Government Debt Review • 2004

Sofia, 2005

Abbreviations

BNB	Bulgarian National Bank
DISCs	Discount Bonds
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EU	European Union
FLIRBs	Front Loaded Interest Reduction Bonds
G-24	The Group of the 24 Most Industrialised Nations
G-7	The Group of the Seven Most Industrialised Nations
GDP	Gross Domestic Product
IABs	Interest Arrears Bonds
IMF	International Monetary Fund
JBIC (JEXIM)	Japan Bank for International Cooperation (former Japan Export – Import Bank)
LIBOR	London Interbank Base Offered Rate
LSPDACB	Law on State Protection of Deposits and Accounts with Commercial Banks in Respect whereof the BNB Has Petitioned the Institution of Bankruptcy Proceedings
MF	Ministry of Finance
NSI	National Statistics Institute
SDR	Special Drawing Rights
SOFIBOR	Sofia Interbank Offered Rate
ZUNK	The Bulgarian Abbreviation of the Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990

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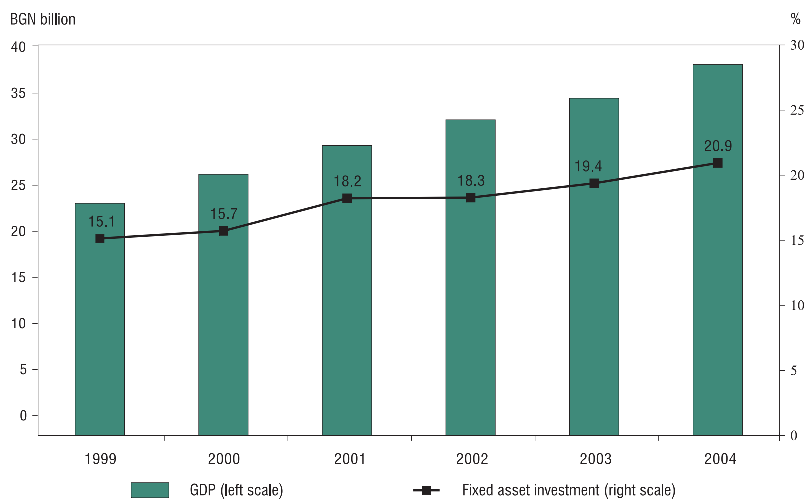
I. Major Parameters of the Bulgarian Economy

In 2004 Bulgaria's economy continued the successful development which has been a feature of the past few years. GDP growth reached 5.6 per cent, a high for the entire post-1990 period, while employment grew by 2.2 per cent. Because of labour market progress, the economic activity ratio grew to 49.7 per cent. Average annual unemployment fell by 1.7 percentage points on 2003. In the third quarter this indicator stood at 11 per cent of the economically active population: a low for the entire history of Bulgarian labour force monitoring.

External demand was the basic driver of economic growth. Exports contributed 7 percentage points to overall GDP growth. Consumption, which had the greatest relative share of GDP structure by final demand, slowed its growth from 6.6 per cent in 2003 to 5 per cent last year, yet remained high. Contributing factors included the significant growth of consumer loans, and growing employment and real household incomes.

In 2004, gross fixed capital formation grew by 12 per cent on 2003, contributing 2.3 percentage points to overall GDP growth. As distinct from prior years, national savings met the greater share of 2004 investment. Regular transfers from abroad played a great role in boosting national savings.

Share of Fixed Asset Investment in GDP



Source: *MF.*

As regards supply, all economic sectors showed positive contributions to GDP growth. Services grew most at 6 per cent, followed by industry at 5.3 per cent. External demand was the major driver of industrial growth. Export-oriented industries grew most, with sales increasing by 41 per cent on 2003. After a 2003 drop, agriculture also recorded a 2.2 per cent growth.

In late 2004, consumer price rises on the prior year reached 4 per cent, while average annual inflation reached 6.1 per cent. Administratively set prices and food prices were the major factors driving consumer price movements during the year. Though partly offset by the falling dollar euro rate, petrol price rises also hit consumer prices.

Over the last three years, overall average annual inflation in Bulgaria has been some 2.8 percentage points above that in the EU15, with an excess high of 4.1 percentage points in 2004. Yet, real lev euro rate increases were not due to export sensitive tradable goods, but to administratively set prices and to non-tradable goods (services). Thus competitiveness suffered little.

A similar conclusion emerges from a comparison of the growth of real salary and labour productivity: 3.9 and 3.1 per cent respectively. While the overall indices were negative, labour productivity growth rates exceeded those of real salary in industry and in some tradable goods sectors like financial intermediation, transport, and communications.

Money supply continued growing strongly in 2004. Broad money grew by 23.1 per cent nominally, indicating continuing remonetisation in the economy. At the year's close, the *M3/GDP* ratio reached 53.7 per cent against 48.1 per cent a year earlier. Domestic lending grew by 34.3 per cent over the year despite the record fall in claims on government. Regardless of the limitations imposed, private sector lending grew by 48.7 per cent to reach 37.1 per cent of GDP. The trend is towards ever longer loan maturities.

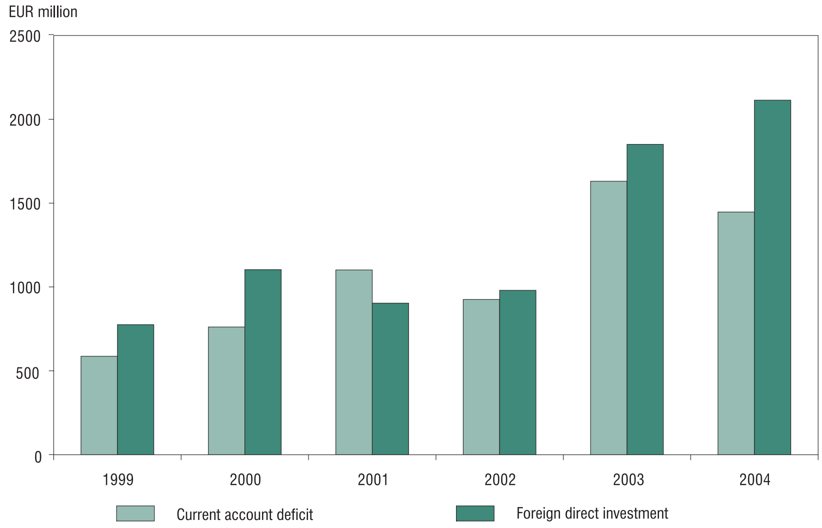
Aggressive lending by commercial banks and increased investment into Bulgaria are the main drivers of the national balance of payments. Preliminary BNB data put the current account deficit for 2004 at EUR1447.1m or 7.4 per cent of GDP. The negative trade balance of EUR-2718m (14 per cent of GDP) was the basic component contributing to the high current account deficit.

Bulgaria's foreign trade grew significantly in 2004. FOB exports grew by 19.9 per cent, with FOB imports increasing by 20.8 per cent. High international market prices and favourable external demand contributed to both export growth and to imports, by satisfying increased raw materials demand for export-oriented industries.

Net revenue from services and current transfers offset almost half of Bulgaria's 2004 trade deficit. Travel again brought the largest contribution, its revenue growing by 20 per cent. In recent years, net current transfers have had a growing and significant beneficial effect on the current account balance, mainly due to a large growth in private transfers.

The volume of finance inflows into Bulgaria increased by comparison with 2003. In 2004, the financial account balance came to EUR2707.5m, covering the current account deficit in entirety. A significant part of the monetary inflows shown on the financial account over the year reflect increased foreign lending to the non-financial sector, and the increase in non-residents' deposits in Bulgarian commercial banks as a result of low interest rates abroad. Excepting the Mobiltel AD sale (EUR649.5m), net foreign direct investment into Bulgaria came to EUR1939.5m, covering the current account deficit one and a half times over. Overall privatisation revenue for 2004 came to EUR936.3m, including the BTC sale and the December sale of the energy distribution companies. Foreign direct investment unrelated to privatisation came to EUR1177.9m.

Current Account Deficit and Foreign Direct Investment



Source: *MF.*

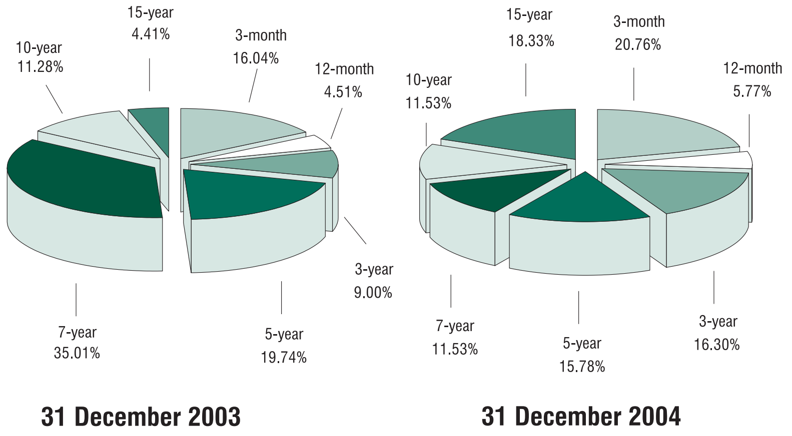
Maintaining macroeconomic stability and attaining stable economic growth in Bulgaria has boosted foreign institutions' and companies' confidence in the Bulgarian economy. The policies of budgetary discipline, cutting government debt, and increasing international reserves also helped. In June 2004, Standard & Poor's assigned Bulgaria an investment rating, later improved to positive outlook. Two months later Fitch also assigned an investment rating (BBB-) with a stable outlook, while Moody's improved Bulgaria's investment rating from Ba2 with a stable outlook, to Ba1 with a positive outlook.

II. Domestic Debt

Under the Council of Ministers' Government Debt Management Strategy, recent years have seen a firm stress put on the need to develop the domestic government securities market in view of favourable conditions for increasing domestic at the expense of external debt. This is foreseen as a measured process, proceeding in line with the state of the balance of payments and the financial system, and with the budget's need for finance.

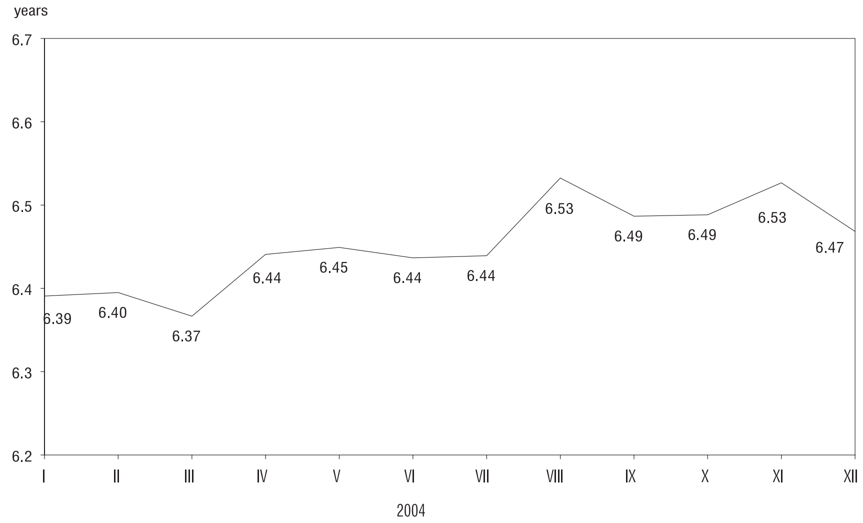
The past year featured increased lending and relatively high banking system liquidity. This reflected in the demand for government securities. Investment in long-term instruments grew further, and optimistic economic forecasts moved demand to the longer end of the curve.

Maturity Structure of Newly Issued Government Securities



Source: *MF.*

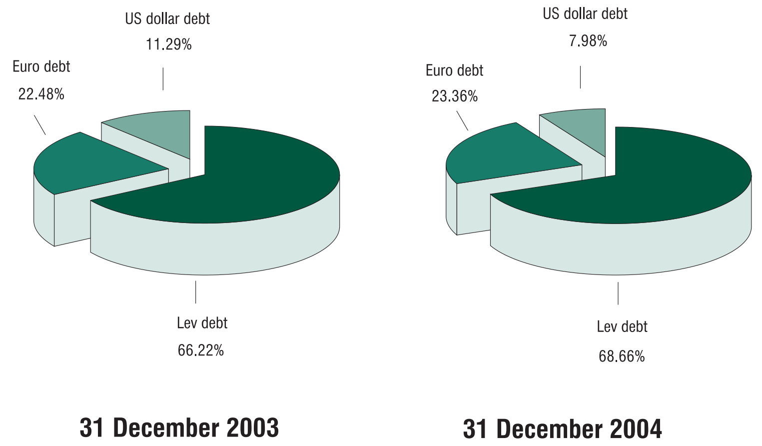
Average Duration of Government Securities Issued for Budget Deficit Financing at the Close of Each Month



Source: *MF.*

Domestic debt grew to BGN2680.6m in 2004. Net domestic financing for the year was positive, coming to BGN440.4m. Because of demand shifts, and in line with the flexible issuing policy, euro-denominated 15-year securities grew most at BGN127.1m, followed by three- and five-year securities with BGN110.8m and BGN106m respectively.

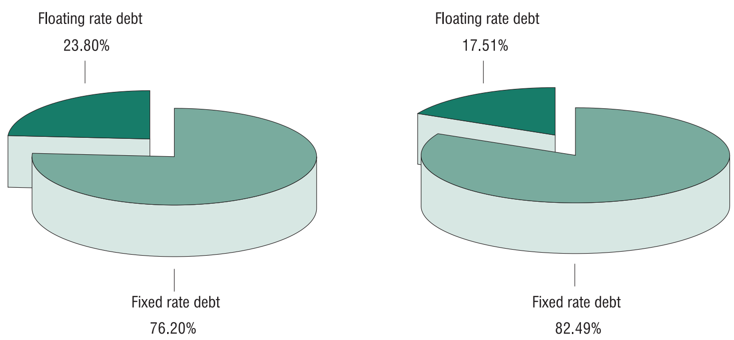
Domestic Debt Currency Structure



Source: *MF.*

In line with Strategy objectives, debt structure showed some other positive changes. The shares of lev and euro debt grew to 68.7 per cent and 23.4 per cent respectively. This was achieved by issuing only lev and euro securities on the domestic market, cutting dollar debt by regular amortisation payments and using it in privatisations and debt repayments to the state, as well as through regular swaps of structural reform bonds from dollars to euro. Interest rate structure also changed, with the share of fixed interest coupon debt growing to 82.5 per cent against 76.2 per cent in late 2003. Average original maturity of government securities issued at auctions grew to six and a half years, or some seven months longer than in the prior year.

Domestic Debt Interest Rate Structure



31 December 2003 **31 December 2004**

Source: *MF.*

1. Issuing Policy

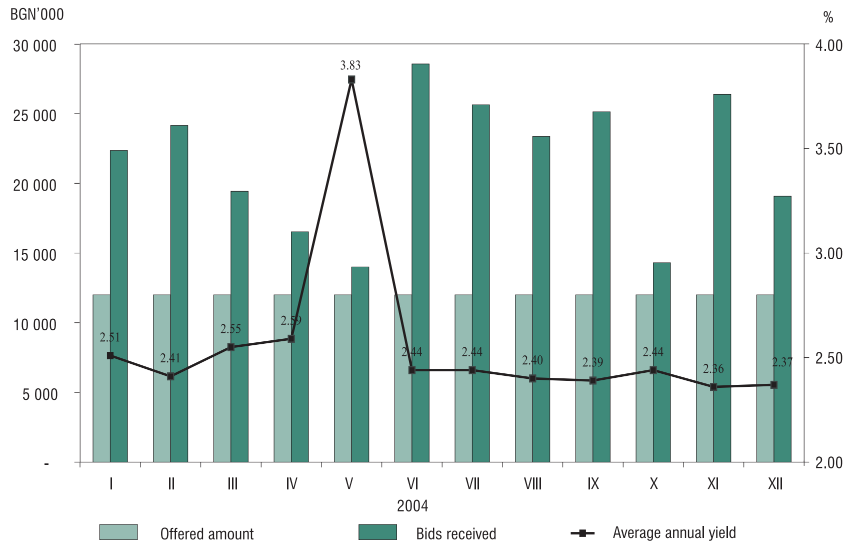
Government securities to an overall nominal value of BGN693.7m were issued on the home market in 2004. Of them, BGN675.8m sold at auctions, with the rest sold directly to individual investors.

Treasury Bill Issues

Short-term treasury bills issued in 2004 came to BGN184m. They had terms of three and 12 months.

The average annual yield of three-month treasury bills continued serving as the basis for setting the base interest rate during the year. The timing of three-month bill auctions changed to monthly. Volumes offered were unchanged *vis-à-vis* the prior year at BGN12m. The November auction reached a yield low of 2.36 per cent, with May marking a high of 3.83 per cent. Overall bill volume for 2004 came to BGN144m, with auction bids coming to BGN259m. The excess of demand over supply was insignificant at an average bid-to-cover ratio of 1.8, and yield of three-month securities largely reflected banking system liquidity.

Three-month Treasury Bill Issues



Source: *MF.*

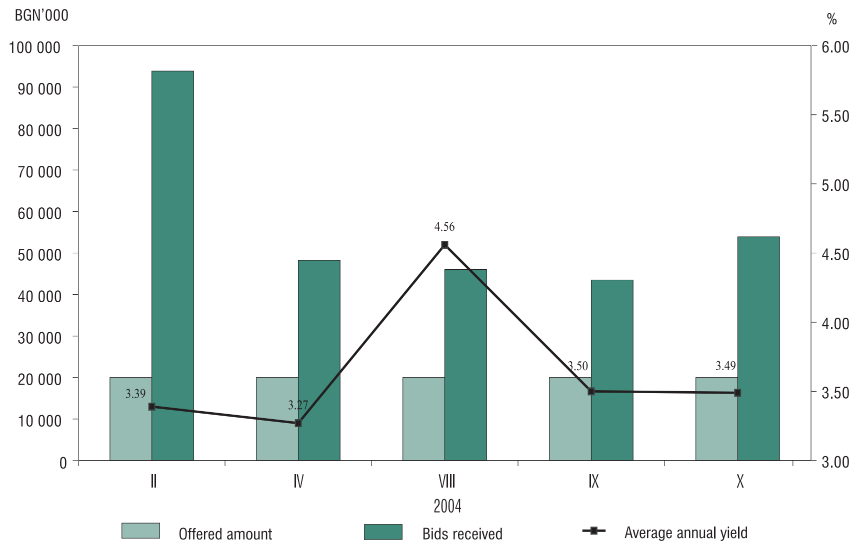
One-year government securities were issued only twice during the year: in January and December. Overall nominal value was BNG40m. Offers were limited due to the relatively high yield demanded by primary market participants. This reached 3.55 per cent early in the year, falling to 2.86 per cent in December because of high banking system liquidity.

Treasury Bond Issues

An overall volume of BGN509.7m of tap treasury bonds was issued in 2004: almost 73 per cent of the sold amount. Of them, most were 15-year bonds, followed by three- and five-year bonds.

Five auctions for the sale of three-year bonds were held, with the offer volume coming to BGN100m. Interest was greatest at the initial offer in February, bids received coming to BGN93.9m against an offer volume of BGN20m. Yield attained at the five auctions varied between 3.39 per cent in February and 4.56 per cent in August.

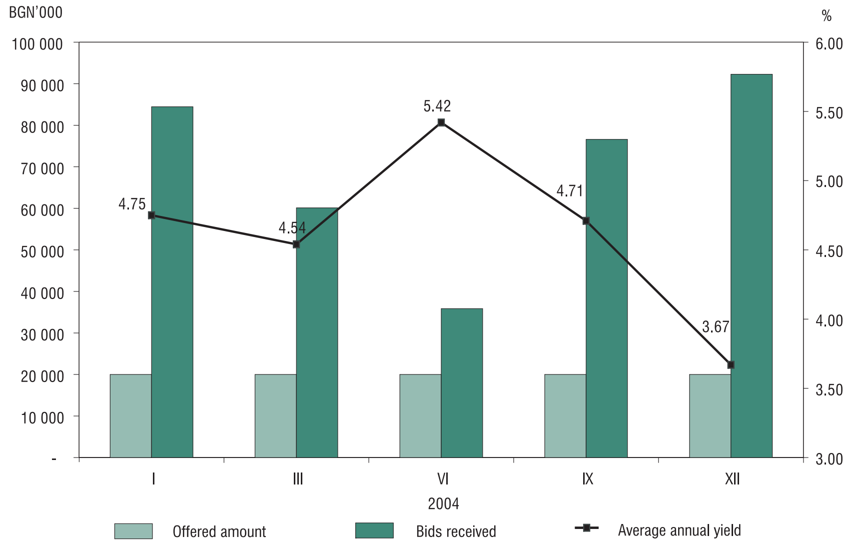
Three-year Bond Issues



Source: *MF.*

Only one issue of five-year bonds was released in 2004, sold at five auctions. Overall nominal value was BGN100m. Interest in five-year bonds remained relatively steady through the year, except in June. Bids came to BGN349.3m: a bid-to-cover ratio of 3.49. Five-year bond yield hovered at 4.62 per cent for the year, with the high being in June, and the low of 3.67 per cent in December.

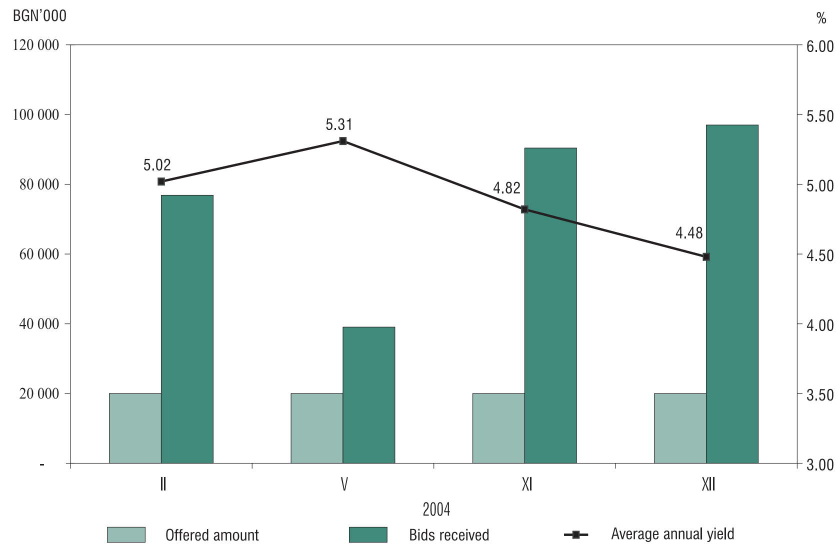
Five-year Bond Issues



Source: *MF.*

One issue of seven-year bonds to a nominal value of BGN80m was offered at four auctions during 2004. Interest was relatively high early in the year (with the lowest bid-to-cover ratio being 1.95). During that period, yield moved between 5 per cent (February) and 5.31 per cent (May). During the second half of the year, demand dipped significantly, with yield at the final auction coming to 4.48 per cent.

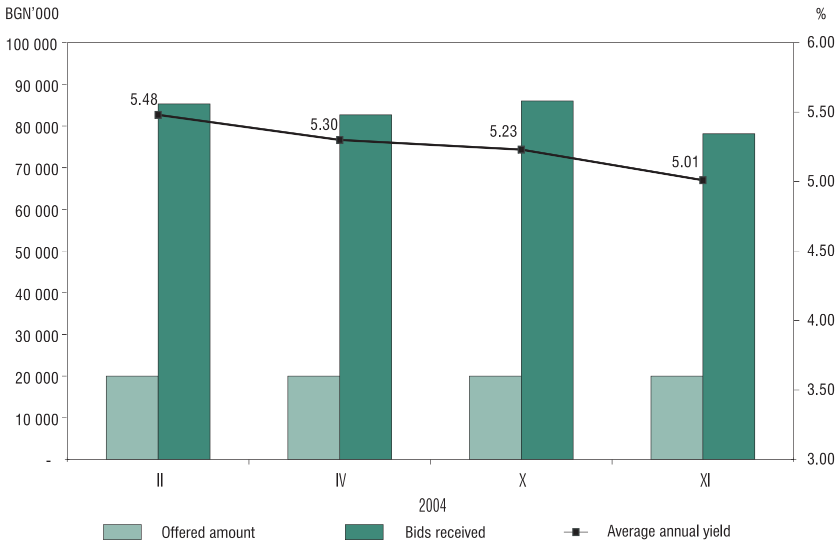
Seven-year Bond Issues



Source: *MF.*

A sole issue sold at four auctions also represented ten-year bonds. Interest remained consistently high, with yield moving between 5.48 per cent in February and 5 per cent in November. Overall sales of bonds with this maturity came to BGN80m, with an average bid-to-cover ratio of 4.15.

Ten-year Bond Issues



Source: *MF*.

November 2003 saw the first offering of 15-year eurobonds. The issue was opened again in 2004 at two auctions. Nominal offer volume was EUR65m. Bid-to-cover ratio was 2.89, with demand coming from traditional buyers like commercial banks, as well as from pension funds, insurers, and foreign investors. Average yield on approved bids came to 6 per cent.

Government Securities Issues in 2004

Table 1

Auction date	Issue date	Issue number	Maturity (months)	Maturity date	Interest rate	Offered amount (BGN/EUR)	Bids received (BGN/EUR)	Bids approved at nominal value (BGN/EUR)	Bids approved at sell price (BGN/EUR)	Average price attained per 100 units nominal value	Minimum approved price per 100 units nominal value	Average annual yield (%)	Maximum approved yield (%)
5.01.2004	7.01.2004	BG 20 300 04 118	60	7.01.2004	4.7	20 000 000	84 450 000	20 000 000	19 957 540.00	99.79	98.00	4.75	4.79
12.01.2004	14.01.2004	BG 30 100 04 003	12	14.01.2005	0.0	20 000 000	40 350 000	20 000 000	19 304 925.00	96.52	95.60	3.55	3.73
19.01.2004	12.11.2003	BG 20 404 03 219*	180	11.10.2018	6.0	50 000 000	124 820 000	50 000 000	49 714 053.51	99.43	91.15	6.06	6.13
26.01.2004	28.01.2004	BG 30 101 04 001	3	28.04.2004	0.0	12 000 000	22 350 000	12 000 000	11 924 752.00	99.37	99.00	2.51	2.59
2.02.2004	4.02.2004	BG 20 400 04 215	120	4.02.2014	5.2	20 000 000	85 300 000	20 000 000	19 570 500.01	97.85	90.34	5.48	5.52
69.02.2004	11.02.2004	BG 20 401 04 213	84	11.02.2011	4.8	20 000 000	76 850 000	20 000 000	19 683 320.01	98.42	92.92	5.02	5.06
16.02.2004	18.02.2004	BG 20 301 04 116	36	18.02.2007	3.3	20 000 000	93 850 000	20 000 000	19 952 240.00	99.76	94.57	3.39	3.51
23.02.2004	25.02.2004	BG 30 102 04 009	3	25.05.2004	0.0	12 000 000	24 150 000	12 000 000	11 928 230.00	99.40	99.15	2.41	2.54
1.03.2004	7.01.2004	BG 20 300 04 118	60	7.01.2009	4.7	20 000 000	60 120 000	20 000 000	20 000 000.00	100.72	98.00	4.54	4.65
29.03.2004	31.03.2004	BG 30 103 04 007	3	30.06.2004	0.0	12 000 000	19 430 000	12 000 000	11 923 405.00	99.36	99.10	2.55	2.79
13.04.2004	4.02.2004	BG 20 400 04 215	120	4.02.2014	5.2	20 000 000	82 680 000	20 000 000	19 839 891.49	99.20	93.00	5.30	5.34
19.04.2004	18.02.2004	BG 20 301 04 116	36	18.02.2007	3.3	20 000 000	48 250 000	20 000 000	19 994 360.00	100.11	92.00	3.27	3.44
26.04.2004	28.04.2004	BG 30 104 04 005	3	28.07.2004	0.0	12 000 000	16 520 000	12 000 000	11 921 415.00	99.35	99.00	2.59	3.27
3.05.2004	11.02.2004	BG 20 401 04 213	84	11.02.2011	4.8	20 000 000	39 060 000	20 000 000	19 354 544.01	96.77	91.80	5.31	5.43
25.05.2004	26.05.2004	BG 30 105 04 002	3	26.08.2004	0.0	12 000 000	14 000 000	12 000 000	11 883 180.00	99.03	98.62	3.83	5.03
7.06.2004	7.01.2004	BG 20 300 04 118	60	7.01.2009	4.7	20 000 000	35 850 000	20 000 000	19 375 985.00	96.88	87.53	5.42	5.59
28.06.2004	30.06.2004	BG 30 106 04 000	3	30.09.2004	0.0	12 000 000	28 560 000	12 000 000	11 925 450.01	99.38	98.68	2.44	2.56
26.07.2004	28.07.2004	BG 30 107 04 008	3	28.10.2004	0.0	12 000 000	25 630 000	12 000 000	11 925 962.50	99.38	99.00	2.44	2.52
2.08.2004	12.11.2003	BG 20 404 03 219*	180	11.10.2018	6.0	15 000 000	62 878 000	15 000 000	15 000 000.00	100.59	95.00	5.94	5.97
9.08.2004	18.02.2004	BG 20 301 04 116	36	18.02.2007	4.6	20 000 000	46 040 000	20 000 000	20 000 000.00	100.08	96.81	4.56	4.58
23.08.2004	25.08.2004	BG 30 108 04 006	3	25.11.2004	0.0	12 000 000	23 360 000	12 000 000	11 927 375.00	99.39	99.16	2.40	2.48
13.09.2004	7.01.2004	BG 20 300 04 118	60	7.01.2009	4.7	20 000 000	76 600 000	20 000 000	19 981 329.99	99.94	97.50	4.71	4.81
20.09.2004	18.02.2004	BG 20 301 04 116	36	18.02.2007	3.5	20 000 000	43 500 000	20 000 000	19 999 858.33	100.03	97.00	3.50	3.53
27.09.2004	29.09.2004	BG 30 109 04 004	3	29.12.2004	0.0	12 000 000	25 130 000	12 000 000	11 927 981.00	99.40	99.25	2.39	2.43
4.10.2004	4.02.2004	BG 20 400 04 215	120	4.02.2014	5.2	20 000 000	86 010 000	20 000 000	19 949 630.01	99.75	93.00	5.23	5.26
11.10.2004	18.02.2004	BG 20 301 04 116	36	18.02.2007	3.5	20 000 000	53 900 000	20 000 000	20 000 000.00	100.08	96.00	3.49	3.51
25.10.2004	27.10.2004	BG 30 110 04 002	3	27.01.2005	0.0	12 000 000	14 300 000	12 000 000	11 925 490.00	99.38	99.12	2.44	2.80
1.11.2004	11.02.2004	BG 20 401 04 213	84	11.02.2011	4.8	20 000 000	90 400 000	20 000 000	19 921 570.00	99.61	95.00	4.82	4.87
15.11.2004	4.02.2004	BG 20 400 04 215	120	4.02.2014	5.2	20 000 000	78 128 000	20 000 000	20 000 000.00	101.47	96.50	5.01	5.10
22.11.2004	24.11.2004	BG 30 111 04 000	3	24.02.2005	0.0	12 000 000	26 380 000	12 000 000	11 927 504.98	99.40	99.11	2.36	2.40
7.12.2004	11.02.2004	BG 20 401 04 213	84	11.02.2011	4.8	20 000 000	97 000 000	20 000 000	20 000 000.00	101.69	97.40	4.48	4.57
13.12.2004	15.12.2004	BG 30 112 04 008	12	15.12.2005	0.0	20 000 000	40 950 000	20 000 000	19 436 337.50	97.18	96.00	2.86	3.05
20.12.2004	7.01.2004	BG 20 300 04 118	60	7.01.2009	4.7	20 000 000	92 285 000	20 000 000	20 000 000.00	103.98	100.00	3.67	3.75
27.12.2004	29.12.2004	BG 30 113 04 006	3	29.03.2005	0.0	12 000 000	19 080 000	12 000 000	11 928 732.00	99.41	99.01	2.37	2.50

* Issue BG2040403219 is denominated in euro and all values related to it are also in euro.

Source: *MF.*

Issues of Government Securities Targeted to Individual Investors

In 2004 the Ministry of Finance continued to issue bonds targeted to retail sale. Issues sold over the year had an overall nominal value of BGN22.6m or 3.26 per cent of the overall government securities volume for the year. This was BGN7.2m less than the volume sold in the prior year.

Securities were issued monthly, staying available for a month. Six issues of three-year lev bonds and four issues of five-year eurobonds were offered. Average yield on lev bonds was 5.73 per cent, with euro yield coming to 4.92 per cent.

The issues continue on offer through the BNB and a network of primary dealers contracted to sell them.

2. Debt Service

Domestic debt repayments during 2004 came to BGN369.2m, or BGN434.3m less than in 2003. Of this, principal repayments came to BGN240.4m and interest to BGN128.8m. Treasury bond interest accounted for BGN116.7m (90.61 per cent). Discounts on treasury bills accounted for BGN2.6m (2.04 per cent), and BGN9.5m (7.35 per cent) was interest on government securities issued in support of structural reform.

Government Securities Issued for Structural Reform

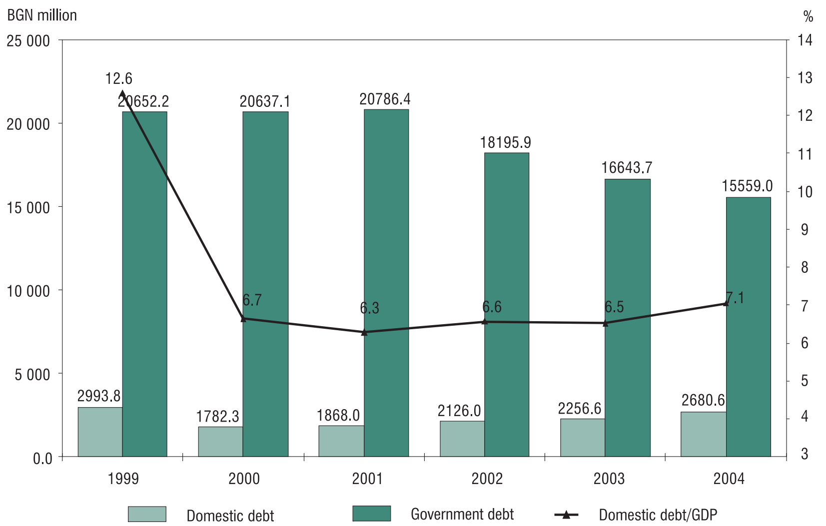
The volume of government securities issued in support of structural reform in the real and banking sectors fell by BGN67.8m.

Four subscriptions were opened during the year for exchanges of dollar denominated ZUNK bonds into euro denominated bonds. Exchanges under §13 of the Transitional and Final Provisions of the 2004 Republic of Bulgaria State Budget Law were effected regularly each quarter. These exchanges, in progress since 1999, are part of domestic debt management measures which aim, *inter alia*, to cut the dollar component of debt in favour of the lev and the euro.

Transactions during the year led to US dollar denominated ZUNK bonds worth a nominal USD701 thousand being exchanged for euro denominated ZUNK bonds to an overall nominal value of EUR571 thousand.

No payments for privatisation deals and repayments of debt to the state by ZUNK bonds were made in 2004.

Domestic Debt



Source: *MF.*

Table 2

Domestic Debt Dynamics*

	Debt by 31 Dec 2003, BGN million	Rise, BGN million	Fall, BGN million	Debt by 31 Dec 2004, BGN million	Nominal rise/fall	%
Government debt	2 256.70	694.85	254.41	2 680.62	423.92	18.78
1. Government securities issued	1 719.50	693.74	202.07	2 211.16	491.66	28.59
3-month	34.17	144.00	142.17	36.00	1.83	5.36
1-year	40.00	40.00	40.00	40.00	0.00	0.00
2-year	14.06	0.00	14.06	0.00	-14.06	-100.00
3-year	254.32	113.10	2.35	365.08	110.76	43.55
5-year	572.54	109.50	3.50	678.55	106.01	18.52
7-year	580.36	80.00	0.00	660.36	80.00	13.78
10-year	184.92	80.00	0.00	264.92	80.00	43.26
15-year	39.12	127.13	0.00	166.25	127.13	0.00
2. Structural reform government securities	528.92	1.12	44.06	469.46	-59.47	-11.24
19-year	2.20	0.00	0.28	1.93	-0.28	-12.50
20-year	262.93	1.12	18.78	245.26	-17.67	-6.72
24-year	1.78	0.00	0.13	1.65	-0.13	-7.14
25-year	262.01	0.00	24.87	220.61	-41.40	-15.80
3. Deposit insurance government securities	8.28	0.00	8.28	0.00	-8.28	-100.00
7-year	8.28	0.00	8.28	0.00	-8.28	-100.00
Overall domestic debt	2 256.70	694.85	254.41	2 680.62	423.92	18.78

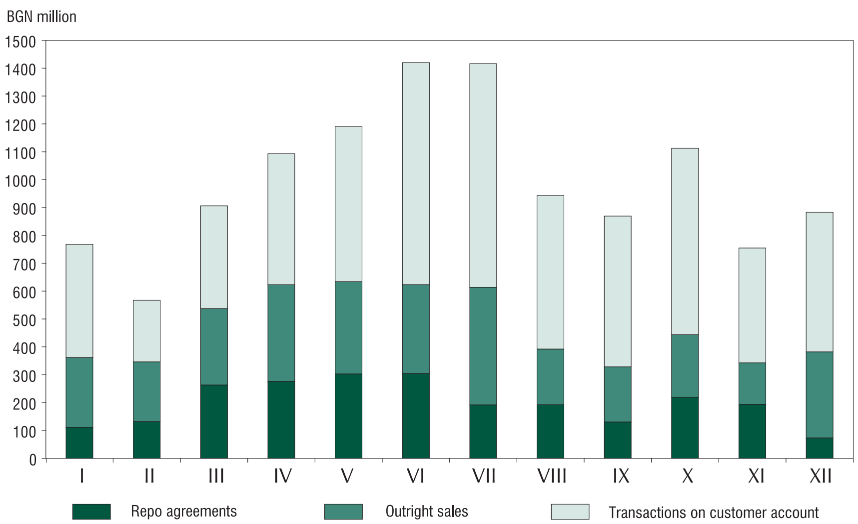
**All data at nominal values.*

Source: *MF.*

III. The Secondary Government Securities Market

In 2004 the secondary market in government debt instruments developed dynamically with marked interest in long- and medium-term bonds. The recent years' upward trend in the secondary market trading continued. Primary dealers used government securities not only as a risk-free and profitable investment, but also as a means of covering current liquidity needs.

The year saw 8978 transactions to a total nominal value of BGN11,197m: a 21.3 per cent increase on 2003. Most deals (49.6 per cent) were with, or on account of, customers, followed by outright transactions (29.1 per cent) and repo agreements (21.3 per cent). The year also saw four privatisation deals to a nominal value of USD111.6 thousand, and 90 settlements of debt to the state to the amount of USD4597.6 thousand and EUR1201.1 thousand.

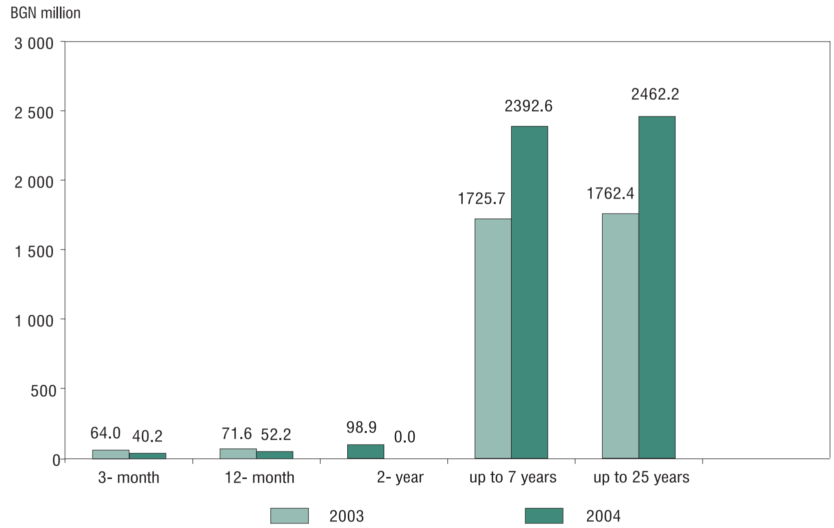


Traded Government Securities Volume in 2004

Notes: *1. Including approved bids at government securities auctions on the account of non-primary dealers, companies, and individuals.*
2. Repo volumes include reverse repo agreements and current day transactions.
3. Foreign exchange denominated government securities are at lev equivalence using BNB rates valid for the day of each transaction.

Source: *BNB.*

Maturity Structure of Government Securities Transactions on the Interbank Market

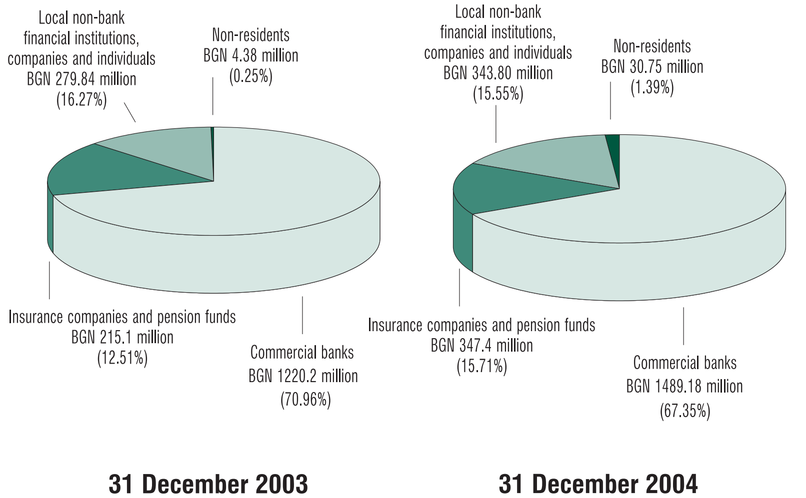


Note: *1. Foreign exchange denominated government securities are at lev equivalence using BNB foreign exchange rates valid on the final business day of each period.*
2. Repo volumes exclude reverse repo agreements.

Source: *BNB.*

Traded volumes were again uneven over individual months. As in previous years, the liveliest trade was on days when new government securities issues were offered, and in periods when commercial banks adjusted their minimum required reserves with the BNB. Most buoyantly traded on the secondary market were long-term government securities which recorded transactions to a nominal value of BGN6962.7m (37.5 per cent higher than in 2003), with medium-term government securities deals notching up BGN4044.4m in nominal value (an 8.5 per cent increase on 2003). Of the total traded volume in 2004, long-term government securities accounted for 62.2 per cent, followed by medium-term and short-term government securities with respectively 36.1 per cent and 1.7 per cent.

Holders of Budget Deficit Financing Government Securities

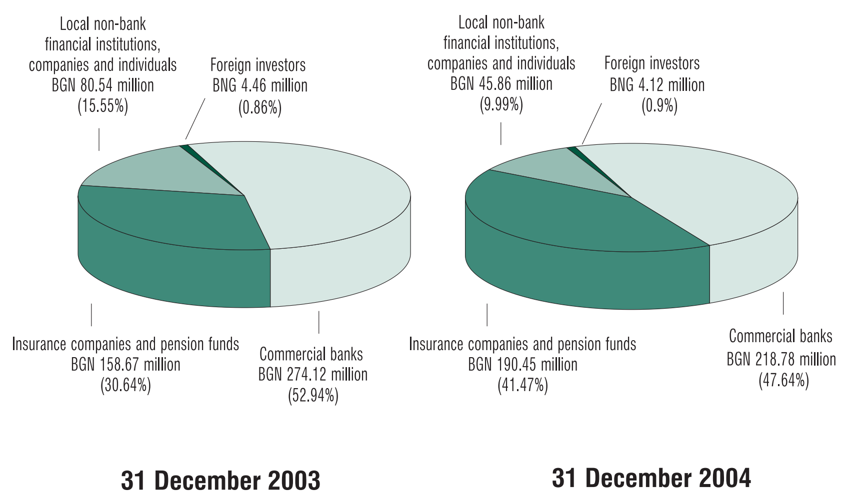


Notes: *1. Including government securities blocked by holders.*
2. Including issues targeted to individual investors.
3. Foreign exchange denominated securities are at lev equivalence using BNB foreign exchange rates valid on 31 December of the corresponding year.

Source: *BNB.*

The structure of government securities holders stayed relatively calm in 2004. Government securities issued for budget deficit financing were again largely held by commercial banks (67.4 per cent), followed by insurance companies and pension funds (15.7 per cent), local non-bank financial institutions, companies and individuals (15.5 per cent), and foreign investors (1.4 per cent).

Holders of Structural Reform Government Securities



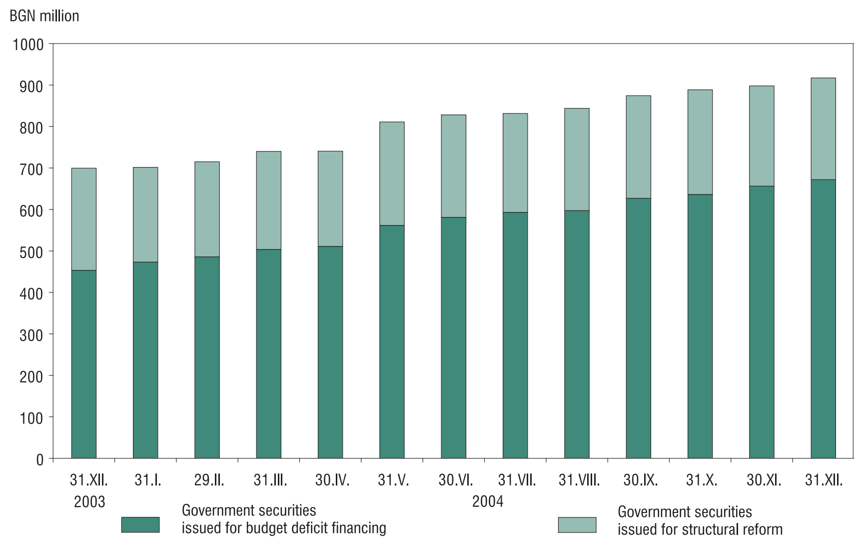
Notes: *1. Including government securities blocked by holders.*
2. The lev equivalent is computed at BNB rate quoted for 31 December of the respective year.

Source: *BNB.*

A similar structure emerges for government securities issued for structural reform: the greatest share of holders are commercial banks (47.6 per cent), followed by insurance companies and pension funds (41.5 per cent), local non-bank financial institutions, companies and individuals (10 per cent), and foreign investors (0.9 per cent).

At the end of 2004 investment into budget deficit financing government securities by non-bank financial institutions, companies, and individuals grew by 42 per cent, while that into structural reform government securities increased by 7.4 per cent on early 2004.

Government Securities Investment by Non-bank Financial Institutions, Companies, and Individuals



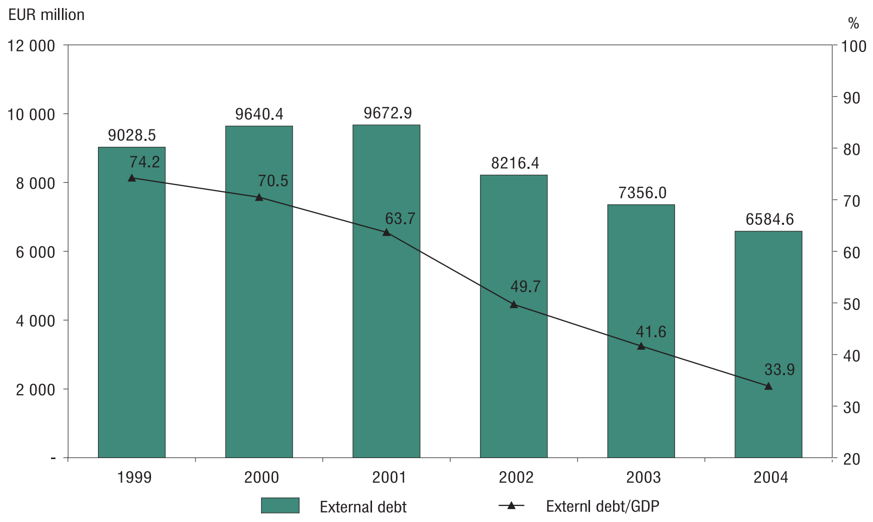
Note: *1. Foreign exchange denominated securities are at lev equivalence using BNB foreign exchange rates valid on the final business day of each period.*

Source: *BNB.*

IV. External Debt

In 2004 external government and government guaranteed debt fell by EUR771.4m to EUR6584.6m. The drop resulted from negative foreign financing and the US dollar fall against the euro. The *external debt to GDP* ratio reached 33.9 per cent against 41.6 per cent in late 2003.

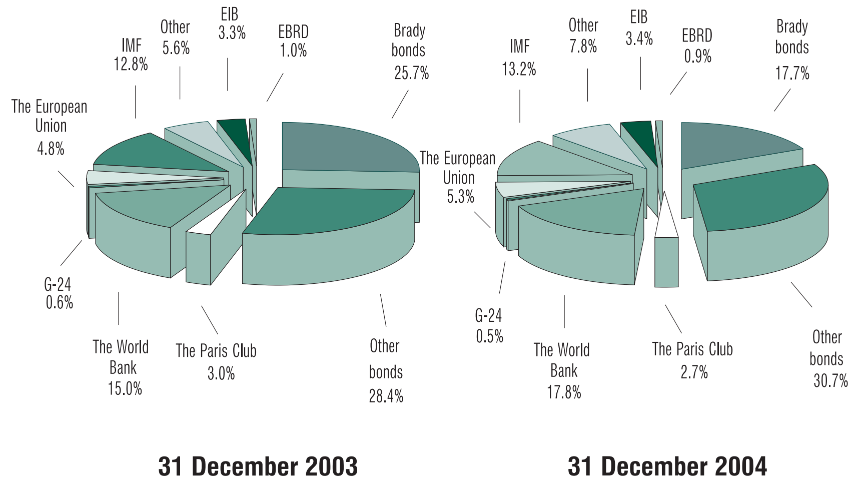
External debt to GDP Ratio



Source: *MF.*

The structure of debt by creditor underwent significant changes. The buybacks of DISC bonds and the falling US dollar cut the Brady bond share by 8.8 percentage points. This boosted the share of eurobonds and World Bank obligations by over two points each, with other debts' shares rising by under a point each. Falls in the share of debt were noted only with regard to the G-24 and the Paris Club. Market debt instruments fell to 48.3 per cent, with loans and government guarantees rising to 44.9 per cent and 6.7 per cent respectively.

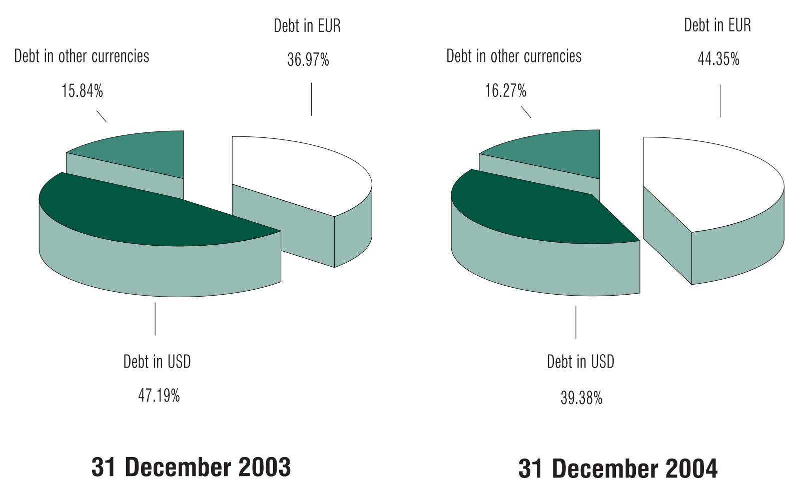
External Debt by Creditor



Source: *MF.*

Over 2004 the currency composition of debt continued to show a rise in the euro component at the expense of US dollars. Euro denominated debt rose by 7.4 percentage points on 2003 to 44.4 per cent. A fall in US dollar debt from 47.2 per cent to 39.4 per cent accompanied this. Currency structure improvement was largely due to the repayment before maturity of some Brady bonds, and to the significant weakening of the US dollar against the euro. The regular repayments of US dollar debt and the policy of borrowing mainly in euro also brought results.

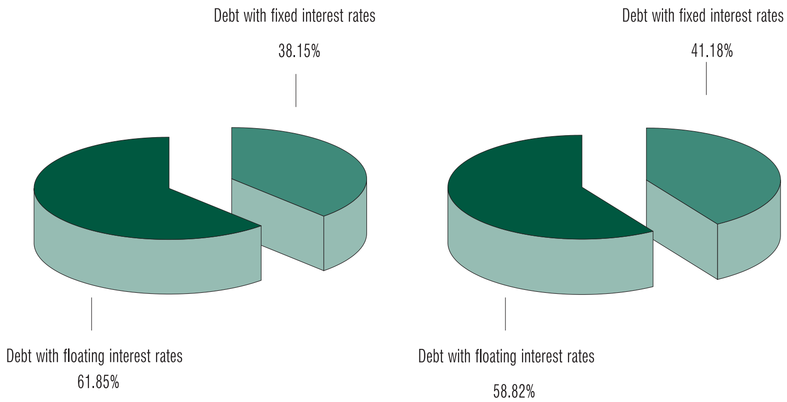
Currency Structure of External Government and Government Guaranteed Debt



Source: *MF.*

The ratio between fixed and floating interest debt also changed over the year, with the fixed interest debt growing by 38.2 per cent to 41.2 per cent. The change again reflected the repayment before maturity of Brady bonds with their floating interest rates, and the fall in US dollar debt, which is largely without fixed interest coupons.

Interest Rate Structure of External Government and Government Guaranteed Debt



31 December 2003 **31 December 2004**

Source: *MF.*

1. External Financing

New external financing received in 2004 came to EUR412.2m, largely from official creditors (the World Bank and the IMF). Most World Bank funds were disbursed under the Second Programmatic Adjustment Loan (PAL 2), coming to EUR103.1m. This is the second of three structural loans in the World Bank's three-year *strategy backing Bulgaria's economy*. The IMF remitted EUR62m into the central budget under the two-year standby agreement. The year also saw the arrival of finance for investment projects funded by government and government guaranteed loans. Government investment finance came to EUR97.4m, with government guaranteed loans comprising EUR129.9m.

Net external financing over the year was negative and totaled EUR558.8m. This was due both to lower borrowing and to the buybacks of Brady bonds (DISCs). The greatest positive balance was under World Bank loans at EUR78.7m, followed by government guaranteed loans at EUR60m. Negative financing also featured in repayments to the IMF, the Paris Club, and the G-24. Net financing under government investment loans in 2004 was positive to the amount of EUR58.4m.

Table 3

New External Financing and External Debt Repayments in 2004

(EUR million)

Structure	Loans or tranches	Repayments, incl.		
		Principal	Interest	Total
Government debt	282.3	901.2	288.6	1 189.8
I. Bonds	-	657.7	202.6	860.2
1. Brady bonds	-	657.7	38.3	696.0
2. Other bonds	-	-	164.3	164.3
II. Loans	282.3	243.5	86.1	329.6
1. Paris Club	-	43.0	7.5	50.4
2. World Bank	122.9	44.2	25.9	70.1
2.1. World Bank	122.9	34.7	23.4	58.1
2.2. JBIC (JEXIM)	-	9.5	2.5	12.0
3. G-24	-	6.2	0.9	7.1
4. European Union	-	-	7.2	7.2
5. IMF	62.0	106.2	25.1	131.3
6. Other	-	-	1.7	1.7
7. Government investment loans	97.4	39.1	16.4	55.5
7.1. World Bank	27.4	2.2	2.4	4.6
7.2. EIB	54.0	26.1	11.0	37.2
7.3. EBRD	0.0	7.9	1.2	9.1
7.4. Other	16.0	2.9	1.7	4.6
8. Called government guarantees	-	4.8	1.4	6.2
8.1. World Bank	-	3.8	1.1	4.8
8.2. EIB	-	0.4	0.1	0.5
8.3. Other	-	0.7	0.2	0.9
Government guaranteed debt	129.9	69.9	16.2	86.1
1. World Bank	14.1	23.4	4.9	28.3
2. EIB	-	35.3	2.3	37.6
3. EBRD	8.8	9.7	0.8	10.5
4. Other	107.1	1.4	8.2	9.7
Overall	412.2	971.1	304.8	1 275.9

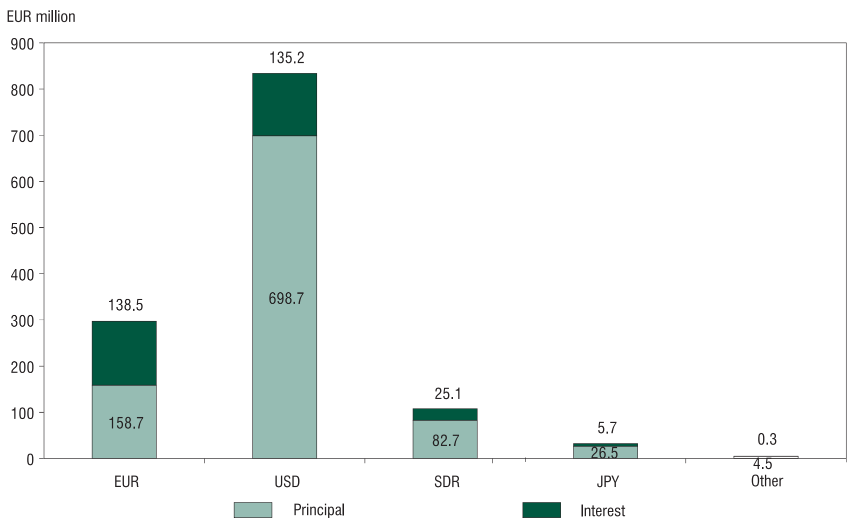
Note: *The lev equivalent of new external financing and repayments is at the BNB central rate at 4pm on the day of respective payment.*

Source: *MF.*

2. Debt Service

Over the past year, external debt repayments came to EUR1275.9m, of which EUR971.1m was of principal and EUR304.8m of interest. US dollar repayments dominated at a euro equivalent of 698.7m, followed by euro repayments of 158.97m and SDR repayments to a euro value of 82.7m.

Currency Structure of External Debt Repayments by 31 December 2004



Source: *MF.*

Most repayments addressed Brady bonds at EUR657.7m, followed by amortisation payments to the IMF at EUR106.2m, the World Bank at EUR44.2m, the Paris Club at EUR43m, and government investment loan repayments of EUR39.1m. Called government guarantees resulted in repayments of EUR4.8m from the state budget.

The falling US dollar euro rate and continuing low international interest rates influenced interest repayments during the year. The relatively high share of dollar debt and floating interest coupons kept interest repayments low. Interest repaid on external obligations in 2004 came to EUR304.8m or 3.4 per cent of overall budget expenditure and 1.4 per cent of GDP. Bond repayments had the largest share at EUR202.6m. Interest on government investment loans came to EUR16.4m, and on government guaranteed loans to EUR 16.2m.

Table 4

External Debt

(EUR million)

Structure	by 31 December 2003	by 31 December 2004
Government debt	6 961.1	6 140.6
I. Bonds	3 981.6	3 182.4
1. Brady bonds	1 890.1	1 164.1
2. Other bonds	2 091.4	2 018.3
II. Loans	2 979.5	2 958.2
1. Paris Club	218.9	176.3
2. World Bank	870.0	930.6
3. G-24	42.0	34.6
4. European Union	350.0	350.0
5. IMF	940.2	868.7
6. Other	125.2	125.2
7. Government investment loans	383.0	428.8
7.1. World Bank	83.1	108.0
7.2. EIB	193.5	214.8
7.3. EBRD	31.8	22.8
7.4. Other	74.6	83.2
8. Called government guarantees	50.2	43.9
8.1. World Bank	41.0	36.4
8.2. EIB	1.8	1.3
8.3. Other	7.4	6.2
Government guaranteed debt	394.9	444.0
1. World Bank	109.2	96.0
2. EIB	44.5	9.2
3. EBRD	39.5	37.2
4. Other	201.7	301.7
Overall	7 356.0	6 584.6

Note: *At nominal values. Euro conversion at BNB central rates for the closing business day of each period.*

Source: *MF.*

V. Government Debt Management Strategy Update

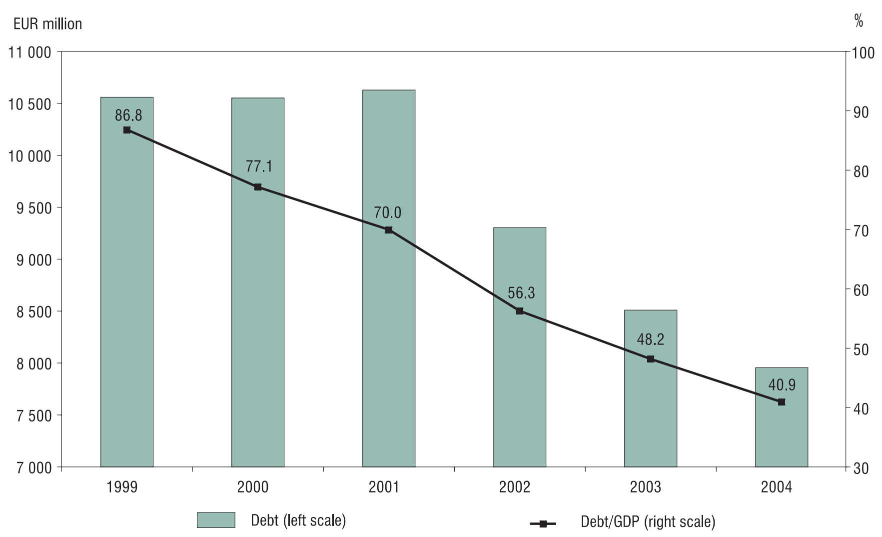
The past year featured an external environment and fiscal parameters which were relatively benign towards the state and the servicing of government debt. The budget balance was positive, with an excess in the revenue helping accumulate a surplus of 1.5 per cent of GDP. This removed the need for positive debt financing and increased fiscal reserve. World interest rates remained low and the dollar euro (and hence lev) rate fell significantly on 2003. In view of the structure of government debt, these factors contributed to cutting the expenditure for its service.

The domestic market of government securities continued developing as expected, with the banking credit expansion exercising the greatest influence. This expansion affected banking liquidity greatly, yet demand for government securities remained high.

The Standard & Poor's and Fitch agencies raised Bulgaria's credit rating to investment in 2004. This assessment rewarded provident fiscal policy, the development of the real sector, and Bulgaria's advance towards European Union accession. The ratings remove Bulgaria to a different borrower category, enabling it to access a much broader investor range and obtain cheaper finance.

In this environment, debt management policy effected a significant improvement in debt parameters. Expressed nominally, debt fell by EUR555m to EUR7.96b, while as a proportion of GDP it fell by 7.3 percentage points to 40.9 per cent. This was the fifth consecutive year to show *debt/GDP* ratio falls in excess of 7 percentage points – something largely due to two factors: stable economic growth and a prudent fiscal policy.

Dynamics of Government and Government Guaranteed Debt between 1999 and 2004



Source: *MF.*

Apart from the debt reduction, the year brought a number of other results stemming from the Government Debt Management Strategy:

A Smooth Increase in the Share of Fixed Interest Debt until Attainment of a Balanced, Risk-neutral Structure (45–50 per cent)

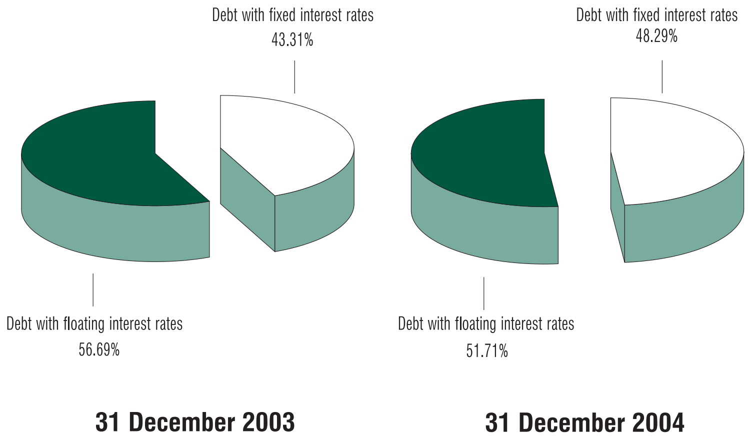
The policy of drawing mainly fixed interest loans continued in 2004. Only one floating interest issue was launched on the home market. Interest payments on that issue reflect the three-month SOFIBOR, and its basic purpose is to support the development of the interbank money market.

External financing over the past year came entirely from international financial institutions and largely comprised disbursements of existing loans and programmes. Whenever lender conditions allowed, and parameters offered were favourable, fixed interest coupons were also preferred.

Discount Brady bonds to a nominal value of USD679.3m were bought back in July, all bonds featuring floating interest coupons. Apart from cutting debt significantly, this also improved its interest structure.

The measures undertaken in 2004 boosted fixed interest debt by 5 percentage points to 48.3 per cent: a result which falls within the set parameters of a balanced structure.

Interest Structure of Government and Government Guaranteed Debt



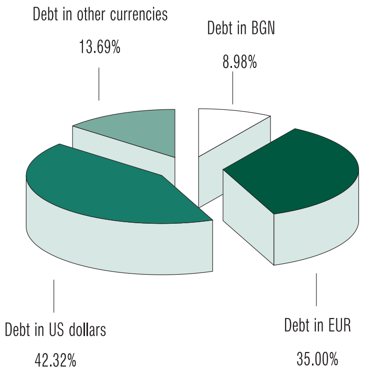
Source: *MF.*

Boosting the Lev and Euro Share of Debt

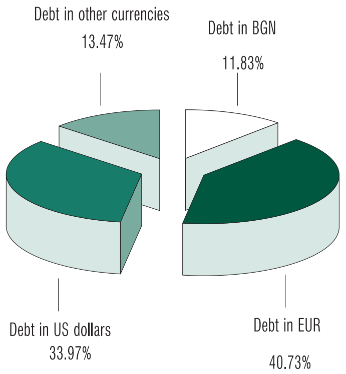
The growing convergence between Bulgaria's economy and that of the European Union reinforces the need to cut the dependence of budget liabilities on the movements of other currencies. In this context, the past year saw a continued reorientation of borrowing to levs and euro, except for minor disbursements of existing government investment loans. The aforementioned discount Brady bond buybacks also effected a major realignment in debt currency structure.

This policy, as well as the falling dollar euro rate cut dollar debt and hence boosted the lev and euro share of debt from 35 per cent to 40.7 per cent in 2004.

Currency Structure of Government and Government Guaranteed Debt



31 December 2003



31 December 2004

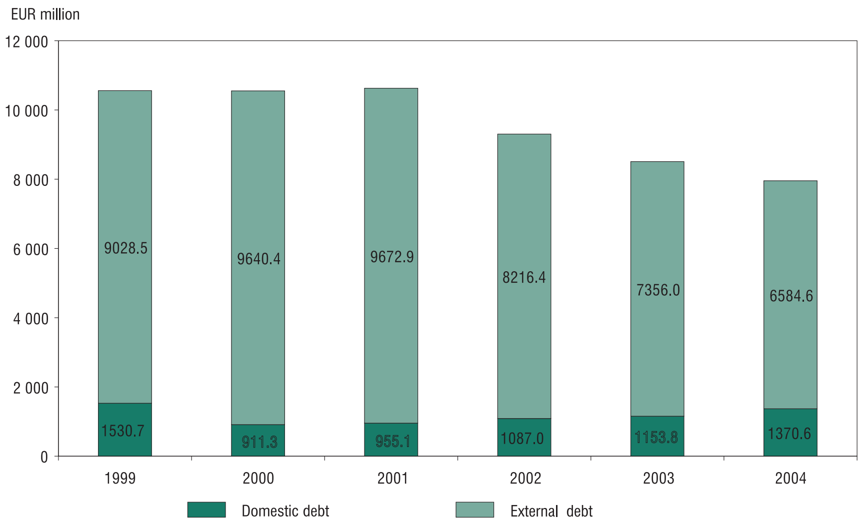
Source: *MF.*

Boosting Domestic Debt at the Expense of External Financing

The last few years' restrictions on contracting new foreign loans, and the favourable macro environment, enabled positive net issues on the domestic market. Demand for government securities remained high over the past year, largely due to the expansion of pension fund assets and to growing banking system liquidity.

The growth of nominal domestic debt over the past year came to BGN424m, or 3.7 percentage points higher as a share of overall debt. Domestic debt reached 17.2 per cent of overall government and government guaranteed debt.

Dynamics of Domestic and External Debts between 1999 and 2004



Source: *MF.*

Creating Conditions for Secondary Market Development

In 2004 the Ministry of Finance adhered to the established practice of issuing tap medium- and long-term securities, thus being able to stimulate each issue's liquidity by boosting its nominal value at subsequent auctions. Cutting the number of issues while increasing issue volumes also had the positive effect of developing the domestic government debt market. Offering government securities of varying maturities which fit major points on the benchmark yield curve was also a basic priority of the policy of creating favourable conditions for the development of the local secondary market. In this connection the year saw short-term (three-month and 12-month) government securities issues which occupied a 28.02 per cent share, medium-term (three- and five-year) government securities with a 29.80 per cent share, and long-term (seven-, ten- and 15-year) government securities with a 42.78 per cent share. Currency diversification accompanied the diversification of government securities by maturity. The year saw auction offers of 15-year EUR-denominated government securities to a total nominal value of EUR65m, or 18.94 per cent of all government securities issues.

In 2004 various other measures aiming to promote Ministry of Finance issuing policy and keep interested parties abreast of developments and to provide feedback on the state of the debt market and on trends in it accompanied the areas of emphasis listed above. Thus the Ministry announced its issuing intentions for 2004 as early as the close of 2003, publishing monthly issue calendars 30 days ahead. In addition, the Ministry maintains a broad range of data on its website and Reuters pages, and attends meetings with market participants.

Developing Auction and Government Securities Registration Systems

In line with the Government Debt Management Strategy, the Ministry of Finance and the Bulgarian National Bank as debt agent undertook a number of measures to develop new systems for the primary sale of government securities at auctions, and for registering, servicing, and secondary market government securities trading consistent with the best practice in this area. The new auction system went live in early November 2004. It allows, *inter alia*, automated auctioneering, standardized orders, alternative communications routes (SWIFT and VPN), cutting auction duration to the minimum, and allowing parallel proceeding of auctions. A new system for government securities registering, servicing, and trading is due to come on stream in coming years, and shall provide the requisite modern infrastructure for the secondary market trade in government securities.

Boosting the Share of Individual Investor Issues

Efforts to boost the volume of issues targeted to individual investors (local and foreign individuals) continued during the year. To this end the Ministry of Finance broadened the range of instruments by offering euro as well as lev government securities, and lengthened securities' maturities from three to five years. February saw the first launch of five-year EUR-denominated government securities issue targeted to individuals. Some EUR4.32m of the issue has sold by the close of the offer period. Nevertheless, the 2004 relative share which individual investor securities occupy in overall domestic government debt remains within the bounds set in the previous year: 1.80 to 1.90 per cent.

In view of the aims of broadening the investor base and attaining the optimum price for issued domestic debt, and of giving retail investors access to the attractive and secure investment that government securities represent, the Ministry of Finance intends to continue monitoring this particular market segment. Thus, ongoing analyses of the development prospects and opportunities for increasing the share of non-institutional investors in domestic debt remains a priority in its own right.

Maintaining a Fiscal Reserve which Covers at Least One Year's Debt Repayments of about a Billion Euro

Under the 2004 State Budget Law, the minimal amount of the fiscal reserve for 2004 was set at BGN2.5b.

The average amount of the fiscal reserve exceeded the set minimum handsomely. Main factors at play were the emergence of a state budget surplus, and privatisation revenues. By the year's close the fiscal reserve comprised some BGN4.6b: the same as its average annual amount. The large excess over the set lower threshold enabled the buyback of Brady bonds and allowed for the net debt financing to remain negative.

Maintaining an Active Dialogue with Ratings Agencies

Proactive communications with ratings agencies remained a basic Ministry of Finance priority over the past year. Regular annual meetings also took place with the four institutions which assigned ratings to Bulgaria, with active exchanges addressing national development and the economy. It is worth noting that Standard & Poor's and Fitch assigned investment rating (BBB-) to Bulgaria's long-term foreign currency debt.

A Restrictive Approach to Financing Public Projects through Government Debt or Government Guarantees

Two projects received approval in 2004 under the current Ordinance setting the criteria which investment projects must meet to qualify for government loans, and for projects seeking government guarantees. Overall government guarantees were BGN451m. This conservative approach was maintained at the 2004 procedure to approve projects for 2005, with a single project winning approval. A government loan to the value of BGN76m will finance this.

Recent years' experience shows that the selection procedure for projects financed by government loans or government guarantees ensures a high degree of transparency and predictability, and enables prioritisation of the spheres where government support is needed.

Supporting Money Market Development

In line with previously announced Ministry of Finance intent, February 2004 saw the launch of a tap government securities issue with a floating interest coupon linked with the three-month SOFIBOR index. The issue has a three-year maturity and an overall nominal value of up to BGN100m.

The introduction of this type of instrument pursued several objectives. First, secondary market trade in the floating interest coupon issue is a guide to market expectations of interest rate movements, and thus renders the issue useful in developing the domestic government securities market. Second, the link between government securities and the SOFIBOR index contributes to the latter's popularity and imposition as a market alternative to the base interest rate.

In defining measures leading to the attainment of Strategy objectives over the closing stage of the three-year period, basic factors will include:

Budget Prospects

The three-year budget framework does not foresee any serious change in the budget balance *vis-à-vis* the past few years. European Union accession is expected to call for additional funds over the first year of membership, and thus 2007 will feature relatively greater spending.

Cofinancing Projects Linked to European Integration

Securing sources of project finance would also involve assessing the opportunities and benefits which government guarantees lend to projects of great importance to national and economic development. The correct definitions of state priorities and abilities (in both financing and implementation) would be exceptionally significant in avoiding unnecessary increases in government debt or the freezing of spending limits for extended periods.

State of the International Markets

International interest rate movements and the dollar euro rate continue to be important factors in budget interest expenditure. The expected long-term rise in interest rates shall be kept in mind in shaping borrowing policy and in putative early repayments of government debt. The coming EU accession will also entail price changes to new debt, calling for additional analyses of instrument types and maturity terms when choosing finance.

Additionally, the prospects before the world economy and that of Europe in particular (Bulgaria's major trading partner and development engine) need to be considered. Reforms in a number of sectors will also influence decisions. Yet overall debt management policy will adhere to Strategy objectives. Efforts to cut the relative share of debt will continue, as will those to attain a balanced interest structure, cut the effect of foreign exchange rate fluctuations, develop the domestic market and prepare it for EU membership, and reduce the share of direct government finance for large investment projects in favour of attracting private partners.

The year will also see a continuation of efforts to improve State Treasury structure and organisation. Improving teamwork and coordination, introducing accurate control procedures, and cutting operational risk and improving staff qualification will create a favourable environment for improving performance and applying the Government Debt Management Strategy. In 2005 a project leading to a fully integrated State Treasury in line with the practice common to EU member states will be implemented.

Table 5

Dynamics of Government and Government Guaranteed Debt between 1999 and 2004*

(EUR million)

Structure	1999	2000	2001	2002	2003	2004
Domestic debt	**1 530.7**	**911.3**	**955.1**	**1 087.0**	**1 153.8**	**1 370.6**
I. Government debt	1 060.3	906.2	951.7	1 086.1	1 153.8	1 370.6
Budget deficit financing government securities	450.9	491.4	554.6	754.9	879.2	1 130.5
Structural reform government securities	495.5	389.9	382.4	321.7	270.4	240.0
Government securities issued under LSPDACB of 1996	113.9	24.9	14.6	9.4	4.2	-
II. Domestic government guarantees	470.4	5.1	3.4	1.0	-	-
External debt	**9 028.5**	**9 640.4**	**9 672.9**	**8 216.4**	**7 356.0**	**6 584.6**
I. Government debt	8 587.1	9 159.5	9 096.6	7 685.9	6 961.1	6 140.6
Brady bonds	4 954.6	5 347.7	5 400.0	2 398.7	1 890.1	1 164.1
Other bonds	-	-	250.0	2 310.0	2 091.4	2 018.3
Paris Club	811.1	645.3	433.5	284.5	218.9	176.3
World Bank	820.5	889.6	941.1	836.1	870.0	930.6
G-24	70.9	60.8	53.8	48.9	42.0	34.6
European Union	400.0	460.0	390.0	390.0	350.0	350.0
IMF	1 126.5	1 309.4	1 183.4	990.9	940.2	868.7
Others	147.7	136.6	136.6	129.2	125.2	125.2
Government investment loans	207.8	251.0	240.3	236.7	383.0	428.8
Called government guarantees	48.1	59.2	67.8	61.0	50.2	43.9
II. Government guaranteed debt	441.4	480.8	576.3	530.5	394.9	444.0
Total debt	**10 559.3**	**10 551.6**	**10 627.9**	**9 303.4**	**8 509.8**	**7 955.2**
GDP (BGN million)	**23 790.4**	**26 752.8**	**29 709.2**	**32 335.1**	**34 546.6**	**38 008.4**
GDP (EUR million)	**12 163.9**	**13 678.5**	**15 190.1**	**16 532.7**	**17 663.4**	**19 433.4**
Total debt/GDP, %	**86.8**	**77.1**	**70.0**	**56.3**	**48.2**	**40.9**

* Nominal figures.

Note: *Euro conversion at BNB central rates for the closing business day of each period.*
GDP data from the National Statistics Institute.

Source: *MF.*

Table 6

Consolidated Government Debt

(EUR million)

Structure	by 31 December 2003	by 31 December 2004
Consolidated government debt	**8 148.7**	**7 556.6**
1. Central government debt	8 114.9	7 511.2
2. Social security funds debt	0.0	0.0
3. Municipal debt	33.8	46.6
Consolidated government debt/GDP, %	**46.1**	**38.9**

Notes: *1. Central government debt shown at nominal value excluding government guaranteed loans.*
2. 2004 GDP is set at BGN38,008.4m and 2003 GDP is set at BGN34,546.6m.
3. Euro recalculations are at BNB central lev rates for the closing business day of each period.

Source: *MF.*