FITCH AFFIRMS BULGARIA AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-London-02 December 2016: Fitch Ratings has affirmed Bulgaria's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-', with Stable Outlooks. The issue ratings on Bulgaria's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB-'. The Country Ceiling has been affirmed at 'BBB+' and the Short-Term Foreign and Local Currency IDRs at 'F3'.

KEY RATING DRIVERS
Bulgaria's ratings are supported by its sound public finances and favourable and improving external finances. However, a pattern of unstable governments cloud policy outlook, potentially holding back effective structural reform, which is needed to boost long-term potential growth and raise GDP per capita levels in line with similar and higher rated peers.

The resignation of Prime Minister Boyko Borisov, of the centre-right Citizens for European Development (GERB) party on 16 November, has increased the likelihood for early elections in 2017 should President Rosen Plevneliev fail to have political parties agree on a new government mandate in the coming weeks. Since 2009, Bulgaria has had five different governments. The last early elections were held back in 2014, when a minority government consisting of the Bulgarian Socialist Party (BSP) and Movement for Rights and Freedom (DPS) became untenable.

A pattern of unstable governments is a weakness for Bulgaria's rating, and in Fitch's opinion disrupts effective policy setting. Fitch does not envision any significant delay in implementing the 2017 fiscal budget. However, budget revisions by a new government could occur post-election. Meanwhile, with the draft election code submitted back to parliament for further discussion, after a national referendum on the bill failed to attract sufficient support, it remains unclear whether changes to Bulgaria's electoral system will be in place in the near term.

Fitch's new macroeconomic baseline forecasts average real GDP growth of 2.8% for 2017-2018, revised up from 2.4% six months ago. Our upward revision reflects positive carryover effects from a much stronger 2016 real GDP outturn than projected back in June, where growth is now expected 1.3pp higher at 3.4%, and above the 'BBB' median of 3.1%. A revision to national accounts indicates a much higher contribution from domestic demand relative to net exports than previous estimates. Year-to-date, resilience in household consumption is offsetting temporary weakness in gross fixed capital formation and low government spending.

Our outlook of higher growth above its current five-year average of 1.8%, suggest progress in convergence towards GDP per capita levels of higher rated peers. However, Bulgaria is characterised by high GDP volatility and faces structural challenges to achieving a higher and more sustainable rate of potential growth in the medium term. Risks to our macroeconomic baseline are balanced. A scenario of prolonged political uncertainty could weigh on economic sentiment. However, upside risks are possible from a higher than planned absorption of EU funds, resumption in credit growth or higher economic growth of Bulgaria's main trading partners.
Fiscal performance has benefited from stronger economic growth and administrative tax measures. Higher than planned receipts in tax revenues and contained government spending indicate the likelihood of a favorable budget outperformance in 2016. Against the government's target deficit of 1.9%, Fitch now expects a deficit of 0.9% of GDP (ESA 2010) for 2016, significantly below the 'BBB' median deficit of 2.7% of GDP. Meanwhile, government debt will increase towards 29% of GDP in 2016 from 26% in 2015, reflecting a EUR2bn dual-tranche Eurobond issuance back in March, but remaining below the 'BBB' median ratio of 40.6% of GDP.

Bulgaria's rating is further supported by its favourable external finances. Sustained current account surpluses in recent years and high level of foreign reserve assets covering 7.5 months of current external receipts (2015), provide stability to the country's existing currency board regime. Trends in net external debt continue to improve, and for the first time fell below the 'BBB' median of 8.2% of GDP in 2015, reaching 3.6% of GDP from a peak of 45.2% of GDP in 2009.

Fitch views the domestic banking sector as a lower probability of risk as a contingent liability on the sovereign's balance sheet, following the results of Bulgaria's banking sector-wide asset quality review (AQR) published in August 2016. The AQR showed a well-capitalised sector (CET1 ratio of 21% at end-3Q16), but this should be viewed against a stockpile of net non-performing loans (NPLs) equivalent to about 45% of the sector's CET1 capital. The sector's NPL ratio was 19% at end-3Q16, one of the highest in the region. Refinancing risk in the sector is low, in view of the banks' ample liquidity buffers, weak demand for loans and deposits growth.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns Bulgaria a score equivalent to a rating of 'BBB' on the Long-Term FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Macroeconomics: -1 notch, to reflect Fitch's view that sustained and higher potential growth is limited by the lack of progress on reforms to address the economy's structural bottlenecks.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The Stable Outlook reflects Fitch's assessment that upside and downside risks to the rating are currently balanced. The main factors that could, individually or collectively, trigger positive rating action include:
- Stronger potential GDP growth and progressive convergence towards peer income levels.
- Sustained improvement in external finances.
- Credible fiscal consolidation that supports stability in the public debt burden.

The main risk factors that, individually or collectively, could trigger negative rating action are:
- Materialisation of contingent liabilities on the sovereign's balance sheet from state-owned enterprises and/or banking sector.
- Higher fiscal deficits that result in a rapid deterioration of the public debt trajectory.

KEY ASSUMPTIONS
The global economy performs broadly in line with Fitch's Global Economic Outlook

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

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Applicable Criteria
Country Ceilings (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885997
Sovereign Rating Criteria (pub. 18 Jul 2016)
https://www.fitchratings.com/site/re/885219