26 August 2022

Sovereign and Public Sector

Republic of Bulgaria
Rating Report

STABLE OUTLOOK

BBB+

Credit strengths

- ERM II membership
- Low government debt levels
- Record of prudent fiscal policies

Credit challenges

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

Rating rationale:

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 over a medium-run horizon, which, if or once achieved, is expected to enhance Bulgaria's level of institutional strength. In addition, the ratings reflect reduction of financial-system risk and significant reforms made in banking-system governance, underscored by successful entry to the Banking Union in October 2020. Finally, Bulgaria's BBB+ ratings are supported by low government debt levels and a record of prudence in fiscal policy making.

However, Bulgaria's ratings remain constrained by challenges related to the economy's vulnerability to shocks as a small, open economy. In addition, above-EU-average ratios of non-performing loans (NPLs) and the limited lender of last resort function of the Bulgarian National Bank (BNB), as well as institutional and demographic weaknesses represent credit constraints.

Bulgaria's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a-		-2/3	BBB+
Public Finance Risk		25%	aaa		-1/3	
External Economic Risk		10%	a-		-1/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Risk	5%	aaa		-1/3	
	Social Risk	5%	b		-1/3	
	Governance Risk	10%	ccc		-1/3	
Overall outcome		a		0	-2	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 GmbH.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Progress under euro-area convergence priorities
- Sustainable increase in economic growth potential
- Progress in addressing institutional challenges

Negative rating-change drivers

- Weaker reform momentum, delays in the euro-accession timetable
- Escalation in institutional challenges and/or political instability
- A sharp slowdown in GDP growth
- 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

Lead Analyst

Levon Kameryan
+49 69 6677389-21
l.kameryan@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook**: We expect Bulgaria's medium-term potential growth at around 2.75% – higher than that of peers but held back by supply-side bottlenecks due to a working-age population projected to decline 0.9% per year between 2021 and 2025. We project growth of 2.2% in 2022 and 3% in 2023, impacted by high inflation and a weakened external environment. Russia's halting of gas supplies raises risk of energy shortages, given relatively low levels of gas stored (54% of capacity), until new supply arrangements are finalised. However, gas makes up a relatively small share of Bulgaria's final energy consumption (12%), reducing the immediate adverse growth impact.

- **Inflation and monetary policy**: We project inflation (HICP) to average a double-digit 11.4% in 2022. Higher commodity prices and worsening of supply bottlenecks resulting from the Russia-Ukraine war fuel price pressures. Bulgaria does not fulfil the criterion on price stability for euro adoption and risks remain that it again fails to meet the criterion next year.

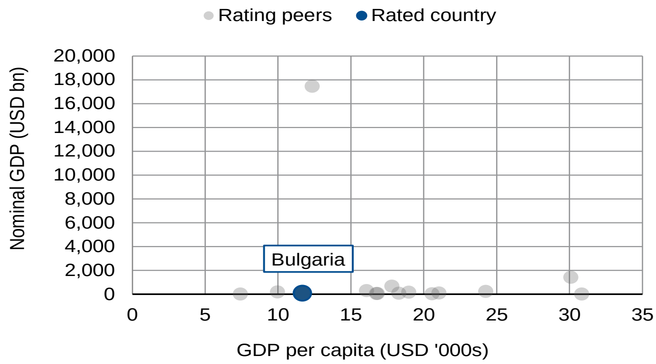
  The anchor of Bulgaria's macroeconomic stability has been the nation's credible currency board since July 1997, which has been given further strong institutional support with entrance to ERM II in July 2020. However, the currency board restricts the BNB's capacity to act as lender of last resort to banks 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**: Following an improvement in the labour market situation with an economic recovery from the Covid-19 crisis, we project a slight increase in the unemployment rate from the current moderate levels over the next year. The unemployment rate stood at 4.3% (LFS) in June, below the EU average of 6%, and below the pre-Covid rate of 5.1% in February 2020.

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

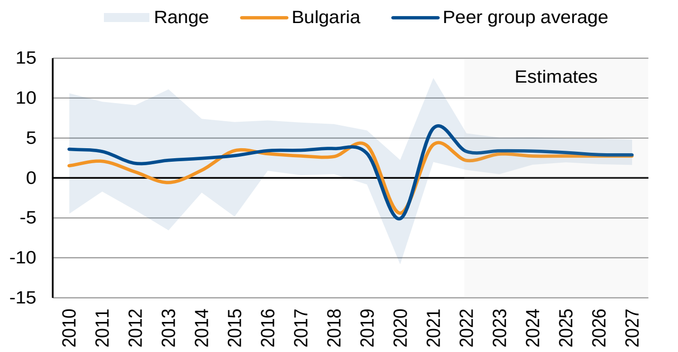
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Growth potential of the economy	Neutral	0	Solid medium-run growth potential, but demographic weaknesses
	Monetary policy framework	Weak	-1/3	Limited monetary-policy flexibility due to currency board system
	Macro-economic stability and sustainability	Weak	-1/3	Exposure to global and idiosyncratic shocks as a developing country with small, open economy

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

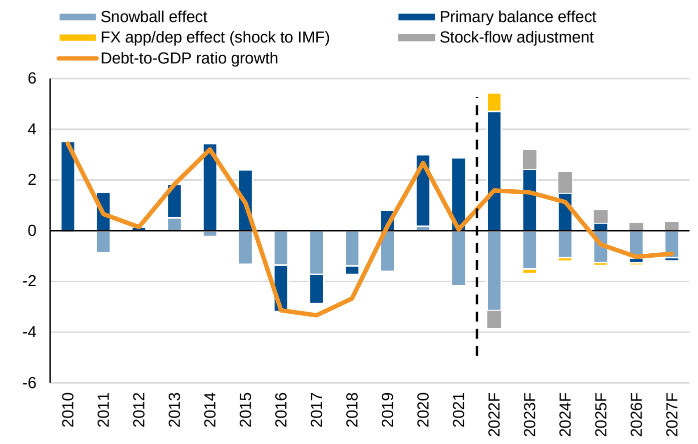
Public Finance Risks

- **Fiscal outlook**: Bulgaria's ratings reflect a track record of prudent fiscal policy setting. The country's fiscal framework based on EU as well as several fiscal rules at the general government and subnational levels helped contain increase in public debt even during the Covid-19 crisis, ensuring that Bulgaria fulfils the criterion on public finances. While Bulgaria's fiscal deficits during Covid-19 were comparatively modest, providing it with fiscal space given low levels of public debt and moderate debt service payments, fiscal consolidation will be needed to contain increases in public debt ratio over the medium-run.
- **Debt trajectory**: Bulgaria's gross public debt is projected to increase to 27% of GDP by 2023, from 20% pre-crisis – returning the debt ratio to 2016 levels. Nevertheless, the increase in the government debt ratio is estimated to be among the most modest of 14 CEE countries covered by Scope. In fact, Bulgaria's public debt ratio remains among the lowest in the EU-27 and is projected to remain broadly stable over the coming years.
- **Market access**: Bulgaria's debt has a long average residual maturity of 7.5 years. A risk, however, is that over two-thirds of debt is denominated in euro. Still, the credible currency board framework mitigates this risk. Long-term interest rates in Bulgaria stood at 0.5% on average between May 2021 and April 2022, well below the 2.6% reference value for the interest rate convergence criterion.

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

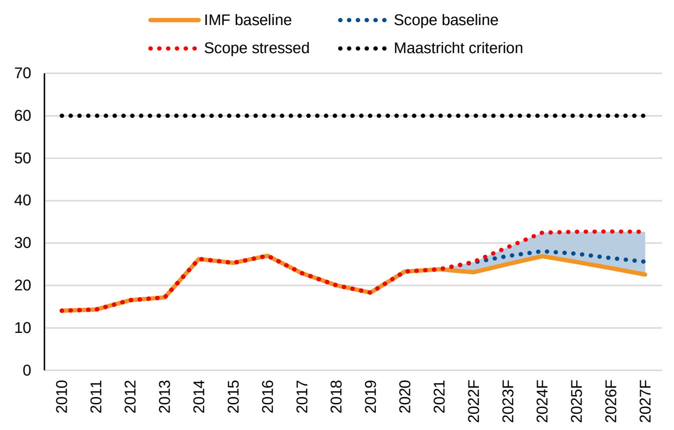
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy, anchored by euro-area convergence requirements
	Debt sustainability	Neutral	0	Solid public debt sustainability, including under adverse scenarios
	Debt profile and market access	Weak	-1/3	High FX denomination of public debt and more restricted access to lenders of last resort

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

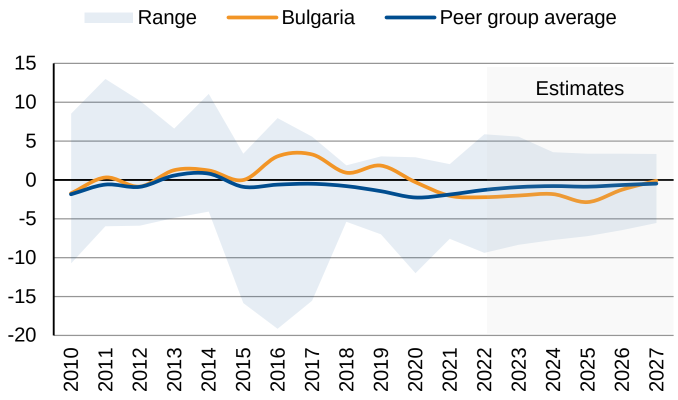
External Economic Risks

- **Current account**: We project Bulgaria's current account deficit to widen to 2%-2.5% of GDP in 2022-2023, from -0.4% of GDP in 2021, mainly reflecting higher international prices for commodities. Russia's halting of gas supplies to Bulgaria will exacerbate inflationary tensions in the short-term, as Bulgaria relied on Russia for almost all its natural gas. While this adversely impacts its import bill, given the relatively small size of Bulgaria's gas market (annual gas consumption of around 3bcm) we expect the country will meet its energy needs via a new pipeline enabling more gas imports from Azerbaijan, and European energy solidarity and co-ordination until new projects are fully operational.
- **External position**: Bulgaria has observed improvements in its net international investment position to -18.6% of GDP as of Q1 2022, from -24.1% in Q1 2021. Gross external debt stood at 58.8% of GDP as of Q1 2022, down from 63.1% of GDP one year before. These improvements strengthen Bulgaria's external position.
- **Resilience to shocks**: Achievement of ERM-II participation represents a milestone in reduction of external-sector risk and has 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 foreign-exchange reserves. Official reserves total EUR 33.5bn in June 2022, near peaks of EUR 34.6bn of end-2021 but still nearly double the EUR 15.6bn as of January 2015. 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*

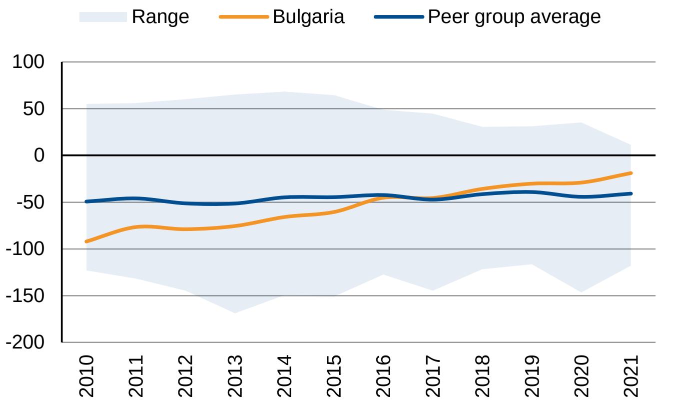
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Current account resilience	Weak	-1/3	Recent weakening in current-account balance, some reliance on remittances
	External debt structure	Neutral	0	Low level of external debt, having been reduced over past years
	Resilience to short-term shocks	Neutral	0	Strengthened reserve adequacy and credible exchange-rate regime, but most countries in peer group issue in reserve currencies

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

- **Banking sector**: While capitalisation of the banking sector is strong, with the Tier-1 ratio exceeding 20%, the non-performing loan ratio remains above the EU average. Although the gross NPL ratio declined to 3.7% in Q1 2022 from 6.7% in Q1 2021, risk for higher NPLs is likely to increase as loan moratoria and extraordinary liquidity support measures are tapered.

  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.

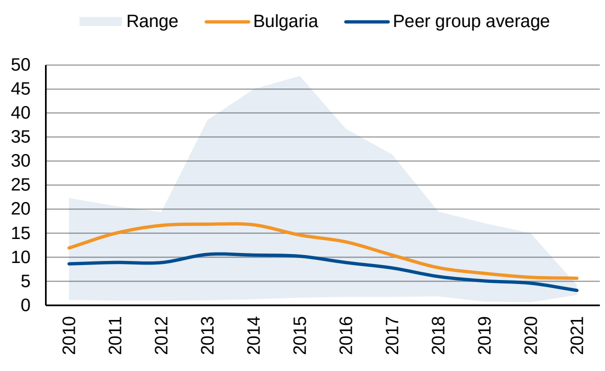
- **Private debt**: Banking-system deposits and loans in foreign currency have been reduced in recent years. As foreign-currency bank deposits and loans are mainly denominated in euro, FX risks will be mainly eliminated upon the euro adoption. However, the recent reduction in foreign currency in the banking system is nonetheless credit positive during the transitory phase in ERM II. In addition, domestic non-financial private-sector debt stood at 94.3% of GDP as of end-2020, slightly above end-2019 lows (90.7%) but below peaks of 140.4% of GDP in 2008.

- **Financial imbalances:** Via entrance to Banking Union, Bulgaria has joined the Single Resolution Mechanism (and Single Resolution Fund) in October 2020 – supporting institutional capacity to respond to banking failures more effectively in the future. While private debt remains relatively high, no excessive imbalances are identified.

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

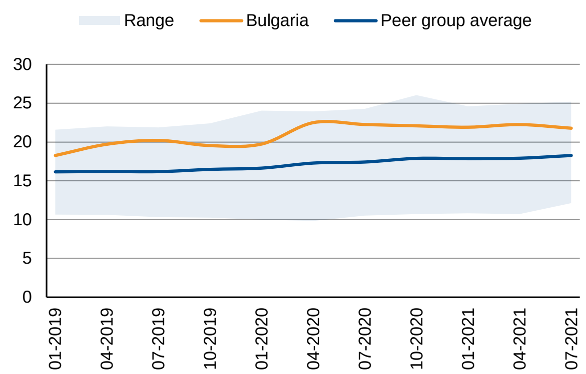
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Comparatively high NPLs, but well-capitalised banking system
	Banking sector oversight	Neutral	0	Significant steps taken to enhance financial-system supervision supported by 2020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

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

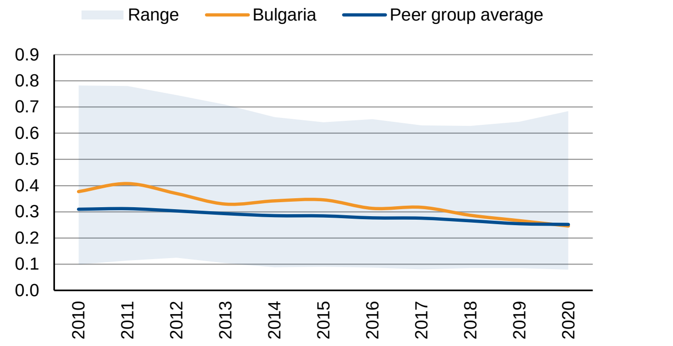
ESG Risks

- **Environment:** We consider Bulgaria's comparatively high level of carbon emissions per unit of GDP, pointing to elevated transition risks. Still, we note positively that Bulgaria has pursued a relatively rapid increase in the share of renewables in overall energy supply and the elimination of high carbon-emitting fuel sources. In addition, risks to Bulgaria's sovereign ratings from exposure to natural disasters is low as evaluated via the United Nations University's World Risk Index, although climate-change-related weather events such as droughts and floods do pose risks.
- **Social:** Our assessment balances Bulgaria's average level of labour force participation (72% 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 Bulgaria's 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 challenges.
- **Governance:** Bulgaria's history of political instability is a rating constraint as it restricts continuity in reform drives, encourages populism (which weighs on the government balance sheet), and reduces capacity for long-term economic planning. Achievement of specific euro-entrance requirements – especially on the institutional side – may prove challenging especially recognising observed postponements in areas of reform due to the Covid-19 crisis and prolonged political instability. Bulgaria will hold early elections in October following the no-confidence vote against the government and the failure of coalition talks, extending political uncertainty. The current political turmoil indicates the danger of rising political fragmentation in Bulgaria. However, we still expect broad-based political commitment to continue for pro-EU policies and adoption of the euro.

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

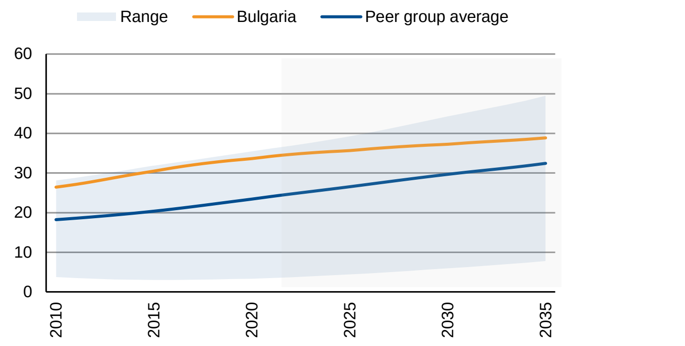
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Environmental risks	Weak	-1/3	Improving environmental track record, but significant challenges remain, for example, related to air quality and greenhouse gas emissions
	Social risks	Weak	-1/3	Emigration challenges and high income inequality compared with peers; average to below-average performance on education indicators and health
	Institutional and political risks	Weak	-1/3	History of unstable governments and institutional challenges

CO2 emissions per GDP, mtCO2e



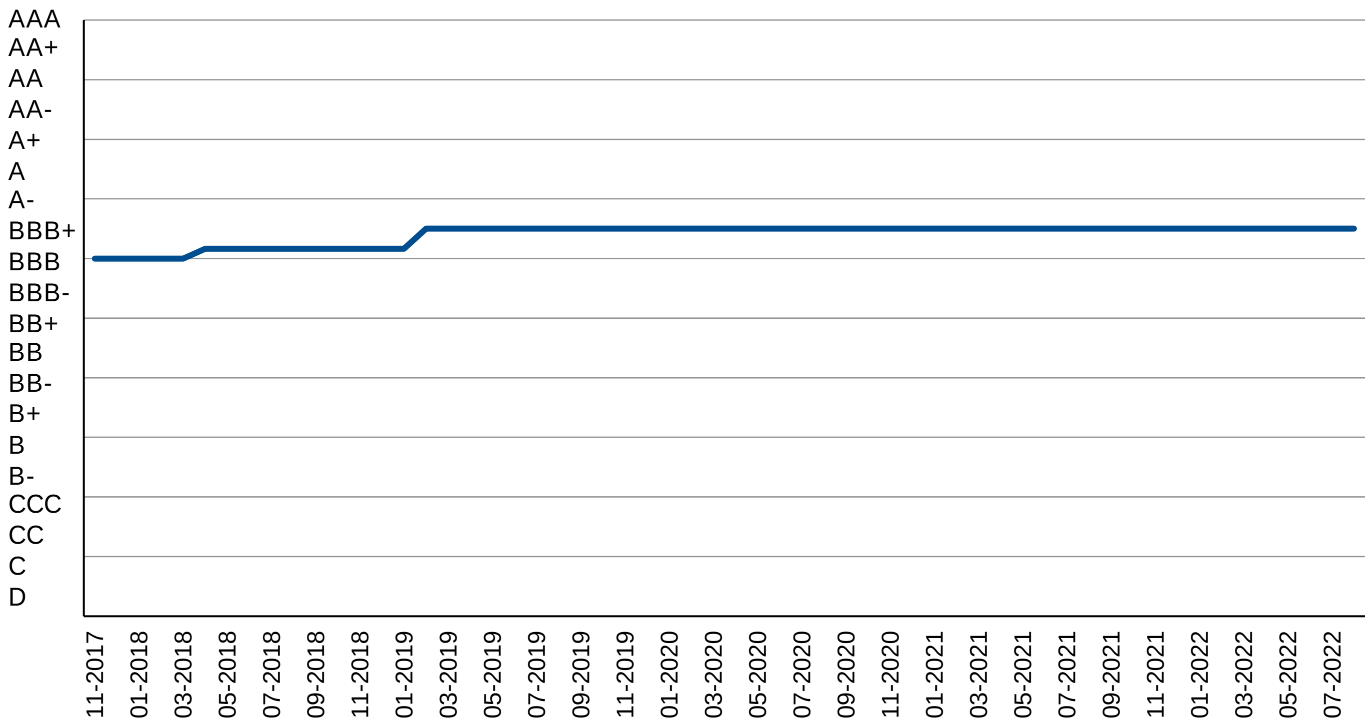
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

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
Bulgaria
China
Croatia
Cyprus
Hungary
Latvia
Poland
Portugal
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 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	7.6	8.4	9.5	9.9	10.1	11.7	13.1	14.4
Nominal GDP, USD bn	53.9	59.3	66.4	68.9	70.0	80.3	89.5	97.8
Real growth, %[1]	3.0	2.8	2.7	4.0	-4.4	4.2	2.2	3.0
CPI inflation, %	-1.3	1.2	2.6	2.5	1.2	2.9	11.4	6.3
Unemployment rate, %[1]	7.7	6.3	5.3	4.3	5.2	5.3	4.6	5.0
Public Finance Risk								
General government debt, % of GDP[1]	29.1	25.1	22.1	20.0	24.7	25.1	25	27
Interest payment, % of government revenue	2.5	2.2	1.7	1.4	1.4	1.3	1.6	1.5
Primary balance, % of GDP[1]	1.2	2.4	2.4	2.7	-3.5	-3.6	-4.2	-2.0
External Economic Risk								
Current account balance, % of GDP	3.1	3.3	0.9	1.9	-0.1	-0.4	-2.3	-2.5
Total reserves, months of imports	8.4	8.2	7.4	7.2	10.6	8.5	-	
NIIP, % of GDP	-47.5	-43.0	-37.0	-30.2	-27.1	-19.8	-	
Financial Stability Risk								
NPL ratio, % of total gross loans (broad scope)	12.9	10.2	7.6	6.5	5.6	4.6	-	
Tier 1 ratio, % of risk weighted assets	20.9	20.9	19.4	19.5	22.1	21.8	-	
Credit to private sector, % of GDP	53.0	51.5	52.2	52.1	54.6	-	-	
ESG Risk								
CO^2 per EUR 1,000 of GDP, mtCO^2e	312.8	316.9	286.2	265.7	245.1	-	-	
Income quintile share ratio (S80/S20), x	8.6	8.2	8.4	8.2	-	-	-	
Labour force participation rate, %	68.7	71.3	71.5	73.2	72.2	72.0	-	
Old age dependency ratio, %	31.3	32.0	32.7	33.2	33.6	34.2	34.7	35.1
Composite governance indicator[2]	0.2	0.2	0.2	0.3	0.1	-	-	

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market and developing economy
5y USD CDS spread (bps) as of 26 August 2022	132

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer