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FOCUS NOTES: BULGARIA

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Bulgaria: Early elections provide no resolution to political stalemate

- **A fragmented multi-party parliament emerged from the early parliamentary elections in Bulgaria**
- **The incoming government cabinet, when it is formed, will be confronted with a number of time pressing issues**
- **Against a backdrop of rising external and internal headwinds, we anticipate moderate GDP growth in the 2H**

Early parliamentary elections provide no resolution to political stalemate

A fragmented new parliament emerged from the early parliamentary elections in Bulgaria on October 5th. Eight parties, the highest number in the post-Communist era, accomplished to surpass the 4% threshold in order to enter the parliament.

In line with the poll forecasts, the main opposition party Citizens for the European Development of Bulgaria (GERB) came first winning around 33% of the vote. Although GERB took a clear lead over its rivals, it failed to collect enough seats in the parliament to form a majority government. With a proportional seats allocation system, GERB is projected to assumed 84 seats short of the 121 seats needed in the 240 seat parliament.

The outgoing coalition major partner Socialist Party (BSP) ranked second collecting only 15.4% of the vote. The Movement for Rights and Freedoms (MRF) which represents primarily Ethnic Turks benefited from the low voters' turnout receiving around 14.8%. A number of smaller parties collected enough votes to enter the parliament: the Reformers' Bloc (RF) with 8.9%, the Patriotic Front with 7.3%, Bulgaria without Censorship (BwC) with 5.6%, the nationalistic Attaka with 4.5% and the left wing ABV with 4.2%.

The arithmetic in the parliament seats looks like: GERB (84 seats), BSP (39 seats), MRF (38 seats), RF (23 seats), the Patriotic Front (19 seats), BwC (15 seats), ABV (11 seats) and ATAKA (11 seats).

With no clear majority party emerging and the allocation of seats in a fragmented multi-party parliament, it would require the parliamentary support of at least three parties (1 major + 2 minor) to form a government. In the aftermath of the elections, deliberations between parties have already started. GERB has stated its intention not to seek a government coalition with MRF or BwC, but seek a center-right coalition with the Reformers' Bloc (RF) and the Patriotic Front instead. Nevertheless, even the latter combination cannot be considered as given and viable in the case RF insists on GERB leader not assuming the post of the Prime Minister. At this point, given the past experience a repeat of last year's inconclusive election result, the scenario of a swift of power to a minority GERB-led government cannot be ruled out.

The incoming cabinet will be confronted with a number of pending and time pressing issues

On the other hand, it may take weeks before a new cabinet is formed. Meanwhile, a number of pressing issues require immediate policy response and government attention. The most pressing issue is the resolution of the Corporate Commercial Bank (Corpbank) case. The consultations of the Central Bank with the political leadership failed to reach an agreement on a resolution plan during the last months of the previous administration. If the bankruptcy procedures in place are to be implemented, deposits only up to €100,000 (or the equivalent of BGN 196,000) are going to be compensated. The European Commission has already put Bulgarian authorities on the spot for failing to comply with the deposit guarantee scheme no later than 20 days after the bank was put under conservatorship. During the summer, the BNB had ordered a thorough audit which is expected to be finalized by mid-October and then make a decision on the resolution of the bank no later than the end of December.

Secondly, the revision of the budget by the incoming government is another pressing issue. The budget revision became a contentious issue between political parties ahead of the start of the pre-election period. The initial fiscal deficit target in 2014 was set at 1.8% of GDP. Nevertheless, the key macro variables and assumptions of the budget framework have already been outdated. The caretaker government has recommended a revision to 4.0% of GDP, which is twice as much the initial target and requires the approval of the new parliament.

Yet it is still uncertain if authorities would be able to meet the revised fiscal target. We see a number of downside risks to the revised budget target. If those materialize, the fiscal deficit is more likely to overshoot the revised fiscal target. One of the key uncertainties in the budget implementation in the 2H is the bail-out costs from the cases of Corpbank and First Investment Bank. The costs of recapitalization or any other resolution plan-which are unknown at the moment of the writing - are going to weigh negatively on the fiscal result. In addition, the ongoing political uncertainty and the recent banking sector episodes are more likely to undermine confidence to some extent putting further pressure on growth and tax compliance while deflation doesnot help.

Thirdly, the unfreezing of EU funds is an interrelated with the budget revision issue. EU funding under operational program "Environment" has been blocked since November 2013, while the EU funding under the "Regional Development" program was stopped in June 2014 on investigation of abuse in the public procurement process. The suspension of EU funding weighted further negatively on the fiscal results in 2013-14. On top of that, the issue of the construction of the Bulgarian section of the South Stream raised a lot of publicity which led to speculation that it may have played a role in the previous administration collapse The controversial tender for a project contractor resulted in the European Commission opening infringement proceedings against Bulgaria in last June. The response of the caretaker government to halt the construction activities in August is a positive but inconclusive step which buys only time.

In retrospect, political uncertainty in the country has increased dramatically over the past couple of years. The political stalemate has had a negative impact on policy continuity and credibility that could put the investment grade at risk in the future ratings. Once a plus in the rating agencies decision process, fiscal discipline may not considered being the strongest asset. Despite the visible slippage, the fiscal position of Bulgaria is less strong than before but still remains among the healthiest in EU-28. The general government deficit even after the revision-including one offs-is expected to be at 4% of GDP and the public debt to GDP ratio is expected to reach 28%.

More importantly, political uncertainty impedes progress in the so much needed structural reforms and casts shadows on the medium term growth prospects. Accelerating structural reforms is a prerequisite for Bulgaria to escape the low growth path. Under the current political situation, the odds are not in favor of accelerating reforms. In fact, the outgoing government coalition made steps back in certain areas (pension, electricity market) increasing the future fiscal cost.

The background of early parliamentary elections on October 5th

After only eleven months in office, the cabinet led by the outgoing Prime Minister Mr. Plamen Oresharsky resigned on July 23rd. Consensus was reached among political parties on early parliamentary elections to take place on October 5th. Following the disappointing performance of the Socialist Party (BSP) in Euro parliament elections, tensions within the government coalition became stronger. The senior coalition partner, the Socialist Party (BSP) collected 18.9% of the vote followed closely by the junior partner, the Movement for Rights and Freedoms (MRF) with 17.3% versus 30.4% for the main opposition party Citizens for the European Development of Bulgaria (GERB). As a result, the MRF which represents Ethnic Turks and benefits from a low voters turnout withdrew its support from the cabinet calling for early elections.

The ruling coalition BSP -MRF was unstable by construction. Ever since it came into power in late May 2013, the BSP-MRF coalition controlled 120 seats out of the 240 seat parliament, but still lacked absolutely majority in the parliament. Thus, it relied on the implicit support of the ultra-nationalist party ATAKA (23 seats) to survive in the parliament. Despite fragile arithmetic, the cabinet survived five motions of no confidence in the parliament. However, mass antigovernment street protests for a number of months undermined government stability. Internal divisions within the BSP made things only worse. Mr. Parvanov, a former leader of BSP, decided to run with his own list of candidates in the European elections. Mr. Ivailo Kalfin, the head of the party's group in the European Parliament, resigned to run with Mr. Parvanov's new party (ABV-Alternativ for Bulgarian Revival).

Second quarter GDP performance came out in line with consensus expectations. Moderate expansion is expected in the 2H-2014

GDP growth registered its strongest quarter on quarter reading in the last two years. In line with consensus expectations, GDP expanded by +0.5% qoq/+1.6% yoy in Q2-2014 vs. +0.3% qoq/+1.2% yoy in Q1-2014 (ESA 95 methodology). From a demand side point of view, domestic demand had a contribution of 1.5pps while net exports had a minor contribution of 0.1pps. The recovery of consumer spending driven by rising real incomes continued at a slower pace in Q2. Consumer spending received support from the rise in the minimum wage and pensions since the beginning of the year. Final consumption decelerated to -0.4% qoq/+2.3% yoy in Q2-2014 vs. +1.9% qoq/+3.0% yoy in Q1-2014. That was the combined result of the deceleration in both private consumption (-0.2% qoq/+1.6% yoy in Q2-2014 vs. +1.3% qoq/+1.8% yoy in Q1-2014) and public consumption (+0.3% qoq/+0.8% yoy in Q2-2014 vs. +0.3% qoq/+1.6% in Q1-2014).

Investments expanded for a sixth consecutive quarter driven by public investments and capital investment in the sectors of industry (+10.5% yoy) and retail trade (+17.7% yoy). Gross fixed capital formation improved to +0.9% qoq/+3.9% yoy in Q2-2014 vs. 0.8% qoq/+3.4% yoy in Q1-2014. As a result, the contribution of gross fixed capital formation climbed to 0.9pps in Q2-2014 vs. 0.8pps in Q1-2014 up from only 0.2pps in Q2-2013. On the net exports side, exports remained unexpectedly strong at +2% qoq/+3.9% yoy in Q2-2014 vs. -2.1% qoq/+1.5% yoy in Q1-2014. Imports slowed down to -1.2% qoq/+3.4% yoy in Q2-2014 vs. +3.8 qoq/+6.3% yoy in Q1-2014. Consequently, the contribution of net exports improved to 0.1pps in Q2-2014 vs. a negative performance of -3.6pps in Q1-2014.

Overall, GDP growth came at 1.4%in 1H-2014 according to the ESA95 methodology. Against a backdrop of rising external and internal headwinds, we anticipate GDP growth to be equally moderate in the 2H. We see full year GDP growth rising to 1.5% yoy up from 0.9% yoy in 2013. Firstly, we note that domestic demand has taken over from net exports as the principal growth driver. However, the rebound of private consumption is set to remain moderate if not sluggish. The rebound of private consumption is driven by one-off increases in the minimum wage and pension and is constrained by relative tight labor and credit market conditions.

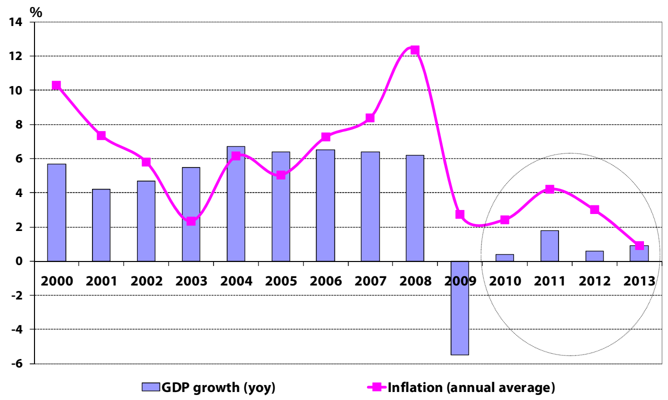
In our analysis dated back in March 2014, we highlighted the downside risks to the domestic demand outlook. The improvement in consumer and business sentiment in a low inflation environment may have provided some room for optimism but overall, we argued that the improvement in domestic demand conditions was still slow and fragile and thus reversible. Ever since, the prolonged domestic political uncertainty, the banking sector troubles, the lower than projected EU funds absorption and the continued delays in the infrastructure projects have played out and weigh negatively on consumer sentiment and investments. At the same time, the external environment became less supportive for net exports ever since. On top, rising external headwinds stemming from the negative sentiment spillovers from the Russia-Ukraine conflict, the FED's tapering and the less-than expected growth recovery of Euroarea (still the main trade partner of Bulgaria) will push the contribution of net exports lower in the 2H.

Bulgaria: Eurobank Research Forecasts

	2011	2012	2013	2014f
Real GDP (yoy%)	1.8	0.6	0.9	1.5
Final Consumption	1.5	2.9	-1.4	2.5
Gross Capital Formation *(Fixed)*	-6.5	4.0	-0.4	3.5
Exports	12.3	-0.4	9.0	3.5
Imports	8.8	3.3	5.7	5.0
Inflation (yoy%)				
CPI (annual average)	4.2	3.0	0.9	-1.5
CPI (end of period)	2.8	4.2	-1.6	-0.4
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-2.0	-0.5	-1.9	-4.0
Gross Public Debt	17.0	18.8	19.1	28.0
Primary Balance	-1.3	0.3	-1.0	-3.0
Labor Statistics				
Unemployment Rate (LFS, %)	11.3	12.3	12.9	12.7
Wage Growth *(total economy)*	5.9	6.6	10.5	3.5
External Accounts				
Current Account (% GDP)	0.1	-0.8	1.9	0.5
Net FDI (EUR bn)	1.3	1.1	1.1	1.0
FDI / Current Account (%)	Na	284.3	Na	Na
FX Reserves (EUR bn)	13.3	15.6	14.4	14.5
Domestic Credit	**2011**	**2012**	**2013**	**Q2 14**
Total Credit (%GDP)	74.4	74.1	74.4	76.3
Credit to Enterprises (%GDP)	47.9	48.9	49.0	50.5
Credit to Households (%GDP)	24.6	23.6	23.7	23.7
FX Credit/Total Credit (%)	63.7	64.0	60.9	60.2
Private Sector Credit (yoy)	3.9	3.8	0.6	2.9
Loans to Deposits (%)	104.0	99.4	92.1	91.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	Currency Board			
EUR/BGN	1.96	1.96	1.96	1.96

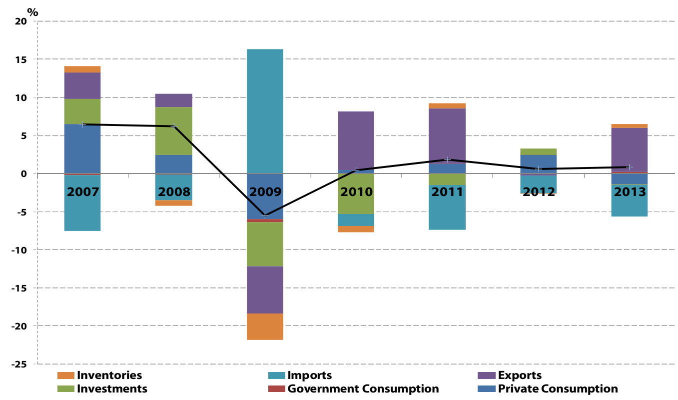
Source: National Sources, Eurostat, IMF, Eurobank Research

Figure 1: GDP & Inflation growth rates



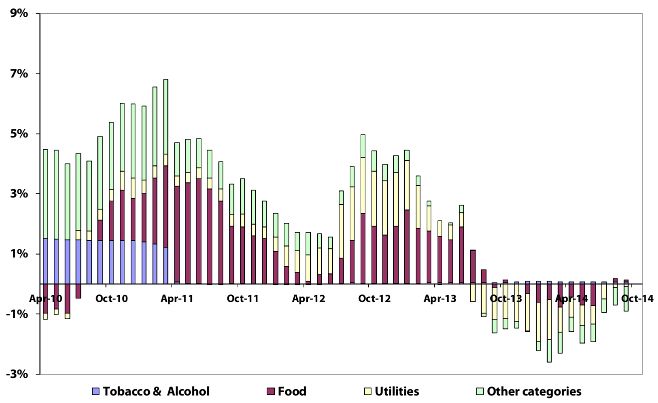
Source:National Statistics, Eurobank Research

Figure 2: GDP growth components



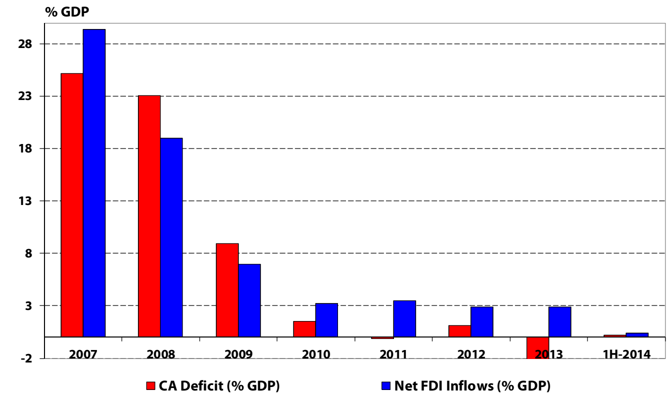
Source:National Statistics, Eurobank Research

Figure 3: Inflation components



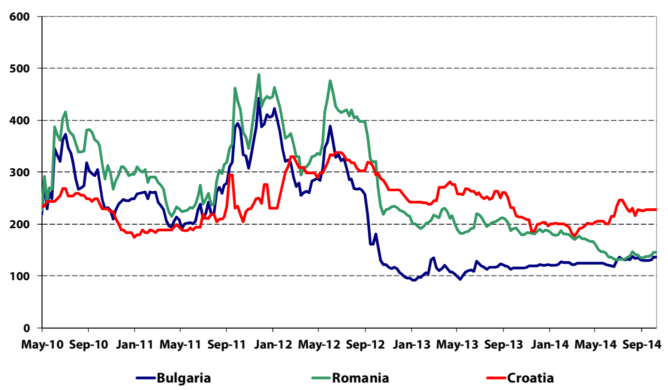
Source: National Statistics, Eurobank Research

Figure 4: CA Deficit & Net FDI inflows



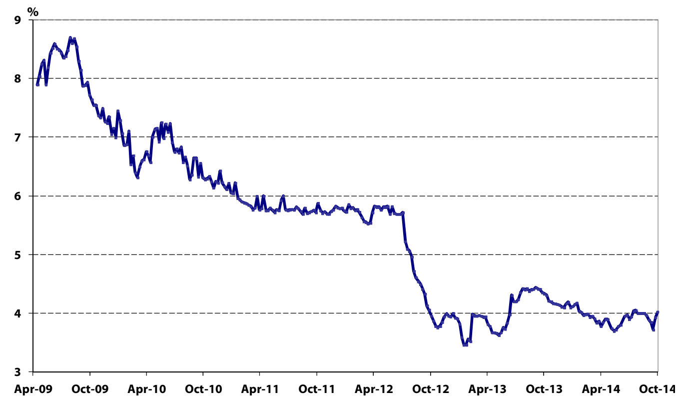
Source: BNB, Eurobank Research

Figure 5: Comparison of regional CDS spreads



Source:Eurobank Research, Ecowin Reuters

Figure 6: Bulgaria's Government Benchmarks 5Y



Source:Reuters Ecowin

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