

Republic of Bulgaria

Rating Report



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 ratios 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 the area of 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%	bbb+	0	-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, institutional convergence delay accession timetable
- Re-escalation in institutional challenges and/or political instability
- 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

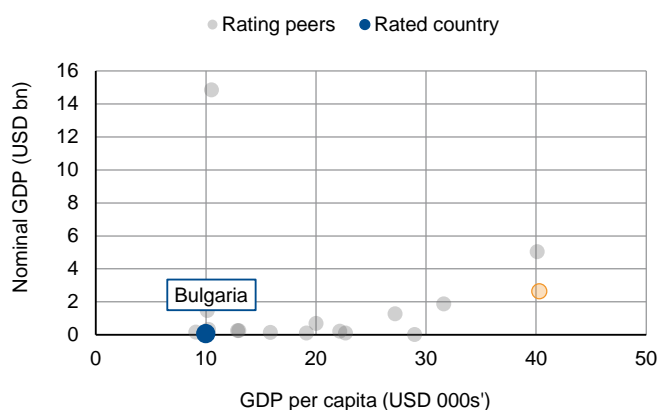
Domestic Economic Risks

- **Growth outlook:** Scope foresees medium-term potential growth averaging 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. Scope projects growth of 1.8% in 2022, down from a previous forecast of 4.8% as of December 2021, due to significantly higher energy prices and weakened external environment.
- **Inflation and monetary policy:** 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:** Labour market situation has been improving with a continuing economic recovery. Unemployment rate declined to 4.7% (LFS) in January, below the EU average of 6.2%, and below the pre-crisis rate of 5.1% in February 2020.

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

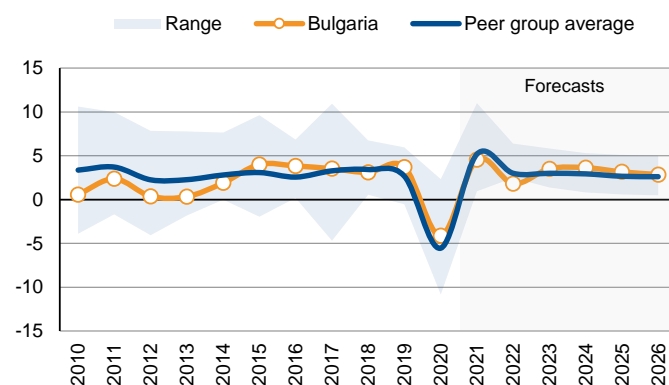
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Neutral	0	Solid medium-run growth potential, but demographic weaknesses
	Monetary policy framework	Weak	-1/3	Limited monetary-policy flexibility due to currency board system
	Macro-economic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

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

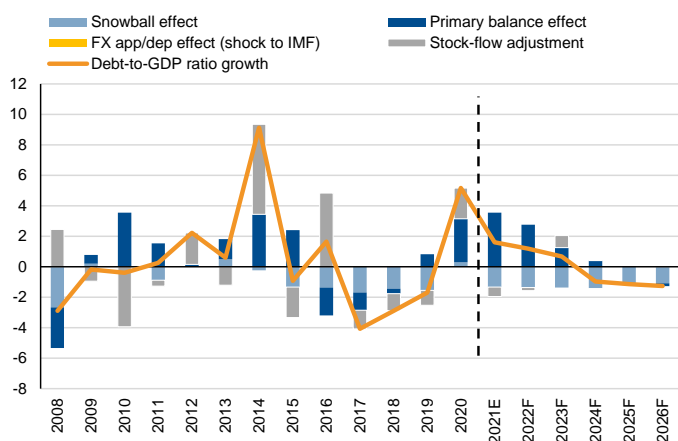
Public Finance Risks

- **Fiscal outlook:** Bulgaria's ratings reflect a track record of prudent fiscal policy setting. While Bulgaria's fiscal deficits during Covid-19 were comparatively modest and Bulgaria does have fiscal space given low levels of public debt and moderate debt service payments, counter-cyclical fiscal consolidation will be needed as the economic recovery continues gathering a foothold.
- **Debt trajectory:** Bulgaria's gross public-debt ratio is projected to increase to 29% of GDP in 2022, 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 and Bulgaria retains among the lowest government-debt ratio in the EU-27.
- **Market access:** Bulgaria's debt has a long average residual maturity of 7.3 years. A risk, however, is the around 80% of general government debt denominated in euro. The credible currency board framework mitigates this risk.

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

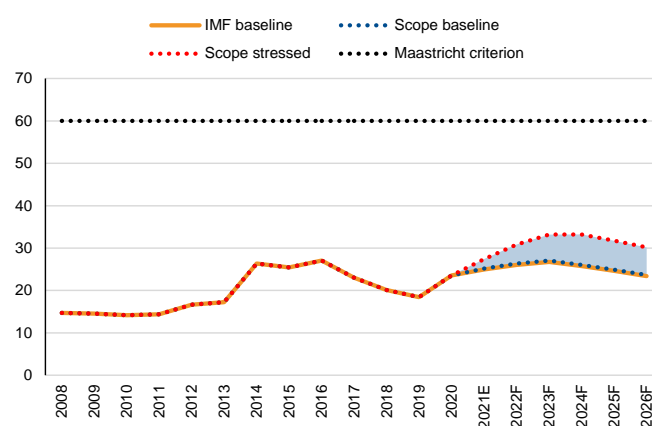
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Record of prudent fiscal policy, anchored by euro-area convergence requirements
	Debt sustainability	Neutral	0	Strong public debt sustainability, including under adverse scenarios
	Debt 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

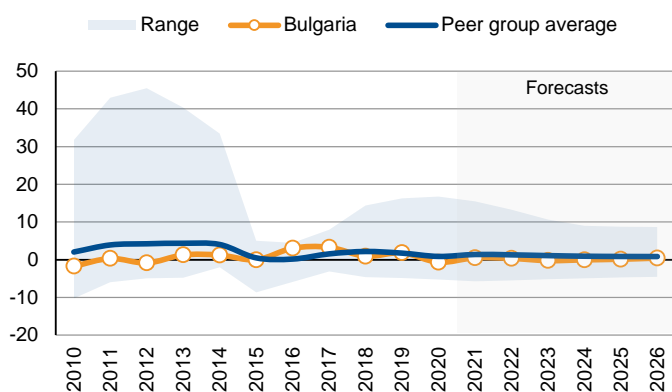
External Economic Risks

- **Current account:** Scope projects the current account deficit to widen to around 3% of GDP in 2022, from 2% of GDP in 2021.
- **External position:** Bulgaria has observed improvements in its net international investment position to -18.1% of GDP as of Q3 2021, from -37.8% in Q3 2018. Gross external debt stood at 61.2% of GDP in end-2021, down from 66.1% of GDP by the end of 2018. 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 Scope assesses as credit positive. The external sector is anchored by enhancements to foreign-exchange reserves. Currently, official reserves total EUR 30.7bn as of end-January 2022, near peaks of EUR 32.5bn of September 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*

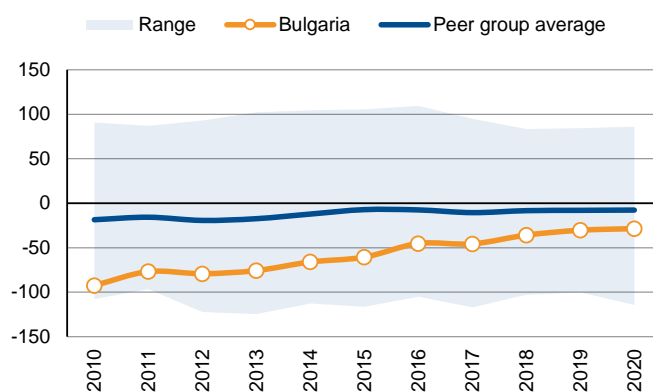
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Current account resilience	Weak	-1/3	Recent weakening in current-account balance, some reliance on remittances
	External debt structure	Neutral	0	Low level of external debt, having been reduced over past years
	Resilience 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, non-performing loan ratio remains above an EU average. Although the gross NPL ratio declined to 6.0% of total loans and advances as of end-Q4 2021 from 8.5% at end-Q3 2018, risks for higher NPLs will 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.

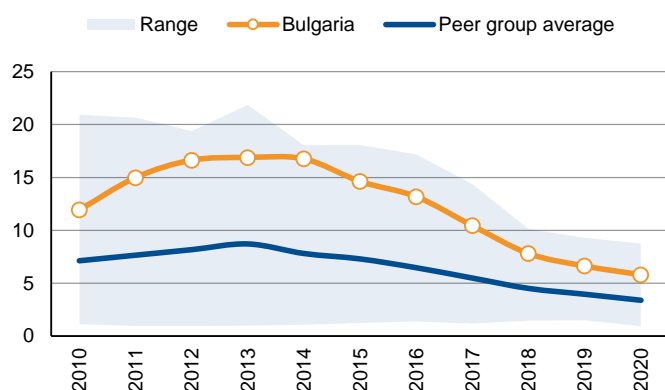
➤ **Private debt:** Banking-system deposits and loans in foreign currency have been reduced. As foreign-currency bank deposits and loans are mainly denominated in euro, FX risks will be mainly eliminated upon event of euro adoption; however, the recent reduction in foreign currency in the banking system 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.

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

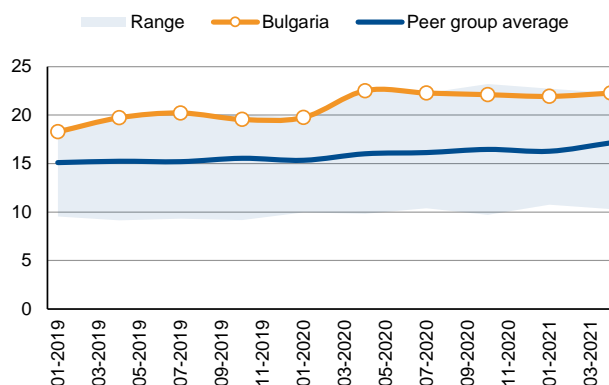
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Comparatively high NPLs, but well-capitalised banking system
	Banking sector oversight	Neutral	0	Significant steps taken to enhance financial-system supervision supported by 2020 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

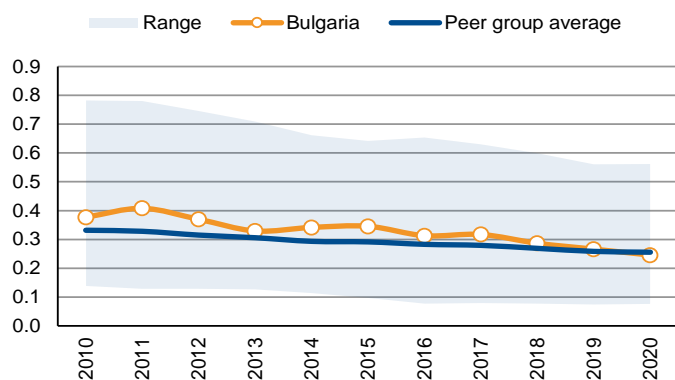
ESG Risks

- **Environment:** Scope considers Bulgaria’s comparatively high level of carbon emissions per unit of GDP. However, risk 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. 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.
- **Social:** Scope considers Bulgaria’s average level of labour force participation but comparatively high level of income inequality. Bulgaria’s old-age dependency ratio compares weakly against that of sovereign peers. High 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 acceleration in areas of reform given significant demographic bottlenecks.
- **Governance:** Bulgaria has middle-range performance on several institutional metrics, such as the World Bank’s Worldwide Governance Indicators. Significant institutional deficits remain. 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.

Overview of Scope’s qualitative assessments for Bulgaria’s ESG Risks

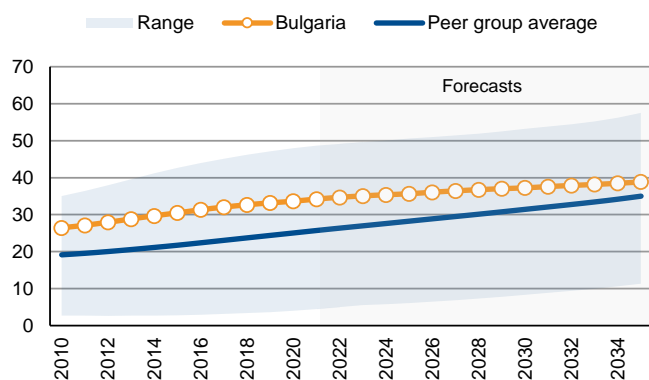
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Environmental risks	Weak	-1/3	Improving environmental track record, but significant challenges remain, for example, related to air quality and greenhouse gas emissions
	Social risks	Weak	-1/3	Emigration challenges and 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



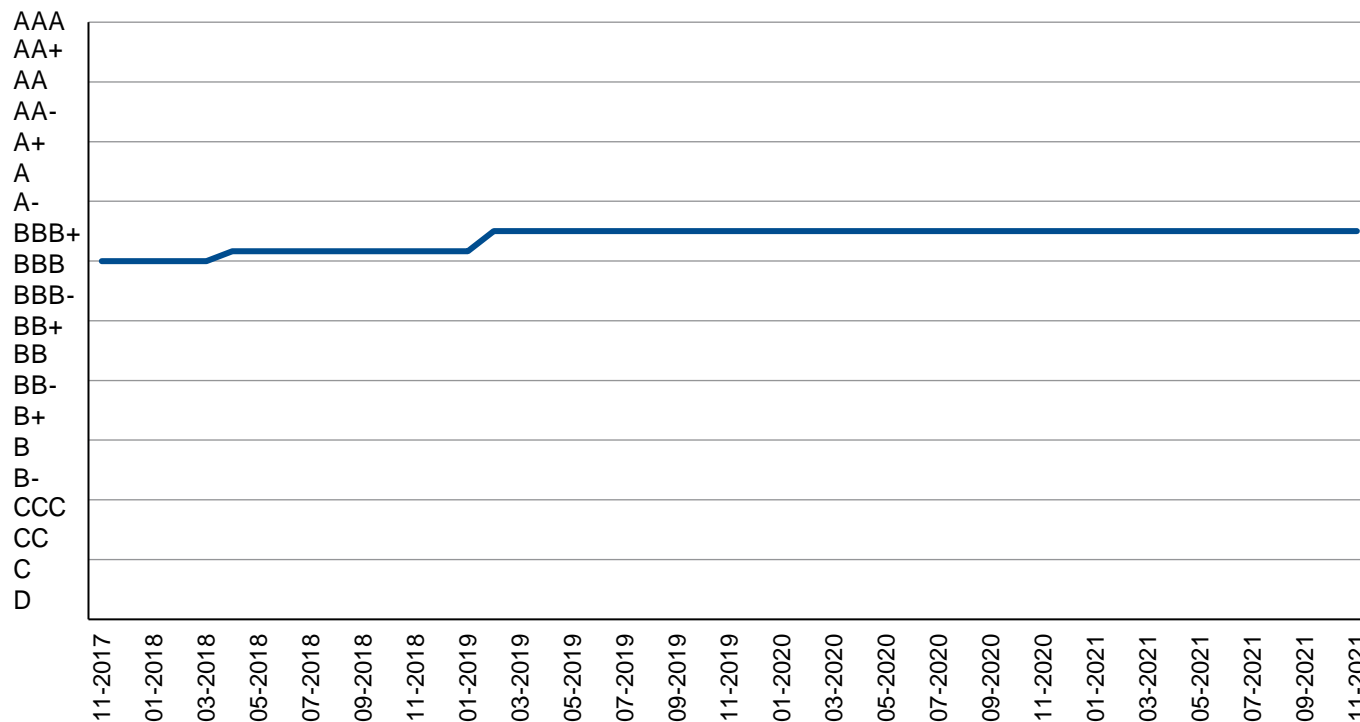
Source: European Commission, Scope Ratings GmbH

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
France
Hungary
Italy
Japan
Malta
Spain
Portugal
Russia
Slovakia

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	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s ¹	7.6	8.4	9.5	9.9	10.0	11.3	12.3
Nominal GDP, USD bn	53.8	59.1	66.3	68.6	69.2	77.9	84.3
Real growth, % ¹	3.0	2.8	2.7	4.0	-4.4	4.2	1.8
CPI inflation, %	-1.3	1.2	2.6	2.5	1.2	2.8	6.5
Unemployment rate, % ¹	7.7	6.7	5.7	5.2	6.3	4.8	4.8
Public Finance Risk							
General government debt, % of GDP ¹	29.1	25.1	22.1	20.0	24.7	27	29
Interest payment, % of government revenue	2.5	2.2	1.7	1.5	1.4	1.5	1.6
Primary balance, % of GDP ¹	1.2	2.4	2.4	2.7	-3.5	-2.8	-3.5
External Economic Risk							
Current account balance, % of GDP	3.1	3.3	0.9	1.9	-0.3	-2.0	-3
Total reserves, months of imports	8.4	8.2	7.4	7.2	11.0	-	-
NIIP, % of GDP	-47.5	-43.0	-37.0	-31.9	-28.1	-	-
Financial Stability Risk							
NPL ratio, % of total gross loans (broad scope)	12.9	10.2	7.6	6.5	5.6	-	-
Tier 1 ratio, % of risk weighted assets	20.9	20.9	19.4	19.5	22.1	-	-
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 ₂ e	312.8	316.9	286.2	265.7	245.1	-	-
Income quintile share ratio (S80/S20), x	8.6	8.2	8.4	-	-	-	-
Labour force participation rate, %	68.8	71.5	71.7	73.4	-	-	-
Old age dependency ratio, %	31.3	32.0	32.7	33.2	33.6	34.2	34.7
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

5y USD CDS spread (bps) as of 11 March 2022

Emerging market and developing economy

71



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