GOVERNMENT DEBT MANAGEMENT STRATEGY FOR THE PERIOD 2012-2014

Ministry of Finance
Republic of Bulgaria

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INTRODUCTION

Government debt management refers to the overall process of developing and implementing a government debt management strategy outlining the approach adopted in pursuing specified targets in terms of securing any necessary debt financing in cases admissible under Article 5 of the Government Debt Act, while taking into account the influence and constraining effects of external and domestic macroeconomic environments and any potential risks. Its scope covers all actions related to incurring government debt by issuing government securities on the local and international capital markets and by means of government loan agreements, actions related to debt servicing and reporting, and actions related to carrying out various financial transactions and operations aiming at reducing risks associated with the government debt structure, and optimisation of government debt servicing.

This paper is a summary of the main principles and guidelines of the government debt management policy in the mid-term. It describes the indicative measures and the toolbox used to achieve the adopted strategic goals, enabling the pursuit of a prudent and consistent government debt management policy. Its public disclosure and wide public access, and the openness of the processes involved in managing government obligations are a key factor in ensuring transparency in government debt management and strengthening relationships with creditors, investors and credit rating agencies.

The Government Debt Management Strategy 2012 - 2014 has been developed by the Minister of Finance on the basis of Article 16 of the Government Debt Act, and has been adopted by the Council of Ministers. The Strategy is to be updated annually and presented to the Council of Ministers for its approval together with the three-year budget forecast.

The GDMS 2012 - 2014 deals with government debt, both domestic and external, which constitutes a major portion of the consolidated government debt reported in accordance with the methodology of the European System of Accounts 95. According to the existing legislation, the remit of the Minister of Finance covers government debt management. The other two components of the consolidated government debt are not dealt with in this strategy paper. It presents detailed information about government guarantees issued under loan agreements in view of the need to monitor them closely because of their importance for the sustainability of the government debt and the budget.

The first part of the Strategy offers an overview of results achieved and the implementation of goals set in the previous Government Debt Management Strategy for the period 2009 - 2011 (GDMS 2009 – 2011). It’s considered on the changes in the size, structure and service cost of government debt resulting from the debt policy implemented over the period, taking into account the degree to which the set goals have been met.

The second part describes the macroeconomic situation in Bulgaria and abroad during the past three-year period, and outlines the trends and the main government and budget priorities for the next three-year period. The Strategy is based on and complies with the main assumptions underlying in the 2012 State Budget of the Republic of Bulgaria Act and the 2013 - 2015 macroeconomic framework developed by the Ministry of Finance, and ensures a consistent link with the 2012 – 2015 Convergence Programme of the Republic of Bulgaria.

The section dealing with the risk management identifies the potential risks related to government debt and provides information enabling their quantification. It describes how the various risk indicators change with a change in the underlying government debt composition. On the basis of assumptions as to changing exchange rate and interest rate levels, a sensitivity analysis of debt is performed, examining how these affect debt service cost.

The fourth part of the paper presents the main strategic goals which the government sets itself for the upcoming three-year period. It provides a brief overview of the measures to be undertaken to achieve the targets set for the period, including a description of the main sources of funding to be used and their components.

I. Overview of achievements in the implementation of the Government Debt Management Strategy (GDMS) for the period 2009 – 2011

Implementing a sound debt policy in the context of ensuring the availability of the funds necessary to finance government priorities and refinance the outstanding debt while keeping government and government guaranteed debt at reasonable levels and the achievement of a sustainable financial position, were the main priorities in the period 2009 - 2011. The image of the Republic of Bulgaria as a country observing strict budget discipline and exhibiting stable fiscal indicators and low government debt rates have contributed to strengthening confidence in it. Against the backdrop of the current insecurity on international capital markets and continuing downgrading of credit ratings of a number of leading economies, in 2011 Bulgaria was recognised for its successful fiscal policy, becoming the first European Union member state since the onset of the debt crisis whose government credit rating was upgraded.

The actions and measures undertaken to meet the targets set in the Government Debt Management Strategy for 2009 – 2011 shaped the performance of government debt and government guaranteed debt reported at the end of 2011.

1. Government debt size and service cost

Chart 1: *Government debt in the period 2006-2011 (in nominal terms, in BGN million)*

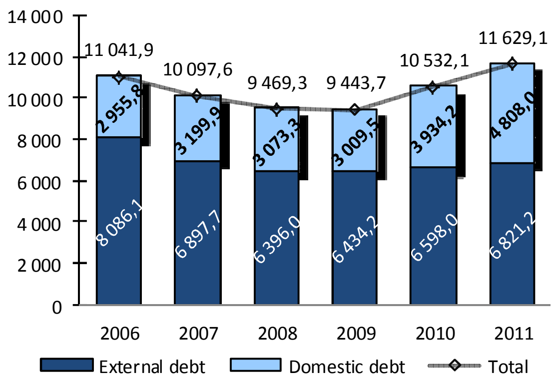
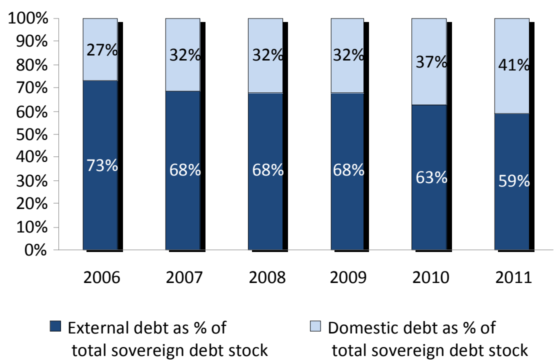


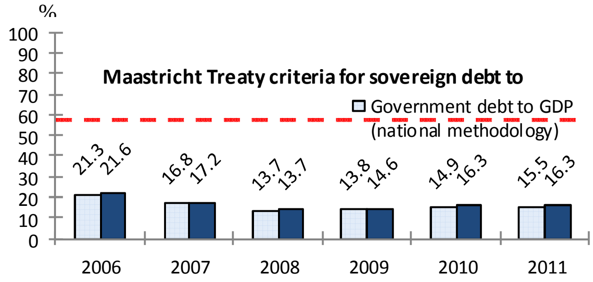
Chart 2: *Structure of the government debt in the period 2006-2011*



As of the end of 2011 the nominal amount of government debt stood at BGN 11 629.1 million, showing an increase of BGN 2 159.9 million during the three-year period under review, from the amount reported at the end of 2008. The increase in the size of government debt is due primarily to the rise in domestic government debt, which grew in size each of the years under examination, reaching at the end of 2011 as high as 41 % of the total government debt. The external government debt, with relative share of 59 % in the government debt stock, went down by about 8.9 p.p. compared to the end of 2008, despite its increase in nominal terms of about BGN 400 million.

The main indicator determining the debt burden, the government debt/gross domestic product ratio, stood at 15.5 % at the end of 2011, marking an increase of 1.8 percentage points from its level of 13.7 % reported as of the end of 2008. Despite the increase registered, this indicator remains far below the 25 % level set in the previous GDMS for the period 2009-2011.

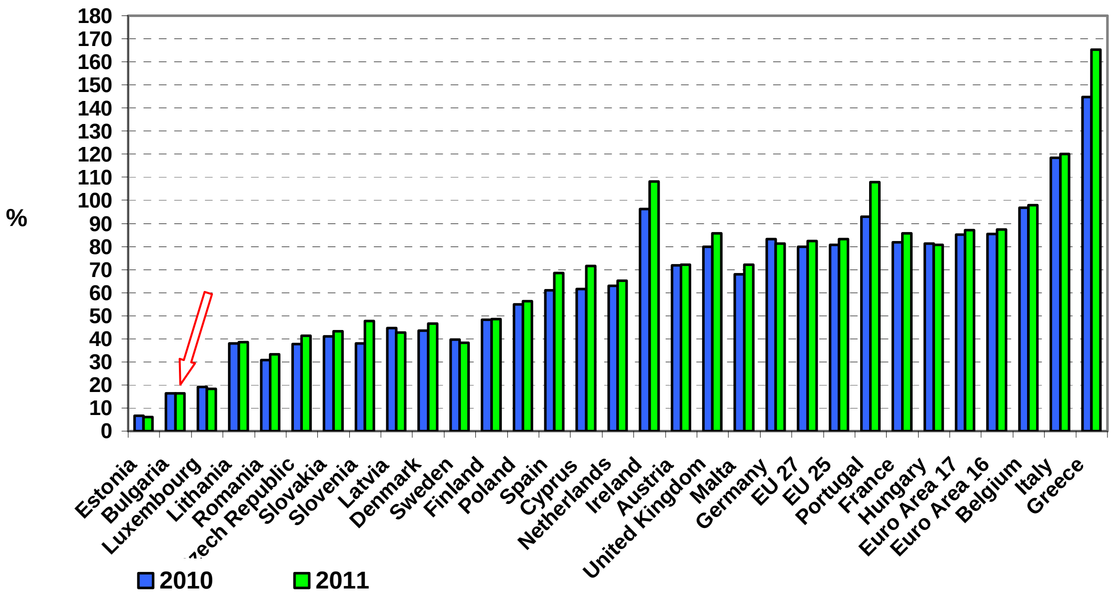
Chart 3: *Government debt/GDP ratio for the period 2006-2011*



As a direct consequence of the global economic crisis, the past year marked a considerable increase in government debt levels in the European Union. In these conditions, for the second year in a row, Bulgaria tops the list of EU member states, being second after Estonia, with a debt[1]/GDP ratio of 16.3 % at the end of 2011.

These data are yet another piece of sound evidence of the government debt management policy implemented by the current Government under constraints far tighter than the requirements applicable to member states of the Euro Area, where the average value of the debt/GDP ratio was 87.2 % at the end of 2011 . The low levels of this indicator achieved over the years are significantly below its reference value ceiling of 60 % set in the Maastricht criteria.

Chart 4: *Government debt/GDP ratio in the period 2010-2011 in EU member states, ESA 95*



➢ ***Domestic government debt and main trends in the development of the domestic government securities market***

The growing importance of government securities issued in the domestic market sets them apart as a major component in the government debt composition and, hence, as a major debt instrument in financing the borrowing needs of the government. By maintaining one of the lowest debt/GDP ratios in Europe and successfully controlling budget deficits, in an

[1] The consolidated government debt measured in accordance with the Manual on Government Deficit and Debt under the European System of Accounts 95 (ESA'95) represents the debt of the "General Government" sector, which consists of debt in the sub-sectors of "Central Government", "Local Government" and "Social Security Funds", with the exception of such liabilities the matching financial assets of which are held by the „State Government" sector.

extremely high-risk economic and financial environment, Bulgaria has reinforced its status as one of the most stable debt issuers in the region. Its increased international prestige further contributed for the development of an efficient investor base in Bulgaria by attracting new long-term investors, which is extremely important for the country.

Table 1: Domestic government debt in the period 2009-2011

Domestic sovereign debt stock	as of 31.12. 2009		as of 31.12. 2010		as of 31.12. 2011	
	BGN mln	%	BGN mln	%	BGN mln	%
1. Government security issues	2 705,3	89,9%	3 652,4	92,8%	4 220,5	87,8%
2. Government securities, structural reform	304,1	10,1%	281,7	7,2%	252,5	5,3%
3. Domestic loans	-	0,0%	-	0,0%	335,0	7,0%
Total	**3 009,5**	100,0%	**3 934,2**	100,0%	**4 808,0**	100,0%

At the end of 2011, the nominal amount of the domestic government debt was BGN 4 808 million. Over the previous three-year period (2009 - 2011), no considerable changes were observed in its composition. As of the end of the period, government securities issued by auction retain their highest relative share of 87.8 %, followed by government securities issued for structural reform purposes – 5.3 %. At the end of 2011 the average duration of bond issues outstanding reached 5 years and 4 months, up from 3 years and 11 months at the end of 2008. During the reporting period, the Ministry of Finance pursued a flexible and market-oriented debt issuance policy, placing on the market government securities from the entire range of the debt curve, including short-term securities and securities denominated in euros in order to attract the interest of a broader range of investors with diverse preferences and risk profiles. All securities placed were fixed-interest coupon. The total face value of newly-issued government securities was BGN 3 121.2 million, of which T-bills with a total face value of BGN 235.9 million and bonds with a total face value of BGN 2 885.2 million, distributed in the following maturity segments by year:

Table 2: New government securities issued in 2009-2011

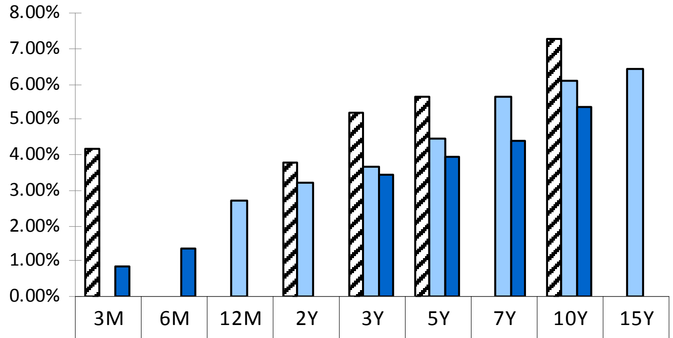
in BGN mln

Government security issues	*Currency denomination*	*Face value of government securities issued*			
		2009	*2010*	*2011*	*Total for the period 2009 - 2011*
Treasury bills		***43,24***	***150,81***	***41,80***	***235,85***
3-month	BGN	43,24	-	15,00	58,24
6-month	BGN	-	-	26,80	26,80
1-year	BGN	-	150,81	-	150,81
Treasury bonds		***445,50***	***603,11***	***800,73***	***1 849,34***
3½-year	BGN	-	30,00	276,51	306,51
5-year	BGN	288,00	130,00	-	418,00
7-year	BGN	-	130,00	170,23	300,23
10-year	BGN	157,50	-	31,09	188,59
10 ½-year	BGN	-	313,11	322,90	636,01
Total amount of BGN-denominated issues (T-bills and bonds)		***488,74***	***753,92***	***842,53***	***2 085,20***
Treasury bonds					-
3-year	EUR	-	-	-	-
2 ½- year	EUR	-	296,36	-	296,36
5 - year	EUR	-	-	281,64	281,64
15 -year	EUR	-	457,87	-	457,87
Total amont of EUR-denominated issues		***-***	***457,87***	***281,64***	***739,51***
Total government securities issued		***488,74***	***1 211,79***	***1 124,17***	***2 824,70***

As part of the pro-active government debt management policy, a number of innovative instruments were implemented during the past period, including repurchase agreements and debt swaps by auction. These operations helped improve the liquidity of the domestic debt market and were aimed primarily at smoothing out the redemption profile of the government debt, thereby reducing the refinancing risk of the government debt portfolio, in connection to the pending peak payments on the Global bonds falling due in 2013 and 2015, and at generating savings on interest expenditures.

As a result of implementing a debt issuance policy which was flexible and adequate to the financial situation, the following positive trends in the local market of government debt were reported for the past three-year period as a whole:

Chart 5: *Government securities yield achieved on the primary market*



	3M	6M	12M	2Y	3Y	5Y	7Y	10Y	15Y
2009	4.16%			3.80%	5.17%	5.63%		7.28%	
2010			2.70%	3.22%	3.69%	4.46%	5.62%	6.08%	6.45%
2011	0.85%	1.38%			3.43%	3.96%	4.38%	5.36%	

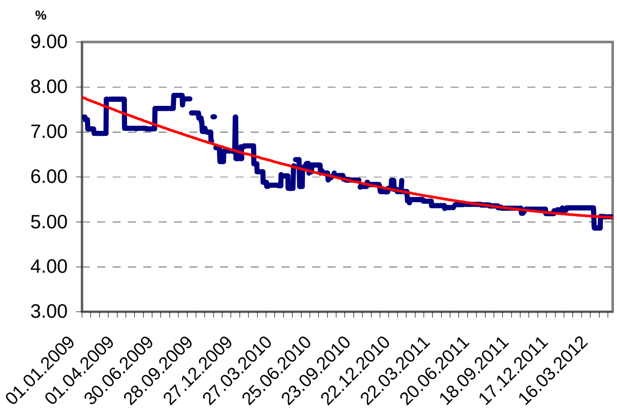
- **Building a highly-liquid benchmark debt yield curve;**

  The active debt issuance policy of the Ministry of Finance on the primary market both in terms of diversifying the currency composition and maturity structure, and in the context of the established practice of reopening bond issues outstanding helped satisfy a broad range of investors with various investment goals and time horizons;

- **Lower yield in primary market;**

  The yield curve over the three-year period made a “parallel shift” to lower yield levels. The weighted average yield of government securities issued in the period 01.01.2011 - 31.12.2011 was 4.21 %, which marks a considerable drop from the 2010 level of 5.06 %, and from the 2009 level of 5.66 %.;

Chart 6: *Long-term interest rate in the period January 2009 - March 2012 (Source: ECB)*

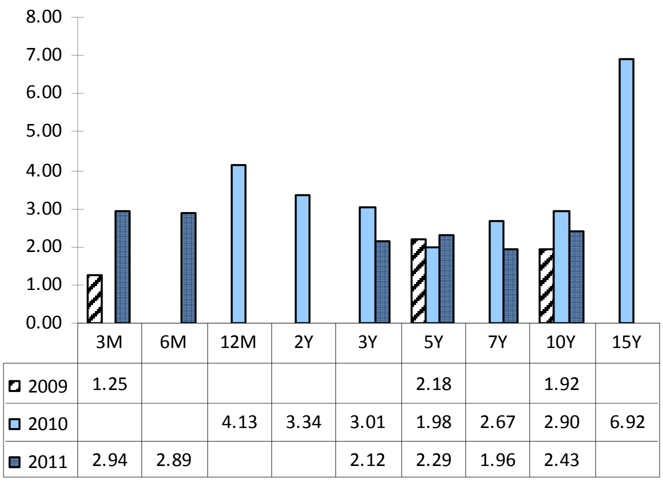


- **Stability and development of long-term supply and demand;**

  The long-term interest rate used in assessing the level of convergence and calculated on the basis of the yield of the benchmark 10-year government bonds of Bulgaria settled below the value of this indicator for 11 EU member states, six of which belong to the Euro Area.

According to this Maastricht convergence criteria, our country is moving in one frame with two member states of the Economic and Monetary Union. Over the period under review (2009-2011), the indicator exhibited a decline, falling from 7.33 % as of the end of 2008 to 5.26 % as of the end of 2011. In March 2012, the current values of the indicator reached record lows of less than 5%.

Chart 7: *Coverage ratios, average for the 2009-2011 period*



- **Government securities coverage ratios broke the record for the Bulgarian market, resulting into a growing demand for government securities and increased investor interest;**
  Throughout the review period, demand for government securities exceeded supply more than two times on the average, with a record-setting coverage rate on an average basis of 3.31 for 2010;

- **Building a highly-liquid and efficient secondary market of government securities**;
  The secondary market of government securities established itself as the most liquid, efficient and effective financial market in Bulgaria. Especially in times of crisis, the secondary market of government securities is an essential complement to the interbank market in providing deposits and facilitating market participants in the management of their liquidity; as it is in a direct relationship with financial market stability.

Table 3: Number and volume of transactions with government securities on the secondary market

Total	**8 999**	**14 957**	**15 013**	**40 293.1**	**76 115.3**	**77 557.9**
1. Repos	4 391	7 733	8 858	25 407.5	46 061.4	54 865.1
2. Final sales and purchases	289	771	804	752.1	1 560.4	2 189.0
3. Transactions with and for the account	1 906	1 861	2 013	3 705.2	3 092.2	3 678.5
4. Government securities	2 413	4 592	3 338	10 428.3	25 401.3	16 825.3

Source: BNB

Notes:

1. The transaction volume is shown at nominal value and includes government securities issued pursuant to Ordinance No. 5 of the MoF and BNB and for structural reform purposes, DVP or FOP on payment accounts with the BNB.
2. The number and volume of repo agreements include reverse repo agreements and those concluded during the current day .
3. The BGN countervalue of transactions in government securities denominated in foreign currency is restated in BGN at the BNB exchange rate of the respective currency on the day of transaction.

- **Bulgaria's credit rating upgrade;**
  The independent assessment of long-term debt stability has reinforced Bulgaria's status as one of the lowest-risk issuers in the region.

Table 4: Dynamics of the sovereign credit rating in the period 01.01.2009-31.12.2011

Credit rating agency	Date	Foreign currency credit rating		Outlook	Local currency credit rating		Outlook
		Short-term	Long-term		Short-term	Long-term	
Moody's	20.3.2009		Baa3	Stable		Baa3	
Moody's	31.8.2010		Baa3	Positive		Baa3	
Moody's	**22.7.2011**		Baa2	**Stable**		Baa2	
S&P	1.12.2009	A-3	BBB	Stable	A-3	BBB	Stable
S&P	17.12.2010	A-3	BBB	Stable	A-3	BBB	Stable
S&P	21.12.2011	A-3	BBB	Stable	A-3	BBB	Stable

Taking into account the dynamics in the development of debt markets and the need to use a wide range of instruments in order to improve the efficiency of government debt management, the Ministry of Finance continued its close coordination and active and full cooperation with the Bulgarian National Bank (BNB), acting as fiscal agent for government debt. In this connection and in response to suggestions made by participants in the government securities market adressed to the Ministry of Finance, BNB launched a project to add the Government Securities Registration and Settlement System (BNBGSSS) as an auxiliary system in TARGET 2-BNB. The two institutions have been working together to change the regulatory basis of trading in government securities and, in particular, on the ensuing amendments to Ordinance No. 5 of 2007 "The terms and procedure for acquisition, registration, redemption of and trade in government securities". The main changes aim to provide a more detailed regulation of the various types of transactions in government securities on the secondary market with regard to segregating transactions depending on whether they involve a movement in the cash settlement accounts (DVP) or not (FOP), which will help ensure transparency and efficient control over transactions in government securities in the secondary market. The constant exchange of information between the two institutions and maintaining an active dialogue with participants in the government debt market provides for a high level of trust and predictability in that important segment of the domestic financial market.

- ***External government debt and external borrowing***

External government debt as of the end of 2011 amounted to BGN 6 821.2 million, which represents an increase of BGN 425.2 million compared to the end of 2008. The external debt to GDP ratio for 2011 was 9.1 %.

Table 5: External government debt over the period 2009 – 2011

Amount of external sovereign debt	**as of 31.12. 2009**		**as of 31.12. 2010**		**as of 31.12. 2011**	
	in BGN mln	**%**	**in BGN mln**	**%**	**in BGN mln**	**%**
1. Bonds	3 082.7	47.9%	3 200.7	48.5%	3 242.9	47.5%
2. Government loans, including	3 351.6	52.1%	3 397.3	51.5%	3 578.3	52.5%
Government investment loans	1 509.7	23.5%	1 595.3	24.2%	1 734.9	25.4%
Total	**6 434.2**	100.0%	**6 598.0**	100.0%	**6 821.2**	100.0%

Compared to the previous strategy period (2006-2008), 2009 saw the first minor rise in external government debt of 0.6 %, followed by 2.6 % and 3.5 % in 2010 and 2011, respectively.

In the composition of external government debt in terms of creditors and debt instruments at the end of 2011, the main share belongs to government loans – 52.5 %, including government investment loans with 25.4 %, followed by global bonds[2] - 47.5 %, the holders of over 50 % of which were residents as of the end of 2011. In terms of foreign currency composition of external debt, the predominant share was that of euro-denominated debt - 70.9 %. The dollar-denominated debt accounted for 24.8 %, and debt denominated in Japanese yens and Kuwaiti dinars was 4.3 %. In terms of interest rate composition, the fixed rate obligations prevailed (73.7 %), and floating rate loans accounted for 26.3 %. Due to the all-times low interest rates at the end of the three-year period, the average interest rate on external debt reached 5.14 %, which is a reduction of more than 1 p.p. compared to the end of 2008. The redemption profile is well balanced, with the exception of the upcoming maturity dates of global bonds in 2013 and 2015. The average residual maturity of external debt as of the end of 2011 showed a reduction of about 6 months compared to the end of 2008 and was down to 7.9 years.

The analysis of external debt above reveals that it is exposed only to the risk associated with the concentration of payments on global bonds due in 2013 and 2015.

The external financing raised over the period under review is intended primarily for supporting the implementation of specific programmes and investment projects in strategic sectors of the economy.

During the period, two development policy loans (SIR DPL II and SIR DPL III) were disbursed. These are part of a series of government loans for policy development in the social sectors (education, healthcare and social assistance) financed by the International Bank for Reconstruction and Development (IBRD) in the amount of BGN 490.9 million. Disbursement began also under the Credit Agreement for a structural programme loan (Bulgaria, co-financing from EU Funds 2007-2013) between the Republic of Bulgaria and the European Investment Bank (EIB). The total amount of financing made available under the Credit Agreement as of the end of 2011 was BGN 263.6 million.

Under government investment loans, the amount used during the period is about BGN 555 million, of which about BGN 424 million from EIB under 7 loans, BGN 125 million from IBRD under 6 loans, and BGN 6 million from other creditors (JBIC and KfW).

The EIB loan funds are used to implement 5 investment projects: „Waste water treatment in the Maritsa River basin", „Construction of a new cross-border multi-modular (road and railway) bridge on the River Dunav between the towns of Vidin (Bulgaria) and Calafat (Romania)" (financed by two loans), "Rehabilitation and upgrading of the railway section Plovdiv – Svilengrad – Turkish border – Greek border" (also financed by two loans), „Transit roads V" and „Regional and municipal water supply", to be used mainly to co-finance the Integrated Water Project for the city of Sofia.

The implementation of the project „Waste water treatment in the Maritsa River basin" was completed at the end of 2011. Three new waste water treatment plants with secondary biological treatment and tertiary treatment in Stara Zagora, Haskovo and Dimitrovgrad have been built, and the sewerage system on the left bank of the Maritsa River in the Dimitrovgrad area has been rehabilitated and extended.

During the period 2009 – 2011, under the project „Construction of new cross-border multi-modular (road and railway) bridge on the River Dunav between the towns of Vidin (Bulgaria) and Calafat (Romania)", 72 % of the construction works on the bridge and 89 % of the works on the associated infrastructure on the Bulgarian side have been completed. In 2012, the railway tracks, road lanes, electric and other systems on the bridge will be built.

[2] Issued in 2002 to replace Brady bonds.

Under the project „Rehabilitation and upgrading of the railway section Plovdiv – Svilengrad", construction works have been completed from the village of Kroumovo to the entry into Dimitrovgrad, with about 50 km one-way fast railway track and 18 km two-way fast rail road, 9 railway bridges, 3 railway underpasses, 4 new traction power substations built, and 58 km of electricity contact grid mounted. The activities to be implemented in 2012 include the section between the entry into the town of Dimitrovgrad and the town of Svilengrad, and the correction of certain shortfalls which were identified.

In 2010 – 2011, construction and assembly works were completed on five lots of the project „Transit roads V", with a total length of 333.3 km. This included the following Class 1 national road network sections: Shipka pass – village of Shipka, Kalofer - Kazanlak, Shipka pass – Sheinovo – Dunavtsi and Maglizh – Gourkovo; and Class 2 national road network sections: the village of Banya – Trakia motorway, Rousse – Silistra and Silistra – Dobrich. Another 247.09 km of the national road network are expected to be completed in 2012.

Under the project „Regional and municipal water supply (Integrated Water Project for the city of Sofia)", the following have been completed and commissioned into operation: the waste water treatment plants in Koubratovo, Mala Tsarkva and Passarel, the sewage pump station in Novi Iskar, water and sewerage grid of the city of Sofia (trunk sewer Bankya - Kakach, the Rila water pipeline and the Vladaya left-side lateral sewer, Perlovska right-side lateral sewer, Slatina right-side lateral sewer, Vladaya right-side lateral sewer and the water pipeline along Blvd. Cherni Vruh in Sofia).

In terms of IBRD financing during the period, (1) two government investment loans were taken out: for implementing a social inclusion project in support of early child development, where the target group is disadvantaged children and children from low-income families; and for implementing a project in municipal infrastructure development aimed at improving planning in the water and sewage grid sector and investments in water dams. (2) The implementation of a project to rehabilitate road infrastructure continued, and a second project was launched, to facilitate trade and transport. (3) A cadastre and property registration project was completed in mid-2009, and a project for social investments and promoting employment was completed in mid-2010.

The road infrastructure rehabilitation project has the following goals: rehabilitation of about 307 km of road sections, Class I, II and III; improvement of the institutional capacity of the Road Infrastructure Agency, the Ministry of Regional Development and Public Works and the Ministry of Transport, Information Technology and Communications; and development and implementation of a package of measures to improve road safety. The main purpose of the project is to reduce road transport costs by improving the condition and the quality of the road network in Bulgaria in the first years following its accession to the European Union.

The second project, to facilitate trade and transport, finances improvements in infrastructure and processes along the external borders of the Republic of Bulgaria as an EU member state. The main investments focus on the delivery of equipment for a number of border checkpoints, including Kalotina, Kapitan Andreevo, the ports of Varna and Bourgas, the rehabilitation and upgrading of border checkpoint Kapitan Andreevo and several smaller checkpoints and the construction of an approach section of the Maritsa motorway leading to border checkpoint Kapitan Andreevo, and its respective infrastructure.

The completed projects on the cadastre and property registration, and social investments and promoting employment, are aimed at the establishment of a single national system of cadastre and property title registration system and, respectively, the creation of social capital in small and poor communities and municipalities by providing grants for micro-projects for infrastructure improvement and small investments.

In 2010, a government loan agreement was signed between the Republic of Bulgaria and Kreditanstalt für Wiederaufbau (KfW), Frankfurt am Main, Germany, to finance the project "Technical infrastructure 2010-2013". The loan is aimed at strengthening embankments and road infrastructure against landslides and floods in the areas of Rousse, Silistra and Pomorie. To date, a consultant has been selected for Pomorie and Silistra. Consultation and approval procedures are underway with the municipalities of Rousse, Silistra and Pomorie, and the development and construction documents required under the Spatial Planning Act are being prepared.

- ***Government debt service costs***

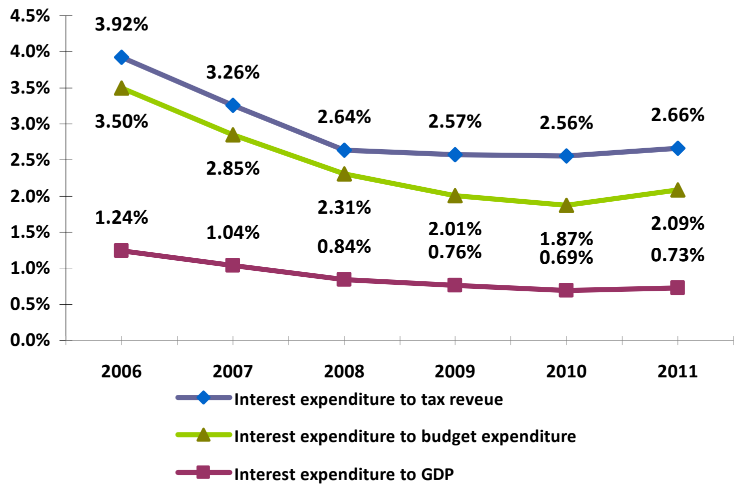
During the period, interest paid out in servicing government debt averaged about BGN 500 million per annum, with the largest portion of interest payments (51.2% per annum on average) associated with bonds issued on international capital markets, followed by payments on government securities issued on the domestic market (30.1% per annum on average) and the interest payments on government loans (18.7% per annum on average).

Table 6: Interest expenditures over the period 2009 – 2011

Amount of interest paid	2009		2010		2011	
	in BGN mln	%	in BGN mln	%	in BGN mln	%
External debt interest payments	**358,33**	**71,8%**	**325,60**	**71,6%**	**335,83**	**66,3%**
on bonds issued on international capital markets	249,16	49,9%	249,56	54,9%	247,43	48,8%
on external government loans	109,17	21,9%	76,04	16,7%	88,40	17,4%
Domestic debt interest payments	**140,98**	**28,2%**	**129,37**	**28,4%**	**170,85**	**33,7%**
on government securities issued by auction	128,16	25,7%	125,49	27,6%	168,74	33,3%
on government securities for structural reform purposes	12,83	2,6%	3,87	0,9%	2,11	0,4%
Total interest paid on sovereign debt	**499,31**	**100%**	**454,97**	**100%**	**506,68**	**100%**

The interest expenditure to GDP ratio and the interest expenditure to tax revenue ratio are widely used indicators enabling an assessment of both the debt burden and the ability of the country to meet its upcoming interest payments. At the end of 2011, the interest expenditures/GDP ratio reached about 0.7 %, i.e. significantly below the 1.5 % assumption made in the previous GDMS 2009 - 2011. The interest expenditures /tax revenue indicator for 2009 – 2011 ranges between 2.6 % and 2.7%, and interest expenditures/budget expenditures ratio ranges between 1.9% and 2.1%.

Chart 8: *Interest expenditures to GDP; interest expenditures to budget expenditures and interest expenditures to tax revenue ratios, 2006-2011*



Despite the registered increase of government debt, the values of the indicators in question fluctuate within a narrow range. The main contribution to limiting interest expenditure came from the conservative policy implemented in new borrowing and the sustainable debt structure achieved, the registered all-time lows of interest rates and the low yield levels reached for government securities issues on the domestic market.

2. Debt portfolio structure and risk exposure

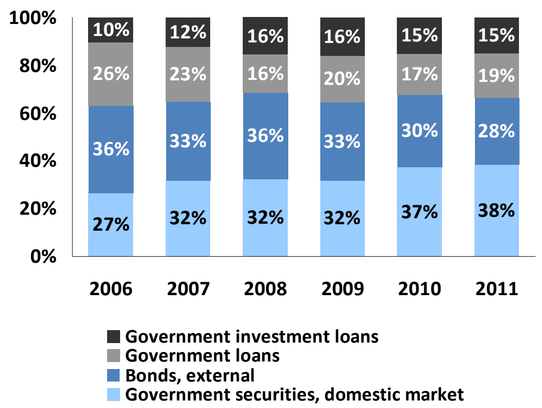
During the reporting period, the government debt management policy was focused on the strategic goals set in GDMS 2009-2011 and resulted in a well-balanced government debt composition as of the end of 2011, including by instrument type, currency, interest rates and maturity.

The values of risk indicators used reveal that the debt portfolio is exposed only to refinancing risk, in view of the concentration of payments pending on the global bonds in the short-term in 2013 and 2015.

➢ *Government debt by type of debt instruments*

As a result of active market-oriented borrowing policy implemented during the period, the government debt structure by type of instrument showed some significant changes as of the end of 2011 compared to the end of 2008. The predominant part of the total amount of debt as of the end of 2011 was the government securities – 66.3 %, of which debt issued on the domestic market – 38 % (BGN 4 473 million), and debt issued on the international markets – 28 % (BGN 3 242.9 million). From 2008 to 2011, the relative share of bonds issued on the international markets decreased. In 2010 and 2011, the government debt structure was dominated by government securities issued on the domestic market.

Chart 9: *Government debt by type of debt instrument 2006-2011*

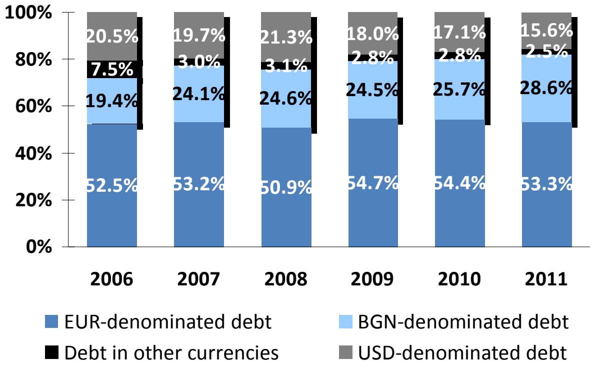


The change was primarily due to shifting the debt policy focus to ensuring a reliable, timely and efficient financing of the budget by issuing government securities on the domestic market. Government loans, including domestic and external, represent 34 % of the total government debt. An important part of the external government loans are loans for financing investment projects, and these amounted to BGN 1 734.8 million, or 15 % of the total government debt.

➢ *Currency composition of government debt*

The currency composition of government debt (Chart 10) shows continuation of the establish trend towards increasing the BGN- and euro-denominated debt (81.9 % as of the end of 2011, including 28.6% in BGN and 53.3% in euro). This is in line with the priority set in the previous strategy paper of maintaining the predominant role of government debt denominated in BGN and in euro – over 75 %. For comparison, at the end of 2008, this component accounted for 75.5 % (including 24.6% in BGN and 50.9% in euro). The share of USD-denominated debt exhibited a decrease, falling from 21.3 % at the end of 2008 to 15.6 % at the end of 2011. The positive changes in the currency structure of government debt are the result of a consistent policy in new borrowing focused primarily on the issuance of government securities on the local market exclusively in BGN and in euro, negotiating external loans in euro, and also the result of making regular debt redemption payments.

Chart 10: *Currency structure of government debt*

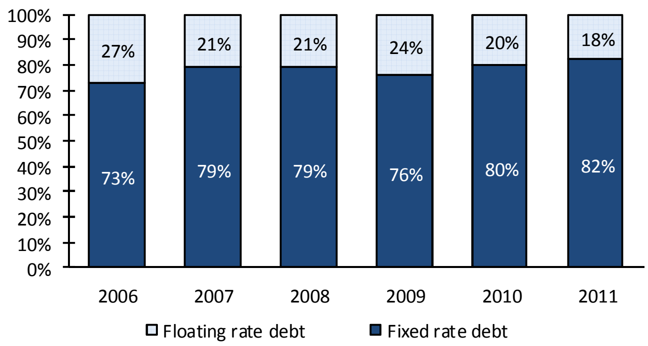


The currency exposure of government debt and the existing currency board arrangement, hence the pegging of the lev to the euro, limit debt vulnerability and the exposure of debt servicing to exchange rate fluctuations, thus improving its risk profile.

➢ ***Interest rate structure of government debt***

Throughout the three-year period, the interest rate composition of government debt remained relatively unchanged and corresponds to the goals set in the previous strategy paper: to restrict government debt service cost by increasing the fixed rate portion of government debt to over 70 %. At the end of the three-year period, fixed rate debt accounts for about 82 % of the total government obligations, against 18 % for floating rate debt. The major portion of floating rate debt is tied to the six-month LIBOR (London Interbank Offered Rate) of the euro (15.4 % as of the end of 2011), which, paired with the fact that over the period under review, that market indicator reached all-time lows, facilitated the implementation of an efficient cost policy.

Chart 11: *Interest rate structure of government debt*



The achieved changes in the interest rate composition of government debt suggest a **low vulnerability of the debt profile in terms of interest rate risk**, while providing for a **better predictability** with regard to the cost of servicing government obligations.

➢ ***Redemption and maturity profile of government debt***

As of the end of 2011, government debt was relatively well rescheduled in time, with the exception of the pending peak payments on the global bonds falling due in 2013 and 2015.

Chart 12: *Redemption profile, in BGN million*

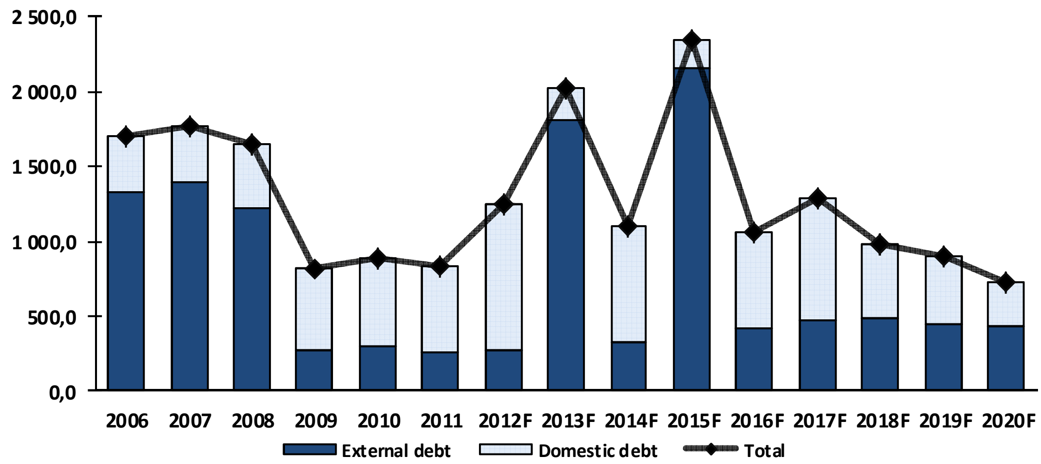
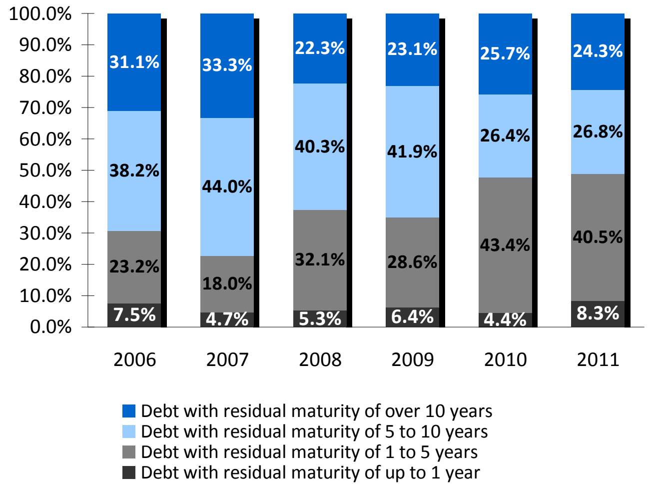


Chart 13: *Maturity structure*



The original maturity of government debt was retained throughout the three-year period at about 13 years, and as of the end of 2011 it was slightly above 12 years and 10 months.

The residual term to maturity of government debt went down from 7 years and 2 months to 6 years and 7 months. The main reasons behind the registered drop are the natural amortisation of government liabilities, and the placement of shorter-term government securities on the local market.

The average time to maturity (ATM) indicator, which shows the weighted average time required to renegotiate the debt portfolio, fell from its level in the previous period - 10.9 years at the end of 2008 to 9.3 years as of the end of 2011. The decreased ATM value suggests a portfolio exposed to a degree to refinancing shocks compared to the end of 2008.

The portion of short-term government debt as of the end of 2011 reached 8.29 % of the total amount of government debt. This is an increase of about 3 p.p. compared to its level at the end of 2008. The relatively low level of this indicator practically does not point to any significant influence on the risk profile of government debt.

3. Government guarantees

As of the end of 2011, government guaranteed debt (GGD) amounted to BGN 1.2 billion, which consists largely by external government guaranteed debt. Compared to the end of 2008, government guaranteed debt went down by BGN 43.8 million in nominal terms. The government guaranteed debt/GDP ratio as of the end of the period was 1.6 %, which is a reduction by 0.2 % compared to the value as of 2008 yearend. The relatively low values of GGD to total stock of government debt and government guaranteed debt (9.3 % as of the end of 2011) and GGD to GDP (1.6% as of the end of 2011) are preconditions for a lower vulnerability of the debt portfolio to shocks caused by an activation of contingent liabilities.

As of the end of 2011, a total of 15 government guaranteed loans were being serviced, distributed primarily between the transport (24.6 %) and energy (64.8 %) sectors. The composition of government guaranteed debt in terms of creditors does not exhibit any significant changes. The largest share remains for the group "Other" (international financial institutions, including EURATOM, CEB, JBIC and others), followed by the World Bank and EBRD.

Table 7: Government guaranteed debt by creditor, in BGN million

	2006	2007	2008	2009	2010	2011
Government guaranteed debt	**1 078.0**	**1 069.8**	**1 240.6**	**1 197.2**	**1 246.1**	**1 197.2**
I. Domestic government guaranteed debt	-	-	-	-	2.8	11.8
II. External government guaranteed debt	1 078.0	1 069.8	1 240.6	1 197.2	1 243.3	1 185.3
1. World Bank	179.1	161.0	145.4	119.2	101.7	87.0
2. EIB	13.7	11.6	9.5	7.4	5.7	4.5
3. EBRD	95.8	82.9	81.0	62.6	46.5	36.8
4. Other	789.4	814.3	1 004.7	1 008.0	1 089.4	1 057.0

In terms of the currency composition of government guaranteed debt, liabilities denominated in Japanese yens had a predominant share – 56.2 %, and a comparison to the same type of liabilities as of the end of 2008 reveals an increase of 14 %. The shares of liabilities denominated in U.S. dollars and in euros went down to 3 % and 39.8 %, respectively, as of the end of 2011. Compared to the end of 2008, the interest rate composition of government guaranteed debt demonstrated a rising trend for fixed rate debt throughout the reporting period (2009-2011), reaching 63.2 %. The average residual maturity of government guaranteed debt as of the end of 2011 was 10.3 years.

Over the period under review, **no new government guarantees** have been issued under external credit agreements. At the end of 2010, the student loan scheme [3] was successfully launched, and by the end of 2011 a total of about BGN 12 million was granted in loans.

During the period from 2009 to 2011, the government guarantees issued under the credit agreements of BDZ EAD and the International Bank for Reconstruction and Development (IBRD) and the European Bank for Reconstruction and Development (EBRD), and the guarantee under the agreement between Toplofikatsia Pernik and IBRD were partially activated. The state budget has been fully reimbursed for the guarantee for Toplofikatsia Pernik paid in 2009, and the amount paid out under the BDZ EAD government guaranteed loans has been repaid partially.

For the first time since the launch of the student loan scheme, the facility was activated and a loan of about BGN 5,000 was repaid at the expense of the state budget. The Student and

[3] The scheme is regulated by the legal framework of the Student and Doctoral-Candidate Loans Act, which aims at providing conditions to improve the quality of education and enhance access to higher education in Bulgaria. The main goal of the programme is to provide conditions for a free development of higher education, for access to higher education by sharing financial responsibilities between users and the government in accordance with the Higher Education Act.

Doctoral-Candidate Loans Act[4] stipulates that the government will pay the outstanding part of the total liability amount (principal and interest amounts) under the loan agreement in case of: the borrower's death; lasting incapacitation at 70 or over 70 per cent for a period longer than 3 years as of the date of disability; and in case of the birth or full adoption of a second or subsequent child within 5 years of the expiry of the grace period.

All other government guaranteed loans have been serviced in accordance with the agreed terms and repayment schedules.

Table 8: Key indicators of government guaranteed debt in the period 2006 – 2011

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Government guaranteed debt in BGN million	**1 078.0**	**1 069.8**	**1 240.6**	**1 197.2**	**1 246.1**	**1 197.2**
GGD as a percentage of total debt	8.9%	9.6%	11.6%	11.3%	10.6%	9.3%
GGD to GDP, %	2.1%	1.8%	1.8%	1.8%	1.8%	1.6%
BGN-denominated GGD, %	0	0	0	0	0.2%	1.0%
USD-denominated GGD, %	25.9%	20.3%	10.0%	6.5%	4.3%	3.0%
EUR-denominated GGD, %	55.9%	56.1%	47.8%	46.8%	41.8%	39.8%
GGD in other currencies, %	18.2%	23.6%	42.2%	46.7%	53.7%	56.2%
Fixed rate GGD, %	33.7%	37.9%	49.5%	54.1%	60.6%	63.2%
Floating rate GGD, %	66.3%	62.1%	50.5%	45.9%	39.4%	36.8%
Average interest rate on GGD	4.1%	4.6%	3.9%	2.2%	2.2%	2.5%
Residual term to maturity of GGD, in years	11.7	11.1	11.1	11.0	10.7	10.1

II. Macroeconomic overview

1. International economic situation

The financial and economic crisis which broke out in 2008 acquired a new dimension in the period 2010 – 2011. The substantial amounts of fiscal stimuli for the real sector and the rescue plans of financial institutions led to a dramatic increase of indebtedness in the public sector in a number of European Union countries. Feeble economic recovery paired with considerable amounts of debt in need of refinancing led to a debt crisis in the periphery of the Euro Area. The crisis manifests itself in restricted access to markets for financing public deficits which remain high.

In response to these serious economic problems, decisive actions were undertaken at the EU level and by the European Central Bank (ECB), in three major areas:

- In order to overcome the failing investor confidence in debt securities issued by some strongly indebted governments in the Euro Area and provide financial institutions with affordable financing, discussions were launched with a view of setting up supra-national institutions with the capacity to lend at rates which would be more favourable that those on financial markets. These include the European Financial Stabilisation Mechanism (EFSM), and the permanent European Stability Mechanism (ESM), incorporating the existing European Financial Stability Facility (EFSF), which were set up in 2010.

[4] Promulgated, SG No. 69/5.08.2008, amended, SG No. 12/13.02.2009, effective 1.01.2010 - amended, SG No. 32/28.04.2009, SG No. 74/15.09.2009, effective 15.09.2009, amended and supplemented, SG No. 99/15.12.2009, effective 1.01.2010

- At the common economic policy level, a policy of strengthening budget discipline was adopted as a means to resolve the heavy legacy of budget deficits and debt burden. One step towards the introduction of stricter fiscal rules was the adoption of a Treaty on Stability, Coordination and Governance in the Economic and Monetary Union by 25 EU member counties. Bulgaria adopted Chapter 3 of the Treaty, which refers to fiscal discipline on the part all member states expressed in restrictions concerning structural balance, mid-term budget targets, public spending and government debt levels. In addition, a package of six Regulations was adopted, to strengthen the Stability and Growth Pact and ensure strict compliance.
- The serious threats faced by the financial system in the Euro Area triggered an active intervention on the part of ECB. First, weak economic growth calmed concerns about high inflation rates in the Euro Area and enabled two consecutive decreases of the base interest rate on refinancing. At the end of the year, it stood at 1.0 %. The expected gradual recovery of economic activity will keep inflation, as measured by the Harmonized Index of Consumer Prices (HICP), as low as 2.0 %, ensuring price stability in the Euro Area in 2012.

In December 2011 and February 2012, ECB moved in to boost liquidity by means of the so-called “Long-Term Refinancing Operations (LTRO)” Programme in the form of three-year loans to a number of European banks. The intervention had a positive effect on banking system liquidity and resulted in shrinking spreads on the bonds of certain countries such as Italy and Spain.

The measures implemented by ECB and the EU, in conjunction with the successful restructuring of the debt of the Greece Republic to private creditors through a long-term strategy to reduce debt and deficit and a fundamental restructuring of its fiscal sector to prevent the generation of new debt in the future, caused financial markets to calm down considerably since mid-March 2012. In united Europe, the focus of attention shifted away from problems with the debt burden to economic growth recovery.

2. Bulgaria’s macroeconomic indicators

Since the Bulgarian economy is small and open to the influence of global processes, developments in Europe affect developments in its macroeconomic indicators. Problems in Europe from the second half of 2011 had a pronounced impact on our country.

2.1. GDP growth

Against the backdrop of such economic instability, Bulgaria’s GDP[5] in 2010 and 2011 went on to register a real growth of 0.4 % and 1.7 %, respectively, on an annual basis. With regard to components of final consumption, the main contributor in GDP growth in 2011 was exports of goods and services, although with a more modest growth (12.8%) than in 2010. The high rates of increase in exports in early 2011 helped retain its contribution to GDP growth, although the wearing off of the base effect from 2010 and the worsening situation of the external macro environment in mid-2011 indicate a slowdown in the growth of exports. This development can be observed in the December growth of the export of goods, which slowed down to 13 % on an annual basis in nominal terms. Exports in the course of the year determined also the faster growth of imports, which reached 8.5 % in 2011. At the same time, final consumption in Bulgaria shrunk by 0.3 %. Investments continued to exert a negative, even less influence on GDP growth, registering a 1.6 % decline.

[5] With GDP in 2011 of BGN 75,265.3 million, preliminary data provided by the National Statistics Institute as of 6 March 2012.

Since consumption accounts for about 76.2 % of the GDP, its weak growth will continue to act as a restraining factor on GDP growth. The reasons for this will be the persisting expectations of high unemployment and the continuing consolidation in the public sector. With investments still low in volume and a slowdown in exports due to the expected slight recession in the Euro Area, Bulgaria's GDP growth in 2012 is not expected to exceed 1.4 %.

2.2. Inflation expectations.

Inflation at the end of the calendar year (in HICP terms) slowed down to 2 %, from 4.4 % at the end of 2010. **National price dynamics in 2011 was largely a reflection of fluctuations in international prices of food and energy goods.** According to the latest forecasts of the Ministry of Finance, the period 2012 – 2014 is expected to see low inflation rates of around 2.5 %, at the end of each year. The main risks related to inflation forecasts lie in the dynamics of international prices and the rate of economic growth in Bulgaria. Low inflation expected in the coming years is a factor for a more sustainable development of the national economy.

These two macroeconomic factors (the change in real GDP and the inflation rate), together with the fiscal factor (the need to ensure financing for the budget), are key drivers in the change of government debt in real terms. A possible slowdown in the growth of global economy may result in poorer performance of Bulgaria's exports, which would have a negative effect on overall growth and tax revenue. The financial crisis experienced by international markets may have an adverse effect on budget revenues not only in terms of shrinking external demand but also of domestic demand, since a higher insecurity in the national economy could curb the decline in investments and consumption.

2.3. Banking system[6]

The financial sector remained stable in 2011, despite shocks in the external environment, worsening economic development outlooks in the Euro Area and the negative expectations of international institutions as to their effects on the Bulgarian economy. The spreading risk aversion among international investors slowed down the inflow of foreign investments.

The banking system, which dominates the local financial sector, operated in an environment of slow recovery of economic growth. The dynamics on the labour market and in income levels failed to provide sufficient support for domestic demand so as to raise solvent demand for loan resources or restrict the share of bad loans which continues to increase.

As a preventive measure and in response to the insecure economic environment, economic agents continue to show a preference for building up their savings, almost exclusively in the form of bank deposits. Deposits in the banking system grew by 4.3% on an annual basis at the end of December 2011, reaching BGN 65.7 billion. In early 2012, these trends persisted and as of the end of March deposits grew by 5.2 % on a year-to-year basis. In 2011, lending exhibited a relatively weak growth of 4.1% as of the end of December, when gross loans (not including loans to credit institutions) reached BGN 56 billion. As of the end of March 2012, the pace of credit growth slowed down somewhat, to 3.7 %, which is normal, in view of the more subdued economic activity at the beginning of the year.

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[6] Source of banking system data: BNB.

The strong volatility in financial markets and the relatively weak level of development of any other financial intermediation channels (a considerably lower share of balance-sheet assets of financial non-banking institutions in GDP terms) do not help provide a viable alternative to bank deposits yet. Hence, in December 2011, deposits of individuals and households grew by 13.8 % on an annual basis and amounted to BGN 31.9 billion (42.4 % of GDP), while in institutions other than credit institutions, the annual rate of increase was 11.3 %, up to BGN 21.6 billion (28.5 % of GDP). At the end of March, deposits of households and non-credit institutions increased on a year-to-year basis by 14.3 % and 7.3 %, respectively. It is important to note the trend towards an increasing role of deposit resources from domestic sources.

The considerable amount of savings attracted by banks provided them with significant financial resources and further strengthened their liquidity positions. Due to the impossibility to use these resources to finance the private sector in the form of loans in the current situation, banks took the opportunity to repay considerable amounts of their external liabilities. The availability of stable sources on the domestic market and profit capitalisation, together with the BNB policy of maintaining and strengthening the capital and liquidity buffers serve as factors generating stability in the national banking system.

Despite the adverse effects of a number of factors, adequate balance sheet and cash flow management makes the Bulgarian banking system one of the best capitalised in the European Union, well-positioned with regard to liquidity and profitability. The inflow of deposits at a low cost and weak lending activity lead to higher liquidity levels in the banking system. The liquid assets to total liabilities ratio was 25.53 % as of the end of 2011 and it is continuing to improve during the current year, reaching 25.75 % at the end of March. The total capital adequacy ratio reached 17.52 % at the end of March 2012, and the capital adequacy ratio of Tier 1 capital reached 15.84%. Bulgaria’s banking system continues to generate a positive net income, which stood at BGN 474 million as of December 2011. In the first quarter of 2012, Bulgarian banks reported a net financial result of BGN 175.7 million. Return on assets (ROA) improved from 0.63 % at the end of 2011 to 0.91 % at the end of March 2012.

2.4. Balance of payments

The above trends of limited consumption and increasing deposits in the banking system translated also in some significant changes in the dynamics of the balance of payments and its main components – the current, capital and financial accounts. The current account and capital account balance[7] in the period January-December 2011 were positive values and amounted to 2.2 % of GDP, against a registered deficit of 0.2 % of GDP in 2010. The current account also remained positive throughout 2011 at 0.9 % of GDP, recording a substantial improvement in comparison to the same period in 2010, when it registered a deficit of 1 % of GDP. A major factor in this development was the lower trade deficit (BGN 3 862.1 million). The balance of trade in 2011 was a negative 5.1 % of GDP, against a negative 7.7 % of GDP in 2010. This reduction was due to the faster growth of exports compared to the growth of imports. Another factor behind the positive dynamics of the current account was the balance of trade under services (BGN 4 473.4 million) and net income from current transfers (4.4 % of GDP). The only item which limited the current account surplus was “income”, with a negative balance in the amount of BGN 3 215.4 million or 4.3 % of GDP. The Ministry of Finance expectations are that in the period 2012 – 2014 the current account will move

[7] BNB data: balance of payments, January – December 2011, 15 March 2012.

smoothly from a positive balance (1.5 % of GDP in 2012) to a negative balance (-0.8 % of GDP in 2014).

The negative balance in the financial account in the period January – December 2011 amounted to BGN 2 335.8 million, against a deficit of BGN 1 366.2 million in 2010. Although foreign direct investments in Bulgaria remain at levels considerably below those in the pre-crisis period, an increase on an annual basis was reported in 2011, up to BGN 2 623.2 million, or 3.5 % of GDP, from BGN 2 363.6 million or 3.4 % in 2010. The prevailing low risk appetite among investors internationally, together with the redemption of liabilities by resident subsidiaries to their parent companies limited the net inflow of foreign investments in Bulgaria.

The dynamics of the financial account has conditioned also by the financial outflows related to:

- An increase in “Other investments, assets” by BGN 1 546.6 million;

- A reduction in “Portfolio investments, liabilities” by BGN 612.9 million in 2011, against a reduction of BGN 168.8 million in 2010.

- A reduction by BGN 2 319 million in liabilities to non-residents under “Other investments, liabilities”.

2.5. Gross external debt

The trends in the economic development of the country, as observable from the situation in the banking system and the dynamics of the balance of payments, led to a significant change in the size and trend of gross external debt in the Bulgarian economy. According to BNB data, as of the end of 2011, external indebtedness amounted to 92 % of GDP, registering a drop of 10.8 p.p. from 102.8 % of GDP in 2010. The largest contributor for this drop was the “Banks” sector, where external liabilities decreased by EUR 1 224.2 million (BGN 2 394.3 million) compared to the end of 2010, or by 4.3 p.p.: from 19 % of GDP to 14.6 % of GDP for the entire 2011. The same direction, but significantly lower in size, was observed in the change of debt in “Other sectors” and the „General government sector” (reductions of BGN 440 million and BGN 176 million, respectively). In GDP terms, the external liabilities of these sectors amounted to 7.2 % and 31.6 %, respectively, from 8 % and 34.4 % as of the end of 2010. Intercompany lending, which reflects the liabilities of Bulgarian subsidiaries to their non-resident parent companies, also showed a decrease of BGN 249.6 million or from 41.4 % of GDP in 2010 to 38.4 % of GDP in 2011.

The drop in external liabilities is a reflection of the weak investment activity of companies in the real sector and the availability of disposable financial resources, which are then used to extinguish external liabilities. The indications for a gradual recovery of economic activity in Bulgaria in the next couple of years create conditions for redirecting financial flows towards investments in the domestic market. In case investment opportunities emerge, maintaining liquid financial resources will be of key importance for the overall support of the economy.

3. Budget

Over the entire three-year period, the focus was and, in the mid-term continues to be, on implementing a prudent fiscal policy, maintaining macroeconomic stability and improving the sustainability of the Bulgarian economy, to enable the maximum extent of the neutralisation of any domestic and external imbalances.

In 2011, the fiscal and budget policy targets set in the State Budget of the Republic of Bulgaria Act (SBRBA) were aimed at keeping the deficit under the Consolidated Fiscal Programme below 3% of GDP, in line with the requirements of the Stability and Growth Pact, and achieving sustainable public finance and a balanced budget in the mid-term.

The legal basis for implementing a sustainable fiscal policy leading to a balanced fiscal position was set out in mid-2011, in the “Financial Stability Pact“. The Pact brought about certain amendments in the Structure of the State Budget Act (SSBA), effective as of 1 January 2012. National fiscal rules were adopted, aimed at providing long-term fiscal sustainability and implementing the framework of the Pact. The changes envisage capping expenditures under the Consolidated Fiscal Programme (CFP) at 40 % of projected GDP, and limiting the deficit of the consolidated budget to 2 % of GDP, thus restricting the redistribution role of the government and enabling a better allocation of expenditure items and facilitating the implementation of reforms to improve their efficiency and effectiveness. The purpose of the approved fiscal rules is to ensure continuity of fiscal policy and guarantees for compliance with Article 126 of the Treaty on the Functioning of the European Union, with regard to the reference values for budget deficit (3 % of GDP) and government debt (60 % of GDP).

As a result of the consistent and purposeful fiscal consolidation, 2011 ended with a significantly improved budget position, both on cash basis and when measured using the ESA 95 methods. The deficit in the “General government” sector in 2011 amounted to 2.1 % of GDP, against 3.1 % in 2010 г[8]. In 2011, Bulgaria achieved an additional fiscal effort amounting to 0.4 p.p. of GDP compared to the annual target set in the 2011-2014 Convergence Programme of the Republic of Bulgaria.

The 2012 State Budget of the Republic of Bulgaria Act set a CFP deficit target of 1.4% of GDP for 2012 on cash basis (1.6 % on accrual basis) and a minimum requirement for the amount of fiscal reserves of BGN 4.5 billion as of the end of the budget year. According to the 2012-2015 Convergence Programme of the Republic of Bulgaria, planned deficit under the CFP for 2013 is set at 1.3 % of GDP, 0.5 % for 2014, until a balanced budget is achieved in 2015.

The updated macroeconomic forecast for the next three-year period imposed strict discipline and a conservative fiscal policy in developing the three-year budget forecast for the period 2013-2015, which was manifested in retaining the assumptions underlying the previous forecasts when developing the main horizontal policies and in continuing to implement the earlier measures for reducing the national budget deficit.

III. Risk analysis

The implementation of a successful government debt management policy is underpinned to a large extent by an in-depth and exhaustive analysis of risks which may affect both the sustainability of debt in a situation of an economic and debt crisis, and the debt burden. The choice of appropriate debt instruments and their characteristic features, including maturity, currency and interest rates, makes it possible to mitigate their adverse effect on budget expenditures.

[8] According to ESA 95.

Risk monitoring and control are vital in order to minimise risk. Risk assessment for the period 2012 – 2014 was carried out under debt financing projections corresponding to estimates from the three-year budget forecast for the period 2013 – 2015 and the 2012 State Budget of the Republic of Bulgaria Act. Plans include issuance of government securities on the domestic market and on the international markets, as well as external borrowing in the form of disbursements under government loans and government investment loans.

The description of the risk exposure is backed by a sensitivity analysis of the debt portfolio and government debt service cost to fluctuations in exchange rates and market interest rates. Using the relevant risk indicators, the analysis determines the degree in which the debt portfolio is exposed to the various types of risk.

The risk analysis is organised in two parts. The first part examines risks stemming from the external environment, and the second part looks at risks associated with the structure of the debt portfolio.

1. Risks generated by the external environment

Currently, the external environment analysis reveals two major factors the dynamics of which is in the focus of attention of investors and policy-makers. On the one hand, the slowdown of economic development and fears of another recession in the world's leading economic powers, mostly in the European Union and Japan, and the slowdown in the growth of fast-growing economies like China, India and Brazil. According to a European Commission publication from April 2012[9], expectations are for a slight dip in GDP in the Euro Area (0.3%), while GDP at the EU level will retain its current value. On the other hand, the factor of inflation caused by rising prices of energy goods and, for the EU, also by the increase in indirect taxation.

1.1. Risk of economic slowdown as a result of the unfolding government debt crisis in the Euro Area

In 2011, the debt crisis in the Euro Area reached a new stage, affecting its banking institutions and the single European currency, and spreading its negative influence over the expectations of economic operators for economic recovery in the rest of the world.

On the one hand, the fiscal policy of austerity, leading to high unemployment rates and restricted consumption, poses the question about the ability of a number of European governments to return to faster economic growth. These negative outlooks and the persisting high budget deficits led to the downgrading of the credit ratings of a number of countries, primarily from the periphery of the Euro Area, by the leading credit rating agencies. The inability to ensure moderate economic growth and at the same time reduce fiscal deficits led investors to refrain from investing in securities issued by highly indebted countries from the Euro Area. This pushed up yields when raising new financial resources.

Despite the positive economic environment and the firm political commitment of EU governments to deal successfully with budget challenges, the debt crisis, especially at the end of 2011, had the following negative effects on taking on government debt:

- **Higher yield on the issuance of fixed-income securities**

In the context of the current economic instability, the interest of investors switches to low-risk instruments on the money market and the debt markets of government securities issued by countries such as the U.S., Japan and Germany. This trend is observed both in the

[9] European Economic Forecast, Spring 2012, European Commission, Directorate General for Economic and Financial Affairs.

case of economic turbulence and in the case of political instability in certain sensitive places around the world. To attract investor interest, higher-risk issuers have to offer higher yields. Which of these trends will prevail is a question to be answered depending on the investor sentiment as to the current situation of debt markets and outlooks for the global economy.

- **High and intense competition to attract financial resources on the part of government debt issuers and financing on international capital markets**

Deterioration in the economic situation would lead to a failure to implement the set targets for planned budget deficits, and hence to more intensive borrowing of financial resources on the international capital markets in order to finance budget deficits. Although certain countries from the Euro Area have been refused access to market-oriented financing, the functioning of stabilisation mechanisms (EFSM, EFSF and the expected introduction of the new ESM facility in 2012), competition for financial resources will remain brisk. The presence of high competition is an additional factor behind the higher cost of financing charged to issuers which are considered a higher-risk.

- **Issuing debt on markets other than the European capital market**

Speculations about the stability of public finance of countries from the Euro Area and of the European banking sector could cause the European debt market practically to close down – a situation which occurred after the announcement of the financial problems experienced by Greece in 2010. This would make it impossible for issuers to obtain the financial resources they need and would force them to enter other capital markets, borrowing in currencies other than their preferred ones, which would mean taking on additional risk.

- **Depreciation of the euro**

The appreciation of the U.S. dollar and the Japanese yen, in their capacity of havens in case of market stress, would lead to an increase in the cost of servicing debt denominated in these two currencies. Since the U.S. financial market is the most sophisticated one and has the broadest investor base, it naturally is an alternative to the European bond market.

The economic slowdown as a consequence of the developing crisis with government debts in the Euro Area, with its various manifestations, generates significant currency and refinancing risks. For that reason, EU countries with credit ratings similar to that of Bulgaria, which up until mid-2011 managed to borrow on international capital markets in euro, had to raise financing at higher yields during the second half of the year, at non-European markets and in currencies other than their preferred ones.

1.2. Inflationary risk

In 2010 and 2011, the inflation rate measured by the Harmonized Index of Consumer Prices (HICP) calculated on an annual average basis went up due to the rise in the prices of raw materials and the replenishment of stocks.

Under the hypothesis of a rising inflation within the GDMS period, borrowers would be affected negatively in the case of loans negotiated at floating interest rates which use as a basis the EURIBOR (Euro Interbank Offered Rate) or LIBOR (London Interbank Offered Rate). Currently, such expectations are relatively unlikely, in view of the forecasts of slower economic growth, yet their existence cannot be discarded, particularly with regard to the influence of the prices of energy resources.

Expected inflation in the Euro Area and the EU in 2012 and 2013, according to the latest forecasts of the European Commission from April 2012, will plateau at its current levels of about 2.0 %.

2. Risks generated by the debt structure

2.1. Refinancing risk

Refinancing risk is an indicator of the threat that it would be impossible to refinance the maturing debt, or would be refinanced at substantially unfavourable conditions. It is important to examine that risk separately from the interest rate risk, although it is focused exclusively on interest rate fluctuations at the time of refinancing the debt.

The redemption profile of the outstanding government debt is one of the main indicators used to measure the exposure of government debt to refinancing risk. Because the level of risk is a function of the time distribution and the size of payments towards the principal amounts in the debt portfolio, the upcoming high concentration of maturity dates in the short-term has a significant effect on indicators for measuring that risk and strengthens its importance in the period 2012 - 2014. Other indicators used, which also influence refinancing risk, are: the share of short-term government debt in the total amount of government debt, and the average time to maturity (ATM), which is a measure of the average time necessary to renegotiate the debt portfolio.

To reduce the impact of that risk, a number of measures were undertaken throughout the previous three-year period, implemented primarily by means of active debt operations on the domestic market of government securities, including by a careful distribution of the maturities of newly-issued government securities so that the concentration of maturity dates in the peak years 2013 and 2015 would not be additionally increased. A key factor in restricting the vulnerability of debt to that risk is the negotiation of long-term government loans. The adopted approach helped also reduce budget expenditures in years of peak repayments.

According to the calculations, ATM values continue to go down after 2011 as well, and for the period under review (2012 - 2014) they move within the range between 7.9 years and 6.5 years. The decrease in that indicator is an indication of the need to renegotiate debt more frequently, i.e. it generates a higher vulnerability of the debt portfolio to refinancing risk. Calculations of the indicator are based solely on debt financing envisaged for the upcoming three-year period and do not take into account any trends in its fluctuations which will occur as a result of the new debt financing in the post-2014 period.

Chart 14: *Average time to maturity, in years*

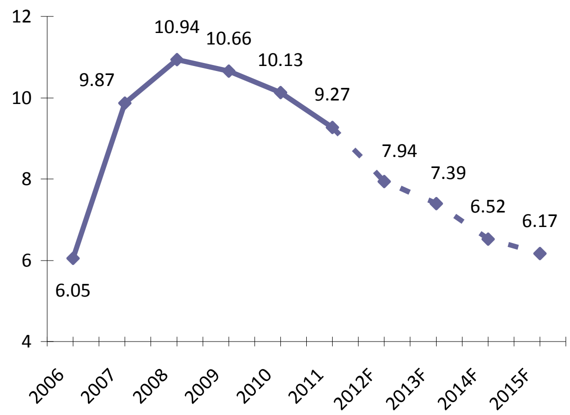
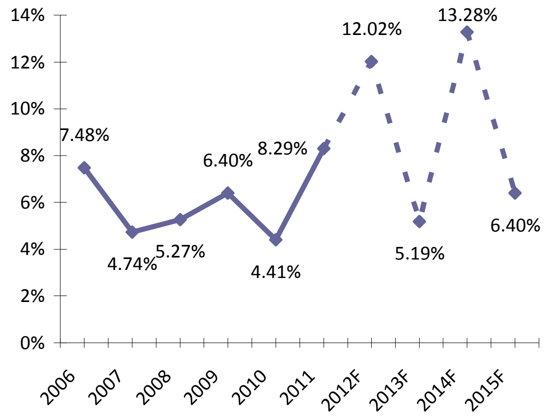


Chart 15: *Share of short-term government debt*



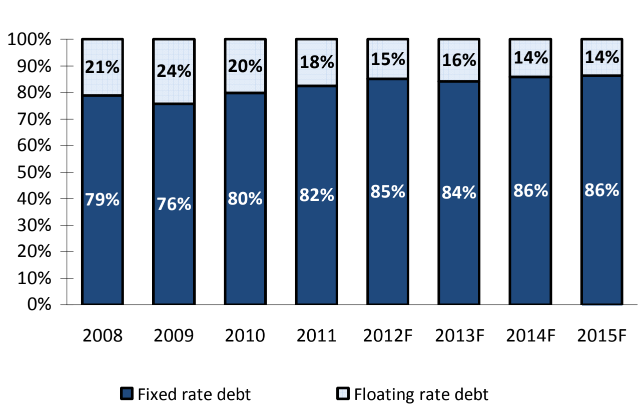
The portion of short-term debt in the overall amount of government debt in 2012 – 2014 rose from 12.0 % in 2012 to 13.3 % at the end of 2014. The main reasons for the indicated peaks have to do with the upcoming maturity dates on the global bonds falling due in 2013 and 2015, which fall within the scope of short-term debt as of the end of year preceding the respective maturity dates. Generally, short-term debt is considered higher-risk than long-term debt but if kept at moderate levels, it does not carry any significant exposure to refinancing risk.

The results presented above demonstrate that in the next three-year period managing refinancing risk will be of primary importance, which means to undertake **measures to extend the maturity of government debt, smooth out the redemption profile, plan an even schedule for future payments and avoid any concentration of payments in the future**. A key policy component of any strategy for reducing refinancing risk in the mid-term is the **development of the domestic market of government securities**, and the execution of repurchasing agreements and debt swap operations.

2.2. Market risk

Market risk refers to the risk resulting from changes in market prices; in particular, in terms of government debt management, the most significant influence comes from changes in interest and exchange rates. These changes influence debt service cost and may cause deviations from the amount of government debt service expenditures planned in the state budget. Therefore, it is necessary to undertake comprehensive measures and actions in order to minimise the negative effect of these changes. Some of these actions are monitoring, assessment and analysis of the status and development prospects of capital and money markets both internationally and domestically, modelling the interest and currency composition of government debt so as to prevent any strong exposure of the debt portfolio to the negative influence of changes in the said market indicators (exchange rates and interest rates). Such form of "protection" implies maintaining and increasing both the share of fixed interest coupons, and of debt denominated in currencies which are risk-neutral for the Bulgarian government such as the lev and euro. To this end, the debt issuance policy of the government over the past three-year period was aimed at borrowing funds primarily in BGN and in euros, and with fixed interest coupons. As a result of the prudent policy of government debt management, the fixed rate debt amounted to BGN 9 580.0 million at the end of 2011, which accounts for 82.4 % of the entire debt portfolio, and the portion of BGN- and euro-denominated debt reached BGN 9 524.7 million, or 82 % of the total government debt. Such a profile helps ensure a relatively good predictability of the cost of servicing the government debt.

Chart 16: *Interest rate structure*



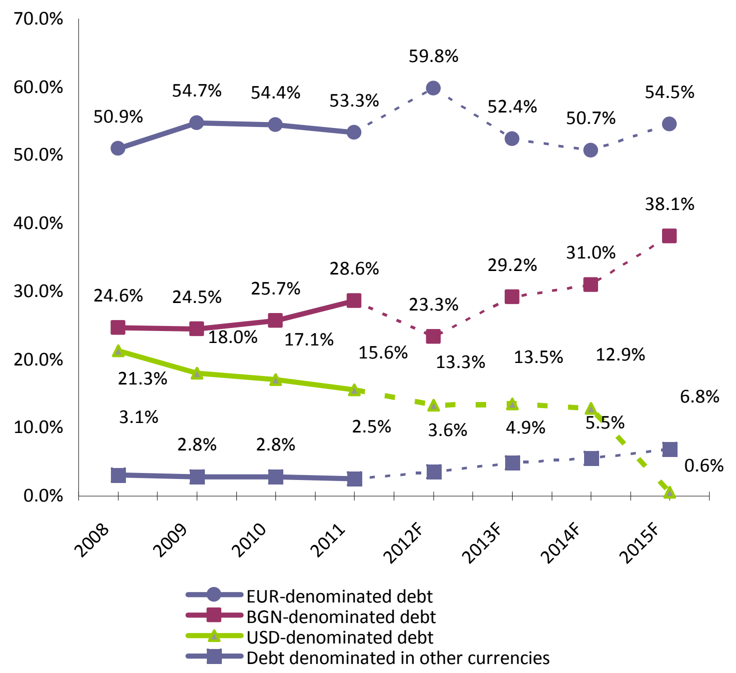
Interest rate fluctuations (i.e. interest rate risk) influence both expenditures associated with servicing current government debt, and the price of newly incurred government liabilities. The influence of such changes in interest rates and exchange rates on the size of payments during the next three-year period was subjected to a sensitivity analysis the results of which are shown below.

Projected payments on external government debt falling due in 2012 amount to about BGN 838.8 million, including principal payments of about BGN 350.1 million and interest payments in the range of BGN 488.7 million. Payments planned for 2012 on domestic debt amount to about BGN 951.7 million, including principal payments of about BGN 735.1 million and interest payments of about BGN 216.6 million. The maturity dates of the global bonds falling due in 2013 and 2015 are of particular importance for the government debt payments in the next three years. The projected amount of government debt payments in 2013 is about BGN 3.0 billion, with about BGN 2.0 billion and BGN 3.3 billion in 2014 and 2015, respectively.

In certain cases, when relatively large interest payments combine with strong interest rate volatility, the interest rate risk may turn into a primary destabilising factor for the government budget, due to considerable unplanned raise in interest payments due on government debt. Within the interest rate exposure of debt as of 31.12.2011, the largest share belongs to expenditures associated with liabilities based on the 6-month EUR LIBOR interest rate – 15.4 % (or BGN 1789.8 million), making the change in that market indicator the most substantial factor in determining the size of debt interest payments. In case of increasing by 2 p.p. over the next years, the interest payments on government debt would rise by an average of about 4.8 % per annum.

Risk related to interest rates fluctuations has a more substantial influence on government debt portfolio that any other market risk covered in this analysis. Currency risk, which is related to fluctuations in exchange rates, could be ranked as the second most important risk. In case the national currency should depreciate against a certain foreign currency, any liabilities denominated in that currency will increase in BGN terms.

***Chart 17:** Currency structure*



The strongest influence on expenditures associated with servicing the government debt of the Republic of Bulgaria might come from an appreciation of the U.S. dollar (USD), since as of 31.12.2011, BGN 1 812 million or 15.58 % of the government debt was dependent on changes in the EUR/USD rate, hence on the BGN/USD rate. A 20 % increase in the USD /EUR rate would increase interest expenditures by 3.5 % on the average per annum, and payments towards the principal amounts will grow by 0.3 %, which is negligible with respect to total debt payments.

Considering the fact that a small portion of the government debt of the Republic of Bulgaria is exposed to the influence of currency risk and interest rate risk, data from the analysis indicate a relatively weak effect of changes in the value of the exchange rate of the

U.S. dollar and of the six-month euro LIBOR rate on the cost of servicing the government debt. An increase in the other floating interest rates (the six-month U.S. dollar LIBOR., the six-month EURIBOR), and in the exchange rates of currencies other than the U.S. dollar to the lev would have an negligible effect. Nevertheless, when defining the specific terms for new debt issues, these rates will continue to be closely monitored and analysed.

Any significant appreciation of foreign currencies in which the government debt is denominated and the impossibility to offset that by a respective increase in tax revenue (or by cutting spending) could have an adverse effect on the state budget.

2.3. Liquidity risk

Liquidity risk reflects the probability of liquidity problems for the budget in the event of overlapping short-term liabilities of the government. In its essence, it is a variety of refinancing risk and is directly related to market risk.

Managing liquidity risk requires careful monitoring and control of the size of debt and the amount of expenditures required to service and refinance debt, since the emergence of any liquidity problems has a significant effect on the national budget and on the balance of payments, and the liquidity in the banking system and in the money market. The policy of managing that risk is extremely important for maintaining the country’s macroeconomic stability and confidence in the currency board arrangement.

For the period 2012 – 2014, risks related to the economic slowdown leading to a decrease in budget revenue will be very important for the public budget. The main focus in the government debt management policy is related to the retirement of the government bonds maturing in January 2013 and in January 2015 in order to prevent risks related to the liquidity of public finance. In this connection, efforts should focus on an in-depth and careful review and the implementation of the various options to refinance the maturing government debt and finance the consolidated government budget.

Under the existing currency board arrangement and the current global economic crisis, a responsible management of government liabilities implies the need to ensure access to financing and strengthen the confidence of the local and international capital markets.

In the context of these limitations, the debt issuance policy has a direct relation to, and supports, and when necessary, even facilitates liquidity in the financial system. Bulgaria’s investment class rating and its macroeconomic fundamentals ensure its capacity to obtain freely market-oriented financing both on the local market and on international capital markets.

Acting in a way that is timely and adequate to the market situation in view of the upcoming peak payments on the global bond issues falling due in January 2013 and 2015 will ensure a stable liquidity position of public finance.

2.4. Risk related to the size of the debt

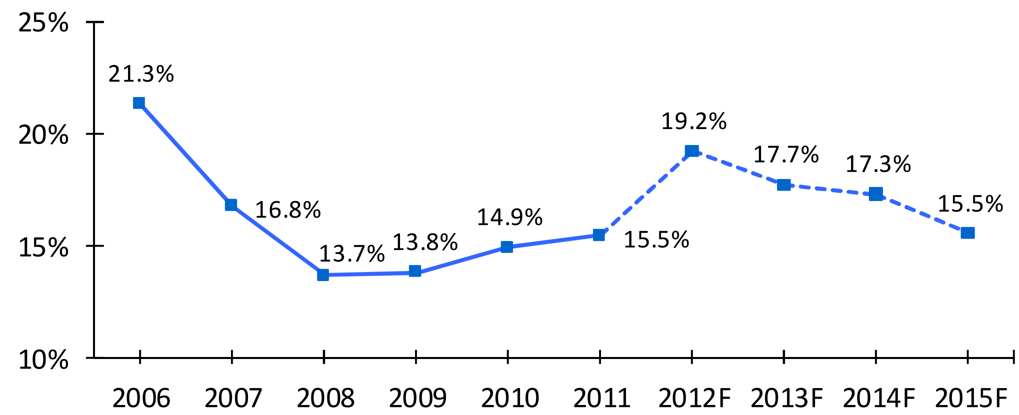
In most general terms, this type of risk is associated with the amount of the government debt, which under certain circumstances may generate considerable threats to the financial stability of the country. It is not by chance that the EU debt crisis in recent years which was caused by the difficulties experienced by certain member states in servicing their large debt exposures has had an adverse effect on the general economic and financial situation in the Union, and in the rest of the world, respectively.

An important indicator in assessing the vulnerability of the government’s financial position is the “government debt/gross domestic product (GDP)” ratio. The ratio between the consolidated government debt[10] and GDP may not exceed the reference value of 60 % identified in the Maastricht convergence criteria which our country has to comply with as an EU member state. Bulgaria retains its second place, preceded by Estonia, with the lowest relative share of consolidated government debt to GDP (16.3 %) among EU member states as of the end of 2011, despite the registered increase of its debt in nominal terms and relative to its debt level reported at the end of 2008.

This reported increase is due primarily to the increase in government debt, which is the subject of analysis in the present strategy paper, and within the remit of the Minister of Finance in terms of control and management responsibilities. As of the end of 2011, the share of government debt is about 93 % of the overall size of the consolidated government debt and hence is the component with the highest relative weight in its structure. The trend of increasing government debt registered in the period 2009-2011 is the result of the policy of taking on new government debt, which is aimed at the provision of reliable, timely and efficient financing for the budget and debt refinancing, while maintaining the stability of key indicators of fiscal trends.

Forecast estimates for the government debt to GDP ratio in the next three-year period point to an increase in its value in 2012, to be followed by a gradual decrease in 2013 and 2014.

Chart 18: *Government debt to GDP ratio, 2006-2015*



As a preventive measure for minimising the risk related to debt size, the annual State Budget Act sets limits on: (1) the maximum amount of the government debt as of the end of the budget year and (2) on the new government debt which may be taken on in the course of the year. Another approach to act, in the event of a danger of breaking the 60-per cent rule concerning the consolidated government debt/GDP ratio is the possibility provided by the legislation for the Council of Ministers to propose restrictions in the State Budget Act for the respective year concerning the issuance of debt by municipalities and social security funds.

Sound risk management of the risk associated with the size of government debt in the mid-term is crucial and will focus on achieving a level and a rate of increase in government debt within sustainable limits, while implementing on-going monitoring of the debt amount and debt profile in order to prevent the negative influence of uncontrollable debt increase on the fiscal and macroeconomic stability of the country in the future. It will be subject to a number of factors, more importantly: government debt structure and redemption profile,

[10] The structure of consolidated government debt includes debt in the following sub-sectors: central government (government debt), social security funds and municipalities.

exchange rate fluctuations, choice and on-going adaptation of the most appropriate borrowing strategy to be aligned with financing requirements, planned budget deficits and growth expectations. According to the European Commission forecasts of April 2012, the GDP growth for Bulgaria in 2012 is a positive value. Taking into consideration the size of government debt, its foreign currency composition and forecasts of the macroeconomic situation in the country in the upcoming three-year period, it can be concluded that the expectations concerning the level and rate of increase of government indebtedness could not pose a threat to the country's financial stability.

2.5. Contingent liability risk

Government guarantees have a significant impact on the sustainability of government debt and are associated with the risk of guarantees being called at a certain point in time; it is therefore important to consider the potential risk of their activation. Risk related to contingent liabilities can be minimised primarily by strengthening oversight and regulating contingent liabilities; it is mitigated by undertaking timely and adequate measures.

For this type of risk, prevention is achieved above all through a careful selection of projects to be financed by loans guaranteed by the government , and annual provisioning in the State Budget of the Republic of Bulgaria Act for the respective year to cover the risk of government guarantees being called. In selecting projects for which a government guarantee would be issued, it is important to carry out a careful and comprehensive analysis of their expected profitability which has to ensure and back the future repayment of loan commitments, together with an assessment of the capacity of the budget to cope with a possible repayment of those liabilities, and then approve the projects with the most appropriate economic parameters.

To minimise the risk, it will be particularly important to provide constant monitoring of the movement of government-guaranteed loans and the implementation of the projects concerned, as well as to monitor the financial condition of borrowers at all times.

IV. Main goal and objectives of government debt management policy in the period 2012 - 2014

The main goal of the government debt management policy for the period 2012 – 2014 will be to ensure the resources necessary to finance the state budget and refinance the outstanding debt at the best possible price and risk level.

The achievement of this goal is linked to the successful realisation of the following objectives:

1. Maintain the debt size at reasonable levels and reinforce the position of the Republic of Bulgaria as a stable debt issuer in the region and in the European Union.

The government debt management policy will focus on strengthening the ability of debt to withstand domestic and external shocks and maintain debt amount at reasonable levels in order to ensure the country's macroeconomic stability. As a result of the constantly changing market conditions and in order to meet the needs for financing in the coming years, the amount of the government debt in nominal terms is expected to increase, which is due to the need to provide resources to refinance the outstanding debt and maintain the level of fiscal reserves within the statutory level set by the annual State Budget of the Republic of Bulgaria Acts.

To reinforce the positions of the Republic of Bulgaria as a stable debt issuer in the region and the EU and to keep the investor confidence, a number of measures will be put in place in the next three-year period, aimed at maintaining the level of the government debt within reasonable low-risk limits, at low levels far below the debt ceiling set by the convergence criterion.

The first measure is aimed at maintaining the sustainability of government debt and adjusting its possible increase, and at limiting the possibility for putting an unplanned burden on the state budget by adding service costs, through setting the annual debt limits[11] in the State Budget of the Republic of Bulgaria Act.

The ceiling on the maximum amount of new government debt which can be taken on during the year covers all possible sources of debt financing for the budget, including the gross amount of government securities to be issued on the domestic and the international market, and estimates of newly negotiated loan funds. Another constraint is the limit on the maximum size of government debt as of the end of the budget year which sets the level up to which government debt could grow in the respective year. That limit shows the net change in government debt on the basis of funds raised by government bond issues, disbursements under government loans and the associated repayments on the outstanding debt. Contingent liabilities incurred in the form of government-guaranteed debt are an important factor from the viewpoint of the risk they generate with regard to budget indicators. Therefore, a limit is set for each budget year for the maximum amount of new government guarantees that may be issued in that year.

The second measure is based on implementing a prudent policy with regard to new borrowing in strict observance of the relevant legal procedures, making it possible to adapt the assumption of debt to the financing needs and the market environment by applying a range of different instruments.

[11] According to Article 8 of the Government Debt Act, promulgated in the State Gazette No. 93 of 1 October 2002, last amended SG No. 99 of 16 December 2011.

On the one hand, new debt financing serves to finance the budget, securing the required liquidity buffer and refinancing the outstanding debt, while on the other hand it is used to make investments. To achieve the set objective, the following is planned for the next three-year period:

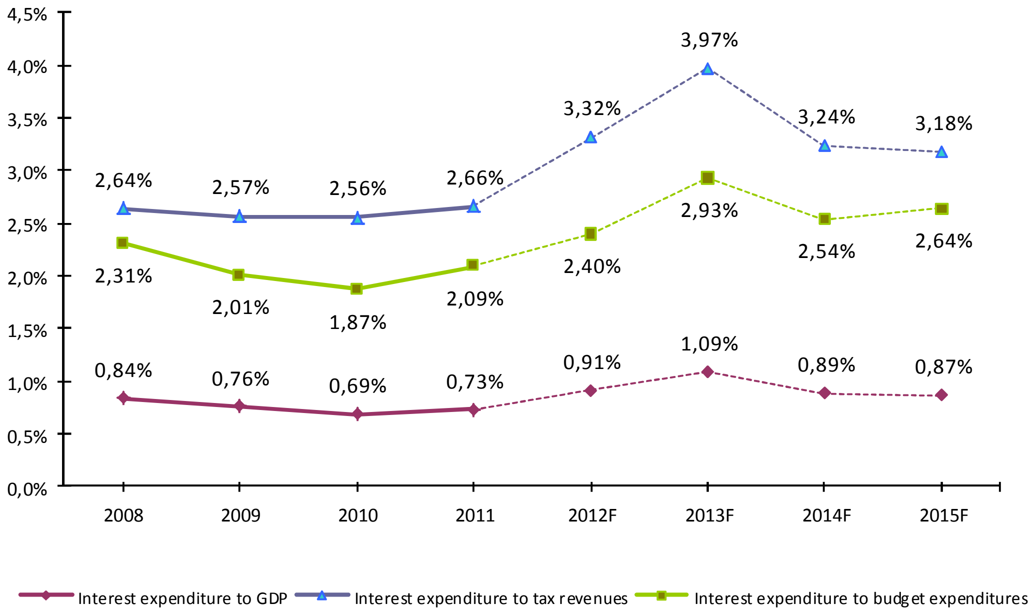
- The approval of new financing for investment projects using government loans and/or government guarantees will be based first and foremost on the appropriateness and the capacity of projects to generate economic and social benefits, and on the level of preparation for project implementation.
- Borrowing on the domestic market will be based on an in-depth analysis of the needs for financing and its effect, and on the country's budget and macroeconomic indicators, the indicative parameters of the government debt, and on the impact on the local financial market. The volume of government securities issues will be limited to the amount of financing necessary to achieve the main goal of debt financing (including funds required to finance the budget and refinance debt).
- Financing through bonds issued on international capital markets will be used primarily in order to refinance identical maturing debt, in strict observance of the relevant legal procedures, in compliance with the requirements of the Constitution of the Republic of Bulgaria and the Government Debt Act. Relatively large-volume bond issues triggered by the amount of refinancing needed, and because of the generally accepted market rules, will cause one-off increases in the size of the debt as of the end of each year preceding the maturity dates, but following the respective bond maturity dates, such hikes will be offset and debt levels will stabilise.

The third measure is to ensure transparent and open procedures related to government debt management policy-making and implementation. During the next strategy period, the same approach will continue to be applied: the debt issuance policy of the government will be announced in advance, with indicative quarterly calendars and monthly debt issuance calendars of upcoming government debt auctions to be published, thus maintaining a market of government securities that is stable, transparent and predictable for investors. Timely information will be provided about undertaking and finalisation of various other debt management operations aimed at optimising the size and structure of the government debt: early redemption, repurchasing agreements, reverse repo transactions and other financial transactions. The information (with various scope and content characteristics) concerning the government debt, the consolidated government debt and government guarantees, to be published in monthly and annual debt overviews, news briefs on the latest developments in the area of government debt, will provide a basis for adequate assessments of the government's debt policy by rating agencies and analysts, and for informed decisions by market participants concerning investments in government debt.

2. Optimisation of debt service costs

The debt portfolio management policy requires an efficient spending policy to be implemented in 2012 - 2014, enabling the country to cover the planned cost of servicing government debt. The amount of contingent expenditures, which depends on the level of government indebtedness, should be assessed also from the standpoint of their effect on the state budget. Expectations about future expenditures related to government debt in the mid-term are based on assumptions about the main factors which affect their amount, including the size of financing, the cost of expected new financing, debt redemption profile, interest rate and the exchange rate fluctuations. Estimates indicate that within the mid-term period in question, the amount of government debt will increase in each year preceding a year with a high concentration of debt payments, which will have an effect on the size of interest payments due as well. In 2012 – 2014, these are expected to range between BGN 580 million and BGN 880 million, and as a percentage of GDP, between 0.9 % and 1.1 %.

Chart 19: *Interest expenditure to GDP ratio; interest expenditure to budget expenditures ratio, and interest expenditure to tax revenue ratio in the period 2008-2015*



To implement the set objective, a well-balanced structure of the government debt will be maintained during the upcoming three-year period in order to minimise any future vulnerability of the budget towards drastic and uneven increases in expenditures related to servicing debt. It is envisaged to focus the government debt management policy on the use of various instruments to finance debt. Their characteristics will be determined taking into account the current structure and redemption profile of the bond issues outstanding and the task to smooth it out gradually. The approach adopted in that regard enables efficient modelling and the maintenance of a stable and balanced government debt structure, for improved predictability with regard to budget expenditures and mitigation of related risks.

A key component of the policy of taking on new government debt (through the market or by negotiating government loans from official creditors) aimed at the optimisation of debt service expenditures will be to retain the dominant share of BGN- and euro-denominated debt and fixed rate debt.

On the other hand, active debt management through the application of instruments that are innovative for the domestic financial market such as repurchasing agreements and debt swap operations will lead to an optimisation of the debt structure, and hence of expenditures related to servicing debt. By diversifying the financial instruments and planning the issuance of government securities with innovative and longer-term maturities (falling due in periods other than the peak years 2013 and 2015), the maturity curve of the debt portfolio will be extended and there will be no concentration of large payments, which is of key importance in minimising government debt risk exposure and will help reduce its refinancing risk. Ensuring an even time distribution of the pending interest and principal amortisation payments on the debt will provide for a government debt service schedule that ensures stable budget indicators.

3. Securing sources of funding in the period 2012 – 2014

To secure the necessary resources, a maximum diversification of financing sources is envisaged. The main debt instruments to be used over the next three-year period to cover future budget deficits, meet payments due on the principal of global bonds and, last but not least, maintain an adequate level of fiscal reserves are instruments which have proved their efficiency in the past years. In taking decision for the use of specific features of the various instruments, in-depth analyses and comprehensive assessments will be carried out, taking into account their specifics and impact. The following main sources have been identified as some of the possible options for obtaining financing in the next three years:

1.1. Issuance of government securities

- ***Issuance of government securities on the domestic market***

The government debt management policy implemented over the past several years was fully tied to the need to ensure stable sources of funding for the budget and for refinancing the government debt. In its part, that required a refocusing of the debt policy towards securing reliable, timely and efficient financing for the budget through the active participation of the government as the issuer of government securities. The main goal of domestic debt financing in recent years was aimed at creating a sufficiently secure and favourable environment for the issuance of securities on the local market, including the use of the entire range of possible tools to promote the development of the domestic market of government securities. The long-established positive trends in the market environment, including the high liquidity of the domestic market, increased interest in the offered government securities issues on the part of a broad range of investors with diverse preferences and risk profiles, decrease in the borrowing costs and elimination of external risks, the recorded drop in yields on the primary market and the coverage ratios breaking record values for the Bulgarian market of government securities, all pointed to the issuance of government securities as being one of the main instruments to finance the borrowing needs of the government.

Over the next three-year period, the Ministry of Finance will continue to implement a debt issuance policy which is active and balanced, and at the same time flexible and adequate to the market environment, following and taking into the highest consideration the market trends and investor interest, in order to encourage the development of the local debt market in the broadest terms. In the coming years, the Ministry of Finance will maintain it behaviour pattern as a predictable issuer, and will do its best to with implement a transparent debt issuance policy in order to support the development of the market and the establishment of the benchmark government securities as an investment alternative with an optimal yield to risk ratio. In selecting any specific type of financial instrument, the goal will be to extend the government securities market by including instruments with the optimal risk characteristics. On the other hand, the choice will take into account the preferences of participants on the domestic financial market of government securities which are interested in debt instruments falling into various maturity segments. It is envisaged to offer securities with a fixed interest coupon, maturities covering a wide range of the debt curve, denominated in euro and in BGN, without ignoring other, wider options, if the market environment is favourable. Over the period, 10-month and 6-month securities will continue to be offered so that the issue can meet the residual maturity requirements for a harmonised interest rate in the respective year of issue. The approach applied so far, which was to refrain from circulating bond issues maturing in 2013 and 2015, when the global bonds of the Republic of Bulgaria mature, will be applied in the future as well. This will make it possible to plan for more even planning of expenditures related to servicing the government debt. The gross annual amount of the bond issues is planned at about BGN 1.2 billion in the years (2012 and 2014) preceding the repayment dates on the global bonds, and at about BGN 1.0 billion in 2013.

➢ ***Issues on the external capital markets***

Another source of funding for the budget and refinancing the outstanding debt is the issuance of bonds on international capital markets. The presence of a high concentration of maturing debt and the refinancing risk in the next three-year period (2012 - 2014) makes it necessary to plan for this source of borrowing as well. Within the current year, it is provisioned in the State Budget of the Republic of Bulgaria Act for 2012, with a cap of BGN 2 billion, or its countervalue in another currency.

The good fiscal indicators of the Republic of Bulgaria and the increased investor interest in Bulgarian government securities in recent years, as well as the favourable market environment achieved following the provision of high liquidity to the European banking system by the ECB, are prerequisites for undertaking actions to go back to external markets, following a ten-year absence, with a euro-denominated bond issue.

The choice of currency for the issue is determined, firstly, by the existing currency board arrangement and the pegging of the lev to the euro, which provides for a practically risk-free issue in terms of the risk of exchange rate fluctuations; secondly, by the lower transaction costs, as it is not necessary to undertake any additional hedging actions; and last but not least, by the fact that the global bonds which mature in 2013 are denominated in euros.

Taking up this opportunity will provide stability in public finance and will ensure an optimal size of the fiscal reserves at the end of 2012 [12], which would enable the country to meet seamlessly the considerable debt payments due in early 2013. Apart from securing the necessary financial resources, the issuance of securities denominated in euros in an amount close to the maximum allowed under the 2012 State Budget of the Republic of Bulgaria Act will produce a benchmark bond which could be used to measure government risk in international markets. Since euro- denominated bonds are highly-liquid financial assets which are acceptable as collateral with the European Central Bank in liquidity-providing operations, the range of interested investors could expand, which provides for better terms of the issue and lower service costs, respectively.

Usually, in the annual State Budget of the Republic of Bulgaria Acts, bond issues on external markets are used as a tool enabling the provision of financing necessary to fund government activities. In this connection and in order to undertake flexible actions towards achieving the budget targets in the coming years as well, it is envisaged to keep these statutory options in subsequent annual budget acts. The sizes of bond issues placed on international capital markets will be determined in line with the specific economic and market environment.

1.2. Loans from official creditors, i.e. International Financial Institutions (IFIs)

➢ ***Characteristics of IFI loans***

Loans from official creditors are an instrument used primarily for obtaining long-term financing; they enable the borrower to choose and specify the various parameters of credit financing such as maturity, grace period, interest rate and loan currency. A typical

[12] The minimum size of fiscal reserves according to §7 of the Transitional and Final Provisions of the 2012 State Budget of the Republic of Bulgaria Act is BGN 4.5 billion.

characteristic of such loans is that funds disbursed are intended for the achievement of concrete targets and projects in various priority areas of government policy. When analysing this source, one should also take into account the additional benefits it generates, stemming from the opportunity to tap into the expertise of the respective credit institution in project preparation, implementation and ex-post control.

In view of the specific features of these instruments, in the next three-year period, financing from IFIs will be complementary and designed largely to assist the government in the implementation of reforms and policies in key sectors of the economy, and in the implementation of important investment projects and concrete programmes in priority areas.

- ***Prospects for further cooperation with International Financial Institutions in the period 2012 - 2014***

IFIs play a significant role in the country's economic development, providing adequate financial and technical assistance. In the coming years, the useful cooperation with IFIs is planned to continue, largely in the field of financing private sector projects and assisting Bulgaria in the efficient uptake of EU funds. It is envisaged to use loan financing from IFIs to the extent necessary for the implementation of on-going projects and programmes, and for the implementation of new structural reform projects.

In terms of the relationship with the International Monetary Fund (IMF), the existing dialogue is maintained. The Republic of Bulgaria can take advantage of the IMF's technical expertise, where necessary. In the future, interactions will continue in the meaning of the institution's general cooperation with countries with which it currently has no on-going programmes. The Bulgarian government does not plan to enter into an agreement with this international institution, which is backed by the current prudent fiscal policy and the stable macroeconomic environment maintained.

As a shareholder in four of the organisations within the World Bank Group, Bulgaria takes part in the governing bodies of the International Bank for Reconstruction and Development, the International Financial Corporation, the Multilateral Investment Guarantee Agency and the International Centre for Settlement of Investment Disputes: boards/councils of governors, administrative councils and boards of directors, which discuss issues related to the policies implemented by those institutions.

In May 2011, the Board of Executive Directors of the World Bank approved the Country Partnership Strategy for 2011-2013 of the International Bank for Reconstruction and Development (IBRD) and the International Financial Corporation for the Republic of Bulgaria for the period 2011 – 2013. The main areas of possible cooperation are education, public finance and competitiveness, public administration, regulatory business environment, innovation, social inclusion, green growth and activities in the area of climate, transport and water sector. The Strategy envisages a shift of accent in the relationship with IBRD from financing to benefiting from the expertise and the global experience and knowledge of that international financial institution, mostly along the lines of the Memorandum of Understanding signed in January 2012 between the Government of the Republic of Bulgaria and the World Bank for partnership and technical support in connection with the implementation of the EU Structural instruments. In the Bank's indicative plan for extending loan financing includes operations only in the railway sector through a series of three development policy loans (DPLs) in the amount of EUR 80 million each, and one investment loan guaranteed by the Government- in support of railway infrastructure maintenance, in the amount of EUR 70 million. Implementation of projects under earlier government investment loans with IBRD in the area of infrastructure and the social area will continue.

As a shareholder in EIB, Bulgaria takes an active role in the functioning of the Bank's governing bodies (the Council of Governors and the Board of Directors) which supervise the implementation of the Bank's policies and goals. Currently, the European Investment Bank (EIB) is an important partner of Bulgaria in providing project financing and assistance in the absorption of resources from the EU Structural and Cohesion Funds. Cooperation includes the extension of both structural programme loans and technical assistance on the basis of the Memorandum of Understanding signed in January 2012 between the Government of the Republic of Bulgaria and the EIB for the provision of support in project implementation. In the next strategy period, the analysis will focus also on the new EIB financing facilities which combine resources from EU Funds and loans from the Bank to address the priority goals of the strategy "Europe 2020". If necessary, steps would be undertaken to negotiate a new structural loan.

The key priorities in the operation of the European Bank for Reconstruction and Development (EBRD) in Bulgaria are outlined in EBRD's Bulgaria Country Strategy for the next three-year period 2012-2015 (approved by the Board of Directors on 8 November 2011). It envisages support for restructuring the energy sector, energy efficiency, improving the export capacity and competitiveness of Bulgarian producers, and can provide support for projects in the area of infrastructure and the financial sector by setting up credit lines for energy efficiency, small and medium-sized enterprises and leasing services.

The operations of the Council of Europe Development Bank (CEB) are aimed primarily at providing financing for social projects to enhance social cohesion in Europe. The main fields of cooperation with that institution are healthcare, environmental protection, job creation and retention, support for underdeveloped regions and social inclusion. As part of this cooperation, the CEB makes financial resources available to commercial banks for financing projects related to the creation and retention of jobs in small and medium-sized enterprises in the Republic of Bulgaria.

The Strategy of the Black Sea Trade and Development Bank (BSTDB) for the period 2011-2014 envisages the provision of between EUR 40 million and EUR 50 million a year for financing the private sector in the Republic of Bulgaria. Expectations are that the bank's country portfolio will double by 2014. BSTDB will make financing available in the following priority sectors: energy (with a special focus on projects for improving energy efficiency), road infrastructure, waste management, development of small and medium-sized enterprises, and development of cultural tourism. In the next three-year period, BSTDB will focus its operations on providing support for the implementation of the government's programme and priorities and will expand its financial programmes for small and medium-sized enterprises.

The relationship with the Japan Bank for International Cooperation (JBIC) in the upcoming three-year period will develop on the basis of existing loan agreements and the implementation of on-going projects, primarily in the sectors of transport and energy.

4. Maintaining a well-functioning government securities market and investor base diversification

4.1. Institutional structure and development of trading infrastructure

In terms of investor base, the government securities market can be provisionally segmented into two target markets: on the one hand, banks and non-banking financial institutions, and on the other, non-financial institutions, i.e. other legal entities, and individuals. The Ministry of Finance will continue to explore opportunities to expand the investor base. A starting point for its efforts will be the extremely positive result achieved so far which indicates that in addition to the traditionally strong presence of commercial banks, there is a growing trend of participation by institutional investors, i.e. pension funds, insurance companies, investment intermediaries and mutual funds. The main factors behind the increased participation of large institutional investors on the government debt market include the increase in pension fund assets and the dynamic development of Bulgaria's insurance sector.

In terms of the levels of structuring the government securities market, it should be noted that trading in government securities takes place through the intermediation of primary dealers. The introduction of a primary dealership system in Bulgaria on the basis of the professional expertise of banks and financial institutions in the area of government debt, and in particular, in government debt distribution, and its dynamic development and modernisation in recent years, places Bulgaria on a par with the systems of primary dealership of the countries which are home to the world's most advanced financial markets. Bulgaria's primary dealership system is a leader in the development of the domestic market of government securities. The selection of primary dealers of Bulgarian government securities is based on objective quantitative and qualitative criteria, which ensures easy market access for all investors.

In line with best international practices, the Ministry of Finance will continue its policy of further improvement of both the current primary dealership system, and of the supporting market infrastructure of the domestic market of government debt. Along with the development of the primary market of government securities, the MoF as an issuer of government securities will focus its efforts on improving trading infrastructure systems which support trading in government securities.

One of the strategic priorities of the debt issuer for the period 2012 - 2014 will be to attract a broader range of investors to the Bulgarian debt market. This objective will be achieved, on the one hand, by diversifying the maturity and currency features of government securities, and on the other hand, by exploring ways to provide foreign investors with easy and fast access to the trading infrastructure platforms which service the government securities market, while observing the highest standards of protecting the ownership rights of the various classes of investors in government securities and the relevant international standards in the area of securities settlement systems.

In its capacity of an issuer on and a participant in the financial market, the Ministry of Finance will ensure the provision of all conditions necessary for maintaining a competitive market environment stimulating the activity of financial market participants and facilitating even higher market efficiency and transparency, by providing a wide range of investment opportunities for market participants, and base line indicators for the main benchmark maturities to measure changes in the yield of the rest of the financial market instruments.

In accordance of the issuer's form commitments to a market-oriented debt issuance policy and maximum transparency with regard to the decision-making process concerning the development of the government securities market, the MoF will continue to maintain both formal and informal communications on a regular basis with participants in the government securities market. Primary dealers of government securities are qualified participants in the primary debt market and important counterparties/partners to the MoF in the process of efficient distribution of domestic government debt, and its subsequent management. A significant challenge for both the MoF and for all market participants will be to identify the best option to achieve the convergence of the Bulgarian market of government securities to the intensifying integration processes of consolidation and enlargement of trading and post-trading infrastructures on the sophisticated European capital markets.

The stable and successful single European market demands compliance not only with the common EU legislation in the area but also taking into account the other institutional and purely market trends. The development of the Bulgarian trading infrastructure which services the government securities trade should be focused on technical and operational integration into an international/European structure of depositories, as a preparatory integration step towards the pan-European payment and settlement platforms for cash and securities.

In the period covered by the Strategy, to achieve a higher degree of harmonisation in post-trading, the MoF will continue its efforts, together with BNB in its capacity of operator of the settlement system, in implementing business processes, where operations in euro-denominated government securities with payment in euro on the primary and the secondary market are carried out according to the principle of delivery versus payment, with cash settlement taking place in TARGET 2 accounts held by the participants with BNB's Government Securities Settlement System (BNBGSSS). The activities underway will also ensure full compliance with the Recommendations for Securities Settlement Systems developed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO), the recommendations of the Committee of European Securities Regulators/the European System of Central Banks (CESR/ESCB), and the Standards for the Use of EU Securities Settlement Systems in ESCB Credit Operations. Along with the technical implementation of the project, action will be taken to amend accordingly the legal framework regulating the government securities market.

With a view of integrating foreign investors into the Bulgarian depository structure servicing the trade in government securities, a special focus will be placed on activities related to facilitating government securities registration and trade, in the context of transborder relationships between sub-depositories of government securities and non-resident legal entities which hold government securities in their own name but for another's account, including in their capacity of custodians. A key consideration behind that is the fact that the government securities market is the main channel of entry for portfolio investments in Bulgaria. The stability of the banking sector, which will play the role of an intermediary and custodian for foreign investors, is a key prerequisite in achieving this objective.

4.2. Implementing a market-oriented debt issuance policy through diversification of the maturity and currency features of newly-issued government securities

In present day conditions, government debt management demands a finer differentiation of approach to prospective investors, based on their diverse interest and risk profiles in terms of government securities, theirs term to maturity, degree of liquidity risk and inflationary risk, and default risk. The development of the government securities market is particularly important in the context of strengthening the status of government securities as one of the main sources of funding for the country's borrowing needs. In this situation, building up a highly-liquid benchmark curve by diversifying the debt instruments on offer and through the diversification of their characteristics in order to target investors with different portfolio management strategies is crucial for the issuer. The diversification of debt instruments is in line with the objective to encourage the development of an efficient secondary market, which in its turn requires large volumes of highly standardised government securities. Another leading feature on which the issuer will focus is to maintain their competitiveness vis-à-vis other investment directions, namely: high security, optimal yield to risk ratio and high liquidity. Efficient response to investor needs through the realisation of the competitive advantages of government securities is the most rational path to achieving the goals of debt management, in the context of today's financial markets.

Legislative Acts and Other Relevant Documents

- The Government Debt Act;
- The State Budget of the Republic of Bulgaria Act for the respective year;
- The Structure of the State Budget Act;
- The Municipal Debt Act;
- The Bulgarian National Bank Act;
- The Law on Settlement of Non-Performing Loans Negotiated Prior to 31 December 1990;
- The Credit Institutions Act;
- The Public Offering of Securities Act;
- The Markets in Financial Instruments Act;
- The Law on Financial Management and Control in the Public Sector;
- Legislative acts regulating the possibility to issue government guarantees to cover third-party financial obligations such as: the Bulgarian Development Bank Act, the Bank Deposit Guarantee Act, the Insurance Code, the Export Insurance Act, the Student Lending Act;
- The European Union regulations in the area of financial services and markets;
- The European Union regulations in the area of government financial statistics;
- Decree of the Council of Ministers on the implementation of the state budget of the Republic of Bulgaria for the respective year;
- Ordinance No. 5 of 2007 on the terms and procedure for acquisition, registration, redemption of and trade in government securities;
- Ordinance No. 15 of 2007 concerning Control over Transactions in Government Securities;
- Ordinance No. 31 of 2007 concerning the Settlement of Government Securities;
- Ordinance on the procedures for using government long-term bonds issued under the Law on Settlement of Non-Performing Loans Negotiated Prior to 31 December 1990 Act, for redeeming obligations to the government ensuing from the said Act, adopted under Decree No. 22 of the Council of Ministers from 1995;
- Ordinance on the Requirements for Investment Projects Financed by Government Loans and Projects Applying for Financing by a Government Guarantee and on the Procedure of their Consideration, adopted under Decree No. 28 of the Council of Ministers from 2003;
- Ordinance No. 9 of 2003 on the Terms and Procedure for Provision of Information on the Status and Movement of the Debt of Municipalities and Social Security Funds;
- Ordinance No. N-19 of 2006 on defining the scope of information which all municipalities are required to keep record of, store and provide to the Ministry of Finance concerning the debt undertaken by them in compliance with the requirements of the European Union and Bulgarian legislation concerning reporting, statistics and budgeting in the public sector, and on the terms and procedure for such reporting and presentation;
- Guidelines on the implementation of the 2012 state budget
- Decision No. 298 of 2012 of the Council of Ministers concerning the approval of the main assumptions and budget forecast for the period 2013-2015 and the adoption of expenditure ceilings by first-level spending units, excluding municipalities, for the period 2013-2015
- The 2012-2015 Convergence Programme of the Republic of Bulgaria.