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2Q 2017

Bulgaria (Baa2 stable/BB+ stable/BBB- stable)*

Outlook – GERB's win in the 26 March snap elections has set the stage for yet another center-right coalition government, this time with the nationalist United Patriots and Volya. This suggests a shift toward somewhat more growth-supportive policies, along with renewed focus on some structural reforms. While financial discipline is likely to be sustained, the government will use ample fiscal room to selectively boost some spending. This, along with the much-improved global environment and the acceleration of EU fund inflows, will boost growth to nearly 4% this year and only slightly less next year. The sustainability of this pace, however, will depend on the progress in growth-enhancing structural reforms, containing corruption and wasteful spending and creating a conducive environment for private investment.

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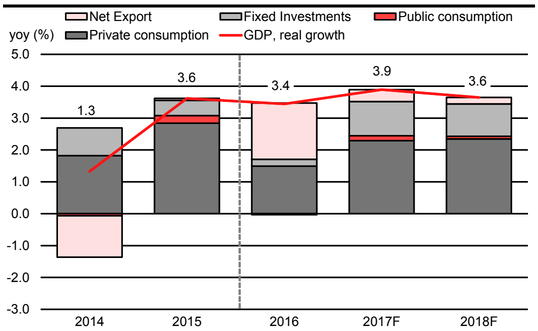
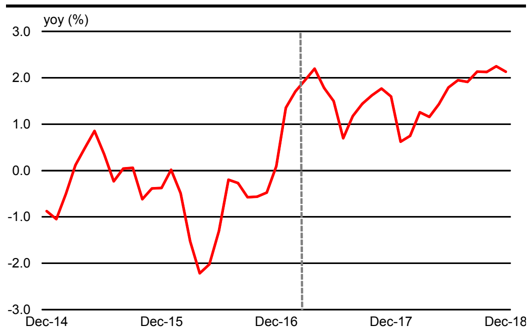
KEY DATES/EVENTS

- Early Apr: Government's coalition agreement announced
- 15 May: Labor force survey data for 1Q17
- 16 May: GDP flash estimates for 1Q17

PRIVATE CONSUMPTION TO DRIVE GDP GROWTH



ULTRA LOW INFLATION IS COMING TO AN END



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2014	2015	2016	2017F	2018F
GDP (EUR bn)	42.8	45.3	47.4	49.9	52.6
Population (mn)	7.2	7.2	7.1	7.1	7.0
GDP per capita (EUR)	5,937	6,330	6,656	7,056	7,467
Real economy, yoy change (%)					
GDP	1.3	3.6	3.4	3.9	3.6
Private Consumption	2.5	3.9	2.1	3.2	3.3
Fixed Investment	3.4	2.7	-4.0	5.4	5.0
Public Consumption	-0.8	2.9	-0.4	2.0	1.1
Exports	3.1	5.7	5.7	5.7	5.3
Imports	5.2	5.4	2.8	5.1	5.0
Monthly wage, nominal (EUR)	420	449	492	536	584
Real wage, change (%)	7.4	7.0	10.3	7.4	7.3
Unemployment rate (%)	11.4	9.1	7.6	6.8	6.0
Fiscal accounts (% of GDP)					
Budget balance	-3.6	-2.8	1.6	-1.5	-2.2
Primary balance	-3.0	-2.0	2.4	-0.7	-1.4
Public debt	26.4	25.6	29.1	25.8	25.7
External accounts					
Current account balance (EUR bn)	0	0.2	1.8	1.0	0.8
Current account balance/GDP (%)	0.1	0.4	3.8	2.1	1.5
Extended basic balance/GDP (%)	4.4	6.8	7.0	6.5	6.0
Net FDI (% of GDP)	2.1	3.5	1.1	2.4	2.6
Gross foreign debt (% of GDP)	92.0	75.3	73.3	69.3	65.7
FX reserves (EUR bn)	16.5	20.3	23.9	25.8	28.1
Months of imports, goods & services	6.5	8.0	9.4	9.5	9.7
Inflation/Monetary/FX					
CPI (pavg)	-1.4	-0.1	-0.8	1.6	1.6
CPI (eop)	-0.9	-0.4	0.1	1.6	2.1
Central bank reference rate (eop)	0.02	0.01	0	0	0
USD/BGN (eop)	1.61	1.79	1.86	1.81	1.71
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.47	1.76	1.77	1.78	1.69
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	139.8	136.9	136.1	137.1	136.0
Change (%)	-1.1	-2.1	-0.6	0.8	-0.8

Source: Eurostat, NSI, BNB, MoF, UniCredit Research

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

Stronger growth ahead

A shift towards the wrong sort of populism was largely avoided this time

No abrupt changes in the course of economic policy-making is anticipated

The new government will selectively boost some spending

The general elections produced few surprises, with GERB, the largest center-right party, set to form a coalition government, this time with the nationalist United Patriots and Volya, a largely populist newcomer to politics (see lhs chart). This suggests that there will be no abrupt shifts in policy making. The new government will remain strongly committed to financial discipline and preserving macroeconomic stability. The goal of maintaining a business-friendly environment, including low and simple taxation of entrepreneurship, endorsed by a long succession of previous governments, will be sustained. At the same time, we expect a shift toward more growth-friendly policies, perhaps with some elements of populism to appease the junior coalition partners, and progress on some structural measures, such as improving the quality of human capital and curtailing some of the remaining infrastructure gaps.

Strengthening the quality of human capital is likely to become key policy priority

The government also plans to spend more to improve the quality of educational resources

A rarely seen political consensus to increase budget allocation to education has taken shape during the election campaign. To this end, the new coalition government is expected to double the salaries of teachers in the next four years and spend more to encourage longer pre-primary education for all children. It remains to be seen, however, whether this additional spending will be accompanied by a comprehensive education restructuring program, which reduces barriers to equal educational opportunities, boosts the quality of vocational education and training, improves the country's ability to retain talents and reduces the brain drain.

BGN 2bn of public sector funding was already invested in the national program for improving energy efficiency of housing

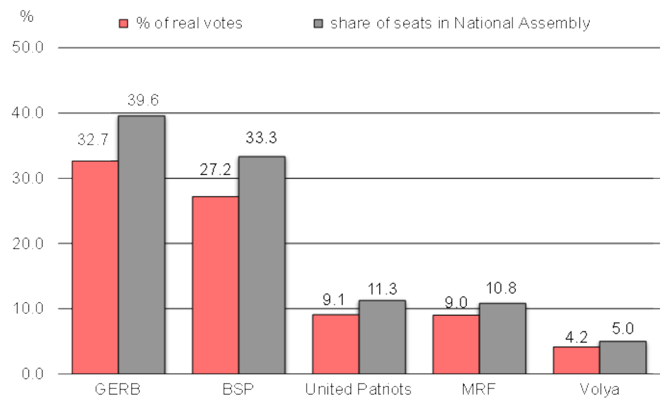
The new government will remain strongly committed to infrastructure investment. The scope of the projects which will receive support from the public sector will be expanded to include not only transport and energy, but also irrigation infrastructure development, while the focus will increasingly shift to the poorest regions of the country. More funding is also likely to be allocated to the national program for improving energy efficiency of housing, which already helped 400,000 people (many of whom energy poor) to reduce their bills.

GERB promises to raise the minimum wage by 9% on average over the next four years, which will help reduce working poverty and cut the underreporting of income

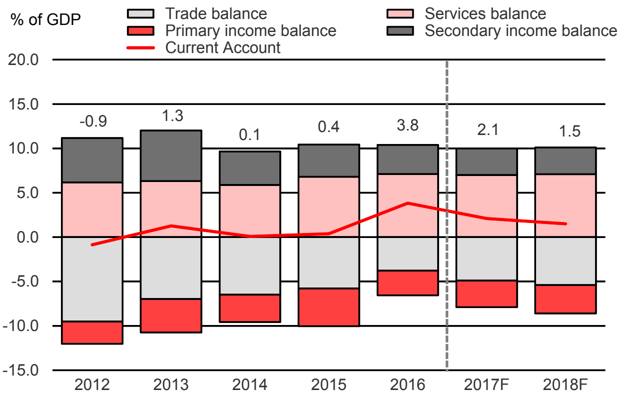
However, promises to increase other social spending were more balanced

The new government is likely to raise some pensions and boost salaries of teachers, doctors and security personnel, which should help household income and lead consumption to moderately increase. This will address the long-overdue problems of understaffing and underpayment in some branches of the public sector, without major risks for the stability of the budget, as there seems to be enough room for fiscal stimulative measures. Even if these translate into some pressure on labor costs in the private sector, this is unlikely to dangerously undermine international cost competitiveness, since the C/A ran a record-high surplus of almost 4% of GDP in 2016 (see rhs chart), which we see declining only modestly in the next two years. Importantly, to ensure that total fiscal spending will remain under control, any further plans to raise pensions and other social spending next year are likely to be made conditional on the pace of real GDP growth and progress on efforts to boost tax collection.

General elections produced no surprises this time around



C/A surplus reached all-time record at the end of 2016



Source: BNB, NSI, UniCredit Research

There is a risk of judiciary reform falling victim to the wrong sort of populism

Among institutional and structural measures, judiciary reform is likely to remain the most closely watched priority. GERB promises to implement all seventeen recommendations in the last report of the European Commission under the co-operation and verification mechanism, while the campaign programs of its junior coalition partners were rather short of detail on what is needed to improve the effectiveness of the judiciary. Given the mixed track record of GERB and lack of sufficient emphasis in the campaign programs of its coalition partners, we are skeptical that the new government will be able and, perhaps also, willing to achieve much on this front. We think that reorganization efforts will continue and we may even see more high-ranking officials convicted of corruption offences, but all this will fall short of what is needed to see strong progress on reducing corruption and to meet public demands in this area.

Bulgaria needs stronger income convergence to fully benefit from euro adoption

GERB will target ERMII entry in 2018, which seems overly ambitious to us, given where the country's income stands relative to that in the EA (see lhs chart), and particularly when taking into account the lack of appetite for euro expansion among its core country members.

There is little clarity on how to force hospitals to stop forging diagnosis to get access to most generously funded clinical treatments

In other areas, commitment to structural policies has been less specific. For example, while healthcare reform is considered a priority, the election programs of GERB and its coalition partner are light on details on how to centralize drug purchases so as to prevent fraud and overpayment by hospitals and what to do about people without healthcare coverage.

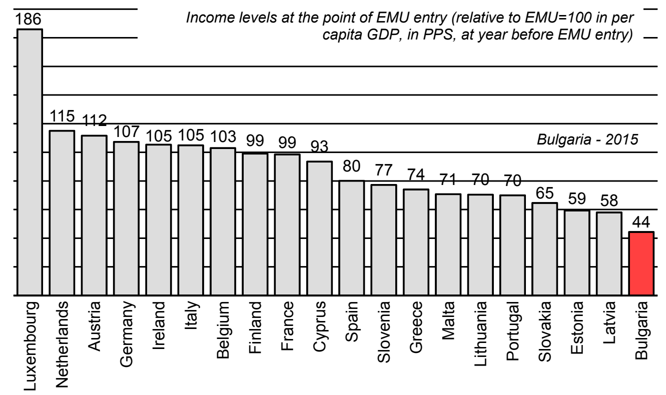
We upwardly revised not only consumption outlook, but also export performance and to a somewhat lesser extent investment in our baseline scenario for 2017 and 2018

Meanwhile, external conditions took a turn for the better. The EA growth has been upwardly revised by 0.3pp to 1.8% in 2017 and up by 0.1pp to 1.5% in 2018, mainly due to stronger pent-up demand. The outlook for EA exports, which is crucial for Bulgarian export-oriented companies that have already been deeply integrated into western European production chains, has been upwardly revised as well. Though to a lesser extent, the investment outlook has also improved. Growth in investment will strengthen not only because of the fading drag from last year's decline in EU structural funds inflow, but also because of signs that production capacity is failing to meet expected demand in some manufacturing sectors. Accelerating mortgage lending along with the rising volume of newly-issued building permits and healthy increases of housing prices, also bodes well for investment this and next year.

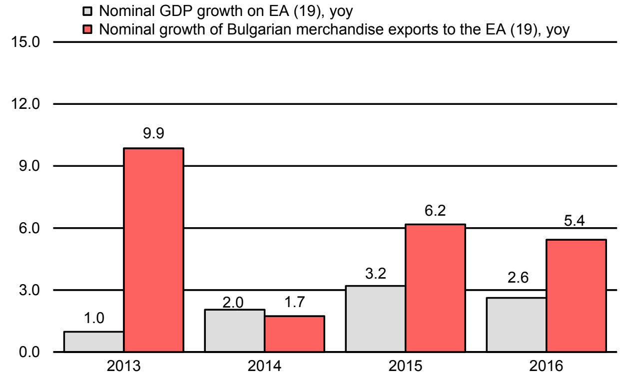
With the economy approaching full employment, domestic demand will remain in the driver's seat

This, along with the shift towards more growth-supportive policies expected from the new government, has led us to upgrade our growth projection. We now expect real GDP growth to accelerate to 3.9% this year (from 3.6%) and 3.6% next year (from 3.4%). Private consumption will remain the key driver of growth, mostly because the labor market will continue to create new jobs and wages will rise further. Higher headline inflation caused by rising oil prices will dent purchasing power. The latter will be more than compensated for, however, by a strongly improving labor market as the economy is getting closer to full employment and by a shift towards more growth supportive fiscal policy, as more public capex and some public sector salary and pension increases are expected to kick in later this year.

Bulgaria needs stronger income convergence before euro adoption



Upwardly revised EA growth forecast to reinforce Bulgarian export



Source: Eurostat, Central Election Commission, NSI, UniCredit Research

Strategy: favor the belly of the curve

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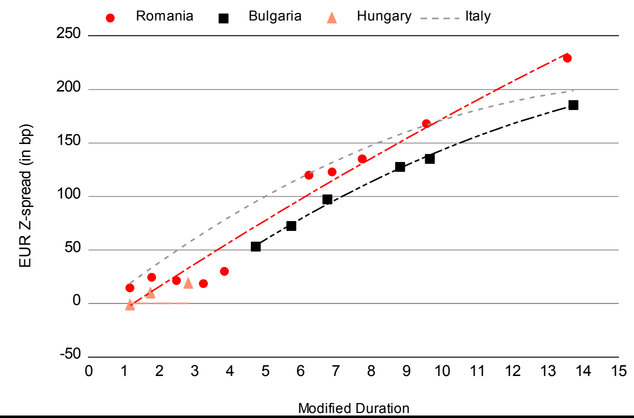
Bulgarian EUR bonds were among the best performers in the CEE area during the first three months of the year. Propped up by their scarcity value, they outperformed rating peer Romania in the long end, tightening between 20-35bp in maturities ranging from 2024 to 2028. We think that this spread differential is justified by the better fiscal position and lower political risk.

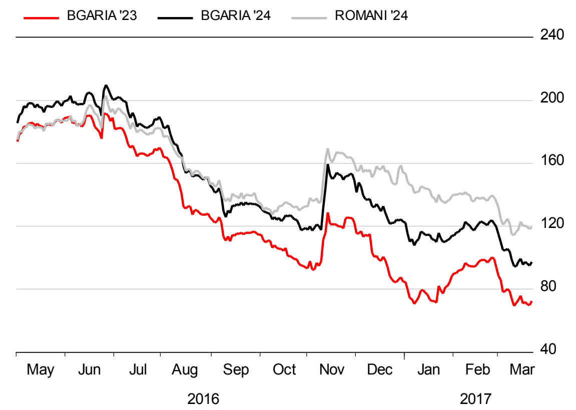
Bulgarian EUR-denominated bonds are tightly priced, trading at a Z-spread similar to that of Spain which has a rating two notches higher. We think that the bonds will remain tightly priced and will continue to benefit from their relative scarcity value.

Government fiscal balances are among the most solid in CEE, with a primary deficit just below 1%, public debt to GDP of 25% and large cash balances, and hence we do not foresee issuance in international capital markets in 2017 or 2018. We expect that most of the EUR 950mn BGARIA bonds maturing in July, held largely by local banks, will be reinvested in the EUR bonds in the belly of the curve which is less richly priced.

Investment grade EUR Z-spread yield curve, in bp



Z-spread of Bulgaria '23/'24 vs. Romania '24



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**0**	**2.3**	**2.0**
Budget deficit	-0.8	0.7	1.2
Amortization of public debt	0.7	1.5	0.8
Domestic	0.5	0.4	0.6
Bonds	0.5	0.4	0.6
Bills	0	0	0
Loans	0	0	0
External	0.2	1.1	0.2
Bonds and loans	0	1.0	0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**0**	**2.3**	**2.0**
Domestic borrowing	0.3	0.5	1.3
Bonds	0.3	0.5	1.3
Bills	0	0	0
Loans	0	0	0
External borrowing	2.0	0.1	0.1
Bonds	1.9	0	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	-2.2	1.7	0.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**10.0**	**11.6**	**10.6**
C/A deficit	-1.8	-1.0	-0.8
Amortization of medium and long term debt	3.9	4.6	3.6
Government/central bank	0.2	1.1	0.2
Banks	0.5	0.4	0.4
Corporates/Other	3.2	3.1	3.0
Amortization of short-term debt	7.9	8.0	7.8
Financing	**10.0**	**11.6**	**10.6**
FDI (net)	0.5	1.2	1.4
Portfolio equity, net	0.6	-0.2	0
Medium and long-term borrowing	5.0	4.0	3.0
Government/central bank	2.0	0.1	0.1
Banks	0.3	0.4	0.4
Corporates/Other	2.8	3.5	2.5
Short-term borrowing	8.0	7.8	7.6
EU structural and cohesion funds	1.5	1.6	1.6
Other	-2.1	-0.8	-0.7
Change in FX reserves	3.6	1.9	2.3
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	1.9	-1.0	0

Source: BNB, MoF, UniCredit Research

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EFI 38