Moody's
INVESTORS SERVICE

Rating Action: Moody's changes Bulgaria's outlook to positive from stable; affirms Baa2 rating

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Frankfurt am Main, August 30, 2019 -- Moody's Investors Service ("Moody's") has today changed the outlook on the Government of Bulgaria's ratings to positive from stable. Concurrently, Moody's has affirmed Bulgaria's long-term issuer rating in foreign and local currency at Baa2, senior unsecured foreign currency debt rating at Baa2, as well as senior unsecured MTN debt programme rating at (P)Baa2.

Moody's decision to change the outlook to positive on Bulgaria's Baa2 ratings reflects the following key drivers:

1) Strengthening fiscal metrics due to the Bulgarian government's prudent policymaking;

2) Growth prospects to benefit from ongoing EU integration and Bulgaria's increased competitiveness.

The Baa2 rating affirmation balances the positive fiscal and macroeconomic trends and the country's strong commitment to join the euro area against ongoing challenges related to Bulgaria's constrained labour supply and skills mismatches, worsening demographics and shortcomings in areas such as corporate governance of state-owned enterprises.

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

RATIONALE FOR CHANGING THE OUTLOOK TO POSITIVE

FIRST DRIVER: STRENGTHENING FISCAL METRICS DUE TO THE BULGARIAN GOVERNMENT'S PRUDENT POLICYMAKING

The first driver informing the positive outlook on Bulgaria's Baa2 ratings relates to the government's strengthening fiscal profile due to a consistently prudent policy stance. Over the last three years, Bulgaria has shown growing budgetary surpluses (0.1% of GDP in 2016, 1.2% of GDP in 2017, 2.0% of GDP in 2018). Importantly, the improving fiscal performance is mainly attributable to a significant shift in the structural balance, which changed to a surplus in 2016 after a deficit in the preceding years. Moody's expects headline fiscal and primary balances to remain in surplus over the next two years at, respectively, 0.8% and 1.5% of GDP on average.

The government's debt reduction has progressed steadily since the 2014 peak (27% of GDP). At 21.2% of GDP at the end of Q1 2019, Bulgaria's general government debt is the second lowest in the EU and now stands at a level that partly offsets the negative effect of the high share of foreign-currency debt (75%), almost entirely denominated in euros. Under its base case scenario, Moody's expects that continued fiscal prudence and positive economic growth will allow public debt to continue its downward trend and reach 19% of GDP in 2020.

In light of declining financing costs, Bulgaria's debt affordability as measured by interest payments to general government revenues has significantly improved, to 1.8% of GDP in 2018 against 2.5% of GDP in 2016. Moody's expects this trend to continue, with interest payments to revenues forecasted to reach 1.7% of GDP in 2020.

Bulgaria's currency board with the euro is expected to continue to act as a policy anchor for the government's fiscal policy. This is also reflected in the sizeable fiscal reserve account (BGN 11.7bn, or 10% of GDP, at the end of June 2019), which has been remarkably stable in the recent years as a share of GDP.

Furthermore, the pension reform enacted in 2015 contributes to the fiscal sustainability of the system via longer working lives for both men and women. The gradual increase in the retirement age for men to 65 years in 2029 (from 64 years and 2 months in 2019) and for women to 65 years in 2037 (from 61 years and 4 months), and the gradual increase in the required contribution period (40 years for men, 37 years for women in 2037) should help contain pension expenditures.

SECOND DRIVER: GROWTH PROSPECTS TO BENEFIT FROM ONGOING EU INTEGRATION AND BULGARIA'S INCREASED COMPETITIVENESS

The second driver of the positive outlook is based on Bulgaria's robust growth prospects underpinned by ongoing EU integration and increased competitiveness. Following a rebound in 2015, with real activity expanding above 3% every year against the backdrop of strong internal demand, Moody's expects positive economic growth to continue in the coming years. Forecasted to reach 2.9% on average in 2019-2020, real GDP growth will hover around potential, which has stabilized at 3% in recent years. Looking ahead, Bulgaria's ongoing EU integration, as well as increased contributions from total factor productivity and capital deepening will drive the country's growth despite increasingly challenging demographics.

In the next two years growth will also be supported by important infrastructure projects, such as the Hemus and Struma motorways and the Sofia-Plovdiv railway line. Moreover, representing the equivalent of 3% of GDP per year over the 2014-2020, EU funds will contribute positively to investment, as Moody's expects the end of the EU's financial cycle to boost EU funds absorption rates, in line with historical evidence. Furthermore, measures aiming at promoting social inclusion will support incomes and consumption.

With 8 of the 10 top export market destinations located in the EU, Bulgaria's integration in the European value chains is expected to continue in the coming years. Increased competitiveness has been reflected in hard data, with a sharp growth in export market share (+15% between 2012 and 2017) in manufacturing and services. Over the last decade, exports have increased notably, reaching 67% of GDP in 2017 against 52% in 2007. The strong performance of the export sector has translated into the current account figures, with a rising surplus in the service balance more than offsetting the goods deficit. The turnaround in current account dynamics reflects the structural improvements in the Bulgarian economy since the crisis, and this broad pattern is expected to continue, although Moody's forecast is that the surplus will shrink in the coming years.

Finally, the simultaneous accession to ERM II and SSM, which Moody's expects to take place in 2020, will support sound macroeconomic policies and a further strengthening of institutions. While Bulgaria's current currency-board arrangement offers a remarkably stable framework for economic activity, the action plan to join the ERM II and SSM as well as the efforts to deepen Bulgaria's cooperation with the OECD is expected to promote the adoption of additional reforms in the areas of corporate governance, budget planning and public administration efficiency.

RATIONALE FOR AFFIRMING THE RATINGS AT Baa2

The rating affirmation takes into account Bulgaria's fundamental credit strengths and positive fiscal and macroeconomic trends balanced by the country's structural challenges and moderate exposure to event risks. Bulgaria's economic strength is supported by relatively high per-capita income and strong potential growth. The country's institutions benefit from the EU membership and the firm commitment of the Bulgarian National Bank to the country's currency-board with the euro. Prudent policymaking has consolidated the government's balance sheet, increasing its capacity to withstand adverse shocks.

At the same time, Bulgaria still faces significant challenges that weigh on the country's growth prospects. While average participation and employment rates have increased alongside the economic recovery, a declining population due to ageing and net migration outflows constrains labour supply. Finally, while the parliament is examining a reform aimed at modernizing the framework of the management of state-owned enterprises (SOE) to bring it in line with best international practice, SOE's continue to weigh on the credit's profile due to their large size and relatively weak profitability.

WHAT WOULD CHANGE THE RATING UP

Bulgaria's government bond rating would be upgraded should Moody's conclude that positive economic and fiscal trends have been sustained. That conclusion would be supported by evidence that economic growth remains broad-based, supporting the economy's resilience to shocks, and that convergence towards European living standards and adoption of institutional best practice continue at a steady pace. Further progress with respect to the government's reform agenda (education, healthcare, state-owned enterprises) and towards euro-area accession and SSM membership would also be credit positive.

WHAT WOULD CHANGE THE RATING DOWN

The positive outlook signals that the rating is unlikely to move down over the next 12 to 18 months. However, the outlook would likely be moved back to stable if Bulgaria's macroeconomic and fiscal policy credibility were to deteriorate due to political volatility, leading to a reversal in Bulgaria's debt trend. Furthermore, a stalling of the reform agenda in the key areas of education, healthcare and state-owned enterprises would also be credit negative.

GDP per capita (PPP basis, US$): 23,156 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.1% (2018 Actual) (also known as GDP Growth)

Inflation Rate (HICP, % change Dec/Dec): 2.3% (2018 Actual)

Gen. Gov. Financial Balance/GDP: 2% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.6% (2018 Actual) (also known as External Balance)

External debt/GDP: 58.6% (2018 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 27 August 2019, 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 materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially increased. Other views raised included: The issuer's institutional strength/ framework, have not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in November 2018. 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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