S&P Global
Ratings

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Research Update:

Bulgaria Ratings Affirmed At 'BBB/A-2'; Outlook Stable

November 27, 2020

Overview

- We have moderated our estimate of Bulgaria's economic contraction in 2020 to 4.5%, since domestic demand has been more resilient than we expected to the impact of the pandemic.
- We expect relatively moderate fiscal deficits this year and next, followed by swift consolidation, supported by EU financial assistance.
- The Bulgarian lev was included in the European Exchange Rate Mechanism (ERM) II and Bulgaria joined the EU Banking Union in July this year. We expect ultimate accession to the eurozone could strengthen monetary arrangements, but we expect this process will take several years.
- We are affirming our 'BBB/A-2' sovereign credit ratings on Bulgaria and maintaining the stable outlook.

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Rating Action

On Nov. 27, 2020, S&P Global Ratings affirmed its 'BBB/A-2' long- and short-term foreign and local currency sovereign credit ratings on Bulgaria. The outlook is stable.

Outlook

The stable outlook reflects our expectation that Bulgaria's economy will rebound quickly following the pandemic. We expect no external or financial sector imbalances to emerge over the next two years. This should enable quick fiscal consolidation and curb the rise of public debt.

Upside scenario

We could raise the ratings if Bulgaria's economic recovery coincides with quicker fiscal consolidation or a stronger external performance than we currently project. In the long run, we could raise the ratings on Bulgaria in the course of its accession to the eurozone.

Downside scenario

We could lower the ratings if the economic contraction proved deeper or the subsequent recovery was delayed. This would likely result in protracted fiscal consolidation and continuously rising net public debt over the next few years. Although unlikely over the medium term, we could also take a negative rating action if we observed increased imbalances in Bulgaria's financial sector.

Rationale

We now expect Bulgaria's GDP to contract by 4.5% in 2020. Domestic demand has remained more resilient than we expected and mitigated a sharp drop in external demand. Overall, Bulgaria has entered the health crisis from a relatively strong external and fiscal position, which should enable a robust recovery over the coming years, supported by significant EU fund inflows. Fiscal space is available, since prudent financial policies over recent years have kept net general government debt below 15% of GDP so far. We think external vulnerabilities are manageable after years of external net deleveraging thanks to recurring current and capital account surpluses, also supported by EU fund inflows. At the same time, we note that the Bulgarian lev was included in the ERM II and Bulgaria joined the EU Banking Union in July 2020. Although the current currency board provides an important anchor of economic stability, our ratings also factor in the country's limited monetary policy flexibility under this arrangement. At the same time, the ratings are still constrained by the country's moderate GDP per capita in a global comparison and remaining structural institutional impediments.

Institutional and economic profile: The pandemic will temporarily dent Bulgaria's growth trajectory, but a robust recovery should follow

- COVID-19 case numbers have risen steeply over recent weeks, but the direct impact of the pandemic has been lower than in other Central and Eastern European countries so far.
- Strong domestic demand, as well as significant EU fund inflows, will provide the foundation for a robust economic recovery following the temporary contraction this year.
- After political turmoil in 2020, we believe further political challenges will follow in the wake of next year's election.

The direct health effect of the pandemic was less severe in Bulgaria in March and April this year because the country invoked a full lockdown when per capita infections were still low. As for many countries in the region, case numbers have risen continuously over the summer, which has led to a significant resurgence of the pandemic. We believe the government will try to avoid a second full lockdown and will instead implement more regionally targeted measures. Parallel to the containment measures to curb the spread of the virus, the authorities have also released fiscal support to cushion the economic impact. The most important fiscal measures include a comprehensive wage support scheme (estimated at about 0.8% of GDP); several wage increases for key workers; additional health care expenditure; and direct fiscal support and tax reductions for heavily affected sectors, such as recreation and hospitality. Other government measures included the increase of funds for public sector financial institutions, such as the Bulgarian Development Bank and the "Fund of Funds," which are aimed at fostering lending to the private sector, particularly small and midsize enterprises. The Bulgarian National Bank (BNB) has mandated that commercial banks capitalize the full amount of profits in the banking system and reduce external exposure to increase liquidity. Furthermore, the BNB cancelled the planned increase of the countercyclical capital buffer rate. These macroprudential adjustments occurred against the backdrop of a private moratorium on bank loan payments initiated by the Association of Banks in Bulgaria, which the BNB approved.

The swift policy response has contributed what we believe will be a somewhat milder economic contraction in 2020 than for other countries in the region. Other factors include a much lower initial direct health impact of the pandemic, as well as generally strong growth dynamics before 2020. Although growth forecasts are subject to high uncertainty and further containment measures by the government, we expect real GDP will contract by about 4.5% before recovering by 4% in 2021. Private investments and exports--in particular tourism--have been hit hard over the past months. However, consumption has been more resilient than initially expected. The government's wage support scheme has also helped to curb the rise in unemployment, which we expect to stand below 6% on average for 2020, compared with 4.2% in 2019.

We expect a relatively robust economic recovery. The economy will benefit from a rise in external demand since we expect the country's most important trade partners will recover in 2021. Despite a tightening labor market, we think that external competitiveness has been preserved, positioning Bulgaria well for further export growth. Labor costs in Bulgaria remain the lowest in the EU despite years of robust nominal wage growth. We note that in the five years before the pandemic, Bulgaria's growth was robust, averaging 3.6% in real terms, and this was not accompanied by macroeconomic imbalances. Bulgaria's recovery will also be supported by the intake of significant EU funds under the various programs from the EU's Multiannual Financing Frameworks for 2014-2020 and 2021-2027, as well as further EU support schemes, such as the Recovery and Resilience Facility. We currently estimate that Bulgaria could be eligible for EU funds totaling close to €30 billion over the period until 2027, which represents close to 50% of pre-pandemic GDP. This figure also includes almost €700 million of quickly available funds under the REACT-EU program, aimed at cushioning the economic effects of the pandemic. We believe it could be difficult to absorb the full amount of funds over the next few years, but the absorption rate should be high.

Over the medium term, we think demographics could hamper potential growth because the labor force continues to shrink due to aging and emigration. At this point, we don't think a return of Bulgarian workers after the pandemic could change this trend. These challenges highlight the need for continued structural reforms, for example through measures that address skill mismatches, improve the business environment, spur income growth, and ultimately help slow net emigration.

Such structural reforms may prove challenging in the current political environment. In the past, we have observed several episodes of political volatility in Bulgaria. This year saw the rise of a significant protest movement for several months, but the government was able to avoid early elections--the next general elections are scheduled for March 2021. In the absence of a major political shift, we expect the new parliament's composition could mirror the current fragmented political landscape, which will make the formation of a viable government coalition challenging. In all likelihood, this could result in a protracted coalition forming or even the necessity for a rerun of the elections. In any case, we expect the political decision-making process to become more complicated.

Importantly, we note that Bulgaria's EU membership and eurozone accession have consensus across the political spectrum, and therefore provide an important policy anchor. We believe that some EU institutions could continue to highlight the necessity for structural reforms regarding specific deficiencies surrounding the rule of law in the country, particularly since such assessments are likely to be tied to the absorption of EU funds going forward. However, we do not expect that such potential assessments will represent a continuous obstacle, given Bulgaria's past track record of adhering to the EU's recommendations and its uncontentious relations with the European Commission (EC). Bulgaria's progress in some of these areas has already been acknowledged in recent years, for example under the European Commission's Cooperation and Verification Mechanism in 2019. The country's ERM II and EU Banking Union accession this year also highlights Bulgaria's legislative efforts to strengthen macroprudential supervision, insolvency proceedings, state-owned enterprise management, nonbanking supervision, and anti-money-laundering.

Flexibility and performance profile: The pandemic's impact on public balance sheets will be temporary and manageable

- We expect moderate fiscal deficits this year and next, with subsequent consolidation; general government debt will therefore remain low.
- The Bulgarian lev was included in the ERM II in July 2020, an important milestone on the path to eurozone accession.
- A balanced current account and low net external debt provide effective buffers against external headwinds.

We think that Bulgaria will maintain its generally prudent fiscal policies despite a temporary general government deficit, which we project at about 5% of GDP in 2020. The deficit is a result of lower tax revenue, due to the economic contraction, as well as the sizable support measures. We expect deficits will remain at a similar level in 2021 before narrowing to less than 2% of GDP in 2023. The projected swift recovery means that the economy will likely not require continuous fiscal stimulus over the coming years. At the same time, Bulgaria has built a very credible track record of tight fiscal management, not least fostered by the currency board, which resulted in general government surpluses over the past four years. We expect the government to revert to this fiscal stance following the pandemic.

The previously tight fiscal stance has also supported public deleveraging over recent years. In our view, general government debt, net of liquid government assets, will rise to about 23% of GDP in 2023, from about 12% before the pandemic. Despite increased future financing needs, we believe that the government's funding options remain plentiful. In addition to a liquid domestic banking system, the current and credible monetary policy arrangements have allowed Bulgaria to tap the deep eurozone capital markets at favorable terms over recent years. As a result, the majority of Bulgaria's debt is denominated in euros and held by nonresidents. In our debt projection for 2020, we include the Bulgarian lev (BGN) 700 million capital increase for the Bulgarian Development Bank for supporting lending to nonfinancial enterprises and individuals, as well as the additional capital needed to cover First Investment Bank's BGN195 million capital increase ahead of Bulgaria's ERM II accession. We also note that the energy sector has in the past been a source of contingent fiscal risk.

The Bulgarian lev was included in the ERM II and Bulgaria joined the Banking Union in July this year. The ERM II represents the waiting room for ultimate eurozone membership, which we expect will occur only after a few more years, given that political considerations outside Bulgaria's control could have an influence on this decision. The ultimate decision lies with the eurozone's and Denmark's finance ministers, as well as with the European Central Bank (ECB). We expect that as of now, the ERM II membership will have limited impact on the BNB's operations. We expect the ECB and BNB will further strengthen their close cooperation, particularly with respect to Bulgaria's integration into the Single Supervisory Mechanism. The current swap line agreement between the ECB and the BNB, totaling €2 billion, further highlights the increasing ties between the two institutions.

Bulgaria's central bank will continue to operate under its currency board, which has been in place since 1997. The arrangement effectively guarantees the convertibility of the lev into euros and vice versa at the fixed exchange rate. Therefore, for our measure of useable reserves, we subtract the country's monetary base. Over the past two decades, authorities have accumulated fiscal and external buffers to underpin their commitment to the fixed exchange rate regime. That commitment has not wavered, despite a series of external and domestic political shocks since Bulgaria's 2007 accession to the EU. The currency board regime and the BNB charter allow provision of liquidity support to the banking system only to the extent that the BNB's foreign exchange reserves exceed its monetary liabilities. Even then, support can occur only under certain conditions and for short periods, against highly liquid collateral.

We project Bulgaria's current account surplus will narrow significantly in 2020, but remain in surplus this year and next. The reduction comes on the back of contracting services exports, particularly tourism, which generally represents 40% of services exports. We also note the high dependency of Bulgarian exports on external demand, which remains volatile. Given the currently strong domestic demand, we therefore project a worsening of Bulgaria's goods and services balance, which will persist over the next few years. At the same time, we also expect lower inflows from remittances and foreign direct investment in 2020, which will only be partially counterbalanced by contracting primary income outflows. However, we believe that EU fund inflows, which are mostly reflected in the transfer balance and the capital account, will pick up over the next several years.

These current account dynamics will support Bulgaria's strong external position, which was characterized by significant net external deleveraging over the past few years. In our view, Bulgaria's liquid external assets will continue to exceed external debt significantly, by 35%-40% of current account payments over 2020-2023. Reserve levels have also risen markedly this year, benefitting from a Eurobond placement by the government this year, as well as a reduction of the banking sector's external asset exposure, in line with the central bank mandate, some of which ultimately result in an increase of BNB's foreign currency reserves. These dynamics will help keep external liquidity at comfortable levels--we expect annual gross external financing needs will total only slightly over 100% of current account receipts and usable reserves over the coming years.

Bulgaria's banking sector is profitable, very liquid, and generally adequately capitalized. With the 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--if necessary and under certain conditions--a resolution fund. Only after exhausting these options and in an extraordinary situation of a systemic crisis would a bank be able to resort to government support. The BNB has consistently implemented measures to ensure the stability of banks (including subsidiaries), among other measures, by strengthening their liquidity and capital buffers. Close cooperation with the ECB will also lead to further alignment of supervisory practices.

Key Statistics

Table 1

Bulgaria Selected Indicators

Mil BGN	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. BGN)	84	89	95	102	110	120	115	122	129	136
Nominal GDP (bil. $)	57	51	54	59	66	69	67	74	79	83
GDP per capita (000s $)	7.9	7.0	7.5	8.3	9.4	9.8	9.6	10.7	11.4	12.1
Real GDP growth	1.9	4.0	3.8	3.5	3.1	3.7	(4.5)	4.0	3.3	3.3
Real GDP per capita growth	2.4	4.6	4.5	4.3	3.9	4.4	(4.2)	4.4	3.7	3.7
Real investment growth	3.5	2.7	(6.6)	3.2	5.4	4.5	(7)	5.0	5.0	5.0
Investment/GDP	21.6	21.0	19.0	19.9	21.3	21.1	20.9	21.0	21.2	21.4
Savings/GDP	22.8	21.2	22.2	23.4	22.2	24.1	21.3	21.4	21.1	21.0
Exports/GDP	64.8	64.0	64.0	67.3	65.8	64.2	57.0	59.0	58.6	58.2
Real exports growth	3.1	6.4	8.6	5.8	1.7	3.9	(10)	7.5	3.0	3.0
Unemployment rate	11.4	9.2	7.6	6.2	5.2	4.2	5.8	5.8	5.3	5.1
External indicators (%)										
Current account balance/GDP	1.2	0.1	3.2	3.5	1.0	3.0	0.4	0.4	(0.1)	(0.4)
Current account balance/CARs	1.7	0.2	4.5	4.7	1.3	4.2	0.7	0.6	(0.1)	(0.6)
CARs/GDP	72.4	71.4	71.1	74.7	73.2	71.2	63.2	64.9	64.6	64.1
Trade balance/GDP	(6.5)	(5.7)	(2.0)	(1.5)	(4.8)	(4.7)	(6.0)	(6.1)	(6.5)	(7.0)
Net FDI/GDP	0.3	4.1	1.1	2.5	1.4	1.3	1.0	1.0	1.5	1.5
Net portfolio equity inflow/GDP	(0.9)	(0.6)	(0.2)	(0.3)	(0.8)	0.7	0	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	120.2	118.6	107.3	99.6	103.9	102.0	106.4	104.2	105.5	106.5
Narrow net external debt/CARs	(3.2)	(16.7)	(24.6)	(30.4)	(32.4)	(34.9)	(40.1)	(37.0)	(38.2)	(40.5)
Narrow net external debt/CAPs	(3.2)	(16.7)	(25.8)	(31.9)	(32.8)	(36.5)	(40.4)	(37.3)	(38.1)	(40.3)
Net external liabilities/CARs	81.0	72.9	52.1	50.8	40.4	35.4	41.9	33.7	29.4	25.9
Net external liabilities/CAPs	82.4	73.1	54.5	53.3	41.0	37.0	42.2	33.9	29.4	25.7
Short-term external debt by remaining maturity/CARs	41.0	43.8	29.8	25.3	26.3	25.1	29.3	28.3	27.2	25.7
Usable reserves/CAPs (months)	1.9	2.5	2.1	2.7	2.5	2.3	2.5	2.7	2.5	2.2
Usable reserves (mil. $)	7,640	6,430	9,315	9,790	9,012	8,835	10,892	10,570	9,957	8,824
Fiscal indicators (general government; %)										
Balance/GDP	(5.4)	(1.7)	0.1	1.1	2.0	1.9	(5.1)	(5.0)	(2.5)	(1.5)
Change in net debt/GDP	6.7	1.7	(0.1)	(1.1)	(1.1)	0.4	5.1	5.0	2.5	1.5
Primary balance/GDP	(4.6)	(0.8)	1.0	1.9	2.6	2.5	(4.5)	(4.3)	(1.7)	(0.7)

Table 1

Bulgaria Selected Indicators (cont.)

Mil BGN	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue/GDP	37.9	38.7	35.1	36.0	38.5	38.2	37.5	38.0	38.0	38.0
Expenditures/GDP	43.3	40.4	35.0	34.9	36.6	36.3	42.6	43.0	40.5	39.5
Interest/revenues	2.3	2.4	2.5	2.2	1.7	1.5	1.5	1.9	2.1	2.1
Debt/GDP	27.1	26.0	29.3	25.3	22.3	20.2	27.7	30.4	30.8	30.3
Debt/revenues	71.5	67.2	83.5	70.2	57.8	52.9	73.9	80.0	81.2	79.7
Net debt/GDP	17.4	18.1	16.9	14.6	12.6	11.9	17.5	21.5	22.8	23.1
Liquid assets/GDP	9.7	7.9	12.4	10.7	9.7	8.3	10.2	8.9	8.0	7.2
Monetary indicators (%)										
CPI growth	(1.6)	(1.1)	(1.3)	1.2	2.6	2.4	0.6	1.3	2.2	2.3
GDP deflator growth	0.5	2.4	2.5	3.9	4.0	5.3	0.7	1.6	2.5	2.5
Exchange rate, year-end (BGN/$)	1.61	1.79	1.86	1.63	1.71	1.74	1.65	1.63	1.63	1.63
Banks' claims on resident non-gov't sector growth	(7.6)	(1.6)	1.8	4.5	8.9	9.7	2.5	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	61.6	56.9	54.4	52.9	53.7	54.0	57.5	57.2	56.7	56.3
Foreign currency share of claims by banks on residents	42.1	33.1	29.0	25.3	23.6	23.5	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	40.9	40.3	38.7	36.9	35.9	34.6	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(0.8)	(3.3)	0.2	1.1	3.3	0.4	N/A	N/A	N/A	N/A

Sources: Eurostat (Economic Indicators), Bulgarian National Bank (External Indicators), Eurostat (Fiscal Indicators), and Bulgarian National Bank, IMF (Monetary Indicators).
Adjustments: Usable reserves adjusted by subtracting monetary base from reported international reserves.
Definitions: 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 claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. BGN--Bulgarian lev. 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

Bulgaria Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	4	Reduced predictability of future policy responses, for example in episodes of heightened political volatility. Transparency and checks and balances can at times be hampered

Table 2

Bulgaria Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
Economic assessment	4	Based on GDP per capita (US$) and growth trends as per Selected Indicators in Table 1.
External assessment	2	Based on narrow net external debt and gross external financing needs/(CAR + useable reserves) as per Selected Indicators in Table 1.
Fiscal assessment: flexibility and performance	2	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	1	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in Table 1.
		80% of gross government debt is denominated in foreign currency.
Monetary assessment	5	The lev has been fixed to the euro via a currency board.
		The Bulgarian National Bank has been successful in maintaining a currency board, supported by political commitment to prudent fiscal policies. 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.
Indicative rating	bbb-	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	1	A change in the fiscal assessment or the external assessment could lead to a multi-notch change in the indicative rating. We think that the weakening of the fiscal assessment might prove transitory after the pandemic given Bulgaria’s strong track record of fiscal prudency. At the same time, a quicker recovery of the export base or a further increase in reserve levels could result in an improvement of the external score.
Final rating		
Foreign currency	BBB	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt.
Local currency	BBB	

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 Dec. 18, 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- The Case For Bold Fiscal Stimulus In The Eurozone, Nov. 17, 2020
- Sovereign Ratings List, Nov. 9, 2020
- Sovereign Ratings History, Nov. 9, 2020
- Sovereign Ratings Score Snapshot, Nov. 2, 2020
- European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery, Oct. 14, 2020
- Sovereign Risk Indicators, Oct. 12, 2020; a free interactive version is available at http://www.spratings.com/sri
- Economic Research: Keynes And Schumpeter Are What The European Economy Needs Right Now, Oct. 12, 2020
- Bulgaria's And Croatia's Entry Into ERM II Will Gradually Strengthen Their Monetary Arrangement, July 13, 2020
- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020

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/Stable/A-2
Transfer & Convertibility Assessment	A
Senior Unsecured	BBB