UniCredit

September 2022

CEE Macro & Strategy Research

CEE Quarterly

Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

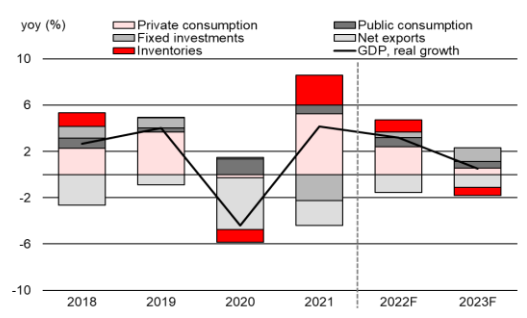
The parliamentary election on 2 October 2022 is likely to produce an inconclusive outcome. Against this backdrop, and after taking into account the deterioration in the near-term outlook in our global scenario, we decided to make significant changes to our forecast. We now think that the economy will undergo a shallow recession at the turn of this year. However, several factors should help the economy avoid a more meaningful growth contraction this year and next. Importantly, commitment to euro adoption in 2024 will be reconfirmed, in our view, which will help to stabilize expectations and keep borrowing costs in check.

Author: **Kristofor Pavlov,** Chief Economist (UniCredit Bulbank)

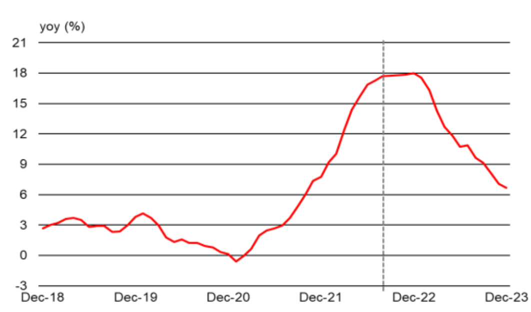
KEY DATES/EVENTS

- 2 Oct: parliamentary elections
- 3 Oct: census 2021 - final data
- 15 Nov, 7 Dec: 3Q22 GDP data (flash, structure)
- 17 Oct, 15 Nov, 14 Dec: CPI
- 18 Nov: sovereign rating review by Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2019	2020	2021	2022F	2023F
GDP (EUR bn)	61.6	61.3	67.9	81.4	92.2
Population (mn)	7.0	6.9	6.8	6.8	6.7
GDP per capita (EUR)	8 855	8 867	9 924	12 030	13 748
Real economy, change (%)					
GDP	4.0	-4.4	4.2	3.2	0.5
Private consumption	6.0	-0.4	8.0	3.5	0.8
Fixed investment	4.5	0.6	-11.0	3.0	6.7
Public consumption	2.0	8.3	4.0	4.3	3.1
Exports	4.0	-12.1	9.9	5.2	1.8
Imports	5.2	-5.4	12.2	6.7	3.0
Monthly wage, nominal (EUR)	648	709	793	894	998
Real wage, change (%)	7.5	7.7	8.5	-2.7	0.5
Unemployment rate (%)	4.2	5.1	5.3	4.7	4.8
Fiscal accounts (% of GDP)					
Budget balance	2.1	-4.0	-4.1	-5.1	-5.5
Primary balance	2.7	-3.5	-3.6	-4.6	-5.0
Public debt	19.6	24.1	24.5	23.9	26.9
External accounts					
Current-account balance (EUR bn)	1.1	0.0	-0.4	-2.4	-2.8
Current-account balance/GDP (%)	1.9	0.0	-0.5	-2.9	-3.0
Extended basic balance/GDP (%)	5.0	5.9	2.1	-0.5	-0.3
Net FDI (% of GDP)	2.0	4.5	1.5	1.1	1.2
Gross foreign debt (% of GDP)	61.3	64.9	61.8	52.7	48.1
FX reserves (EUR bn)	24.8	30.8	34.6	31.4	31.8
Months of imports, goods & services	7.4	10.4	9.3	5.9	4.9
Inflation/monetary/FX					
CPI (pavg)	3.1	1.7	3.3	15.4	11.2
CPI (eop)	3.8	0.1	7.8	18.0	6.7
LEONIA (eop)	-0.61	-0.70	-0.53	n.a.	n.a.
USD/BGN (eop)	1.74	1.60	1.73	2.02	1.86
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.75	1.71	1.66	1.88	1.90
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Bulgarian National Bank, Eurostat, National Statistical Institute, UniCredit Research

*long-term foreign-currency credit ratings as provided by Moody's, S&P and Fitch, respectively

Headwinds to growth are intensifying

The election is likely to produce an inconclusive outcome…

…paving the way for a new vote in the spring of 2023

With Bulgarians set to head to the polls for a fourth time in less than two years, the outlook is for a fragmented parliament and radicalization of the vote in favor of populist parties. We think the next parliament will not likely be able to form a stable government, which will pave the way for a new parliamentary election in the spring of next year. Under the likeliest scenario, a minority government or neutral government run by technocrats would be formed. Such a government would have a short lifespan and limited to-do list. Its main priorities would be to navigate the economy through a difficult winter and to increase the volume of EU-funded investments at a time when the economy is approaching a technical recession.

Real sector reforms are expected to lose further momentum…

…but commitment to euro adoption should be reconfirmed

Failure to form a stable government would leave the country without a clear policy direction at a time when the economy is entering a shallow recession and the cost-of-living crisis is aggravating. Unpopular structural reforms needed to unlock the country's long-term growth potential are likely to lose further momentum. On the positive side, we expect Bulgaria's commitment to euro adoption in 2024 to be reconfirmed, as the parties with pro-Western geopolitical orientation are likely to control around two-thirds of the seats in the new parliament.

We have revised upward our GDP-growth projection for 2022

We have raised our 2022 real GDP-growth forecast by 0.5pp to 3.2% after a 0.8% qoq GDP expansion in 2Q22 beat our expectations. Consumption and exports were the main drivers, more than offsetting a contraction in investments, as public capex underperformed.

The near-term outlook has deteriorated…

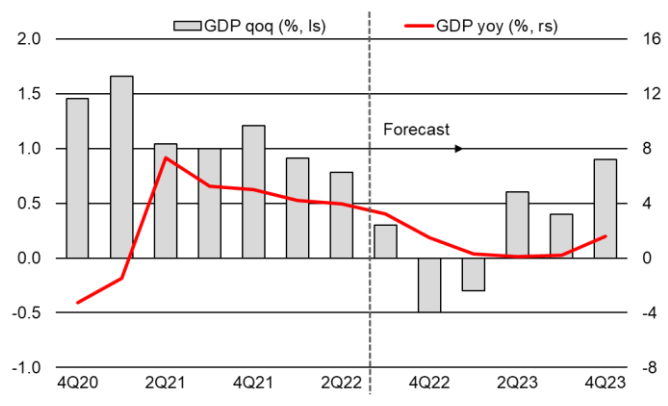
…because the inflation shock turned sharper and much more prolonged

We think economy will undergo a shallow recession in 4Q22 and 1Q23 (see chart). The downturn will mostly reflect further declines in real-incomes growth in response to the soaring gas prices envisaged in our revised global scenario. Moreover, we now expect the ECB to overdo its interest-rate tightening cycle. The resulting tighter financial conditions in the euro area are expected to translate into a markedly larger increase in the cost of lending in the local economy than the one we anticipated three months ago. Importantly, lower global growth, in our revised global scenario, is set to weigh on the country's export performance. Against this weakening internal and external backdrop, we now expect economy to slow sharply from 4Q22, and this prompted us to cut our 2023 real GDP-growth forecast by 1.5pp to 0.5% yoy.

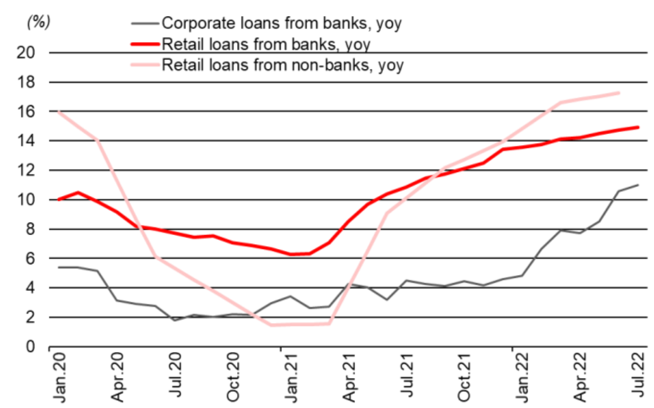
The economy is set to avoid a deep recession

However, several factors suggest that economy is likely to escape a meaningful growth contraction. First, strong rises in the exports of electricity, food and ammunition are set to continue, as such exports would be little affected by the slow growth expected in the euro area. Another reason we think the Bulgarian economy will avoid meaningful growth contraction is its solid credit growth. All categories of credit, including loans by non-bank financial institutions have accelerated so far this year (see chart). This bodes well for consumption at the turn of this year, although the aggressive monetary tightening we expect to occur in the euro area should eventually push the cost of credit higher, thereby gradually cooling demand for new loans in the course of next year. The fiscal support measures the government deployed in July,

WE EXPECT A SHALLOW RECESSION AT THE TURN OF THE YEAR



ACCELERATION OF CREDIT BODES WELL FOR CONSUMPTION



Source: National Statistical Institute, Bulgarian National Bank, UniCredit Research

Frozen electricity prices for households are expected to lower headline inflation at its peak

which our ballpark estimate puts at 2.6% of GDP annually, should also help mitigate the negative impact from high inflation in 2H22 and 2023. Finally, the decision to keep electricity prices for households fixed and to subsidize those for companies (by transferring into the state budget the extra profits of state-owned electricity producers) will lower inflation at its peak, by supporting real incomes growth and helping to keep inflation expectations in check.

We have materially revised our inflation forecast

Following significant revision in gas prices in our global scenario, we now expect to see consumer-price inflation peaking higher, around 18% yoy (previously 16.5%), and averaging 15.1% in 2022 (13.7% previously). The scale of revision in 2023 is even higher, to 10.1% yoy on average, from 7.8% in our previous forecast published three months ago (see chart).

Soaring gas prices are expected to keep inflation higher for longer

Food-price inflation has not peaked yet, but qoq increases show signs of moderation. A markedly-higher-than-previously-anticipated surge in energy-price inflation will spill over into non-energy components. Incorporating it in our forecast, we now expect core inflation to need more time to peak and to do so at a markedly higher level. We expect higher inflation to further squeeze real incomes, pushing yoy consumption growth into negative territory for several quarters. Uncertainty surrounding our inflation forecast is particularly elevated this time and related mostly to the size and timing of the spillover effects of higher natural-gas prices.

The labor market remains a bright spot in the economy

The latest labor-market data delivered a positive combination of rising employment and falling joblessness and inactivity. At the same time, wage growth fell below average inflation in 2Q22, and real wage growth is likely to remain negative for several quarters (see chart). We think the risk of a wage-price spiral is limited. Not only high inflation historically have been associated with only subdued wage growth, but low unionization of labor suggests that workers' bargaining power would likely fall short of what is necessary to fuel a sustained wage-price spiral.

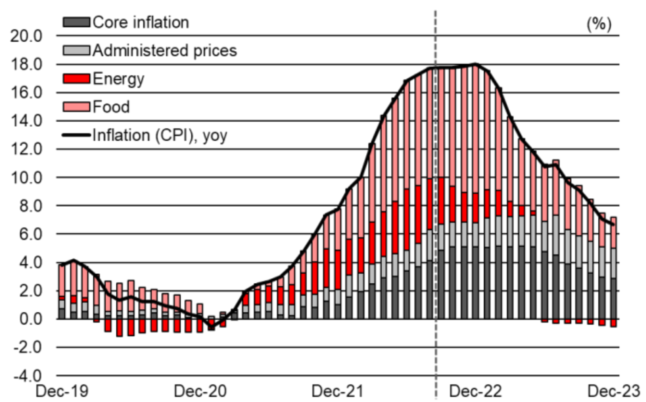
Fiscal support measures in response to elevated inflation are to continue next year

We are keeping our budget deficit projection for this year at 5.1% of GDP on an accrual basis. However, we think deficit will rise to 5.5% next year (from 3.5% in July), as economy is approaching a recession and the cost-of-living crisis is aggravating. We assume that fiscal support measures introduced in mid-2022 to contain the negative impact of high inflation will be prolonged until the end of 2023. On top of that, we assume that further fiscal measures equivalent to 0.5% of GDP will be deployed in an effort to shield the most vulnerable.

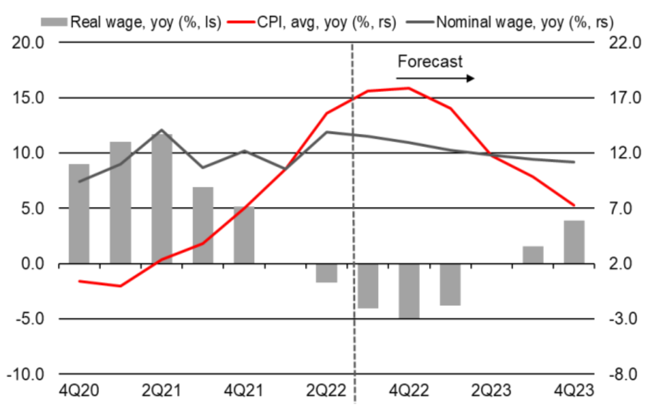
Soaring gas prices will force some companies to halt production this winter, but gas rationing looks unlikely

Gas rationing is not part of our baseline scenario, as connecting infrastructure to Greece will be operational soon and Bulgaria will get all remaining gas agreed with Azerbaijan. Soaring gas prices will force some manufacturing companies that rely on natural gas as a key input to halt production temporarily and will push demand for electricity higher. The country looks well prepared to deal with this challenge, however, because it has a significant amount of installed electricity-generation capacity relative to the size of its economy. We expect the across-the-board design of the electricity-subsidy scheme for companies to be replaced with a more-selective one, where the focus is to provide support only to those sectors and companies that are most negatively affected, while removing excessively generous subsidies for the rest.

INFLATION TO CLIMB MUCH HIGHER THAN EXPECTED BEFORE



NOMINAL WAGE GROWTH TO FALL BELOW INFLATION IN 2023



Source: National Statistical Institute, UniCredit Research

DISCLAIMER

This document is based upon public information sources, that are considered to be reliable, but for the completeness and accuracy of which we assume no liability. All estimates and opinions in the document represent the independent judgment of the analyst as of the date of the issue. We reserve the right to modify the views expressed herein at any time without notice, moreover we reserve the right not to update this information or to discontinue it altogether without notice.

This document is for information purposes only, and is not intended to and (i) does not constitute or form part of any offer for sale or subscription or solicitation of any offer to buy or subscribe for any financial instruments (ii) does not constitute an advice for solicitation of any offer to buy or subscribe for any financial instruments, or any advice in relation of an investment decision whatsoever.

The information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual investment advice. Investors must take their own determination of the appropriateness of investments referred to herein, based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial positions.

As this document does not qualify as direct or indirect investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into any contract or commitment whatsoever.

Neither UniCredit Bulbank, nor any of its directors, officers or employees shall accept any liability whatsoever vis-a-vis any recipient of this document or any third party for any loss howsoever arising from any use of this document or its contents herewith.

This document is not intended for private customers and the information contained herewith may not be disclosed, redistributed, reproduced or published for any purpose, without prior consent by UniCredit Bulbank**.**