GOVERNMENT DEBT MANAGEMENT STRATEGY

SOFIA
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RESUME

The government debt management strategy is a document that summarizes the objectives of the government on the debt management policy in the medium term. It is prepared pursuant to the Government Debt Law and covers a three-year period. Its main objective is to familiarize the public with the directions of the development of this sector and respectively the impact, which it will have on the entire economy of the country.

The strategy is comprised of three parts. The first one gives information on the present state of the institutional structure, the regulatory arrangements, the organization of the management and status of the debt as of the end of 2002.

The second part reviews the risks arising from the size and structure of the debt and defines the objectives of the management policy, which must lead to minimizing these risks. The major objective is to ensure the financing of the budget and refinancing of the debt at a lowest possible cost in medium- to long-term consistent with a prudent degree of risk. A number of sub-objectives have been set for achieving the major goal. The prerequisites for achieving them have been reviewed as well as the reasons, which require the respective changes.

The third part includes specific measures, which the government envisages to take for achieving the objectives. They are determined in accordance with the state and outlook for development of the different sectors of the economy and are consistent with the macroeconomic forecasts in a three-year horizon. Different scenarios have been outlined depending on the performance and on the domestic and international market environment.

The document is backed by data analyses and statistics whose goal is to present the basis of the presented analyses and set objectives.

The strategy will be updated annually in accordance with the economic development, the market indicators and the achieved results. It will be approved by the Council of Ministers together with the three-year budget forecast.

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The government debt management strategy is intended to outline the key avenues and priorities of the medium-term debt policy. The significant volume of the debt and of the expenditures on its servicing and refinance have had a considerable impact both on the budget of the country and on the balance of payments, banking system and money market. In view of the above, a debt management policy is extremely important for maintaining macroeconomic stability and confidence in the currency board system. Setting 2007 as the objective for accession to the European Union and, accordingly, accepting the requirements of the monetary union also results in new requirements for the institutional organization and infrastructure of the domestic market. The present document covers the years 2003 through 2005 on the basis of the budget framework and macroeconomic development forecasts while setting longer-term objectives in the context of economic processes associated with the accession, as well as with commitments to meet membership criteria.

I. Institutional Structure and Regulatory Arrangements

The **Government Debt Law** was passed in 2002; the law unified existing regulatory arrangements and ensured clarity with regard to procedures and the authority to issue debt.

The Council of Minister is the body, which assumes debt on behalf of the state and issues government guarantees pursuant to the requirements of the Constitution. The authority to issue government securities and to negotiate and sign government loan agreements and government guarantee agreements within the confines established by the State Budget Law is delegated to the minister of finance. The Ministry of Finance manages and monitors the debt, as well as provides official information. The Bulgarian National Bank is the agent for government and government guaranteed debt. The responsibilities envisaged for the Bulgarian National Bank are maintaining systems for registering and servicing the debt, organizing and holding auctions of government securities, registration of transactions with government securities in the secondary market, participation in the selection of primary dealers, and other mutually agreed activities.

The law prohibits the growth of the ratio of consolidated government debt (central government debt, local governments' debt and debt of the social insurance funds) to GDP until its volume exceeds 60 percent. Limits set annually in the State Budget Law on the maximum volume of new government and government guaranteed debt which may be assumed were also introduced, as well as the maximum outstanding government debt as of the end of the year.

The local governments' debt, debt of the social insurance funds, the Bulgarian National Bank, and other local entities shall not be government debt and shall not entail any obligations for the state except where a government guarantee was issued.

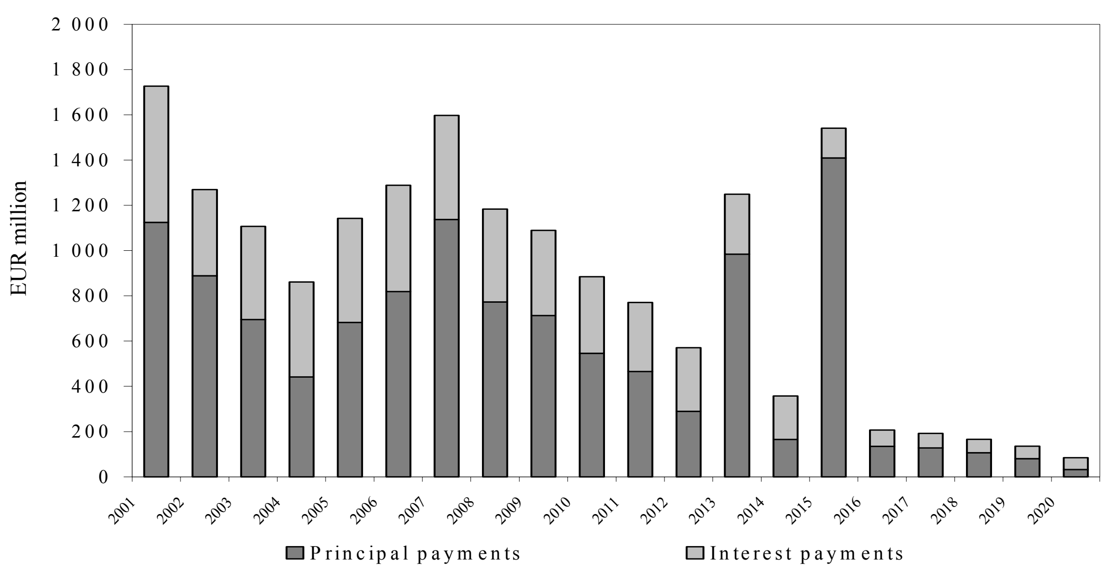
Government guarantees are issued by the Council of Ministers in compliance with the requirements of the Constitution with regard to ratification. The negotiation and signing of guarantee agreements and letters of guarantee is delegated to the minister of finance. Projects, which are financed by loans with a government guarantee are selected by the Council of Ministers; a list of such projects constitutes a part of the law on the state budget for the respective year.

II. Debt Structure

As of the end of 2002, government and government guaranteed debt amounted to EUR 9.3 billion; external debt accounted for 88.4 percent and domestic debt for 11.6 percent. Debt to GDP ratio is 56.0 percent. The bulk of the debt is denominated in foreign currency whereas only 8.2 percent is denominated in leva. The balance is mostly in U.S. dollars (55 to 56 percent, taking into account the dollar-denominated component of SDR debt), which was preordained by the borrowing policy in the 1980s and early 1990s. With political and trade priorities oriented toward the European Union, the share of euro-denominated obligations also increased. In December 2002, their share was 31.5 percent (including the euro-denominated component of SDR debt). The interest rate structure of the debt likewise is not balanced: obligations on which floating interest rates are paid account for 59.1 percent. The debt is relatively well distributed – the larger portion of obligations has a maturity of over 5 years. The years 2007, 2013, and 2015 are exceptions: when issues of Eurobonds and global bonds come due.

Chart 1

Payments on Domestic and External Government and Government Guaranteed Debt



Note: Forecasted payments are based on the loans ratified as of December 31, 2002

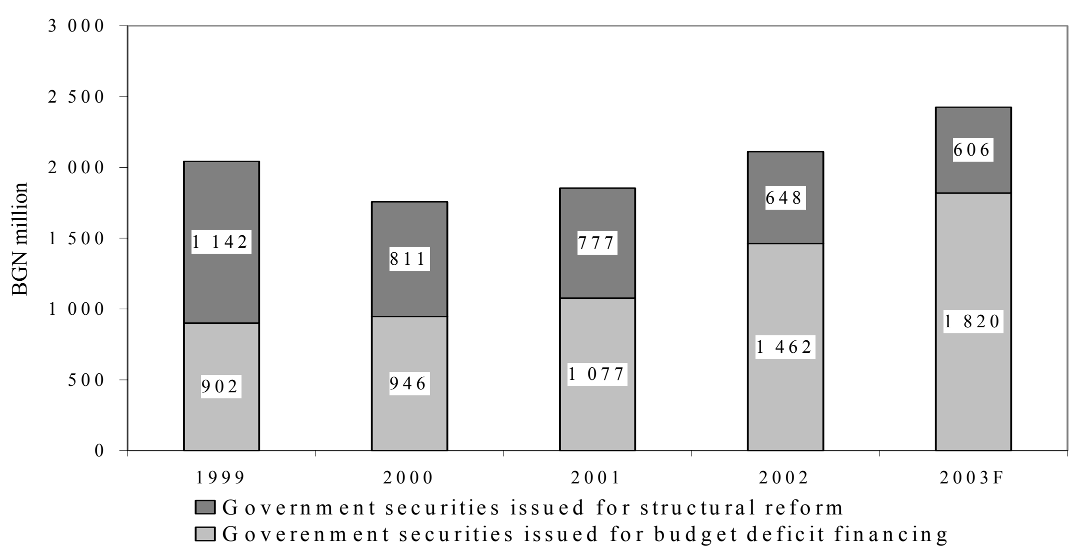
The payments in 2013 and 2015 range between EUR 1.2 billion and EUR 1.5 billion, that is, when the service burden is compared to the projected GDP for corresponding years, it will be considerably lower than the level of 2001 when debt payments exceeded EUR 1.5 billion. The present value (PV) of such payments amounts respectively to EUR 0.69 billion (discounted with the yield of the 2013 euro-denominated issue – 6 percent) and EUR 0.71 billion (discounted with the yield of the 2015 US dollar-denominated issue – 6.6 percent). For this reason, the above years are not seen as problematic from the point of view of servicing. Only 2007 remains a period with a relatively high burden of amortization payments. Out of about EUR 1 billion in principal falling due, EUR 260 million is for the IMF, EUR 250 million is on a Eurobond issue, EUR 209 million on Brady bonds, and EUR 260 million for the World Bank, the European Union, on state investment loans and state guarantees etc. This spike in payments may be addressed through active measures and the use of derivatives by the Ministry of Finance; likewise, it may be passively refinanced in 2006 and 2007.

<u>Domestic Debt</u>

All domestic debt is in the form of securities. Most of the government securities have been issued to finance the budget deficit – 69.2 percent. The remainder consist of issues intended to solve structural problems in the period of transition – to cover non-performing bank loans granted to state enterprises prior to 1990 and to guarantee deposits in banks declared insolvent in the period 1996 through 1998.

Chart 2

Changes in the Composition of Domestic Government Debt



Government securities for financing the deficit are issued on auctions, primarily according to a previously published calendar. It is provided to the public before the end of the year and covers the next fiscal year. The possibility of extraordinary issues with a two-week advance notice is also envisaged. Over the last several years, the maturities of government securities have lengthened considerably as a result of a stable macroeconomic environment and banking system, the entry of pension funds with long-term capital, and improved confidence of external and domestic investors in the government's debt management policy. **The average maturity of outstanding government securities increased from 30 to 57 months** (Chart 19) while at the same time the yield curve lengthened from 5 to 10 years. **It must be noted in this instance that, despite the growing volume of issues and lengthening of maturities, a substantial decline in yields on the primary market also occurred** (Charts 4 and 5).

Chart 3

Issues of Short and Long-Term Government Securities in the Primary Market

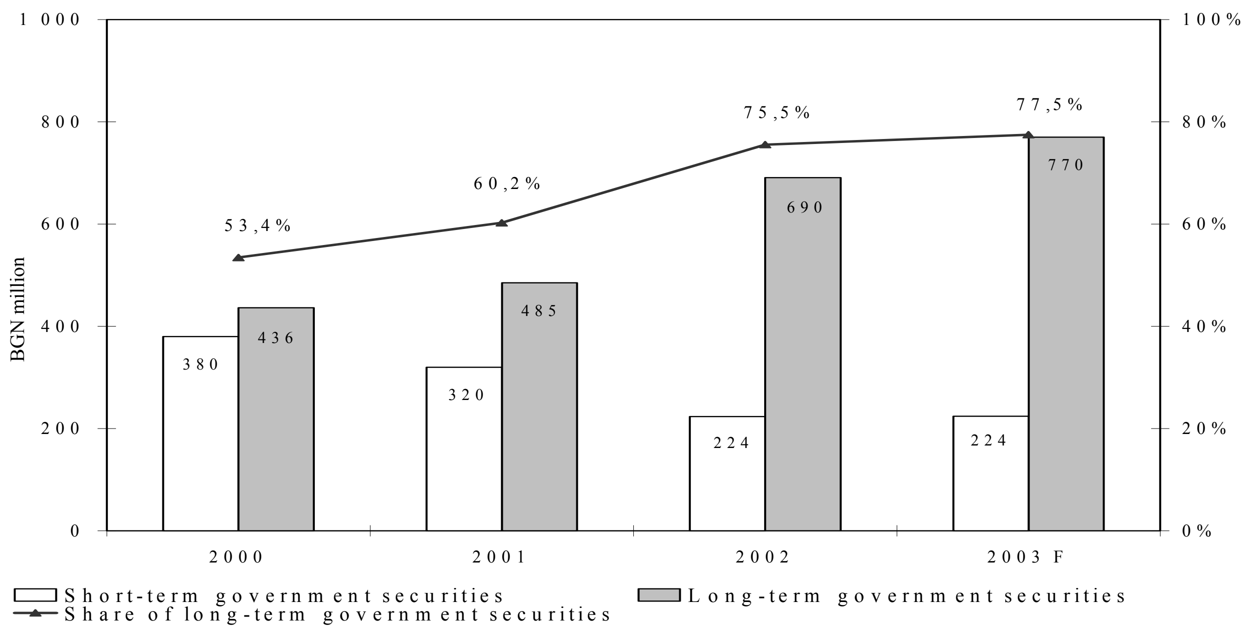


Chart 4

Yields of Government Securities in the Secondary Market as of February 21, 2003

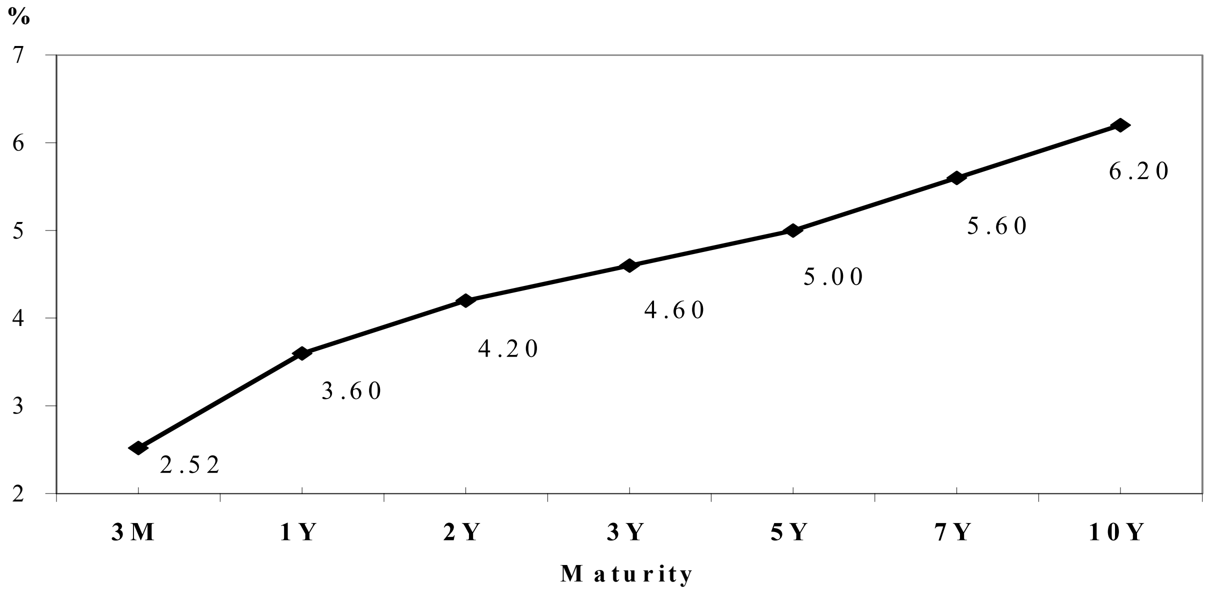
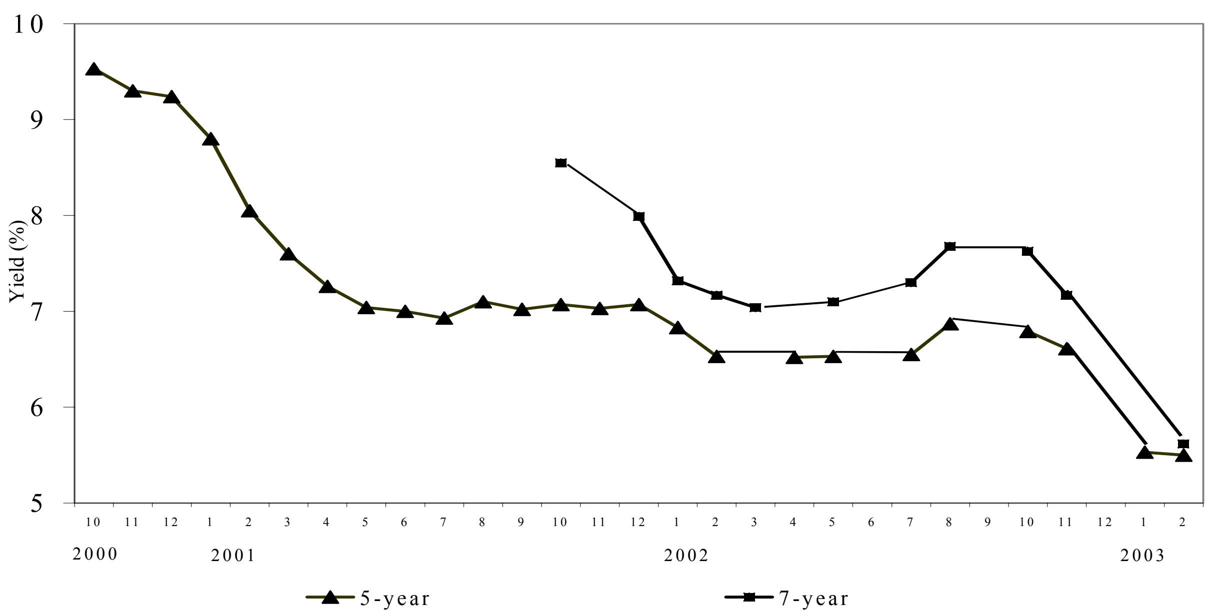


Chart 5

Yields of Government Securities in the Primary Market



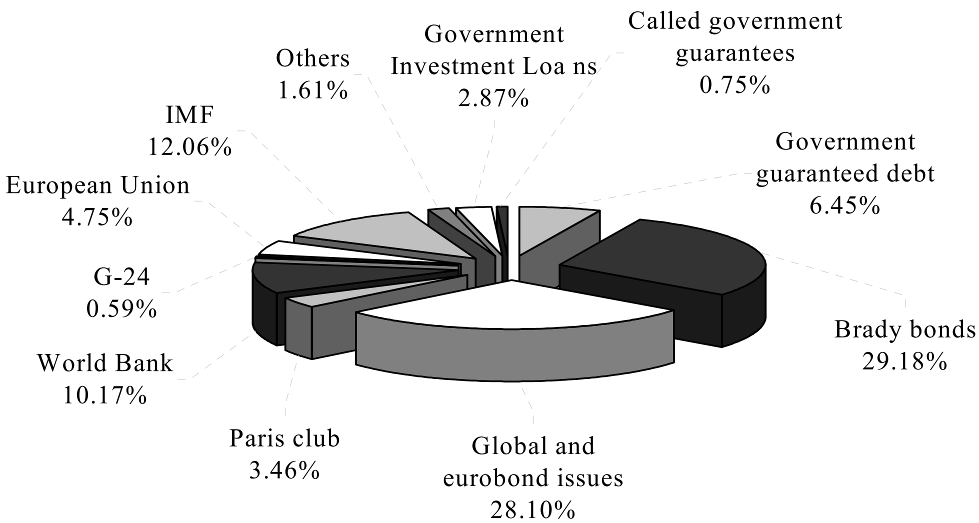
The primary market operates through a system of primary dealers. They are selected for a period of six months on the basis of meeting the criteria set by the Ministry of Finance and the Bulgarian National Bank, which reflect the financial situation and activities of financial institutions in the primary and secondary markets. The secondary market is still insufficiently active; its development is one of the important priorities of the Ministry of Finance.

External Debt

Much of the external debt was generated in the 1980s. A moratorium on servicing the debt in 1990 led to the signing of agreements on restructuring obligations to the London Club (in 1994) as a result of which Brady bonds were issued and to the Paris Club (in 1992 through 1994). The remainder of the debt consists of loans from the World Bank, IMF, European Union and other official creditors. Following a long break, five-year Eurobonds were issued in November 2001, with bids in the auction held exceeding 4.5 times the offered amount . In 2002, a partial swap of Brady bonds for global bonds was carried out. By the end of 2002, traded securities accounted for 57.3 percent of the external debt and loans accounted for 42.7 percent.

Chart 6

Breakdown of the External Debt by Creditors as of December 31, 2002



Brady Bond Exchanges

The exchanges of Brady bonds effected in April and October 2002 were implemented as a part of a general strategy for optimizing the debt structure. At the time of the two transactions, the following strategic results were achieved:

- the nominal value of external debt was reduced by US$209 million;

- the duration of external debt was lengthened by approximately 2.7 years as a result of the launch of two new global issues;

- NPV savings of about US$110 million;

- US$360 million in collateral was released due to which the size of the fiscal reserve was increased and the need to effect new issues in a comparatively unfavorable market environment was obviated (such as the uncertainty about developments in the Brazilian presidential election);

- a significant improvement in the currency structure of state debt through increasing the proportion of euro-denominated debt at the expense of debt denominated in U.S. dollars (during 2002, the volume of dollar-denominated obligations declined accordingly by 13 percentage points reaching 50 percent as of the end of the year);

- progress toward meeting one of the long-term objectives of debt management, namely, the modification of the interest structure in an effort to reduce the proportion of the floating rates (their share at the end of 2002 fell to 59 percent of the total state debt);

- limitation of the risk of paying additional interest on the Discount Bonds linked to GDP growth;

- reduction of the cost of the budget and the private sector financing through the issuance of debt on the international and domestic capital markets. This results from continuous tightening of the long-term risk premiums on the Bulgarian bond debt by 2 to 4 percent, depending on the maturity;

- creation of a liquid yield curve of standard instruments traded in foreign markets;

- extension of the yield curve for refinancing in euros to 10 years and in U.S. dollars to 12 years;

- reduced dependence on official external creditors by ensuring free access to private debt markets.

III. Organization of Debt Management

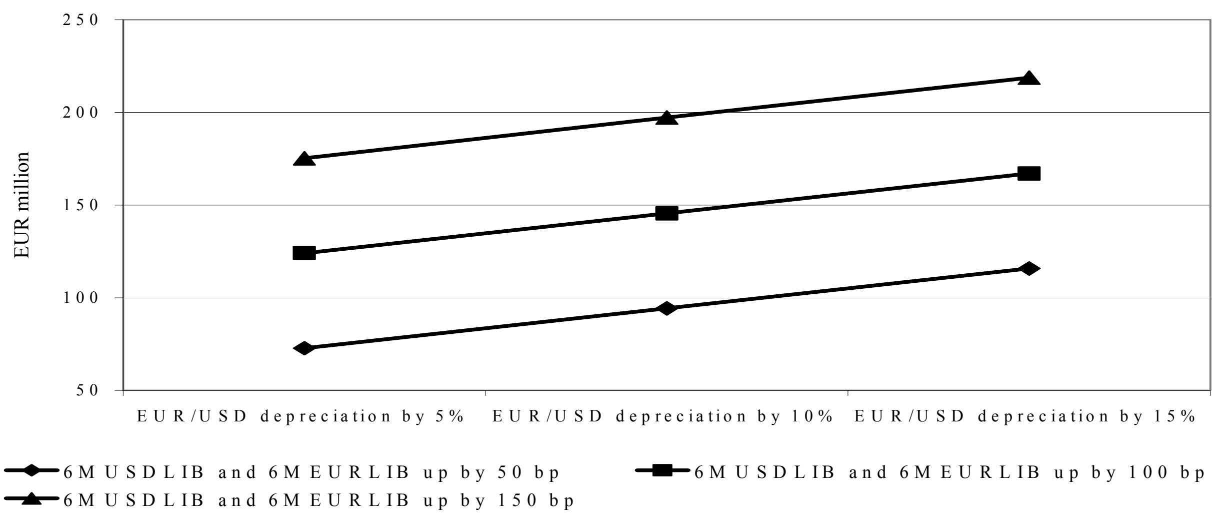
In recent years, debt management has been concentrated in the Ministry of Finance. The Government and Government Guaranteed Debt Directorate was established in 1997; it consists of three divisions:
Domestic Debt – organizes issuance in the domestic market, tracks the servicing of domestic debt, and monitors money markets;
External Debt – tracks the servicing of external debt, prepares issuance of securities in international markets, monitors government guaranteed debt and municipal debt;
Debt Analyses – monitors the status and changes in debt, prepares analyses, prepares periodical publications on government debt, monitors international markets, and prepares statistical data on the debt.
The External Finance Directorate negotiates loans from international financial institutions. This is also the unit responsible for collecting debt arrears from third countries.
Auctions at which government securities are sold on the domestic market are conducted by the Bulgarian National Bank on the basis of a joint regulation and a signed contract. The terms of issues are announced in advance by the Ministry of Finance.
The fiscal reserve is managed jointly by the Bulgarian National Bank and the Ministry of Finance on the basis of prior instructions from the Ministry of Finance.
Since 1999, the Ministry of Finance has maintained a system for registering and analyzing government and government guaranteed debt. The system provides an opportunity to monitor the debt, calculate the amounts due, project the cash flows and debt, as well as to assess the effect of changes in currency exchange rates and interest rates on debt payments. Such information may be used in different formats, including information on the structure of the debt (maturity, currency, interest, etc.).

IV. Risks Associated With the Debt Structure

The debt burden on the economy of the country may be evaluated on the basis of various criteria. The debt to GDP ratio is one of the most important indicators. The level of 56 percent reached at the end of 2002 may already be seen as acceptable from the point of view of the Maastricht criteria and in comparison with most European countries. The average 2001 indicator for the EU was 63 percent, but for most countries it ranged between 40 and 57 percent. However, it should be clear at the same time that the refinancing risk of such an amount of debt in the member countries is considerably lower since they have investment grade credit ratings. Interest expenditures to GDP may be viewed as a second indicator. In 2002, it stood at 2.3 percent in Bulgaria; in the next three years, it is projected to be around 2.3 – 2.4 percent. However, these levels depend on currency exchange rates and interest rates on the international markets.

Chart 7

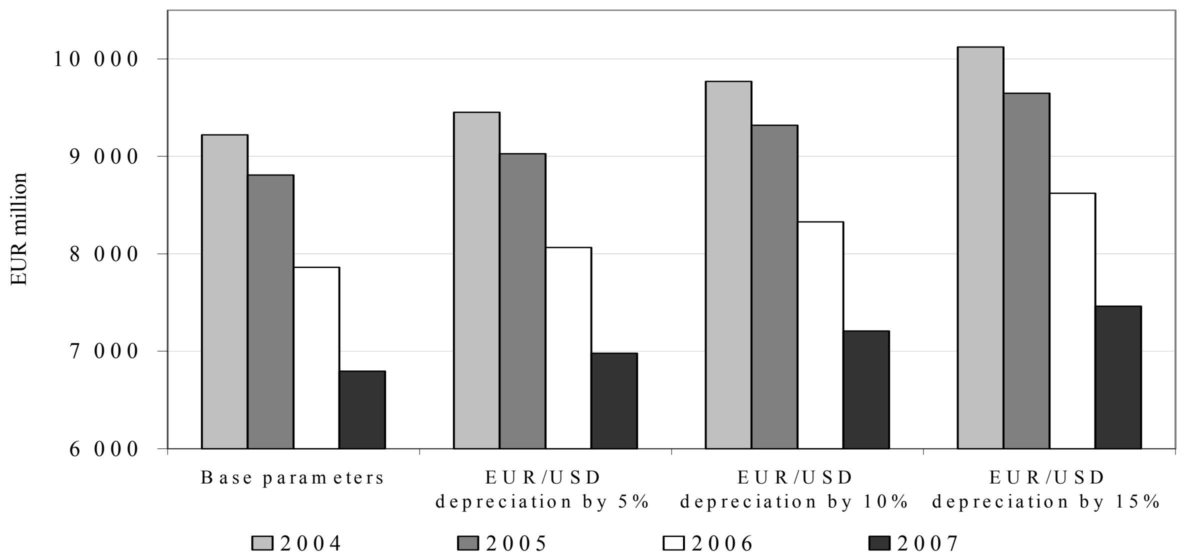
Effect of Changes in Currency Exchange Rates and Interest Rates on Debt Payments (Interest and Principal) in 2004



The analyses done for 2004 suggest that, given the unchanged debt structure, the growth of 6-month LIBOR for the U.S. dollar and the euro by 100 basis points increases interest payments by about EUR 40 million to EUR 50 million. On the other hand, a 10-percent depreciation of the euro against the dollar leads to a growth in the nominal value of state debt (domestic and external) expressed in euros by about EUR 540 million, which corresponds to 2.8 percent of GDP.

Chart 8

Effect of Changes in Foreign Exchange Rates
on the Volume of Government Debt (Domestic and External)



Calculations made on the basis of the debt outstanding as of December 31, 2002

Based on these indicators and the debt structure, several key risks may be inferred which should be kept in mind when priorities are set for debt management.

1. *Refinancing Risk*

Refinancing risk is associated with the issuance of debt to cover the repayment of already existing debt. It applies to both the opportunity for accumulating the necessary funds and the price of financing. The degree of risk is a function of the time distribution and volume of debt payments.

As has already been mentioned, the debt of Bulgaria is relatively well distributed and concentrations of payments occur only in certain years. In the 1990s, loans from official creditors were the primary source for the refinancing of external debt; the issuance of securities in the domestic market was such a source with regard to domestic debt. Given a significant improvement in economic conditions over the last five years, and especially in the last year and a half, **in the future the borrowing policy will be increasingly oriented toward the capital markets and private creditors, i.e., toward a greater proportion of securitized debt.** In turn, this requires that more attention be paid to planning the financial needs and, accordingly, their financing, as well as to **building and expanding a loyal diversified base of institutional and private investors in Bulgarian debt.**

2. *Risk Associated With the Volume of Debt*

Usually, in assessing this type of risk a determination is made as to whether the volume of debt may create prerequisites for disturbing the financial sustainability. Since the level of the Bulgarian debt has indisputably been high in the last two decades, an analysis of risk associated with the volume of debt should be more focused on determining the level to which debt should be reduced. The debt-to-GDP ratio in 2002 and major downward trends in the last three years are favorable factors. The budget deficit planned at below 1 percent of GDP and the objective of reaching a balanced budget in 2005 likewise indicate a favorable condition for reducing the debt. The above notwithstanding, financing investment and social projects out of government loans remains a serious issue, especially in the context of obligations assumed in conjunction with accession to the EU.

3. *Market Risk*

Market risk is associated with the movement of the foreign exchange rates and interest rates on the domestic and international capital markets. The structure of Bulgarian debt predetermines considerable dependence of debt servicing and, accordingly, expenditures of the budget on market indicators. In view of a restrictive fiscal policy and a large volume of budgetary expenditures associated with structural changes, the debt policy should be aimed at reducing the uncertainty caused by foreign exchange and interest rate fluctuations and ensuring more predictable interest payments.

4. *Liquidity Risk*

Liquidity risk is associated with the possibility of synchronizing short-term obligations and expenditures. As the currency board system was introduced in Bulgaria, it was decided to maintain a fiscal reserve at a certain level, in order to minimize the risk to finance short-term needs. **At present, the floor of the fiscal reserve is accepted as the amount of one-year debt service (about EUR 1 billion).** However, in practice the level of the reserve is well above the minimum. This, in turn, brings up the issue of effective cash management with a view to striking a balance between liquidity and returns for the budget.

5. *Risk Associated With the Assumption of Contingent Liabilities*

At present, government guaranteed debt amounts to about 4.4 percent of the government debt. Difficulties in accessing capital markets and low profitability on projects carried out in the public sector put an increasing pressure on the issuance of government guarantees. This process should be strictly regulated, subordinated to certain criteria, and tied to the assessment of budget risks.

The risks enumerated above do not constitute an exhaustive analysis of problems associated with the debt but do provide the basis for establishing priorities in debt management.

V. Objectives of Debt Management

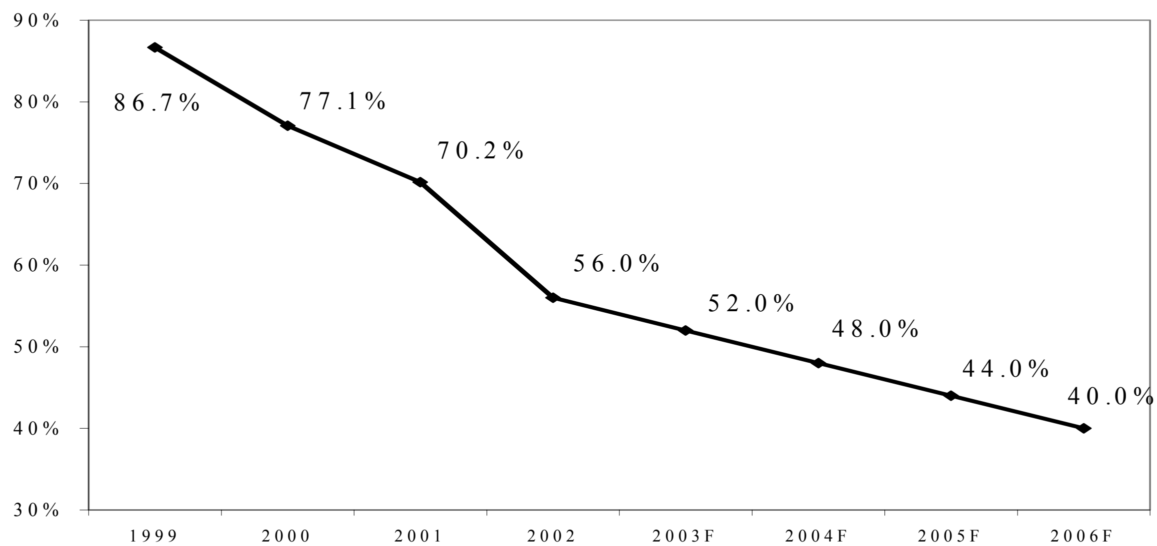
The major objective is to ensure the financing of the budget and refinancing of the debt at a lowest possible cost in medium- to long-term consistent with a prudent degree of risk.
With a view to accomplishing it, the following will be priority subordinate objectives:

1. Maintenance of a stable nominal volume of debt, with a gradual decline of the debt to GDP ratio.

Despite the tremendous progress reached in this direction over the last few years, the volume of debt remains quite high. In the next decade, debt service will claim between EUR 860 million and EUR 1,600 million annually which, in the environment of a current account deficit, requires major inflows of external capital from direct foreign investment or market refinancing. Also, in view of a decrease in revenues from privatization in the next few years, a careful and safe borrowing policy is exceptionally important for macro stability and confidence in the currency board.

Chart 9

Government Debt–to-GDP Ratio



Projections have been made on the following assumptions for the years 2004 through 2006: growth of GDP – 4 percent; inflation – 3.5 percent, forward EUR/US$ exchange rate; stable nominal volume of debt.

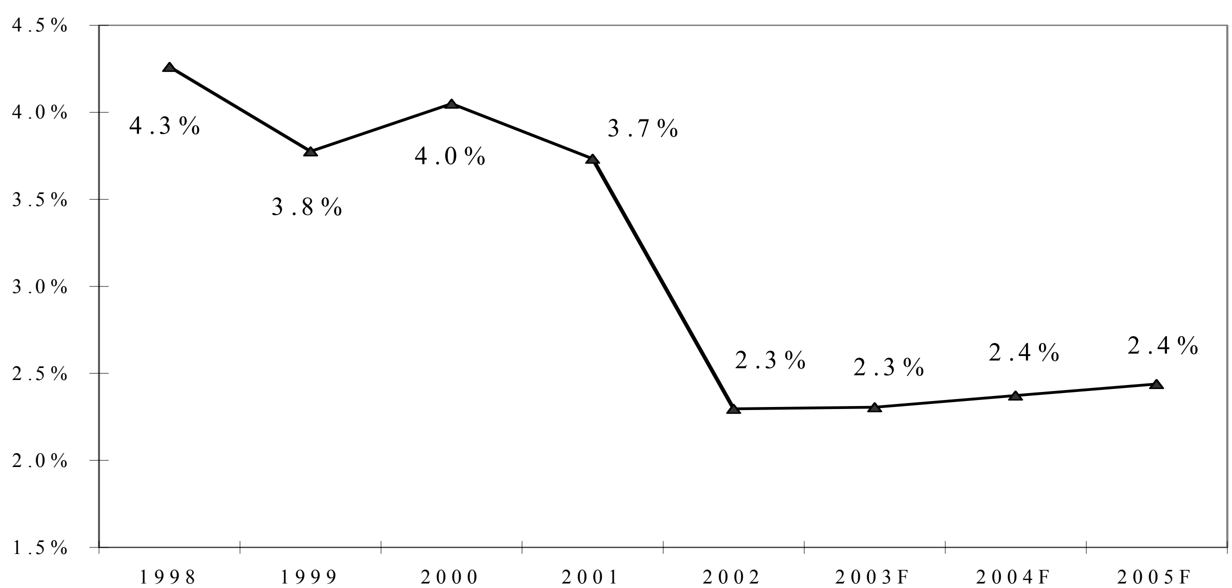
Gross external debt to GDP is mostly dependent on currency exchange rates (euro/dollar) and on domestic inflation. Shocks on GDP growth, real interest rates and budget revenues have a relatively weak influence. In all scenarios, the debt to GDP ratio registers a decline, albeit in the medium term (source: IMF, Debt Sustainability Analysis, Second Review Under the Stand-By Arrangement). These linkages should be taken into account in planning and structuring future debt issues.

2. Reduction of the Budget Risk Related to Debt Service

Interest expenditures on the debt in the next three years will range between 2.3 and 2.4 percent of GDP, which is below the level of countries with considerably higher credit ratings and does not pose the threat of a budget deficit and debt refinancing. In this regard, maintaining a primary surplus of 1.8 – 2.4 percent of GDP will ensure financial stability and facilitate the balancing of the budget in the three-year period. The expected growth of the ratio to 2.4 percent is based on the market data of forward curves. A reduction of interest expenditures from 3.8 – 4.3 percent under the previous government to 2.3 –2.4 percent is due both to a temporary decline in LIBOR rates and, for the most part, a continuous decrease in the long-term risk premium on Bulgarian debt and an improved credit rating.

Chart 10

Interest Expenditures on Debt Service (Percentage of GDP*)



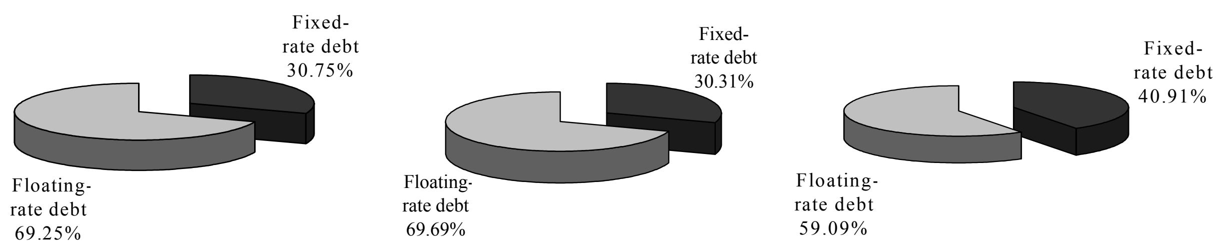
*Projected volume in accordance with a three-year macroeconomic projection.

2.1.<u>Gradual Achievement of a Balanced Interest Rate Structure</u>

The debt structure preordains considerable dependence of payments on international interest rates.

Chart 11

Interest Rate Structure of Government and Government Guaranteed Debt (Domestic and External)

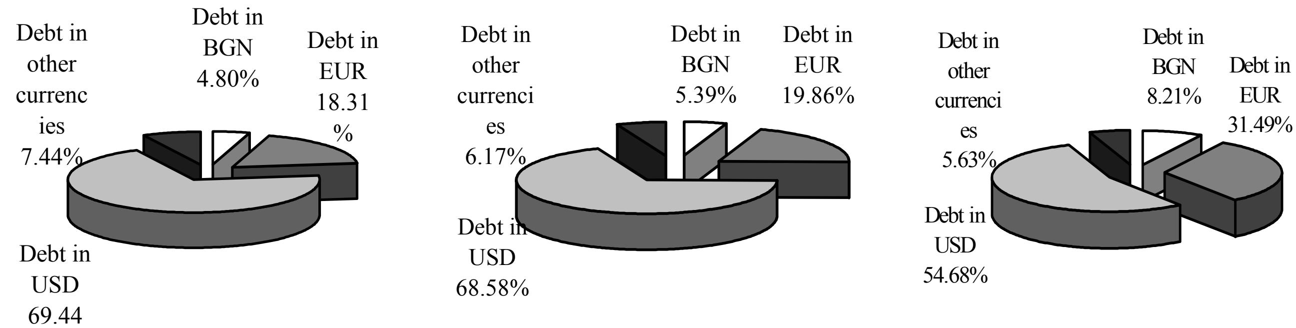


December 31, 2000 **December 31, 2001** **December 31, 2002**

59.1 percent of debt is floating rates. . In determining the optimal level to which this share is to be reduced, we should keep in mind the advantages and disadvantages of the dependence of debt service on LIBOR fluctuations. On the one hand, a higher share of fixed coupon brings about better predictability of interest expenditures and, hence, a lesser need for reserve funds to cover exchange rate and interest rate fluctuations. As a result, an opportunity appears to implement a more effective expenditure policy. On the other hand, in an open economy such as that of Bulgaria, floating interest rates play the role of a natural hedge against weak growth in the USA and the Eurozone. Low rates of growth in the economies of key trading partners bring about a decline in the reference LIBOR for the euro and the U.S. dollar, which translates into smaller interest expenditures for our budget. **For these reasons, it is desirable to achieve and maintain a balanced ratio of floating and fixed rates in the years to come.**

Chart 12

Foreign Currency Structure of Government and Government Guaranteed Debt (Domestic and External)



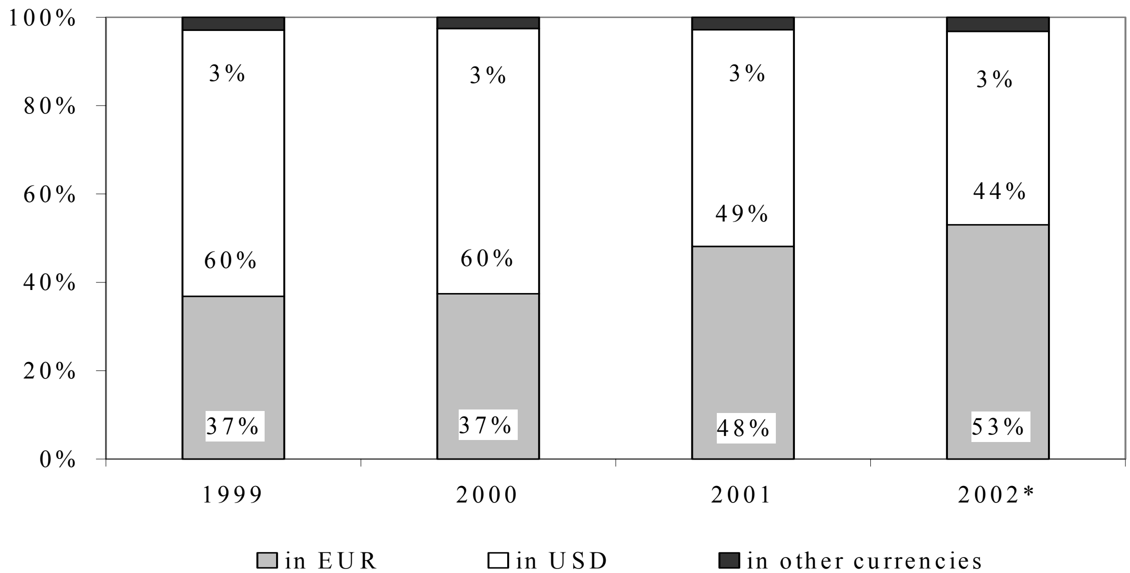
December 31, 2000 **December 31, 2001** **December 31, 2002**

2.2.<u>Reduction of the Proportion of Debt Denominated in U.S. Dollars</u>

The currency denomination of debt should be aligned with several key factors, primarily with the currency of the currency board (the euro), the predictability of payments with regards to the budget, and cash flows from exports. In the last decade, the structure of exports has changed considerably from predominant dollar-denominated receipts to a dominant share of European currencies. Taking into account the process of expansion of the European Union and growth of trade exchanges with candidate countries (about 6 percent) and EU members (around 53%), **in the next three to five years, the debt in euros and leva should reach 65 to 70 percent of total debt, whereas the dollar component (including the dollar component of the SDR) should decline to 25 – 30 percent.** This proportion of currencies takes into account the linkage of the currency board to the euro and replicates export revenues, which amounts to a natural cushion for fluctuations in the dollar/euro exchange rates.

Chart 13

Structure of Exports in Original Currencies



* Data as of September 30, 2002
Source: Bulgarian National Bank

3. Increase in the Share of Domestic Debt With a Reduction in External Financing

After the 1997 financial crisis, the management of domestic debt was aimed at reducing its volume, bringing the yield within acceptable confines, building confidence in, and improving the predictability of policy in this area, and extending the maturities of the newly issued securities. The measures implemented, in combination with the entry of a new type of investors (pension funds) and high liquidity in the banking system, already provide an opportunity for increasing the net issuance of government securities while reducing external financing. This policy will be in line with the accomplishments in the EU accession countries of the first wave where domestic debt accounts for 60 to 80 percent of total debt (Poland, the Czech Republic, Hungary) and financing is drawn primarily from local markets.

4. Gradual Increase in the Duration of Debt

The average weighted term (duration) of debt will be gradually increased until it reaches the average EU levels of 5 to 5.5 years. The setting of this objective is associated with accession to the EU in 2007. Some of the medium-term payments will be concentrated in the subsequent period of 1 to 2 years, when the price of budget financing is projected to be considerably lower.

5. Reducing Refinancing Risk Through Maintaining aSmooth Repayment Profile

The considerable volume of debt payments requires a careful distribution of debt service for new borrowings with a view to reducing the refinancing risk (Chart 1). An opportunity to use long-term market instruments may also be used to spread payments to years with lower burdens. The optimization of the maturity structure may also be the objective of active operations.

6. Improved Coordination of the Functions of Debt Management and Budget Asset Management

The generation of a considerable fiscal reserve in recent years requires that more attention be paid to its management. Efforts should be made to maintain optimal liquidity and rate of return at a low degree of risk.

7. Maintenance of the Minimal Level of Issued Government Guarantees and Financing of Investment Projects With Government Loans

The volume of government guaranteed debt and debt incurred to finance investment projects has trended upward, although at a slow rate. This entails risks for the budget whose reduction should be sought through the disintermediation of the state and incentives for financing by the private sector (public-private partnership, road concessions, etc.) wherever possible.

In addition to the above-mentioned debt management objectives, the following **general principles** will be observed:

- the conducted policy will be consistent with the macroeconomic status and forecasts;
- debt management will be based exclusively on the market principles;
- the interaction with the market participants will be carried out with maximum transparency and openness on behalf of the Ministry of Finance.

VI. Measures for Meeting Strategic Objectives in the Medium Term

It is envisaged that the following measures will be taken in the medium term in order to achieve the objectives defined, while adjusting them to the changing circumstances:

A. Gradual Increase in Debt With Fixed Interest Rates Until a Balanced, Risk-neutral Structure Is Achieved (45 to 50 Percent)

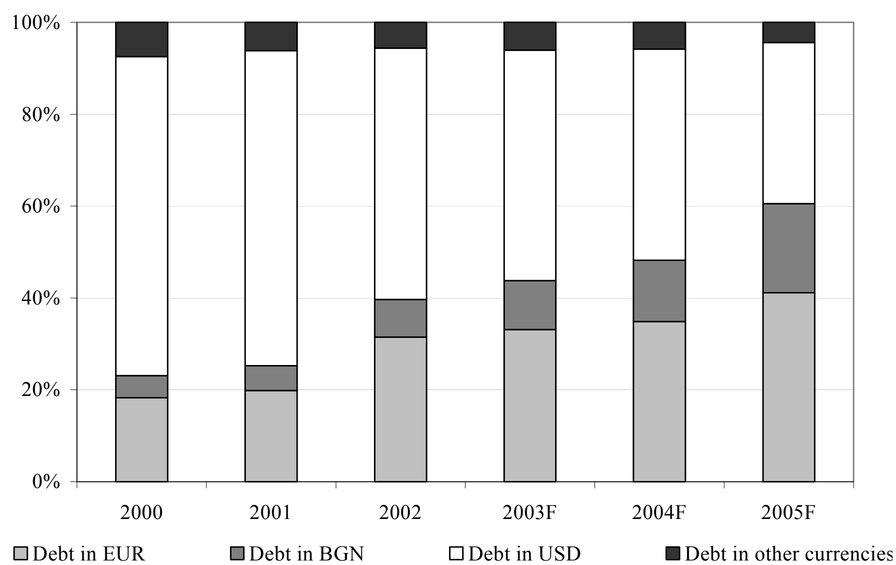
A change in the interest rate structure may be accomplished **passively** through the borrowing policy and by conducting **active** transactions. The trend in budget financing in the years to come will be to gradually displace loans from official creditors through the issuance of securities in capital markets. Such instruments are usually issued with fixed coupons since this is the market standard and are aimed to cover a broader investor base. In this manner the interest rate structure will be changed by repaying floating rate debt, which is refinanced by securitized fixed rate debt, but the change will be in the longer term. In addition, various standard instruments will be used to reduce risk (interest swaps). **Given suitable conditions, such as a considerable increase in long-term (10-year) interest rates and interest swaps in the reference currencies of the dollar and the euro, it is possible to swap some or all of the fixed coupons on the already issued Eurobonds back for floating coupons with a view to optimizing interest expenditures of the budget and balancing the interest rate risk.** It is also advisable to fix the long-term interest rates (on 7 and 10-year paper) when they are at a historically low level. A 10% deviation from the targeted objective (risk-neutral exposure of 50% floating interest) is permissible depending on the market conditions.

B. Increasing the Proportion of Debt Denominated in Leva and Euros

The structure of exports in the last three years has resulted in a drastic decline in dollar-denominated receipts while receipts dominated in euros have increased. In the first three quarters of 2002, the euro component reached about 53 percent, with the share of the dollar being 47 percent. Projections for the next 3 to 5 years indicate that exports to the Eurozone (including the 10 new members) will increase to 60-65 percent. **Given such data, it is desirable for the share of dollar-denominated debt to decline below 50 percent by 2005, with the prospect of being about 30 percent by 2009.**

Chart 14

Foreign Currency Structure of Government and Government Guaranteed Debt (Domestic and External)



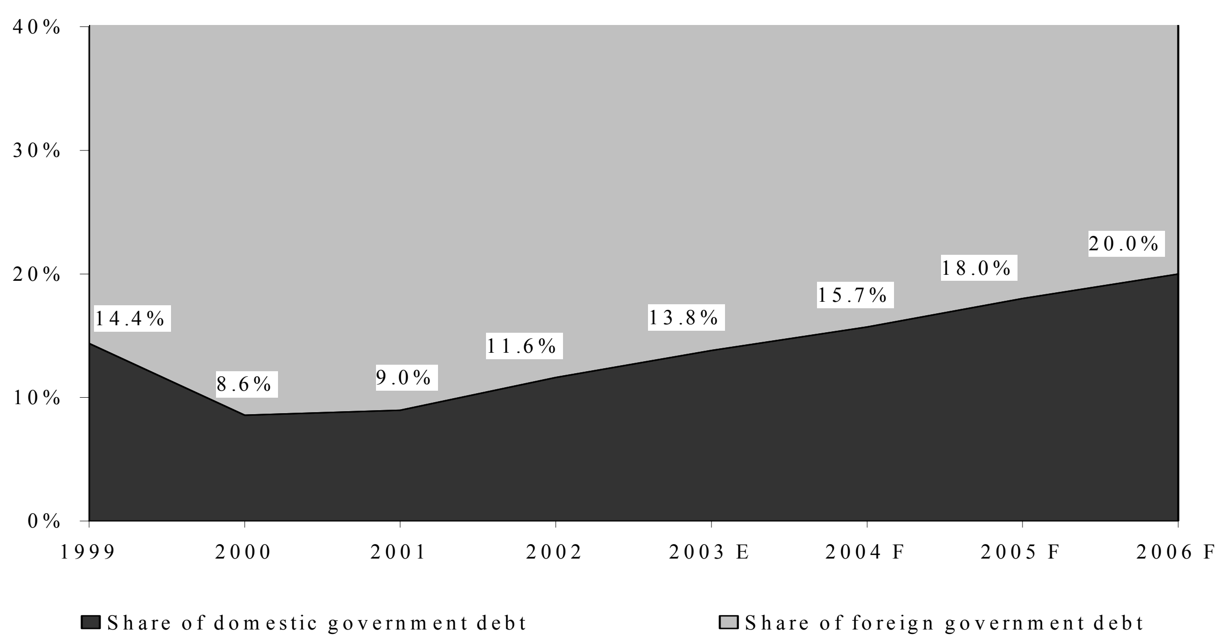
In the medium term, this objective will be achieved **passively** by assuming new debt mostly in euros and leva. Exchanges of dollar-denominated ZUNK bonds for euro-denominated ones announced on a quarterly basis will continue. Various **active** hedging techniques (currency swaps, options, forward transactions) with first-class financial institutions or official creditors as partners may be used to avoid current risks caused by exchange rate changes. To this end, it is advisable to adopt the market practice of ISDA (International Swap Dealers Association) documentation; also, the first transactions may be performed with international financial institutions (for example, the World Bank), which provide an opportunity to hedge the loans they grant.

C. Increasing the Proportion of Domestic Debt While Reducing External Financing

The share of domestic debt should be increased gradually, in line with the needs of the budget, the balance of payments, and the financial system. At the current stage, the need to finance the budget deficit is minimal. A three-year budget projection indicates a deficit of 0.7 percent in 2003, with a balanced budget being achieved over three years. During this period, revenues will also be generated from privatization, which will meet the need for funds to finance the deficit. This makes it possible to implement a more flexible issuance policy aimed primarily at improving the structure of the debt.

Chart 15

Domestic Debt as a Share of Total Debt



The condition of the country's financial system and prospects for its development in the coming years likewise provide a basis for taking action to increase domestic debt. Following the 1997 banking crisis, lending activity is still low compared to the member countries of the EU, although it exhibits a steady upward trend.

Assets of the Banking System

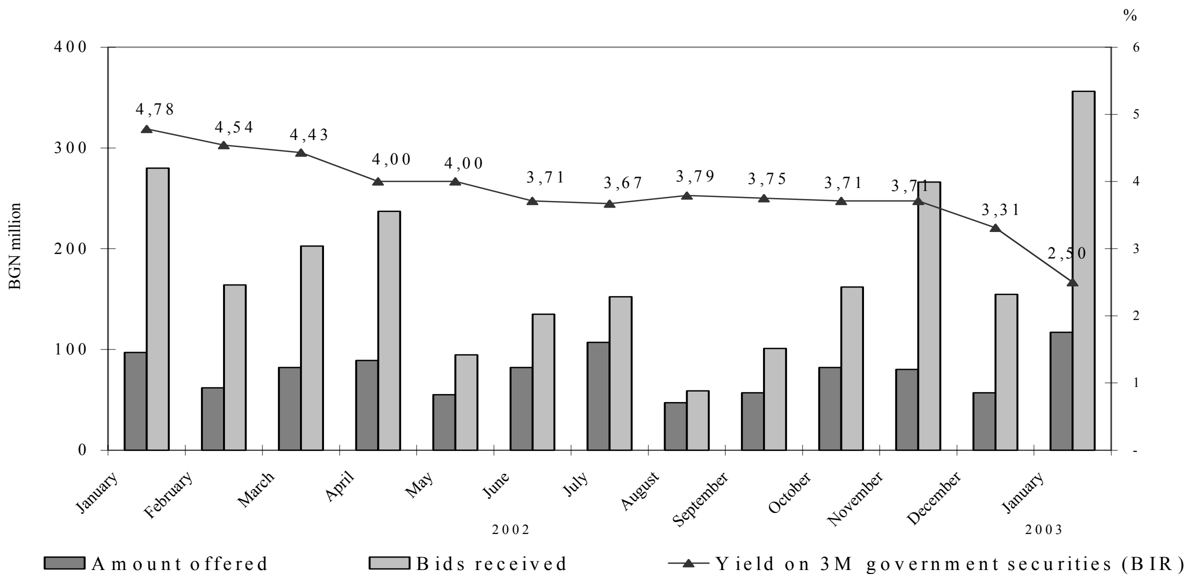
BGN million

ASSETS	31.12.2001	Percentage share (%)	31.12.2002	Percentage share (%)
Vault cash and current accounts with the Bulgarian National Bank	1 286,3	10,5	1 263,7	8,7
Claims on banks and other financial institutions	4 065,5	33,3	3 514,4	24,1
Securities in trading portfolio	1 520,4	12,5	1 703,9	11,7
Securities in investment portfolio	518,4	4,2	1 113,4	7,6
Crerdits granted	4 133,4	33,9	6 033,9	41,5
Assets for resale	14,7	0,1	12,8	0,1
Claims on interest and other assets	202,4	1,7	298,6	2,1
Fixed assets	462,7	3,8	616,4	4,2
TOTAL ASSETS	**12 203,7**	**100,0**	**14 557,1**	**100,0**

The banking system is very well capitalized, its liquidity is quite high; in the last two years, financial intermediation has increased sharply. The share of deposits in other financial institutions is to a great degree due to a lack of investment alternatives: The activity of the capital market is relatively weak, whereas the volume of government securities is still comparatively small in view of the zero net issuance in the first three to four years following the introduction of the currency board system. Overall growth of the assets of the banking system (by 18 to 20 percent in the last three years) has occurred along with the growth of investment in Bulgarian securities (growth by 115 percent in 2002 compared to 2001).

Chart 16

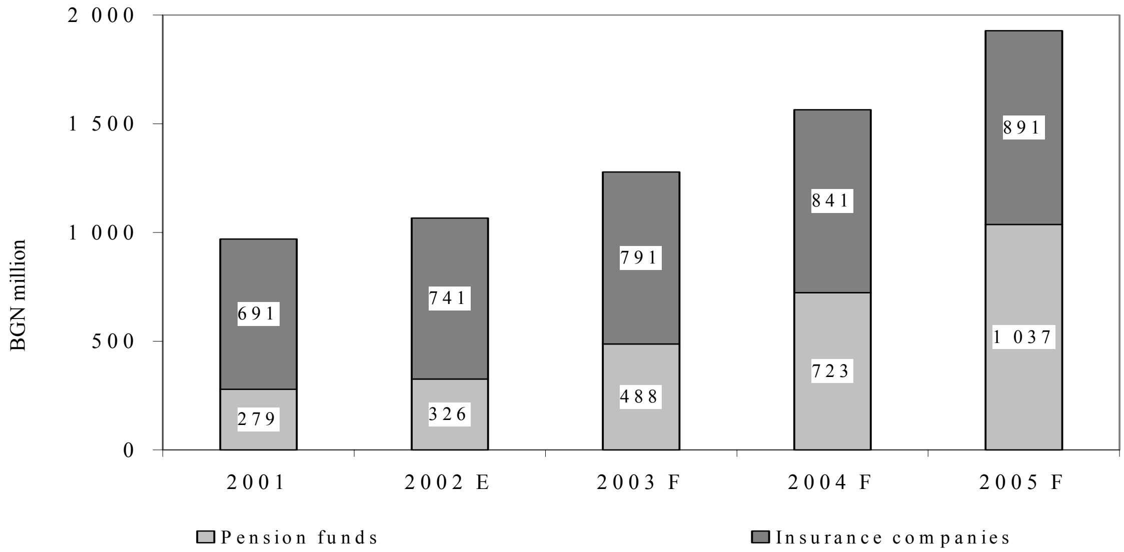
Amounts of Government Securities Offered by the Ministry of Finance and Bids Received by Primary Dealers in the Primary Market



With the beginning of the pension reform, prerequisites were created for the accumulation of significant funds in yet another financial sector. According to preliminary data, as of the end of 2002, the assets of pension funds came to Leva 326 million; they are projected to grow by about 45 percent in each of the next three years. The condition of the insurance sector also suggests annual growth of assets by about 6 to 7 percent.

Chart 17

Assets of Pension Funds and Insurance Companies



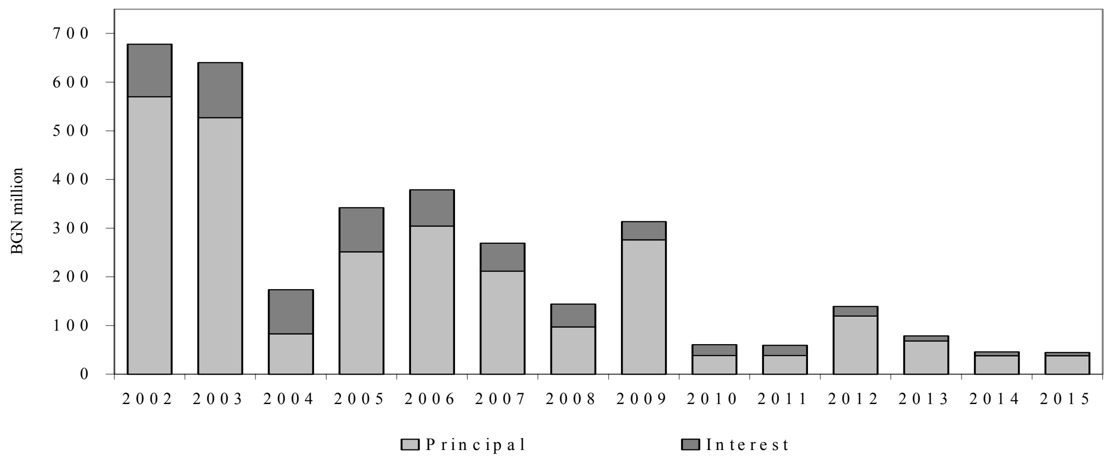
Sources: National Social Security Supervision Agency and Insurance Supervision Agency

A reduced amortization schedule for domestic debt between 2004 and 2007 is a prerequisite for further adjustment in favor of domestic debt (Chart 18). In the last two years, gross issuance of government securities on the domestic market has been between Leva 800 million and Leva 900 million, with positive net financing being Leva 70 million and Leva 330 million, respectively. These factors give us grounds to conclude that the **positive domestic net issuance may range between Leva 200 million and Leva 400 million annually in the next 2 to 3 years** (which corresponds to Leva 350 – Leva 800 million gross issuance, which is considerably less than the issuance in the last two years) without—other things being equal—bringing about the growth of yields at auctions. Issuance in the primary market will be in line with factors, which affect liquidity – payments from and to the budget, seasonal imbalances, external factors, and others. Instruments will be structured in keeping with demand, especially as far as maturity and currency (the lev and the euro) are concerned.

In case of a considerable increase of the yield on government securities due to the higher issuance volume or an observed crowding-out of the private sector, the budget financing may be smoothly redirected towards external sources.

Chart 18

Domestic Government Debt Service



The expansion of domestic issuance of government debt will be carried out as lending activity in the banking system and demand for credit resources from the private sector are carefully monitored **in order to prevent the crowding-out of private financing by state financing**. Actually, reduced external financing of the budget and a decline in the risk premium will create favorable prerequisites for the growth of external financing of the private sector (20-percent growth in 2002 compared to 2001) at considerably reduced interest rates and spreads.

D. Creating Prerequisites for the Development of a Secondary Market

The development of a secondary market will also facilitate achieving the above objective. More active trading will create greater demand by both the financial sector and other investors. A policy of negative external financing and the consolidation of a stable and liquid domestic market with a transparent issuance policy, as well as the prospect of EU accession, should restore the interest of foreign investors in government securities. The following is envisaged in order to achieve this objective:

- to stimulate the liquidity of individual issues by increasing their volume. To this end, the number of issues in the course of a year will be reduced; however, with a view to bringing the supply in the primary market and demand into balance, they will be complemented by several auctions, which, depending on the size of the issues, may take place over a period longer than one year. It is desirable for the volume of individual issues to exceed Leva 100—150 million;

- old illiquid leva-denominated issues may be repurchased through reverse auctions , exchanged for new ones, or opened and increased in volume;

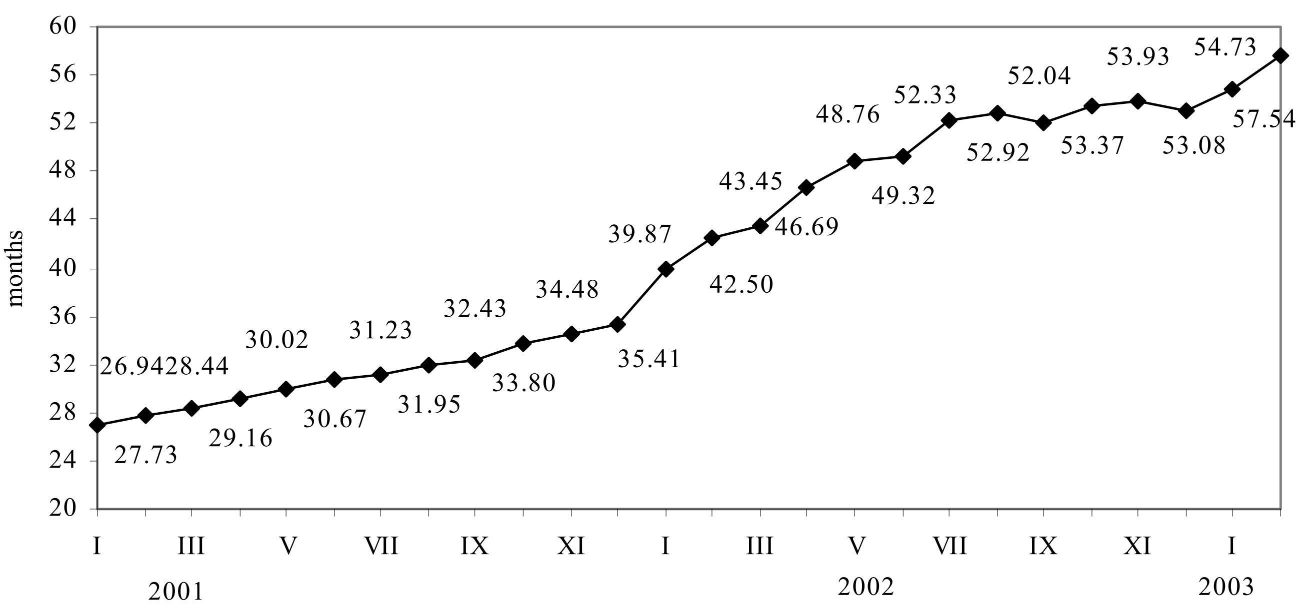
- with a view to bringing the domestic market into line with the European market and providing prerequisites for attracting foreign investors, a limited number of long-term issues of euro-denominated government securities may be offered. With auctions brought into line with external and domestic conditions, this type of securities will also be well received by the banking system which maintains about 55 percent of its deposits in foreign exchange of which euros account for one-half.

The First Issue of Euro-Denominated Government Securities in the Domestic Market

The first auction to sell an issue of government securities denominated in euros and registered on the domestic market was held on February 18, 2003. The issue will be traded in accordance with the requirements of the domestic regulatory framework. The maturity of the securities is 7 years and 3 months with an annual interest coupon of 5.75 percent. The amount offered for sale was between EUR 25 million and EUR 50 million whereas bids received amounted to EUR 139 million. The first batch of the issue was placed with an average yield of 5.58 percent. The achieved results confirm the existence of excess liquidity in euros in the banking system and open a new important segment for refinancing in the local market.

Chart 19

Average Maturity of Outstanding Government Securities Issued for Budget Deficit Financing



E. Development of Systems for Holding Auctions and Registration of Government Securities

In the short term, the development of systems for the registration and servicing of domestic debt at the central bank should ensure the implementation of the government's strategy in this area through:

- improving communication with participants in the market of government securities in compliance with international procedures and standards (introduction of SWIFT and other alternative technical equipment);

- perfecting the process of holding auctions so that greater numbers of participants and bids will not hamper the timely announcement of results (in EU countries, the results are announced within 30 minutes);

- updating the electronic system for registering and servicing trade in government securities by introducing straight-through processing of securities transactions. This will ensure more effective regulation and control of the operation of the secondary market of government securities and its increased liquidity.

In conjunction with the country's accession to the EU it is advisable to gradually introduce in the period before 2007 international standards associated with the registration and settlement of transactions with government securities and to apply Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements.

F. Increasing the Proportion of Issues for Small Investors

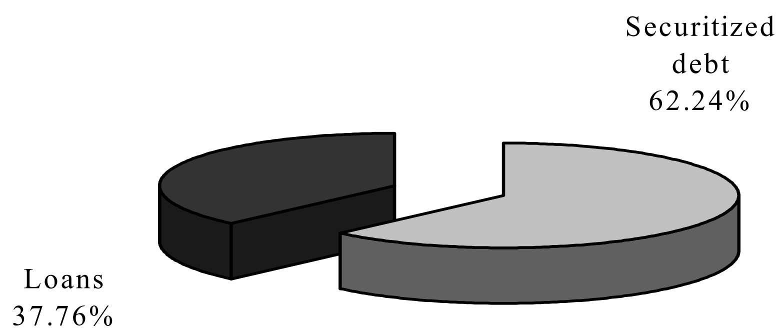
A greater share of small non-institutional investors in government securities will ensure a stable and diversified investor base and will influence savings favorably. The practice of offering instruments meeting the needs of individuals from the point of view of maturity, current income, sales channels, and ensured opportunity for repurchase in the absence of a secondary market will continue. It is desirable to increase the volume of sales above the present-day Leva 15-20 million a year by diversifying distribution and improving marketing.

G. Increasing the Share of Market Instruments While Reducing Loans From Official Creditors

The improving economic situation in the country and the attendant improvement of its credit rating will require and make possible the gradual switch in financing to private creditors . This should be done at a stage at which it should not be reflected in a significant increase in resource prices. In the next few years, the need for external financing will not be great in view of which issues in international markets may be brought into line with market conditions and may be aimed at ensuring greater access of the country to the corresponding type of investors. It is expected that once an investment-grade credit rating is obtained the bulk of borrowed resources will be ensured through the issuance of tradable instruments. There are several advantages to having such a debt portfolio. First of all, greater volumes may be placed through such issues and the process of borrowing runs faster. In addition, opportunities for pursuing a more flexible policy will be greater since a large proportion of securities may be easily and rapidly restructured through market operations, such as reverse purchases, use of swaps, and others.

Chart 20

Debt Structure by Type of Instrument as of December 31, 2002



H. Diversifying External Issue Markets and the Investor Base

As a result of two Brady bond swaps and the issuance of Eurobonds, Bulgaria has firmly established itself in the American and Eurobond markets. In the future, it is desirable to establish a presence in other markets, which have a weak correlation with Europe and the USA. **An issue in Japan may be carried out at a suitable moment under favorable conditions for financing in Japanese yens or as a result of the credit rating by Japanese agencies being raised to investment grade. Issues are also possible in British pounds in view of high liquidity and weak correlation with other major markets.** Issues in Japanese yens and British pounds will broaden the investor base, which will also bring about a stable reduction in issuance expenditures and yields of securities. Subsequently, issues in currencies other than the euro may be swapped back for euros or kept in original currencies with a view to portfolio diversification. However, the lev and the euro will remain key currencies of issue.

I. Maintenance of a Fiscal Reserve Covering at Least One-Year Debt Payments (About EUR 1 Billion)

This objective is being set due to several factors. The high nominal volume of debt is perceived by investors as an element of risk in its servicing, and the maintenance of a reserve which guarantees the timely performance of payments for a minimum of one year is a formidable prerequisite for reducing the price of financing. On the other hand, debt service is influenced significantly by international interest rates and foreign currency rates, which also requires the maintenance of liquid assets to ensure fiscal stability. 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.

The volume of the fiscal reserve is expected to be maintained above the one-year debt repayment volume until the country obtains an investment grade rating and joins the EU; thereafter, it may be gradually reduced, depending on the structure of the debt and its servicing. Its current level and the average volume of about Leva 3.5 billion projected for the year cover the domestic and external principal debt for a period of about 3 years.

Management of the Fiscal Reserve in 2002

In 2002, the fiscal reserve increased from Leva 2.4 billion to Leva 4 billion; at the end of the year it was Leva 3.3 billion. This increase occurred despite the principal repayment of Leva 1.7 billion during the year and was due to receipts from privatization (Leva 286.1 million), collateral released on exchanged Brady bonds (about Leva 700 million), and profits generated in debt transactions (about Leva 55 million). The Ministry of Finance intentionally kept the fiscal reserve funds throughout the year mostly in leva and euros which brought in about Leva 470 million in additional profits in view of the depreciation of the U.S. dollar.

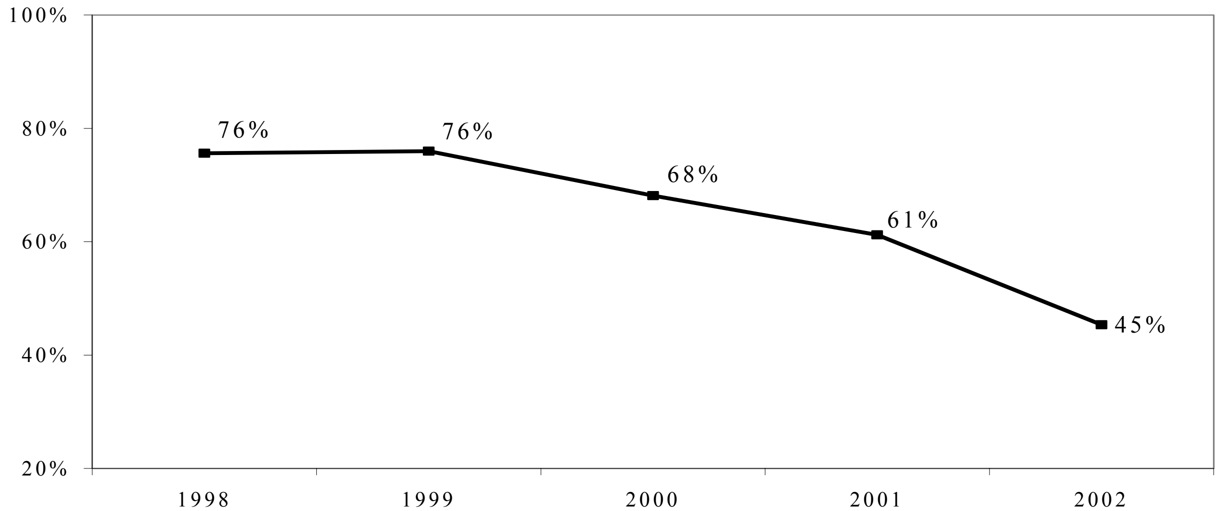
Structure of the Fiscal Reserve as of December 31, 2002*
(million leva)

I. Current accounts and time deposits in the Bulgarian National Bank	**3,053.6**
in leva	1,297.3
in other currencies	1,756.3
II. Current accounts and time deposits in commercial banks	**282.1**
in leva	31.8
in other currencies	250.3
Total (I + II)	**3,335.7**

* The leva equivalent is calculated at program exchange rates agreed with the IMF (official exchange rates of the Bulgarian National Bank as of December 31, 2001)

Chart 21

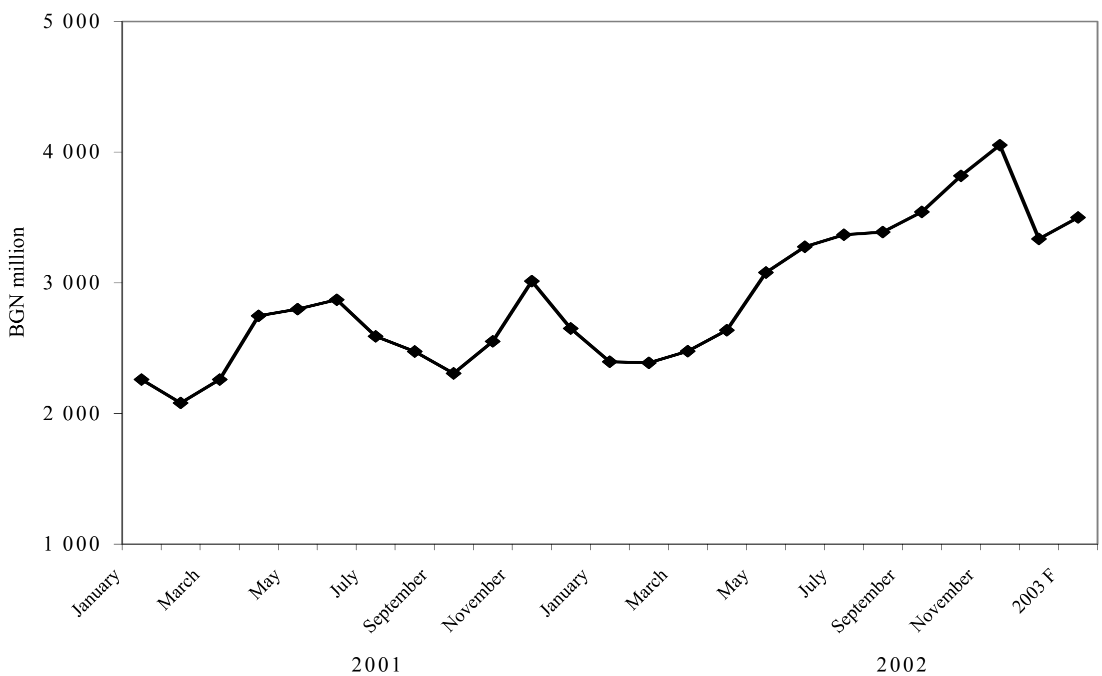
Net Government Debt* (Percentage of GDP)



* Government and government guaranteed debt less the fiscal reserve

Chart 22

Fiscal Reserve Volume



* Projected average volume

Contracts for portfolio management will be signed with supranational financial institutions (the World Bank) and the Bulgarian National Bank with a view to achieving the optimal parameters of assets in the fiscal reserve. The capacity of specialized investment subdivisions will be used in this manner whereas the contracts may provide for fiduciary or joint management. Assets in which investment may be made will be severely restricted in terms of issuers, credit ratings, liquidity of issues, and portfolio duration. It is expected that at the current stage the Ministry of Finance will stay with the securities of countries and multinational corporations with a credit rating above AA- and issue volumes above EUR 1 billion, the average portfolio duration being about 4.5 years.

It is expected that a greater portion of the fiscal reserve will be kept in short-term leva deposits at the Bulgarian National Bank and invested by the Bulgarian National Bank in short-term euro-denominated deposits. At present, the Ministry of Finance maintains exceptionally high liquidity by using staggered weekly deposits, which mature and are reinvested on a daily basis.

The currency breakdown of the fiscal reserve will be mostly kept in leva and euros while other currencies may account for about 25—30 percent, depending on the currency structure of liabilities. Options and forward contracts may be used for hedging against currency risk with a view to ensuring a balanced management of assets and liabilities.

The volume and currency structure of the fiscal reserve will be published on an annual basis, which will ensure greater transparency of the budget and will facilitate the decision-making of financial institutions with regard to investment.

J. Improving Coordination Between Debt Management and Assets in the Fiscal Reserve

The maintenance of a large fiscal reserve calls for improving the capacity for its efficient management. The objective is to achieve the highest possible yield at the optimal degree of risk and liquidity. To achieve this, it is necessary to establish an arrangement for coordinating debt management and cash flows, which is expected to be accomplished by improving the planning capacity.

K. Introduction of Repurchase Transactions

Direct and reverse repurchase transactions with first-class local banks may be used in order to optimize the revenues of the fiscal reserve and to resolve possible short-term leva liquidity imbalances in the financial system. Such transactions may be effected by the Ministry of Finance directly or in an auction format. The volume of this type of transactions will be limited up to BGN 100 million and they will be executed in strict adherence to the currency board regulations and the credit risk exposure of the budget to the different commercial banks. The introduction of these operations will be performed in coordination with the liquidity facility, which will be provided by the Bulgarian National Bank under the terms of the Real Time Gross Settlement System.

The Bulgarian National Bank will be consulted on the evaluation of the effects from the intended repo-transactions.

L. Taking Advantage of Opportunities for the Early Repayment of Debt

An opportunity may be sought for the early repayment of external debt to official creditors, given the continuation of a low budget deficit, implementation of positive issuance of domestic debt at the expense of negative net external financing, and maintenance of the fiscal reserve well above the minimum levels. Liabilities with a short time remaining to maturity or those maturing in years with heavy payment loads may be repaid, as well as those with the high price of service. Investment in Bulgarian government securities, which may be used to reduce debt in a period of medium-term financial and macroeconomic stability will be allowed within the framework of management of the fiscal reserve. Likewise, in a favorable environment there is an opportunity to pay the debt on Brady bonds early by taking the call option at face value on the date of each interest coupon.

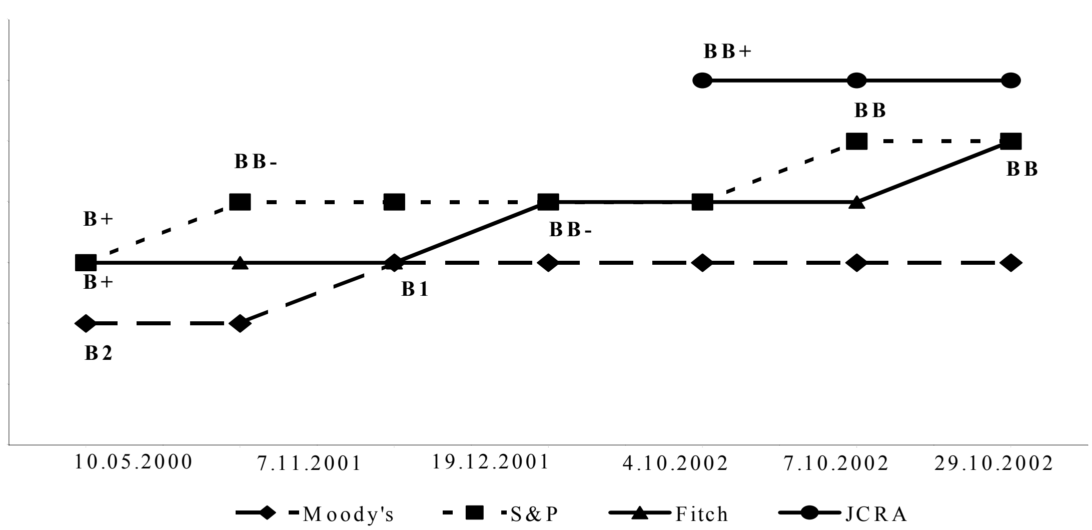
The impact on the budget and the future issuance policy and the balance of payments will be evaluated in the process of decision-making. The volume of these repayments will be set as a percentage of the fiscal reserve and will be consulted with the Bulgarian National Bank.

M. Maintaining an Active Dialogue With Rating Agencies

Contacts with credit rating agencies will be a priority, when necessary direct contacts will be maintained. The Ministry of Finance will organize the collection and supply of timely and complete information on the developments in the country. Transparency, regular data exchanges, and objective improvements in the macroeconomic environment and debt ratios are expected to bring about further improvements in the credit rating.

Chart 23

History of the Credit Rating of Bulgaria



N. Restrictive Approach to Financing Public Projects With Government Debt or Government Guarantees

Upon the passage of the Government Debt Law, the minister of finance became the sole person authorized to sign government loan agreements and guarantees on behalf of the government. Also, he must participate in negotiations on signing the agreements. Such provisions significantly improve coordination in the course of financing public projects through debt by providing an opportunity for harmonization with the overall debt policy. In addition, the Council of Ministries adopted a Regulation on terms, which should be met by projects that seek financing through government loans and government guarantees. It establishes an arrangement for the approval of projects, which will be financed through increasing government debt in accordance with the priorities of government policy.

Within the framework of this procedure, funding for public projects will be brought into line with the potential of the budget for assuming new debt, prospects for generating revenues out of which the debt will be serviced, and the risk of government guarantees being called. On the whole, the approach will be highly restrictive. Profitable projects will be oriented toward financing by private creditors without government guarantees whereas in the case of public projects alternative sources will be sought—budgetary funds, pre-accession programs, etc.

O. Facilitating the Development of the Money Market

The Ministry of Finance will create the environment for and assist in the establishment of market indicators other than yields on short-term government securities, which will strengthen and promote the money market. In February 2003, the SOFIBOR index calculated by the Bulgarian National Bank was introduced; it amounts to the fixing of quotations of unsecured deposits denominated in Bulgarian leva offered on the Bulgarian inter-bank market. It will be announced for terms ranging between one day and three months and will reflect in a more realistic manner the interest levels on the leva money market, providing a better benchmark for the banking system.

P. Promoting Leva-Denominated Issues in International Financial Institutions

Issues of limited size (up to Leva 100 million) denominated in the Bulgarian currency by international financial institutions (the EIB, EBRD, World Bank) will facilitate the establishment of convertibility of the lev and the introduction of financial innovations such as currency and interest rate swaps in leva on the Bulgarian money market. Issues of this type may also be traded in the international markets and may get foreign investors more interested in leva-denominated assets.

Q. Implementing a Proactive and Pragmatic Approach to Collecting Debt Claims From Other Sovereigns and Reducing the Net Debt

In the absence of other high-priority geopolitical factors, the collection of claims should be guided by considerations of the present value of debt. Some of the countries on which Bulgaria has claims participate in the initiative for highly indebted poor countries (HIPC), which have secured the forgiveness of all or a large proportion of the debts on terms required by the Paris Club. Compliance with them is being closely watched by the IMF and the World Bank.

Since Bulgaria’s quota of greenhouse gases (set in the Kyoto Protocol which we recently ratified) has a considerable surplus, it is possible to use innovative approaches to monetize such potential assets.