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Research Update:

Bulgaria Outlook Revised To Positive On Improving External Position; 'BB+ / B' Ratings Affirmed

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Research Update:

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Overview

- Solid external and fiscal performance has lifted Bulgaria's credit metrics, and the economy is more export driven and less leveraged than in the past.
- We are therefore revising our outlook on Bulgaria to positive from stable and affirming our 'BB+/B' long- and short-term sovereign credit ratings.
- The positive outlook on Bulgaria reflects our view that there is a rising likelihood that we will raise our ratings on Bulgaria over the next 12 months if we observe a further reduction of external and other macroeconomic vulnerabilities, and it points to potential ratings upside from improving monetary transmission due to the financial sector's continued progress reducing the still-high level of nonperforming loans.

Rating Action

On June 2, 2017, S&P Global Ratings revised its outlook on the Republic of Bulgaria to positive from stable. At the same time, we affirmed our 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings.

Rationale

The outlook revision reflects our expectation that Bulgaria's fiscal and external metrics will continue to improve, and that the authorities will take further steps to strengthen Bulgaria's financial sector, where the gross level of nonperforming loans, at 13% of total financial sector claims, remains considerable. Almost one-half of total lending in Bulgaria is denominated in foreign currency, nearly all in euros. Although euroization is declining, the still relatively high level of foreign currency lending constrains the authorities' ability to fine tune monetary policy, also reflecting the minimal policy flexibility under the currency board arrangement, which pegs the Bulgarian lev to the euro.

The ratings on Bulgaria remain constrained by Bulgaria's relatively low income levels, with GDP per capita estimated at \$7,200 in 2017. Another constraint on Bulgaria's creditworthiness, in our view, is the government's and central bank authorities' limited policy flexibility due to the country's currency board regime, which was introduced in 1997. We recognize, however, that the currency board regime has been an important stability anchor for the country. Bulgaria's weak institutional settings, especially in the judiciary, and Bulgaria's long-term demographic challenges also weigh on the ratings.

Following the March 2017 snap elections, center-right GERB party formed a coalition with the United Patriots, comprising several rightist political parties. Given that

key figures, including Prime Minister Boyko Borissov, have resumed their government positions, we expect a high degree of policy continuity. However, the caretaker government episode between January 2017 and May 2017 illustrates the relative instability of Bulgarian governments in the past few years, as early elections have been a frequent occurrence.

Although the government's priority areas in health care, education, and defense remain largely unaltered, we anticipate that general government deficits will average 0.5% of GDP over 2017-2020, higher than the government's own fiscal targets, which foresee a slight surplus of the general government by 2019. We think that some spending pressures beyond the budgetary targets could arise regarding the public sector or the social area, as in the already decided pension increases, in order to deliver on electoral promises. That said, we project that general government debt net of liquid assets is set to decline further to below 16% of GDP by 2020 from almost 17% in 2016. We note that about 80% of total government debt is denominated in foreign currency, mainly euros. Bulgaria's moderate government debt burden (net of liquid assets) grants the country fiscal space to respond to external and domestic shocks, should they arise. This is all the more important given Bulgaria's currency board arrangement, which acts as an important nominal anchor, but affords minimal monetary policy flexibility.

Bulgaria's economic recovery will likely continue in 2017, with an increasing contribution from domestic demand compared with previous years, when net exports were the main growth drivers. Furthermore, the improvements are reflected in the labor market, thereby raising disposable incomes and private consumption. With the beginning of the new EU budget cycle, public investment projects financed by EU structural and cohesion funds will also be an important contributor to economic performance, following the break in 2016 due to the end of the previous programming period. We understand that policymakers are well prepared to absorb the maximum possible amount from the available funds. At the same time, Bulgaria continues to face a structural constraint from demographic challenges. Net emigration, especially of skilled parts of the labor force, and an aging society pose challenges to economic policy and potentially social cohesion.

Bulgaria's current account posted a strong surplus in 2016 of more than 4% of GDP, crowning a period of steady growth in real exports in recent years. Although we expect the current account surplus to narrow gradually until 2020 as domestic demand firms, export growth will remain sound, in our opinion, supporting Bulgaria's improving external profile. In our view, there is substantial upside potential for wage growth without affecting competitiveness. That said, government policies to raise the minimum wage would likely not weigh on the export-oriented sector. While exports represented an estimated 64% of GDP in 2016 (versus 50% in 2010), Bulgaria's economy is highly open. We note, however, that not all exports are making large net contributions to headline GDP. This is because exports with high import content and moderate added value from the domestic economy--such as refined petroleum--represent an important part of total exports. As in 2016, we expect the services balances this year will benefit from a strong tourist season helped by external factors, such as perceived instability or insecurity in competing destinations.

Contingent liabilities that could materialize include those from the energy sector, although the government has recently reduced losses at Natsionalna Elektricheska Kompania (NEK). The government provided financing of 1.4% of GDP to NEK following the arbitration court decision to compensate Russia-based Atomstroyexport for equipment already produced for the cancelled Belene nuclear power plant. The new government will have to decide what to do with the equipment: Sell to another country or even complete the plant, as had been discussed previously.

As a result of last year's Asset Quality Review by the Bulgarian authorities, two domestic financial institutions had to replenish their additional capital buffers by April 2017. Most prominently, First Investment Bank had to increase its additional capital buffers by Bulgarian lev 206 million (about €105 million) as an outcome of the stress test's adverse scenario, and the bank delivered on this recommendation via its 2016 profits. While the banking sector overall is adequately capitalized, nonperforming loans in the sector remain high at almost 13% of total loans in March 2017, albeit on a decreasing trend.

As per its charter--and according to the currency board regime under which it operates--the Bulgarian National Bank's (BNB's) ability to act as a lender of last resort is limited. BNB 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.

Bulgaria is currently not part of the EU's Exchange Rate Mechanism II (ERM II), the precursor to eurozone entry. But we think that the country could move toward ERM II over the next couple of years, even though the political hurdle of receiving the invitation backed by all eurozone members is high. Until then, policymakers' commitment to the currency board remains strong. 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. Headline inflation will be positive in 2017 following three years of deflation. One sign of the currency regime's solidity is that Bulgaria's foreign currency reserves cover the monetary base by 1.7x as of April 2017.

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. Moreover, the board does not allow the exchange rate to react in response to domestic or external conditions.

With Bulgaria's adoption of the EU Banking Resolution and Recovery Directive in 2015, the failure of a bank will necessitate a bail-in of shareholders, creditors, and then a resolution fund. Only after exhausting these options would a bank be able to resort to government support.

The banking sector could be vulnerable to external factors, for example, if depositor confidence in Greek banks' subsidiaries were to suffer due to developments

there. However, the BNB has implemented measures to ensure the stability of these Greek subsidiaries, which together account for around 10% of the sector's assets as of March 2017. The BNB has taken steps to increase 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.

Outlook

The positive outlook reflects our view that there is at least a one-in-three likelihood of an upgrade over the next 12 months if, alongside the continued economic recovery, and strengthening of Bulgaria's external profile, we observe further reductions in the banking sector's nonperforming loans, which we believe would support an improvement in the monetary transmission channel. We might also raise the rating if Bulgaria was granted entrance to the ECB's ERM II monetary framework, which we think would further bolster policy credibility. Still, we expect this decision could be delayed for several more years.

We could revise the outlook to stable if pressures on Bulgaria's balance of payments emerged or the domestic financial system required substantial government support or if the declining trend in nonperforming loans reversed.

Key Statistics

Table 1

Republic of Bulgaria Selected Indicators										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	81	82	82	84	89	93	97	102	107	112
Nominal GDP (bil. \$)	57	54	56	57	50	52	52	55	60	64
GDP per capita (000s \$)	7.8	7.4	7.7	7.8	7.0	7.3	7.2	7.8	8.5	9.2
Real GDP growth	1.9	0.0	0.9	1.3	3.6	3.4	3.0	2.8	2.8	2.7
Real GDP per capita growth	2.6	0.6	1.5	1.9	4.2	4.1	3.5	3.3	3.3	3.2
Real investment growth	(4.4)	1.8	0.3	3.4	2.7	(4.0)	2.7	3.8	4.0	4.1
Investment/GDP	21.5	21.9	21.3	21.4	21.2	20.3	20.3	20.5	20.9	21.2
Savings/GDP	21.8	21.1	22.6	21.5	21.1	24.5	22.9	22.4	21.5	21.0
Exports/GDP	59.1	60.8	64.7	65.0	64.1	63.6	64.8	65.8	66.3	66.8
Real exports growth	12.6	2.0	9.6	3.1	5.7	5.7	4.4	4.4	4.0	3.9
Unemployment rate	11.3	12.3	13.0	11.4	9.2	7.6	7.0	6.5	6.3	6.1
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.3	(0.9)	1.3	0.1	(0.1)	4.2	2.7	1.9	0.6	(0.2)
Current account balance/CARs	0.5	(1.2)	1.7	0.1	(0.2)	5.9	3.7	2.6	0.8	(0.3)

Table 1

Republic of Bulgaria Selected Indicators (cont.)										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
CARs/GDP	66.0	68.9	73.9	72.5	71.3	70.7	72.5	73.4	73.9	74.2
Trade balance/GDP	(6.5)	(9.5)	(7.0)	(6.5)	(5.8)	(3.9)	(4.4)	(5.0)	(5.9)	(6.8)
Net FDI/GDP	2.9	2.5	3.0	2.1	5.3	1.1	1.0	1.5	1.8	2.0
Net portfolio equity inflow/GDP	0.1	(0.1)	(0.3)	(1.0)	(0.6)	(0.2)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	124.1	122.8	117.4	121.6	119.3	107.7	102.4	99.3	100.5	101.7
Narrow net external debt/CARs	8.1	5.0	0.7	(3.2)	(15.0)	(24.3)	(28.5)	(29.1)	(28.0)	(25.6)
Net external liabilities/CARs	105.3	106.4	93.5	84.6	75.2	56.2	50.2	40.8	34.6	30.6
Short-term external debt by remaining maturity/CARs	48.4	43.8	41.6	41.1	44.6	32.3	31.6	27.7	25.9	23.9
Usable reserves/CAPs (months)	2.3	2.2	2.3	1.9	2.6	2.2	3.1	3.2	3.0	2.7
Usable reserves (mil. \$)	6,750	7,914	6,544	7,640	6,430	9,322	10,572	10,793	10,578	9,733
FISCAL INDICATORS (% , General government)										
Balance/GDP	(2.0)	(0.3)	(0.4)	(5.5)	(1.6)	0.0	(0.6)	(0.6)	(0.5)	(0.4)
Change in debt/GDP	1.0	1.7	0.3	10.3	0.5	4.6	(1.4)	0.6	0.5	0.4
Primary balance/GDP	(1.2)	0.5	0.4	(4.6)	(0.7)	0.8	0.3	0.2	0.3	0.4
Revenue/GDP	31.9	34.1	37.2	36.6	39.0	35.5	34.9	35.5	35.5	35.4
Expenditures/GDP	33.8	34.5	37.6	42.1	40.7	35.5	35.5	36.1	36.0	35.8
Interest /revenues	2.3	2.3	2.0	2.4	2.4	2.2	2.5	2.4	2.4	2.4
Debt/GDP	15.2	16.7	17.0	27.0	26.0	29.5	26.8	26.2	25.5	24.7
Debt/revenue	47.8	48.9	45.7	73.7	66.6	83.1	76.7	73.8	71.7	69.7
Net debt/GDP	8.9	9.0	11.0	17.3	18.0	16.8	16.6	16.5	16.2	15.8
Liquid assets/GDP	6.4	7.7	6.0	9.7	8.0	12.7	10.2	9.7	9.3	8.8
MONETARY INDICATORS (%)										
CPI growth	3.4	2.4	0.4	(1.6)	(1.1)	(1.3)	1.4	1.7	2.0	2.1
GDP deflator growth	6.0	1.6	(0.7)	0.5	2.2	1.1	1.8	1.8	2.0	2.2
Exchange rate, year-end (LC/\$)	1.5	1.5	1.4	1.6	1.8	1.9	1.9	1.8	1.8	1.7
Banks' claims on resident non-gov't sector growth	3.9	2.8	0.2	(7.6)	(1.6)	1.8	3.9	4.0	4.5	4.7
Banks' claims on resident non-gov't sector/GDP	67.3	68.1	68.1	61.8	57.5	55.9	55.4	55.1	54.9	54.7
Foreign currency share of claims by banks on residents	51.3	49.5	47.6	42.1	33.1	29.1	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	45.3	41.2	41.2	40.9	40.3	38.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	2.7	(1.9)	1.3	(0.5)	(3.2)	0.2	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. 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

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- 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

- Sovereign Ratings List - May 05, 2017
- Sovereign Ratings History - May 05, 2017
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions - April 18, 2017
- Sovereign Risk Indicators - April 10, 2017. An interactive version is available at www.spratratings.com/sri
- Default, Transition, and Recovery: 2016 Annual Sovereign Default Study AndRating

Transitions - April 03, 2017

- Global Sovereign Rating Trends 2017 - January 10, 2017
- Sovereign Debt 2017: Global Borrowing To Drop By 4% To US\$6.8 Trillion - February 23, 2017
- Calendar Of 2017 EMEA Sovereign, Regional, And Local Government Rating Publication Dates - December 16, 2016
- Banking Industry Country Risk Assessment: Bulgaria - December 30, 2016

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+/Positive/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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