3 February 2023

Sovereign and Public Sector

Republic of Bulgaria
Rating Report

SCOPE BBB+ STABLE OUTLOOK

Credit strengths

- ERM II and Banking Union memberships
- Low government debt
- Record of prudent fiscal policies

Credit challenges

- Small, open economy
- Relatively high NPL ratio and limited lender of last resort function of the BNB
- Institutional, demographic weaknesses

Rating rationale:

Credit strengths: Bulgaria's BBB+ investment-grade ratings are supported by the inclusion of the Bulgarian lev into the Exchange Rate Mechanism II (ERM II) in July 2020. The inclusion reinforces a roadmap to adoption of the euro medium-run. In addition, the ratings reflect reduction of financial-system risk and significant reforms made in banking-system governance in recent years. Finally, Bulgaria's BBB+ 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) above-EU-average NPL ratios, and limited lender of last resort function of the Bulgarian National Bank (BNB); and iii) institutional and demographic weaknesses.

Euro progress: Despite the prolonged political instability, we believe Bulgaria will be able to meet the public finances, interest rates and exchange-rate stability criteria in the European Commission's May 2023 assessment of its progress on convergence. The price stability criterion remains a key risk factor for the planned euro adoption by 2024, 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.

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%	aaa		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 Rating Methodology. Source: Scope Ratings

Outlook and rating triggers

The Stable Outlook reflects the view that risks to the ratings are balanced in the next 12-18 months.

Positive rating-change drivers

- Progress under euro-area convergence
- 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

Local and foreign currency

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

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Bloomberg: RESP SCOP

Domestic economic risk

- **Growth outlook**: We estimate Bulgaria's medium-term potential growth at 2.5% - 3% annually – held back by a declining working-age population (projected 1% decline annually this decade). We project real GDP growth of 1% in 2023, after an estimated 3.4% growth last year, affected by high inflation and prolonged political instability with the caretaker government still in office. New supply arrangements have lowered risk of energy shortages from Russia's halting of gas deliveries. However, gas makes up a relatively small share of Bulgaria's final energy consumption (12%), reducing the immediate adverse growth impact. The diversification of gas supplies via Greece, Turkey and Azerbaijan should also help ease pressures during the 2023-24 winter.

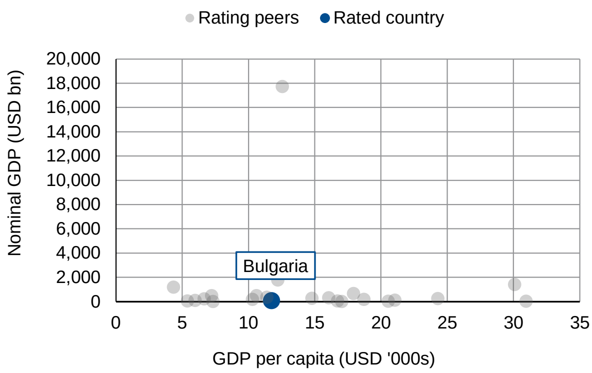
- **Inflation and monetary policy**: We project inflation (HICP) to average above 7% in 2023, after 13% in 2022. We consider high inflation to be the main risk factor to progress on the convergence criteria for euro adoption. In the past 12 months, Bulgaria's inflation rate has been substantially higher than that of the three best performing EU member states and risks remain that Bulgaria again fails to meet this criterion this year. The anchor of Bulgaria's macroeconomic stability has been the nation's credible currency board since July 1997, which has been given further strong institutional support with entrance to ERM II in July 2020. However, the currency board 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 market**: The unemployment rate stood at a moderate 4% (LFS) in November 2022, below the EU average of 6% and the pre-Covid rate of 5.1% in February 2020. We do not expect major pressures in the labour market in 2023 with only a moderate increase in the unemployment rate. However, emigration and ageing population remain key constraints on the labour-market performance long-term.

Overview of Scope's qualitative assessments for Bulgaria's *domestic economic risk*

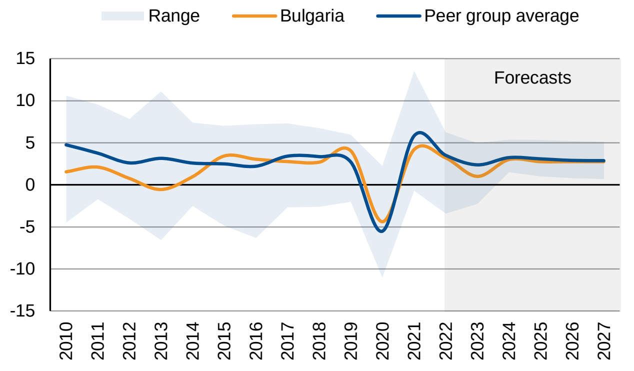
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Strong	+1/3	Solid medium-run growth potential, but declining working-age population
	Monetary policy framework	Weak	-1/3	Limited monetary-policy flexibility due to currency board system
	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



Source: IMF, Scope Ratings

Real GDP growth, %



Source: IMF, Scope Ratings

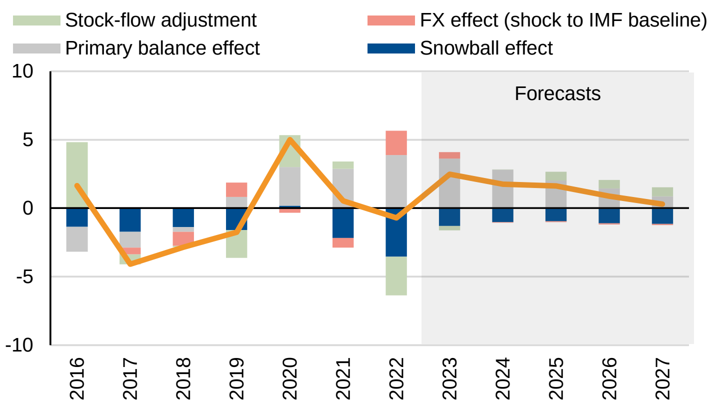
Public finance risk

- **Fiscal outlook**: Bulgaria's ratings are supported by a credible 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, the prolonged political instability has increased pressure on the budgetary outlook, as it has hindered passage of key reforms necessary for an effective absorption of EU funds under the national Recovery and Resilience Plan (RRP). Bulgaria received the first tranche under the RRP of BGN 2.7bn (EUR 1.37bn) only in December 2022. We project a budget deficit of 3.7% in 2023, after an estimated 2.9% in 2022, in part due to low expenditures under the EU funds last year and shifts in implementation of investment projects into 2023 and subsequent years.
- **Debt trajectory**: At 23.1% of GDP in Q3 2022, Bulgaria's general government debt remains among the lowest in the EU-27, providing the authorities with fiscal policy space. Although political instability is affecting the fiscal outlook, we expect the next governments in Bulgaria 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.
- **Market access**: Bulgaria's debt has a long average residual maturity of 7.5 years, (60% of debt has an original maturity of over 10 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 managed to raise EUR 1.5bn in January 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 risk*

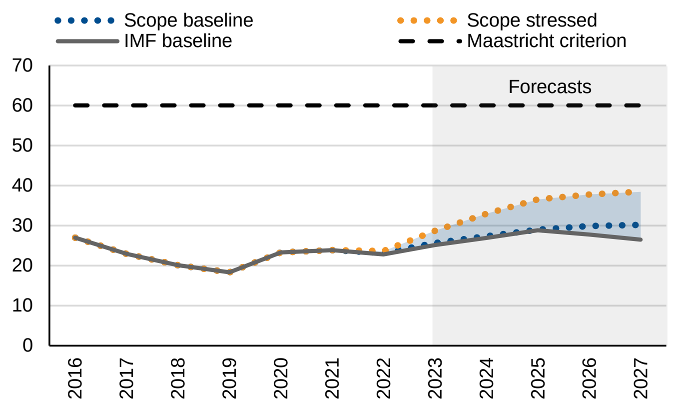
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy, anchored by euro-area convergence requirements, but political instability clouds the fiscal outlook
	Debt sustainability	Neutral	0	Solid public debt sustainability including under adverse scenarios, but pressure from high investment needs
	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

Contribution to changes in debt, pps of GDP



Source: Scope Ratings

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings

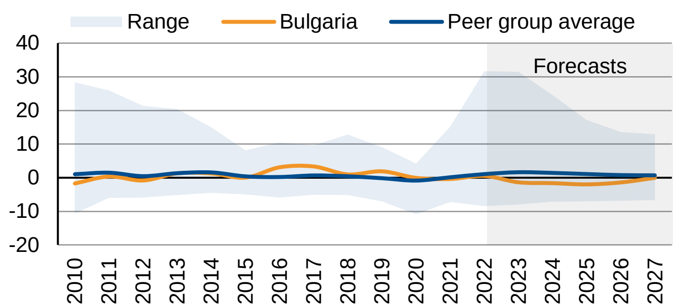
External Economic Risks

- **Current account**: We estimate a current account surplus of 0.5% of GDP in 2022, in line with pre-war trends for the years between 2019 and 2021. The war in Ukraine has not harmed Bulgaria's terms of trade as much as it has for EU peers. This is because the country's exports remain centered on basic goods and raw materials rather than high-value items. The higher electricity exports to neighbouring countries have also supported the trade balance. We believe Bulgaria can meet its gas needs (annual consumption of around 3bcm) through a new pipeline that allows more gas imports from Azerbaijan as well as the recent agreements giving access to Turkish and Greek LNG terminals. However, the war in Ukraine will still be felt through a higher gas bill, as Russian gas will likely be costly to substitute. Over 2023-24, we expect the current account to turn into a narrow deficit of 1%-2% of GDP once import-intensive investments pick up on the back of expected EU fund inflows.
- **External position**: Bulgaria maintains a relatively strong external position. The net international investment position improved to -12.9% of GDP in Q3 2022, from -25.5% of GDP in Q3 2020. Gross external debt stood at 54.2% of GDP in the same period, down from 63.9% of GDP two years before. We believe that higher EU fund inflows and resumed FDI will help finance current account deficit 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 participation 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 38.4bn in December 2022, the highest level to date, and nearly double the EUR 20.3bn in December 2015. Bulgaria's current level of reserves covers eight months of imports of goods and services, comfortably above the 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*

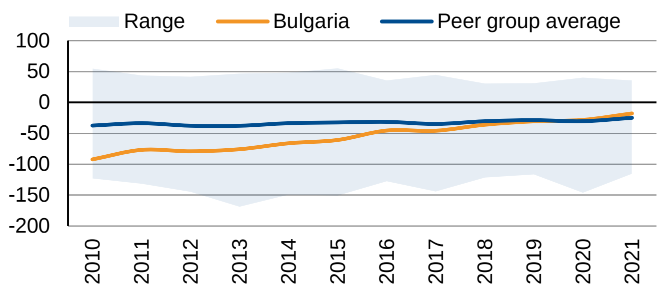
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Lesser terms-of-trade deterioration from global shocks due to Russia-Ukraine conflict compared to EU peers
	External debt structure	Strong	+1/3	Low level of external debt, having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

Net international investment position, % of GDP



Source: IMF, Scope Ratings

Financial stability risk

- **Banking sector**: Bulgaria's banking system remains adequately capitalized, with the Tier-1 ratio exceeding 20%. Although the NPL ratio declined to 3.2% in Q3 2022 from 7.2% in Q3 2020, it remains above the euro area averages, and NPLs are likely to increase as loan moratoria and extraordinary liquidity support measures are gradually withdrawn.

  Bulgaria's ratings reflect 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. Per 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.

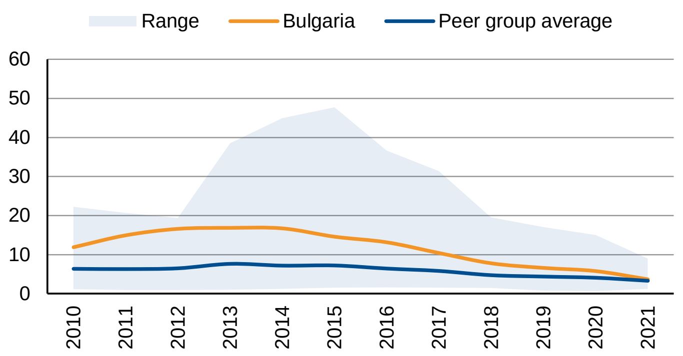
- **Private debt**: The share of foreign-currency deposits has fallen to 40% of total bank deposits from 65% at end-2009, while the share of foreign-currency loans has declined to 38% of bank loans from a 2012 peak of 67%. As foreign-currency bank deposits and loans are mostly denominated in euro, FX risks will be mainly eliminated upon the euro adoption. However, the reduction of foreign currency in the banking system is nonetheless credit positive during the transitory phase in ERM II. In addition, domestic non-financial private-sector debt stood at 84.4% of GDP as of end-2021, below the 90.7% at end-2019 and the peak of 140.4% of GDP in 2009.

- **Financial imbalances:** 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 risk*

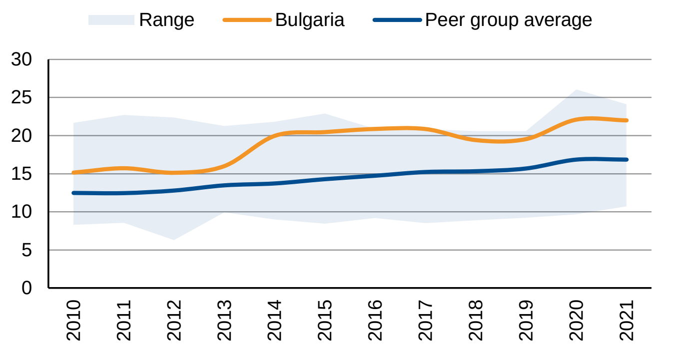
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised banking system, but comparatively high NPLs
	Banking sector oversight	Neutral	0	Significant steps taken to enhance financial-system supervision supported by 2020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

NPLs, % of total loans



Source: IMF, Scope Ratings

Tier 1, % of risk-weighted assets



Source: IMF, Scope Ratings

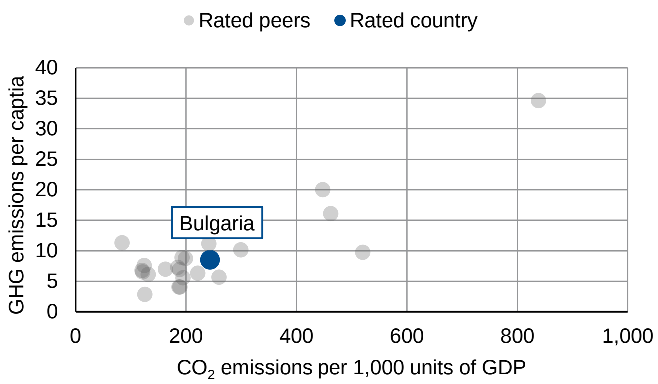
ESG risk

- **Environment:** Bulgaria's comparatively higher level of carbon emissions per unit of GDP points to elevated transition risks. Still, we note positively that Bulgaria increased share of renewable sources in primary energy (11.5% in 2021, up from under 5% in 2011). In addition, its new 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 do pose risks to economic activity.
- **Social:** Our assessment balances Bulgaria's level of labour force participation (72% vs 73.8% for the EU-27 in 2021) with its comparatively high level of income inequality and elevated old-age dependency ratio, which compares weakly against that of sovereign peers. High economic growth since the 2007 accession to the EU has advanced income convergence and reduced levels of unemployment. However, faster convergence towards EU average incomes requires additional reforms while net emigration poses 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. Achievement of specific euro-entrance requirements – especially on the institutional side – may prove challenging especially recognizing postponements in areas of reform due to the Covid-19 crisis and prolonged political instability. Bulgaria will hold another early election in April following the failure of coalition talks, extending political uncertainty into 2023. The current political turmoil indicates the danger of rising political fragmentation in Bulgaria. Still, we expect the next 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 risk*

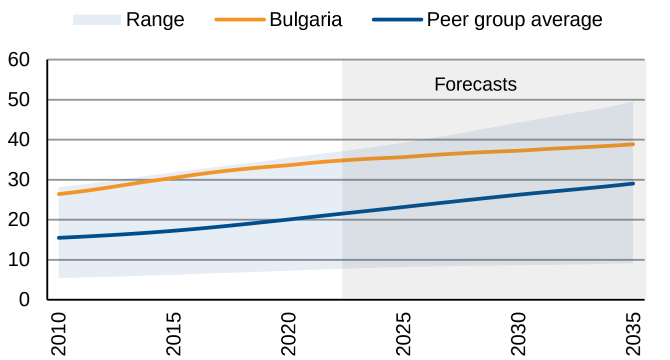
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental factors	Neutral	0	Improving environmental track record, but significant challenges remain, for example, related greenhouse gas emissions
	Social factors	Weak	-1/3	Emigration challenges and high income inequality; 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, mtCO2e



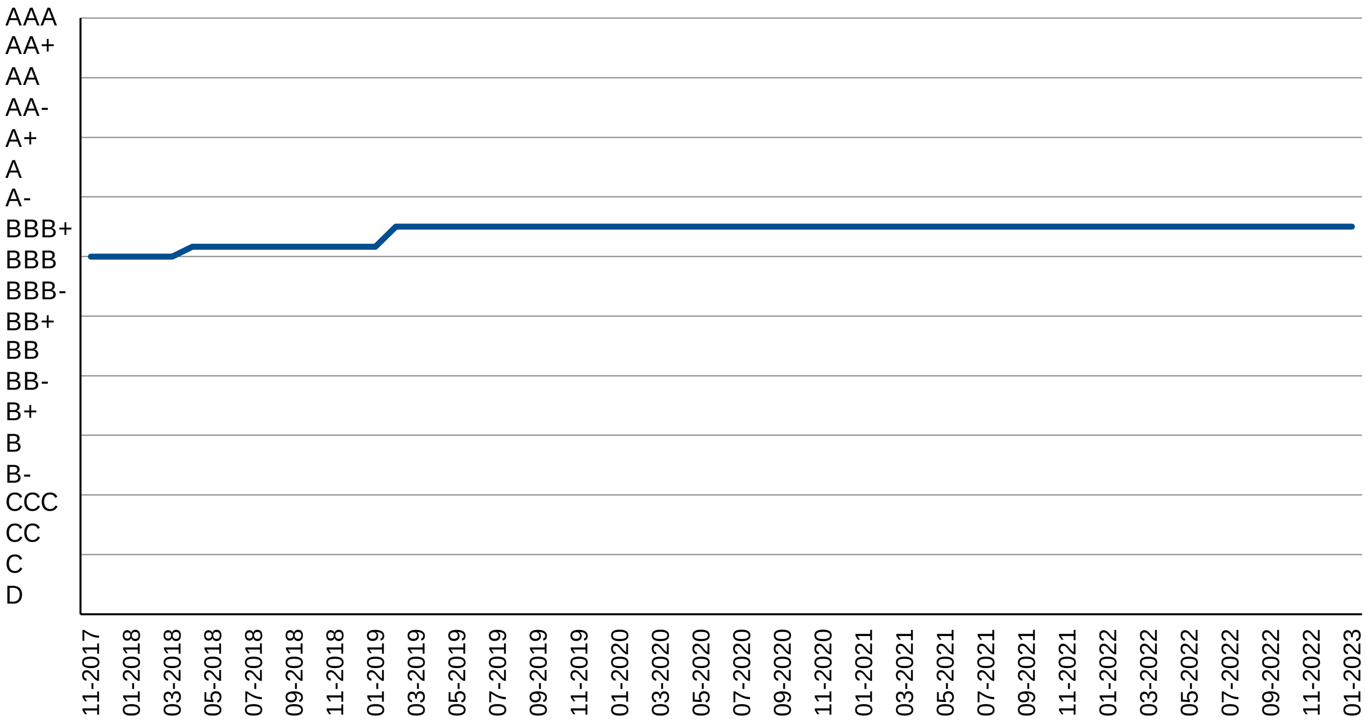
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



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.

Peer group*
China
Cyprus
Hungary
Latvia
Poland
Portugal
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	2017	2018	2019	2020	2021	2022E
Domestic Economic	**GDP per capita, USD 000s'**	IMF	8.4	9.5	9.9	10.1	11.7	12.5
	Nominal GDP, USD bn	IMF	59.3	66.4	68.9	70.0	80.3	85.0
	Real growth, %	IMF/NSI	2.8	2.7	4.0	-4.0	7.6	3.4
	Inflation, %	IMF	1.2	2.6	2.5	1.2	2.8	13.0
	Unemployment rate, %	WB	7.2	6.2	5.7	7.4	5.5	4.5
Public Finance	**Public debt, % of GDP**	Eurostat	25.1	22.1	20.0	24.5	23.9	23.0
	Interest payment, % of revenue	Eurostat	2.2	1.8	1.6	1.3	1.4	1.5
	Primary balance, % of GDP	Eurostat	2.4	2.4	2.7	-3.3	-3.4	-3.5
External Economic	**Current account balance, % of GDP**	IMF	3.3	0.9	1.9	0.0	-0.5	0.5
	Total reserves, months of imports	IMF	9.8	11.1	8.0	8.5	8.6	8.0
	NIIP, % of GDP	IMF	-45.6	-35.9	-30.3	-28.0	-17.6	-
Financial Stability	**NPL ratio, % (broad scope)**	IMF/BNB	10.2	7.6	6.5	5.6	4.6	-
	Tier 1, % of RWA	IMF/BNB	20.9	19.4	19.5	22.1	22.0	-
	Credit to private sector, % of GDP	WB/BNB	51.5	52.2	52.1	54.6	-	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	314.6	287.9	265.3	243.6	270.0	-
	Income share of bottom 50%, %	WID	16.4	16.5	16.5	16.5	16.5	-
	Labour-force participation rate, %	WB	71.3	71.5	73.2	72.2	72.0	-
	Old-age dependency ratio, %	UN	32.8	33.5	34.3	34.9	35.3	35.2
	Composite governance indicators*	WB	0.2	0.2	0.3	0.1	0.1	-

*Average of the six World Bank Governance Indicators

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market and developing economy
5y USD CDS spread (bps) as of 3 February 2023	162

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