

Economic Review

2/2016



BULGARIAN
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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.

The *Economic Review*, issue 2/2016 was presented to the BNB Governing Council at its 14 July 2016 meeting. It employs statistical data published up to 1 July 2016.

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

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Contents

Summary	7
1. External Environment	9
Current Business Situation	9
International Commodity Prices	15
2. Financial Flows, Money and Credit	18
External Financial Flows	18
Monetary and Credit Aggregates	20
Interest Rates	24
Financial Flows between the General Government and Other Sectors of the Economy	28
3. Economic Activity	30
Current Economic Environment	30
Household Behaviour	32
Fiscal Policy Effects on the Economy	35
Behaviour of Firms and Competitiveness	37
Exports and Imports of Goods and Services	41
4. Inflation	47
5. Bulgarian National Bank Forecast of Key Macroeconomic Indicators for 2016–2018	54

Charts

Global PMIs	9	Currency in Circulation	22
World Trade	9	Foreign Currency Purchases and Sales between the BNB and Banks (on a Monthly Basis)	22
Inflation Measured through CPI	10	Annual Growth of Loans to Non-financial Corporations and Contributions of Individual Types of Loans	22
Contributions to Real GDP Growth in the Euro Area by Country (Quarterly)	10	New Loans to Non-financial Corporations (Monthly Volumes)	23
Contributions to Real GDP Growth in the Euro Area by Component (Quarterly)	10	Annual Growth of Household Credit and Contributions of Individual Types of Loans	23
Euro Area Consumer Confidence Indices	11	New Loans to Households (Monthly Volumes)	23
Changes in GDP and PMIs of Manufacturing and Services	11	Changes in Credit Standards	24
Euro Area Unemployment Rate and Employment Growth	11	Interbank Money Market Instruments Yield Curve	25
EURIBOR Dynamics	12	Interest Rates on Three-month Deposits	25
Euro Area Inflation Rate	12	Interbank Money Market Interest Rates on Overnight Deposits	25
ECB Interest Rates, EONIA and Excess Liquidity in the Euro Area Banking System	12	Interest Rates on New Time Deposits	26
Contribution to US GDP Growth by Component (Quarterly)	12	Variation of Interest Rates on New Household Time Lev Deposits	26
US Manufacturing and Services <i>ISM-PMIs</i> and GDP Growth (quarterly)	13	Interest Rates on New Loans to Non-financial Corporations by Currency	27
US Consumer Confidence Indices	13	Interest Rates and Annual Percentage Rate of Charges on New Household Loans	27
US Inflation Rate	13	Variation of Interest Rates on New Housing Loans in Euro	28
US Unemployment Rate and Number of New Employees in the US Non-Agricultural Sector	14	Interest Rates on Ten-Year-and-Six-Month Government Securities on the Primary and Secondary Markets	28
Manufacturing and Services PMIs in China	14	Effect of Consolidated Budget on Other Sectors' Liquidity (Quarterly)	29
Total Fixed Capital Investment in Selected Sectors in China	14	Contribution to GDP Growth by Final Use Component	30
Inflation Indices in China	15	Factors Hampering Activities of Businesses	31
House Prices in China	15	Business Climate and Consumer Confidence	31
RMB/USD Exchange Rate and RMB Effective Exchange Rate Index	15	Expectations about Future Economic Activity	31
Brent Crude Oil Prices	15	Employment and Nominal Wage Bill	32
World Crude Oil Supply and Demand (Quarterly)	16	Economic Activity and Share of Discouraged Persons	32
Brent Crude Oil Futures Prices	16	Unemployment Rate	32
Price Indices of Major Raw Materials and Commodity Groups ...	17	Private Consumption and Consumer Confidence	33
Current and Capital Account Dynamics and Contribution by Component (on an Annual Basis)	18	Household Unemployment Expectations in the Following 12 Months	33
Financial Account Dynamics and Contribution by Component (on an Annual Basis)	19	Household Propensity to Save and Expectations	33
Direct Investment Liabilities by Type of Investment (on an Annual Basis)	20	Contribution of Major Groups of Revenue to Growth in Total Revenue and Grants, Cumulatively (on an Annual Basis)	35
Annual Rate of Change in M3 and Contribution by Component	20	Contribution of Major Tax Groups to Tax Revenue Growth, Cumulatively (on an Annual Basis)	35
Annual Growth of the Non-government Sector's Deposits and Contribution by Sector	21	Contribution of Major Groups of Expenditure to Total Expenditure Growth, Cumulatively (on an Annual Basis)	36
Reserve Money	21	Contribution of Government Consumption Components to Real GDP Growth	36
Bank Deposits with the BNB	21		

Value Added Growth and Contribution by Sector	37
Industrial Turnover Dynamics	38
Construction Production Dynamics and New Buildings Permits Issued	38
Gross Operating Surplus at Current Prices.....	38
Contribution to Changes in the Number of Employed by Economic Sector	39
Labour Productivity Developments (Value Added <i>per</i> Employee).....	39
Compensation <i>per</i> Employee at Current Prices	40
Unit Labour Costs.....	40
Industrial Output Index and Production Capacity Utilisation in Industry	40
Contribution of Changes in Production Factors to GDP Growth	40
Exports and Imports of Goods Dynamics	41
Exports and Imports of Services Dynamics	41
Dynamics of Exports to EU and non-EU Countries.....	42
Exports of Goods: Geographical Breakdown.....	42
Exports of Machines, Vehicles, Appliances, Instruments and Weapons	43
Exports of Mineral Products and Fuels	43
Exports of Base Metals and Related Products.....	43
Exports of Animal and Plant Products, Food, Drinks and Tobacco.....	44
Exports of Chemical Products, Plastics and Rubber	44
Annual Change of Exports of Services and Contribution by Sub-components	44
Imports of Energy Resources.....	45
Imports of Raw Materials	45
Imports of Consumer Goods.....	45
Imports of Investment Goods.....	46
Annual Change of Imports of Services and Contribution by Sub-components	46
Annual Inflation and Contribution of Major Commodity and Services Groups to It.....	47
Rate of Change in Manufacturing PPI and HICP	48
Rate of Change in the PPI on Domestic Market and Contributions by Major Sub-sectors.....	48
Monthly Rate of Change in the Prices of Brent Crude Oil and A95 Petrol.....	48
Annual Rate of Change in Producer Prices on the Domestic Market by Main Industrial Groupings	49
Rate of Change of Food Price Index.....	49

Contribution of Non-food Goods (Excluding Energy Products) and Major Services Sub-groups to Overall Inflation	49
Annual Growth Rate of Nominal Retail Trade (Excluding Automobile and Motorcycle Trade) and Selected Sub-sectors.....	50
Annual Growth Rate of Nominal Retail Trade in Non-Food Goods (Excluding Automobile Fuels and Lubricants)	50
Core Inflation	50
Contribution of Services and Major Services Sub-groups to Overall Inflation	51
Contribution of Tobacco Products and Major Sub-groups of Administratively Controlled Prices to Overall Inflation.....	51
Share of Firms by Economic Sectors Pointing to Insufficient Demand as a Factor Limiting Their Activity.....	52
Diffusion Index of Major Goods and Services Groups	52
Selling Prices Expectations in Industry, Retail Trade and Services over the Next Three Months	52
Fan Chart of the Expected Annual Rate of Change in Real GDP	58
Fan Chart of the Expected Annual Rate of Change in Inflation at the End of the Period	58

Tables

Projections of the Annual Rate of Change of Euro Area Real GDP	11
Projections of Annual Inflation in the Euro Area	11
Flows on Balance of Payments Accounts	19
Banks' Flows on Balance of Payments Financial Account	19
Gross External Debt as of April 2016	20
Real GDP Growth by Component of Final Use	31
Employment and Income Dynamics	34
Retail Trade Turnover	34
Revenue, Expenditure and Budget Balance on the Consolidated Fiscal Programme for 2015–2016	37
Gross Value Added Growth.....	40
Net Exports of Commodity Groups by Use, January–March 2016.....	41
Exports by Commodity Group, January–March 2016	42
Imports of Commodity Groups by Use, January–March 2016.....	45
Rates of Change of Major Goods and Services Groups Prices and Contribution of these Groups to Services	53
Forecast of Key Macroeconomic Indicators for 2016–2018.....	59

Abbreviations

ABSPP	Asset-Backed Securities Purchase Programme
APP	Asset Purchase Programme
APRC	Annual percentage rate of charge
BIR	Base interest rate
BOP	Balance of Payments
BTC	Bulgarian Telecommunications Company
b.p.	basis points
CBPP3	Covered Bond Purchase Programme
CEECs	Central and East European countries
CEFTA	Central European Free Trade Association
CFP	Consolidated Fiscal Programme
CIF	Cost, insurance, freight
CNY	Chinese Yuan
CPI	Consumer Price Index
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
EWRC	Energy and Water Regulatory Commission
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
OTC	over-the-counter
PBoC	People's Bank of China
PMI	Purchasing Managers' Index
p.p.	percentage points
PPP	Purchasing Power Parity
PSPP	Public Sector Purchase Programme
RON	Romanian new leu
SITC	Standard International Trade Classification
WTI	West Texas Intermediate

Summary

In April and May 2016 the global economic indicator continued to decline, signalling an ongoing slowdown in global growth. Across regions, this decline was again entirely due to the worsened economic activity expectations in some developed economic regions, such as the euro area and Japan. As a result of these developments, a number of international institutions, such as the European Central Bank (ECB), the International Monetary Fund (IMF), and the European Commission (EC) revised downwards their forecasts of 2016 global economic growth.

Global inflation continued to slow down amid declining international commodity prices on an annual basis. In April and May euro area inflation was negative (-0.2 and -0.1 per cent, respectively) which was a reason for the ECB to leave its interest rates unchanged. As of 8 June 2016 a new ECB Corporate Sector Purchase Programme was launched for purchasing euro-denominated investment-grade bonds issued by non-bank corporations established in the euro area. On 22 June the ECB conducted the first operation in its new series of four targeted longer-term refinancing operations. Low inflation and risks ensuing from both slower growth in the US labour market and expectations of adverse developments in the global economy were among major reasons for the FOMC's decision taken at the June meeting to keep unchanged the US Federal Reserve monetary policy.

The external environment will continue to be a source of uncertainty for the development of the Bulgarian economy in the third and fourth quarters of 2016. Current economic indicators in the euro area signal a growth slowdown which could affect the external demand for Bulgarian goods and services over the third and fourth quarters of 2016. In addition to the downward trend in global growth observed since early 2016, the result of the United Kingdom European Union membership referendum (the referendum in the United Kingdom) held on 23 June, which was in favour of UK leaving the EU, increased uncertainty, caused serious financial market fluctuations and may have an adverse effect on consumer and investor confidence not only in the EU but worldwide, as well. If these assumptions materialise, they would have a negative effect on the external demand for Bulgarian goods and services in the third and fourth quarters of 2016. The result of the UK referendum may also adversely affect business and consumer sentiment in Bulgaria.

In the January–April 2016 period, the current and capital account surplus increased on the corresponding period of the previous year, reflecting declines in the trade deficit and primary income deficit. Over the second half of 2016 the current and capital account surplus is expected to decrease as a percentage of GDP on an annual basis compared to the end of the first quarter of 2016, reflecting lower capital account and secondary income account surpluses.

In the first five months of 2016 funds attracted from the non-government sector in the banking system continued growing at a relatively high pace. The dynamics of loans to non-financial corporations and households was impacted by the continued restructuring of banks' portfolios. Concurrently, positive trends toward an increase in regular and new loans were observed. Expectations point to a gradual increase in annual growth of loans to non-financial corporations and households by the close of the year. Interest rates on new time deposits will continue to decrease in the third and fourth quarters of 2016, though at a slower pace. This, coupled with the high liquidity sustained in the banking system, will be the reason for a downward trend in lending rates, as well.

In the first quarter of 2016 real GDP increased by 0.7 per cent on a quarterly basis. Private consumption and net exports contributed most significantly to this growth. Government consumption and gross fixed capital formation contributed negatively.

Short-term economic indicators over the first quarter and beginning of the second quarter of 2016 gave mainly positive signals about the economic development. The positive sentiment of households and corporations amid persistently low petroleum prices and declining interest rates create conditions for boosting consumption and corporations' investment activity, providing opportunities for opening new jobs. Still, the high uncertainty surrounding the international economic situation will limit investment and expenditure policy of corporations. Quarterly GDP growth in the third and fourth quarters of 2016 is expected to slightly moderate due to lower government investment and a lower positive contribution of net exports.

In the first five months of 2016 inflation in Bulgaria followed a downward trend, reaching -2.5 per cent in May. The accelerated decline in consumer prices reflected mainly the international oil price decrease and its pass-through to domestic prices of fuels, transport and some administrative services affected indirectly by fuel prices. The effect of domestic factors, which entailed mainly declines in unprocessed food prices and acceleration in the long-term downward trend in the prices of telecommunication services and durable goods, strengthened the deflationary trend in consumer prices. The increased labour costs exerted no pressure on consumer prices amid declining expenses of firms on raw materials and an appreciation of the lev against the currencies of Bulgaria's major trading partners measured by the nominal effective exchange rate. Changes in tax legislation related to higher excise rates of tobacco products and road fees had a slight positive contribution to inflation since the beginning of the year.

In the second half of 2016 inflation is expected to remain negative, though tending to gradually decrease its negative value. This will be mainly driven by the projected slower annual decline in energy product prices in the context of rising global oil prices.

This Economic Review issue includes the BNB forecast of key macroeconomic indicators for 2016–2018. The forecast is based on information published as of 17 June 2016 and employs ECB, EC and IMF assumptions of international economic developments as of 8 June 2016. This issue contains also a comparative table of forecast revisions of real GDP and inflation rates *vis-à-vis* the macroeconomic forecast published in the Economic Review, issue 4 of 2015. Results of the UK's EU membership referendum in favour of Brexit increases the overall uncertainty in the external and internal environment, creating additional risks that have not been quantitatively accounted for in the macroeconomic projection. The analysis of risks to the projection, however, includes a qualitative assessment of their impact on the Bulgarian economy.

Global economic growth is expected to accelerate in 2016 from 2015, given the recovery in economic activity in a number of developing countries and the continued gradual increase in US and euro area growth. Based on latest ECB and IMF forecasts of global economic developments, external demand for Bulgarian goods and services between 2016 and 2018 is expected to be in line with the projected increase of economic activity in Bulgaria's major trading partners. Despite the first signs of rebalancing in world demand for and supply of commodities, their average prices in 2016 are expected to remain lower than in 2015 due to the high level of inventories and output worldwide. International commodity prices are likely to begin rising from 2017.

Domestic GDP growth in 2016 and 2017 is expected to moderate from the growth rate in 2015. Government investment will have the largest contribution to this moderation over the two years, whereas growth acceleration is expected in the remaining components of domestic demand. With increased government investment in 2018, growth is projected to reach 3.1 per cent. Risks to the economic activity projection in the baseline scenario are assessed as balanced for 2016, unlike 2017–2018 when some risks of lower than expected growth may arise.

Reflecting global price developments, domestic inflation will remain negative in 2016. Specific factors, as price decreases in some services and further declines in durable goods prices, will also act in the same direction. If global price rise assumptions materialise, inflation in 2017–2018 is projected to be positive and begin to increase slowly. There are risks for inflation to be lower than projected if our expectations of international price dynamics do not materialise or administrative cuts occur in some services prices, reflecting indirectly fuel prices.

1. External Environment

The decline in the global economic indicator continued in April and May 2016. Across regions, this decline was again entirely due to the worsened economic activity expectations in some developed economic regions, such as the euro area and Japan.

Global inflation continued to slow down amid declining international commodity prices on an annual basis. Low inflation in the USA was one of the major factors behind the June decision of the US Federal Reserve System to keep unchanged the federal funds rate.

The downward trend in global economic indicators and uncertainty caused by the result of the United Kingdom European Union membership referendum are likely to have a dampening effect on euro area GDP growth in 2016, which, in turn, may affect the external demand for Bulgarian goods and services.

Current Business Situation

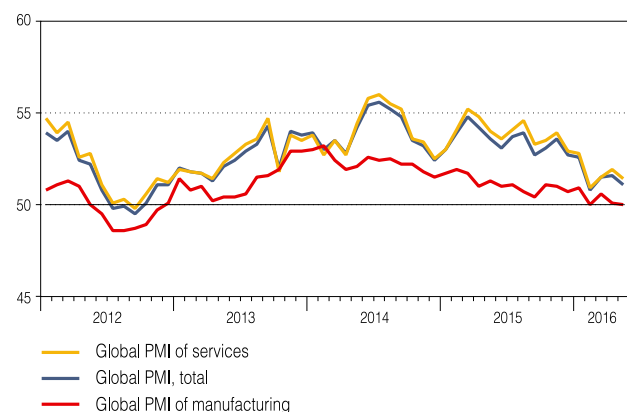
The global economic indicator (global *PMI*) continued its mid-2015 downward trend, with the industrial production index reaching the neutral level of 50 in May 2016. Whereas the global economic indicator drop in 2015 could largely be attributed to developing economies, lowered expectations of the global business situation since early 2016 were entirely due to developed economies. These data indicate moderation in the growth across regions, especially the euro area and Japan. Signs indicating a slowdown in the global economic activity rate gave grounds for a number of international institutions, as the ECB, EC and IMF, to downgrade their forecasts of the global economic growth.

Between January and April 2016 the average growth rate of world trade decreased compared to January–April 2015, reflecting lower foreign trade volumes in developing economies and the USA. Concurrently, euro area foreign trade posted growth on both quarterly and annual basis.

Global inflation continued to decrease amid falling international commodity prices on an annual basis. In April 2016 global inflation was 1.2 per cent on an annual basis, with declines in price indices reported in both developed and developing countries.

The external environment will continue to be a source of uncertainty for the development of the Bulgarian economy in the third and fourth quar-

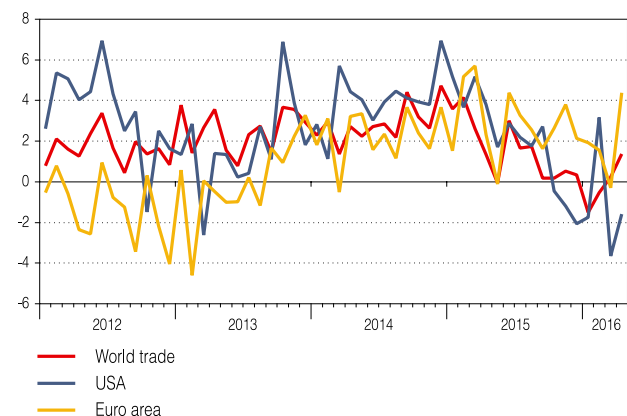
Global PMIs



Source: JP Morgan.

World Trade

(annual rate of volume growth, per cent)



Source: CPB Netherlands Bureau for Economic Policy Analysis.

ters of 2016. In the euro area – a major economic partner of Bulgaria – current economic indicators signal a slight slowdown in the growth. Results of the UK EU membership referendum of 23 June 2016 in favour of UK leaving the EU increased the overall uncertainty,¹ thus likely to affect adversely consumer and investor confidence in this region. If this assumption is materialised, this could have a negative effect on external demand for Bulgarian goods and services over the third and fourth quarters of 2016.

Euro Area

In the first quarter of 2016 euro area real GDP growth rose by 0.6 per cent on a quarterly basis against 0.4 per cent growth in the fourth quarter of 2015. Real GDP accelerated in Germany (0.7 per cent), France (0.6 per cent) and Italy (0.3 per cent), unlike Spain where it remained unchanged (0.8 per cent). GDP components with a positive contribution to euro area growth were investment (0.2 percentage points), private and government consumption (0.3 and 0.1 percentage points, respectively) and changes in inventories (0.1 percentage points). Net exports (-0.1 percentage points) recorded a negative contribution for a third consecutive quarter.

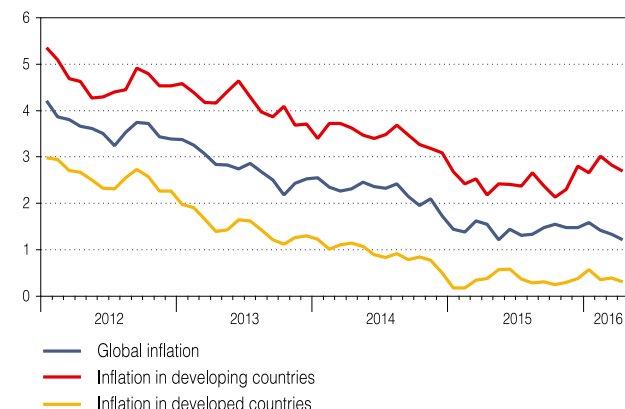
Over the second quarter of 2016 dynamics of euro area leading economic indicators, including PMIs and EC indices, shows that euro area growth is likely to slow slightly from the level of the previous period. The uncertainty arising from UK referendum results may have an adverse effect on investor and consumer confidence within the euro area which would limit GDP growth over the second half of the year.

Labour market situation continued to improve gradually in the euro area, with unemployment remaining at 10.2 per cent in April 2016 for a second consecutive month, the lowest level since August 2011. Dynamics of the expected unemployment rate in the following twelve months, included in the EC consumer confidence index, shows improving consumer expectations of labour market developments.

¹ According to UK's electoral commission, 48.1 per cent of voters indicated a preference to remain, while 51.9 per cent voted in favour of leaving the EU. <http://www.electoralcommission.org.uk/find-information-by-subject/elections-and-referendums/upcoming-elections-and-referendums/eu-referendum/electorate-and-count-information>

Inflation Measured through CPI

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

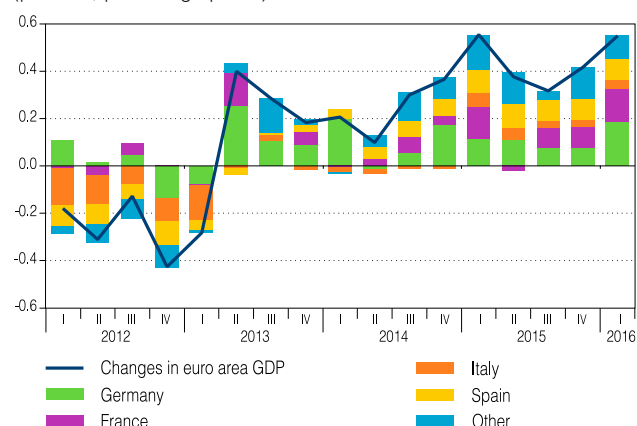


Note: The World Bank measures the change of CPI in individual groups as a weighted average of CPI changes in the countries of the group. For calculating the weights of the countries, real GDP based on purchasing power parity is used. Groups include only World Bank Member States classified by the World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

Source: the World Bank.

Contributions to Real GDP Growth in the Euro Area by Country (Quarterly)

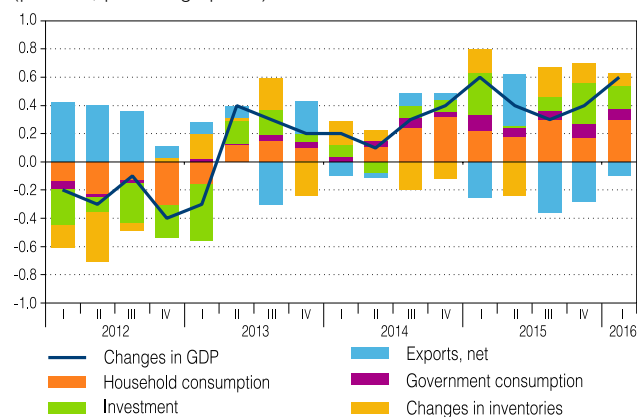
(per cent, percentage points)



Sources: Eurostat and BNB calculations.

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

(per cent, percentage points)



Source: Eurostat.

In June the ECB revised upwards its forecast of GDP growth in the euro area for 2016 *vis-à-vis* the March 2015 forecast, reflecting improved investment and foreign trade prospects.

Euro area inflation declined to a negative territory, with Eurostat data pointing to an annual HICP drop of 0.2 per cent in April and 0.1 in May. HICP developments continued to reflect largely energy price declines, with the significant negative contribution of the energy component in HICP likely to be sustained throughout 2016, according to the ECB. Therefore, the ECB euro area inflation forecast of June was not revised significantly *vis-à-vis* the previous forecast.

At its monetary policy meetings on 21 April and 2 June 2016, the ECB Governing Council made no changes to its interest rate policy and forward guidance about the future course of monetary policy. As regards already taken measures, the ECB published information on the technical parameters of the new Corporate Sector Purchase Programme (CSPP), whose implementation began on 8 June 2016.

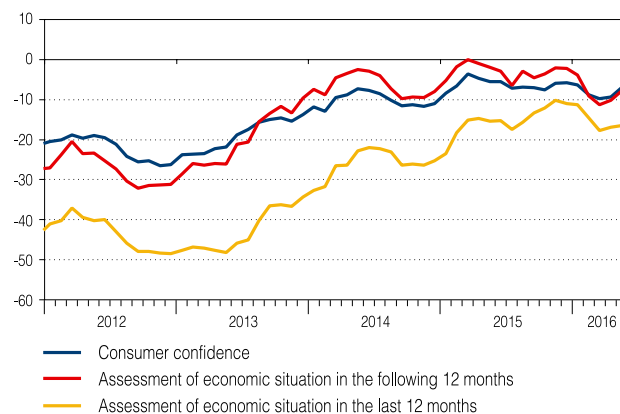
On 17 June 2016 the cumulative amount of the assets purchased under the four asset purchase programmes (PSPP, CBPP3, ABSPP and CSPP) came to EUR 851.7 billion, EUR 181.1 billion, EUR 19.6 billion and EUR 2.2 billion, respectively. On 24 June 2016 the ECB conducted its first operation of the second series of targeted longer-term refinancing operations (TLTRO II), and allotted EUR 399.3 billion among 514 banks. The net effect on banking system liquidity was EUR 38.2 billion, after banks have repaid in advance EUR 367.9 billion on the first series of targeted longer-term refinancing operations (TLTRO I). Excess liquidity in the euro area banking system increased to EUR 821.3 billion, from EUR 710.0 billion at the end of March 2016, with the ECB balance sheet figure reaching EUR 3.110 trillion.

Projections of the Annual Rate of Change of Euro Area Real GDP (per cent)

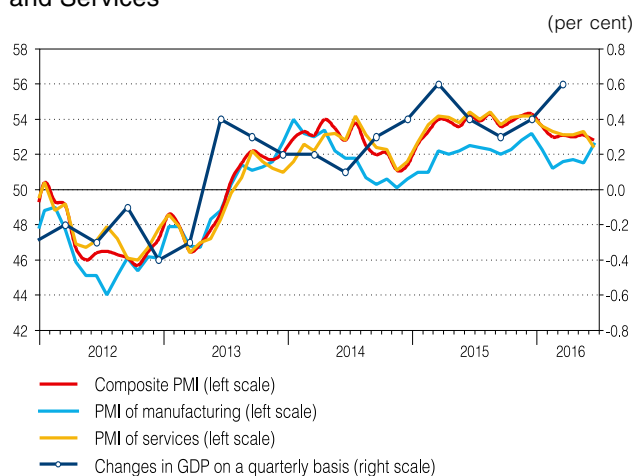
Institution	Date of release	2016		2017		2018	
		latest	previous	latest	previous	latest	previous
ECB	June 2016	1.6	1.4	1.7	1.7	1.7	1.8
EC	May 2016	1.6	1.7	1.8	1.9	-	-

Sources: the ECB, EC.

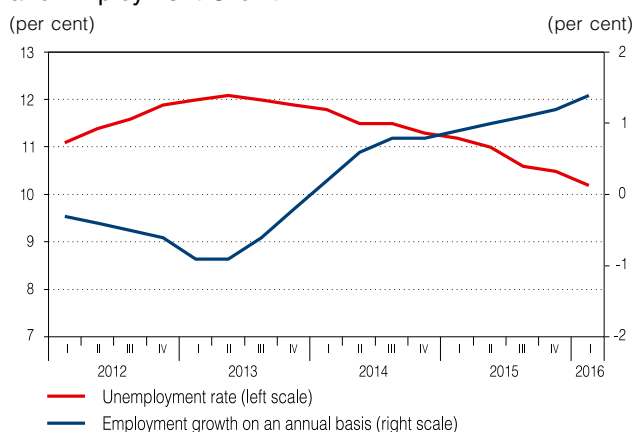
Euro Area Consumer Confidence Indices



Changes in GDP and PMIs of Manufacturing and Services



Euro Area Unemployment Rate and Employment Growth



Projections of Annual Inflation in the Euro Area (per cent)

Institution	Date of release	2016		2017		2018	
		latest	previous	latest	previous	latest	previous
ECB	June 2016	0.2	0.1	1.3	1.3	1.6	1.6
EC	May 2016	0.2	0.5	1.4	1.5	-	-

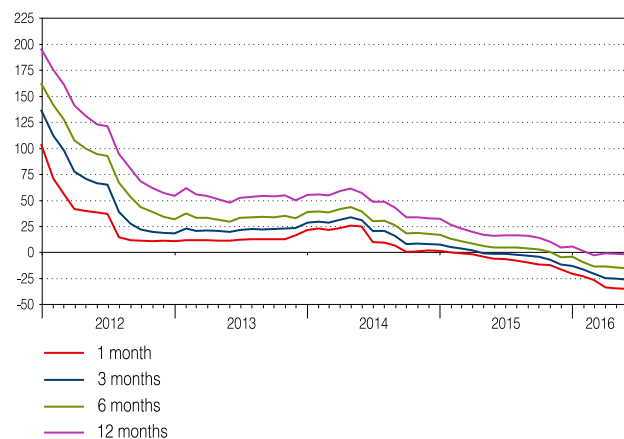
Sources: the ECB, EC.

Increased excess liquidity resulted in a further decline in EONIA, its average value reaching -0.34 per cent for the 1 April – 17 June 2016 period (-0.26 per cent for the first quarter of 2016). The volume of overnight deposits traded in the euro area's interbank market decreased slightly, as their daily average value in the same period came to EUR 11.5 billion (against EUR 13.7 billion for the first quarter of 2016).

EURIBOR rates on interbank market deposits continued to follow a downward trend, their values remaining negative across all maturity sectors. On 17 June 2016 one-month interest rates reached -0.36 per cent (-2 basis points from end-March), while six and twelve-month rates declined to -0.16 per cent (-3 basis points on

EURIBOR Dynamics

(basis points)



Source: the ECB.

end-March) and -0.03 per cent (-2 basis points on end-March), respectively.

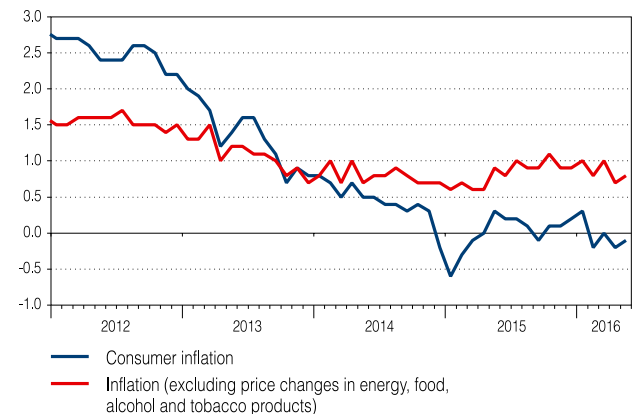
The United States

In the first quarter of 2016 the annual rate of US GDP growth stand at 2.0 per cent for a second consecutive quarter. The quarterly rate of change in GDP slowed down to 0.2 per cent, from 0.3 per cent in the fourth quarter of 2015, reflecting mainly the accelerated decline in total investment and lower growth in household consumption.

In the second quarter of 2016 there were diverse, but positive developments in US leading economic indicators. The ISM Manufacturing PMI index remained close to its value of the end of the first quarter, signalling a further

Euro Area Inflation Rate

(per cent, change on the same period of previous year)

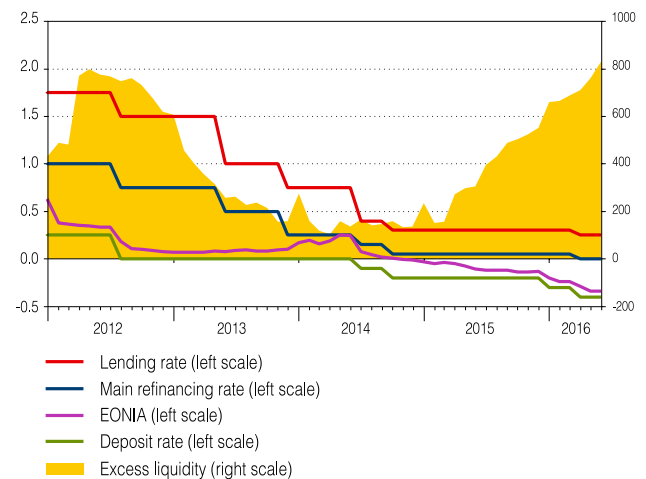


Source: Eurostat.

ECB Interest Rates, EONIA and Excess Liquidity in the Euro Area Banking System

(per cent)

(EUR billion)

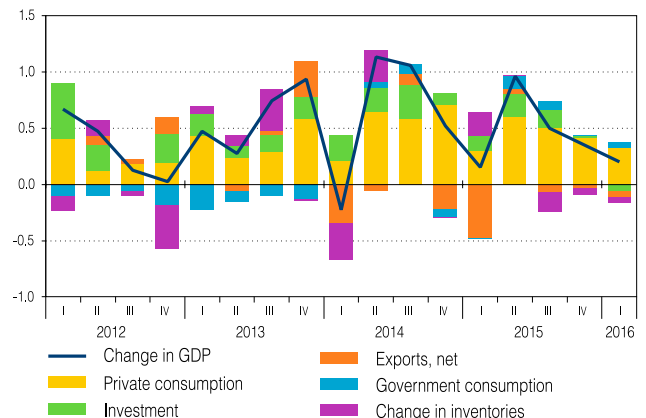


Note: Average EONIA value for the month.

Source: the ECB.

Contribution to US GDP Growth by Component (Quarterly)

(per cent; percentage points)



Source: Bureau of Economic Analysis.

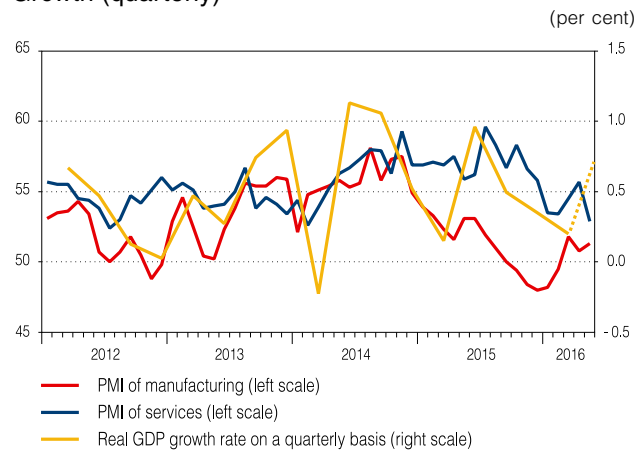
slight increase in economic activity. The analogous indicator of services recorded a greater volatility in the second quarter, though remaining significantly above the threshold of 50. Consumer confidence indicators over the second quarter showed divergent movements, while the monthly growth rate of consumer expenditure and retail sales accelerated strongly over the review period. Economic data released as of mid-June 2016 indicate an increase in the growth rate of US real GDP in the second quarter.

US inflation indicators posted a slight increase. The annual rate of change in personal consumption expenditure price index accelerated to 1.1 per cent in April, reflecting mainly the increased services and food prices, while the annual growth of core inflation (excluding food and fuel prices) stabilised at 1.6 per cent. May data on the other main indicator of US inflation – consumer price index (CPI), showed an insignificant moderation in the annual inflation rate, as regards the overall index, and a slight acceleration in the core inflation index. However, preliminary June data regarding the expectations of consumer price developments in the period of one to five years, a component of the University of Michigan consumer confidence index, point to stabilisation in short-term inflation expectations and declines in longer-term expectations.

In the second quarter of 2016 US employment growth slowed down markedly. In May the average quarterly number of new employees in the US non-farm sector was 116,000 compared with 200,000 *per* month for the last five years. The US unemployment rate dropped to 4.7 per cent *vis-à-vis* 5 per cent in the previous two months due to the decreased number of persons considered part of the labour force and lower labour force participation rate. Up-to-date employment statistics of leading economic activity indicators show that US labour market conditions continue to be favourable.

Still low inflation and economic growth risks ensuing from slower growth of the US labour market and expectations of adverse developments in the global economy were among the main reasons for FOMC's decision taken at the 14–15 June meeting to keep unchanged the US Federal Reserve monetary policy. Risks associated with the then pending UK referendum were

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

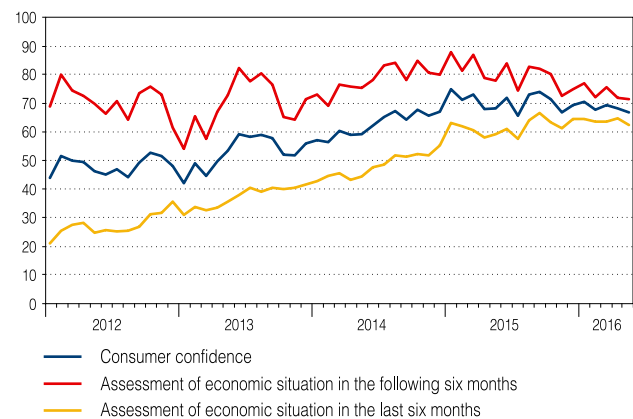


Note: The dotted line shows the economic growth forecast for the USA according to the Federal Reserve Bank of Atlanta model (GDPNow).

Sources: Institute for Supply Management, Bureau of Economic Analysis (BEA), Federal Reserve Bank of Atlanta and BNB calculations.

US Consumer Confidence Indices

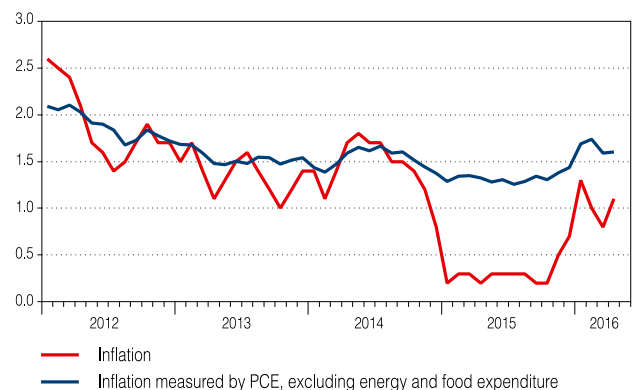
(2000 = 100)



Source: The Conference Board.

US Inflation Rate

(per cent, on an annual basis)



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

Source: Bureau of Labor Statistics.

also indicated as a factor behind this decision. Individual forecast releases of the FOMC members about adequate federal funds rate levels at the end of 2017 and 2018 and the long-run equilibrium level were revised downwards, reflecting members' expectations of slower growth rates *vis-à-vis* March projections and more gradual rises in interest rates. At the same time, notwithstanding the reallocation of expectations, the median of forecasts about the adequate interest rate level at the end of 2016 remained unchanged at 0.9 per cent.

Market expectations of the target range for the federal funds rate changed significantly after the publication of UK referendum results. By end-June the probability of an increase in the federal funds rate derived from exchange-traded futures decreased to a level close to zero.

China

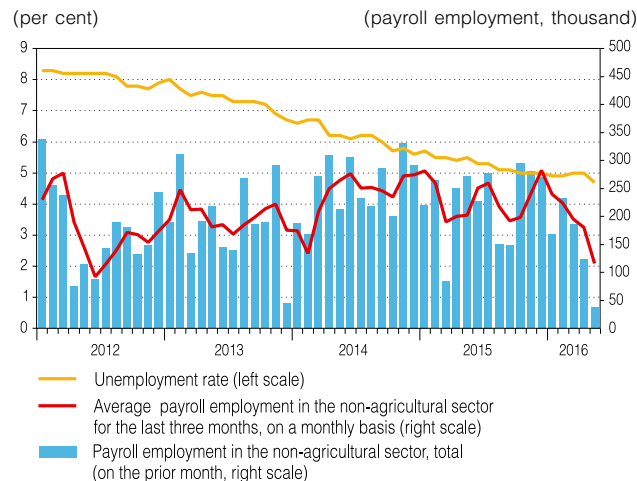
Mid-June data indicate stabilisation in China's economic growth over the second quarter of 2016, reflecting largely enhanced lending and government's investment programmes mobilised in March.

The average value of manufacturing PMIs in April and May increased by 0.2 percentage points from the first quarter (to 50.1), while that of services PMIs remained unchanged at 53.3. The services sector, the largest components of which are real estate and finance, has already generated most of the Chinese GDP, contributing most significantly to the economic growth.

After a temporary increase in March, as a result mainly of strong public investment over the period, the annual growth of industrial production in China stabilised at 6 per cent in April and May. Given the fact that public investment continue to be concentrated largely in infrastructures and other construction, the cement and steel production continue to be the main factor behind the overall growth of industrial production.

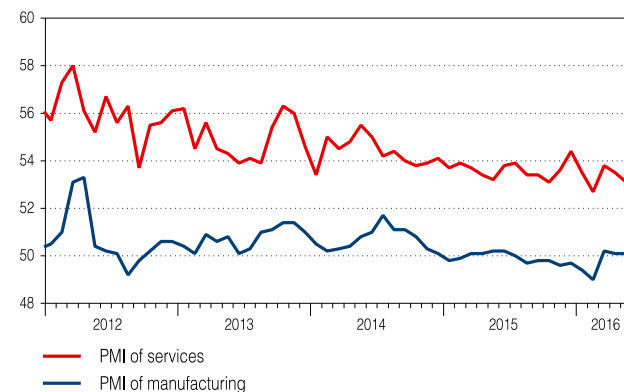
In May CPI inflation in China moderated to 2.0 per cent, which was broadly due to the lower increase in food prices. The increase of real estate prices in larger cities also began to moderate in May, as the local authorities in larger cities, such as Shanghai, Shenzhen and

US Unemployment Rate and Number of New Employees in the US Non-Agricultural Sector



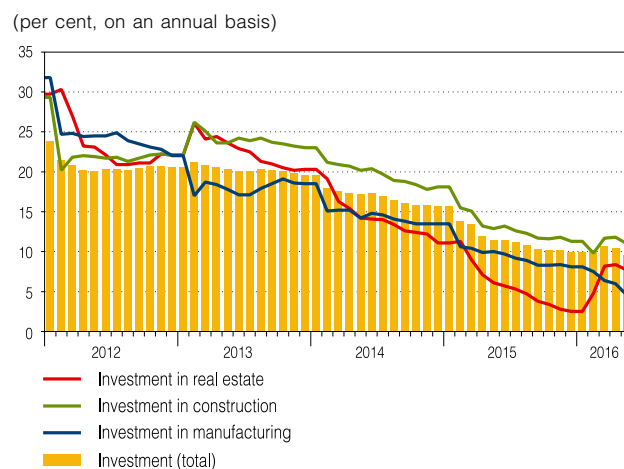
Source: Bureau of Labor Statistics.

Manufacturing and Services PMIs in China



Source: China Federation of Logistics and Purchasing.

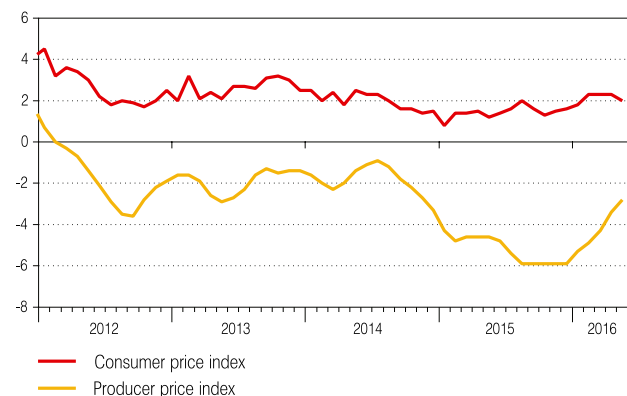
Total Fixed Capital Investment in Selected Sectors in China



Source: National Bureau of Statistics of China.

Inflation Indices in China

(annual rate of change, per cent)



Source: National Bureau of Statistics of China.

Nanjing, have tightened home-purchase rules and mortgage lending requirements.

Over the second quarter of 2016 the People's Bank of China made no changes in its monetary policy stance. The central bank intervened actively in the interbank market with the aim to maintain the interbank interest rate within the 2.0 to 2.5 per cent band. The Chinese renminbi continued to depreciate gradually against the US dollar (by 1.2 per cent), whereas its nominal effective exchange rate *vis-à-vis* the basket of 13 currencies (CFETS)² decreased more essentially (by 5.5 per cent).

International Commodity Prices

Crude Oil

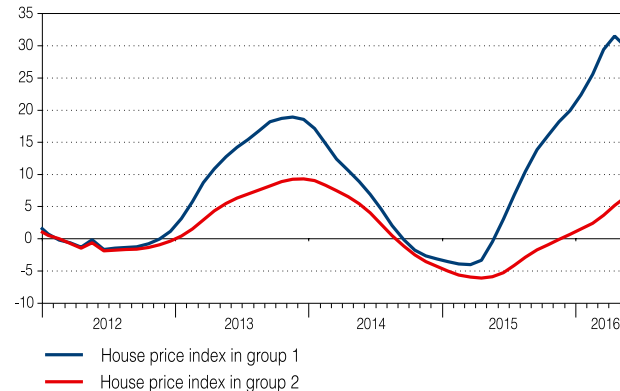
Since the beginning of 2016 crude oil prices have gradually increased on a monthly basis, reaching USD 47.1 *per barrel* in May, notwithstanding the continuing excess supply and high-level inventories worldwide. The increase was largely driven by concerns regarding a possible contraction in oil supply as a result of decreasing production in the USA where low oil prices led to shutdowns of inefficient fields and limited investment in the energy sector, as well as temporary supply disruptions in Nigeria and Canada. In addition, Canada's oil-rich provinces were hit by forest fires.

According to the International Energy Agency (IEA), however, global excess supplies of crude

² China Foreign Exchange Trade System.

House Prices in China

(annual rate of change, per cent)



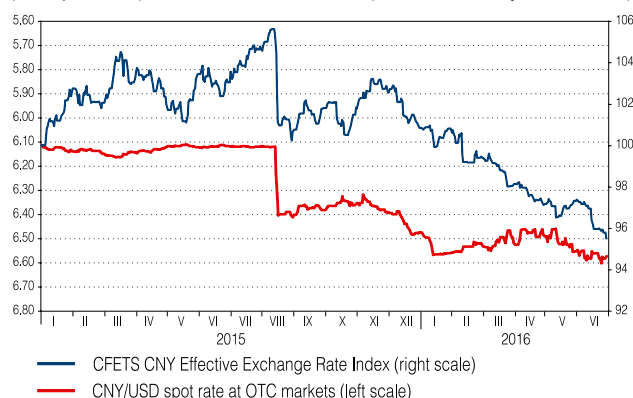
Note: Group 1 includes the four largest cities in China: Beijing, Shenzhen, Guangzhou, Shanghai. Group 2 includes the capitals of the rest provinces.

Source: National Bureau of Statistics of China.

RMB/USD Exchange Rate and RMB Effective Exchange Rate Index

(RMB *per* USD)

(index, 1 January 2015 = 100)



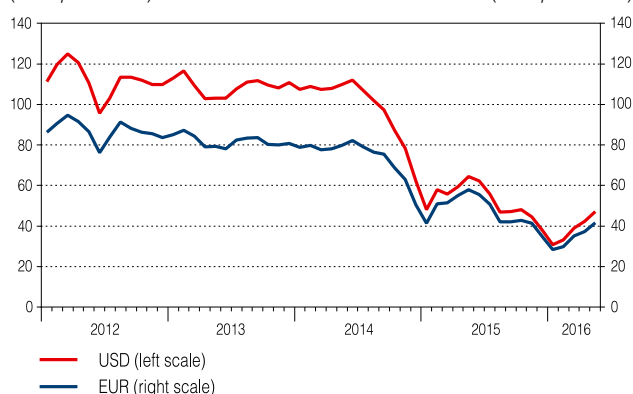
Note: Inverted left-hand scale.

Source: National Bureau of Statistics of China.

Brent Crude Oil Prices

(USD *per* barrel)

(EUR *per* barrel)



Source: the World Bank.

oil will continue in 2016, with high inventories limiting the rate of price increases.

In June market expectations of oil prices for the third and fourth quarters of 2016, based on crude oil futures prices, increased *vis-à-vis* March, ranging from USD 50 to USD 55 *per barrel*.

Major Raw Material and Food Prices

Since early 2016 metal prices have tended to increase on a monthly basis in both euro and US dollars. They reflected mainly higher oil prices, USD depreciation against the rest major currencies and temporarily increased demand from China due to enhanced government investment expenditure. Average metal prices in US dollars between April and May rose by 8.9 per cent from the first quarter of the year (up 5.9 per cent in euro). At the end of the first quarter, the copper price, which is fundamental to the Bulgarian goods exports, increased significantly month on month, reflecting increased purchases by China associated with strong public investment in infrastructures. In the following months, Chinese imports slowed down again, as an approval was announced to expand existing production capacities in this sector³ which led to a new price decline on a monthly basis. Despite the upward trend in metal prices since early 2016, global production and inventories retained their high levels. These factors are expected to limit the growth rate of metal prices which are projected to exceed the level of the corresponding period in 2015 by end-2016.

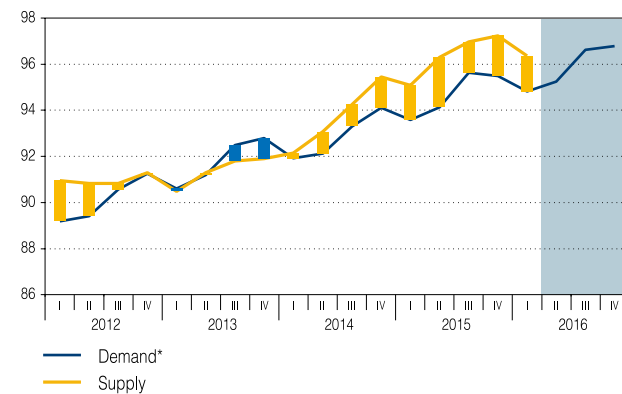
Since early 2016 average food prices have tended to increase on a monthly basis in both euro and US dollars. This was partly linked to lower supply of individual sub-components of this group due to unfavourable weather conditions across the world.⁴ In addition, food price increases reflected also the US dollar depreciation and oil price rises. Between April and May food prices in US dollars picked up 4.8 per cent on average (2.0 per cent in euro) from the first quarter of 2016. The wheat price, which plays an important role in Bulgarian goods exports,

³ Commodity Market Monthly, IMF, 10 June 2016, p. 2.

⁴ Commodity Market Monthly, IMF, 14 April 2016, p. 2, and Commodity Market Monthly, IMF, 10 June 2016, p. 2.

World Crude Oil Supply and Demand (Quarterly)

(million barrels per day)

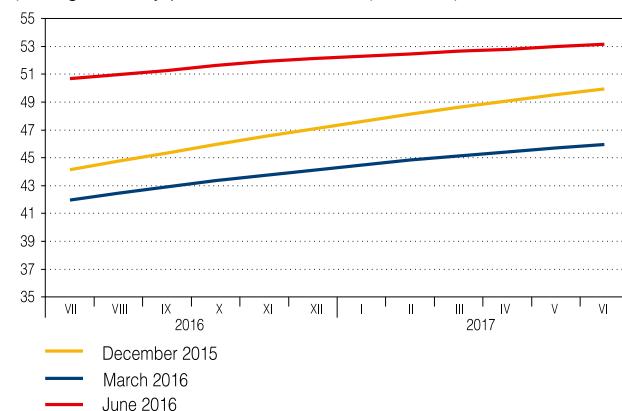


* Latest IAE crude oil demand data of April 2016.

Source: the IAE.

Brent Crude Oil Futures Prices

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



Source: JP Morgan.

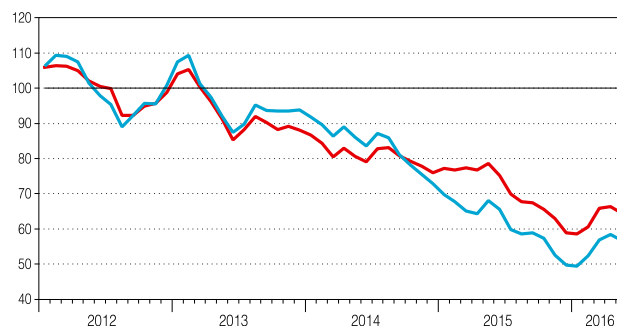
went up on a quarterly basis, though forecasts of abundant harvests in 2016 might limit further price rises.⁵ In the third and fourth quarters of 2016 food prices are expected to increase on an annual basis in both euro and US dollars.

Based on our forecasts of major raw material and food price dynamics, the terms of trade in Bulgaria are expected to remain favourable in the second half of 2016.

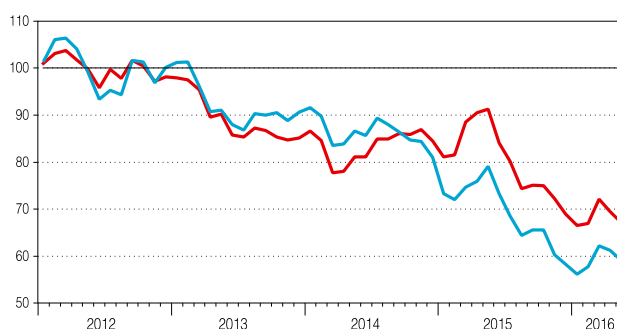
Price Indices of Major Raw Materials and Commodity Groups

(2012 = 100)

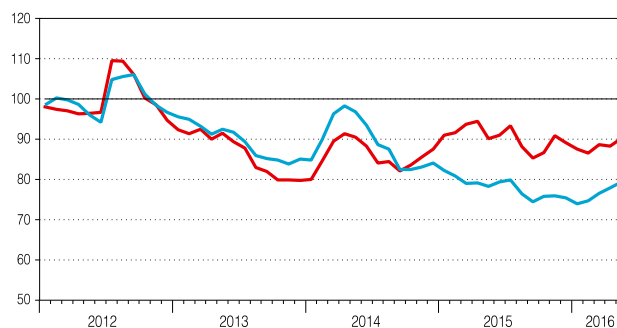
Metals



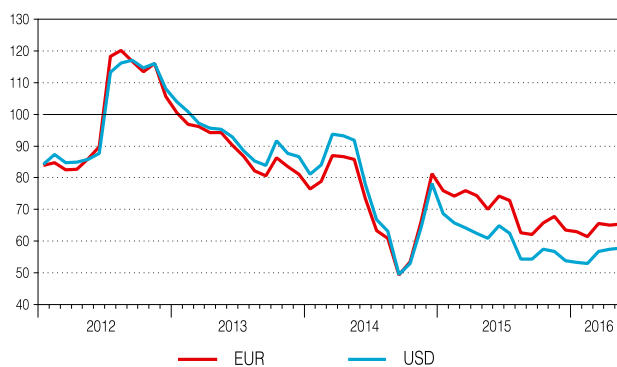
Copper



Food



Wheat



Sources: the ECB and BNB calculations.

⁵ According to USDA Wheat Outlook, May 2016, p. 6.

2. Financial Flows, Money and Credit

In the January–April 2016 period, the current and capital account surplus increased on the corresponding period of the previous year, reflecting declines in the trade deficit and primary income deficit. Over the second half of 2016 the current and capital account surplus is expected to decrease as a percentage of GDP on an annual basis compared to the end of the first quarter of 2016, reflecting the lower capital account and secondary income account surpluses.

In the first five months of 2016 funds attracted from the non-government sector in the banking system continued growing at a relatively high pace. The dynamics of loans to non-financial corporations and households was impacted by the continued restructuring of banks' portfolios. Concurrently, positive trends toward an increase in regular and new loans were observed. Expectations point to a gradual increase in annual growth of loans to non-financial corporations and households by the close of the year. Interest rates on new time deposits will continue to decrease in the third and fourth quarters of 2016, though at a slower pace. This, coupled with the high liquidity sustained in the banking system, will be the reason for a downward trend in lending rates, as well.

External Financial Flows

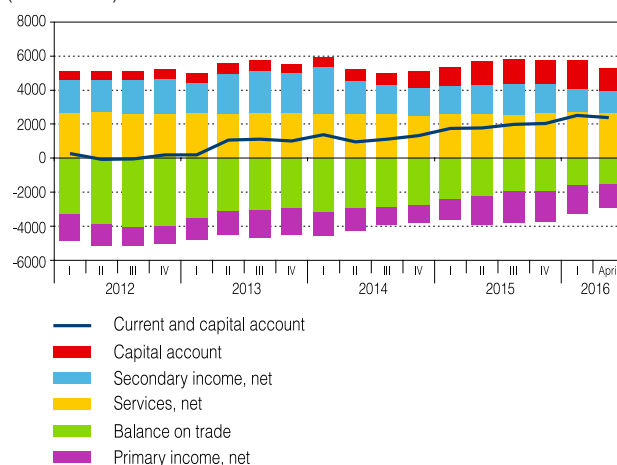
Between January and April 2016 the current and capital account surplus increased from the corresponding period of 2015, reflecting largely the primary income deficit and trade deficit declines. The trade deficit decrease from the corresponding period of 2015 was driven by both higher real growth in exports compared to imports and favourable terms of trade in the first quarter of 2016. At the same time, lower outflows under the reinvested profit and dividend and distributed profit items between January and April 2016, coupled with low dynamics of gross operating surplus in 2015 led to a substantial reduction in the primary income deficit.

The increase in the current and capital account surplus was partly limited by the drop in the secondary income surplus and, to a lesser degree, capital account surplus. Lower surpluses on these accounts resulted from smaller transfers on EU programmes. The lower surplus on services trade balance stemming from a higher decline in nominal services exports than that of imports also had a limiting effect on the overall current and capital account balance between January and April.⁶

⁶ For a more detailed analysis of exports and imports of goods and services, see Chapter 3.

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

(EUR million)



Source: the BNB.

In the second half of 2016 the current and capital account balance as a share of GDP is expected to shrink on an annual basis from the end of the first quarter of 2015. The lower capital account surplus will reflect still weak inflows under EU operational programmes for the 2014–2020 period. Subdued economic activity in countries important for Bulgaria's tourism will be a precondition for reducing the annual services surplus as a share of GDP. Trade balance deficit will further decline as a share of GDP, reflecting both higher annual growth in real exports compared to real imports and favourable terms of trade.

In the January to April period, a negative financial account was recorded due to the higher increase in liabilities than in assets. The increase in foreign assets of the financial account resulted mainly from transactions of banks which boosted their foreign assets in the form of other investment by EUR 1056.2 million.⁷ Growth in liabilities was largely ascribable to government's transactions as in March new Eurobonds were issued in international capital markets (EUR 1994 million in total). Funds attracted from other sectors in the form of direct and other investment also contributed, though to a lesser extent, to the increase in liabilities.

Between January and April 2016 liabilities on foreign direct investment (reporting an inflow of foreign direct investment into Bulgaria) were lower than in the same period of 2015,⁸ with the largest FDI inflow coming from the Netherlands.

Positive net flows on the current and capital account, as well as the inflow of funds on the financial account led to an increase in gross international reserves by EUR 1170.7 million in the first four months of 2016,⁹ according to balance of payments data. In April 2016 the international reserve coverage of the average nominal imports of goods and non-factor services for the last 12 months remained high (9.3 months), posting an increase against April 2015 (8.2 months).

⁷ A more detailed analysis of banks' activities is presented in the Monetary and Credit Aggregates section of Chapter 2.

⁸ Preliminary data subject to revision.

⁹ Valuation adjustments and price revaluation excluded.

Flows on Balance of Payments Accounts

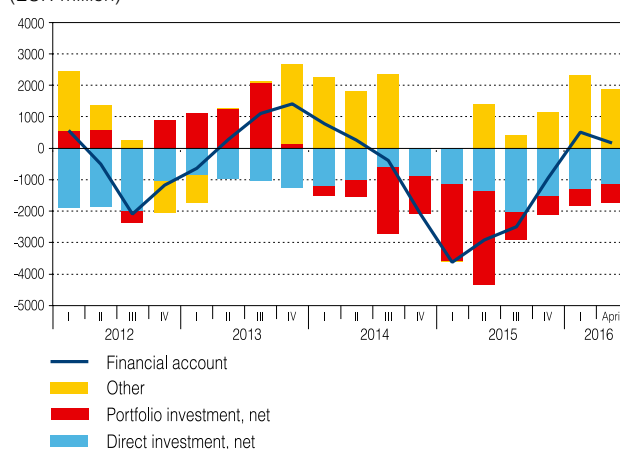
(EUR million)

	2014	2015	January–April 2016
Current account	364.6	609.0	219.1
Trade balance	-2776.6	-1916.6	-319.1
Services, net	2514.2	2703.5	271.6
Primary income, net	-988.6	-1817.9	-292.0
Secondary income, net	1615.6	1640.0	558.6
Capital account	959.6	1418.0	539.1
Financial account	-2087.3	-938.7	-535.0
Changes in reserves	1807.3	3729.7	1170.7

Source: the BNB.

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

(EUR million)



Note: The Other item includes Other Investments, net, and Financial Derivatives (Other than Reserves) and Employee Stock Options, net.

Source: the BNB.

Banks' Flows on Balance of Payments Financial Account

(EUR million)

	2014	2015	January–April 2016
Direct Investment			
assets	27.9	-0.8	0.1
liabilities	106.1	275.5	-106.2
Portfolio investment			
assets	-309.4	-787.0	34.8
liabilities	-50.6	1.4	-1.4
Other investment			
assets	1064.6	-2023.0	1056.2
liabilities	-235.4	-1586.7	-274.6
Total assets	783.1	-2810.8	1091.0
Total liabilities	-179.9	-1309.8	-382.1
Net assets	963.0	-1501.0	1473.2

Source: the BNB.

In April Bulgaria's gross external debt increased on the end of 2015, mainly in terms of the government debt. Government external debt growth resulted from Eurobond issue in international capital markets in March 2016.¹⁰ The share of long-term debt in Bulgaria's total gross external debt rose on end-2015, accounting for 78.6 per cent in April.

In the context of continuing interest rate decreases in international financial markets, favourable conditions for debt assumption by Bulgarian residents were sustained in the first four months of the year. It is evidenced by an annual increase of 1.4 per cent in new external loans and deposits and 69.9 per cent growth in financial credit transactions declared by non-residents. Concurrently, the share of long-term loans in total new loans increased to 63.2 per cent (43.4 per cent in January–April 2015).

Monetary and Credit Aggregates

In the first five months of 2016, developments in monetary aggregates continued to reflect the sustained high inflow of deposits in the banking system. The continuous optimisation of bank portfolios affected claims on the non-government sector.

In May 2016 the broad monetary aggregate M3 grew by 8.1 per cent on an annual basis. Overnight deposits continued to have the strongest contribution to M3 growth, with money outside MFIs and deposits with an agreed maturity of up to two years preserving their relatively lower contributions.

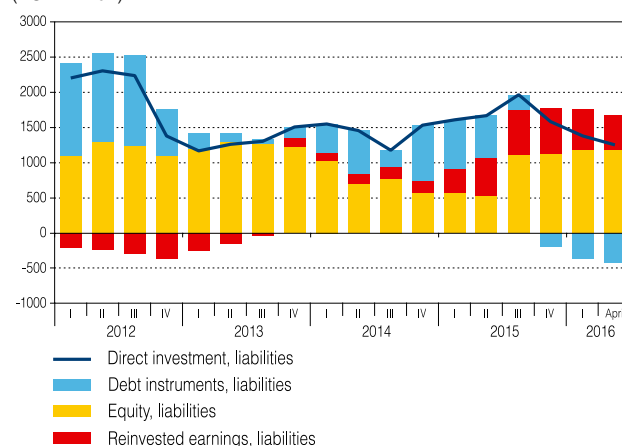
Non-government sector's deposits¹¹ in the banking system continued to rise at high rates in the first five months of 2016, with their growth rate in May reaching 8.8 per cent on an annual basis. Household deposits remained the major source of growth in attracted funds, amounting to BGN 43.2 billion in May (growth of 6.5 per cent annually). Unlike 2015 when households

¹⁰ Government Debt Management Bulletin, the Ministry of Finance, March 2016: <http://www.minfin.bg/bg/statistics/1>

¹¹ Non-government sector's deposits include deposits of households, non-financial corporations and financial corporations. Deposits of households and non-financial corporations occupied the largest share of all non-government sector's deposits (95 per cent on average for the last 12 months as of May), and therefore, the analysis is focused on these two sectors.

Direct Investment Liabilities by Type of Investment (on an Annual Basis)

(EUR million)



Source: the BNB.

Gross External Debt as of April 2016

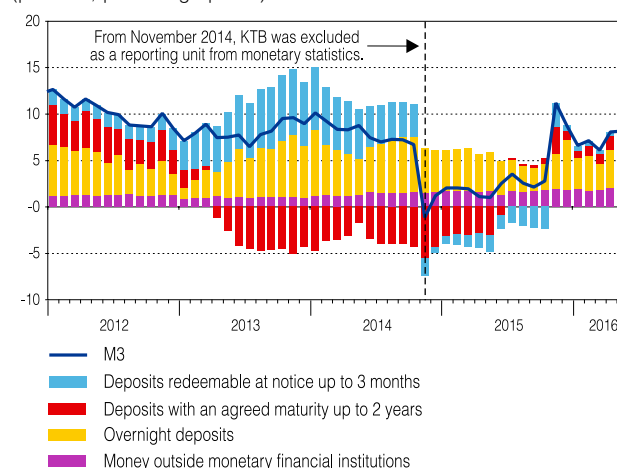
(EUR million)

	Amount	Change	
		Compared to December 2015	Last 12 months
General government	6 720.7	1 144.4	500.1
Central bank	0.0	0.0	0.0
Banks	3 908.1	-218.3	-1 140.7
Other sectors	11 953.6	217.7	194.1
FDI: intercompany loans	12 796.8	144.4	-2 941.8
Total	35 379.1	1 288.1	-3 388.4

Source: the BNB.

Annual Rate of Change in M3 and Contribution by Component

(per cent, percentage points)



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

Source: the BNB.

preferred to save mainly in time deposits, since the beginning of 2016 overnight deposits have been a preferred way for saving free funds. Changed household preferences can be attributed largely to the ongoing trend toward decreasing interest rates. In terms of currency structure, households continued to save primarily in national currency.

Deposits of non-financial corporations also continued to contribute to the growth in attracted bank funds, their amount reaching BGN 17.7 billion in May (up 13.5 per cent annually). Corporations continued to deposit their free funds in overnight deposits. As regards the currency structure, corporations preferred to save mostly in lev-denominated deposits.

Following the increase in the share of funds attracted from residents in the banking system, the effective implicit rate of minimum required reserves rose to 9.30 per cent in May 2016 (9.28 per cent by end-2015).¹² Commercial banks' deposits with the BNB comprised 8.22 percentage points of minimum reserve requirements, and the remaining 1.08 percentage points were in the form of recognised cash balances.¹³

Since early 2016 the annual growth rate of reserve money tended to slow, accounting for 12.3 per cent in May (43.0 per cent in December 2015). Monetary base contraction was mainly due to the decreased funds of banks with the BNB as a result largely of declines in banks' excess reserves since early 2016.¹⁴ In May the excess of funds maintained by banks with the BNB over the required minimum under Ordinance No 21 was 88.3 per cent on an average daily basis (127.8 per cent in December 2015).

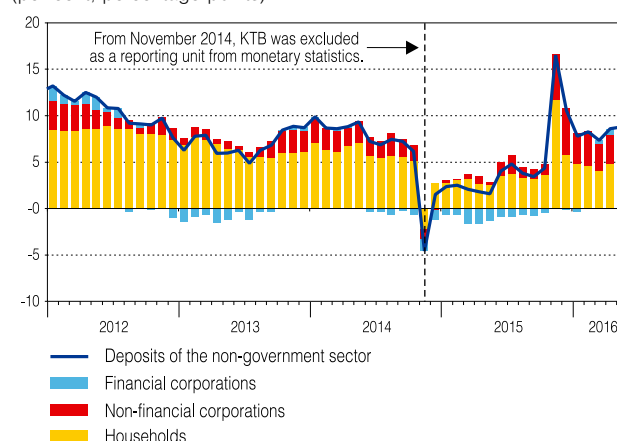
¹² According to Article 3 of the new BNB Ordinance No 21 on the Minimum Required Reserves Maintained with the BNB by Banks, effective as of 4 January 2016, the rate of minimum required reserves on funds attracted from residents remains 10 per cent of the deposit base, from non-residents 5 per cent and from the state and local government budgets 0 per cent.

¹³ Article 4 of the new BNB Ordinance No 21 (effective as of 4 January 2016) removes the recognition of banks' funds in the TARGET2-BNB national system component as reserve assets.

¹⁴ The new Ordinance applies a negative interest rate on excess reserves where the ECB deposit facility rate is negative and a zero rate where the ECB rate is positive or zero. Since 4 January 2016, the BNB has applied the ECB deposit facility rate on banks' excess reserves: -0.30 per cent in the beginning and -0.40 per cent from 16 March 2016.

Annual Growth of the Non-government Sector's Deposits and Contribution by Sector

(per cent, percentage points)

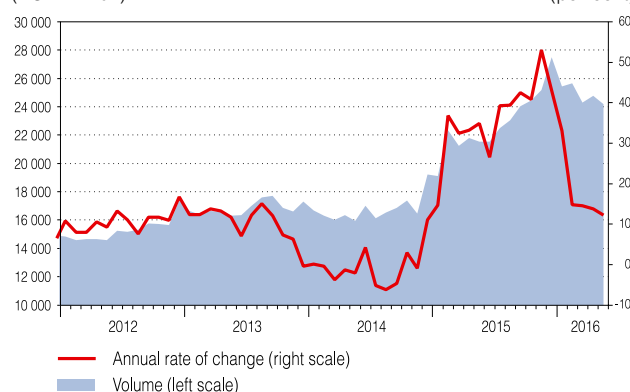


Source: the BNB.

Reserve Money

(BGN million)

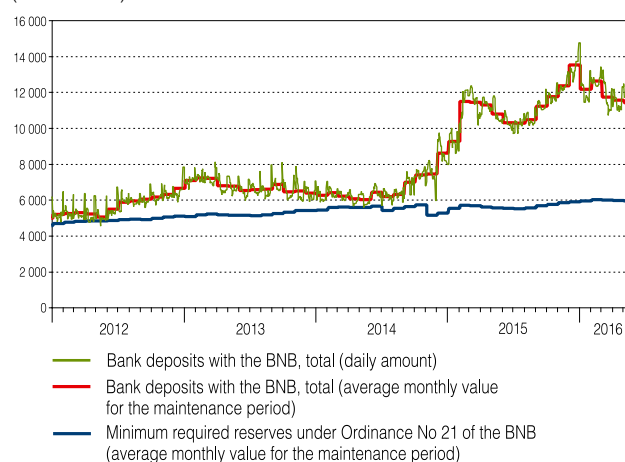
(per cent)



Source: the BNB.

Bank Deposits with the BNB

(BGN million)



Source: the BNB.

Currency in circulation contributed further to reserve money growth, posting in May an increase of 12.6 per cent on an annual basis (9.8 per cent in December 2015). Factors behind the increase of currency in circulation since early 2016 were the positive developments in private consumption and ongoing declines in deposit interest rates.

Banking system liquidity remained high, with the liquid asset ratio¹⁵ accounting for 37.02 per cent in May (36.71 per cent in December 2015). In managing their financial resources, since early 2016 banks sought to increase their foreign assets and Bulgarian government bond portfolios (mostly Eurobonds) unlike the previous year when they deposited the bulk of liquid funds into excess reserves with the BNB.

Banks managed their liquid resources also through foreign currency trading with the BNB. In January 2016 reserve currency trading between banks and the BNB retained its long-term trend of banks being a net purchaser, unlike the February to May period when the trend was reversed and euro sales exceeded euro purchases. As of May banks sold to the BNB EUR 0.2 billion for the last 12 months.

In May loans to non-financial corporations and households decreased by 1.1 per cent on an annual basis. The continuous optimisation of bank portfolios affected their dynamics in the first five months of the year. At end-2015 and in the first five months of 2016 bad and restructured loans posted a stronger decline compared with recent developments. At the same time, regular loans to non-financial corporations and households, excluding overdrafts, have tended to grow since early 2016.

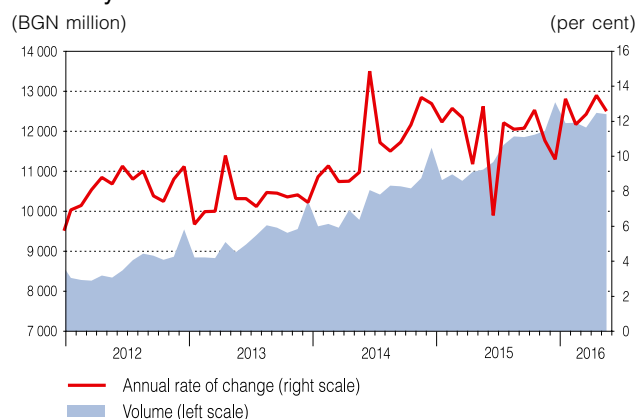
In May the annual rate of decline of the credit to non-financial corporations was -1.1 per cent,¹⁶ while the end-2015 upward trend in new loans to corporations¹⁷ continued in the first months of 2016. As of May the average share of newly extended lev loans to corporations for the last 12 months broadly remained at its end-2015 level at 46.1 per cent. Concurrently, the share of new

¹⁵ See Ordinance No 11 of the BNB.

¹⁶ Based on 12-month moving average.

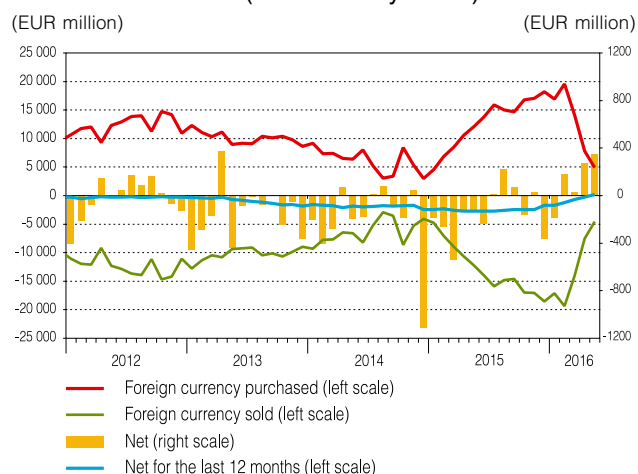
¹⁷ The terms 'new' and 'newly extended' are hereinafter referred to as the statistical category 'new business'.

Currency in Circulation



Source: the BNB.

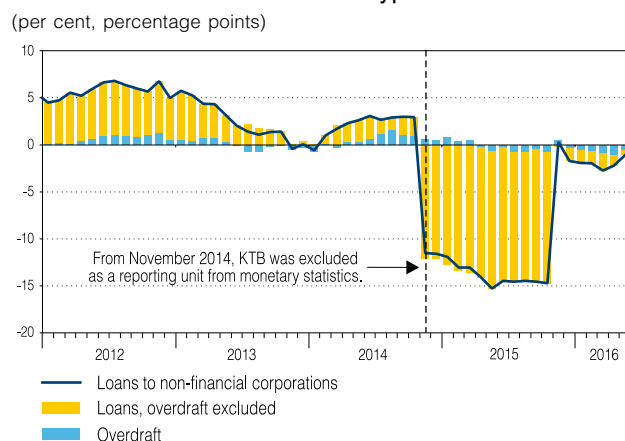
Foreign Currency Purchases and Sales between the BNB and Banks (on a Monthly Basis)



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

Source: the BNB.

Annual Growth of Loans to Non-financial Corporations and Contributions of Individual Types of Loans



Source: the BNB.

corporate loans in euro fell to 49.9 per cent at the expense of the increased share of US dollar-denominated loans (4 per cent in May).

The annual change in the credit to households was -1 per cent in May, with housing and other loans having low positive contributions. New household loans retained their upward trend in the first five months of 2016, with consumer loans and, to a lesser extent, housing and other loans contributing most positively.

BNB lending survey results in the first quarter of 2016 recorded broadly retained demand for loans by corporations and an increase in demand by households compared to the last quarter of 2015. A slight increase in demand for long-term corporate loans was observed over the quarter. Households, however, recorded stronger interest in consumer and housing loans. Banks tightened their standards on corporate loans¹⁸ and eased them further on household lending, more pronounced on consumer loans. Major factors behind credit policy tightening on corporations included¹⁹ lower risk appetite of banks, their assessments of decreased borrower solvency and heightened collateral risk. Consumer and housing loan standards were eased under the influence of falling costs of borrowed funds and high bank liquidity, increased competition within the banking sector, lowered risk assessment and heightened bank risk appetite. In the second quarter of 2016 banks expect increasing demand for loans by both households and non-financial corporations. Banks envisage more essential easing of credit standards on consumer and housing lending and, to a lesser extent, on corporate lending.

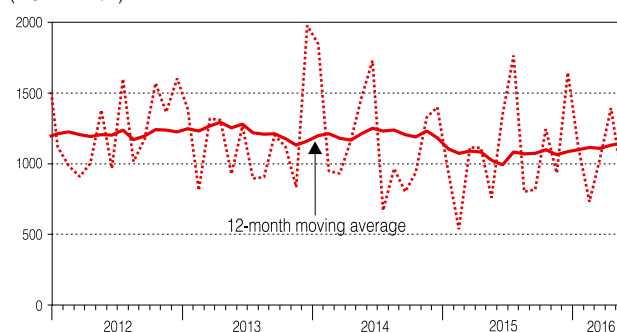
In the third and fourth quarters funds attracted from residents are expected to continue growing, though at slower rates, reflecting the likely growth in private consumption and compara-

¹⁸ Credit standards are understood as bank internal guidelines and criteria for loan approvals established prior to negotiating the terms of extended loans. Credit standards determine the type of the loan and collateral considered admissible by banks, taking into account specific priorities by sector, *etc.* Credit standards specify also all relevant conditions to be met by a borrower.

¹⁹ Credit policy refers to credit standards and credit conditions applied by banks in extending loans. Credit conditions typically involve the reference interest rate surcharge, the loan amount, conditions for its utilisation and other conditions, fees and commissions, collateral or guarantees to be provided by a borrower.

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

(BGN million)

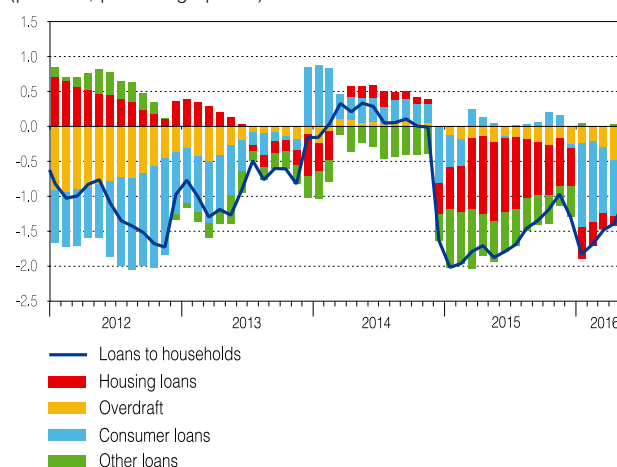


* For data characterised by significant fluctuations, additionally moving averages computed for suitably selected periods are provided, in order to smooth the fluctuations in corresponding time series and present the trends in their development.

Source: the BNB.

Annual Growth of Household Credit and Contributions of Individual Types of Loans

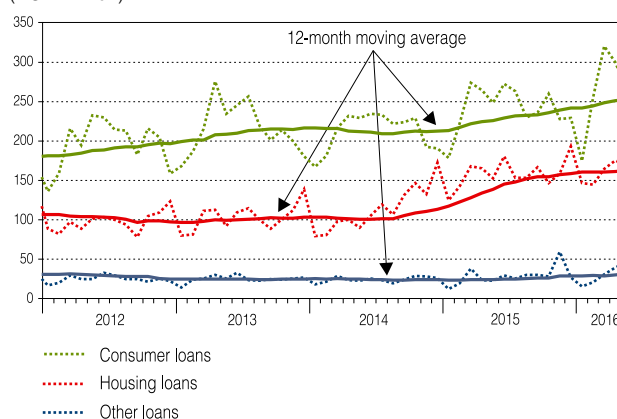
(per cent, percentage points)



Source: the BNB.

New Loans to Households (Monthly Volumes)

(BGN million)



Source: the BNB.

tively high demand for currency in circulation. In line with projected developments in attracted funds, high bank liquidity is expected to be preserved in the following two quarters. Expectations of continuous positive trends in regular and newly extended loans and decreasing effects of bank portfolio optimisation with the finalisation of the asset quality review will drive gradually accelerating annual growth of loans to non-financial corporations and households by the end of the year.

Interest Rates

The downward trend in interbank money market rates was sustained across all maturities in the first six months of 2016. The decrease was most pronounced in January and February, driven strongly by Ordinance No 21 amendments of early 2016 under which the BNB applies the ECB deposit facility rate on excess reserves where this rate is negative.²⁰

These amendments led to acceleration of the ECB monetary policy transmission to interbank money market rates in Bulgaria.²¹ As of June the averaged values between bid and offer quotations of unsecured deposits with maturities of up to three months declined to a negative territory. Changes in bank excess reserve remuneration reflected also in the interbank deposit rate spread at three-month maturity in both Bulgaria and the euro area. In January this spread decreased significantly, stabilising thereafter at a level of 23 basis points in June. Longer-term rates declined significantly in the first two months of the year. In June six-month and twelve-month deposit rates decreased by 45 and 57 basis points, respectively, compared to December 2015.

In early 2016 LEONIA became negative. Between March and June its volatile dynamics reflected the small number and low volumes of interbank money market transactions. This led to strong fluctuations in the spread between

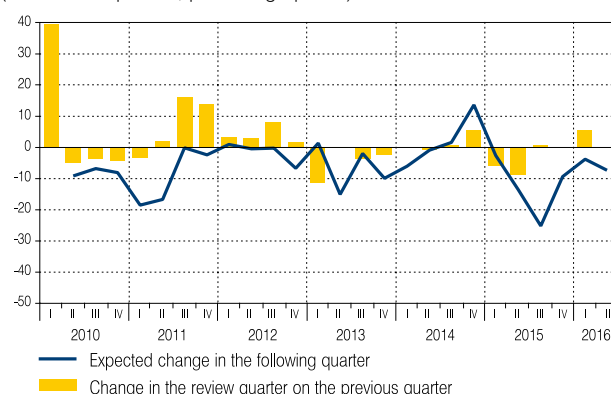
²⁰ The BNB continued to apply a zero interest rate on excess reserves where the ECB deposit facility rate is positive or nil. As regards minimum reserve requirements, the BNB retained its zero interest-rate policy.

²¹ For more information, see the research topic on *The Effect of the ECB Monetary Policy on Interest Rates in Bulgaria*, *Economic Review*, 1/2016.

Changes in Credit Standards

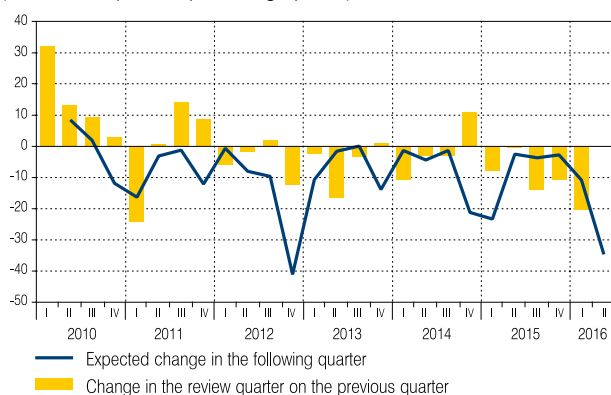
a) corporate loans

(balance of opinions; percentage points)



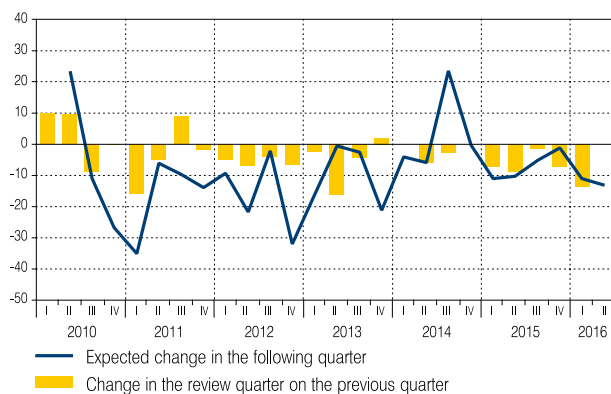
b) consumer loans

(balance of opinions; percentage points)



c) housing loans

(balance of opinions; percentage points)



Note: These charts present banks' balance of opinions defined as a difference in percentage points between the percentage of banks responding 'tightened' ('considerably' and 'somewhat'), and the percentage of banks responding 'eased' ('considerably' and 'somewhat'). All opinions are weighted with the bank's market share in the relevant credit segment. Expectations are shown in the charts by shifting the data a quarter forward.

Source: the BNB.

LEONIA and EONIA since early 2016, its value being negative in June at 5 basic points.

High bank liquidity amid still subdued demand for loans and lack of investment alternatives for banks continued to drive the downward interest rate dynamics in new time deposits. In May the average weighted interest rate on new time deposits of non-financial corporations and households accounted for 0.8 per cent (1.2 per cent in December 2015). Since early 2016 the cost of funds attracted from households has followed a clearly pronounced downward momentum. Rates on deposits from non-financial corporations recorded some fluctuations in individual months.

In May average weighted interest rates on new time deposits of non-financial corporations and households in leva and euro decreased from December 2015, unlike US dollar-denominated deposits whose remuneration increased slightly. In May the share of funds attracted from households and non-financial corporations in foreign currency, the bulk of them in euro, accounted for 40.8 per cent in May, matching the level reported at the end of 2015.

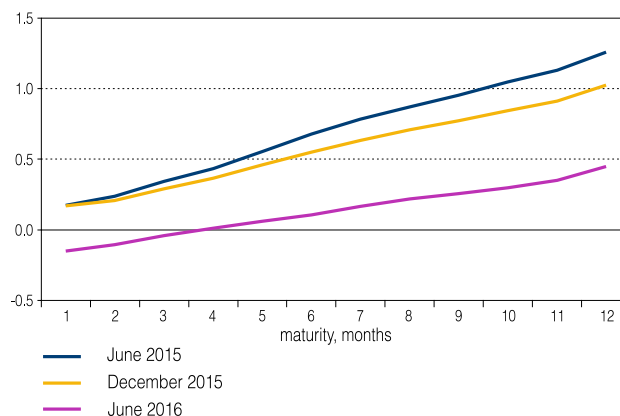
Between end-February and end-May 2016 the average interest rate at which banks attracted new leva time deposits from households contracted by 41 basis points to 1.0 per cent. The decrease in standard deviation by 5 basis points to 0.56 per cent in the same period shows that bank interest rates on household deposits have been converging accordingly. The number of banks offering new time deposit rates of below 0.5 per cent increased from February, along with those offering rates in the 1 to 1.5 per cent band. Fewer banks offered rates between 0.5 and 1 per cent, as well as between 1.5 and 2 per cent.

Lower cost of borrowing and high liquidity of the banking system continued to drive the retention of the downward trend in interest rates on newly extended loans in the first five months of 2016. The increased competition within the banking sector which contributed to easing bank credit policies was probably an additional factor in favour of declines in lending rates.

Interest rates on new loans to non-financial corporations have continued to decrease since early 2016. This decrease from December 2015

Interbank Money Market Instruments Yield Curve

(per cent)

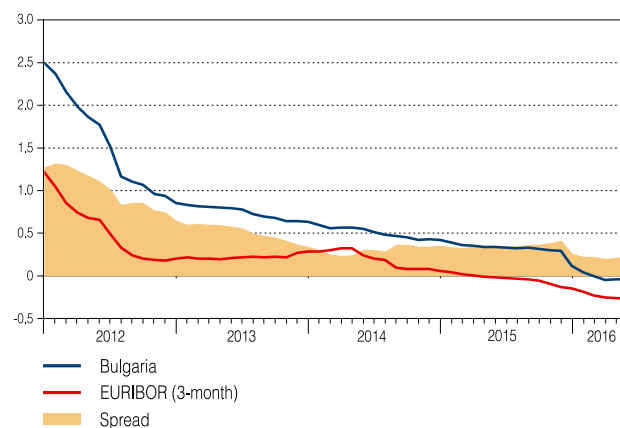


Note: Values reflect the average value of SOFIBOR and SOFIBID quotes for unsecured three-month deposits in leva.

Source: the BNB.

Interest Rates on Three-month Deposits

(per cent, percentage points)

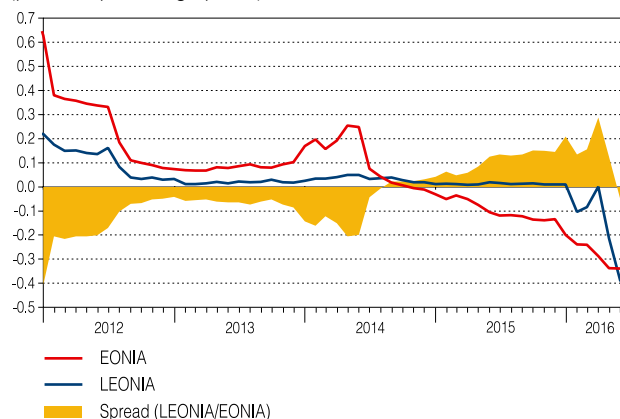


Note: Values for Bulgaria reflect the average value of SOFIBOR and SOFIBID quotes for unsecured three-month deposits in leva.

Sources: the BNB, ECB.

Interbank Money Market Interest Rates on Overnight Deposits

(per cent; percentage points)



Source: the BNB.

refers to both loans in levs and those in euro and US dollars. As of May the interest rate on new lev loans was 5.7 per cent, with cost of borrowing in euro reaching 5.9 per cent, and in US dollars 6.6 per cent.²²

The downward tendency in the annual percentage rate of charge (APRC) on household loans was also retained. In the first five months the decrease in APRC on housing loans was more pronounced than that in consumer loans. In May APRC on housing loans was 6.0 per cent.²³ Both interest and non-interest components of charges contributed to this drop from the previous year. Dynamics of APRC on consumer loans (11.3 per cent) was driven by a decline in interest rates and a rise in the implicit rate of non-interest service charges.

In May the average interest rate on new housing euro loans went down 27 basis points from February to 5.61 per cent. Over the same period the standard deviation remained unchanged at 0.70 per cent. The number of banks offering lending rates of up to 5 per cent remained unchanged *vis-à-vis* February, unlike the decreased number of banks with higher lending rates.

In the third and fourth quarters interest rates on new time deposits are expected to decrease further, albeit at a slower pace than that in the second half of 2015 and first quarter of 2016. High banking system liquidity and banks' access to cheaper funding in the context of missing investment alternatives will further predetermine the downward trend in lending rates over the following two quarters.

In the second quarter one ten-year-and-six-month bond auction was conducted at an average annual yield of 2.41 per cent, down 17 basis points *vis-à-vis* the first opening of this issue in January.

The secondary market yield of the benchmark issue with a maturity of ten years and six months continued to decline to reach 2.37 per cent in May, keeping pace with primary market developments. The activity on the domestic secondary

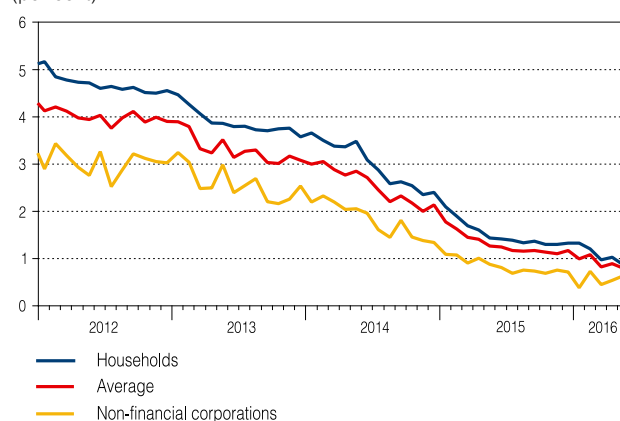
²² These values are weighted averages of the interest rates on loans to non-financial corporations on a 12-month basis.

²³ Values indicating APRC and interest rates are weighted averages of the interest rates on household consumer and housing loans on a 12-month basis.

Interest Rates on New Time Deposits

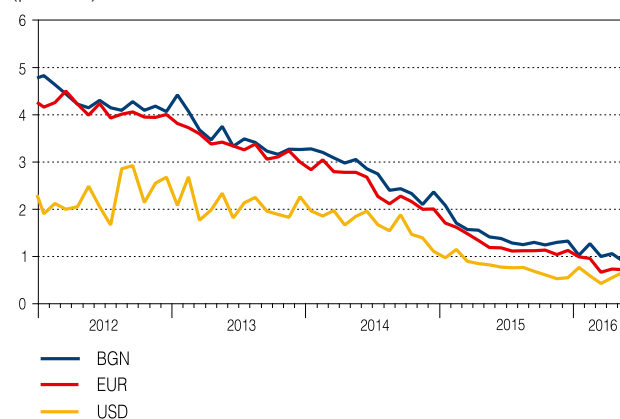
a) by sector

(per cent)



b) by currency

(per cent)

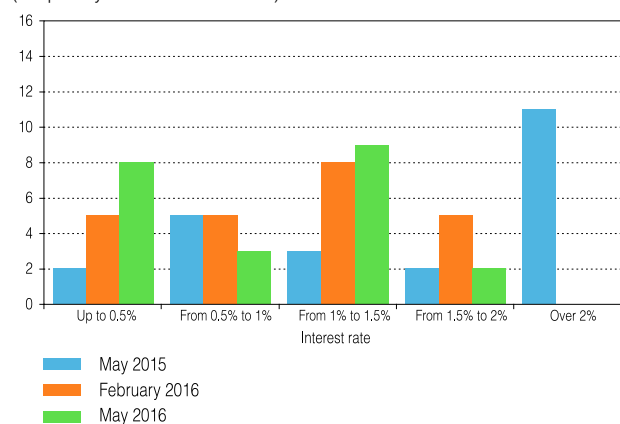


Note: The average interest rate is calculated for all sectors, maturities and currencies weighted by the relevant volumes of new deposits.

Source: the BNB.

Variation of Interest Rates on New Household Time Lev Deposits

(frequency – number of banks)



Note: In a context of continuing declines in interest rates on new time deposits and for reasons of clarity, starting from issue 1 of the Economic Review quarterly for 2016, intervals in the chart are moved downward.

Source: the BNB.

government bond market was relatively low, and the market uncertainty regarding Ministry of Finance's issuing policy in the second half of 2016 and high bank liquidity stimulated government securities purchases from the outset in the primary market.

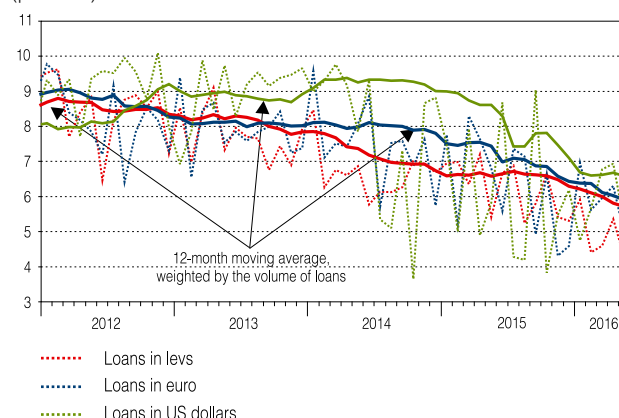
Bulgarian Eurobonds yields remained close to end-March levels, with only long-term issues recording a slight drop. The April increase in the volumes sold under ECB's asset purchase programme reinforced the downward trend in German benchmark yields. The spread between Bulgarian and German government securities increased somewhat in May and June, more pronounced in the long-term end of the maturity curve.

Bulgarian government bond yields are expected to continue decreasing slowly in the second half of 2016 as a result mainly of domestic factors: retention of low government bond supply along with strong demand driven by the high liquidity in the banking system. These factors will affect both government securities yields on the primary and secondary markets and Bulgarian Eurobonds yields, given the significant share held by residents (47.4 per cent). At the same time, risks may arise in the short run, associated with significant fluctuations in government bond prices in international capital markets due to the uncertainty stemming from UK referendum results which may cause volatility in Bulgarian Eurobonds yields.

Developments in financial flows generated in the process of external and internal economic factor interaction contributed to the growth in international foreign exchange reserves. In June 2016 the market value of international reserves (assets on the Issue Department balance sheet) rose from the end of the previous year by EUR 2.2 billion to EUR 22.4 billion (BGN 43.9 billion). According to the currency board principles, the increase in international reserves corresponds to the increase in the Issue Department balance sheet liabilities. In the first six months, this dynamics was largely driven by the rise of the government deposit with the BNB *vis-à-vis* December 2015, reflecting Eurobonds proceeds in March and the large surplus on consolidated fiscal programme accumulated between January

Interest Rates on New Loans to Non-financial Corporations by Currency

(per cent)



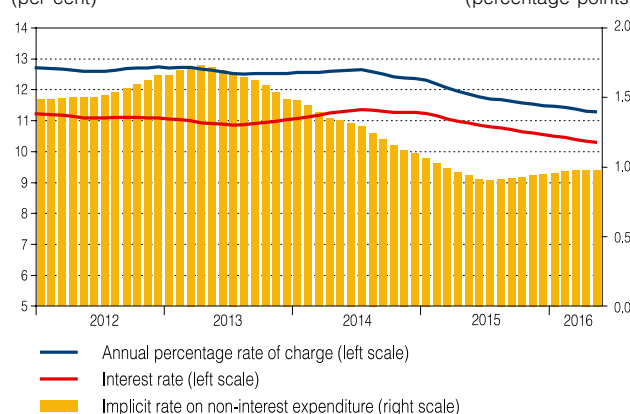
Source: the BNB.

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

a) consumer loans

(per cent)

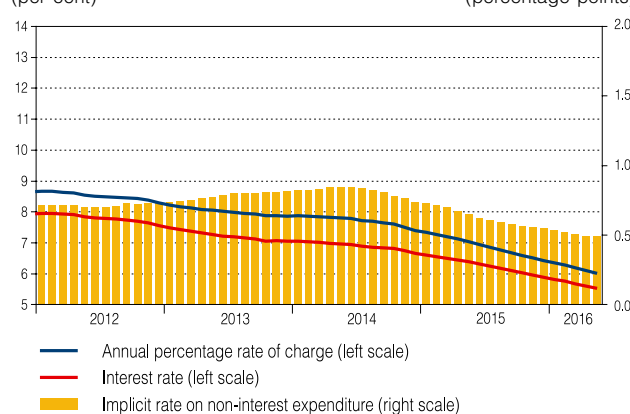
(percentage points)



b) housing loans

(per cent)

(percentage points)



Notes: Interest rates in all maturities and currencies are weighted by the relevant volumes of new loans for a 12-month period. The implicit rate 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: the BNB.

and May. Concurrently, the reduced liabilities to banks *vis-à-vis* the end of the prior year limited the growth in Issue Department's liabilities.

In the third and fourth quarters of 2016 banks' funds with the BNB are expected to remain at comparatively high levels. Government deposit with the BNB will depend on the budget balance in the review period and the issuing policy pursued in the domestic market. Currency in circulation is expected to continue growing on an annual basis, though at a slowing annual growth rate.

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

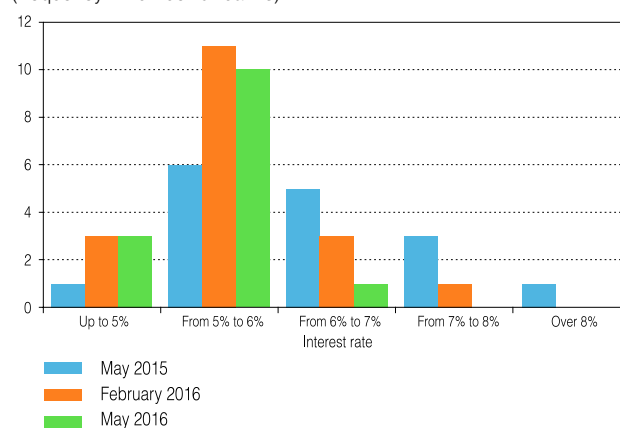
Government's revenue and expenditure policy and budget financing operations affect the allocation of liquidity among economic sectors.

The first quarter saw significant inflows from the external sector to the budget, with their share reaching 21.3 per cent of GDP. The March issue of government securities in international capital markets was a major contributor to this. By end-March 62.4 per cent of newly issued Eurobonds (equivalent to BGN 2.4 billion) was held by non-residents. In addition, EU grants of BGN 1281.1 million were received over the period, and payments of BGN 655.7 million under the EU Common Agricultural Policy were reimbursed. The inflow of liquid funds from non-residents exceeded significantly outflows from the budget to the external sector. In the first quarter no significant payments were made on the debt held by non-residents, and the contribution to the EU budget (BGN 253.9 million) was significantly lower than that in the same period of the previous year.

The financial sector was also a net source of liquidity to the budget, accounting for 5.6 per cent of GDP over the quarter. The volume of Eurobonds issued in international capital markets and purchased by residents (BGN 1464.6 million) and of government securities sold in the domestic market (BGN 394.2 million) was significantly higher than payments on maturing government and municipal securities in this period (BGN 813.7 million).

Variation of Interest Rates on New Housing Loans in Euro

(frequency – number of banks)

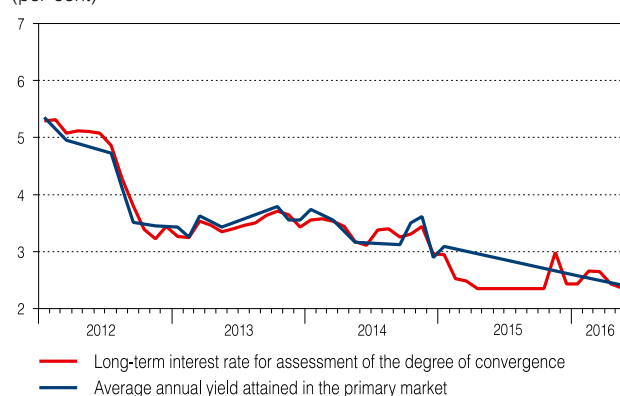


Note: In a context of continuing declines in interest rates on new deposits and for reasons of clarity, starting from issue 1 of the Economic Review quarterly for 2016, intervals in the chart are moved downward.

Source: the BNB.

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

(per cent)



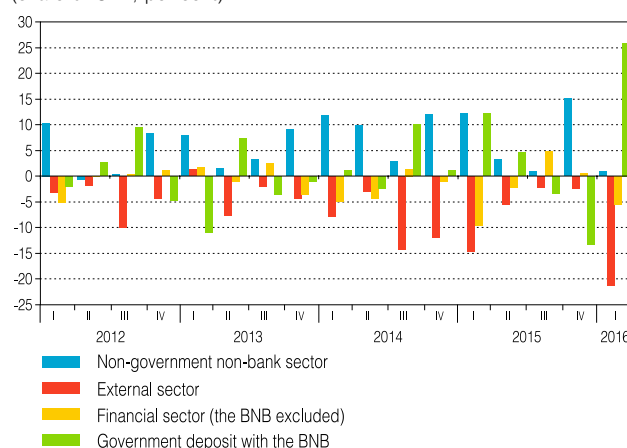
Source: the BNB.

In the first quarter of the year funds attracted from the external and financial sectors contributed to the strong increase in the government deposit with the BNB (BGN 4792 million). Net flows from the budget to the non-government non-bank sector were positive, though in minimum amounts, with outflows from this sector in the form of tax and non-tax revenue recording lower volumes than budget expenditure on transfers and other payments (including farm subsidies paid in January).

Preliminary monthly data of end-June 2016 indicate that in the second quarter of 2016 the external sector will continue to be a source of liquidity for the consolidated state budget, mainly due to EU grants (including BGN 529.6 million reimbursed by the EU on the second tranche of farm subsidies paid in April by the State Fund Agriculture). The financial sector is also expected to continue providing liquidity to the budget due to the positive net issue of government securities in the domestic market (BGN 98.7 million). Budget inflows from the external and financial sectors are anticipated to decrease in volume from the previous quarter. The BGN 1428.6 million increase in the government deposit with the BNB could be broadly explained by inflows from the non-government non-bank sector as a result of the excess of tax and non-tax revenue over non-interest budget expenditure made in the review period.

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

(share of GDP, per cent)



Sources: the MF, BNB.

3. Economic Activity

In the first quarter of 2016 real GDP increased by 0.7 per cent on a quarterly basis. Private consumption and net exports contributed most significantly to this growth. Government consumption and gross fixed capital formation contributed negatively.

Short-term economic indicators over the first quarter and beginning of the second quarter of 2016 gave mainly positive signals about the economic development. The positive sentiment of households and corporations amid persistently low petroleum prices and declining interest rates create conditions for boosting consumption and corporations' investment activity, providing opportunities for opening new jobs. Still, the high uncertainty surrounding the international economic situation will limit investment and expenditure policy of corporations. Quarterly GDP growth is expected to moderate slightly in the third and fourth quarters of 2016, reflecting lower government investment and a lower positive contribution of net exports to GDP growth.

Current Economic Environment

In the first quarter of 2016 quarterly growth²⁴ of real GDP reached 0.7 per cent, with domestic demand components still playing a significant role thereto. Private consumption and net exports had the most significant positive contribution to the change in GDP due to reduced imports and retained exports of goods and services. Government consumption and gross fixed capital formation declined in the first quarter and had a negative contribution to growth.

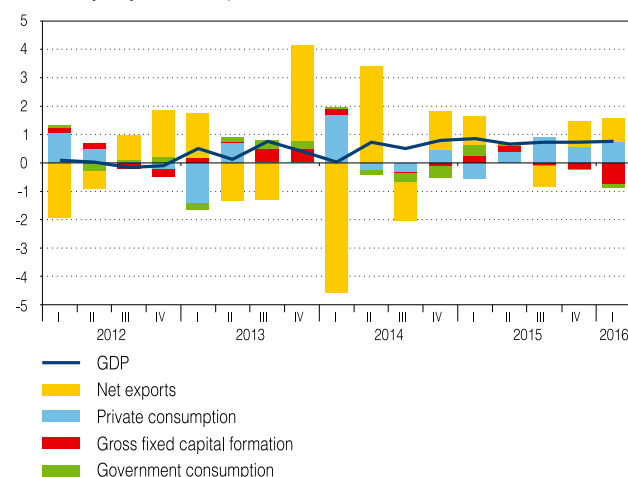
Indicators tracking firms and households' sentiment (NSI business climate and consumer confidence survey) remained at high levels in the first two quarters of 2016. In June 2016 the business climate indicator picked up, with improvements observed in all sectors, excluding construction. Expectations of the future economic activity for the total economy continued to suggest improved sentiment.

Quarter-on-quarter real GDP growth in the third and fourth quarters of 2016 is expected to be weaker than that observed in 2015 and in the first quarter of 2016. The external environment remains a source of uncertainty. The exter-

²⁴ The quarter-on-quarter analysis in this section employs seasonally adjusted data, unless otherwise indicated. The seasonal adjustment of indicators, on which the NSI or Eurostat do not officially publish seasonally adjusted data, was made via the *TRAMO SEATS* or *OxMetrics* programme by using an automated setup for diagnostics and optimisation of adjustment parameters.

Contribution to GDP Growth by Final Use Component

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



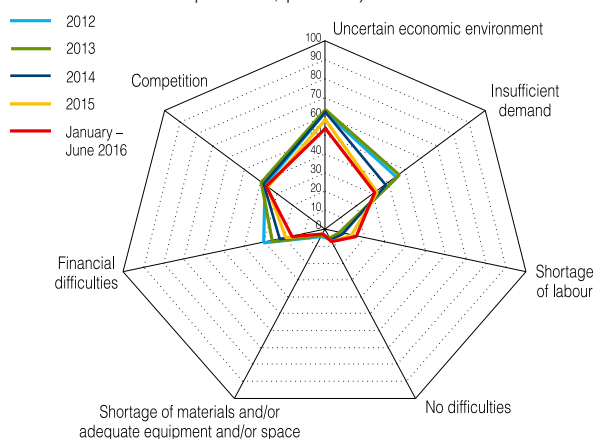
Note: Non-additive data due to direct chain-linked and seasonal adjustment of GDP and its components; the contribution of the change in inventories has not been included.

Sources: the NSI, BNB calculations.

nal demand for Bulgarian goods and services might be weaker than expected in the event of a slower recovery in our main trading partners and given the uncertainty related to the UK referendum. Low oil prices are expected to continue to stimulate consumption and help firms maintain lower production costs. The positive trends in economic indicators allow for higher than expected private investment and consumption in the third and fourth quarters. The probability of higher uncertainty following the announcement of the UK referendum results to be reflected in lower than expected investment activity of firms within 2016 is estimated as low. Risks in both directions exist also with regard to public investment.

Factors Hampering Activities of Businesses

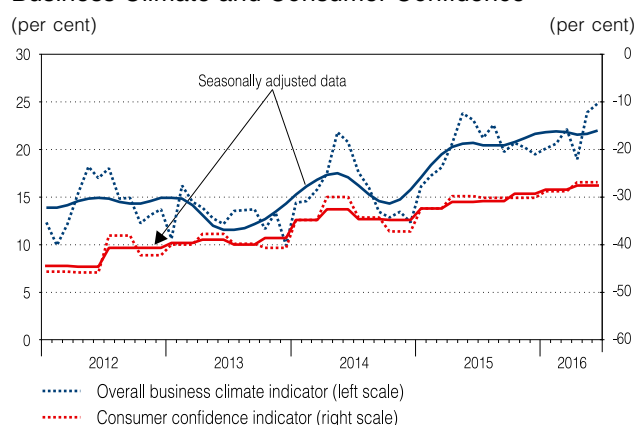
(relative share of all corporations, per cent)



Note: Average for the respective period, sector-weighted (industry, construction, trade and services).

Sources: the NSI, BNB calculations.

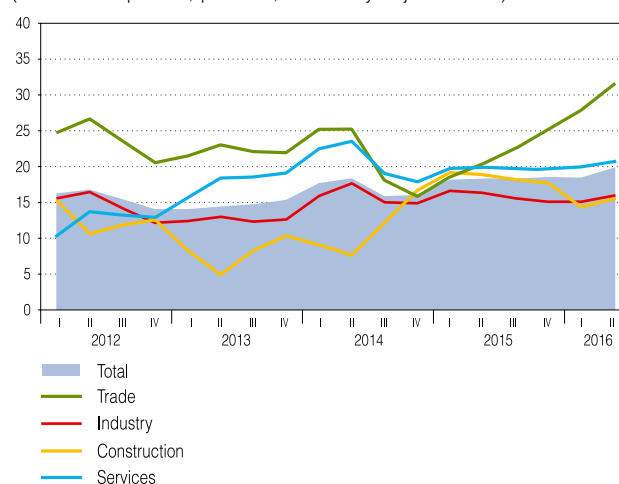
Business Climate and Consumer Confidence



Sources: the NSI, BNB calculations.

Expectations about Future Economic Activity

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



Sources: the NSI, BNB calculations.

Real GDP Growth by Component of Final Use

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

	2013				2014				2015				2016
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Consumption	-3.6	1.6	1.1	0.8	0.9	-0.2	-0.5	-0.1	0.0	0.5	0.8	0.5	0.4
incl.													
Household consumption	-1.2	0.2	0.3	0.4	1.8	0.0	-0.3	0.4	-0.3	0.4	0.9	0.6	0.6
Government final consumption expenditure	-2.7	2.3	-1.4	2.7	1.3	-0.9	0.8	-5.1	0.8	5.0	-1.6	-0.1	4.7
Collective consumption	-0.3	1.5	2.9	1.2	-0.3	-1.0	-3.1	-1.5	2.2	-0.9	-0.1	-1.1	-2.4
Gross fixed capital formation	0.9	0.2	2.1	2.1	1.1	0.0	-0.4	-0.6	1.2	1.1	-0.3	-1.1	-3.5
Exports of goods and non-factor services	6.5	1.2	2.5	-0.2	-4.0	3.4	-0.7	4.8	5.8	-3.0	-2.0	5.4	0.0
Imports of goods and non-factor services	3.5	3.3	4.3	-5.2	3.3	-2.1	1.5	2.4	4.1	-3.0	-0.8	3.8	-1.2
GDP	0.5	0.1	0.8	0.4	0.0	0.7	0.5	0.8	0.9	0.7	0.7	0.7	0.7

Source: the NSI.

Household Behaviour

In the first quarter of 2016 household consumption growth accelerated, while the savings rate remained at comparatively high levels. According to national accounts data, employment continued to grow in the first quarter of 2016 and corporations' employment expectations point to a continued recovery in demand for labour by firms in all economic sectors. Improving labour market situation has a favourable effect on consumer confidence and labour income. The growth rate of household income from remuneration accelerated over the review period (both annually, according to non-seasonally adjusted data on wage bill and average wage *per* employee, and quarterly, according to seasonally adjusted national accounts data). These factors will continue to have a positive effect on employment and labour income, and stimulate consumer demand growth in the short-term.

According to the NSI labour force survey, the first quarter of 2016 saw lower labour supply by households, as measured by the reduction of the labour force²⁵ in the same quarter (both annually, according to non-seasonally adjusted data, and quarterly, according to seasonally adjusted data). The decline in the labour force was coupled with a slight increase in the number of discouraged persons in the first quarter 2016 (based on seasonally adjusted data). At the same time, despite the continued working-age population decline, the labour force participation rate²⁶ also moderated slightly on the previous quarter reflecting reduced labour force. The Labour Force Survey shows that the unemployment rate²⁷ continued to decline in the first quarter of 2016, reaching 8.6 per cent (according to non-seasonally adjusted data, the unemployment rate came to 7.8 per cent), with unemployed of up to one year contributing most to this. The seasonally adjusted unemployment

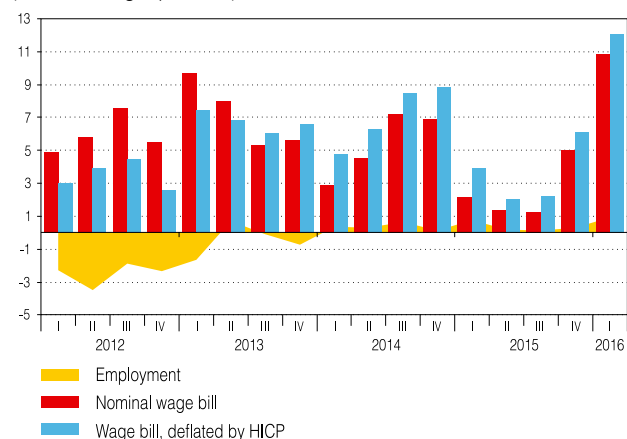
²⁵ Labour force (currently economically active population) comprises persons aged 15 and older who provide the supply of labour for the production of goods and services. Labour force includes both employed and unemployed persons.

²⁶ Labour force participation rate is the proportion between economically active persons (labour force) and the population of the same age.

²⁷ Unemployment rate is the proportion between the number of unemployed and the labour force based on Labour Force Survey data.

Employment and Nominal Wage Bill

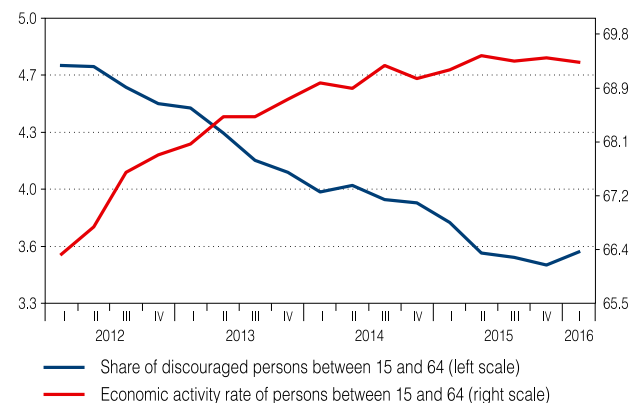
(annual change, per cent)



Sources: the NSI – SNA, BNB calculations.

Economic Activity and Share of Discouraged Persons

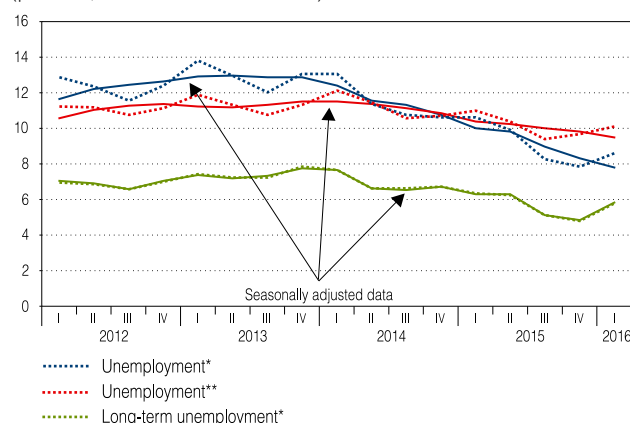
(per cent, seasonally adjusted data) (per cent, seasonally adjusted)



Sources: the NSI – SNA, BNB calculations.

Unemployment Rate

(per cent, share of the labour force)



* NSI data.

** Employment Agency data.

Sources: the NSI – SNA, Employment Agency, BNB calculations.

rate²⁸ based on Employment Agency data also declined in 2016, coming to 8.8 per cent in May (8.7 per cent according to non-seasonally adjusted data).

Seasonally adjusted national account data show that in the first quarter of 2016 household consumption rose by 1.2 per cent on a quarterly basis and 4.2 per cent on an annual basis, respectively. Over the same period the food, drinks and tobacco group²⁹ reported more pronounced growth in retail trade turnover. Despite the slowdown in retail trade turnover in April compared to that in the first quarter of 2016, consumption development indications remained positive, while household expectations about an increase in their basic spending improved. The trend toward an increase in new consumer credit continued in line with growing consumer demand over the recent months. Concurrently, according to seasonally adjusted data, the consumer confidence indicator went up in April due to prevailing better expectations of households about their economic and financial position reported in the NSI Consumer Survey.³⁰ Against the background of low oil prices, rising labour income and improved consumer confidence, household consumption is expected to continue to recover in the third and fourth quarters of 2016.

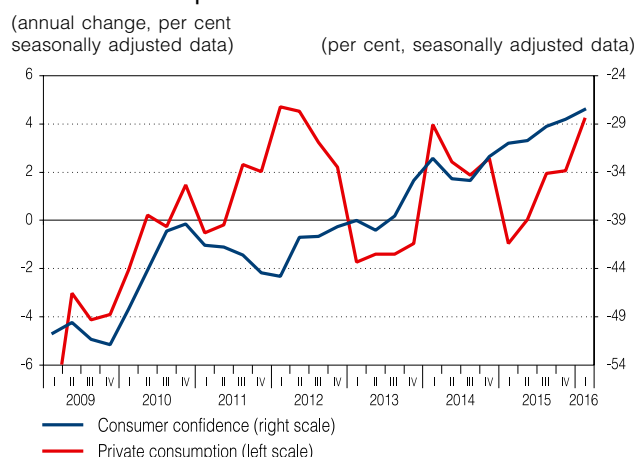
Household savings rate increased slightly in the first quarter of 2016 and remained relatively high. NSI Household Budget Survey data show that the share of savings in household disposable income continued to increase. The share of

²⁸ The definition of the unemployment rate according to the Employment Agency corresponds to that referred to in footnote 28, but using a constant rate of labour force comprising the number of persons in the respective age group since the last census of the population.

²⁹ As of 1 January 2016 the excise duty on tobacco products was increased. Under Article 70 of the Regulations for Application of the Law on Excise Duties and Tax Warehouses, upon a change of latest registered prices of manufactured tobacco released for consumption with affixed excise labels with the old prices written on them shall be sold at the price written on the excise labels until depletion of the quantities. This option is likely to be reflected in increased demand for tobacco products in the first quarter of 2016.

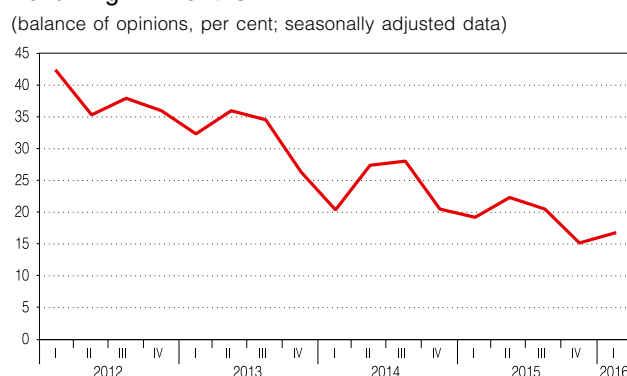
³⁰ Final results of the Consumer Survey represent balances of opinions and are calculated as a difference between the relative shares of positive and negative opinions on raised issues. The composite consumer confidence indicator is calculated as the arithmetic mean of expectation balances in the following 12 months for the development of: financial position and savings of households, the overall economic situation in the country and unemployment (the latter with the sign reversed).

Private Consumption and Consumer Confidence



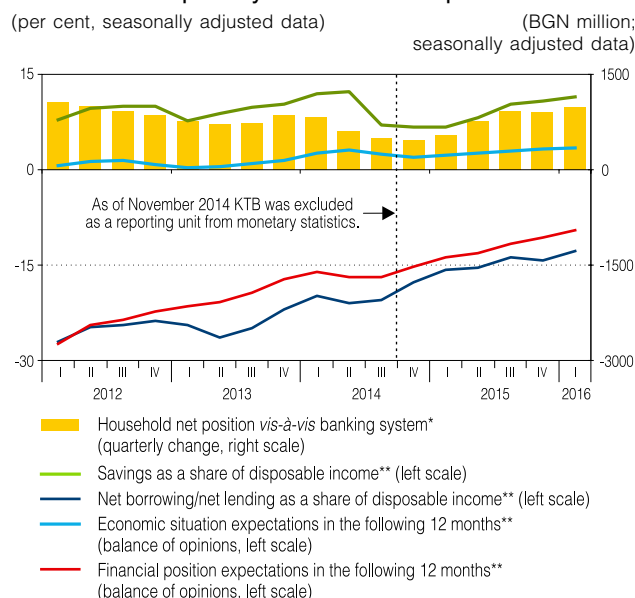
Sources: the NSI – Consumer Survey, BNB calculations.

Household Unemployment Expectations in the Following 12 Months



Source: the NSI – Consumer Survey.

Household Propensity to Save and Expectations



* BNB data.

** NSI data.

Sources: the NSI – Household Budget Survey, NSI Consumer Survey, the BNB.

households, which intend to increase their savings in the following 12 months, also remained high (according to the Consumer Survey of April 2016). Net assets of households measured by their net position *vis-à-vis* the banking system (BNB monetary statistics) continued to increase over the first quarter of 2016.

In the third and fourth quarters of 2016 higher labour income and employment are expected to create conditions for a moderate increase in consumer demand and a higher household savings rate, while labour supply is expected to remain relatively low.

Employment and Income Dynamics

	2013				2014				2015				2016
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
(per cent, quarter-on-quarter; seasonally adjusted data)													
Employees	-0.3	0.6	-0.5	0.1	0.3	0.2	0.2	-0.1	0.3	-0.1	0.1	0.1	0.3
Nominal wage <i>per employee</i> *	3.2	0.6	0.9	1.3	1.5	1.3	1.8	0.4	-1.5	1.4	1.2	2.6	3.5
Real wage <i>per employee</i> **	2.3	1.3	1.3	1.3	2.7	1.5	1.7	1.5	-2.0	2.0	1.6	2.3	3.3
Wage bill, nominal terms	3.1	0.6	0.7	1.3	1.4	1.6	1.6	0.4	-0.9	1.5	1.6	2.7	3.6
Wage bill, real terms**	2.2	1.2	1.1	1.3	2.5	1.8	1.5	1.5	-1.4	2.0	2.1	2.5	3.4
(per cent, on corresponding quarter of previous year, non-seasonally adjusted data)													
Employees	-1.7	0.7	-0.1	-0.7	0.3	0.3	0.7	0.1	0.8	0.2	0.2	0.3	0.9
Nominal wage <i>per employee</i> *	12.3	8.6	6.2	6.6	3.5	4.3	7.3	7.3	1.3	0.9	-0.1	3.7	9.2
Real wage <i>per employee</i> **	9.9	7.4	6.9	7.7	5.4	6.1	8.5	9.2	3.1	1.5	0.9	4.8	10.4
Wage bill, nominal terms	9.7	8.0	5.3	5.6	2.9	4.5	7.2	6.9	2.1	1.4	1.3	5.0	10.9
Wage bill, real terms**	7.4	6.9	6.0	6.7	4.8	6.3	8.5	8.8	3.9	2.0	2.2	6.1	12.1

* The wage is calculated according to NSI data (SNA), with social security contributions paid by the employer deducted from the compensation *per employee*. The difference is divided by the number of employees.

**Data deflated by HICP.

Sources: the NSI – SNA, BNB calculations, Eurostat.

Retail Trade Turnover

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

	2013				2014				2015				2016	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	April
Retail trade, excluding motor vehicles and motorcycles	0.9	4.2	0.1	1.1	7.4	0.8	1.1	0.0	0.3	-0.1	-0.1	0.5	2.2	1.4
incl.														
Food, drinks and tobacco products	-4.6	3.7	3.3	-0.5	19.8	1.3	-1.0	-1.4	0.6	-0.3	-1.1	-0.6	16.6	-1.0
Textile, clothing, footwear and leather	-0.3	7.4	6.0	-2.3	0.0	4.7	3.8	-2.6	-7.4	2.1	-0.3	2.4	7.5	5.5
Household appliances, furniture and other household goods	1.6	2.6	2.0	2.0	-0.9	0.7	0.4	2.1	2.4	-0.2	0.4	-1.1	0.4	-0.9
Computer and communication equipment	11.4	-0.8	-2.8	8.5	-3.6	-3.2	-1.3	-0.1	0.7	-0.6	-0.6	-0.7	-12.9	6.6
Pharmaceutical and medical goods, cosmetics and toiletries	5.7	5.6	4.5	2.4	3.8	1.0	1.6	3.5	2.6	0.7	1.3	1.7	0.4	0.4
Unspecialised shops with different kinds of goods	-4.9	13.5	-3.2	0.6	1.9	2.1	1.4	-2.9	2.0	1.3	-0.5	-1.9	-1.6	-1.4
Automobile fuels and lubricants	-4.2	5.6	-5.2	-1.3	5.8	-1.2	9.3	-3.0	5.2	-5.4	-2.9	7.1	-3.9	5.0

Source: the NSI, short-term business statistics.

Fiscal Policy Effects on the Economy

In the first five months of 2016 Bulgaria's budget position improved significantly on the corresponding period of 2015. The budget balance on the consolidated fiscal programme was positive at BGN 2773.6 million (3.1 per cent of projected GDP for the year) against a deficit of BGN 1091 million (1.3 per cent of GDP) for the January–May 2015 period. The marked budget balance improvement was due to both the increase in total revenue and the decrease in total expenditure.

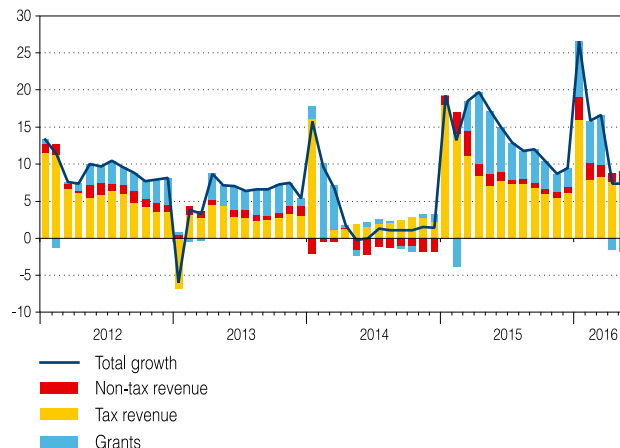
Over the first five months of 2016 total consolidated fiscal programme revenue was marked by a high growth rate (7.5 per cent), with tax revenue contributing most significantly to its growth in May. The main factors behind high revenue growth in the first five months remained the increase of indirect taxes reflecting the windfall VAT and excise duty receipts in January, the measures to boost tax collection and, to a lesser extent, the favourable household consumption dynamics at the end of 2015 and early 2016. Direct tax revenue also contributed to tax revenue growth reporting a sizeable increase of 8.3 per cent on an annual basis. At the same time, revenue from grants reported a negative contribution to budget revenue growth due to the significant repayments already made for the 2007–2013 programming period which was completed at the end of 2015 and the gradual transition in the beginning of 2016 to the implementation of the new projects under the 2014–2020 programming period.

In May 2016 total expenditure on the consolidated fiscal programme posted a decrease of 5.1 per cent on an annual basis on the corresponding period of the previous year. This was entirely due to lower capital expenditure resulting from the still low amount of funds under projects funded by the EU for the 2014–2020 programming period. Operating expenditure and the contribution to the EU budget also reported a decline.

In May social insurance payments grew by 3.0 per cent on an annual basis due to higher expenditure on pensions and health insurance payments. The increase in pension expenditure in the first quarter of 2016 reflected largely the higher number of retired servicemen and

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

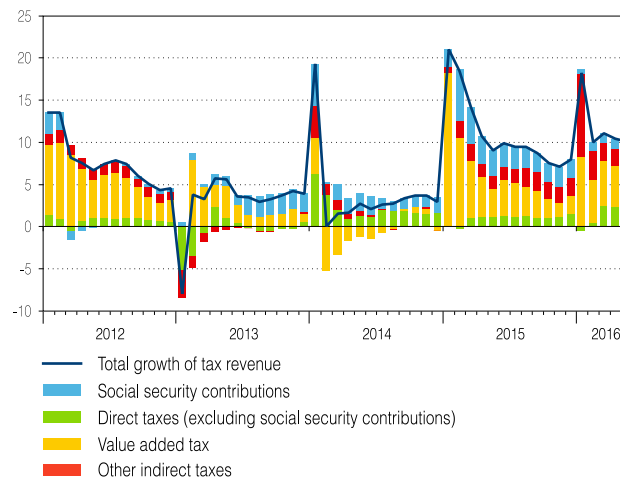
(per cent; percentage points)



Sources: the MF, BNB calculations.

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

(per cent; percentage points)



Sources: the MF, BNB calculations.

civil servants.³¹ Wage expenses reported an annual increase of 3.2 per cent, with the more significant rise in wage expenses in municipality budgets and social insurance being offset somewhat by keeping the wage expenses in the state budget unchanged from the same period of previous year.

The current dynamics of key nominal consumption sub-components indicates that government consumption will have a low positive contribution to real GDP growth in the second quarter of the year.

According to preliminary data and MF estimates, the accumulated budget surplus in June was BGN 3085.9 million (3.5 per cent of projected GDP for the year) largely due to the higher tax revenues and the sizeable reduction of capital expenditure. Budget revenue implementation in the third and fourth quarters of 2016 will continue to be influenced by the increased tobacco and fuel excise duties and higher minimum insurance thresholds and minimum wage, and by the expected acceleration of the annual growth of private consumption and compensation *per* employee.

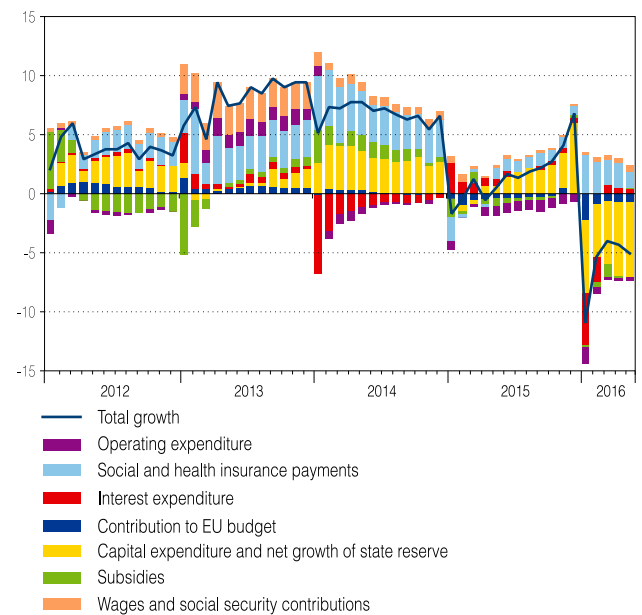
Reduced capital expenditure under the consolidated fiscal programme in the first four months of 2016 was more pronounced than projected for the year. This points to a possible concentration of a significant portion of investment project funding in the second half of the year. The estimated lower total government investment for 2016 was a decisive factor behind the contraction of gross fixed capital formation in the total economy.

Based on the current non-interest expenditure dynamics and the parameters laid down in the State Budget Law, we expect government consumption to have a limited positive contribution to GDP growth in the third and fourth quarters of the year.

³¹ Officers mainly from the Ministry of Interior and the Ministry of Defence acquiring entitlement to pension under Article 69 of the Social Insurance Code.

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

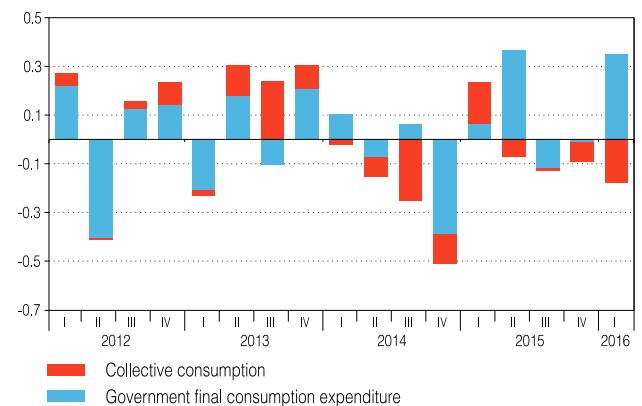
(per cent, percentage points)



Sources: the MF, BNB calculations.

Contribution of Government Consumption Components to Real GDP Growth

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



Sources: the NSI, BNB calculations.

Revenue, Expenditure and Budget Balance on the Consolidated Fiscal Programme for 2015–2016

Consolidated fiscal programme	2015								2015		2016		2015		2016	
	I		II		III		IV		January–December		I		January–May ¹		January–May ¹	
	BGN million	% ²	BGN million	% ²	BGN million	% ²	BGN million	% ²	BGN million	% ²	BGN million	% ²	BGN million	% ²	BGN million	% ²
Total revenue and grants	7 795.1	18.5	8 508.4	12.0	7 858.7	6.4	8 051.1	2.5	32 213.4	9.5	9 097.1	16.7	13 818.6	17.3	14 852.1	7.5
Tax revenue	5 937.4	14.2	6 348.7	6.2	6 282.3	6.6	6 287.2	5.6	24 855.6	7.9	6 596.9	11.1	10 283.9	9.0	11 321.0	10.1
Corporate tax	463.8	2.4	544.6	9.8	230.3	5.0	621.7	21.6	1 860.4	10.8	555.3	19.7	912.0	4.3	996.5	9.3
Income tax for individuals	621.2	-0.2	734.9	8.4	670.5	4.0	704.6	8.1	2 731.2	5.2	643.9	4.5	1 136.7	3.3	1 222.1	7.5
Value added tax	1 969.4	21.8	1 976.9	5.8	2 136.3	5.3	1 657.3	-5.2	7 740.0	6.5	2 293.8	16.5	3 266.7	11.3	3 708.7	13.5
Excise duties	949.8	11.1	1 056.9	7.9	1 325.9	15.1	1 192.4	13.4	4 525.0	12.0	1 069.2	12.6	1 638.5	8.7	1 869.5	14.1
Customs duties	39.4	12.5	36.1	2.8	37.8	-9.4	45.7	10.6	159.0	3.8	41.0	4.1	63.4	8.1	70.4	11.2
Social security and health insurance contributions	1 624.7	16.4	1 727.2	5.2	1 729.1	5.2	1 866.1	5.6	6 947.1	7.7	1 696.6	4.4	2 778.6	11.0	2 912.3	4.8
Other taxes	269.1	21.7	272.1	-3.0	152.4	-7.5	199.3	10.4	892.9	5.4	297.1	8.4	487.9	6.6	541.5	11.0
Non-tax revenue	1 079.8	25.8	939.1	-2.7	832.2	-4.8	859.0	12.8	3 710.1	7.2	1 200.0	11.1	1 756.4	11.3	1 980.7	12.8
Grants	777.9	50.3	1 220.6	87.9	744.2	20.8	904.9	-20.5	3 647.7	24.9	1 300.2	66.9	1 778.3	133.4	1 550.4	-12.8
Total expenditure (including the contribution to EU budget)	7 539.2	1.2	7 874.8	2.1	8 115.6	3.1	11 167.9	18.2	34 697.6	6.8	7 233.5	-4.1	12 727.5	0.5	12 078.5	-5.1
Wages and social security contributions	1 415.2	1.4	1 519.3	1.8	1 459.6	-0.8	1 688.9	1.8	6 083.0	1.1	1 448.8	2.4	2 446.5	1.4	2 505.5	2.4
Operating expenditure	1 004.8	-1.1	1 021.8	-10.8	958.6	-6.3	1 493.8	-3.1	4 479.0	-5.2	992.6	-1.2	1 685.6	-5.5	1 639.8	-2.7
Interest	262.8	31.8	46.8	15.2	320.6	18.4	68.2	-1.3	698.3	20.4	310.8	18.3	293.0	33.8	345.6	18.0
Social security, assistance and social care	3 388.3	0.4	3 503.6	4.2	3 472.1	2.5	3 577.3	-0.1	13 941.2	1.7	3 551.8	4.8	5 755.9	2.0	5 929.2	3.0
Subsidies	400.7	21.9	378.4	-25.8	287.9	-1.2	594.4	41.3	1 661.4	7.1	315.5	-21.3	624.0	-13.8	636.3	2.0
Capital expenditure and reserves of the general government sector	765.4	-2.6	1 201.6	26.3	1 497.8	16.6	3 423.4	78.3	6 888.2	39.4	360.1	-53.0	1 471.6	5.9	665.5	-54.8
Contribution to general budget of the European Union	301.9	-13.4	203.4	-4.5	119.2	-14.1	321.9	26.5	946.4	-0.9	253.9	-15.9	450.9	-8.9	356.6	-20.9
	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)	BGN million	difference ³ (BGN million)
Budget balance, on a cash basis	255.9	1 130.6	633.6	755.3	-257.0	225.6	-3 116.8	-1 522.8	-2 484.2	588.7	1 863.6	1 607.7	1 091.1	1 979.7	2 773.6	1 682.4

Note: The difference between the sum of individual components and total sum is due to rounding.

¹ Based on monthly reports on the implementation of budget and EU fund accounts of first-level budget spending entities.

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

³ Budget balance changes on the same period of previous year.

Source: the MF.

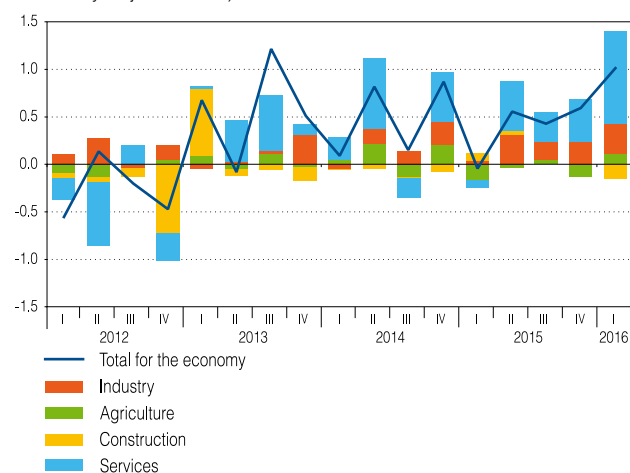
Behaviour of Firms and Competitiveness

In the first quarter of 2016 real value added growth in the total economy accelerated to 1.0 per cent on a quarter-on-quarter basis, from 0.6 per cent in the previous quarter. The industrial sector and services contributed most to this growth. The 1.4 per cent increase in gross value added in the industrial sector in the first quarter of 2016 was coupled with a rise in the real component of industrial turnover on both domestic and external markets. Value added in services continued its upward dynamics from the previous year going up 1.4 per cent on a quarterly basis in the first quarter of 2016, with trade³², financial and insurance activities and

³² In this chapter, it should read wholesale and retail trade, repair of motor vehicles and motorcycles; transportation and storage; accommodation and food service activities sub-sector according to economic activity groupings (A10).

Value Added Growth and Contribution by Sector

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



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

Sources: the NSI, BNB calculations.

scientific and technical activities sub-sectors having the most sizeable positive contribution to this growth.³³ Value added in construction went down 2.6 per cent in the first quarter of 2016, and based on construction production index data (at constant prices), over the same period a decline was also observed in both building and civil construction. However, the number of issued new buildings permits increased slightly for both residential and administrative buildings.

NSI data on short-term business statistics (turnover in industry, construction and trade) for April 2016 indicated a slowdown in gross value added growth in the respective industries in the second quarter of 2016. April saw a reduction in the volume of sales in industry from the average for the first quarter of 2016 in both domestic and external markets. Construction production index declined on the first quarter of the year. Over the same period retail trade turnover³⁴ at constant prices moderated on a quarterly basis.

Currently available data point to an increase in corporations' investment activity in the first quarter of 2016. According to national accounts data and BNB calculations (based on quarterly non-financial accounts of the general government sector and the consolidated fiscal programme performance reports published by the NSI and the Ministry of Finance, respectively), the overall decrease in fixed capital investment of 3.5 per cent in real terms on a quarterly basis in the first quarter of 2016 was due entirely to lower government investment, while private investment increased. Gross operating surplus also increased on a quarterly basis in the first quarter, with services and trade and financial and insurance activities in particular having the most sizeable positive contribution to this growth.

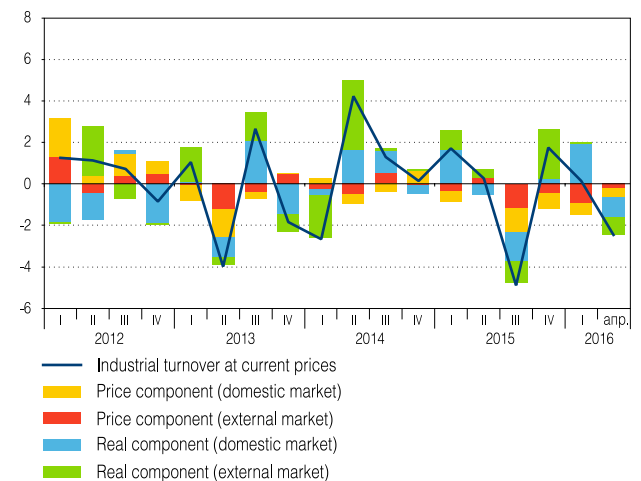
Improved economic activity in services over the first quarter of 2016 contributed to the gradual increase in employment in the economy. Employment in the trade and scientific and technical activities sub-sectors also increased on a quarterly basis. In the other economic sectors, firms' employment policy remained cautious amid still

³³ In this chapter, it should read professional, scientific and technical activities; administrative and support service activities sub-sector according to economic activity groupings (A10).

³⁴ For further details, see the Household Behaviour section in this Chapter.

Industrial Turnover Dynamics

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

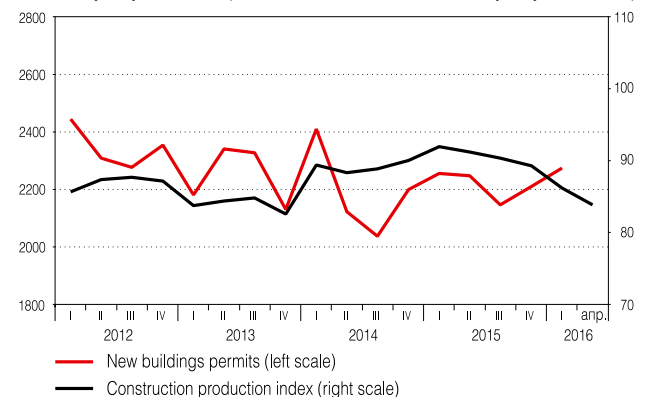


Sources: the NSI, BNB calculations.

Construction Production Dynamics and New Buildings Permits Issued

(number of buildings; seasonally adjusted data)

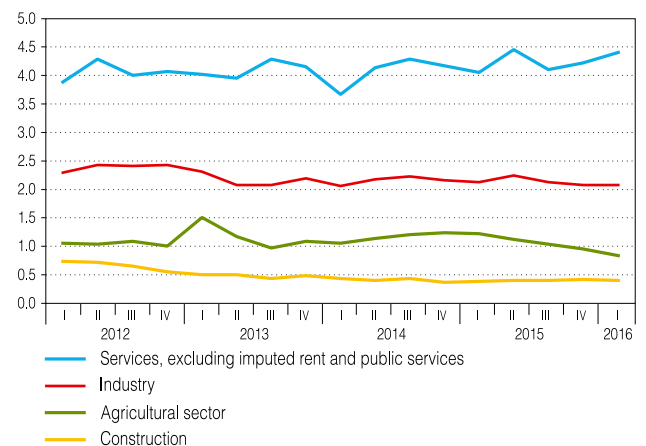
(2010 = 100; seasonally adjusted data)



Sources: the NSI, BNB calculations.

Gross Operating Surplus at Current Prices

(BGN billion; seasonally adjusted data)



Sources: the NSI, BNB calculations.

heightened uncertainty about the economic environment. Improved corporations' expectations about the number of staff in the following three months in all economic sectors, however, points to a gradual recovery in employment until the end of 2016.

As a result of the weak employment dynamics and the accelerating growth of gross value added, labour productivity in the total economy continued to increase on a quarterly basis in the first quarter of 2016. The indicator went up in all sub-sectors except construction and real estate operations.

The nominal compensation *per* employee accelerated on both a quarterly and annual basis in the first quarter of 2016. On the one hand, this increase can be associated with higher labour productivity and, on the other, with the more substantial increase in minimum insurance thresholds in early 2016.

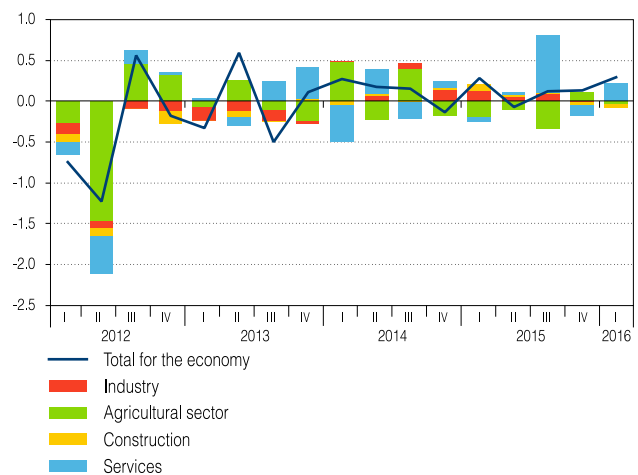
The stronger compensation *per* employee than labour productivity growth resulted in an increase in the nominal unit labour costs in industry and in the total economy in early 2016. This indicator went up in real terms on both a quarterly and annual basis.

As a result of the sustained capacity utilisation at high levels in the first quarter of 2016, capital and total factor productivity remained the main positive contributors to real GDP growth decomposed into production factors. The low contribution of labour reflects weak employment dynamics.

The gradual recovery in demand for goods and services and the sustained high capacity utilisation amid low oil prices and declining interest rates on loans to corporations helped improve firms' sentiment and expectations and favoured a long-lasting trend toward real growth. However, the uncertain economic environment still remains a factor limiting the investment activity and expenditure policy of firms. As a result, private investment and employment growth are expected to remain moderate in the third and fourth quarters of 2016.

Contribution to Changes in the Number of Employed by Economic Sector

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

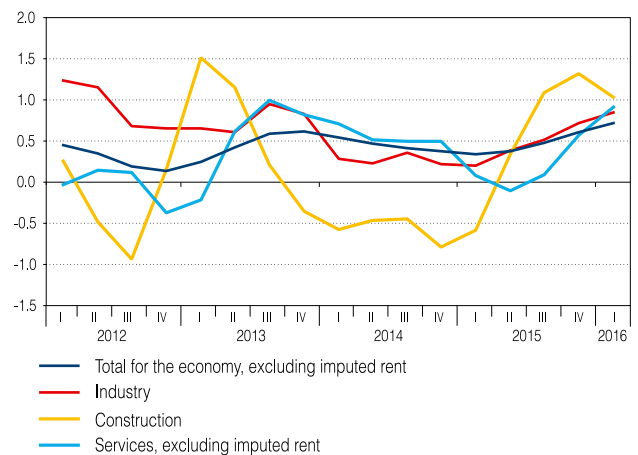


Note: Non-additive data on contributions due to direct seasonal adjustment of the total amount and its components.

Sources: the NSI, BNB calculations.

Labour Productivity Developments (Value Added *per* Employee)

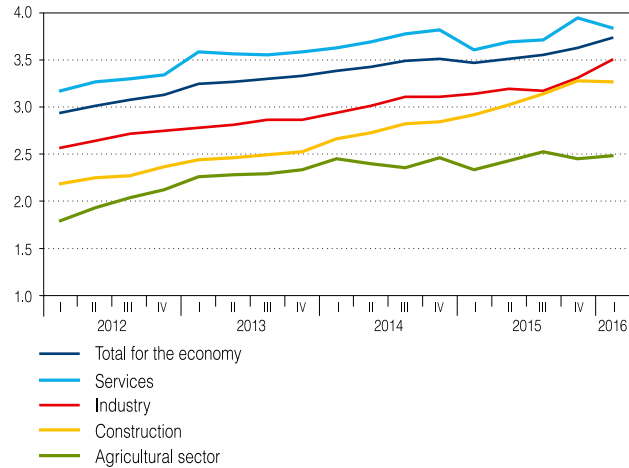
(per cent, quarter-on-quarter; seasonally adjusted data)



Sources: the NSI, BNB calculations.

Compensation per Employee at Current Prices

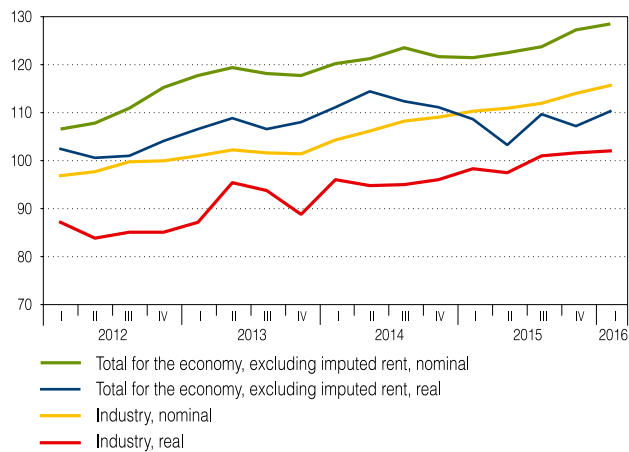
(BGN thousand; seasonally adjusted data)



Sources: the NSI, BNB calculations.

Unit Labour Costs

(2010 = 100; seasonally adjusted data)



Sources: the NSI, BNB calculations.

Gross Value Added Growth

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

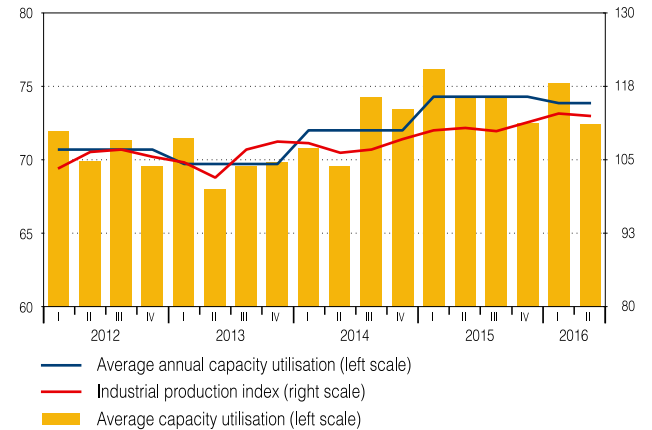
	2013				2014				2015				2016
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Agriculture, forestry, hunting and fishing	1.8	-1.0	2.4	-0.6	0.9	4.7	-2.8	4.4	-3.3	-0.7	1.1	-2.7	2.4
Mining and quarrying, manufacturing, production and distribution of electricity, gas and water	-0.2	0.1	0.1	1.4	-0.2	0.7	0.7	1.1	0.2	1.4	0.8	1.0	1.4
Construction	11.7	-1.2	-0.9	-2.2	-0.2	-0.8	-0.2	-1.2	1.3	0.8	0.0	0.2	-2.6
Trade, repair of motor vehicles and motorcycles, transport, storage and mail services, hotels and restaurants	0.9	0.2	1.5	0.6	-0.4	1.2	-0.5	0.2	-0.3	1.3	1.0	0.9	1.8
Creation and dissemination of information and author products; telecommunications	0.7	0.3	0.6	0.1	0.1	0.4	0.4	0.7	0.5	0.4	0.5	0.5	0.6
Financial and insurance activities	0.7	2.6	-2.0	-2.3	-0.2	3.3	-2.2	-0.2	0.4	1.4	-0.3	2.2	3.4
Real estate activities	-0.5	-0.3	-0.3	0.0	0.3	-0.1	1.4	0.7	1.2	0.7	-0.1	0.4	0.0
Professional activities and scientific research; administrative and ancillary activities	-0.7	4.2	-1.2	1.7	2.1	-0.7	0.7	0.3	-1.0	1.0	0.7	1.3	3.0
Public administration, education, human health and social work activities	-1.5	0.0	3.1	-0.1	2.0	1.7	-1.4	2.6	-1.2	-0.2	0.7	-0.8	0.7
Culture, sport and entertainment; other activity; activities of households as employers; non-identified activities of households producing goods and services for own use; activities of extraterritorial organisations and bodies	1.4	-0.2	3.4	3.1	-2.9	2.2	1.5	0.8	-0.3	-0.1	-0.4	1.5	2.0
Gross value added, total for the economy	0.7	-0.1	1.2	0.5	0.1	0.8	0.2	0.9	0.0	0.6	0.4	0.6	1.0

Source: the NSI.

Industrial Output Index and Production Capacity Utilisation in Industry

(per cent)

(2010 = 100; seasonally adjusted data)

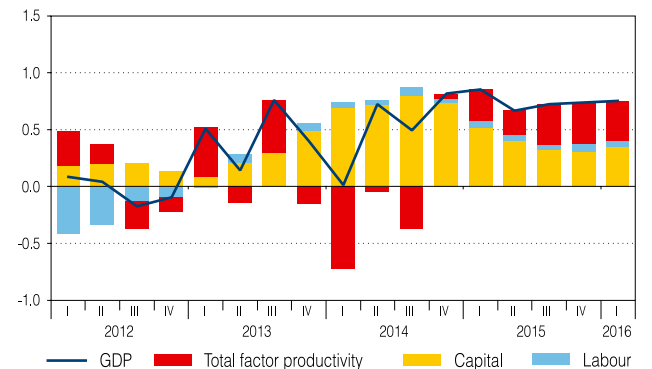


Note: Data on industrial production index for the first quarter of 2016 refer to January and February 2016.

Sources: the NSI, BNB calculations.

Contribution of Changes in Production Factors to GDP Growth

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



Sources: the NSI, BNB calculations.

Exports and Imports of Goods and Services

In the first quarter of 2016 nominal exports of goods dropped by 1.5 per cent on an annual basis, while nominal imports of goods fell by 6.7 per cent.³⁵ According to non-seasonally adjusted GDP data, real annual growth in exports of goods came to 3.5 per cent in the first quarter of 2016, while real imports of goods increased by 1.5 per cent. Cross-checking the changes in exports and imports of goods in nominal and real terms shows that dynamics in global prices curbed the nominal growth of international trade flows in the first quarter of 2016.

In the third and fourth quarters of 2016 real growth of exports and imports of goods is expected to continue to increase on an annual basis, with faster exports than imports growth being sustained, which will contribute to the contraction of the trade deficit as a per cent of GDP. Real exports dynamics will comply with the expectations about the external demand for Bulgarian goods, while real imports of goods will reflect mainly the projected increase in consumption in Bulgaria. The anticipated increase in global prices of major commodity groups by the close of 2016 will have a positive effect on nominal exports and imports growth – a trend that will be more pronounced in exports of goods.

According to balance of payments data for the January–April 2016 period, exports and imports of services declined on the corresponding period of 2015. Based on national accounts data for the first quarter of 2016 this was due mainly to the fall in prices, while real volumes grew.

In the third and fourth quarters of 2016 real exports of services is expected to increase on an annual basis, but this growth will be limited due to the lower revenue growth in the travel sub-item, resulting from a slowdown in the economic activity in key trading partners of Bulgaria's tourist sector. At the same time, real exports of services is expected to increase at a moderate pace in line with domestic demand.

In the first quarter of 2016 nominal exports of goods to EU Member States increased by

Net Exports of Commodity Groups by Use, January–March 2016

	Balance, EUR million	Change*, EUR million	Exports Growth**, per cent	Imports growth**, per cent
Consumer goods	192.0	56.8	7.9	4.3
Raw materials	-228.8	-145.5	-11.5	-5.1
Investment goods	-193.1	234.8	18.0	-1.7
Energy resources	-208.7	195.1	-24.9	-34.9
Other imports	-21.0	-1.2	17.3	9.7
Total	-459.5	339.9	-1.5	-6.7

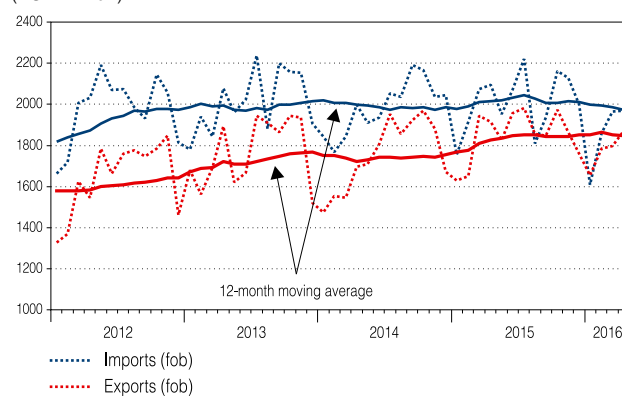
* Balance change on the same period of previous year.

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

Source: the BNB.

Exports and Imports of Goods Dynamics

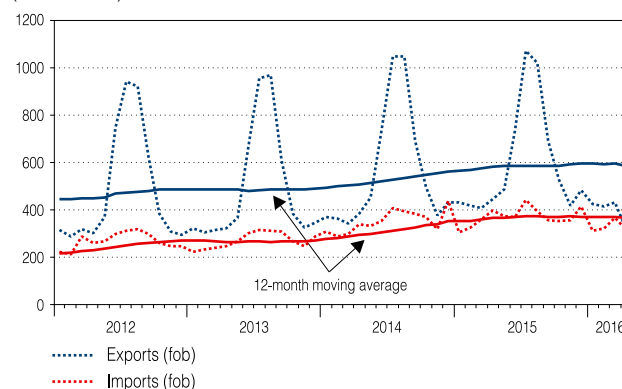
(EUR million)



Source: the BNB.

Exports and Imports of Services Dynamics

(EUR million)



Source: the BNB.

³⁵ Foreign trade data.

2.6 per cent on an annual basis, keeping pace with the improvement of EU economic activity. Exports to Romania and Italy contributed most markedly to this growth. Exports of chemical products³⁶ and machines³⁷ contributed most significantly to the dynamics of exports to EU Member States by commodity group. In the first quarter of 2016 exports to non-EU countries went down 8.8 per cent on an annual basis, with exports to Turkey and Singapore reporting the most pronounced decline. Metals³⁸ and energy products³⁹ were the main negative contributors to annual growth in exports to non-EU countries in the first three months of the year. In the first quarter of 2016 the share of exports to EU Member States increased at the expense of that to non-EU countries.

Over the same period nominal exports of most commodity groups under the Combined Nomenclature reported an increase on an annual basis except for the metals, energy products and food products⁴⁰, which reported a decline on an annual basis. Exports of machinery and chemical products had the most sizeable positive contribution to overall exports growth in 2015 and early 2016.

In the first quarter of 2016 exports of machines increased on an annual basis, reflecting both higher exported volumes and higher prices.⁴¹ A sizeable increase in the nominal exports of this group was observed in both exports to EU and non-EU countries. Exports of machines are expected to continue to increase sustainably in the second and third quarters of 2016.

In the first quarter of 2016 nominal exports of energy products posted a decrease on an annual basis largely due to lower international oil prices. Concurrently, exported physical volumes fell slightly on the corresponding period

³⁶ In this chapter, it should read chemical products, plastics and rubber group under the Combined Nomenclature.

³⁷ In this chapter, it should read the machines, vehicles, appliances, instruments and weapons group under the Combined Nomenclature.

³⁸ In this chapter, it should read the base metals and their products group under the Combined Nomenclature.

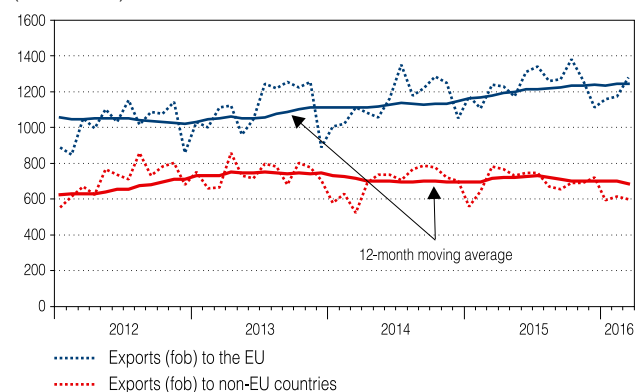
³⁹ In this chapter, it should read mineral products and fuels group under the Combined Nomenclature.

⁴⁰ In this chapter, it should read the animal and plant products, food, drinks and tobacco group under the Combined Nomenclature.

⁴¹ 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 2016.

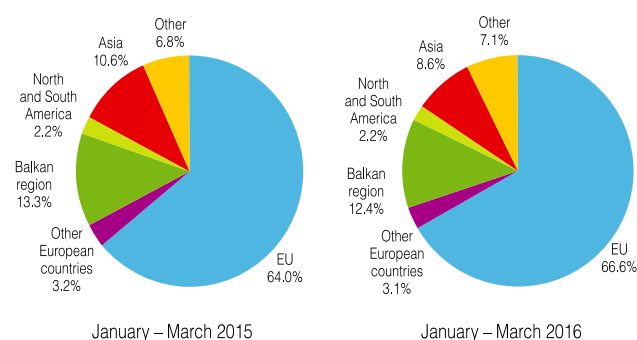
Dynamics of Exports to EU and non-EU Countries

(EUR million)



Source: the BNB.

Exports of Goods: Geographical Breakdown



Source: the BNB.

Exports by Commodity Group, January-March 2016

	EUR million	Change* (EUR million)	Growth** (per cent)	Contribution** (percentage points)
Wood products, paper, ceramics and glass	295.8	8.2	2.9	0.1
Machines, vehicles, appliances, instruments and weapons	1 524.6	196.9	14.8	3.6
Mineral products and fuels	528.7	-160.6	-23.3	-2.9
Base metals and related products	717.6	-266.4	-27.1	-4.8
Animal and vegetable products, foods, drinks and tobacco	819.4	-26.8	-3.2	-0.5
Textiles, leather, clothing, footwear and other consumer goods	823.6	99.4	13.7	1.8
Chemical products, plastics and rubber	706.3	64.2	10.0	1.2
Total exports	5 416.1	-85.1	-1.5	

* Change on the corresponding period of previous year.

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

Source: the BNB.

of 2015.⁴² Both exports to EU Member States and non-EU countries reported a decline on an annual basis. In the third and fourth quarters of the year exported volumes are expected to remain close to those in the first quarter of 2016, and by the close of the year the recovery in oil prices will contribute to the increase in group's nominal exports.

In the first quarter of 2016 exports of base metals went down on an annual basis in both real and nominal terms and was the main negative contributor to total export growth.⁴³ The temporary cut in copper products output due to repairs and expansion of production facilities in one of the sector's key corporations was the main reason behind the decline in real exports of this group.⁴⁴ Another factor behind the fall in nominal exports of this group was the decline of global metal prices on an annual basis which continued in the first quarter of 2016. By the end of 2016 nominal exports of metals is expected to start to increase on an annual basis. This will reflect on the one hand, the anticipated growth in physical volumes following the repairs in the sector and, on the other hand, the projected rise in metal prices on an annual basis at the end of 2016.

Nominal exports of animal and plant products went down on an annual basis in the first quarter of 2016 entirely due to the weaker exports to non-EU Member States. The drop in exports of this group's products reflected the lower prices of exports on the corresponding period of 2015 while real volumes increased.⁴⁵ In the third and fourth quarters of 2016 this groups' nominal exports is expected to increase on an annual basis due to anticipated good harvest⁴⁶ in Bul-

⁴² According to the Balance of Payments of Bulgaria, April 2016, p. 53 and using the quarterly export deflators for the mineral fuels, oils and related products group under SITC in the first quarter of 2016.

⁴³ According to the Balance of Payments of Bulgaria, April 2016, p. 53, and using the quarterly export deflators for the precious metals and other non-ferrous metals group under SITC in the first quarter of 2016.

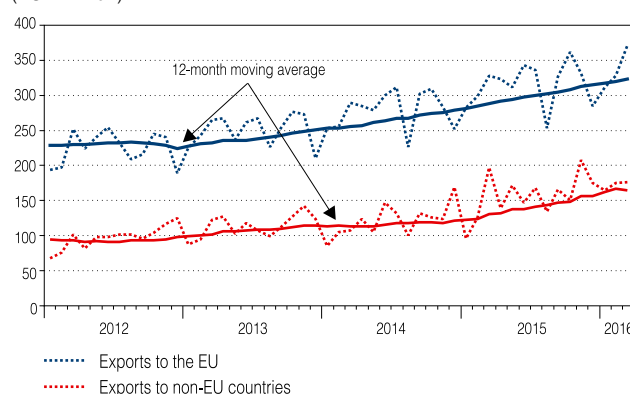
⁴⁴ According to a press release published on 10 May 2016 on the Aurubis website: <http://bulgaria.aurubis.com/bg/novini-i-publikacii/sobshchenija-za-mediite/aurubis-otchita-dobri-rezultati-za-shestmesechieto/>

⁴⁵ The quarterly export deflators for the food and live animals group under SITC were used to estimate the price effect in the first quarter of 2016.

⁴⁶ According to USDA *Wheat Outlook*, May 2016, p. 6.

Exports of Machines, Vehicles, Appliances, Instruments and Weapons

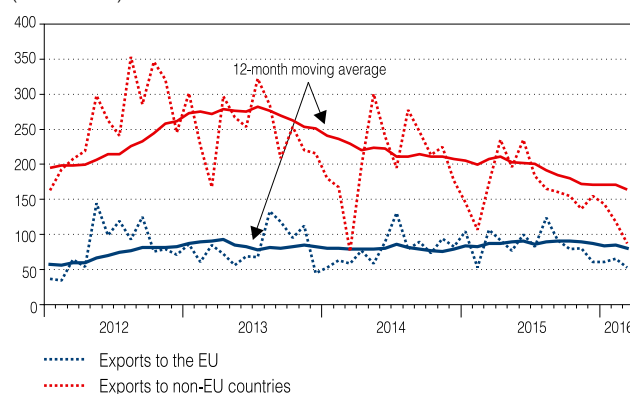
(EUR million)



Source: the BNB.

Exports of Mineral Products and Fuels

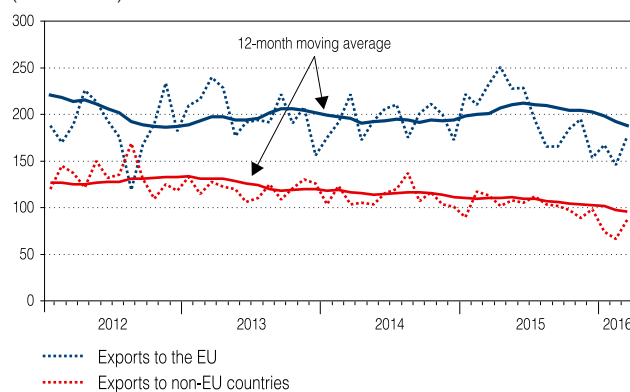
(EUR million)



Source: the BNB.

Exports of Base Metals and Related Products

(EUR million)



Source: the BNB.

garia and projected rises in international food prices.

In the first quarter of 2016 exports of chemical products rose markedly on an annual basis, with exports to EU Member States contributing most substantially to this growth. Pharmaceuticals and plastic products contributed most to this group's export growth over the review period. Larger physical volumes had a positive contribution to the nominal export growth of this group, while prices declined.⁴⁷ In the third and fourth quarters of 2016 exports in the group are expected to continue increasing on an annual basis.

According to balance of payments data, exports of services went down 6.5 per cent between January and April 2016 and all sub-items, except for earnings from tourism, reported a decline on an annual basis. Earnings from tourism went up 8.0 per cent between January and April 2016, with NSI data showing an increase of 8.1 per cent of foreigners travelling for tourism in Bulgaria compared to the corresponding period of 2015. The increase was mainly attributable to the higher number of visits from Macedonia.

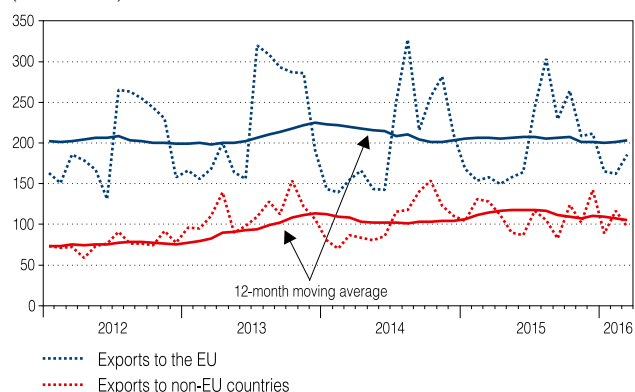
In the January–March 2016 period nominal imports of goods decreased on an annual basis entirely due to the fall in prices. Energy resources, followed by raw materials contributed most to the nominal decline in imports of goods by use.

Imports of goods from EU Member States fell slightly on an annual basis in the first quarter of 2016, with imports from Germany and Romania reporting the most marked decline. A fall in imports from non-EU countries was recorded in both 2015 and the first quarter of 2016 largely due to imports from Russia. Imports from Russia are almost entirely made up of petrol products, and the reported decline was due to the falling international prices thereof. In the first quarter of 2016 the share of imports from EU countries increased on an annual basis, coming to 55.6 per cent.

⁴⁷ 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 2016.

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

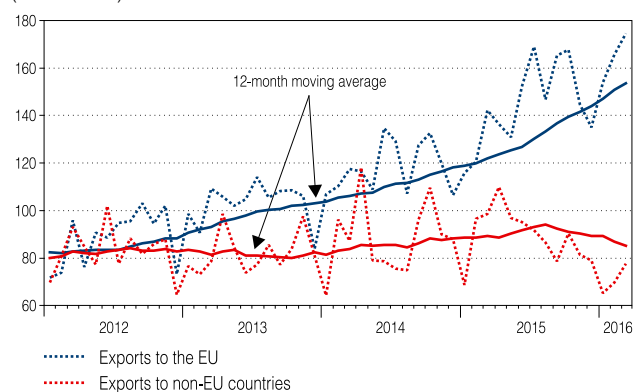
(EUR million)



Source: the BNB.

Exports of Chemical Products, Plastics and Rubber

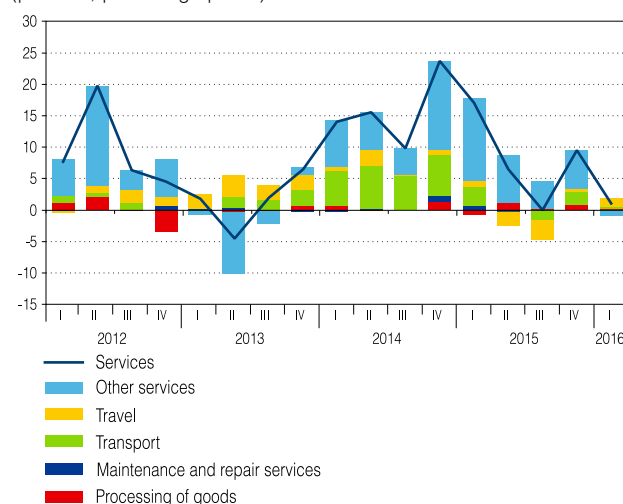
(EUR million)



Source: the BNB.

Annual Change of Exports of Services and Contribution by Sub-components

(per cent, percentage points)



Source: the BNB.

Imports of energy resources reported the most sizeable decrease on an annual basis in the first quarter of 2016 – a trend observed also in 2015. This was due to falling international oil prices⁴⁸, but at the same time imported physical volumes increased. Based on expectations for a gradual recovery in oil prices in dollars and euro, the nominal fall in imports of energy products is expected to be less pronounced in the third and fourth quarters of 2016.

Imports of the raw materials group also declined on an annual basis in the first quarter of 2016 and made a significant contribution to lower total nominal imports. The assessment of price changes shows that the group's lower imports were largely due to falling prices.⁴⁹ Ores imports had the most sizeable negative contribution to the growth in imports of this group over the review period. If the projection for a gradual recovery of international prices of major commodity groups materialises by the end of the year, imports of raw materials are expected to decline at a moderate pace over the projection horizon.

In the first quarter of 2016 consumer goods imports increased on an annual basis, with the clothing and footwear sub-group contributing most to this growth. This group's dynamics was in line with the growing annual private consumption. Imports of consumer goods are projected to continue to increase in the third and fourth quarters of 2016 underpinned by the anticipated rise in private consumption.

Nominal imports of investment goods fell in the first quarter of 2016 on the corresponding quarter of 2015 despite the increase in imports of transportation vehicles and electrical machines. Lower imports of investment goods compared to the first quarter of 2015 was the result of falling prices and rising imported physical volumes.⁵⁰ Given the anticipated weak private investment,

⁴⁸ According to the Balance of Payments of Bulgaria, April 2016, p. 53 and using the quarterly import deflators for the mineral fuels, oils and related products group under SITC in the first quarter of 2016.

⁴⁹ The quarterly import deflators for the groups of food and live animals; inedible (crude) materials (excluding fuels); chemicals and chemical products and manufactured goods classified chiefly by materials under the SITC were used to estimate the price effect in the first quarter of 2016.

⁵⁰ 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 2016.

Imports of Commodity Groups by Use, January–March 2016

	(EUR million)	Change* (EUR million)	Growth** (per cent)	Contribution** (percentage points)
Consumer goods	1 348.4	55.5	4.3	0.9
Raw materials	2 313.9	-124.9	-5.1	-2.0
Investment goods	1 560.2	-26.6	-1.7	-0.4
Energy resources	620.6	-332.0	-34.9	-5.3
Other imports	32.5	2.9	9.7	0.0
Total imports (cif)	5 875.7	-425.1	-6.7	

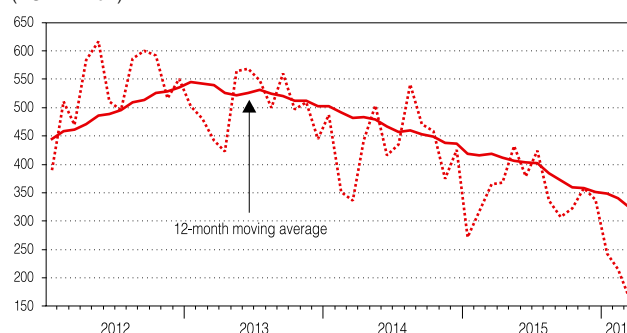
* Change on the corresponding period of previous year.

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

Source: the BNB.

Imports of Energy Resources

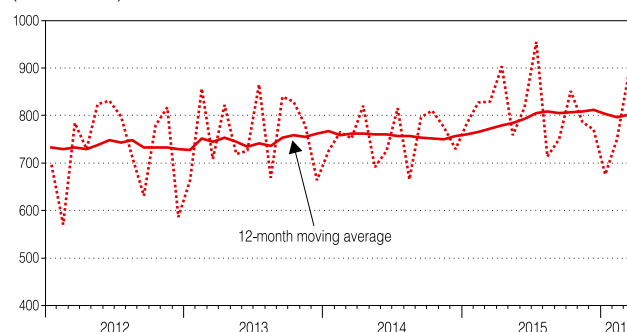
(EUR million)



Source: the BNB.

Imports of Raw Materials

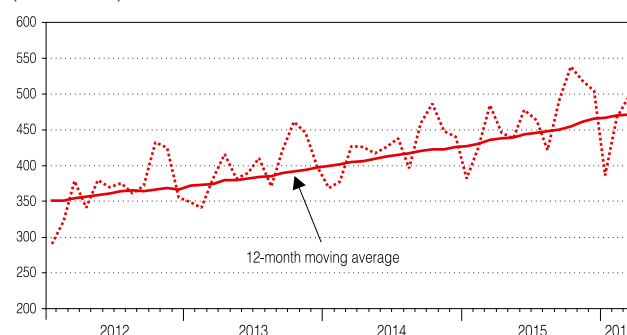
(EUR million)



Source: the BNB.

Imports of Consumer Goods

(EUR million)



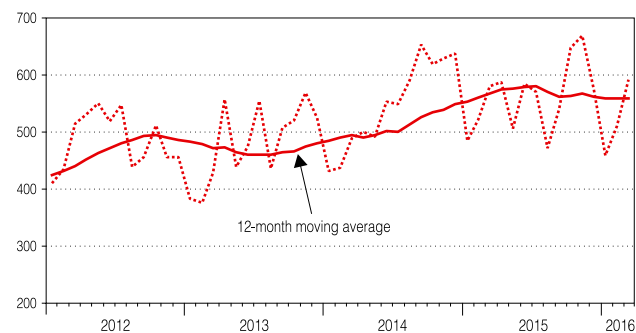
Source: the BNB.

nominal imports of investment goods are projected to remain subdued in the third and fourth quarters of 2016.

According to balance of payments data, imports of services dropped 4.5 per cent on an annual basis for the January–April 2016 period, with transport services reporting the most sizeable decrease. The fall in imports of services was partly limited due to the increase in Bulgarian residents' expenditure on visits abroad. According to NSI data, Bulgarians' visits abroad increased on an annual basis in the January–April 2016 period, with visits to Greece making the most significant contribution to this growth.

Imports of Investment Goods

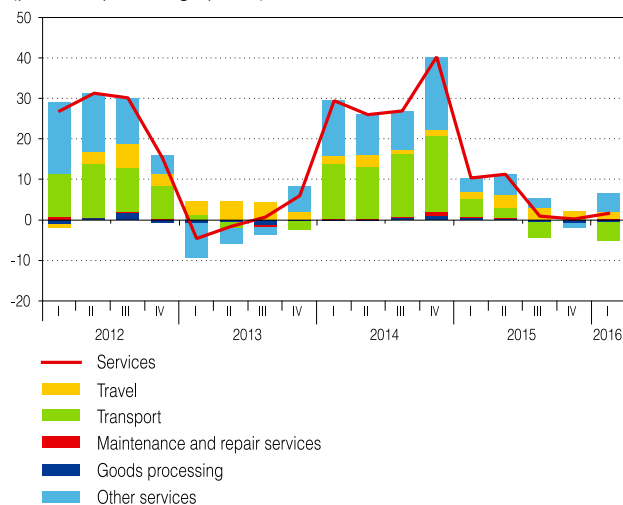
(EUR million)



Source: the BNB.

Annual Change of Imports of Services and Contribution by Sub-components

(per cent, percentage points)



Source: the BNB.

4. Inflation

In the first five months of 2016 inflation in Bulgaria followed a downward trend, reaching -2.5 per cent in May. The accelerated decline in consumer prices reflected mainly the international oil price decrease and its pass-through to domestic prices of fuels, transport and some administrative services affected indirectly by fuel prices. The effect of domestic factors, which entailed mainly declines in unprocessed food prices and acceleration in the long-term downward trend in the prices of telecommunication services and durable goods, strengthened the deflationary trend in consumer prices. The increased labour costs exerted no pressure on consumer prices amid declining expenses of firms on raw materials and an appreciation of the nominal effective exchange rate of the lev. Changes in tax legislation related to higher excise rates of tobacco products and road fees had a slight positive contribution to inflation since the beginning of the year.

In the second half of 2016 inflation is expected to remain negative, though tending to gradually decrease its negative value. This will be mainly driven by the projected slower annual decline in energy product prices in the context of rising global oil prices.

In the first five months of 2016 the fall in consumer prices accelerated and came to -2.5 per cent in May (-0.9 per cent at the end of 2015).⁵¹ Falling inflation since the year-start reflected largely the deflationary effect of international crude oil and raw materials prices. Lower import⁵² and domestic prices of certain agricultural products contributed to the deflation reported in the group of unprocessed food since the beginning of the year. The internal factors linked to the accelerated long-term trend toward cheaper telecommunication services and durable goods, strengthened further the deflationary trend in consumer prices. The increase in firms' labour costs in the first quarter of 2016 did not put upward pressure on consumer prices in the context of firms' lower expenditure on raw materials and appreciation of the nominal effective exchange rate of the lev.

The impact of the international prices of fuel, food and major raw materials on inflation may be seen through the price dynamics of goods imported into Bulgaria. In the first quarter of 2016 the price deflator for imported goods continued to decrease, reaching -9.7 per cent (-3.4 per cent on average in 2015).⁵³ This was

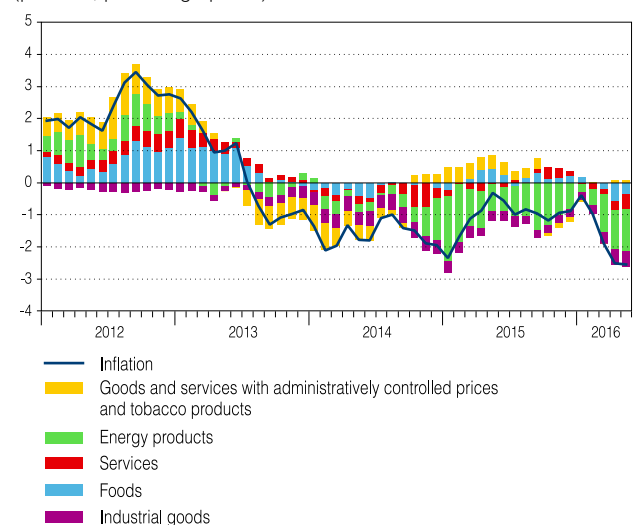
⁵¹ The analysis in this section employs NSI data on HICP.

⁵² Import data under the Standard International Trade Classification (SITC).

⁵³ Import data under the Standard International Trade Classification (SITC).

Annual Inflation and Contribution of Major Commodity and Services Groups to It

(per cent; percentage points)



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

Sources: the NSI, BNB calculations.

very much driven by the sizeable decrease in international oil and food prices in euro at 32.9 and 4.2 per cent on average for the first five months of the year. Lower import prices were rapidly transmitted through the supply chain on domestic producer prices and consumer prices.

The total producer price index (PPI) in the domestic market continued to decrease on an annual basis, reaching -4.1 per cent in April 2016 (-3.2 per cent at the end of 2015). Since the beginning of the year lower producer prices of industrial products have been observed across different economic sub-sectors, but in terms of their use, energy and intermediate consumption products, forming part of firms' production costs, played a significant role for the change in the PPI.

The sub-sector related to the production of electricity, heating and gas⁵⁴ had the largest negative contribution to producer price dynamics, consistent with the continuous price decreases of imported natural gas. On the basis of this, the Energy and Water Regulatory Commission (EWRC) cut the end price of natural gas and heating as of 1 April 2016.⁵⁵ This, in conjunction with the three consecutive cuts in heating prices in April, July and October 2015, accounted for the negative contribution of administratively controlled prices to overall inflation in May 2016.

The manufacturing sub-sector also had a significant negative contribution to the decline in the total producer price index in April 2016. This was largely due to lower industrial product prices related to the manufacture of refined petroleum products, metals and chemical products.⁵⁶ The translation of lower international crude oil prices through the supply chain into end-user transport fuel prices, which recorded a considerable fall of 20.2 per cent in May 2016, was the reason why this group had the largest negative contribution to the change in HICP (-1.32 percentage points).

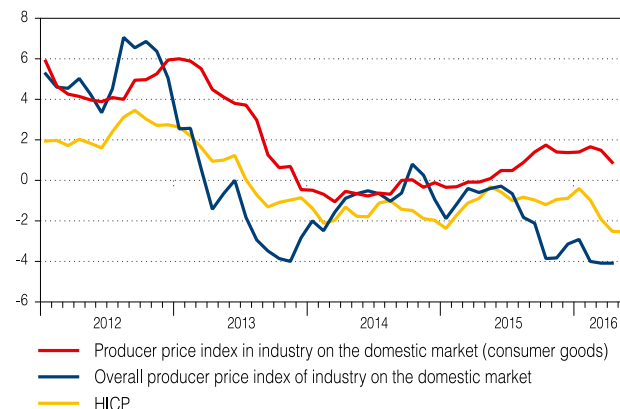
⁵⁴ Production and distribution of electricity, heating and gas.

⁵⁵ For more information, see: <http://www.dker.bg/newsbg.php?n=2729>

⁵⁶ Manufacture of coke and refined petroleum products, manufacture of basic metals and fabricated metal products, except machinery and equipment and manufacture of chemicals and chemical products.

Rate of Change in Manufacturing PPI and HICP

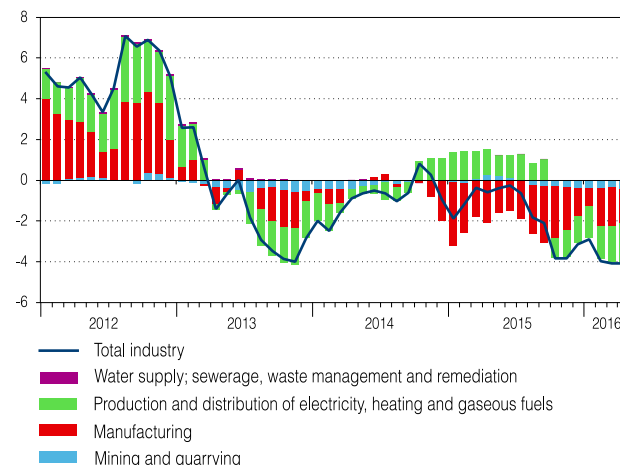
(per cent, on an annual basis)



Source: the NSI.

Rate of Change in the PPI on Domestic Market and Contributions by Major Sub-sectors

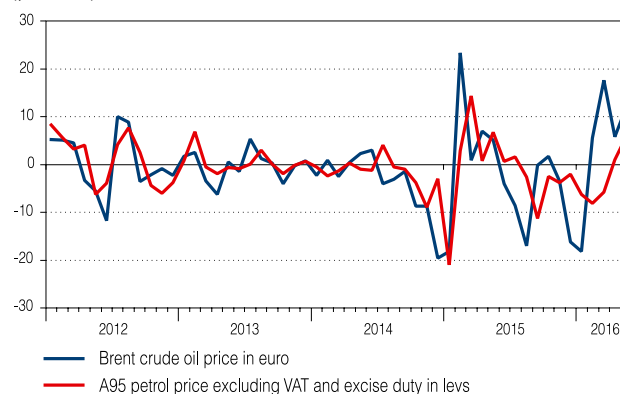
(per cent, on an annual basis)



Source: the NSI.

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

(per cent)



Sources: the ECB, the NSI, BNB calculations.

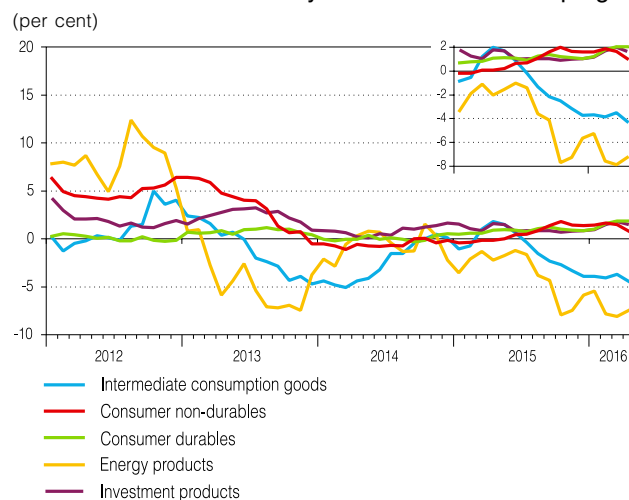
In manufacturing, the trend toward a lower positive contribution to the growth of producer prices observed since mid-2015 and reflecting manufacture of non-durable and durable products remained sustained in the first four months of 2016. The price developments of consumer non-durable goods were influenced mainly by the increase in the prices of tobacco, some food products and clothing. Higher producer prices of tobacco products and higher excise duties on cigarettes introduced in early 2016 predetermined the acceleration of inflation in this group to 2.9 per cent in May 2016. Higher producer prices of food products were also passed on consumer prices of processed food which reported slight annual growth of 0.4 per cent in May 2016.

In the first five months of 2016, consumer prices of unprocessed food tended to decline on an annual basis, and inflation in this group came to -4.3 per cent in May, contributing to the forming of deflation in the group of food. This was due to the fall in prices of vegetables and fruit in line with the decrease in the prices of these Bulgarian agricultural products⁵⁷ observed in the first quarter of 2016. Between January and May 2016, the prices of the meat and meat products group continued to follow the downward trend of the import prices of these products observed over the last three years, and also made a negative contribution to the changes in the harmonised index of consumer prices.

Although producer prices in durable and some non-durable goods such as clothing and footwear increased in the first four months of 2016, this was not sufficient to reverse the deflationary trend in consumer prices of non-food goods. Inflation in this group came to -2.3 per cent in May (-1.4 per cent at the end of 2015), largely due to the enhanced deflation of durable goods and, to a lesser extent, to the fall in non-durable goods' prices. Automobiles, computers and television equipment, furniture and furnishings prices continued to have a relatively high negative contribution to annual inflation in the January to May 2016 period. The accelerating pace of decline in the prices of these goods, most of which imported in Bulgaria, was in line with the appreciation of the nominal effective exchange rate of

⁵⁷ NSI data on price indices of agricultural produce.

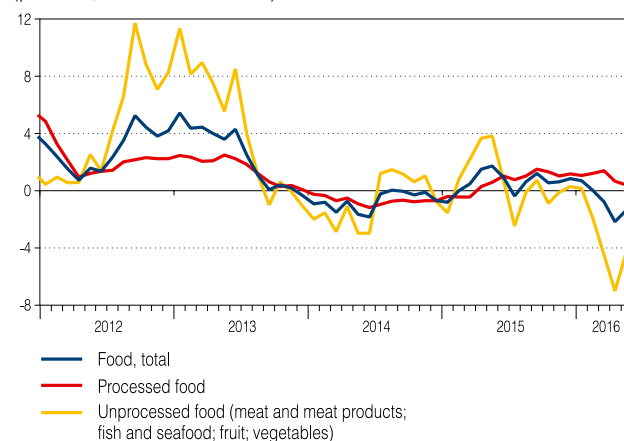
Annual Rate of Change in Producer Prices on the Domestic Market by Main Industrial Groupings



Source: NSI.

Rate of Change of Food Price Index

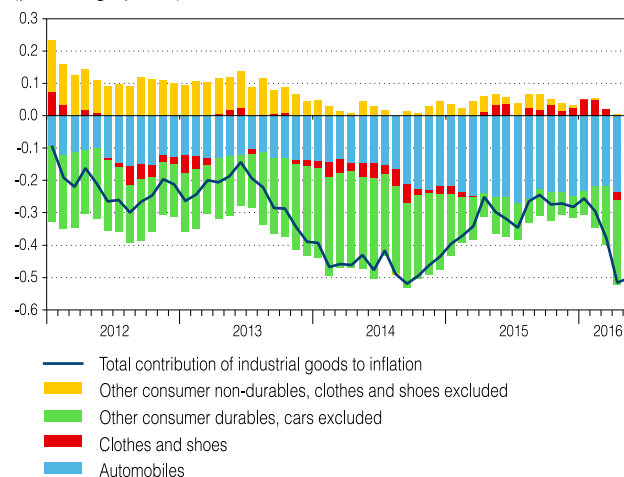
(per cent, on an annual basis)



Sources: the NSI, BNB calculations.

Contribution of Non-food Goods (Excluding Energy Products) and Major Services Sub-groups to Overall Inflation

(percentage points)



Sources: the NSI, BNB calculations.

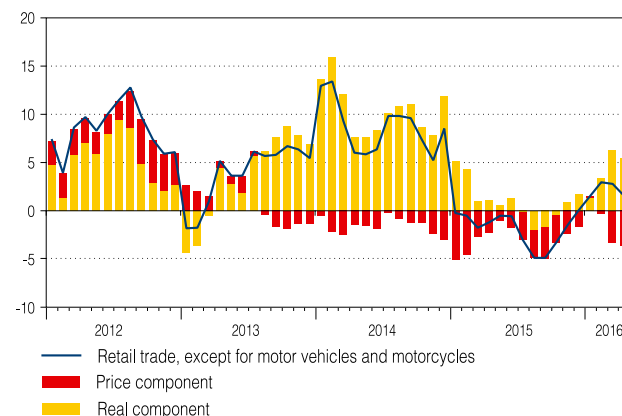
the lev against the currencies of our major trading partners. Monthly NSI data on retail trade turnover signal an increase in consumer demand between January and April 2016 compared to the corresponding period of the prior year, but it remains uneven across commodity groups. The food, drinks and tobacco group had the most sizeable positive contribution since the year start, whereas trade in non-food goods recorded a slight decline on an annual basis.

Core inflation, including services and non-food prices, followed a downward trend in the first five months of 2016, reaching -1.9 per cent in May (-0.4 per cent at the end of 2015). In addition to the downward non-food price dynamics, accelerating deflation in core HICP components reflected the deflationary process in the group of services since early 2016. In May 2016 services inflation (excluding administratively controlled prices) came to -1.7 per cent (0.5 per cent at the close of 2015). Reflecting the lower international oil prices, transport services prices continued to contribute negatively to overall inflation, primarily as a result of lower air transport prices. Other factors with sizeable contributions to the deflation observed in the services group in May 2016 were the accelerated long-term trend toward cheaper telecommunications services amid price competition in this sector, lower auto insurance prices and cheaper accommodation services. Catering prices displayed low positive inflation throughout the first quarter of 2016 in line with reported growth in the prices of processed food.

The changes in tax legislation related to the introduction of higher fees and excise duties on tobacco products since the beginning of the year exerted a weak pro-inflationary pressure. The increase in both road fees of 47.4 per cent on average and tobacco product prices of 2.9 per cent in May contributed by 0.23 percentage points to annual inflation. This effect, however, was partially offset by the negative contribution of administratively controlled prices of heating and gas supply. Medicines were another group in the consumer basket whose prices followed a downward year-on-year trend since the year start.

Annual Growth Rate of Nominal Retail Trade (Excluding Automobile and Motorcycle Trade) and Selected Sub-sectors

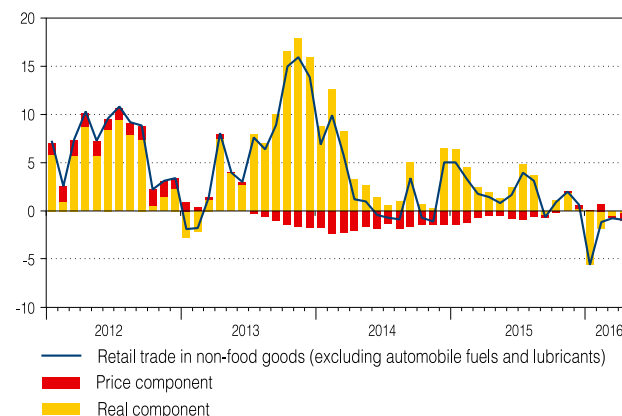
(per cent, on an annual basis, seasonally adjusted data)



Sources: the NSI, BNB calculations.

Annual Growth Rate of Nominal Retail Trade in Non-Food Goods (Excluding Automobile Fuels and Lubricants)

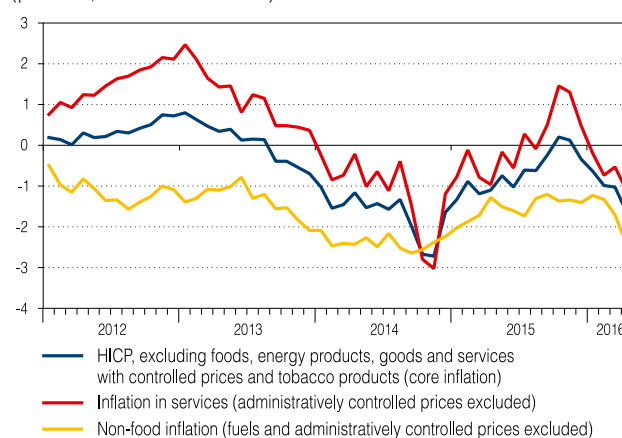
(per cent; working day-adjusted data)



Sources: the NSI, BNB calculations.

Core Inflation

(per cent, on an annual basis)



Sources: the NSI, BNB calculations.

In the first five months of 2016 the diffusion index, showing the share of groups of goods and services with declining prices on an annual basis, followed a gradual upward trend and reached 45.2 per cent in May (against 35.5 per cent at the end of 2015). This was due to the higher number of food and non-food goods sub-groups with declines in prices and was consistent with the reported deflation in those groups in May 2016. The increase in the diffusion index indicates that we can expect retained HICP deflationary dynamics in the following months which will also be underpinned by the early 2016 trend toward a gradual reduction in the number of groups of goods and services in the consumer basket with relatively higher inflation (above 1 per cent).

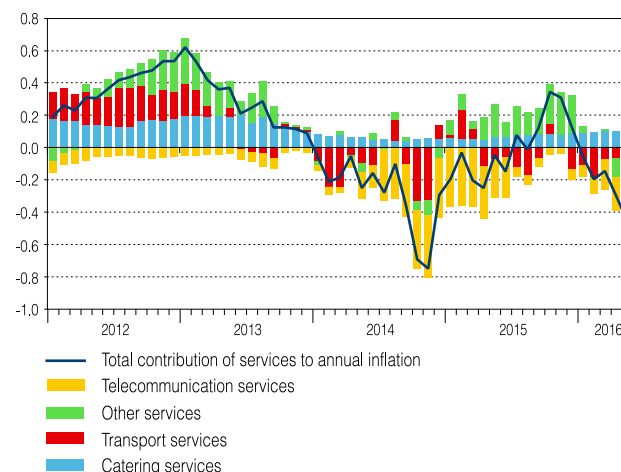
According to the NSI business surveys, in May 2016 most managers in industry, services and retail trade expect that selling prices will remain unchanged in the following three months. The balance of opinions in all three sectors was slightly positive due to the larger share of managers expecting price rises as compared with those expecting price declines. Managers' sentiment gives no ground of expecting an upward pressure on selling prices in the following months, as the uncertain economic environment continues to be the main factor hampering business developments, followed by competition in the sector and insufficient demand in Bulgaria. Retail trade firms that are relatively closer to end users in the supply chain reported slight strengthening of the negative influence of those factors in May.

Firms' labour costs policy impacted consumer price dynamics. According to national accounts data, unit labour costs in the total economy increased by 6.7 per cent in nominal terms on an annual basis over the first quarter of 2016 (-0.7 per cent on average in 2015). Falling fuel and intermediate consumption product prices offset firms' higher labour costs in full.

In the second half of 2016 inflation is expected to remain negative. This will reflect the significant fall in domestic fuel prices in early 2016 and the expected slow recovery thereof over the third and fourth quarters of the year in line with the upward dynamics in international oil prices.

Contribution of Services and Major Services Sub-groups to Overall Inflation

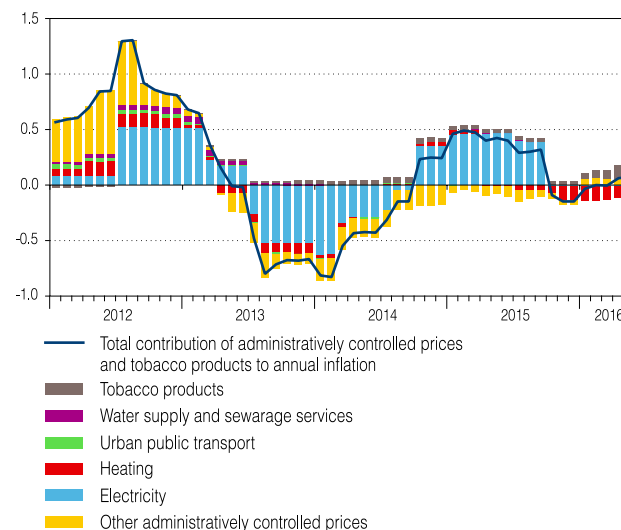
(percentage points)



Sources: the NSI, BNB calculations.

Contribution of Tobacco Products and Major Sub-groups of Administratively Controlled Prices to Overall Inflation

(percentage points)

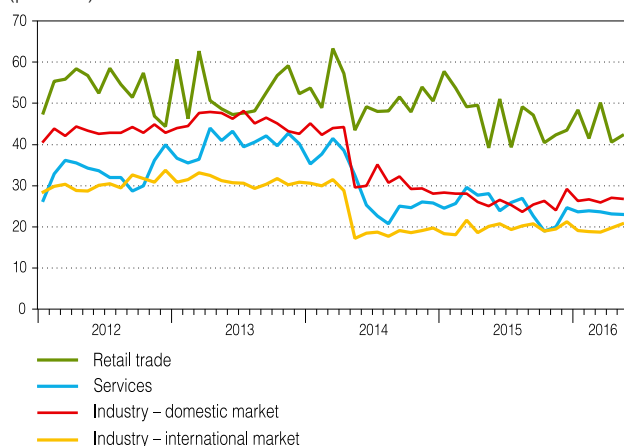


Sources: the NSI, BNB calculations.

International food prices in euro are expected to increase on both quarter-on-quarter and annual basis in the following two quarters, pushing down deflation in the food group. The quality of agricultural harvests in Bulgaria and the region will be another important factor which is likely to affect domestic food prices over the following months. Other risks to the projection relate to possible decreases in the administratively controlled prices of some services as of July 2016, such as natural gas and heating prices, which are indirectly influenced by international oil prices. The anticipated gradual increase in tobacco prices in the following months related to the higher tobacco excise duties introduced since early 2016 and the increase of urban transport tickets in Sofia since June 2016 will continue to push administratively controlled prices up.

In the following months core inflation will continue to have a significant negative contribution to overall inflation. This will reflect the sizeable drop in the prices of some goods and services, such as telecommunication services and durable goods prices observed since the year start, for which we do not expect the deflationary trend to reverse. Higher consumer demand might limit services deflation over the next two quarters.

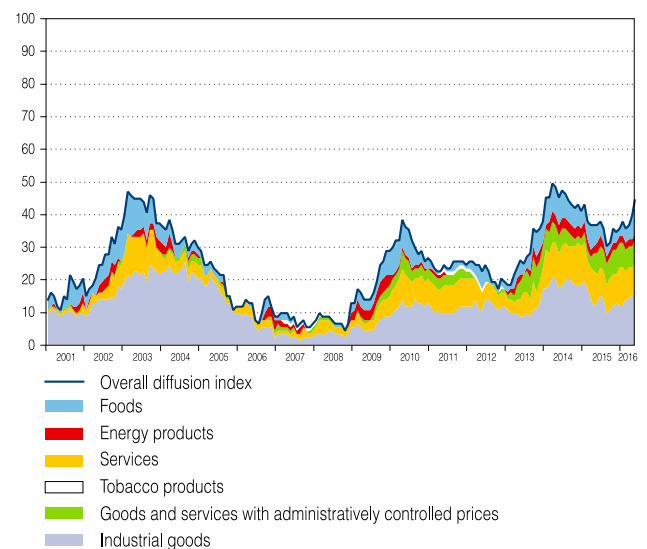
Share of Firms by Economic Sectors Pointing to Insufficient Demand as a Factor Limiting Their Activity
(per cent)



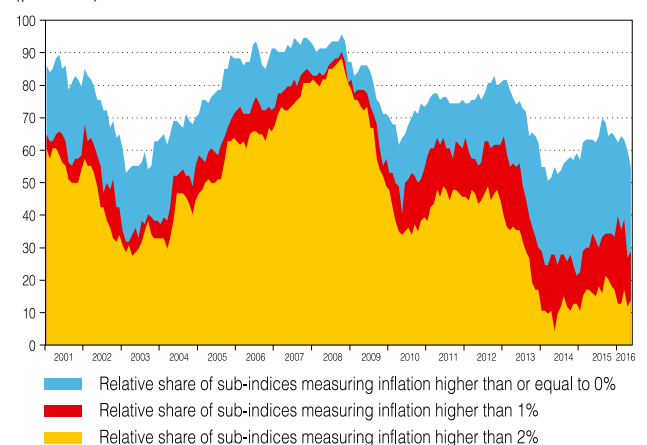
Sources: the NSI, BNB calculations.

Diffusion Index of Major Goods and Services Groups

(a) relative share of declining HICP sub-indices on an annual basis
(per cent)



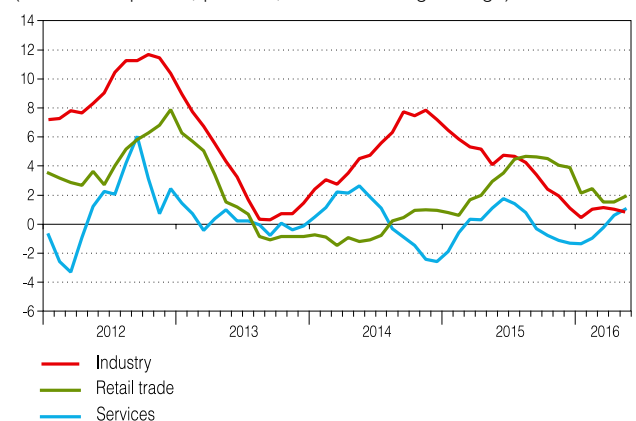
(b) relative share of declining HICP sub-indices on an annual basis
(per cent)



Sources: the NSI, BNB calculations.

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

(balance of opinions, per cent, 6-month moving average)



Source: the NSI.

Rates of Change of Major Goods and Services Groups Prices and Contribution of These Groups to Services

	Accumulated inflation as of May 2015 (May 2014 = 100)		Accumulated inflation as of May 2016 (May 2015 = 100)		Annual Rate of Inflation as of May 2016 (May 2015 = 100)	
Inflation (%)	0.2		-1.5		-2.5	
	Inflation rate by group (%)	Contribution (percentage points)	Inflation rate by group (%)	Contribution (percentage points)	Inflation rate by group (%)	Contribution (percentage points)
Food	2.4	0.62	0.1	0.04	-1.4	-0.36
Processed food	0.4	0.07	-0.3	-0.05	0.4	0.07
Unprocessed food	6.1	0.54	1.2	0.09	-4.3	-0.42
Services	-1.2	-0.31	-3.4	-0.89	-1.7	-0.46
Catering services	0.5	0.03	0.6	0.03	1.6	0.09
Transport services	-7.1	-0.27	-6.8	-0.26	-3.3	-0.13
Telecommunication services	0.1	0.00	-4.4	-0.24	-5.8	-0.30
Other services	-0.7	-0.08	-3.7	-0.43	-1.0	-0.11
Energy products	0.0	0.00	-8.8	-0.51	-18.3	-1.30
Transport fuels	0.1	0.01	-9.6	-0.50	-20.2	-1.20
Industrial goods	-0.3	-0.06	-1.2	-0.28	-2.3	-0.50
Goods and services with administratively controlled prices*	-0.3	-0.05	0.4	0.06	-0.4	-0.06
Tobacco products	0.2	0.01	2.5	0.12	2.9	0.14

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

Sources: the NSI, BNB calculations.

5. Bulgarian National Bank Forecast of Key Macroeconomic Indicators for 2016–2018

The BNB forecast of key macroeconomic indicators is based on the information published as of 17 June 2016. ECB, EC and IMF assumptions on the global economic developments as of 8 June 2016 were used. Results of the UK's EU membership referendum in favour of Brexit increases the overall uncertainty in the external and internal environment, creating additional risks that have not been quantitatively accounted for in the macroeconomic projection. The analysis of risks to the projection, however, includes a qualitative assessment of their impact on the Bulgarian economy.

Global economic growth is expected to accelerate in 2016 from 2015, given the recovery in economic activity in a number of developing countries and the continued gradual increase in US and euro area growth. Based on latest ECB and IMF forecasts of global economic developments, external demand for Bulgarian goods and services between 2016 and 2018 is expected to be in line with the projected acceleration in the economic activity of Bulgaria's major trading partners. Despite the first signs of rebalancing in world demand for and supply of commodities, their average prices in 2016 are expected to remain lower than in 2015 due to the high level of inventories and output worldwide. International commodity prices are likely to begin rising from 2017.

Domestic GDP growth in 2016 and 2017 is expected to moderate from the growth rate in 2015. Government investment will have the largest contribution to this moderation over the two years, whereas growth acceleration is expected in the remaining components of domestic demand. With increased government investment in 2018, growth is projected to reach 3.1 per cent. Risks to the economic activity projection in the baseline scenario are assessed as balanced for 2016, unlike 2017–2018 when some risks of lower than expected growth may arise.

Reflecting global price developments, domestic inflation will remain negative in 2016. Specific factors, as price decreases in some services and further declines in durable goods prices, will also act in the same direction. If global price rise assumptions materialise, inflation in 2017–2018 is projected to be positive and begin to increase slowly. There are risks for inflation to be lower than projected if our expectations of international price dynamics do not materialise or administrative cuts occur in some services prices, reflecting indirectly fuel prices.

Forecast

Given the signals of a slowdown in global economic activity in early 2016, previous forecasts of global economic growth in a number of international institutions, such as the ECB, the IMF and the EC, were revised downwards for 2016 and 2017. Despite the revisions, global economic growth is expected to accelerate compared with 2015 in line with the recovery of economic activity in a number of developing countries and the ongoing gradual acceleration of growth in the USA and the euro area. Based on latest ECB and IMF forecasts of global economic developments, external demand for Bulgarian goods and services between 2016 and 2018 is expected to be in line with the projected acceleration in the economic activity of Bulgaria's major trading partners.

In the second quarter of 2016 the first signs of demand and supply rebalancing occurred in international commodity markets. Over this period prices (in US dollars) of petroleum and non-energy commodities started to increase on a quarterly basis. However, they remained below the levels of the corresponding period of 2015. The main factors contributing to the quarterly price hike were related to temporary declines in supply (mostly in petroleum and food) and depreciation of the US dollar *vis-à-vis* the euro. Until end-2016, prices are expected to significantly decrease their rate of quarterly growth and,

amid high levels of global inventories and output, to remain below the 2015 level. More notable rebalancing of demand and supply in commodity markets, which may lead to a rise in energy and non-energy product prices on an average annual basis may be expected in 2017.

In 2016 and 2017 Bulgaria's GDP growth is expected to be lower than that in 2015. Economic activity dynamics is anticipated to be driven mainly by the components of domestic demand. Growth of final consumption components is expected to accelerate over the whole forecast horizon. Private consumption will become the major factor behind the increase in economic activity and will accelerate its growth as a result of higher real disposable income against the background of improved labour market situation and household sentiment. Concurrently, the high production capacity utilisation, increased demand for goods and services and improved business environment support the assumption for a reversal of the downward trend in private investment in 2016, and for an increase over the forecast horizon. These positive effects of accelerated final consumption and private investment are expected to be limited by lower government investment than in 2015, which have been revised for the projection horizon in line with Bulgaria's Convergence Programme for the 2016–2019 period published in April 2016. The expected private investment growth in 2016 and 2017 will be insufficient to compensate for the lower volume of government investment and will therefore lead to a decline in gross fixed capital formation in real terms over this period. In 2018 this effect will fade away, and total investment will increase due to both continuing growth in private investment and increased government investment.

In the 2016–2018 period the positive contribution of net exports to GDP growth will gradually contract compared with its relatively high level in 2015. Real export growth in 2016 is anticipated to slow down compared with the previous year before it starts to accelerate consistent with the assumption for the dynamics of external demand for Bulgarian goods and services. Growth in imports of goods and services will also slow down in 2016, reflecting the contraction in government investment, and it will be lower than growth in exports. Subsequently, the growth rate of real imports will accelerate over the projection horizon along with gradually accelerating domestic demand and exports.

Given the above assumptions, real GDP growth is expected to moderate to 2.2 per cent in 2016 and to accelerate again to 2.5 per cent in 2017 and 3.1 per cent in 2018.

If the forecast of international price dynamics materialises, the terms of trade (measuring the change in export prices against import prices) are expected to remain favourable for Bulgaria through most of the forecast period, which along with the anticipated faster growth of real exports compared with imports will lead to lower balance of payments trade deficit between 2016 and 2018. In 2016 services trade balance is expected to decrease as a percentage of GDP compared with its 2015 level, due to a stronger increase in services imports against exports, and to stabilise in 2017 and 2018. Lower growth of services exports in 2016 reflects to a large extent the weaker increase in earnings from tourism due to still subdued economic activity in countries important for Bulgaria's tourism. Concurrently, services imports are expected to gradually increase driven by the improving economic activity, employment and incomes in Bulgaria. The improvement of the economic activity in Bulgaria is expected to boost companies' profits which will lead to a gradual increase in payments of dividends and distributed profit to non-residents, and correspondingly to a rise in the deficit of the BOP primary income account at the end of the forecast horizon. Between 2016 and 2018 net transfers are expected to decline as a percentage of GDP compared with the 2015 level, reflecting still low inflows of EU funds for the 2014–2020 programming period. As a result of these developments, in the 2016–2018 period the current account balance will remain positive, and by the end of the projection horizon will gradually contract as a percentage of GDP.

Employment will continue to increase in 2016 at a rate close to that in 2015. Despite positive labour market developments in the first quarter of 2016, companies will remain cautious in opening new jobs, while optimising their labour costs. In 2017 and 2018 employment growth is expected to slightly accel-

erate. In 2016–2018 the unemployment rate is expected to decline further. Given the expected slow employment growth, labour productivity will largely follow the real GDP dynamics. The growth of compensation *per* employee is expected to gradually approach labour productivity growth. As a result, unit labour costs will grow by over 2 per cent over the forecast horizon.

The significant drop in global oil and commodity prices in early 2016 will be a factor for retaining the negative rate of change in the consumer price index, with annual inflation expected to reach -0.8 per cent at the end of 2016. This trend will be further influenced by indirect effects of lower fuel prices on transportation and administratively controlled services prices along with specific factors relating to lower prices of some services, as telecommunications, and continuing declines in durable goods prices. In line with international price dynamics, inflation in Bulgaria is expected to be positive over 2017, further accelerating slowly until the end of 2018. Goods and services with administratively controlled prices will have a positive contribution to inflation, reflecting more expensive road fees since early 2016, higher tobacco excise duties in 2016–2018 and increased transport tickets in Sofia since June 2016. Core inflation is anticipated to reverse its deflationary trend in the second half of 2017, driven by higher consumer expenditure of households in the context of ongoing labour market improvements and increased real disposable income. Catering and transportation services inflation reflecting indirectly domestic food and fuel prices will follow the expected upward tendency in these groups' prices.

Over the projection horizon, funds attracted from the non-government sector will continue to rise, remaining a driver for high liquidity in the banking system despite the expectations of retaining a downward trend in deposit interest rates throughout 2016 and their relative stabilisation in 2017–2018 at the attained low levels. Loans to non-financial corporations and households are likely to gradually increase in line with continuous positive developments in regular loans over the recent months. Another factor for credit growth will be the recovery in private consumption and private investment, with further declines in lending interest rates also likely to exert a positive effect.

Forecast Revisions

Compared to the forecast published in Economic Review, issue 4 of 2015, real GDP growth has been revised upwards for 2016 and downwards for 2017. Forecast revisions are largely due to changes in model-external assumptions.

By final use component, more significant revisions relate to the gross fixed capital formation, particularly government investment, which is revised for the whole projection horizon in line with Bulgaria's Convergence Programme for the 2016–2019 period published in April 2016. Compared to the previous forecast, a higher volume of government investment is projected for 2016 and a lower volume for 2017. The downward revision in external demand assumptions entails lower growth of goods and services exports for 2016 and 2017 *vis-à-vis* the previous forecast. This dynamics suggests also a lower increase in goods and services imports.

Our expectations of inflation in 2016–2017 have been revised downwards. The projected lower inflation for 2016 reflects stronger than expected energy price declines in the first five months of the year and the assumption that domestic fuel prices will begin to follow the gradual upward trend in global oil prices since the second half of 2016. In April–May 2016 enhanced deflation in core HICP components, arising from a decrease in some services prices, as telecommunications, which are expected to continue containing consumer price rises, results in a downward revision in core inflation over the current and following year.¹ June 2016 forecast includes lower administrative prices of heating and natural gas since 1 April 2016 and slower than anticipated increase in tobacco product prices.

¹ For more information on core inflation dynamics, see Section 4, Inflation.

GDP and Inflation Forecast Revisions (23 June 2016 *vis-à-vis* 15 December 2015)

(annual rate of change)

	Forecast as of 23 June 2016		Forecast as of 15 December 2015		Revision (percentage points)	
	2016	2017	2016	2017	2016	2017
GDP at constant prices	2.2	2.5	2.1	2.8	0.1	-0.3
Private consumption	2.5	2.6	2.3	2.4	0.2	0.2
Government consumption	1.3	2.0	1.4	2.1	-0.1	-0.1
Gross fixed capital formation	-1.2	-0.2	-2.2	3.1	1.0	-3.3
Exports (goods and services)	3.0	4.1	3.7	4.3	-0.7	-0.2
Imports (goods and services)	2.1	3.3	2.3	4.0	-0.2	-0.7
HICP at end of period	-0.8	1.2	1.0	1.6	-1.8	-0.4
Core Inflation	-1.8	0.4	0.2	1.0	-2.0	-0.6
Energy	-3.9	8.7	5.1	7.7	-9.0	1.0
Food	-0.2	1.3	0.5	0.9	-0.7	0.4
Goods and services with administratively controlled prices and tobacco products	1.6	1.0	1.8	1.3	-0.2	-0.3

Source: BNB.

Risks to the Outlook

Risks to the economic growth outlook are balanced for 2016 and shifted downwards for 2017–2018. As regards the world economy, risks for the whole projection horizon are related to slower developments compared to the baseline scenario. Balanced risks to government investments are anticipated. Within a short-term horizon, positive current developments in economic indicators in 2016 are likely to materialise into more dynamic increases of private components of domestic demand *vis-à-vis* the baseline scenario. In the 2017 to 2018 period the enhanced uncertainty of the external environment is expected to exert a limiting effect on investment decisions of firms and consumer sentiment of households.

Lower than expected economic growth would be mainly driven by possible unfavourable developments in the external environment, increased geopolitical tensions, heightened uncertainty around discussions and pending negotiations over Brexit, worsened investment conditions in the private sector and lower than anticipated volumes of government investments. Higher growth may be achieved if domestic demand grows at a higher than projected pace, reflecting both the stronger increase in private consumption and private investment, and a possible lower decline in public investment over 2016 and 2017. In case of international environment improvements, lower geopolitical tensions, or higher growth in the euro area and developing countries compared to the assumptions, higher than expected economic growth may be reached.

The uncertainty over the outlook for a particular indicator may be graphically illustrated by means of the so-called fan chart.² Chart bands, depicted in a particular colour, set an interval in which with a certain probability the projected value is expected to fall (for further details, see the note to the fan chart on GDP growth). Each interval widens by an increase in a projected horizon, reflecting an increasing uncertainty regarding a more distant future. The fan chart on the annual GDP growth shows that real GDP growth is less likely to exceed 4 per cent in 2016. The chart shows higher than 50 per cent probability for annual GDP growth to range from 1 to 3 per cent that year.

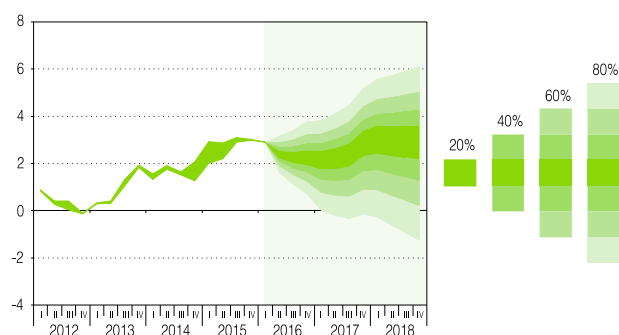
² The use of fan charts is discussed in details in the box entitled *Measurement and Presentation of Uncertainty in Forecasting Economic Indicators*, Economic Review, 1/2012.

Risks to the inflation forecast are shifted to lower inflation compared with the baseline scenario. Major risks stem from global crude oil and food price developments and the degree of their pass-through into domestic fuel and food prices. Uncertainty about the inflation forecast stems also from possible changes in some administrative prices (heating and gas supply), reflecting also indirect effects of lower oil prices. The balance of risks regarding inflation is graphically shown in the fan chart.

The external environment, and notably the economic activity in Bulgaria's major trading partners, remains the major source of uncertainty to the balance of payments projection. If external demand for Bulgarian goods and services is lower than projected, a higher trade balance deficit and lower services surplus may be expected, leading to a lower current account surplus.

Risks to the monetary sector outlook relate to a slower than anticipated recovery of private consumption and investment and continuing optimisation of bank portfolios. A possible materialisation of the above discussed risks would delay the recovery of credit to the non-government sector.

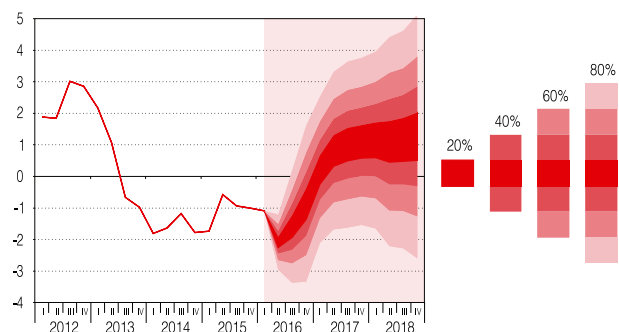
Fan Chart of the Expected Annual Rate of Change in Real GDP



Note: The fan chart shows the expert views of the forecasters on the uncertainty surrounding the projected value based on a probability distribution. The reporting period shows revisions of 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.

Fan Chart of the Expected Annual Rate of Change in Inflation at the End of the Period



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

Source: BNB.

Forecast of Key Macroeconomic Indicators for 2016–2018

(per cent)

	2014	2015	2016	2017	2018
<i>Annual rate of change</i>					
GDP at constant prices	1.5	3.0	2.2	2.5	3.1
Private consumption	2.7	0.8	2.5	2.6	2.7
Government consumption	0.1	0.3	1.3	2.0	2.3
Gross fixed capital formation	3.4	2.5	-1.2	-0.2	4.0
Exports (goods and services)	-0.1	7.6	3.0	4.1	4.6
Imports (goods and services)	1.5	4.4	2.1	3.3	4.4
HICP at end of period	-2.0	-0.9	-0.8	1.2	1.4
Core Inflation	-1.6	-0.3	-1.8	0.4	1.4
Energy	-13.9	-10.5	-3.9	8.7	4.5
Food	-0.7	0.9	-0.2	1.3	1.0
Goods and services with administratively controlled prices and tobacco products	1.2	-0.7	1.6	1.0	0.9
Employment	0.4	0.4	0.4	0.5	0.5
Unit labour costs	4.4	-0.7	2.3	2.4	2.3
Labour productivity	1.2	2.6	1.7	2.0	2.6
Unemployment rate (share of labour force)	11.4	9.1	8.0	7.7	7.4
Claims on non-government sector	-7.7	-1.6	0.2	1.6	2.9
Claims on corporations	-12.0	-1.6	-0.3	1.7	3.1
Claims on households	-1.6	-1.3	0.5	1.6	2.8
Deposits of non-government sector	1.5	10.6	5.7	5.6	5.7
<i>Per cent of GDP</i>					
Balance of payments current account	0.9	1.4	1.9	2.4	2.2
Trade balance	-6.5	-4.3	-2.9	-2.4	-2.0
Services, net	5.9	6.1	5.7	5.6	5.6
Primary income, net	-2.3	-4.1	-3.9	-4.1	-4.6
Secondary income, net	3.8	3.7	3.0	3.3	3.2
<i>Annual rate of change</i>					
External assumptions					
External demand	3.3	1.3	2.4	3.8	4.1
Average annual Brent oil price (in USD)	-9.1	-47.1	-16.2	19.0	8.1
Average annual price of non-energy products (in USD)	-8.7	-19.9	-4.1	3.3	4.5
Brent oil price at end of period (in USD)	-30.5	-42.9	11.7	13.4	3.5
Prices of non-energy products at end of period (in USD)	-13.3	-20.3	7.4	2.3	5.2

Source: BNB.

