BULGARIA
95, Evlogi Georgiev blvd.
1142 Sofia
Tel. (+359 2) 9876363
www.bcra-bg.com

Republic of Bulgaria

November 2018

Radostina Stamenova
Lead economic analyst
stamenova@bcra-bg.com

Kalina Dimitrova
Economic analyst
k.dimitrova@bcra-bg.com

Ventzislav Petrov
Financial analyst
v.petrov@bcra-bg.com

SOVEREIGN RATING	Initial rating	Review	Review	Review	Review
Date of public disclosure:	12 Sept 2014	12 May 2017	10 Nov 2017	04 May 2018	02 Nov 2018
Date of Rating Committee:	05 Sept 2014	10 May 2017	08 Nov 2017	03 May 2018	31 Oct 2018
Long-term sovereign rating:	BBB- (ns)	BBB- (ns)	BBB- (ns)	BBB (ns)	BBB (ns)
Outlook:	Negative	Stable	Positive	Stable	Stable
Short term sovereign rating:	A-3 (ns)	A-3 (ns)	A-3 (ns)	A-3 (ns)	A-3 (ns)

● (ns) – not solicited rating

***BCRA – CREDIT RATING AGENCY AD (BCRA)** is the third fully recognized rating agency in the EU, registered pursuant to Regulation No. 1060/2009 of the European Parliament and of the Council. The credit ratings, assigned by the BCRA are valid throughout the EU and are fully equal to those, of the other agencies, recognized by the European Securities and Markets Authorities, without any territorial or other limitations.*

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

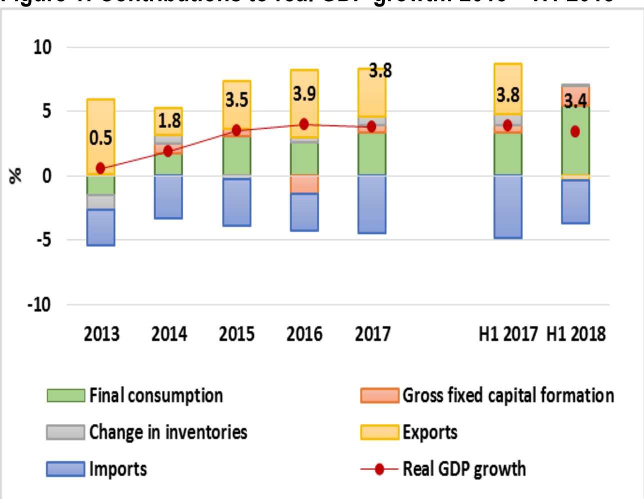
BCRA's officially adopted Sovereign Rating Methodology has been applied http://www.bcra-bg.com/files/file_330.pdf.

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.

Overview

The Government of the Republic of Bulgaria is committed to speed up the process of joining the euro area by officially submitting a letter of intent. In August 2018, the Council of Ministers approved an Action Plan including measures for realizing Bulgaria's intentions to join the Exchange Rate Mechanism II and the Banking Union by July 2019. A number of legislative changes related to financial sector supervision, insolvency framework, anti money laundering framework and modernisation of the management of state-owned enterprises are envisaged. The measures will be implemented by national and international institutions in coordination. Progress in all these areas, if and when achieved, should pave the way for the country to join both the ERM II and the Banking Union.

Figure 1: Contributions to real GDP growth: 2013 – H1 2018



Source: National Statistical Institute

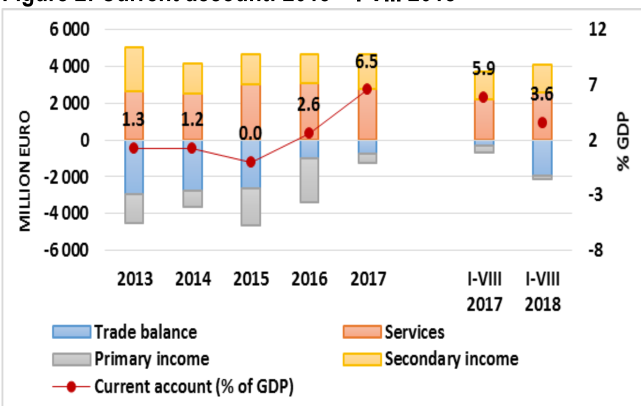
In the first half of 2018, the Bulgarian **economy** expanded by 3.4%[1] in real terms. Domestic demand (consumption and investment) contributed positively to GDP dynamics. Household consumption increased by 7.9% on an annual basis, boosted by the favourable labour market developments and credit acceleration. Investments' trend is also in an upward direction. Gross fixed capital formation accelerated considerably, reaching an annual growth of 8.5% (compared to 3.3% in the same period of 2017). Enhanced investment activity was driven by both public (mainly EU programs) and private investment.

On the other hand, the net exports had negative contribution to the GDP growth in the first half of 2018. Problems in the economies of important trading partners outside the EU (mainly Turkey) have been materialized through the foreign trade channel. As a result, Bulgarian exports contracted by 0.7% in real terms. Backed by the domestic demand, imports continued to increase, albeit at a slower pace, recording 4.8% growth in the first half of 2018.

Export of goods[2] in the period January – July 2018 decreased by 1.8%. The drop is entirely related to weak trade with non-EU countries, while exports of Bulgarian goods to the Union registered a nominal growth of 10.8% and its relative share increased to 70.9% of total exports. Exports to third countries, however, decreased by 23.2% as compared to the same period in 2017. The unfavourable changes are related to the structure of the country's foreign trade and to the current economic situation of some partner countries. Exports to Bulgaria's main trading partner outside the EU, namely Turkey, decreased by 25.4% on an annual basis and the relative share of the country in the geographical structure of Bulgarian exports decreased by 2.1 pp. to 6.7%. A significant decline was also reported in exports to Russia.

In contrast to exports, imports of goods from EU and from third countries both increased. The depreciation of the Turkish lira since the beginning of the year has impacted not only exports but also imports from Turkey, which reported nominal growth of 3.9% on an annual basis. However, we expect the consequences of the Turkish economy's problems to remain limited to the foreign trade channel.

Figure 2: Current account: 2013 – I-VIII 2018



Source: National Statistical Institute

For the period January – August 2018, the **current account balance** recorded a surplus of EUR 1 973 million (3.6% of projected GDP), compared to a

[1] *Unadjusted data.*

[2] *According to foreign trade data.*

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

surplus of EUR 3 029 million (5.9% of GDP) in the respective prior year period. The lower surplus was related to the higher trade deficit, which increased by EUR 1 601 million on an annual basis, reaching EUR 1 938 million. On the other hand, the services surplus rose by EUR 345 million to EUR 2 569 million, mainly driven by tourism and transport services. The balances on both income articles also reported improvement. We expect the downward trend in the current account surplus to sustain over the coming months until the end of 2018 as a result of worsened terms of trade.

The inflow of **foreign direct investment** to the country is decreasing. According to preliminary data, foreign direct investments in Bulgaria for the first eight months of 2018, reported according to the principle of the initial direction of the investment, amounted to EUR 231 million or 0.4% of projected GDP, which represents a nominal decrease of 71.6% compared to the same period of the previous year.

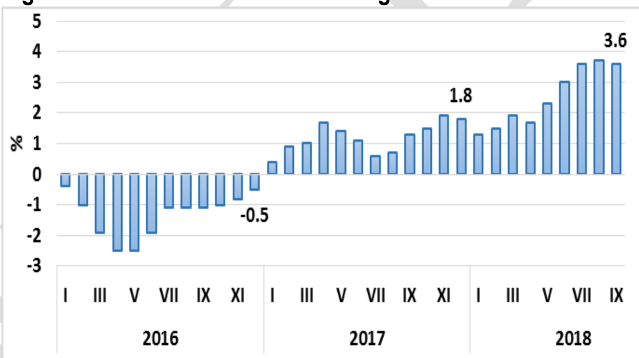
At the end of August 2018, country's **gross external debt** amounted to EUR 33 805 million (61.1% of projected GDP). In nominal terms, the debt increased by EUR 408 million compared to the end of 2017. The relative share of the public sector's external debt fell to 18.2%, while that of the private sector rose to 81.8% of the total external debt.

As of the end of August 2018, the **BNB's international reserves** amounted to EUR 23 960 million (43.3% of projected GDP) and provided 160.7% coverage of the monetary base, a solid buffer used by the central bank to ensure the stability of the currency board. Reserve adequacy indicators retain their high levels. As of August 2018, the proportion (in months) of reserves to the average imports of goods and non-factor services for the last 12 months stood at 8.4, while the coverage of short-term external debt equalled to 295.6%.

The **labour market** marks a favourable development. In the first half of 2018 the growth of the economy continued to mobilize the labour supply as the number of unemployed decreased in all of the age groups[3]. As a result, the unemployment rate dropped to 5.6% on average for the first two quarters of the year (6.6% in the same period of 2017). Employment growth was also confirmed except for younger age groups (between 15 and 34), whose number is mainly decreasing as a result of other effects like the demographic crisis and the external migration of working-age population.

Labour incomes in the economy retain their upward trend. In the first half of 2018, the average gross wage in Bulgaria reached BGN 1 101 per month (~EUR 563 per month), nominally increasing by 7.6% compared to the same period in 2017. Annual minimum wage hikes in the country continued to be a major factor for the wage growth in some economic activities. Gross base remuneration was raised by 11% to BGN 510 per month from the beginning of 2018, also having analogous impact on the labour costs.

Figure 3: HICP – annual rate of change: 2016 – IX 2018



Source: National Statistical Institute

Over the first eight months of 2018, the **inflation** followed an upward trend. In September 2018, the annual inflation rate (measured by the HICP) reached 3.6%, while the average rate for the last 12 months accelerated to 2.3%. The price level was impacted jointly by internal and external factors. The rise was mainly driven by services inflation accelerating in line with the strengthened domestic demand. Additional pro-inflationary pressure was generated by hikes in some of the administered goods and services' prices. External factor of significant contribution was the increase of international prices of oil and other major commodities, exerting both direct effects, as well as indirect effects on other HICP components.

Public finance indicators are improving, backed by the robust economic activity in recent years. In the period January - August 2018, total budget revenues under the Consolidated Fiscal Programme (CFP) increased by 11.6% compared to the same period of the previous year, with the tax revenues being the main driver. Tax revenues (including social security contributions) grew by 10.0% on an annual basis summing up to 82.3% of total CFP revenues for the period. The steady increase in revenues from income tax and social security contributions reflected the favourable labour market developments, the increase in the pension contribution by 1 percentage point, as

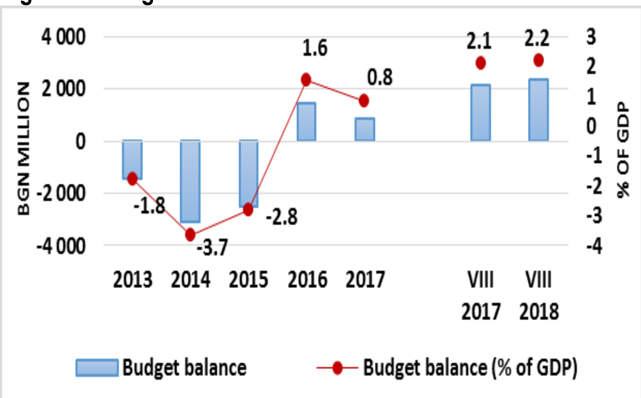
[3] *According to the Labour Force Survey for population aged 15 years and over.*

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

well as the increase of the minimum wage and the minimum insurable income. Proceeds from indirect taxes were favoured by the consumption growth.

Total budget expenditures under the CFP recorded analogical to the revenues' growth amounting to 11.6% for the period January – August 2018. An increase is recorded for all expenditure items except for interest payments. However, the overall growth came mainly on account of higher social security expenditures and higher capital expenditures on the EU funds accounts.

Figure 4: Budget balance on CFP: 2013 – VIII 2018

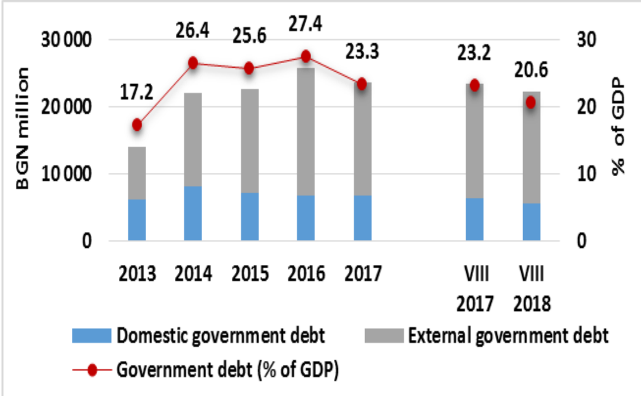


Source: Ministry of Finance

The budget balance as of August 2018 posted a surplus in the amount of BGN 2 388 million or 2.2% of projected GDP, compared to a surplus of BGN 2 151 million or 2.1% of GDP in the same period of 2017. The CFP for 2018 set a budget deficit target at 1.0% of GDP, but based on the budget execution so far we expect 2018 to be the third consecutive year with deficit projected by law but an actual budget surplus achieved.

The **budget framework for 2019** envisages a deficit under the CFP amounting to 0.5% of GDP, and the updated mid-term forecast reaffirms the balanced budget objectives in 2020 and 2021. The government plans 10% increase in the funds for wages and contributions in the budget sector as from 2019, while the wage hike in the education sector would be 20% in line with the existing government commitment. The minimum wage in the country is scheduled to reach BGN 560 per month. Pensions are set to increase by 5.7% from July 1, 2019, and their maximum amount would reach BGN 1 200. Other measure with impact on the insurance policy include an increase in the maximum insurable income to BGN 3 000 and an increase of the minimum insurable income for the self-insured persons to BGN 560.

Figure 5: Government debt[4] of the Republic of Bulgaria: 2013 – VIII 2018



Source: Ministry of Finance

The **government debt** follows a positive downward trend both in nominal terms and as a share of GDP. At the end of August 2018, government debt amounted to BGN 22 320 million (20.6% of projected GDP). The debt decreased nominally by BGN 1 215 million compared to the end of 2017 due to regular repayments and absence of new obligations during the year. As a result, the relative share of domestic debt dropped to 25.3% while the share of external debt rose to 74.7% of total government debt.

Interest rate and currency structure of the government debt minimize the impact of market risks. The maturity profile is also favourable. The euro-denominated debt predominates in the currency structure, followed by a debt denominated in the national currency, which results in a low dependency of the debt and the cost of its servicing from exchange rate changes in the context of the currency board operating in the country.

Bulgarian government securities achieve relatively low **yield** for the region. The yield on the long-term benchmark issue (with a maturity of 10Y and 6M), based on actual concluded deals on the secondary market, fell beneath 1% for the first time in January 2018 and reached 0.81% in August, which is the lowest monthly value of the long-term interest rate for convergence assessment purposes reported so far.

The low government debt level is assessed as a positive factor also in comparison with the other EU countries. As of the end of Q2 2018, the consolidated debt of "General Government" sector amounted to BGN 24 815 million or 23.8% of GDP. The country

[4] *"Government Debt" is the debt assumed under the Law on Government Debt.*

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

has a significantly lower level of government debt than the Maastricht convergence criterion of 60% and is among the three EU countries with lowest government debt level, being outpaced only by Estonia and Luxembourg.

Liquidity and capital adequacy ratios of the **banking system** remain high as well as savings from households and non-financial corporations continue to contribute for expanding the amount of banks' deposit base.

In line with expectations, however, lending has been more active since the end of 2017, and by the end of June 2018, gross credit portfolio of the banking system annually increased by 6.1% - a record high value for the past five years. Household loans, whose growth accelerated in both consumer and housing loans, contributed most to growth. The structure of bank assets remained dominated by cash on hand and loans.

The quality of bank portfolios continue to improve, which is evidenced by the decreasing ratio of the gross non-performing exposures to gross value of loans, which, however, remains relatively high (9.1%).

There have been some structural changes concerning ownership in some banks, a further outflow of Greek capital and the ongoing consolidation in the system.

The European Central Bank plans to execute asset quality review and stress tests of Bulgarian banks in 2019 in order to ensure a smooth transition to the Banking Union.

Outlook

The stable outlook reflects BCRA's opinion that risks to country's credit rating are currently balanced. Fiscal parameters are kept stable. The country maintains high level of foreign exchange reserves and demonstrates resilience to short-term external shocks, while monetary policy flexibility is limited by the existence of a currency board.

Factors that could lead to a **positive** pressure on the Sovereign Rating and/or the Outlook include:

- Implementation of important structural reforms and progress in the fight against corruption;
- Inclusion of the Bulgarian lev in ERM II which would increase the confidence in the effectiveness of macroeconomic policy;
- Restoration of investors' interest to the country
- Continuous improvement of banking system assets quality.

The Sovereign Rating and/or the Outlook would be **negatively** affected in case of:

- Emerging of political instability, leading to delays in needed structural reforms;
- Adverse shocks in the banking system;
- Decline in economic activity.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

- **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 minutes of the Rating Committee:

On the 31st of October 2018, Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a meeting, on which the **Report regarding the review of unsolicited sovereign rating of Republic of Bulgaria** was discussed.

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Sovereign Rating Model** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**. The members of the Committee discussed in detail the development of the economic processes in the country, taking place in a stable internal environment. The economic growth achieved in the first half of 2018 was backed by the domestic demand, while net exports had a negative contribution. The labour market demonstrates favourable dynamics. The assessment took into account public finance indicators and the reduction of government debt. The Committee's members also commented the draft budget for 2019 and the expected effects of proposed fiscal measures. The current condition of the banking sector was discussed.

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

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

Main macroeconomic indicators:

Republic of Bulgaria					Developing economy[1]		
Real sector							
Indicator	**H1 2018**	**H1 2017**	**2017**	**2016**	**2015**	**2014**	**2013**
Gross domestic product (million BGN)	48 291	45 277	101 043	94 130	88 575	83 756	81 866
Final consumption (million BGN)	39 687	35 648	77 047	72 049	69 676	66 500	64 969
Gross capital formation (million BGN)	10 196	9 135	20 295	18 020	18 768	18 044	17 234
Exports of goods and services (million BGN)	31 513	31 386	68 071	60 223	56 781	54 373	53 122
Imports of goods and services (million BGN)	33 106	30 892	64 371	56 163	56 650	55 161	53 459
Gross domestic product (annual real growth rate, %)	3.4	3.8	3.8	3.9	3.5	1.8	0.5
GDP per capita (BGN)	-	-	14 280	13 206	12 340	11 594	11 268
Average monthly wages and salaries (BGN), gross	1 101	1 023	1 060	948	878	822	775
Unemployment rate[2] (population aged 15+; %)	5.6	6.6	6.2	7.6	9.1	11.4	12.9
HICP - annual average rate of change for the last 12 m.	1.6	0.1	1.2	-1.3	-1.1	-1.6	0.4
Exchange rate BGN / EUR	1.96	1.96	1.96	1.96	1.96	1.96	1.96
Exchange rate BGN / USD	1.62	1.81	1.74	1.77	1.76	1.47	1.47
External sector							
in million EUR	**VIII 2018**	**VIII 2017**	**2017**	**2016**	**2015**	**2014**	**2013**
Current account	1 973	3 029	3 368	1 244	-15	531	536
Trade balance	-1 938	-338	-766	-984	-2 622	-2 777	-2 933
Services	2 569	2 223	2 765	3 060	3 004	2 544	2 653
Primary income	-210	-346	-496	-2 417	-2 037	-852	-1 581
Secondary income	1 553	1 489	1 865	1 585	1 640	1 616	2 396
Capital account	392	321	530	1 071	1 422	960	469
Financial account	2 348	1 807	2 161	4 135	3 080	441	887
Foreign direct investment[3]	230	812	1 390	1 003	2 399	347	1 384
Gross external debt	33 805	33 330	33 397	34 221	33 493	39 338	36 936
International investment position, net	-	-	-21 600	-23 663	-28 542	-30 956	-30 605
BNB reserve assets	23 960	24 444	23 662	23 899	20 285	16 534	14 426
% of GDP[4]							
Current account	3.6	5.9	6.5	2.6	0.0	1.2	1.3
Trade balance	-3.5	-0.7	-1.5	-2.0	-5.8	-6.5	-7.0
Services	4.6	4.3	5.4	6.4	6.6	5.9	6.3
Primary income	-0.4	-0.7	-1.0	-5.0	-4.5	-2.0	-3.8
Secondary income	2.8	2.9	3.6	3.3	3.6	3.8	5.7
Capital account	0.7	0.6	1.0	2.2	3.1	2.2	1.1
Financial account	4.2	3.5	4.2	8.6	6.8	1.0	2.1
Foreign direct investment[3]	0.4	1.6	2.7	2.1	5.3	0.8	3.3
Gross external debt	61.1	64.5	64.6	71.1	74.0	91.9	88.2
International investment position, net	-	-	-41.8	-49.2	-63.0	-72.3	-73.1
BNB reserve assets	43.3	47.3	45.8	49.7	44.8	38.6	34.5

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia
tel.: (+359-2) 987 6363
www.bcra-bg.com

Public Finance							
in million BGN	**VIII 2018**	**VIII 2017**	**2017**	**2016**	**2015**	**2014**	**2013**
Revenue and grants	25 976	23 285	35 317	33 959	32 200	29 409	28 977
Total expenditures	23 588	21 133	34 471	32 491	34 685	32 482	30 418
Budget balance	2 388	2 151	845	1 468	-2 485	-3 073	-1 441
Government debt[5]	22 320	23 424	23 534	25 751	22 714	22 102	14 119
Domestic government debt	5 647	6 433	6 712	6 725	7 283	8 252	6 290
External government debt	16 672	16 991	16 822	19 027	15 431	13 851	7 829
Government guaranteed debt	1 900	2 034	1 997	1 673	587	655	773
General government gross debt[6]	-	-	25 908	27 862	23 217	22 724	13 978
Fiscal reserve	10 860	11 632	10 289	12 883	7 873	9 170	4 681
% of GDP[4]							
Revenue and grants	24.0	23.0	35.0	36.1	36.4	35.1	35.4
Total expenditures	21.8	20.9	34.1	34.5	39.2	38.8	37.2
Budget balance	2.2	2.1	0.8	1.6	-2.8	-3.7	-1.8
Government debt[5]	20.6	23.2	23.3	27.4	25.6	26.4	17.2
Domestic government debt	5.2	6.4	6.6	7.1	8.2	9.9	7.7
External government debt	15.4	16.8	16.6	20.2	17.4	16.5	9.6
Government guaranteed debt	1.8	2.0	2.0	1.8	0.7	0.8	0.9
General government gross debt[6]	-	-	25.6	29.6	26.2	27.1	17.1
Fiscal reserve	10.0	11.5	10.2	13.7	8.9	10.9	5.7

Banking system							
in million BGN	**Q2 2018**	**Q2 2017**	**2017**	**2016**	**2015**	**2014**	**2013**
Assets of the banking system	100 135	93 016	97 808	92 095	87 524	85 135	85 747
Loans and advances (regardless credit institutions)	58 911	55 529	56 084	54 467	54 121	55 590	58 489
Non-performing loans	7 702	9 462	8 292	9 961	11 026	-	-
Share of non-performing loans (%)	9.1	12.1	10.2	12.9	14.5	-	-
Deposits (regardless credit institutions)	80 749	74 442	78 406	74 129	69 276	63 710	62 230
ratio (%)							
Total capital adequacy	20.8	22.5	22.1	22.2	22.2	21.9	16.9
Liquid asset ratio	-	36.9	39.0	38.2	36.7	30.1	27.1
Return on assets (ROA)[7]	1.4	1.3	1.2	1.4	1.0	0.9	0.7
Return on equity (ROE)[7]	10.8	9.5	9.6	10.6	8.1	6.9	5.3

[1] According to IMF classification (World Economic Outlook);
[2] NSI Data - Labour Force Survey;
[3] According to the directional principal;
[4] 2018 data are calculated on the basis of GDP amounting to BGN 108 141 million (Ministry of Finance estimate);
[5] "Government Debt" is the debt assumed under the Law on Government Debt;
[6] Data based on ESA 2010 methodology in accordance with the Council Regulation (EC) No1222/2004 of 28 June 2004;
[7] The coefficient is calculated using the Trailing twelve months (TTM) method.

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