GOVERNMENT DEBT MANAGEMENT STRATEGY

2009-2011

JUNE 2009

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Acronyms used

BDIF	*Bank Deposits Insurance Fund*
BNB	*Bulgarian National Bank*
CAD	*Current Account Deficit of the balance of payment*
CFP	*Consolidated Fiscal Programme*
EC	*European Commission*
ECB	*European Central Bank*
EIB	*European Investment Bank*
EU	*European Union*
EURIBOR6M	*6-month EURIBOR*
FDI	*Foreign Direct Investment*
FR	*Fiscal Reserve*
FSC	*Financial Supervision Commission*
GDP	*Gross Domestic Product*
GDMS	*Government Debt Management Strategy*
GDL	*Government Debt Law*
GIL	*Government investment loans*
GL	*Government loans*
GS	*Government securities*
IFI	*International Financial Institutions*
IMF	*International Monetary Fund*
MoF	*Ministry of Finance*
NSI	*National Statistical Institute*
LIB6MEUR	*6-month LIBOR EUR*
LIB6MUSD	*6-month LIBOR USD*
SBL	*State Budget Law*
SGP	*Stability and Growth Pact*
SPS	*Steam Power Station*
WB/IBRD	*World Bank / International Bank for Reconstruction and Development*

Executive Summary – Purpose and objectives of the GDMS

GDMS is a fundamental document aimed at summarising the main priorities of the government in the area of medium term government debt management and defining the tools to be used for its implementation. Its main purpose is to assess and limit as much as possible the various risks, which the debt structure and profile generate and to ensure stable sources for sovereign liabilities financing.

The elaboration of this Strategy takes into account the circumstances that the potential risks for the Bulgarian economy, resulting from the global financial crisis, outlined in the GDMS updated in 2008, are real facts of the current macroeconomic situation. These risks are manifested in: the gradual increase in interest rates on loans and in the service costs; decrease in the resources granted to the Bulgarian banks by their headquarters and limitation of lending; decrease in exports; decrease in FDI; decline in GDP growth and budget revenue.

As a result, an important factor, which influenced significantly the development of the new strategic document for the next three years, was the assessment of the effects of the crisis which formed the basis for outlining the activities of the government for the implementation of the priorities identified aimed at maintaining the fiscal consolidation achieved. The established traditions, the efforts made and the results attained during the last six years in this respect have reaffirmed the role of the Strategy as integral part of the public finance management within the macroeconomic programme of the government.

GDMS is prepared pursuant to the GDL. It is a public document which ensures optimum transparency and ensures the efficiency of the public control process. It comprises of four sections. The first section gives an overview of the specific macroeconomic situation in the country and analyses the trends. The second section illustrates the dynamics in the levels and parameters of government debt in the period 2006 - 2008. The third section assesses the risks predefined by the amount and structure of the debt, while making an assessment of the respective risk exposure. The last, fourth section defines the main objective of government debt management in the upcoming three-year period 2009 - 2011 and describes the measures to be undertaken to attain it.

I. Macroeconomic analysis – current situation and trends

The global financial crisis which started in mid 2007 in the USA was caused by misevaluation by the market players of the value of structured venture mortgage bonds. The increasing lack of confidence in the financial markets limited the liquidity and increased the interest rates at the interbank markets. The coordinated measures undertaken by a number of central banks aimed at ensuring liquidity at the international markets did not have significant influence and the markets remained unstable. The problems with the stability of the large American and European financial institutions influenced the stock markets, and were subsequently transferred to the real sector, in many EU economies, as well as the American, where decline was noted during the fourth quarter of 2008. Most international institutions are still decreasing their growth forecasts for the global economy. According to the spring forecasts of the EC[1] since the beginning of 2009 the global economy will drop down to (-1.4%) in 2009 and will start recovering next year with a forecast growth of 1.9%.

1 European Commission Economic Forecast Spring 2009.

There are two channels through which the global economic and financial crisis impacts the Bulgarian economy – decrease in the financial flows to the country and slow-down of the growth / decline in external demand.

- The global economic crisis has had no influence on the real sector in the country during the first half of 2008. GDP growth speeded up to 7.1% compared to 6.5% during the same period of 2007, and then slowed down and reached 3.5% at the end of the year. The industry had a major contribution to the decrease in the economic growth. The GDP growth per annum was 6%. In 2009 the Bulgarian economy is expected to slow-down significantly as a result of the intensified crisis, mainly due to the lower growth rate of investment. According to the above mentioned EC forecasts the Bulgarian economy will shrink by 1.6%, and the EU GDP is expected to shrink by approximately 4% in 2009.

- During the second half of the past year foreign trade of the country slowed-down its growth rate as a result of price effects and the global crisis. Export of goods decreased by 10% nominally during the fourth quarter (on annual basis) due to the sharp decrease in the global prices of petrol products and metals and the weaker foreign demand. During the last six months of 2008 import of goods gradually slowed down, while during the last quarter it dropped by 5.1% compared to the same period in 2007. Imports of consumer goods remained relatively stable. Imports decreased by 29.8% on annual basis during the first quarter of 2009, and exports – by 23.3%. The trade deficit was lower by EUR 769 mln. compared to the same period of the preceding year.

In the period 2005 - 2007 CAD increased from 12.4% to 25.1% of GDP. In 2008 this trend was eliminated while the deficit was maintained and amounted to 25.3% of GDP. Major factors contributing to the reported dynamics include the high deficit in trade with goods, which reached 25.7% of GDP in 2008, as well as outflows of incomes in the form of payments to foreign investors and for the service of private debt, which reached a share of 3.5% of GDP.

In 2008 inward bound FDI reached EUR 6.2 bln. or EUR 2.3 bln. less than the prior year[2]. During the last six months of 2008 inflows of FDI dropped by 42.1%. During the second half of 2008 the most significant decline noted was in financial intermediation (-52.2%), real estate sector (-31.8%), trade (-59.3%) and processing industry (-67.7%).

Inward bound FDI covered 71.4% of the CAD in 2008 compared to 116.8% in 2007 and more than 130% during the preceding years. As a result the importance of the current account debt financing increased and the foreign debt of the country reached 107.4% of GDP last year. In December and January however, the financial account of the balance of payment reported negative amounts due to withdrawal of deposits. FX reserves started decreasing in December as the Central Bank decreased the statutory reserves of commercial banks in December and January.

Bulgaria's financial system is relatively stable and banks do not have exposures to the so-called "toxic assets". The share of "bad debts" within the total debt increased up to 2.8% at the beginning of 2009, compared to approximately 2% in the preceding periods. However, this is due to some extent to technical factors, such as the slowing down in lending growth. Despite the complicated market situation and the losses reported in other banking systems, the bank sector in our country reported a profit of BGN 271 mln. during the first quarter of this year, which ensures 1.6% return on assets and serves as an additional buffer against possible future negative processes. The financial intermediation sector had the highest contribution to GDP growth during the past year.

During the first two months of 2009 annual inflation continued to drop and in February it reached 5.4% on annual basis. The significant slow-down in its levels as of mid 2008 is within the general trend of decline in global demand and decrease in prices of petrol and main raw materials. During the current year less pressure is expected on price increases. Some of the internal factors thereto are the increase of unemployment levels and slow-down of domestic demand growth.

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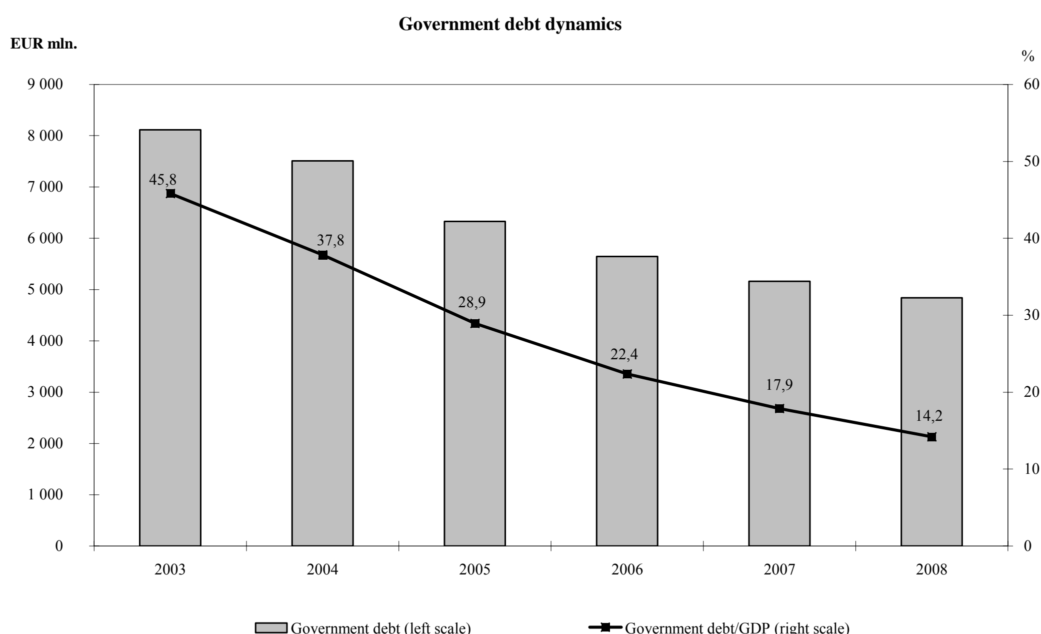
[2] Preliminary data.

II. Government debt dynamics in the period 2006 - 2008

1. Debt portfolio analysis

The past three-year period was marked by the efforts to achieve high and sustainable economic growth and to maintain a stable macroeconomic environment. In this respect a main priority was to maintain sustainable public finance and level of government and government guaranteed debt, ensuring the long-term compliance with the Maastricht criterion, which was reflected in the objective set out in the GDMS for the period. The reported results explicitly confirm the effectiveness of the efforts in this area. As at the end of 2008 the nominal government debt amounted to EUR 4 841.6 mln. The decrease of the debt in absolute terms compared to the end of 2006 is EUR 804.1 mln. The decrease in the debt / GDP ratio in the period is 8.2 percentage points reaching 14.2% as at 2008. The stable economic growth and the prudent fiscal policy shifted the two parameters in different directions and as a result made it possible to report decrease in the ratio for a ninth consecutive year. Throughout the overall period under review the reported debt decrease was mainly due to the decrease in foreign government debt, mainly because of the early redemptions to the WB, IMF and Spain at a total amount of EUR 350.2 mln. in 2006, to IMF and Switzerland - EUR 244.4 mln. in the following year and the WB (including Japan) – EUR 296.9 mln. last year. In fulfilment of the objectives set out in the GDMS 2006 – 2008 and due to the favourable foreign markets situation, in 2006 and 2007 domestic government debt grew with a realised positive net issue equivalent to EUR 60.8 mln. and EUR 129.2 mln. respectively. The interest of the market players to GS of all maturity groups remained stable almost until the end of the period. At the end of 2007 and mainly during the last year of validity of the preceding strategy, the local securities market, influenced by the global financial crisis, shrank and the GS volumes offered at auctions were dominated by the redemptions of already issued ones, which resulted in a decrease in the amount of domestic GS outstanding.



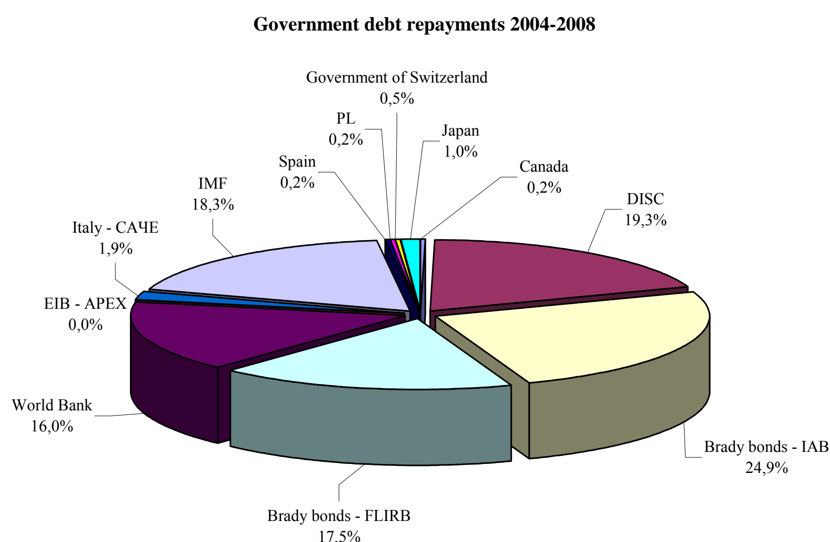
Source: MoF

1.1. Foreign government debt

At the end of 2008 foreign government debt amounts to EUR 3 270.2 mln., which represents a decrease of 20.9% compared to the end of 2006. No GS were issued at the international capital markets during the period. The financial stability maintained throughout

the reporting period, the budget surpluses, the increasing fiscal reserve balance and the goals for priority development of the domestic market laid down in the effective strategy predetermined the trend for gradual decrease of foreign debt. Throughout the whole period 2006 – 2008 negative external net financing was reported. Only GIL recorded more disbursements than redemptions within the structure of foreign liabilities. Their relative share at the end of 2008 is 23.1% within the total foreign debt and it increases constantly, with nominal growth of 28.6% during the period. The growth trend is expected to continue in the future due to the absorption of funds on already launched projects, and as a result of negotiation of new loans to finance investment projects and social programmes. In addition to the buy backs, regular payments to foreign creditors were made in accordance with the contractual amortisation schedules. The most significant payments in 2006 were those on loans from the IMF – EUR 278.8 mln. (including EUR 151.4 mln. early redemptions), WB – EUR 207.8 mln. (including EUR 188 mln. early redemptions), EU – EUR 72.5 mln. In 2007 the redemptions in descending order are on loans from IMF – EUR 254.8 mln. (including EUR 230 mln. early redemptions), on bonds issued at the international financial markets – EUR 250 mln. (due to maturity of bond issue denominated in EUR), on loans from the EU – EUR 87.5 mln., respectively. The most significant share of the budget funds spent during the past year belongs to liabilities to the WB - 273.4 mln. (including EUR 268.6 mln. early redemptions), EU – EUR 87.5 mln. and Japan – EUR 31.1 mln. (EUR 28.3 mln. early redemptions), respectively. The approximate parity of the share of bonds and loans within the foreign debt structure by creditor has remained unchanged during the period.

Government debt repayments 2004-2008

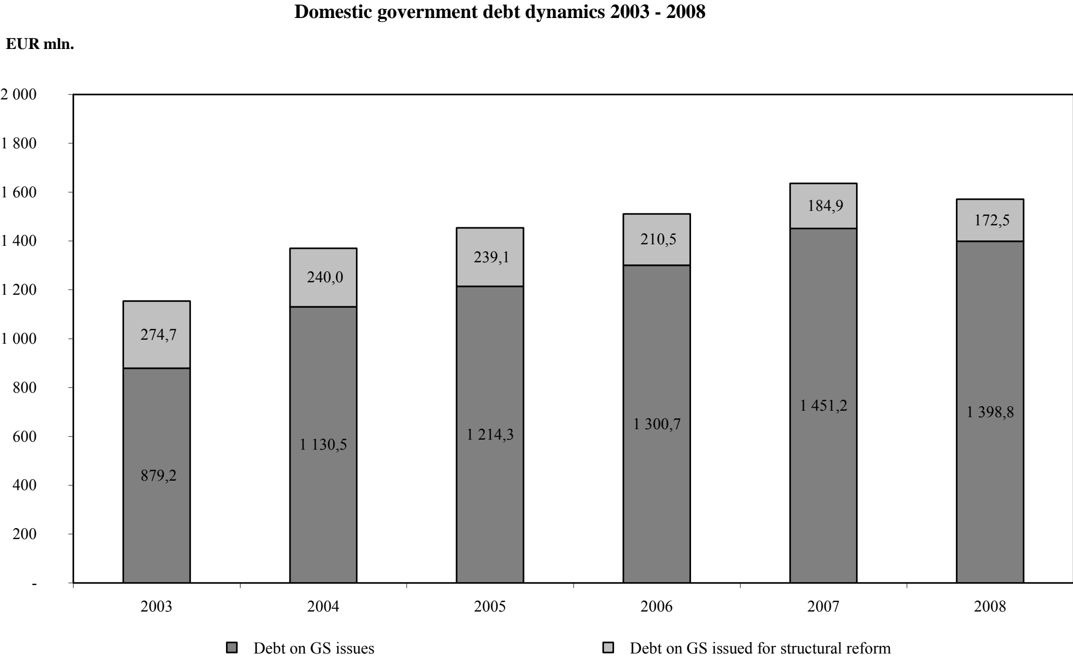


Source: MoF

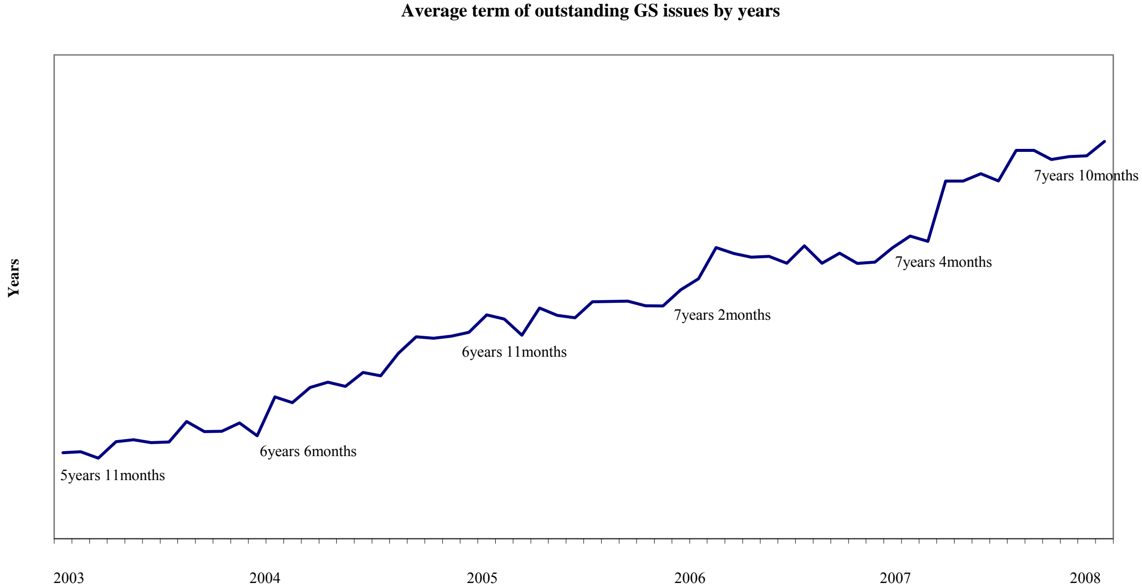
1.2. Domestic government debt

At the end of 2008 the nominal amount of domestic government debt amounts to EUR 1 571.3 mln. Throughout the period domestic debt gradually increased as a share of the total government liabilities reaching almost 32.5%, despite the deteriorated market conditions, which at the end of 2008 resulted in a negative net issue. The portion of GS issued to finance the budget remained dominating with a share of 89%, at the expense of securities issued in support of the structural reform. MoF continued its policy for priority issue of GS at the domestic market, while maintaining the 3-, 5- and 10-year issues already recognised and established at the market, as well as 3-month treasury bill issues. Extreme priority was

attached to the issuance of a 10-year GS issue with a volume ensuring the high liquidity of the securities, in view of compliance with the requirements as to the long-term interest rate for convergence assessment.

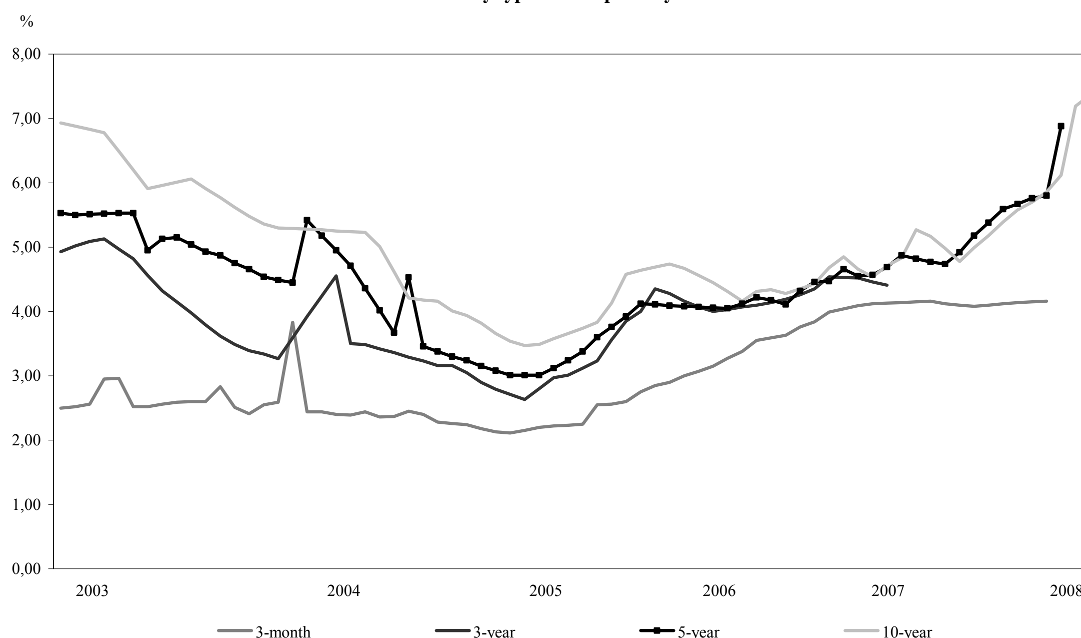


The average term of the outstanding issues reached 7 years and 10 months due to the priority issue of long-term GS at the domestic market.



As a result of the significant turmoil at the international capital markets, accompanied by the deteriorated liquidity, massive outflow and reallocation of capitals, as well as the increased investor requirements as to the expected returns on their investments in accordance with the globally increased risk, the yield on the newly issued GS gradually increased (up to approximately 7% on the 10-year bonds).

Yield of GS by types on the primary market



Source:MoF

Following the best practices worldwide the MoF continued its efforts for the enhancement of both the primary dealership system and the infrastructure of the domestic market of government debt. During the second half of 2007 the regulations[3] in the area of issuance, acquisition, registration, settlement and trade with GS were amended and supplemented, mainly in the context of its adapting in relation to Bulgaria's EU membership. As of November 2007 new Criteria for Selection of Primary GS Dealers have come into effect, which introduced requirements related to maintaining liquid and transparent market by means of fixed floor of the market share of dealers, participation of the dealers in consultations with the issuer, the rendering of affordable services to GS investors, etc., in addition to those related to the participation at the primary market. Throughout the three-year period there were continued efforts aimed at enhancing the market infrastructure of domestic government debt, mainly along the line of continuous development and introduction of new functionalities of the systems[4] serving the primary and secondary GS market, established and maintained by BNB (in the capacity of government debt agent).

1.3. Government debt by types of instruments

At the end of 2008 the structure of debt by instruments is prevailed by the share of securities issued on the foreign capital markets (35.9%), followed by GS issued on the domestic market (32.5%) and GL (15.7%) within the total government liabilities. Loans intended for the implementation of investment projects with a priority for the country's economy have a share of 15.6%, despite the reported absorption rate lower than the envisaged one.

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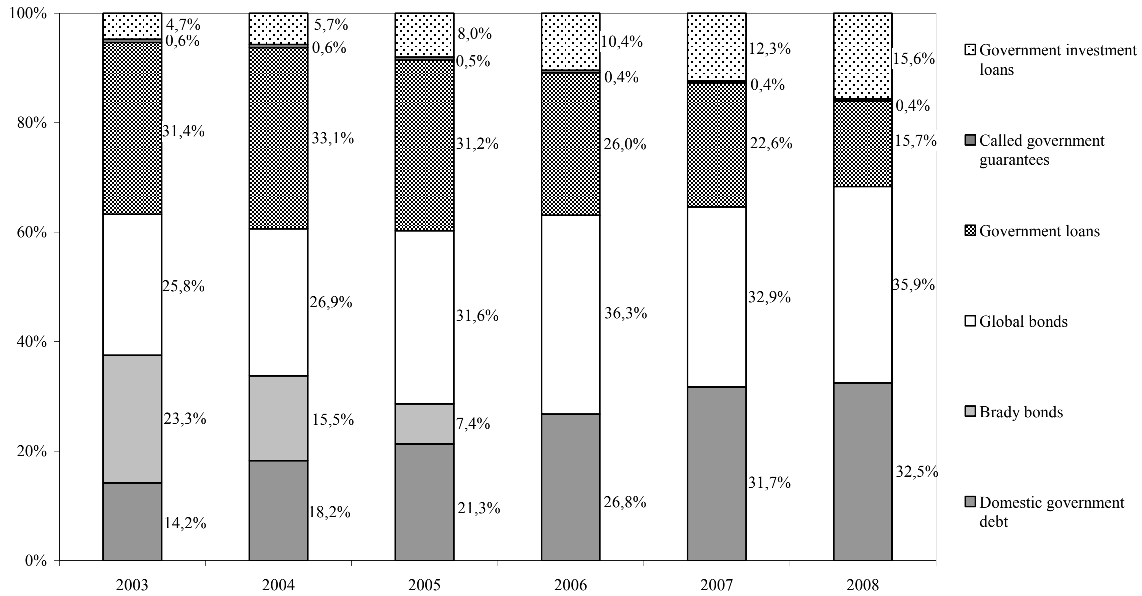
[3] Amendment and supplement of the Government Debt Law (promulgated SG, issue 52 of 29.06.2007, in effect as of 1.11.2007, issue 23 of 27.03.2009, in effect as of 1.11.2009); passed new Ordinance No 5 of 4.10.2007 on the Order and Conditions to Acquire, Register, Settle and Trade with GS (promulgated SG, issue 85 of 23.10.2007, in effect as of 1.11.2007), Ordinance No 15 of 4.10.2007 on the Terms and Procedure for Acquisition, Registration, Redemption and Trade in GS (promulgated SG, issue 85 of 23.10.2007, in effect as of 1.11.2007), Ordinance No 15 of 4.10.2007 on the Control over Transactions in GS (promulgated SG, issue 85 of 23.10.2007, in effect as of 1.11.2007), Ordinance No 31 of 4.10.2007 on the Settlement of GS (promulgated SG, issue 85 of 23.10.2007, in effect as of 1.11.2007)

[4] System for Auctions and Subscriptions for the Sale of GS (AGS), Electronic System for Registration and Serving of GS Settlement (SGS).

Government debt structure by types of instruments



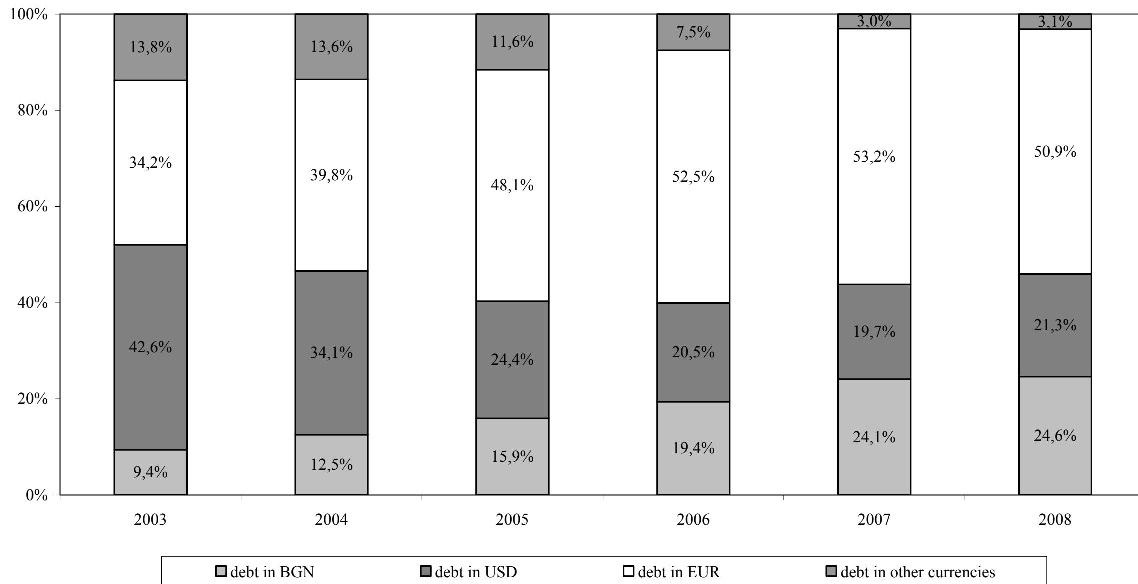
Source: MoF

1.4. Currency structure of government debt

The FX structure of government debt also underwent a change towards a smooth increase of the portion of debt denominated in national currency as a result of the GS issued on the local market in BGN – up to 24.6% of the total debt at the period-end. The share in the single currency remained prevailing with 50.9%, (despite the early redemptions of foreign debt denominated in EUR - approximately 80% of the early redemptions and the maturity of the Euro bond issue with a nominal of EUR 250 mln.) mainly due to the newly absorbed foreign debt from the WB amounting to EUR 114 mln. (DPL1 loan)[5]. The FX composition of the debt was predetermined mainly by the political and economic orientation of the country – the effective Currency Board Arrangement and proceeds from trade transactions with EU member-states. Thus the share of debt influenced by the fluctuations of the foreign currency exchange rates was limited to only one fourth, naturally due to the regular amortisation of USD denominated debt according to schemes agreed with the foreign creditors and the executed buy backs made (16% of the total amount). This assisted and significantly simplified the budget planning of debt service.

[5] Development Policy Loan

Government debt currency structure

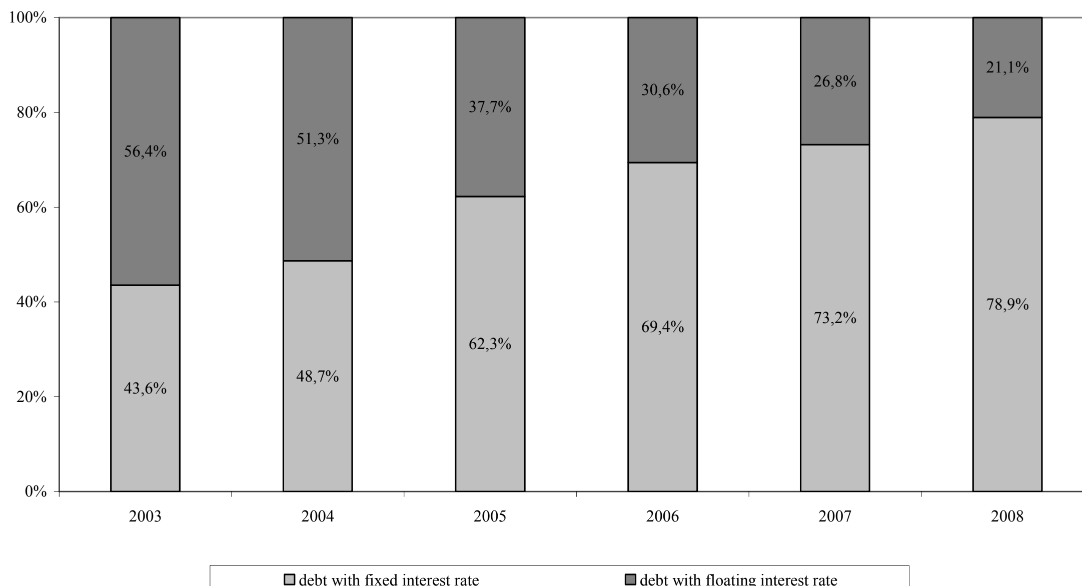


Source: MoF

1.5. Interest rate structure of government debt

The interest rate structure was also positively influenced by the consistently pursued policy of placement of fixed interest rate GS which reflected the current market conditions, as well as by the negotiation of new foreign loans with subsequent service under similar terms and conditions, when possible and acceptable in view of the cost of borrowed capital. At the end of the three-year period the share of fixed interest debt is 78.9%. However, it should be taken into account that maintaining a part of the floating interest rate coupon debt within reasonable levels assists the implementation of effective expenditure policy in periods of low levels of international interest rates. Furthermore, the proper management of this portion of government liabilities allows a change in the duration of the debt, by extending or reducing it, depending on its amount, thus limiting the risk exposure.

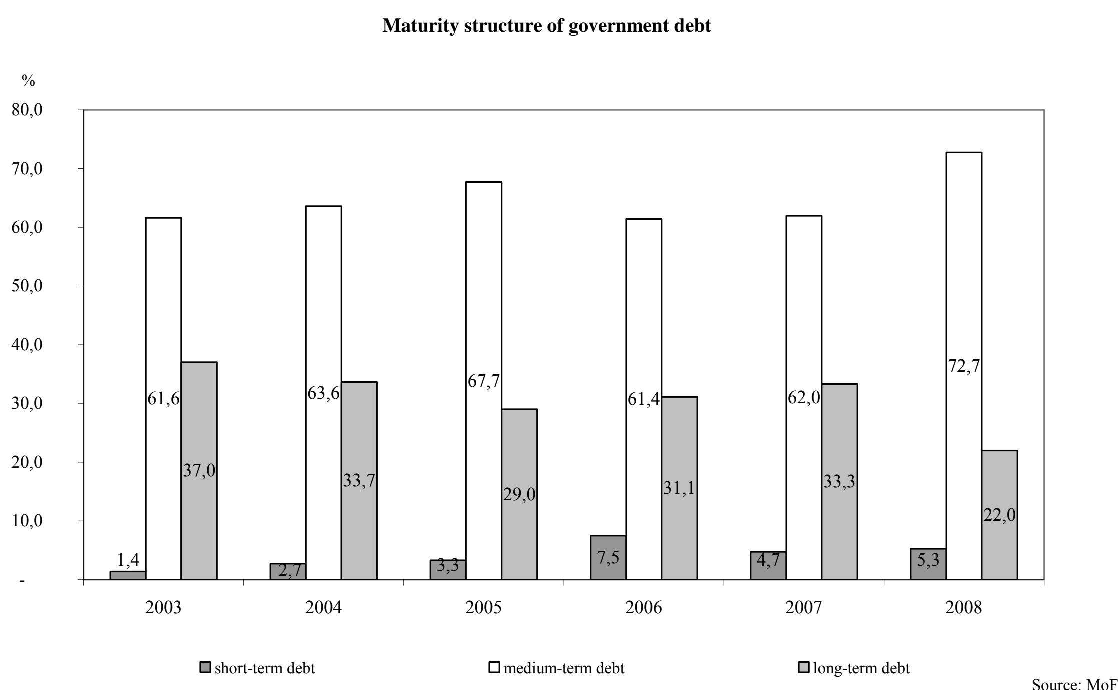
Government debt interest rate structure



Source: MoF

1.6. Maturity structure of government debt

The original maturity of government debt during the period increased slightly by approximately six months, while at the end of 2008 it is almost 13 years. The remaining maturity – an indicator of the risk exposure followed the opposite trend, reaching 7 years and 2 months. The main reasons for the noted relative decrease by approximately 4 months were the executed buy backs of foreign debt, the reduction of the volume of GS issued on the domestic market in 2008 (as a result of the difficulties of the domestic market situation caused by the unfavourable economic conditions) and the regular amortisation of government liabilities. As a result the short-term and long-term government debt shrunk their shares by 2 and 9 percentage points respectively. The disbursements of the GL and GIL have the opposite effect, compensating the drop in the levels of the two indicators, as well as maintaining the volume of 10-year long-term bond issues in 2008 identical to that of 2006, due to which the share of medium term debt increased by more than 11 percentage points.

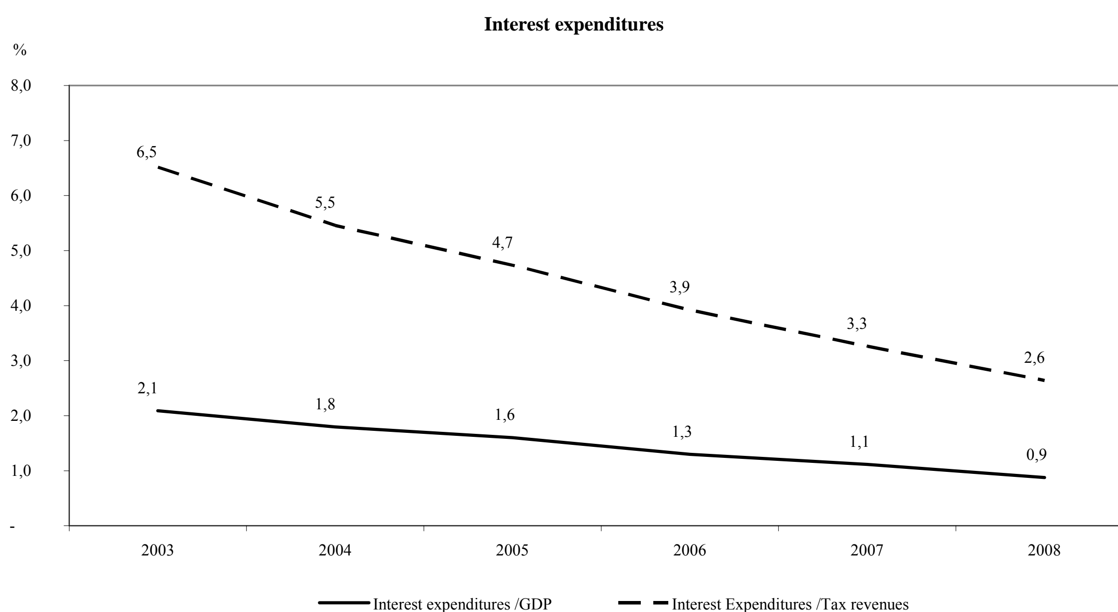


1.7. Government guaranteed debt

At the end of 2008 government guaranteed debt amounted to EUR 634.3 mln. Its size increased in nominal terms (by EUR 83.1 mln. compared to that at the end of 2006) and as a percentage of government debt, but still remained within 2% of GDP. The increase was against absorptions on already contracted old loans. The last project approved, launched with the financial support of the government dates back in 2004 with the Japan Bank for International Cooperation for the rehabilitation of blocks 1-4 of Maritsa East 2 SPS. The main sectors, financed with government guaranteed debt and retain their priority in the policy implemented by the government to support key sectors of the economy, are still the energy and transport sectors. As a result of the ex-ante analysis of the loans' terms and conditions, the financial solvency of the beneficiaries, the project's potential to generate profits to cover the costs on the agreed borrowing, as well as the continuous monitoring of the fulfilment of the commitments of the parties under the concluded contracts, there have been no cases of called government guarantees during the last years.

1.8. Government debt expenditures

The decreasing government debt resulted in lower interest expenditures. The average cost savings in 2007 and 2008 amount to EUR 43.6 mln. of the resources allocated in the budget. In addition to the lower level of the debt, the reduction of the planned expenditures is due to the difference between the forecasts used in planning the funds, mainly in respect of the 6-month LIBOR for EUR and USD, as well as the forecast exchange rate of the US currency and the actual rate at payment date. The ratios of this indicator to GDP and tax revenue respectively during the three-year period under review follow a descending trend, determined by the reported economic growth in the country, the improved tax collection and the strengthened customs control and they reach 0.9% and 2.6% respectively at the end of 2008. The biggest shares in the total expenditures were held by global bonds at an average for the period 49.5%, followed by GS issued on the domestic market - 24.6 %, WB - 9.3 %, GIL – 8.6%.



Note: Data based on the Consolidated Fiscal Programme

Source: MoF and NSI

2. Government debt sensitivity analysis in the period 2009 - 2011

The influence of a potential change in the levels of foreign exchange rates and the interest rates on the nominal value of government debt, as well as on the amount of the upcoming payments, was determined by the executed sensitivity analysis. The values of the major market indicators as at March 2009 have been used as base scenario. The results confirmed the following dependence of debt liabilities:

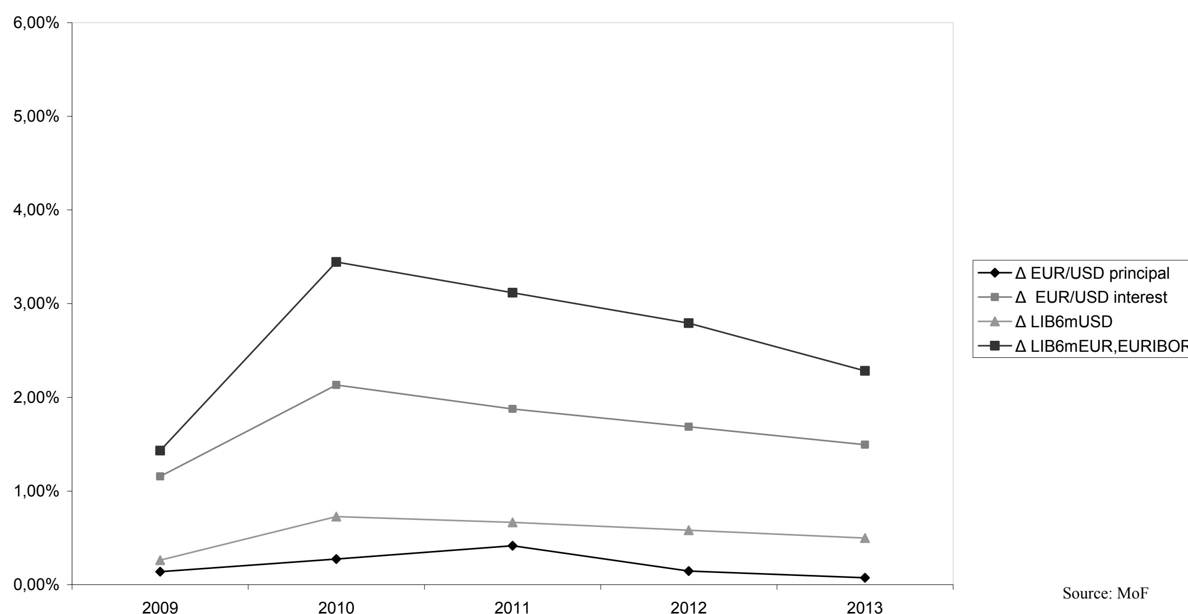
2.1. Effect of the changes in the exchange rates of the major currencies in which debt is denominated

The alternative scenario used is based on the assumption for a ten-percent change in the EUR / USD ratio over the medium term. It was established that this change in the ratio at an average over the period 2009 – 2011 will cause fluctuation of the principals due under the debt by less than 0.3% compared to the base scenario and respectively 1.7% in the interest expenditures envisaged. The nominal level of government debt will react with a deviation of approximately EUR 270 mln. (or 1.4% of the medium term change). A similar assumption as to the change of the current exchange rate of the JPY (the foreign currency holding the next largest share in the currency debt composition after the EUR and the USD) has a

significantly weaker influence. Under this assumption the debt in the period will change by approximately EUR 50 mln., which represents an average annual deviation of the levels of the government liabilities during the period of less than 0.3% from the base scenario.

2.2. Effect of the changes in interest rates

This analysis of an alternative scenario uses the assumption for a change of 100 basis points in the level of international interest rates, which are determining for calculation of debt interest payments. The simultaneous change in LIB6MEUR and EURIBOR6M by 1% would cause a change of 2.7% at an average in the interest expenditures envisaged in the period 2009 - 2011 (a peak of 3.45% in 2010). The data from the analysis indicate that under the same assumptions as to the change in LIB6MUSD, the budget resources allocated for interest payments will change by less than 0.6% .



Source: MoF

III. Debt portfolio analysis and risk management

Government debt management is a process where the main efforts are aimed at assessing and analysing the debt structure in order to minimise the generated risks, in view of their direct impact on the budget, the balance of payment, the financial system and capital market, and hence on the fiscal and macroeconomic stability of the country.

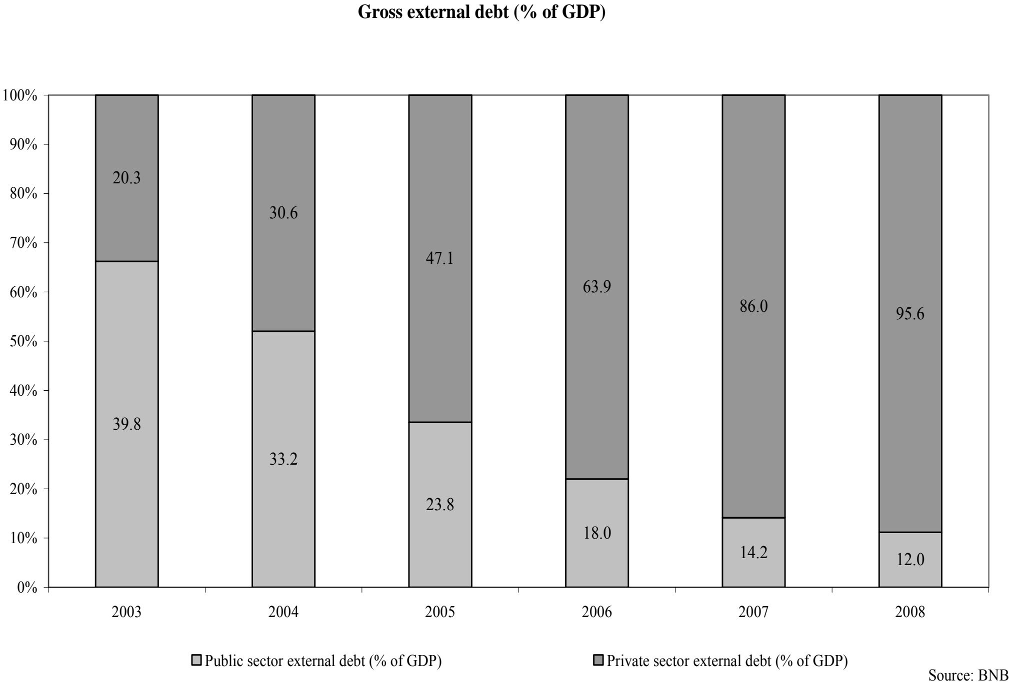
1. Types of risk

1.1. Macroeconomic risk

Over the last years extreme progress was achieved in the decrease of government debt in nominal terms, and as a percentage of GDP. However, it should be pointed out that the level of the CAD remained a significant problem for the country. Due to the fact that the Bulgarian economy has the features of a developing market, it continues to be strongly dependent on the balance of the trade account. Despite the fact that due to the economic and financial crisis the inflow of foreign investments will decrease and will probably shrink CAD, it is possible, if necessitated by the situation, to ease further the pressure on the balance of payment by debt financing.

Another issue is the gross foreign debt dynamics, which exceeds the nominal GDP for 2008. In this respect the trend for reasonable limitation of the foreign government debt becomes increasingly important. Government funds should be used for particularly important projects or social programmes, which have no access to other form of financing, as well as for the purpose of restructuring future cash flows aimed at servicing government liabilities. The fact that the foreign debt / GDP ratio is sensitive to the fluctuations of the exchange rate of the single European currency to the US Dollar, as well as the domestic inflation should also be taken into account. In this sense, under the hypothesis for static amount of the debt and appreciation of the US currency, the gradual increase of the share of EUR denominated component, simultaneously with the decreasing inflation (as a result of the crisis), will stimulate further the increase of this indicator. Therefore, regardless of the low debt level at present, the implementation of predictable and prudent borrowing policy is of extreme importance to preserve the macroeconomic stability.

Gross external debt (% of GDP)



Source: BNB

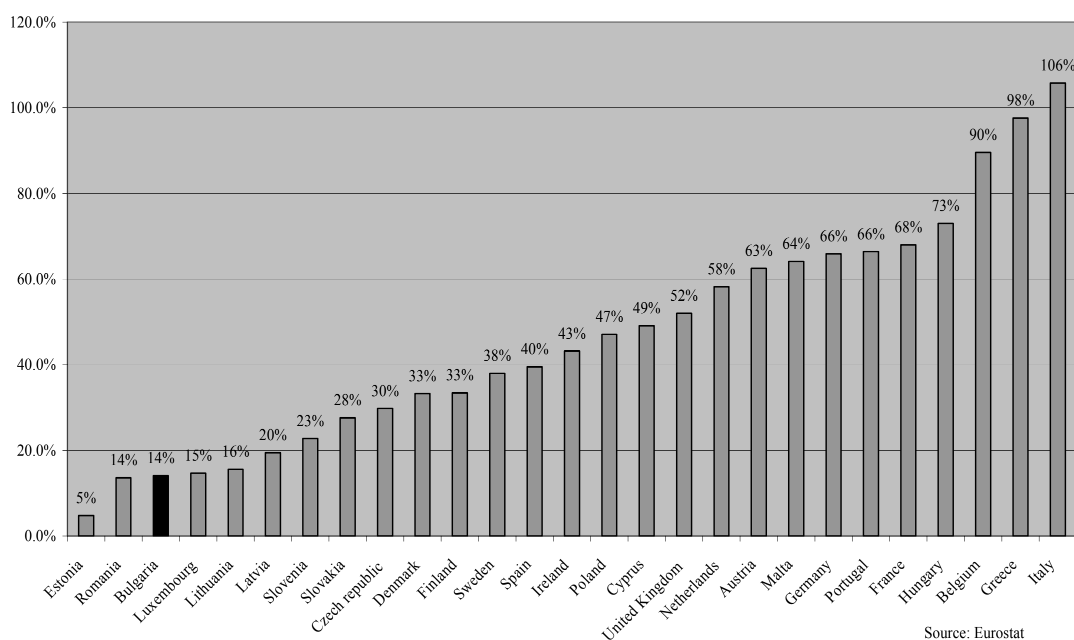
1.2. Fiscal risk

Maintaining the economic stability in the country requires from the government to continue following robust fiscal policy, while limiting expenditure increase in view of the existing external misbalances and possible decreases in revenue. In general, the fiscal policy should be structured in such a way that primary balance should increase with GDP and vice versa. Such fiscal policy allows the management of future flows on the primary surplus. In the context of management of state-owned assets and given the framework, which asset and liability management defines, this risk is minimised when the financial characteristics of the two sides of the balance sheet match. In this sense, debt with features in which the service of government commitments decreases when the primary balance decreases and which increases when the primary balance increases, minimises the risks of increasing tax burden, for limiting the expenditures or even hypothetical not performing debt service obligations. A policy where the debt service expenditures co-vary positively with the primary balance can be qualified as a policy adequately balancing the budget in compliance with the existing environment. Following this economic logic and the government debt management goal to limit interest expenditures and to smooth the debt redemption profile (discussed below) will replicate the forecasts for low growth of GDP, potential decrease in tax revenue and lower primary balance respectively.

1.3. Risk related to the debt level

As it was already pointed out, during the three-year period under review the level of debt followed a stable descending trend, both as a nominal amount and as a ratio to GDP. Although the consolidated debt amount and specifically its ratio to GDP is not subject to analysis in view of the scope and content of this document, it is a value the country is committed to monitor in the context of the EU membership and as a mandatory indicator for accession to the EURO zone. The reduction in the ratio consolidated debt / GDP in the period 2006-2008 was by 8.6 percentage points and reached the record low level of 14.1%, which ranks our country third amongst all 27 member states of the Community. The decrease in the assessed indicator is mainly due to the reduction in the level of central government debt (government debt), that represented 97.7% in the total amount. Another mechanism for preventive control over the debt level are the limits set out in the yearly SBL - the maximum nominal amount as at the year end and the maximum amount of newly issued debt. Furthermore, based on the results from the sensitivity analysis the relatively weak dependency of the debt indicators on the change in the international interest rate levels and foreign exchange rates was confirmed. The currently observed declining trend in the interest rates globally, as a result of the measures to counteract the crisis and to stimulate the global economy, should also be added to these facts. In view of the above mantioned a conclusion can be draw that the current amount, structure and parameters of the debt do not impose material medium term risks.

Gross general government debt (% of GDP)- 2008*



*Forecast data

Consolidated debt – the debt of sub-sectors of the central government (government debt), municipalities and social security funds, less assets representing debt for any of the above listed sub-sectors.

1.4. Market risk

This risk is associated mainly with the risk of changes in foreign exchange rates and interest rates. Exposed to this risk are mainly the foreign government liabilities and liabilities with floating interest rates, the dependence / sensitivity of which could be multiplied several times as a result of the very unstable international situation.

- Risk related to fluctuations of the foreign exchange rates

This risk is generated as a result of the instruments in the government debt portfolio denominated in currencies other than the EUR and the BGN, the changes in the exchange rates of which result in a change in both the nominal value of debt, and the financial resources budgeted for its servicing. **The domestic / foreign debt ratio** provides information as to the foreign currency exposure of the debt portfolio. The higher the portion of debt in domestic currency (domestic debt[6]), and in a conditions of Currency Board - that of the reserve currency – the EUR, the lower the dependency on foreign exchange rate fluctuations. Domestic debt increased gradually throughout the whole period under review against a decrease in foreign debt, which at the end of 2008 had the effect of an increase in the share of debt in local currency by 5.2%. Although the EUR component in the structure of foreign debt decreased slightly by 1.6% compared to the level at the end of 2006, the trend for limitation of the shares of debt denominated in US Dollars and other currencies remained, and they decreased by 3.6% cumulatively over the period. This information considered in parallel with the FX structure of export revenue is an indication of the level of natural hedge of the portion of the debt portfolios denominated in fluctuating currencies.

- Risk related to changes in interest rate levels

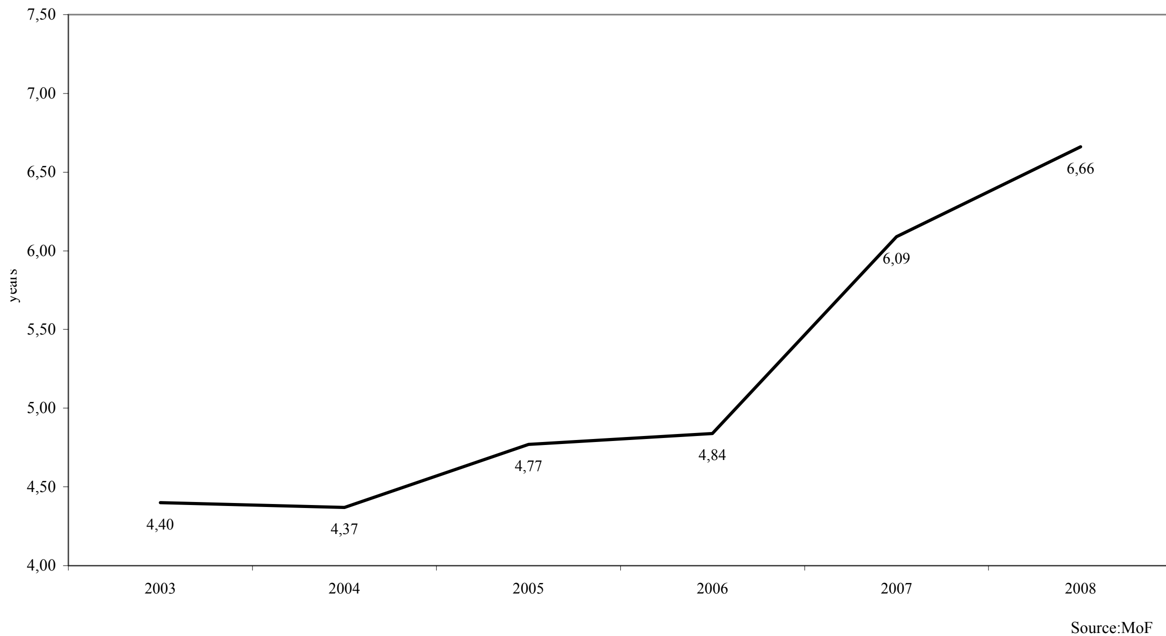
It is determined by the likelihood of a change in the amount of the budgeted upcoming interest payments as a result of fluctuations in the interest rate levels in case of refinancing debt and the elasticity of the future expenditures on floating rate coupon debt instruments outstanding. The assessment of this type of risk should take into account its direct impact on the cost of the overall government portfolio, in view of the reciprocity of the fluctuation of the cost and interest coupon parameters. This risk is determined by:

- The fixed interest rate debt to floating interest rate debt ratio. An increase in the portion of fixed interest rates reduces the risk exposure of the debt. In fulfilment of the GDMS 2006 – 2008 the portion of floating interest rate debt was gradually reduced and resulting in a decrease by 9.5 %, reaching 21.1% at the end of 2008;

- Average time to refixing (ATR). The higher ATR value is an indication that relatively significant portion of the debt is neutral to the change in interest rate coupons in the short-term and suggests lower risk. Over the period under review the ATR increased by approximately 2 years, and at the end of the period its level reached almost 7 years.

The duration indicator has not been used for the purpose of the interest rate risk analysis due to two significant shortfalls. The first one is that as an average measure for the cost and risk profile of the debt this indicator does not provide information on the spread of the payments i.e. it does not distinguish the risk between a portfolio where the instruments are repaid in accordance with a certain amortisation scheme (barbell portfolio) and a single bullet portfolio. Obviously the two portfolios will exhibit different refinancing risk. Another weakness is that duration measures the effect of parallel shift in interest rate level but does not measure the twist in interest rate changes.

[6] At present the domestic government debt contains negligible component denominated in US Dollars.



1.5. Refinancing risk

This risk refers to the likelihood of not being able to obtain new financing as debt matures, or only at very high cost. Although this risk is usually accompanied by the risk of changes in the interest rates because it is focused mainly on them, the risk of changes in interest rate levels can be determined as a more general because it depends on factors such as rapid economic growth, inflation and restrictive monetary policy. It should be taken into account that with the increase in the share of fixed interest rate instruments the exposure of the debt portfolio to the risk of changes in interest rate levels approximates the refinancing risk.

The refinancing risk depends on:

- The debt amount to be refinanced in a specific period – usually one year taken to financial flows;
- The concentration of payments in certain years (alternatively).

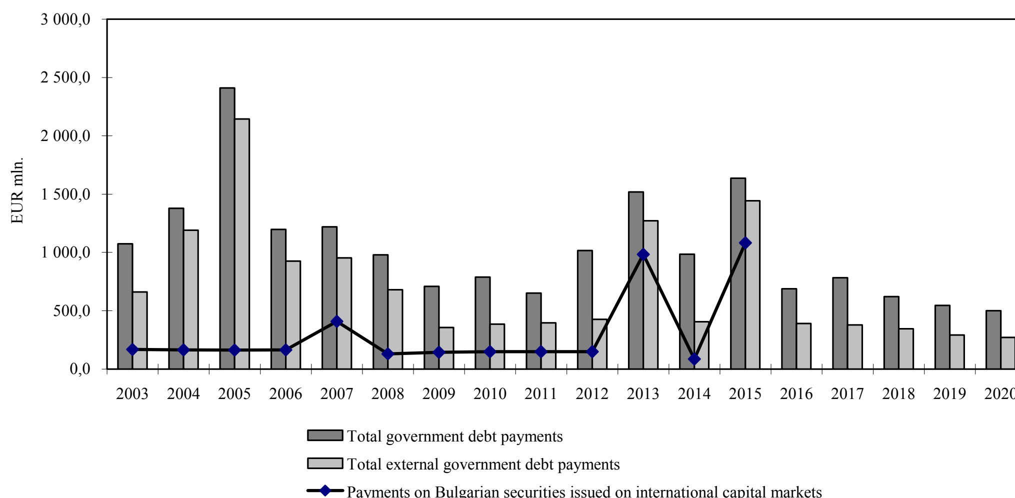
The indicators of refinancing risk include:

- Debt redemption profile – the smooth redemption profile reduces the risk of financing significant debt in a period of unfavourable market conditions. In this sense when determining the design of the borrowing policy the impact on the redemption profile should be taken into account. Markets with fully developed yield curves allow the future payments to be distributed more evenly. Furthermore, a liquid and active secondary market would facilitate transactions (buy backs, exchanges) changing the redemption profile. Therefore, the development of the domestic market is a key component in the policy to mitigate refinancing risk in the medium term.

The redemption profile of the debt is relatively even with isolated peaks in 2013 and 2015 when the Global Bonds mature. In view of relieving the budget expenditures in these years, and having in mind the specific macroeconomic external and domestic environment, taking into account the investor interest, the transaction cost and other factors, it is appropriate to analyse the various possibilities to restructure the payments, including buy backs of a portion or the total liability for certain debt instrument, exchange of a certain nominal of a

new issue placed at foreign markets, etc.

Government debt payments for the period 2003-2020 (F)

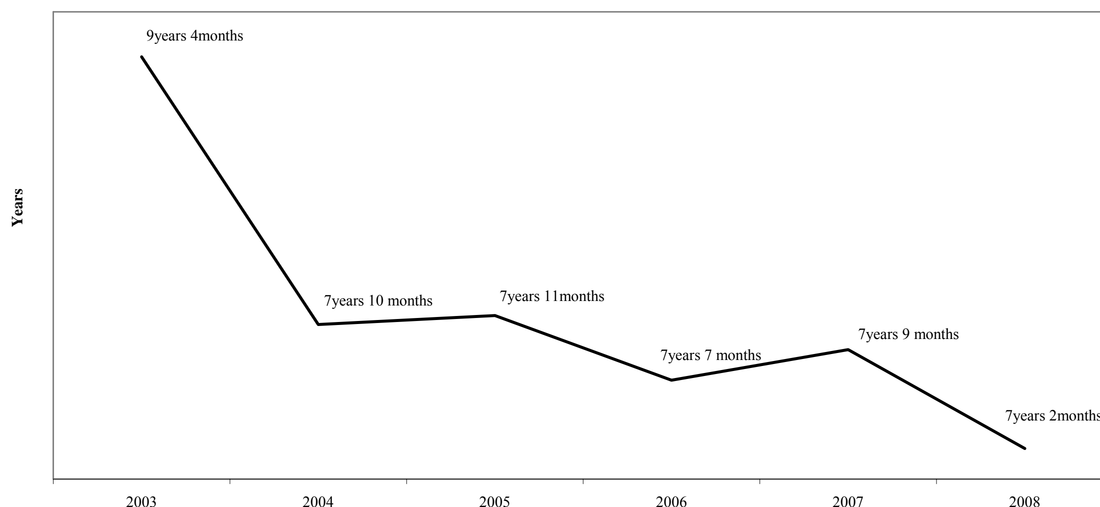


Source: MoF

- Average time to maturity (ATM) – a weighted sum of redemptions weighted by the time to maturity. The extension of maturity of debt limits the risk of changes in interest rates. That suggests reduction of accumulations of payments in the front end of the redemption profile and therefore exposure to refinancing risk. In principle in periods when the debt / GDP ratio is declining, the ATM parameter decreases too, in view of higher capacity of the government to absorb risk.

This parameter decreases in parallel with the decrease of the debt level. It has dropped from 7 years and 5 months in 2006 to 7 years and 1 month in 2008.

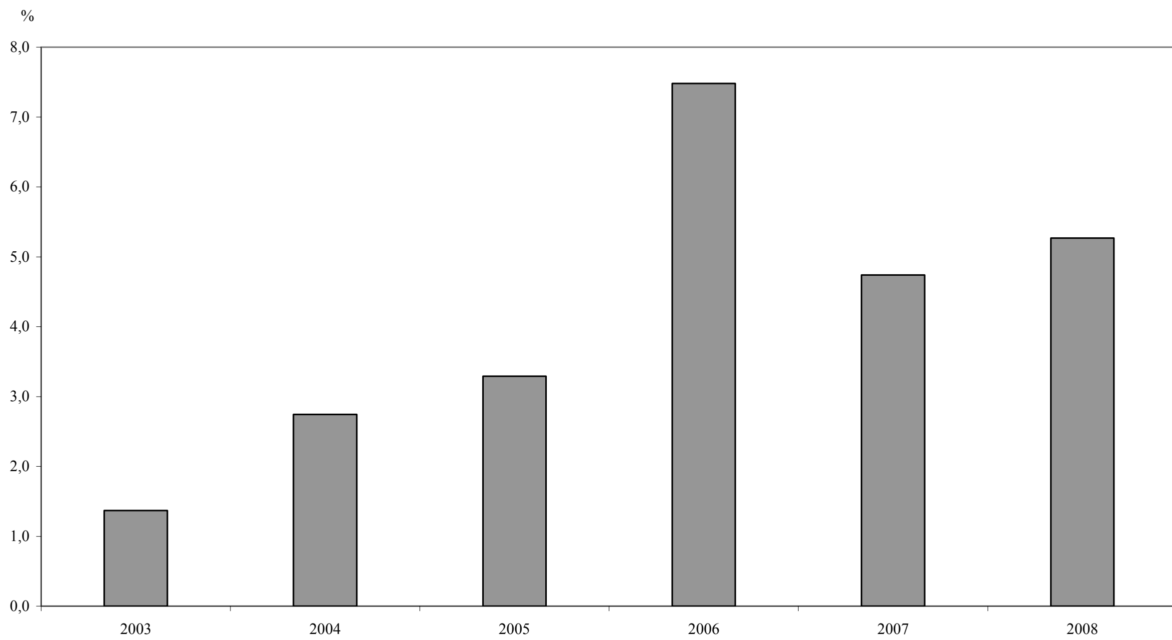
Average time to maturity of the government debt



Source: MoF

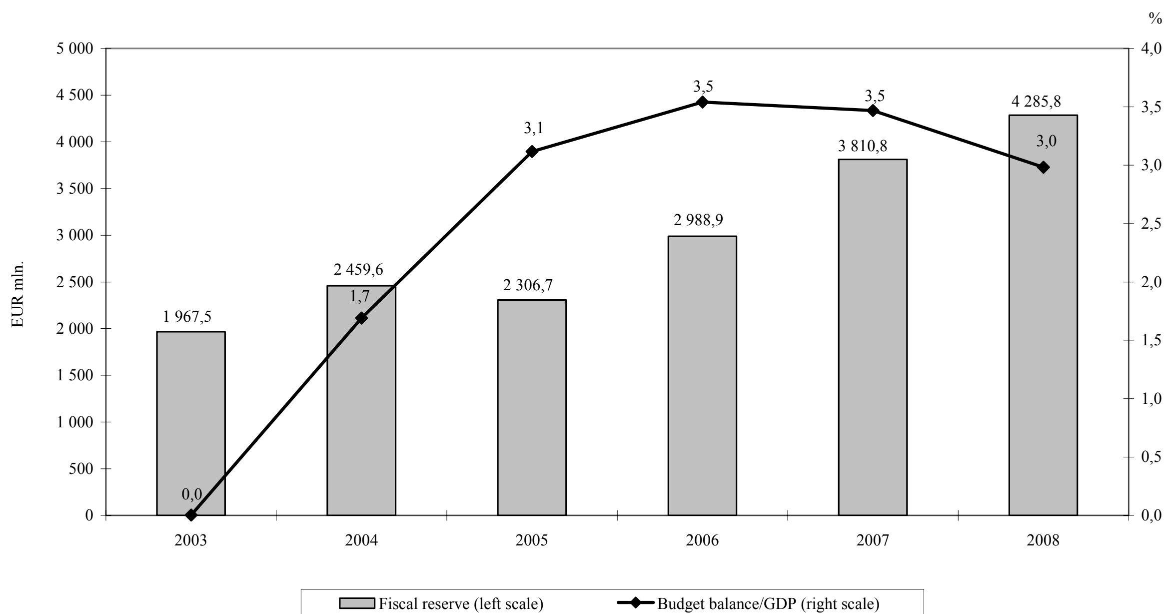
These two indicators (redemption profile and ATM) should be used in combination in view of the fact that the average time to maturity allows a smooth redemption profile.

- Share of short-term debt. During the period this indicator dropped by more than two percentage points and at the end of 2008 it reached 5.3%, thus indicating practical neutrality of the portfolio to this risk indicator. The reason for this decline is mainly the maturity of the euro-denominated bond in 2007.



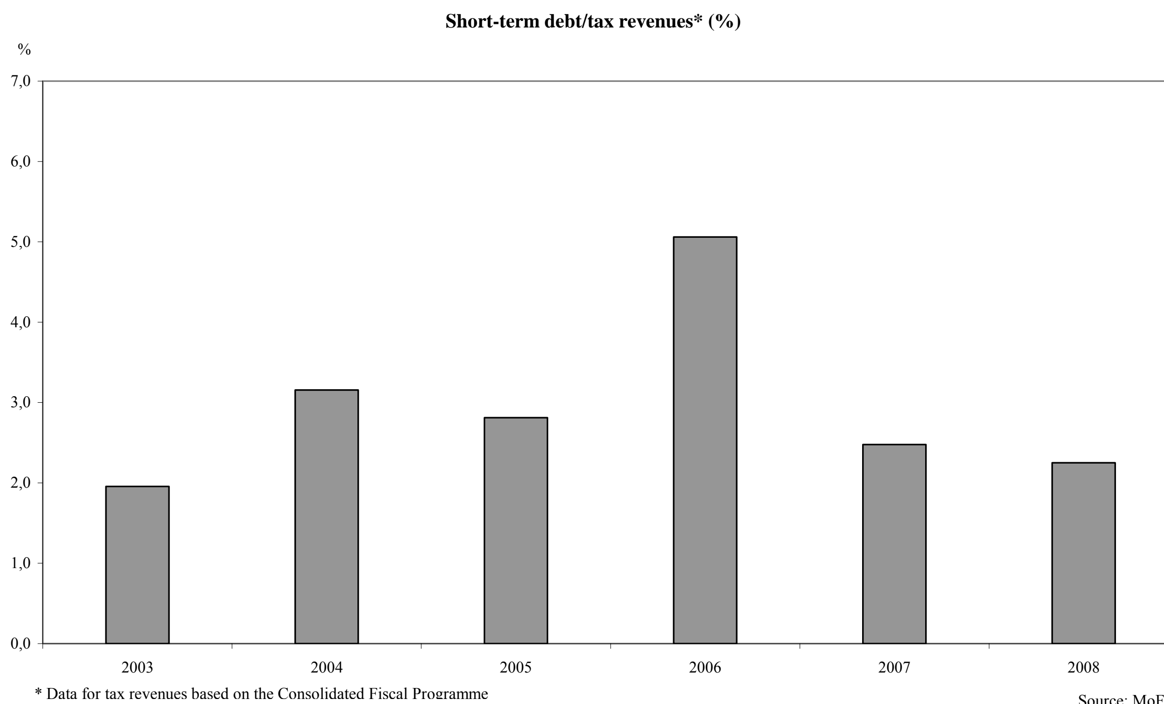
1.6. Liquidity risk

This risk is a specific type of the refinancing risk which takes into account the asset-side. It is defined by the need for liquid funds to cover short-term liabilities. It arises from the mismatch between the maturities and the liquidity of assets and liabilities. Factors with preventive effect on the risk exposure of the debt during the period have been the high budget surpluses (3.5% of GDP during the first two years of the period and 3% in 2008) and the availability of FR. Apart from exceeding many times the upcoming one-year payments on the debt and minimising the potential negative effects arising from liquid risks as at the end of 2008 the accumulated FR represents almost 90% of the total government debt. The financial resources generated by the government allowed the issuance of GS to be intended mostly for refinancing existing debt, promoting primary market and maintaining liquid secondary market.



The availability of such a resource will likewise make it possible to ensure lower prices of new financing because the borrowing of funds need not be strictly fixed in time and advantage may be taken of suitable market conditions. Besides it is a source of funds for early debt repayment.

Another risk indicator is the **short-term debt – tax revenue** ratio**.** Tax revenue increased during the period as a result of the stable GDP growth, the amendments in the tax legislation which significantly improved the tax collection rate, as well as the customs reform. Furthermore in view of the described short-term change trend, this indicator was sharply reduced, thus allowing a summary that liquidity risk is strongly limited.



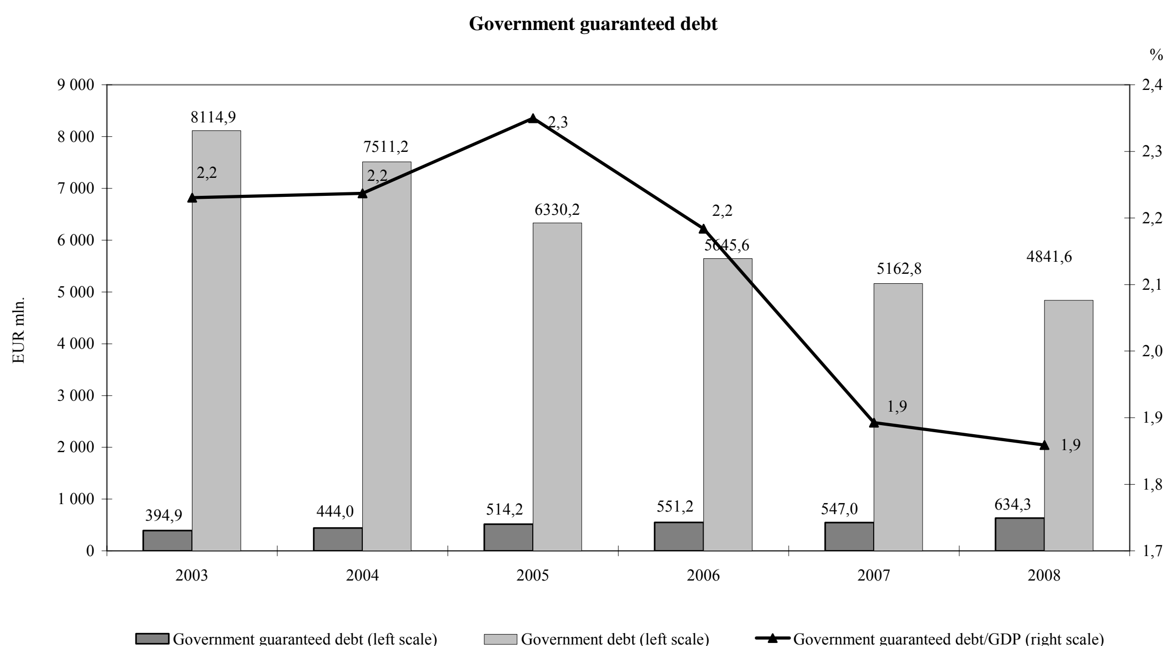
1.7. Risk associated with the assumption of contingent liabilities

The prevention of the risk associated with the assumption of contingent liabilities is mainly focused on an analysis of the profitability of the projects, which ensures the repayment of the loan commitments by the beneficiary, assessment of the potential risk guarantees to be called and allocation of buffers in the budget for their potential coverage. In view of the fact that significant strategic projects in the public sector which have difficult access to alternative financing are funded with instruments guaranteed by the government, their precise selection is of high importance. In this respect the compliance with the order and procedures set out in the Ordinance on the Conditions Which Have to be Met by the Investment Projects Financed with Loans from the State and the Projects Applying for Financing Guaranteed by the State and the Order for their Review[7]is a prerequisite for transparent selection of projects with the most economically favourable parameters and with limited risk to be called. This in turn, results in minimisation of the annual provisions to secure such potential liabilities in the SBL and facilitates the implementation of a more effective policy for allocation of public resources. Although the debt guaranteed by the government represents a contingency, under crisis conditions the probability for the state to step in and take over the beneficiary's rights under the loan agreement increases. This requires close monitoring of the loan service, as well as monitoring of the financial status of the borrowers. Indicators of this risk are the following ratios:

- State-guaranteed debt / government debt

[7] The Ordinance was passed by virtue of Decree of the Council of Ministers No 28 of 7.02.2003 (promulgated SG, issue 15 dated 14.02.2003)

- State-guaranteed debt / GDP



Source: MoF

1.8. Credit risk

Credit risk is the risk of non-performance of obligations under financial agreements. From the perspective of sovereign debt portfolio management this risk is associated with the bids approved on the GS auctions as well as the existence of a derivative instruments market. The turbulence on the global financial market stability reflected in a decrease the in issuer's credit ratings, which in turn results in an increase in the risk premium for new financing. The widening of the interest rate differentials raises the budgeted resource to cover the expenditures on new debt service. The analysis of the exposure to this risk of sovereign debt portfolios should take into account that the tradable debt instruments are more vulnerable to the influence of this risk. In global financial crisis conditions, revised credit rating, the issued benchmark GS are directly exposed to the changes of the domestic market parameters – a function of the global changes and they react with an increase in the yield. The data on the yield spreads of the 10-year bonds issued regularly on the domestic market and similar maturity bunds show a difference in the range of 300 b. p. at the end of 2008, and Global bonds denominated in EUR – respectively about 400 b. p. The borrowing expenditures from foreign banks and institutions are also increasing. On the other hand the credit derivatives market is also a market for the sale – purchase of credit risk, respectively credit protections. Since at present the sovereign debt portfolio management practically does not use any derivatives[8], these structured financial instruments are not part of the credit risk analysis and assessment.

1.9. Operational and institutional risk

Operational risk is identified mainly through the form of organisation of the management and control of government liabilities. Following and implementing the best practices as well as the legal provisions on the financial management and control in the public sector limit the exposure to this risk.

[8] With the exception of a foreign currency swap on a WB loan in 2003, in accordance with the Law on Ratification of the Base Agreement of the International Association for Swaps and Derivatives between the Republic of Bulgaria and the International Bank for Reconstruction and Development, Definitions "Issue 2000" and the Appendix representing integral part thereto (promulgated SG, issue 91 of 14.10.2003)

With this understanding in mind in February 2006 with the financial support of 2004 EU PHARE Programme, MoF launched a joint project with the Italian Ministry of Economy and Finance for the establishment of an Integrated State Treasury. In October 2007 the project was completed successfully and its task - "Harmonisation of the Functions and the Structure of the State Treasury in Bulgaria in Accordance with the Best Practices in the EU Member-States" was fully attained. A Concept of an Optimised State Treasury Model was developed and approved as a result of the project.

At present government debt management is carried out through an organisation of the activity based on clear policy on the implementation and control of the activities, as well as detailed provisions of the obligations of the various officers. In accordance with the established principles of organisation of the activity related to sovereign debt management, the operational responsibilities are allocated between units equivalent to the back, middle and front offices established in the international practice.

A new structure was set up in June 2007 within the debt management unit, designed to be responsible for the regulation of the financial markets and to assist the Minister of Finance in formulating the government policy in the area of financial markets and services, in maintaining the financial stability at national and Community level, in crisis prevention, and in case of occurrence – their rational management, as well as the adequate participation in the working formats of the EU.

The activities related to the minimisation of the assessed risk are directly related to the compliance with the approved Internal Control Standards[9], aimed at applying consistent, comprehensive and standardised internal control system.

In fulfilment of these standards detailed rules and procedures are developed dealing with the organisation and allocation of the activities within the structural unit in charge of debt management, as well as the deadlines for their implementation.

The risk of inadequate operational control is managed also through the use of suitable and reliable software with automated data processing. In relation to the commitments undertaken by Bulgaria to provide statistic data on the debt, in its capacity as full-fledged EU member state, mainly to Eurostat and ECB, Statistic Module is developed and is in use. The module is integrated with the Official Register of Government and Government guaranteed debt, while its main purpose is automation of the data processing, prepared in compliance with the commitments relating to government financial statistics. The incoming information flow includes data on the liabilities of all sub-sectors of Government Management Sector – Central Government, Municipalities and Social Security Funds.

The launching of the activities for the development of risk analysis and assessment module assisting the decision-making process and risk control in an environment of active debt management is envisaged in the short-term.

2. Risk exposure analysis at alternative debt management assumptions

Risk analysis generated by the current structure was made on the basis of a forecast issue calendar for the period 2009 - 2011, with underlying positive net financing from the domestic market, as well as planned foreign debt disbursements in the form of GIL and GL intended for the implementation of specified policies and ensuring national co-financing for the absorption of the resources from the EU funds. Subject of the analysis are also the external conditions and their trends for a change over the medium term period, by virtue of which our country strongly correlates and their subsequent effect on an open-type economy such as ours. On one hand the efforts of the global economies to overcome the crisis and the deepening lack of confidence in the global financial stability, were reflected as a drastic decrease in the interest rate levels in an attempt to encourage lending and to stimulate the real sector, and on the other, nationally – a hesitant decrease of the relatively high yield reached during the last quarter of 2008 on GS issued and decrease of the volumes envisaged for placement on the

[9] Developed on the grounds of the Law on Administration and the Law on Financial Management and Control in the Public Sector

domestic market. If such a functional dependence is retained, then it is possible to see a reorientation towards borrowing of external financial resource which is to be used to rebalance the debt structure in the following years. Two scenarios alternative to the basic one described above were considered. The first one analyses the hypothesis of a 50% reduction of the planed net domestic financing and issuance of a ten-year government bond on international market at the amount of EUR 200 mln. The second one assesses a hypothetical zero net domestic financing (only for refinancing of the outstanding debt) and international capital market issue at the amount of EUR 500 mln. with similar maturity. The results of the simulation show certain advantages of the second assumption scenario. The potential issuance at par of up to EUR 500 mln. would significantly facilitate the future redemptions on the Global bonds in 2013/2015 – years from the budget. The implementation of such opportunity would smoothen significantly the debt redemption profile over the medium term, will increase the portion of liabilities denominated in EUR, will maintain practically unchanged the share of the fixed coupons within the interest rate structure, the average time to refinancing will be increased by approximately one year until 2011, while at the same time the nominal debt amount will remain relatively stable, in the range of EUR 5.5 bln. and EUR 6.3 bln. The latter is particularly important given the unclear at present effect of the crisis on the economy growth. In a forecast for growth at levels based on updated assumptions in an environment of unstable external financial situation and maintaining close deviation range in the forecast amount of government liabilities, the main ratio - debt / GDP will remain under 25%. It should be explicitly clarified that the simulation experiment was based on the current information on the planned foreign loan disbursements and those under negotiation.

IV. Main government debt management objective and steps to attain it

The major objective of government debt management in the period 2009 – 2011 is to ensure the necessary resources for the budget financing and debt refinancing , at minimum cost, while hedging the financial risks and taking into account the development of the domestic capital market in the context of the financial system as a whole.

With a view to accomplishing it, the following **subordinate objectives will be pursued as priorities:**

1. Controlled increase of government debt while containing the reference level of the debt / GDP ratio within 25%.

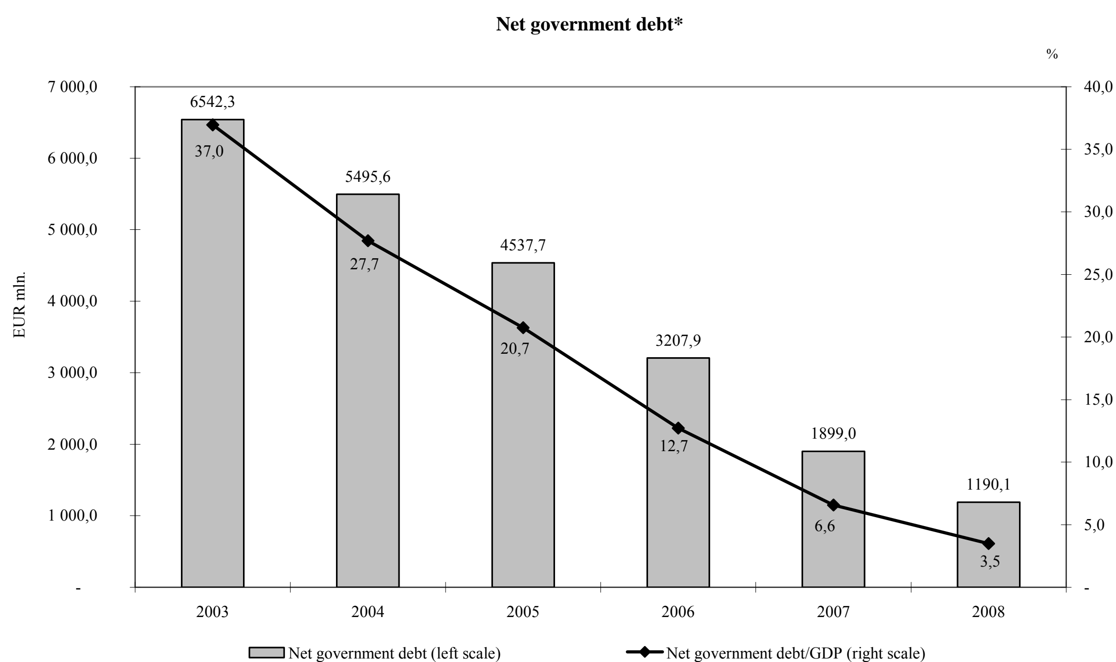
As already pointed out the period preceding the one under review in this strategy was characterised with gradual decrease in the government debt levels in absolute terms and relatively - as a ratio of the GDP, reaching levels far below the reference ones set out in the SGP. These achievements, together with the budget surpluses reached over the recent years and the FR maintained at a level significantly exceeding the one-year debt payments, allowed the new financing negotiated and the GS issued on the domestic market to be intended not towards ensuring the needs of the budget, but to be specially earmarked. In this respect during the next three-year period the envisaged increase in government liabilities will be aimed to support investment projects, government policies, including Bulgaria's participation in the EU Funds absorption, as well as maintenance of predictable and liquid domestic GS market. The risks for a country like Bulgaria in an environment of intensified turbulence at the international capital markets are related to the potential global slow-down or reduction of capital inflows, which would strongly limit economic growth. Decline in the economic growth is also expected due to the drop in consumption and slow-down in lending. Given such hypothesis of increasing debt, even moderately and weak growth of GDP, their ratio is expected to increase but within reasonable range – up to 25% over the medium term.

The financing of public sector projects with loans guaranteed by the government will follow the established legally regulated practice, suggesting analytical and restrictive approach, which at the same time allows public monitoring and control.

The implementation of the borrowing policy like that will ensure maintenance of the indicative debt parameters, compliance with the legally set government debt limits, and it will impact the expenditures related to its service.

Last but not least, the significant CAD and the gross foreign and municipal debts increasing over the recent years (as a function of the legally regulated financial decentralisation of the local budgets) largely predetermine the conservative approach in the management of government liabilities, which will be kept stable and at amounts not violating the established macroeconomic stability, while at the same time seeking and implementing solutions alternative to debt financing.

In this respect the restrictive and prudent government debt management policy implemented will be followed over the next three-year period, which will replicate fully the government's plans in the fiscal area.



2. Limitation of the government debt service expenditures

A trend for a slight increase in interest expenditures in absolute terms is expected during the next three-year period, and probably as a ratio to GDP and tax revenue as a result of the diverse directions of the changes taking place in the indicators – increase of the debt, slow down of economic growth (or temporary discontinuation) and possible decrease in the tax collection level. In this respect the reasonable limitation of the increase in debt expenditures in the upcoming 3-year period will contribute to the implementation of the policy followed in the budget area despite the low base reached at present. The implementation of the priority set will be ensured mainly in two directions – on one hand, strict observance and control over the newly agreed financing and on the other hand, the maintenance and possibly increase of the share of fixed interest debt and debt in risk neutral currency – EUR and BGN. Maintaining and strengthening the local debt market, while taking into account the limitations imposed by the developments in the global economic crisis, as well as the preferences of the major government debt investors will also have effect on the amount of the debt service expenditures. Interest expenditures over the next three years are expected to be in the range of 1.5% of the updated assumptions for economic growth for the period.

2.1. Maintaining a dominating share of government debt denominated in BGN and EUR above 75%.

The currency structure of the debt in the upcoming period is largely predetermined having in mind the specifics of the current market situation, the medium term financial markets trends in the country and globally, as well as in the context of the macroeconomic framework – Currency Board Arrangement in effect, the exchange rate of BGN to EUR fixed, full membership of the country in the EU and last, but not least – export revenue having significant share of proceeds in EUR. The financial resource borrowed on the domestic market will be denominated mainly in the national currency, and the new foreign financing will be negotiated mainly in EUR. For the purpose of eliminating the effects of the market fluctuations in the exchange rates of the other currency the strategic priority in the management of government liabilities is clearly defined and followed. It is aimed at maintaining the share of EUR and national currency denominated liabilities at levels above 75%. Depending on the development of the financial crisis (status at the international markets, key indicator rates) and taking into account its immediate impact on the macroeconomic stability of the country, analysis of the possibility to issue on the foreign capital markets of sovereign EUR denominated securities with fixed interest is assumed – features which will further reduce the exposure to market risks and will improve its structure.

2.2. Gradual increase in the portion of fixed interest rate government debt above 70%.

The change in the interest rate structure can be implemented **passively** through the borrowing policy using the advantages of the existing international market situation with unprecedented low interest rate levels at present and / or through the implementation of **active** operations at appropriate conditions. The following years will see borrowing policy oriented mainly towards financing through borrowing from reputable lending institutions, possibly where the terms and conditions allow fixed coupons. The volumes of the securities envisaged for realisation will be maintained in accordance with the implemented policy of establishing a stable and liquid domestic market, while taking into account the interests of the issuer. These instruments are usually issued with fixed coupons, to meet the market standards and are aimed at covering a broader investor base. Thus, following the principle of priority financing at fixed interest rate coupons and following the planned floating rate debt amortisation schedule, liabilities with fixed service expenditures will increase gradually and they are expected to reach more than 70% at the end of the period.

Although at present the amount and structure of debt payments does not necessitate the use of derivative instruments – currency and / or interest rate swaps, it is possible (for example in case of significant increase in the interest rates and swaps in EUR and US D) to use such in the future in order to optimise the interest rate and / or currency risk, as well as to adjust the duration of the debt.

2.3. Maintaining a smooth government debt redemption profile

The maintenance of a smooth debt redemption profile reduces the refinancing risk of the sovereign debt portfolio, while at the same time it ensures the maintenance of smooth allocation of service expenditures in the budget over the following years. The debt has an evenly distributed amortisation schedule over the 3-year period under review, based on the forecast issue calendar and the planned foreign debt disbursements (including such in process of negotiation). In order to meet the objective in longer term, in view of the maturing Global bonds in 2013 and 2015, when relative increase in payments is expected, the possibility for execution operations such as redemption, exchange, issue aimed at using the resource for redemption of a certain portion can be considered and assessed over the period of

effectiveness of this strategy. This will reduce the budget funds required to service the debt in the respective years. The results of the simulation experiment prove that undertaking such activities in favourable market conditions would improve other debt characteristics, including some risk indicators, in addition to significantly smoothing the debt amortisation profile.

3. Ensuring stable sources of budget financing and government debt refinancing

3.1. Domestic market financing

Priority sources of budget financing and debt refinancing are the GS issued on the domestic market.

The GS issue process is carried out while monitoring and analysing the dynamics of the macroeconomic, fiscal and market factors nationally and globally and required taking into account the following aspects:

- The current interest rate levels both in the country and in the EU member states;
- The yield on the benchmark GS in the European Union;
- The role of the domestic market as a source of financing;
- The fluctuations in the liquidity of financial markets, etc.

Assessing the global financial crisis effects on the Bulgarian economy and on the financial sector in the country the MoF intends to continue its policy for priority issue of GS on the domestic market, while maintaining the offering of 3-, 5- and 10-year bonds already known and established at the market, of BGN 250-350 mln. each, as well as issues of 3-month treasury bills with a total volume of approximately BGN 40-50 mln. The offered issues will have fixed coupons and will be denominated in BGN. Extreme priority for the MoF is the issuance of 10-year GS in volumes ensuring high liquidity of the securities, in view of compliance with the requirements for a long-term interest rate for the convergence assessment.

The issue calendars will support the liquidity on the key GS maturities – three month, three-year, five-year and ten-year respectively with priority benchmark volumes on the ten-year bonds.

In parallel the new domestic debt issuance will correspond to the outlined goals and commitments undertaken for the maintenance of a liquid benchmark yield curve with a focus on its long end.

3.2. External market financing

External borrowing within the upcoming three-year time horizon will be aimed at strengthening and development of the strategic cooperation with the IFI, as an important source of financing, which is envisaged to be oriented in the following three directions:

3.2.1. Financing intended to support the government of the Republic of Bulgaria in the implementation of medium term reforms and of policies in various areas

The priorities set out in respect of the use of foreign credit resources are characterised by the same spirit of continuity as the external market financing principles and goals underlying the GDMS 2006 – 2008. Medium term borrowing again will be implemented along the line of leading IFI which allow relatively quick access to their financial products at favourable terms and conditions. During the first year of effect of this Strategy the government of the Republic of Bulgaria will continue and complete loan disbursement under the WB Partnership Strategy effective during the current year and aimed at convergence with the living standards in the rest EU member states. The disbursed financial resources will support the implementation of policies with the following goals:

- progress in the social sector reforms, acceleration of growth and convergence with the EU;

- increase in employment and laying the foundations for lasting increase in productivity through incentives for the creation of new jobs, improvement of the quality of education;

- stimulation of the financial sustainability of the social sectors through improvement of their effectiveness.

The facts that the adverse consequences of the global financial crisis and the challenges to the EU convergence emphasise the importance of the existing commitments in the structural and institutional reform agenda are also taken into account. In this sense the IFI support, apart as a source of financing, will be considered in the light of the technical assistance offered by them in support of the successful transition of the country from centrally planned to full market economy. In confirmation of the above mentioned, as an addition to the agreed financing extension of the cooperation of the Republic of Bulgaria with the WB is expected through the conclusion of a new Strategy for Regional Partnership with the Central European and Baltic Countries covering the period 2009 – 2013. The new Strategy will outline the framework for the future cooperation of the Bank with our country.

Another direction in the development of the relations with IFI results from the full membership of our country in the EU and the possibility to support the national co-financing for projects (which is a relief for the state budget) in the priority sectors for Bulgaria and facilitation of the optimum absorption of the resources from the Structural Funds and the Cohesion Fund.

The financing under the Loan Agreement for Structural Programme Loan (Bulgaria, Co-financing of the EU Funds 2007 - 2013) between the Republic of Bulgaria and EIB has a similar purpose. Its utilisation will be over the time of validity of this Strategy. The loan is granted to support the balance of payment in the implementation of structural reforms and policies in sectors which are a priority for the government. It is also intended to support mainly the national co-financing and if necessary, the refinancing of Transport and Environment Operational Programmes as they will be used to finance mainly strategic infrastructure projects of national importance, which are a priority for the EIB as well.

Furthermore, not only during the time of implementation of this Strategy, but also during the following years, the analysis and assessment of the innovative financial products offered by the IFI will be of interest in the context of their purpose, priority lending areas and, of course, financial terms and conditions.

3.2.2. Financing aimed at the implementation of specific programmes and significant infrastructure projects in priority areas of the social and economic life

Over the period under review foreign financing will be oriented to already planned GIL, as well as to the new priority projects financing and programmes in key areas for which the support of IFI will be sought. It is important to point out that the financing through GIL will be intended for projects which have no access (or access is difficult) to other resources. In this sense the main principle to be observed in approving such loans is that priority projects meeting the financing criteria under the different operational programmes will not be financed through loans, in order to create the opportunity for ensuring funds for national financing.

Domestic financing is envisaged to cover the shortage of funds in strategic areas such as social assistance, infrastructure, transport, etc. over the period under review.

The financing institutions which will ensure funds for the timely implementation of projects within the priority sectors set out include IBRD, EIB, Nordic Investment Bank, Credit Institute for Recovery, etc.

3.3.3. International capital market issue intended to restructure existing liabilities

During the next medium term period subject to analysis and in-depth study will be the possible issue of securities on the international capital markets aimed mainly at the

restructuring of the redemptions on the Global bonds of the Republic of Bulgaria in EUR and USD, maturing in 2013 and 2015 respectively. A direct consequence of the possible restructuring of the outstanding liabilities of the government will be the following effects:

- Smoothing of the government debt redemption profile;
- Decrease of the effect of debt in the upcoming government expenditures which will ease the burden on the budget especially in 2013 and 2015 and will release significant financial resources from the state budget, which may be reallocated to other areas;
- Extension of the sovereign benchmark yield curve.

3.3. Government guarantees

Proposals, for which issuance of state guarantees is required are subject to careful and precise analysis in the context of the outlined government priorities, in strict compliance with the legislative framework, regulating the terms and conditions to undertake this kind of liabilities.

The increasing need to implement large-scale infrastructure projects, to develop key sectors of the economy suggests urgent financing mechanism and predetermines the support of the state in respect of the borrowing, agreed at the best cost possible.

The reforms launched in the energy, transport and in the education sectors during the recent years raise the need to implement projects meeting the high needs in these sectors.

In this respect undertaking new contingent liabilities within the period will be focused mainly on providing government support for projects of national importance.

During the period emphasis is placed on the deployment of the potential of the established student lending model. The commitments of the state in this model are regulated in the Student and Doctoral-Candidate Loans Act. It regulates the terms, the order for the lending and the government financial support. Loans are granted for the whole or part of the training period in accordance with the educational plan for payment of the tuitions and / or subsistence.

Last, but not least, in the context of the packages of measures applied within the EU[10] in the form of financial support schemes aimed at overcoming the effects of the global crisis, the possibility to apply the guarantee schemes-related measures will be subject to in-depth monitoring and analysis. The potential use of such instruments, however, may be considered only if necessary and following assessment of the condition of the financial system and the financial institution in particular, taking into account the effectiveness of undertaking measures to stabilise the financial market and encourage lending to the real sector in the country. The potential use of guarantee schemes will be closely coordinated with BNB.

4. Development of the government securities domestic market

During the last few years some of the efforts were focused on reduction of the existing misbalance between the domestic and foreign debt, taking into account a number of factors, such as borrowing cost, condition at the domestic and international capital markets, preferences of the main sovereign debt investors, speed and access to borrowings, development of the GS domestic market, etc. The situation at the domestic debt market at present facilitates the government debt management policy to continue to incorporate efforts aimed at maximum use of the conditions for increase in financing through the issue of GS on the domestic market. The efforts of the Ministry of Finance to maintain a liquid GS market through the implementation of safe and predictable issue policy will continue to contribute to affirming the role of GS as one of the main instruments for financing of the borrowing needs of the state. Such acts will contribute to the stabilisation of the capital market as a whole, on one hand, and on the other – for the achievement of high efficiency and transparency of the

[10] Report of ECOFIN Council to the European Union of 18-19 June 2009, regarding *the effectiveness of the financial support schemes*

cost of borrowing. The existence of a developed secondary market of GS and the establishment and maintenance of liquid benchmark yield curve are the foundation of the formation of adequate market valuation of the sovereign debt outstanding. Last but not least the development of the domestic market of government debt, especially in a situation of financial crisis and massive reallocation of capitals, is one of the prerequisites to prevent the outflow of capitals from the country.

The presumption as to maintaining the interest of the investors to the Bulgarian domestic government debt is largely facilitated by the need to ensure further safety and stability in the financial sector as a whole. To this end the efforts will continue to be aimed at stimulating the demand for GS through the application of a more differentiated approach to the potential investors (segmentation of the market). Such segmentation would take into account the different interests of the GS buyers, the terms of the debt instruments, their liquidity and inflation risk, etc. The diversification of the debt instruments may be well combined with the efforts to develop effective financial markets, which requires the issue of large volumes of highly standardised GS ensuring a well-functioning domestic capital market.

The directions for the future development of the GS market are in ensuring sufficient diversity of types of securities, both in terms of issue in volumes guarantee its normal functioning, and safe harbour for GS investors at a time of financial crisis. Last, but not least, encouraging the development of the GS domestic market is a guarantee for the successful adoption and implementation of active measures by the MoF at the domestic debt market, if necessary, including in case of liquidity difficulties within the banking system, such as repo auctions, buy backs and exchange of sovereign debt, etc.

5. Coordination and exchange of information between the Ministry of Finance, the Bulgarian National Bank and the Financial Supervision Commission in the context of the global financial crisis, as well as relations with Eurostat and rating agencies

Ensuring the normal functioning of the processes in the economic and financial system in particular means keeping the trust in the Currency Board. Therefore the crisis prevention , and in case of occurrence of such – their effective management with minimum public resources is of particular importance to the welfare of society.

On the grounds of the existing national legislation, including that of the EU, an Action Plan has been developed in case of a "financial crisis" which is to ensure cooperation between the BNB, MoF and FSC, and if necessary with the BDIF, by establishing procedures for exchange of information and assessments of the situation of the financial system, including the coordination of the overall assessment of the processes in the financial system. The strict compliance with the Plan will facilitate the fulfilment of the functions and tasks of the different institutions and will assist the ensuring and maintenance of the financial stability in the country.

The cooperation between the institutions at national and EU level, both in normal circumstances and at times of financial crisis will be mainly in the form of:

- Exchange of information required for prevention, management and resolution of systematic financial crises;
- Exchange of assessments of the financial system operation, aimed at facilitation of the timely assessment of the systematic nature and consequences of the crisis, using a systematic assessment framework[11];
- Coordination of the public communication and development of overall communication policy in situations threatening the financial stability and financial crisis;
- Implementation of stress tests and simulation exercises at national level and participation in simulation exercises at EU level.

[11] In accordance with the Memorandum of Understanding regarding the financial supervision authorities, Central Banks and Ministries of Finance in the EU member states for cross-border financial stability, in effect as of 1 June 2008.

5.1. Relations with Eurostat

Intensive development characterises the relations of our country with the European institutions according to the commitments for regular submission of statistical information. Bulgaria, as EU member state, has the obligation to prepare and provide quarterly data on the liabilities of General government and its sub-sectors – Central Government, Municipalities and Social Security Funds[12], and also to report Notification Table on the Deficit and Debt twice a year[13]. In this respect a priority is the continuation of the efforts aimed at achieving optimum compliance of the government financial statistics with the requirements underlying the European System of Accounts (ESA 95) and the Manual on Government Deficit and Debt.

5.2. Relations with rating agencies

Under the signed Credit Rating Agreements the active dialogue with the four international rating agencies – Standard and Poor's, Fitch Ratings, Moody's Investors Service and Japan Credit Rating Agency continued, aimed at supporting the process of realistic assessment of the current macroeconomic situation in the country, which is reflected in the sovereign credit rating set. The ratings are public and are used both by the recipients of the rating and other subjects (investors, analysis, etc.) and market players, which predetermines their huge influence on the financial markets globally.

Legislative acts and other documents

- Government Debt Act;
- State Budget of the Republic of Bulgaria Act for the respective year;
- State Budget Procedures Act;
- Municipal Debt Act;
- Bulgarian National Bank Act;
- Act to settle Non-performing Loans contracted by 31 December 1990
- Credit Institutions Act;
- Public Offering of Securities Act;
- Markets in Financial Instrument Act;
- Financial Management and Control in the Public Sector Act;
- Regulations settling the possibility to issue state guarantees to secure financial liabilities of these parties, such as: Bulgarian Development Bank Act, Bank Deposits Guarantee Act, Insurance Code, Export Insurance Act, Student and Doctoral – Candidate Loans Act, Social Investment Fund Act.
- EU Regulations in the area of financial services and markets;
- EU Regulations in the area of state financial statistics;

[12] In accordance with Council Regulation (EC) № 1222/2004 of 28 June 2004 concerning the compilation and transmission of data on the quarterly government debt

[13] In accordance with Council Regulation (EC) № 3605/1993 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community and subsequent amendments

- Decree of the Council of Ministers on the execution of the State Budget of the Republic of Bulgaria in the respective year;
- Ordinance No 5 of 2007 on the order and conditions to acquire, register, settle and trade with government securities;
- Ordinance No 31 of 2007 on the settlement of government securities;
- Ordinance No 15 of 2007 on the control over government security transactions;
- Ordinance on the order to use government term bonds issued under the Law on Settlement of Non-Performing Loans Agreed until 31 December 1990, regarding redemption of liabilities to the state arising under this law;
- Ordinance on the terms and conditions to be met by investment projects financed with state loans and the projects applying for financing with state guarantee and the order for their assessment;
- Ordinance No 9 of 2003 on the order, manner and deadlines to provide information as to the position and movement of municipal debt and social security funds;
- Ordinance No H-19 of 2006 on the scope of information which all municipalities are obliged to record, maintain and provide to the Ministry of Finance in respect of debts undertaken in accordance with the requirements of the European Union and the Bulgarian legislation on the reporting, statistics and budgeting in the public sector, as well as on the order, manner and deadlines for reporting and submission of such information;
- Government Debt Management Strategy for the period 2006-2008;
- Guidelines on the execution of the state budget in 2009.