Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

The outlook for the economy continues to be dominated by the Russia-Ukraine conflict and its impact on inflation and the stability of energy supplies. We are raising our GDP growth forecast for this year to fully capture the strength of the economy in 1Q22. However, we are lowering our growth projection for next year, as we now see a less favorable external environment, with higher interest rates expected in the euro area on top of weaker growth for some of Bulgaria's key trading partners. The recent rise in political uncertainty is not likely to translate into any major change in economic policy. We continue to see euro adoption in 2024 as more likely than not, but we are worried that the transition to a new government could slow decision making in administration, which will negatively affect public capex supporting infrastructure, the green transition and digitalization.

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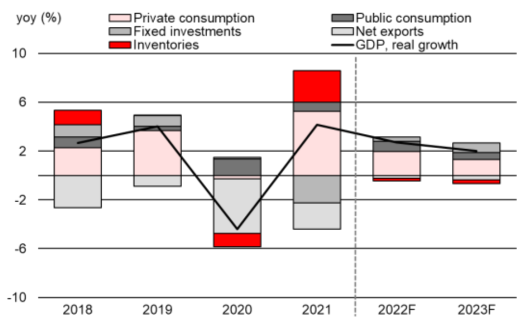
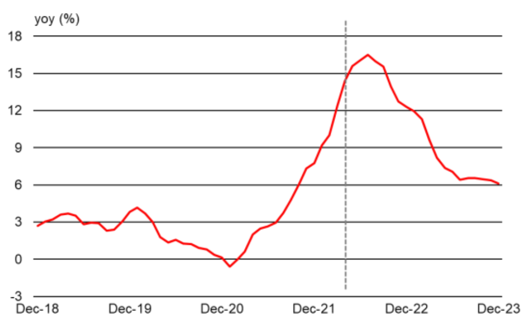
KEY DATES/EVENTS

- 15 Jul, 16 Aug, 14 Sep: CPI
- 17 Aug, 7 Sep: 2Q22 GDP (flash, structure)
- 23 Sep: HPI 2Q22
- 30 Sep: sovereign rating review by Moody's

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	80.0	88.9
Population (mn)	7.0	6.9	6.8	6.8	6.7
GDP per capita (EUR)	8 855	8 867	9 924	11 811	13 269
Real economy, change (%)					
GDP	4.0	-4.4	4.2	2.7	2.0
Private consumption	6.0	-0.4	8.0	2.9	1.9
Fixed investment	4.5	0.6	-11.0	2.0	4.4
Public consumption	2.0	8.3	4.0	4.4	3.1
Exports	4.0	-12.1	9.9	3.5	3.3
Imports	5.2	-5.4	12.2	3.4	3.5
Monthly wage, nominal (EUR)	648	709	793	878	968
Real wage, change (%)	7.5	7.7	8.5	-3.0	2.4
Unemployment rate (%)	4.2	5.1	5.3	5.1	5.5
Fiscal accounts (% of GDP)					
Budget balance	2.1	-4.0	-4.1	-5.3	-3.5
Primary balance	2.7	-3.5	-3.6	-4.8	-3.0
Public debt	19.6	24.1	24.5	24.6	25.3
External accounts					
Current account balance (EUR bn)	1.1	0.0	-0.3	-2.3	-1.9
Current account balance/GDP (%)	1.9	-0.1	-0.4	-2.9	-2.1
Extended basic balance/GDP (%)	5.0	5.8	2.4	-0.4	0.7
Net FDI (% of GDP)	2.0	4.5	1.7	1.3	1.3
Gross foreign debt (% of GDP)	61.3	64.9	61.8	53.8	49.4
FX reserves (EUR bn)	24.8	30.8	34.6	32.0	31.5
Months of imports, goods & services	7.4	10.4	9.3	6.4	5.5
Inflation/monetary/FX					
CPI (pavg)	3.1	1.7	3.3	13.7	7.8
CPI (eop)	3.8	0.1	7.8	12.3	6.1
LEONIA (eop)	-0.61	-0.70	-0.53	n.a.	n.a.
USD/BGN (eop)	1.74	1.60	1.73	1.81	1.73
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.75	1.71	1.66	1.83	1.76
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 by Moody's, S&P and Fitch, respectively

Higher-for-longer inflation to keep GDP growth subdued

Another coalition government supported by the same four parties is likely

Snap election cannot be ruled out later this year

The Bulgarian political scene was thrust into uncertainty after the government of Prime Minister Kiril Petkov was forced to resign. We see two equally likely scenarios from here. In the first one, we think the odds are good that the four parties in the outgoing government will form a new coalition government, perhaps one with a limited mandate for reforms, which will implement most of the budget amendments that have already been agreed in order to mitigate the negative impact of surging inflation. In this scenario, there is a probability that Kiril Petkov, founder and co-leader of the largest party in parliament, would not be the next prime minister, and that some of the other leaders of WCC partly would replace him. In the second scenario, the parliament would be dissolved and new general election would be held in the autumn.

No major changes in economic policy likely

Risks to rise in case of new election

Either way, we do not expect any major changes in economic policy. This is because we think that Bulgaria's position on North Macedonia's EU accession talks was the key reason for the collapse of Mr. Petkov's government, not its economic policy. We continue to see euro adoption in 2024 as more likely than not, since the parties with a pro-Western geopolitical orientation combined can count on the support of around three-fifths of the electorate. In the event of new elections, the transition to a new government is likely to slow decision making in the administration. This is bad news for public capex and the country's chances of speeding up the green transition and digitalization. It may also threaten country's euro entry in 2024, especially if another round of election lead to an increase of the support for populist parties

We have raised our 2022 GDP growth forecast

The outlook for the economy continues to be dominated by the Russia-Ukraine conflict and the impact it is having on commodity prices, and by supply-chain disruptions, leading to higher inflation. However, a host of indicators have revealed that growth momentum had reached a very strong level before the Russian invasion of Ukraine at the end of February. The strength of the recovery in 1Q22 is perhaps best illustrated by the industrial production index, which posted its strongest year-on-year reading in more than two decades (see chart). Consequently, we have raised our 2022 GDP growth forecast to 2.7%, from 1.4% we forecast in April.

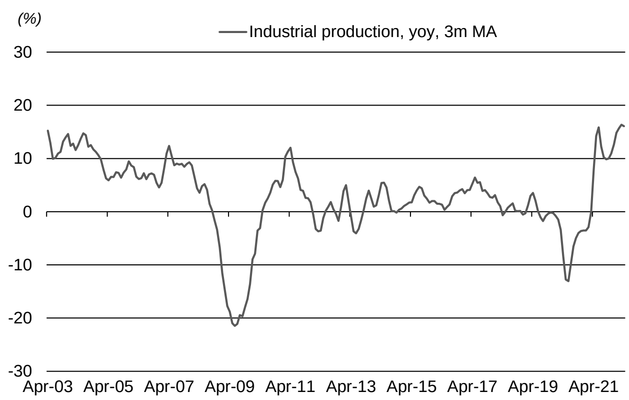
Mild contraction is likely in 2Q22

We expect a mild contraction in 2Q22, as industrial production and consumer confidence face serious headwinds from supply disruptions and surging prices resulting from continued lockdowns in parts of China, as well as the Russia-Ukraine conflict. However, we expect a slight pickup in quarterly growth in 3Q22 as fiscal support measures are activated, wages rise in the context of the tight labor market, and some of the headwinds to industrial activity fade.

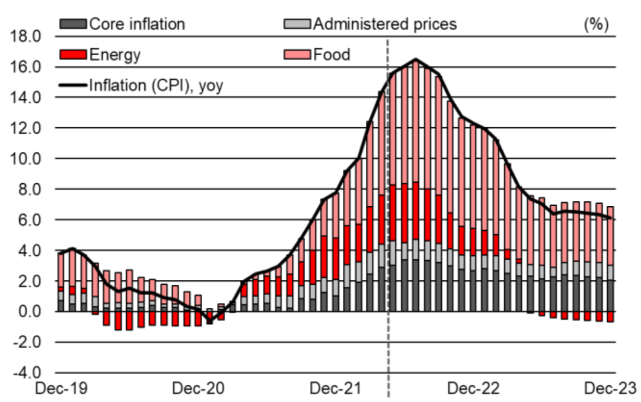
We have lowered our growth outlook for 2023

We have downwardly revised our GDP growth outlook for next year to 2.0% yoy, from 3.5% in April. This mostly reflects higher oil and gas prices in our global scenario, which implies higher-for-longer inflation (see chart), which will act as a larger drag on real incomes. Moreover, our global scenario envisages higher interest rates in the euro area on top of somewhat weaker growth for some of Bulgaria's key trading partners, which will weigh on export volumes.

STRENGTH OF ECONOMIC RECOVERY SURPRISED IN 1Q22



BUT HIGHER-FOR-LONGER INFLATION LIES AHEAD



Source: National Statistical Institute, UniCredit Research

Inflation to remain elevated this year

Consumer price inflation is set to remain high throughout this year. The Russia-Ukraine conflict has already pushed Bulgaria's energy and food prices to levels not seen since the late stages of the real estate bubble period preceding the global financial crisis in 2008-9. Russia's decision to suspend gas supplies to Bulgaria, for its refusal to start paying in rubles, has pushed prices even higher, although these increases were contained for the time being, as consumption of gas went down significantly after the end of the heating season.

We see higher-for-longer inflation

We expect inflation to peak in 3Q22 and to remain elevated in 4Q22 and 1H23. In Ukraine, the fighting has forced farmers to leave large areas of arable land unplanted and pushed fertilizer prices markedly higher, leading to a reduced harvest volumes and increased pressure on food commodity prices in response. To make things worse, Russia has blocked Ukrainian grain exports via the Black Sea, which threatens to cause food shortages in some of the poorest countries in the world while pushing food commodity prices higher for longer.

To capture all of these developments we have upwardly revised our 2023 average inflation forecast to 7.8%, from 4.5% in April. We still think that the shock to real incomes will ultimately significantly dampen aggregate demand and price pressure. This will need more time to materialize however and we now expect 6.1% inflation at the end of 2023, from 3.4% in April.

Consumers to reshuffle their spending priorities

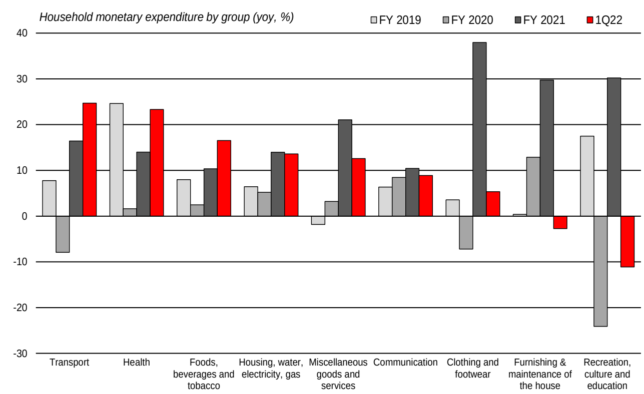
Consumers are set to become gloomier, but this does not mean they will stop spending. As the summer holiday season approaches, consumers will prepare for more services spending and particularly for more vacation-related spending, such as spending on restaurants and hotels. To do so they will have to reshuffle their spending priorities, as inflation is set to reach new heights in the summer. We expect consumers to cut back on discretionary purchases of cars, furniture, electronics and online shopping to keep little changed the portion of their budget allocated on necessities such as food, gasoline and shelter, which are now pricier (see chart).

Fiscal support of 1.4% of GDP proposed to contain high inflation impact on incomes

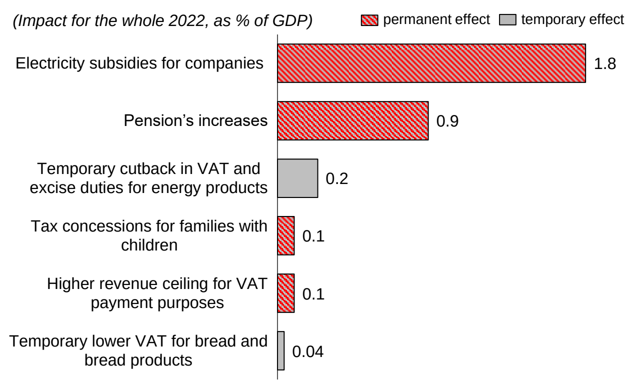
The budget revision would not trigger large deficit widening

To mitigate the impact of high inflation, fiscal measures amounting to BGN 2.1bn or 1.4% of GDP were proposed as part of the government's plan to revise the budget (see chart). This comes on top of electricity subsidies for companies, which would cost another 1.8% of GDP in 2022. Almost two-thirds of support would go to increasing pensions, which is positive, as high inflation hits pensioners harder than any other group in society. However, there were some controversial proposals, such as the temporary reduction of VAT on bread, which gained government backing despite being heavily criticized as untargeted and regressive. We think that most measures are justified and properly targeted. The size of the measures have been calibrated such so as not to lead to exceeding the budget deficit target this year. Essentially, the measures will return to the households and companies the revenue windfall triggered by inflation, which is set to exceed significantly the level in the initial budget forecast. At the same time, public capex remains forecast at a very ambitious 5.3% of GDP, which leaves room for adjustment in the rest of the year, in case other needs emerge or some risks materialize.

RESHUFFLING OF SPENDING PRIORITIES TO CONTINUE



FISCAL SUPPORT MEASURES TO REACH 3.2% OF GDP IN 2022



Source: Eurostat, National Statistical Institute, MoF, UniCredit Research

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