

Economic Review

1/2014



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Economic Review

1/2014



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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. Processes and trends in the external environment are also analysed since the Bulgarian economy is directly influenced by them. This publication contains also quantitative assessments of the development in major macroeconomic indicators in the short run: inflation, economic growth, exports, imports, trade balance and BoP current account, foreign direct investment, monetary and credit aggregate dynamics.

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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
CFP	Consolidated Fiscal Programme
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
PBoC	People's Bank of China
PLN	Polish zloty
PMI	Purchasing Managers' Index
p.p.	percentage points
PPP	Purchasing Power Parity
CIS	Commonwealth of Independent States
RON	Romanian new leu
WTI	West Texas Intermediate

Summary

In early 2014 global economic environment continued to improve slowly. Euro area and US economic indicators improved, while expectations in the Chinese manufacturing sector deteriorated, signalling economic growth slowdown. World trade volumes increased further. Based on the trends of the leading economic indicators and positive world trade developments, global economic activity is expected to retain its gradual upward trend over the second and third quarters of 2014, with developed economies contributing most significantly to the overall growth.

Global inflation continued to slow down on an annual basis, reflecting mainly the weak price dynamics of major commodity and energy products traded on international markets. Market expectations for the second and third quarters of 2014 show an ongoing decline in crude oil prices due to estimates for growing supply and concerns about weaker demand by China where an economic growth slowdown is expected. In early 2014 international commodity prices in euro showed volatile dynamics due to political problems in Ukraine and Russia and economic growth slowdown in China. In the second and third quarters of 2014 market expectations point to a slight rise in metal prices, while cereal prices are expected to further increase, though remaining below their levels of corresponding quarters in the previous year.

The positive external environment developments in 2013 and the economic recovery in Bulgaria's major trading partners contributed to the sustainable growth rate of domestic exports of goods and services. The weak domestic demand and, to a lesser degree, the favourable dynamics of the terms of trade led to a reduction in the trade deficit and to a surplus in the BoP current account in 2013. Banks' financial transactions, foreign direct investments in Bulgaria and corporate bond issuance in November had a major impact on the BoP financial account flows. If the expectations of slight changes in both terms of trade and growth in external demand for Bulgarian goods and services materialise, the positive current and capital account balance is projected to further increase over the second and third quarters of 2014.

In the context of maintained high savings rate, the inflow of attracted funds into the Bulgarian banking system continued to significantly exceed demand for borrowings. In February deposits of the non-government sector increased by 8.7 per cent on an annual basis, with household deposits further contributing most sizably to their growth. The increase in the credit to the non-government sector remained comparatively weak at 0.8 per cent annually as of February. Demand for loans remained low due to the sustained weak economic activity and cautious bank lending. Optimising the return on managed assets, banks continued to invest the major portion of attracted funds in foreign assets, repaying their foreign liabilities and investing in securities issued by the Bulgarian government.

The relatively high growth of funds attracted from residents in the banking system is expected to remain unchanged in the second and third quarters of 2014, which will be reflected in maintaining high banking system liquidity and in an increase in banks' net foreign assets. A slight increase in lending to the non-government sector is also expected in the light of the gradual increase of economic activity in Bulgaria.

In the fourth quarter of 2013 economic activity increased on a quarterly basis, with a positive contribution to growth by net exports and investment in fixed assets, while private consumption had a negative contribution. The change in inventories also contributed positively to growth. Industry was the main

factor behind this growth, with a value added increase associated with both export growth and investment activity improvements in the second half of 2013. Despite the recovery in domestic economic activity, firms abstained from new jobs creation, and the overall employment declined insignificantly in the last quarter of 2013. According to the seasonally adjusted data of the Labour Force Survey, in the fourth quarter of 2013 the level of unemployment slightly increased from the comparatively constant levels of the first three quarters and reached 13 per cent.

On a quarterly basis, economic activity in Bulgaria is expected to slightly increase over the second and third quarters of 2014. Domestic demand will gradually recover, contributing positively to growth as a result of the moderate recovery of private consumption and fixed capital formation. Despite the improved economic situation in Bulgaria's major trading partners, external environment continues to pose risks to the domestic economic growth. Another source of uncertainty to our projections relates to deflationary processes in Bulgaria observed since the third quarter of 2013. In case of a prolonged period of declines in the overall price level, households and firms are likely to generate expectations for retention of this trend in the future, which could depress consumption and investment due to postponement of expenditure.

In 2013 Bulgaria's budget position depended to a great extent on the weak domestic demand and low price dynamics, limiting tax income growth, on the one hand, and higher social security, support and care expenses, on the other hand. Overall, government consumption had a low positive contribution to GDP growth in real terms in 2013. In line with the 2014 State Budget Law parameters and social expenditure developments observed since early 2014, it may be expected that fiscal policy will affect the economic activity mainly through increasing household disposable income from budget social transfers. In the second and third quarters of 2014 government consumption is expected to have a positive, though limited, contribution to GDP growth.

In the first two months of 2014 the HICP rate of decline accelerated to -2.1 per cent on an annual basis (-0.9 per cent at the end of 2013). As of February 2014 almost all major goods and services groups in the consumer basket reported a decline in prices on an annual basis, with administratively controlled prices, fuels and non-foods (excluding fuels) recording the most sizeable fall. Controlled prices continued to have the largest negative contribution to overall inflation (-0.9 percentage points). Core inflation followed its downward trend due to the significant decrease in transport services prices and, to a lesser extent, to the acceleration of annual non-food (excluding fuels) price fall, being negative at -1.5 per cent and contributing -0.7 percentage points by February.

In the second and third quarters of 2014 the rate of decline of the overall HICP is expected to gradually moderate, reflecting mainly the lower negative contribution of controlled prices and the suspended fall in food prices. Major risks to this projection relate mainly to the uncertainty surrounding international food and oil price developments and could be materialised both upwards and downwards, while potential adjustments in administratively controlled prices are among internal factors posing inflationary pressure. According to the March Survey of Business Developments in Industry, Retail Trade and Services, managers prevailing expectations suggest that prices are to remain at current levels, while customers reported a fall in inflation expectations over the last year. A continued decline in oil prices and international food prices, together with a weakening or sluggish consumer demand rate may result in a sustained rate of decline in overall HICP. The risks to the expected inflation outlook are assessed as balanced.

1. External Environment

Global economic environment continued to improve slowly in early 2014. Euro area and US economic indicators exhibited improvements, while expectations in the Chinese manufacturing sector declined further, signalling economic growth slowdown. At the end of 2013 and the beginning of 2014 world trade volumes continued to increase. Based on leading economic indicators and the positive world trade developments, global economic activity is expected to retain its gradual upward trend over the second and third quarters of 2014, with developed economies contributing most significantly to the growth. Global inflation continued to slow down on an annual basis, reflecting mainly the weak price dynamics of major commodity and energy products traded on international markets.

Current Business Situation

Global PMI continued to rise in early 2014, though at a slower growth rate. Expectations about the development of the manufacturing sector improved most sizeably, with expectations of new and export orders contributing most to this improvement. Services dynamics moderated owing to the decreased expectations of employment in this sector.

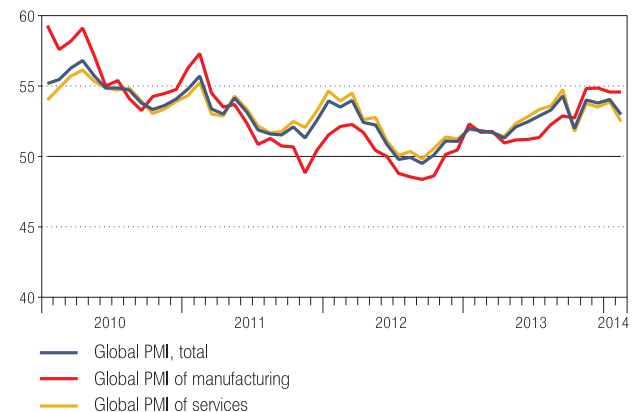
Developments in economic indicators show differences across regions. Euro area and US PMI improved mainly due to the positive sentiment in the manufacturing sector. Expectations in the Chinese manufacturing sector declined further, signalling economic growth slowdown.

At the end of 2013 and the beginning of 2014 world trade volumes continued to increase, with US foreign trade growth still outstripping that of the euro area.

Based on leading economic indicators and positive world trade developments, global economic activity is expected to increase gradually over the second and third quarters of 2014, with developed economies contributing most significantly to this growth.

Global inflation continued to slow down on an annual basis, driven mainly by the weak dynamics of major commodity and energy

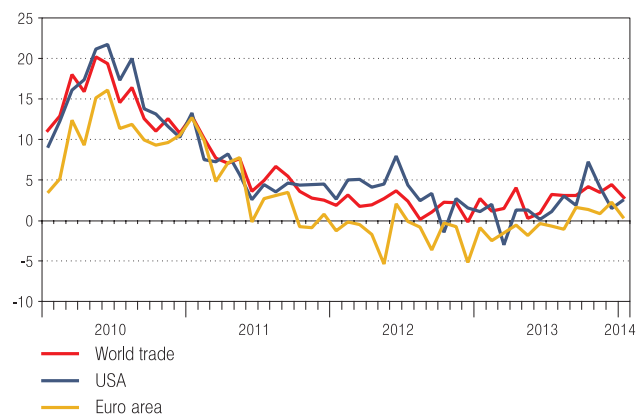
Global PMI



Source: JP Morgan.

World Trade

(annual rate of volume growth, per cent)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

product prices in international markets. Inflation continued to moderate in developed countries and increased in developing economies.

Euro Area

In the fourth quarter of 2013 real GDP in the euro area grew by 0.5 per cent on an annual basis against a 0.3 per cent decline in the previous quarter.¹ Data suggest divergent real GDP rates of change across euro area countries. Economic growth in Germany and France accelerated to 1.4 per cent (from 0.6 per cent in the third quarter) and 0.8 per cent (from 0.3 per cent in the third quarter) respectively. The decline slowed down to -0.2 per cent in Spain (-1.1 per cent in the previous quarter) and -0.9 per cent in Italy (-1.9 per cent in the previous quarter). The largest GDP drop was reported in Cyprus (-5 per cent) and Greece² (-2.6 per cent) and the strongest growth was observed in Latvia (3.7 per cent) and Malta (2.2 per cent).³

On a quarterly basis, euro area real GDP increased by 0.3 per cent in the fourth quarter against 0.1 per cent growth in the previous quarter. GDP components with positive contributions to growth were net exports (0.4 percentage points), investment (0.2 percentage points) and household consumption (0.1 percentage points). Inventories and government consumption had negative contributions of 0.3 and 0.1 percentage points respectively. On a quarterly basis, only Cyprus (-0.8 per cent) and Finland (-0.3 per cent) reported declines⁴.

Leading economic indicators continued to improve in early 2014, with the EC economic sentiment index for the euro area rising to 102.4 in March, from 101.2 in February, and the business climate indicator came to 0.39, from 0.36 in February. The EC consumer confidence index in the euro area also increased to -9.3 in March, from -12.7 in February. In March euro area PMIs slightly decreased, though showing positive economic activity dynamics, with the composite PMI staying at 53.2 (against 53.3 in February)

¹ Eurostat data.

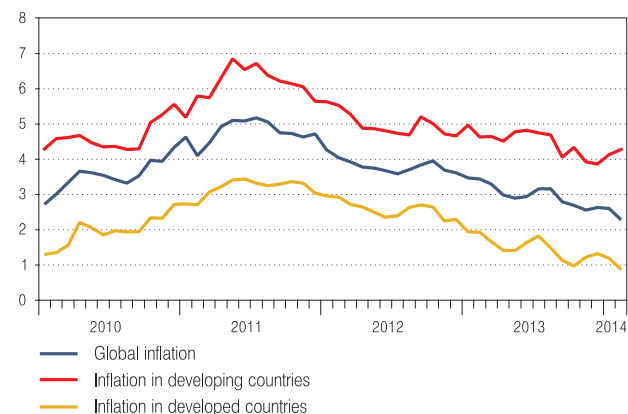
² Data have not been seasonally adjusted.

³ No data published about Ireland and Luxembourg.

⁴ No data published about Ireland, Greece and Luxembourg.

Inflation Measured through CPI

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

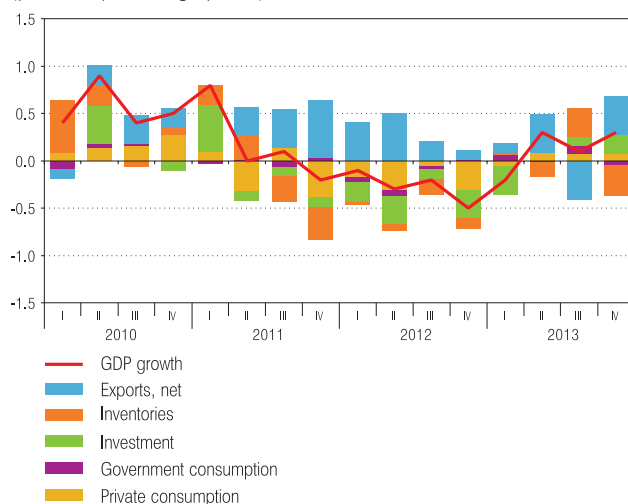


Note: The World Bank measures the change of CPI in individual groups as a weighted average of CPI changes in the countries of the group. For calculating the weights of the countries, real GDP based on purchasing power parity is used. Groups include only World Bank Member States classified by the World Bank as developing and developed countries.

Source: World Bank.

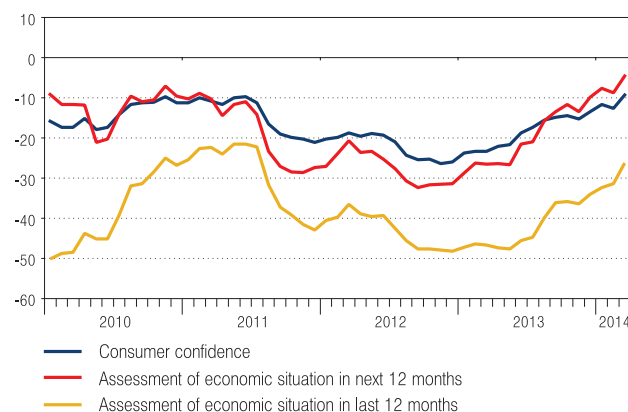
Contribution to Real GDP Growth in the Euro Area by Component (Quarterly)

(per cent; percentage points)



Source: Eurostat.

Euro Area Consumer Confidence Indices



Source: European Commission.

and manufacturing and services PMIs at 53 and 52.4 respectively (against 53.2 and 52.6 in February), above the neutral level of 50.

Euro area economic indicator analysis gives grounds to expect weak economic growth in the euro area over the second and third quarters of 2014. According to the latest ECB forecasts of March 2014, GDP growth will range between 0.8 and 1.6 per cent in 2014 (previous forecast: between 0.4 and 1.8 per cent) and between 0.4 and 2.6 per cent in 2015.

In February euro area annual inflation came to 0.7 per cent compared with 0.8 per cent in January. On a monthly basis, HICP rose by 0.3 per cent in February, *vis-à-vis* a 1.1 per cent decline in January. Major reasons behind the inflation decline were energy price falls and slower food price growth. Euro area core inflation accelerated to 1 per cent on an annual basis, compared with 0.8 per cent in January.

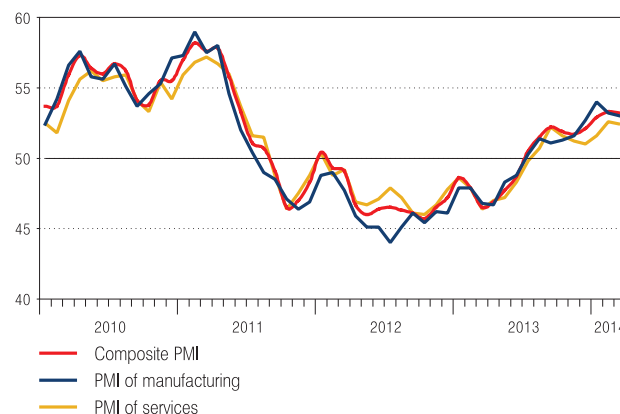
In February negative annual inflation was recorded in Cyprus (-1.3 per cent) and Greece (-0.9 per cent). Portugal (-0.1 per cent) and Slovakia (-0.1 per cent) also registered negative annual inflation rates. Inflation was highest in Finland (1.6 per cent), Malta (1.6 per cent) and Austria (1.5 per cent). In February annual inflation declined to 1 per cent in Germany, from 1.2 per cent in the previous two months, and accelerated in France to 1.1 per cent (0.8 per cent in the previous three months).

According to Eurostat's flash estimate published on 31 March, euro area inflation was 0.5 per cent in March, which confirms that inflation continues to trend downwards.

According to the ECB projections of early March 2014, euro area inflation is estimated at 1 per cent for 2014 (previous forecast: 1.1 per cent) compared to 1.4 per cent in 2013, with the inflation rate expected to increase in 2015 and 2016 to 1.3 and 1.5 per cent respectively.

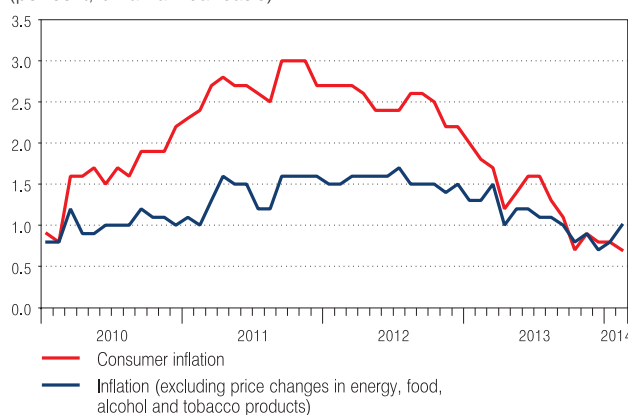
Labour market situation remained impaired in the euro area. According to the data for the last quarter of 2013, euro area employment contracted by 0.5 per cent on an annual basis. The most significant decline was reported in construction (-2.9 per cent) and industry

Manufacturing and Services PMIs



Euro Area Inflation Rate

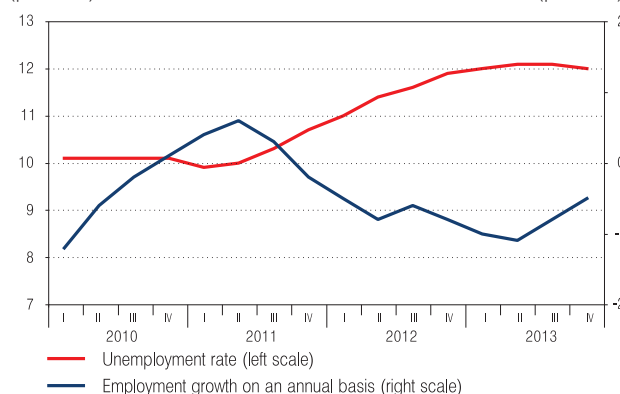
(per cent, on an annual basis)



Euro Area Unemployment Rate and Employment Growth

(per cent)

(per cent)



(-1.2 per cent), but slowing downward trends were observed in both sectors.

For the fourth consecutive month, unemployment remained high at 12.0 per cent in January. The highest unemployment level was recorded in Greece⁵ (28 per cent), Spain (25.8 per cent) and Cyprus (16.8 per cent), with slight declines in the latter two countries. Austria and Germany still reported the lowest values at 4.9 and 5.0 per cent, respectively.

The indicator of the expected unemployment rate in the following twelve months, included in the EC consumer confidence index, rose to 26.3 in February, its average level for the last three months (26.6) staying below the previous period's average. Its dynamics shows an improvement in consumer expectations concerning labour market developments.

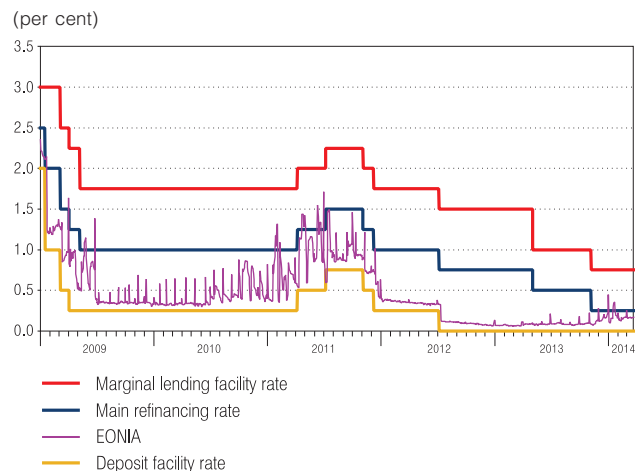
In the first quarter of 2014 the ECB kept the interest rates on the main refinancing operations, deposit facility and marginal lending facility at 0.25, 0 and 0.75 per cent, respectively. At its monetary policy meetings, the ECB reiterated that they continue to expect euro area interest rates to remain at present or lower levels for an extended period of time based on the low inflation and weak GDP and broad money growth, as well as the commitment to maintain monetary stimulus policy to support the economic recovery.

At the monetary policy meeting of 9 January, two contingencies that would cause the ECB to act were signalled: 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.

On 24 January the ECB announced discontinuation of the three-month refinancing operations in US dollars from April 2014 due to the low interest by banks and improved market conditions. Weekly auctions will be conducted until the end of July 2014. After the November meeting, the ECB communicated that it would continue to maintain its fixed-rate full allotment procedure at least until the end of the sixth maintenance period of 2015, ending on 7 July 2015.

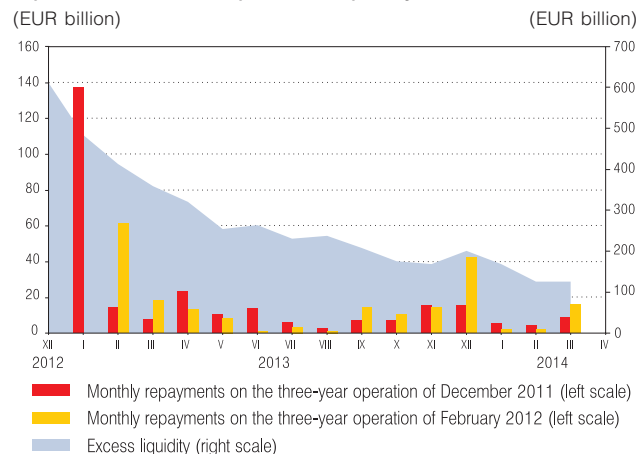
⁵ The latest available data refer to November 2013.

ECB Interest Rates and the EONIA



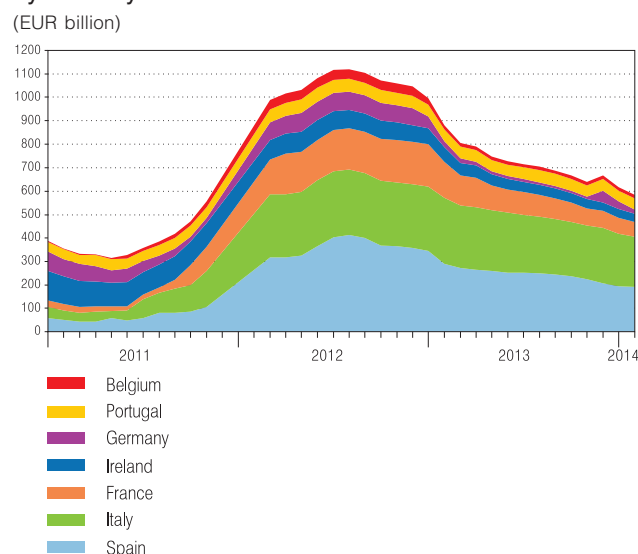
Source: ECB.

Repayments on ECB Three-year Refinancing Operations and Surplus of Liquidity



Source: ECB.

Bank Participation in ECB Refinancing Operations by Country



Source: National central banks of relevant countries.

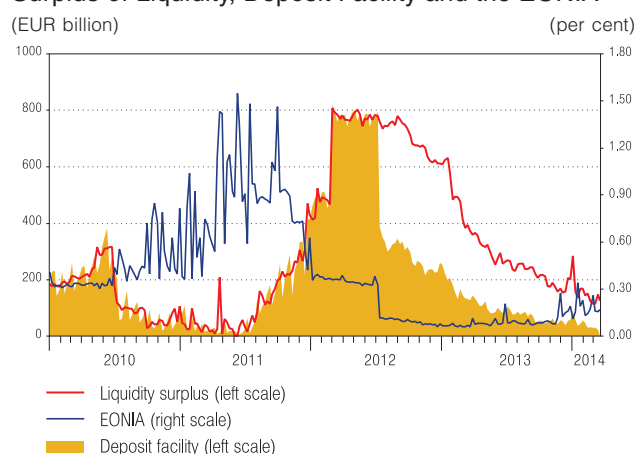
As of 21 March 2014 repayments on the December 2011 three-year operation were EUR 277.3 billion, with the outstanding amount falling to EUR 211.9 billion. In addition, EUR 207.0 billion were repaid in the February 2012 three-year operation and the outstanding amount was EUR 322.6 billion. In net (gross) terms, 93 per cent (48 per cent) of the funds allotted through the two longer-term operations were refunded. NCB data suggest that in January and February 2014 the most substantial decrease in the outstanding amount of longer-term refinancing operations was reported by Spanish, French and Irish banks: by EUR 10.8 billion, EUR 9.7 billion and EUR 3.1 billion respectively. LTRO outstanding value of Spanish and Italian banks remained highest at EUR 176.1 billion and EUR 211.7 billion.

The downward trend in the euro area surplus of liquidity, reflecting repayments on the three-year ECB operations, continued in the first quarter of 2014. On 21 March the surplus fell to EUR 125 billion (from EUR 200 billion by the end of the fourth quarter of 2013) ranging between EUR 114 billion and EUR 283 billion throughout the first quarter.

The EONIA reference overnight interest moved within a broad interval of 0.10 and 0.36 per cent, with the average quarterly value accounting for 0.17 per cent (compared with 0.12 per cent in the fourth quarter of 2013). In the beginning of the year EONIA was characterised by high volatility due to the substantial fall in the surplus of liquidity in early 2014 and money market fragmentation. The results of weekly liquidity-absorbing operations under the Securities Markets Programme, in which the average-weighted and the marginal interest rates increased significantly and two of the January operations which failed to attract bank interest, were also a result of the decreased surplus of liquidity.

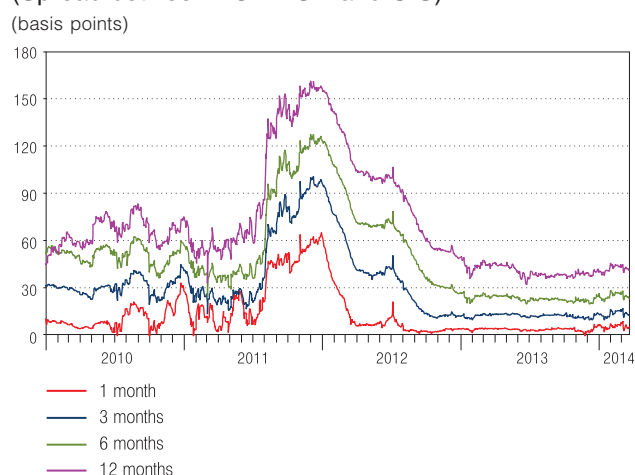
EURIBOR interest rates on interbank market deposits increased moderately, their change being more pronounced in long-term maturity segments. On 21 March 2014 one-month interest rates reached 0.24 per cent (+2 basis points on end-December 2013), and those with maturities of six and twelve months came to 0.42 per cent (+3 basis points on end-December) and 0.59 per cent (+4 basis points on end-

Surplus of Liquidity, Deposit Facility and the EONIA



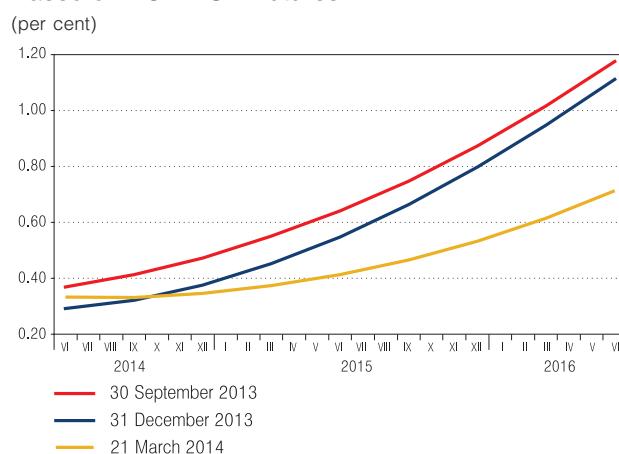
Source: ECB.

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



Source: European Banking Federation.

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



Source: European Banking Federation.

December) respectively. Credit and liquidity risk premia measured by the spread between EURIBOR and OIS broadly declined. Risk premia in the three- and six-month segments ended the period at a level of 13 basis points (unchanged on end-December) and 23 basis points (-1 basis point on end-December).

As of 21 March 2014 market expectations derived from the prices of three-month EURIBOR futures contracts signal no change in the ECB repo rate until the end of the year and a possible increase at the end of 2015 or in early 2016.

The United States

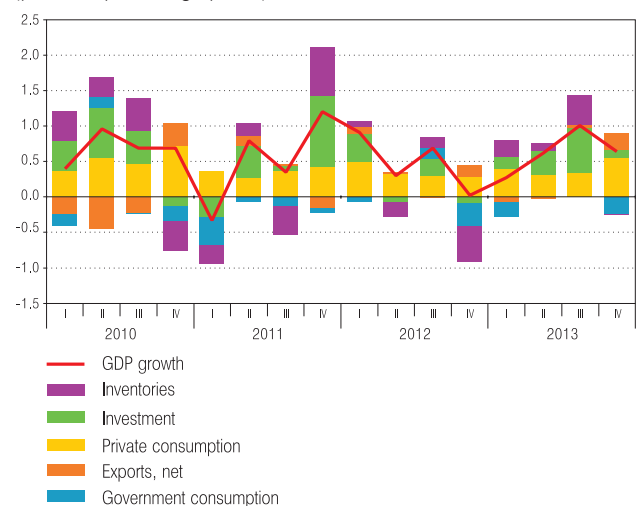
In the fourth quarter of 2013 US economic growth was 2.6 per cent on an annual basis against 2 per cent in the third quarter. On a quarterly basis, it moderated to 0.7 per cent, from 1 per cent in the previous quarter. This slowdown was largely due to the lower change in inventories and increased negative contribution of federal government consumption and investment. The fall in housing investment and close to zero growth of government consumption in individual US states and local authorities also contributed to the lower growth rate of the economy. The positive contribution of net exports to the quarterly growth over the fourth quarter increased to 0.2 percentage points against 0.03 percentage points in the previous quarter, reflecting the faster growth of exports compared to imports. Acceleration was also observed in household consumption and business investment.

In the first quarter of 2014 divergent changes in US leading economic activity indicators were observed. Business and consumer sentiment was most strongly influenced by unfavourable weather conditions in the winter.

According to preliminary data, consumer confidence measured by the University of Michigan index decreased to 80 percentage points in March against 81.6 in February and 81.2 in January. Over the first quarter the Conference Board Consumer Confidence Index also displayed a volatile development, increasing significantly in March to reach its highest value since 2008.

Contribution to US GDP Growth by Component (Quarterly)

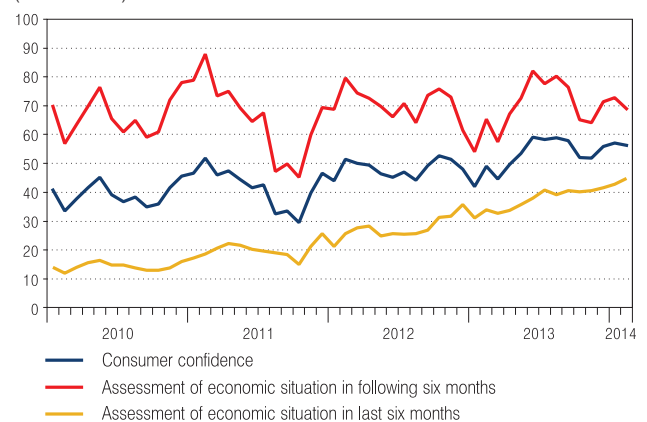
(per cent; percentage points)



Source: Bureau of Economic Analysis.

US Consumer Confidence Indices

(2000 = 100)



Source: The Conference Board.

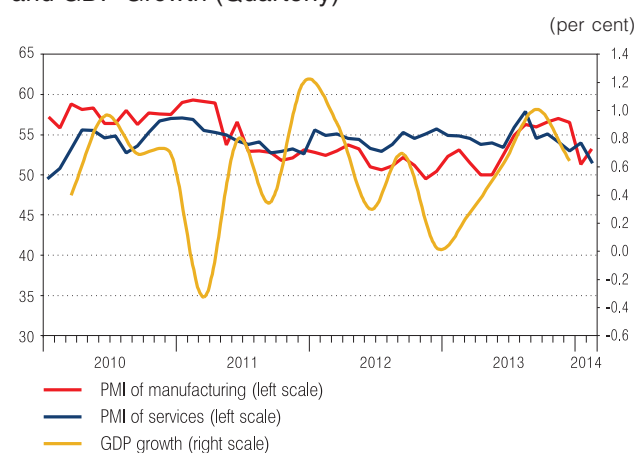
The volatile development of consumer confidence indicators over the first quarter corresponded to the slowdown in the monthly growth rate of consumer expenditure and retail sales compared to the fourth quarter of 2013. In March individual consumption expenditure rose by 0.3 per cent on a monthly basis, from 0.2 per cent in February and 0.1 per cent in January. Its average monthly growth was 0.4 per cent over the previous quarter. Retail sales in January went down 0.6 per cent on a monthly basis against an increase of 0.1 per cent in December, rising by 0.3 per cent in February. Their annual growth rate slowed down in February to 1.5 per cent, from 1.9 per cent in January and 3.4 per cent in December.

In the first quarter of 2014 manufacturing and services indicators reported divergent developments. In February manufacturing ISM-PMIs went up to reach 53.2 points against 51.3 points a month earlier. In February services ISM-PMIs dropped to 51.6 percentage points, the lowest value since 2009, compared to 54 in January. However, the indicator remained above the 50 percentage point limit, with values above it signalling an increase in economic activity.

US housing market recovery slowed down over the first quarter of 2014 mainly due to the hard winter. In 2013 the S&P/CaseShiller 20-City Composite House Price Index posted the highest annual growth since 2005. In January its annual rate of growth was 13.2 per cent, compared with 13.4 per cent in December. Despite the unfavourable weather conditions, employment in construction increased in the first quarter of 2014. In February it rose by 15,000 employees compared to 50,000 in January. On the other hand, the annual growth rate of new residential construction and building permits slowed down in early 2014. In March the National Association of Home Builders (NAHB) index went up to 47 points, from 46 in February, though remaining below the 50 point threshold. Each value above 50 indicates that most home builders view sales conditions as good.

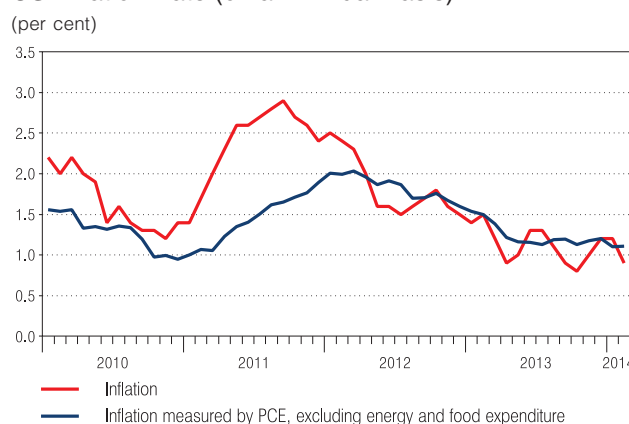
In February the annual inflation rate measured by the personal consumption expenditure deflator (PCE) decreased to 0.9 per cent, from 1.2 per cent in the previous month. In February

US Manufacturing and Services ISM-PMIs and GDP Growth (Quarterly)



Source: Institute for Supply Management.

US Inflation Rate (on an Annual Basis)



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

Source: Bureau of Labor Statistics.

the annual growth rate of the core PCE price index (excluding food and energy prices) remained unchanged at 1.1 per cent for a second consecutive month.

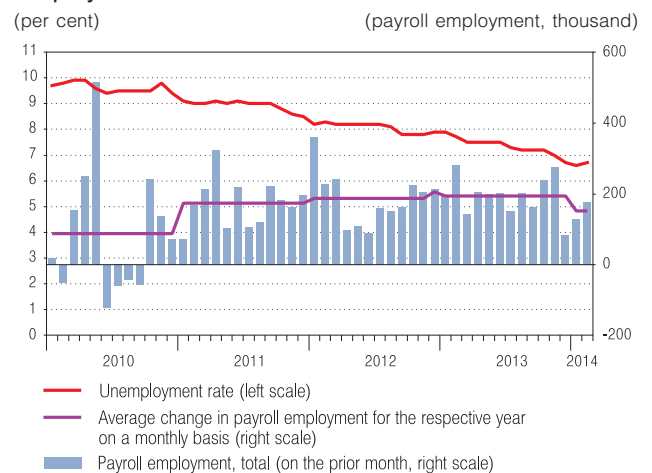
In February the annual growth rate of consumer price index, the other measure of US inflation, declined significantly to 1.1 per cent on an annual basis, while the core consumer price index stayed at 1.6 per cent for a second consecutive month.

The expectations of consumer price inflation in the period of one to five years, a component of the University of Michigan consumer confidence index, were stable in the first quarter of 2014. In March short- and long-term inflation expectations remained unchanged from February at 3.2 and 2.9 per cent respectively. In the following two quarters inflation in the USA is expected to remain below 2 per cent on an annual basis.

The improvement in labour market conditions is projected to continue. In January US unemployment dropped to 6.6 per cent, the lowest level recorded since November 2008. In February it rose to 6.7 per cent, broadly reflecting the increased number of the persons considered as part of the labour force. The number of employed in the non-agricultural sector rose by 175,000 compared to 129,000 in January. New jobs created in the first two months of 2014 were less than in the fourth quarter of 2013 as a result of the hard winter. On an average monthly basis, employment in the non-agricultural sector rose by 152,000 in the first quarter, compared to 198,000 in the previous quarter.

At its meeting of 18 and 19 March, the US Federal Open Market Committee decided to keep its federal funds rate unchanged within a range of 0 to 0.25 per cent. It was decided again to reduce the volume of purchased assets under the Federal Reserve System programmes (the third round of quantitative easing, known as QE3) by another USD 10 billion to USD 55 billion *per* month, effective as from 1 April 2014. After the third consecutive reduction, the amount of purchased government bonds reached USD 30 billion (previous value: USD 35 billion) and that of purchased mortgage-backed securities was USD 25 billion (previous value: USD 30

US Unemployment Rate and Changes in Payroll Employment



Source: Bureau of Labor Statistics.

billion). A decision was taken to continue investing the receipts of maturing government securities of the US Federal Reserve balance sheet again in US government securities, as well as to reinvest the receipts from government-sponsored agencies' unsecured and mortgage bonds available in the US Federal Reserve balance sheet in new mortgage bonds.

It was decided at the meeting to change the nominal threshold for the US unemployment rate to 6.5 per cent indicating, if achieved, that the monetary policy pursued may change coupled with a broader expert estimate of Committee members concerning the progress in Federal Reserve System goals toward full employment and inflation of 2 per cent. The estimate will be based on a wide range of information, including measures of labour market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments in the USA. In addition, the Committee members anticipate that the current target range for the federal funds rate will be maintained for a considerable time after the asset purchase programme ends, especially if projected inflation continues to run below the Committee's 2 per cent longer-run goal, and provided that longer-term inflation expectations remain well anchored.

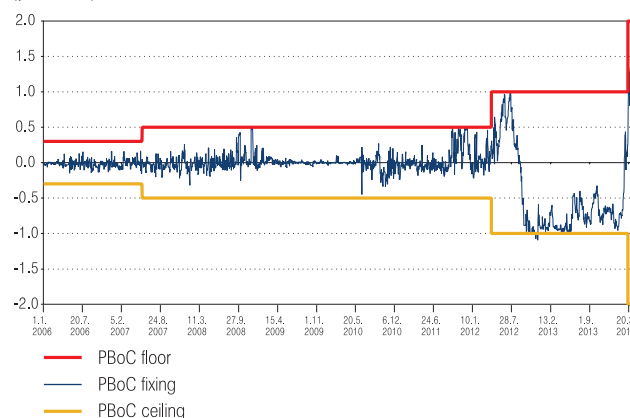
China

In March Chinese political leaders announced that the government efforts would focus on reforms related to the exchange rate of the domestic currency, pushing ahead with yuan convertibility. The 2014 target GDP growth rate remained unchanged at 7.5 per cent, as in the previous year. M2 money supply growth rate was estimated to reach 13 per cent and the budget deficit 2.1 per cent of GDP.

The reforms undertaken in the first quarter of 2014 were focused on the financial market and included financial sector and exchange rate liberalisation. In March five banks owned entirely by private companies were registered under a pilot project. As one step in the process towards liberalisation, it is expected the cap on deposit rates to be removed in the next two years. The most significant measure towards exchange rate liberalisation was the widening of the US dollar trading band from ± 1 to ± 2 per cent.

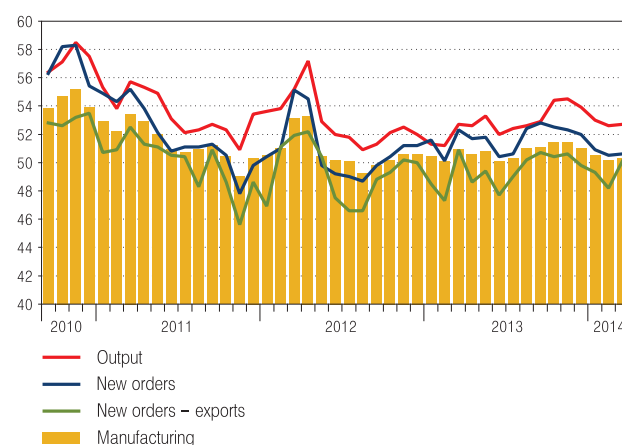
Renminbi Central Exchange Rate and Trading Band

(per cent)



Source: National Bureau of Statistics of China.

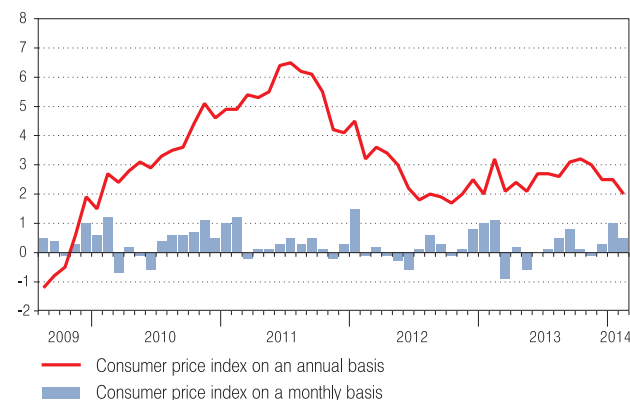
Manufacturing, Output and New Orders PMIs



Source: China Federation of Logistics and Purchasing.

Inflation Indices (Rate of Change)

(per cent)



Source: National Bureau of Statistics of China.

According to manufacturing PMIs, the economic activity slowed down in the first months of 2014. In February it continued to fall to 50.2 from 50.5 in January. In the first two months a cumulative decline of 0.8 points was observed as a result of seasonal factors. PMI output sub-index dropped slightly to 52.6, from the previous value of 53.0, that of new orders declined to 50.5 (previous value: 50.9), and the sub-index for new export orders contracted from 49.3 in January to 48.9 in February. Sub-indices for imports posted strong declines (46.5, previous value: 48.2) along with those for employment (48.0 against 48.2 in January).

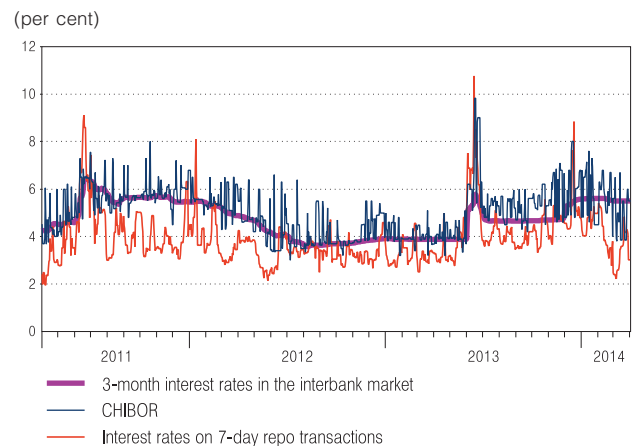
In January China's annual inflation remained unchanged at 2.5 per cent compared to December, though moderating to 2.0 per cent in February. The annual growth rate of food prices continued to slow down to 3.7 per cent in January and 2.7 per cent in February. Non-food prices accelerated for a short period to 1.9 per cent annually in January against 1.7 per cent in December, moderating to 1.6 per cent in February.

The annual inflation of producer prices accelerated its negative trend to reach -1.6 per cent in January against -1.4 per cent in December 2013.

The Chinese central bank continued to manage more actively liquidity in the interbank market by withdrawing liquidity to push up interbank interest rates to the end-2013 levels. The growth rate of M2 monetary aggregate decreased slightly to 13.2 per cent annually in January against 13.6 per cent in December. Despite the great volatility of credit data on a monthly basis, the trend shows a gradual decline towards a lower indebtedness announced by the government.

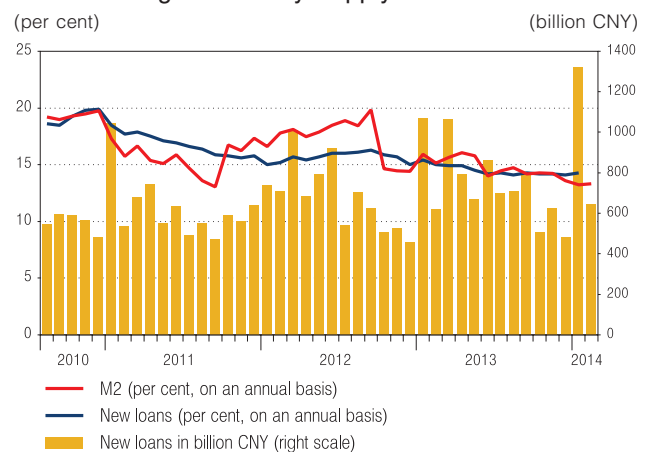
In January new loans in domestic currency rose above the expected level (to CNY 1320 billion compared to the expected CNY 1100 billion and previous value of CNY 483 billion). On a monthly basis, the aggregate credit (bank and non-bank) to the economy doubled to CNY 2580 billion. An essential factor behind this rise was the so-called Chinese new year which is usually a period of increased demand for loans, thereby boosting currency in circulation.

Interbank Market Interest Rates



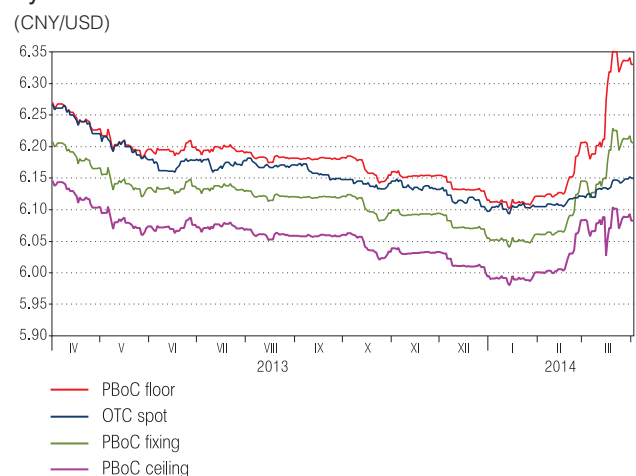
Source: People's Bank of China.

Bank Lending and Money Supply



Source: People's Bank of China.

Renminbi Exchange Rate and Trading Band Set by the Chinese Central Bank



Source: People's Bank of China.

In the last week of February the central bank of China decreased sharply the exchange rate of domestic currency against the US dollar, thereby causing an unusual volatility of the domestic financial market. Market participants betting on a constant renminbi appreciation perceived this as a cause for investor hesitation and preparation for widening the trading band of the domestic currency.

International Commodity Prices

Crude Oil

The Brent oil price stood at around USD 108 *per barrel* as of end-2013 and early 2014, with an average value of USD 107.9 *per barrel* (EUR 78.0) in March (preliminary data). On an annual basis, USD crude oil prices fell by 4.3 per cent over the first quarter of 2014, while those in EUR decreased by 7.8 per cent as a result of the 3.8 per cent euro appreciation against the US dollar.

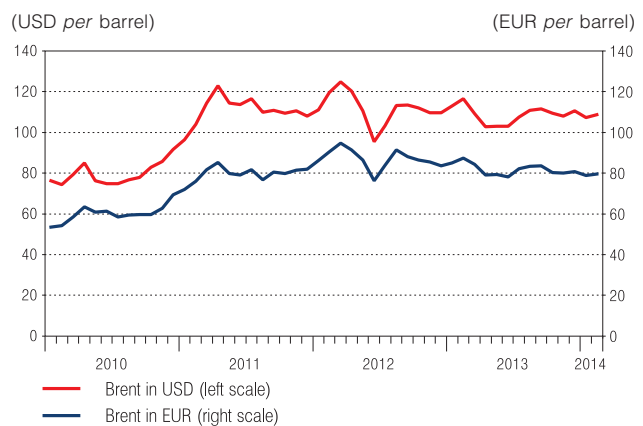
According to the International Energy Agency (IEA) forecast of March 2014, global demand for crude oil is expected to rise on an annual basis in the second and third quarters of 2014. At the same time, IEA reported an increased crude oil production in the USA, Canada and Brazil, with increased supply expected to contribute for retaining crude oil prices at levels close to the current ones.

However, market expectations show a decrease in the Brent crude oil price over the second and third quarters of 2014. In March Brent crude oil futures prices for the following 12 months were within the range of USD 100–110 *per barrel*. Lowered expectations compared to December may be explained by the released March data on the growth of US oil inventories and the slow-down of economic activity in China.

Major Raw Material and Food Prices

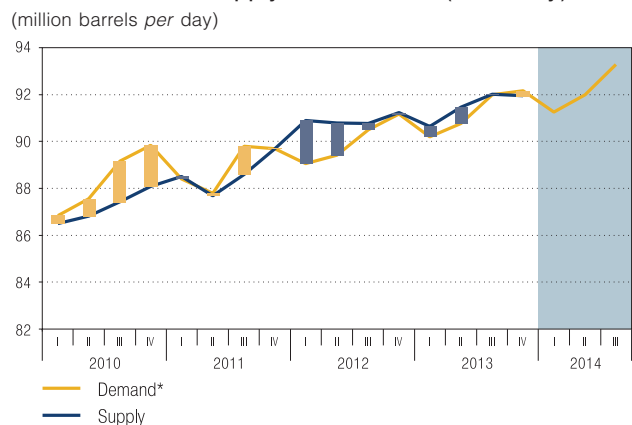
In the January to February 2014 period international euro prices of major groups of goods showed divergent developments. The metals price index published by the ECB decreased by 10.2 per cent annually, remaining broadly unchanged from the fourth quarter of 2013.

Crude Oil Prices



Source: World Bank.

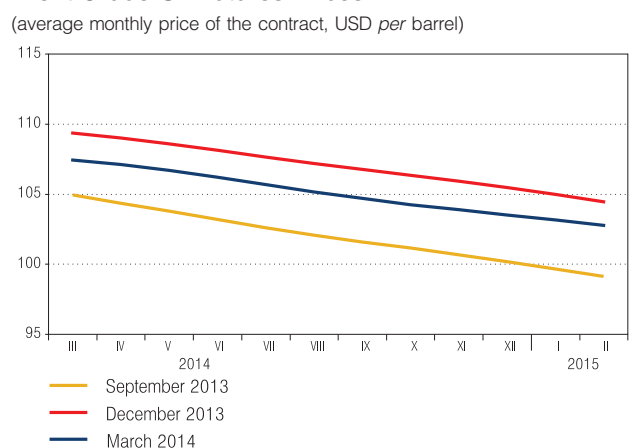
World Crude Oil Supply and Demand (Quarterly)



* Including the March 2014 IEA forecast about crude oil demand in 2014.

Source: IEA.

Brent Crude Oil Futures Prices



Source: JP Morgan.

Copper prices picked up in January, but the downward trend was restored in February. For the January to February period, copper prices declined by 12.4 per cent on an annual basis, mainly driven by the economic growth slowdown in China where around 40 per cent of world copper production is consumed. Over the same period, the overall non-ferrous metal index went down by 0.25 per cent compared with the fourth quarter of 2013 and by 15.3 per cent on an annual basis.

Market expectations for metal prices in the second and third quarters of 2014 show a slight increase. The main reason behind this dynamics will be the ongoing recovery of economic growth in the euro area and the USA, as well as the threat of interruption of Russian deliveries due to the situation in Ukraine. Risks of a possible decrease in prices reflect the insufficient demand against the backdrop of continuous moderation of China's economic growth.

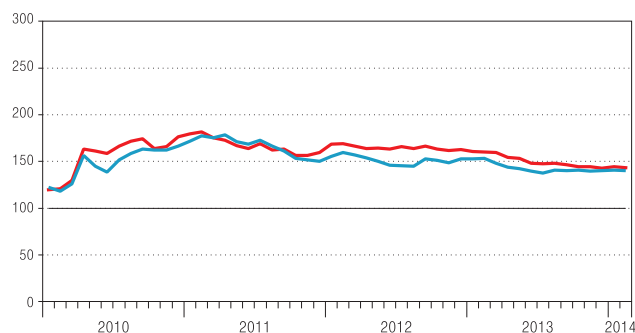
Over the January to February period, food and cereal prices on international markets continued to decline on an annual basis, though the prices of most food groups posted an increase on the fourth quarter of 2013 under the effect of the unfavourable weather conditions in the big producer countries and the geopolitical tensions between Ukraine and Russia. In February the highest monthly price growth was reported in wheat and cereals since Ukraine and Russia are among the top global producers of these commodities. The food price index increased by 2.2 per cent between January and February 2014 compared with the fourth quarter of 2013, with the meat price index posting the strongest growth. In the second and third quarters of 2014 market expectations show a further increase in cereal prices, though they will still remain below the level of corresponding periods in the previous year.

If market expectations for an increase in metal and food prices and for a decrease in crude oil prices materialise, the terms of trade in Bulgaria would improve, contributing to the higher nominal growth of exports *vis-à-vis* imports.

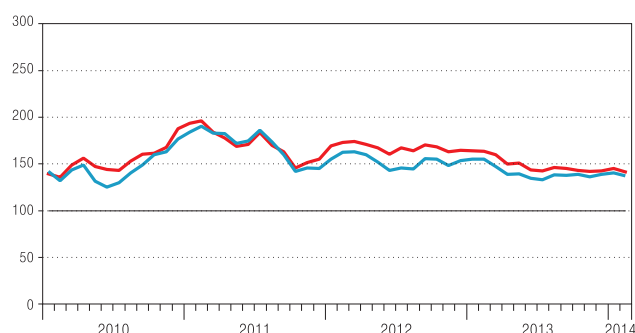
Price Indices of Major Raw Material and Commodity Groups

(2009 = 100)

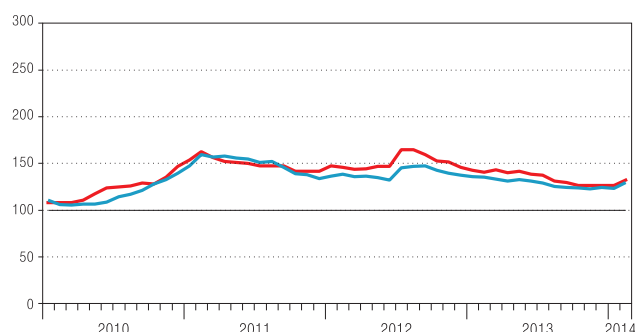
Metals



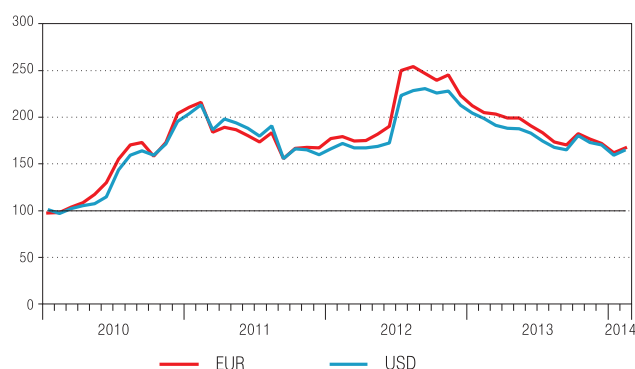
Copper



Food



Wheat



Sources: ECB and BNB calculations.

2. Financial Flows, Money and Credit

The positive external environment developments in 2013 and the economic recovery in Bulgaria's major trading partners contributed to the sustainable growth rate of domestic exports of goods and services. The weak domestic demand and, to a lesser degree, the favourable dynamics of the terms of trade led to a decline in the trade deficit and a surplus in the BoP current account over 2013. If the expectations of slight changes in both terms of trade and growth in external demand for Bulgarian goods and services materialise, the positive current and capital account balance is projected to further increase over the second and third quarters of 2014.

Banks' financial transactions, foreign direct investments in Bulgaria and corporate bond issuance in November had a major impact on the BOP financial account flows. Given the high savings ratio, low demand for loans against the background of maintained weak economic activity and cautious lending by banks, the flow of attracted funds in Bulgaria's banking system significantly outstripped demand for borrowed funds. As part of their investment strategies, banks invested a significant portion of their financial resources in foreign assets and optimised the cost of servicing liabilities by repaying part of their foreign liabilities. Furthermore, banks continued to increase the share of Bulgarian government securities in their portfolios.

The relatively high growth of funds attracted from residents in the banking system is expected to remain unchanged in second and third quarters of 2014, which will be reflected in maintaining high banking system liquidity and in an increase in banks' net foreign assets. A slight increase in lending to the non-government sector is also expected in the light of the gradual increase of economic activity in Bulgaria.

Given the interaction of external and internal economic factors and resulting financial flows, Bulgaria's international reserves (excluding valuation adjustments and price revaluation) posted an increase of EUR 85.6 million on an annual basis by January 2014 (based on BoP data).

The market value of international reserves⁷ (assets on the Issue Department balance sheet) declined by EUR 326.3 million to BGN 26.6 billion (EUR 13.6 billion) at the end of February 2014. Besides methodological reasons the difference between the change in reserves in the Issue Department balance sheet and that in the balance of payment reflected to a large degree the impact of valuation adjustments resulting from the decrease in gold price by 20.7 per cent⁸ over the review period.

Changes in the liabilities side of the balance sheet (monetary liabilities of the BNB)⁹, including

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

⁸ Source: BNB.

⁹ The Law on the BNB Article 28, paragraph 1 provides that 'the aggregate amount of the monetary liabilities of the BNB shall not exceed the lev equivalent of gross international reserves,' with that equivalent based on the fixed exchange rate.

the decrease in the obligations to banks, mostly resulting from the lower banks' funds in the TARGET2-BNB payment system¹⁰ and reduced excess reserves on the minimum required reserves accounts, contributed most strongly to the decline in the Issue Department balance sheet value on an annual basis by February 2014. The lower gold price led to a significant decline in the Banking Department deposit.

The flows prompting a change in international reserves in line with the currency board principles reflected economic agents' demand for cash in foreign currency or levs. In 2013 banks' foreign currency purchases from the BNB exceeded sales and the trend was sustained in the first quarter of 2014. The major factor behind this trend observed since 2011 was the banks' policy to increase their foreign assets and reduce their foreign indebtedness in the context of high liquidity in the banking system.

By January 2014 the international reserves coverage of the average nominal imports of goods and non-factor services over the last 12 months came to 5.9 months.

By the end of the third quarter of 2014 international reserves (if it is assumed that the gold price and the price of securities assets will not change) are expected to increase on an annual basis. The major reason behind this will be the projected issue of government debt in international capital markets, the earnings of which will prompt an increase in the government deposit with the BNB. The expected surplus on the overall current and capital account balance over the review period will also contribute to the increase in international foreign currency reserves.

External Financial Flows

Throughout 2013 a gradual rise in the surplus of BoP overall current and capital account balance was observed on an annual basis. This was mainly a result from lower trade balance deficit due to faster growth of the physical volume of exports of Bulgarian goods compared with

External Cash Flows in Foreign Currency

(EUR million)

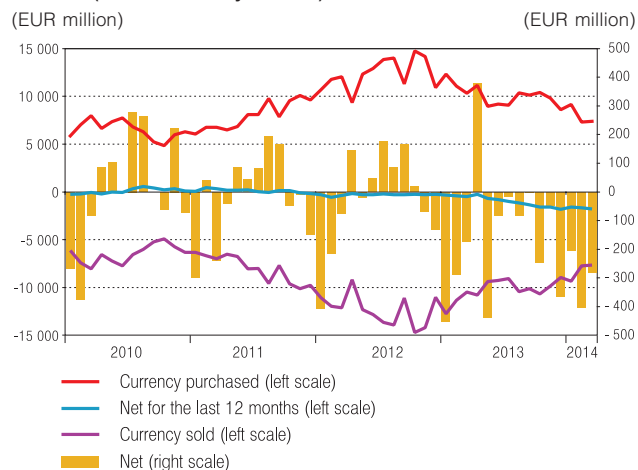
External flows	2012	2013
Total for the period	1 527	-429
Purchases and sales of euro	-317	-1 429
at tills	-10	-21
banks, incl.	-307	-1 408
purchases from banks	46 550	35 169
sales to banks	-46 856	-36 577
Flows on accounts of banks, the MF, etc.	1 844	1 000
Minimum required reserves	40	-92
Government and other depositors	1 804	1 091

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

Source: BNB.

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

(EUR million)



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

Source: BNB.

¹⁰ The national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2).

imports of goods and, to a lesser extent, the favourable dynamics in the terms of trade. As a result exports increased significantly in nominal terms while nominal imports posted weak growth.¹¹ In the last months of 2013 and in early 2014 the first signs of a change in the downward trend of trade balance deficit was reported after export growth slowed down, while growth rates of imports stabilised and then gradually accelerated.

The surplus in the services balance went down in 2013 and in early 2014 mostly due to an increase in imports and to a lesser extent to a fall in exports. Tourist services and other business services recorded a significant increase in imports, while tourist services had the largest positive contribution to exports.

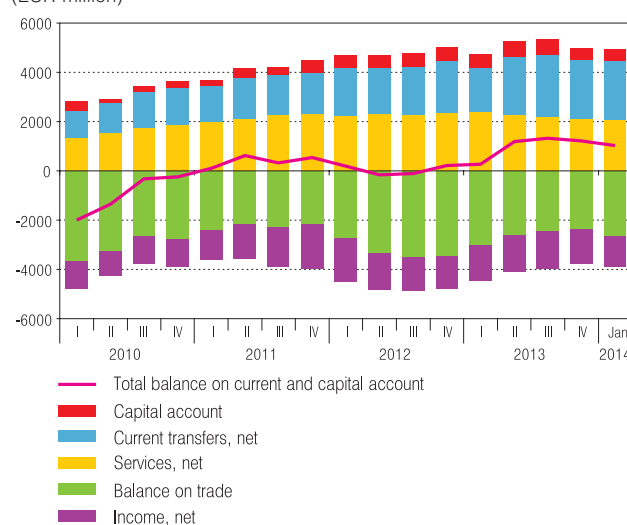
The income account reported a deficit which widened in 2013 reflecting the faster increase of outflows compared with inflows. Income from other capital (interest) and dividends and distributed earnings from direct investments comprised the largest share in external payments. As regards inflows, in 2013 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 period. By the end of 2013 and early 2014 signs of a reversal of the upward trend in the deficit on the income account occurred due mainly to lower payments in the form of dividends and distributed earnings.¹²

The balance on net current transfers was positive in 2013, with inflows reporting a decline on an annual basis only by the close of the year and in early 2014 due largely to a base effect from 2012. The bulk of inflow of current transfers was formed by grants received under EU funds.

In the event of an insignificant change in the terms of trade in Bulgaria the trade deficit is expected to stabilise and gradually decrease in the second and third quarters. This will result in an increase of surplus on the overall current and

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

(EUR million)



Source: BNB.

Flows on Balance of Payments Main Accounts

(EUR million; cumulative since the beginning of the year)

	2012	2013	January 2014
Current account	-333.9	751.3	-282.0
Trade balance	-3 460.3	-2 353.3	-324.1
Services balance	2 380.1	2 108.1	21.2
Income account	-1 328.2	-1 385.4	-4.8
Current transfers, net	2 074.5	2 381.9	25.7
Capital account	541.0	466.4	-3.3
Financial account	1 466.2	-1 465.6	-441.7
FDI in Bulgaria	1 070.3	1 092.4	58.3
Changes in reserves	2 161.0	-599.2	-627.4

Source: BNB.

¹¹ For a more detailed analysis of exports and imports of goods, see Chapter 3.

¹² Preliminary data subject to revision.

capital account over the period. A factor which could lead to lower values of this balance is the faster than expected recovery of domestic demand that will accelerate nominal imports.

In 2013 the financial account dynamics reflected mainly transactions of banks, FDI inflows in Bulgaria and the November issues of corporate bond loans¹³. Though at a lesser extent, financial account dynamics was influenced by the January 2013 external debt payments by the government¹⁴.

Based on the balance of payments preliminary data FDI inflows in Bulgaria in 2013 almost matched that of 2012¹⁵. By the end of 2013 and in early 2014 this trend was sustained. In the second and third quarters of 2014 FDI inflows are expected to remain at a level around 2.5 per cent of GDP.

In 2013 banks continued to increase their assets in the form of an outflow from the financial account totalling EUR 1861.8 million (portfolio and other investment). Banks decrease their foreign assets to a lesser extent: by EUR 631.8 million (portfolio and other investment) based on balance of payments data.

The balance of payments financial account dynamics prompted changes to the gross foreign debt and in 2013 the gross foreign debt exhibited a gradual decline compared with end-2012. This dynamics was a result of lower debt of banks and the government, while inter-company loans and other sector loans posted an increase. In early 2014 gross foreign debt remained at levels close to those of end-2013.

By sector an increase in gross external debt in 2013 resulting from intercompany loans of other sectors was reported in manufacturing (EUR 1705.7 million). A significant decrease in external debt was registered in transport, storage and communications (EUR -870.0 million), production and distribution of electricity and heating,

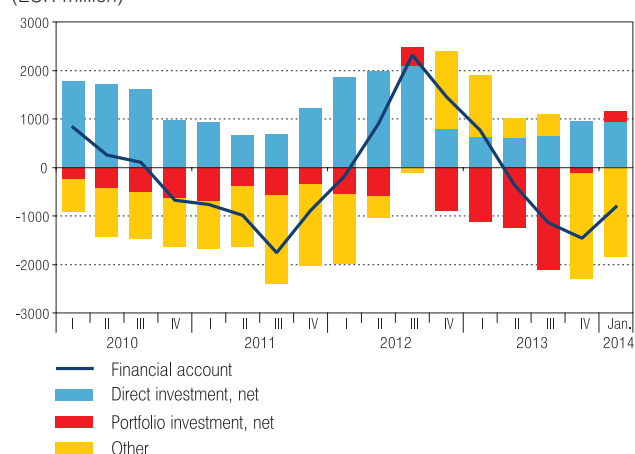
¹³ For further details on the issue of corporate bonds in November, see Economic Review, 4/2013, p. 29.

¹⁴ For more details on payments of government global bonds maturing in January 2013 and their implications on balance of payments financial account and external debt, see Economic Review, 1/2013, p. 30.

¹⁵ Preliminary data subject to revision.

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

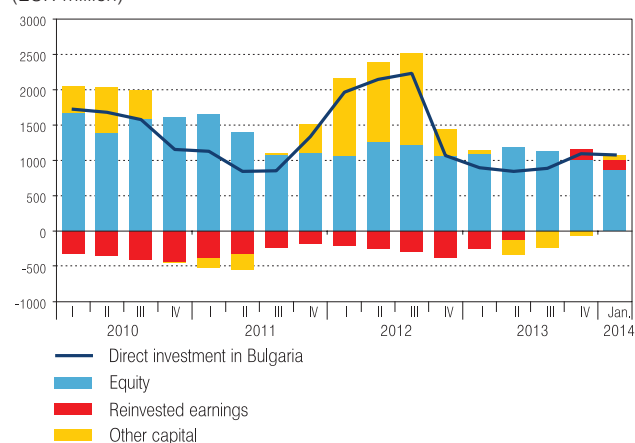
(EUR million)



Source: BNB.

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

(EUR million)



Source: BNB.

Banks' Flows on Balance of Payments Financial Account

(EUR million; cumulative since the beginning of the year)

	2012	2013	January 2014
Net direct investment	-48.8	-23.2	12.8
abroad	-0.7	3.3	0.0
in Bulgaria	-48.1	-26.5	12.8
Net portfolio investment	-1 132.5	-225.3	-78.0
assets	-1 150.0	-292.3	-36.2
liabilities	17.4	67.0	-41.8
Other investment	1 545.2	-2 268.3	-482.9
assets	730.4	-1 569.5	-320.7
liabilities	814.8	-698.8	-162.2
<i>Portfolio and other investment</i>	<i>412.7</i>	<i>-2 493.6</i>	<i>-560.9</i>
Total	363.9	-2 516.8	-548.1

Source: BNB.

gaseous fuels and water (EUR -691.2 million) and financial intermediation (EUR -512.4 million).

By the end of 2013 long-term external debt increased by 0.9 per cent on the end of the previous year. Short-term external debt contracted by 6.5 per cent over the same period, its share in total external debt comprising 26.1 per cent by December 2013. In January 2014 the trends were sustained with short-term debt accounting for 25.8 per cent of total external debt.

Based on the statistics of declared new loans and external debt service it could be concluded that economic agents in Bulgaria continued to have access to favourable conditions on the new external financing received and to smoothly service their external obligations. If no shocks in the international environment occur, the cost of external financial resources is likely to decline further in the second and third quarters of 2014. The onset of a new interest rate cycle in monetary policy of leading central banks, implied by rising global money and capital market rates, could entail a risk of a reversal of this trend but the probability for this scenario to materialise over the projection horizon appears to be relatively small.

Monetary and Credit Aggregates

By the end of February 2014 reserve money posted a slight decrease on an annual basis. Reserve money dynamics reflected the decline in banks' reserves with the BNB driven mostly by lower funds available on their accounts in the TARGET2-BNB system, a trend which occurred in the second quarter of 2013, and to a lesser extent by lower banks' excess reserves¹⁶. The decline in these components of bank deposits with the BNB was mostly a result of higher euro area money market rates which led to accelerated annual growth of banks' foreign assets in the second half of 2013.

Concurrently, deposit base growth led to an increase in bank funds allocated into minimum

¹⁶ In February bank excess reserves measured by the excess of funds on banks' minimum reserve accounts with the BNB over the required minimum under Ordinance No 21 reached 5.4 per cent on an average daily basis (8.7 per cent in February 2013).

Gross External Debt as of January 2014

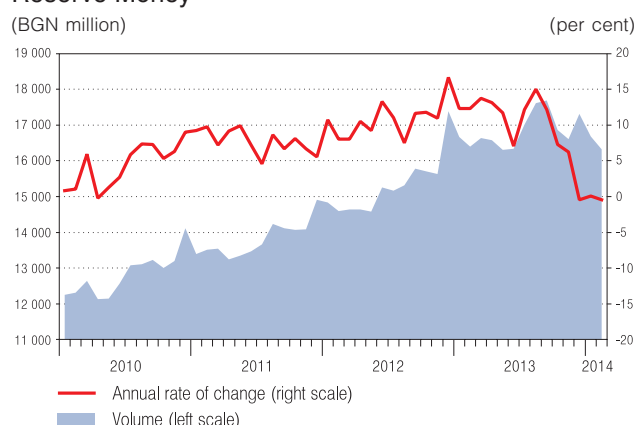
(EUR million)

	Amount	Change	
		January 2014	Last 12 months
General government	3 353.2	21.6	191.6
Central bank	0.0	0.0	0.0
Banks	5 683.7	-73.8	-632.2
Other sectors	12 305.1	-71.5	227.4
FDI: Intercompany loans	15 926.6	53.5	115.3
Total	37 268.6	-70.2	-98.0

Source: BNB.

Reserve Money

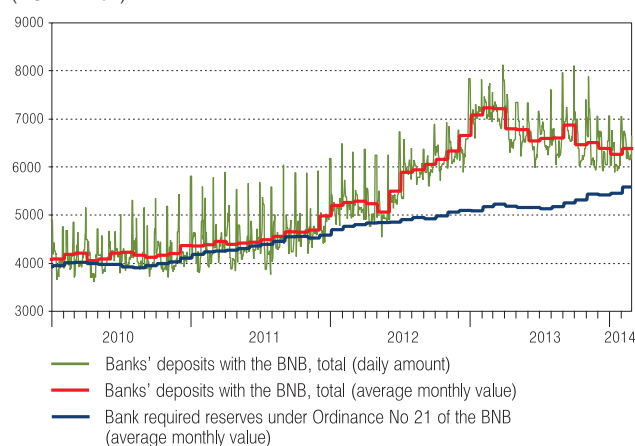
(BGN million)



Source: BNB.

Bank Deposits with the BNB

(BGN million)



Source: BNB.

required reserves. The positive contribution to the dynamics of banks' required reserves with the BNB was significantly lower than the negative contribution of banks' funds in the TARGET2-BNB system and excess reserves. Cash in circulation accelerated on an annual basis since early 2014 which limited the rate of reserve money decline.

Reflecting the developments and structure of attracted funds in the banking system, the effective implicit rate of minimum required reserves maintained with the BNB reached 8.95 per cent¹⁷ in February, with banks' reserves with the BNB comprising 7.87 percentage points and the remaining 1.08 percentage points formed by cash and funds on banks' settlement accounts in the TARGET2-BNB system¹⁸.

The money multiplier expresses the interrelation between reserve money dynamics and money stock in the economy. As banks' excess reserves and cash on settlement accounts in the TARGET2-BNB system contracted and the high inflow of attracted funds in the banking system was sustained, the money multiplier reached 4.1 (against 3.7 in the same period of 2013). Broad money retained their high growth rates reported in the fourth quarter of the previous year, with annual growth by February accounting for 9.2 per cent. Overnight deposits and deposits redeemable at notice of up to three months contributed most substantially to broad money dynamics, while the contribution of deposits with an agreed maturity of up to two years remained negative.

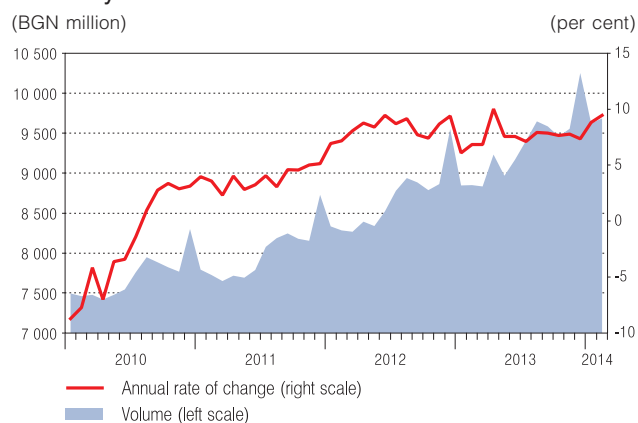
Deposits of the non-government sector, the major bank resource, retained its upward trend in the first two months of 2014¹⁹. Deposits of non-government sector attracted by banks increased by 8.7 per cent on an annual basis by February. Household deposits continued to contribute most strongly to growth but their upward dynamics between September 2013 and February 2014

¹⁷ According to Article 3, paragraph 1 of BNB Ordinance No 21, the rate of minimum required reserves of funds attracted from residents is 10 per cent of the deposit base, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

¹⁸ See Article 4 of Ordinance No 21 of the BNB.

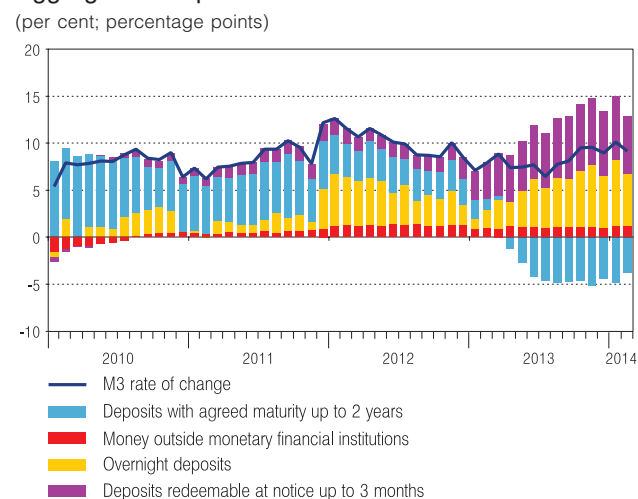
¹⁹ The analysis is based on the annual changes in the balances according to the data of the analytical reporting of other monetary financial institutions.

Currency in Circulation



Source: BNB.

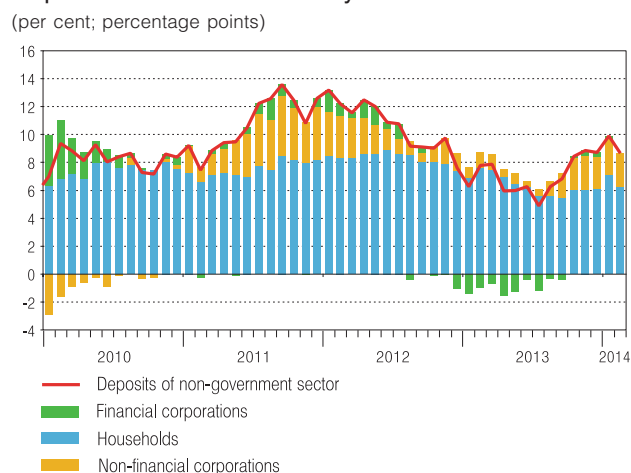
Annual M3 Growth Rate and Contribution by Aggregate Component



Note: The contribution of marketable instruments is not shown on the chart due to the insignificant contribution to broad money growth.

Source: BNB.

Annual Growth of the Non-government Sector Deposits and Contributions by Sector



Source: BNB.

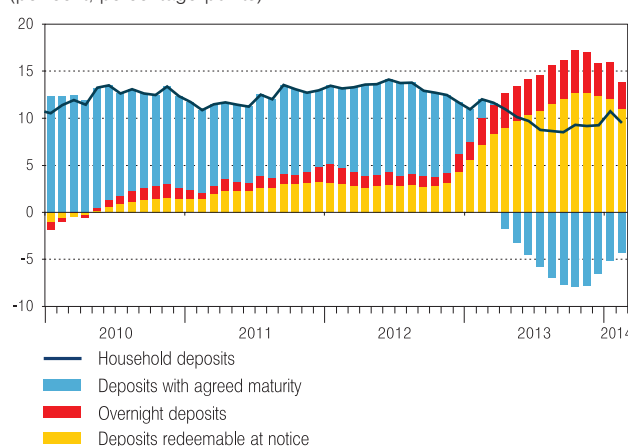
was mainly driven by growth of deposits of non-financial corporations. As regards the currency structure, lev-denominated deposits continued to contribute most strongly to deposit base growth, with the contribution of foreign currency deposits (mostly in euro) retaining their upward trend started in the second half of 2013. By the end of February 42 per cent of deposits in the Bulgarian banking system were denominated in foreign currency.

The structural change in the type and maturity of household deposits, started in the fourth quarter of 2012 as a result of the introduction of a new tax on individuals' time deposit interest, continued in the first two months of 2014. Since early year deposits (overnight and deposits redeemable at notice of up to three months) which are beyond the scope of the tax grew at relatively high rates, while deposits with agreed maturity continued to decrease. In the first two months of 2014 the gradual slowdown observed since the end of the previous year in the annual growth rates of overnight deposits and those redeemable at notice continued. This trend is probably attributable to the effect of strong growth of these deposits at the end of 2012 and early 2013 on the one hand, and the cut in the tax rate of 2 percentage points to 8 per cent effective from 2014. The change in the structure of household deposits is expected to continue in the second and third quarters of 2014, with the effects of restructuring on developments of deposits with various maturity gradually subsiding.

Given the comparatively low demand for loans due to still weak economic activity and relatively tight credit standards, the increasing volume of attracted funds was the factor for maintaining high liquidity in the banking system. In the first two months of 2014 banks continued to invest the bulk of attracted funds in foreign asset, repaying their foreign liabilities and investing in government securities issued by the Bulgarian government. Growth of credit to the non-government sector remained relatively weak. The annual increase in claims on the non-government sector amounted to 0.8 per cent in February (BGN 439 million reflecting net purchases of loans in the amount of BGN 180 million).

Annual Growth of Household Deposits and Contribution by Type of Deposit

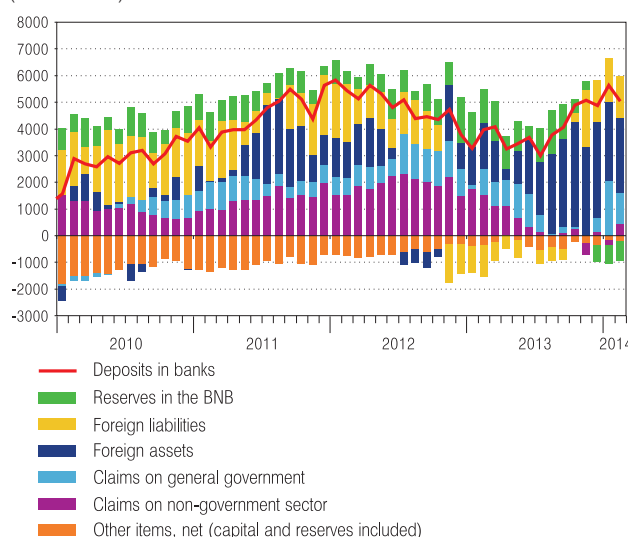
(per cent; percentage points)



Source: BNB.

Changes in Balance Sheet Items of Banks (on an Annual Basis)

(BGN million)



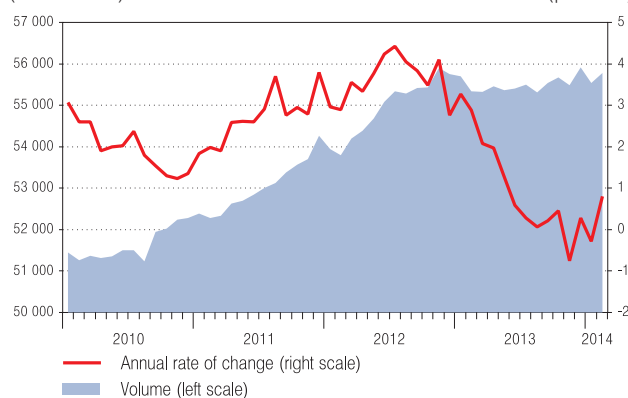
Note: The changes shown are based on balances from the analytical reporting of other monetary financial institutions.

Source: BNB.

Claims on Non-government Sector

(BGN million)

(per cent)



Source: BNB (monetary statistics: monetary survey).

The moderation in the growth of claims on non-financial corporations which started in the second half of 2012 was discontinued by the end of 2013 and in early 2014; their annual growth rate reaching 1.3 per cent by February. Available alternative sources of financing, including gross operating surplus used by corporations and, to a lesser extent, foreign direct investment in Bulgaria, were probably the factors with a limiting effect on demand for bank loans.²⁰

By the end of 2013 in most economic sectors the growth rate of loans to non-financial enterprises slowed down. The energy sector²¹ and the other services sector²² had a stronger negative contribution to total annual growth of loans, while real estate operations had the major positive contribution. Compared with end-2012 credit growth in industry and trade²³ exhibited a significant decline. Credit dynamics in the trade and real estate operations sectors was partly impacted by reclassification between the two sectors²⁴.

The volume of new loans²⁵ to non-financial corporations remained high in early 2014. Concurrently, the total credit to non-financial corporations posted low annual growth showing the effect of various factors as extension of new loans with funds from matured loans, renegotiation or refinancing of loans. In the first two months of the year the upward trend in the volume of loans with a maturity of over five years, which started since 2011, was sustained. Between March 2013 and February 2014 the average monthly volume of these loans accounted for 49.4 per cent of all new loans compared with 42.3 per cent a year earlier.

²⁰ More detailed analysis of firms' behaviour is presented in Section 3.

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

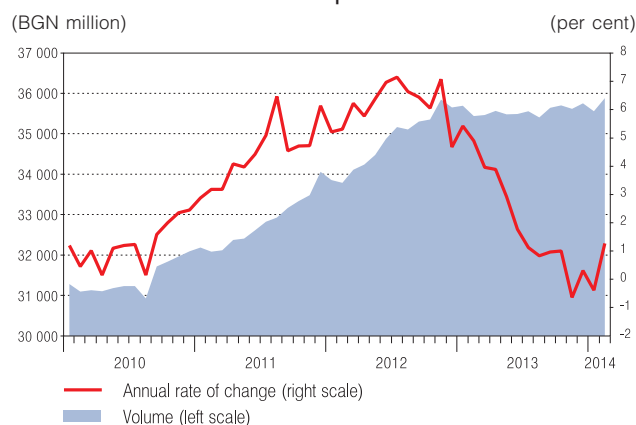
²² Included are: 'professional, scientific and technical activities', 'administrative and support activities', 'education', 'human health and social work activities', 'culture, sport and entertainment' and 'other activities'.

²³ 'Wholesale and retail trade; repair of motor vehicles and motorcycles'.

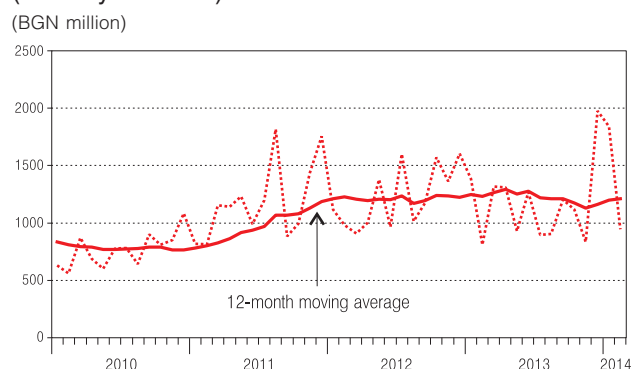
²⁴ The reclassification is mainly a result of the modified sector classification.

²⁵ The terms 'new' and 'newly extended' refer to the statistical category 'new business'.

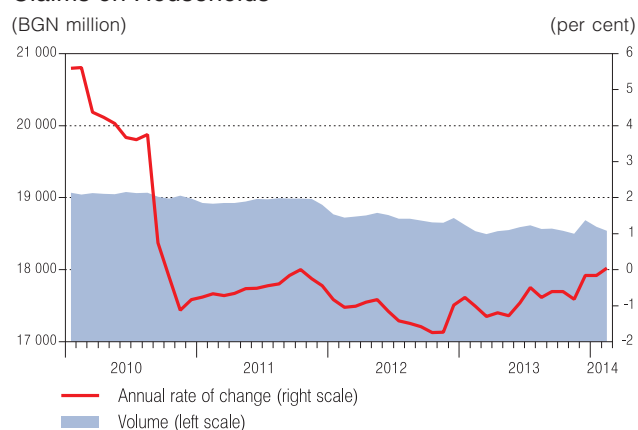
Claims on Non-financial Corporations



New Loans to Non-financial Corporations (Monthly Volumes)



Claims on Households



Since the end of 2013 the first signs of stabilisation occurred in household lending. The amount of household loans exhibited no change on an annual basis in February (against a decline by 1 per cent in the same month of the previous year). In early 2014 the divergent trends in individual loan categories were sustained. Overdraft, housing loans and the other loans category recorded an annual decline. Concurrently, the end-2013 upward trend in consumer loans continued. As of February 2014 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.

Faster growth in claims compared to nominal GDP growth in 2013 led to a minimum increase in the claims on non-government sector to GDP ratio to 71.6 per cent (71.4 per cent at the end of 2012). Since 2011 the ratio shows a relative stability around 72 per cent.

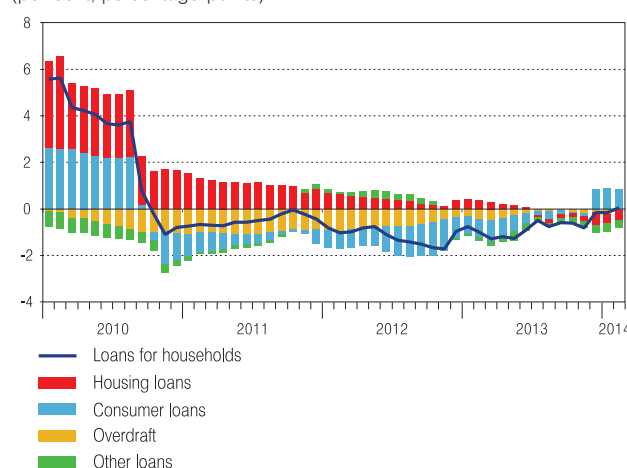
The dynamics of cash in circulation and broad money is expected to gradually slow down during the third quarter of 2014. This trend reflects our expectations for a gradual recovery of domestic demand amid retained high household savings rate and low negative inflation over the forecast horizon. Growth of funds attracted from residents in the banking system is expected to continue exceeding demand for loans, which will be reflected in maintaining high banking system liquidity and in an increase in banks' net foreign assets. Growth of loans to the non-government sector is projected to slowly increase, with growth of loans to non-financial corporations exceeding that of loans to households.

Interest Rates

The downward trend in interbank money market interest rates in Bulgaria was sustained in the first quarter of 2014. Quotations with a maturity of up to two weeks exhibited a minimal increase on a quarterly basis, while other maturities posted a decrease. LEONIA hovered around 0.04 per cent and the spread between LEONIA and EONIA widened to about -15 basis points. Quotations of interbank deposits with a maturity

Growth of Loans to Households and Contribution by Type of Loans

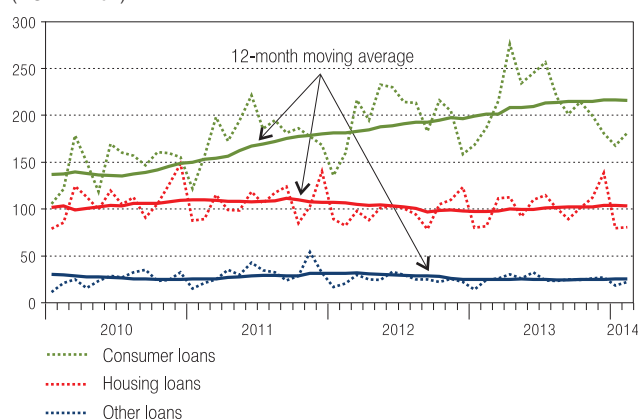
(per cent; percentage points)



Source: BNB.

New Loans to Households (Monthly Volumes)

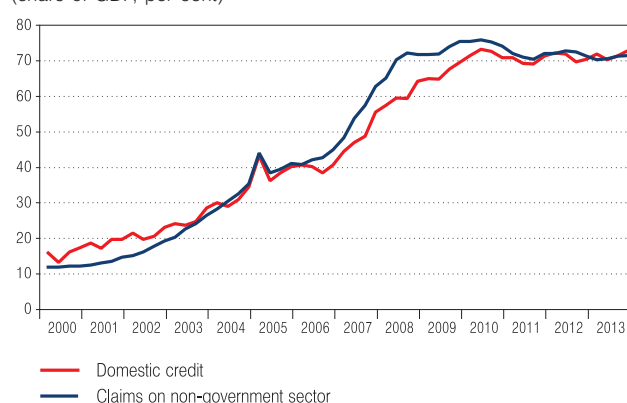
(BGN million)



Source: BNB.

Domestic Credit

(share of GDP, per cent)



Source: BNB.

of three months²⁶ accounted for 0.60 per cent on average in the first quarter, with the spreads against corresponding euro area quotations declining to 31 basis points.

The stronger decrease in quotations in long-term maturity sectors of the interbank money market yield curve compared with those with shorter maturity sectors observed since the second half of 2010 was sustained. By March a fall of 37 basis points was reported in the six-month horizon, while in the 12-month horizon, it was 56 basis points.

The volumes traded in the Bulgarian money market remained relatively low as the market plays only a supporting role in bank liquidity management. The dynamics of Bulgarian money market interest rates continued to reflect still 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 of households and firms continued to decrease. The downward dynamics in interest rates was driven by the sizeable growth of deposits from residents and low demand for bank loans. By February 2014 the average weighted interest rate on new time deposits accounted for 3.06 per cent (3.80 per cent in February 2013). A year-on-year fall was observed in rates of deposits denominated in all currencies. By maturity, a stronger annual decline was reported in deposits with a maturity of one to three months and from one to two years. In the February 2013–February 2014 period interest rates on household deposits corresponded to that on deposits of non-financial corporations.

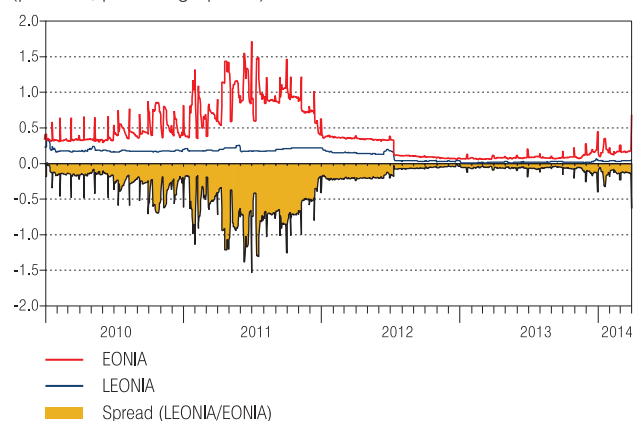
A comparison between the February and December 2013 breakdown of interest rates on household time lev deposits showed that the number of banks offering rates in the band from 3 to 4 per cent increased and those offering rates within the band of up to 3, from 5 to 6 and over 6 per cent decreased. The average interest rate on time lev deposits dropped by 9 basis points to 3.73 per cent and the

²⁶ Comments are based on the average value between the SOFIBOR and SOFIBID quotes of unsecured three-month deposits in levs.

Interbank Money Market Interest Rates

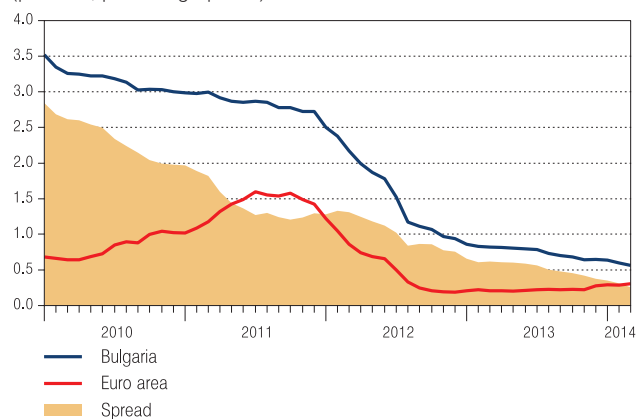
Overnight

(per cent; percentage points)



Deposits with a maturity of three months

(per cent; percentage points)

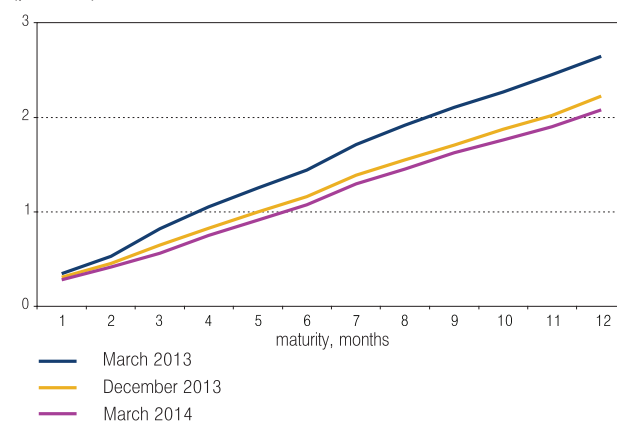


Note: The values for Bulgaria reflect the average value between the SOFIBOR and SOFIBID quotes of unsecured three-month deposits in levs.

Source: BNB.

Interbank Money Market Yield Curve

(per cent)



Note: The values reflect the average value between the SOFIBOR and SOFIBID quotes of unsecured deposits in levs.

Source: BNB.

standard deviation fell by 40 basis points to 1.03 percentage points.

The downward trend in the average cost of financing in the banking system²⁷ was sustained (from 3.13 per cent in late 2012 to 2.75 per cent in February 2014) as a result of the dynamics of prices and volumes of attracted funds.

In early 2014 interest rates applied by banks to finance non-financial corporations remained highly volatile on a monthly basis. Interest rate levels attained in the fourth quarter of the previous year were largely sustained, with a year-on-year decrease reported on new lev loans and a slight increase on new loans denominated in euro. By February interest rates on new loans to non-financial corporations amounted to 7.8 per cent on loans in levs and 8.1 per cent on those in euro.²⁸

The annual percentage rate of charge (APRC)²⁹ on household consumer loans reported a slight increase in the first two months of 2014 following the trend of maintaining the levels observed since mid-2013. This increase reflected the higher interest rates on these loans that exceeded the decline in the implicit rate of non-interest service charge³⁰ on these loans. The annual percentage rate of charge on new housing loans stabilised at levels observed in the fourth quarter of 2013, with the value reflecting the sustained levels of both the interest rates and the implicit rate of non-interest service charge on these loans. By February the annual percentage rate of charge on consumer and housing loans stood at 12.6 per cent and 7.9 per cent, respectively .

As regards the distribution of interest rates on new housing loans in euro, by February 2014 compared to December 2013, the number of

²⁷ The indicator is calculated *ex post* using data of the BNB Bank Supervision Department published on the BNB web-site 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.

²⁸ The figures below are the weighted average of the interest rates on loans to non-financial corporations on a 12-month basis.

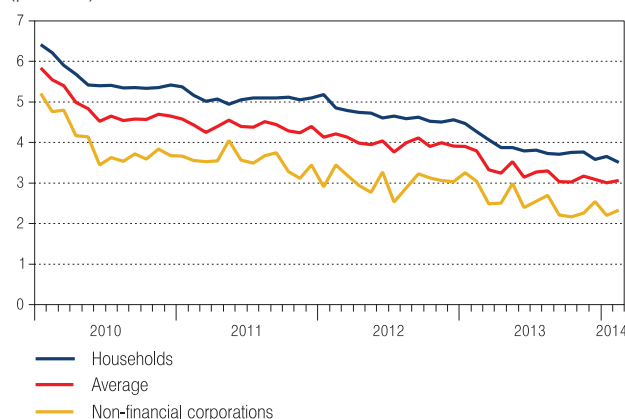
²⁹ The values below are the weighted average of the interest rates on household consumer and housing loans on a 12-month basis.

³⁰ Implicit per cent of non-interest loan service charges is the difference between the APRC and interest rates.

Interest Rates on New Time Deposits

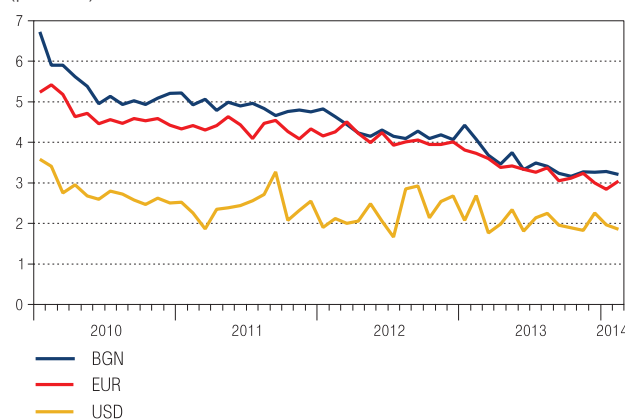
By sector

(per cent)



By currency

(per cent)

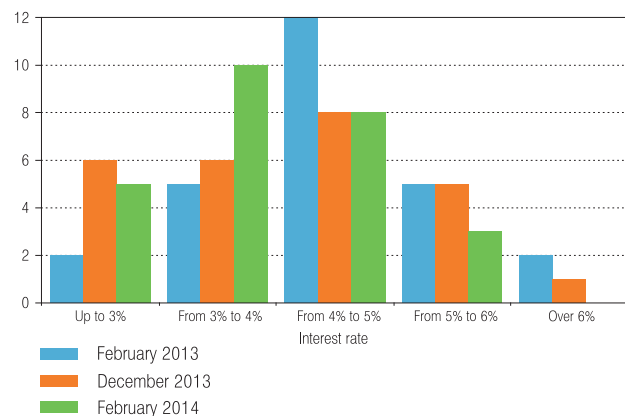


Notes: The average interest rate is calculated for all sectors, maturities and currencies weighted by the relevant volumes of new deposits.

Source: BNB.

Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



Source: BNB.

banks offering rates from 7 to 8 per cent and over 9 per cent increased at the expense of those offering rates of up to 6 per cent and from 6 to 7 per cent. Over the same period, the average interest rate level increased by 21 basis points to 7.38 per cent, and the standard deviation went up 11 basis points to 1.01 percentage points.

In the first quarter of 2014 a price decrease and correspondingly a yield rise was observed at most of Bulgarian government securities auctions on the primary market. At the first auction for a sale of benchmark government securities with a ten-year-and-six-month original maturity held in January the yield was 31 basis points higher compared with the first opening of the benchmark issue in January 2013. The sizeable volume of short-term treasury bills (BGN 1200 million) issued in January and February, which enjoyed a significant investor interest, was to some extent a factor responsible for the price fall of bonds with medium and long-term maturity. The lower yield at the auction of government bonds with maturity of two years and six months compared with the issue with a similar maturity sold in the previous year was also indicative of major primary market investors' preference for securities with shorter maturity.

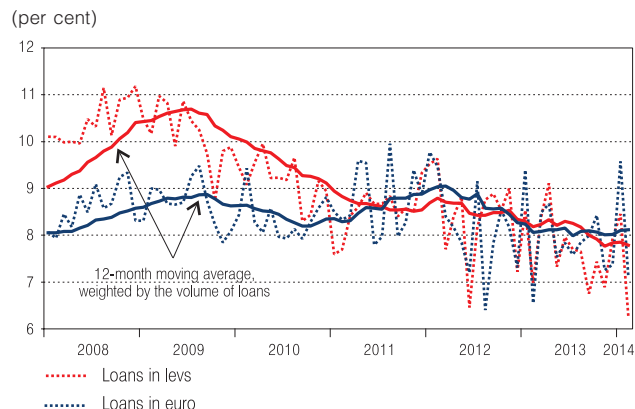
Consistent with primary market dynamics the long-term interest rate³¹ rose by end-February by 15 basis points from the end of 2013 to 3.58 per cent.

The yields of Bulgarian Eurobonds maturing in July 2017 and traded on the secondary market posted a decline. By the end of the first quarter the price of these bonds gradually rose to 109.0 (equal to an annual yield of 1.42 per cent), after 108.2 (a 1.80 per cent yield) at the end of 2013. The price dynamics of Bulgarian Eurobonds was in line with the yield decline in EU Member States securities with similar maturities recorded between January and March.

In the second and third quarters of 2014 deposit rates are expected to marginally decline which

³¹ The long-term interest rate for assessing the degree of convergence is based on the yield to maturity on the secondary market according to a long-term security (benchmark) issued by the Ministry of Finance (central government) and denominated in national currency.

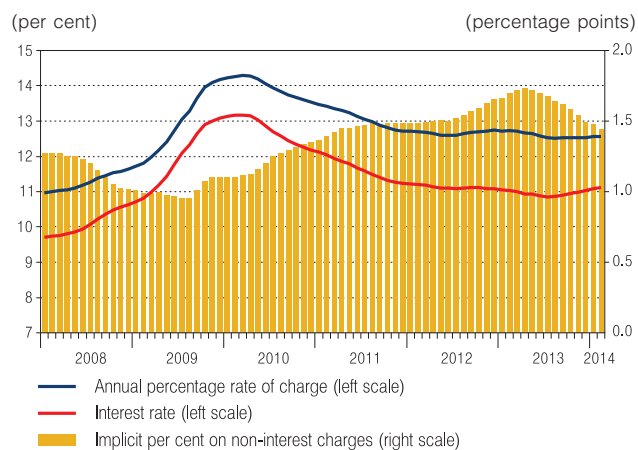
Interest Rates on New Loans in Levs and Euro to Non-financial Corporations



Source: BNB.

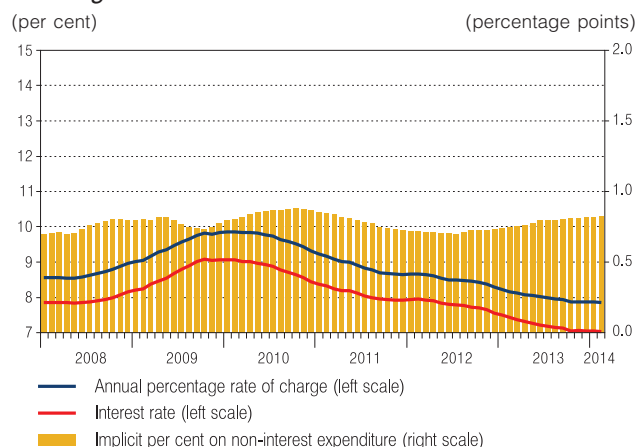
Interest Rates and Annual Percentage Rate of Charges on New Household Loans

Consumer loans



Source: BNB.

Housing loans



Notes: Interest rates in all maturities and currencies are weighted by the relevant volumes of new loans for a 12-month period. The implicit per cent is the difference between the APRC and the relevant interest rates and reflects the approximate per cent of all non-interest service charges on loans (including fees and commissions).

Source: BNB.

will be mainly driven by the high banking system liquidity and comparatively weak demand for loans. Lending rates are expected to hover around the levels attained. These trends may be reversed, if the monetary policy of leading central banks enters a new upward interest rate cycle. However, such a scenario is unlikely to materialise over the forecast horizon. Interest rates on domestic government debt are expected to remain close to their first quarter's level and their primary market dynamics will continue to be driven mostly by banks' demand for government securities.

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

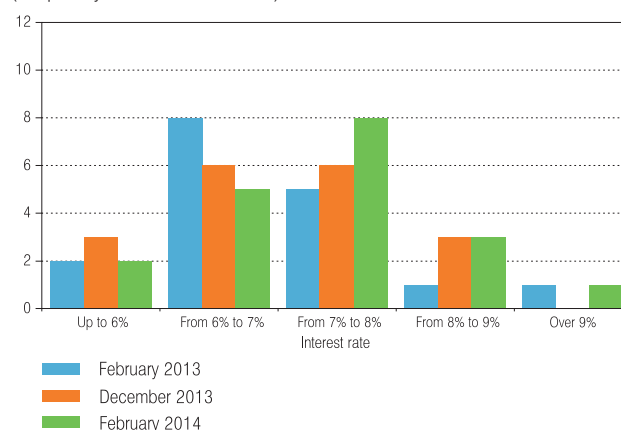
Government's revenue and expenditure policy and budget financing operations affected the allocation of liquidity among economic sectors.

In line with the expectations for the fourth quarter of 2013 the receipts in the consolidated state budget from current and capital grants received under the EU funds and foreign investors purchases of transferable *Schuldschein* loans significantly exceeded the repayments and interest expenditure on external loans and Bulgaria's contribution to EU common budget. As a result of these financial flows the external sector was a net source of liquidity for the general government, with the inflow of liquid resources from the external sector reaching 4.6 per cent of GDP for the fourth quarter.

The government issuing policy on budget deficit financing (budget deficit for 2013 amounted to BGN 1085 million) and the low amount of government securities maturing in the fourth quarter of 2013 resulted in a net inflow of liquidity to the general government from the financial sector (the BNB excluded) accounting for 3.8 per cent of GDP for the review quarter. In addition to the domestic gross issue of government securities (BGN 438 million), factors behind the net outflow of liquid resources from the financial sector were the *Schuldschein* loans purchased by domestic banks (BGN 344 million), the corporate tax paid by financial institutions (BGN 32.5 million) and extremely small amount of government bonds maturing over the

Distribution of Interest Rates on New Housing Loans in Euro

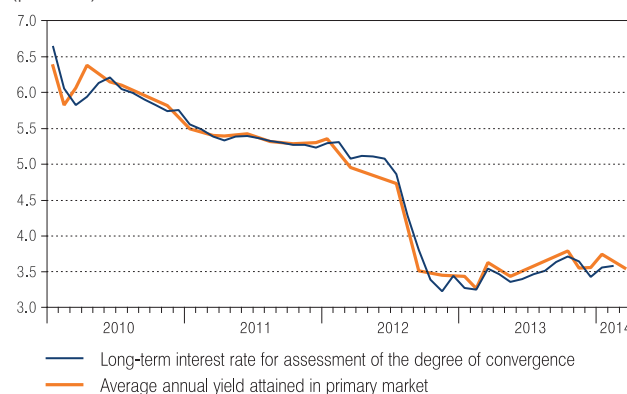
(frequency – number of banks)



Source: BNB.

Interest Rates on Ten-Year-and-Six-Month Government Securities on the Primary and Secondary Market

(per cent)



Source: BNB.

review period (BGN 0.4 million). The gross issue of government debt in the last three months of 2013 was insufficient to finance the consolidated budget. Therefore, the government used BGN 248 million from its funds deposited with the BNB.

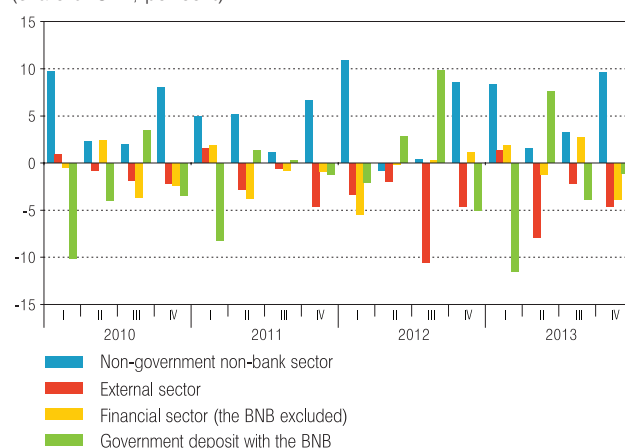
Government's revenue and expenditure policy and consolidated state budget financing operations in the fourth quarter of 2013 led to a net reallocation of liquid funds to the non-government non-bank sector in the amount of approximately BGN 2 billion.

Based on data available by end-March 2014 it may be concluded that in the first quarter of 2014 the financial sector (the BNB excluded) was the main source of liquid funds for financing of the consolidated budget. As a result of the active issuing policy of the government on the domestic market, the issued securities in the review period reached approximately BGN 1450 million, of which BGN 1200 million with a maturity shorter than one year. In net terms, funds provided by the domestic market amounted to approximately BNB 970 million. The bulk of this amount is expected to be used for budget deficit financing in the first quarter of the year. The negative budget balance in turn will contribute to the net increase of liquid funds in the non-government non-bank sector.

Budget financing operations in the second and third quarters of 2014 are expected to continue playing an important role in reallocation of liquidity across economic sectors. On the one hand, sizeable payments on maturing treasury bonds and bills (approximately BGN 1400 million) in the review period will be a factor for increasing the liquidity in the financial sector. On the other hand, resident financial institutions are expected to use the released financial resources for purchase of a portion of government securities issue in international capital markets planned by the government. The issue is projected to amount to BGN 3000 million. The government securities issue in international capital markets will result in an inflow of liquidity in the central bank in the form of an increase in the government deposit with the BNB.

Consolidated Budget Effect on Other Sectors' Liquidity (Quarterly)

(share of GDP, per cent)



Sources: MF, BNB calculations.

3. Economic Activity

In the fourth quarter of 2013 economic activity measured by the quarterly GDP growth accelerated. Net exports and investment in fixed capital contributed positively to this, while the contribution of private consumption was negative.

Short-term economic indicators since early 2014 point to a better economic situation in Bulgaria reflected in improved expectations of economic agents concerning future economic activity. The continuous recovery observed in our major trading partners and the improvement of the external environment are expected to have a positive effect on the growth of exports of goods and services and on overall economic activity in the first quarter of 2014, while the improved expectations of economic agents are likely to contribute to the gradual recovery in domestic demand from the second quarter of 2014.

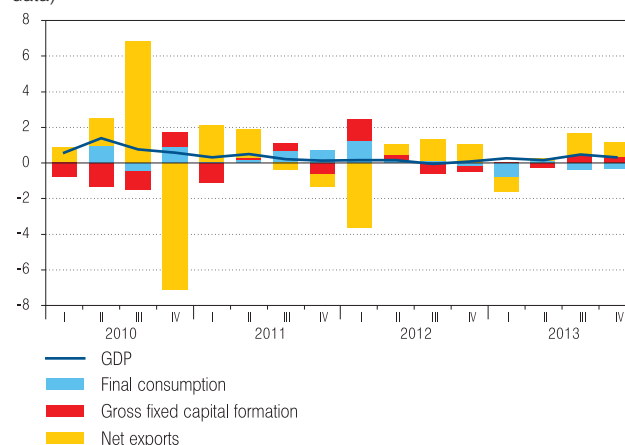
In 2013 economic recovery in Bulgaria's major trading partners of the euro area and the other EU Member States was observed, affecting favourably Bulgarian economic activity. Net exports had the main contribution to GDP growth in 2013, with exports of goods and services growing faster in real terms than imports of goods and services. Against the background of high unemployment, slightly declining employment and no significant improvement in overall consumer confidence, households retained their high savings rate, while household consumption fell. As a result of the weak domestic demand and the lack of more favourable expectations about future economic activity, firms retained their conservative policies with respect to investment spending and gross fixed capital formation posted a decline in 2013. Government consumption grew in real terms mainly due to the rise in operating expenditure driven by the higher EU funds absorption and, to a lesser extent, to the increased wages in the public sector.

In the fourth quarter of 2013 real GDP growth rate went up 0.3 per cent³² on the previous quarter, net exports contributing most to this. In the fourth quarter both exports and imports of goods and services decreased on a quarterly basis, but the improvement in net exports was due to the more pronounced slowdown in imports compared with exports. Domestic

³² 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.

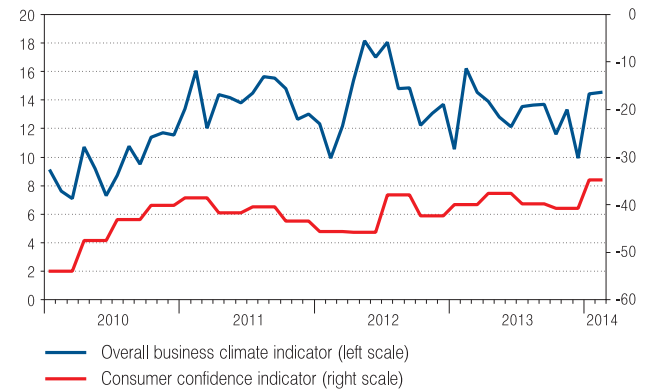
demand remained close to its previous quarter's level, as private consumption decline was offset by the increased fixed capital investment. In the fourth quarter of 2013 the build-up of inventories also contributed positively to this growth.

Short-term economic indicators reported a slight improvement in early 2014. Households' confidence indicator improved due to the higher expectations of future economic situation and households' financial position, creating a prerequisite for private consumption recovery. Households' expectations about the future level of unemployment reported a decline, which was also a driving factor behind the increased confidence.

The overall business climate indicator tracking entrepreneurs' sentiment in industry, construction, retail trade and other services sub-sectors went up in the first quarter of 2014 largely reflecting the more favourable assessment of the expected business situation. Improved firms' expectations of the number of staff were seen as positive signal of accelerating employment growth. Higher leading economic indicators in Bulgaria's major trading partners support our expectations of rising external demand for exports of Bulgarian goods and services.

Over the second and third quarters of 2014 economic activity in Bulgaria is expected to increase slightly on a quarterly basis. Domestic demand will start to recover gradually, contributing positively to the growth as a result of the slight increase in private consumption and fixed capital investments. In the context of enhanced domestic demand imports of goods and services are likely to rise at rate similar to that of exports of goods and services, and net exports to have a slightly negative contribution to the growth. Government consumption is expected to grow

Business Climate and Consumer Confidence



Sources: NSI, BNB calculations.

GDP Growth by Component of Final Use

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

	2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Consumption incl.	0.1	0.2	0.9	0.8	1.5	0.2	0.1	-0.2	-0.9	0.1	-0.5	-0.4
Household consumption	0.2	0.2	1.2	1.0	1.6	0.5	0.0	-0.4	-0.8	-0.6	-0.7	-0.6
Final government consumption expenditure	0.0	2.7	-2.2	0.7	-1.8	0.1	1.1	0.7	1.1	0.1	0.0	-0.3
Collective consumption	3.0	-1.1	-1.1	1.1	-1.3	1.2	0.3	1.6	1.0	0.4	0.5	-0.6
Gross fixed capital formation	-4.8	0.5	1.8	-2.7	5.7	1.5	-2.5	-1.3	0.2	-1.1	1.8	1.5
Exports of goods and non-factor services	5.5	1.6	3.5	0.3	-8.2	8.5	-1.5	0.4	3.5	2.1	4.3	-0.5
Imports of goods and non-factor services	1.9	-0.8	3.9	1.3	-2.6	6.5	-2.9	-1.0	4.3	1.7	2.3	-1.5
Real GDP growth	0.3	0.5	0.2	0.1	0.2	0.2	-0.1	0.1	0.3	0.2	0.5	0.3

Source: NSI.

more significantly on a chain basis in the first two quarters of 2014 and to stabilise over the third quarter of the year.

In line with the described quarter-on-quarter dynamics, annual real GDP growth over the first three quarters of 2014 is projected to remain at the level observed in the fourth quarter of 2013. Net exports and, to a lesser extent, the moderate private consumption decline and the gradual recovery of economic activity in Bulgaria will contribute most to annual economic activity growth.

Despite the improved economic situation in Bulgaria's major trade partners, external environment continues to pose risks to the domestic economic growth. A slower than expected recovery of euro area and EU countries would lead to an economic activity moderation in Bulgaria. Another source of uncertainty to our projections relates to deflationary processes observed in Bulgaria since the third quarter of 2013. In case of a prolonged period of declines in the overall price level, households and firms are likely to generate expectations for retention of this trend in the future, which could dampen their consumption and investment due to postponement of expenditure.

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 in the fourth quarter of 2013.

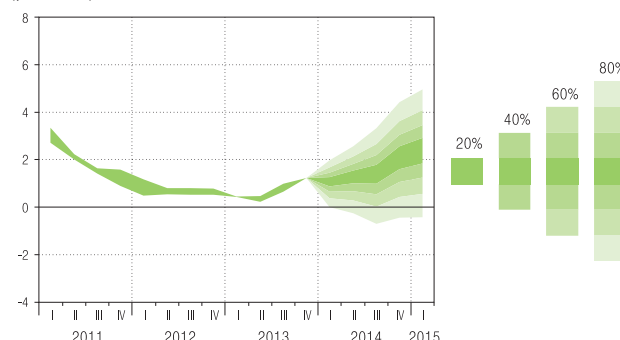
According to seasonally adjusted national account data, in the fourth quarter of 2013 household consumption continued to decrease on a quarterly and annual basis (after falling in the first three quarters of 2013). In the fourth quarter of 2013, as in the remainder of the year, consumption in the non-food and communications groups grew, while that of food and purchased non-production services³³ marked a decline.

Despite the decline in real consumption in 2013, indicators on the basis of which change in consumer demand may be assessed suggest rather positive signals of gradual recovery in consumption. An increase in both retail trade

³³ Purchased non-production services include services other than catering services, water supply, heat energy and electricity, transport and communications.

Fan Chart of the Expected Annual Rate of Change of GDP

(per cent)

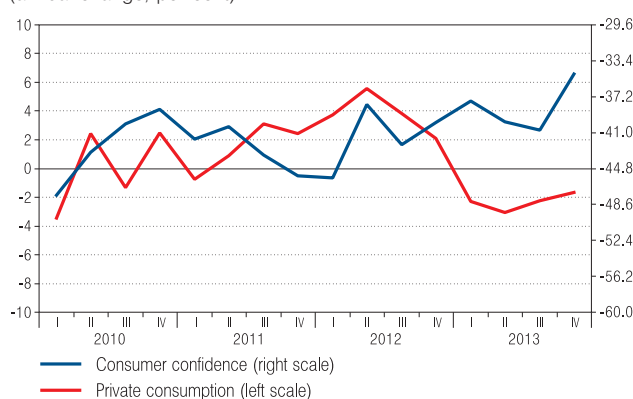


Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The reporting period includes revised GDP growth estimates. The middle band of the chart, depicted in the darkest colour, includes the central projection and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

Private Consumption and Consumer Confidence

(annual change, per cent)



Sources: NSI Consumer Survey and BNB calculations.

turnover and consumer confidence indicators was observed. Retail turnover has been growing since early 2013, a trend observed also in January 2014. Household appliances, furniture and computer and communication equipment contributed most to this, which is indicative of the gradual recovery in consumption.

In January 2014 the consumer confidence indicator reported in the NSI consumer survey³⁴ rose, reflecting the improvement in all its sub-components. Expectations of the economic situation and financial state of households, as well as unemployment expectations also improved.

The continuous increase in income from remuneration, the main source of income for the households, will probably create conditions for the moderate recovery in consumption in the second and third quarters of 2014. According to seasonally adjusted national account data, in the fourth quarter of 2013 the wage bill and the average wage accelerated slightly on a quarterly basis.³⁵ On an annual basis, the growth of non-seasonally adjusted data on wage bill and average wage *per* employee in nominal terms in 2013 was less significant than in 2012. In the fourth quarter higher rates of wage growth were observed in the low-pay construction sector, as well as in public services, while in some services sub-sectors, such as trade, transport, hotels and restaurants, creation and dissemination of information and author products, finance and insurance activity, gross wages fell. Uneven income dynamics by sector will probably limit consumption growth.

In the context of comparatively high unemployment, low and uneven recovery of employment and income by sector and related uncertainty, the share of savings in household disposable income remained high.³⁶ The January 2014 consumer survey showed that the share of house-

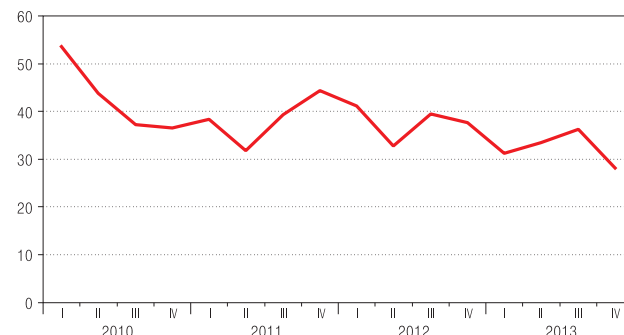
³⁴ Final results of the Consumer Survey represent balances of opinions calculated as a difference between the relative shares of positive and negative opinions on raised issues. The composite consumer confidence indicator is calculated as the arithmetic mean of expectation balances in the following twelve 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).

³⁵ Quarter-on-quarter rates of change in seasonally adjusted data indicate recent developments in indicators that are not subject to base effects in the corresponding period of prior year.

³⁶ Disposable income (based on the household budget survey) is obtained by subtracting tax expenditure, social contributions and transfers from the total income.

Unemployment Expectations in the Following 12 Months

(balance of opinions; per cent)



Source: NSI Consumer Survey.

Expectations about the Financial Position and Economic Situation in the Following 12 Months

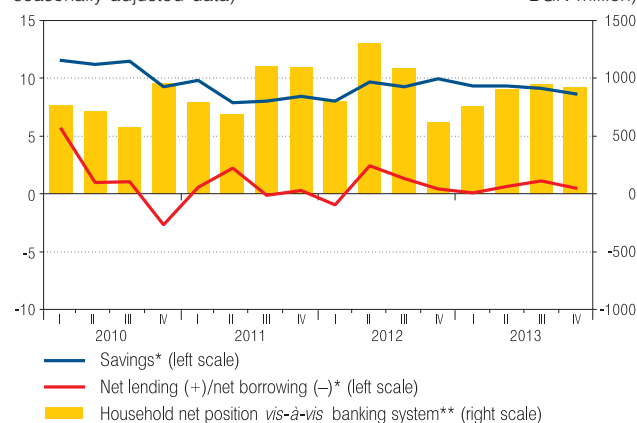
(balance of opinions; per cent)



Source: NSI Consumer Survey.

Household Propensity to Save

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



* NSI data.

** BNB data.

Sources: NSI Household Budget Survey, BNB.

holds which intend to increase savings in the following 12 months remained relatively high. Households' net assets measured by their net position in the banking system increased (according to the BNB monetary statistics). The share of savings in household disposable income remained also high (according to NSI household budget survey data). This signals a sustained savings rate in the second and third quarters of 2014, which could be seen as a sign of a slow recovery of consumption over the projection horizon.

The Labour Force Survey indicators, by which household labour supply may be assessed, suggest that labour supply was weaker in the second half of 2013. Even though, economic activity rate rose in the fourth quarter, it was reflecting the decrease in the number of working-age persons. On the other hand, the decline observed in the number of discouraged persons was not accompanied by a rise in the labour force. The changes of these indicators suggest that in the period of still weak labour demand by corporations the future increase in labour supply is likely to be limited.

The Labour Force Survey shows that in the fourth quarter of 2013 the unemployment level rose slightly from comparatively constant levels of the first three quarters of the year and reached 13 per cent. Based on the Employment Agency data, the seasonally adjusted unemployment rate³⁷ also rose slightly in the fourth quarter of 2013, but in early 2014 it fell to reach 11.4 per cent by February (12.2 per cent according to non-seasonally adjusted data). According to the Labour Force Survey data, the number of long-term unemployed (unemployed persons more than a year) continued to increase slightly, reaching 7.8 per cent of labour force in the fourth quarter in the context of a relatively high unemployment rate and low labour demand by corporations.

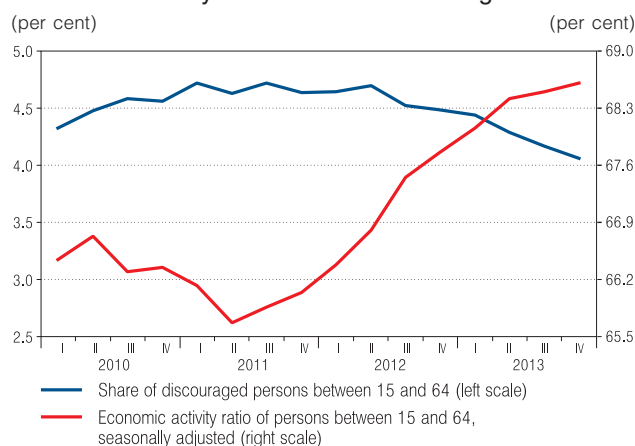
According to the business trend survey, labour demand³⁸ will remain close to its current levels, with a tendency of slight improvement in most sectors. Firms' sentiment concerning personnel employment³⁹ expectations in industry and

³⁷ The Employment Agency uses a constant rate of labour force.

³⁸ 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.

³⁹ NSI, Survey of Business Developments in Industry, Construction, Trade and Services; last survey as of March 2014.

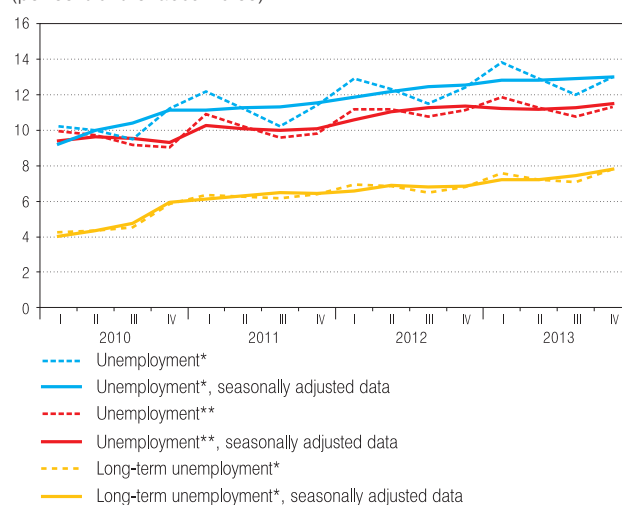
Economic Activity and Share of Discouraged Persons



Sources: NSI Labour Force Survey, BNB calculations.

Unemployment

(per cent of the labour force)



* NSI data.

** Employment Agency data.

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

Employment and Income Dynamics

	2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Per cent on the previous quarter (seasonally adjusted data)												
Employed	-0.2	-0.5	-0.9	-0.5	-0.7	-1.1	0.1	-0.3	0.0	0.4	-0.2	-0.2
Nominal wage <i>per employee</i> *	1.6	3.7	2.0	0.5	2.4	2.7	2.2	1.9	0.9	0.8	0.5	2.0
Real wage <i>per employee</i> **	0.5	2.7	1.6	-0.1	2.1	1.9	1.2	1.5	1.1	1.0	1.0	1.7
Wage bill, nominal terms	1.2	2.0	1.4	1.6	1.2	1.8	2.0	1.0	1.2	0.8	0.6	0.9
Wage bill, real terms**	-1.2	2.0	0.6	0.2	1.7	0.9	1.1	0.7	1.4	0.9	0.5	1.4
Per cent on the corresponding period of the previous year (not seasonally adjusted data)												
Employed	-1.6	-2.3	-2.3	-2.6	-2.3	-3.5	-1.9	-2.3	-1.7	0.7	-0.1	-0.7
Nominal wage <i>per employee</i> *	0.5	7.1	8.5	8.8	7.1	7.9	8.5	8.3	9.6	5.9	3.6	4.0
Real wage <i>per employee</i> **	-3.8	3.6	5.2	6.1	5.2	6.0	5.4	5.3	7.3	4.8	4.3	5.1
Wage bill, nominal terms	-0.8	5.6	7.2	6.3	4.9	5.9	7.7	5.5	7.1	5.4	2.8	3.1
Wage bill, real terms**	-5.0	2.1	4.0	3.6	3.0	4.0	4.5	2.6	4.8	4.3	3.5	4.1

* The wage is calculated on the basis of NSI (SNA) data by subtracting employers' social contributions from the compensation of employees and the difference is divided by the number of employees.

** 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)

	2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Retail trade turnover, excluding cars and motorcycles incl.	0.4	-0.4	-0.3	0.7	5.8	-1.4	0.0	-0.6	0.8	1.8	1.9	1.4
Foods, drinks and tobacco	0.6	0.3	1.0	1.2	1.6	0.7	0.4	0.6	-3.1	2.9	7.1	-4.3
Textile, clothing, footwear and leather	1.9	-1.2	-2.1	-0.2	10.0	-3.9	1.9	1.9	6.7	4.1	2.7	-0.4
Household goods and home appliances	-0.5	-2.1	-0.1	1.2	9.2	-0.4	-2.5	-1.1	0.4	1.8	2.8	4.0
Computers and communication equipment, etc.	-3.8	-0.1	-1.5	0.6	-1.8	-0.3	-0.5	-7.7	2.2	2.7	1.8	5.5
Pharmaceutical and medical goods, cosmetics and toiletries	-0.3	3.3	1.8	5.6	3.8	-0.2	0.5	-4.2	-1.4	3.3	3.4	2.7
Unspecialised shops with different kinds of goods	2.0	0.5	-1.1	0.0	6.2	-2.3	1.1	2.6	2.9	7.0	-2.5	0.5
Automobile fuels and lubricants	-1.7	-2.1	-1.4	1.1	4.4	0.2	2.5	1.0	-0.9	3.4	-1.3	-2.4

Source: NSI Domestic Trade Survey.

services improved by March 2014, while it slightly deteriorated in construction. Weak labour demand is expected to keep overall employment close to its current levels, leading to a limited increase in labour supply in the second and third quarters of 2014.

The uncertain economic environment, comparatively high unemployment and still weak labour demand are expected to continue affecting household behaviour over the following quarters. Nevertheless, some favourable developments in the labour market associated with stabilisation of overall employment and its slight growth in some sectors are projected to create conditions for a gradual recovery in household consumption. Risks to the projection relate mainly to factors affecting consumer confidence, such as employment and income developments. These developments largely depend on firms' propensity to hire personnel and enhance investment activity.

Impact of Fiscal Policy on the Economy

In 2013 the budget position depended to a great extent on the weak domestic demand and low price dynamics, limiting tax revenue growth, on the one hand, and the increased social expenditure, on the other hand.

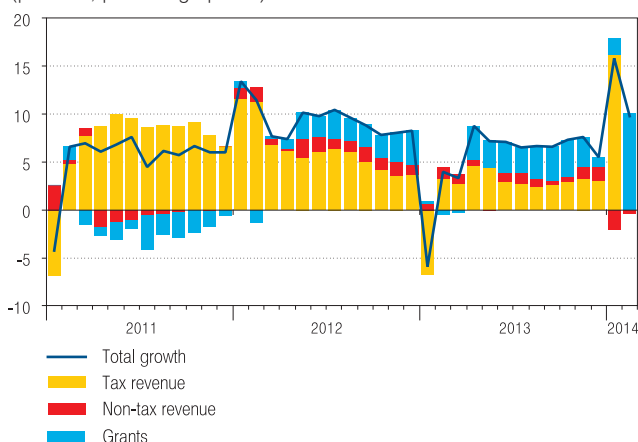
By end-2013 a moderation in total budget revenue under the consolidated fiscal programme (CFP) was observed, but in the beginning of 2014 the growth rate accelerated significantly mainly due to one-off factors, including base effects. These factors comprised mostly changes to the terms of accrual and payment of direct taxes and social insurance contributions in 2013, contributing to the negative growth of revenues from these taxes in early 2013. Base effects were observed in the VAT receipts related to the significant amount of VAT refunds in January 2013, which pushed the base down, while in February 2013 VAT receipts increased due to non-refunded VAT and old arrears of BGN 65 million, thereby raising the base. Amendments to the 2014 State Budget Law adopted since the beginning of the year had a comparatively weaker positive effect on tax and social insurance revenue dynamics in the first two months of 2014.⁴⁰ After the effect of one-off factors expires in early 2014, tax insurance revenue dynamics will be driven mainly by the expectations of gradual recovery in domestic demand and sustained negative inflation of consumer prices.

By end-February 2014 the annual growth of social expenditure came to 10.7 per cent against 7.3 per cent increase in total budget expenditure. Given their high share, social expenses were the largest contributors to the growth of total budget expenditure over the first two months of 2014. This trend has been observed since the beginning of the second quarter of 2013, when pensions have been indexed by 9.3 per cent on average. As a result, the role of social benefits in supporting disposable income of pensioners and socially vulnerable households strengthened.

Government capital expenditure accelerated in late 2013 and in the first two months of 2014 reflecting the increase in expenses on EU programmes. These data point to an acceleration of investment growth in the general government

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

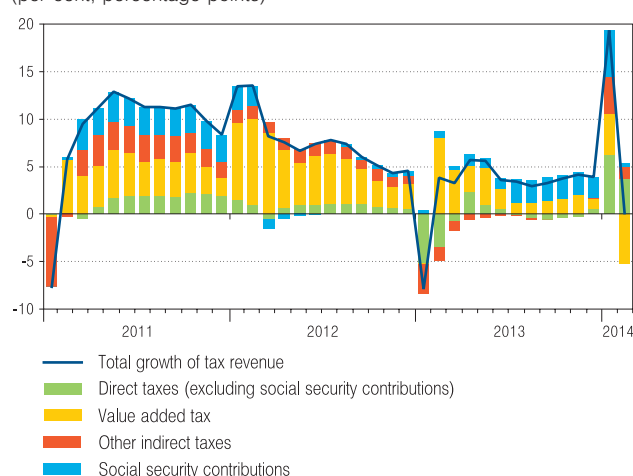
(per cent, percentage points)



Sources: MF, BNB calculations.

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

(per cent, percentage points)



Sources: MF, BNB calculations.

⁴⁰ For changes in tax insurance policy adopted by the 2014 State Budget Law, see Economic Review, 4/2013.

sector and an increase in its positive contribution to the change in gross fixed capital formation overall in the economy.

As a result of social and investment expenditure dynamics, government fiscal policy had a more pronounced effect on household disposable income and total investment in the last quarter of 2013. Government consumption, which mainly comprises compensation of employees in the general government sector and operating expenditure, made a slightly negative contribution to GDP growth between October and December 2013. The annual growth rate of expenses on compensation *per* employee and operating expenditure moderated in the last quarter of 2013. The downward trend was sustained between January and February 2014, which should result in a close to nil contribution of government consumption to GDP growth in the first quarter of the year.

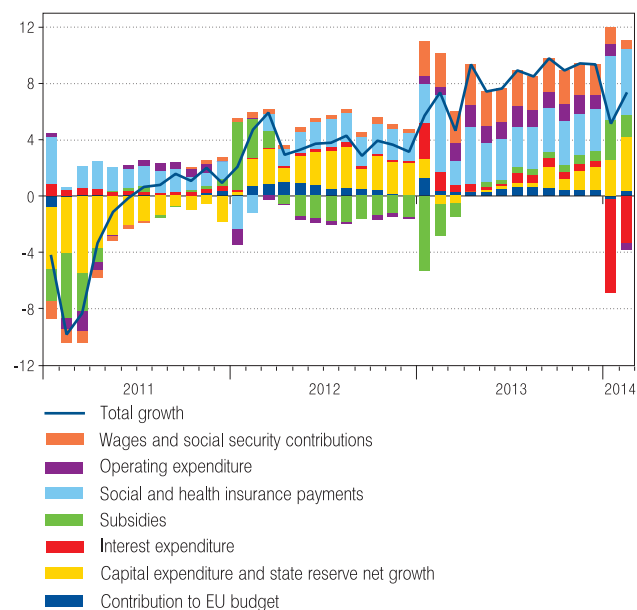
Overall, government consumption in 2013 had a low positive contribution (0.4 percentage points) to real GDP growth. The change in the model of payment to civil servants effective as of mid-2012, the 20 per cent rise of social security contributions in special bodies since early 2013 and the higher operating expenditure under EU programmes compared with 2012 contributed to the relatively high growth rate of government consumption in nominal terms (9.9 per cent), while real government consumption grew by 2.5 per cent in 2013.

According to our assessment, the increase in total budget revenue in the second and third quarters of 2014 will be limited due to the expiration of the positive effect of one-off factors affecting tax revenue dynamics in the first months of 2014, the expected slow recovery in domestic demand and labour market coupled with the negative consumer price inflation. This will adversely affect the contribution of tax revenue to total revenue and correspondingly funding possibilities of priority expenditure policy over the review period.

The 2014 State Budget Law parameters and expenditure developments observed in January and February show that government fiscal policy will affect the economic activity through supporting household disposable income from social transfers. Additional positive effects on

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

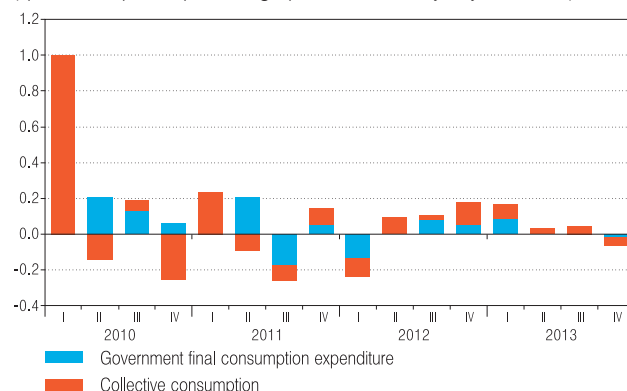
(per cent, percentage points)



Sources: MF, BNB calculations.

Contribution of Government Consumption to Real GDP Growth

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



Sources: NSI, BNB calculations.

low-income household consumption may be expected in line with the pension supplements approved by the government on 12 March 2014, which will be paid in April, and with the one-off payments to the eligible for energy assistance. Positive effects of government social policy on disposable income and possibly on private consumption will most likely have a short-run effect and to a large extent will depend on limited household liquidity and their propensity to save.

The 2014 State Budget Law parameters and increases in wages of special bodies' employees adopted in February 2014 provide for positive, though limited, contribution of government consumption to GDP growth over the second and third quarters of 2014.

Revenue, Expenditure and Budget Balance on Consolidated Fiscal Programme for 2013–2014

Consolidated Fiscal Programme	2013												2014	
	I quarter		II quarter		III quarter		IV quarter		Total		January – February ¹		January – February ¹	
	BGN million	per cent ²	BGN million	per cent ²	BGN million	per cent ²	BGN million	per cent ²	BGN million	per cent ²	BGN million	per cent ²	BGN million	per cent ²
Total revenue and grants	6157.8	3.4	8008.0	10.2	7141.6	5.6	7669.9	2.5	28977.3	5.5	3827.3	4.0	4202.8	9.8
Tax revenue	5118.3	3.3	5767.0	2.8	5637.6	3.8	5847.4	5.7	22370.3	3.9	3247.9	3.9	3251.4	0.1
Corporate tax	464.2	-10.9	450.1	1.3	192.5	-27.6	446.3	80.8	1553.1	5.1	37.8	-75.9	52.7	39.5
Personal income tax	512.1	-1.3	595.9	-6.6	628.0	15.2	612.5	2.8	2348.5	2.2	359.7	6.6	464.7	29.2
Value added tax	1803.9	16.0	1805.3	-3.2	1871.9	2.2	1885.5	-0.8	7366.6	3.0	1331.1	23.2	1160.9	-12.8
Excise	805.6	-5.6	1000.7	2.5	1184.8	0.2	1064.6	2.7	4055.7	0.2	551.2	-7.5	588.1	6.7
Customs duties	31.9	14.3	34.4	18.2	44.1	36.1	35.8	26.5	146.2	24.2	20.4	11.5	23.3	14.1
Social and health insurance contributions	1318.8	2.3	1586.9	14.0	1551.2	10.9	1603.3	5.7	6060.2	8.3	867.2	2.8	875.9	1.0
Other taxes	181.8	-4.0	293.8	10.3	165.2	-6.7	199.4	-3.7	840.2	0.0	80.5	-15.1	85.7	6.4
Non-tax revenue	886.4	7.0	1305.6	11.6	727.5	-13.6	1031.2	40.7	3950.7	10.6	563.5	8.0	548.9	-2.6
Grants	153.1	-11.5	935.4	91.7	776.5	59.6	791.4	-35.1	2656.4	12.2	15.9	-50.5	402.5	2439.6
Total expenditure (incl. the contribution to EU budget)	6955.5	4.6	7216.5	10.8	7496.9	14.1	8758.6	8.2	30427.5	9.3	4559.3	7.4	4891.0	7.3
Wages and social security contributions	1346.6	12.7	1446.1	13.7	1424.4	11.8	1605.7	9.5	5822.8	11.8	886.9	13.0	914.4	3.1
Operating expenditure	1078.3	7.3	1113.2	5.2	1025.6	6.3	1480.0	1.9	4697.1	4.8	644.1	3.4	618.4	-4.0
Interest	318.8	10.3	61.0	-13.6	275.1	72.9	33.9	-37.2	688.8	20.3	313.1	21.7	165.8	-47.0
Social security, assistance and social care	3047.5	4.2	3239.4	9.8	3202.2	8.5	3257.8	8.0	12746.9	7.6	2011.2	13.3	2226.5	10.7
Subsidies	311.1	-15.1	339.7	39.8	278.7	15.7	501.8	31.1	1431.3	16.1	143.2	-39.9	214.5	49.8
Capital expenditure and state reserve growth	525.4	-6.3	811.4	6.7	1077.3	31.6	1692.4	9.8	4106.5	11.6	303.2	-7.0	477.5	57.5
Contribution to EU budget	327.8	6.8	205.6	28.7	213.7	31.7	187.0	3.6	934.1	15.4	257.6	6.6	274.1	6.4
	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³	BGN million	difference in BGN million ³
Budget balance on cash basis	-797.7	-106.7	791.5	38.6	-355.4	-546.4	-1088.7	-477.0	-1450.3	-1091.5	-732.0	-167.0	-688.2	43.8

Note: Difference between sum by components and total sum is due to rounding.

¹ Based on preliminary monthly data on CFP implementation for 2013 and 2014.

² Annual rate of change on the same period of previous year.

³ Budget balance change in BGN million on the same period of previous year.

Sources: MF, BNB calculations.

Behaviour of Firms and Competitiveness

Seasonally adjusted national account data show that value added in the economy rose by 0.6 per cent in the fourth quarter of 2013 compared with the previous quarter. Industry contributed most to economic activity growth; value added growth in the sector reflecting export growth and investment activity improvements over the second half of 2013. This is evidenced by increasing receipts from sales on the external market and domestic sales of investment goods⁴¹ observed in the fourth quarter of 2013. On the other hand, the fall in total industrial sales made on the domestic market in the fourth quarter of 2013 reflected sluggish domestic demand. Lower industrial firms' expectations about the production assured with orders, which were reported in the first quarter of 2014, also support this fact. By January 2014 the turnover in industry went down due to the one-off drop in domestic sales revenue, on the one hand, and as a result of the continuous fall in industrial producer prices, on the other hand. The production in this sector rose in January 2014 on the back of improved industrial firms' expectations about the future economic activity; this resulted in growing current inventories given the lower revenue from sales. According to NSI survey observations for the first quarter of 2014, firms' managers in industrial sector also reported accumulated inventories.

The level of the utilised production capacity in the industrial sector reported in the beginning of the first quarter of 2014 went up slightly in line with January's higher industrial output growth (up 1.4 per cent) compared with that in December 2013. Nevertheless, the rate of capacity utilisation did not significantly exceed that in recent quarters, meaning that there is no need for firms to expand production capacity in the context of still weak demand.

Services sub-sectors, such as creation and dissemination of information and author products, telecommunications and public services, contributed most to the value added growth for the economy in the fourth quarter of 2013.

⁴¹ The Main Industrial Groupings classification was used covering the following sectors: manufacture of intermediate consumption goods, energy product production and water related activities, investment product manufacturing and consumer goods production. Energy products are viewed, excluding production and distribution of electricity, heating and gas, and water supply.

Value Added Growth and Contribution by Sector

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

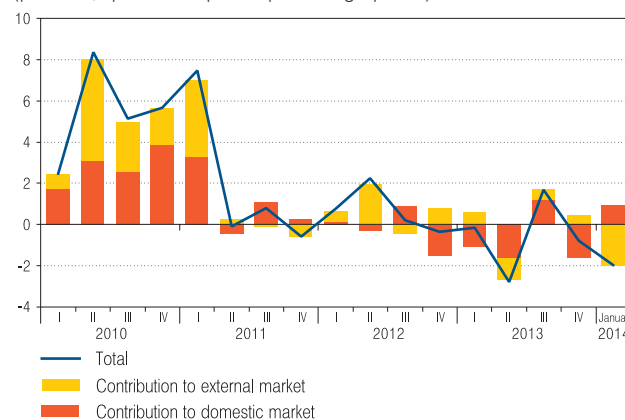


Note: Non-additive data on contributions due to direct seasonal adjustment of value added and its components.

Sources: NSI, BNB calculations.

Industry Turnover Dynamics

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

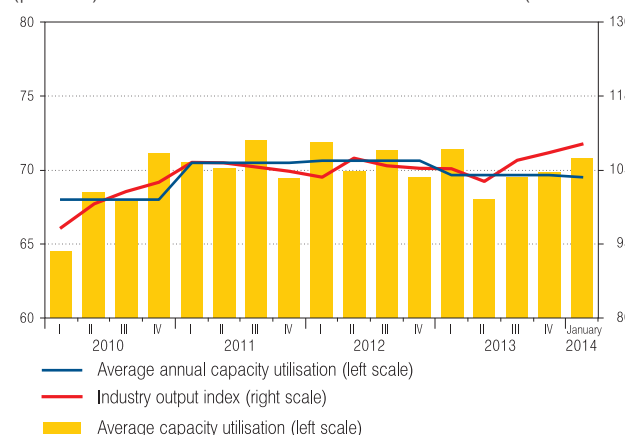


Sources: NSI, BNB calculations.

Industry Output Index and Production Capacity Utilisation in Industry

(per cent)

(2005 = 100)



Sources: NSI – Industry Business Survey, BNB calculations.

According to companies' survey observations, over the fourth quarter of 2013 and the first quarter of 2014 managers' expectations about future demand for services and hiring staff in the following three month in the services sub-sector improved, which will probably maintain economic activity growth in the sector.

Construction had the main negative contribution to growth in gross value added in economy over the fourth quarter of 2013. Decreases in the number of building permits and house prices over the fourth quarter of 2013 give grounds for concluding that demand on the housing market continued to contract. However, January 2014 data on construction index point to a significant increase in civil and engineering construction which is likely to have a positive effect on the economic activity in this sector.

Managers' expectations about future economic activity in the fourth quarter of 2013 retained their level of the previous two quarters. They improved markedly in the first quarter of 2014 in all economic sectors. Firms' activity was less impeded by the uncertain economic environment in construction and industry.

According to national account data, in the third and fourth quarters of 2013 investment in fixed capital went up both in real and nominal terms on a quarter-on-quarter basis. The seasonally adjusted data point also to an increase in expenditure on acquisition of tangible fixed assets in nominal terms throughout 2013, with industry and trade, cars and motorcycles repair, transport, storage and mail services, hotels and restaurants along with general government, education, healthcare and social services contributing most to this. Higher investment activity in industry is possibly related to the improvement of external environment and increased exports of goods, which are expected to continue in 2014. However, taking into account the available spare production capacity in industry, investments were more focused on improving the production efficiency in order to preserve and improve competitive positions on international markets. The improved expectations of overall production and economic activity registered in the first quarter of 2014 indicate the continuous recovery of investment activity that is expected to be more pronounced in the second and third quarters of 2014.

The operating surplus also increased in the last quarter of 2013 after four quarter-on-quarter

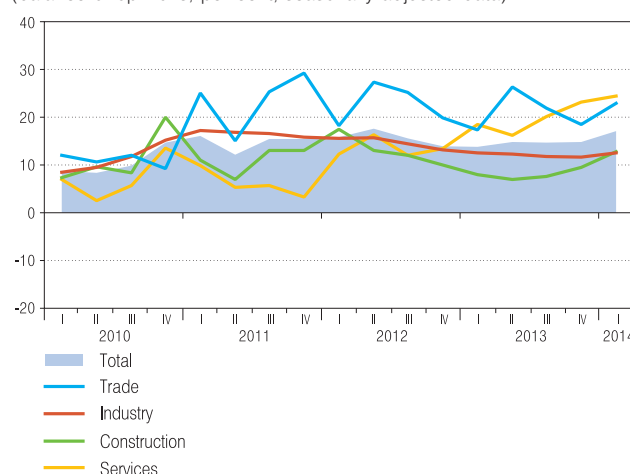
Construction Output Dynamics and New Buildings Permits Issued



Sources: NSI, BNB calculations.

Expectations about Future Economic Activity

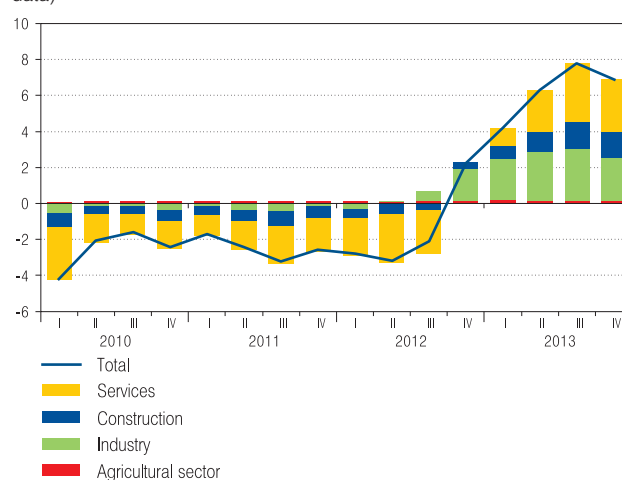
(balance of opinions, per cent; seasonally adjusted data)



Sources: NSI, BNB calculations.

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.

declines. Export-oriented industry that reported higher economic activity had the major contribution along with some services sectors as culture, sport and entertainment, other activity, and finance and insurance activities.

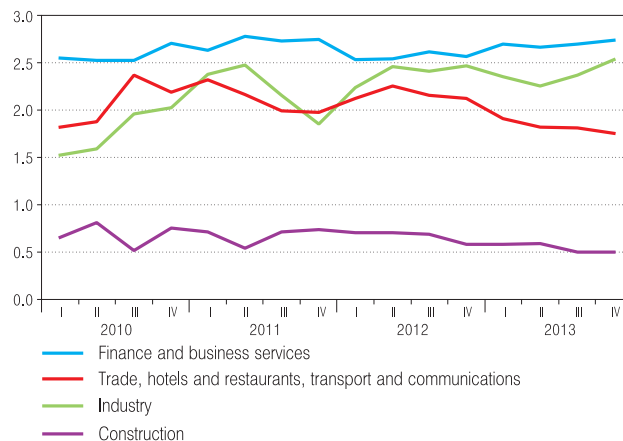
Bank lending to non-financial corporations grew in the fourth quarter of 2013 on a quarter-on-quarter basis. This was largely due to the higher investment activity in industry despite the reported increase in operating surplus, which required additional financing.

In the fourth quarter of 2014 funding from sources other than operating surplus went up in industry, while in services it went down. FDI inflow remained positive in industry, where a rise in external liabilities was reported. The reduction in funding from sources other than operating surplus contracted in services sector (excluding financial intermediation) mainly due to the repayment of external obligations other than intercompany loans in transport, storage and communications and trade, repair of motor vehicles and motorcycles, personal belongings and household goods. Higher investment activity in industry over the second half of 2013 in the context of declines in operating surplus earlier this year could be the reason behind the stronger demand for external financing. Alongside the recovery of domestic investment activity in the third and fourth quarters of 2014, demand for internal and external financing is expected to rise.

Despite the revival of economic activity in Bulgaria, firms remained cautious in hiring staff. Seasonally adjusted national account data and Labour Force Survey show that total employment in the fourth quarter of 2013 remained close to previous quarters' levels, falling slightly by 0.2 per cent on a quarterly basis. A decline in employment was observed over the fourth quarter in the sectors with relatively high share of total employment, such as agriculture, forestry and fishing, industrial sub-sectors and trade, transport, hotels and restaurants, while employment in creation and dissemination of information and author products, telecommunications and in public services rose slightly. According to the Labour Force Survey data, the employment breakdown by education points to an ongoing increase in the number of persons with higher education, and a decrease in persons with secondary education. By age group, employment of persons between the ages of 15 and 34 continued falling, while that of persons

Gross Operating Surplus at Current Prices

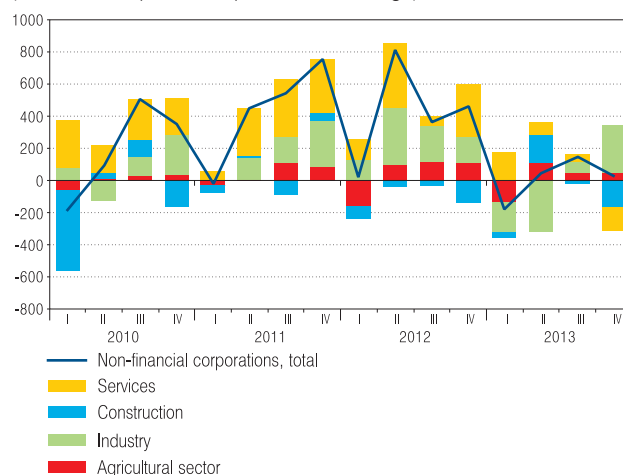
(billion BGN, seasonally adjusted data)



Sources: NSI, BNB calculations.

Bank Loans to Non-financial Corporations

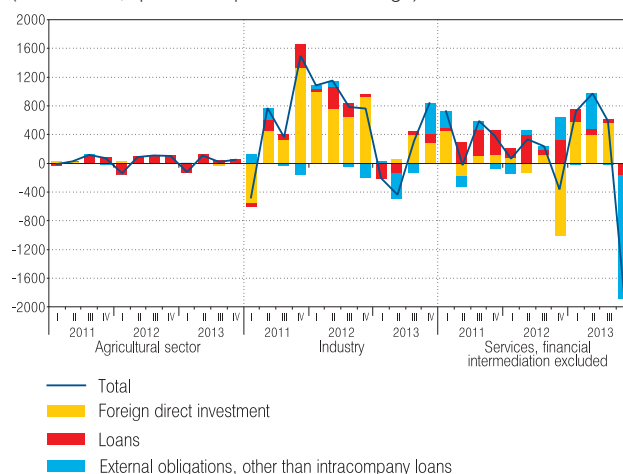
(BGN million, quarter-on-quarter stock change)



Source: BNB.

Financing Sources*

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



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

Source: BNB.

above 35 years rose. These dynamics point to a continued demand for more skilled and experienced staff, which is probably more productive, and therefore higher paid.

Further improvement in corporations' expectations about the number of personnel suggest that employment will gradually recover in line with the enhanced economic activity and labour demand by firms.

Labour productivity continued to grow in the fourth quarter of 2013 on a quarterly basis, reflecting the slight decrease in employment and concurrently, the increase in gross value added in economy. Industry and trade, cars and motor-cycles repair, transport, storage and mail services, hotels and restaurants contributed most. In export-oriented industry, employment contraction and higher labour productivity were probably driven by a long-term trend toward transition to lower labour utilisation production. This improves firms' competitiveness in this sector on the international markets.

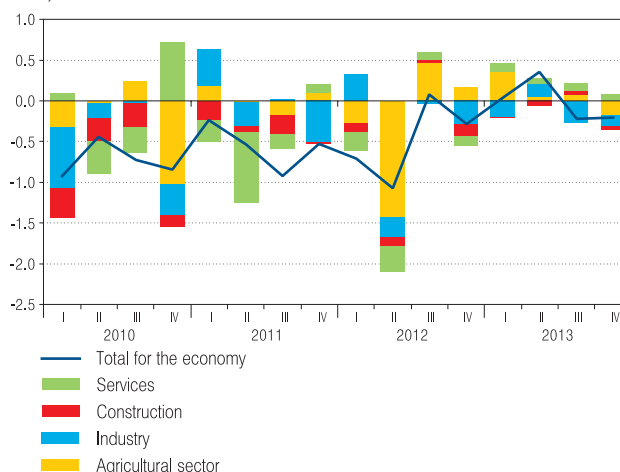
Though wage expenditure of corporations went up in the fourth quarter of 2013 on a quarterly basis, labour productivity recorded a more sizeable increase. As a result, unit labour costs decreased in nominal and real terms.

The revival of economic activity in the fourth quarter of 2013 observed in export-oriented industry had the main contribution to real GDP growth. The marginal decrease in employment had a slightly negative contribution, while that of total factor productivity was almost zero.

The continuous recovery of external conditions is expected to support industrial firms' activity and to contribute to Bulgaria's economic growth. Demand for services is projected to continue strengthening in line with the recovery in total domestic demand. Despite the improvement in global economic environment, it continued to be a source of uncertainty about economic activity in Bulgaria, but related risks are assessed as balanced. There is a risk stemming from the still uncertain domestic economic environment that firms may remain cautious in their behaviour with respect to investment and recruitment. Deflationary processes in Bulgaria may cause corporations to postpone their investment plans for the future.

Contribution to Changes in the Number of Employed by Economic Sector

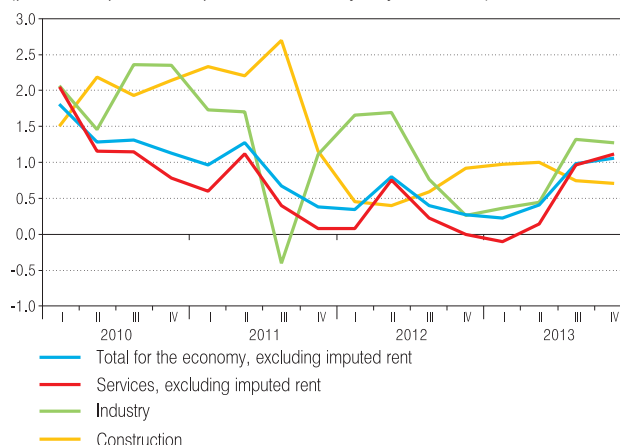
(per cent, quarter-on-quarter percentage points, seasonally adjusted data)



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

Labour Productivity Developments (Value Added per Employee)

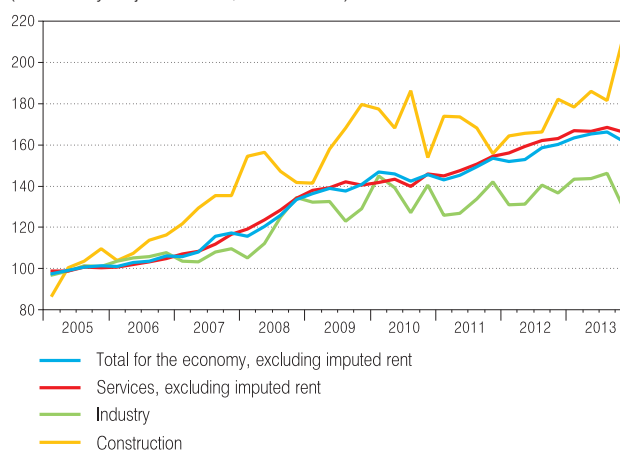
(per cent, quarter-on-quarter; seasonally adjusted data)



Sources: NSI, BNB calculations.

Nominal Unit Labour Costs

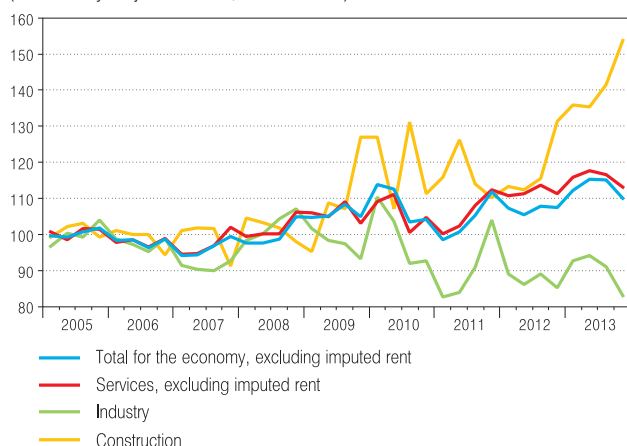
(seasonally adjusted data; 2005 = 100)



Sources: NSI, BNB calculations.

Real Unit Labour Costs

(seasonally adjusted data; 2005 = 100)



Sources: NSI, BNB calculations.

Contribution of Changes in Production Factors to GDP Growth

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



Sources: NSI, BNB calculations.

Gross Value Added Growth

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

	2011				2012				2013			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Agriculture and forestry, hunting and fishing	0.0	0.1	0.1	0.1	-0.5	-0.1	0.0	0.1	0.1	0.0	0.0	0.0
Mining and quarrying, manufacturing, production and distribution of electricity, heating and gaseous fuels; water supply; sewerage, waste management and remediation activities	0.7	0.3	-0.1	0.1	0.2	0.2	-0.2	0.3	-0.4	0.4	0.0	0.4
Construction	-0.2	-0.2	0.5	-0.2	0.0	0.0	-0.1	-0.1	0.1	0.0	0.0	-0.1
Trade, cars and motorcycles repair; transport, storage and mail services; hotels and restaurants	-0.6	-0.2	0.2	-0.4	0.3	0.3	0.1	0.2	-0.3	-0.1	0.0	0.0
Creation and dissemination of information and author products; telecommunications	0.2	-0.1	0.1	0.0	-0.1	0.0	0.0	0.0	-0.1	0.1	0.2	0.2
Finance and insurance activity	0.0	0.2	-0.1	0.2	-0.5	-0.3	0.3	0.0	0.3	0.3	-0.2	-0.1
Real estate activities	-0.2	0.1	0.1	0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Professional activities and scientific research; administrative and ancillary activities	0.6	-0.7	0.3	0.6	-0.5	0.0	0.1	-0.1	0.0	0.1	-0.1	0.0
General government; education; healthcare and social services	0.2	-0.1	0.2	-0.4	0.3	-0.1	-0.1	0.3	0.0	0.2	0.1	0.2
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	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross value added, total for the economy	0.4	0.6	-0.1	-0.1	0.0	-0.1	0.0	0.3	0.2	0.4	0.6	0.6

Source: NSI.

Exports and Imports of Goods

In the fourth quarter of 2013 exports and imports dynamics continued to be driven by the fall in the international prices of groups of goods of importance to Bulgaria's foreign trade turnover. In the fourth quarter nominal exports increased 5.1 per cent on an annual basis (7.8 per cent in the third quarter), while nominal imports of goods went up 2.8 per cent on an annual basis (5.0 per cent in the third quarter). Nominal exports and nominal imports grew 7.0 and 1.5 per cent respectively in 2013. Trade deficit for 2013 came to EUR 2353.3 million: down EUR 1106.9 million compared with 2012.

Net Exports of Commodity Groups By Use, January–December 2013

	Balance, EUR million	Change*, EUR million	Exports growth**, per cent	Imports growth**, per cent
Consumer goods	442.0	26.7	8.1%	8.2
Raw materials	495.4	285.5	7.6%	4.5
Investment goods	-1811.4	518.7	13.3%	-0.9
Energy resources	-2654.2	285.7	-2.8%	3.7
Total	-3616.6	1072.3	7.0%	1.5

* Balance change on the same period of previous year.
 ** Growth of exports and imports for the period (on an annual basis).
 Exports are reported at FOB prices and imports – at CIF prices.
 Source: BNB.

Based on seasonally unadjusted GDP data real annual export growth in the fourth quarter of 2013 was 13.0 per cent (15.0 per cent in the third quarter), reflecting the continuous recovery in external demand for Bulgarian goods at the end of the year. Real growth of imports of goods in the fourth quarter moderated to 6.0 per cent on an annual basis (9.1 per cent in the third quarter) owing to the weak domestic demand and sluggish exports.

Cross-checking the changes in exports and imports in nominal and real terms shows that the falls in international prices curbed nominal growth of international trade flows in the fourth quarter. This is confirmed by the export and import price indices under the Standard International Trade Classification (SITC), pointing to an annual fall in exports and imports of 7.4 and 3.8 per cent respectively in the fourth quarter.

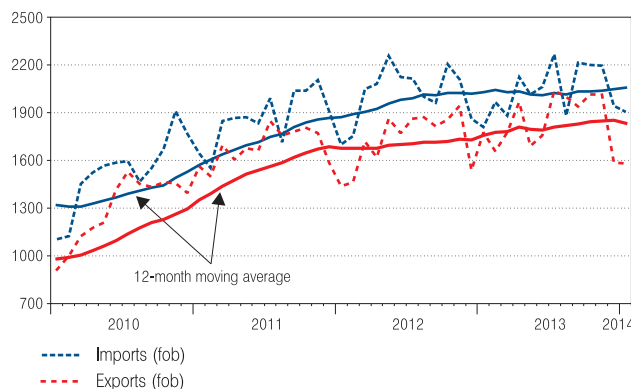
According to balance of payments data, in January 2014 exports reported an annual fall due mainly to a base effect reflecting their unusually high level in 2013. Over the same period imports increased on an annual basis probably due to the recovery in consumer demand, as judged by the short-term economic indicators for retail trade turnover and consumer confidence.

In the second and third quarters of 2014 exports are expected to continue to maintain high nominal growth rates on an annual basis compared with the corresponding period of 2013, mainly due to higher physical volumes. The increase in exports in real terms will be determined by the growing demand in the economies of our major trade partners. In the second and third quarters of 2014 exports growth rates will accelerate slightly as a result of recovering domestic demand; higher physical volumes once again playing a significant role, while weak international price dynamics over the period is expected to act as a deterrent. The trade balance deficit is expected to be between 5.5 and 6.0 per cent of GDP in the second and third quarters of 2014.

Risk of a lower than projected trade deficit could be realised in the event of a faster demand growth observed in Bulgaria's major trade partners and provided that Bulgarian exporters use exports capacity more flexibly, as well as in the event of further improvement in the terms of trade. Higher than expected trade deficit could be realised if the downward trend in export

Export and Import Dynamics

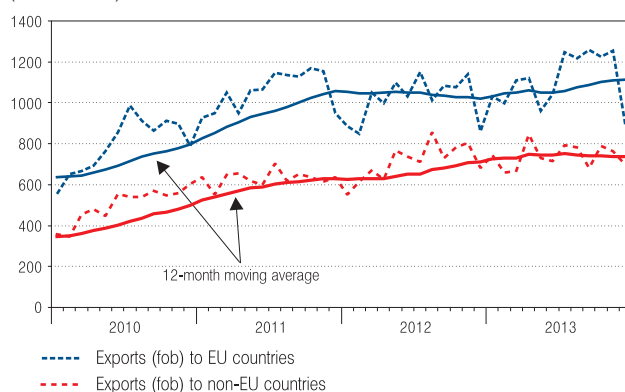
(EUR million)



Source: BNB.

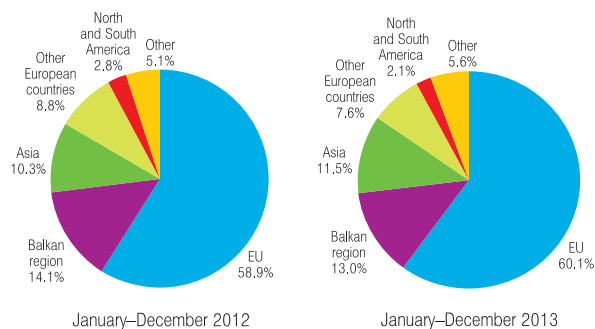
Dynamics of Exports to EU and non-EU Countries

(EUR million)



Source: BNB.

Geographical Distribution of Exports



Source: BNB.

growth and the stabilisation in import growth observed over the last months of 2013 and in early 2014 continue.

In 2013 exports to EU countries increased by 9.1 per cent on an annual basis, with machines, transport facilities and appliances, instruments and weapons; base metals and related products; and animal and plant products, foods, drink and tobacco contributing most to this growth. Exports to non-EU countries went up 4.0 per cent over this period, largely due to animal and plant products; food, drinks and tobacco; and machines, vehicles, appliances, instruments and weapons.

The share of exports to EU countries increased by 1.2 percentage points in 2013 in line with the ongoing recovery in EU economies. A contrasting trend was observed in the share of exports to non-EU countries which started shrinking since mid-2013. The share of Bulgaria's exports to the EU in total Community imports retained its upward dynamics over the review period against the background of the sustainable competitive positions of Bulgarian exporters in international markets.

In 2013 all major commodity groups in exports excluding the group of mineral products and fuels reported growth. Animal and plant products; food, drinks and tobacco; machines, vehicles, appliances, instruments and weapons; and chemical products, plastics and rubber contributed most significantly to this growth.

Exports of mineral products and fuels decreased by 2.8 per cent in 2013. Over the period exported volumes increased significantly while the nominal decrease was entirely due to prices⁴². In the second and third quarters of 2014 physical volumes are expected to retain their key role for the dynamics in the light of the slight increase in the prices of energy resources.

The sustainable annual growth in exports of machines, vehicles, appliances, instruments and weapons continued at high rates in 2013 largely due to higher exported volumes, while higher export prices were of secondary importance⁴³. Over the projection horizon the export dynamics of the group is expected to remain stable amid strengthening external demand.

⁴² According to the Balance of Payments, January 2014, p. 46.

⁴³ The quarterly export deflators for the machines, equipment and transportation vehicles group under SITC were used to estimate the price effect for 2013.

Exports by Commodity Groups, January–December 2013

	million EUR	Change*	Growth**, per cent	Contribution**, percentage points
Mineral products and fuels	4 018.6	-114.0	-2.8	-0.5
Machines, vehicles, appliances, instruments and weapons	4 357.2	496.3	12.9	2.4
Base metals and related products	3 868.4	29.5	0.8	0.1
Animal and plant products, food, drinks and tobacco	4 034.5	722.9	21.8	3.5
Chemical products, plastics and rubber	2 224.5	173.9	8.5	0.8
Wood products, paper, ceramics and glass	987.1	33.8	3.6	0.2
Textiles, leather, clothing, footwear and other consumer goods	2 738.0	115.5	4.4	0.6
Total exports	22 228.2	1 458.0	7.0	

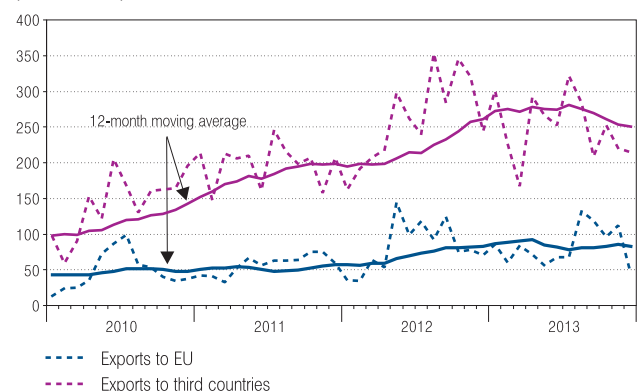
* Change on corresponding period of previous year, EUR million.

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

Source: BNB.

Exports of Mineral Products and Fuels

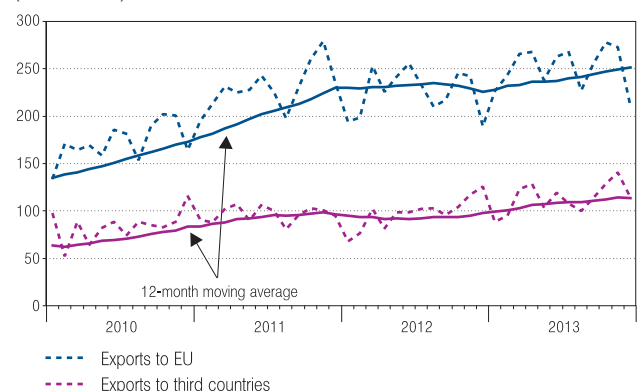
(EUR million)



Source: BNB.

Exports of Machines, Vehicles, Appliances, Instruments and Weapons

(EUR million)



Source: BNB.

In 2013 exports of base metals and related products rose slightly on 2012. The increase of exports in the group was entirely due to exported volumes, while prices in this group went down over the review period⁴⁴. International prices will probably continue to have a dampening effect on export growth in this commodity group in the second and third quarters of 2014.

Exports of the animal and plant products, food, drinks and tobacco reported its strongest annual rate of growth in 2013. Higher exports in the group were entirely due to exported volumes, while prices in the group went down, especially in the second half of the year⁴⁵.

Exports of chemicals, plastics and rubber increased in 2013 mainly due to price rises⁴⁶. Over the projection horizon exports in the group will probably continue to increase at rates close to the current ones due to the expected moderate dynamics of respective international prices.

In 2013 imports (cif) reported a slight increase in nominal terms. Based on the System of National Accounts (SNA) data for 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 imports. Imports of consumer goods and imports of raw materials contributed to the nominal growth of imports by use, while energy resources and investment goods had a downward effect on the nominal volumes of imports.

The quarterly import dynamics of the raw materials group was volatile exhibiting an increase of 4.9 per cent in 2013. The assessment of the price change effects in this group⁴⁷ suggests that growth reflected mostly the larger physical volumes. If the recovery of domestic demand

⁴⁴ According to the Balance of Payments of Bulgaria, January 2014, p. 46, for the non-ferrous metals subgroup and using the quarterly export deflators for the cast iron and steel group under SITC for 2013.

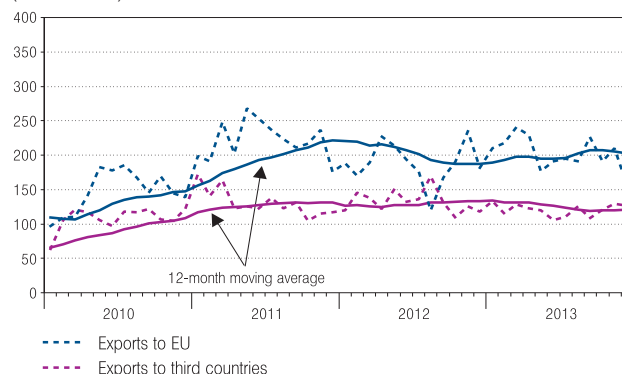
⁴⁵ To estimate the price effect, see the respective quarterly export deflators for the listed divisions in 2013 under SITC: for cereals – the deflator of cereals and mill products; for oil seeds and fruit – the deflator of oil seeds and fruit; for tobacco and manufactured tobacco substitutes – the deflator of tobacco and manufactured tobacco substitutes.

⁴⁶ The quarterly export deflators for the chemicals and chemical products group under SITC were used to estimate the price effect in 2013.

⁴⁷ According to the Balance of Payments of Bulgaria, January 2014, p. 46, and the respective quarterly 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 2013.

Exports of Base Metals and Related Products

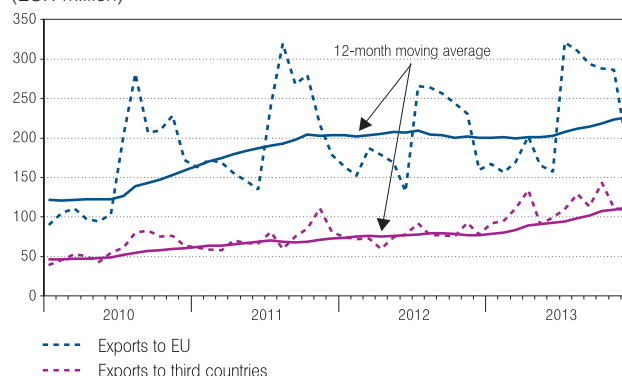
(EUR million)



Source: BNB.

Exports of Animal and Plant Products, Food, Drinks and Tobacco

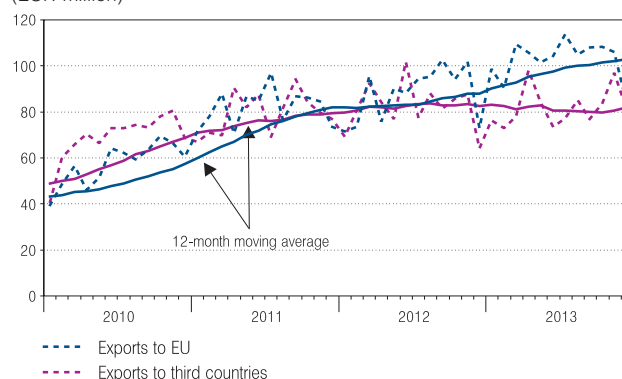
(EUR million)



Source: BNB.

Exports of Chemical Products, Plastics and Rubber

(EUR million)



Source: BNB.

Net Imports of Commodity Groups By Use, January–December 2013

	EUR million	Change*	Growth** per cent	Contribution**, percentage points
Consumer goods	4 768.7	361.6	8.2	1.4%
Raw materials	9 153.4	397.7	4.5	1.6%
Investment goods	5 770.1	-52.7	-0.9	-0.2%
Energy resources	6 039.0	-382.2	-6.0	-1.5%
Imports, total (cif)	25 844.7	385.6	1.5	

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

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

Source: BNB.

remains sustained and the effects of international price changes are limited, we may expect that the growth rate of imported raw materials will slightly accelerate over the projection horizon.

Imports of consumer goods was of major importance in total import developments in 2013 and the group reported sustainable quarterly dynamics. Imports of consumer goods' dynamics does not correspond to consumption dynamics on national accounts mainly due to the composition of imports. Weaker consumption was largely attributable to the fall in consumer spending on food while medicines and cosmetics and furniture and home equipment contributed most to higher imports of consumer goods. In the second and third quarters of 2014 imports of consumer goods will probably increase in line with the expected improvement in private consumption.

Imports in the group of energy resources fell in 2013 due mainly to lower prices of imported energy resources⁴⁸. In case the market expectations of falling international crude oil prices materialise, nominal imports of energy resources are likely to contract further over the projection horizon.

In 2013 imports of investment goods went down. The dynamics of the group was divergent in both the first and second half of the year. In the first half-year imports of investment goods declined on the corresponding period of 2012 due to lower import prices⁴⁹ and volumes. In the second half-year imports of investment goods increased at higher rates due to both higher import prices and increased import volumes. In case no essential changes in the international prices of investment goods occur, in the first and second quarters of 2014 their imports will increase as a result of the recovery in investment activity in Bulgaria.

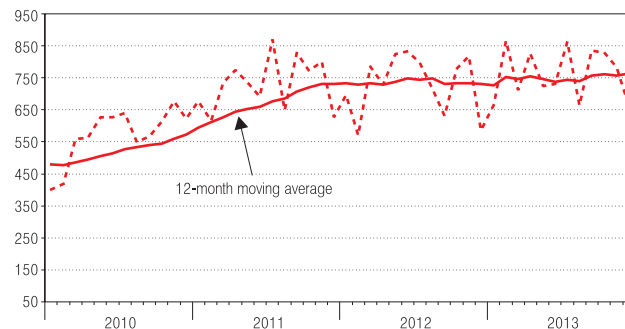
In 2013 imports from EU member states increased by 3.6 per cent and those from countries outside the Union fell by 0.4 per cent.

⁴⁸ According to the Balance of Payments, January 2014, p. 46.

⁴⁹ The quarterly import deflators for the machines, equipment and transportation vehicles group under SITC were used to estimate the price effect in 2013.

Imports of Raw Materials

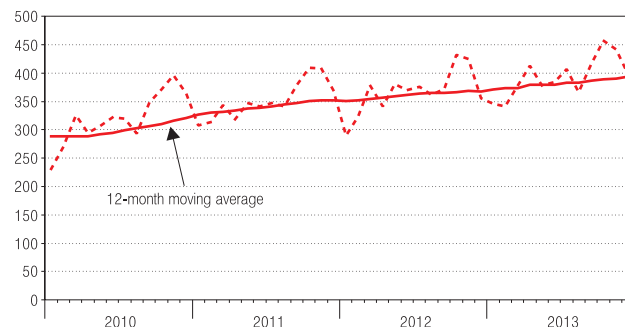
(EUR million)



Source: BNB.

Imports of Consumer Goods

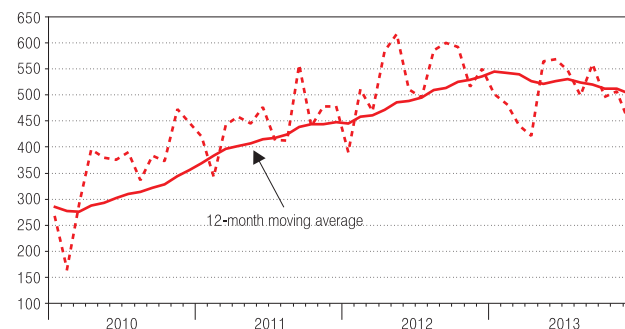
(EUR million)



Source: BNB.

Imports of Energy Resources

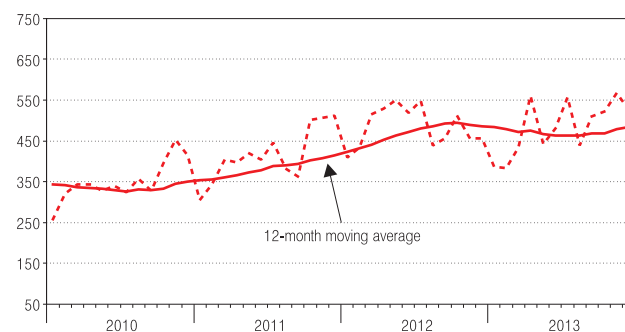
(EUR million)



Source: BNB.

Imports of Investment Goods

(EUR million)



Source: BNB.

4. Inflation

In the first two months of 2014 the HICP rate of decline accelerated to -2.1 per cent on an annual basis (-0.9 per cent at the end of 2013). The accelerated decline in the overall price level was largely the result of the decrease in transport fuel and transport services prices and the cuts in some administratively controlled prices. As of February 2014 almost all major commodity and services groups in the consumer basket reported a fall in prices on an annual basis, with administratively controlled prices, fuels and non-foods (excluding fuels) reporting the most sizeable decrease.

In the second and third quarters of 2014 the rate of decline of the overall HICP is expected to gradually moderate, reflecting mainly the lower negative contribution of controlled prices and the discontinuation of the decline in food prices price decline. According to the March Survey of Business Developments in Industry, Retail Trade and Services, managers prevailing expectations suggest that prices are to remain at current levels, while customers reported a fall in inflation expectations over the last year.

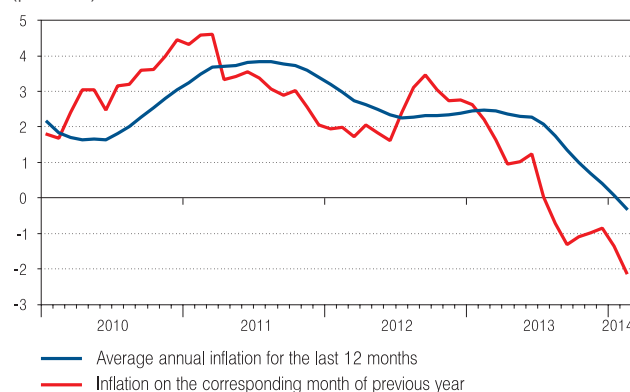
The downward trend in annual HICP observed since the second half of 2013 intensified in the first two months of 2014.⁵⁰ By February the annual decline in HICP came to -2.1 per cent, and the average annual inflation was negative (-0.3 per cent compared with 0.4 per cent in 2013).

Realised lower than expected inflation in early 2014 reflects the impact of both domestic and external factors. The ongoing decrease in oil prices on international markets together with the slight appreciation of the euro which led to a fall in fuel prices played a decisive role for stronger consumer price deflation in the first two months of the year. In early 2014 new reductions in some of the administered prices were approved which were not taken into consideration in the previous projection. The sizeable fall in transport services prices resulting from the methodological change in air fare reporting and the stronger rate of decline in non-foods (excluding fuels) added further to higher overall deflation.

In early 2014, as well as in 2013, the downward dynamics of international food prices continued to push down domestic food prices which are heavily dependent on the international market situation. Meanwhile, the weak dynamics of household consumption and competition in the trade sector further affected the firms' behaviour with regard to cost restraints amid stabilisation or a slight decline in prices.

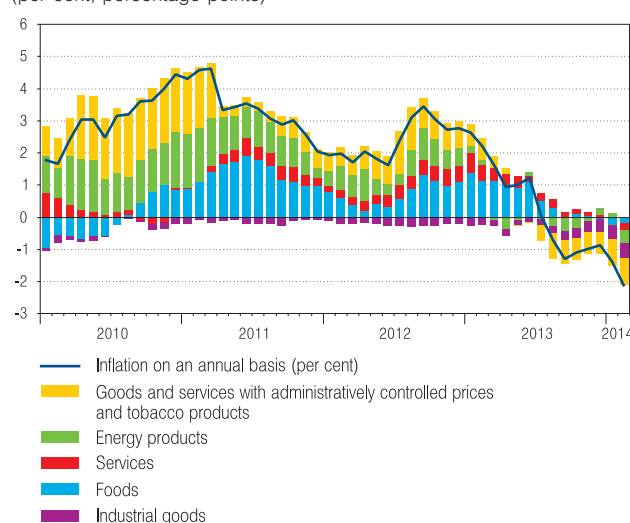
⁵⁰ The analysis in this section is based on NSI data on HICP.

Inflation
(per cent)



Source: NSI.

Annual Inflation and Contribution of Major Commodity and Services Groups to It
(per cent, percentage points)



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

Sources: NSI, BNB calculations.

As of February 2014 almost all major commodity and services groups in the consumer basket reported price declines on an annual basis, with administratively controlled prices, transport fuels and non-foods (excluding fuels) reporting the most sizeable decrease.

The trend toward an increase in the share of goods and services reporting an annual fall in prices observed since the second half of the previous year continued in the first two months of 2014⁵¹. As of February the diffusion index calculated as a share of the subindices reporting a fall of over -0.1 per cent on the corresponding period of 2013 came to 44.1 per cent. The observed increase in the diffusion index on mid-2013 reflected the higher number of sub-groups reporting a fall in the prices of non-foods (excluding fuels), services (excluding administratively controlled prices) and foods. At the same time, the comparatively low growth rates in sub-groups which recorded no declines on an annual basis and had lower relative weight are insufficient to offset the price declines in the remaining groups. As a result the annual decline in the overall HICP remained unchanged.

The strong impact of international prices on consumer price changes in Bulgaria may be seen through import and producer price dynamics. According to national accounts data, the import deflator of goods reported quarterly annual declines throughout 2013 which totalled -4.5 per cent. By sector of the SITC the deflators of most major imported groups were characterised by a downward dynamics in the previous year and in the fourth quarter of 2014 an annual fall in deflators was reported by imports of food, fuels and other raw materials, as well as by manufactured goods.

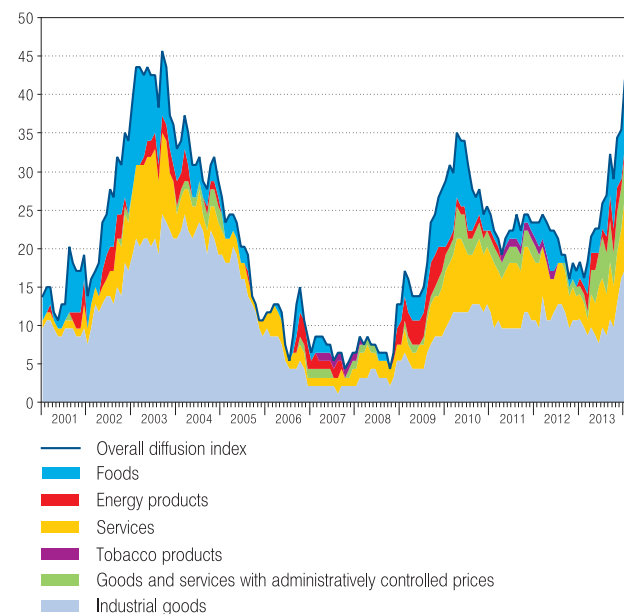
Lower international prices were reflected also in the dynamics of the overall PPI on the domestic market which continued to decline on an annual basis and as of February 2014 reported a -2.5 per cent fall. The trend toward a higher annual rate of decline was observed in intermediate consumption goods while energy product prices reported a lower rate of decline on end-2013.⁵²

⁵¹ Based on the four-digit COICOP (classification of individual consumption by purpose) disaggregation of HICP by country published by Eurostat.

⁵² The Main Industrial Groupings classification was used covering the following sectors: manufacture of intermediate consumption goods, energy product production and water

Diffusion Index of Major Goods and Services Groups

(relative shares of declining HICP sub-indices on an annual basis)

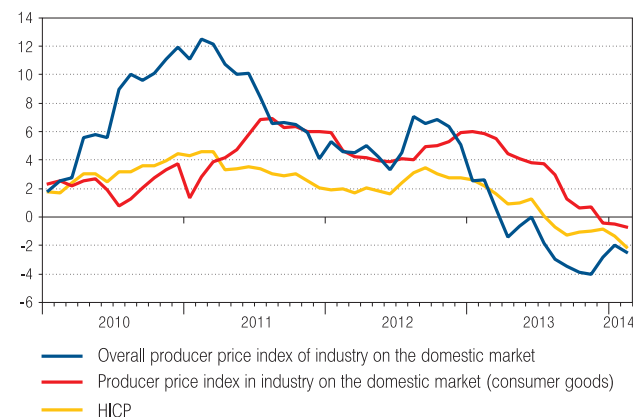


Note: The HICP subindices with an annual fall of more than -0.1 per cent are considered.

Sources: NSI, BNB calculations.

Rate of Change in Producer Price Index and HICP

(per cent, on an annual basis)



Source: NSI.

The moderate annual fall in producer prices of non-durable consumer goods reflected mainly the lower price dynamics in food production. Meanwhile, the producer price index in investment products on the domestic market retained its positive rate of growth in both 2013 and in the first two months of 2014.

Firms' labour costs and investment policy was reflected in consumer price dynamics. Against the backdrop of still limited household demand and free production capacity firms remained cautious about spending. According to short-term statistics data on employment and labour costs, 2013 saw moderate annual rate of growth of the wage bill in the manufacturing and services sectors. In 2013 total investment in fixed capital in the economy remained close to the 2012 level. In the second half of the year firms' investment activity in manufacturing intensified⁵³, which may be explained by the observed improvements in the international environment.

Household demand, which remained relatively sluggish in 2013, also plays a key role in the formation of consumer prices. According to the national account data, in 2013 households' final consumption expenditure were lower compared with the previous year. In the fourth quarter of 2013 food consumption contracted further (a trend observed since end-2012) in contrast to catering and non-food goods expenditure which increased on an annual basis. The differences in the degree of recovery of consumer demand by economic sector allow firms to apply different pricing and spending policy.

Turnover in retail trade, the latter serving as a link between producer and end-use prices for most consumer goods, signal recovery in consumption by end-2013 and in early 2014.⁵⁴ Relatively high growth rates of turnover at constant prices on an annual basis are observed in non-food goods; computer and communication equipment, and home appliances, furniture and other household goods contributing most

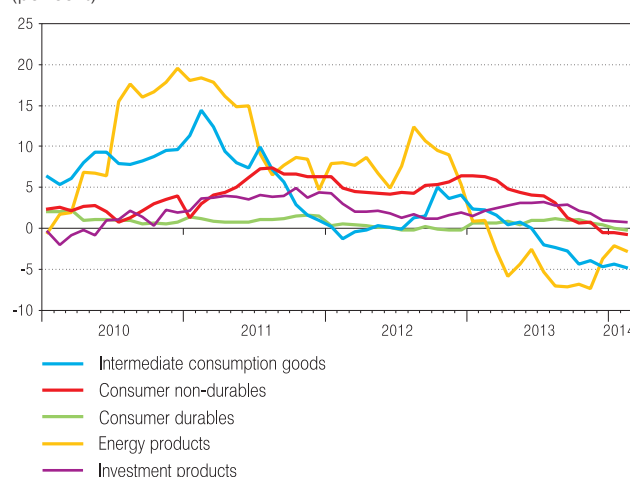
related activities, investment product manufacturing and consumer goods production. Energy products are viewed as production and distribution of electricity, heating and gas, and water supply.

⁵³ According to preliminary NSI data on nominal expenditure on acquisition of tangible fixed assets.

⁵⁴ For further details see Household Behaviour in the Economic Activity section.

Annual Rates of Change in Producer Prices on the Domestic Market by Major Industrial Groupings

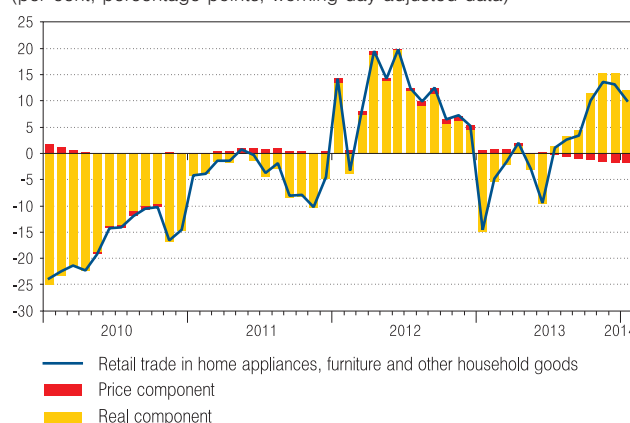
(per cent)



Source: NSI.

Annual Growth Rate of Nominal Retail Trade in Household Appliances, Furniture and Other Household Goods

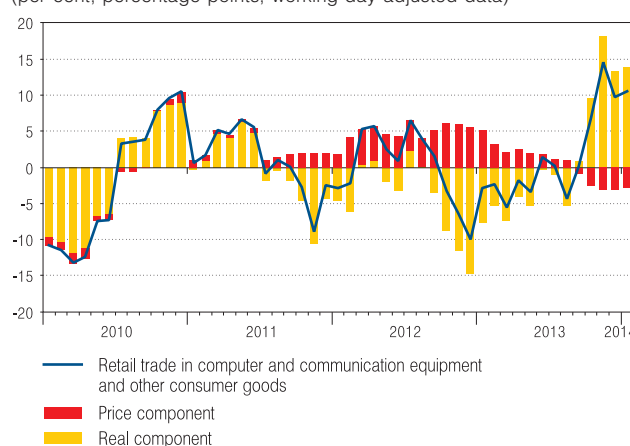
(per cent, percentage points, working-day adjusted data)



Sources: NSI, BNB calculations.

Annual Growth Rate of Nominal Retail Trade in Computer and Communication Equipment and Other Consumer Goods

(per cent, percentage points, working-day adjusted data)



Sources: NSI, BNB calculations.

significantly to this. The corresponding prices of these groups in the consumer basket reported a decline, which is probably a sign of the stimulating effect of lower prices on households' final demand. The retail trade turnover dynamics corresponds also to the more optimistic household sentiment about the purchase of durable goods⁵⁵ in the following 12 months, registered in early 2014. At the same time, in the second half of 2013 real turnover growth on an annual basis moderated in food, drinks and tobacco, as well as in trade in non-specialised shops; prices remaining unchanged or being slightly lower in these groups. By the end of 2013 and in January 2014 trade in textile, clothing, footwear and leather with relatively unchanged prices on an annual basis also reported moderate turnover growth rates, but from comparatively high levels.

Unprocessed food and in a lower degree processed food contributed most to negative inflation in food prices which came to -0.8 per cent by February (compared with -0.3 per cent in December 2013). Unprocessed food inflation dynamics was underpinned mainly by the meat and meat products, fruit and vegetables groups which are strongly dependent on the changes in import prices and on the quality of the harvest in Bulgaria and in the region. The fall in processed food prices came to -0.4 per cent largely due to animal and vegetable oils and fats and bread and cereals whose prices continued to reflect the lower international prices of cereals, fats and oils in the first months of 2014.

Since early 2014 transport fuel prices recorded a decline on the corresponding period of the previous year⁵⁶ against the background of a continued fall in oil prices in euro. In February the annual rate of change in energy products prices was -4.3 per cent (2.2 per cent as of December 2013).

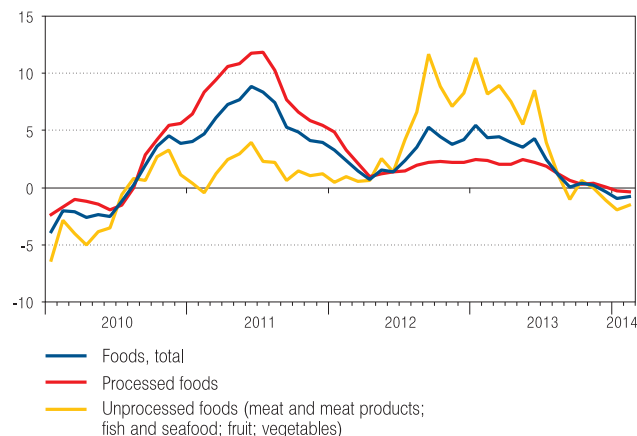
In the first two months of 2014 administratively controlled prices still reported the highest negative contribution to overall inflation. The annual rate of decline in this group accelerated on the end of 2013 and in February 2014 stood

⁵⁵ Such as purchase of furniture, electrical/electronic devices, etc.

⁵⁶ In the group of energy products (excluding the administratively controlled prices of energy, heating and central gas supply) transport fuels occupy the largest relative share; hence, their price developments determine the price dynamics of energy products in general.

Rate of Change of Food Price Index

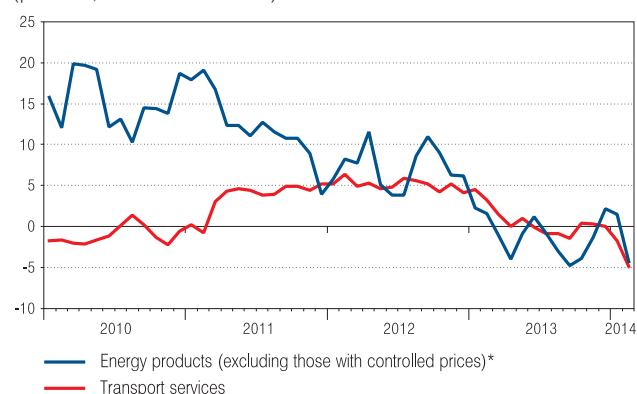
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

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

(per cent, on an annual basis)

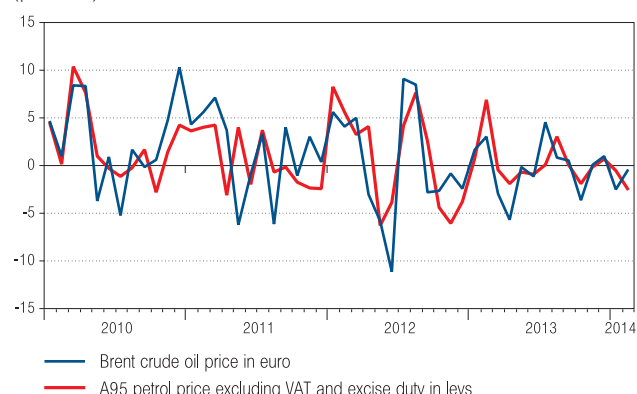


* Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB calculations.

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

(per cent)



Sources: ECB, NSI, BNB calculations.

at -4.9 per cent (a negative contribution of 0.9 percentage point to overall inflation). The more pronounced reduction in controlled prices observed over the review period reflected the third consecutive cut in the controlled price of electricity for households (down 2.7 per cent as of January) and the lower fees for visits to GPs and other medical specialists who have concluded contracts with the National Health Insurance Fund (down 28.6 per cent).

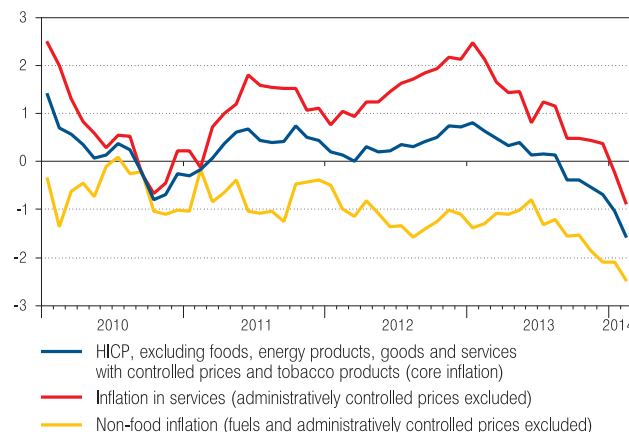
The 2013 trend toward a decrease in core inflation continued in early 2014. As of February core inflation on an annual basis was negative at -1.5 per cent (-0.7 per cent decline at the end of 2013) and contributed to the further fall in the overall HICP. Core inflation dynamics reflected mainly the sizeable deflation transport services and to a lesser extent the higher annual rate of decline in the prices of non-foods (excluding fuels).

Manufactured goods deflation which came to -2.5 per cent in February (compared with -2.1 per cent in December 2013), was still driven largely by the lower durable goods prices. Since early 2014 television equipment, household appliances and automobiles reported stronger price falls, and the prices of computer equipment and furniture and furnishings continued to decline. As of February the non-durables price index reported a slight annual decline reflecting mainly the lower clothing and footwear prices.

In early 2014 the group of services reported annual deflation for the first time since 2010 which came to -0.9 per cent. A key factor behind this development was the methodological change in air fare reporting. As a result, air fares reported a fall in prices of around 12 per cent on an annual basis as of February and the overall index of transport services (excluding the administratively controlled ones) went down by 7 per cent respectively. Concurrently, passenger automobile transport prices which reported lower inflation in 2013 due to the downward fuel price dynamics, and marginal price falls by end-2013, continued to report insignificant price declines in early 2014. Dental services had a sizeable negative contribution to overall services inflation since early 2014, owing to the cut in the user fees paid to dentists having concluded contracts with the National Health Insurance of 28.6 per cent as of January. As food prices declined in early 2014, catering services inflation retained its positive contribution

Core Inflation

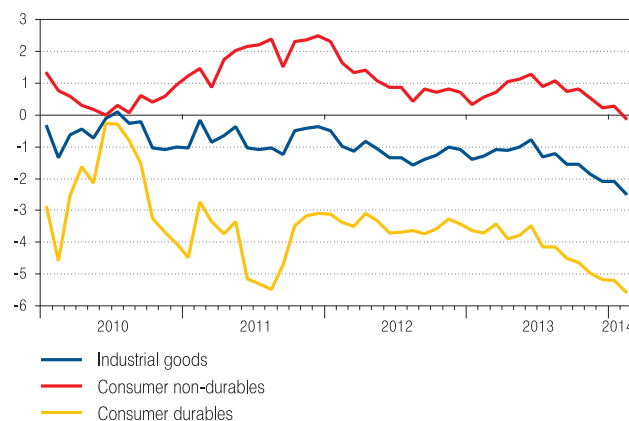
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

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

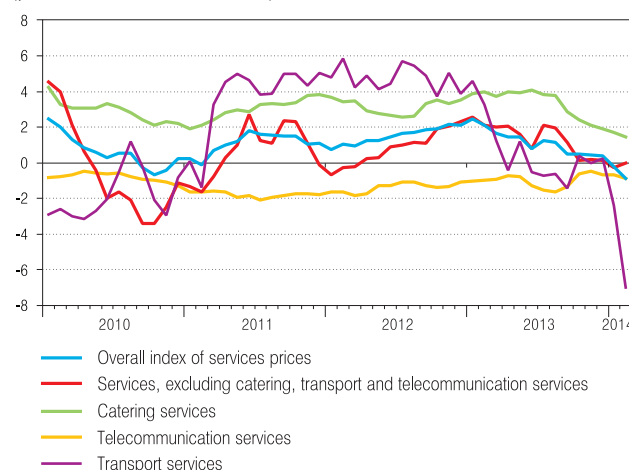
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

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

(per cent, on an annual basis)



Sources: NSI, BNB calculations.

to overall inflation, but continued to moderate, while the prices of telecommunication services products followed a long-term downward trend.

According to the Survey of Business Developments in Industry, Retail Trade and Services as of March 2014, managers prevailing expectations suggest that prices are to remain at current levels in the following three months, while customers reported a fall in inflation expectations for the following 12 months throughout 2013.⁵⁷ At the same time, the share of retail trade managers expecting price decline slightly exceeds the share of managers expecting price increases. Since the end of 2013 these developments form different selling price expectations in retail trade compared with those in the manufacturing and services sectors. These selling price expectations in retail trade reflected the firms uncertainty related to economic environment developments, weak consumer demand and competition in the sector. Competition, which was outlined by the managers participating in the business survey as a factor hampering the activity of the corporations, may also be considered a factor curbing price rises. The increase in the market shares of commercial chains in the trade in food and the expansion of the activity of the modern format of large commercial centres contribute to stronger competition in the trade sector. In addition to the downward dynamics in international prices, competition also had a dampening effect on consumer prices of foods and non-foods (excluding fuels). Over the recent years NSI surveys recorded a trend toward intensified competition in the services sector.

In January 2014 the NSI consumer survey continued to report lower current inflation and inflationary expectations estimates (a trend observed since 2013), but with a smaller share of consumers expecting a fall in consumer prices in the following 12 months (0.4 per cent).

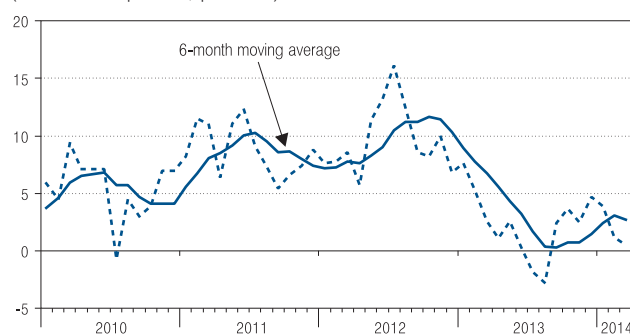
Inflation expectations for the following quarters and the related uncertainty are presented in the fan chart on the annual rate of change in the HICP.⁵⁸ In the second quarter of 2014 we expect negative inflation (from -1.6 per cent to -0.7 per

⁵⁷ Due to the small range of services covered by the National Health Insurance Fund, dental services are not treated as services with administratively controlled prices in the consumer basket.

⁵⁸ For further details, see the Measurement and Presentation of Uncertainty in Forecasting Economic Indicators box, Economic Review, 1/2012.

Selling Prices Expectations in Industry over the Next 3 Months

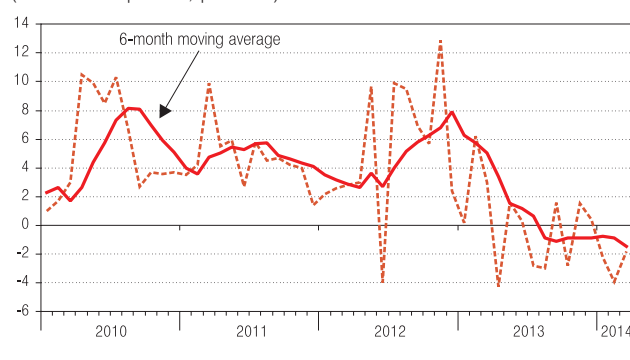
(balance of opinions, per cent)



Source: NSI.

Selling Prices Expectations in Retail Trade over the Next 3 Months

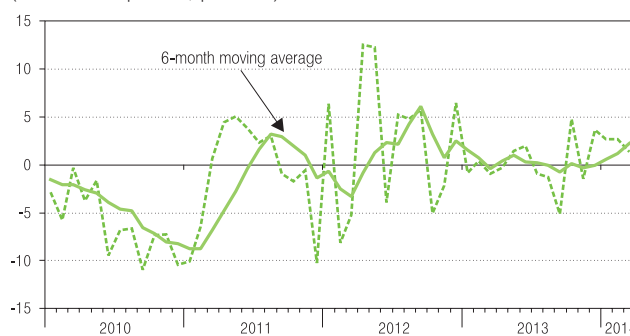
(balance of opinions, per cent)



Source: NSI.

Selling Prices Expectations in Services over the Next 3 Months

(balance of opinions, per cent)



Source: NSI.

cent) and in the third quarter it is expected to vary between -1.1 per cent and 0.1 per cent.⁵⁹ The projected gradual moderation in the pace of decline in the overall HICP will reflect mainly the lower negative contribution of controlled prices and the suspended fall in food prices.

The projection is based on an assumption for a moderate annual fall in food prices on the international markets in the second quarter of 2014 (they are likely to increase on a quarterly basis), followed by a slight increase in the second half of the year. With a view to this assumption, we expect that negative inflation in food prices in Bulgaria will remain low in the first half of the year and that a slight upward trend is likely to follow. The oil prices in euro are expected to increase slightly in the second quarter, and then fall on both quarter-on-quarter and annual basis. The contribution of core inflation to overall inflation is likely to remain negative reflecting indirect effects of lower food and fuel prices and the sustained downward dynamics observed in durable goods prices. There is a high degree of uncertainty surrounding inflation dynamics in transport services in the group of air transport.

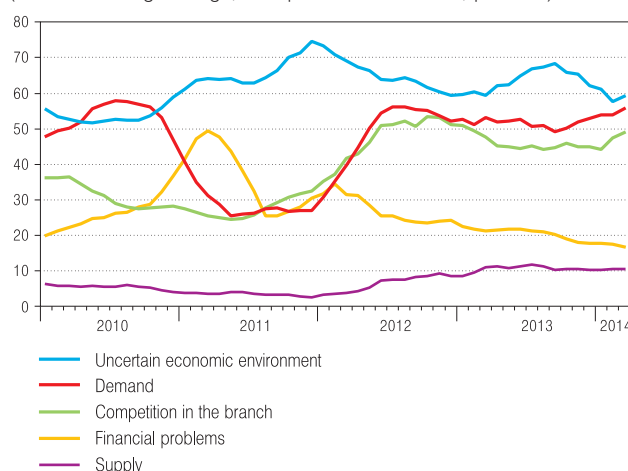
In early 2014 administratively controlled prices will retain their sizeable negative contribution to overall HICP dynamics. The contribution of controlled prices is expected to gradually decrease throughout the year due to the base effect of the sizeable declines in prices of electricity for households in 2013.

Major risks to the projected overall inflation dynamics in the second and third quarters of 2014 relate mainly to the uncertainty surrounding international food and oil price developments and could be materialised both upwards and downwards. Among internal factors inflation risks stem from potential adjustments in administratively controlled prices. A continued decline in oil prices and international food prices, together with a weakening or sluggish rate of consumer demand may result in a sustained rate of decline in overall HICP. Risks to the inflation outlook for the second and third quarters of 2014 are assessed as balanced.

⁵⁹ 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.

Factors Hampering the Activity of Corporations in the Retail Sector

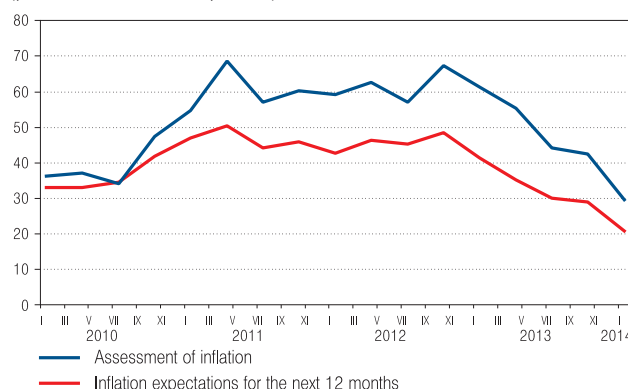
(6-month moving average, enterprises relative share, per cent)



Source: NSI.

Assessment of Inflation and Inflation Expectations According to the Consumer Survey

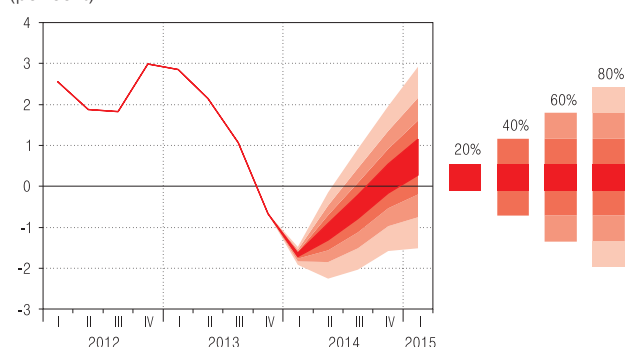
(per cent, balance of opinions)



Source: NSI.

Fan Chart of the Expected Annual Inflation Rate

(per cent)



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. 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.

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

	Inflation accumulated as of February 2013 (December 2012 = 100)		Inflation accumulated as of February 2014 (December 2013 = 100)		Annual inflation rate as of February 2014 (December 2013 = 100)	
Inflation (per cent)	0.4		-0.9		-2.1	
	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points	Inflation rate by group, per cent	Contribution, percentage points
Foods	1.4	0.37	1.0	0.25	-0.8	-0.20
Processed foods	0.3	0.04	-0.2	-0.03	-0.4	-0.06
Unprocessed foods	3.6	0.33	3.1	0.28	-1.6	-0.14
Services	-0.1	-0.02	-1.3	-0.32	-0.9	-0.21
Catering services	0.6	0.03	0.1	0.01	1.5	0.08
Transport services	-1.5	-0.05	-8.6	-0.31	-7.0	-0.24
Telecommunication services	0.0	0.00	-0.2	-0.01	-0.9	-0.04
Other services	0.1	0.01	-0.1	-0.01	0.0	0.00
Energy products	3.5	0.33	-3.0	-0.28	-4.3	-0.40
Transport fuels	3.8	0.33	-3.2	-0.28	-4.2	-0.36
Industrial goods	-1.1	-0.21	-1.5	-0.29	-2.5	-0.47
Goods and services with administratively controlled prices*	-0.4	-0.07	-1.5	-0.24	-4.9	-0.87
Tobacco products	0.1	0.00	0.1	0.00	0.9	0.04

* The index of goods and services with administratively controlled prices is calculated through weighting the relevant elementary aggregates in the consumer basket.

Sources: NSI, BNB calculations.