FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Bulgaria at 'BBB'; Outlook Positive

Fri 17 Jun, 2022 - 5:02 PM ET

Fitch Ratings - Frankfurt am Main - 17 Jun 2022: Fitch Ratings has affirmed Bulgaria's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Positive Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Credit Fundamentals: Bulgaria's ratings are supported by its strong external and public balance sheets versus 'BBB' peers and a credible policy framework, underpinned by EU membership and a long-standing currency-board. This is balanced by unfavourable demographics, which weigh on potential growth and government finances over the long term, as well as by slightly weaker governance indicators than peers.

Positive Outlook: The Positive Outlook reflects the prospect of euro adoption, which would lead to further improvements in external metrics. Despite renewed political instability, we believe the authorities remain committed to euro adoption by 2024, with risks around the timeline mainly tied to exogenous shocks. At present, we do not expect a delay of more than one year in euro accession if the country fails to meet convergence criteria in 2023, as we consider that there is a clear commitment at EU level to expedite the process.

Growth Outlook Weakens: We forecast GDP growth to slow to 3% in 2022 from 4.2% in 2021 (versus the current 'BBB' median of 3.4%) as higher inflation and weaker external demand affect domestic consumption and trade, respectively. Economic performance in 1Q22 (up 0.8% qoq) held up surprisingly well as private consumption remained resilient, but we expect activity to weaken as inflationary pressures accentuate throughout 2022.

We continue to expect a modest acceleration of growth in 2023 (to 3.8%) largely due to stronger investment linked to EU Funds. Political uncertainty remains an important downside risk, given renewed prospects of new elections that could delay absorption of funds linked to the Recovery and Resilience Plan (RRP), which was finally approved in April. However, the risks around a more substantive slowdown appear contained at present, highlighting the economy's resilience in the last couple of years to both domestic and external challenges.

Delinking from Russian Energy: The authorities are making concerted efforts to reduce energy reliance from Russia, in particular following the decision in April by Gazprom to halt gas deliveries (Russian gas accounted for around 80% of Bulgaria's 3.2billion cubic metre gas consumption). Gas flows from neighbouring countries have served as stop-gap measure, while a new interconnector with Greece and new supply agreements with other countries will largely help cover the gap by winter 2022 (when gas demand increases sharply). Combined with Bulgaria being exempt from EU oil sanctions against Russia until 2024, this reduces the risks of energy supply disruptions that could significantly affect households and industry, although in such a scenario indirect impacts would still create significant macro challenges.

Inflation Pressures Intensify: Fitch projects that harmonised inflation (HICP) will average 11.8% in 2022 the highest in 15 years, as high energy and food prices feed through all price categories. Although we expect inflation to gradually moderate in 2H22 as base effects kick in, risks are clearly tilted to the upside, given uncertain external developments and rising inflation expectations that will augment wage demands (beyond the close to 10% increase in wages seen in 2021). Government measures to support households could add further demand pressures. In our baseline scenario, inflation will average 6% in 2023, remaining above the Fitch eurozone and 'BBB' median forecast.

Euro Adoption: The implementation of Bulgaria's ERMII post-entry commitments is ongoing and according to the ECB's June Convergence Report, the country fulfils most of the convergence criteria, including interest rate, exchange rate and public finances. However, the country's legal framework is not yet aligned and price convergence was not met. There are rising risks that Bulgaria again fails to meet price stability criterion in May 2023 (the key date for 2024 euro adoption), particularly as Bulgaria HICP inflation is much more sensitive to food and energy costs than most EU member states. Delays to implement a technical changeover plan could also challenge the 2024 goal.

Meeting all other criteria is less challenging, and as long as political commitment remains firm in Bulgaria and the EU we would expect flexibility in the convergence assessment (as shown in Croatia). Overall, we consider euro adoption as supportive of the rating, as underlined by our view that all things being equal, we would upgrade Bulgaria's Long-Term Foreign-Currency IDR by two notches between the inclusion of the Bulgarian lev into ERM II to joining the euro.

Renewed Political Uncertainty: The junior coalition partner TISP announced the withdrawal of its four ministers from the government in mid-June. The three remaining coalition partners intend to continue their mandate with a working minority in order to avoid political instability until end of 2022. A key test would be the approval of the budget revision law before end-June. Fitch notes that current political uncertainty might prove challenging for the government to deliver milestones required for the second tranche of RRP, as 22 reforms including anti-corruption laws need to be passed by the end of the year, requiring political commitment to tackle these issues. The first review of the milestones and targets will take place in 3Q22, with little risk of targets being missed, which would release the first disbursement of EUR 1.4 billion (around 2% of GDP) in 4Q22. Delay in meeting milestones poses risks to completion of the programme and could complicate medium-term fiscal plans.

Budget Revision Amid Inflation Shock: In response to inflation and energy price shock, the government proposed a budget law revision that foresees a set of support measures worth around BGN2.1 billion (2.0% of GDP). Next to VAT rate cuts on some products, increase of tax relief for families and fixed compensation for fuel prices, the plan envisages a two-stage pension hike. If the budget revision is approved in June, pensions will be raised by 10% in July, while the anti-Covid-19 bonus of BGN60 will be permanently included in the pension size. The second increase, due in October, plays a more important role as it aims at reducing inequalities between the pensioners. The total budget cost of pension hikes for this year is expected to be BGN1.4 billion.

Deficit to Widen, Public Debt Below Peers: Fitch forecasts the deficit to widen to 4.9% of GDP in 2022, from 4.1% of GDP in 2021, driven predominantly by support measures. In our view, the government deficit will narrow to 2.9% of GDP in 2023 as expenditure pressures recede. Despite wider deficits expected in the medium term and the post-pandemic increase in debt, Bulgaria's public debt ratio will remain very low compared with EU countries and 'BBB' peers (current 'BBB' median: 55.9%). The government intends to benefit from still low financing costs this year and will aim to pre-finance a large 2023 Eurobond redemption, which will add to increase of public debt level this year. Nevertheless, Fitch expects the public debt/GDP ratio to remain below 30% within the forecast horizon.

External Finances: We expect the current account deficit (CAD) to widen to 2.6% of GDP (from 0.4% of GDP in 2021) owing to the trade and primary income deficits. Although export growth reached a high double-digit dynamic in 1Q22, it was outpaced by import growth. The latter was led by strong domestic demand and soaring international energy prices. The capital and financial accounts will be supported by projected increase in capital transfers from the EU as well as steady FDI inflows, which will keep the net external creditor position at about 30% of GDP in 2022-23 (vs. current 'BBB' median: 4.4%). Despite a foreseen temporary deterioration in current account dynamics, external finances remain Bulgaria's rating strength and a factor that has helped reduce macro vulnerabilities.

ESG - Governance: Bulgaria has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Bulgaria has a medium WBGI ranking in the 56th percentile, reflecting a history of unstable coalitions, relatively high perceptions of corruption and moderate institutional capacity versus track record of peaceful transitions and above average regulatory quality.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-External Finances: A significant delay in the timeline of eurozone accession due, for example, to adverse policy developments or a deterioration in macroeconomic conditions.

-Macro: A large adverse macroeconomic shock, for example due to energy rationing in Europe, which would materially lower medium-term growth prospects compared with Fitch's current expectation.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-External Finances: Progress toward eurozone accession, including greater confidence in Bulgaria meeting membership criteria and the likely timing of euro adoption.

-Macro: An improvement in growth potential, for example via the implementation of structural and governance reforms to improve the business environment and/or effective use of EU funds.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Bulgaria a score equivalent to a rating of BBB on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

Macro: Fitch has removed the -1 notch in macro to reflect Fitch's view that despite long-term structural challenges (mainly an ageing population), the economy has shown resilience to both the pandemic and the war in Ukraine without significant scarring.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SUMMARY OF DATA ADJUSTMENTS

n.a.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Bulgaria has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Bulgaria has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Bulgaria has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Bulgaria has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Bulgaria, as for all sovereigns. As Bulgaria has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

Bulgaria	LT IDR BBB Rating Outlook Positive Affirmed	BBB Rating Outlook Positive
	ST IDR F2 Affirmed	F2
	LC LT IDR BBB Rating Outlook Positive Affirmed	BBB Rating Outlook Positive
	LC ST IDR F2 Affirmed	F2
	Country Ceiling A- Affirmed	A-
senior unsecured	LT BBB Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 11 Apr 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Bulgaria	EU Issued, UK Endorsed

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Sovereigns Europe Bulgaria