



## RATING ACTION COMMENTARY

# Fitch Affirms Bulgaria at 'BBB'; Outlook Positive

Fri 21 Jan, 2022 - 5:01 PM ET

Fitch Ratings - Frankfurt am Main - 21 Jan 2022: Fitch Ratings has affirmed Bulgaria's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Positive Outlook.

A full list of rating actions is at the end of this rating action commentary.

## KEY RATING DRIVERS

Bulgaria's ratings balance its strong external and public balance sheets and credible policy framework, underpinned by EU membership and a long-standing currency-board arrangement, against weak potential growth, partly due to unfavourable demographics, which could weigh on government finances over the long term. Governance indicators have fallen below peers, reflecting a deterioration in government effectiveness and control of corruption prior to 2021.

The Positive Outlook reflects the prospect of euro adoption, which would lead to significant improvements in external metrics. In Fitch's view, short-term downside risks tied to the coronavirus pandemic have eased and are more than offset by prospects of substantial EU funding for investment and a broad commitment to macro and fiscal stability (anchored by the inclusion since July 2020 of the Bulgarian lev into Exchange Rate Mechanism II; ERMII).

The formation of a four-party coalition government in December 2021 has significantly reduced near-term political uncertainty following a succession of inconclusive elections last year. The coalition parties have pledged a comprehensive anti-corruption agenda to

improve rule of law, while promising increased investment and more effective public spending. The authorities have reinstated the goal of joining the euro in January 2024 while safeguarding a long policy record of fiscal prudence and sound macroeconomic management. Although we expect broad political stability in the short term, friction among the coalition could increase if there are policy setbacks or as parties start preparing for regional elections in 2H23.

In the short term, the government will focus on pandemic management and dealing with rapidly increasing energy prices. Covid-19 still presents risks to the economy, accentuated by the lowest vaccination rate in the EU and an underfunded healthcare system. On the energy front, public support schemes could put some pressure on the budget. These challenges could delay some of the government's agenda.

Nevertheless, Fitch maintains its view that economic prospects will be favourable over the next years, supported by substantial EU funding (for a total of around 36% of GDP in 2021 prices in 2022-27). We forecast GDP growth of 3.7% in 2022, accelerating to 4.5% in 2023. Current inflation dynamics could dent private consumption, but this will be partly offset by ongoing support schemes and recovery in employment. Although persistent concerns around absorption capacity and likely labour and supply shortages could limit the effectiveness of investment, the sheer size of the plans will have a positive spill-over effect on the wider economy.

Bulgaria's Recovery and Resilience Facility (RRF) is expected to be approved over the next couple of months, following delays last year over government formation, with a first transfer of funds likely by mid-2022. The coalition is currently making some amendments to the original draft with a focus on rule of law and decarbonisation strategies. Key investment and reform areas will be energy, healthcare and digitalisation, with reforms aiming at improving public sector administration and governance. It is unclear at present how successful the country will be in implementing the RRF, and whether it will be an effective policy anchor. However, combined with other investment programmes this could help lift longer-term economic prospects by raising productivity and potentially slow the rate of decline in the population.

Fitch forecasts average inflation will rise to 5.2% in 2022, the highest rate since 2008, driven by higher commodity prices (and subsequent pass through effects), and to a lesser extent, domestic demand side pressures. The recent increase in inflation has been broad-based and could remain a more permanent feature of the macro-environment over the medium term, in part as pricing power in key segments such as retail food is highly

concentrated. Unlike other countries in the region, the labour market still has some slack, limiting wage pressures outside the public sector. Nevertheless, as the economy gathers momentum a tightening labour market could represent an addition inflationary factor.

Following the authorities' expressed commitment to eurozone accession, the focus will now turn to meeting structural criteria under EMU and convergence criteria. Fitch maintains its view that meeting price convergence will remain the most challenging criteria, as interest and exchange rate convergence will be easily met while the country is set to return to gradual fiscal consolidation in 2023 (and has very low public debt). At the same time, there appears to be commitment across the wider eurozone to complete the process promptly, with potentially some room for flexibility once Bulgaria's convergence criteria is assessed, which should take place in 2Q23. Overall, we consider euro adoption as supportive of the rating, as underlined by our view that all things being equal, we would upgrade Bulgaria's Long-Term Foreign-Currency IDR by two notches between admission to the EMU to joining the euro.

After a better-than expected outturn with a government deficit of 3.8% in 2021 due to strong revenue growth, we expect the general government deficit to fall to 3% in 2023 from 4.6% this year. This would be consistent with the public debt/GDP ratio increasing to 30% in 2023, from 20% in 2019 and still well below the current 'BBB' median of 60.3%. The government's external debt servicing will rise in 2022-24 as large Eurobonds mature, but it enjoys favourable financing conditions. and has cash reserves of over 8% of GDP (at end-2021) to help manage the repayments. Interest expenditure to revenue is the lowest in the rating category.

The government approved fiscal transfers of over BGN1.2 billion (0.9% of GDP) to tackle the surge in gas and electricity prices in 4Q21 and 1Q22 with possible further support in 2Q22. Higher transfers from energy state-owned enterprises could offset some of the costs, but if the crisis persists this could put pressure on the authorities to increase deficit spending or optimise expenditure elsewhere. The government aims to formalise its medium-term fiscal strategy by mid-2022, largely focusing on reducing administrative burden, increasing tax compliance and rebalancing social transfer/pension schemes in part to reduce reliance on short-term measures.

Bulgaria's banking sector maintained adequate liquidity through 2021 and capitalisation remained solid (with common equity Tier 1 at 21.4% in 3Q21). Asset quality has continued to improve despite the pandemic and even as most moratoria schemes have now expired, with the ratio of gross non-performing loans at 5.0% in 3Q21 from 5.7% at end-2020 and

6.6% at end-2019. Following a muted lending cycle in 2020, the credit cycle has accelerated, particularly to households. In January-November 2021, consumer and household lending increased by 10.4% and 16.8%, respectively. The Bulgarian National Bank has reacted by raising the countercyclical capital buffer to 1.5% in 1 January 2023 (from 0.5% currently, and 1% announced for 1 October. Nevertheless, supply and demand factors will likely support credit growth over the next two years.

Bulgaria's solid external finances are a rating strength and a factor that has helped reduce macro vulnerabilities. We expect the current account deficit (CAD) to widen gradually, from an estimated 1% of GDP in 2021 to 1.4% in 2023, as service exports continue to struggle and import demand picks up in line with stronger investment growth. Given the stable wage picture, we do not expect major competitiveness problems to arise. The modest CADs will be more than offset by increasing capital transfers and steady FDI inflows, which will keep the net external creditor position at close to 30% of GDP in 2022-23 (versus the BBB peer median of 1.6%).

ESG - Governance: Bulgaria has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Bulgaria has a medium WBGI ranking in the 56th percentile, reflecting a history of unstable coalitions, relatively high perceptions of corruption and moderate institutional capacity versus track record of peaceful transitions and above average regulatory quality.

## **RATING SENSITIVITIES**

### **Factors that could, individually or collectively, lead to negative rating action/downgrade:**

-External: A significant delay in the timeline of eurozone accession due, for example, to adverse policy developments or a deterioration in macroeconomic conditions.

-Fiscal: A prolonged rise in public debt driven for example by persistent fiscal easing, the materialisation of contingent liabilities on the sovereign's balance sheet or weaker growth prospects.

### **Factors that could, individually or collectively, lead to positive rating action/upgrade:**

-External: Progress toward eurozone accession, including greater confidence in Bulgaria meeting membership criteria and the likely timing of euro adoption.

-Macro: An improvement in growth potential, for example via the implementation of structural and governance reforms to improve the business environment and/or effective use of EU funds, which would cause the removal of the -1QO notch.

## **SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)**

Fitch's proprietary SRM assigns Bulgaria a score equivalent to a rating of 'BBB' on the Long-Term Foreign-Currency (LT FC) IDR scale.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis. The SRM output has temporarily migrated to 'BBB' from 'BBB+'. Consequently, the committee decided to adopt the 'BBB+' rating as the starting point for its analysis, unchanged from the prior committee.

Fitch's sovereign rating committee adjusted the output from the adopted SRM score to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: -1 notch, notch, to reflect Fitch's view that adverse demographic trends and slow progress on structural reform constrain potential growth over the long term.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit

<https://www.fitchratings.com/site/re/10111579>.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

### ESG CONSIDERATIONS

Bulgaria has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Bulgaria has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Bulgaria, as for all sovereigns. As Bulgaria has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4' for Demographic Trends as a falling and ageing population hinder the economy's medium-term growth potential. This has a negative impact on the credit profile, is relevant to the rating and a rating driver.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Bulgaria	LT IDR    BBB Rating Outlook Positive Affirmed	BBB Rating Outlook Positive
	ST IDR    F2    Affirmed	F2
	LC LT IDR    BBB Rating Outlook Positive Affirmed	BBB Rating Outlook Positive
	LC ST IDR    F2    Affirmed	F2
	Country Ceiling    A-    Affirmed	A-
senior unsecured	LT    BBB    Affirmed	BBB

[VIEW ADDITIONAL RATING DETAILS](#)

### FITCH RATINGS ANALYSTS

#### Federico Barriga Salazar

Director

Primary Rating Analyst

+49 69 768076 145

federico.barrigasalazar@fitchratings.com

Fitch Ratings – a branch of Fitch Ratings Ireland Limited

Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

#### Paul Gamble

Senior Director

Secondary Rating Analyst  
+44 20 3530 1623  
paul.gamble@fitchratings.com

**Jan Friederich**  
Senior Director  
Committee Chairperson  
+852 2263 9910  
jan.friederich@fitchratings.com

## **MEDIA CONTACTS**

**Peter Fitzpatrick**  
London  
+44 20 3530 1103  
peter.fitzpatrick@thefitchgroup.com

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

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## **APPLICABLE CRITERIA**

[Country Ceilings Criteria \(pub. 01 Jul 2020\)](#)

[Sovereign Rating Criteria \(pub. 26 Apr 2021\) \(including rating assumption sensitivity\)](#)

## **APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

[Country Ceiling Model, v1.7.2 \(1\)](#)

[Debt Dynamics Model, v1.3.1 \(1\)](#)



Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

## **ADDITIONAL DISCLOSURES**

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Bulgaria

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Sovereigns   Europe   Bulgaria

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