Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

The prolonged period of political uncertainty has ended, after the two largest parties with pro-European geopolitical orientation formed a government of experts with rotating prime ministers. In response, we expect the normal functioning of the public sector institutions to be restored and the quality of policymaking to improve. Judicial reform and deepening the country's European integration are the two main priorities of the parties backing the new government. To this end, the government has pledged to keep the budget deficit in line with the 3%, rule in order to remove all remaining hurdles to the country adopting the euro at the beginning of 2025.

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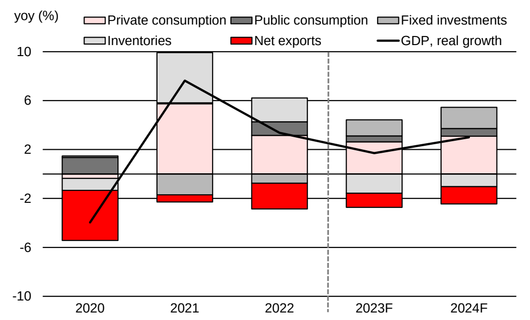
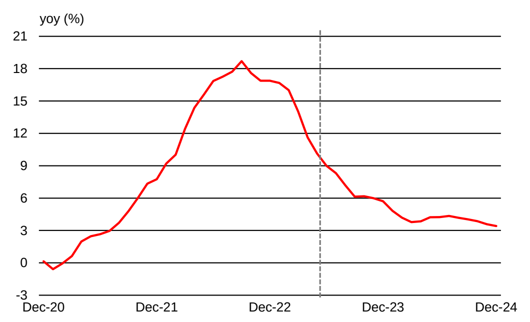
KEY DATES/EVENTS

- July: 2023 government budget
- 04 August: sovereign-rating review by Moody's
- 17 July, 16 August, 15 September: CPI
- 16 August, 07 September: 2Q23 GDP (flash, structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2020	2021	2022	2023F	2024F
GDP (EUR bn)	61.6	71.1	84.6	95.5	103.5
Population (mn)	6.9	6.5	6.4	6.4	6.3
GDP per capita (EUR)	8 912	10 902	13 115	14 927	16 320
Real economy, change (%)					
GDP	-4.0	7.6	3.4	1.7	3.0
Private consumption	-0.6	8.8	4.8	3.9	4.5
Fixed investment	0.6	-8.3	-4.3	8.2	10.1
Public consumption	8.3	0.4	6.5	2.7	3.5
Exports	-10.4	11.0	8.3	1.0	3.9
Imports	-4.3	10.9	10.5	2.4	5.3
Monthly wage, nominal (EUR)	711	798	900	1011	1099
Real wage, change (%)	8.0	9.0	-2.5	2.5	4.6
Unemployment rate (%)	5.1	5.3	4.2	4.0	3.8
Fiscal accounts (% of GDP)					
Budget balance	-4.0	-4.1	-2.8	-3.0	-3.1
Primary balance	-3.5	-3.6	-2.3	-2.5	-2.6
Public debt	23.9	23.4	22.4	22.6	24.3
External accounts					
Current-account balance (EUR bn)	0.0	-1.3	-0.6	-0.3	-0.4
Current-account balance/GDP (%)	0.0	-1.9	-0.7	-0.4	-0.4
Extended basic balance/GDP (%)	5.8	1.1	2.5	3.3	4.7
Net FDI (% of GDP)	4.5	1.8	2.4	2.5	2.9
Gross foreign debt (% of GDP)	63.3	58.0	52.5	50.6	49.6
FX reserves (EUR bn)	30.8	34.6	38.4	39.7	41.2
Months of imports, goods & services	10.4	9.3	7.7	6.9	6.3
Inflation/monetary/FX					
CPI (pavg)	1.7	3.3	15.3	9.8	4.1
CPI (eop)	0.1	7.8	16.9	5.8	3.3
LEONIA (eop)	-0.70	-0.53	1.82	3.89	3.16
USD/BGN (eop)	1.72	1.65	1.86	1.75	1.69
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.61	1.73	1.85	1.79	1.72
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

Pro-European government positive for outlook

Prolonged political crisis comes to an end

After a prolonged period of intense confrontation, the two main pro-European parties in the country formed a government of experts with rotating prime ministers.

The country's outlook has improved

We think this was the best possible outcome, given the current allocation power in parliament. The outlook is for a pro-European government that would resume providing military aid to Ukraine, thereby boosting the country's credentials as a reliable EU and NATO member. The parties that ensure the government's parliamentary majority have agreed on a common legislative actions centered on two main priorities. These are reforming the judiciary system, which is key to reducing high-level corruption and countering pro-Russian interference along with deepening the country's EU integration, with target dates for entry into the free-movement Schengen area and euro adoption being reconfirmed at 2024 and 2025, respectively. Also positively, the parties backing the government have agreed to keep the budget deficit in line with the 3% rule, to clear all remaining concerns regarding the trajectory of the country's public sector finances, after the bizarre decision of the minister of finance in the caretaker government to table a draft budget with a 6.4% deficit earlier this year. Structural measures including those needed to improve the absorption of EU funds are also among the agreed common legislative actions. The letter should help public capex to increase and restore the normal functioning of the public sector, following an extended period during which the economy was left drifting without a clear policy direction.

Constitutional amendments to reform the judiciary have good chances to materialize

Parties backing the government agreed on a budget with 3% deficit

The new government could stay in power longer than what's initially envisaged

The power-sharing agreement envisages the government remaining in power for an initial period of 18 months, with a change of prime minister after nine months. However, the likelihood of the government remaining in power for longer seems high if constitutional amendments currently under discussion with the other parties are implemented, and especially if the euro is adopted at the beginning of 2025, in line with the existing target date, which we expect.

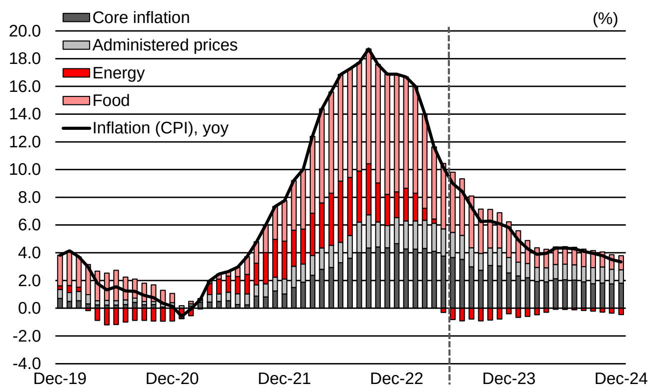
The economy is proving more resilient than expected…

We are raising our real GDP growth forecast for this year by 0.4pp to 1.7% to reflect the ongoing resilience of the economy. The upward revision is mostly attributable to the slower-than-expected tightening of borrowing costs for households so far in 2023. On top of that, a sharper-than-expected deceleration in inflation (see left chart), as the downward adjustment in energy prices is set to prove more pronounced, also helps explain why the economy is likely to prove more resilient than we thought three months ago. We remain of the view that export growth will probably fail to impress, given the weak external backdrop envisaged in our global macroeconomic scenario. At the same time, we continue to anticipate an improved absorption of EU funds (see right chart) to help investment growth accelerate this year.

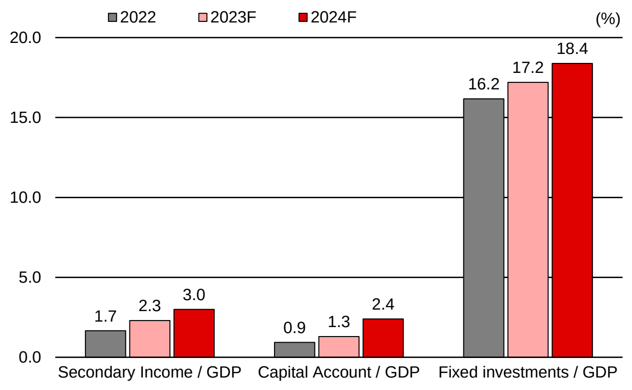
…leading us to raise our GDP growth forecast for both this year and next year

We are also raising our GDP growth projection for next year by 0.7pp to 3.0%. The less-sticky inflation that we expect next year, compared to our forecast three months ago, implies somewhat stronger purchasing power of households' incomes, which would be positive for consumption.

INFLATION PEAKED AND IS TRENDING DOWNWARD



IMPROVED ABSORPTION OF EU FUNDS TO PUSH INVESTMENT



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

The general trend remains one of considerable headwinds

Despite these positive developments, the overall picture includes significant headwinds. The ongoing war in Ukraine continues to fuel uncertainty, which negatively affects investment and growth. This would be aggravated next year when the temporary government support to help the economy deal with the elevated inflation is set to end. The latter would come on top of the negative impact higher household borrowing costs would have next year, as we now think that most of the increase in mortgage interest rates will materialize in 2024 rather than in 2023.

Both headline and core inflation have already peaked

Inflation eased 5.5pp to 10.1% yoy in May, which was below our expectations. We see this easing of inflation as very positive, especially when taking into account that the disinflationary process has now broadened to include all major price categories, including core inflation.

The pace of the decline in inflation remains very uncertain

We see consumer price inflation gradually decreasing over the coming quarters and expect it to average 9.8% this year, compared to 11.1% envisaged in our baseline macro scenario three months ago. We think that headline inflation will continue to fall, as large base effects caused by last year's surge in energy prices come into play later this year. Falling commodity prices and easing supply chain disruption feeding through to lower consumer prices are also likely to contribute to the sharp deceleration of inflation in the second half of this year. At the same time, it is very encouraging to see that there is no evidence that strong wage inflation last year has translated into any significant additional pressure on core prices so far in 2023.

Borrowing costs for companies increased markedly…

…but those for the retail sector did not

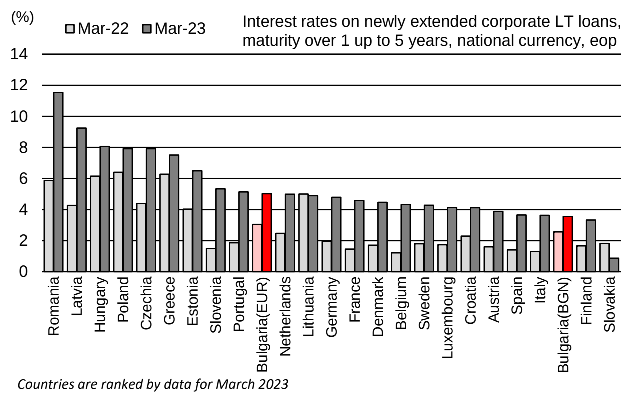
The transmission of higher interest rates in Europe to a higher cost of credit for local companies has increased markedly since our last *CEE Quarterly* publication (see chart). At the same time, interest rates for households and particularly mortgage interest rates have barely budged (see chart). In response, the BNB raised the minimum mandatory reserve requirement (MRR) rate and signaled that more increases are likely if the process of normalization of interest rates on loans extended to local households (or the exit from ultra-low rates) progresses too slowly.

Normalization of interest rates on mortgage loans likely to take more time…

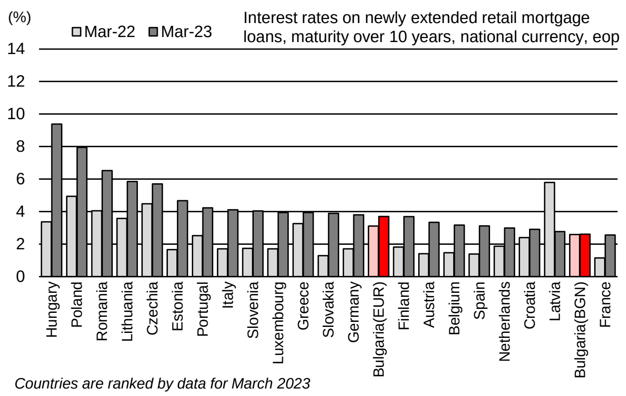
…which would weigh on consumption and growth in 2024 rather than in 2023

We were surprised by the degree to which local mortgage rates have detached from those prevailing in the rest of Europe. However, we remain of the view that borrowing costs for Bulgarian households are set to increase, although it appears that it will take longer for this trend to materialize than we thought three months ago. We now see interest rates on newly extended BGN-denominated mortgage loans rising to 3.5% on average in 2024 and to 3.75% in 2025, from roughly 2.7% currently. Interest rates on outstanding mortgage loans (most of which are linked to the cost of BGN-denominated retail funding attracted from local commercial banks) are forecast to increase by around half a percentage point in both 2024 and 2025, when we expect the normalization of mortgage interest rates (or the exit from ultra-low rates) to be completed. The latter will weigh on consumption next year, but not as much as we previously thought, as we now think that the increase in household borrowing costs, rather than simply being delayed, will also be moderately lower overall.

CORPORATE LONG-TERM RATES ARE IN LINE WITH EUROPE



MORTGAGE INTEREST RATES HAVE BARELY BUDGED



Source: European Central Bank, Bulgarian National bank, UniCredit Research

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