

# Economic Review

2/2014



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# Economic Review

2/2014



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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

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The improvement of global economic situation in early 2014 was sustained in the second quarter. Optimism in expectations continued to increase in the USA, China and the euro area. In the beginning of 2014 world trade volumes continued to rise on an annual basis. Over the second quarter global inflation continued to slow down on an annual basis, driven by the weak dynamics of major commodity and energy product prices in international markets. Based on leading economic indicators and positive world trade developments, global economic activity is expected to increase gradually over the third and fourth quarters of 2014, with developed economies contributing most significantly to this growth.

In the second quarter of 2014 oil prices in US dollars picked up on an annual basis due to concerns about falls in oil supplies as a result of the conflicts in Iraq, Libya and Ukraine. On the other hand, the increase in euro oil prices was significantly lower due to the euro appreciation against the US dollar. Market expectations for the third and fourth quarters show a decrease in the oil price. Projections by the International Energy Agency point to increasing oil demand over the second half of the year, though at a rate lower than that of the supply growth rate. Between April and June 2014 international euro prices of most commodity groups continued to decline. In the second half of the year rates of decline in international euro prices are expected to slow down with divergent developments observed in individual groups. Metal prices will continue to fall, stabilising even at the end of 2014, while food prices are expected to increase.

Between January and May 2014 Bulgarian foreign trade balance flow dynamics was mainly driven by international price declines and domestic demand growth. These factors contributed to the increase in the trade deficit and an annual decline in the BOP current and capital account surplus. Financial account developments reflected mainly the lower outflows of banks. If the slowdown in the decline rates of international euro prices materialises during the second half of 2014 and the external demand strengthens, a slow recovery may be expected in the nominal export growth. In case the import growth rate, reflecting domestic demand dynamics, also accelerates, a lower year-on-year positive balance is expected on the current and capital account over the third and fourth quarters.

The retained high household savings rate continued to boost attracted funds in the banking system between January and June 2014 which contributed to the maintenance of high bank liquidity. Growth rates of overnight deposits and those redeemable at notice of up to three months remained high in the first half of the year, unlike deposits with an agreed maturity which continued to decline. Between January and May banks used a significant portion of their liquidity to increase foreign assets, to invest in Bulgarian government securities, to boost claims on the non-government sector and to cut, though to a lesser extent, their foreign liabilities. By the end of June banks' foreign assets declined compared to the end of May and the Bulgarian government securities share increased in bank portfolios. The annual growth rate of claims on the non-government sector began to accelerate in February to reach 2.4 per cent in June, reflecting the increased lending to non-financial corporations coupled with a slight rise in household loans.

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 in the third and fourth quarters of 2014. The expected decline in euro area money market interest rates is likely to encourage banks to seek investment solutions in the domestic market. In the third and fourth quarters of 2014 deposit rates may further decline which will be mainly driven by the high banking system



liquidity, lower money market rates in the euro area and comparatively weak demand for bank credit. Lending rates are expected to hover around the attained levels.

In the first quarter of 2014 economic activity increased on a quarterly basis reflecting mainly stronger growth in domestic demand and increased inventories. Private consumption went up, investment activity also increased, with government investment contributing substantially to this effect. Industry contributed most to economic activity growth, with a value added increase attributable to a large degree to higher inventories. Firms remained cautious in hiring staff due to still uncertain economic environment. In the first quarter of 2014 total employment remained at levels close to those reported in the fourth quarter of 2013, posting a slight increase on a quarterly basis. The Labour Force Survey seasonally adjusted data show that in the first quarter of 2014 the unemployment level slightly decreased reaching 12.4 per cent.

The continuous economic recovery observed in our major trading partners and enhanced external demand are expected to have a positive impact on growth of exports of goods and services and on economic activity in Bulgaria from the second quarter of 2014 onwards. As a result, net exports are anticipated to contribute positively to the quarterly growth of real GDP until the end of 2014. In the third and fourth quarters domestic demand is expected to remain close to the level of the first half of the year. Risks to the outlook for economic activity stem mainly from external environment effects on Bulgaria's economy reflecting both the situation in the euro area and the EU as a whole and increased geopolitical tensions in Ukraine and Russia. Another source of uncertainty to our projections relates to ongoing price processes as the continuing deflation may prompt a decline in firms' profits which will deteriorate their expectations and limit investments. The placement of Corporate Commercial Bank, the fourth largest bank in Bulgaria, under special supervision will have a negative impact on the economic activity of firms and households which are customers of the bank. Increased political uncertainty surrounding early parliamentary elections in October may also have a negative effect on expectations, sentiment and behaviour of economic agents.

In the first five months of 2014 Bulgaria's budget position deteriorated on the corresponding period of 2013 impacted by slower growth rates of tax revenue which was not offset by constraining budget expenditure by the government. As a result of accelerated investment expenditure and maintained high growth rates of social payments, the government fiscal policy continued to have a positive effect on total investment and household disposable income. In the first quarter of 2014 the contribution of government consumption to GDP growth also increased. Obviously, the consolidated fiscal programme deficit of 1.8 per cent of GDP for 2014 is less likely to be realised given the weaker tax revenue implementation and the higher health insurance payment costs. The contribution of government consumption to GDP growth is likely to decrease in the second half of the year.

In the first half of 2014 the still negative annual HICP inflation rate decelerated to -1.8 per cent (-0.9 per cent at the end of 2013). In the January–June 2014 period deflation continued to spread across a broader range of goods and services included in the consumer basket – a trend observed since the second half of 2013. Deepening deflation was largely driven by the fall in the prices of transport fuels, food and services reflecting mainly lower international prices and some specific factors related to certain groups of services. The lower negative contribution of administratively controlled prices in March limited the rate of decline of the overall HICP. The downward trend in core inflation, which developed in 2013, continued in 2014, and as of June the negative core inflation was largely driven by the decelerating services inflation and, to a lesser extent, by the accelerating annual rate of decline in the prices of non-food items (excluding fuels).

In the third and fourth quarters of 2014 inflation is expected to remain negative and the rates of decline in consumer prices are likely to gradually moderate. The further reduction in the negative contribution of administratively controlled prices, together with the end of the fall in food prices and the lower negative contribution of core inflation in the second half of 2014 will be the main factors behind the waning deflationary processes. Major risks to the projected overall inflation dynamics in the second half of 2014 relate to international food and oil price developments.

# 1. External Environment

The improvement of global economic situation in early 2014 was sustained in the second quarter. Improved expectations continued to be observed in the USA, China and the euro area. Between January and April 2014 world trade volumes continued to rise on an annual basis. Based on leading economic indicators and positive world trade developments, global economic activity is expected to increase gradually over the third and fourth quarters of 2014, with developed economies contributing most significantly to this growth. Over the second quarter global inflation continued to slow down on an annual basis, driven by the weak dynamics of the prices of major commodity groups on international markets.

## Current Business Situation

Global PMI continued to rise in the second quarter of 2014. Expectations about the development in the services sector improved most sizeably, with expectations of new business and higher employment contributing most to this. Improved expectations in the manufacturing sector were mainly driven by expectations of lower input prices and new orders.

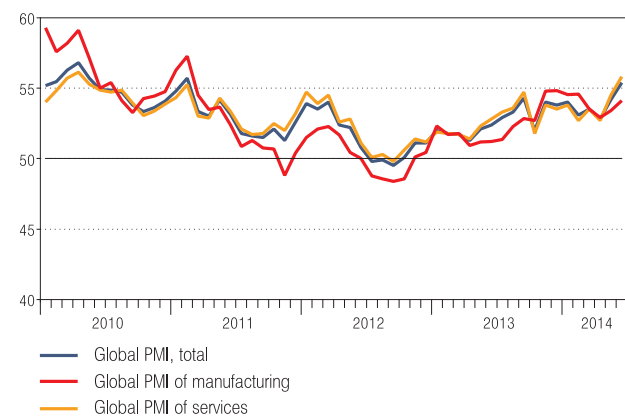
Developments in economic indicators show differences across regions. The United States contributed most to the increased expectations about the global indexes of the services and of manufacturing sector, while in the euro area the rate of improvement of the expectations about the economic activity started to moderate. Expectations in the Chinese manufacturing sector improved slightly, showing the optimism of the business stemming from the economic growth stimulus measures initiated by the government.

In the January–April 2014 period world trade volumes continued to increase on an annual basis, with US foreign trade growth further 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 third and fourth quarters of 2014, with developed economies contributing most significantly to this growth.

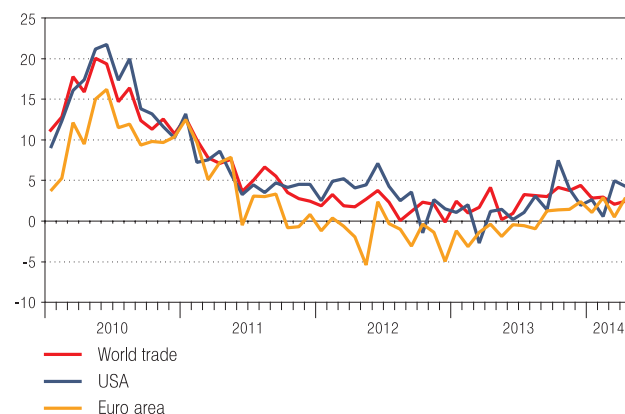
In the April to June 2014 period global inflation continued to slow down on an annual basis,

Global PMI



World Trade

(annual rate of volume growth, per cent)



with developed economies contributing most to this. The weak dynamics of major commodity and energy product prices in international markets was an important factor behind the moderation.

## Euro Area

In the first quarter of 2014 real GDP in the euro area grew by 0.9 per cent on an annual basis against 0.5 per cent in the previous quarter.<sup>1</sup> Data suggest significant differences across countries. Economic growth in Germany came to 2.3 per cent (from 1.4 per cent in the fourth quarter of 2013), while in France it remained unchanged at 0.7 per cent. For the first time in the last two years Spain reported 0.5 per cent growth (a 0.2 per cent decline in the previous quarter) and Italy saw a decline in the GDP of 0.5 per cent (-0.9 per cent in the previous quarter). Cyprus reported the largest GDP fall: -4.1 per cent.

On a quarterly basis, euro area real GDP increased by 0.2 per cent in the first quarter of 2014 against 0.3 per cent growth in the previous quarter. GDP components with positive contributions to growth were inventories (0.2 percentage points), investment (0.1 percentage point) and household and government consumption (0.1 percentage point each). Net exports had a negative contribution of 0.2 percentage points. On a quarterly basis, GDP declined in Estonia (-0.7 per cent), Italy (-0.1 per cent), Cyprus (-0.7 per cent), the Netherlands (-1.4 per cent), Portugal (-0.7 per cent), Slovenia (-0.3 per cent) and Finland (-0.4 per cent).<sup>2</sup>

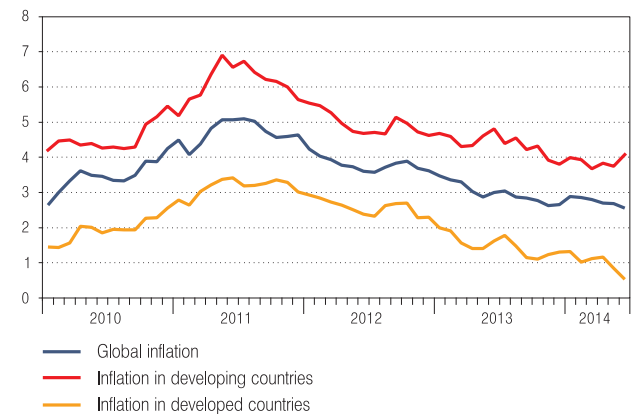
Leading economic indicators reported a slight decline, with the EC economic sentiment index for the euro area going down to 102 in June, from 102.6 in May, and the business climate indicator came to 0.22, from 0.36 in May. The EC consumer confidence index in the euro area also declined to -7.5 in June, from -7.1 in May. Euro area PMIs decreased slightly but remained above the neutral level of 50 suggesting expectations of positive dynamics of economic activity. In June the composite PMI was 52.8 (53.5 in

<sup>1</sup> Eurostat data.

<sup>2</sup> Data on Greece are not available.

## Inflation Measured through CPI

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

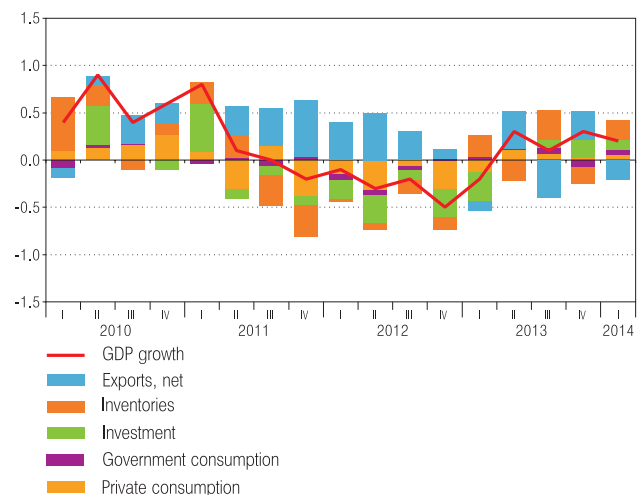


Note: The World Bank measures the change of CPI in individual groups as a weighted average of CPI changes in the countries of the group. For calculating the weights of the countries, real GDP based on purchasing power parity is used. Groups include only World Bank Member States classified by the World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

Source: World Bank.

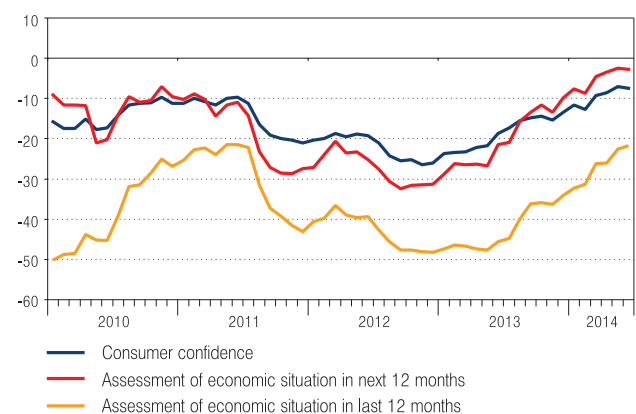
## Contribution to Real GDP Growth in the Euro Area by Component (Quarterly)

(per cent; percentage points)



Source: Eurostat.

## Euro Area Consumer Confidence Indices



Source: European Commission.

May) and manufacturing and services PMIs stood at 51.8 and 52.8 respectively (against 52.2 and 53.2 in May).

Euro area economic indicator analysis gives grounds to expect weak economic growth in the euro area by end-2014. According to the latest ECB forecasts of June 2014, GDP growth will range between 0.6 and 1.4 per cent in 2014 (previous forecast: between 0.8 and 1.6 per cent) and between 0.6 and 2.8 per cent in 2015 (previous forecast: between 0.4 and 2.6 per cent). According to the European Commission's Spring Economic Forecast, euro area GDP is expected to grow 1.2 per cent in 2014 (unchanged from the EC's Winter Forecast) and 1.7 per cent in 2015 (1.8 per cent from the previous EC report).

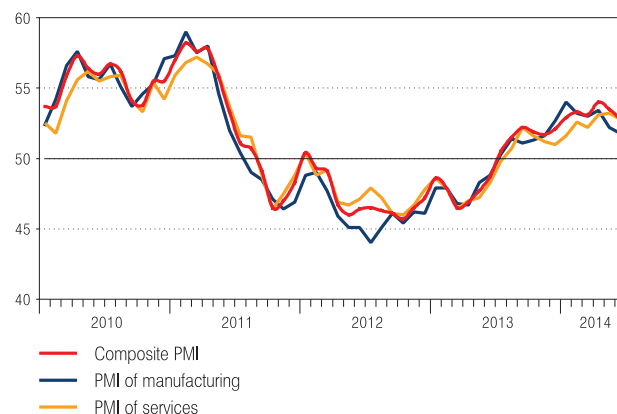
Euro area annual inflation held steady at the 0.5 per cent level reported in the previous month. The annual HICP rose by 0.1 per cent *vis-à-vis* a 0.1 per cent decline in May. The major factors behind maintaining low inflation in June were the lower prices of food and industrial goods (excluding energy products) and the slight rise in the prices of energy and services. Euro area core inflation came to 0.8 per cent on an annual basis compared with 0.7 per cent in May.

In June negative annual inflation was recorded in Greece (-1.5 per cent), Portugal (-0.2 per cent) and Slovakia (-0.1 per cent). Annual inflation was very low in the Netherlands and Italy: 0.3 and 0.2 per cent respectively, and remained unchanged in Spain and Cyprus. Inflation was highest in Austria<sup>3</sup> (1.7 per cent), Luxembourg (1.2 per cent) and Finland (1.1 per cent). In June annual inflation accelerated to 1.0 per cent in Germany, from 0.6 per cent in May, while in France it decelerated to 0.6 per cent, from 0.8 per cent in May.

According to the ECB projections of early June 2014, euro area inflation is estimated at 0.7 per cent for 2014 (previous forecast: 1 per cent) and 1.1 per cent in 2015 (previous forecast: 1.3 per cent). In its spring forecast, the European Commission said euro area inflation is expected to be 0.8 per cent in 2014 (1 per

<sup>3</sup> Preliminary data.

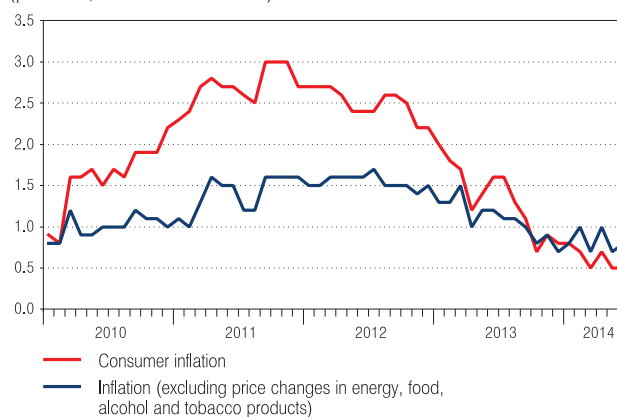
## Manufacturing and Services PMIs



Source: Markit.

## Euro Area Inflation Rate

(per cent, on an annual basis)



Source: Eurostat.

cent in the Commission's Winter Forecast) and 1.2 per cent in 2015 (1.3 per cent in the previous EC report).

Euro area labour market showed some signs of improvement. Data on the first quarter of 2014 show that employment in the euro area increased by 0.2 per cent compared with the decline of 0.4 per cent in the fourth quarter of 2013. This was the first employment growth in the region reported for the last two years.

Unemployment declined slightly to 11.6 per cent in May, from 11.8 per cent in the start of the year. The highest unemployment rate was recorded in Greece<sup>4</sup> (26.8 per cent), Spain (25.1 per cent) and Cyprus (15.3 per cent), but in all three countries this rate declined. Austria and Germany still reported the lowest values at 4.7 and 5.1 per cent, respectively.

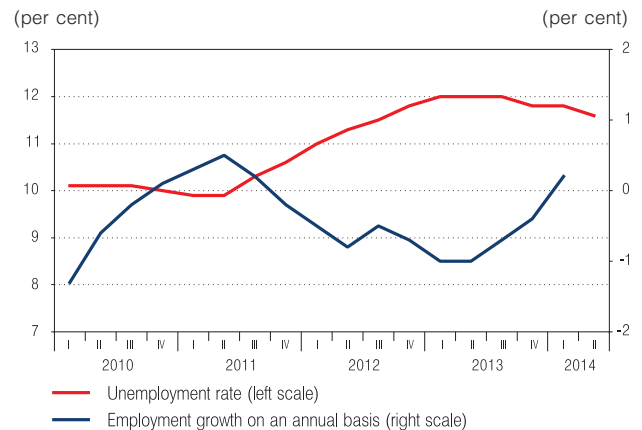
The indicator of the expected unemployment rate in the following twelve months, included in the EC consumer confidence index, showed divergent dynamics in the second quarter and in June it rose to 16.2, from 15.1 in May but was below the April level of 18.4. The sub-index came to 16.6 in the second quarter, from 23.8 in the first one. This fall suggests improved consumer expectations concerning labour market developments.

In the first quarter of 2014 unit labour costs increased by 0.5 per cent on an annual basis (0.7 per cent in the previous quarter). Over the same period compensation *per* employee picked up by 1.3 per cent on an annual basis (against 1.6 per cent) and labour productivity by 0.8 per cent on an annual basis (against 0.9 per cent).

At its meeting of 5 June, the ECB decided to cut the benchmark interest rates in the money market, as follows: the main refinancing rate by -10 basis point to 0.15 per cent, the rate on the marginal lending facility by -35 basis points to 0.40 per cent and that on the deposit facility by -10 basis point to -0.10 per cent. The ECB underlined that the interest rates will remain at these levels for an extended period of time and, if necessary, they will use further monetary stimuli.

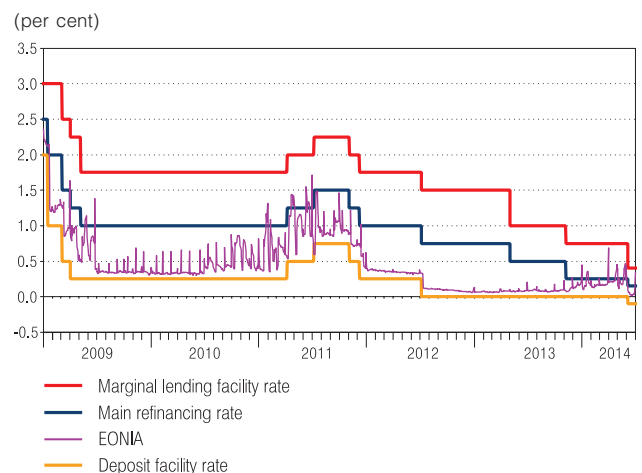
<sup>4</sup> The latest available data refer to March 2014.

## Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

## ECB Interest Rates and the EONIA



Source: ECB.



The ECB clarified that the negative interest rate on the deposit facility will be applied to: (i) banks' average reserve holdings in excess of the minimum reserve requirements; (ii) general government deposits held with the Eurosystem that exceed certain thresholds; (iii) Eurosystem reserve management services accounts if not currently remunerated; (iv) participants' account balances in TARGET2; (v) non-Eurosystem NCB balances (overnight deposits) held in TARGET2; and (vi) other accounts held by third parties with Eurosystem central banks when stipulated that they are not currently remunerated or are remunerated at the deposit facility rate.

Apart from lowering the benchmark interest rates, the ECB adopted an additional monetary stimuli package. The ECB decided that by June 2016 it will conduct a series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector, excluding loans to households for house purchase. In the TLTROs in September and December 2014, the counterparties will be entitled to borrow an amount that cumulatively does not exceed 7 per cent of the total amount of the aforementioned loans to the euro area non-financial private sector outstanding on 30 April 2014. The ECB expects that some EUR 400 billion will be allotted at the first two operations. An option for early repayment of the amounts is provided for 24 months after each TLTRO at a six-monthly frequency.

During the period from March 2015 to June 2016, all counterparties will be able to borrow additional amounts. These additional amounts can cumulatively reach up to three times each bank's net lending provided between 30 April 2014 and the respective allotment reference date in excess of a specified benchmark. Counterparties that have borrowed under the TLTROs in the period from 1 May 2014 to 30 April 2016 and whose net lending is below the benchmark will be required to pay back borrowings in September 2016. All operations will mature in September 2018 and the interest rate is equal to that on the main refinancing operations (MROs) at the time of take-up, plus a spread of 10 basis points.

To enhance the monetary policy transmission to the real economy, the ECB considers also purchasing simple and transparent asset-backed securities (ABS) with underlying assets consisting of claims against the euro area non-financial private sector. To this end, the ECB decided to step up preparations for direct purchases of ABS.

In addition to the above decisions, the full allotment of liquidity on main and three-month refinancing operations will continue at least until December 2016. The interest rate on main refinancing operations was kept fixed and that on three-month refinancing operations will be the average interest rate on main refinancing operations for the period. Furthermore, it was decided to extend the existing eligibility of additional assets as collateral (credit claims) at least until September 2018.

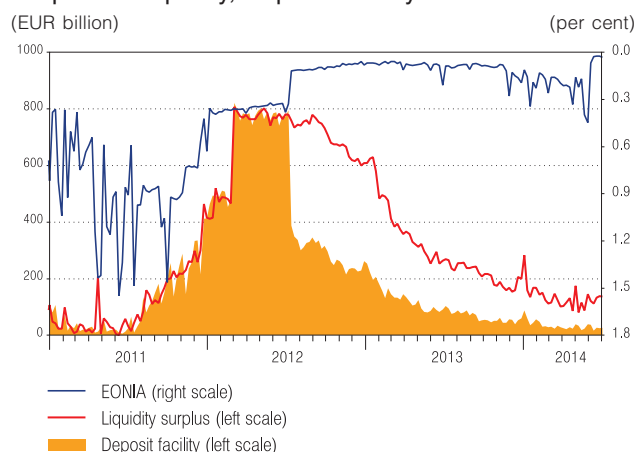
Another decision taken at this meeting was to suspend the weekly fine-tuning operations sterilising the liquidity injected under the Securities Markets Programme (SMP) in order to ensure additional liquidity in the banking system and lower the volatility of EONIA before the conduct of the first TLTRO in September. As at 13 June the outstanding amount under the SMP was EUR 162.7 billion. It was decided also to discontinue the one-month Special-Term Refinancing Operations. The weekly operations for time deposits and the one-month refinancing operations are discontinued as of 10 June 2014.

At its meeting of 3 July, the ECB decided to leave the interest rates unchanged and on further technical details of targeted longer-term refinancing operations (TLTROs).

The EONIA reference overnight interest moved within a broad interval of 0.10 and 0.47 per cent before the June meeting of the ECB Governing Council, and the average quarterly value prior this meeting was 0.25 per cent (compared with 0.17 per cent in the first quarter of 2014). After the monetary policy meeting of the ECB of 5 June, EONIA declined gradually, reaching 0.03 per cent at the end of June.

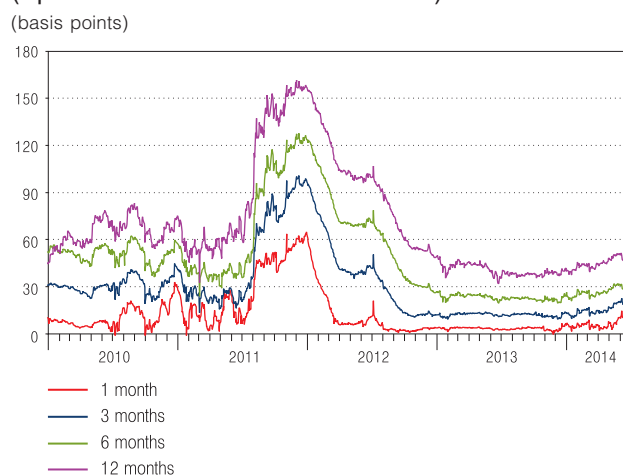
The high EONIA volatility prior to the 5th June meeting of the ECB was due to the sizeable fluctuations in the amount of excess liquidity

## Surplus of Liquidity, Deposit Facility and EONIA



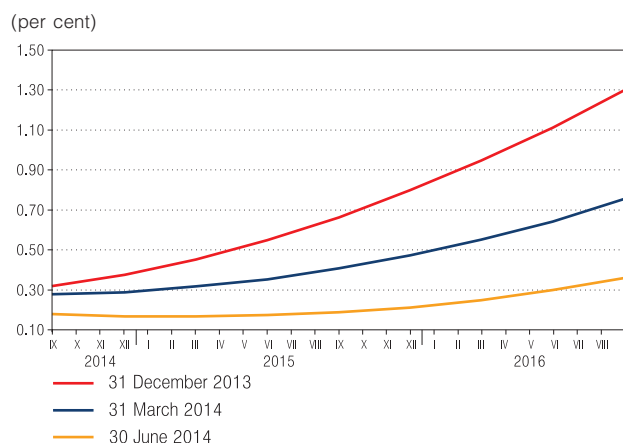
Source: ECB.

## 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.

over the said period (between EUR 70 billion and EUR 179 billion), which signals continued fragmentation in the money market.

EURIBOR interest on interbank market deposits followed an upward dynamics until mid-May, before reverting. On 30 June 2014 one-month interest rates reached 0.10 per cent (-14 basis points on end-March 2014), and those with maturities of six and twelve months came to 0.30 per cent (-12 basis points on end-March) and 0.49 per cent (-10 basis points on end-March) respectively. Credit and liquidity risk premia measured by the spread between EURIBOR and OIS reported different but almost insignificant changes. Risk premia in the three- and six-month segments ended the period at a level of 15 basis points (unchanged on end-March) and 25 basis points (-1 basis point on end-March).

As at 30 June 2014 market expectations derived from the prices of three-month EURIBOR futures contracts pointed to a retention of the reference interest rate at 0.15 per cent until the end of 2015.

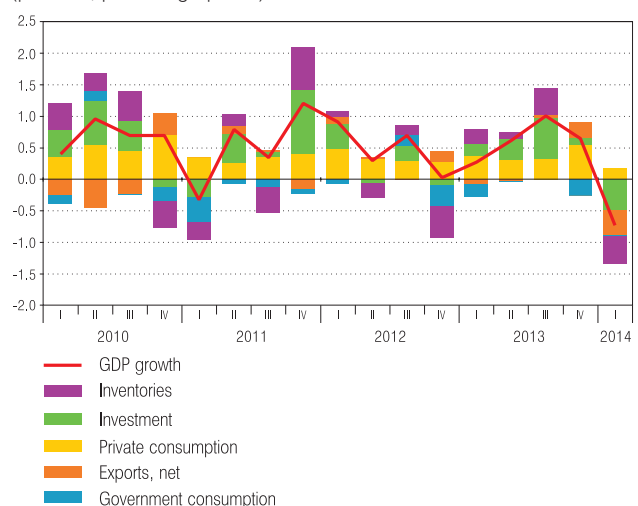
## The United States

In the first quarter of 2014 economic growth in the USA slowed down to 1.5 per cent on an annual basis, from 2.6 per cent in the fourth quarter and 2 per cent in the third quarter of 2013. The first quarter of 2014 saw a quarter-on-quarter decline of 0.7 per cent against an increase of 0.7 per cent in the previous quarter. This was largely due to temporary factors, such as the severe winter which was reflected in the sizeable negative contribution of the change in inventories to quarter-on-quarter GDP growth of 0.42 percentage points. In the first quarter of 2014 net exports, business investment, housing investment and government consumption of individual states and local authorities were also among the components of final consumption with negative contributions. Household consumption and federal government consumption and investment were the only ones to report positive contributions.

In the second quarter of 2014 there were volatile but mainly positive changes in US leading economic activity indicators, which confirmed

## 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.

that the fall in the first quarter will not last long and the economic growth will accelerate in the following quarters.

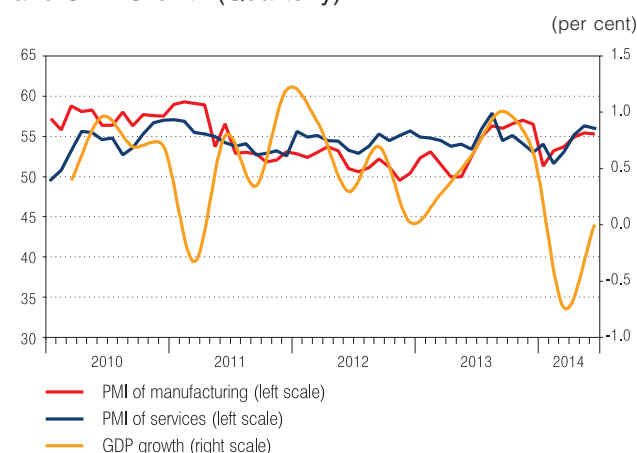
Consumer confidence measured by the University of Michigan consumer confidence index increased from 81.9 percentage points in May to 82.5 percentage points in June but remained below its April level of 84.1 percentage points. Over the second quarter the Conference Board Consumer Confidence Index also displayed a volatile development, increasing significantly in June.

The volatile development of consumer confidence indicators over the second quarter corresponded to the data on the monthly growth rate of consumer expenditure and retail sales in the USA. After the March rise in individual consumer expenditure of 0.8 per cent on a monthly basis, it reported nil growth in April and 0.2 per cent in May. In June retail sales went up 0.2 per cent on a monthly basis against an increase of 0.5 per cent in May. Their annual growth rate slowed down insignificantly to 4.3 per cent in June, from 4.6 per cent in May.

In the first quarter of 2014 manufacturing and services indicators reported mainly upward dynamics. After reaching 54.9 percentage points in April, the ISM-PMI of manufacturing went up to 55.4 percentage points and in June went down slightly to 55.3 percentage points. The ISM-PMI of the services sector reported similar changes in the second quarter. In May it reached 56.3 percentage points compared with 55.2 in the previous month but in June it fell to 56.3 percentage points. Both indicators remained well above the 50 percentage point threshold. Values above this threshold signal an increase in economic activity.

Over the review quarter US housing market recovery was slower compared with that in the other sectors. The S&P/CaseShiller 20-City Composite House Price Index moderated to 10.8 per cent in April, from 12.4 per cent in March and 12.9 per cent in February but remained relatively high. Employment in construction increased further in the second quarter of 2014. In June the National Association of Home Builders (NAHB) index went up to 49 points, from 45 in May and 46 in

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



Source: Institute for Supply Management.

the previous quarter, but remained below the 50 percentage point threshold suggesting that respondent home builders still do not qualify sales conditions as favourable.

The annual inflation rate measured by the personal consumption expenditure deflator (PCE) increased to 1.8 per cent in May, from 1.6 per cent in the previous month. In April the annual growth rate of the core PCE price index (excluding food and energy prices) increased slightly to 1.5 per cent on 1.4 per cent in April.

The consumer price index – the other measure of the US inflation – went up to 2.1 per cent in May, from 2 per cent in April and 1.5 per cent in March. The annual growth rate of the core PCE price index accelerated to 1.9 per cent, from 1.8 per cent in April and 1.6 per cent in March.

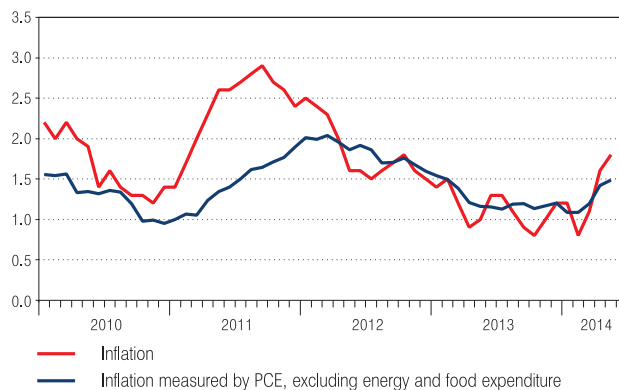
The expectations of consumer price inflation in the period of one to five years, a component of the University of Michigan consumer confidence index, remained relatively stable in the second quarter of 2014. In June 2014 short-term inflation expectations slowed down to 3.1 per cent against 3.3 per cent in May, while long-term inflation expectations increased somewhat to 2.9 per cent against 2.8 per cent in May. In the following two quarters inflation in the USA is expected to remain close to 2 per cent on an annual basis.

The positive dynamics on the US labour market continued in the second quarter of 2014. In June the US unemployment rate dropped by 0.6 percentage points, from 6.7 per cent at the end of the first quarter to 6.1 per cent, the lowest value since September 2008. The number of employed in the US non-agricultural sector rose by 288,000 compared to 224,000 in May and 304,000 in April. Employment growth in this sector accelerated to an average of 272,000 jobs *per* month: up from 190,000 in the first quarter.

At its meeting of 17–18 June, the Federal Open Market Committee (FOMC) decided to continue to cut the monthly asset purchases under the Federal Reserve Third round of quantitative easing (QE3) by another USD 10 billion to USD 35 billion *per* month as of 1 July 2014. After the fifth consecutive reduction, the amount of purchased government bonds will reach USD 20 billion (previous value: USD 25 billion)

### US Inflation Rate (on an Annual Basis)

(per cent)



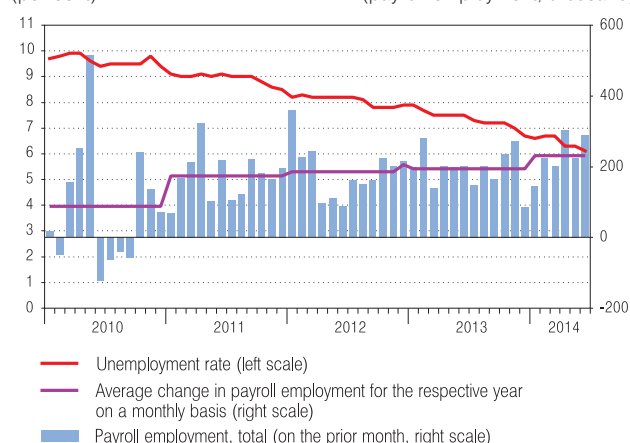
Note: Inflation is measured by the personal consumption expenditure deflator.

Source: Bureau of Labor Statistics.

### US Unemployment Rate and Changes in Payroll Employment

(per cent)

(payroll employment, thousand)



Source: Bureau of Labor Statistics.



and that of purchased mortgage-backed securities was USD 15 billion (previous value: USD 20 billion). The members of the Committee decided also to continue investing the receipts of maturing US government securities of the US Federal Reserve balance sheet again in US government securities, as well as to reinvest the revenue from government-sponsored agencies' unsecured and mortgage bonds available in the US Federal Reserve balance sheet in new mortgage bonds.

The target range for the federal funds rate was kept at 0 to 0.25 per cent. FOMC representatives maintained their position about the additional monetary stimulus. In the statement of the meeting, the forward guidance of March was confirmed according to which the adequacy of the measures would be estimated 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 economic developments in the USA will justify the lower than the 'normal' and long-term rates target range for the federal funds for a 'considerable time' even if the levels of unemployment and inflation rates are consistent with the Federal Reserve's objectives.

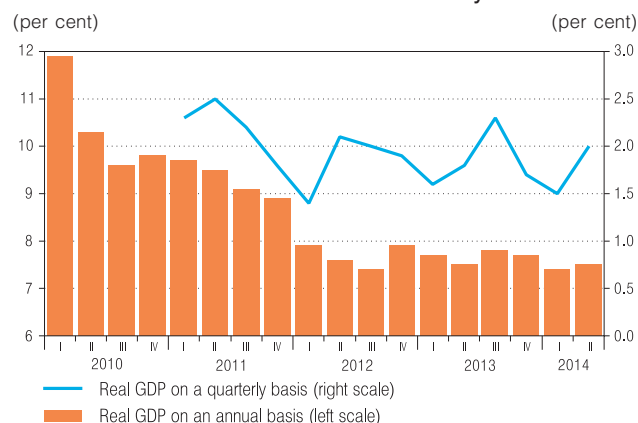
## China

In the second quarter Chinese authorities undertook a series of small but targeted economic stimulus measures to tackle the economic slowdown. At the same time, the initiatives aimed at gradual but urgent reforms in key areas, such as convertibility of the national currency and liberalisation of financial services have continued. In June the minimum reserve requirement ratio was reduced for some financial institutions,<sup>5</sup> crediting the agricultural sector and small and medium-sized enterprises (SMEs). In early April the government announced a package of initiatives, including investment in railway transport and residential property and tax relief for the small businesses.

The World Bank revised downwards its forecast for the Chinese economy in 2014 to 7.6 per

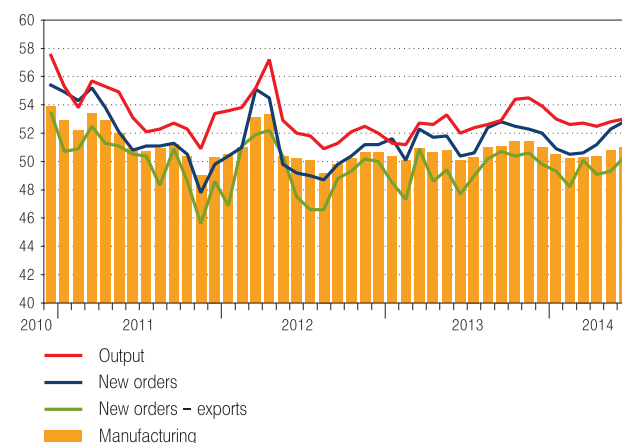
<sup>5</sup> Industrial Bank, Minsheng Bank and Merchants Bank.

## China's GDP on an Annual and Quarterly Basis



Source: National Bureau of Statistics of China.

## Manufacturing, Output and New Orders PMIs



Source: China Federation of Logistics and Purchasing.

cent and claimed that it could slow down to 7.5 per cent in 2015. In June the International Monetary Fund also announced its revised forecast according to which growth in China is expected to come to 7.5 per cent in 2014 and around 7.0 per cent in 2015.

In the first quarter of 2014 year-on-year GDP growth in China slowed to 7.4 per cent – a figure slightly above but close to the expected 7.3 per cent year-on-year growth. In the second quarter year-on-year GDP growth slightly accelerated to 7.5 per cent which was above but close to the expected 7.4 per cent year-on-year growth. The latest figures show stabilisation of the rate of economic growth due to investment, lending and exports. Economic activity dynamics shows that the selective stimulus package of the government gives moderate but sufficient results in order to stop the slowdown observed in the recent quarters and to reach the set target of 7.5 per cent economic growth in 2014. Data point to quarter-on-quarter growth of 2.0 per cent in the second quarter, from 1.4 per cent in the first one.

Manufacturing PMIs tended upwards in the second quarter. In June manufacturing PMI went up to 51.0, from 50.8 in May and 50.4 in April. The developments in individual components show that this was mainly due to new and export orders. The manufacturing output sub-index improved to 53.0, from 52.8 in May.

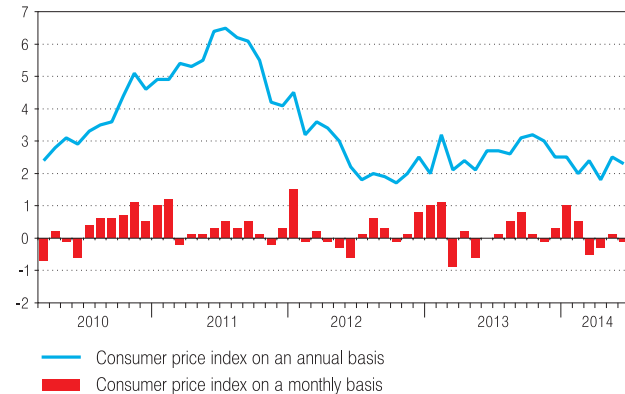
Industrial production rose 9.2 per cent year on year in June, topping the 9 per cent estimate, and 8.8 per cent in May. This was in line with government measures aimed at accelerating infrastructure projects and stabilisation of the exports growth rate.

In May inflation in China went up to 2.5 per cent on an annual basis compared with 1.8 per cent in April and 2.4 per cent in March. Food prices rose 4.1 per cent in May from a year earlier, quickening from April's 2.3 per cent rise. Non-food prices also reported a slight increase on an annual basis, from 1.6 per cent in April to 1.7 per cent in May.

The annual producer price inflation slowed its negative trend and annual producer prices

### Inflation Indices (Rate of Change)

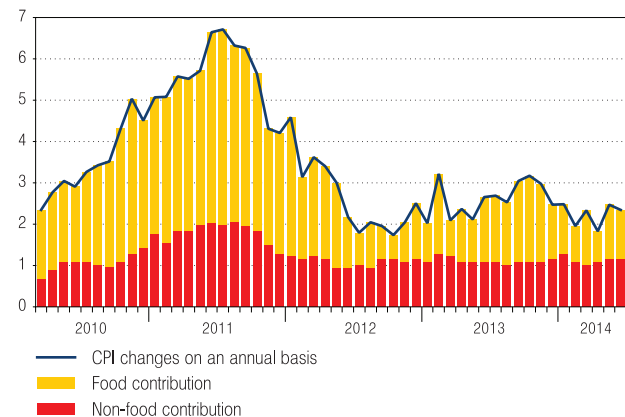
(per cent)



Source: National Bureau of Statistics of China.

### Price Indices (Rate of Change)

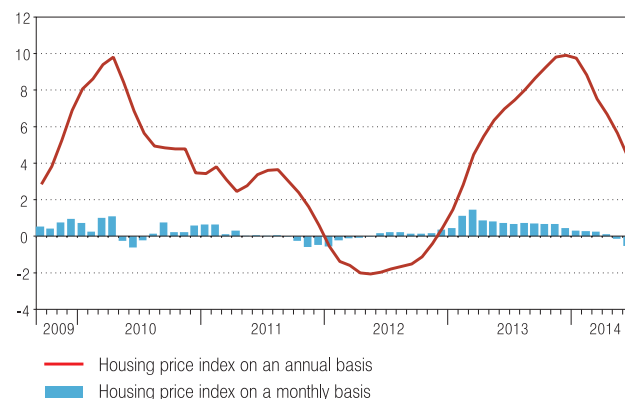
(per cent, on an annual basis)



Source: National Bureau of Statistics of China.

### Housing Price Indices in China (Rate of Change)

(per cent)



Source: National Bureau of Statistics of China.

went down -1.4 per cent on an annual basis compared with -2.0 per cent in April

In June housing price growth rates in China moderated to 4.3 per cent on an annual basis, from 5.6 per cent in May and 6.7 per cent in April. The month-on-month decline in June was -0.5 per cent, from -0.1 per cent in May. These trends reflected the moderately restrictive policy in lending in the first months of the year and the overall level of indebtedness in the economy.

The Chinese National Bank continued to manage more actively liquidity in the interbank market mainly by providing additional liquidity in order to cut interbank interest rates in the second quarter of 2014. The growth rate of M2 monetary aggregate accelerated to 14.7 per cent on an annual basis in June, from 13.4 per cent in May and 13.2 per cent in April. Despite the great volatility of credit data on a monthly basis, the trend reveals primarily a gradual increase in bank lending in the period April–May 2014. In June this trend was reversed, with non-bank lending outstripping bank lending.

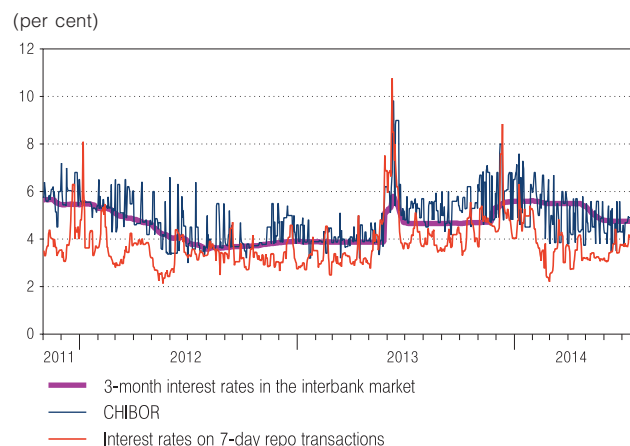
In April and May the central bank of China cut further the exchange rate of domestic currency against the US dollar, thereby providing a partial stimulus to boost exports. In June the renminbi exchange rate started to appreciate against the dollar.

In the second quarter China's trade surplus stabilised at USD 31.6 billion in June, after increasing of USD 35.9 billion in May (USD 18.5 billion in April). Imports and exports increased despite the sizeable annual base effect of the trade with Hong Kong in 2013 (the so-called 'fake invoices'<sup>6</sup>). Exports reported year-on-year growth of 7.1 per cent in June, following the 7.0 per cent year-on-year growth in May and the slight growth of 0.9 per cent in April. Trade with Europe, the USA and the ASEAN countries contributed most to this growth despite the Hong Kong base effect.

Imports rose 5.6 per cent on an annual basis, after the May decline of -1.6 per cent and the April increase of 0.8 per cent.

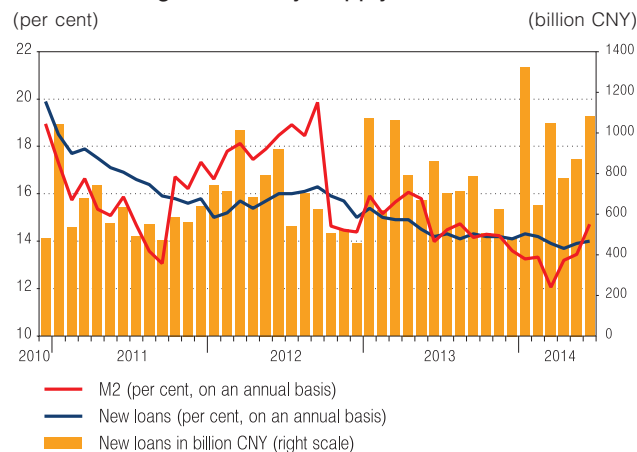
<sup>6</sup> A scheme to circumvent the restrictions on cross-border capital flows, which provides for arbitrage between global and local interest rates.

## Interbank Market Interest Rates



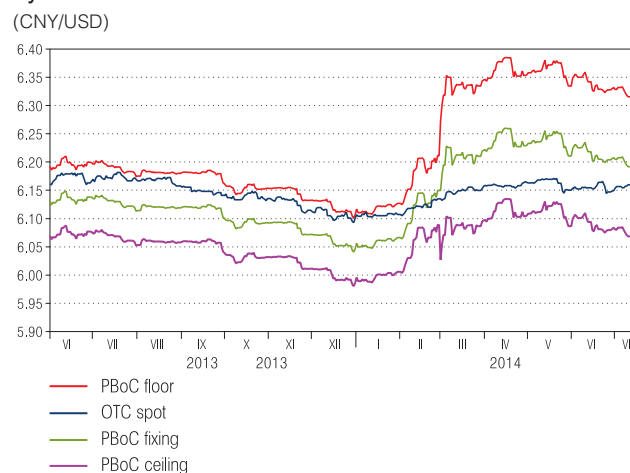
Source: People's Bank of China.

## Bank Lending and Money Supply



Source: People's Bank of China.

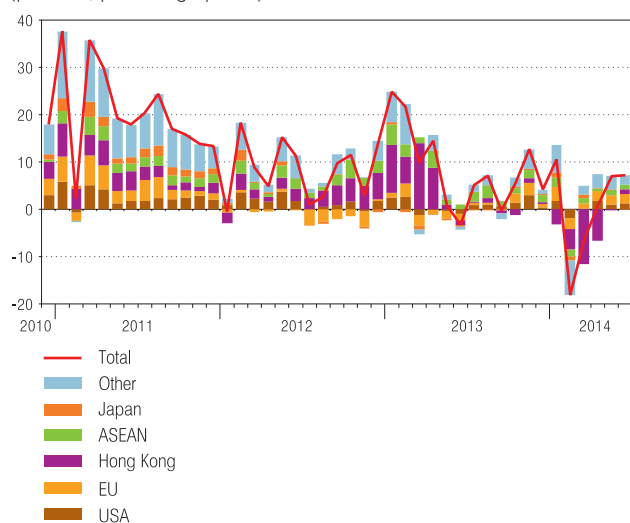
## Renminbi Exchange Rate and Trading Band Set by the Chinese Central Bank



Source: People's Bank of China.

## Export Growth Rate and Contributions of Individual Countries

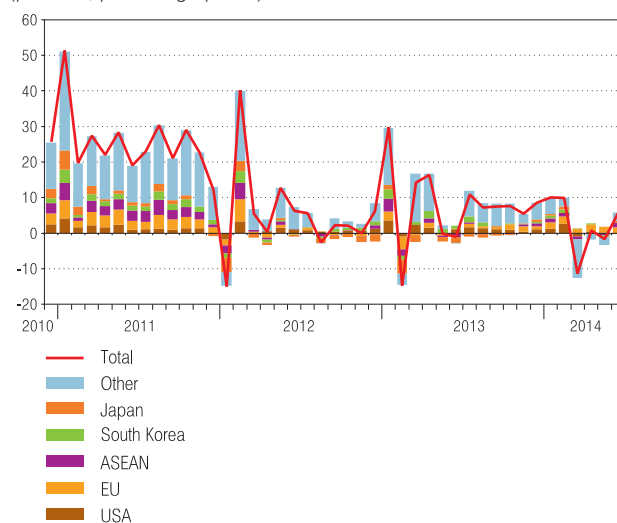
(per cent; percentage points)



Source: National Bureau of Statistics of China.

## Import Growth Rate and Contributions of Individual Countries

(per cent; percentage points)



Source: National Bureau of Statistics of China.

## International Commodity Prices

### Crude Oil

In April 2014 Brent crude oil prices continued to fluctuate around USD 108 *per barrel*, a trend observed since early 2014. A more sizeable rise in oil prices was observed since May 2014 and by end-June it was traded at around USD 112.3 *per barrel* (EUR 82.1 *per barrel*). The oil price increase reflected mainly concerns about possible oil supply losses related to the conflicts in Iraq, Libya and Ukraine. On an annual basis, USD crude oil prices picked up 6.6 per cent over the second quarter of 2014, while the increase in crude oil prices in euro was less pronounced (1.6 per cent) reflecting mainly the 4.9 per cent appreciation of the euro against the US dollar.

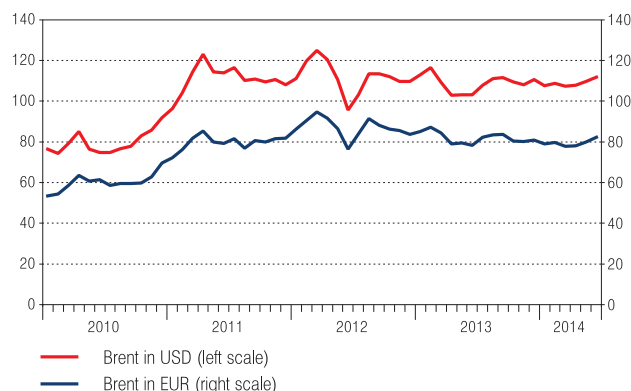
According to the International Energy Agency (IEA) forecast of July 2014, global demand for crude oil is expected to rise on an annual basis in the third and fourth quarters of 2014, but will not exceed the growth in supply, which will be driven mainly by non-OPEC countries. The IEA takes into account that the fall in Libyan oil production was offset by the raised oil production in Saudi Arabia, but if the conflict in Iraq, the second largest OPEC oil producer, intensifies, this will have a strong impact on oil prices.

However, market expectations seen through futures prices point to a decrease in the Brent

### Crude Oil Prices

(USD *per barrel*)

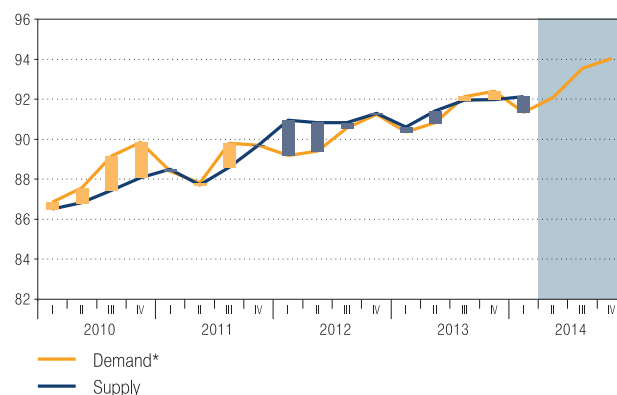
(EUR *per barrel*)



Source: World Bank.

### World Crude Oil Supply and Demand (Quarterly)

(million barrels *per day*)



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

Source: IEA.

crude oil price over the third and fourth quarters of 2014. In June Brent crude oil futures prices for the following 12 months were within the range of USD 100–110 *per barrel*: higher than projected in March, probably due to concerns about the oil supplies from Iraq and Libya.

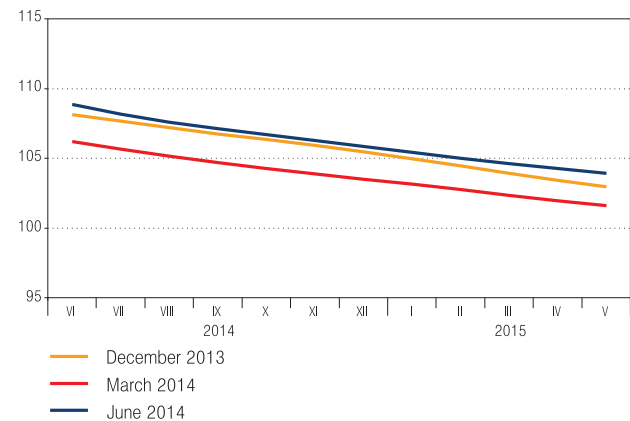
### Major Raw Material and Food Prices

In the second quarter of 2014 international euro prices of most commodity groups continued to decline. The price index for metals published by the ECB showed that the price in euro went down 9.6 per cent in the April–June period and that in US dollars by 5.1 per cent. Copper prices in both US dollars and euro decreased, with that in euro falling 9.5 per cent on an annual basis. These developments were mainly driven by the expectations of economic growth slowdown in China where around 40 per cent of world copper production is consumed. The overall index in euro of non-ferrous metal prices went down 3.8 per cent on an annual basis between April and June 2014. The price of nickel reported the most sizeable increase on an annual basis, due to the banned exports from Indonesia which is the largest producer of this raw material, as well as the closure of production capacities in New Caledonia. The threat of sanctions against Russia, the second largest producer of nickel in the world, posed further upward price pressures. The price of iron in euro fell on an annual basis due to the weaker demand from China and the increased supply of this raw material.

Market expectations for metal prices in euro point to a moderate decline on an annual basis in the third quarter and stabilisation in the fourth quarter of 2014. The weak demand from China and the high global supply will be the main factors behind this dynamics in the third quarter. The price may be pushed up by enhanced economic activity in China and uncertainty surrounding supplies of metals by large exporters, such as Russia and Indonesia. Risks of a possible decrease in prices reflect the insufficient demand against the backdrop of continuous moderation of China's economic growth.

### Brent Crude Oil Futures Prices

(average monthly price of contract, USD *per barrel*)



Source: JP Morgan.



In the April to June 2014 period, the overall food price index went up 3.8 per cent in US dollars, while the price in euro reported a slight decline. Price dynamics varied significantly across individual groups. Meat and beverages reported the most sizeable increase. The price of meat went up largely due to the contagious pig disease in the USA, which according to IMF data<sup>7</sup> crushed around 10 per cent of the pigs. The prices of coffee and oranges also went up due to the drought in Brazil. Between April and June 2014 the price of cereals and wheat fell on an annual basis, after rising somewhat in the first quarter of 2014. This is due to the expectations of good harvest and high stocks of these goods.<sup>8</sup>

Our expectations for the third and fourth quarters of 2014 point to a rise in the harmonised index of food prices, with divergent dynamics across individual groups of goods. The main risk to the projection relates to the weather conditions, but currently the agricultural season is well under way and it seems there are no serious risks to the harvest.

If market expectations for 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.

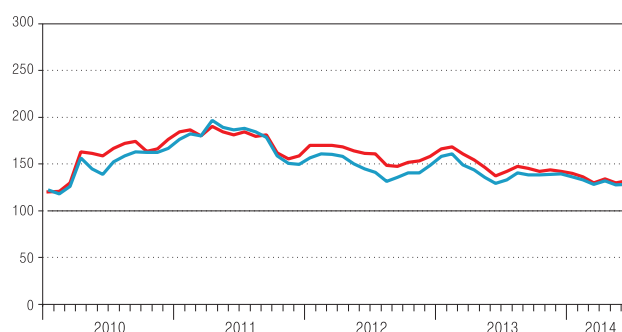
<sup>7</sup> IMF: Commodity Market Monthly, 11 June 2014.

<sup>8</sup> FAO: Food Outlook, May 2014.

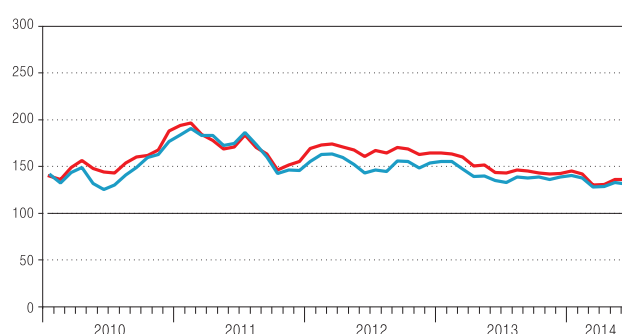
## Price Indices of Major Raw Material and Commodity Groups

(2009 = 100)

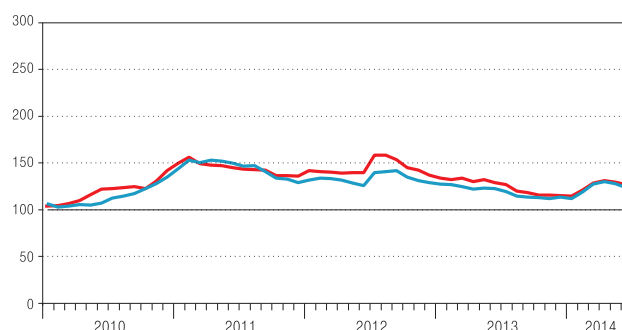
### Metals



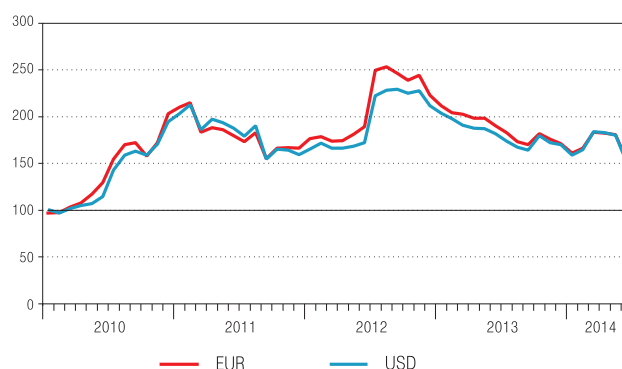
### Copper



### Food



### Wheat



Sources: ECB and BNB calculations.

## 2. Financial Flows, Money and Credit

Between January and May 2014 foreign trade balance flow dynamics was mainly driven by international price declines and domestic demand growth. These factors contributed to the increase in the trade balance deficit and an annual decline in the BOP current and capital account surplus. If the slowdown in the decline rates of international euro prices materialises during the second half of 2014 and the external demand strengthens, a slow recovery may be expected in the nominal export growth. In case the import growth rate, reflecting domestic demand dynamics, also accelerates, a lower year-on-year positive balance is expected on the current and capital account over the third and fourth quarters.

Financial account flow developments reflected mainly the lower outflows of banks. Between January and May banks used a significant portion of their liquidity to increase foreign assets, to invest in Bulgarian government securities, to boost claims on the non-government sector and to cut, though to a lesser extent, their foreign liabilities. By the end of June foreign bank assets declined compared to May and government securities increased. Attracted funds in the banking system continued to grow at high rates, reflecting the still high savings rate in the economy.

A baseline scenario shows that the growth rates of currency in circulation and broad money are expected to gradually slow down during the third and fourth quarters of 2014.

According to balance of payments data, the annual fall in Bulgaria's international reserves was EUR 797.5 million in May 2014 (excluding valuation adjustments and price revaluation) and was due to the financial flows resulting from the interaction between external and domestic economic factors.

The market value of international reserves<sup>9</sup> (assets on the Issue Department balance sheet) declined by EUR 267.8 million coming to EUR 14.3 billion (BGN 28.0 billion) at the end of June 2014. The difference between the change in reserves in the Issue Department balance sheet and that in the balance of payments is due to methodological reasons.

The annual change in the balance sheet value of the Issue Department as of June 2014 was influenced mainly by the changes on the liability side of the balance sheet (monetary liabilities of the BNB).<sup>10</sup> These changes reflected mainly the reduction in BNB liabilities to the govern-

### External Cash Flows in Foreign Currency

(EUR million)

External flows	2013	I quarter 2013	I quarter 2014
<b>Total for the period</b>	<b>-429</b>	<b>-1 249</b>	<b>-530</b>
<b>Purchases and sales of euro</b>	<b>-1 429</b>	<b>-870</b>	<b>-1 096</b>
at tills	-21	-5	-4
banks, incl.	-1 408	-865	-1 092
purchases from banks	35 169	7 309	6 453
sales to banks	-36 577	-8 174	-7 545
<b>Flows on accounts of banks, the MF, etc.</b>	<b>1 000</b>	<b>-379</b>	<b>566</b>
Minimum required reserves	-92	164	-17
Government and other depositors	1 091	-542	583

Note: The table shows only foreign currency inflows and outflows in 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 lead to changes in gross international reserves.

Source: BNB.

<sup>9</sup> The market value of international reserves includes changes stemming from transactions, valuation adjustments and price revaluation.

<sup>10</sup> 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.

ment and budget organisations and the fall in bank deposits. Obligations to banks decreased as a result of the fall in excess reserves on their minimum required reserve accounts and reduced bank funds in the payment system TARGET2-BNB.<sup>11</sup> The decrease in deposits of the government and budget organisations for the June 2013–June 2014 period was largely due to the increase in the budget deficit and its financing through deposits which are part of the fiscal reserve.

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. As regards foreign currency trading between the BNB and banks, the BNB foreign currency sales continued to outstrip foreign currency purchases, a trend observed in 2013. The negative balance of BNB foreign currency trading with banks was partially offset by the positive balance in BNB sales and purchases with budget organisations.

In May 2014 the international reserves coverage of the average nominal imports of goods and non-factor services came to 5.9 months for the last twelve months.

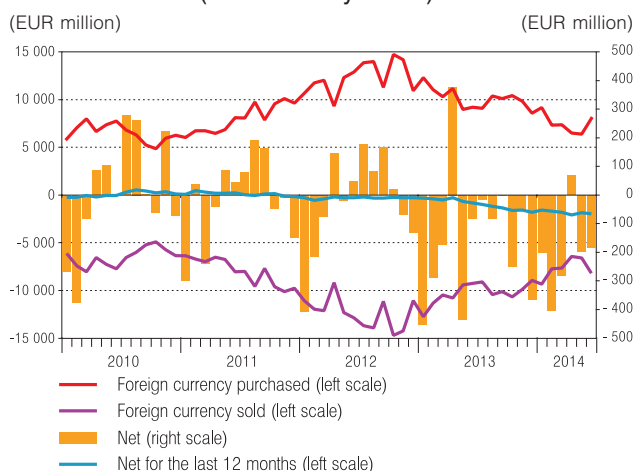
We expect that in the third and fourth quarters of 2014 international reserves will increase on an annual basis mainly due to the government debt issue in international capital markets to ensure financial resources to meet the payments on global bonds maturing in 2015. The receipts of this issue increased the government deposit with the BNB in early July.<sup>12</sup> On the other hand, the possibility for a higher consolidated government budget deficit for 2014 and the placement of the Corporate Commercial Bank AD under conservatorship on 20 June<sup>13</sup> entail risks of a decrease in the government deposit with the BNB.

<sup>11</sup> The national system component of the Trans-European Automated Real-time Gross settlement Express Transfer system for the euro (TARGET2).

<sup>12</sup> The projection has been made on the basis of a technical assumption that the gold price and the price of assets in securities will remain unchanged, and provided that banks will retain their excess reserves and their funds in the TARGET2-BNB payment system at current levels.

<sup>13</sup> See the BNB press release of 20 June 2014.

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



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.

## External Financial Flows

In early 2014 the downward trend in the annual growth of nominal exports of goods which started in the last months of 2013 deepened further, with exports falling on an annual basis between January and May. This reflects mainly the declining international commodity prices, while the decrease in real terms was minimal. International prices subdued also the change in nominal imports of goods over the first five months of 2014. However, imports remained broadly unchanged since international price declines were compensated by the increased physical volumes under the influence of the rising domestic demand.<sup>14</sup> In May goods trade dynamics led to an increase in the trade deficit for both the fifth months of 2014 and on an annual basis. The latter, in turn, was the major factor for a certain annual decline in the BOP current and capital account surplus compared to the end of 2013.

Between January and May 2014 services trade balance improved slightly on the corresponding period of the previous year under the simultaneous effect of rising services exports and a slight fall in services imports. The increase in services exports was driven by the expanded exports of transport and tourist services, while services imports dropped due to the fall in imported transport and other services.

In the first five months of 2014 income account deficit shrank essentially compared with the same period of 2013. Decreased outflow payments on the investment income contributed most significantly to this, while flows on the credit side of this item remained broadly unchanged. The fall in investment income repayments was primarily due to the lower outflows on the *Direct Investment* and *Other Investment* sub-items.<sup>15</sup> Such dynamics corresponds to the lower gross operating surplus in 2013 *vis-à-vis* 2012 and lower dividends, distributed profit and interest paid to foreign investors, respectively.

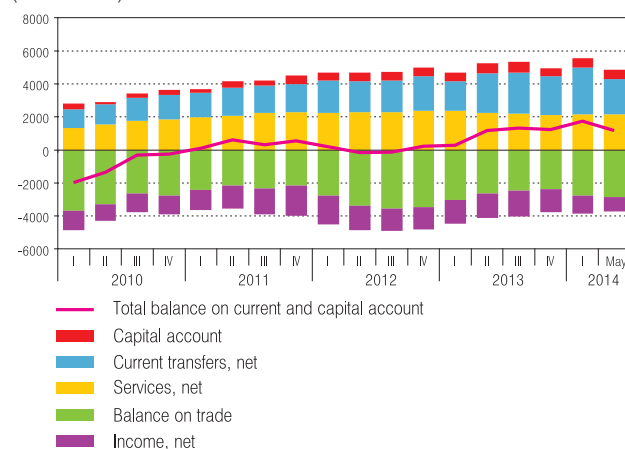
The positive balance of net current transfers declined in the January–May 2014 period

<sup>14</sup> For a more detailed analysis of exports and imports of goods, see Chapter 3.

<sup>15</sup> Preliminary data, subject to revision.

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

(EUR million)



Source: BNB.

## Flows on Balance of Payments Accounts

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

	January – May 2013	January – May 2014
<b>Current account</b>	<b>-80.5</b>	<b>-232.2</b>
Trade balance	-929.9	-1 402.3
Services balance	227.0	280.1
Income account	-559.3	-45.2
Current transfers, net	1 181.6	935.3
<b>Capital account</b>	<b>106.1</b>	<b>197.4</b>
<b>Financial account</b>	<b>-882.2</b>	<b>-480.5</b>
FDI in Bulgaria	456.9	302.6
<b>Changes in reserves</b>	<b>-479.0</b>	<b>-677.3</b>

Source: BNB.

compared to the same period of the previous year mainly due to the lower current transfers to the general government sector other than EU grants. The remaining items under net current transfers remained close to their values of the first five months of 2013.

If the expected slowdown in the decline rates of international prices in euro materialises over the second half of 2014 and the external demand strengthens, a slow recovery may be expected in the nominal export growth. Provided the growth rate of imports driven by domestic demand dynamics also accelerates, in the third and fourth quarters the surplus on the current and capital account is expected to decrease on an annual basis compared with the first quarter. Risks to the projection stem from a slower recovery of export dynamics in the second half of the year which could deepen the worsening of trade balance and the overall current and capital account balance. At the same time, a possible weak domestic demand dynamics could dampen the trade balance growth and correspondingly improve the overall current and capital account balance.

In the first five months of 2014 more moderate developments were observed in BOP financial account flows compared with the January to May 2013 period. They reflect the lack of significant external debt operations like those in early 2013<sup>16</sup> and weaker outflows of banks.

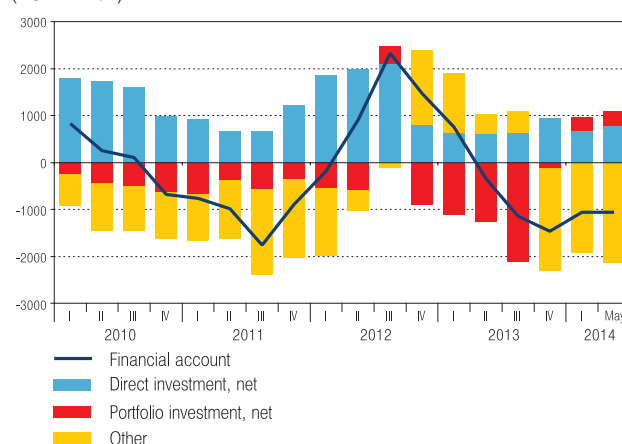
Preliminary data show that FDI inflows for the first five months of 2014 declined from the corresponding period of 2013.<sup>17</sup> This decline was entirely due to lower flows on the *Equity capital* sub-item, reflecting also one-off effects such as acquisition of non-residents' ownership by domestic economic agents. In the first five months of 2014 FDI into Bulgaria stood at a slightly higher level than in 2013. Over the second half of 2014 no essential change is expected in the level of FDI compared to the previous year.

<sup>16</sup> For more details on payments on 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.

<sup>17</sup> Preliminary data, subject to revision.

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

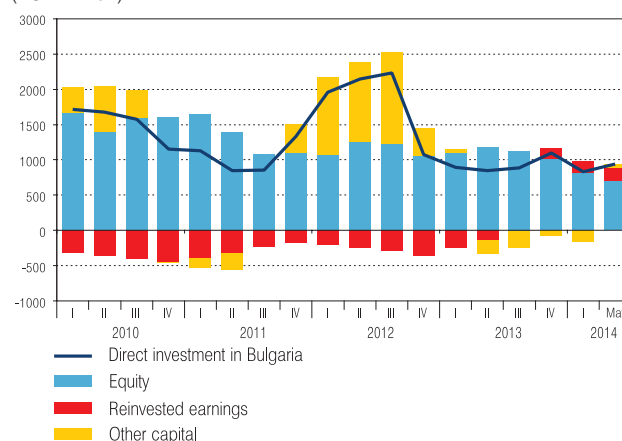
(EUR million)



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)

	January – May 2013	January – May 2014
<b>Net direct investment</b>	<b>54.5</b>	<b>98.3</b>
abroad	-0.4	0.0
in Bulgaria	54.9	98.3
<b>Net portfolio investment</b>	<b>-198.1</b>	<b>-37.1</b>
assets	-230.2	8.3
liabilities	32.2	-45.4
<b>Other investment</b>	<b>-908.4</b>	<b>-744.3</b>
assets	-576.2	-521.8
liabilities	-332.2	-222.5
<i>Portfolio and other investment</i>	<i>-1 106.5</i>	<i>-781.4</i>
<b>Total</b>	<b>-1 052.0</b>	<b>-683.1</b>

Source: BNB.



BOP data show that banks continued to increase their foreign assets and decrease foreign liabilities for the January–May period. This trend, however, was less pronounced compared with the same period of 2013, and the respective outflows were smaller. A possible reason for this is the pursuit of alternatives to place bank resources in the domestic market.

In May 2014 Bulgaria's external debt posted an increase on the end of 2013, reflecting higher obligations of *Other sectors* and the debt component of FDI in terms of intercompany loans. The maturity breakdown shows growth in the long-term external debt and a minimal drop in the short-term debt.

The increased external debt of *Other sectors* over the first quarter was mainly due to higher loans of the *manufacturing* sector (EUR 198.9 million), followed by the obligations of the sectors *real estate operations, lessors activities and business services* (EUR 88.7 million) and *trade, repair of motor vehicles and motorcycles, personal belongings and household goods* (EUR 29.3 million).

Since early 2014 there have been no signs of essential changes in the conditions for access of residents to new external financing and external debt service by domestic economic agents. Variations in the statistics of declared new loans and external debt service remained within customary limits. Hence, it could be said that favourable conditions for financing and external debt service were sustained in the first months of 2014.

## Monetary and Credit Aggregates

Over the first five months of 2014 reserve money continued to decline on an annual basis, driven by the decrease in bank deposits with the BNB. This decline reflected primarily lower funds available on bank accounts in TARGET2-BNB, a trend emerged in the second quarter of 2013, and to a lesser extent, the decreased excess reserves of banks<sup>18</sup>. Concurrently, bank funds allocated to meet minimum reserve

<sup>18</sup> In May excess reserves on banks' minimum reserve accounts with the BNB over the required minimum under Ordinance No 21 came to 2.6 per cent on an average daily basis (6.8 per cent in May 2013).

## Gross External Debt in May 2014

(EUR million)

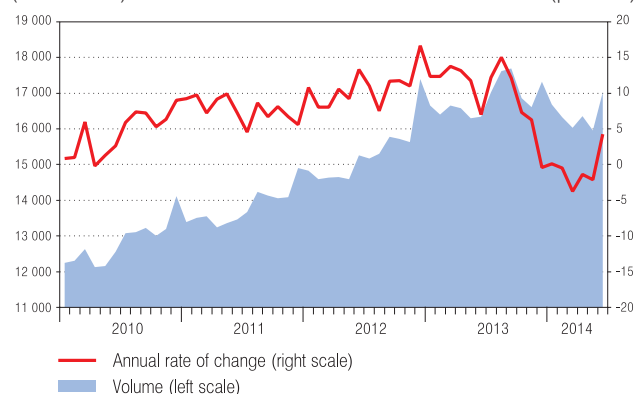
	Amount	Change	
		December 2013	Last 12 months
General government	3 311.4	-20.3	62.1
Central bank	0.0	0.0	0.0
Banks	5 678.0	-79.5	-501.0
Other sectors	12 683.9	307.4	457.5
FDI: Intercompany loans	16 270.7	397.5	129.3
<b>Total</b>	<b>37 944.0</b>	<b>605.1</b>	<b>147.9</b>

Source: BNB.

## Reserve Money

(BGN million)

(per cent)



Source: BNB.

requirements continued to increase due to the rise in the deposit base.

At the close of June a significant increase in currency in circulation and to a lesser extent in bank deposits with the BNB was observed.<sup>19</sup> As a result, reserve money grew by 4.2 per cent on an annual basis. Reflecting the developments and structure of attracted funds in the banking system, the effective implicit rate of minimum required reserves reached 8.99 per cent<sup>20</sup> in June, with bank reserves with the BNB comprising 7.89 percentage points, while the remaining 1.11 percentage points were in the form of cash and funds on banks' settlement accounts in the TARGET2-BNB system.<sup>21</sup>

Money multiplier reflects the interrelation between reserve money dynamics and money stock in the economy. The decreased excess reserves and balances of banks on their settlement accounts in TARGET2-BNB in the context of persistently high attracted funds in the banking system contributed to the growth of the money multiplier to 4.1 on average in the first half year (against 3.8 in the same period of 2013).

Broad money experienced a gradual downward trend, with their annual growth reaching 8.7 per cent in May. Overnight deposits and those redeemable at notice of up to three months again had the strongest contribution to the broad money dynamics, while deposits with an agreed maturity of up to two years retained their negative contribution. At the same, the review period was marked by a moderate decrease in the positive contributions of the former components and a drop in the negative contribution of the latter. These developments were driven by both the considerable growth in deposits with non-taxable interest over 2013 and the 2 percentage point reduction of the tax of interest rates on time deposits to 8 per

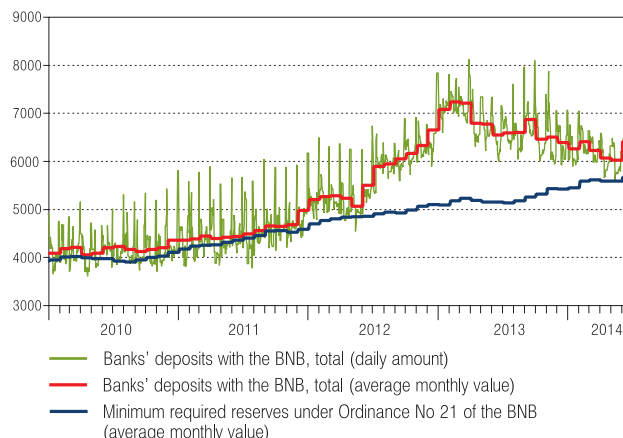
<sup>19</sup> The conservatorship imposed upon Corporate Commercial Bank on 20 June and subsequent attempts to destabilise the banking system, which were promptly neutralised, led to changes in money and credit aggregates developments in June compared to the first five months of the year. These changes are presented in the analysis.

<sup>20</sup> According to Article 3, paragraph 1 of BNB Ordinance No 21, the rate of minimum required reserves for funds attracted from residents is 10 per cent of the deposit base, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

<sup>21</sup> See Article 4 of Ordinance No 21 of the BNB.

## Bank Deposits with the BNB

(BGN million)

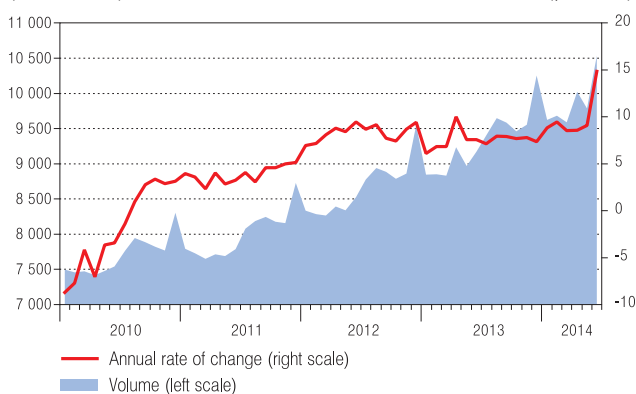


Source: BNB.

## Currency in Circulation

(BGN million)

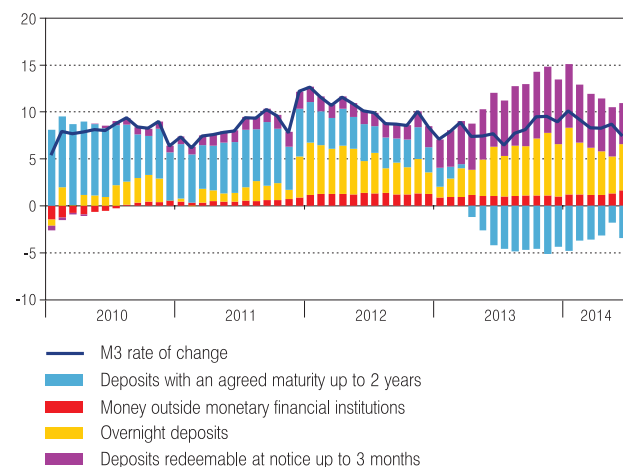
(per cent)



Source: BNB.

## Annual M3 Growth Rate and Contribution of Individual Components

(per cent; percentage points)



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

Source: BNB.

cent since early 2014. Another factor behind the changes in the composition of deposits was the slight cuts in interest rates on bank deposits not subject to taxation since the beginning of the year. By end-June the annual growth rate of broad money slowed down to 7.4 per cent, with a temporary increase in the contribution of overnight deposits and an enhanced negative contribution of deposits with an agreed maturity of up to two years.

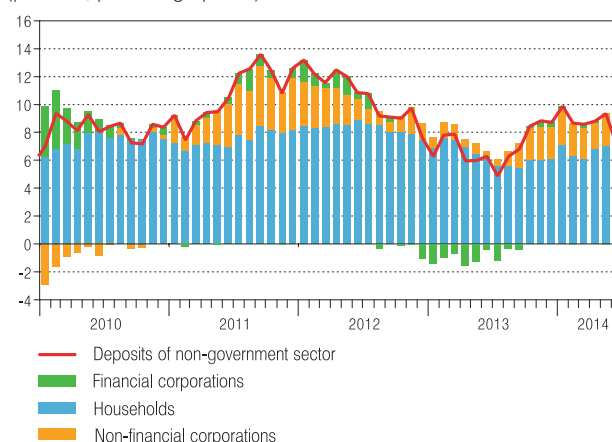
In the first five months of 2014 non-government sector's deposits attracted by banks continued to rise at high rates, with their annual growth coming to 9.3 per cent in May.<sup>22</sup> Household deposits continued to contribute most strongly to this growth but their upward dynamics from the third quarter of 2013 to May 2014 was mainly driven by the growth of non-financial corporations' deposits. In June the annual growth rate of non-government sector's deposits decelerated to 7.2 per cent, with declines registered in both household deposits and non-financial corporations' deposits. In terms of the currency composition, lev-denominated deposits continued to have a greater contribution to the overall deposit growth. However, a temporary drop in these deposits was recorded in June. The contribution of foreign currency deposits (primarily euro-denominated) retained their upward trend of the second half of 2013, with 43 per cent of all deposits in the Bulgarian banking system denominated in foreign currency by end-June.

The structural change in the type and maturity of household deposits, which started in the fourth quarter of 2012 after the introduction of the new tax on time deposit interest, continued in the first half of 2014. Growth rates of overnight deposits and non-taxable deposits redeemable at notice of up to three months remained comparatively high, unlike those with an agreed maturity which continued to decline. At the same time, the gradual slow-down in the annual growth rates of these two types of deposits which began at the end of 2013 continued in the first six months of 2014. Changes in the structure of household deposits

<sup>22</sup> This analysis is based on annual changes in the balances according to the analytical reporting of other monetary financial institutions.

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

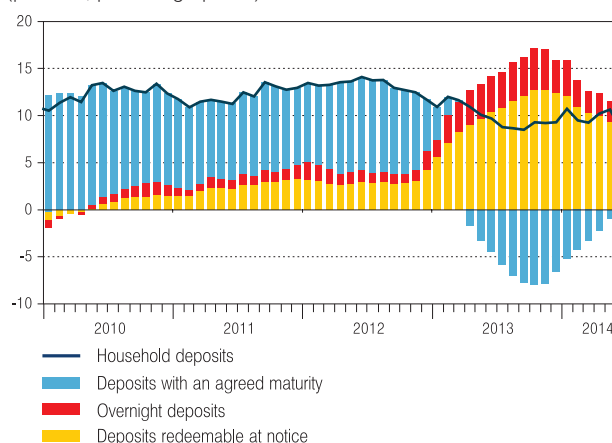
(per cent; percentage points)



Source: BNB.

### Annual Growth of Household Deposits and Contributions by Type of Deposit

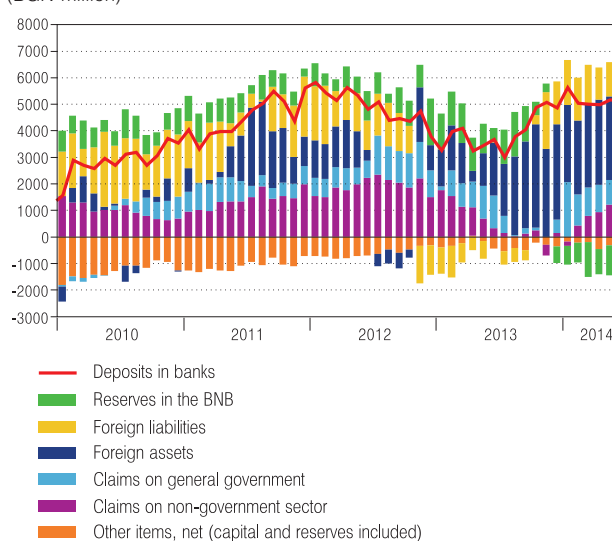
(per cent; percentage points)



Source: BNB.

### Changes in Bank Balance Sheet Items (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.

are expected to continue in the second half of 2014, with effects of this restructuring subsiding moderately.

The retained high household savings rate continued to boost attracted funds in the banking system, contributing to the maintenance of the high bank liquidity. Between January and May banks used a significant portion of their liquidity to increase foreign assets, to invest in Bulgarian government securities, to boost claims on the non-government sector and to cut, though to a lesser extent, their foreign liabilities. As a result, net foreign assets of banks reached BGN 3.1 billion in May. By the end of June foreign assets declined and Bulgarian government securities in their portfolios increased compared to May.

After recording negative values in January, the annual growth of claims on the non-government sector began to accelerate from February to reach 2.4 per cent in June (up BGN 1.4 billion, including net purchases of loans in the amount of BGN 214 million).<sup>23</sup> Following the significant decline throughout 2013, the annual growth rate of claims on non-financial corporations has followed an upward trend since February 2014 to reach 3.3 per cent in June. Over the first quarter operations in real property and industry had the major positive contributions to the overall annual growth of loans to corporations. More essential negative contributions were reported by energy<sup>24</sup> and professional activities<sup>25</sup>.

The volume of new loans<sup>26</sup> to non-financial corporations extended in the review period remained high with a slight upward tendency, reaching BGN 8.1 billion for the first six months. Most of them were extended with a maturity of over five years, with their average monthly volume between July 2013 and June 2014 accounting for 47.1 per

<sup>23</sup> Based on Banking Supervision Department data, domestic banks had the major contribution to the accelerated growth of credit to corporations and retail exposures as of 31 March 2014 *vis-à-vis* December 2013. The insignificant mismatches in credit dynamics data according to monetary and supervisory statistics are due to methodological differences in defining the scope of credit portfolio for statistical and supervisory purposes.

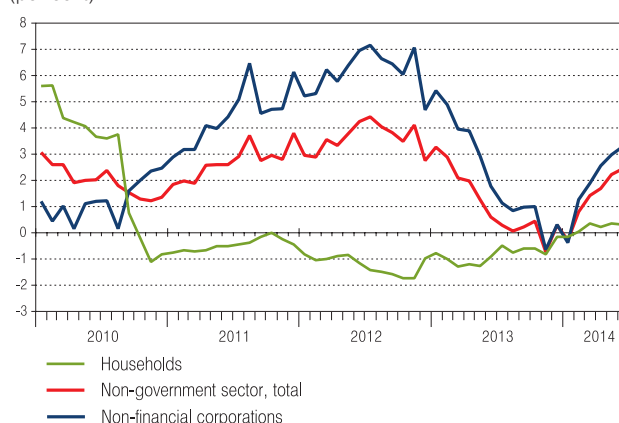
<sup>24</sup> Production and distribution of electricity, heating and gaseous fuels.

<sup>25</sup> 'Professional, scientific and technical activities.'

<sup>26</sup> The terms 'new' and 'newly extended' hereinafter referred to as the statistical category 'new business'.

### Claims on Non-government Sector (growth on an annual basis)

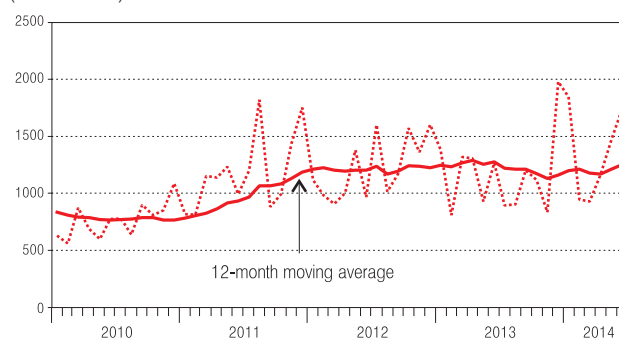
(per cent)



Source: BNB (monetary statistics: money survey).

### New Loans to Non-financial Corporations (Monthly Volumes)

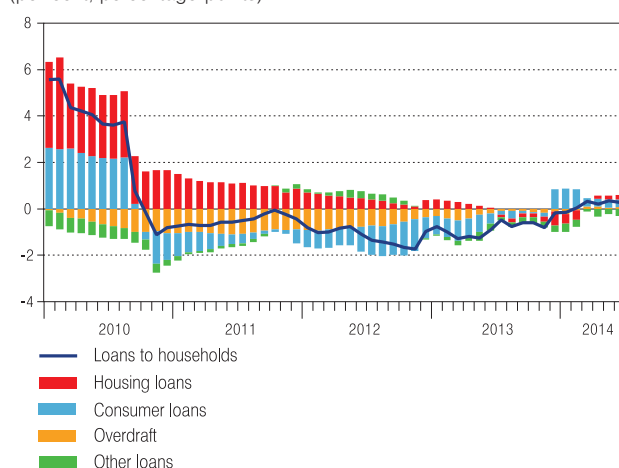
(BGN million)



Source: BNB.

### Growth of Loans to Households and Contribution by Type of Loans

(per cent; percentage points)



Source: BNB.

cent of all new loans compared to 45.0 per cent a year earlier. At the same time, since early 2014 a gradual decrease in the share of loans with a maturity of over five years has been observed unlike the increased share of loans with maturities from one to five years.

From the end of 2013 the first signs of stabilisation were reported in household lending. In June the amount of household loans exhibited growth of 0.3 per cent on an annual basis (against a decline of 0.9 per cent in the same month of the previous year). *Overdraft, housing and consumer loans* posted annual growth, while the *other loans* category retained its downward trend of end-2012. As of June 2014 the volume of new consumer loans showed a slight downward trend for the last 12 months, while the levels of newly extended housing loans and other loans remained stable.

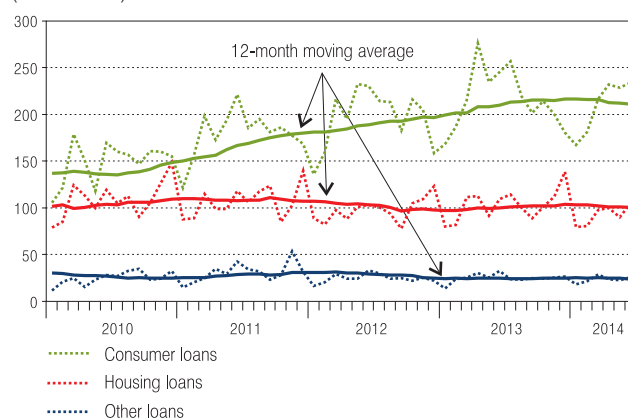
Growth in claims on the non-government sector and declines in nominal GDP over the first quarter of 2014 led to an increase in the *claims on non-government sector to GDP* ratio to 72.1 per cent (70.4 per cent in the first quarter of 2013).

Summarised results of the BNB quarterly lending survey show that ten banks reported a rise in demand for loans by corporations in the first quarter of 2014 and two banks a decline. The market share of banks reporting a rise was somewhat lower than those reporting a decline. As regards households, lower demand was recorded in both consumer and housing loans. Concurrently, banks eased their credit standards for consumer loans of households, while those for corporate and housing loans remained unchanged from the previous quarter. The collateral risk contributed further to tightening of the lending policy, whereas bank competition was the main factor behind its easing along with the cost and volume of attracted funds, albeit to a lesser extent. For the second quarter of 2014, banks expect that lending standards will remain unchanged for corporate loans and eased for consumer and housing loans.

A baseline scenario shows that growth rates of currency in circulation and broad money are expected to slow down further during the third and fourth quarters of 2014. Major factors

### New Loans to Households (Monthly Volumes)

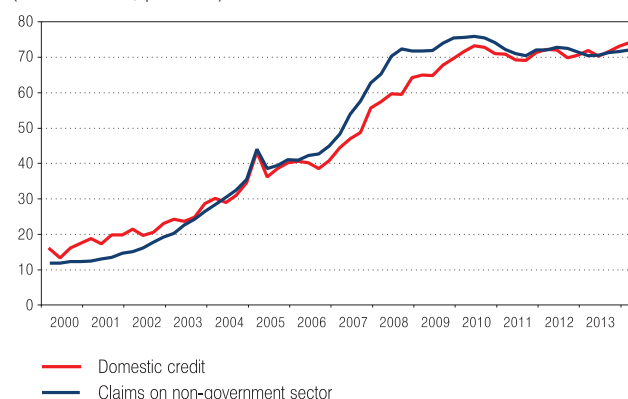
(BGN million)



Source: BNB.

### Domestic Credit

(share of GDP, per cent)



Source: BNB.

driving these developments are our expectations of retaining domestic demand at the levels of the first half year in the context of persistently high household savings rates and continuous deflation over the forecast horizon. The expected growth of funds attracted from residents in the banking system will continue to exceed demand for loans, which will be reflected in maintaining high banking system liquidity. Concurrently, in June the ECB cut interest rates on main refinancing operations and marginal lending facility and set negative interest on deposit facility, which led to a decrease in euro area money market rates, causing downside effects on bank foreign asset management policy in Bulgaria. In the absence of high yield investment alternatives outside the country, banks may look for investment solutions in the domestic market by extending new loans to corporations and households and investing in Bulgarian government bonds. The increased internal uncertainty around Corporate Commercial Bank's conservatorship may increase banks' cautiousness in extending loans and worsen firms and households' sentiment, resulting in a corresponding decline of demand for loans.

## Interest Rates

From the beginning of 2014 to the middle of June, interest rate trends in Bulgaria's interbank money market show increases in quotations with a term of up to three weeks and declines in maturities of over one month. LEONIA rose from 0.04 per cent in the first quarter to 0.05 per cent in April and May, with the spread between LEONIA and EONIA widening to -20 basis points. Between April and May quotations of interbank deposits with a maturity of three months<sup>27</sup> dropped by 3 basis points on the first quarter to reach 0.57 per cent on average, with spreads against the corresponding euro area quotations declining to 25 basis points.

The ECB decision to cut interest rates on main refinancing operations and on marginal lending facility and to set a negative rate on deposit facility in force as from 11 June 2014 led to a

<sup>27</sup> The analyses is based on the average value of SOFIBOR and SOFIBID quotations of unsecured three-month deposits in levs.

## Changes in Credit Standards Applied to Corporate Loans

(balance of opinions)



## Changes in Credit Standards Applied to Consumer Loans

(balance of opinions)



## Changes in Credit Standards Applied to Housing Loans

(balance of opinions)



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

Source: BNB.



significant decline in domestic money market quotations, albeit lower than in the euro area. In the middle of June, LEONIA and EONIA quotations became realigned as a result of the essential drop in EONIA. Values of both indices remained close in July as well, with their negative spread shrinking to almost 1 basis point. In addition, after the entry into force of the lower interest rate on ECB main refinancing operations, certain widening of the three-month quotation spread was recorded due to the slower decline of money market interest rates in Bulgaria, with this trend continuing in the first half of July.

Quotations in long-term maturity sectors of the yield curve in the interbank money market retained their downward trend formed in the second half of 2010. In June declines in the six-month and 12-month horizons were 33 and 42 basis points, respectively.

Volumes traded in the Bulgarian money market remained comparatively low as the market plays only a supporting role in managing bank liquidity. The retained high banking liquidity in Bulgaria and the ECB monetary policy continued to be the main driving factors behind domestic money market interest dynamics.

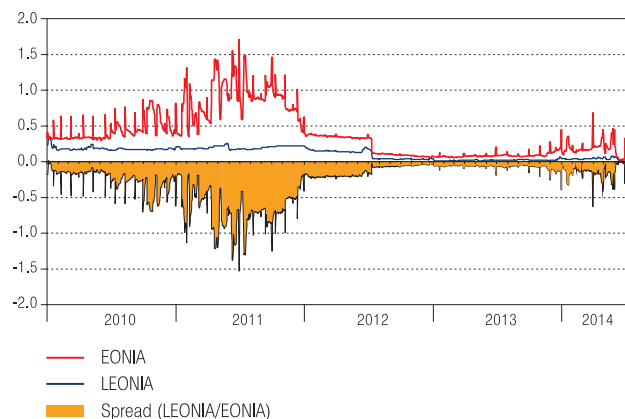
In June 2014 interest rates on new time deposits of households and firms sustained their downward movement. Strong growth of deposits from residents and comparatively weak demand for bank products continued to be the drivers of interest rate developments. In June the average weighted interest rate on new time deposits accounted for 2.72 per cent (3.15 per cent in June 2013). Year-on-year declines were registered in interest rates on lev- and euro-denominated deposits, with euro rates recording a larger drop. In terms of maturity, a stronger annual decline was reported in deposits with a maturity of one to three months and from three to six months. In the June 2013 to June 2014 period, the decline in interest rates on household deposits exceeded that in rates on non-financial corporations' deposits.

A comparison between the June and March 2014 breakdown of interest rates on household time lev deposits shows that the number

## Interbank Money Market Interest Rates

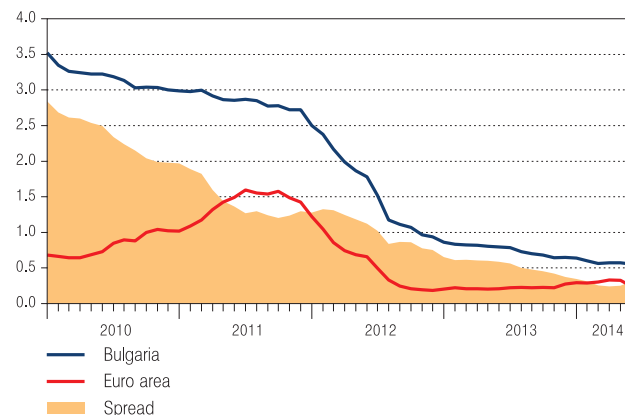
### Overnight

(per cent; percentage points)



### Deposits with a maturity of three months

(per cent; percentage points)

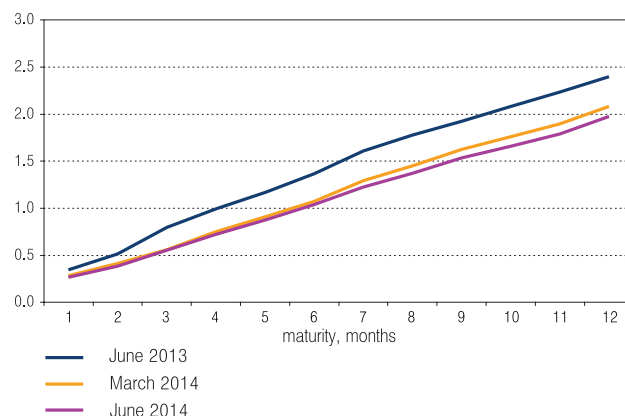


Note: The values for Bulgaria reflect the average value of SOFIBOR and SOFIBID quotes of unsecured three-month deposits in levs.

Source: BNB.

## Interbank Money Market Yield Curve

(per cent)



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

Source: BNB.

of banks offering rates in the up to 3 per cent band increased and those offering rates within the 3 to 4 per cent and 4 to 5 per cent bands decreased. The average interest rate on time lev deposits dropped by 21 basis points to 3.41 per cent and the standard deviation fell by 5 basis points to 1.07 percentage points.

The downward trend in the average cost of financing in the banking system<sup>28</sup> was sustained (from 2.81 per cent in late 2013 to 2.66 per cent in May 2014) reflecting dynamics of interest rates and volumes of attracted funds.

In the first half of 2014 interest rates on loans to non-financial corporations retained their high monthly volatility, with the currency breakdown recording divergent trends. A year-on-year decrease was observed in rates on new lev loans, while euro-denominated ones remained close to those of the same period of 2013. In June interest rates on new loans to non-financial corporations were 7.2 per cent in lev and 8.1 per cent in euro.<sup>29</sup>

The annual percentage rate of charge (APRC)<sup>30</sup> on consumer loans for households increased slightly in the first half of 2014. This reflects the increase of interest rates on these loans which exceeded the decline of the implicit rate of non-interest service charges<sup>31</sup> on these loans. The APRC on new housing loans decreased slightly in June, with its value reflecting lower levels of interest rates and a slight rise in the implicit rate of non-interest service charges on these loans. In June the APRC on consumer and housing loans accounted for 12.7 and 7.8 per cent.

The bank breakdown of interest rates on new housing loans in euro in June 2014 compared to March 2014 shows that the number of banks offering rates of over 9 per cent increased at the

<sup>28</sup> This indicator is calculated *ex post* using data of the BNB Bank Supervision Department published on the BNB website as a ratio between interest payments on attracted funds over the last 12 months and the average volume of attracted funds over the same period.

<sup>29</sup> The figures are the weighted average of the interest rates on loans to non-financial corporations on a 12-month basis.

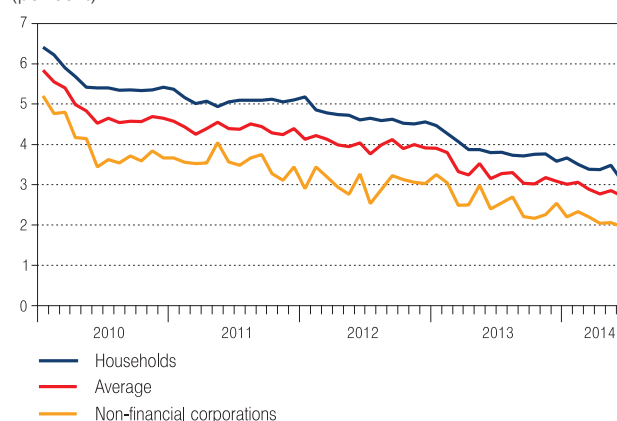
<sup>30</sup> These values are the weighted average of the interest rates on household consumer and housing loans on a 12-month basis.

<sup>31</sup> Implicit per cent of non-interest loan service charges is the difference between the APRC and interest rates.

## Interest Rates on New Time Deposits

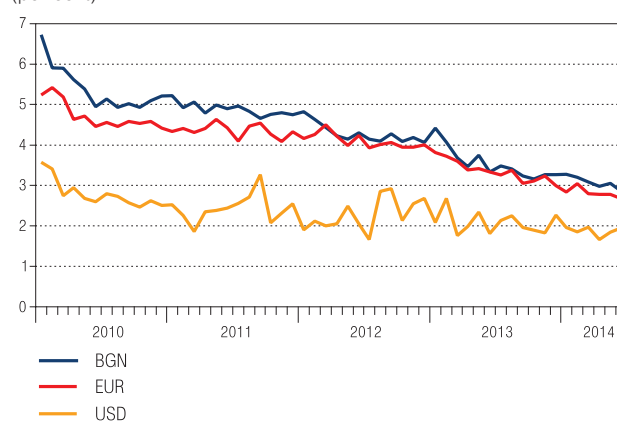
### By sector

(per cent)



### By currency

(per cent)

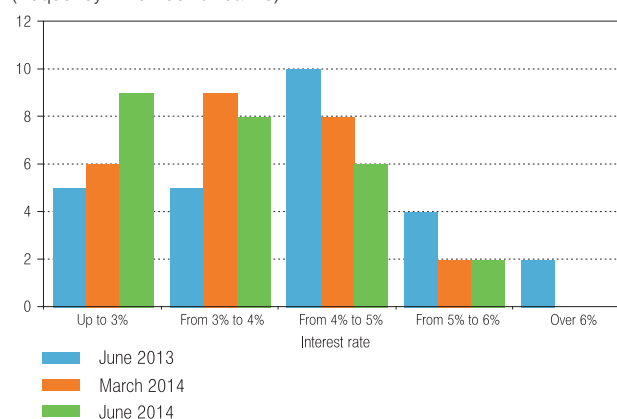


Note: The average interest rate is calculated for all sectors, maturities and currencies weighted by the relevant volumes of new deposits.

Source: BNB.

## Distribution of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



Source: BNB.

expense of those offering rates of up to 6 per cent, from 6 to 7 per cent and from 7 to 8 per cent. Over the same period, the average interest rate level decreased by 21 basis points to 6.88 per cent, and the standard deviation went up 110 basis points to 1.93 percentage points.

In the second quarter of 2014 a downward trend in yields and correspondingly an upward trend in prices of Bulgarian government securities were registered at all primary market auctions (except for the extraordinary auction of 30 June 2014). Unlike the first quarter when three short-term issues were sold to the amount of BGN 1200 million, between April and mid-June the issuing policy of the government was focused on supply of medium- and long-term government bonds. A factor exerting a downward pressure on the yield attained at government bond auctions in the primary market was the high liquidity of banks and other major investors. The yield achieved at the May auction for sale of benchmark government securities with an original maturity of ten years and six months was 3.16 per cent,<sup>32</sup> historically lowest yield in this maturity sector. Lower yields were also recorded at the auctions of lev-denominated two-year-and-six-month and five-year bonds, as well as euro-denominated seven-year bonds. In June ten-year benchmark Eurobonds of the Bulgarian government to the nominal value of BGN 1.493 billion maturing on 3 September 2024 were issued, their yield amounting to 3.055 per cent. At the end of June an extraordinary five-month treasury bill issue of BGN 1.23 billion was sold, the average yield to maturity being 0.83 per cent.

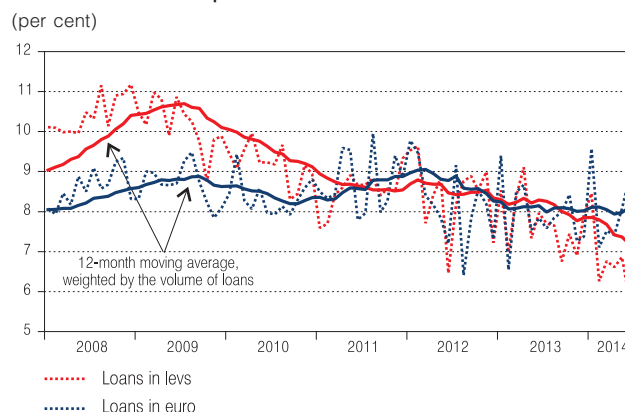
Consistent with primary market dynamics, by end-June the long-term interest rate<sup>33</sup> fell by 32 basis points on end-2013 to 3.11 per cent.

The downward trend in yields which started in the last quarter of 2013 and the upward trend in prices of Bulgarian Eurobonds maturing in July 2017 and traded in the secondary market were

<sup>32</sup> Compared to a 3.55 per cent yield attained at the previous auction in March.

<sup>33</sup> 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.

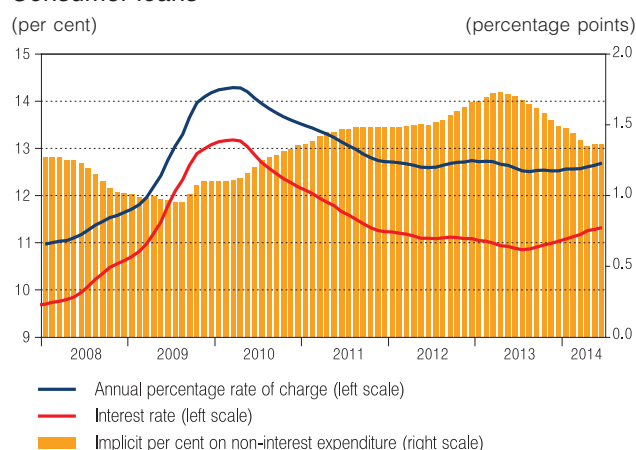
## Interest Rates on New Loans in Levs and Euro to Non-financial Corporations



Source: BNB.

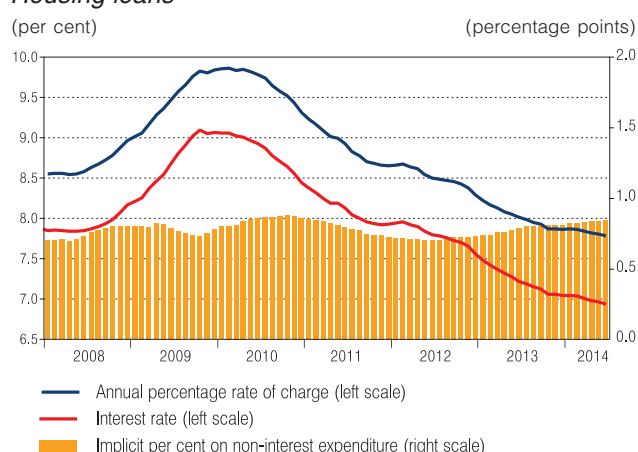
## Interest Rates and Annual Percentage Rate of Charges on New Household Loans

### 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.

reversed in the second half of June. By mid-July their prices hovered around the level of 107.3–108.2 (corresponding to 1.44–1.69 per cent yield).

In the second half of 2014 deposit rates are expected to further decline which will be mainly driven by the high banking system liquidity, lower money market rates in the euro area and comparatively weak demand for credit. Lending rates are projected to hover around the attained levels. Risks to the projection relate largely to the effects of the negative interest rate on ECB deposit facility which could lower the return on foreign assets of Bulgarian banks, thus possibly contributing to a decline of interest rates on new deposits. On the other hand, the internal political uncertainty may affect negatively the Bulgarian government bond market and prices which could have implications on interest rates on domestic loans and deposits.

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

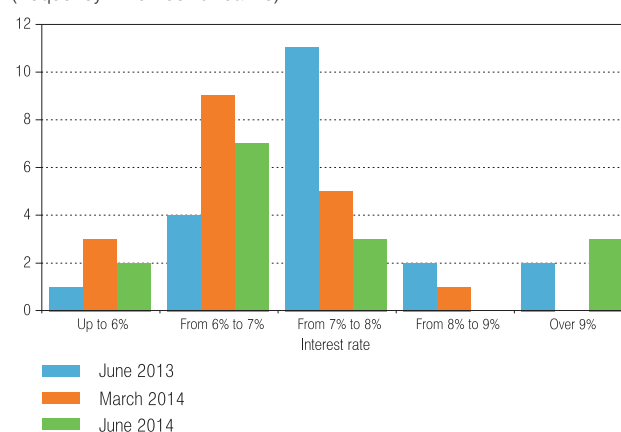
Government's revenue and expenditure policy and budget financing operations affected the allocation of liquidity between economic sectors.<sup>34</sup>

In the first quarter of 2014 the flow of liquid funds from the external sector to the budget was 8.2 per cent of GDP determining its leading position as a source of liquidity for the general government sector. Most of these financial flows comprised the subsidies refunded in March by the European Commission (BGN 1157.9 million) for payments under the EU Common Agricultural Policy. At the same time, the amount of consolidated government budget receipts from current and capital grants under EU funds was BGN 503.6 million. In the first quarter the total amount of EU subsidies and grants exceeded multiple times the national contribution to EU budget for the review period and the January interest payments on global bonds maturing in 2015.

<sup>34</sup> For more details on financial flows between the budget and other sectors, see *Economic Review*, May 2004, p. 28. The sign '+' of the respective financial flow indicates that as a result of its operations the budget provided net funds to the respective sector, while the sign '-' means that the budget withdrew net funds from the respective sector.

### Distribution of Interest Rates on New Housing Loans in Euro

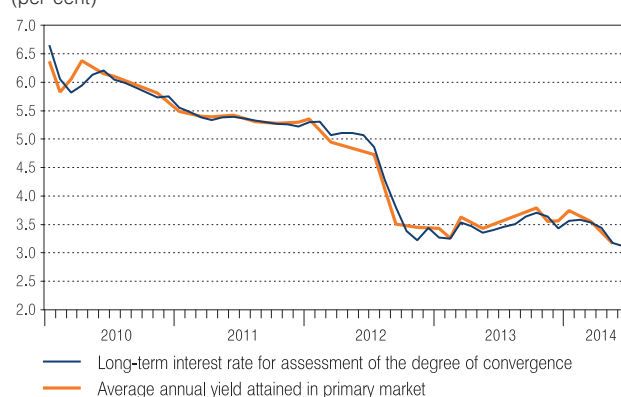
(frequency – number of banks)



Source: BNB.

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

(per cent)



Source: BNB.

In line with our expectations, in the first quarter of 2014 the financial sector (the BNB excluded) was also an important source of liquid funds for the consolidated budget. Net inflows from this sector to the general government sector came to 5.2 per cent of GDP for the first quarter, generated mostly by a net government bond issue in the domestic market to the amount of BGN 968.7 million. Treasury bills of BGN 1200 million were issued in the review period, their maturities falling due in equal portions over the second, third and fourth quarters of the year.

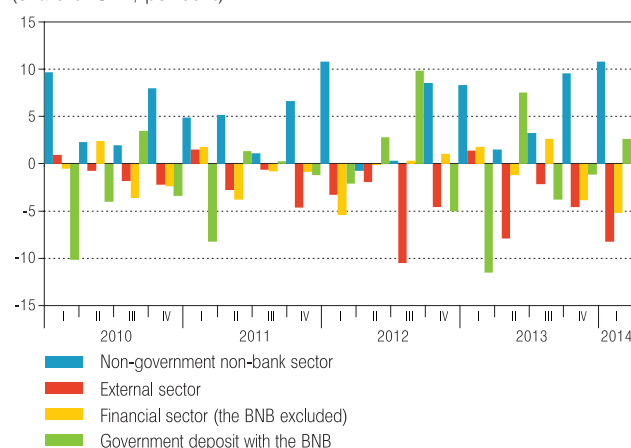
Most flows attracted from the external and financial sectors were used to finance the budget deficit (BGN 874.0 million) for the first quarter implying allocation of liquid resources mainly to the non-government non-bank sector. Fewer funds went on increasing the government deposit with the BNB (up BGN 181.0 million).

Based on available data of mid-July 2014, a conclusion can be drawn that in the second quarter net financial flows from the external sector to the general government sector were positive, though significantly lower than in the previous quarter due to the lack of large EU Common Agricultural Policy payments, while EU Cohesion and Structural Funds payments (BGN 418.1 million) slightly exceeded the levels of the first quarter. Despite the positive net government securities issue of BGN 820.9 million in the second quarter whereby liquidity was withdrawn from the financial sector, at the end of June government budget deposited the funds generated in the extraordinary auction to support the liquidity of one bank.

Budget financing operations in the third and fourth quarters of 2014 are expected to continue playing an important role in reallocation of liquidity across economic sectors. The government securities issue of 26 June 2014 sold in international capital markets (EUR 1493 million) boosted the government deposit with the BNB in early July, with resident financial institutions acquiring 15 per cent of the nominal value in line with our expectations. In the second half of the year maturing treasury bills and bonds will amount to BGN 2.3 billion, contributing to the increase of banking system liquidity.

### Consolidated Budget Effect on Other Sectors' Liquidity (Quarterly)

(share of GDP, per cent)



Sources: MF, BNB calculations.

# 3. Economic Activity

In the first quarter of 2014 economic activity increased, with domestic demand and increased inventories contributing positively to quarter-on-quarter GDP growth and net exports having a negative contribution.

In June 2014 short-term economic indicators report an improvement in expectations of economic agents about the future economic activity compared to January. The continuous economic recovery observed in our major trading partners and enhanced external demand are expected to have a positive effect on the growth of exports of goods and services and on economic activity in Bulgaria from the second quarter of 2014. As a result, net exports are anticipated to contribute positively to the quarterly growth of real GDP until the end of 2014. In the third and fourth quarters of 2014 domestic demand is expected to remain close to the level of the first half of the year.

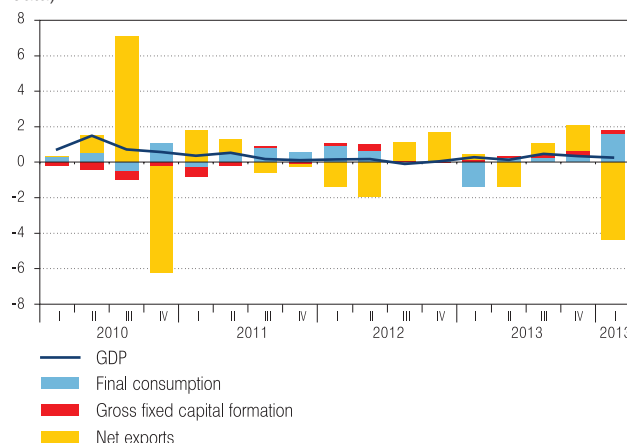
In the first quarter of 2014 economic activity increased on a quarterly basis reflecting mainly stronger growth in domestic demand and increased inventories. Private consumption grew and contributed substantially to real GDP growth. Growth of government consumption in real terms reflected the increase in the wage and healthcare expenditure. Investment activity also increased, with government investment contributing substantially to this effect. Exports of goods and services went down affected by specific factors<sup>35</sup> of one-off effect (see the Exports and Imports Section). Imports of goods and services exhibited an increase on a quarterly basis as a result of increased domestic demand. Given the dynamics of exports and imports, net exports contributed negatively to GDP growth in the first quarter of 2014.

Between January and May short-term economic indicators improved and slightly deteriorated in June. The consumer confidence indicator increased mainly due to the improved expectations about the future unemployment level and stronger expectations about future economic situation and future household financial status. The improved consumer confidence in the context of still low employment and slow household labour income growth will probably keep private consumption close to current levels and

<sup>35</sup> The decline in the mineral fuels and distilled products group, attributable to the renovation and building of new oil production capacities, contributed most significantly to the slowdown in exports of goods and services.

## 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.



the high savings rate retained in the following quarters.

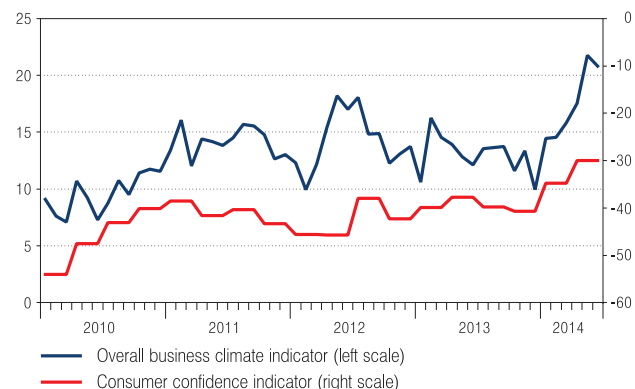
The overall business situation indicator exhibited an increase between January and May, reflecting mainly the improved business assessments about the expected business situation. Despite the lower decline in June, the indicator remained higher compared to January 2014.

Higher leading economic indicators in Bulgaria's major trading partners support the expectations of rising external demand for exports of Bulgarian goods and services in the second half of the year. As a result, net exports are expected to have a positive contribution to quarterly real GDP growth in the second half of the year. Despite the improvement in household and business expectations about future economic activity, private consumption and investments may remain close to their current levels in the third and fourth quarters due to still uncertain economic environment. Government consumption is expected to grow slower from the second quarter until the end of the year (on a quarterly basis) compared with the growth reported in the first quarter.

Consistent with the described quarterly dynamics, the baseline scenario on the GDP growth is for keeping the real annual growth rate in the second half of 2014 close to that reported in the beginning of the year.

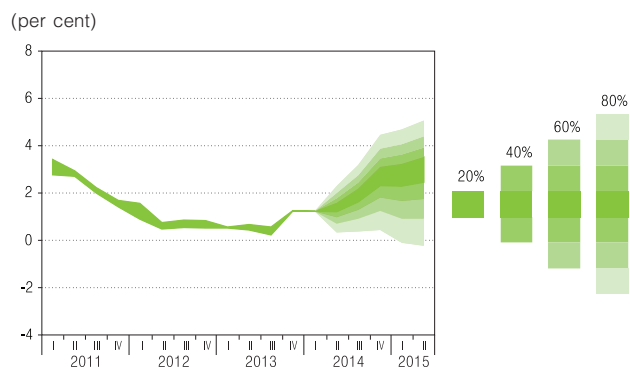
The assessment of risks to outlooks is rather for lower growth compared with the baseline scenario as seen from the fan chart of the expected annual rate of change of GDP. Despite the economic recovery in Bulgaria's major trade partners, euro area and EU environment as a whole continues to pose risks to the outlook for domestic economic growth. On the other hand, there are risks associated with the increased geopolitical tensions in Ukraine and Russia. Escalation of the crisis may have a negative effect on Bulgaria's economic growth. Another source of uncertainty to our projections relates to deflationary processes in Bulgaria since the third quarter of 2013. Although the expectations of manufacturers in industry and services shifted toward a price increase, in case of continued deflation there is a risk of contracting firms'

## Business Climate and Consumer Confidence



Sources: NSI, BNB calculations.

## Fan Chart of the Expected Annual Rate of Change of GDP



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

Source: BNB.

## GDP Growth by Component of Final Use

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

	2011				2012				2013				2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Consumption	-0.3	0.5	0.9	0.7	1.1	0.8	0.0	0.1	-1.6	0.3	0.3	0.4	1.9
incl.													
Household consumption	-0.6	1.0	1.5	0.9	1.4	0.7	0.8	0.6	-5.5	1.3	0.9	1.4	1.1
Final government consumption expenditure	0.4	1.4	-0.7	0.2	0.1	-1.2	0.7	0.7	-0.1	1.2	0.4	0.1	1.8
Collective consumption	1.3	-0.3	-0.6	0.7	0.1	-0.1	0.2	1.4	0.4	1.1	0.7	-0.5	0.3
Gross fixed capital formation	-2.3	-0.9	0.5	-0.6	0.6	1.7	0.2	-0.1	0.6	0.3	0.9	1.3	0.9
Exports of goods and non-factor services	5.6	-1.2	3.4	1.4	-5.2	4.3	-1.3	1.8	5.4	-0.3	3.1	0.9	-2.1
Imports of goods and non-factor services	2.4	-2.3	4.0	1.5	-2.9	6.6	-2.6	-0.6	4.5	1.5	1.9	-1.1	3.8
<b>Real GDP growth</b>	<b>0.4</b>	<b>0.5</b>	<b>0.2</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.3</b>	<b>0.1</b>	<b>0.5</b>	<b>0.3</b>	<b>0.3</b>

Source: NSI.

profits which will deteriorate their expectations and limit investments. The placement of Corporate Commercial Bank, the fourth largest bank in Bulgaria, under conservatorship will have a negative effect on the economic activity of firms and households which are customers of the bank. Increased political uncertainty surrounding early parliamentary elections in October may also have a negative effect on expectations, sentiment and behaviour of economic agents.

## Household Behaviour

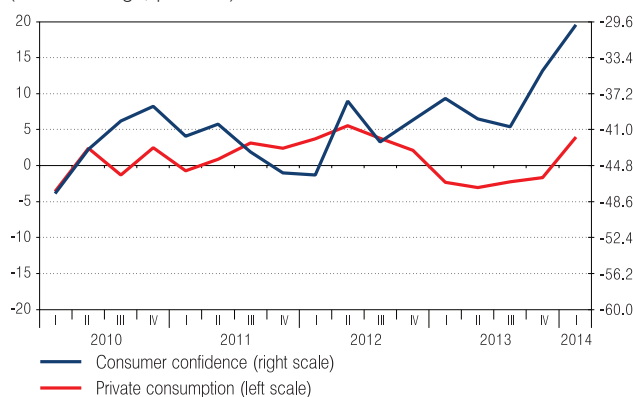
The uncertain economic environment, relatively high unemployment rate, and uneven employment and wage movements by sector continued to impact household behaviour in terms of consumption, savings rate and labour supply in the first quarter of 2014. Notwithstanding, the improvement in some indicators had a favourable effect on household behaviour in the first quarter of 2014. The indicators, by which the expected change in household behaviour may be assessed, signal that consumer demand in 2014 will rather remain at levels close to current ones along with the high household savings rate.

According to seasonally adjusted national account data, in the first quarter of 2014 household consumption continued to increase on a quarterly and annual basis (after the temporary fall in 2013 it restored its 2012 level). In the first half of 2014 household consumption in the non-food, transport and purchased non-production services groups increased<sup>36</sup>. Consumption in real

<sup>36</sup> Purchased non-production services include services other than catering services, water supply, heat energy and electricity, transport and communications.

## Private Consumption and Consumer Confidence

(annual change, per cent)



Sources: NSI Consumer Survey and BNB calculations.

terms recovered also in the food and catering groups. In the first quarter of 2014 retail trade turnover continued to increase, particularly in some groups of durable goods (computer and communication equipment and other consumer goods and household appliances, furniture and other household goods). A factor that might have boosted real consumption of these goods was the continuous fall in their prices.

Although the volumes in retail trade continued to increase on an annual basis, based on seasonally adjusted data, they exhibited a decline on a quarterly basis between February and May 2014, albeit at lower rates. This may keep real consumption at rates close to current levels in the second quarter of 2014.

On the other hand, In April 2014 the consumer confidence indicator reported in the NSI consumer survey<sup>37</sup> continued to rise, reflecting the improvement in all its sub-components. Expectations of the economic situation and household financial state, and unemployment expectations also improved.

Employment remained at relatively low levels despite the slight increase in some sectors, while household income from remuneration posted growth in the total economy but at slower rates and not in all sectors. In the first quarter of 2014 the wage bill and the average wage<sup>38</sup> based on seasonally adjusted national account data<sup>39</sup> increased slower than in the previous quarters both in nominal and real terms. Slower growth in the annual labour income compared with previous years (based on non-seasonally adjusted data on the wage bill and the average wage *per employee*) was

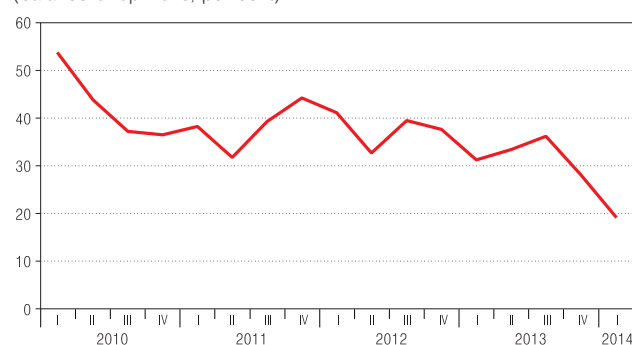
<sup>37</sup> Final results of the Consumer Survey represent balances of opinions calculated as a difference between the relative shares of positive and negative opinions on raised issues. The composite consumer confidence indicator is calculated as the arithmetic mean of expectation balances in the 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).

<sup>38</sup> 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.

<sup>39</sup> The seasonal adjustment of indicators, on which the NSI does not officially publish seasonally adjusted data, was made *via* the TRAMO SEATS programme by using automated set up for diagnostics and optimisation of adjustment parameters.

## 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.

sustained. The first quarter of 2014 saw stronger growth of remunerations in the sectors with lower average wage as construction and agriculture and fishing, as well as in professional activities and scientific research, administrative and ancillary activities, which was less affected by the crisis both in terms of gross value added and employment. In some of services sub-sectors such as trade, transport, hotels and restaurants, and real estate operations, gross wages went down on an annual basis.

Despite the improved household sentiment, employment and income dynamics signal that consumption will remain at levels close to current levels and savings rate high over the forecast horizon.

The share of savings in household disposable income remained high<sup>40</sup> in the first quarter of 2014. The share of households which intend to increase savings in the following 12 months remained relatively high according to the April 2014 Consumer Survey. 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).

According to the Labour Force Survey, labour supply in the first quarter of 2014 increased following the temporary reversal of this trend in the second half of 2013. In the first quarter of 2014 the ratio of economic activity went up due to increased labour force. This was accompanied by a fall of discouraged persons. Despite these observations, in a period of a low recovery of labour demand by firms, future increases in labour supply are expected to be limited.

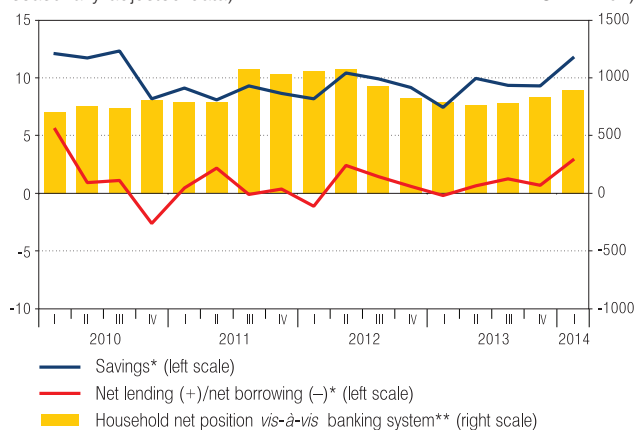
The Labour Force Survey shows that in the first quarter of 2014 the unemployment level slightly decreased reaching 12.4 per cent. Based on the Employment Agency data, the seasonally adjusted unemployment rate<sup>41</sup> slightly decreased in the first and second quarters of 2014 to reach 10.7 per cent (11.2 per cent according to non-seasonally adjusted data). The Labour Force

<sup>40</sup> Disposable income (based on the household budget survey) is obtained by subtracting tax expenditure, social contributions and transfers from the total income.

<sup>41</sup> The Employment Agency uses a constant labour force measure.

## Household Propensity to Save

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



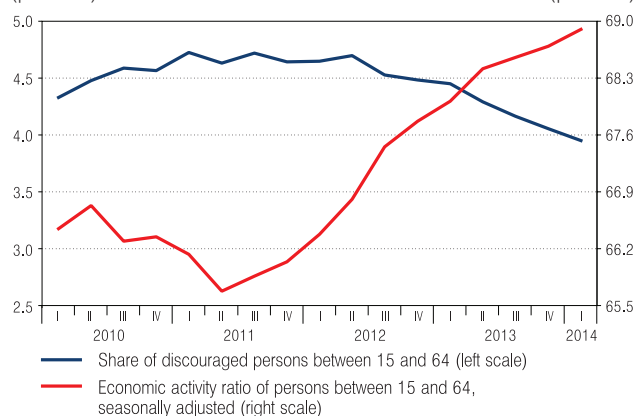
\* NSI data.

\*\* BNB data.

Sources: NSI Household Budget Survey, BNB.

## Economic Activity and Share of Discouraged Persons

(per cent) (per cent)



Sources: NSI Labour Force Survey, BNB calculations.

## Employment and Income Dynamics

	2011				2012				2013				2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Per cent on the previous quarter (seasonally adjusted data)													
Employed	-0.2	-0.6	-0.9	-0.6	-0.7	-1.0	0.1	-0.2	-0.2	0.4	-0.2	-0.1	0.2
Nominal wage <i>per employee</i> *	1.2	3.2	1.9	2.2	2.1	1.9	1.9	1.3	1.7	0.5	0.7	0.7	0.2
Real wage <i>per employee</i> **	0.5	2.7	1.6	-0.1	2.2	1.9	1.2	1.5	1.2	0.9	0.9	1.6	0.9
Wage bill, nominal terms	1.3	2.5	1.3	1.9	1.4	1.4	1.8	0.6	1.5	0.5	0.5	0.5	0.0
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	1.3	1.0
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	0.3
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	2.5
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	4.4
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	1.9
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	3.8

\* 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				2014	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	April – May
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	1.7	-1.7
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	1.2	-0.1
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	-0.1	-2.5
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	0.9	-1.8
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	5.9	-2.2
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	0.2	-0.5
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	0.8	-0.1
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	-0.5	-4.3

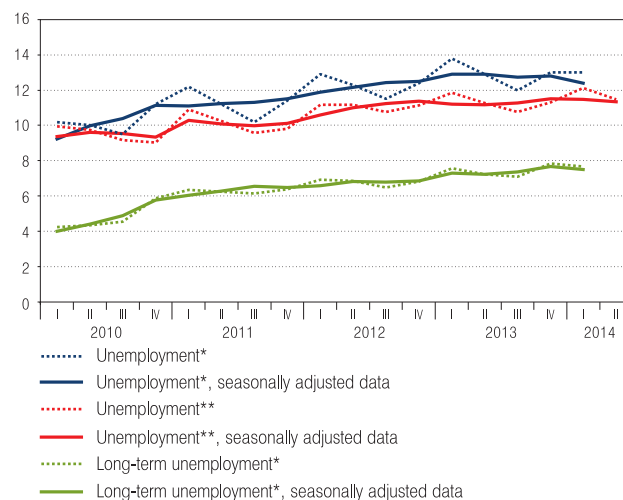
Source: NSI Domestic Trade Survey.

Survey shows that in the context of relatively high unemployment rate and low labour demand by corporations, the number of long-term unemployed (persons unemployed more than a year) remained comparatively high as a share of labour force in the first quarter at 7.5 per cent.

Risks to the expectations for consumption levels remaining relatively unchanged and the savings rate high in the second half of 2014 relate mainly to factors affecting adversely consumer confidence such as income and employment dynamics, as well as the effects of placing the Corporate Commercial Bank under conservatorship and the political uncertainty. In its turn, employment and income depend to a large extent on firms' propensity to hire personnel and enhance investment activity.

## Unemployment

(per cent of the labour force)



\* NSI data.

\*\* Employment Agency data.

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

## Impact of Fiscal Policy on the Economy

In the first five months of 2014 Bulgaria's budget position deteriorated on the corresponding period of 2013 impacted by slower growth rates of tax revenue which were not offset by limited budget expenditure by the government. As a result of maintaining high growth rates of investment expenditure and social payments, the government fiscal policy continued to have a positive effect on total investment and household disposable income.

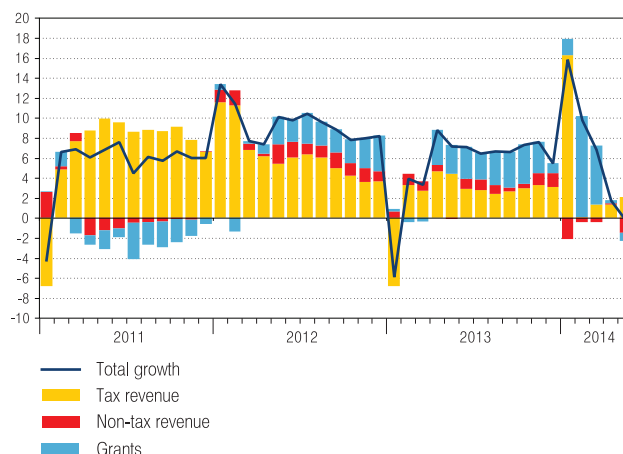
Tax revenue growth in the first five months of 2014 was limited. The main factors behind the slow dynamics of tax revenue were associated with depressed household nominal consumption growth due to continuing downward price dynamics, on the one hand, and the effect of some one-off factors which prompted a decrease in VAT receipts, on the other hand.<sup>42</sup> Lower corporate tax revenues also contributed to the contraction of tax revenue growth. Concurrently, social security receipts had the largest positive contribution to tax revenue growth, reflecting partly the increased minimum insurance thresholds and maximum social security income since early 2014. The revenue from personal income tax had relatively lower positive contribution to growth of tax revenue between January and May.

The negative effect of the weaker tax revenue performance as compared with the annual projections of tax revenue was not offset by a contraction of budget expenditure. In the first five months of 2014, as in the prior year, social payments had the largest contribution to total budget expenditure growth. Strong growth of social expenditure reflected to a large degree the pension increase in April 2013 and to a lower degree spending on covering old debts of hospitals in February and supplements to the pensions and to energy assistance in April 2014. As a result, the role of social benefits in supporting disposable income of pensioners and socially vulnerable households continued

<sup>42</sup> For further details on the effect of these one-off factors in January and February, see *Economic Review*, 1/2014. Planned repair works in Lukoil in the first months of the year also had a negative effect on VAT revenue growth.

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

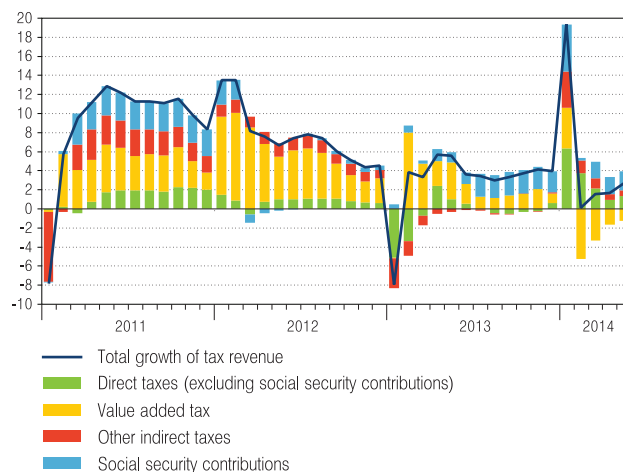
(per cent, percentage points)



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.



strengthening, consistent with the trend observed in 2013.

In May 2014 accelerated spending of funds under EU programmes (mainly increasing intensively capital expenditure) observed since end-2013 was sustained. Concurrently, the time gap in making these expenses and their refunding from the EU contributed significantly to the accumulated deficit on the consolidated fiscal programme on a cash basis. Accelerated capital expenditure on the consolidated fiscal programme indicates an increase in the contribution of the general government sector investment to the change in gross fixed capital formation in the total economy.

In the first quarter of 2014 the contribution of government consumption to GDP growth also increased. Growth of government consumption reflected the increase in the wage and health-care expenditure, while operating expenditure was lower than in the prior year.

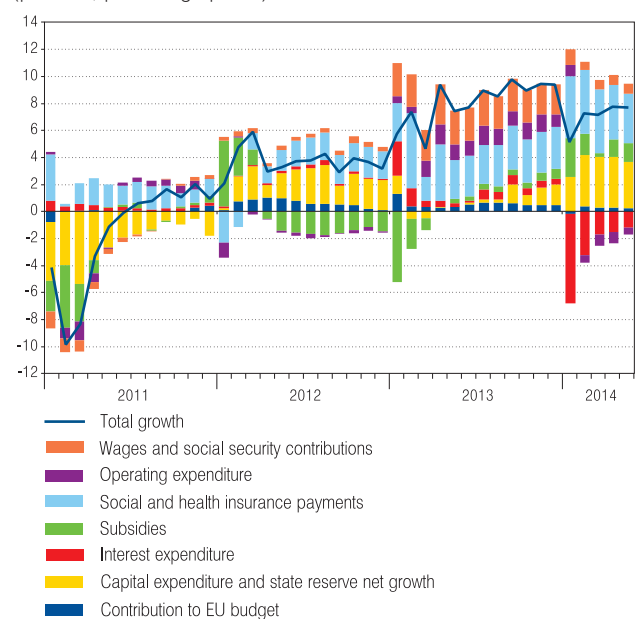
Political uncertainty and related risks to consumer confidence give grounds to expect that low tax revenue growth rates will be sustained in the second half of 2014.

The consolidated fiscal programme deficit of 1.8 per cent of GDP for 2014, as planned in the Budget Law for 2014, is less likely to materialise given the risks of weaker tax revenue performance and the higher health insurance payment costs on the National Health Insurance Fund budget. The contribution of government consumption to GDP is likely to decrease in the second half of the year. Provided a government support for the Corporate Commercial Bank is required, these costs should not directly impact the 2014 cash deficit, but they would affect the deficit on an accrual basis, with the size of this effect depending on the government support mechanism.

Given the limited budget expenditure due to lower revenue, a significant slowdown or even negative annual growth is expected in the general government sector investment over the second half of 2014.

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

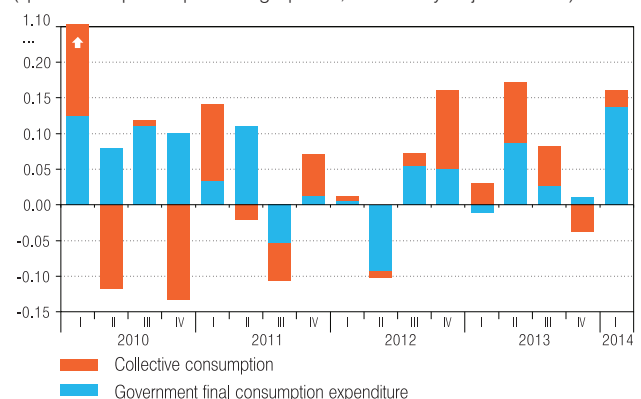
(per cent, percentage points)



Sources: MF, BNB calculations.

### Contribution of Government Consumption to Real GDP Growth

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



Sources: NSI, BNB calculations.

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

Consolidated Fiscal Programme	2013										2014		January – May 2013 <sup>1</sup>		January – May 2014 <sup>1</sup>	
	I quarter		II quarter		III quarter		IV quarter		Total		I quarter		BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>
	BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>	BGN million	per cent <sup>2</sup>				
Total revenue and grants	6158	3.4	8008	10.2	7142	5.6	7670	2.5	28977	5.5	6576	6.8	11802	7.2	11776	-0.2
Tax revenue	5118	3.3	5767	2.8	5638	3.8	5847	5.7	22370	3.9	5200	1.6	9190	5.6	9436	2.7
Corporate tax	464	-10.9	450	1.3	193	-27.6	446	80.8	1553	5.1	453	-2.5	880	2.5	874	-0.7
Personal income tax	512	-1.3	596	-6.6	628	15.2	613	2.8	2349	2.2	623	21.6	1024	6.2	1101	7.5
Value added tax	1804	16.0	1805	-3.2	1872	2.2	1886	-0.8	7367	3.0	1617	-10.3	3051	12.4	2936	-3.8
Excise	806	-5.6	1001	2.5	1185	0.2	1065	2.7	4056	0.2	855	6.1	1458	-2.3	1507	3.4
Customs duties	32	14.3	34	18.2	44	36.1	36	26.5	146	24.2	35	9.7	56	17.4	59	4.9
Social and health insurance contributions	1319	2.3	1587	14.0	1551	10.9	1603	5.7	6060	8.3	1396	5.8	2316	4.3	2503	8.1
Other taxes	182	-4.0	294	10.3	165	-6.7	199	-3.7	840	0.0	221	21.6	405	0.3	458	13.0
Non-tax revenue	886	7.0	1306	11.6	728	-13.6	1031	40.7	3951	10.6	859	-3.1	1750	-0.5	1578	-9.8
Grants	153	-11.5	935	91.7	777	59.6	791	-35.1	2656	12.2	518	238.0	863	57.5	762	-11.7
Total expenditure (incl. the contribution to EU budget)	6956	4.6	7217	10.8	7497	14.1	8759	8.2	30428	9.3	7451	7.1	11757	7.4	12665	7.7
Wages and social security contributions	1347	12.7	1446	13.7	1424	11.8	1606	9.5	5823	11.8	1396	3.7	2327	13.3	2413	3.7
Operating expenditure	1078	7.3	1113	5.2	1026	6.3	1480	1.9	4697	4.8	1016	-5.7	1842	7.3	1784	-3.1
Interest	319	10.3	61	-13.6	275	72.9	34	-37.2	689	20.3	200	-37.4	362	8.5	219	-39.5
Social security, assistance and social care	3048	4.2	3239	9.8	3202	8.5	3258	8.0	12747	7.6	3375	10.7	5212	6.4	5641	8.2
Subsidies	311	-15.1	340	39.8	279	15.7	502	31.1	1431	16.1	329	5.7	557	6.4	724	29.9
Capital expenditure and state reserve growth	525	-6.3	811	6.7	1077	31.6	1692	9.8	4107	11.6	786	49.5	991	0.4	1389	40.2
Contribution to EU budget	328	6.8	206	28.7	214	31.7	187	3.6	934	15.4	349	6.4	465	7.9	495	6.4
	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>	BGN million	difference in BGN million <sup>3</sup>
Budget balance on cash basis	-798	-107	792	39	-355	-546	-1089	-477	-1450	-1092	-875	-77	46	-22	-889	-934

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

<sup>1</sup> Based on preliminary monthly data on CFP performance for 2013 and 2014.

<sup>2</sup> Annual rate of change on the same period of previous year.

<sup>3</sup> Budget balance change in million levs on the same period of previous year.

Sources: MF, BNB calculations.

## Behaviour of Firms and Competitiveness

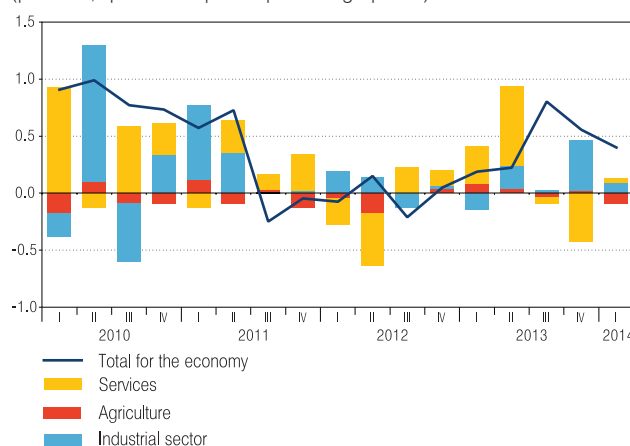
According to seasonally adjusted national account data, in the first quarter of 2014 value added in the economy rose in real terms by 0.4 per cent on a quarterly basis. As a result, growth slowed down compared with that in the third and fourth quarters of 2013.

Industry contributed most to economic activity growth, with a value added increase attributable to a large degree to higher inventories.

The industrial production index (at comparable prices) increased in the first quarter of 2014, while income from sales in industry slowed down. The difference between the dynamics of the volume of output and real income from sales

## 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.

resulted in an increase in inventories in the sector. Given the improved managers' expectations about future economic activity observed in the short-term business statistics, the inventories accumulated since early year are expected to be sold in the following quarters. Nominal sales in the international market had a negative contribution to income mainly due to the fall in international prices of raw materials. The recovery of domestic demand in the first quarter of the year had a positive effect on nominal revenue from sales in the domestic market, mainly in the manufacturing sub-sector. In the first quarter turnover by commodity group<sup>43</sup> in the domestic market exhibited quarter-on-quarter growth in sales of consumer durables. Between April and May 2014 industrial sector turnover posted an increase, with the revenue from external market sales contributing positively to this effect.

Irrespective of the fall in total industrial sector turnover observed in the first quarter of 2014 and the decline in nominal operating surplus in the sector, managers expectations about future economic activity and the business climate indicator improved in the first two quarters of 2014 compared with January 2014. This was probably related to the continuous economic recovery in our major trading partners and growth reported in Bulgaria.

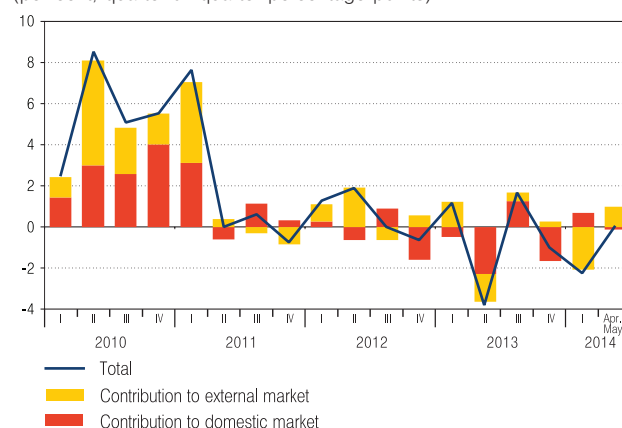
The production capacity utilisation rate in industry over the first quarter of 2014 was in line with the increased industrial output over the same period. Notwithstanding, the production capacity utilisation rate did not significantly exceed the average rate reported in 2013. In the context of recovering, but low demand, firms still do not have a serious need for expanding their production capacity.

The mild winter had a favourable effect on the construction sector in the first quarter of 2014, with construction activity, measured by the construction output index (at constant prices) posting growth due to substantially increased

<sup>43</sup> The Main Industrial Groupings classification was used to cover the following sectors: manufacture of intermediate consumption goods, energy product production and water related activities, investment product manufacturing and consumer goods production. Energy products exclude production and distribution of electricity, heating and gas, and water supply.

## Industry Turnover Dynamics

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

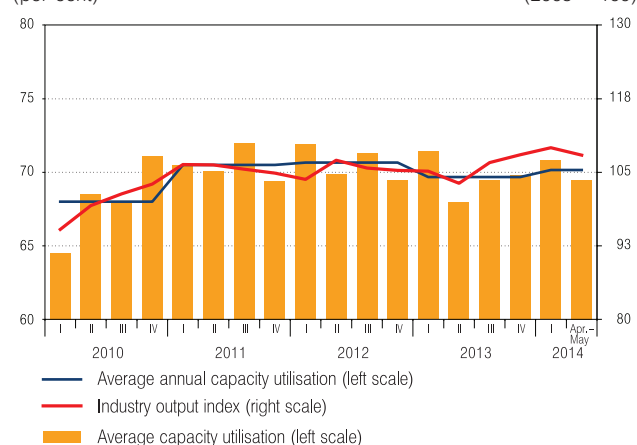


Sources: NSI, BNB calculations.

## Industry Output Index and Production Capacity Utilisation in Industry

(per cent)

(2005 = 100)

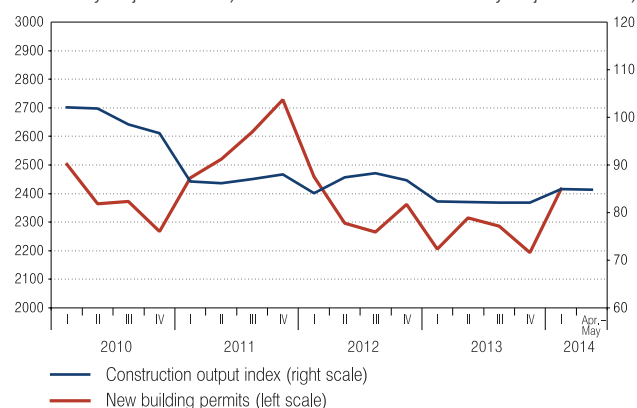


Sources: NSI – Industry Business Survey, BNB calculations.

## Construction Output Dynamics and New Buildings Permits Issued

(number of buildings; seasonally adjusted data)

(2010 = 100, seasonally adjusted data)



Sources: NSI, BNB calculations.

civil and engineering construction. Between April and May 2014 the construction activity matched the first quarter's level. The number of issued building permits for new buildings also exhibited an increase. This had also a positive effect on expectations of managers in the construction sector about future economic activity in the first quarter of the year, while in the second quarter the expectations slightly worsened.

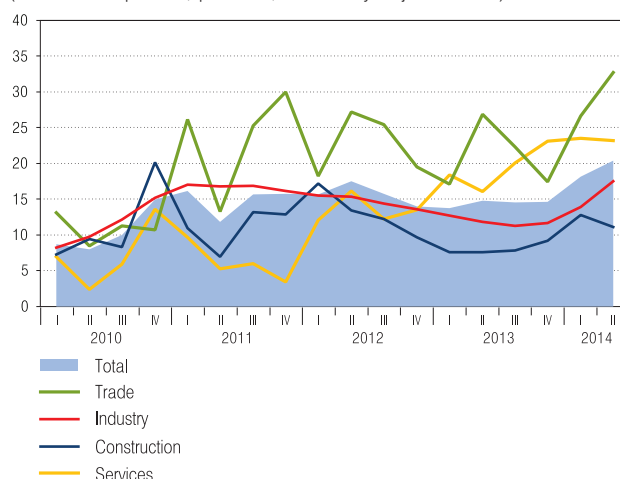
Besides the industry sector, some services sub-sectors also contributed to the value added growth for the overall economy in the first quarter of 2014. These sub-sectors include: financial and insurance activities; professional activities and scientific research; administrative and ancillary activities. On the other hand, agriculture, where the value added went down by 1.7 per cent on a quarterly basis, had a negative contribution to the change in economic activity in the first quarter of 2014.

Managers' expectations about future economic activity in the first and second quarters of 2014 strengthened, with industry and trade contributing most significantly to this increase. Despite the worsened expectations in services and even stronger worsening of expectations in construction in the second quarter of 2014, expectations in all sectors exceeded the levels reported in the fourth quarter of 2013. The assessment of output assured with orders both for Bulgaria and abroad suggested a significant increase in industry in the second quarter of 2014. This is probably ascribable to the improved economic conditions in Bulgaria and in our major trading partners.

According to national account data, in the first quarter of 2014 investment in fixed capital went up in real terms on a quarterly basis but decreased in nominal terms due to lower prices. The upward trend in nominal expenditure on acquisition of fixed assets (seasonally adjusted data) observed from the second quarter of 2013 was sustained in the first quarter of 2014, although the growth rate slowed down. As in the previous three quarters, industry had the largest share in investments, while the contribution of services contracted slightly on the previous quarter. Taking into account the available spare production capacity in industry, it may be

## Expectations about Future Economic Activity

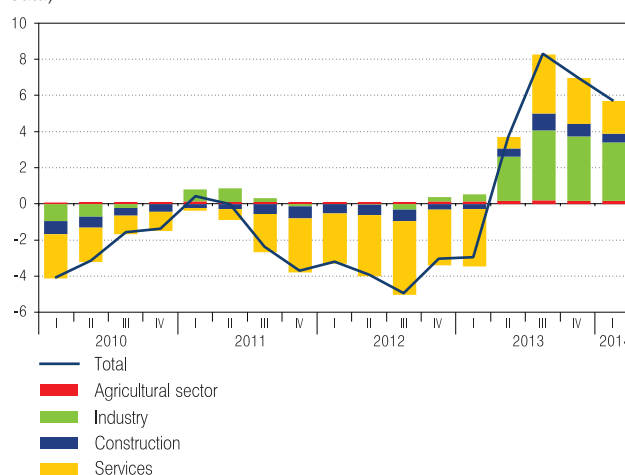
(balance of opinions, per cent; seasonally adjusted data)



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)

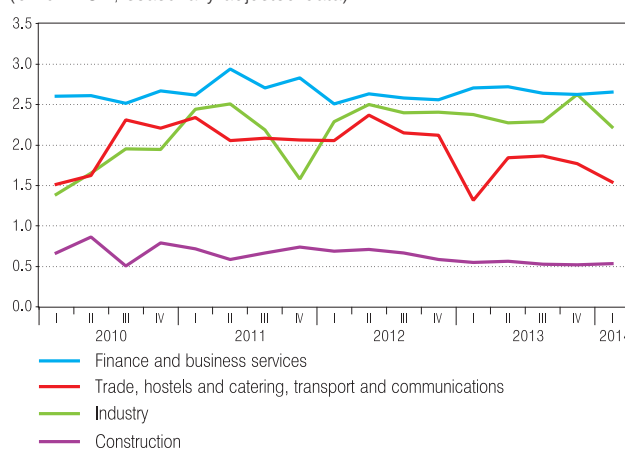


Note: Preliminary quarterly data due to the lack of final data.

Sources: NSI, BNB calculations.

## Gross Operating Surplus at Current Prices

(billion BGN, seasonally adjusted data)



Sources: NSI, BNB calculations.

presumed that investments were more focused on improving the production efficiency in order to preserve and improve competitive positions on international markets. If firms' expectations remain positive, and the recovery of domestic and external demand continues and ensures profit growth, it may be expected that investment activity will strengthen. On the other hand, as a result of a possible slowdown in corporate profits, investment activity will remain weak.

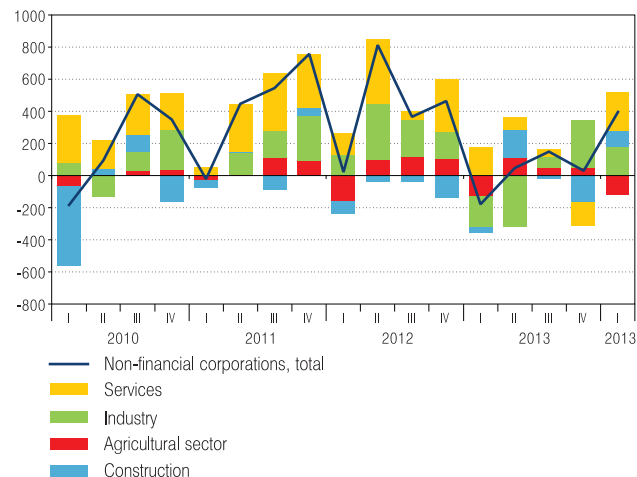
Following a slight rise in the gross operating surplus in nominal terms over the fourth quarter of 2013, the indicator posted a decline on a quarterly basis in the first quarter of 2014. Agriculture had the largest negative contribution to it but industry and services sub-sector, including trade, hotels and restaurants, transport and communications, also contributed significantly to the fall in the operating surplus in total economy. The slowdown in the operating surplus in the export oriented sector of industry was due to the fall in international raw material prices and the related decrease in nominal external market volumes reported in the first quarter of 2014. Despite the fall in prices of intermediate consumption goods, it appeared to be insufficient to offset profit declines in industry. The quarter-on-quarter decline in the gross operating surplus in the sectors of trade, hotels and restaurants, transport and communications was due to the continuous fall in consumer prices observed since 2013. However, the indicator exhibited a strong annual increase, which might reflect the stronger private consumption in the first quarter of 2014. The decline in the operating surplus in agriculture was ascribable to significantly reduced subsidies for production reported in the first quarter.

Bank lending to non-financial corporations grew in the first quarter of 2014. Lending to industry and services sectors contributed most significantly to the growth of bank loans but these sectors' external debts other than intercompany loans also posted an increase.

In the industrial sector, financial resources other than the operating surplus slowed down slightly in the first quarter of 2014, reflecting mainly lower FDI flows on the fourth quarter of 2013. In the first quarter of 2014 FDI inflow was reported

## Bank Loans to Non-financial Corporations

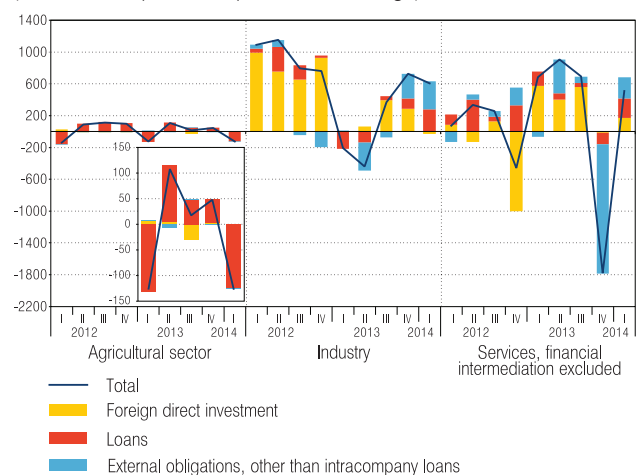
(BGN million, quarter-on-quarter stock change)



Source: BNB.

## Financing Sources\*

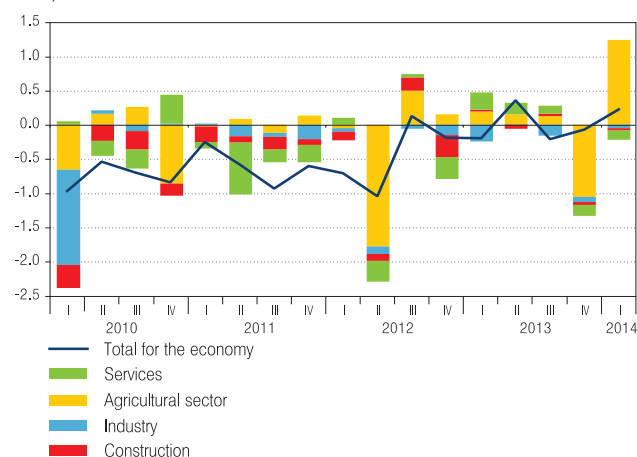
(BGN million, quarter-on-quarter stock change)



\* The chart displays financing sources other than gross operating surplus.  
Source: BNB.

## 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.

only in the services sector (excluding financial intermediation) where sources of financing other than the operating surplus also posted an increase.

Firms remained cautious in hiring staff due to still uncertain economic environment. In the first quarter of 2014 total employment remained at levels close to those reported in the fourth quarter of 2013 posting a slight increase on a quarterly basis by 0.2 per cent based on seasonally adjusted national account data and by 0.8 per cent based on Labour Force Survey data. According to national account data, agriculture, where employment rose by 6.6 per cent on a quarterly basis, contributed most strongly to employment growth. Industry and services sub-sectors exhibited divergent dynamics which had an insignificant contribution to the change in total employment.

Improvements observed in expectations of enterprises about the number of staff reported in the first quarter of 2014 were reversed. In case of a steady increase in economic activity, labour demand by firms will also increase accordingly.

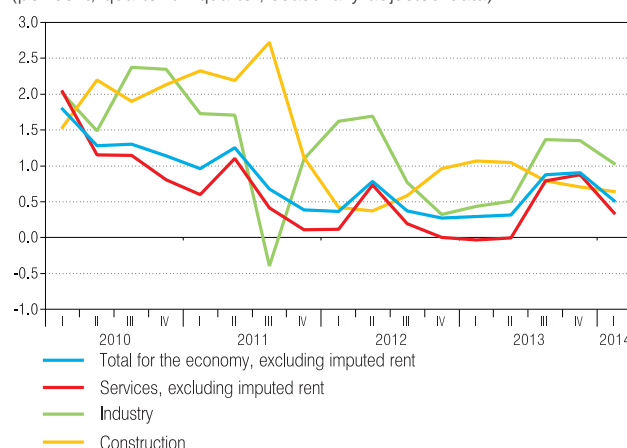
In the first quarter of 2014 labour productivity continued to increase on a quarterly basis in the overall economy but growth slowed down on the previous quarter. By sector, agriculture alone posted no increase in the indicator. Total labour productivity developments depend on keeping employment close to its previous quarter's level and the concurrent increase in gross value added in the economy. The decline in the labour productivity in agriculture in the first quarter of 2014 was a result of the decrease in the value added and strong growth in sector's employment.

Both nominal and real unit labour costs rose in the first quarter of 2014 compared with the fourth quarter of 2013. Nominal labour costs in export oriented sectors of industry were close to those in 2013, *i.e.* the sector preserves its competitive positions in respect of labour costs.

According to the decomposition of real GDP growth by production factor in the first quarter of 2014, enhanced investment activity had the major positive contribution to stronger economic activity. The slow recovery of employment had a small positive contribution and total factor

## Labour Productivity Developments (Value Added per Employee)

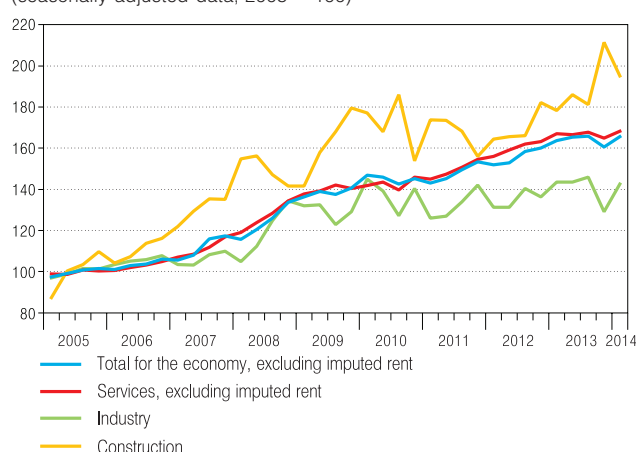
(per cent, quarter-on-quarter; seasonally adjusted data)



Sources: NSI, BNB calculations.

## Nominal Unit Labour Costs

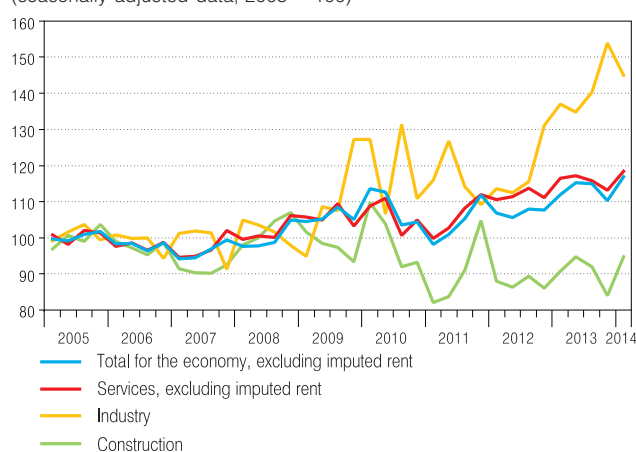
(seasonally adjusted data; 2005 = 100)



Sources: NSI, BNB calculations.

## Real Unit Labour Costs

(seasonally adjusted data; 2005 = 100)



Sources: NSI, BNB calculations.



## Gross Value Added Growth

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

	2011				2012				2013				2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Agriculture and forestry, hunting and fishing	0.7	0.4	0.0	0.0	0.2	0.1	-0.1	0.0	-0.1	0.2	0.0	0.4	0.1
Mining and quarrying, manufacturing, production and distribution of electricity, heating and gaseous fuels; water supply; sewerage, waste management and remediation activities	-0.1	0.1	0.1	0.0	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Construction	-0.1	0.3	0.1	0.3	-0.2	-0.5	0.2	0.1	0.3	0.7	-0.1	-0.4	0.0
Trade, cars and motorcycles repair; transport, storage and mail services; hotels and restaurants	0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Creation and dissemination of information and author products; telecommunications	-0.3	0.3	0.0	0.5	-0.5	-0.7	0.2	-0.1	0.4	0.5	-0.2	-0.6	0.1
Finance and insurance activity	-0.1	0.1	0.1	0.2	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real estate activities	0.2	-0.2	0.1	0.1	-0.2	0.1	0.1	0.0	0.0	0.1	0.0	0.1	0.1
Professional activities and scientific research; administrative and ancillary activities	0.2	-0.2	0.3	-0.4	0.3	-0.1	-0.1	0.2	0.0	0.1	0.1	0.2	-0.2
General government; education; healthcare and social services	-0.1	-0.1	0.0	-0.1	-0.1	0.1	0.0	0.0	0.1	-0.1	0.0	0.0	0.0
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	0.6	0.7	-0.2	0.0	-0.1	0.1	-0.2	0.0	0.2	0.2	0.8	0.6	0.4
<b>Gross value added, total for the economy</b>	<b>0.6</b>	<b>0.7</b>	<b>-0.2</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.1</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.2</b>	<b>0.2</b>	<b>0.8</b>	<b>0.6</b>	<b>0.4</b>

Source: NSI.

productivity had a negative contribution to the growth.

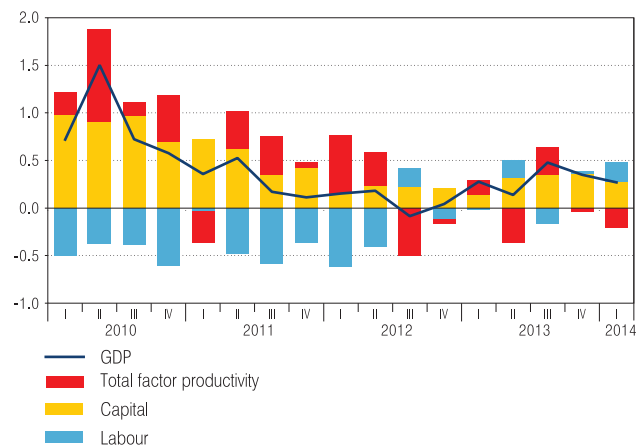
Improvement in external environment is expected to continue and to contribute to the economic growth in Bulgaria but it will remain a source of uncertainty for the economic activity in Bulgaria. As economic growth observed since early 2013 remains yet weak and deflationary processes continue, the internal environment is also a source of uncertainty. Increased uncertainty by the end of June following the placement of the Corporate Commercial Bank under conservatorship and the political instability before early parliamentary elections may negatively affect the expectations of firms as to their intents for investment and hiring personnel.

## Exports and Imports of Goods

In the first quarter of 2014 nominal exports and imports dynamics continued to be driven by decreases in international prices of groups of goods important for Bulgaria's foreign trade turnover and by increasing domestic demand. In the first quarter of 2014 nominal exports decreased by 6.6 per cent on an annual basis,

## Contribution of Changes in Production Factors to GDP Growth

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



Sources: NSI, BNB calculations.

while nominal imports of goods went up by 0.4 per cent on an annual basis. Trade deficit came to EUR 825.6 million, deteriorating by EUR 376.7 million on an annual basis.

Seasonally unadjusted GDP data point to a real annual decline in exports of goods by 0.5 per cent (against an increase of 13.0 per cent in the fourth quarter of 2013). Based on foreign trade statistics data, it may be concluded that the groups of mineral fuels and distilled products and base metals contributed most substantially to this decline.

Real annual growth of imported goods accelerated to 6.3 per cent in the first quarter of 2014 (against 6.0 per cent in the fourth quarter of 2013), reflecting the recovery in domestic demand. In the first quarter of 2014 overall import dynamics was driven by the decline in the mineral fuels and distilled products group imported from Russia. This, as well as the export dynamics of the group, was due to the renovation and building of new oil production capacities.<sup>44</sup>

Cross-checking the changes in exports and imports in nominal and real terms shows that the falls in global prices curbed nominal growth of international trade flows in the first quarter of 2014. If the effect of crude oil, petroleum products and natural gas prices is removed, total nominal decrease of exported goods (fob) between January and March 2014 would be 5.4 per cent on an annual basis (the reported decrease of 6.6 per cent), while nominal import growth (fob) would amount to 2.4 per cent (reported growth of 0.6 per cent).<sup>45</sup> The weaker performance of exports and imports is confirmed by export and import price indices under the Standard International Trade Classification (SITC), pointing to an annual fall in exports and imports of 8.0 and 4.4 per cent respectively in the first quarter of 2014.

In the third and fourth quarters of 2014 nominal export growth is expected to recover on an

## Net Exports of Commodity Groups By Use, January–April 2014

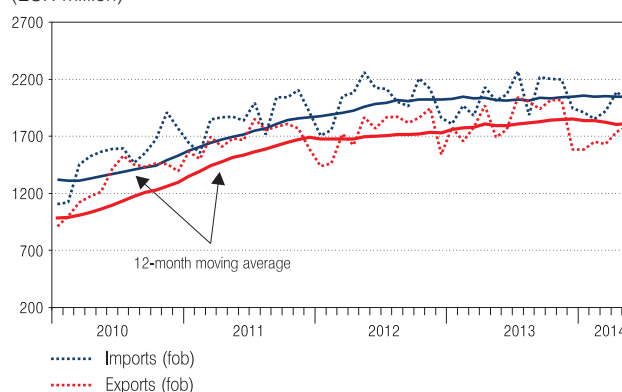
	Balance, EUR million	Change*, EUR million	Export growth**, per cent	Import growth**, per cent
Consumer goods	243.0	89.9	11.9	7.1
Raw materials	-355.7	-441.0	-13.5	0.5
Investment goods	-522.2	-69.0	2.6	5.9
Energy resources	-912.5	-148.7	-35.2	-12.6
<b>Total</b>	<b>-1576.4</b>	<b>-571.0</b>	<b>-8.0</b>	<b>0.0</b>

\* Balance change on the same period of previous year.

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

## Export and Import Dynamics

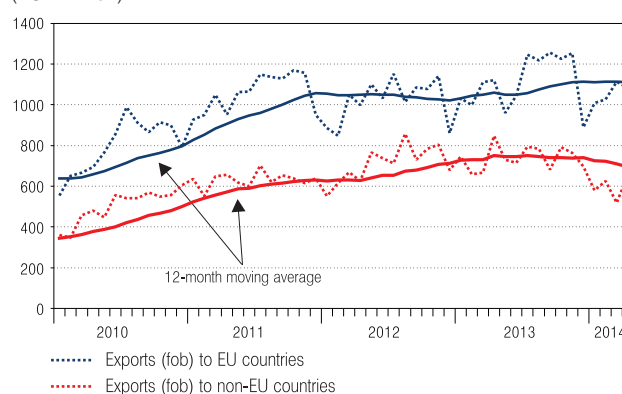
(EUR million)



Source: BNB.

## Dynamics of Exports to EU and non-EU Countries

(EUR million)



Source: BNB.

<sup>44</sup> Budget Performance Monthly Bulletin of the Ministry of Finance, only in Bulgarian, March 2014, p. 6. Based on information published by the Press Centre of LUKOIL Neftochim on its website.

<sup>45</sup> According to the Balance of Payments of Bulgaria, April 2014, p. 8.

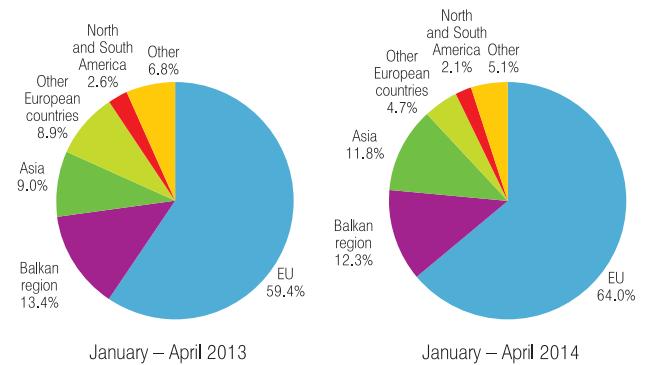
annual basis. This will mainly be due to the growth in physical volumes, which will be prompted by the strengthening external demand in Bulgaria's major trade partners and the recovery in the mineral fuels and distilled products group. In the third and fourth quarters of 2014 growth rates of imports (mainly physical volumes) may accelerate provided that domestic demand accelerates. The trade balance deficit is projected to be around 7.5 per cent of GDP in the third and fourth quarters of 2014.

Risks related to higher than expected trade deficit could be materialised if the moderation in export growth observed in the first quarter of 2014 continues. Lower than projected trade deficit could occur in the event of faster demand growth in Bulgaria's major trade partners, more flexible use of exports capacity by Bulgarian exporters, further improvements in the terms of trade, and lower import growth as a result of the retained or reduced domestic demand.

According to preliminary data on external trade by commodity group, between January and April 2014 exports to EU countries decreased slightly by 0.9 per cent on an annual basis, with base metals and related products; and animal and plant products, food, drinks and tobacco having the major negative contributions to this growth. Machines, vehicles, appliances, instruments and weapons; and textile, leather, clothing, footwear and other consumer goods had the strongest positive contribution. Exports to non-EU countries went down 18.4 per cent largely due to mineral products and fuels; and animal and plant products, food, drinks and tobacco.

The share of exports to EU countries increased by 4.6 percentage points on an annual basis between January and April 2014 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 remained almost unchanged over the review period against the background of the sustainable competitive positions of Bulgarian exporters in international markets.

## Geographical Distribution of Exports



Source: BNB.

## Exports by Commodity Groups, January–April 2014

	million EUR	Change*	Growth**, per cent	Contribution**, percentage points
Mineral products and fuels	859.2	-433.4	-33.5	-6.0
Machines, vehicles, appliances, instruments and weapons	1497.0	65.5	4.6	0.9
Base metals and related products	1200.7	-191.2	-13.7	-2.7
Animal and plant products, food, drinks and tobacco	928.9	-195.0	-17.3	-2.7
Chemical products, plastics and rubber	804.9	73.0	10.0	1.0
Wood products, paper, ceramics and glass	355.6	44.7	14.4	0.6
Textiles, leather, clothing, footwear and other consumer goods	960.7	63.1	7.0	0.9
<b>Total exports</b>	<b>6607.0</b>	<b>-573.2</b>	<b>-8.0</b>	

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

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

Source: BNB.

In the January–April 2014 period most commodity groups of exports reported growth, excluding the groups of mineral fuels and distilled products; base metals; and animal and plant products, food, drinks and tobacco. Mineral products and fuels contributed most to the annual decline.

Exports of mineral fuels and distilled products decreased by 33.5 per cent on an annual basis between January and April 2014 mainly due to lower exports to non-EU countries. The decrease broadly reflected the reduction of exported volumes due to the renovation and building of new oil production capacities.<sup>46</sup> The fall in international oil prices contributed further to this.<sup>47</sup> In the third and fourth quarters of 2014 exported physical volumes of this group are expected to recover, positively affecting total Bulgarian export growth. International price dynamics is expected to have a dampening effect on nominal export growth over the third and fourth quarters of 2014.

The sustainable annual growth in exports of machines, vehicles, appliances, instruments and weapons continued between January and April, contributing strongly to total export growth. Growth reflected mostly the larger exported volumes, while higher export prices exerted a dampening pressure on nominal exports.<sup>48</sup> Over the projection horizon, the export dynamics of the group is expected to remain stable amid strengthening external demand.

Between January and April 2014 exports of base metals fell on an annual basis. This reflected mainly the fall in international prices, while exported volumes contributed less to the lower exports in the group.<sup>49</sup> Rates of decline in international metal prices in euro will slow down in the third quarter and will stabilise in the

<sup>46</sup> See: Note 44.

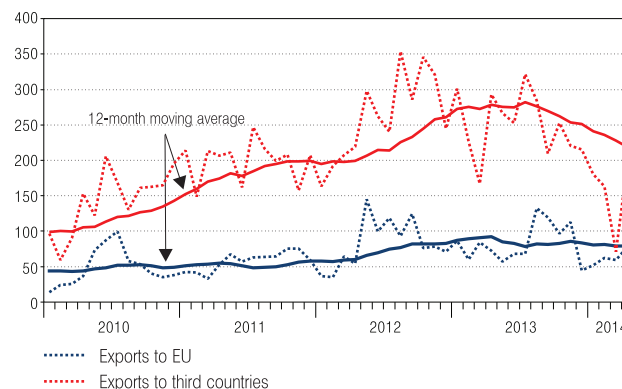
<sup>47</sup> According to the Balance of Payments of Bulgaria, May 2014, p. 40, and using the quarterly export deflators of the mineral fuels, oils and related products group under SITC for the first quarter of 2014.

<sup>48</sup> The quarterly export deflators for the machines, equipment and vehicles group under SITC were used to estimate the price effect in the first quarter of 2014.

<sup>49</sup> According to the Balance of Payments of Bulgaria, May 2014, p. 40, for the non-ferrous metals subgroup using the quarterly export deflators for the cast iron and steel group under SITC for the first quarter of 2014.

## Exports of Mineral Products and Fuels

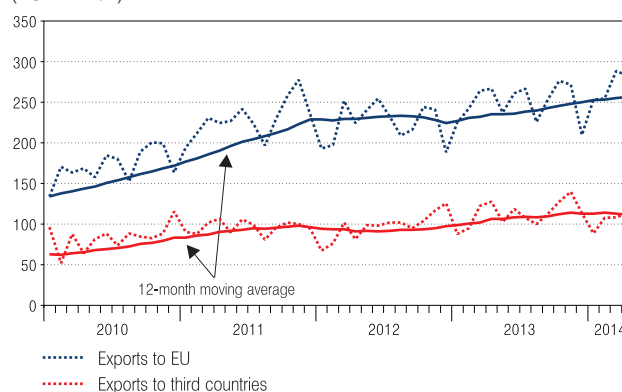
(EUR million)



Source: BNB.

## Exports of Machines, Vehicles, Appliances, Instruments and Weapons

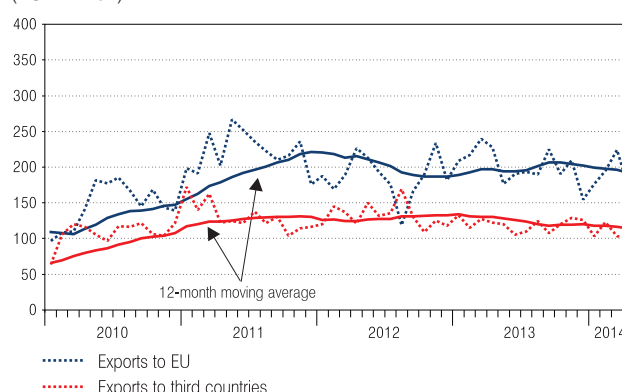
(EUR million)



Source: BNB.

## Exports of Base Metals and Related Products

(EUR million)



Source: BNB.

fourth quarter of 2014, which will have a dampening effect on nominal exports in this group.

Exports of animal and plant products, food, drinks and tobacco reported a decline on an annual basis between January and April 2014, reflecting mainly lower international export prices, rather than the fall in exported physical volumes.<sup>50</sup> Our expectations for the third and fourth quarters of 2014 point to a rise in international food prices, which will boost nominal exports in the group.

Exports of chemicals, plastics and rubber increased in the January to April 2014 period, contributing most to total export growth. This group's exports to EU countries increased more steadily. Higher exports in the group were entirely due to price rises, while physical volumes remained almost unchanged compared to the corresponding period of 2013.<sup>51</sup> Over the projection horizon exports in the group are expected to continue growing at rates close to the current ones due to the expected moderate dynamics of respective international prices.

Imports (cif) remained unchanged in nominal terms in the January–April 2014 period on an annual basis. Based on the System of National Accounts (SNA) data for the first quarter of 2014, 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 investment and consumer goods contributed to the nominal growth of imports by end-use, while energy resources had a downward effect on the nominal volumes of imports.

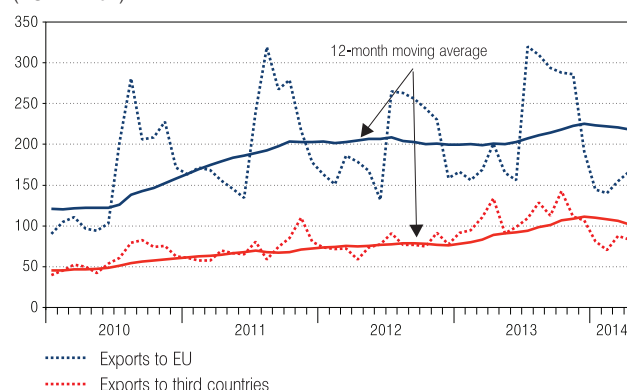
In the period from January to April 2014 imports from EU Member States increased by 4.3 per cent and those from non-EU countries fell by 4.1 per cent. The decline in imports from non-EU countries was largely due to Russia, the

<sup>50</sup> To estimate the price effect, see the respective quarterly export deflators for the listed divisions in the first quarter of 2014 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.

<sup>51</sup> The quarterly export deflators for the chemicals and chemical products group under SITC were used to estimate the price effect in the first quarter of 2014.

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

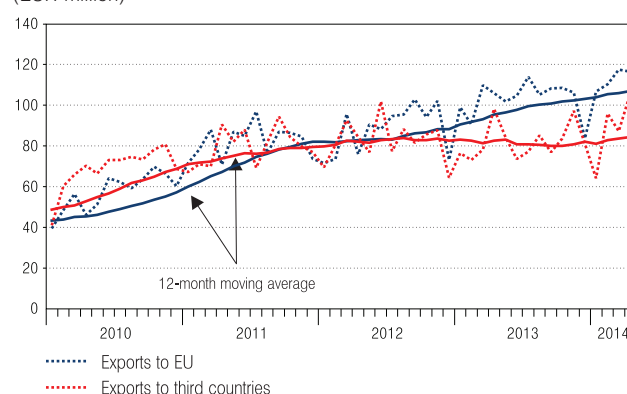
(EUR million)



Source: BNB.

## Exports of Chemical Products, Plastics and Rubber

(EUR million)



Source: BNB.

## Imports of Commodity Groups By Use, January–April 2014

	EUR million	Change*	Growth** per cent	Contribution**, percentage points
Consumer goods	1598.4	106.0	7.1	1.3
Raw materials	3080.4	15.5	0.5	0.2
Investment goods	1850.7	102.8	5.9	1.3
Energy resources	1614.5	-232.3	-12.6	-2.8
<b>Imports, total (cif)</b>	<b>8183.4</b>	<b>-2.3</b>	<b>0.0</b>	

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

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

Source: BNB.

main exporter of petroleum products to Bulgaria, where they are processed and subsequently exported.<sup>52</sup>

Imports in the group of energy resources fell in the period from January to April 2014 due mainly to lower imported physical volumes and to a lesser extent to falling international prices of imported energy resources.<sup>53</sup> Imports of energy resources' dynamics are linked to export dynamics. Accordingly, import physical volumes are expected to recover over the third and fourth quarters of 2014 when exports of energy resources are expected to begin recovering. The expected decline in international prices of this group will have a dampening effect on nominal imports.

Imports of the raw materials group reported a slight increase in the January–April 2014 period. The assessment of the price change effects in this group<sup>54</sup> suggests that growth reflected mostly the larger physical volumes. The ongoing recovery in domestic demand will contribute to the increase in imported physical volumes, while international price dynamics will have a dampening effect on nominal import growth of raw materials over the third and fourth quarters of 2014.

Imports of consumer goods rose in the January to April 2014 period in line with higher domestic demand. Clothing and footwear and medicines and cosmetics had the largest contribution to the growth. In the third and fourth quarters 2014 imports of consumer goods are expected to slightly increase on an annual basis in line with private consumption dynamics.

In the January–April 2014 period imports of investment goods posted significant growth largely due to higher physical volumes.<sup>55</sup>

<sup>52</sup> See footnote 44.

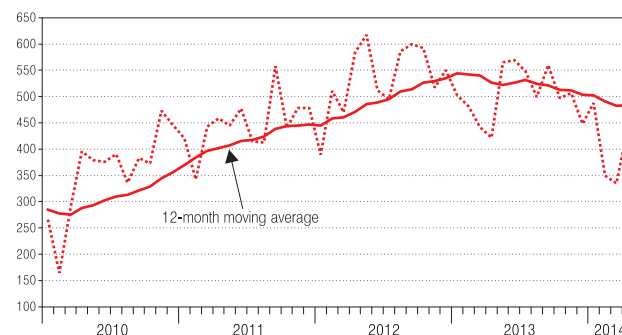
<sup>53</sup> According to the Balance of Payments of Bulgaria, May 2014, p. 40, and using the quarterly import deflators of the mineral fuels, oils and related products group under SITC for the first quarter of 2014.

<sup>54</sup> According to the Balance of Payments of Bulgaria, April 2014, p. 42, and the quarterly import deflators of the groups of food and live animals, inedible (crude) materials (excluding fuels), chemicals and chemical products and manufactured goods classified chiefly by materials under SITC for the first quarter of 2014.

<sup>55</sup> The quarterly import deflators for the machines, equipment and vehicles group under SITC were used to estimate the price effect in the first quarter of 2014.

## Imports of Energy Resources

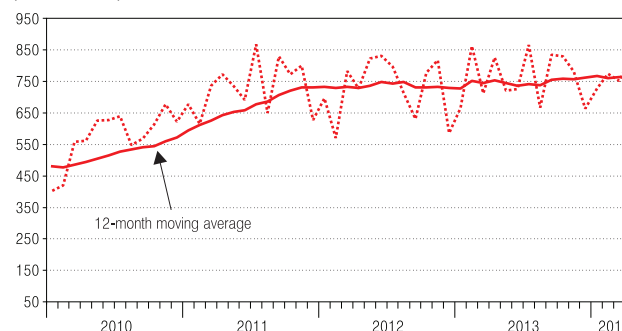
(EUR million)



Source: BNB.

## Imports of Raw Materials

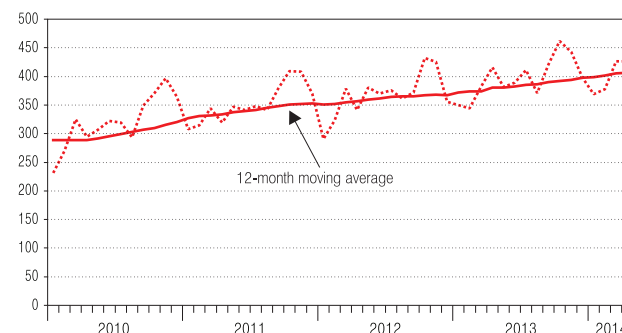
(EUR million)



Source: BNB.

## Imports of Consumer Goods

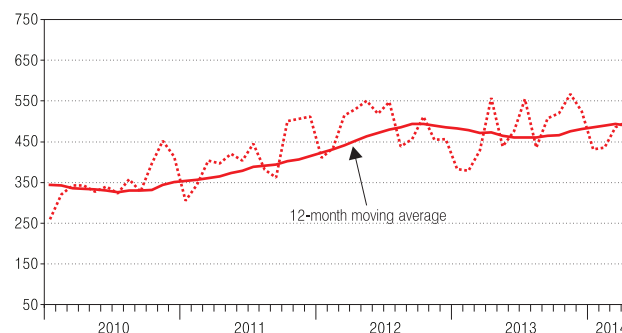
(EUR million)



Source: BNB.

## Imports of Investment Goods

(EUR million)



Source: BNB.



Machines, vehicles and appliances and spare parts and equipment contributed most to it. In case no essential changes in the international prices of investment goods occur, in the third and fourth quarters of 2014 their imports will remain at rates close to the current ones, reflecting the slight recovery in investment activity in Bulgaria.

## 4. Inflation

In the first six months of 2014 the still negative annual HICP inflation rate decelerated to -1.8 per cent (-0.9 per cent at the end of 2013). Deepening deflation was largely driven by the fall in the prices of transport fuels, food and services, reflecting mainly lower international prices and some specific factors related to certain groups of services. The lower negative contribution of administratively controlled prices in March limited the rate of decline of the overall HICP.

In the third and fourth quarters of 2014 inflation is expected to remain negative, although the rates of price declines will tend to slow down. Until the end of the year, slight growth in food prices and a reduction of the negative contribution of administratively controlled prices and core inflation are expected.

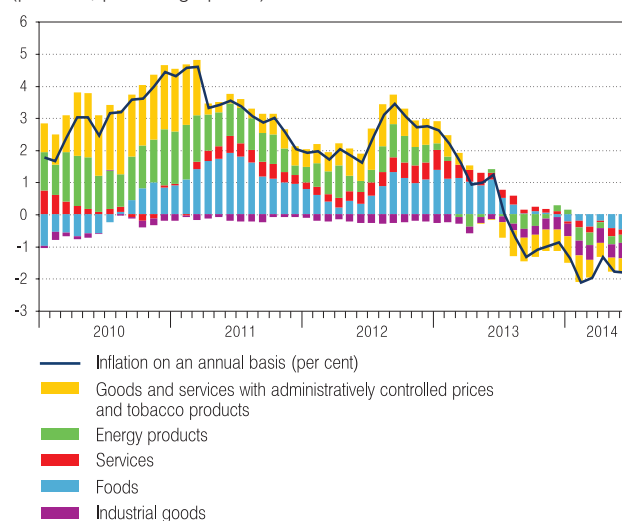
In the January to June 2014 period the annual inflation of consumer prices remained negative.<sup>56</sup> In June, HICP reported a -1.8 per cent decline (-0.9 per cent in December 2013) on an annual basis.

Deepening deflation in early 2014 reflected mainly the effect of external factors: lower international fuel, major commodity and food prices. According to national accounts data, the import deflator of goods posted a -5.3 per cent annual decline in the first quarter of 2014 for the sixth consecutive quarter (against -4.5 per cent in 2013). Price falls in certain groups of services, which were driven by specific factors, added further to stronger overall deflation on the end of 2013. At the same time, in line with our expectations, the lower negative contribution of administratively controlled prices in the March to June period limited the rate of decline of the overall HICP, although by June the negative contribution of administratively controlled prices in the overall HICP remained high (-0.47 percentage points).

In the January–June 2014 period deflation continued to spread across a broad range of goods and services included in the consumer basket – a trend observed since the second half of 2013. This was mainly due to the higher number of sub-groups

**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.

<sup>56</sup> The analysis in this section is based on NSI data on HICP.

reporting a fall in the prices of non-foods (excluding fuels), services (excluding administratively controlled prices) and foods. As of June 2014, the diffusion index, calculated as a share of declining HICP sub-indices on an annual basis, decreased slightly (to 47.3 per cent) from its peak reported in March (49.5 per cent), non-food goods contributing most to it.<sup>57</sup> Concurrently, price increases in the goods and services sub-group which recorded no declines in prices and had weight of 39.42 per cent<sup>58</sup> in the consumer basket in June are insignificant and insufficient to offset the negative contribution of goods and services with falling prices to overall HICP.

International price dynamics and the appreciation of the euro against the US dollar was the major factor behind the consumer price deflation between March and June. The fall in transport fuel prices reflecting mainly lower international oil prices in euro contributed by -0.24 percentage points to annual inflation in June (+0.24 percentage points at the close of 2013). Price decreases in processed and unprocessed foods (with a total contribution of -0.48 percentage points) contributed significantly to the reported deflation, with processed food prices reflecting the ongoing trend towards a depreciation of major agricultural raw materials on an annual basis on the international markets directly affecting domestic prices.

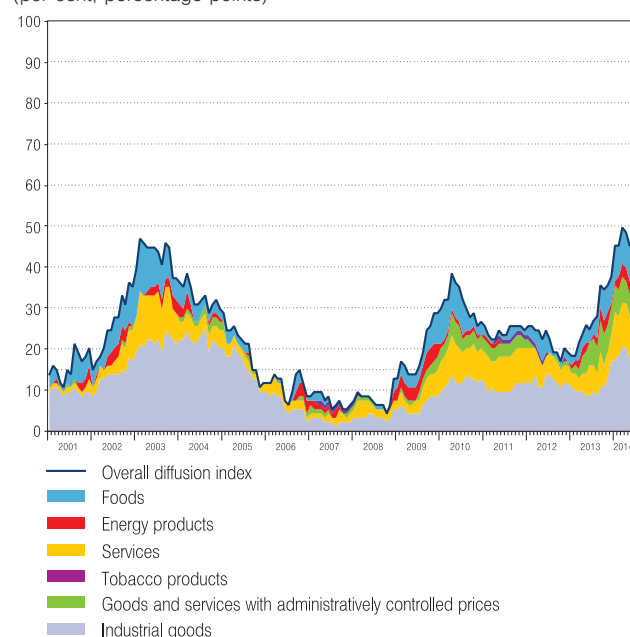
The total producer price index (PPI) on the domestic market, which continued falling on an annual basis, had an effect on end-use consumer prices. This dynamics reflected both the impact of international prices and the decrease in domestic electricity price in 2013. Lower negative contribution of electricity, heating and gas production and manufacturing contributed to the moderation in the decline rate of PPI to -0.7 per cent in May (-2.8 per cent at the end of 2013). Producer prices

<sup>57</sup> Based on the four-digit COICOP index (classification of individual consumption by purpose).

<sup>58</sup> The weights are updated as of December 2013 (Source: Eurostat).

### Diffusion Index of Major Goods and Services Groups (relative shares of declining HICP sub-indices on an annual basis)

(per cent, percentage points)

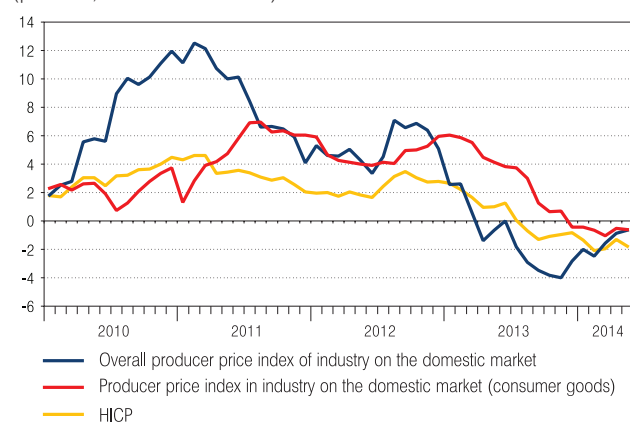


Note: The difference between the calculated diffusion index and 100 per cent represents the share of HICP sub-indices, which increase or remain unchanged on an annual basis.

Sources: NSI, BNB calculations.

### Rate of Change in Producer Price Index and HICP

(per cent, on an annual basis)



Source: NSI.

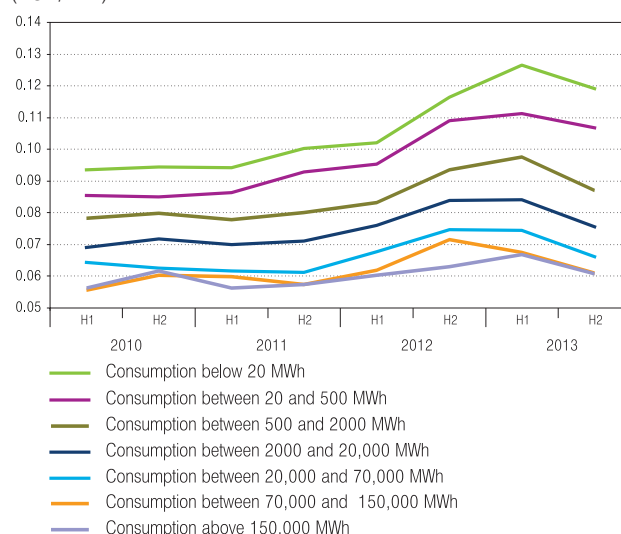
in manufacturing remained at its level of the corresponding month of the previous year, while food, drink and tobacco product production retained their negative contribution by May.

In the first five months of 2014 the relatively high annual rate of decline in producer prices of intermediate consumption goods was retained, which contributed to reducing industrial production costs and decreasing end-use consumer prices. Over the period under review the rate of decline in energy product prices was significantly lower than in late 2013, while in May a slight increase on an annual basis was reported in this group.<sup>59</sup> The low negative rate of change on an annual basis in the prices of non-durable consumer goods in early 2014 reflected mainly the downward price dynamics in food production. Between January and May 2014 the producer price index in investment products on the domestic market retained its upward trend observed since the previous year, though at a lower rate.

How firms respond to the falling international prices and weak consumer demand may be analysed by decomposing the contribution of unit labour costs, unit profit and net unit tax to gross value added deflator dynamics. In the first quarter of 2014 gross value added deflator in total economy posted a -3.3 per cent fall on an annual basis, reflecting mainly the contraction in unit profits. Concurrently, unit labour costs had a small positive contribution to value added deflator, with compensation *per* employee displaying a recent year's trend towards a moderation in their annual growth. Lower profits indicates that firms could not offset the lower end product prices in the context of weak demand only by reducing expenses on intermediate goods and limiting labour costs.

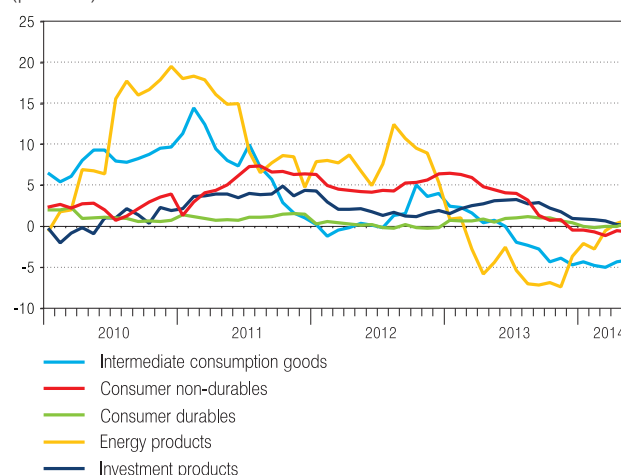
<sup>59</sup> The Main Industrial Groupings classification was used to cover the following sectors: manufacture of intermediate consumption goods, energy product production and water related activities, investment product manufacturing and consumer goods production.

**Price of Electric Power Supplied to the Industrial Consumers (BGN/kWh) Depending on Consumption**  
(BGN/kWh)



Source: Eurostat.

**Annual Rates of Change in Producer Prices on the Domestic Market by Major Industrial Groupings**  
(per cent)



Source: NSI.

By economic sector, a relatively high reduction in unit profits was observed in industry probably due to the lower international prices and industrial turnover of enterprises on international markets.<sup>60</sup> Unit labour costs had a much smaller negative contribution to the rate of change in this deflator in industry. In the services sector, since early 2013 firms have tended to offset lower unit profits by reducing labour costs, which are the main factor behind pricing. In the first quarter of 2014 unit labour costs and profits of the total sector had a small negative contribution.

The differences in the extent to which the consumer demand has recovered allow firms in the relevant economic sectors to apply different pricing and expenditure policy. According to the national account data, in the first quarter of 2014 household final consumption expenditure grew in real terms by 3.8 per cent on an annual basis after following its downward trend of the prior year. Non-foods and catering, as well as foods contributed positively to the higher household expenditure.

Retail trade turnover points to a recovery in consumption at the end of 2013 and in early 2014.<sup>61</sup> Between January and May food, drinks and tobacco reported relatively high growth rates of turnover at comparable prices on an annual basis, coupled with a depreciation of goods included in the consumer basket. A similar upward trend in real trade turnover against the background of falling end-use consumer prices was also observed in non-foods, with computer and communication equipment contributing most to turnover growth.

The retail trade turnover dynamics corresponds also to the improving household sentiment about the purchase of durable goods<sup>62</sup> in the following 12 months, registered in early 2014. At the same time, in early 2014 real

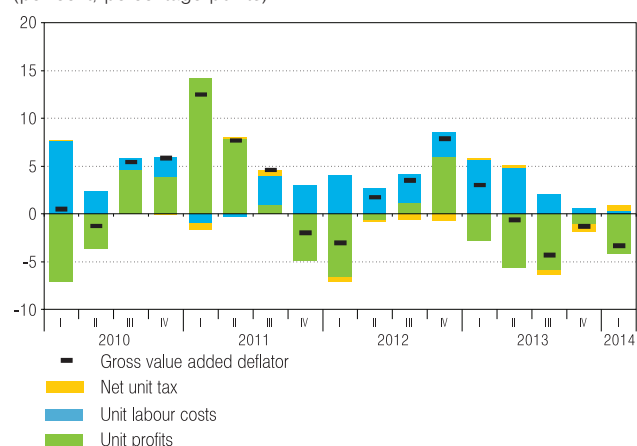
<sup>60</sup> For further details see Behaviour of Firms and Competitiveness in the Economic Activity section.

<sup>61</sup> For further details see Household Behaviour in the Economic Activity section.

<sup>62</sup> Such as purchase of furniture, electrical/electronic devices, etc.

### Annual Rates of Change in Value Added Deflator in Total Economy and Contribution by Component

(per cent, percentage points)



Note: The contribution of each component to value added deflator is calculated by multiplying the percentage change in the component and its share in total unit price (representing its share in gross value added). Unit labour costs also include the approximation of labour costs for the self-employed persons. The approximation is based on the assumption that the compensation *per* self-employed is equal to the average compensation *per* employee.

Sources: NSI, BNB calculations.

### Annual Rates of Change in Value Added Deflator in Industry and Contribution by Component

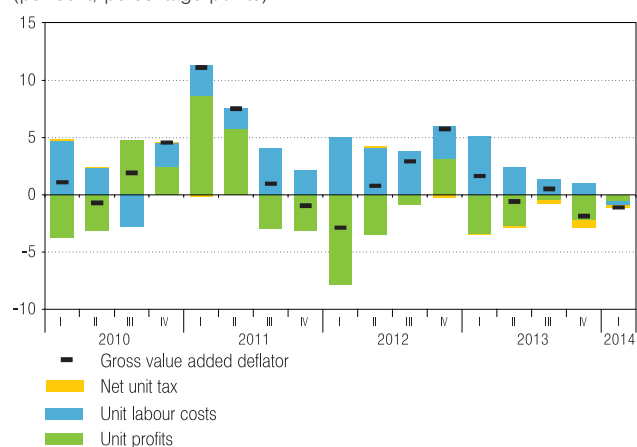
(per cent, percentage points)



Sources: NSI, BNB calculations.

### Annual Rates of Change in Value Added Deflator in Services and Contribution by Component

(per cent, percentage points)



Sources: NSI, BNB calculations.

turnover growth moderated on an annual basis in textile, clothing, footwear and leather, as well as in trade in unspecialised shops, with prices remaining unchanged or being slightly lower. In April and May 2014 turnover in these groups reported an annual decline at comparable prices.

The following trends were observed in price dynamics of major goods and services groups in the HICP. As of June food prices fell by 1.8 per cent on the corresponding period of the previous year (-0.3 per cent in December 2013), including unprocessed and processed food prices. The main factors behind the downward dynamics of food prices in early 2014 involve the ongoing decrease of production costs in agriculture, mild winter and still low international prices, which spilled over relatively quickly along the supply chain to end-user prices in Bulgaria.

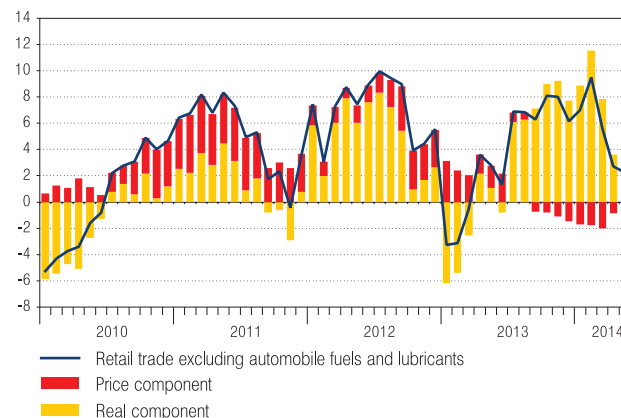
Sugar, jams, honey, chocolate and sugar products; animal and vegetable oils and fats, and bread and cereals contributed most to the cut in processed food prices in June 2014, the last two sub-groups continuing to reflect the depreciation in international prices of major raw materials, as sunflower seeds and wheat. Such a relation could not be made about sugar, which contributed significantly to the negative inflation of processed food. According to the State Commission on Commodity Exchanges and Market-places data, in June the price of wholesale sugar fell by 29.3 per cent on an annual basis and the retail price by 25.7 per cent.

Unprocessed food depreciation on an annual basis was underpinned mainly by the price decline of meat and meat products, which started at the end of 2013, and by more pronounced declines in vegetables in individual months. Lower end-use consumer prices of the latter sub-group were in line with the annual decrease in wholesale prices<sup>63</sup> of domestic and imported products on commodity markets

<sup>63</sup> According to the State Commission on Commodity Exchanges and Market-places data.

### Annual Growth Rate of Nominal Retail Trade Excluding Automobile Fuels and Lubricants

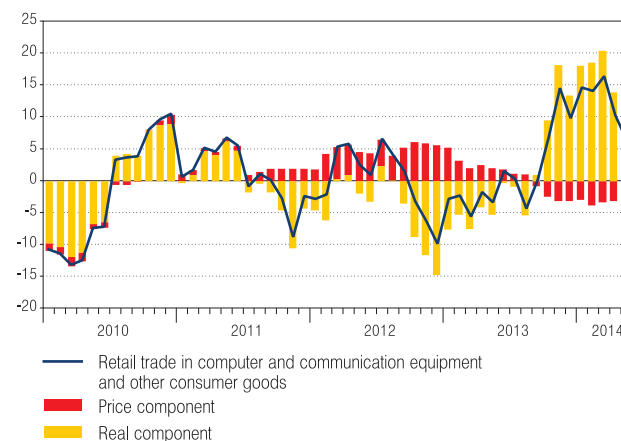
(per cent, percentage points, working-day adjusted data)



Sources: NSI, BNB calculations.

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

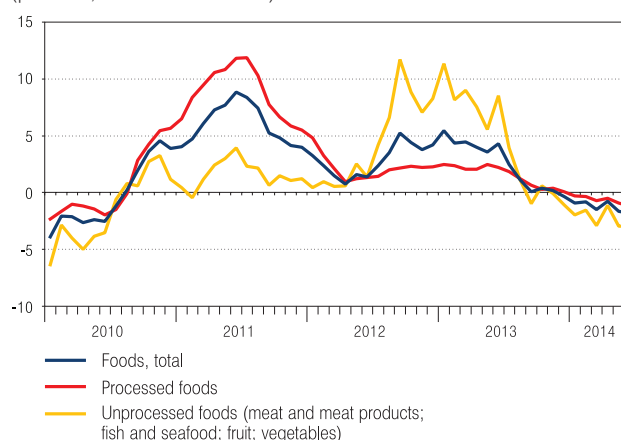
(per cent, percentage points, working-day adjusted data)



Sources: NSI, BNB calculations.

### Rate of Change of Food Price Index

(per cent, on an annual basis)



Sources: NSI, BNB calculations.



in Bulgaria. Vegetable prices are strongly dependant on the changes in import prices and on the quality of the harvest in Bulgaria and in the region. The reported deflation in meat and meat products does not correspond to the increasing international prices. This may be explained by internal factors, such as lower production costs in the second half of 2013 (on animal feed crops, electric power and fuels) and higher supply of pigmeat at the end of 2013 and in early 2014.<sup>64</sup>

Between January and June 2014 transport fuel prices recorded a decline on the corresponding period of the previous year in line with the continued annual fall in oil prices in euro.<sup>65</sup>

In the first half of 2014 administratively controlled prices still reported a high negative contribution to overall inflation, though the contribution tended to decrease due to the base effect of lower prices of electricity in March 2013. The annual decline rate in the prices of this group came to -2.7 per cent in June, with a -0.47 percentage point negative contribution to overall inflation. The third consecutive cut in the regulated price of electricity for households (down -2.7 per cent as of January) observed since the second half of 2013 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 as of January) contributed to the ongoing reduction in controlled prices in early 2014.

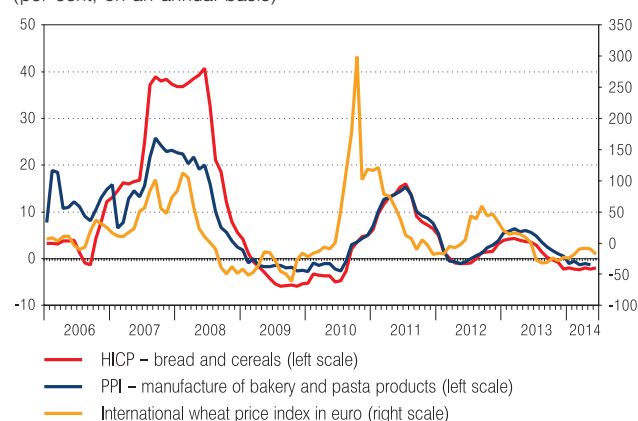
The downward trend in core inflation, which developed in 2013, continued in the first half of 2014. This pushed up the negative contribution of this group to overall inflation. June saw negative core inflation (-1.4 per cent, from -0.7 per cent by end-2013), largely driven by the decelerating services inflation

<sup>64</sup> Red meat: a situation and outlook analysis in 2013 and a forecast for 2014, Ministry of Agriculture and Food, May 2014.

<sup>65</sup> 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.

### Annual Rate of Change in Bread and Cereals Prices on the Domestic Market and Wheat Prices on the International Markets

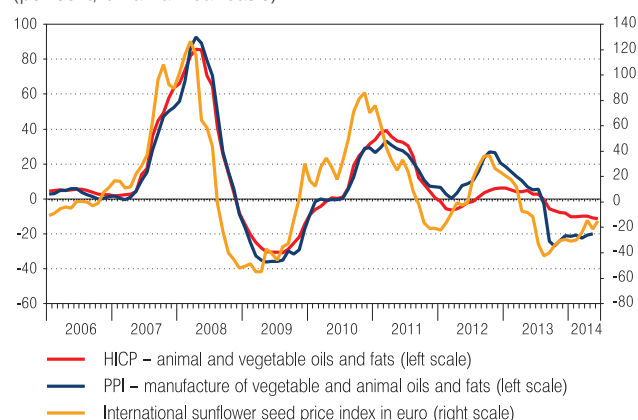
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

### Annual Rate of Change in Oils and Fats Prices on the Domestic Market and Sunflower Seed Prices on the International Markets

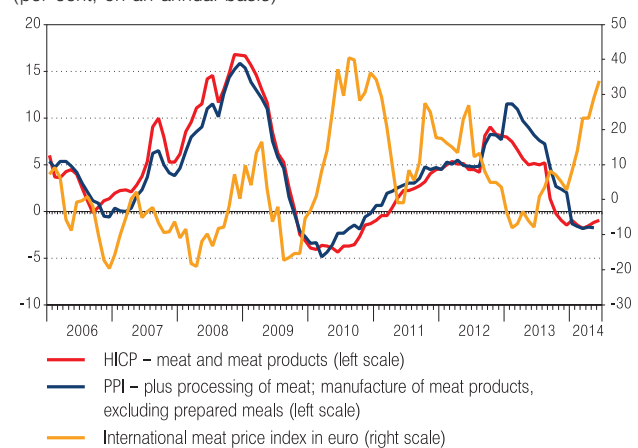
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

### Annual Rates of Change in Meat and Meat Product Prices on the Domestic Market and Meat Prices on the International Markets

(per cent, on an annual basis)



Sources: NSI, BNB calculations.

and, to a lesser extent, by the accelerating annual rate of decline in the prices of non-foods (excluding fuels).

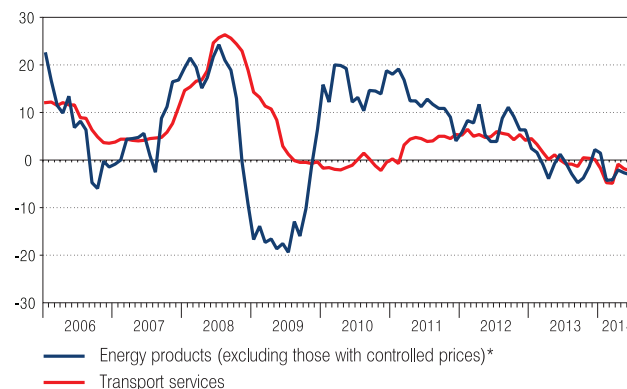
The deflation in non-foods came to -2.5 per cent in June 2014 (-2.1 per cent in December 2013). Price developments in this group were still driven mainly by the negative contribution of durables, which is likely to reflect the trend towards an appreciation of the euro observed since the second half of 2013. Since early 2014 the annual rate of decline in automobile, television and computer equipment prices remained relatively high, while household appliances, furnishings and furniture reported a relatively lower depreciation. As of June the non-durables price index went down slightly compared with the corresponding period of the previous year.

In 2014, unlike the previous year, annual deflation reported in the groups of services was negative and came to -0.6 per cent in June. This was largely driven by specific factors in certain groups of services, as telecommunications, air transport and dental services. Telecommunication services prices fell by -2.9 per cent by June (-0.7 per cent by December 2013). A methodological change in air fare reporting, which has been applied since early 2014, had a key role for their negative contribution to the downward price dynamics in services since the beginning of the year. In 2014 the prices of dental services<sup>66</sup> also contributed to the decline in overall services price index, owing to the cut in the user fees paid to dentists having concluded contracts with the National Health Insurance to the amount -28.6 per cent effective as of January. Other important factors behind the deflation were the moderate inflation in catering and the decreasing prices in passenger automobile transport, which are indirectly affected by the food and fuel prices in Bulgaria.

<sup>66</sup> 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.

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

(per cent, on an annual basis)

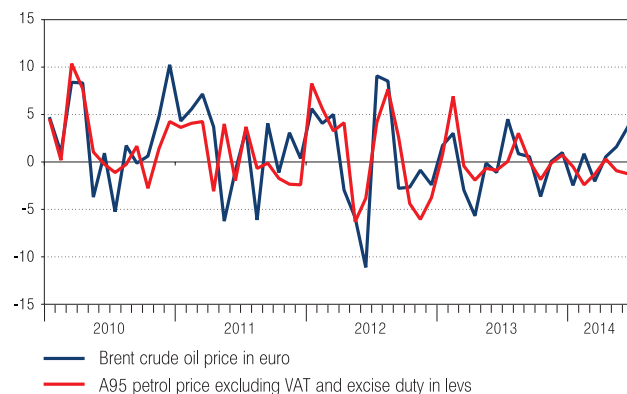


\*Energy products, excluding those with controlled prices, include fuels and lubricants for personal transportation vehicles, and solid, fluid and gaseous fuels for households.

Sources: NSI, BNB calculations.

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

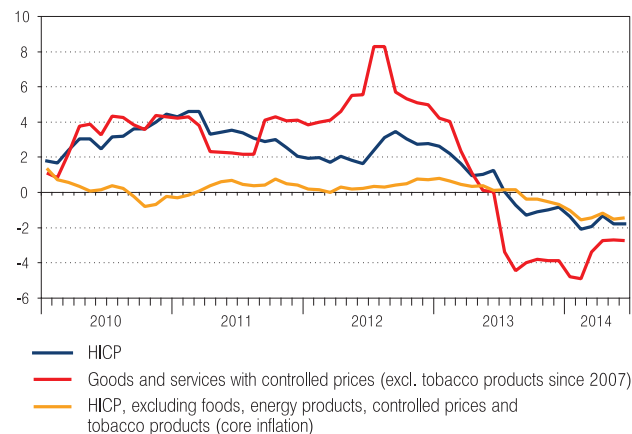
(per cent)



Sources: ECB, NSI, BNB calculations.

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

(per cent, on an annual basis)



Sources: NSI, BNB calculations.

The Survey of Business Developments in Industry of June 2014 reported an increase in the opinion balance regarding the expected selling prices in the following three months, which is in line with the improvement in entrepreneurs' assessments of current production activity. Prevailing expectations of managers are for keeping selling prices in services unchanged in the following three months. In retail trade, the balance of opinion retained its previous months' level amid prevailing expectations of a stabilisation or a slight decline in prices.

Inflation expectations for the following quarters and related uncertainty are presented in the fan chart on the annual rate of change in the HICP.<sup>67</sup> In the third quarter of 2014 we expect negative inflation at -1.1 – -0.2 per cent and in the fourth quarter it is expected to range between -0.7 per cent and 0.5 per cent.<sup>68</sup> The further reduction in the negative contribution of administratively controlled prices, together with the end of the fall in food prices and the lower negative contribution of core inflation in the second half of 2014 will be the main factors behind the moderation in the current decline rate of consumer price index. The weaker transfer of international price rises since the beginning of the year to the consumer prices in Bulgaria and the downward price dynamics in services give grounds to revise downwards our assessment for overall inflation until the end of the year.

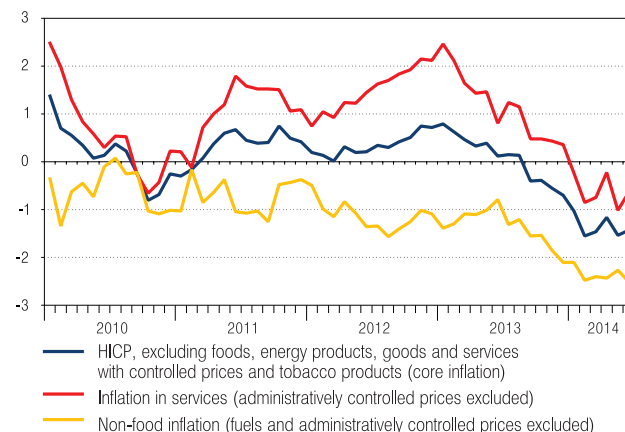
The projection is based on the assumption for an increase in international food prices on a quarterly and annual basis in the second half of 2014. The oil prices in euro are expected to slightly decrease on an annual basis in the third and fourth quarters. The projection includes the assumption that administratively controlled prices will remain at their current levels until year-end. Therefore, we expect further reduction in the negative contribu-

<sup>67</sup> For further details, see the Measurement and Presentation of Uncertainty in Forecasting Economic Indicators box, Economic Review, 1/2012.

<sup>68</sup> 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.

## Core Inflation

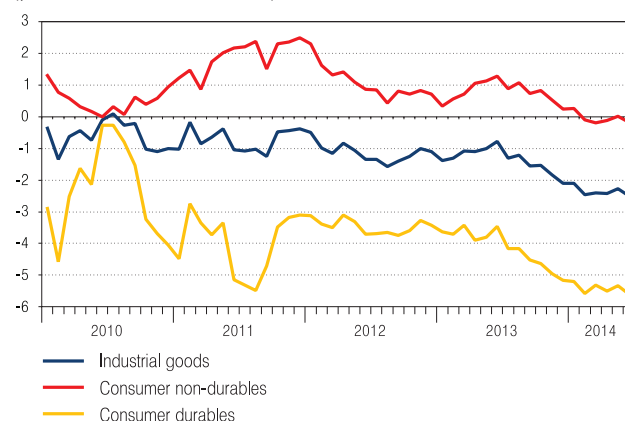
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

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

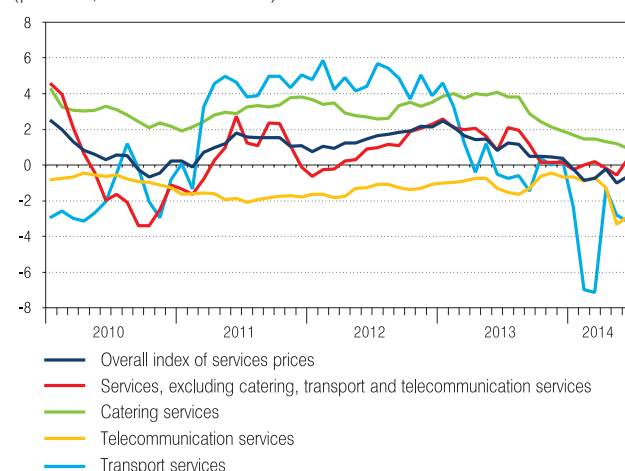
(per cent, on an annual basis)



Sources: NSI, BNB calculations.

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

(per cent, on an annual basis)



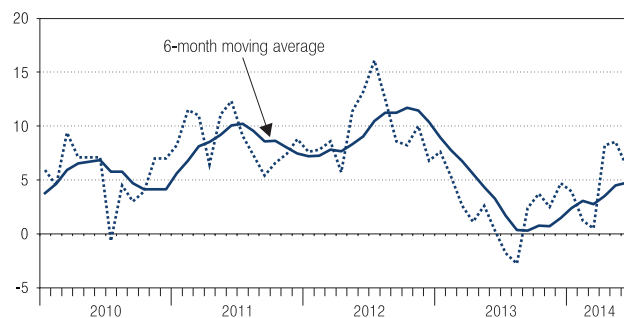
Sources: NSI, BNB calculations.

tion of this group to overall inflation. This will reflect the base effect of price declines in electricity for households in mid-2013 and the increase in prices of electricity for households and heating as of 1 July 2014, which was announced by the State Energy and Water Regulatory Commission.

Major risks to the projected overall inflation dynamics in the second half of 2014 relate mainly to international oil and food price developments that may push consumer prices up or down. There is a risk that the dynamics of food prices in Bulgaria may continue to differ from that on the international markets in case of a good harvest in the region and rising international prices of some types of food, whose price dynamics does not affect directly domestic price developments.

### Selling Prices Expectations in Industry over the Next 3 Months

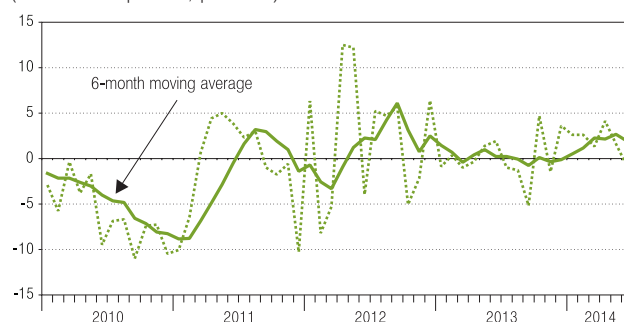
(balance of opinions, per cent)



Source: NSI.

### Selling Prices Expectations in Services over the Next 3 Months

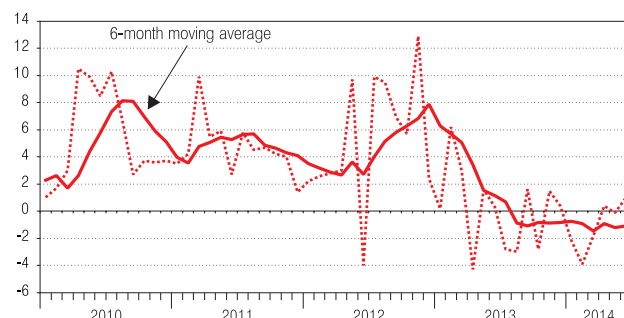
(balance of opinions, per cent)



Source: NSI.

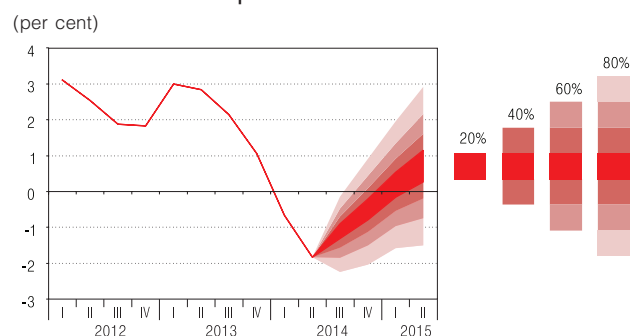
### Selling Prices Expectations in Retail Trade over the Next 3 Months

(balance of opinions, per cent)



Source: NSI.

## Fan Chart of the Expected Annual Inflation Rate



Note: The fan chart shows the expert views of the forecasters on the uncertainty around the projected value based on probability distribution. The middle band of the chart, depicted in the darkest colour, includes the central projection. 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 June 2013 (December 2012 = 100)		Inflation accumulated as of June 2014 (December 2013 = 100)		Annual inflation rate as of June 2014 (December 2013 = 100)	
Inflation (per cent)	-0.8		-1.7		-1.8	
	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
<b>Foods</b>	0.4	0.11	-1.1	-0.28	-1.8	-0.48
Processed foods	0.1	0.02	-1.1	-0.19	-1.2	-0.20
Unprocessed foods	1.0	0.09	-0.9	-0.09	-3.0	-0.28
<b>Services</b>	-0.7	-0.18	-1.7	-0.43	-0.6	-0.16
Catering services	1.3	0.07	0.4	0.02	0.9	0.05
Transport services	-1.3	-0.04	-4.6	-0.16	-3.2	-0.11
Telecommunication services	-0.6	-0.03	-2.8	-0.14	-2.9	-0.14
Other services	-1.6	-0.17	-1.4	-0.15	0.3	0.04
<b>Energy products</b>	-1.0	-0.09	-6.0	-0.55	-3.0	-0.26
Transport fuels	-0.8	-0.07	-6.3	-0.54	-3.0	-0.24
<b>Industrial goods</b>	-0.9	-0.17	-1.3	-0.26	-2.5	-0.48
<b>Goods and services with administratively controlled prices*</b>	-2.6	-0.47	-1.4	-0.24	-2.7	-0.47
<b>Tobacco products</b>	0.2	0.01	0.4	0.02	1.1	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.