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Republic of Bulgaria **May 2018**	**Kalina Dimitrova** **Lead economic analyst** **k.dimitrova@bcra-bg.com** **Radostina Stamenova** **Economic analyst** **stamenova@bcra-bg.com** **Ventceslav Petrov** **Financial analyst** **v.petrov@bcra-bg.com**

SOVEREIGN RATING	Initial rating	Review	Review	Review
Date of public disclosure:	12 Sept 2014	12 May 2017	10 Nov 2017	04 May 2018
Date of Rating Committee:	05 Sept 2014	10 May 2017	08 Nov 2017	03 May 2018
Long-term sovereign rating:	BBB- (ns)	BBB- (ns)	BBB- (ns)	BBB (ns)
Outlook:	Negative	Stable	Positive	Stable
Short term sovereign rating:	A-3 (ns)	A-3 (ns)	A-3 (ns)	A-3 (ns)

● (ns) – not solicited rating

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"BCRA - CREDIT RATING AGENCY" AD rates Bulgaria with unsolicited sovereign long-term rating BBB(ns) and short-term A-3(ns) with stable outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied http://www.bcra-bg.com/files/file_330.pdf.

The report has been prepared and the rating – assigned, based on public information, made available by the National Statistical Institute, Bulgarian National Bank, Ministry of Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however it cannot guarantee the accuracy, adequacy and completeness of the information used.

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Overview

The center-right GERB party, headed by Prime Minister Boyko Borisov, took over their third ruling mandate in May 2017 and so the party remains the leading political force in the country.

There are differences in political positions both within the coalition cabinet, as well as within some main state institutions. However, significant social tensions and threats to civil peace are not observed, as opposition parties and especially civil society are not expected to jeopardize the stability of governance because they remain weak and disunited.

Bulgaria is still in a monitoring regime due to country's problematic spheres (the fight against corruption and improving the functioning of the judiciary). Therefore, the Commission's Co-operation and Verification Reports (CVM) give an important feedback to the authorities' effectiveness. In the latest EC report of November 15, 2017, it is noted that action has been taken and significant progress has been made by Bulgaria towards the recommendations of the previous, January 2017 report. Although the Commission cannot yet conclude that the indicators are satisfactorily covered for the current phase, they remain on the opinion that Bulgaria is able to meet the CVM recommendations in the near future.

The Presidency of the EU Council, started January 1, 2018, is the main challenge for the country's external relations due to the tense EU situation, both internationally and internally.

There is no final consensus on a number of key issues in the Union such as the next multiannual financial framework, migration issues and the common policy on refugees, the EU's external relations, development of the Western Balkans etc. Uncertainty about future prospects for political and economic development stems also from the complicating geopolitical situation on a regional and global scale including the process of Brexit.

Currently Bulgaria has favourable positions in its foreign policy, demonstrating stability and readiness to mediate in major international conflicts.

In line with the relatively stable political environment, country's macroeconomic indicators continue to improve. In 2017, the economy is expanding by 3.6% (3.9% in 2016), with the main contribution of domestic demand. Supported by continued income and employment growths, household consumption is increasing by 4.8%. The fixed capital formation contributes also in a positive direction. Unlike in the previous year, net exports generate a negative contribution to the economic growth due to a significant acceleration in import's growth and a decline in the growth rate of exports.

The country's foreign trade in goods continues to grow in nominal terms over 2017, with EU member states remaining its most active partner. However, the aggregate share of EU imports shrinks compared to 2016. In this respect, Bulgaria's trade relations with third countries are enhancing. The decrease in EU imports is offset by growth in trade with Russia, the Balkans, Asia and America.

The structure of exports is improving in 2017. The share of raw materials remains the highest, but due to their high nominal growth, investment goods gain larger share in exports structure, thus outperforming consumer goods. Imports have a similar structure but in 2017 as a result of the rise in oil prices on international markets energy commodities start to regain their share after a four-year slowdown.

According to Doing Business Report (World Bank survey), however, the country's business environment has deteriorated for the third consecutive year. The unfavourable development is confirmed by the observation that the inflow of foreign direct investment to the country continues to decrease both in nominal terms and as a ratio to GDP. Net amount of foreign direct investment[1] in Bulgaria equals to 1.9% of GDP in 2017. Compared to 2016, growth is only observed for investments in debt instruments.

The trade deficit is growing as a result of some deterioration in the terms of trade for Bulgaria in 2017. However, the current account balance records a surplus of 4.5% of GDP by the end of 2017, backed by a significant contraction of the primary income deficit and surpluses on services balance and secondary income.

The reserve assets of the Bulgarian National Bank remain solid by the end-2017, thus, ensuring the stability of the currency board in the country. Reserve coverage of average nominal imports of goods and non-factor services for the past twelve months is 8.7 months, high enough to avoid potential external shocks.

[1] According to the directional principle.

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A lowering in the risk associated with the level of gross external debt is also observed. In 2017, it decreases both in nominal terms and as a percentage of GDP and remains predominantly long-term. The repayment of Eurobonds maturing in July lead to reduction in the government's share, eventually resulting in fall in the gross external debt to 66.1% of the country's GDP. However, external debt of banks and intra-corporate lending increase on an annual basis. About 90% of the debt is denominated in euro, which means a low currency risk given the existence of a currency board and the adequate level of foreign exchange reserves.

Labour market data in 2017 confirms the positive trends since 2014, reporting record high indicators of economic activity and employment of the population. The unemployment rate lowers to 6.2%, almost approaching its pre-crisis level. On the other hand, this puts the market in front of the challenging structural nature of the existing unemployment and the limited opportunities for a continuing mobilization of labour resources in the medium term. The trend in labour incomes is also upward, but the purchasing power of the population remains the lowest in the EU.

The price level in Bulgaria in 2017 is characterized by a smooth rise and overcoming the average annual deflation of the previous three years. The average annual price change, measured by the HICP, records rising positive values in the first quarter of 2018, reaching 1.4% at the end of March 2018. The main factor of the observed processes in 2017 was the appreciation of oil as well as other major commodities on international markets, incorporated into food and energy commodity prices. Accelerated growth in services' prices and rising administrative prices have a more significant contribution to the inflation in the country for the first three months of 2018, while the impact of international prices is weakening.

Public finance indicators are improving, backed by the robust economic activity in recent years. The budget balance under the Consolidated Fiscal Programme (CFP) posts a surplus for a second consecutive year. In 2017, the surplus amounts to 0.9% of GDP. Both the national budget and the EU funds register surpluses.

Overall CFP revenues register a nominal growth of 4.0% on an annual basis, as a result of the increased tax and non-tax revenues, while grants mark a decrease in value. Tax revenues (including social security contributions) increase by 10.0% in 2017 due to the favourable development of the labour market and some administrative measures such as the increase in the social security contribution to the Pension Fund by 1 p.p. (from the beginning of 2017). The expenditures under the consolidated budget are by 6.3 p.p. lower than the budget plan for 2017. In nominal terms, compared to 2016, expenditures mark a growth of 6.1%, mostly due to higher current expenditures. The budget execution in the category of capital expenditures is very low - by 39.5 p.p. below the planned level – mainly as a result of a lower implementation of the projects funded by the European programs.

The CFP for 2018 projects a budget deficit amounting to 1.0% of GDP. The government declares its intention to pursue a policy of gradual consolidation and plans to achieve a balanced budget in 2020. No significant changes in tax policy are planned during the projection horizon. The scheduled increase in the amount of the minimum wage (by BGN 50 up to BGN 510) and the 1 percentage point increase in the social security contribution to the Pension Fund have been enforced since January 2018.

At the end of 2017 government debt stands at BGN 23 534 million. Government debt to GDP ratio drops to 23.9% against 27.4% at the end of December 2016. In nominal terms, government debt decreases by BGN 2 217 million (8.6%) on an annual basis, as a result of repayments of a significant amount of liabilities on government securities issued on the local market and international capital markets. Thus, levels of both the internal and the external indebtedness are reduced. Interest and currency structure of government debt minimize the impact of market risks, therefore, the refinancing risk over the next three years remains low.

Government securities issued on the domestic market are the main source of debt financing in 2017. On the auction held in November 2017, for the first time in the history of the domestic sovereign debt market, the yield achieved was in negative territory (-0.19%). At the same time, yield on the benchmark issue of 10.5-year government securities, based on real deals concluded on the secondary market declines from 1.80% at the end of 2016 to 1.02% in December 2017. In January 2018, the yield on Bulgarian bonds even drops below the 1% threshold, reaching 0.90% which is country's lowest long-term interest rate for convergence assessment purposes reported so far.

The maximum amount of the new government debt, which can be assumed under the Government Debt Act in 2018 is BGN 1.0 billion. It is planned to

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absorb funds on already contracted government loans totalling BGN 0.5 billion. As a ratio to GDP, the Ministry of Finance envisages a reduction government debt to 22.3% of GDP by the end of 2018 and to 20.0% by the end of 2020.

The country has a significantly lower level of government debt compared to the Maastricht convergence criterion of 60%. As of end-2017, the consolidated debt of general government sector amounts to BGN 25 064 million or 25.4% of GDP. In comparative perspective, Bulgaria retains its third position among the Member States at the lowest level of government indebtedness being outpaced only by Estonia (9.0%) and Luxembourg (23.0%).

The preceding two-year favourable trends in the Bulgarian banking sector (that was confirmed in the successfully conducted asset quality review and stress tests for sustainability) are continued in 2017. Liquidity and capital adequacy ratios stay high and profitability in the system is at competitive levels.

This development is based on positive trends in core banking activities. Deposits of the non-financial sector continue to follow their upward movement, providing a stable liquidity for banks. As of end-2017, lending is more active, in line with expectations, based mainly on the contribution of the household segment. The non-financial corporations register slight decrease on an annual basis. Also, credit growth in the system supports the increase in assets. The process of improving banks portfolio quality continues, which is evidenced by the decreasing ratio of the gross non-performing exposures to gross value of loans, which, however, remains relatively high (10.2%).

Increasing shares of deposits and loans denominated in BGN witnesses for an enhancing confidence of economic agents both in the banking system and in the local currency over the last year. Simultaneously the restructuring processes in the system persist.

Outlook

The stable outlook reflects BCRA's opinion that risks for the credit of the country are balanced. Improvements in the country's macroeconomic performance have been confirmed over the past year. Maintaining the fiscal consolidation policy support the sustainability of country's public finance. External imbalances are diminishing. The three-year deflation is overcome.

Accelerated implementation of important structural reforms and progress in the fight against corruption could result in positive rating action. Other factors that would have a positive impact on the rating are the restoration of investors' interest to the country and continuous improvement of banks' loan portfolio. A possible inclusion of the Bulgarian lev in ERM II would increase confidence in the effectiveness of macroeconomic policy.

The Sovereign Rating and/or the Outlook would be negatively affected in case of emerging of political instability, leading to unpredictability and delays in needed structural reforms Adverse shocks in the banking system and decline in economic activity also would be assessed unfavourable

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Regulatory announcements

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

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Summary of the minutes of the Rating Committee:

On the 3th of May 2018 Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a session, on which the **Report regarding the upgrading of a long-term unsolicited sovereign rating to: BBB(ns) / and a short-term: A-3(ns) of Republic of Bulgaria** was discussed.

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Model for grading** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The members of the Committee discussed in detail the features of the country's institutional environment. Economic development was positively assessed in relation to maintaining high economic growth supported by domestic consumption and exports. Robust economic activity in 2017 enables favourable labour market dynamics. Attention was paid to the sustainability of fiscal indicators and the reduction of government indebtedness. The contraction in foreign investment inflow as well as the still low levels of gross capital formation were viewed unfavourable.

The current sovereign rating and the related outlook have been determined based on the above discussion.

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Table with main indicators:

Republic of Bulgaria	*Developing economy[1]*				
Real sector					
Indicator	2017	2016	2015	2014	2013
Gross domestic product (million BGN)	98 631	94 130	88 571	83 634	82 166
Final consumption (million BGN)	*76 531*	*72 049*	*69 672*	*66 496*	*64 969*
Gross fixed capital formation (million BGN)	*20 591*	*18 020*	*18 768*	*17 928*	*17 534*
Exports of goods and services (million BGN)	65 418	60 223	56 781	54 373	53 122
Exports of goods and services (million BGN)	63 909	56 163	56 650	55 161	53 459
Gross domestic product (annual real growth rate, %)	3.6	3.9	3.6	1.3	0.9
GDP per capita (BGN)	13 939	13 206	12 339	11 577	11 310
Average monthly wages and salaries (BGN)	1 060	948	878	822	775
HICP - annual average rate of change (%)	1.2	-1.3	-1.1	-1.6	0.4
Unemployment rate (population aged 15+; %)[2]	6.2	7.6	9.1	11.4	12.9
Exchange rate BGN / EUR	1.96	1.96	1.96	1.96	1.96
Exchange rate BGN / USD	1.63	1.86	1.79	1.61	1.42
External sector					
in million EUR	2017	2016	2015	2014	2013
Current account	2 269	1 091	-17	35	536
Trade balance	-2 074	-984	-2 622	-2 777	-2 933
Services	3 016	2 937	3 004	2 514	2 653
Primary income	-534	-2 446	-2 038	-1 318	-1 581
Secondary income	1 861	1 585	1 640	1 616	2 396
Capital account	526	1 070	1 422	960	469
Financial account	2 222	4 065	2 991	-282	887
Foreign direct investment	950	1 080	2 476	1 161	1 384
Gross external debt	33 309	34 219	33 493	39 338	36 936
International investment posiotion, net	-20 416	-22 256	-27 711	-32 155	-30 605
BNB reserve assets	23 662	23 899	20 285	16 534	14 426
% of GDP					
Current account	4.5	2.3	0.0	0.1	1.3
Trade balance	-4.1	-2.0	-5.8	-6.5	-7.0
Services	6.0	6.1	6.6	5.9	6.3
Primary income	-1.1	-5.1	-4.5	-3.1	-3.8
Secondary income	3.7	3.3	3.6	3.8	5.7
Capital account	1.0	2.2	3.1	2.2	1.1
Financial account	4.4	8.4	6.6	-0.7	2.1

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Foreign direct investment	1.9	2.2	5.5	2.7	3.3
Gross external debt	66.1	71.1	74.0	92.0	87.9
International investment position, net	-40.5	-46.2	-61.2	-75.2	-72.8
BNB reserve assets	46.9	49.7	44.8	38.7	34.3
Public Finance					
in million EUR	2017	2016	2015	2014	2013
Revenue and grants	35 316	33 959	32 200	29 409	28 977
Total expenditures	34 471	32 494	34 685	32 482	30 418
Budget balance	846	1 465	-2 485	-3 073	-1 441
Government debt	23 534	25 751	22 714	22 102	14 119
Domestic government debt	6 712	6 725	7 283	8 252	6 290
External government debt	16 822	19 027	15 431	13 851	7 829
Government guaranteed debt	1 997	1 673	587	655	773
Consolidated debt of general government sector[3]	25 064	27 321	23 023	22 554	13 978
Fiscal reserve	10 289	12 883	7 873	9 170	4 681
% of GDP					
Revenue and grants	35.8	36.1	36.4	35.2	35.3
Total expenditures	34.9	34.5	39.2	38.8	37.0
Budget balance	0.9	1.6	-2.8	-3.7	-1.8
Government debt	23.9	27.4	25.6	26.4	17.2
Domestic government debt	6.8	7.1	8.2	9.9	7.7
External government debt	17.1	20.2	17.4	16.6	9.5
Government guaranteed debt	2.0	1.8	0.7	0.8	0.9
Consolidated debt of general government sector[3]	25.4	29.0	26.0	27.0	17.0
Fiscal reserve	10.4	13.7	8.9	11.0	5.7
Banking system					
in million BGN	2017	2016	2015	2014	2013
Assets of the banking system	97 808	92 095	87 524	85 135	85 747
Loans and advance payments (regardless credit institutions)	56 084	54 467	54 121	55 590	58 489
Classified loans[4]	-	-	-	12 495	13 607
Share of classified loans (%)	*-*	*-*	*-*	*18.8*	*20.0*
Non-performing loans	8 292	9 961	11 026	-	-
Share of non-performing loans (%)	*10.2*	*12.9*	*14.5*	*-*	*-*
Deposits (regardless credit institutions)	78 406	74 129	69 276	63 710	62 230
ratios (%)					
Total capital adequacy	22.1	22.2	22.2	21.9	16.9
Liquid asset ratio	39.0	38.2	36.7	30.1	27.1
Return on equity (ROE)	9.3	10.6	8.1	6.9	5.3
Return on assets (ROA)	1.2	1.4	1.0	0.9	0.7

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[1] According to classification of IMF (World Economic Outlook).
[2] NSI Data - Labour Force Survey.
[3] Data based on ESA 2010 methodology in accordance with the Council Regulation (EC) No1222/2004 of 28 June 2004.
[4] From the beginning of 2015, the BNB announces the quality of the loans on the basis of a revised classification according to CRD IV.

Sources: ***Bulgarian National Bank; National Statistical Institute; Ministry of Finance; World Bank; International Monetary Fund; European Commission; Eurostat***