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REGIONAL ECONOMICS & MARKET STRATEGY FOCUS NOTE

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BULGARIA
Fitch and S&P sovereign reviews: long term sovereign rating upgraded by one notch, outlook stable

- On December 1st, both Fitch and S&P upgraded the long-term sovereign rating of Bulgaria by one notch in their respective ratings scale. More specifically, Fitch upgraded the long-term sovereign rating from BBB- to BBB with a stable outlook. At the same time, Standard and Poor's upgraded the long-term sovereign rating from BB+ to BBB- placing Bulgaria at the investment grade for the first time since December 2014.

- According to S&P, the decision reflects primarily the solid improvement in external metrics, the expansion and diversification of the exports base and its' resilience to labor cost growth amid a rise in domestic savings. In turn, the risk of abrupt and material shifts in external financing flows-particularly in FDI investment- has reduced significantly. The solid external performance has strengthened the credit metrics and the economy is now more export driven and less leveraged than previously. At the same time, public financial management has been prudent in further support to the currency board regime. In the S&P view, the stable outlook balances the improved growth prospects and the track record of conservative fiscal policy-unlike many of its CESSE peers- against the potential re-emergence of political instability. The agency tied further positive rating action in the next 24 months upon a further reduction in the banking system's NPL (currently at around 12%) and a strengthening in fiscal performance beyond expectations. Alternatively, if Bulgaria was granted ERM2 access- even though the political hurdle to receive unanimous Euroarea members support is very high- that would further bolster the credibility of the current monetary framework by providing additional external buffers.

- On the other hand, Fitch also focused its argumentation for the upgrade on the improvement of the external debt ratios which has led Bulgaria's external metric to outperform the majority of its BBB peers. Moreover, Fitch anticipates the net creditor external position to strengthen further in the medium term and stay above the median of the BBB peers underpinned by strong current account surpluses. The current account surpluses are expected to remain strong at 3.4% in 2017-19 supported by further gains in export competitiveness and diversifying export base. In addition, Fitch stressed that Bulgaria outperforms its peers, both in terms of the projected budget deficits driven by higher expenditure on pension, salaries, defense and social welfare and the general government debt to GDP ratio which will remain below 25% in 2017-2019. Risks are estimated as balanced and may stem from lower absorption of EU structural funds or slow credit growth. Risks stemming from the local banking sector's contingent liabilities have been reduced due to banks' ample capital buffers, high liquidity, stable deposits and moderate profits and mitigate the risks stemming from the high stock of legacy NPLs.

- The economy is in the best shape in the post Lehman period. The country's fiscal and external position has been on an improving trend. Bulgaria has been running either a balanced or a surplus in the current account since 2013. In addition, Bulgaria has been running a balanced budgetary position in ESA2010 terms in the last couple of years, so that its public debt is the 3rd lowest in EU-28.

- According to the flash estimate release, real GDP expanded by 0.9% QoQ/3.9% YoY in Q3 compared to 1.0% QoQ/3.7% YoY in Q2 vs. 0.9% QoQ/3.7% YoY in Q1. As usual, there will be another estimate of the national accounts data published at a later stage and there will most probably be huge revisions and reallocations within the individual growth drivers' components. Although the components are yet to be known, growth most probably was once again domestic demand-driven.

- Final consumption remained strong on an annual basis, expanding by 1.1% QoQ/4.6% YoY in Q3 vs. 0.5% QoQ/3.8% YoY in Q2 compared to 1.0% QoQ/4.6% YoY in Q1. Final consumption received support from sustained labor market improvement coupled with still high real wage growth, a more expansionary fiscal stance compared to the same period last year, accelerating credit activity and increased tourism revenues in Q3. The unemployment rate declined further down to 6.1% in Q3-2017 down from 7.4% a year ago, the lowest level since Q1-2009, as the economy adds new jobs in the areas of specialized business and IT services. At the same time, real wage growth dynamics accelerated to 8.6% YoY in Q3 vs. 7.6% YoY in Q2 underpinned by the inflation slowdown (from 2.3% YoY in Q2 to 1.6% YoY in Q3). Credit to the non-government sector accelerated to 4.9% YoY in Q3 vs. only 1.5% YoY in 2016, compared to -1.2% YoY in 2015 and -8.2% YoY in 2014. Financial institutions are now less reluctant to lend, as heavy regulatory requirements posed by the banking system-wide AQR and Stress test are behind, and are still confronted by the negative interest rates on excess reserves. In addition, the net travel services surplus had reached 3.8% of GDP in 9M up from 1.1% in H1.

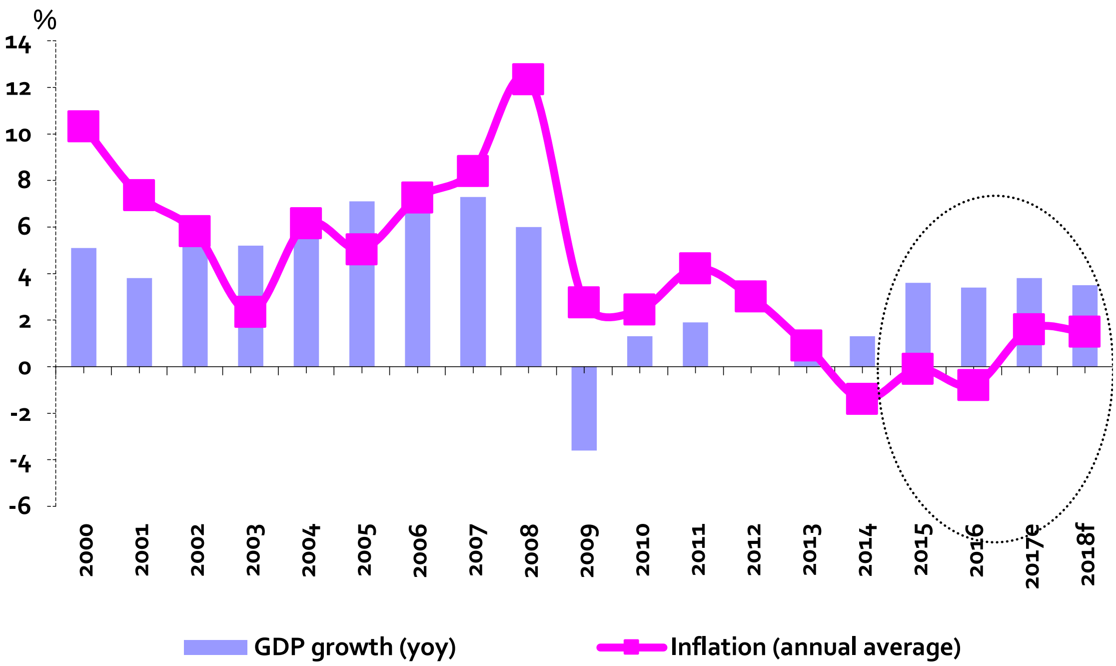
- Having expanded by around 3.8% YoY on average in the first three quarters of 2017, Bulgaria is now expected to register another year of strong-above potential-growth in 2018 (Figure 1). Private consumption dynamics are broadly set to remain strong as the economy benefits from an improving labor market, strong real wage growth, accelerating credit activity dynamics, a more expansionary fiscal policy stance next year, a vibrant export oriented manufacturing sector and an emerging tourism destination. On top, investments are expected to receive more support from improved EU-funds absorption.

- Nominal wages have been expanding at an average 7.4% YoY in 2014-2016 albeit from comparatively low levels. The labor productivity (measured by GDP/employed) lagged behind growing by 2.4% YoY on average in the same period. Real wages were growing even faster during the same period (on average by 8.9% YoY) because of deflation. Nominal wage growth has been outpacing labor productivity since 2012 (Figure 2). Wages in Bulgaria remain still the lowest in EU-28. So far, this has had a negligible negative impact on exports competitiveness. The export market share growth (of both goods and services, average five year) stood at 6.3% in 2016 down from 8.5% in 2010 (the relevant value has been always very positive with the exception of 2012) and above the EU Commission MIP monitoring threshold (-6%). The share of exports of G&S as a percentage of GDP stood at 63.5% (G:47.6% +S:15.8%) in 2016, broadly unchanged in 2013-2016 vs. 50.2% in 2010. Interestingly, the exports of goods in volume terms have been in positive territory in 2013-2016 (11.2%, 1.8%, 8.7%, and 2.6% respectively), while exports prices have been declining in the same period (-3.1% -3.2% -3.8% and-6.0% respectively).

- Finally, recent market talk has focused on the probability of Bulgaria's joining the Exchange Rate Mechanism 2 (ERM2) mechanism**.** The incoming government coalition has vowed to accelerate the application to ERM2 on top of the efforts by the caretaker government before the elections of late March 2017. Joining the ERM2 for a period of at least two years is a formal prerequisite for Euro area membership. Currently, Bulgaria fulfills most of the nominal convergence criteria for Euroarea entry.

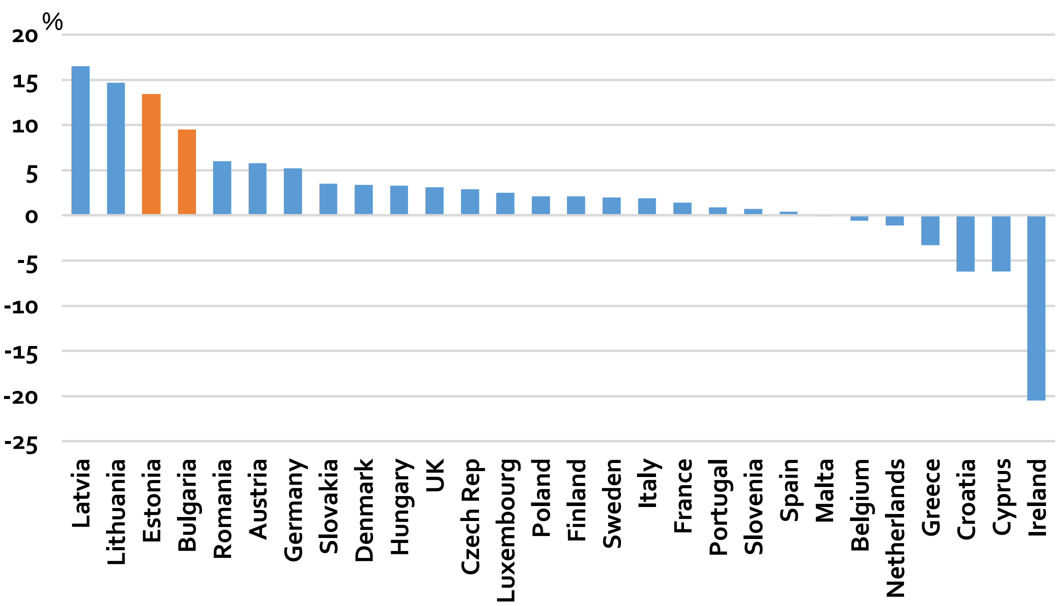
- On the other hand, real convergence criteria are not satisfied, although officially these are not part of the evaluation procedure. The living standards are the lowest in EU-28, productivity is equally the lowest in EU-28. The country is still subject to the Co-operation and Verification mechanism, which was set up in 2007 to monitor progress in the fields of judicial reform, corruption and organized crime. Even after accounting for the fast GDP growth trajectory in 2015-2018, GDP per capita in PPS terms will have only climbed to 50% by the end of 2018.

Figure 1: Growth dynamics are set to remain strong in 2017-2018



Source: Eurobank Research, Eurostat, National Authorities

Figure 2: Unit Labor Costs on the rise in 2014-2016 (3Y average, %)



Source: Eurobank Research, Eurostat

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