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FITCH AFFIRMS BULGARIA AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-London-19 June 2015: Fitch Ratings has affirmed Bulgaria's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB-' and 'BBB', respectively. The Outlooks are Stable. The issue ratings on Bulgaria's senior unsecured foreign and local currency bonds have been affirmed at 'BBB-'and 'BBB', respectively. The Country Ceiling has been affirmed at 'BBB+' and the Short-term foreign currency IDR at 'F3'.

Bulgaria's ratings are currently supported by the sovereign's lower level of domestic and external indebtedness relative to its 'BBB' range peers, as well as a sufficient level of foreign reserves, which provide stability to its existing currency board regime. These factors offset large structural weaknesses in the economy, which constrain higher trend growth.

KEY RATING DRIVERS

Bulgaria's headline fiscal deficit (ESA 2010) at 2.8% of GDP (end 2014) has now moved in line with the 'BBB' median fiscal deficit. The widening of 2014's deficit by 1.9pp from 0.9% of GDP in 2013 has increased pressure on the government to keep public finances compliant with EU rules under the European Commission's preventive arm to which Bulgaria is liable. This will be challenging given Fitch's baseline of a weaker economic environment in 2015 than in 2014. For 2015, our latest projection is for a fiscal deficit close to 3.0% of GDP.

Despite the widening fiscal deficit, Bulgaria's gross government debt ratio, at 27.6% of GDP, (end-2014) remains below the 'BBB' range median debt ratio of 42.3% of GDP. Bulgaria's low level of indebtedness affords it a rating strength relative to its peers, although this is diminishing as the debt ratio moves higher. Our latest debt projections have Bulgaria's debt-to-GDP ratio not peaking until 2022-2023 at close to 35% of GDP, well above our baseline one year ago for debt to peak around 23% of GDP by 2017-2018. The biggest risks to Bulgaria's debt levels is a lack of commitment to fiscal consolidation and potentially further support for the banking sector, neither of which are incorporated into our baseline.

Weaknesses in the banking sector are a continuing risk for Bulgaria's ratings. Although the negative developments which occurred mid 2014 in domestically-owned banks Corpbank (KTB) and First Investment Bank (FIBank) were not systemic in nature, they highlighted problems in corporate governance and supervision in domestically-owned banks. The eventual implementation of a sectorwide Asset Quality Review (AQR) will add much delayed clarity over the sector's financial health, and could help restore confidence in the sector.

A potentially near-term risk to Bulgaria's banking sector relates to developments in Greece. Given the increased liquidity and solvency pressures in the Greek banking sector, Greek subsidiaries in Bulgaria cannot rely on receiving potential support from parent banks, making them a potential liability for the Bulgarian government.

For 2015 and 2016, Fitch forecasts real GDP growth of 1.2% and 1.5%, respectively. This is below potential growth, which is estimated to be between 1.5%-2.0%, and more than half the five-year average growth rate of the 'BBB' median range (3.2%). We expect positive contributions to growth from both domestic demand and net exports in 2015. However, domestic demand growth will be lower than the previous year given our weaker outlook for wage and employment growth which will slow down household consumption, as well as uncertainty in the banking sector which has delayed new investment by the private sector.

Bulgaria's external finances are supportive of its ratings. The country's net external debt position has been on a sustained downward trajectory since peaking at 46.7% of GDP in 2009. The net external debtor position of non-financial corporates remains high (52% of GDP; 2014), although the majority of it comprises intercompany lending (40% of GDP), is euro-denominated and has long maturities. Meanwhile, the sovereign has a strong net creditor position (22% of GDP; 2014), which lends adequate support to its existing currency board arrangement. Fitch also forecasts Bulgaria to maintain current account surpluses for 2015 and 2016.

Bulgaria's ratings are constrained by structural bottlenecks, which continue to constrain stronger growth rates, and limits Bulgaria's convergence progress with western European standards of living. Bulgaria is amongst the poorest EU states. GDP per capita is below the 'BBB' median and 47% of the EU average.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's assessment that upside and downside risks to the rating are currently balanced. The main risk factors that, individually or collectively, could trigger negative rating action are:

- Re-emergence of instability in the banking sector, which may increase pressure on government fiscal finances and economic growth.

- Further fiscal slippage that threatens the long-term sustainability of public finances.

- A negative economic shock that causes a downward revision in medium-term GDP.

The main factors that, individually, or collectively, could trigger positive rating action include:
- Credible fiscal consolidation that supports the long-term sustainability of public debt dynamics.
- Stronger trend GDP growth and progressive convergence towards average EU income levels.
- Sustained improvement in institutional governance.

KEY ASSUMPTIONS

Fitch assumes that Bulgaria's currency board arrangement will remain in place and that governments will continue to pursue policies consistent with it.

Fitch assumes that there will be no material escalation in developments between Russia and Ukraine that would lead to a significant external shock to Bulgaria's economy.

The European Central Bank's asset purchase programme should help underpin inflation expectations, and supports our base case that, in the context of a modest economic recovery, the eurozone will avoid prolonged deflation. Fitch also assumes the gradual progress in deepening fiscal and financial integration at the eurozone level will continue; key macroeconomic imbalances within the currency union will be slowly unwound; and eurozone governments will tighten fiscal policy over the medium term.

Fitch's base case is that Greece (CCC) will remain a member of the eurozone, though it recognises that 'Grexit' is a material risk.

Contact:
Primary Analyst

Kit Ling Yeung

Associate Director

+44 20 3530 1527

Fitch Ratings Limited

30 North Colonnade

London E14 5GN

Secondary Analyst

Vincent Forest

Associate Director

+44 20 3530 1080

Committee Chairperson

James McCormack

Managing Director

+44 20 3530 1286

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria

Country Ceilings (pub. 28 Aug 2014)

Sovereign Rating Criteria (pub. 12 Aug 2014)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy