03 November 2017

Public Finance

Republic of Bulgaria Rating Report

SCOPE BBB STABLE OUTLOOK

Credit strengths

- EU membership
- Low and declining public debt ratio
- Current account surplus and declines in external debt ratio
- Increases in reserves, supporting the fix to the euro

Credit weaknesses

- High private sector debt
- Risks in the banking sector
- Restricted monetary flexibility
- Institutional weaknesses and record of unstable governments

Rating rationale and Outlook: The affirmation of Bulgaria's long-term sovereign rating at 'BBB' reflects credit strengths including the country's European Union (EU) membership, improved public finances with a low public debt burden, current account surpluses, declines in the external debt ratio owing to private sector deleveraging, as well as stronger reserve levels – backing the country's peg to the euro. Bulgaria's ratings are constrained by still-high levels of non-financial private sector debt, continued risks in the banking sector (though material efforts have been made in recent years), monetary inflexibility, vulnerabilities as a small, open economy, alongside institutional weaknesses. The Outlooks are Stable, reflecting Scope's view that risks are balanced moving ahead.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Bulgaria	Peer comparison		
		Average	Romania	Hungary
Domestic economic risk				
Public finance risk				
External economic risk				
Financial risk				
Political and institutional risk				
Qualitative adjustment (notches)	0		0	0
Final rating	BBB		BBB	BBB

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Stronger than anticipated fiscal results, lowering the debt ratio
- Further reform to banking supervision or material private deleveraging
- Improvements in political stability, supporting structural reform

Negative rating-change drivers

- Renewed stress in the banking sector or higher private debt
- Deterioration in public finances
- Worsened current account balance or higher external debt, decreasing reserve coverage ratios

Ratings and outlook

Foreign currency

Long-term issuer rating	BBB/Stable
Senior unsecured debt	BBB/Stable
Short-term issuer rating	S-2/Stable

Local currency

Long-term issuer rating	BBB/Stable
Senior unsecured debt	BBB/Stable
Short-term issuer rating	S-2/Stable

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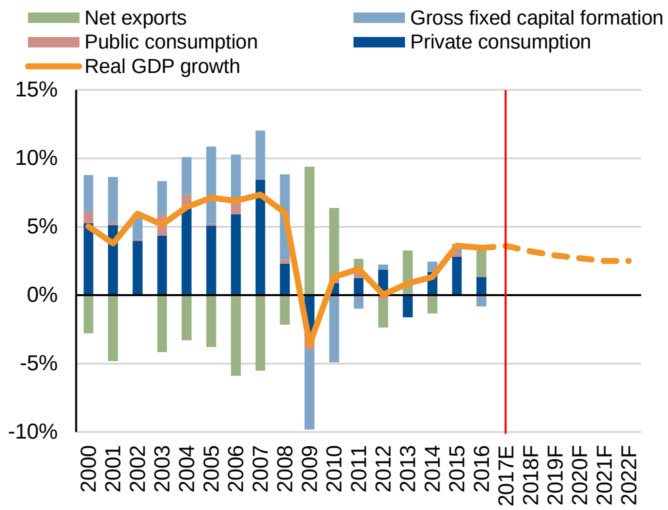
Domestic economic risk

Recovery from the 2010-14 slowdown

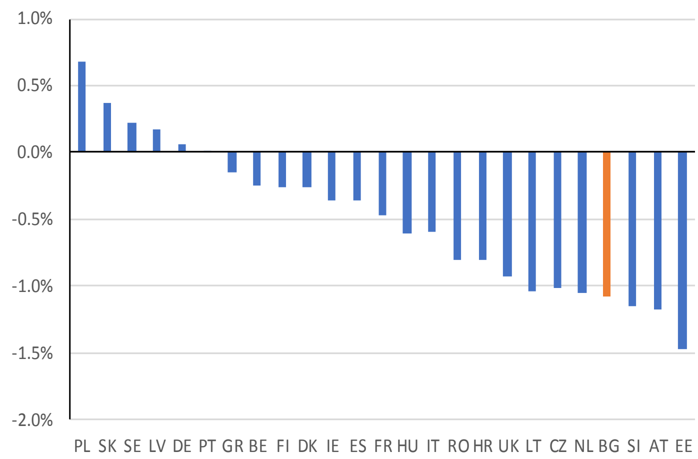
Bulgaria's economy has experienced a sustained recovery, with real GDP growth accelerating to 3.6% and 3.9% in 2015 and 2016, after average growth of 1.1% over 2010-14 (the latter incorporating the Corporate Commercial Bank (KTB) crisis of 2014). Though a marked improvement since 2015, growth remains below the average rates of 6.0% experienced in 2000-08. Recent growth is broadly based with private consumption strengthening, a gradual recovery in investment, and exports rising on the back of improved external demand (with recovery in the EU). On the production side, Bulgaria's growth momentum has been driven by a range of services alongside manufacturing.

Figure 2: Real GDP growth by expenditure contribution



Source: IMF, Scope Ratings AG calculations

Figure 3: Working-age population growth, average projected growth rate during years 2017-2022, vs EU peers



Source: UN Population Division, Scope Ratings AG calculations

In the first half of 2017, Bulgaria grew by 3.7% YoY. In the third quarter, positive signals continued in industrial production (where levels are now close to those pre-Great Financial Crisis), retail trade, unemployment and business/consumer climate indices.

In October, the IMF revised its projection for 2017 growth for Bulgaria to 3.6% from 2.9%, and for 2018 growth to 3.2% from 2.7%. The economy continues to benefit from improvements in labour market conditions, with the unemployment rate down to 6.2% as of August (sharply down from peaks of 13.2% in late 2013), higher labour force participation (at 71.8% in Q2 2017, the highest on record), very strong real wage growth (with nominal wages growing at near 10% as of June and inflation at only 1.3% YoY in September) and increases in pension and social benefits. Moreover, domestic demand is also benefitting from a recovery in private sector credit, which has been expanding at 4.1% YoY as of September; credit growth is accelerating after contraction from October 2014 to February 2016. Additionally, investment has resumed, contributing positively to growth, with the higher absorption of EU funds after the beginning of the new EU budget cycle (following the break in 2016 due to the end of the 2007-2013 programming period).

While Bulgaria's recovery is robust, Scope expects medium-run potential growth to average a more modest 2.25% – implying an easing of growth over time compared with the present, as the labour market nears full employment and elevated real wage growth tempers. Lower potential growth reflects important supply-side bottlenecks due to a declining labour force. Bulgaria's working-age population has declined by 1.2% annually in the past decade, due to net emigration, low fertility and an ageing workforce. Moving ahead, UN projections see the drop in the working-age population averaging 1.1%

Table of Contents

between 2017 and 2022 (Figure 3), but with this rate of decline easing over the period. The negative contribution to potential growth from a decreasing population should be offset in the near term through positive effects from rising labour force participation and employment growth, however. Scope assumes labour productivity growth of about 2.5% in the potential growth estimate, with productivity somewhat restricted owing to the emigration of skilled labour. By comparison with our potential growth estimate, the IMF anticipates medium-term growth in Bulgaria of 2.5%.[1]

Challenges range from an ageing population to monetary inflexibility

Challenges include the ageing population: according to the European Commission[2], Bulgaria's total dependency ratio will rise from 49% in 2013 to 84% by 2060, the latter estimate amongst the highest in the EU. A pronounced skills mismatch in the workforce and weaknesses in the business climate represent further challenges. Moreover, the still high level of foreign currency (largely euro) lending (see section on 'Financial Stability Risk' in this report) constrains Bulgaria's ability to tailor the monetary transmission. The currency board arrangement – which fixes the Bulgarian lev to the euro – reduces policymaking flexibility, limiting the ability of the Bulgarian National Bank (BNB) to control money supply and act as a lender of last resort.

Bulgaria maintains peg to the euro, and seeks entry to ERM II

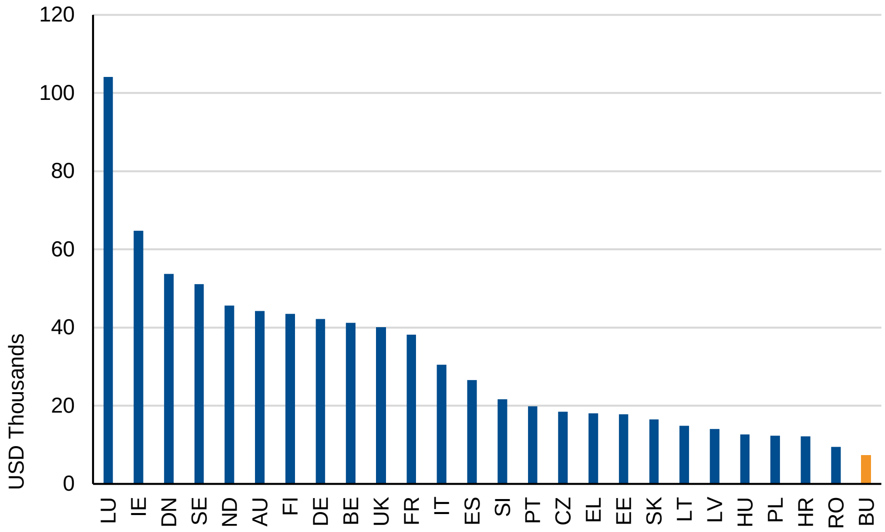
Bulgaria is not part of the EU's Exchange Rate Mechanism II (ERM II), the precursor to euro area entry. Prospects concerning Bulgaria's aspirations to join ERM II should be clarified in the years ahead. The political hurdles still appear to be high, however, owing to a gap between Bulgaria and euro area member states with regard to living standards and institutional framework. Until such a time that ERM II is entered, Scope expects policymakers to remain committed to the euro fix, for which there is cross-party political support. Bulgaria's currency board was introduced in 1997 after a 1996-97 banking crisis under hyperinflationary conditions. The board successfully installed policy discipline, lowered inflation and interest rates, and prevented further bouts with the hyperinflation endemic in the 1990s. Scope has a positive view of the currency board's record of stabilising Bulgaria's economy, but also recognises the constraints the peg places on the central bank.

Low income level and small economic size are constraints

Bulgaria's ratings are constrained by the nation's low GDP per capita (USD 7,377 in 2016), which is below the average for 'bbb'-level sovereign peers and significantly below the EU average. However, per capita real growth has been robust (4.2% in 2016), placing Bulgaria on a path towards gradual convergence. A small and open economy (with nominal GDP of USD 52bn in 2016), Bulgaria remains vulnerable to idiosyncratic as well as global shocks. Bulgaria's economic competitiveness, moreover, is a constraint, ranked 49th out of 137 countries in the World Economic Forum's 2017-2018 Global Competitiveness Report, although this was an improvement on 62nd (of 144 countries) in 2012-13. In this light, Scope considers Bulgaria's EU membership to be an important credit strength, providing investment support, crisis assistance and programmes that incentivise fiscal discipline and structural reform.

[1] IMF's forecast for 2022 growth, per October 2017's World Economic Outlook.
[2] European Commission. 'The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)'. European Economy 3|2015.

Figure 4: GDP per capita, in US dollars, 2016, versus EU peers



Source: IMF

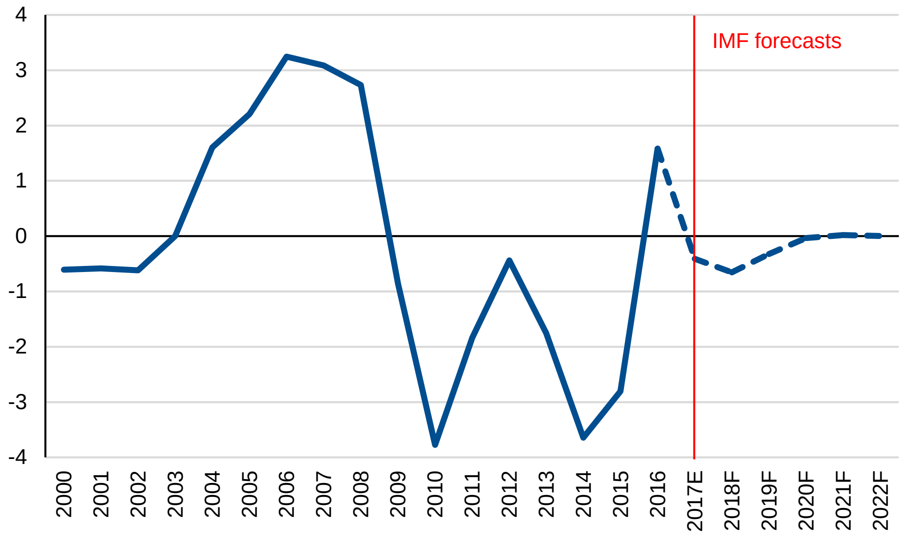
Public finance risk

An improved fiscal balance

In 2016, Bulgaria recorded a consolidated budget surplus of 1.6% of GDP on a cash basis and a balanced budget under ESA 2010 definitions. This represented a sharp consolidation since 2014, when the cash balance was -3.7% of GDP and the ESA-defined budget balance was -5.5% of GDP. The deficit had widened in 2014 from balances of -1.8% on a cash basis and -0.4% under ESA in 2013, as revenues slowed and expenditures jumped during the political turmoil of 2013-14. The fiscal overperformance in 2016 reflected higher-than-expected growth and revenue collection, and under-implementation of capital expenditures owing to a low absorption of EU funds.

Year-to-date, Bulgaria's consolidated cash surplus has totalled 2.5% of GDP in the first nine months of 2017, compared with a 3.6% of GDP cash surplus in the first nine months of 2016. Buoyant growth has bolstered tax revenues this year, but lower grant revenues and stronger expenditure growth in public sector compensation and social expenditure (reflecting, in part, the fulfilment of electoral promises surrounding early elections in March) have negated this. The IMF expects the cash balance to revert back to a small deficit of 0.4% of GDP in 2017, partly reflecting the unwind of some temporary factors in 2016, before a deficit of 0.7% in 2018, prior to reaching a balanced position in the medium term by 2021 and 2022. A balanced budget by 2021 would be one year later than the government's target of 2020. Scope has a positive view of the strides forward made in improving the budget balance since 2014, but stresses the importance of continued discipline in keeping a balanced budget moving ahead.

Figure 5: General government net lending/borrowing, % of GDP



Source: IMF

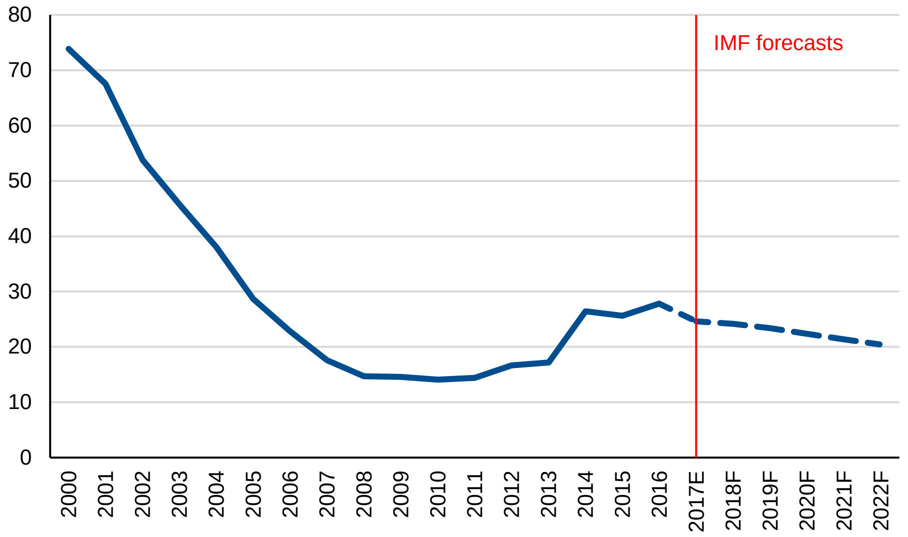
Observance of EU and national fiscal rules

As an EU member, Bulgaria is subject to the EU's fiscal rules and is a signatory of the European Fiscal Compact, requiring a structural deficit of, at most, 1.0% of GDP for countries with debt-to-GDP of under 60%, a debt brake rule and an automatic correction mechanism. Bulgaria's structural deficit is estimated at 0.5% of GDP in 2017 according to the European Commission in the latest Convergence Programme. In addition, Bulgaria has enacted national fiscal rules including a nominal deficit rule stipulating that, in cash terms, it should not exceed 2% of GDP, as well as rules safeguarding that total expenditures: i) do not exceed 40% of GDP; and ii) do not exceed the reference growth rate of potential GDP. The recently established Fiscal Council oversight body is now also operational. However, the resources available to it coupled with its limited financial autonomy prevent it from playing its full role in the national fiscal framework. Scope considers enhancements in Bulgaria's fiscal framework in its ongoing assessment.

While worse than several years ago, Bulgaria's public balance sheet remains strong

The government's balance sheet is sound with a low and declining debt level as well as sizeable fiscal reserves. Bulgaria's gross public debt ratio stood at 27.7% of GDP as of Q2 2017, relatively unchanged since early 2015, but substantially higher than lows of 12.7% of GDP in Q1 2009. The rise from 2009 reflects the earlier economic slowdown, pick-up in the fiscal deficit, crystallisation of contingent liabilities arising from the failure of KTB in 2014 and pre-financing activity that raised debt levels but also raised liquid reserves. At present, Bulgaria has the third-lowest debt-to-GDP ratio in the EU, after Estonia and Luxembourg. However, Scope recognises that, given Bulgaria's weaker institutional setting and small economy, its means to manage high debt are also more restricted than EU peers. Going forward, the IMF projects the debt ratio to decline gradually to 20% of GDP by 2022, supported by favourable debt dynamics and a balanced budget.

Figure 6: General government gross debt, % of GDP



Source: IMF

Bulgaria has sizeable fiscal reserves, which have increased from BGN 5.8bn (7.1% of GDP) in mid-2014 to BGN 11.6bn (11.7% of estimated GDP) as of August 2017, despite recent drawdowns. As such, in recent years, the government's net debt ratio has risen at a considerably slower pace than the gross debt ratio, with government debt net of liquid reserves standing at 14% of GDP as of Q2 2017.

Bulgaria's debt profile is sound

Bulgaria's public debt profile is sound. Interest payments as a share of total government revenues were 2.2% in 2016, compared to an EU average of 4.8%. The weighted average interest rate on Bulgaria's public debt was about 2.8% in 2016. Moreover, the debt has a long average residual maturity of about 7.8 years currently – high compared to 'bbb' sovereign peers, with almost the entire stock on fixed rates.

However, about 80% of total government debt is denominated in foreign currency, predominantly in euros. This represents a risk in crisis scenarios. While the Bulgarian lev is fixed to the euro and backed by the nation's credible currency board regime, it is not a null risk that the peg could come under pressure in highly adverse environments.

Contingent liabilities and demographics are risks

Contingent liabilities are a core risk to Bulgaria's fiscal balance sheet. The dangers of spill-over from banks to the sovereign books became apparent in the 2014 crisis. In addition, contingent liabilities could materialise from the energy sector, although the government has reduced losses at Natsionalna Elektricheska Kompania (NEK).

Demographic challenges are a constraint in the very long run. With an ageing and declining population, fiscal pressure on the pension system will increase, absorbing the gains from a 2015 pension reform that lifts the retirement age gradually towards 65 over the long term from just over 57 and boosts social contributions. The European Commission estimates that public pension expenditures will decrease as a share of GDP until 2028, before increasing thereafter. It measured total age-related expenditures to decrease by 1.3% of GDP between 2013-40, before hikes of 1.6% of GDP between 2040-60.

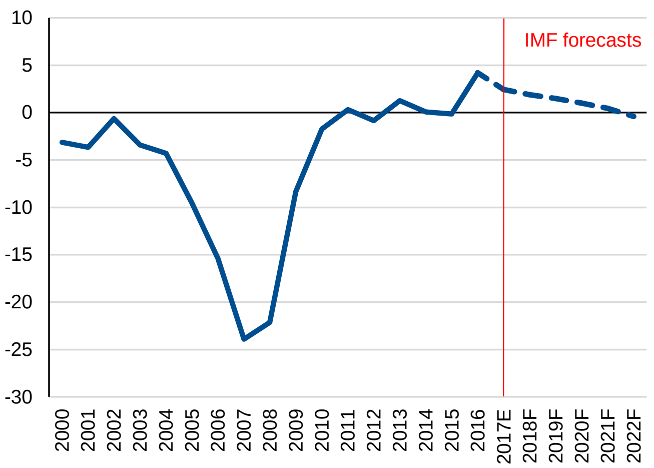
External economic risk

Improvements in a volatile current account

Bulgaria's current account showed a strong surplus in 2016 of 4.2% of GDP (based on IMF estimates), a significant improvement on a balance of -0.1% of GDP in 2015. This reflected a contraction in fuel imports and in FDI income outflows, alongside resilient export performance. Scope is mindful that Bulgaria's current account can be volatile: the current account balance reached lows of -23.9% of GDP in 2007 and -22.1% of GDP in 2008, before rapid consolidation to +0.3% of GDP by 2011. In Scope's view, current account volatility is a potential vulnerability, making Bulgaria susceptible to spill-overs from rapid economic growth or changes in regional economic health. Exports and imports of goods and services account each for around 60% of GDP in a well-integrated, open economy; Bulgaria's export performance has been strong, with exports of goods and services rising from 50% of GDP in 2010 to about 64% of GDP by 2016.

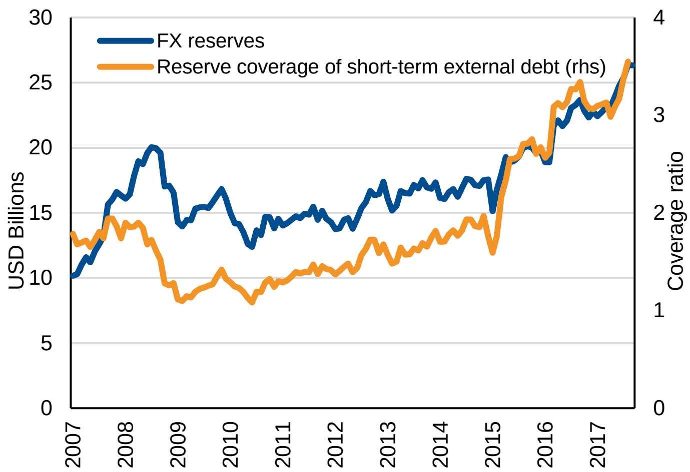
Over the long term, the IMF expects the current account surplus to revert gradually to a modest deficit of 0.4% of GDP by 2022. Robust domestic demand will raise imports. While export growth will remain sound in view of resilient growth in the EU (the EU is the destination for about two-thirds of Bulgaria's exports), the competitiveness of Bulgaria's export sectors may be impacted in the long term by rapid wage growth, although existing wage gaps with higher-income trading partners present a meaningful buffer against this.

Figure 7: Current account balance, % of GDP



Source: IMF

Figure 8: FX reserves and FX reserve coverage of short-term external debt



Source: Bulgarian National Bank, Scope Ratings AG calculations

Bulgaria's gross external debt ratio, while still high, has fallen

Bulgaria holds a net international investment position of -46% of GDP as of Q2 2017, an improvement from -98% of GDP in Q2 2010, driven by deleveraging led by the banking sector alongside current account improvements. Bulgaria's gross external debt has declined to 68% of GDP as of Q2 2017, from over 100% of GDP in early 2010. Scope considers improvements in Bulgaria's current account and external position to be credit-positive.

Reserves have nearly doubled, providing support to the peg

Bulgaria's macroeconomic performance is buoyed by broad-based support for its currency board arrangement, which pegs the FX at 1.9558 levs to the euro and continues to be a crucial factor anchoring macroeconomic policies. The credibility of the currency board arrangement is bolstered by the central bank's reserve accumulation, with foreign exchange reserves totalling USD 26.3bn as of September 2017 (Figure 8), up significantly from USD 15.1bn in January 2015. In combination with the effect from debt deleveraging, forex reserve coverage of short-term external debt amounted to 3.0x as of July 2017, doubling from 1.4x as of January 2015, and compared with under 1.0x between 2008 and 2011. Scope considers this higher reserve coverage ratio to be critical for the maintenance of economic stability.

Financial stability risk

2014 KTB crisis has shaped financial sector reforms

Bulgaria's financial system was shaken in 2014 by the collapse of Corporate Commercial Bank, the country's then fourth largest lender, due to a fraud scandal. The bank run and subsequent government takeover raised questions about the health of other banks, causing broader deposit outflows temporarily, and gave rise to concerns about the supervision and crisis management tools of the Bulgarian authorities. Since then, Bulgaria has conducted an Asset Quality Review of the financial system, initiated reforms to financial supervision, introduced a new bank resolution authority and requested a Financial Sector Assessment Program from the IMF[3].

However, risks to financial stability remain

As a result of Bulgaria's 2016 Asset Quality Review and stress test, two domestic financial institutions raised capital buffers (notably, First Investment Bank increased capital levels by about EUR 105mn). However, continued risks were identified in the IMF's 2017 assessment, highlighting weaknesses in some banks, high nonperforming loans, and limitations in the BNB's ability to provide liquidity support during crises. While the banking sector overall has improved its funding structure (with higher dependence on deposits), shows significant liquidity and is adequately capitalised (Tier 1 capital stood at 21.31% of risk-weighted assets as of Q2 2017), nonperforming loans remain high (at 12.4% of total loans as of Q2, though on a declining trend). The IMF noted certain accounting, collateral valuation and risk management practices that have contributed to disincentives for NPL reduction. In addition, 39% of total lending in Bulgaria is denominated in foreign currency, nearly all in euros; while this is down from 64% in 2012, the still highly euro-based nature of Bulgaria's banking structure represents a risk in very stressed environments.

The banking sector could, moreover, be vulnerable to certain external factors, including risks to depositor confidence in local subsidiaries of Greek banks should risks in Greece rearise. However, the BNB has implemented measures to ensure the stability of these Greek subsidiaries.

The EU's Bank Recovery and Resolution Directive has entered into force

The EU's Bank Recovery and Resolution Directive entered into force on 1 January 2015 and will support earlier interventions in banking crises before these degenerate, learning from the 2014 experience. Under the directive, the failure of a bank will necessitate a bail-in of shareholders, specific creditors and then the new resolution fund. A bank may only request government support once it has exhausted these options.

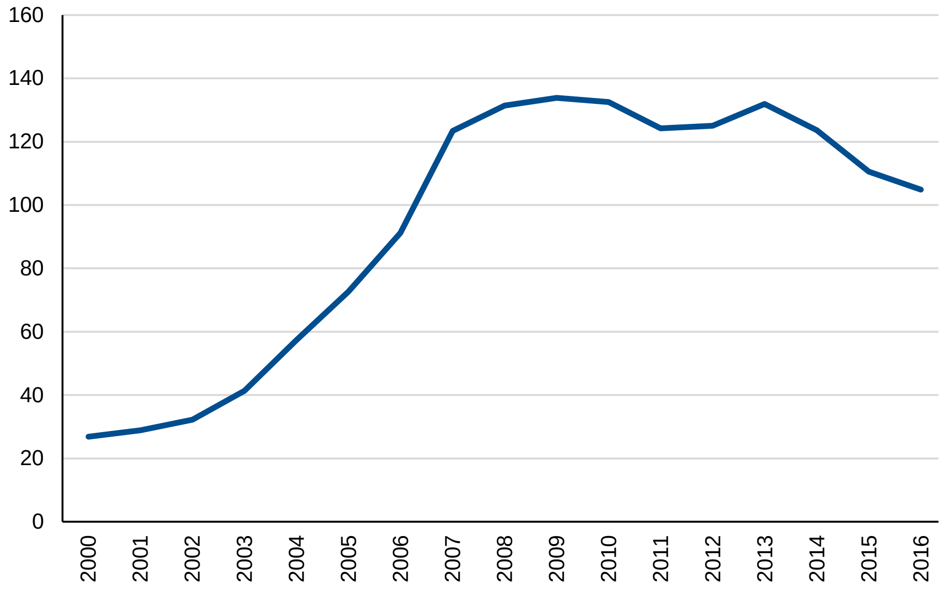
A measure of stability in the banking sector is also supported by a recovery in the real estate market. House price growth stands at 8.6% YoY as of Q2 2017, after having fallen by 38% between a 2008 peak and 2013 trough. Scope considers greater stability in and reforms to Bulgaria's banking sector to be important, while recognising the legacy of the 2014 crisis and the still-material vulnerabilities present within the system. On balance, Scope continues to regard financial stability risks to be an important weakness hindering Bulgaria's sovereign rating.

High private debt represents a core risk

Consolidated private debt remains high, at 104.9% of GDP at end-2016, according to European Commission data. While this has declined from 133.8% of GDP as of end-2009, the still-high level of debt – particularly in the corporate sector – represents a serious vulnerability and constraint on Bulgaria's BBB rating. In addition, high inter-company lending is a risk, reflected in accounts payable totalling 115% of GDP as of Q2 2017 – this figure was not included in the previously noted consolidated private debt statistic.

[3] International Monetary Fund. 'Bulgaria: Financial System Stability Assessment-Press Release; Staff Report; and Statement by the Executive Director for Bulgaria', Country Report No. 17/132, 23 May 2017.

Figure 9: Consolidated private debt, % of GDP



Source: European Commission

Lack of a lender of last resort

According to the currency board system, the Bulgarian National Bank's ability to act as a lender of last resort is restricted. This is a constraint on Bulgaria's sovereign rating. The BNB can provide liquidity support to the banking system only by the degree that reserves exceed monetary liabilities. In addition, support can only be given under certain conditions and for short periods, against liquid collateral. The Bulgarian government's currency board prevented the Bulgarian National Bank from creating money to pay KTB's depositors. As a result, Bulgaria violated the EU's Deposit Guarantee Schemes Directive by not repaying eligible deposits within 20 days after the bank's failure.

Institutional and political risk

Bulgaria is a parliamentary representative democratic republic, in which the prime minister is the executive and head of government. Legislative power is vested in both the government and the National Assembly, Bulgaria's unicameral parliament. The judiciary is independent. Bulgaria will hold the rotating presidency of the Council of the EU from January to June 2018.

Institutional weaknesses remain

Bulgaria achieves middle-range scores on institutional metrics, such as the World Bank's Worldwide Governance Indicators, where it attained somewhat weaker scores than 'bbb' sovereign peers. On 'rule of law', Bulgaria ranked in the 54th percentile in 2016, up from the 51st percentile in 2006. On 'control of corruption', Bulgaria ranked in the 51st percentile in 2016, down from the 56th in 2006. On 'voice and accountability', Bulgaria ranked in the 60th percentile in 2016, down from the 66th in 2006. In the World Economic Forum (WEF)'s latest Global Competitiveness Report, institutional strength (including property rights, intellectual property protection, judicial independence, etc.) was a limitation to Bulgaria's performance. In the WEF's Executive Opinion Survey 2017, corruption, inefficient government bureaucracy and tax rates were cited as the main obstacles to doing business in the country. Moreover, Bulgaria struggles with organised crime; the United States Department of State's Bureau of Diplomatic Security assesses Bulgaria's crime rating as 'High'. These institutional issues weigh on Scope's outlook.

Unstable governments undermine reform momentum

Bulgaria has seen significant turnover in governments in recent years. Early elections in May 2013 were followed by turmoil after the formation of the Plamen Oresharski government and the appointment of controversial media mogul Delyan Peevski as a chief of the National Security State Agency led to large-scale protests and five votes of no-confidence. This led to the dissolution of parliament and fresh early elections in October 2014. In the October 2014 election, the centre-right GERB was the largest party and formed a coalition government with the Reformist Bloc. However, Prime Minister Boyko Borisov from GERB resigned in January 2017 following the defeat of his candidate in November 2016 presidential elections. In the March 2017 snap election, GERB won a plurality, forming a new coalition with the nationalist United Patriots. Mr Borisov returned as prime minister in May 2017, after several months of a caretaker government.

Bulgaria's history of unstable governments represents a constraint on the potential for rating upside as it restricts continuity in reform drives, raises incentives for populism that weighs on the fiscal balance sheet, reduces the capacity for long-term economic planning, and undermines the business environment and investor confidence.

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "BBB" ("bbb") rating range for the Republic of Bulgaria. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the Republic of Bulgaria, the following relative credit strength is identified: i) good resilience to short-term external shocks. Relative credit weaknesses are signalled for: i) current account vulnerabilities; ii) recent events and policy decisions; iii) financial sector oversight and governance; and iv) macro-financial vulnerabilities and fragility. Combined relative credit strengths and weaknesses generate no adjustment and signal a sovereign rating of BBB for Bulgaria. A final rating of BBB was assigned to the Republic of Bulgaria.

Rating overview	
CVS category rating range	bbb
QS adjustment	BBB
Final rating	BBB

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case letters.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance assessments, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Bulgaria's debt is mainly issued in foreign currency (about 80% of the total government debt stock is in foreign currency), with almost all of this issued in euros. However, Bulgaria has maintained a currency board arrangement since 1997 and currently retains an enhanced level of FX reserves backing the euro fix, mitigating the differentiation between lev-denominated and euro-denominated debt. Currently, Scope sees no evidence that Bulgaria would differentiate among any contractual debt obligations based on currency denomination.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	35%
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	30%
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	15%
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	10%
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	10%
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**BBB**
Final rating	**BBB**

QS

Maximum adjustment = 3 notches

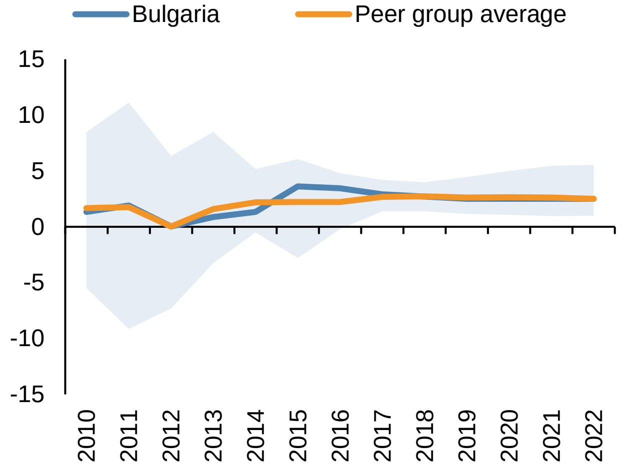
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	● Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	● Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	● Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	● Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	● Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings AG

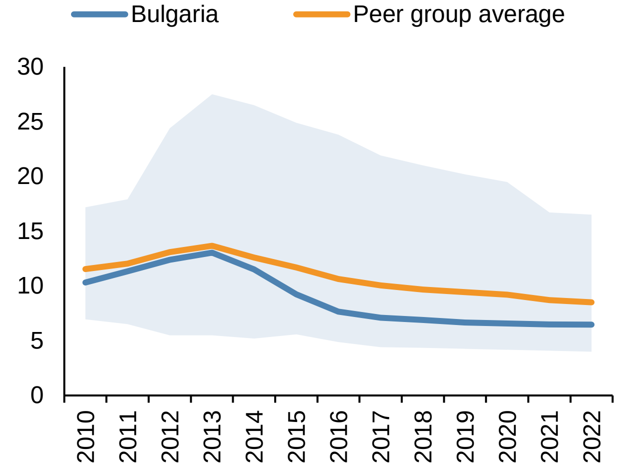
III. Appendix: Peer comparison

Figure 10: Real GDP growth



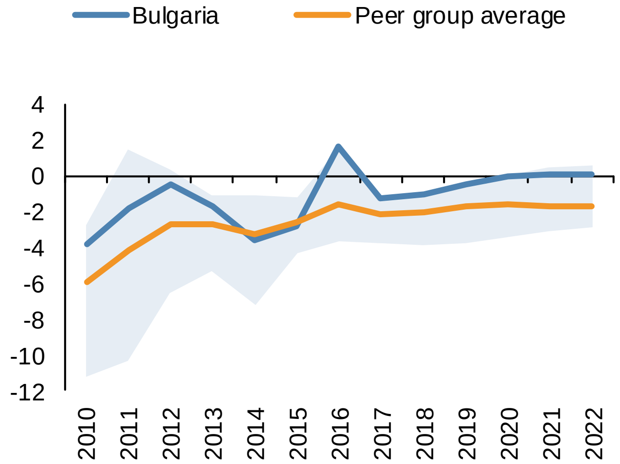
Source: IMF, Calculations Scope Ratings AG

Figure 11: Unemployment rate, % of total labour force



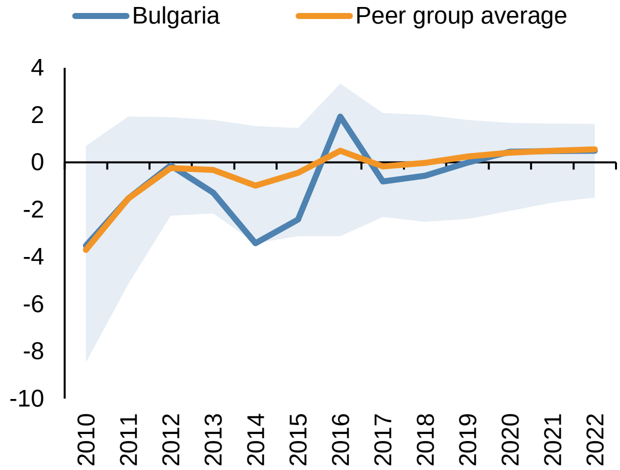
Source: IMF, Calculations Scope Ratings AG

Figure 12: General government balance, % of GDP



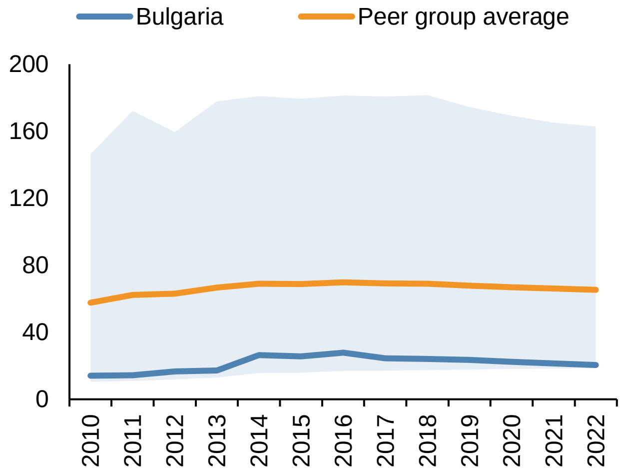
Source: IMF, Calculations Scope Ratings AG

Figure 13: General government primary balance, % of GDP



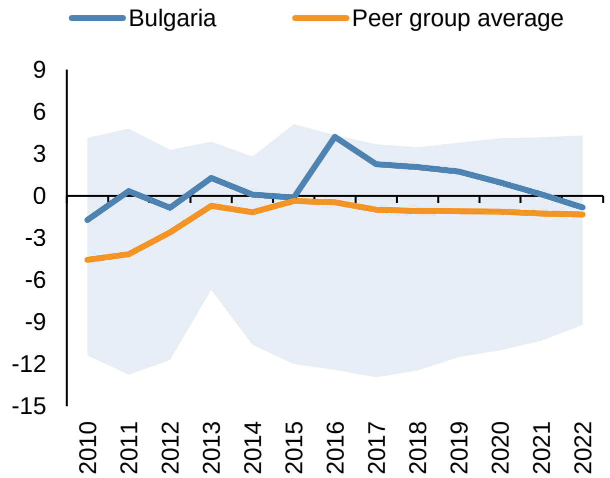
Source: IMF, Calculations Scope Ratings AG

Figure 14: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 15: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (BGN bn)	82	82	84	89	93	97	102
Population ('000s)	7,282	7,238	7,202	7,154	7,102	7,061	7,021
GDP-per-capita PPP (Int'l USD)	16,208	16,647	17,406	18,249	19,199	-	-
GDP per capita (BGN)	11,266	11,352	11,612	12,381	13,044	13,740	14,466
Real GDP growth, % change	0.0	0.9	1.3	3.6	3.4	3.6	3.2
GDP growth volatility (10-year rolling SD)	3.7	3.8	3.7	3.4	3.1	2.6	2.2
CPI, % change	2.4	0.4	-1.6	-1.1	-1.3	1.1	1.4
Unemployment rate (%)	12.4	13.0	11.5	9.2	7.7	6.6	6.4
Investment (% of GDP)	21.9	21.3	21.4	21.2	20.3	20.1	19.7
Gross national savings (% of GDP)	21.1	22.6	21.5	21.1	24.5	22.5	21.6
Public finances							
Net lending/borrowing (% of GDP)	-0.4	-1.8	-3.6	-2.8	1.6	-0.4	-0.7
Primary net lending/borrowing (% of GDP)	-0.1	-1.3	-3.4	-2.4	1.9	0.0	-0.2
Revenue (% of GDP)	32.3	33.8	33.7	35.0	35.3	34.9	35.5
Expenditure (% of GDP)	32.8	35.5	37.3	37.8	33.7	35.3	36.2
Net interest payments (% of GDP)	0.3	0.5	0.2	0.4	0.3	0.4	0.4
Net interest payments (% of revenue)	0.9	1.4	0.7	1.1	0.9	1.2	1.2
Gross debt (% of GDP)	16.7	17.2	26.4	25.6	27.8	24.6	24.2
Net debt (% of GDP)	4.5	6.5	13.2	15.6	11.6	12.4	12.4
Gross debt (% of revenue)	51.6	50.9	78.5	73.4	78.8	70.5	68.0
External vulnerability							
Gross external debt (% of GDP)	92.9	91.0	97.7	81.5	79.4	-	-
Net external debt (% of GDP)	25.4	21.6	18.3	1.5	-9.5	-	-
Current-account balance (% of GDP)	-0.9	1.3	0.1	-0.1	4.2	2.5	1.9
Trade balance [FOB] (% of GDP)	-	-7.0	-6.5	-5.8	-3.6	-4.2	-4.2
Net direct investment (% of GDP)	-2.5	-3.0	-2.1	-5.1	-0.7	-	-
Official forex reserves (EOP, USD bn)	20.5	19.9	20.0	22.0	25.2	-	-
REER, % change	-2.1	0.1	-0.8	-3.4	-0.4	-	-
Nominal exchange rate (EOP, BGN/USD)	1.5	1.4	1.6	1.8	1.9	-	-
Financial stability							
Non-performing loans (% of total loans)	19.8	18.6	14.4	13.0	11.2	-	-
Tier 1 ratio (%)	15.1	16.0	19.6	19.9	20.3	-	-
Private debt (% of GDP)	125.0	131.9	123.6	110.5	104.9	-	-
Domestic credit-to-GDP gap (%)	-15.8	-10.6	-11.8	-21.6	-19.5	-	-

Sources: IMF, European Commission, World Bank, BIS, OECD, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Dennis Shen, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director, Public Finance

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Republic of Bulgaria are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

The main points discussed by the rating committee were: i) Bulgaria's economic performance and outlook; ii) fiscal performance and debt sustainability; iii) Bulgaria's fiscal framework and exchange rate regime; iv) external position and resilience; v) banking sector performance and oversight; vi) Bulgaria's business environment; vii) the convergence process with euro area members; and viii) peer considerations.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: IMF, Bulgarian National Bank, Bulgaria's National Statistical Institute, Ministry of Finance of the Republic of Bulgaria, Eurostat, European Commission, United Nations and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Conditions of use / exclusion of liability

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