Bulgaria

Baa2 stable/BBB- positive/BBB stable*

Outlook

As some of the risks in our previous baseline macroeconomic scenario have materialized, we decided to downwardly revise our growth forecast for 2019 to 3.3%, from 3.9%. A tad weaker growth (3.1%) is likely in 2020. Despite some easing envisaged in both 2019 and 2020, the fiscal position will remain strong enough to have sufficient room to react during the turbulent period ahead, as risks for global growth and trade have reached their most elevated levels in a decade.

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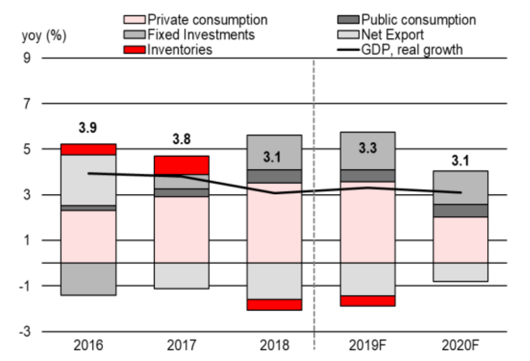
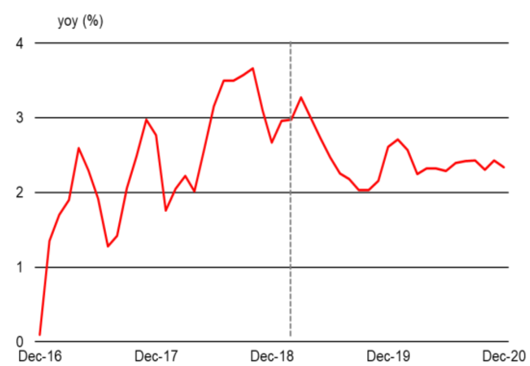
KEY DATES/EVENTS

- 15 May – GDP flash estimate for 1Q19
- 15 May – Labor force survey data for 1Q19
- 26 May – elections to the European Parliament
- 31 May – sovereign rating update by S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2016	2017	2018	2019F	2020F
GDP (EUR bn)	48.1	51.7	55.2	58.4	61.6
Population (mn)	7.1	7.1	7.0	7.0	6.9
GDP per capita (EUR)	6,777	7,328	7,882	8,403	8,927
Real economy, change (%)					
GDP	3.9	3.8	3.1	3.3	3.1
Private Consumption	3.5	4.5	6.4	4.5	3.5
Fixed Investment	-6.6	3.2	6.5	7.5	6.8
Public Consumption	2.2	3.7	4.8	4.6	4.2
Exports	8.1	5.8	-0.8	3.3	3.9
Imports	4.5	7.5	3.7	5.1	5.2
Monthly wage, nominal (EUR)	484.8	530.4	580.4	634.3	690.2
Real wage, change (%)	8.1	10.2	6.6	6.7	6.4
Unemployment rate (%)	7.6	6.2	5.2	4.5	4.1
Fiscal accounts (% of GDP)					
Budget balance	0.2	1.1	1.3	-0.5	-0.6
Primary balance	1.1	1.7	1.9	0.1	0.0
Public debt	28.6	25.4	22.1	21.3	21.3
External accounts					
Current account balance (EUR bn)	1.2	3.4	2.5	2.1	1.7
Current account balance/GDP (%)	2.6	6.5	4.6	3.6	2.8
Extended basic balance/GDP (%)	5.9	9.4	7.7	7.2	6.4
Net FDI (% of GDP)	1.3	2.1	2.2	2.3	2.3
Gross foreign debt (% of GDP)	71.1	64.6	59.3	54.9	51.7
FX reserves (EUR bn)	23.9	23.7	25.1	27.0	28.9
Months of imports, goods & services	9.4	8.2	8.1	8.2	8.0
Inflation/Monetary/FX					
CPI (pavg)	-0.1	-0.8	2.8	2.6	2.4
CPI (eop)	-0.4	0.1	2.7	2.6	2.3
Central bank reference rate (eop)	0.00	-0.39	-0.50	-0.49	-0.49
USD/BGN (eop)	1.86	1.63	1.71	1.72	1.63
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.77	1.74	1.66	1.75	1.67
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Eurostat, NSI, BNB, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Domestic demand to keep growth resilient

Some risks identified in our forecast three months ago have materialized, while others have become more prominent

Although the pace of economic expansion lost traction last year (from 3.8% in 2017 to 3.1% in 2018), the carryover into 2019 was strong and we expect 2019 GDP growth to remain above potential for a fifth year in a row. As some of the risks in our previous baseline scenario have materialized, we decided to downwardly revise our growth forecast for this year. We thus expect 3.3% real growth in 2019, compared with 3.9% previously. The revision captures weaker-than-expected growth in 2018 along with likely weaker demand for exports this year, as a slowdown in the EA proved more pronounced than we had thought. A tad weaker growth of 3.1% is forecasted in 2020 as a result of the cyclical downturn anticipated in advanced economies and lower job creation at home due to shrinking population numbers.

Resilient domestic demand will keep growth above potential in both 2019 and 2020

We remain confident that the solid domestic demand expansion will help growth to weather weaknesses that have materialized on the external front. Domestic demand will draw support from the boost in both infrastructure construction and residential construction. The 10% rise in public sector wages implemented in the beginning of 2019 is likely to spill over onto the rest of the economy, as available resources of free labor dropped to levels not seen before in the modern history of the country. All these, along with the lower energy prices envisaged in our global scenario, should provide support to incomes and consumption at a time when job creation is set to slow down, under the pressure of the shrinking working age population.

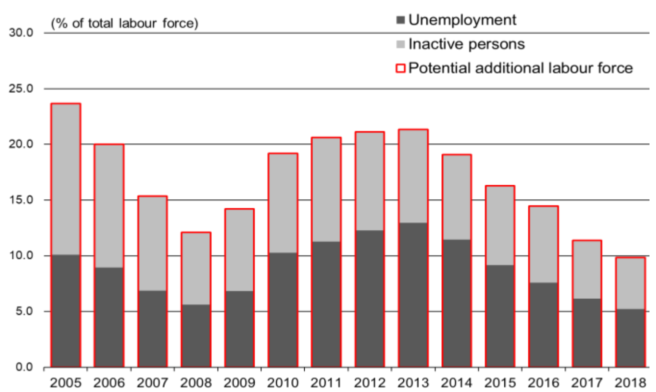
Moderate export grow is expected in 2019 amid weaker global growth and trade outlook

Moving in the opposite direction, the external environment will remain challenging, after a combination of factors (including some country specific shocks such as the weaker-than-expected harvest due to the summer drought and the unplanned maintenance and repair shutdown of the largest copper smelter Aurubis Bulgaria) already pushed real export growth into negative territory (-0.8%) last year for the first time since 2009. To make matters worse, global growth and trade weakness became more pronounced in early 2019, as a cyclical slowdown in the EA materialized earlier and also proved sharper than we had assumed. On the positive side, the growth deceleration in the EA will mean that the anticipated worsening in financing conditions will be postponed, perhaps starting no earlier than in 2021.

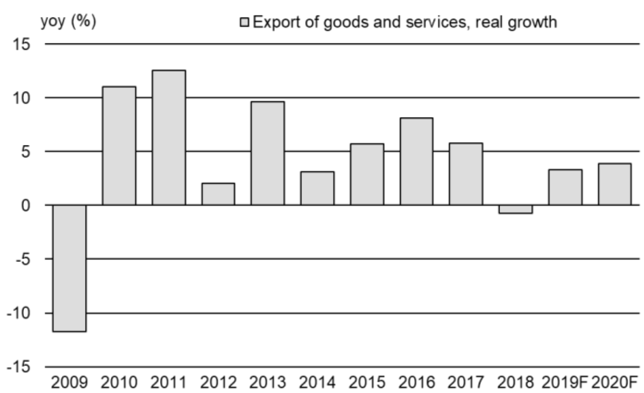
Private consumption will remain the key growth driver

Private consumption will remain the most important growth driver, despite weaker job creation. With the economy now operating at full employment, job creation is set to lose its importance as a key growth-supporting factor. Indeed, from 1.5% on average in the past five years, employment growth is forecasted to slow to 0.4% on average in the next three years, with the improvement coming from a rising participation rate of those aged 55+ and from a fall in the unemployment rate. Shrinking gains from new job creation will be offset by higher wage growth, as the government plans another 10% hike in public sector wages next year.

POTENTIAL ADDITIONAL JOBS REACHED ALL-TIME LOW



SEVERAL FACTORS PUSHED REAL EXPORT GROWTH DOWN



Source: Eurostat, NSI, UniCredit Research

Positive fiscal impulse is forecasted in 2019 and to a somewhat lesser degree in 2020

In addition, household spending will draw support from the wealth effect stemming from higher housing prices, which are expected to continue rising at a rate slightly above nominal GDP growth in 2019 and 2020, and from easing consumer price inflation.

More pronounced interest rates repricing is not in the cards this year

The budget ended 2018 with a surplus for a third year in a row – a performance matched only by a handful of countries in EU28, such as Germany and the Netherlands. We forecast moderate fiscal expansion this and to a lesser extent next year. Despite fiscal easing envisaged in our scenario, the budget position will remain very strong, with a deficit on accrual basis below 1% of GDP in both 2019 and 2020. The purpose of this policy is twofold: first, to highlight the government's commitment to fiscal prudence, thus boosting euro adoption hopes; and second, to keep room to maneuver during a turbulent period ahead, as risks for global trade and growth have reached their most elevated levels in a decade.

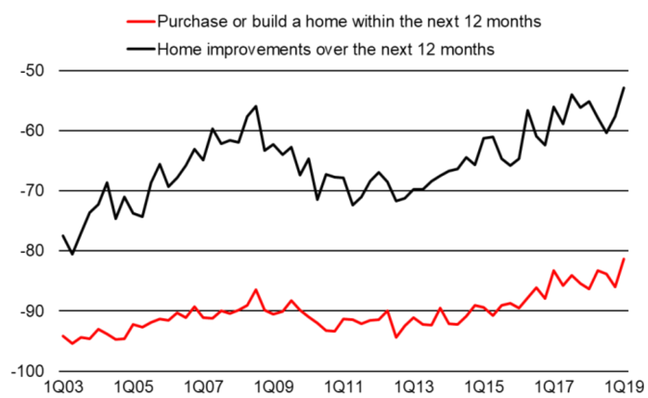
In 2018, infrastructure construction remained weak for a third consecutive year, but we expect it to shift to higher gear in 2019 and further in 2020

We keep our bullish view on residential construction this and next year. Newly issued building permits in 4Q18 posted another double digit yoy increase, while households' intention to purchase new housing continued to break records, amid growing signs that any upward repricing of mortgage loan interest rates will be postponed for the time being. Residential construction is only in the third year of its expansion, which means that Bulgaria is still lagging behind when compared with most CEE economies. Above all, expansion progresses at a healthier pace this time around, which makes us optimistic that the country will avoid the "boom-and-bust" pattern of development that ended so badly in 2009.

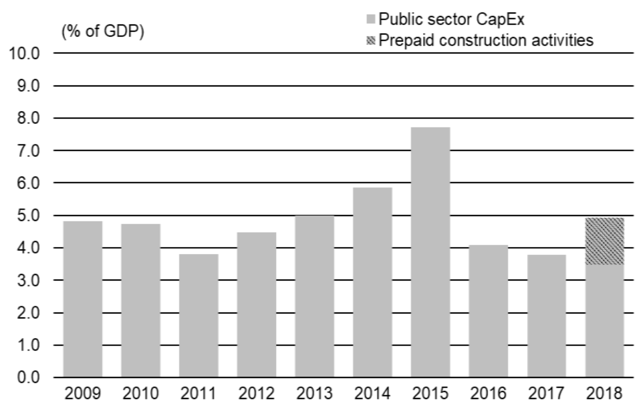
To boost construction sector's supply side capacity, the largest state-owned construction company began to invest in new machinery and equipment

Infrastructure construction failed to impress in 2018 but is set to rise in 2019 and further in 2020. On paper, public capex rose markedly to 4.9% of GDP in 2018 from 3.8% in 2017. However, this included BGN 1.4bn for the completion of the Hemus Highway and BGN 0.5bn for the reconstruction of municipal dams in need of repair, which were transferred into special budget accounts in 2018, while the corresponding construction activities have not started yet. While the reasons for the weak infrastructure construction are not entirely clear, one probable explanation is that the construction sector is failing to respond to increased demand, as it already operates at full capacity. The problem is that construction companies are reluctant to rise investment necessary to boost capacity as they are afraid that once the ongoing residential construction expansion is over, demand will fall and they will suffer losses similar to what happened after the real estate bubble burst in 2009. To fix the problem, the completion of the Hemus Highway was assigned without a tender to a state-owned construction company specialized in road maintenance. Soon thereafter, investment in new road construction machinery and equipment was made as the company's existing capacity to deal with a project of such a scale was insufficient. While this is positive, in our view, it will take time for the supply side to adjust, which, in turn, suggests that infrastructure construction is likely to increase very slowly this year before shifting to a higher gear next year.

INTENTION TO PURCHASE NEW HOUSING AT ALL-TIME HIGH



PUBLIC CAPEX RISE IN 2018 REFLECTS PREPAID ACTIVITIES



Source: Eurostat, NSI, MoF, UniCredit Research

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