BD2011-051a

**BLACK SEA TRADE AND DEVELOPMENT BANK**

# BULGARIA

## Country Strategy

## 2011-2014

**THESSALONIKI**
**APRIL, 2011**

**BoD Approved**

## TABLE OF CONTENTS

**Table 1: Basic Macroeconomic Indicators at a Glance**

Country Long Term Foreign Currency Sovereign Risk Rating: **S&P: BBB | Moody's: Baa3 | Fitch: BBB-**

| No. | INDICATOR | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Population (end-year; million) | 7.64 | 7.61 | 7.56 | 7.44 | 7.40 | 7.35 | 7.31 | 7.26 |
| 2 | Average exchange rate (BGL / USD) | 1.43 | 1.34 | 1.41 | 1.48 | 1.57 | 1.63 | 1.66 | 1.69 |
| 3 | Inflation rate (CPI Avg.; %) | 8.4% | 12.3% | 2.8% | 2.4% | 3.3% | 3.4% | 3.0% | 2.8% |
| 4 | Average monthly earnings (USD; 1995-1998 data for public sector; 1999 on for total economy) | 301.11 | 406.59 | 431.97 | 437.44 | n.a. | n.a. | n.a. | n.a. |
| 5 | GDP at current prices (BGL m) | 60,184.63 | 69,295.03 | 68,321.61 | 70,474.30 | 80,149.10 | 85,070.60 | 90,473.70 | 96,994.10 |
| 6 | GDP at current prices (USD bn) | 42.12 | 51.82 | 48.72 | 47.77 | 51.21 | 52.20 | 54.60 | 57.53 |
| 7 | GDP / capita (in crt. prices; USD) | 5,512.32 | 6,812.54 | 6,441.57 | 6,926.96 | 6,922.61 | 7,098.48 | 7,472.41 | 7,921.94 |
| 8 | Real GDP growth (%) | 6.5% | 6.2% | -5.5% | 0.2 | 2.6% | 3.7% | 4.1% | 3.9% |
| 9 | Unemployment rate (ILO definition; eop; %) | 6.9% | 5.6% | 6.8% | 10.2% | 8.2% | 7.2% | 6.6% | 6.0% |
| 10 | Industrial output growth (%) | 12.4% | 4.4% | -7.8% | 1.9% | 4.0% | 5.2% | 7.2% | 7.5% |
| 11 | Agricultural output growth (%) | -27.3% | 29.6% | -6.1% | 3.9% | 1.5% | 1.5% | 1.5% | 1.5% |
| 12 | Remittances - Current transfers, net (USD m) | 984.18 | 1,279.21 | 1,290.85 | 2,035.90 | 1,920.50 | 1,904.70 | 1,937.30 | 1,984.20 |
| 13 | Direct foreign investment in the country (USD m) | 13,214.50 | 9,926.78 | 4,594.59 | 1,600.00 | 3,550.00 | 5,500.00 | 6,100.00 | 6,500.00 |
| 14 | Consolidated budget balance / GDP (%) | 3.3% | 2.9% | -0.9% | -3.9% | -3.0% | -1.4% | -1.1% | -0.5% |
| 15 | Gross external debt (USD m) | n.a. | n.a. | n.a. | 35,696.30 | 34,186.30 | 33,590.60 | 34,632.70 | 34,927.20 |
| 16 | Gross external debt / GDP (%) | 94.30% | 104.87% | 107.99% | 101.79% | 66.8% | 64.4% | 63.4% | 60.7% |
| 17 | Public external debt / GDP (%) | 13.3% | 11.1% | 12.0% | 11.9% | n.a. | n.a. | n.a. | n.a. |
| 18 | Private external debt / GDP (%) | 81.0% | 93.8% | 96.0% | 89.9% | n.a. | n.a. | n.a. | n.a. |
| 19 | Goods: Exports (f.o.b.; USD m) | 19,469.00 | 22,484.20 | 16,377.60 | 20,863.30 | 22,450.60 | 24,031.40 | 26,295.30 | 28,709.30 |
| 20 | Goods: Imports (f.o.b.; USD m) | -30,041.00 | -35,107.70 | -22,152.90 | -23,623.00 | -25,924.00 | -28,080.00 | -31,227.00 | -34,498.00 |
| 21 | Trade balance (exp. f.o.b. - imp.f.o.b.; USD m) | -10,572.00 | -12,623.50 | -5,775.30 | -2,759.70 | -3,473.40 | -4,048.60 | -4,931.70 | -5,788.70 |
| 22 | Trade balance / GDP (%) | -23.55% | -24.27% | -11.95% | -6.70% | -6.8% | -7.8% | -9.0% | -10.1% |
| 23 | Current account balance (USD m) | -11,437.00 | -11,888.00 | -4,751.15 | -91.50 | -1,350.30 | -2,048.30 | -2,795.80 | -3,188.50 |
| 24 | Current account / GDP (%) | -25.20% | -23.12% | -8.93% | -0.99% | -2.6% | -3.9% | -5.1% | -5.5% |
| 23 | Forex reserves (excluding gold; eop; USD m) | 16,477.90 | 16,815.50 | 17,127.30 | 14,754.20 | 16,250.40 | 17,414.40 | 17,789.30 | 18,415.30 |

Last updated on April 14, 2011

Sources:

Data for items 1, 5, 8 from National Statistical Institute

Data for items 2-4, 9,  15 from Bulgarian National Bank

Data for item9 Unemployment rate - Annual averages, following the ILO definition.

Data for items 10-11 from EIU Country Reports & Profiles

Data for items 12-13, 17-18, 21 in USD from IFS, IMF, January 2011; same data in EUR from Bulgarian National Bank

Data for item 14 from the Ministry of Finance

Data for items 23 from IFS, IMF, January 2011

Numbers in bold blue revised by BNB

Projections from EIU Country Data (Latest update - 14 January 2011)

## I. Recent Economic Developments and Outlook

Bulgaria is a middle-sized country, member of the EU, with a population of 7.5 million and GDP per capita of about USD 6,500. The effects of the crisis were serious, but the economy stabilized towards the end of 2010. The macroeconomic environment is expected to improve in 2011, when real GDP is projected to grow by 2.5 to 3.0%. The currency board arrangement proved resilient through the crisis and is expected to continue contributing to macroeconomic stability. The Bulgarian banks have weathered the crisis well. Although, profits are declining and NPLs rise, banks' capital and provisioning are high, by international standards and provide a reasonable cushion against the effects of the crisis. The banking system's liquidity is very high by any standards – with very high liquidity ratio, continuing growth and significant share of core deposit funding.

### *a. Real Sector*

Following the 2007 EU membership the expectation of large amounts of EU funds, the confidence in the EU convergence process, and the subsequent sovereign rating upgrades, had a positive impact to the already favorable investment climate. The strong fiscal performance[1] and the sizeable reduction in public debt prior to EU accession provided an anchor of stability. This, along with the confidence inspired by the expectations of improvements in living standards, spurred investment as well as consumption, as the main engines of growth. This strong growth has been buoyed also by high levels of foreign direct investment and foreign-financed expansion of domestic credit.

In 2008, just as the world economy was approaching the point of implosion, the Bulgarian economy was booming with real growth at over 6%, fixed investment growing at almost 22%, inflation accelerating to over 12%, current account deficit ballooning at over 23% of GDP, and foreign debt skyrocketing to over 100% of GDP. This development model led to accumulating internal and external imbalances. In spite of its notable socio-economic achievements, Bulgaria remained facing important development challenges, e.g. poor infrastructure, energy inefficiencies, high regional disparities, and growing income inequality.

The reduction in domestic demand, after years of excesses, sent a shock wave throughout the economic system. The adjustment in the number of jobs in some non-tradable sectors has been profound, resulting in an increase in unemployment by 50%, and seems not yet over. The reliance on cheap credit was replaced by high levels of precautionary savings and household balance sheet restructuring, with a combined dumping effect on domestic demand, which remained weak throughout 2010.

After going into recession in 2009, the Bulgarian economy recovered in 2010. The rapid increase in exports compensated for the continuous sharp contraction in domestic consumption and investment, to result overall in a 0.2% growth rate for 2010. This "stagnation" actually masks a very positive turning point, a reference moment in the return of the Bulgarian economy to a path of sustainable growth starting with 2011, after 2010 has been a year with encouraging signs for stabilization of investments, when manufacturing started to create new jobs again.

Persistent unemployment and excess capacity, along with high precautionary savings, should continue to weigh on individual consumption as the economy moves into 2011. Furthermore, excess capacity and lack of investor confidence coupled with the need for fiscal consolidation would most likely prevent any pick up in investment in 2011.The engine of growth therefore is manufacturing and in particular the export sector.

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[1] 2005 budget surplus was 2.4% and the 2006 target was 3%

As the economy starts growing again, at an expected just below 3% rate in 2011, before accelerating to the new long term potential growth rate of 4%, conditions are ripe for balanced growth on the back of a prudent policy framework, with the expected result of gradual decline in the foreign debt to GDP ratio. With increased absorption capacity of EU funds, the economic recovery has the potential to contribute to more even regional development and equitable income distribution, with corresponding improvement in social indicators.

### *b. Public Sector and Fiscal Policy*

*Public Policy*

Over the past years the Bulgarian government has committed itself to pursue a cautious budgetary policy and to continue adhering to the currency board arrangement. Under the currency board arrangement there is an institutionalized fixed exchange rate to the Euro, and the central bank does not control directly the monetary base except for minimum reserve requirements and is not allowed to hold any form of Bulgarian debt. For this reason the stability of the monetary regime requires not only fiscal prudence, but in fact prevents to a large extent the use of fiscal policy for demand management. Consequent to the above, Bulgaria has actually recorded significant fiscal surpluses, which have been accumulated into the government's fiscal reserves. At the onset of the crisis the reserves amounted to about 20% of GDP.

Vulnerabilities prior to the crisis, reflected in growing domestic and external imbalances, constrained the ability of the government to respond to the challenges raised by the global economic and financial crisis, as there was only limited room to relax fiscal policy, and almost no room for accommodating monetary policy. While the incremental financial flows that were expected from the EU were slow to materialize, Bulgaria had ample fiscal reserves, and the government was ready to spend its reserves without issuance of new public debt or crowding out access to credit.

The use of the fiscal surplus was substantial for about seven consecutive quarters. Currently the size of the fiscal reserve is less than half of its size in October 2008. It is difficult to assess the effectiveness of such policy stance since the economy contracted severely in 2009, but it is fair to assume that the contraction might have been far larger in the absence of the stimulus. It is fair to say that the contraction of the economy in 2009 was due to the nature of the Bulgarian economy, small and open with fully liberalized current and capital account and fixed exchange rate, subject to large fluctuations in financial flows (credit, FDI, remittances). Therefore, the fiscal effort of the government was larger than shown by the use of fiscal reserves alone, as the economic contraction resulted in lower revenues and in the end a relatively large fiscal deficit of about 5% of GDP. However, at the beginning of 2011 the effects of the crisis were well contained, and the economy is poised for a sustained resumption of export led growth.

The general government debt, excluding state guarantees, increased to EUR 5.39bn as of the end of December 2010, when total public debt accounted for 14.7% of the full-year GDP. Domestic government debt went up by 30.7% in annual terms. External government debt rose to 62.6% of the total. The fiscal reserve covered 57.1% of the public debt at the end of December, excluding state guarantees. The ratio was reported at 81.2% at end-2009 and 88.5% at the end of 2008.

*Fiscal Policy*

The Government is committed to prudent fiscal policy for the future, to restore the fiscal balance and thus to provide the necessary support for the sustainability of the currency board agreement, and for debt reduction. This would require a prudent and improved expenditure management. Some cost cutting measures were already implemented in 2010, including job cuts in the public sector and expenditure reductions. In addition to the measures implemented in 2010, and in order to avoid further deterioration of the fiscal position, the government adopted a medium-term fiscal consolidation program containing additional expenditure-cutting and revenue-raising measures. The aim is to exit the EU Excessive Deficit Procedure and to ensure medium-term fiscal stability. The program targets a budget deficit declining from 2.5% of GDP in 2011, to 1.0% in 2013.

Within this framework, imbalances are projected to diminish gradually, complemented by a higher degree of absorption of EU funds. This policy stance may be facilitated by a temporary decline in private demand and a corresponding increase in savings. In order to enhance its impact, the fiscal policy would need to be supported by substantial growth promoting structural reforms addressing the product and labor market, with a view to support competitiveness.

### c. *Monetary and Financial Sector*

*Monetary Policy & Inflation*

Bulgaria's consumer price inflation accelerated in the period preceding the crisis, but fell sharply in 2009. In 2010 some inflationary pressures reemerged due to higher alcohol and tobacco prices, but overall CPI averaged just 2.4% for the full year. Provided that the anticipated gradual fiscal consolidation is accompanied by a policy mix of strict income policies and moderate rate of growth of domestic credit, inflation should remain in between 2 and 3% for most of the planning period. Also planned reductions in public expenditures should also have a dampening effect on prices.

However, in 2010 salaries increased in nominal terms by 9.7% (in real terms by 7.1%) after having also increased by 13.3% in nominal terms in 2009[2], in spite of the fact that employment declined by 6.2% in 2010 and that unemployment, calculated using ILO methodology, is 10.2%.

Looking ahead, there is some inflationary pressure coming from internationally higher food and energy prices, but core inflation should remain low, as existing excess capacity and high unemployment would reduce the pressure on wages and producer prices, and therefore inflation should normally decline in 2011. However, inflation may inch up above expectations if commodity prices continue to rise.

One of Bulgaria's main objective is to gain access to the ERM-II as a first step towards the full adoption of the Euro as the official currency, maintaining the Currency Board arrangement in place. The ultimate aim of achieving ERM-II entry and adopting the Euro has been delayed by the global crisis, but Bulgaria plans to undertake the necessary structural adjustment measures to accelerate the process once the effects of the crisis recede.

*Banking & Financial Sector*

The Bulgarian financial system proved resilient to the global crisis, benefiting from a strong regulatory and supervisory framework. Bulgaria's banking system remains well capitalized, with robust provisioning levels. The system-wide capital to risk-weighted assets ratio still stands at end-2010 at 17.48%, comfortably above the minimum limit of 12%.

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[2] The statistics used is the monthly one. In addition, the annual statistics on wages points to a further deceleration in the wage growth of 6.3% in 2010 (3.8% real-term growth) rather than the 9.7% (7.1% real-term growth), the latter according to the monthly statistics.

However, there is increasing evidence of the adverse repercussions of Bulgaria's buoyant economic growth of past years on the health of both corporations and financial sector institutions. Prior to 2008 non-performing loans (loans that are overdue by 90 days or longer) remained stable at around 2.3 % of total loans. Non-performing loans (bad and restructured loans) rose to 14.2% of the total from 8.3% at end-2009, and 2.44% at the end of 2008, and are likely to continue to rise further into 2011. The share of loans overdue by 90 days or more[3] rose to 11.9% of total as of the end of December as compared to 6.42% at end-2009. As a result of the deterioration of the quality of the loan portfolio and of an increase in bank funding costs the net profit of banks declined in 2010 by 21% in comparison to 2009, according to BNB data. According to the latest data as of January 2011, the liquidity position of the Bulgarian banks remains stable and adequate. The ratio of liquid assets to liabilities is 23.76%, impairments were covered by core activity revenues and banks generated a positive net profit amounting at 46 mln. Leva[4]

One particular concern for the health of the banking sector might be the fact that according to the World Bank's latest *Doing Business 2011* report, bankruptcy and liquidation procedures for the real sector can take up to 3.3 years on average (compared with an OECD average of 1.7 years), with a low recovery rate of 31 cents per US dollar (compared with an OECD average of 69 cents per dollar). However, there is no evidence that Bulgarian banks are affected by this fact.

### *d. External Sector*

*External debt*

The general government debt position (public debt) is very low, at just 16.1% of GDP at the end of 2010, well below the level registered in 1997 when the general government debt was 105% of GDP. In January 2011 it fell further to 14.7% of GDP. This in itself is a remarkable achievement.

Currently, the prevailing share in total volume of government debt is in government bonds traded on foreign capital markets (33%), followed by government bonds traded at home (31%) and government loans - 19%. State guaranteed debt as a percent of GDP is expected to remain within two percent

However, private debt is large: according to the Bulgarian National Bank the gross foreign private debt position, as of end-2010, was 89.9%of GDP, contributing to a total gross external debt of 101.79%of GDP.

Debt-to-GDP ratio may decline slightly over the forecast period, falling below 100% of GDP in 2011 due mainly to good trade performance in 2010 and 2011, but also as a result of effective measures towards fiscal consolidation. The lack of credit availability and presumably a higher cost of credit would act to limit the potential for growth of the Bulgarian economy.

*Foreign trade*

The buoyant growth of Bulgaria's economy, that has been evident in recent years, has been accompanied by a substantial increase in the country's external vulnerability. In fact, buoyant domestic demand, fueled in part by rapid bank credit growth, has boosted imports and contributed to an increase in inflation. The widening of the current account deficit, which has accompanied past strong GDP growth, has been rapid and substantial.

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[3] Loans as defined by Ordinance №9 of the BNB

[4] Press release of BNB for January 2011

Having risen sharply in 2005-07, the current account deficit narrowed in 2009 to 8.9% of GDP. Figures released by the Bulgarian National Bank show a further improvement in 2010, to the point of achieving a balanced current account. The improvement mainly occurred in the merchandise (goods) trade, with a very strong rise in export. Although bolstered by the recovery in certain EU markets, export earnings shot up more rapidly on non-EU trade, notably with Turkey. The ability of the Bulgarian tradable sector to make swift changes in the direction of trade and take advantage of the potential for cooperation within the BSEC space proved a winning bet. In 2010, the current account also benefited from a larger surplus on services trade, mainly as a result of lower spending on tourism and transport abroad by Bulgarian residents.

Credible macroeconomic policy framework, anchored by the currency board mechanism and a prudent medium-term fiscal framework, should continue to attract sufficient capital inflows to 'finance' the current account deficit. FDI levels should increase after they have fallen to a third of the 2007 level, and remittances should also strengthen as the EU economy recovers.

### *e. Forecast for 2011-2014*

Last year's positive signs are encouraging. Bulgaria's economic growth is set to accelerate in 2011 and remain strong in 2012 and most likely beyond. Such growth is expected to be fuelled in particular by export, and subsequently by increasing investment flows.

In 2011 domestic demand is expected to expand by almost 3%, recovering somehow from the very sharp declines of 14.2% in 2009 and almost 6% in 2010. After having fallen sharply, fixed investment is likely to rise by just over 5% especially as the pick up in export has pushed capacity utilization up to 67.2% in the final quarter of 2010. Consumer spending however is expected to remain flat in 2011, after shrinking by nearly 4% in 2009 and 5% in 2010.

The growth of exports of goods and services should accelerate to reach substantially higher levels, following the adjustment in 2009 and 2010. Still, on the supply side, persistently high energy and comodity prices will probably continue to hold back growth – at least in some sectors, and in particular construction.

The Convergence Program of the Bulgarian Government – based on a 2009–2012 macroeconomic framework elaborated under the assumptions of the European Commission, the International Monetary Fund, and the Agency for Economic Analysis and Forecasting, and on estimates of the Ministry of Finance, the National Social Security Institute and the National Health Insurance Fund – provide a policy framework focused on the achievement of a desired set of medium-term objectives. The policy aims at maintaining macroeconomic and financial system stability, adequate domestic market liquidity, support to the currency board arrangement regime, and finally joining ERM II.

The medium-term budgetary objective of a surplus of 0.5% of GDP satisfies the triple aim set in the Stability and Growth Pact, and provides a fiscal policy framework to ensure long term stability of public finances:

a. providing a safety margin with respect to the 3%-of-GDP deficit limit;
b. achieve a structural budget deficit of 1.75% of GDP;
c. stabilise the level of government debt at 60% of GDP;

During 2010-2012 the main objectives of government domestic debt policy is to limit government debt servicing costs, with interest costs within 1% of GDP.

*Opportunities*

Over the period 2011-2014 real GDP growth is expected to to be more broad-based as a result of successful structural reforms underpined by prudent macroeconomic policy. However, looking ahead, persistent unemployment, slower wage rises in the public sector; more moderate growth in bank lending and the end of the construction boom are likely to restrain the pace of domestic demand growth – at least over the 2011-2012 period.

Thereafter, the expected effect of combined rising investment rates, acceleration of economic restructuring, pick up in export oriented activity in manufacturing (where past investments start to show results) and renewed domestic demand from 2012 onwards, would likely be an acceleration of growth to its long-term potential of about 4% per annum.

Exports should perform well in 2011-2014 and shall make an increasingly positive contribution of net exports to GDP formation. The achievement of sustainable growth is expected to trigger some employment growth and unemployment is thus set to decrease over the planning period to well below 10 percent.

*Challenges*

While Bulgaria has great potential for GDP growth in future years, nevertheless important challenges still lie ahead. More explicitly, Bulgaria must continue to maintain macroeconomic stability, make progress on structural reforms to sustain growth momentum, and achieve further reductions in poverty and unemployment, while improving income distribution.

Further reforms in the health, education and social security, as well as developing administrative capacity, are necessary in order to support fiscal consolidation on a long-term sustainable basis. The main risks in the implementation of the budget in the medium term are related to:

1. slowdown of domestic demand and economic growth;
2. more unfavourable structure of economic growth in the medium term;
3. ageing of the population resulting in a pressure on the pension system;
4. poor absorption of EU Funds.

The expectation that economic growth will be driven mainly by export also constitutes a risk for the budget, because export is not subject to taxation; an economic growth generated by exports would result in a rate of growth in tax revenues lower than the rate of growth of GDP.

As mentioned in a recent World Bank report, "removing structural barriers can strengthen growth without bringing back unsustainable domestic demand booms fuelled by excessive credit expansion. The reform agenda includes easing regulations for doing business; increasing incentives for labor force participation and skill acquisition; and facilitating technology absorption and market integration".

Such broad based reforms might require the support of international institutions in coordination with the EU. The World Bank is preparing a new strategy for partnership with Bulgaria in the period 2011-2015 to help the country achieve sustainable growth through focusing on policy reforms and strengthening the institutional capacity in specific sectors.

## II. Overview of BSTDB Portfolio

*Cumulative Operational Portfolio*

Since the start of operations, the Bank has made significant efforts to identify suitable operations for Bank financing. The strategy of much of the BSTDB's operations in the country has been mainly to support major manufacturing companies, the financial sector and to promote SMEs, but also to provide support for infrastructure, and in particular for renewable energy. When necessary, BSTDB financing has been made available via the financial sector.

Cumulatively, from the beginning of operations in June 1999, the Bank's Board of Directors has approved 23 operations for a total of USD 281 million, representing 9.7% of the total approved amount.

*Active Portfolio*

As of end-December 2010 the Bank's portfolio of operations in Bulgaria amounts to USD 121 million in 9 BoD approved operations, representing 8% of the active portfolio. The outstanding amount is USD 71 million in 9 operations, representing 8% of the total outstanding amount.

**Table 2: Current BSTDB Portfolio - BoD Approved Operations**[5]

USD

| No. | Operation | Type | Amount approved | BoD Approval | Signing Date | Amount signed | Outstanding amount |
|---|---|---|---|---|---|---|---|
| 1 | ProCredit Bank Medium-Term Senior Loan | Debt – Micro and SME Loan | 43,062,500 | 10/1/2003<br>27/02/04<br>03/12/05<br>07/06/08 | 24-Feb-03<br>16-Mar-04<br>21-Dec-05<br>7-Jul-08 | 38,425,000 | 19,212,500 |
| 2 | Trans-Balkan SME Equity Fund | Equity investment / Financial Institutions / Private sector | 1,333,334* | 16/6/2000 | 20-Jul-00 | 1,333,334 | 0 |
| 3 | Maritza East I * | A/B Loan; Syndication | 23,850,000 | 01/10/05 | 7-Dec-05 | 23,850,000 | 23,850,000 |
| 4 | Balkan Accession Fund* | Equity Investment Fund | 2,920,300 | 10/08/06 | 4-Oct-06 | 2,920,300 | 1,731,520 |
| 5 | BM Leasing | SME Credit line | 6,625,000 | 27/07/07 | 7-Feb-08 | 6,625,000 | 4,416,667 |
| 6 | Bulgarian American Credit Bank* | Loan | 16,562,500 | 01/02/08 | 23-Apr-08 | 16,562,500 | 0 |
| 7 | Emerging Europe Accession Fund* | Equity fund | 1,555,108 | 25/09/09 | 21-Jun-10 | 1,545,833 | 18,426 |
| 8 | Bulgarian Development Bank* | Credit line | 10,600,000 | 25/09/09 | 9-Oct-09 | 10,600,000 | 10,600,000 |
| 9 | Suvorovo Wind Farm* | Renewable energy | 14,575,000 | 20/11/09 | 15-Jan-10 | 14,575,000 | 11,144,026 |
| | **TOTAL** | | **121,083,742** | | | **116,436,967** | **70,973,140** |

*Operations in EURO; exchanged to USD for the rate as of end-December 2010

[5] As of December 31, 2010.

## III. Review of Country Strategy

### INTRODUCTION

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2007-2010 Country Strategy for Bulgaria. Its goal is to provide accountability to the Board of Directors and Board of Governors as well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated targets with actual results as of end of 2010, and provides a country-oriented analytical picture. A mid-term evaluation of the Country Strategy was conducted in early 2009 and reported to the Board of Directors and Board of Governors in June 2009, as part of the Annual Evaluation Overview, issued by the Evaluation Office.

### PERFORMANCE OF BULGARIA COUNTRY STRATEGY 2007-2010

The 2007-2010 Country Strategy was approved by the Board of Directors in early 2007, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier strategies, conducted by the Evaluation Office in late 2006. It was aligned with the objectives of the Bank's Business Plan 2007-2010 and was therefore evaluated in that context.

Overall, the implementation of the Country Strategy was consistent with the Business Plan implementation. The performance of the strategy is rated as Partly Unsatisfactory, as the targets were implemented at about 50%, including the intended sector coverage, as illustrated in the following table.

| Post Evaluation of 2007-2010 Country Strategy Bulgaria (approved 04.02.2007) | | | | |
|---|---|---|---|---|
| 2007- 2010 TARGETS | | | RESULTS (end of 2010) | |
| **General** | **Sectors** | **Target operations:**<br>**Number approved / number signed;**<br>**USD approved/**<br>**USD signed (million)** | **Actual operations:**<br>**Number approved / number signed;**<br>**USD approved/**<br>**USD signed (million)** | **Evaluation Summary** |
| Assistance with the EU accession process and in compliance with the Memorandum of Understanding between the EU and WB, EBRD, EIB, NIB, IFC, NEFC, CEB and BSTDB.<br><br>Priority to direct financing of infrastructure, energy and transport. | 1. ***Trade finance***<br>2. ***Financial sector***<br>▪ Residential mortgage credit lines<br>▪ Finance banking consolidation<br>3. ***SME sector***<br>▪ Direct financing of medium size companies<br>4. ***Manufacturing***<br>▪ Focus on post-privatization investments, and investments of local companies<br>▪ Support exporters and regional cooperation<br>5. ***Transport***<br>▪ Finance transport, jointly with IFIs/banks<br>6. ***Tourism***<br>7. ***Energy and Infrastructure***<br>▪ Energy transportation infrastructure, mining<br>▪ Public-private partnerships and private concessions (water/sewage, | 16/13<br>137/NA | 6/6<br>64/32 | ***1. Volume:*** modest, below 50% of target values:<br>Approved number: 38%<br>Approved volume: 47%<br>Signed number: 46%%<br>Signed volume: N/A<br><br>***2. Sector coverage:***<br><br>ProCredit bank (SME)<br><br>BM Leasing (SME)<br><br>BAC Bank (SME)<br><br>Emerging Europe Accession Fund (Equity, SME) |

| | | | | |
|---|---|---|---|---|
| | etc.)<br>▪ Finance for 'downstream' operations,<br>▪ Co-finance infrastructure with EBRD and EIB<br>*9. **Telecommunications, IT/Media***<br>▪ Upgrade of telecommunication infrastructure<br>▪ Expansion of telecom in other countries<br>▪ IT and media | | | Bulgarian Development Bank (SME)<br><br>Suvorovo Wind Farm (Energy)<br><br>***3. Performance:*** Partly Unsatisfactory**.** Targets generally achieved at 50% levels, including sector coverage. |

## IV. Priorities for 2011 – 2014

**The economic policy of the Bulgarian Government** is directed at development of three priority sectors:

- **Information and communication technologies** - Bulgaria has traditions in this sector and large number of well trained IT professionals. Sector is characterized by high productivity and growth in value added. Bulgaria has already gained good reputation in this sector among the leading companies worldwide.

- **Eco and energy-saving technologies –** Bulgaria is energy-intensive economy and most of the energy resources are imported. The priority is put on the introduction of energy efficient technologies, taking in account the targets set in the Strategy Europe 2020.

- **Health Innovation** – Bulgaria has great potential in the field of health and healthy lifestyles - a large number of well trained medical staff, developed pharmaceutical industry, opportunities for healthy foods production.

**Areas for BSTDB Financing**:

The Bank's role and priorities are defined (i) in accordance with the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2011-2014* and (ii) country needs and objectives, as well as (iii) available resources, strategies and policies of BSTDB. In this respect, BSTDB will seek viable opportunities and will continue closely monitoring the developments in the Bulgarian economy in order to stand prepared to support bankable projects in all sectors pertaining to the Bank's field of action. In addition the Bank shall seek co-financing opportunities with IFIs, public sector institutions and private partners.

The BSTDB will focus in the next four years on providing support for the implementation of the Government program and priorities, while responding to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities promoting export of goods and services, and development of infrastructure, including energy efficiency. In addition, through selected intermediaries, the Bank would attempt to expand its financing programs in favor of SMEs.

Based on the 2011- 2014 BSTDB Medium Term Strategy and Business Plan (MTSBP), the Bank would expect to approve about 4 new operations per annum during this period, for approximately EUR 47.3 million per year. Over the four year period, this implies around 14 to 18 approved operations for approximately EUR 166.5 million to EUR 212 million. This scenario would involve a substantial expansion of activities in Bulgaria during the 2011-2014 period. With the Bank determined to raise the level of commitments (signed operations) to approved operations to over 85%, the Bank expects signings for 2011-2014 to be on the order of 13 to 16 operations for EUR 167 million (a range of EUR 147 million to EUR 187 million).

These indicative targets are based on the Base Case Scenario of the MTSBP, and given appropriate circumstances and sufficient operational opportunities the Bank would make efforts to exceed this level. In case of higher regional economic growth rates, increased demand for Bank funding, and an improved situation in financial markets, a phased increase in the average number and size of operations would allow the Bank to move towards achieving the targets envisaged under the High Case Scenario.

Moreover, at the Mid-Term Review, depending upon performance and prospects, the above targets may be revised upwards[6].

The Bank will consider undertaking activities and providing services in Bulgaria as may advance its purpose, including but not limited to:

- Providing facilities in the form of well-balanced debt-equity finance and convertible loans;
- Providing a range of banking activities and special products aimed at promoting the access of Bulgarian public or private enterprises to the international and domestic capital markets;
- Entering into appropriate financial sector operations.

**Trade Finance and Financial Sector** Strategy have been created in order to develop a network of financial intermediaries, through whom to deliver its trade finance and SME finance products.

Since BSTDB began its operations, the following products have been introduced through selected financial intermediaries in Bulgaria for the purpose of Trade Finance, Micro Finance, and SME development:

- Pre-export finance Facility
- Combined Trade Finance (export/import) product
- Medium –Term Micro and SME Finance product
- Leasing Facility for SMEs

BSTDB supports the economic development in Bulgaria, in particular by providing financial assistance in the following areas:

*Trade finance* is necessary to provide financing for increasing exports and expanding regional trade. Financing to exporting companies may help improve competitiveness and content of value added in exports.

*SME sector* – is in need of medium term finance, which would promote modernization of equipment and diversification of products and services. In addition, job creation and income generation effects of SME sector development may have positive social impact. BSTDB will continue to offer SME products through eligible Financial Intermediaries in conformity with the Bank's SME Strategy, using Commercial and Development Banks as well as Leasing Companies.

The Bank intends to use the leasing product not only for financing capital expenditure of SMEs but also for other companies as an effective financing tool for the promotion of regional trade. Medium-term credit lines opened to leasing companies for trade related purpose will enable them to offer their customers finance for capital expenditures on imports from other countries in the region.

BSTDB was cautious to provide Mortgage Financing for individuals, while commercial banks were very active in this sector. However, within the framework of SME Financing, BSTDB provides loans for real estate investment of SMEs for commercial purposes.

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[6] Under no circumstances would targets be revised downwards unless the lower case scenario of the 2011-2014 BSTDB Business Plan were to be followed.

The Bank will also consider the option to take equity participations in selected financial institutions and funds, and will also seek to develop quasi-equity products, such as subordinated loans.

The Bank will also keep in regular contact with complementary international financial institutions (IFIs) such as EBRD and IFC to seek ways to coordinate activities and share experiences, given the opportunities which exist for joint involvement.

Thus, BSTDB will focus on supporting local enterprises especially for their modernization and expansion investments that increase their global competitiveness. Financing modernization of sea and river ports, airports and motorways will also be among the priorities of the Bank within the next four year period in transportation sector. The Bank will actively seek co-financing possibilities with local and international banks for such projects.

**Manufacturing:**

The structural transformation of the economy to a more competitive one within the EU is the main challenge of Bulgaria. Especially after the EU accession, some local companies in Bulgaria faced problems in terms of competitiveness. These companies had to catch up with EU standards, which usually required substantial amount of capital expenditure. The Bank will continue to support local companies for their modernization and expansion investments. Foreign investments have significant contribution to the Bulgarian economy, despite relative slow down in recent years. Such investments are particularly important in bringing know-how and up-to-date technology to the country and also to increase employment. The Bank will support such foreign investments that have positive economic impact for the country. This support will be in the form of equity and quasi equity, where it is deemed financially feasible.

Bulgaria has competitive advantages in production of paper, pharmaceuticals, and basic metals (both ferrous and non-ferrous). These sectors are export oriented and have significant contribution to the exports of the country.

However, there is still space for further growth and improvement in these sectors. The performance of these sectors was good despite the crisis during last years, and expectations for the coming years are also positive. BSTDB will focus on the modernization, expansion, and green field investments in these sectors. Also, investments aiming at improving efficiency and at reducing environmental pollution would be given priority to finance.

**Transportation:**

Transportation investments are important growth drives for the country's economy. Major cross country roads and highways are supported by the EU funding schemes. The Bank will actively look for opportunities in financing transport projects, jointly with other IFIs and commercial banks.

Thus, BSTDB will focus on supporting local enterprises especially for their modernization and expansion investments that increase their global competitiveness. Financing modernization of sea and river ports, airports and motorways will also be among the priorities of the Bank within the next four year period in transportation sector. The Bank will actively seek co-financing possibilities with local and international banks for such projects.

**Real Estate and Tourism:**

Construction and real estate sectors were badly affected by the global crisis during the last few years. There has been a boom of supply of residential, office, and retail space activities, while demand remained smaller. Consequently the vacancy rates remain high and the sector is in a stagnant situation. The investors' indebtedness is usually also high due to this downturn. Thus, BSTDB will be very selective in financing projects in this sector.

Regarding tourism, the investments were focused on big cities and on the coastline so far. The tourism potential in some less developed mountain areas is yet to be explored. Cultural tourism is also considered as a priority for BSTDB financed projects.

The Bank will focus on selected, high quality tourism projects in the less developed regions. This would contribute to the reduction of regional inequalities in the economic development of the country.

**Infrastructure**

The BSTDB's energy and infrastructure strategy in terms of financing instruments will be the medium and long-term loans to both local companies including those with foreign participation and foreign companies, which will utilize the loan proceeds in one or several BSEC countries. The Bank will use these instruments not only for the purpose of financing capex, corporate and development needs but also for financing of working capital requirements as well as for re-financing of existing borrowings of local companies.

The Bank will consider project opportunities where BSTDB may provide financing in the form of equity and/or quasi equity instruments. The proactive marketing will be focused on the following areas, however the Bank will pay due attention to other areas too:

*Energy and Infrastructure*

Given the E&I development needs, so long as projects are 'bankable', the Bank will be keen to offer support. This applies to all key infrastructure sectors, including energy (especially renewable) and electricity, transport infrastructure, telecommunications, and municipal infrastructure. The existence of an appropriate competitive environment and regulatory framework will be an important consideration in ascertaining 'bankability' alongside development impact. In particular, the Bank will be looking forward for more "renewable energy" opportunities (especially solar and wind power) to appear as the new "renewable energy" law is in place (expected during 2011).

In case of the consideration of financing at the privatization stage of any E&I objects, the presence of a strategic investor would be key factor for the Bank, and the Bank's assistance would likely come in the form of post-privatization financing to upgrade facilities and restructure.

Other involvement in infrastructure operations will need to be via creative arrangements such as public-private partnerships.

The Bank will continue to ensure that all BSTDB E&I operations in Bulgaria meet sound banking principles and comply with the Bank's Environmental Rules and Procedures and incorporate, where appropriate, Environmental and Social Action Plans.

The Bank will also maintain its contacts with complementary international financial institutions (IFIs) and organizations such as EBRD, IFC, KfW, DEG, OEaB, etc. to seek ways to coordinate activities and share experiences.

<u>BSTDB Energy and Infrastructure strategy in terms of banking instruments:</u>

- Project Finance limited recourse transactions;
- Corporate recourse financing transactions;
- Exploration of financing in form of Equity;
- Co-financing of transactions with other international financial institutions, and commercial banks;
- Participation in the syndicated facilities for the E&I deals in Bulgaria

<u>Areas of particular focus in Energy and Infrastructure:</u>

- Energy (including renewable),
- Electricity,
- Transport infrastructure
- Telecommunications,
- Municipal infrastructure

*Telecommunications, Information Technology and Media*

- Projects, which support upgrade and extension the telecommunication infrastructure.
- Projects involving IT, software and hardware assembly, and development of media businesses.

The Bank will continue to ensure that all BSTDB operations in Bulgaria meet sound banking principles and comply with the Bank's Environmental Rules and Procedures and incorporate, where appropriate, Environmental and Social Action Plans.

The Bank will work in cooperation with other IFIs and commercial banks in joint energy and infrastructure sector projects as an important source of institutional knowledge transfer.