Bulgaria

Baa2 stable/BBB- positive/BBB stable*

Outlook

The economy is on track to register in 2018 the fastest growth rate since the global financial crisis. Real GDP growth is set to reach 4.0% yoy this year, powered by rapidly rising income, stronger releveraging in the household sector as well as a rebound in residential construction and EU funds absorption. All this is likely to make growth broad-based and resilient enough to slow only marginally in 2019 to 3.9% yoy. In addition, the rebound in EU funds will almost entirely compensate for the forecasted narrowing of the C/A surplus, thereby helping to maintain a strong positive extended basic balance.

Strategy

Text

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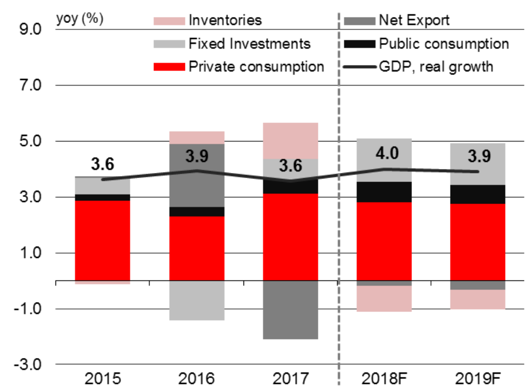
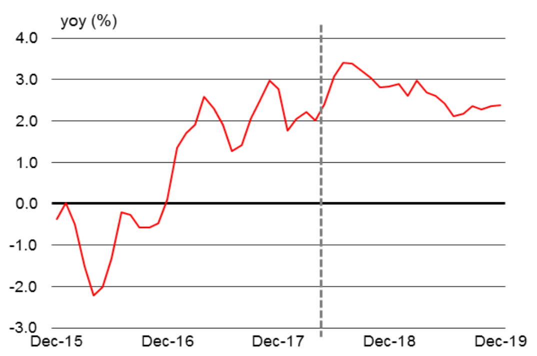
KEY DATES/EVENTS

- 29 June: Housing Price Index for 1Q18
- 14 Aug: Labor force survey data for 2Q18
- 14 Aug: GDP flash estimates for 2Q18

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2015	2016	2017	2018F	2019F
GDP (EUR bn)	45.3	48.1	50.4	53.8	57.4
Population (mn)	7.2	7.1	7.1	7.0	7.0
GDP per capita (EUR)	6 330	6 777	7 153	7 666	8 211
Real economy, change (%)					
GDP	3.6	3.9	3.6	4.0	3.9
Private Consumption	4.5	3.5	4.8	4.3	4.2
Fixed Investment	2.7	-6.6	3.8	8.2	7.6
Public Consumption	1.4	2.2	3.2	4.6	4.2
Exports	5.7	8.1	4.0	5.8	5.5
Imports	5.4	4.5	7.2	5.9	5.8
Monthly wage, nominal (EUR)	449	485	542	591	644
Real wage, change (%)	7.0	8.8	9.8	6.3	6.3
Unemployment rate (%)	9.1	7.6	6.2	5.4	5.0
Fiscal accounts (% of GDP)					
Budget balance	-1.6	0.2	0.9	0.4	0.0
Primary balance	-0.7	1.1	1.7	1.0	0.6
Public debt	25.6	28.6	25.1	23.5	22.6
External accounts					
Current account balance (EUR bn)	0.0	1.1	2.3	0.8	0.8
Current account balance/GDP (%)	0.0	2.3	4.5	1.5	1.4
Extended basic balance/GDP (%)	8.0	5.8	6.7	5.6	5.4
Net FDI (% of GDP)	5.1	1.5	1.4	2.2	2.3
Gross foreign debt (% of GDP)	74.0	71.1	66.1	62.7	59.3
FX reserves (EUR bn)	20.3	23.9	23.7	25.2	26.9
Months of imports, goods & services	8.0	9.4	8.2	7.8	7.7
Inflation/Monetary/FX					
CPI (pavg)	-0.1	-0.8	2.1	2.7	2.7
CPI (eop)	-0.4	0.1	2.8	2.8	2.9
Central bank reference rate (eop)	0.01	0.00	-0.39	-0.39	0.00
USD/FX (eop)	1.79	1.86	1.63	1.63	1.56
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.76	1.77	1.73	1.64	1.59
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	136.9	136.1	138.4	142.7	145.4
Change (%)	-2.1	-0.6	1.7	3.1	1.9

Source: Eurostat, NSI, UniCredit Research

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

Stronger growth ahead

Growth will remain resilient thanks to rapidly rising income, stronger releveraging in the household sector, a rebound in residential construction and larger EU funds inflows

High frequency indicators for the first four months in 2018 turned out somewhat weaker than we had expected. This was reconfirmed by 1Q18 GDP growth data at 0.9% qoq and 3.6% yoy, respectively, below our call for 1.2% qoq and 3.9% yoy growth. This, along with the higher oil prices envisaged in our revised international scenario, led to a small downward revision in our growth forecast. We now expect real GDP growth of 4.0% yoy in 2018 (from 4.4%) and 3.9% yoy in 2019 (from 4.2%). Despite this downward revision, our GDP growth projection remains above consensus (3.7% in 2018 and 3.4% in 2019). Looking at the individual growth components, we see investment and net exports little changed compared to our previous forecast. However, private consumption growth will be a tad weaker, as disposable income will rise less in response to higher oil prices and their negative impact on consumer price inflation.

The unemployment rate in 1Q18 came close to its all-time low

The situation in the labor market continues to improve. The unemployment rate fell to 5.7% in 1Q18 (seasonally adjusted) on the back of a favorable combination of a 16% yoy drop in the number of jobseekers (to just 189K or close to the all-time low of 178K in 4Q08) and solid 2.1% yoy employment growth. The economy created 63K new jobs in 1Q18 yoy which were almost equally divided between export-oriented manufacturing, transportation and business-services outsourcing sectors, on the one side, and domestic demand-oriented jobs, predominately in the rapidly growing construction and real estate activities sectors, on the other (see lhs chart). It was encouraging that a large number of the new jobs created so far this year comprised well-paid positions in business services outsourcing, whose importance continued to rise in line with the trend established in recent years. The balance between hiring and firing intentions of business managers in the different sectors of the economy is either at or very close to its post-crisis peaks, while households' employment expectations have reached new post-crisis highs (see rhs chart). At the same time, the average monthly wage rose 7.1% yoy in 1Q18, slower than the double digit growth in 4Q17 (10.6%) and 3Q17 (10.2%) including 9.1% yoy in 1Q17.

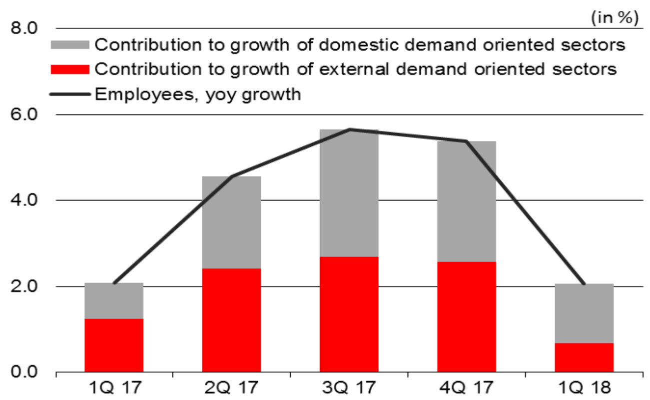
As full employment is achieved, some moderation of job creation is expected in 2018 and beyond

For 2018, we expect the unemployment rate to average only 5.4%, the lowest level on record in three decades. Looking further ahead, unemployment improvements will not be able to match the high pace so far in the cycle, since the remaining joblessness seems almost entirely driven by structural factors, such as skill mismatches and insufficient labor mobility.

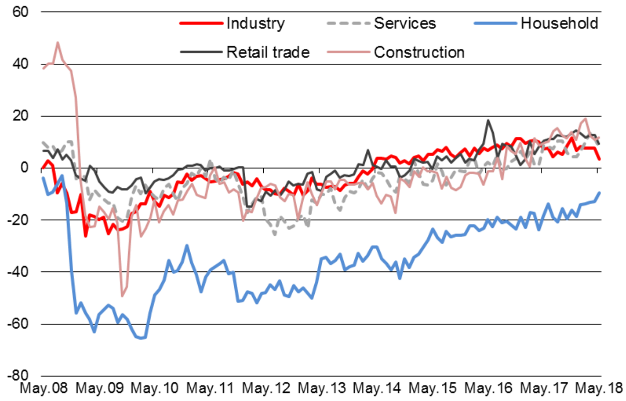
Headline inflation stabilized at around 2% yoy so far this year

In April, CPI decelerated to 2.0% yoy, after peaking at 3.0% yoy in November 2017. However, this slowdown was almost entirely driven by volatile components, namely food prices, which decelerated to just 1.2% in April 2018, from 4.9% in November 2017. At the same time, core inflation accelerated to 2.3% yoy in April, its highest level in five years. While not entirely clear at the moment, the latter seems driven by some one-offs, such as a price increase in mobile telephone services and higher accommodation costs, along with a rise of demand-pull inflationary pressure, as the slack in the economy has been on a rapidly decreasing trend.

Job creation remained solid so far this year…



…with households' employment expectations pretty buoyant



Source: Eurostat, NSI, UniCredit Research

The recent rebound in oil prices should boost headline inflation this year

We expect headline inflation to continue its slow upward trend, averaging 2.7% this year. This would be consistent with some deceleration of core inflation in the second half of the year, as the upward effect from one-offs will drop out of the base, while, on the other hand, some services prices are likely to increase. At the same time, most of the rise in headline inflation this year will be attributable to higher energy prices, and crude oil costs in particular.

A significant change in public policy is unlikely

Economic polices in the near term will be geared to support Bulgaria's euro zone membership application likely to be submitted soon. The government continues to pursue very conservative fiscal policy, which is on track to produce a surplus equivalent to 0.4% of GDP in 2018, only marginally lower than the 0.9% of GDP reported in 2017 in ESA 2010 terms.

Budget spending increases will be easy to finance

This year's budget envisages selective wage increases in the public sector, such as a 15% raise in teachers' salaries and almost 11% hike in the minimum wage. These will come on top of a significant double-digit surge in public investment in 2018, as absorption of EU funds from the current period enters in its most crucial phase. All these additional spending commitments are likely to boost non-interest expenditures by about 1.9% of GDP compared to 2017. Almost half of the envisaged spending increase this year (or 0.9% of GDP) is likely to be financed by rising tax revenues amid continuing solid economic growth and improving tax collection. What's more, we expect EU funds inflows to increase by an amount equivalent to 0.6% of GDP (or roughly EUR 0.4bn) to 2.1% of GDP for the whole of 2018, compared to just 1.5% of GDP in 2017.

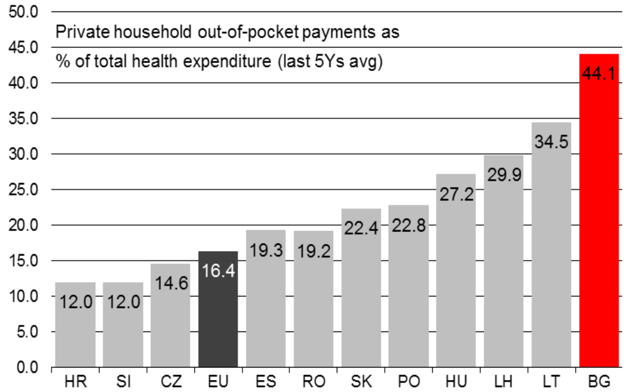
Some progress in fighting corruption looks likely

However, the GERB-led coalition government's agenda seems less ambitious when it comes to structural reforms, especially in the fundamentally important judiciary system. It is true that the prosecution office has produced more indictments against corruption offences recently, which is positive. Nevertheless, it is too early to say whether this will translate into any tangible progress in curbing widespread corruption practices and boosting citizens' trust in the rule of law.

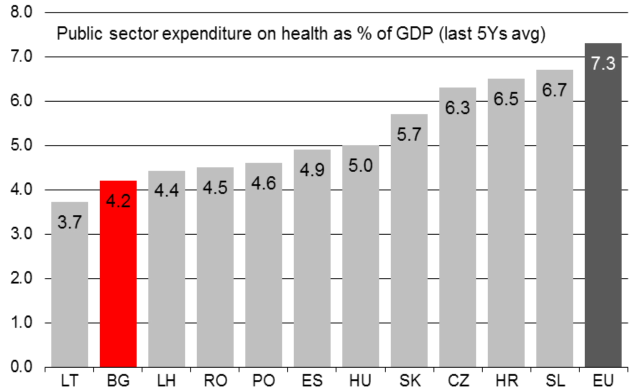
Reducing widespread spending inefficiency in healthcare remains a particularly challenging policy priority

At the same time, efforts to reduce rent-seeking and improve spending efficiency in healthcare have produced few tangible results so far. Efforts to centralize drug purchases so as to prevent fraud and overpayment by hospitals have stalled, while there seems to be no clear strategy of how to press ahead with reducing the number of Bulgarians without health insurance, which is one of the highest in the EU. Large out-of-pocket payments (see lhs chart), which mostly reflect a low level of public spending (see rhs chart) channeled to the sector, turned into a particularly severe problem which, however, has remained overlooked for years. Use of finger prints, as part of the registration of patients admitted for hospital treatment, was discarded altogether after years of preparation, without sufficient clarity as to when alternative measures will be put in place to prevent manipulation of medical records. On a positive note, steps have been made to raise the wages of nurses and some other categories of medical personnel, which helped reduce the number of those leaving for abroad, but this alone is unlikely to improve the quality and financial sustainability of healthcare without broader and more generously funded reforms.

Large share of out-of-pocket payments…



…which mostly reflect a low level of public spending



Source: World Health Organization, UniCredit Research

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