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

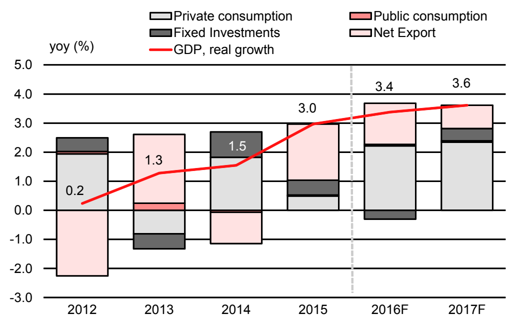
Outlook – With a renewed slump in energy prices and stronger-than-expected labor market recovery now in the cards, we feel comfortable enough to raise our GDP growth forecast to 3.4% (from 3%) for this year and to 3.6% (from 2.9%) next year. Not only did growth become more balanced last year, but sustained C/A surpluses have also cut foreign debt to more manageable levels, adding to the already existing signs that the economy is gradually shifting toward a less credit intensive growth model. As before, we expect private consumption and, to a somewhat lesser degree, exports to provide most of the fuel for growth in 2016 and 2017. A strong commitment to fiscal prudence will help keep the budget deficit at moderate levels in both 2016 and 2017, while a supportive capital flows environment will boost central bank reserves even higher.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

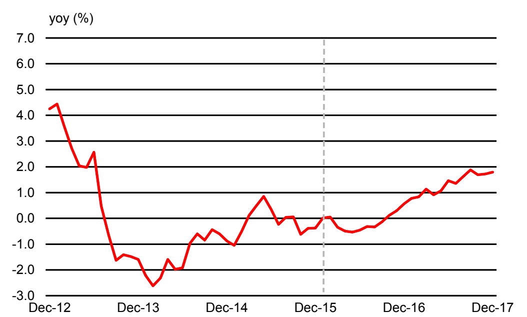
KEY DATES/EVENTS

- 13 May: GDP flash estimate 1Q16
- 16 May: Number of employed for 1Q16
- 25 April: 1Q monetary statistics

GDP GROWTH TO STABILIZE AT A HIGHER LEVEL



INFLATION TO RECOVER GRADUALLY



Source: NSI, BNB, MoF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2013	2014	2015	2016F	2017F
GDP (EUR bn)	41.9	42.8	44.2	45.6	47.9
Population (mn)	7.2	7.2	7.2	7.1	7.1
GDP per capita (EUR)	5,784	5,936	6,171	6,406	6,760
Real economy, change (%)					
GDP	1.3	1.5	3.0	3.4	3.6
Private Consumption	-1.1	2.5	0.7	3.2	3.4
Fixed Investment	0.3	3.4	2.5	-1.3	2.3
Public Consumption	3.1	-0.8	0.4	0.6	0.6
Exports	9.2	-0.1	7.6	5.5	4.4
Imports	4.9	1.5	4.4	3.2	3.2
Monthly wage, nominal (EUR)	396	423	453	485	522
Real wage, change (%)	5.1	8.2	7.1	7.3	6.2
Unemployment rate (%)	12.9	11.4	9.1	7.8	6.5
Fiscal accounts (% of GDP)					
Budget balance	-1.8	-3.6	-2.9	-2.2	-1.8
Primary balance	-0.9	-3.0	-2.1	-1.2	-0.8
Public debt	17.6	26.4	26.4	29.9	29.3
External accounts					
Current account balance (EUR bn)	0.8	0.5	0.5	0.9	0.6
Current account balance/GDP (%)	1.8	1.2	1.2	1.9	1.2
Extended basic balance/GDP (%)	6.1	5.4	7.6	6.8	6.2
Net FDI (% of GDP)	3.0	2.0	3.4	3.6	3.7
Gross foreign debt (% of GDP)	88.1	92.1	77.3	73.1	68.3
FX reserves (EUR bn)	14.4	16.5	20.3	22.1	23.9
Months of imports, goods & services	5.7	6.6	7.9	8.4	8.6
Inflation/Monetary/FX					
CPI (pavg)	0.9	-1.4	-0.1	-0.1	1.4
CPI (eop)	-1.6	-0.9	-0.4	0.6	1.8
Central bank reference rate (eop)	0.07	0.02	0.01	-0.13	-0.10
USD/FX (eop)	1.42	1.79	1.80	1.75	1.66
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.47	1.47	1.76	1.81	1.68
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	140.90	144.60	142.19	142.02	140.55
Change (%)	-0.91	2.63	-1.66	-0.12	-1.03

Source: BNB, NSI, UniCredit Research

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

Growth is off to a solid start of the year

Unexpected market weakness and turmoil have raised uncertainty…

…but domestically the real economy produced a host of very encouraging data

Whereas global financial markets have gone through a period of pronounced weakness, fueling a sense of uncertainty and uneasiness early this year, domestically the real economy has produced a host of solid results. Powered by private consumption and investment, real GDP growth for the whole of 2015 accelerated to 3.0% (above our 2.8% forecast). Pretty much the same positive message came from sentiment indicators in January and February. The headline economy-wide indicator remained only slightly below the highest post-crisis print reported in December, which further reconfirmed our view that the economy is off to a solid start to 2016.

The balance between hiring and firing intentions of business managers is either at or very close to its post-crisis peaks. Households' employment expectations are also improving

However, it was the labor market which produced the most encouraging news since our last CEE Quarterly publication. For a start, the unemployment rate eased to 7.9% in 4Q15 (from 8.3% in 3Q15 and 10.6% a year ago), underpinned by a 2.4% yoy gain in the number of jobs. This was the strongest yoy rise in employment since the start of the labor market recovery (see lhs chart), which was not only twice as much as the average in the preceding two quarters, but also well above both the market's and our own projections. In line with the trend established over the past two years, the bulk of new hiring comprised relatively well-paid jobs from IT and other business services sectors where outsourcing activities have been most pronounced. Labor costs rose, at the same time, with the average wages index jumping 8.0% yoy in 4Q15.

Industry and business servicing sectors should continue to add jobs, though less so than before, as the economy approaches full employment

The renewed slump in crude oil prices is set to provide a stronger boost to household purchasing power in 2016 than earlier projected

Looking ahead, we expect the recovery to continue, although the pace of job gains is unlikely to accelerate further, but rather stay at a very solid level of around 1.5% yoy. The combination of renewed energy prices slump and stronger-than-previously forecasted labor market recovery should help private consumption to rise even more. Consequently, we revised up our GDP growth forecast to 3.4% in 2016 (from 3.0%) and 3.6% in 2017 (from 2.9%). As before, we expect private consumption and, to a somewhat lesser degree, exports to provide most of the fuel for growth in 2016. A somewhat less supportive external environment in 2017, as the euro firms and energy prices begin to recover, will constrain the pace of export expansion, but this will be more than offset by stronger investment and private consumption growth at home.

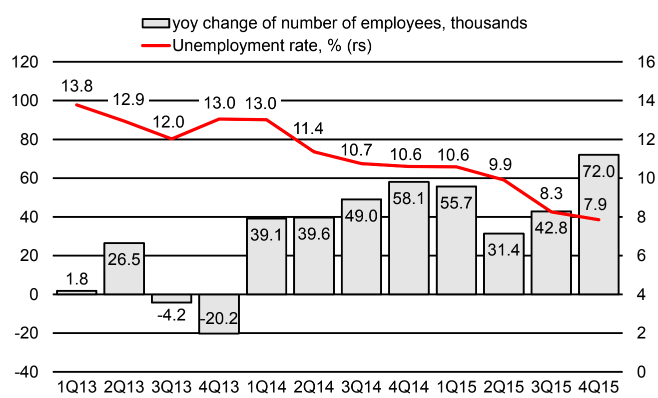
The budget benefited from the increase in revenues resulting from the cycle and improved tax collection

The pace of fiscal consolidation will remain broadly the same over the next two years

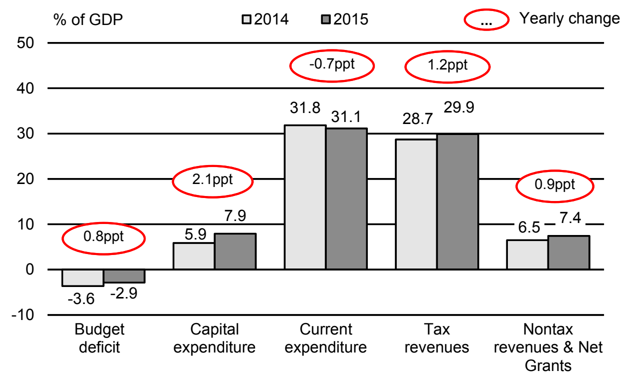
Preparations to award a 30Y concession contract for Sofia airport is well under way

A solid commitment to fiscal prudence helped to cut the deficit to 2.9% of GDP last year (a notch better than the 3% target), from 3.6% in 2014 (see rhs chart). Improved tax collection and cyclical factors pushed tax revenues 7.9% higher yoy, which was enough to accommodate a pickup in public investment to 7.9% of GDP, from 5.9% in 2014, as EU funds absorption posted a record-high improvement. Spending, at the same time, was well contained as current expenditures (excluding contributions to the EU budget) declined to 31.1% of GDP, from 31.8% in 2014. This year, we expect the government to miss only narrowly its budget deficit target (set at 2% of GDP). Implementation risks related to fiscal revenues look rather small, since tax revenues are targeted to rise a modest 4.5% nominally. Prioritizing spending would be more challenging, however, with current expenditures planned to rise just 1.5% yoy.

Employment growth accelerated, pushing unemployment rate down…



…while fiscal position improved



Source: NSI, BNB, UniCredit Research

FDI rose to 3.4% of GDP last year from 2.0% in 2014 on the back of a healthy expansion in export capacity

The fall in oil prices produced a record high improvement in the net energy import bill

A marked rise in capital flows (see lhs chart) boosted central bank reserves by the equivalent of 8.4% of GDP last year, only slightly below the record 8.9% rise at the peak of the pre-crisis boom in 2007. This reflected both a combination of robust export expansion and lower energy prices, which helped shift the goods and services balance to a surplus of 1.5% of GDP from a 0.5% deficit in 2014, as well as improved EU funds absorption and stronger FDI. However, the single strongest boost came from the banking sector, which repatriated part of its liquidity reserves held abroad to cut losses from the deepening negative interest rates environment in the EA. These inflows more than offset continued large repayments of foreign debt.

In contrast to the boom years, the capital flows surge in 2015 was not associated with rising foreign debt

As a result, the surge in capital inflows was accompanied by a marked drop in gross external debt, which fell to 77.3% of GDP at the end of 2015, from 92.1% a year ago (see rhs chart). The shift toward a less credit intensive growth model is likely to continue next year, when we expect gross external debt to decline to 73.1% of GDP.

Downside risks to our scenario remain plentiful

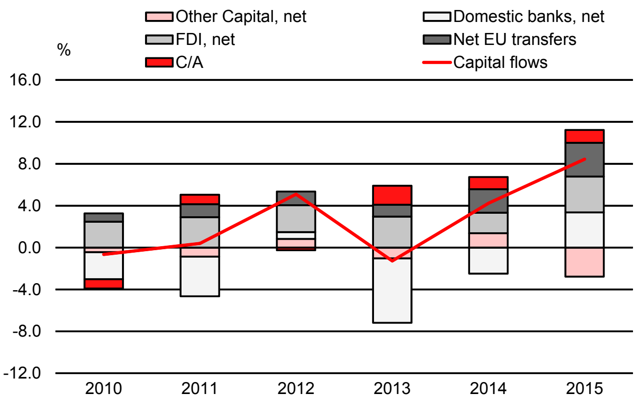
The potential fallout from the VW scandal is less of a concern, as Bulgarian economy has only limited exposure to the car industry

A major slowdown in the EA remains the key downside risk to our benign scenario, given the small and export dependent Bulgarian economy. A sharper-than-expected slowdown in China is the second most relevant risk on the external front, not only because of the large indirect impact via the supply chains to West European exporters, but also because of the downward pressure on prices of commodities, which account for more than one-third of the country's merchandise exports. Limited exposure to US investors suggests that the negative impact from the Fed liftoff will be small. The latter would mostly hurt Bulgaria indirectly, via trade links with Croatia, Serbia, and especially Turkey, which are highly vulnerable, given their high dependence on foreign funding. Recently, geopolitical developments moved to the forefront again, as the conflict in Syria seems far from over, while the EU is struggling to forge a joint policy response to high migration flows. So far, Bulgaria has remained outside the main migration routes, which means that if this risk were to materialize the direct impact is likely to be limited. Nevertheless, the country will be hurt indirectly, via the deterioration in market sentiment in neighboring countries and wider Europe.

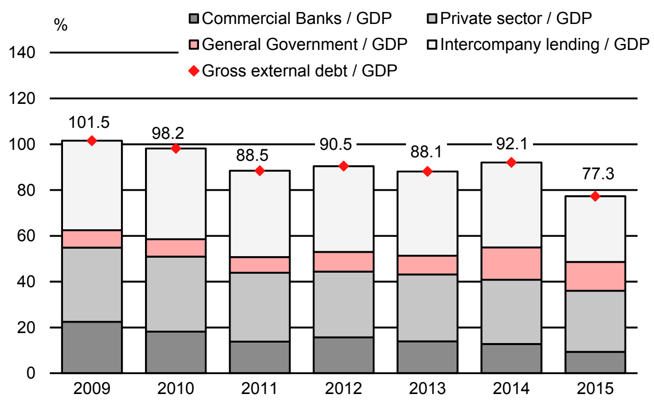
Restructuring of the energy sector contributed to the financial stabilization of NEK (company controlling state-owned assets in the energy sector), which helped one of the key downside risks on the domestic front to recede

On the domestic front, there are two major downside risks. First, the resignation of the judiciary minister in December has reinforced the impression that efforts to reduce corruption remain hostage to politically well-connected and powerful interests of obscure local oligarchs. Second, if gaps in individual banks' provision levels can be used as a benchmark, it seems that the upcoming stress test and AQR are likely to reveal some shortages of provisions and capital in a limited number of privately-owned lower-tier local lenders. These will be of manageable proportions, given the strength of public sector finances and available fiscal reserves, which stand at a very comfortable level of BGN 7.3bn or 8.2% of GDP in January, on top of BGN 5.6bn (6.3% of GDP), which the BNB can use as a lender of last resort.

A broad-based increase in inflows gathered pace…



…supporting a reduction in external indebtedness



Source: Eurostat, NSI, UniCredit Research

Strategy: Newly issued bond has scope for price gains

The MinFin sold EUR 2bn of 7Y and 12Y bonds under the GMTN program

The MinFin successfully returned to the external market following the ECB's announcement of new monetary easing measures, selling EUR 1.994bn as part of its Global Medium Term Note (GMTN) program. This further strengthened the fiscal buffer prior to a stress test and AQR exercise for the banking sector, planned to run until mid-August, and covers most of the sovereign's funding needs for 2016 (see table below). The two-tranche auction came one year after a previous tap of EUR 3.1bn under the GMTN program which runs until end-2017.

Domestic investors are expected to support demand…

…which should lead to a strong start to secondary market trading…

The 7Y and 12Y bonds, which will most likely begin secondary market trading on 21 March, were reasonably oversubscribed, particularly in the shorter end with a bid to cover ratio of 1.84, and 1.76 for the longer-dated security. This still compares favorably to the results a year ago when bonds with similar maturity and volume saw demand at 1.76x and 1.5x supply, respectively. Similar to the 2015 tap, domestic investors were strongly represented, taking 33% and 25% of the book value, compared to 35% and 26% for the 7Y and 12Y tranches a year ago. Bulgarian investors, mainly banks, further expanded their holdings of last year's issue to almost two-thirds as of end 2015. This, alongside the marginally overpriced bonds (with yields at 2.16% and 3.18%, respectively), gives us sufficient reason to believe that secondary market trading will begin with a decent downward push on yields as domestic investors try to make the best of what seems to be the only opportunity for stocking up on more GBs in 2016 and channeling excess liquidity towards assets with decent yields.

… as 12Y paper looks cheap and will likely benefit the most

We see more room for yield reduction in the 12Y segment, where most of the demand from pension funds will be channeled, while banking sector demand is likely to be more evenly split between the two tranches.

Author: Nikola Georgiev, Economist (UniCredit Bulbank)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**4.9**	**1.7**	**2.4**
Budget deficit	1.3	1.0	0.9
Amortization of public debt	3.5	0.5	1.4
Domestic	1.0	0.5	0.4
Bonds	0.1	0.5	0.4
Bills	1.0	0	0
Loans	0	0	0
External	2.6	0.2	1.1
Bonds and loans	2.4	0	1.0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**4.9**	**1.7**	**2.4**
Domestic borrowing	0.7	0.6	0.5
Bonds	0.6	0.6	0.5
Bills	0.1	0	0
Loans	0	0	0
External borrowing	3.3	2.1	1.4
Bonds	3.2	2.0	1.3
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	1.0	-1.0	0.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**16.4**	**11.0**	**11.3**
C/A deficit	-0.5	-0.9	-0.6
Amortization of medium and long term debt	7.0	4.0	4.7
Government/central bank	2.6	0.2	1.1
Banks	0.6	0.5	0.5
Corporates/Other	3.8	3.2	3.1
Amortization of short-term debt	10.0	7.9	7.2
Financing	**16.4**	**11.0**	**11.3**
FDI (net)	1.5	1.6	1.8
Portfolio equity, net	1.0	0.5	0.4
Medium and long-term borrowing	4.8	5.7	4.8
Government/central bank	0.6	2.1	1.4
Banks	0.5	0.4	0.4
Corporates/Other	3.8	3.2	3.1
Short-term borrowing	7.9	7.2	6.8
EU structural and cohesion funds	1.9	1.0	1.2
Other	3.1	-3.3	-2.0
Change in FX reserves (- = increase)	-3.8	-1.8	-1.8
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	2.2	2.0	0.3

Source: BNB, MoF, UniCredit Research

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