

Republic of Bulgaria

September 2014

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SOVEREIGN RATING	Initial Rating 05.09.2014
Long-term rating	BBB- (ns)
Outlook:	negative
Short-term rating:	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 the Republic of Bulgaria with unsolicited sovereign long-term rating BBB- (ns) and short-term A-3 (ns) with negative 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 Bulgarian National Bank, the National Statistical Institute, the 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 assigned rating reflects BCRA’s opinion that the Republic of Bulgaria is characterized by:

- an unstable political climate,

- a high level of institutional corruption and clientelism, which remain a significant structural obstacle to the realization of the economic potential and sustainable development of the country,
- an economy, showing few signs of overcoming the economic crisis, with respect to the low growth of GDP, the decreasing volume of foreign direct investments, low increase in the domestic consumption and sustained high unemployment,
- a high level of monetary liquidity, represented in the relatively cheap and accessible sources of financing,
- a comparatively low level of fiscal indebtedness.

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In the past two years, there was an increasing decline in trust and public support to political parties. Consequently, the country entered a period of political instability which obstructs the conducting of structural reforms. Following the resignation of the government in July 2014 to conduction of pre-term parliamentary elections, the country is ruled by caretaker government with limited powers. After the conduction of the elections in October, 2014, however, it is not expected to be formed government that would be honoured with the strong support necessary to be able to implement reforms leading to a sustainable economic growth.

The public distrust of political elites and the inefficiency of government are transformed into distrust of institutions, including the judicial, healthcare and law-enforcement systems, and even in the central Bank and the banking system. The corruption and weaknesses in ensuring the rule of law continue to be the main impediments to Bulgaria's progress and are reasons for the standstill in the process of integrating Bulgaria in the EU.

Bulgaria is characterized by a very good macroeconomic stability, but at a very low base in comparison with the other member states of the EU. The Gross Domestic Product (GDP) per capita amounted to BGN 10,752 in 2013. Expressed in purchasing power parity, this GDP per capita represents 47% of the European Union (EU) average. Despite there is a continuing trend of gradual increase of this indicator by 1-2 percentage points per annum, Bulgaria still ranks last in the EU according to this indicator. In the period 2009-6.2014 the economy of Bulgaria is negatively influenced by the effects the global economic crisis. Following a decline of 5.5% in GDP (real) in 2009, until the end of 2013 a weak annual growth of the indicator was observed ranging between 0.4% and 1.8%. At the end of the first half of 2014 it was 1.6%.

In the period 2009-2012, the average annual change of the consumer price index and of the harmonized index of consumer prices stabilized at a favorable level of approximately 3% per annum. In 2013, however, and especially in the first half of 2014, the downward trending inflation gradually transformed in a clearly expressed deflationary trend. This is partially due to the decreased costs of the imports and raw materials,

as well as the administrative price controls. In the period July 2013 – July 2014, a 1.1% drop is observed in the harmonized index of consumer prices, which is the highest level of deflation among the EU-member states, as the average inflation in the EU in that period is 0.6%.

Since the start of the global economic crisis, the direct foreign investments in Bulgaria display a steady downward trend. This trend is somewhat due to the continuing economic crisis, but also the unstable political environment, corruption and weaknesses in ensuring the rule of law.

As a whole, the labor market in Bulgaria in the period 2009-2013 exhibits no signs of overcoming the economic crisis, but in the first half of 2014 a slight decrease in unemployment was registered.

The banking system in Bulgaria is relatively stable, with good capital adequacy and very good liquidity, but also with low profitability. A risk to the system is the reduced confidence in the central bank as an effective regulator, due to its activity to put the bank panics under control as of June 2014. In this respect, we welcome the steps taken towards Bulgaria's entry into the Single Supervisory Mechanism of the European Central Bank.

The debt of the public sector, i.e., the sum of the public and the publicly guaranteed debt, increased significantly as a percent of GDP during the last few years, from 15.6% in 2009 to 19.1% in 2013, according to the national reporting methods or from 14.6% to 18.9% in the same period, according to the ECC '95 methodology, used for the purposes of the Maastricht Stability and Growth Pact (SGP). At these levels, Bulgaria's debt remain far below the reference value of 60% set out in the SGP and at one of the top positions in the European Union. According to the latest data provided by the Ministry of Finance, the deficit for 2014 is expected to be of 1.8% of GDP. This number, however, may be subject to significant changes, if the budget is updated in order for the budget to cover a part of the suspended payments under EU programmes or a portion of the deficits in the budgets of the National Health Insurance Fund, the Bulgarian Energy Holding, the National Electric Company, the Bulgarian State Railways, and other public or publicly guaranteed companies.

The Bulgarian fiscal reserve at the end of July 2014 amounts to a total of BGN 8.9 billion.

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BGN 8.3 billion of this are held in deposits mainly in the central bank at zero interest rates, and the remaining BGN 0.6 billion are receivables from EU funds for certified expenditures, advances and others. It should be noted, however, that a number of significant payments are about to mature in the following months as follows: October – BGN 400 million, November – BGN 1,229 million (for liquidity support scheme in favor of the banking system) and January 2015 – BGN 1 580 million, adding up to over BGN 3.2 billion. Once again, there is a significant risk here, of a possible updating of the National Budget for 2014 and an increase in the debt ceiling, which may reasonably be expected to aggravate the current extremely beneficial fiscal position.

In the period 2009-2012, the average annual change of the consumer price index and of the harmonized index of consumer prices stabilized at a favorable level of approximately 3% per annum. In 2013, however, and especially in the first half of 2014, the downward trending inflation gradually transformed in a clearly expressed deflationary trend. This is partially due to the decreased costs of the imports and raw materials, as well as the administrative price controls. In the period July 2013 – July 2014, a 1.1% drop is observed in the harmonized index of consumer prices, which is the highest level of deflation among the EU-member states, as the average inflation in the EU in that period is 0.6%.

Outlook

The negative outlook reflects BCRA's opinion that after the parliamentary elections to take place later this year, the political environment will stabilize to a certain extent, but there will be still no preconditions for passing the ever more pressing reforms in the pension, healthcare, education, legislative, judicial, and administrative systems, among others. The main economic factors will remain stable, with slight positive trends of improving, in line with those of Bulgaria's main trading partners – the other EU-member states, but there is a measurable risk of impairment of the fiscal indicators of the country in the next year. Further adverse political and economic effects of the significantly impaired public trust in the independence and competence of the central bank and the prosecution, as institutions, are also expected.

The rating and outlook would be positively affected by the stabilization of the

political and institutional environments. Also, they would improve in case of favourable economic changes such as: an increased growth in GDP, a considerable increase of the investment interest towards Bulgaria and of direct foreign investments, a steady decrease in unemployment, remaining the fiscal indicators at their current favorable levels.

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:

The members of the Rating Committee discussed the assessment of a number of rating factors included in the rating model, and analyzed in the rating report, in accordance with the Sovereign Rating Methodology. Special attention was paid to the matters related to the instability resulting from the electoral-campaign environment and the adverse developments in the banking system beginning in June this year. Also discussed were the currently stable fiscal indicators of the country and the possibility that they would be impaired as a result of a budget update or the possible materialization of some of the contingent liabilities of the government. In order for the risk levels assigned to the rating factors in the model to take account of the analysis of the latest developments, the following adjustments have been made on an expert level:

- the risk level of category Political Risk was increased, mostly due to rating factors in the Internal Environment (especially, the crime level and corruption) and the Stability and Effectiveness of the Institutions (especially, Rule of Law and Stability of the Political System);
- the risk level of category Macroeconomic Stability was increased, mostly due to the low economic growth;

- the risk level of category Efficiency of the Monetary Policy was increased, mostly due to the latest developments in the banking system.

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

Selected Rating Factors:

	2009	2010	2011	2012	2013	2014(f)	2015(f)
Nominal GDP (million BGN)	68,322	70,511	75,308	78,089	78,115	80,164	83,045
GDP per capita (BGN)	9,007	9,359	10,248	10,689	10,752	11,104	11,584
GDP per capita as % of the average purchasing power in the EU	43.8%	44.1%	46.5%	47.5%	48.1%	48.6%	49.1%
Annual growth rate of real GDP	-5.5%	0.4%	1.8%	0.6%	0.9%	1.7%	2.0%
Annual growth rate of real GDP per capita	-5.0%	1.1%	4.4%	1.2%	1.4%	2.4%	2.7%
Average annual salary (BGN)	7,308	7,776	8,232	8,772	9,696		
Average annual growth of the GDP deflator	4.3%	2.8%	4.9%	3.1%	-0.8%	0.9%	1.6%
Average annual growth of the harmonized index of consumer prices	2.5%	3.0%	3.4%	2.4%	0.4%	-0.4%	0.9%
Unemployment rate, as a % of the workforce, aged 15+	6.8%	10.2%	11.3%	12.3%	12.9%	12.5%	11.9%
Export of goods/GDP	33.5%	43.2%	52.6%	52.0%	55.7%	55.9%	58.4%
Import of goods/GDP	45.4%	50.8%	58.2%	60.7%	61.5%	61.9%	64.6%
Foreign direct investment/GDP	6.9%	3.2%	3.5%	2.7%	2.7%		
Current account balance /GDP	-8.9%	-1.5%	0.1%	-0.8%	1.9%	-0.4%	-2.1%
Gross fixed capital formation /GDP	29.4%	22.9%	21.9%	21.7%	20.9%	21.6%	21.8%
Government budget balance on a cash basis /GDP	-0.9%	-4.0%	-2.0%	-0.5%	-1.8%	-1.7%	-1.2%
Government primary budget balance /GDP	-0.2%	-3.3%	-1.3%	0.3%	-1.0%	-0.9%	-0.4%
Public and publicly guaranteed debt/GDP	15.6%	16.7%	17.0%	18.8%	19.1%	23.7%	23.3%

Budget balance/GDP (based on the Maastricht criteria)	-4.3%	-3.1%	-2.0%	-0.8%	-1.5%	-1.9%	-1.8%
Public debt/GDP (based on the Maastricht criteria)	14.6%	16.2%	16.3%	18.4%	18.9%	23.1%	22.7%
Foreign currency reserves (million BGN)	25,267	25,380	26,108	30,418	28,215		
Gross domestic debt/GDP	108.3%	102.7%	94.3%	94.6%	93.5%	115.32%	113.64%
Short-term domestic debt/GDP	34.7%	31.1%	26.3%	26.1%	24.4%	28.8%	28.4%
Yield of the 10-year government bonds at the end of the year	6.3%	5.6%	5.1%	3.0%	3.5%	3.6%	3.7%
BGN/USD exchange rate	1.36	1.47	1.51	1.48	1.42	1.42	1.42
BGN/EUR exchange rate	1.95583 fixed by a Currency Board						
Economic development	Developing market						
Default history:	1990 – moratorium on servicing foreign debt, fully restructured as of 1994						

(f)=BCRA forecasts