Research

Bulgaria Outlook Revised To Negative On Weak Growth Prospects; 'BBB/A-2' Ratings Affirmed

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OVERVIEW

- Bulgaria's growth prospects are being challenged by anemic domestic demand--resulting from low credit growth and still-high unemployment--and the complex political climate, which could slow reforms.
- The fiscal track record of Bulgarian policymakers, however, remains a ratings strength.
- We are therefore revising our outlook on Bulgaria to negative from stable, and affirming our 'BBB/A-2' long- and short-term sovereign credit ratings.
- The negative outlook indicates at least a one-in-three possibility that we could lower the ratings on Bulgaria within the next two years, if the political environment deteriorates, weighing on already-weak growth prospects.

RATING ACTION

On Dec. 13, 2013, Standard & Poor's Ratings Services revised its outlook on the Republic of Bulgaria to negative from stable. At the same time, we affirmed our long- and short-term foreign and local currency sovereign credit ratings on Bulgaria.

RATIONALE

The outlook revision reflects our view that Bulgaria's economic performance will remain under pressure as a result of:

- Weak lending by banks, reflecting low demand for credit given high real interest rates, a dearth of bankable projects, and financial constraints at the head office level of foreign parent banks;
- Constrained investment growth over the period reflecting, among other factors, a low pick-up in foreign direct investment inflows; and
- High unemployment and an increasing proportion of long-term unemployment.

We also believe that the uncertain political environment and the possibility of early elections will slow the adoption of reforms, weighing on potential economic output.

The Bulgarian economy's recovery has been shallow, with real GDP growth averaging just 1% in 2010-2012. This coincides with economic deleveraging, with credit to the private sector growing by about 3% over the same period. The resolution of nonperforming loans (NPLs) has been slow--NPLs are estimated at 17% of gross loans. On the other hand, the central bank reports that the average tier I capital ratio of the banking system exceeds 15%.

We expect economic stagnation in 2013, with higher public consumption and net exports almost completely offset by anemic household consumption and private investment growth. We anticipate that the unemployment rate will average just under 13% in 2013, well above the 5.6% level that prevailed before 2008. Roughly 60% of unemployed have been out of work for more than a year. We do not believe that Bulgaria will reach full employment during the forecast horizon.

Bulgaria's political environment has been challenging in 2013. After parliamentary elections in May, the Bulgarian Socialist Party and the Movement for Rights and Freedoms joined to form a minority coalition government. Shortly after taking office, the government faced calls to resign over an appointment to head the State Agency for National Security. While the government has so far resisted popular protests to dissolve, we believe that increased pressure from civil society could complicate policymaking and raise the possibility of early elections. Bulgaria's political settings are also characterized by a judicial system and public procurement process that the EU believes would benefit from strengthening.

Partly as a response to social pressure and partly due to subdued economic growth, we expect the general government deficit to widen to 2% of GDP in 2013 after having narrowed since 2010. In our view, this will be driven by the government's decision to increase social transfers and pensions and to pay down arrears to the corporate sector.

That said, we do not see these steps as a significant deviation from Bulgaria's robust fiscal track record. Although policymakers have suspended plans to join the European Exchange Rate Mechanism (ERM-II), the precursor to entry into the European Economic and Monetary Union, we see no signs of the government backing away from its national fiscal compact. We therefore expect the government to undertake consolidation measures, over and above those already outlined in the budget, should its expectations of economic performance in 2014 not be met. We believe this will happen even though the current environment may make this task more difficult than when the government undertook similar efforts previously.

As a result, we project that the annual change in general government debt will average 1.5% over 2013-2016, bringing the stock of net general government debt to a still-low 15% of GDP in 2016 from an estimated 12% in 2013. We estimate general government interest expense will remain low at 2.8% of general government revenues in 2013. Just under 70% of Bulgaria's government debt stock is denominated in foreign currency.

The low rate of economic activity and difficult external funding conditions have caused import compression coinciding with an increase in Bulgarian exports' market shares. Between 2004 and 2011 export growth was notably higher than in trading partners.

Between 2008 and our estimates for year-end 2013, the net external position of the financial sector experienced outflows of nearly $9 billion as foreign head offices repatriated funding and as Bulgarian banks generally reduced cross border interbank deposits, investing surplus funds abroad (domestic deposit growth has been outstripping lending growth). These outflows were matched by a sharp adjustment of Bulgaria's current account, which swung from a 23% of GDP deficit in 2008 to what we project will be a balanced position this year.

In line with our expectations for economic growth, we expect Bulgaria's current account deficits to be modest and its need for net external borrowing to be relatively limited through 2016. As a result, we believe Bulgaria's gross external financing needs (current account payments plus short-term external debt by residual maturity) will reduce to 110% of current account receipts and usable reserves in 2016, from an estimated 120% in 2013.

In addition to recent cuts to regulated prices, the recent deflationary trend in Bulgaria reflects weak economic conditions in the eurozone (to which Bulgaria's monetary stance is tied through its currency board arrangement), as well as high real interest rates for private borrowers.

OUTLOOK

The negative outlook indicates at least a one-in-three possibility that we could lower the ratings on Bulgaria within the next two years.

We could lower the ratings if there is a marked deterioration in the policy environment such that it weighs on the country's already-weakened growth prospects and adversely influences private investment flows, or if we see continued outflows in the financial account of the balance of payments.

On the other hand, downward pressure on Bulgaria's ratings could ease if its political situation stabilizes, allowing its institutions to strengthen, which we believe would likely improve its growth prospects.

KEY STATISTICS

Table 1

Republic of Bulgaria - Selected Indicators

	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (US$ bil)	33.21	42.12	51.82	48.57	47.73	53.54	50.97	53.66	56.1	58.82	61.92
GDP per capita (US$)	4,302	5,561	6,893	6,504	6,431	7,266	6,957	7,346	7,718	8,133	8,605
Real GDP growth (%)	6.5	6.5	6.2	(5.5)	0.4	1.8	0.8	0.5	1.5	1.8	2.2
Real GDP per capita growth (%)	7.1	8.5	7.0	(4.8)	1.0	2.6	1.4	0.8	2.0	2.3	2.7
Change in general government debt/GDP (%)	(2.5)	(1.4)	(1.3)	0.8	2.1	1.1	2.7	0.8	1.8	1.5	1.1
General government balance/GDP (%)	1.9	1.2	1.7	(4.3)	(3.1)	(2.0)	(0.8)	(2.0)	(1.8)	(1.5)	(1.1)
General government debt/GDP (%)	21.6	17.2	13.7	14.6	16.2	16.3	18.6	18.7	19.7	20.3	20.4
Net general government debt/GDP (%)	10.8	4.6	1.6	4.3	7.5	9.5	10.4	12.1	13.4	14.2	14.6
General government interest expenditure/revenues (%)	3.7	2.9	2.2	2.1	2.1	2.2	2.5	2.8	2.8	3.1	3.3
Oth dc claims on resident non-govt. sector/GDP (%)	44.8	62.7	71.6	75.4	74.0	72.0	71.8	69.9	68.2	67.0	65.9
CPI growth (%)	7.4	7.6	12.0	2.5	3.0	3.4	2.4	0.5	1.5	2.0	2.0
Gross external financing needs/CARs +use. res (%)	134.5	151.6	155.4	155.6	135.4	123.4	122.0	118.3	120.2	113.7	108.4
Current account balance/GDP (%)	(17.6)	(25.2)	(23.1)	(9.0)	(1.5)	0.1	(1.3)	0.4	(0.1)	(0.7)	(1.2)
Current account balance/CARs (%)	(25.4)	(38.1)	(35.3)	(16.4)	(2.3)	0.1	(1.7)	0.5	(0.1)	(0.8)	(1.4)
Narrow net external debt/CARs (%)	(1.3)	3.6	20.9	20.7	8.3	(2.9)	(8.7)	(11.3)	(16.4)	(18.5)	(20.0)
Net external liabilities/CARs (%)	87.7	131.8	142.2	193.6	149.5	107.5	108.4	99.3	92.9	84.9	78.1

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013
- Emerging Europe Sovereign Ratings Remain Vulnerable To Political And Fiscal Pressures, Sept. 11, 2013
- Emerging Market Sovereigns In Europe Could Be Most At Risk In A Liquidity Squeeze, July 4, 2013
- The Eurozone's Long, Unwinding Road, Dec. 3, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook.

RATINGS LIST

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Bulgaria (Republic of)		
Sovereign Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	
Short-Term Debt	A-2	
Transfer & Convertibility Assessment	A	

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