

## Bulgaria: new elections next year remain the most likely scenario

- The center-right pro-EU Citizens for European Development of Bulgaria (GERB) won the snap election held last Sunday and will be in the driver's seat in negotiations to form a new government.
- The former ruling party, the centrist We Continue the Change (PP), finished second, as the party's approval rating fell following the collapse of the PP-led coalition government in June.
- Support for the populist parties remained little changed from the previous election. However, the vote for the populist parties was further radicalized, with support for the ultra-nationalist, pro-Russian Revival party rising to 10.2%.
- The election results showed that supporters of Russia are a clear minority. This is important because the parliamentary election turned into a de facto referendum on Bulgaria's NATO and EU membership.
- We continue to see another caretaker government and a new election early next year as the most likely scenario from here.
- A second likely scenario, with small-to-moderate probability of materializing, involves the formation of a pro-Western coalition government. Quality of policymaking is likely to improve if a pro-Western coalition government is put together.

### Support for populist parties failed to increase by much but was further radicalized

GERB managed to win the snap parliamentary election with 25.3% of the vote (Charts 1 and 2), after all voting lists were aggregated by the central election committee. The GERB's share of the total vote increased by roughly 3pp compared to the previous election in 2021 (Charts 1 and 2). The strong showing by GERB reflects voters' disappointment with the PP-led government's controversial management of the economy following its landslide election victory in November 2021.

The PP lost around 5.5% of votes compared to 2021, the most by any party that entered this parliament. It finished second with 20.2% of the vote, ahead of the mostly ethnic Turkish party, Movement for Rights and Freedoms (MRF), which finished third, with 13.8% of the vote. PP has seen its approval rating slowly erode as voters have shunned the confrontational rhetoric of its leaders.

The pro-Russian and anti-EU ultranationalist Vazrazhdane (Revival) Party benefited mostly from the populist vote. They finished fourth, more than doubling their approval rating, to 10.2% from 4.9% in 2021. Revival attracted the most fanatic Russian supporters by using aggressive ultra-nationalistic rhetoric bordering with hate speech, according to some commentators.

Support for the Bulgarian Socialist Party (BSP) fell further, and the BSP finished fifth, with 9.3% of the vote.

Democratic Bulgaria (DB), an alliance of three right-wing formations, managed to improve its support to 7.4% from 6.4%, as some of the disappointed voters of the PP switched their allegiance in favor of the DB.

The last party to clear the 4% hurdle for parliamentary entry was the newly created Bulgarian Rise Party (BR), which garnered 4.6% of the vote. Its leader, Stefan Janev, served as prime minister of the caretaker government appointed by pro-Russian President Rumen Radev during the height of the coronavirus pandemic in 2021.

On the positive side, support for the populist parties remained little changed compared to the previous election. However, the vote for the populist parties was further radicalized, with support for Revival rising markedly, at the expense of other nationalist formations that share less extreme views on policymaking.

The results showed that the fanatic supporters of Russia are a minority of the electorate. This is important, because the election turned into a de facto referendum on Bulgaria's NATO and EU membership. The approval rating of Revival was far below the results that its leaders hoped to achieve. When support for the BSP and the BR, which share more-mainstream views is taken into account, the share of the vote that went to pro-Russian parties rises to one-fourth of the total.

**A FOURTH HUNG PARLIAMENT IN A ROW WITH A MAJORITY OF PRO-WESTERN MPS**

Chart 1: seven parties will be present in the new parliament

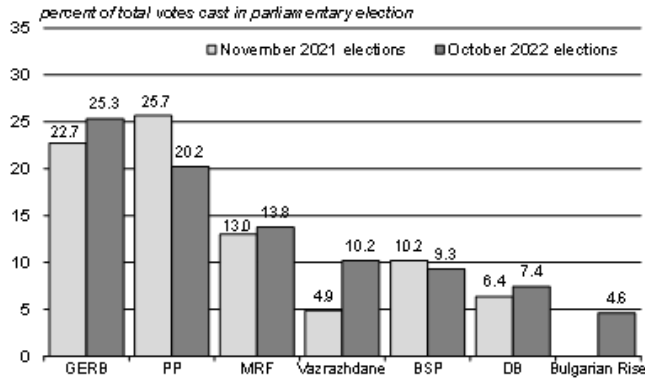
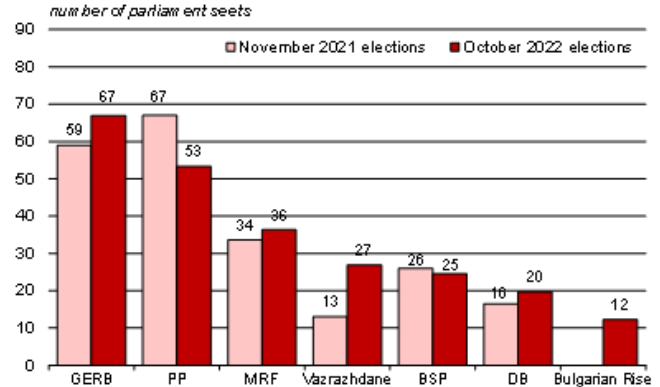


Chart 2: pro-Western parties will have more than 70% of MPs



Source: Central Election Commission (based 100% of processed data), UniCredit Research

**Our baseline scenario remains that Bulgaria will have another caretaker government and that a new election will take place early next year**

Under this scenario, the parliament fails to form a government and is dissolved soon afterwards. Political power remains in the hands of Mr. Radev, whose caretaker government will continue to run the country until March or perhaps April next year, when the next snap parliamentary election will be organized.

Failure to form a stable government would leave the country without a clear policy direction at a time when the economy is entering a technical recession, a cost-of-living crisis is being aggravated and the Russia-Ukraine crisis is likely escalating. The country and its economy need a stable government also because there are decisions that would be costly to postpone.

We are worried that an unending election saga could threaten Bulgaria’s euro adoption, which serves as a main policy anchor and thus plays a big role in shaping market expectations. We still expect Bulgaria to swap the lev for the euro in 2024, but this would require political support for reforms from those who are in charge of the country’s policymaking as well as a sufficiently strong degree of cooperation between the government and the central bank. Meanwhile, long-term planning and fiscal thrift have taken a back seat, while the volume of public sector funded infrastructure investments have continued to disappoint.

If this scenario materializes, the chances that further fiscal measures will be implemented to support the most vulnerable before mid-2023 will diminish significantly. Structural reforms that are so important to boost supply side of the economy will lose momentum further. Judiciary reform will come to a halt. Modernization of the army will have to be postponed, while sending weapons to Ukraine will be left up to a president with a pro-Russian geopolitical orientation. Reform of the energy sector would also likely suffer, especially those parts that are designed to make the economy greener and less dependent on Russia as a main supplier of primary energy resources and technology for the country’s only nuclear power plant, in Kozloduy.

**Pro-Western coalition government is one option despite a limited desire to seek compromise**

A second likely scenario, one with a small-to-moderate probability of materializing, involves the formation of a pro-Western coalition government. Under this scenario, the four parties with a pro-Western geopolitical orientation, GERB, PP, MRF and DB, put aside their differences and form a government. Chart 3 shows all four possible pro-Western coalitions that are feasible.

There are several reasons why we think such a coalition is possible, although its formation is seen as less likely than new elections being called in early 2024.

First, all four parties not only have a similar geopolitical orientation but also share similar views in a number of policy areas (see Table 1), such as fiscal policy, taxation and euro adoption. This would be key in the forthcoming coalition talks, especially given the limited amount of time the participants in the negotiations will have to reach an agreement.

Second, and more importantly, the prospect of escalation of the Russia-Ukraine crisis makes such a coalition a necessity. It would be problematic for a NATO and EU member state, where pro-Western parties have just won more than two-thirds of the parliamentary vote, to leave the pro-Russian Mr. Radev to appoint another caretaker government to run the country this winter.

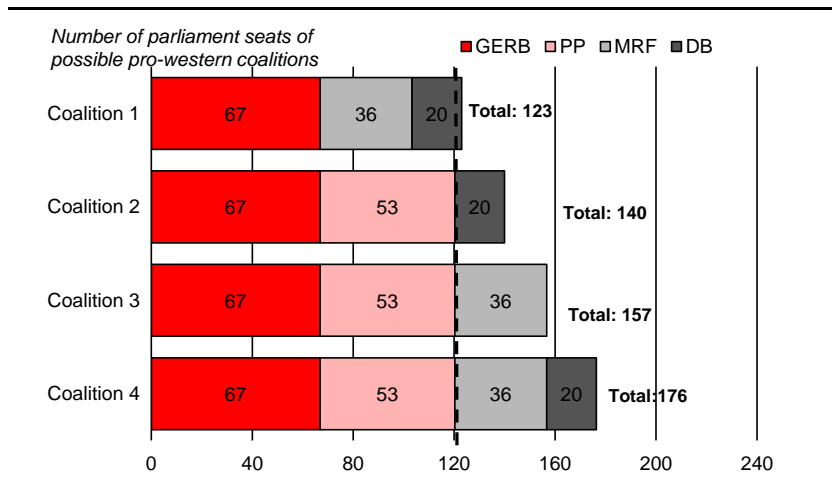
Third, municipal elections in 2023 are likely to stimulate the parties to be part of the next government. This is because governing parties are in a more favorable position to organize the vote. The latter is particularly relevant for GERB, whose strong results historically have been attributable, among other things, to its very solid presence in the country's local administration.

At the same time, such a coalition looks difficult to put together. The PP and DB, which were partners in the previous government, are among the harshest critics of GERB. They would perhaps be tempted to leave responsibility for running the country in the hands of GERB, because given how difficult the winter is likely to be, such a move could bring them back to power soon.

What further complicates the situation is that the PP and DB practically share a common base of supporters. Part of those who voted for the PP in 2021 decided to shift their support to the DB on Sunday. This helped the latter improve its showing compared to the 2021 election, while the main opposition party, GERB, overtook the PP. Against this backdrop, each of these two parties would be very hesitant to form a coalition with GERB if the other one remains in opposition, as there could potentially be a heavy political price to be paid next time when the voters go to the ballot boxes.

Perhaps judiciary reform is the area where compromise will be hardest to reach. However, the fact that when taken together these parties control more than two-thirds of the seats in the parliament offers a chance for a compromise that, in our view, should be seized upon. Moreover, GERB made it clear that it is ready to discuss the replacement of the general prosecutor, Ivan Geshev, and perhaps commit to other reforms, if this is what is needed to push reform momentum. This may prove crucial eventually as, apart from the divisive figure of Mr. Geshev, all four parties have expressed support for the recommendations made by the Venice Committee. These recommendations are described in more detail in the column focusing on judiciary reform in Table 1 and perhaps suggest that agreement is likely about a long list of concrete reform steps that need to be implemented.

**CHART 3: THERE ARE FOUR FEASIBLE COALITIONS THAT PRO-WESTERN PARTIES CAN FORM**



Source: Central Election Commission (based 100% of processed data), UniCredit Research

**TABLE 1: SELECTED POLICIES OF POLITICAL PARTIES PRESENT IN THE NEW PARLIAMENT**

	Fiscal policy	Taxation	NATO / EU/ stance on war in Ukraine	Euro adoption	Judiciary reform
<b>GERB</b>	Cut deficit to 3% of GDP in 2026. Support fiscal decentralization. Increase public spending for education to 5% of GDP. Higher wages for public health care and education.	Keep existing level of taxes and model of taxation.	Pro-NATO and pro-EU. Supports provision of weapons to Ukraine.	Support euro adoption in 2024.	Split the Supreme Judiciary Council (SJC) into two bodies - one for the judges and another for prosecutors. Reduce the quota of the parliament in electing SJC members. Judicial control over a prosecutor's refusals to initiate pre-trial proceedings. New structure of Commission for Anti-Corruption and Illegal Assets Forfeiture (CACIAF). Increase accountability of the Prosecutor General (PG).
<b>PP</b>	Adopt long-term capital spending program based on cost-benefit analysis. More pension increases.	Cut income tax for families with children. Cut income tax on parents raising children with disabilities.	Pro-NATO and pro-EU. Supports provision of weapons to Ukraine.	Support euro adoption in 2024.	Incumbent PG to resign. Split the SJC into two bodies - one for the judges and another for prosecutors. Reduce the quota of the parliament in electing SJC members. Split of CACIAF into two independent commissions. Increase accountability of the PG. Judicial control over a prosecutor's refusals to initiate pre-trial proceedings.
<b>MRF</b>	Cut budget deficit in the medium-term. More pension increases.	Keep existing level of taxes and model of taxation.	Pro-NATO and pro-EU. Supports provision of weapons to Ukraine.	Support euro adoption in 2024.	Split the SJC into two bodies - one for the judges and another for prosecutors. Reduce the quota of the parliament in electing SJC members. Increase accountability of the PG.
<b>Vazrazhdane</b>	Cut government employees by 40% in order to increase salaries of the remaining job holders by 50%.	Cut income tax for families with children. Cut VAT rate to 18%. Zero VAT rate for drugs and food. Increase the threshold for VAT registration. Tax incentive for investment. Higher taxes on gambling.	Against NATO. Against sanctions on Russia. Against sending weapons to Ukraine.	Against euro adoption. Wants to keep national currency BGN indefinitely.	Split the SJC into two bodies - one for the judges and another for prosecutors. Abolition of the parliament quota in SJC. The SJC must report to the National Assembly.
<b>BSP</b>	Increase public capex via public-private partnership. More pension increases. Cost-free drugs for people above 75.	Introduce tax-free allowance on personal income equal to the poverty line. Shift to progressive scale for taxation of personal income in the long run. Cut VAT on drugs and medical products.	Nominally a pro-EU party. However, it often take positions that favor Russia. Against provision of weapons to Ukraine.	Euro adoption is not an immediate priority. It should be made only after full guarantees are in place that households' incomes and savings will be protected.	Incumbent PG to resign. Increase accountability of the PG. New law, structure, functions and powers of CACIAF.
<b>DB</b>	Smaller state. Achieve balanced budget in the medium-term. Cut public spending below 40% of GDP immediately (41% in 2021) and 35% in the medium-term. Rule-based setting of minimum wage to avoid its excessive growth.	Introduce tax free-allowance on personal income. Increase the threshold for VAT registration to help SMEs and some high-income individuals to benefit.	Pro-NATO and pro-EU. Supports provision of weapons to Ukraine.	Support euro adoption in 2024.	Incumbent PG to resign. Split the SJC into two bodies - one for the judges and another for prosecutors. Reduce the quota of the parliament in electing SJC members. Election of the PG by the parliament with a three-fifths majority. Increase accountability of the PG.
<b>Bulgarian Rise</b>	Not covered in the party's programme.	Higher taxes for companies with public procurement contracts.	Nominally a pro-EU party. However, it has too strong pro-Russian sentiments, which could be a source of concern. Against provision of weapons to Ukraine.	Postpone euro adoption, without specifying a concrete target date.	Reduce the quota of the parliament in electing SJC members. Increase accountability of the PG.

Source: political parties' programs, interviews with local media, UniCredit Research

**Quality of policymaking is likely to improve if a pro-Western coalition is formed**

If a pro-Western, right-wing coalition government is put together, the country's macro-policy management is likely to improve.

Similarities in the four parties' views on taxation and fiscal policy management could be instrumental to reaching an agreement on consolidating the country's fiscal position (see Table N1) once recession threat is over.

If formed, such a coalition government is likely to unlock public-sector investment. To this end, the government will have to remove the obstacles standing in the way of restarting the infrastructure projects initiated by GERB's administration prior to 2021. In addition, the government will have to prepare new legislation that is required for the release of tranches of EU funding under the country's Recovery and Resilience Program. All these will have to be adopted quickly. Otherwise, Bulgaria will run the risk of failing to increase the volume of EU-funded investment at a time when its economy is heading into a recession.

If such a coalition is formed, it is likely to change the design of the energy-subsidy scheme for companies, where across-the-board support for all companies is replaced with a more-selective approach. Such move will help cut public-sector funding channeled to energy subsidies at a moment when the fiscal position is under rising pressure due to the decelerating economy.

Reconfirming euro adoption in 2024 seems to be an area where agreement would perhaps be most easy to reach (see table N1). This would help to stabilize expectations and keep the cost of borrowing in check at a challenging moment, when the ECB looks likely to overtighten monetary conditions in the euro area.

Finally, such a coalition is likely to restart the long-overdue modernization of the Bulgarian army and to send soviet-style weapons to support Ukraine, while other modern equipment compatible with NATO standards is urgently acquired.

We have decided to keep our baseline macroeconomic scenario unchanged because the downward revision in the country's outlook in our last *CEE Quarterly* was already based on the assumption that the parliament will fail to form a stable government and a new election would be called next year. However, if a pro-Western government is put together, we stand ready to upwardly revise our forecast, once more details about economic policies and the timeline of reform implementation are made available.

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This report was completed and first published on 11 October 2022 at 15:04.

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