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FOCUS NOTES: BULGARIA

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Descent growth performance in turbulent times

- GDP growth remained flat at 0.5% yoy in Q2-2012 on robust private consumption dynamics and surprisingly resilient exports performance
- Inflation jumped to 3.9% yoy in August against only 1.6% yoy in June, the highest rate since 2007
- Credit growth inched up to 4.2% yoy in July driven by the recovery in corporate loans

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Output growth remained flat at 0.5% yoy in Q2-2012 driven by final consumption

The Bulgarian economy demonstrated signs of strength in the second quarter in an in an adverse EU-27 growth environment. On a yearly basis, real GDP grew by 0.5% yoy unchanged compared to Q1. On a quarter on quarter seasonally adjusted basis, GDP growth grew higher at 0.3% qoq, up from 0.0% qoq in Q1.

Final consumption, the largest component of GDP, further accelerated to +2.4% qoq/+3.2% yoy, compared to +0.4% qoq/+1.2% yoy in the prior quarter. As a result, the contribution of final consumption doubled to 2.4pps from 1.2pps in Q1. Final consumption received support primarily from positive real wages despite weak labor market conditions. Average annual inflation declined further to 1.6% yoy in Q2 down from 2.0% yoy in Q1 and 2.5% yoy in Q4-2011. At the same time nominal wages increased by 8.4% in Q2 vs. 8.9% in Q1 compared to 8.7% yoy in Q4-2011. Unemployment stood at 11.0% in Q2 marginally down from 11.4% in Q1 (the highest level in 2009-2011).

Investment activity was once again in red for a fourteen quarter in a row dragging down growth performance. Investment contracted by -2.1% yoy in Q2 against -5.4% yoy in Q1 vs. -10.4% yoy in the last quarter of 2011. However, the good news is that investment registered its lowest negative yoy performance so far boosted by higher EU funds absorption. That said, investment recorded its second positive qoq growth since Q4 2008 (+1.5% qoq in Q2 vs. +0.4% qoq in Q1 compared to -1.2% qoq in Q4), which creates hopes of bottoming out. Investments as a percentage of GDP have dropped to 23% in 2011 against a record high at 37% in 2008. The post-crisis drop in investments is largely explained by the decline of FDI inflows (from 9 bn. Euros in 2007 to 1.3bn Euros in 2011 and further to only 849mn Euros in Jan-July2012).

The positive news of the reading is the robust positive dynamics of exports. Exports expanded by 3.9% yoy in Q2 up from -0.1% yoy in Q1. Part of this strength is explained by the diversification of exports portfolio towards non-EU markets (exports to non-EU markets have climbed up to approximately 40% of total). On the other hand, imports expanded by 8.6% yoy in Q2 up from flat growth in Q1. Consequently, the negative contribution of net exports came at 3.2pps in Q1 up from 0.1pps in Q2 (Figure 1).

Overall, we still hold our GDP growth forecast to 1% in 2012 despite the sluggish performance (+0.5% yoy) in the 1H-2012. Better than expected agricultural output during the summer months and higher EU funds absorption is anticipated to make a difference in the second half of the year. However, downside risks to our forecast are significant and stem from the Euroarea sovereign crisis. Bulgaria is highly dependent on EU, not only in terms of trade and capital flows, but also through banking system interlinkages. In the worst case scenario, an external shock from a prolonged EU debt crisis or a disruption in capital flows could push Bulgaria again into deep recession.

Higher electricity and food prices pushed inflation sharply to 3.9% in August

Inflation rose sharply during the summer months. Consumer prices climbed from a multi month low of 1.6% yoy in June to 3.1% yoy in July and further to 3.9% yoy in August. Accordingly, the Harmonized Consumer Price Index (HICP) climbed from 1.6% yoy in July to 2.4% in July and further to 3.1% yoy in August. The main drivers behind the inflation rally were the spike in food and energy prices.

The spike mirrors the higher trend of food and fuels in the international markets. Food inflation, which still carries a 38.5% weight in the consumption basket, climbed to 4.0% yoy in August up from 2.4% yoy in July and 0.9% yoy in June. Fuels increased by 8.8% yoy in August from 3.7% yoy in July and 3.6% yoy in June. On top of that the hike in electricity prices by 13% yoy and gas prices by 4.9% yoy in July added another 1.8pps to inflation and is expected to maintain inflation relatively high until Q2-2012 (Figure 2).

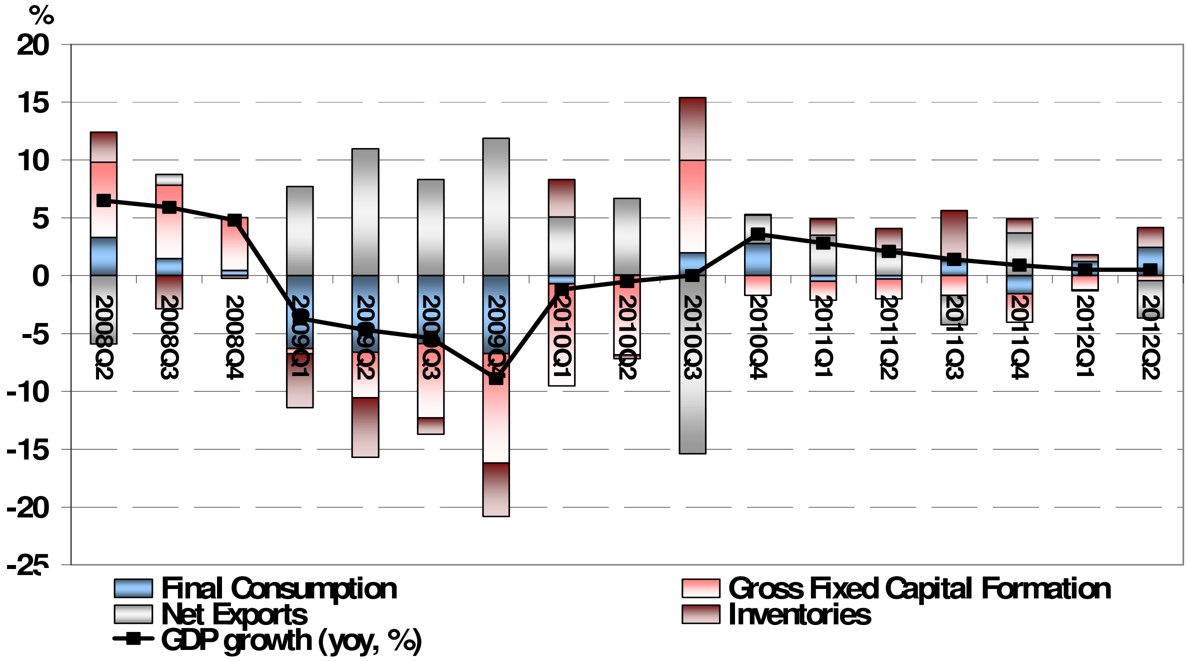
Although upside risks to inflation outlook are material, they still carry a low probability. Core inflation stayed at 0.2% yoy in August a clear indication that demand side pressures are non existent, an illustration of the supply side nature of the spike. In addition, the spike could be partially offset by the good performance of the domestic harvest.

Credit growth inched up to 4.2% yoy in August driven by the recovery in corporate loans

While the economy is recovering at a slow pace, credit growth remains relatively subdued. Overall, credit growth to the non-government sector stood at 4.2% yoy in August marginally higher than the same month of last year. Credit developments have been shaped by two opposing forces. On the one hand, deleveraging continued in the retail segment. Credit to consumers is broadly stagnating or edging within negative territory since November 2010. On a yearly basis, the contraction of credit to consumers deepened -1.2% yoy in August down from -0.6% yoy in December 2011. The consumer lending stock has dropped by 1.4% cumulatively since the end of 2010. On the other hand, stronger appetite for credit comes from the corporate sector, so that corporate credit remains the single driver of credit growth. Credit to corporates advanced further by 6.4% yoy in August up from 5.1% yoy in last January.

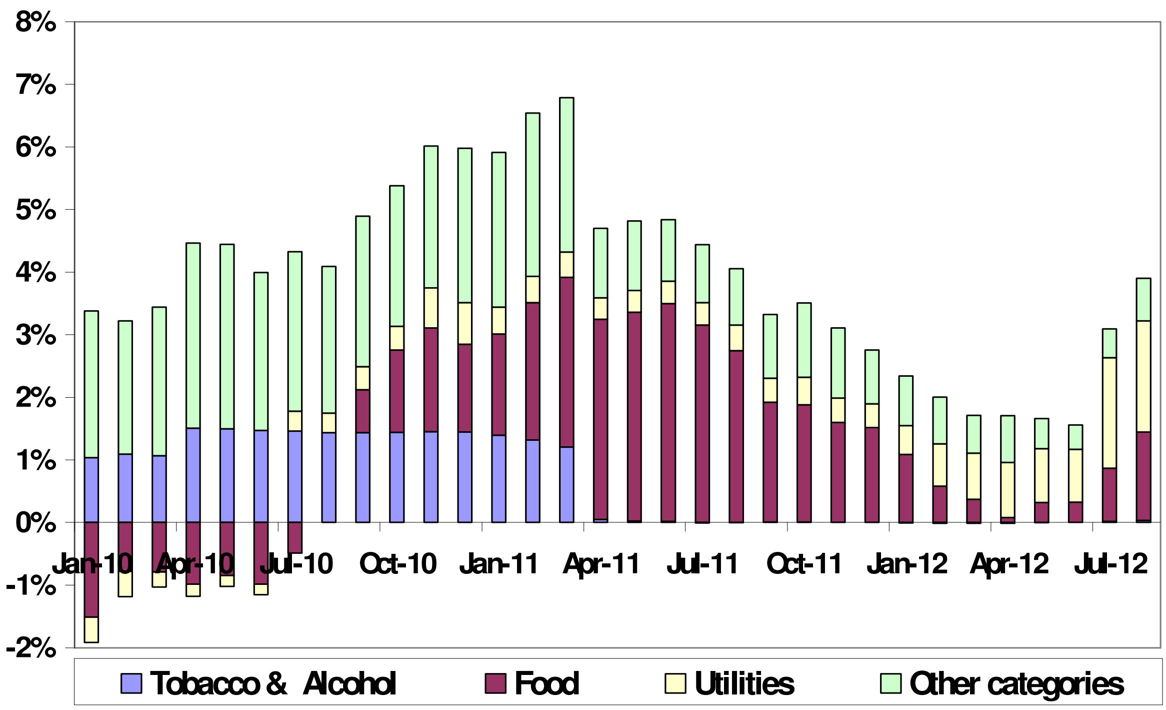
In contrast, robust deposit growth has increased liquidity thus diminishing external financing needs. Deposit growth remained at relatively high levels at 9.6% yoy in August down from 12.7% yoy in January. Deposits growth is largely driven by healthy local deposits growth (+16.4% yoy in August) as household's savings propensity remained high. Overall, the situation in the banking sector remains steady. Asset quality continued to deteriorate albeit at a slower pace. NPLs ratio climbed further to 16.9% in 1H-2012 against 14.9% in 2011. However the capital adequacy remains strong at 16.7% in 1H-2012 compared to 17.63% in 2011. Accordingly, the system's Loans to Deposits ratio stood at 100.7% much lower than the pre-crisis levels. Given its solid capital base and liquidity, the IMF mission conclusions praised the banking sector for its stability but at the same time pointed out that the low growth environment poses challenges in the areas of non- performing assets and strengthening the banking regulation.

Figure 1: GDP growth remained flat in Q2-2012 driven by robust private consumption contribution



Source: National Statistics, Eurobank Research

Figure 2: Inflation climbed to 3.9% in August driven by the sharp rise of food and utilities prices



Source: National Statistics, Eurobank Research

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