

# Government Debt Review · 2005



Republic of Bulgaria  
Ministry of Finance

# **Government Debt Review • 2005**

Sofia, 2006

## Abbreviations

AEAF	The Agency for Economic Analysis and Forecasting
BIR	Base Interest Rate
BNB	Bulgarian National Bank
CPI	The Consumer Price Index
DISC	Discount Bonds
EBRD	European Bank for Reconstruction and Development
FDI	Foreign Direct Investments
EIB	European Investment Bank
EU	European Union
EMBI	Emerging Markets Bond Index
FLIRB	Front Loaded Interest Reduction Bonds
FOB	Free on Board
G-24	The Group of the 24 Most Industrialised Nations
G-7	The Group of the Seven Most Industrialised Nations
GDP	Gross Domestic Product
GS	Government Securities
IAB	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
LEONIA	Lev OverNight Index Average
LFS	Labour Force Survey
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
USD	US dollar
WB	The World Bank
ZUNK	The Bulgarian Abbreviation of the Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990

© Ministry of Finance, 2006

ISBN-954-91720-4-X

ISBN-978-954-91720-4-1

Computer design and typeset: BNB Publications Division

Translation, editing and proofreading by the Ministry of Finance

Printed and bounded in the BNB Printing Centre

Contact Point:

The Ministry of Finance

102, Rakovski Street

1040 Sofia

Bulgaria

Tel. +359 2 9859 2497, +359 2 9859 2452

Website: [www.minfin.bg](http://www.minfin.bg)

## Contents

<b>Macroeconomic Development of Bulgaria in 2005</b>	<b>5</b>
1. Economic growth, labor market	6
2. External sector (current account, financial account)	8
<b>Domestic Debt</b>	<b>11</b>
1. Domestic financing	15
2. Debt Service	20
<b>Review of the Secondary Government Securities Market</b>	<b>23</b>
<b>External Debt</b>	<b>29</b>
1. External financing	34
2. External Debt Service	36
<b>Government Debt Management Strategy for the Period 2006-2008</b>	<b>39</b>



**Macroeconomic  
Development of Bulgaria  
in 2005**

## 1. Economic growth, labor market

The real GDP growth in 2005 strengthened the trend towards sustainable economic growth after 1997. GDP has increased by 5.5% in real terms compared to 2004 which ranks Bulgaria among the leaders in this respect. Investment and consumption were fostered by the inflow of foreign capital in the banking system that was attracted by the growing confidence in the economy and by the maintenance of sound macroeconomic policy after the elections in the middle of the year.

On the demand side, the growth of gross fixed capital formation and import of goods and services was the highest – 19.0% and 14.6% respectively. Final consumption and investment<sup>1</sup> have contributed most to the overall GDP growth – 5.9 and 5.5 percentage points respectively. Export growth accelerated from 9.2% in the first quarter to 12% in the second quarter of the year. In the third quarter it slowed down to 1.1% and again accelerated in the fourth quarter to 8.9%. As a result of these changes the cumulative growth for the year reached 7.2%, which is by 5.7 percentage points less than the growth of exports in 2004. Exports growth was outstripped by that of imports, which accelerated to 14.6% in 2005 compared to the previous year and again the contribution of net export of goods and services to overall growth remained negative.

### Structure of GDP Real Growth and Contribution of each Expenditure Element

	2004		2005		2004	2005
	Real growth (%)	Contribution to growth* (p. p.)	Real growth (%)	Contribution to growth* (p. p.)	% of GDP* (current prices)	
Final consumption	5.1	4.5	6.8	5.9	86.8	88.6
Investment in Gross fixed capital formation	13.5	2.6	19.0	4.0	20.8	23.8
Export of goods and services	13.0	6.9	7.2	4.2	58.0	60.8
Import of goods and services	14.1	- 8.9	14.6	- 9.9	68.2	77.4
Gross Domestic Product	5.7	5.7	5.5	5.5	100.0	100.0

\* The contribution of inventory changes and the statistical error are omitted.

Source: AEAF

<sup>1</sup> Including stock.

On the supply side the growth of industry was highest – 7.3%, but its contribution to the overall growth of gross value added (GVA) remained second, by 2.2 percentage points respectively. At the same time, while growing slower (6.6%) the largest economic sector – services – contributed most to GVA increase – 3.9 percentage points, more than the same period of 2004.

## *Wages development*

According to labor force survey (LFS) data the average annual activity rate<sup>2</sup> in 2005 was 62.1%, registering a small increase of 0.35 percentage points compared to 2004. This is due to 2.4% employment growth in the country on an annual basis.

The stable economic growth in recent years has also created good prerequisites for lowering the unemployment rate in the country in 2005. According to NSI the number of unemployed people decreased by 16.4% compared to 2004 and the average annual unemployment rate dropped to 10.1%, which is 1.9 percentage points less than in the previous year.

In 2005 the annual average salary per month was EUR 163 (EUR 203 in the public sector and EUR 145 in the private sector)<sup>3</sup>. Compared with the previous year it has risen by 4% in real terms. The increase is 3.2% in the public sector and 6.1% in the private sector.

## *Inflation*

The inflation measured at the end of 2005 was 6.5%. The contribution of administratively set prices to the overall inflation is 1.3 percentage points. In 2005 the factors that influenced inflation most were the rise of food prices after the summer floods, the sharp rise of fuel prices and the rise in the price of some services, including the price of central heating for households. The consumer price index (CPI) for non-regulated (market) prices in 2005 was 6.5%, which is significantly higher than in 2004 – 1.6%. Its share in the overall inflation is 5.2 percentage points. The main reason for the higher and positive CPI for market prices was the cumulative rise of food prices in 2005 by 6.8%.

<sup>2</sup> Population between 15 and 64 years of age.

<sup>3</sup> According to NSI preliminary data.



The annual average inflation in 2005 reached 5.0%, mostly due to the rise in consumer prices at the end of 2004.

## CPI change (monthly), 2005

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
0.74	0.87	0.33	1.07	-0.48	-1.31	0.10	0.58	1.40	1.18	0.99	0.83

Source: AEAF

## 2. External sector (current account, financial account)

According to the amended by BNB methodology in 2005 the balance of payments<sup>4</sup> of the country deteriorated due to the almost double increase of the current account deficit compared to 2004. The latter reached 11.8% of GDP. This development was mainly due to the deterioration of the trade deficit – by EUR 1.4 billion respectively, reaching 20.4% of GDP. However, it should be noted that the high trade deficit in 2005 resulted from the strong growth of imports due to the record high fuel prices and due to the restructuring of imports in favor of investment goods. The latter rose by 31.2% in 2005 compared to 2004 and amounted to 27.6% of overall imports. Furthermore, the import of goods and raw materials mainly for the export industries maintained their greatest share of almost 36%. Their increase by 14.8% compared to 2004 was slower than the growth of investment goods imports. At the same time, the imports growth remained high thus further contributing to the stable increase of the import of raw materials for the export industries. However, on the other hand the observed accelerating rate of investment goods imports confirms the successful restructuring of the Bulgarian economy towards production and export of goods with higher added value.

<sup>4</sup> The new methodology for balance of payments compilation, amended in March 2006 and implemented since the beginning of 2006, has led to substantial changes in the 2004 and 2005 data. The current account deficit for the past year has been reduced by EUR 632.4 million and according to the new data is 11.8% of GDP. The most important changes refer to the estimation of imports at FOB prices, receipts and payments regarding the freight transportation, and flows due to unofficial employment of Bulgarians in other countries. At the same time 2004 data for foreign direct investment and the related thereto income payable have been corrected. Through the changes implemented EUR 790.3 million from the accrued for 2005 EUR 1016.6 million errors and omissions have been allocated.

The macroeconomic stability in Bulgaria and the favorable economic situation encouraged foreign capital inflows thus ensuring the funding of the increasing investment. Foreign direct investments (FDI) in Bulgaria amounted to EUR 1.8 billion, reaching 8.3% of GDP.

The financial account remained stable and covered 114% of the current account deficit. In 2005 the overall balance of the balance of payments reached EUR 569.3 million, thus providing an opportunity to increase the BNB Reserve Assets by EUR 324.3 million. This increase was enough to ensure growth of the monetary base and the monetary aggregates under a Currency Board Arrangement. In this sense, the balance of payment development as a whole did not have a negative effect on the overall economic development.

### *Monetary policy*

At the end of December 2005, the money supply measured by its broadest monetary aggregate M3 registered in real terms 16.3% growth on an annual basis. Under the Currency Board Arrangement in the country the money supply is determined mainly by the broadening of the financial intermediation of the banking sector which at the beginning of 2005 registered relatively high credit growth for the non-government sector. The remonetization of the national economy continues, as the monetary aggregate M3 reached 60.2% of GDP at the end of December 2005. At the end of 2004 it was 53.3%.

The regulatory measures undertaken by the Bulgarian National Bank (BNB) in April attained their goal to curb credit growth. The receivables from the non-government sector increased by 24.4% on an annual basis in real terms and at the end of 2005 amounted to 44.5% of GDP. For 2004 this indicator reported 42.9% growth on an annual basis and by the end of December was 36.8% of GDP. At the end of February 2006 the growth of the receivables on an annual basis dropped to 28.7%.

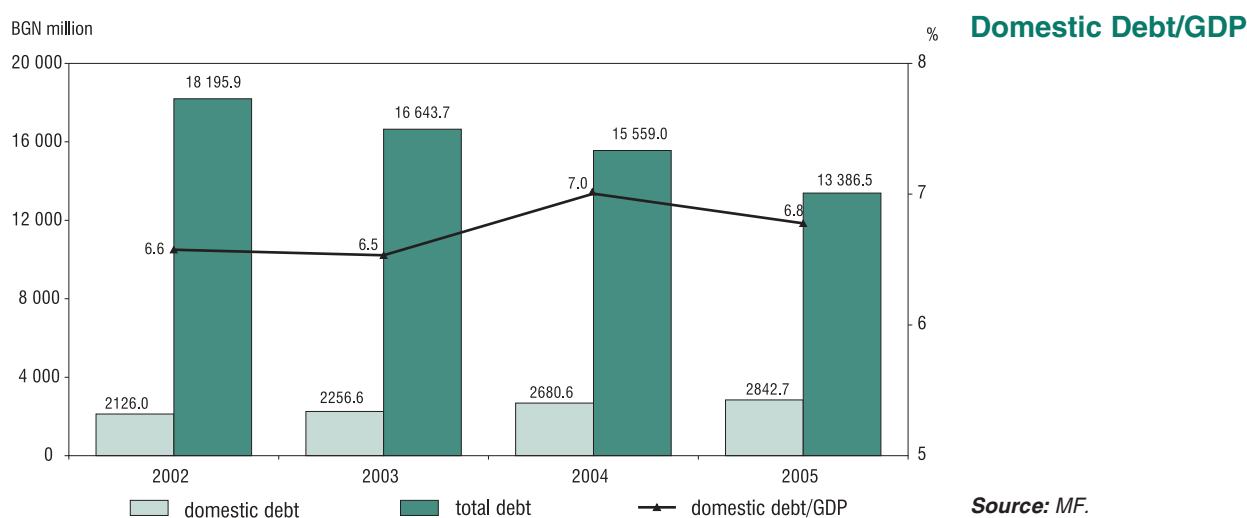
Although credit activity is boosting in the country, the share of performing loans is still stable. The average interest rates on domestic credits slightly dropped.

### *Fiscal policy*

In 2005 the fiscal policy was focused on ensuring fiscal stability by maintaining sound budget discipline, control over non-interest expenditures and high level of budgetary consolidation. At the end of 2005 the consolidated fiscal program ended with a surplus of 3.2% of GDP, while the planned budget deficit had been 0.5% of GDP. The primary fiscal position during this period was restrictive, as the primary fiscal surplus increased from 3.6% of GDP in 2004 to 4.9% of GDP in 2005.

# Domestic Debt

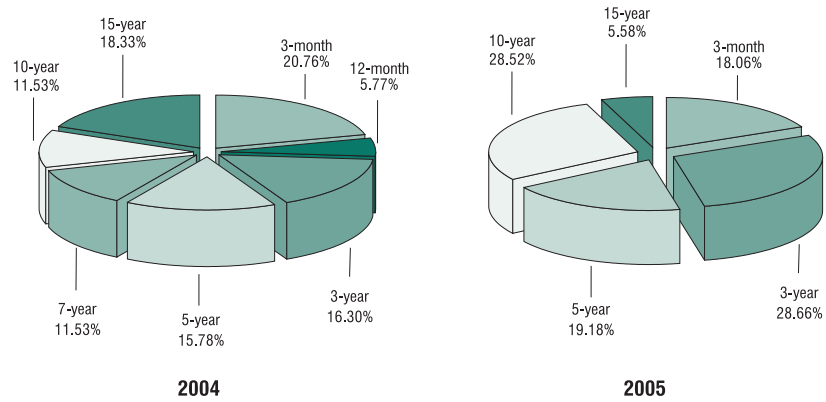
As of the end of 2005 the domestic debt was BGN 2 842.7 million in nominal terms, of which BGN 2 375.1 million was the share of GS issues and BGN 467.7 million – of GS in support of the structural reform. The debt increase in absolute terms as compared to 2004 is by BGN 162.1 million which is due to the positive net financing from GS issues in the domestic market. As compared to the total debt amount the share of the domestic debt has registered an increase of approximately 4 percentage points for the period December 2004 – December 2005.



The market environment for domestic debt issue remained favourable in 2005, with the interest of market participants in GS from all maturity groups being preserved. GS demand continued exceeding offer which reflected in attainment of comparatively high bid-to-cover ratios and slight reduction of the yield achieved at the auctions. This contributed to the implementation of the government strategy for the domestic debt expressed in increase of its relative share, priority issuance of medium-term and long-term GS and extension of the average period of issues in circulation. The average original maturity of government securities issued at auctions was extended to 6 years and 11 months which is by around five months more in comparison to the end of the previous year.

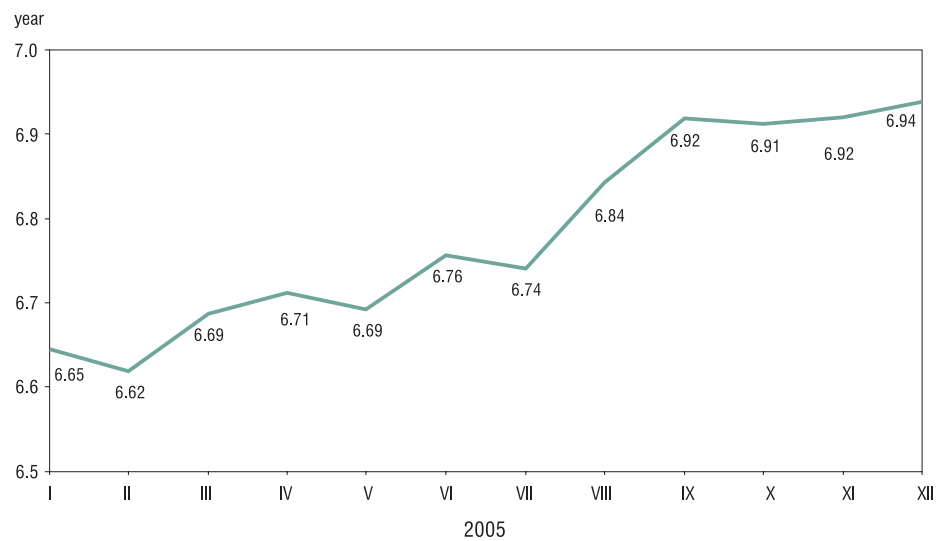
## Maturity Structure of Newly Issued Government Securities

Source: MF.

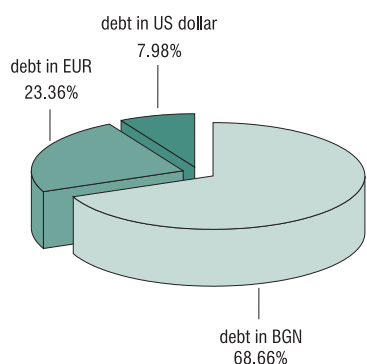


## Average Duration of Government Securities Issued at the Close of Each Month

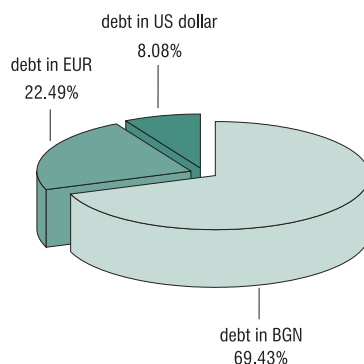
Source: MF.



The currency and interest composition of the domestic debt underwent positive changes expressed in increase of the relative share of the BGN component and increase of debt with fixed interest coupons. The BGN-denominated debt amount increased and reached 69.4% respectively. The same results from the issuance of only BGN-denominated issues in the domestic market as well as from the regular amortization payments under the USD component and the exchange of USD-denominated bonds issued in support of the structural reform for euro-denominated ones.



31 December 2004

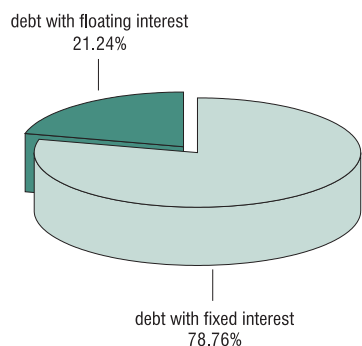


31 December 2005

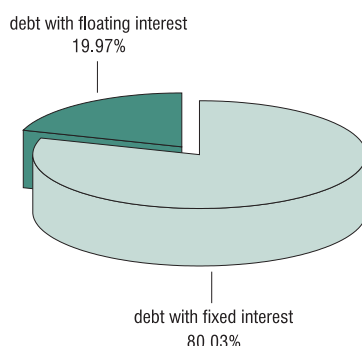
## Domestic Debt Currency Structure

Source: MF.

The share of fixed interest coupons in the interest structure of debt grew to 80.0% as 78.8% compared to end -2004.



31 December 2004



31 December 2005

## Domestic Debt Interest Rate Structure

Source: MF.

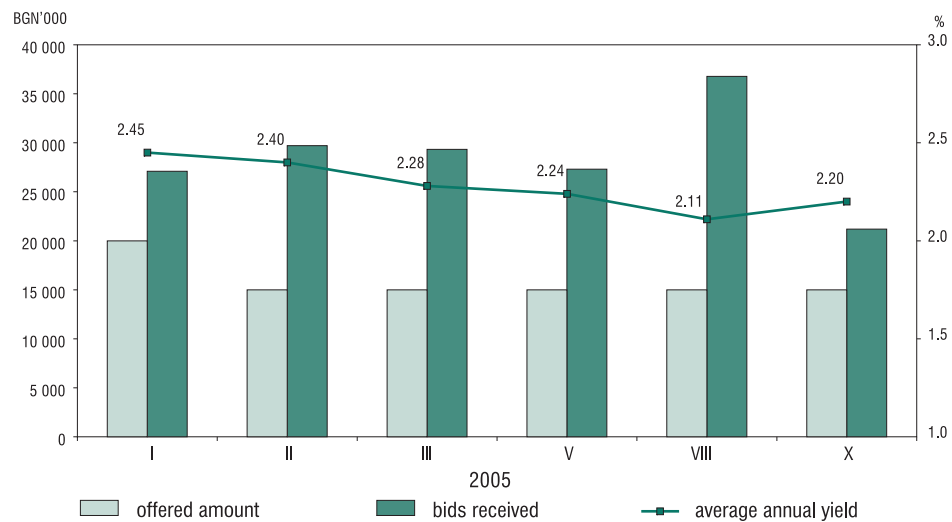
## 1. Domestic financing

The government securities issued in the domestic market in 2005 were to the amount of BGN 526.0 million. Of this, BGN 524.3 million was issued at auctions, with the balance sold directly to individual investors-natural persons. The total amount of newly issued GS as compared to 2004 is lower which ensues from the smaller quantities of short-term GS issued in 2005. The reduction of BGN 167.8 million registered in connection therewith is related to the change of the methods for BIR determination. Since 1 February 2005 the BIR is equal to the average arithmetical value of the LEONIA index (LEONIA: Lev Over Night Index Average, reference index of concluded and finalized transactions in overnight deposits in BGN) for the business days of the previous months, which has led to dropping out of the need of monthly offers of 3-month GS whose yield had served as a basis for BIR determination.

### Treasury Bill Issues

In 2005 the Ministry of Finance held six auctions of 3-month GS whereat securities with an overall nominal value of BGN 95.0 million were issued. The lowest average annual yield was reached at the auction in August – 2.1% and the highest one in January – 2.5%. The offered quantity of 3-month bills was BGN 95.0 million while the demanded quantities at the auctions were for BGN 171.4 million. The average weighted bid-to-cover ratio of issues placed during the year is 1.80.

### Three-month Treasury Bill Issues

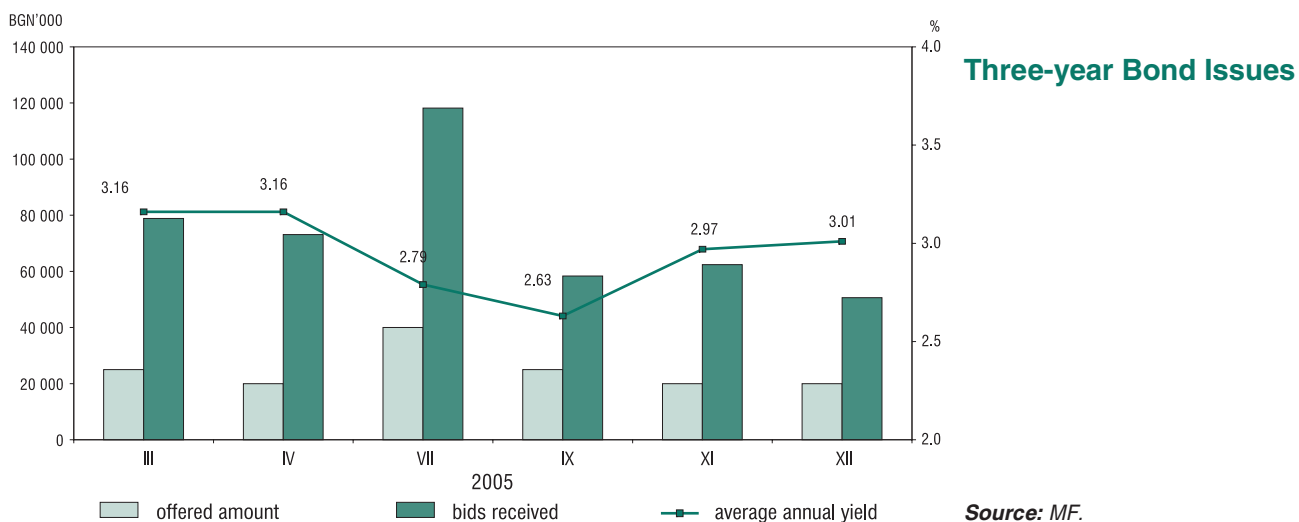




### Treasury bond issues

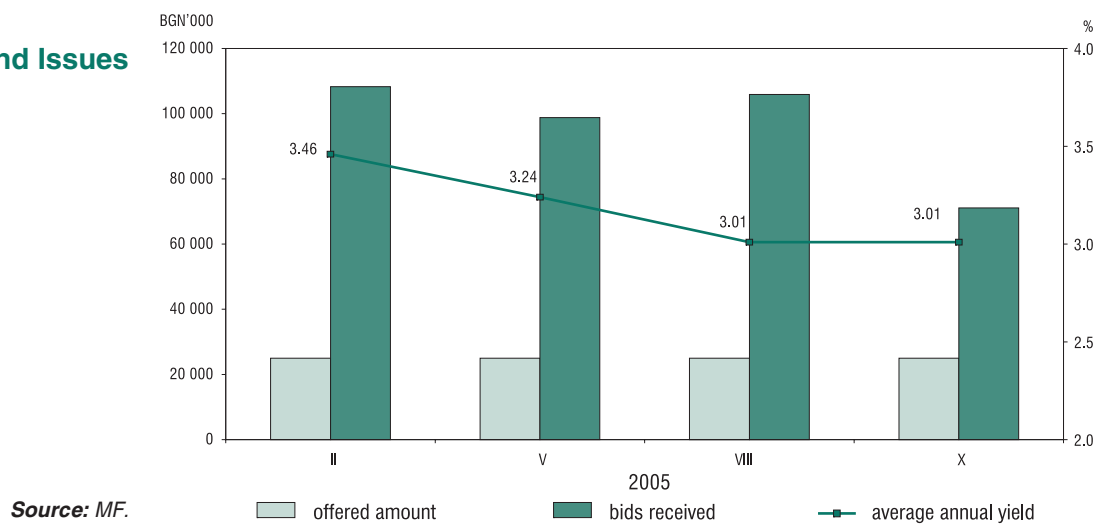
The medium-term and long-term bonds issued during the year were to the amount of BGN 429.3 million (excluding those targeted to individual investors). The volume includes both newly issued BGN-denominated treasury bonds with 3-, 5- and 10-year maturity, and the consecutive (fourth) offer of the euro-denominated issue with maturity of 14 years and 11 months. For each of the above issues the demand exceeded many times the quantities offered and for this reason the yield realized at the auctions has been decreased. The largest share of treasury bonds newly issued during the year belongs to the three-year bonds, followed by ten- and five-year bonds.

Six auctions for the sale of three-year bonds were held in 2005, with the total offer volume coming to BGN 150.0 million. The interest therein was greatest at their third offer in July, with the bids received coming to BGN 118.2 million against an offer volume of BGN 40.0 million. The trend of increase of the average weighted bid-to-cover ratio from 2.86 in 2004 to 2.94 in 2005 has maintained during the year. The yield achieved at the auctions varied between 2.6% and 3.2%.



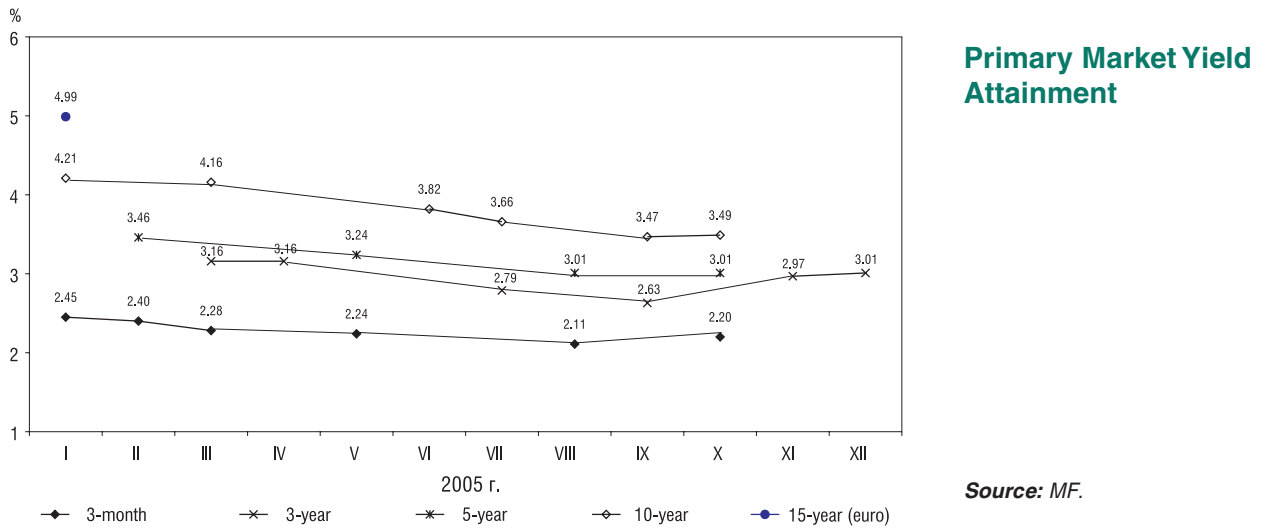
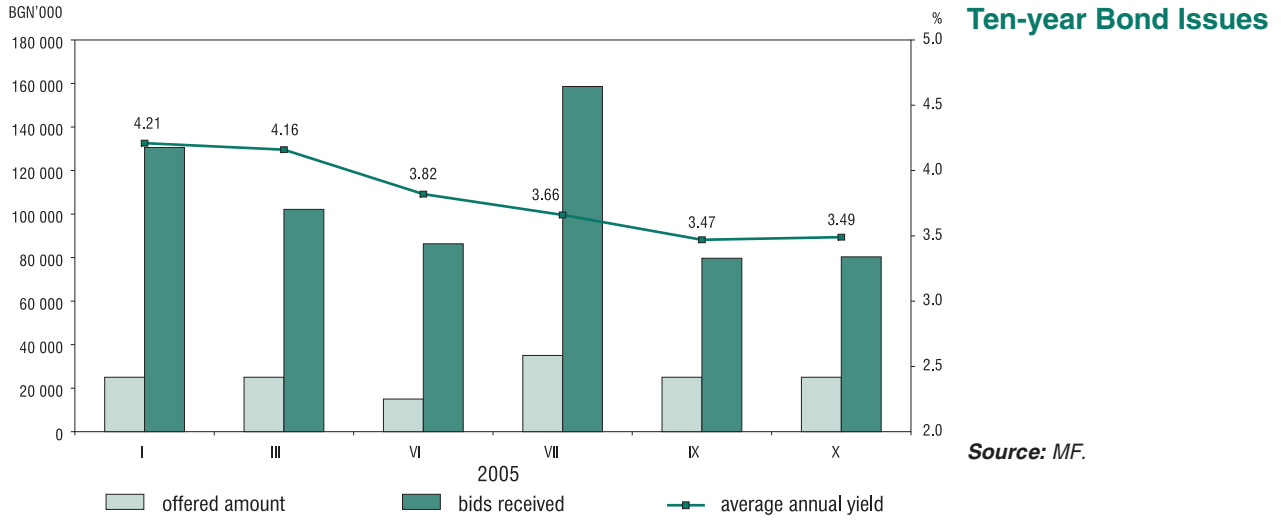
One issue of five-year government securities was released during the year, sold at four auctions. The overall nominal value was BGN 100.0 million. The interest in five-year securities remained relatively high throughout the year. Bids came to BGN 384.1 million, the bid-to-cover ratio being 3.84. Five-year GS yield in the primary market was in the range from 3.0% to 3.5%.

## Five-year Bond Issues



One issue of ten-year bonds with nominal value of BGN 150 million was released during the year, offered at six auctions. The interest in that issue was extremely high in the first half of the year having in mind the registered bid-to-cover ratio of 5.76 at the 3rd offer of the issue in June. Ten-year GS yield in the primary market was in the range from 3.5% to 4.2%.

# Government Debt Review • 2005



## Government Securities Issues in 2005

Auction date	Issue date	Issue number	Maturity (months)	Maturity date	Interest rate	Offered amount (BGM/EUR)	Bids received (BGM/EUR)	Bids approved at nominal value (BGM/EUR)	Bids approved at sell price (BGM/EUR)	Average price attained per 100 units nominal value	Minimum approved price per 100 units nominal value	Average annual yield (%)	Maximum approved yield (%)
3.01.2005	12.11.2003	BG 20 404 03 219*	180	11.10.2018	6.0	15 000 000	89 545 000	15 000 000	15 000 000.00	110.58	110.38	4.99	5.01
10.01.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	25 000 000	130 600 000	25 000 000	25 000 000.00	100.68	100.16	4.21	4.27
24.01.2005	26.01.2005	BG 30 100 05 000	3	26.04.2005	0.0	20 000 000	27 100 000	20 000 000	19 877 510.01	99.39	99.37	2.45	2.54
14.02.2005	16.02.2005	BG 20 301 05 113	60	16.02.2010	3.8	25 000 000	108 300 000	25 000 000	25 000 000.00	101.43	100.95	3.46	3.57
21.02.2005	23.02.2005	BG 30 101 05 008	3	23.05.2005	0.0	15 000 000	29 700 000	15 000 000	149 111 570.00	99.41	99.39	2.40	2.48
7.03.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	25 000 000	102 150 000	25 000 000	25 000 000.00	101.09	100.80	4.16	4.19
14.03.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	25 000 000	78 870 000	25 000 000	25 000 000.00	101.06	100.88	3.16	3.22
28.03.2005	30.03.2005	BG 30 102 05 006	3	30.06.2005	0.0	15 000 000	29 330 000	15 000 000	14 912 599.99	99.42	99.40	2.28	2.36
4.04.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	20 000 000	73 120 000	20 000 000	20 000 000.00	101.03	100.84	3.16	3.23
9.05.2005	16.02.2005	BG 20 301 05 113	60	16.02.2010	3.8	25 000 000	98 810 000	25 000 000	25 000 000.00	102.36	101.92	3.24	3.34
16.05.2005	18.05.2005	BG 30 103 05 004	3	18.08.2005	0.0	15 000 000	27 300 000	15 000 000	14 914 580.00	99.43	99.42	2.24	2.28
6.06.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	15 000 000	86 325 000	15 000 000	15 000 000.00	103.74	103.42	3.82	3.86
4.07.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	35 000 000	158 625 000	35 000 000	35 000 000.00	105.00	104.71	3.66	3.69
11.07.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	40 000 000	118 207 000	40 000 000	40 000 000.00	101.89	101.60	2.79	2.90
15.08.2005	16.02.2005	BG 20 301 05 113	60	16.02.2010	3.8	25 000 000	105 900 000	25 000 000	25 000 000.00	103.17	102.92	3.01	3.07
29.08.2005	31.08.2005	BG 30 104 05 002	3	30.11.2005	0.0	15 000 000	36 775 000	15 000 000	14 919 900.02	99.47	99.45	2.11	2.19
12.09.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	25 000 000	58 350 000	25 000 000	25 000 000.00	102.14	101.95	2.63	2.71
19.09.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	25 000 000	79 707 000	25 000 000	25 000 000.00	106.40	105.99	3.47	3.52
3.10.2005	12.01.2005	BG 20 400 05 212	120	12.01.2015	4.3	25 000 000	80 350 000	25 000 000	25 000 000.00	106.20	105.94	3.49	3.52
10.10.2005	16.02.2005	BG 20 301 05 113	60	16.02.2010	3.8	25 000 000	71 100 000	25 000 000	25 000 000.00	103.09	102.84	3.01	3.07
24.10.2005	26.10.2005	BG 30 105 05 009	3	26.01.2006	0.0	15 000 000	21 200 000	15 000 000	14 916 335.01	99.44	99.43	2.20	2.24
7.11.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	20 000 000	62 400 000	20 000 000	20 000 000.00	101.26	101.01	2.97	3.08
5.12.2005	16.03.2005	BG 20 300 05 115	36	16.03.2008	3.5	20 000 000	50 600 000	20 000 000	20 000 000.00	101.13	100.06	3.01	3.14

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

Source: MF.

## *Issues of Government Securities Targeted to Individual Investors*

In July 2005 the Ministry of Finance discontinued issuing any GS of saving nature and targeted to individual investors – local and foreign natural persons. In the past years there has been a strong trend of reduction of volumes of sold target issues of GS, with their sale in the first half of 2005 being almost symbolic which preconditioned their discontinuation together with other reasons. During the reporting year such GS were sold to the amount of only BGN 1.6 million.

## **2. Debt Service**

The total debt repayments during 2005 came to BGN 521.1 million, including BGN 390.5 million amortization payments and BGN 144.3 million interest payments. In the interest payments structure the treasury bond interest accounted for BGN 132.0 million. Discounts on treasury bills and bonds accounted for BGN 3.0 million, and BGN 9.3 million was interest on government securities issued in support of structural reform.

## *Government Securities Issued for Structural Reform*

The volume of debt under GS issued in support of structural reform was BGN 467.7 million at the end of 2005.

One swap of USD-denominated ZUNK bonds into euro-denominated ZUNK bonds was carried out during the year. As a result of this USD-denominated bonds to the amount of USD 15.0 thousand were swapped for euro-denominated bonds with nominal value of EUR 11.3 thousand. The swap has been effected on the grounds of §13 of the Transitional and Concluding Provisions of the 2005 State Budget of the Republic of Bulgaria Law, being part of the measures aimed at cutting down the dollar component of debt in favour of the lev and the euro.

In the past year payments with ZUNK bonds with total nominal value of BGN 31.5 million were effected under debts to the state, the domestic debt being reduced by the same amount respectfully.

## Domestic Debt Dynamics

Debt Structure	Debt by 31 Dec. 2004 BGN million	Rise, BGN million	Fall, BGN million	Debt by 31 Dec. 2005 BGN million	Nominal rise/fall	%
Domestic Government Debt	2 680.62	526.00	394.68	2 842.72	162.11	6.05
1. Government securities issued	2 211.16	525.98	362.08	2 375.05	163.89	7.41
3-month	36.00	95.00	116.00	15.00	-21.00	-58.33
12-month	40.00	-	40.00	-	-40.00	-100.00
3-year	365.08	150.74	177.45	338.37	-26.71	-7.32
5-year	678.55	100.90	28.63	750.82	72.27	10.65
7-year	660.36	-	-	660.36	-	-
10-year	264.92	150.00	-	414.92	150.00	56.62
15-year	166.25	29.34	-	195.58	29.34	17.65
2. Structural reform government securities	469.46	0.02	32.60	467.67	-1.79	-0.38
19-year	1.93	-	0.28	1.65	-0.28	-14.29
20-year	245.26	0.02	16.56	228.72	-16.54	-6.74
24-year	1.65	-	0.13	1.53	-0.13	-7.69
25-year	220.61	-	15.63	235.77	15.16	6.87

*Note: All data at nominal values.*

*Source: MF.*



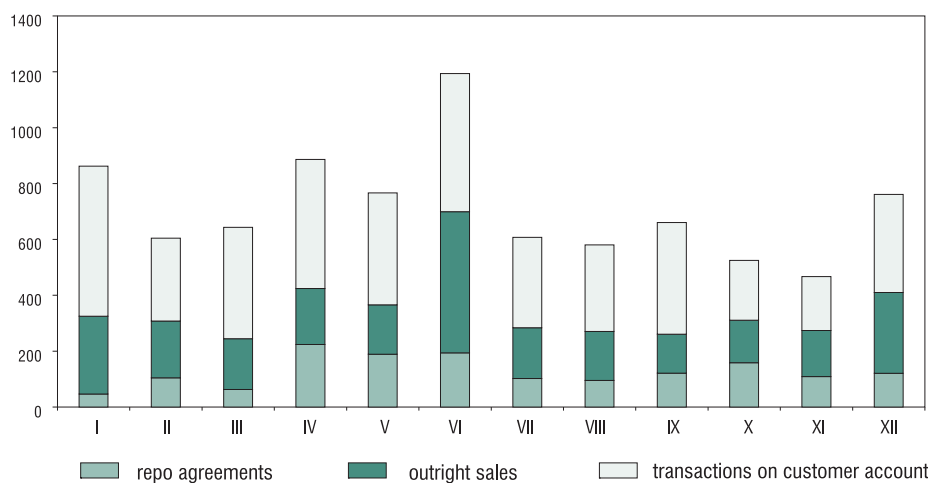
**Review  
of the Secondary Government  
Securities Market**



In 2005 the secondary market in government debt instruments developed dynamically, with marked interest being shown in long-term and medium-term GS. Primary dealers saw government securities not only as a risk-free and profitable investment, but also as a means of covering current liquidity needs.

The year saw 7 890 transactions in the secondary market with a total nominal value of BGN 13 336.1 million. Most deals (35.1%) were connected with GS freezing/unfreezing, followed by deals with or on account of customers (33.6%), outright transactions (19.8%) and repo agreements (11.5%). In 2005 the number of repo agreements was 886, of outright transactions – 1 218, and of deals with or on account of customers – 4 015. The number of deals connected with GS freezing/unfreezing was 1 771, of them 1 749 were intended to secure budget funds in commercial banks and the remaining 22 – to institute special pledges on GS. No privatization deals were registered during the year.

BGN million



## Traded Government Securities Volume in 2005

### 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.

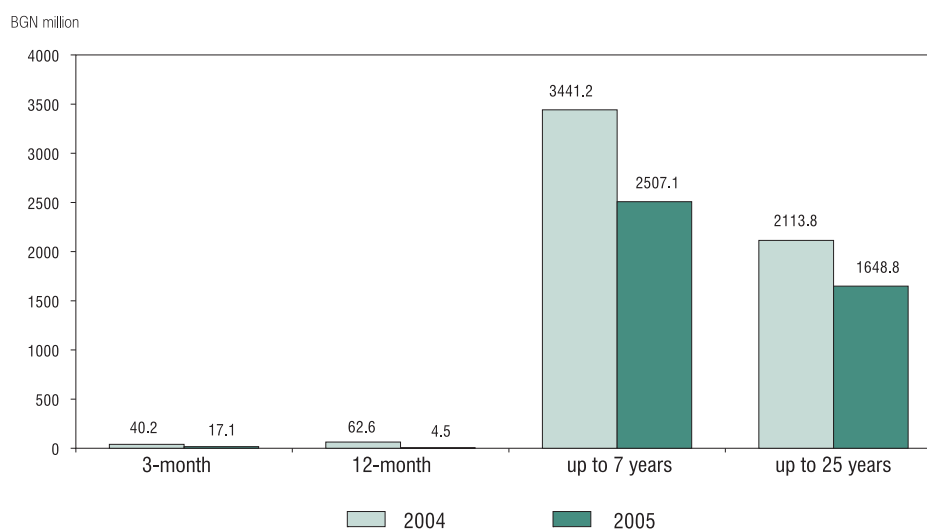
# Review of the Secondary Government Securities Market

## Maturity Structure of Government Securities Transactions on the Interbank Market

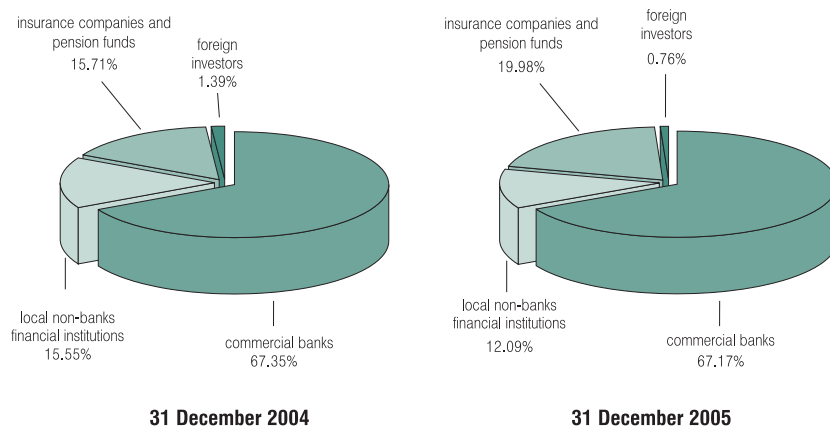
**Notes:** 1. Foreign exchange denominated government securities are at lev equivalence using BNB foreign exchange rates valid on the final business day of each period.

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 acquired, and in periods when commercial banks adjusted their minimum required reserves with the BNB. In 2005 most buoyantly traded on the secondary market were long-term government securities which recorded 3 900 transactions to a nominal value of BGN 5 121.1 million, with 2 127 medium-term government securities deals notching up BGN 3 428.7 million in nominal terms. Of the total traded volume in 2005, long-term government securities accounted for 59.2%, followed by medium-term and short-term government securities – 39.6% and 1.2% respectively.

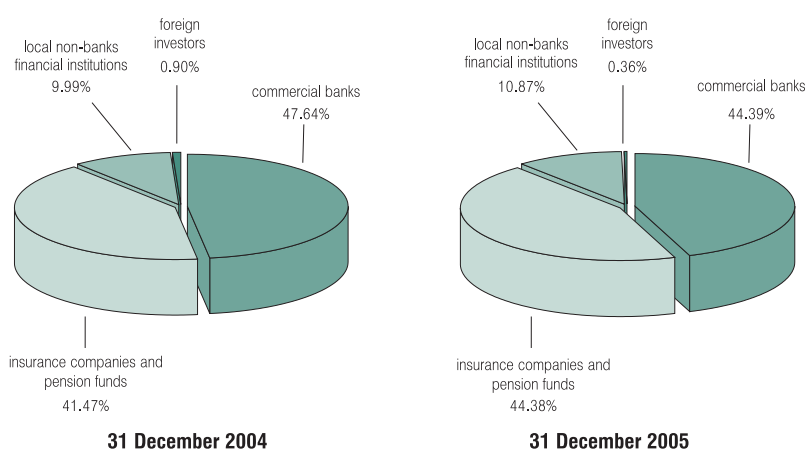


## Holders of Government Securities

**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 profile of government securities holders remained relatively stable in 2005 as well. As to government security issues, commercial banks continued representing the largest market segment – 67.0%, followed by insurance companies and pension funds – 20.0%, local non-banking financial institutions, companies and individuals – 12.1%, foreign investors – 0.8%. As to government securities for structural reform, insurance companies and pension funds hold the biggest share – 44.4%, followed by commercial banks – 44.4%, local non-banking financial institutions, companies and individuals – 10.9% and foreign investors – 0.4%.



## 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.

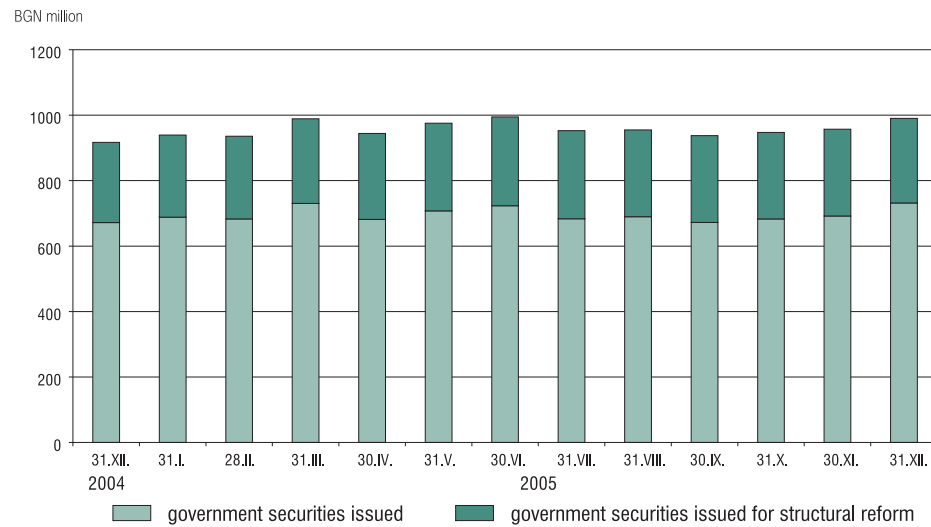
# Review of the Secondary Government Securities Market

At the end of 2005 investment in non-banking financial institutions, companies and individuals in auction-issued government securities marked a net growth of 6.3%, while the percentage of government securities for structural reform was 3.1% compared to the beginning of 2005.

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

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

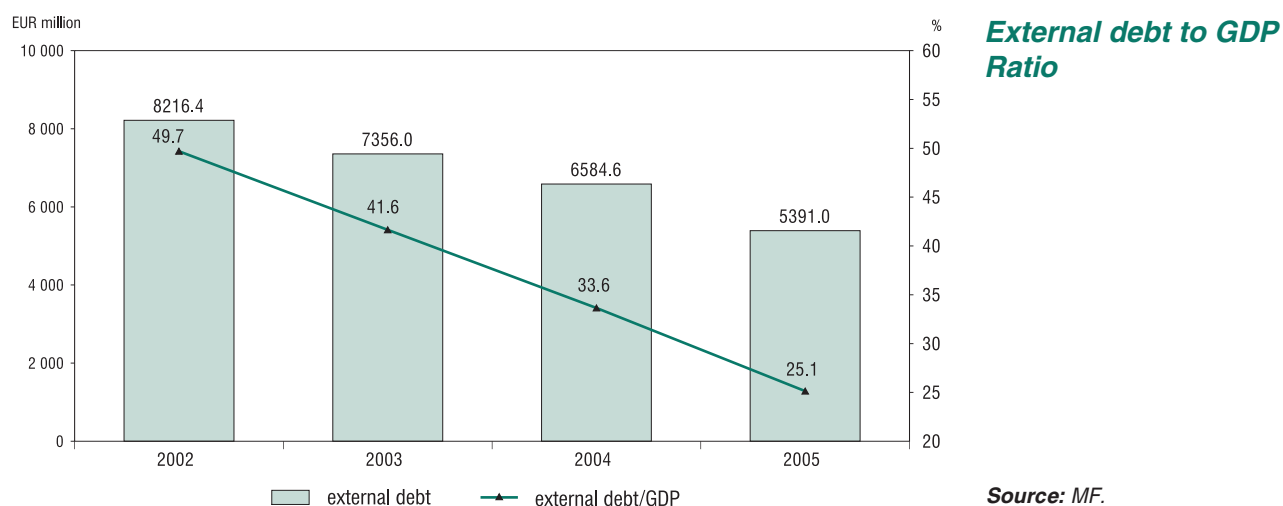
**Source:** BNB.





# External Debt

By end-2005 the foreign debt amounted to EUR 5 391.0 million, which was a drop by EUR 1 193.7 million in nominal terms and by 8.5% of GDP compared to 2004. The major reasons therefor were both GDP growth rates and the regular debt payments, and the advance external government debt operations effected during the year.



After the Brady-for-global bond exchange in 2002 and the subsequent bond repayment at a discount DISC, last year the remaining FLIRB and IAB bonds amounting to USD 1 545.2 million, an amount recalculated EUR 1164.1 million by the end period, were totally repaid. As a result of the pre-payment of three tranches from the Extended Three-Year Agreement with IMF, as well as of the regular payments of principals, there was a reduction of EUR 309.2 million in the debt to IMF. There was also a substantial reduction in the Other Loans row as a result of the prepayment of the debt to Italy amounting to EUR 53.8 million under the Framework Agreement for application of a compensatory mechanism for repayment of the debt of Stopanska Banka and Mineralbank to the Italian creditor /SACHE/. The debt to the World Bank under the Private Investment and Export Financing loan to the amount of EUR 5.4 million and to EIB under the Global APEX loan to the amount of EUR 1.3 million in the Activated Government Guarantee part were totally repaid.

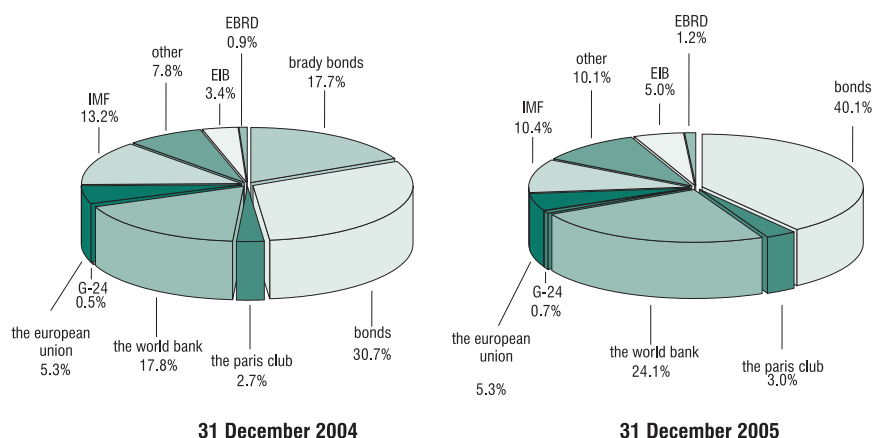
There was an increase in the share of debt under investment projects funded by government loans and government guarantees by the World Bank, EIB and Other financial institutions /including the Japanese Bank for International Cooperation /JBIC/, the International Economic Cooperation Fund, EURATOM, etc./ The relative share of debts under Government Investment Loans /GILs/ and Government Guarantees /GGs/ was 10.2% and 9.5% respectively in the overall profile of foreign government and government-guaranteed debt. In recent years there has been an increase of debt in these items, with a growth of 3.7 and 2.8 percentage points registered for GILs and GG respectively for 2005 only.

The Programmatic Adjustment Loan /PAL 3/, received at the end of the year, included in the World Bank Country Support Strategy for 2004-2006 and amounting to EUR 116.1 million, as well as the regular payment of principals determined the rising debt in the World Bank row by EUR 89.4 million.

As a direct consequence from the policy carried out in the field of new external lending and the early repayment of foreign debt, as well as resulting from regular payments made, debt per creditors underwent a substantial change in the period December 2004 – December 2005. The Brady bond part of debt dropped out due to the buy-back of the Bulgarian bonds of this types. The 17.7 percentage points reduction in the Brady debt and the drop of debts to the IMF by 2.8 percentage points had mostly lead to an increase of the relative weight of Global bond debt and the World Bank debt by 9.4 and 6.3 percentage points respectively in the overall foreign debt structure. The Bonds category had the biggest share by end-2005 – 40.1%, followed by the World Bank debt – 24.1%, IMF – 10.4% and Other Creditors – 10.1%, representing institutions financing public investment projects.



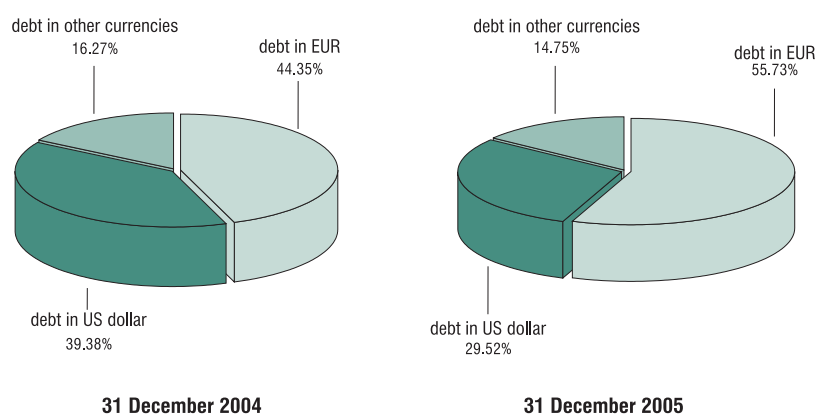
## External Debt Creditor



Source: MF.

As to the currency and interest rate composition of debt, some positive changes were witnessed relating to the mitigation of the impact of the volatile nature of market indicators such as exchange rates and interest rates. The actions undertaken in 2005 to pre-pay foreign USD-denominated debts, the regular payments of USD-denominated debt and the policies on contracting and receiving new euro-denominated loans under investment projects mostly preconditioned the continuation of the trend to minimize the dependency of the amount of debt on changes in the levels of US currency. Compared to 2004, the share of euro-denominated debts rose from 44.4% to 55.7%. The increase of 11.4 percentage points was on account of the USD-component drop of 9.9 percentage points within the same period. There was a 1.5 percentage points, too, in the part of other currency debt mostly finding expression in minimization of the risk from the JPY movement on international markets.

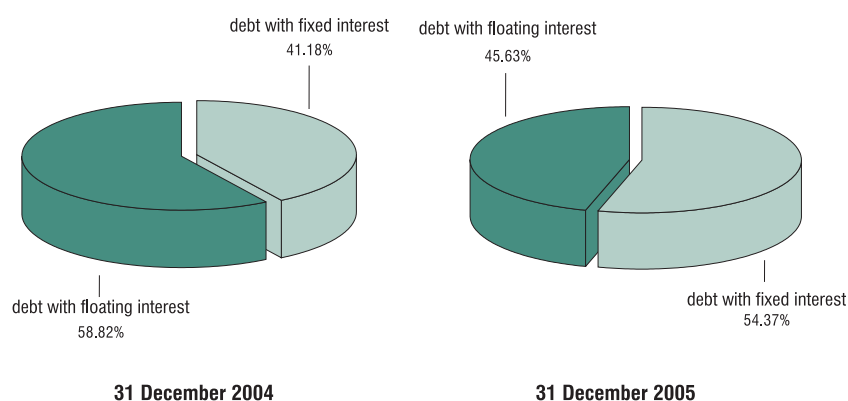
## Currency Structure of External Government and Government Guaranteed Debt



Source: MF.

Achieving a balanced interest rate structure has been one of the priorities in respect to debt management in recent years. There was a balance in fixed/ floating interest rate ratio by the end of 2005, with fixed coupon instruments being slightly higher – 54.4% in the overall profile of foreign government and government-guaranteed debt. Respectively, the floating debt rate dropped by 13.2 percentage points and reached 45.6% from foreign debt at the end of the period. The change in the interest rate composition was mostly due to the redemption of the Brady debt tied to the 6-month USD LIBOR, the pre-payment of tranches to the IMF charged at a floating rate for SDR, the repayment of bilateral debts tied to floating EUR- or USD-interest rates, adhering to absorption of foreign fixed-rate credits.

## Interest Rate Structure of External Government and Government Guaranteed Debt



Source: MF.

### 1. External financing

Funds to the amount of EUR 330.2 million were absorbed throughout the year. The major part of them, EUR 141.9 million, were under investment loans funded by international creditors like the World Bank, EIB, etc /including the Japanese Bank for International Cooperation /JBIC/, the International Economic Cooperation Fund, EURATOM, Citibank USA, DZI-Rosexim, etc./. The current account was supported only by the funds from the last of the three loans included in the indicative programme of the World Bank, PAL 3. As a result, new foreign financing is EUR 82.0 million less than in 2004. New foreign financing of government guaranteed debts also marked a drop by EUR 57.8 million for the same period.

As a whole, net foreign financing by end-2005 was negative, amounting to EUR 1 557.9 million. This figure takes account of the outcome from foreign debt pre-payment and regular principal payments according to the amortization schedules agreed. As to the individual financing components, however, the figure for net financing for GIL is positive – EUR 102.6 million – and that for government guaranteed debt – EUR 47.1 million. On the one hand, this was due to the active absorption of funds under new projects launched, as well as due to the fact that most of the loans were in a grace period, meaning no payments were made thereunder.

## New External Financing and External Debt Repayments in 2005

(EUR million)

Structure	Loans or tranches	Repayments, incl.		
		Principal	Interest	Total
Government debt	258.0	1 863.0	280.8	2 143.8
I. Bonds	-	1 259.0	190.6	1 449.5
1. Brady bonds	-	1 259.0	26.7	-
2. Bonds	-	-	163.9	163.9
II. Loans	258.0	604.1	90.2	694.3
1. Paris Club	-	12.6	5.9	18.5
2. World Bank	116.1	58.5	25.7	84.2
2.1. World Bank	116.1	46.7	23.6	70.3
2.2. JBIC /JEXIM/	-	11.8	2.1	13.9
3. G-24	-	-	1.2	1.2
4. European Union	-	62.5	7.0	69.5
5. IMF	-	359.8	29.0	388.8
6. Other	-	60.1	1.7	61.9
7. Government investment loans	141.9	39.4	18.5	57.9
7.1. World Bank	46.3	4.4	3.0	7.4
7.2. EIB	62.0	26.7	12.0	38.7
7.3. EBRD	-	7.8	1.1	8.9
7.4. Other	33.7	0.5	2.5	2.9
8. Called government guarantees	-	11.2	1.3	12.4
8.1. World Bank	-	8.9	1.0	9.9
8.2. EIB	-	1.5	0.1	1.6
8.3. Other	-	0.8	0.2	1.0
Government guaranteed debt	72.1	25.0	16.2	41.3
1. World Bank	5.7	9.2	3.8	13.0
2. EIB	-	1.1	0.2	1.3
3. EBRD	13.3	4.6	1.1	5.7
4. Other	53.1	10.1	11.2	21.3
Total:	330.2	1 888.1	297.0	2 185.1

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

**Source:** MF.

## 2. External Debt Service

Resulting from the changes in the currency and interest rate structure of debt made in recent years, the risks from the impact of the major market indicators on service costs have been significantly reduced. The rise of the US dollar in 2005 had a weak influence on the amount of payments made. Repayments totaled EUR 1 888.1 million. Taking account of the regular amortization debt profile in 2005, the increased repayments of EUR 917 million compared to end-2004 was mostly due to the buy-back of Brady bonds amounting to EUR 1 259.0 million and the pre-payment of debt to the IMF amounting to EUR 147.4 million.

The rise of the 6-month US dollar LIBOR and the 6-month EUR LIBOR for January-December 2005 did not substantially influence the interest rates paid by the end of the year. The reported figure of EUR 297 million was almost equal to the costs incurred in 2004. Brady bonds had the biggest share – EUR 163.9 million, followed by the World Bank /including JBIC/ – EUR 25.7 million, and IMF – EUR 29.0 million.

The amount of interest rates paid under government investment loans is determined by the level of absorption of loan funds, the interest rate terms and conditions specified in the individual agreements and the currency denomination of the certain credit. New foreign financing under investment projects was higher by EUR 44.5 million in 2005 as compared to 2004. Accelerated absorption of investment project funds, as well as the changes in interest rate level in the past year were reflected in the higher amount of interest rates paid. By end-2005, they amounted to EUR 18.5 million compared to EUR 16.4 million for end- 2004.

## External Debt

(EUR million)

Structure	by 31 December 2004	by 31 December 2005
<b>Government debt</b>	<b>6 140.6</b>	<b>4 876.8</b>
I. Bonds	3 182.4	2 162.5
1. Brady bonds	1 164.1	-
2. Bonds	2 018.3	2 162.5
II. Loans	2 958.2	2 714.3
1. Paris Club	176.3	163.7
2. World Bank	930.6	1 020.0
3. G-24	34.6	36.9
4. European Union	350.0	287.5
5. IMF	868.7	559.5
6. Other	125.2	62.3
7. Government investment loans	428.8	549.2
7.1. World Bank	108.0	150.6
7.2. EIB	214.8	262.6
7.3. EBRD	22.8	17.0
7.4. Other	83.2	119.0
8. Called government guarantees	43.9	35.2
8.1. World Bank	36.4	28.9
8.2. EIB	1.3	-
8.3. Other	6.2	6.3
<b>Government guaranteed debt</b>	<b>444.0</b>	<b>514.2</b>
1. World Bank	96.0	102.4
2. EIB	9.2	8.1
3. EBRD	37.2	48.6
4. Other	301.7	355.1
<b>Total:</b>	<b>6 584.6</b>	<b>5 391.0</b>

*Note: All nominal values.*

*Euro conversion at BNB central rates for the closing business day of each period.*

*Source: MF.*



**Government Debt  
Management Strategy  
for the Period 2006-2008**



## Summary

The Government Debt Management Strategy has been developed by the Minister of Finance and approved by the Council of Ministers of the Republic of Bulgaria on the grounds of the Government Debt Law. The time span of the document is medium term and covers the period 2006-2008.

The functional nature of the Strategy as a whole is to outline the intentions of the Government in the area of government debt management and to define the instruments for their realization. Making it public is a prerequisite for implementing the medium term debt policy outlined in a transparent and predictable way, allowing the exercise of an effective public control. Such control is essential in the context of the importance of the issues and their long-term effects on the country's economic and social development.

The Strategy is structured in three main parts.

The first one deals with the status of the debt, its key indicators and the regulatory environment as of the end of 2005. This part also makes a review and analysis of the accomplishments of the previous Government Debt Management Strategy for the Period 2002-2005.

The second part defines the risks arising from the size and structure of the debt. The risks identification is accompanied by brief theoretical explanations about their nature and impact, and an analysis of the changes in their dimensions due to the done so far in the debt management field. The individual possibilities for future minimizing of the impact of these risks on the objectives set forth in the Strategy are also emphasized.

The third part sets forth the objectives of the debt management policy. The instruments that would lead both to their realization and to minimizing any potential risks are also outlined. The specific measures that should ensure the attainment of the main goal are formulated based on analysis of the current and future status of the debt, and on the forecasts for the macroeconomic environment development and the market situation for a three-year period.

The Strategy is also backed by data analyses and statistics that provide opportunities for more detailed familiarization with the matter, its dynamics inclusive.

Under the provisions of the Government Debt – Law, the Strategy will be updated annually, and this up-date will again be approved by the Council of Ministers together with the three-year budget forecast. This will allow the timely and adequate redefinition of part of the objectives and measures in

accordance with the economic development, the market indicators and the results achieved in the course of the implementation of the Strategy.

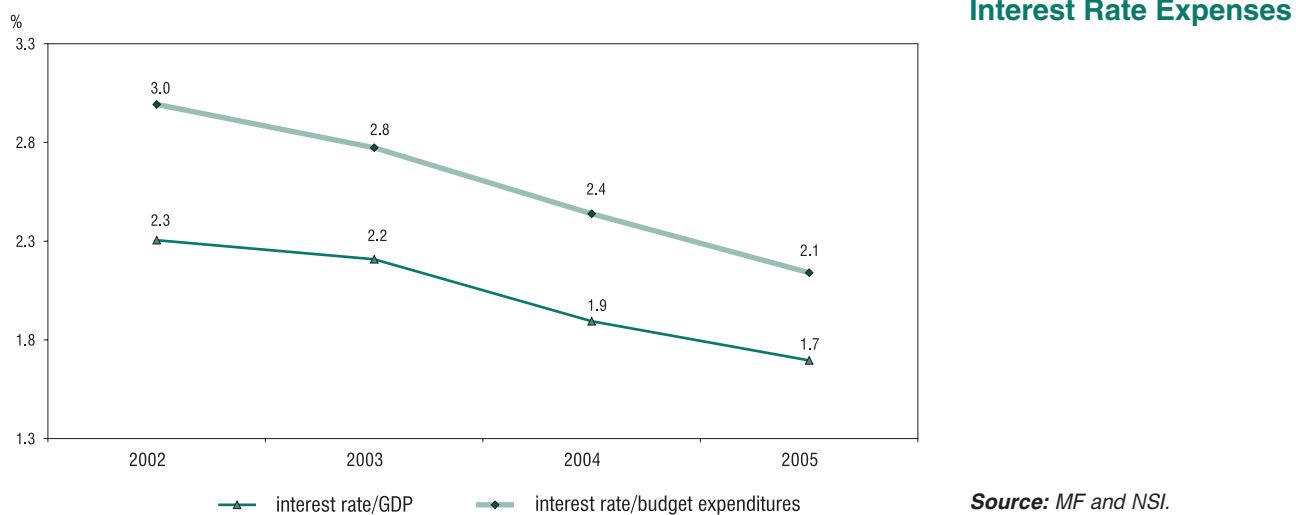
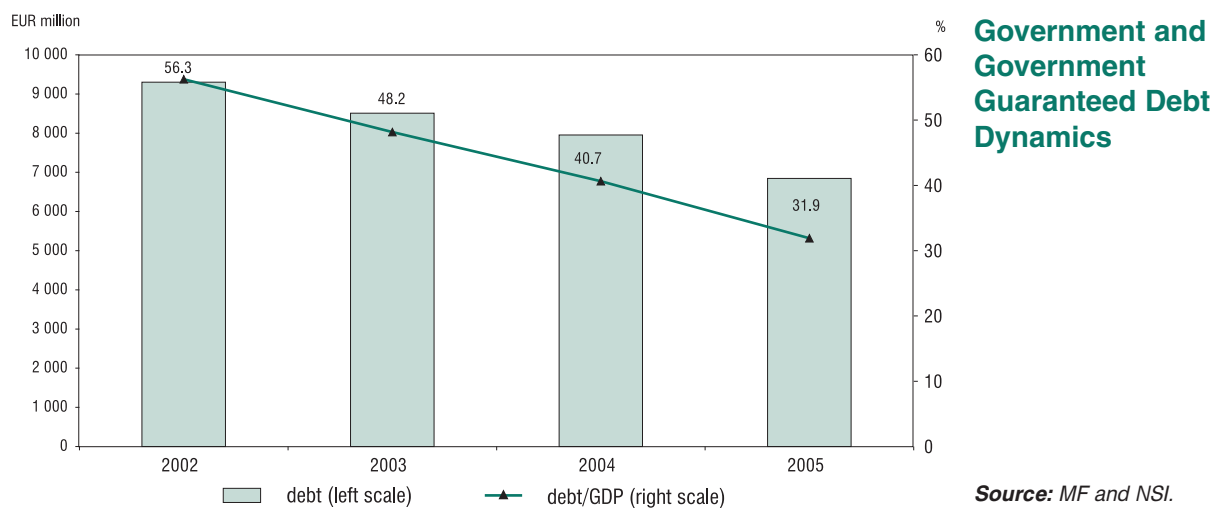
## 1. Status of the debt and Regulatory environment

### *Status of the debt*

In line with the objectives set in the Government Debt Management Strategy for the Period 2002-2005, the measures undertaken have predetermined substantial positive changes in the qualitative and quantitative parameters of the debt. This practically in 2002 resulted in meeting the Maastricht criterion for the size of the consolidated government debt. The achievements reported in the government debt area, should also be considered in the context of the tight and consistent fiscal policy implemented, based either on a balanced budget or surplus, macroeconomic stabilization and trust in the Currency Board Arrangement, as well as the liberalization and restructuring of the economy that have resulted in high national income growth rates.

On this background, when analyzing the present status of the government debt it is essential to put a stress on the levels of the quantitative indicators, related to the evaluation of the debt burden – the size of the debt, the debt to GDP ratio and the level of the debt service costs. The total government debt / incl. government guarantees -/ at the end of 2005 amounts to EUR 6 844.4 million, which is a reduction of EUR 2 458.0 million in nominal term or 26.4% compared to 2002. The government debt /incl. government guarantees / to GDP ratio at the end of 2005 is 31.9%, which compared to 2002 is a decrease of 24.4 percentage points. Similar changes are reported also when evaluating the debt service costs/budget expenditures, which from 3.0% in 2002 has dropped to 2.1% in 2005. The reduction of the portion of the national income used for servicing the government debt is evident also from the indicator debt service costs/GDP, which for the period under consideration has also dropped by 0.6 percentage points respectively.

# Government Debt Review • 2005



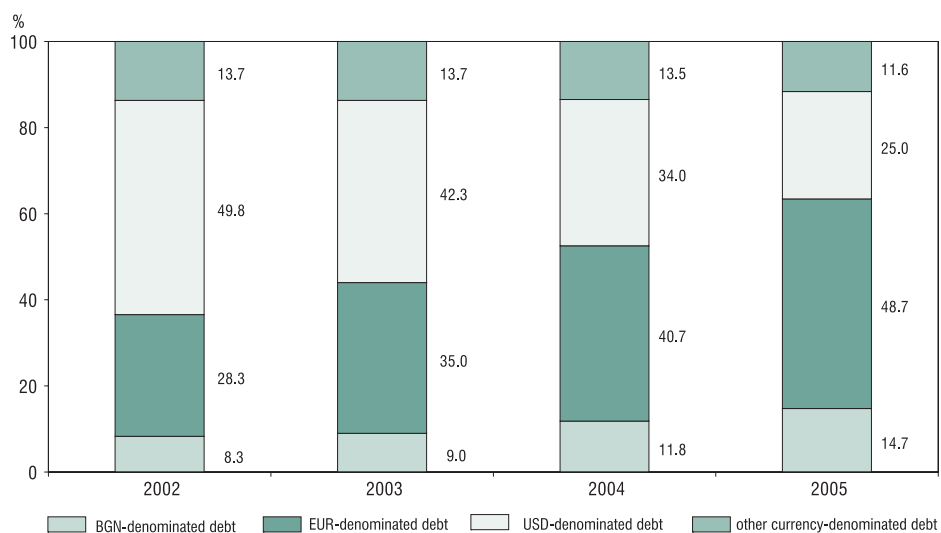
## Government Debt Management Strategy for the Period 2006–2008

The reported substantial improvement of the quantitative indicative parameters of the government debt is supported also by a positive qualitative change in its structure.

In the past three years, part of the efforts were focused on reducing the existing imbalance between domestic and external debt, taking into account however the impact of a number of factors, such as the price of loans, situation of the domestic and international capital markets, the development of the internal government securities market, etc. Those efforts achieved the effect sought, at the end of 2005 compared to 2002 the share of domestic debt almost doubled to reach 21.2% of the total government debt. This is due both to the absolute reduction of the external debt and to the positive net domestic debt issues. However, it should be noted that this process is not accompanied by an increase of the domestic debt/GDP ratio; it remains within the limits of 6.5% and 7.0%.

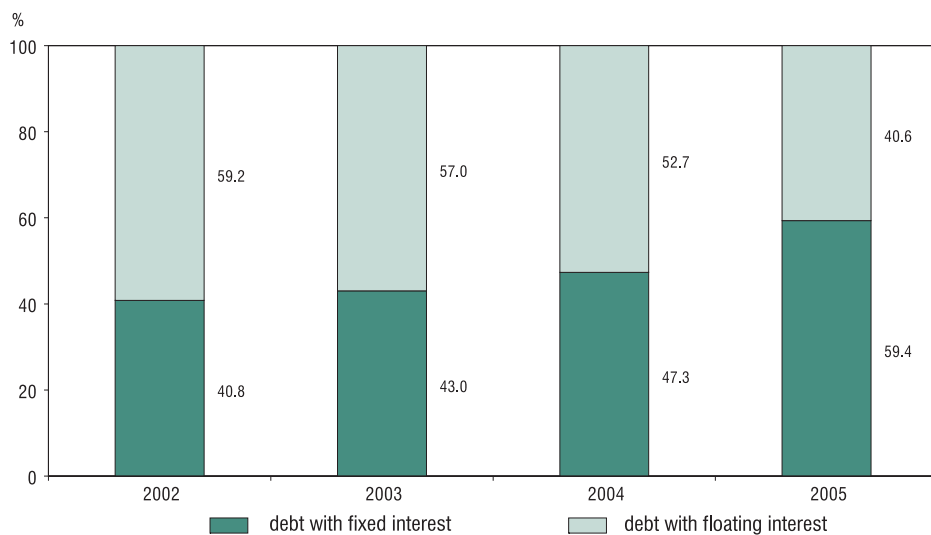
**The interest and foreign currency structures** of the government debt also are showing positive changes, which is essential, in view of the priority of the actions focused on minimizing the risks arising from the interest rate and exchange rate fluctuations on the international financial markets. At the end of 2005 the government debt structure, in terms of the ratio between debt with floating and with fixed interest rates, is characterized by prevalence of the share of fixed interest rate coupons, which amounts to 59.4%. In respect of the foreign currency composition, the euro and BGN components are predominant, having together 63.4%. The values of the ratios under consideration are essential in view of ensuring predictability and streamlining of the required for the government debt service budget resources. The absence of any need to keep substantial in volume buffers, allows the reallocation of these resources to other important sectors of the social and economic life in the country. When setting and implementing the objectives for changes of the foreign currency and interest structure other circumstances have also been taken into account, such as the Currency Board Arrangement and the pegging of the lev to the euro, the forthcoming accession of our country to the EU structures and the ongoing in this connection multi-aspect convergence.

# Government Debt Review • 2005



**Currency Structure of Government and Government Guaranteed Debt**

Source: MF.

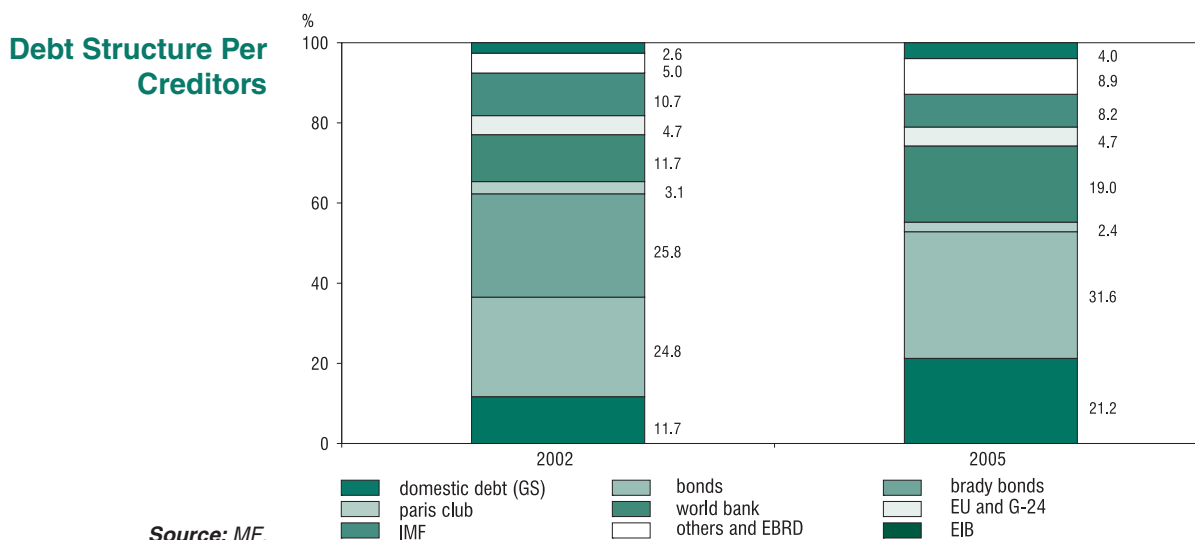


**Interest Rate Structure of Government and Government Guaranteed Debt**

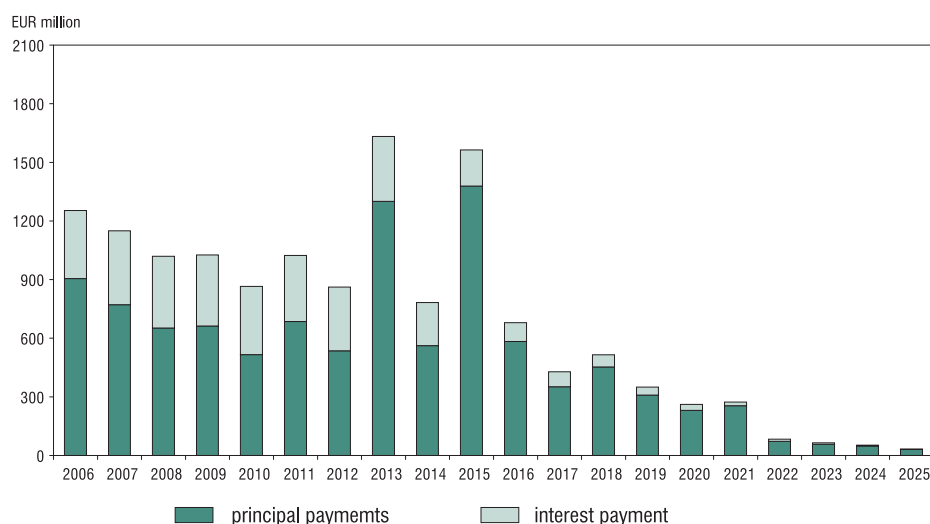
Source: MF.

# Government Debt Management Strategy for the Period 2006–2008

In terms of the complex analysis of the government debt, also interesting are the changes in the status and quality of the debt portfolio that have happened during the three-year period under consideration. As of the end of 2005 the debt to the Paris Club and the bilateral liabilities accumulated during 1980s have been almost fully redeemed. The bonds issued in consequence of the restructuring of the debt to the London Club, have also been paid through several buy back operations. As a result presently the debt constitutes mainly bonds – 52.8%, loans from the World Bank – 19.0%, IMF – 8.2%, the European Union and G-24 – 4.7%, EIB – 4.0% and others. As a whole, the reduction of the debt to official creditors is also a result of decreasing Bulgaria’s risk premium due to the rising investors’ trust in the country, the upgraded credit rating and the forthcoming accession to the European Union.



In the period under consideration, changes have occurred also in the repayment profile. As a whole the debt is well scheduled with gradually lowering debt burden in a twenty-five year span, with the exception of years 2013 and 2015, when the global bonds mature. The balanced repayment profile in time ensures stability in respect of its service and refinancing and it is also an original form for neutralization of substantial impacts, generated by adverse conditions on the domestic and international markets.



## Forecast Government and Government Guaranteed Debt Payments 2006-2025

*Note: Payments are forecast on the basis of debt status as of 31.12.2005*

**Source: MF.**

### Regulatory environment

Under the Constitution of the Republic of Bulgaria the National Assembly is the authority denouncing and ratifying by law any international contracts, containing financial obligations of the State and it is the authority approving the conclusion of contracts for government loans.

The primary and the related to it secondary legislation in the debt field is comparatively new. It was adopted at the end of 2002 and the beginning of 2003 and as a whole is underlined by the principles for sustainable regulation of the matter related to the issue and management of government debt, based on its long term influence and effect on the economic and social development of the country. The functional construction of the regulations is built both on the existing practice until its adoption and the relevant improvements towards its harmonization with the European standards in this field.

**The Government Debt Law** gives in general comprehensive definitions of the types of debt; outlines the debt related powers; introduces clear relationships between the institutions; provides for restrictions as to debt growth; provides for equality of all the types of government debt and priority of its service costs to the rest of the budget expenditures; provides for an obligation for announcing a medium term debt management strategy and an annual report on the implementation thereof; regulates the powers and procedures for issuing government guarantees; regulates the fiscal agency of BNB, etc.

The adoption of the Law and the concentration of the responsibilities in a limited number of institutions ensure that the issue of debt is a result of a single

policy in this field, which on its turn is a prerequisite for its optimization and for reducing the cost of budget financing in the medium term.

Subsequently, based on the Government Debt Law, secondary legislation has been adopted adding to the regulation of the government debt issues. The main are as follows:

1. **Ordinance on the requirements to be met by the investment projects financed by government loans and the projects applying for financing by government guarantee, and on the procedure of their consideration.** The Ordinance provides for the procedure and manner under which projects apply for government investment loans or for loans, requiring government guarantees. The procedure provides for presentation of the projects by the line ministries at the Ministry of Finance, their subsequent approval by the Council for Economic Policy and the Council of Ministers, and inclusion of the loans approved for the projects' financing in the State Budget Law for the relevant year. The approach for approval of any new government guarantees and government investment loans is strictly regulated. Thus both an opportunity for good planning of the budget and preparation of the projects, and the necessary transparency in terms of the economic priorities and the budget risks are ensured.
2. **Ordinance No. 9 of 2003 of the Minister of Finance on the procedure, manner and deadlines for provision of information on the status and movement of the debt of the municipalities and the social security funds.** The Ordinance is issued on the grounds of Article 40 of the Government Debt Law under which the Minister of Finance determines the procedure and the specific requirements in respect of the information related to the liabilities of the municipalities and the social security funds in view of the fact that these liabilities constitute part of the consolidated government debt.
3. **Ordinance No. 5 of 2002 on the terms and procedure for acquisition, redemption and trade in government securities,** issued by the Minister of Finance and the BNB Governor. The Ordinance regulates the manner of issue of government securities on the domestic market, as well as the procedure for their redemption and subsequent trade on the secondary market. The statutory act regulates the rights and obligations of the issuer, the fiscal agent, the primary dealers and other holders of government securities in respect of government securities acquisition, repurchase, replacing and redemption. The



different types of transactions with government securities on the secondary market are also regulated. In respect of the Bulgarian National Bank, in its capacity of an agent for the government debt and official depository of the State, its main functions and obligations are regulated, as follows: to establish and maintain a computerized book-entry system of government securities settlement accounts; organize and carry out government securities auctions; register the government securities issued and the transactions therewith on the secondary market; monitor and service the payments under the debt, etc.

4. **Ordinance No. 15 of 2002 on the control over transaction in book-entry government securities (GS)**, issued by the Minister of Finance and the BNB Governor. The Ordinance regulates the procedure and ways of control over GS transactions, such as: selection of GS primary dealers; control over criteria observance by the -GS primary dealers upon their selection; control over the systems for registration of GS transactions in the BNB and primary dealers. This regulation is focused both on ensuring the observance of the provisions of the Government Debt Law and the other secondary legislation, and on ensuring an effective and transparent GS market.
5. **Ordinance No. 31 of 2003 on government securities settlement**, issued by the BNB Governor. The Ordinance is issued on the grounds of the BNB -Law and regulates the settlement of GS transactions, conducted on the primary and secondary markets under Ordinance No. 5, and for the purpose the BNB shall establish and manage an electronic System of GS Settlement.

## 2. Risks

Government debt management is carried out by taking into account the provisionalities in the process of forecasting a number of factors, that influence considerably the decisions in this sphere. This presumes to regard the debt management as a process related to risk management. On the other hand, in case these factors exceed their acceptable levels, debt management should ensure such a policy that prevents or at least minimizes any possible risks for the budget. In this sense, debt management is a process closely related to and directly dependent on a very complex and multi-aspect environment, incorporating the following elements:

- **macroeconomic environment** – the Bulgarian and global economy growth rates, inflation, global economic crises, monetary policy, etc.;

# Government Debt Management Strategy for the Period 2006–2008

- **fiscal environment** – status of the state budget, budget policy and restrictions, privatization, etc.;
- **market environment** – level of domestic and international interest rates at the relevant segments of the yield curve, exchange rates, level of domestic market development, GS demand, etc.;
- **institutional and legal environment** – changes in the legislation, European integration, debt management institutional framework, etc.

The concepts set forth should be viewed in the context of the debt burden evaluation both based on its present level and on the assumptions for any changes under the three-year budget forecast for the period 2007-2009. Based on the level of the ratio of consolidated government debt (including debt of central government, social security funds and municipalities ) to GDP, which ratio at the end of 2005 is 29.9%, we can make the conclusion that the debt is not a threat for the country's financial stability. To support this: this indicator is more than two times lower than the average for EU, which at the end of 2005 is 63.4%. However, the circumstances, related to the present creditworthiness of the country and the ongoing overall restructuring processes, which presuppose the maintenance of a lower level, compared to the EU average, of the indicator under consideration, should be taken into account. Another key indicator when assessing the debt burden is interest expenditures on debt service to GDP. At the end of 2005 the level of this indicator is 1.7%, and for the next three-year period it is expected to be within 1.3%-1.5%. However, forecast levels, even not so much, continue to depend on the fluctuation of the interest and exchange rates on the international financial markets, and of course on the changes in the debt amount and national income.

In view of the above stated, we can summarize that the possible negative effects of the risks, related to the volume and structure of the debt have been considerably reduced compared to the end of 2002. In this connection, the main risks defined in the present Strategy are the same as those in the previous one, but with substantial differences in the measurement of their potential impact.

## *Refinancing risk*

The refinancing risk is identified with the issue of new debt to ensure the financing of the budget in relation to the need to cover the repayment of already existing debt. This risk is associated both with the possibilities to repay the maturing debt and with the volume of expenditures generated by the newly

issued debt. Hence, the direct connection that the higher the volume of the payment on maturing debt and the closer the date of its payment, the higher would be the refinancing risk. The volume of debt, as well as its structure in time, also has an impact on the refinancing risk level. The extension of the debt maturity and the improvement of its repayment profile in time help to limit this risk.

The share of short term debt as of the end of 2005 amounts to 3.1%. The average time remaining to maturity of the debt as of the end of the same period is 8 years and 2 months. Despite the good current levels of the indicators, the circumstances should be taken into account that they are rather simplified indicators of the refinancing risk, as they do not reflect whether the debt payments are evenly distributed in time. This requires careful monitoring of the repayment profile in order to avoid peak debt payments – as in the years 2013 and 2015.

The limiting of the refinancing risk can be done via careful changes in the debt structure in favor of the instruments that have longer maturity at the expense of those with shorter maturity. However, such change presumes to undertake higher levels of debt servicing costs, arising from the risk premium, associated with the longer investment horizon. In this connection and having in mind the circumstance that underdeveloped and lower liquidity markets presuppose higher premium, part of the efforts should be focused on gradual stretch of the yield curve. Currently the longest instrument in circulation on the domestic market are 15-year GSs denominated in euro with fixed interest coupon, while with the status of a benchmark issue are 10-year GSs, denominated in BGN, also with fixed interest coupon.

Another prerequisite for reducing any potential negative impacts of the refinancing risk is prevention of possible actions that might lead to fast uneven growth of the debt volume. The prevention of such growth is particularly important in the process of ensuring domestic financing and co-financing of projects and programs under the European Union Funds. For the purpose, the opportunities to issue long term debt should not be based only on the ongoing needs for financing, but also on assessment of investor's interest and the market development in the context of limiting the refinancing risk in the future.

### *Risk Associated With the Debt Volume*

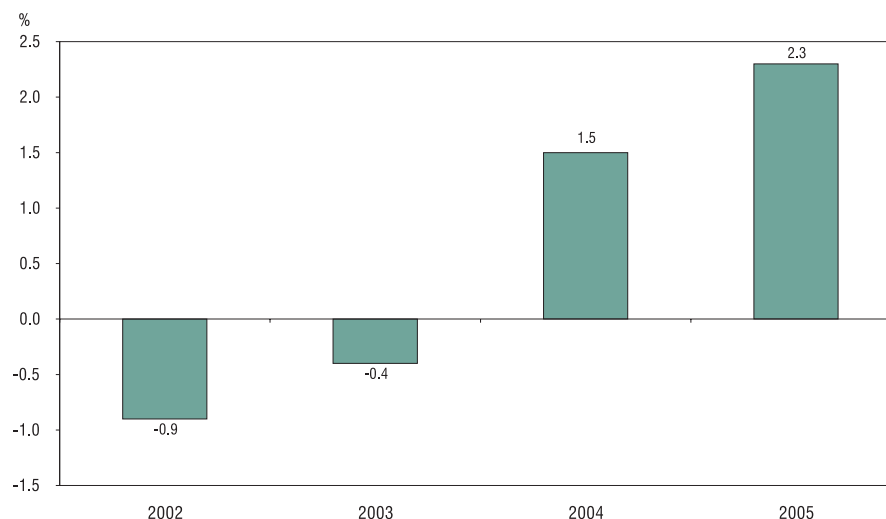
Minimization of the impact of the risk associated with the volume of the debt can be achieved through keeping the government debt on a 'safe' level so that

# Government Debt Management Strategy for the Period 2006–2008

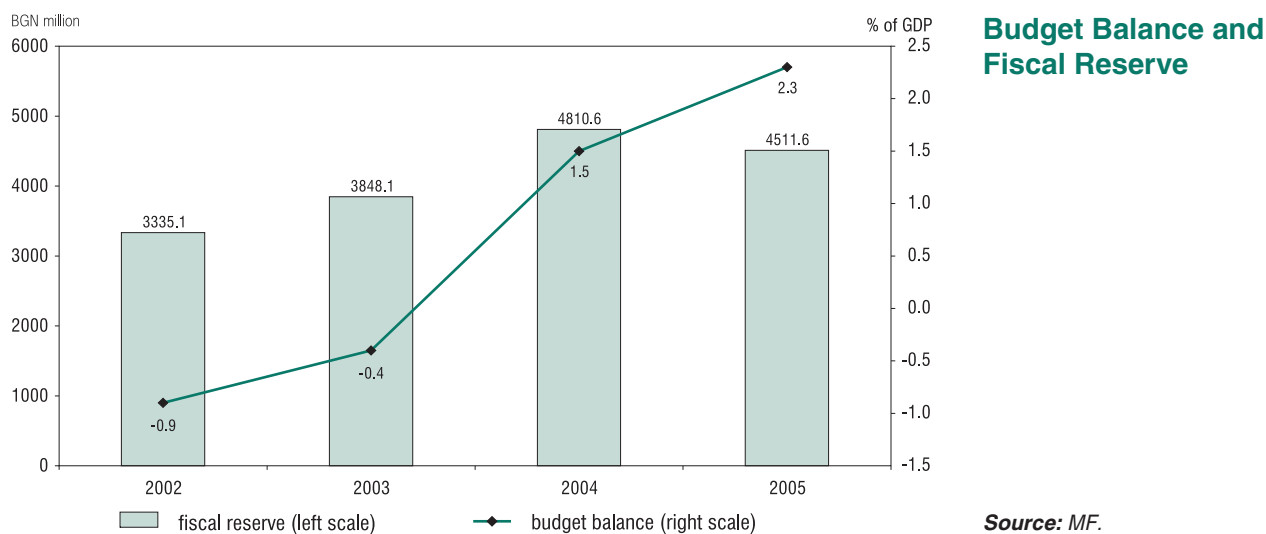
its timely service and refinancing for a long period of time do not jeopardize the financial and macroeconomic stability of the country as a whole. Such „safe“ level is predetermined by the development of the economy and its capacity to generate national income wherefrom ensues the definition of the main risk measure. The specific rate of the debt/ GDP ratio is directly dependent on a number of factors, the major of them being: level of economic development, growth of the national economy, social and political stability, effectiveness of public institutions, international relationships, inflation and interest rates, debt structure, development of domestic financial markets, access to international capital markets. In this connection the conclusion is imposed that the lower the overall economic development of a country, respectively the higher the risk of potential imbalances in time as regards debt payments and its refinancing is, the higher the expectations of financial markets to those countries to keep relatively low the debt/GDP ratio as well as a higher rate of return on invested capital are.

At end-2005 the consolidated government debt/GDP ratio is 29.9% and as noted above it is considerably below the average levels for EU. The major factors that result in changes to the two quantities forming the indicator are: favorable environment for the absolute reduction of the debt having in mind the budget deficits of below 1% of GDP (2001-2003) and surpluses of over 1.5% of GDP (2004-2005); generation of a significant amount of the fiscal reserve (BGN 4.5 billion at end-2005) as a source of funds for early debt repayment; restrictive policy as regards the financing of various projects and programs with government loans and government guaranteed loans; high and stable economy growth rates.

## Budget Balance



Source: MF.



Within the context of the necessity funds to be ensured, including by means of assuming new debts, for national financing and co-financing of projects under the European Funds any potential upward changes to the debt/ GDP indicator should be closely monitored. The maximum rate of this indicator is part of the convergence criteria (the Maastricht criteria) in the process of Bulgaria's integration into the Eurozone and any potential excess of the 60-percent limit would have a considerable adverse effect on this process. Moreover, in compliance with both the Bulgarian and the European legislation the nominal volume of the consolidated government debt, which comprises the debt of the central government, the municipalities and the social security funds, is used by definition in the calculation of the debt/GDP indicator. While the first component of the consolidated debt is within the competence of the government, the other two are beyond it. In this connection and in the presence of circumstances which would lead to a danger of exceeding the upper 60-percent limit, the legislation provides the opportunity for the government to propose in the State budget Law for the relevant year thresholds for the municipality and social security fund debts issuance. Such restriction should be considered as an extreme measure aimed at avoiding any essential adverse effects from the excessive increase of the debt volume.

As regards to the debt currency structure, its volume is also influenced by the fluctuations in the ratios of the main currencies. The greatest share of liabilities denominated in a currency other than BGN and EUR are those in

USD. The USD devaluation as compared to the EUR in the last three years has led to a reduction of the government debt volume. However, after the buyback of all Brady bonds and the early repayments of loans extended by the IMF and the World Bank, the influence of the exchange rates fluctuation on the debt volume is considerably limited. A 10% devaluation of the EUR as compared to the USD in the three-year period would lead to an increase of the debt by around EUR 120 million. Out of the rest of the currencies only the Japanese Yen has a relatively high share in the debt portfolio but a 10%-increase of its value as compared to the euro would lead to an increase of the debt by only EUR 18 million. That influence of the major currencies' fluctuations can be further reduced by continuing the policy of taking mainly BGN- and euro-denominated loans.

### *Market risk*

As a rule, the market risk is determined by the fluctuations in the foreign exchange rates and interest rates in the domestic and international capital markets. In this sense the minimization of the effects of its influence presumes complex activities. Some of them are expressed in careful monitoring and evaluation of the state and prospects for development of the individual segments of the financial markets (cash and capital). This, however, does not ignore the risk of considerable revisions and uneven fluctuations as markets are particularly sensitive and quickly respond to economic imbalances on national, regional and global level. Other activities are aimed at careful modeling of the interest and currency structure of the debt so that this structure does not predetermine high level of correlation with market indicators. However, such form of „neutrality“ presumes increase of both the debt with fixed interest coupons and the BGN- and euro-denominated debt. For this purpose in the past three-year period the issue policy was aimed at taking loans in BGN and EUR, mainly with fixed interest coupons. In addition, the debt bound to market indicators was reduced through making use of the possibilities for its early repayment. As a result, at the end of 2005 the share of debt with fixed interest reached 59.4%, and the share of BGN- and euro-denominated debt – 63.4%. Such profile leads to ensuring a relatively good forecastability of debt service costs and makes it unnecessary to maintain in amount budget funds to offset potential fluctuations of foreign exchange and interest rates.

With the current debt structure the analysis data show that the changes to the major market indicators have relatively low influence on the debt service costs. The reasons for that include reduction of the share of instruments with floating interest coupons and of instruments denominated in currencies other than euro and BGN. The amortization structure of debt, whose repayment schedule is long-term and relatively even as a whole, is also important.

The results show that an eventual rise in the six-month LIBOR rates for euro and USD by 100 b.p. would lead to an increase of the funds needed for payment of interest by approximately EUR 16 million per year in the period 2006-2008, the costs' sensibility to any changes in the interest rates for the euro being higher. This change represents only 4 – 5% of the total interest under the debt. A simultaneous 10% increase of the USD exchange rate as compared to the euro would increase the interest costs by around EUR 8 million per year, and the principal payments – by around EUR 5 million, which is immaterial as compared to the total debt payments. Nevertheless, in determining the concrete conditions of newly issued debt those proportions would continue to be closely monitored and analyzed.

### *Liquidity risk*

Liquidity risk is associated with the possibility of the budget to timely and fully cover its concrete short-term liabilities. The management of risk and reducing it to reasonable levels presumes actions leading to timely ensuring of the required budget financing regardless of the unforeseen circumstances which accompany it, where taking loans from the financial markets is either impossible or unfavorable. In this connection, with the establishment of a currency board regime in the country in 1997 a decision was made for creation of a fiscal reserve which was to be a kind of a „buffer“ in the cases of possible liquidity difficulties and an instrument for minimization of potential negative effects arising from the liquidity risk. The bottom level of the fiscal reserve was initially fixed at the amount of the one-year debt payments (around EUR 1 billion) but in practice its real levels significantly exceeded this minimum in the course of time. The reasons for this situation should firstly be sought in the pursued conservative fiscal policy which has led to generation of considerable surpluses in the last two years. Secondly, the increase of the fiscal reserve was influenced by the privatization revenues and sale of collateral released with the early repayment of the Brady bonds. On the other hand, the reform carried out in the budget sector, in its part related to the establishment of a single account aimed at consolidating the resources and using a unified system for the

payments to all spending units (except for municipalities), has led to centralization of the free cash resource in the fiscal reserve and contributed to the improvement of the effectiveness in its use and administration.

As a whole, we may sum it up that the higher levels of the fiscal reserve enable a more flexible debt planning and management in the short and the medium term.

### *Risk Associated With the Assumption of Contingent Liabilities*

In order to reduce the risk associated with the assumption of contingent liabilities we should strictly: comply with the legislation regulating the terms, order and procedures on issuance of government guarantees; make an impartial evaluation of the terms of the projects applying for financing with government guarantees in the context both of the priorities set out by the government in relation to the individual sectoral policies in the public sector, and the priorities related to government debt state and management; carry out continuous monitoring on the state and service of loans for which government guarantees have already been issued in view of the timely identification of the potential risks of activation of those guarantees; take all measures pursuant to the Bulgarian legislation for recovery of any sums paid under activated government guarantees.

With the current debt structure the influence of the risk associated with the assumption of contingent liabilities is limited having in mind the relative share of 7.5% of government guarantees out of the total volume of debt as of the end of 2005. In the previous three-year period that share rose by 1.8%. When government guarantees are assumed we should also take into account the concrete profile of the government guaranteed debt, based on the potential risks of activation of government guarantees and possibilities of actual collection by the state of the amounts paid thereunder. At present, the major part of the guarantees have been provided under loans of large companies important for the transport and energy sectors, which are subject to restructuring.

When making evaluation of the future impact of risk we should take into account the growing needs of financing of large infrastructure projects in the areas of energy, water supply network and road infrastructure. Bulgaria's accession to the European Union and the absorption of resources from the European funds also necessitates provision of national co-financing part of which will be ensured through government guaranteed loans. On its part, that



would lead to an increase of the absolute and relative share of government guarantees in the debt structure, with growing influence of the risk associated with the assumption of contingent liabilities, respectively.

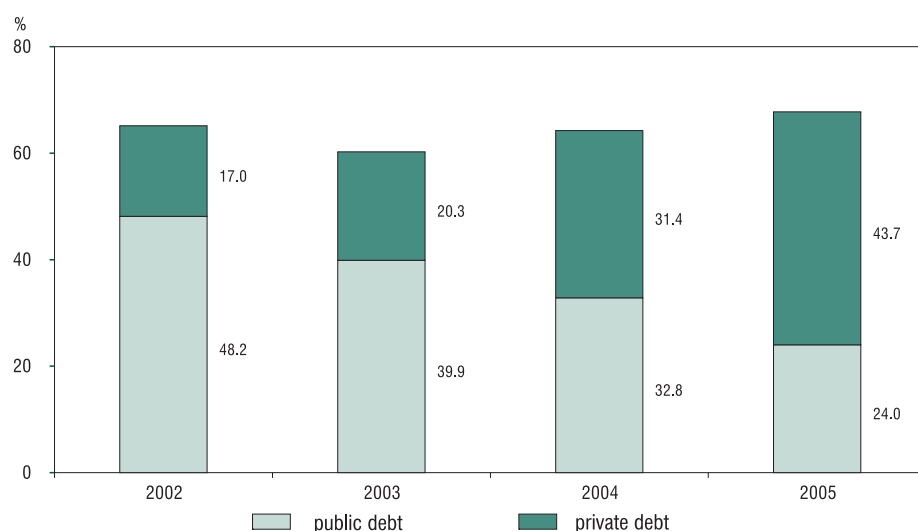
## 3. Objectives of Debt Management

**The main objective of the debt policy is to ensure unobstructed financing of the budget and refinancing of the debt at a lowest possible cost in medium- and long-term as well as at an optimal degree of risk.**

With a view to accomplishing it, priority will be the following subordinate objectives:

### I. Strict monitoring on the volume of debt

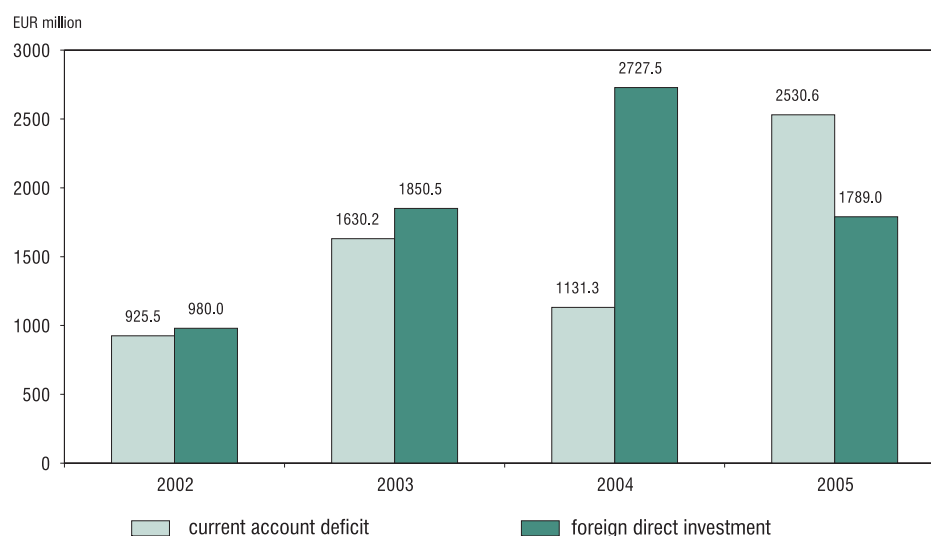
For this objective to be attained the debt management is to be based on the economic and financial policy pursued in the country. Such approach presumes maintaining the debt on a level which does not predetermine a considerable negative impact on the macroeconomic stability; meeting the nominal convergence criteria for EU membership; preparing and executing the state budget. The volume of the government debt should also take into account the current account deficit which has been rising in the recent years and the fast growing private debt. And last but not the least we should also take into account the impact of the municipal debt increase mostly predetermined by the need of ensuring local financing under projects and programs of regional importance for which financial assistance under EU is envisaged.



Source: BNB.

# Government Debt Management Strategy for the Period 2006–2008

## Current Account Deficit and Foreign Direct Investment



Source: MF and AEAf.

As a result of the considerable reduction of the debt burden achieved, at end-2005 the amount of the government debt /incl. the government guarantees/ was EUR 6 844.4 million and as a share of GDP it was 31.9%. The estimated amount of the annual debt payments in a ten-year term is smoothly decreasing by reaching its maximum level of around EUR 1 600 million in the years when global bonds fall due.

In the next couple of years the need of financing will be determined by a number of factors. The EU accession presumes absorption of considerable resources which, however, require provision of funds in advance and envisaging expenses for their co-financing. In addition, as from the date of accession the country will have unconditional obligation to make contributions to the budget of the Union in connection with the Community's system of own resources. In this sense, it is of key importance, especially in the first years after the accession, a national capacity for effective absorption of the agreed financial assistance to be generated. The decrease in the number of state-owned enterprises subject to privatization predetermines a decrease in the proceeds from privatization to the budget as well as in the revenues from rents. On the other hand, the budget policy will in principle presume allocation of increasingly smaller part of the national income through the state budget; of course this should not be absolutized, especially in the first years after Bulgaria's accession to EU.

Taking the above into consideration, the following actions are planned in view of the attainment of the defined objective:

1. Implementing a prudent and safe loan policy presuming a comprehensive analysis of the purpose of debt; possibilities of generating public benefits; evaluation of the domestic and international market environment and the specific terms of financing by international financial institutions; assessment of the time periods for assumption of debt, etc.
2. Monitoring the debt volume and profile with a view to prevent any breaches of its indicative parameters, possibilities of its service and refinancing, uncontrollable increase, negative effect on the financial and macroeconomic stability, breach of the debt limits settled by the law, and the Maastricht criterion on the debt/GDP ratio.
3. Using various techniques to reduce the risk associated with the volume and structure of debt as well as to optimize its service. Under appropriate conditions and in consistency with the concrete objectives of the issuer we could: carry out transactions of early repayment of liabilities under the government debt; conclude agreements for currency and interest swap transactions as well as ones aimed at reducing the risk upon refinancing and smoothing the maturity structure of the debt; issue government securities for the purpose of redemption of internal and external liabilities of the country, etc. In such transactions assessment will be made of the effect on the state budget, the fiscal reserve, the future issue policy and the balance of payments, and for this purpose the transactions will be discussed with BNB, as well.
4. Strictly observing the legislatively regulated order, terms and procedures of evaluation and selection of investment projects which are to be financed by government or government guaranteed loans, while seeking and applying solutions alternative to debt financing at the same time.

### **II. Keeping the debt service costs low in the medium and the long term, at an admissible degree of risk**

Debt service costs need to be kept low also in view of the pursued policy of reducing the share of the state in the reallocation of the gross domestic product and maintaining a balanced budget.

In the next three years debt interest costs are expected to vary between 1.3% and 1.5% of GDP. The greatest influence on those rates is expected to be

## Government Debt Management Strategy for the Period 2006–2008

exerted by the future loan policy and the changes to the debt volume and structure ensuing therefrom; the fluctuations in foreign exchange rates and interest rates are expected to have a lower influence. The development and strengthening of the local debt market, the reduction of the long-term risk premium on the Bulgarian debt, and the upgrading of the credit rating of the country will also affect the amount of the debt service costs. The following actions are planned in view of the attainment of the defined objective and in compliance with the budget framework and the concrete market situation:

1. Optimal selection of possible debt instruments upon taking new loans in terms of their amount, type, structure, place of issuance and main parameters (issue date, maturity date, amount and frequency of the payments, currency denomination, interest coupons, etc.).
2. Supporting the development of an efficient and liquid local government debt market and of the capital market as a whole, including as regards its smooth integration into the European market. Those actions, in conformity with the concrete market conditions and the further development of financial intermediation in the country, would contribute to the smooth extension of the yield curve as regards the main maturity segments, with a positive effect on debt service costs, respectively.
3. Maintaining a smooth distribution of debt service costs and amortization payments with a view to protect the budget against any potential difficulties in the accumulation of considerable in amount financial resources for those payments or against any rise of the risk of refinancing, respectively.
4. Sticking to the policy of negotiating fixed interest coupons upon taking new loans; however, this should not be absolutized. We should take into account both the possibilities provided by fixed interest rates for enhancement of budget expenditures' stability and forecastability, and the possibilities provided by floating interest rates for creation of a kind of hedge in case of future downward adjustment of market interest indices.
5. Sticking to a policy of taking BGN- and euro- denominated loans in view of the forthcoming accession of our country to EU, the pegging of the currency board to the euro, the structure of the proceeds from export (60.5% in euro as of 31.12.2005), and the forecastability of payments in terms of the budget.

6. Using derivative instruments in view of the more adequate formation of the cash flows related to debt payments. Thus we provide for a more efficient and flexible management of the risk of changes to market indicators (interest rates and foreign exchange rates) and the risk of refinancing, related to the structure of debt by means of modifying its characteristics. The use of derivatives will be in compliance with market conditions and sought effects in the process of implementing the debt policy.

### **III. Ensuring stable sources for budget financing and debt refinancing**

Debt policy as an important part of the overall economic policy of the government is to prevent the formation of possible instabilities, including such caused by difficulties in ensuring stable debt financing sources that, for their part, create certain risks for financial stability and growth.

Implementation of this objective presupposes outlining, monitoring and analyzing the possible domestic and international sources for financing in terms of their type, access rate, regulation and procedures, scale and financial conditions. This is the only approach that could guarantee stability of financing at minimum price and optimum degree of risk from the point of view of the issuer.

In this context, government issues on the domestic and international markets and loans from international financial institutions have been prioritized as sources for funding the needs of the budget and refinancing of debt in circulation.

#### **1. Debt issuance on the domestic and international capital markets**

The role and importance of markets as an effective distributor of capital nation- and worldwide has been constantly increasing. Their progress is based on both several century-old traditions and on the gradual imposing of the principles of free movement of people, goods, services and capital combined with the growing preferences of investors that are residents of a certain country to hold assets issued by non-residents. Having this in mind, capital markets represent an important source of financing for the separate issuers that provides them with an easy, large-scale and highly standardized access to wide investor base. Furthermore, such debt instruments provide various opportunities for active management and restructuring through market operations such as buyback, use of currency and interest rate swaps, etc.

## 1.1. International capital markets as a source of financing

As a result of the reduction of long-term interest rates in developed economies and the attendant reduction of risk premiums in developing economies, in the last couple of years there has been stronger investors' interest in securities issued on international capital markets by Central and Eastern-European countries. Such interest has been prompted first and foremost by the region's political stability and European integration (most of the countries are already or are expected to become EU members), as well as by the best combination of opportunities for higher yield at lower risk level. Bulgaria is not an exception to the global trends, all the more it has greatly contributed thereto. In general, this contribution has found expression in the stable macroeconomic environment, the sustainably high growth rates, the positively changing structure of economy, the enhanced competitiveness and improved business climate, the strict and consistent fiscal policy, the forthcoming membership in the EU with all resulting future positive effects. At this background, the sovereign investment credit rating together with the reduction of the risk premium of Bulgarian government debt has led to creating and confirming the international investors' confidence. The government debt management policy has considerably contributed thereto.

Having in mind the above, the following actions are envisaged in order to attain the objective:

- 1.1.1. Careful and in-depth monitoring of the status and development of international capital markets. From a strategic point of view, knowing the major markets as capital sources will allow to undertake timely actions together with favourable combining of the conditions related to the need for funding, market environment, issue expenses and funding price.
- 1.1.2. Assessment of the choice of a given market first and foremost on the basis of the capital price criterion. In addition, the positions of the American and the EU bond markets, which Bulgaria has already approved, will also be taken into account.
- 1.1.3. Selection of securities characteristics in a manner that presupposes meeting the requirements for benchmark issue status at the respective market standardized conditions such as: fixed interest coupon, interest payment frequency, nominal payment, amount of issue, maturity, etc. Such compliance presupposes future issue liquidity and making a benchmark yield curve of Bulgarian government debt on international capital markets. These circumstances, other things being equal, will lead to stronger interest of investors and improvement of the price

parameters of loan resources. As a whole, however, issue characteristics will be structured in a manner that corresponds to the specific market conditions as well as to the objective of the issuer to provide financing at minimal price at minimal level of risk in medium- and long-term aspect.

- 1.1.4. Giving priority to the euro as the main currency of issues which, all other things being equal, will eliminate substantially the currency risk taken by the budget in their future servicing.
- 1.1.5. Use of various options to provide full, timely and regular information about the country's progress, including about debt management activities, given the fact that conducting policies of transparency and predictability is a prerequisite for consolidation of the investors' confidence. In this context, maintaining an active dialogue with rating agencies is of significant importance.

### **1.2. The domestic market as a source of financing**

Most of the countries promote their support for development of an efficient domestic government debt market as an important objective of their debt strategies. In the short run, attaining this objective may presuppose acceptance of higher expenses by issuers than they have expected. Most of them, however, tend to accept these circumstances expecting that in the course of time their efforts will be rewarded by the lower price of debt resources on the domestic market as a result of market growing and its liquidity all along the yield curve. That also helps to have a less risky debt portfolio since a well-functioning domestic market enables the issue of long-term debt on a larger scale in local currency and at fixed coupons, having effect on the reduction of interest charges and the refinancing risk of the debt in circulation. Further focusing on the need for domestic market development is a consequence of the concomitant smaller dependence on changes in external sources of financing. Last but not least, the role of the domestic market as a source of financing has been increasing in recent years directly resulting from growing competition among the issue countries as a consequence of the on-going integration processes of capital markets with the introduction of the euro.

The high priority of this objective fully corresponds to the vision presented above. It is supported by Bulgaria's forthcoming accession to the EU which requires consolidation of what has been achieved so far in this field as well as

capacity building in order to respond to the new challenges in relation to the integration of domestic debt market into the European one. The good quality and the low level of credit risk of domestic government debt market is the basis for stimulating financial market development in the country in the broadest sense. The experience of the countries which were at a similar stage of economic development at the time of their accession to the EU shows that only those with well-arranged, transparent and liquid government securities market could integrate smoothly and compete effectively with the other issuers of government securities.

In this connection, attaining the objective related to ensuring domestic market as a stable source of financing goes through its further development, strengthening and fostering market liquidity. In order to implement these, the following actions will be taken:

- 1.2.1. Carrying out a transparent, consistent and foreseeable issue policy. In this respect, the major parameters of the issue policy for the ensuing year will continue to be announced as well as the characteristics of the issues based on monthly issue calendars. In order to disseminate information, all possible channels such as the web-pages of MoF, Reuters and Bloomberg Information Systems as well as those of the BNB will continue to be used.
- 1.2.2. Sticking to policies of positive net domestic financing complied with the specific budget needs, outstanding debt refinancing, searching definite debt instruments, financial system liquidity, increasing the assets of pension funds, insurance sector and other big institutional investors. Other factors that will also be influential are domestic market integration into the European one and competition of other low-risk investment instruments.
- 1.2.3. Continuing the efforts aimed at further development of primary government debt market and oriented in two main directions organization of market infrastructure and standardization of debt instruments proposed. Improving the primary market infrastructure will be mostly determined by the actions aimed at enhancement and establishment of the automated auction system. Various modifications of buyback, swap and government securities subscriptions will be gradually developed and introduced, and technical possibility for consolidation and conversion of BGN-denominated debt into euro-denominated one will be provided in relation to the introduction of the euro as national currency at of the moment of joining the Eurozone area.



Respective amendments to legislation will be required. As far as the standardization of debt instruments offered on the primary market is concerned, the aim is most of all to unify them with the general market conventions, which will to a large extent improve the comparability of Bulgarian government securities with those issued by other countries. Focus on fully standardised government securities will provide for attracting new groups of investors, including foreign ones.

- 1.2.4. Continuing the efforts of maintaining a liquid benchmark yield curve of domestic government debt under the main maturity segments – 3 months, 3, 5 and 10 years by emphasizing the curve's long end. Maintaining and achieving a long-term interest rate for convergence purposes that is compliant with the Maastricht criteria is a compulsory requirement for membership in the EMU. Last but not least are the positive effects from similar policies of promoting the development and enhancing the liquidity of government debt market with concomitant influence on the financing price. For this purpose it is envisaged to continue the issuance of at least one government securities issue within a year of the maturities mentioned above in volumes ensuring liquidity in the secondary market. Furthermore depending on the status of market environment and the expectations for its dynamics, the volumes of issues, whose interest coupons are fixed at reasonable levels from the point of view of the issuer, may be reopened and expanded.
- 1.2.5. Keeping within such an issue policy that considers the factors influencing the market liquidity. Those factors are payments from and to the budget, seasonal instabilities, external factors, specific investors' preferences of government securities, etc. In this connection, the close coordination between MoF and the BNB will continue to be of importance.
- 1.2.6. Creating prerequisites encouraging the development of secondary government debt market. Part of the efforts will be directed towards appropriate structuring of the characteristics of government securities offered on the primary market, the positive effects of which are presented in item 1.2.3. For that purpose, the issuance of at least one government securities issue within a year of the maturities mentioned above will continue in volumes ensuring its high liquidity. It is desirable for the volume of individual issues to exceed BGN 200-250 million, naturally in compliance with the gross debt issue for the respective year. In addition, under the proper circumstances and in line with the issuer's specific goals, all possible instruments for promotion of the

development of secondary debt market are envisaged to be used.

- 1.2.7. Developing the system for primary dealing in government securities by amending the conditions for authorizing investment brokerage in government securities are issued. On the one hand, these changes will involve greater competition among primary dealers on the primary and secondary market by introducing a wider range of requirements for market behaviour with respective access to certain operations related to external debt issue and management. On the other hand, the changes will be oriented towards the future treatment of foreign institutions as primary dealers in government securities in view of the country's accession to the EU and the related requirements. Reformulating the criteria for assessment and selection of primary dealers will be aimed at enhancing the liquidity, transparency and effectiveness of the domestic debt market.
- 1.2.8. Supporting market initiatives aimed at establishing and introducing e-platforms for trading in government securities, which would contribute to the increase of market liquidity and transparency as a whole.
- 1.2.9. Introducing new debt instruments various in type and purpose, including derivatives. Actions in this direction are to be undertaken after the establishment of the required legal and organizational environment for their operation by the respective adjustment of accounting methods to the peculiarities of operations involving similar instruments. Their introduction will comply with the situation and the extent of market readiness, investment needs and their contribution to achieving the objectives of debt policy.
- 1.2.10. Undertaking actions to harmonise the legislation and ensuring the organizational structure in line with European regulations and practices in relation to the use of government securities as financial security, government securities transactions, conducting trustee services, etc.
- 1.2.11. Supporting the efforts of the BNB aimed at improving the systems for registration and settlement of government securities in order to further align them with ESCB standards and CERS as well as with EU directives on financial markets in view of providing conditions for future consolidation and integration of European market structures. This will promote the establishment and relations with international settlement systems such as Euroclear and Clearstream, which is one of the prerequisites to stimulate the interest of foreign investors by enabling them to operate in a familiar environment.

### **2. International financial institutions<sup>5</sup> (IFIs)**

In latest Bulgarian history, IFIs play substantial role in the country's economic development by rendering extensive financial and technical assistance. This assistance has been determined above all by the need for financial security of the actions undertaken and aimed at achieving macroeconomic stability during the country's transition to market economy and the general implementation of structural reforms. Furthermore, the fact that IFIs provide a relatively easy access to long-term resources at favourable financial conditions has also been taken into account, a fact that has been of utmost importance in the early years of transition especially when Bulgaria experienced some difficulties in getting access to alternative sources of financing. Equally important are the circumstances related to the access to the expertise of these institutions as well as to their control over projects funded and the introduction and implementation of the best practices and international standards.

Bulgaria's forthcoming accession to the EU and reaching a maximum degree of convergence predetermine close cooperation with IFIs as a source of additional funding in the process of absorbing grants from the European funds. Such a conclusion is also supported by the policy of closer cooperation with IFIs adopted by the EU itself. This cooperation is targeted at providing coordinated financial support for newly acceded countries which are required to adopt EU acquis, achieve compliance with EU sector policies and build administrative and institutional capacity.

The following actions are envisaged to be taken in order to attain the objective:

- 2.1. Outlining the priorities of funding where the support of IFIs will be sought. In this case it is extremely important to determine correctly the focus of future cooperation. On the one hand, it is to help achieve better compliance with EU policies in this sector in a number of key areas such as transport, energy and environment as well as in the field of diminishing poverty and building administrative and institutional capacity. On the other hand, the areas of specialization and priority fields of activity of IFIs themselves are to be taken account of so as to eliminate any possibilities for duplication of activities or competition among the institutions when funding specific projects. The

---

<sup>5</sup> The definition of International Financial Institutions includes: the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the Council of Europe Development Bank.

Memorandum of Cooperation, signed in 1998 between the European Commission and EIB, EBRD, IBRD, the International Financial Cooperation, Nordic Investment Bank, the Council of Europe Development Bank and the Black Sea Trade and Development Bank in relation to the preparation of CEE countries, Cyprus, Malta and Turkey for EU accession, follows the same line.

- 2.2. Being familiar, with the aim of possible contracting, with various innovative financial products offered by IFIs in relation to the absorption of the financial aid that Bulgaria will receive after joining the EU. In general, these products presuppose better effectiveness of funds received and could be considered and contracted within the present and future strategies for country support by the individual IFIs.
- 2.3. Maintaining cooperation with IFIs predetermined by both the country's future accession to the EU and the favourable financial parameters of the products offered. Such cooperation, however, requires careful planning of the financial needs in compliance with the extent to which the individual projects are ready in the context of the policies carried out in relation to the management of debt and its indicative parameters.

#### **IV. Maintaining close coordination and mutual awareness between the Ministry of Finance and the Bulgarian National Bank.**

In the broadest sense, maintaining macroeconomic stability and fulfilling the national strategic priorities related to Bulgaria's accession to the EU require coordination of intentions and policies between the BNB and the government. This coordination takes place by abiding by national legislation and European requirements for institutional, personal and financial independence of the Central Bank, which fully complies with the commitments undertaken by the country in the process of negotiations. Pursuing such policies not only creates an atmosphere of predictability and helps define and implement national priorities, but also leads to minimising the macroeconomic risks related to the relatively high growth rate of public sector credit and the current account deficit.

In this line, an Agreement between the Council of Ministers and the Bulgarian National Bank on the introduction of the euro in the Republic of Bulgaria by 2009/2010 was signed in November 2004. According to one of the commitments therein, another Agreement between the Ministry of Finance and the Bulgarian National Bank was signed in February 2006 in order to define the

long-term tasks of the Central Bank as a government agent. Those tasks are based on the primary and secondary legislation and arrangements that regulate the activities of the Central Bank as a fiscal agent and depository of the state.

The environment thus outlined provides opportunities for obtaining the defined objective by taking the following actions:

1. Maintaining and developing appropriate mechanisms for exchange of information related to the fiscal and debt policy of the Ministry of Finance. Extremely important in this case is the information related to government financial flows in the context of the measures adopted by the BNB to reduce the growth rate of bank credits to sustainable levels. On the other hand, the provision of summarized information by the BNB on the liquidity in the financial system enables better structuring of the issue schedules of domestic government debt and of the operations related to their management.

2. Further developing the opportunities provided by the joint advisory committees to present and discuss not only the policies of both institutions depending on their competence, but specific issues of crucial importance and mutual interest.

3. Rendering support (mostly methodological) to the BNB as debt agent aimed at development and improvement of the systems for issuance, servicing and trading in government securities that it maintains. This will, on the one hand, ensure the flexible and adequate debt policy implemented by MoF in line with the objectives set in this Strategy, and on the other hand will promote the development of a transparent, effective and liquid government debt market by preconditioning its future smooth integration into the European debt market.

# Government Debt Management Strategy for the Period 2006–2008

## Dynamics of Government and Government Guaranteed Debt between 1999 and 2005

(EUR million)

Structure	1999	2000	2001	2002	2003	2004	2005
Domestic debt	1 530.7	911.3	955.1	1 087.0	1 153.8	1 370.6	1 453.5
I. Government debt	1 060.3	906.2	951.7	1 086.1	1 153.8	1 370.6	1 453.5
Budget deficit financing government securities	450.9	491.4	554.6	754.9	879.2	1 130.5	1 214.3
Structural reform government securities	495.5	389.9	382.4	321.7	270.4	240.0	239.1
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	5 391.0
I. Government debt	8 587.1	9 159.5	9 096.6	7 685.9	6 961.1	6 140.6	4 876.8
Brady bonds	4 954.6	5 347.7	5 400.0	2 398.7	1 890.1	1 164.1	-
Bonds	-	-	250.0	2 310.0	2 091.4	2 018.3	2 162.5
Paris Club	811.1	645.3	433.5	284.5	218.9	176.3	163.7
World Bank	820.5	889.6	941.1	836.1	870.0	930.6	1 020.0
G-24	70.9	60.8	53.8	48.9	42.0	34.6	36.9
European Union	400.0	460.0	390.0	390.0	350.0	350.0	287.5
IMF	1 126.5	1 309.4	1 183.4	990.9	940.2	868.7	559.5
Other	147.7	136.6	136.6	129.2	125.2	125.2	62.3
Government investment loans	207.8	251.0	240.3	236.7	383.0	428.8	549.2
Called government guarantees	48.1	59.2	67.8	61.0	50.2	43.9	35.2
II. Government guaranteed debt	441.4	480.8	576.3	530.5	394.9	444.0	514.2
Total debt	10 559.3	10 551.6	10 627.9	9 303.4	8 509.8	7 955.2	6 844.4
GDP ( BGN million)	23 790.4	26 752.8	29 709.2	32 335.1	34 546.6	38 275.3	41 948.1
GDP (EUR million)	12 163.9	13 678.5	15 190.1	16 532.7	17 663.4	19 569.9	21 447.7
Total debt/GDP(%)	86.8	77.1	70.0	56.3	48.2	40.7	31.9

**Note:**

\*Nominal figures.

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

Source: MF and NSI

## Consolidated Government Debt

(EUR million)

Structure	by 31 December 2004	by 31 December 2005
Consolidated Government Debt	7 557.8	6 422.9
1. Central government debt	7 511.2	6 330.2
2. Social security funds debt	0.0	0.0
3. Municipal debt	46.6	92.6
Consolidated government debt/GDP(%)	38.6	29.9

**Note:** 1. Central government debt shown at nominal value excluding government guaranteed loans.  
 2. 2005 GDP is set at BGN 41 948.1 million and 2004 GDP is set at BGN 38 275.3 million.  
 3. Euro recalculations are at BNB central lev for rates for the closing business day of each period.  
**Source:** MF.

## Credit Ratings Range for Bulgaria 2003-2005

	Moody's	S&P	Fitch	
	Aaa	AAA	AAA	
	Aa1	AA+	AA+	
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	17 August 2005
	Baa2	BBB	BBB	27 October 2005
	Baa3	BBB-	BBB-	17 November 2004
investment rating	Ba1	BB+	BB+	
non-investment rating	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	
	B2	B	B	
	B3	B-	B-	
	Caa	CCC+	CCC	
	...	...	...	
	C	D	D	

long-term GS: foreign currency    ↑    long-term GS: local currency    ↑