Economic Review

1/2009

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

The *Economic Review, issue 1/2009* was presented to the BNB Governing Council at its 23 April 2009 meeting. It employs statistical data published up to 23 April 2009.

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

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

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Highlights

Abbreviations

BIR	Base interest rate
BOP	balance of payments
BTC	Bulgarian Telecommunications Company
b.p.	basis points
CEFTA	Central European Free Trade Association
CIF	Cost, insurance, freight
CIS	Commonwealth of Independent States
CZK	Czeck koruna
EA	Employment Agency
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
EONIA	Euro OverNight Index Average
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	foreign direct investment
FOB	Free on board
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
mt	metric tons
NPISHs	Non-profit institutions serving households
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PLN	Polish zloty
PMI	Purchasing Managers' Index
p.p.	percentage points
PPP	Purchasing Power Parity
CIS	Commonwealth of Independent States
RON	Romanian new leu
WTI	West Texas Intermediate

Summary

The global economic crisis continued to deepen and expand over the first quarter of 2009. Most economies reported declines in output and foreign trade. Consumer and investment demand in major industrial economies continued to decrease, albeit at lower rates. The downward trend in global economic activity indicators was reversed and in the beginning of 2009 they stabilised at the attained low levels. Declines in major commodity and crude oil prices were also reversed in early 2009. These indicators may be seen as a sign of a potential start of recovery in world economic growth at the end of the current and in the beginning of the next year. Following the decisive actions taken by governments and central banks of leading economies in support of financial institutions, as well as the decisions of the G-20 summit (see the *Major Decisions Taken at the G-20 Summit held on 2 April 2009* box), financial markets have shown signs of partial stabilisation.

The global economic crisis has increasingly affected the economy of Bulgaria (see the *Effects of the Global Economic Crisis on the Bulgarian Economy* box). In the last quarter of 2008 real GDP growth moderated to 3.5 per cent, industry posted negative growth at the end of 2008 and in early 2009, industrial export sales declined significantly.

In the first two months of 2009 the balance of payments current account deficit began to rapidly fall and this change was due to significantly contracted trade deficit reflecting faster slowdown in imports than in exports. According to preliminary balance of payments data for the first two months of 2009, foreign direct investment covered 89.4 per cent of the overall deficit on the current and capital account, which shrank to EUR 484.5 million (compared to EUR 1452.4 million deficit in the same period of 2008).

Nominal exports continued to slow down due to the sharp contraction in external demand and to the fall in international commodity and fuel prices occupying a considerable share in its structure. In the context of the world trade and demand declines in the countries which are Bulgaria's major partners, the market share of Bulgarian goods in total imports of Community Member States continued to rise and reached 0.59 per cent in the fourth quarter of 2008 (on an annual basis) against 0.57 per cent a year earlier.

As a result of weaker external demand, Bulgarian companies have to undertake measures for counteracting the negative impact of lower sales on their financial performance through limiting expenditure. Lower major commodity and fuel prices, labour cost flexibility and government measures against unemployment or reduced working hours help to cushion the unfavourable effect of lower demand on the financial performance of enterprises. The slow reaction of government regulators in adjusting downward some administrative prices has the opposite effect.

Households react to the high uncertainty about their future income, the possible unemployment increase and higher deposit and lending interest rates by reducing their consumption and increasing the savings rate. Over the fourth quarter their consumption growth rate fell to 1.5 per cent although household incomes rose by 3.5 per cent in real terms, including real money income which went up 8.7 per cent.

The above observations on economic agents' behaviour in Bulgaria support our expectations that the economy can flexibly respond to the worsening international environment. The government and the central bank also undertook actions at the end of 2008 and in the beginning of 2009 which were intended to cushion the negative effects of the global economic crisis. Amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks adopted by the BNB aim to facilitate banks operating in Bulgaria in managing their liquidity. In November 2008 the BNB took a decision to reduce the minimum required reserve rate, as follows: as of 1 December this rate was reduced from 12 to 10 per cent on all attracted funds and as of 1 January 2009 the rate was further reduced to

5 per cent on funds attracted from non-residents and 0 per cent on funds attracted from the central and local governments. Following these decisions, significant funds were released, with the total effect of the amendments reaching around BGN 3 billion (see *Economic Review*, 2008, issue 4). The amendments aim at facilitating banks in managing their liquidity, given the lack of efficiency in world financial markets functioning.

As a result of the measures undertaken by the BNB and the government, bank and government deposits with the BNB dropped at the end of 2008 and in the beginning of 2009. Consequently, international foreign exchange reserves also fell in line with the currency board principles (see *The Principles of Operation of the Currency Board in Bulgaria* box). On the other hand, the above measures boosted liquidity in the economy which allowed economic agents (bank and non-bank institutions) to reduce their foreign obligations or to increase their foreign assets. In the balance of payments data, these transactions are reported as a financial account deficit of EUR 409.7 million for the January to February 2009 period (a deficit of EUR 647.0 million in January and a surplus of EUR 237.3 million in February). The balance of payments total balance recorded a deficit of EUR 886.2 million in the first two months of 2009 in parallel with BNB international reserves (valuation adjustments excluded). The international reserves reached EUR 11.8 billion at the end of March 2009. The average monthly coverage of imported goods and services by BNB international reserves rose to 8.2 months by February 2009 against 5.5 months a year earlier.

The downward trend in the annual credit growth rate was sustained due to the external environment uncertainty, the tightening of credit standards and the slump in demand. The release of bank liquidity does not automatically lead to higher lending levels: on the one hand, lending depends on demand for borrowed funds by households and firms and on banks' risk assessment of these loans, on the other hand. The fall in the cost of financing in the interbank money market in Bulgaria and the euro area is a factor which may have a stabilising effect on interest rates on loans extended by banks in Bulgaria. The dynamics of the interest rates level on time deposits will depend on banks' needs of attracted resources to finance their lending and on international financial markets developments.

In the second and third quarters of 2009 further deepening of the global economic crisis will depress external demand for Bulgarian goods. Worsened international situation and lower domestic demand will affect negatively the investment plans of enterprises. Weaker activity in construction will also contribute to the slowdown of investments in 2009. The expected lower income growth and decreased employment along with household cautiousness will limit domestic consumption. Net exports will contribute positively to GDP dynamics. Production capacity utilization will moderate and the expected economic growth rate will be significantly lower than the potential as a result of weaker external and domestic demand.

The downward trend in economic growth in 2009 leads to expectations of lower growth rates in budget revenue compared to expenditure. Government consumption contribution to GDP growth is anticipated to be close to zero, while the budget balance is expected to decrease as a share of GDP on an annual basis but to remain positive over the projected horizon.

The downward trend in inflation is expected to be sustained in the second and third quarters as a result of the slowdown in domestic demand growth and the ongoing impact of the lower prices of raw materials and fuels compared with 2008. The anticipated decrease in some administratively controlled prices will also contribute to the fall in inflation.

1. External Environment

Following the decisive actions taken by governments and central banks of leading economies in support of financial institutions, during the first quarter of the current year financial markets showed signs of partial stabilisation.

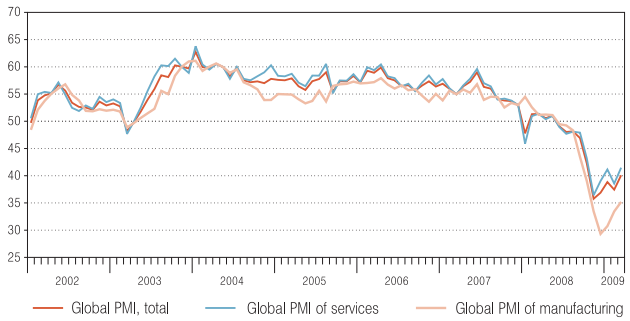
Consumer and investment demand in major industrial economies continued to decrease, although at slightly lower rates. Raw material prices retained their low levels, while inflation in industrialised countries started to decline fast. After lowering dramatically their reference interest rates, the Federal Reserve and the central banks of the United Kingdom, Japan and Switzerland undertook non-standard liquidity-providing measures through new programmes launched specially for the purpose. The ECB cut the reference interest rate to 1.25 per cent and the deposit interest rate to 0.25 per cent and is considering a further reduction in the interest rate and adoption of non-standard monetary measures with the aim of stepping up the transmission of the monetary policy.

The global economic crisis continued to intensify during the first quarter of 2009 despite the partial stabilisation of financial markets. Most leading economies reported declines in output and foreign trade. January data show a record downturn of 17 per cent of world trade on an annual basis. Banks went on tightening the lending conditions, thus impeding economies' normal functioning.

Global economic activity indicators reported a slight improvement during the first three months of the year following the dramatic drop in expectations at the close of 2008. This can be a positive sign of a turnaround in the quick economic activity decline and arouses hopes for a recovery in world growth by the end of the present year and the beginning of the next one.

Major commodity markets stabilised during the first quarter, while inflation in industrialised countries was significantly under the target of most central banks.

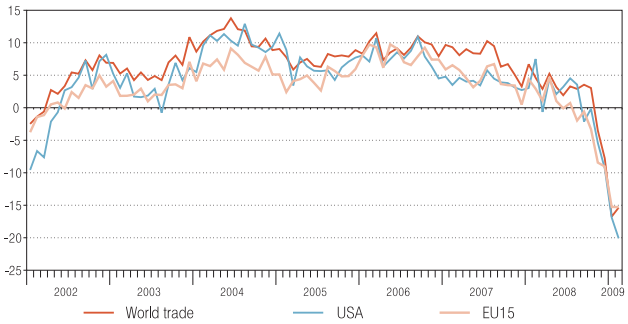
Global PMI



Sources: NTC Research, JP Morgan.

World Trade

(annual rate of volume growth, %)



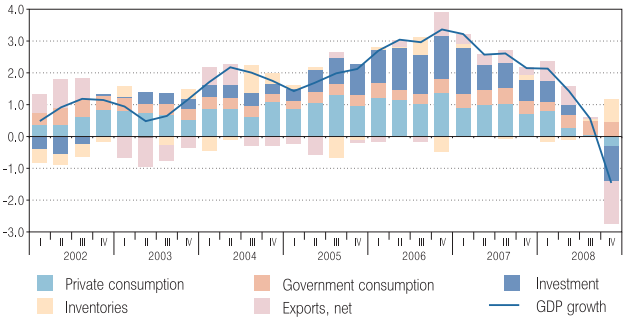
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Euro Area

During the last quarter of 2008 GDP reported a 1.6 per cent drop on the previous quarter (1.5 per cent on an annual basis). Economic activity slowdown is associated with the decline in business sector investment activity, the weaker external demand, and the decrease in consumer demand.

Contribution to Euro Area Growth by GDP Component (Quarterly)

(%)



Source: Eurostat.

Major Decisions Taken at the G-20 Summit Held on 2 April 2009

Following the last summit held on 2 April 2009, the G-20 leaders stated that all necessary measures will be initiated to:

- restore confidence, growth, and jobs;
- repair the financial system to restore lending;
- strengthen financial regulation to rebuild trust;
- fund and reform international financial institutions to overcome this crisis and prevent future ones;
- promote global trade and investment and reject protectionism, to underpin prosperity.

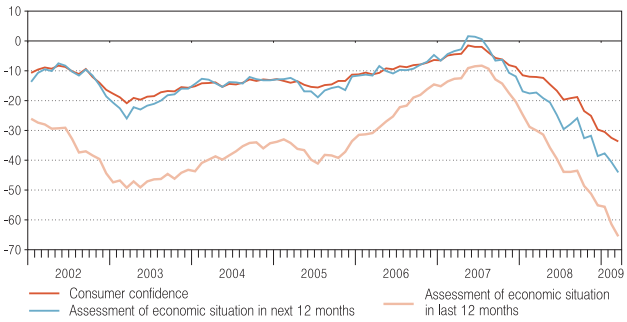
Major actions involve:

- Increasing IMF funding capacity;
- establishing a Financial Stability Board (FSB) as a successor to the Financial Stability Forum (FSF) to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- extending oversight to systemically important financial institutions, markets and instruments;
- taking action against low-tax jurisdictions and for regulation of Credit Rating Agencies;
- Improving accounting standards.

The following distribution of financial resources has been projected to restore the credit market, growth and employment in the world economy.

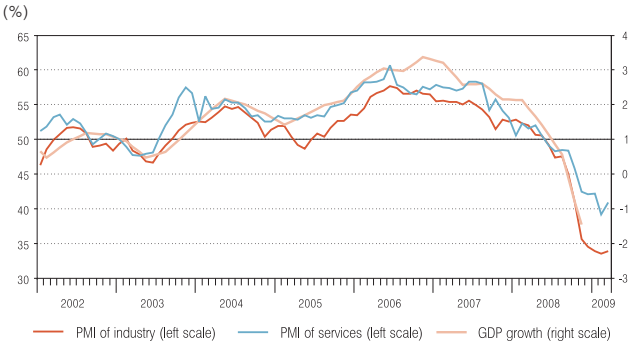
- USD 750 billion to the IMF;
- USD 100 billion to multilateral development banks;
- USD 250 billion to support a new SDR allocation;
- USD 250 billion to trade finance;
- additional funds from the sale of gold to the IMF in support of the poorest countries.

Euro Area Consumer Confidence Indices



Source: Eurostat.

PMI of Industry and Services and Euro Area GDP Growth



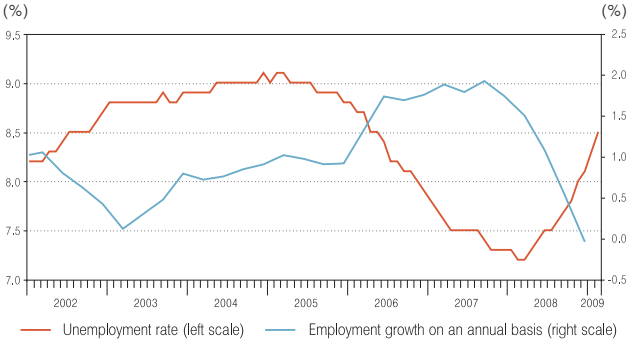
Sources: NTC Research, Eurostat.

During the first three months of 2009 a number of economic activity indicators went on weakening (EC indices, PMI, and regional business and consumer confidence indices). These indicators show the continuously worsening euro area economic performance, but with a certain slowdown in the decline rate. Pessimistic perceptions concerning the state of consumer demand, the anticipated increase in unemployment and the reduction in personal disposable incomes, as well the falling corporate earnings will support the trend towards declining consumption and investment. The behaviour of economic agents will be further impacted by the hampered access to funding. The euro area real GDP is expected to continue decreasing during the second and third quarters of 2009. According to early March ECB forecast, in 2009 the euro area GDP will report a decline within the range of 2.2 per cent to 3.2 per cent on an annual basis.

The downward trend in euro area harmonized inflation was sustained during the first quarter of 2009. The falls in the prices of raw materials, transportation services and foods contributed most to this. According to the preliminary assess-

ment for March, HICP went up by 0.6 per cent on an annual basis against a 1.2 per cent growth on an annual basis for the previous month. End-February data on core inflation reported a 1.7 per cent growth.

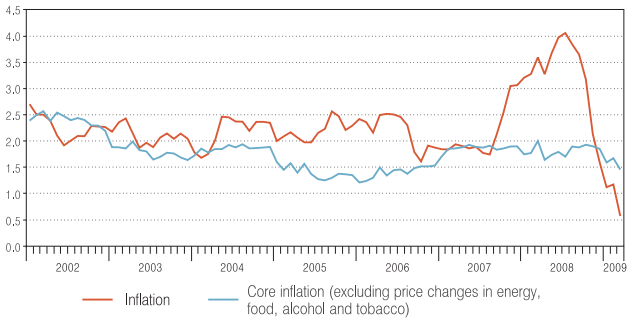
Euro Area Unemployment Rate and Employment Growth



Source: Eurostat.

Euro Area Inflation Rate

(percentage change on same period of previous year)



Source: Eurostat.

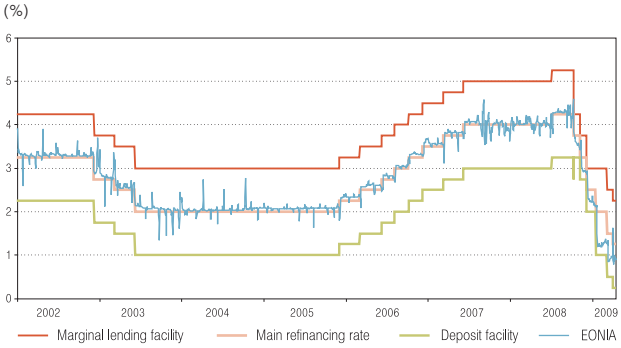
Euro area inflation is anticipated to stay low, below the ECB 2 per cent target, as oil and other commodity prices are expected to retain their relatively low levels and the trend towards wage rises to be discontinued. In the short run, dramatically reduced consumer demand and high levels of finished output inventories are prerequisites for a heightened risk of further declines in inflation. Recent market surveys show that short-term inflation expectations fluctuate around some 1 per cent. According to ECB projections till the year end euro area harmonized inflation will continue to moderate within the range of 0.1 per cent to 0.7 per cent.

Against a background of continuously declining inflation and negative real GDP growth, the ECB cut the repo interest rate in March and April by a total of 75 basis points to 1.25 per cent. As a result of the adopted changes, the euro area interbank market effective overnight interest rate fell to 0.8–0.9 per cent in early April, and in the three-month segment to 1.48 per cent.

Despite the cumulative 300 basis point reduction in the repo interest rate by the ECB between October 2008 and April 2009, at present no corresponding changes in the interest rates on banks' credit operations are taking place. Financial crisis effects on the banks' balance sheets and the higher credit risk premia are the factors behind the impeded transmission of ECB interest rate changes to the interest rates on loans extended by banks.[1]

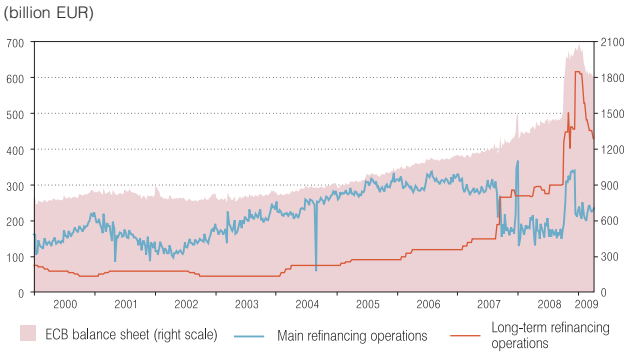
During the first quarter the euro area interbank market remained unstable; liquidity and credit risk premia show that tensions in the maturity segments beyond the scope of ECB operations in the money market remained. The ECB is expected to launch in May a new set of money market operations aimed at easing banks' refinancing within a six-month to one-year horizon. The anticipated outcomes of these operations are an improvement in the transmission mechanism and strengthening the effect of ECB reference interest rate on lending rates.

Euro Area Interest Rates



Source: Bloomberg.

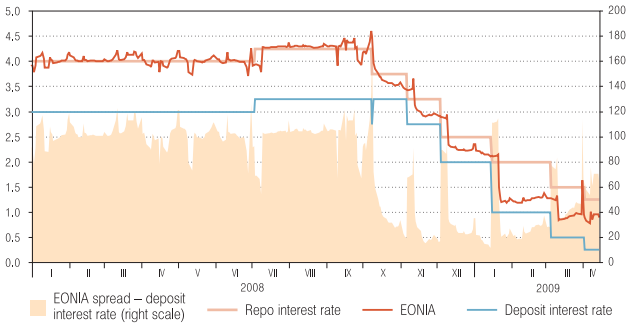
ECB Balance Sheet



Source: ECB.

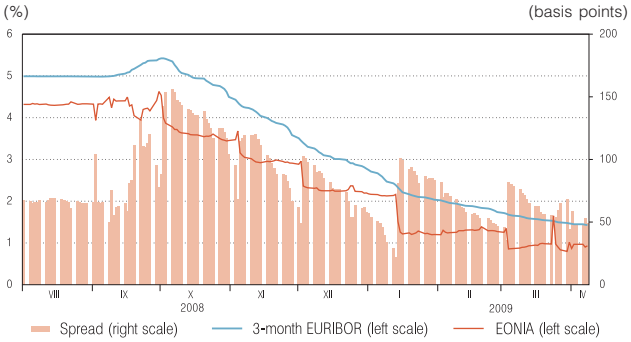
[1] See the analysis in *Economic Review*, 2008, Issue No. 4, p. 30 in the *Monetary Policy Transmission in the Euro Area and in Bulgaria* box.

Short-term Euro Area Interest Rates



Source: ECB.

Liquidity Risk Premium (Spread between the Three-month EURIBOR and EONIA)



Source: Bloomberg.

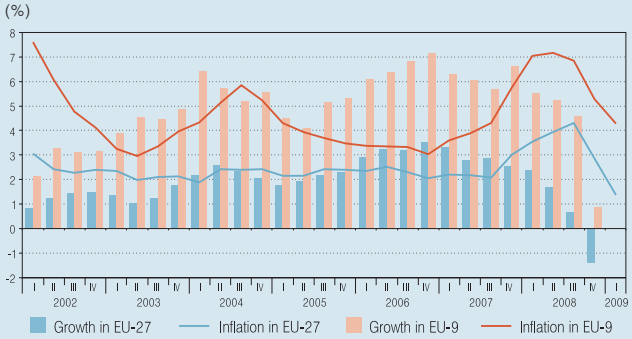
EU-9*

The global financial crisis affected also non-euro area EU countries. Economic growth in these countries slowed down, and in the fourth quarter of 2008 it came to 0.9 per cent on an annual basis (4.6 per cent in the third quarter). Bulgaria and Romania reported the highest growth (3.5 per cent and 2.9 per cent) respectively, while the Baltic region countries and Hungary reported a decline (the most dramatic being in Latvia, 10.3 per cent). Private consumption and export declines were the driving factors behind this. Inflation moderated by 1 percentage point in the first quarter of 2009 to reach 4.3 per cent on an annual basis.

Paralysed international financial markets in the fourth quarter of 2008 had a strong effect on the exchange rates of the countries with a floating exchange rate. The national currencies of Poland, Hungary, Romania and the Czech Republic depreciated dramatically. This trend was reversed with the common declaration of banking supervision authorities of Bulgaria, Romania, Poland, Slovakia, the Czech Republic and Hungary in which these countries take a stand against speculations about banks' stability in the Central and Eastern Europe.

Under specific conditions, the depreciation of the national currency would support exports. However, under the current conditions of worsening economic situation, the currency depreciation may have mostly adverse effects on the economy of the respective country. Hedging costs of foreign currency claims increase, thus reducing the potential positive effect of depreciation on exports. Prerequisites for increasing inflationary expectations and disproportions in corporate and household balance sheets are in place, since the bulk of their debts is denominated in foreign currency.

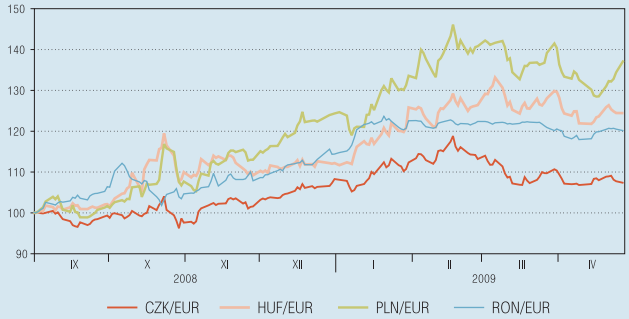
Growth and Inflation in EU-27 and EU-9



Sources: Eurostat, own calculations.

Nominal Exchange Rates to the Euro

(1 September 2008 = 100)



Note: An increase in the index indicates depreciation of the respective national currency against the euro.
Sources: ECB, BNB.

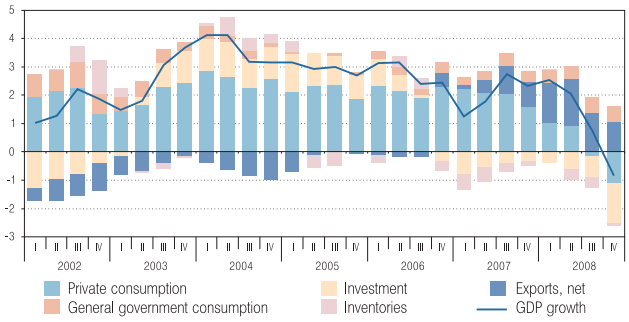
* EU-9 includes the states that joined the EU from 2004, Slovenia, Malta and Cyprus excluded. As of 1 January 2007 Slovenia and as of 1 January 2008 Malta and Cyprus have the status of full members of the Economic and Monetary Union.

The USA

During the fourth quarter of 2008 GDP in the USA reported a 1.6 per cent drop on the previous quarter. Low consumer activity (-0.8 percentage points) and reduced private investment (-0.9 percentage points) contributed most to this trend. Decreased external demand led to a fall in the contribution of net exports. Data on business indicators during the first quarter of 2009 indicate that the economic downturn in the USA is deepening, albeit at a slower pace.

Contribution to US Growth by GDP Component (Quarterly)

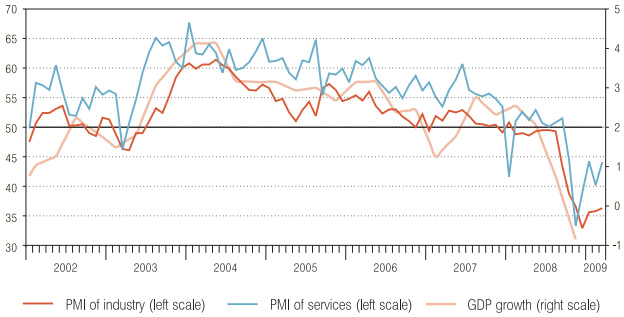
(%)



Source: Bureau of Economic Analysis.

US PMI of Industry and Services and GDP Growth

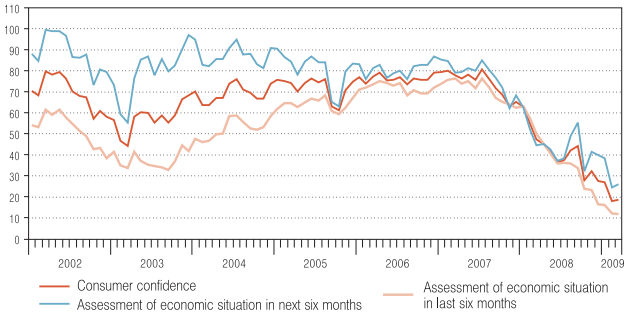
(%)



Sources: Institute for Supply Management, Bureau of Economic Analysis (BEA).

US Consumer Confidence Indices

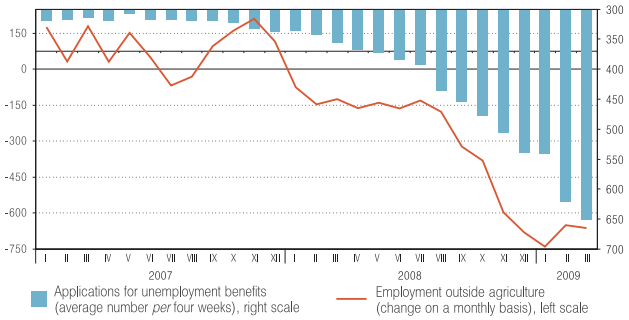
(2000 = 100)



Source: The Conference Board.

Labour Market

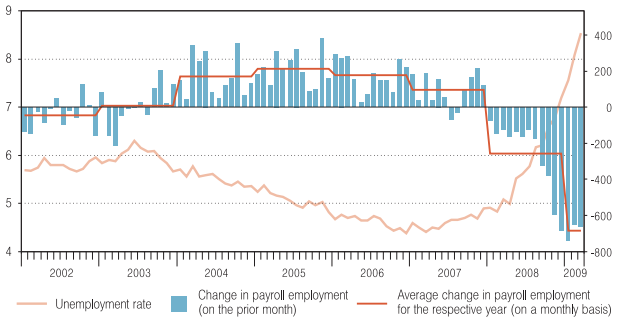
(thousands of persons)



Source: Bureau of Labour Statistics.

US Unemployment Rate and Changes in Payroll Employment

(%) (payroll employment, thousand)



Source: Bureau of Labour Statistics.

The downward trend in employment continued in the first quarter, with data pointing to a cumulative decline of over 2 million jobs. Unemployment picked up to 8.5 per cent: the highest level of the indicator over the past 25 years. Consumer confidence also fell to new historical levels, reflecting households' reduced real disposable incomes and net wealth in an environment of an ongoing housing market crisis.

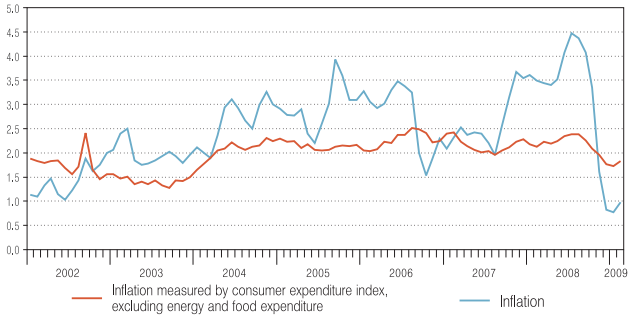
The imbalance between housing demand and supply was preserved, with selling prices falling down and the stock of houses for sale staying high. Investment in new construction decreased, while the growing number of houses offered for sale pushed up, supporting the market price negative trend. Despite the Federal Government programme on forestalling foreclosures and restricting public sales of mortgaged property through incentives for renegotiating lending agreements, housing market imbalances will be sustained in the short run.

Inflation rates stayed low and the consumer price index reached 1.0 per cent in February, while the index excluding food and energy rose to 1.8 per cent on an annual basis. Low consumer and investment activity poses a risk of further de-

clines in inflation in the short run. In the long term, however, risks of rises in inflation grow owing to the unprecedented monetary and fiscal expansion.

US Inflation Rate

(percentage change on same period of previous year)

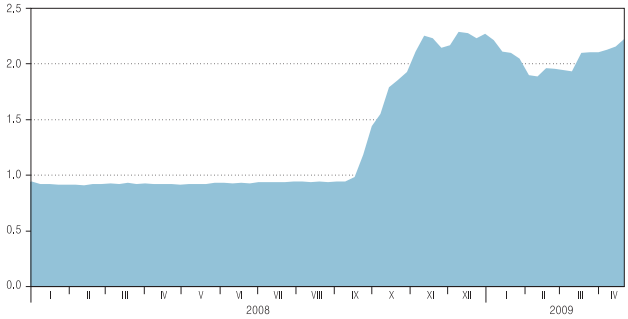


Sources: Bureau of Labour Statistics, Bureau of Economic Analysis.

During the first quarter of the year the Federal Reserve preserved the effective interest rate on federal funds within the band of 0.00 per cent to 0.25 per cent set in December 2008. Having exhausted all possibilities of lowering the interest rate, the Federal Reserve started to actively use the balance sheet, introducing new monetary operations. The adopted programme for buying on the secondary market of government securities with a residual maturity of over two years and a nominal value of up to USD 300 billion is an innovation in the Federal Reserve operations. The programme aims to decrease the level of long-term interest rates. The Federal Reserve announced a USD 750 billion expansion in buying mortgage debt issued by the federally sponsored agencies with a view to decreasing the interest rates on new mortgage loans and easing refinancing of already extended mortgage loans. The cumulative effect of the new monetary operations launched in mid-March will result in a Federal Reserve asset growth by some USD 1 trillion (about 7.4 per cent of GDP in the USA).

Federal Reserve Balance Sheet

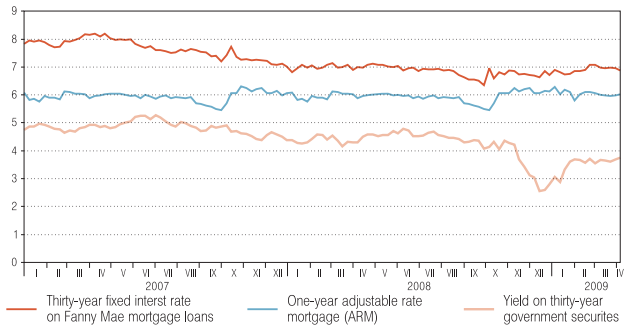
(trillion USD)



Source: Board of Governors of the Federal Reserve System.

Interest Rates on Housing Loans

(%)



Source: Bloomberg.

USD/EUR Exchange Rate

Over the first quarter of 2009 the US dollar followed an unstable trend towards appreciation against the euro. The most significant change was reported in January (a 9.1 per cent appreciation), followed by a relative stabilisation in February and a 4.4 per cent depreciation in March. Over the quarter the EUR/USD exchange rate was highly volatile, moving within a wide range (1.25–1.40). During the whole period the EUR/USD exchange rate speculative positions showed a net excess of short positions over the long ones in favour of the US dollar.

USD/EUR Exchange Rate

(USD per EUR 1)

Source: ECB.

Decreased ECB reference interest rate (by 50 basis points to 2 per cent) and heightened investor risk aversion, supporting the demand for US dollars as safe haven, contributed to US dollar appreciation at the start of the period. The other significant effects came from the expected disclosure of further losses in the annual accounts of financial institutions in the USA and Europe, as well as the ongoing negative macroeconomic developments in the two leading economies.

The slight change in EUR/USD exchange rate in February reflected factors with opposite effects. On

The Balkan Region

Economic growth in the Balkan countries posted a significant slowdown over the fourth quarter of 2008. An essential decline was also reported in external demand due to the global economic crisis. Private consumption and investment also decreased. Turkey reported a 6.2 per cent drop, with private consumption, investment in fixed assets and inventories contributing negatively to growth (2.9, 4.7 and 4 percentage points respectively). The positive contribution of net exports by 5 percentage points was mainly a result of the 23 per cent import decrease. Industrial production in all Balkan countries fell by almost 15 per cent in the first two months of 2009. The downward trend in inflation rates was sustained.

Our expectations show declining growth in this region throughout 2009. The worsened international situation will further push down foreign investment flows to the region although the inflow will not be interrupted. The Balkan region will retain its investment and development potential which allows these countries to remain attractive for foreign investors.

Real Growth and Inflation in Balkan Countries (Quarterly)

	2007	2008					2009
	Total	I	II	III	IV	Total	I
Growth (on the corresponding period of previous year, %)							
Bulgaria	6.2	7.0	7.1	6.8	3.5	6.0	
Greece	4.0	3.4	3.3	2.9	2.2	2.9	
Macedonia	5.9	5.6	6.7	5.8	2.1	5.0	
Romania	6.2	8.2	9.3	9.2	2.9	7.1	
Turkey	4.7	7.3	2.8	1.2	-6.2	1.1	
Croatia	5.5	4.3	3.4	1.6			
Serbia	6.9	8.5	6.0	4.9	2.8	5.4	
Inflation (averaged for the period, %)							
Bulgaria	7.6	12.4	14.0	12.6	9.1	12.0	5.1
Greece	3.0	4.3	4.8	4.8	3.1	4.2	1.8
Macedonia	2.3	9.5	9.9	8.4	5.5	8.3	0.9
Romania	4.9	8.0	8.6	8.2	6.9	7.9	6.8
Turkey	8.8	8.8	10.3	11.7	10.9	10.4	8.4
Croatia	2.9	5.9	6.5	7.4	4.5	6.1	3.8
Serbia	6.4	13.4	15.8	12.3	10.1	12.9	9.7

Sources: Statistical institutes and central banks of respective countries.

the one hand, global economic fundamentals continued worsening, and, on the other hand, risk aversion became lower following the efforts of authorities in a number of countries to boost their economies. In the USA the Congress approved Barack Obama's fiscal programme coming to USD 787 billion.

In March investor optimism grew, underpinned by the non-standard measures for counteracting the crisis adopted by the central banks of Japan, the United Kingdom and the USA. During the same month, the Federal Reserve unexpectedly launched the programme for buying government securities, while the Minister of Finance Geitner announced details concerning the US bail-out plan for the financial sector. The results of the G-20 summit also led to improving market sentiment, as consent on coordinated actions for overcoming the crises was declared.

During the second and third quarters of 2009 the high exchange rate volatility showing no clearly pronounced trend is expected to be sustained.

International Prices of Crude Oil, Major Raw Materials, and Gold

Crude Oil

The fall in crude oil prices came to an end at the start of 2009 and during the first quarter prices stabilised at USD 40–50 *per* barrel.

Economic activity slowdown impacted significantly crude oil demand which continued to decline during the first quarter of 2009. OPEC countries' actions for constraining supply were insufficient to offset the decline in demand. Data on 2008 show a dramatic excess of supply over de-

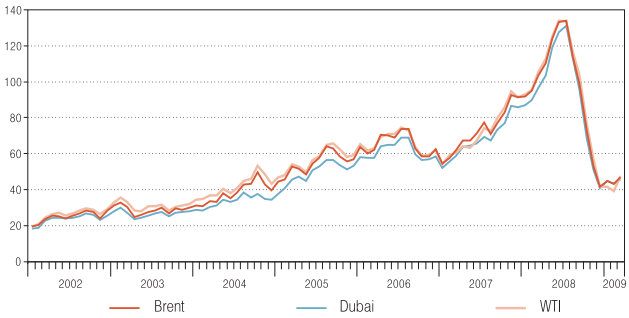
mand and an increase in global inventories of oil and oil products. Discontinuation of price falls was supported by market concerns that low raw material prices will result in termination of important investment in production capacities extension, which will considerably push up prices during the next period of world economy expansion.

The International Energy Agency (IEA) continued to revise its crude oil demand projections; as of March a 2.8 per cent contraction in 2009 is anticipated (down 2.2 percentage points on the January projections).

Market expectations are for oil price fluctuations within the range of USD 40–60 per barrel in the second and third quarters.

Crude Oil Prices

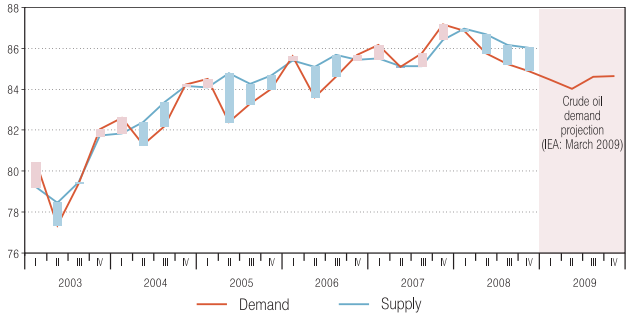
(USD per barrel)



Source: World Bank.

World Crude Oil Demand and Supply (Quarterly)

(million barrels per day)



Source: IEA.

Major Raw Material and Commodity Prices

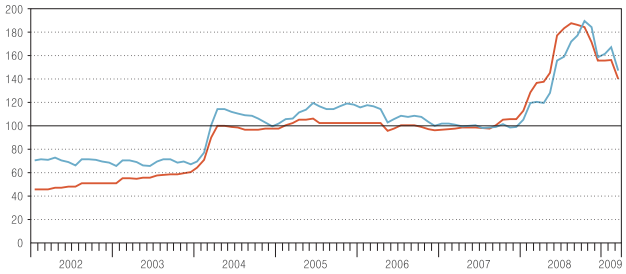
During the first quarter of 2009 metal prices stabilised. The metal price index showed a decrease of about 5 per cent on the previous period. Aluminum prices posted the most significant drop of 25 per cent and copper prices declined by 12 per cent. Steel prices fell by 12 per cent parallel to a sizable fall in output of some 20 per cent in early 2009. Expectations are for retention in metal prices in the second quarter and a slight appreciation until the end of the year.

Food prices also stopped declining in the first quarter. A slight increase of 2.5 per cent was reported on a quarterly basis. Rice and wheat

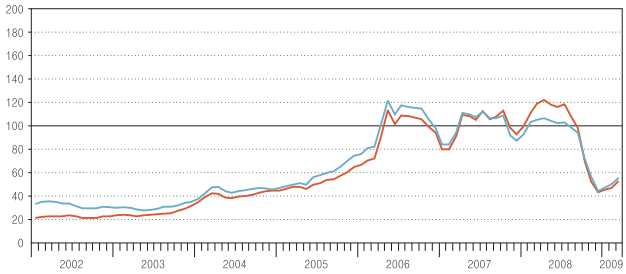
Price Indices of Major Commodities and Commodity Groups

(2007 = 100)

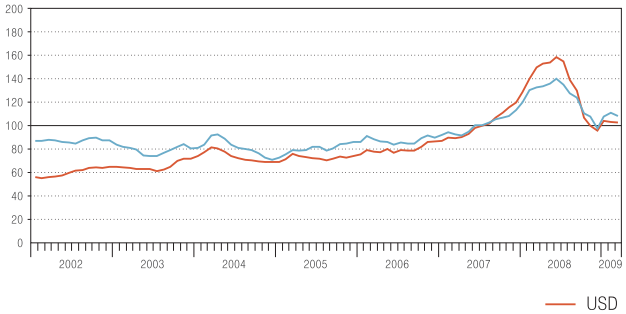
Steel



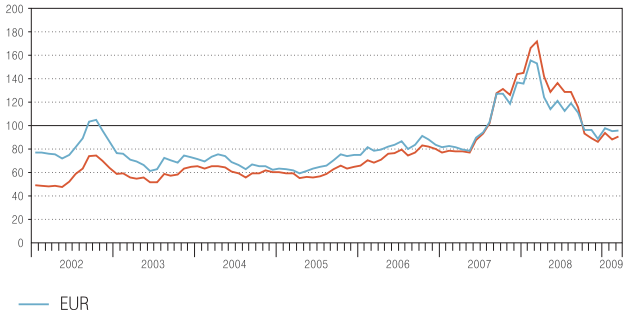
Copper



Food



Wheat



Sources: World Bank, BNB.

prices rose by about 2.5 per cent, while corn depreciated by approximately 1 per cent. The downward trend in vegetable oil prices was sustained: during the period sunflower oil depreciated by some 11 per cent following a price fall of almost 50 per cent in the prior quarter.

Forecasts point to a 5 per cent rise in world food production and record highs during the 2008 to 2009 period compared with the previous season. Wheat inventories are expected to grow by almost 30 per cent. Expectations for the next season are also favourable which will help retain the price levels during the next two quarters.

The USD exchange rate volatility was essential for raw material price fluctuations in the first three months of 2009. These fluctuations are likely to remain in the next quarters, impacting raw material prices.

The sea freight price index (BDI), which is the leading indicator of world trade growth, stayed at low levels at the start of the second quarter reflecting ongoing low global demand.

Gold

Over the first quarter of 2009 the average gold price (one-month futures) went up to USD 909 per troy ounce (+14.0 per cent on a quarterly basis). As regards the euro, the rise was more clearly pronounced (+15.5 per cent) due to its depreciation against the US dollar. The US dollar exchange rate contributed significantly to price fluctuations, accounting for some 60 per cent of US dollar price fluctuations.

Spot Price of Gold

(USD per troy ounce)

Source: The London Bullion Market Association.

Over the review period, and especially in January, when gold appreciated most, the demand for it as safe haven was the highest. This pushed down its correlation with the US dollar, commodity and stock market indices to relatively low levels. The major driver of the precious metal prices changes in February and March were investors' perceptions of economic performance, inflation expectations and risk appetite dynamics.

The demand was predominantly for physical gold and purchases of assets by exchange-traded funds (ETF). Based on recent data, by end March the assets of the largest gold ETF – SPDR Goldtrust – reached 1140 tons.

Bulgarian External Debt Dynamics on International Financial Markets

In the first quarter of 2009 the yield spread of the government debt in the Central and East European countries widened, with the JP Morgan Euro EMBI Global index growing by 32 basis points. The index fluctuated within the range of 377–449 basis points and by the end of the quarter it was 379 basis points.

During the first two months of the year the index followed an upward trend reaching peak values by end-February and early March. The main factor behind the upward dynamics were the mounting concerns regarding the state of key financial institutions operating in West Europe, which occupy a large share in East European banking markets. Attitudes towards the East European region worsened further after the publication of a macro data series showing a fall in euro area real GDP and spilling over of the effects to the region. The ECOFIN Council call of early March was for assessing the risk in the countries in this region on the basis of economic fundamentals' performance rather than market sentiment.

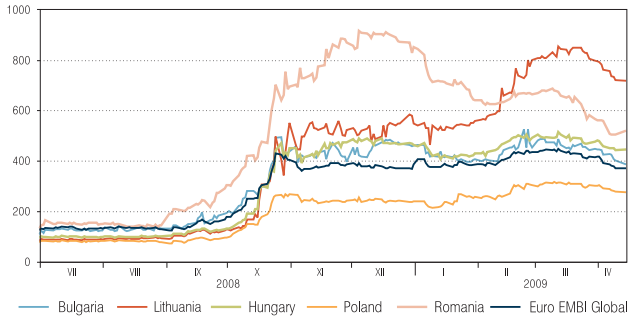
Within the period until March 2009 the risk premia increase was dominated by investors' high risk aversion and deteriorating attitudes towards the region. During this period the difference in the values for individual countries in the overall regional index to a lesser extent reflected divergences in each country's macroeconomic and financial fundamentals. Countries displaying good fundamentals like Poland registered lower index values than the overall regional index, while the indices of Bulgaria, Hungary and Turkey hovered around the overall index. After March markets started to differentiate between individual countries based on the fiscal positions and the possible guarantees provided by agreements with external official creditors. A substantial upward de-

viation was observed in the indicators of Lithuania and Romania. At the end of March Romania reached an agreement with the IMF on financing to the amount of up to USD 20 billion, which prompted a sizable drop in the risk premium. Similar dynamics occurred in Turkey, which is in an advanced stage of negotiations with the IMF on concluding a stabilisation agreement.

Bulgaria's government debt spreads, measured by the JP Morgan index, exhibited an upward trend in January and February, while in March and early April a significant fall was observed. Markets responded to the ECOFIN Council call for a reaction to the risk in the countries in this region based on the economic fundamentals; the adjustment reflected Bulgaria's stable fiscal position by the end of 2008. The index fluctuated within the range of 400–527 basis points, while at the start of April it dropped below 400 basis points.

Government Securities Yield Spreads in Bulgaria, Romania, Poland, the Czech Republic and Hungary (Euro EMBI Global index)

(basis points)



Source: JP Morgan.

2. Financial Flows, Money and Credit

Balance of payments current account deficit started to improve quickly over the first two months of 2009 owing to the considerable decrease in the trade deficit. Nominal exports continued to slow down due both to the sharp contraction in external demand and to the fall in international prices of commodities and fuels which comprised a considerable share in the export structure. On the other hand, imports slumped faster (and on a higher base) than exports. The fall in international commodity and fuel prices and the slower growth of domestic demand led to a decrease in nominal imports. According to preliminary balance of payments data for the first two months of 2009, foreign direct investment covered 89.4 per cent of the overall deficit on the current and capital account, which shrank to EUR 484.5 million (compared to EUR 1452.4 million deficit in the same period of 2008).

The amendment to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks reducing the amount of minimum required reserves on funds attracted by banks from abroad from 10 per cent to 5 per cent, removing the reserve requirements on funds attracted from state and local government budgets and keeping that on other attracted funds at 10 per cent is in effect as of early 2009.[2] As a result of this change banks deposits with the BNB decreased by BGN 1 billion in January, which resulted in gross international reserves decrease in line with the currency board principles. Local banks used funds released by the BNB to discharge of external obligations and to increase their foreign assets.

At the end of 2008 and in the beginning of 2009 the government used its funds deposited with the BNB to increase the capital of the Bulgarian Energy Holding and of Bulgarian Development Bank, as well as for other expenditure. The decrease in the government deposits with the BNB also had an immediate effect on the reduction of BNB gross international reserves.

Cash Flows Which Prompted Significant Changes in Gross International Reserves

(million EUR)

	2008, total	2008, I quarter	2009, I quarter
Total for the period	55	19	-1 123
Purchases and sales of euro	1 222	150	-934
at tills	-54	-13	-9
banks, incl.	1 275	163	-925
bank's purchases	125 543	26 334	29 591
bank's sales	-124 268	-26 171	-30 516
Flows on accounts of banks, the MF, etc.	-1 166	-131	-189
Minimum required reserves	-657	102	-197
Government and other depositors	-509	-233	8

Source: BNB.

As a result of the above stated actions of the government and the BNB, liquidity in the economy increased at the end of 2008 and in the first months of 2009, thus giving economic agents in Bulgaria (bank and non-bank institutions) the possibility to reduce the amount of their foreign obligations or to increase their foreign assets.

Accordingly, these transactions were reflected in the balance of payments data. In January the financial account saw EUR 647 million deficit. The positive balance on the financial account of EUR 237.3 million in February partly offset this fall but over the January to February 2009 period the financial account still marked a deficit of EUR 409.7 million. The balance of payments total balance recorded a deficit of EUR 886.2 million in the first two months of 2009. BNB international reserves decreased by the same amount (taking into account valuation adjustments).

The Issue Department balance sheet figure came to BGN 23,111 million (EUR 11,816.5 million) by the end of March 2009. The average monthly coverage of imported goods and services by BNB international reserves reached 8.2 months by February 2009 against 5.5 months a year earlier.

[2] For more details, see the box entitled *Amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks* in issue No 4 of the BNB Economic Review.

[3] See the box entitled *The Principles of Operation of the Currency Board in Bulgaria* in this issue.

The Principles of Operation of the Currency Board in Bulgaria

The continuing investor risk aversion and reduced liquidity in global financial markets at the end of 2008 tended to affect the capital inflow to emerging markets which were marked by collapsing stock prices and increasing spreads on private and public debts. In some countries, difficulties in attracting foreign financing led to significant fluctuations and depreciation of their national currency which magnified the negative effects of the global crisis *via* an increased uncertainty in the economic environment, rising financing costs and unfavourable changes in the balance sheets of banks, enterprises and households.

In Bulgaria, the currency board regime plays a key role in maintaining macroeconomic stability. The benefits of the currency board as a specific regime of monetary policy are clearly evident in the current global crisis. The fixed exchange rate of the lev to the euro is a strong nominal anchor guaranteeing stability of the exchange rate level. The stability of the currency board is supported also by the prudent fiscal policy and stringent banking supervision policy which ensured the accumulation of significant financial reserves in the period of high economic growth. These reserves can serve as a cushion against the effects of the global crisis on the Bulgarian economy.

The operation of the currency board is based on three major principles laid down in the Law on the BNB, namely: (1) a fixed exchange rate which as of the moment of the euro introduction is BGN 1.95583 *per* EUR 1; (2) the total amount of BNB monetary liabilities is fully covered by full high-liquid foreign reserves. BNB monetary liabilities consist of banknotes and coins in circulation, liabilities *vis-à-vis* banks, the government and budget organizations, liabilities to other depositors (see *Issue Department balance sheet* on the BNB website); (3) the central bank's obligation to unconditionally and irrevocably sell and purchase levs against euro at the exchange rate fixed by the Law on the BNB. These principles mean that the national currency is issued solely against providing reserve currency at the fixed exchange rate.

The currency board and the fixed exchange rate are further protected by the following provisions in the Law on the BNB:

(1) The BNB may not extend loans and guarantees in any form whatsoever, including through purchase of debt instruments, to the Council of Ministers, municipalities, as well as to other government and municipal institutions, organizations and enterprises. This provision excludes the possibility, in order to support the government in financing budget expenditure, to issue national currency beyond the limit corresponding to the currency board principles.

(2) The Bank may not provide credit to banks except in the case of liquidity risk threatening to affect the stability of the banking system. The terms and procedure for extending this credit, and criteria for identifying the existence of liquidity risk are set by an ordinance of the BNB, and the credit is to be extended up to the amount exceeding the lev equivalent of gross international reserves *vis-à-vis* the total amount of BNB monetary liabilities. This provision also excludes the possibility, in order to support the banks, to issue national currency beyond the limit corresponding to the currency board principles.

(3) The BNB shall invest its gross international reserves in accordance with the principles and practices of prudent investment, with investments in securities being limited to liquid debt instruments satisfying the following requirements: debt instruments issued by foreign countries, central banks, other foreign financial institutions or international financial organizations, whereof obligations are assigned one of the two highest ratings by two internationally recognized credit rating agencies, and which are payable in freely convertible foreign currency. Rules for investing gross international reserves are also intended to protect the quality of assets in which these reserves are invested.

The above principles of the currency board operation guarantee an automatic mechanism of balancing national currency demand and supply at the fixed exchange rate determined by the law. Under the currency board, it is impossible that the issue of national currency exceeds the level of the gross international foreign exchange reserves, which could, otherwise, lead to erosion of the fixed exchange rate (a key difference between a currency board and a standard fixed exchange rate regime). The change in the level of BNB gross international reserves reflects the net result of demand for national currency by economic agents, government and banks, as well as changes in the market value of gold (as part of international reserves) and financial assets in which these reserves are invested.

Under the conditions of the fixed exchange rate against the euro and a free movement of capital, the BNB has no control over the interest rates and therefore, monetary conditions in Bulgaria follow to a great extent those in the euro area. Thus, the currency board largely reproduces the conditions in which the euro area economy is functioning. The main instrument used by the BNB to affect monetary conditions is the regulation of the minimum required

(continued)

(continued)

reserves maintained by banks with the central bank. For example, the reduction of the minimum required reserves rate since early 2009 has boosted liquidity in the banking system and contributed to falling interest rates in the interbank money market. It is possible for the central bank to indirectly influence the monetary conditions in Bulgaria by implementing supervisory and administrative measures but their objective is mainly financial stability rather than affecting monetary conditions.

Fiscal policy also may affect money supply and liquidity in the economy through a change in the amount of the government deposit with the BNB, the net government securities issuance and their maturity or repurchases. Withdrawal of funds from the government deposit at the end of 2008 and in early 2009 and their depositing on other banks' accounts, as well as net repayment on government securities in the first months of the current year boosted banking system liquidity.

The implementation of these macroeconomic policy instruments affects the level of international reserves. The increased liquidity in the economy allowed economic agents in Bulgaria (banks and non-bank institutions) to make repayments on foreign obligations or to increase their foreign assets – transactions which were reflected in the balance of payments data as of the end of 2008 and in the first two months of 2009.

Financial Flows and External Position Sustainability

A lower net flow of financial resources into the Bulgarian economy is expected over the second and third quarters of 2009 due to the global economic crisis and the tension on international financial markets. Lower capital flow and slower economic activity in Bulgaria contributed to the improvement of the balance of payments current and capital account deficit.

For the January–February 2009 period the balance of payments financial account deficit was EUR 409.7 million, resulting mainly from local banks transactions. They repaid external obligations of about EUR 284 million, increased their assets in currency and deposits abroad by EUR 134.4 and their portfolio investment assets picked up by EUR 89.8 million over the same period. *General government* portfolio investment liabilities decreased by EUR 179 million over the period. Foreign direct investments for the January–February 2009 period came to EUR 433.2 million[4]: up by 0.2 per cent compared to the first data release for the same period in 2008, and the coverage of the current and financial account deficit was 89.4 per cent.

Data on the changes in BNB international reserves, excluding changes due to market revaluation of gold, point to a decline of about EUR 1 billion in the first quarter of 2009. To a large extent this decrease was a response to the actions undertaken by the central bank and the government, namely the BNB reduced the minimum required reserves and the government increased the capital of the Bulgarian Energy Holding and that of the Bulgarian Development Bank, and made other expenses. Reflecting these measures, liquidity in the economy increased thus allowing for the reduction of external obligations and increasing private economic agents' (banks and non-bank institutions) foreign assets.

The intensifying global economic crisis and ongoing stagnation on international financial markets have an immediate impact on the macroeconomic developments in Bulgaria. Given the high degree of economic openness in Bulgaria and the enhanced integration within the single European market these developments will continue to affect the dynamics and direction of external current, capital and financial flows over the second and third quarters of 2009. Regardless of the high degree of uncertainty related to the external environment, our baseline scenario foresees the positive net flow of capital to Bulgaria to be sustained over the forecast horizon mainly in the form of foreign direct investment and to a lesser extent in the form of debt financing. The key factors under-

[4] Data subject to regular revisions upon receiving additional information from corporations. Recent years have witnessed systematic upward revision of original data on foreign direct investment flows; therefore the comparison of original 2009 data with the 2008 data is not correct. The above note also applies to intercompany loans and reinvested earnings.

lying our expectations are the prudent macroeconomic policy pursued and the prevailing long-term investor interest.

As to the potential speculative capital withdrawal, the degree of vulnerability of Bulgarian economy remains low. According to data on the international investment position, portfolio investment continued to decrease as a share of Bulgaria's gross liabilities and reached 3.5 per cent by the end of 2008. The share of gross short-term external debt also started to fall over the recent months and in February 2009 came to 36 per cent of total external debt and BNB international reserves coverage was 91.5 per cent.

According to preliminary data, foreign direct investment in Bulgaria came to EUR 433.2 million between January and February 2009.[5] Over the same period of 2008 foreign direct investment data were revised upwards several times and currently their amount is EUR 674.1 million. The comparison between the data for January–February 2009 and initially reported data for the corresponding period of 2008 points to a minimum increase in foreign direct investment inflow by 0.2 per cent. As of February 2009 foreign direct investment accounted for 17.1 per cent of projected GDP on an annual basis. Foreign direct investment inflow is expected to continue during the second and the third quarter of the year.

Investments attracted in the first two months of 2009 are mostly in the form of *other equity*: EUR 234.2 million (54.1 per cent of the total inflow). Initial estimates of *reinvested earnings* point to a decrease of EUR 14.2 million on an annual basis to EUR 68.1 million.

Between January and February 2009 EUR 130.8 million or 30.2 per cent of the total inflow entered the economy in the form of *share capital*. Over the first two months no funds were received from privatization transactions and foreign persons' investment in real property came to EUR 82.8 million (EUR 224.7 million in the same period of 2008). The trend toward lower non-resident investment for acquiring real estate in Bulgaria was sustained. Regardless of the decrease in these investments on an annual basis, they remain at higher than average levels observed over the years up to 2006 when the non-residents' interest in acquiring real estate in Bulgaria sharply intensified.

By end-2008 *real estate operations and business services* (22.8 per cent), *manufacturing* (18 per cent), *financial intermediation* (17.5 per cent), and *trade and repairs* (14.3 per cent) occupied the largest shares in the structure of cumulative foreign direct investment by industry. Trends in investment flow by economic sector showed moderation in almost all sectors by the end of 2008, while these industries retained their key role for the net inflow. The composition of FDI by country in the January to February 2009 period suggests that foreign direct investments attracted from the Netherlands (30 per cent), the United Kingdom (25.1 per cent), Switzerland (5.7 per cent) and Hungary (5.3) accounted for the largest shares.

Over the same period Bulgaria's gross external debt fell by EUR 231.3 million. Net repayment of borrowed funds amounted to EUR 529.2 million (revaluations and the net change in trade and revolving loans excluded). Over the first two months of 2009 loans and deposits of EUR 438 million were received, and principal payments of EUR 967.2 million serviced. As a result, by the end-February 2009 Bulgaria's gross external debt reached EUR 36.5 billion or 105.2 per cent of expected GDP on an annual basis.

In the first two months of 2009 general government external debt posted a decrease of EUR 90.8 million coming to 7.2 per cent of Bulgaria's total debt. The total amount of public and publicly guaranteed debt fell by EUR 75.2 million.

Private non-guaranteed external debt declined by EUR 156.1 million between January and February, with the greatest contribution being that of deposits by non-residents (EUR 163.1 million) and long-term loans repaid by local banks (EUR 154.5 million). Banks' debt to foreign parent banks incurred in connection with their activity in Bulgaria occupies a large share in banks' external debt (81 per cent as of December 2008). Reduced minimum required reserves[6] allowed banks to decrease the amount of their external debt by EUR 865.9 million and thus banks' share in Bulgaria's gross external debt fell to 24 per cent between the December 2008 and February 2009 period.

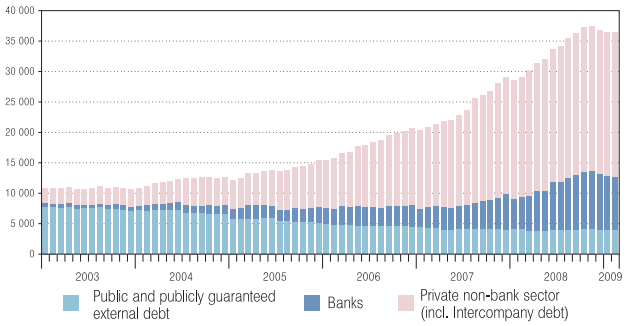
[5] See footnote 4.

[6] See the *Monetary Aggregates* subsection in this issue.

In the first two months of 2009 intercompany loans increased by EUR 231.8 million and their share in total debt rose to 35.9 per cent. This dynamics points to a long-lasting interest of foreign owners of local companies. The volume of intercompany loans will be revised upwards in the following revisions due to the quarterly reporting of corporations.

Gross External Debt

(million EUR)



Source: BNB.

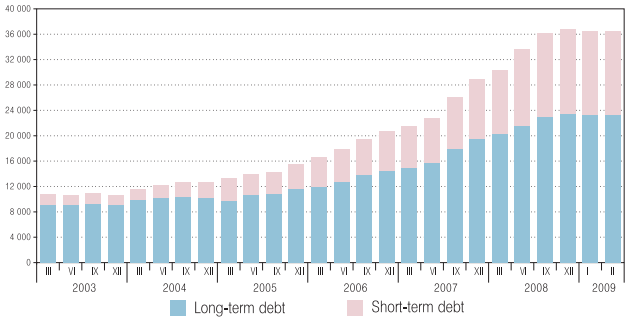
Gross external debt servicing in January–February 2009 reached EUR 1089.1 million compared to EUR 1367.3 million in the corresponding period of the prior year. For the first two months of 2009 residents declared new loans to be extended by non-residents to the amount of EUR 815.6 million (new loans declared for the same period of 2008 were EUR 1.28 billion). The largest share in actual borrowings for the January–February 2009 period is occupied by banks (51.8 per cent) and by loans related to direct investment (32.3 per cent). These data show that local economic agents still have access to international financial markets, but the demand for new debt financing will probably be weaker in the context of deteriorating economic environment.

The average weighted interest rates on new loans declared between January and February 2009 suggest a decrease (on an annual basis) in the cost of externally borrowed funds: in euro by 1.8 percentage points to 2.8 per cent and in US dollars by 1 percentage point to 5.2 per cent respectively. The differential between interest rates on long-term loans to corporations, extended by local banks and interest rates on external long-term loans remained positive. The interest rate differential on euro-denominated loans was 5.1 percentage points and that on US dollar-denominated loans was 6.1 percentage points respectively. Interest rates on domestic and external loans are not directly comparable due to the different characteristics of corporations with access to both markets. Nevertheless, lower interest rates on external loans preserve the incentives for external borrowing from Bulgarian companies.

By December 2008 no notable changes occurred in the structure of private non-bank external debt[7] by industry, with *real estate operations, lessors activities and business services* retaining their relatively large share in the external debt of *other sectors* (17.7 per cent) and in intercompany loans (21 per cent). Within the structure of *other sectors*' debt, *the electricity, gas and water supply* (15.8 per cent) and *financial intermediation* (15.5 per cent) had more significant shares, while in intercompany loans; *financial intermediation* (22.3 per cent) occupied the largest share.

Long- and Short-term Gross External Debt Dynamics

(million EUR)



Source: BNB.

Gross external debt maturity structure remained relatively stable, with the share of short-term external debt going down to 36 per cent over the recent months. Newly opened non-residents' deposits with domestic banks contributed most to the overall increase in short-term debt: up by EUR 4 billion as of February 2009 compared to the corresponding month of the previous year.

By the end of 2008 the euro retained its leading position (85.6 per cent) in the gross external debt currency structure. The euro occupied the largest share (93.2 per cent) in intercompany loans and the smallest share in the *general government* sector (67.7 per cent). This foreign currency structure of gross external debt significantly reduces risks associated with exchange rate fluctuations in the international markets.

Bulgaria's gross foreign assets decreased by EUR 425.6 million between January and February 2009, with the BNB international reserves fall of

[7] Excluding trade and bond loan liabilities.

EUR 700.1 million being partially offset by the increase in foreign assets of banks by EUR 274.5 million.[8] As a result of Bulgaria's gross foreign assets and gross external debt dynamics, net external debt increased by EUR 194.3 million in the first ten months of 2009, reaching 56.4 per cent of the projected GDP on an annual basis.

Bulgaria's external current and capital transactions dynamics was broadly in line with the change in the economic environment observed in the last two quarters. Between January and February 2009 the current and capital account deficits contracted to EUR 484.5 million against EUR 1452.4 million in the corresponding period of the prior year.

The trade in goods balance recorded the most significant improvement, with the trade deficit decreasing by EUR 501.9 million and coming to EUR 699.4 million in the first two months of the current year. Over the same period imports marked a decrease of 32.3 per cent on an annual basis and exports fell by 27.4 per cent. Production activity slowdown and lower demand for raw materials and energy resources and weaker investor and consumer demand in Bulgaria, were mainly responsible for this trend.[9]

In January and February 2009 the balance on services, the capital account and net current transfers improved by EUR 170 million, EUR 152.6 million and EUR 148.1 million respectively as compared to the corresponding period of 2008. The improvement in the capital and current transfers were almost entirely attributable to the EU funds inflow. Net transfers to the *general government* came to EUR 223.7 million, posting an increase of EUR 305.9 million on an annual basis. Net current and capital transfers to the non-government sector were positive (EUR 59.2 million), but declined by EUR 5 million on an annual basis.

The balance on trade in services recorded a deficit of EUR 37.6 million over the January–February 2009 period, while the deficit in the corresponding period of the prior year was EUR 207.6 million. This improvement was mostly attributable to the lower external transport, tourist and other business services costs (coming to a total of EUR 197.3 million), rather than to higher receipts.

[8] See the *International reserves and liquidity in foreign currency template*: statistical information published on BNB website under *Statistics*.
[9] For a detailed discussion of exports and imports dynamics, see the *Economic Activity* section in this issue.

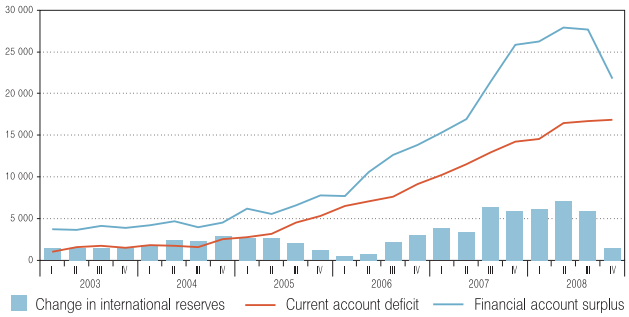
On the credit side only exports of *other business services* improved by EUR 24.6 million, while income from transport and tourist services saw a decline of EUR 51.9 million on an annual basis.

In the first two months of 2009 income balance exhibited a decline of EUR 4.5 million on an annual basis (a deficit of EUR 30.1 million). This is the only deteriorating component of the current account. The reported decline on an annual basis reflected mainly lower income from compensations to employees (down EUR 48.6 million) and lower income from foreign debt assets (down EUR 25.8 million). The lower income paid in connection with the foreign direct investment in Bulgaria (down EUR 38.2) helped decrease the *income* account deficit. Income from intercompany loans improved (up EUR 56.2 million), while dividends increased by EUR 32.3 million compared to the corresponding period of 2008.

Taking into account the available data on the balance of payments flows and changes in external debt, we may confirm the conclusion that there are no signs of serious risks to the sustainability of Bulgaria's external position amid the worsening global economic crisis. The analysis of major factors responsible for the changes in the Bulgarian economy external position reveals that the measures taken by the central bank and the government has played a key role.

Dynamics of Current Account, Financial Account and International Reserves (on an Annual Basis)

(million BGN)



Source: BNB.

Expectations for the second and third quarters of 2009 are characterized by high degree of uncertainty due to the still high tension in international financial markets and to the further slump in demand observed in most of Bulgaria's major partner countries. Lower capital flow and slower economic activity in Bulgaria will continue to contribute to the decrease of the balance of payments current and capital account deficit.

Monetary Aggregates

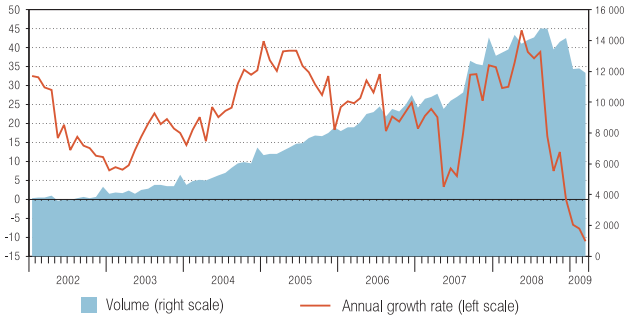
The levels of bank deposits with the BNB and money market interest rates stabilised due to the exhaustion of the direct effects from the amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks, which resulted in an increase of banking system liquidity. The dynamics of interest rates on time deposits will depend on banks' needs for attracted resources to finance their lending and on international financial markets development.

In the first quarter of 2009 reserve money posted a decline of 15.9 per cent (BGN 2.3 billion) on December 2008, and of 11.1 per cent on an annual basis. Amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks in force as of 1 January 2009 contributed most significantly to the decline from the corresponding period of 2008.

These amendments include: reducing the minimum required reserves on funds attracted by banks from abroad from 10 per cent to 5 per cent and on funds attracted from state and local government budgets from 10 per cent to 0 per cent. The direct effect of these measures was a decline in bank deposits with the BNB of BGN 924 million, which was partially offset by the change in cash in vaults and in banks' excess reserves. As a result, bank deposits with the BNB posted a decrease of BGN 882 million (down by 27.7 per cent as compared to the end of March 2008).

Reserve Money

(annual rate of growth, %) (volumes, million BGN)

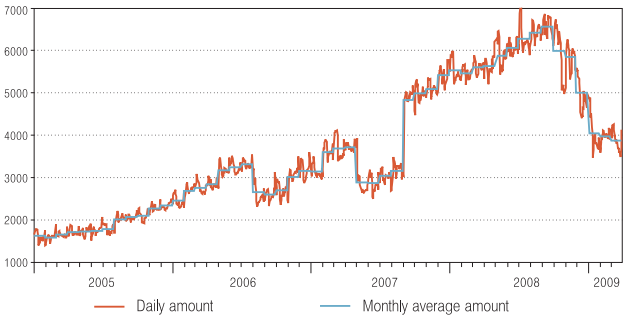


Source: BNB.

The seasonal decline in cash in circulation, which is typical for the start of the year, also affected the level of reserve money. In the first quarter cash in circulation decreased by BGN 1.38 billion on the end of 2008, but their annual growth rate remained positive at levels of 0.9 per cent by the end of March (9.1 per cent by end-December 2008). The slower annual growth in cash in circulation was attributable both to the high base and the increased deposit rates, attracting part of the liquidity available to the public and firms. The levels of cash in circulation and bank reserves are expected to stabilise during the second and third quarter of 2009.

Bank Deposits with the BNB

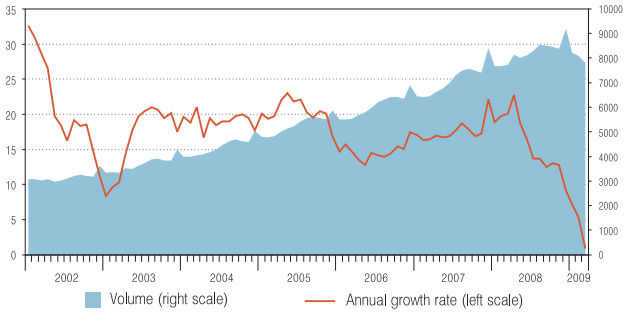
(million BGN)



Source: BNB.

Currency in Circulation

(annual rate of growth, %) (volumes, million BGN)

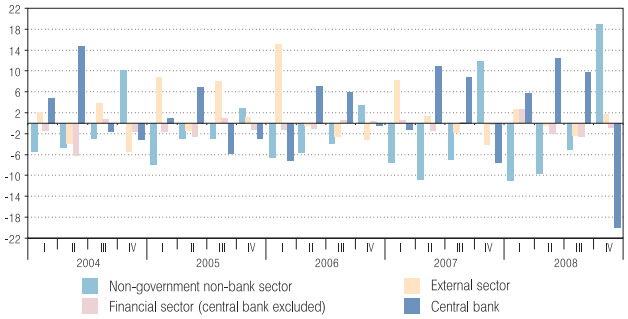


Source: BNB.

By the end of 2008 the additional social and investment expenditure that are part of the government plan approved by the National Assembly in October 2008, provided liquidity from the budget in favour of the non-government sector. Consequently, in the fourth quarter of 2008 government deposits with the BNB decreased by BGN 3735.3 million and reached BGN 7291.6 million by the end of the year. The external sector had little discernible effect on government sector liquidity. In the fourth quarter of 2008 the aid received from other countries amounted to BGN 111 million and the contribution to the EU budget totaled BGN 241.3 million.

Influence of Consolidated Budget on Other Sectors Liquidity (Quarterly)

(share of GDP, %)

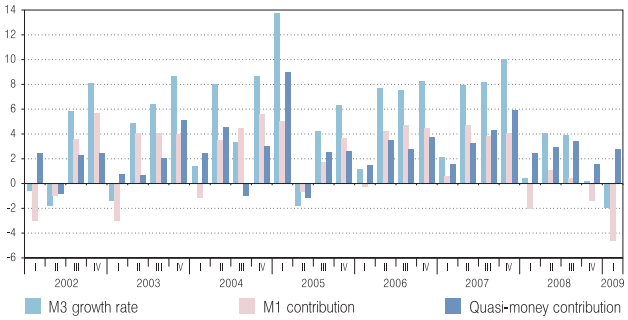


Sources: MF, BNB.

M3 increased by 6.2 per cent (on an annual basis) on March 2008 posting an annual growth of 8.8 per cent at the end of December 2008. The downward trend in broad money growth started in early 2008 and largely reflected the high base and lower credit growth rates also emerging in early 2008. Over the first quarter of 2009 the fall in overnight deposits continued, but it was offset by an increase in time deposits included in quasi-money. Another factor behind the changes in M3 observed since the year start was the seasonal decline in cash in circulation typical of this time of the year.

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

(percentage points)



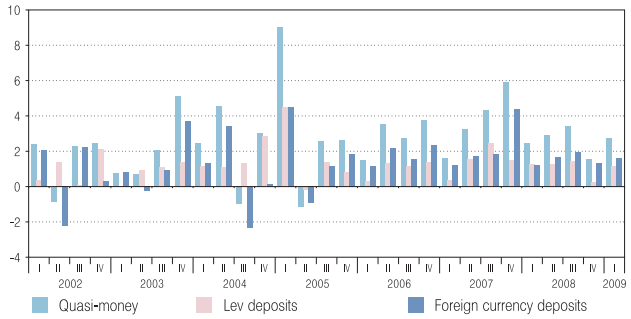
Source: BNB.

M1 posted an annual decline of 10.6 per cent as of end-March 2009 compared to the annual fall of 4.1 per cent as of end-December 2008. The main factor behind this was the decline in overnight deposits: down by 16.6 per cent on March 2008. By the end of March 2009 overnight deposits of non-financial corporations in levs and in foreign currency decreased by 11.9 per cent and 27.8 per cent on an annual basis respectively, while overnight deposits of households in levs decreased by 6.8 per cent and those denominated in foreign currency declined by 37.8 per cent. Factors pushing down overnight deposits were: decreased bank lending, ongoing repayment of obligations and shifting overnight to time deposits reflecting interest rate increases.

Quasi-money continued to increase, although its annual growth remained unchanged and by the end of March 2009 its value was 21.1 per cent (equal to that observed as of end-December 2008). Deposits with agreed maturity of up to two years still contributed most to quasi-money growth, with household deposits in levs going up by 36.9 per cent on an annual basis by the end of March and those in foreign currency by 21.3 per cent respectively. The annual growth rate of non-financial corporations' lev deposits with agreed maturity of up to two years amounted to 10.2 per cent and that of deposits in foreign currencies came to 12.8 per cent respectively.

Contribution of Quasi-money and Their Components to M3 Growth (Quarterly)

(percentage points)

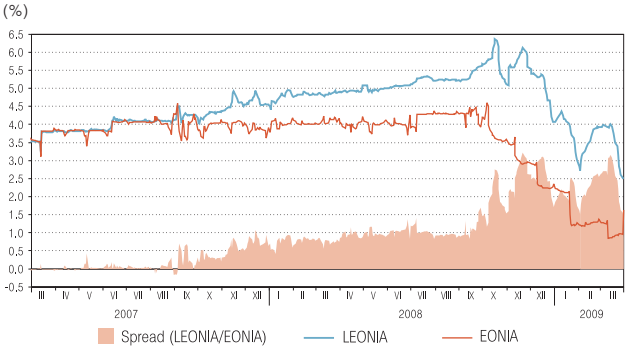


Source: BNB.

Interest rate levels in the interbank money market saw a marked fall in the first quarter of 2009. The decline in interbank interest rates in January was mainly due to the liquidity released as a result of the amendments to BNB Ordinance No. 21 and to the net redemption of government securities. These factors had lower effect in February when interest rate levels in the interbank money market posted an increase of around 1 percentage point. In March there was a new interest rate cut driven by increased banking system liquidity (banks maintained significant amounts of excess reserves with the BNB at the beginning of March) and by the cuts in ECB interest rates on main refinancing operations. The average interest rate on transactions concluded on the interbank money market fell to 2.55 per cent and LEONIA to 2.5 per cent respectively by the end of March. The average spread *vis-à-vis* EONIA contracted to 177 basis points in the last week of March 2009

compared to 224 basis points on average in the last week of December 2008.

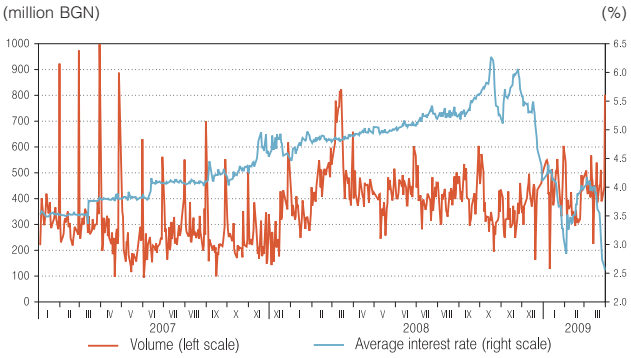
LEONIA/EONIA



Source: BNB.

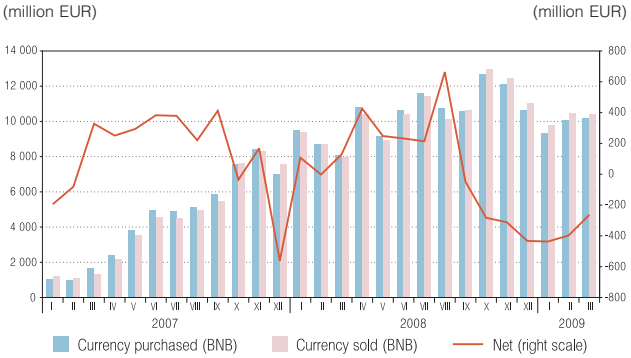
Interbank money market trade remained active and over the first quarter of 2009 the average daily volume of transactions rose to BGN 432 million, from BGN 379 million between September and December 2008. Apart from the transactions on the money market, banks also used currency trade with the BNB as a liquidity management instrument. Trade volumes remained high, with the value of foreign currency purchased by banks exceeding that of currency sold by EUR 1.12 billion over the first quarter of 2009.

Trade Volume and Interbank Money Market Interest Rates



Source: BNB.

Currency Sales or Purchases between Banks and the BNB

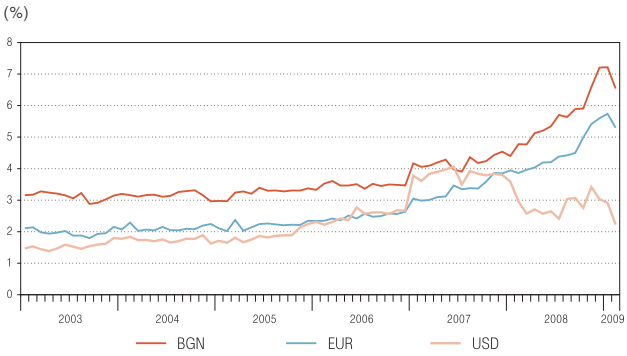


Source: BNB.

In the first quarter of 2009 interest rates on newly attracted deposits started to decrease following the dramatic rise observed by end-2008, mainly due to increased competition in the deposit markets. The decrease in interest rates since the year start was mainly attributable to the increase in non-government sector deposits, the stabilisation of international money markets and to the measures taken by the ECB and the BNB.

In February 2009 the average interest rates on time deposits denominated in levs and euro fell to 6.54 per cent and 5.30 per cent respectively, against 7.21 per cent and 5.60 per cent in December 2008. Expectations point to interest rates stabilisation in the coming months, and their change will be driven mainly by the banks' needs for domestic resources, ECB and BNB measures and the situation on global financial markets.

Interest Rates on Time Deposits

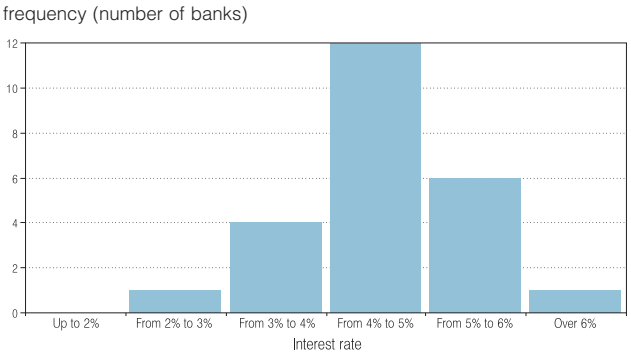


Source: BNB.

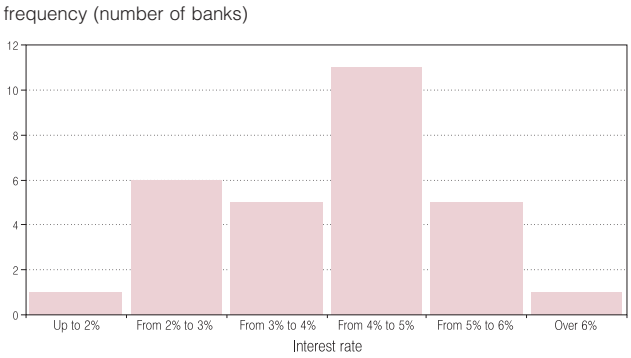
As regards the distribution of interest rates on household deposits with maturity of up to one month by bank, the number of banks offering rates within the 2 to 3 per cent band increased at the expense of those offering rates within the 4–5 per cent and 5–6 per cent bands. In addition to the decrease in the average interest level, more dispersion was observed in February 2009 *vis-à-vis* November 2008 along with agreed interest rate levels of under 2 per cent.

Distribution of Interest Rates on Household Deposits with Maturity of up to One Month

as of November 2008



as of February 2009



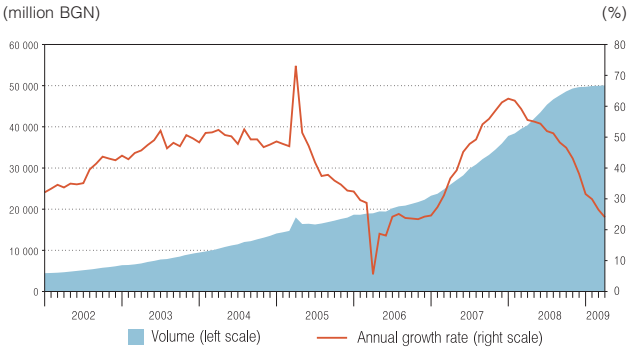
Source: BNB.

Credit Aggregates

The downward trend in credit growth was sustained due to macroeconomic environment uncertainty, the tightening of credit standards and the slump in demand. The cuts in interest rates on the interbank money market and the fall in commodity prices in the euro area will play a key role in stabilising lending interest rates.

The uncertainty resulting from the negative external trends continued to affect lending activity in the first two months of 2009. This effect was seen in the moderate credit demand and in credit policy tightening pursued by banks. In the first quarter of 2009 claims on non-financial corporations rose by BGN 356.1 million against BGN 2580 million in the same period of 2008. The increased cost of borrowed funds and tightened requirements for approving loans helped retain the downward trend in credit growth rate of loans, with the annual growth in claims on the non-government sector falling to 24 per cent by end-March. The annual growth rate of claims on the non-government sector will continue to moderate in the coming months.

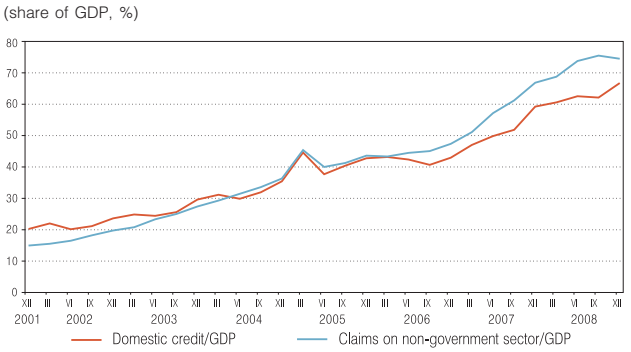
Claims on Non-government Sector



Source: BNB.

The slowdown in lending growth affected the claims on the non-government sector to GDP ratio. By the end of December 2008 this ratio reached 74.5 per cent, up 1 percentage point on the end of September 2008.

Domestic Credit

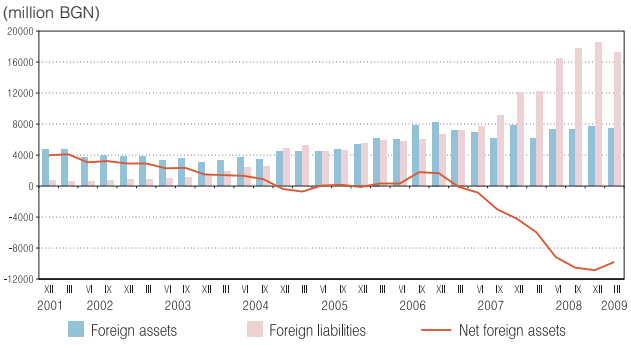


Source: BNB.

An increase in net foreign assets of banks was observed in the first quarter of 2009. Over the same period banks' funds borrowed from non-residents decreased by BGN 1260.7 million, and their foreign assets fell by BGN 199.2 million.

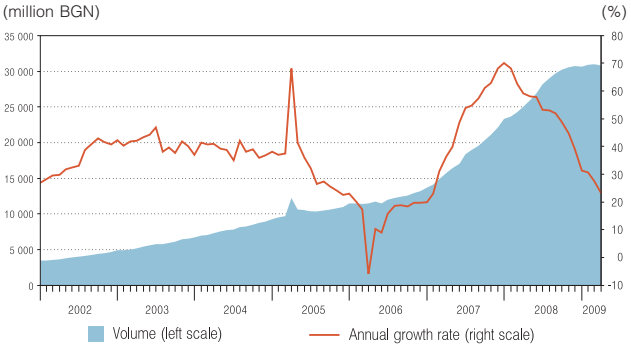
The moderate credit demand and tightened lending policy continued to impede growth in claims on the non-financial corporations. Between January and March 2009 claims on non-financial corporations rose by BGN 166.1 million (up BGN 1670.7 million in the same period of 2008). The annual growth rate of these claims tended to moderate reaching 23.2 per cent by the end of March.

Foreign Assets and Liabilities of Banks



Source: BNB.

Claims on Non-financial Corporations



Source: BNB.

Limited activity was also observed in lending to households. In the first quarter of 2009 claims on households rose by BGN 167.7 million (up BGN 867.7 million in the same period of 2008). Their annual growth rate continued to moderate reaching 24.7 per cent by the end of March. Although residential mortgage loans exhibited comparatively high growth rates compared to the other household borrowing components, their growth rate moderated to 32.8 per cent on an annual basis by the end of March. The households' demand for loans dampened as a result of heightened income and employment uncertainty. Expectations for a drop in real estate prices also played a key role with regard to residential mortgage loans dynamics.

It should be noted that easing liquidity conditions in the banking system attained through the changes in minimum reserve requirements regulations does not automatically boost lending. On the one hand, against the backdrop of high uncertainty with regard to economic development outlook, banks' risk appetite reduces and, on the other hand, firms and households' demand for loans dampens. This is why the release of bank liquidity does not automatically result in higher lending.

Changes in Major Balance Sheet Items of Banks (Quarterly)

(million BGN)

	2007		2008				2009
	III	IV	I	II	III	IV	I
Claims on non-financial corporations	1938.1	3010.1	1670.7	3190.4	2047.4	408.1	166.1
Deposits of non-financial corporations	1156.1	1678.3	-422.9	297.5	62.5	23.1	-1182.6
Claims on households	1308.6	1543.9	867.7	1634.8	1306.7	505.7	167.7
Deposits of households	1079.8	1734.7	811.9	954.3	1204.4	122.7	411.6
Foreign assets	-789.8	1764.5	-1681.4	1099.2	-8.9	361.6	-199.2
Foreign liabilities	1384.2	2955.8	63.5	4304.6	1361.5	680.6	-1260.7
Claims on general government	226.5	32.4	-103.6	-34.0	21.6	3.8	4.0
Deposits of general government	113.7	404.6	-200.3	322.8	-31.0	-188.7	-220.6
Claims on central government	201.7	-6.9	-106.2	-34.1	22.1	-17.6	7.3
Liabilities to central government	88.3	448.6	-310.1	145.2	-36.8	199.3	-356.4

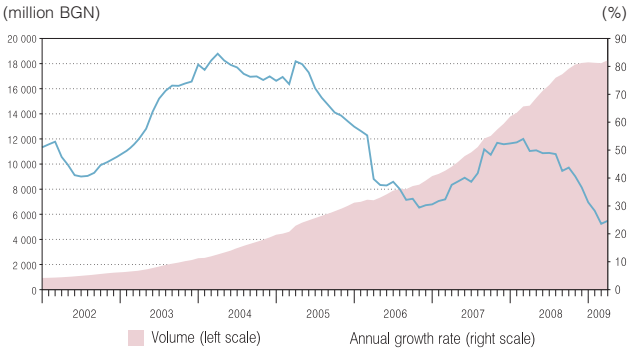
Source: BNB.

Claims on Non-government Sector (Quarterly)

	Annual growth rate, %								Structure as of 31 March 2009
	2007			2008				2009	
	II	III	IV	I	II	III	IV	I	
Claims on non-government sector, incl.:	47.8	55.9	62.5	55.5	52.0	46.6	31.6	24.0	
on non-financial corporations	53.9	61.2	70.2	59.2	53.3	48.8	31.4	23.2	61.6
on households and NPISHs	38.6	48.3	52.4	49.7	49.0	43.7	31.3	24.7	36.5
on financial corporations	46.0	43.9	33.3	56.3	64.7	28.6	44.2	38.8	2.0

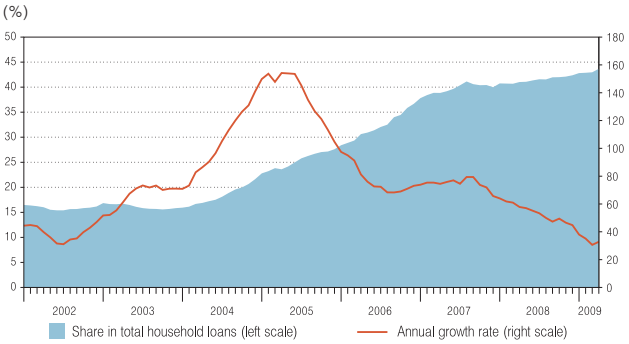
Source: BNB.

Claims on Households



Source: BNB.

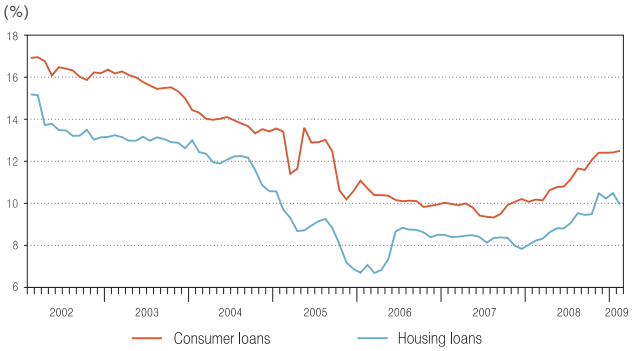
Residential Mortgage Loans



Source: BNB.

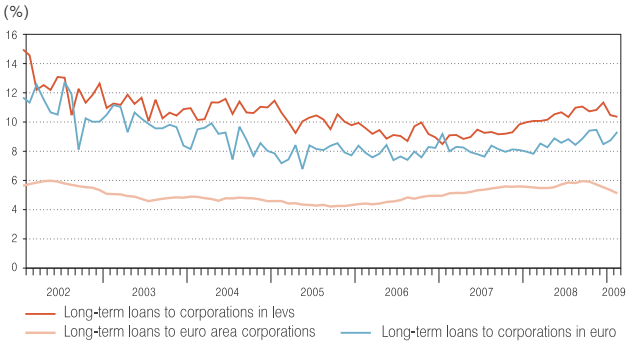
The fall in the price of resources on the interbank money market had a stabilising effect on interest rates on loans. Against the background of reduced lending banks have a significant amount of liquidity, which prevents rates from further rises. The available observations since the beginning of the year are not enough to make more definite conclusions for a change in this trend. Currently, a significant uncertainty exists around lending interest rate dynamics in the coming months. On the one hand, the cut in ECB interest rates on the main refinancing operation of 50 basis points in March and of 25 basis points in April 2009 allows for a decrease in interest rates on loans. At the same time, the uncertain external macroeconomic environment may result in a higher risk premium in interest rates on loans, which will not allow a sizable fall in the price of borrowed funds.

Interest Rates on Newly Extended Household Loans



Source: BNB.

Interest Rates on Long-term Loans in Levs and Euro



Source: BNB.

3. Economic Activity

Real GDP growth in 2008 remained relatively high (at 6 per cent) but the fourth quarter saw the adverse effects of the global crisis on the economic activity in Bulgaria and the growth rate slowed down to 3.5 per cent.

The external demand for Bulgarian goods is expected to further contract over 2009. Worsened international economic situation will affect negatively the investment plans of enterprises. Lower income growth and decreased employment will limit domestic consumption. Imports are expected to moderate faster than exports contributing to the improvement of foreign trade deficit. Rates of economic growth are anticipated to be significantly lower than the potential.

The 2008 real GDP growth in Bulgaria remained relatively high: an average of 6 per cent compared with the previous year. In the first half of the year it reached 7 per cent but from the third quarter of 2008 it tended to slow down in individual economic sectors. Over the fourth quarter when the global financial crisis affected sharply the real sector in all countries worldwide, the economic activity in Bulgaria was also affected by its negative effects. Annual GDP growth moderated to 3.5 per cent.

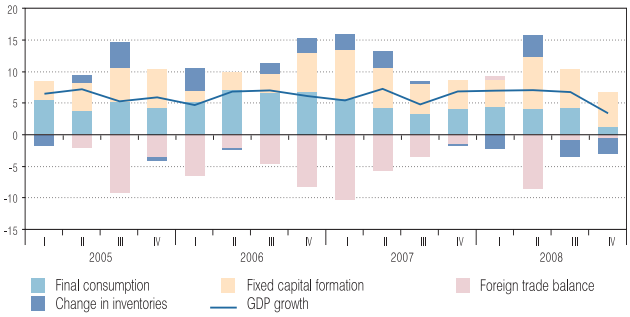
The largest contribution of fixed capital investment to GDP growth, a trend observed in recent years, was sustained in 2008. The average annual gross fixed capital formation went up by 20.4 per cent in real terms, contributing by 6.1 percentage points to economic growth. Over the fourth quarter the investment activity remained high – the physical volume of investments increased by 15.8 per cent on an annual basis and contributed substantially to growth: by 5.4 percentage points.

Final consumer expenditure increased by 4.9 per cent in 2008. Household consumption played a key role in the dynamics of final consumer expenditure, while the government consumption did not contribute to economic growth in 2008. Over the fourth quarter household consumption moderated to 1.5 per cent. The increased uncertainty and more conservative bank lending policy encouraged higher rate of household savings.

Foreign trade balance continued to contribute negatively to real GDP growth in 2008. However, compared with previous years the contribution was lower (-2.3 percentage points). Since mid-year both imports and exports annual growth have been slowing down. In the fourth quarter both indicators posted a decrease in nominal and real terms compared with the last quarter of 2007.

Contribution to GDP Growth by Component of Final Consumption (Quarterly)

(%, percentage points on the corresponding period of previous year)



Source: NSI.

Unfavourable developments in external demand affected exports of Bulgarian enterprises in the second half of 2008. Given the sizable share of exported output by manufacturing industry, this sector began experiencing the negative effects of the global economic crisis in the third quarter of 2008 and the value added in manufacturing in the fourth quarter declined by 5 per cent annually in real terms. As a result of the negative growth in the second half of the year the real value added growth in the manufacturing in 2008 slowed down to 1.9 per cent. Preliminary data on sales and output in industry in January and February reveal that industries providing raw materials for construction also faced difficulties.

Agriculture contributed substantially to the strong developments in value added. Following the reduction in agricultural production in 2007 and given favourable weather conditions in 2008 the sector reported a recovery of production volumes. In 2008 the sector's value added growth was 26.7 per cent.

The services sector rose by approximately 6 per cent in real terms in 2008 with financial intermediation contributing most substantially by 3.6 percentage points. In the fourth quarter the annual real growth of value added in services slowed down to 3.8 per cent (6.8 per cent for the first nine months of 2008).

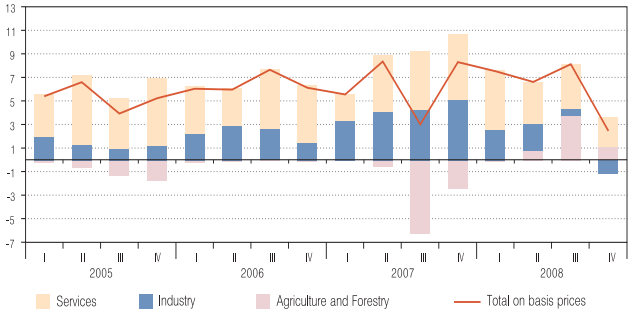
The lower rate of household consumption growth by the end of 2008 affected the value added growth in trade which slowed down from 5.6 per cent in the first nine months of 2008 to 1.6 per cent in the fourth quarter.

Construction and real estate operations and business services retained their high growth rates in 2008: 8.5 per cent and 5.5 per cent respectively. However, over the last quarter the annual growth rate went down to 4.4 per cent and 0.6 per cent respectively.

Further deepening of global economic crisis led to a reduced external demand for Bulgarian goods over the current year. Worsened international economic situation, uncertainty of investment outcomes coupled with more expensive and difficult access to financing will negatively affect the investment plans of enterprises. Weaker activity in construction will also contribute to the slowdown of investment in 2009. The expected lower income growth and decreased employment will limit domestic consumption. Given the relatively high import component in investment and consumer expenditure, imports will decrease faster than exports. Net exports will contribute positively to GDP developments. Production capacity utilization will moderate and the expected economic growth rate will be lower than the potential as a result of weakened external and domestic demand.

Value Added Growth and Contribution by Sector

(%, percentage points on the corresponding period of previous year)



Source: NSI.

GDP by Component of Final Consumption (Real Rate)

(%, on corresponding period of previous year)

	2007				2008			
	I	II	III	IV	I	II	III	IV
Consumption	6.0	5.0	4.2	4.5	4.7	4.8	5.4	1.4
incl.								
Household consumption	7.8	6.1	5.1	2.7	6.5	5.4	6.5	1.5
Final government consumption expenditure	-1.2	-1.0	2.3	8.5	-2.9	4.1	-0.3	4.6
Collective consumption	-2.7	0.7	-2.5	13.3	-5.8	0.3	0.9	-1.5
Gross fixed capital formation	35.9	24.7	19.7	14.0	15.5	28.6	22.3	15.8
Exports of goods and non-factor services	3.7	5.3	5.4	6.0	9.2	5.1	3.8	-6.0
Imports of goods and non-factor services	14.7	11.1	9.3	5.7	5.8	13.7	4.2	-3.2
Real GDP growth	**5.5**	**7.3**	**4.9**	**6.9**	**7.0**	**7.1**	**6.8**	**3.5**

Sources: NSI, BNB.

Household Behaviour

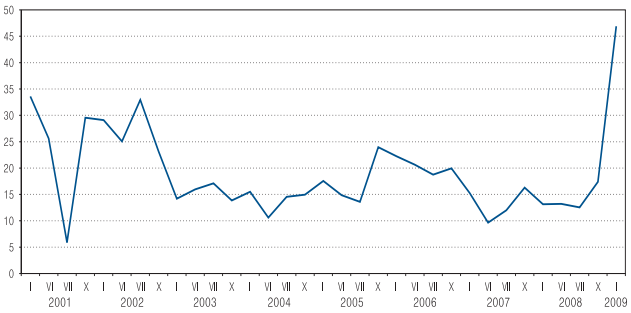
The stable household consumption growth in the first nine months of 2008, a result of the increasing real disposable income, was reversed by the end of the year. In the fourth quarter household consumption slowed down to 1.5 per cent, with consumption of non-food products and net expenditure on travelling abroad having a negative contribution. At the same time retail trade in food products posted an increase on an annual basis. Current statistical data show that expenditure on non-food products and travelling abroad tended to further decline in early 2009. Retail sales of household appliances, furniture and other household goods, as well as sales of computer and communications equipment and automobiles registered a significant decline on an annual basis during the first two months of the current year. In February sales in the remaining retail trade groups, with the exception of food products and pharmaceuticals, also exhibited a decline.

By the end of 2008 and in the first two months of the current year Bulgarian citizens reduced their trips abroad: their number went down by 27.7 per cent on an annual basis. Visits of foreigners decreased by 10.3 per cent on a year earlier basis.

The reason behind lower consumption growth was the increased rate of savings by households. This is evidenced by household budgets survey data. In the fourth quarter of 2008 real income increased by 3.5 per cent, including the real monetary income by 8.7 per cent. Household real income continued to increase in the first two months of 2009. Between January and February it rose by 5.7 per cent on an annual basis. Although the contribution of property income and self-employment income tended to be negative from mid-2008, remuneration income supported the real growth of total household income. The faster increase in income compared with expenditure reveals increased propensity to savings due to uncertainty as regards future income and relatively higher lending and deposit rates by the end of 2008 and early 2009.

Unemployment Expectations

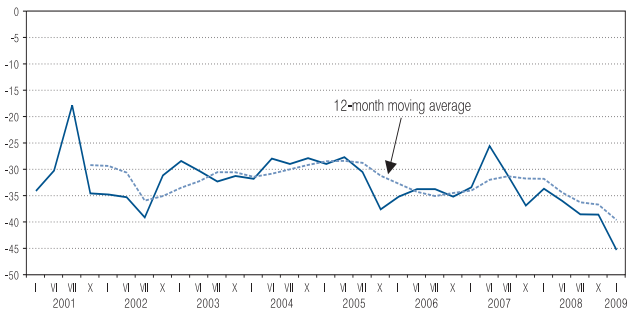
(balance of assessments)



Source: NSI – Consumer Survey.

Households Confidence Indicator

(balance of assessments)



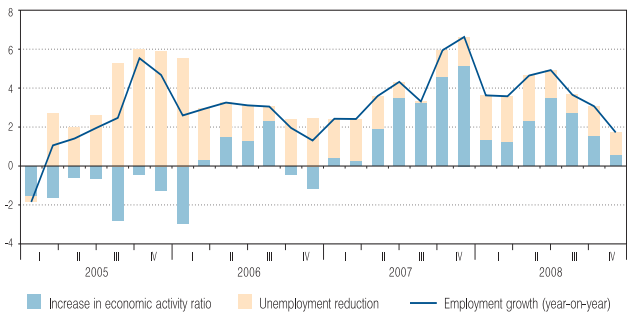
Source: NSI – Consumer Survey.

Consumer confidence in January 2009 decreased due to negative expectations about future economic situation and the unemployment level reflecting deepened economic crisis. Increased uncertainty impacted household savings decisions. Consequently, consumers postpone some purchases of durable goods and revise their plans for their major expenses (furniture, household devices, etc.). On the other hand, assessments of consumers about their financial state and the expectations of their future financial state improved which probably reflect the current inflation and inflation expectations slowdown for the following 12 months. The more favourable assessment of household financial performance confirms that reduced consumer expenditure does not reflect financial difficulties but it is a result of higher household propensity to save.

Household income dynamics depend to a great extent on labour market developments. In 2008 employment and labour income continued to increase. Over the last quarter of 2008 the employment rate was 64.3 per cent (against 62.9 per cent in the fourth quarter of 2007). The impact of the global crisis on Bulgaria's economy over the last quarter of 2008 led to zero growth of employment in industry, lower annual growth rate of labour income in the sector, as well as to a slight decrease in the ratio of vacancies in the entire economy. These indicators show that the trend toward enhanced demand for free labour recently observed was reversed. Data on registered unemployment show the first signals of future rise in unemployment. In February and March it went up to 6.7 per cent and 6.9 per cent respectively compared with the previous month which was atypical of recent years. These developments will contribute to limiting consumer expenditure in 2009. On the other hand, the lower inflation rate will help retain the purchasing power of incomes.

Sources of Employment Growth

(%)



Source: NSI – Labour Force Survey.

Employment and Income Dynamics (Quarterly)

(% on corresponding period of previous year, unless otherwise indicated)

	2007				2008			
	I	II	III	IV	I	II	III	IV
Employed	4.9	3	2.1	1.6	3.3	2.9	2.8	2.6
Real wage	11.8	14.2	11.6	10.8	10.7	8.9	8.9	10.2
Wage fund	17	17.2	13.7	12.1	14.1	11.7	11.8	12.7
Unemployment at the end of the period, % of the labour force	8.9	7.4	6.8	6.9	6.8	6.0	5.8	6.3

Sources: NSI – Enterprise Survey, Employment Agency.

Real Consumer Demand Dynamics (Quarterly)

(percentage growth in real terms on corresponding period of previous year)

	2007				2008			
	I	II	III	IV	I	II	III	IV
Consumer spending *per* household member	10.6	12.0	8.9	6.5	6.5	1.8	1.7	-0.7
Retail sales	13.8	13.1	8.4	9.0	11.3	7.7	4.4	-1.2
Income from retail trade,	23.4	21.1	17.2	15.7	7.8	5.3	2.2	-1.2
incl.								
Food, drinks, tobacco	17.8	18.2	11.9	10.0	4.6	0.0	2.4	4.6
Universal stores offering varied goods	38.9	34.2	32.2	35.7	11.9	13.6	8.1	3.8
Automobile fuels and lubricants	17.7	14.1	6.8	2.8	3.4	4.0	0.8	-5.9
Pharmaceutical and medical goods, cosmetics and toiletries	10.2	8.7	12.7	10.6	11.8	7.8	5.0	5.6
Textile, clothing, footwear and leather	22.1	15.0	23.7	23.7	22.9	13.1	2.3	0.1
Household goods and home appliances	40.3	38.6	34.0	31.5	10.2	5.8	1.3	-1.7
Computers and communication equipment	32.6	23.8	21.4	24.2	13.2	12.2	3.8	-4.5
Out of stores	12.0	12.8	11.2	11.4	0.0	-1.6	0.7	-1.5
Income from trade in automobiles and repairs	37.7	36.1	34.6	34.4	22.6	13.5	10.5	-4.6

Source: NSI Household Budgets and Domestic Trade Survey.

Government Finance and Consumption

The downward trend in economic growth in 2009 result in expectations of lower growth in the budget revenue compared with the expenditure. The contribution of government consumption to real GDP growth is expected to be close to zero and the budget balance is anticipated to decrease as a share of GDP on an annual basis but to remain positive over the projected horizon.

Over 2008 the consolidated fiscal programme surplus came to BGN 1989.8 million or 3 per cent of reported GDP for the year. Despite the slowdown in receipts on the consolidated budget by the close of 2008, total revenue picked up by 13.5 per cent annually. Tax revenue rose by 14.7 per cent irrespective of more moderate income growth in the economy observed since mid-2008. As a result of increased fuel and tobacco excise rates, excise receipts exhibited the highest growth (22.2 per cent on an annual basis) in the group of indirect taxes. Despite the registered slowdown in VAT receipts, the annual revenue grew by 13.4 per cent over 2008.

Total expenditure on consolidated budget (EU budget contribution included) increased by 14.6 per cent on an annual basis. Current expenditure (EU budget contribution included) rose by 16 per cent per annum, reflecting mostly the indexation of pensions and wages and the funds of the extraordinary social package from the budget launched by the end of 2008. Capital expenditure reported an increase by 18.1 per cent which is mostly attributable to the investment spending in the fourth quarter related to the additional funds allocated for infrastructure projects, a part of the plan for distribution of additional budgetary loans approved by the Parliament. Despite the increase

in the expenditure side of the budget the real growth of government consumption and the government sector contribution to this increase remained close to zero in the second half of 2008.

The consolidated fiscal programme balance for the first two months of 2009 was positive amounting to BGN 587.6 million, up by BGN 12.9 million on the corresponding period of 2008.

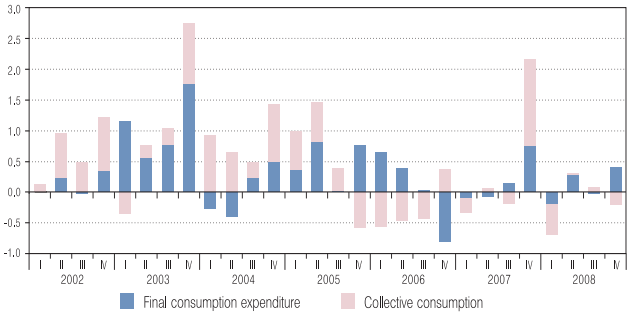
Government revenues in January and February 2009 picked up by 9.9 per cent on an annual basis. This was mostly ascribable to significantly increased aids by BGN 347.6 million on an annual basis. Tax revenue posted an annual rise by 1.2 per cent. Direct taxes exhibited annual growth of 11.7 per cent and indirect taxes 2.5 per cent. On a year earlier basis VAT receipts in January and February 2009 fell by 4.6 per cent, reflecting mainly the reduced volume of imports and lower prices of fuels and raw materials in the international markets. Despite the higher excise duties in some commodity groups, since early 2009 excise revenue has exhibited a slight increase by 2.4 per cent on an annual basis.

Expenditure on consolidated budget (EU budget contribution included) went up by 12 per cent on an annual basis in January and February 2009 consistent with the increase in all major expenditure elements. Similar growth rate (12.8 per cent on an annual basis) was also reported in current non-interest expenditure (EU budget contribution included). Interest payments posted a 2 per cent decline, and capital expenditure increased by 17.8 per cent on an annual basis. As of February 2009 Bulgaria's contribution to the EU budget rose by BGN 13.3 million on the corresponding period of the previous year.

The 2009 expectations are for lower growth in revenue compared with budget expenditure. Government consumption contribution to real GDP growth is anticipated to be close to zero in the second and third quarter of 2009. The budget balance is expected to decrease as a share of GDP on an annual basis but to remain positive over the projected horizon.

Contribution of Government Final Consumption Expenditure and Collective Consumption to Economic Growth (Quarterly)

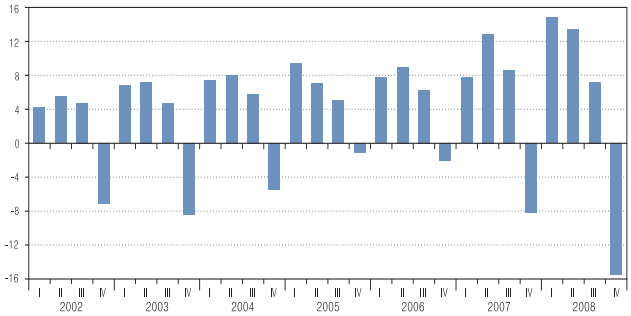
(%)



Sources: NSI, BNB.

Primary Balance (Quarterly)

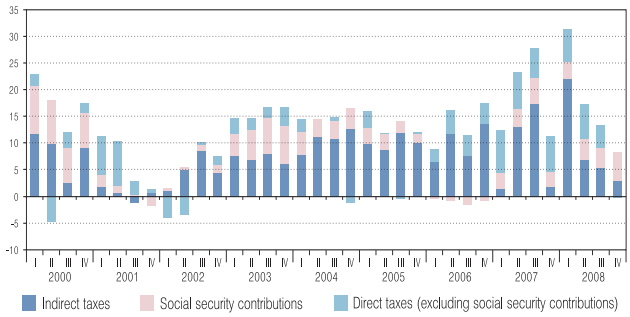
(share of GDP for the quarter, %)



Sources: MF, BNB.

Contribution of Major Tax Groups Growth to Tax Revenue Growth under the Consolidated Fiscal Programme (Quarterly)

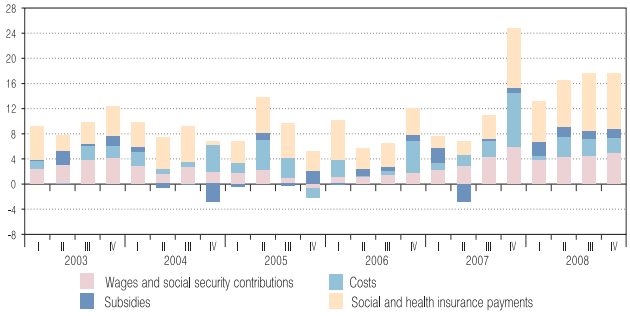
(%)



Sources: MF, BNB.

Contribution of Major Groups of Current Non-interest Expenditure to Total Growth (Quarterly)

(%)



Sources: MF, BNB.

External demand decreased significantly directly affecting export capacity of Bulgarian industrial enterprises. Construction and the industries related to it, as well as real estate operations slowed down.

Companies most strongly affected by the global economic crisis managed to partly mitigate the negative effect on their financial performance by reducing expenditure. As a result, the financial performance of enterprises remained relatively good. Labour market flexibility and government protection measures against unemployment will cushion the negative effects of the crisis on the state of the labour market.

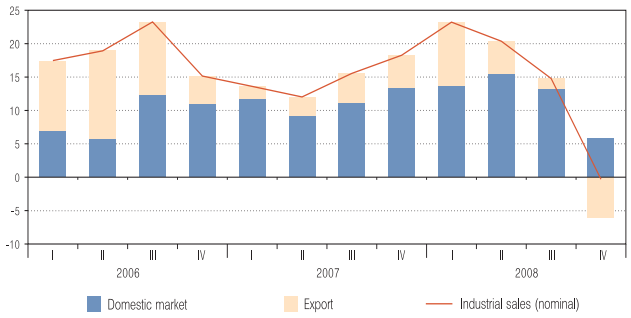
Deepened global economic crisis by the close of 2008 and in early 2009 prompted a significant decline in external demand directly affecting export capacity of Bulgarian industrial enterprises. In the third quarter of 2008 problems in the industrial sectors were limited mostly to the fall in production activity in metallurgy, while in the fourth quarter of 2008 and in the January-February 2009 period most industrial sectors reported a lower nominal turnover and weaker production on a year earlier basis. The exception was the production of food which in principle is not strongly correlated with the business cycle. The production in food industry was also supported by the restored agricultural output in 2008.

Industries experiencing difficulties to sell their output in international markets since mid-2008, that is textile and clothing, metallurgy, machinery and production of spare parts and automobile accessories, were most strongly affected by the weak external demand.

Monthly data on industrial sales earmarked for exports confirm that the slowdown in industrial production growth reflects the unfavourable external environment. Between October 2008 and February 2009 the nominal annual decline in the turnover of industrial enterprises in the international market continued: from -12 per cent in October to -30 per cent in February. Domestic market turnover decreased in the fourth quarter of 2008 but remained positive (8 per cent), while in January and February it went down by 3.8 per cent and 10.6 per cent respectively. The sectors *manufacturing products of rubber, plastics and other non-metal mineral products and metallurgy*, which are closely related to construction as they provide materials for intermediate consumption, exhibited strongly negative annual growth in the first two months of 2009.

Industrial Sales Growth

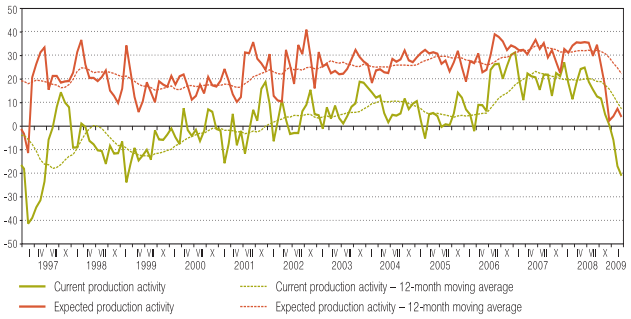
(% on corresponding quarter of previous year)



Sources: NSI, BNB.

Business Climate in Industry

(balance of assessments)



Source: NSI.

As a result of weaker external demand Bulgarian companies faced the need of mitigating the negative impact of lower sales on their financial performance. The main instrument for limiting the negative effects of the worsened external environment was to reduce expenses. As expected (see also Economic Review, 2008, issue 4) lower prices of raw materials contributed to reducing the adverse effect of the lower demand on enterprises. The gross production deflator rose faster than intermediate consumption in all economic sectors and particularly in manufacturing in the fourth quarter. As a result, the value added in manufacturing posted a nominal increase by 6.8 per cent in the fourth quarter (against 2.2 per cent nominal growth in gross output for the same period).

However, in the fourth quarter the intermediate consumption expenditure at constant prices remained at levels close to those in the corresponding period in the previous year, while gross output went down by 0.7 per cent. The retained level of expenditure against the background of a declining turnover was probably attributable to a certain fixed component in it which decreases its elasticity in respect of production activity.

Wage expenditure in manufacturing comparatively quickly reacted to the lower production activity. The nominal annual growth slowed down from 24.8 per cent in the first nine months to 16.3 in the fourth quarter. Labour cost flexibility reflects to the largest extent the flexible forms of remuneration in manufacturing enterprises bound by labour productivity.

Reduced wage costs and higher value added deflator in manufacturing[10] resulted in lower growth of real unit labour costs (7.3 per cent on an annual basis in the fourth quarter). Despite companies' efforts to mitigate the negative impact of the weak demand on the financial performance, the operating surplus in manufacturing declined by approximately 10 per cent in the fourth quarter compared with the same period of 2007, and its share in the total value added fell to 30 per cent (38 per cent in the first nine months of 2008). The sustained positive operating surplus and the limited annual decrease to 10 per cent suggest that the financial performance of manufacturing enterprises deteriorated in the last quarter but remained relatively good against the background of the worsened situation in international markets.

The business survey in industry also reveals the adverse effect of weaker external demand on the financial performance of enterprises. Global economic indicators have worsened progressively from November 2008. The production assured with orders for exports for industry is continuously declining which influences the current assessment and expectations of production activity and business situation in the industry. As of early 2009 expectations of entrepreneurs in industry remain at the low levels reached at the end of 2008, while the assessments of current situation further deteriorate. This suggests that managers expect no further worsening of the economic situation in the future.

The declines in external demand and high degree of uncertainty have changed the assessments about constraints to industrial enterprises' activity. Given the worsened assessment of production assured with orders an increasing number of companies (about 30 per cent) points to the insufficient demand as an obstacle to business development. However, business concerns about uncertainty of economic environment appear to be even stronger and more significant constraint to enterprises in the sector: in March 2009 more than 50 per cent of the respondents pointed to this factor as one having dissuasive effect on their activity. The financial performance was determined as an obstacle by approximately 20 per cent of the respondents but irrespective of the slight increase since November its significance remains far below the long-term average for the sector. The conclusion drawn on the basis of national accounts, that despite worsening the financial performance of companies is comparatively good, has been confirmed. Enhanced uncertainty will probably force some of the companies to postpone their more ambitious investment projects and their intentions to hire more employees. To this end, in November and December 2008 the significance of insufficient labour force as an obstacle to business development dramatically declined, and the companies planning to hire additional staff were just 5 per cent in January 2009 (against 11 per cent a year earlier).

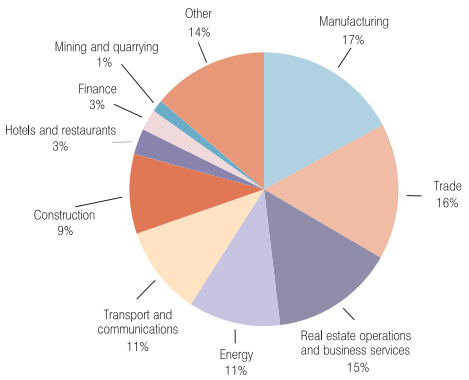
Investment decisions of industrial enterprises depend on the degree of production capacity utilisation which is closely related to production activity. Between mid-2006 and end-2008 along with accelerated production activity, enterprises' available production capacities were more intensively utilized and the indicator approached 80 per cent. Data on production capacity utilisation in January show a slight decrease in this indicator from about 75 per cent to 70 per cent. This fall pertains to the reduced share of enterprises utilising the available production capacities at levels between 90 and 70 per cent at the expense of the increased share of companies operating under 70 per cent of their production capacity. Despite the decrease in total degree of production capacity utilisation, the share of industrial enter-

[10] Higher value added deflator in the fourth quarter is a result of the double deflation methodology for calculating GDP indicators using the output method whereby in case of faster growth in the price index of final output compared to the dynamics of price indices of intermediate consumption, the value added deflator is higher than the output deflator.

prises utilising the available capacity at over 90 per cent remained approximately 30 per cent in early 2009. This suggests that the bulk of enterprises utilised their entire production capacity and the sustained investment activity in industry by the close of 2008 partly reflects the increase in production capacities in these companies.

All sectors are characterised by modernisation of production capacities. Contributions by sector to expenditure growth on acquisition of fixed assets in 2008 were relatively equal in nominal terms. The broad-based nature of expenditure growth on fixed assets will mitigate the negative effect on total investment activity if investment in an individual economic sector moderates. In the fourth quarter spending on acquisition of fixed assets grew by 25.8 per cent on annual basis. In most sectors the high investment activity was sustained. Slower annual growth in investment compared with previous years' growth was reported in *construction, real estate and trade*, probably reflecting weaker demand in these sectors in the fourth quarter of 2008.

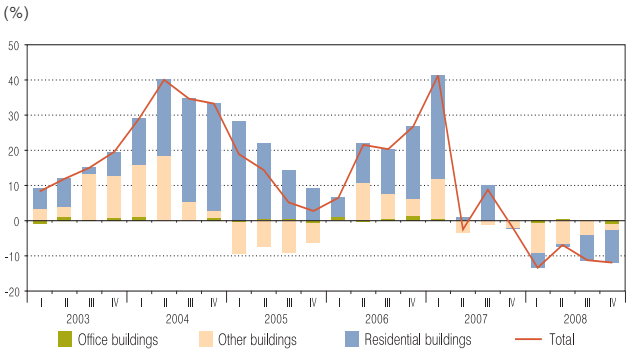
Structure of Expenditure on Acquiring Fixed Assets by Economic Activity in 2008



Source: NSI.

In line with expectations construction activity in the last quarter of 2008 posted lower annual growth, with value added rising by 4.4 per cent. Preliminary data on construction output in January and February reveal a fall in construction activity by 6.1 per cent and 5.8 per cent on an annual basis respectively. Sentiments and expectations of business managers in the sector in December worsened stronger than usual for this season. The number of issued construction permits continued to follow its downward trend of end-2007, supporting the expectations of more moderate construction activity in the future. Based on managers' assessments in the sector the orders inflow has dramatically declined since December 2008.

Annual Growth of Permits Issued for Construction of New Buildings



Source: NSI.

Lending for new house purchases also substantially moderated in the second half of 2008 and in the first two months of 2009. New residential mortgage loans extended between July 2008 and February 2009 decreased by 38.5 per cent compared with those a year earlier. The decline continued to reach 75.4 per cent in February.

Parallel to the worsening of orders inflow, the assessments of the current production activity and expectations of the future construction activity, as well as the plans for increasing or retaining the existing staff have become more pessimistic. The number of customers with delayed payments also rose, with the share of firms experiencing the same problem increasing to levels close to those in the period from 2000 to 2001 which preceded the sector's brisk performance. Despite all unfavourable trends, construction enterprises assess the current situation as comparatively favourable: just about 11.7 per cent of them assess their business situation as poor. The level of the gross operating surplus continued to rise on an annual basis in the fourth quarter as well, which indicates the profits reported by this sector.

As in other sectors, the uncertain economic environment in construction is the most important impediment to development, and in March 2009 66 per cent of the respondents assumed this factor as driving. Similar to the developments in manufacturing, lower material prices are beneficial for business which is seen in the decreasing importance of material prices to business activity.

Since the fourth quarter of 2008 average housing prices have registered a decline on a chain basis, with a 12.4 per cent fall in the first three months of 2009. This trend is expected to continue in the coming periods due to weaker demand, lower material costs and potential decreases in high profits which were registered in previous periods.

Both nominal and real unit labour costs in construction continued to rise at high rates throughout 2008. The expected slowdown in construction activity in the following periods will subdue the accelerated growth in wage costs in this sector. However, part of the actual adjustment in wages may not be reported due to the existing shadow employment in the sector.

March saw an improvement in the business climate in construction following the dramatic worsening in December. However, it should be borne in mind that this slight improvement contains a considerable seasonal component associated with better weather conditions.

The economic activity in the services sector remained high in the first nine months of 2008. Over the fourth quarter value added growth in *trade* and *real estate operations and business services* moderated to 1.6 and 0.6 per cent as a result of more modest demand in these sectors. Services other than predominately state owned sectors retained their positive growth in 2008 thanks to the sustainable domestic demand driven by the increasing wages and employment in economy.

Financial intermediation had the most significant contribution to value added growth in 2008. This sector's efficiency continued to improve over the year which prompted a rapidly growing labour productivity (almost 16 per cent on an annual basis) and a 6 per cent decline in intermediate consumption expenditure in real terms against a real rise in the turnover by more than 20 per cent. Value added in this sector increased by 24 per cent in real terms over the fourth quarter of 2008. At the end of 2008 banks adopted a more conservative lending policy which is expected to be also maintained in 2009. Nevertheless, financial intermediation is expected to continue intensifying, albeit at lower rates, reflecting the stability of the banking system and long-term strategic interests of financial institutions operating in Bulgaria.

In December 2008 business environment in retail trade and other services worsened dramatically followed by stabilisation in the balance of opinions. March saw a slight improvement which is likely to reflect adjustments in response to the very sharp decline in December. As in other sectors, the uncertain economic environment is the most important impediment to business developments, with the number of firms with financial disturbances increasing insignificantly. In the fourth quarter the operating surplus in other services rose by 10.4 per cent on an annual basis. Over the same period gross operating surplus in trade fell nominally by 6 per cent on an annual basis, but its share in value added remained high at 58.4 per cent (65.7 per cent a year earlier). These data confirm the retention of comparatively good financial state of the firms in *trade and other services*. The worsened expectations in retail trade concerning orders to foreign suppliers support expectations of lower consumer demand for imported goods (see the *Household Behaviour* subsection).

The worsened unit labour costs in the whole economy over the fourth quarter are primarily due to the stronger increase in the wage bill of *trade and operations in real property and business services* sectors compared to value added growth. Given the expected weaker demand in these sectors, firms are likely to review their expenditure policies along with limiting labour costs in 2009. Maintaining high growth in wage costs of the public sector also contributes significantly to higher unit labour cost over the fourth quarter. Statements for pay freezes in the budgetary sphere will contribute to lower rates of wage growth in the whole economy.

Changes in labour legislation effective as of early 2009 provide for extending the period of reduced working hours from three to six months in case of a temporary decrease in orders and production activity of enterprises. The national action plan on employment for 2009 provides for extra measures directed at overcoming the negative effects on the labour market. Persons working part-time are eligible to receive 50 per cent of the minimum wage for a period of three months in order to compensate the decrease in labour income. Furthermore, subsidies for employers who hire unemployed and those made redundant due

to restructuring or insolvency/liquidation of enterprises are envisaged. The overall assessment of labour market flexibility along with the above measures give grounds to expect that limiting labour costs in near future will materialize mainly in lower growth in wages combined with a moderate drop in employment.

The Impact of the Global Economic Crisis on the Bulgarian Economy

Since the end of 2007 until mid-September 2008 the global economic crisis had limited impact on the Bulgarian economy.

- The first effect of the crisis was observed on the Bulgarian Stock Exchange with a downward trend of indices and decreasing daily turnover since October 2007 due to global uncertainty and reduced liquidity. SOFIX-index lost nearly 70 per cent of its value between October 2007 and mid-September 2008.
- The increased international risk perceptions and lower liquidity affected the interbank money market, where spreads started to increase versus interest rates in the euro area from the last quarter of 2007. By October 2008 the spread between LEONIA and EONIA was approximately 250 basis points against the level of under 20 basis points in the middle of the previous year. A similar pattern was observed in the dynamics of lending and deposit rates.
- Banks operating in Bulgaria and those abroad started tightening lending conditions and standards and increasing lending rates. In Bulgaria, banks' claims on the non-government sector increased by 12.4 per cent at the end of the second quarter of 2008 (against the first quarter), and by 7.1 per cent in third quarter (against the first half-year).
- The fall in a number of international commodity and fuel prices since the second half of 2008 contributed to the rapid decrease of inflation in Bulgaria.

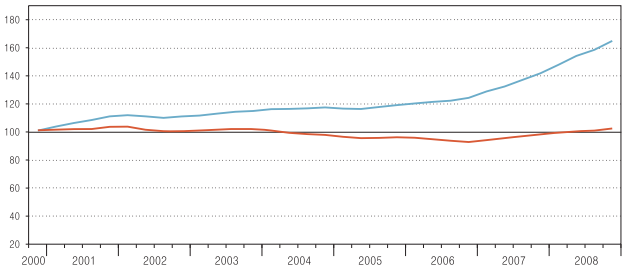
Since September 2008, following Lehman Brothers default, the global financial crisis grew into global economic crisis and the severity of the slowdown in economic activity in advanced economies was defined as the strongest in terms of scope and scale after the Great Depression of 1930s. The decline in the volume of world trade and global output markedly affected Bulgaria's economy:

- The industrial export sales dropped significantly. Production assured with orders for industry exports is deteriorating, suggesting that economic activity in the sector will remain low in the following periods. Production capacity utilisation of industrial enterprises decreased from about 75 per cent in 2008 to less than 70 in the first months of 2009.
- The increasing uncertainty of the economic environment appears to be the most serious constraint to business development in all economic sectors forcing some of the companies to postpone their investment projects and the intentions to hire more employees.
- Consequently, consumers react to the uncertainty about future income by postponing some purchases of durable goods and home repairs, increasing the savings rates accordingly.
- As a result of the weaker domestic, consumer and investment demand imports started to decline. Between December 2008 and February 2009 imports exhibited a faster decline than exports which helped improve the balance of payments current account trade balance. This trend is expected to be sustained in the following months.
- Companies face the challenge of flexibly reacting to the worsened external environment and lower external demand by decreasing production costs. Boosting production efficiency is the only instrument for companies to counteract the crisis. International commodity and fuel prices, declining dramatically in 2008 against 2007, contributed to the decrease in companies' intermediate consumption costs. The reduction of labour costs is another instrument for flexible cost management.
- Banks continued to tighten lending standards and conditions. Concurrently, the uncertain environment and revision of consumption and investment plans by non-bank institutions and households lead to lower demand for loans, particularly long-term and investment loans.
- In the first months of 2009 budget revenue growth did not meet the expectations. This entails additional reduction of costs over the buffers projected in the State Budget Law.
- As a result of weaker external and domestic demand the expected economic growth rate will be significantly lower than the potential.

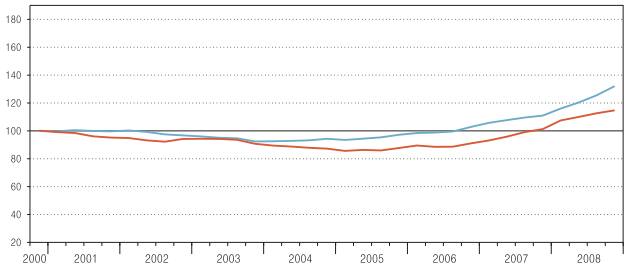
Unit Labour Cost (Quarterly)

(2000 = 100)

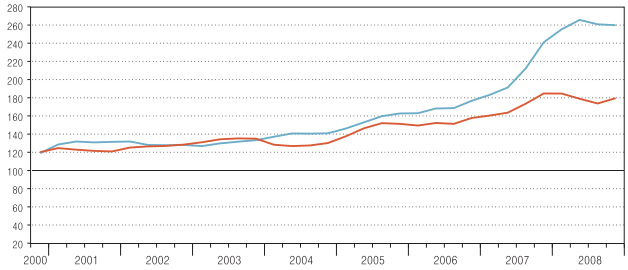
Total for the Economy



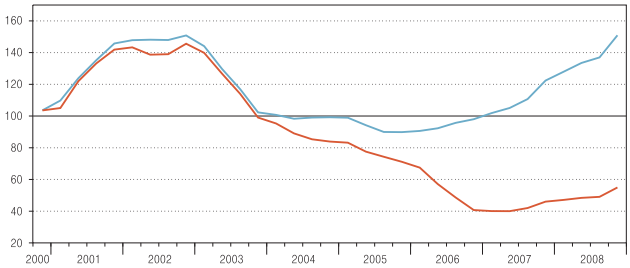
Manufacturing



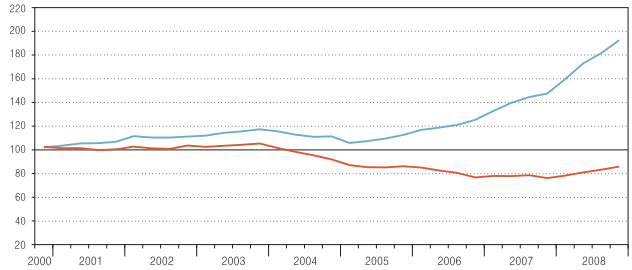
Agricultural Sector



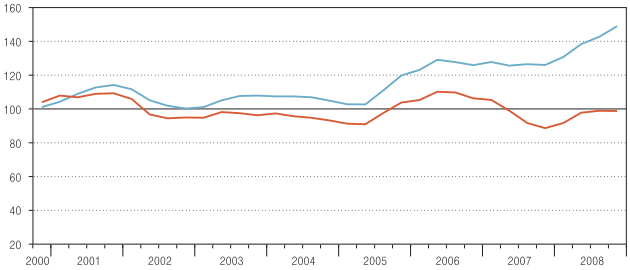
Mining and Quarrying



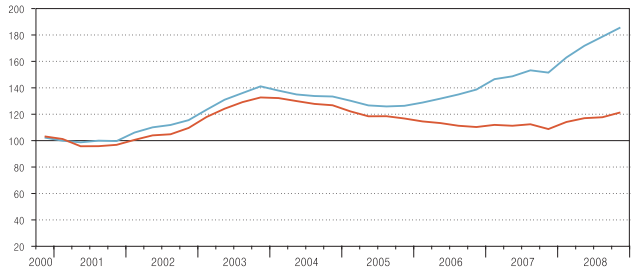
Construction



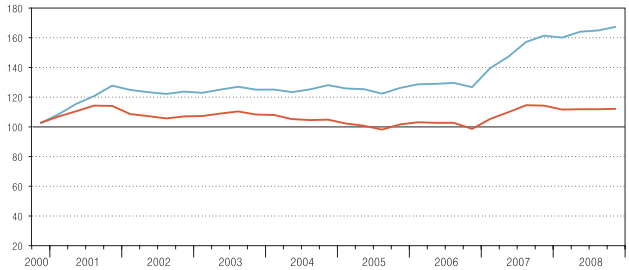
Electricity, Gas and Water Supply



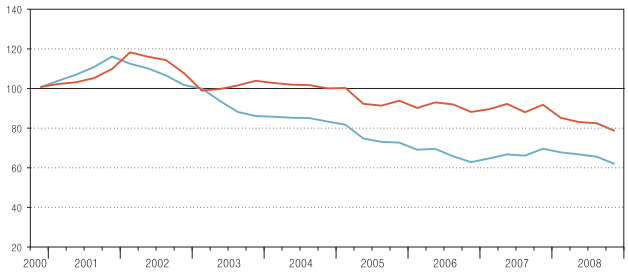
Trade



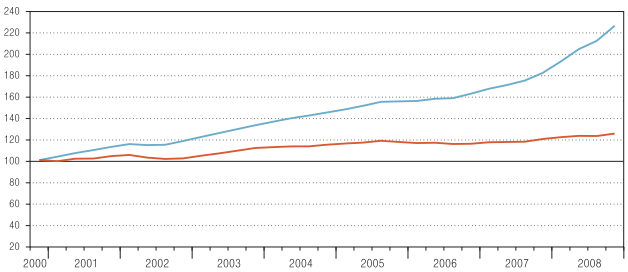
Transport and Communications



Financial Intermediation



Other Sectors



Four-quarter moving average (nominal)
Four-quarter moving average (real)

Note: The methodology of computing unit labour costs has been changed and complies with ECB methodology. Nominal unit labour costs are computed as a ratio of compensation *per* employee and labour productivity (real value) *per* employee. Real unit labour costs are computed using the same formula but labour productivity *per* employee is based on nominal value added.

Sources: NSI, BNB.

Exports and Imports of Goods

In the second and third quarters of 2009 negative export and import growth rates are expected due to the continued economic crisis in the world and especially in our major trading partner, the EU countries. A faster decline in imports compared to exports is expected, which will decrease the trade deficit.

Despite the export and import growth rates at 13 and 16 per cent respectively in 2008, the deepening global economic crisis and significantly worsened economic outlooks in the European market led to a dramatic slowdown in the dynamics of foreign trade flows to Bulgaria in the last two months of 2008 and early 2009.[11] In November 2008 export growth was negative at -15.1 per cent on November 2007, and imports registered an 11.3 per cent decrease. In December 2008 and the first two months of 2009 this trend continued, with imports declining faster than exports (in January exports fell by 28 per cent and imports by 33 per cent, while in February exports decreased by 27 per cent and imports by 32 per cent).

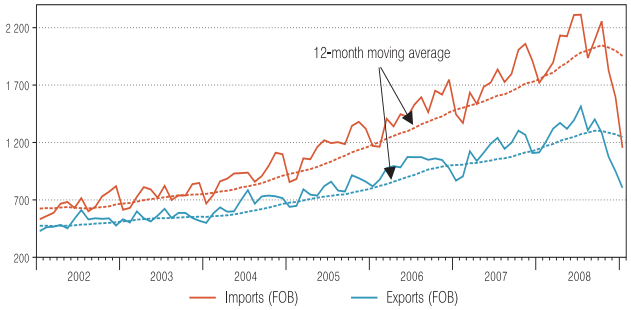
Despite the world trade and demand declines in countries which are Bulgaria's major partners, the market share of Bulgarian goods in total imports of Community Member States continued to rise and reached 0.59 per cent in the fourth quarter of 2008 (on an annual basis) against 0.57 per cent a year earlier.

According to preliminary data, in 2008 goods exports in euro reached EUR 15,278 million, a nominal growth of EUR 1765.6 million, or 13.1 per cent on the previous year. Imports (FOB) comprised EUR 24,035.8 million in 2008, and the nominal increase came to EUR 3278.6 million or 15.8 per cent compared with 2007. Groups by use which reported a more pronounced drop in exports and imports in the last two months of 2008 and in January 2009 include *mineral products and fuels*, and *raw materials*. The mineral product and fuel group traditionally shows a procyclical pattern. In the raw material group, exports fell due to external demand contraction and price decreases, while the import fall is driven by both lower prices and reduced exports of investment and consumer goods.

Over the January to December 2008 period energy resources and consumer goods contributed most (by 8.1 and 6.8 percentage points respectively) to trade deficit growth (by EUR 1513 million). In the first group, oil product imports rose, reflecting high international oil prices. In 2008 the average price of imported crude oil in euro increased by 34.7 per cent on 2007, and imported oil products rose by 1.4 per cent. In the consumer goods group, due to the weak external demand, a decline was observed in exports of drink, clothing and footwear, medicines and cosmetics, more pronounced in the last two months of 2008. Dynamics in exports of raw materials for the food industry and imports of textiles contributed to the reduction in trade deficit. Exports of raw materials for the food industry rose by 139.7 per cent on an annual basis due mainly to high exports in the third quarter of 2008 as a result of the recovery in agriculture. Imports of textiles dropped by 10.6 per cent, reflecting the reduced exports of clothing.

Dynamics of Exports and Imports

(million EUR)



Source: BNB.

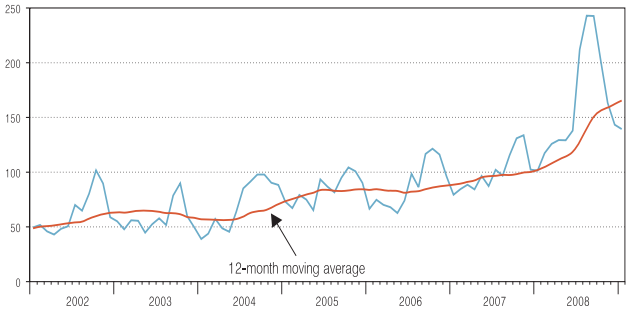
In 2008 all groups excluding *textiles, leather, clothing, footwear* and *other consumer goods*, as well as *wood, paper, pottery and glass* affected positively export growth, with the dynamics of *animal and plant products* (5.2 percentage points), *machines, transportation vehicles and other* (3.6 percentage points) and *mineral products and fuels* (2.8 percentage points) contributing most to this. In 2008 export revenue of the first category amounted to EUR 1950.4 million, up by 61.9 per cent on the corresponding period of 2007. The group's major positive contribution to the total export dynamics was registered by *cereals* (2.7 percentage points) and *seeds* (1.1 percentage

[11] The analysis presented in this section is based on data about nominal exports and imports in euro.

point) due to better harvest in 2008. In both cases, clearly pronounced growth was recorded in the third quarter followed by a slowdown in the fourth quarter of 2008 and in January 2009. Our expectations of animal and plant product exports are for continued moderation due to external demand contraction.

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

(million EUR)

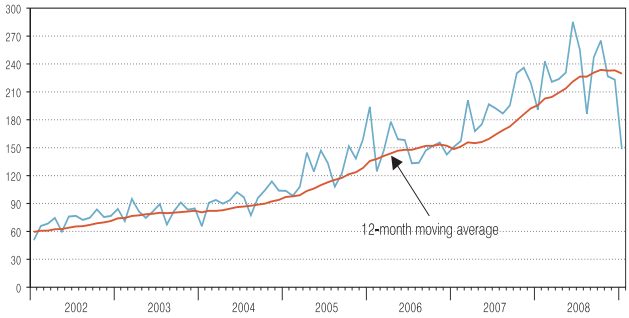


Source: BNB.

Revenue from exports *of machines, transportation vehicles and appliances* increased by EUR 490.8 million (21.2 per cent), with dynamics of *electrical machines and appliances* and *nuclear reactors, boilers, machines, appliances and machinery* contributing most to total growth (by 1.3 and 1.2 percentage points respectively). Due to the worsened international environment, the fourth quarter saw more essential slowdown (4.3 per cent) against 20 per cent in the third quarter and 37.2 per cent in the second quarter. In January 2009 negative growth was reported (-22.2 per cent) which is likely to continue in the projected horizon.

Exports of Machines, Transportation Vehicles and Appliances

(million EUR)

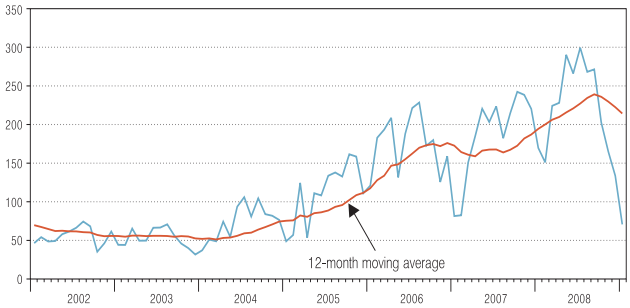


Source: BNB.

Revenue from exports of mineral products and fuels went up EUR 426.3 million (18.9 per cent). Positive developments were registered in almost all major positions in this group except for *ores* (-0.5 percentage points) which experienced more significant declines over the fourth quarter of 2008 and in January 2009, reflecting price falls and external demand contraction. In the *mineral fuels* subgroup, a decrease was also reported in the fourth quarter, but the contribution to annual growth was positive due to high growth rates in previous quarters. In January 2009 this contribution was negative. Mineral products and fuels exports are expected to continue their downward dynamics due to weaker demand and lower prices.

Exports of Mineral Products and Fuels

(million EUR)

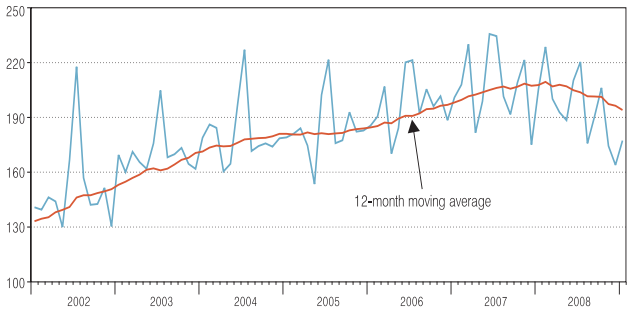


Source: BNB.

Exports of textiles, clothing and footwear had a negative contribution (-1.1 percentage points) to total export growth in 2008. Revenue from exports of textiles decreased by EUR 131.2 million (5.3 per cent) compared with 2007, with the decrease in clothing exports (a contribution of -0.5 percentage points) having the strongest impact on it. Over the projected period the downward trend which had started since early 2007 and continued during 2008 and in January 2009 is expected to be sustained due to restructuring in this industry and the worsened external environment.

Exports of Textile, Clothing and Footwear

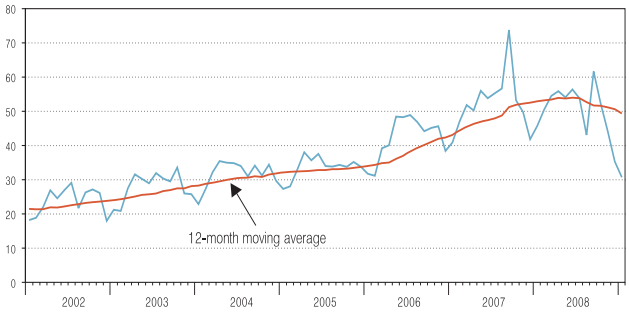
(million EUR)



Source: BNB.

Exports of Wood, Paper, Pottery and Glass

(million EUR)



Source: BNB.

Exports of wood, paper, pottery and glass also had a negative contribution (-0.2 percentage points) to total export growth in 2008. Revenue from their exports decreased by EUR 23 million (3.6 per cent) compared with 2007, with the *wood and wood product* subgroup having the strongest negative contribution at -0.4 percentage points. This subgroup has exhibited negative growth since the fourth quarter of 2007, with the fall deepening in the third quarter of 2008 and moderating in the fourth quarter due to the base effect. It worsened again in January 2009. Over the projected period this fall is expected to continue due to external demand contraction.

Contribution of Commodity Groups to Trade Growth, January – December 2008

	Exports		Imports	
	growth, %	contribution, p.p.	growth, %	contribution, p.p.
Consumer goods	6.1	1.5	21.4	3.5
Raw materials	11.3	5.1	8.7	3.2
Investment goods	18.5	3.0	14.2	3.9
Energy resources	24.0	3.5	26.9	5.3
Growth, total	**13.1**		**15.9**	

Source: BNB.

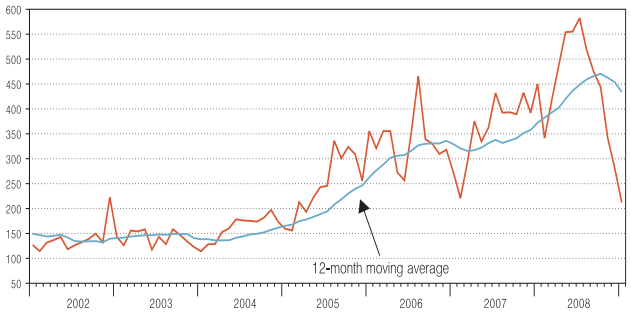
Imports (CIF) reached EUR 25,333.5 million in the January to December 2008 period; a nominal increase of EUR 3472.3 million (15.9 per cent) on the respective period of the prior year. In the structure of imports by use, mineral products and fuels registered the highest positive contribution (5.3 percentage points), followed by investment goods (3.9 percentage points) and consumer goods (3.5 percentage points).

Payments on imports of mineral products and fuels in 2008 came to EUR 5459.5 million, with fuels and crude oil and natural gas having a major contribution (4.8 and 4.4 percentage points respectively) due mainly to higher prices in 2008.

Our expectations for the second and third quarters of 2009 show that declines in the nominal growth rates of the last two months of 2008 and January 2009 will continue due to lower global prices and reduced external demand.

Imports of Energy Resources

(million EUR)

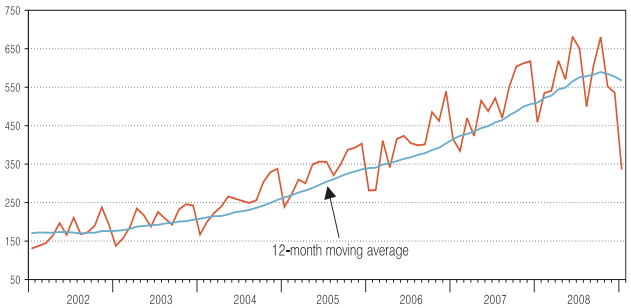


Source: BNB.

Investment goods imports rose by 14.2 per cent in 2008; these products ranked second in imports (after raw materials) with a share of 27.3 per cent. Their value reached EUR 6928.1 million (14.2 per cent), with *machines and equipment* contributing most to total growth (1.5 percentage points) followed by *transportation vehicles* (1 percentage point). In the last two months of 2008 and January 2009 investment goods experienced also a decline. Imported raw materials in 2008 totalled EUR 8593.1 million, an increase of EUR 688.8 million (8.7 per cent) on 2007. Within this group, *cast iron, iron and steel* and *raw materials for the food industry* contributed most substantially to total growth: by 1.2 and 0.6 percentage points respectively. In January 2009 all items in this group except raw materials for the food industry experienced declines. Our expectations for the second and third quarter of 2009 show further worsening in both groups due to lower world prices and weakening domestic demand.

Imports of Investment Goods

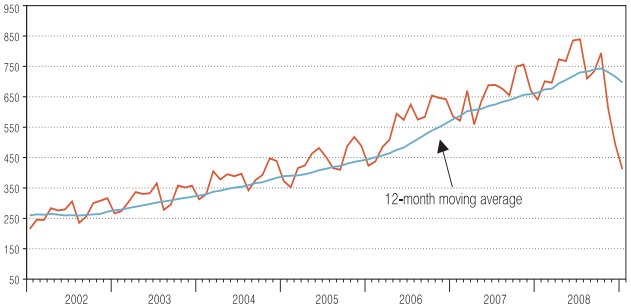
(million EUR)



Source: BNB.

Imports of Raw Materials

(million EUR)

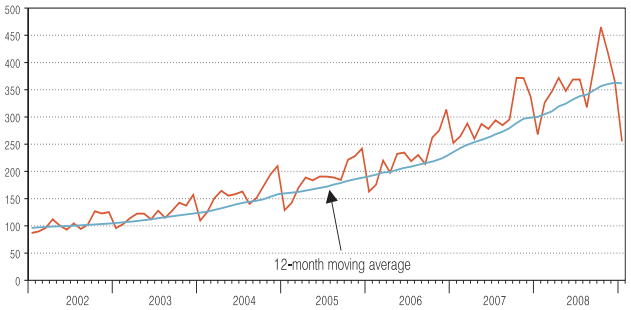


Source: BNB.

Imports of consumer goods picked up during 2008 by EUR 767.9 million (21.4 per cent) on the same period of the prior year, with their value reaching EUR 4353.5 million. In this group, *food, drink and tobacco* products and *furniture* had major contributions to total imports (by 1.4 and 0.5 percentage points respectively). A slowdown was reported in the last months of 2008 followed in January by lower growth in imports of all items in this group excluding *food, drink and tobacco*, and *medicines and cosmetics*. Sustainable growth was reported in the former group throughout 2008 and January 2009, while the latter experienced a base effect. We expect the trend in consumer goods imports to deepen in the projected horizon.

Imports of Consumer Goods

(million EUR)



Source: BNB.

According to preliminary data, Bulgaria's exports to other EU Member States in 2008 grew by 11.8 per cent, while exports to non-EU countries increased by 15 per cent. Goods imported from the Community picked up 12.8 per cent, while those from third countries by 19.2 per cent. Over the forecast horizon no significant changes in Bulgaria's foreign trade geographic structure are expected.

Industry was most significantly affected by declining external demand. Production assured with orders for industry exports (according to managers' opinions as of March 2009) continued to worsen. This is an important economic indicator related, with a certain lag, to the production activity index of industry.

The declining international prices and shrinking external and domestic demand will continue to affect the economic activity in the second and third quarter. Nominal imports are expected to continue decreasing at faster rates than exports which will improve trade deficit.

4. Inflation

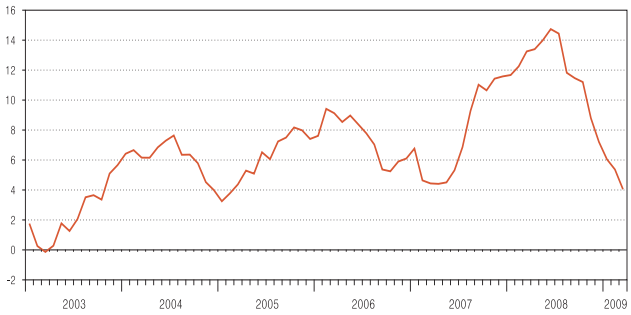
In the first quarter of 2009 inflation on an annual basis continued to go down underpinned by moderating growth in the prices of all major groups of goods and services excluding tobacco products.

The downward trend in inflation is expected to be sustained in the second and third quarter as a result of the slowdown in domestic demand and the ongoing impact of the lower raw material and fuel prices compared with 2008. The anticipated decrease in some administratively controlled prices will also contribute to the fall in inflation.

In early 2009 inflation on an annual basis continued to go down fast, reaching 4.0 per cent in March (7.2 per cent in December 2008). Moderating growth in food and fuel prices, a trend that formed during the second half of 2008, played a key role in this respect. As of March, contribution of food prices to inflation was positive (0.5 percentage points), while that of fuels was negative (-1.4 percentage points). Domestic demand slower growth and increased uncertainty about the economic environment depressed prices, especially of non-foods and services; therefore a clearly pronounced trend towards a decrease in their annual growth rates was also observed. The considerable inflation moderation in the prices of transportation services and public catering reflected the indirect effects of food and fuel price dynamics, as well as a base effect related to rises in the prices of these groups during the same period of the prior year.

Harmonized Index of Consumer Prices

(inflation on corresponding month of previous year, %)

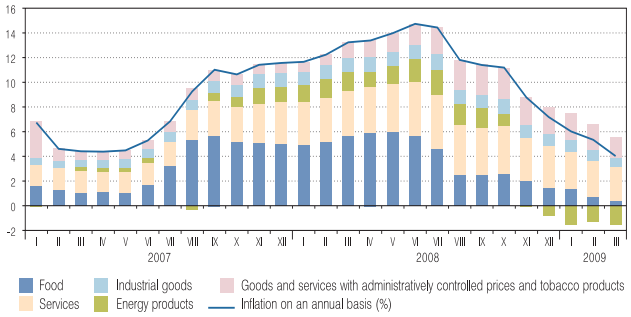


Source: NSI.

In the first quarter of 2009 accumulated inflation came to 0.5 per cent: down 3 percentage points on the corresponding period of 2008. Lower rates of growth in the prices of all major goods and services groups (excluding tobacco products) were observed. Services prices went up by 1.2 per cent (against 3.5 per cent over the January to March 2008 period). Administratively controlled prices also rose, albeit to a lesser degree (0.9 per cent against 3.5 per cent in 2008). Fuels and industrial goods prices reported deflation of -4.6 per cent and -0.2 per cent respectively.

Inflation Rate on the Corresponding Month of Previous Year and Contribution of Major Goods and Services Groups*

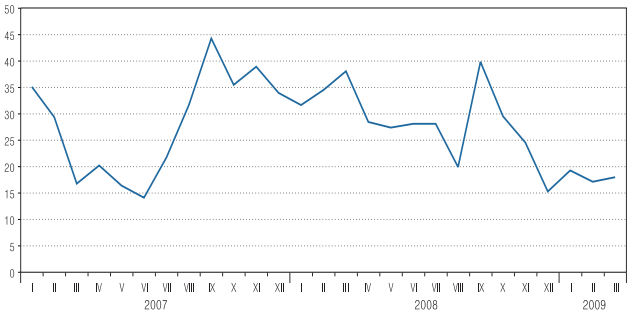
(on corresponding month of previous year, %)



* This structure corresponds to the Eurostat classification; tobacco products and goods and services with administratively controlled prices are presented separately.

Sources: NSI, BNB.

Diffusion Index*



* The diffusion index is calculated on the basis of the elementary aggregates in the consumer basket and is a relative share of the aggregates with a monthly growth rate of prices higher than 1 per cent.

Sources: NSI, BNB.

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

Inflation (%)	January – March 2008		January – March 2009		March 2008 – March 2009	
	3.5		0.5		4.0	
	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.	Inflation rate by group, %	Contribution, p.p.
Food	**5.0**	**1.26**	**1.1**	**0.26**	**1.9**	**0.46**
Processed food	3.1	0.49	-1.4	-0.21	0.6	0.11
Unprocessed food	8.1	0.77	5.1	0.47	3.8	0.36
Services	**3.5**	**1.03**	**1.2**	**0.37**	**9.2**	**2.68**
Catering services	4.3	0.46	1.9	0.22	12.2	1.31
Transportation services	5.5	0.28	-0.2	-0.01	9.7	0.50
Telecommunication services	-0.5	-0.02	-0.3	-0.01	-0.9	-0.04
Other services	3.5	0.31	1.8	0.17	10.2	0.90
Energy products	**4.9**	**0.42**	**-4.4**	**-0.34**	**-17.4**	**-1.52**
Transportation fuels	4.7	0.36	-4.6	-0.31	-20.8	-1.40
Industrial goods	**1.0**	**0.17**	**-0.2**	**-0.03**	**4.2**	**0.72**
Goods and services with administratively controlled prices	**3.5**	**0.57**	**0.9**	**0.14**	**7.4**	**1.19**
Tobacco products	**2.8**	**0.10**	**3.3**	**0.09**	**15.7**	**0.51**

Sources: BNB, NSI.

The diffusion index, reporting the share of the groups in the consumer basket with a monthly growth rate of prices higher than 1 per cent has followed a downward trend since the start of the fourth quarter of 2008; during the first three months of the present year an average of 18 per cent of all goods and services registered higher monthly inflation.

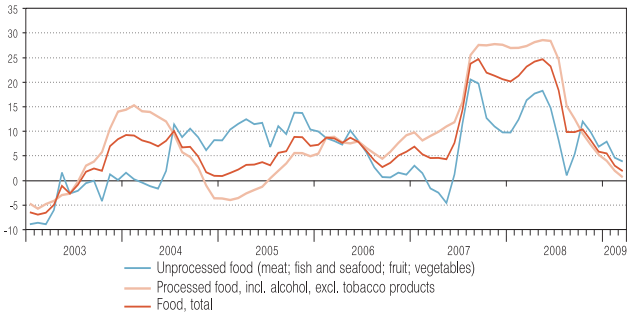
Food Prices

In early 2009 the growth rates of food prices on an annual basis continued to fall fast owing mainly to the dramatic slowdown in processed food inflation. As of March the prices of processed foods were higher by 0.6 per cent compared with the same month of the previous year, while those of unprocessed foods by 3.8 per cent.

Growing supply of major food commodities, such as wheat and sunflower, led to falls in their prices.[12] Declines in the prices of these commodities were the main driver of the fall in flour and vegetable oil prices that continued at the start of the current year. During the first quarter of 2009 the price of flour dropped by 5 per cent, while that of sunflower oil by 12.5 per cent; as of March flour prices were lower by 28 per cent on an annual basis and sunflower oil prices by 34 per cent respectively. Compared with the monthly falls in the prices of these two groups in the last months of 2008, during the first quarter of 2009 deflation rates gradually slowed down, suggesting that the indirect effects of agricultural price declines began to subside. During the first three months of 2009, the indirect effects of the falls in the price of flour in the group of bread and cereals were sustained; in addition to deflation in bread prices, the prices of some bakery and pastry products also dropped. In March 2009 the prices of bread and cereals, and vegetable fats and oils posted a decrease of 0.6 per cent and 25 per cent respectively on March 2008.

Harmonized Price Indices of Food

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

Since early 2009 milk and dairy products reported deflation of -0.2 per cent. It was due to the falls in the prices of white cheese, yellow cheese and yoghurt, which can partially be explained by seasonal factors. Another factor behind price falls in this group was the decrease in fodder prices in Bulgaria. Inflation in the group of milk and dairy products continued to fall on an annual basis, coming to 2.6 per cent in March.

[12] The harvest in 2008 was good due to the favourable weather conditions during the year, while in 2007 there was a considerable drop in agricultural produce due to the exceptionally bad weather.

Price developments in unprocessed foods also contributed to the dramatic slowdown in the overall food inflation. This stemmed mainly from vegetable and fruit price falls on an annual basis by 1.2 per cent and 13.4 per cent respectively. At the same time, the annual growth rate of meat and meat products prices was still high (14.5%) despite deflation in this group (-0.6 per cent on December 2008).

During the next two quarters the trend towards slowing down of food inflation is expected to be sustained and deflation in the group of foods may be registered. This dynamics will be determined mainly by processed food prices, into which the falls in the prices of commodities (including the imported ones) on the previous year will continue to spill over with a time lag. The downward food price dynamics will be supported by a good harvest during the present year.

Energy Products Prices

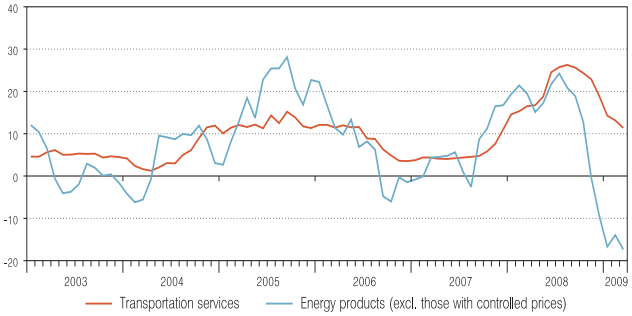
During the first three months of the current year the prices of energy products (excluding those with controlled prices) retained their negative growth rate on an annual basis, reflecting the sharp drop in the price of oil compared with the start of the previous year. In March fuels, which are the main component in the group of energy products, reported a 21 per cent decrease on the same month of 2008.

The dynamics of transportation services prices (including administratively controlled prices) followed that of fuels, although the trend was less clearly pronounced. A base effect owing to price rises in the same period of 2008 exerted a downward pressure, while the fact that inflation in transportation services showed no further slowdown can be explained by the more permanent demand compared with that of other goods and services and the stronger downward rigidity of urban transport administratively controlled prices. As a result, deflation of transportation services prices since the year start is insignificant (-0.1 per cent). It resulted from the slight decrease in interurban transport market prices by -0.3 per cent and the increase in urban transport prices by 0.7 per cent.

Despite the expected gradual rise in oil prices underpinned by a base effect, inflation of energy products on an annual basis will remain negative till the end of the third quarter. The trend towards contained prices of transportation services is anticipated to be sustained; as a result, their annual growth rate will slow down dramatically.

Harmonized Price Indices of Energy Products and Transportation Services

(inflation on corresponding month of previous year, %)



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

Sources: NSI, BNB.

Administratively Controlled Prices and Tobacco Products Prices

During the first quarter of 2009 the annual growth rate of administratively controlled prices gradually decelerated, reaching 7.4 per cent in March. The still relatively high inflation of goods and services with administratively controlled prices had a major contribution to headline annual inflation, following the group of services.

Increases in medical and hospital services prices due to higher minimum wages in 2009 and rises in the charges for collection and disposal of household refuse contributed most to inflation of administratively controlled prices accumulated since early year. The effect of an increase in heat energy by 17 per cent in January was to a great extent offset by the subsequent suspension of central heating higher prices in Sofia.

Inflation of controlled prices is anticipated to continue slowing down during the second and third quarters of the year. This will result from falls in the prices of heating and of calls between fixed and mobile networks, provided that the other groups of goods with administratively controlled prices, about which no adjustments have been announced, retain their levels.[13]

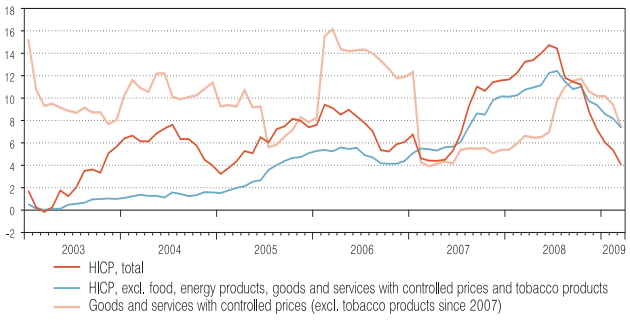
[13] The enforcement of the new positive list of medicines may lead to changes in the prices of medical goods, but their impact on inflation cannot be assessed at present.

Owing to the decrease in natural gas prices during the second quarter of the year and the expected further falls in its price during the following quarters, lower heat energy prices will exert a downward pressure on inflation. The effect on inflation may be stronger during the last quarter of 2009 due to the relation between reflecting the services prices in the consumer basket and the actual period of their consumption. In this case the decrease in hot water prices, which will be reflected faster in the prices, will have a stronger impact on inflation during the following two quarters.

The decision of the Communications Regulation Commission about faster phased decreases in the wholesale prices of phone calls in fixed and mobile networks, adopted in compliance with the European Commission's recommendations, will have a deflationary influence since mid-year. Price falls will be reflected in administratively controlled prices (due to declining prices of calls from fixed to mobile networks) and probably to some extent in market prices of calls between mobile operators.

Harmonized Indices of Goods and Services with Controlled and Non-controlled Prices

(inflation on corresponding month of previous year, %)



Note: Given the relation between tobacco product prices and administratively set excise rates, tobacco products are excluded from the group of goods and services with non-controlled prices despite the liberalization of the tobacco market in early 2007.

Sources: NSI, BNB.

During the first quarter of 2009 tobacco products were the only group in the major groups of goods and services with higher inflation compared with the same period of the prior year. Owing to the last increase in the excise duties in early 2009, tobacco products price rises are expected to reach some 15–16 per cent, while the relatively faster price increases, observed so far, may have resulted from the shorter grace period (three months) of sales at prior year prices.

Industrial Goods Prices

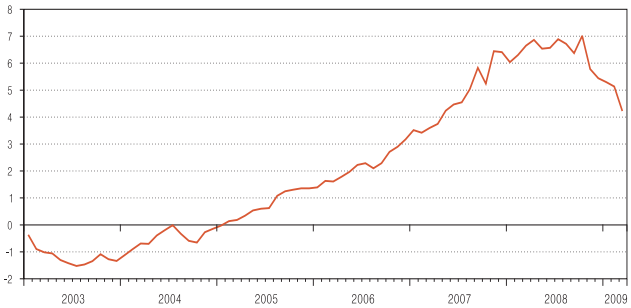
At the year start the trend that formed in the last few months of 2008 towards slowing down in the annual growth rate of industrial goods prices (excluding those with controlled prices) was sustained. In March inflation in this group decreased to 4.2 per cent.

Reduced real non-food consumption on an annual basis during the prior year fourth quarter was the first indicator of lower expenditure reflecting enhanced uncertainty about the economic environment and impeded access to credit. Data on the relatively rapid moderation in non-food inflation at the start of the current year are indicative of the sustainable trend to reduced demand in this group.

Industrial goods price dynamics complies with domestic retail sales data in Bulgaria which shows declines in demand primarily of non-foods excluding pharmaceutical and medical goods, cosmetics and toiletries (see the *Economic Activity* section in this issue). The most recent consumer survey of January 2009 indicates worsening in the balance of opinions on the current developments in the purchases of durables, which is another proof of contained non-food demand.

Harmonized Price Indices of Industrial Goods Excluding Energy Products and Those with Administratively Controlled Prices

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

As of March, deflation in automobiles and decelerating growth in the prices of spare parts, clothes and footwear, and household appliances contributed most to the decline in non-food inflation. Price dynamics of audio-visual, photographic and information processing equipment largely reflects the global trend to price falls; in Bulgaria clearly pronounced negative price growth developments are observed in photographic equipment and records and compact discs for audio-visual and photographic equipment.

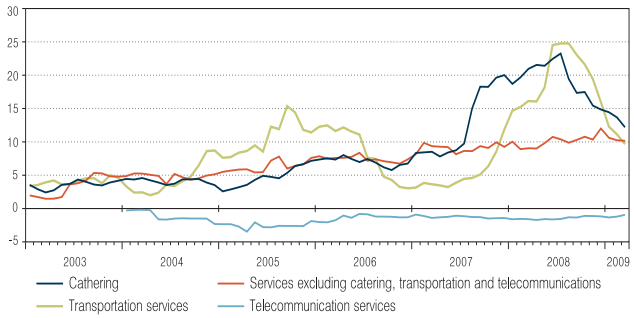
During the next two quarters inflation in non-foods is anticipated to gradually become lower; some groups, such as automobiles and leisure time equipment, are likely to report an accelerating downward trend in prices. The relatively more persistent demand for some goods (for example consumer non-durables) will maintain their growth rates positive and will impact in the opposite direction the price dynamics in the entire group of non-foods.

Prices of Services

During the first quarter of 2009 inflation of services (excluding those with administratively controlled prices) picked up at a significantly reduced pace on the same period of 2008. The declining inflation rates stemmed from the insignificant deflation in transportation services (on December 2008) and the lower inflation of catering and the remaining services. In March annual inflation of services decreased to 9.2 per cent.

Harmonized Price Index of Services
Excluding Those with Controlled Prices

(inflation on corresponding month of previous year, %)



Sources: NSI, BNB.

Moderating inflation in services stemmed from indirect effects of fuel and food price downward dynamics on transportation services and catering prices; it probably reflects consumer demand slower growth as well. The annual inflation rate of these two groups decreased quickly underpinned by a base effect of the significant rises in the prices of transportation services and catering during the first quarter of 2008. The annual inflation rate in the other services (excluding telecommunication services) went down relatively slower, reaching 10.2 per cent in March (against an annual rate of 12 per cent in December 2008).

Against the background of heightened economic environment uncertainty companies in the services sector are likely to cut dramatically their expenditure growth, including wage growth, thus easing indirectly the pressure of expenditure on prices. Consumer demand will be a factor behind pricing. Provided it slows down considerably during the current year, inflation in services may decrease strongly. Reflecting a base effect, the lower inflation of catering and transportation services will contribute to decelerating the annual growth in the prices of services due to the larger share of these groups in the consumer basket.[14] Price dynamics in the services other than transportation and catering will depend on consumer demand and reduction in inflation may be faster in individual sectors with higher competition, such as accommodation services and package holidays. The planned reduction in the prices of terminating traffic in mobile networks since early July 2009 is another factor that will contribute to moderation in services inflation.

Deflation in the group of services on an annual basis is unlikely, provided consumer demand growth rate slows down or is sustained, but not if it sharply contracts.

Inflation Expectations for the Second and Third Quarter of 2009

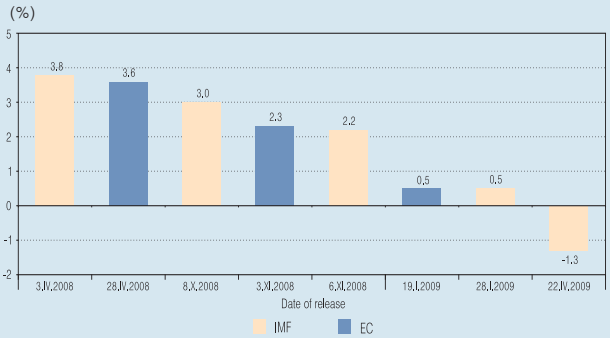
The trend towards declining annual inflation rates is expected to continue during the second and the third quarter of the year. `Growth in consumer prices will be impeded by the slowdown in domestic demand as a result of the heightened economic environment uncertainty, low wage growth and decline in employment. The impact of the lower prices of raw materials and fuels compared with 2008 and the expected falls in some administratively controlled prices will also add to the decline in inflation.

[14] In 2009 the relative share of catering in the consumer basket is 11 per cent, while that of transportation services (excluding those with controlled prices) 4.8 per cent.

Revisions to the Projections for the Global Economic Development and the Economic Development of Bulgaria for 2009

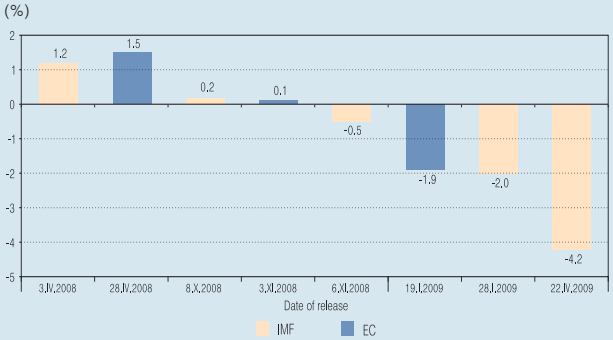
In the course of 2008 with the development of the global financial and economic crisis the global economy forecasts, published by leading financial institutions, have constantly been revised downwards. Statistical information, reporting faster than projected deterioration of the economic environment, was the main factor behind these revisions. The speed of deterioration of global economic indicators increased after the *Lehman Brothers* default in September 2008 which resulted in more frequent and more significant revisions to global economic development outlook for 2009. Revisions are characterised by increasingly negative growth rates in leading economies and in global trade, as well as by lower inflation rates.

World Growth Projection for 2009



Sources: IMF, EC.

Euro Area Growth Projection for 2009



Sources: IMF, EC.

The worsening outlook for global economic growth affected Bulgaria's economic development prospects. The BNB uses the estimates for the developments in the world economy and in the euro area countries as an input to its macroeconomic projections for Bulgaria. The lower external demand projections and the uncertainty of the future have resulted in a downward revision of the GDP growth forecast both due to lower exports and to weaker domestic demand.

Major Macroeconomic Indicators for Bulgaria in 2009

Projection preparation time frame	Institution	Projections for 2009		
		GDP growth, %	Inflation (average for the period, %)	Current account (% of GDP)
April 2008	EC	5.6	5.9	-20.9
	IMF	4.8	6.0	-18.9
	BNB	6.5	4.7	-20.3
October – November 2008	EC	4.5	7.9	-22.3
	IMF	4.2	7.0	-21.5
	BNB	4.9	5.4	-21.1
January – February 2009	EC	1.8	5.4	-24.0
	IMF	1.0	4.7	-15.3
	BNB	2.4	3.0	-18.3
April 2009	IMF	-3.5	3.3	-12.0
	BNB	between 0.6 and -2.0	between 2.5 and 1.7	between -17.2 and -13.8

Sources: IMF, EC, and BNB.