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Research Update:

Bulgaria Outlook Revised To Positive On Improving Monetary Conditions; 'BBB-/A-3' Ratings Affirmed

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Overview

- We expect strong growth to continue this year, on the back of expanding domestic demand, exports, and supportive credit conditions.
- Net general government debt is forecast to decline in absolute terms during 2018, for the fourth consecutive year.
- External leverage is low and the current account remains in surplus.
- We are therefore revising our outlook on Bulgaria to positive from stable and affirming our 'BBB-/A-3' long- and short-term sovereign credit ratings.

Rating Action

On June 1, 2018, S&P Global Ratings revised its outlook on Bulgaria to positive from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Bulgaria.

Outlook

The outlook revision signifies that the authorities have successfully improved domestic financial conditions and have strengthened their fiscal and external buffers.

We could raise the ratings over the next 12-24 months if we observe further reductions in the level of nonperforming loans (NPLs) in the Bulgarian banking sector, combined with additional progress on normalizing the credit channel, which should benefit economic growth. We could also raise the ratings if the government's fiscal performance strengthens beyond our current projections. Finally, we would also raise the rating if the Bulgarian lev were accepted to the European Central Bank (ECB) exchange rate mechanism (ERM II) monetary framework, which we think would further bolster policy credibility.

We could revise the outlook to stable if pressures on Bulgaria's balance of payments emerged, fiscal buffers weakened, or if the declining trend in NPLs reversed. This could occur if we saw any indications that the real effective exchange rate was rapidly appreciating, for example, via higher price and wage inflation. This would lead to an unexpected loss of competitiveness and a deterioration in Bulgaria's external position.

Rationale

The ratings on Bulgaria reflect the country's longstanding track record of prudent fiscal policy and sound external performance. Low GDP per capita and institutional deficiencies constrain the ratings. The Bulgarian National Bank's limited policy flexibility under the currency board also constrains the ratings, although the fixed exchange rate regime has helped contain inflation and anchored stability. Bulgaria's longstanding commitment to fiscal prudence has helped to underpin the credibility of its fixed exchange rate arrangement, in our view.

Institutional and Economic Profile: Domestic demand is taking over as key driver of growth

- Domestic demand is fueling the expansion of Bulgaria's economy, which we expect to grow at 3.9% in 2018.
- We think that policy continuity will be ensured as long as the ruling coalition remains stable.
- Demographics remain challenging.

After three years of robust growth in Bulgaria (above 3% in 2015-2017), we forecast that real GDP growth will reach just under 4% in 2018. The role of domestic demand is growing as disposable incomes rise, and the labor market approaches full employment. We think that both public and private investment dynamics will accelerate, supported by a pick-up in EU funds absorption. As domestic demand propels imports, net exports are weighing on growth, signifying that the current account will gradually shift into deficit, although not before 2021, according to our projections. As the cyclical recovery continues, we expect the output gap to close in 2018 and to be positive in the coming years.

At the same time, employment and labor force participation are growing and we project that the unemployment rate will decline to 5.8% in 2018 from 6.2% in 2017. Nominal wage growth accelerated to 12% in 2017. Wage growth permits income convergence toward the EU average, and also reflects labor shortages in key sectors. We see no evidence at present that rising labor costs have undermined export competitiveness; export market shares continue to rise, and the labor-intensive services sector, in particular, continues to post large external surpluses.

Inflation is gradually picking up to around 2% on average in 2018-2021 after Bulgaria pulled out of deflation only in 2017. We see this as a positive development, particularly for debt-servicing capacity in the private sector.

Over the longer term, Bulgaria's potential growth rates will be constrained if large-scale net emigration of skilled workers continues. Over the next decade, we project that Bulgaria's population will decline by just under 6%, and that it will also age. This has negative implications for medium-term fiscal stability, should efforts to retain workers not intensify.

In our view, high rates of net emigration also indirectly reflect sluggish progress on institutional reforms--such as measures directed at increasing judicial independence, enhancing public administration and the governance of state-owned enterprises, and improving public education and health. Taken together, Bulgaria's weaker institutional settings lower its potential growth rate, in our opinion.

Political volatility and a weak institutional environment partly explain Bulgaria's subdued private investment activity in 2010-2016. However, over our three-year forecast horizon, we expect policy continuity. The current coalition, formed by the center-right GERB party and the United Patriots, has been in office since 2017. During the first half of 2018, Bulgaria assumed the rotating presidency of the EU.

Flexibility and Performance Profile: External and fiscal buffers remain solid

- Fiscal prudence continues and external buffers are substantial.
- NPLs are on a firm downward trend.
- We expect Bulgaria to apply to enter ERM II in 2018.

Following years of sluggish or negative credit growth, lending to the private sector has recently started to accelerate, expanding by around 5% in early 2018 (as of end-February 2018). Mortgage and other consumer loans were the main contributors to credit growth. During the latter part of 2018, we project a recovery in corporate lending to follow. Bulgaria's strong cyclical recovery has facilitated the decrease of NPLs in the banking sector to below 10% (according to Bulgarian National Bank data) as of the first quarter of 2018. Corporate lending rates on new loans averaged around 3.8% for the 12 months to March 2018, compared with underlying consumer price index inflation of 2.2%.

In 1997, Bulgaria introduced a currency board regime, which effectively guarantees the convertibility of euros (originally Deutsche mark) into Bulgarian lev at a fixed exchange rate. Over the past two decades, the authorities have accumulated fiscal and external buffers to underpin their commitment to the fixed exchange rate regime, and that commitment has not wavered, despite a series of external and domestic political shocks, since Bulgaria's 2007 accession into the EU. Bulgaria's foreign currency reserves comfortably cover the monetary base by over 1.5x as of March 2018. 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. 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.

Under Article 5 of the treaty governing the accession of Bulgaria and Romania to the EU, Bulgaria is committed to adopt the euro. However, it can only do so subject to an agreement with eurozone member countries and the ECB permitting its currency to enter into ERM II, a fixed exchange rate mechanism that acts as a precursor to eurozone entry.

Bulgaria's policymakers have stated their intention to apply for entrance into ERM II in 2018. If they can garner political backing from key eurozone parties, we think that the application could be filed in the coming months. Although we anticipate that Bulgaria will face some political obstacles in persuading all eurozone members to support its application, we understand that it is fulfilling the macroeconomic and fiscal criteria for the eurozone.

During 2017, Bulgaria's current account posted a surplus of more than 4% of GDP, reflecting the growing role of exports for the Bulgarian economy in recent years. We expect the current account surplus to narrow gradually until 2020 and turn into a deficit by 2021 on the back of rising domestic demand. However, we anticipate that export growth will remain sound, supporting Bulgaria's improving external profile. As in 2016-2017, 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. The services balance is also likely to benefit from robust information and communication technology (ICT) service exports. Foreign direct investment into manufacturing has been positive, spurring higher value-added exports and supply-chain integration.

Despite bouts of political instability, Bulgarian authorities have consistently endeavored to maintain low levels of public debt, and substantial levels of liquid fiscal assets. Last year, Bulgaria posted a 0.9% surplus at the general government level, underpinned by rising tax revenues and collection, higher social security contributions, and delays in EU-funded investment projects. We project that the general government balance will post an average deficit of 0.2% in 2018-2021 against the government's forecast of surpluses over the same time horizon. Our forecast is slightly less buoyant than the government's because we consider that spending pressures on public sector salaries, social infrastructure, or defense capabilities could exceed the current medium-term planning.

Fiscal contingent liabilities that could fall on the government's balance sheet include those from the energy sector, despite improving financials at Natsionalna Elektricheska Kompania (NEK). However, the government's accumulated liquidity buffer (some 10% of GDP) will likely allow Bulgaria to easily accommodate such fiscal risks. We project that general government debt, net of liquid assets, will modestly decline to 12% in 2021 from 14% in 2017. About 80% of total government debt is denominated in a foreign currency, mainly euros. Bulgaria's low debt burden grants the country fiscal space to respond to external and domestic shocks, should they arise.

The Bulgarian banking sector is generally adequately capitalized, and few domestic institutions had to replenish their additional capital buffers following the 2016 asset quality review. 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. Banking supervision and regulation has been strengthening following the lessons learned from the liquidity crisis and the collapse of KTB (Corporate Commercial Bank) in 2014. For example, the BNB has consistently implemented measures to ensure the stability of banks (including subsidiaries) by strengthening their liquidity and capital buffers. The BNB has also taken steps to increase the liquidity of Bulgarian-based subsidiaries of Greek banks, which account for some 10% of the sector's assets. For example, it has mandated that these banks hold higher deposits with the BNB, increase the proportion of liquid assets held, and reduce exposure to parent banks. All banks cover the minimum requirements and the additional capital buffers.

Bulgaria's implementation of its latest set of regulation and crisis management tools has yet to be tested. Although Bulgaria is not formally a member of the eurozone, the ECB has made available a line of support to the BNB in relation to 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.

The recent pickup in the real estate market, notably in house prices and construction activity, reflects rising demand due to higher incomes, savings, and favorable financing conditions. It has been the last sector to recover from the crisis, with a significant lag, following nine years of downward adjustment. The rising prices have not been fueled by an unsustainable increase in credit.

Key Statistics

Table 1

Bulgaria Selected Indicators

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	82	82	84	89	94	99	105	111	117	123
Nominal GDP (bil. $)	54	56	57	50	53	57	68	73	75	78
GDP per capita (000s $)	7.4	7.7	7.8	7.0	7.4	8.0	9.6	10.4	10.7	11.2
Real GDP growth	0.0	0.9	1.3	3.6	3.9	3.6	3.9	3.4	3.0	2.9
Real GDP per capita growth	0.6	1.5	1.9	4.2	4.6	4.3	4.4	3.9	3.5	3.3
Real investment growth	1.8	0.3	3.4	2.7	(6.6)	3.8	9.5	7.0	7.0	6.8
Investment/GDP	21.9	21.3	21.4	21.2	19.1	20.9	21.6	22.0	22.5	23.1
Savings/GDP	21.1	22.6	21.5	21.2	21.4	25.4	23.8	23.4	22.7	22.5
Exports/GDP	60.8	64.7	65.0	64.1	64.0	66.3	67.0	66.3	64.9	63.9
Real exports growth	2.0	9.6	3.1	5.7	8.1	4.0	4.9	4.0	2.5	2.6
Unemployment rate	12.3	13.0	11.4	9.2	7.6	6.2	5.8	5.7	5.6	5.5

Table 1

Bulgaria Selected Indicators (cont.)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(0.9)	1.3	0.1	0.0	2.3	4.5	2.2	1.5	0.2	(0.6)
Current account balance/CARs	(1.2)	1.7	0.1	(0.1)	3.2	6.1	3.0	2.0	0.3	(0.9)
CARs/GDP	68.9	73.9	72.5	71.3	71.1	74.0	73.9	72.8	71.5	70.6
Trade balance/GDP	(9.5)	(7.0)	(6.5)	(5.8)	(2.0)	(4.1)	(5.0)	(5.5)	(6.4)	(7.1)
Net FDI/GDP	2.5	3.0	2.1	5.1	1.5	1.4	1.9	1.9	1.9	1.9
Net portfolio equity inflow/GDP	(0.1)	(0.3)	(1.0)	(0.6)	(0.2)	(0.4)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	122.8	117.4	121.6	118.9	108.5	98.6	102.3	102.5	101.6	99.4
Narrow net external debt/CARs	5.0	0.7	(3.2)	(16.8)	(24.9)	(32.6)	(32.6)	(33.8)	(37.6)	(38.9)
Narrow net external debt/CAPs	5.0	0.7	(3.2)	(16.7)	(25.7)	(34.7)	(33.6)	(34.5)	(37.7)	(38.6)
Net external liabilities/CARs	106.4	93.5	84.6	72.3	50.0	45.8	33.6	27.5	25.2	23.2
Net external liabilities/CAPs	105.1	95.2	84.7	72.2	51.6	48.8	34.6	28.0	25.3	23.0
Short-term external debt by remaining maturity/CARs	43.8	41.6	41.1	44.2	30.1	26.5	25.3	23.1	24.2	23.2
Usable reserves/CAPs (months)	2.2	2.3	1.9	2.6	2.1	2.8	2.4	2.2	2.6	3.0
Usable reserves (mil. $)	7,914	6,544	7,640	6,430	9,315	9,790	9,650	11,710	13,725	14,692
FISCAL INDICATORS (%, General government)										
Balance/GDP	(0.3)	(0.4)	(5.5)	(1.6)	0.2	0.9	0.1	(0.3)	(0.2)	(0.2)
Change in net debt/GDP	0.3	2.0	6.5	1.7	(0.4)	(1.4)	(0.1)	0.3	0.2	0.2
Primary balance/GDP	0.5	0.4	(4.6)	(0.7)	1.1	1.7	0.8	0.4	0.6	0.5
Revenue/GDP	34.1	37.2	36.6	39.1	35.2	36.1	36.3	36.4	36.2	36.2
Expenditures/GDP	34.5	37.6	42.1	40.7	35.0	35.2	36.2	36.7	36.4	36.4
Interest /revenues	2.3	2.0	2.4	2.4	2.5	2.2	2.0	2.0	2.1	2.0
Debt/GDP	16.7	17.0	27.0	26.0	29.0	25.4	23.9	22.9	21.9	21.0
Debt/Revenue	48.9	45.7	73.7	66.5	82.5	70.3	65.7	62.8	60.5	58.0
Net debt/GDP	9.0	11.0	17.3	18.0	16.5	14.3	13.4	13.0	12.5	12.1
Liquid assets/GDP	7.7	6.0	9.7	8.0	12.5	11.1	10.4	9.9	9.4	8.9
MONETARY INDICATORS (%)										
CPI growth	2.4	0.4	(1.6)	(1.1)	(1.3)	1.2	1.9	2.0	2.1	2.1
GDP deflator growth	1.6	(0.7)	0.5	2.2	2.2	1.2	2.1	2.3	2.3	2.2
Exchange rate, year-end (LC/$)	1.5	1.4	1.6	1.8	1.9	1.6	1.5	1.5	1.6	1.6
Banks' claims on resident non-gov't sector growth	2.8	0.2	(7.6)	(1.6)	1.8	4.5	5.0	5.0	4.8	4.8
Banks' claims on resident non-gov't sector/GDP	68.1	68.1	61.8	57.5	55.0	54.9	54.3	53.9	53.6	53.4
Foreign currency share of claims by banks on residents	49.5	47.6	42.1	33.1	29.1	25.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	41.2	41.2	40.9	40.3	38.7	36.9	N/A	N/A	N/A	N/A

Table 1

Bulgaria Selected Indicators (cont.)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real effective exchange rate growth	(1.9)	1.3	(0.5)	(3.1)	0.1	2.2	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

Bulgaria Ratings Score Snapshot	
Key rating factors	
Institutional assessment	4
Economic assessment	4
External assessment	2
Fiscal assessment: flexibility and performance	2
Fiscal assessment: debt burden	1
Monetary assessment	6

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

- Sovereign Ratings History, May 7, 2018

- Global Sovereign Rating Trends: First-Quarter 2018, April 11, 2018
- Sovereign Risk Indicators, April 10, 2018. An interactive version is also available at http://www.spratings.com/sri
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Global Sovereign Rating Trends 2018, Jan. 10, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2017
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions, April 18, 2017

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

	To	From
Bulgaria		
Sovereign Credit Rating	BBB-/Positive/A-3	BBB-/Stable/A-3
Transfer & Convertibility Assessment	A-	A-
Senior Unsecured	BBB-	BBB-
Short-Term Debt	A-3	A-3

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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.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.