

Economic Review

4/2013



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

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Abbreviations

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

The global composite PMI indicator increased throughout 2013, recording a substantial improvement in the euro area and the USA. The decline in the euro area economy moderated to 0.3 per cent on an annual basis in the third quarter, retaining the diverse growth rate dynamics by country. Economic growth in the USA boosted to 2 per cent in the third quarter of 2013 and according to preliminary data to 2.7 per cent in the fourth quarter. In 2013 China's real GDP increased by 7.7%, with growth slightly moderating in the fourth quarter. Global annual inflation continued to moderate in the fourth quarter, showing signs of stabilisation at the end of 2013. Based on leading economic indicators we may expect a gradual increase in global economic activity in the first half of 2014, with developed economies contributing most to this growth by mid-2014.

The Brent crude oil price posted a slight decline in the fourth quarter of 2013 as a result of higher production, growing US oil inventories and subsiding political instability in the Middle East. These factors are expected to remain in the first half of 2014 and to contribute to a decrease in crude oil prices with a moderating rate of decline. Between October and December 2013 international prices of most commodity groups in euro continued to fall, though at a slower rate than in the previous two quarters. Prices are expected to continue falling at a moderating rate in the first half of 2014.

In the January–November 2013 period the surplus on the overall balance of payments current and capital account balance tended to gradually increase in Bulgaria driven by the strong growth rate of exports, moderate growth of imports and the positive net current transfers from the EU. Financial flow dynamics was driven by banks' transactions, foreign direct investment in Bulgaria, the November issues of corporate bonds and government debt repayment in January. This resulted in a net deficit on the financial account which led to a decrease in Bulgaria's international foreign exchange reserves on an annual basis. The overall current and capital account balance is expected to remain positive on an annual basis in the first two quarters of 2014, albeit gradually moderating, due to the expected gradual recovery in domestic demand which will prompt an increase in the trade deficit.

The sustained high household savings rate continues to boost attracted funds growth in the banking system, which coupled with comparatively low demand for loans predetermined the banks' ample liquidity. Banks continued to keep part of their liquidity in the form of excess reserves with the BNB and in government securities, primarily of the Bulgarian government. A substantial part of their liquidity was used for purchasing foreign assets and reducing foreign liabilities. These developments resulted in a positive balance of net foreign assets of banks since August 2013. The downward trend observed since April in balances kept by banks on accounts in the TARGET2–BNB was sustained until year-end.

In 2013 annual growth of credit to the non-government sector slowed down due to lower lending to non-financial corporations, while banks' claims on households reported an insignificant decline. Low demand for loans in the context of still weak economic activity and the sustained high household savings rate were the key factors determining the trends in lending. Broad money growth is expected to remain relatively high in the first half of 2014. As a result banks will continue to operate under the conditions of high liquidity. Given the expected gradual recovery of economic activity growth rates of loans to the non-government sector are projected to slowly accelerate.

Economic activity in Bulgaria increased in the third quarter of 2013, largely reflecting export growth. High exports were due to the economic growth recovery in Bulgaria's major trading partners, prede-

termining the positive contribution of net exports to growth. Domestic demand continued to rise at a low rate close to that in the first and second quarters of 2013. Firms remained cautious in hiring staff and households in consumption. Households opted to retain their high savings rate, which led to a 0.1 per cent decrease in private consumption growth. In real terms, investment matched its second quarter's level, though slightly increasing nominally. Seasonally adjusted national accounts data show that total employment between July and September remained at levels close to those in the second quarter. According to seasonally adjusted data of the NSI Labour Force Survey, unemployment stood unchanged at 12.8 per cent in the third quarter.

In the first half of 2014 economic activity in Bulgaria is expected to gradually accelerate in the context of a moderate recovery in private consumption and investment activity of firms, boosting import growth rates. At the same time, we project a slower rise of exports after the high rates registered in the first nine months of 2013. As a result, the contribution of net exports will decline due to matching import and export growth rates. Should an accelerated revival in Bulgaria's major trading partners materialise, goods and services exports may recover more strongly than projected. A low risk exists, however, for deflationary processes to last longer than expected. This would cause declines in firms' trading profit and revenue and postponement of new investment projects which will have a negative effect on economic growth.

MF preliminary data show that consolidated fiscal programme deficit for 2013 was BGN 1448.4 million (1.8 per cent of GDP), which is BGN 144.9 million (0.2 per cent of GDP) below the approved level in Amendments to the 2013 State Budget Law. Between January and December total revenue on consolidated fiscal programme was BGN 28,981 million or 95.4 per cent of planned budget revenue in 2013 budget amendment. Concurrently, total government expenditure, including Bulgaria's contribution to the EU budget, amounted to BGN 30,430 million or 95.2 per cent of the amended annual target. According to the State Budget Law for 2014 and latest government's medium-term budget projections of January 2014, consolidated fiscal programme cash deficit is planned to reach 1.8 per cent of GDP forecast (BGN 1472.3 million). In the first two quarters of 2014 government consumption is likely to have a low positive contribution to GDP growth.

In 2013 consumer price inflation followed a clear downward trend. Between August and December it was negative, with a tendency to a gradual slowdown observed over the last few months. By end-2013 the Harmonised Index of Consumer Prices fell by 0.9 per cent on an annual basis, and average annual inflation accounted for 0.4 per cent.

The largest contributions to the downward inflation dynamics came from the decreased price of electricity for households and lower international commodity prices. The latter added to the fall in food and fuel consumer price indices in Bulgaria. Simultaneously, the weak dynamics of household consumption affected the price behaviour of firms, triggering expenditure restraint policy amid stabilisation or a slight decline in goods and services prices. In December 2013 core inflation (including services and non-food prices, excluding fuels) was negative at -0.7 per cent on an annual basis and 0.1 per cent on an average annual basis.

In the first quarter of 2014 the slight CPI fall is expected to be retained on an annual basis, largely due to the negative contribution of administratively controlled prices. In the second quarter the fall in prices is expected to come to a halt due to the gradually reduced negative contribution of controlled prices and the low positive inflation in food and fuel prices.

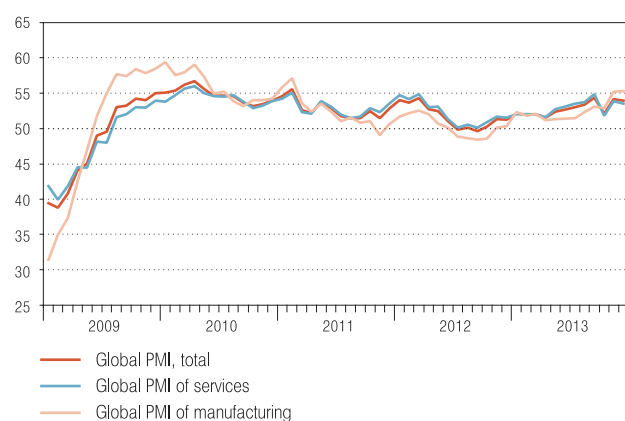
1. External Environment

The global composite PMI indicator increased throughout 2013, recording a substantial improvement in the euro area and the USA. In the second half of the year world trade set to grow faster. In 2013 the fall in euro area economy moderated to 0.3 per cent on an annual basis in the third quarter, retaining the diverse growth rate dynamics by country. Economic growth in the USA boosted to 2 per cent in the third quarter and according to preliminary data to 2.7 per cent in the fourth quarter of the year. Global annual inflation continued to moderate in the fourth quarter, showing signs of stabilisation at the end of 2013. In December annual inflation in the euro area came to 0.8 per cent against 0.9 per cent in November, while in the USA it reported a slight increase. Responding to lower euro area inflation, in November ECB lowered the interest rate on its main refinancing operations by 25 basis points to 0.25 per cent and on the marginal lending facility to 0.75, and kept the interest rate on the deposit facility unchanged at 0 per cent. Based on leading economic indicators we may expect a gradual increase in global economic activity in the first half of 2014, with developed economies contributing most to this growth by mid-2014.

Current Business Situation

Following the gradual increase throughout the year the global economic indicator (global PMI) stabilized and remained high at the end of 2013. In the fourth quarter of 2014 leading indicators in the manufacturing sector increased sizeably largely reflecting expectations of new orders and export orders. Over the same period services sector dynamics moderated owing to the weaker new business expectations.

Global PMI



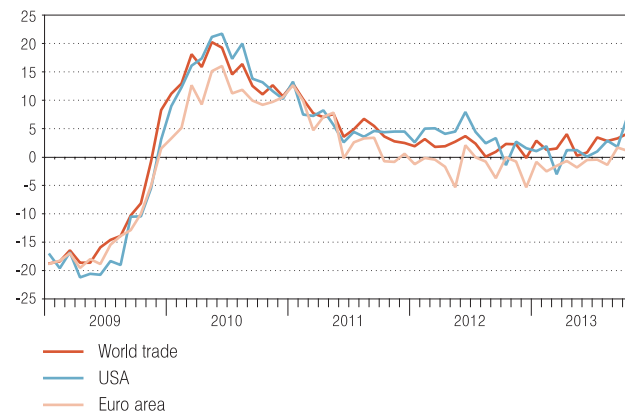
Source: JP Morgan.

The last quarter of 2013 saw divergent economic indicators dynamics by region. The PMI indicators in the euro area and in the USA improved significantly mainly due to the positive sentiment in the manufacturing sector. On the other hand, services sector and manufacturing sector expectations

weakened slightly in China by the close of the year, signalling moderation of economic growth.

World Trade

(annual rate of volume growth, per cent)



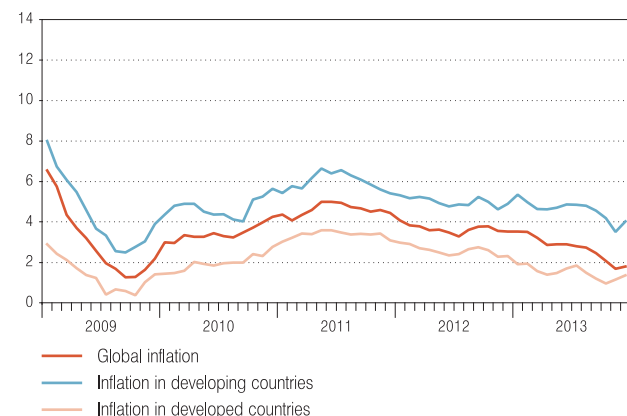
Source: CPB Netherlands Bureau for Economic Policy Analysis.

In the third and in the beginning of the fourth quarter international trade volumes increased significantly. Emerging economies remained the key contributor to growth, but a sizeable growth rate acceleration was also observed in developed economies. The US foreign trade turnover increased markedly, while in September and October the euro area indicator reported an increase for the first-time in fourteen months.

Based on leading economic indicators we may expect a gradual increase in global economic activity in the first half of 2014, with developed economies contributing most to this growth by mid-2014.

Inflation Measured through CPI

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



Note: The World Bank measures CPI changes in individual groups as a weighted median of CPI changes in the countries, included in each group. To construct the weights of individual countries, data on the real GDP at PPP have been used. Only members of the World Bank Group are included in the groups and are classified as developing and developed countries.

Source: World Bank.

Global annual inflation continued to moderate in the fourth quarter, showing signs of stabilisation at the end of 2013. The main factor behind this fall was the low price dynamics in the main commodity groups and energy products traded on international markets. Inflationary pressure subsided significantly in developing economies and only marginally in developed economies.

Euro Area

In the third quarter of 2013 euro area real GDP declined by 0.3 per cent on an annual basis compared with 0.6 per cent fall in the previous quarter.¹ Data by country show highly divergent rates of change in euro area countries GDP. Economic growth in Germany and France came to 0.6 per cent (0.5 per cent in the previous quarter) and 0.2 per cent (0.5 per cent in the previous quarter) on an annual basis respectively. The fall came to 1.1 per cent on an annual basis in Spain from -1.6 per cent in the second quarter, and to 1.8 per cent in Italy from -2.2 per cent in the previous quarter. In the third quarter of 2013 Cyprus and Greece reported the most sizeable decline in GDP on an annual basis of -5.6 per cent and -3 per cent².

Real GDP grew 0.1 per cent on a quarter-on-quarter basis in the July–September period (0.3 per cent in the second quarter). GDP components reporting positive contribution to growth

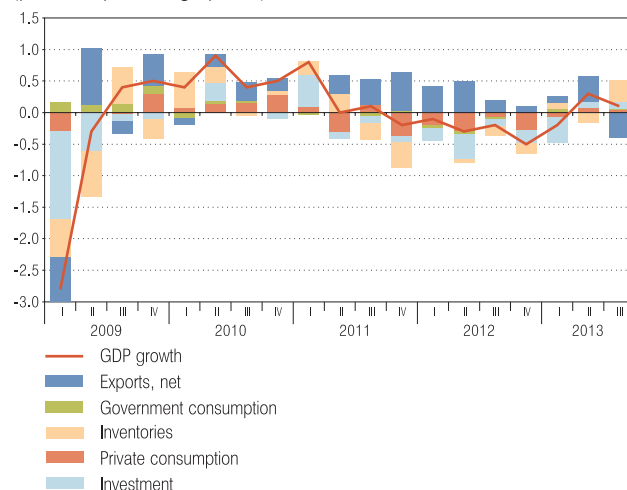
¹ Eurostat data.

² Data have not been seasonally adjusted.

were inventories (0.3 percentage points) and investment (0.1 percentage points). Net exports had a negative contribution of -0.4 percentage points: household and government consumption were almost neutral as regards their contribution to growth and the overall domestic demand contribution was +0.5 percentage points.

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

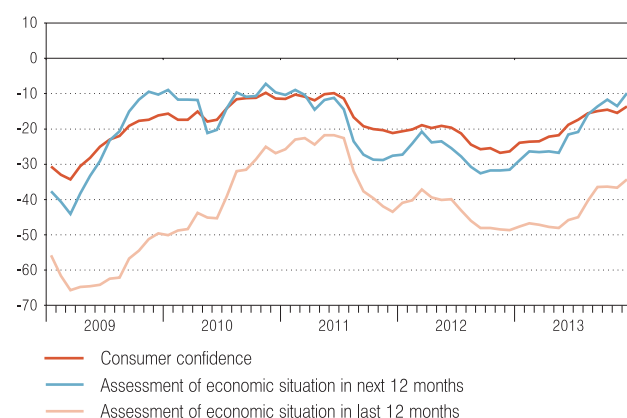
(per cent; percentage points)



Source: Eurostat.

The leading economic indicators reported improvements in 2013 – a trend which continued in January 2014. The economic sentiment index in the euro area published by the European Commission (EC) increased to 100.9 in January 2014 from 100.4 in December, and the business climate indicator came to 0.19 from 0.20 per cent in December 2013. The EC consumer confidence index in the euro area also went up to -11.7 in January, from -13.5 in December.

Euro Area Consumer Confidence Indices

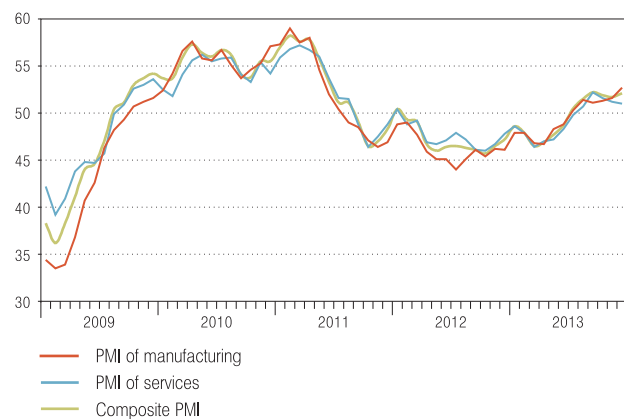


Source: European Commission.

PMI indices in the euro area also increased over the year outstripping, albeit slightly, the neutral

level of 50. In December 2013 the composite PMI was 52.1 (51.7 in the previous month) and the sub-indices of manufacturing and services were 52.7 и 51 respectively (51.6 and 51.2 in November). According to preliminary data for January 2014 the overall index rose to 53.2 and the indicators for manufacturing and services went up to 53.9 and 51.9 respectively. These PMI values (above the neutral level of 50) point to expectations of slight acceleration of overall growth in the economy and in individual sectors.

Manufacturing and Services PMIs



Source: Markit.

The analysis of economic indicators in the euro area gives grounds to expect weak economic growth in the euro area in the fourth quarter of 2013 and in the first quarter of 2014. According to the latest ECB forecasts of December 2013, GDP growth will remain between 0.4 per cent and 1.8 per cent in 2014 (previous forecast for September: 0–2 per cent) and between 0.4 and 2.6 per cent in 2015.

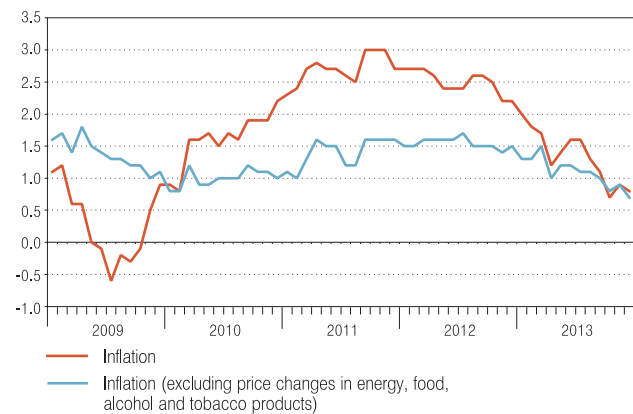
In December annual inflation in the euro area came to 0.8 from 0.9 per cent in November. The month-on-month HICP went up by 0.3 per cent in December (down 0.1 per cent in November). The main reason behind lower inflation was the fall in the prices of telecommunication services (-0.14 percentage points), fuels (-0.13 percentage points) and healthcare services (-0.07 percentage points). Core inflation in the euro area came to 0.7 per cent on an annual basis in December compared to 0.9 per cent in November.

By country the lowest annual inflation in December was reported in Greece (-1.8 per cent), Cyprus (-1.3% per cent) and Portugal (0.2 per cent). Estonia, Austria and Finland reported

the highest values of 2.0, 2.0 and 1.9 per cent respectively. A gradual increase in inflation has been observed in Austria and Finland for several months, while consumer prices in Estonia reported the opposite trend. In December annual inflation in Germany declined to 1.2 per cent from 1.6 per cent in November and in France remained at its previous month level of 0.8 per cent.

Euro Area Inflation Rate

(per cent, on same period of previous year)



Source: Eurostat.

According to the December ECB projections, inflation in the euro area will be 1.1 per cent on average in 2014 compared to 1.4 per cent on average in 2013 and is expected to accelerate slightly to 1.3 per cent on average in 2015.

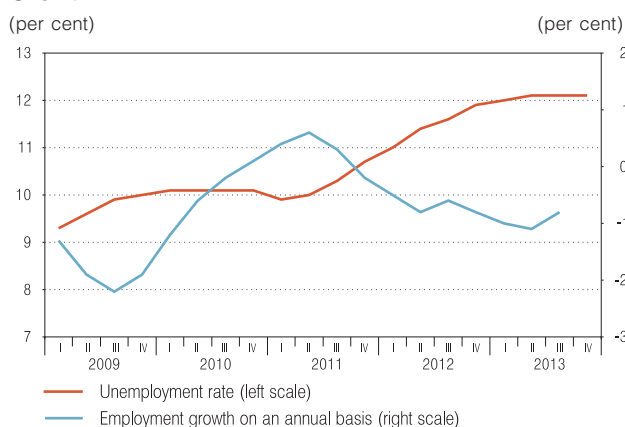
Weak economic activity in the euro area continued to weigh negatively on labour market conditions. In the third quarter of 2013 the number of employed decreased by -0.8 per cent on an annual basis (compared with -1.0 per cent in the second quarter). In 2013 unemployment remained stable at more than 12.0 per cent, and in November stood at the October level of 12.1 per cent. The highest unemployment by country was reported in Greece³ (27.4 per cent) and Spain (26.7 per cent), and in Portugal (15.5 per cent), where a deceleration is taking place. Austria and Germany still report the lowest level of unemployment at 4.8 per cent and 5.2 per cent.

The indicator of the expected rate of unemployment over the next twelve months included in the EC consumer confidence index rose slightly on the previous quarter to 29.2 in December (up 0.6 points). The average level of the subindex for the fourth quarter of 2013 (30 points) was

³ The latest data available are for September 2013.

slightly above the average for the third quarter of 29.8 points. The changes in this indicator support the expectations for still weak labour demand in the euro area in the following months.

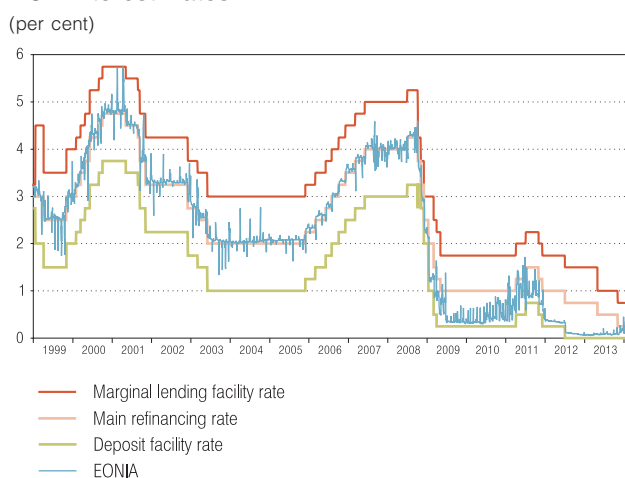
Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

In the fourth quarter of 2013 the ECB cut the main refinancing rate by 25 basis points to 0.25 per cent and the interest rate on the marginal lending facility to 0.75 per cent and left the deposit rate unchanged at 0 per cent. Hence, the standing facilities' corridor was narrowed unilaterally by 25 basis points to -25/+50 basis points. The decision was taken at the ECB monetary policy meeting of 7 November 2013 and following the publication of unexpectedly low euro area inflation data in October 2013. The ECB pointed out that the euro area may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to 2 per cent later on.

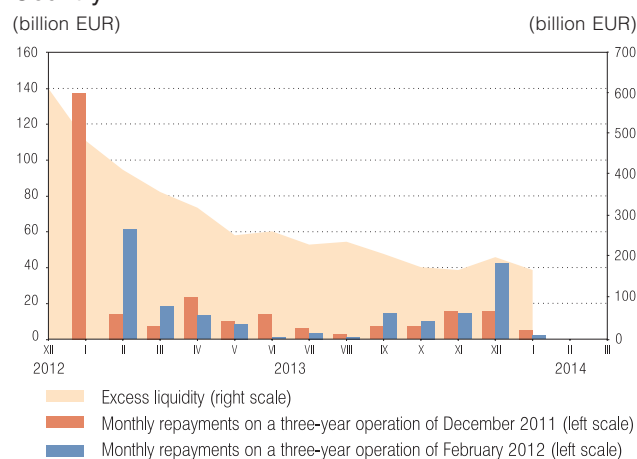
ECB Interest Rates



Source: ECB.

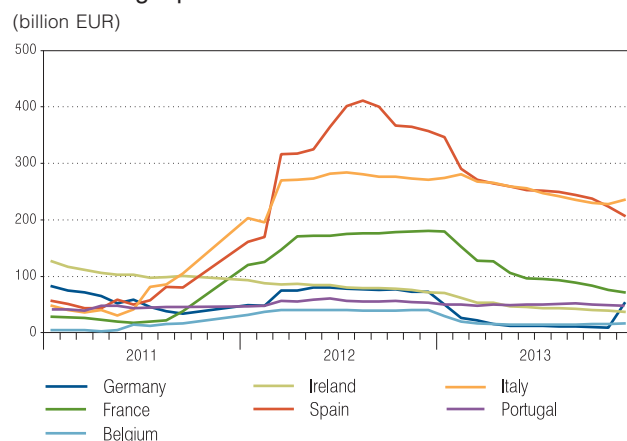
At its monetary policy meeting in November the ECB decided that the unlimited distribution of liquidity on the main, one-month and long-term refinancing operations (MROs) will last at least until the end of the sixth maintenance period for 2015 ending on 7 July 2015. The interest rate on main and one-month refinancing operations remained fixed and that on three-month longer-term refinancing operations, to be allotted until mid-2015, will be fixed at the average rate of the MROs for the period.

Bank Participation in ECB Refinancing Operations by Country



Source: ECB.

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



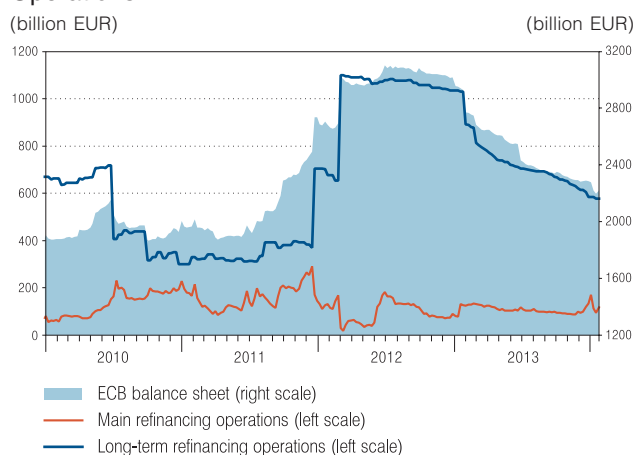
Source: National central banks of respective countries.

At its first monetary policy meeting of 9 January 2014 the ECB reiterated that they continue to expect euro area interest rates to remain at present or lower levels for an extended period of time. The institution pointed out that they stand ready to take decisive actions, if necessary, using all available monetary policy instruments. They outlined two scenarios that would cause them to act: one is an unwarranted tightening of

the short-term money markets, and the other one is a worsening of the medium-term outlook for inflation.

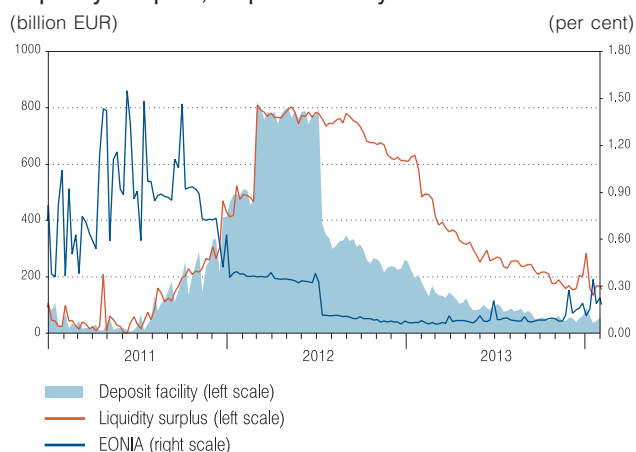
As of 27 December 2013 repayments on the December 2011 three-year operation amounted to EUR 259.4 billion with a residual refinancing value of EUR 229.7 billion. Repayments of EUR 186.9 billion were made on the three-year operation of February 2012 and the outstanding amount came to EUR 342.6 billion. In net terms, 89 per cent (gross 44 per cent) of the funds allotted through the two LTROs were refunded. In the fourth quarter of 2013 banks in Spain, Italy and France made the most significant repayments, with the outstanding amounts on ECB long-term refinancing operations going down by EUR 38.8 billion to EUR 20.3 billion and EUR 17.9 billion. At present, around 70 per cent of the ECB long-term refinancing is provided to Spanish (outstanding amount: EUR 186.9 billion) and Italian banks (outstanding amount EUR 213.7 billion).

ECB Balance Sheet Figure and Refinancing Operations



Source: ECB.

Liquidity Surplus, Deposit Facility and EONIA

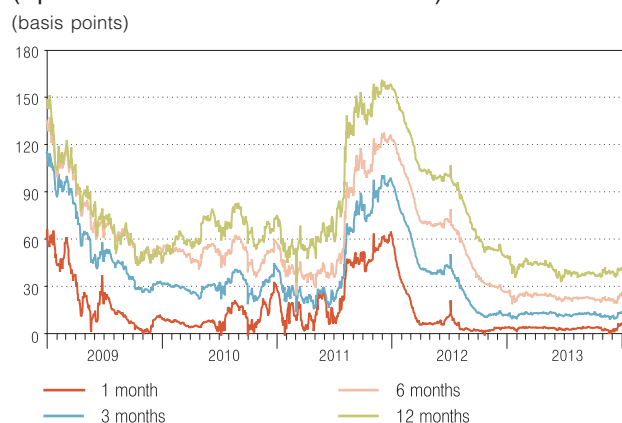


Source: ECB.

By the end of 2013 euro area banking system liquidity surplus⁴ decreased to EUR 162 billion (from EUR 211 billion at the end of the third quarter) owing to the increase in autonomous liquidity factors⁵ of EUR 6.5 billion to EUR 330.7 billion and the decrease of EUR 50.3 billion in refinancing operations to EUR 716.9 billion. The balance sheet of the ECB shrank by 2.3 per cent on the end of September and came to EUR 2.285 trillion on 27 December 2013.

In the fourth quarter of 2013 euro area market interest rates increased. The EONIA reference overnight interest moved within the interval of 0.07 per cent and 0.45 per cent, reporting 0.12 per cent average value for the October–December period (compared with 0.09 per cent in the third quarter). The broader volatility interval reflected the spike in EONIA to 0.45 per cent on the last day of the calendar year, mostly related to technical factors. EONIA was highly volatile in early 2013 mainly due to the reduction in the excess liquidity in the banking system of the euro area.

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



Source: European Banking Federation.

EURIBOR deposit interest rates on interbank market deposits increased, reporting more pronounced changes in the short-term maturity sector. On 31 December 2013 one-month interest rates were 0.22 per cent (+9 basis point on end-September 2013), and those with maturities of six and 12 months reached 0.39 per

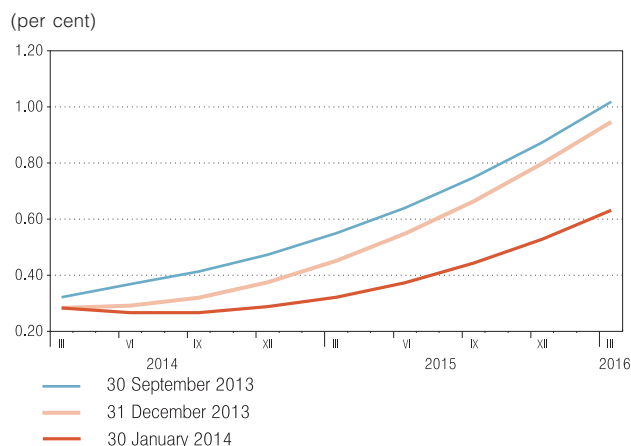
⁴ Excess liquidity is measured as the difference between the outstanding amount of ECB refinancing operations and two covered bond purchase programmes and the amount of required reserves and autonomous factors.

⁵ Autonomous factors are liquidity factors that are not under the direct control of the ECB and include banknotes in circulation and government deposits with the national central banks.

cent (+5 on end-September) and 0.56 per cent (+2 basis points on end-September). Credit and liquidity risk premia measured by the spread between EURIBOR and OIS increased slightly. Risk premia in the three- and six-month segments ended the period at a level of 13 basis points (+1 basis point against the end of September 2013) and 24 basis points (+2 basis points against the end of September).

As of 30 January 2014 market expectations derived from the prices of three-month EURIBOR futures contracts pointed to a retention of the reference interest rate which stood at 0.25 per cent until the end of 2013 and to a possible increase in early 2016.

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



Source: European Banking Federation.

The Balkan Region

In the third quarter of 2013 economic activity in most Balkan countries accelerated significantly and in other countries the rate of decline moderated. Greece and Croatia continued to report a contraction in their economies, though at a slower pace. Turkey and Romania exhibited the highest growth.

In the third quarter of 2013 industrial production in **Bosnia and Herzegovina** increased further, with manufacturing and energy production sectors contributing most substantially to growth. By the end of the second quarter of 2013 unemployment decreased by 0.5 percentage points.

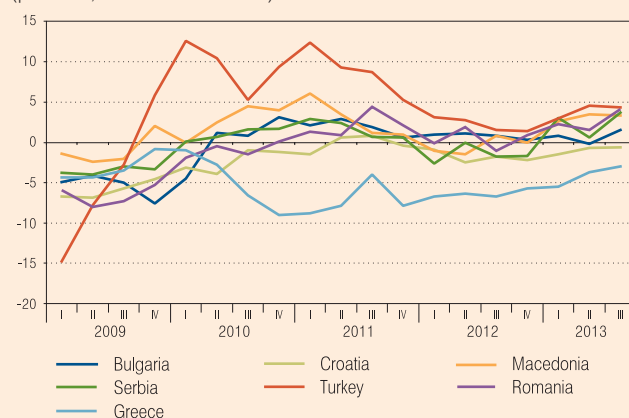
Macedonia's real GDP posted growth for a fifth consecutive quarter, net exports contributing most significantly to this. Year-on-year growth was reported in all economic sectors, with the industrial output and information and communications sectors exhibiting the highest growth rate. The unemployment rate continued to fall for a third consecutive quarter. Annual inflation also slowed down compared with the first quarter of 2013, reflecting mostly falls in international prices of fuels and foods. In July the central bank cut its base interest rate by 25 basis points to 3.25 per cent to encourage lending activity.

In the third quarter of 2013 the economic activity in **Greece** contracted further and the downward trend in economic slowdown was sustained. Private consumption again contributed most strongly to the annual decline in the real GDP. Net exports and gross capital formation had positive contributions, giving the first positive sign of a recovery in the Greek economy. On an annual basis, value added in construction and information and communications services posted a strong decline, while real estate operations and public services exhibited an increase. Employment continued to decline at a slower pace, while unemployment slightly increased. In the third quarter of 2013 inflation measured by the Harmonized Index of Consumer Prices (HICP) accelerated on the corresponding period of the previous year reflecting mainly price declines in transport services.

The rate of **Romania's** real GDP growth accelerated throughout 2013. In the third quarter net exports and private consumption contributed to the strengthened economic activity, while the contribution of investment and government consumption was negative. Between July and September gross value added went up significantly in agriculture and industry (excluding construction), while public services and trade exhibited a contraction. Enhanced economic activity helped subdue unemployment which is the lowest in the region. In the third quarter the average annual inflation in Romania slowed down compared with the first half of the year reflecting the lower prices of

Real GDP Growth Rate

(per cent; on an annual basis)



Sources: Eurostat, statistical institutes of relevant countries, BNB calculations.

transport and communication services. The lower inflation rate allowed Romania's central bank to continue gradually cutting the reference interest rate to 4.5 per cent in August. By the end of 2013 and in early 2014 the reference interest rate was again cut to 3.75 per cent in January.

Serbia's real GDP growth rate accelerated significantly in the third quarter of 2013. Net exports contributed most strongly to growth, while domestic demand exhibited a contraction. The unemployment rate slowed down in line with increased employment. Between July and September inflation in Serbia further slowed down due mainly to falling prices of agricultural produce, weak domestic demand and relatively stable dynamics of the exchange rate of the Serbian dinar. Given the low inflationary pressure in October and November the central bank of Serbia cut by 0.5 percentage points each month its reference interest rate to 10 per cent. In October the medium-term inflation target was adopted: in 2015 and 2016 the inflation rate is to be maintained at 4 per cent deviating by +/-1.5 percentage points.

Turkey's real GDP continued to grow at high rates in the third quarter of 2013. Private consumption and investment

contributed most significantly to growth, while the slowdown in net exports limited real GDP growth. Financial intermediation and manufacturing were the largest contributors to the increase in gross value added, while mining solely exhibited a further decline. In the third quarter the upward trend in unemployment accelerated despite real GDP growth, reflecting to a certain extent the increase in the economic activity ratio. Over the review period inflation accelerated as a result of higher food and transport services prices, while services price movements helped dampen inflationary pressure. The upward developments in the overall price level and strengthened eco-

Real GDP Growth on an Annual Basis (per cent, three-month not seasonally adjusted data)

Country	2010				2011				2012				2013		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Bulgaria	-4.5	1.2	0.8	3.1	2.1	2.9	1.9	0.6	1.0	1.1	0.8	0.3	0.8	-0.2	1.5
Greece	-1.0	-2.8	-6.6	-9.0	-8.8	-7.9	-4.0	-7.9	-6.7	-6.4	-6.7	-5.7	-5.5	-3.7	-3.0
Croatia	-3.1	-3.9	-1.0	-1.2	-1.5	0.6	0.8	-0.4	-0.9	-2.5	-1.8	-2.2	-1.5	-0.7	-0.6
Romania	-1.9	-0.5	-1.5	0.1	1.3	0.9	4.4	2.1	-0.1	1.9	-1.1	0.9	2.2	1.5	4.1
Macedonia	0.0	2.5	4.5	4.0	6.1	3.5	1.2	1.0	-1.1	-1.5	0.8	0.0	2.6	3.5	3.3
Serbia	0.1	0.7	1.6	1.7	2.9	2.4	0.7	0.6	-2.6	0.0	-1.8	-1.7	3.0	0.6	3.7
Turkey	12.6	10.4	5.3	9.3	12.4	9.3	8.7	5.3	3.1	2.8	1.5	1.4	3.0	4.5	4.4

Growth and Contribution to Real GDP Growth on an Annual Basis (per cent; percentage points)

Country	GDP growth, third quarter of 2013	Private consumption	Government consumption	Investment	Exports, net
Bulgaria	1.5	0.1	0.8	0.1	1.0
Greece	-3.0	-5.5	0.0	1.2	1.1
Croatia	-0.6	0.1	-0.2	-0.8	-0.1
Romania	4.1	1.1	-0.8	-0.5	3.4
Macedonia	3.3	1.2	-0.7	-5.1	7.3
Turkey	4.4	3.4	0.1	3.2	-2.2

Note: Non-additive data on contributions due to chain-linked adjustment of GDP data.

Inflation on an Annual Basis (per cent, three-month data)

Country	2010				2011				2012				2013		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Bulgaria	1.9	2.9	3.3	4.0	4.5	3.4	3.1	2.5	1.9	1.8	3.0	2.8	2.2	1.1	-0.7
Greece	3.0	5.1	5.6	5.1	4.5	3.3	2.1	2.6	1.7	1.1	0.8	0.6	0.0	-0.4	-0.8
Croatia	1.1	0.8	1.0	1.4	2.2	2.3	2.0	2.4	1.7	3.2	4.1	4.4	4.2	2.4	2.2
Romania	4.6	4.3	7.5	7.8	7.5	8.3	4.2	3.4	2.7	2.1	4.2	4.7	4.8	4.4	2.4
Macedonia	1.3	1.9	2.3	3	3.8	4.5	3.6	3.5	2.5	2.1	3.8	3.8	3.5	3.6	3.3
Serbia	4.5	4.0	6.5	9.6	12.6	13.6	10.7	7.9	4.7	4.1	8.1	12.3	12.1	10.4	6.9
Turkey	9.3	9.2	8.4	7.4	4.3	5.9	6.4	9.2	10.5	9.4	9.0	6.8	7.2	7.0	8.3

Note: Inflation in EU-27 countries is measured by the change in HICP. The national CPI is used for inflation in the other countries.

Unemployment (per cent, three-month seasonally adjusted data)

Country	2010				2011				2012				2013		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Bulgaria	9.3	10.1	10.5	11.2	11.2	11.2	11.2	11.5	12	12.2	12.3	12.6	12.9	12.9	12.8
Greece	11.2	12.1	12.8	14.1	15.3	16.7	18.3	20.6	21.9	23.8	25.5	26.2	26.6	27.4	27.6
Croatia	10.3	12.2	12.6	12.2	13.1	13.7	13.4	13.9	15.1	15.0	15.8	17.5	17.0	17.1	17.8
Romania	7.5	7.2	7.2	7.2	7.2	7.4	7.5	7.4	7.3	7.1	7.0	6.7	7.1	7.4	7.3
Macedonia	33.5	32.1	31.7	30.9	31.2	31.3	31.2	31.2	31.6	31.2	30.6	30.6	29.9	28.8	28.7
Turkey	11.5	10.7	10.5	9.9	9.2	9.2	8.6	8.2	8.2	8.0	8.1	8.3	8.4	8.6	9.1
	April	October			April	November			April	October			April	Oct.	
Serbia*	22.2	19.2			25.5	23.7			25.5	22.4			24.1	20.1	

* Labour force survey in Serbia is conducted twice a year within one calendar month.

Sources: Eurostat, statistical institutes and central banks of relevant countries, BNB calculations.

conomic activity allowed the central bank of Turkey to raise its reference interest rate by 1.25 percentage points to 7.75 per cent in August.

In the third quarter **Croatia** again reported negative economic growth, albeit at a slower rate since early 2013. Between July and September private consumption alone had a positive contribution to real GDP growth, while investment exhibited the strongest contraction. The tourism sector reported an increase in gross value added by 2.7 per cent on an annual basis. The subdued economic activity in industry (excluding construction) and construction were the reason behind the employment decline and higher unemployment in these sectors. In the third quarter of 2013 inflation went down to 2.2 per cent impacted by falls in international raw materials prices and weak domestic demand. In December the central bank of Croatia decreased banks' minimum required reserve ratio from 13.5 per cent to 12 per cent to encourage lending.

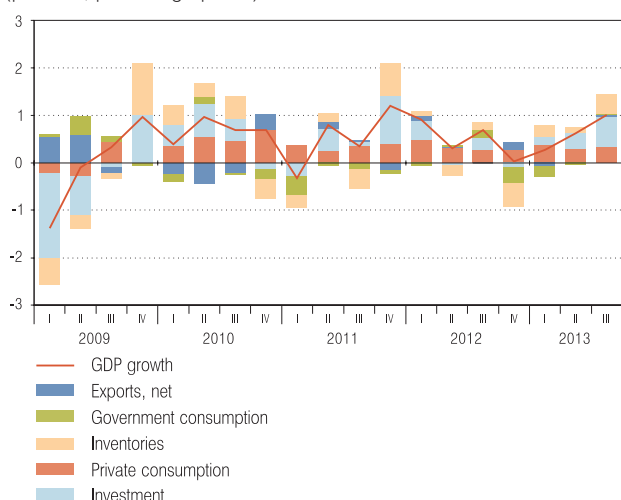
Industrial production in **Montenegro** increased by 8.8 per cent on an annual basis in the July–September 2013 period, gross value added posting growth in energy (by 58.8 per cent) and mining and quarrying (by 1.1 per cent). Manufacturing reported a slowdown (-14.9 per cent). The number of tourists who visited the country went up 3 per cent between January and September 2013 and the duration of their stay fell by 2.3 per cent. The average annual inflation in the third quarter was 0.7 per cent. Alcohol and tobacco products and transport services contributed most to the increase in the overall price level.

United States

Economic growth in the USA accelerated to 2 per cent on an annual basis in the third quarter of 2013 from 1.6 and 1.3 per cent in the second and first quarters respectively.

Contribution to US GDP Growth by Component (Quarterly)

(per cent; percentage points)



Source: Bureau of Economic Analysis.

US economic growth also accelerated to 1 per cent on a quarter-on-quarter basis between July and September from 0.6 per cent in the previous quarter. Higher growth rate reflected the significant positive contribution of changes in inventories. Household consumption and net exports also reported robust growth, as well as consumption and investment in the government sector, the latter two having negative contribution to overall growth in the previous quarter. In the third quarter net imports made positive contribu-

tion to growth due to the significant slowdown in imports of goods and services in the USA. The positive contribution of the government sector reflected the robust consumption and investment at state and local levels, while federal government made negative contribution.

Based on preliminary data in the fourth quarter of 2013, US real GDP growth was 0.8 per cent on a quarterly basis and 2.7 per cent on an annual basis. The moderation in growth in the third quarter was largely due to the negative contribution of the government sector and the lower contribution of the changes in inventories. The flash estimate about GDP growth in 2013 suggests a moderation to 1.9 per cent against 2.8 per cent in 2012.

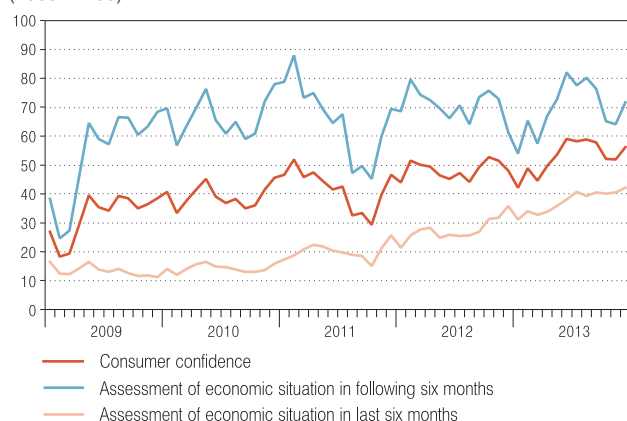
In the fourth quarter of 2013 there were diverse but positive changes in US leading economic activity indicators. The contradictions between democrats and republicans in the US congress on the fiscal policy pursued just before the outburst of the new financial crisis on 1 October had a significant impact on business and consumer sentiment. These disagreements prompted the financial crisis and caused the partial government shutdown in the USA between 1 and 16 October after Congress failed to approve appropriating funds. The crisis came as a result of the desire of the Republican Party (having majority in the lower house) to use the need for a Congress resolution on the debt-ceiling increase and approval of the state budget for the 2014 financial year as a tool to exert pressure on the government in order to stop the healthcare or the so-called Obamacare reform.

The compromise reached between Democrats and Republicans on 16 October 2013 ensured federal government funding until 15 January 2014 and temporarily lifted the Treasury's debt ceiling until 7 February. This gave the necessary time to find a long-term decision for overcoming fiscal uncertainty. By mid-December 2013 the so-called budgetary agreement set the level of government expenditure for 2014 and 2015 and prevented a new shutdown of federal government until October 2015. The agreement also provided for a reduction in automatic spending cuts set for March 2013. In relation to the expiration of government funding (on 15 January), the Congress passed a new law which provides for the allocation of the appropriations agreed in December 2013 until the end of the 2014 financial year. This was another step towards the normalisation of the budget process. The probability of further confrontation between Democrats and Republicans in the Congress regarding the need for a new upward revision of the Treasury debt ceiling in February is relatively low.

The fiscal crisis and its resolution had a more significant impact on consumer confidence indicators. Consumer confidence measured by the University of Michigan index fell to 73.2 percentage points from 77.5 percentage points in September. In the next two months this indicator increased, reaching 82.5 percentage points in December. Leading Conference Board Consumer Confidence Index reported similar changes in the fourth quarter of 2013.

US Consumer Confidence Indices

(2000 = 100)



Source: The Conference Board.

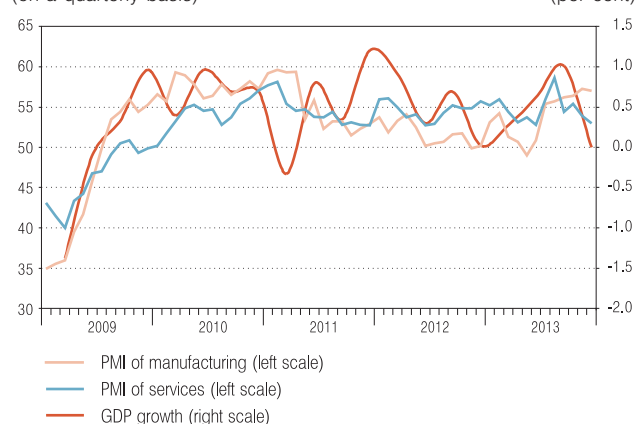
The increase in the consumer confidence indices by the close of the year was observed together with enhanced monthly growth rate in consumer expenditure and retail sales. Individual consumer

spending increased by 0.5 per cent on a monthly basis in November compared with a 0.4 per cent growth in the previous month. Retail sales increased by 0.2 per cent on a chain basis in December (0.4 per cent in November and 0.5 per cent in October) and their annual growth rate moderated slightly to 4.1 per cent in December (4.2 per cent in November). Lower growth rate in December was largely due to the 1.8 per cent fall in automobile sales, which were strongly affected by bad weather conditions. Retail sales (excluding automobiles) picked up by 0.7 per cent on a monthly basis compared with a 0.2 per cent increase in November.

US Manufacturing and Services ISM-PMI and GDP Growth

(on a quarterly basis)

(per cent)



Source: Institute for Supply Management.

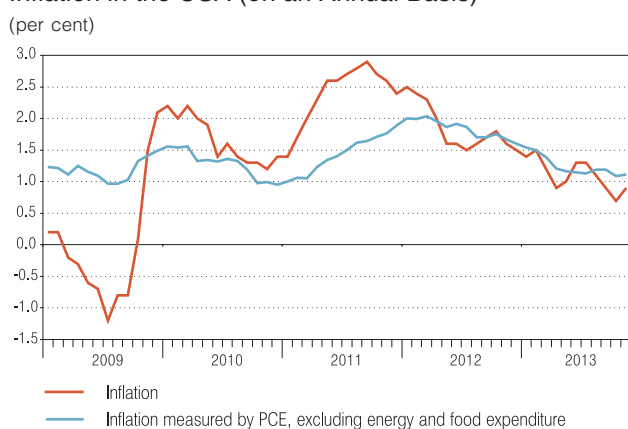
In the fourth quarter of 2013 industry and service indicators reported divergent developments. In November 2013 the ISM-PMI manufacturing index rose to 57.3, the highest since April 2011, and in December reported a marginal fall, reaching 57 percentage points. The ISM-PMI for the services sector fell from 53.9 percentage points in November to 53 percentage points in December – the lowest level reported in 2013. However, the indicator remained above the 50 percentage points limit which signalled higher economic activity.

In the fourth quarter of 2013 recovery in the housing sector continued at a relatively lower pace. The S&P/Case-Shiller 20-City Composite House Price Index rose to 13.6 per cent in October from 13.3 per cent in September. In December employment in the construction sector reported a decline on the previous two months. At the end of 2013 new residential construction activities moderated and building permits reported a decline on an annual basis, largely

reflecting the unfavourable weather conditions. In December the National Association of Home Builders (NAHB) index dropped to 56 percentage points from 57 in November, but remain high above the 50 percentage point limit. Each value above 50 indicates that most interviewed home builders view sales conditions as good.

The annual inflation rate measured by the personal consumption expenditure deflator (PCE) increased to 0.9 per cent in November from 0.7 per cent in the previous month. The annual growth rate of the core PCE price index (excluding food and fuel) remained unchanged at 1.1 per cent in November for a second consecutive month.

Inflation in the USA (on an Annual Basis)



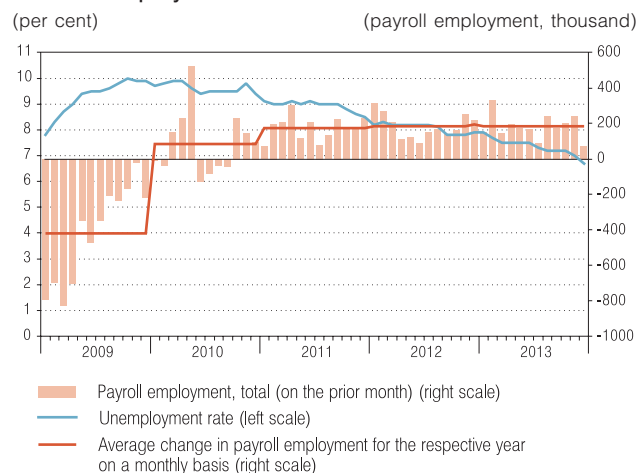
Note: Inflation is measured by the personal consumption expenditure deflator.

Source: Bureau of Labor Statistics.

The other US inflation indicator – the annual rate of increase in the consumer price index, accelerated to 1.5 per cent on an annual basis in December compared with 1.2 per cent in November. Core CPI annual growth rate remained at 1.7 per cent in December for a fourth consecutive month.

Consumer price inflation expectations in the up to one year horizon and up to five years horizon, which are components of the University of Michigan consumer confidence index, were relatively stable in the fourth quarter of 2013 and in early 2014. According to preliminary data for January 2014, short-term inflation expectations remained unchanged from December at 3 per cent, and longer-term inflation expectations went up to 2.9 per cent from 2.7 per cent in December. In the first half of 2014 inflation in the USA is expected to remain below 2 per cent on an annual basis.

US Unemployment Rate and Number of New Employees in the USA



Source: Bureau of Labor Statistics.

US unemployment rate came to 6.7 per cent in the fourth quarter of 2013 – the lowest level recorded since November 2008. Despite the ongoing signals for positive dynamics on the US labour market and the higher number of jobs created in the fourth quarter compared with the third quarter of 2013: only 74 thousand new jobs in December compared with 214 thousand jobs in November and 200 thousand in October. Average monthly employment in the non-agricultural sector in October and December rose by 171 thousand, about 4 thousand more new jobs on average compared with the previous month, but 15 thousand less compared with the jobs created in the first nine months of 2013. The uneven demand for labour in the last quarter reflected the uncertainty stemming from the ambiguity in the Federal Reserve communications related to the monetary policy and the rising political tension between Republicans and Democrats which caused the temporary US government shutdown in early October. The adverse weather conditions in the northern parts of the USA were another unfavourable factor observed by the end of the review quarter.

At its meeting of 17–18 December the Federal Open Market Committee (FOMC) decided to cut the monthly purchases of assets under the Federal Reserve Third round of quantitative easing (QE3) by a total of USD 10 billion as of January 2014. Thus, from the beginning of 2014 the amount of purchased assets decreased by USD 5 billion to USD 35 billion per month of mortgage-backed securities and USD 40 billion per month of US treasury securities or to a total of

USD 75 billion per month. Despite reduced purchases, the FOMC decided that the revenue from maturing Treasury securities of the US Federal Reserve balance sheet would further be invested back in US Treasury securities. Revenue from mortgage loans of government sponsored agencies in the US Federal Reserve debt balance sheet will continue to be reinvested in mortgage bonds.

FOMC decided to keep the federal funds rate of 0–0.25 per cent unchanged, reiterating that the interest rate will remain unchanged within the set range at least until the US unemployment rate reaches or falls below 6.5 per cent and unless the expected inflation within the one- to two-year horizon exceeds the threshold of 2.0–2.5 per cent and long-term inflation expectations remain stable. It was indicated that highly accommodative stance of monetary policy will remain appropriate for a considerable period of time, even after the unemployment rate falls below 6.5 per cent. This was reflected also in the FOMC Economic Projections. It was also stated that if economic indicators remain within the limits outlined in these projections, they will cut purchases further by USD 10 billion at the forthcoming Committee meeting in 2014 and by the close of 2014 the QE3 purchases will end. FOMC members expect a gradual increase in the main federal reserve fund rate by end-2015. The Committee stands ready to take necessary action in case the downward trend in inflation continues and remains below the 2 per cent target.

In line with the approved policy, the FOMC members announced a second USD 10 billion reduction of QE to USD 65 billion per month.

China

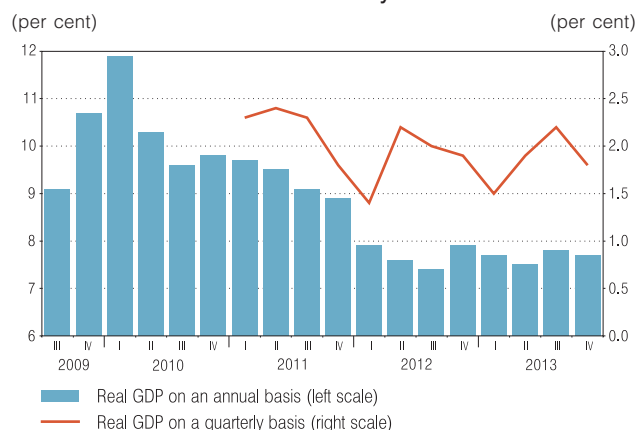
In November 2013 Chinese political leadership in Beijing gave more details on the reforms announced at the Congress of the Communist Party in early 2013. The Third Plenum of the Communist Party of China's 18th Central Committee decided to ease one child family policy by allowing couples to have two children if one parent is a single child. The relaxation is expected to contribute to maintaining a steady labour rate of working age population. The other reforms provide for further liberalisation of the financial market (allowing private entities as small bank founders) and controlled liberalisation

of capital flows using the so-called free-trade zones like that in Shanghai.

As regards privileged state-owned enterprises restrictions are to be introduced for the existing monopolies in certain sectors by gradual market liberalisation. Furthermore, private enterprises will be allowed to invest in joint projects with the state-owned companies. Some prices such as water prices, end-use natural gas prices and transport and telecommunications prices are to be liberalised.

In the fourth quarter of 2013 China's real GDP growth moderated slightly to 7.7 per cent on an annual basis compared with 7.8 per cent in the previous quarter. China's economy grew 7.7 per cent in 2013, which is above the 7.5 per cent growth target set by the leadership. The moderation of the quarter-on-quarter economic growth to 1.8 per cent in the October–December period (2.2 per cent in the third quarter) reflected the measures aiming to contain the rapid credit growth in the economy.

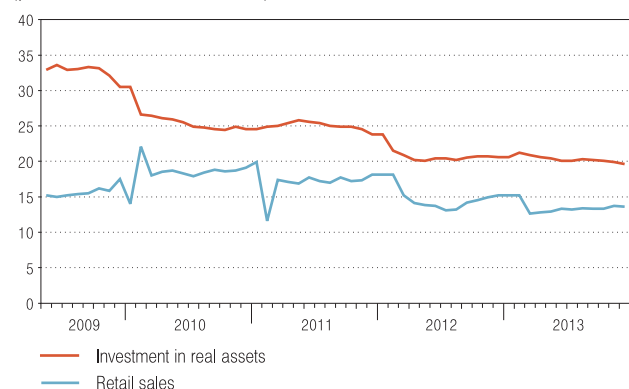
GDP on an Annual and Quarterly Basis



Source: National Bureau of Statistics of China.

Investment and Retail Sales

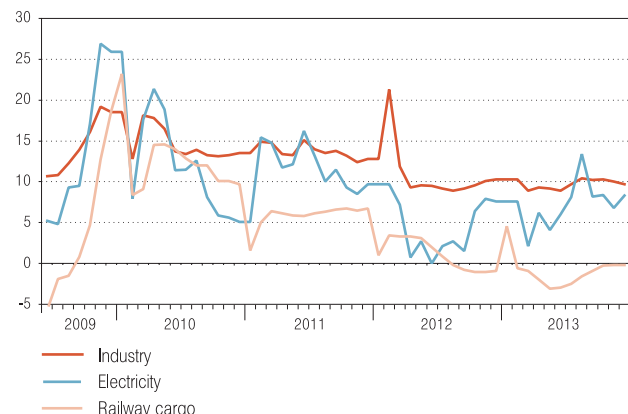
(per cent on an annual basis)



Source: National Bureau of Statistics of China.

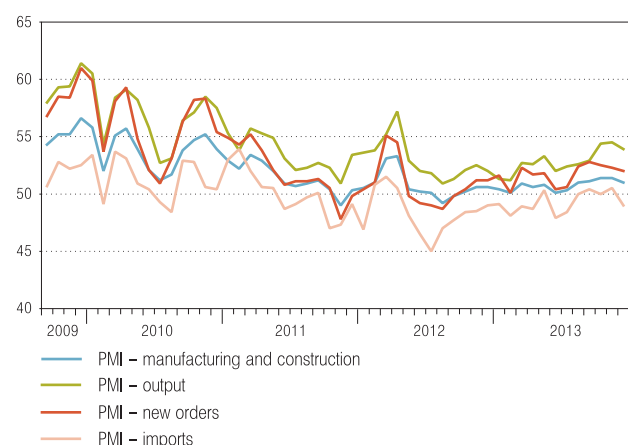
Industrial Output and Energy Generation and Railway Cargo Indices (Li Keqiang Index) (on an Annual Basis)

(per cent)



Source: National Bureau of Statistics of China.

Manufacturing, Output, New Orders and Imports PMIs



Source: China Federation of Logistics and Purchasing.

According to manufacturing PMI, in the last quarter of 2013 economic activity moderated and from 51.4 in October and November came to 51.0 in December. Developments in individual components suggest a retention of the upward trend. The new orders index fell to 52.0 in December from 52.3 in the previous month, and the employment index came to 48.7 from 49.6 in November.

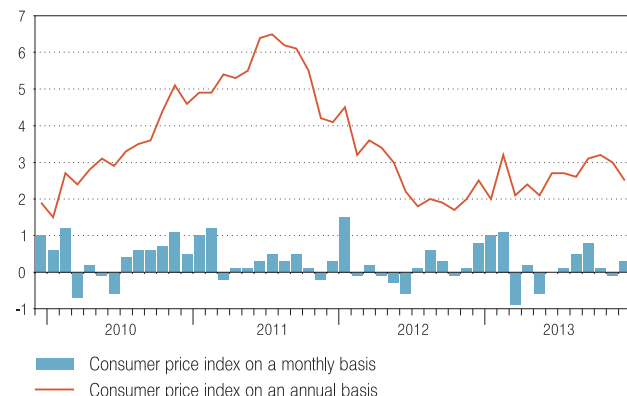
In December PMI for the services sector posted a decrease, reaching 54.6 compared with 56 in November and 56.3 in October.

Inflation moderated to 2.5 per cent on an annual basis in December compared with 3.0 per cent in November and 3.2 per cent in October. Data suggest no inflationary pressure on the backdrop of a significant deviation from the 4 per cent inflation target. The fall in food prices, whose

annual growth rate moderated to 4.1 per cent in December compared with 6.5 per cent in October, contributed most to lower inflation.

Inflation Indices (Rate of Change)

(per cent)

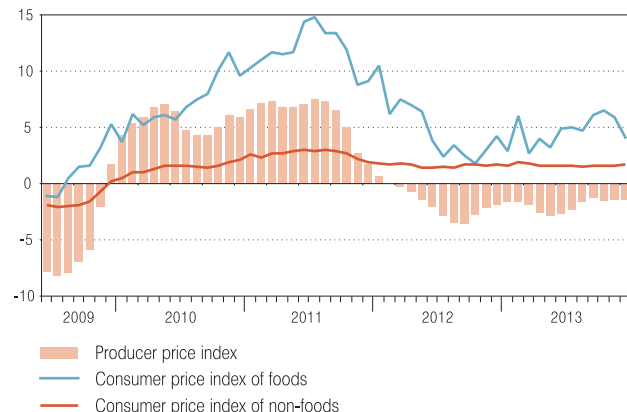


Source: National Bureau of Statistics of China.

Output prices declined steadily by 1.4 per cent in November and December, and remained unchanged on a monthly basis.

Price Indices (Rate of Change)

(per cent on an annual basis)



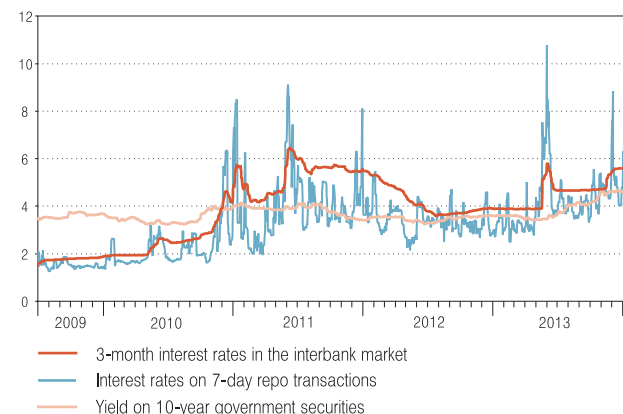
Source: National Bureau of Statistics of China.

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

The People's Bank of China was more active in liquidity management on the international market, which in contrast to the retail banking market is characterised by liberalised interest rates.

Interbank Market Interest Rates

(per cent)

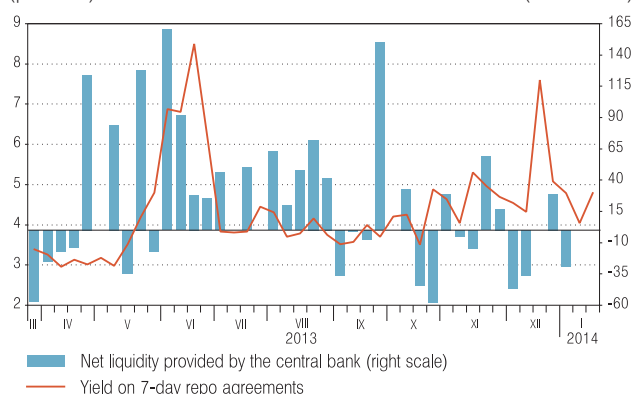


Source: People's Bank of China.

December saw new tensions on the interbank money market. As a result, the People's Bank of China had to inject liquidity through reverse repo transactions but at sustainably higher interest rate levels.

Interbank Market Liquidity

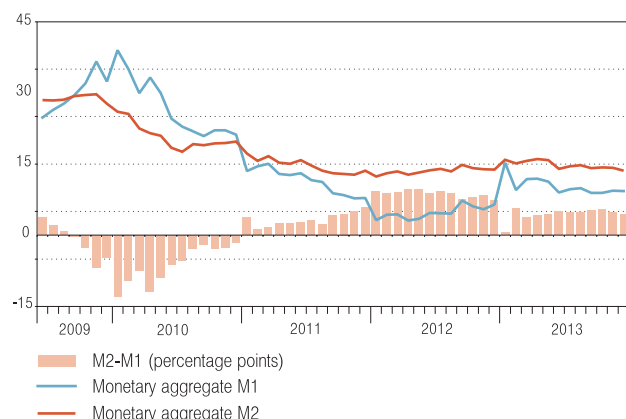
(per cent)



Source: People's Bank of China.

Credit Aggregates (Rate of Change)

(per cent, on an annual basis)



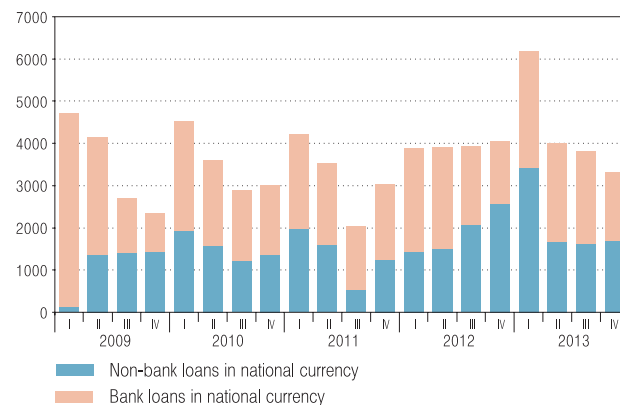
Source: People's Bank of China.

The supply of money moderated its growth on an annual basis to 13.6 per cent in Decem-

ber compared with 14.2 per cent in November and 14.3 per cent in October. Nevertheless, it remained above the leadership target of 13.0 per cent. The main reason behind this is the policy of the People's Bank of China aimed at reducing the overall indebtedness in the economy mainly by moderate bank credit growth and tighter interbank market conditions targeting lower non-bank credit growth.

Bank and Non-bank Lending in National Currency

(billion CNY)



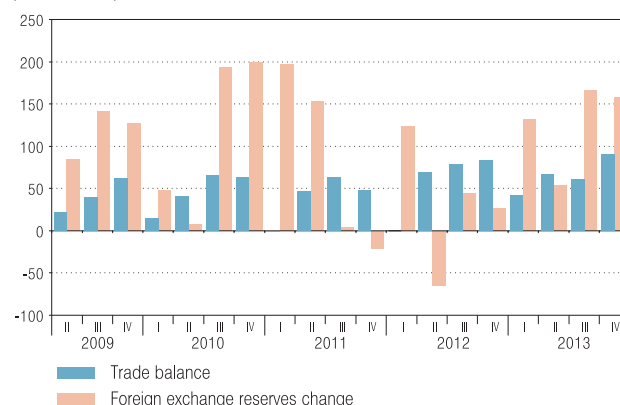
Source: People's Bank of China.

In the fourth quarter new bank loans in national currency decreased to CNY 1611 billion, from CNY 2200 billion in the previous quarter (-26.7 per cent on a quarterly basis).

Based on central bank's data on the so-called aggregate financing (bank and non-bank) in national currency came to CNY 3322 billion in the fourth quarter of 2013: down 13 per cent on a quarterly basis and 18 per cent on an annual basis.

Foreign Exchange Reserves (Change) and Trade Balance

(billion USD)



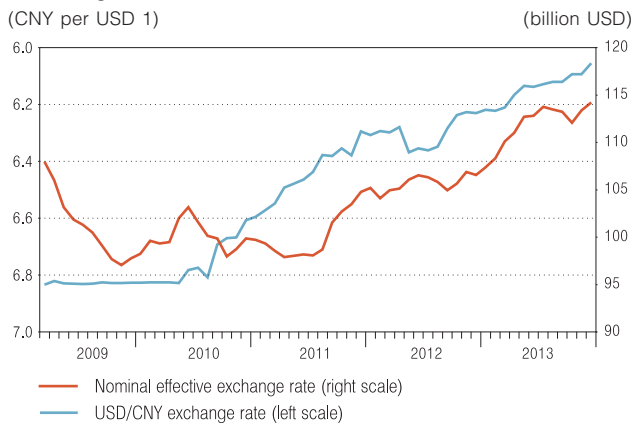
Source: Bloomberg.

In the fourth quarter of 2013 China's foreign exchange reserves went up USD 157 billion (USD 166 in the third quarter) and reached

USD 3.82 trillion. 2013 saw an overall increase in foreign exchange reserves of USD 508 billion compared with USD 130 billion in 2012.

In the fourth quarter of the year the Chinese currency appreciated by 1.1 per cent against the US dollar, showing a higher rate of increase in December. In 2013 the Chinese renminbi appreciated 2.8 per cent on the US dollar, and the nominal EER went up by 7.2 per cent.

CNY/USD Exchange Rate and Nominal Effective Exchange Rate



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

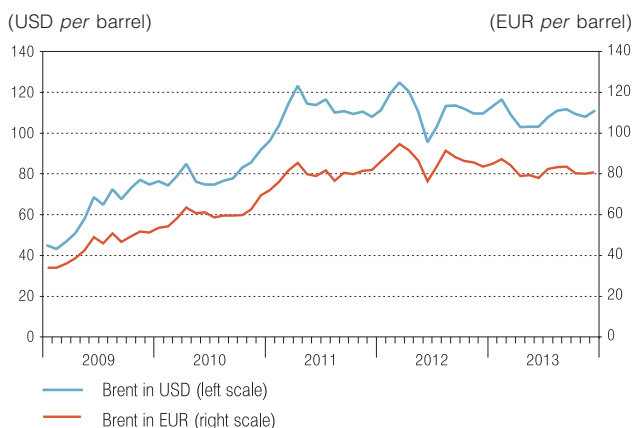
Sources: The People's Bank of China, Bank for International Settlements, Basel.

International Commodity Prices and the USD/EUR Exchange Rate

Crude Oil

The Brent crude oil price went down slightly in the fourth quarter of 2013 and was traded at USD 109.4 or EUR 80.4 *per barrel* on average: 1 per cent fall on an annual basis.

Crude Oil Prices



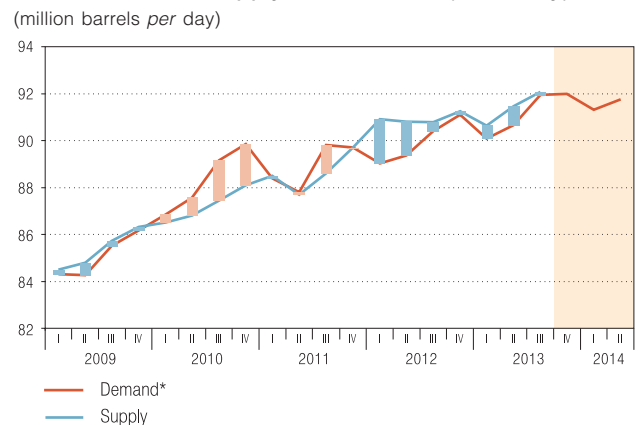
Source: World Bank.

Lower oil prices in the fourth quarter of 2013 reflected mostly higher production and growing

US oil inventories. Lower political instability in the Middle East also had a dampening effect on oil prices.

International Energy Agency (IEA) data of January 2014 suggest that global demand for crude oil is expected to increase on an annual basis in the first half of 2014. On the other hand, the increased production in the USA, the partial recovery in production and supplies from Lebanon, and the lifted sanctions against Iran will boost supply and cause oil price retention.

World Crude Oil Supply and Demand (Quarterly)



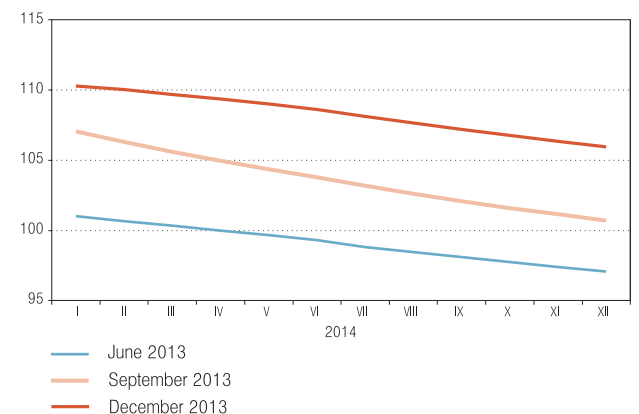
* Including the December 2013 IAE forecast about crude oil demand in 2014

Source: IEA.

Expectations of lower Brent crude oil prices in the first half of 2014 were reflected in market sentiment. In December the Brent crude oil futures prices for the following 12 months remained within the range of USD 105–110 *per barrel*: higher than projected in September and July, probably due to the higher oil prices in December. By mid-January 2014 its price fell below the average in the last quarter.

Brent Crude Oil Futures Prices

(average price of the contract in the corresponding month, USD *per barrel*)



Source: JP Morgan.

Major Raw Material and Commodity Prices

Between October and December 2013 international prices of most commodity groups in euro continued to fall, though at a slower pace than in the previous two quarters. The overall metal price index published by the ECB dropped by 2.3 per cent on the third quarter of 2013 and by 11.4 per cent on the fourth quarter of 2012. In the fourth quarter copper prices fell by 1.6 per cent on the previous quarter and by 13.7 per cent on the same period of 2012. The overall non-ferrous metal price index went down 2.2 per cent on quarter-on-quarter basis and by 15.5 per cent on an annual basis.

The downward trend in metal prices is expected to moderate in the first half of 2014 and to stabilise by the middle of the year. The continuing recovery of both euro area and US economic growth will be the main driving factor behind this dynamics. Risks related to a decrease in prices reflect the insufficient demand against the backdrop of a continuous moderation of China's economic growth.

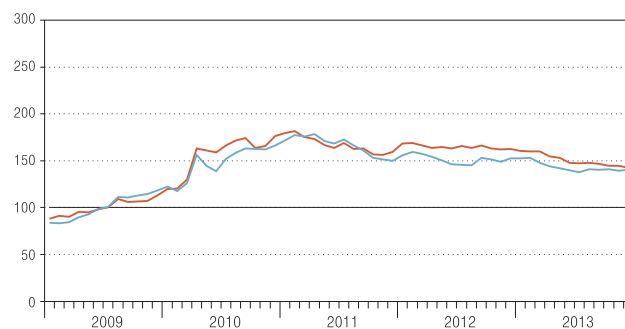
Food and cereal prices on international markets continued to decline – a trend observed over the last 18 months. In the last quarter of 2013 cereals reported a 9.7 per cent drop on the previous quarter and a 28.4 per cent fall on an annual basis. Corn prices reported the most sizeable decline in this group, going down by 30.7 per cent on the previous quarter and 46.3 per cent on an annual basis. The fall in cereal prices reflected mainly the record high yield in the USA and the CIS and the large quantity of inventories. The downward trend in the food price index was sustained, the latter reporting a 4.7 per cent decrease on the previous quarter and a 15.8 per cent fall on an annual basis. Cereal prices are expected to decline further by mid-2014, albeit at a lower pace, which will result in a decline in the food price index.

International market commodity price dynamics is expected to continue to ease the inflationary pressure in Bulgaria and at the same time to exert dampening pressure on nominal export and import growth.

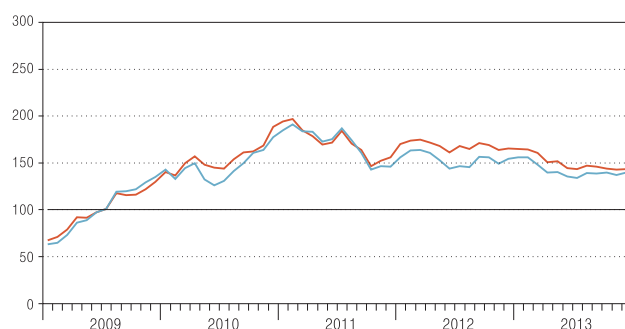
Price Indices of Major Raw Material and Commodity Groups

(2009 = 100)

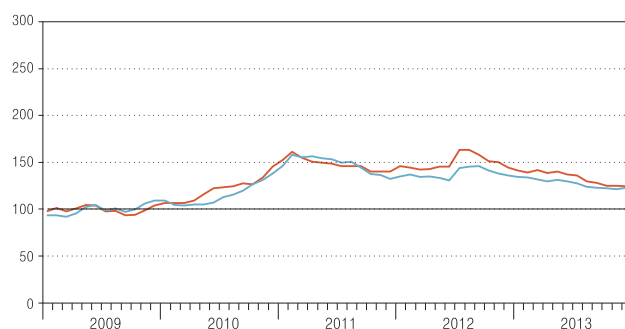
Metals



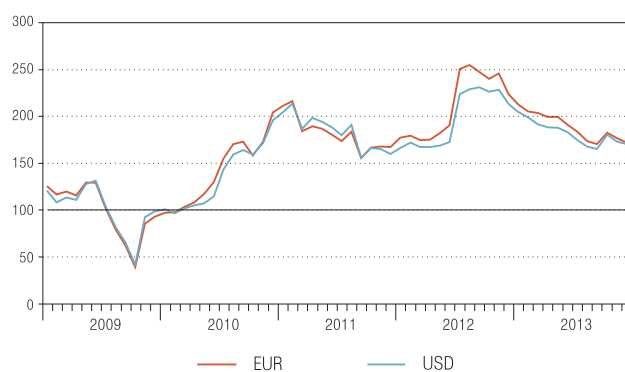
Copper



Food



Wheat



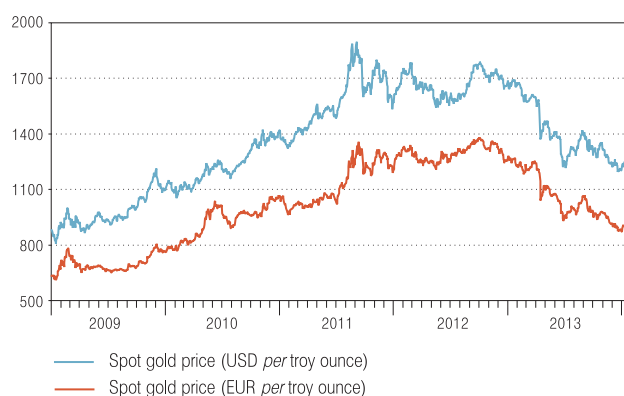
Sources: ECB and BNB calculations.

Gold

In the fourth quarter of 2013 the average spot price of gold dropped by 9.5 per cent on a quarterly basis to USD 1205 *per* troy ounce. The euro gold price declined by 11.1 per cent to EUR 871.9 *per* troy ounce. After twelve consecutive years of gold price rises, in 2013 gold prices fell 28.1 per cent (the most significant decline for the last 32 years). The gold price in euro dropped down by 31.3 per cent in 2013.

The fall in the prices of gold reflected mainly: the favourable macroeconomic data on US economy limiting the demand for gold; the decision of the Federal Reserve announced in December 2013 on tapering the bond purchase programme; the moderation in developed countries inflation and weaker demand for gold as a hedge against inflation; the increase in the US stock market indices and investor shift towards higher yield assets. These factors contributed to the ongoing closure of positions of exchange-traded funds (ETF).

Spot Gold Price



Source: London Bullion Market Association.

In the fourth quarter of 2013 total assets of funds collateralised by gold decreased by 151.7 tonnes to 1606.7 tonnes of gold (-8.6 per cent on a quarterly basis). In 2013 total assets of funds decreased by 792.2 tonnes of gold (-33 per cent on an annual basis).

The USD/EUR Exchange Rate

In the fourth quarter of 2013 the US dollar depreciated against the euro by 1.6 per cent. Over the period the US currency traded nominally within a range of 1.34–1.38 *per* euro.

The volatility on foreign exchange markets declined, but uncertainty was the main factor

behind foreign exchange dynamics. The political disagreements in Washington regarding the US debt ceiling and the related uncertainty around the Federal Reserve's gradual reduction in monetary stimulus and the future ECB policy despite the early November interest rate cuts were the factors behind this dynamics.

The USD/EUR Exchange Rate

(USD *per* EUR 1)



Source: ECB.

In the beginning of the review quarter the euro appreciated due to the ongoing political blockade regarding the budget in Washington. The actual shutdown of Federal government caused relatively weak market reactions. A political agreement on fiscal issues was reached in the USA by mid-year and the public debt ceiling was temporarily raised. The countries in the periphery of the euro area reported improved macro indicators, progress in ongoing reforms and/or political stabilisation.

In the beginning of November foreign exchange markets entered a more dynamic phase of fluctuations, especially following the cut in the ECB reference interest rate in early November and the downgrading of the AA+ (negative outlook) rating of France to AA (stable outlook). By end-November the USA reported higher expectations related to the forthcoming tapering of monetary stimuli following the data on the increase in employment in the non-agricultural sectors in October and on the GDP for the third quarter. The release of the minutes of the US Federal Reserve Open Market Committee meeting of 28–29 April 2009 played a key role for this.

In December foreign exchange markets fell the impact of the last FOMC meeting and ended the year under the influence of the FOMC announcement about the cut in monthly purchased by USD 10 billion per month as of January 2014.

2. Financial Flows, Money and Credit

The high savings rate maintained in the economy at the background of weak investment activity of corporations was a fundamental factor behind the significantly improved current account balance in the January–November 2013 period. Banks' financial transactions, foreign direct investment in Bulgaria, corporate bond issuance in November and government debt repayments in January 2013 had a major impact on the balance of payments financial account flows. Banking system liquidity remained high against the background of the continued increase in attracted funds and weak lending. Given the expected gradual recovery in domestic demand, in the first two quarters of 2014 the overall current and capital account balance is projected to remain positive on an annual basis, albeit gradually moderating, while non-government sector lending growth is expected to accelerate slowly.

Between January and November 2013 BOP current and capital account balance reported a surplus. Financial account flow dynamics was mainly driven by net transactions of banks, foreign direct investment in Bulgaria, corporate bonds issued in November and repayments on government global bonds maturing in January 2013.

The continued increase in funds attracted from residents and comparatively low demand for borrowed funds predetermined the ample liquidity of the banking system. Substantial part of this liquidity was used by banks to increase foreign assets and decrease foreign liabilities. Another part of free funds was invested in government securities, primarily of the Bulgarian government. The remaining bank resources went on lending in line with demand for borrowings by the non-government sector, which remained low, triggering a downward trend in credit growth.

Given the interaction of external and internal economic factors and resulting financial flows, in November Bulgaria's international foreign exchange reserves (excluding valuation adjustments and price revaluation) posted a decrease of EUR 239.9 million on an annual basis (based on BOP data). The market value of international reserves⁶ (assets on the Issue Department balance sheet) declined by EUR 1127 million to BGN 28.2 billion (EUR 14.4 billion) at the end of December 2013. The difference between the change in reserves in the Issue Department bal-

ance sheet and that in the balance of payments reflects the downward trend in gold prices.

Reduced liabilities to the government and budget organisations, reflecting the 2013 budget deficit financed by the government deposit at the BNB, had the major contribution to the December fall in the Issue Department balance sheet on an annual basis.⁷ The Issue Department balance sheet was strongly impacted by volatile gold prices which resulted in its almost 31 per cent decrease since early 2013.

External foreign 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. In 2013 banks made net purchases of foreign currency from the BNB. This recent years' trend was due to the banks' policy to boost foreign assets and reduce external indebtedness.

The international reserves coverage of the average nominal imports of goods and non-factor services over the last 12 months was 6.1 months in November.

The overall current and capital account balance is expected to remain positive on an annual basis in the first half of 2014, although the surplus may gradually decline due to the expected smooth recovery in both domestic consumption and imports which will boost the trade deficit. Broad money growth will remain comparatively high as

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

⁷ Based on MF preliminary data, CFP deficit accounted for 1.8 per cent of GDP for 2013.

a result of the retained high household savings rate. Growth rates of loans to the non-government sector are projected to slowly increase in the first two quarters of 2014 due to the expected gradual recovery in economic activity and the related strengthening of demand for loans by non-financial corporations. It is expected that the gradual consumer demand revival will further decrease the speed of decline in household loans on an annual basis.

External Cash Flows in Foreign Currency

(million EUR)

External flows	2012	2013*
Total for the period	1 527	-982
Purchases and sales of euro	-317	-1 429
at tills	-10	-21
banks, incl.	-307	-1 408
purchases from banks	46 550	35 169
sales to banks	-46 856	-36 577
Flows on accounts of banks, the MF, etc.	1 844	447
Minimum required reserves	40	-92
Government and other depositors	1 804	538

* Preliminary data.

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

Source: BNB.

External Financial Flows

On an annual basis, the current account surplus came to EUR 800.3 million in November (compared to a deficit of EUR 520.8 million by end-2012).⁸ The decreased trade balance deficit contributed to an improvement of the current account balance, along with the positive net current transfers. High growth rates of nominal exports during the whole year and weak growth of nominal imports added to the significant fall in trade balance deficit.

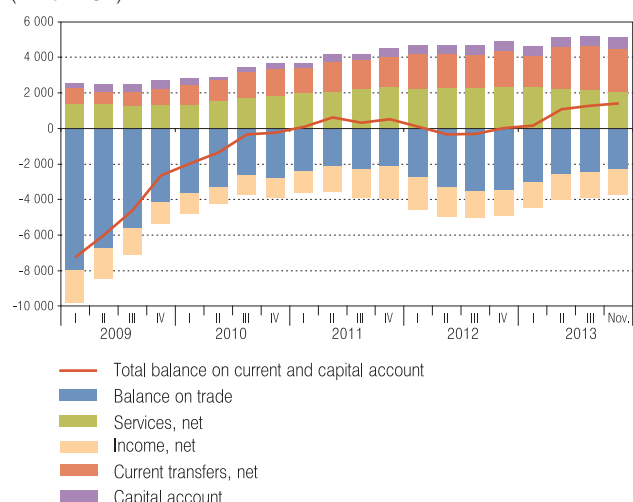
Between January and November exports to EU countries increased at high rates. Favourable terms of trade also contributed to the trade deficit decline. Nominal goods exports rose by 7.2 per cent on an annual basis and nominal imports by 1 per cent, reflecting mainly the decline in imported commodity prices.⁹

⁸ Data in this section are obtained from the balance of payments statistics. Preliminary data, subject to revision.

⁹ For a more detailed analysis of exports and imports of goods, see Section 3.

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

(million EUR)



Source: BNB.

The services balance surplus fell between January and November 2013 owing to lower exports and higher imports of services. Tourist services exports recorded the strongest growth on the same period of 2012. Tourist services imports also registered a significant increase, unlike construction services which posted the largest fall. External demand recovery, particularly in the euro area, gives grounds to expect a gradual rise in services exports over the first half of 2014.

Flows on Balance of Payments Main Accounts

(million EUR; cumulative since early 2013)

	as of 30 November 2012	as of 30 November 2013
Current account	-192.1	1 129.0
Trade balance	-3 138.3	-1 972.7
Services balance	2 287.0	2 035.1
Income account	-1 163.7	-1 131.9
Current transfers, net	1 822.8	2 198.5
Capital account	316.6	387.5
Financial account	1 702.0	-1 876.2
FDI in Bulgaria	1 732.4	1 226.4
Changes in reserves*	1 604.6	-796.3

* A positive sign indicates an increase in international reserves.

Source: BNB.

According to November data, income account deficit continued to decline in 2013 as a result of the greater increase of inflows compared to outflows on the income account. As regards inflows, the most substantial growth was recorded in compensation of employees and income from portfolio investments (interest). Higher interest income can be attributed mainly to the bank policy toward increasing portfolio investments abroad.

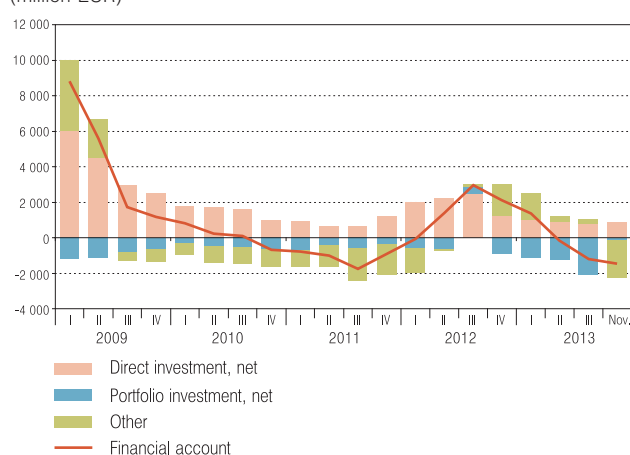
over the last quarters. The bulk of payments was made in the form of dividends and distributed profit from direct investments, though declining on the same period of 2012 due to the subdued economic activity in Bulgaria over 2013.

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

If the gradual recovery in domestic demand materialises over the first half of 2014, nominal import growth may accelerate and trade deficit may gradually increase which will reduce the overall current and capital account surplus. A factor which could lead to higher values of this balance is the continued improvement of the terms of trade in Bulgaria that will negatively affect the nominal imports.

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

(million EUR)



Source: BNB.

In the first eleven months of 2013 BOP financial account dynamics reflected mainly transactions of banks, FDI inflows and November issues of corporate bond loans worth EUR 900 million. Though to a lesser extent, financial account dynamics was influenced by the January 2013 external debt payments by the government.¹⁰

In November the Bulgarian Telecommunications Company EAD and the Bulgarian Energy Holding EAD issued corporate bonds to the amount of EUR 400 million and EUR 500 million respectively. The major portion of them was bought by

¹⁰ For more details on payments on government global bonds maturing in January 2013 and their implications for balance of payments financial account and external debt, see Economic Review, 1/2013, p. 26.

foreign investors as reflected in the liabilities side of portfolio investments in the form of inflows of EUR 838 million under the *long-term debt instruments* sub-account of *other sectors*.

Between January and November 2013 banks continued to increase their foreign assets and, to a lesser extent, to reduce foreign liabilities in the context of ample liquidity and limited demand for loans in the national economy.

If domestic demand in Bulgaria begins to recover in the first half of 2014, demand for financial resources may be expected to increase. Reflecting these developments, the growth rate of foreign bank assets is likely to slow down.

Banks' Flows on Balance of Payments Financial Account

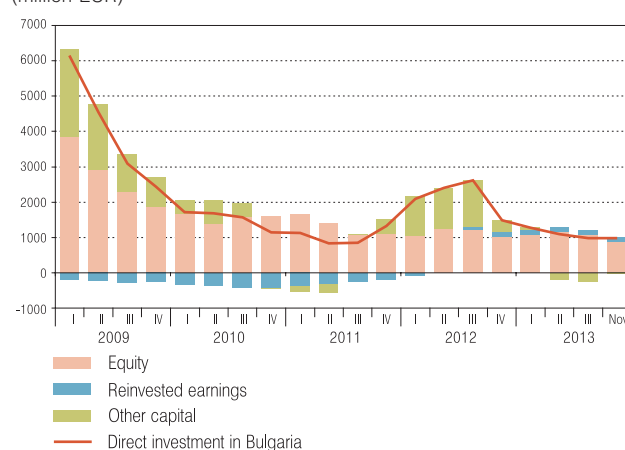
(million EUR; cumulative since early 2013)

	as of 30 November 2012	as of 30 November 2013
Net direct investment	140.9	-36.7
abroad	-0.6	-0.6
in Bulgaria	141.5	-36.1
Net portfolio investment	-1 109.9	-232.0
assets	-1 132.4	-299.7
liabilities	22.5	67.8
Other investment	980.0	-2 629.1
assets	127.8	-1 925.8
liabilities	852.3	-703.2
Portfolio and other investment	-129.9	-2 861.0
Total	11.0	-2 897.7

Source: BNB.

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

(million EUR)



Source: BNB.

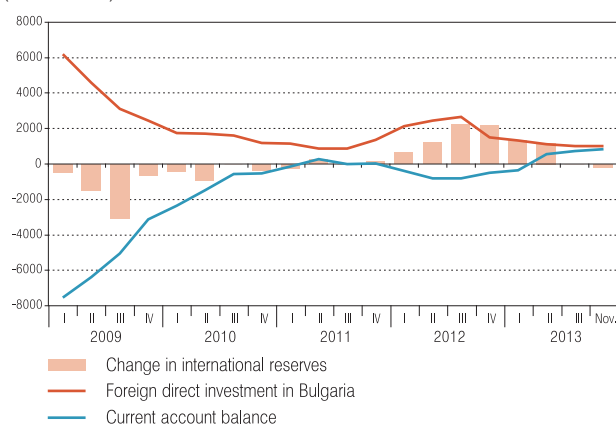
According to preliminary BOP data for the January to November 2013 period, FDI inflows into Bulgaria totalled EUR 1226.4 million, down EUR 505.9 million on the respective period of

the prior year.¹¹ Given the significant fluctuations in FDI monthly data and revisions thereof, it is difficult to assess their level in the first half of 2014.

As a result of the net BOP flows, international reserves of the BNB (excluding valuation adjustments and price revaluation) posted an annual fall of EUR 239.9 million as of November.

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

(million EUR)



Source: BNB.

BOP financial account dynamics had implications for the gross external debt. In the first eleven months of 2013 gross external debt declined on end-2012 largely due to the reduced government and bank debt. Only intercompany loans and other sectors marked an increase from the beginning of the year. Over the first nine months an increase in gross external debt in terms of intercompany loans and other sectors was reported in manufacturing (EUR 1016.3 million) and trade, repair of motor vehicles and motorcycles, personal belongings and household goods (EUR 669.3 million). A decrease was registered in production and distribution of electricity and heating, gaseous fuels and water (EUR -640.8 million) and financial intermediation (EUR -343.9 million). In September 2013 obligations of the firms with a foreign direct participation and government guaranteed loans comprised 74.4 per cent (EUR 7802.3 million) of the amount of other sectors' loans. They dropped by EUR 52.4 million on end-2012 (EUR 7854.7

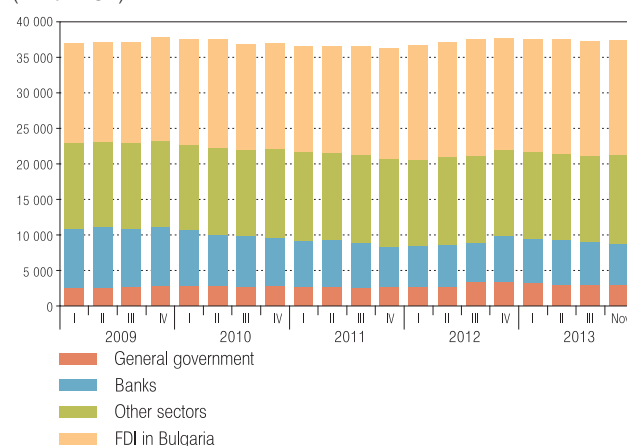
¹¹ Preliminary data, subject to revision. Given the volatility in monthly FDI data and revisions thereof, FDI between January and November 2013 are to be compared with the first release estimate for the same period of 2012, which point to an inflow of EUR 1399 million.

million, a relative share of 74.2 per cent). Compared to September 2012 (EUR 7831.5 million, a relative share of 73.8 per cent), these liabilities fell by EUR 29.1 million.

Long-term external debt increased by 0.4 per cent on end-2012. Short-term external debt contracted by 3.2 per cent, its share in total external debt comprising 27.0 per cent.

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

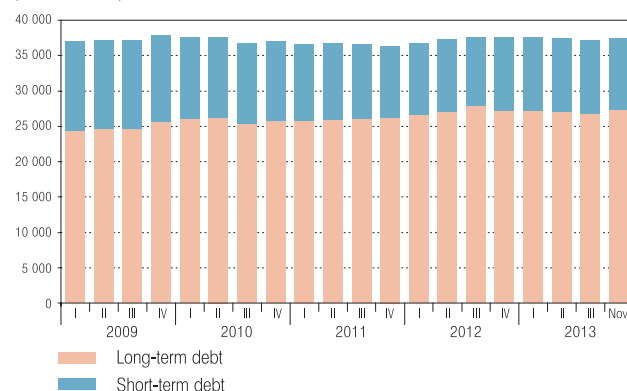
(million EUR)



Source: BNB.

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

(million EUR)



Source: BNB.

Gross External Debt as of November 2013

(million EUR)

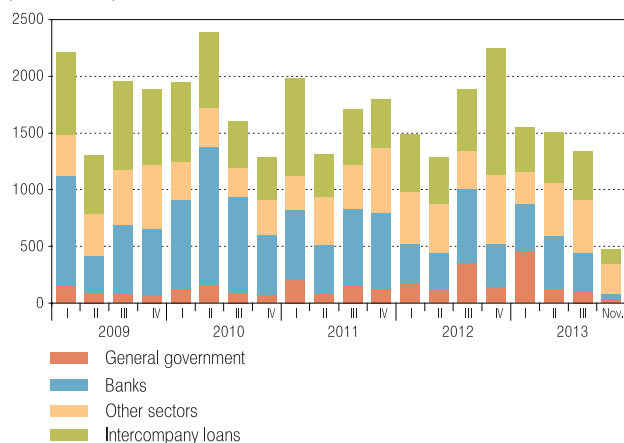
	Amount	Change	
		January–November 2013	Last 12 months
General government	3 046.6	-327.7	-333.8
Central bank	0.0	0.0	0.0
Banks	5 750.2	-704.3	-726.7
Other sectors	12 603.1	446.7	609.1
FDI: Intercompany loans	16 020.5	370.4	-45.0
Total	37 420.5	-215.0	-496.4

Source: BNB.

External debt service payments in the January–November period totalled EUR 5487.1 million (of which EUR 1588.4 million from banks and EUR 709.8 million from general government) compared to EUR 6070.4 million in the same period of 2012.

Gross External Debt Service by Institutional Sector

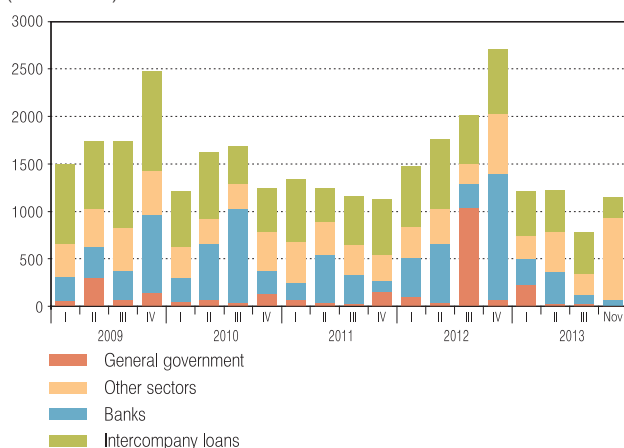
(million EUR)



Source: BNB.

Loans and Deposits Received by Institutional Sector

(million EUR)



Source: BNB.

Loans and deposits disbursed between January and November 2013 amounted to EUR 4493.6 million compared to EUR 7272.7 million in the corresponding period of the previous year. Of them, almost 75 per cent were utilised by other sectors (39.4 per cent) and in the form of intercompany loans (36.1 per cent).

According to the information on new loans declared during the first eleven months, the share of long-term loans was 47.4 per cent. The average weighted maturity of new loans fell on the corresponding period of 2012 to reach seven years and eleven months (against six years in 2012).

The relative share of declared new loans in euro in the total amount of declared loans remained high over the January to November period (79.2 per cent), with a slight increase of loans denominated in US dollars (20.6 per cent, from 18.3 per cent in the same period of 2012).

In the first eleven months of the year the downward trend in average weighted interest rate on euro-denominated loans was sustained, its value reaching 2.6 per cent against 3.5 per cent between January and November 2012.

The average weighted interest rate on new USD loans increased by 2.4 percentage points to 2.8 per cent compared to the first eleven months of 2012. This rise can be attributable to the 2012 base effect, when the cost of borrowed funds in US dollars was extremely low.

If no shocks in the international environment occur, a further drop in the cost of external financial resources may be expected in the first half of 2014. A new interest rate cycle in the monetary policy of leading central banks implied by rising global money and capital market rates could entail a risk of discontinuation of this trend.

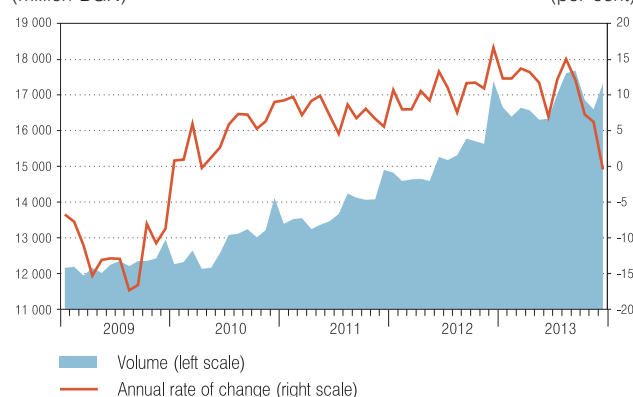
Monetary Aggregates

In 2013 reserve money developments were marked by significant fluctuations, with its annual rate of growth dropping from 12.4 per cent in early 2013 to -0.4 per cent as of end-December. The major factor affecting reserve money dynamics was related to the fluctuations in the balances of bank accounts in TARGET2-BNB.¹²

Reserve Money

(million BGN)

(per cent)

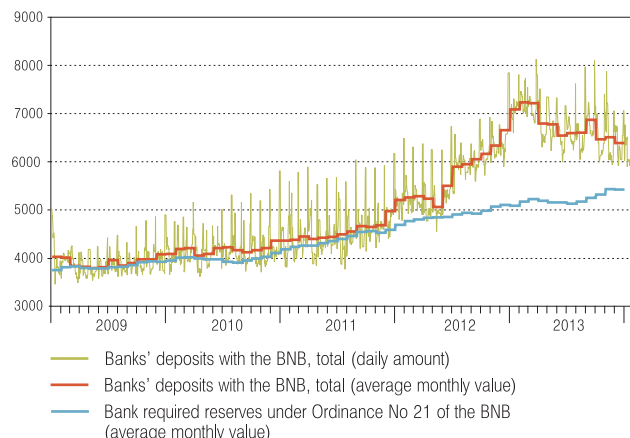


Source: BNB.

¹² The national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2).

Bank Deposits with the BNB

(million BGN)



Source: BNB.

Deposit base growth led to a comparatively high growth rate of bank funds allocated into minimum required reserves. However, TARGET2-BNB account balances had the strongest effect on bank deposits with the BNB. These balances followed a clear downward trend until the end of 2013 after the high values in the first quarter, which predetermined the 10 per cent annual fall in the overall amount of bank deposits with the BNB in December.

The average daily volume of funds attracted from residents¹³ continued to increase in 2013, their growth reaching BGN 4480 million (against BGN 4280 million in 2012). For the fourth quarter of 2013 this growth was BGN 1889 million, its quarterly value exceeding that in the previous few quarters. Between October and December the average daily volume of funds attracted from non-residents contracted by BGN 411 million, funds from non-resident banks going down BGN 550 million and from non-residents (banks excluded) rising BGN 139 million. Reflecting the developments and structure of attracted funds, the effective implicit rate of minimum required reserves maintained with the BNB reached 8.95 per cent¹⁴ in December, with banks' reserves comprising 7.81 percentage points, and the remaining 1.14 percentage points formed by cash and funds on banks' settlement accounts in the

¹³ This analysis employs 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.

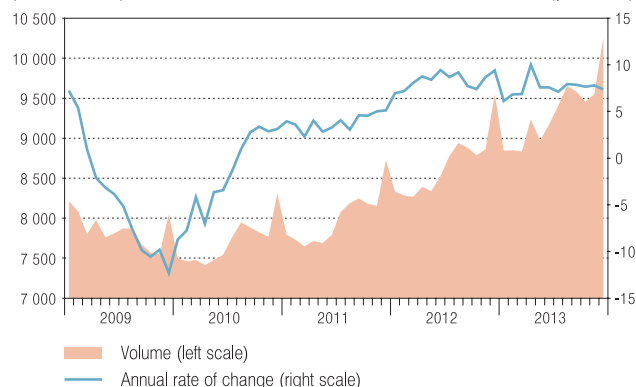
¹⁴ According to Article 3, paragraph 1 of BNB Ordinance No 21, the rate of minimum required reserves for funds attracted from residents is 10 per cent of the deposit base, for those attracted from non-residents 5 per cent and from state and local budgets 0 per cent.

TARGET2-BNB system.¹⁵ In the fourth quarter bank excess reserves measured by the excess of funds on reserve accounts over the required minimum under Ordinance No 21 reached 7.9 per cent on an average daily basis (7.2 per cent in 2013).

Currency in Circulation

(million BGN)

(per cent)

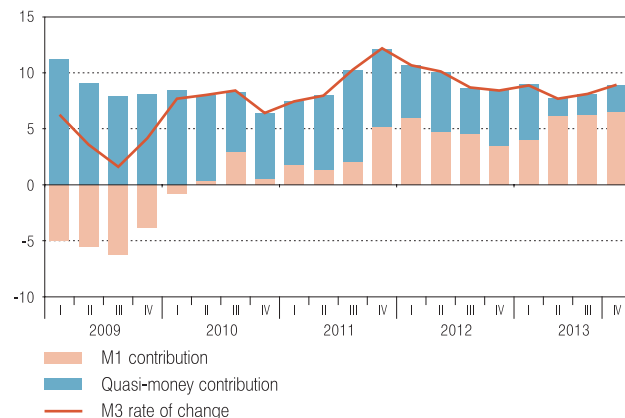


Source: BNB.

The annual growth rate of currency in circulation stabilised at 7–8 per cent. Over the first two quarters of 2014 its dynamics is expected to stay close to the current one. This trend will be driven by the expectations of a slow economic activity recovery and a slight increase in private consumption.

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

(per cent; percentage points)



Source: BNB.

The downward trend in broad money growth since 2012 continued in the first half of 2013. Over the second half year this trend reversed, and in the last quarter the growth rate accelerated from the third quarter to reach 8.9 per cent on an annual basis as of December (8.4 per cent at the end of 2012). Broad money accel-

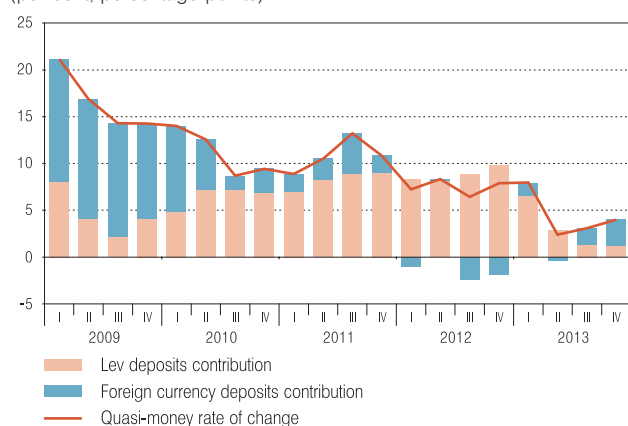
¹⁵ See Article 4 of Ordinance No 21 of the BNB.

eration was driven by the greater contribution of quasi-money at the end of December and retained high contribution of overnight deposits.

In December the growth rate of household deposits accelerated on the third quarter to 9.3 per cent on an annual basis,¹⁶ and that of non-financial corporations' deposits rose to 8.3 per cent annually.

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

(per cent; percentage points)



Source: BNB.

If the high household savings rate is retained in the first two quarters of 2014, broad money growth is expected to remain comparatively high. Over the second half of 2013 an increase in the contribution of foreign currency deposits to the annual quasi-money growth was observed. These developments reflect mainly the increased foreign currency deposits of households and, to some extent, of non-financial corporations. Concurrently, the early 2013 downward trend in lev deposits' contribution to quasi-money growth was retained. By end-December the share of lev-denominated deposits in quasi-money fell to 52.6 per cent compared with 53.5 per cent at end-2012.

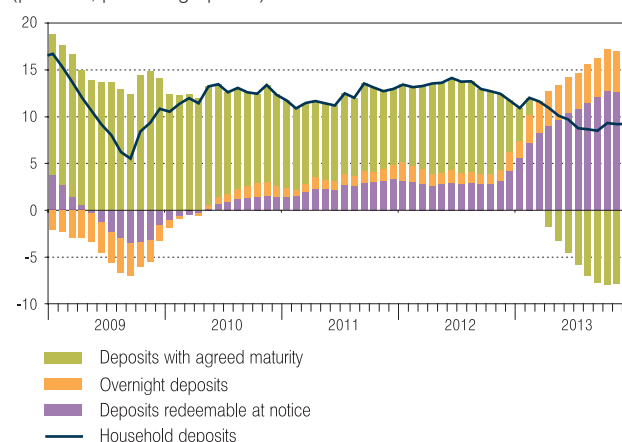
The change in the structure of household deposits by type and maturity, which started in the fourth quarter of 2012, was maintained until the end of 2013.

The contribution of deposits redeemable at notice and overnight deposits in total annual growth of household deposits increased until October, while the contribution of deposits with agreed maturity remained negative until the end

of the year. Since November, annual growth rates of overnight deposits and of those redeemable at notice have gradually slowed down, reflecting broadly the effect of their increase at the end of 2012. Changes in household preferences driven by the introduced taxation on time deposit interest earnings from the beginning of 2013 affected bank policy in setting interest rates on different types of deposits. Interest rates on households' overnight deposit balances grew by 34 basis points in 2013, while those on deposits redeemable at notice by 25 basis points. Over the same period time lev deposit interest rates decreased by 65 basis points.

Annual Growth of Household Deposits and Contribution by Type of Deposit

(per cent; percentage points)



Source: BNB.

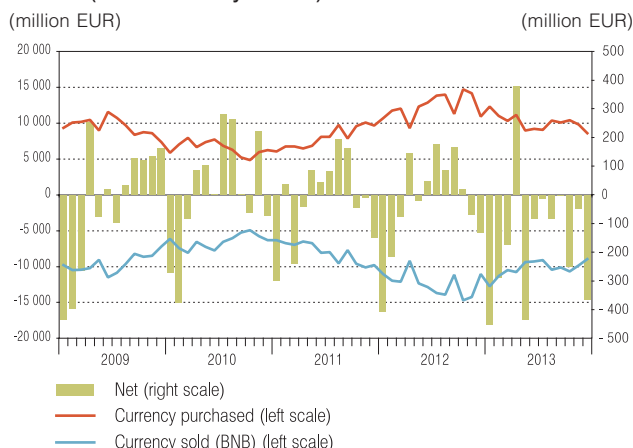
In the first two quarters of 2014 further changes in the structure of household deposits are expected, and the growth rates of overnight deposits and of those redeemable at notice will gradually slow down. The reduced deposit income tax from 10 to 8 per cent since 1 January 2014 will have an additional effect on the deposit structure, boosting time deposits of households.

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

Over 2013 banks were net purchasers of foreign currency worth BGN 1820 million against BGN 281 million in 2012.

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.

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

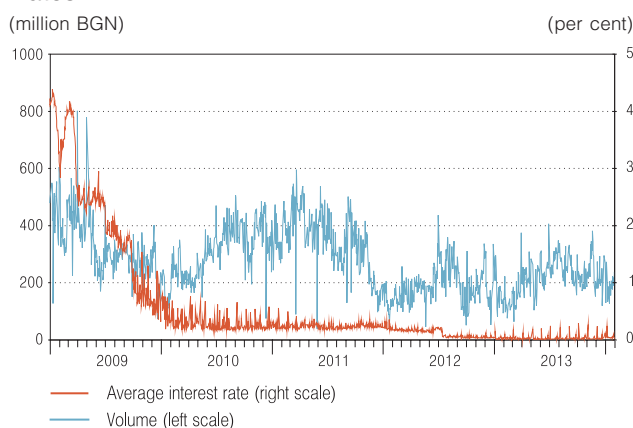


Note: 'Net' means currency bought minus currency sold by the BNB. Data refer to all bank transactions in foreign currency, including liquidity management operations related to the transfer of own funds from lev accounts with the BNB to own euro accounts with the BNB and vice versa.

Source: BNB.

Interest rates in the interbank money market in Bulgaria retained their low levels throughout 2013. Over the fourth quarter the average interest rate on transactions concluded in the interbank money market remained unchanged from the previous quarter at 0.04 per cent and average daily volumes traded in the interbank money market posted a slight decline.

Trade Volumes and Interbank Money Market Interest Rates

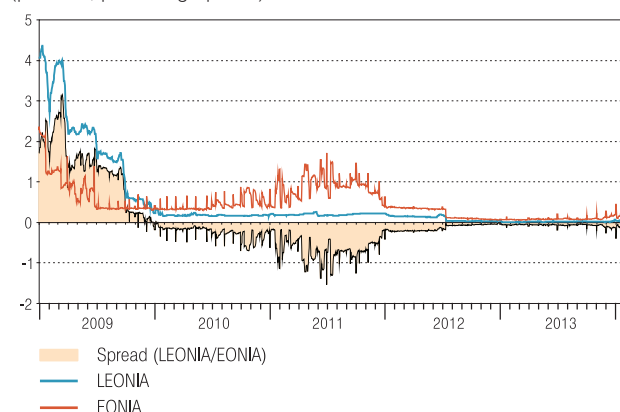


Source: BNB.

In 2013 LEONIA hovered around the level of 0.02 per cent. Until the third quarter, the average value of the negative spread between LEONIA and EONIA fluctuated around 6–7 basis points. The slight spread expansion to -10 basis points over the fourth quarter was due to the EONIA growth at the end of the year. In January 2014 the negative spread expanded further to -17 basis points.

Spread between LEONIA and EONIA

(per cent; percentage points)

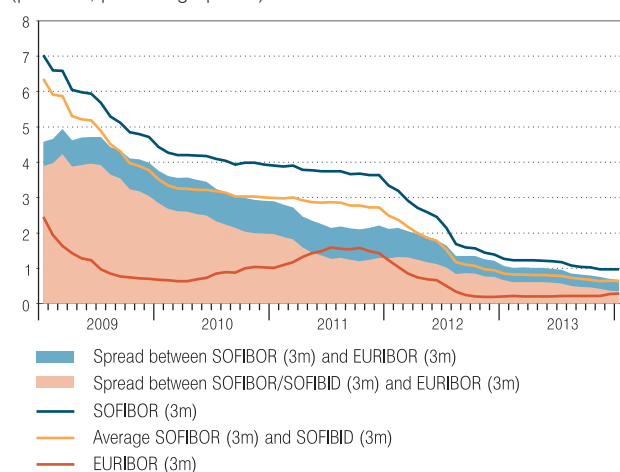


Source: BNB.

The SOFIBOR reference rate (3m) used as an indicator for short-term interest rates followed a trend to a gradual decrease to 0.97 per cent in December (1.39 per cent by end-2012). Money market quotations in Bulgaria continued to narrow their spread *vis-à-vis* euro area quotations. Between September and December 2013 the spread between the three-month SOFIBOR and EURIBOR decreased by 12 basis points to 70 basis points (121 basis points in December 2012). The average three-month SOFIBOR/SOFIBID index¹⁷ declined to 0.65 in December and its spread to EURIBOR came to 37 basis points (0.75 by end-2012).

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

(per cent; percentage points)

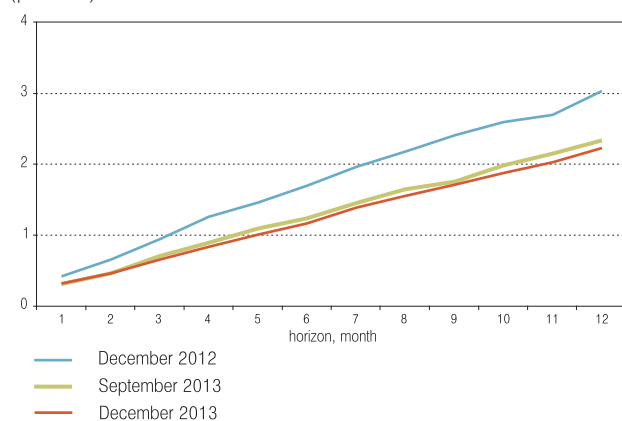


Source: BNB.

¹⁷ The average SOFIBOR/SOFIBID index gives a better picture of the interest rate level in Bulgaria. Correspondingly, it is more correctly to compare its value with EURIBOR as the closest rate to the actual price at which transactions are concluded. For further methodological notes, see the box *Differences between the Methodology for Calculating Money Market Indices in the Euro Area and in the New EU Member States*, Economic Review, 2/2010, p. 27.

The prevailing downward trend of quotations in the long-term maturity sectors of the interbank money market yield curve *vis-à-vis* short-term ones since the second half of 2010 continued in the fourth quarter of 2013. In December year-on-year declines in the six-month and 12-month horizons were 53 and 80 basis points respectively.

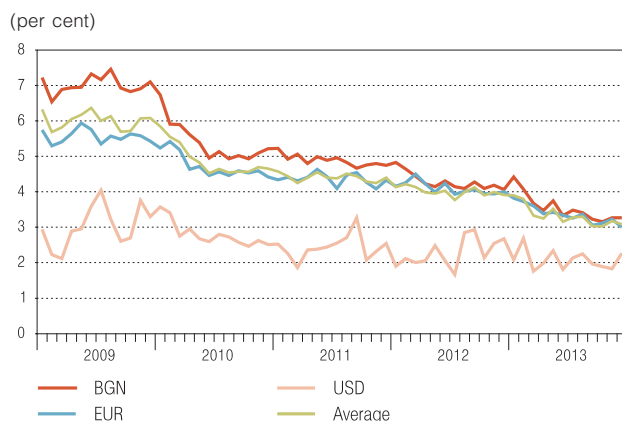
Interbank Money Market Yield Curve
(Based on Average SOFIBOR/SOFIBID Quotations)
(per cent)



Source: BNB.

Factors behind the developments in traded volumes and Bulgarian money market interest rates were still related to the retained high liquidity of the Bulgarian banking system and the ECB policy for maintaining low interest rates in the euro area.

Interest Rates on New Time Deposits in Relevant Currencies



Note: The average interest rate is calculated for all sectors, maturities and currencies weighted by the relevant volumes of new deposits.

Source: BNB.

Interest rates on new¹⁸ time deposits of households and corporations continued to decrease in 2013 at rates significantly exceeding those in 2012. The main factors behind these trends were

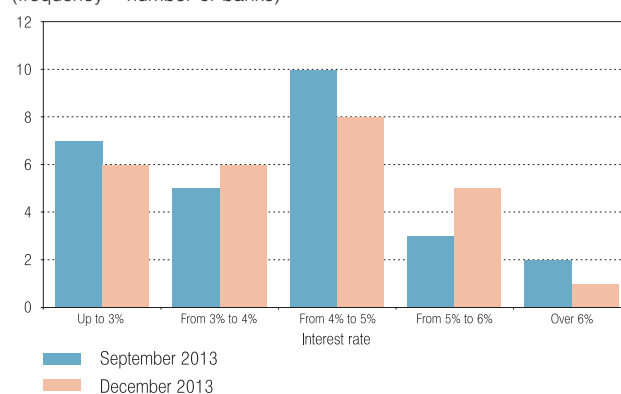
¹⁸ The terms *new*, *new contracted* and *new disbursed* loans and deposits refer to the *new business* statistical category.

the sustained sizeable growth of attracted funds from residents, high bank liquidity and relatively low demand for bank loans. In December the average weighted interest rate was 3.09 per cent (3.91 per cent at end-2012), with year-on-year declines observed in interest rates on deposits in all currencies.

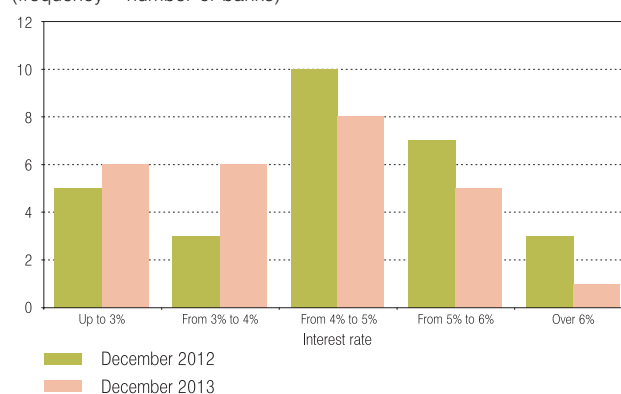
A comparison between the December and September 2013 breakdown of interest rates on household time lev deposits shows that the number of banks offering rates in the band from three to four and from five to six per cent increased and those offering rates within the band of up to three, from four to five and over six per cent decreased. The average interest rate on time lev deposits dropped by 16 basis points to 3.82 per cent and the standard deviation rose by 2 basis points to 1.43 percentage points.

Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



(frequency – number of banks)



Source: BNB.

The downward trend in the average cost of financing in the banking system¹⁹ was sustained

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

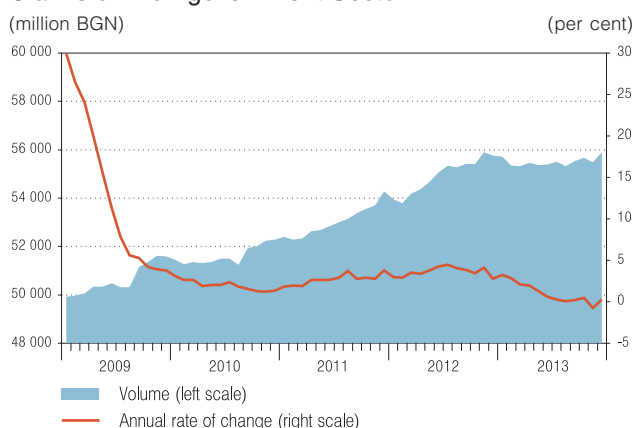
(from 3.13 per cent in late 2012 to 2.81 per cent at end-December 2013). It was driven by persistently low interest rates in the interbank market in Bulgaria and the money market in the euro area and by the decreased interest rates on attracted deposits.

Interest rates on time deposits are expected to slightly decline in the first two quarters of 2014. This trend may be terminated, if the monetary policy of leading central banks enters a new upward interest rate cycle. Concurrently, high banking system liquidity and comparatively low demand for borrowed funds will exert a major downward pressure on time deposit interest rates.

Credit Aggregates

In 2013 the annual growth rate of claims on the non-government sector moderated to 0.3 per cent in December against 2.8 per cent at the end of 2012. This dynamics was mainly influenced by the slowing growth of claims on non-financial corporations to 0.3 per cent (4.7 per cent by end-2012). At the same time, the decrease in bank claims on households fell to -0.2 per cent (from -1 per cent in December 2012). Low demand for loans in the context of still weak economic activity and retained household savings rates were the key factors determining the trends in domestic lending. By end-December claims on the non-government sector rose by BGN 156 million on an annual basis.

Claims on Non-government Sector

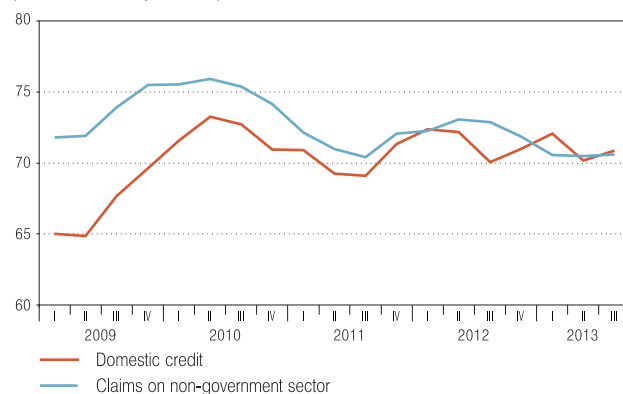


Slower growth in claims compared to the nominal GDP over the third quarter led to a decline in the *claims on non-government sector to GDP*

ratio to 70.6 per cent in September (71.9 per cent at the end of 2012).

Domestic Credit

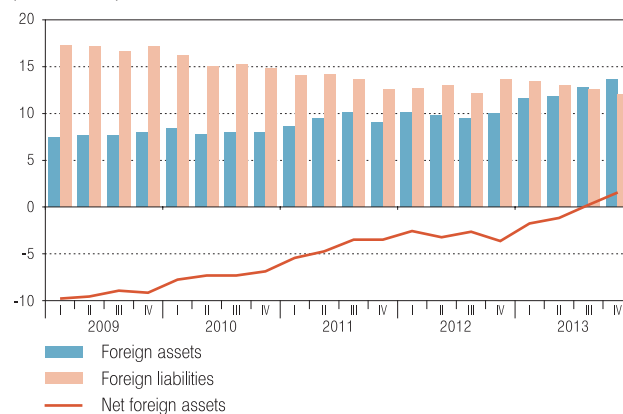
(share of GDP, per cent)



The continuous growth in attracted funds since the beginning of 2013 and the ample liquidity of banks led, for the first time since early 2007, to a positive balance of their foreign assets over the third quarter. In December net foreign assets of banks were positive at BGN 1552 million. Our projections show that in the first two quarters of 2014 banks will continue to maintain positive net foreign assets in the context of retained high liquidity of the banking system.

Foreign Assets and Liabilities of Banks

(billion BGN)



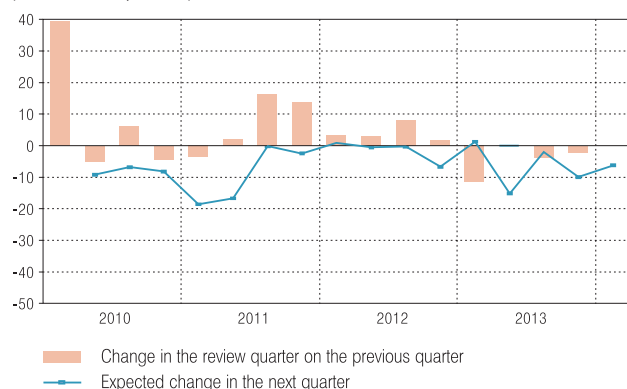
According to the results of the BNB quarterly lending survey, in the October–December 2013 period banks reported a quarter-on-quarter increase in demand for loans by corporations for a second consecutive quarter. Demand for working capital and investment loans posted an increase. Over the fourth quarter demand for housing loans by households slightly increased from the previous quarter when declines were

recorded. Consumer loans also posted acceleration in demand, though at slower rates than in the July to September period. Banks had more optimistic expectations regarding the demand for loans in the first quarter of 2014, mainly for consumer and housing household loans and, to a lesser extent, for corporate loans.

In the fourth quarter of 2013 banks eased somewhat their lending standards in relation to corporate loans and tightened them slightly for consumer and housing loans. Banks specified the following factors which contributed to credit policy easing: the increased volume and decreased cost of borrowed funds, competition among banks, and declines in alternative investment income. Bank expectations for the first quarter of 2014 suggest that credit standards will remain unchanged for consumer loans and will be slightly eased for corporate and housing loans.

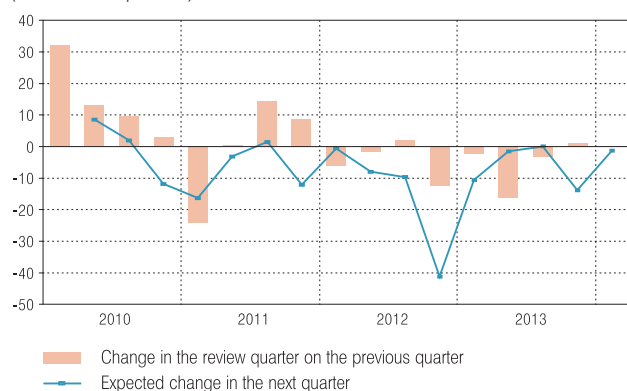
Changes in Credit Standards Applied to Corporate Loans

(balance of opinions)



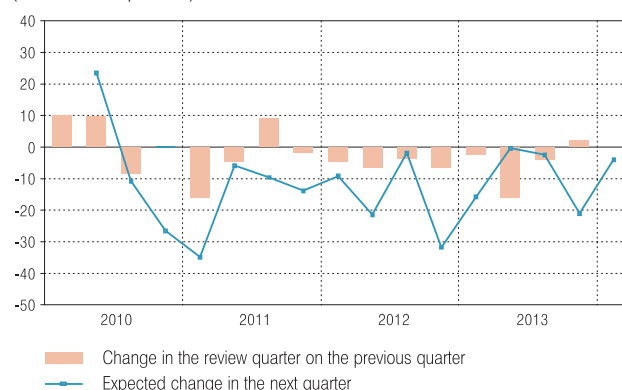
Changes in Credit Standards Applied to Consumer Loans

(balance of opinions)



Changes in Credit Standards Applied to Housing Loans

(balance of opinions)



Note: The charts present banks' balance of opinions defined as a 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.

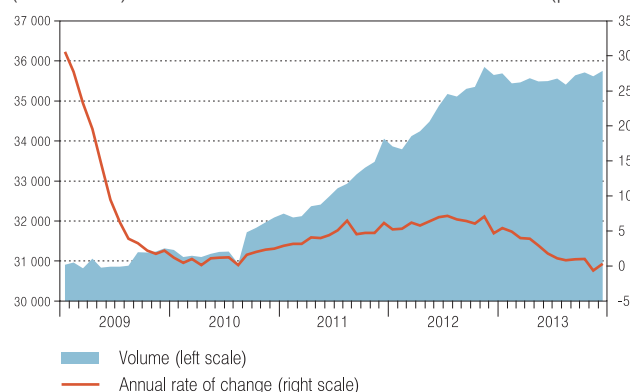
Source: BNB.

The moderation in the growth of claims on non-financial corporations since the second half of 2012 continued in 2013, their annual growth rate reaching 0.3 per cent in December compared to 4.7 per cent by end-2012. Available alternative sources of financing, including gross operating surplus used by corporations, amid the overall weak demand for borrowed funds are likely to limit future demand for bank loans. Energy and real estate operations made a substantial negative contribution to the annual growth of loans to non-financial corporations in the third quarter.²⁰ Positive contributions were recorded by trade,²¹ agriculture and other services.

Claims on Non-financial Corporations

(million BGN)

(per cent)



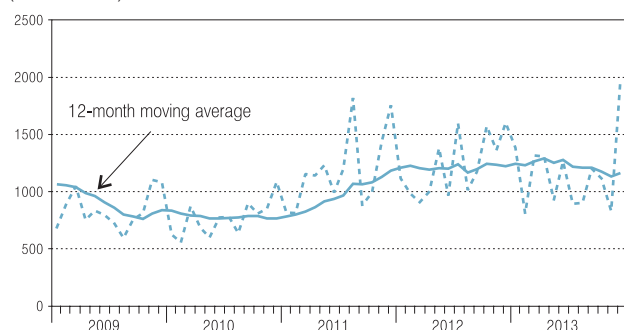
Source: BNB.

²⁰ Production and distribution of electricity, heating and gaseous fuels.

²¹ Trade, cars and motorcycles repair.

New Loans to Non-financial Corporations (Monthly Volumes)

(million BGN)

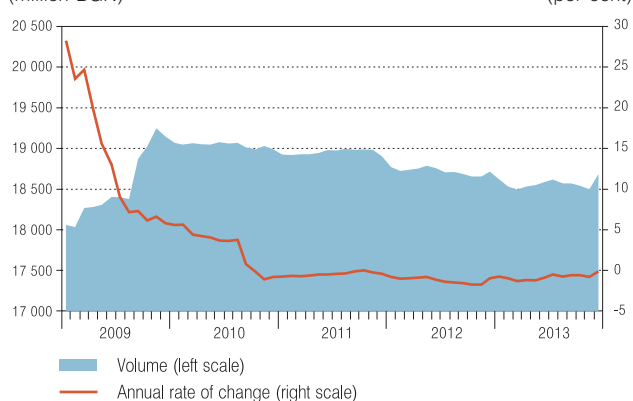


Source: BNB.

Between January and November 2013 the volume of new loans to NFCs remained high, with a slight downward year-on-year trend toward the 2008 levels at the end of the review period.

Claims on Households

(million BGN)



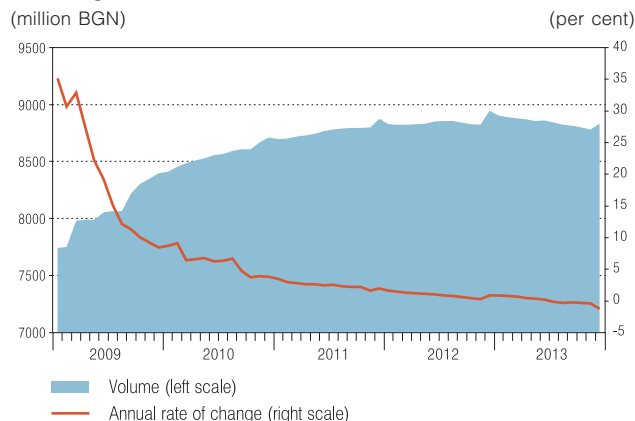
Source: BNB.

In December the amount of loans to households fell by 0.2 per cent on an annual basis (-1 per cent at end-2012). However, individual categories of loans were marked by divergent trends. Overdrafts reported an annual decline (-1.4 per cent), which is significantly lower than that in December 2012. For the first time since the onset of the economic crisis, in July 2013 housing loans decreased on an annual basis, their rate reaching -1.2 per cent, while declines in other loans deepened from -1.5 per cent in December 2012 to -6 per cent at the end of 2013. The annual decrease in housing loans was ascribable to the fall in euro-denominated loans unlike the lev housing loans which increased on an annual basis by 5.5 per cent in December. Concurrently, for the first time since the third quarter of 2010 consumer credit posted annual growth of 2.2 per cent. As of December 2013 the volume of new consumer loans showed a clearly pronounced upward trend over the last 12 months, while

the levels of newly extended housing loans and other loans remained stable.

Housing Loans

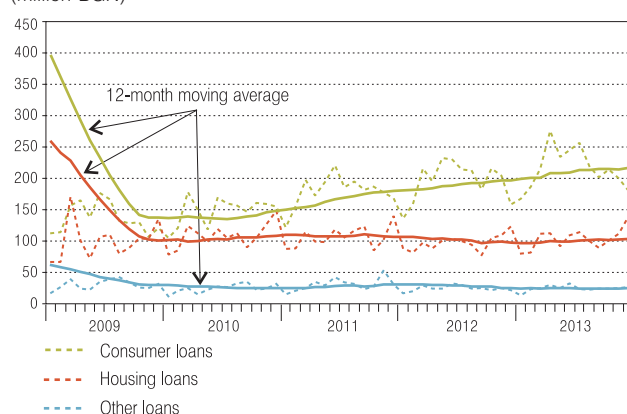
(million BGN)



Source: BNB.

New Loans to Households (Monthly Volumes)

(million BGN)



Source: BNB.

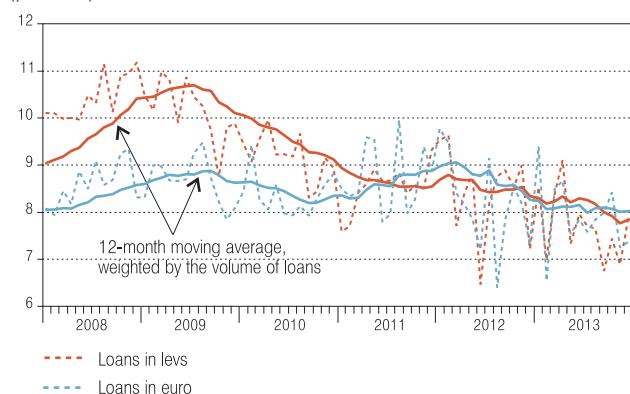
Our expectations point to a slow increase in the growth rate of loans to the non-government sector over the first half of 2014. If the economic activity in Bulgaria gradually strengthens, demand for loans by NFCs would increase, thus contributing to the accelerated growth of bank claims on NFCs. The trend to a moderate annual slowdown in the household credit decline is projected to continue in the first two quarters of 2014.

Since the middle of 2013, following a period of relative stabilisation over the first half year, a slight downward trend in interest rates on new loans to NFCs has been observed. These developments were more clearly pronounced in interest rates on lev loans, whereas those on new loans in euro stabilised. In December interest rates on new lev and euro loans to NFCs were 7.8 and 8.0 per cent (8.3 per cent by end-2012).²²

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

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

(per cent)

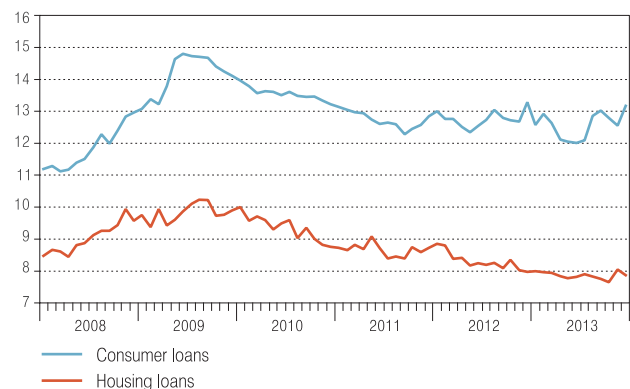


Source: BNB.

The annual percentage rate of charge (APRC) on new housing loans reversed its gradual downward trend, stabilising around the levels of early 2013 (7.9 per cent) in December. APRC applied to consumer loans retained its comparatively high levels, reaching 13.2 per cent at the end of the year.

Annual Percentage Rates of Charge on New Household Loans

(per cent)



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

Source: BNB.

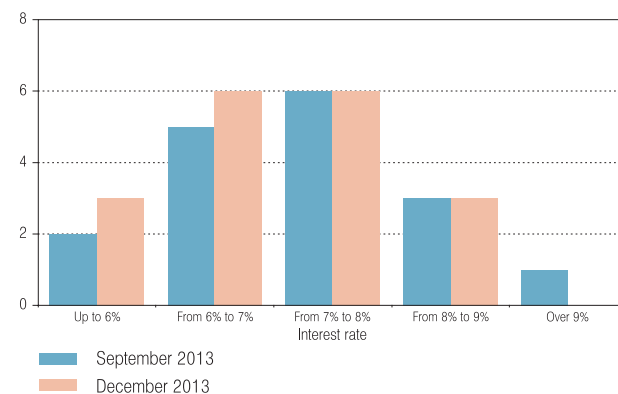
As regards the distribution of interest rates on new housing loans in euro, in December compared to September 2013, the number of banks offering rates up to 6 per cent and from 6 to 7 per cent increased at the expense of those offering rates over 9 per cent. Over the same period, the average interest rate level fell by 30 basis points to 7.17 per cent, and the standard deviation went down 20 basis points to 0.90 percentage points.

If the expected gradual acceleration in economic activity continues in the first and second quarters of 2014, the gradual decrease in lending

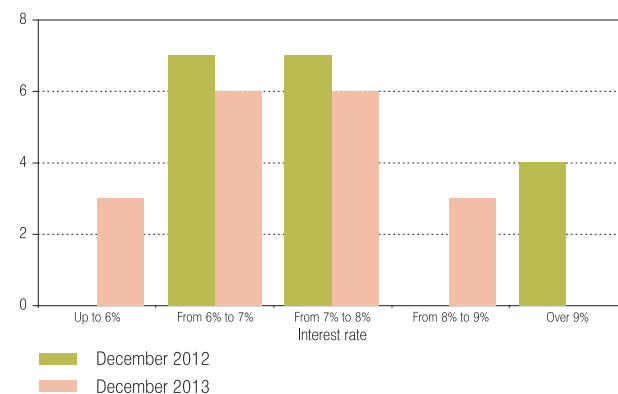
interest rates is projected to be retained. This trend will be largely underpinned by the fall in the cost of financing, high bank liquidity and the ongoing attracted funds growth in the banking system. The onset of a new interest rate cycle in the monetary policy of leading central banks, apparent through interest rate increases on international money and capital markets, could push lending rates upwards.

Distribution of Interest Rates on New Housing Loans in Euro

(frequency – number of banks)



(frequency – number of banks)



Source: BNB.

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

Government's revenue and expenditure policy and budget financing operations affected the allocation of liquidity between economic sectors.

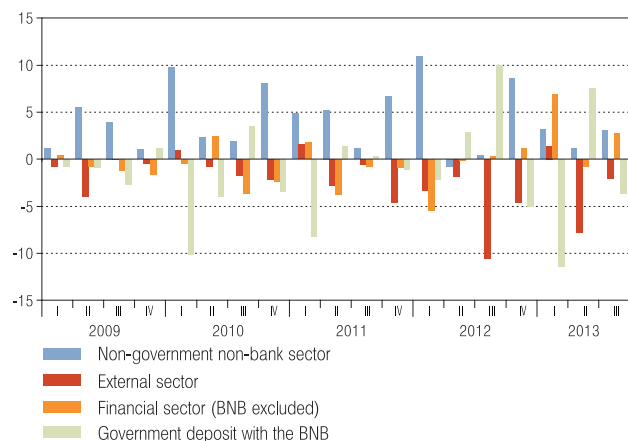
Over the third quarter inflows to the government from the external sector remained positive at 2.1 per cent of GDP. Over the third quarter, as in the April to June period, these inflows continued to be driven by EU funds absorption, with grants to the budget (mainly from the EU) reaching almost BGN 777 million (3.7 per cent

of GDP for the review quarter). In addition, the amount of allocated funds to the external sector was broadly determined by Bulgaria's contribution to the overall EU budget and repaid interest on foreign government debt instruments held by foreign investors. Most interest expenditure included coupon payments on global bonds denominated in US dollars maturing in January 2015 and on Eurobonds issued in international capital markets in July 2012.

Government operations on budget financing between July and September made the financial sector (BNB excluded) a beneficiary of liquidity. Net allocations comprised 2.7 per cent of GDP, mainly due to the net negative issue of domestic government securities (BGN -417 million) and interest payments on government debt instruments to residents. Budget financing policy led also to a decrease in government and budget organisation's deposit with the BNB. Given the net negative debt financing in the domestic market and reported budget deficit in the third quarter, the government deposit with the BNB was a net source of funds comprising around 3.7 per cent of GDP.

Consolidated Budget Effect on Other Sectors' Liquidity (Quarterly)

(share of GDP, per cent)



Sources: MF, BNB calculations.

A conclusion may be drawn based on current data that in the fourth quarter of 2013 the external sector will remain a net source of significant funds since the current and capital receipts on EU funds and December sales of transferable Schuldschein loans (EUR 290 million) will significantly exceed the repayments and interest expenditure on external loans and Bulgaria's contribution to the EU common budget.

In addition to the funds from sold transferable Schuldschein loans, the budget deficit between October and December was financed through the government deposit with the BNB and the positive net government bond issue sold in the domestic market to the amount of BGN 438 million. As a result of the budget financing policy, the financial sector (BNB excluded) and government and budget organisations' deposit with the BNB will be the sources of liquidity accounting for 1.8 and 1.2 per cent of GDP over the last quarter, with the bulk of funds allocated to the non-government sector.

The information available by end-January 2014 shows that in the first quarter the financial sector will continue to be a net source of liquid funds mainly due to the large volume of the MF indicative gross issuance in the domestic market. According to the MF issue calendar, between January and March 2014 government securities of BGN 1450 million will be issued on the domestic market and amortisation payments on bond maturities will come to BGN 483 million. As in the previous year, liquid fund inflows from the financial sector are expected to cover both higher budget deficit over the first quarter and advance subsidy payments under the EU Common Agricultural Policy.

In the first months of 2014 direct payments to farmers will reach almost BGN 1100 million,²³ being of major importance for liquidity allocation among economic sectors. It is expected that the government will initially draw the required funds from the financial sector in the form of interest bearing bills and then redirect them to the non-government non-bank sector from the government deposit with the BNB. Given the fact that these funds are recoverable from the EC, the external sector is expected to be a net source of liquidity in the first three months of 2014.

²³ Agricultural Fund data show that the major portion of these funds (BGN 1.02 billion, including extra national payments) were disbursed in the last week of January.

3. Economic Activity

Economic activity in Bulgaria increased in the third quarter of 2013 largely reflecting export growth. Firms remained cautious with respect to labour employment and households were cautious in their consumption. Economic activity growth in Bulgaria is expected to moderate on a chain basis due to the lower contribution of net exports in the fourth quarter of 2013 and to enhance gradually in the first half of 2014 reflecting higher domestic demand.

Economic activity in Bulgaria slightly increased in the third quarter of 2013. The contribution of net exports to growth was positive due to the high exports, reflecting the economic growth recovery in Bulgaria's major trading partners. Domestic demand continued to rise at a low rate, close to that in the first and second quarters of 2013. Households opted to retain their high savings rate, which led to a 0.1 per cent decrease in private consumption growth. In real terms, investment matched its second quarter's level, though slightly increasing nominally. Low domestic demand dynamics was the main factor behind the lower import growth compared to the export growth. As a result, net exports contributed most to real GDP growth by 0.5 per cent²⁴ on a quarterly basis in the third quarter of 2013. The change in inventories had a slightly negative contribution to quarter-on-quarter GDP growth in the third quarter, with firms executing the increasing foreign orders by reducing inventories of finished goods.

²⁴ 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 optimization of adjustment parameters.

Contribution to GDP Growth by Component of Final Consumption

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



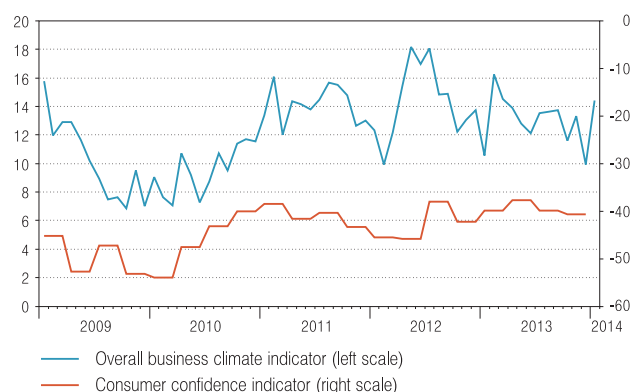
Note: Non-additive data due to direct chain-linked and seasonal adjustment of GDP and its components; the contribution of the change in inventories has not been included.

Sources: NSI, BNB calculations.

Short-term economic indicators show that the economic environment in Bulgaria slightly deteriorated over the fourth quarter of 2013. Unemployment level remained broadly unchanged, as well as households' expectations about its future level. This created preconditions for consumer confidence indicator to retain its previous months' level.

The overall business situation indicator tracking industrial sentiment of entrepreneurs in construction, retail trade and services sector decreased at the end of 2013 mainly due to the deterioration of managers' assessment in construction about the future business situation, while in other sectors it remained relatively unchanged. Leading indicators in Bulgaria's major trading partners point to a continuing economic activity recovery.

Business Climate and Consumer Confidence Indicator



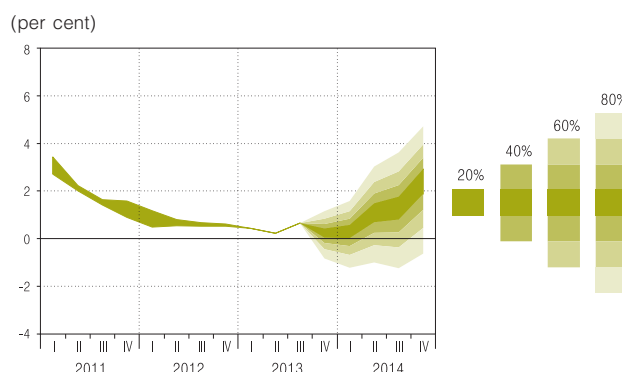
Sources: NSI, BNB calculations.

Economic activity growth in Bulgaria is expected to moderate on a chain basis in the fourth quarter of 2013 and to enhance gradually in the first half of 2014. Slowing growth will reflect the lower contribution of net exports in the last quarter of 2013 due to matching import and export growth rates. Import growth will accelerate as a result of the gradual recovery in private consumption and mainly of the improvement of firms' investment activity. Concurrently, exports are expected to moderate after the high rates observed in the nine months of 2013. In the first half of 2014 these trends will continue, leading to a slow acceleration of quarter-on-quarter GDP growth.

Quarter-on-quarter GDP growth dynamics described above will result in a moderation of annual GDP growth (see Fan Chart of the Expected Annual Rate of Change of GDP) in the fourth quarter of 2013 due to higher annual growth of exports, while that of imports will remain close to its third quarter's level. In the first half of 2014 domestic demand will prob-

ably make the main positive contribution to the gradual acceleration in the annual GDP growth rate, which will be partly offset by the higher negative contribution of exports.

Fan Chart of the Expected Annual Rate of Change of GDP



Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The reporting period includes revised GDP growth estimates. The middle band of the chart, depicted in the darkest colour, includes the central projection 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.

If the recovery process accelerates in Bulgaria's major trading partners, exports of goods and services may be higher than projected. On the other hand, it is possible, but unlikely, deflationary processes in economy to last longer than expected, which would cause postponement of firms' investment projects and lower economic growth.

GDP Growth by Component of Final Use

(per cent real growth 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	Q3
Consumption incl.	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	0.2
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	-0.1
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	0.6
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	1.7
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	0.1
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	3.5
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	2.3
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	0.5

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 rate and labour supply.

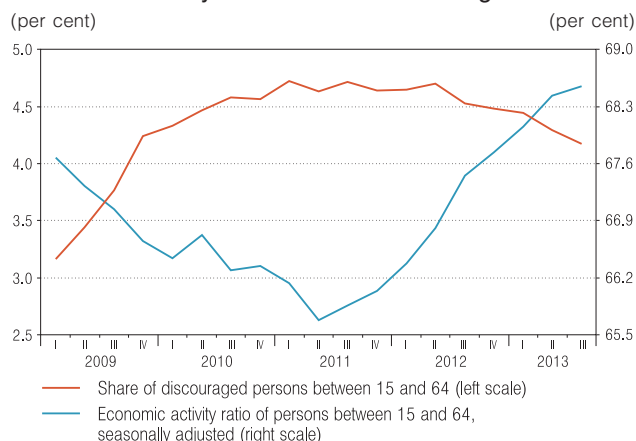
According to seasonally adjusted national account data, in the third quarter of 2013 the real growth rate of household consumption experienced no significant changes on a quarterly and annual basis. In real terms, consumption fell by 0.1 per cent on a quarterly basis (after rising 0.9 per cent in the second quarter of 2013) and remained at its level of the corresponding quarter of 2012. Between July and September 2013 communication services consumption had the main positive contribution to growth, while consumption of purchased non-production services²⁵ and food continued to contribute negatively. No substantial changes occurred in the other groups.

Retail turnover grew in early 2013, a trend observed since the beginning of the fourth quarter, with household appliances, furniture and computer and communication equipment contributing most. Employment stabilisation since mid-2012 and the continuous increase in income from remuneration had a favourable effect on consumption dynamics, as reflected in high retail trade volumes.

According to the Labour Force Survey, economic activity rate measuring the labour force to working-age persons ratio (15–64 years) continued rising in the third quarter due to the decreased number of working-age persons. The number of discouraged persons and their share in total working-age population also declined.

²⁵ Purchased non-production services include services other than catering services, water supply, heat energy and electricity, transport and communications.

Economic Activity and Share of Discouraged Persons



Sources: NSI Labour Force Survey, BNB calculations.

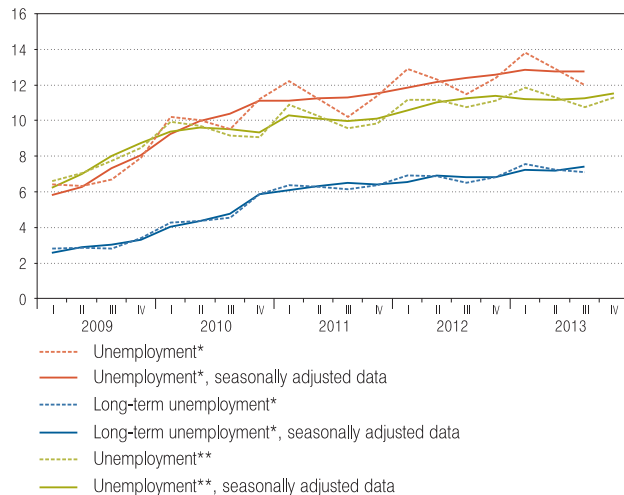
Seasonally adjusted Labour Force Survey data show that employment has been stabilised since the beginning of 2012. In the third quarter of 2013 it decreased slightly by 0.3 per cent on a quarterly basis (after a slight increase in the first and second quarters of 2013). The employment breakdown by education points to an increase in the number of persons with primary and lower education, a slight increase in those with higher education and a decrease in persons with secondary education with professional qualification.

According to seasonally adjusted data of the Labour Force Survey, over the third quarter unemployment retained its first two quarters' level of 12.8 per cent. Based on the Employment Agency data, the seasonally adjusted unemployment rate²⁶ slightly accelerated in the fourth quarter to reach 11.6 per cent in December 2013. The Labour Force Survey show that in the context of a relatively high unemployment rate and low labour demand by corporations the number of long-term unemployed in the third quarter 2013 (unemployed persons more than a year) slightly increased to 7.4 per cent of labour force.

²⁶ The Employment Agency uses a constant rate of labour force.

Unemployment

(percentage of the labour force)



* NSI data.

** Employment Agency data.

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

Employment and unemployment stabilisation in the context of a continuous increase in income from remuneration, the main source of income for the households, created conditions for the moderate recovery in consumption in the second half of 2014. The wage bill and average wage slightly accelerated to 1.8 per cent and 1.2 per cent on a quarterly basis in the third quarter (against 1.3 per cent and 1 per cent in the second quarter of 2013) according to seasonally adjusted data²⁷ on short-term statistics on employment and labour costs²⁸.

For non-seasonally adjusted data the annual growth of wage bill and average wage *per* employee between January and September 2013 grew (by 3.9 per cent and 3 per cent respectively) at lower rates than in 2012 (10.8 per cent and 7.1 per cent in the first nine months of 2012). In the third quarter the wage bill and nominal wage maintained their growth rate of 3.1 per cent and 3.7 per cent respectively.

In the context of comparatively high unemployment, low and uneven recovery of employment by sector and related uncertainty about income, the share of savings in household disposable

²⁷ The seasonal adjustment of indicators, on which the NSI does not officially publish seasonally adjusted data, was made *via* the TRAMO SEATS programme by using automated set up for diagnostics and optimisation of adjustment parameters.

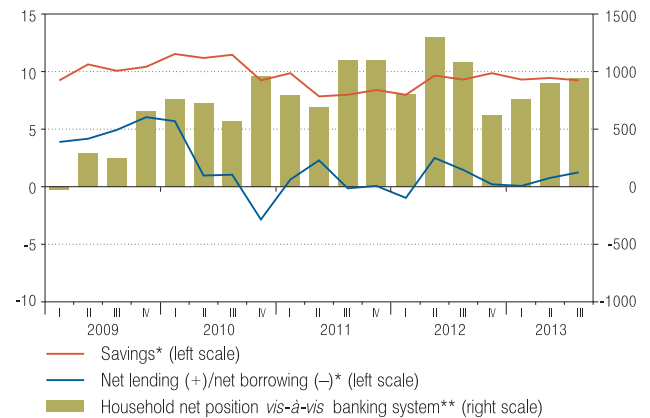
²⁸ Household income analysis is based on the short-term statistics of employment and labour costs (see Economic Review, 3/2013, p. 40).

income remained high²⁹. As in the previous quarters, consumer survey of October 2013 suggests household intentions to increase savings in the following 12 months. Their net assets measured by household net position in the banking system increased (according to the BNB monetary statistics), signalling a retention of high savings rate in the first half of 2014 and a slow recovery of consumption over the projection horizon.

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.

** According to BNB data.

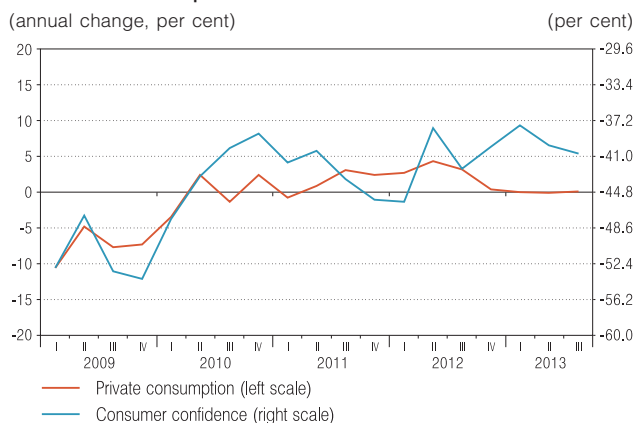
Sources: NSI Household Budget Survey, BNB.

Uncertain economic environment and still weak labour demand are expected to continue affecting household behaviour in the next quarters. In July and October 2013 the household confidence indicator reported in the NSI Consumer Survey³⁰ declined slightly reflecting the deteriorated expectations about economic situation and unemployment, but remained close to its previous quarters' levels.

²⁹ Disposable income (based on the household budget survey) is obtained by subtracting tax expenditure, social contributions and transfers from the total income.

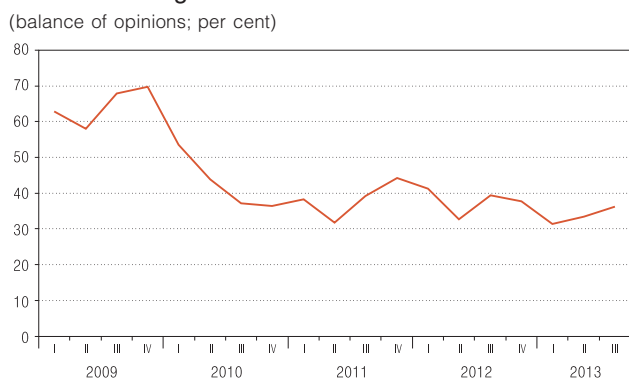
³⁰ Final results of the Consumer Survey represent balances of opinions calculated as a difference between the relative shares of positive and negative opinions on raised issues. The composite consumer confidence indicator is calculated as the arithmetic mean of expectation balances in the following twelve 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).

Private Consumption and Consumer Confidence



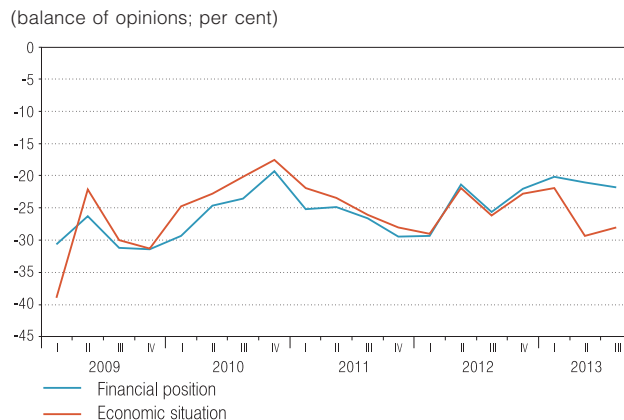
Sources: NSI Consumer Survey and BNB calculations.

Unemployment Expectations in the Following Twelve Months



Source: NSI Consumer Survey.

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



Source: NSI Consumer Survey.

Despite the effect of the above mentioned factors, some favourable labour market trends related to the stabilisation of total employment and its slight increase in some sectors are expected to create preconditions for a gradual recovery in consumption.

Risks to these expectations relate mainly to factors affecting consumer confidence, such as employment and income developments. The latter largely depend on firms' propensity to hire personnel and enhance investment activity.

Employment and Income Dynamics

	2010				2011				2012				2013		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
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	-0.2
Nominal wage <i>per employee</i>	1.6	1.6	2.1	2.2	1.6	2.2	2.1	2.1	3.3	2.4	1.7	1.8	0.4	1.0	1.2
Real wage <i>per employee</i> *	0.8	0.2	1.6	1.3	-0.1	2.1	1.4	1.7	3.9	1.1	0.3	1.5	-0.5	1.5	1.9
Wage bill, nominal terms	0.4	0.3	1.3	2.8	1.9	1.3	1.1	0.8	2.5	2.4	1.2	1.8	-1.1	1.3	1.8
Wage bill, real terms*	-1.0	-0.5	0.8	1.5	0.3	1.3	0.7	0.7	2.8	0.6	-0.2	0.8	-0.5	1.9	1.5
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	-0.1
Nominal wage <i>per employee</i>	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	3.7
Real wage <i>per employee</i> *	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	4.4
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	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	3.8

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	Q4
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	2.7	1.5
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	7.6	-3.6
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	8.1	-1.9
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	4.2	6.1
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	0.9	9.6
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	3.0	3.0
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	-1.5	1.8
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	-1.4	-3.2

Source: NSI Domestic Trade Survey.

Public Finance and Government Consumption

According to the MF quarterly data on the consolidated fiscal programme performance in the third quarter of 2013 the cash-based budget balance ended in a deficit of BGN 361.6 million. MF preliminary monthly data show that the consolidated fiscal programme deficit in 2013 was BGN 1448.4 million (1.8 per cent of projected GDP), including the EU programme deficit of BGN 556.8 million. The deficit was BGN 144.9 million (0.2 per cent of GDP) less than the targeted level in the 2013 Revised State Budget Law. The budget balance deteriorated by BGN 1098.2 million on 2012.

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

(per cent, percentage points)



Sources: MF, BNB calculations.

Over the July–September 2013 period total budget revenue under the consolidated fiscal programme slowed down to 5.6 per cent mainly

due to the lower growth rate of EU fund grants and uneven quarterly profile of receipts from non-tax income on 2012. In the third quarter a moderate recovery in tax revenue was observed, though their contribution to the growth of total budget revenue remained low at 3.0 percentage points compared to those of grants (4.3 percentage points).

Over the third quarter of 2013 major trends determining tax revenue dynamics in the April to June period were sustained. Social and health insurance contributions still contributed most to the annual growth of tax revenue (3.8 per cent). Their dynamics was due largely to the 20 percentage points rise of social security contributions paid by special bodies' employees to the Pension Fund. This increase is also associated with the relevant growth in social security expenses of special bodies and therefore has no bearing on the budget balance. If the effect of increased security contributions is eliminated, this revenue would be 7.0 per cent.

After falling by 1 per cent in the second quarter, indirect tax growth accelerated to 1.8 per cent on an annual basis as a result of the higher import VAT and duty revenue, which corresponds to the nominal annual growth of imported goods (5.5 per cent)³¹. On the other hand, the nominal decline in private consumption (-2.4 per cent)³² accounts for the fall in VAT revenue from domestic and intra-Community transactions (net). VAT refund in the second half-year also contributed

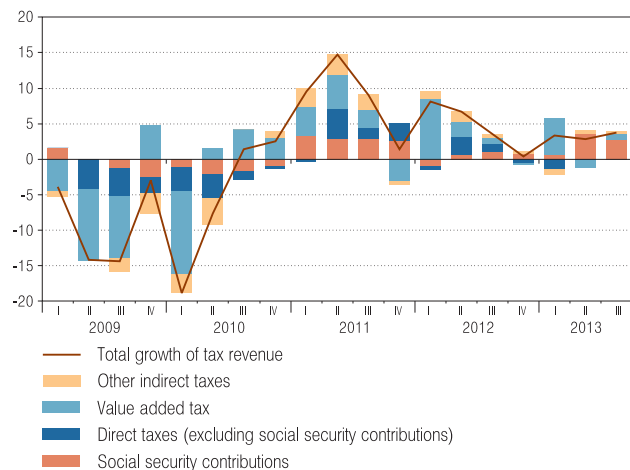
³¹ Seasonally non-adjusted data, annual rate of change.

³² Seasonally non-adjusted data, annual rate of change.

to the lower net receipts from VAT. According to MF data, VAT not refunded in due time was BGN 320.1 million by early July, while in the beginning of October it was BGN 241.7 million.

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

(per cent, percentage points)



Sources: MF, BNB calculations.

Over the third quarter the decrease in direct taxes moderated to 0.3 per cent, from 0.7 per cent in the second quarter. Over the review period corporate tax revenue decreased, but this dynamics reflected entirely the changes in tax legislation introduced in early 2013.³³ These changes affected significantly the quarterly profile of receipts from corporate tax and made it incomparable to the dynamics of its respective macroeconomic base: gross operating surplus. Revenue from personal income tax also experienced changes in the quarterly profile of tax revenue compared to the previous year as a result of the change in tax legislation in the beginning of 2013. Their lower nine months' growth than that of wage bill (3.0 per cent) can be explained by the postponement of these receipts³⁴, taking into account the contribution of the new tax on receipts from interest on time deposits³⁵ introduced in the beginning of the year.

³³ For further information on early 2013 changes in tax legislation and the effect thereof on the profile of tax revenue, see the *Major Tax Legislation Amendments Effective since 1 January 2013* box, Economic Review, 1/2013, p. 53.

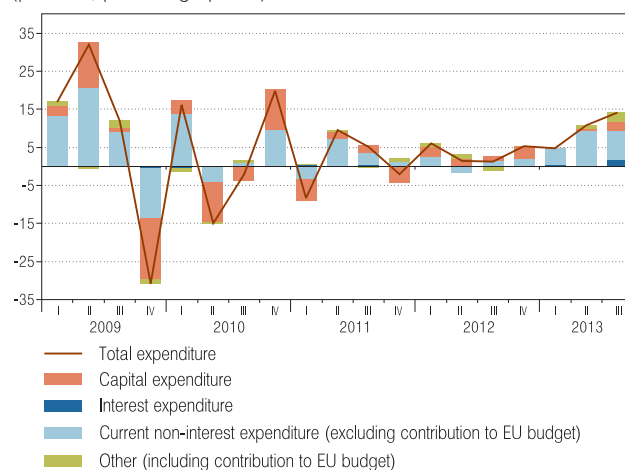
³⁴ This indicator is taken from short-term statistics on employment and indicates the base, on which personal income tax on labour contracts is levied.

³⁵ Revenue from personal income tax came to BGN 24.3 million in the third quarter of 2013.

In the third quarter of 2013 total government expenditure growth continued to accelerate to 14.1 per cent. Unlike the previous quarter, the increase in public investment was the factor behind higher expenditure growth, while current expenditure growth (without the contribution to the EU budget) slightly moderated from 11.1 per cent to 9.2 per cent.

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

(per cent, percentage points)



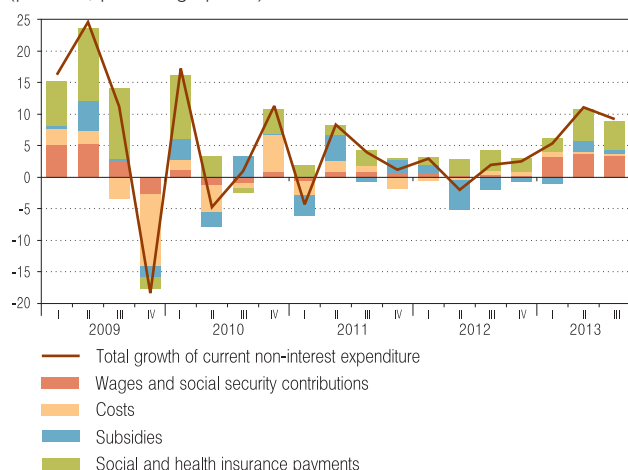
Sources: MF, BNB calculations.

Social security, assistance and care expenditure continued to contribute most (4.5 percentage points) to higher current expenditure. Their growth reflected the pension increase of 9.3 per cent on average effective as of 1 April 2013, and to a less extent the measures initiated by the caretaker cabinet to support the most vulnerable groups in the society and boost employment, as well as the additional social expenditure approved in August by the 2013 Revised State Budget Law of the Republic of Bulgaria.

The contribution of expenditure on compensation of employees in the public sector (3.4 percentage points) to higher current expenditure remained high. Their increase was largely driven by the wage indexation in the second half of 2012 and the change in the allocation of funds for additional financial incentives over the year. Higher expenditure on compensation of employees was influenced to some extent by the effect of increased security contributions paid by special bodies' employees and to a lesser extent by growth of this expenditure in the EU funds budget.

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.

Over the third quarter EU funds budget expenditure (including national co-funding) grew by 47.1 per cent compared with the same period last year, from 24.2 per cent in the second quarter.³⁶ Significant part of total operating and subsidy expenditure growth was still driven by the increase in the expenses on the EU programmes, while those on the national budget posted a decline in subsidies and minimum growth in operating expenditure. An analogous situation holds for public investment, its rate accelerating to 31.6 per cent in the third quarter mainly due to higher capital expenditure on the EU Structural and Cohesion Funds.

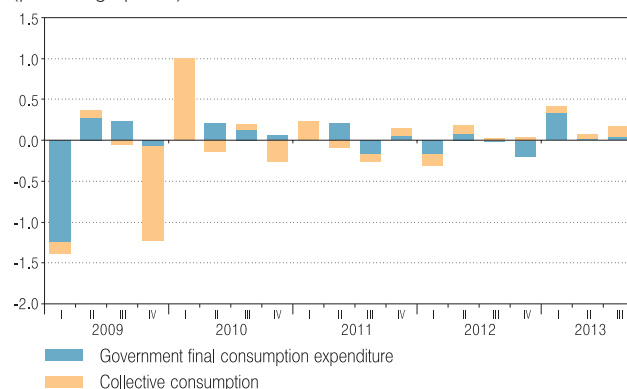
Driving factors behind nominal and real government consumption dynamics in the third quarter were similar to prior quarter's drivers. The accelerated implementation of EU programmes contributed to the moderate real growth of government consumption in terms of higher operating expenditure. The significant increase in expenditure on compensation of employees affected the deflator of government consumption for the review period. As a result, nominal and real government consumption growth remained relatively high at 11 per cent and 6.0 per cent. Given the relatively low share of government consumption in GDP, the contribution of government consumption to quarterly growth of season-

³⁶ MF monthly data on consolidated fiscal programme performance are published on the MF website. It should also be noted that the amounts under these programmes are initially financed from the national budget and subsequently reimbursed by the EU, following their certification.

ally adjusted GDP was 0.2 percentage points in the third quarter (0.1 percentage points in the second 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.

As in 2013 the increase in household disposable income through higher social transfers and subsidies projected by the government will be the main channel, through which fiscal policies will support consumption recovery in the first two quarters of 2014. Parameters of the 2014 State Budget Law of the Republic of Bulgaria provides for low but positive contribution of government consumption to GDP growth over the first two quarters of 2014. An increase in expenditure on compensation of employees, the major component of government consumption, may be expected in line with the increases in minimum wage, minimum wage of civil servants and wages in health-care sector effective as of 1 January 2014.

Preliminary MF monthly data on consolidated fiscal programme performance show that total revenue and grants for 2013 was BGN 28,981 million (up 5.5 per cent on 2012) or 95.4 per cent of the levels projected in the Revised State Budget Law.

The contribution of tax revenue to growth of 2013 total budget revenue was 3.1 percentage points. The annual growth of indirect taxes came to 2.2 per cent, contributing 0.9 percentage points to total revenue growth. Despite the significant fluctuations in receipts from corporate tax and personal income tax between January and September 2013, direct taxes (without security contributions) had a positive contribution of 0.5 percentage points to total revenue growth

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		III quarter		January–December*	
	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	per cent	percent- age points
Total revenue and grants	7.7		11.6		7.1		6.6		3.4		10.2		5.6		5.5	
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	3.8	3.0	3.9	3.1
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	-27.6	-1.1	5.1	0.3
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	15.2	1.2	2.3	0.2
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	2.2	0.6	3.0	0.8
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	0.2	0.0	0.2	0.0
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	36.1	0.2	24.2	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	10.9	2.3	8.4	1.7
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	-6.7	-0.2	0.2	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	-13.6	-1.7	10.8	1.4
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	59.6	4.3	11.7	1.0
Total expenditure (incl. the contribution to EU budget)	6.0		1.5		1.3		5.3		4.6		10.8		14.1		9.4	
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	11.8	2.3	11.8	2.2
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	6.3	0.9	5.6	0.9
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	72.9	1.8	20.3	0.4
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	8.5	3.8	7.3	3.1
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	15.7	0.6	16.0	0.7
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	31.6	3.9	11.8	1.6
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	31.7	0.8	15.4	0.4

* Based on preliminary monthly data on consolidated fiscal programme performance.

Sources: MF, BNB calculations.

throughout 2013. The implementation of tax revenue was 97.9 per cent *vis-à-vis* the targets.

In 2013 total government expenditure, including Bulgaria's contribution to the EU budget, amounted to BGN 30,430 million, their annual growth reaching 9.4 per cent. Compared to the parameters of the 2013 Revised State Budget Law, total budget expenditure, including the contribution to EU budget, were implemented at 95.2 per cent. Social and health insurance expenditure (3.1 percentage points) and compensation of employees in the public sector (2.2 percentage points) had a major contribution to total expenditure growth, a trend being sustained for most of the year. Despite the reported acceleration in annual growth of capital expenditure, its contribution to the annual growth of total government expenditure came to just 1.6 percentage points by the end of December.

Between January and December 2013 the budget deficit and government debt payments amounted to BGN 4325.8 million. They were financed by gross government securities issue on the domestic market worth to BGN 2323 million³⁷, fiscal reserve funds of BGN 1400 million and new external loans of BGN 1119 million. As a result, net external financing was negative (BGN -688.1 million), net government securities issue of the domestic market amounted to BGN 1317 million, and fiscal reserve funds fell to BGN 4681 million by end-December.

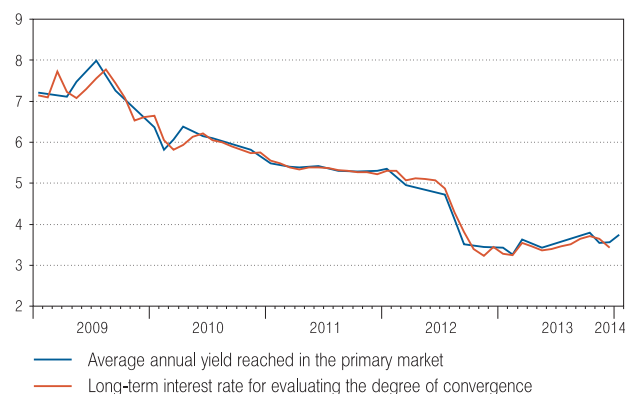
According to the national methodology, by end-November government debt totalled BGN 13,268 million in nominal terms: a decrease of BGN 406 million on the end of 2012.

³⁷ For details on individual issues of domestic government securities, see *Government Debt Management* monthly bulletin of the Ministry of Finance.

Over the fourth quarter of 2013 a slight price rise and a yield fall was observed at most of Bulgarian government securities auctions on the primary market. Only at the auctions for sale of government securities with an original maturity of ten years and six months yields increased due to lower investors' demand, as reflected in lower bid-to-cover ratio.

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

(per cent)



Source: BNB.

The long-term interest rate on the secondary market fell by 21 basis points by end-December, from 3.43 per cent at the end of the third quarter.

Yields on Bulgarian Eurobonds maturing in July 2017 and traded on the secondary market also posted a decline. In the last three months of 2013 the price of these bonds rose gradually to 108.2 (equal to an annual yield of 1.8 per cent), after hovering around 107.5 (a 2.2 per cent yield) in the third quarter.

In accordance with the MF issuing policy for 2014, the government plans a new government securities issue with an indicative total volume of about BGN 3 billion to be sold on international capital markets. In 2014 a positive net government bond issue on the domestic debt market is projected to reach approximately BGN 400 million as a result of the issuance of interest-bearing government securities worth nominally BGN 1.2 billion.

Major Parameters of the 2014 State Budget Law of the Republic of Bulgaria

According to the State Budget Law for 2014 and latest government's medium-term budget projection of January 2014, consolidated fiscal programme cash deficit is planned to reach 1.8 per cent of GDP forecast (BGN 1472.3 million).

As regards the budget revenue side, tax and social security revenue is expected to increase significantly (by 6.5 per cent compared to the planned receipts for 2013), offsetting the temporary fall in the revenue from grants under EU programmes*. Planned rises reflect mainly the expected outcomes from measures for fighting VAT fraud and smuggling**. Additional revenue from social security contributions and personal income tax is also envisaged due to the rise in minimum insurance thresholds (2.6 per cent on average) and minimum wage (from BGN 310 to BGN 340). Corporate tax revenue of some BGN 100 million is expected to be transferred to 2014 in line with early 2013 changes in tax legislation. Since early 2014 the rate of personal income tax on deposits was reduced from 10 per cent in 2013 to 8 per cent for income acquired in 2014. Receipts from the new tax on renewable energy sources are estimated at BGN 150 million.

As regards spending, government policy of expansion in social benefits to households, aimed at supporting domestic consumption recovery, remains unchanged. The significant increase in pensions (3.2 per cent) compared to 2013 budget is driven by the base effect of the pension increase in April 2013 and the re-introduction of the 'Swiss rule' for the pension indexation, that will prompt an increase of about 3 per cent in all pensions as of 1 July. The freeze of the rise in minimum retirement age and required number of contribution years will also contribute to pension growth over the year. Current transfers, compensations and aids for households are also expected to grow significantly (by 8.4 per cent compared to the budgeted expenditure for 2013) due to the increase in child benefits for children aged one to two years, family assistance measures and child disability allowances. Farmer subsidies are planned to rise by 7.6 per cent compared to the 2013 budget figures, resulting from the different measures to support them. Contingent and urgent expenses are projected to increase significantly (from BGN 675.7 million in 2013 to BGN 1140.6 million in 2014). The bulk of them will support government investment programme and energy projects.

* It should be taken into account that the grants projected for 2014 are lower (by 13.5 per cent) than the projection for the previous year, but they are higher than the outcome for 2013.

** According to the report to the State Budget Law, the positive effect of the VAT reverse charge mechanism for supplies of cereals and industrial crops is BGN 400 million, while the introduction of fiscal control over movements of goods with high fiscal risk within the territory of Bulgaria amounts to BGN 220 million.

Eurostat data show that at the end of the third quarter of 2013 nominal consolidated debt of the general government sector reached BGN 13,611 million or 17.3 per cent of the projected GDP, a decrease of BGN 777 million or 1.2 per cent of GDP on the end of 2012.

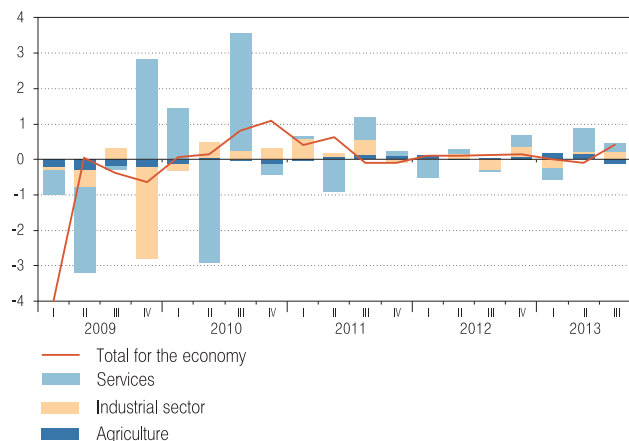
Behaviour of Firms and Competitiveness

In the third quarter and the beginning of fourth quarter of 2013 positive dynamics were reported in manufacturing production activity. Declines in construction moderated, with the number of employees rising slightly in the sector. The contribution of services remained positive to value added growth in total economy, boosting sector employment.

Seasonally adjusted national account data show that value added in the economy rose by 0.4 per cent in the third quarter compared to the previous quarter of 2013, with industry and services reporting the major positive contribution.

Value Added Growth and Contribution by Sector

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



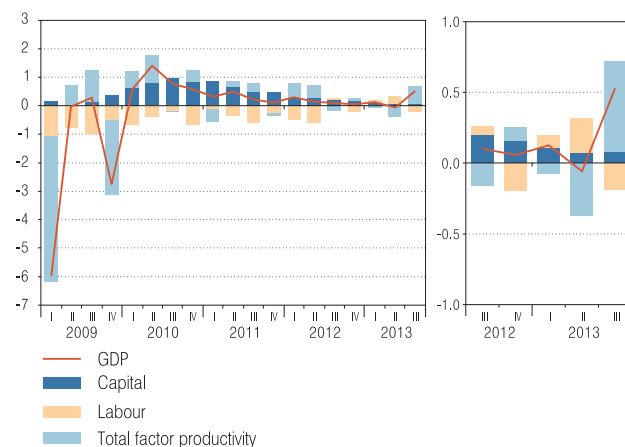
Note: Non-additive data on contributions due to direct seasonal adjustment of value added and its components.

Sources: NSI, BNB calculations.

The major factors behind GDP growth in the third quarter of 2013 were labour productivity growth and firms' policy to use capital more efficiently. The contribution of employment was negative, while that of the used capital was close to nil due to lower capacity utilisation and still weak investment activity in real terms.

Contribution of Changes in Production Factors to GDP Growth

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

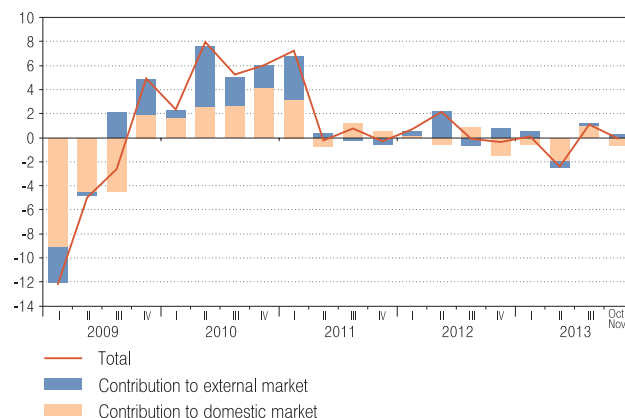


Sources: NSI, BNB calculations.

Revenue from industrial sales went up between July and September, after falling slightly in the second quarter of 2013, and remained unchanged in October and November.

Industry Turnover Dynamics

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



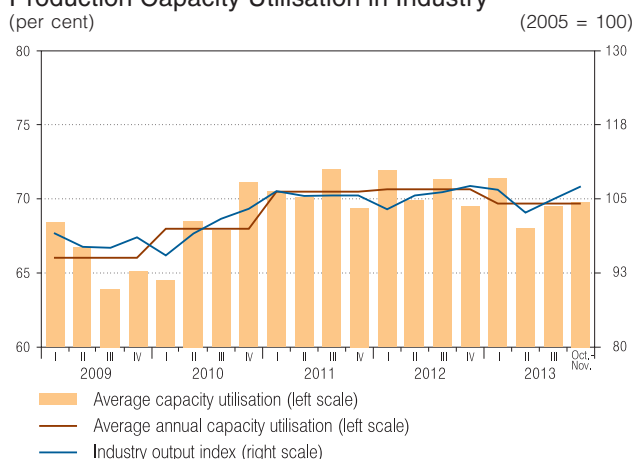
Sources: NSI, BNB calculations.

Industrial turnover dynamics reflected two opposite trends. Physical output volume measured by the industrial production index rose, while selling prices fell. Increased volumes helped to offset almost entirely the effect triggered by the fall in the prices.

External sales, boosted by the economic recovery of our major trading partners, made the main positive contribution to higher sales volumes. The external demand for manufactured goods was focused mainly on investment products and consumer durables, while energy products marked a decline. As a result of weak domestic demand, domestic sales revenue reported a

decline in most commodity groups except investment goods, which rose as investment activity in Bulgaria stabilised.

Production Capacity Utilisation in Industry

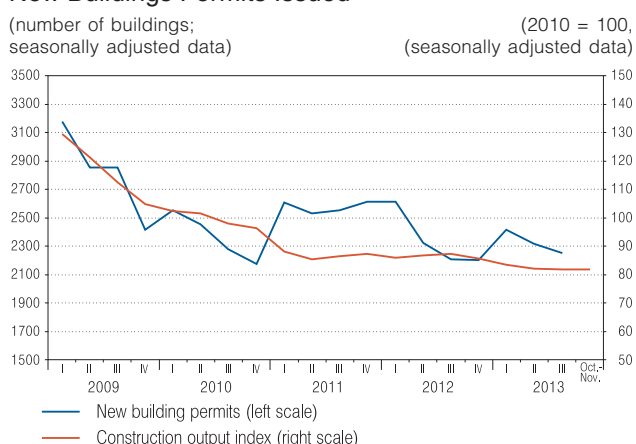


Source: NSI, Industry Business Survey, BNB calculations.

Capacity utilisation for the industrial sector in the fourth quarter of 2013 followed the positive dynamics of the industrial production index, but remained close to the 2012 levels. The sector has free production capacity and investment will probably continue to be focused on improving the capacity efficiency, rather than expanding production capacities.

The economic slack in construction was sustained over the third quarter of 2013 along with moderating decline rates of construction output index. The decrease in production volumes of building construction continued in October and November. Over the same period an increase was reported in civil engineering construction, contributing to the slowdown of the total decline rate in the sector.

Construction Output Dynamics and New Buildings Permits Issued



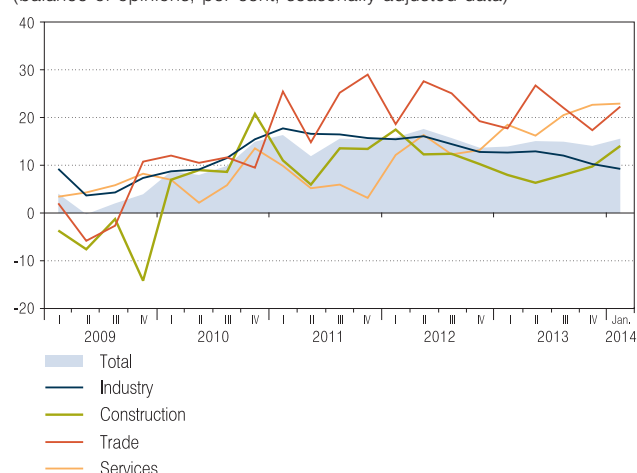
Sources: NSI, BNB calculations.

The upward trend in retail trade turnover³⁸ on a quarterly basis continued in the third and fourth quarters of 2013. In the third quarter of 2013 turnover growth was boosted by the non-durable consumer goods as foods, drinks and tobacco, while by November durable consumer goods as computer and communication equipment and other consumer goods and household appliances, furniture and other household goods made an increasing contribution. Enhanced economic activity in trade probably added to the higher transport turnover, with sub-sectors related to freight shipping exhibiting the largest increase in revenues. The demand for business services continued growing due to the positive dynamics of investment activity in Bulgaria.

Higher managers' expectations about future economic activity reported in the second and third quarters of 2013 remained broadly unchanged in the fourth quarter, which had a positive effect on Bulgarian investment activity.

Expectations about Future Economic Activity

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



Sources: NSI, BNB calculations.

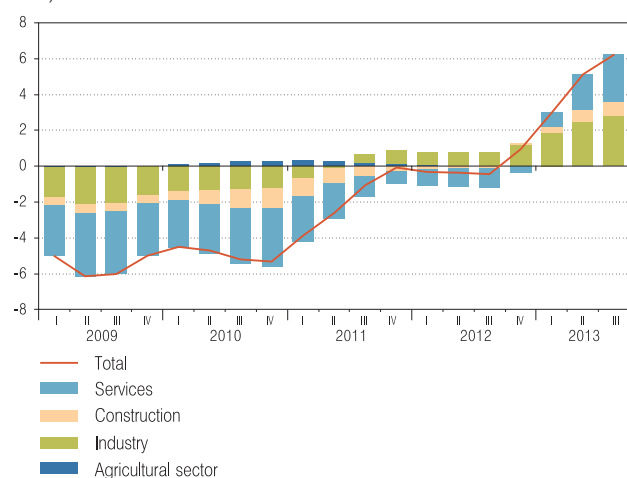
According to national account data, investment in fixed capital remained unchanged in the third quarter of 2013 compared to the prior quarter. Investment went up by 4.1 per cent in nominal terms on a quarter-on-quarter basis. The seasonally adjusted data point also to an increase in expenditure on acquisition of fixed assets in nominal terms, with industry contributing most to this. The services sector also contributed positively to the overall growth in expenditure on acquiring fixed assets, reflecting the continuous

³⁸ See the *Retail Trade Turnover* table in the *Household Behaviour* section in this chapter.

improvement of firms' economic activity in this sector and increased expectations of managers about the future economic activity. Industrial firms continued to invest in order to improve the capacity efficiency, rather than expand production capacities due to still low demand compared to the pre-crisis period and available spare production capacity. The retention at the expected level suggests that the investment activity in Bulgaria will grow in the fourth quarter of 2013 and the first half of 2014, though at a slower pace.

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.

Firms' investment focused on improving the capacity efficiency is not high in comparison to that intended for expanding production capacity, and financing needs are smaller. Therefore, firms are able to finance the bulk of their investment projects by their own funds from operating surplus and the demand for other sources of funding diminishes.

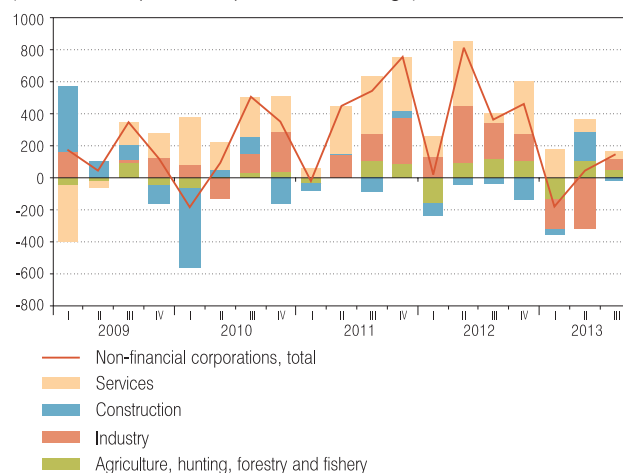
In the third quarter of 2013 bank credit increased on the second quarter, with its growth rate slowing down compared with the corresponding period of the previous year. Industry (mainly production and distribution of electricity and heating, gaseous fuels and water) contributed most, with the firms using free resources to reduce their liabilities to banks.

Funding from sources other than operating surplus went down both in industry and services. Nevertheless, FDI inflow remained posi-

tive, mostly directed to business services and transport.

Bank Loans to Non-financial Corporations

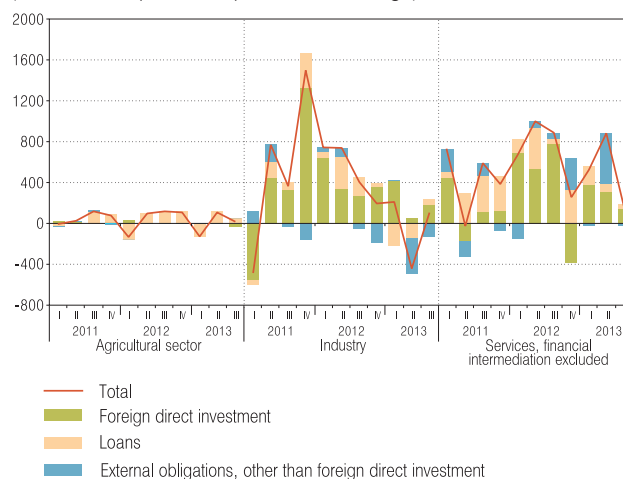
(million BGN, quarter-on-quarter stock change)



Source: BNB.

Financing Sources*

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



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

Source: BNB.

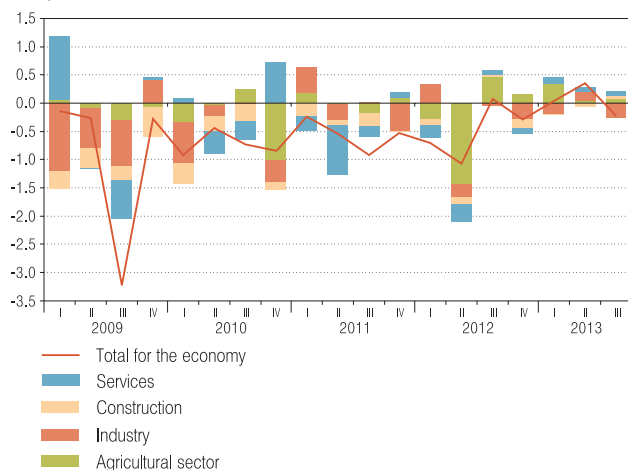
Firms remained cautious with respect to labour employment, despite the improvement in economic activity in Bulgaria. A probable explanation is that firms remained uncertain about future economic activity and continued to optimise their labour costs.

Seasonally adjusted national account data show that total employment in the third quarter of 2013 remained at levels slightly below those in the second quarter, falling by 0.2 per cent on a quarterly basis. Employment in industry (construction excluded) experienced more significant decline by 1.3 per cent on a quarterly basis, while employment in construction, real

estate activities and public services rose slightly by 0.9 per cent, 0.6 per cent and 0.8 per cent respectively. No significant changes were reported in other sectors.

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.

According to the business trend survey, labour demand³⁹ will remain close to its current levels, with a tendency of slight improvement in some sectors. Firms' sentiment concerning personnel employment⁴⁰ retained its previous months' levels in construction and services by January 2014 and improved in industry. In the first half of 2014 weak labour demand is expected to keep overall employment close to its current levels, leading to a limited increase in labour supply.

In the third quarter of 2013 labour productivity retained its quarter-on-quarter growth rate in total economy due to the slight decline in employment and recovering economic activity in Bulgaria. Construction and industry had the major contribution to this growth. Low construction activity continued to be the reason for firms to optimise further their labour costs. In export-oriented industry, firms exposed to international competition conduct investment policies of improving the capacity efficiency and expanding

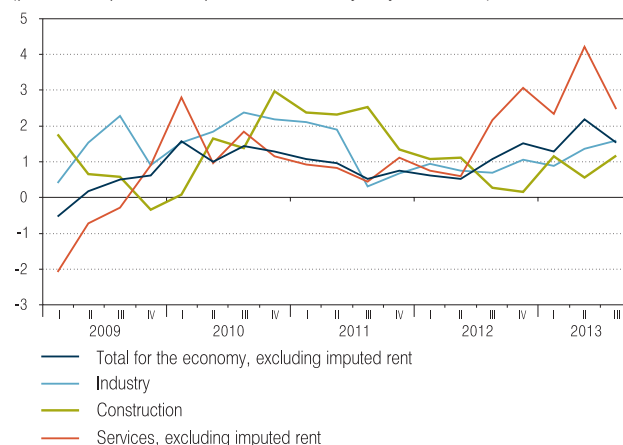
³⁹ In the *Household Behaviour* section, labour market situation is analysed in the context of labour supply by households. Labour demand by firms is discussed in greater detail in the *Behaviour of Firms and Competitiveness* section.

⁴⁰ NSI, Survey of Business Developments in Industry, Construction, Trade and Services; last survey as of September 2013.

production capacities in order to become more competitive.

Labour Productivity Developments (Value Added per Employee)

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

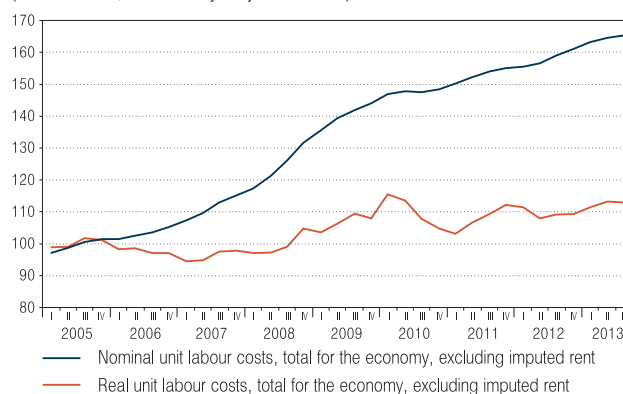


Sources: NSI, BNB calculations.

Wage expenditure of corporations broadly corresponded to labour productivity growth in the beginning of the year. As a result, unit labour costs in nominal and real terms experienced no significant changes.

Unit Labour Costs

(2005 = 100; seasonally adjusted data)



Sources: NSI, BNB calculations.

The economic recovery in Bulgaria's major trading partners is expected to support the activity of export-oriented firms and exports to contribute to GDP growth. The upward trend in services demand is likely to continue at moderate, but stable rates. There is a risk, however, that firms may retain their cautious behaviour and reduce investment activity, and may cut their labour costs through dismissing employees due to still uncertain economic environment.

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	Q3
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	-2.0
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	0.9
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	0.2
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	0.1
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	1.3
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	0.9
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	0.1
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	-2.6
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	0.8
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	2.1
Gross value added, total for the economy	0.1	0.1	0.8	1.1	0.4	0.6	-0.1	-0.1	0.1	0.1	0.1	0.1	0.0	-0.1	0.4

Source: NSI.

Exports and Imports of Goods

In the second half of 2013 export and import dynamics continued to be driven by decreases in international prices of goods important for Bulgaria's foreign trade turnover. Export growth was also impacted by the recovery of external demand for Bulgarian goods. Over the third quarter the rate of export growth accelerated to 7.6 per cent on an annual basis against 3.2 per cent in the second quarter. Imports of goods went up nominally by 4.7 per cent on an annual basis against a decrease of 4 per cent in the second quarter. Between January and November 2013 the export growth in nominal terms accounted for 7.2 per cent and import growth 1 per cent. The trade balance for the January to November period amounted to EUR -1972.7 million: up EUR 1165.6 million on the same period of 2012.

Based on GDP non-seasonally adjusted data real exports grew by 15 per cent on an annual basis in the third quarter (7.5 per cent in the second quarter), with accelerated growth reflecting the continuous recovery of external demand for Bulgarian goods in the second half of the year. Real export growth was 8.4 per cent (1.7 per cent in the second 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 third quarter. This is confirmed by export and import price indices under the Standard International Trade Classification (SITC), pointing to an annual fall in exports by 4.7 per cent and imports by 5.1 per cent in the third quarter.

In the fourth quarter growth rates of exports and imports signalled a slowdown. In the October–November period exports increased by 5.1 per cent and imports by 0.7 per cent on an annual basis.

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

	Balance, million EUR	Change*, million EUR	Exports growth**, per cent	Imports growth**, per cent
Consumer goods	417.5	7.1	6.7	7.3
Raw materials	399.9	237.9	7.9	4.9
Investment goods	-1410.3	630.4	15.1	-4.0
Energy resources	-2193.3	303.4	1.2	-5.0
Total	-2858.6	1142.8	7.8	1.0

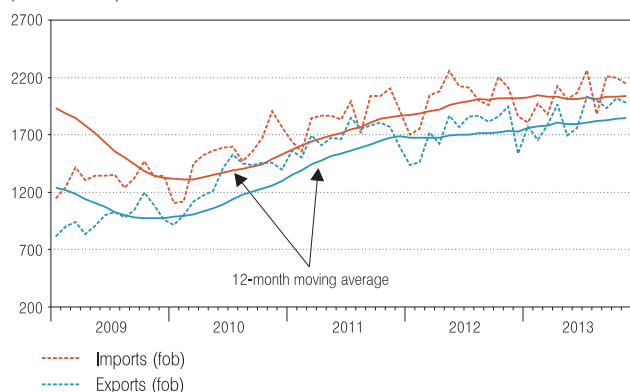
* Balance change on the same period of previous year.

** Growth of exports and imports for the period (on an annual basis).

Source: BNB.

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

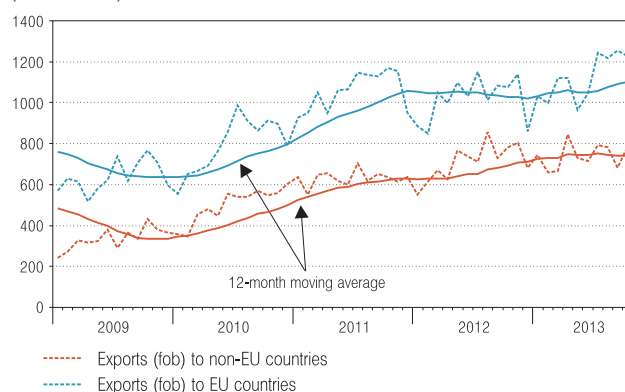
Nominal export growth is expected to slow down somewhat on an annual basis impacted by weak dynamics in international prices of some groups of goods important for Bulgaria's exports and due to high base of the first half of 2013. Demand in the economies of Bulgaria's major trade partners continued to increase which will support the increase in the physical volume of Bulgarian exports. In the first two quarters of 2014 import growth will slightly accelerate as a result of recovering domestic demand. As in exports these trends will be limited by the dynamics of international prices over the period. The trade balance deficit will probably deteriorate slightly in the first half of 2014 moving within the 6.0 to 6.5 per cent of GDP interval.

Lower than projected trade deficit could be realised in the event of a faster increase in demand of Bulgaria's major trade partners and if Bulgarian exporters use exports capacity more flexibly, as well as in the event of further improvement of terms of trade to support export growth.

Between January and October 2013 exports to EU countries increased by 9.7 per cent on an annual basis, with machines, transport facilities, appliances, instruments and weapons, base metals and their products, and animal and plant products, foods, drinks and tobacco contributing most to this growth. Exports to non-EU countries went up 5.1 per cent largely due to animal and plant products, foods, drinks and tobacco, and machines, transport facilities, appliances, instruments and weapons.

Dynamics of Exports to EU and non-EU Countries

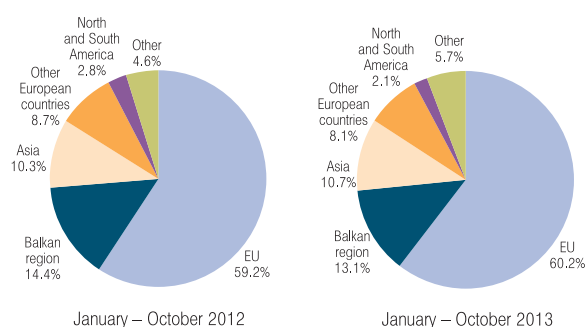
(million EUR)



Source: BNB.

Following the strong monthly fluctuations in the first half of 2013 the growth rate of exports to the EU Member States started to accelerate in the second half of the year in line with the ongoing recovery of EU economies. An opposite trend was observed in exports to non-EU countries which slowed down significantly since mid-2013. Between January and October the share of exports to the EU in total Bulgaria's exports increased by 1 percentage point compared with the corresponding period of 2012. The share of Bulgaria's exports to the EU in total EU imports retained its upward trend over the review period against the background of sustainable competitive positions of Bulgarian exporters in international markets.

Geographical Distribution of Exports



Source: BNB.

Between January and October all major export groups recorded an increase on an annual basis. Animal and plant products, foods, drinks and tobacco, machines, transport facilities, appliances, instruments and weapons, and chemical products, plastics and rubber contributed most significantly to this growth.

Exports by Commodity Group, January–October 2013

	million EUR	Change*	Growth**, per cent	Contribution**, percentage points
Mineral products and fuels	3 425.3	8.6	0.3	0.0
Machines, vehicles, appliances, instruments and weapons	3 620.2	430.7	13.5	2.5
Base metals and related products	3 259.0	78.7	2.5	0.5
Animal and vegetable products, foods, drinks and tobacco	3 338.0	584.9	21.2	3.4
Chemical products, plastics and rubber	1 855.6	132.5	7.7	0.8
Wood products, paper, ceramics and glass	833.5	22.4	2.8	0.1
Textiles, leather, clothing, footwear and other consumer goods	2 304.0	91.0	4.1	0.5
Total exports	18 635.6	1 348.7	7.8	

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

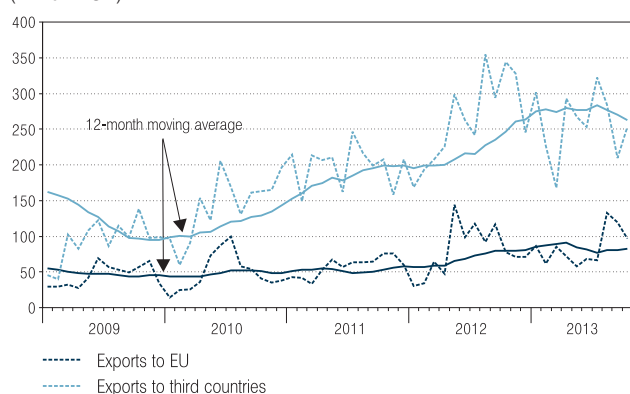
** Growth/contribution to total export growth over the period on an annual basis.

Source: BNB.

Between January and October exports of mineral products and fuels practically remained unchanged compared to the corresponding period of 2012 (an increase by 0.3 per cent). Over the review period price movements in this group were reduced to an increase in nominal volumes⁴¹. In the first half of 2014 this effect is expected to be sustained amid the depressed price dynamics of energy resources.

Exports of Mineral Products and Fuels

(million EUR)



Source: BNB.

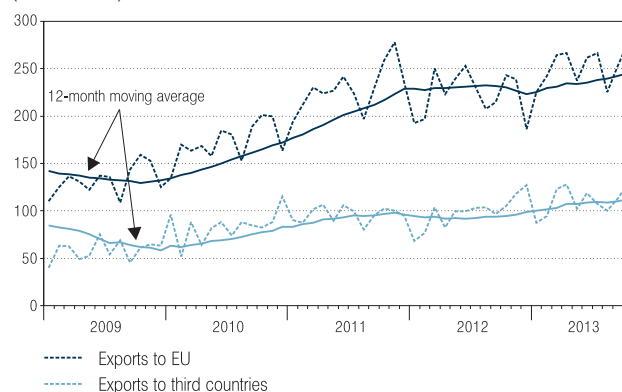
Between January and October exports of machines, vehicles, appliances, instruments and weapons continued to increase steadily at high rates. This was due mainly to higher exported volumes, while the increased export prices were

⁴¹ According to the Balance of Payments of Bulgaria, January–November 2013, p. 40.

of secondary importance for annual growth of exports in this group.⁴² Over the projection horizon the export dynamics of the group is expected to remain stable amid strengthening external demand.

Exports of Machines, Vehicles, Appliances, Instruments and Weapons

(million EUR)

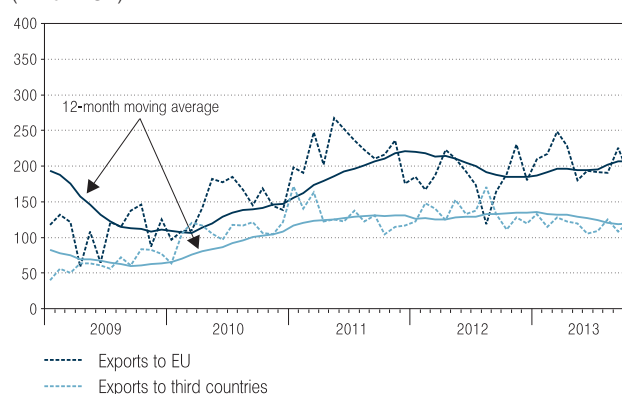


Source: BNB.

Over the January to October 2013 period exports of base metals and their products rose insignificantly on the respective period of 2012. The increase of exports in the group was entirely due to exported volumes, while prices in this group went down in the review period⁴³. International prices will probably continue to have a dampening effect on export growth of these goods in the first two quarters of 2014.

Exports of Base Metals and Related Products

(million EUR)



Source: BNB.

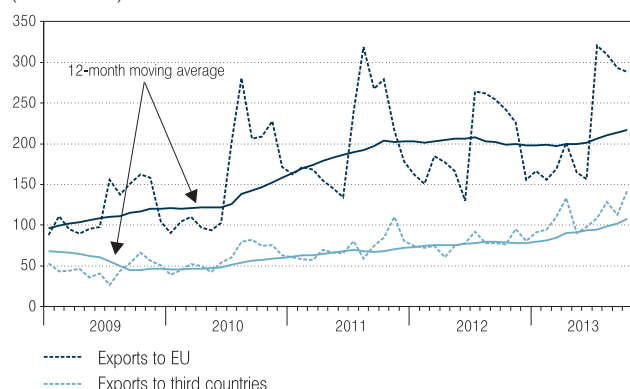
⁴² The export deflators for the machines, equipment and transportation vehicles group under SITC were used to estimate the price effect in the first three quarters of 2013.

⁴³ According to the Balance of Payments of Bulgaria, January–November 2013, p. 40, for the non-ferrous metals subgroup using the export deflators for the cast iron and steel group under SITC for the first three quarters of 2013.

The group of animal and plant products, foods, drinks and tobacco reported the strongest annual rate of growth among all export groups between January and October. The dynamics of the group was driven by exported volumes, while the price effect was almost neutral⁴⁴. In the first half of 2014 an increase in imports of these goods may be expected due to a base effect of sizeable exported volumes in 2013 and expected decreases on an annual basis in international food prices over the projection horizon.

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

(million EUR)



Source: BNB.

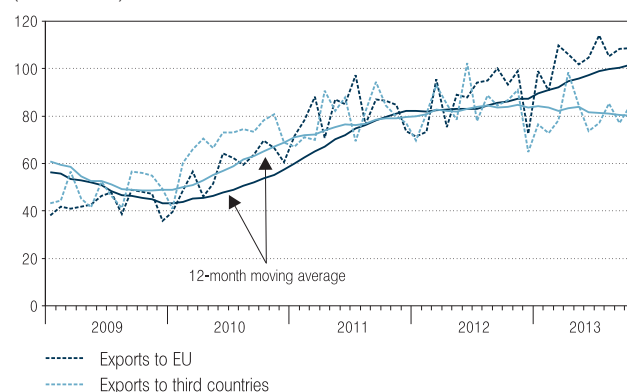
Between January and October exports of the chemicals, plastics and rubber group exhibited an increase with both the price rise⁴⁵ and growth of exported volumes contributing to similar extent. Over the projection horizon exports in the group will probably continue to increase at rates close to current ones due to the expected moderate dynamics of the respective international prices.

⁴⁴ To estimate the price effect, see the respective export deflators for the listed divisions in the first three quarters of 2013 under SITC: 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.

⁴⁵ The export deflators for the chemicals and chemical products group under SITC were used to estimate the price effect in the first three quarters of 2013.

Exports of Chemical Products, Plastics, Rubber

(million EUR)



Source: BNB.

Imports of Commodity Groups by Use, January–October 2013

	million EUR	Change*	Growth** per cent	Contribution**, percentage points
Consumer goods	3 889.0	263.0	7.3	1.2
Raw materials	7 712.4	359.3	4.9	1.7
Investment goods	4 714.9	-196.7	-4.0	-0.9
Energy resources	5 084.7	-269.6	-5.0	-1.3
Imports, total (cif)	21 494.3	205.9	1.0	

* 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) slightly increased in nominal terms in the January–October 2013 period compared with the corresponding period of 2012. Based on the System of National Accounts (SNA) data for the first nine months of 2013 it may be concluded that growth was attributable to the increased volumes of imported output, while import prices had a dampening effect on the change in nominal value of imports. Imports of consumer goods and imports of raw materials contributed to growth of imports by use, while investment goods and energy resources had a downward effect on nominal volumes of imports.

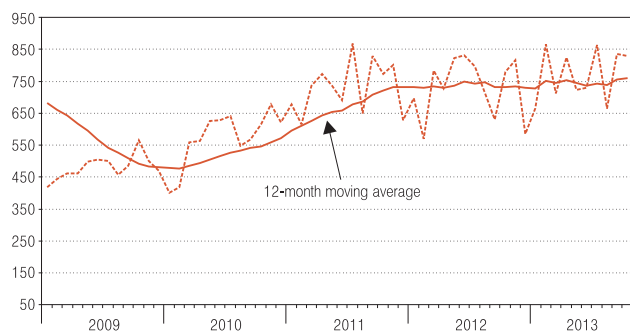
The quarterly dynamics of imports of raw materials group was volatile exhibiting an increase by 4.9 per cent between January and October. The assessment of price change effects in this group⁴⁶ suggests that growth is mostly attributable to larger physical volumes. Should the recovery of domestic demand is sustained and

⁴⁶ According to the Balance of Payments of Bulgaria, January–November 2013, p. 40, and the respective import deflators of the groups of foods and live animals, inedible (crude) materials (excluding fuels), chemicals and chemical products and manufactured goods classified chiefly by materials under SITC for the first three quarters of 2013.

effects of international price changes are limited, the growth rate of imported raw materials is expected to accelerate somewhat over the projection horizon.

Imports of Raw Materials

(million EUR)

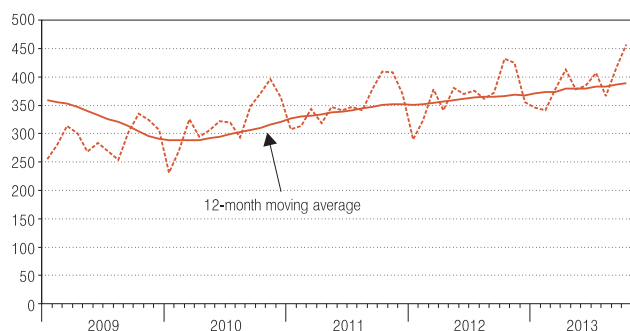


Source: BNB.

Imports of consumer goods was of major importance in total import developments in the first nine months of 2013. The quarterly dynamics of the group was stable: growth was reported in all major sub-groups, with medicines and cosmetics and automobiles contributing most to it. In the first half of 2014 imports of consumer goods will probably grow at rates similar to current ones provided the expected recovery of consumption materialises.

Imports of Consumer Goods

(million EUR)



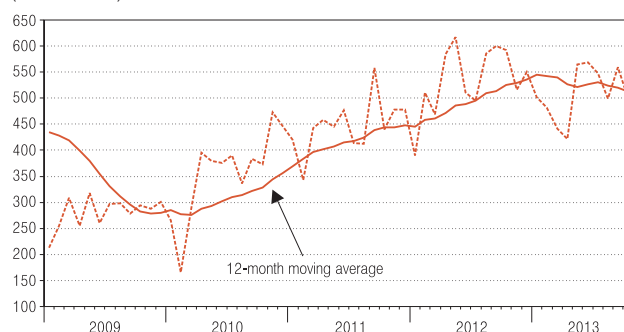
Source: BNB.

Imports in the energy resources group posted a decline in the January–October 2013 period. It was prompted by lower prices of imported energy resources⁴⁷, while imported volumes remained practically unchanged compared with the corresponding period of the previous year. Over the projection period the dynamics of international prices of energy resources is expected to remain depressed which will result in slight changes to the nominal value of group's imports.

⁴⁷ According to the Balance of Payments of Bulgaria, January–November 2013, p. 40.

Imports of Energy Resources

(million EUR)

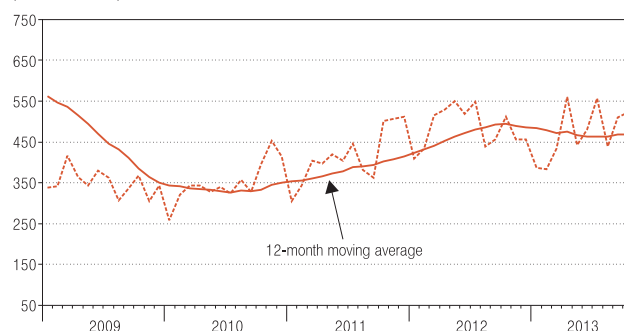


Source: BNB.

Imports of investment goods went down between January and October compared with the corresponding period of 2012. The dynamics of the group was divergent in the first and second quarters. In the first half of the year imports of investment goods decreased on the corresponding period of 2012 due to lower import prices⁴⁸ and the additional impact of the base effect associated with more intensive imports of certain groups of investment goods in the first six months of 2012. In the second half of the year imports of investment goods started again to increase at low rates amid the neutral effect of prices of imported goods. Given the lack of essential changes in their international prices imports of investment goods in the first two quarters of 2014 will reflect the expected moderate dynamics of investment demand in the country for the review period.

Imports of Investment Goods

(million EUR)



Source: BNB.

Between January and October 2013 imports from EU member states increased by 2.8 per cent and those from non-EU countries fell by 0.7 per cent.

⁴⁸ The import deflators for the machines, equipment and transportation vehicles group under SITC were used to estimate the price effect in the first three quarters of 2013.

4. Inflation

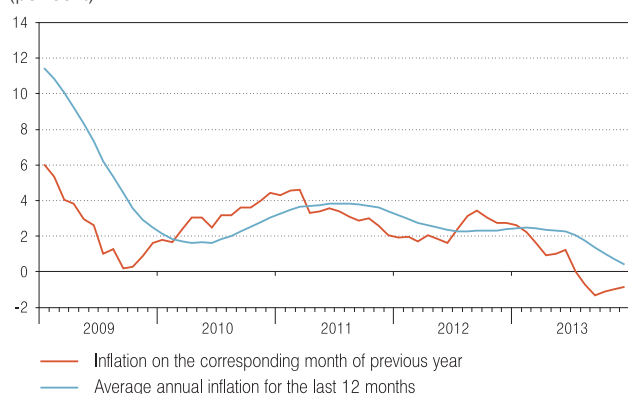
In 2013 annual inflation followed a clearly pronounced downward trend, turning negative since August and reaching -0.9 per cent by the end of the year. The fall in the price of electricity for households and the lower international prices of major raw materials contributed most to this. The domestic economic environment characterised by weak demand had a less pronounced impact on inflation.

The slight CPI fall is expected to remain sustained on an annual basis in the first quarter of 2014, reflecting mainly the negative contribution of administratively controlled prices. In the second quarter the fall in prices is expected to come to a halt due to the gradually reduced negative contribution of controlled prices and the low positive inflation in food and fuel prices.

In 2013 consumer price inflation reported a strong decline compared with 2012.⁴⁹ Between August and December it was negative, with the negative rate tending to gradually slow down in recent months. By end-2013 the Harmonised Index of Consumer Prices fell by 0.9 per cent on an annual basis and the average annual inflation accounted for 0.4 per cent (2.4 per cent in 2012). The major factors behind the slower price rise in the first half of 2013 and reported deflation in the second half of the year were associated with a decrease in some administratively controlled prices, downward dynamics of international raw material and commodity prices, good harvest both in Bulgaria and worldwide and sluggish consumer demand.⁵⁰

Inflation

(per cent)



Source: NSI.

⁴⁹ The analysis in this section is based on NSI data on HICP.

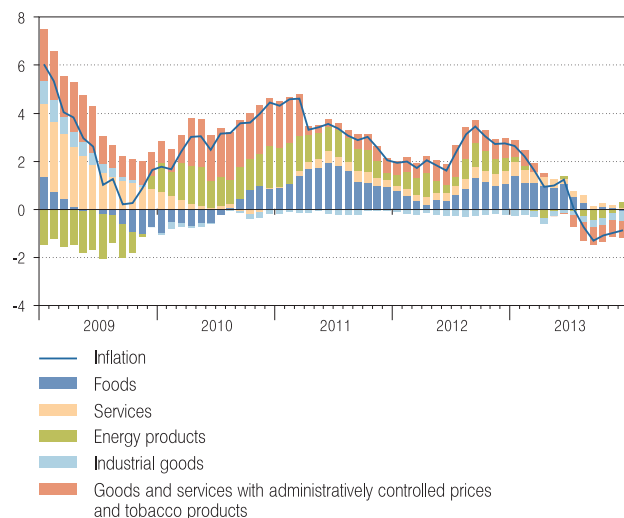
⁵⁰ For further details, see the box entitled *Analysis of the Factors for the Deflation in Bulgaria over the Third Quarter of 2013 and of the Possible Effects on Domestic Economic Activity*, Economic Review, 3/2013.

The inflation fall in 2013 reflected the impact of external and internal factors on individual groups of goods and services with a relatively high weight in the consumer basket. The drop in petroleum price in terms of US dollars was relatively quickly spilled over to end-prices of transport fuels in the domestic market. Lower international food prices since early 2013 also contributed to the downward movements of overall inflation. Their impact on domestic prices was stronger in the second half of 2013 due to good harvests both in major producing countries and in Bulgaria, as well as to the base effect of high food prices in the second half of 2012. Lower international food and fuel prices throughout the year had an indirect effect on the price dynamics of other groups in the consumer basket such as transport services and catering.

Among internal factors impacting inflation the March and August decreases in the controlled price of electricity for households had the largest contribution to the inflation decline cumulatively accounting for 11 per cent. By the end of 2013 administratively controlled prices had the largest negative contribution to overall consumer price inflation.

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

(per cent; percentage points)



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

Sources: NSI, BNB calculations.

Consumer price dynamics was strongly affected by the behaviour of firms and households. The internal economic environment in 2013 characterised by weak household demand and spare production capacity, as well as by uncertainty about international economic developments forced firms to retain their cautious policies in respect of labour and investment spending. According to the short-term statistics on employment and labour costs the annual growth rate of the wage bill between January and September 2013 slowed down both in industrial and services sectors compared with end-2012. Total fixed capital investment in the first nine months of the year almost matched that of the corresponding period of 2012.

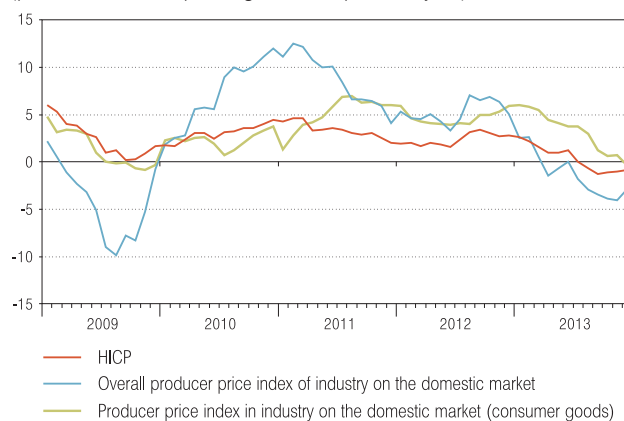
The drop in international prices of commodities such as foods, fuels and metals and lower prices of electricity, heating and gas production and distribution put downward pressure on firms' costs.

The total producer price index (PPI) in the domestic market in 2013 exhibited a downward dynamics and by December accounted for -2.8 per cent on an annual basis (against 5.1 per cent in December 2012). The decline in PPI throughout the year was mostly attribut-

able to: the downward trend in prices of energy product production (due mostly to the decreased regulated price of electricity for households) and intermediate consumption goods; a significant slowdown in price growth of non-durable consumer goods, with a slight annual decline reported in this group in December. In line with price developments in international non-durable consumer goods the inflation in food production in 2013 exhibited the strongest decline, with a deflation reported in September on an annual basis, which reached -4.2 per cent by December. Concurrently, durable consumer goods were characterised by low positive inflation in 2013 which exceeded the inflation reported in 2012.

Rate of Change in HICP and Industrial PPI

(per cent, on corresponding month of previous year)



Source: NSI.

Household demand, which remained relatively sluggish in 2013, affected seriously the dynamics of consumer prices. According to the national account data, in the first nine months of 2013 final household consumption remained at the previous year's level. This was mainly due to slower expenditure growth in catering and non-foods, and the continuing decline in food consumption on an annual basis.

Household behaviour had an effect on firms, triggering expenditure restraint policy amid stabilisation or a slight decline in goods and services prices. Data on retail trade turnover (at comparable prices), exhibiting strong growth on an annual basis in the second half of 2013, signalled a recovery of consumer demand. Should the recovery is sustained for a longer period of time it may be expected a reorientation of the firms' price policy toward an increase in consumer prices.

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

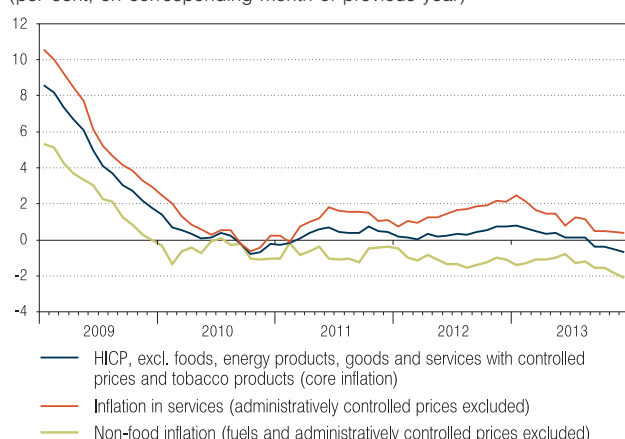
	Inflation accumulated as of September 2012 (December 2011 = 100)		Inflation accumulated as of December 2013 (December 2012 = 100)		Annual inflation for 2013 (2012 = 100)	
Inflation (per cent)	2.8		-0.9		0.4	
	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points
Foods	4.2	1.09	-0.3	-0.09	2.5	0.63
Processed foods	2.2	0.39	0.1	0.01	1.5	0.25
Unprocessed foods	8.3	0.69	-1.1	-0.10	4.4	0.37
Services	2.1	0.54	0.4	0.09	1.2	0.29
Catering services	3.5	0.18	1.9	0.10	3.4	0.17
Transport services	3.9	0.17	0.3	0.01	0.6	0.03
Telecommunication services	-1.1	-0.06	-0.7	-0.03	-1.0	-0.05
Other services	2.3	0.25	0.1	0.01	1.4	0.14
Energy products	6.3	0.54	2.2	0.20	-1.1	-0.09
Transport fuels	6.0	0.49	0.0	0.24	-1.1	-0.09
Industrial goods	-1.1	-0.21	-2.1	-0.39	-1.4	-0.25
Goods and services with administratively controlled prices*	5.0	0.81	-3.9	-0.71	-1.0	-0.20
Tobacco products	0.1	0.00	0.9	0.03	0.3	0.01

* The index of goods and services with administratively controlled prices is calculated at the respective elementary aggregates level in the consumer basket.

Sources: NSI, BNB calculation.

Core Inflation

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

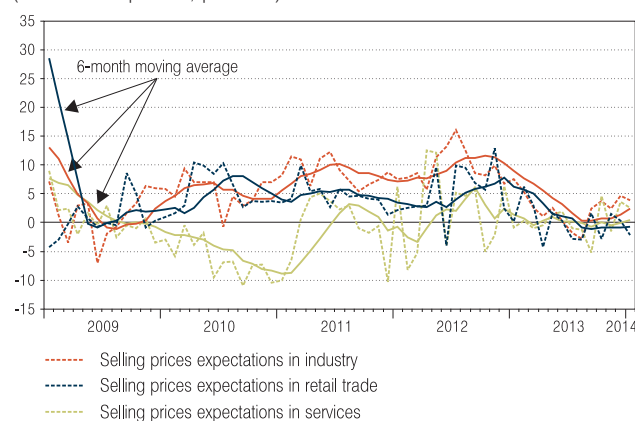
Core inflation tended to decline in 2013 and by December it accounted for -0.7 (against 0.7 by end-2012). Core inflation developments over the year reflected largely the decrease in services price inflation (excluding administratively controlled prices), while non-food prices (excluding fuels) continued to report marginal annual decline which tended to accelerate in the second half of the year.

The business situation survey data in 2013 suggested that expectations about an increase in industrial, retail trade and services purchasing prices weakened compared with end-2012.

According to NSI survey observations managers' prevailing expectations were for keeping prices at their current levels in the three sectors over the second half of the year. This policy probably reflected the uncertainty of firms about economic environment development and worsened assessments about the expected business situation in Bulgaria reported in the second half of 2013.

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

(balance of opinions, per cent)



Source: NSI.

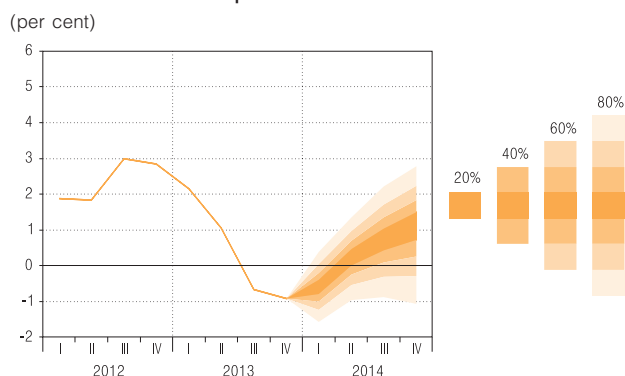
Inflation expectations for the following two quarters and related uncertainty are presented in the fan chart on the annual rate of price changes.⁵¹

⁵¹ For further details, see the box entitled *Measuring and Presenting Uncertainty in Projections of Economic Indicators*, Economic Review, 1/2012.

In the first quarter of 2014 deflation is projected to slightly decrease compared with current levels (from -1.0% to -0.2 per cent) and the inflation rate to vary between -0.2 per cent and 0.7 per cent in the second quarter of 2014.⁵²

The projection is based on the assumption of a moderating decrease in international food prices and a subsiding decline in petroleum prices (in euro terms).

Fan Chart of the Expected Annual Inflation Rate



Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The middle band of the chart, depicted in the darkest colour, includes the central projection 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. 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.

We expect a slight upward dynamics in food and fuel price inflation in the domestic market. Administratively controlled prices will continue to contribute most substantially to the slightly negative inflation, reflecting price decreases in electricity for households announced in 2013 by the State Energy and Water Regulatory Commission and the decision of end-December for a further slight price decrease as of 1 January 2014. The contribution of controlled prices is expected to gradually decrease throughout the year due mainly to the base effect of lower prices of electricity for households in the first half of 2013. No essential contribution of core inflation to the overall inflation dynamics is expected given the uncertainty surrounding the economic environ-

ment prospects, still weak household consumption and indirect effects of lower food and fuel prices.

The current period of deflation is expected to remain for a limited period of time in early 2014 as it reflects mainly the fall in international commodity prices and the decrease in some of controlled prices, and to lesser extent weak domestic demand. Therefore, the decrease in overall consumer price index is not anticipated to have a steady effect on the expectations of firms and households which will result in postponement of household consumption and halting or contraction of firms' investment activity. The temporary price decline may even have a positive effect on the real disposable income of households which will encourage consumer demand growth.

Major risks to the projected overall inflation dynamics in the first half of 2014 relate mainly to the uncertainty surrounding international oil and food price developments. The effect of internal factors such as adjustments to controlled prices is expected to be weaker. In case of higher than expected food and oil price increase in international markets a higher overall inflation of consumer prices in Bulgaria is to be expected. On the other hand, deflation may be sustained throughout the first half of 2014 provided petroleum prices and international food prices decline coupled with weakening or sluggish consumer demand. Risks to the inflation outlook in the first and second quarters of 2014 are assessed as shifted slightly downward.

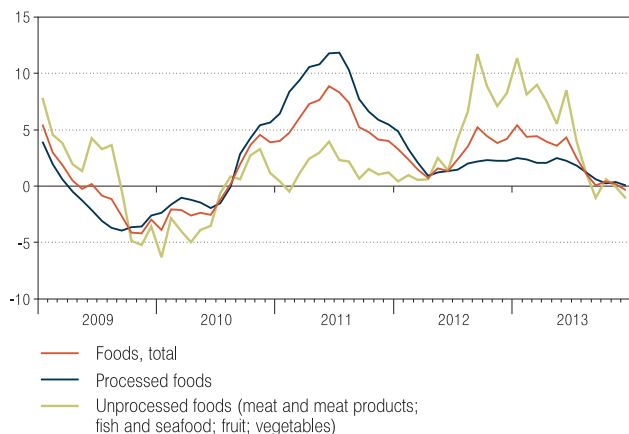
Food Prices

In 2013 food inflation was characterised by strong fluctuations and by the close of the year inflation posted a 0.3 per cent annual decline (against 4.2 per cent in December 2012). The strong decline in inflation of unprocessed foods (from 11.4 per cent in January to -1.1 in December) contributed most significantly to this dynamics. Inflation of processed foods slowed down compared with the beginning of the year (from 2.5 per cent in January to 0.1 per cent in December).

⁵² 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.

Rate of Change of Food Price Index

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

In 2013 the group of unprocessed foods exhibited a significant slowdown in inflation, and by December an annual depreciation in the meat and meat products, fish and seafood and fruit groups. Price developments of the fruit item also posted a strong rate of decline and by the close of the year this sub-group reported a low positive inflation.

Downward price developments in the fruit and vegetables sub-groups reflected the favourable weather conditions in Bulgaria and the slower growth rate of expenditure on goods and services for current consumption in agriculture (by -3.7 per cent in the third quarter of 2013). External factors influencing most strongly the inflation dynamics in the meat and meat products group were the significant decline in international cereal prices with an indirect effect on feed, and lower international market price of meat in the first half of 2013.⁵³ The reason for the fast spillover of international prices to domestic market was the increasing share of large European trade chains with established import channels from the EU in the domestic trade with this commodity group.⁵⁴

The bread and cereals sub-group contributed most to the lower inflation of processed foods in 2013 and the animal or vegetable fats and oils sub-group to lesser extent. The major factor

⁵³ The decline in international meat prices is measured by the import deflator of this commodity group. BNB calculations based on NSI data on price indices of imports by commodity group under the SITC.

⁵⁴ Poultry meat and eggs: a situation and outlook analysis in 2012 and a forecast for 2013, Ministry of Agriculture and Food, December 2013.

behind this dynamics was the fall in international cereals prices and that of fat or oil.

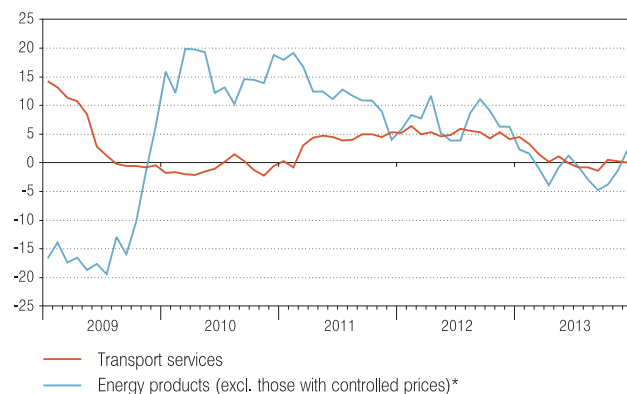
In the first half of 2014 the annual rate of change in international food prices is expected to remain negative, with the decline tending to be reversed. As a result food inflation is projected to be low with a slight upward dynamics.

Energy Product Prices

Since early 2013 inflation in energy products⁵⁵ (excluding those with controlled prices) was driven mainly by changes in international petroleum prices in terms of euro. The downward trend in prices of this group was most strongly pronounced in the first three quarters, with the third quarter reporting a deflation of -2.9 on an annual basis. In the fourth quarter the price decline slowed down due mainly to the base effect of the depreciation of these products at the end of 2012. An annual decrease in prices of this group of -1.0 per cent on average was reported in the fourth quarter, and by December the annual inflation was positive and amounted to 2.2 per cent.

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

(per cent, on corresponding month of previous year)



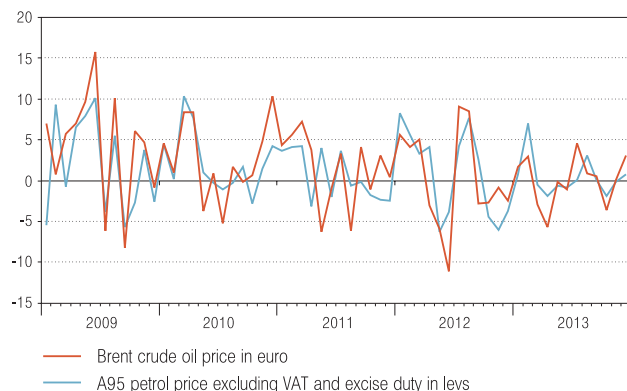
* Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB calculations.

⁵⁵ In the group of energy products (excluding administratively controlled prices of energy and heating) transport fuels occupy the largest relative share; hence, their price developments determine the price dynamics of energy products in general.

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

(per cent)



Sources: ECB, NSI, BNB calculations.

If it is assumed that the rate of decrease in the international petroleum price in euro terms will slow down by mid-2014, the price index of energy products is expected to remain close to previous year's levels, and inflation is expected to record a low positive value in the second quarter.

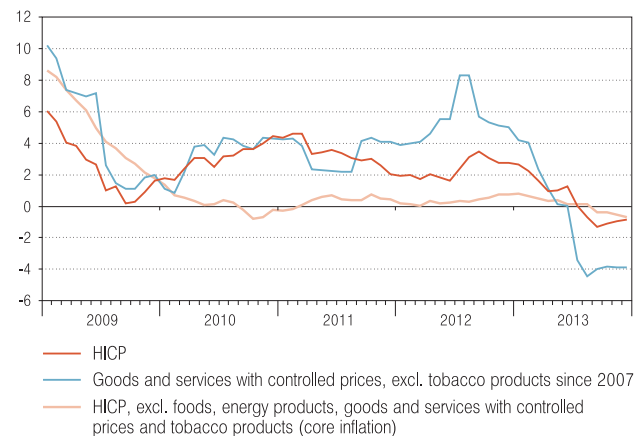
Administratively Controlled Prices and Tobacco Product Prices

Over 2013 the annual rate of growth of administratively controlled prices slowed down significantly: from 5 per cent by the end of 2012 to -3.9 per cent in December 2013. The decrease in the controlled price of electricity for households in March by 7.2 per cent and in August by 4.3 per cent and the base effect associated with the increased price in July 2012 had the strongest effect on the price dynamics in this group. The price falls in the heating and medicals and other pharmaceutical products groups contributed to a lesser degree to the lower inflation in administratively controlled prices.

The negative contribution of administratively controlled prices to overall inflation is expected to be sustained in the first half of 2014. The contribution of controlled prices to overall inflation will decline throughout the year, with the projection including adjustments in other administratively controlled prices as no specific information on this issue is currently available.

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 liberalization of tobacco products. Administratively controlled prices are calculated at elementary aggregates level in the consumer basket.

Sources: NSI, BNB calculations.

Industrial Goods Prices

In 2013 the downward trend in prices of industrial goods observed since mid-2010 (excluding administratively controlled prices) continued. By December the annual inflation rate in non-food goods was -2.1 per cent (against -1.1 per cent at the end of 2012).

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.

A stronger deflation in non-foods was observed in the second half of the year reflecting mainly the increasing negative contribution of durable goods and a slower price rise in non-durable goods. As in 2012 automobile, computer and television equipment prices continued to have

the largest negative contribution in the group of durable goods. Concurrently, the higher deflation in the entire group over the last two quarters was driven by stronger price decreases in the furniture, furnishings and household appliances groups.

The number of new passenger car registrations in the automobile market in 2013 declined compared with 2012 both in Bulgaria (-0.3 per cent) and the EU (-1.7 per cent on average), signalling a further decrease in demand for automobiles.⁵⁶

The global downward trend in prices of computers and television equipment was sustained reflecting on the price dynamics in Bulgaria. The strong competition in industrial goods retailing amid weak consumer demand was an internal factor which also exerted downward pressure on prices of these goods.

Services Prices

Since early 2013 inflation in services (excluding administratively controlled prices) followed a trend toward a gradual decrease reaching 0.4 per cent by the end of the year from 2.1 per cent by the end of 2012.

The negative contribution of transport services (automobile and air services), impacted by the price dynamics of transport fuels, played an essential role in the inflation slowdown. The growth rate of catering prices stood stable at 4 per cent in the first half of 2013. Then, it started gradually moderating following the downward dynamics of prices in the group of foods and producer prices of food production. Due to relatively high weight of catering in the consumer basket, the inflation slowdown in this group also contributed to the slower rate of price rises in the entire group of services.

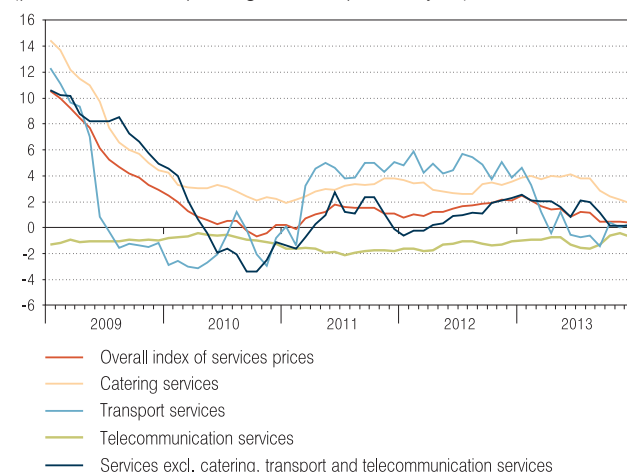
Telecommunication services depreciated further in 2013 and the average price decline in this group was close to that recorded in recent years.

By the end of the year inflation of services (excluding catering, transport and telecommunication services) accounted for 0.1 per cent, exhibiting a significantly lower level on

the end of 2012 (2.3 per cent in December). It reflected the lower inflation dynamics of the bulk of individual services included in this group. By the end of 2013 a deflation was reported in rents, package holidays and accommodation, auto insurance and services related to cultural recreation.

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

(per cent, on corresponding month of previous year)



Sources: NSI, BNB calculations.

In line with the assumption of low positive dynamics of household consumption in the first half of 2014 inflation of services is expected to remain low in the beginning of the period and to have no essential contribution to overall consumer price inflation.

⁵⁶ Based on the European Automobile Manufacturers' Association press release on the number of registrations of passenger cars in July 2013.