FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Bulgaria at 'BBB'; Outlook Positive

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Fitch Ratings - Frankfurt am Main - 27 Oct 2023: 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

Credit Fundamentals: Bulgaria's ratings are supported by its strong external and public balance sheets versus 'BBB' peers and credible policy framework, underpinned by EU membership and a long-standing currency board. This is balanced by low level of investments/GDP and unfavourable demographics, which weigh on potential growth and government finances over the long term. World Bank Governance Indicators (WBGI) have worsened in recent years, reflecting a history of unstable coalitions and relatively high perception of corruption.

Positive Outlook: The Positive Outlook reflects the prospects for euro adoption, which would lead to further improvement in external metrics. Despite a delay in the eurozone accession process, there is broad political commitment to euro adoption in 2025. Since the formation of the new government, parliament has passed all remaining post-ERMII commitments, while the amendment of the central bank law should be approved by end-2023.

Euro Adoption: Bulgaria's HICP inflation is easing but remains significantly above that of the three best performing EU member states, and it does not currently comply with the price stability criterion. Given considerable uncertainty about the inflation trajectory, it remains questionable whether Bulgaria will meet the price stability criterion in mid-2024 (the key date for 2025 euro adoption).

The criterion allows a degree of flexibility as price developments in a country can be judged an outlier if its inflation rate is significantly lower than that of the other member states owing to country-specific factors. Exclusion of two outliers from the calculation allowed Croatia to meet this criterion in 2022. However, it remains unclear how flexibility could be applied in Bulgaria's case. Bulgaria is on course to meet all other euro-adoption nominal criteria (public finances, interest rate and exchange rate). Overall, we consider euro adoption as supportive to the rating, as all else equal, the output of Fitch's proprietary Sovereign Rating Model (SRM) would improve by around two notches.

Government Formed, Risks to Durability: Following April 2023 snap elections, WCC-DB and GERB-SDS formed a government. The groups agreed a rotational cabinet for 18 months (nine months each), which has a parliamentary majority. While there are risks to the longevity of the current government, its formation enhances political stability and supports reform implementation.

Resilient Growth to Accelerate: The economy expanded in 1H23 despite slowing external demand, high inflation and elevated uncertainty. Fitch has raised its GDP growth forecast for this year to 1.9% (from 1.3% expected in May) as household consumption will likely be supported by higher fiscal spending, the strong labour market, reduction in the saving rate and strong credit growth. Investment growth should gradually improve in 2H23 as EU transfers increase.

We forecast GDP growth at 2.8% in 2024 and 3% in 2025, as easing of private consumption will be balanced by stronger investment supported by EU transfers. The government is committed to implementation of Recovery and Resilience Facility reforms and recently submitted the second payment request for EUR724 million (0.8% of 2023 GDP). The total grant allocation stands at EUR5.7 billion (6% of GDP).

Medium-term Growth Challenges: While Bulgaria could receive up to EUR16 billion (17% of 2023 GDP) of funds under various EU programmes by 2030, we see risks of under-execution due to institutional capacity and delays in programme implementation. In Fitch's view, unfavourable demographics and persistent labour shortages will weigh on Bulgaria's medium-term growth potential, unless labour productivity increases. Labour productivity stood at 55.9% of EU27 average at end-2022 and was the lowest in the EU.

Inflation to Gradually Ease: Fitch projects headline HICP inflation will continue to gradually decelerate, while core pressures will decline slower due to strong private consumption, a tight labour market and second-round effects. Fitch sees inflation on average at 9.1% in 2023, 4.6% in 2024 and 2.9% in 2025, above the current 'BBB' median of

5.9%, 3.9% and 3%, respectively. The inflation outlook remains subject to considerable uncertainty stemming mainly from development of commodity prices and persistency of second-round effects.

Wider Medium-Term Fiscal Deficits: We forecast the budget deficit at 2.6% of GDP in 2023, affected by the lower-than-planned cost of energy support measures, higher social and capital spending, and public sector wage increases. While Bulgaria has a good record of fiscal prudence, we believe the current government might favour slightly wider deficits in the medium term to boost public sector investment and increase social transfers to reduce inequalities. We expect budget deficits of 2.8% of GDP in 2024 and 3.5% of GDP in 2025.

Low Public Debt: Despite wider fiscal deficits, Bulgaria's public debt ratio will remain very low compared with EU countries and 'BBB' peers. We project general government debt/GDP ratio to remain below 30% until 2027. Almost all government debt is fixed rate, with a long average maturity, which reduces Bulgaria's exposure to monetary tightening abroad. General government interest payments will average 1.6% of revenues in 2023-2025, significantly below the current 'BBB' median of 9.1% in 2025.

Strong External Finances: Fitch expects the current account to return to historical surpluses in 2023 and to reach 1.2% of GDP, compared to a deficit of 1.4% in 2022. The improvement will be predominantly driven by narrowing of the trade deficit, due to lower imports and more favourable terms of trade. We project surpluses of 0.7% of GDP and 1.0% in 2024-2025. The capital account surplus will widen compared with 2022 (0.9% of GDP), in line with larger transfers of EU funds. Bulgaria's external position is further supported by a sizeable foreign-reserves position and private-sector deleveraging.

Stable Banking Sector: The Bulgarian banking sector remains stable, with solid capitalisation (total capital ratio at 21.4% at end-1H23) and improving asset quality. The ratio of gross impaired loans decreased to 4.5% at end-1H23 from 6.6% at end-2021, according to Fitch's estimates. Loan growth remained strong across the major segments, with a strong contribution from retail mortgages and resilient demand among corporates.

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. Theses scores reflect the high weight that the WBGI have in our proprietary Sovereign Rating Model. Bulgaria has a medium WBGI ranking at 52nd percentile, reflecting a history of unstable coalitions, relatively high perception 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 Finances/ Structural: Lack of progress in eurozone accession due to persistent political instability or a failure in meeting convergence criteria.

-Macro: Lower medium-term growth prospects driven, for example, by a large adverse macroeconomic shock or inflation entrenched at high levels.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-External Finances: 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.

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.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

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.

COUNTRY CEILING

The Country Ceiling for Bulgaria is 'A-', +2 notches above the LT FC IDR. This reflects strong constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +1 notch above the IDR. Fitch's rating committee applied a further +1 notch qualitative adjustment to this, under the Long-Term Institutional Characteristics pillar, as we view trade and financial integration as stronger than the model outputs, supported by EU membership.

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 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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

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

Country Ceiling Model, v2.0.0 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bulgaria	EU Issued, UK Endorsed

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