



Introduction

In the course of the third quarter of 2010, NBRM continued relaxing the monetary conditions as a result of favorable foreign exchange market movements and estimated nonexistence of increased risks to the foreign exchange rate stability. Therefore, after cumulative reduction of 3,5 percentage points in the first half of 2010, the key interest rate of NBRM in August was additionally corrected by 0,5 percentage points, thus coming down to 4,5 %, or at historically the lowest level. The favorable setting for monetary relaxation can be observed in the indicators of the economic and financial conditions. Namely, in the first half of the year the activity of the domestic economy experienced a fall at annual level. Expectations regarding the foreign exchange rate are stable, providing increasing inflows via private transfers and decreased euroization in the banking system. The credit activity of banks, although with increasing dynamics, is still not sufficiently strong to cause significant pressures over the stability of the foreign exchange rate. Although the interest rates of NBRM transferred into decreased price of loans, and the sources of financing continued to increase, still the preferences of banks for investment in non-risk instruments remained high. Thus, the banks did not use the new sources completely for more active financial support of the spending and investments of the private sector.

The last revisions of the macroeconomic projections until the end of the year and the estimates for the following year confirm the justification of the monetary relaxation. They point to a similar environment to the one present until now. Namely, the economy recovery is expected to continue at faster pace in the course of the following year, which shall result in decreasing the negative production gap. However, the gap is still estimated to remain in negative zone not creating significant pressures over the current account and the inflation. In the external sector, although until the end of the year the foreign reserves are expected to decrease, still they shall remain at adequate level. In the next year, the capital inflows are expected to be sufficiently large to cover the current account gap and to provide additional cumulating of foreign reserves. At such expectations the growth of new loans, as percentage of the GDP, is not expected to be significantly higher than the one of the current year. **However, the unfavorable risks regarding this scenario are present and mostly located at two points.** First, non-realization of the presumed capital inflows may negatively influence the foreign exchange market. Second, the pressures over the inflation from import prices may be more significant, which might potentially destabilize the expectations regarding the foreign exchange rate.

The performance of the real sector in the second quarter of the year is in line with projections. After the fall in the previous quarter, in the second quarter annual growth was noticed of 0,4%. The export sector is chief generator of the growth, but significantly driven by increased use of metal industry capacities, given the favorable conditions on the metal markets. Taking into consideration the variability of movements at these markets, there are risks from unfavorable changes again. Second most significant factor over the growth are the domestic investments, which given the indications of decreased investments in fixed assets, signalize accumulation of reserves, an effect which might also be exhausted relatively fast. On the other hand, the private spending remained anemic, given the slower growth of income, instable labor market movements and insufficient credit support. The public spending kept the decreasing continuity in the second quarter of the year as well. Risks related to the pace of economic recovery until the end of this and in the course of the following year arise on the basis of several segments. Thus, the latest information point out to inadequate economic recovery globally, i.e. accelerated pace of growth of the Asian countries, and slower economic recovery of the European Union, which is our most significant trading partner. At the same time, the recovery of our most important export partners is uncertain due to gradual exhausting of the positive effects of monetary and fiscal stimuli and the need to initiate the process of fiscal consolidation in most of the countries. Additional risks arise from labor market movements. The latest data from the labor market presented interruption in the fall of employment, but still they point out to higher volatility and should be interpreted with care. Anyhow, the labor market appeared as potential limitation factor for higher growth of the private consumption. The consumption perspectives shall depend also on expectations of economic entities,



which in the last period were in favor of increasing the saving. The investment activity is expected to be supported by the increasing role of the state in the investment cycle, the entry of new foreign direct investments, as well as the growth of credit approval of banks, as domestic source of financing of the domestic demand. Still, all these three factors are accompanied by high uncertainty, creating risks related to the new investment activity.

Contrary to the uncertain trajectory of the economic growth, the movements and prognosis for the inflation are more stable. In the third quarter of 2010, under influence of seasonal fluctuations of the prices of food, the general price level was lower by 0,4% on quarterly basis, while the annual increase of prices achieved 1,8%. In addition to the contribution of the higher prices of oil and the administrative increases of the electricity and heating energy prices, additional contribution to the annual increase of prices was also made by the prices of food. This pointed out to exhaustion of the deflationary pressure of the food component, created in the previous year. The core inflation registered marginal intensifying, while slower increase was observed in the prices of producers of industrial products. Although in the following period the inflation is expected to intensify mildly, still no significant inflationary pressures are expected so far. The pressures for increase in prices are expected from import prices, while the domestic demand, in conditions of lower capacity utilization, is estimated not to have inflationary influence. However, the risks regarding the estimations of inflation are dominantly upward. This ascertainment is mainly a result of the increase in the world food prices which might be more intensive and with higher effects on the food component of the domestic inflation.

The activity at the credit market continued to grow also in the second and third quarter, accompanied by growth in the deposit potential, relaxed credit conditions and higher demand for loans. Thus, in conditions of further growth of the deposit potential of banks (quarterly growth of 4,6%), the credit activity of banks increased on quarterly basis by 2,5% (as compared to 1,4% in the previous quarter). These changes point out to improved perceptions of banks regarding risks, which contributed to decreasing the restraint, characteristic during the period of crisis, from increased activity at the credit market. Still, certain indicators point out that, although decreased, the risks in banking operations still represent major restrictive factor for higher credit growth. The ratio loan-deposit is continuously decreasing, presenting incomplete allocation of the new financing in credit support of the private sector. At the same time, the participation of the low risk assets in the total assets of banks is increasing, pointing out to a still present restraint from accepting higher risks. Therefore, the milder dynamics of the credit growth in the analyzed period is most probably a result of the current perceptions of banks for weaker recovery of the financial position of companies and individuals. In the following period the banks' perception of risks related to the financial position of clients and hence the quality of credit demand, shall be of crucial importance for the credit market activity. .

In the external sector, in the second quarter of 2010 the current account deficit continued to shrink, but accompanied at the same time with worsened trade account balance. Thus, the current account deficit in the second quarter of the year was reduced to 0,6% of GDP (from 1,1% of GDP in the first quarter of the year), in conditions of exceptionally favorable current transfers dynamics, given the stable expectations regarding the foreign exchange rate. On the other hand, the trade deficit worsened in this period. Namely, the favorable dynamics of exports, which started at the beginning of the year, continued also in the second and third quarters of the year, while the imports, after six quarters of decrease, for the first time registered annual growth. Major factors for increased import demand were the higher imports of oil and oil derivatives¹, export – import dependence of production and the government measures for importing cars. Capital inflows, although at low level, were sufficient for complete financing of the current account deficit and for additional accumulation of foreign reserves. In the course of July and August there was additional accumulation of foreign reserves, which at the end of September achieved Euro 1.689 million and were at adequate level providing 4.3 monthly coverage for import of goods and services in the following year. Significant disruptions in the

¹ In conditions of increased quantity demand and import price.



external balance are not expected in the following period. The current account deficit is estimated as acceptable, but it is of high importance the projection of estimated capital inflows to be fulfilled. Thus, in the following period the focus of monetary decisions shall continue to be on the estimations of risks in the external sector, the increase or decrease of which with regard to the initial estimates shall be of crucial importance for the changes of the monetary policy stance.