FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Bulgaria at 'BBB'; Outlook Positive

Fri 12 May, 2023 - 5:01 PM ET

Fitch Ratings - Frankfurt am Main - 12 May 2023: Fitch Ratings has affirmed Bulgaria's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Positive Outlook.

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

KEY RATING DRIVERS

Credit Fundamentals: Bulgaria's ratings are supported by its strong external and public balance sheets versus 'BBB' peers and credible policy framework, underpinned by EU membership and a long-standing currency board. This is balanced by low level of investments/GDP and unfavourable demographics, which weigh on potential growth and government finances over the long term. World Bank Governance Indicators (WBGI) have worsened in recent years, reflecting a history of unstable coalitions and relatively high perception of corruption.

Positive Outlook: The Positive Outlook reflects the prospects of euro adoption, which would lead to further improvement in external metrics. Despite a series of inconclusive snap elections over the past two years, Fitch believes the key political parties remain committed to euro adoption. We think that required legislative amendments should be adopted once the political environment stabilises, with risks around the timeline for eurozone entry mainly tied to meeting price stability criterion.

Euro Adoption Process: The government postponed the target date for euro adoption into 2025 due to elevated inflation and a delay in adoption of necessary legislation. While HICP inflation in Bulgaria has begun to ease in recent months, it remains significantly above the rate of three best performing EU member states, and Bulgaria does not currently comply with price stability criterion. Given considerable uncertainty about the trajectory of inflation, it remains questionable whether Bulgaria will meet the price stability criterion in mid-2024 (the key date for 2025 euro adoption). Croatia was able to meet this criterion after the exclusion of two outliers from the calculation.

Meeting all other criteria (public finances, interest rate and exchange rate) is less challenging. Overall, we consider euro adoption as supportive of 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 the inclusion of the Bulgarian lev into ERM II to joining the eurozone.

Prolonged Political Instability: Political instability extended into 2023 as another early election, the fifth in two years, took place in April. The latest snap vote followed inconclusive coalition negotiations after the October 2022 election, and once again resulted in a highly fragmented legislature. Although there is a broad political consensus on the reform agenda and policy direction, the coalition negotiations remain difficult, despite the absence of substantive policy differences between the two main parties. In Fitch's view, the prolonged political instability has begun to weigh on Bulgaria's real economy as it has slowed EU funds absorption and progress on Recovery and Resilience Facility (RRF) reforms.

Inflation to Moderate Slowly: Fitch projects average HICP inflation of 9.6% in 2023 (vs. current 'BBB' median at 6.4%), down from 13% in 2022. While lower global commodity prices and strong base effects should bring headline inflation down this year, solid domestic demand will keep core pressures elevated, resulting in average HICP inflation of 4% in 2024. Wage dynamics have been broadly in line with inflation, with gross nominal wage growth at 12.8% in 2022, predominantly driven by private sector increases. Our inflation forecast remains subject to substantial uncertainty, mainly stemming from the potential duration of second-round effects.

Weakening Growth Outlook: Fitch expects growth to decelerate to 1.3% in 2023, from 3.4% in 2022. We expect a sharp decrease in inventories, as companies lower their stocks, and moderation of private and public consumption. Private consumption will nonetheless continue to benefit from the solid labour market, with minimum wage and social payment increases supporting lower-income households. We expect investment growth to start to pick up as EU funds flows increase. In 2024, growth should accelerate to 2.6%. The delay in implementation of RRF reforms is the key negative risk factor.

Uncertain Budget Outlook: This year's fiscal performance is uncertain as the caretaker government operates under provisions of the 2022 budget law. We expect the general government deficit to widen to 3.4% of GDP in 2023, from 2.8% in 2022, in line with current 'BBB' median. Strong nominal GDP growth will support tax revenues, while increases of pensions and public sector wages, and a pick-up in capex will push expenditures up. A record of fiscal prudence and the commitment of key political parties to fiscal consolidation supports our view that the medium-term fiscal trajectory should not be threatened. We expect the budget deficit to narrow toward 2.5% of GDP in 2024.

Low Public Debt: Despite wider deficits expected in the medium term, Bulgaria's public debt ratio will remain very low compared with EU countries and 'BBB' peers. We expect the public debt/GDP ratio to remain below 30% during the forecast horizon. Almost all public debt is at a fixed rate, with a long average maturity. This leaves Bulgaria less exposed to monetary tightening abroad. We see general government interest payments increasing only marginally to 1.6% of revenues in 2023, well below the current 'BBB' median of 7.2%.

Strong External Finances: We expect the current account deficit to remain broadly unchanged at 0.5% of GDP in 2023-2024 as weaker external demand should be offset by an improvement in terms of trade. The current account deficit will continue to be offset by steady inflows of FDI and higher EU transfers. Bulgaria's external position is supported by sizeable foreign reserves and private-sector deleveraging. As a result, we expect Bulgaria's net external position to further improve in 2023-2024 (surplus of 34% of GDP in 2022, compared with the 'BBB' median of 2.1% of GDP deficit).

Stable Banking Sector: The Bulgarian banking sector remains stable, with solid capitalisation (at 20.9% at end-2022) and improving asset quality. The ratio of non-performing loans decreased to 5.2% at end-2022 from 6.5% at end-2021, according to Fitch's estimates. Loans to non-financial corporates increased by 10.4% at end-2022, reflecting strong demand for short-term financing, mainly for working capital. Growth of loans to households was 14.6% at end-2022, with housing loans rising by

17.9%. Although the majority of loans are floating rate, the pass-through of rising interest rates in the euro area to interest rates in Bulgaria is slow at present due to significant liquidity and competition in the banking sector.

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. Theses scores reflect the high weight that the WBGI have in our proprietary Sovereign Rating Model. Bulgaria has a medium WBGI ranking at 55th percentile, reflecting a history of unstable coalitions, relatively high perception of corruption and moderate institutional capacity versus track record of peaceful transitions and above average regulatory quality.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-External Finances/ Structural: Lack of progress in eurozone accession due to persistent political instability or a failure in meeting convergence criteria.

-Macro: Lower medium-term growth prospects driven by, for example, a large adverse macroeconomic shock or inflation entrenched at high levels.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-External Finances: 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 use of EU funds.

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 did not adjust the output from the SRM to arrive at the final LT FC IDR.}

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.

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 WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI 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. As Bulgaria has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4[+]'for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

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. As Bulgaria has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Bulgaria	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Positive
	ST IDR	F2	Affirmed	F2
	LC LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Positive
	LC ST IDR	F2	Affirmed	F2

	Country Ceiling	A-	Affirmed	A-
senior unsecured	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. 06 Apr 2023) (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, v1.7.3 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.13.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bulgaria	EU Issued, UK Endorsed

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Sovereigns Europe Bulgaria