Bulgaria

Baa2 stable/BBB- positive/BBB positive*

Outlook

We keep unchanged our GDP growth forecast for this year at 3.3% and for next year at 3.1%. Growth acceleration this year will come from stronger investments and a recovery in exports, as many of the factors which weighed on the export performance last year fade. At the same time, private consumption growth is about to lose some traction, as its growth trajectory will be increasingly shaped by the country's unfavorable demographic trends. Slower global trade will likely be the main drag on growth next year, but domestic demand expansion is set to be strong enough to keep growth above 3% in 2020.

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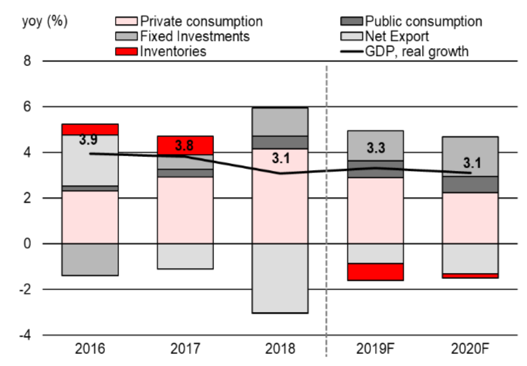
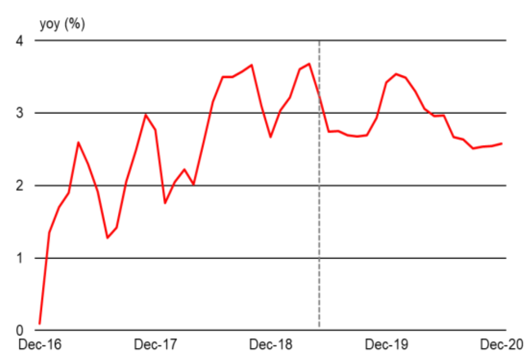
KEY DATES/EVENTS

- 28 June: Housing Price Index for 1Q19
- 15 July, 14 Aug, 16 Sep: CPI
- 14 Aug, 05 Sep: 2Q19 GDP (flash, structure)
- 23 Aug, 30 Aug: rating review from Fitch and Moody's

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2016	2017	2018	2019F	2020F
GDP (EUR bn)	48.1	51.7	55.2	58.7	62.2
Population (mn)	7.1	7.1	7.0	7.0	6.9
GDP per capita (EUR)	6 777	7 328	7 883	8 443	9 013
Real economy, change (%)					
GDP	3.9	3.8	3.1	3.3	3.1
Private Consumption	3.5	4.5	6.4	4.3	3.3
Fixed Investment	-6.6	3.2	6.5	6.7	8.5
Public Consumption	2.2	3.7	4.8	4.5	4.0
Exports	8.1	5.8	-0.8	4.0	3.0
Imports	4.5	7.5	3.7	5.1	4.7
Monthly wage, nominal (EUR)	485	530	580	637	695
Real wage, change (%)	8.8	7.3	6.6	6.6	6.3
Unemployment rate (%)	7.6	6.2	5.2	4.3	3.9
Fiscal accounts (% of GDP)					
Budget balance	0.1	1.2	2.1	0.5	-0.1
Primary balance	1.0	2.0	2.9	1.1	0.5
Public debt	28.6	25.4	22.1	20.4	20.0
External accounts					
Current account balance (EUR bn)	1.2	1.6	2.5	2.4	2.1
Current account balance/GDP (%)	2.6	3.1	4.6	4.1	3.3
Extended basic balance/GDP (%)	5.9	7.8	8.1	7.9	7.3
Net FDI (% of GDP)	1.3	3.9	2.6	2.5	2.5
Gross foreign debt (% of GDP)	71.1	65.5	60.4	55.3	51.2
FX reserves (EUR bn)	23.9	23.7	25.1	27.3	29.5
Months of imports, goods & services	9.4	8.2	8.2	8.2	8.1
Inflation/Monetary/FX					
CPI (pavg)	-0.8	2.1	2.8	3.1	2.9
CPI (eop)	0.1	2.8	2.7	3.4	2.6
Central bank reference rate (eop)	0.00	-0.39	-0.50	-0.46	-0.44
USD/FX (eop)	1.86	1.63	1.71	1.66	1.61
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.77	1.74	1.66	1.71	1.63
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Eurostat, NSI, BNB, UniCredit Research

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

Growth drivers rebalancing

We keep our GDP growth forecast unchanged

We decided to keep unchanged our GDP growth forecast for this year at 3.3% and next year at 3.1%. However, we made some rebalancing of growth drivers in our baseline scenario when compared with our projection made three months ago.

Somewhat lower contribution to growth from private consumption…

Private consumption is set to remain the key growth contributor this and next year, supported not only by rising wages and employment but also by further gains in credit channeled to the household sector. Another 10% rise in public sector wages looks very likely next year, which in combination with higher minimum wages, and some selective social payment increases, should provide a boost to household incomes in 2020, in broadly similar proportions as in 2019. Nevertheless, private consumption is forecasted to grow at a somewhat weaker pace than we had envisaged three months ago, as labor market tightening looks likely to become more pronounced, particularly when taking into account that the structure of the Bulgarian economy is dominated by labor intensive sectors where the lack of workers is set to constrain expansion.

... should be offset by the stronger contribution from investment…

This will be partly offset by stronger investment, as Bulgaria has utilized only a third of its EU funds allotment (see chart), while, at the same time, the investment appetite of local governments is likely to increase, due to the municipal elections this autumn. In addition, expansion in residential construction looks far from over, with supply of new housing lagging behind demand, even in the context of the unfavorable demographic outlook. Finally, expected investment in manufacturing and expansion of the gas supply network should help GFCF rise at a somewhat stronger clip this and next year than we had anticipated three months ago.

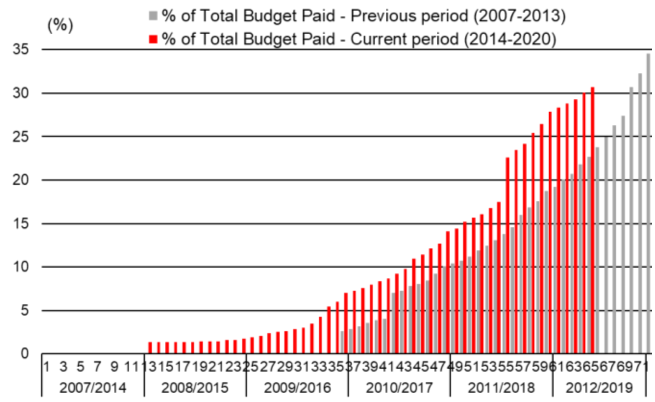
… and recovery in exports

However, it is the stronger export recovery this year which we see as the main factor to compensate for the weaker private consumption envisaged in our new scenario. Strong export recovery was already visible in 1Q19 data (see chart), where in nominal terms exports rose by 9.5% yoy, the strongest reading since 4Q17. This was above all attributable to the waning effect of some of the factors which had constrained export growth last year, including: 1) weaker-than-expected harvest for some agricultural products due to the summer drought, and 2) unplanned maintenance and repair shutdown in copper smelter Aurubis and in Neftochim crude oil refinery, which both account for approximately 15% of the country's total merchandise exports.

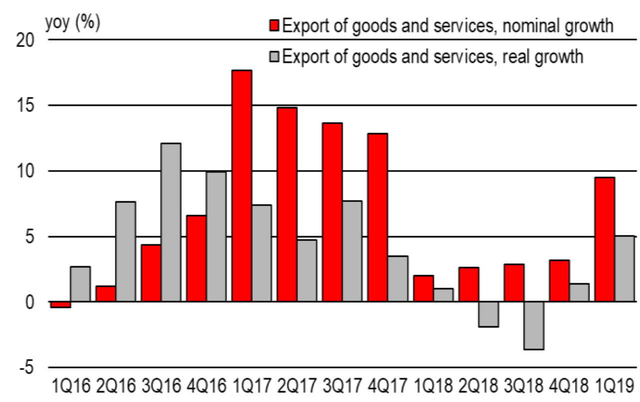
Continuing investment in manufacturing and services outsourcing will help exports at a time when foreign demand is weakening

In addition, exports are likely to receive a stronger boost from business investment implemented last year when GFCF in machinery and equipment was up 7.1% in real terms (the strongest reading since 2015 and fifth highest in CEE11). And while Bulgaria hasn't been able to attract any large investments in car manufacturing, there were several medium-size projects of EUR 30 to 50 million each, which, although not yet precisely clear by how much, should have boosted automotive industrial production capacity by something between 10 and 15%.

BULGARIA HAS UTILIZED ONLY A THIRD OF ITS EU FUNDS



EXPORT RECOVERY WAS ALREADY VISIBLE IN EARLY 2019



Source: BNB, NSI, UniCredit Research

Trade surplus will likely narrow further

Technology imports in manufacturing and energy sector on top of the purchase of new military equipment (in line with the commitment to raise military spending closer to 2% of GDP) will ensure that imports outpace exports for a third consecutive year, which will further narrow the trade surplus to 1.6% of GDP in 2019 and 0.7% of GDP in 2020. While we do not expect a further escalation of trade wars, the deceleration of growth in advanced economies envisaged in our global scenario next year will dampen Bulgarian exports to the eurozone in 2020.

Companies and households have been taking advantage of favorable financing conditions

This and next year are likely to witness the largest credit impulses so far in the current business cycle, as total loans expanded by 7% yoy in April, led by retail loans and mortgage household loans in particular. When adjusted for the sale of NPLs, credit growth was even stronger, perhaps a tad above 8% yoy, thus enabling the pace of credit growth to exceed nominal GDP growth for a second year in a row. Solid credit growth drew support from the slowly sliding cost of borrowing, with the most recent interest rate on newly extended mortgage loans denominated in local currency, for example, falling below the 3.2% mark (see chart) for the first time ever.

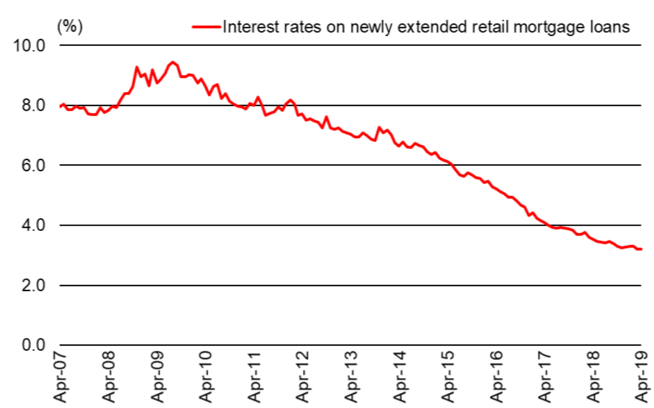
Inflation looks set to ease slightly in the rest of this and next year

We expect inflation to ease slightly in the period of the forecast (see chart), despite CPI acceleration to 3.7% in April on the back of higher-than-expected food prices. Energy price inflation will soon start receding in yoy terms, as the base effect is vanishing, although it might lead to a temporary spike in headline inflation in 4Q19. Food price increases are not over yet, however, as more time will be needed for the recent surge in unprocessed food costs to feed through into the prices of processed foods. Administratively regulated prices are set to exceed headline inflation this and next year, in our view, as some of the long overdue investments in energy and water supply networks' rehabilitation and expansion are likely to be finally implemented. Demand-pull inflation is forecasted to remain low in 2019 and 2020, as rising wages are likely to start translating into core price inflation increases only very slowly.

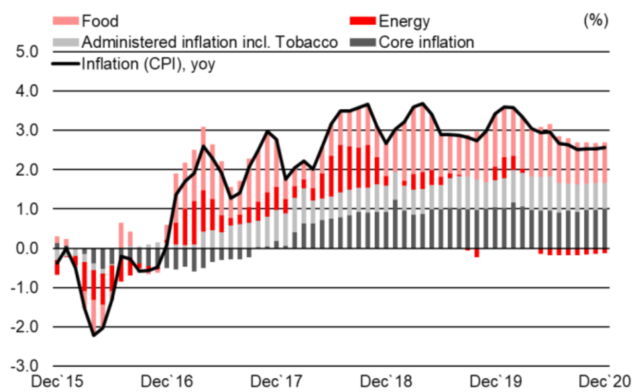
Significance of the European Parliament elections was limited by the low turnout

Despite the scandal with the purchases of apartments at below market prices, the ruling right-wing GERB party won the European Parliament elections. But the significance of this victory was limited by the very low turnout (32%, the fifth lowest in EU) which, in turn, further boosted the importance of municipal elections due this autumn. Surveys indicate that voter frustration with corruption might weigh on the GERB's election results, despite government efforts to boost GDP growth and incomes. Our baseline scenario is that GERB will keep its control over local administration, though some losses can be expected, especially in the northern parts of the country, where incomes, employment and public infrastructure investment are lagging. In this case, it is hard to see what would motivate the ruling party to change its policies substantially. Admittedly, the government would keep its growth-neutral fiscal policy and ease control on administratively regulated prices, as the need for populist measures would diminish once the election is over. Significant losses for the GERB are likely to trigger snap general elections next year. In this scenario, the government could opt for more populist policies, including higher fiscal spending in an attempt to boost GDP growth and incomes as soon as possible.

SLOWLY SLIDING COST OF BORROWING



INFLATION LOOKS SET TO EASE SLIGHTLY



Source: BNB, NSI, UniCredit Research

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