Standard & Poor's Research

Bulgaria (Republic of)

Primary Credit Analyst:
Marko Mrsnik, Madrid (34) 91-389-6953; marko_mrsnik@standardandpoors.com

Secondary Contact:
Frank Gill, London (44) 20-7176-7129; frank_gill@standardandpoors.com

Table Of Contents

Bulgaria (Republic of)

Major Rating Factors

Sovereign Credit Rating
BBB/Stable/A-2

Strengths:

- Favorable economic growth prospects.
- Political consensus favoring macroeconomic stability and supporting the country's currency board arrangement.
- Solid budgetary performance, low government debt, and low contingent liabilities.

Weaknesses:

- Relatively low GDP per capita.
- Relatively high external debt, although improving.

Rationale

The ratings on the Republic of Bulgaria reflect Standard & Poor's Ratings Services' view of: the government's strong track record of appropriate fiscal policy and low gross debt, despite the severe recession and subsequent slow recovery; and the country's solid growth prospects in the medium term, particularly if they are backed by improving absorption of EU funds and other benefits stemming from EU membership. Somewhat offsetting these strengths are: relatively low GDP per capita; and large, albeit correcting, external imbalances and related risks, given the adverse economic backdrop.

After 1.7% GDP growth in 2011, we expect the economy to grow by about 0.5% in 2012. This is on the back of continued weakness in domestic demand and moderation of previously strong export performance, amid a decline in external demand in particular from the EU. But as recovery in external demand trickles through the economy and spurs domestic demand, we believe that annual real GDP growth could reach 3% after 2013. Meanwhile, we believe the reliance on export growth will likely support the stabilization of the current account, which is likely to move close to balance before slipping into deficit as domestic demand recovers. In our view, net equity inflows and EU transfers will nonetheless cover this external imbalance.

We believe the Bulgarian government has appropriately addressed budgetary deterioration, despite a deep recession, a relatively high budget deficit in 2009, and slow subsequent economic recovery. We expect the government to overperform this year's budget deficit target of 1.6% of GDP and to cut the deficit further in the coming years. As a result, we expect general government debt will be around 17% of GDP in 2012 and decline thereafter. In keeping with Bulgaria's legal requirements and past budgetary performance, the government maintains a fiscal reserve. Considering the sovereign's fiscal reserve--established to cover at least one year of amortization and interest payments--net government debt will reach about 10% of GDP in 2012, in our opinion.

The banking sector in Bulgaria appears well capitalized--with a capital adequacy ratio at 16.7% at end–second-quarter 2012--and liquid. It is able to contain the risks represented by the deterioration in asset quality reflected in the nonperforming loan (NPL) ratio of 16.9% at end-June 2012. The system is largely foreign-owned; therefore, problems that have affected foreign banks, such as dislocations in the financial sectors of other European economies, have had a knock-on effect on Bulgarian banks. In particular, Greek banks own about one-third of the banking system, which has increased risks for Bulgarian banks with respect to the provision of liquidity and capital. The country's strong regulatory and supervisory framework and bilateral standstill agreements between the Bulgarian central bank and several key commercial banks contribute to the financial stability of the banking system.

Outlook

The stable outlook balances our view of Bulgaria's favorable fiscal position and economic growth prospects against its external debtor position. If the country's fiscal position weakens or its external liquidity position deteriorates, downward pressure could build on the ratings. On the other hand, if external conditions for the financial system ease and exports continue to lead economic growth toward a more balanced structure, while eroding the external debt burden, we could consider raising the ratings.

Table 1

Republic of Bulgaria - Selected Indicators

	2005	2006	2007	2008	2009	2010	2011	2012e	2013f	2014f	Median BBB
GDP per capita ($)	3,723	4,302	5,484	6,783	6,385	6,310	7,130	6,775	7,149	7,721	12,830
Real GDP (% change)	6.4	6.5	6.4	6.2	(5.5)	0.4	1.7	0.5	1.7	2.5	3.0
Real GDP per capita (% change)	6.9	7.1	7.0	6.7	(5.1)	1.0	2.5	0.8	2.0	2.8	2.4
General government balance (% of GDP)	1.0	1.9	1.2	1.7	(4.3)	(3.1)	(2.1)	(1.3)	(1.0)	(0.5)	(2.8)
General government debt (% of GDP)	27.5	21.6	17.2	13.7	14.6	16.3	16.3	17.0	17.2	16.8	41.3
Net general government debt (% of GDP)	17.0	10.4	4.4	1.5	4.2	7.4	9.4	10.4	10.9	10.8	36.9
General government interest exp. (% of revenues)	4.2	3.7	2.9	2.2	2.1	1.8	1.9	2.0	2.0	2.1	7.6
Domestic credit to private sector & NFPEs* (% of GDP)	40.9	44.8	62.6	71.6	75.4	74.0	72.0	72.3	72.0	72.0	116.5
Consumer price index (average; % change)	6.0	7.4	7.6	12.0	2.5	3.0	3.4	2.5	2.7	3.0	2.9
Gross ext. financing needs¶ (% of CARs and usable reserves)	132.9	131.9	150.0	146.4	146.9	130.0	120.4	115.6	116.7	117.2	113.3
Current account balance (% of GDP)	(11.6)	(17.6)	(25.2)	(23.1)	(8.9)	(1.5)	0.3	0.1	(0.6)	(1.8)	(0.8)
Narrow net external debt§ (% of CARs)	7.7	3.4	7.6	25.0	28.7	17.1	4.2	6.2	7.1	8.1	29.2

*Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. §Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. e--Estimate. NFPEs--Nonfinancial public sector enterprises. CARs--Current account receipts.

Political Risk: Government To Remain Committed To Macroeconomic Stability

- Despite weakened popular support for the minority government, we see limited scope for political disturbance.
- The government has said it will continue to focus on fighting organized crime and corruption, achieving macrofinancial stability, and pushing ahead with structural reforms.
- A broad political consensus supports the currency board arrangement and macroeconomic stability.

Against a background of economic recession and gradual recovery, support for the minority government of Citizens for European Development of Bulgaria (CEDB) has weakened. The government counts on support from individual parliamentarians if necessary, as disagreements with the right-wing Ataka party have lead to the latter withdrawing its support. Nevertheless, ongoing backing from individual members enables the government to implement its agenda and mitigates the risk of early elections. Moreover, despite the decline in public support, which could erode further due to ongoing fiscal tightening and structural reforms, CEDB continues to be the best-supported political party--more so than the Socialist Party. This was confirmed in the 2011 presidential and municipal elections, which have kept CEDB in pole position ahead of the mid-2013 general elections.

The government has voted to combat organized crime and corruption, after the previous government's lack of success in this domain. Although some progress has been made, the European Commission continues to be critical--especially regarding the judiciary's effectiveness at processing organized crime and corruption cases. More success in this area would likely further boost public support for the government, crucial ahead of the 2013 elections. If unaddressed, these issues will probably continue to drag on Bulgaria joining the Schengen area. At present, although the EU's findings on Bulgaria confirm the country's compliance with technical requirements of the Schengen area, the opposition of some EU member states to expanding the Schengen zone suggests to us that Bulgaria's changes of entry are limited in the near term.

The government is focused on structural reforms and budget performance.In the context of the eurozone sovereign debt crisis, it has indefinitely delayed the plans to join the eurozone. That said, it remains committed to its macroeconomic stability and structural reform agendas as shown by its ongoing record. It continues to implement a budgetary consolidation plan (see section on fiscal risk) and reforms to improve labor productivity, reduce barriers in product markets, and increase the absorption of EU funds. It is also focused on the implementation of much-needed reforms to pensions (enacted in January 2012), education, and health care. Implementing this agenda would support the currency board arrangement and the sovereign's creditworthiness, as well as reinforce macrofinancial stability against uncertainties regarding economic and financial developments in Greece.

Economic Risk: Gradual Recovery On Track And Strengthening In 2013

- Per capita income is low and constrains Bulgaria's creditworthiness.
- The economy still has high growth potential, and we anticipate a broad-based recovery.
- Competitiveness continues, but we expect FDI will be lower than in the past.

Table 2

Republic of Bulgaria - Economic & Financial Indicators										
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012e**	**2013f**	**2014f**
Nominal GDP (bil. BGN)	45.5	51.8	60.2	69.3	68.3	70.5	75.3	78.1	82.0	86.6
Nominal GDP (bil. $)	28.9	33.2	42.1	51.8	48.6	47.7	53.5	50.7	53.3	57.4
GDP per capita ($)	3,723	4,302	5,484	6,783	6,385	6,310	7,130	6,775	7,149	7,721

Table 2

Republic of Bulgaria - Economic & Financial Indicators (cont.)										
Real GDP (% change)	6.4	6.5	6.4	6.2	(5.5)	0.4	1.7	0.5	1.7	2.5
Real GDP per capita (% change)	6.9	7.1	7.0	6.7	(5.1)	1.0	2.5	0.8	2.0	2.8
Unemployment rate (%)	10.1	9.0	6.9	5.6	6.8	10.3	11.3	12.7	12.0	11.6
Real GDP per employee growth (%)	4.2	2.1	1.8	2.8	(2.4)	7.0	5.2	0.5	1.2	1.5
Consumer price index (% change)	6.0	7.4	7.6	12.0	2.5	3.0	3.4	2.5	2.7	3.0
Domestic credit to private sector & NFPEs (% change)	32.6	24.7	62.7	31.6	3.8	1.4	3.8	4.2	4.6	5.5
Domestic credit to private sector & NFPEs (% of GDP)	40.9	44.8	62.6	71.6	75.4	74.0	72.0	72.3	72.0	72.0

f--Forecast. e--Estimate. NFPEs--Nonfinancial public sector enterprises.

Following a sharp contraction in GDP in 2009, the economy has been recovering modestly. After virtual stagnation in 2010 and 1.7% real growth in 2011, we expect a deceleration in 2012 amid worsening external demand, and a gradual rebound from 2013. Following the adjustment--which saw an abrupt drop in imports that prompted the country's previously large current account deficit to move into surplus in 2011--we anticipate the current account will be close to balance as domestic demand recovers.

Bulgaria is more open to trade compared with some peers. Exports account for around two-thirds of GDP, suggesting the economy could reorient toward external demand more quickly than some peers. Almost two-thirds of Bulgaria's exports are to EU member states, reflecting the importance of EU conditions for its economy. Despite the stronger-than-previously-expected recession in Greece, Bulgaria's overall export performance has not been particularly affected, partly also because Greece represents less than 8% of total Bulgarian exports. While its economic recovery was kick-started by its export performance, domestic demand has remained weak. As we expected, however, it strengthened somewhat in first-half 2012 amid wage growth and despite a weak labor market.

Bulgaria's medium-term growth prospects remain strong in our view, although less so than previously given recent tighter global credit conditions, particularly for investment activity. After a credit boom in the run up to the crisis, tightening credit conditions as well as a housing downturn have seen this growth flatten. Nevertheless, a significant part of investment went into the tradables sector. From 2004-2009, around one-fifth of all investment was in the manufacturing sector, followed by energy at around 17%. Real estate and construction together represented about 14% of total investment. We expect that credit activity bottomed-out in 2010 and that it will gradually recover, albeit not to pre-crisis levels. In 2011, credit to the private sector grew by 3.3% and is expected to remain broadly at this level of growth in 2012, before potentially slowly increasing (subject to eurozone credit conditions and related uncertainties).

The economic slowdown has weighed on the labor market, causing wage pressures to subside. Annual real wage growth, for example, fell from 13.0% in 2008 to 3.2% in 2010, but has been on an upward trend since, posting 6.9% growth in Q1 2012. At the same time, unemployment has been on a continuous upward trend, reaching 11.4% at the end of Q1 2012 before declining slightly to 10.8% in June 2012 as the gradual recovery in exports has not yet boosted the job market. As such, the labor market situation will be a drag for economic growth and will fail to support private consumption, which, together with slowly growing investment activity, would more-resolutely contribute to a broad-based economic recovery. We believe that public consumption may increase in 2013 as there is a risk of the government increasing discretionary spending ahead of the 2013 general elections. Growing domestic demand will likely boost imports, although we do not expect the current account deficit to rise to prerecession levels.

Competitiveness is being maintained while FDI inflows are likely to moderate. Despite rapid wage increases during the good times, and recent currency depreciations in several neighboring economies implying a risk for Bulgaria's external competitiveness, labor costs still remain low compared with other sovereigns, including EU members. This is despite the depreciation of several currencies in the region (Serbia, Romania).

FDI collapsed in 2009 during the global economic and financial crisis. Still, FDI covered the current account deficits of 2009 and 2010. In coming years, FDI will follow a path of gradual recovery--it bottomed-out in 2010 at just above €1 billion and reached €1.2 billion in 2011. Although we expect this trend to strengthen this year and in the future, the FDIs are probably not going to reach pre-crisis levels because credit inflows have stalled and previous channels appear largely exhausted. That said, the absorption of EU funds could increase further; these have so far been underused although absorption has been increasing lately.

Fiscal Risk: Budgetary Consolidation Well On Track

- After reaching almost 5% of GDP in 2009, we expect the budget deficit to contract to below 1.5% of GDP in 2012.
- Fiscal reserves provide additional flexibility; we expect a debt-to-GDP ratio of around 17% in 2012.
- Contingent liabilities remain low, mainly due to past privatization and still-low financial intermediation by the banking sector.

Table 3

Republic of Bulgaria - Fiscal Indicators

	2005	2006	2007	2008	2009	2010	2011	2012e	2013f	2014f	2015f
(% of GDP)											
General government revenues	38.3	36.2	40.9	40.0	36.3	34.3	33.1	33.5	33.7	34.0	34.0
Of which central government	25.3	26.7	31.5	30.0	26.5	25.8	24.0	24.7	25.1	25.8	26.3
General government expenditures	37.3	34.4	39.8	38.3	40.7	37.4	35.2	34.8	34.7	34.5	34.3
Of which central government	23.9	24.5	30.3	28.2	30.3	27.8	26.3	26.0	26.0	26.3	26.7
General government balance	1.0	1.9	1.2	1.7	(4.3)	(3.1)	(2.1)	(1.3)	(1.0)	(0.5)	(0.3)
Of which central government	1.4	2.2	1.1	1.8	(3.8)	(2.0)	(2.3)	(1.3)	(0.9)	(0.5)	(0.4)
General government primary balance	2.7	3.2	2.3	2.5	(3.6)	(2.5)	(1.5)	(0.6)	(0.3)	0.2	0.4
Central government primary balance	3.0	3.5	2.3	2.7	(3.0)	(1.4)	(1.7)	(0.7)	(0.2)	0.2	0.3
General government balance (% of revenues)	2.7	5.2	2.8	4.2	(11.9)	(9.1)	(6.3)	(3.9)	(3.0)	(1.5)	(0.9)
General gov't interest payments (% of revenues)	4.2	3.7	2.9	2.2	2.1	1.8	1.9	2.0	2.0	2.1	2.0
Central gov't interest payments (% of revenues)	6.3	5.0	3.7	2.9	2.8	2.3	2.6	2.6	2.7	2.6	2.5
General government debt	27.5	21.6	17.2	13.7	14.6	16.3	16.3	17.0	17.2	16.8	16.2
Of which central government debt	27.2	21.3	16.9	13.4	14.2	15.6	15.7	16.5	16.6	16.2	15.7
General government net debt	17.0	10.4	4.4	1.5	4.2	7.4	9.4	10.4	10.9	10.8	10.5
Of which central government net debt	16.7	10.1	4.0	1.2	3.7	6.8	8.8	9.8	10.3	10.2	10.0

f--Forecast. e--Estimate.

A prudent fiscal policy is, in our view, fundamental to the viability of the currency board arrangement and to Bulgaria's macroeconomic stability. We think the government's policy stance has continuously and appropriately reflected this imperative, despite the budget deficit of almost 5% of GDP in 2009. The significantly-better-than-expected budgetary performance before the recession hit reflected the government's awareness of the need for an appropriate fiscal stance.

Since peaking in 2009, the deficit reduced to 2.1% of GDP in 2011 on the back of the current government's corrective measures. In the context of current gradual economic recovery, the government has implemented several revenue and expenditure side measures. On the revenue side, measures include a hike in excise taxes on tobacco and some energy products. As of 2012, excise tax rates on some energy goods have increased in line with EU harmonization requirements. Also, an excise tax on natural gas has come in, as well as increases in the pension contribution rate and the minimum mandatory insured income threshold for main economic activities (by 6.9% for activities/occupations agreed by the social partners and by 4.5% administratively imposed for the rest of the activities/occupations). On the expenditure side, the government has frozen public sector wages and intermediate consumption and social transfers at their 2010 nominal terms. The public-sector wage freeze has remained in place in 2012, together with pension indexation and streamlining public services. At the same time, the government decreased the annual spending limit on commitment payments to suppliers and in the context of the pension reform increased the retirement age by four months. These measures, together with improving tax compliance, are in our view likely to allow the government to respect its budgetary target of 1.35% of GDP.

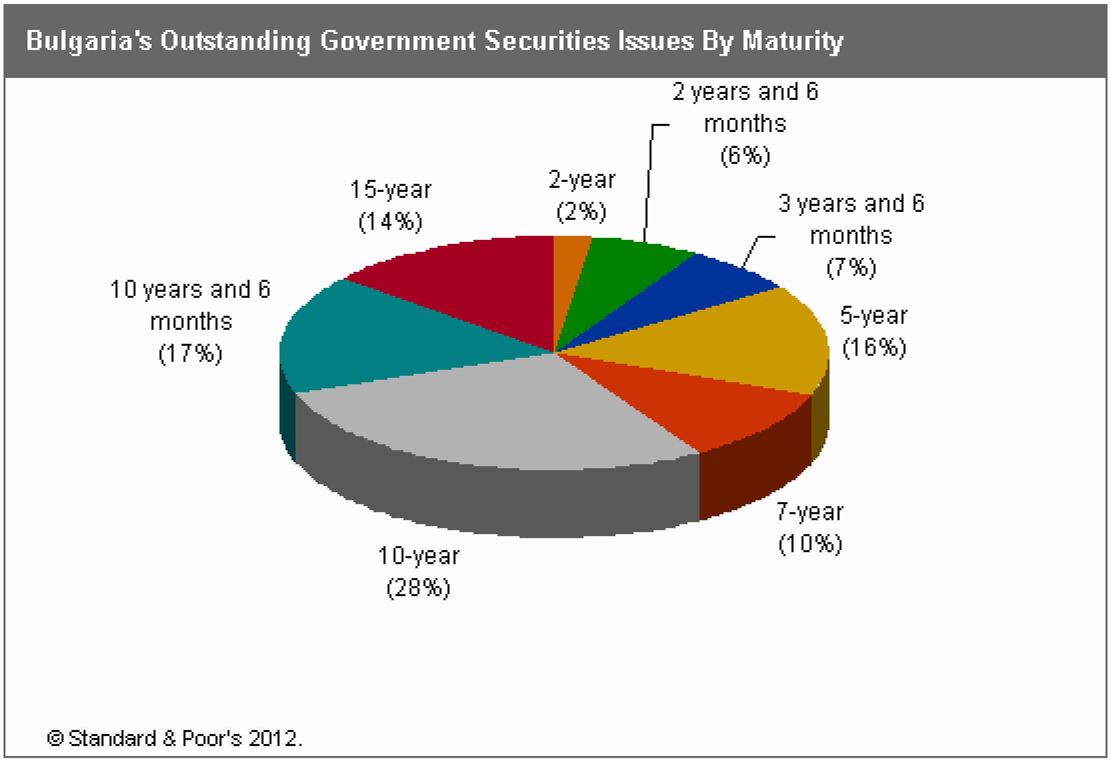
In order to strengthen the fiscal policy framework, the government in 2011 adopted a fiscal stability pact that limits its spending to 40% of GDP and budget deficit to 2% of GDP. According to the pact, the government spending limit is defined, based on the last 10-year history of the indicator, while the deficit limit is tighter than the EU's Stability and Growth Pact and is according to the deficit forecasts it is already complying with this year. If fully respected, the national budgetary rules will contribute to a prudent budgetary policy stance.

The government debt burden was at modest 16.3% of GDP in 2011, reflecting strong fiscal performances and solid real economic growth. This was after bottoming-out at 13.7% of GDP in 2008, from 37.9% in 2004. We expect the general government debt to continue below 20% of GDP in line with the general government balance performance and future privatization revenues. In keeping with Bulgaria's past robust budgetary performance, the government maintains a fiscal reserve--established to cover at least one year of amortization and interest payments--but it has been gradually declining since end-2008. This reserve has cushioned budgetary pressures and contributed to macroeconomic stability, and has helped underpin the sovereign's creditworthiness. Due to its relatively low level of government debt and deficit, Bulgaria (along with Estonia, Luxembourg, and Sweden) is among the very few countries in the EU with interest expenditure representing below 1% of GDP (0.6% of GDP in 2011).

We view Bulgaria's banking system as now significantly stronger than in the period following the crisis of the mid-1990s. The regulatory framework appears to be strong and improving, accompanied by good banking supervision. Despite the current recession coming on the heels of fast lending growth, we believe the banking sector is well capitalized. At the end of second-quarter 2012, the capital adequacy ratio stood at around 16.7%. The ratio of NPLs increased from 2.4% at end-2008 to around 16.9% at end-second-quarter 2012.

Any financial distress in the banking system could also test the government's fiscal resilience by forcing authorities to inject capital into weak institutions. Still, Standard & Poor's sees only limited potential for significant recapitalization costs to the Bulgarian government, not least because most of the system continues to receive new capital from foreign parent banks. Also, additional policy options to stem eventual distress are available if needed.

Chart 1



Monetary Policy Flexibility: Inflation Still Subdued, While Financial Stability Remains The Focus

- We expect the euro-based currency board to remain in place until Bulgaria joins the European Economic and Monetary Union.
- We expect the euro-based currency board to remain in place although the Bulgarian government has decided to delay its eurozone accession plans.
- Inflation will, in our view, likely remain moderate.

Amid the ongoing sovereign debt crisis in the eurozone, the government has decided to delay its plans to join. Meanwhile, the currency board arrangement's sustainability is enhanced by the authorities' prudent fiscal policies, in our opinion. Although the current account deficit has adjusted rapidly and the external debt has come off its 2009 peak, the still-substantial external financing represents a vulnerability for the economy as monetary policy flexibility is limited by the provisions of the currency board arrangement.

Given tightening lending conditions and the consequent narrowing of parent banks' credit availability, domestic credit growth decelerated sharply in 2009 and has now stalled following the 60% rise in 2007 and the roughly 35% increase in 2008. Lending to the private sector is scarce as credit conditions have tightened and demand has declined. We expect this will continue until end-2011 before perhaps gradually recovering as economic growth boosts domestic demand. Financial sector distress due to an external shock would likely delay recovery and limit near-term growth prospects. Moreover, foreign parent banks have in several cases been following their domestic regulators' advice to gradually reduce exposure abroad, which is leading to pressure on the size of balance sheets. Nevertheless, rebalancing of exposure is occurring also through the increase in deposits. Their growth has been significantly outpacing credit growth, reducing the loan-to-deposit ratio in the banking system.

We note the central bank's policy responses during 2008-2010. In order to avoid liquidity problems in the banking system, the bank from the outset provided capital relief, liquidity, and eased lending conditions, including lowering the minimum reserve requirement, expanding the range of acceptable collateral, and prohibiting the distribution of dividends to instead boost capital.

As domestic demand slowly recovers, inflation will likely be moderate. Given weak domestic demand, inflationary pressures are currently mainly external: higher food and energy prices, and excise tax increases (see fiscal risk section). In the context of ongoing economic recovery, we believe wage pressures will continue to be relatively moderate in 2012 although external shocks present a risk. As the recovery gains pace in 2012, upward inflationary pressures are likely to emerge.

External Risk: Eurozone Woes Take Toll On Pace Of Export Performance

- External vulnerabilities are still a weakness for Bulgaria's rating, but adjustments are ongoing.
- Strong export performance has contributed to eliminating the current account deficit in 2011, and has been improving external liquidity.
- The current account is likely to be close to balance and an eventual deficit position would be covered by FDI or EU transfers.

Table 4

Republic of Bulgaria - External Indicators

	2005	2006	2007	2008	2009	2010	2011	2012e	2013f	2014f
(% of GDP)										
Current account balance	(11.6)	(17.6)	(25.2)	(23.1)	(8.9)	(1.5)	0.3	0.1	(0.6)	(1.8)
Trade balance	(19.0)	(21.0)	(23.5)	(24.3)	(12.0)	(7.7)	(5.6)	(5.5)	(6.1)	(6.3)
Net foreign direct investment	13.9	23.0	28.7	17.5	7.2	2.7	4.1	4.3	4.4	4.5
(% of CARs)										
Current account balance	(17.7)	(25.4)	(38.1)	(35.3)	(16.4)	(2.3)	0.4	0.1	(0.7)	(2.1)
Net external liabilities	63.6	87.7	131.8	142.2	193.6	148.5	107.1	110.8	105.8	100.8
Gross external debt	70.7	82.7	96.5	97.1	126.5	96.0	67.2	69.3	64.4	59.9
General government external debt	27.7	21.2	16.4	10.4	15.4	12.5	9.1	9.1	7.9	7.1
Narrow net external debt*	7.7	3.4	7.6	25.0	28.7	17.1	4.2	6.2	7.1	8.1
Net public sector external debt	(36.6)	(47.3)	(56.7)	(50.9)	(68.8)	(56.7)	(45.7)	(48.4)	(45.3)	(41.4)
Net nonfinancial private sector external debt	26.1	40.2	48.6	48.0	63.5	52.0	38.2	41.2	39.4	37.8
Net financial sector external debt	(0.6)	(7.8)	4.6	17.9	17.8	6.8	(1.1)	(2.1)	(2.3)	(2.9)
Gross ext. financing needs¶ (% of CARs and usable reserves)	132.9	131.9	150.0	146.4	146.9	130.0	120.4	115.6	116.7	117.2

*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. ¶Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

After reaching a record high of about 24% of GDP in 2008, Bulgaria's current account deficit adjusted sharply as imports decreased rapidly. This happened on the back of foreign capital inflows plummeting after global financial crisis. Following the adjustment, we think the current account deficit may widen again, although not so quickly, as imports growth resumes. This will be underpinned by the recovery in domestic demand, although not to the same extent as before the crisis given that credit growth will continue to drag.

Under the currency board arrangement, the sharp reduction in the current account deficit during 2009-2010 is positive. This is because the decline in FDI and portfolio inflows removes some pressure from foreign currency reserves because external financing needs are lower. In the medium term, the ongoing EU fund transfers of €7 billion over 2006-2013 should partly compensate for eventual deficits, although we expect a rather balanced current account in near term.

Export performance helped improve external liquidity indicators, although external debt still represents a drag for the sovereign's ratings. Bulgaria's high gross financing need (current account payments plus short-term debt plus medium- and long-term debt amortization) as a percentage of CARs and usable reserves--which indicates the potential for pressure on the country's external liquidity--is expected to remain relatively stable over the medium term at around 115%. This is down from around 150% in 2009. Recent solid export performance has been the underlying contributor to reducing the external debt and external liquidity ratios. Reserves used to compute this ratio are trimmed to reflect the currency board arrangement, which constrains the use of reserves for liquidity purposes. Bulgaria's narrow net external debt burden (total external debt minus liquid nonequity external assets) also decreased steadily since 2009, when it was at 28%. We estimate it to be at 7% of CARs in 2012 before declining further. For the public sector, we forecast a net external creditor position of just below 50% of CARs in 2012.

Dominant foreign ownership by some of the EU's biggest banks cushions the risks associated with Bulgaria's banking sector external borrowing, which is mainly funds attracted directly from parent banks. The parent banks have so far demonstrated their support for the subsidiaries, although in the current financial environment we believe parent banks will likely continue rationing their cross-border lending to local subsidiaries.

Comparative Analysis

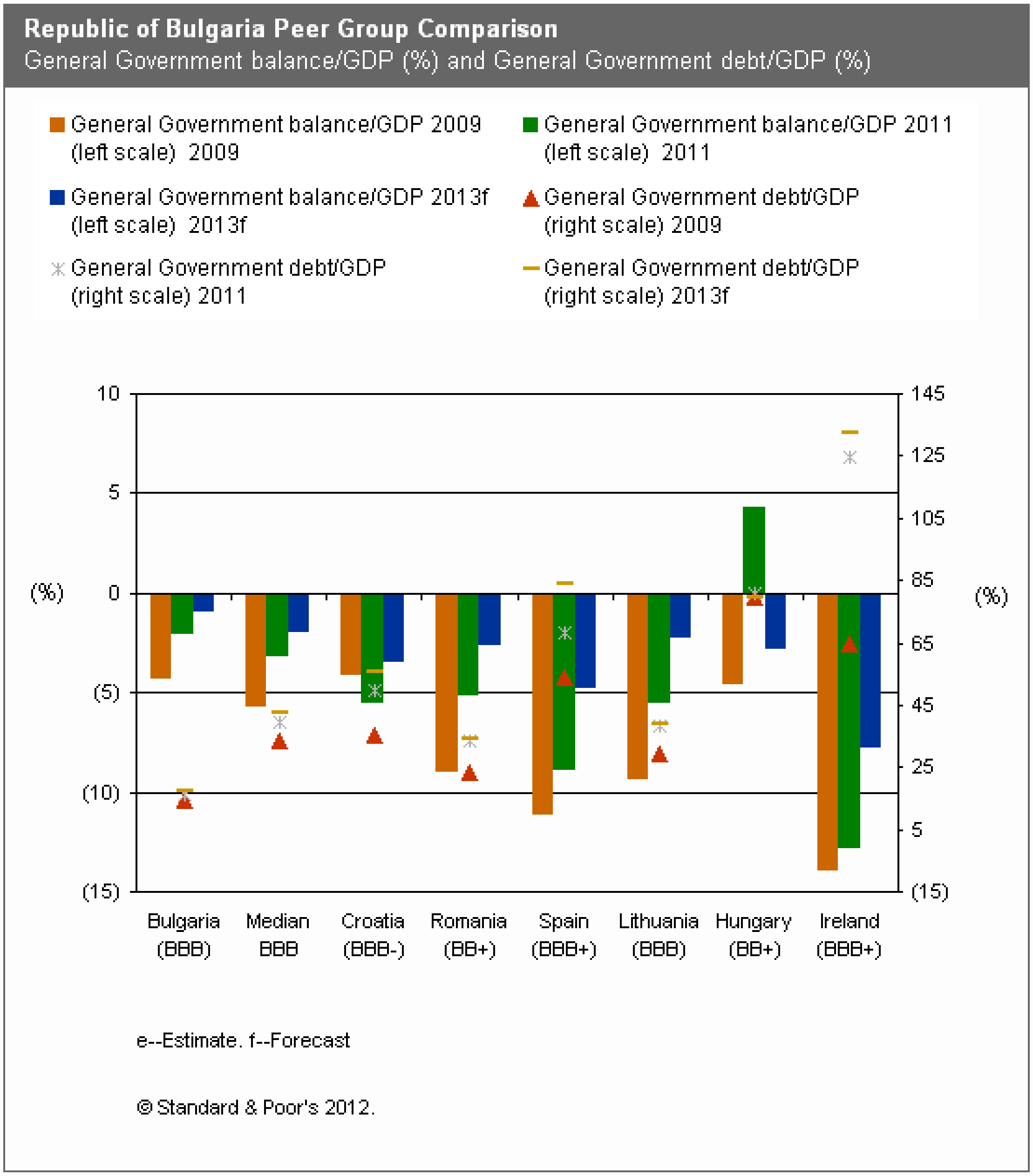
Continuously strong budgetary performance sets Bulgaria apart from its peers.In line with the demands of the currency board arrangement, Bulgaria had a consistently tight budgetary stance before the crisis. This contrasts with Hungary (foreign currency BB+/Negative/B; all ratings hereafter refer to foreign currency sovereign credit ratings), Latvia (BBB-/Stable/A-3), Lithuania (BBB/Stable/A-2), Romania (BB+/Stable/B), and Croatia (BBB-/Negative/A-3), where during the 2003-2007 credit boom governments failed to appropriately tighten fiscal policy. This, coupled with high external debt in several countries, necessitated arrangements with the IMF. Nevertheless, as in Spain (BBB+/Negative/A-2) and Ireland (BBB+/Negative/A-2), the headline budgetary surpluses masked the underlying structural deficit. Although the significant GDP contraction in 2009 led the budgetary stance to deteriorate, with general government deficit of 4.7% of GDP, the Bulgarian authorities remained committed to budgetary discipline and promptly stepped up budgetary consolidation efforts. We expect the general government deficit to be below 1.5% of GDP in 2012, the lowest among peers.

The Bulgarian government has shown its willingness to implement prudent income policies. Since 2009 it has reduced public spending, widened the tax base, and hiked excise taxes and social security contributions to counter the large decline in the revenues. Tough public sector wage cuts and other consolidation measures have been implemented in all other peers, although to a lesser extent in Croatia.

The peers' debt-to-GDP ratios reflect underlying budgetary performance.However, except for Hungary where general government debt to GDP in 2007 was already at 66% of GDP, none of the rated 17 non-EMU Eastern European countries entered the global credit crunch with debt levels above the Maastricht ceiling of 60% of GDP. Indeed, average non-EMU Eastern European public debt in 2007 was 26% of GDP versus 66% in the eurozone. This implied that most of the region had sufficient fiscal space to absorb the shock to finances associated with a sharp contraction of domestic and external demand, albeit with IMF and EU help in the cases of Hungary, Latvia, and Romania.

As a result of deficits since 2009, Bulgaria's general government debt is likely to increase, although to a still-relatively-low level (the second lowest of the EU member states). Moreover, the fiscal reserve account improves the government's net debt position and alleviates government financing needs, although it has been on a steady decline since end-2008. The benefits of prudent fiscal policies are becoming clear in other peers including Romania, which has made substantial headway in stemming a steep increase in government debt. On the other hand, debt dynamics in Spain and Ireland have seen significant contingent liabilities crystallize on the government balance sheet, a burden that led to external support program by the EFSF and in the case of the later, also by the IMF.

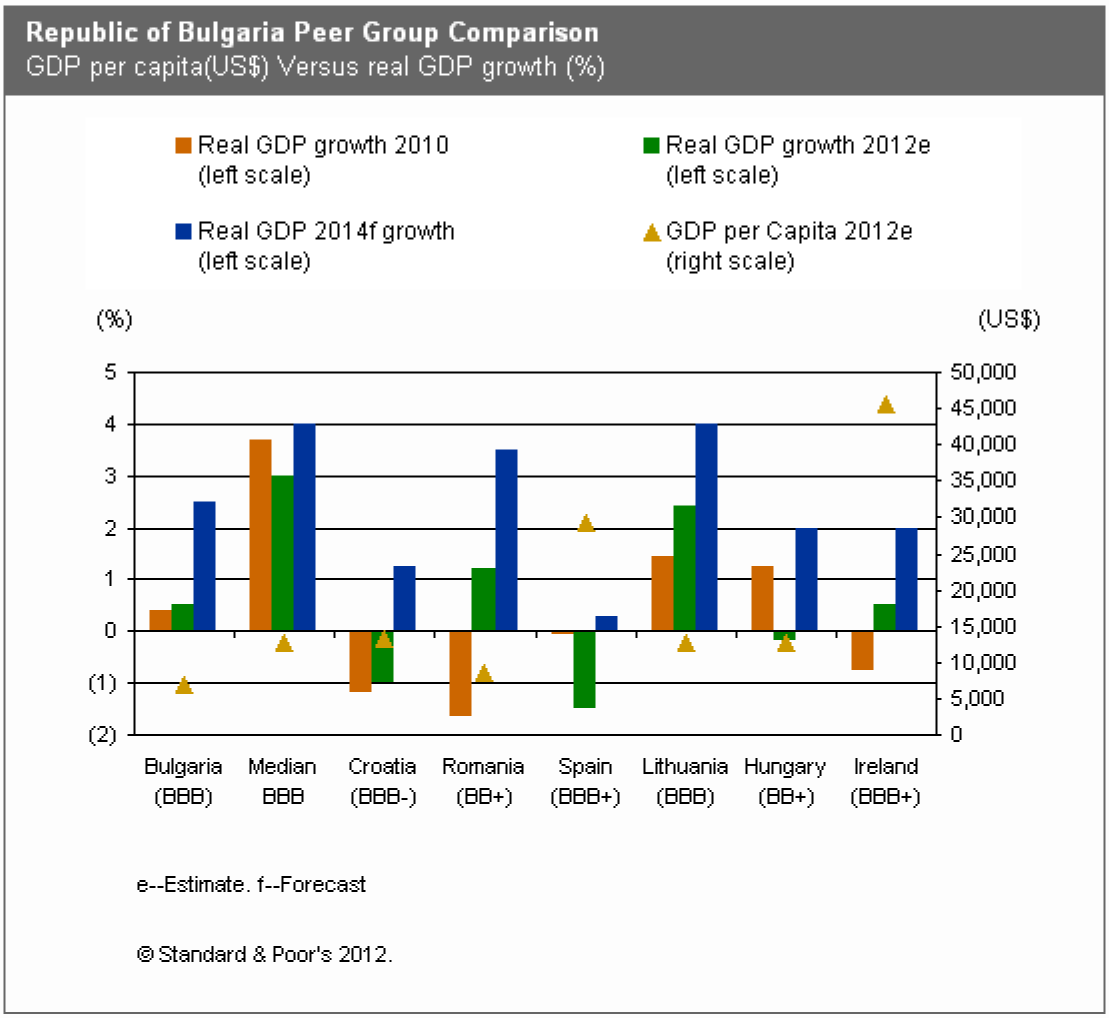
Chart 2



Bulgaria lags its 'BBB' peers in terms of GDP per capita; at around $7,000 it has the lowest in the EU. Nevertheless, the gap between it and wealthier peers has been narrowing on ongoing gradual economic recovery (see chart 3). Moreover, Bulgaria has undergone a less-adverse GDP contraction compared with some other peers, which continue to be mired in a prolonged recessionary period, like Spain. Despite its fixed-exchange-rate regime, nominal wages increased by about 15% in 2010-2011 in Bulgaria--although it stayed competitive because its wages are still the lowest in the EU. Much of Bulgaria's labor market adjustment occurred through layoffs as unemployment increased to 11.2% in 2011 from 5.6% in 2008. Similarly, in Spain, due to rigid labor market legislation prior to the latest reforms the burden of that adjustment fell on employment levels, and less so on wages. Also, Spain, as a member of the monetary union, is unable to regain competitiveness through depreciation or devaluation of its currency. In Romania, on the contrary, the floating exchange rate largely helped restore competitiveness as the Romanian leu depreciated by about 20% against the euro between end-2007 and end-2010, reducing the domestic cost base compared to key trading partners.

Eurozone accession remains an objective for some countries, but Bulgaria has decided to delay its decision on joining. The National Bank of Romania has set a target of 2015 for euro adoption in the hope that this will motivate the Romanian government to carry out timely reforms. This decision stands in stark contrast to other countries in the region with floating exchange rates, such as Poland, Hungary, and the Czech Republic, which have put their euro adoption plans on hold as they appear unwilling to lose control over monetary policy.

Chart 3



Similar to elsewhere across the region, we expect the current sluggish credit activity will weigh on growth over the medium term. Nevertheless, compared with other Balkan economies such as Romania (exports represent 25% of GDP), Serbia (24%), and far richer Greece (20%), Bulgaria is a more open economy (66%). Similar to the Baltic economies, greater openness has already contributed to Bulgaria's growth in 2011, however given the economic slowdown in the eurozone, its main export market, in 2012 we expect GDP growth to decelerate as domestic demand soften and recover only gradually. Similarly for peers domestic demand is anemic and still recovering from the 2009 shock.

Weak credit activity is likely to continue. Bulgaria's past buoyant growth stemmed from strong investment spurred by the credit boom. Credit to the private sector has been virtually flat since 2009 and is expected to recover only slowly. Nevertheless, we observe that foreign parent bank support in Bulgaria, and in other peers, has so far remained in place, whether measured as provisions as a share of NPLs or fresh capital injections, even if through unpaid dividends. Nevertheless, since third-quarter 2008, regional subsidiary banks have been aligning credit growth with that of deposits or have been matching outstanding credit with deposits, while at the same time paying down liabilities, leading to gradual deleveraging. We expect this trend to continue, as the foreign parent banks, in particular, face increased pressure to deleverage and increase their capital ratios.

Most peers have experienced rapid correction in external imbalances. In Bulgaria, the deficit fell from around 25% of GDP in 2008 to a surplus of about 0.5% of GDP in 2011. Given reduced credit availability, we expect FDI into Eastern Europe will fall significantly compared with pre-crisis levels. That said, as recovery strengthens and the credit environment improves, we expect that any delayed investment projects would resume, at least in part. Finally, some inflows from privatization-related FDI can be expected, although these governments have already sold most of their assets. On the whole, however, this may be sufficient to maintain coverage of current account deficits, which we expect will widen again (although not as much as before the recession) with FDI.

At the same time, strong export performance, particularly in an open economy such as Bulgaria, has boosted the sovereign's current account receipts, reducing external financing needs and implying lower pressure on the national balance of payments. Nevertheless, high external debt, albeit gradually declining, represents a weakness for Bulgaria's ratings..

Chart 4

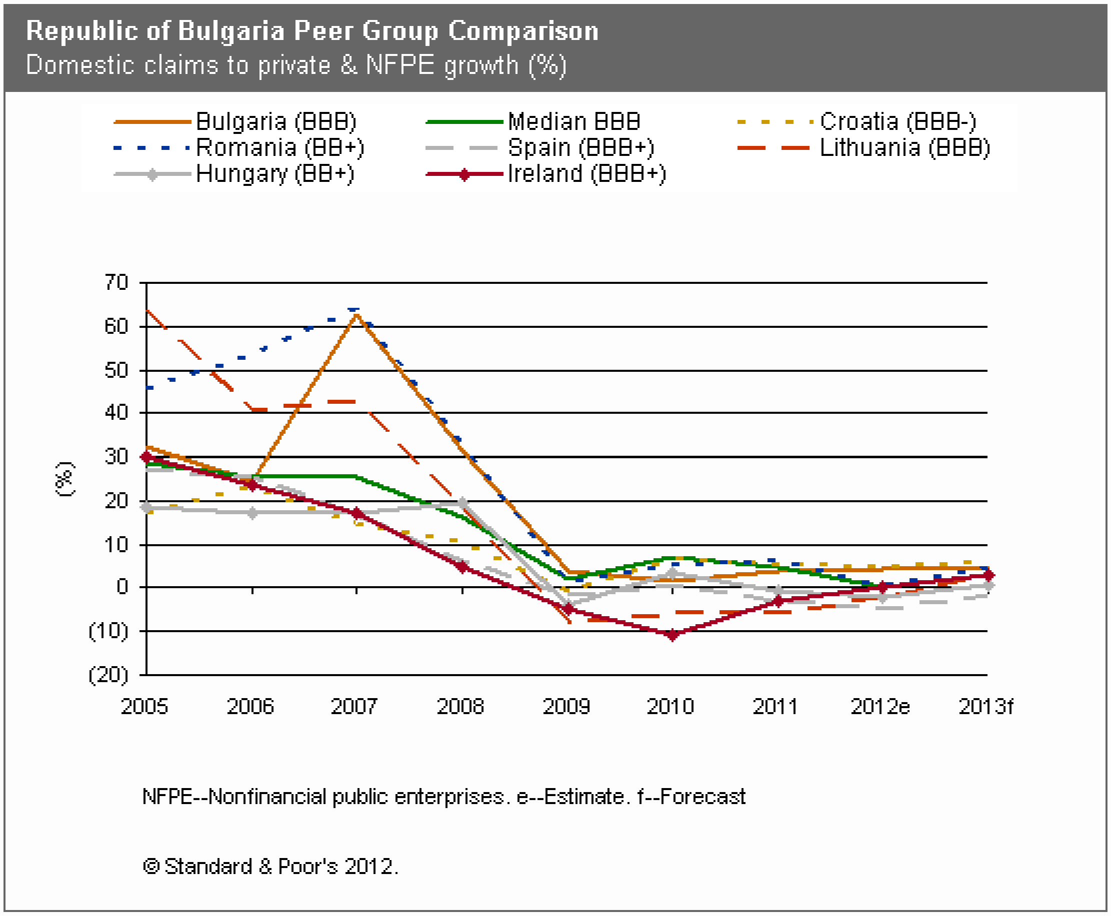
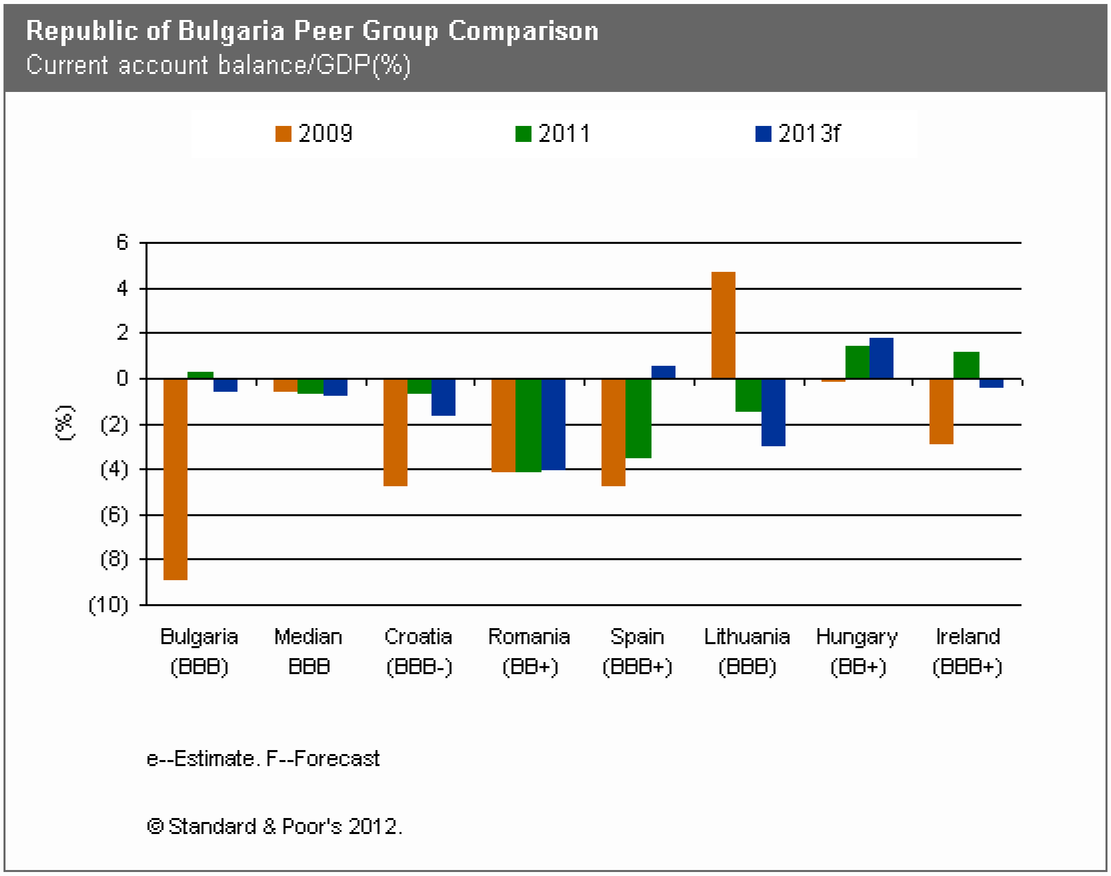
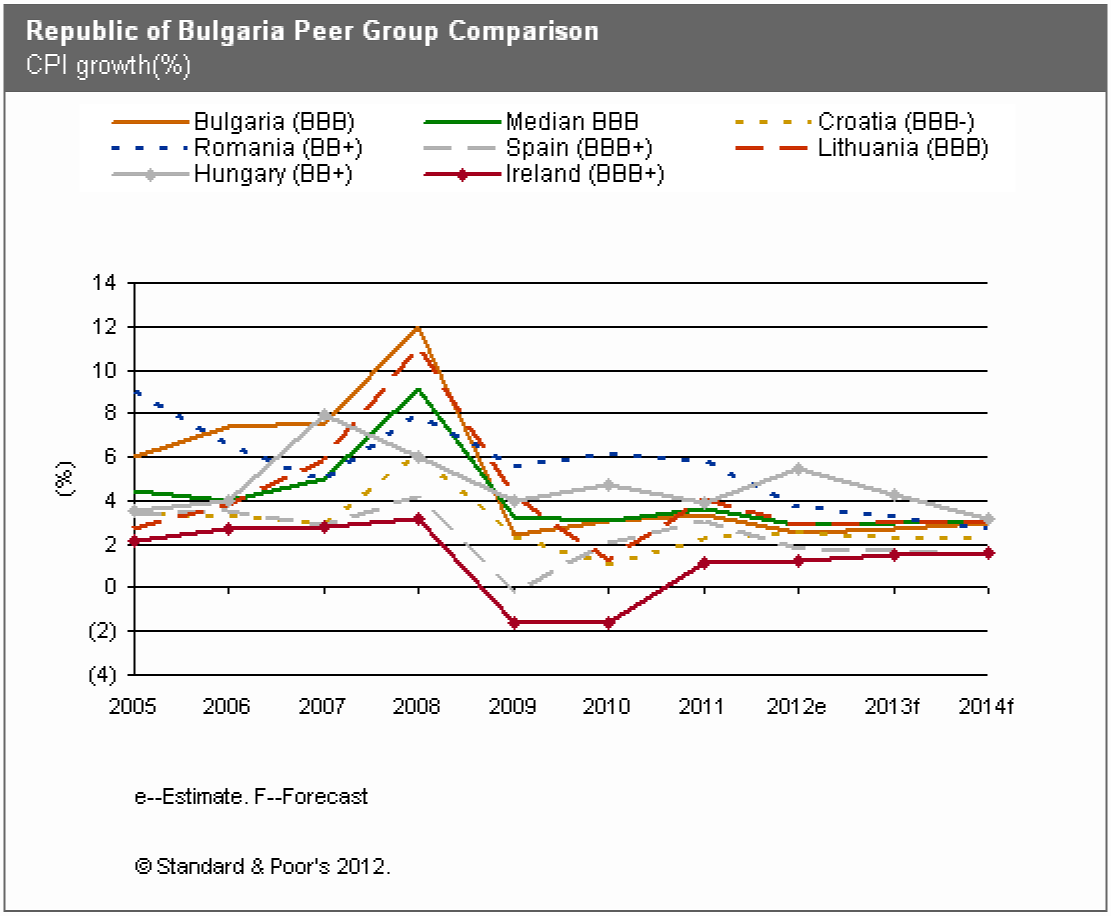

Republic of Bulgaria Peer Group Comparison
Domestic claims to private & NFPE growth (%)
Bulgaria (BBB)
Median BBB
Croatia (BBB-)
Romania (BB+)
Spain (BBB+)
Lithuania (BBB)
Hungary (BB+)
Ireland (BBB+)
(%)
70
60
50
40
30
20
10
0
(10)
(20)
2005
2006
2007
2008
2009
2010
2011
2012e
2013f
NFPE--Nonfinancial public enterprises. e--Estimate. f--Forecast
© Standard & Poor's 2012.

Chart 5



The export performance has not translated into labor market while inflation risks remain balanced. After reaching 11.2% in 2011 we expect the unemployment rate in Bulgaria to grow further to above 12% by the end of this year. In peer countries, the situation is similar; countries where the construction and retail segments have triggered rapid growth in employment are under the most pressure and will take more time to recover. The outlier is Spain with around 25% unemployment, which we believe is likely to worsen in near term before eventually recovering. Meanwhile, across the region inflationary pressures, mainly due to higher energy and food prices, have emerged. Still-weak domestic demand as well as gradual local currency appreciation (where relevant) also presents a downside risk (see chart 6).

Chart 6



Transfer & Convertibility Assessment

The transfer and convertibility assessment remains three notches above our sovereign foreign currency rating on Bulgaria and reflects our view that the probability of the sovereign restricting access to foreign exchange needed for non-sovereign debt service is lower than the probability of the sovereign defaulting on its foreign currency obligations.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Sovereign Ratings And Country T&C Assessments, July 28, 2011

Ratings Detail (As Of September 28, 2012)	
Bulgaria (Republic of)	
Sovereign Credit Rating	BBB/Stable/A-2
Transfer & Convertibility Assessment	A
Senior Unsecured	BBB
Short-Term Debt	A-2

Ratings Detail (As Of September 28, 2012) (cont.)	
Sovereign Credit Ratings History	
10-Aug-2012	BBB/Stable/A-2
01-Dec-2009	BBB/Stable/A-3
30-Oct-2008	BBB/Negative/A-3
23-Oct-2008	BBB+/Watch Neg/A-2
Population	7.6 million
Per Capita GDP	$6,930
Current Government	
Prime Minister Boiko Borisov heads a minority government. President Rosen Plevniev is head of state.	
Election Schedule	
Parliamentary Last....July 2009 Next....by July 2013 Presidential Last....October 2011 Next....October 2016	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:
Sovereign Ratings; SovereignLondon@standardandpoors.com