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Research Update:

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

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Overview

- We estimate that the Bulgarian economy will grow by 3% in 2015 supported by the government's efforts to increase the absorption of EU structural and cohesion funds.
- We believe Bulgaria's financial sector continues to face important challenges, but we note that efforts are underway to mitigate risks, including an asset quality review slated for 2016.
- We are therefore affirming our 'BB+/B' long- and short-term sovereign credit ratings on Bulgaria.
- The stable outlook reflects the balance between the risks we see from potential vulnerabilities in the financial sector against Bulgaria's fiscal space arising from still-low government debt.

Rating Action

On Dec. 11, 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 on Bulgaria are constrained by its relatively low income levels, with GDP per capita estimated at US$6,800 in 2015; weak institutional settings; the limited flexibility of monetary authorities in light of the country's currency board regime; and the high proportion of loans and deposits denominated in euros (i.e. high euroization), which further restrict the effective transmission of monetary policy.

The ratings are supported by the government's moderate net debt position, estimated at nearly 20% of 2015 GDP, which affords Bulgaria some fiscal space to respond to external and domestic shocks, should they arise. We note, however, that this space has been eroded to some extent by the sharp increase in government debt following support extended to the banking sector last year. The ratings also benefit from Bulgaria's moderately leveraged external balance sheet following half a decade of external deleveraging, led primarily by the financial sector. However, while this has led to a marked reduction in external indebtedness, we observe that the process has had resonance on economic growth through a contraction in bank lending, although the latter is in part also fueled by poor demand for credit amid ongoing private sector deleveraging.

The Bulgarian economy is currently benefitting from a period of relative political calm. The current coalition government, the fifth since early 2013, was formed after the parliamentary elections in late 2014 and was immediately tasked with the resolution of the vestiges of the banking sector turbulence in the summer of 2014. To this end, the state extended a loan to the Deposit Guarantee Fund, which allowed reimbursement of the guaranteed deposits of the failed Corporate Commercial Bank (KTB), nearly six months after its failure. The government has made some progress in passing parametric pension reform earlier this year through an increase in the retirement age and pension contributions. However, movement from the private pension pillar to the government-managed first pillar, while likely to provide a short-term boost to government finances through increased contributions, could potentially undermine the positive effects of pension reforms in the longer run by increasing future liabilities to the state. Being a minority coalition, the government relies on support from parties outside the coalition with differing ideologies, and this represents a source of potential instability, which in turn could have implications for the direction of policy-making and the reform agenda.

In the absence of the political uncertainty that has characterized recent years and in conjunction with lower energy prices, a reduction in unemployment, and acceleration in the absorption of EU funds, domestic demand has continued to strengthen. Demand for Bulgarian exports has also been strong, with export volumes increasing by nearly 8% in the first three quarters of 2015. These factors have contributed to real GDP growth of 3% year on year in the first nine months of the year. We have accordingly revised up our estimate of real GDP growth to 3% in 2015, against our previous estimate of 1.5%.

We believe the prospects for 2016-2018 are somewhat weaker, however. With the beginning of a new EU budget cycle, there will be a lag before new public investment projects financed by EU structural and cohesion funds can resume momentum. These funds have been an important source for financing growth in 2015 because policymakers have been keen to absorb the maximum possible amount from the available envelope. Indeed Bulgaria's absorption rate has increased to over 90% as of November 2015 from under 70% a year ago.

However, the strength of the recovery, independent of elevated government spending, is still uncertain, as domestic demand has struggled to gain momentum in the years following the 2008-2009 global financial crisis. Although we estimate that Bulgarian lev (BGN)-denominated nominal GDP will be nearly 20% higher than its 2008 peak, we expect domestic demand will only exceed its 2008 level in 2016.

An important reason for Bulgaria's weak recovery is that the drying up, or even reversal, of foreign inflows into the banking, construction, and property sectors--which propelled growth in the years leading up to the crisis--has not been fully offset by foreign inflows into other sectors, such as tradeables. As a result, positive labor market developments have taken a long time to materialize. We note a recent reduction in the unemployment rate to 9.9% in the second quarter of 2015 (compared with 11.4% in 2014); however, it is unlikely that it will revert to the precrisis low of 5.6% in the absence of a growth model that will pick up the slack in the wake of the crisis. Bulgaria is also facing a structural drag from demographic challenges. Its population has shrunk by nearly 15% over the past two decades, reflecting an aging society and net emigration.

Eurostat revised its assessment of Bulgaria's general government deficit upward to 5.8% in 2014 from 2.8% to account for the difference between the Deposit Insurance

Fund's (DIF) repayment of guaranteed deposits and expected liquidation proceeds from KTB. We do not include the outstanding loans to First Investment Bank or the DIF in government assets, nor do we account for any repayments from either in our forecast of the general government debt trajectory through 2015-2018.

We expect the general government deficit to narrow to 2.8% of GDP in 2015 on an accrual basis. Thereafter, we expect the fiscal deficit to gradually narrow to 2% of GDP in 2018. Following state support of the banking sector, general government debt rose by nine percentage points to 27% of GDP in 2014. We expect that the fiscal deficit will remain debt financed over the forecast horizon through 2018, with gross general government debt rising further to 33% by the end of 2018. General government debt, net of liquid assets, will amount to 19% of GDP in 2015 and 25% in 2018. We include government deposits with commercial banks and the Bulgarian National Bank (BNB) in our assessment of government liquid assets. These are inclusive of the deposit assets of the Fiscal Reserve Account.

Contingent liabilities that could potentially materialize on the government's balance sheet include those from the energy sector. The liabilities of the sector total BGN7.7 billion (about €4 billion; 8% of 2015 GDP), while its highest net losses arise from the Natsionalna Elektricheska Kompania (NEK; B/Negative/--), estimated by the Ministry of Finance at 0.3% of GDP for 2015.

Another source for contingent liabilities is the banking sector. Data from the BNB indicate that the system is well capitalized, with an average capital adequacy ratio of 22% in September 2015. The results of the asset quality review (AQR) the authorities plan to conduct in 2016 could, however, potentially expose further vulnerabilities. To this end, the 2016 borrowing plan includes a buffer of BGN2 billion (2% of GDP). As per its charter and under the currency board regime under which it operates, the BNB's ability to act as a lender of last resort is limited. It can provide liquidity support to the banking system only to the extent that its reserves exceed its monetary liabilities. Even then, support can occur only under certain conditions and for short periods against liquid collateral.

As of Sept. 30, 2015, the BNB's reserves covered monetary liabilities by 1.6x. With the adoption of the EU Banking Resolution and Recovery Directive (BRRD) into Bulgarian law, the failure of a bank will necessitate a bail-in of shareholders, creditors, and then a resolution fund. Only after exhausting these options would budgetary support be needed. In Bulgaria, banks' contributions to the resolution fund have not yet begun. Therefore, if the results of the AQR indicate a capital shortfall of a systemically important bank, there is still a likelihood that state support may be needed.

The banking sector is also vulnerable to external factors, given the large presence of Greek subsidiaries, which together account for about one-fifth of the sector's assets. The 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. While formally not a member of the eurozone, a line of support from the European Central Bank is available to the BNB in relation to any confidence losses arising at Greek-owned subsidiaries.

Details of this support, such as how it can be obtained or whether collateral would be needed, have not been released.

Policy makers' commitment to the currency board remains strong. This is evident in their track record of small fiscal surpluses or low deficits, and moderate general government indebtedness. The currency board was instated in 1997 in the wake of a banking crisis amid hyperinflationary conditions, which were fueled by central bank financing of budget deficits. The board successfully lowered price inflation and prevented further episodes of hyperinflation. However, the regime restricts policy response. Apart from limiting the BNB's ability to act as a lender of last resort, it restricts control over money creation. The board also does not allow the exchange rate to react in response to domestic or external conditions. Indeed, Bulgaria's adjustment following the 2008-2009 global financial crisis has come from downward wage effects, labor shedding, and an internal devaluation.

The low inflationary environment persisting in the eurozone has also been reflected in Bulgaria through the currency board. Indeed, in all of Europe, price deflation has been the most marked in Bulgaria after Greece--aggravated until recently by weak demand and domestic cuts in administered prices, particularly energy. While annual average deflation came in at 1.2% in October, core inflation (i.e., inflation adjusted for food, energy, alcohol, and tobacco) moved into positive territory for the first time since May 2013.

Outlook

The stable outlook on Bulgaria reflects the balance between the economic and fiscal risks we see from potential vulnerabilities in the financial sector against the fiscal space arising from still-low general government debt.

We could lower the ratings if the domestic financial system requires further substantial government support, or if outflows on the financial account result in pressures on the balance of payments.

We could consider an upgrade if Bulgaria effectively addresses governance issues, thereby boosting its growth potential and attracting higher foreign direct investment to the tradeables 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

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. BGN)	73	74	80	82	82	84	87	89	91	94
Nominal GDP (bil. US$)	52	50	57	54	56	57	49	48	50	51
GDP per capita (US$ 000s)	6.9	6.7	7.7	7.3	7.6	7.8	6.8	6.7	6.9	7.2

Table 1

Republic of Bulgaria Selected Indicators (cont.)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP growth	(4.2)	0.1	1.6	0.2	1.3	1.5	3.0	1.5	1.5	1.7
Real GDP per capita growth	(3.6)	0.7	2.3	0.8	1.9	2.1	3.5	2.0	2.0	2.2
Real investment growth	(17.7)	(17.7)	(4.4)	1.8	0.3	3.4	3.0	(2.0)	1.0	1.5
Investment/GDP	28.6	22.9	21.6	22.1	21.4	21.4	21.6	21.1	21.1	21.2
Savings/GDP	20.3	22.0	22.6	21.8	23.2	22.6	23.2	22.5	22.4	22.1
Exports/GDP	42.4	53.7	62.3	63.4	67.0	65.1	66.4	67.7	69.2	70.9
Real exports growth	(11.7)	17.2	11.5	0.8	9.2	(0.1)	5.0	4.5	4.5	5.0
Unemployment rate	6.8	10.3	11.3	12.3	13.0	11.4	10.5	10.3	10.0	9.8
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(8.4)	(0.9)	0.9	(0.3)	1.8	1.2	1.6	1.5	1.2	0.8
Current account balance/CARs	(16.3)	(1.4)	1.3	(0.4)	2.4	1.6	2.1	2.0	1.6	1.1
Trade balance/GDP	(13.0)	(9.4)	(6.5)	(9.5)	(6.9)	(6.4)	(6.1)	(6.4)	(6.8)	(7.0)
Net FDI/GDP	6.8	2.5	2.9	2.6	3.0	2.0	2.0	2.0	2.0	2.0
Net portfolio equity inflow/GDP	(0.4)	(0.5)	0.1	(0.1)	(0.4)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
Gross external financing needs/CARs plus usable reserves	155.5	135.1	122.9	121.8	116.7	120.8	117.6	103.1	104.3	105.3
Narrow net external debt/CARs	20.7	24.5	9.8	6.9	2.9	(0.9)	(13.6)	(14.5)	(14.4)	(13.7)
Net external liabilities/CARs	193.4	143.3	103.1	104.6	94.0	83.4	83.5	83.0	80.3	77.7
Short-term external debt by remaining maturity/CARs	81.0	69.7	46.9	42.8	40.8	41.6	44.4	32.6	32.5	31.2
Reserves/CAPs (months)	2.8	3.2	2.2	2.1	2.3	1.9	2.6	3.3	3.1	2.9
FISCAL INDICATORS (%, General government)										
Balance/GDP	(4.1)	(3.2)	(2.0)	(0.6)	(0.8)	(5.8)	(2.8)	(2.6)	(2.3)	(2.0)
Change in debt/GDP	0.7	2.0	1.0	2.6	0.4	9.4	2.6	2.6	2.3	2.0
Primary balance/GDP	(3.3)	(2.4)	(1.3)	0.2	(0.0)	(4.9)	(1.6)	(1.3)	(1.0)	(0.6)
Revenue/GDP	35.4	33.4	32.1	34.0	36.9	36.3	37.0	36.5	36.3	36.0
Expenditures/GDP	39.5	36.6	34.1	34.7	37.6	42.1	39.8	39.1	38.6	38.0
Interest /revenues	2.1	2.1	2.3	2.4	2.0	2.4	3.3	3.4	3.5	3.9
Debt/GDP	13.7	15.5	15.3	17.6	18.0	27.0	28.6	30.5	32.0	33.0
Net debt/GDP	4.0	7.0	8.8	9.9	11.9	17.2	19.4	21.5	23.3	24.6
Liquid assets/GDP	9.7	8.5	6.6	7.8	6.1	9.7	9.1	8.9	8.7	8.4
MONETARY INDICATORS (%)										
CPI growth	2.5	3.0	3.4	2.4	0.4	(1.6)	(1.4)	0.0	1.0	1.2
GDP deflator growth	4.0	1.2	6.9	1.6	(0.7)	0.4	0.8	1.0	1.2	1.2
Banks' claims on resident non-gov't sector growth	4.0	1.6	4.2	2.8	0.1	(6.7)	(5.0)	2.0	2.0	2.0
Banks' claims on resident non-gov't sector/GDP	72.8	73.0	70.1	70.8	70.5	64.5	59.0	58.7	58.3	57.8

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Table 1

Republic of Bulgaria Selected Indicators (cont.)										
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Foreign currency share of claims by banks on residents	47.0	47.8	49.0	47.3	45.0	38.0	50.2	50.2	50.2	50.2

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository 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. BGN--Bulgarian lev. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. 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

- Credit FAQ: What's Ahead For Emerging Market Sovereigns In 2016 - December 10, 2015
- The Heat Is On: How Climate Change Can Impact Sovereign Ratings - November 25, 2015
- Why Politics Matters To Sovereign Ratings - November 06, 2015
- The Emerging Market Sovereign Outlook: What's Gone Wrong? - October 20, 2015
- Sovereign Risk Indicators - October 12, 2015. An interactive version is available at www.spratings.com/sri
- Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends - September 29, 2015
- Central, Eastern, and Southeastern Europe Sovereign Rating Trends Mid-Year 2015 - July 13, 2015
- Global Sovereign Rating Trends Mid-Year 2015 - July 13, 2015
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US$6.7 Trillion - March 05, 2015
- Central And Eastern Europe Debt Report 2015: Borrowing To Decrease To EUR119 Billion - March 05, 2015
- Default Study: Sovereign Defaults And Rating Transition Data, 2013 Update - September 17, 2014

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

	Rating	
	To	From
Bulgaria (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BB+/Stable/B	BB+/Stable/B
Transfer & Convertibility Assessment	BBB+	BBB+
Senior Unsecured		
Foreign and Local Currency	BB+	BB+
Short-Term Debt		
Foreign and Local Currency	B	B

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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