S&P Global
Ratings

RatingsDirect®

Research Update:

Bulgaria 'BB+/B' Ratings Affirmed; Outlook Stable

Primary Credit Analyst:
Ludwig Heinz, Frankfurt (49) 69-33-999-246; ludwig.heinz@spglobal.com

Secondary Contact:
Felix Ejgel, London (44) 20-7176-6780; felix.ejgel@spglobal.com

Table Of Contents

Bulgaria 'BB+/B' Ratings Affirmed; Outlook Stable

Overview

- Bulgaria’s economic recovery has been accelerating so far in 2016, alongside improvements in the labor market, a narrowing government budget deficit, and a current account surplus.
- These improvements could be thwarted if the increased political uncertainty following the recent government resignation hampers economic recovery or leads to an overly lax fiscal stance.
- We are therefore affirming our 'BB+/B' long- and short-term sovereign credit ratings on Bulgaria.
- The stable outlook reflects our view that the government’s still-moderate debt burden with ample fiscal space balances the risks of a potential weakening of the external environment, a re-emergence of risks in the financial sector, and the prevalent political uncertainty.

Rating Action

On Dec. 2, 2016, S&P Global Ratings affirmed its 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Bulgaria. The outlook is stable.

Rationale

The ratings remain constrained by Bulgaria's relatively low income levels, with GDP per capita estimated at $7,200 in 2016. They are also constrained by the government and central bank authorities' limited policy flexibility due to the country's currency board regime and the high--albeit decreasing--proportion of loans and deposits denominated in euros, hampering the effective transmission of monetary policy regarding credit to the real economy. A further constraint is the weak institutional setting, where progress on the reform of the judiciary has been slow--an area that would be key for strengthening the business environment.

The ratings are supported by the government's moderate net debt position, projected at 18% of 2016 GDP. They also benefit from Bulgaria's moderately leveraged external balance sheet following half a decade of external deleveraging, led primarily by the financial sector. That said, credit growth, especially to the corporate sector, remains subdued although there are tentative signs of a recovery--notably mortgage lending has been increasing in 2016 in line with better labor market indicators.

Following the government’s resignation in mid-November, Bulgaria is facing uncertainty about the future path of economic policy. We view it as highly likely that early elections will be called for spring 2017 and a caretaker government will come into office until the snap elections. The transition in the president’s office following the recent presidential elections--which was the external trigger for the government’s resignation--will, in our view, not greatly affect the caretaker administration in the next few months, nor will it affect the day-to-day politics of a new government.

That said, this political impasse adds to the experience of frequent government changes in Bulgaria over the past few years. We expect that political uncertainty will remain elevated leading up to the probable snap elections and the outcome might not lead to higher government stability, given the likely strengthening of smaller political forces adding to an already fragmented political landscape. In the next few months, political considerations could lead to a looser fiscal stance, or electoral promises regarding higher spending beyond the priority areas identified by the outgoing government such as health care and education. Additionally, a political standstill could weigh on private sector investment decisions and consumption and therefore hurt the ongoing recovery.

That said, economic recovery in Bulgaria has gained momentum over 2016, underpinned by sound net exports and increasing private consumption. At the same time, we expect employment will grow by around 1% in 2016 and the unemployment rate will further decrease to around 8% by year-end--well below the 13% recorded three years ago but still above pre-crisis levels. Despite the political uncertainty, we expect growth to persist in 2017 as we anticipate sound net exports and increased domestic demand with rising disposable incomes to persist. With the beginning of the new EU budget cycle, public investment projects financed by EU structural and cohesion funds will also be an important contributor to economic performance, following the break in 2016 due to the previous programming period ending. We understand that policymakers are well prepared to absorb the maximum possible amount from the available funds. We also expect Bulgaria’s deflationary trend to end in 2017 when we project core and headline inflation to return to positive.

Bulgaria's moderate government debt burden (net of liquid assets) affords the country fiscal space to respond to external and domestic shocks, should they arise. This is all the more important given Bulgaria's currency board arrangement, which acts as an important nominal anchor, but affords minimal monetary policy flexibility. Bulgaria posted a particularly strong budgetary performance in 2016, and we expect the deficit in accrual terms to narrow to 0.8% of GDP from 1.7% of GDP in 2015, supported by measures to widen the tax base and improve collection and especially lower investments as the EU programming period came to an end. We expect this deficit to reduce further to 1.2% of GDP by 2019. Risks for fiscal consolidation in the near term mainly stem from the political situation as the likely electoral campaign may induce a looser fiscal stance in the coming months.

We expect that gross general government debt will remain roughly stable at just below 30% over the forecast horizon, reaching 28% of GDP by 2019. We note that about 80% of total government debt is denominated in foreign currency, mainly euros.

Although the government has sizable deposits that increased with its March 2016 Eurobond issuance, there are still significant fiscal risks stemming from contingent liabilities associated with Bulgaria’s state-owned enterprises. Contingent liabilities that could materialize include those from the energy sector, although the government has recently succeeded in reducing losses at Natsionalna

Elektricheska Kompania (NEK). However, the government has decided to provide financing following the arbitration court decision on NEK--to compensate Russia-based Atomstroyexport for equipment already produced for the cancelled Belene nuclear power plant. The government is waiting for the European Commission's decision on compliance with state aid procedures before it provides the financing of 1.4% of GDP to NEK.

Following the recent publication of the results of this year's Asset Quality Review, the banking sector is adequately capitalized. However, two domestic institutions have to replenish their additional capital buffers by spring next year. Most prominently, we understand that as an outcome of the stress test's adverse scenario, First Investment Bank, the country's third-largest bank, needs to increase its additional capital buffers by Bulgarian lev 206 million (about €105 million) by April 2017. While this task seems manageable, there are persisting vulnerabilities for some domestic banks and nonperforming loans in the sector remain high at almost 14% of total loans in September 2016.

As per its charter--and according to the currency board regime under which it operates--the Bulgarian National Bank's (BNB) ability to act as a lender of last resort is limited. It can provide liquidity support to the banking system only to the extent that its reserves exceed its monetary liabilities. Even then, support can occur only under certain conditions and for short periods, against liquid collateral.

Since 2007, Bulgaria's current account deficit has narrowed by about 25% of GDP, primarily on the back of a strong expansion in real exports. Exports with high import content and moderate added value from the domestic economy--such as refined petroleum--are an important part of total exports. In 2016, the services balance was also supported by a strong tourist season helped by external factors. While wage levels have increased considerably since Bulgaria joined the EU in 2007, the process of convergence toward European averages has been only gradual. That said, there is still significant upside potential for wages before competitiveness is affected. The total hourly labor costs (mainly wages) in industry, construction, and services are slightly less than one sixth of the EU-28 average. Bulgaria is also facing a structural constraint from demographic challenges. Its population has shrunk by nearly 15% over the past two decades, reflecting an aging society and net emigration.

Bulgaria is not part of the EU's Exchange Rate Mechanism II, the precursor to eurozone entry. Furthermore, policymakers' commitment to the currency board remains strong, as demonstrated by their track record of small fiscal surpluses or low deficits, and moderate general government debt. The currency board was introduced in 1997 in the wake of a banking crisis amid hyperinflationary conditions, which were fueled by central bank financing of budget deficits. The board successfully lowered price inflation and prevented further episodes of hyperinflation. However, the regime restricts policy response. Apart from limiting the BNB's ability to act as a lender of last resort, it restricts control over money creation. The board also does not allow the exchange rate to react in response to domestic or external conditions. As of October 2016, the BNB's reserves covered monetary liabilities by almost 1.8x.

With the adoption of the EU Banking Resolution and Recovery Directive into Bulgarian law, the failure of a bank will necessitate a bail-in of shareholders, creditors, and then a resolution fund. Only after exhausting these options would government support be needed.

The banking sector is vulnerable to external factors. However, measures by the BNB have ensured the stability of Greek subsidiaries, which together account for slightly below one fifth of the sector's assets. The BNB has taken steps to increase the liquidity of these subsidiaries, such as mandating higher deposits with the BNB, increasing the proportion of liquid assets held, and reducing exposure to parent banks. These subsidiaries could therefore be mainly affected by events in Greece if depositor confidence were to suffer. Although Bulgaria is not formally a member of the eurozone, a line of support from the European Central Bank is available to the BNB regarding any confidence-related losses arising at Greek bank subsidiaries. Details of this support, such as how it can be obtained or whether collateral would be needed, have not been released.

Outlook

The stable outlook on Bulgaria reflects the balanced risks from fiscal and economic uncertainty amid the political standstill--which will potentially last for several months--against our expectation that fiscal space is preserved and economic recovery continues.

We could consider an upgrade if Bulgaria effectively addressed political and judicial governance issues, thereby boosting its growth potential; if its fiscal performance improved beyond our current expectations; and if Bulgaria managed to further reduce external vulnerabilities and liabilities.

We could lower the ratings if the domestic financial system required further substantial government support, or if outflows on the financial account resulted in pressures on the balance of payments. A weaker-than-projected fiscal consolidation path, with significant expenditure slippage or a regress on institutional advancements, could also put pressure on the ratings.

Key Statistics

Table 1

Republic of Bulgaria Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	75	81	82	82	84	89	91	94	98	102
Nominal GDP (bil. $)	51	57	54	56	57	50	52	51	54	56
GDP per capita (000s $)	6.8	7.8	7.4	7.7	7.8	7.0	7.2	7.2	7.6	7.9
Real GDP growth	1.3	1.9	0.0	0.9	1.3	3.6	3.3	3.0	2.6	2.6
Real GDP per capita growth	1.9	2.6	0.6	1.5	1.9	4.2	3.8	3.5	3.1	3.1

1766647 | 301735970

Table 1

Republic of Bulgaria Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real investment growth	(17.7)	(4.4)	1.8	0.3	3.4	2.7	0.4	2.7	2.3	2.6
Investment/GDP	22.6	21.5	21.9	21.3	21.4	21.2	21.1	21.3	21.4	21.5
Savings/GDP	20.8	21.8	21.1	22.6	21.5	21.6	22.3	21.7	21.5	20.9
Exports/GDP	50.2	59.1	60.8	64.7	65.0	64.1	64.6	65.2	65.7	66.1
Real exports growth	11.0	12.6	2.0	9.6	3.1	5.7	4.6	3.9	3.8	4.0
Unemployment rate	10.3	11.3	12.3	13.0	11.4	9.2	8.2	7.9	8.0	8.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(1.7)	0.3	(0.9)	1.3	0.1	0.4	1.3	0.4	0.1	(0.6)
Current account balance/CARs	(3.0)	0.5	(1.2)	1.7	0.1	0.5	1.8	0.5	0.1	(0.8)
CARs/GDP	57.3	66.0	68.9	73.9	72.5	71.5	71.3	72.1	72.5	72.8
Trade balance/GDP	(9.4)	(6.5)	(9.5)	(7.0)	(6.5)	(5.8)	(5.4)	(5.9)	(6.1)	(6.6)
Net FDI/GDP	2.4	2.9	2.5	3.0	2.1	3.5	3.2	3.2	3.2	3.2
Net portfolio equity inflow/GDP	(0.5)	0.1	(0.1)	(0.3)	(1.0)	(0.6)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	137.6	124.1	122.8	117.4	121.6	118.7	110.8	107.0	102.6	100.2
Narrow net external debt/CARs	23.2	8.1	5.0	0.7	(3.2)	(15.2)	(17.8)	(23.9)	(29.0)	(33.0)
Net external liabilities/CARs	147.9	105.3	106.4	93.5	84.9	71.8	70.4	68.0	62.2	58.2
Short-term external debt by remaining maturity/CARs	73.2	48.4	43.8	41.6	41.1	44.5	32.7	31.4	29.7	28.5
Reserves/CAPs (months)	3.3	2.3	2.2	2.3	1.9	2.6	2.2	2.7	3.1	3.5
Reserves (mil. $)	7,271	6,750	7,914	6,544	7,640	6,655	8,242	10,214	11,861	13,822
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.1)	(2.0)	(0.3)	(0.4)	(5.5)	(1.7)	(0.8)	(1.0)	(0.9)	(1.2)
Change in debt/GDP	2.0	1.0	1.7	0.3	10.3	0.6	4.1	0.0	0.9	1.2
Primary balance/GDP	(2.4)	(1.2)	0.5	0.3	(4.6)	(0.8)	0.1	(0.0)	0.1	(0.2)
Revenue/GDP	33.1	31.9	34.1	37.1	36.6	39.0	38.2	38.2	38.2	38.2
Expenditures/GDP	36.2	33.8	34.5	37.6	42.1	40.7	39.0	39.2	39.1	39.4
Interest /revenues	2.1	2.3	2.3	2.0	2.4	2.4	2.4	2.6	2.6	2.6
Debt/GDP	15.3	15.2	16.7	17.0	27.0	26.0	29.4	28.4	28.3	28.3
Debt/Revenue	46.3	47.8	48.9	45.8	73.7	66.7	77.0	74.4	74.0	74.2
Net debt/GDP	7.1	8.9	9.0	11.0	17.3	18.1	18.3	18.7	18.9	19.4
Liquid assets/GDP	8.2	6.4	7.7	6.0	9.7	8.0	11.1	9.7	9.3	9.0
MONETARY INDICATORS (%)										
CPI growth	3.0	3.4	2.4	0.4	(1.6)	(1.1)	(1.0)	0.5	1.2	1.5
GDP deflator growth	1.1	6.0	1.6	(0.7)	0.5	2.2	(0.3)	0.5	1.2	1.5
Exchange rate, year-end (LC/$)	1.47	1.51	1.48	1.42	1.61	1.79	1.80	1.87	1.80	1.80
Banks' claims on resident non-gov't sector growth	1.4	3.9	2.8	0.2	(7.6)	(1.6)	0.7	3.5	3.5	3.5

Table 1

Republic of Bulgaria Selected Indicators (cont.)										
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Banks' claims on resident non-gov't sector/GDP	69.9	67.3	68.1	68.1	61.8	57.5	56.2	56.2	56.0	55.6
Foreign currency share of claims by banks on residents	50.0	51.3	49.5	47.6	42.1	33.1	49.4	49.4	49.4	49.4
Foreign currency share of residents' bank deposits	49.0	45.3	41.2	41.2	40.9	40.3	40.3	40.3	40.3	40.3
Real effective exchange rate growth	(3.9)	2.7	(1.9)	1.3	(0.5)	(3.2)	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Bulgaria Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Strength
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014

- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- 2015 Annual Sovereign Default Study And Rating Transitions - May 24, 2016
- Sovereign Risk Indicators - October 13, 2016. For an interactive version, go to www.spratings.com/sri
- Global Aging 2016: 58 Shades Of Gray - April 28, 2016
- Global Sovereign Rating Trends Mid-Year 2016 - July 13, 2016
- Why Politics Matters To Sovereign Ratings - November 06, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that all key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Bulgaria (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	BB+/Stable/B	BB+/Stable/B
Transfer & Convertibility Assessment	BBB+	BBB+

Ratings List Continued...

Senior Unsecured		
Foreign and Local Currency	BB+	BB+
Short-Term Debt		
Foreign and Local Currency	B	B

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.