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Bulgaria: In search of sustainable growth

- GDP growth expanded by 0.9% in 2013 up from 0.6% in 2012 supported entirely by net exports
- The external position of the country continued to improve in 2013
- The risk of deflation casts shadows on the growth outlook improvement in 2014
- Structural reforms are urgently required to boost the medium term growth prospects
- Under the projected growth differentials with EU, full income convergence will be achieved in four decades

Net exports continued to support growth in 2013. Domestic demand failed to recover meaningfully for yet another year.

Full year growth inched up by 0.9% yoy in 2013, up from 0.6% yoy in 2012 entirely driven by net exports. Net exports contributed 1.7ppps in 2013 vs. a negative -2.6ppps in 2012. Helped by the recovery in the key trade partners, exports expanded by 8.9% yoy in 2013 compared to -0.4% yoy in 2012. On the other hand, imports accelerated to 5.7% yoy in 2013 vs. 3.3% yoy in 2012.

The bad news is that domestic demand failed to recover for yet another year in 2013. Investments contracted by -0.3% yoy in 2013 vs. +4.0% in 2012. Despite the improved performance in the 2H-2013, investments had a negative contribution of -0.1ppps in 2013 down from +0.8ppps in 2012. Private consumption remained in recession in 2013. Private consumption contracted by -1.8% yoy in 2013 after expanding by +3.2% yoy in 2012. The deterioration was partially offset by the rise in government consumption. Government consumption expanded by 2.9% yoy in 2013 up from +0.2% yoy in 2012. The latter translated into an increase of the government consumption contribution to +0.2ppps for the first time since 2006.

Overall, the output performance failed to impress in 2013. Domestic demand has kept growth at a slow speed in 2013. The rise in real incomes has not translated into a rise in consumption spending as this is portrayed in the national accounts. Households and corporates were more cautious in their spending and investment decisions driven by higher real rates and protracted political uncertainty. In contrast, growth was the combined result of the robust net exports performance, a bumpier agricultural period and the shift to more expansionary fiscal policies during the past year.

The external position of the country continued to improve in 2013

The current account surplus reached record highs in 2013. The current account surplus exceeded market expectations, reaching a record €751mn in 2013, compared to a deficit €333 mn in 2012. As a percentage of projected GDP, the current account surplus widened to 1.9% in 2013 up from a deficit of 0.8% of GDP in 2012 and a surplus of just 0.1% in 2011. The improvement in the current account in 2013 primarily reflects the decline in the trade and income deficits and the rise in current transfers.

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The surplus of services reached 5.3% of GDP in 2013 compared to 6.0% of GDP in 2012. Tourism revenue remained strong at 4.7% of GDP in 2013. In addition, the current transfers' surplus stepped up to 6.0% of GDP in 2013 up from 5.2% in 2012 on increased EU funds absorption. Meanwhile, the balance of income deteriorated in 2013, with the corresponding deficit widening to 3.5% of GDP compared to 3.3% in 2012. On the other hand, the trade deficit stabilized at relatively low levels, declining to 5.9% of GDP in 2013 from 8.7% in 2012 and 11.9% in 2009. Exports expanded by 7.0% yoy in 2013 vs. 2.5% yoy in 2012. Imports remained virtually unchanged at 1.4% yoy in 2013, down from 8.1% yoy in 2012.

From the financing side, the shift to hefty current account surpluses is partially outweighed by rising capital outflows. Bulgaria is running a financial account deficit after a hefty surplus in 2012. The financial account deficit reached 3.7% of GDP in 2013 compared to a surplus 3.7% of GDP in 2012. If the capital account surplus is included, the deficit is contained at 2.5% of GDP in 2013 vs. a hefty 5.0% surplus in 2012. Net FDI inflows remained relatively subdued in 2013 compared to their pre-crisis levels, amounting to only €1.09 bn compared to €1.07bn a year earlier (up by 2.0% yoy). More importantly, the financial account deficit has been driven by the negative balance of other and portfolio investments, which reached a cumulative deficit of €2.3bn in 2013 vs. a 0.7bn surplus in 2012. Overall, if net errors and omissions are included, the balance of payments recorded a small deficit of €599mn in 2013 vs. a €2.161mn surplus in 2012. The latter explains only some of the decrease in FX reserves over that period, which if the reevaluation of other assets is included then the drop in total reserves reached 1.2bn in 2013. Overall, international reserves (FX reserves plus gold and IMF drawing rights) remain at relatively high levels (€14.4 bn or 33.2% of GDP in 2013 vs. €15.5bn in 2012), enough to cover the country's external financing needs. International reserves coverage of short term debt remained almost unchanged to 148.7% in 2013 vs. 148.9% in 2012.

The risk of deflation casts shadows on the growth outlook improvement in 2014

Looking ahead, growth is anticipated to accelerate to 1.6% in 2014. The painful rebalancing from net exports to domestic demand as the principal growth driver continues slowly. Our forecast is in line with consensus, as we are not yet convinced that domestic demand will catch up and contribute to growth as meaningfully as anticipated.

Improved EU funds absorption can help investments to some extent as legacies of the pre-crisis period still weigh negatively in the construction and real estate sectors. On the positive side, the external environment will most probably remain supportive for Bulgarian exports in 2014. The main trade partner, the Euroarea has started recovering from recession. In turn, this means that

there is room for net exports to extend their gains in 2014 as well.

Yet the evidence for the outlook of private consumption from surveys is mixed. The improvement recorded in consumer and business sentiment recently provides some room for optimism, but overall is still slow and fragile and thus reversible. Households and corporates have become more confident on their financial situation and their economic prospects ahead but

Bulgaria: Eurobank Research Forecasts				
	2011	2012	2013	2014f
Real GDP (yoy%)	1.8	0.6	0.9	1.6
Final Consumption	1.5	2.9	-1.4	0.7
Gross Capital Formation (Fixed)	-6.5	4.0	-0.3	2.5
Exports	12.3	-0.4	8.9	6.5
Imports	8.8	3.3	5.7	5.0
Inflation (yoy%)				
CPI (annual average)	4.2	3.0	0.9	-0.4
CPI (end of period)	2.8	4.2	-1.6	1.0
Fiscal Accounts (%GDP) - Cash Basis				
General Government Balance	-2.0	-0.5	-1.9	-2.0
Gross Public Debt	17.0	18.8	19.1	22.1
Primary Balance	-1.3	0.3	-1.0	-1.2
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	1.0
Net FDI (EUR bn)	1.3	1.1	1.1	1.2
FDI / Current Account (%)	Na	284.3	Na	Na
FX Reserves (EUR bn)	13.3	15.6	14.4	14.5
Domestic Credit	2010	2011	2012	2013
Total Credit (%GDP)	76.4	74.4	74.1	74.4
Credit to Enterprises (%GDP)	48.2	47.9	48.9	49.0
Credit to Households (%GDP)	26.4	24.6	23.6	23.7
FX Credit/Total Credit (%)	61.3	63.7	64.0	60.9
Private Sector Credit (yoy)	2.1	3.9	3.8	0.6
Loans to Deposits (%)	112.9	104.0	99.4	92.1
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

at the same time their willingness to increase their spending on big ticket items has not changed dramatically. The evidence from retail sales is a bit more encouraging. Retail sales expanded by 2.6% yoy in 2013, for the first time since 2008.

In addition, unemployment remains very high, which makes economic recovery prospects even more fragile. Bulgaria suffered disproportionately heavier losses in the labor market during the international crisis. Four years after, unemployment is still on an increasing trend. The unemployment rate (LFS survey) climbed even further to 12.9% in 2013 vs. 12.3% in 2012 and 11.3% in 2011. Although there is a sizeable structural component in unemployment and the labor force has increased, gains in employment have not been able to contribute to a decline in the unemployment rate in the last couple of years. Gains in employment on a year on year basis came also to a halt in the last quarter of 2013, which is illustrative of the difficulty of the economy to create new job opportunities.

Tight credit conditions don't help either in a domestic demand

rebound. Even though funding conditions have improved over the past years, lending to the private sector remains stagnant. Lending to households remains negative (-0.2% yoy in 2013 vs. -1.0% yoy in 2012) and lending to corporates almost zero (0.1% yoy in 2013 vs. 5.0% yoy in 2012). At the same time, the rise in incomes has translated in an increase of bank deposits instead of spending. The annual average growth in total deposits stood at 9.5% yoy in 2010-2013. Household deposits climbed to BGN 39.8bn up by 10.7% yoy in 2013 only.

Deflation is the number one risk to our forecast. Although we have not subscribed to it as our main scenario, deflation in principle has a negative impact on private consumption and investments. In the case where a self-fulfilling downward spiral deflation prevails, both consumers and corporates postpone their consumption decisions today in anticipation of lower prices in the future.

Deflation so far has emerged as the result of one-off factors such as the government decisions on the electricity prices and the bumper agricultural season impact on food prices. Inflation has retreated into negative territory since August 2013. Inflation came at -2.3% yoy in February 2014 down from -0.7% yoy in August 2013. On the other hand, it would be fair to say that the number of items in the consumer basket which are in negative territory has increased markedly over the past year. Price dynamics for other consumer basket categories (e.g. restaurants & hotels or education) are subdued. On a more worrying note, inflation expectations (depicted in the consumer survey of NSI) have been on a free fall. The balance of answers in the question "Expectations about inflation over the next 12 months" have landed to a multi-year low in Q1-2014. In any case, deflation is expected to prevail in the 1H-2014 and subdued inflation in the 2H-2014 so that the average annual inflation will be slightly negative in 2014 unless another price shock occurs in the 2H (e.g. a spike in imported food prices from the Ukraine crisis).

Ongoing political uncertainty weighs negatively on the country's outlook. Key structural reforms will be required to boost the medium growth potential of the country in the years to come.

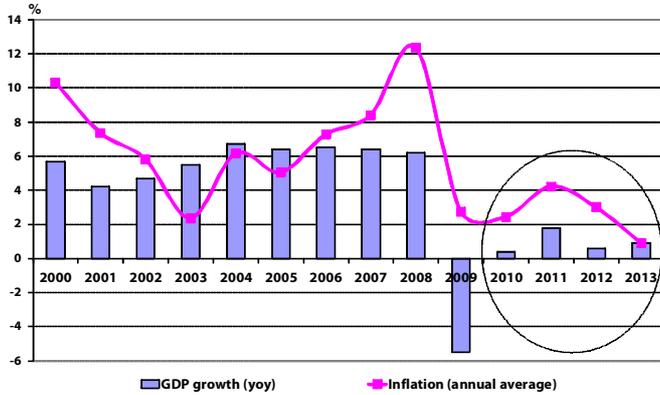
Overall, growth in Bulgaria has been lackluster in the aftermath of the international crisis in 2008-2009. Bulgaria capitalized on its strong fiscal position and buffers to avoid a deep prolonged recession, but recovery ever since has been extremely slow. Even after the revision of last year's data, the average GDP growth stood at 0.9% in 2010-2013, a low gear rebound from the -5.5% output contraction recorded in 2009 and significantly lower than the 6.5% recorded in 2004-2007. More importantly, GDP per capita in PPS terms is still the lowest in EU (47% of EU-28 average in 2012). In essence, Bulgaria is trapped in a low growth path. According to the latest IMF consultation, even with a sustained growth differential of 2 percentage points (which is based on a 3% GDP forecast for Bulgaria vs. 2% for EU) full income convergence would still take four decades to be achieved.

Without deeper structural reforms growth prospects will most probably going to be subdued and below its peers in the period ahead unless total factor productivity improves dramatically. The Bulgarian economy is constrained by capital and labor from a production function point of view. Capital flows are not going to reach their pre-crisis levels any soon while domestic savings need to increase further to be able to support domestic financing. At the same time, labor supply is constrained by the aging of population and the emigration abroad. Accelerating structural reforms could be a catalyst for boosting growth both in the short and medium term and raise living standards. From a growth diagnostics perspective, the emphasis ought to turn on improving institutional quality. Bulgaria scores very low in EU-28 in a number of related areas such as enforcing contracts, resolving insolvencies, and some areas of red tape. According to the latest World Bank doing business report, Bulgaria's ranking deteriorated in the aforementioned areas.

More generally, the judicial system is viewed in surveys as problematic, while corruption and cronyism is identified as a key constraint. An illustration of the findings above can be found both in the latest assessment of European Commission and the latest IMF consultation report published in last January and February respectively. The European Commission issued its annual progress report on judicial reform and the fight against organized crime in Bulgaria (under the so-called co-operation and verification mechanism). Despite some improvement, the report finds that progress in the combat against corruption and organized crime are insufficient and fragile. Bulgaria has made limited progress in that area seven years since EU entry. On the positive side, there is some progress in the area of EU funds absorption and management, an area where most problems noted in the previous years' progress reports. The EU funds absorption rate jumped from 10% in 2010 to 27% in 2012 and further to 50% in 2013.

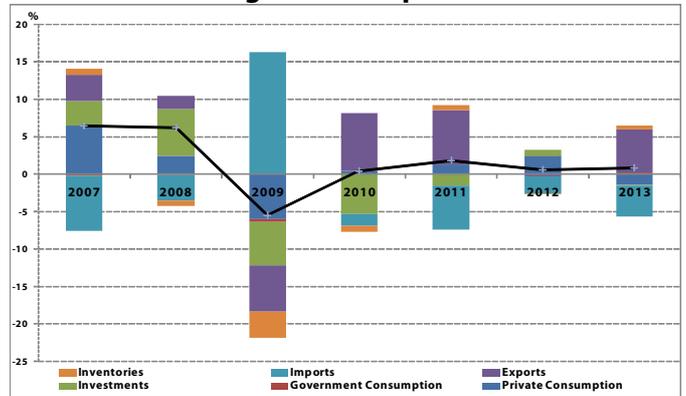
The prolonged political uncertainty has had a negative impact on the implementation structural reforms. Under the current political situation, the odds are not in favor of accelerating reforms. In fact the current government coalition has made steps back in certain areas increasing the future fiscal cost. A concrete example is the adoption of the Swiss rule in the pension system which deteriorated its sustainability. To make things worse, political uncertainty weighs also negatively on the country's outlook. In the past December, Standard and Poor's revised Bulgaria's outlook to negative indicating that there is at least a one-in-three possibility that the ratings on Bulgaria could be lowered within the next two years, if the political environment deteriorates, weighing on already-weak growth prospects. At the same time, the rating agency affirmed the current long-term foreign currency sovereign rating at BBB, which is investment grade. The strong track record of fiscal prudence, the relatively low deficit and debt stock is acknowledged by rating agencies so that Bulgaria never lost its investment grade status in the post Lehman period.

Figure 1
GDP & Inflation growth rates



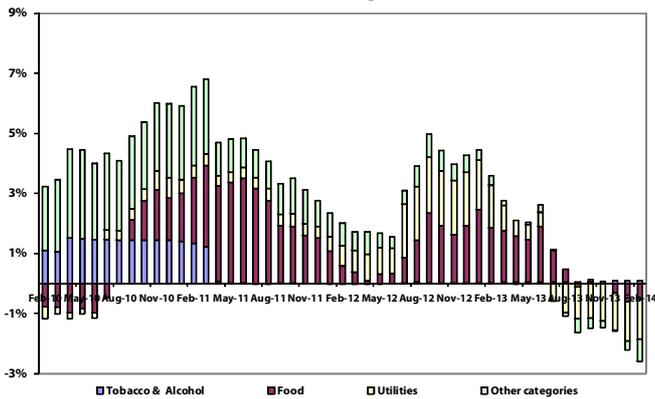
Source: National Statistics, Eurobank Research

Figure 2
GDP growth components



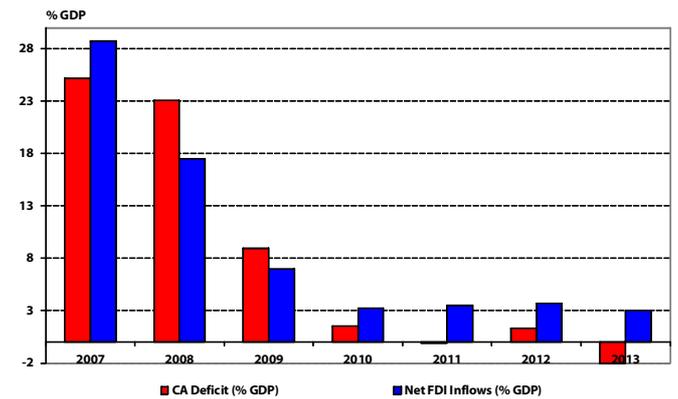
Source: National Statistics, Eurobank Research

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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