

Republic of Bulgaria November 2017	Kalina Dimitrova Lead economic analyst k.dimitrova@bcra-bg.com
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SOVEREIGN RATING	Initial rating	Review	Review
Date of public disclosure:	12 Sept 2014	12 May 2017	10 Nov 2017
Date of Rating Committee:	05 Sept 2014	10 May 2017	08 Nov 2017
Long-term sovereign rating:	BBB- (ns)	BBB- (ns)	BBB- (ns)
Outlook:	Negative	Stable	Positive
Short term sovereign rating:	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 positive 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.

The presidential elections from the end of 2016 lead to holding of pre-term parliamentary election in early 2017, thus defining the course of internal political events in the country during the year. Despite the larger electoral support for the opposition-nominated candidate (by Bulgarian Socialist Party) for president, the parliamentary elections at the end of March 2017 confirms the leading position of the political party GERB.

A coalition agreement for a joint governing between GERB and the United Patriots after a negotiation process is reached in April. The stated fundamental values in the future program of the two parliamentary groups are the national security and stability, and the European path of development of the country.

The Presidency of the EU Council within the first half of 2018 is the main challenge for the country in its international relations. Certain shift in the political layers of some EU member states is triggered by nationalist and xenophobic attitudes, which have been observed in the respective countries, with an impact on election outcomes in a number of them in 2017. The common refugee policy is provoking disagreements in the Union. Additional suspense and uncertainty are created by the process of Brexit. Along this line of thinking, Bulgaria is going to face a number of challenges during its Presidency, the overcoming of which may have an important role in determining the significance of the country among the member states.

The growth of the Bulgarian economy accelerates to 3.9% in 2016, supported by strong domestic consumption and improvement in the trade balance of the country, while the formation of fixed capital still reports volatility. Services continue to be the main category contributing to the growth in the gross value added (GVA) of the country. Industry remains robust. Reduction is observed in the GVA created by the construction sector for 2016.

During the first half of 2017, GDP has grown by 3.7% in real terms compared to the same period of 2016. 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.

Despite the noticeable leap in the flow of foreign direct investment in 2015, it decreases to its lowest levels for the past five years in 2016 – both in nominal terms and as a ratio to GDP. Preliminary data shows that the decline in investment is continued in the first half of 2017.

Favourable terms of trade for Bulgaria in 2016 helped for a trade deficit significant reduction. As a

result, the current account balance registers a surplus of 5.3% of GDP at the end of 2016.

The share of trade with the EU is steadily increasing over the period: 2012-2016, reaching 66% of total exports and 55% of total imports. Germany, Italy, Romania and Greece are major partners of Bulgaria in the international trade. During the first half of 2017, however, the share of the EU slightly declines at the expense of growth in trade with third countries (including China, Russia, Balkan countries). Changing shares of some partners are to a large extent attributable to current geopolitical processes and to their impact on the individual economies.

The structure of export and import of goods by ways of use remains similar with that of the previous year. During 2016, raw materials followed by consumer goods and investment goods are increasing their shares at the expense of the share of energy commodities which decreases. However, by mid-2017 energy commodities has begun recovering part of their share in both categories.

The reserve assets with Bulgarian National Bank increase as a result of the improvement in the current account, thus, confirming their post-2013 growth trend. Reserve coverage of average nominal imports of goods and non-factor services for the past twelve months is 9.4 months, high enough to avoid potential external shocks.

In 2016, the gross external debt increases in nominal terms due to Eurobond issue by the government. The GDP growth, however, outpaces its rate of increase defining a lower external debt-to-GDP ratio. At the end of August 2017, the gross external debt stands at 66.1% of GDP. About 90% of the debt is denominated in euro, which means a low currency risk given the existence of a currency board and the high level of foreign exchange reserves.

The labour market registers record high indicators of economic activity and employment of the population as of mid-2017. The trend in labour incomes is also upward. The unemployment rate reaches its pre-crisis levels (6-7%), which, on the other hand, 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.

Average annual deflation demonstrates a decrease for the period January-May 2017 due to a slowdown in the decline of key categories. Since June 2017, the average annual price change (measured by HICP) turns positive gradually reaching 0.6% as of end- September 2017.

The public finance is improving, backed by the robust economic activity in recent years. The budget balance on a consolidated basis registers a surplus of 1.6% of GDP in 2016, entirely due to the account balance of EU funds (2.4% of GDP) while the national budget reports a deficit of 0.8% of GDP. There is a very low execution observed in the category of capital expenditures as a result of the negative dynamics in the indicator in the budget of the European funds, in which the capital expenditures decrease almost five times.

As of September 2017, the consolidated budget balance registers a positive value of BGN 2 421 million or 2.4% of the projected GDP. A deficit in the amount of 1.4% of GDP has been set as a target for 2017, but the Ministry of Finance expects improvement of the projected value and a balanced budget at the end of the year.

The consolidated budget balance, set out in the draft budget for 2018, is deficit of 1.0% of GDP. The government declares its intention to pursue the policy of gradual consolidation and achieve a balanced budget in 2020. No significant changes in tax policy are foreseen during the projection horizon. The minimum salary will rise from BGN 460 to BGN 510, starting January 2018, and the social security contribution to the Pension Fund of the state public insurance will be increased by one percentage point.

In 2014, the government debt increases substantially as a result of a Eurobonds issue. For the next two years (2015, 2016) the ascending trend is maintained, albeit at slower paces, again in relation to bonds issued in international capital markets (ICMs). At the end of September 2017, the government debt stands at BGN 23.5 billion (23.6% of projected GDP).

In 2018, the issuance of new (solely) domestic debt in the form of government securities will be limited up to the amount of BGN 1 billion. Absorption of funds on already contracted government loans totaling BGN 0.5 billion is also envisaged. The Ministry of Finance plans to reduce the government debt as a ratio to GDP to 22.3% by the end of 2018, and further to 20.0% by the end of 2020, in line with a moderate nominal debt growth and higher GDP growth rates over the projected horizon.

At the end of September 2017, the fiscal reserve stands at BGN 11.9 billion. This amount of funds is enough adequate to provide the needed coverage on forthcoming government debt payments.

During the first half of 2017, the trends in the Bulgarian banking sector did not change significantly compared to a year earlier and it remained stable.

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 mid-2017, lending is more active, in line with expectations, rising significantly in the household segment on an annual basis and generating growth in the non-financial corporations since the beginning of the year. 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 (12.1%).

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.

Outlook

The positive outlook reflects BCRA's opinion that the Bulgarian economy has experienced a sound macroeconomic performance over the past year. Consolidation measures in the fiscal sector support the sustainability of country's public finance. External imbalances are diminishing. The three-year deflation is overcome.

Maintaining the above trends and continuous improvement in economic performance of the country would have a positive impact on the country's Sovereign Rating. Other factors that would have a positive effect to the assessment are also increase in formation of equity, restoration of investor's interest to the country and continuous improvement of banks' loan portfolios.

The Sovereign Rating and/or the Outlook would be negatively affected by deterioration of the above mentioned indicators and also a slowdown in economic growth, deterioration of the labour market or of the banking sector. Restoration of the political instability in the country, as well as transfer of effects from geopolitical events and conflicts to the economy of Bulgaria would be assessed as an unfavourable development. Volatility in national currency rate and deterioration in external indicators would be assessed as potential risks.

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.

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

Summary of the minutes of the Rating Committee:

On the 8th of November 2017 Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the affirmation of a long-term unsolicited sovereign rating: 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 noted that the political uncertainty of the last year has been overcome with the formation of a consecutive government with the mandate of GERB, which implies a lack of significant policy changes from recent years. Attention was paid to maintaining high economic growth which, supported by domestic consumption and exports, favours a positive development of the labour market. During the first half of 2017, enhanced economic activity, a decrease in unemployment and an increase in the incomes of the population have been marked. The contraction in foreign investment inflows as well as low levels of gross capital formation were viewed unfavourably. Positive changes in the country's fiscal indicators were discussed. Public debt has been stabilizing and the budget balance has continued to improve. The state of the banking sector remains stable.

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

General macroeconomic indicators:

Republic of Bulgaria		Developing economy ^[1] (Emerging and Developing Europe)						
Real sector								
Indicator	I-VI 2017	I-VI 2016	2016	2015	2014	2013	2012	
GDP (EUR mln)	22 607	21 560	48 128	45 286	42 762	42 011	41 947	
GDP (BGN mln)	44 214	42 167	94 130	88 571	83 634	82 166	82 040	
Real GDP growth (%)	3,7	4,3	3,9	3,6	1,3	0,9	0,0	
Consumption (BGN mln)	35 414	33 353	72 049	69 672	66 496	64 969	66 642	
Gross capital formation (BGN mln)	9 300	8 076	18 020	18 768	17 928	17 534	18 001	
Export of goods and services (BGN mln)	30 240	27 283	60 223	56 781	54 373	53 122	49 882	
Import of goods and services (BGN mln)	30 740	26 545	56 163	56 650	55 161	53 459	52 485	
GDP per capita (BGN)	-	-	13 206	12 339	11 577	11 310	11 229	
	Q2 2017	Q2 2016	2016	2015	2014	2013	2012	
Average monthly salary, net (BGN)	1 027*	936*	950	894	822	775	731	
Inflation (annual HICP change, %)	0,1*	-1,3*	-1,3	-1,1	-1,6	0,4	2,4	
Unemployment rate (in %, 15+ y. o.) ²	6,3	8,0	7,6	9,2	11,5	12,9	12,3	
Exchange rate BGN / EUR	1,96	1,96	1,96	1,96	1,96	1,96	1,96	
Exchange rate BGN / USD	1,71	1,76	1,86	1,79	1,61	1,42	1,48	
External sector								
Balance of payments ³								
	EUR mln	I-VI 2017	I-VI 2016	2016	2015	2014	2013	2012
A. Current account		428	977	2 561	-17	35	536	-358
Current account (% of GDP)		1,9	4,5	5,3	0,0	0,1	1,3	-0,9
Goods and services, net		-95	396	2 108	381	-262	-279	-1 403
Trade balance		-1 235	-560	-984	-2 622	-2 777	-2 933	-3 992
Services, net		1 141	956	3 092	3 004	2 514	2 653	2 589
Primary income, net		-305	-554	-1 131	-2 038	-1 318	-1 581	-1 053
Secondary income, net		828	1 135	1 585	1 640	1 616	2 396	2 099
B. Capital account		192	812	1 070	1 422	960	469	546
C. Financial account		-392	1 745	4 308	2 991	-282	887	957
Direct investments, net		-354	-735	-340	-2 329	-882	-1 243	-1 068
D. Reserve assets of BNB		173	1 831	3 467	3 730	1 807	-532	2 121
		Q2 2017	Q2 2016	2016	2015	2014	2013	2012
Gross external debt (EUR mln)		33 671	34 063	34 046	33 317	39 338	36 936	37 714
Gross external debt (% of GDP) ⁴		67,1	70,8	70,7	73,6	92,0	87,9	89,9

Republic of Bulgaria			Developing economy ^[1] (Emerging and Developing Europe)					
NIIP (EUR mln)	-22 631	-25 698	-22 621	-27 711	-32 155	-30 605	-32 658	
NIIP (% of GDP) ⁴	-45,1	-53,4	-47,0	-61,2	-75,2	-72,8	-77,9	
Public finance								
	<i>BGN mln</i>	IX 2017	IX 2016	2016	2015	2014	2013	2012
Consolidated revenue and grants	26 151	25 650	33 959	32 200	29 409	28 977	27 469	
Consolidated total expenses	23 054	21 677	32 494	34 685	32 482	30 418	27 828	
Consolidated cash budget balance	2 421	3 362	1 465	-2 485	-3 073	-1 441	-359	
Government debt ⁵	23 469	25 873	25 751	22 714	22 102	14 119	13 674	
Domestic government debt	6 518	6 722	6 725	7 283	8 252	6 290	4 981	
External government debt	16 951	19 151	19 027	15 431	13 851	7 829	8 693	
Guaranteed government debt	2 010	543	1 673	586	651	772	1 009	
General government debt ⁶	-	-	27 322	23 024	22 554	13 978	13 700	
Fiscal reserve	11 867	14 287	12 883	7 873	9 170	4 681	6 081	
	<i>% of GDP⁷</i>							
Consolidated revenue and grants	26,3	27,2	36,1	36,4	35,2	35,3	33,5	
Consolidated total expenses	23,1	23,0	34,5	39,2	38,8	37,0	33,9	
Consolidated cash budget balance	2,4	3,6	1,6	-2,8	-3,7	-1,8	-0,4	
Government debt	23,6	27,5	27,4	26,3	26,4	17,2	16,8	
Domestic government debt	6,5	7,1	7,1	8,4	9,9	7,7	6,1	
External government debt	17,0	20,3	20,2	17,9	16,6	9,6	10,7	
Guaranteed government debt ⁶	2,0	0,6	1,8	0,7	0,8	0,9	1,2	
General government debt ⁶	-	-	29,0	26,0	27,0	17,0	16,7	
Fiscal reserve	11,9	15,2	13,7	8,9	11,0	5,7	7,4	
Banking system								
	<i>BGN mln</i>	Q2 2017	Q2 2016	2016	2015 ⁸	2014	2013	2012
Assets	93 016	88 650	92 095	87 524	85 135	85 747	82 416	
Loans and advances (regardless credit institutions)	55 529	53 705	54 467	54 121	55 590	58 489	57 841	
Classified loans	-	-	-	-	12 495	13 607	13 734	
Share of classified loans (%)	-	-	-	-	18,8	20,0	21,2	
Non-performing loans	9 462	10 592	9 961	11 026	-	-	-	
Share of gross non-performing loans (%)	12,1	14,0	12,9	14,5	-	-	-	
Deposits (regardless credit institutions)	74 442	70 736	74 129	69 276	63 710	62 230	57 256	
Total capital adequacy (%)	22,5	22,7	22,2	22,2	21,9	16,9	16,7	
Liquid asset ratio (%)	36,9	36,6	38,2	36,7	30,1	27,1	26,0	

* Data corresponds to the end of the period.

[1] According to classification of IMF (World Economic Outlook).

[2] NSI Data - Labor Force Survey.

[3] Accumulated data from the beginning of the year.

[4] 2017 data are calculated on the basis of GDP amounting to BGN 98 105 million (BNB estimate).

[5] Data based on national methodology.

[6] Data based on ESA 2010 methodology in accordance with the Council Regulation (EC) No 1222/2004 of 28 June 2004.

[7] 2017 data are calculated on the basis of GDP amounting to BGN 99 624 million (Ministry of finance estimate).

[8] 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: BNB, NSI, Ministry of Finance, World Bank, International Monetary Fund, European Commission, Eurostat

RATIONALE