

Republic of Bulgaria Outlook Revised To Stable From Negative; 'BBB/A-3' Sovereign Ratings Affirmed

Primary Credit Analyst: Marko Mrsnik, London, (44)20-7176-7116;
marko_mrsnik@standardandpoors.com

Secondary Credit Analyst: Frank Gill, London, (44) 20-7176-7129;
frank_gill@standardandpoors.com

Additional Contact: Sovereign Ratings;
SovereignLondon@standardandpoors.com

Overview

- We are revising our outlook on the Republic of Bulgaria to stable from negative, and affirming the 'BBB/A-3' sovereign credit ratings.
- The stable outlook reflects our view of the government's commitment to fiscal discipline, and our expectation that the government will implement structural reforms in the social security system.

Rating Action

On Dec. 1, 2009, Standard & Poor's Ratings Services revised its outlook on the Republic of Bulgaria to stable from negative. The 'BBB' long-term and 'A-3' short-term sovereign credit ratings were affirmed.

Rationale

The ratings on Bulgaria reflect our view of the government's strong track record of prudent fiscal policy and low gross debt; solid growth prospects over the medium term; and the country's EU membership. Offsetting these strengths somewhat are large external imbalances and the related risks as a result of the adverse economic environment, which we expect to continue in 2010.

In our view, Bulgaria continues to face economic risks due to the uncertain outlook for external demand and the sharp tightening of the external commercial credit channel, which negatively affects domestic demand. As a result, the current account deficit, which peaked in 2008 at 25.4% of GDP amid an overheating economy, has contracted sharply and is expected at around 10% in 2009 (we expect the deficit to be fully funded by foreign direct investment flows). We expect GDP to contract by around 6% in 2009 and a further 2% in 2010, followed by a positive growth rate in 2011.

The large adjustment of the country's external balances and real economy--via expected declines in both real and nominal wages--has presented the Bulgarian government with significant budgetary challenges due to large declines in tax revenues, in particular value-added tax. In the first half of 2009, the budget surplus rapidly shifted into deficit, a situation exacerbated by the July 2009 general elections and an associated increase in discretionary spending. However, the new government promptly reversed the situation by means of corrective budgetary measures. In 2009, therefore, we expect a deficit of up to 1% of GDP, the lowest in the EU. A similarly low deficit is expected in 2010, on the back the government's plan to implement significant budgetary adjustment. We believe these measures demonstrate the authorities' commitment to fiscal discipline as a support to the country's currency board arrangement. In our view, ongoing fiscal prudence, low government debt, and the preservation of the fiscal reserve (which has fallen from 2008 to above 12% of GDP in 2009) provide adequate buffers against fiscal pressures emanating from the ongoing economic adjustment.

Given the severe recession, we believe the soundness of the financial sector will continue to be under pressure. The banking system appears to be well capitalized (capital adequacy ratio of above 17% of GDP in October 2009), which provides support as the credit portfolio continues to worsen, with an increasing share of nonperforming loans in total loans. Moreover, we take comfort in the fact that Western banks, which have almost 85% market share in Bulgaria (with Greek banks dominant at around one-quarter of total market share), have expressed their resolve to support their Bulgarian subsidiaries.

Outlook

"The stable outlook reflects our view of the government's commitment to fiscal discipline. We believe this is likely to be demonstrated by the full implementation of the budgetary plan and supplementary deficit-reducing measures, should the current downturn lead to stronger budgetary pressure than what is currently foreseen," Standard & Poor's credit analyst Marko Mrsnik said. "The outlook also hinges on our expectation that the government will implement structural reforms in the social security system, particularly in health care, despite the adverse economic environment."

We believe that the authorities will successfully sustain the currency board arrangement, and that foreign parent banks will continue to finance their local subsidiaries.

A lasting improvement in external financing conditions would support the ratings at the current level. If fiscal performance deviates from the government's targeted trajectory

(anchored by balanced budgets), or if external financial liquidity worsens, the ratings on Bulgaria could come under downward pressure.

Related Research

- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

| | To | From |
|--------------------------|----------------|------------------|
| Republic of Bulgaria | | |
| Sovereign credit ratings | BBB/Stable/A-3 | BBB/Negative/A-3 |

N.B.--This list does not include all ratings affected.