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Research Update:

Bulgaria 'BBB-/A-3' Ratings Affirmed; Outlook Remains Positive

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Overview

- Bulgaria's monetary conditions continue to improve, credit conditions support growth, and the country is making steadfast progress on entering the Exchange Rate Mechanism II.
- We anticipate robust growth in 2018-2021 on the back of strong private consumption and accelerating investments. We also expect continued absorption of EU funding and tightening labor market conditions to support productivity over time.
- We are affirming our 'BBB-/A-3' long- and short-term sovereign credit ratings on Bulgaria.
- The outlook is positive.

Rating Action

On Nov. 30, 2018, S&P Global Ratings affirmed its 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Bulgaria. The outlook remains positive.

Outlook

The positive outlook reflects the considerable likelihood that Bulgaria will join the Exchange Rate Mechanism II (ERM II) over the next 12-18 months. We believe its aspiration toward eurozone membership would also support the country's continued effort to address remaining institutional impediments and structural issues.

We could raise the ratings on Bulgaria if the Bulgarian lev enters ERM II, which would, in our view, further support the credibility and effectiveness of monetary policy. Additional progress on institutional and structural reforms, for example regarding the judiciary system, could also facilitate improving creditworthiness.

We could revise the outlook to stable if the improvements in banks' balance sheets reversed or if pressures on Bulgaria's balance of payments emerged, for example due to rebuilding of imbalances or an external shock to Bulgaria's open economy. We could also revise the outlook to stable if Bulgaria's path toward euro adoption were derailed for a protracted period.

Rationale

The ratings on Bulgaria reflect its very low government indebtedness and sound fiscal policies, as well as a track record of external deleveraging. The ratings also take into account remaining institutional impediments and Bulgaria's low GDP per capita relative to other EU member states. Moreover, we factor Bulgaria's limited monetary policy flexibility under the currency board into our ratings, although the board has been an important anchor of stability for the country.

Institutional and Economic Profile: Near-term growth prospects are sound but longer-term structural challenges persist

- Domestic demand is propelling economic expansion, as EU fund absorption fuels investments and increases in disposable income spur private consumption.
- Political volatility could re-emerge as EU and local elections are coming up in 2019.
- Labor shortages are emerging as a key structural constraint for businesses, partly reflecting Bulgaria's demographic challenges.

Bulgaria's economy continues to expand at a robust pace despite a slight deceleration. For the full year 2018, we have slightly revised down our growth forecast to 3.6% from 3.9% in our previous review. Exports were weaker than expected at the beginning of the year, mainly due to one-off factors. Conversely, domestic demand soared as private consumption rose by over 7% in the first half of the year. This was mainly driven by strong labor market developments: Unemployment fell to a 10-year low of 5.9% in October.

Consequently, labor shortages are set to emerge. This is exacerbated by Bulgaria's demographic profile due to aging and emigration, with a projected decline of the population by around 5% by 2025. Furthermore, Bulgaria's labor force participation rate remains below the EU average, partly reflecting skills and regional mismatches. As such, we believe that greater activity could both underpin above-potential growth in 2018 and 2019, as well as mitigate overheating risks in the labor market.

Investments will also bolster economic expansion in the coming two to three years, as EU fund absorption is usually heavily tilted to the end of the programming period. The current implementation period is 2014-2020, with an additional three years to spend allocated funds after its end. Total allocated funds for Bulgaria exceed 20% of GDP and the absorption rate will reach approximately 30% by the end of the year, indicating the scope for acceleration in the coming years. In addition, the pickup in construction activity will also support growth.

HICP inflation has accelerated over the course of 2018, reaching 3.6% year on year in October 2018. At the same time, nominal wage growth has slowed compared with 2017. We think that wage growth is important for Bulgaria's income convergence with the EU average, and we currently do not observe pressures on external competitiveness, for example, as market share of Bulgaria's exports increase. In turn, Bulgaria is exposed to potential weaknesses in external demand from its main European trading partners.

Potential growth rates will remain constrained by the decreasing working age population. Although we think that net emigration is set to slow somewhat, public education and infrastructure bottlenecks remain structural impediments to faster income convergence. In addition, perceived institutional weaknesses remain, although we note the reform of anti-corruption legislation earlier this year. The newly established anti-corruption agency will have to garner credibility by building an unwavering track record of pushing back illicit activities.

The efficiency of the judiciary system remains a perceived weakness of the business environment, not least due to the crucial importance of unbiased contract enforcement. In that regard, the election of the new Supreme Judicial Council in 2017 has been an important step. At the same time, the transparent appointment of judges at all levels of the judiciary and the alleviation of bottlenecks at the busiest courts--usually in the capital city of Sofia--remains key.

The current government coalition, formed by center-right GERB and the United Patriots, has recently faced the resignations of several government members. Political volatility could flare up, depending on the results of the European elections in the spring and the local elections in the fall of 2019. That said, we currently expect overall policy continuity to be preserved over the next two to three years.

Flexibility and Performance Profile: Bulgaria has strong fiscal and external buffers

- Net government debt continues to decrease, the current account is in surplus, and external leverage is low.
- Nonperforming loans (NPLs) are declining rapidly.
- Bulgaria aims to join ERM II and the Banking Union in summer 2019.

Earlier this year, Bulgaria applied to enter ERM II, the waiting room for eurozone membership, and the Banking Union. In preparation, the ECB will conduct an asset quality review of six Bulgarian banks, with results expected for next year. Several amendments to Bulgaria's legislation are also prerequisites, and we understand that the government is pressing ahead with legislative changes to fulfill its commitments, according to its comprehensive action plan.

As part of the resulting changes to the Law on Credit Institutions, borrower-based macro-prudential tools will be introduced to strengthen the supervision framework. Other commitments concern the strengthening of supervision of insurers and pension funds, and a framework for their asset and liabilities valuation. Additional legislative amendments are ongoing in the fields of anti-money-laundering and the insolvency framework.

The Bulgarian authorities intend to join ERM II by July 2019, but this timeline will, in our view, ultimately hinge on political support from eurozone member states, which in turn could rely on macroeconomic conditions or political developments inherently out of the Bulgarian government's control. That said, Bulgaria is likely to be in compliance with Maastricht criteria and is making determined progress on institutional convergence commitments, for example on central bank legislation.

As part of its efforts to join ERM II, Bulgaria has committed to strengthening its state-owned enterprise (SOE) sector. In that regard, the management of SOEs would be more aligned with international good practices, and work in the field is currently ongoing together with the Organization for Economic Co-operation and Development. We understand that financials in the energy sector, including at Natsionalna Elektricheska Kompania, are improving. By year-end, the parliament will decide on the resumption of the construction of the Belene nuclear power plant with a strategic investor, and without government support. The government's accumulated liquid assets of roughly 10% of GDP provide a buffer against potential fiscal contingent liabilities, in our view.

Bulgaria has a track record of prudent fiscal policy, with general government surpluses in 2016-2017 and our expectation of another surplus in 2018. While strong cyclical revenue performance will continue to support the budget, the government plans to increase expenditures in 2019, for investments, but also according to its priorities in social and income policy (for example to boost teachers' wages). Consequently, we project that the general government balance will post an average deficit of 0.2% in 2019-2021 against the government's forecast of surpluses after 2019. Nonetheless, the overall prudent fiscal policies will enable further reduction of government debt net of liquid assets to 12% of GDP in 2021 from 14% in 2018.

Bulgaria's track record and commitment to fiscal prudency is also underpinning the credibility of its currency board regime. In 1997, Bulgaria introduced a currency board regime, which effectively guarantees the convertibility of euros (originally Deutsche Mark) into the lev at a fixed exchange rate. Over the past two decades, the authorities have accumulated fiscal and external buffers to underpin their commitment to the fixed exchange rate regime, and that commitment has not wavered, despite a series of external and domestic political shocks, since Bulgaria's 2007 accession into the EU. Bulgaria's foreign currency reserves comfortably cover the monetary base by over 1.6x as of end-September 2018. As per its charter--and according to the currency board regime under which it operates--the Bulgarian National Bank's (BNB's) ability to act as a lender of last resort is limited. BNB 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.

Bulgaria's current account surplus is set to narrow to 2.6% of GDP in 2018 from a very high 6.5% in 2017. Bulgaria's vulnerability to political and macroeconomic developments in its trading partners is a flipside of the increasing integration in global value chains--exports now account for almost 70% of GDP versus 50% in 2010. As domestic demand pulls in imports, we anticipate that the current account balance will swing to a deficit by 2021. We project net foreign direct investment to average below 2% in the coming years. This reflects generally lower capital flows and high savings, but removing perceived impediments to the business climate could also contribute to reviving direct investment flows. We also note that foreign direct investment in the manufacturing sector has been positive in recent years, a key difference to the high pre-2009 inflows into real estate investment, which contributed to the build-up of macroeconomic imbalances.

We observe that financial conditions are normalizing, not least as credit growth is accelerating, both in corporate and household lending. Moreover, NPLs in the banking sector have declined rapidly to 8.5% of total loans as of September 2018 from around 10% in the beginning of the year. Although this is still high in a European comparison, we expect that further de-risking will proceed until the end of the year. Overall, we think that Bulgaria's monetary transmission channel has improved, as interest rates remain favorable, bank credit has recovered, and private sector balance sheets are solid.

The Bulgarian banking sector is profitable and generally adequately capitalized. Three domestic institutions had to replenish their additional capital buffers following the 2016 asset quality review. With Bulgaria's transposition of the EU Banking Resolution and Recovery Directive in 2015, the failure of a bank will necessitate a bail-in of shareholders, creditors, and then a resolution fund. Only after exhausting these options would a bank be able to resort to government support. Banking supervision and regulation has been strengthening following the lessons learned from the liquidity pressure and the collapse of KTB (Corporate Commercial Bank) in 2014. For example, the BNB has consistently implemented measures to ensure the stability of banks (including subsidiaries), among other measures by strengthening their liquidity and capital buffers. The BNB recently announced an increase in the counter-cyclical capital buffer effective October 2019, in order to safeguard the system from cyclical risks linked to credit growth and real estate price growth. The close cooperation procedure under the auspices of the ECB will also lead to further alignment of supervisory practices as the country moves toward joining the banking union.

Key Statistics

Table 1

Bulgaria Selected Indicators

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. BGN)	82	82	84	89	94	101	108	114	121	127
Nominal GDP (bil. $)	54	56	57	50	53	58	65	68	76	81
GDP per capita (000s $)	7.4	7.6	7.8	7.0	7.4	8.2	9.2	9.7	10.8	11.6
Real GDP growth	0.0	0.5	1.8	3.5	3.9	3.8	3.6	3.6	3.2	3.0
Real GDP per capita growth	0.6	1.1	2.4	4.1	4.6	4.6	4.1	4.1	3.6	3.4
Real investment growth	1.8	0.3	3.4	2.7	(6.6)	3.2	9.0	9.0	7.0	6.8
Investment/GDP	21.9	21.1	21.5	21.2	19.1	20.1	21.1	22.0	22.8	23.7
Savings/GDP	21.1	22.3	22.8	21.2	21.7	26.6	23.8	22.1	21.2	20.2
Exports/GDP	60.8	64.9	64.9	64.1	64.0	67.4	66.0	65.3	64.2	63.3
Real exports growth	2.0	9.6	3.1	5.7	8.1	5.8	2.5	2.9	2.9	2.8
Unemployment rate	12.3	13.0	11.4	9.2	7.6	6.2	5.5	5.4	5.3	5.2
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(0.9)	1.3	1.2	(0.0)	2.6	6.5	2.6	0.1	(1.6)	(3.5)
Current account balance/CARs	(1.2)	1.7	1.7	(0.0)	3.6	8.7	3.6	0.2	(2.3)	(5.1)
CARs/GDP	68.9	74.2	72.5	71.3	71.1	74.8	73.1	72.2	70.6	69.6
Trade balance/GDP	(9.5)	(7.0)	(6.5)	(5.8)	(2.0)	(1.5)	(3.4)	(5.4)	(6.9)	(8.5)
Net FDI/GDP	2.5	3.0	0.3	5.0	1.3	2.1	1.4	1.9	1.9	1.9
Net portfolio equity inflow/GDP	(0.1)	(0.4)	(0.9)	(0.6)	(0.2)	(0.3)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	122.8	117.4	120.2	118.9	108.1	96.3	101.9	101.9	105.7	109.1
Narrow net external debt/CARs	5.0	0.7	(3.2)	(16.8)	(24.9)	(31.3)	(31.9)	(31.8)	(30.5)	(27.4)
Narrow net external debt/CAPs	5.0	0.7	(3.2)	(16.7)	(25.8)	(34.3)	(33.1)	(31.8)	(29.8)	(26.0)
Net external liabilities/CARs	106.4	93.5	81.0	74.8	53.9	48.4	39.3	36.0	33.5	34.8
Net external liabilities/CAPs	105.1	95.2	82.4	74.8	55.9	53.0	40.8	36.1	32.7	33.1
Short-term external debt by remaining maturity/CARs	43.8	41.6	41.0	44.2	30.1	25.6	26.5	25.0	24.6	23.6
Usable reserves/CAPs (months)	2.2	2.3	1.9	2.6	2.1	2.8	2.6	2.7	2.3	2.0
Usable reserves (mil. $)	7,914	6,544	7,640	6,430	9,315	9,790	11,092	10,722	10,142	8,710
FISCAL INDICATORS (%, General government)										
Balance/GDP	(0.3)	(0.4)	(5.4)	(1.7)	0.2	1.1	0.3	(0.2)	(0.2)	(0.2)
Change in net debt/GDP	0.3	2.0	6.7	1.7	(0.1)	(1.1)	(0.3)	0.2	0.2	0.2
Primary balance/GDP	0.5	0.4	(4.6)	(0.7)	1.1	1.9	1.0	0.5	0.5	0.5
Revenue/GDP	34.1	37.3	37.7	38.8	35.3	36.2	36.5	37.3	36.4	36.0
Expenditures/GDP	34.5	37.7	43.1	40.5	35.1	35.1	36.2	37.5	36.6	36.2
Interest /revenues	2.3	2.0	2.3	2.4	2.5	2.2	2.0	2.0	2.1	2.0
Debt/GDP	16.7	17.1	27.1	26.2	29.6	25.6	23.8	22.6	21.6	20.7
Debt/Revenue	48.9	45.7	71.9	67.6	83.9	70.9	65.1	60.5	59.2	57.4
Net debt/GDP	9.0	11.0	17.5	18.2	17.1	14.8	13.6	13.0	12.5	12.1
Liquid assets/GDP	7.7	6.1	9.7	8.0	12.5	10.8	10.1	9.5	9.0	8.6
MONETARY INDICATORS (%)										

Table 1

Bulgaria Selected Indicators (cont.)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
CPI growth	2.4	0.4	(1.6)	(1.1)	(1.3)	1.2	2.7	2.5	2.2	2.2
GDP deflator growth	1.6	(0.7)	0.5	2.2	2.2	3.4	2.8	2.6	2.4	2.2
Exchange rate, year-end (BGN/$)	1.48	1.42	1.61	1.79	1.86	1.63	1.71	1.63	1.57	1.57
Banks' claims on resident non-gov't sector growth	2.8	0.2	(7.6)	(1.6)	1.8	4.5	6.2	6.2	6.1	6.2
Banks' claims on resident non-gov't sector/GDP	68.1	68.3	61.7	57.5	55.0	53.5	53.4	53.4	53.6	54.0
Foreign currency share of claims by banks on residents	49.5	47.6	42.1	33.1	29.1	25.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	41.2	41.2	40.9	40.3	38.7	36.9	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(1.9)	1.3	(0.5)	(3.1)	0.1	2.2	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. BGN--Bulgarian lev. CARs--Current account receipts. N/A--Not applicable. 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

Bulgaria Ratings Score Snapshot

Key rating factors	
Institutional assessment	4
Economic assessment	4
External assessment	2
Fiscal assessment: flexibility and performance	2
Fiscal assessment: debt burden	1
Monetary assessment	5

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). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score 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 scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Banking Industry Country Risk Assessment Update: November 2018, Nov. 23, 2018
- Sovereign Ratings History, Nov. 7, 2018
- Sovereign Ratings List, Nov. 7, 2018
- Sovereign Risk Indicators, Oct. 11, 2018. An interactive version is also available at http://www.spratings.com/sri.
- Global Sovereign Rating Trends: Third-Quarter 2018, Oct. 3, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Global Sovereign Rating Trends 2018, Jan. 10, 2018
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions, April 18, 2017

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's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

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

Ratings Affirmed

Bulgaria	
Sovereign Credit Rating	BBB-/Positive/A-3
Transfer & Convertibility Assessment	A-
Senior Unsecured	BBB-
Short-Term Debt	A-3

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