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FOCUS NOTES: BULGARIA

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Headwinds to the domestic growth outlook

- **Bulgarian economy recorded flat quarter on quarter growth in Q3 after six quarters of positive growth.**
- **The deterioration in the economic sentiment worldwide is particularly worrying and puts the growth recovery of the Bulgarian economy at risk**

After recording six quarters of positive growth rates -since Q1 2010- the economy stagnated in the third quarter. On a quarter on quarter seasonally adjusted basis, GDP growth was flat in the third quarter, down from 0.3% qoq in the second and 0.5% qoq in the first. On a yoy basis, real GDP grew by 1.3%, down from 2.0% yoy in the second quarter and 3.3% yoy in the first quarter. This is the lowest rate in a year and compares unfavorably to the EU-27 average (+0.2% qoq/+1.4% yoy) in Q3.

From a sectorial point of view, agriculture contracted by 0.9% qoq /-0.1% yoy in the third quarter compared to 0% qoq/-2.5% yoy in the second quarter. The industrial sector expanded on a yoy basis, although its gross value added slowed to+4.1% (-1.4% qoq), from +6.5% yoy (+2.4% qoq) in the prior quarter. The services sector accelerated to +2.9% qoq/+1.9% yoy, from +3.5% qoq/-0.3% yoy in the prior quarter.

From the demand side, private consumption, the largest component of GDP, accelerated to +0.4% qoq/+1.7% yoy, compared to +0.5% qoq/+1.4% yoy in the prior quarter. After two positive quarters, investment contracted by -13.7% qoq/-3.1% yoy in the third quarter vs. +3.0% qoq/+8.4% yoy in the second. Exports demonstrated signs of weakness on a quarterly basis, expanding by +1.4% qoq/+1.7% yoy in Q3 compared to -1.3% qoq/+12.2% yoy in Q2. On a similar trend, imports inched down to +0.8% qoq/+7.5% yoy in Q2 against +0.1% qoq/+10% yoy.

Net exports' contribution turned negative in the third quarter. The GDP reading is not supportive of our FY 2011 forecast

Unless there is some major revision in the detailed GDP data to be released in December, the third quarter GDP flash estimate is not supportive of our FY 2011 forecast (currently at 2.5%). After a very strong start in the year (+3.4% yoy in Q1), the economy slowed in the second (+2% yoy in Q2). The third quarter reading brings the overall performance at 2.2% in the nine month period. The government has revised down its official forecast in the budget to 2.8% in 2011, compared to 3.6% in the spring.

First of all, agriculture did not prevent a growth slowdown in Q3. In contrast to other New Europe peers, agriculture recorded a negative annual year on year reading despite expectations and signs of a very good harvest. Without any doubt this is hard to explain. Moreover, the excellent tourist season (the surplus of the travel services in the current account has reached 3% of GDP in Jan-Sep 2011) was not entirely reflected in the GDP numbers. Broadly speaking, the positive news from services is not strong enough to make the picture brighter.

To make things worse, the output boost from the industrial sector is fading away. The decelerating output trend is most likely related to the deterioration of economic sentiment worldwide during last summer. More specifically, the rapid deterioration of economic conditions in the major export EU markets had a more pronounced impact on the external sector performance. For that reason, net exports had a negative contribution in the third quarter (-1.1 pps) for the first time since the second quarter of 2008. In addition, investment is still dragging down economic activity despite increased EU funds absorption. In particular, a big component of investments, construction, has not yet emerged from recession after the collapse of the real estate market in 2008 (output contracted by -8.3% yoy in August vs. -14.2% yoy in July).

Last but not least, it is important to note that total consumption held up well in Q3. The contribution of total consumption was positive for a fourth quarter in a row. In fact, the contribution of total consumption accelerated to 1.4pps in the third quarter against 1.1pps in the previous quarter. There is a two fold explanation for that. First of all, private consumption received support from positive real wages as inflation has been rapidly decelerating. In addition, declining food and energy prices- the biggest spending items of their budgets- allowed households to take a breath, which may prove ephemeral. At the same time public consumption stopped ha no negative contribution to growth in Q3.

Looking ahead, the picture from high-frequency indicators is not particularly promising. The downside risks of external environment uncertainties have started feeding in the survey and real data. Firms and consumers are either showing or expressing plans for further retrenchment, which most likely points to a weaker growth reading in the last quarter:

o **Exports**: In principle, exports have held up well that far (up by 32% yoy in Jan-Sep 2011) yet they showed signs of deceleration on a quarterly basis in Q3. Part of this strength is explained by the diversification of Bulgarian exports towards non-EU markets. Exports to non-EU markets expand more rapidly and now represent approximately 40% of total portfolio.

- **Industrial sales**: The industrial sector turnover was supported by robust exports. Industrial sales have slowed down to 13.9% yoy in August vs. 14.8% yoy in July and 32.8% yoy in Q1.
- **New manufacturing orders**: Manufacturing new orders were flat on a month on month basis in September (0.2% qoq vs. -2.3% qoq in EU-27), up from -3.9% qoq in August. Yet, on a yoy basis they rose by 14% in September (+2.3% yoy in EU-27), down from +15.9% yoy in August (+6% yoy in EU-27) and 20% yoy (+8.4% yoy in EU-27) in June.
- **Industrial production**: Accordingly, industrial production readings in the last months have been on a decelerating trend too. Industrial production came at +2.4% qoq/+1.6% yoy in September, compared to 0% qoq /+9.1% yoy in last May.
- **Consumer-Business Surveys**: Both consumer and business surveys deteriorated in November. The composite business sentiment indicator fell by 2.1pps in a month. All areas (industry, construction and services sectors) showed deterioration of expectations.
- **Retail sales**: The contraction of retail sales volume (Eurostat data) worsened to -2.9%? in August up from -2.8% in July and -0.8% in June.
- **Labor market**: After a short seasonal improvement in the summer, unemployment inched up again (registered unemployment higher by 0.2% to 9.6% in September). It has been a jobless recovery that far.
- **Credit growth:** Growth in household credit was still negligible-almost zero (0.2% year to September), while total credit was still stagnating (3.2% year to September).

Threats to growth outlook on the rise- Softening growth outlook in 2012

Overall, the deterioration in the economic sentiment worldwide is particularly worrying and puts the recovery of the Bulgarian economy at risk. The recovery in 2010-2011 from the deep recession of 2009 was driven by net exports and industry. The openness of the Bulgarian economy (exports plus imports accounted for 110% of GDP in 2008) and the quick absorption of earlier macroeconomic imbalances (current account deficit dwindled from double digits in 2 years) allowed it to return to positive growth rates more quickly. At the same time, consumer spending has only stabilized but was never expected to be the main growth driver in the post-Lehman period in any case.

At the current juncture, uncertainties are very high and risks are heavily skewed to the downside. A number of international organizations have also downgraded their forecasts for 2012. EU Commission and EBRD forecasts stand at 2.3% (autumn forecasts) and IMF earlier forecast stands at 2.5% (WEO September). At the moment, the government assumption in the budget stands higher at 2.9% for

2012, but the Ministry of Finance has expressed its intention of lowering it. Although this is not our main scenario, the Bulgarian economy has started flirting with a recession again, at least from a technical point of view (two consecutive quarters with a negative quarter) in 2012.

While the emerging global slowdown does not bode well, the Euroarea sovereign crisis is the most imminent threat to Bulgaria. 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 in deep recession. On the positive side, Bulgaria has developed strong buffers that allow us to be more optimistic:

Currency Board Arrangement remains solid:
- Large International Reserves (FX reserves+ Gold+ IMF reserve position) at €13.2 bn in October 2011 (33.4% of GDP), enough to cover potential financing needs from future external liabilities
- The coverage of domestic monetary base by reserves still high -at183.3% October 2011

Banking sector in relatively good shape:
- Profitable and well capitalized (Capital to assets ratio at **10.6%,** Tier 1 at **15.4%** in March 2011)
- Diversified Foreign Ownership of banking sector (a crucial difference relative to Baltics, where there is an overwhelming presence of two Swedish banks)

Strong fiscal position and solid fiscal performance vs. EU & New Europe peers:
- The gross public debt to GDP ratio is the second lowest in EU27 (17.5% in 2011).
- The general government deficit stood below the 3% Maastricht threshold (FY 2011: 2.5%-of-GDP, way below that of the EU27-4.7%)

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