Bulgaria

Baa2 stable/BBB- positive/BBB stable*

Outlook

We expect GDP growth to accelerate moderately to 3.9% in 2019, from 3.5% in 2018. The drivers of the acceleration will include moderate fiscal stimulus, an acceleration of investment and slightly lower energy prices. Importantly, an easing of the fallout from the crisis in Turkey will help exports to rebound. A pronounced deceleration of GDP growth to 3% is forecasted in 2020 as a result of the cyclical downturn anticipated in advanced economies and tighter financing conditions.

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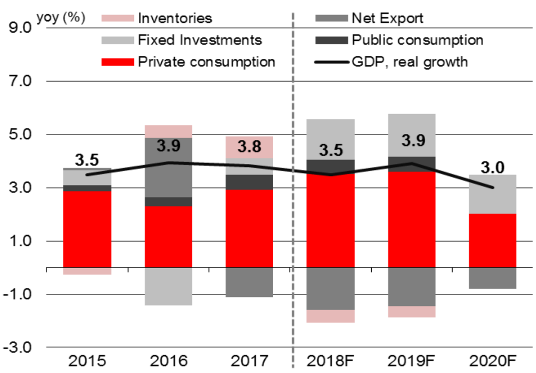
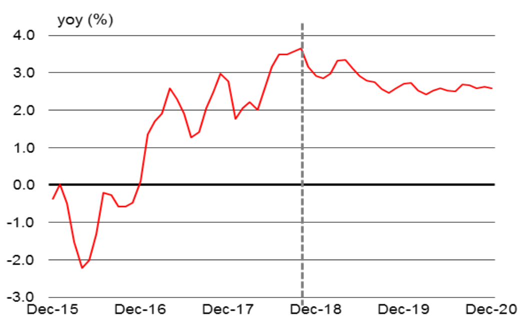
KEY DATES/EVENTS

- Mid-Feb: GDP flash estimates for 4Q18
- Mid-Feb: Labor force survey data for 4Q18
- End-Mar: Nationwide house price index for 4Q18
- 8 Mar, 22 Mar: Rating updates from Moody's, Fitch

GROWTH IS ABOUT TO ACCELERATE IN 2019



HEADLINE INFLATION TO EASE SLIGHTLY



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2016	2017	2018E	2019F	2020F
GDP (EUR bn)	48.1	51.7	54.9	58.7	61.9
Population (mn)	7.1	7.1	7.0	7.0	6.9
GDP per capita (EUR)	6 777	7 328	7 832	8 405	8 920
Real economy, change (%)					
GDP	3.9	3.8	3.5	3.9	3.0
Private Consumption	3.5	4.5	5.4	5.4	3.0
Fixed Investment	-6.6	3.2	8.0	8.2	7.0
Public Consumption	2.2	3.7	3.4	3.7	2.2
Exports	8.1	5.8	1.2	3.1	3.0
Imports	4.5	7.5	3.5	5.1	4.0
Monthly wage, nominal (EUR)	485	542	586	642	696
Real wage, change (%)	8.8	9.8	5.3	6.7	5.8
Unemployment rate (%)	7.6	6.2	5.2	4.6	4.3
Fiscal accounts (% of GDP)					
Budget balance	0.2	0.9	0.7	-0.6	-0.8
Primary balance	1.1	1.7	1.3	0.0	-0.2
Public debt	28.6	24.5	21.9	21.3	21.3
External accounts					
Current account balance (EUR bn)	1.2	3.4	1.6	1.0	0.6
Current account balance/GDP (%)	2.6	6.5	3.0	1.7	0.9
Extended basic balance/GDP (%)	5.9	9.4	6.8	5.6	4.9
Net FDI (% of GDP)	1.3	2.1	2.5	2.6	2.6
Gross foreign debt (% of GDP)	71.1	64.5	58.7	53.7	50.8
FX reserves (EUR bn)	23.9	23.7	25.6	27.2	29.2
Months of imports, goods & services	9.4	8.1	8.2	8.0	8.0
Inflation/Monetary/FX					
CPI (pavg)	-0.8	2.1	2.8	2.9	2.6
CPI (eop)	0.1	2.8	2.9	2.7	2.6
Central bank reference rate (eop)	0.00	-0.39	-0.47	-0.26	-0.03
USD/FX (eop)	1.86	1.63	1.72	1.72	1.63
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.77	1.73	1.66	1.76	1.67
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 is expected to accelerate in 2019

Growth is forecasted to accelerate in 2019…

…before easing in 2020 to a level slightly above potential

After the economic expansion lost some traction in 2018, with annualized growth on track to reach 3.5%, we expect growth to accelerate to 3.9% in 2019, marking the fifth consecutive year of above-potential growth. The impact of temporary factors (including a hefty fall in export volumes to Turkey, higher energy prices and a weaker-than-expected harvest due to a summer draught), which were behind the growth deceleration in 2018, will likely ease in 2019. In addition, growth in 2019 will be supported by a moderate fiscal stimulus and an acceleration of both private and public investment. Working in the opposite direction, the external environment is likely to become more challenging in 2H19, with both slower growth in advanced economies and anticipated EUR appreciation potentially weighing on exports. A further deceleration of growth to 3% is forecasted in 2020, due to a cyclical downturn expected in advanced economies and a slowly progressing deterioration in financing conditions. However, firm domestic demand will likely prevent growth from falling to below potential, making Bulgaria an outperformer in EU-CEE.

The fiscal impulse will increase moderately in 2019…

…but will lose strength in 2020

Expansionary fiscal policy is expected to support growth moderately in 2019, before shifting back to growth-neutral in 2020. Among the planned measures, the boost in infrastructure spending and the increase in public sector wages are expected to be the most effective in supporting domestic demand in 2019. At the same time, the start of the electronic toll system in mid-2019 should ensure fairer sharing of costs for road construction and maintenance, while also helping to boost fiscal revenues. We assume that slow implementation of the EU funded infrastructure projects will persist in 1H19, before improving in 2H19, thus mitigating the positive impact on growth in 2019, but transferring part of it to 2020.

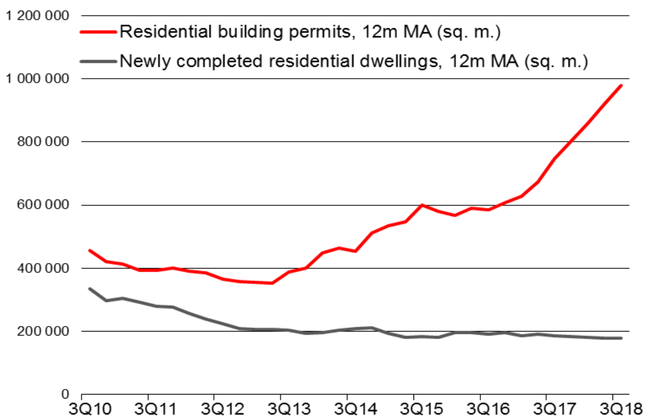
Investment growth will be broad-based

The economy entered into a more advanced phase of the expansion cycle in 2018, with the composition of growth gradually shifting from consumption to investment. This positive trend is likely to continue in 2019 as we expect investment growth (8.2%) to exceed private consumption growth (5.4%) for a second consecutive year. Record-high capacity utilization should bolster capex spending in 2019, but a decrease in export volumes should temporarily weaken investment growth in 2020. Construction activity should remain brisk, as signaled by the record-high levels of business confidence and the significant mismatch between the volume of issued residential building permits and the volume of completed residential construction projects (see left chart). There are no signs of excess construction supply. On the contrary, a number of relevant indicators suggest that construction is still recovering following the very depressed levels in the period from 2009 to 2017 (see right chart).

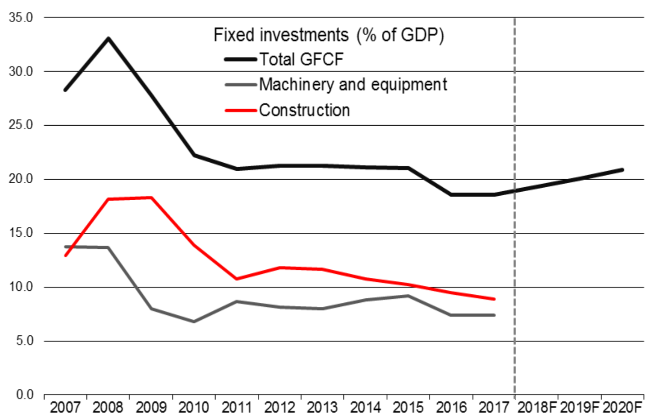
The fallout from the crisis in Turkey will ease in 2H19

The fallout from the crisis in Turkey proved significant in 2018, but manageable and limited to the trade channel, as Bulgaria's vulnerability indicators remain at very comfortable levels.

NEWLY-ISSUED BUILDING PERMITS FAR EXCEED NEWLY COMPLETED HOUSING



RECOVERY IN CONSTRUCTION INVESTMENT APPEARS TO BE IN AN EARLY STAGE



Source: Eurostat, NSI, UniCredit Research

A sharp drop in export volumes heavily weighed on growth in 2018, while the effect is likely to fade in 2019, before turning positive in the course of 2020, when our global macro scenario envisages growth in the Turkish economy to start accelerating again.

Unemployment rate is to decline only moderately in 2019

The job creation is expected to lose some momentum, as economy now operates close to full employment. With an unemployment rate below 5%, we expect job gains to slow from around 20K annually in 2018 towards 10K and below in the course of 2019. This will be offset by an acceleration in wages, as solid wage gains in the public sector are likely to spill over into the rest of the economy, thus keeping private consumption growth unchanged in 2019.

Credit is expected to be growth neutral in 2019

After a moderate positive credit impulse in 2018, we expect the credit growth dynamic to be growth-neutral in 2019. In October, credit to non-financial corporations and households posted its strongest yoy rise (6.8%) since 2008. Thus, credit growth in 2018 is set to exceed nominal GDP growth for the first time in a decade (see left chart), which will spell the end of the prolonged period of deleveraging. However, given the upcoming stress tests and AQR planned for 1H19 and the possible introduction of macroprudential measures, whose timing and magnitude look hard to pinpoint with precision from today's perspective, credit growth is unlikely to accelerate in 2019, and will therefore cease to boost GDP growth.

Deterioration of financial conditions is on the cards

Financial condition are expected to remain little changed in 2019, but to gradually worsen in 2020, when average 3M Euribor is forecasted to rise to 0.10%, from -0.31% in 2019 and -0.32% in 2018. More pronounced interest rate repricing is thus expected only in 2020 because the positive savings-to-investment balance will continue to act as an important mitigating factor that should help local liquidity condition to tighten only very gradually.

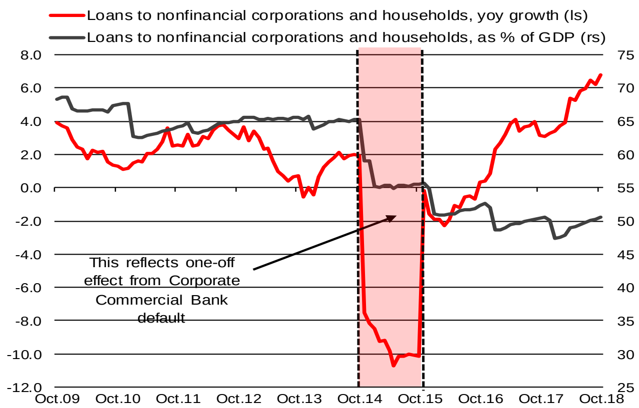
Headline inflation will ease, while core inflation will creep up in both 2019 and 2020

Headline inflation likely peaked at 3.7% in October 2018 and seems on track to progressively ease to 2.7% by the end of 2018 and further to 2.6% in 2020. This will be driven by the fall in oil prices and more generally by weaker import prices, as global growth is set to lose momentum in 2019 and particularly in 2020. Core inflation reached 2.5% in October and is expected to continue creeping up over the whole forecasting horizon. The latter will be attributable to the ongoing reduction of economic slack, where strong wage increases will progressively spill over into services prices. The main reason behind the divergence between headline and core inflation is our oil price and EUR-USD assumptions, which imply that energy prices will put downward pressure on headline inflation over 2019 and 2020.

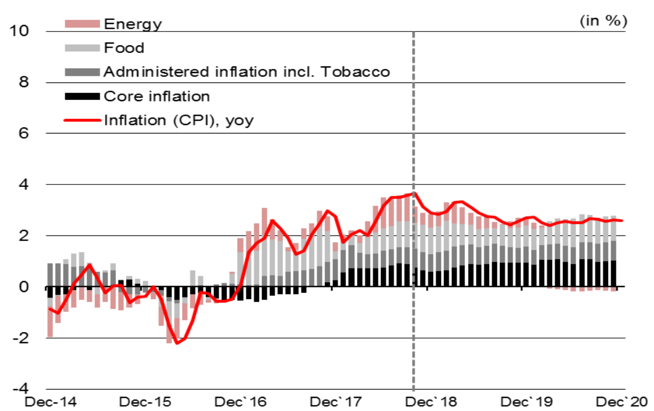
The most prominent risk to the outlook is external

The most prominent risk to our favorable macroeconomic scenario for Bulgaria stems from developments in global growth and trade. If upside risks to our global growth forecasts materialize, exports would be stronger, thereby adding another few tenths of percentage points to Bulgaria's GDP growth in 2019, and particularly in 2020. If downside risks materialize and, in particular, if there is a more severe and earlier US downturn, growth in Bulgaria will suffer more than our baseline macroeconomic scenario envisages.

FINANCIAL LEVERAGE IS SET TO INCREASE FOR THE FIRST TIME SINCE 2008



ONGOING REDUCTION IN ECONOMIC SLACK WILL PUSH UP CORE PRICES



Source: BNB, NSI, UniCredit Research

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