Bulgaria Rating Report – April 2018
Rating Report

SCOPE BBB POSITIVE OUTLOOK

Credit strengths

- EU membership
- Low and declining public debt ratio
- Current account surplus and declines in external debt ratio
- Increases in reserves, supporting the fix to the euro

Credit weaknesses

- High private sector debt
- Risks in the banking sector
- Restricted monetary flexibility
- Institutional weaknesses and record of unstable governments

Rating rationale and Outlook: The revision of the Outlook to Positive on Bulgaria's long-term sovereign rating reflects credit strengths including European Union (EU) membership, improved public finances with a low and declining public debt ratio, current account surpluses, declines in the external debt ratio owing to private sector deleveraging, as well as stronger reserve levels – backing the country's fix of the lev to the euro. Bulgaria's ratings are constrained by still-high levels of private sector debt, lingering risks in the banking sector (though efforts have been made in recent years), monetary inflexibility, vulnerabilities as a small, open economy, alongside institutional weaknesses.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Bulgaria	Peer comparison Average	Romania	Hungary
Domestic economic risk				
Public finance risk				
External economic risk				
Financial risk				
Political and institutional risk				
Qualitative adjustment (notches)	0		0	0
Final rating	BBB		BBB	BBB

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Strong fiscal results, lowering the debt ratio
- Further reform to banking supervision or material private deleveraging
- Boost to reserve coverage and external debt deleveraging

Negative rating-change drivers

- Renewed stress in the banking sector or higher private debt
- Deterioration in public finances
- Reduction in external resilience or institutional challenges re-arise

Ratings and outlook

Foreign currency

Long-term issuer rating	BBB/Positive
Senior unsecured debt	BBB/Positive
Short-term issuer rating	S-2/Stable

Local currency

Long-term issuer rating	BBB/Positive
Senior unsecured debt	BBB/Positive
Short-term issuer rating	S-2/Stable

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Bloomberg: SCOP

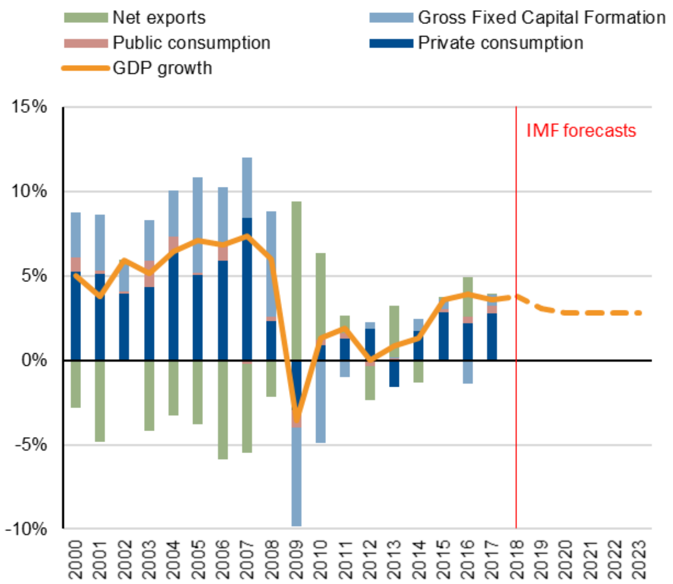
Domestic economic risk

Growth potential of the economy

Sustained growth in recent years

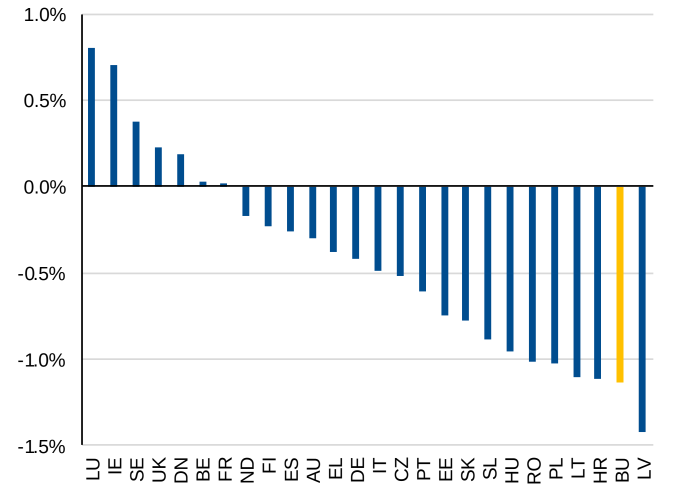
Bulgaria's economy has experienced a recovery, with real GDP growth accelerating to 3.9% and 3.6% in 2016 and 2017, after average growth of 1.1% over 2010-14 (the latter incorporating the Corporate Commercial Bank (KTB) crisis of 2014). Though a marked improvement since 2015, growth remains below the average rates of 6.0% experienced in 2000-08. Recent growth has been driven by domestic demand, with robust private consumption and a gradual recovery in investment, though exports are also rising on the back of growth in the EU.

Figure 2: Real GDP growth by expenditure contribution



Source: IMF, European Commission, Scope Ratings GmbH calculations

Figure 3: Working-age population growth, average projected growth rate during years 2018-2023, vs EU peers



Source: UN Population Division, Scope Ratings GmbH calculations

Through April of 2018, positive signals continued in business climate and consumer confidence indicators.

This month, the IMF revised its projection for 2018 growth for Bulgaria to 3.8% from 3.2% in the October forecast, and its forecast for 2019 to 3.1% from 2.9%. The economy continues to benefit from improvements in labour market conditions, with registered unemployment falling to 6.2% in March 2018, from 7.4% a year earlier (and sharply down from peaks of 11.6% in late 2013), higher labour force participation (at 55.5% in Q4 2017), very strong real wage growth (with nominal wages growing at about 11% as of last December and inflation at 1.9% YoY in March 2018) as well as increases in pension and social benefits. Inflation returned above zero in 2017, after a battle with deflation between 2012 and 2016. Moreover, domestic demand continues to benefit from a recovery in private sector credit, which has been expanding at 3.8% YoY as of March; credit growth has returned after contraction from October 2014 to February 2016. Additionally, investment has resumed, contributing positively to growth, with the higher absorption of EU funds after the beginning of the new EU budget cycle (following the break in 2016 due to the end of the 2007-2013 programming period).

While Bulgaria's recovery is robust, Scope expects medium-run potential growth to average a more modest 2.25% – implying an easing of growth over time compared with the present, as the labour market nears full employment and elevated real wage growth tempers.

Table of Contents

Lower potential growth reflects important supply-side bottlenecks due to a declining labour force. Bulgaria's working-age population has declined by 1.3% annually in the past decade, due to net emigration, low fertility and an ageing workforce. Moving ahead, UN projections see the drop in the working-age population averaging 1.1% between 2018 and 2023 (**Figure 3**), but with this rate of decline easing over the course of the period. The negative contribution to potential growth from a decreasing population should be offset in the near term through positive effects from rising labour force participation and employment growth, however. By comparison with our medium-run estimate of 2.25%, the IMF anticipates medium-term growth in Bulgaria of 2.8%.[1]

Economic policy framework & macroeconomic stability and imbalances

Challenges range from an ageing population to monetary inflexibility

Challenges include the ageing population: according to the European Commission[2], Bulgaria's total dependency ratio will rise from 49% in 2013 to 84% by 2060, the latter estimate amongst the highest in the EU. A pronounced skills mismatch in the workforce and weaknesses in the business climate represent further challenges; next, income inequality is higher than the EU average. Moreover, the still high level of foreign currency (largely euro) lending (see section on 'Financial Stability Risk' in this report) constrains Bulgaria's ability to tailor the monetary transmission. The currency board arrangement – which fixes the lev to the euro – reduces policymaking flexibility, limiting the ability of the Bulgarian National Bank (BNB) to control money supply and act as a lender of last resort.

Bulgaria maintains peg to the euro, and seeks entry to ERM II

Bulgaria is not part of the EU's Exchange Rate Mechanism II (ERM II), the precursor to euro area entry[3]. Prospects concerning Bulgaria's aspirations to join ERM II should be clarified in the years ahead, with the government in negotiations with the European Commission, European Central Bank and member states. Bulgarian finance minister Vladislav Goranov has indicated his interest to place an application by mid-this year to join ERM II. While the lev has been fixed to the Deutsche Mark (and then the euro) since 1997, political hurdles to ERM II still exist, owing to reservations around the disparity in average incomes between Bulgaria and the euro area average alongside institutional weaknesses. Scope could consider a successful entry to ERM II to be credit positive.

Until such a time that ERM II is entered, Scope expects policymakers to remain committed to the euro fix, for which there is cross-party political support. Bulgaria's currency board was introduced after a 1996-97 banking crisis under hyperinflationary conditions. The board successfully installed policy discipline, lowered inflation and interest rates, and prevented further bouts with the hyperinflation of the 1990s. Scope has a positive view of the currency board's record of stabilising Bulgaria's economy, but also recognises the significant constraints the fix places on the central bank.

Low income level and small economic size are constraints

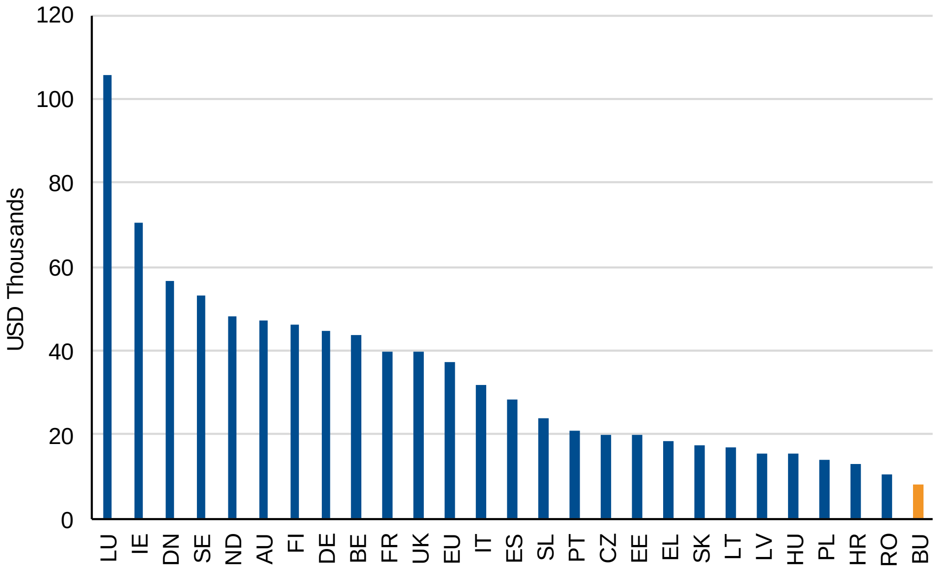
Bulgaria's ratings are constrained by the nation's low GDP per capita (USD 8,064 in 2017), which is below the average for 'bbb'-level sovereign peers and significantly below the EU average (**Figure 4**). However, per capita real growth has been robust at 3.2% on average since Bulgaria's EU accession in 2007, compared with 0.7% over this 2007-17 period in the EU as a whole – placing Bulgaria on a path of gradual convergence.

A small and open economy (with nominal GDP of USD 57bn in 2017), Bulgaria remains vulnerable to idiosyncratic as well as global shocks. Bulgaria's economic competitiveness, moreover, is a constraint, ranked 49th out of 137 countries in the World Economic Forum's 2017-2018 Global Competitiveness Report, although this was an increase on 62nd (of 144 countries) in 2012-13.

[1] IMF's forecast for 2023 growth, per April 2018's World Economic Outlook.
[2] European Commission. 'The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)'. European Economy 3|2015.
[3] Participation in ERM II is voluntary although, as one of the convergence criteria for entry to the euro area, a country must participate in the mechanism without severe tensions for at least two years before it can qualify to adopt the euro.

In this light, Scope considers Bulgaria's EU membership to be an important credit strength, providing investment support, crisis assistance (via access to the EU's Balance of Payments assistance facility) and programmes that incentivise fiscal discipline and structural reform.

Figure 4: GDP per capita, in US dollars, 2017, versus EU peers



Source: IMF

Public finance risk

Fiscal performance

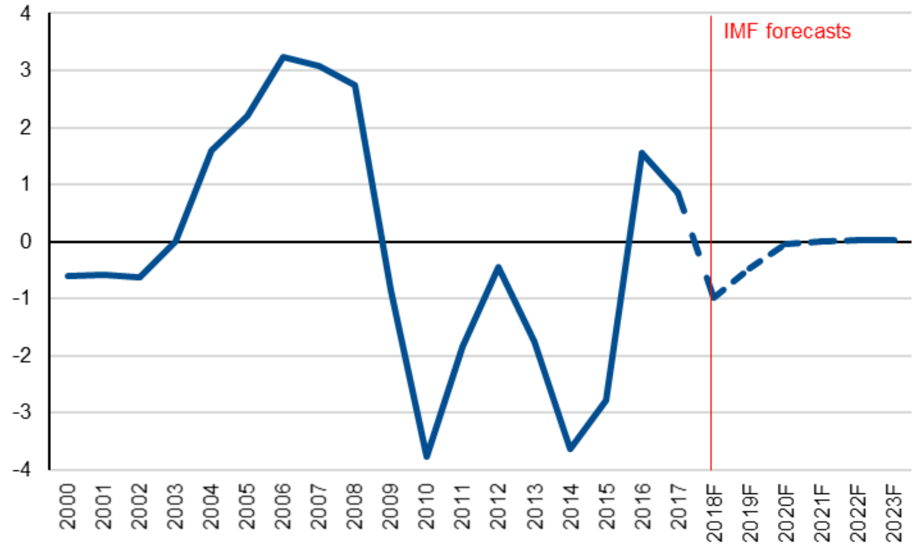
An improved fiscal balance

In 2017, Bulgaria recorded a consolidated budget surplus of 0.9% of GDP on a cash basis (under ESA terms, also 0.9% of GDP in 2017). This represented a sharp consolidation since 2014, when the cash balance was -3.7% of GDP and the ESA-defined budget balance was -5.5% of GDP. The deficit had widened in 2014 from balances of -1.75% on a cash basis and -0.4% under ESA in 2013, as revenues slowed and expenditures jumped during the political turmoil of 2013-14. The budget significantly outperformed expectations in 2017, reflecting mainly higher-than-expected growth and revenue collection, and lower-than-budgeted capital expenditures. However, the slightly reduced budget surplus in 2017 compared with in 2016 (when the cash surplus totalled 1.6% of GDP) owed to lower EU grant transfers, alongside some increases in public sector compensation and social expenditure.

The 2018 budget envisions the cash balance to revert back to a deficit of 1% of GDP (0% of GDP on an accrual basis), reflecting increased public investment, though increases in public sector wages (including for teachers) and spending on public health also contribute. However, the revised medium-term budget framework sees the cash balance easing back towards a balanced position by 2020.

Scope has a positive view on the strides forward made in improving the budget balance since 2014 and recognises the benefits of increased public investment, but stresses at the same time the importance of continued discipline in maintaining a balanced budget moving ahead and ensuring a degree of counter-cyclicality in budgetary policy – implying tightening during periods of above-potential economic expansion like the present, saving revenue windfalls and building on fiscal buffers.

Figure 5: General government net lending/borrowing, % of GDP



Source: IMF

Subject to EU and national fiscal rules

As an EU member, Bulgaria is subject to the EU's fiscal rules and is a signatory of the European Fiscal Compact, requiring a structural deficit of, at most, 1.0% of GDP for countries with a debt-to-GDP of under 60%, a debt brake rule and an automatic correction mechanism. Bulgaria's structural balance stood at an estimated 1.1% of GDP in 2017 according to the IMF. In addition, Bulgaria has enacted national fiscal rules including a nominal deficit rule stipulating that, in cash terms, it should not exceed 2% of GDP, as well as rules safeguarding that total expenditures: i) do not exceed 40% of GDP; and ii) do not exceed the reference growth rate of potential GDP. Scope considers enhancements in Bulgaria's fiscal framework in its ongoing assessment.

Debt sustainability, market access and funding sources

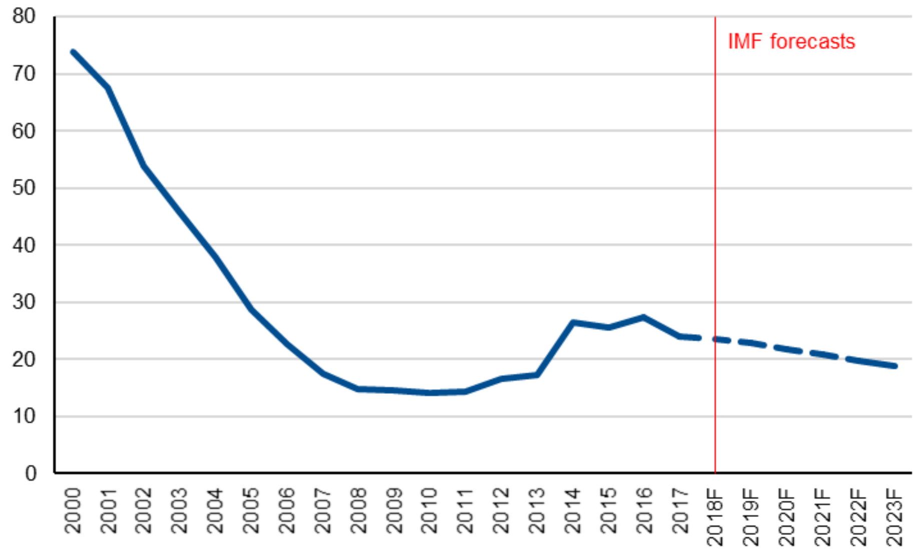
While worse than several years ago, Bulgaria's public balance sheet remains strong

The government's balance sheet is sound with a low and declining debt level as well as sizeable fiscal reserves. Bulgaria's gross public debt ratio stood at 25.4% of GDP as of Q4 2017, slightly lower than peaks from 2016, but substantially higher than lows of 12.7% of GDP in Q1 2009. The rise from 2009 reflects the earlier economic slowdown, pick-up in the fiscal deficit, crystallisation of contingent liabilities arising from the failure of KTB in 2014 and pre-financing activity that raised debt levels but also raised liquid reserves. At present, Bulgaria has the third-lowest debt-to-GDP ratio in the EU, after Estonia and Luxembourg. However, Scope recognises that, given Bulgaria's weaker institutional setting and small economy, its means to manage high debt are also more restricted than EU peers.

Going forward, the IMF projects the debt ratio to decline gradually to 19% of GDP by 2023, supported by favourable debt dynamics and a balanced budget. In Bulgaria's February 2018 Article IV, the IMF concluded that public debt would remain under 30% of GDP and gross financing needs under 6% of GDP under various shock scenarios.[4]

[4] International Monetary Fund. (2018) "2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for Bulgaria". IMF Country Report No. 18/46.

Figure 6: General government gross debt, % of GDP



Source: IMF

Bulgaria has sizeable fiscal reserves, which have increased from BGN 5.8bn (7.1% of GDP) in mid-2014 to BGN 10.7bn (about 10.6% of GDP) as of February 2018, despite recent drawdowns. As such, in past years, the government's net debt ratio rose at a considerably slower pace than the gross debt ratio, with government debt net of liquid reserves standing at 15% of GDP as of Q4 2017.

Bulgaria's debt profile is sound

Bulgaria's public debt profile is sound. Interest payments as a share of total government revenues were 2.2% in 2017, compared to an EU average of 4.4%. The weighted average interest rate on Bulgaria's public debt was about 3.0% in 2017. Moreover, the debt has a long average residual maturity of about 7.8 years currently – high compared to 'bbb' sovereign peers, with almost the entire stock on fixed rates.

However, about 80% of total government debt is denominated in foreign currency, predominantly in euros. Before Bulgaria formally adopts the euro, this represents a risk in crisis scenarios. While the Bulgarian lev is fixed to the euro and backed by the nation's credible currency board regime, there remains the risk that the fix could come under pressure under highly adverse environments.

Contingent liabilities and demographics are risks

Contingent liabilities are a core risk to Bulgaria's fiscal balance sheet. The dangers of spill-over from banks to the sovereign books became apparent in the 2014 scandal. In addition, contingent liabilities could materialise from the energy sector, although the government has reduced losses at Natsionalna Elektricheska Kompania.

Demographic challenges are a constraint in the very long run. With an ageing and declining population, fiscal pressure on the pension system will increase, absorbing the gains from a 2015 pension reform that lifts the retirement age gradually towards 65 over the long term from just over 57 and boosts social contributions. The European Commission estimates that public pension expenditures will decrease as a share of GDP until 2028, before increasing thereafter. It measured total age-related expenditures to decrease by 1.3% of GDP between 2013-40, before hikes of 1.6% of GDP between 2040-60.

External economic risk

Current account vulnerabilities

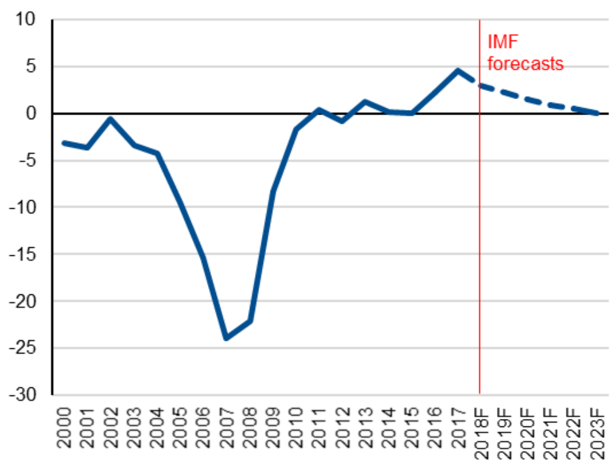
Improvements in a volatile current account

Bulgaria's current account remained in surplus in 2017 at 4.5% of GDP, an improvement on balances of 2.3% and -0.0% of GDP in 2016 and 2015. This reflected a boost in the income balance to -1.1% of GDP in 2017 from -5.1% of GDP in 2016, owing to a sharp drop-off in FDI income outflows. Meanwhile, the goods deficit *widened* to 4.1% of GDP in 2017 from 2.0% of GDP in 2016, as imports rose under rapid economic growth and oil prices climbed. This is an area of concern.

Scope is mindful that Bulgaria's current account can be volatile: the current account balance reached lows of -23.9% of GDP in 2007 and -22.0% of GDP in 2008, before rapid consolidation to +0.3% of GDP by 2011. In Scope's view, current account volatility is a vulnerability, making Bulgaria's surplus subject to change under a scenario of rapid economic growth or changes in regional economic health. Exports and imports of goods and services account each for over 60% of GDP in a well-integrated, open economy; Bulgaria's export performance has been strong, with exports of goods and services rising from 50% of GDP in 2010 to about 66% of GDP by 2017.

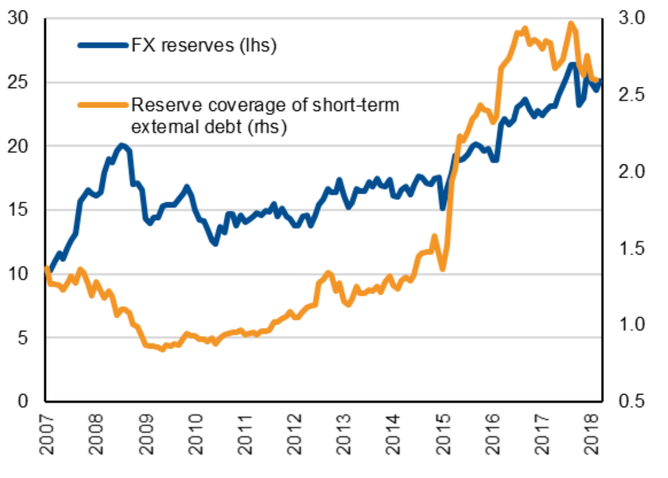
Going forward, the IMF expects the current account surplus to revert gradually to 3.0% of GDP in 2018 before 0.1% of GDP by 2023. Strong domestic demand will raise imports. While export growth will remain sound in view of still strong growth in the EU (the EU is the destination for about two-thirds of Bulgaria's exports), the competitiveness of Bulgaria's export sectors may be impacted in the long term by rapid wage growth. The unit labour cost-deflated real effective exchange rate is now near 70% higher than as of early 2006. However, existing wage gaps with higher-income trading partners present a meaningful buffer against competitiveness issues becoming more profound.

Figure 7: Current account balance, % of GDP



Source: IMF

Figure 8: FX reserves and FX reserve coverage of short-term external debt



Source: Bulgarian National Bank, Scope Ratings GmbH calculations

External debt sustainability

Bulgaria's gross external debt ratio, while still high, has fallen

Bulgaria holds a net international investment position of -40% of GDP as of Q4 2017, an improvement from -98% of GDP in Q2 2010, driven by deleveraging led by the banking sector alongside current account improvements. Bulgaria's gross external debt has declined to 66% of GDP as of Q4 2017, from over 100% of GDP in early 2010. Scope considers improvements in Bulgaria's current account and external debt position to be credit-positive.

Vulnerability to short-term shocks

Reserves have nearly doubled, providing support to the euro fix

Bulgaria's macroeconomic performance is buoyed by broad-based support for its currency board arrangement, which pegs the FX at 1.9558 levs to the euro and continues to be a crucial factor anchoring macroeconomic policies. The credibility of the currency board arrangement is supported by the central bank's reserve accumulation, with foreign exchange reserves totalling USD 25.1bn as of March 2018 (**Figure 8**), up significantly from USD 15.1bn in January 2015. In combination with the effect from debt deleveraging, forex reserve coverage of short-term external debt amounted to 2.6x as of February 2018, almost doubling from 1.4x as of January 2015, and compared with under 1.0x between 2008 and 2011. Scope considers this higher reserve coverage ratio to be critical for the maintenance of external sector and FX stability.

Financial stability risk

Financial sector performance, oversight and governance

2014 KTB crisis has shaped financial sector reforms

Bulgaria's financial system was shaken in 2014 by the collapse of Corporate Commercial Bank, the country's then fourth largest lender, due to a fraud scandal. The bank run and subsequent government takeover raised questions about the health of other banks, causing broader deposit outflows temporarily, and gave rise to concerns about the supervision and crisis management tools of the Bulgarian authorities. Since then, Bulgaria has conducted an Asset Quality Review (AQR) of the financial system, initiated reforms to financial supervision (including in the BNB's governance structure), introduced a new bank resolution authority and implemented recommendations from a Financial Sector Assessment Program with the IMF[5].

The banking system is healthier, but risks linger

The banking system is profitable, has improved its funding structure (with higher dependence on deposits) and is liquid and well capitalised as a whole. System-wide tier 1 capital stood at 20.9% of risk-weighted assets as of Q4 2017. However, two banks identified in the 2016 AQR and stress test still require additional capital and new investment. Actions are also still needed to furthermore improve bank supervision and regulation, and reduce non-performing loans (NPLs).

The NPL ratio is high, and at 10.4% of total loans as of Q4 2017 is more than double the EU average – though the NPL ratio has been on a steep downward trajectory. In addition, 48% of outstanding loans in Bulgaria are denominated in foreign currency, nearly all in euros; while this is down from 67% in 2012, the still highly euro-based nature of Bulgaria's banking structure represents a risk in very stressed environments.

The EU's Bank Recovery and Resolution Directive entered into force

The EU's Bank Recovery and Resolution Directive entered into force on 1 January 2015 and will support earlier interventions in banking crises before these degenerate, learning from the 2014 experience. Under the directive, the failure of a bank will necessitate a bail-in of shareholders, specific creditors and then the new resolution fund. A bank may only request government support once it has exhausted these options.

Lack of a lender of last resort

According to the currency board system, the Bulgarian National Bank's ability to act as a lender of last resort to domestic banks is restricted. The BNB can provide liquidity support to the banking system only by the degree that reserves exceed monetary liabilities. In addition, support can only be given under certain conditions and for short periods, against liquid collateral. The Bulgarian government's currency board prevented the BNB from creating money to pay KTB's depositors. As a result, Bulgaria violated the EU's Deposit Guarantee Schemes Directive by not repaying eligible deposits within 20 days after the bank's failure.

[5] International Monetary Fund. 'Bulgaria: Financial System Stability Assessment-Press Release; Staff Report; and Statement by the Executive Director for Bulgaria', Country Report No. 17/132, 23 May 2017.

The amended Public Finance Act facilitates a legal framework to address the lack of lender of last resort liquidity functions, seeking to bridge a route consistent with the currency board arrangement and enabling transition from early intervention into resolution. However, significant procedural aspects still need to be resolved and compliance with EU state aid rules ensured.

A measure of stability in the banking system is also supported by a recovery in the real estate market. House price growth stands at 8.2% YoY as of Q4 2017, after having fallen by 38% between a 2008 peak and 2013 trough. Scope considers greater stability in and reforms to Bulgaria's banking sector to be critical, while recognising the legacy of the 2014 crisis and the still-lingering vulnerabilities present within the system. On balance, Scope continues to regard financial stability risks to be a weakness hindering Bulgaria's sovereign rating, emphasising the import of continued reform efforts.

Macro-financial vulnerabilities and fragility

High private debt represents a core risk

Domestic non-financial private debt remains high, at 217% of GDP as of Q4 2017. While this has declined from 275% of GDP as of Q2 2010, the still-high level of debt – particularly in the corporate sector – represents a vulnerability and rating constraint. This reflects in significant part high inter-company lending, with accounts payable totalling 101% of GDP as of Q4 2017.

Figure 9: Domestic non-financial private debt, % of GDP

Source: Bulgarian National Bank, Haver Analytics, calculations Scope Ratings GmbH

Institutional and political risk

Recent events and policy decisions

Bulgaria is a parliamentary representative democratic republic, in which the prime minister is the executive and head of government. Legislative power is vested in both the government and the National Assembly. Bulgaria has held the rotating presidency of the Council of the EU (for its first time) since January of this year until June 2018. In the November 2017 Eurobarometer, survey results showed Bulgaria as the nation with the second (after Lithuania)-highest favourable responses towards the European Union, with 57% of responses favourable on the EU.

Institutional weaknesses remain

Bulgaria achieves middle-range scores on institutional metrics, such as the World Bank's Worldwide Governance Indicators, in which it attained somewhat weaker scores than 'bbb' sovereign peers. In the World Economic Forum (WEF)'s latest Global Competitiveness Report, institutional strength (including property rights, intellectual property protection, judicial independence, etc.) was a limitation to Bulgaria's performance. In the WEF's Executive Opinion Survey 2017, corruption, inefficient government bureaucracy and tax rates were cited as the main obstacles to doing business. In addition, Bulgaria struggles with organised crime. Addressing these governance challenges remains a priority, with institutional reforms underway, including to enhance the independence and operation of the Supreme Judicial Council and address corruption.

Unstable governments undermine reform momentum

Bulgaria has seen significant turnover in governments in recent years. Early elections in May 2013 were followed by turmoil after the formation of the Plamen Oresharski government and the appointment of controversial media mogul Delyan Peevski as a chief of the National Security State Agency. This led to the dissolution of parliament and fresh early elections in October 2014. In the October 2014 election, the centre-right GERB was the largest party and formed a coalition government with the Reformist Bloc. However, Prime Minister Boyko Borisov from GERB resigned in January 2017 following the defeat of his candidate in November 2016 presidential elections. In the March 2017 snap election, GERB won a plurality, forming a new coalition with the nationalist United Patriots. Mr Borisov returned as prime minister in May 2017.

Bulgaria's history of unstable governments restricts continuity in reform drives, raises incentives for populism that weighs on the fiscal balance sheet, reduces the capacity for long-term economic planning, and undermines the business environment and investor confidence. These issues are rating relevant.

Methodology

The methodology applicable for this rating and/or rating outlook "Public Finance Sovereign Ratings" is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "BBB" ("bbb") rating range for the Republic of Bulgaria. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the Republic of Bulgaria, the following relative credit strengths are identified: i) economic policy framework; and ii) good resilience to short-term external shocks. Relative credit weaknesses are signalled for: i) current account vulnerabilities; ii) recent events and policy decisions; and iii) macro-financial vulnerabilities and fragility. The combined relative credit strengths and weaknesses indicate a sovereign rating of BBB for Bulgaria. A final rating of BBB was assigned to the Republic of Bulgaria.

Rating overview

CVS category rating range	bbb
QS adjustment	BBB
Final rating	BBB

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case letters.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance assessments, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Bulgaria's debt is mainly issued in foreign currency (about 80% of the total government debt stock is in foreign currency), with almost all of this issued in euros. However, Bulgaria has maintained a currency board arrangement since 1997 and currently retains an enhanced level of FX reserves backing the euro fix, mitigating the differentiation between lev-denominated and euro-denominated debt. Currently, Scope sees no evidence that Bulgaria would differentiate among any contractual debt obligations based on currency denomination.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	35%
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	30%
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	15%
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	10%
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	10%
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	

QS

Maximum adjustment = 3 notches

	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	◉ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	◉ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	◉ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	◉ Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	◉ Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate

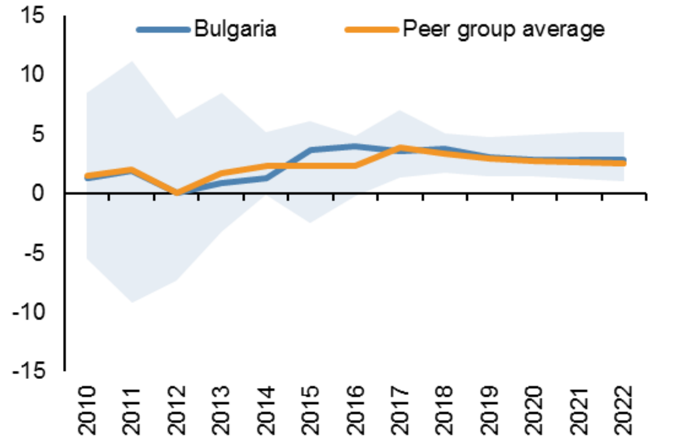
Indicative rating range	bbb
QS adjustment	BBB
Final rating	**BBB**

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

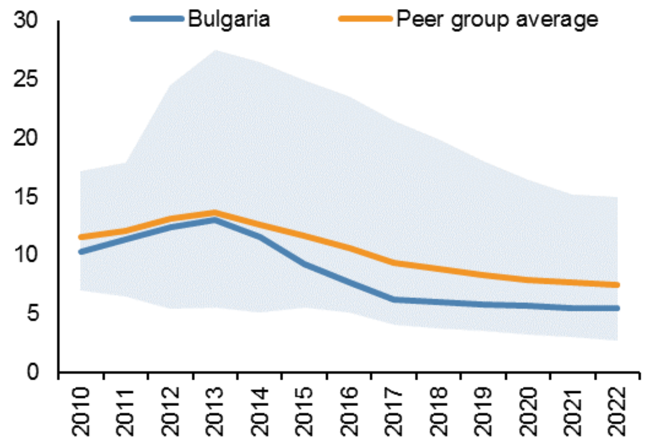
III. Appendix: Peer comparison

Figure 10: Real GDP growth



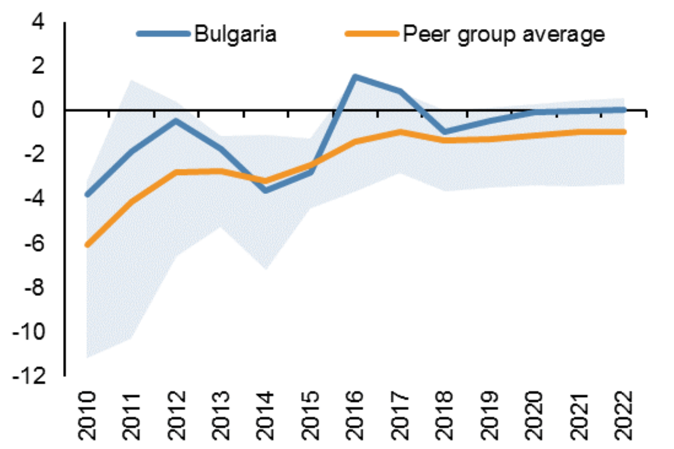
Source: IMF, Calculations Scope Ratings GmbH

Figure 11: Unemployment rate, % of total labour force



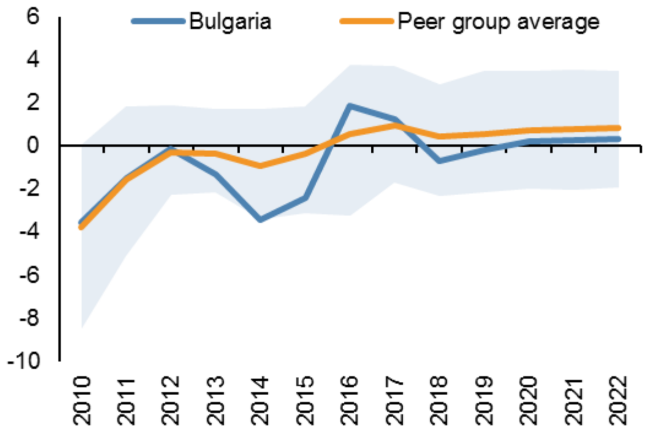
Source: IMF, Calculations Scope Ratings GmbH

Figure 12: General government balance, % of GDP



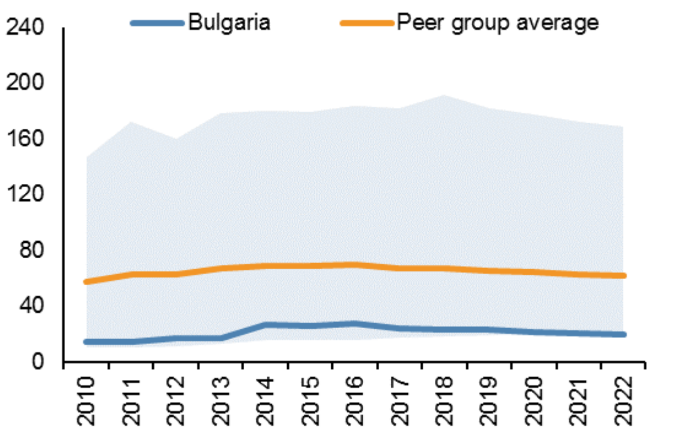
Source: IMF, Calculations Scope Ratings GmbH

Figure 13: General government primary balance, % of GDP



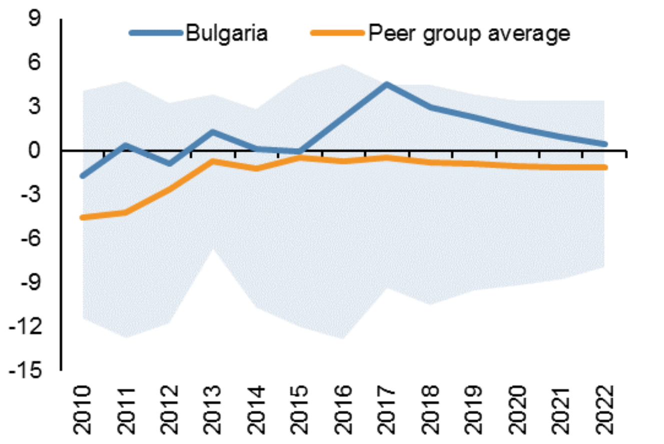
Source: IMF, Calculations Scope Ratings GmbH

Figure 14: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 15: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

IV. Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (USD bn)	55.8	56.7	50.2	53.2	56.9	64.8	68.5
Population ('000s)	7,246.0	7,202.0	7,154.0	7,102.0	7,061.0	7,021.0	6,981.0
GDP per capita PPP (Int'l USD)	16,631.7	17,508.9	18,115.2	19,242.6	-	-	-
GDP per capita (USD)	7,695.7	7,877.1	7,017.1	7,496.1	8,064.0	9,226.6	9,810.8
Real GDP, % change	0.9	1.3	3.6	3.9	3.6	3.8	3.1
GDP growth volatility (10-year rolling SD)	3.8	3.7	3.4	3.1	2.6	2.3	1.4
CPI, % change	0.4	-1.6	-1.1	-1.3	1.2	2.0	2.1
Unemployment rate (%)	13.0	11.5	9.2	7.7	6.2	6.0	5.8
Investment (% of GDP)	21.3	21.4	21.2	19.1	20.9	21.5	21.2
Gross national savings (% of GDP)	22.6	21.5	21.2	21.4	25.4	24.4	23.5
Public finances							
Net lending/borrowing (% of GDP)	-1.8	-3.6	-2.8	1.6	0.9	-1.0	-0.5
Primary net lending/borrowing (% of GDP)	-1.3	-3.4	-2.4	1.9	1.2	-0.7	-0.2
Revenue (% of GDP)	33.8	33.7	35.0	34.7	34.0	34.9	34.9
Expenditure (% of GDP)	35.5	37.3	37.8	33.1	33.2	35.9	35.4
Net interest payments (% of GDP)	0.4	0.2	0.4	0.3	0.4	0.3	0.3
Net interest payments (% of revenue)	1.3	0.7	1.1	0.8	1.0	0.7	0.8
Gross debt (% of GDP)	17.2	26.4	25.6	27.4	23.9	23.6	22.9
Net debt (% of GDP)	6.5	13.2	15.6	11.5	10.9	11.1	10.9
Gross debt (% of revenue)	50.9	78.5	73.4	78.8	70.3	67.5	65.5
External vulnerability							
Gross external debt (% of GDP)	87.9	92.0	74.0	71.1	66.0	-	-
Net external debt (% of GDP)	21.6	18.3	1.5	-9.5	-13.8	-	-
Current-account balance (% of GDP)	1.3	0.1	0.0	2.3	4.5	3.0	2.3
Trade balance [FOB] (% of GDP)	-7.0	-6.5	-5.8	-2.0	-3.1	-2.9	-2.8
Net direct investment (% of GDP)	-3.0	-2.1	-5.1	-1.5	-1.4	-	-
Official forex reserves (EOP, Bil.USD)	17.3	17.6	19.8	22.8	25.7	-	-
REER, % change	0.1%	-0.8%	-3.4%	-0.3%	0.5%	-	-
Nominal exchange rate (EOP, BGN/EUR)	1.96	1.96	1.96	1.96	1.96	-	-
Financial stability							
Non-performing loans (% of total loans)	-	-	14.6	13.2	10.4	-	-
Tier 1 ratio (% of RWA)	-	-	20.5	20.9	20.9	-	-
Domestic non-financial private debt (% of GDP)	250.9	250.9	233.3	224.9	216.9	-	-
Domestic credit-to-GDP gap (%)	-8.4	-9.8	-20.8	-20.1	-	-	-

Sources: IMF, Bulgarian National Bank, European Commission, World Bank, Scope Ratings GmbH

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Dennis Shen, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director, Public Finance

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The ratings/outlooks were last updated on 03.11.2017.

The senior unsecured debt ratings as well as the short-term issuer ratings were last updated by Scope on 03.11.2017.

The main points discussed by the rating committee were: (1) Bulgaria's economic performance and outlook; (2) fiscal performance and debt sustainability; (3) Bulgaria's exchange rate regime and reserve coverage; (4) external debt and net international investment position; (5) banking system reforms and fragilities; (6) institutional weaknesses; and (7) peer considerations.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: IMF, Bulgarian National Bank, Bulgaria's National Statistical Institute, Ministry of Finance of the Republic of Bulgaria, Eurostat, European Commission, United Nations and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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