

## Bulgaria's primary challenge lies with its pace of economic recovery

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Prepared for the meeting of the EU Club to the Bulgarian Chamber of Commerce and Industry

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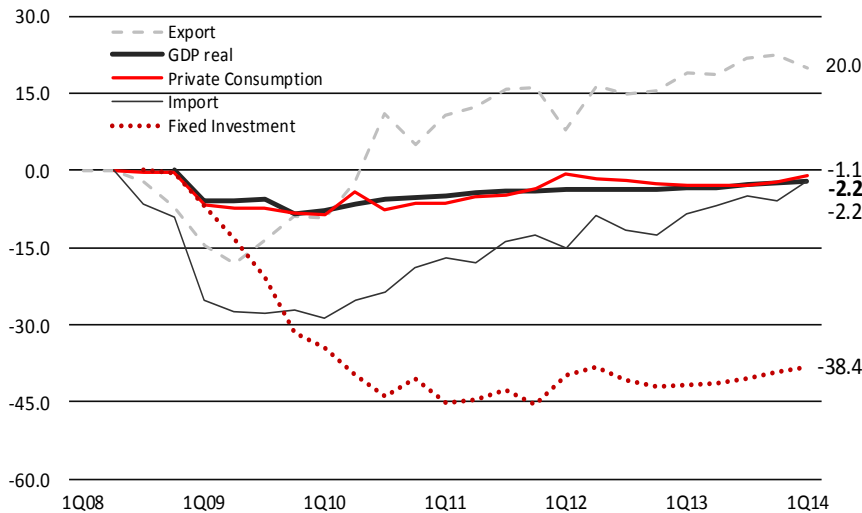
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Sofia, 01 July 2014

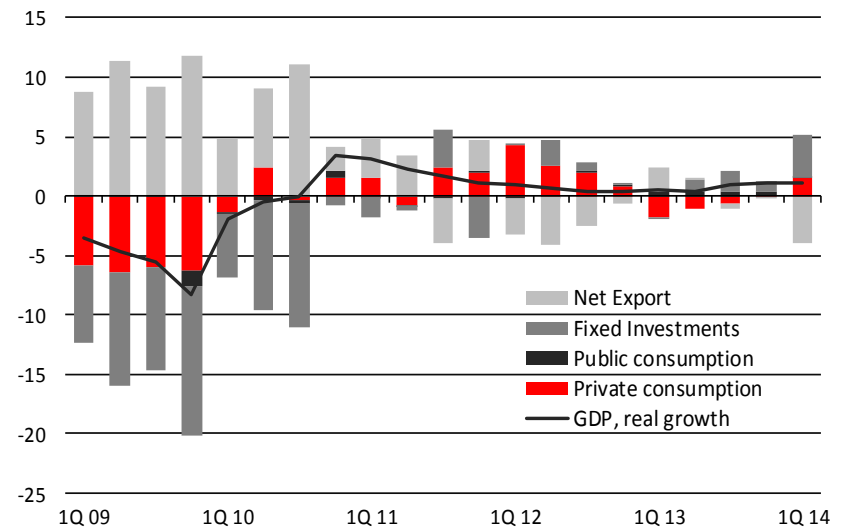
# The longest period of sub-par growth in the modern history of the country is not over

- ❖ The shift toward less restrictive fiscal policy was a good news, but failure on the structural reforms front and especially in the energy sector, on top of political instability and EU funds freezing were clear negatives
- ❖ Abnormally subdued inflation and persistently high unemployment indicate that policy is too tight and the risk of too slow domestic demand recovery remains largely neglected
- ❖ To kick-start the economy, policy makers should consider a more active role for fiscal policy, including not only more investments in infrastructure, but also in health care and education, which are crucial to boost the quality of the labor force

Real GDP growth by components since the start of the downturn, in % swda (1Q 2008 – 1Q 2014)



GDP growth and contribution to growth, yoy in % swda (1Q 2009 – 1Q 2014)



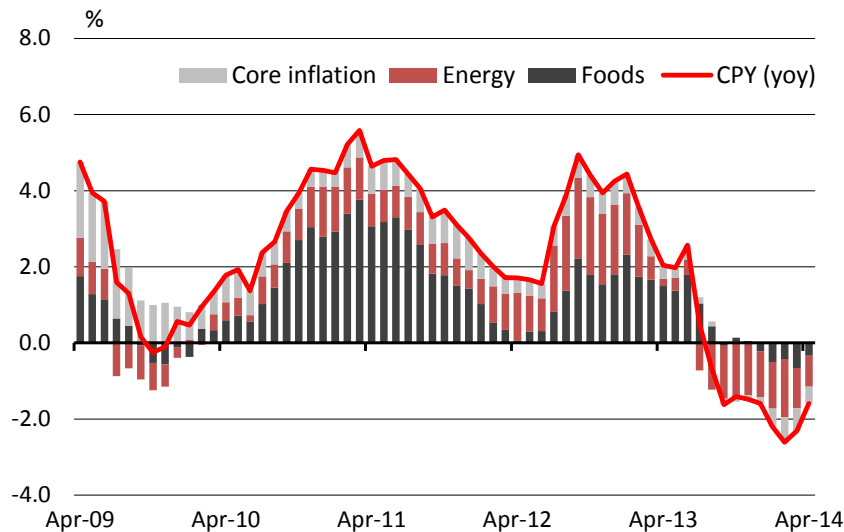
Source: NSI, UniCredit Bulbank Economic Research

Note: Weaker export in 1Q14 seems mostly driven by one-off factors of technical nature, including terms of trade losses and reduced export of petroleum products, as some of the production facilities of the oil refinery in Burgas are closed for planned renovation activities

# We are not particularly worried that Bulgaria will plunge into a classic self-perpetuating deflationary spiral

- Recent CPI numbers provided evidence that the anticipated normalization in the inflation dynamic has started to materialize
- Deflation is prompted by: 1) considerable slack in the economy and; 2) the pronounced impact of one-off factors, such as the cutbacks in heating and electricity prices and externally-driven fall in food and energy costs
- But while current deflationary pressure is more of a transitory phenomenon, low inflation is something that is going to stay with us for an extended period of time

Contribution to CPI dynamics by components, in % (Apr'2009 – Apr'2014)



Inflation (CPI) by CEE countries, yoy, in % (2012 – 2015f)

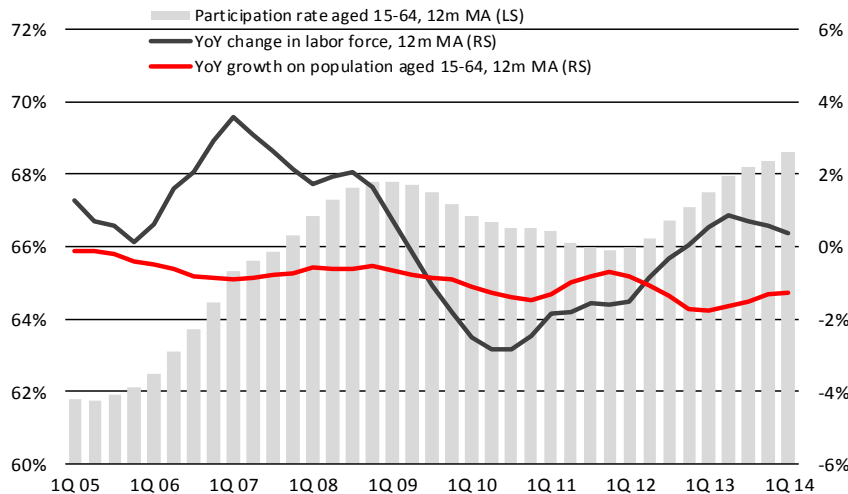
	2012		2013		2014f		2015f	
	avg.	eop	avg.	eop	avg.	eop	avg.	eop
<b>Bulgaria</b>	<b>3.0</b>	<b>4.2</b>	<b>0.9</b>	<b>-1.6</b>	<b>-0.8</b>	<b>0.7</b>	<b>1.4</b>	<b>1.5</b>
Croatia	3.4	4.7	2.2	0.3	0.5	1.8	1.6	1.2
Czech Republic	3.3	2.4	1.4	1.4	0.8	1.6	2.2	2.1
Hungary	5.7	5.0	1.6	0.4	0.5	2.0	3.0	3.6
Poland	3.7	2.4	0.9	0.7	0.4	0.8	2.2	2.1
Romania	3.3	5.0	4.0	1.6	1.7	3.0	3.3	3.3
Slovakia	3.6	3.2	1.4	0.4	0.2	1.0	1.8	2.0
Turkey	8.9	6.2	7.5	7.4	8.3	8.1	5.8	6.4
Russia	5.1	6.6	6.8	6.5	7.3	7.2	5.6	4.9
Ukraine	0.6	-0.2	-0.3	0.5	11.2	17.3	10.8	6.4

Source: Eurostat, NSI, UniCredit Research

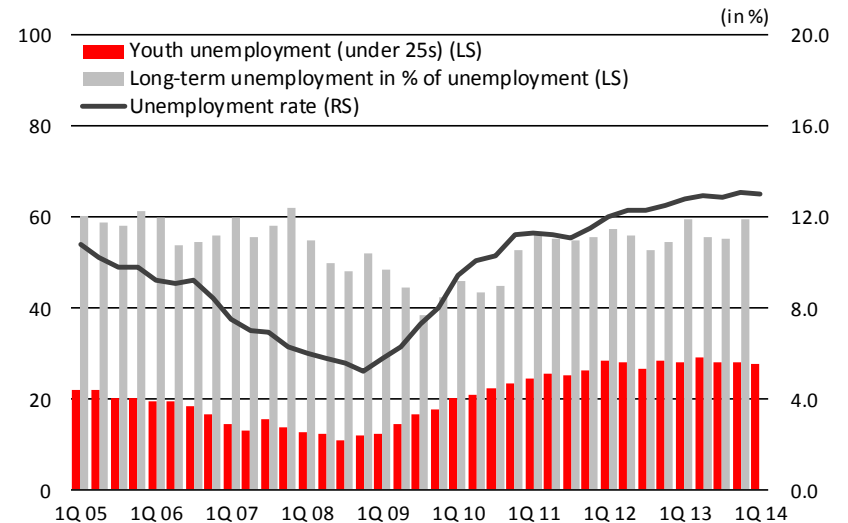
# Labor market pain has eased recently, but adjustment is not over

- ❌ The worst in terms of jobs shedding is over and, albeit only very slowly, a job recovery will take hold from here
- ❌ Labor market recovery is in its early stages and both youth (27.8%) and long-term unemployment (59.5%) still remain dangerously elevated
- ❌ All forecasts indicate that bringing unemployment rates down to levels consistent with full employment would need many years to materialize

**Participation rate, labor force and population dynamics (1Q 2005 – 1Q 2014)**



**Unemployment rate (1Q 2005 – 1Q 2014)**



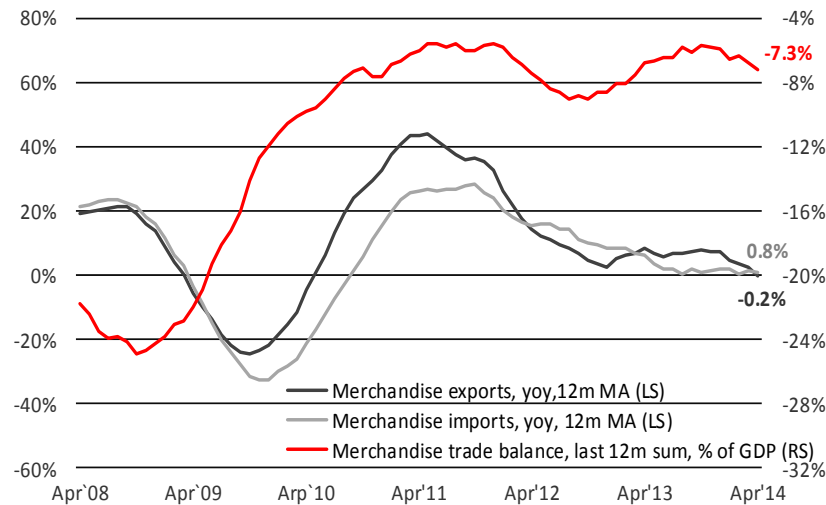
Source: Eurostat, NSI, UniCredit Bulbank Economic Research

Note: Participation rate is a ratio between labor force (which includes not only those who have jobs but also those who are actively searching for jobs) and population.

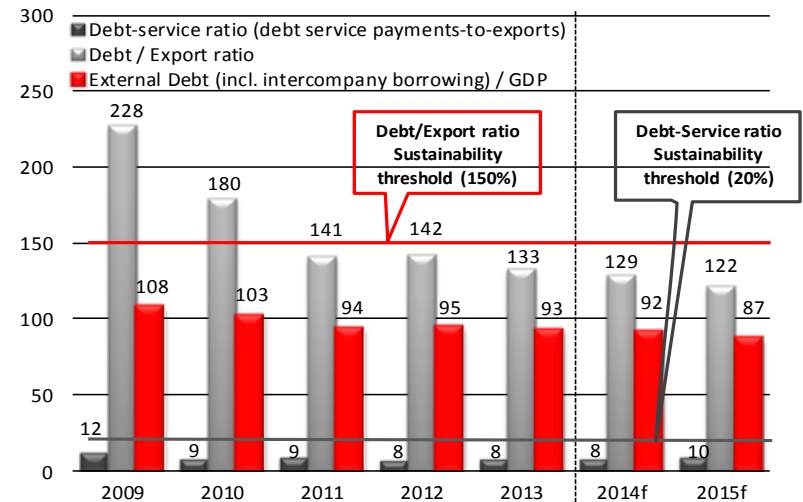
# Bulgaria's external position has seen a marked improvement

- This was led by exports and public current transfers, due to better EU funds absorption
- The solid improvement in the external position indicates that the downturn adjustment in economic activity is now over
- Stronger external position was also reflected in the improvement of the country's debt sustainability indicators, which is important as foreign debt at 93% of GDP (in end-2013) is seen as relatively high for the standards of emerging market economies

**External merchandise trade developments, 12m MA (Apr'2008 – Apr'2014)**



**Debt sustainability indicators (2009 – 2015f)**

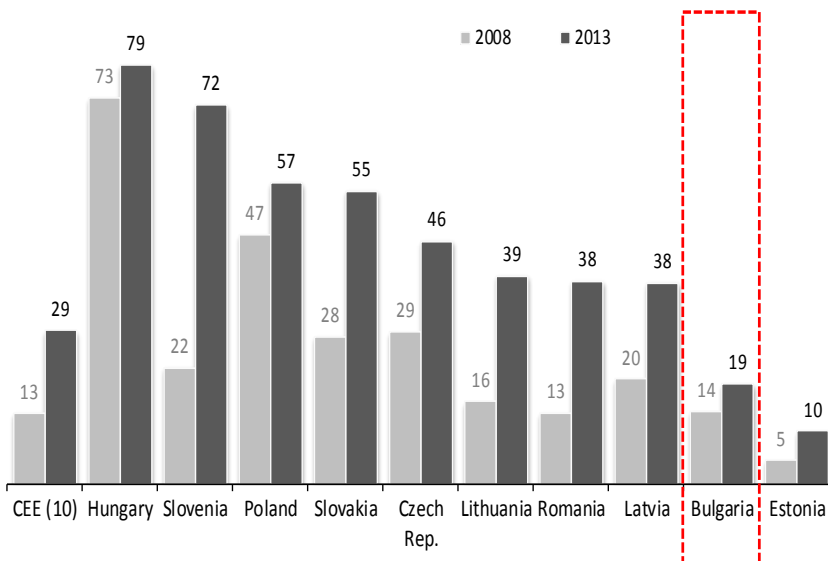


Source: BNB, NSI, UniCredit Bulbank Economic Research

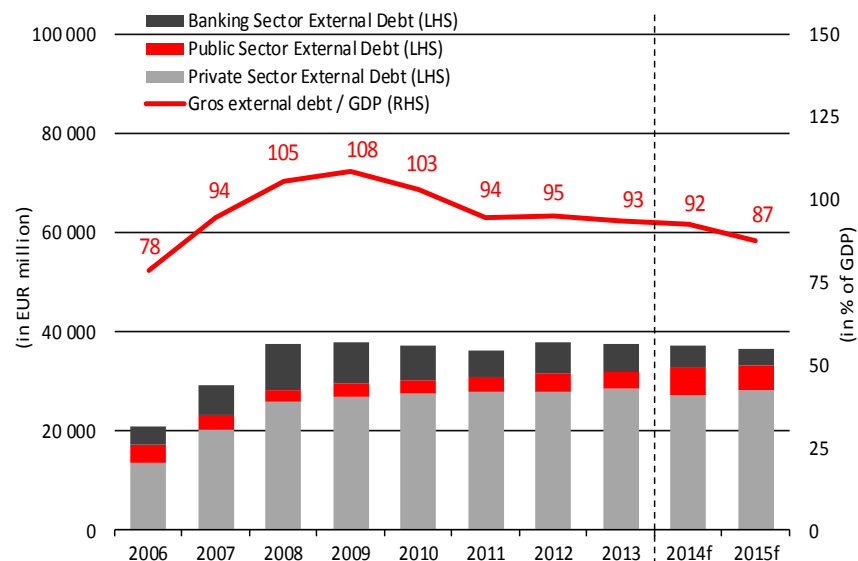
# Can Bulgaria turn its low public debt into an even stronger advantage?

- Over-proportioned fear of a Greek style scenario deterred Bulgaria from using more decisively its low public debt advantage from 2008 to 2012
- The fiscal impulse in 2013 (as deficit increased to 1.9% of GDP from 0.4% a year ago) helped economic recovery to gain some momentum
- For us, more public sector investments needs to be encouraged, not only in infrastructure, but also in the underfinanced education and health care sectors, which are crucial to reduce raising skewness in income distribution and address pressing demographic challenges that Bulgaria faces

Public debt to GDP ratio in CEE countries (2008 – 2013)



Gross external debt by sectors (2006 – 2015f)

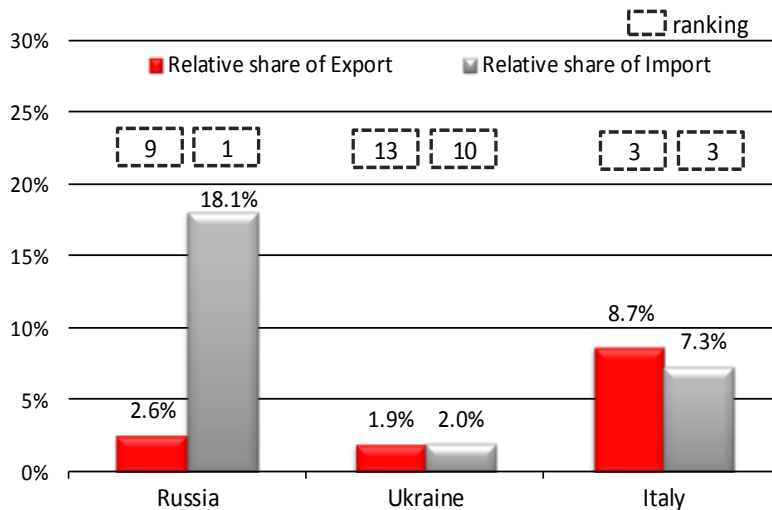


Source: Eurostat, NSI, MF, UniCredit Bulbank Economic Research

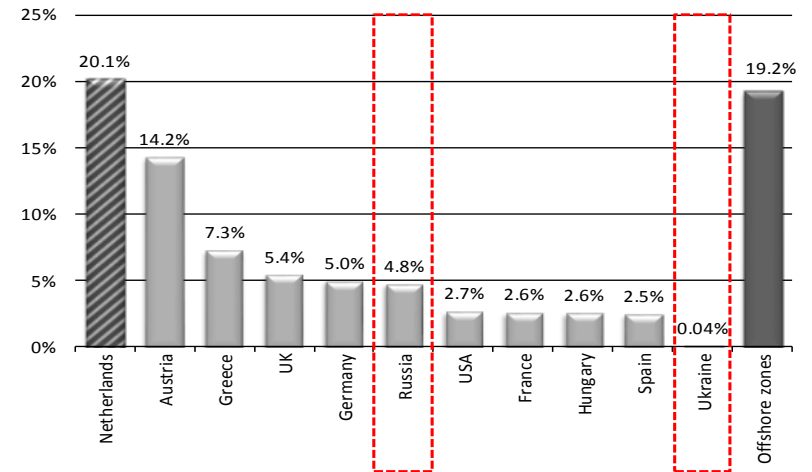
# The economies of CEE, including Bulgaria are among the most exposed to spillover effects from the Crimea crisis, but as things stand the economic impact is likely to be limited

- Impact through trade and investments channels would be rather small, as the outlook for Bulgarian export and investments will remain determined by the developments in its key partner - EU region
- Impact on tourist flows remains uncertain. Importantly, severe economic adjustment underway in Ukraine and to a lesser extent in Russia may even prompt demand for cheaper tourist destinations to rise
- South Stream project would be in fact frozen by EU, because it makes no sense to pour billions of euros to support Ukraine, while at the same time allowing Russia to bypass Ukraine as a major hub for Gazprom's natural gas supplies channeled to Europe. On the positive side, this conflict may encourage Bulgaria (with some help from EU) to do more to lessen its dependence on Russian energy

Share of Bulgarian export and import with some specific countries (2013)



Relative share of FDI in Bulgaria by geographical region, stock (2013)

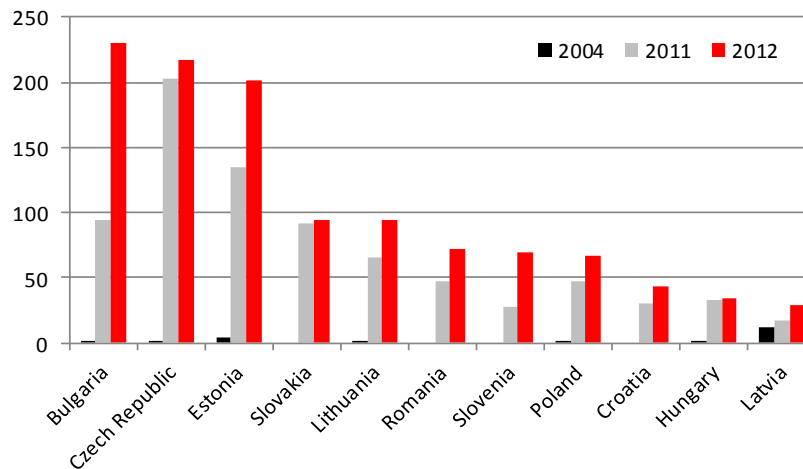


Source: BNB, NSI, UniCredit Bulbank Economic Research

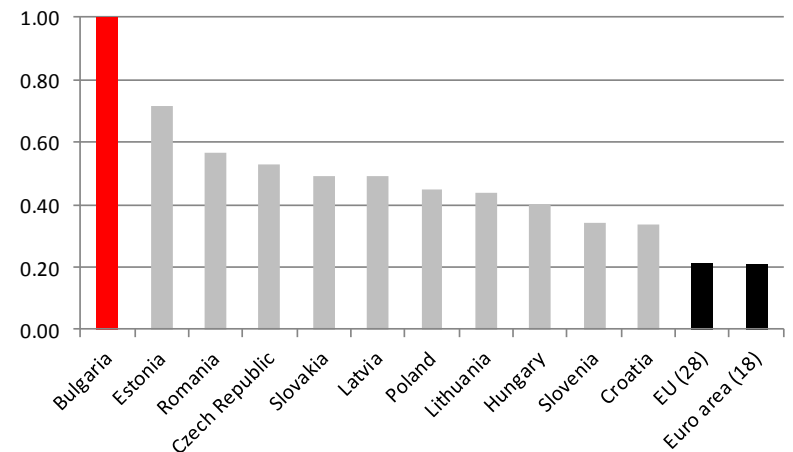
# Urgent policy shift is needed in the energy sector

- ❌ Bulgaria needs to rethink its energy strategy and define clear priorities which are backed by the major political players. The focus should shift from more state support for adding new electricity generation capacities toward investing more public money to improve efficiency and diversification of the sources of supply
- ❌ Pricing decisions need to change. Price of electricity for the household sector should cover the corresponding production and distribution costs, including investment costs which are needed to guarantee the security of electricity supplies. At the same time, the needs of the poor should be addressed by increasing the subsidies and by improving the capacity of the administration to identify with a decent degree of precisions those who are most in need to receive these subsidies

**Total installed capacity of PV and wind in CEE, in per capita terms - MW/mn people (2004-2012)**



**Energy intensity of the economy, Bulgaria=100 (2012)**



Source: Eurostat, UniCredit Bulbank Economic Research





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**THANK YOU FOR YOUR ATTENTION!**

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