Economic Research

Bulgarian economy in 2015

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"Acceleration of structural reforms and growth trajectory, despite lack of fiscal stimuli"

- We expect Bulgarian GDP to defy gravity and to rise by another 1.5% in real terms this year.
- In a low-export growth environment in combination with limited room for more expansionary fiscal policy, we think that improved absorption of EU funds and some support for private consumption, via lower energy prices and a declining savings rate, will be the main GDP growth drivers.
- Acceleration of some long-postponed structural measures is also expected this year, which if implemented should not only boost capacity of the economy to produce more goods and services in the long run, but should also help to economic recovery and jobs creation via its positive impact on sentiments.
- Despite weaker euro, Bulgarian export recovery is likely to progress only very gradually this year.
- Lower crude oil prices should help GDP growth and balance of payments to improve.
- Tentative labour market recovery seen last year will carry over into 2015.

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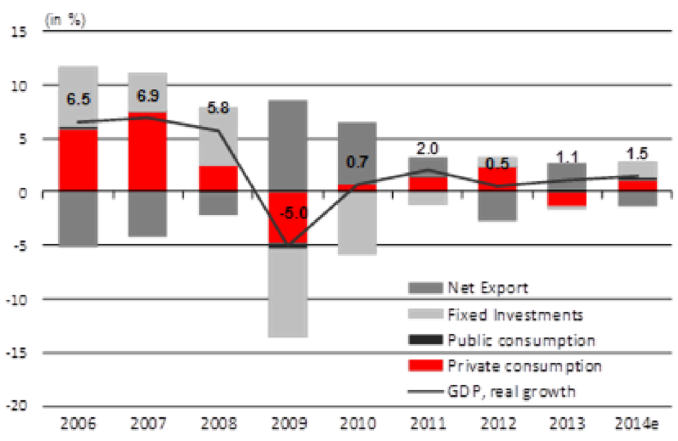
Acceleration of structural reforms and growth trajectory, despite lack of fiscal stimuli

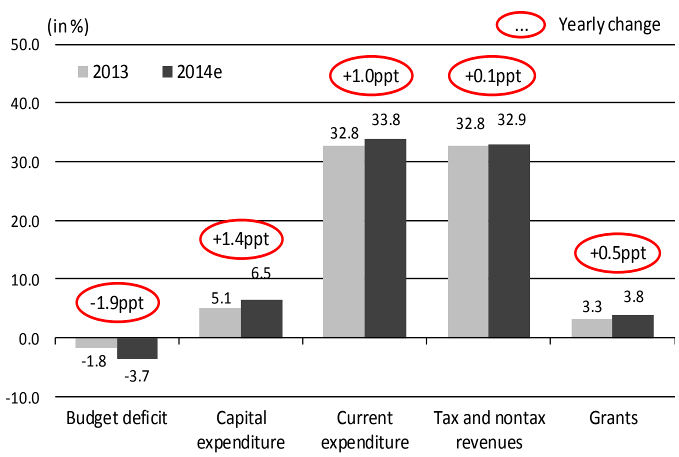
The negative impact that political instability, frozen EU funds and June's bank crisis had on the pace of the Bulgarian economic recovery was compensated for by a pronounced shift towards a more growth supportive fiscal policy and the long-anticipated jobs recovery in the external demand oriented sectors, which both helped real GDP growth to strengthen to 1.5% last year, from 1.1% in 2013. Perhaps even more importantly, GDP growth became more broadly based, with investments and to a lesser extent household consumption joining industry and exports, as drivers of recovery.

The shift toward more growth supportive fiscal policy was crucial for GDP growth acceleration last year. This shift allowed government capital expenditure to rise by 1.4 ppt of GDP to 6.5% of GDP in 2014, from 5.1% one year earlier and 4.5% on average in the period 2010 – 2012. Thus, more than half of the budget deficit widening in 2014, with 1.9 ppt of GDP to 3.7% of GDP, was used to boost government capital spending to their highest level since the start of transition. In fact, three consecutive governments – left-wing coalition of Mr. Oresharski, interim government of Mr. Bliznashki and right-wing coalition government of Mr. Borissov – were behind this increase in the government capital expenditures, which is a step in the right direction, particularly when compared with the shortsighted policy pursued until early 2013, when fiscal policy prioritized urgent reduction of budget deficit without taking into account the negative implications for GDP growth and jobs creation.

GDP growth and contribution to growth, yoy, swda



Consolidated fiscal program, as % of GDP



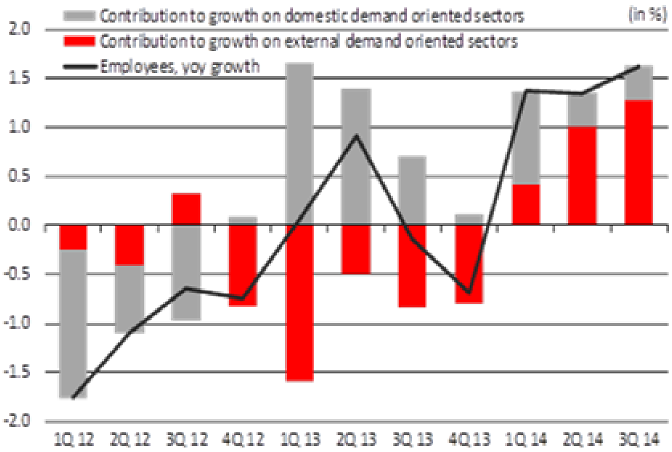
Source: NSI, MF, UniCredit Bulbank

2014 was the best year for Bulgarian labor market since the start of global crisis in 2008. Practically all key labor market indicators last year impressed on the positive side. With some delay strong exports growth seen in 2013, helped job numbers in economy to increase, starting with the jobs in the external demand oriented sectors, which, in turn, was apparently enough to push households' consumption expenditures moderately higher by 1.5% in real terms last year. For the first nine months of the previous year, 43 thousand jobs were added to the economy, when compared with the same period one year earlier, which corresponds to 1.4% yoy rise. There is also positive news in the fact that almost two-third of these jobs increase came from the external demand oriented sectors. This is particularly encouraging, when taking into account that external demand oriented sectors have continued losing jobs for the whole period since the start of the global crisis in 2008 until early 2014, despite the fact that real exports in end-2013 was already more than a quarter above its level posted in the pre-crisis 2008.

But despite the shift toward more growth supportive fiscal policy and the long anticipated recovery of jobs in the external demand oriented sectors, the pace of GDP growth recovery failed to impress on the positive side. Crucial for this was that 2014 turned into another lost year for the implementation of the long-delayed structural reforms. Backtracking on reforms pledges led to an increase in the quasi fiscal deficits in a number of sectors of the economy including pensions, health care and energy sector, while prolonged period of subpar economic growth is on course to inflict a permanent damage to the capacity of the economy and to worsen its chances to press ahead with the processes of modernization and income convergence.

Geopolitical shock triggered by the Russian incursion in Ukraine further undermined already weak emerging markets demand for Bulgarian exports and in combination with ongoing political uncertainty, collapse of the fourth largest local lender and EU funds freezing, all added to the list of growth constraining factors at play in 2014.

YoY growth on employees and contribution to growth by sectors



Yearly change of employees by economic sectors

Yearly change (number)	2009	2010	2011	2012	2013	9M 2014
Agriculture, forestry and fishing	-20.5	-22.6	-7.1	-12	6.5	15.9
Manufacturing and Mining & Quarrying	-56.8	-77.5	-51.1	10.2	-27.1	2.5
Transportation and storage	-1.9	-10.3	-3.6	2.6	4.5	-6.2
Accommodation and food service activities	-0.1	-9.0	-0.5	-6.5	-6.6	8.4
Construction and Real estate activities	-18.8	-57	-40.6	-24.2	2.8	10.3
Wholesale and retail trade	-2.1	3.2	13.3	-17.5	-1.4	-8.5
Electricity, Gas, Water, Waste	-3.0	0.2	8.3	-1.2	-6.8	-5.0
Other sectors	-3.9	-27.8	-6.2	17.5	28.9	25.2
Total employees	**-107.1**	**-200.8**	**-87.5**	**-31.1**	**0.8**	**42.6**

Source: NSI, UniCredit Bulbank

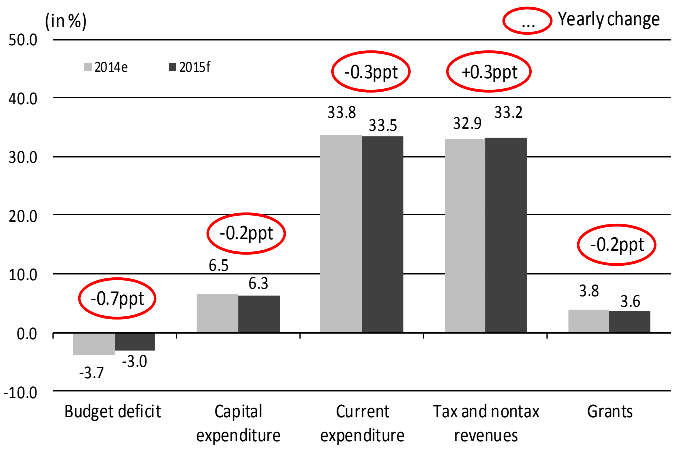
In a low-export growth environment in combination with no room for more expansionary fiscal policy, we expect that improved absorption of EU funds and some support for private consumption, via lower energy prices and a gradually declining savings rate, will be the main growth drivers in 2015. Importantly, acceleration of some long-postponed structural measures will also help to preserve the pace of GDP growth this year broadly in line with those seen in 2014.

The environment for implementation of unpopular measures became more conducive after elections held in October 2014 and there are rising signals that Bulgaria is on course to press ahead with some long-delayed structural reforms. For example, the right-wing coalition government of Mr. Boyko Borissov looks resolved to implement some of the painful steps needed to balance the pension system including tightening access to disability pensions, abolishing of early retirement privileges for some categories of public sector workers and perhaps criminalizing most severe cases of contribution nonpayment. Possible increase in the pension contribution payments, higher retirement age and reform of private pension companies regulation are also among policy moves under discussion.

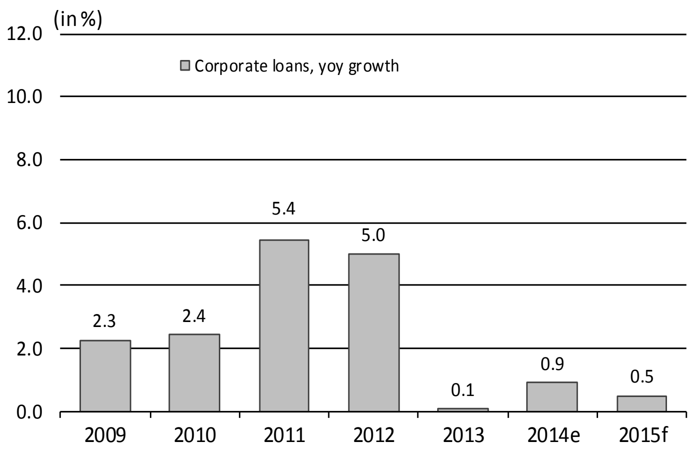
The government plans to reform emergency medical services and to base funding allocation decisions on results instead of activities carried out in the health care sector. Authorities already reversed populist cuts in energy prices undertaken by the previous administration and broadened access of the poor to state funded electricity and heating assistance. Senior coalition partner GERB looks resolved to create a working mechanism for channeling public funds into projects aimed at improving energy efficiency of multi-family residential buildings, and to renegotiate prices at which NEK (National Electrical Company) purchases electricity from some of the coal firing power plants in the Maritsa East basin as well as wind and solar power energy producers operating with the highest cost margins. Above all, consensus is gradually building up around some long contested measures for reform in the judiciary sector, which if implemented should strengthen the independence of courts and help preventing corruption practices.

While 2014 brought a shift to a more growth supportive fiscal stance, we expect fiscal policy to remain growth neutral this year, as the government has embarked on a gradual fiscal consolidation aimed at budget deficit reduction to 3% of GDP from 3.7% one year ago. The bulk of the deficit narrowing is planned to materialize via lower compensation of government employees and improved tax collection, while only a tiny part will come from lower public investments. The good news here is not only that the government has abandoned previous plans for aggressive fiscal consolidation, which given still elevated unemployment and broadly based deflationary pressure threatens to push the economy into a new recession, but also that policy makers want to cut the deficit in a way which is least detrimental for growth and jobs recovery in the short run.

Consolidated fiscal program, as % of GDP



YoY growth rate on corporate loans*



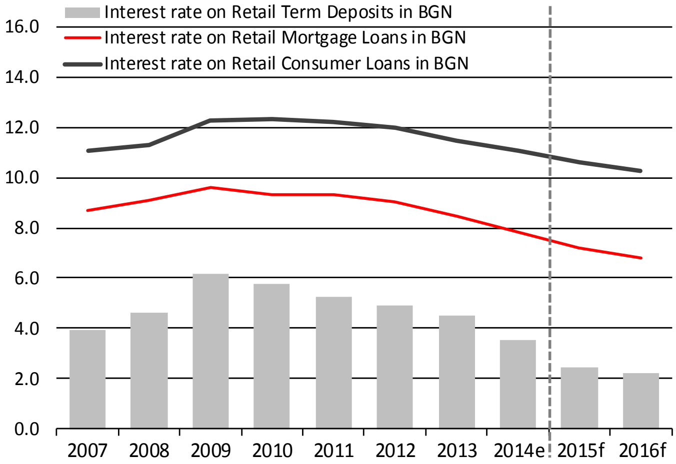
Source: NSI, BNB, MF, UniCredit Bulbank

* Corporate loan growth projections are adjusted with CoCB numbers

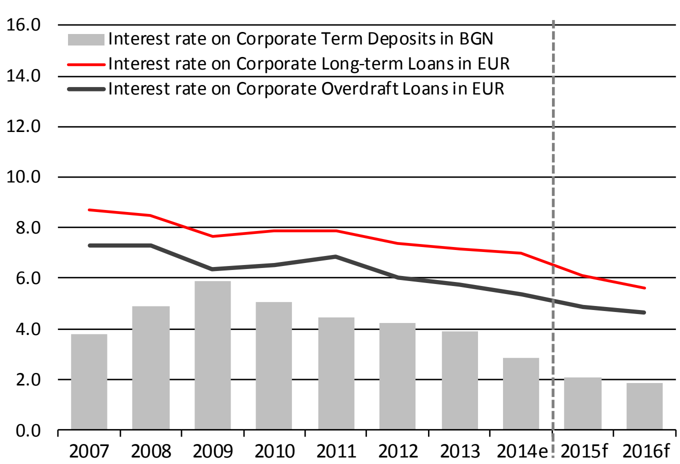
Some deceleration of credit growth is likely in 2015, but its scale will be smaller than most analysts expect and, in our view, we are far from a severe credit crunch scenario. Many economists, including those from the European Commission in their most recent forecast on Bulgaria, have rightly pointed out that the crisis in the segment of privately owned domestic lenders would have some negative impact on the domestic monetary conditions, perceived as the price and access to credit for the companies and households from the real economy. This is because the segment of privately owned domestic banks has contributed much stronger to consolidated credit growth numbers over the last six years than the segment of foreign lenders. But credit deceleration in the aftermath of the COCB crisis is likely to be rather small for two reasons. First and foremost, slow credit growth mostly reflects weak demand, while supply side capacity of Bulgarian banks has been constantly improving over the last several years and particularly after February 2013, when loan-to-deposit ratio fell below the crucial 100% benchmark. And second, credit slowdown in the segment of privately owned domestic lenders is likely to be at least partially compensated by foreign lenders, whose capacity to provide more credit has either remained intact or even improved in the course of the crisis, as deposits outflows from domestic banks added to deposits in those foreign banks which are perceived as most stable. Still some small credit deceleration would be hard to avoid this year, as prior to the crisis the segment of domestic lenders has had higher tolerance to risk and lower lending standards when compared with most of its foreign rivals. This suggests that even though foreign banks would have sufficient capacity to fully offset diminished supply of new credit from privately-owned domestic lenders, they would not be ready to do so because some of the prospective borrowers would not be able to meet their credit standards.

The June's crisis caused far reaching changes in the behavior of Bulgarian banks as regards deposits pricing, a trend which we expect to progress further next year. In the aftermath of June's events almost all local lenders embarked on a pronounced reduction in the price of domestically attracted deposits, which is an even more welcomed adjustment given pronounced deflationary pressure that Bulgarian economy has been through over the last several years and particularly in 2014 when average headline inflation is expected to have fallen by 1.4% on yoy basis. We think interest rates will continue trending downward this year and perhaps even next year, which is a clear positive, as it helps to redirect some stimuli from those who save to those who borrow, thus pushing savings rate down while channeling more income to consumption and investments.

Interest rates on outstanding retail loans and deposits, average



Interest rates on outstanding corporate loans and deposits, average



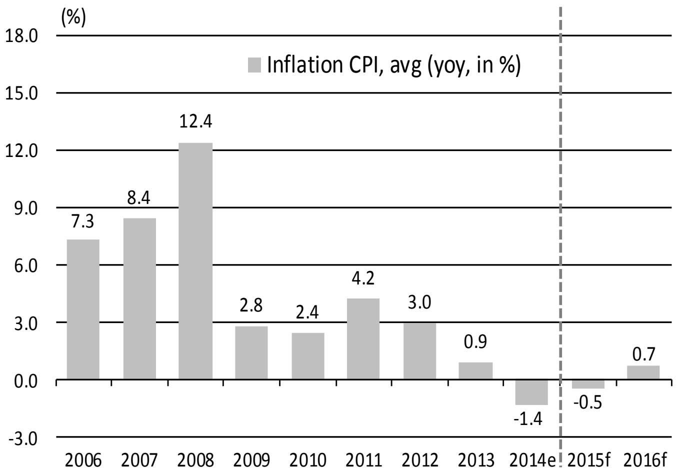
Source: BNB, UniCredit Bulbank

Unfortunately despite weaker euro, Bulgarian export recovery is likely to progress only very gradually this year. This is because GDP growth in our key trading partners from the EU area remains weak, while demand for investment goods in China is cooling down, which is a bad news not only for Germany, but also for Bulgaria to the extent that there are local producers of spare parts and equipment integrated in the German production chains. Elevated geopolitical risks on the other hand, will also weigh on global trade outlook this year, and thus on export performance and its contribution to Bulgarian recovery.

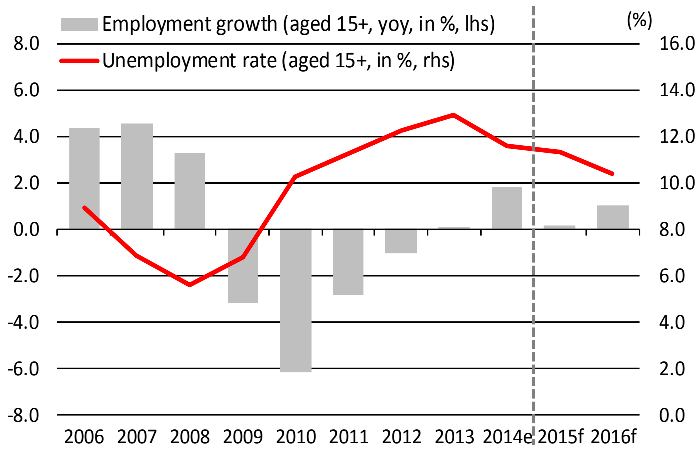
Lower crude oil prices, if sustained, should have sizeable positive effect on GDP growth and balance of payments. Each time when crude oil prices go down wealth is shifting from energy producing to energy consuming countries. Having in mind that energy accounts for 13% of households' consumption expenditures, while energy intensive sectors control roughly 30% in gross manufacturing output, lower prices of energy should have a sizeable positive contribution to Bulgarian GDP growth this year, which should mostly materialize via increased purchasing power of household incomes channel.

Albeit very slowly our baseline scenario envisages labor market conditions to continue improving from here. But the pace of the unemployment rate improvement is set to lose some momentum this year, due to job cuts in the public sector that are planned as part of the fiscal consolidation and structural reform efforts.

Inflation (CPI), yoy



Employment growth and Unemployment rate



Source: NSI, UniCredit Bulbank

To summarize all these, we expect GDP to defy gravity and to rise by another 1.5% in real terms this year. In a low-export growth environment in combination with limited room for more expansionary fiscal policy, we think, that improved absorption of EU funds and some support for private consumption, via lower energy prices and a declining savings rate, will be the main GDP growth drivers. Importantly, acceleration of some long-postponed structural measures is also expected this year, which if implemented should not only boost capacity of the economy to produce more goods and services in the long run, but should also help to economic recovery and jobs creation, via its positive impact on sentiments in the household and business sector.

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