

Bulgaria: A heterogeneous coalition in the making

- The new centrist party, We Continue The Change, (PP), won the third parliamentary election held this year, and will be in the driver's seat in the negotiations to form a new coalition government.
- All other protest parties, plus the Bulgarian Socialist Party (BSP) lost support to varying degrees, following their failure to form a government in July and take over responsibility for the management of the country during its worst health crisis.
- The likeliest outcome of the negotiations is a coalition government between the PP, the remaining two protest parties and the left-wing BSP.
- If the new government successfully addresses the negative impact of surging energy prices and ends the health crisis, it is likely to last longer than just a couple of months.
- The election will not dramatically change the course of the Bulgarian economy, as all four parties that are likely to form the next government share many, fairly mainstream, views on policymaking.

The new centrist party PP radically redistributed the protest vote, after ITN, DB and IMV failed to form a government

The PP garnered 25.7% of the vote and will have 67 seats in the 240 strong parliament (Chart 1 and 2), according to 99.51% of the protocols counted by the central election committee. The PP was set up in September, by two Harvard-educated entrepreneurs Kiril Petkov and Assen Vassilev, who served in the first caretaker government nominated by President Rumen Radev. The PP attracted large share of the protest vote, which during the previous elections supported There Is Such a People (ITN) the party of the popular singer, Slavi Trifonov and to a lesser extent Democratic Bulgaria (DB) and Stand UP! Mafia OUT!

The former ruling party, GERB (Citizens for European Development of Bulgaria) finished second with 22.8% of the vote and will have 59 MPs in parliament. GERB failed to increase its approval rating despite the poor management of the health crisis by the caretaker government, which caused the number of deaths to rise sharply during the fourth wave of the pandemic. GERB acknowledged that taking part in the next coalition government is unlikely and the party will remain in opposition.

The Movement for Rights and Freedoms (MRF), a mostly ethnic Turkish party, received 12.9% of the vote, somewhat better than anticipated, after garnering large part of the Roma vote (Chart 1 and 2).

The BSP finished fourth and was among the big losers. The BSP received 10.3% of the vote and will have 27 MPs, which is weaker than their showing in both the April and July elections. The BSP not only failed to win the vote of the young, who flocked to support the new generation of politicians who have studied and worked abroad, but also lost the support of many of its traditional elderly voters, who were compelled to stay at home to reduce health risks amid the fourth wave of the pandemic.

ITN, the party that benefited most from the protest vote in April and July, suffered a resounding defeat, losing more than half of its support in just three months. ITN will have 25 seats in the parliament, compared to 65 and 51 seats in April and July, respectively. ITN's approval rating fell sharply following its failure to form a government and take over the responsibility for managing the country. Its excessively confrontational rhetoric was shunned by voters and the party lost considerable ground.

The DB's performance was also hit by the strong showing of the PP, although the scale of their losses was significantly smaller than that of ITN. The DB received 6.3% of the vote and will have 16 seats in parliament (Chart 1 and 2), according to the information available at the website of the central election committee.

The last party that surpassed the 4% threshold for parliamentary entry was the ultranationalist Vazrazhdane (Revival) party. This party based its campaign on anti-vaccination rhetoric. The party is also against NATO and Bulgaria's membership of the EU. The Revival party received 4.9% of the vote and will have 13 seats in parliament (Chart 1 and 2).

CHART 1: THE THIRD ELECTION OF 2021 PRODUCED A MORE FRAGMENTED PARLIAMENT

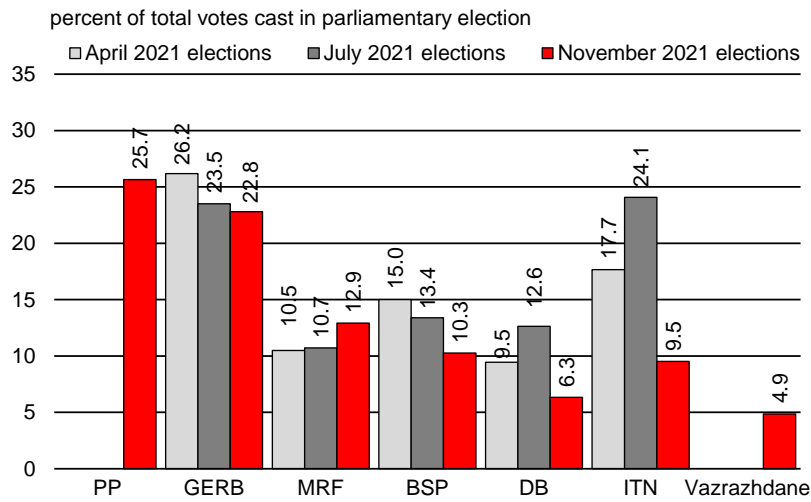
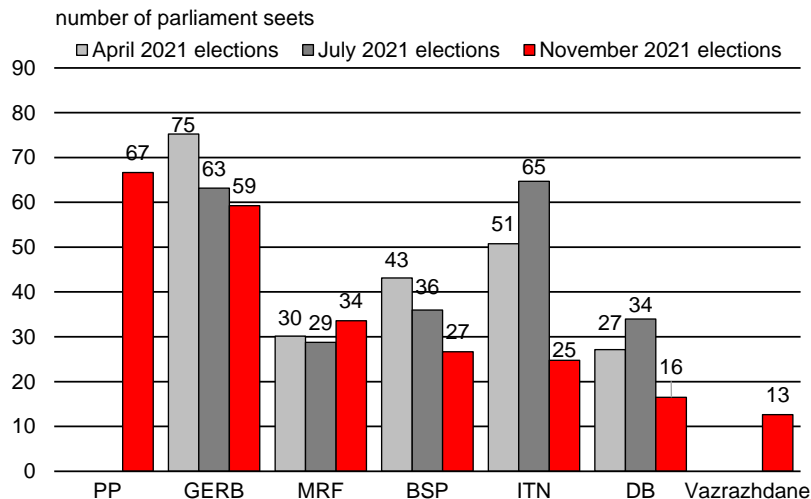


CHART 2: PROTEST PARTIES WILL HAVE 108 MPS IN THE NEW PARLIAMENT



Source: Central Election Commission (based on 99.51% of processed data), UniCredit Research

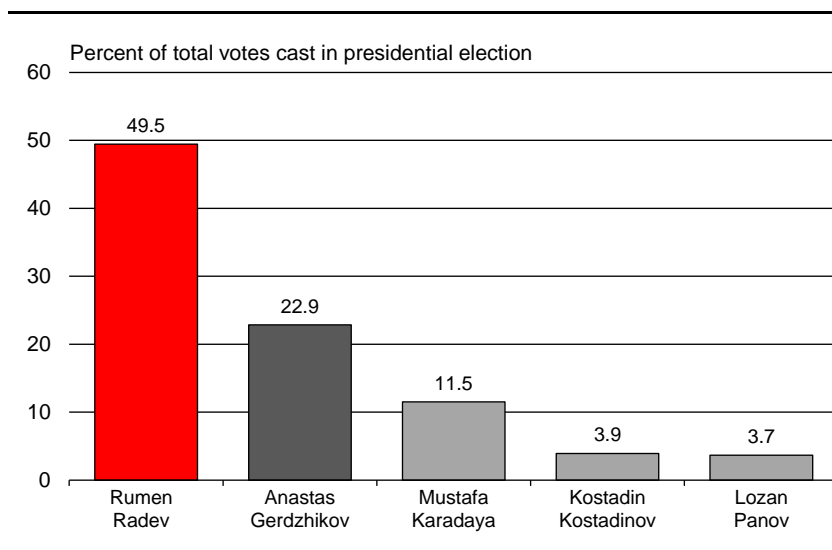
Rumen Radev is likely to win the run-off of the presidential election next weekend

Incumbent Rumen Radev won the first round of the presidential election with 49.5% of the vote (Chart 3), with Anastas Gerdzhikov, the rector of the most prominent university in Bulgaria, coming in second with 22.9%.

It was interesting to see that Mr. Radev did not appear to have paid a political price for the poor handling of the health crisis and especially for the low vaccination levels. Perhaps, this result reflects the unique and very comfortable position in which Mr. Radev found himself, with the presidential election being organized and administered by his own caretaker government.

Despite Mr. Radev’s very strong showing in the first round, the run-off next week may prove more of a contest, especially if the MRF, whose candidate finished third on Sunday, calls on its voters to support Mr. Gerdzhikov.

CHART 3: INCUMBENT RUMEN RADEV IS FAVORITE TO WIN THE PRESIDENTIAL RUN-OFF



Source: Central Election Commission (based on 99.51% of processed data), UniCredit Research

Good chance that a government will be formed, albeit with an even more fragmented parliament

The elections resulted in an even more fragmented parliament, with a record-high number of seven parties clearing the 4% hurdle for parliamentary entry. Nevertheless, it looks likely that a new government will be formed, in our view.

This is because no one from the parties that are likely to take part in the new government is interested in going to another election straight away. The main protest party, the PP is likely to be wary of sharing the fate of the other protest parties, which have suffered major electoral losses following their repeated failure to form a government in April and June. Although perhaps to a lesser degree, the same is probably true for the other two protest parties present in the new parliament, as well as the BSP.

It has been encouraging to see the PP leaders having undertaken a more rational approach. During the election campaign, they refrained from using excessively aggressive rhetoric against their political rivals, which was positive, because it has helped to create a more constructive environment for the forthcoming difficult coalition talks.

Mr. Petkov, who will be the PP’s nominee for prime minister, has already had preliminary talks with some of the other protest parties and said that forging an alliance with the DB would be easy, while ITN might be a somewhat more difficult partner. The PP’s leaders declared themselves open to dialog and compromises and made it clear that their party’s single most important priority would be to overhaul the judiciary and reduce corruption. Mr. Petkov said that replacing the chief prosecutor and creating a very strong anti-corruption agency would be the key issues of the coalition talks. In a press conference held on election night, when it became clear that the PP won the parliamentary vote, Mr. Petkov made a commitment to work towards “making Bulgaria a success story of how a small country can eradicate corruption in a very short time”.

Four-party coalition government with two main priorities in the short term

Under the likeliest scenario, the largest protest party, the PP, joins forces with the liberal DB and the anti-establishment ITN and forms a government together with the BSP. A PP-BSP-ITN-DB governing coalition would have a comfortable majority of 135 seats in the 240-seat parliament. Under this scenario, all four members of the new coalition government put aside their disagreements and ideological differences and initially agree on just two main priorities.

In our view, its first priority would be to end the current health crisis. To this end, a PP-BSP-ITN-DB government would likely introduce stricter restrictions to contain the spread of the disease and perhaps even announce a new lockdown. We expect vaccination to be made compulsory for certain professions, starting with medical personnel and teachers, with more categories added afterwards. The use of a green pass would be expanded to all public gatherings, while, at the same time, tighter restrictions on those who go on refusing vaccination would likely be introduced.

We think that, if implemented with sufficiently strong determination, such a strategy would result in two-thirds of the population being vaccinated by early spring of next year. This should then end the health crisis and help GDP growth accelerate.

The second key priority would be to address the negative impact of surging energy prices. We think the focus should be on the most vulnerable citizens. This is a relatively large group, because 28% of households in Bulgaria are energy-poor. Covering first-round effects on all of Bulgaria's energy poor is likely to cost BGN 452mn (less than 0.4% of GDP), if retail prices of electricity increase by 20% from 1 January 2022 and are frozen by the end of the year.

If the new government deals successfully with these two tasks, we think its shelf life is likely to prove longer than just a couple of months.

We do not expect there to be major changes to economic policy

The election is unlikely to change the Bulgarian economy dramatically, as all four parties that are likely to form the next government share many, and fairly mainstream, views on policymaking.

All four of the parties that would make up a PP-BSP-ITN-DB coalition support the introduction of a tax-free allowance on personal income. The size of such an allowance would most likely be equal to the minimum wage and be applied to all earners. Apart from that, we do not expect to see any major changes to taxation. In our view, the BSP would have to give up on its plan to remove the flat tax and replace it with moderately progressive taxation of personal incomes, because the other three parties in the ruling coalition have shown little support for such a move. Plans for reducing VAT, such as the BSP's proposal to cut VAT charged on foods and drugs or the DB's proposal to increase the threshold for VAT registration in order to reduce small-business taxation, have limited chances of materializing in the short term. This is because the immediate priority of any new government would likely be to demonstrate that it can sustain fiscal prudence, despite the destabilizing pressure that the ongoing health crisis and surging energy prices are exerting on the budget.

All four founding members of such a government are in favor of raising social transfers to the most vulnerable. A deeper look reveals that the fiscal impact of higher social transfers is likely to be modest. The BSP has made the most generous proposals to raise child allowances and social payments for people with disabilities, as this was one of the priorities of its campaign. However, even if all of the BSP's proposals are implemented, their total fiscal impact is likely to amount to around 0.3% of GDP annually.

We think these proposals would be positive for economic growth and job creation because they are aimed at helping those at the bottom of income distribution and because they would help reduce the country's elevated level of income inequality.

The health-care, the policy of the new government will be shaped by the BSP. The BSP is committed to keeping the single-payer state-owned system for the basic package of primary health care services. Services not included in the basic package will continue to be covered by supplementary insurance, provided by private insurers on a voluntary basis. To improve spending control, the new administration is likely to tighten the accreditation of private hospitals, which makes sense to us, as Bulgaria is already one of the countries with the highest number of hospitals per capita in the EU. Introduction of a centralized procurement system and expanding the share of digitalized services will be among the priorities of the new administration as well.

None of the main political parties in the country dared to propose raising health insurance contributions during the campaign, although practically all of them agreed that public sector spending on health care needs to rise, when compared to the 4.4% of GDP spent on average over the last five years prior to the start of the corona virus pandemic.

We view the BSP's health-care vision as more pragmatic than those of their main rivals. We are skeptical that plans to replace Bulgaria's state-owned single-payer system with a private health-care insurance system will improve spending control. We think this could result in higher health-care price inflation and further increase large out-of-pocket payments, which in Bulgaria are the highest in the EU, when compared to the size of public-sector-funded payments for health care.

The recent surge in energy prices helped consolidate support in favor of the Belene nuclear power plant project. It is now clear that there will be no shortage of demand for the electricity the new power plant is to produce. This has helped put to rest most of the concerns surrounding the financial viability of the project. This is crucial because such concerns formed the basis of the central argument against the construction of the Belene plant only half an year ago.

We expect the Belene project to be restarted soon after a new government is formed. Local energy experts estimate the funding necessary for the completion of Belene at EUR 7bn because its two nuclear reactors (1000 MW each) have been purchased already. Most likely, the project will be structured as 100% state-owned and will be financed via government borrowing. This suggests that sovereign funding needs could potentially increase by up to EUR 7bn in the medium term.

In our view, the Belene project will be a major test of the capacity of a PP-BSP-ITN-DB coalition government to carry out a massive public infrastructure project in an efficient and transparent way, especially as this particular project has already been a source of serious corruption concerns from its onset more than a decade ago.

In case a PP-BSP-ITN-DB coalition is formed, Bulgaria's adoption of the euro could become an area of disagreement. While the DB has been among the keenest supporters of Bulgaria's adopting the euro, the PP's and especially the BSP's rhetoric during the campaign suggest that they harbor some reservations. For example, the PP argue that they are in favor of fast euro adoption, but that it should take place only after an open and broad-based public debate. We think the BSP's stance seems even more ambiguous. Its election program states that Bulgaria's adoption of the euro should take place only if there are full guarantees protecting the savings and incomes of Bulgarian citizens.

What this means exactly would become clear soon because the terms of three management-board members of the BNB have expired, and parliament will have to select their successors. In our view, perhaps the best way to dissipate doubts as to whether they support Bulgaria's adoption of the euro would be for the ruling coalition to support the BNB Governor Dimitar Radev, who is seen as having done a lot to prepare Bulgaria for the adoption of the euro and is now running for reappointment.

Timely completion of the large infrastructure projects started by the previous administration remains a source of risk. The most problematic looks to be the construction of the Hemus highway, which the GERB promised to complete by 2024 and which is the country's single most important infrastructure project financed by the national budget alone. To boost fiscal revenues this year, Bulgaria's caretaker government transferred BGN 500mn that the GERB set aside for the completion of the highway in 2018 and scrapped many of the construction contracts awarded by the previous administration.

Kristofor Pavlov, Chief Economist Bulgaria (UniCredit Bulbank)
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

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UniCredit Research*

Macro Research



Erik F. Nielsen
 Group Chief Economist
 Global Head of CIB Research
 +44 207 826-1765
 erik.nielsen@unicredit.eu



Dr. Ingo Heimig
 Head of Research Operations
 & Regulatory Controls
 +49 89 378-13952
 ingo.heimig@unicredit.de

Head of Macro Research



Marco Valli
 Head of Macro Research
 Chief European Economist
 +39 02 8862-0537
 marco.valli@unicredit.eu

European Economics Research



Dr. Andreas Rees
 Chief German Economist
 +49 69 2717-2074
 andreas.rees@unicredit.eu



Dr. Loredana Federico
 Chief Italian Economist
 +39 02 8862-0534
 loreदानamaria.federico@unicredit.eu



Stefan Bruckbauer
 Chief Austrian Economist
 +43 50505-41951
 stefan.bruckbauer@unicreditgroup.at



Tullia Bucco
 Economist
 +39 02 8862-0532
 tullia.bucco@unicredit.eu



Edoardo Campanella
 Economist
 +39 02 8862-0522
 edoardo.campanella@unicredit.eu



Walter Pudschedl
 Economist
 +43 50505-41957
 walter.pudschedl@unicreditgroup.at



Chiara Silvestre
 Economist
 chiara.silvestre@unicredit.eu

International Economics Research



Daniel Vernazza, Ph.D.
 Chief International Economist
 +44 207 826-7805
 daniel.vernazza@unicredit.eu

EEMEA Economics Research



Dan Bucsa
 Chief CEE Economist
 +44 207 826-7954
 dan.bucsa@unicredit.eu



Gökçe Çelik
 Senior CEE Economist
 +44 207 826-6077
 gokce.celik@unicredit.eu



Mauro Giorgio Marrano
 Senior CEE Economist
 +43 50505-82712
 mauro.giorgiomarrano@unicredit.de



Artem Arkhipov
 Head, Macroeconomic Analysis
 and Research, Russia
 +7 495 258-7258
 artem.arkhipov@unicredit.ru



Hrvoje Dolenc
 Chief Economist, Croatia
 +385 1 6006-678
 hrvoje.dolenc@unicreditgroup.zaba.hr



Dr. Ágnes Halász
 Chief Economist, Head, Economics and
 Strategic Analysis, Hungary
 +36 1 301-1907
 agnes.halasz@unicreditgroup.hu



Ľubomír Koršňák
 Chief Economist, Slovakia
 +421 2 4950 2427
 lubomir.korsnak@unicreditgroup.sk



Anca Maria Negrescu
 Senior Economist, Romania
 +40 21 200-1377
 anca.negrescu@unicredit.ro



Kristofor Pavlov
 Chief Economist, Bulgaria
 +359 2 923-2192
 kristofor.pavlov@unicreditgroup.bg



Pavel Sobíšek
 Chief Economist, Czech Republic
 +420 955 960-716
 pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
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