Bulgaria

Baa2 stable/BBB- stable/BBB stable*

Outlook

Economic growth is likely to reach a cyclical peak of around 4.4% in 2018, before easing marginally to 4.2% in 2019. Last year, growth was supported by two main drivers: exports and private consumption. This year and next, however, they are likely to be joined by investment, given signs that, after a prolonged period of stagnation, it has gained momentum recently. With its composition more balanced, the expansion will become more sustainable as well.

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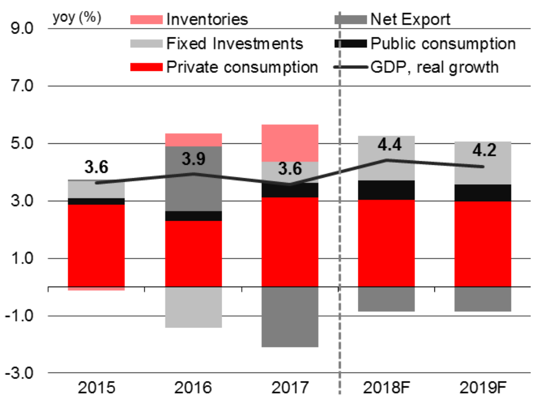
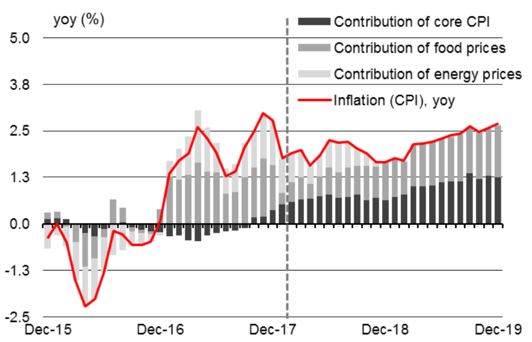
KEY DATES/EVENTS

- 15 May – GDP flash estimate for 1Q18
- 15 May – Labor force survey data for 1Q18
- 30 June – End of Bulgarian EU Council Presidency

GROWTH WILL ACCELERATE IN 2018



INFLATION DRIVER ROTATION IS IN PLAY



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2015	2016	2017	2018F	2019F
GDP (EUR bn)	45.3	48.1	50.4	53.6	57.1
Population (mn)	7.2	7.1	7.1	7.0	7.0
GDP per capita (EUR)	6 330	6 777	7 138	7 629	8 166
Real economy, change (%)					
GDP	3.6	3.9	3.6	4.4	4.2
Private Consumption	4.5	3.5	4.8	4.6	4.5
Fixed Investment	2.7	-6.6	3.8	8.0	7.5
Public Consumption	1.4	2.2	3.2	4.4	4.0
Exports	5.7	8.1	4.0	5.0	4.8
Imports	5.4	4.5	7.2	6.1	5.9
Monthly wage, nominal (EUR)	449	485	542	593	648
Real wage, change (%)	7.0	8.8	9.8	7.5	7.0
Unemployment rate (%)	9.1	7.6	6.2	5.4	5.0
Fiscal accounts (% of GDP)					
Budget balance	-1.6	0.0	0.2	-0.3	-0.7
Primary balance	-0.7	0.8	0.9	0.3	-0.1
Public debt	25.6	28.6	25.1	24.5	24.2
External accounts					
Current account balance (EUR bn)	0.0	1.1	2.3	1.2	0.5
Current account balance/GDP (%)	0.0	2.3	4.5	2.2	0.9
Extended basic balance/GDP (%)	8.0	5.8	6.7	6.3	4.8
Net FDI (% of GDP)	5.1	1.5	1.4	2.2	2.3
Gross foreign debt (% of GDP)	73.6	70.7	64.6	60.5	57.2
FX reserves (EUR bn)	20.3	23.9	23.7	25.0	26.3
Months of imports, goods & services	8.0	9.4	8.2	8.0	7.6
Inflation/Monetary/FX					
CPI (pavg)	-0.1	-0.8	2.1	1.9	2.3
CPI (eop)	-0.4	0.1	2.8	1.7	2.7
Central bank reference rate (eop)	0.01	0.00	-0.39	-0.39	0.00
USD/FX (eop)	1.79	1.86	1.63	1.48	1.44
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.76	1.77	1.73	1.51	1.45
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	137.5	136.6	139.1	142.8	143.1
Change (%)	-2.1	-0.7	1.8	2.7	0.2

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

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

The peak is yet to come

The slowdown of economic activity in 4Q17 was temporary

GDP growth slowed unexpectedly to 3.5% yoy in 4Q17, from 3.8% on average in the previous three consecutive quarters, bringing down FY17 real GDP growth to 3.6%, which is below both consensus (3.7%) and our call (4%). However, we should not try to read too much into the data for at least two reasons. First, these are preliminary estimates, which are usually subject to large revisions. What's more important, since the economic expansion has not peaked yet, the revision, when it comes, is more likely to be upwards. A case in point is the GDP data for 2016. In March of last year, the preliminary estimate stood at 3.4% yoy growth, only to be upwardly revised to 3.9% a couple of months later. Second, and perhaps more importantly, the deceleration in the pace of economic expansion in 4Q17 is not confirmed by other data releases. Most other indicators, including high frequency indicators, foreign trade data, and sentiment indicators, seem to suggest that the pace of underlying economic growth at the turn of the year remained little changed.

2018 may be the best post-crisis year for the economy

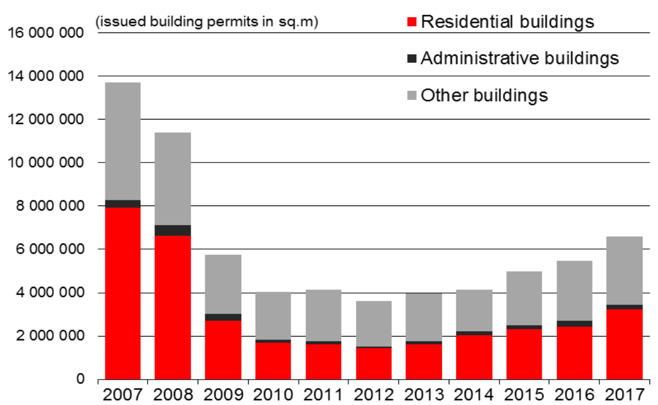
We decided to keep unchanged our above-consensus GDP growth forecast for this year at 4.4% and next year at 4.2%. We see the slowdown in 4Q17 as temporary and we expect a solid rebound in 1Q18 and perhaps to a lesser extent in 2Q18. Private consumption will remain the main growth driver in 2018 and 2019, but the acceleration of growth will come from investment. Both public and private investment are set to accelerate following a prolonged period of weakness. This would improve the structure of GDP and make growth more broad-based, helping to improve its sustainability as well. Importantly, the factors driving growth will change. EU funds, more favorable financing conditions, and government spending are likely to take over from job creation in both 2018 and 2019.

Investment is set to stage a comeback …

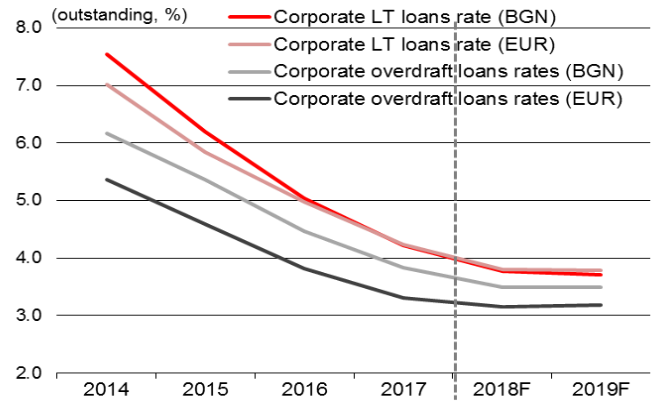
… with the long-overdue recovery in private investment, which started last year expected to get stronger in 2018 and 2019

The first signs of the recovery in investment became already present last year, when investment, at 3.8%, posted its strongest real increase since 2008. This expansion came against the backdrop of stagnant or perhaps even shrinking public investment (MoF data show a 3% nominal yoy drop in fixed public investment in 2017), which suggests private investment probably surged around 7% yoy. All components of private investment are expected to rise this year. Private residential construction contributed the most to the investment expansion last year. Stronger growth is forecasted this year as well, underpinned by rising house prices, a surge in new construction permits (see left chart) and continuing improvement in financing conditions (see right chart). Private construction is also likely to draw support from rising demand for commercial real estate for logistic, leisure and particularly for administrative purposes. We expect investment in machinery and equipment to increase too. The manufacturing sector, which will benefit the most from the ongoing expansion of production capacity, includes basic and fabricated metals, medicine and cosmetic products, and manufacturing of spare parts for the automotive industry.

Construction backlogs are on a steady rise…



…supported by easier access to credit



Source: NSI, BNB, UniCredit Research

Capacity utilization is at its highest prost-crisis level

After starting from scratch less than a decade ago, today the automotive industry accounts for more than 10% of manufacturing output, while three-quarters of firms in the sector plan to increase their production capacity, according to a recent poll of manufacturers' investment intentions for 2018.

Had it not been for the under-execution of public capex, GDP growth would have reached 4.5% or perhaps even more last year

In 2017, public capex went down to the lowest level in five years. The under-execution of the public capex budget last year (BGN 6.2bn planned versus BGN 3.9bn implemented) reflects unrealistic projections on top of poor planning and preparation of infrastructure projects. The delays which the snap elections in March 2017 caused also played a role, but a less prominent one. Nevertheless, the volume of public capex is forecasted to increase markedly in 2018 and further in 2019, because the government simply cannot afford more delays without risking repetition of the heavily back-loaded spending timetable from the previous planning period.

Private consumption will be helped more by wage growth than by higher employment

Consumption will be the key growth engine in 2018, slowing only marginally compared with 2017. The small slowdown will be above all attributable to weaker job creation expected this year, following very rapid employment growth in 2017. Nevertheless, we think that Bulgaria's low participation rate, when compared with most other CEE-EU members (see left chart), indicates some more scope for employment increases, especially if more carefully designed and more generously funded programs are put in place to reduce existing regional disparities in job opportunities. This includes the acceleration of infrastructure investment to boost connectivity (and hence labor force mobility), and measures to promote employment among young NEETs (Not in Education, Employment, or Training) individuals, which in Bulgaria has the highest share of total population among all CEE EU members (see right chart).

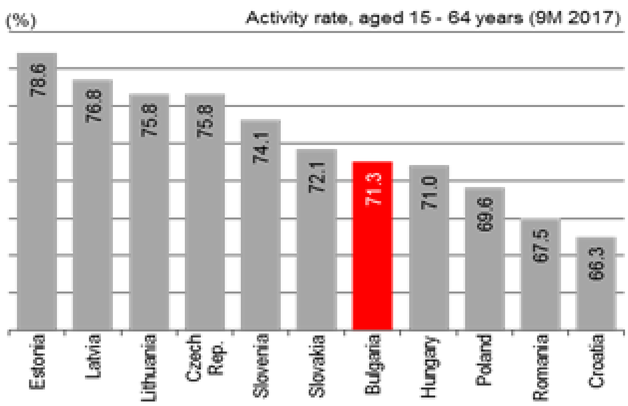
Tightening labor market will help wages to see another very solid increase

In the meantime, fast wage growth is expected to continue unabated, as the economy hasn't achieved full employment yet. Rapid wage growth will also reflect the labor shortage, which, starting from sectors using skilled labor, is gradually spilling over to the rest of the economy, In addition, the government's decision to raise the minimum wage and wages for some categories of public sector employees will also intensify upward pressures. As wage costs have been rising faster than productivity, some low-profit margin businesses are likely to suffer. This might trigger some structural transformations in the economy, with companies likely to shift more labor resources to higher value-added manufacturing sectors, or substitute capital for labor via the introduction of more capital-intensive technologies. However, such processes never tend to be smooth and may produce higher unemployment as a temporary consequence, which is one additional factor that makes us more cautious about the growth outlook for the economy in the medium term.

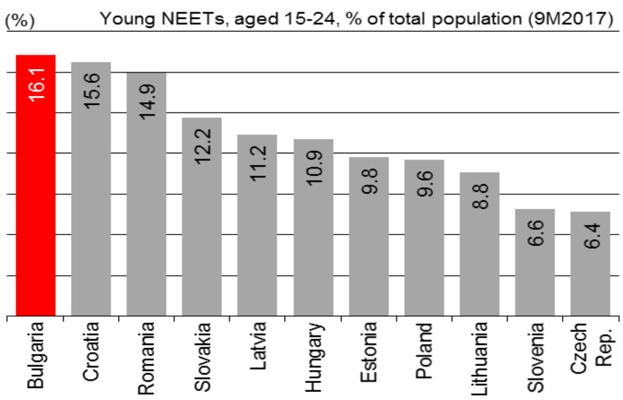
Lower real interest rates on retail loans will help private consumption

Consumption is also supported by higher housing prices (9.0% yoy in 3Q17, after a weaker 7.0% rise in FY16), which was among the factors that helped push household confidence to its highest post-crisis levels. The positive outlook for private consumption is further underpinned by easing consumer price inflation this year and downward trend in credit rates, which are forecasted to stimulate demand for consumer and particularly for mortgage loans.

Participation rates are below CEE-EU median levels…



…as young people remain disengaged



Source: Eurostat, UniCredit Research

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