Bulgaria 'BB+/B' Ratings Affirmed; Outlook Stable

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OVERVIEW

- Following a sharp deterioration in 2014, we expect Bulgaria's general government finances to stabilize and then gradually improve over the next four years.
- We believe Bulgaria's financial sector continues to face important challenges but we note efforts are underway to mitigate risks.
- We are therefore affirming our 'BB+/B' long- and short-term sovereign credit ratings on Bulgaria.
- The stable outlook reflects the balance between risks we see from potential vulnerabilities in the financial sector and still-low government debt.

RATING ACTION

On June 12, 2015, Standard & Poor's Ratings Services affirmed its 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Bulgaria. The outlook is stable.

RATIONALE

The ratings are constrained by Bulgaria's relatively low income levels, weak governance, worsening demographics, exchange rate regime, and high proportion of non-lev-denominated loans, which limits the central bank's ability to act as a lender of last resort. The ratings are supported by low, albeit rising, general government debt.

Bulgaria's domestic banking system continues to face important risks. We believe that supervisory lapses contributed to the problems faced by systemically important banks last year (see "Bulgaria Ratings Lowered to 'BB+/B' On Fiscal Risks From State Support Of Banks; Outlook Stable," published Dec. 12, 2014, on RatingsDirect). Since then, efforts have been underway to strengthen supervision. The authorities are currently in the process of adopting the EU Bank Recovery and Resolution Directive, which prescribes rules enabling them to deal with the failure of banks while minimizing the burden on taxpayers. We understand that the central bank is also drafting methodology for a comprehensive review of banks' asset quality. The banking sector is also vulnerable to external factors, given the large presence of Greek subsidiaries, which together account for more than onefifth of the sector's assets. The Bulgarian National Bank (BNB) has taken steps to shore up the liquidity of these subsidiaries, such as mandating higher deposits with the BNB, increasing the proportion of liquid assets held, and reducing exposure to parent banks.

Under the country's currency board arrangement, the BNB can only provide liquidity support to the banking system to the extent that its reserves exceed its monetary liabilities. Even then, support can only occur under certain conditions and for short periods against liquid collateral. As of April 2015, the BNB's reserves covered monetary liabilities by 1.7x. That said, we also think Bulgaria's European partners could extend extraordinary support in the event of a stress situation. We currently classify Bulgaria's banking sector in group '7' under our Banking Industry Country Risk Assessment (BICRA) methodology (on a scale of '1' to '10', with '1' denoting the lowest-risk banking sector). Our BICRA assessment reflects weak governance and transparency in Bulgaria, and the impact of slow economic growth on the further deterioration of asset quality. In 2014, the deterioration of the general government deficit and the state support extended to the banking system contributed to the increase in general government debt. Although our general debt forecast does not explicitly include future government support to banks, we believe the risk of additional support is not insignificant.

We see the general government deficit narrowing gradually to 2% of GDP by 2018; this differs from the government's target of 1.3% of GDP because we assume weaker nominal GDP growth. As a result, we expect that general government debt will increase by an annual average of 2.5% of GDP in 2015-2018. We don't believe the currency composition of government debt will differ materially over this period. Currently, about 80% of government debt is denominated in foreign currency.

Bulgaria has struggled to find a new growth model in the wake of the global financial crisis. From 2010 to 2014, exports increased by about 8% annually in real terms. However, this export performance has not led to a recovery in business investment or meaningfully reduced overall unemployment levels. This is even though we note that the unemployment rate declined by 1.6 percentage points to 11.4% in 2014, the first decline since 2008. We forecast that real GDP growth will average 1.3% over 2015-2018, compared with 6.3% over 2005-2008. Our forecast reflects our view of Bulgaria's financial stability and continued weak domestic demand, despite recent improvements in household consumption. In particular, we expect private-sector investment activity to remain muted, reflecting, among other factors, sluggish growth in bank lending.

Challenges to Bulgaria's banking system and a deterioration of the country's fiscal position have been exacerbated by a sustained and pronounced deflation of consumer prices since the second half of 2013. Domestic demand has, until recently, also been depressed by parent banks' net withdrawals of funding from their Bulgarian subsidiaries and banks' increasing external assets. Between 2009 and 2014, about 92% of financial sector external debt was rolled over every year. The direct link between money growth and balance-of-payments inflows under the currency board has magnified the impact of these recent balance-of-payments outflows on the economy, particularly on prices.

The banking sector's overall liquidity appears to have helped banks reduce external debt by $5 billion between 2008 and 2014, while increasing assets held abroad by $8.4 billion (according to international investment position data). Net outflows from the financial system during that period have cumulatively constituted about 30% of the GDP figure in 2015. We expect that outflows from Bulgaria's banking sector will persist until 2016, when we expect them to stabilize, and that this will continue to depress domestic credit conditions and, consequently, the money supply and prices.

We assume that 86% of Bulgaria's short-term external debt due in 2015 will be rolled over. This roll-over rate is lower than in previous years, because the government has replaced a short-term external bridge loan it took in 2014 with longer-term external debt that it issued earlier this year. We expect current and capital account receipts, foreign direct investment, and net debt inflows to fully finance Bulgaria's long-term external debt amortization and current account payments, totaling $38 billion.

Bulgaria's exchange rate regime and high proportion of non-lev-denominated loans (about 55%) restrict its monetary flexibility and the BNB's ability to act as a lender of last resort. In this context, we believe that the BNB's limited success in stimulating credit growth in the face of anemic domestic demand and in effecting a reduction of the banking sector's gross nonperforming loans--about 17% of its total loan book--reflect a weakened transmission channel for monetary policy.

Bulgaria's political environment has remained in flux, with five governments and two general elections since early 2013. Parliamentary elections held in October 2014 yielded a minority coalition of the GERB (the Citizens for the European Development of Bulgaria) and the Reformist Bloc (comprising five parties). The government relies on outside support from the Patriotic Front (an alliance of two parties) and the Alternative for Bulgarian Revival. With the numerous changes in power over the past two years, there have been several policy reversals, including on fiscal policy, which have weighed on business and consumer confidence. We note that the government has taken steps to reduce losses in the energy sector, and parliament is currently debating pension reform. However, given that the government relies on outside support to pass legislation and is itself composed of several factions, we think policy uncertainty may persist, and implementation of reform could continue to face challenges.

OUTLOOK

The stable outlook on Bulgaria reflects the balance between the risks we see from potential vulnerabilities in the financial sector and still-low general government debt. We could lower the ratings if the domestic financial system requires further government support, or if outflows on the financial account of the balance of payments do not moderate.

On the other hand, we could consider an upgrade if Bulgaria effectively addresses governance issues, thereby boosting its growth potential and attracting higher foreign direct investment to the tradables sector; or if the economy expands faster than we anticipate, such that general government finances consolidate more rapidly.

KEY STATISTICS

Table 1

Republic of Bulgaria Selected Indicators

	2008	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
Nominal GDP (bil. US$)	53.32	50.16	48.67	55.77	52.59	54.48	55.74	45.30	43.54	44.54	45.66
GDP per capita (US$)	7,092	6,718	6,558	7,567	7,177	7,479	7,692	6,284	6,069	6,241	6,430
Real GDP growth (%)	5.8	(5.0)	0.7	2.0	0.5	1.1	1.7	1.0	1.3	1.5	1.5
Real GDP per capita growth (%)	6.5	(4.4)	1.3	2.7	1.1	1.7	2.3	1.5	1.8	2.0	2.0
Change in general government debt/GDP (%)	(1.2)	0.7	2.0	1.1	2.6	0.4	9.7	2.9	2.6	2.3	2.0
General government balance/GDP (%)	1.6	(4.2)	(3.2)	(2.0)	(0.7)	(0.9)	(2.8)	(2.9)	(2.6)	(2.3)	(2.0)
General government debt/GDP (%)	13.3	14.2	15.9	15.7	18.0	18.3	27.6	30.1	32.2	33.7	34.9
Net general government debt/GDP (%)	1.6	4.1	7.4	9.1	10.1	12.2	17.8	20.4	22.6	24.4	25.8
General government interest expenditure/revenues (%)	2.2	2.1	2.1	2.3	2.4	2.0	2.0	2.8	2.9	3.3	3.5
Other dc claims on resident nongovernment sector/GDP (%)	69.6	73.0	72.6	69.1	69.6	69.5	62.7	63.4	64.1	64.5	64.8
CPI growth (%)	12.0	2.5	3.0	3.4	2.4	0.4	(1.6)	(0.5)	0.7	1.2	1.5
Gross external financing needs/CARs plus usable reserves (%)	155.2	155.5	135.1	122.5	121.3	116.3	120.2	123.5	107.6	108.9	109.6
Current account balance/GDP (%)	(22.6)	(8.6)	(0.9)	0.9	(0.3)	1.9	0.9	1.2	1.2	1.4	1.0
Current account balance/CARs (%)	(35.3)	(16.3)	(1.4)	1.3	(0.4)	2.4	1.1	1.5	1.5	1.8	1.3
Narrow net external debt/CARs (%)	20.8	20.7	8.4	(2.3)	(8.3)	(11.6)	(9.3)	(17.0)	(13.2)	(9.9)	(9.0)

Net external liabilities/CARs (%)	141.4	193.4	151.3	108.5	107.4	96.4	101.5	109.8	116.7	114.6	110.7

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. f--Forecast. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

RATINGS SCORE SNAPSHOT

Table 2

Republic of Bulgaria Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Strength
Monetary assessment	Weakness

Standard & Poor's 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). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors 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 assessments.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators - March 31, 2015. An interactive version is available at www.spratings.com/sri

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 agreed that all key rating factors were unchanged.

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	
	To	From
Bulgaria (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BB+/Stable/B	BB+/Stable/B

Transfer & Convertibility Assessment		
T&C Assessment	BBB+	BBB+
Senior Unsecured		
Foreign and Local Currency	BB+	BB+
Short-Term Debt		
Foreign and Local Currency	B	B

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