FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Bulgaria's Outlook to Positive; Affirms at BBB

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Related Fitch Ratings Content:
Bulgaria - Rating Action Report

Fitch Ratings - Frankfurt am Main - 19 Feb 2021: Fitch Ratings has revised the Outlook on Bulgaria's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Positive from Stable and affirmed the IDR at 'BBB'.

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

KEY RATING DRIVERS

The revision of the Outlook reflects the following key rating drivers and their relative weights:

MEDIUM

Bulgaria's Positive Outlook reflects the dissipation of macroeconomic risks stemming from the Covid-19 pandemic, underpinned by a more resilient economy and a sound policy framework, as well as continued gradual progress towards euro adoption. In Fitch's view, short-term downside risks tied to the coronavirus pandemic and an uncertain electoral outcome are largely offset by prospects of substantial funding for investment from the EU and broad commitment to macro and fiscal stability (anchored by the long-standing currency board framework and by the inclusion of the Bulgarian lev into Exchange Rate Mechanism II; ERMII).

Fitch now estimates a 4% contraction in 2020, compared with our previous 5.7% forecast and a 6.9% contraction for 'BBB' peers. Private consumption proved much more resilient in 2020 thanks in part to fiscal support measures, while key sectors such as manufacturing were less affected due partly to lighter restrictions than in other EU countries. Although economic activity will remain weak in 1H21 due to ongoing challenges from the health crisis--including the slow pace of vaccination--Fitch expects growth to accelerate from 2H20, as the effects of the pandemic wane, and consumption and investment are driven by higher external demand and EU Fund absorption.

Bulgaria is set to be one of the main beneficiaries of EU transfers in the coming years, including EUR16.6 billion (27% of 2020 GDP) in next 2021-27 Multi Annual Framework and EUR7.5 billion (12% of GDP) in grants from Next Generation EU (NGEU). Although there are questions surrounding the capacity of Bulgaria to absorb such a large amount of funds, Fitch believes this could lift growth from a projected 3% in 2021 to 4%-5% in 2022-25.

Fitch has yet to make an assessment about the impact of NGEU on longer-term growth potential, as the draft plans have yet to be finalised. An effective programme implementation could help lift investment and productivity, offsetting structural constraints such as an ageing population. The European Commission estimates an average 12% decline in the labour force in each of the next three decades (one of the sharpest falls in the EU).

Following entry into ERMII in July 2020, the authorities are now targeting euro adoption by January 2024. At present, Bulgaria meets all quantitative ERMII convergence criteria except for price stability. Inflation has been trending downwards since 2H20 (headline harmonised consumer price inflation was negative 0.4% in January 2021) and is expected to remain low as a negative output gap persists, reducing the risks that the Bulgaria-eurozone inflation differential becomes a temporary obstacle for euro adoption. Bulgaria will also have to show progress on meeting structural commitments, some of which might be delayed given political dynamics. Nevertheless, at present there is commitment across the political spectrum on euro adoption. Overall, Fitch considers euro adoption as supportive to the rating, as underlined by our view that all things being equal, we would upgrade Bulgaria's Long-Term Foreign-Currency IDR by two notches between admission to the ERM II to joining the euro.

Bulgaria's 'BBB' rating also reflects the following rating drivers:

Bulgaria's ratings are supported by its strong external and fiscal balance sheets and credible policy framework, underpinned by EU membership and a long-standing currency-board arrangement. The ratings are constrained by slightly lower income levels compared with the current 'BBB' median and unfavourable demographics, which could hinder growth and weigh on government finances over the long term. Governance indicators are slightly above peers.

Despite the economic fallout from the pandemic, Bulgaria's public finance metrics have remained strong compared with 'BBB' peers and EU member states, thanks to a long track record of fiscal prudence. Fitch estimates the fiscal deficit at 4% of GDP in accrual terms in 2020 (compared with the 6.9% peer median), driven mostly by Covid-19-related expenditure measures of around 3% of GDP. Revenue outperformed the revised budget targets, thanks in part to improvements in tax collection and a less pronounced economic contraction than previously expected.

We forecast an unchanged fiscal deficit in 2021, reflecting increased willingness by the authorities to extend income support measures (with discretionary measures potentially higher than in 2020), as well as planned wage and pension hikes. The authorities plan a gradual narrowing of the deficit starting in 2022 as nominal growth speeds up and the need for pandemic-related support fades. In our view, the upcoming legislative elections pose limited downside risks to the medium-term fiscal outlook, with commitment to fiscal prudence well entrenched across the political spectrum.

Under our baseline scenario, general government debt/GDP will rise to 25.2% in 2021-22 from 20.2% in 2019, less than half the current 'BBB' median. Low indebtedness, combined with very favourable financing conditions and liquid fiscal reserves of BGN8.6 billion in December (7.4% of GDP), provide substantial fiscal buffers. Risks from contingent liabilities are modest (10.7% of GDP at end-2019 versus 44.2% EU average), while government guaranteed debt has remained low (estimated at 1.4% of GDP end-2020) reflecting only modest use of such schemes during the pandemic.

Legislative elections scheduled for 4 April are likely to result in a fragmented parliament, with polls showing relatively weak support for the two main parties, centre-right GERB and centre-left BSP. There is high uncertainty at present about the shape of the next government, but issues around rule of law, institutional quality and corruption have taken centre stage. Although government formation could take time and a multi-party coalition could prove highly unstable, at present Fitch does not see major risks to economic policy or to Bulgaria's commitment to the EU. That said, the next government will likely face pressures to implement political/institutional reforms in order to avoid social protests similar to those in summer 2020.

Bulgaria's solid external finances are a rating strength and a factor that has helped reduce macro vulnerabilities. Like other countries in the region, Bulgaria saw a sharp fall in goods and services exports due to much weaker global demand, which was only partly offset by import compression. Following a narrowing of the current account surplus to an estimated 1% of GDP in 2020, we expect a modest improvement in 2021-22 thanks to a recovery in exports and remittances. Bulgaria's foreign reserves increased to over 50% of GDP at end-2020, which combined with ongoing external deleveraging by the private sector, has pushed the net external creditor position to above 30% of GDP in 2020 according to Fitch's estimates (compared with the 'BBB' median net debtor position of 7%).

The country's banking sector remains liquid and well capitalised (total capital ratio of 22.9% at 3Q20), with the Bulgarian National Bank maintaining a cautious approach to safeguard the sector. Bulgaria's entry into the Banking Union in October 2020 means that supervisory capacity will be reinforced, and in case of resolution Bulgarian banks will have access to the Single Resolution Fund. Asset quality remained broadly stable for most of 2020 (non-performing loans were 8.2% of customer loans at end-2020), held down by loan moratoria measures (which by end 2020 was 12.6% of total loans to non-financial corporates and households). As the moratoria expire, asset quality is likely to deteriorate but the sector is well positioned to absorb such losses and the authorities are likely to put pressure on banks to address delinquency issues promptly.

ESG

ESG - Governance: Bulgaria has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Bulgaria has a medium WBGI ranking in the 61th percentile, reflecting a history of unstable coalitions, relatively high perceptions of corruption and moderate institutional capacity versus track record of peaceful transitions and above average regulatory quality.

RATING SENSITIVITIES

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

-Structural/External: Progress toward eurozone accession, including greater confidence in Bulgaria meeting membership criteria and the likely timing of euro adoption.

-Macro: An improvement in growth potential, for example via the implementation of structural and governance reforms to improve the business environment and/or effective implementation of EU funds, that leads towards faster convergence with income levels of higher rated peers which would cause the removal of the -1 QO notch on Macro.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Macro/Structural: Adverse policy developments, for example following period of political paralysis, that reduce confidence in economic recovery and the policy framework.

- Fiscal: A prolonged rise in public debt driven for example by persistent fiscal easing, the materialisation of contingent liabilities on the sovereign's balance sheet or weaker growth prospects.

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 Foreign-Currency (LT 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:

-Macroeconomic Performance, Policies and Prospects: -1 notch, to reflect Fitch's view that adverse demographic trends and slow progress on structural reform constrain potential growth over the long term

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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

The global economy performs broadly in line with Fitch's latest Global Economic Outlook published on 7 December 2020. Eurozone real GDP forecast to recover by 4.7% in 2021 and 4.4% in 2022.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Bulgaria has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight.

Bulgaria has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. Some of these issues have held back implementation of structural reforms and hindered medium-term growth potential.

Bulgaria has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as World Bank Governance Indicators, which have the highest weight in Fitch's Sovereign Rating Model (SRM), are relevant to the rating and a rating driver.

Bulgaria has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Bulgaria, as for all sovereigns.

Bulgaria has an ESG Relevance Score of 4 for Demographic Trends as a falling and ageing population hinder the economy's medium term growth potential. This is relevant to the rating and a rating driver.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Bulgaria	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Stable
•	ST IDR	F2	Affirmed	F2
•	LC LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Stable
•	LC ST IDR	F2	Affirmed	F2
•	Country Ceiling	A-	Affirmed	A-
• senior	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Sovereigns Europe Bulgaria