21 July 2023 | Sovereign and Public Sector

Republic of Bulgaria
Rating Report

SCOPE BBB+ POSITIVE OUTLOOK

Credit strengths

- ERM II and Banking Union memberships, prospect of euro area entry
- Low government debt, favourable debt profile
- Record of prudent fiscal policies

Credit challenges

- Vulnerability to shocks as a small, open economy
- Institutional weaknesses, political instability
- Limited lender of last resort function of the central bank
- Demographic pressures

Rating rationale:

Credit strengths: Bulgaria's BBB+ ratings are supported by the inclusion of the Bulgarian lev into the Exchange Rate Mechanism II (ERM II) in July 2020. The inclusion reinforced a roadmap to adoption of the euro in the medium-term. In addition, the ratings reflect reduction of financial-system risk and significant reforms made in banking-system governance in recent years. Finally, Bulgaria's ratings are supported by low government debt levels and a credible record of prudent fiscal policy.

Credit challenges: Bulgaria's ratings remain constrained by challenges related to i) the economy's vulnerability to shocks as a small, open economy; ii) institutional weaknesses and political instability; iii) limited lender of last resort function of the Bulgarian National Bank (BNB); and iv) demographic challenges.

Progress on euro area entry: Despite the prolonged political instability, we believe Bulgaria will be able to meet the public finances, interest rate and exchange-rate convergence criteria in the European Commission's and ECB's mid-2024 Convergence Reports. The price stability criterion remains a key risk factor for the planned euro adoption by 2025, given Bulgaria's still-elevated inflation rate. Adopting the euro would support Bulgaria's ratings, as it would provide the sovereign with the ability to issue debt in a reserve-currency, among other credit-positive factors.

Bulgaria's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bbb-	BGN [+0]	0	BBB+
Public Finance Risk		20%	aa+		0	
External Economic Risk		10%	bbb+		+1/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Factors	5%	a+		0	
	Social Factors	7.5%	ccc		-1/3	
	Governance Factors	12.5%	ccc		-1/3	
Indicative outcome			**bbb+**		**0**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve-currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Positive Outlook reflects our view that risks to the ratings are skewed to the upside over the next 12-18 months.

Positive rating-change drivers

- Formalisation of euro area accession
- Sustainable increase in economic growth potential
- Progress in addressing institutional challenges

Negative rating-change drivers

- Escalation in institutional challenges and/or political instability
- Weaker economic prospects
- Deterioration in public finance outlook
- Stress in the banking system or weakening external-sector resilience

Ratings and Outlook

Foreign currency

Long-term issuer rating BBB+/Positive

Senior unsecured debt BBB+/Positive

Short-term issuer rating S-2/Positive

Local currency

Long-term issuer rating BBB+/Positive

Senior unsecured debt BBB+/Positive

Short-term issuer rating S-2/Positive

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Bloomberg: RESP SCOP

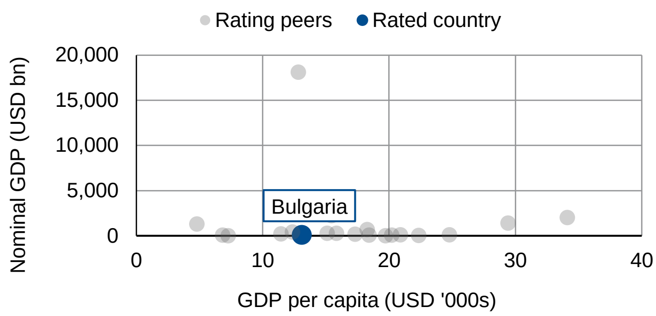
Domestic Economic Risks

- **Growth outlook:** We expect real GDP growth will decline to 1.6% this year, from 3.4% in 2022, given slowing household consumption (-0.8% QoQ in Q1 2023), amid persistent price pressures and decelerating wage growth. Higher borrowing costs and prolonged political instability are weighing on private investment. After reaching 8.2% last year, export growth is also set to moderate as the economic momentum among Bulgaria's trade partners moderates. Output growth is expected to pick up to 3.0% in 2024, supported by an expected normalisation in price dynamics and robust public investment, in line with the roll-out of the country's Recovery and Resilience Plan (RRP, EUR 5.7bn in grant funding, around 8% of GDP). Alternative supply arrangements have minimised energy supply risks following Russia's halting of gas deliveries to Bulgaria. Notably, the diversification of gas supplies via Greece, Turkey and Azerbaijan should also help ease pressures during the 2023-24 winter. We estimate Bulgaria's medium-term potential growth at 2.5%-3% annually, held back by a declining working-age population (projected to decline by 1% per year until 2030).
- **Inflation and monetary policy:** After rising rapidly from late 2021, inflation (HICP, YoY) peaked in September 2022, at 15.6% and declined sharply to 7.5% by June 2023, driven by disinflation in energy and food products. Core inflation remains elevated at 9.2% as of June (down from a December-peak of 11.1%). High inflation remains the main risk regarding meeting convergence criteria necessary for euro adoption, although a projected decline should raise the likelihood of meeting the criterion by mid-2024. Still, outliers would likely need to be omitted for the criterion to be met, as was the case in mid-2022. A credible currency board, in place since 1997, has anchored Bulgaria's macroeconomic stability. It was given further institutional support with entrance to ERM II in July 2020. However, it restricts the BNB's capacity to act as lender of last resort to banks as support can occur only under strictly specified conditions and over short periods, against highly liquid collateral, and only to the extent that the central bank foreign-exchange reserves exceed its monetary liabilities.
- **Labour markets:** The unemployment rate is moderate and stable at 3.9% as of May 2023, below the EU average of 5.9% and the pre-Covid rate of 5.0% in February 2020. The employment rate stands at a historical high of 70.4% as of Q4 2022. Tight labor markets have fueled robust nominal wage growth (+16.3% YoY in March 2023), which should however decelerate over the coming months as labour demand cools. Emigration and adverse ageing dynamics remain key constraints on labour-market performance long-term.

Overview of Scope's qualitative assessments for Bulgaria's *Domestic Economic Risks*

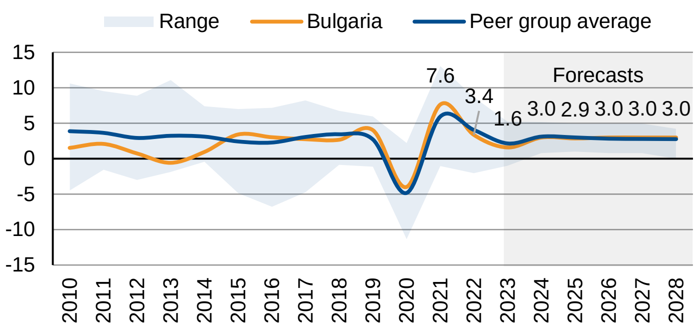
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Growth potential of the economy	Strong	+1/3	Solid medium-run growth potential despite declining working-age population
	Monetary policy framework	Weak	-1/3	Limited monetary-policy flexibility due to currency board system
	Macro-economic stability and sustainability	Neutral	0	Exposure to global and idiosyncratic shocks as a small-open economy, but good labour-market performance

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

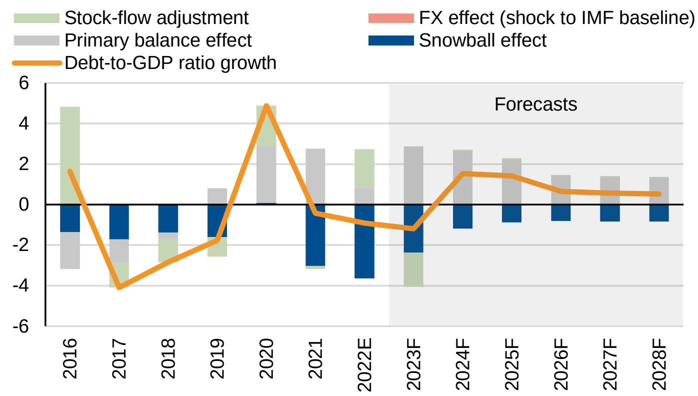
Public Finance Risks

- **Fiscal outlook:** Bulgaria's ratings are supported by a record of prudent fiscal management, which helped contain the increase in government debt during the Covid-19 and energy crises and ensured Bulgaria fulfils the convergence criterion on public finances. However, recurrent episodes of political instability add uncertainty to the budgetary outlook and hinder passage of key reforms necessary for an effective absorption of EU funds under the national recovery and resilience plan. Bulgaria received the first tranche under the RRP of BGN 2.7bn (EUR 1.4bn) in December 2022. We project the general government budget deficit to widen to around 3% of GDP in 2023-24, after 2.8% of GDP in 2022 (down 1.1pp from 2021) given a deceleration in nominal growth and a pickup in the implementation of previously-delayed investment projects.
- **Debt trajectory:** At 22.9% of GDP as of end-2022, Bulgaria's general government debt remains the second-lowest in the EU-27, providing the authorities with fiscal policy space. Although political instability is affecting the fiscal outlook, we expect the government to remain committed to fiscal discipline. This should help keep debt below 30% of GDP in the medium-term. At the same time, a balanced fiscal stance will be needed to contain spending pressures arising from adverse demographics and high infrastructure investment needs. We forecast the debt-to-GDP ratio will decline to 21.7% this year, before trending upwards from 2024 on, ending a forecast horizon at about 26.4% by 2028.
- **Debt profile and market access:** Bulgaria's debt has a long average residual maturity of 7.4 years supported by its access to relatively favorable capital-market financing. This prevents an immediate jump in interest costs from tighter domestic and global monetary conditions. Bulgaria raised EUR 1.5bn in January 2023 in a 10-year Eurobond issue with a fixed coupon of 4.5%, with investor subscription reaching EUR 7.3bn. A risk, however, is that over two-thirds of debt is denominated in euro. Still, the credible currency board mitigates this risk ahead of the planned euro-area entry. Adopting the euro will support Bulgaria's access to euro capital markets.

Overview of Scope's qualitative assessments for Bulgaria's *Public Finance Risks*

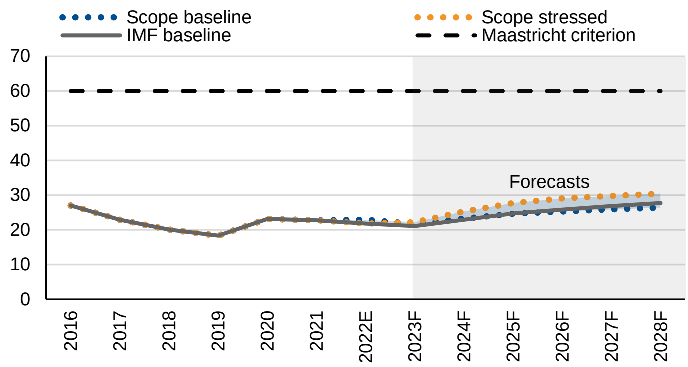
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy, anchored by euro-area convergence requirements, but recurrent episodes of political instability cloud the fiscal outlook
	Debt sustainability	Neutral	0	Solid public debt sustainability including under adverse scenarios
	Debt profile and market access	Neutral	0	More restricted access to lenders of last resort, high FX denomination of public debt mitigated by the credible currency board

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

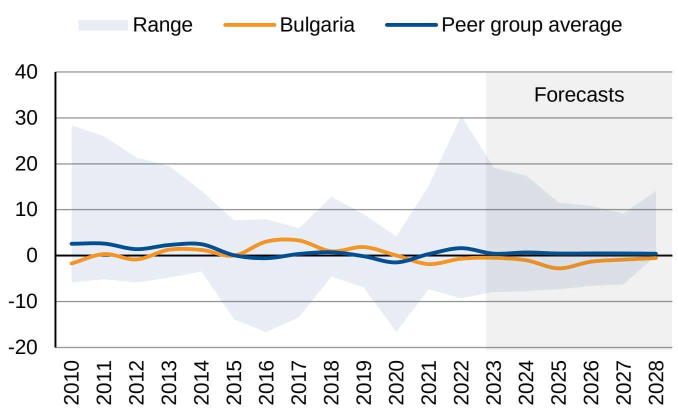
External Economic Risks

- **Current account:** The current account deficit narrowed to 0.7% of GDP in 2022, down 1.2pp from the previous year, amid recovering services exports, lower investment income outflows, and despite a surge in nominal goods imports. We expect the trade balance will weaken over the medium-term, as a result of weaker demand from European trade partners and from the roll-out of investment projects included in Bulgaria's RRP, which should lead to a pickup in capital goods imports. Looking ahead, we expect the current account deficit to moderate to around 0.5% of GDP by 2028.
- **External position:** Bulgaria maintains a relatively strong external position. The net international investment position improved to -12.7% of GDP in Q1 2023, from around -25.5% of GDP at end-2020. Gross external debt stood at 51.6% of GDP in the same period. We believe that higher EU fund inflows and resumed foreign-direct investment will help finance current account deficits in the coming years and limit recourse to new debt. This should contain the risk of the external balance sheet deteriorating markedly during periods of global stress and retain Bulgaria's access to sufficient external liquidity.
- **Resilience to shocks:** Bulgaria's successful ERM II entry has reduced external-sector risk and reinforced a clear roadmap to medium-run accession to the euro area, which we assess as credit positive. The external sector is anchored by enhancements to international reserves. Official reserves totalled EUR 34.8bn in May 2023, nearly doubling from their 2015 average level despite moderating from an all-time high of 38.4bn in December 2022. Reserves currently cover around 9 months of imports and more than 400% of short-term external debt, comfortably above international recommendations. Bulgaria's adequate reserves back the credibility of the exchange rate during the current period of participation of the lev in ERM II.

Overview of Scope's qualitative assessments for Bulgaria's *External Economic Risks*

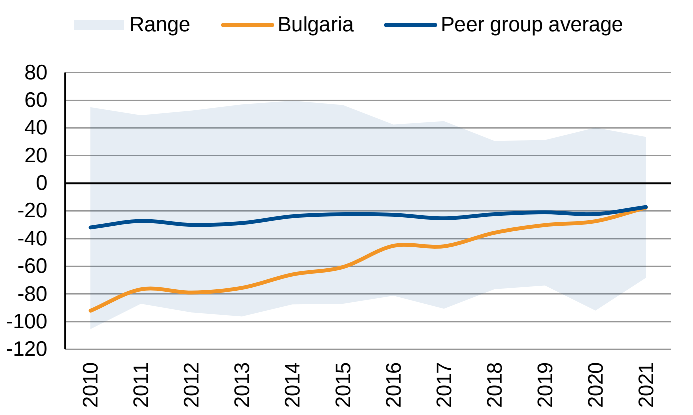
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Current account resilience	Neutral	0	Lesser terms-of-trade deterioration from global shocks due to Russia-Ukraine conflict compared to EU peers
	External debt structure	Strong	+1/3	Low level of external debt, having been reduced over past years; a significant share of FDI in external liabilities
	Resilience to short-term external shocks	Neutral	0	Strengthened reserve adequacy and credible exchange-rate regime, but many sovereign peers issue in reserve currencies

Current-account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

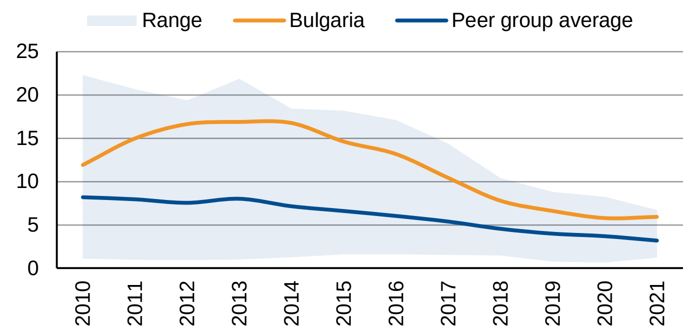
Financial Stability Risks

- **Banking sector:** Bulgaria's banking system remains well capitalised, with the Tier-1 ratio exceeding 20%. The NPL ratio has declined sharply in recent years, to 2.5% in Q4 2022 (from 7.2% in Q4 2019), primarily reflecting a sharp improvement in the quality of non-financial corporate loans. Profitability is strong and improving, as reflected in an aggregate return on equity ratio of 13.1% as of Q4 2022, up 2.2pp from a year prior in a context of rising interest rates. Bulgaria's favourable financial stability assessment reflects significant reforms made to banking-sector governance, underscored by successful entry to the Banking Union. Starting 1 October 2020, the ECB assumed direct supervisory responsibilities over five significant Bulgarian banks. Maintenance of a commitment to reform in financial-system governance is crucial over the period ahead. For example, Bulgaria's legal framework is expected to be adapted to fully comply with EU treaties and statutes in fields of central bank independence, the prohibition of monetary financing and central bank integration in the Eurosystem.
- **Private debt:** The share of foreign-currency deposits has fallen to 33.1% of total bank deposits at end-May 2023, while the share of foreign-currency loans has declined to 25.5% of bank loans. As foreign-currency bank deposits and loans are mostly denominated in euro, FX risks will be mainly eliminated upon euro area entry. However, the reduction of foreign currency risks in the banking system is nonetheless positive during the transitory phase in ERM II. Aggregate non-financial private-sector debt stood at 83% of GDP as of Q1 2023, below the 101% at end-2019 and the peak of 150% of GDP in 2009. As of 2022, 42.4% of Bulgarian households reported being unable to face an unexpected financial expense as of 2022, up from 36.5% in 2019, one of the highest levels in the EU, pointing to significant fragility in the household sector.
- **Financial imbalances:** After rising markedly since 2020, credit growth has decelerated somewhat in recent months in line with the rise in lending rates, all the while remaining well above pre-pandemic levels (+11.9% YoY in Q1 2023). The Bulgarian National Bank is set to raise the counter-cyclical capital buffer rate to 2.0% by October 2023, from 1.5% presently and 0.5% in September 2022. Via entrance to the Banking Union, Bulgaria has joined the Single Resolution Mechanism (and Single Resolution Fund) in October 2020 – supporting its institutional capacity to respond to banking failures more effectively. While private debt remains relatively high, no excessive imbalances are identified.

Overview of Scope's qualitative assessments for Bulgaria's *Financial Stability Risks*

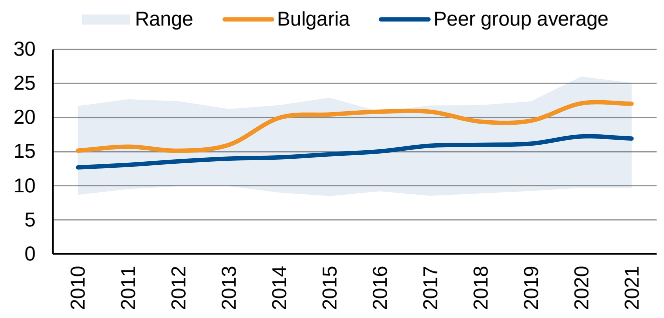
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and profitable banking system
	Banking sector oversight	Neutral	0	Significant steps taken to enhance financial-system supervision supported by 2020 entry to Banking Union
	Financial imbalances	Neutral	0	Relatively high private-sector debt levels, although significant deleveraging over past years

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

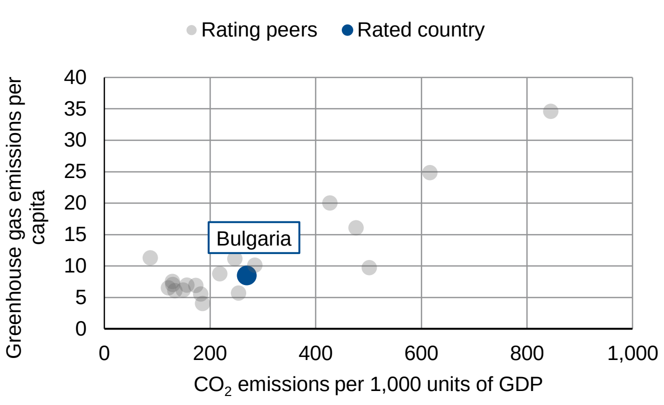
ESG Risks

- **Environment:** Bulgaria's comparatively higher level of carbon emissions per unit of GDP points to elevated transition risks. While we note positively that Bulgaria has nearly doubled its share of renewable sources in primary energy over 2010-21 to 15%, this increase has been comparatively slow, while reliance on fossil fuels (63%) remains elevated. Bulgarian authorities' energy plan, with an estimated cost of around EUR 46bn for the period 2023-2053, includes building four new nuclear reactors to strengthen power generation and export capabilities as well as use of domestic lignite coal for power generation until 2030, with its gradual phase-out by 2038. Risks to Bulgaria's ratings from exposure to natural disasters is low, although climate-change-related weather events such as droughts and floods pose risks to economic activity.
- **Social:** Our assessment balances Bulgaria's moderate level of labour force participation (73.7% as of Q1 2023, close to the EU-27 average of 74.7%) with its comparatively high level of income inequality and elevated old-age dependency ratio, which compare poorly against that of sovereign peers. High economic growth since the 2007 accession to the EU has supported income convergence and significant employment gains. However, faster convergence towards EU average incomes requires additional reforms while net emigration and ageing pose medium-term growth and fiscal challenges.
- **Governance:** Bulgaria's history of political instability is a rating constraint as it weakens policy continuity, encourages populism, which weighs on an otherwise strong government balance sheet, and reduces capacity for long-term economic reform. Bulgaria held early elections in April 2023, its fifth in two years, after coalition negotiations broke down. Center-right party GERB and an anti-corruption alliance led by We Continue the Change and Democratic Bulgaria (PP-DB) agreed to form a coalition government, which will be led by two rotating prime ministers. PP-DB's designate, Nikolay Denkov, is set to lead government until February 2024. We expect the newly formed government to remain broadly committed to pro-EU and pro-NATO policies and adoption of the euro.

Overview of Scope's qualitative assessments for Bulgaria's *ESG Risks*

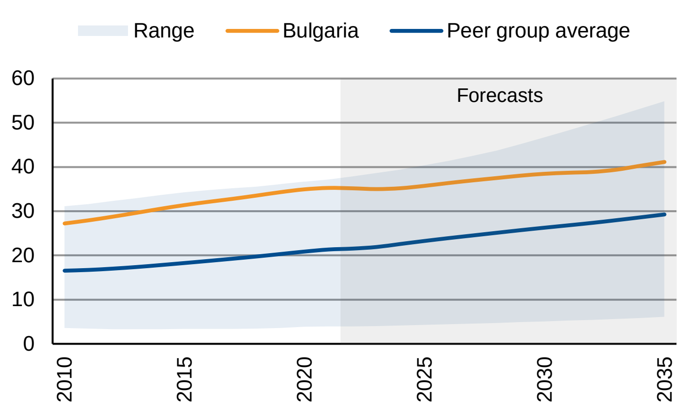
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental factors	Neutral	0	Improving environmental track record, but significant challenges remain to reduce greenhouse gas emissions
	Social factors	Weak	-1/3	Emigration challenges and high income inequality; average to below-average performance on education indicators and health
	Governance factors	Weak	-1/3	History of unstable governments and institutional challenges

Emissions per GDP and per capita, $mtCO_2e$



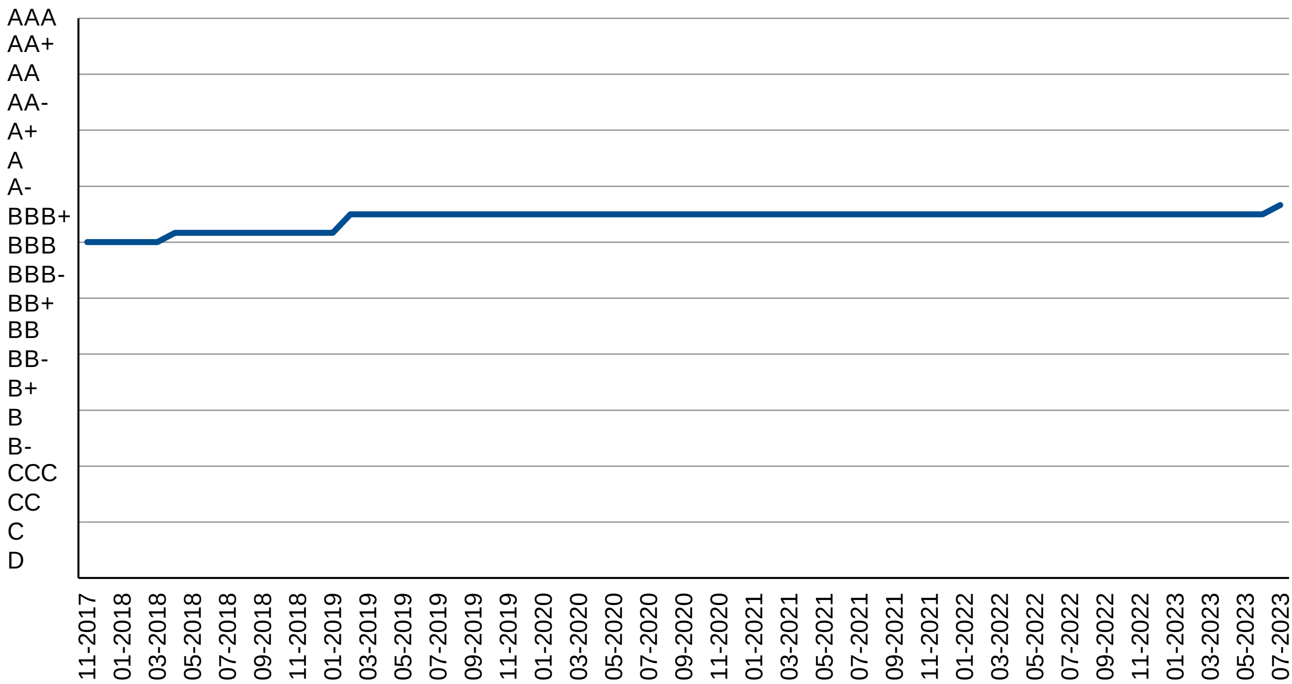
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
China
Croatia
Hungary
Italy
Latvia
Poland
Romania
Slovakia
Spain

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2018	2019	2020	2021	2022
Domestic Economic	GDP per capita, USD '000s	IMF	9.5	9.9	10.2	12.3	13.1
	Nominal GDP, USD bn	IMF	66.4	68.9	70.3	84.1	89.1
	Real growth, %	IMF	2.7	4.0	-4.0	7.6	3.4
	CPI inflation, %	IMF	2.6	2.5	1.2	2.8	13.0
	Unemployment rate, %	WB	5.2	4.2	5.1	5.3	4.4
Public Finance	Public debt, % of GDP	IMF	20.1	18.3	23.2	22.8	21.8
	Interest payment, % of revenue	IMF	0.6	0.4	0.3	0.2	0.0
	Primary balance, % of GDP	IMF	0.3	-0.8	-2.8	-2.8	-0.8
External Economic	Current account balance, % of GDP	IMF	0.9	1.9	0.0	-1.9	-0.7
	Total reserves, months of imports	IMF	7.4	7.2	10.7	8.5	7.5
	NIIP, % of GDP	IMF	-35.9	-30.3	-27.5	-17.7	-12.7
Financial Stability	NPL ratio, % of total loans	IMF	7.8	6.6	5.8	-	-
	Tier 1 ratio, % of risk-weighted assets	IMF	19.8	18.3	19.8	21.9	20.5
	Credit to private sector, % of GDP	WB	50.3	49.5	51.5	48.3	-
ESG	CO_2 per EUR 1,000 of GDP, mtCO_2e	EC	287.9	265.3	243.6	270.0	-
	Income share of bottom 50%, %	WID	16.5	16.5	16.5	16.5	-
	Labour-force participation rate, %	WB	71.7	73.4	72.6	72.6	-
	Old-age dependency ratio, %	UN	33.5	34.3	34.9	35.3	35.2
	Composite governance indicators*	WB	0.2	0.3	0.1	0.1	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market and developing economy
5y USD CDS spread (bps) as of 19 July 2023	120

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