Bulgaria

Baa2 stable/BBB- positive/BBB stable*

Outlook

A pickup in investment will provide a welcome boost to growth at a moment when exports are likely to lose some steam with demand in some key trading partners forecasted to slow down. The fallout from the crisis in Turkey will be significant, but manageable and limited to the trade channel, as Bulgaria's vulnerability indicators remain at very comfortable levels. Fiscal policy is set to shift from growth neutral this year to moderately stimulative next year, supporting growth in 2019.

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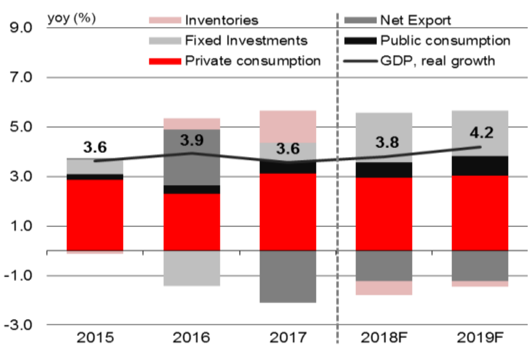
KEY DATES/EVENTS

- Oct/Nov: 2019 Government Budget
- 3 Oct, 14 Nov, 7 Dec: GDP data (revised data for 2017, 3Q18 flash estimate, 3Q18 structure)
- 19 Oct, 19 Nov, 18 Dec: Balance of payments
- 15 Oct, 14 Nov, 12 Dec: CPI inflation

CHART TITLE



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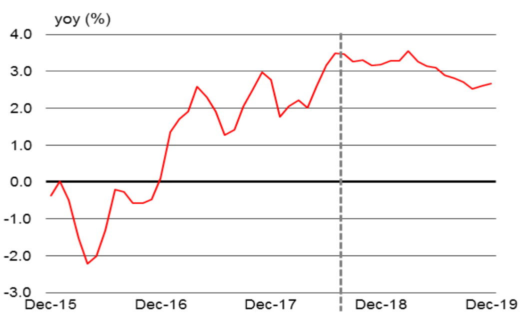


Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2015	2016	2017	2018F	2019F
GDP (EUR bn)	45.3	48.1	50.4	53.8	57.6
Population (mn)	7.2	7.1	7.1	7.0	7.0
GDP per capita (EUR)	6 330	6 777	7 153	7 665	8 259
Real economy, change (%)					
GDP	3.6	3.9	3.6	3.8	4.2
Private Consumption	4.5	3.5	4.8	4.5	4.6
Fixed Investment	2.7	-6.6	3.8	10.5	9.0
Public Consumption	1.4	2.2	3.2	4.1	5.1
Exports	5.7	8.1	4.0	3.8	3.6
Imports	5.4	4.5	7.2	5.5	5.2
Monthly wage, nominal (EUR)	449	485	542	591	644
Real wage, change (%)	7.6	8.8	9.8	6.2	6.0
Unemployment rate (%)	9.1	7.6	6.2	5.3	4.8
Fiscal accounts (% of GDP)					
Budget balance	-1.6	0.2	0.9	0.7	-0.2
Primary balance	-0.7	1.1	1.7	1.3	0.4
Public debt	25.7	28.6	25.1	23.1	22.1
External accounts					
Current account balance (EUR bn)	0.0	1.2	3.4	1.4	1.0
Current account balance/GDP (%)	0.0	2.6	6.7	2.6	1.8
Extended basic balance/GDP (%)	7.8	5.9	9.7	6.1	5.4
Net FDI (% of GDP)	4.9	1.3	2.1	2.2	2.3
Gross foreign debt (% of GDP)	74.0	71.1	66.1	60.1	54.8
FX reserves (EUR bn)	20.3	23.9	23.7	25.3	26.9
Months of imports, goods & services	8.0	9.4	8.1	8.1	8.0
Inflation/Monetary/FX					
CPI (pavg)	-0.8	-0.8	2.1	2.8	3.0
CPI (eop)	0.1	0.1	2.8	3.2	2.7
Central bank reference rate (eop)	0.01	0.00	-0.39	-0.47	-0.26
USD/FX (eop)	1.79	1.86	1.63	1.63	1.56
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.76	1.77	1.73	1.64	1.59
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	136.9	136.1	138.5	145.9	150.2
Change (%)	-2.1	-0.6	1.8	5.3	3.0

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

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

Investment to give the economy a fresh impetus

The shift in the composition of growth from consumption to investment continues

Spurred by synchronized recoveries in consumption and investment, the economy expanded by 3.4% yoy in 2Q18, a tad weaker than both the 3.7% average reported during the preceding four quarters and our call for 3.8% real GDP growth. On the positive side, the composition of GDP growth continued shifting from consumption to investment, which is a welcome transformation that will make the ongoing expansion more balanced and lasting, if policy makers are successful in preventing another unsustainable increase in real estate prices.

The Turkish economy looks poised for a recession, which will hit Bulgarian exports

The recent weakness of the Turkish economy has spurred contagion concerns. Indeed, Bulgaria looks vulnerable, with slightly less than 8% of last year's goods exports going to Turkey. The decline was already visible in the first seven months so far this year when exports to Turkey dropped a hefty 25.4% yoy. Our baseline macro scenario for Turkey envisages that this trend will persist in the rest of 2018 and 2019, before reversing in 2020 when growth is expected to rebound. Apart from the negative effect via the trade channel, the fallout from Turkish problems should be limited, as Bulgaria's vulnerability indicators are at very comfortable levels, which should limit spillover via financial and any other contagion channel. Nevertheless, the size of the export contraction will be strong enough to trigger a slight downward revision to our growth projection for this year to 3.8% (from previously 4.0%).

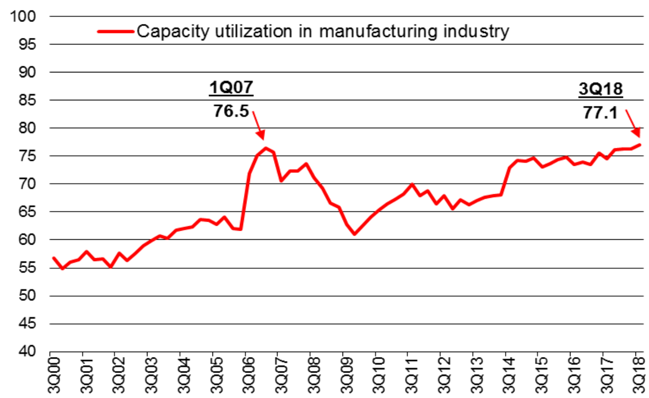
Fiscal policy is likely to shift from growth neutral in 2018 to moderately stimulative in 2019

Encouraged by constantly improving tax collection, the government has announced plans to raise public sector wages next year. This should help to address understaffing and underpayment in some parts of the public sector such as health care, defense, and particularly education, where the situation looks most alarming. The size of the increases will vary by sector and is likely to be around 10% on average, with the exception of education, where the government will stick to its already existing commitment for a 20% rise. The planned spending increase is equivalent to an additional 1.0% of GDP and, given its size, it should provide a solid boost to incomes and consumption next year, despite the advanced stage of the ongoing recovery. Therefore, we revised upward our real GDP growth forecast for next year to 4.2% from the 3.9% forecasted three months ago.

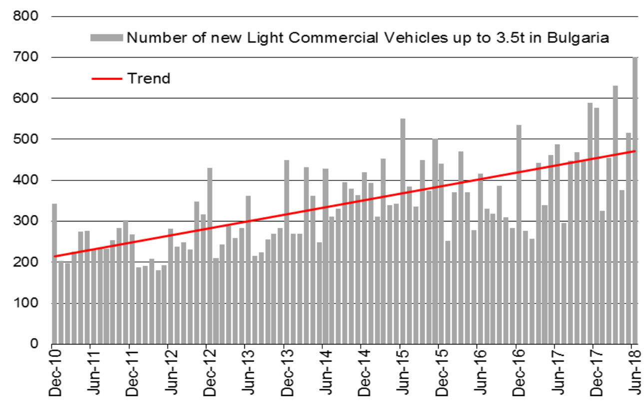
Housing construction shifted to a higher gear

Public investment spending rose to 1.6% of FY GDP for the first seven months of the year, after tumbling to its lowest level in the same period in 2017 (1.0%). Manufacturing companies have continued to channel part of their savings into new plant and equipment, as capacity utilization reached a record high in 3Q18 (see lhs chart), while investment in transport equipment is likely to post another hefty rise, after newly registered light commercial vehicles increased 32.4% yoy in 1H18 (see rhs chart). But it was housing construction that contributed the most to the investment expansion in 1H18. Even stronger growth is likely in 2H18 and in 2019, underpinned by rising real estate prices and a surge in new construction permits, as

Capacity utilization index climbed to a new high …



…while investment in transport equipment is likely to post another solid rise this year



Source: Eurostat, ACEA, UniCredit Research

We see a stronger credit impulse this year than we forecasted previously

demand for both residential and commercial real estate looks far from satiated. Favorable financing conditions also helped investment. Credit growth accelerated to 6.0% yoy in July (see lhs chart), which will likely prove even stronger when adjusted for NPL sales, which are set to hit a fresh high as banks are preparing for the new stress tests and AQR due next year.

Bulgaria is the first non-euro zone member to seek joining the banking union

In August, the government approved a roadmap to euro adoption. On top of the pledge to reduce corruption and organized crime, which, in our view, remain the Achilles heal of the economy, the roadmap contains commitments to improve the performance in several important areas. These include: strengthening banks, and the supervision of the non-banking financial sector in close cooperation with the ECB, improving the insolvency and anti-money laundering framework, as well as the governance of state-owned enterprises. Progress in all these areas, if and when achieved, should open the way for Bulgaria to join simultaneously both ERM II and the Banking Union. The agreement signed in June with the finance ministers of EA member states and the ECB sets a one-year horizon, during which these commitments should be met before the ECB assesses the progress and considers Bulgaria's ERM II entry.

Euro adoption will provide an important policy anchor

The commitments to reduce corruption and organized crime and reform the judiciary are not new, but their inclusion in the June memorandum is important, because by linking them to the country's euro adoption aspirations, they become policy anchors with increased pressure to perform. The commitment to improve financial sector supervision is also not new, but the need to comply with Banking Union requirements will accelerate the process and make it more transparent. To ensure a smooth transition into the Banking Union, the ECB will carry out an AQR and stress test for the local banking sector. These are planned to take place in the course of 2019 and will be based on banks' financial performance at the end of 2018.

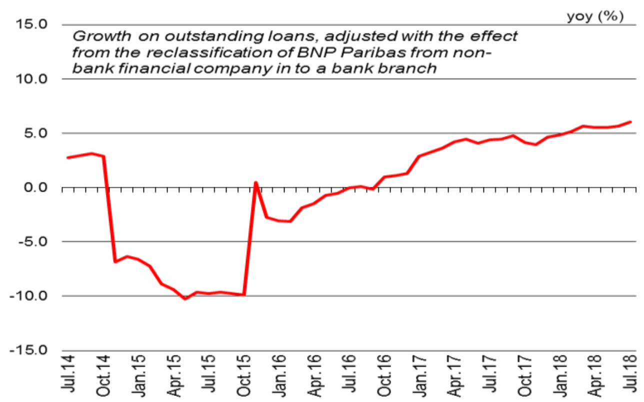
Inflation increased to 3.5% in August, driven by a combination of factors

Inflation accelerated, touching 3.5% in August, while core inflation climbed to a 7-year high (2.5% yoy) at the same time. This reflects a combination of factors. Exogenous factors played an important role, mainly higher energy prices (first and second-round effects), as well as firmer food prices, as bad weather affected the harvest of some fruits and vegetables during the summer. At the same time, demand-side related factors also contributed to higher inflation so far this year, as both wages and credit feed into core inflation, albeit with a lag.

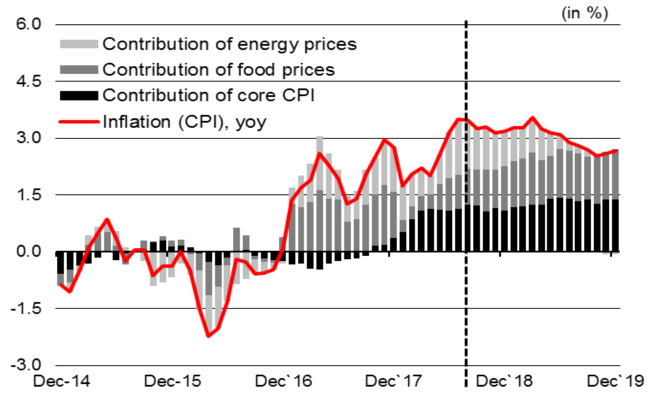
Inflation looks set to ease slightly later this year, but creep up again in 2019

We expect inflation to ease slightly later this year, but to start creeping up again in 2019. Energy price inflation will soon start receding in yoy terms as the base effect is vanishing. Food price increases however are not over yet, as more time will be needed for the recent surge in unprocessed food costs to feed through into the prices of processed food. Demand-side related factors are forecasted to add more pressure on core prices. Consequently, we forecast 2.8% average headline inflation in 2018 and 3.0% in 2019, while average core inflation is seen to rise to 2.1% in 2018 and further to 2.7% in 2019 (see rhs chart).

After a prolonged period of weakness, credit growth is on a rise



Headline inflation to ease slightly



Source: BNB, NSI, UniCredit Research

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