

# SPRING MACROECONOMIC FORECAST

# 2016

*The Spring macroeconomic forecast\* of the Ministry of Finance reflects the better than expected performance of the Bulgarian economy in 2015. It is based on the most recent assumptions on the external demand and world prices.*

## 1. International environment

Global economic growth assumptions have been revised downwards as a result of weaker than expected performance in 2015, mainly due to the economic slowdown in emerging markets. In the medium term a smooth acceleration of global growth is expected as a result of more favourable developments in part of the emerging economies. Expectations of the development of the EU economy remain unchanged, but risks to the EU's GDP growth augmented. They are related to the lower growth of world trade, the continued geopolitical uncertainty and increasing migration flows to EU countries.

The assumption on the BGN/USD exchange rate is based on the pegged exchange rate of the Bulgarian lev vis-à-vis the euro and a technical assumption for the USD/EUR exchange rate. The latter is assumed to remain unchanged over the projection horizon at the average levels prevailing in the two-week period ending on the cut-off date of 11 March 2016.

All main commodity price indices are expected to decline in 2016, mainly due to the abundant global supply

and the weak demand. The autumn projection of the Brent price has been revised downwards over the entire projection period. Its anticipated fall in 2016 is similar to the one registered in 2015, nevertheless the price per barrel of Brent crude oil is assumed to increase in 2017–2019. Still, these assumptions are subject to substantial uncertainty. Downside risks are mainly related to continuing rise in supply given the relatively weak demand from emerging market economies. On the upside, higher prices could result from cuts of costly production, supply freeze by major producers or unexpected disruptions mostly due to conflicts.

A stronger decline is also expected for non-energy commodity prices in 2016 compared to the autumn forecast, and their previously expected recovery in 2017 has been revised to a further decline. Metal prices are projected to decline largely on the account of higher global supply and slowing demand in China. All main agricultural price indices are also expected to decrease amid abundant supply and high levels of stocks.●

External assumptions: revisions since the Autumn forecast

	Spring forecast 2016				Autumn forecast 2015			Revisions since the Autumn forecast		
	2016	2017	2018	2019	2016	2017	2018	2016	2017	2018
World real GDP, %	3.2	3.6	3.7	3.9	3.8	3.9	3.9	-0.5	-0.3	-0.2
EU28 real GDP, %	2.0	2.0	1.9	1.9	2.0	1.9	1.9	0.0	0.1	0.0
USD/EUR exchange rate	1.09	1.09	1.09	1.09	1.13	1.13	1.13	0.0	0.0	0.0
Oil price, Brent (USD/barrel)	39.7	45.3	49.2	52.6	51.8	57.0	61.5	-12.1	-11.7	-12.3
Non-energy commodity prices, in USD (annual percentage change)	-9.5	-0.7	0.1	0.6	-5.2	0.3	0.0	-4.3	-1.0	0.1

Source: EC, WB, IMF, MoF

\* The forecast is based on statistical data up to 17 March 2016 with the exception of the specifically mentioned.

## 2. Gross Domestic Product

In 2015 the Bulgarian GDP growth reached 3 %, the highest since 2008. The growth was driven by both external and domestic (consumption and investment) demand, with net exports having the biggest contribution. In 2016 an increase in household consumption is expected, coupled by lower positive contribution of net exports. Due to the decline in public capital expenditure, a decrease in investment in the economy is also expected. Hence, the GDP of the country will increase by 2.1 %.

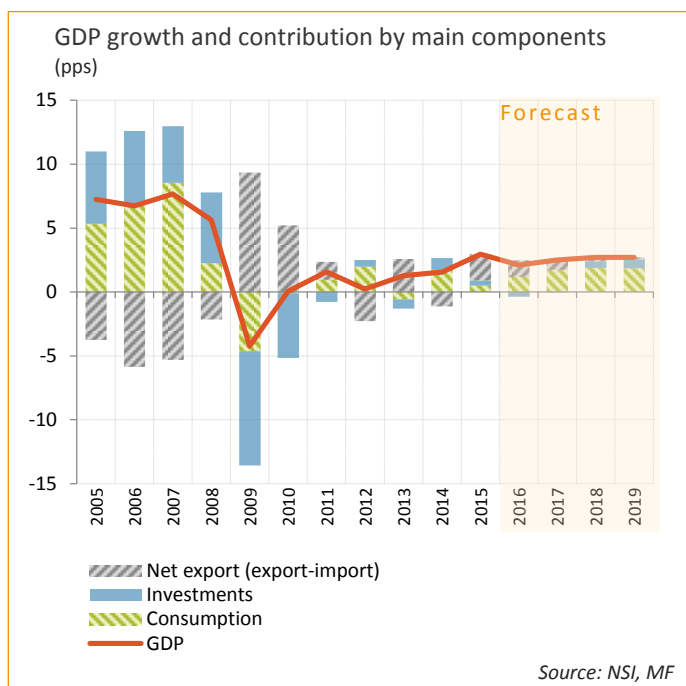


In 2015 the labour market was characterised by favourable developments, reflected in continuing increase in employment and a decline in unemployment. At the same time, there was a deceleration in the growth of compensation per employee, which had a restrictive impact on consumption dynamics. In 2016 the favourable trends will continue, together with a gradual increase in households' real disposable income. The latter will support the 2.1 % increase of consumer expenditure, observed since the second half of 2015.

In the period 2013–2015 the growth of fixed investments in the country was boosted by public capital expenditure related mainly to the EU funds absorption. In 2016, with the launch of the new EU funds absorption cycle, a fall in public capital expenditure is expected. It will not be fully offset by the increase in private investment, and the total investment will have negative contribution to the GDP growth. Private investment will recover backed by the increase in investments in dwellings and machinery and equipment where positive signs have been witnessed in 2014 and 2015 already. The recorded increase in sales of properties in 2015 is expected to continue and along with increase in real house prices to bring an improvement in construction activity. On the other hand, increased capacity utilisation in industry implies future increase in investments for expansion of production capacity.

Due to base effects, growth of exports of goods and services will decelerate in 2016. This will entail a slowdown in imports as well, determined mainly by the dynamics of the raw materials required by the export oriented sectors. In the opposite direction, consumption of households will be supportive to the import growth. Thus, the contribution of net exports to GDP growth will be reduced to 1.3 percentage points from 2.1 percentage points in 2015.

In 2017 the growth of the Bulgarian economy will accelerate to 2.5 % mainly due to the increase in private consumption supported by further increase of employment and consumers' confidence. At the same time, it is expected that investments will remain neutral to GDP growth in 2017. The higher domestic demand growth will be reflected in accelerated increase in imports, as a result of which the contribution of net exports will continue to decrease.



In 2018 and 2019 economic growth will accelerate to 2.7 %, backed by the private consumption and investment, in line with the improvement of the business climate and the increase of the credit activity. As of 2018 public capital expenditures are also expected to contribute positively. Final government consumption is expected to grow, but its contribution to GDP growth will be fairly limited, because of the need for consolidation and adherence to the Stability and Growth Pact framework. Exports of goods and services will also increase and together with the improving domestic demand will

### 3. Current Account

In 2015 the current account balance improved to a surplus of 1.4% of GDP, on the back of favourable price dynamics, exports growth surpassing imports growth, and higher transfers to the General government.

The expected further decline in international prices (in USD terms) in 2016, along with stabilization in the BGN/USD exchange rate, will again result in negative trade deflators. However terms of trade will remain positive. Shift in the export/import deflator dynamics is ex-

pected from 2017 onwards, in line with the global price changes. The hike in import prices (especially fuel prices) will be much stronger than the increase in export prices and will lead to negative terms of trade.

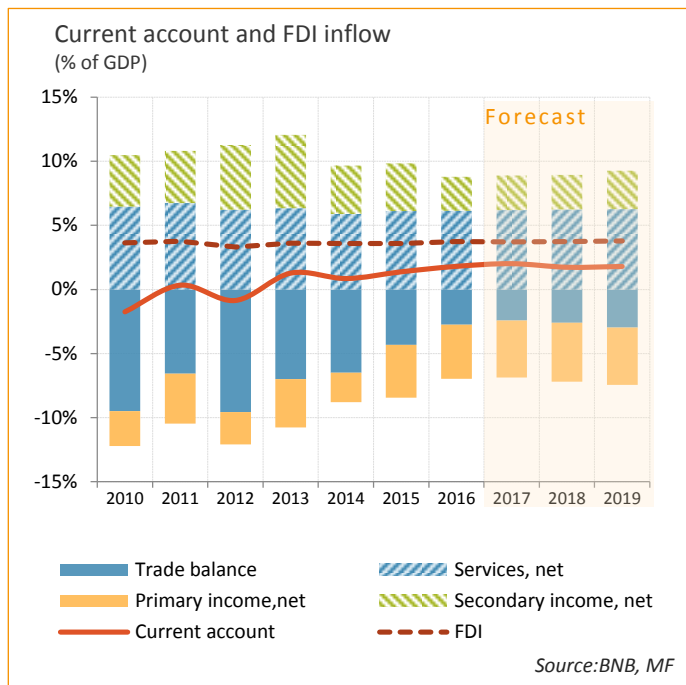
Due to price and volume effects, in 2016–2017 the nominal rise in export of goods will outpace the increase in imports, improving the trade deficit from 4.3% of GDP in 2015 to 2.8% in the current year, and 2.4% in 2017. Trade deficit will increase gradually in the period there-

lead to an acceleration of import growth. The positive contribution of net exports will gradually deplete up to 0.1 percentage points at the end of the forecast period.

Risks to the growth forecast of the Bulgarian economy are balanced.

Main downward risk is related to the uncertainties of the external environment, where the global economic perspectives are still unfavourable. This stems from the likelihood of further growth deceleration of the emerging markets and the stagnation in larger developed economies, on top to the risks of a prolonged international price collapse. The migration pressure and strengthening the border controls in the EU countries may restrict trade in the region. The lower demand in some big EU economies will negatively affect Bulgaria's exports, and may also have an impact on the investment activity and consumer confidence in the country.

On the other hand, the positive evolution of the labour market may lead to higher-than-projected consumption expenditures. Measures to improve the investment environment would lead to pick-up in private investment in the economy. Any reduction in geopolitical uncertainty and the improvement of the external environment will be reflected in stronger economic growth. The migration flows to EU countries may also lead to policy of higher than foreseen government spending for all countries in the region and thus to higher final consumption. ●



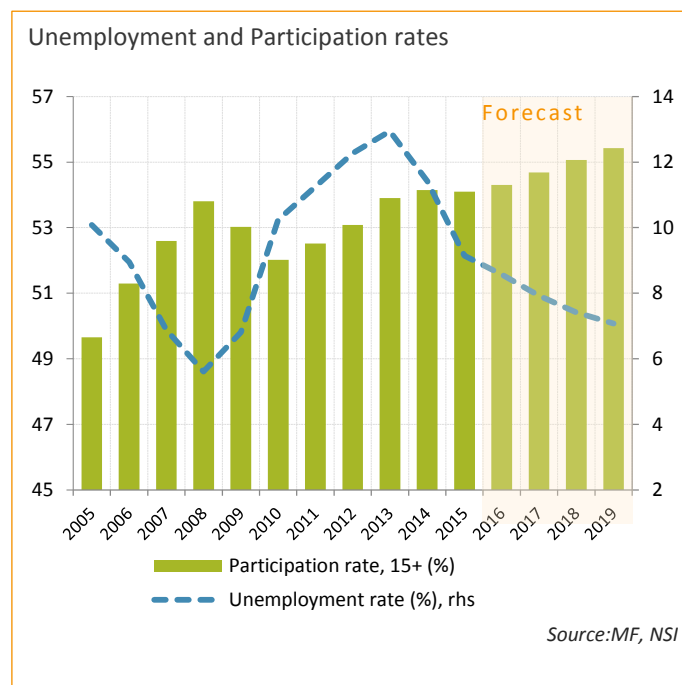
after. In the forecast horizon the surplus on services balance will remain almost unchanged as a GDP share (6.1-6.3%). The increase in gross operating surplus and in the FDI inflows will lead to higher payments of investment income to non-residents and will push the primary income deficit from 4.1% of GDP to 4.5% in 2019. The balance on secondary income will also deteriorate, as transfers related to the projects under the 2007–2013 programming period will cease and the start-up of projects and payments under the new programming period will require time. The surplus will decline in 2016 (to a level below 3% of GDP), before increasing gradually in the following years.

Current account surplus will improve to 1.8% of GDP in 2016 and will remain relatively stable in the period up to 2019. ●

## 4. Labour Market and Incomes

The expected labour market developments in the period 2016–2019 reflect a downward revision of the unemployment rate as compared with the updated autumn forecast, due to the higher than expected labour force decrease in 2015.

The positive 2015 labour market trends are expected to continue in 2016 as well. Short-term business expectations for employment developments in services and manufacturing improved in the first three months of 2016. These sectors are considered to support the overall employment growth in 2016 with the largest contribution coming from service sector activities, while employment growth in manufacturing will remain close to the its 2015 value. Expectations for employees’ dynamics in construction remained on a negative territory, but also improved. Their contribution to employment dynamics is expected to remain positive, following the expected favourable private investments developments in the coming years. Thus, employment number in 2016 is



expected to increase by 0.5% yoy, slightly up from 0.4% in 2015. Higher labour demand would contribute to further decrease in unemployment rate to 8.6%, which is in line with the observed monthly data on registered unemployment during the first two months of 2016.

With the expansion of domestic economic activity annual employment growth is expected to reach 0.6% on average in the period 2017–2019, while the unemployment rate will go down to 7.1% at the end of the forecast horizon. The decrease in the unemployment rate is expected to be slower compared to 2014 and 2015, as the fall in labour force would be smaller due to the measures undertaken for raising the retirement age and the length of service requirements. These measures are expected to have stronger impact on the work force towards the end of the forecast horizon due to the gradual increase in the age and length of service needed for retirement.

Compensation per employee followed the expected path of development, but with a more sizable slowdown to 1.8% in 2015 as compared to the previous forecast, which resulted in a downward revision in expectations for their nominal growth rate in the coming years. In 2016, labour income growth is foreseen to accelerate to 2.7% in nominal terms in line with the higher real productivity and increasing demand for labour in the country. The industrial sector will perform above the country average growth, supported by the export-oriented industries and higher private sector investment activity. Labour demand for high-skilled workers in cer-

tain service sector activities is likely to continue and to boost the wage growth there.



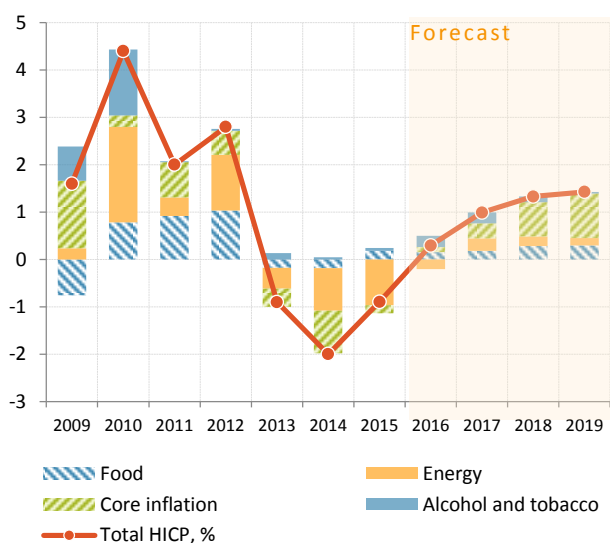
Following the expected increase in economic activity, domestic demand, and the positive inflation dynamics, the nominal growth of compensation per employees will accelerate further in period of 2017–2019. Throughout the entire forecasting period labour productivity growth is expected to reach an annual average of 2–2.5%. Thus, the share of compensation of employees in the gross value added will gradually increase, while unit labour costs growth will be moderate at an annual average rate of 0.4% and 1.5% in real and nominal terms, respectively.

## 5. Inflation

Consumer prices are expected to report a positive change at the end of 2016 as the negative inflation rate is assumed to decelerate and turn positive in the second half of the year. Nevertheless, the annual average HICP inflation rate will still be negative at -0.8%.

Energy will largely account for the negative change in the headline rate at the year-end mostly because of the expected fall in international crude oil prices and, accordingly, lower domestic prices of transport fuels. The projected depreciation of the euro against the US dollar will provide for a further slowdown in the negative

End-of-period HICP Inflation Rate contributions by main components, in pps



Source: NSI, MF

change in prices of non-energy industrial goods. On the other hand, food prices are expected to report an increase similar to the one at end-2015, while the rise in prices of services is assumed to accelerate, backed by higher domestic demand.

The annual average inflation rate in 2017 is projected at 1.1% and it is expected to accelerate in 2018-2019 under

## 6. Monetary Sector

Monetary sector projections for the 2016-2019 period had been revised upwards compared with the 2015 autumn forecast due to the better than expected economic performance in 2015 and taking into account the dynamics of the main monetary indicators at the end of the previous year and the beginning of 2016. The higher expectations for money supply growth would be supported by the higher projected growth of the FX reserves. Expectations about claims to the private sector in 2016 had been revised downward. Their annual growth rate will be smaller in view of the preparation for the asset quality reviews (AQRs). Although at a moderate pace,

the assumption for higher international prices of crude oil and other major non-energy commodities, as well as stronger domestic demand.

Changes in the tax policy over the projection horizon will have a relatively weak impact on consumer price dynamics. The envisaged hike in excise taxes on tobacco at end-2016 and 2017 will contribute by 0.17 and 0.15 pps to the change in the headline rate in the corresponding year. Prices of cigarettes in 2018 are expected to increase by 1.8% which will add 0.08 pps to the end-of-period inflation.

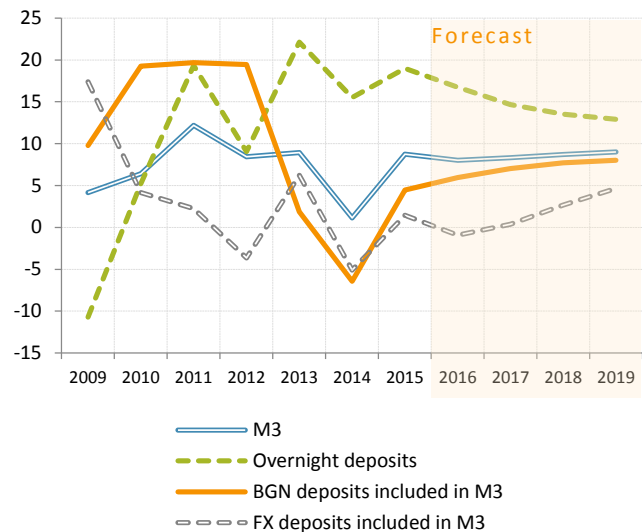
Risks to the inflation outlook are largely tilted to the downside. Stronger-than-assumed fall in prices of crude oil and other non-energy commodities would trigger a larger decrease in the headline rate. At the same time, weaker domestic demand growth could result in more subdued core inflation than currently expected. On the other hand, supply disruptions of major agricultural commodities, especially food products, due to adverse weather conditions could cause higher inflation in the country. A possible supply freeze agreement among OPEC members could also result in a faster-than-assumed rebound in crude oil prices. ●

claims to the private sector will recover at a higher rate compared to the previous forecast.

Money supply is expected to grow by 8% in 2016 and slightly accelerate to 8.3% in the following year. Broad money will keep growing slowly towards 9% in 2019. Main contribution to the M3 increase in 2016 and 2017 will come from overnight deposits, but in 2018 and 2019 their growth will slow down at the expense of a faster growth of less liquid deposits. This will reflect the gradually diminishing higher liquidity preferences of economic agents, which date back to mid-2014.

Money Supply and Deposits

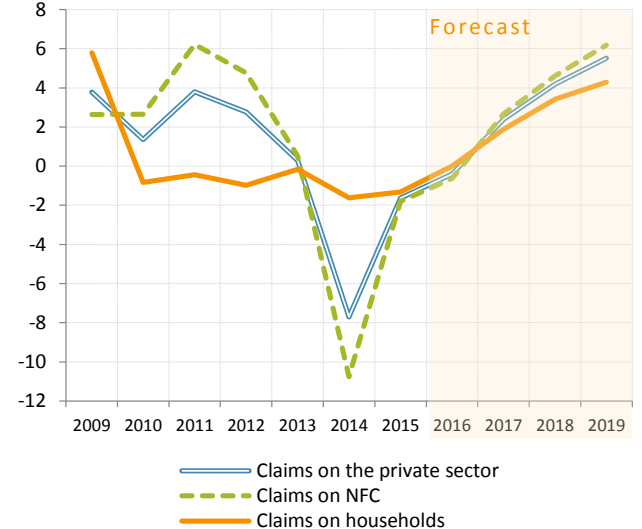
(yoy growth, %)



Source: BNB, MF

Claims on the Private Sector

(yoy growth, %)



Source: BNB, MF

Net foreign assets of the banking system will continue their upward trend, but their annual growth rate will slow down significantly in 2018 and 2019, when foreign assets are expected to stop growing. Net foreign assets' dynamics will be determined mainly by the expectations that deposits attracted from residents will exceed the amount of loans extended during the whole period.

Credit to the private sector will gradually intensify during the period 2016–2019. At the end of 2016 its annual growth rate will be slightly negative (-0.4%). This will be to a great extent due to the ongoing optimization of the credit portfolios, which began in 2015 and continued in early 2016. More distinct acceleration of private sector credit growth will take place in 2017 (up to 2.4% yoy), and in 2018 and 2019 it will reach 4.2% and 5.5% yoy, respectively. The main driver will be corporate credits, which in 2016 and 2017 will be for working capital, while in the last two years of the forecasting period the weight of investment credits will increase. Credit to households will accelerate, due to both consumption and mortgage loans. Credit activity will be driven by the expected acceleration in private consumption growth, the positive trends in labour market in terms of employment and income, as well as by the ongoing recovery of the real estate market. ●

MAIN ECONOMIC INDICATORS	ACTUAL DATA*		PROJECTIONS			
	2014	2015	2016	2017	2018	2019
<b>International environment</b>						
World real GDP (%)	3.4	3.1	3.2	3.6	3.7	3.9
EU28 real GDP (%)	1.4	1.9	2.0	2.0	1.9	1.9
USD/EUR exchange rate	1.33	1.11	1.09	1.09	1.09	1.09
Crude oil, Brent (USD, bbl)	98.9	52.4	39.7	45.3	49.2	52.6
Non-energy commodity prices (in USD, %)	-4.6	-15.1	-9.5	-0.7	0.1	0.6
<b>Gross domestic product</b>						
Nominal GDP (mln BGN)	83 612	86 373	89 219	92 426	95 979	99 730
Real GDP growth (%)	1.5	3.0	2.1	2.5	2.7	2.7
Consumption	2.2	0.7	1.5	2.2	2.5	2.4
Gross fixed capital formation	3.4	2.5	-1.8	-0.1	2.7	3.5
Export of goods and services	-0.1	7.6	4.5	4.7	4.9	5.1
Import of goods and services	1.5	4.4	2.6	3.6	4.7	5.2
<b>Labour market and prices</b>						
Employment growth (SNA, %)	0.4	0.4	0.5	0.6	0.6	0.6
Unemployment rate (LFS, %)	11.4	9.1	8.6	7.9	7.4	7.1
Compensation per employee (%)	5.6	1.8	2.7	3.4	3.8	4.0
GDP deflator (%)	0.4	0.3	1.2	1.1	1.1	1.2
Annual average HICP inflation (%)	-1.6	-1.1	-0.8	1.1	1.2	1.4
<b>Balance of payments</b>						
Current account (% of GDP)	0.9	1.4	1.8	2.0	1.7	1.8
Trade balance (% of GDP)	-6.5	-4.3	-2.8	-2.4	-2.6	-3.0
Foreign direct investments (% of GDP)	3.6	3.6	3.7	3.7	3.7	3.8
<b>Financial sector</b>						
Money M3 (%)	1.1	8.8	8.0	8.3	8.7	9.0
Corporate credit (%)	-10.8	-1.8	-0.6	2.7	4.6	6.2
Credit to households (%)	-1.6	-1.3	0.0	1.9	3.4	4.3

\* The Macroeconomic forecast is based on statistical data received up to March 17, 2016.