Recent Developments and Short-term Outlook on the Bulgarian Economy

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The real GDP growth in the second quarter of 2015 surpassed again expectations, reaching 2.4% yoy. After three months of deflation, in August, a flat inflation rate was observed. A slight positive inflation is expected in the upcoming months. The state budget accumulated a significant surplus as a result of a solid increase in revenues and a moderate rise in expenditures. In July, the current account was positive. The export accelerated by 7.3% yoy, while the import went up at a faster pace by 13.3%.

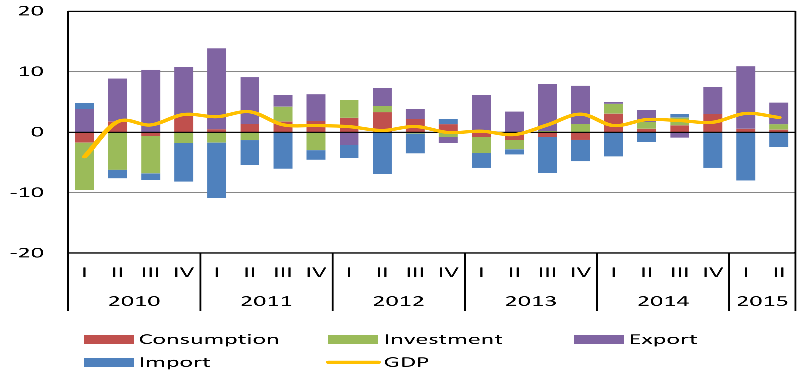
The coverage of the monetary base with FX reserves was high as of July. Thus, currency board and banking system remain stable. Lending contracted for the ninth consecutive month. However, the share of non-performing and restructured loans narrowed. Deposits continued growing against the background of gradually lowering interest rates.

1. Export boosted the GDP growth

According to last available data of the National Statistical Institute (NSI),[1] during the second quarter (Q2) of 2015 the external demand was once again a crucial driver of economic growth in contrast to the entire 2014. Against this background, the net export contributed by 3.6pp to the GDP dynamics, while the domestic demand donated 1.3pp. Within the domestic demand, gross investments as well as household consumption registered a positive contribution of 0.8pp and 0.4pp, respectively. Regarding the GDP components, the export increased by 5.3% in real terms, while the import went up by 3.5% yoy. Both the export and import growth rates exceeded the levels in Q2 2014, as a consequence of the weaker euro. In turn, investments rose by 3.6% year-on-year (yoy), whereas consumption stepped up by 0.6% yoy.

[1] National Statistical Institute: *http://www.nsi.bg/bg/content/тримесечни-данни* and own calculations.

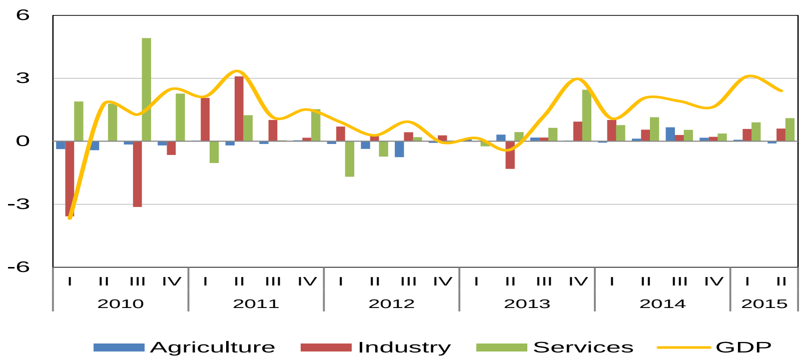
Contributions to real GDP growth on the demand side (pp)



Source: NSI

On the production side, in Q2 a solid contribution to the GDP growth again came from the services sector (1.1pp), followed by the industry (0.7pp), while agriculture made a negative endowment (-0.1pp). In the services, as expected, the real estate operations (0.4pp), education, healthcare, administration and social services (0.3pp) in addition to trade and repair of motor vehicles, hotels and restaurants (0.2pp) shore up the growth most intensively. They were followed by the creation and dissemination of information (0.1pp), the scientific research (0.1pp) and the financial and insurance activities (0.1pp). These facts reflect what happened in the sector during Q2: increased number of purchases of real estate and motor vehicles due to low interest rates on deposits, uncertainty around the future of the euro, caused by the Greek crisis and the living memories from the bank panic around the Corporate Commercial Bank. Within the industry, mining and manufacturing (including production and distribution of electricity, gas and water) contributed much more significantly (0.7pp) to the GDP growth, than construction, which remained flat (0.0pp).

Contributions to real GDP growth on the supply side (pp)

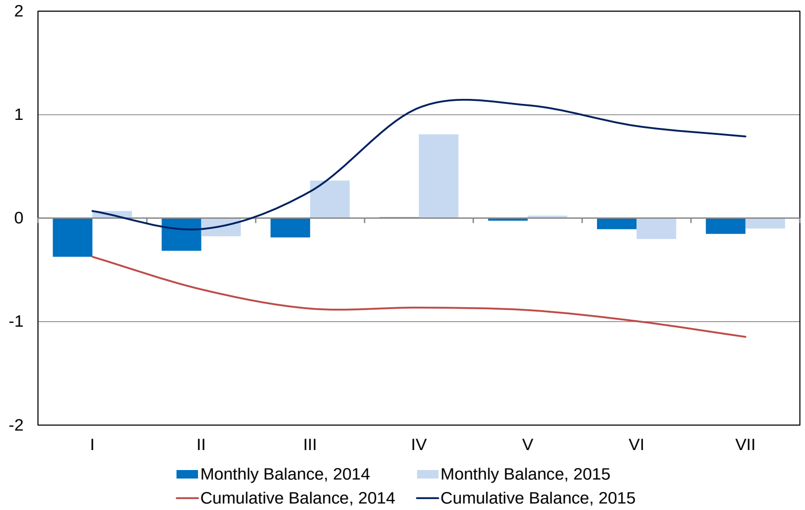


Source: NSI

2. *Positive developments on the budget side*

By the end of July 2015, the gross state budget accumulated a significant surplus of BGN 789.4 mn, unlike the same period in 2014, where a large deficit of BGN 1.2 bn was encountered. The total budget revenues for the first seven months of the year amounted to BGN 19.0 bn (12.9% yoy growth), while the total spending (including the contribution to the EU budget) reached BGN 18.2 bn (1.3% increase). The far more intensive increase in revenues resulted from a 7.4pp contribution of tax revenues, 0.6pp of non-tax revenues and 5.0pp from grants. The latter were a result of an improved absorption of EU funds and programs. Positive inputs to the expenses were made by: capital expenses (1.9pp), social expenses (0.9pp) and salaries expenses (0.1pp). On the other hand, maintenance expenses (-0.9pp) and subsidies (-0.2pp) contributed negatively.[2]

Gross budget balance (BGN mn)



Source: MF

Compared to July 2014, public debt in July 2015 rose strikingly by BGN 5.3 bn, as the external debt marked an increase of BGN 4.7 bn and the internal debt went up by BGN 659.5 mn. In July, the external public debt reached BGN 15.4 bn debt and the internal debt was BGN 8.3 bn, which together accounted to a total public debt of BGN 23.7 bn.[3]

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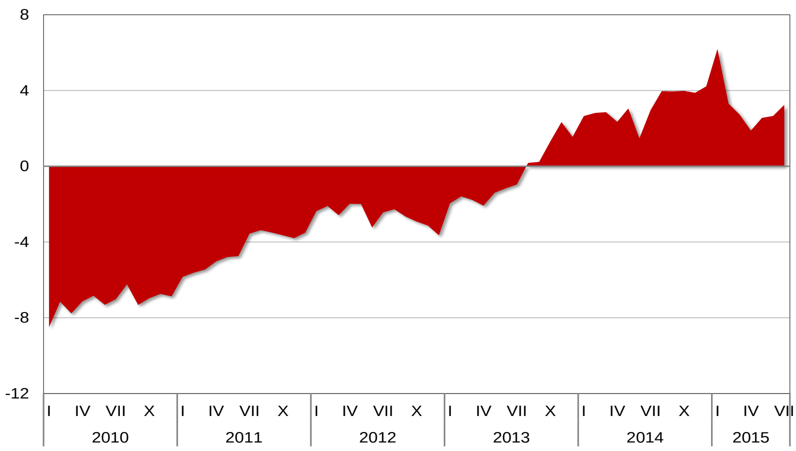
[2] Ministry of Finance: http://www.minfin.bg/bg/statistics/5

[3] Ministry of Finance*: Държавен дълг, месечен бюлетин, 21.08.2015 г.:* http://www.minfin.bg/bg/statistics/1

3. *Stable currency board and banking system*

In July, a substantial growth in FX reserves by BGN 800 mn was observed compared to their level in June. Meanwhile, the monetary base widened more significantly by BGN 943.5 mn mom, as a consequence of an increase in the currency in circulation by BGN 429.2 mn mom and an expansion in liabilities to banks by BGN 514.3 mn mom. As a result, the coverage of the monetary base with FX reserves decreased by 3.8pp mom, reaching 170.8%. Otherwise, the broad money (M3) narrowed by BGN 363.2 mn mom in July, which led to a slight decrease in its coverage with FX reserves by 0.4pp mom, reaching the level of 54.4%. These figures are an evidence for the stability of the currency board.[4]

Net foreign assets of the banking system (BGN bn)



Source: BNB

Net foreign assets of banks again marked a month-on-month increase, for the third consecutive month up to BGN 3.2 bn by the end of July. The rise was a result of a more intensive growth of the foreign assets by BGN 657.9 bn compared to the expansion in the foreign liabilities by BNG 71.0 mn. This dynamics was induced by tackling the Greek crisis, when Bulgarian banks demanded more liquidity and disposed of foreign assets, as well as the limited options for interest-bearing investments in the internal market.[5]

[4] Bulgarian National Bank: http://www.bnb.bg/Statistics/index.htm and own calculations.

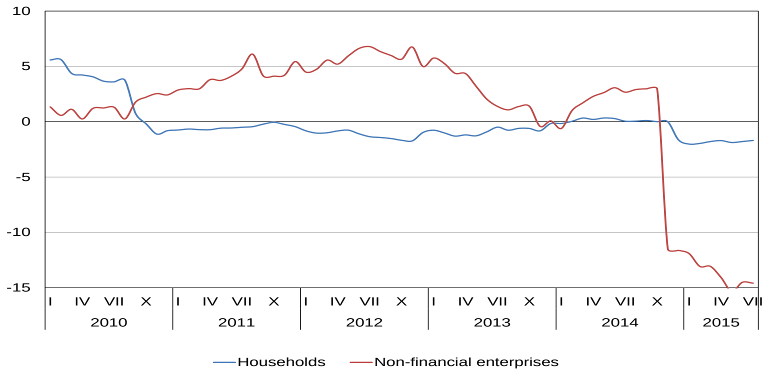
[5] Ibid.

4. Slump in lending deepens

In July, the monetary statistics of the Bulgarian National Bank (BNB)[6] recorded a repeated contraction in loans by 10.2% yoy, for the ninth consecutive month. Within the general trend, the annual decline in lending to non-financial enterprises was 14.6% yoy, while those in loans to households decreased by 1.7% yoy.

The level of non-performing and restructured loans (excluding overdrafts) dropped down by 0.3pp mom to 23.9% in July. Out of them, the NPLs to households were 19.1%, while those to non-financial enterprises reached a more significant share of 27.7%.

Loans development (% yoy)



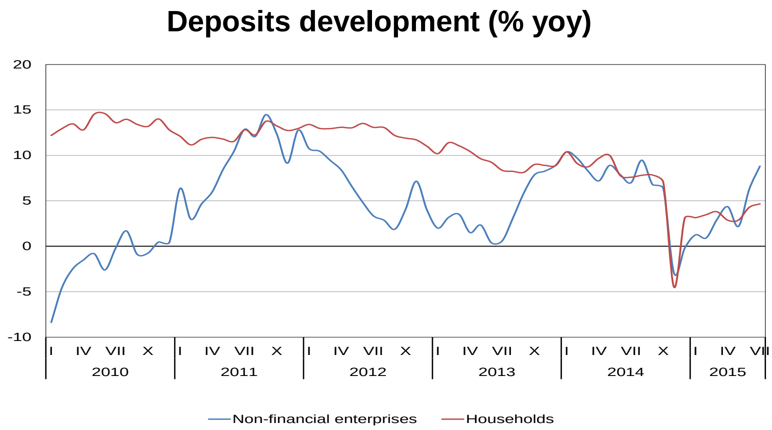
Source: BNB

The average nominal interest rate on new loans rose by 0.6pp mom in July, reaching 7.4% per annum.

Deposits marked an increase again in July by 5.9% yoy. The rise in the deposits of households' segment reached 4.7% yoy, while the increase in the deposits of non-financial enterprises was 8.8% yoy.

The average interest rate on deposits was 1.1% per annum, following a moderate downward trend.

[6] Ibid.



Source: BNB

5. Short-term outlook

The business surveys of the National Statistical Institute among the sectors of the economy show an increase in the general business climate indicator in August. Concerning the industry, the forecasts over the next three months are less favorable as a consequence of the uncertain economic environment. Meanwhile, a stronger negative impact of the factor 'weakness in economic legislation' is observed, which the factor 'insufficient domestic demand' shifts to the third place. The assessment of the construction entrepreneurs is positive, indicating stable construction activity over the next three months. Obstacles for the sector's development, beside the uncertain economic environment, are the competition in the branch and financial problems. In turn, retailers have more optimistic assessments about the present business situation. They also expect an increased volume of sales over the next three months. As the main factor limiting the activity in the branch retailers point out the insufficient demand. On the other hand, the indicator for the business climate in service sector remains unchanged. The tendency for services demand is estimated as decreasing and the expectations over the next three months are also more reserved. Again the uncertain economic environment remains the most serious obstacle for the business, followed by the competition in the branch and the insufficient demand. Over the next months, in all sectors no change in the selling prices is expected.[7]

6. Concluding Remarks

The municipal elections in October 2015 will likely confirm the current political setting. As a result, the government is expected to remain stable in the medium term. The external environment, however, is getting more and more complicated: In addition to the military conflicts in Ukraine and the Middle East, the economic strain in Greece and the political turbulence in Turkey, the inflow of refugees to the western neighboring countries of Macedonia and Serbia is escalating dramatically. Despite the turbulent external environment, real GDP again grew faster than anticipated in Q2 2015, increasing by 2.4% yoy. As expected, the main drivers were net exports, which made a contribution of 1.1pp, and investment activity, which provided a boost of 0.8pp. Against this backdrop, the rise in household consumption remained moderate, contributing only 0.3pp to the GDP dynamics. The low energy prices, the weak euro, the cheaper money and the accelerated recovery of the euro area are expected to provide more stimuli for exports than for imports. Therefore, net exports are projected to further bolster the GDP dynamics in Q4. Otherwise, better capacity for the absorption of EU funds and lower interest rates on business loans will encourage investments in Q4 2015 and Q1 2016, whereas household consumption is projected to increase slightly. The ongoing improvement of the labour market (9.9% eop unemployment rate in Q2) and public finance (BGN 0.5 bn budget surplus through July) is expected to continue at a moderate pace this year and in H1 2016, reflecting the positive GDP dynamics. Conditions remained positive in the banking sector. The expected negative effects on the banking sector and the economy due to the financial tensions in Greece proved to be exaggerated. In particular, Greek-owned banks are maintaining high capital adequacy and are not dependent on financing from parent banks and the Greek government for the most part.[8]

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[7] http://www.nsi.bg/sites/default/files/files/pressreleases/Economy2015-08_48AKK5U.pdf

[8] CEE Strategy

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