MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Bulgaria's Baa2 issuer ratings; outlook stable

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London, 26 May 2017 -- Moody's Investors Service, ("Moody's") has today affirmed Government of Bulgaria's Baa2 long term issuer rating, the Baa2 senior unsecured rating and the (P)Baa2 long term senior unsecured MTN program rating. The outlook remains stable.

The affirmation of the rating with stable outlook balances the following key rating factors:

1. Bulgaria's resilient economy and robust medium-term growth prospects, supported by predictable macroeconomic policies.

2. The government's strong balance sheet with a low and declining debt level as well as sizeable fiscal reserves.

3. Bulgaria's structural challenges, including adverse demographic developments and a pronounced skill mismatch.

Bulgaria's long-term local currency bond and deposit ceilings remain unchanged at A3, and the foreign currency bond and deposit ceilings remain also unchanged at A3 and Baa2, respectively. The short-term foreign currency bond and deposit ceilings are also unaffected by this rating action and remain at Prime-2.

RATINGS RATIONALE

FIRST DRIVER: Bulgaria's resilient economy and robust medium term growth prospects, supported by predictable macroeconomic policies

The first driver of the affirmation of Bulgaria's Baa2 rating with a stable outlook relates to the country's resilient economy and robust medium term growth prospects, supported by predictable macroeconomic policies. The Bulgarian economy has experienced a steady recovery over the past two years, with real GDP growth accelerating to 3.6% and 3.4% in 2015 and 2016, respectively. The growth recovery is broad based with private consumption strengthening and net exports rising on the back of improved external demand and improved competitiveness. On the production side, the key sectors driving Bulgaria's strong growth momentum include manufacturing, real estate and trade services sectors.

Looking ahead, Moody's expects the country's growth performance will continue to benefit from the improved labour market conditions, as wages rise faster than inflation. Moreover, Moody's expects domestic demand to be additionally strengthened by credit expansion, given a confidence boost from the central bank's asset quality review and a stress test completed in August 2016. Lending has already resumed, with private credit growth picking up from negative territory to 1.5% year-on-year in December 2016 after almost two years of contraction and Moody's expects this upward trend to continue in the year ahead. Additionally, Moody's expects investment to resume its positive contribution to growth owing to greater absorption of EU funds. Overall, Moody's forecasts real GDP growth of 2.9% in 2017 and 2018.

Bulgaria's macroeconomic performance is underpinned by the strong broad-based support within Bulgaria for its Currency Board Arrangement (CBA), which continues to be a crucial factor in anchoring the country's macroeconomic policies. The credibility of the CBA is further bolstered by the central bank's continued reserve accumulation which has helped to maintain foreign exchange reserves coverage of total monetary liabilities above 150%, significantly higher than in other countries with currency board arrangements.

SECOND DRIVER: The government's strong balance sheet with low and declining debt levels and sizeable fiscal reserves

The second driver of today's rating action is based on the government's strong balance sheet with low and declining debt levels, as well as sizeable fiscal reserves. Bulgaria has made significant progress in restoring its fiscal position. Preliminary data for 2016 show a fiscal surplus of 1.6% of GDP on a cash basis and a balanced budget in ESA 2010 terms, representing a sharp fiscal consolidation since 2014 when the cash deficit was -3.7% of GDP and the deficit on ESA terms was -5.5% of GDP. The 2016 fiscal over-performance compared to the government's forecasts, reflects higher-than-expected growth and revenue collection and under-execution of capital expenditures, the latter owing to low absorption of EU funds.

In 2017, Moody's expects a fiscal deficit of 0.6% of GDP, reflecting an increase in both revenues—in line with our expectation for continued growth momentum—and expenditures as greater absorption of EU funds supports increased capital expenditures. Overall, Moody's projects the fiscal deficit to remain narrow, comfortably reaching the authorities' target of fiscal balance by 2020.

Moody's also projects a decline in Bulgaria's general government debt-to-GDP ratio to 23% of GDP by 2020, from a peak of 29.5% of GDP in 2016. Moreover, Bulgaria's debt ratio is significantly below the median debt ratio for Baa2 rated peers (46%). And Bulgaria's debt affordability metrics are also significantly lower when compared to the EU average and Baa2 rated peers --interest payments as a share of total government revenue were 2.2% in 2016, compared to 4.9% and 8.7% median for EU- and Baa2-rated peers.

Bulgaria also has sizeable fiscal reserves, which have doubled from BGN 5.9 billion (7.1% of GDP or EUR 3 billion) at the beginning of 2014 to BGN 12.9 billion (13.9% of GDP or EUR 6.7 billion) at end-2016. As a result, in recent years the government's net debt ratio has risen at a slower pace than its gross debt ratio, and its net debt ratio stood at 15.6% in 2016.

THIRD DRIVER: Bulgaria's structural challenges, including adverse demographic developments and a pronounced skills mismatch

The third driver of the affirmation of the Baa2 rating with stable outlook relates to Bulgaria's structural challenges, particularly an ageing population, emigration and skills mismatch of the workforce which constrain the labour supply and weigh on the economy's longer-term potential growth outlook.

Bulgaria's population has declined by an average of 0.8% annually over the past two decades mainly due to emigration and declining fertility rates. According to the European Commission (EC), these trends will cause Bulgaria's old age dependency ratio to increase from 46% in 2013 to 55% by 2030, one of the highest among European countries. Bulgaria also has a relatively high dispersion of employment and unemployment rates across skill levels compared to other European countries pointing to a higher skills mismatch of the labour force, an additional constraint on the country's falling labour supply.

As a result of the aging population and the increasing life expectancy, Moody's expects potential growth will in the absence of significant structural reforms gradually decline alongside the decline in labour supply over the coming years. Without additional reforms, the fiscal pressure on the pension system will increase in the long run, absorbing the gains from recent pension reforms. While these challenges are likely to weigh on Bulgaria's growth potential and long term fiscal sustainability, Moody's views their impact on near term credit metrics as fairly limited.

WHAT COULD CHANGE THE RATING - UP

Upward rating pressure would be likely should fiscal consolidation resume at a significantly faster pace bringing government debt levels closer to pre-crisis levels. The passage and implementation of structural reforms targeting Bulgaria's structural constraints and raising potential output levels could also exert upward pressure on Bulgaria's government bond rating.

WHAT COULD CHANGE THE RATING - DOWN

A downgrade could be triggered in case of (1) renewed political volatility which interferes with policy making and undermines the government's commitment to stable macroeconomic policies; and (2) although unlikely given regulatory reforms, renewed stress in the banking system; and (3) signs of a reversal in the authorities' commitment to containing budget deficits and the public debt stock.

GDP per capita (PPP basis, US$): 20,327 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.4% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -0.5% (2016 Actual)

Gen. Gov. Financial Balance/GDP: 0% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.3% (2016 Actual) (also known as External Balance)

External debt/GDP: 74.2% (2015 Actual)

Level of economic development: Moderate level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 24 May 2017, a rating committee was called to discuss the rating of the Bulgaria, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/ framework, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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