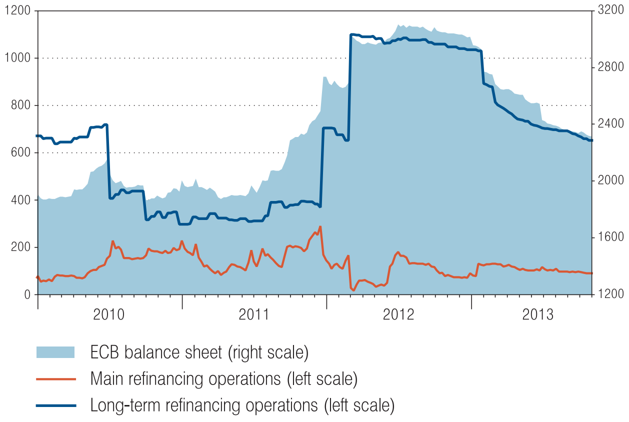
(billion EUR)

Country	Residual value				Change for the quarter		
	2012	2013					
	Q4	Q1	Q2	Q3	Q1	Q2	Q3
Spain	316.1	246.6	229.0	225.7	-69.5	-17.6	-3.3
France	174.4	119.3	95.4	89.1	-55.1	-23.9	-6.3
Germany	69.7	21.6	11.8	9.9	-48.1	-9.8	-1.9
Italy	268.3	262.0	244.4	234.0	-6.3	-17.6	-10.4
Ireland	63.1	44.4	37.3	35.4	-18.7	-7.1	-1.9
Belgium	39.9	16.1	14.5	14.4	-23.8	-1.6	-0.1

Source: National Central Banks.

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

(billion EUR) (billion EUR)



Source: ECB.

The ECB balance sheet figure exhibited a decline by 4.8 per cent on end-June 2013 and amounted to EUR 2.314 trillion by 2 November 2013. On the asset side, refinancing operations dropped to EUR 740.2 billion (from EUR 822.7 billion by end-June 2013) and deposit facility funds in the balance sheet liabilities fell to EUR 52.1 billion (from EUR 92.2 billion by end-June 2013).

Economic Development of EU-7

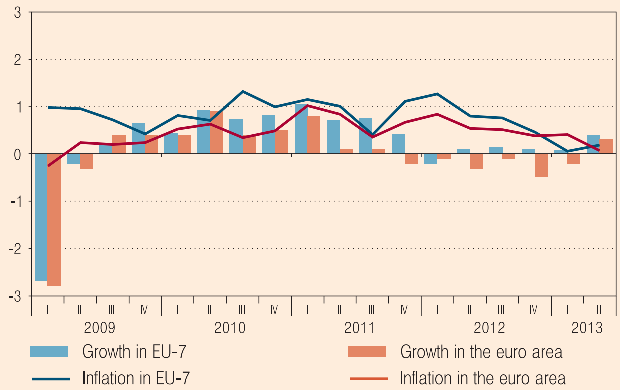
In the second quarter of 2013 economic activity in the EU-7 countries[1] accelerated its growth rate following a four consecutive quarters of slow growth. Lithuania and the Czech Republic reported the strongest growth, while Bulgaria reported a decline. Quarter-on-quarter real GDP growth for the EU-7 countries totalled 0.4 per cent in the April–June period against 0.1 per cent in the previous quarter. The average inflation for the EU-7 countries slightly accelerated in the second quarter but remained low. Falling international energy and food prices contributed most to the inflation decline. Between April and June the unemployment rate decreased in all countries with the exception of Bulgaria and Romania. The volatile dynamics of the real GDP since early year allowed most of the EU-7 central banks implementing an independent monetary policy to cut their reference interest rates.

Between April and June 2013 economic growth in **Latvia** slowed down following the accelerated growth in the first quarter of 2013. Private consumption and net exports contributed positively to growth in the first half of the year, while the contribution of gross capital formation was negative. Industrial output contributed most to the increase in gross value added by sector in the second quarter, while trade had the largest negative contribution to this increase. The unemployment rate (seasonally adjusted data) slowed down. The downward trend in inflation started since early 2011 continued in the first half of 2013, with deflation reported in Latvia on a quarterly basis reflecting mostly the fall in energy prices, transportation and communication services. Since early 2013 the central bank of Latvia cut in two steps its reference interest rate by 50 basis points each to 1.5 per cent by September 2013.

Real growth in **Lithuania** moderated in the second quarter of 2013 but remained relatively high. Gross capital formation had the major contribution to growth, while net exports contributed negatively. Construction contributed most substantially to value added growth by sector, while the contribution of industrial output was negative. In the first half of 2013 unemployment significantly went down. Lower energy and fuel prices contributed to zero inflation in the first and second quarters of the year.

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

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



Sources: Eurostat, own calculations.

Economic growth in **Poland** accelerated in the second quarter of 2013. Net exports and government consumption had the major positive contribution to growth, while investments reported a decline. Growth was reported by all sectors with the exception of construction. The unemployment rate remained almost unchanged. Inflation remained low impacted most strongly by declining prices of energy, clothing, transport and communication services. This was a ground for the central bank of Poland to continue implementing its policy of cutting its reference interest rate which was decreased between January and July by 1.5 percentage points to 2.5 per cent.

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

Romania's real GDP continued to increase modestly in the second quarter of 2013. Net exports contributed significantly to this growth, while investments exhibited a sizeable decline. Industry (excluding construction) and agriculture contributed most to growth, while construction and trade reported a decline. The unemployment rate slightly had increased after the economic activity ratio had risen and employment slightly decreased. Over the second quarter of 2013 inflation also slowed down. The factors halting the inflationary pressure were prices of some services, while the depreciation of the Romanian leu against the euro recorded the highest inflation across the countries in the group. Notwithstanding, the central bank of Romania cut its reference interest rate several times between July and October to 4.25 per cent.

In the April–June period **Hungary's** economy continued recovering on a quarterly basis, albeit at lower rates compared with the first quarter of the year. Gross capital formation and private consumption were the main positive contributors to GDP dynamics, while net exports impacted growth negatively. Industry and professional and scientific activities reported the strongest growth, while trade and agriculture reported the largest decline. The unemployment rate went down in the first half of 2013, while employment exhibited an increase. Inflation declined as a result of the lower prices of fuels and goods and services with administratively controlled prices, as well as lower prices of some services. The Hungarian central bank continued its policy of monthly cutting its reference interest rate which reached 3.60 per cent by September 2013.

The economic activity in the **Czech Republic** showed the first signs of recovery in the second quarter. The real GDP rose on a quarterly basis following six consecutive quarters of a contraction. Net exports contributed positively to growth, while investment dynamics had a negative effect on GDP. Industry, financial and information services contributed most significantly to positive growth of economic activity, while the contribution of services related to real estate was negative. Improving economic activity had a positive effect on labour market and the unemployment rate continued to decrease in the second quarter reaching the lowest level in the group of EU-7 countries. Inflation in the Czech Republic accelerated in the second quarter due mostly to increasing food prices.

Real GDP Growth

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

Country	2011				2012				2013	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	0.3	0.5	0.2	0.1	0.3	0.1	0.1	0.1	0.1	-0.1
Czech Republic	0.7	0.2	0.0	-0.2	-0.4	-0.4	-0.3	-0.3	-1.3	0.6
Hungary	1.1	-0.1	0.0	0.3	-1.5	-0.5	0.0	-0.5	0.6	0.1
Latvia	1.2	2.6	1.0	0.4	0.6	2.1	1.8	0.8	1.8	0.1
Lithuania	2.0	1.5	0.8	1.1	0.4	0.6	1.7	0.7	1.1	0.7
Poland	1.3	1.4	0.8	1.0	0.3	0.0	0.4	0.1	0.2	0.4
Romania	0.7	-0.4	2.5	-0.9	-1.0	1.4	-0.5	1.0	0.4	0.5
Average	*1.0*	*0.7*	*0.8*	*0.4*	*-0.2*	*0.1*	*0.1*	*0.1*	*0.1*	*0.4*

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	-0.1	0.7	0.1	-0.5	-0.3
Czech Republic	0.6	0.0	-0.1	-1.0	2.0
Hungary	0.1	0.3	0.0	0.4	-0.3
Latvia	0.1	1.1	0.2	-3.0	2.4
Lithuania	0.7	0.8	0.0	2.3	-4.2
Poland	0.4	0.1	0.3	-0.9	1.8
Romania	0.5	0.3	0.2	-1.9	1.7

Sources: Eurostat, own calculations.

Inflation

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

Country	2011				2012				2013	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	1.2	0.6	0.3	0.5	0.5	0.6	1.4	0.3	-0.2	-0.4
Czech Republic	0.2	0.7	0.8	1.1	1.4	0.4	0.5	0.6	0.1	0.3
Hungary	1.1	0.9	0.6	1.3	2.7	0.9	1.0	0.6	0.1	0.2
Latvia	1.4	1.3	0.8	0.6	0.7	0.4	0.2	0.3	-0.5	-0.1
Lithuania	1.1	1.7	0.6	0.6	0.7	0.9	1.0	0.4	0.0	0.0
Poland	1.3	1.0	0.5	1.3	1.3	0.9	0.4	0.2	-0.2	0.2
Romania	1.4	1.6	-0.3	0.8	0.7	0.9	1.8	1.3	0.8	0.4
Average	*1.2*	*1.0*	*0.4*	*1.1*	*1.3*	*0.8*	*0.8*	*0.5*	*0.0*	*0.2*

Source: ECB.

Unemployment

(per cent; quarterly, seasonally adjusted data)

Country	2011				2012				2013	
	I	II	III	IV	I	II	III	IV	I	II
Bulgaria	11.2	11.3	11.2	11.5	12.0	12.2	12.3	12.6	12.9	12.9
Czech Republic	6.9	6.9	6.6	6.5	6.8	6.9	7.0	7.2	7.2	7.0
Hungary	11.0	11.0	11.0	10.9	11.1	11.0	10.7	11.0	10.9	10.4
Latvia	17.1	16.9	16.0	15.4	15.5	15.6	14.3	14.0	12.6	11.4
Lithuania	16.7	15.9	15.3	13.8	13.9	13.6	13.1	12.9	12.6	11.9
Poland	9.5	9.5	9.7	9.9	9.9	10.0	10.2	10.4	10.6	10.5
Romania	7.2	7.4	7.5	7.4	7.3	7.1	7.0	6.7	7.1	7.4

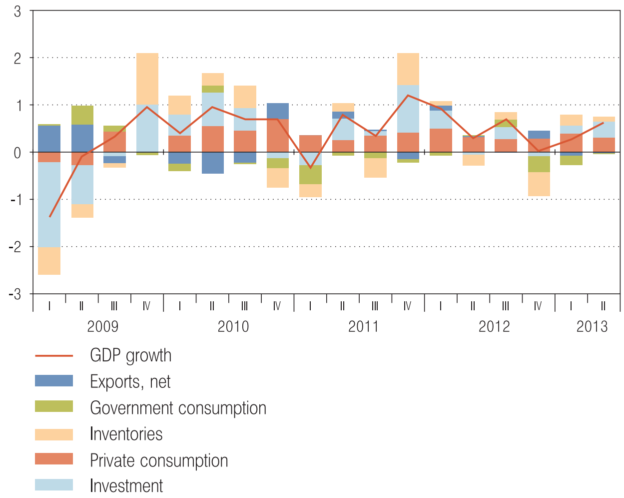
Source: Eurostat.

United States

In the second quarter of 2013 economic growth in the USA accelerated to 1.6 per cent on an annual basis against 1.3 per cent fall in the first quarter. Economic growth on a quarterly basis also accelerated in the April–June period to 0.6 per cent against 0.3 per cent in the previous quarter. Investment in the business sector, household consumption and the change in inventories contributed positively to growth.

Contribution to US GDP Growth by Component (Quarterly)

(per cent; percentage points)

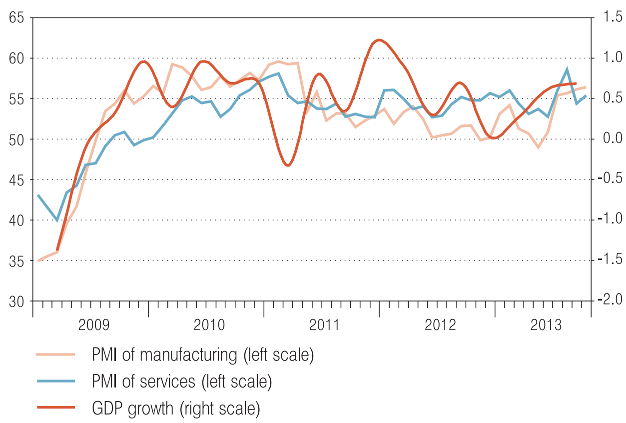


Source: Bureau of Economic Analysis.

In the third quarter of 2013 manufacturing and services indicators increased to levels significantly exceeding the threshold of 50. ISM-PMI index of manufacturing prices rose to 56.2 against 55.7 in August and the services sector indices decreased to 54.4 against 58.6 in August.

US Manufacturing and Services ISM-PMI and GDP Growth

(on a quarterly basis) (per cent)

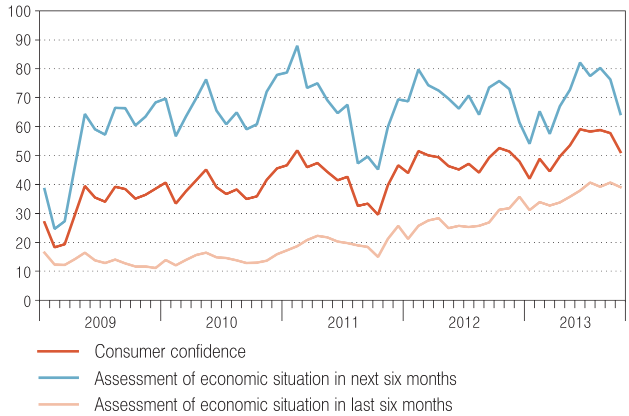


Source: Institute for Supply Management.

Consumer confidence measured by the University of Michigan consumer confidence index decreased in October to 73.2 against 77.5 in September and 82.1 in August. The Conference Board Consumer Confidence Index developments were volatile in the third quarter and in August increased insignificantly to 81.8 against 81 July, while in September and October it went down to 80.2 and 71.2 respectively. The major factor impacting consumer confidence indicators was the lower rate of opening new jobs in the third quarter.

US Consumer Confidence Indices

(2000 = 100)



Source: The Conference Board.

In the third quarter the monthly growth rate of retail sales and consumer expenditure slowed down. Retail sales in September posted a decline by 0.1 per cent on a monthly basis against an increase by 0.2 per cent in August, and the annual growth rate slowed down to 3.2 per cent against 4.6 per cent in August and 5.7 per cent in June.

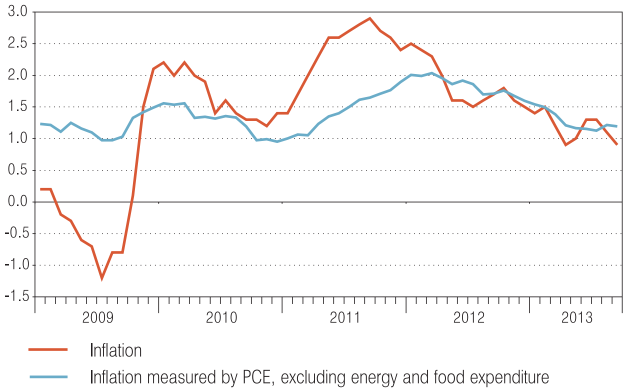
The recovery of the housing sector continued in the third quarter of 2013 albeit at a relatively slower pace compared with the previous period. The annual growth rate of the house price index in the 20 largest cities in the USA (S&P/CaseShiller 20) accelerated insignificantly to 12.8 per cent in August, from 12.3 per cent in July. Employment in the housing sector also exhibited an increase in September following a six-month slack. The annual growth rate of new residential construction and construction permits slowed down but remained relatively high.
In August the National Association of Home Builders (NAHB) index reached 58 points, the highest value since the end of 2005, and then declined to 57 points.

Despite the divergent dynamics in the third quarter the indicators of consumer confidence and economic activity (including construction) give grounds to expect that economic recovery will continue in the fourth quarter of 2013 and in the first quarter of 2014.

Inflation rate measured by the personal consumption expenditure deflator (PCE) decreased insignificantly to 0.9 per cent in September, from 1.1 per cent in the previous month. The annual growth rate of the core PCE price index (excluding food and fuel) remained at 1.2 per cent in September for a second consecutive month.

Inflation in the USA
(on an annual basis)

(per cent)



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

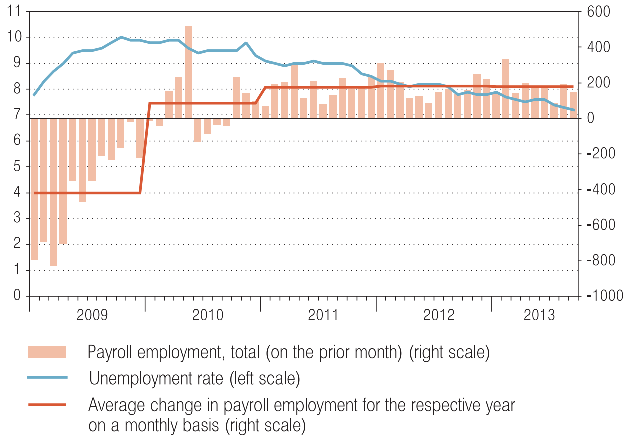
Source: Bureau of Labor Statistics.

The annual growth rate of the consumer price index, the other measure of the US inflation, slowed down to 1.2 per cent in September, from 1.5 per cent in August. The annual growth rate of the core PCE price index in September declined to 1.7 per cent against 1.8 per cent in August.

Consumer price inflation expectations in the period of one to five years, a component of the University of Michigan consumer confidence index, stood relatively stable in the third quarter. Short-term inflationary expectations decreased to 3 per cent in October, and long-term expectations to 2.8 per cent against 3.3 per cent and 3 per cent in September respectively. In the following two quarters the US inflation is expected to slightly increase but to remain bellow 2 per cent on an annual basis.

US Unemployment Rate and Number
of New Employees in the USA

(per cent) (payroll employment, thousand)



Source: Bureau of Labor Statistics.

By the end of the third quarter of 2013, the US unemployment rate decreased to 7.2 per cent, the lowest level recorded since November 2008. Despite the reported positive dynamics of sentiments among business representatives and the construction sector, in September another 148,000 new jobs were created, compared to 193,000 in August and 89,000 in July. Between July and September monthly employment in the non-agrarian sector rose by 143,000 on average, down by 39,000 and 51,000 respectively compared with the average number of newly opened jobs in the second and first quarters. The weaker demand for labour force in the third quarter was a result of uncertainty in respect of the economic policy pursued, associated both with the volatile signals in communication by US Federal Reserve representatives as to the monetary policy implemented and the increased political tension related to the adoption of the budget for the 2014 fiscal year.

At its meeting held on 29 and 30 October, 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 to purchase USD 40 billion agency mortgage-backed securities *per* month and US treasury securities worth USD 45 billion *per* month. At the meeting it was confirmed that the interest rate on US federal funds would be maintained within the 0–0.25 per cent range at least until the US unemployment rate reached or fell below 6.5 per cent and unless the expected inflation within the one- to two-year horizon exceeded the threshold of 2.0–2.5 per cent and long-term inflation expectations remained stable.

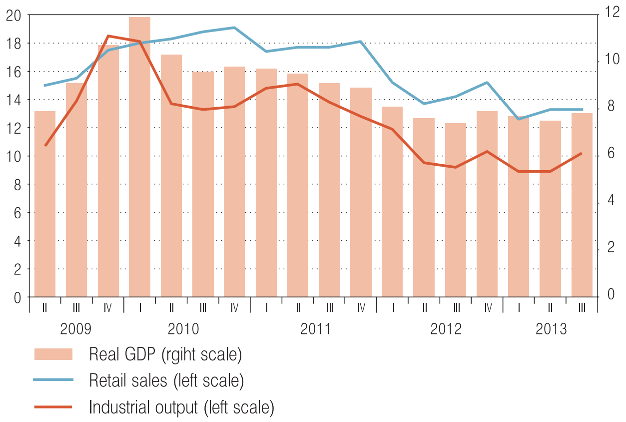
China

In July China's political governance announced publicly the policy which would be implemented until year-end intended to accomplish the declared priority goals: sound and balanced economic growth, modest stimulation of the economy, restructuring and reforms. The target budget deficit will remain at 2.1 per cent of GDP in 2013 and the economy will be stimulated by the lower tax burden of micro and small enterprises and the 5 per cent cut in public administration expenditure.

In the third quarter of 2013 China's real GDP growth accelerated to 7.8 per cent year on year against 7.5 per cent in the second quarter of 2013.

GDP, consumption and industrial output (on an annual basis)

(per cent) (per cent)

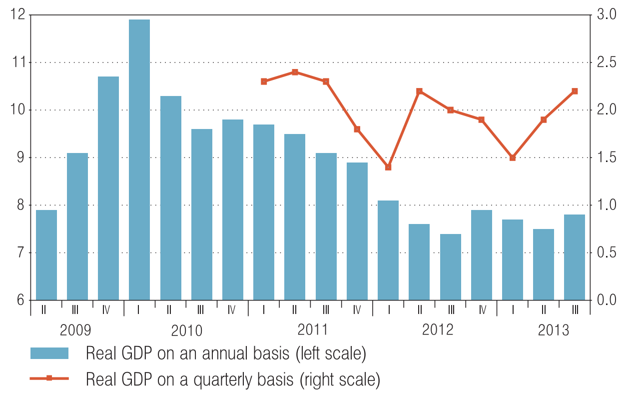


Source: National Bureau of Statistics of China.

On a quarterly basis the economy grew by 2.2 per cent between July and September against 1.9 per cent in the second quarter and 1.6 per cent in the first quarter of 2013.

Real GDP Growth (on an annual and quarterly basis)

(per cent) (per cent)

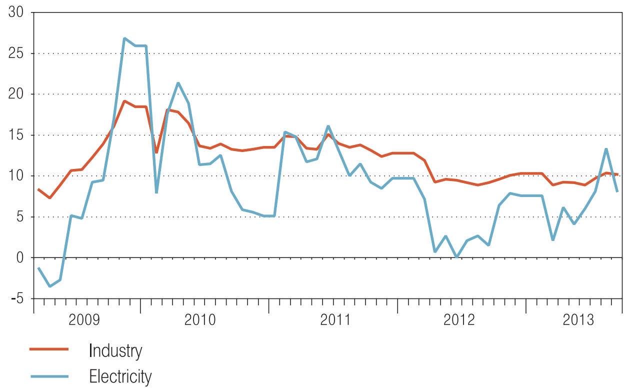


Source: National Bureau of Statistics of China.

The slower growth in the second quarter was practically overcome by activating investments in infrastructure, mostly railway, cutting taxes for small- and medium-scale enterprises and slightly softening some administrative measures limiting real estate market.

Industrial Output and Energy Generation Indices (on an annual basis)

(per cent)

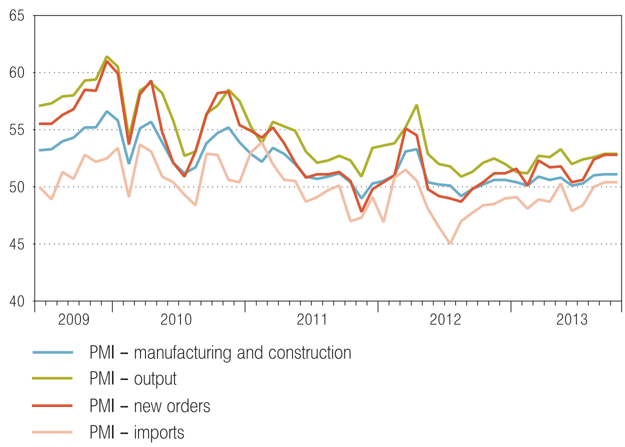


Source: National Bureau of Statistics of China.

According to manufacturing PMIs the activity went up during the quarter: to 51.1 per cent in September against 51.0 in August and 50.3 in July. Developments in Individual components point to a stabilisation of the upward trend. The major factor behind the increase in the index were the new orders and current output.

In September PMI for the services sector posted a significant increase reaching 55.4 compared with 53.9 in August and 54.1 in July.

Manufacturing PMI, Output and New Orders

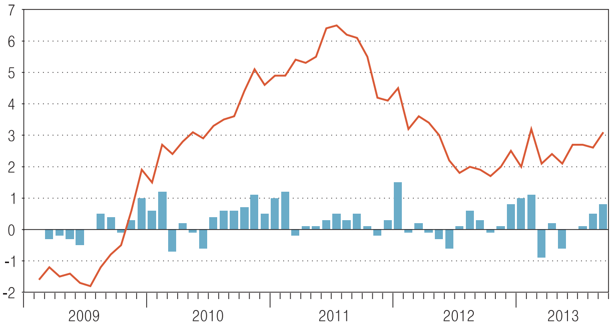


Source: China Federation of Logistics and Purchasing.

In September inflation accelerated to 3.1 per cent on an annual basis against 2.6 per cent in August and 2.7 per cent in July. Food price developments, accelerating their rate of growth in September to 6.1 per cent on an annual basis (from 4.7 per cent in August), had the major contribution to the increase.

Inflation Indices (Rate of Change)

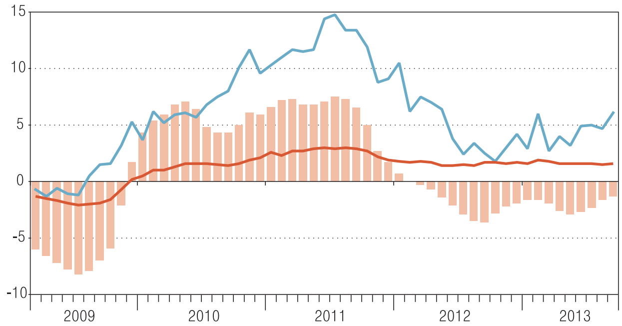
(per cent)



Source: National Bureau of Statistics of China.

Price Indices (Rate of Change)

(per cent on an annual basis)

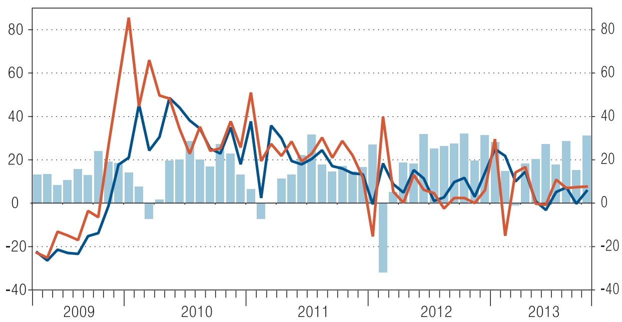


Source: National Bureau of Statistics of China.

Rates of producer price declines moderated significantly in September, falling by 1.3 per cent year on year compared to a decline of 1.6 per cent in August and 2.3 per cent in July.

Foreign trade (Rate of Change)

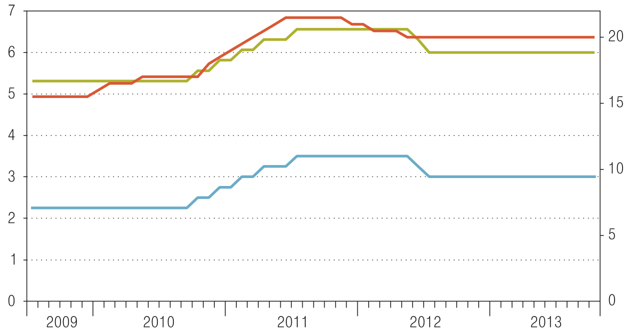
(billion BGN) (per cent)



Source: National Bureau of Statistics of China.

Monetary Policy of the People's Bank of China

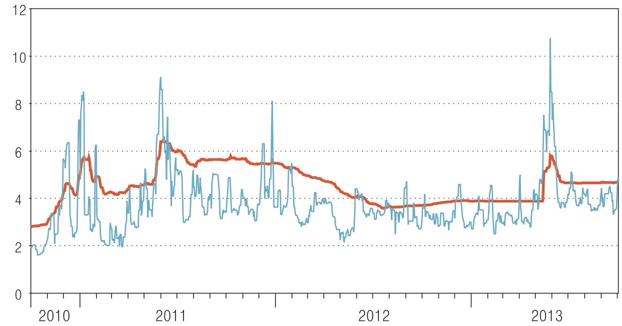
(per cent) (per cent)



Source: People's Bank of China.

Interbank Market Interest Rates

(per cent)

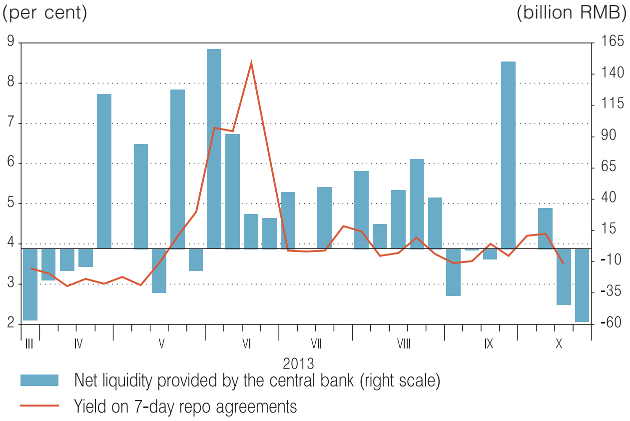


Source: People's Bank of China.

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

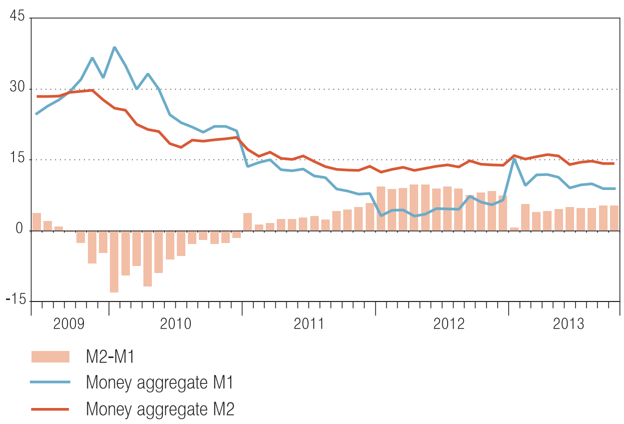
Following the turmoil in the interbank money market as of June, the People's Bank of China continued to provide liquidity through reverse repo agreements but at higher interest rates.

Interbank Market Liquidity



Source: People's Bank of China.

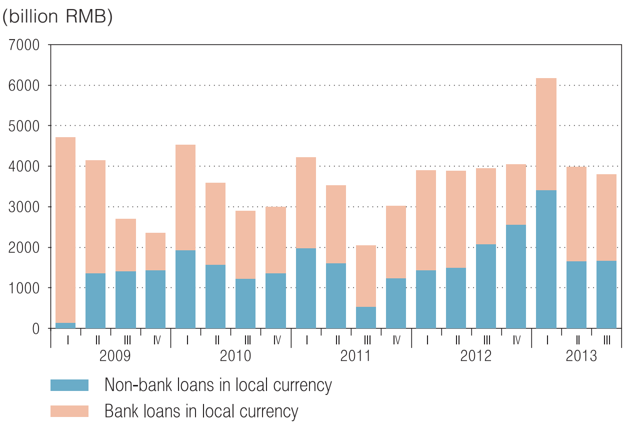
Credit Aggregates (Rate of Change)



Source: People's Bank of China.

The seven-day interest rate on repo agreements which is considered a measure of interbank credit market confidence moved within a relatively narrow corridor of about 4 per cent in the entire period. This was a result of the quantitative manipulation of interbank market liquidity by the People's Bank of China.

Bank and Non-bank Lending in National Currency

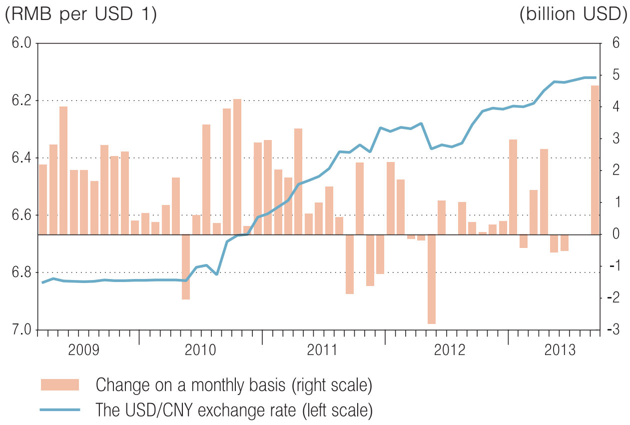


Source: People's Bank of China.

In the third quarter new bank loans in national currency decreased to RMB 2122 billion, from RMB 2325 billion in the previous quarter (-8.7 per cent on a quarterly basis).

Based on central bank's data on the so-called Total Social Financing (TSF), in the third quarter total financing to the economy (bank and non-bank) in national currency amounted to RMB 3787 billion, posting a decrease by 5 per cent on a quarterly basis and 4 per cent on annual basis.

RMB/USD Exchange Rate and Foreign Currency Reserves



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

Source: Bloomberg.

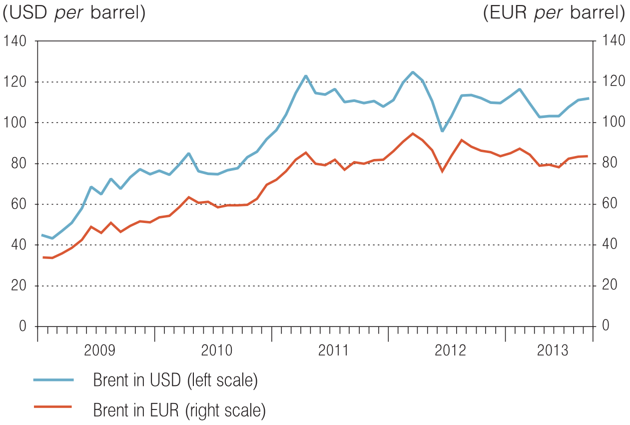
In the third quarter of the year the Chinese currency appreciated by 0.3 per cent against the US dollar. The rate of growth did not follow a sustainable trend. In July and and August the Chinese currency appreciated by 0.14 per cent each month, while in September it depreciated by 0.01 per cent on a monthly basis. In July and August foreign exchange reserves remained unchanged but in September they exhibited an increase by about USD 5 billion.

International Commodity Prices and the USD/EUR Exchange Rate

Crude Oil

Brent crude oil appreciated over the third quarter of 2013 following the dramatic fall between April and June. Between July and September Brent crude oil was traded at USD 110.1 per barrel (EUR 83.1) on average, up 0.1 per cent on an annual basis.

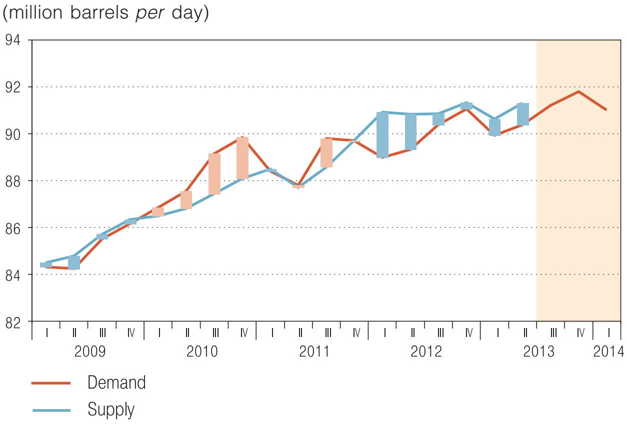
Crude Oil Prices



Source: World Bank.

The oil price rise in the third quarter reflected the temporarily interrupted production and deliveries, mostly in OPEC countries, seasonally increased demand and repair works on oil platforms in the North Sea.

World Crude Oil Supply and Demand (Quarterly)

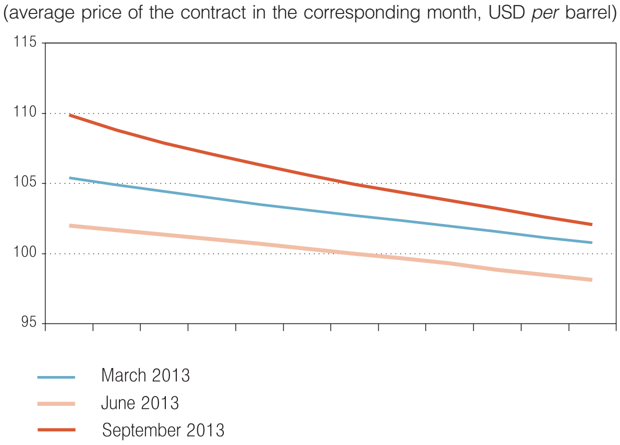


* Including the October 2013 IAE forecast about crude oil demand.
Source: IEA.

According to the International Energy Agency (IEA) data the global oil supply will increase and will exceed the demand which will probably result in a decline (on an annual basis) of the oil price in international markets at the end of 2013 and early 2014.

According to the market sentiment measured by the futures prices, Brent crude oil will trade in the USD 100–110 range *per* barrel in the following twelve months. This marks an increase in the expected price as compared with June and March. This dynamics may be explained by higher prices in July and August which impacted market participants' sentiment in the short run. This is confirmed by the fact that the effect on the expectations at the long end of the curve is minimal.

Brent Crude Oil Futures Prices



Source: JP Morgan.

Major Raw Material and Commodity Prices

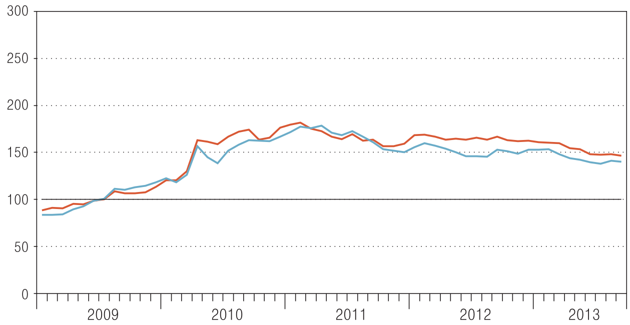
Between July and September 2013 international prices of most commodity groups in euro continued to fall, though at a slower rate as compared with the first half of the year. The metals price index published by the ECB went down by 3 per cent compared with the second quarter of 2013. Copper prices also continued to decline (by 2.4 per cent). The non-ferrous metal index decreased by 3.5 per cent on a quarterly basis. A depreciation was also reported on an annual basis: metals by 10.8 per cent, copper and non-ferrous metals by 13.4 per cent each.

Metal prices are expected to continue declining on a quarterly basis by the end of 2013 and early 2014, though at a slower pace. Projected growth of global economic activity will exert upward pressure on metal prices.

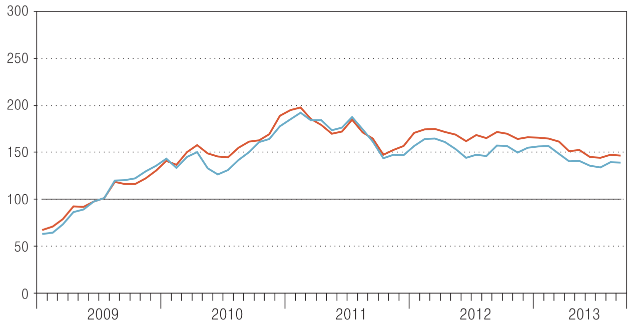
Wheat and cereal prices continued to fall in international markets, a trend observed in the last 12 months. Cereals depreciated significantly between July and September 2013: by 10.5 per cent on a quarterly basis mostly due to good corn crops in the USA. As a result corn and wheat prices exhibited the strongest decline: -15.4 per cent and -10.4 per cent respectively. Over the same period the food price index also retained its downward trend, prices declining by 5.4 per cent on the previous quarter and by 18.7 per cent on an annual basis. Based on the expectations of the International Grains Council of September cereal yields growth over 2013/2014 will remain high. Correspondingly, it may be expected an annual decrease of food prices over the fourth quarter of 2013 and a stabilisation over the first quarter of 2014.

Price Indices of Major Raw Material and Commodity Groups
(2009 = 100)

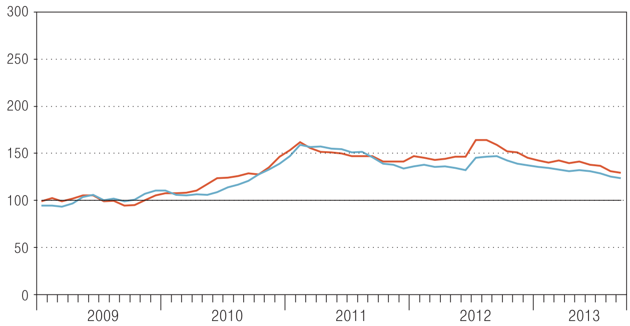
Metals



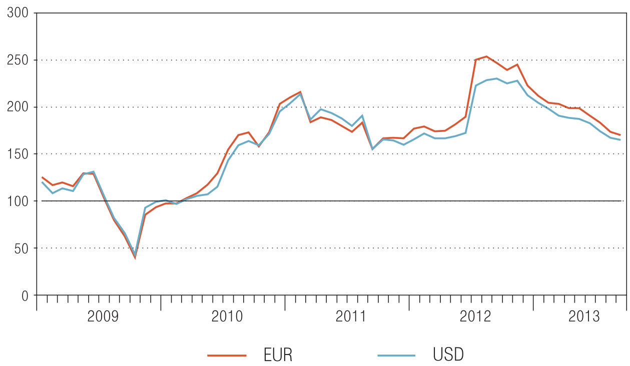
Copper



Food



Wheat



Sources: ECB and BNB calculations.

The price dynamics in global commodity markets is expected to further weaken the inflationary pressure in Bulgaria having concurrently a dampening effect on Bulgaria's nominal export growth.

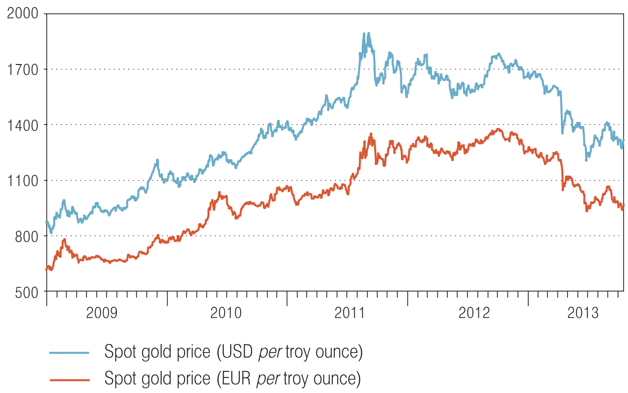
Gold

Over the third quarter of 2013 the spot price of gold rose by 7.6 per cent on a quarterly basis to USD 1328.9 per troy ounce. The euro gold price increased by 4.2 per cent to EUR 980.3 per troy ounce.

Following the dramatic depreciation in the second quarter gold appreciated in July and August as a result of the slower closure of positions of exchange-traded funds collateralised by gold (ETF) and enhanced search for security due to a threat of military intervention in Syria. In early September gold partially lost its positions as a result of subsided tension in Syria and the expected reduction in asset purchases by the US Federal Reserve. However, these expectations did not materialise which resulted in a stronger gold demand for inflation protection and correspondingly to a gold price hike.

In the third quarter total assets of funds collateralised by gold decreased by 105.9 tonnes to 1758.4 tonnes of gold (-5.7 per cent on a quarterly basis). However the fall was significantly lower compared with the second quarter when the assets of funds decreased by 368.6 tonnes.

Spot Gold Price



Source: London Bullion Market Association.

In the third quarter India again raised the gold import duty from 8 per cent to 10 per cent intended to limit the deficit increase on the balance of payments current account. This is the third increase from the beginning of the year.

India is the world's biggest gold importer and the raised duty will limit the physical demand for gold.

The USD/EUR Exchange Rate

In the third quarter of 2013 the US dollar depreciated against the euro by 4.0 per cent. Over the period the US currency traded nominally within a range of 1.28–1.35 per euro. The volatility of foreign exchange markets remained strong, with the expectations and uncertainty about the gradual decrease in the US Federal Reserve monetary incentives and the crisis in Syria in early September being the major factors responsible for foreign exchange fluctuations.

The USD/EUR Exchange Rate

(USD *per* EUR 1)

Source: ECB.

In the beginning of the third quarter the euro depreciated against the US dollar after the monetary policy session of 4 July when the ECB announced for the first time forward guidance of a change in its interest rates, and particularly stating that interest rates were expected to remain unchanged or at lower levels for a long period of time. The duration of the effect of this new element of the ECB policy pursued was relatively short and at the end of the summer the euro started again to appreciate.

In August the USD downward trend and the EUR upward trend were sustained due to a series of positive macroeconomic data of the euro area and the active re-channelling of assets from emerging markets to the USA and the euro area. At the end of August this process was interrupted for some time by the geopolitical turmoil in Syria and the search for security in USD-denominated assets. When the immediate threat of military intervention in the Middle East dissipated, markets returned to factors supporting the single currency before the crisis in Syria. By the end of September the EUR/USD exchange rate responded strongly to the gradual reduction of incentives that was not initiated by the US Federal Reserve.

2. Financial Flows, Money and Credit

Between January and August 2013 a gradual rise in the surplus of BOP current and capital account balance was observed on an annual basis. This trend was largely driven by the strong trade deficit contraction, stemming from the accelerated growth of exports and slight decline of imports. Flows on balance of payments financial account reflected mainly bank financial operations oriented towards an increase in their foreign assets. Financial account dynamics in the beginning of the year was also driven by financial flows related to repayments on Bulgarian global government bonds maturing in January. Financial flows resulting from the interaction between external and domestic economic factors contributed to the annual increase in Bulgaria's international foreign exchange reserves.
The overall current and capital account balance is expected to remain positive on an annual basis at the end of 2013 and in the first quarter of 2014. Relatively low household consumption and investment activity will have a dampening effect on credit activity in Bulgaria, with the volume of extended loans starting to slowly increase. Bank deposit growth will retain its high levels, enabling banks to invest part of their liquidity in foreign assets, to reduce external liabilities and increase credit supply in case of higher demand for loans.

The uncertainty in expectations of economic agents around external and internal environment developments remained relatively high. Firms remained cautious about their investment decisions and households continued to maintain high savings rate, which was reflected in the balance of payments flows. Accelerated export growth since the year start along with slightly moderating imports contributed to the current account surplus reported in April, with the positive balance coming to EUR 1.0 billion in August. The balance of payments financial account dynamics was largely driven by the financial flows of banks, which increased their foreign assets and, to a lesser extent, reduced their foreign liabilities. These developments resulted in a positive balance of banks' net external assets between August and September for the first time since early 2007. The repayment of Bulgarian government's global bonds maturing in January also affected financial account outflows at the beginning of 2013.

Banking system liquidity remained high. Banks continued to maintain a large portion of their liquidity in the form of excess reserves with the BNB and funds on their accounts in TARGET2-BNB.[6] However, the April to October period saw a downward trend in these funds compared to the first quarter. Banks continued investing in government securities, primarily of the Bulgarian government, though their growth rate moderated somewhat over the third quarter following the maturing of six-month Bulgarian government bonds worth BGN 800 million in August. Annual growth of credit to the non-government sector moderated further, including that to non-financial corporations, while banks' claims on households reported an insignificant decline.

According to preliminary balance of payments data as a result of the interaction between external and domestic economic factors and of the resulting financial flows, Bulgaria's international foreign exchange reserves (excluding valuation adjustments and price revaluation) posted an increase on an annual basis. By August 2013 it came to EUR 210.1 million. On the other hand, the market value of international reserves[7] (an asset in the Issue Department balance sheet) came to BGN 28.3 billion (EUR 14.5 billion) at the end of October 2013, down EUR 643 million on an annual basis. The difference between the change in reserves in the Issue Department balance sheet and that in the balance of payment reflected the downward trend in gold price.

[6] The national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2).

[7] The market value of international foreign reserves includes changes stemming from transactions, valuation adjustments and price revaluation.

The decline in government and budget organisations' debt contributed most to the reduction in the Issue Department balance sheet figure. The annual fall was affected by the issue of five-year government securities with a nominal value of EUR 950 million[8] on international capital market in July 2012, pushing up the level of international reserves between July 2012 and January 2013. The volatility in the gold price resulted in a 21 per cent depreciation over the first half-year, which had a strong impact on the Issue Department balance sheet.

External currency flows related to the change in international reserves in line with the currency board principles reflected economic agent needs for cash in foreign currency or levs. Between January and September 2013 banks realised net purchases of currency from the BNB. This recent years' trend continued largely due to the banks' policy to boost their foreign assets and to reduce external indebtedness.

The international reserves coverage of the average nominal imports of goods and non-factor services over the last 12 months came to 6.5 months in August.

External Cash Flows in Foreign Currency

(million EUR)

External flows	2012	January–September	
		2012	2013*
Total for the period	1 527	1 413	-553
Purchases and sales of euro	-317	-213	-1 152
at tills	-10	-8	-18
banks, incl.	-307	-205	-1 135
banks' purchases	46 550	35 897	26 366
banks' sales	-46 856	-36 102	-27 501
Flows on accounts of banks, the MF, *etc.*	1 844	1 626	600
Minimum required reserves	40	85	237
Government and other depositors	1 804	1 541	363

* Preliminary data.
Note: The table shows only 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 liabilities are not reported, as they do not prompt changes in gross international reserves.

Source: BNB.

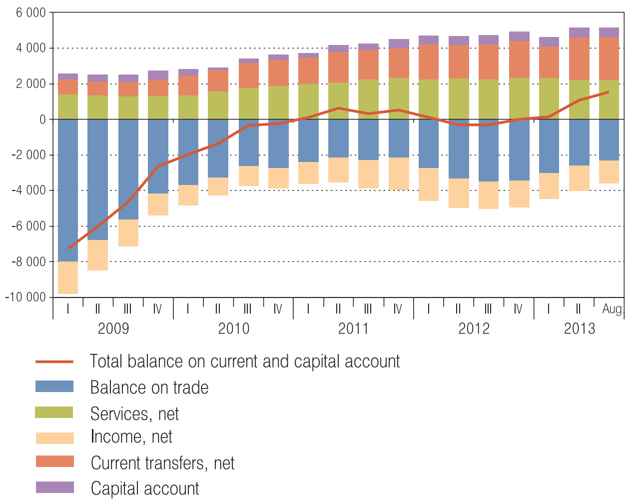
The overall current and capital account balance is expected to remain positive on an annual basis in late 2013 and early 2014. Monetary aggregate M3 will continue to rise at relatively high rates, with a tendency of gradual deceleration over the fourth quarter of 2013 and the first quarter of 2014. Growth rates of corporate loans are expected to remain low in late 2013 and to start gradually accelerate in the first quarter of 2014. The downward trend in household credit is projected to discontinue in the fourth quarter and to slightly grow in the first quarter of the next year, reflecting our expectations of a gradual recovery in consumer demand.

External Financial Flows

Between January and August 2013 the overall current and capital account balance[9] reported a surplus, with the current account contributing most. As a result of the high export growth rate and, to a lesser extent, of slight declines in imports, the trade balance deficit decreased significantly. The surplus in the balance of net current transfer, mostly from EU funds, also contributed to the positive current account balance.

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

(million EUR)



Source: BNB.

In the first eight months of 2013 exports of goods grew nominally by 7.9 per cent on an annual basis, reflecting the accelerated growth of exports to EU countries and the ongoing increase of exports to third countries. Nominal imports reported a minimum decline of 0.4 per cent between January and August 2013 due to the decrease in goods imports from third countries. As a result of exports and imports

[8] The issuance was intended to provide funding for global bonds maturing in January 2013.

[9] Data in this section are obtained from the balance of payments statistics. They are preliminary and subject to revision.

dynamics, the trade deficit shrank by almost half over the same period of the prior year.[10]

The surplus in the services balance fell slightly between January and August 2013 owing to the decline in services exports partly offset by lower imports of services. Among the exports of services, tourist services reported the highest growth in the first eight months of 2013 compared with the January to August 2012 period. The lower imports of services reflected the decrease mainly in construction services. Tourist services posted the strongest increase in services imports. External demand recovery, particularly in the euro area, gives grounds to expect that services imports will gradually rise at the end of 2013 and in the first quarter of 2014.

Flows on Balance of Payments Main Accounts

(million EUR; cumulative as of early 2013)

	as of 31 August 2012	as of 31 August 2013
Current account	-279.2	1 255.1
Trade balance	-2 476.6	-1 342.0
Services balance	1 791.8	1 687.6
Income account	-1 034.6	-873.4
Current transfers, net	1 440.1	1 782.9
Capital account	186.4	164.7
Financial account	1 832.7	-1 722.6
FDI in Bulgaria	1 593.5	772.5
Changes in reserves*	1 554.3	-396.6

* A positive sign indicates an increase in international reserves.
Source: BNB.

The downward trend in the Income Account deficit observed throughout 2012 continued in the first eight months of 2013. The Income Account outflows decreased; while inflows increased. Lower outward flows were reported in the income from other capital (interest) and from other investment (income from loans in particular), while inflows posted the significant growth in income from dividends and distributed profit. Inflows posted the most substantial growth in compensations to employees and income from portfolio investments (interest).

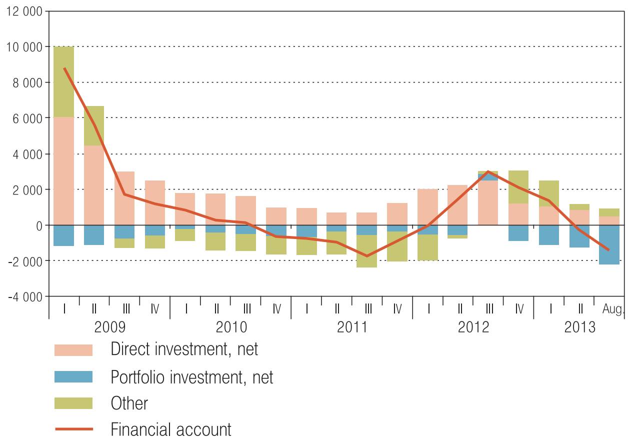
The positive balance on current transfers between January and August 2013 also increased on the corresponding period of 2012 mainly due to increased EU receipts.

Given the trends observed in the current account dynamics and in case the trend toward a recovery of economic activity in the euro area stabilise, the overall current and capital account balance is expected to remain positive on an annual basis at the end of 2013 and the beginning of 2014. The factor that would contribute to lower values of this balance is the deterioration of trading conditions in Bulgaria that will result in nominal import growth.

In the first eight months of 2013 the balance of payments financial account dynamics reflected mainly transactions of banks and external debt repayments by the Bulgarian government in January[11].

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

(million EUR)



Source: BNB.

Between January and August 2013 banks continued to increase their foreign assets and, to a lesser extent, to reduce their foreign liabilities against the background of ample liquidity and limited demand for loans in the national economy. These trends are likely to continue in the second and the third quarters of 2014.

According to preliminary BOP data for the first eight months of 2013, foreign direct investment (FDI) inflow in Bulgaria totalled EUR 772.5 million, down EUR 820.9 million on the respective period of the prior year.[12] Given the significant fluctuations in FDI monthly data and revisions to them, it is difficult to assess their level at the end of 2013 and the beginning of 2014.

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

[11] For more details of the payments on government global bonds maturing in January and their effects on balance of payments financial account and external debt, see Economic Review, 1/2013, p. 29.

[12] Preliminary data subject to revision. Given the volatility in monthly data on FDI and data revisions, FDI between January and August 2013 should be compared to the original release of the data for the same period of 2012, which point to an inflow of EUR 873.1 million.

Banks' Flows on Balance of Payments Financial Account

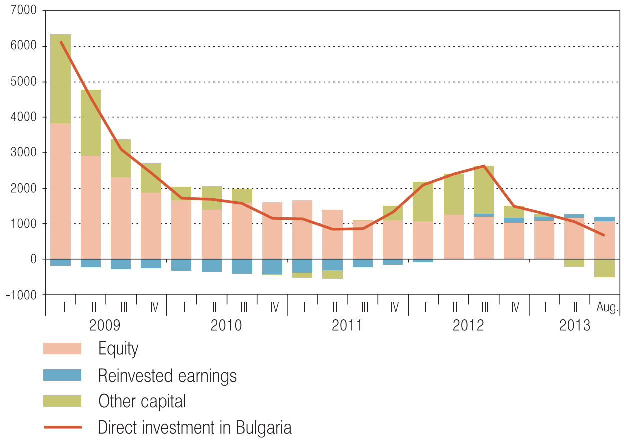
(million EUR; cumulative as of early 2013)

	as of 31 August 2012	as of 31 August 2013
Net direct investment	104.1	79.8
abroad	-0.3	-0.6
in Bulgaria	104.4	80.4
Net portfolio investment	-51.2	-347.5
assets	-62.8	-375.3
liabilities	11.6	27.8
Other investment	-474.4	-1 576.3
assets	-340.6	-1 075.4
liabilities	-133.7	-500.8
Portfolio and other investment	*-525.6*	*-1 923.8*
Total	*-421.5*	*-1 844.0*

Source: BNB.

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

(million EUR)



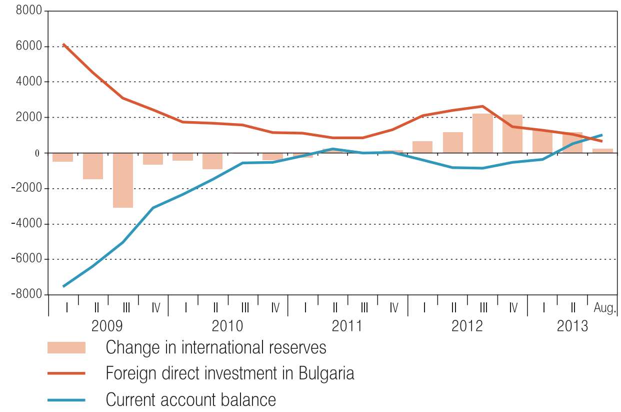
Source: BNB.

Balance of payments net flows, mostly as a result of the repayment of Bulgarian government's global bonds maturing in January, and the rise in banks' net foreign assets reduced BNB international reserves by EUR 396.6 million between January and August 2013 (valuation adjustments and price revaluations excluded). By August they reported an increase of EUR 210.1 million on an annual basis.

The balance of payments financial account dynamics in early 2013 had an effect on the gross external debt change. In the first eight months of 2013 gross external debt declined on end-2012 largely due to the reduced government and bank debt. Only *intercompany loans* marked an increase since the beginning of the year. By June 2013, obligations of direct investment companies comprised 70.5 per cent (EUR 7402.8 million) of the amount of *other sectors*' loans. They rose by EUR 36.2 million on end-2012 (EUR 7366.6 million, with a relative share of 69.6 per cent). Compared to June 2012 (EUR 7269.5 million, with a relative share of 68.5 per cent), these liabilities grew by EUR 133.3 million.

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

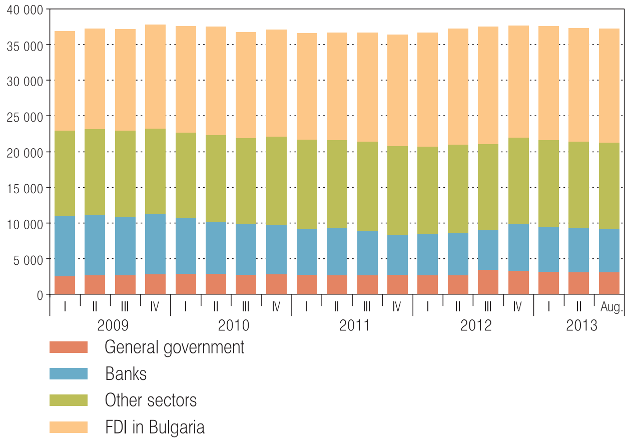
(million EUR)



Source: BNB.

Gross External Debt by Institutional Sector (at the End of the Review Period)

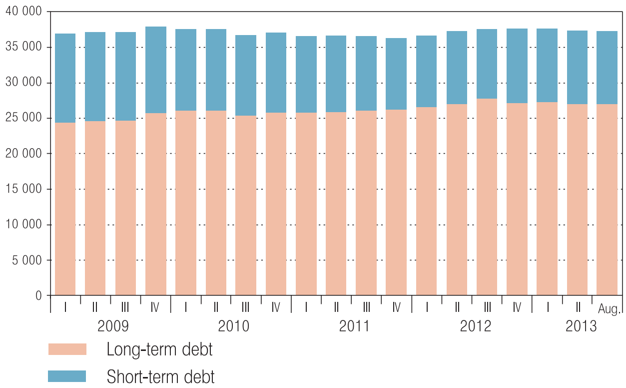
(million EUR)



Source: BNB.

Long- and Short-term Gross External Debt Dynamics (at the End of the Review Period)

(million EUR)



Source: BNB.

By August long-term external debt decreased by 0.8 per cent. Short-term external debt contracted by 1.8 per cent, coming to 27.5 per cent of total external debt.

Gross External Debt as of August 2013

(million EUR)

	Amount	Change	
		January–August 2013	Last 12 months
General government	3 109.2	-265.1	-350.5
Central bank	0.0	0.0	0.0
Banks	6 010.0	-444.5	514.9
Other sectors	12 095.1	-61.3	-117.5
FDI: Intercompany loans	16 022.8	372.7	-322.5
Total	37 237.1	-398.3	-275.6

Source: BNB.

Payments on external debt servicing in the January–August 2013 period totalled EUR 3679.5 million (of which EUR 1178.2 million from banks and EUR 631.4 million from general government) compared to EUR 4337.2 million in the same period of 2012.

Gross External Debt Service by Institutional Sector

(million EUR)

Source: BNB.

Loans and deposits disbursed between January and August 2013 amounted to EUR 2763.7 million compared to EUR 4915.2 million in the corresponding period of the previous year. Approximately 37.3 per cent of them were intercompany loans.

According to the information on new loans declared during the first eight months, the share of long-term loans is almost 35.6 per cent. The average weighted maturity on new loans grew on the corresponding period of 2012, reaching 8 years and 7 months (against 4 years and 1 month in 2012).

Loans and Deposits Received by Institutional Sector

(million EUR)

Source: BNB.

The relative share of new loans in euro in the total amount of declared new loans remained high for the January and August 2013 period (71.3 per cent), while new loans in US dollars reported an increase (28.5 per cent from 23.0 per cent between January and August 2012).

In the first eight months of 2013 the downward trend in average weighted interest rate on loans in euro continued. It came to 2.8 per cent *vis-à-vis* 3.8 per cent in the same period of 2012.

The average weighted interest rate in declared new loans in USD matched the average weighted interest rate in euro (2.8 per cent) after rising 2.4 percentage points on the January – August 2012 period. This rise can be explained by the 2012 base effect, when the cost of borrowed funds in US dollars was extremely low.

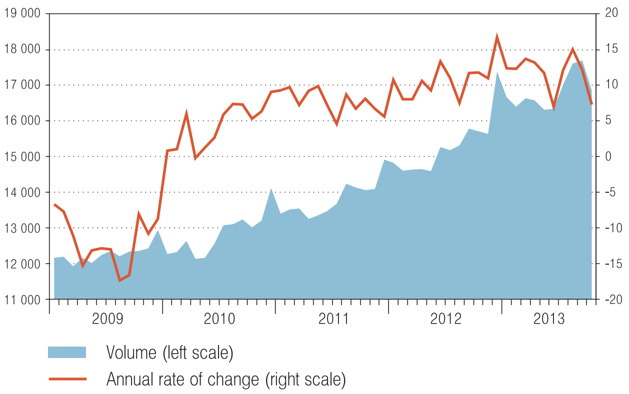
If no shock in the international environment occurs, a further drop in the cost of external financial resource in late 2013 and early 2014 may be expected. The onset of a new interest rate cycle of monetary policy of leading central banks in the form of increases in global money and capital market rates would entail a risk of discontinuation of this trend.

Monetary Aggregates

The volatility in banks' deposits with the BNB continued to affect significantly reserve money dynamics. As a result the reserve money went up in the third quarter of 2013, while in October their annual growth rate moderated to 7.3 per cent.

Reserve Money

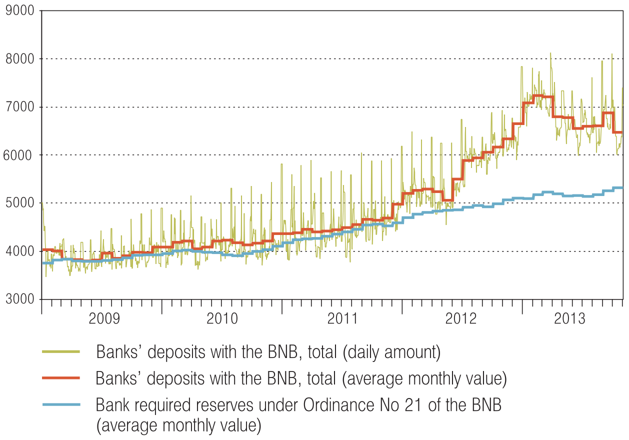
(million BGN) (per cent)



Source: BNB.

Bank Deposits with the BNB

(million BGN)



Source: BNB.

The dynamics of banks' deposits with the BNB reflected the relatively large excess reserves and funds on their accounts in TARGET2-BNB. The April to October period saw a downward trend in these funds compared to the first quarter. Banks' funds on minimum reserve requirements reflecting the deposit base growth also contributed to the increase in banks' deposits with the BNB.

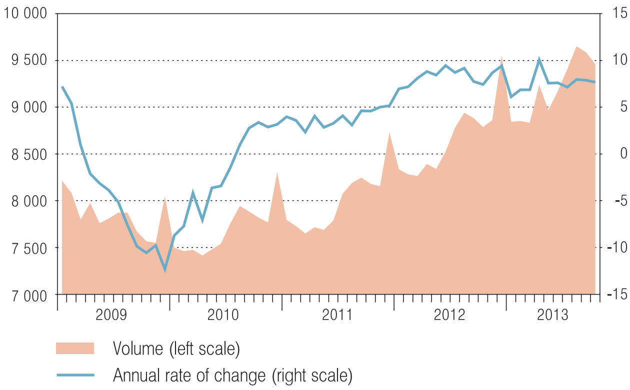
In October 2013 the growth in the average daily volume of funds attracted from residents[13] accelerated to 3.6 per cent on a quarterly basis against 0.1 per cent in the second quarter, coming to BGN 1924 million between July and October. Over the same period the average daily volume of funds attracted from non-residents contracted by BGN 629 million, funds from non-resident banks going down BGN 498 million and from non-residents (banks excluded) BGN 131 million. Reflecting the developments and structure of attracted funds, the effective implicit rate of minimum required reserves maintained with the BNB was 8.91 per cent[14] in October, with banks' reserves with the BNB coming to 7.79 percentage points, and the remaining 1.12 percentage points were formed by cash and funds on banks' settlement accounts in the TARGET2-BNB system.[15] The excess of banks' funds on minimum reserve requirements accounts with the BNB under Ordinance No 21 increased to an average daily volume of 6.3 per cent in the third quarter of 2013 (6.0 per cent in the second quarter). In October excess reserves continued to rise, their level reaching 7.5 per cent.

The growth of bank deposits with the BNB is anticipated to moderate in the fourth quarter of 2013 and the first quarter of 2014. If banks' holdings on their settlement accounts in TARGET2-BNB are retained, at the beginning of 2014 banks' deposits with the BNB may decline on an annual basis. Though at a lesser extent, the growth rate of banking system deposits will affect bank reserves.

The annual growth of currency in circulation stabilised at approximately 7–8 per cent in April, with a tendency of acceleration. Over the fourth quarter of 2013 and the first quarter of 2014 the dynamics of currency in circulation are expected to stay close to current ones.

Currency in Circulation

(million BGN) (per cent)



Source: BNB.

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

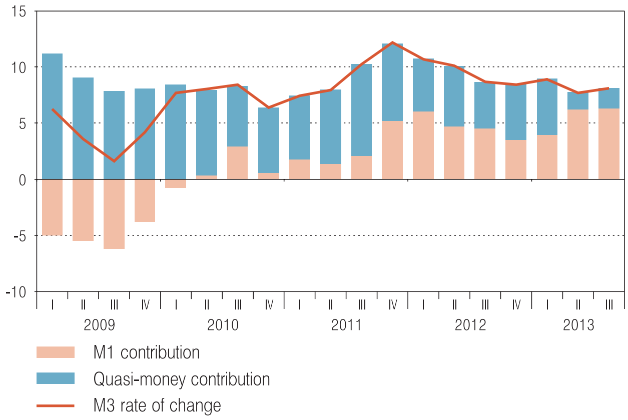
[14] According to Article 3, paragraph 1 of BNB Ordinance No 21, the rate of minimum required reserves of funds attracted from residents is 10 per cent of the deposit base, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

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

Broad money growth accelerated slightly to 8.1 per cent in September on the second quarter. This dynamics was mainly driven by the higher contribution of quasi-money at the end of the third quarter and the continuous high contribution of household overnight deposits. In the third quarter the downward trend in the growth of household deposits continued[16], but still remained relatively high at 8.5 per cent on an annual basis by end-September. As regards the deposits of non-financial corporation, their growth accelerated to 6.2 per cent on an annual basis.

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

(per cent; percentage points)



Source: BNB.

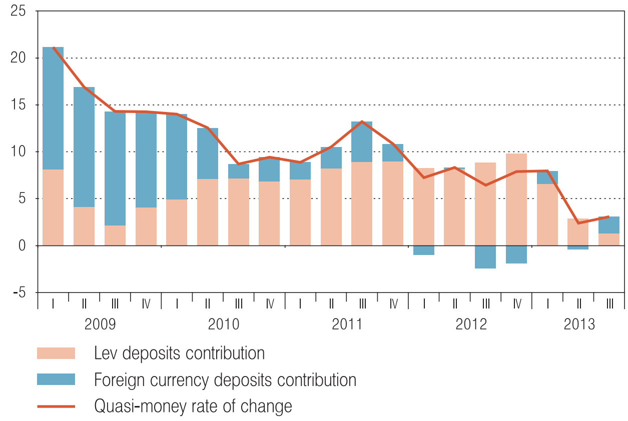
In the fourth quarter of 2013 and first quarter of 2014 broad money growth is expected to remain high as a result of the retained comparatively high savings rate. If revenues continue growing, the projected gradual increase in household consumption may lead to a gradual moderation in broad money growth.

In the third quarter of 2013 foreign currency deposits, included in the *quasi-money* aggregate, reported an increase, while lev-denominated deposits retained the downward trend observed since the second quarter. By the end of September the share of lev-denominated deposits in quasi-money reached 51.8 per cent compared with 52.0 per cent by June.

[16] 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 Quasi-money Growth Rate and Contribution of its Components (Quarterly)

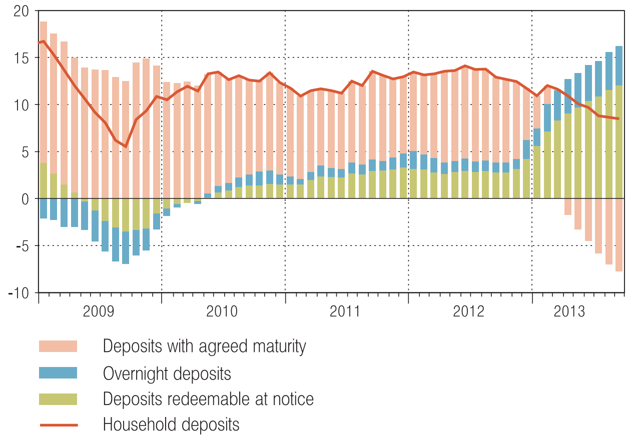
(per cent; percentage points)



Source: BNB.

Annual Growth of Household Deposits and Contribution by Type of Deposit

(per cent; percentage points)



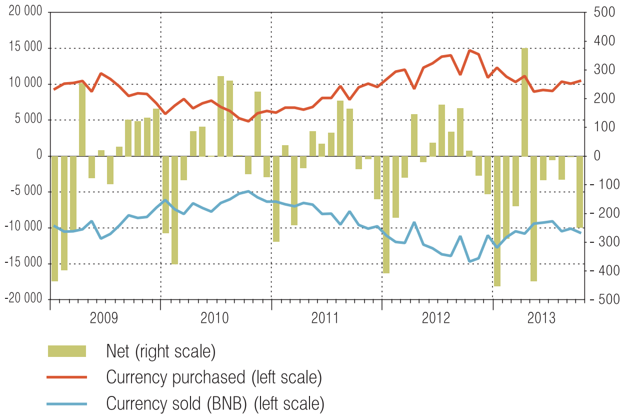
Source: BNB.

The change in the structure of household deposits by type and maturity of deposit which started in the fourth quarter of 2012 continued over the third quarter of 2013.

Deposits redeemable at notice and overnight deposits contributed more to the total annual growth of household deposits, while the contribution of deposits with agreed maturity remained negative. These structural changes are 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, which concurrently affected banks' policy in setting interest rates on different types of deposit. Interest rates on households' overnight deposit balances grew by 53 basis points between November 2012 and September 2013, while those on deposits redeemable at notice by 27 basis points. Over the fourth quarter of 2013 and the first quarter of 2014 the change in the structure of household deposits is expected to continue.

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

(million EUR) (million EUR)



Note: Net means currency bought 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.

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.

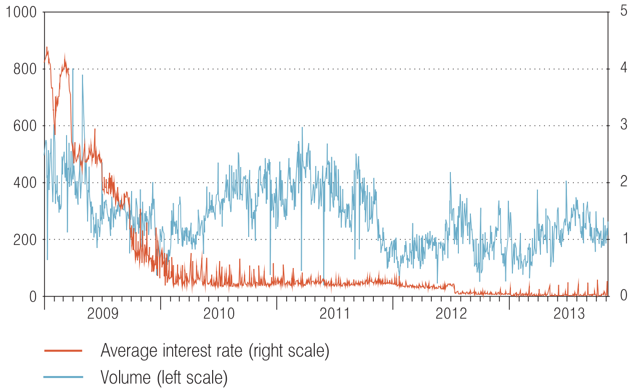
In the third quarter of 2013 banks realised net purchases of currency from the BNB. This trend continued due to the banks' policy to boost their foreign assets and to reduce external indebtedness.

Interest rates on the interbank money market in Bulgaria retained their low levels in the third quarter of 2013. Over the review period the average interest rate on transactions concluded on the interbank money market increased marginally by 1 basis point to 0.04 per cent. At the same time, the average daily volumes traded on the interbank money market between August and October 2013 decreased.

Between July and October LEONIA remained unchanged at 0.02 per cent on the second quarter of 2013. Over the same period the average value of the negative spread between LEONIA and EONIA hovered around 6 basis points, reaching 7 basis points in October due to the rise in EONIA.

Trade Volumes and Interbank Money Market Interest Rates

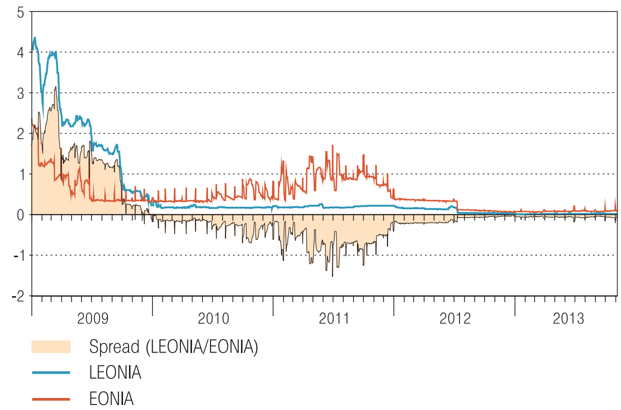
(million BGN) (per cent)



Source: BNB.

Spread between LEONIA and EONIA

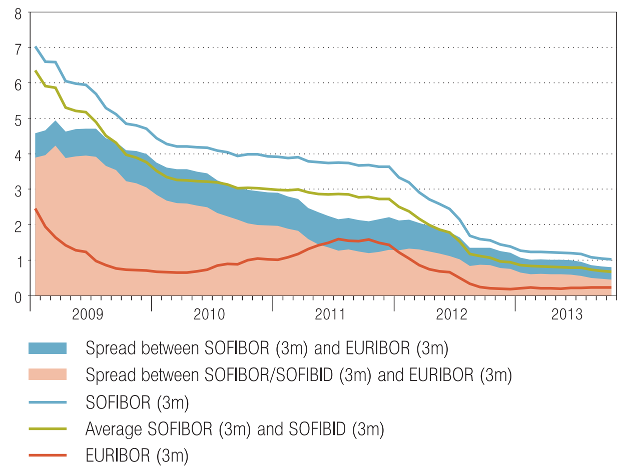
(per cent; percentage points)



Source: BNB.

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

(per cent; percentage points)



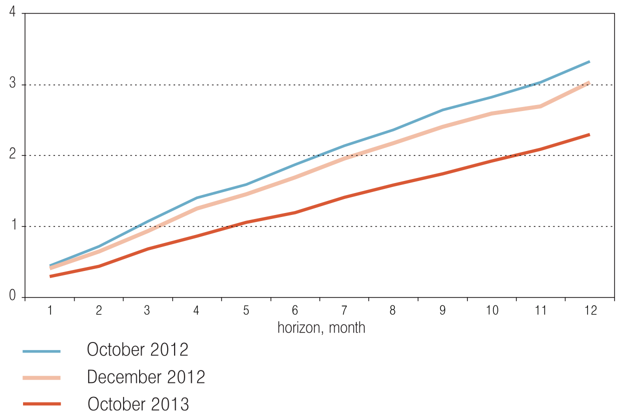
Source: BNB.

The SOFIBOR reference rate (3m) used as an indicator for short-term interest rates moderated to 1.03 per cent in October from 1.20 per cent in June. Between June and October quotations on the money market in Bulgaria continued to narrow their spread *vis-à-vis* euro area quotations. The spread between the three-month SOFIBOR and EURIBOR decreased by 19 basis points from June to reach 80 basis points in September. The average three-month SOFIBOR/SOFIBID reference rate[17] declined to 0.68 in October and its spread came to 46 basis points.

The downward trend in quotations in long-term maturity sectors of the interbank money market yield curve observed since the second half of 2010 continued in the third quarter of 2013. In October a year-on-year fall of 67 basis points was reported in the six-month horizon, while in the 12-month horizon, it was 103 basis points.

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

(per cent)



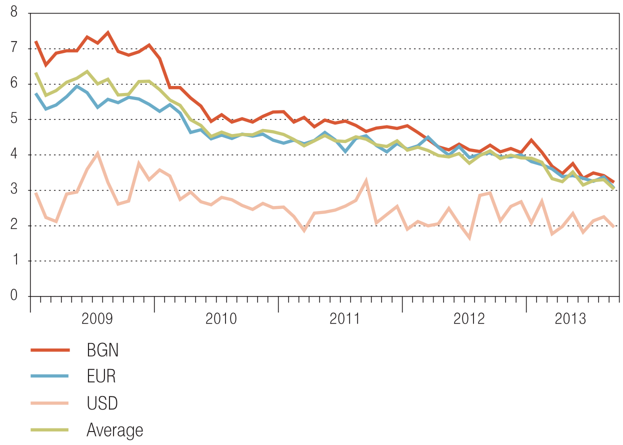
Source: BNB.

The factors behind the dynamics of traded volumes and Bulgarian money market interest rates were still related to the high liquidity of Bulgarian banking system and to ECB policy for maintaining low interest rates and providing unlimited liquidity to euro area banks.

Interest rates on new[18] time deposits of households and firms continued to decrease. The main factors behind these trends were the sustained sizeable growth of attracted funds from residents, high bank liquidity and relatively low demand for bank loans. Over the third quarter the average weighted interest rate came to 3.2 per cent on an annual basis, the interest on lev and euro-denominated deposits posting a more sizeable decline than that on USD-denominated deposits.

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 by their respective volumes of new deposits.

Source: BNB.

A comparison between the June and September 2013 breakdown of interest rates on household time lev deposits showed that the number of banks offering rates in the up to 3 per cent band increased and those offering rates within the 5 to 6 per cent band decreased. The average interest rate level on time lev deposits dropped by 7 basis points to 3.98 per cent and the standard deviation rose by 11 basis points to 1.42 percentage points.

The downward trend in the average cost of financing in the banking system[19] remained sustained (from 3.13 per cent in late 2012 to 2.88 per cent by end-September 2013). On the one hand, it was driven by the lower interest rate levels on the interbank 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.

Interest rates on time deposits are likely to fall insignificantly in the fourth quarter of 2013 and the first quarter of 2014. This trend may be terminated, if leading central banks enter a

[17] The average SOFIBOR/SOFIBID index gives a better picture of the interest rates in Bulgaria. Correspondingly, it is more correctly 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.

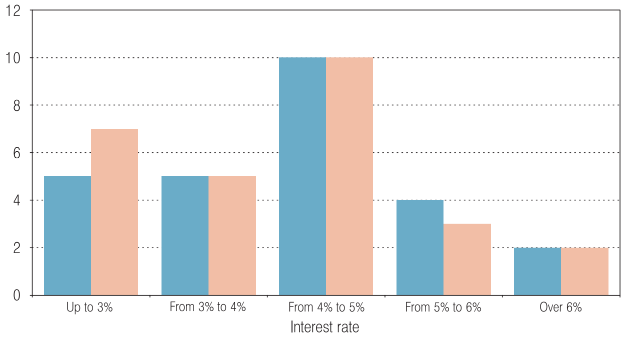
[18] The terms *new*, *new contracted* and *new disbursed loans and deposits* refer to the new business statistical category.

[19] The indicator is calculated *ex post* using data of the BNB Bank Supervision Department published on the BNB website as the ratio between interest payments on attracted funds over the last 12 month and the average volume of attracted funds over the same period.

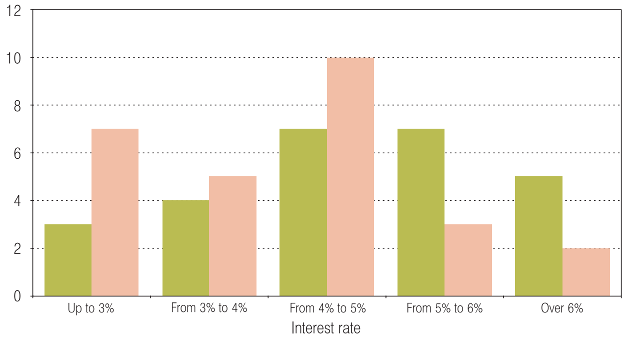
new interest rate cycle. Concurrently, the high propensity to save and related high deposit supply along with the expected weak credit demand in the economy will contribute to the downward trend in deposit interest rates.

Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



(frequency – number of banks)



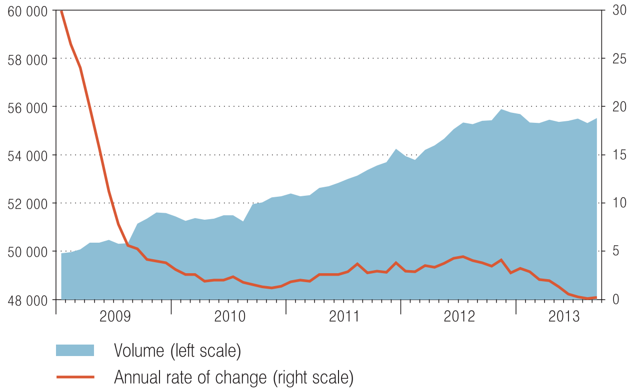
Source: BNB.

Credit Aggregates

The moderation in the growth of claims from the non-government sector observed since the second half of 2012 continued in the third quarter of 2013. The downward trend in credit growth reflected the reduced demand for loans amid still weak economic activity. The annual growth of claims on the non-government sector slowed down to 0.2 per cent by September (against 2.8 per cent by end-2012) due to the relatively low growth in loans to non-financial corporations and the ongoing slight decrease in bank claims on households. Slower growth in claims compared to the nominal GDP led to a decline in the claims on non-government sector to GDP ratio to 70.5 per cent in mid-2013.

Claims on Non-government Sector

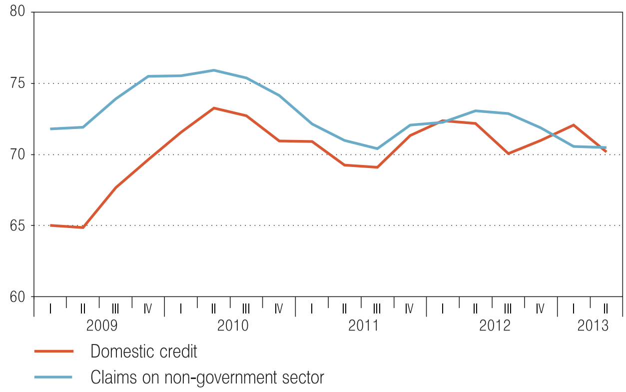
(million BGN) (per cent)



Source: BNB (monetary statistics: monetary survey).

Domestic Credit

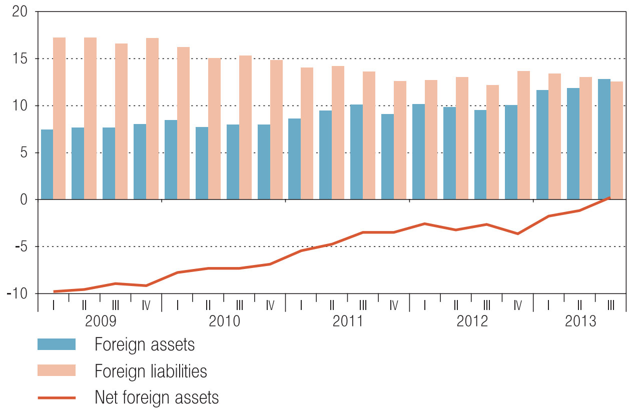
(share of GDP, per cent)



Source: BNB.

Foreign Assets and Liabilities of Banks

(billion BGN)



Source: BNB.

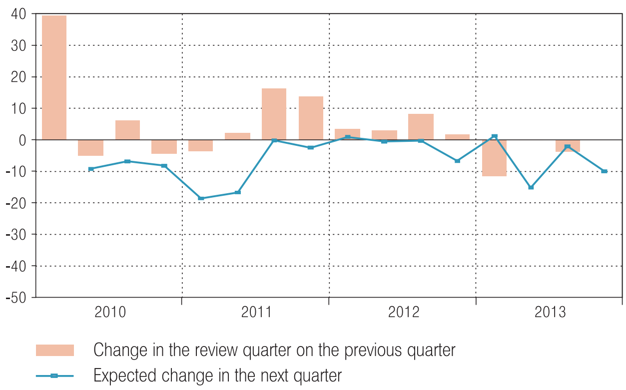
The continuous growth in attracted funds since the beginning of 2013 and the ample liquidity allow banks to boost their foreign assets and repay foreign liabilities. As a result banks' net external assets were positive at BGN 239 million by September. In the fourth quarter of 2013 and the first quarter of 2014 banks are expected to continue to use liquid resources to further increase foreign assets and reduce foreign liabilities. The upward trend in the net external assets is anticipated to continue.

According to the results of the BNB quarterly lending activity survey, banks reported an increase in demand for loans from corporations in the July–September 2013 period compared to the previous quarter. Enhanced investment activity and credit demand to cover working capital needs contributed most to higher demand for loans by corporations. Concurrently, more opportunities for intercompany sources of funding contributed to lower demand. Corporations' demand for short-term and long-term loans rose. There were divergent developments in loans to households. Banks reported a slight increase in consumer loans compared to the previous quarter, and a decrease in housing loans. Banks have more optimistic expectations regarding the demand for loans in the fourth quarter of 2013, mainly for consumer loans by households and, to a lesser extent, for housing and corporate loans.

In the third quarter of 2013 banks eased lending standards on loans to households and enterprises. The amount of attracted resources and their lower prices, competition from other banks, and the decline in alternative investment yield were the factors behind the easing of lending policy. The collateral risk, and to a lesser extent credit risk, business climate in the sectors occupying large shares in banks' credit portfolios, and the macroeconomic environment were the factors contributing to a tighter bank lending policy. In the fourth quarter of 2013 banks expect further easing of credit standards for loans to enterprises and households.

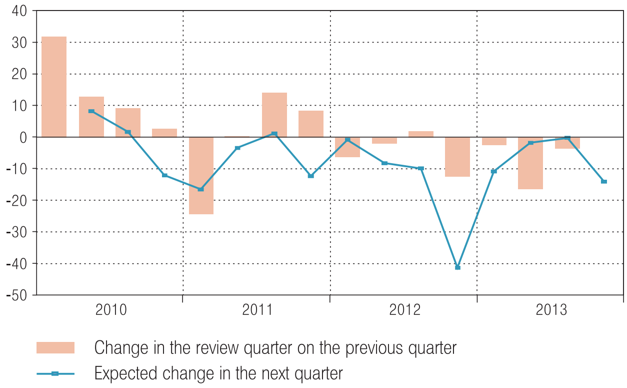
Changes in Credit Standards Applied to Loans to Enterprises

(balance of opinions)



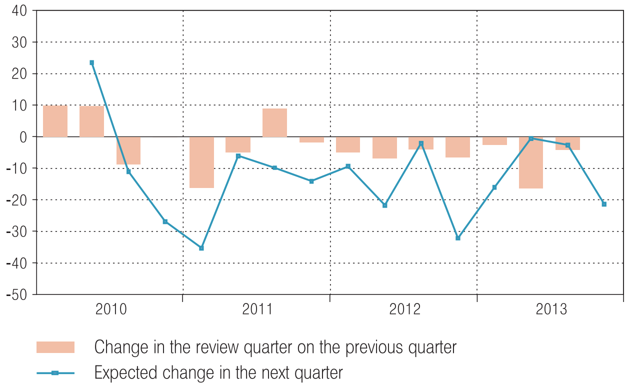
Changes in Credit Standards Applied to Consumer Loans

(balance of opinions)



Changes in Credit Standards Applied to Loans to Households for House Purchase

(balance of opinions)



Note: The charts present banks' balance of opinions defined as the difference in percentage points between the percentage of banks responding 'tightened considerably' and 'tightened somewhat' and the percentage of banks responding 'eased considerably' and 'eased somewhat'. All responses are weighted according to banks' market share in the respective credit segment. The expectations are shown in the charts by shifting the data a quarter forward.

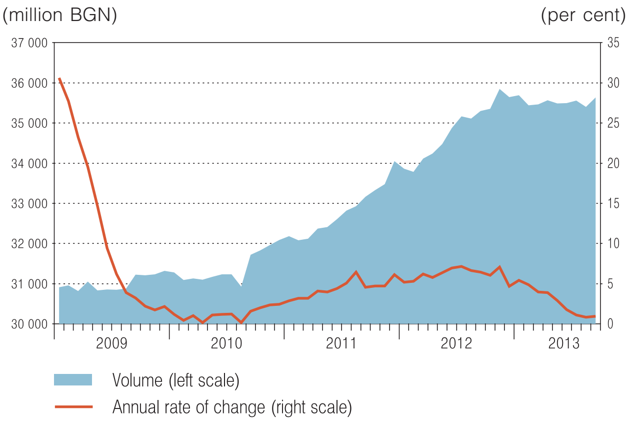
Source: BNB.

The moderation in the growth of claims on non-financial corporations, which started in the second half of 2012, continued in the third quarter of 2013. The annual growth of claims on non-financial corporations slowed down to 1.0 per cent in September 2013 against 4.7 per cent at the end of the prior year. Trade[20], professional activities and scientific research, and agriculture had the major positive contribution by economic sector. Energy[21] and real estate activities made a substantial negative contribution to the annual growth of loans to non-financial corporations by mid-year.

[20] Trade, cars and motorcycles repair.

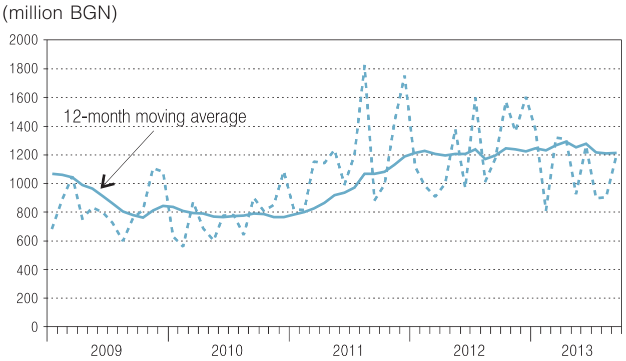
[21] Production and distribution of electricity, heating and gaseous fuels.

Claims on Non-financial Corporations



Source: BNB.

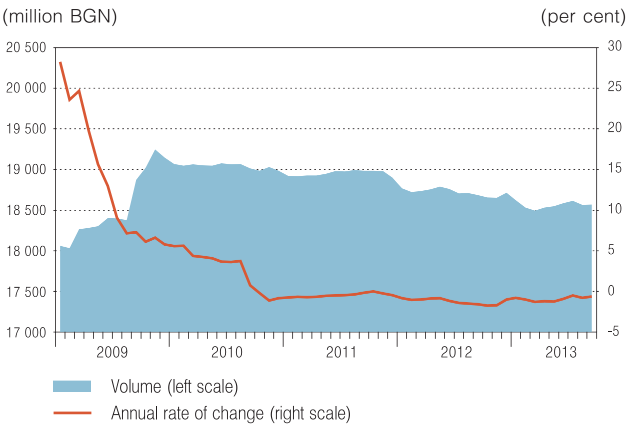
New Loans to Non-financial Corporations (Monthly Volumes)



Source: BNB.

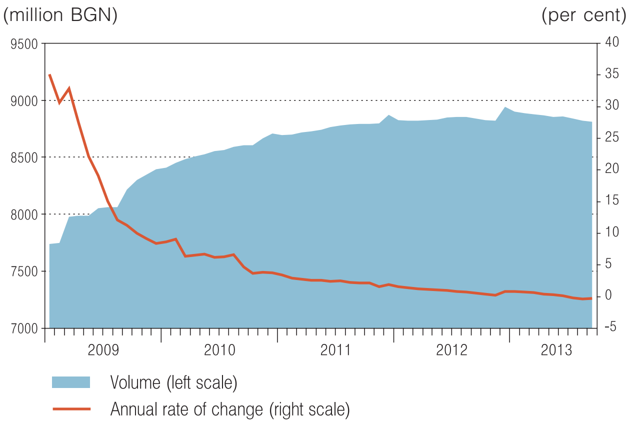
Between January and September 2013 the volume of new loans to NFCs remained high, with a slow downward trend on an annual basis observed by end-September.

Claims on Households



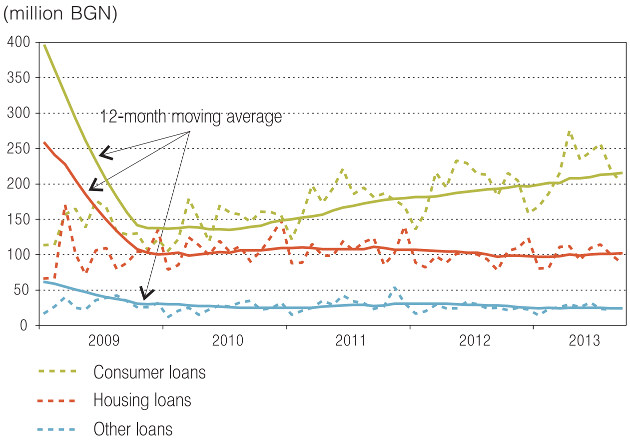
Source: BNB.

Housing Loans



Source: BNB.

New Loans to Households (Monthly Volumes)



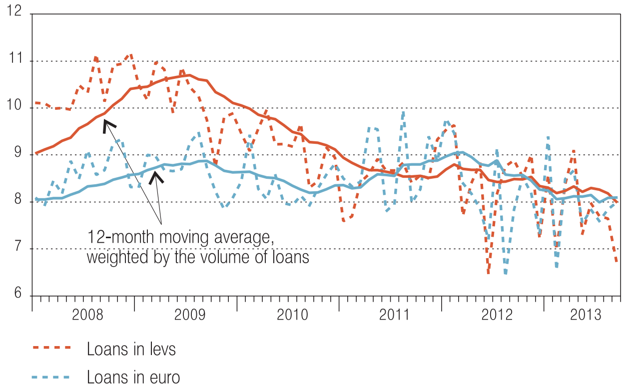
Source: BNB.

Against the background of continuous uncertainty related to economic environment developments and high unemployment, credit demand by households is insufficient to increase the volume of borrowings in this sector due to the higher amount of repaid maturing non-renewable loans. At the end of September the amount of loans to households fell by 0.6 per cent on an annual basis (1 per cent on an annual basis by end-2012). All household loans reported a decline on an annual basis (*overdrafts*: 0.9 per cent; *housing* and *consumer loans*: 0.3 per cent each; and *other loans*: 4.5 per cent). At the same time, the amount of new consumer loans showed a clearly pronounced upward trend for the last 12 months by end-September 2013 according to the BNB lending activity survey, while the levels of new *housing loans* and *other loans* remained stable.

Growth rates of loans to the non-government sector are projected to remain low and to slightly increase over the next quarters due to the expected gradual recovery in economic activity boosting growth of loans to non-financial corporations. The drop in household loans is projected to slow down on an annual basis, reflecting our expectations of a gradual recovery in consumer demand.

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

(per cent)

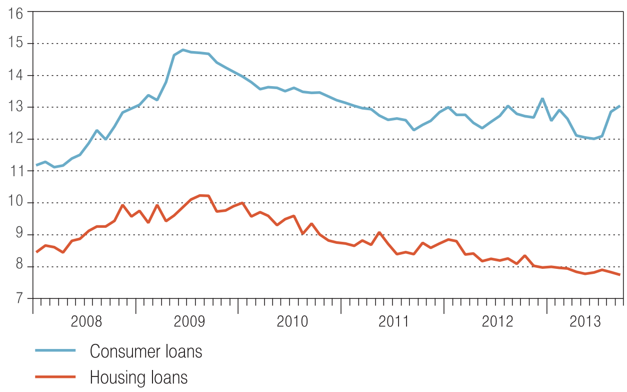


Source: BNB.

Overall, a slower decline and stabilisation of interest rates on new loans was observed between January and September 2013. Interest rates on new loans to non-financial corporations denominated in levs and euro came to around 8.0 per cent and 8.1 per cent by September.[22] The annual percentage rate of charge (APRC) on new loans for home purchase continued to follow its trend toward a gradual decrease, accounting for 7.7 per cent by September. The downward trend in APCR on consumer loans was discontinued at the end of 2012, rising to 13.0 per cent in September.

Annual Percentage Rates of Charges on New Household Loans

(per cent)



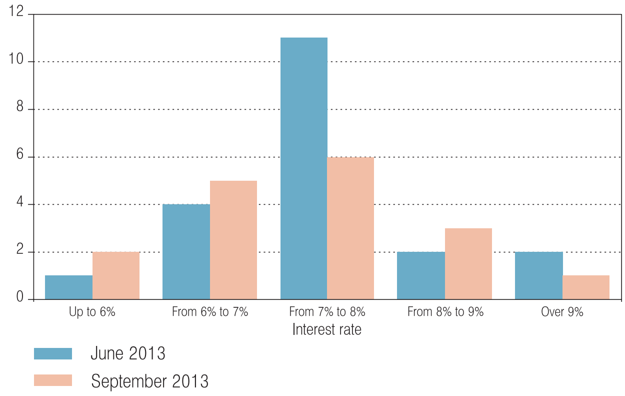
Note: Interest rates in all maturities and currencies are weighted by the relevant volumes of new deposits over the review period.

Source: BNB.

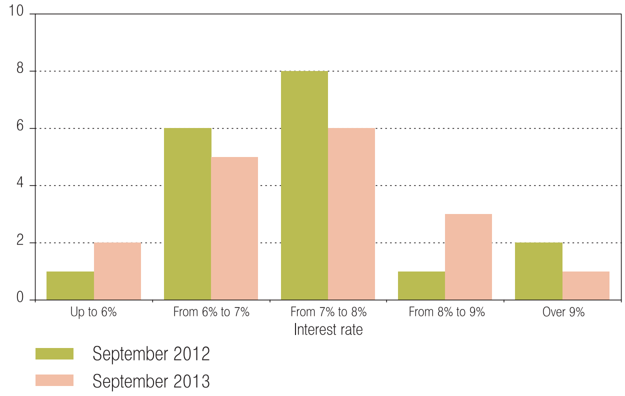
[22] The figures below are the weighted average of the interest rates on loans to non-financial corporations on a 12-month basis.

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 new housing loans in euro, in September 2013 compared to June 2013 the number of banks offering rates up to 6 per cent, from 6 to 7 per cent and from 8 to 9 per cent increased at the expense of those offering rates within the 7 to 8 per cent and over 9 per cent bands. Over the same period the average interest rate level rose by 10 basis points and the standard deviation went up by 14 basis points to 1.10 percentage points.

Against the background of gradual economic recovery in the next two quarters, the reduction in interest rates on loans is expected to continue. This trend will be underpinned by the fall in the cost of financing, high bank liquidity and ongoing rise in attracted funds in the banking system. The onset of a new interest rate cycle in the form of interest rate increases on international money and capital markets may push lending rates upwards.

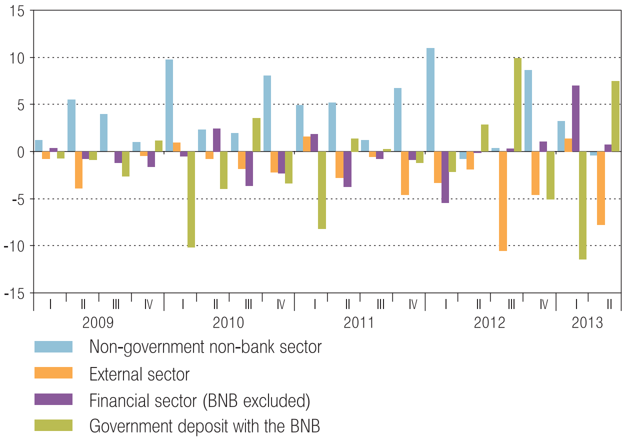
Financial Flows between the General Government and the Other Sectors of the Economy

Government fiscal policy affects the allocation of liquidity between economic sectors.

In the second quarter of 2013 budget revenue from EU amounted to BGN 1841.4 million. Given the acceleration of EU fund utilisation, between April and June current and capital grants worth BGN 930.8 million, mostly from EU funds, entered into the state budget. In addition, farm subsidies of BGN 910.6 million paid in advance from the government deposit with the BNB were reimbursed by EC on the government account with the BNB in April.

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

(share of GDP, per cent)



Sources: MF, BNB calculations.

Received funds from these transactions exceeded the amount of interests and payments on external government loans and Bulgaria's contribution to the total EU budget (worth BGN 355.5 million). As a result the net inflow from the external sector to the government came to 7.8 per cent of GDP in the third quarter.

The reallocation of liquid funds between the budget and the central bank may be analysed by the change in government and budget organisation's deposits with the BNB. As a net beneficiary of liquidity the central bank received funds to the amount of 7.5 per cent of GDP in the April–June 2013 period due to the net external funds inflow and the reported budget surplus of BGN 791.5 million.

Over the same period the government absorbed liquidity from the financial sector (BNB excluded) by realising a positive net government securities issue of BGN 218.2 million and corporate tax receipts from financial institutions of BGN 29.2 million.

In the second half of 2013 the external sector is expected to continue to be a net source of liquidity, reflecting our expectations of a further rise in the EU Structural and Cohesion Funds absorption rate and the new external loan of EUR 360 million projected by the government.

The information available by end-September shows that in the third quarter the financial sector will be a net beneficiary of liquid funds due mainly to the six-month treasury bonds worth BGN 800 million maturing in August. However, during the second half-year the financial sector will play a neutral role in the allotment of liquidity, as the total volume of gross government bond issue planned for the end of 2013 is similar to the debt instruments maturing over the same period.

In the second half of 2013 the Ministry of Finance is expected to finance the planned budget deficit by funds from the government deposit with the BNB, which is an inflow of liquid funds from the central bank to the budget. Some of these funds will be initially withdrawn by the external sector in the form of external loan deposited with the BNB and subsequently will be reallocated from consolidated budget to non-government non-bank sector.

3. Economic Activity

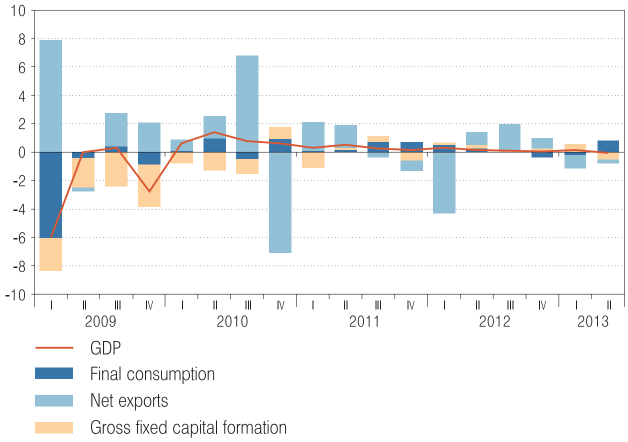
The uncertainty about future global economic activity remained relatively high and continued to dampen Bulgarian economic growth in the second quarter of 2013. Firms opted to remain cautious to their fixed capital investments which led to a 2.4 per cent quarter-on-quarter decrease in the second quarter. Households sustained their high propensity to save, with private consumption rising by 0.9 per cent on a quarterly basis. Exports of goods and services are expected to continue growing, underpinned by the improvement in global economic environment observed since early 2013, which, in turn, is likely to have a positive effect on domestic demand in the second half of 2013 and first quarter of 2014.

After growing by 0.1 per cent[23] on a quarterly basis in the first quarter of 2013, real GDP fell by 0.1 per cent in the second quarter. Divergent weak dynamics of domestic economic activity in the first half of 2013 was mainly due to the euro area recession since 2012 and slowing quarterly growth rates in domestic demand. Private consumption in the first quarter and investment in the second quarter had the highest negative contributions to the slowdown in domestic demand growth. The improved global environment since 2013 favoured export and import volumes which increased on a quarterly basis. Higher growth rates of imports compared to those of exports led to a negative contribution of exports to GDP growth over the first and second quarters of 2013. Unlike the first quarter when firms executed the increased orders from abroad through reducing inventories, the slight recovery in inventories in the second quarter contributed positively to GDP growth.

[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 programme by using automated set up for diagnostics and optimisation of adjustment parameters.

Contribution to GDP Growth by Component of Final Use

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



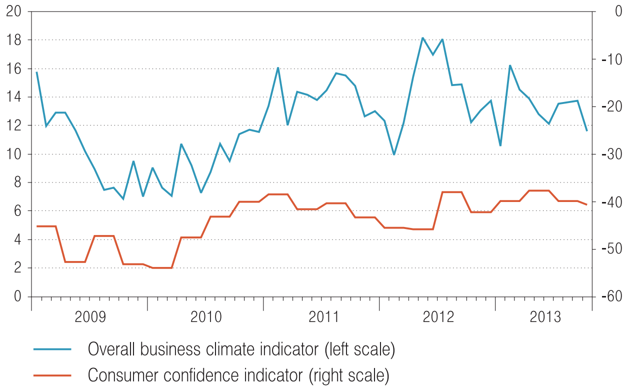
Note: Non-additive data due to direct chain-linked and seasonal adjustment of GDP and its components; the contribution of the change in inventories has not been included.

Sources: NSI, BNB calculations.

The economic situation in Bulgaria remained broadly unchanged in the third quarter of 2013. The unemployment rate underwent no significant change, favouring household expectations of labour market stabilisation in the following months. This stimulated consumption measured by trade volumes.

The overall business climate indicator tracking business sentiment stabilised in the middle of the year mainly due to the improved assessment of the current business situation in trade and services. Leading indicators in Bulgaria's major trading partners show that economic activity revival will continue, supporting growth in exports of Bulgarian goods and services.

Business Climate and Consumer Confidence Indicator

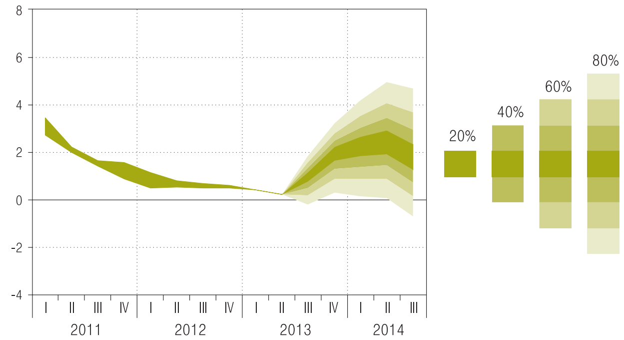


Sources: NSI, BNB calculations.

Based on currently available data, domestic demand is expected to slightly increase quarter on quarter in the second half of 2013 and first quarter of 2014. Private consumption is likely to retain its quarterly growth rate close to that in the second quarter of 2013 and investment activity will rise under the influence of improved expectations of firms about the future economic activity. A further quarter-on-quarter increase in exports is expected, though at lower rates compared with the first half, and import growth will overstate that of exports following domestic demand dynamics. Generally, net exports are likely to have a slight negative contribution to the growth on a quarterly basis. The above real growth dynamics on a quarterly basis will result in a gradual GDP growth acceleration on an annual basis mainly due to higher growth rates of investment and private consumption. Net exports are expected to have the main negative contribution to the growth on an annual basis, reflecting the stronger annual growth rate of goods and services imports in line with the projected domestic demand developments.

Fan Chart of the Expected Annual Rate of Change in GDP

(per cent)



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

Source: BNB.

Exports of goods and services are likely to increase at faster-than-expected rates in case of more intensive recovery of Bulgaria's major trade partners or more flexible reorientation of exporters to fast-growing markets. However, household propensity to save is likely to further increase due to still high unemployment levels which will hold up consumer demand recovery in the fourth quarter of 2013 and first quarter of 2014.

GDP Growth by Component of Final Use

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

	2010				2011				2012				2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Consumption	0.1	1.2	-0.6	1.1	0.1	0.2	0.9	0.8	0.6	0.3	0.0	-0.5	-0.3	1.0
incl.														
Household consumption	-0.2	1.0	-0.5	0.7	0.2	0.2	1.2	1.0	1.0	0.4	-0.1	-0.6	-0.7	0.9
Final government consumption expenditure	0.0	2.8	1.8	0.8	0.0	2.7	-2.2	0.7	-2.2	1.1	-0.3	-2.7	4.7	0.3
Collective consumption	13.2	-1.7	0.7	-3.1	3.0	-1.1	-1.1	1.1	-1.8	1.3	0.3	0.5	1.0	0.7
Gross fixed capital formation	-3.0	-5.3	-4.3	3.7	-4.8	0.5	1.8	-2.7	0.6	1.1	0.3	1.0	2.5	-2.4
Exports of goods and non-factor services	-0.5	7.1	13.2	-5.8	5.5	1.6	3.5	0.3	-8.4	8.5	-0.3	-0.7	3.1	2.3
Imports of goods and non-factor services	-1.6	3.7	1.3	5.0	1.9	-0.8	3.9	1.3	-1.7	6.0	-2.8	-1.6	4.1	2.4
Real GDP growth	**0.6**	**1.4**	**0.8**	**0.6**	**0.3**	**0.5**	**0.2**	**0.1**	**0.3**	**0.1**	**0.1**	**0.1**	**0.1**	**-0.1**

Source: NSI.

Household Behaviour

The uncertain economic environment, relatively high unemployment rate and uneven employment and wage growth by sector continued to impact household behaviour in terms of consumption, savings rates and labour supply. According to seasonally adjusted national account data, in the second quarter of 2013 household consumption increased in real terms by 0.9 per cent on a quarterly basis (after a 0.7 per cent decrease in the first quarter), still remaining at comparatively low levels. In the first two quarters of 2013 the non-food goods group had the major positive contribution to consumption growth, while purchased non-production services[24] posted negative growth. No substantial changes occurred in the other groups.

Trade volumes have recovered since early 2013 and this trend continued in the third quarter, indicating a continual rise in consumption.

Total employment dynamics is expected to have a favourable effect on household consumption. According to national account data,[25] since mid-2012 employment has stabilised after a continuous period of declines started in early 2009. Seasonally adjusted data show that in the second quarter of 2013 total employment increased by 0.3 per cent on a quarterly basis. The employment growth was unevenly distributed across sectors, with slight rises or stabilisation reported in some of the most vulnerable to crisis sectors, as total industry (excluding construction) and trade; transport, storage and mail services; hotels and restaurants occupying comparatively high shares of employed persons. Employment in construction and real estate operations continued to decline. In some services subsectors where employment was not strongly affected by the crisis, as information and communication, telecommunications, culture, sports and other activities with a relatively low share of employed, a continuous increase or retention of employment levels was observed.

Since early 2012 employment stabilisation is also recorded by seasonally adjusted data[26] of the labour force survey, with a slight 0.3 per cent quarter-on-quarter increase reported in the second quarter (0.3 per cent in the first quarter). At the same time, industry trend survey[27] shows that labour demand will stay close to the current levels with a trend to a slight improvement in some sectors.[28] Firms' sentiment concerning personnel employment in industry and trade as of September 2013 matched the previous months' level. These factors together with the uneven recovery of sectoral economic activity are expected to keep the overall employment close to its current level in the fourth quarter of 2013 and first quarter of 2014.

According to labour income data (derived from national accounts and short-term employment and labour costs statistics), labour income of employees increased further in the second quarter of 2013. Due to partial data revisions of employment and hours worked from national accounts,[29] in the first and second quarters of 2013 it is not correct to calculate growth rates for the indicators *compensation of employees*, *compensation per employee*, and the rest derivative indicators of employment and hours worked. Therefore, the following analysis employs data from the short-term statistics of employment and labour costs.

Short-term employment and labour costs statistics data (not seasonally adjusted) show moderation in annual growth rates of the wage bill in nominal and real terms, as well as in the

[24] Purchased non-production services include services other than catering services, water supply, heat energy and electricity, transport and communications.

[25] With the national account data for the second quarter of 2013, only revised data on employment and hours worked between 2008 and 2012 are published by the NSI. Revisions reflect changes in the methodology of short-term employment and labour costs statistics to increase the comparability between sample quarterly and annual comprehensive data on the basis of which these statistics are compiled.
Revised national account data on employment for 2008–2012 show a less significant decrease and earlier stabilisation (from mid-2012) than unrevised ones.
GDP indicators using the income approach in relation to employment and hours worked since early 2013 are compiled on the basis of short-term employment and labour costs statistics data, though not revised for previous periods. Hence, there is a break in series in the beginning of 2013. Developments in these indicators partially reflect a base effect of the time series break. Eurostat statistics show this as a break in employment series in the first quarter of 2013.

[26] For this section's indicators on which the NSI does not publish seasonally adjusted data, adjustment is made *via* the TRAMO SEATS programme by using automated set up for diagnostics and optimisation of adjustment parameters.

[27] Business trend survey in industry, construction, trade and services, the NSI, September 2013.

[28] Labour market situation is analysed here 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.

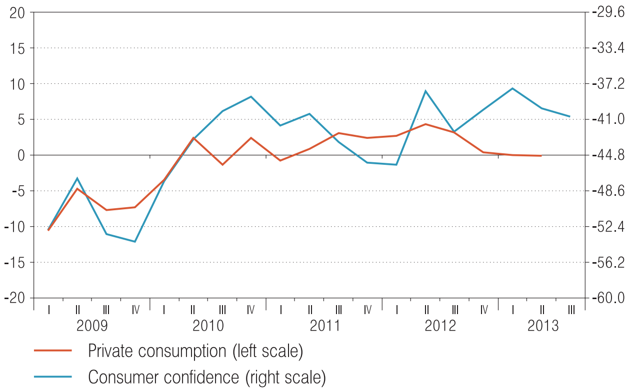
[29] See footnote 25.

average wage *per* employee for the first two quarters of 2013. Nominal wage growth rate declined to 3.7 per cent in the second quarter of 2013 after rising by 4.3 per cent in the first quarter of 2013 and 10.6 per cent on average in 2012. Seasonally adjusted data on wages for the first two quarters show a 0.9 per cent quarterly increase in the second quarter against 0.3 per cent in the first quarter. Based on non-seasonally adjusted data, the wage bill growth moderated from 7.1 per cent in 2012 to 2.8 and 3.1 per cent in the first and second quarters of 2013.

The increase in wage income, the main source of household incomes, coupled with a gradual recovery of consumer confidence are likely to create conditions for a moderate revival of consumption in the second half of 2013 and the first quarter of 2014. Since labour income growth relates exclusively to employees, the degree of employment recovery is also expected to affect positively the speed of consumption recovery. The weak and uneven sectoral employment growth and retention of comparatively high unemployment are likely to further dampen both consumption and consumer confidence. Despite the slight decline in the consumer confidence indicator (reported in the NSI consumer survey)[30] in July and October 2013, reflecting the worsened economic situation expectations, its levels remained close to those of the previous quarters.

Private Consumption and Consumer Confidence

(annual change, per cent) (per cent)

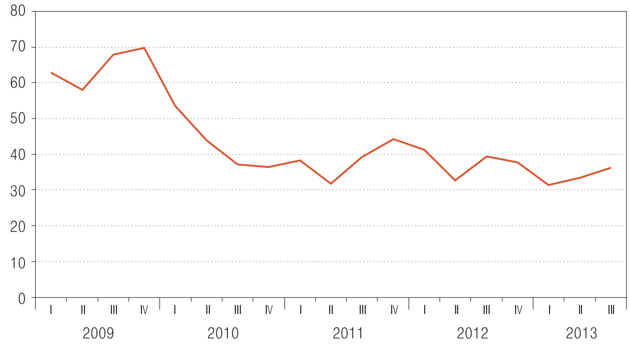


Sources: NSI Consumer Survey and BNB calculations.

[30] 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).

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)

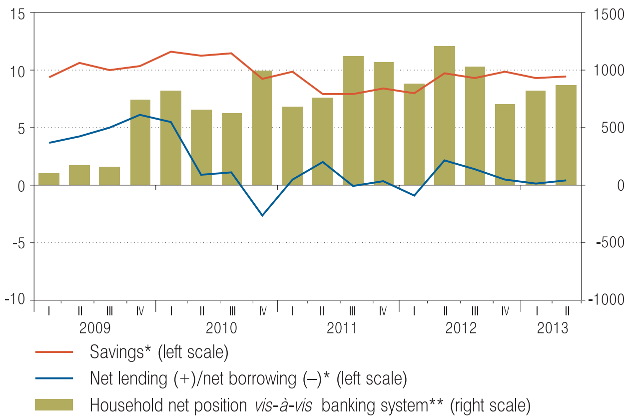
Source: NSI Consumer Survey.

The uneven and volatile recovery of employment and economic activity by sector, as well as associated uncertainty around economic prospects are the factors behind the retained high share of savings in disposable income of households[31]. Net assets measured by households' net position in the banking system continued to increase according to the BNB monetary statistics. As in the previous quarters, the October 2013 consumer survey shows that comparatively large part of households continued to express intentions to increase savings in the following 12 months. This signals retention of the savings rate over the last quarter 2013 and first quarter of 2014, though it may be interpreted as an intention to slightly recover consumption.

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

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.

According to the NSI Labour Force Survey, labour force began to increase from the second quarter of 2012, boosting the economic activity rate. The change in status from non-active to active job seekers and, hence, their inclusion in labour force continued to be reported in the first and second quarters of 2013.

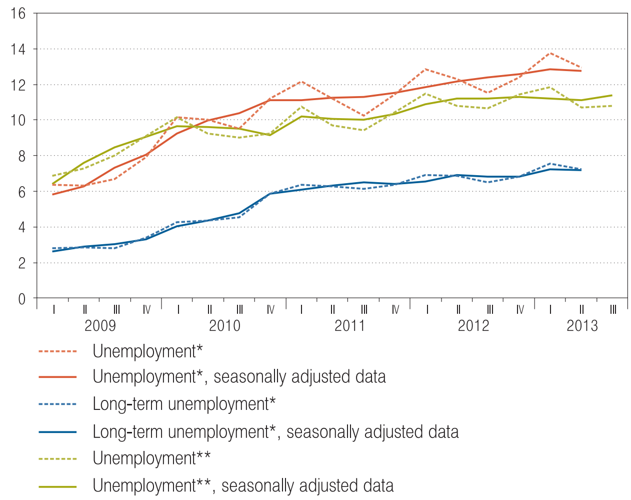
The unemployment level (seasonally adjusted data of the labour force survey) in the second quarter of 2013 retained its first quarter's value of 12.8 per cent. The increased labour force, especially in the second quarter, was mainly a result of the growth in employed, rather than unemployed persons. Labour force survey shows that in both first and second quarters newly employed persons were mainly university graduates between 35 and 55 years.

Employment Agency data which reflect only unemployed registered in the labour offices but not the shift of inactive people towards the labour force pointed to a slight decrease in the seasonally adjusted number of unemployed registered in the second quarter.[32] Over the third quarter their number stayed close to the levels of the first half of 2013 with a slight upward trend. According to Employment Agency seasonally adjusted data, unemployment rose to 11.4 per cent in September. These developments signal still uncertain and weak recovery of employment over the third quarter.

Labour Force Survey shows that the number of long-term unemployed (for more than a year) matched the first quarter's level, still remaining at 7.2 per cent as a share of labour force.

Unemployment

(per cent of labour force; seasonally adjusted data)

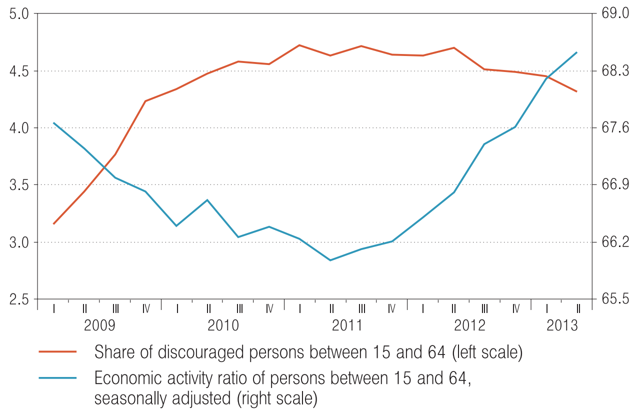


* NSI data.
** Employment Agency data.
Sources: NSI Labour Force Survey, Employment Agency, BNB calculations.

Economic activity rate continued to rise in the second quarter. Unlike the second quarter of 2012 when the decreased number of working-age persons had a higher contribution to its growth, over the first quarter of 2013 labour force growth contributed more significantly. The inclusion of inactive persons in the labour force over the second quarter was accompanied by a drop in discouraged people, with their share in total working-age population posting a decline.

Economic Activity and Share of Discouraged Persons

(per cent) (per cent)



Sources: NSI Labour Force Survey, BNB calculations.

[32] The Employment Agency uses a constant rate of labour force.

Employment and Income Dynamics

	2010				2011				2012				2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Per cent on the previous quarter (seasonally adjusted data)														
Employed	-0.9	-0.4	-0.7	-0.8	-0.2	-0.5	-0.9	-0.5	-0.7	-1.1	0.1	-0.3	0.0	0.3
Nominal wage *per* employee	1.6	1.6	2.1	2.2	1.6	2.2	2.1	2.1	3.3	2.4	1.8	1.7	0.3	0.9
Real wage *per* employee*	0.8	0.2	1.6	1.3	-0.2	2.1	1.5	1.7	3.9	1.0	0.6	1.4	-0.6	1.3
Wage bill, nominal terms	0.3	0.8	1.3	2.5	1.8	1.8	0.8	1.1	3.7	1.0	1.1	1.0	-0.3	1.3
Wage bill, real terms*	-0.5	0.1	0.2	1.1	0.9	0.6	1.3	0.5	1.6	0.8	0.5	1.2	0.3	1.6
Per cent on the corresponding period of the previous year (not seasonally adjusted data)														
Employed	-4.6	-4.8	-2.5	-3.7	-1.6	-2.3	-2.3	-2.6	-2.3	-3.5	-1.9	-2.3	-1.7	0.7
Nominal wage *per* employee	7.0	6.3	6.8	8.5	7.6	8.6	7.8	7.9	11.5	10.4	10.5	10.2	4.3	3.7
Real wage *per* employee*	4.9	3.4	3.4	4.3	3.0	5.0	4.5	5.2	9.4	8.4	7.2	7.2	2.1	2.6
Wage bill, nominal terms	1.6	1.0	3.3	4.8	6.7	7.7	7.0	5.5	7.5	6.8	7.1	7.0	2.8	3.1
Wage bill, real terms*	-0.3	-1.8	0.0	0.8	2.1	4.1	3.8	2.9	5.6	4.9	4.0	4.1	0.7	2.0

Note: Wage and wage bill data are based on the short-term statistics of employment and labour costs (NSI).
* Data deflated by HICP.

Sources: NSI – SNA and short-term statistics of employment and labour costs, BNB calculations.

Retail Trade Turnover

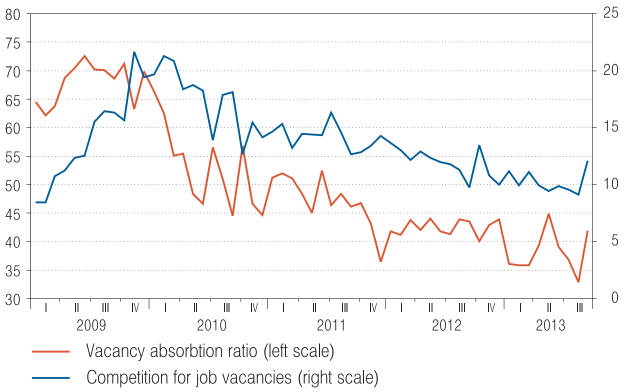
(per cent on the previous quarter; seasonally adjusted data at constant prices)

	2010				2011				2012				2013		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Retail trade turnover, excluding cars and motorcycles incl.	-2.8	-1.3	-0.4	-0.9	3.7	-1.0	-1.3	-0.3	-1.8	1.2	-0.9	-1.8	-0.1	2.1	2.6
Foods, drinks and tobacco	0.2	1.0	0.5	0.7	1.0	0.1	0.5	0.6	0.3	0.0	-0.5	-0.9	-0.9	2.7	8.0
Textile, clothing, footwear and leather	11.5	-0.9	-1.1	-2.3	13.6	-4.4	-6.3	-2.0	-7.8	-2.1	0.5	-0.6	2.5	8.5	8.3
Household goods and home appliances	-13.0	-0.9	1.3	-0.8	-1.3	-2.4	-1.0	-1.7	-6.7	3.6	-4.5	-4.4	-2.5	2.8	3.7
Computers and communication equipment, *etc.*	-1.1	-1.4	7.7	0.4	-2.5	-0.5	-0.3	0.6	0.3	-0.5	-1.0	-3.2	-0.5	0.3	-0.2
Pharmaceutical and medical goods, cosmetics and toiletries	3.1	1.3	0.9	2.8	-0.1	3.4	1.8	5.2	-0.8	0.0	0.9	-4.5	-1.3	2.3	2.4
Unspecialised shops with different kinds of goods	6.2	4.7	5.5	3.5	1.6	0.3	-2.1	-2.0	-3.5	-1.5	-0.6	-0.4	1.5	10.9	-1.1
Automobile fuels and lubricants	-29.6	0.4	2.7	-1.1	-0.3	-2.1	-2.6	-0.4	-0.1	1.0	0.2	-2.3	2.2	5.0	-1.2

Source: NSI Domestic Trade Survey.

Competition and Job Vacancy Absorption Rate

(per cent, seasonally adjusted data) (number of persons)



Sources: Employment Agency, BNB calculations.

According to the Employment Agency, vacancy absorption[33] remained relatively low in the second and third quarters of 2013. This continued to reflect mainly the lower absorption rate of vacancies under employment programmes[34]

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

[34] Some of the Employment Agency programmes are funded at the national level (*From Social Assistance to Employment, Disabled People's Assistants, Assistance for Retirement, National Programme for Employment and Vocational Training of People with Permanent Disabilities*, *Melpomena*, *Activation of Inactive Individuals, New Employment Opportunity*) and other at the European level (*Career Start, Interest-free Loan for People with Disabilities, Beautiful Bulgaria, Job Opportunities 2013* project, *Chances of Success* project, *Professionals* project). The EU Human Resources Operational Programme receives funding from the European Social Fund and the state budget.

due to significant job vacancies not occupied in previous months. However, the absorption of job vacancies outside employment programmes remained relatively high. The overall increase in job vacancies determined the downward trend in competition for occupying a vacancy reported in 2012 and early 2013.

The uncertain economic situation, comparatively high unemployment and unevenly rising employment and wages in individual sectors are expected to further impact the household behaviour over the following quarters. Nevertheless, favourable developments in the labour market associated with stabilisation of overall employment and its slight growth in some sectors are projected to create conditions for a gradual recovery in household consumption at rates close to those of the second quarter of 2013. The future upward path of labour supply is expected to be limited due to still moderate economic activity revival and indications of insufficient vacancy absorption under EA employment programmes. Risks to the projection relate mainly to factors affecting consumer confidence, such as employment and income developments. These developments largely depend on firms' propensity to hire personnel and enhance investment activity.

Public Finance and Consumption

In August 2013 the National Assembly adopted the Law on Amendment of Republic of Bulgaria State Budget Law for 2013 which envisages growth in consolidated government budget deficit to BGN 1593.4 million (2 per cent of GDP), which is the maximum level under the effective fiscal rules, compared to the initial projection of BGN 1100 million (1.3 per cent of GDP). Deficit revision was largely due to the increase in current expenditure associated mainly with repayment of obligations to corporations and new social measures. Another part of this increase is ascribable to lower than initially planned budget revenue, mostly lower indirect tax income, only partially compensated by higher non-tax receipts. The annual limit on newly issued government debt under the State Budget Law was raised from BGN 2 billion to BGN 3 billion.

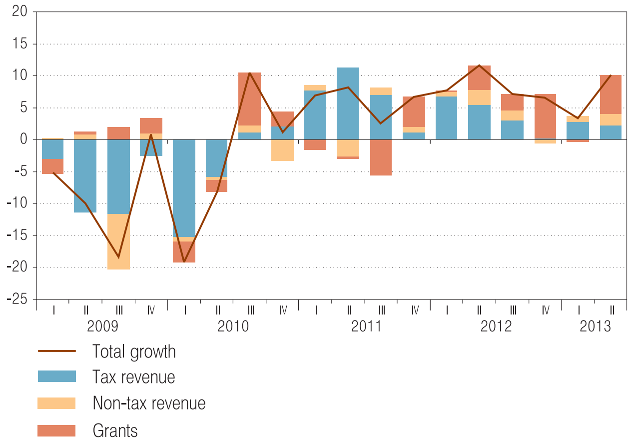
Based on the notification tables published by Eurostat in October 2013, the deficit planned by the government for the general government sector in 2013 amounts to BGN 1580 million, or 2.0 per cent of the nominal GDP projected by the Ministry of Finance. The expected budget deficit of the general government sector corresponds to the Consolidated Fiscal Programme (CFP) deficit under the State Budget Law for 2013 and is 0.7 percentage points higher than that in Bulgaria's Convergence Programme of April 2013.

According to quarterly data on CFP performance, budget balance surplus was BGN 791.5 million in the second quarter: almost BGN 40 million higher than the budget surplus in the same period of the prior year.

Between April and June growth in total CFP budget revenue accelerated to 10.2 per cent. In contrast to the first quarter of the year when the increase in government revenue was primarily due to higher tax income, in the second quarter EU fund grants had the major contribution to the growth of total budget revenue (6.2 percentage points).

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 calculations.

The major contribution to the annual tax revenue growth (2.8 per cent) in the second quarter came from social and health insurance payments. Their increase was mainly driven by the 20 percentage point rise in the social security contributions paid by special bodies' employees to the Pension Fund[35] and undesignated liabilities of BGN 168.8 million allocated into social security contributions to the National Social

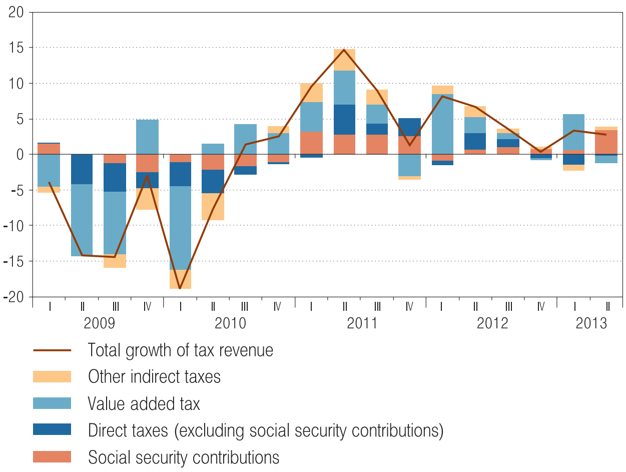
[35] This increase is also associated with the relevant growth in social security expenses of special bodies and, therefore, has no bearing on the overall CFP balance.

Security and the National Health Insurance Fund on the basis of MF estimates.[36]

Over the second quarter the structure of indirect taxes enjoyed an improvement in the performance of excise and customs duties revenue, which broadly offset the negative annual rate of change in VAT receipts (-3.2 per cent). Based on MF monthly data on CFP performance, the decrease in VAT revenue between April and June was due to lower import VAT payments which corresponded to the nominal decline of goods and services imports (-2.7 per cent) and the zero nominal growth in private consumption.[37]

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

(per cent, percentage points)



Sources: MF, BNB calculations.

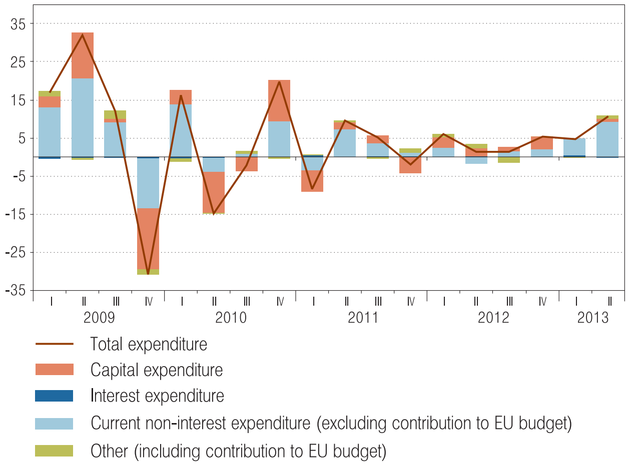
In the second quarter direct tax revenue continued to fall on an annual basis. Total corporate and personal income tax payments dropped by 3.4 per cent on an annual basis. Unlike the first three months of the year when the overall decline was driven by lower corporate tax receipts, between April and June this group's dynamics reflected primarily the decreased personal income tax revenue (-6.6 per cent). It should be noted that the monthly profile of profit tax revenue was greatly influenced by changes in tax legislation since early 2013 associated with the conditions for calculation and time limits of this tax.[38] These changes affected adversely the comparability of these data with those in the same period of the previous year, as well as with the corresponding macroeconomic base: gross operating surplus dynamics for total economy.

Income tax revenue reflected income from the new tax on time deposit interest estimated at BGN 24.4 million between April and June. If this revenue is deducted, the decline in total income tax revenue would be 10.5 per cent on the same period of 2012 instead of the reported annual drop of 6.6 per cent. These developments diverge significantly from the 3.1 per cent growth in the wage bill,[39] remaining positive despite some moderation on 2012, according to the statistics of employment and labour costs.

In the second quarter total government expenditure growth accelerated to 10.8 per cent. As in the previous three months, it was driven almost entirely by current expenditure dynamics (without the contribution to the EU budget), while public investment growth was significantly lower.

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

(per cent, percentage points)



Sources: MF, BNB calculations.

The largest contribution to higher current expenditure (10.8 per cent) in the second quarter came from social security, assistance and care expenses (5.2 percentage points). Their growth reflected the pension increase of 9.3 per cent on average, effective as of 1 April 2013 and, albeit to a less extent, the measures initiated by the caretaker cabinet to support the most vulnerable groups in the society and boost employment.

[36] According to the monthly bulletins of the Ministry of Finance on consolidated fiscal programme performance.

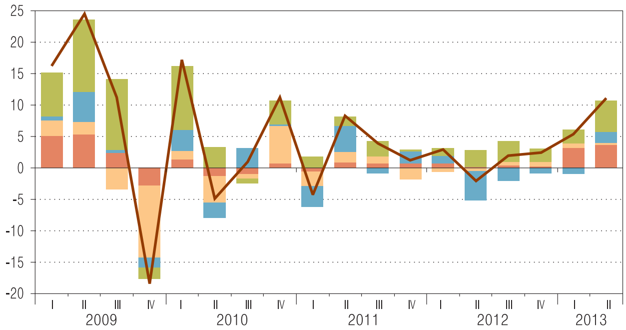
[37] Seasonally adjusted data, annual rate of change.

[38] For further information on early 2013 changes in tax legislation and the effect thereof on the monthly profile of tax revenue, see the box *Major Tax Legislation Amendments Effective since 1 January 2013*, Economic Review, 1/2013, p. 53.

[39] Indicating the tax base for income from employment relationships.

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 calculations.

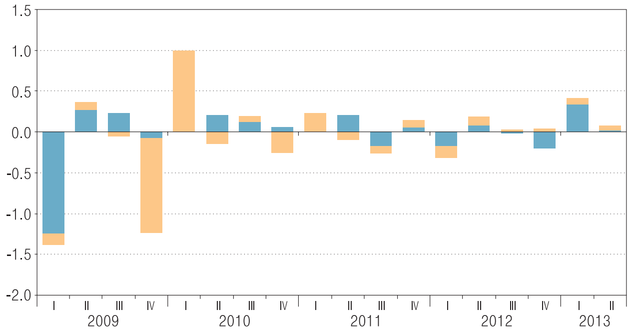
Based on CFP performance data, growth in compensation of employees in the public sector between April and June remained high (13.7 per cent) and close to that of the first three months (12.7 per cent). Higher expenditure on compensation of employees was influenced to some extent by the effects of increased social security contributions paid by special bodies' employees and to a less extent by the growth of this expenditure in the EU funds budget.

Acceleration of the EU structural and cohesion fund absorption rate had an essential influence on other expenditure categories in the second quarter. MF monthly data on CFP performance show that operating expenditure growth was broadly the result of its increase in the EU funds budget. Significant part of the annual growth in expenses on subsidies (39.8 per cent) and public investment (6.7 per cent) over the second quarter was also due to the increase in the expenditure side of the EU funds budget.

The accelerated rate of the EU structural and cohesion fund absorption in the second quarter affected real government expenditure in terms of higher operating expenditure, while the nominal growth in compensation of employees in the public sector was broadly compensated by the high deflator of government consumption.[40] As a result, the annual growth in government consumption reached 11.3 per cent in nominal terms and 3.6 per cent in real terms.[41] The contribution of government consumption to the quarterly growth of seasonally adjusted GDP for the second quarter was 0.1 percentage points (0.4 percentage points in the first quarter of 2013).

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

(percentage points)



Sources: NSI, BNB calculations.

Until the end of the year, the government consumption contribution to GDP growth is expected to remain positive, while maintaining the upward trend in operating expenditure due to the continued acceleration of EU structural and cohesion fund absorption. The increase in minimum wage, in health care wages and in the lowest public sector's wage provided for in the 2014 State Budget Law may affect positively, though to a small extent, the contribution of government consumption to GDP growth in early 2014. On the other hand, discussed government administration reduction, if materialises in the very beginning of 2014, and the minimum growth of operating expenditure set in the 2014 State Budget Law could limit the role of the government expenditure policy for economic growth in the first quarter of 2014.

Preliminary MF monthly data on CFP performance for the first nine months of 2013 pointed to a budget deficit of BGN 360.5 million generated from an EU programme deficit of BGN 144.1 million and a national budget deficit of BGN 216.4 million. In July, August and September the CFP balance was negative at BGN 160.5 million, BGN 44.5 million and BGN 147.8 million respectively.

[40] Operating expenditure and expenditure on wages and social insurance contributions under the CFP are two of the major components of government consumption.

[41] Not seasonally adjusted data.

Between January and September total budget revenue on consolidated fiscal programme accounted for BGN 21,308 million, or 70.1 per cent of projected budget revenue in the amended budget for 2013. Total CFP revenue and grants growth was 6.5 per cent on an annual basis. Grant revenue (3.6 percentage points), whose accelerated annual growth of 62.6 per cent reflects the increased EU grants, continued to have the major contribution to this growth. Compared to the previous quarter, the contribution of tax income to total CFP revenue growth slightly grew to 2.6 percentage points, while the contribution of non-tax income declined further to 0.4 percentage points in the first nine months. By end-September the second quarter's trend for the growth of tax revenue to be driven mainly by the annual increase in social and healthcare income (9.6 per cent) was sustained. If the effect of increased security contributions paid by special bodies' employees is eliminated, this revenue's growth would reach 5.6 per cent by end-August[42]. The trend to a gradual slowdown in VAT income growth was retained[43], only partially compensated by the moderate recovery of excise revenue and continual high growth of customs duties receipts.

Between January and September direct tax revenue continued to decline (-3.3 per cent) due mainly to lower corporate tax income (-10.2 per cent). Revenue from personal income tax slightly picked up by 1.7 per cent, including BGN 64.1 million from the new deposit income retention tax introduced in early 2013. However, if these receipts were deducted, the revenue from personal income tax in August would drop by 2.0 per cent on the same period of 2012.

In the third quarter no substantial changes occurred in the government expenditure policy compared with the second quarter.

Over the same period, total government expenditure, including Bulgaria's contribution to the EU budget, amounted to BGN 21,668 million, or 67.8 per cent of the amended annual projection. Major contributions to the annual growth of total CFP expenditure (9.8 per cent) again came from social expenses (3.2 percentage points) and compensation of employees in the public sector (2.4 percentage points), whose growth by end-September was 12.7 per cent[44]. After the first quarter's low drop, at the end of the third quarter capital expenditure posted a strong increase, its rate of change reaching 13.0 per cent. By September the growth rate of operating expenditure (7.0 per cent) remained close to that of end-June, with large part of its growth reflecting again operating expenditure under EU programmes.

Over the first nine months of 2013 budget was financed through a positive net government bond issue sold in the domestic market (BGN 878.8 million). The nominal value of newly issued government securities since early 2013 was BGN 1884.8 million, and repayments amounted to BGN -1005.9 million.[45] In addition, fiscal reserve funds of BGN 1116.1 million were used for budget financing. At the end of September fiscal reserve accounted for BGN 4964.9 million and the decrease since early 2013 was largely the result of Eurobond principal payments of BGN 1546 million, maturing in January 2013.

Over the third quarter prices of Bulgarian government securities declined and yields increased in the primary market. Five-year bond prices fell most significantly, with the average annual yield attained at the two auctions in the third quarter rising by almost 50 basis points compared with the previous April issue. Ten-year bond prices also fell and the attained yield at the October auction was 36 basis points higher than in the previous opening in May.

[42] Including BGN 179.0 million undesignated liabilities allocated largely into social security contributions to the National Social Security and the National Health Insurance Fund based on MF estimates.

[43] Based on MF monthly bulletin on CFP performance, this dynamics reflects higher tax credit refunds (under the Law on the Value Added Tax) in August, while net monthly VAT receipts were higher in September.

[44] If the effect of increased security contributions paid by special bodies' employees is eliminated, the annual growth of expenses on compensation of employees would be 8.3 per cent.

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

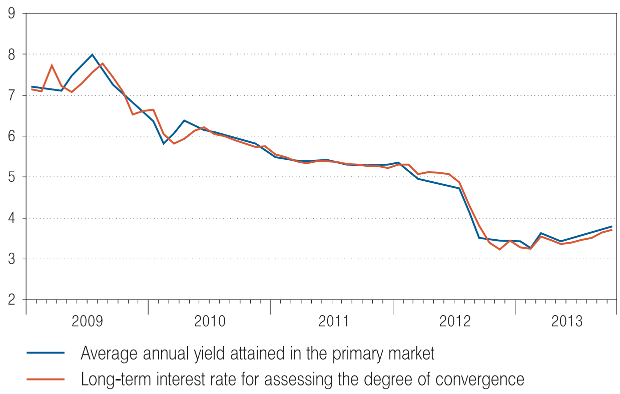
Revenue and Expenditure on Consolidated Fiscal Programme for 2012–2013
(percentage changes and contributions to growth)

Consolidated fiscal programme	2012								2013					
	I quarter		II quarter		III quarter		IV quarter		I quarter		II quarter		January–September*	
	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	per cent	percent-age points	per cent	percent-age points
Total revenue and grants	**7.7**		**11.6**		**7.1**		**6.6**		**3.4**		**10.2**		**6.6**	
Tax revenue	8.2	6.8	6.7	5.4	3.6	3.0	0.4	0.3	3.3	2.8	2.8	2.1	3.3	2.6
Corporate tax	-9.7	-1.0	19.5	1.1	9.2	0.4	-18.8	-0.8	-10.9	-0.9	1.3	0.1	-10.2	-0.6
Personal income tax	4.1	0.4	8.6	0.8	6.1	0.5	2.7	0.2	-1.3	-0.1	-6.6	-0.6	1.7	0.1
Value added tax	33.4	7.0	6.7	1.8	2.3	0.7	-0.5	-0.1	16.0	4.2	-3.2	-0.8	4.4	1.1
Excise	6.3	0.9	7.9	1.1	3.1	0.6	2.9	0.4	-5.6	-0.8	2.5	0.3	-0.7	-0.1
Customs duties	-2.4	0.0	13.7	0.1	-20.8	-0.1	-21.8	-0.1	14.3	0.1	18.2	0.1	23.5	0.1
Social and health insurance contributions	-3.2	-0.8	2.8	0.6	3.9	0.8	2.6	0.6	2.3	0.5	14.0	2.7	9.6	2.0
Other taxes	7.2	0.2	0.3	0.0	6.7	0.2	4.7	0.1	-4.0	-0.1	10.3	0.4	1.4	0.0
Non-tax revenue	4.7	0.7	15.0	2.3	13.9	1.6	-5.1	-0.6	7.0	1.0	11.6	1.9	2.7	0.4
Grants	9.1	0.3	104.9	3.8	49.0	2.5	64.9	6.8	-11.5	-0.3	91.7	6.2	62.6	3.6
Total expenditure (incl. the contribution to EU budget)	**6.0**		**1.5**		**1.3**		**5.3**		**4.6**		**10.8**		**9.8**	
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	13.7	2.7	12.7	2.4
Operating expenditure	-1.4	-0.2	-2.3	-0.4	2.8	0.4	3.1	0.6	7.2	1.1	5.2	0.8	7.0	1.1
Interest	1.8	0.1	44.1	0.3	1.4	0.0	-5.6	0.0	10.3	0.4	-13.6	-0.1	26.3	0.7
Social security, assistance and social care	2.7	1.2	6.0	2.6	5.9	2.6	4.8	1.8	4.2	1.9	9.8	4.4	7.2	3.2
Subsidies	24.4	1.1	-52.6	-4.2	-31.6	-1.7	-12.1	-0.7	-15.1	-0.8	39.8	1.5	9.1	0.4
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	6.7	0.8	13.0	1.4
Contribution to EU budget	22.7	0.9	36.1	0.7	1.1	0.0	-28.1	-0.9	6.8	0.3	28.7	0.7	18.8	0.6

* Based on preliminary monthly data on CFP performance.

Sources: MF, BNB calculations.

Ten-Year-and-Six-Month Government Bond Primary and Secondary Market Dynamics
(per cent)



Source: BNB.

Yield dynamics in the secondary market was similar to that in the primary market. The long-term interest rate[46] rose to 3.64 per cent by end-September, from 3.40 per cent in June. In October it increased by further 7 basis points to 3.71 per cent.

Despite the significant volume of government securities issued in the primary market since early 2013 and the relevant positive net domestic issue (BGN 878.9 million), at the end of September the nominal value of the government debt fell by BGN 624 million on end-2012 to reach BGN 13,050 million (national methodology data). This decrease was primarily due to the global bonds maturing in January 2013. Based on the notification tables published by Eurostat, the government projects that the nominal consolidated debt of the general government sector as of end-2013 will be BGN 15,267 million, or 19.3 per cent of the MF nominal GDP projections.

[46] 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.

Behaviour of Firms and Competitiveness

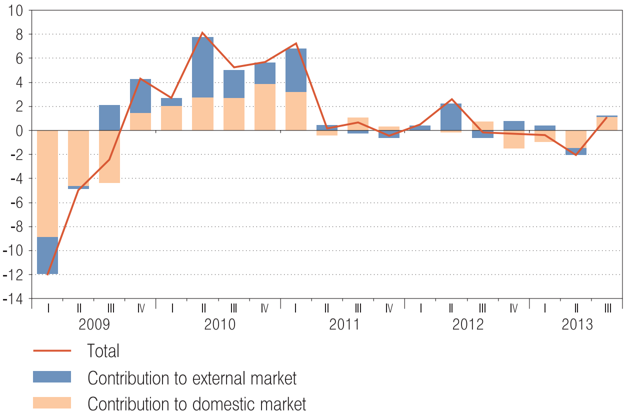
Over the second quarter positive developments occurred in the export-oriented sector of industry in terms of production activity and employment. Downward trends in construction were retained and firms continued to optimise their labour costs through staff reductions. The sustainable development of the services sector continued in the second quarter, boosting sector employment, and value added growth had the strongest positive contribution to the change of gross value added in total economy.

In the second quarter industrial sales declined on the first quarter due to decreased sales in both internal and external markets. Mining and quarrying and production and distribution of electricity, heating and gas had the largest negative contribution to this decline. Decreased volumes in these sectors result from both reduced production and lower sale prices. Decreased volumes in manufacturing industry reflect falling sales in the domestic market, while revenue from external sales increased.

In the third quarter turnover data and industrial production index point to an economic activity increase in manufacturing due mainly to household consumption growth in Bulgaria. Capacity utilisation over the third quarter remained close to the 2012 levels and the free production capacity of this sector will probably continue to be used for improving the capital efficiency, rather than expanding production capacities.

Industry Turnover Dynamics

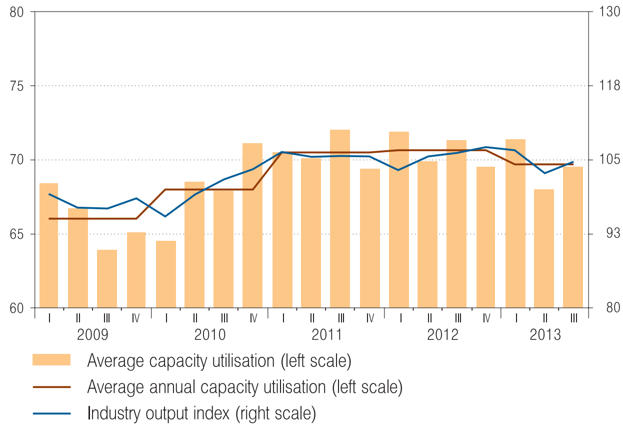
(per cent, quarter-on-quarter percentage points)



Sources: NSI, BNB calculations.

Production Capacity Utilisation in Industry

(per cent)

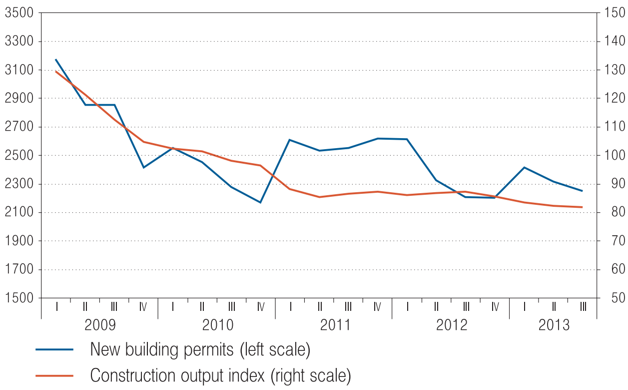


Source: NSI Industry Business Survey, BNB calculations.

Economic activity deceleration in construction deepened over the second quarter along with declines in production volumes of civil engineering and building construction. Whereas weak household demand was the driving factor for building construction developments, civil and engineering construction declines were associated with lower capital expenditure by the government. The increased building permits did not still affect the construction output index. This was probably due to postponement of projects by investors due to the uncertain economic environment, indicated by the managers as the major factor behind the reduced economic activity.

Construction Output Dynamics and New Buildings Permits Issued

(number of buildings; seasonally adjusted data) (2010 = 100, seasonally adjusted data)



Sources: NSI, BNB calculations.

The quarterly upward trend in retail trade[47] was sustained in the second and third quarters. This is largely attributable to the increased domestic consumption in the foods, drinks and tobacco

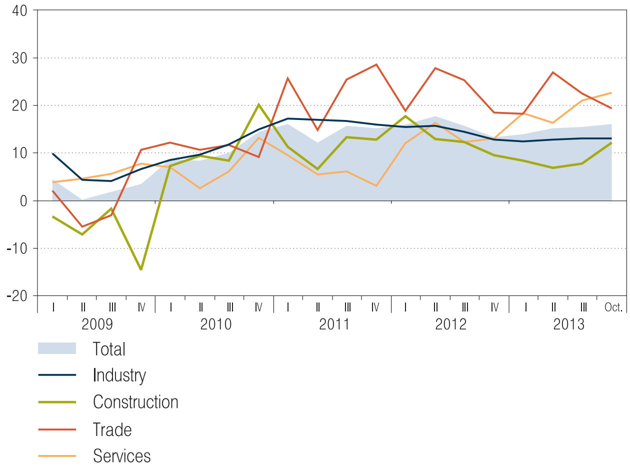
[47] See the *Retail Trade Turnover* table in the *Behaviour of Households* section.

product group. According to data on stocks in services other than trade, demand for business services continued to rise.

Reflecting the increasing demand for services, managers' expectations in trade and services concerning the future economic activity contributed most significantly to the overall sentiment improvement in economy over the first three quarters of 2013. In the export-oriented sector of industry, this indicator underwent no essential changes due to the high global uncertainty.

Expectations about Future Economic Activity

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



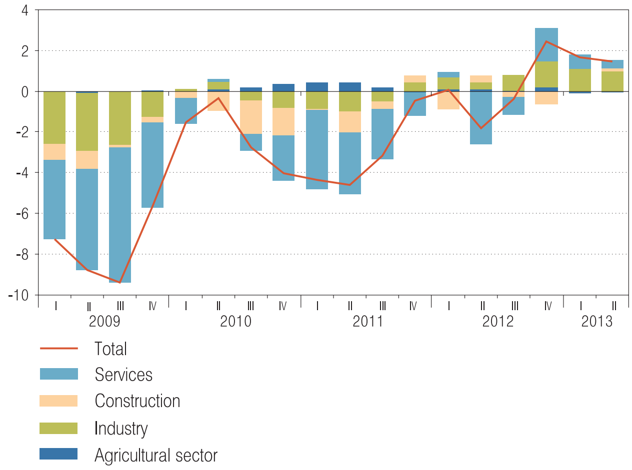
Sources: NSI, BNB calculations.

In the second quarter investment activity in Bulgaria declined on the first quarter. National account data show that fixed capital investment posted a quarterly decline of 2.4 per cent in real terms and 1.9 per cent in nominal terms. Seasonally adjusted data point also to an increase in expenditure on acquisition of fixed assets in nominal terms. Industry where companies continued to improve the efficiency of the used capital contributed most to this. The services sector also contributed positively to the overall growth in expenditure on acquiring fixed assets, reflecting the continual improvement of economic activity in this sector and increased expectations of the managers about the future economic activity. The overall improvement of expectations suggests that domestic investment activity will increase in the second half of 2013 and first quarter of 2014.

FDI inflow was an important source for funding firms' operations in the second quarter of 2013. In industry, FDI developments were driven by the lower inflow of funds to the production and distribution of electricity, gas and water subsector.

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.

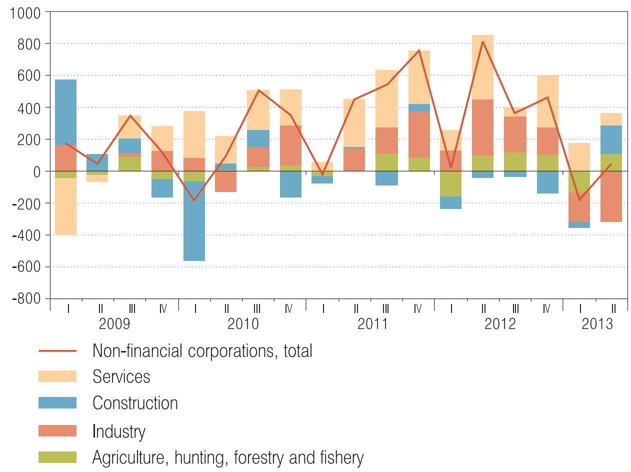
Sources: NSI, BNB calculations.

Bank credit increased on the first quarter, with its growth rate slowing down compared with the corresponding period of the previous year. Industry contributed most, with the firms using free resources to reduce their liabilities to banks.

Funding from sources other than operating surplus further went down in industry due probably to the lower needs of external financing for firms given the smaller volume of investments targeted at improving production efficiency. Financial flows in the services sector increased as a result probably of better growth expectations in this sector as compared with other sectors.

Bank Loans to Non-financial Corporations

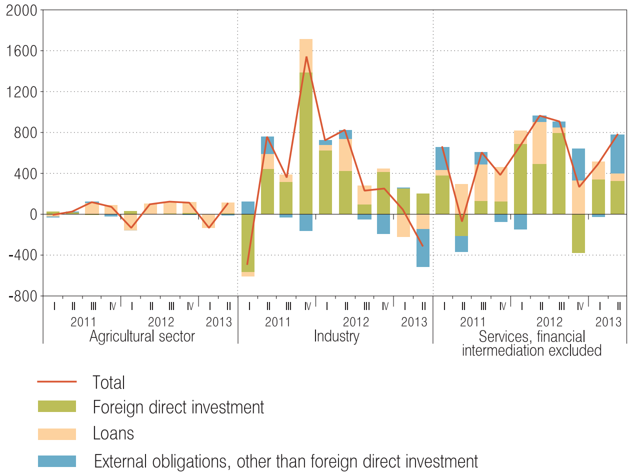
(million BGN, quarter-on-quarter stock change)



Source: BNB.

Financing Sources*

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



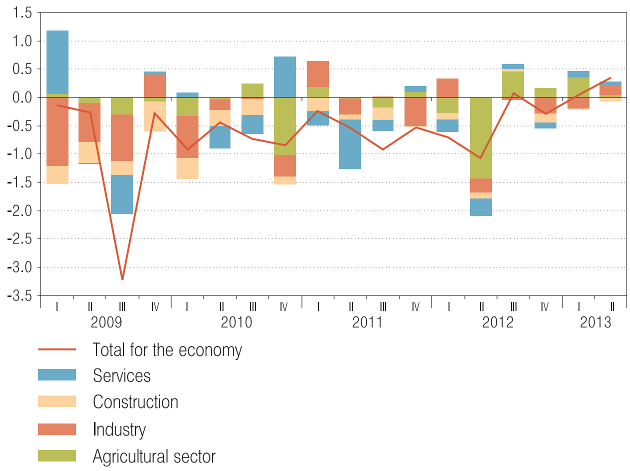
* The chart displays financing sources other than gross operating surplus.

Source: BNB.

Better managers' expectations about the future economic activity affected positively employment in total economy. The number of people employed in industry and business services picked up on a quarterly basis, along with relatively stronger optimism.

Contribution to Changes in the Number of Employed by Economic Sector

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



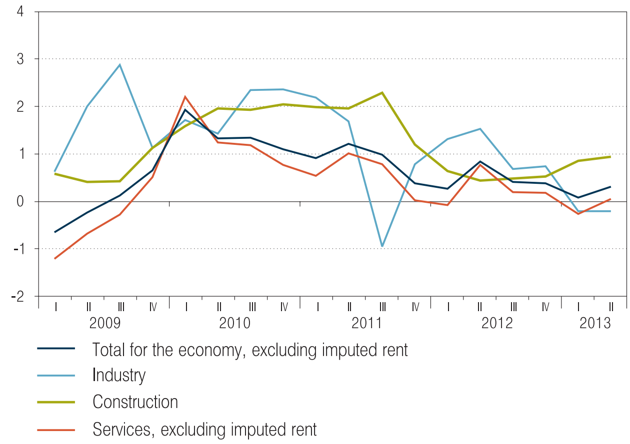
Note: Non-additive data on contributions due to direct seasonal adjustment of the total amount and its components.

Sources: NSI, BNB calculations.

The quarterly growth rate of labour productivity continued to moderate in total economy over the second quarter of 2013 due to employment growth and still weak economic activity in Bulgaria. Since 2009 the strongest increase in labour productivity has been recorded in industry and construction. These sectors registered the largest drop in economic activity and firms optimised their labour costs through both dismissing low skilled workforce and improving the relationship between labour productivity and compensation, which in turn led to declines in real unit labour costs.

Labour Productivity Developments (Value Added *per* Employee)

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

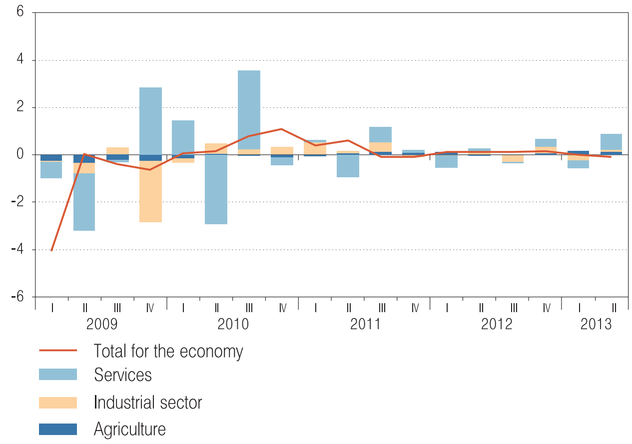


Sources: NSI, BNB calculations.

Wage expenditure of corporations broadly corresponded to labour productivity growth in the second quarter of 2013. Short-term statistics of employment and labour costs show that wages slowed down their growth rate in industry and declined in business services. In construction, a gradual upward trend in wages was registered in line with labour productivity dynamics. Nominal unit labour costs increased in the total economy, still remaining close to 2012 levels in real terms.

Value Added Growth and Contribution by Sector

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

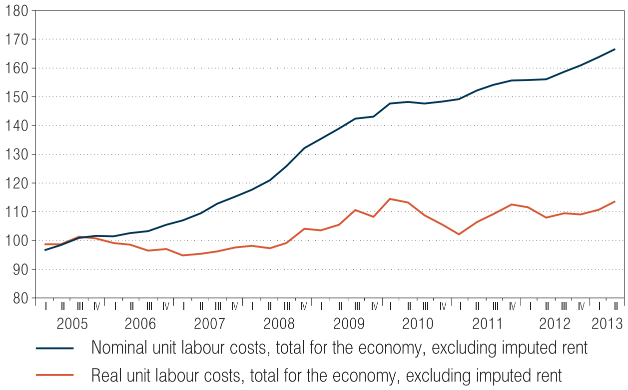


Note: Non-additive data on contributions due to direct seasonal adjustment of value added and its components.

Sources: NSI, BNB calculations.

Unit Labour Costs

(2005 = 100; seasonally adjusted data)



Sources: NSI, BNB calculations.

According to seasonally adjusted national account data, in the second quarter of 2013 value added in economy declined by 0.1 per cent on the previous quarter. Construction again had the major negative contribution unlike services and trade which recorded positive contributions.

Contribution of Changes in Production Factors to GDP Growth

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

Sources: NSI, BNB calculations.

The increased employment in the second quarter contributed to GDP growth, while the overall factor productivity declined as a result of slowing labour productivity growth rates. The downward trend in the contribution of the capital was sustained due to lower capacity utilisation and still weak investment activity in Bulgaria.

Gross Value Added Growth

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

	2010				2011				2012				2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Agriculture and forestry, hunting and fishing	-2.3	0.7	-0.5	-2.2	-0.7	1.2	2.4	1.8	2.0	-0.2	0.3	0.9	2.6	2.2
Mining and quarrying, manufacturing, production and distribution of electricity, gas and water	-0.8	1.8	1.6	1.4	3.3	1.2	-0.6	0.4	0.5	1.0	-0.6	2.1	-0.6	0.5
Construction	0.1	0.7	-1.4	0.2	-2.7	-2.9	9.1	-2.7	-1.9	-1.1	-2.5	-3.2	-1.8	-0.7
Trade, cars and motorcycles repair; transport, storage and mail services; hotels and restaurants	7.8	-15.1	20.1	0.7	-2.9	-1.0	0.8	-1.8	1.1	1.3	-0.2	1.7	-1.3	0.4
Creation and dissemination of information and author products; telecommunications	0.9	1.6	-1.0	-0.2	2.6	-1.6	1.0	-0.7	-2.4	-0.6	0.9	0.5	0.5	0.7
Finance and insurance activity	-0.5	-4.0	4.0	-2.3	0.4	2.1	-0.8	2.4	-2.1	0.2	-0.4	-2.3	0.9	3.9
Real estate activities	3.3	0.0	1.0	0.3	-2.0	1.7	0.8	2.6	-1.2	0.1	-0.4	-0.8	0.2	0.2
Professional activities and scientific research; administrative and ancillary activities	-1.2	15.0	-7.4	-2.0	12.5	-13.8	6.6	13.5	-12.7	-0.5	0.4	-2.0	2.4	2.0
General government; education; healthcare and social services	-2.7	0.9	-3.3	-1.2	1.5	-1.2	1.3	-3.4	3.1	-1.0	0.0	2.3	-2.1	0.7
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	-0.4	-0.7	-2.0	-0.8	-2.6	-3.2	-0.7	-2.9	0.3	-0.1	-0.6	0.4	-0.9	-0.3
Gross value added, total for the economy	0.6	1.4	0.8	0.6	0.3	0.5	0.2	0.1	0.3	0.1	0.1	0.1	0.1	-0.1

Source: NSI.

Improvements in firms' sentiment are expected to have a favourable effect on their decisions to launch investment projects, thus stimulating economic activity. The recovery observed in our major trading partners is expected to boost activity in export-oriented firms and contribute to GDP growth. However, still uncertain economic environment poses a risk for the firms to retain their cautious behaviour which will have a negative effect on both domestic demand dynamics and employment.

Exports and Imports of Goods

In the second quarter and in the beginning of the third quarter of 2013 exports and imports dynamics reflected the fall in prices of the important for Bulgaria's external trade commodity groups and the base effects related to the external trade developments in 2012. In the second quarter of 2013 exports of goods moderated its nominal growth to 3.3 per cent compared with 13 per cent in the first quarter. Imports of goods went down 3.8 per cent on an annual basis against an increase of 2.9 per cent in the first quarter. The trade balance for the January to August period was EUR 1342 million: up EUR 1134.6 million on the same period of 2012.

Seasonally unadjusted data for the GDP point to a real annual growth in exports of 7.5 per cent (12.2 per cent in the first quarter). This was probably the result of base effects, given that domestic demand for Bulgarian goods improved in the second quarter compared with the first quarter of 2013. Real imports growth was 1.7 per cent (6.5 per cent in the first quarter).

Cross-checking the changes in exports and imports in nominal and real terms shows that the changes in export and import prices limited the nominal growth of international trade flows in the second quarter. The last statement is supported also by export and import indices under the Standard International Trade Classification (SITC), pointing to an annual fall in exports and imports of 2.9 and 3 per cent respectively.

The rates of growth of both exports and imports improved by 8 and 0.6 per cent on an annual basis for the July to August 2013 period. Between January and August nominal exports increased by a total of 7.9 per cent, while imports declined by 0.4 per cent.

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

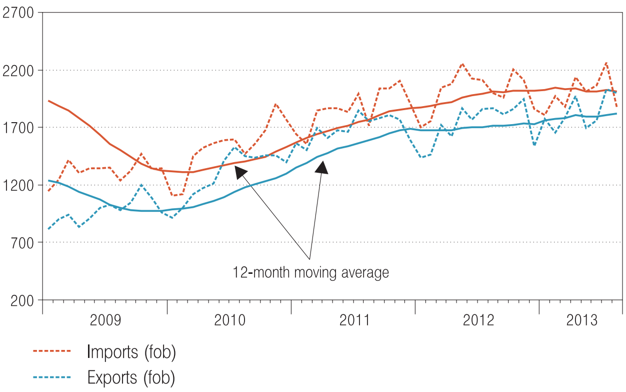
	Balance, million EUR	Change*, million EUR	Exports growth**, per cent	Imports growth**, per cent
Consumer goods	270.6	-61.7	4.5	7.6
Raw materials	107.9	167.7	6.5	3.2
Investment goods	-939.2	584.6	16.1	-7.6
Energy resources	-1580.9	202.6	8.6	-1.3
Total	**-2191.2**	**869.1**	**8.0**	**0.5**

* Balance change on same period of previous year.
** Exports and imports growth for the period on an annual basis.

Source: BNB.

Exports and Imports Dynamics

(million EUR)



Source: BNB.

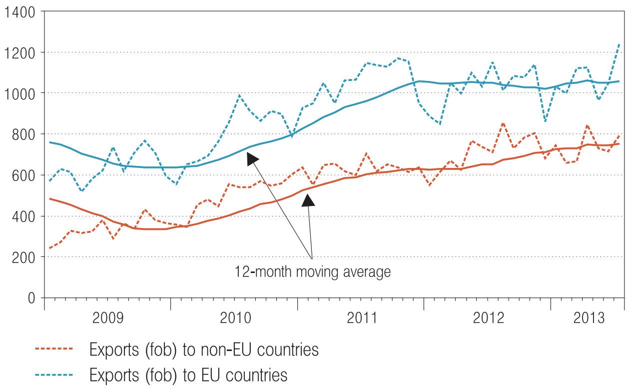
In the fourth quarter of 2013 and the first quarter of 2014 exports growth is expected to moderate on an annual basis. The projected annual fall in international prices of commodity groups of importance for Bulgara's exports together with the high base effect from the first quarter of 2013 are the key factors behind this outlook. On the contrary, the economic of recovery in our major trade partner, *i.e.* the European Union, will support Bulgarian exports. Over the projection horizon imports are expected to report lower positive growth rates due to improving domestic demand, but against the backdrop of still subdued international price dynamics. As a result, the trade balance deficit will deteriorate slightly in the fourth quarter of 2013 and in the first quarter of 2014 moving within the 6.5 to 7.5 per cent of GDP interval.

Lower than projected trade deficit could be realised in the event of faster recovery in EU economies and if Bulgarian exporters use exports capacity more flexibly to support exports growth. Risk related to higher than projected trade deficit may occur in case of unexpected deterioration in trading conditions over the projection horizon.

Between January and July 2013 exports to EU countries increased by 6.6 per cent on an annual basis, with machines, vehicles, appliances, tools and weapons; chemical products, plastics and rubber; and base metals and their products contributing most to this growth. Exports to non-EU countries went up 10.2 per cent, largely due to machines, transport facilities, appliances, tools and weapons; mineral products and fuels; and animal and vegetable products, foods, drinks and tobacco.

Dynamics of Exports to EU and non-EU Countries

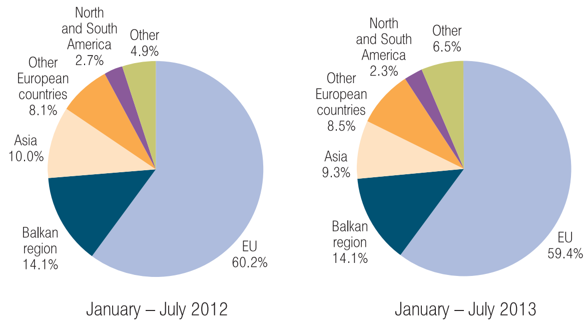
(million EUR)



Source: BNB.

In the first seven months of the year exports to EU countries showed significant fluctuations in its monthly rates of change, while exports to non-EU counties, although with a similar dynamics, were more stable. This was largely due to the diverse structure of exported goods for individual regions that resulted in asymmetric effects of international prices on the rates of change. As a consequence, over the review period the share of exports to EU countries in total Bulgarian exports declined by less than 1 percentage point compared with the same period in 2012. At the same time, the share of Bulgarian exports to EU countries in total EU exports increased further over the third quarter supporting the claim of the sustainable competitive positions of Bulgarian exports on international markets.

Geographical Distribution of Exports



Source: BNB.

Between early 2013 and July 2013 all commodity groups reported nominal increase in exports. Machines, vehicles, appliances, instruments and weapons; exports of animal and vegetable products, foods, drinks and tobacco; and mineral products and fuels contributed most significantly to this growth.

Exports by Commodity Groups in the January–July 2013 Period

	million EUR	Change*	Growth**, per cent	Contribution**, percentage points
Mineral products and fuels	2 332.5	195.5	9.1	1.7
Machines, vehicles, appliances, instruments and weapons	2 525.8	306.6	13.8	2.6
Base metals and related products	2 303.1	7.1	0.3	0.1
Animal and vegetable products, foods, drinks and tobacco	2 063.0	300.3	17.0	2.6
Chemical products, plastics and rubber	1 287.7	113.0	9.6	1.0
Wood products, paper, ceramics and glass	576.1	13.3	2.4	0.1
Textiles, leather, clothing, footwear and other consumer goods	1 597.3	8.2	0.5	0.1
Total exports	12 685.4	944.0	8.0	

* Change on corresponding period of previous year, million EUR.
** Growth/contribution to total export growth over the period on an annual basis.

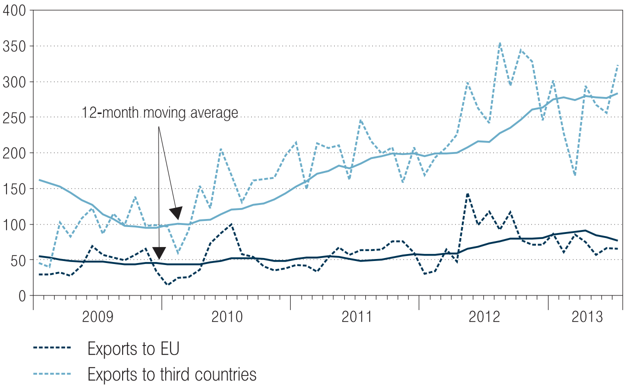
Source: BNB.

Between January and July exports of mineral products and fuels increased by 9.1 per cent compared with the corresponding period of 2012. This was largely due to the changes in exported quantities while the prices in this group have helped to halt the increase.[48] In the last quarter of 2013 and in the first quarter of 2014 energy commodity prices are likely to continue to exert dampening pressure on the increase in nominal volumes of exports in this group.

[48] According to the Balance of payments for the January to August 2013 period, p. 41.

Exports of Mineral Products and Fuels

(million EUR)



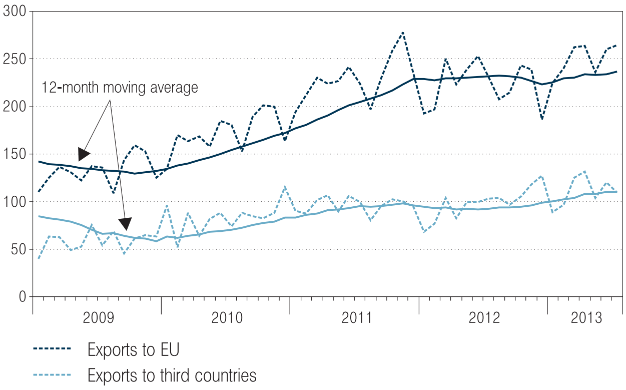
Source: BNB.

Exports of machines, transportation vehicles, appliances, instruments and weapons retained its sustainable annual growth rate throughout the January to July period. The increase in exports in this group reflected mainly the higher exported quantities and was supported, albeit to a lesser extent, by the export price rise[49].

Over the forecast horizon exports dynamics is expected to remain stable against the background of enhanced domestic demand.

Exports of Machines, Vehicles, Appliances, Instruments and Weapons

(million EUR)

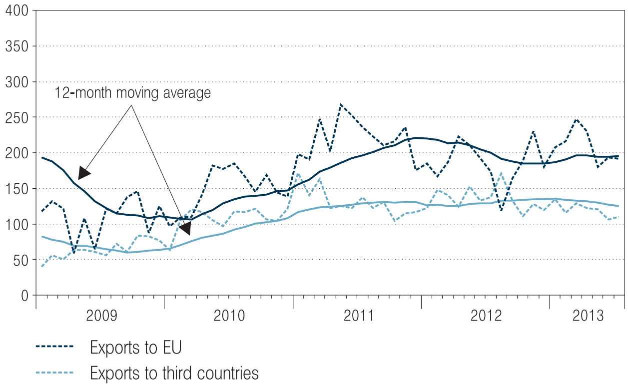


Source: BNB.

Over the January to July 2013 period exports of base metals and their products remained practically unchanged compared with the corresponding period in 2012, owing to the higher exported quantities which offset the fall in prices for this group[50]. International market prices are expected to continue to exert dampening effect on the exports of this group by the end of 2013 and in early 2014.

Exports of Base Metals and Related Products

(million EUR)

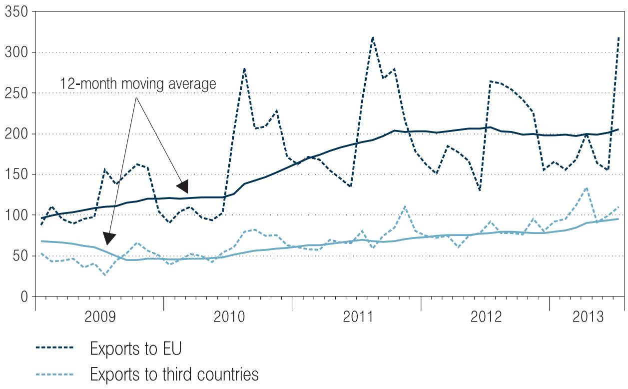


Source: BNB.

Exports of animal and plant products, foods, drinks and tobacco increased at high rates over the first seven months of the year mainly due to the higher physical volumes of exported products and with a slight contribution of the changes in the respective prices[51]. In the fourth quarter of 2013 and the first quarter of 2014 growth is likely to moderate mainly due to the base effect of the exported quantities at the end of 2012 and in early 2013. International price developments will not impact exports growth in this group over the projection horizon.

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

(млн. евро)



Source: BNB.

[49] The export deflator for the machines, equipment and transportation vehicles group under SITC was used to estimate the price effect in the first and second quarters of 2013.

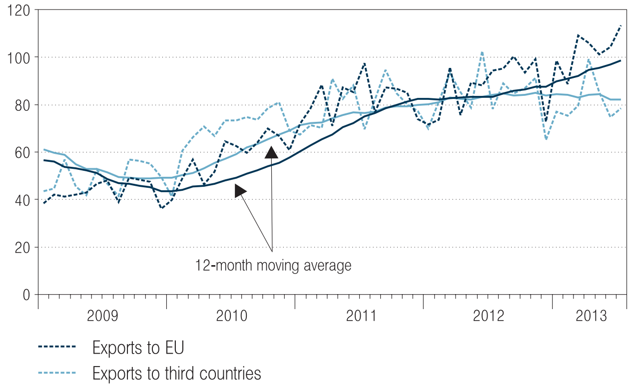
[50] According to the Balance of payments for the January to August 2013 period, p. 41, for the ferrous metals subgroup and using the export deflator for the cast iron and steel group under SITC for the first and second quarters of 2013.

[51] The export deflators for the following positions under SITC have been used to estimate the price effect in the first and second quarters of 2013: for cereals – the deflator of cereals and mill products; for oil seeds and fruit – the deflator of oil seeds and fruit; for tobacco and manufactured tobacco substitutes – the deflator of tobacco and manufactured tobacco substitutes.

Exports of the chemicals, plastics and rubber went up in the January–July period reflecting the simultaneous increase in exported quantities and the price rise in this group[52], with slightly dominating effect of physical volumes. Individual items within this group exhibited divergent dynamics, with pharmaceuticals and plastics and plastic goods boosting growth. Over the projection horizon this group is likely to sustain its upward trend in exports, albeit with similar or lower than reported rates, with a view to the divergences observed in individual subgroups' growth and the expected slight impact of respective international prices.

Exports of Chemical Products, Plastics, Rubber

(million EUR)



Source: BNB.

Imports of Commodity Groups by Use, January–July 2013

	million EUR	Change*	Growth** per cent	Contribution**, percentage points
Consumer goods	2 646.6	186.7	7.6	1.3
Raw materials	5 398.0	168.1	3.2	1.1
Investment goods	3 240.8	-264.9	-7.6	-1.8
Energy resources	3 528.3	-48.0	-1.3	-0.3
Imports, total (cif)	**14 876.7**	**74.9**	**0.5**	

* Change on corresponding period of previous year, million EUR.
** Growth/contribution to total import growth over the period on an annual basis.

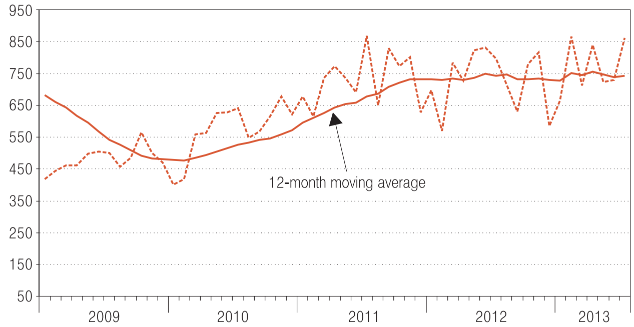
Source: BNB.

Imports (cif) remained practically unchanged in nominal terms over the January–July 2013 period compared with the corresponding period of the previous year. However, the review period saw fluctuations, which according to the System of National Accounts data, may be viewed as due to the changes in imported product quantities. Investment goods contributed most to the fall in imports by use in the second quarter, followed by the imports of energy resources.

Imports of the raw materials group increased slightly on an annual basis over the review period reflecting the higher physical volumes, while price movements curbed growth in this group[53]. Given that the expectations for domestic demand recovery and weak effects from the changes in international prices materialise, the growth in imports of raw materials is likely to boost over the forecast horizon.

Imports of Raw Materials

(million EUR)



Source: BNB.

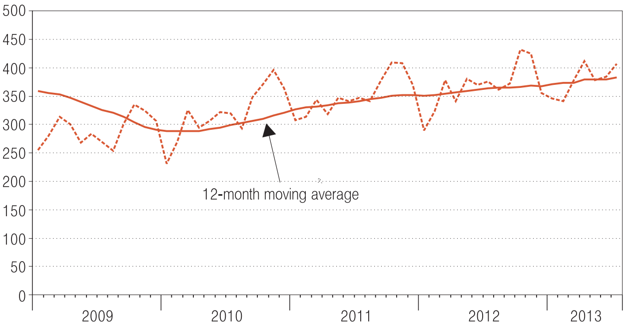
Imports of consumer goods played a key role for overall imports dynamics over the first seven months of the year. All major items in the group reported an increase. Medicines and cosmetics, and automobiles contributed most to this. The said changes correspond to the moderate recovery dynamics observed in consumption in the first half year. Given that the rise in consumption continues over the last quarter of 2013 and in early 2013, imports of consumer goods is likely to increase at similar or slightly higher than the currently observed rates.

[52] The export deflator for the chemicals and related products group under SITC was used to estimate the price effect in the first and second quarters of 2013.

[53] Based on Balance of payments data for the January–August 2013 period, p. 41 and the respective import deflators of the the following SITC groups: food and live animals; crude materials, inedible, except fuels; chemicals and related products and manufactured goods classified chiefly by material for the first and second quarters of 2013.

Imports of Consumer Goods

(million EUR)

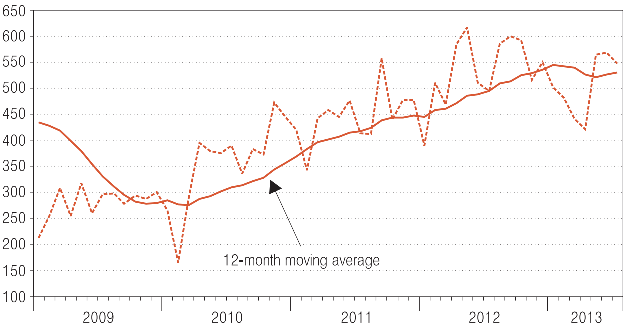


Source: BNB.

Imports of energy resources reported a slight decline on an annual basis in the January to July 2013 period. The fall in the prices of imported energy resources determined the change direction[54], whereas imported quantities picked up on the same period of the previous year. Slight changes in the nominal value of imports in this group may be expected over the forecast horizon, given that our projection for low annual fall in energy resource prices materializes.

Imports of Energy Resources

(million EUR)

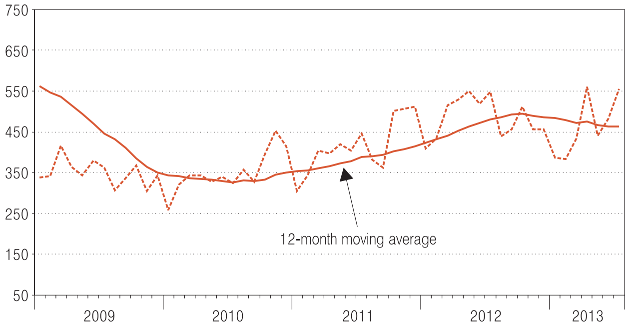


Source: BNB.

For the January to July 2013 period imports of investment goods reported a decline on the corresponding period of 2012. Both lower import prices[55] and lower quantities of imported investment goods contributed to this fall, which reflected the subdued investment demand in Bulgaria in the first half of the year. The base effect related to the more intensive imports of some groups of investment goods in the first six months of 2012 was another factor boosting this trend. Given that investment activity recovers at the end of 2013 and in early 2014, it is likely to expect recovery in investment goods imports.

Imports of Investment Goods

(million EUR)



Source: BNB.

Between January and July 2013 imports from EU member states increased by 4 per cent and that from non-EU countries fell by 2.6 per cent.

[54] According to the Balance of payments, January–April 2013, p. 41.

[55] The import deflator for the machinery and transport equipment group under SITC was used to estimate the price effect in the first and second quarters of 2013.

4. Inflation

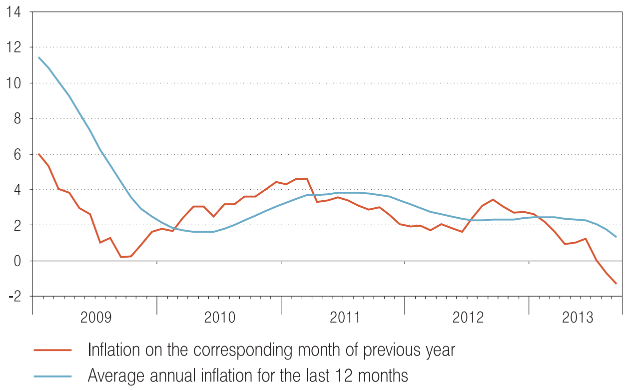
In the first nine months of 2013 annual inflation tended to decrease, with a negative value of 1.3 per cent observed in September. Major driving factors involve the decreased electricity price for households and, to a lesser extent, cuts in other administratively controlled prices along with downward international price developments of food and energy products.

In the fourth quarter of 2013 a slight deflation is anticipated as a result primarily of the continuous negative contribution of administratively controlled prices. Expectations for the first quarter of 2014 show a slow increase in inflation under the influence mainly of lower growth rates of food and energy prices.

In the first half of 2013 the downward trend in annual inflation remained unchanged, in the third quarter the rate of decline accelerated, and in September annual inflation was negative at 1.3 per cent (against 2.8 per cent inflation in December 2012).[56] Inflation dynamics since early 2013 reflected the downward effect on consumer prices of both domestic and external factors and was characterised mainly by changes in the prices of the groups of goods and services, having a relatively high weight in the consumer basket (electricity, food products, energy products and transport services).

Inflation

(per cent)

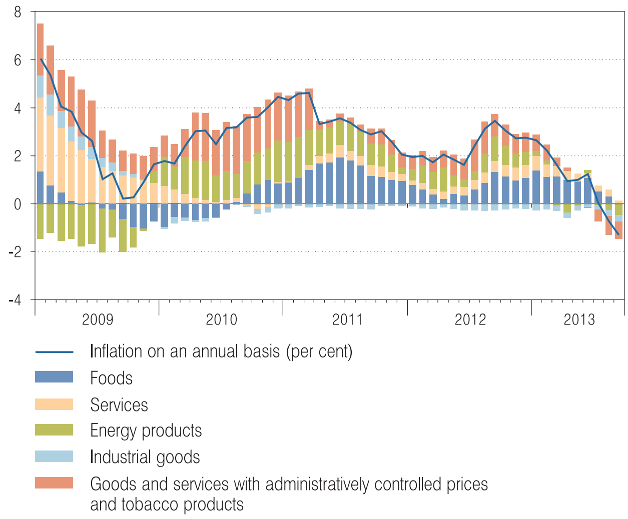


Source: NSI.

Lower international crude oil prices on international markets observed since early 2013 contributed to the easing of the growth rate in energy product prices[57] and to their annual depreciation in the second and third quarters of 2013. The downward trend in international food prices was reflected more pronouncedly in the end-use consumer prices in Bulgaria in the third quarter of 2013. As of September 2013 the prices of unprocessed foods dropped down on an annual basis, and those of processed foods reported a very low positive rate of growth. The downward dynamics in fuel and food prices had an indirect effect on the prices of other groups of goods and services in the consumer basket. This effect was most pronounced in transport services prices[58] where the annual growth rate moderated significantly since early 2013 and in the April–September 2013 period turned negative on an annual basis.

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

(percentage points, per cent)



Notes: The used 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.

[56] The analysis in this Section is based on NSI data on the Harmonised Index of Consumer Prices (HICP).

[57] Excluding those with administratively controlled prices (electricity generation and heating).

[58] Excluding those with administratively controlled prices (passenger railway transport and urban transport).

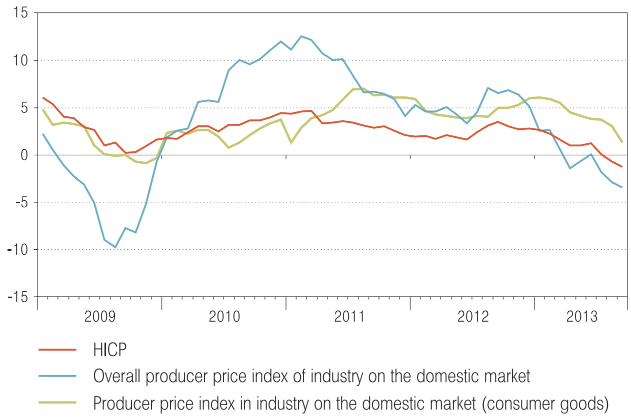
As regards domestic factors influencing inflation, the March and August reduction of the administratively controlled prices of electricity for households and, to a lesser extent, the lower administratively controlled prices of other goods and services contributed most substantially to the decline in the overall consumer price index. As of September administratively controlled prices went down 4 per cent on the corresponding period of the prior year and reported the highest negative contribution to overall consumer price inflation.

Companies' pricing and expenditure policy is an important domestic factor with bearing on consumer price inflation. Against the background of uncertainty surrounding external economic environment developments and weak economic activity in Bulgaria, firms remained cautious to investment and labour costs. According to the short-term statistics data on employment and labour costs, in the first half of 2013 the annual rate of increase in the wage fund in both the manufacturing sector and the services sector moderated. Furthermore, the fall in international prices of major commodities such as foods, fuels and metals contributed to a reduction in the external pro-inflationary pressure on companies' expenditure in manufacturing. As a result, the overall producer price index (PPI) on the domestic market in 2013 exhibited a downward dynamics and in September reported a 3.5 per cent fall on the corresponding month of the previous year. PPI developments largely reflected the international price dynamics; energy products[59] reporting a decline since early 2013. Over the same period inflation in the production of food products moderated significantly. Consumer products also reported price rise ease, and as of September intermediate consumption goods reported a decline on an annual basis.

In the first half of 2013 the trade, repair of motor vehicles and motorcycles sector interconnecting the producer prices and end-use prices for most goods reported a slight fall in the number of employed and a moderate average wage growth. The current pricing policy[60] of the companies in this sector is characterised by a moderate rate of increase in prices of the food, beverages and tobacco products subsector and a freeze or a slight decline in the prices of the non-food products (except trade in automotive fuels and lubricants) subsector and a decline in the prices of automotive fuels and lubricants. In addition to international prices and wage expenditure other factors related to companies' expenditure and pricing policy are probably related to high competition and relatively slight increase in household consumption exerting downward pressure on prices.

Rate of Change in HICP and Industrial PPI

(per cent on corresponding month of previous year)



Source: NSI.

Monthly data on retail trade turnover at constant prices for the third quarter of 2013 give grounds to anticipate gradual increase in household consumption by the close of the year. Current deflation may also have a favourable effect on the consumption dynamics by boosting households' disposable income. Nevertheless, expectations related to a continued high savings rate in the economy and a relatively high unemployment rate will further dampen household demand in the following months, which will continue to push company's expenditure and prices down.

The still relatively low core inflation reflected both international environment and household and firm behaviour. As of September core inflation dropped 0.4 per cent on an annual basis owing to the low services inflation, tending downwards largely due to the lower transport services prices, and the continued downward

[59] The Main Industrial Groupings classification was used to cover the following sectors: manufacture of intermediate consumption goods; energy product production and water related activities; investment product manufacturing and consumer goods production. Production and distribution of electricity and heating, gaseous fuels and water supply were not included in the considered energy products.

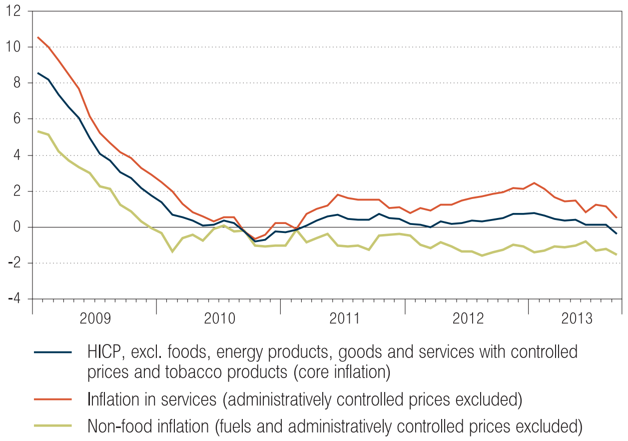
[60] The companies' pricing policy is assessed based on turnover data for the subsector of retail trade, excluding motor vehicles and motorcycles at current and constant prices for the January 2012 to August 2013 period.

trend in prices reported by the overall index of non-food products.

The business situation survey data in 2013 point to weaker expectations of higher selling prices in manufacturing, retail trade and serves compared with the end of 2012.

Core Inflation

(per cent on corresponding month of previous year)

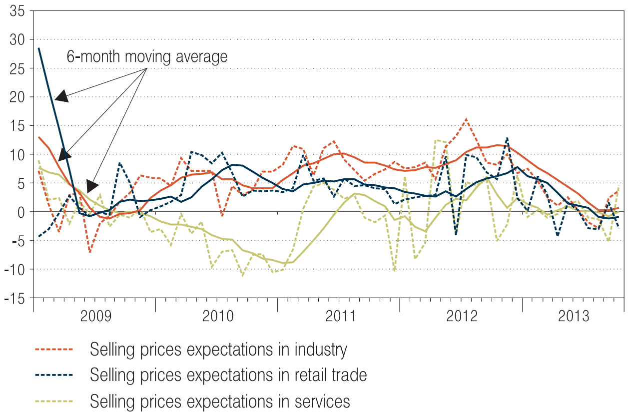


Sources: NSI, BNB calculations.

According to NSI survey observations for the April to October period, prevailing managers' expectations are that the prices will remain unchanged.

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

(balance of opinions, per cent)

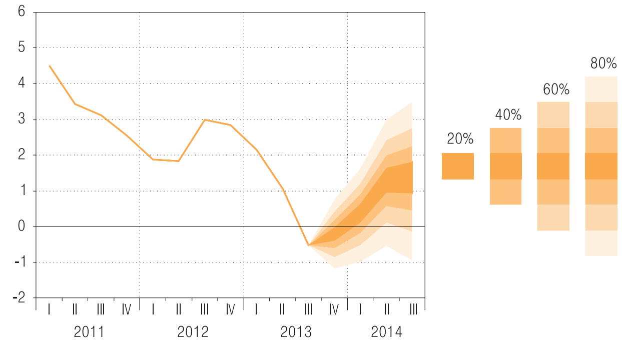


Source: NSI.

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.[61] Inflation in the fourth quarter of 2013 is expected to remain around its current levels: between -0.6 per cent and 0.2 per cent, and in the first quarter of 2014 to remain within the -0.2 per cent and 0.9 per cent interval.[62]

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 and the probability distribution shows 20 per cent probability for the actual value to fall in this band in each of the quarters. If neighbouring bands (in the same brighter colour) are added to the middle band, there would be 40 per cent coverage of the probability mass. Thus, by adding each same colour couple of bands, the probability for the value to fall there would be increased by 20 percentage points to reach 80 per cent. The probability for the value to remain outside the coloured part of the chart is 20 per cent based on the distribution chosen.

Source: BNB.

Assuming that the gradual stabilisation in international prices at the end of 2013 and in early 2014 materializes, we foresee only a short downturn in the overall consumer price interest which will not have a long-lasting impact on household and firm expectations. Therefore, the current price dynamics is not expected to contribute to a further moderation of growth or to a fall in wages or to postpone household consumption over time. The temporary price drop-down may even have a positive effect on real disposable income of households and thus stimulate consumer demand.

Administratively controlled prices dynamics is expected to be a key factor behind the realised slightly negative inflation at the end of 2013 and the low positive inflation in the first quarter of 2014 provided that the price of electricity remains at its current levels. The projection is based also on the assumption of a moderate fall in international food and fuel prices on an annual basis by the end of 2013 and early 2014. Core inflation is not expected to make a substantial contribution to overall inflation, given the relatively weak

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

[62] 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.

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

	Inflation accumulated as of September 2012 (December 2011 = 100)		Inflation accumulated as of September 2013 (December 2012 = 100)		Annual inflation rate as of September 2013 (September 2012 = 100)	
Inflation (per cent)	2.8		-1.3		-1.3	
	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	**3.5**	**0.89**	**-0.7**	**-0.17**	**0.1**	**0.02**
Processed foods	1.4	0.24	-0.2	-0.04	0.6	0.11
Unprocessed foods	7.8	0.66	-1.4	-0.13	-1.0	-0.09
Services	**0.8**	**0.20**	**-0.8**	**-0.20**	**0.5**	**0.12**
Catering services	2.1	0.11	1.5	0.08	2.9	0.14
Transport services	5.5	0.24	0.1	0.00	-1.5	-0.07
Telecommunication services	-0.8	-0.04	-1.0	-0.05	-1.3	-0.07
Other services	-1.0	-0.11	-2.1	-0.23	1.2	0.11
Energy products	**13.9**	**1.20**	**2.1**	**0.19**	**-4.7**	**-0.45**
Transport fuels	14.3	1.16	0.0	0.22	-4.9	-0.42
Industrial goods	**-1.8**	**-0.35**	**-2.3**	**-0.42**	**-1.6**	**-0.29**
Goods and services with administratively controlled prices*	**5.1**	**0.82**	**-3.9**	**-0.72**	**-4.0**	**-0.73**
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 calculation.

household consumption and the indirect impact of the lower fuel and food prices.

Major risks to the expected inflation dynamics relate to the price developments on international commodity markets and to potential changes in administratively controlled prices.

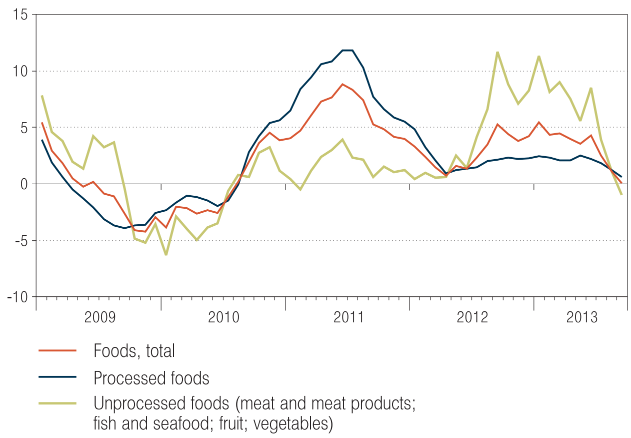
Food Prices

The downward trend in food product prices of early 2013 continued in the third quarter of the year and as of September annual inflation in this group came to 0.1 per cent (4.2 per cent as of December 2012). Price dynamics reflected mainly the sizeable decline in unprocessed food price inflation. Inflation in processed foods also moderated since the year start in parallel to the moderation in producer price rise on the domestic market in the manufacture of food products, beverages and tobacco sector.

However, unprocessed food products (meat and meat products, fruit, vegetables and fish) reported a 1.0 per cent deflation in September (8.3 per cent inflation as of December 2012). The marked declines observed in the meat and meat products group and lower vegetable prices played a decisive role for the negative annual rate of change in unprocessed food prices realised in September. The key factors behind this were the sizeable fall in international cereal prices which had an indirect impact on fodder prices, the decline in international meat and meat products prices and the good harvest in the agricultural sector in Bulgaria in 2013. Lower meat and meat products import prices were reported according to the data on the deflator of this commodity group on an annual basis between the second half of 2012 and the first half of 2013.[63]

Rate of Change of Food Price Index

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

Processed food price inflation moderated in the third quarter in 2013, reaching 0.6 per cent in September (2.2 per cent in December 2012). Bread and cereals, and animal and vegetable

[63] BNB calculations based on NSI data on import price indices by commodity groups under SITC.

oils and fats contributed most significantly to the fall in inflation in this group since early 2013. This reflected the annual decline in the international prices of cereals, fats and oils.

Assuming that the fall in international prices continues, albeit at a lower pace, inflation in this group is expected to remain low in the fourth quarter of 2013 and increase slightly in early 2014.

Energy Product Prices

The annual fall in inflation of energy products (excluding those with administratively controlled prices) observed since the fourth quarter of 2012 continued in the third quarter of 2013. In line with the fall in oil prices on international markets, as of September transport fuel prices declined by 4.9 per cent on the corresponding period of the previous year.[64]

Rate of Change of Energy Product Price Index and 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.

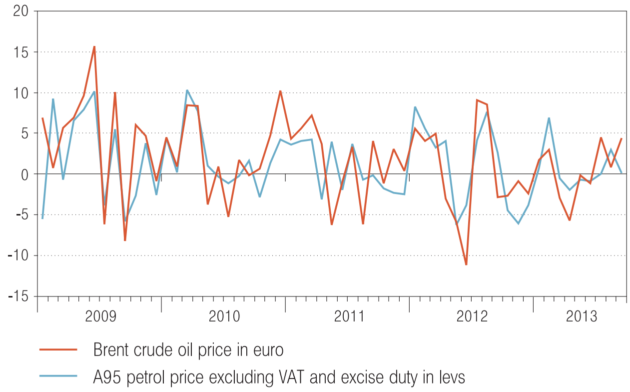
Sources: NSI, BNB calculations.

Low energy product deflation at the end of 2013 and slightly rising prices in early 2014 are expected upon an assumption about moderate fall in international fuel prices in euro in the fourth quarter of 2013 and in the first quarter of 2014. Considerable oil price fluctuations over the period might also result in an analogous development in the rates of change of end-use fuel prices in Bulgaria.

[64] In the group of energy products (excluding electricity, heating and gaseous fuels, having administered prices) transport fuels occupied the largest relative share; hence, their price developments determine the overall price dynamics of energy products.

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

(per cent)



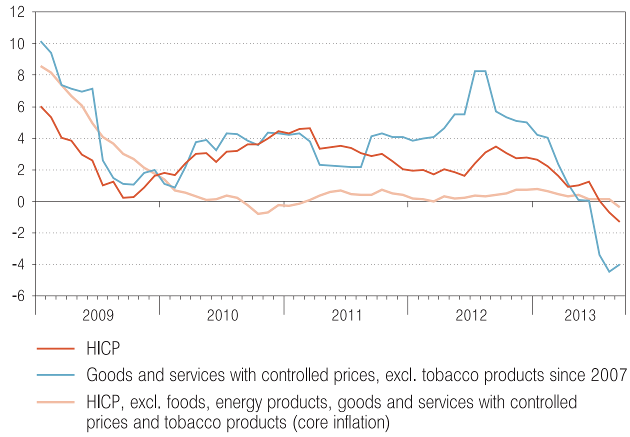
Sources: ECB, NSI, BNB calculations.

Administratively Controlled Prices and Tobacco Product Prices

In the third quarter of 2013 annual inflation in administratively controlled prices slowed down further, turning negative in September: -4.0 per cent compared to 5.0 per cent as of December 2012. Price developments in this group reflected mainly the March and August 2013 reductions in administratively controlled prices of electricity for households of 7.2 per cent and 4.3 per cent respectively, together with the base effect related to the July 2012 price rise. The reduction in heating prices and medicines and other pharmaceutical products prices contributed less to the fall in administratively controlled price inflation.

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

(per cent, on corresponding month of previous year)



Notes: 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 liberalisation of tobacco products. Administratively controlled prices are calculated at an elementary aggregates level in the consumer basket.

Sources: NSI, BNB calculations.

Administratively controlled prices are expected to sustain their negative contribution to overall inflation in the following two quarters and thus play a decisive role for the weak deflation at the end of 2013 and the low positive inflation in early 2014.

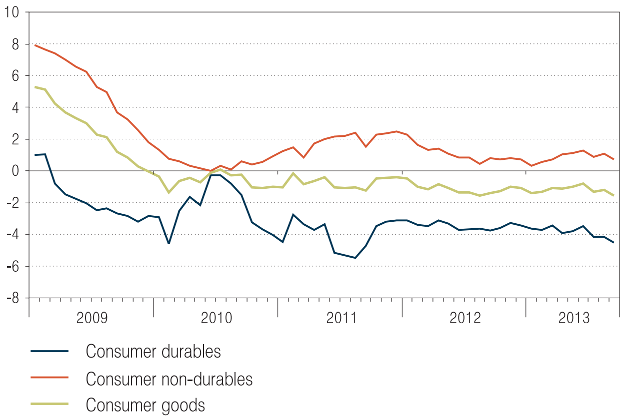
Industrial Goods Prices

In the third quarter of 2013 the slight downward trend in industrial goods prices (excluding administratively controlled prices) observed since mid-2010 continued. As of September the annual rate of change in the prices in this group came to -1.6 per cent (-1.1 per cent as of December 2012), with durables (mainly cars and computer and communication equipment) still reporting the highest negative contribution.

Between January and September 2013 new car registrations declined on the same period of the last year both in Bulgaria (-2.5 per cent) and on average in the European Union (-3.9 per cent), pointing to a continued fall in demand for cars.[65]

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.

The global downward trend in the prices of computer and communication equipment continued and was reflected in the price developments in Bulgaria. The high degree of competition in the retail trade of manufactured goods is a domestic factor exerting further downward pressure on their prices.

[65] European Automobile Manufacturers' Association press release data on the number of passenger car registrations.

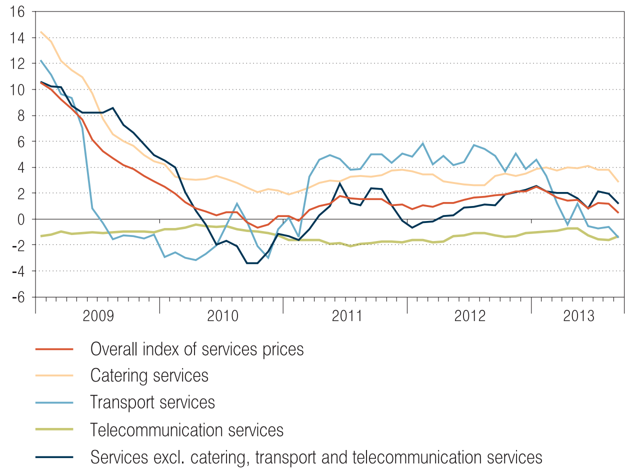
Services Prices

In the third quarter of 2013 annual inflation in services (excluding those with administratively controlled prices) continued to decline gradually, reaching 0.5 per cent in September (2.1 per cent as of December 2012).

The fall in annual services inflation reflected mainly the negative contribution of transport services (automotive and air transport), driven mainly by the downward dynamics in transport fuels.

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

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

The continued downward trend in communication services prices had only a modest contribution to overall services inflation moderation. As regards the telecommunication services market, the key factors behind the fall in prices were the ongoing restructuring processes in the sector and the price competition policy.

Prices in catering, which is another group of services with a relatively high weight in the overall consumer price index, retained their sustainable upward trend, reporting an average inflation of 4 per cent in the first half of 2013 and moderate growth of up to 2.9 per cent in September.

At the end of the third quarter of 2013 annual inflation in services, excluding catering, transport and telecommunication services, came to 1.2 per cent staying close to the level reported in the second quarter and below that in early 2013 (2.6 per cent in January).

If household consumption increases in the third quarter of 2013 and in the first quarter of 2014, services inflation is expected to follow a slight upward dynamics.

Analysis of the Factors for the Deflation in Bulgaria over the Third Quarter of 2013 and of the Possible Effects on Domestic Economic Activity

The economic literature pays close attention to inflationary processes, particularly high and persistently high inflation due to the negative effects on economic activity, income distribution, economic agents' expectations and behaviour. However, in recent months the impact of low inflation/deflation on the economy has become an important topic of economic discussions.

Deflation may be defined as an extended period of price declines that covers a substantial part of the goods and services groups in the consumer basket.[1] The major factor behind such price declines is usually a significant decrease in demand resulting from a negative shock whereby firms respond by reducing end-use prices and lowering profit margins. Lower profit margins, in turn, result in a reduction of expenditure on investment projects and in a decrease in the number of employees and/or nominal remuneration. This response of firms practically intensifies deflationary processes in the economy and may induce a deflationary spiral and a sustained decrease in demand. Negative effects on the economy in a period of deflation also stem from the reaction of households, which may postpone the consumption of some goods and services due to expectations of continuing price declines. Deflation pushes up the cost of credit due to rising real interest rates and an increase in the real value of accumulated debt. Deflation may have a positive aspect, if it results from labour productivity growth and technological innovation, which significantly reduce production costs.

In 2013 inflation in Bulgaria followed a downward trend, slowing down from 2.8 per cent on an annual basis at the end of 2012 to -1.3 per cent by September 2013. The producer price index on the domestic market also declined reaching -3.5 per cent in September. This analysis aims to present the factors behind the rapid decline in inflation since the beginning of the year and to assess the possible effects on expectations and behaviour of households and enterprises.

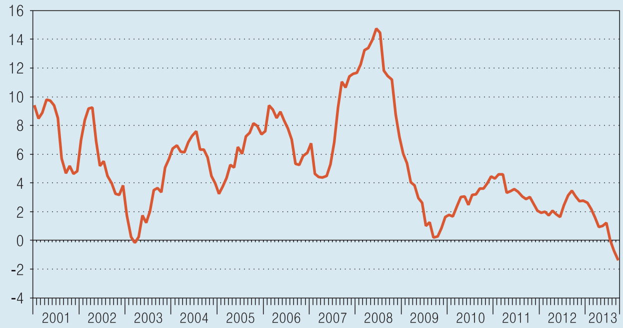
Since 2000 inflation in Bulgaria has been low compared to the 1991 to 1998 period, albeit significantly volatile across years. Long-term processes of real and nominal convergence affect inflation in Bulgaria, though it depends primarily on conjunctural factors. Inflation developments in Bulgaria are mostly driven by international fuel and commodity price dynamics, while domestic factors of key significance include changes in administratively controlled prices, excise duty increases to reach minimum EU levels, and the quality of agricultural harvests for the respective year.

Applying a diffusion index, measured as the share of HICP sub-indices decreasing more than 0.1 per cent on an annual basis on the same period of the previous year, allows determining the range of goods and services with declining prices in the consumer basket. Data for Bulgaria over the 2001 to 2013 period show that each month, even in periods of relatively higher inflation, prices of at least 10 per cent of the goods and services groups declined.

The diffusion index exceeded 30 per cent between September 2002 and July 2004, with consumer price deflation reported only in March 2003. After the onset of the global financial and economic crisis, the diffusion index again exceeded 30 per cent between February and July 2010 and in September 2013, with the overall HICP recording a year-on-year decrease only in the third quarter of 2013. If a more strict definition of the diffusion index is given as an above 3 per cent price fall on an

Inflation

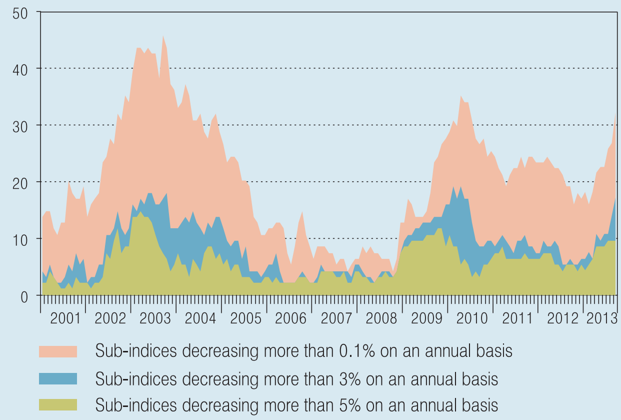
(on corresponding month of previous year)



Source: NSI.

Diffusion Index

(per cent of HICP sub-indices recording a decline on an annual basis)



Sources: NSI, BNB calculations.

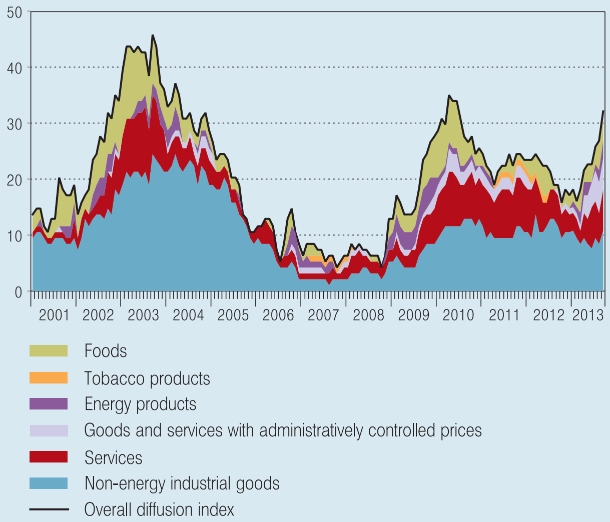
[1] This analysis could also be based on GDP deflator dynamics. However, since available HICP data are as of the third quarter of 2013 and those on GDP deflator are as of the second quarter, the analysis employs consumer price information.

annual basis, in September 2013 declines were observed in 17 per cent of the HICP sub-indices. A similar share was reported in the first half of 2010 and in 2003.

The diffusion index decomposition by major goods and services groups in the consumer basket indicates that in the periods when the prices of a comparatively higher number of goods and services groups decline, all major groups (food, energy products, non-energy industrial goods, services, tobacco products and administratively controlled prices) record price falls. In the 2002 to 2004 period, as well as between 2010 and September 2013, non-energy industrial goods occupied the largest share of all HICP declining sub-indices, which may be explained by relatively high dependence of this group on international price developments. In 2013 all major HICP groups, excluding tobacco products, include declining price sub-indices.[2] By September the declining HICP sub-indices in the consumer basket had the following composition: non-energy industrial goods accounted for almost one-third, services – for approximately one-fifth, foods and goods and services with administratively controlled prices comprised about 15 per cent each, and energy products comprised around 10 per cent.[3] Concurrently, the most significant increase in the number of declining sub-indices compared to the second half of 2012 was recorded in controlled prices, food and energy products, and to a lesser extent in services, while their number in non-foods (excluding fuels) remained broadly unchanged. The negative contribution of administratively controlled and energy prices and the substantially reduced positive contribution of foods were the driving factors for HICP deflation in September. Comparatively low growth rates in those HICP sub-groups which do not record a decline on an annual basis are insufficient to offset the price declines in the other groups, as reflected in the overall HICP drop as of the end of the third quarter of 2013.

Diffusion Index by Major Goods and Services Groups

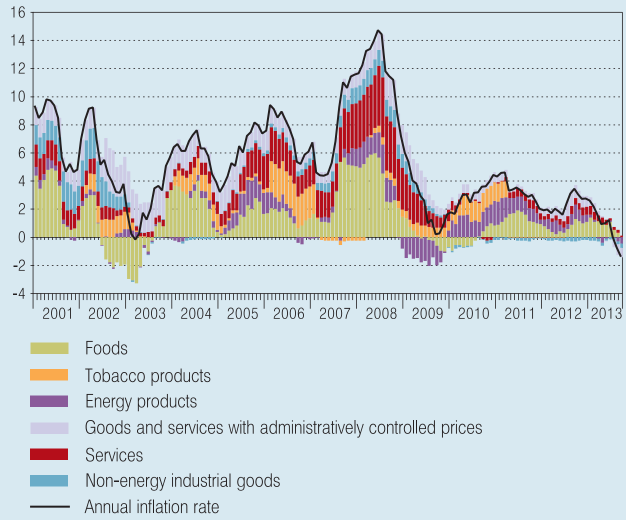
(per cent of HICP sub-indices recording a decline on an annual basis)



Sources: NSI, BNB calculations.

Annual Inflation and Contributions of Major Goods and Services Groups

(per cent, percentage points)



Sources: NSI, BNB calculations.

The analysis of the factors for overall consumer price deflation requires further consideration of the sub-groups with declining prices, and major goods and services consumer basket groups are surveyed at a lower level of aggregation. The food group analysis shows that by September deflation was mainly recorded in unprocessed foods (vegetables, fruit, fish and products thereof) whose prices depend primarily on import prices and the quality of domestic agricultural harvest, and only in those sub-groups of processed food which show strongest dependence on fluctuations in world prices (such as vegetable oils and sugar products). Among consumer basket goods and services with administratively controlled prices, declines were registered in electricity, heating, pharmaceuticals and hospital services. In the energy group where the crude oil price is the driving factor, declines were observed in all fuels for personal transportation vehicles, as well as in fuels for household use. Recent years' downward trend in non-energy industrial goods prices continued in 2013, most pronounced in durable

[2] In 2013 the weights of the major groups of goods and services in the consumer basket are as follows: food (25.4 per cent), energy products (9.2 per cent), non-energy industrial goods (18.6 per cent), services (25.4 per cent), tobacco products (3.8 per cent), goods and services with administratively controlled prices (17.6 per cent).

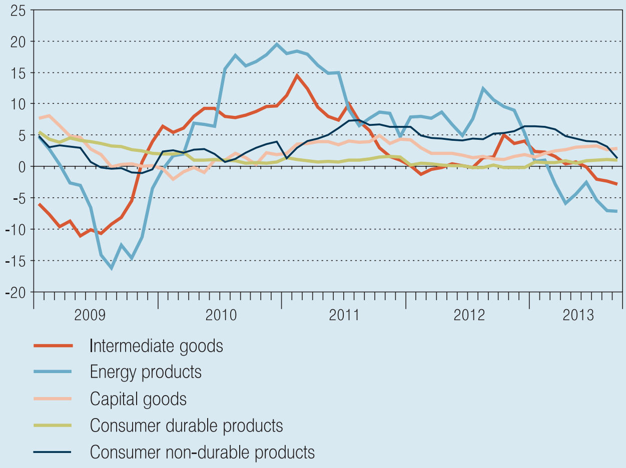
[3] In the energy product group, excluding controlled price products, transport fuels occupy the largest share.

goods[4] prices which largely reflect international price developments and global trends. The services group is characterised by the smallest number of declining price sub-groups, with only transport (due to indirect effects of downward price dynamics in transportation fuels), telecommunications (reflecting mostly global trends), cultural services, package holidays, and auto insurance services reporting year-on-year price falls in September 2013.

The analysis of the data presented above suggests that the negative inflation registered at the end of the third quarter results to some extent from sluggish domestic demand and weak economic activity, but largely from declines in international prices of raw materials and commodities (with their direct and indirect effects on goods and services prices), good harvest in both Bulgaria and the world, global trends in some consumer goods and services prices and decisions to cut administratively controlled prices.

Annual Rates of Change in Producer Price Index on Domestic Market by Major Industrial Groupings

(per cent)



Source: NSI.

The strong effect of international prices on consumer price developments in Bulgaria can be seen through import and producer price dynamics. In the first half of 2013 the import deflator of goods decreased by 4.9 per cent on an annual basis, while the overall domestic producer price index fell by 0.5 per cent on average between January and September on the corresponding period of 2012, its decline reaching 3.5 per cent in September. The downward producer price dynamics was mainly driven by energy and intermediate goods price declines. Consumer non-durables prices recorded a positive rate of change with a slowing down trend, mainly due to declines in producer prices of vegetable and animal oils and fats and to a lesser extent to the contracting positive contribution of producer prices of meat and meat products. Consumer durables and capital goods prices recorded positive growth rates in 2013, which indicates that the overall producer price index decrease is not driven by a demand shock affecting all sectors since some sectors' firms are able to increase prices even in the context of remaining weak economic activity.

Comparatively low household consumption has a curbing effect on the fast growth of end-use prices of goods and services with relatively lower dependence on international price dynamics. It is also possible that in some groups of goods and services weak private consumption exerts pressure for retaining or decreasing the level of prices. For instance, turnover data on retail trade by sub-sectors, excluding motor vehicles and motorcycles, at current and constant prices show that declines in retail trade volumes coupled with relatively constant prices were observed in the group of household appliances, furniture and other household goods[5]. Trade in computer and communication equipment and other consumer goods[6] reported a decrease in trade volumes and a decelerating price growth rate. Trade in pharmaceuticals and medical goods, cosmetics and toiletries[7] registered declining sale volumes and lowering of prices.

At the same time, the reduced pro-inflationary pressure through the decrease in the import deflator of goods and services, the lower domestic producer price index in 2013 and the cheaper transport fuels could have a positive effect on intermediate input costs of firms as it enables them to increase profits or reduce end-use prices. In addition, the decreased regulated price of electricity for households has a favourable effect on the costs of small businesses on so-called 'protected market' where the electricity price is set by the State Energy and Water Regulatory Commission. The current period of decline in the overall consumer price index may push up consumption by boosting household disposable income.

If we take into account the fact that the present decline in the HICP results mainly from decreases in international commodity and some controlled prices and to a lesser extent from weak domestic demand, it may be supposed that deflation will have a comparatively little impact on economic activity in Bulgaria if it lasts a limited period of time. Signs of stabilising employment in 2013 coupled with conjunctural indicators of retail trade turnover at constant prices have so far shown no postponement of household consumption due to expectations of continuing

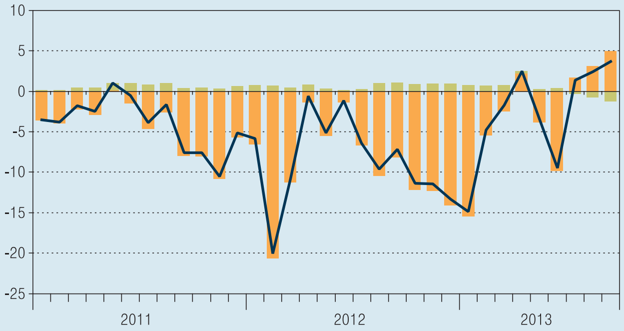
[4] Such as automobiles, televisions, computers, cameras, household appliances, furniture and furniture items.

[5] Retail sale of audio and video equipment; hardware, paints and glass; electrical household appliances, *etc*. in specialised stores.

[6] Retail sale of computers, peripheral units and software; telecommunications equipment, *etc*. in specialised stores.

[7] Dispensing chemist; retail sale of medical and orthopaedic goods, cosmetic and toilet articles in specialised stores.

Annual Growth Rate of Nominal Turnover in Retail Trade in Household Appliances, Furniture and Other Household Goods (working day adjusted data)



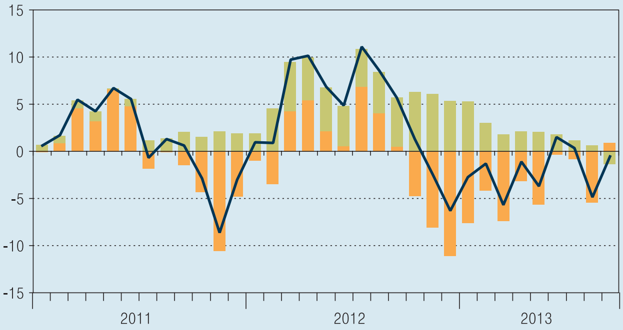
Price component

Real component

Retail trade in household appliances, furniture and other household goods

Sources: NSI, BNB calculations.

Annual Growth Rate of Nominal Turnover in Retail Trade in Computer and Communication Equipment and Other Consumer Goods (working day adjusted data)



Price component

Real component

Retail trade in computer and communication equipment and other consumer goods

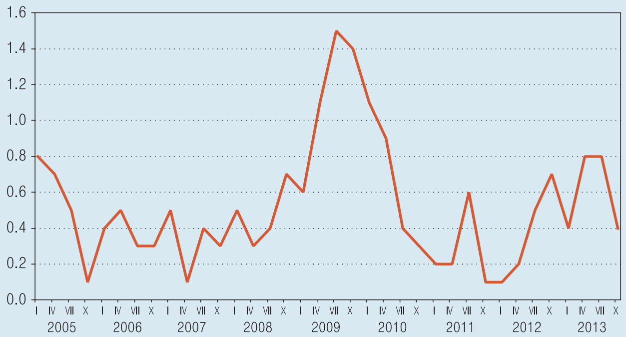
Sources: NSI, BNB calculations.

consumer price declines. In addition, industrial turnover of investment goods on the domestic market rose by 10 per cent on an annual basis in the third quarter of 2013, so at present it could be argued that no negative implications of deflation on investment activity are observed.

Business situation and consumer survey data show no signals of deflation expectations for now. Consumer survey of October 2013 suggests significantly less pronounced inflation expectations compared to end-2012, though with a very low share of consumers (0.4 per cent) expecting consumer price declines over the next 12 months. Business survey in industry as of October recorded a slight increase on end-2012 in the share of managers expecting declines in selling prices over the next three months, although this share remains relatively low (on average around 5 per cent between August and October). A similar upward trend was also observed in trade, with the number of firms expecting price declines exceeding slightly that of industrial firms in the beginning of the fourth quarter. Concurrently, managers' sentiments for price decreases in the services sector weakened on 2012. According to NSI Business Survey observations for the April to October period, expectations of keeping prices constant over the next three months prevail in all of the three sectors.

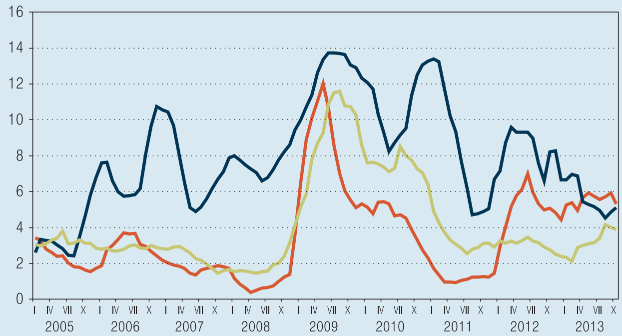
Based on the current information about economic activity developments in Bulgaria along with the assumptions of a gradual stabilisation in international commodity prices, lack of further regulated price decreases and strengthening domestic demand, a short-term deflationary period may be expected. The analysis suggests that potential negative effects of the present period of deflation on household consumption and investment activity of firms are limited. Negative macroeconomic effects could emerge in a prolonged period of global commodity price declines coupled with decreasing or weak household consumption.

Per Cent of Consumers Expecting Price Declines over the Next 12 Months



Source: NSI: Consumer Survey.

Per Cent of Firms Expecting Selling Price Declines over the Next Three Months



Trade, six-month moving average

Services, six-month moving average

Industry, six-month moving average

Source: NSI: Business Survey in Industry, Trade and Service Sector.