S&P Global Ratings

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Research Update:

Bulgaria Outlook Revised To Stable From Positive On COVID-19-Related Risks; 'BBB/A-2' Ratings Affirmed

May 29, 2020

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Overview

- We expect the Bulgarian government's measures to contain the spread of COVID-19 will push the country's economy into a recession in 2020, versus our previous forecast of continued growth.
- However, Bulgaria's strong fiscal and external balance sheets will help it absorb the shock before the economy recovers in 2021.
- Bulgaria still aims to join the EU's Exchange Rate Mechanism (ERM II) and the Banking Union in the near term, which could gradually strengthen its monetary arrangements.
- We are therefore revising our outlook on Bulgaria to stable from positive and affirming our 'BBB/A-2' sovereign credit ratings.

Rating Action

On May 29, 2020, S&P Global Ratings revised its outlook on Bulgaria to stable from positive. At the same time, we affirmed our 'BBB/A-2' long- and short-term foreign and local currency sovereign credit ratings on the country.

Outlook

The outlook is stable because we believe Bulgaria's strong fiscal and external balance sheets will counterbalance the adverse effects of the pandemic over the next two years.

Downside scenario

We could lower our ratings if, contrary to our current expectations, balance-of-payment pressures emerged. We could also take a negative rating action if, given Bulgaria's limited monetary policy flexibility, its policy response to the pandemic led to more significant or permanent macroeconomic or fiscal imbalances.

Upside scenario

We could raise the rating if Bulgaria's economy returns to its previous growth trajectory without a buildup of major macroeconomic imbalances, or if its external performance is significantly better than our current projections.

Rationale

The outlook revision follows a significant deterioration of growth prospects for Bulgaria and other economies in 2020, mainly related to measures to contain the COVID-19 pandemic. Risks to the macroeconomic and fiscal path have increased, removing the likelihood of an upgrade in the near term. However, Bulgaria's macroeconomic imbalances have reduced markedly over the past years and we think the economy will recover in 2021. Bulgaria is entering the recession with a strong external balance sheet after years of external deleveraging, thanks to recurring current account surpluses. Moreover, government debt is low and Bulgaria has posted general government surpluses over the past four years. That said, we think that the government's fiscal response to the pandemic will remain relatively measured, not least due to Bulgaria's currency board regime, which fosters prudent fiscal policies. The country is making steadfast progress toward joining ERM II and the Banking Union simultaneously.

While our ratings continue to reflect Bulgaria's prudent fiscal policy and strong external balance sheet, we also factor the country's limited monetary policy flexibility under its currency board arrangement into our analysis. The board has provided an important anchor of stability for the country. The ratings are still constrained by remaining institutional impediments and the country's low GDP per capita in a European comparison.

Institutional and economic profile: The pandemic has interrupted Bulgaria's strong growth trajectory

- We project that Bulgaria's economy will contract by 6.5% in 2020.
- Bulgaria's sound macroeconomic fundamentals will help absorb the shock before growth recovers in 2021.
- We think that Bulgaria's EU membership supports its developing institutional strength.

Bulgaria's economy will contract in 2020 as a result of the deteriorated global growth outlook and measures introduced to contain the spread of COVID-19. Sectors such as retail, transport, and tourism (the latter contributing about 10% to current account receipts) were directly affected by the containment measures and we expect strong spill-over effects, for example on investments and private consumption. However, the authorities have started to relax restrictions on economic activity. As of mid-May 2020, the state of emergency has been lifted, while certain epidemiological measures remain in place. Similar to other countries in Central and Eastern Europe, Bulgaria is reporting fewer COVID-19 cases than many developed markets. We therefore think the economy will recover toward the end of 2020, mainly as domestic demand increases. We think that, in 2021, exports will recover as well, but the shock that Bulgaria's trading partners are facing will likely dampen external demand compared with pre-pandemic years.

We project the unemployment rate will increase to around 9% in 2020 from a record low of 4.2% in 2019. The government intends to cushion the impact of the pandemic through various measures.

For example, it is covering 60% of employees' wages in affected sectors, including employers' social security contributions, to prevent layoffs. It has also provided a Bulgarian lev (BGN) 700 million ($395 million or 0.6% of GDP) capital increase to the state-owned Bulgarian Development Bank to enable guarantees to commercial banks for corporate loans and for interest-free loans to employees on unpaid leave or the self-employed. Other initiatives target small and midsize enterprises or affected individuals directly. The government's measures aim to limit the increase in unemployment and provide needed liquidity to affected firms, but their effectiveness will only become apparent with time.

Before the pandemic began, Bulgaria was showing robust growth averaging 3.6% over the past five years, which was not accompanied by the buildup of macroeconomic imbalances. Despite a tightening labor market, we think that external competitiveness has been preserved, positioning Bulgaria well for further export growth once its European trading partners recover. Labor costs in Bulgaria remain the lowest in the EU despite years of robust nominal wage growth.

However, structural challenges remain. We think demographics could hamper potential growth as the labor force continues to shrink due to aging and emigration. At this point, we don't think the return of Bulgarian workers after the pandemic will change this trend. Bulgaria's demographic challenges also highlight the need for continued structural reforms. For example, measures to address skill mismatches could partly alleviate the labor shortage. Sustainable structural reform efforts could benefit the business environment, spur income growth, and help slow net emigration. Building a track record of fighting illicit activities would also underpin institutional improvements. We note that Bulgaria's progress in these areas was acknowledged under the European Commission's Cooperation and Verification Mechanism in 2019. Another anchor for further institutional improvement is Bulgaria's aspirations to join ERM II and the Banking Union in 2020. Under its action plan, Bulgaria has, for example, implemented legislative amendments concerning the central bank and macroprudential supervision, and amended the frameworks for insolvency, state-owned enterprise management, nonbanking supervision, and anti-money-laundering.

We still think the current government coalition of the center-right GERB and the United Patriots could serve its term until 2021, absent major adverse events. In the past, however, we have observed episodes of political volatility in Bulgaria. We think that important issues, such as the country's ERM II accession, have consensus across the political spectrum, and therefore provide an important policy anchor.

Flexibility and performance profile: Debt will increase in 2020 from very low levels

- We expect Bulgaria's net general government debt to rise to 17% of GDP from 12% in 2019 due to pandemic-related fiscal measures.
- The current account surplus is set to narrow through 2023.
- Bulgaria is aiming to join ERM II and the Banking Union simultaneously in the coming months.

The Bulgarian National Bank (BNB) has implemented various measures in response to COVID-19. For example, banks have reduced their foreign exposures to further increase liquidity in the banking system, the planned increase of the countercyclical capital buffer rate has been cancelled, and banks have capitalized their full profits. Moreover, a precautionary €2 billion swap line with the European Central Bank (ECB) has been agreed.

The swap line agreement, in our view, reflects Bulgaria fulfilling almost all conditions to join ERM

II, the waiting room for eurozone membership, and the Banking Union. We understand that the key remaining issue is further improving the capital position of one domestic bank, which the ECB identified in last year's asset-quality review and stress test. This is necessary to prepare for the close cooperation between the BNB and the ECB, and Bulgaria's integration into the Single Supervisory Mechanism, which Bulgaria committed to join at the same time as it enters ERM II. We understand the capital increase is currently in progress.

Nevertheless, we still think political considerations outside Bulgaria's control could have an influence on whether the country can join ERM II by the July 2020 target. This is because the ultimate decision lies with the eurozone and Denmark's finance ministers, as well as with the ECB. ERM II accession would, in our view, support the credibility of Bulgaria's monetary policy framework.

Bulgaria has been operating under its currency board since 1997, which effectively guarantees the convertibility of the lev into euros at a fixed exchange rate. Over the past two decades, authorities have accumulated fiscal and external buffers to underpin their commitment to the fixed exchange rate regime. That commitment has not wavered, despite a series of external and domestic political shocks since Bulgaria's 2007 accession to the EU. The BNB's foreign currency reserves cover the monetary base by about 1.5x as of April 30, 2020. 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. The 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 highly liquid collateral.

We project the harmonized index of consumer price inflation will be subdued in 2020 due to the impact of falling oil prices, and accelerate to an average of 2.1% in 2021-2023.

We think that Bulgaria will maintain prudent fiscal policies despite a temporary general government deficit, which we project at 4% of GDP in 2020. This is due to lower tax revenue and the government's sizable fiscal support measures. Apart from the wage scheme, these include deferral of corporate tax payments until June 30, certain additional wage payments in the public sector, bonuses in the health and social sector, and other support for affected groups and the unemployed. From 2021, we expect the general government deficit to decrease significantly alongside the projected recovery, assuming the continuation of prudent fiscal policy.

The government has a track record of conservative fiscal policies, not least fostered by the currency board. In that regard, we note that Bulgaria has posted general government surpluses over the past four years. This facilitated a reduction of net general government debt to a very low 12% of GDP in 2019 from 18% in 2015. As a result of higher financing needs in 2020, we expect net general government debt to increase to 17% before gradually reducing to 15% by 2023. In our projection for the increase of debt in 2020, we include the BGN700 million capital increase for the Bulgarian Development Bank. We also note that the energy sector has in the past been a source of contingent fiscal risk.

We project Bulgaria's current account surplus will narrow in 2020 to just below 2% of GDP, due to the contraction of both exports and imports. In this context, we note the high share of foreign value added in Bulgarian exports, which thus suffer when value chains are interrupted. Despite the sizable import content of Bulgaria's exports and lower investment-induced imports, we project a worsening of Bulgaria's trade balance. In line with other countries in the region, we expect that tourism--which contributes about 10% of current account receipts--will be among the most affected sectors. And changing preferences or subdued travel demand for a longer period could hamper the sector's recovery. At the same time, we also expect lower inflows from remittances and foreign direct investment (FDI) in 2020. FDI in the manufacturing sector has been increasing in recent years, whereas high pre-2009 inflows into real estate contributed to the buildup of macroeconomic imbalances. In addition, Bulgarian exports now include a much higher share of machinery exports than lower value-added goods. That said, we anticipated weaker external demand even before COVID-19, and challenges to global trade could delay the recovery of Bulgaria's exports. It remains uncertain whether Bulgaria could benefit from a potential reorganization of global value chains.

We expect Bulgaria's liquid external assets to exceed external debt by around 47% of current account payments on average over 2020-2023. Gross external financing needs will likely be slightly over 100% of current account receipts and usable reserves.

Bulgaria's banking sector is profitable and generally adequately capitalized. With the transposition 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--if necessary and under certain conditions--a resolution fund. Only after exhausting these options and in an extraordinary situation of a systemic crisis would a bank be able to resort to government support. The BNB has consistently implemented measures to ensure the stability of banks (including subsidiaries), among other measures, by strengthening their liquidity and capital buffers. Close cooperation with the ECB will also lead to further alignment of supervisory practices as Bulgaria moves toward joining the European Banking Union.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety

Key Statistics

Table 1

Bulgaria Selected Indicators

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. BNG)	84	89	95	102	110	119	112	121	129	136
Nominal GDP (bil. $)	57	51	54	59	66	68	62	70	74	77
GDP per capita (000s $)	7.9	7.0	7.5	8.3	9.4	9.7	8.9	10.1	10.7	11.2
Real GDP growth	1.9	4.0	3.8	3.5	3.1	3.4	(6.5)	5.9	2.9	2.9
Real GDP per capita growth	2.4	4.6	4.5	4.3	3.8	4.1	(6.2)	6.3	3.3	3.3
Real investment growth	3.5	2.7	(6.6)	3.2	5.4	2.2	(7.9)	6.0	5.4	5.6
Investment/GDP	21.6	21.1	19.0	19.9	21.3	19.5	19.4	19.5	20.0	20.6
Savings/GDP	22.8	21.2	22.2	23.4	22.6	23.5	21.2	21.2	21.1	21.0
Exports/GDP	64.8	64.0	64.1	67.3	65.9	63.6	54.2	54.6	53.4	52.2
Real exports growth	3.1	6.4	8.6	5.8	1.7	1.9	(14)	8.0	2.4	2.3
Unemployment rate	11.4	9.2	7.6	6.2	5.2	4.2	8.9	6.0	5.3	5.1
External indicators (%)										
Current account balance/GDP	1.2	0.1	3.2	3.5	1.4	4.0	1.8	1.7	1.0	0.4

Table 1

Bulgaria Selected Indicators (cont.)

Current account balance/CARs	1.7	0.2	4.5	4.7	1.9	5.7	3.0	2.8	1.7	0.7
CARs/GDP	72.4	71.5	71.2	74.8	73.6	70.5	60.9	60.8	59.5	58.3
Trade balance/GDP	(6.5)	(5.7)	(2.0)	(1.5)	(3.3)	(2.8)	(3.1)	(3.0)	(3.5)	(4.0)
Net FDI/GDP	0.3	4.1	1.1	2.5	1.3	1.3	0.5	1.9	1.9	1.9
Net portfolio equity inflow/GDP	(0.9)	(0.6)	(0.2)	(0.3)	(0.7)	0.7	(0.7)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	120.2	118.6	107.3	99.6	103.5	100.8	105.2	101.9	105.0	104.8
Narrow net external debt/CARs	(3.2)	(16.7)	(24.6)	(30.4)	(32.2)	(35.6)	(47.0)	(44.2)	(47.2)	(47.0)
Narrow net external debt/CAPs	(3.2)	(16.7)	(25.8)	(31.9)	(32.8)	(37.7)	(48.5)	(45.5)	(48.0)	(47.4)
Net external liabilities/CARs	81.0	72.9	52.1	50.8	39.8	36.6	41.0	31.9	27.6	24.6
Net external liabilities/CAPs	82.4	73.1	54.5	53.3	40.5	38.8	42.2	32.8	28.1	24.8
Short-term external debt by remaining maturity/CARs	41.0	43.8	29.8	25.3	26.1	25.5	32.6	29.7	29.6	29.2
Usable reserves/CAPs (months)	1.9	2.5	2.1	2.7	2.5	2.4	2.9	3.0	2.7	2.7
Usable reserves (mil. $)	7,640	6,430	9,315	9,790	9,012	8,835	10,491	9,564	10,209	10,402
Fiscal indicators (general government; %)										
Balance/GDP	(5.4)	(1.7)	0.1	1.1	2.0	2.1	(4)	(1.6)	0.1	0.2
Change in net debt/GDP	6.7	1.7	(0.1)	(1.1)	(1.1)	0.4	4.0	1.6	(0.1)	(0.2)
Primary balance/GDP	(4.6)	(0.8)	1.0	1.9	2.6	2.6	(3.4)	(0.9)	0.8	0.9
Revenue/GDP	37.9	38.7	35.1	36.1	38.5	38.4	37.4	38.6	38.0	38.0
Expenditures/GDP	43.3	40.4	35.0	34.9	36.6	36.3	41.4	40.2	37.9	37.8
Interest/revenues	2.3	2.4	2.5	2.2	1.7	1.5	1.6	1.7	1.8	1.7
Debt/GDP	27.1	26.0	29.3	25.3	22.3	20.4	25.6	25.2	23.7	22.2
Debt/revenues	71.5	67.2	83.5	70.2	57.8	53.1	68.5	65.4	62.4	58.4
Net debt/GDP	17.4	18.1	16.9	14.6	12.6	12.0	16.7	17.0	16.0	14.9
Liquid assets/GDP	9.7	7.9	12.4	10.7	9.7	8.4	8.9	8.2	7.7	7.3
Monetary indicators (%)										
CPI growth	(1.6)	(1.1)	(1.3)	1.2	2.6	2.4	0.5	1.9	2.2	2.2
GDP deflator growth	0.5	2.4	2.5	3.9	4.0	4.7	0.9	2.4	2.9	2.9
Exchange rate, year-end (BNG/$)	1.61	1.79	1.86	1.63	1.71	1.74	1.78	1.72	1.75	1.78
Banks' claims on resident non-gov't sector growth	(7.6)	(1.6)	1.8	4.5	8.9	9.7	1.0	5.2	5.2	5.2
Banks' claims on resident non-gov't sector/GDP	61.7	57.0	54.5	52.9	53.7	54.5	58.3	56.6	56.2	55.9

Table 1

Bulgaria Selected Indicators (cont.)

Foreign currency share of claims by banks on residents	42.1	33.1	29.0	25.3	23.6	23.5	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	40.9	40.3	38.7	36.9	35.9	34.6	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(0.8)	(3.3)	0.2	1.1	3.3	0.4	N/A	N/A	N/A	N/A

Sources: Eurostat (Economic Indicators), Bulgarian National Bank (External Indicators), Eurostat (Fiscal Indicators), and Bulgarian National Bank, International Monetary Fund (Monetary Indicators).
Adjustments: Usable reserves adjusted by subtracting monetary base from reported international reserves.
Definitions: 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. N/A--Not applicable. BNG--Bulgarian lev. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. 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

Bulgaria Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	4	Reduced predictability of future policy responses, for example in episodes of heightened political volatility. Transparency and checks and balances can at times be hampered.
Economic assessment	4	Based on GDP per capita (US$) and growth trends as per Selected Indicators in Table 1.
External assessment	2	Based on narrow net external debt and gross external financing needs/(CAR + useable reserves) as per Selected Indicators in Table 1.
Fiscal assessment: flexibility and performance	2	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	1	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in Table 1.
		80% of gross government debt is denominated in foreign currency.
Monetary assessment	5	The lev has been fixed to the euro via a currency board.
		The Bulgarian National Bank has been successful in maintaining a currency board, supported by political commitment to prudent fiscal policies. 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.
Indicative rating	bbb-	As per Table 1 of "Sovereign Rating Methodology."

Table 2

Bulgaria Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
Notches of supplemental adjustments and flexibility	1	A change in the fiscal assessment could lead to a multi-notch change in the indicative rating. We think that the weakening of the fiscal assessment might prove transitory given Bulgaria's strong track record of fiscal prudency. The fiscal assessment might thus improve again after the usage of Bulgaria's fiscal space to mitigate the impact of the COVID-19 pandemic.
Sovereign credit rating		
Foreign currency	BBB	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt.
Local currency	BBB	

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). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score 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 scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020
- Sovereign Ratings List, May 11, 2020
- Sovereign Ratings History, May 11, 2020
- Sovereign Ratings Score Snapshot, May 6, 2020
- European Economic Snapshots: Larger Risks To Growth Loom Ahead, May 5, 2020
- Sovereign Risk Indicators, April 24, 2020. An interactive version is also available at http://www.spratings.com/sri
- Europe Braces For A Deeper Recession In 2020, April 20, 2020
- FAQ: Sovereign Ratings And The Effects Of The COVID-19 Pandemic, April 16, 2020
- Stress Scenario: The Sovereigns Most Vulnerable To A COVID-19-Related Slowdown In Tourism, March 17, 2020

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's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

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

Outlook Action; Ratings Affirmed

	To	From
Bulgaria		
Sovereign Credit Rating	BBB/Stable/A-2	BBB/Positive/A-2
Transfer & Convertibility Assessment	A	A
Senior Unsecured	BBB	BBB

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website 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.