

Government Debt Review · 2006



Republic of Bulgaria
Ministry of Finance

Government Debt Review • 2006

Sofia, 2007

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
GDP	Gross Domestic Product
GS	Government Securities
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, 2007

ISSN 1313–1729

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

Contents

The Macroeconomic Development of Bulgaria in 2006	5
Economic growth	6
Labour market	7
Inflation	8
Monetary policy and financial sector	9
Foreign sector	10
Fiscal policy and state budget	11
Domestic Debt	13
Domestic financing	18
Domestic debt service	24
GS Secondary Market Overview	25
External Debt	31
External Financing	34
Debt Service	37
Government Debt Management Strategy Update	39

The Macroeconomic Development of Bulgaria in 2006

The most typical feature of Bulgaria's macroeconomic development in 2006 was the acceleration of economic growth, which had a direct, positive impact on employment and business activity.

Measures taken by the Bulgarian National Bank (BNB) to curtail the increase of lending activities have to a certain extent slowed down the growth rate of new loans authorized in 2006. However, these measures did not reduce the current account deficit – by most recent data, in 2006 it came to 15.8% of the country's Gross Domestic Product (GDP). All this deficit was fully covered by the stream of direct foreign investments in Bulgaria and thus the overall balance of payments, in the amount of EUR 1,785.6 million, remained a positive value. Growth of the current account deficit has been restricted to some extent by the government's fiscal policy – according to latest data, in 2006 the budget surplus was 3.5% of GDP.

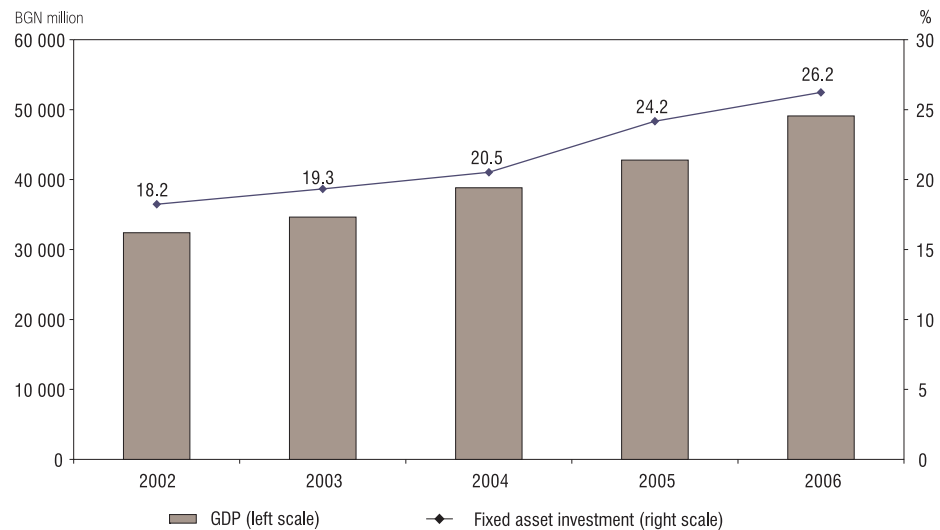
Economic growth

Bulgaria is in a period of sustainable economic growth, which began in 1998 and continues to date. In the course of nine consecutive years the Bulgarian economy has been scoring a constant increase of GDP, and indeed during the latest three years growth rates have been above 6%. To compare with, the average annual growth rate of Bulgaria's economy during the years 2001–2004 was in the range of 5%. Maintaining this tendency over the next few years, combined with satisfactory use of the benefits deriving from inclusion in the single European market, would provide a good basis for successful and real convergence of the Bulgarian economy with the other EU economies.

Services have been the most dynamic economic sector in Bulgaria over the recent years. Their average annual growth in 2002–2005 was 6.2% against 4.8% for the industry sector. However, services continue to be the greatest driver of Gross Value Added (GVA) growth. Conversely, GVA in the agricultural sector has dropped markedly during the last two years.

The Macroeconomic Development of Bulgaria in 2006

GDP Share of Fixed Asset Investment



Source: NSI

On the end-use side, the main contributor to GDP growth during the past two years has been domestic demand. The most dynamic component of domestic demand during that period were investments, which grew in real terms by 20.4%. Although investments are the fastest growing GDP component viewed from end-use perspective, the most important element, which to a large extent predefines GDP performance as a whole, is final consumption. In real terms, in 2006 it grew by 6.5% vs. 2005 and contributed 5.7 percentage points to the increase of newly generated income. The surging consumption has been driven mainly by the growth of private consumption. In turn, private consumption has been propelled mostly by the increase of consumers' own resources (pensions and wages).

Labour market

The increasing growth of Bulgaria's economy relates to an increased employment. According to Workforce Monitoring (WM) data of the National Statistical Institute (NSI), compared to 2005, in 2006 the average number of employed persons rose by 130,000 people or 4.4%. The accelerated employment growth rate compared to previous years is due mainly to the increased number of employees in the private sector. In turn, increased employment in the private sector is caused by two factors: (i) the higher economic activity of private companies and (ii) the lower social security rate, introduced in the beginning of 2006, which reduced employers' labour costs

and created motivation for legalization of employment contracts and wages. Since 2005, the impact of proactive employment promotion measures and programmes has been decreasing, mainly due to the limited scope of subsidised employment programmes.

The dynamic growth of employment has lead, inter alia, to an appreciable increase in the rate of economically active population. In 2006, the average workforce share in the population aged 15 years or more reached 51.3%, which is 1.6 percentage points more than the value of the same indicator for 2005.

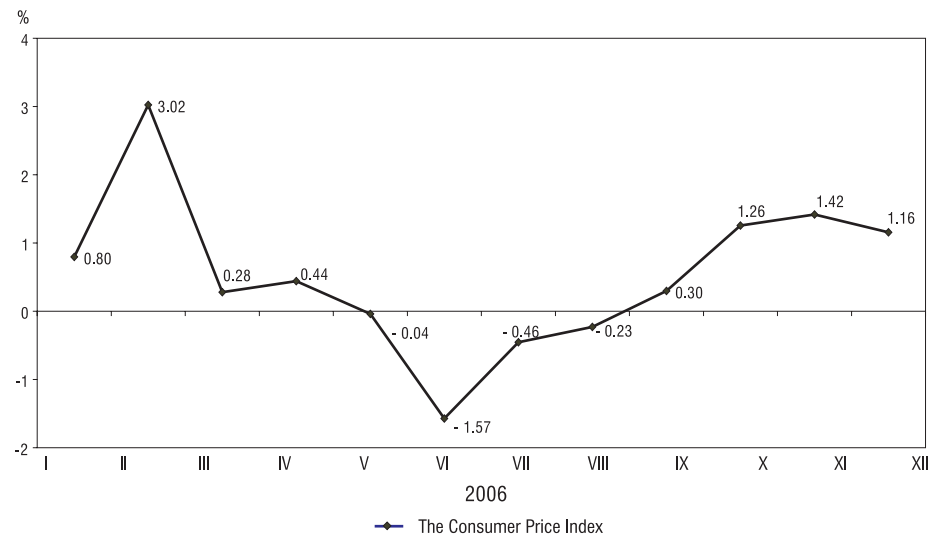
Steady development of the private sector over the past years has been the major factor for the decreasing unemployment levels – a tendency, which continued in 2006. Based on WM data, the average number of unemployed persons in 2006 dropped to 305,700. This is 9% of the employable population and 1.1 percentage points down from the 2005 level. According to administrative statistics produced by the Bulgarian Employment Agency, the average annual level of registered unemployment in 2006 was 9.6% or 1.8 percentage points less compared to the previous year.

Inflation

The inflation rate reported at 2006 yearend was 6.5%, with an average annual value of 7.3%. To a large extent, inflation was fueled by increased administrative prices. On average annual basis, administrated prices rose by 15.3%, while non-regulated prices increased modestly by 5.1%. The sizable increase of administrative prices is due mainly to the new excise rates on cigarettes, which were introduced in the beginning of the year. The purpose of this measure was to pre-empt the impact of harmonization between Bulgarian and EU excise rates on the inflation level in 2008, when Bulgaria will be monitored to assess whether or not it meets the Euro zone membership criteria, one of which is price stability. In the beginning of the year, new excise rates were also imposed on alcoholic beverages and liquid fuels.

The Macroeconomic Development of Bulgaria in 2006

The Consumer Price Index change (monthly)



Source: AEF

The Consumer Price Index

Monetary policy and financial sector

The banking sector will remember 2006 with the lending growth restrictions imposed by the Bulgarian National Bank. These measures have largely contributed to the limitation of credit-related risks and to the continuing financial stability.

As opposed to the previous two years, 2006 did not provide clear indications that increased credit levels have had an appreciable contribution to increased consumption in the economy. Reduced growth rates are observed with all types of credits, except housing loans, the most notable reduction being with consumer credits. In 2006 consumer credits grew by a weak BGN 234 million against BGN 1 billion plus increases in the preceding two years.

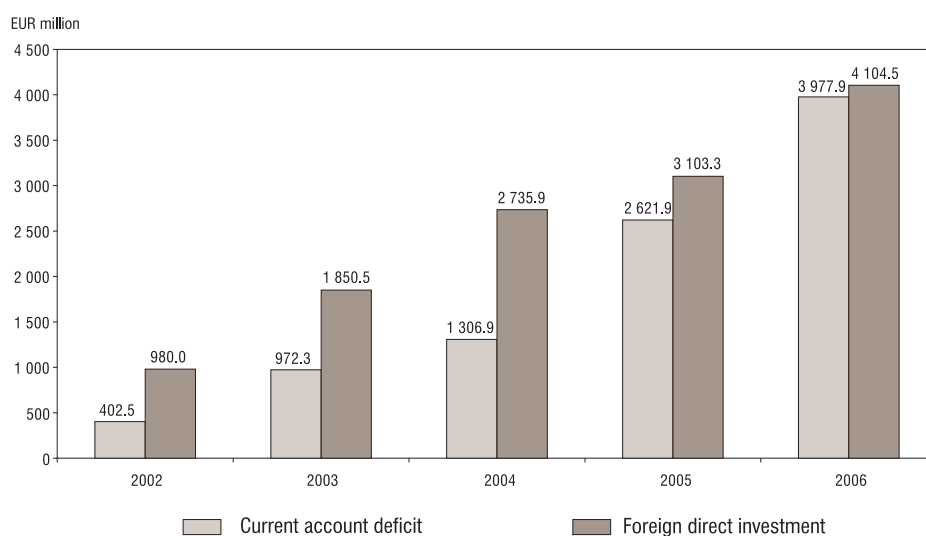
Interest rate levels in Bulgaria are higher than those in Europe due to higher risk margins compared to EU Member-States. As banks began to actively provide credit facilities to the private sector in 2003–2004, interest rates have declined owing to stronger competition between banks and increased liquidity of the system. This tendency slowed down after the introduction of lending caps in spring 2005, but was also due to the increased interest rates worldwide, which have kept interest spread to relatively high levels – in the range of 5.5 percentage points.

2006 was a very dynamic year for the capital market. Stock exchange indices reached lofty growth levels. At yearend, SOFIX rose by nearly 50% on annual basis. The main drivers of this growth include positive expectations from Bulgaria's full membership in the EU after 1 January 2007 as well as the perspective of more international players entering the local capital market, which has not unfolded its full potential. Other contributors to the dynamic development of the capital market were the incentivising microeconomic environment, the continuing stability and the sustained economic growth, all of which enabled businesses to generate high profits.

Foreign sector

Although the measures imposed by the BNB managed to restrict credit activity in Bulgaria, the balance of payments on current account deficit continued to increase. The outturn figure for 2006 is EUR 3,977.9 million compared to EUR 2,621.9 million one year earlier. This adverse development is mainly due to the increased trade deficit as trade balance in 2006 plummeted to minus EUR 5,390.1 million against minus EUR 4,409.7 million in 2005. Although positive, the weaker balances of services, income and current transfers also had an adverse impact on the current account.

In 2006, the current account deficit was fully offset by the inflow of direct foreign investments. Thus, the overall balance of payments was positive at EUR 1,785.6 million, outperforming by more than three times the level achieved in the previous year.



Current Account Deficit and Foreign Direct Investment

Sources: BNB and AEAF

Within the structure of the financial account, the 'other investments' asset demonstrated an appreciable increase. The main part of this asset is the deposits held by Bulgarian commercial banks with international financial institutions. On the other side, the limited share of net portfolio investments in the financial account indicates that financial streams are steadily flowing into the economy, because portfolio investments are typical conductors of speculative capital.

Fiscal policy and state budget

The year 2006 saw again very good performance on central budget targets. According to estimates, budget surplus has by far outstripped the target value laid down in the Budget Act and is evaluated to 3.5% of GDP. This is due mainly to strong performance on the revenue part and to the high nominal growth of revenues from most types of taxes. The most serious change in social security taxation in the beginning of 2006 related to a 6 percentage points reduction of mandatory contributions to the Pension Fund. The actual effect of this measure was very much below the anticipated negative impact on budget revenues and contributed to over-passing the revenue target. Same as in the previous year, high import volumes were the main factor for the fast growth of revenues from indirect taxes.

Consolidated budget spending during the period grew by 9.6%, virtually all this growth comes from current expenditure. In nominal terms, capital expenditure was 18.3% up compared to 2005. Interest expenditure in 2006 dropped by 6.6% and subsidies were down by 17%. Fiscal policy in the past year was focused on the social sphere – social spending from the consolidated budget rose by 13.6% against 2005, mainly on account of higher pension costs as well as greater social aid payments.

Domestic Debt

The domestic debt policy pursued in 2006 adhered strictly to the Government Debt Management Strategy 2006–2008 as adopted by the Council of Ministers, and to the priority objectives laid down in the Strategy.

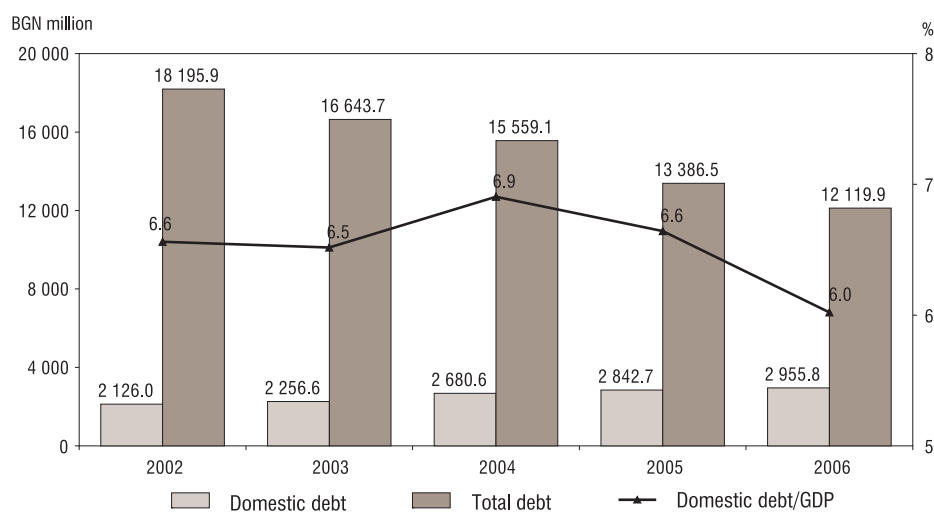
One of the debt policy aims pursued during the year was to continue the efforts for developing an efficient, liquid and transparent market for Government Securities (GS), ensuring its smooth operation and seamless integration into the European debt markets. The specific measures undertaken to that end were aimed at maintaining a consistent, transparent and predictable issuing policy conformed both to budget needs and financial system liquidity levels, and to demand of definite debt instruments from the investment community, in particular from commercial banks, pension funds and insurance companies.

The past year offered a relatively favourable environment for domestic debt issues. In the context of the Government Debt Management Strategy, the government continued the policy of borrowing primarily from the domestic market, taking into account several underlying limitations such as the need to maintain fiscal sustainability and strictly respect government debt benchmarks, the expected high budget surplus, the fiscal reserve account level, the highly negative balance of the current account and other macroeconomic indicators. Generally, in 2006 the GS market continued to follow the tendency established in previous years. Demand for government securities continues to exceed the amounts offered with investors being strongly interested in medium-term and long-term bonds. The average original maturity of auctioned government securities grew to 7 years and 2 months, which is 3 months longer than the one achieved during the previous year. The continually growing yield in the Euro zone led to the bid-to-cover ratios being lower compared to last year, and to a gradual increase of GS yields during the reporting year.

At 2006 yearend, the nominal value of domestic government debt was BGN 2,955.8 million or 6.0% of GDP. This includes BGN 2,544.0 million debt on government securities issued on market principle and BGN 411.8 million debt on GS issued in the context of structural reform. Expressed in percent, market-based government securities account for 86.1% of the total domestic debt, and GS issued as part of the structural reform are 13.9%. Compared to 2005, domestic government debt saw an increase of BGN 113.1 million in nominal terms, which is due to the positive net financing achieved. This is in line with the government debt management policy pursued during the recent

years, which aims to increase the share of domestic debt at the expense of external debt. Accordingly, compared to the total debt amount in the end of 2005, domestic debt has increased its share in the overall debt structure by 1 percentage point.

Domestic Debt/GDP



Source: MF

Net domestic financing during the reporting year was positive and came to BGN 135.3 million. Accordingly, gross domestic financing was BGN 517.7 million, resulting from one issue in each of the main maturity segments, namely: 10-year government bonds in the amount of BGN 170.0 million, 5-year bonds in the amount of BGN 155.0 million, 3-year bonds in the amount of BGN 127.7 million and 3-month government bills in the amount of BGN 65.0 million.

Domestic Debt Dynamics

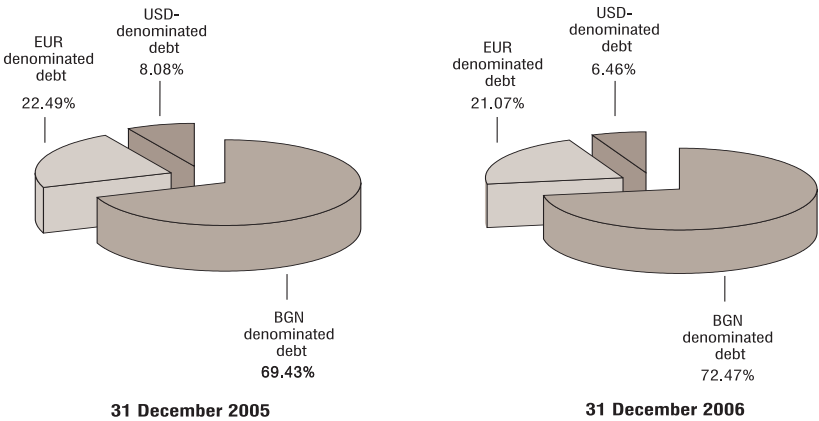
Debt Structure	Debt by 31 Dec. 2005 BGN million	Rise, BGN million	Fall, BGN million	Debt by 31 Dec. 2006 BGN million	Nominal rise/fall	%
Domestic Government Debt	2,842.72	517.73	382.42	2,955.81	113.09	3.98
1. Government securities issued	2,375.05	517.73	348.77	2,544.01	168.96	7.11
3-month	15.00	65.00	80.00	–	–15.00	–100.00
3-year	338.37	127.73	77.05	389.06	50.68	14.98
5-year	750.82	155.00	191.72	714.09	–36.72	–4.89
7-year	660.36	–	–	660.36	–	–
10-year	414.92	170.00	–	584.92	170.00	40.97
15-year	195.58	–	–	195.58	–	–
2. Structural reform government securities	467.67	–	33.65	411.80	–55.87	–11.95
19-year	1.65	–	0.28	1.38	–0.28	–16.67
20-year	228.72	–	16.34	212.38	–16.34	–7.14
24-year	1.53	–	0.13	1.40	–0.13	–8.33
25-year	235.77	–	16.91	196.64	–39.14	–16.60

Note: All data at nominal values.

Source: MF

The favourable shifts in the currency structure of domestic government debt were sustained in 2006. In line with the objectives laid down in the Strategy, and upholding a policy of domestic borrowing in local currency, all securities issued during the year were denominated in Bulgarian Lev. This, together with the regular amortization payments on the dollar bonds issued for the structural reform, has led to a 3 percentage points increase of the BGN-denominated debt share, which reached 72.5% of the overall domestic debt.

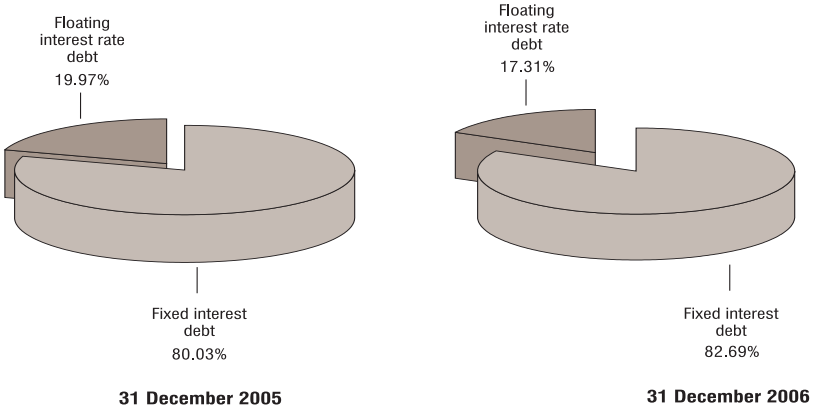
Currency Structure of Domestic Debt



Source: MF

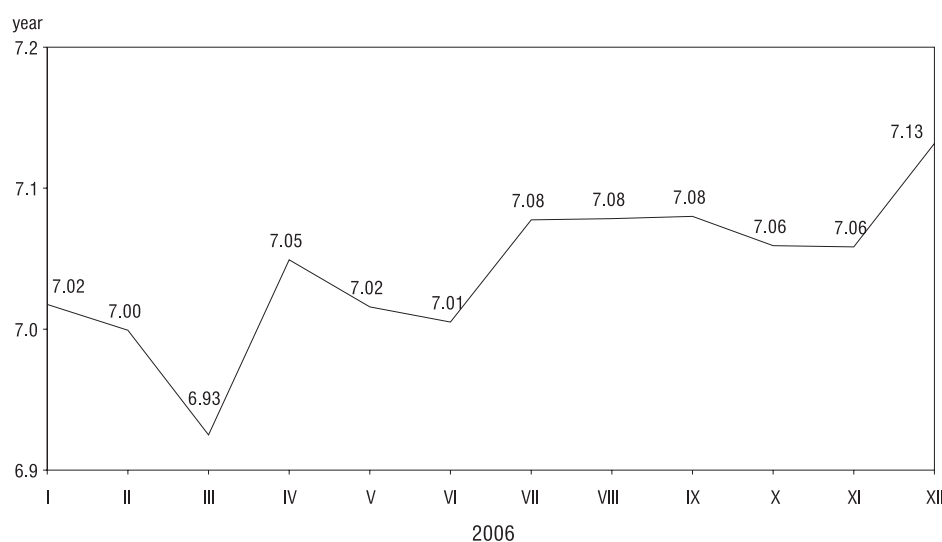
The interest structure continued to evolve in terms of increasing the debts with fixed interest coupons, which reached 82.7% against 80.0% at 2005 yearend. These results both from the new borrowing, which took place only at fixed rates and from the regular amortization payments on floating rate debts.

Interest Rate Structure of Domestic Debt



Source: MF

The reporting period also saw positive adjustments in the original maturity of government securities issued on auction. From an average maturity of 6 years and 11 months as reported at 2005 yearend, in the end of 2006 this figure was already 7 years and 2 months.



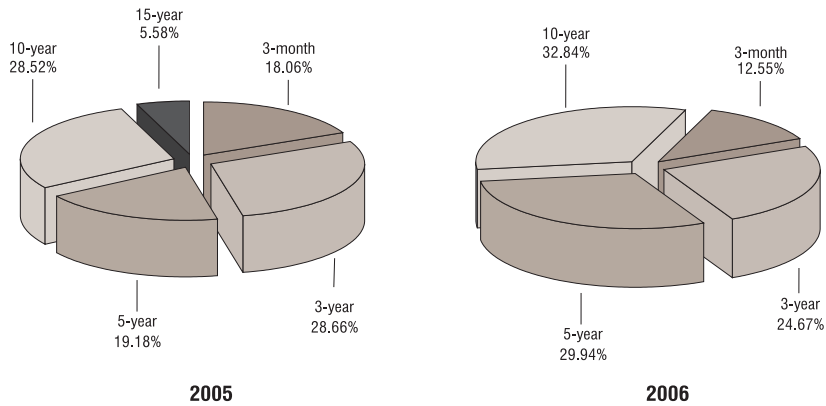
Average Original Maturity of Government Securities issued by auction end of the Month

Source: MF

Domestic financing

Government securities in the total amount of BGN 517.7 million were issued in the domestic market during 2006. The tendency of offering GS on the basis of an issue calendar pre-announced on monthly basis in four main maturity segments – 3 months, 3, 5 and 10 years – continued during the reporting year. Government bills were 12.6% of all GS issues in 2006, the remaining 87.4% being medium- and long-term bonds. This strong prevalence is in agreement with the issuer's emphasis on the long end of the yield curve as well as with investors' preferences.

Maturity Structure of Government Bond and Bills issued per year

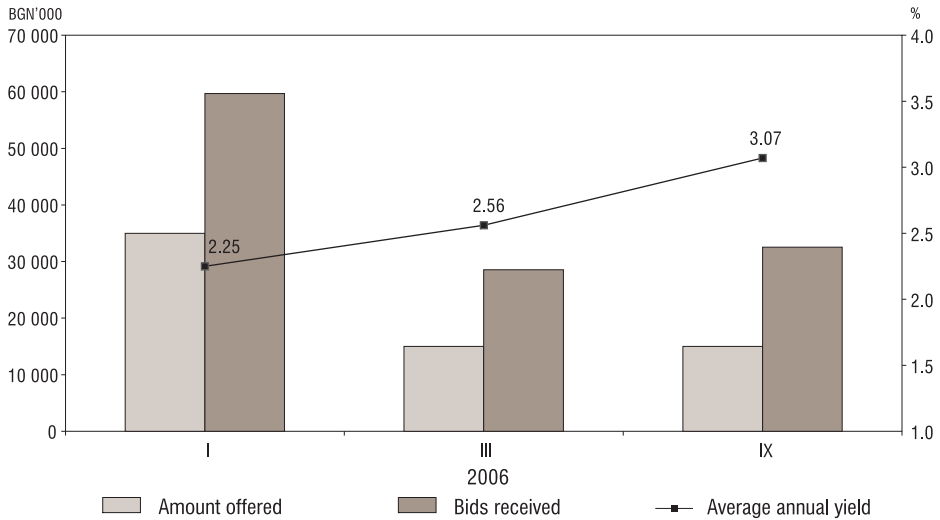


Source: MF

Issues of Treasury Bills

All government bills issued in 2006 were with 3-month maturity and totaled to BGN 65.0 million on nominal value basis. The periodicity of auctions for 3-month treasury bills was reduced in 2006, and three auctions for this type of bills were held. The lowest mean annual yield of 2.25% was achieved at the January auction, and the highest one of 3.07% – at the auction held in September. All the orders placed for the amount put on the market came to BGN 120.8 million, meaning that the weighted average bid-to-cover ratio of the 3-month treasury bills sold was 1.86.

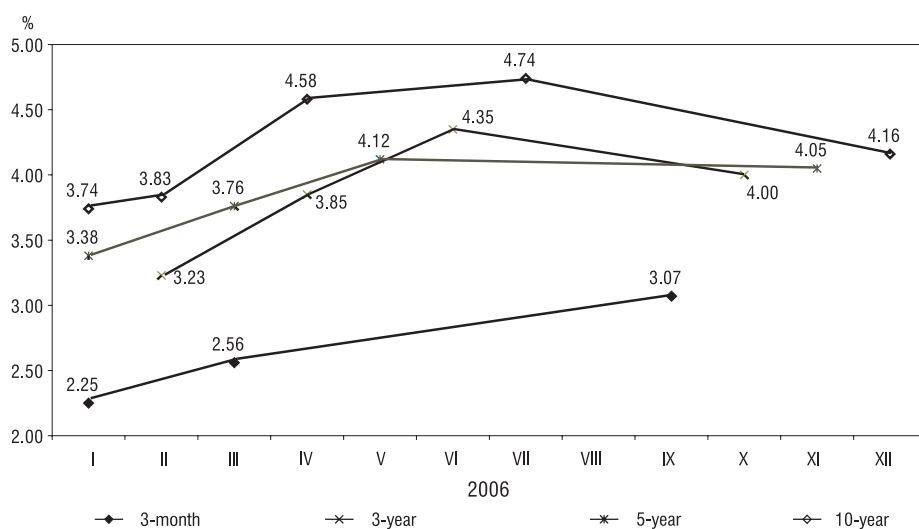
Three-month Treasury Bill Issues



Source: MF

Issues of Treasury Bonds

The nominal value of treasury bonds issued during the year was BGN 452.7 million. In terms of maturity structure, the treasury bonds offered were 3-, 5- and 10-year government bonds denominated in national currency. The strong interest on the part of investors resulted in demand for this type of securities exceeding by far the amounts available for sale. Nonetheless, the auctions ended up in higher yields on account of the straightforward dependency between the Bulgarian benchmark yield curve and the Euro zone one. The bonds with 10-year maturity were the best performers among the new treasury bonds issued in 2006, followed by 5-year and 3-year securities.

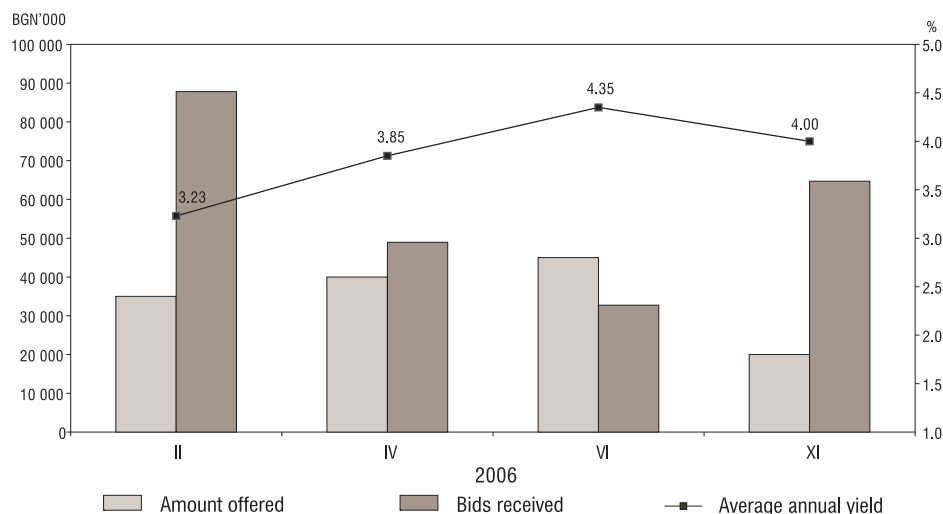


Yield Primary Market Government Securities

Source: MF

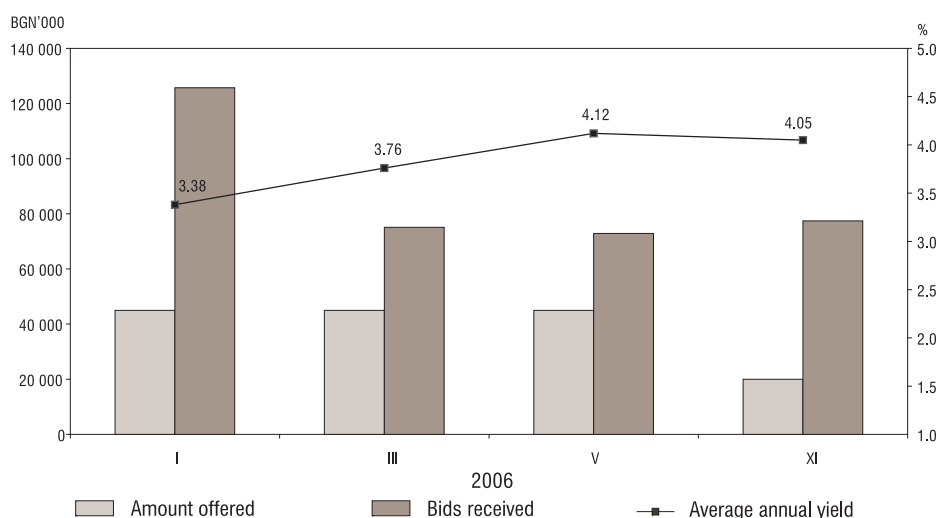
In 2006, four auctions were held to sell one issue of three-year treasury bonds. The total amount offered during the year was BGN 140.4 million, and the subscribed amount was BGN 127.7 million. The orders for 3-year GS placed in 2006 totalled to BGN 234.2 million on nominal value basis. The weighted average bid-to-cover ratio at the auctions carried out during the year dropped from 2.94 in 2005 to 1.67 in 2006. The average annual yield scored at these auctions was between 3.23% and 4.35%.

Auctions of Three-year Bond Issue



Source: MF

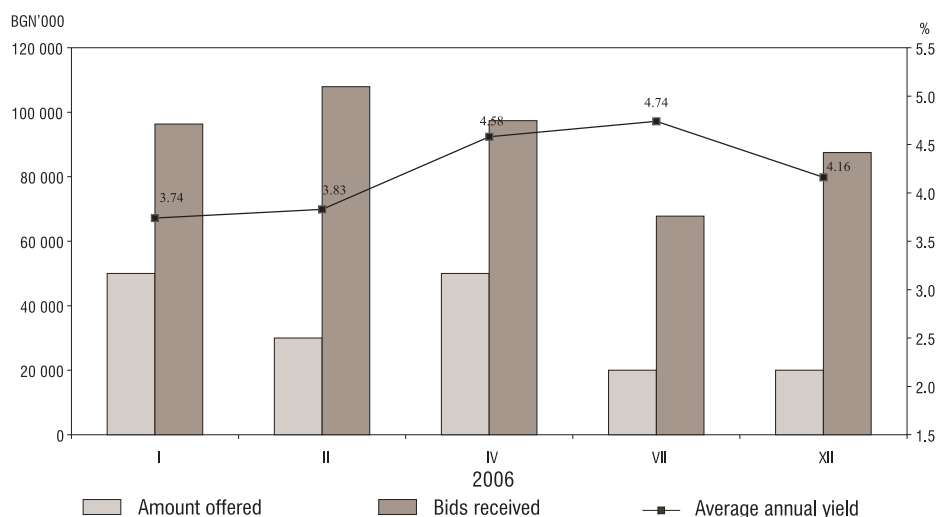
Five-year government securities were represented by one issue with a total nominal value of BGN 155.0 million, placed in four auctions. Demand for securities of five-year maturity was relatively high throughout the year – orders in the total amount of BGN 351.1 million were placed, resulting in weighted average bid-to-cover ratio for the four auctions of 2.27. Yield at the primary market for five-year government securities varied within the bracket of 3.38% to 4.12%.



Auctions of Five-year Bond Issue

Source: MF

One issue of 10-year bonds to a nominal value BGN 170 million was launched during the year, placed by five auctions. As a continuing tradition, the 10-year issue was the one most demanded by the market, with orders totalling to BGN 456.9 million and the average bid-to-cover ratio reaching 2.69. The second half of the year saw the greatest interest in that issue – as evidenced by the 4.38 bid-to-cover ratio at the fifth auction, which is the highest bid-to-cover ratio achieved at all auctions during the year. The yield in the primary market for the 10-year GS issue varied between 3.74% and 4.74%.



Auctions of Ten-year Bond Issue

Source: MF

Government Securities Issues in 2006

Auction date	Issue date	Issue number	Currency	Maturity (months)	Maturity date	Interest rate	Amount offered	Bids received	Bids approved at nominal value	Bids approved at sell price	Average price attained per 100 units nominal value	Minimum approved price per 100 units nominal value	Average annual yield (%)*	Maximum approved yield (%)
03.01.2006	04.01.2006	BG 20 400 06 210	BGN	120	04.01.2016	3.50	50 000 000.00	96 350 000.00	50 000 000.00	49 122 745.03	98.26	97.65	3.74	3.82
23.01.2006	25.01.2006	BG 20 300 06 113	BGN	60	25.01.2011	3.00	45 000 000.00	125 710 000.00	45 000 000.00	44 267 839.00	98.37	98.08	3.38	3.45
25.01.2006	27.01.2006	BG 30 100 06 008	BGN	3	27.04.2006	0.00	35 000 000.00	59 700 000.00	35 000 000.00	34 804 275.00	99.44	99.43	2.25	2.29
08.02.2006	08.02.2006	BG 20 301 06 111	BGN	36	08.02.2009	2.75	35 000 000.00	87 800 000.00	35 000 000.00	34 557 355.00	98.74	98.46	3.23	3.33
20.02.2006	04.01.2006	BG 20 400 06 210	BGN	120	04.01.2016	3.50	30 000 000.00	107 905 000.00	30 000 000.00	29 282 549.00	97.61	97.23	3.83	3.88
20.03.2006	25.01.2006	BG 20 300 06 113	BGN	60	25.01.2011	3.00	45 000 000.00	75 100 000.00	45 000 000.00	43 567 875.00	96.82	96.27	3.76	3.89
27.03.2006	29.03.2006	BG 30 101 06 006	BGN	3	29.06.2006	0.00	15 000 000.00	28 562 500.00	15 000 000.00	14 902 332.50	99.35	99.33	2.56	2.64
10.04.2006	08.02.2006	BG 20 301 06 111	BGN	36	08.02.2009	2.75	40 000 000.00	48 950 000.00	40 000 000.00	38 878 565.00	97.20	96.85	3.85	3.99
25.04.2006	04.01.2006	BG 20 400 06 210	BGN	120	04.01.2016	3.50	50 000 000.00	97 410 000.00	50 000 000.00	46 011 793.00	92.02	91.25	4.58	4.68
29.05.2006	25.01.2006	BG 20 300 06 113	BGN	60	25.01.2011	3.00	45 000 000.00	72 870 000.00	45 000 000.00	42 959 757.50	95.47	94.97	4.12	4.24
19.06.2006	08.02.2006	BG 20 301 06 111	BGN	36	08.02.2009	2.75	45 000 000.00	32 730 000.00	32 730 000.00	31 482 767.00	96.19	92.21	4.35	6.09
24.07.2006	04.01.2006	BG 20 400 06 210	BGN	120	04.01.2016	3.50	20 000 000.00	67 765 000.00	20 000 000.00	18 200 870.50	91.00	90.15	4.74	4.87
11.09.2006	13.09.2006	BG 30 102 06 004	BGN	3	13.12.2006	0.00	15 000 000.00	32 525 000.00	15 000 000.00	14 884 902.00	99.23	99.21	3.07	3.15
23.10.2006	08.02.2006	BG 20 301 06 111	BGN	36	08.02.2009	2.75	20 000 000.00	64 720 000.00	20 000 000.00	19 476 271.00	97.38	97.27	4.00	4.06
13.11.2006	25.01.2006	BG 20 300 06 113	BGN	60	25.01.2011	3.00	20 000 000.00	77 450 000.00	20 000 000.00	19 223 160.00	96.12	95.95	4.05	4.10
18.12.2006	04.01.2006	BG 20 400 06 210	BGN	120	04.01.2016	3.50	20 000 000.00	87 500 000.00	20 000 000.00	19 072 745.01	95.36	95.18	4.16	4.19
								530 000 000.00	1 163 047 500.00	517 730 000.00	500 695 801.54			

*Government securities yield has been calculated according to ISMA-International Yield.

Source: MF

Domestic debt service

All payments made in 2006 came to BGN 528.9 million, of which BGN 381.9 million in amortization payments and BGN 147.1 million in interest payments. Within the interest payments, BGN 133.9 million were interests and discounts on treasury bills/bonds and BGN 13.1 million were interest payments on GS issued in support of structural reform.

Government securities issued for structural reform

The 2006 yearend debt on GS issued in support of structural reform was BGN 411.8 million. The debt dropped by BGN 55.9 million from the level in 2005 mainly as a result of regular amortization payments and, to a minor extent, foreign exchange rate fluctuations.

Principal repayments during the period were BGN 33.7 million and interest payments were BGN 13.1 million.

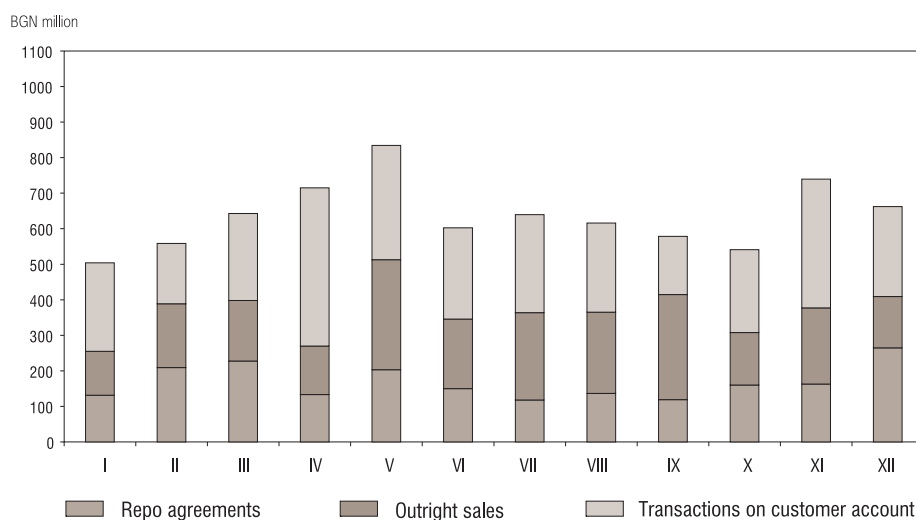
No subscriptions were launched during the year for replacement of ZUNK bonds denominated in US Dollars with Euro-ZUNKs.

Furthermore, no GS issued for structural reform were used in 2006 as means of payment in privatization deals or for extinction of liabilities to the state.

GS Secondary Market Overview

2006 witnessed a dynamic secondary market for government bonds and bills with a pronounced demand for medium- and long-term bonds. Generally, the primary dealers' interest in Government Securities (GS) was underpinned by the opportunity to use them as a risk-free and profitable investment, secure the government money handled by them and cover their current liquidity needs.

In 2006 the secondary market registered 6,355 deals with a nominal value total of BGN 12,312 million. The greatest portion of these (37.6%) were GS block/unblock transactions, followed by transactions with, or on account of, customers (26.6%), final buys/sales (19.4%) and repo transactions (16.4%). 2006 saw 907 repos, 984 final buys/sales and 2,959 transactions with, or on account of, customers. There were 1,505 GS block/unblock transactions, of which 1,485 were made to secure government money held by commercial banks, 19 related to raising pledges on government securities and in 1 case the GS were unlocked for other reasons. No privatisation deals were registered during the year.



Volume of Transactions in Tradeable Government Securities

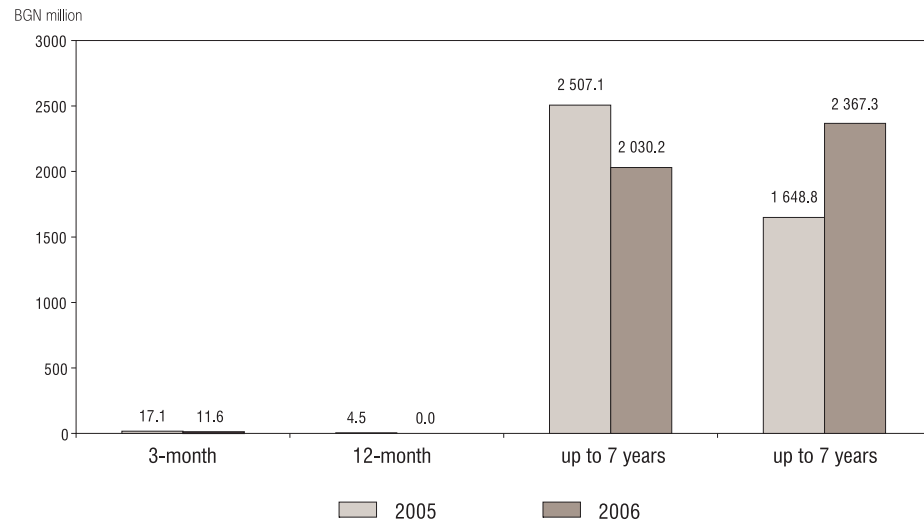
Notes: 1. Repo agreements include reverse repo agreements and those concluded during the current day.
2. Transactions in government securities denominated in foreign currency are in BGN at BNB exchange rates of the respective currency on the day of transaction.

Source: BNB

Maturity Structure of Government Securities Transactions on the Interbank Market

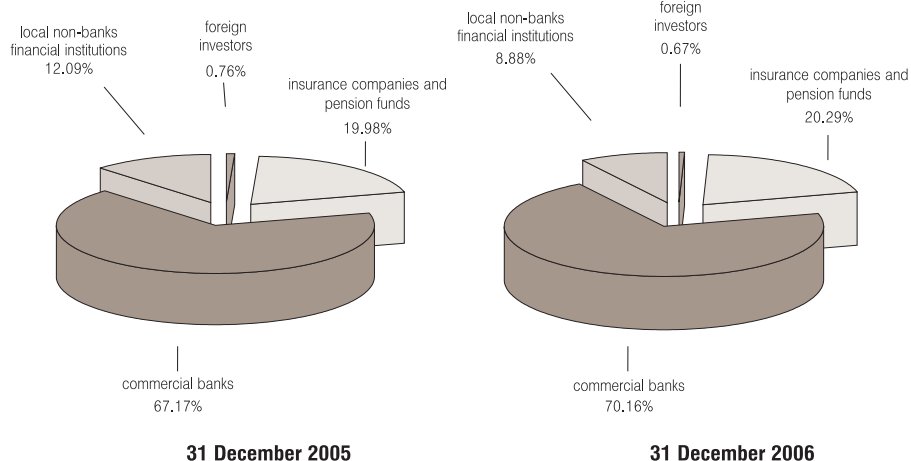
Notes: Transactions in government securities denominated in foreign currency are in BGN at BNB exchange rate quoted for the last business day of corresponding period.
2. Repo agreements do not include reverse repos.

Source: BNB



Again, the traded volumes followed an uneven distribution pattern over the year. As in previous years, the liveliest trade occurred during days for acquisition of new GS issues and at times when the budget-funded organisations were actively switching their positions at the commercial banks. The secondary GS market experienced negative impacts from a lasting tendency, which was observed throughout the year, namely that more and more government securities are blocked to secure government money held by commercial banks – from BGN 952.7 million by nominal value in the end of 2005, these blocked securities grew to BGN 1,217.5 million by nominal value at 2006 yearend. The heavyweights of the 2006 secondary market for government securities were the long-term ones – they accounted for 58.7% of all trade in that market, medium-term bonds also performed well and accounted for 40.6%, while treasury bills scored a marginal 0.7%.

Government Debt Review • 2006

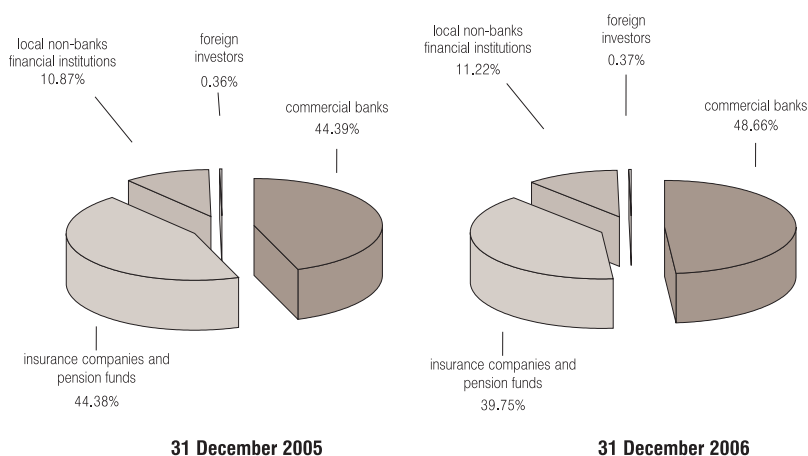


Holders of Government Securities

Notes: 1. Including frozen government securities.
 2. Including target issues earmarked for individuals investors.
 3. Preliminary data of the BNB and government securities primary dealers.
 4. The lev equivalent of government securities denominated in foreign currency is based on BNB exchange rate of foreign currencies against the Bulgarian lev quoted on 31 December 2006.

Source: BNB

The structure of GS holders remained relatively stable in 2006 as well. Commercial banks again took the largest segment of GS issued by auctions – 70.2%, followed by insurance companies and pension funds – 20.3%, local non-banking financial institutions, companies and individuals – 8.9%, and foreign investors with 0.7%. Commercial banks again accounted for the greatest share of government securities issued in support of structural reform – 48.7%, followed by insurance companies and pension funds – 39.7%, local non-banking financial institutions, companies and individuals – 11.2%, and foreign investors with 0.4%.



Holders of Structural Reform Government Securities

Notes: 1. Including frozen government securities.
 2. The lev equivalent is based on BNB exchange rate quoted for 31 December of the respective year.
 3. Preliminary data of the BNB and government securities primary dealers.

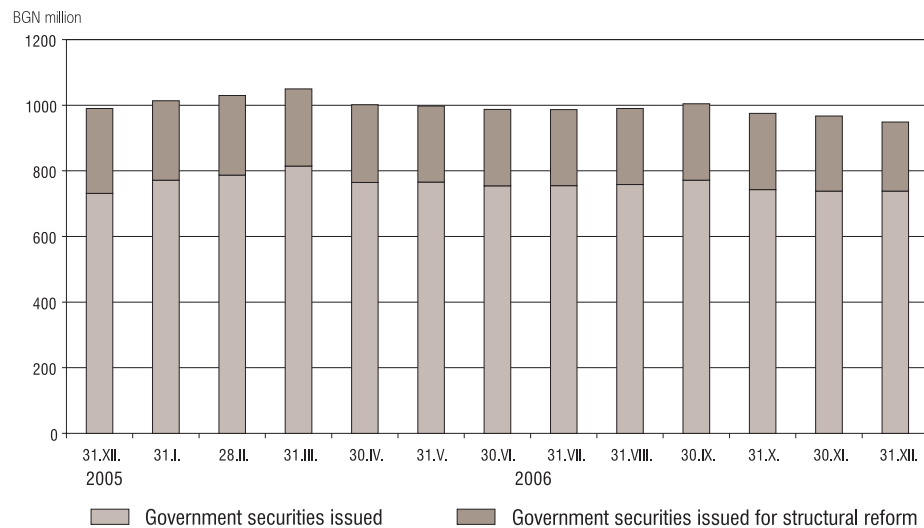
Source: BNB

At 2006 yearend, investments of non-banking financial institutions, companies and individuals in government securities issued by auctions scored a net growth of 0.9%, while these investments in bonds issued for structural reform were down 18.8% net vs. 2005 yearend levels.

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.

Source: BNB

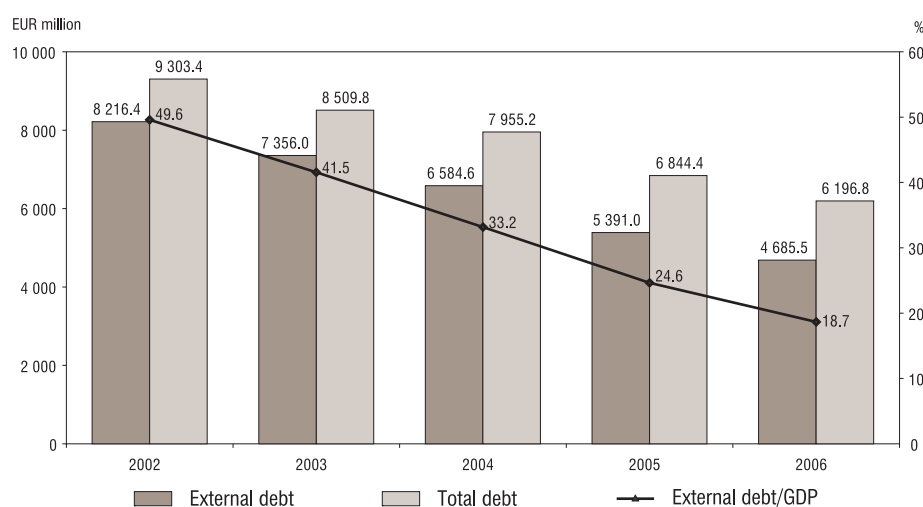


May 2006 saw the successful launch of the Modernized Electronic System for Registration and Service of Trade in GS (ESROT). The new system introduced online Straight-Through Processing (STP) of GS transactions at the secondary market processing of transactions one by one in real time, which led to significant cuts in settlement times. Market players believe that introduction of the modernized ESROT scraps a number of technical barriers to the development of the secondary market for government securities.

External Debt

Continual diminishment of the external debt and improvement of its quality parameters are tendencies that have been sustained over the recent years, and 2006 made no exception. At the end of the year, the nominal amount of external government and government-guaranteed debt dropped to EUR 4,685.5 million – an absolute reduction of EUR 705.5 million from the 2005 level. The cause of this reduction is the negative net financing achieved, including through premature debt extinction operations during the year. The external debt/GDP ratio is 6 percentage points down the level in 2005, and is evaluated to 18.7%.

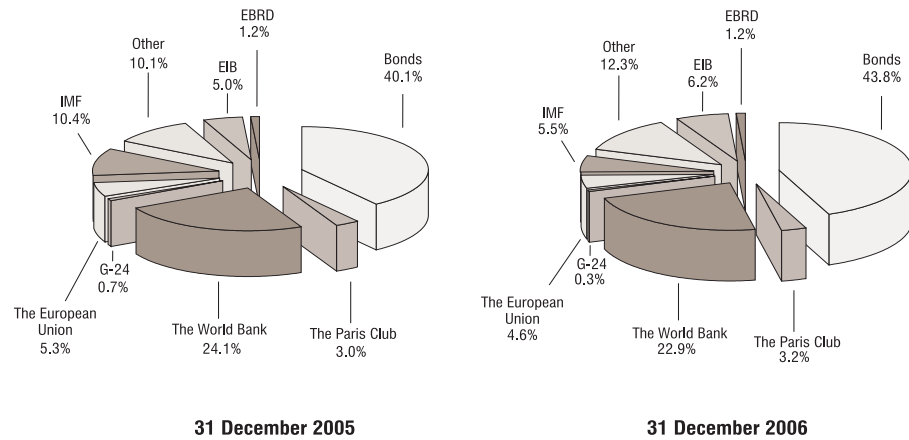
External Debt/GDP



Sources: MF and NSI

The policy pursued in the area of new borrowing, the premature extinction of external government debt and the regular payments made during the year have all led to an essential change of the debt structure in terms of lenders. The repayments to the World Bank and IMF have reduced the weight of the debt to these institutions by 1.3 and 4.9 percentage points respectively, and have thus increased the weight of global bonds, Eurobonds and other lenders. 2006 yearend figures demonstrate that the largest external debt share goes to bonds issued at international capital markets – 43.8%, followed by the debt to the World Bank – 22.9% and to other creditors – 12.3%. Debt to the IMF and miscellaneous lenders take less than 10.0% of the overall debt structure.

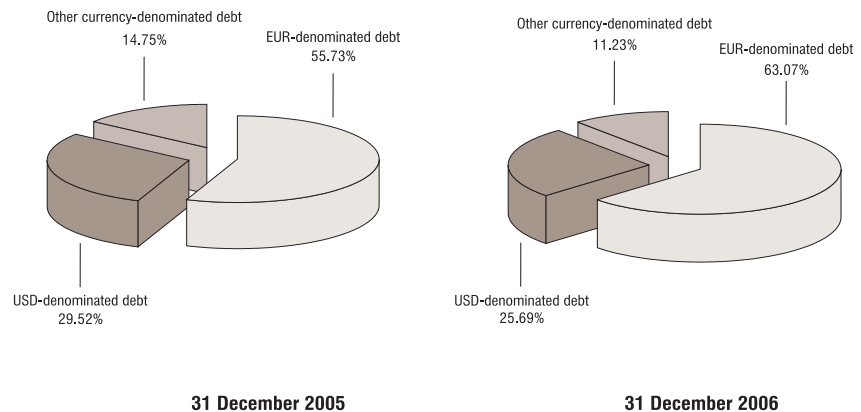
External Debt Creditor



Source: MF

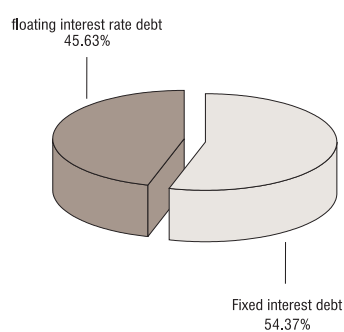
2006 saw a positive change in the currency structure of the debt, the underlying factors being predominant new financing in Euro, regular extinction of dollar debts and premature repayment of liabilities expressed in US dollars and Special Drawing Rights (SDR). Against end of 2005 data, the Euro debt share rose by 7.3 percentage points, reaching 63.1%. This is due to reduction of dollar debts from 29.5% to 25.7%. A further reduction of 3.5 percentage points is reported for debts denominated in other currencies, resulting mainly in the reduction of risks associated with Japanese Yen fluctuations at the international markets.

Currency Structure of External Government and Government Guaranteed Debt

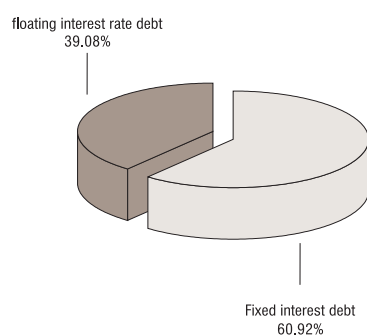


Source: MF

Borrowing policy in 2006 was again centred around procurement of financial resources at fixed interest rates with a view to reducing the impact of floating interest rates on debt service costs. The fixed/floating rate structure at the end of the year demonstrates prevalence of the debt at fixed coupons – 60.9%. Accordingly, the share of debt at floating rates dropped by 6.6 percentage points, reaching 39.1%. Among other factors, the main cause of this reduction was the advance repayment of liabilities to the World Bank and the IMF, which were both at floating rates.



31 December 2005



31 December 2006

Interest Rate Structure of External Government and Government Guaranteed Debt

Source: MF

External financing

The new external financing received in 2006 amounted to EUR 207.2 million. The main part of the receipts comes from official international lenders such as the European Investment Bank (EIB), the World Bank and others. Most of the disbursements made during the year came in the framework of already agreed investment projects funded with government and government-guaranteed loans. The receipts from government investment loans in 2006 were in the total amount of EUR 113.2 million, and those from government-guaranteed loans were EUR 94.0 million.

Net external financing for the year is negative and comes to EUR 501.1 million. The reason is twofold: slippage on disbursement schedules of government investment loans and premature repayments of government external debt totaling to EUR 350.2 million. In early 2006, five external loans to the World Bank in the total amount of EUR 188.0 million were paid in advance, as well as six tranches under the two-year standby agreement with the IMF totaling to EUR 151.4 million. The debt to the Government of the Kingdom of Spain was fully liquidated in September, and all liabilities to the Commodity Credit Corporation under the Agricultural Commodities Sale Agreement (PL) were repaid in November. Positive financing has been achieved only with government-guaranteed loans (EUR 64.1million) and government investment loans (EUR 62 million).

Government Debt Review • 2006

New External Financing and External Debt Repayments in 2006

(EUR million)

Structure	Loans or tranches	Repayments, incl.		
		Principal	Interest	Total
Government debt	113.2	678.4	247.7	926.1
I. Bonds	–	–	165.3	165.3
1. Bonds	–	–	165.3	165.3
II. Loans	113.2	678.4	82.4	760.8
1. Paris Club	–	12.6	5.5	18.1
2. World Bank	–	215.8	24.1	240.0
2.1. World Bank	–	207.9	22.6	230.5
2.2. JBIC /JEXIM/	–	8.0	1.5	9.5
3. G–24	–	20.7	1.4	22.0
4. European Union	–	72.5	7.0	79.5
5. IMF	–	278.8	19.3	298.2
6. Other	–	17.8	1.9	19.6
7. Government investment loans	113.2	51.2	22.2	73.5
7.1. World Bank	25.4	7.4	4.8	12.2
7.2. EIB	62.0	33.7	13.2	46.9
7.3. EBRD	–	7.9	0.9	8.8
7.4. Other	25.8	2.1	3.4	5.5
8. Called government guarantees	–	9.0	0.9	9.9
8.1. World Bank	–	3.3	0.8	4.1
8.2. EIB	–	–	–	–
8.3. Other	–	5.7	0.2	5.8
Government guaranteed debt	94.0	30.0	19.9	49.9
1. World Bank	5.1	9.7	3.7	13.5
2. EIB	–	1.1	0.2	1.3
3. EBRD	8.9	6.7	1.9	8.6
4. Other	80.1	12.5	14.0	26.5
Total	207.2	708.4	267.6	976.0

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

Source: MF

Debt service

The decreasing absolute value of the external debt, combined with the accomplished interest rate and currency structure – with prevalence of Euro denominations and fixed coupon rates – have mitigated the market risks associated with interest and exchange rate fluctuations at international markets, and have also reduced the costs for attending to the outstanding debt. During the past year payments on external debt were EUR 976.0 million, of which EUR 708.4 million towards principal and EUR 267.6 million towards interest liabilities. Most repayments were made in Euros – EUR 597.5 million, followed by USD and JPY payments – 99.8 million and 10.0 million in EUR counter-value respectively.

Most repayments went to the IMF – EUR 278.8 million, followed by government loan repayments to the World Bank – EUR 215.8 million, to the European Union – EUR 72.5 million and to government investment loans – EUR 51.2 million. EUR 30.0 million have been paid under government-guaranteed loans.

The increase of 6-month LIBOR levels in 2006, both for US Dollars and Euros, did not affect seriously the interest payments made during the year owing to the limited share of floating coupon debts. Interest payments during the year were EUR 267.6 million, or 10% less than those made in 2005. The overall reduction is due, inter alia, to the negative net external financing obtained as a direct result of premature debt repayments and regular extinction of outstanding debts. Most interest payments in 2006 went to bonds issued at international capital markets – EUR 165.3 million. Important interest payments were also made on loans from international organisations and institutions – EUR 31.2 million (this includes payments to the World Bank, JBIC and the European Union), followed by interest on government investment loans – EUR 22.5 million, loans from other states – EUR 8.72 million (including what is known as 'the Paris Club', G-24, the Polish National Bank and China). During the reporting period, EUR 19.9 million were paid by way of interest on government-guaranteed loans, and the provision allotted in the government budget to cover eventual calls on state guarantees remained unused.

External Debt

(EUR million)

Structure	by 31 December 2005	by 31 December 2006
Government debt	4 876.8	4 134.3
I. Bonds	2 162.5	2 050.2
1. Bonds	2 162.5	2 050.2
II. Loans	2 714.3	2 084.1
1. Paris Club	163.7	151.1
2. World Bank	1 020.0	787.0
3. G-24	36.9	14.3
4. European Union	287.5	215.0
5. IMF	559.5	258.9
6. Other	62.3	44.2
7. Government investment loans	549.2	588.6
7.1. World Bank	150.6	168.2
7.2. EIB	262.6	282.8
7.3. EBRD	17.0	8.1
7.4. Other	119.0	129.6
8. Called government guarantees	35.2	25.0
8.1. World Bank	28.9	25.0
8.2. Other	6.3	-
Government guaranteed debt	514.2	551.2
1. World Bank	102.4	91.6
2. EIB	8.1	7.0
3. EBRD	48.6	49.0
4. Other	355.1	403.6
Total	5 391.0	4 685.5

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

Source: MF

Government Debt Management Strategy Update

The economic and fiscal policy pursued in 2006 was aligned with the economic policy guidelines applicable to EU Member–States, and was focused on growth potential and ensuring sound budget positions. The main priorities of the fiscal policy were maintenance of macroeconomic stability in a Currency Board environment and in the light of Bulgaria’s forthcoming membership in the EU; fostering sustainable economic development and implementation of priority policies in the public sector subject to optimal use of the available budget resources.

The major risks to the macroeconomic environment in 2006 were mainly related to the impact of external factors, which reflected, first and foremost, on the imbalance of Bulgaria’s external position. Based on final data, the balance of payments current account deficit (CAD) at 2006 yearend amounted to 15.8% of the Gross Domestic Product (GDP). The main cause of this is the negative trade balance, which in turn is due to a strong increase of imports propelled by fast–growing internal demand, including for investment goods, as well as by the international prices of energy commodities and certain strategic raw materials.

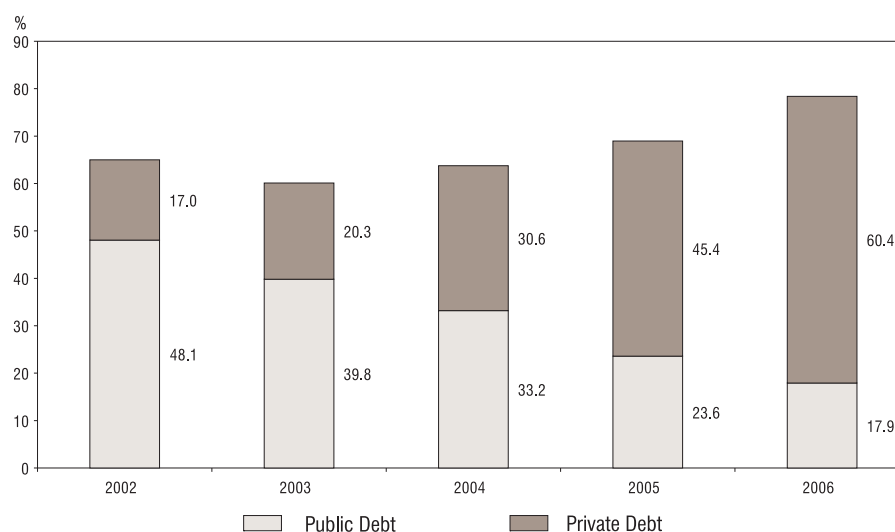
The fact that balance of payments CAD growth has become a lasting tendency – even though the deficit was fully covered by the receipts from direct foreign investments and thus the overall balance of payment in 2006 was positive – rendered it necessary to narrow down the fiscal position and achieve a budget surplus higher than the original target. The budget surplus was 3.5% of GDP, which was attained by cutting costs through triggering the caps embedded in the 2006 budget and saving a large portion of the surplus revenue.

The consistent and stringent fiscal policy conducted in 2006 made unnecessary to maintain positive debt financing and contributed to increasing the fiscal reserve (BGN 5.8 billion by programme exchange rates at 31.12.2006). The stable fiscal reserve levels made it possible to continue premature repayments on government debt in 2006 as well – BGN 0.7 billion were repaid to international creditors ahead of time.

Government Debt Management Strategy Update

Transactions for external government debt redemption have a broad impact in terms of holding back the growth of the country's gross external debt (GED) both nominally and relatively to GDP (78.4% at 2006 yearend). Bulgaria's GED/GDP ratio is higher than the mean values for the group of countries with similar credit rating, whereas GED has been on the rise during the last three years, withal strongly outpacing the nominal GDP. This development is mainly due to borrowings by the banking sector, which are driven by the banks' increased credit activity, as well as to inter-company loans. Bearing in mind that the GED/GDP ratio is one the important criteria for evaluating the external solvency, creditworthiness and liquidity of Bulgaria, the overall reduction of the external government debt contributed to maintaining the stability and diminishing the vulnerability of external finances.

Gross Foreign Debt



Source: BNB

As in previous years, in 2006 the development tendencies of domestic and international financial markets alike continued to impact the amount of debt and debt service costs as well as the cost of new debt financing. In unison with the expectations for long-term increase of international interest rates, the past year saw a tendency of increased profitability for all major maturities

present in the Bulgarian yield curve. However, this tendency is synchronized at similar levels with the Euro zone yield curve, certainly taking into account the risk premium on the Bulgarian government debt. Nonetheless, the domestic market for government securities continued to evolve as expected and demand for GS remained high, the strongest driver being the liquidity of the banking system – impacted to a certain extent by the pace of lending growth. The US dollar devaluation, especially in the second half of the year, brought about positive shifts in debt size and debt service costs. The positive evaluation of the Bulgaria's creditworthiness, accession to the EU and related convergence of the local debt market into the Community debt market will predefine a change of the cost of new borrowing and in the use of various debt instruments, after due assessment of the possible funding sources.

In this context, in 2006 the government credit benefited from yet another increase by three rating agencies – *Moody's*, *Standard & Poor's* and *Japan Credit Rating Agency*. The upgraded credit rating is an appreciation for a prudent fiscal policy, real sector development and successful finalization of Bulgaria's accession to the EU. The investment class rating, awarded to Bulgaria for the first time in 2004, and its subsequent upgrades, places the country in the category of borrowers that can rely on a much wider range of investors and financing sources, in parallel with cheaper borrowing, which goes hand in hand with this process.

Conducted in the so described environment, the government debt management policy has led to positive adjustments of the absolute debt and its weight vs. GDP. Compared to 2005, the nominal value of government and government-guaranteed debt dropped by EUR 647.6 million to EUR 6.20 billion. As a percentage of GDP, it amounted to 24.7%, which is a reduction of 6.6 percentage points. 2006 was the fifth consecutive year, in which the debt/GDP ratio was down by more than 6 percentage points – an achievement, which is due mainly to two factors: stable economic growth and prudent fiscal policy.

The so outlined macroeconomic environment, the forecasts for its medium-term development together with the size and structure of the debt, do not render it necessary to redefine the objectives laid down in the Government Debt Management Strategy 2006–2008, or of the means for accomplishing these objectives. In this context however, taking into account the dynamically changing situation and the challenges related with the membership of our country in the EU, the efforts will continue to be focused on the strict and consistent accomplishment of the following objectives:

Government Debt Management Strategy Update

Dynamics of Government and Government Guaranteed Debt between 1999–2006

(EUR million)

Structure	1999	2000	2001	2002	2003	2004	2005	2006
Domestic debt	1 530.7	911.3	955.1	1 087.0	1 153.8	1 370.6	1 453.5	1 511.3
I. Government debt	1 060.3	906.2	951.7	1 086.1	1 153.8	1 370.6	1 453.5	1 511.3
Budget deficit financing government securities	450.9	491.4	554.6	754.9	879.2	1 130.5	1 214.3	1 300.7
Structural reform government securities	495.5	389.9	382.4	321.7	270.4	240.0	239.1	210.5
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	4 685.5
I. Government debt	8 587.1	9 159.5	9 096.6	7 685.9	6 961.1	6 140.6	4 876.8	4 134.3
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	2 050.2
Paris Club	811.1	645.3	433.5	284.5	218.9	176.3	163.7	151.1
World Bank	820.5	889.6	941.1	836.1	870.0	930.6	1 020.0	787.0
G-24	70.9	60.8	53.8	48.9	42.0	34.6	36.9	14.3
European Union	400.0	460.0	390.0	390.0	350.0	350.0	287.5	215.0
IMF	1 126.5	1 309.4	1 183.4	990.9	940.2	868.7	559.5	258.9
Other	147.7	136.6	136.6	129.2	125.2	125.2	62.3	44.2
Government investment loans	207.8	251.0	240.3	236.7	383.0	428.8	549.2	588.6
Called government guarantees	48.1	59.2	67.8	61.0	50.2	43.9	35.2	25.0
II. Government guaranteed debt	441.4	480.8	576.3	530.5	394.9	444.0	514.2	551.2
Total debt	10 559.3	10 551.6	10 627.9	9 303.4	8 509.8	7 955.2	6 844.4	6 196.8
GDP (BGN million)	23 790.4	26 752.8	29 709.2	32 401.6	34 627.5	38 822.6	42 797.4	49 090.6
GDP (EUR million)	12 163.9	13 678.5	15 190.1	16 566.7	17 704.8	19 849.7	21 882.0	25 099.6
Total debt/GDP	86.8%	77.1%	70.0%	56.2%	48.1%	40.1%	31.3%	24.7%

Notes: 1. Nominal figures.

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

3. GDP data from the National Statistics Institute.

Sources: MF and NSI

Strict monitoring of the debt level

New borrowing in 2006 followed the adopted fiscal policy and respected the government debt benchmarks laid down in the 2006 budget. Account was also taken of the current status and predicted development of numerous key factors such as the balance of payments current account deficit, the increasing gross external debt of Bulgaria, the current performance on budget targets and the budget balance formation, the fiscal reserve level, as well as the state of play at local and international markets.

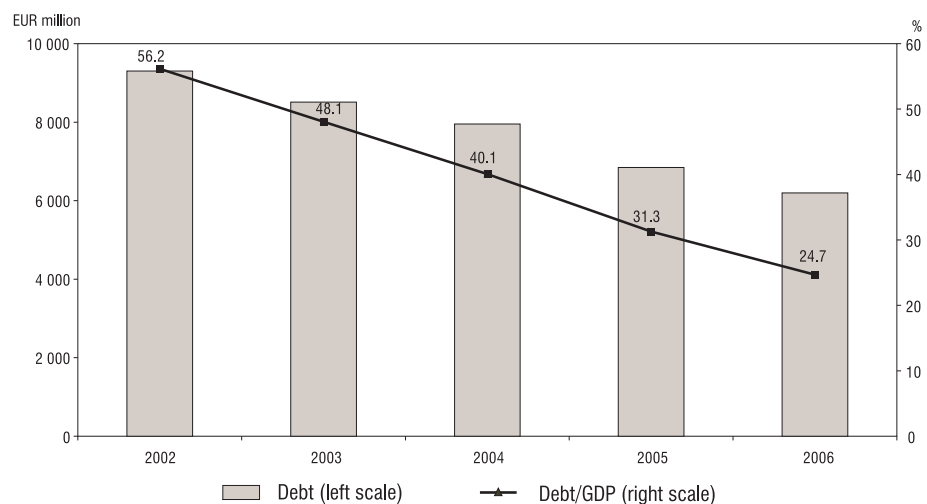
The narrowed fiscal position, the budget surplus achieved and the steadily growing fiscal reserve level have underpinned the formation of negative net debt financing in the amount of BGN 986.6 million. The greatest contributors to the negative financing value were the buy backs made in 2006 towards redemption of external government debt – BGN 685 million, the reduced amount of government securities issued on the local market – this was due to the specific market situation; and the slippage on government investment loans disbursement schedules, including the utilization of new loans. Viewed in debt instruments cross-section, positive net financing has been achieved only with GS issued on the local market (BGN 118.8 million), as well as with government investment loans (BGN 121.2 million). The positive value of GS issues ensued from the need to ensure the normal functioning of a liquid local debt market. Accordingly, the positive net financing in the case of investment loans directly results from the agreed loan disbursement and utilization arrangements, which are linked to the practical implementation of the projects financed thereby.

In 2006 alike, debt financing policy was paralleled by comprehensive analyses of borrowing resources, specific financing terms, possible debt instruments, macroeconomic and market developments as well as by ongoing debt monitoring in terms of debt size, profile and service costs.

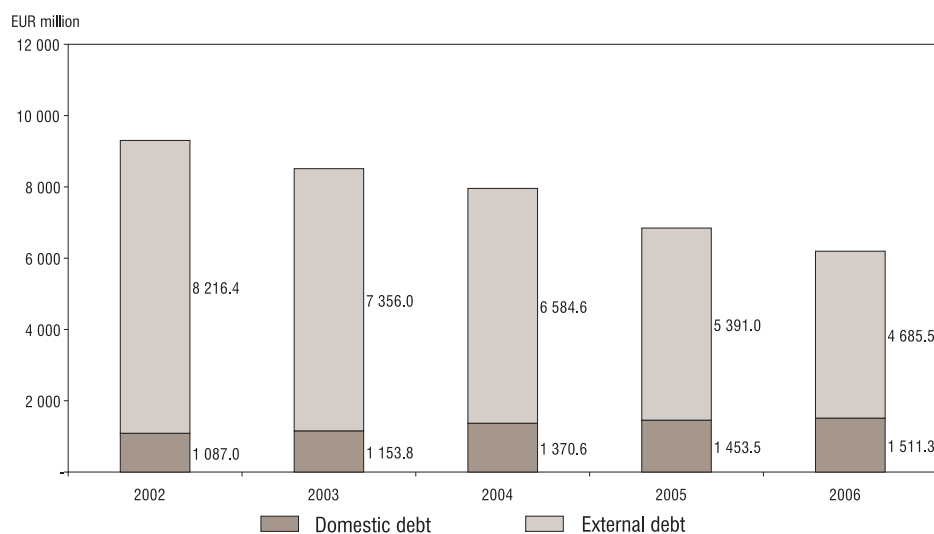
Government Debt Management Strategy Update

As noted in the previous paragraphs, at 2006 yearend the government and government-guaranteed debt amounted to EUR 6,196.8 million; including EUR 1,511.3 million domestic debt and EUR 4,685.5 million external debt. The overall debt burden as a share of GDP came to 24.7%, of which 6.0% is the weight of domestic and 18.7% is the weight of external debt. These values point to an overall decrease, except the amount of domestic debt, which grew by EUR 57.8 million from the 2005 level as a direct consequence of the positive net issues realized. However, this nominal increase of domestic debt has been offset by the GDP growth and thus, in the end of the one-year period, the relative weight of domestic debt even fell by 0.6%. This is followed by improvements of other monitored and analysed indicators, related mainly with the debt structure as represented by domestic/external debt ratio, debt at fixed/floating interest coupons, debt denominations split between BGN (or EUR) and other currencies, debt service costs and so forth.

Dynamics of Government and Government Guaranteed Debt



Sources: MF and NSI



Dynamics of Domestic and External Debt 2002–2006

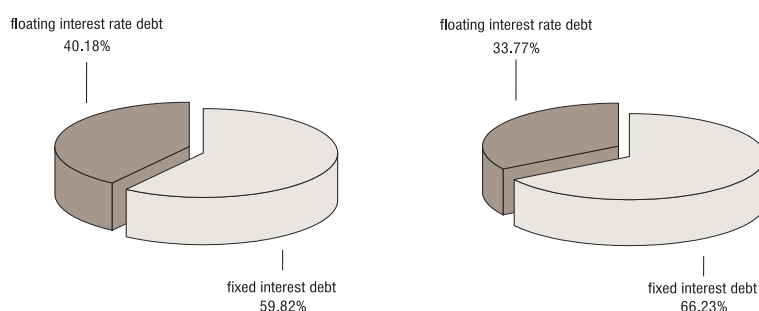
Source: MF

In the end of 2006, liabilities to foreign lenders in relative terms represented 75.6% of the overall debt. Although a strong figure, these liabilities follow a downward tendency dropping by 3.15% in just one year. This downside results mainly from the negative net external financing and, respectively, the net positive domestic financing, but has also been impacted by the USD devaluation. Gradual reduction of external indebtedness is of crucial importance in the context of maintaining the stability of external finances as a counterweight to the increasing gross external debt of Bulgaria.

The interest structure of the debt is dominated by fixed interest bearing liabilities. As at the end of 2006, their share amounted to 66.2%, which is an absolute growth of 6.4% vs. the previous year. This ratio stems from the new financing being obtained prevalingly at fixed interest as well as from the buy backs and regular amortizations of floating interest debts. At times of growing interest rates, and long-term expectations at present point exactly to such developments, fixed interest coupons add more security and predictability to the budget in terms of costs for attending to the debt in circulation.

Government Debt Management Strategy Update

Interest Rate Structure of Government and Government Guaranteed Debt



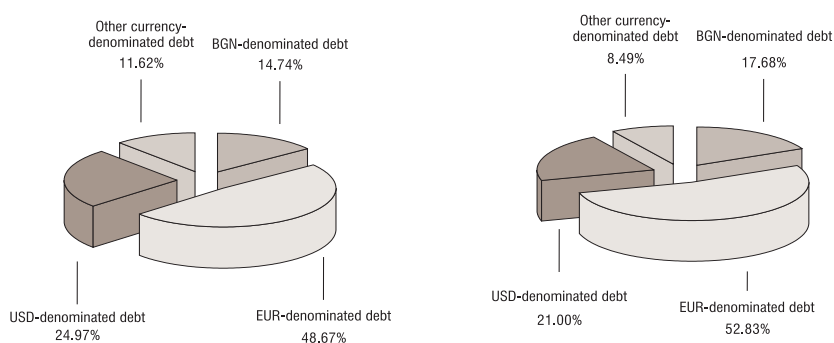
Source: MF

31 December 2005

31 December 2006

In terms of currency denominations, the combined weight of BGN and EUR debts strongly prevailed over the weight of other currencies, reaching 70.5% at the end of 2006. The relative weight of these liabilities increased by 7.1% vs. the previous year due to nearly equal slides of components expressed in dollars and in other currencies. The causes for these developments mainly stem from new borrowing being dominantly in Euro and Bulgarian Lev (at the domestic market), regular amortization and buy backs of debt expressed in US dollars and other currencies, such as special drawing rights.

Currency Structure of Government and Government Guaranteed Debt

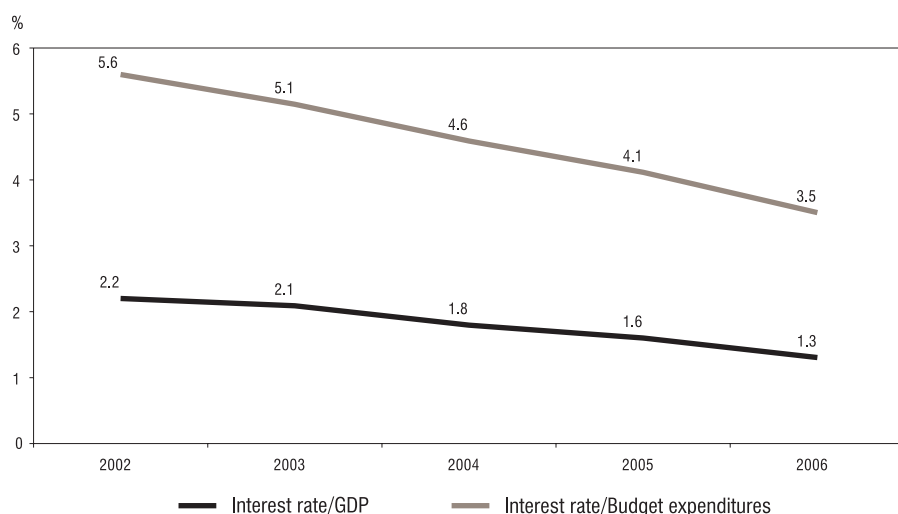


Source: MF

31 December 2005

31 December 2006

2006 saw a continuing tendency of decreasing debt service costs/GDP ratios as a direct result of GDP growth and debt decrease, but also due to fixed interest coupons prevailing in the interest structure of the debt, which in turn minimized the volatility of costs amidst expectations for long-term increase of interest levels. Compared to the previous year, the debt service costs/GDP ratio fell by 0.3 percentage points and reached 1.3%. A similar downfall was observed with the debt service costs/budget expenditure ratio, which dropped to 3.5% in the end of 2006 from a level of 4.1% in 2005. Certainly, these ratios will continue to experience the influence of other factors such as exchange rate fluctuations, local debt market developments, long-term risk premiums for Bulgarian debt and the perceived creditworthiness of Bulgaria as reflected in the government credit ratings awarded by rating agencies.



Interest Rate Expenses

Sources: MF and NSI

The ahead-of-time repayments of government external debt made in 2006 also had an important contribution to the positive changes in debt size and debt monitoring indicators. These repayments were made in pursuance of the targets laid down in the Government Debt Management Strategy, but also with due regard to their impacts on the progress towards achievement of budget targets, fiscal reserve account and gross external debt levels, etc. External government debt buy back transactions during the year totaled to BGN 685 million altogether.

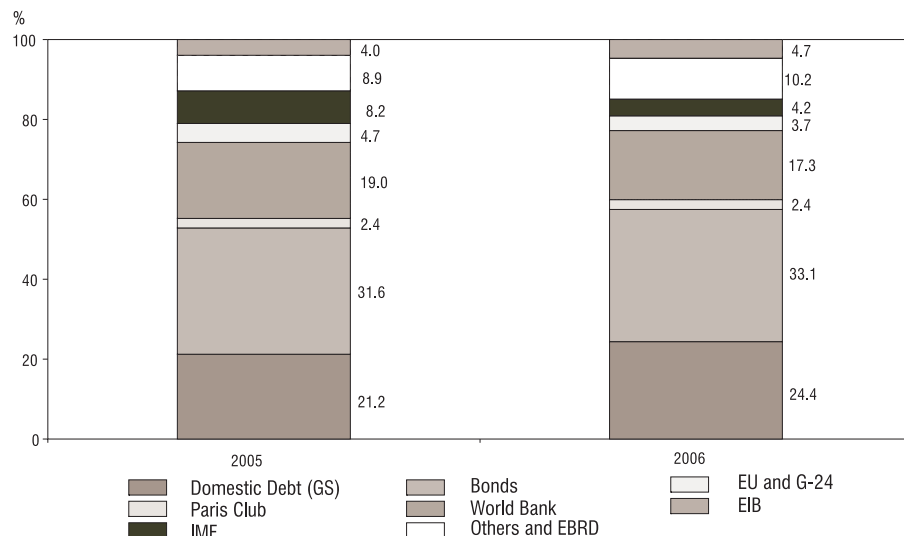
Government Debt Management Strategy Update

Most of these went towards redemption of five loans from the International Bank for Reconstruction and Development (IBRD) in the total amount of BGN 367.6 million, and of six tranches under the two-year standby agreement with IMF, in the total amount of 296.2 million. Also, all liabilities to the Kingdom of Spain and the US Commodity Credit Corporation under the Agricultural Commodities Sale Agreement (PL) were fully extinguished.

Taking into account the debt amount and the increasing requirements for national cofinancing to complement EU support for investment projects of national remit, six investment projects, in the total amount of EUR 730.3 million, were approved for funding in 2006 with government loans. A significant part of these projects relates to the modernization of the Bulgarian Armed Forces in the light of Bulgaria's commitments as a NATO nation.

Respectively, 8 infrastructural projects totaling to EUR 815.4 million were approved in 2006 for funding by government and government-guaranteed loans in 2007. The financing institutions for these projects are the European Investment Bank and the World Bank.

Debt Structure Per Creditors



Source: MF

These investment projects were approved in strict compliance with regulatory requirements and budgeting procedures for the relevant year, as well as in a highly transparent and predictable environment, taking into account the government priorities that require support from the state. The need to build national capacity for utilization of EU grants was also taken into account.

With regard to the progress achieved towards accomplishment of this objective, efforts will continue to be focused on its sustainable and unwavering implementation, using appropriate instruments defined in the Government Debt Management Strategy.

Keep debt service costs at low levels in medium- and long-term perspective with an acceptable degree of risk

The tendency of reducing debt service costs in both absolute and relative terms continued in 2006. All debt service costs came to BGN 640.3 million, which is BGN 45.2 million less compared to 2005. A similar change was seen with the indicators that gauge what part of national income and budget expenditure is used for attendance to the debt in circulation. At 2006 yearend, the interest payments/GDP ratio stood at 1.3%, which represents a 0.3% downslide in one year's time. For the same period of time, the interest payments/budget expenditure ratio fell by 0.6 percentage points and reached 3.5%.

The most important factor for these developments has been the unidirectional impact of debt reduction and GDP growth. The decreasing risk premium on Bulgarian government debt, as resulting from the upgraded government credit rating and the devaluated US dollar, has also had its bearing, albeit a minor one.

In accomplishing the goal to maintain low debt service costs at an acceptable risk level, great care has been taken to select the most appropriate debt instruments for new borrowing exercises. With reference to the fact that new external borrowing in 2006 is earmarked for funding of investment projects, the focus has been placed first of all on the easy access to long-term resources, the lender's own expertise and capabilities to control proper spending strictly for project implementation purposes. These services need to be provided by the lender as assurance for efficient utilization of public resources. Nonetheless, high priority was placed on the financial parameters of the borrowed resources in terms of future yield from the funded projects,

and on the impact of such funding on the overall debt and debt service costs. As a direct consequence, new investment projects have been funded mainly with loans provided by international financial institutions in the face of the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB).

As concerns domestic financing, in keeping with the reference values implanted in the 2006 budget, the efforts for maintaining low interest costs were supported by a comprehensive analysis of the concrete amount of borrowing, its deployment over time, the main parameters of the debt issues, the current performance on budget targets, the fiscal reserve account level, the liquidity of the financial system as well as the local and international capital market developments. Against this background, the nominal value of the government securities issued during the year was reduced by half and came to BGN 517.7 million, the greatest contributors to this reduction being the budget surplus, which eliminated the need of borrowing to bridge budget shortfalls, the stable level of the fiscal reserve account and the increasing yield of all maturities on the Bulgarian yield curve. The latter is in unison with the increasing Euro zone yield curve and with the rising international interest levels. This rendered it extremely important to continue the efforts for floating a single reference issue in each one of the major maturity segments of the yield curve (3 months, 3, 5, and 10 years) in volumes facilitating the issue's subsequent liquidity in the secondary market for government debt. Due to the lasting interest of market players towards medium- and long-term government securities, these accounted for a major portion of the newly issued GS – 87.5%. Of these, the largest individual issue was comprised of 10-year government securities worth of BGN 170.0 million – which is significant with a view to the emphasis on the long end of the yield curve as well as in consideration of the fact that these government securities form the basis for determining the long-term interest rate. The latter is one of the Maastricht criteria, the accomplishment of which is a condition precedent for membership in the Economic and Monetary Union. Naturally, short-term securities of 3-month maturity continued to be issued in 2006, reaching a total of BGN 65.0 million, mostly to maintain a liquid benchmark yield curve for the Bulgarian government debt, including at its short end. The building of such a curve aims mainly to support the development of an efficient and liquid local market for government debt, which in turn should lead, certainly if all other factors remain unchanged, to subsequent optimization of borrowing costs.

This being said, in 2006 the secondary market for government debt instruments continued to develop along the lines plotted during recent years, with strong interest towards medium and long-term maturities and GS denominated in local currency. Most of the registered transactions related to blocking and unblocking of government securities used as collateral for the government money held, followed by final buys/sales and repo transactions. Traded volumes were again unevenly distributed in the course of the year. As in previous years, the liveliest trade occurred during days for acquisition of new GS issues and at times when the budget-funded organisations were actively switching their positions at the commercial banks. This points to an insufficiently liquid market, which in turn suggests that efforts should continue to focus on achieving higher liquidity, including through positive net financing.

In pursuance of the objective at issue, during the year successful use has also been made of the instruments that implement the principle, according to which new borrowing should predominantly take place at fixed interest coupons and in BGN or EUR. This approach was driven by the requirement to maintain stable and predictable budget expenditure, by the bondage between the Euro and the Currency Board operating in Bulgaria and by the structure of export income. Last but not least, account has been taken of the tendencies for long-term growth of interest rates and the state of play in the individual financial market segments, together with the standard funding terms applied by international financial institutions. Thus, with a view to the new international political setting, in which the Bulgarian economy operates after the country's accession to the EU, and with regard to the forecasted development of macroeconomic and market environments, the borrowing policy during the year was primarily focused on preference for standardized debt instruments with fixed interest coupons and denominated in national currency or in Euros.

The identified progress towards achievement of this objective and its continuing relevance suggest that efforts should continue to focus on making maximum use of the instruments envisaged in the Government Debt Management Strategy.

Ensure stable budget financing and debt refinancing sources

In 2006 alike, ensuring stable borrowing sources was an objective of priority dimension. Implementation of this objective involves ongoing analysis of possible local and international funding sources with a view to reaching the goals pursued by each specific funding exercise. It was also important to

identify the borrowing sources that offer most suitable conditions such as financial parameters, rapid access, regulations, procedures, scales and so forth. The analysis also takes into consideration the impact of each new financing on the overall debt size and structure, the amount of debt service costs, the budget situation and current performance on budget targets, the fiscal reserve account level and so forth.

During 2006, and in keeping with the reference values embedded in the 2006 budget, the circulating debt was refinanced by issuing government securities on the local market, while project funding was procured through loans from international financial institutions. Although no securities were issued in the international capital markets, the latter were carefully and profoundly monitored and analysed, because they are an alternative to local funding sources and a basis for comparing the price levels of the resources borrowed.

In pursuance of the objective for ensuring that the domestic market is a stable funding source, nearly the full set of instruments envisaged in the Government Debt Management Strategy was applied in a timely manner during 2006. This set is characterized by comprehensive measures for encouraging both primary and secondary market development, based on the understanding that these two markets are unbreakably bonded.

The issuing policy pursued at the primary market continued to be transparent, consistent and predictable. This was achieved by publicizing the conceptual background of this policy during the year and, at a more practical level, by pre-announcing the specific parameters of the various issues on monthly basis. In 2006 the government debt issuer continued to pursue positive net domestic financing, although in a lesser amount than the originally foreseen one. In turn, this is due to the budget surplus achieved, to the appreciable margin, by which the current fiscal reserve exceeded the statutory minimum and to the increased yield of all maturities. Together with the achieved significant reduction of gross and net issues alike, the issuing policy was also tuned to the factors that determine market liquidity levels. This was done to pre-empt the eventual increase of primary market yields beyond the levels justified by objective factors. A number of such factors have been identified, the most important of them being outgoing and incoming budget flows, regulations determining the banks' mandatory reserves, lending growth rates, seasonal imbalances, external factors, investors' preferences to certain GS types and so forth. Last but not least, efforts for promoting the local market for domestic government debt continued along the line of improving the

infrastructure of that market, including by development of a methodology for reflecting in the budget the various modifications at repo and exchange auctions as well as subscriptions for GS conversions from one type to another.

Another element of great importance for primary and secondary markets alike is the appropriate structuring of the key parameters of the government securities issued. In this respect, taking into account the need to diminish the gross issue in the course of the year, the issuer continued the practice of issuing one issue at each main maturity point of the yield curve – 3 months, 3, 5, and 10 years, in volumes ensuring minimum levels of liquidity. From the perspective of their key parameters, the debt instruments issued were standardized and aligned with the generally accepted market conventions. In practice, this enables the maintenance of a liquid benchmark yield curve with the related positive effects on market development and debt financing costs.

Another contributor to the higher efficiency of secondary trade in domestic government debt was the Modernized Electronic System for Registration and Service of Trade in GS (ESROT), which was launched in mid-2006. The new system introduced online Straight-Through Processing (STP) of GS transactions "from the input to the output", which led to appreciable cuts in settlement times. Market players believe that introduction of the Modernized Electronic System scraps a number of technical barriers to the development of the secondary market for government securities. Modernization of the market infrastructure called for relevant amendments to the regulatory framework concerning primarily registration, trading and settlement of GS transactions.

Bulgaria's accession to the EU brought forth the need to intensify and prioritize the efforts for harmonizing the legal framework of the markets for financial instruments in a broadest sense, and in practice such efforts looked at problems much wider than those of the market for government debt instruments. In this context, links at operational level were built between the institutions concerned, in particular between the Ministry of Finance, the Bulgarian National Bank and the Financial Supervision Commission (FSC). Each of these institutions, within the scope of its competencies, undertook drafting work to develop new or amend existing legislation in the area of financial instruments, services and markets. Improvement of technical and regulatory mechanisms as well as harmonization of the prevailing national legislation with EU regulations in this sector are aimed at ensuring a transparent, efficient and reliable capital market, with a view to its successful integration into the single market structures of the Community. Along these

lines, a number of new bills were drafted in 2006, such as Law on Extended Supervision on Financial Conglomerates, Law on Credit Institutions, Law on Contracts Secured by Financial Collateral, Law on the Measures against Financial Fraud and Law on Remote Provision of Financial Services, together with a series of amendments to the Public Offering of Securities Act and the Bank Deposits Guarantee Act.

As noted earlier, important efforts were made during the year to strengthen and expand strategic cooperation with international financial institutions in their capacity of highly significant funding sources. The priority of this cooperation ensues from the need to build national and regional capacity for efficient utilization of EU funds – both in terms of providing the required national cofinancing and developing eligible projects. The urgent installation of a mechanism for funding and timely implementation of projects that respond to crucial investment requirements and are based on prioritized investment programmes in the key sectors (transport, utilities, environment protection, agriculture and others) will promote the long-term prosperity of the country.

Against this background and with regard to the expiry of the Support Strategy, which covered the fiscal period 2002–2005 and included a series of programme loans in support of restructuring efforts and comprehensive structural reforms, in 2006 Bulgaria and the World Bank (WB) agreed on a new Partnership Strategy for the financial years 2007–2009. The Partnership Strategy is a fundamental document, which details the support to be provided by the WB to Bulgaria for sustainable economic growth and successful integration into the European Union. The Strategy covers all planned operations of the WB in Bulgaria, which include lending activities, analytical work and technical assistance. The document provides that until 2009 the WB will be extending loans of maximum USD 300m per annum, including loans for policies development. Together with this, the WB commits to undertake important analytical work and consultancy services focused on the priority economic objectives of Bulgaria, such as improvement of the investment climate for private sector growth and employment promotion. Towards attainment of these objectives, the WB will finance projects and programmes in priority sectors such as the outstanding reforms in the sphere of human capital development. The WB will also support the implementation of financially sustainable investment programmes for infrastructure, social inclusion and regional development, in the context of utilizing the significant grants available from EU Funds. In addition, the Bank is expected to provide support through analysis of and advice on policies.

Another important document signed in 2006 was the Memorandum of Understanding (MoU) between the Government of Bulgaria and the European Investment Bank (EIB). The Memorandum pertains to the development and financing of infrastructures in the framework of the Bulgarian Government's Investment Plan for transport and basic infrastructure (2007–2013). The document outlines how the parties will cooperate to secure cofinancing for programmes and projects supported by the EU Structural and Cohesion Funds as well as by the European Agricultural Fund for Rural Development (EAFRD). The MoU also provides that EIB will render assistance for successful development of Public–Private Partnerships as an important mechanism for implementation of investment projects addressing the significant infrastructural needs of Bulgaria.

Under the Memorandum, the EIB commits to extend credit facilities for cofinancing of aid from the Cohesion and Structural Funds of the EU within the relevant Sectoral Operating Programmes. These credit facilities will also complement the aid from the EAFRD for improvement of infrastructure and environment in rural regions. There will be a special instrument, known as 'bridge financing', which will allow refinancing of eligible project costs in advance to disbursements from the EU, with the aim to speed up the implementation of relevant projects and ensure good utilization of the funds provided by the Union. The MoU identifies the overall amount of support to be made available by the EIB during the period 2007–2013 that is up to EUR 700 million per annum, which will be provided within the framework of the Bulgarian Government's Investment Plan for transport and basic infrastructure.

Taking into account the current progress towards achievement of this objective, efforts should continue for its consistent implementation within the time frame of the Government Debt Management Strategy.

Maintain close coordination and information exchange between the Ministry of Finance and the Bulgarian National Bank

Bulgaria's membership in the EU to a large extent predetermined a widening inter-institutional cooperation between the Ministry of Finance and the Bulgarian National Bank (BNB). In pursuance of their commitments, undertaken by virtue of the Agreement defining the long-term tasks of the Central Bank as a Government agent, the two institutions continued to collaborate in the development and upgrade of BNB's systems for issuance, registration, trade and settlement of government securities. This process has

taken on board the need for aligning the systems concerned with European standards in this area as well as for ensuring efficient operation of the local GS market and control on GS transactions.

Together with this, the two institutions continued to exchange information related with government debt issuance policy and management strategy. Current practices have benefited from the establishment of an additional working group of experts. The task of this work group was to define a procedure for coordinating the forecasts on financial flows between the two institutions, i.e. BNB's contributions to the government budget and the deposits of public money at BNB. Other tasks of the expert group include development of rules for exchange of information on the liquidity of the banking system and on sharing of macroeconomic and other important analyses.

Bulgaria's membership in the EU highlighted the impending need for efficient cooperation in harmonizing national legislation in the area of financial services and financial markets with EU acquires. To this end, and subject to the principles for strict delineation of responsibilities, transparency and regular exchange of information, the Ministry of Finance, the Bulgarian National Bank and the Financial Supervision Commission concluded an agreement laying down the framework of their cooperation in the area of financial stability, services and markets. On the basis of the Agreement, the three institutions established a high-level National Group on Financial Stability. This as a permanent body with coordinating functions, at which the three institutions are represented by senior officials. The objective of the National Group is to design an appropriate mechanism for coordination of the common national policy in the area of financial services and markets.

Furthermore, the two institutions continued to cooperate in calculating the long-term interest rate for convergence purposes, which is one of the Maastricht criteria.¹ In the context of its responsibility to calculate and report to the European Central Bank (ECB) daily and monthly values of the long-term interest rate, the BNB developed, in consultation with the MoF, guidelines for calculation, reporting and monitoring of that rate.

¹To comply with this criterion, the Member-State must maintain a stable long-term interest rate, determined on the basis of long-term government securities and not exceeding by more than 2 percentage points the rate in the three Eurozone countries with highest price stability.

Another intensively developing and rapidly progressing tendency of inter-institutional cooperation is information exchange in the area of government financial statistics, which are at a later stage provided to a number of EU institutions, including the ECB. This domain has seen an appreciable progress both in terms of data consolidation and approximation to the quality standards established by the best practices of leading countries in this area. Another noteworthy fact is that the EU statistical office has commended Bulgaria's strict compliance with the requirements for completeness, timeliness and consistency of the information on consolidated government debt. To continue providing such information, the MoF undertook the development of an additional module to the Government Debt Register database, which will process automatically the information needed for provision of regular reports to European and other international institutions.

The continuing relevance of this objective calls for continued efforts towards its sustainable achievement over the next years.

Consolidated Government Debt

(EUR million)

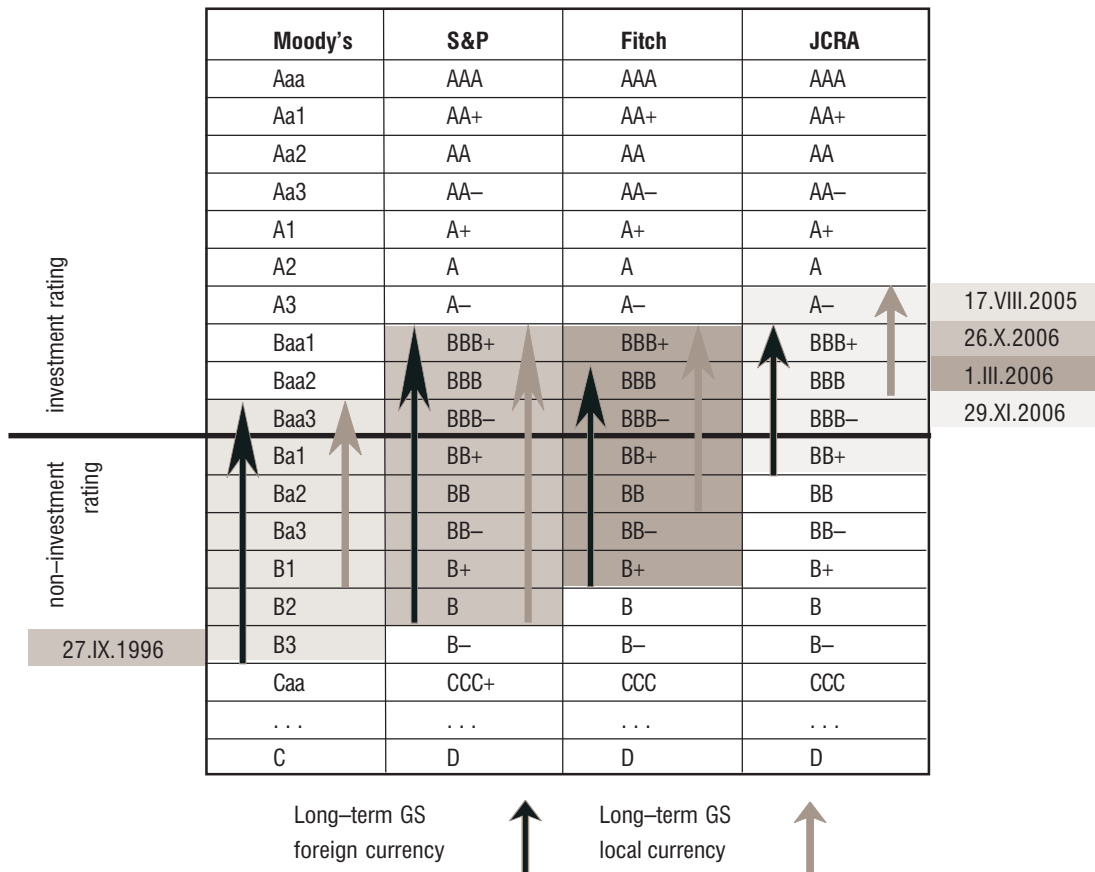
Structure	by 31 December 2004	by 31 December 2005	by 31 December 2006
Consolidated Government Debt	7 557.8	6 422.9	5 764.3
1. Central government debt	7 511.2	6 330.2	5 645.6
2. Social security funds debt	0.0	0.0	0.0
3. Municipal debt	46.6	92.6	118.7
Consolidated government debt/GDP(%)	38.1	29.4	23.0

Notes: 1. Central government debt shown at nominal value excluding government guaranteed loans.
 2. 2006 GDP is set at BGN – 49 090.6 million and 2005 GDP is set at BGN – 42 797.4 million and 2004 GDP is set at BGN – 38 822.6 million.
 3. Euro recalculations are at BNB central lev for rates for the closing business day of each period.

Source: MF

Government Debt Management Strategy Update

Credit Ratings Range for Bulgaria 2005–2006



Source: MF