CEE

Quarterly

Economics & FI/FX Research
Credit Research
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3Q 2017

“Your Leading Banking Partner in Central and Eastern Europe”

Contents

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Bulgaria (Baa2 stable/BB+ positive/BBB- positive)*

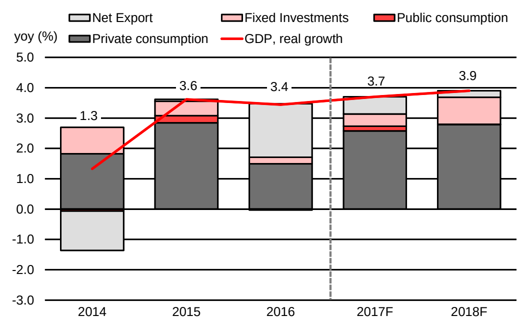
Outlook – The return to power of another GERB-led coalition has caused political risks to abate. However, with the caretaker government unable to implement many policy changes, delays have emerged in the implementation of EU-funded infrastructure projects. This, in turn, triggered some rebalancing in our growth forecasts for 2017 and 2018. Real GDP growth is now forecasted to peak next year, supported by buoyant export and domestic demand prospects. Compared to the rest of CEE5, Bulgaria's recovery remains at a less advanced phase. However, growth in Bulgaria is better balanced and doesn't come at the expense of deteriorating C/A balances and indebtedness levels, which suggests that the recovery is more gradual, but at the same time more sustainable than in most of the rest of CEE-EU countries.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

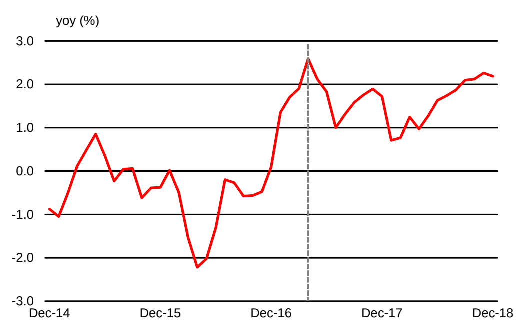
KEY DATES/EVENTS

- 9 Jul: Settlement of a EUR 950mn sovereign bond
- 14 Aug: Labor force survey data for 2Q17
- 16 Aug: GDP flash estimates for 2Q17

GDP TO ACCELERATE IN THE MEDIUM TERM



CPI RECOVERY WILL REMAIN UNEVEN



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2014	2015	2016	2017F	2018F
GDP (EUR bn)	42.8	45.3	47.4	49.9	52.7
Population (mn)	7.2	7.2	7.1	7.1	7.0
GDP per capita (EUR)	5,937	6,330	6,669	7,069	7,495
Real economy, yoy change (%)					
GDP	1.3	3.6	3.4	3.7	3.9
Output gap, % potential GDP	-1.5	-1.3	-0.9	-0.4	0.6
Private Consumption	2.5	3.9	2.1	3.6	3.9
Fixed Investment	3.4	2.7	-4.0	2.0	4.5
Public Consumption	-0.8	2.9	-0.4	2.0	0.1
Exports	3.1	5.7	5.7	6.5	5.8
Imports	5.2	5.4	2.8	5.6	5.5
Monthly wage, nominal (EUR)	420	449	492	537	588
Real wage, change (%)	7.4	7.0	10.3	7.6	7.9
Unemployment rate (%)	11.4	9.1	7.6	6.5	5.8
Fiscal accounts (% of GDP)					
Budget balance	-5.5	-1.6	0	-0.9	-0.8
Primary balance	-4.6	-0.7	0.8	-0.1	-0.1
Public debt	26.4	25.6	29.1	25.9	25.5
External accounts					
Current account balance (EUR bn)	0	-0.1	2.0	1.8	1.8
Current account balance/GDP (%)	0.1	-0.1	4.2	3.6	3.4
Extended basic balance/GDP (%)	4.4	8.0	7.4	8.0	7.9
Net FDI (% of GDP)	2.1	5.3	1.1	2.4	2.6
Gross foreign debt (% of GDP)	92.0	75.3	73.3	69.9	66.1
FX reserves (EUR bn)	16.5	20.3	23.9	26.2	28.8
Months of imports, goods & services	6.5	8.0	9.5	9.5	9.6
Inflation/Monetary/FX					
CPI (pavg)	-1.4	-0.1	-0.8	1.7	1.6
CPI (eop)	-0.9	-0.4	0.1	1.7	2.2
Central bank reference rate (eop)	0.02	0.01	0	0	0
USD/BGN (eop)	1.61	1.79	1.86	1.77	1.68
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.47	1.76	1.77	1.72	1.66
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	139.8	136.9	136	135.4	136.1
Change (%)	1.1	-2.1	-0.6	-0.5	0.6

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

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

Growth set to peak next year

No major changes in economic policy are expected after the elections

GERB's win in the March snap general election and the formation of a new coalition government with nationalists from United Patriots helped to reduce political uncertainty. The new GERB-led government reconfirmed its commitment to preserving financial discipline and macroeconomic stability. Maintaining business-friendly taxation and pressing ahead with infrastructure investments likewise remain high on the agenda of the new administration.

The government plans to spend more to improve the quality of human capital

Progress on some structural measures can also be expected. The new government plans to selectively increase pensions and public sector salaries, which should boost household income and moderately support private consumption. Importantly, to address long-overdue problems with the underpayment and understaffing in education, the government vows to double teachers' salaries during its mandate. We see this as a positive first step which, however, should not be taken as a substitute for a comprehensive program for education reform that is urgently needed to improve human capital and boost the country's competitiveness. To be successful, education reform requires broadly-based agreement involving all major stake holders, including the opposition in Parliament, since it is an effort which far exceeds the term in office of the current government. This agreement should address a vast number of issues, which goes far beyond the scale and timing of teacher salary increases, something that has yet to take shape.

Judiciary sector remains a key reform area to watch

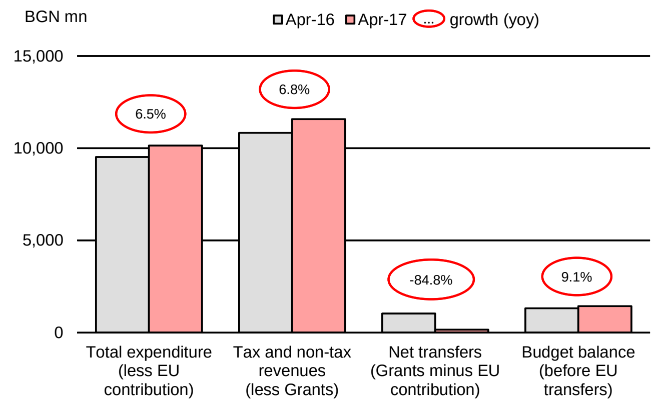
In the sensitive area of cracking down on corruption and overhauling the dysfunctional judiciary system, the new government promises to implement all 17 recommendations in the last report of the European Commission. While these measures would help improve the judiciary's efficiency, it remains to be seen whether they will suffice to ensure judges' impartiality and ease perceptions of corruption. The mixed track record of GERB and the lack of specific emphasis on judiciary reform in the program of its collation partner suggest that one can hardly expect significant progress soon in this key area.

Scope for fiscal accommodation has increased this year with both inflation and growth likely to be somewhat stronger than initially expected

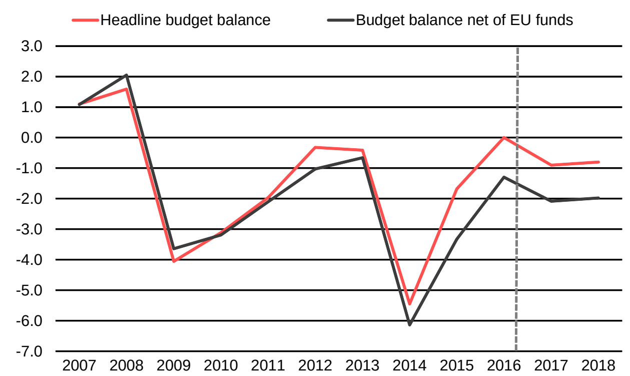
Fiscal policy will be strongly stimulative in 2017, benefiting from much better-than-targeted fiscal performance last year

Fiscal performance so far this year has surprised on the upside. Improved tax collection and cyclical factors on top of the one percent rise in the pension contribution rate pushed general government cash revenues 6.8% higher yoy. This, along with weaker spending growth, was enough to produce a cash surplus (net of EU transfers) equivalent to 1.5% of GDP in January-April (see charts). Looking ahead, we think that the better-than-expected revenues will be enough to accommodate the promised 15% rise in teacher salaries and minimum pensions (from BGN 161 to BGN 200). Both were key election pledges of both coalition partners and are estimated to add (taken together) 0.3% of GDP to spending this year. All in all, we expect the ESA 2010 general government to a shift to 0.9% of GDP deficit for the full year, slightly above the target set at 0.6% of GDP, which, given the balanced budget balance in the previous year, should mean a moderate stimulus in 2017.

Fiscal policy continues to tighten in 4M 2017…



… but we still expect a moderate boost to the economy in 2H 2017



Source: Eurostat, NSI, MoF, UniCredit Research forecasts

The acceleration of headline inflation so far this year was driven by the non-core component

The acceleration of headline inflation in April (to 2.6% yoy - see lhs chart) has been entirely driven by higher food (5.1% yoy) and especially energy prices (7.9% yoy). Core inflation has fallen deeper into negative territory at the same time (to -0.9% yoy), suggesting that there is still some remaining slack in the economy. We think that April's 2.6% reading is likely to be the peak for headline inflation over our two-year forecast horizon for two reasons. First, the base effect from energy prices most likely has already reached its peak. And second, and perhaps more importantly, the recent surge in food prices was mainly attributable to higher unprocessed food prices, which suggests that it is likely to be partly reversed before long.

Core prices will remain very subdued, suggesting that the labor market recovery is not over

Looking ahead, we think that the negative trend in core prices is set to ease gradually. Core inflation will turn positive toward the end of 2017, but will remain low, not exceeding 1.2% yoy in the course of 2018. All in all, our forecast for average headline inflation is 1.7% for 2017 (core inflation: -0.5%) and 1.6% for 2018 (core inflation: 0.9%) respectively.

The expansion in GDP growth continues to be not only strong, but also well balanced

Meanwhile, the 1Q17 GDP outturn (up 3.5% yoy) reconfirmed that the economy started the year on a solid footing. Sentiment and activity indicators suggest that the pace of economic expansion is about to accelerate in 2Q17. Importantly, another 10% rise in tourism arrivals is expected this year, which augers well for GDP growth and the C/A in both 2Q17 and 3Q17.

Difficult security situation in Turkey will add strength to the growth of Bulgarian tourism in 2017, similar to 2016

The inability of the caretaker government to implement policies shifted the timing of some public investments

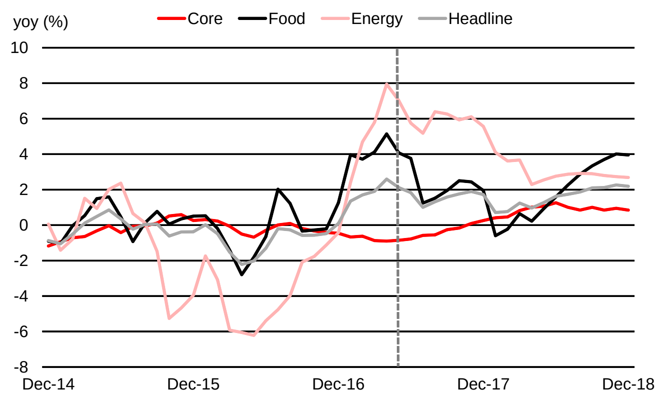
After a weak 2016, fixed investment is set to gain momentum in 2017, driven by a solid increase in EU funded projects from the new programing period. The recovery in investments will also draw support from strong export demand, which should encourage export-oriented companies to expand production capacity. However, the inability of the caretaker government to implement many policy changes produced some delay in the implementation of infrastructure projects which are already in the pipeline. With the new administration up and running, part of the delay will be offset. Nevertheless, we expect the fiscal boost associated with the surge in infrastructure investments to need more time to materialize. The result would be that much of the uptick in infrastructure investment will affect GDP numbers with some delay, boosting GDP growth in early 2018, rather than in late 2017, as we had previously thought. To reflect this development, we have revised our GDP growth forecast downward for 2017 to 3.7% (from 3.9%), and upward for 2018 to 3.9% (from 3.6%).

Private consumption will remain the major driving force of growth next year…

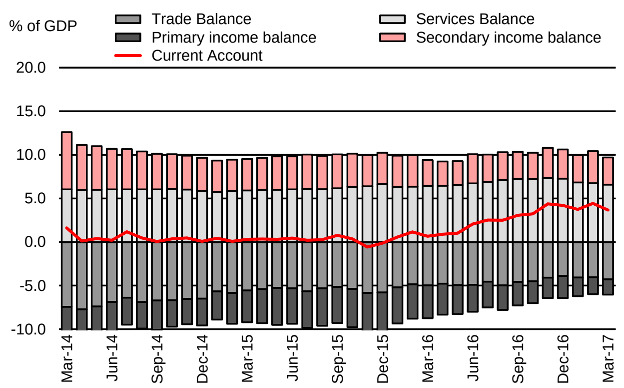
…while external conditions are likely to remain very supportive

Next year has the potential to be the year when real GDP growth could reach its peak. Private consumption is set to provide most of the fuel for growth in 2018, as the drag of higher inflation will be more than offset by the favorable combination of a solid rise in wages, further gains in employment, and stepped-up household borrowing. Compared to the rest of the CEE5, Bulgaria's economic recovery remains at a less advanced phase. However, growth in Bulgaria is better balanced and does not come at the expense of deteriorating C/A balances (see rhs chart) and indebtedness levels, which suggests that the recovery is more gradual, but at the same time more sustainable than in the most of the rest of CEE-EU.

Non-core inflation drove recent CPI spike



C/A surplus remains close to all-time high



Source: NSI, MoF, UniCredit Research

Strategy: bond scarcity to increase

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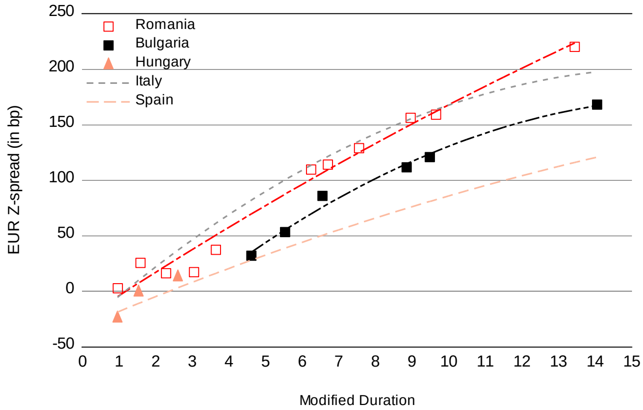
Bulgarian Eurobonds continue to outperform their CEE peers, particularly in the long end. As we have pointed out previously, the combination of twin surpluses and a dearth of issuance in international markets have created a scarcity value that favors Bulgarian bonds over peers.

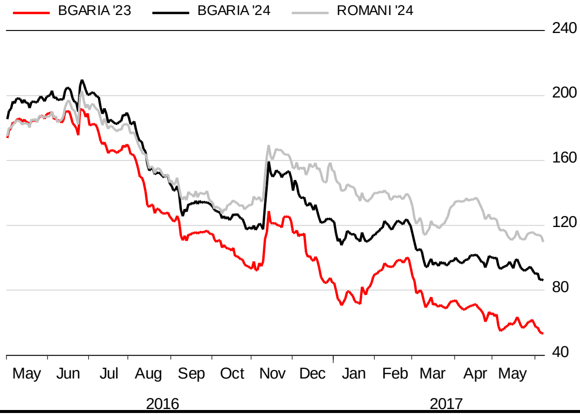
The country's external rating outlook was recently raised by S&P and Fitch, and we believe that it is on a path for further upgrades in the next 12 months based on the strength of the fiscal positions which are expected to outperform budget targets, as well as the strength of external balances.

Eurobonds are poised to remain scarce in the months ahead, with the EUR 950mn Eurobond maturity in July and a lack of issuance in the pipeline. Bulgarian investors own most of the maturing Eurobond (about 60%) and foreign investors may be willing to reinvest in existing Bulgarian bonds.

EUR Z-spread curve in bp



EUR Z-spread of Bulgarian and Romanian bonds



Source: UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**0**	**2.2**	**1.4**
Budget deficit	-0.8	0.7	0.7
Amortization of public debt	0.7	1.5	0.7
Domestic	0.5	0.4	0.5
Bonds	0.5	0.4	0.5
Bills	0	0	0
Loans	0	0	0
External	0.2	1.1	0.2
Bonds and loans	0	1.0	0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**0**	**2.2**	**1.4**
Domestic borrowing	0.3	0.5	1.0
Bonds	0.3	0.5	1.0
Bills	0	0	0
Loans	0	0	0
External borrowing	2.0	0.1	0.1
Bonds	1.9	0	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	-2.2	1.6	0.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2016	2017F	2018F
Gross financing requirement	**9.8**	**10.8**	**9.7**
C/A deficit	-2.0	-1.8	-1.8
Amortization of medium and long term debt	3.9	4.6	3.6
Government/central bank	0.2	1.1	0.2
Banks	0.5	0.4	0.4
Corporates/Other	3.2	3.1	3.0
Amortization of short-term debt	7.9	8.0	7.8
Financing	**9.8**	**10.8**	**9.7**
FDI (net)	0.5	1.2	1.4
Portfolio equity, net	0.6	-0.2	0
Medium and long-term borrowing	5.0	4.1	3.0
Government/central bank	2.0	0.1	0.1
Banks	0.3	0.4	0.5
Corporates/Other	2.8	3.6	2.4
Short-term borrowing	8.0	7.8	7.7
EU structural and cohesion funds	1.5	1.6	1.6
Other	-2.3	-1.5	-1.3
Change in FX reserves	3.6	2.3	2.6
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	1.9	-1.0	0

Source: BNB, MoF, UniCredit Research

Acronyms and abbreviations used in the CEE Quarterly

- BNB – Bulgarian National Bank
- C/A – current account
- CBR – Central Bank of Russia
- CBRT –Central Bank of the Republic of Turkey
- CE – Central Europe
- CEE – Central and Eastern Europe
- CNB – Czech National Bank
- DM – developed markets
- EA – euro area
- EC – European Commission
- ECB – European Central Bank
- EDP – Excessive Deficit Procedure of the European Commission
- EM – emerging markets
- EMU – European Monetary Union
- EU – European Union
- FCL – Flexible Credit Line (from the IMF)
- FDI – foreign direct investment
- IFI – international financial institutions
- IMF – International Monetary Fund
- MoF – Ministry of finance
- NBH – National Bank of Hungary
- NBP – National Bank of Poland
- NBR – National Bank of Romania
- NBS – National Bank of Serbia
- NBU – National Bank of Ukraine
- PLL – Precautionary and Liquidity Line (from the IMF)
- PM – prime minister
- PPP – public – private partnership
- qoq – quarter on quarter
- sa – seasonally adjusted
- SBA – Stand-by Arrangement (with the IMF)
- SOE – state-owned enterprise
- WB – World Bank
- yoy – year on year
- ytd – year to date

Notes

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Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: Link

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