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FOCUS NOTES: BULGARIA

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Bulgaria: Softer than expected GDP growth in the second quarter

- GDP growth slowed at 2.0% yoy in the second quarter compared to 3.3% yoy in the first quarter
- Net exports were again the component with the largest contribution to GDP growth in the second quarter; Domestic demand has gained more pace as private consumption stabilized further and investments rebound
- Headwinds in the international macroeconomic environment have prompted us to put our earlier GDP forecast under review

GDP growth decelerated to 2% yoy in the second quarter compared to 3.3% in the first, yet it remained above the EU-27 average for a second consecutive quarter

After a very dynamic start in the first quarter, growth slowed in the second quarter. Real GDP growth came in at 2.0% yoy, from 1.9% yoy originally in the flash estimate, down from 3.3% in the first quarter. On a quarter-on-quarter seasonally adjusted basis, real GDP slowed down to 0.3% in Q2:2011, from 0.5% qoq in Q1:2011. From a sectoral standpoint, agriculture and construction still recorded annual negative growth in Q2. However, the pace of contraction slowed down sharply for both of them compared to their first quarter performance. Agriculture contracted by 0% qoq/ -2.5% yoy in Q2 vs. -3.8% qoq/-1.4% yoy in Q1. Construction was still in red, contracting by +4.4% qoq/-0.4% yoy in Q2 compared to -24.9% qoq/-13.7% yoy in Q1. On the other hand, the industrial sector expanded on a yoy basis, although its gross value added slowed to +1.4% qoq/+7.7% yoy, from 1.5% qoq/+11.6% yoy in the prior quarter. Moreover, services were still in positive territory yet they slowed down to -1.2% qoq/+1.3% yoy, from 1.7% qoq/+3.6% yoy in the prior quarter. However, the picture within individual categories of services is diverse.

Wholesale and retail trade was in red, contracting by -3.5% qoq/-2.7% yoy in Q2 for the first time since Q1:2010 due to the high base effect (+28.2% yoy in Q2:2010). Two of the key services sectors-financial services (+3.3% qoq/-0.1% yoy vs. -4.7% qoq/-2.7% yoy) and real estate services (+4.5% qoq/+1.8% yoy vs. -0.5% qoq/-7.9% yoy) improved compared to the first quarter.

On the demand side, the preliminary signs of a mild recovery in private consumption we discussed in our previous issue of New Europe Economics & Strategy are becoming more visible. Private consumption expanded by +0.5% qoq/1.4% yoy in Q2 compared to 0.3%qoq/+1.5% yoy. . In addition, public consumption, a drag on economic activity until now, had a less negative contribution to GDP growth in the second quarter. Public consumption contracted by +0.5% qoq/-1.3% yoy against +0.3% qoq/-4.3% yoy in the first quarter. The positive surprise came from the investments side, which finally exited recession after 7 quarters of negative readings. Gross fixed capital formation registered a positive reading for a second consecutive quarter after the upward revision of Q1 figures. Gross fixed capital formation accelerated to +3.0% qoq/+8.4% yoy in Q2 compared to 0.8% qoq/+1.6% yoy in Q1. However, inventories had another quarter of negative contribution. As a result, gross capital formation still contracted by 5.1% yoy compared to -12.3% yoy in the prior quarter. On the negative side, net exports showed less strength in the second quarter. Exports showed some signs of slowing down on a quarterly basis, expanding by -1.3% qoq/+12.2% yoy in Q2 compared to +5.6% qoq/+21.6% yoy in Q1. On a similar trend, imports inched down to +0.8% qoq/+7.5% yoy in Q2 vs. +0.1% qoq/+10% yoy.

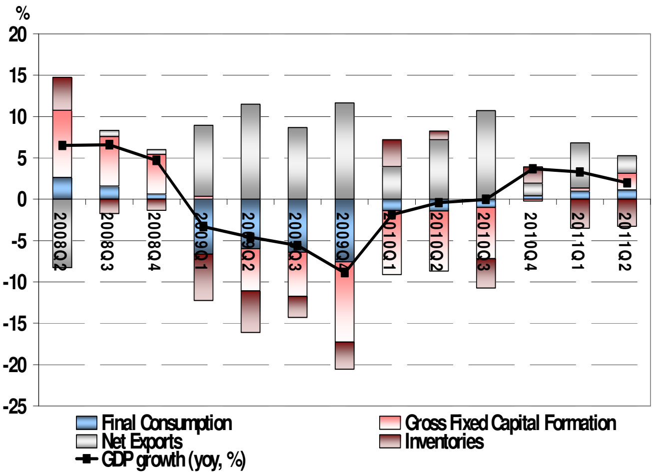
Net exports were again the component with the largest contribution to GDP growth in the second quarter; Domestic demand is gaining more pace as private consumption stabilized further and investments rebound

From a decomposition point of view, net exports were again the driver of growth in the second quarter. However, the contribution of net exports to GDP growth in the second quarter was half than that in the first. Net exports contributed 2.1pps to the GDP growth rate in Q2 down from 5.4pps in Q1. As we had pointed in our previous issue of New Europe Economics & Strategy, the contribution of net exports is expected to remain positive throughout 2011, yet its boost is expected to start fading away gradually, because a slowdown in exports is expected to come into play in the 2H on deteriorating sentiment in the main EU market.

Our second observation focuses on the role of domestic demand. It is important to note that domestic demand gained pace in the second quarter. Private consumption registered positive performance for another quarter-for a third consecutive quarter. Its contribution to growth has remained almost unchanged at 1.1pps, which in turn increases the relative share in the lower growth rate. We anticipate that private consumption, having bottomed out in Q3 2010, will continue to grow mildly in the 2H. There are some reasons to be optimistic about that: the increase of the minimum wage by 12.5% since early June.

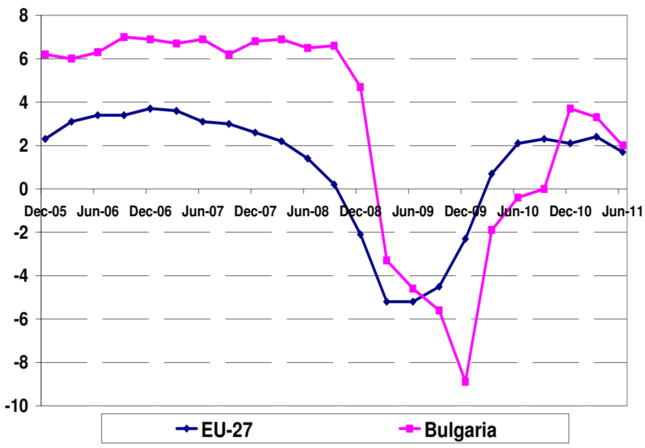
More importantly, investments have made also a dynamic comeback in Q2. Investments are going to receive support from the improvement in the EU funds absorption and the government's privatization program. The government targets EU funds absorption, mainly headed towards infrastructure projects, to reach 20% by the end of 2011. The privatization program is also anticipated to attract more investments. Privatizations have already kicked off with the sale of the tobacco state owned company "Bulgartabac Holding". Some other privatization projects are already on the pipeline and are expected to be completed until the end of the year (e.g. electricity distribution companies).

Figure1: The contribution of net exports to GDP growth in the second quarter was half than in the first



Source: National Statistics, Eurobank Research

Figure2: GDP growth in Q2-2011 was stronger than EU-27 average for a third consecutive quarter



Source: National Statistics, Eurobank Research

All in, our impression from the second quarter data is mixed. The good news is that the Bulgarian economy continues recovering, even at a slower pace, but still growing above the EU-27 average for a third consecutive quarter. Moreover, private consumption has stabilized further while investments are no longer a drag on economic activity. Looking ahead, we anticipate growth to hold up relatively well in the third quarter:

- A number of traditional industries (tourism, agriculture and mining) with a meaningful share in the local economy have performed very well in Q3. Overall, according to the latest estimates, income from tourism is expected to rise by 4.5% and the number of tourists is expected to grow by 14% in 2011.
- Business confidence is maintained at high levels: The business confidence index has improved by 1.2 points mom. On the positive side, those industries related to domestic demand-retail trade-are more optimistic than before.
- Exports were still expanding at 37.2% yoy in Jan-July 2011. However, industrial production and industrial sales have been on a slowing down trend recently. Industrial sales have slowed down to 14.8% yoy in July compared to 32.8% yoy in Q1. Industrial production slowed down to 6.5% yoy in Q2 compared to 10.9% yoy in Q1.

On the other hand, headwinds in the both the domestic and international macroeconomic environments have increased. Signs of a slowdown in external demand have shown up worldwide both in advanced and emerging economies as growth is losing steam in US and EU. On top of that, financial markets have come under stress worldwide over fiscal and debt sustainability concerns. At the current juncture, uncertainties are very high and risks are heavily skewed to the downside. Bulgaria has escaped unscathed from unfavorable financial market spillovers from the deepening Euroarea sovereign crisis. In fact, Bulgaria was among those few countries whore sovereign rating was upgraded by Moody's. At best, a slowdown in the Euroarea is likely to put a lid on the strength of Bulgarian exports. In conclusion, the deterioration in the economic environment during the third quarter has led us to put our earlier GDP forecasts (3.2% since our trip to Sofia last March) under revision.

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