



Introduction

At the end of November 2009, NBRM reduced its key interest rate by 50 basis points, from 9% to 8.5%, while in January the key interest rate was lowered again by additional 50 basis points, down to 8%. The change in the monetary policy stance is a result of the changed environment, i.e. the significantly improved trends in the external sector relative to the expectations and the more favorable outlook for the forthcoming period. Instead of the expected imbalance on the foreign exchange market in the last three months of the year as a result of stronger pressures of the demand for foreign exchange, the trend of increased supply continued, opening room for monetary adjustment toward policy relaxation. The reasons for the absence of the expected pressures on the foreign exchange market could be located at several points. First, **the stabilization of the expectations** continued at a faster pace in the past three months translating into an increased supply and decreased demand for cash foreign currency on the currency exchange market and, consequently, high rise of the net-purchase from currency exchange operations. Prudent policies, lower contraction of the economy, as well as the signals for recovery of the global economy are factors that boosted the expectations in this period. Second, amid lower income, the **public consumption** was lower than projected, thus providing for lower outflow of foreign exchange through this channel, relative to the expectations. Third, a **significant portion of the demand for foreign exchange of the real sector was satisfied through the banks**, partially through external borrowing. Thus, the banks did not make a conversion of the portfolio from denars into foreign exchange, which could be explained with the favorable yields of the instruments in domestic currency and more stable expectations. Fourth, **capital inflows** are estimated as higher relative to the current projections, which contributed to the greater supply of foreign currency relative to the expectations.

The monetary reaction to the lower current pressures on the exchange rate with a reduction of the key interest rate, primarily reflects the improved expectations about the future trends. This, however, does not mean that there are no possibilities for adverse shocks. The risks concerning the size and the sources of financing the current account deficit are still present. At the same time, the expectations of the domestic agents and their transmission effects on the demand for foreign exchange are still sensitive and contingent upon a number of factors. Hence, the policies are still conducted in an uncertain environment, which imposes the need of precaution. Anyway, the realized performances in 2009, which were better than expected, primarily regarding the level of foreign reserves, indicate greater capacity of the monetary policy for absorbing the possible adverse shocks during 2010.

As for the real economy, the latest data on GDP confirm the NBRM assessments for deepest contraction of the economy in the third quarter of 2009. Such trends were caused by the recovery pace of the economies of the main trading partners, the increasingly lower credit flows in the domestic economy, the increased precaution of the economic agents amid the still present uncertainty, as well as by the expectations for slow recovery of the demand, and hence destimulation of the new investments. The decomposition by individual category indicates the same structure of GDP fall in the third quarter, as in the previous quarter. The further decline in the private consumption (although at a slower pace, compared with the preceding quarter) and the contraction of the new investments resulted in a negative contribution of the domestic demand. In the export segment, the effects from the reduced demand were still present in the third quarter, which resulted in an insufficient utilization of the potential of the export capacities. The downward adjustment of the domestic and the export demand still cause a decline in the imports and lowering of the imbalances in external trade. Thus, also in the third quarter, net-exports had a positive contribution to the annual growth of GDP. The decline in the economy in the third quarter of 2009 was less intensive compared with the NBRM projections (projected decline of 2.5%), which is a result of the smaller decline of the foreign effective demand in the second half of the year, as opposed to the assumptions¹ used in the projections. In the last quarter, the economy is expected to stabilize. However, the risks for deterioration of the trends in the real sector are still present. Mainly, they pertain to the more intensive reaction of the labor market and the insufficiently intensive recovery of the export demand.

The decline in the price level continued in the fourth quarter of 2009. In the last quarter of the year, a negative inflation of 2.1% was registered, as opposed to -1.4% in the preceding quarter. Such trends in the domestic prices are mainly a result of the changes in the import prices, which, after the sharp growth in the first three quarters of the preceding year, since the last quarter of 2008 and throughout 2009 have been continuously following a disinflationary path. On a cumulative basis, in 2009, an average annual fall in the prices of 0.8% was registered, which does not deviate significantly from the projected dynamics for the inflation. In the last quarter, core inflation entered a negative zone (annual fall of 0.6%), pointing to the secondary effects

¹ Source used for the assumptions: Consensus Forecast, October 2009.



of the decline in the prices of food and energy and lower pressures from the demand. On average, in 2009, the core inflation was positive and equaled 0.3%. Thus, these prices returned to the trajectory of low growth rates, after the intensified growth in the preceding year, partially due to the excessive growth of food and energy prices. In the forthcoming period, inflation is expected to increase moderately, caused by the forecasts for growth of the import prices and by the increase in the regulated prices.

The latest trends of the deposit and credit market segment, where growth in deposits and credits is registered, confirm the assessments for more stable expectations, lower, though still present risks and favorable tendencies in the external position of the economy. In the third quarter, the total deposit potential went up on a quarterly basis (1.9%), while the November data indicate further more intensive increase in the inflow of new saving in the banking system, compared with end September (3.2%). The changes in the banks' deposit base correspond with the more stable flows in the economy and the improved expectations of the economic agents, as well as with the foreign exchange inflows in the economy generated through the position of the balance of payments in this period. The credit market registered the first signs of recovery, after the significant contraction in the second quarter of the year. Thus, in the third quarter, the quarterly decline of the credit activity was significantly lower than the one registered in the preceding quarter, and during October and November the banks provided new financial support, primarily aimed at the corporate sector. Such trends, essentially correspond with the assessments of the banks in the Survey on the credit activity, regarding the stabilization of the lending terms and demand for credits in the last quarter of the year, as well as the minor intensification of the activity in individual segments. The future trends in the access to credits, are heavily contingent upon the dynamics of saving and banks' perceptions of risk. For the time being, the assessments are directed toward a moderate increment of the credits in the forthcoming period and moderate reduction in the interest rates, given the still cautious credit policy of banks and focus on the credit portfolio quality.

In the last quarter of the year, there were no pressures on the demand for foreign exchange. Contrary to the expectations, the gap between the supply and the demand for foreign exchange in this period was positive, allowing NBRM interventions with purchase of foreign exchange and accumulation of foreign reserves. Such a situation is an indicator of further correction of the external imbalances, whose pressures on the economy have started to diminish significantly since the end of the second quarter. In the third quarter, these trends intensified, with the faster pace of decline of the import demand, as well as the fast growth of the private transfers resulted in a current account surplus (1.6% of GDP). This, in combination with the high inflows from the government's borrowing on the foreign financial markets and allocation of SDRs, enabled the foreign reserves to stand above the level registered at the end of the preceding year. **The continuous purchasing of foreign exchange also in the last quarter is a clear indicator of further adjustment of the external position and of the positive expectations of domestic economic agents.** Trade deficit continued to narrow also during October and November (annual decline of 7.9%), while the growing trend of the net-inflows from currency exchange operations intensified (annual growth of 96.4% in the last quarter). At the same time, in this period, the risks from pressures on the foreign exchange market due to the repatriation of a larger amount of dividends to foreign investors, did not materialize. These foreign exchange outflows were compensated through short-term borrowing of banks. Such trends enabled further accumulation of foreign reserves, which registered an annual increment of around Euro 100 million at the end of the year. Although **the movements on the foreign exchange market, which were in the focus of the monetary policy, were continuously favorable in the second half of 2009, their sustainability remains to be the key question.** This is mainly a result of three reasons. First, the narrowing of the negative gap in trade is driven by the downward adjustment of imports, rather than by the revival of the export demand. Hence, the fulfillment of the assumption for recovery of the exports in the forthcoming period is an important precondition for continuity of the favorable movements on the foreign exchange market. Second, the inflows from current transfers (primarily cash the source of which is the net-purchase from currency exchange operations) explain a large portion of the excess supply of foreign currency. Having in mind their volatility and unpredictability, the risks still remain. Third, one of the main segments which is expected to provide for correction of the external imbalance are the capital inflows, which under these circumstances are function of the pace of global recovery and the perceptions of the foreign investors, and hence they are uncertain.