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Research Update:

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

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Overview

- The Bulgarian economy is likely to continue facing challenges to real and nominal GDP growth.
- However, the government's moderate debt position allows it fiscal space to respond to shocks.
- We are therefore affirming our 'BB+/B' long- and short-term sovereign credit ratings on Bulgaria.
- The stable outlook reflects our view that Bulgaria's fiscal flexibility, arising from still-low general government debt, balances potential risks from the financial sector.

Rating Action

On June 3, 2016, S&P Global Ratings 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, with GDP per capita estimated at $6,800 in 2016; weak institutional settings; the authorities' limited policy flexibility, in light of the country's currency board regime; and the high proportion of loans and deposits denominated in euros, which further restricts 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 fiscal space to respond to external and domestic shocks, should they arise. We note, however, that this leeway has reduced somewhat, due to the increase in government debt after the state provided support to the banking sector in 2014. 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. Yet, although external debt has reduced substantially, we observe that the deleveraging process has weighed on growth through a contraction in bank lending, which has also been affected by weak demand for credit.

In 2015, Bulgaria's economy expanded by 3%, supported by export growth and an acceleration in the absorption of EU funds. This was Bulgaria's highest growth rate since 2009, well above the 2010-2014 average of 0.9%. On a per capita basis, real GDP growth was higher at 3.6%, reflecting in part the 0.6% decline in Bulgaria's population. We continue to believe that the prospects for 2016-2019 are 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 were an important source of growth financing in 2015 because policymakers have been keen to absorb the maximum possible amount from the available envelope.

Moreover, the strength of the underlying economic recovery is still uncertain. Domestic demand has struggled to gain momentum following the 2008-2009 global financial crisis. Although we estimate that nominal GDP in local currency will be nearly 20% higher than its 2008 peak, domestic demand will only just reach its 2008 level in 2016. In this context, we also note that, in 2015, private consumption demand increased by only 0.8%, despite relatively lower political uncertainty and higher disposable incomes, supported by rising employment and low inflation. Bulgaria's weak consumption has also contributed to the most marked price deflation in all of the EU. Bulgaria's deflationary trend has also been aggravated by domestic cuts in administered prices, particularly energy prices. In April this year, annual deflation was 2.5% and core inflation (that is, adjusted for food, energy, alcohol, and tobacco prices) moved back into negative territory at -1.2%.

An important reason for Bulgaria's weak recovery is that the reversal of nonresident financing of 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 9.4% in 2015 from 11.4% in 2014; however, unemployment remains substantially above the precrisis low of 5.6%. 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.

Since 2007, Bulgaria's current account deficit has narrowed by about 25% of GDP, primarily on the back of a strong expansion in real exports. Exports with high import content and moderate added value from the domestic economy--such as refined petroleum--are an important part of total exports. On its own, the improvement in Bulgaria's current account has been impressive, but it has not been particularly supportive of the domestic economy. While wage levels have increased considerably since Bulgaria joined the EU in 2007, the process of convergence toward European averages has been only gradual. As of last year, the total hourly labor costs (mainly wages) in industry, construction, and services were slightly less than one-sixth of the EU-28 average. Since 2000, the hourly wage in Bulgaria has actually declined as a percentage of those in peers such as Romania and Estonia.

The general government deficit narrowed to 2.1% of GDP in 2015 on an accrual basis, following revenue outperformance as measures to widen the tax base and improve collection were implemented. We expect this deficit to gradually reduce to 1.7% of GDP in 2019. We think that challenges to budgetary consolidation persist, particularly from poor growth and low inflation. Political considerations could also have an important bearing on the fiscal outturn. The withdrawal of support from one of the parties backing the minority coalition government could hinder further consolidation efforts. The electoral calendar could also become relevant, with presidential elections scheduled for later this year and parliamentary elections in 2018.

We expect that debt will continue to finance the fiscal deficit through to 2018, with gross general government debt inching up to almost 32% by the end of 2019. We note that about 80% of total government debt is denominated in foreign currency, mainly euros.

Contingent liabilities that could materialize include those from the energy sector, with the highest losses likely to be at Natsionalna Elektricheska Kompania (NEK), estimated by the Ministry of Finance at 0.3% of GDP for 2015. We note that the recent repayment of NEK's outstanding payables to two power plants has paved the way for a tariff renegotiation that could potentially trim the company's losses.

Another source of contingent liabilities is the banking sector. Data from the Bulgarian National Bank (BNB) indicate that, although nonperforming loans remain high at nearly 15% of total loans in March 2016, the banking system is well capitalized, with an average capital adequacy ratio of 23%. The results of the ongoing asset quality review could, however, expose vulnerabilities. To this end, the government's 2016 borrowing plan includes a buffer of Bulgarian lev (BGN) 2 billion (2% of GDP). As per its charter--and according to 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 March 31, 2016, the BNB's reserves covered monetary liabilities by 1.7x. With the adoption of the EU Banking Resolution and Recovery Directive 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 government support be needed.

The banking sector is 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. Although Bulgaria is not formally a member of the eurozone, a line of support from the European Central Bank is available to the BNB regarding any confidence-related losses arising at Greek bank subsidiaries. Details of this support, such as how it can be obtained or whether collateral would be needed, have not been released.

Bulgaria is not part of the EU's Exchange Rate Mechanism II, the precursor to eurozone entry. Furthermore, policymakers' commitment to the currency board remains strong, as demonstrated by their track record of small fiscal surpluses or low deficits, and moderate general government debt. The currency board was introduced 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.

Bulgaria's adjustment following the 2008-2009 global financial crisis appears to have come from labor shedding, in our view.

Outlook

The stable outlook on Bulgaria reflects the balance between the economic and budgetary risks that could potentially arise from the financial sector, against the fiscal space created by still-low general government debt.

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

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

Key Statistics

Table 1

Republic of Bulgaria Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	74	80	82	82	84	86	88	90	92	95
Nominal GDP (bil. $)	50	57	54	56	57	49	49	49	50	52
GDP per capita (000s $)	6.7	7.7	7.3	7.6	7.8	6.8	6.8	6.9	7.1	7.3
Real GDP growth	0.1	1.6	0.2	1.3	1.5	3.0	1.5	1.5	1.7	1.7
Real GDP per capita growth	0.7	2.3	0.8	1.9	2.1	3.6	2.0	2.0	2.2	2.2
Real investment growth	(17.7)	(4.4)	1.8	0.3	3.4	2.5	(2.0)	0.5	1.5	1.5
Investment/GDP	22.9	21.6	22.1	21.4	21.4	21.3	20.9	21.0	21.2	21.3
Savings/GDP	21.1	22.0	21.2	22.7	22.3	22.7	22.8	22.5	22.2	21.4
Exports/GDP	53.7	62.3	63.4	67.0	65.1	66.5	67.8	69.9	71.9	73.7
Real exports growth	17.2	11.5	0.8	9.2	(0.1)	7.6	4.8	4.8	5.0	5.0
Unemployment rate	10.3	11.3	12.3	13.0	11.4	9.4	9.2	9.0	8.9	8.8
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(1.7)	0.3	(0.9)	1.3	0.9	1.4	1.9	1.5	1.0	0.0
Current account balance/CARs	(3.0)	0.5	(1.2)	1.7	1.2	1.9	2.5	1.9	1.2	0.1
Trade balance/GDP	(9.5)	(6.6)	(9.6)	(7.0)	(6.5)	(4.3)	(4.0)	(4.2)	(4.6)	(5.3)
Net FDI/GDP	2.5	2.9	2.6	3.0	2.1	3.4	3.0	3.0	3.0	3.0
Net portfolio equity inflow/GDP	(0.5)	0.1	(0.1)	(0.4)	(1.0)	(0.6)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	137.6	124.1	122.8	117.4	120.7	117.4	100.1	107.3	106.0	104.8
Narrow net external debt/CARs	23.2	8.1	5.0	0.7	(3.1)	(15.0)	(16.7)	(18.9)	(20.8)	(21.4)

Table 1

Republic of Bulgaria Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Net external liabilities/CARs	147.9	105.3	106.4	93.5	84.2	70.4	71.9	69.7	66.9	65.4
Short-term external debt by remaining maturity/CARs	73.2	48.4	43.8	41.6	41.0	44.0	33.1	29.3	27.8	26.3
Reserves/CAPs (months)	3.3	2.3	2.2	2.3	1.9	2.6	3.7	2.3	2.3	2.5
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.2)	(2.0)	(0.3)	(0.4)	(5.4)	(2.1)	(2.0)	(1.9)	(1.9)	(1.7)
Change in debt/GDP	2.0	1.0	1.7	0.3	10.3	0.5	2.0	1.9	1.9	1.7
Primary balance/GDP	(2.4)	(1.3)	0.5	0.3	(4.6)	(1.1)	(1.1)	(0.9)	(0.9)	(0.6)
Revenue/GDP	33.5	32.1	34.4	37.2	36.6	38.2	38.2	38.2	38.2	38.2
Expenditures/GDP	36.7	34.1	34.7	37.6	42.1	40.2	40.2	40.1	40.1	39.9
Interest /revenues	2.1	2.3	2.3	2.0	2.4	2.5	2.5	2.5	2.7	2.9
Debt/GDP	15.5	15.3	16.8	17.1	27.0	26.7	28.2	29.5	30.6	31.5
Debt/Revenue	46.3	47.8	48.9	45.8	73.7	69.8	73.7	77.2	80.2	82.4
Net debt/GDP	7.2	8.9	9.1	11.0	17.3	18.5	20.1	21.6	23.0	24.0
Liquid assets/GDP	8.3	6.4	7.7	6.0	9.7	8.2	8.0	7.9	7.7	7.4
MONETARY INDICATORS (%)										
CPI growth	3.0	3.4	2.4	0.4	(1.6)	(1.1)	(0.2)	0.5	0.7	1.0
GDP deflator growth	1.2	6.9	1.6	(0.7)	0.4	0.3	0.4	0.6	0.9	1.2
Exchange rate, year-end (LC/$)	1.5	1.5	1.5	1.4	1.6	1.8	1.8	1.8	1.8	1.8
Banks' claims on resident non-gov't sector growth	1.6	4.2	2.8	0.1	(6.7)	(1.6)	0.0	1.5	2.0	2.0
Banks' claims on resident non-gov't sector/GDP	73.0	70.1	70.8	70.5	64.5	61.4	60.3	59.9	59.6	59.0
Foreign currency share of claims by banks on residents	46.3	47.4	45.2	43.7	40.8	47.4	47.4	47.4	47.4	47.4
Foreign currency share of residents' bank deposits	49.0	45.3	41.2	41.2	40.9	40.3	40.3	40.3	40.3	40.3
Real effective exchange rate growth	(3.9)	2.7	(2.0)	1.3	(0.5)	(3.2)	N/A	N/A	N/A	N/A

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. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' 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	Strength
Fiscal assessment: debt burden	Strength
Monetary assessment	Weakness

S&P Global Ratings 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 S&P Global Ratings' "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 S&P Global Ratings' 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: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- 2015 Annual Sovereign Default Study And Rating Transitions - May 24, 2016
- Sovereign Risk Indicators - May 3, 2016. For an interactive version, go to www.spratings.com/sri
- Global Aging 2016: 58 Shades Of Gray - April 28, 2016
- Central And Eastern Europe Debt Report 2016: Commercial Borrowing To Increase By 12% To EUR114 Billion - February 29, 2016
- Central And Eastern Europe Rating Trends 2016 - January 18, 2016
- 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
- Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends -

September 29, 2015

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 the fiscal assessment had improved. All other 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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. 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 S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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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