

FITCH AFFIRMS BULGARIA AT 'BBB'; OUTLOOK STABLE

Fitch Ratings-London-01 June 2018: Fitch Ratings has affirmed Bulgaria's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB'. The Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Bulgaria's ratings are supported by its sound sovereign balance sheet and credible policy framework aimed towards gradual accession to eurozone membership. The economy is currently at a strong cyclical position and this will help Bulgaria's gradual convergence process towards higher income levels of higher rated sovereigns.

Bulgaria looks set to maintain economic growth above the average rate of its 'BBB' category peers. After real GDP growth of 3.6% in 2017, Fitch forecasts Bulgaria to grow 3.7% and 3.4% in 2018 and 2019, respectively. This compares with an average of 3.3% across its rating peers. Headline GDP growth will be mainly driven by domestic demand. Positive employment prospects, higher real wages and improved consumer confidence will support growth in household consumption. Private and public sector investment look set to rebound from a low base given the later stage of the EU structural fund cycle, favourable financing environment and improved business sentiment.

The European Commission estimates long-term potential growth over 2020-22 in the range of 2.3%-2.7%. Higher potential growth is constrained by structural headwinds present in the labour market, where worsening demographics contribute towards labour skill mismatches. Higher potential growth, and thus progress in income convergence, will depend on how successfully the authorities implement structural reform. Bulgaria's GDP per capita level currently stands below the 'BBB' median.

Inflationary pressures have picked up, consistent with closing of the output gap, higher wage growth and low unemployment. Fitch's forecast is for average inflation of 2.0% in 2018-2019, from 1.2% in 2017. As a small, highly open economy and price taker, Bulgaria is vulnerable to developments in global commodity prices. Inflation volatility in Bulgaria is higher than the peer group median (3.9% vs 1.9%). The impact of stronger domestic demand has also seen a pickup in core inflation (2.0% in March 2018 from an average 0.2% in 2017).

The strength of Bulgaria's sovereign's balance sheet remains a key support to its rating. Data revisions show Bulgaria achieved fiscal surpluses since 2016 (0.2% of GDP in 2016 and 0.9% of GDP in 2017). Based on current fiscal policies, surpluses will remain in 2018-2019, with Fitch forecasting an average surplus of 0.1% of GDP. A lower surplus reflects higher government spending, consistent with higher absorption of EU funds and increasing spending in priority sectors such as education, healthcare and defence. This includes an increase in public sector wages and various social benefits. Bulgaria has the fourth-lowest revenue to GDP ratios among EU states, although it is above the 'BBB' median. Tax policy remains focused on indirect taxes (hikes in excise duties) and tackling the shadow tax economy.

At 25.4% of GDP, Bulgaria's general government debt ratio is significantly below the peer median ratio of 40.5% of GDP. Projected primary fiscal surpluses will contribute to further debt reduction. Public debt sustainability is supported by the sovereign's low gross external financing needs (average 3.3% of international reserves, 2018-2019) and relatively long average residual debt maturity. The government faces no large upcoming debt redemption until 2022 (a EUR 1.25 billion

Eurobond), allowing the authorities to keep medium-term debt management focused on domestic markets.

Bulgaria's external finances outperform the majority of its 'BBB' peers. Gains in export market shares, sustained export competitiveness, anchored by real effective exchange rate stability, are set to continue supporting current account surpluses. Stronger domestic activity will result in a widening of the goods trade deficit, while dividend payments abroad will lower the income balance on account of the improved financial health of corporates. Nonetheless, Fitch forecasts an average current account surplus 1.9% of GDP for 2018-2019. This compares with a projected median current account deficit 0.7% of GDP for 'BBB' peers.

Bulgaria also has a stronger net external creditor position than its peers. In 2017, this reached 15.9% of GDP, from net debt of 45% in 2009. The median net external creditor position of 'BBB' category peers was 3.5% of GDP. External buffers are also high. Foreign reserves accounting for 47% of GDP, covering 8.6 months of imports, in addition to external liquidity at 296% (end-2017), provide more than adequate liquidity support for Bulgaria's long-standing and credible currency board regime.

Developments in the banking sector have been stable. Consistent with higher economic activity, credit demand has moderately picked up. Credit supply is ample. The sector's common equity Tier 1 capitalisation ratio was 20.4% end-2017. Asset quality has stabilised but non-performing loans (NPL) remain high. The gross NPL ratio (excluding exposure to banks) improved to 14.8% at end-2017 (end-2016: 18.3%), but remains high by EU standards. Efforts towards improving insolvency legislation, banking supervision and reduction of corporate NPLs are ongoing.

Bulgaria's governance indicators are in line with its 'BBB' category peers. There remains broad political consensus in favour of further EU integration, with the government expressing strong intentions in recent months for its preference to join ERMII as a first step towards eurozone membership.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Bulgaria a score equivalent to a rating of 'BBB+' on the Long-Term FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

-Macroeconomics: -1 notch, to reflect Fitch's view that structural bottlenecks, particularly labour market rigidities and adverse demographic trends, constrain potential growth compared with peers.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could, individually or collectively, could lead to positive rating action are:

-Stronger medium-term GDP growth potential.

-Progressive convergence towards income levels of higher rate peers.

The main factors that could, individually or collectively, could lead to negative rating action are:

-Re-emergence of external imbalances, for example from prolonged widening of the current account deficit and/or deterioration of external competitiveness.

- Fiscal deficits that result in deterioration of the public debt trajectory.
- Materialisation of contingent liabilities on the sovereign's balance sheet; for example, from state-owned enterprises.

KEY ASSUMPTIONS

- Fitch assumes the Bulgarian authorities will maintain continuity in economic and fiscal policies, and in relations with the EU.
- The global economy performs in line with Fitch's Global Economic Outlook.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'BBB'; Outlook Stable
Long-Term Local-Currency IDR affirmed at 'BBB'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'F2'
Short-Term Local-Currency IDR affirmed at 'F2'
Country Ceiling affirmed at 'A-'
Issue ratings on long-term senior unsecured debt affirmed at 'BBB'

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Applicable Criteria

Country Ceilings Criteria (pub. 21 Jul 2017)
<https://www.fitchratings.com/site/re/901393>
Sovereign Rating Criteria (pub. 23 Mar 2018)
<https://www.fitchratings.com/site/re/10024428>

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