UniCredit

CEE

Quarterly

Macro Research
Strategy Research
Credit Research

1Q 2018

Bulgaria

Baa2 stable/BBB- stable/BBB stable*

Outlook – Our baseline scenario envisages real GDP growth to accelerate to 4.4% this year, well above the 4% likely to have been recorded in 2017. Importantly, the structure of GDP growth will improve, with investment expected to join the strong expansion in consumption and exports, thus helping improve the sustainability of growth. 2019 is likely to be another strong year as well, with growth easing only marginally to 4.2% on the back of the anticipated slowdown in global growth and weaker job creation at home as labor market conditions tighten. Risks for this above-consensus macroeconomic forecast remain broadly balanced, with the main question whether the authorities will use the very favorable environment afforded by the strong cyclical recovery to deal with some of the remaining long-term structural weaknesses.

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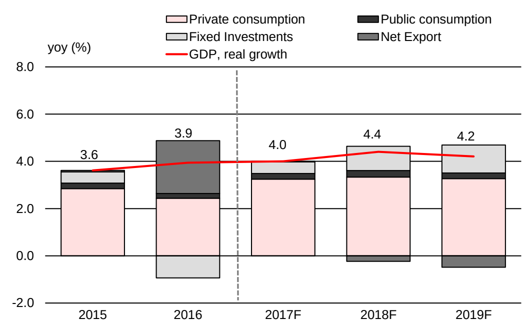
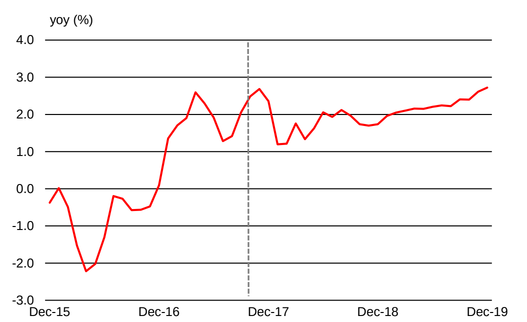
KEY DATES/EVENTS

- 1H18: Bulgaria to preside over EU Council
- Mid-Feb: GDP flash estimates for 4Q17
- Mid-Feb: Labor force survey data for 4Q17

FASTER GROWTH ON THE HORIZON



INFLATION ON AN UPTREND



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2015	2016	2017E	2018F	2019F
GDP (EUR bn)	45.3	48.1	51.0	54.1	57.6
Population (mn)	7.2	7.1	7.1	7.0	7.0
GDP per capita (EUR)	6,330	6,777	7,222	7,703	8,245
Real economy, yoy change (%)					
GDP	3.6	3.9	4.0	4.4	4.2
Private Consumption	3.9	3.4	4.5	4.6	4.5
Fixed Investment	2.7	-6.6	2.7	5.5	6.2
Public Consumption	2.9	2.6	3.0	3.5	3.1
Exports	5.7	8.1	5.6	6.1	5.9
Imports	5.4	4.5	5.6	6.5	6.6
Monthly wage, nominal (EUR)	449	492	540	592	647
Real wage, change (%)	7.0	10.3	7.9	7.8	7.1
Unemployment rate (%)	9.1	7.6	6.2	5.3	4.6
Fiscal accounts (% of GDP)					
Budget balance	-1.6	0	0.2	-0.3	-0.7
Primary balance	-0.7	0.8	0.9	0.3	-0.1
Public debt	25.6	28.6	25.1	23.9	23.2
External accounts					
Current account balance (EUR bn)	0	2.6	2.5	2.0	1.8
Current account balance/GDP (%)	0	5.3	4.9	3.7	3.1
Extended basic balance/GDP (%)	8.0	8.1	7.9	6.7	6.4
Net FDI (% of GDP)	5.1	0.7	2.3	2.2	2.3
Gross foreign debt (% of GDP)	73.6	70.7	64.1	60.0	56.1
FX reserves (EUR bn)	20.3	23.9	22.9	24.3	26.2
Months of imports, goods & services	8.0	9.4	8.2	7.8	7.6
Inflation/Monetary/FX					
CPI (pavg)	-0.1	-0.8	2.0	1.7	2.3
CPI (eop)	-0.4	0.1	2.4	1.7	2.7
Central bank reference rate (eop)	0.01	0	0	0	0
USD/BGN (eop)	1.79	1.86	1.64	1.56	1.53
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.76	1.77	1.73	1.60	1.54
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	137.5	136.6	138.7	139.0	137.5
Change (%)	-2.1	-0.6	1.5	0.2	-1.0

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

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

Wind in the sails for the economy

We keep our above consensus growth forecast for 2018 (4.4% versus 3.3% Consensus)

For the Bulgarian economy, 2017 was a very strong year, with GDP growth likely to have reached 4%. The outlook remains very favorable, and we expect GDP growth will accelerate to 4.4% in 2018, before easing only slightly to 4.2% in 2019. The acceleration in growth in 2018 will be driven by four main factors: a rebound in global trade; a shift toward more growth- supportive fiscal policy; stronger private sector capex in both construction and machinery and equipment, and more EU funds-financed public infrastructure projects. The less vigorous growth expectations for 2019 are mostly attributable to the anticipated slowdown in global growth and weaker job creation at home as the labor market recovery reaches an advanced phase and the number of sectors facing labor shortages increases. We expect headline inflation to remain weak, while core prices will be on a shallow upward trend in both 2018 and 2019, as the economy is coming closer to full employment. Importantly, strong GDP growth will be accompanied by a further reduction in external debt, which will help the net international investment position to improve to a level below the -35% of GDP threshold set in the EC macroeconomic imbalances procedure in 2018, after peaking at -92% of GDP in 2010.

Strong global trade will offset the drag stemming from euro appreciation

The rebound in global trade, which already started in 2017, is set to continue into 2018. Against this very positive external backdrop, we expect Bulgarian export growth to firm slightly to 6.1% in 2018, from an already strong 5.6% in FY2017 (see lhs chart), with the impulse from the solid global trade growth more than offsetting the negative impact stemming from the euro's appreciation. Export volumes will also draw support from the gradual expansion of production capacities in manufacturing and higher business travel revenues associated with the rotating Presidency of the EU in 1H18. A slight moderation in export growth is envisaged in 2019 (to 5.9%) to reflect the continuing euro appreciation and a tad weaker global growth.

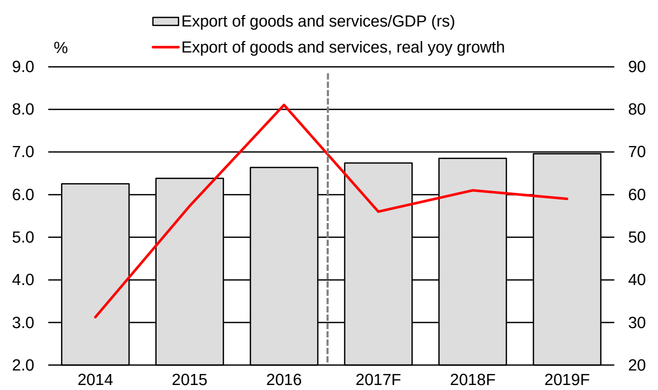
Fiscal policy will be growth supportive

After fiscal policy remained broadly growth neutral last year, it is set to turn slightly stimulative in 2018. With nominal GDP growth likely to be stronger than the 5.3% (real GDP growth plus average HCPI) envisaged in the fiscal program, revenues are likely to exceed the 35.8% of GDP target. This, in turn, should create additional fiscal room to increase spending, on top of the moderate rise in public sector wages and capex already incorporated in the budget. All in all, we expect the ESA 2010 general government balance to shift to a 0.3% of GDP deficit (slightly below the balanced budget target in the fiscal plan), which, given the 0.2% surplus expected in the previous year, should translate into a modest fiscal stimulus in 2018.

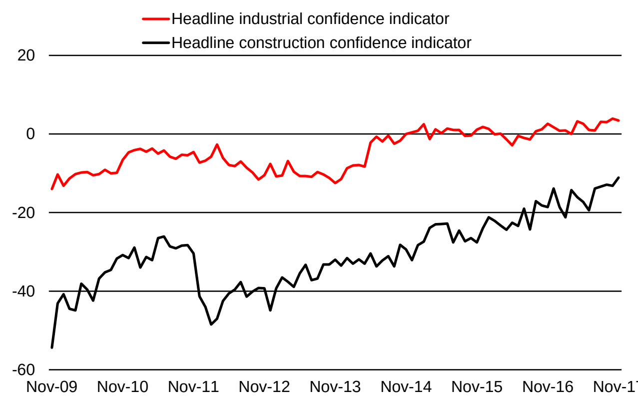
Large part of the acceleration in GDP growth will come from investment

The recovery in investment is likely to gain traction in 2018. Business sentiment is at a post-2009 high both for companies in manufacturing and in construction (see rhs chart). Fixed investment will continue benefiting from improved corporate profitability, sizeable net corporate savings, and loose financial conditions, which are likely to push bank lending rates down even further in 2018.

The export focus of the economy will deepen…



…pulling sentiment higher across the economy



Source: Eurostat, NSI, UniCredit Research

The recovery in GFCF is likely to broaden in 2018…

…to involve public on top of private sector …

…and not only construction, but also machinery and equipment component

This reconfirms the pattern in place so far in this upswing, with companies financing new investment through internally generated funds. This explains the still very lackluster credit growth so late in the cycle. It was private residential construction that helped boost the fixed investment rise in 2017 by an estimated 2.7%. In 2018, we forecast investment to accelerate to 5.5% (see lhs chart), supported in two ways. First, we expect public sector construction to finally join the recovery, with earlier delays in the preparation of the EU-funded projects now overcome and a large number of infrastructure projects from the new planning period likely to start soon. Second, and perhaps more importantly, we expect private investment in machinery and equipment to rise as well. This is because export-oriented manufacturers, belonging to global production chains, are set to expand their production capacity. This expansion, in our view, is likely to go beyond large cities, where unemployment is already only a fraction of the national average, and include regions with pockets of high unemployment in order to benefit from the still available labor pool.

Private consumption is far from losing steam

We forecast private consumption to expand by 4.6% in 2018 – similar to the 4.5% likely to have been recorded in 2017. This is supported by solid wage growth, which has pushed household confidence to its highest post-crisis level (rhs chart below), and has been the main driver behind the pronounced growth in disposable income. This GDP recovery has seen an increase in the labor participation rate to a level never seen since the onset of the transition. Nevertheless, at 67.2% labor participation is still below that in many CEE EU members, which suggests that there is room for a further increase in job creation, especially if more and better financed programs are put in place to promote employment among young people and women. The positive outlook for individual consumption is further underpinned by low retail credit rates and the positive wealth effect thanks to the ongoing rise in housing prices.

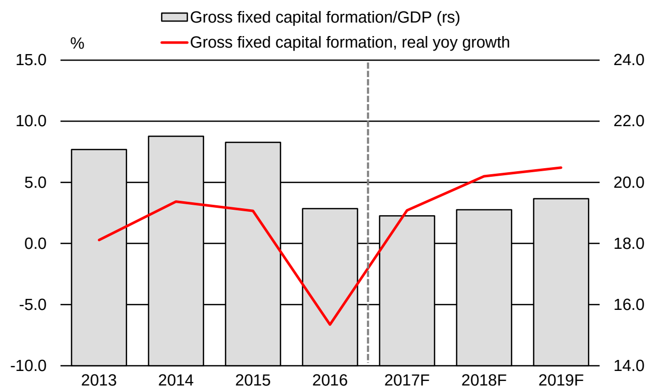
Geopolitical risks remain elevated

Despite the favorable outlook, a number of risks remain. On the external front, geopolitical risks abound. Further escalation of the tension between Saudi Arabia and Iran could potentially lead to much higher crude oil prices. Higher inflation in developed economies could hurt economic growth in some of Bulgaria's main trading partners and force central banks to bring their accommodative monetary policy to a halt. The potentially most damaging effect from such a scenario, however, is likely to be indirect, as the resulting reversal of capital flows could deal a major blow to growth in Turkey – Bulgaria's third largest export market.

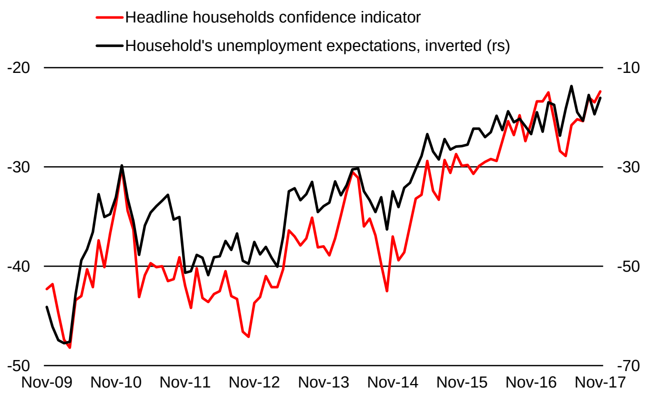
Higher headline inflation can hurt consumption

There are also several internal risks to watch. Potentially most disruptive among them would be a resurgence of inflation. So far, high wage growth has had almost no impact on core inflation, suggesting that the pronounced rise in labor costs over the past two years mostly reflects a reduction of the grey economy, while the genuine rise in labor costs is smaller – something which strong export growth seems to reconfirm. But with house price inflation returning and with the economy now close to full employment, the "wrong type" of inflation may prove closer than anticipated. And finally, while the risks of a policy slippage seem limited, it would be wrong to think of them as nonexistent, especially on structural reforms.

Investment is on course to recover



Optimism is close to pre-crisis highs



Source: Eurostat, NSI, UniCredit Research

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