
Summary

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

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

The Strategy is structured in three main parts.

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

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

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

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

Under the provisions of the Government Debt - Law, the Strategy will be updated annually, and this up-date will again be approved by the Council of Ministers together with the three-year budget forecast. This will allow the timely and adequate redefinition of part of the objectives and measures in accordance with the economic development, the market indicators and the results achieved in the course of the implementation of the Strategy.

**Status of the debt**

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

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

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

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

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

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

**Regulatory environment**

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

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

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

The adoption of the Law and the concentration of the responsibilities in a limited number of institutions ensure that the issue of debt is a result of a single policy in this field, which on its turn is a prerequisite for its optimization and for reducing the cost of budget financing in the medium term.
Subsequently, based on the Government Debt Law, secondary legislation has been adopted adding to the regulation of the government debt issues. The main are as follows:

1. **Ordinance on the requirements to be met by the investment projects financed by government loans and the projects applying for financing by government guarantee, and on the procedure of their consideration.** The Ordinance provides for the procedure and manner under which projects apply for government investment loans or for loans, requiring government guarantees. The procedure provides for presentation of the projects by the line ministries at the Ministry of Finance, their subsequent approval by the Council for Economic Policy and the Council of Ministers, and inclusion of the loans approved for the projects’ financing in the State Budget Law for the relevant year. The approach for approval of any new government guarantees and government investment loans is strictly regulated. Thus both an opportunity for good planning of the budget and preparation of the projects, and the necessary transparency in terms of the economic priorities and the budget risks are ensured.

2. **Ordinance No. 9 of 2003 of the Minister of Finance on the procedure, manner and deadlines for provision of information on the status and movement of the debt of the municipalities and the social security funds.** The Ordinance is issued on the grounds of Article 40 of the Government Debt Law under which the Minister of Finance determines the procedure and the specific requirements in respect of the information related to the liabilities of the municipalities and the social security funds in view of the fact that these liabilities constitute part of the consolidated government debt.

3. **Ordinance No. 5 of 2002 on the terms and procedure for acquisition, redemption and trade in government securities,** issued by the Minister of Finance and the BNB Governor. The Ordinance regulates the manner of issue of government securities on the domestic market, as well as the procedure for their redemption and subsequent trade on the secondary market. The statutory act regulates the rights and obligations of the issuer, the fiscal agent, the primary dealers and other holders of government securities in respect of government securities acquisition, repurchase, replacing and redemption. The different types of transactions with government securities on the secondary market are also regulated. In respect of the Bulgarian National Bank, in its capacity of an agent for the government debt and official depository of the State, its main functions and obligations are regulated, as follows: to establish and maintain a computerized book-entry system of government securities settlement accounts; organize and carry out government securities auctions; register the government securities issued and the transactions therewith on the secondary market; monitor and service the payments under the debt, etc.
4. **Ordinance No. 15 of 2002 on the control over transaction in book-entry government securities (GS),** issued by the Minister of Finance and the BNB Governor. The Ordinance regulates the procedure and ways of control over GS transactions, such as: selection of GS primary dealers; control over criteria observance by the -GS primary dealers upon their selection; control over the systems for registration of GS transactions in the BNB and primary dealers. This regulation is focused both on ensuring the observance of the provisions of the Government Debt Law and the other secondary legislation, and on ensuring an effective and transparent GS market.

5. **Ordinance No. 31 of 2003 on government securities settlement,** issued by the BNB Governor. The Ordinance is issued on the grounds of the BNB -Law and regulates the settlement of GS transactions, conducted on the primary and secondary markets under Ordinance No. 5, and for the purpose the BNB shall establish and manage an electronic System of GS Settlement.

**Risks**

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

- macroeconomic environment – the Bulgarian and global economy growth rates, inflation, global economic crises, monetary policy, etc.;
- fiscal environment – status of the state budget, budget policy and restrictions, privatization, etc.;
- market environment – level of domestic and international interest rates at the relevant segments of the yield curve, exchange rates, level of domestic market development, GS demand, etc.;
• institutional and legal environment – changes in the legislation, European integration, 
debt management institutional framework, etc.

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

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

1. **Refinancing risk**

The refinancing risk is identified with the issue of new debt to ensure the financing of 
the budget in relation to the need to cover the repayment of already existing debt. This risk is 
associated both with the possibilities to repay the maturing debt and with the volume of 
expenditures generated by the newly issued debt. Hence, the direct connection that the higher 
the volume of the payment on maturing debt and the closer the date of its payment, the higher 
would be the refinancing risk. The volume of debt, as well as its structure in time, also has an 
impact on the refinancing risk level. The extension of the debt maturity and the improvement 
of its repayment profile in time help to limit this risk.
The share of short term debt as of the end of 2005 amounts to 3.1%. The average time remaining to maturity of the debt as of the end of the same period is 8 years and 2 months. Despite the good current levels of the indicators, the circumstances should be taken into account that they are rather simplified indicators of the refinancing risk, as they do not reflect whether the debt payments are evenly distributed in time. This requires careful monitoring of the repayment profile in order to avoid peak debt payments - as in the years 2013 and 2015.

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

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

2. **Risk Associated With the Debt Volume**

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

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

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

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

3. Market risk

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

With the current debt structure the analysis data show that the changes to the major market indicators have relatively low influence on the debt service costs. The reasons for that include reduction of the share of instruments with floating interest coupons and of instruments denominated in currencies other than Euro and BGN. The amortization structure of debt, whose repayment schedule is long-term and relatively even as a whole, is also important.
The results show that an eventual rise in the six-month LIBOR rates for Euro and USD by 100 b.p. would lead to an increase of the funds needed for payment of interest by approximately Euro 16 million per year in the period 2006-2008, the costs’ sensibility to any changes in the interest rates for the Euro being higher. This change represents only 4 – 5 % of the total interest under the debt. A simultaneous 10% increase of the USD exchange rate as compared to the Euro would increase the interest costs by around Euro 8 million per year, and the principal payments – by around Euro 5 million, which is immaterial as compared to the total debt payments. Nevertheless, in determining the concrete conditions of newly issued debt those proportions would continue to be closely monitored and analyzed.

4. **Liquidity risk**

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

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

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

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

When making evaluation of the future impact of risk we should take into account the growing needs of financing of large infrastructure projects in the areas of energy, water supply network and road infrastructure. Bulgaria’s accession to the European Union and the absorption of resources from the European funds also necessitates provision of national co-financing part of which will be ensured through government guaranteed loans. On its part, that would lead to an increase of the absolute and relative share of government guarantees in the debt structure, with growing influence of the risk associated with the assumption of contingent liabilities, respectively.

**Objectives of Debt Management**

The main objective of the debt policy is to ensure unobstructed financing of the budget and refinancing of the debt at a lowest possible cost in medium- and long-term as well as at an optimal degree of risk.
With a view to accomplishing it, priority will be the following subordinate objectives:

I. Strict monitoring on the volume of debt

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

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

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

Taking the above into consideration, the following actions are planned in view of the attainment of the defined objective:
1. Implementing a prudent and safe loan policy presuming a comprehensive analysis of the purpose of debt; possibilities of generating public benefits; evaluation of the domestic and international market environment and the specific terms of financing by international financial institutions; assessment of the time periods for assumption of debt, etc.

2. Monitoring the debt volume and profile with a view to prevent any breaches of its indicative parameters, possibilities of its service and refinancing, uncontrollable increase, negative effect on the financial and macroeconomic stability, breach of the debt limits settled by the law, and the Maastricht criterion on the debt/ GDP ratio.

3. Using various techniques to reduce the risk associated with the volume and structure of debt as well as to optimize its service. Under appropriate conditions and in consistency with the concrete objectives of the issuer we could: carry out transactions of early repayment of liabilities under the government debt; conclude agreements for currency and interest swap transactions as well as ones aimed at reducing the risk upon refinancing and smoothening the maturity structure of the debt; issue government securities for the purpose of redemption of internal and external liabilities of the country, etc. In such transactions assessment will be made of the effect on the state budget, the fiscal reserve, the future issue policy and the balance of payments, and for this purpose the transactions will be discussed with BNB, as well.

4. Strictly observing the legislatively regulated order, terms and procedures of evaluation and selection of investment projects which are to be financed by government or government guaranteed loans, while seeking and applying solutions alternative to debt financing at the same time.

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

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

In the next three years debt interest costs are expected to vary between 1.3% and 1.5% of GDP. The greatest influence on those rates is expected to be exerted by the future loan policy and the changes to the debt volume and structure ensuing therefrom; the fluctuations in foreign exchange rates and interest rates are expected to have a lower influence. The development and strengthening of the local debt market, the reduction of the long-term risk
premium on the Bulgarian debt, and the upgrading of the credit rating of the country will also affect the amount of the debt service costs.

The following actions are planned in view of the attainment of the defined objective and in compliance with the budget framework and the concrete market situation:

1. Optimal selection of possible debt instruments upon taking new loans in terms of their amount, type, structure, place of issuance and main parameters (issue date, maturity date, amount and frequency of the payments, currency denomination, interest coupons, etc.).

2. Supporting the development of an efficient and liquid local government debt market and of the capital market as a whole, including as regards its smooth integration into the European market. Those actions, in conformity with the concrete market conditions and the further development of financial intermediation in the country, would contribute to the smooth extension of the yield curve as regards the main maturity segments, with a positive effect on debt service costs, respectively.

3. Maintaining a smooth distribution of debt service costs and amortization payments with a view to protect the budget against any potential difficulties in the accumulation of considerable in amount financial resources for those payments or against any rise of the risk of refinancing, respectively.

4. Sticking to the policy of negotiating fixed interest coupons upon taking new loans; however, this should not be absolutized. We should take into account both the possibilities provided by fixed interest rates for enhancement of budget expenditures’ stability and forecastability, and the possibilities provided by floating interest rates for creation of a kind of hedge in case of future downward adjustment of market interest indices.

5. Sticking to a policy of taking BGN- and Euro-denominated loans in view of the forthcoming accession of our country to EU, the pegging of the currency board to the Euro, the structure of the proceeds from export (60.5% in Euro as of 31.12.2005), and the forecastability of payments in terms of the budget.

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

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

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

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

1. Debt issuance on the domestic and international capital markets

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

1.1. International capital markets as a source of financing

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

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

1.1.1. Careful and in-depth monitoring of the status and development of international capital markets. From a strategic point of view, knowing the major markets as capital sources will allow to undertake timely actions together with favourable combining of the conditions related to the need for funding, market environment, issue expenses and funding price.

1.1.2. Assessment of the choice of a given market first and foremost on the basis of the capital price criterion. In addition, the positions of the American and the EU bond markets, which Bulgaria has already approved, will also be taken into account.

1.1.3. Selection of securities characteristics in a manner that presupposes meeting the requirements for benchmark issue status at the respective market standardized conditions such as: fixed interest coupon, interest payment frequency, nominal payment, amount of issue, maturity, etc. Such compliance presupposes future issue liquidity and making a benchmark yield curve of Bulgarian government debt on international capital markets. These circumstances, other things being equal, will lead to stronger interest of investors and improvement of the price parameters of loan resources. As a whole, however, issue characteristics will be structured in a manner that corresponds to the specific market conditions as well as to the objective of the issuer to provide financing at minimal price at minimal level of risk in medium- and long-term aspect.

1.1.4. Giving priority to the euro as the main currency of issues which, all other things being equal, will eliminate substantially the currency risk taken by the budget in their future servicing.

1.1.5. Use of various options to provide full, timely and regular information about the country’s progress, including about debt management activities, given the fact that conducting
policies of transparency and predictability is a prerequisite for consolidation of the investors' confidence. In this context, maintaining an active dialogue with rating agencies is of significant importance.

1.2. The domestic market as a source of financing

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

The high priority of this objective fully corresponds to the vision presented above. It is supported by Bulgaria’s forthcoming accession to the EU which requires consolidation of what has been achieved so far in this field as well as capacity building in order to respond to the new challenges in relation to the integration of domestic debt market into the European one. The good quality and the low level of credit risk of domestic government debt market is the basis for stimulating financial market development in the country in the broadest sense. The experience of the countries which were at a similar stage of economic development at the time of their accession to the EU shows that only those with well-arranged, transparent and liquid government securities market could integrate smoothly and compete effectively with the other issuers of government securities.

In this connection, attaining the objective related to ensuring domestic market as a stable source of financing goes through its further development, strengthening and fostering market liquidity. In order to implement these, the following actions will be taken:
1.2.1. Carrying out a transparent, consistent and foreseeable issue policy. In this respect, the major parameters of the issue policy for the ensuing year will continue to be announced as well as the characteristics of the issues based on monthly issue calendars. In order to disseminate information, all possible channels such as the web-pages of MoF, Reuters and Bloomberg Information Systems as well as those of the BNB will continue to be used.

1.2.2. Sticking to policies of positive net domestic financing complied with the specific budget needs, outstanding debt refinancing, searching definite debt instruments, financial system liquidity, increasing the assets of pension funds, insurance sector and other big institutional investors. Other factors that will also be influential are domestic market integration into the European one and competition of other low-risk investment instruments.

1.2.3. Continuing the efforts aimed at further development of primary government debt market and oriented in two main directions – organization of market infrastructure and standardization of debt instruments proposed. Improving the primary market infrastructure will be mostly determined by the actions aimed at enhancement and establishment of the automated auction system. Various modifications of buyback, swap and government securities subscriptions will be gradually developed and introduced, and technical possibility for consolidation and conversion of BGN-denominated debt into EUR-denominated one will be provided in relation to the introduction of the euro as national currency at of the moment of joining the Eurozone area. Respective amendments to legislation will be required. As far as the standardization of debt instruments offered on the primary market is concerned, the aim is most of all to unify them with the general market conventions, which will to a large extent improve the comparability of Bulgarian government securities with those issued by other countries. Focus on fully standardised government securities will provide for attracting new groups of investors, including foreign ones.

1.2.4. Continuing the efforts of maintaining a liquid benchmark yield curve of domestic government debt under the main maturity segments – 3 months, 3, 5 and 10 years by emphasizing the curve’s long end. Maintaining and achieving a long-term interest rate for convergence purposes that is compliant with the Maastricht criteria is a compulsory requirement for membership in the EMU. Last but not least are the positive effects from similar policies of promoting the development and enhancing the liquidity of government debt market with concomitant influence on the financing price. For this purpose it is envisaged to continue the issuance of at least one government securities issue within a year of the maturities mentioned above in volumes ensuring liquidity in the secondary market. Furthermore depending on the status of market environment and the expectations for its dynamics, the
volumes of issues, whose interest coupons are fixed at reasonable levels from the point of view of the issuer, may be reopened and expanded.

1.2.5 Keeping within such an issue policy that considers the factors influencing the market liquidity. Those factors are payments from and to the budget, seasonal instabilities, external factors, specific investors’ preferences of government securities, etc. In this connection, the close coordination between MoF and the BNB will continue to be of importance.

1.2.6. Creating prerequisites encouraging the development of secondary government debt market. Part of the efforts will be directed towards appropriate structuring of the characteristics of government securities offered on the primary market, the positive effects of which are presented in item 1.2.3. For that purpose, the issuance of at least one government securities issue within a year of the maturities mentioned above will continue in volumes ensuring its high liquidity. It is desirable for the volume of individual issues to exceed BGN 200-250 million, naturally in compliance with the gross debt issue for the respective year. In addition, under the proper circumstances and in line with the issuer’s specific goals, all possible instruments for promotion of the development of secondary debt market are envisaged to be used.

1.2.7. Developing the system for primary dealing in government securities by amending the conditions for authorizing investment brokerage in government securities are issued. On the one hand, these changes will involve greater competition among primary dealers on the primary and secondary market by introducing a wider range of requirements for market behaviour with respective access to certain operations related to external debt issue and management. On the other hand, the changes will be oriented towards the future treatment of foreign institutions as primary dealers in government securities in view of the country’s accession to the EU and the related requirements. Reformulating the criteria for assessment and selection of primary dealers will be aimed at enhancing the liquidity, transparency and effectiveness of the domestic debt market.

1.2.8. Supporting market initiatives aimed at establishing and introducing e-platforms for trading in government securities, which would contribute to the increase of market liquidity and transparency as a whole.

1.2.9. Introducing new debt instruments various in type and purpose, including derivatives. Actions in this direction are to be undertaken after the establishment of the required legal and organizational environment for their operation by the respective adjustment of accounting methods to the peculiarities of operations involving similar instruments. Their
introduction will comply with the situation and the extent of market readiness, investment needs and their contribution to achieving the objectives of debt policy.

1.2.10. Undertaking actions to harmonise the legislation and ensuring the organizational structure in line with European regulations and practices in relation to the use of government securities as financial security, government securities transactions, conducting trustee services, etc.

1.2.11. Supporting the efforts of the BNB aimed at improving the systems for registration and settlement of government securities in order to further align them with ESCB standards and CESR as well as with EU directives on financial markets in view of providing conditions for future consolidation and integration of European market structures. This will promote the establishment and relations with international settlement systems such as Euroclear and Clearsystem, which is one of the prerequisites to stimulate the interest of foreign investors by enabling them to operate in a familiar environment.

2. International financial institutions\(^1\) (IFIs)

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

Bulgaria’s forthcoming accession to the EU and reaching a maximum degree of convergence predetermine close cooperation with IFIs as a source of additional funding in the process of absorbing grants from the European funds. Such a conclusion is also supported by the policy of closer cooperation with IFIs adopted by the EU itself. This cooperation is targeted

\(^1\) The definition of International Financial Institutions includes: the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the Council of Europe Development Bank.
at providing coordinated financial support for newly acceded countries which are required to adopt EU acquis, achieve compliance with EU sector policies and build administrative and institutional capacity.

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

2.1. Outlining the priorities of funding where the support of IFIs will be sought. In this case it is extremely important to determine correctly the focus of future cooperation. On the one hand, it is to help achieve better compliance with EU policies in this sector in a number of key areas such as transport, energy and environment as well as in the field of diminishing poverty and building administrative and institutional capacity. On the other hand, the areas of specialization and priority fields of activity of IFIs themselves are to be taken account of so as to eliminate any possibilities for duplication of activities or competition among the institutions when funding specific projects. The Memorandum of Cooperation, signed in 1998 between the European Commission and EIB, EBRD, IBRD, the International Financial Cooperation, Nordic Investment Bank, the Council of Europe Development Bank and the Black Sea Trade and Development Bank in relation to the preparation of CEE countries, Cyprus, Malta and Turkey for EU accession, follows the same line.

2.2. Being familiar with the aim of possible contracting, with various innovative financial products offered by IFIs in relation to the absorption of the financial aid that Bulgaria will receive after joining the EU. In general, these products presuppose better effectiveness of funds received and could be considered and contracted within the present and future strategies for country support by the individual IFIs.

2.3. Maintaining cooperation with IFIs predetermined by both the country’s future accession to the EU and the favourable financial parameters of the products offered. Such cooperation, however, requires careful planning of the financial needs in compliance with the extent to which the individual projects are ready in the context of the policies carried out in relation to the management of debt and its indicative parameters.

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

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

In this line, an Agreement between the Council of Ministers and the Bulgarian National Bank on the introduction of the euro in the Republic of Bulgaria by 2009/2010 was signed in November 2004. According to one of the commitments therein, another Agreement between the Ministry of Finance and the Bulgarian National Bank was signed in February 2006 in order to define the long-term tasks of the Central Bank as a government agent. Those tasks are based on the primary and secondary legislation and arrangements that regulate the activities of the Central Bank as a fiscal agent and depositary of the state.

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

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

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

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

![Graph showing debt dynamics from 2002 to 2005]

Source: MoF and NSI

Interest Rate Expenses

![Graph showing interest rate expenses from 2002 to 2005]

Source: MoF and NSI
Debt Structure Per Creditors

Source: MoF

Forecast Government and Government Guaranteed Debt Payments
2006-2025

Payments are forecast on the basis of debt status as of 31.12.2005.

Source: MoF
Budget Balance

- Budget balance as a percentage of GDP:
  - 2002: -0.9%
  - 2003: -0.4%
  - 2004: 1.5%
  - 2005: 2.3%
  - 2006*: 3.0%

Source: MoF

Budget Balance and Fiscal Reserve

- Fiscal reserve in million BGN:
  - 2002: 3,351
  - 2003: 3,848
  - 2004: 4,811
  - 2005: 4,512

- Budget balance as a percentage of GDP:
  - 2002: -0.9%
  - 2003: -0.4%
  - 2004: 1.5%
  - 2005: 2.3%

Source: MoF

* according to IMF Programme
Gross External Debt

Source: BNB

Current Account Deficit and Foreign Direct Investment

Source: MoF and AEAF
## Credit Ratings Range for Bulgaria 2003-2006

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Long-term GS: foreign currency

Long-term GS: local currency

Source: MoF