UniCredit

March 2022

CEE Macro & Strategy Research

CEE Quarterly

Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

The conflict in Ukraine has changed the outlook for the Bulgarian economy significantly. The impact of the conflict on commodity and food prices as well as the potential aggravation of supply-chain disruptions will probably lead to a combination of very weak real GDP growth and double-digit inflation this year. To cushion the blow, the government is likely to raise the funding channeled to various employment-retention schemes and to extend more support to businesses hit by record-high energy costs. The impact is likely to subside next year, when we expect real GDP growth to accelerate markedly and inflation to slow to less than 3% by the end of the year.

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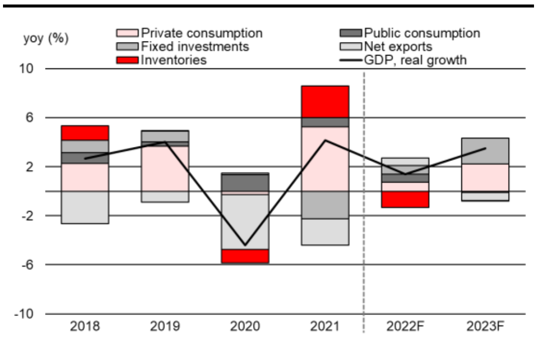
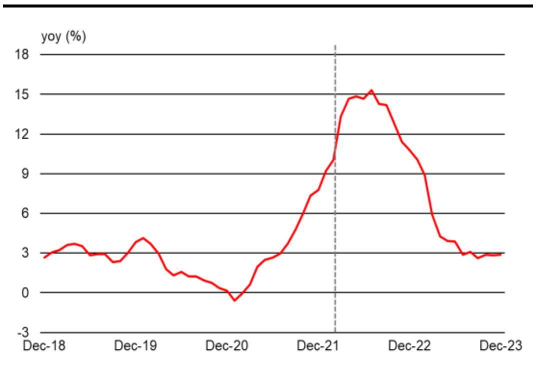
KEY DATES/EVENTS

- 01 April, 17 June: sovereign rating review from Moody`s and Fitch
- 19 April, 19 May, 17 June: CPI
- 12-13 May, 03-06 June: 1Q22 GDP (flash, structure)

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	78.6	86.0
Population (mn)	7.0	6.9	6.5	6.5	6.4
GDP per capita (EUR)	8 855	8 867	10 409	12 140	13 382
Real economy, change (%)					
GDP	4.0	-4.4	4.2	1.4	3.5
Private consumption	6.0	-0.4	8.0	1.1	3.3
Fixed investment	4.5	0.6	-11.0	4.1	11.5
Public consumption	2.0	8.3	4.0	3.5	-0.5
Exports	4.0	-12.1	9.9	1.8	7.9
Imports	5.2	-5.4	12.2	0.8	8.1
Monthly wage, nominal (EUR)	648	709	793	871	964
Real wage, change (%)	7.5	7.7	8.5	-3.2	6.2
Unemployment rate (%)	4.2	5.1	5.3	5.9	5.0
Fiscal accounts (% of GDP)					
Budget balance	2.1	-4.0	-4.0	-7.4	-4.3
Primary balance	2.7	-3.1	-5.0	-2.2	-1.9
Public debt	19.6	24.1	24.5	26.1	28.3
External accounts					
Current account balance (EUR bn)	1.1	0.0	-0.3	-2.3	-1.5
Current account balance/GDP (%)	1.9	-0.1	-0.4	-3.0	-1.8
Extended basic balance/GDP (%)	5.0	5.8	2.4	0.5	2.1
Net FDI (% of GDP)	2.0	4.5	1.7	1.3	1.5
Gross foreign debt (% of GDP)	61.3	64.6	61.2	57.4	55.8
FX reserves (EUR bn)	24.8	30.8	34.6	33.1	34.3
Months of imports, goods & services	7.4	10.4	9.3	7.3	6.7
Inflation/monetary/FX					
CPI (pavg)	3.1	1.7	3.3	13.0	4.5
CPI (eop)	3.8	0.1	7.8	10.8	2.9
LEONIA (eop)	-0.61	-0.70	-0.53	n.a.	n.a.
USD/BGN (eop)	1.74	1.60	1.73	1.78	1.81
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.75	1.71	1.66	1.77	1.81
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

Changing headwinds driven by the conflict in Ukraine

Russian invasion of Ukraine will weigh on growth and inflation outlook

The Bulgarian economy faces shifting headwinds. While the Omicron wave has faded, the conflict in Ukraine has triggered a surge in energy prices not seen since 2008 on top of further disruptions to global supply chains already severely damaged by the pandemic. These are likely to lead to a combination of double-digit inflation and very slow growth this year. More precisely, we are reducing our real GDP growth forecast for this year to 1.4% (from 3.6%) and for next year to 3.5% (from 4.3%). We are raising our average inflation forecast for this year to 13.0% (from 6.0%). We think that the shock to real incomes will dampen demand, leading to a significant deceleration of consumer price inflation to just 2.9% yoy at the end of 2023.

Uncertainty reached unprecedented proportions

The economic impact of the conflict in Ukraine will depend on the duration and intensity of the fighting, and the severity of sanctions and counter-sanctions imposed. Given the high uncertainty surrounding these and other assumptions needed to model any plausible scenario, our forecast should be seen as a best guess in a radically uncertain environment.

Indirect impact via trade channel will be larger than the direct one

Companies will struggle to maintain production at normal levels

The direct impact via the trade channel would be limited, as Ukraine and Russia together account for less than 3% of the country's goods and services exports. However, the indirect impact, via weaker demand in the main trading partners in the EA and the CEE region, is likely to push Bulgaria's real export growth down to a small single digit number in 2022. The impact will mainly be borne by the manufacturing sector. Although Russia and Ukraine are only partly integrated into the European production chains, they supply a number of key inputs. Russia and Ukraine also represent important export markets for the German investment goods sector, which means that many local manufacturers are likely to be negatively affected indirectly by the conflict-induced fall in European demand. German carmakers have already announced temporary production cuts due to shortages of parts from Ukraine. Energy-intensive companies may also halt production as high energy prices make some activities unprofitable, and there is a risk that further escalation of the conflict could trigger a halt in Russian gas supplies.

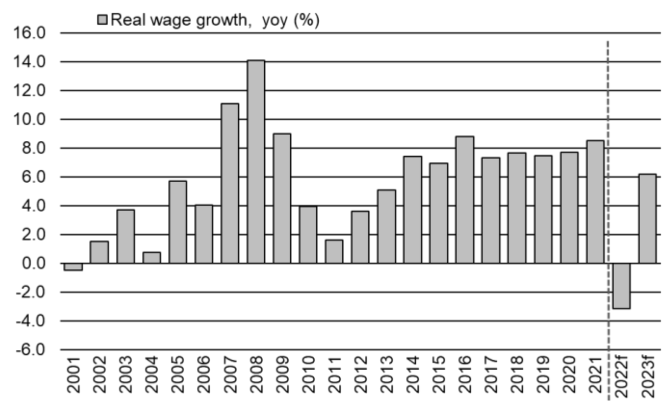
Negative real wage growth will weigh on consumption

We expect household demand to go down, as public wages and pensions are set to rise more slowly this year compared to the election-induced increases one year ago. Private-sector wages are also likely to take a hit, as companies reassess their sales growth outlooks against the backdrop of decreasing demand and shrinking employment opportunities. In the context of very high inflation, our baseline scenario envisages real wages growth turning negative this year (-3.2%) for the first time since 2001 (see chart). To preserve employment, the government is likely to increase the funding channeled to various employment-retention schemes, while, at the same time, changing their design in order to cushion the negative impact of the conflict-induced surge in energy and food costs and disruptions to supply chains.

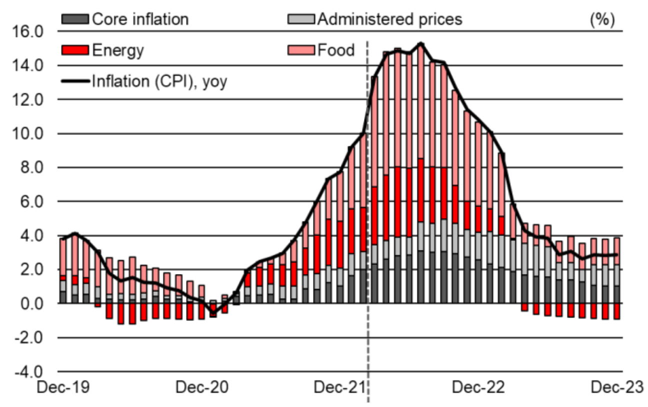
Inflation will hit consumers hard

The chief culprit for weak household demand will be inflation. Even before the conflict triggered a surge in energy and food costs, CPI had reached double-digits in February (see chart).

REAL WAGE GROWTH WILL TURN NEGATIVE THIS YEAR



INFLATION TO REACH DOUBLE-DIGIITS IN 2022



Source: National Statistical Institute, UniCredit Research

The conflict in Ukraine has delivered an unprecedented shock to energy prices

Prices of some foods have reached levels not seen since the Arab spring…

…while the price of fertilizer has almost doubled

Our baseline scenario is predicated on the assumption that Russia will continue to supply crude oil and gas to Bulgaria. However, energy prices are likely to remain elevated for an extended period, as supply was significantly disrupted by the sanctions against Russia. To make things worse, the prices of some food products have risen markedly since the start of the conflict in Ukraine. This is especially the case for the prices of sunflower oil and wheat, for which Russia and Ukraine together account for a great deal of global exports. Meanwhile, elevated prices of fertilizers are likely to become a further drag on agricultural output this year. Higher prices mean farmers are likely to use less fertilizer, leading to a reduced harvest and increased pressure on food prices. However, the fact that Bulgaria is a large producer and exporter of many crops, such as wheat, corn and sunflower seed will provide some important relief, especially if the government introduces limits on the export of some categories of food. Our modeling of the food-price shock shows Bulgaria's food inflation peaking at around 21% yoy in the next several months, before easing to slightly below 15% toward the end of the current year (see chart).

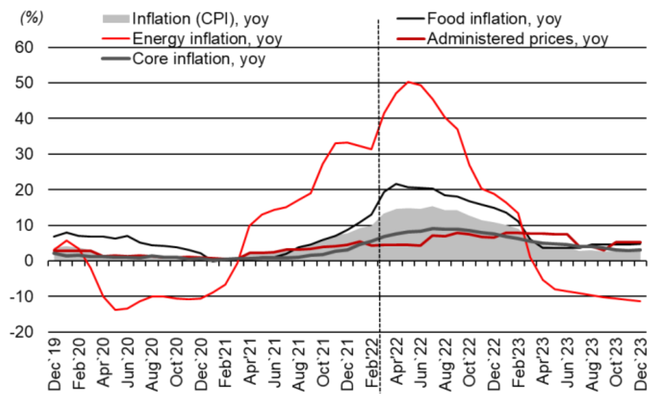
Households will struggle to maintain consumption in the context of the negative real wages growth

Strong household balance sheets will cushion some of the negative impact on consumption. Households look richer than ever thanks to rising net financial assets coupled with a surge in house prices. What's more, households are not burdened with the same level of debt that dragged on spending in the years following the global financial crisis in 2008. However, much of the population have no access to emergency funding (see chart), which means that so-called hand-to-mouth consumers form a significant part of the country's consumption. To make things worse, a substantial portion of the involuntary savings accumulated in the course of 2020 have already been exhausted, according to our calculations. As a result, we expect a large part of the population to see its purchasing power tumble if consumer price inflation reaches the levels envisaged in our baseline macroeconomic scenario. The combination of negative real wage growth and large share of hand-to-mouth consumers is set to translate into only very slight 1.1% positive real private consumption growth, if our calculations are correct.

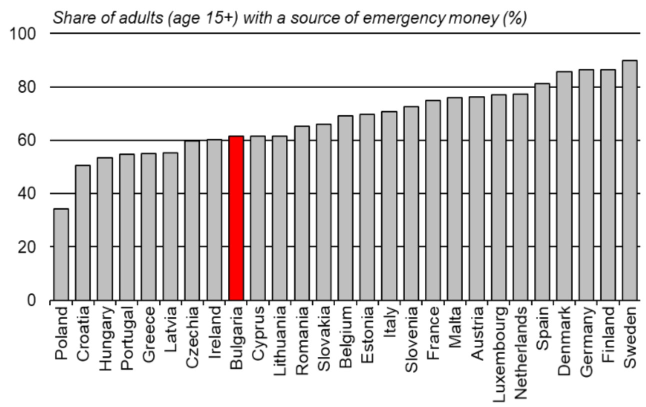
Stretched affordability and low supply will constrain the number of housing transactions

We expect the Bulgarian housing market to cool after 2021 boom. Both the number of transactions and house prices in the most desirable locations posted double-digit increases last year. House price growth accelerated further in 1Q22 on the back of rising building material costs, which caused most housing affordability metrics to deteriorate. The conflict in Ukraine is likely to extend these trends for the rest of this year, as supply-chain disruptions and upward pressure on building material costs are set to persist for longer. We expect that this will price some buyers out of the market, which, in turn, should bring the number of transactions down this year. We think that decline in the number of housing deals will be more pronounced in the largest cities, where affordability ratios are already stretched. We don't consider rising interest rates in the EA to be a serious threat to house prices in the near term for two reasons. First, the number of interest rate hikes will be very limited, in our view, and second, competition for new borrowers is likely to keep mortgage interest rates in check.

ENERGY AND FOODS WILL SPEARHEAD INFLATION SURGE



THE SHARE OF HAND-TO-MOUTH CONSUMERS LOOKS HIGH



Source: World Bank, National Statistical Institute, UniCredit Research

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