Republic of Bulgaria

EUR 950,000,000

4.25 per cent. Notes due 2017

Issue price: 99.182 per cent.

The issue price of the EUR 950,000,000 4.25 per cent. Notes due 2017 (the ''**Notes**'') of the Republic of Bulgaria (the ''**Issuer**'', the ''**Republic**'' or ''**Bulgaria**'') is 99.182 per cent. of their principal amount.

The Notes will bear interest from and including 9 July 2012 at the rate of 4.25 per cent. per annum payable annually in arrear on 9 July in each year commencing on 9 July 2012. See ''*Terms and Conditions of the Notes – Interest*''. Payments under the Notes will be made free and clear of, and without withholding or deduction for, any taxes imposed by the Republic, to the extent described under ''*Terms and Conditions of the Notes— Taxation*''. Unless previously redeemed, or purchased and cancelled, the Notes will be redeemed at their principal amount together with accrued interest on 9 July 2017 and are not redeemable prior to that date. See ''*Terms and Conditions of the Notes—Redemption, Purchase and Cancellation*''.

Application has been made to list the Notes on the Official List of the Luxembourg Stock Exchange and to trade the Notes on the regulated market ''Bourse de Luxembourg'' of the Luxembourg Stock Exchange (the ''**Luxembourg Stock Exchange**''), which is a regulated market for the purposes of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments.

SEE ''*RISK FACTORS*'' STARTING ON PAGE 1 FOR A DISCUSSION OF CERTAIN FACTORS TO BE CONSIDERED IN CONNECTION WITH AN INVESTMENT IN THE NOTES.

THE NOTES HAVE NOT BEEN, AND WILL NOT BE, REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933, AS AMENDED (THE ''SECURITIES ACT''). THE NOTES ARE BEING OFFERED AND SOLD IN OFFSHORE TRANSACTIONS OUTSIDE THE UNITED STATES BY THE JOINT LEAD MANAGERS (AS DEFINED IN ''SUBSCRIPTION AND SALE'') IN ACCORDANCE WITH REGULATION S (''REGULATION S'') UNDER THE SECURITIES ACT, AND MAY NOT BE OFFERED, SOLD OR DELIVERED WITHIN THE UNITED STATES OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, ANY U.S. PERSONS EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT.

The Notes will be issued in registered form in denominations of EUR 100,000 and integral multiples of EUR 1,000 in excess thereof. The Notes will be represented by a global registered note certificate (the ''**Global Note Certificate**'') registered in the name of the nominee for, and deposited with, the common safekeeper for Euroclear Bank SA/NV (''**Euroclear**'') and Clearstream Banking, *société anonyme* (''**Clearstream, Luxembourg**''). Individual note certificates (''**Note Certificates**'') evidencing holdings of Notes will only be available in certain limited circumstances. See ''*Summary of Provisions relating to the Notes while in Global Form—Exchange for Note Certificates*''.

Joint Lead Managers

BNP PARIBAS **HSBC** **RAIFFEISEN BANK INTERNATIONAL AG**

Offering Circular dated 4 July 2012

The Issuer, having made all reasonable enquiries, confirms that this Offering Circular contains all information with respect to the Issuer and the Notes which is material in the context of the issue and offering of the Notes, that the information contained in this Offering Circular is true and accurate in every material respect and is not misleading, that the opinions and intentions expressed in this Offering Circular are honestly held and that there are no other facts the omission of which makes misleading any statement herein, whether of fact or opinion. The Issuer accepts responsibility for the information contained in this Offering Circular accordingly.

This Offering Circular neither constitutes a prospectus pursuant to Part II of the Luxembourg law on Prospectus for securities (*loi relative aux prospectus pour valeurs mobilieres*) dated 10 July 2005 (the "**Luxembourg Prospectus Law**") which implements Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 (the "**Prospectus Directive**") nor a simplified prospectus pursuant to Chapter 2 of Part III of the Luxembourg Prospectus Law. Accordingly, this Offering Circular does not purport to meet the format and the disclosure requirements of the Prospectus Directive and Commission Regulation (EC) No. 809/2004 implementing the Prospectus Directive, and it has not been, and will not be, submitted for approval to any competent authority within the meaning of the Prospectus Directive and in particular the Supervisory Commission of the Financial Sector (*Commission de Surveillance du Secteur Financier*), in its capacity as competent authority under the Luxembourg Prospectus Law. The Notes issued pursuant to this Offering Circular will therefore not qualify for the benefit of the single European passport pursuant to the Prospectus Directive.

No person has been authorised in connection with the offering of the Notes to give any information or make any representation regarding the Issuer or the Notes other than as contained in this Offering Circular. Any such representation or information should not be relied upon as having been authorised by the Issuer or any agency thereof or the Joint Lead Managers (as defined under "*Subscription and Sale*"). Neither the delivery of this Offering Circular nor any sales made in connection with the issue of the Notes shall, under any circumstances, constitute a representation that there has been no change in the affairs of the Issuer since the date hereof.

To the fullest extent permitted by law, the Joint Lead Managers do not accept any responsibility for the contents of this Offering Circular or for any other statement, made or purported to be made by the Joint Lead Managers in connection with the Issuer or the issue and offering of the Notes. The Joint Lead Managers accordingly disclaim all and any liability whether arising in tort or contract or otherwise which any of them might otherwise have in respect of this Offering Circular or any such statement. Each person receiving this Offering Circular acknowledges that such person has not relied on any Joint Lead Manager or any person affiliated with any Joint Lead Manager in connection with its investigation of the accuracy of such information or its investment decision. Each person contemplating making an investment in the Notes must make its own investigation and analysis of the creditworthiness of the Issuer and its own determination of the suitability of any such investment, with particular reference to its own investment objectives and experience and any other factors which may be relevant to it in connection with such investment.

This Offering Circular does not constitute an offer of, or an invitation by or on behalf of the Issuer or any agency thereof or any Joint Lead Manager to subscribe or purchase, any of the Notes. The distribution of this Offering Circular and the offering of the Notes in certain jurisdictions may be restricted by law. Persons into whose possession this Offering Circular comes are required by the Joint Lead Managers to inform themselves about and to observe any such restrictions. For a description of certain further restrictions on offers and sales of Notes and distribution of this Offering Circular, see "*Subscription and Sale*".

In this Offering Circular, all references to "**BGN**", "**Lev**" and "**Leva**" are to the lawful currency for the time being of the Issuer, all references to "**U.S. dollars**", "**U.S.$**" and "**USD**" are to the lawful currency for the time being of the United States of America, all references to "**€**", "**EUR**" and "**euro**" are to the currency introduced on 1 January 1999 at the start of the third stage of European Economic and Monetary Union pursuant to the Treaty establishing the European Community, as amended. Since 1 July 1999, the exchange rate of the Lev against the euro has been fixed at €1.00 = BGN 1.95583.

Unless otherwise stated, all annual information, including budgetary information, is based on calendar years. Figures included in this Offering Circular have been subject to rounding adjustments; accordingly, figures shown for the same item of information may vary, and figures which are totals may not be the arithmetical aggregate of their components.

Statistical data appearing in this Offering Circular has been extracted or compiled from the records, statistics and other official public sources of information in Bulgaria, and has not been independently verified or checked by the Joint Lead Managers. Similar statistics may be obtainable from other sources, although the underlying assumptions and methodology, and consequently the resulting data, may vary from source to source. While there have been significant steps taken to improve the accuracy of the statistics, it is inevitable in the context of a transition economy that there is a degree of uncertainty as to the accuracy or reliability of the statistics when compared with those produced by countries that have for many years been preparing market economy statistics. In addition, the statistics may not be calculated on the basis that is fully in accordance with international standards, and the statistics have in the past been and may in the future be subject to significant revision. Certain statistical data appearing in this Offering Circular may not have been restated to reflect inflation. Investors should be aware that distortions caused by inflation are present in such statistics and that period-to-period comparisons may not be meaningful.

Bulgaria is a sovereign state. Consequently, it may be difficult for investors to obtain judgments of courts in countries outside Bulgaria against Bulgaria. Enforcement of such judgments in Bulgaria may be refused in certain circumstances in the absence of an applicable treaty facilitating such enforcement. See "*Risk Factors—Risks Relating to the Notes—Enforcement of Liabilities; Waiver of Immunity*".

In connection with the issue of the Notes, BNP Paribas (the "Stabilising Manager") or any person acting on behalf of the Stabilising Manager may over-allot Notes or effect transactions with a view to supporting the market price of the Notes at a level higher than that which might otherwise prevail. However, there is no assurance that the Stabilising Manager (or any persons acting on behalf of the Stabilising Manager) will undertake stabilisation action. Any stabilisation action may begin on or after the date on which adequate public disclosure of the terms of the offer of the Notes is made and, if begun, may be ended at any time, but it must end no later than the earlier of 30 days after the issue date of the Notes and 60 days after the date of the allotment of the Notes. Any stabilisation action or over-allotment must be conducted by the Stabilising Manager (or persons acting on behalf of the Stabilising Manager) in accordance with all applicable laws and rules.

FORWARD-LOOKING STATEMENTS

This Offering Circular includes forward-looking statements. All statements other than statements of historical fact included in this Offering Circular regarding, among other things, Bulgaria's economy, fiscal condition, politics, debt or prospects may constitute forward-looking statements. In addition, forward-looking statements generally can be identified by the use of forward-looking terminology such as ''may'', ''will'', ''expect'', ''project'', ''predict'', ''aim'', ''intend'', ''estimate'', ''anticipate'', ''believe'', ''continue'', ''could'', ''should'', ''would'' or similar expressions or the negative thereof or other variations thereof or comparable terminology or discussions of strategy, plans or intentions, involve a number of risks and uncertainties. Although the Issuer believes that expectations reflected in its forward-looking statements are reasonable as at the date of this Offering Circular, there can be no assurance that such expectations will prove to have been correct. The Issuer undertakes no obligation to update the forward-looking statements contained in this Offering Circular or any other forward-looking statement it may make. Forward-looking statements involve inherent risks and uncertainties.

For the Issuer, in addition to the factors described in this Offering Circular, including, but not limited to, those discussed under ''*Risk Factors*'', the following factors, among others, could cause future conditions to differ materially from those expressed in any forward-looking statements made herein:

- Decisions of international organisations regarding the terms of their financial assistance in Bulgaria and accordingly the net flow to or from such organisations over the life of the Notes.
- External factors, such as:
  - the impact of the international economic environment on the Bulgarian economy, including liquidity in the international financial markets and volatility in international equity, debt and foreign exchange markets;
  - interest rates in financial markets outside Bulgaria;
  - the impact of any changes in the credit rating of Bulgaria;
  - the impact of changes in the international prices of commodities; and
  - economic conditions in Bulgaria's major export markets.
- Internal factors, such as:
  - general economic and business conditions in Bulgaria;
  - foreign currency reserves;
  - the level of domestic debt;
  - domestic inflation;
  - the ability of Bulgaria to effect key economic reforms;
  - the level of foreign direct and portfolio investment; and
  - the level of Bulgarian domestic interest rates.

EXCHANGE RATES

On 1 July 1997 the Lev was fixed to the German Mark (“**DEM**”) at a rate of 1 BGN for 1 DEM. Since 1 January 1999, with the introduction of the euro for electronic payments, the Lev has been pegged to the euro at a rate of BGN 1.95583 to €1.00.

The following table sets forth the Lev to U.S. dollar and the U.S. dollar to euro exchange rates for the last day of the periods indicated and the average exchange rates during the periods indicated:

	2006	2007	2008	2009	2010	2011
			(BGN per U.S.$)(1)			
Year or period end	1.48506	1.33122	1.38731	1.36409	1.47276	1.51158
Average for year or period	1.55927	1.42904	1.33723	1.40670	1.47738	1.40645
			(U.S.$ per €)(2)			
Year or period end	1.3170	1.4721	1.3917	1.4406	1.3362	1.2939
Average for year or period	1.2556	1.3705	1.4708	1.3948	1.3257	1.3920

(1) *Source*: Bulgarian National Bank

(2) *Source*: European Central Bank

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RISK FACTORS

Investment in the Notes involves risks. Prospective investors should carefully consider the following risk factors, together with the other information set out in this Offering Circular, before making a decision to invest in the Notes and should understand that the risks set forth below could, individually or in the aggregate, have a material adverse effect on Bulgaria's capacity to repay principal and make payments of interest on the Notes or otherwise fulfil its obligations under the Notes. Most of these factors are contingencies which may or may not occur and the Issuer is not in a position to express a view on the likelihood of any such contingency occurring. Additional risks and uncertainties not currently known to the Issuer or that the Issuer currently deems to be immaterial may also materially affect Bulgaria's economy and its ability to fulfil its obligations under the Notes. In any such case, investors may lose all or part of their investment in the Notes. Words and expressions defined in "Terms and Conditions of the Notes" or elsewhere in this Offering Circular have the same meanings in this section.

Risk Factors Relating to Bulgaria

Bulgaria's economy remains vulnerable to external shocks, including the recent global economic crisis and those that may be caused by future significant economic difficulties of its major trading partners or by more general "contagion" effects, which could have a material adverse effect on Bulgaria's economic growth.

As a small open economy Bulgaria faces the risk of external shocks, including the recent global economic crisis. A decline in the economic growth of Bulgaria's major export partners (such as Germany, Romania, Turkey, Italy and Greece), could in the future have a significant adverse impact on Bulgaria's external demand and hence affect Bulgaria's economic growth.

As international investors' reactions to events occurring in a single market can result in a "contagion" effect, in which an entire region or class of investment is disfavoured by international investors, Bulgaria could be adversely affected by negative economic or financial developments in other EU Member States (such as Greece, Italy, Portugal and Spain) or countries with credit ratings similar to those of Bulgaria. Following the recent global economic crisis Bulgaria's economy, including gross domestic product ("**GDP**") and employment levels, was adversely affected by such contagion effects and similar developments could affect the Bulgarian economy in the future.

The global financial crisis which started in 2007 had a material negative effect on the Bulgarian economy. As a result of the slowdown in the global economy, Bulgaria suffered a decline in GDP of 5.5 per cent. in 2009. GDP growth was 0.4 per cent. in 2010 and 1.7 per cent. in 2011 as a result of stronger exports. Significant volatility in the international financial markets during 2011 and the first half of 2012, however, has cast doubt over the sustainability of the Eurozone and therefore the pace of economic growth in Bulgaria. The near-term economic outlook for Bulgaria has weakened. The International Monetary Fund (the "**IMF**") is projecting real GDP growth of 0.8 per cent. in 2012 and 1.5 per cent. in 2013, despite an expected increase in the absorption of EU funds.

Significantly higher rates on sovereign debt in some Eurozone countries have affected national economies and the risk of a squeeze on liquidity has risen across the European Union (the "**EU**"). A further downgrade of sovereign debt ratings, including those of Bulgaria's major trading partners, may result in an enhanced risk of deleveraging and credit contraction and, in turn, could have a material adverse effect on the Bulgarian economy.

Greece is Bulgaria's fifth most important export partner, accounting for 7 per cent. of all Bulgarian exports in 2011. The ongoing crisis in Greece is likely to result in reduced export demand and lower investment from Greece. The crisis is likely to limit the recovery of lending growth in Bulgaria in the near term, with Greek banks at present accounting for 23 per cent. of total banking assets in Bulgaria and 26 per cent. of loans. In the event of a Greek default, the crisis could have a negative impact on the Bulgarian economy, both through the banking sector and, if contagion were to spread further across the Eurozone, through weaker external demand.

Bulgaria is dependent on the import of fuels and fluctuations in international fuel prices

Bulgaria's energy and petrochemical industry is dependent on the supply of fuels from abroad, principally oil and natural gas from Russia. Currently, Bulgaria receives over 98 per cent. of its natural gas needs from Gazprom, based in Russia. The country's only operational oil refinery, Neftochim, which provides more than 70 per cent. of the petrol in the country, is fully owned by Lukoil, domiciled in Russia. Russia is also the only supplier of the Bulgarian Kozloduy nuclear powerplant. Bulgaria is also a transit country for Russian natural gas to Turkey, Greece and Macedonia.

Furthermore, consumer price dynamics in Bulgaria largely follow international food and energy price developments. A sharp increase of the price of oil will strengthen external inflation factors and will result in higher domestic inflation, both through higher energy prices and some secondary effects on the other components of the Harmonised Index of Consumer Prices (‘‘**HICP**’’), which in turn could suppress domestic demand and have a material adverse effect on the GDP growth.

Lower European Fund transfers may substantially reduce revenues and thus undermine public finances in Bulgaria

In order to improve and stimulate domestic investment activity, the government of Bulgaria (the ‘‘**Government**’’) also utilises European finances from the Cohesion and Structural funds of the EU. As of 2005, foreign direct investment (‘‘**FDI**’’) in export oriented sectors such as the processing industries increased considerably, while FDI in real estate and construction peaked dramatically in the run up prior to the crisis. The decline in FDI flows in those sectors following the 2008 crisis contributed to the substantial drop in real estate prices. After the sharp decline in FDI following the onset of the global financial and economic crisis, European funds have become the main financial resource for the Bulgarian economy. Lower than anticipated transfers in the medium term may substantially reduce Government revenues and thus reduce public finances, which could have an adverse effect on the Bulgarian economy and the Government’s ability to repay the Notes.

Further deterioration of the quality of credit portfolios of the banking sector

A new slowdown of economic growth in the Eurozone or the EU as a whole will put pressure on Bulgarian exports, due to a reduction in demand for Bulgarian goods. This may lead to a deterioration of the liquidity position of exporters, which in turn may lead to an increase in companies being unable to make timely payments or repay their debts and a resulting deterioration of the banks’ credit portfolio quality and lower bank profitability. The deterioration in banks’ portfolios could make them more susceptible to aggregate shocks, such as increases in their own cost of borrowing.

High level of foreign ownership in the Bulgarian banking system makes it vulnerable to disruption as a result of internal or external factors

As at 31 December 2011, 76.5 per cent. of the total assets of the banking system in Bulgaria were foreign owned, and 23.5 per cent. of banks were domestically owned according to supervisory data reported by the Bulgarian National Bank (the ‘‘**BNB**’’). Out of 76.5 per cent. of foreign owned banks, EU banks had a share of 73.4 per cent., of which 69 per cent. were subsidiaries of EU banks and 4.4 per cent. were branches (See ‘‘*Monetary and Financial System – Banking System*’’). The Bulgarian banking system is exposed to the banking systems of other countries, including Italy, Greece, Austria and France. Foreign banks may rebalance their global loan portfolio in a manner adversely affecting Bulgaria as a result of events related or unrelated to Bulgaria, including as a result of the ongoing economic turbulence in the Eurozone and sovereign debt markets. In addition, foreign banks may decrease funding to their subsidiaries operating in Bulgaria due to actual or perceived deterioration in asset quality, particularly in the event of a weaker than expected economic performance and a rise in non-performing loans. As a result of these or other factors, or other potential shocks, foreign banks may revise their business strategies in, or relating to, Bulgaria and in particular their decision to fund their subsidiaries in Bulgaria. This may negatively affect the Bulgarian fiscal tax base.

Bulgaria maintains a currency board arrangement and therefore has limited ability to set monetary policy

Bulgaria maintains a currency board arrangement pursuant to which the exchange rate for the Lev has been fixed to the Deutsche Mark since 1 July 1997 and subsequently to the euro since 1 January 1999 (see ‘‘*Monetary and Financial System*’’). Under the currency board arrangement, the BNB is able to manage the liquidity of the banking system via a foreign exchange window, reserve requirements and other regulatory and supervisory measures, but it lacks the ability to set monetary policy by adjusting money supply and interest rates.

Bulgaria’s currency board has not been implemented in the same way currency boards in other countries have been established, in that foreign reserves cover not only the monetary base, but also the Government’s deposits with the BNB’s Issue Department and the Banking Department’s deposits with the Issue Department. The currency board has assisted Bulgaria in achieving macroeconomic stability and has instilled fiscal and monetary discipline. Having created a predictable economic environment, the arrangement promoted economic growth and facilitated Bulgaria's accession to the EU in 2007. Furthermore, the currency board arrangement and the BNB's macroprudential policy have been pivotal in maintaining financial stability in the country during the global financial and economic crisis. However, the lack of policy flexibility associated with the maintenance of the currency board could operate as an impediment to Bulgaria's recovery in the context of the current economic crisis if it were to have an adverse effect on growth, and there can be no assurance that the limitations imposed by the currency board arrangement will not have an adverse effect on the Bulgarian economy in the future.

Risks affecting the financial stability of pension and health systems

Part of the fiscal challenges facing the country's economy is to ensure fiscal stability of the public social security and health systems by measures aimed at reducing pressure on costs and increasing revenues in the medium and long term. In the long term a significant increase in the proportion of older people and a deterioration of the demographic structure is anticipated in Bulgaria, which poses a serious risk to fiscal sustainability and will lead to pressure on public pensions and health care spending.

This process presents a challenge to the sustainability of public finances and necessitates the adherence to a conservative fiscal policy with respect to budget balance, pension reforms and improvement in the quality of public health care expenditures. In the event the Government cannot successfully implement such policies, this could have an adverse effect on the fiscal stability of public social security and health systems and sustainability of public finances in Bulgaria.

Changes in Bulgaria's relationships with western governments and institutions may have a negative impact on its economy

The relationships that Bulgaria maintains with western governments and institutions vary and any change in such relationships could have a negative impact on the economy of Bulgaria. The EU has conveyed concerns on medium-term issues such as deficiencies in the judiciary, and on specific contraventions of commitments, such as those on water and waste management, and regarding tenders within the communications sector. The latest interim report by the European Commission, published in February 2012, pointed to piecemeal achievements, but also to ongoing failures, including the lack of significant convictions in organised crime cases and concerns about oversight within the judiciary. In addition, Bulgaria has had problems absorbing EU funds in the past, which led to the loss of some allocations in the first years following accession. In order to strengthen the administration of EU funds, the Government has implemented a more focused institutional oversight in the cabinet and the prosecutor's office. A position was introduced for a minister without portfolio, to be responsible for EU funds management in order to boost absorption while maintaining tight expenditure controls. As a result, the absorption rate has increased in the past two years and is expected to improve further. Nevertheless, work still remains to be done if the full allocation of EU funds is to be administered. Any deterioration in Bulgaria's relationships with the EU, which in turn could limit the amount of transfers of EU funds to Bulgaria, could have an adverse effect on the Bulgarian economy.

Risks relating to the Notes

Notes May Not be a Suitable Investment for All Investors

Each potential investor in the Notes must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

- have sufficient knowledge and experience to make a meaningful evaluation of the Notes, the merits and risks of investing in the Notes and the information contained in this Offering Circular or any applicable supplement;
- have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Notes and the impact such investment will have on its overall investment portfolio;
- have sufficient financial resources and liquidity to bear all of the risks of an investment in the Notes;
- understand thoroughly the terms of the Notes; and
- be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

A potential investor should not invest in the Notes unless it has the expertise (either alone or with the help of a financial adviser) to evaluate how the Notes will perform under changing conditions, the resulting effects on the value of such Notes and the impact this investment will have on the potential investor's overall investment portfolio.

Modification and Waivers

The Terms and Conditions of the Notes contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority. For example, under these provisions, certain key terms of the Notes may be amended, including the maturity date, interest rate and other payment terms, with the consent of the holders of 75 per cent. of the aggregate principal amount of the outstanding Notes.

The Terms and Conditions of the Notes also provide that the Notes and such Conditions may, subject to the prior written approval of the Issuer, be amended without the consent of the Noteholders to correct a manifest error. In addition, the parties to the Fiscal Agency Agreement (as defined in "*General Information*") may agree to modify any provision thereof, but the Issuer shall not agree, without the consent of the Noteholders, to any such modification unless it is of a formal, minor or technical nature, it is made to correct a manifest error or it is, in the opinion of such parties, not materially prejudicial to the interests of the Noteholders.

Minimum Denomination

As the Notes have a minimum denomination consisting of EUR 100,000 plus higher integral multiples of EUR 1,000, it is possible that the Notes may be traded in amounts in excess of EUR 100,000 (or its equivalent) that are not integral multiples of EUR 100,000 (or its equivalent). In such case a Noteholder who, as a result of trading such amounts, holds a principal amount of less than the minimum denomination may not receive a Note Certificate in respect of such holding (should Note Certificates be printed) and would need to purchase a principal amount of Notes such that its holding amounts to the minimum denomination.

The EU Savings Directive may result in certain holders not receiving the full amount of interest

Under EC Council Directive 2003/48/EC on the taxation of savings income (the "**EU Savings Directive**"), each Member State is required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to or for an individual or certain limited types of entity established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system (the applicable rate of withholding now being 35 per cent.) in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). The withholding system is subject to an exception whereby the beneficial owner of the interest or other income may elect for the exchange of information instead. A number of non-EU countries and territories including Switzerland have adopted, or agreed to adopt, similar measures (a withholding system in the case of Switzerland) and certain dependent or associated territories of EU Member States have adopted the same measures. The European Commission has proposed certain amendments to the EU Savings Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

If an amount of, or in respect of, tax were to be withheld from a payment of principal or interest under a Note, pursuant to the EU Savings Directive, any other European Union Directive implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. See Condition 8 (*Taxation*) of the "*Terms and Conditions of the Notes*". However, the Issuer is required, as provided in Condition 12 (*Agents*) of the "*Terms and Conditions of the Notes*", to maintain a Paying Agent in a Member State that does not impose an obligation to withhold or deduct tax pursuant to the EU Savings Directive or any law implementing or complying with, or introduced in order to conform to, the EU Savings Directive or any such other Directive.

Change in Law

The "*Terms and Conditions of the Notes*" are based on English law in effect as at the date of this Offering Circular. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice after the date of this Offering Circular.

The Terms and Conditions of the Notes restrict the ability of an individual holder to declare a default and permit a majority of holders to rescind a declaration of default

The Terms and Conditions of the Notes contain a provision which, if an Event of Default occurs, allows the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes to declare all the Notes to be immediately due and payable by providing notice in writing to the Issuer, whereupon the Notes shall become immediately due and payable, at their principal amount with accrued interest, without further action or formality.

The Terms and Conditions of the Notes also contain a provision permitting the holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to notify the Issuer to the effect that the Event of Default or Events of Default giving rise to any above mentioned declaration is or are cured following any such declaration and that such holders wish the relevant declaration to be withdrawn. The Issuer shall give notice thereof to the Noteholders, whereupon the relevant declaration shall be withdrawn and shall have no further effect.

The Secondary Market Generally

The Notes may have no established trading market when issued, and one may never develop. If a market does develop, it may not be liquid. Therefore, investors may not be able to sell their Notes easily or at prices that will provide them with a yield comparable to similar investments where a developed secondary market exists.

Legal Investment Considerations May Restrict Certain Investments

The investment activities of certain investors are subject to investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) the Notes are legal investments for it, (2) the Notes can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any Notes. Financial institutions should consult their legal advisers or the appropriate regulators to determine the appropriate treatment of the Notes under any applicable risk based capital or similar rules.

Exchange rate risks and exchange controls

The Issuer will pay principal and interest on the Notes in euro. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "**Investor's Currency**") other than euro. These include the risk that exchange rates may significantly change (including changes due to devaluation of euro or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to euro would decrease (1) the Investor's Currency equivalent yield on the Notes, (2) the Investor's Currency equivalent value of the principal payable on the Notes and (3) the Investor's Currency equivalent market value of the Notes.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.

Interest rate risks

Investment in the Notes involves the risk that subsequent changes in market interest rates may adversely affect the value of the Notes.

Credit Ratings May Not Reflect All Risks

In general, European regulated investors are restricted under Regulation (EC) No. 1060/2009 (the "**CRA Regulation**") from using credit ratings for regulatory purposes, unless such ratings are issued by a credit rating agency established in the EU and registered under the CRA Regulation (and such registration has not been withdrawn or suspended), subject to transitional provisions that apply in certain circumstances whilst the registration application is pending. Such general restriction will also apply in the case of credit ratings issued by non-EU credit rating agencies, unless the relevant credit ratings are endorsed by an EU-registered credit rating agency or the relevant non-EU rating agency is certified in accordance with the CRA Regulation (and such endorsement action or certification, as the case may be, has not been withdrawn or suspended).

The Issuer has been assigned sovereign credit ratings of Baa2 by Moody's Investors Service Ltd. (''**Moody's**'') on 22 July 2011 and BBB by Standard & Poor's Credit Market Services Europe Limited (''**Standard & Poor's**'') on 1 December 2009, as reaffirmed on 21 December 2011. Each of Moody's and Standard & Poor's is established in the EU and registered under the CRA Regulation. A credit rating is not a recommendation to buy, sell or hold the Notes. Credit ratings are subject to revision or withdrawal at any time by the assigning rating agency. The Issuer cannot be certain that a credit rating will remain for any given period of time or that a credit rating will not be downgraded or withdrawn entirely by the relevant rating agency if, in its judgment, circumstances in the future so warrant. The Issuer has no obligation to inform Noteholders of any such revision, downgrade or withdrawal. A suspension, downgrade or withdrawal at any time of the credit rating assigned to the Issuer may adversely affect the market price of the Notes.

Enforcement of Liabilities

Bulgaria is a sovereign state. Consequently, it may be difficult for investors to obtain judgments of courts in countries outside Bulgaria against the Republic. In the absence of any applicable international treaty, recognition and enforcement of judgments of courts outside the European Union in Bulgaria may be refused on the grounds provided in Bulgaria's Private International Law Code. Such non-enforcement grounds are similar to, yet are slightly broader than, the grounds under Council Regulation (EC) No. 44/2001 of 22 December 2000 on the jurisdication and the recognition and enforcement of judgments in civil and commercial matters (the ''**Council Regulation (EC) No. 44/2001**'').

As at the date of this Offering Circular, a judgment obtained in an English court should be enforceable in Bulgaria on the basis that Council Regulation (EC) No. 44/2001 is directly applicable in Bulgaria, *provided, however, that* the conditions of enforcement set out therein are met.

After a final court judgment, whether of an English court or of any other court of competent jurisdiction, is recognised in Bulgaria it has the validity of a Bulgarian judgment and will be subject to enforcement against the Republic in accordance with the provisions of Bulgaria's Civil Procedure Code. It is notable, that enforcement against the Republic will be carried out in accordance with procedures which differ from the enforcement procedures applicable to other defendants (for example, the attachment of or forcible liquidation of assets of the Republic located in Bulgaria is not possible).

TERMS AND CONDITIONS OF THE NOTES

The following is the text of the Terms and Conditions of the Notes which, subject to completion and amendment will be endorsed on each Note Certificate (if issued):

The EUR 950,000,000 4.25 per cent. Notes due 2017 (the "**Notes**", which expression includes any further notes issued pursuant to Condition 14 (*Further Issues*) and forming a single series therewith) of the Republic of Bulgaria (the "**Issuer**") were authorised by the 2012 State Budget Act of the Republic of Bulgaria, the resolutions of the Council of Ministers dated 3 May 2012 and dated 5 June 2012 and by the law on ratification of the Fiscal Agency Agreement (as defined below), the Subscription Agreement (as defined in "*Subscription and Sale*") and the Deed of Covenant (as defined below) adopted by parliament on 8 June 2012, sealed by the President on 15 June 2012 and published by the State Gazette Issue No. 46 on 19 June 2012 and in force as of 23 June 2012 (the "**Law on Ratification**"). A fiscal agency agreement dated 4 June 2012, as amended or supplemented from time to time (the "**Fiscal Agency Agreement**") has been entered into, between the Issuer and The Bank of New York Mellon as fiscal agent and the other agents named in it. The Notes have the benefit of a Deed of Covenant dated 4 June 2012 (the "**Deed of Covenant**") executed by the Issuer relating to the Notes. The fiscal agent, the registrar, and any transfer agent for the time being are referred to below respectively as the "**Fiscal Agent**", the "**Registrar**" and the "**Transfer Agents**". "**Paying Agents**" means the Fiscal Agent and the paying agents named in the Fiscal Agency Agreement, which expression includes any other paying agent or paying agents appointed from time to time with respect to the Notes. "**Agents**" means the Fiscal Agent, the Paying Agents, the Registrar, the Transfer Agents and any other agent or agents appointed from time to time with respect to the Notes. Certain provisions of these Conditions are summaries of the Fiscal Agency Agreement and are subject to its detailed provisions. The Fiscal Agency Agreement includes the form of the Notes. Copies of the Fiscal Agency Agreement and the Deed of Covenant are available for inspection by Noteholders (as defined below) during normal business hours at the Specified Offices (as defined in the Fiscal Agency Agreement) of each of the Paying Agents, the Registrar and any Transfer Agents, the initial Specified Offices of which are set out below. The holders of the Notes are bound by, and are deemed to have notice of all the provisions of the Fiscal Agency Agreement applicable to them.

All capitalised terms that are not defined in these terms and conditions (the "**Conditions**") will have the meanings given to them in the Fiscal Agency Agreement, the absence of any such meaning indicating that such term is not applicable to the Notes. References to "Conditions" are, unless the context otherwise requires, to the numbered paragraphs of these terms and conditions.

1. FORM, DENOMINATION AND TITLE

The Notes are serially numbered and in registered form in denominations of EUR 100,000 and integral multiples of EUR 1,000 in excess thereof (each such denomination an "**Authorised Holding**").

The Notes are intended to be issued under the new safekeeping structure and are represented by registered certificates ("**Note Certificates**") and, save as provided in Condition 2(a) (*Transfer*), each Note Certificate shall represent the entire holding of Notes by the same holder.

Title to the Notes shall pass by registration in the register that the Issuer shall procure to be kept by the Registrar at its Specified Office in accordance with the provisions of the Fiscal Agency Agreement (the "**Register**"). The holder (as defined below) of any Note shall (except as otherwise required by law) be treated as its absolute owner for all purposes (whether or not it is overdue and regardless of any notice of ownership, trust or any other interest therein, any writing thereon or any notice of any previous loss or theft thereof) and no Person shall be liable for so treating the holder. No Person shall have any right to enforce any term or condition of the Notes under the Contracts (Rights of Third Parties) Act 1999.

In these Conditions:

"**Noteholder**" and "**holder**" means the Person in whose name a Note is registered in the Register (or, in the case of joint holders, the first name thereof); and

"**Person**" means any individual, company, corporation, firm, partnership, joint venture, association, organisation, state or agency of a state (including the Ministry of Finance and Council of Ministers) or other entity (including the Bulgarian National Bank), whether or not having separate legal personality.

2. TRANSFER OF NOTES

(a) Transfer: One or more Notes may, subject to the terms of the Fiscal Agency Agreement and to Condition 2(c) (*Transfer or Exercise Free of Charge*) and 2(d) (*Closed Periods*), be transferred in whole or in part in an Authorised Holding upon the surrender (at the Specified Office of the Registrar or any Transfer Agent) of the Note Certificate(s) representing such Notes to be transferred, together with the form of transfer endorsed on such Note Certificate(s) (or another form of transfer substantially in the same form and containing the same representations and certifications (if any), unless otherwise agreed by the Issuer), duly completed and executed and any other evidence as the Registrar or Transfer Agent may reasonably require. In the case of a transfer of part only of a holding of Notes represented by one Note Certificate, a new Note Certificate shall be issued to the transferee in respect of the part transferred and a further new Note Certificate in respect of the balance of the holding not transferred shall be issued to the transferor. In the case of a transfer of Notes to a Person who is already a holder, a new Note Certificate representing the enlarged holding shall only be issued against surrender of the Note Certificate representing the existing holding. All transfers of Notes and entries on the Register will be made in accordance with the detailed regulations concerning transfers of Notes scheduled to the Fiscal Agency Agreement. The regulations may be changed by the Issuer, with the prior written approval of the Registrar and the Fiscal Agent (such approval not to be unreasonably withheld or delayed). A copy of the current regulations will be made available by the Registrar to any Noteholder upon request. A Note may be registered only in the name of, and transferred only to, a named Person or Persons. No transfer of a Note will be valid unless and until entered on the Register.

(b) Delivery of New Note Certificates: Each new Note Certificate to be issued pursuant to Condition 2(a) (*Transfer*) shall be available for delivery within five business days of receipt of a duly completed form of transfer and surrender of the existing Note Certificate(s). Delivery of the new Note Certificate(s) shall be made at the Specified Office of the Transfer Agent or of the Registrar (as the case may be) to whom delivery or surrender of such form of transfer or Note Certificate shall have been made or, at the option of the holder making such delivery or surrender as aforesaid and as specified in the relevant form of transfer or otherwise in writing, be mailed by uninsured post at the risk and at the expense of the holder entitled to the new Note Certificate to such address as may be so specified, unless such holder requests otherwise and pays in advance to the relevant Transfer Agent or the Registrar (as the case may be) the costs of such other method of delivery and/or such insurance as it may specify. In this Condition 2(b), ''business day'' means a day, other than a Saturday or Sunday, on which banks are open for general business (including dealing in foreign exchange and foreign currency deposits) in both London and the place of the Specified Office of the relevant Transfer Agent or the Registrar (as the case may be).

(c) Transfer or Exercise Free of Charge: Note Certificates, on transfer, exercise of an option or partial redemption, shall be issued and registered without charge by or on behalf of the Issuer, the Registrar or any Transfer Agent, but subject to (i) the payment by the Person making the application for transfer of any tax, duties or other governmental charges that may be imposed in relation to it (or the giving of such indemnity as the Registrar or the relevant Transfer Agent may require), (ii) the Registrar being satisfied with the documents of title and/or identity of the Person making the application, and (iii) such reasonable regulations as the Issuer may from time to time agree with the Registrar.

(d) Closed Periods: No Noteholder may require the transfer of a Note to be registered during the period of 15 days immediately prior to the due date for any payment of principal or interest in respect of the Notes.

(e) Authorised Holdings: No Note may be transferred unless the principal amount of Notes transferred and (where not all of the Notes held by a holder are being transferred) the principal amount of the balance of the Notes not transferred are Authorised Holdings.

3. STATUS

The Notes constitute direct, general, unconditional and (subject to Condition 4 (*Negative Pledge*)), unsecured and unsubordinated obligations of the Issuer and the full faith and credit of the Issuer is pledged for the due and punctual payment of principal of, and interest on, the Notes and for the performance of all other obligations of the Issuer pursuant to the Notes. The Notes shall at all times rank *pari passu* without any preference among themselves and at least *pari passu* in right of payment with all other present and future unsecured and unsubordinated obligations of the Issuer, save for such obligations as may be preferred by provisions of law that are of mandatory application.

4. NEGATIVE PLEDGE

So long as any of the Notes remain outstanding (as defined in the Fiscal Agency Agreement), the Issuer will not grant or permit to be outstanding, and will procure that there is not granted or permitted to be outstanding, any mortgage, charge, lien, pledge or other security interest over any of its present or future assets or revenues or upon the International Monetary Assets of the Issuer (which expression includes the gold and the reserves of the Issuer by whomsoever and in whatever form owned or held or customarily regarded and held out as the International Monetary Assets thereof) or any part thereof, to secure any Public External Indebtedness or any Guarantee thereof unless the Issuer shall, in the case of the granting of the security, before or at the same time, and in any other case, promptly, procure that all amounts payable in respect of the Notes are secured equally and rateably, or such other security or other arrangement is provided as shall be approved by an Extraordinary Resolution (as defined in the Fiscal Agency Agreement) of the Noteholders.

For this purpose, ***Public External Indebtedness*** means any present or future indebtedness (a) in the form of, or represented by, notes, bonds or other similar instruments which are for the time being, or are capable of being, quoted, listed or ordinarily dealt in on any stock exchange, over the counter or other securities market and (b) which is not (i) denominated in Bulgarian lev, (ii) admitted to trading on a market of the Bulgarian Stock Exchange, (ii) registered with the Central Depositary AD of the Republic of Bulgaria, (iii) expressed to be governed by the laws of the Issuer, or (iv) placed or sold in the Republic of Bulgaria. For the purposes of this Condition, an issue is ''placed or sold in the Republic of Bulgaria'' if more than 50 per cent. of its aggregate principal amount is initially placed in the Republic of Bulgaria.

In these Conditions:

''**Agency**'' means any political sub-division, regional government, ministry, department, central or local authority or statutory corporation of the Republic of Bulgaria or the Government (whether or not such statutory corporation is autonomous) and any corporation or other entity (but not any commercial corporation or other commercial entity except, in each case, to the extent that any International Monetary Assets are owned, controlled, held or administered thereby) which is directly or indirectly controlled (whether by reason of whole or partial ownership, control over voting or other relevant decision making power to direct management, the composition of management or otherwise) by the Republic of Bulgaria or the Government or one or more Agencies (including, without limitation, the Ministry of Finance, Council of Ministers or the Bulgarian National Bank);

''**Bulgaria's Monetary Authorities**'' means the Bulgarian National Bank (including its Issue Department, or any other relevant body within the Bulgarian National Bank) and, to the extent that they perform monetary authorities' functions, currency boards, exchange stabilisation funds and treasuries;

''**Government**'' means the government of the Republic of Bulgaria from time to time;

''**Guarantee**'' means any guarantee of or indemnity in respect of indebtedness or other like obligation; and

''**International Monetary Assets**'' means all of the Issuer's official holdings of gold and all of the Issuer's and Bulgaria's Monetary Authorities' holdings of Special Drawing Rights, Reserve Positions in the Fund and Foreign Exchange of the Government or any agency or department of the Government from time to time, and the terms ''**Special Drawing Rights**'', ''**Reserve Positions in the Fund**'' and ''**Foreign Exchange**'' have, as to the types of assets included, the meanings given to them in the International Monetary Fund's (''**IMF**'') publication entitled ''International Financial Statistics'' or such other meanings as shall be formally adopted by the IMF from time to time.

5. INTEREST

Each Note bears interest from 9 July 2012 (the ''**Issue Date**'') at the rate of 4.25 per cent. per annum (the ''**Rate of Interest**''), payable in arrear on 9 July in each year (each, an ''**Interest Payment Date**''), subject as provided in Condition 7 (*Payments*).

Each Note will cease to bear interest from the due date for redemption unless, upon due presentation of the corresponding Note Certificate, payment of principal is improperly withheld or refused, in which case it will continue to bear interest at such rate (both before and after judgment) until whichever is the earlier of (a) the day on which all sums due in respect of such Note up to that day are received by or on behalf of the relevant Noteholder and (b) the day which is seven days after notice has been given to the Noteholders that the Fiscal Agent has received all sums due in respect of the Notes up to such seventh day (except, in the case of payment to the Fiscal Agent, to the extent that there is any subsequent default in payment in accordance with these Conditions).

The amount of interest payable on each Interest Payment Date shall be EUR 4,250 in respect of each Note of EUR 100,000 denomination and EUR 42.50 in respect of each integral amount of EUR 1,000 denomination thereafter. If interest is required to be paid in respect of a Note on any other date, it shall be calculated by applying the Rate of Interest to the Calculation Amount, multiplying the product by the Day Count Fraction and rounding the resulting figure to the nearest cent (half a cent being rounded upwards) and multiplying such rounded figure by a fraction equal to the denomination of such Note divided by the Calculation Amount, where:

"**Calculation Amount**" means EUR 1,000;

"**Day Count Fraction**" means, in respect of any period, the number of days in such period, from (and including) the first day to (but excluding) the last day, divided by the number of days in the Regular Period in which such period falls; and

"**Regular Period**" means each period from (and including) the Issue Date or any Interest Payment Date to (but excluding) the next Interest Payment Date.

6. REDEMPTION, PURCHASE AND CANCELLATION

(a) Final Redemption

Unless previously purchased and cancelled, the Notes will be redeemed at their principal amount on 9 July 2017 subject as provided in Condition 7 (*Payments*).

(b) Purchase

The Issuer and its Agencies may at any time purchase Notes in the open market or otherwise at any price. Any Notes so purchased, while held by or on behalf of the Republic or any Agency, shall not entitle the holder to vote at any meeting of Noteholders and shall not be deemed to be outstanding for the purposes of calculating quorums at meetings of Noteholders.

All Note Certificates representing Notes so purchased may be held or resold or surrendered to the Registrar for cancellation.

(c) Cancellation

Any Note Certificate so surrendered for cancellation pursuant to Condition 6(b) (*Purchase*) may not be reissued or resold and upon such cancellation the obligations of the Issuer in respect of any such Note shall be discharged.

7. PAYMENTS

(a) Principal: Payments of principal shall be made by euro cheque drawn on, or, upon application by a Noteholder to the Specified Office of the Fiscal Agent not later than the fifteenth day before the due date for any such payment, by transfer to a euro account (or other account to which euro may be credited or transferred) maintained by the payee with, a bank in a city in which banks have access to the TARGET System and (in the case of redemption) upon surrender (or, in the case of part payment only, endorsement) of the relevant Note Certificates at the Specified Office of any Paying Agent.

(b) Interest: Payments of interest shall be made by euro cheque drawn on, or upon application by a Noteholder to the Specified Office of the Fiscal Agent not later than the fifteenth day before the due date for any such payment, by transfer to a euro account (or other account to which euro may be credited or transferred) maintained by the payee with, a bank in a city in which banks have access to the TARGET System and (in the case of interest payable on redemption) upon the due date for payment.

(c) Interpretation:

In these Conditions:

"**TARGET2**" means the Trans-European Automated Real-Time Gross Settlement Express Transfer payment system which utilises a single shared platform and which was launched on 19 November 2007;

"**TARGET Settlement Day**" means any day on which TARGET2 is open for the settlement of payments in euro; and

"**TARGET System**" means the TARGET2 system.

(d) Payments subject to fiscal laws: All payments in respect of the Notes are subject in all cases to any applicable fiscal or other laws and regulations in the place of payment, but without prejudice to the provisions of Condition 8 (*Taxation*). No commissions or expenses shall be charged to the Noteholders in respect of such payments.

(e) Payments on business days: Where payment is to be made by transfer to a euro account (or other account to which euro may be credited or transferred), payment instructions (for value the due date, or, if the due date is not a business day, for value the next succeeding business day) will be initiated and, where payment is to be made by cheque, the cheque will be mailed (i) (in the case of payments of principal and interest payable on redemption) on the later of the due date for payment and the day on which the relevant Note Certificate is surrendered (or, in the case of part payment only, endorsed) at the Specified Office of a Paying Agent and (ii) (in the case of payments of interest payable other than on redemption) on the due date for payment. A Noteholder shall not be entitled to any interest or other payment in respect of any delay in payment resulting from (A) the due date for a payment not being a business day or (B) a cheque mailed in accordance with this Condition 7 arriving after the due date for payment or being lost in the mail. In this Condition 7(e), "business day" means:

   (i) in the case of payment by transfer to a euro account (or other account to which euro may be credited or transferred) as referred to above, any day which is a TARGET Settlement Day; and

   (ii) in the case of surrender (or, in the case of part payment only, endorsement) of a Note Certificate, any day on which banks are open for general business (including dealings in foreign exchange and foreign currencies) in the place in which the Note Certificate is surrendered (or, as the case may be, endorsed).

(f) Partial payments: If a Paying Agent makes a partial payment in respect of any Note Certificate, the Issuer shall procure that the amount and date of such payment are noted on the Register and, in the case of partial payment upon presentation of a Note Certificate, that a statement indicating the amount and the date of such payment is endorsed on the relevant Note Certificate.

(g) Record date: Each payment in respect of a Note will be made to the Person shown as the holder in the Register at the close of business in the place of the Registrar's Specified Office on the fifteenth day before the due date for such payment (the "Record Date"). Where payment in respect of a Note is to be made by cheque, the cheque will be mailed to the address shown as the address of the holder in the Register at the close of business on the relevant Record Date.

8. TAXATION

All payments of principal and interest in respect of the Notes by the Issuer shall be made free and clear of and, without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature imposed, levied, collected, withheld or assessed by or on behalf of the Republic of Bulgaria or any political subdivision of, or any authority therein or thereof having power to tax, unless the withholding or deduction of such taxes, duties, amendments or governmental charges is required by law. In that event, the Issuer will pay such additional amounts as will result in receipt by the Noteholders after such withholding or deduction of such amounts as would have been received by them had no such withholding or deduction been required, except that no additional amounts shall be payable in relation to any payment in respect of any Note:

(a) where (in the case of a payment of principal or interest on redemption) the relevant Note Certificate is surrendered for payment by or on behalf of a holder which is liable to such taxes, duties, assessments or governmental charges in respect of such Note by reason of its having some connection with the Republic of Bulgaria other than the mere holding of the Note; or

(b) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC or any other European Union Directive implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive; or

(c) where (in the case of a payment of principal or interest on redemption) the relevant Note Certificate is surrendered for payment by or on behalf of a holder who would have been able to avoid such withholding or deduction by surrendering the relevant Note Certificate to another Paying Agent in a member state of the European Union; or

(d) more than 30 days after the Relevant Date except to the extent that the holder of such Note would have been entitled to such additional amounts on surrendering such Note Certificate representing such Note for payment on the last day of such period of 30 days.

In these Conditions, ''**Relevant Date**'' means whichever is the later of (1) the date on which the payment in question first becomes due and (2) if the full amount payable has not been received in a city in which banks have access to the TARGET System by the Fiscal Agent on or prior to such due date, the date on which (the full amount having been so received) notice to that effect has been given to the Noteholders.

Any reference in these Conditions to principal or interest shall be deemed to include any additional amounts in respect of principal or interest (as the case may be) which may be payable under this Condition 8.

9. EVENTS OF DEFAULT

If any of the following events (each an ''**Event of Default**'') occurs and is continuing:

(a) Non-payment

Any default is made in the payment of any interest due in respect of the Notes or any of them when due and the default continues for a period of 15 days; or

(b) Breach of Other Obligations

The Issuer fails to perform or observe any of its other obligations under these Conditions and (except in any case where the failure is incapable of remedy when no continuation or notice as is hereinafter mentioned will be required) the failure continues for the period of 30 days after written notice thereof, addressed to the Issuer by any Noteholder, has been delivered to the Issuer or to the Fiscal Agent requiring the same to be remedied; or

(c) Cross-default

(i) the holders of any Public External Indebtedness of the Issuer accelerate such Public External Indebtedness or declare such Public External Indebtedness to be due and payable, or required to be prepaid (other than by a regularly scheduled required payment), prior to the stated maturity thereof; or

(ii) the Issuer fails to pay in full any principal of, or interest on, any Public External Indebtedness when due (after expiration of any applicable grace period) or any Guarantee thereof given by the Issuer shall not be honoured when due and called upon (after the expiration of any applicable grace period);

provided that the aggregate amount of the relevant Public External Indebtedness or Guarantee in respect of which one or more of the events mentioned above in this paragraph (c) shall have occurred equals or exceeds EUR 100,000,000 or its equivalent in any other currency or currencies; or

(d) Unenforceability

For any reason whatsoever, any of the Issuer's obligations under the Notes are declared by a court of competent jurisdiction pursuant to a final non-appealable decision to be no longer binding or no longer enforceable against the Issuer or as a result of a judgment or any other act of the Constitutional Court of the Republic of Bulgaria or for any other reason whatsoever any such obligation ceases to be in full force and effect; or

(e) Validity

The Republic of Bulgaria, or any of its political sub-divisions, authorised Agencies or officials (on its behalf) repudiates or contests the validity of the Notes;

then the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes may, by notice in writing to the Issuer (with a copy to the Fiscal Agent), declare all the Notes to be immediately due and payable, whereupon they shall become immediately due and payable at their principal amount together with and accrued interest without further action or formality. Notice of any such declaration shall promptly be given to all other Noteholders by the Issuer.

If the Issuer receives notice in writing from holders of at least 50 per cent. in aggregate principal amount of the outstanding Notes to the effect that the Event of Default or Events of Default giving rise to any above mentioned declaration of acceleration is or are cured following any such declaration and that such holders wish the relevant declaration to be withdrawn, the Issuer shall give notice thereof to the Noteholders (with a copy to the Fiscal Agent), whereupon the relevant declaration shall be withdrawn and shall have no further effect, but without prejudice to any rights or obligations which may have arisen before the Issuer gives such notice (whether pursuant to these Conditions or otherwise). No such withdrawal shall affect any other or any subsequent Event of Default or any right of any Noteholder in relation thereto.

10. PRESCRIPTION

Claims against the Issuer for payment in respect of the Notes shall become void unless made within a period of ten years, in the case of principal, and five years, in the case of interest, of the appropriate Relevant Date (as defined in Condition 8 (*Taxation*)).

11. REPLACEMENT OF NOTE CERTIFICATES

If any Note Certificate is lost, stolen, mutilated, defaced or destroyed it may be replaced at the Specified Office of the Registrar or such other Transfer Agent as may from time to time be designated by the Issuer for that purpose and notice of whose designation is given to Noteholders, subject to all applicable laws and stock exchange requirements, upon payment by the claimant of the expenses incurred in connection with such replacement and on such terms as to evidence, security, indemnity and otherwise as the Issuer may reasonably require. Mutilated or defaced Notes Certificates must be surrendered before replacements will be issued.

12. AGENTS

In acting under the Fiscal Agency Agreement and in connection with the Notes, the Agents act solely as agents of the Issuer and do not assume any obligations towards or relationship of agency or trust for or with any of the Noteholders.

The initial Agents and their initial Specified Offices are listed below. The Issuer reserves the right at any time to vary or terminate the appointment of any Agent and to appoint a successor registrar, principal paying agent and additional or successor paying agents and transfer agents; *provided, however, that* the Issuer shall at all times maintain (a) a fiscal agent and a registrar and (b) a paying agent in an EU member state that will not be obliged to withhold or deduct tax pursuant to any law implementing European Council Directive 2003/48/EC.

Notice of any change in any of the Agents or in their Specified Offices shall promptly be given to the Noteholders in accordance with Condition 15 (*Notices*).

13. MEETINGS OF NOTEHOLDERS; WRITTEN RESOLUTIONS

(a) Convening Meetings of Noteholders

The Fiscal Agency Agreement contains provisions for convening meetings of Noteholders to consider matters relating to the Notes, including the modification of any provision of these Conditions or the provisions of the Fiscal Agency Agreement. Such a meeting may be convened by the Issuer or the Fiscal Agent and shall be convened by the Issuer or the Fiscal Agent at any time upon the request in writing of holders of at least 10 per cent. of the aggregate principal amount of the outstanding Notes.

(b) Quorum

The quorum at any meeting of Noteholders convened to vote on an Extraordinary Resolution will be:

(i) two or more persons present and holding or representing at least 50 per cent. of the aggregate principal amount of the outstanding Notes; or

(ii) where a meeting is adjourned and rescheduled owing to a lack of quorum, at any rescheduled meeting of Noteholders, one or more persons present and holding or representing at least 25 per cent. of the aggregate principal amount of the outstanding Notes, *provided, however, that* any proposals relating to a Reserved Matter may only be approved by an Extraordinary Resolution passed at a meeting of Noteholders at which two or more persons present and holding or representing at least 75 per cent. of the aggregate principal amount of the outstanding Notes form a quorum.

(c) Reserved Matters

In these Conditions, "**Reserved Matter**" means, any proposal:

(i) to change the date, or the method of determining the date, for payment of principal, interest or any other amount in respect of the Notes, to reduce or cancel the amount of principal, interest or any other amount payable on any date in respect of the Notes or to change the method of calculating the amount of principal, interest or any other amount payable in respect of the Notes on any date;

(ii) to change the currency in which any amount due in respect of the Notes is payable or the place in which any payment is to be made;

(iii) to change the quorum required at any meeting of Noteholders or the majority required to pass an Extraordinary Resolution, Written Resolution or any other resolution of Noteholders or the number or percentage of votes required to be cast, or the number or percentage of Notes required to be held, in connection with the taking of any decision or action by or on behalf of the Noteholders or any of them;

(iv) to change this definition, the definition of "Extraordinary Resolution", the definition of "outstanding" or the definition of "Written Resolution";

(v) to change or waive the provisions of the Notes set out in Condition 3 (*Status*);

(vi) to change any provision of the Notes describing circumstances in which Notes may be declared due and payable prior to their scheduled maturity date, set out in Condition 9 (*Events of Default*);

(vii) to change the law governing the Notes, the courts to the jurisdiction of which the Issuer has submitted in the Notes, the Issuer's obligation to maintain an agent for service of process in England or the Issuer's waiver of immunity, in respect of actions or proceedings brought by any Noteholder, set out in Condition 17 (*Governing Law and Jurisdiction*); or

(viii) to modify any provision of these Conditions in connection with any exchange or substitution of the Notes for, or the conversion of the Notes into, any other obligations or securities of the Issuer or any other person, which would result in the Conditions as so modified being less favourable to the holders of Notes are subject to the Conditions as so modified than:

(A) the provisions of the other obligations or securities of the Issuer or any other person resulting from the relevant exchange or substitution or conversion; or

(B) if more than one series of other obligations or securities results from the relevant exchange or substitution or conversion, the provisions of the resulting series having the largest aggregate principal amount.

(d) Modifications

Any modification of any provision of these Conditions may be made if approved by an Extraordinary Resolution or a Written Resolution. In these Conditions, "**Extraordinary Resolution**" means a resolution passed at a meeting of Noteholders duly convened and held in accordance with the Fiscal Agency Agreement by a majority of at least:

(i) in the case of a Reserved Matter, 75 per cent. of the aggregate principal amount of the outstanding Notes; or

(ii) in the case of a matter other than a Reserved Matter, 50 per cent. of the aggregate principal amount of the outstanding Notes which are represented at that meeting.

Any Extraordinary Resolution duly passed at any such meeting shall be binding on all the Noteholders, whether present or not and whether they voted in favour or not.

(e) Written resolutions

In addition, the Fiscal Agency Agreement contains provisions relating to Written Resolutions. A "**Written Resolution**" is a resolution in writing signed by or on behalf of the holders of at least 75 per cent. of the aggregate principal amount of the outstanding Notes, in the case of a Reserved Matter, or 50 per cent. of the aggregate principal amount of the outstanding Notes, in the case of a matter other than a Reserved Matter. Any Written Resolution may be contained in one document or several documents in the same form, each signed by or on behalf of one or more Noteholders. Any Written Resolution shall be binding on all of the Noteholders, whether or not signed by them.

(f) Manifest error, etc.

The Notes, these Conditions and the provisions of the Fiscal Agency Agreement may be amended without the consent of the Noteholders to correct a manifest error. In addition, the parties to the Fiscal Agency Agreement may agree to modify any provision thereof, but the Issuer shall not agree, without the consent of the Noteholders, to any such modification unless it is of a formal, minor or technical nature or it is not materially prejudicial to the interests of the Noteholders.

(g) Outstanding Notes

For the purposes of (i) ascertaining the right to attend and vote at any meeting of Noteholders, (ii) this Condition 13 and Schedule 3 to the Fiscal Agency Agreement and (iii) Condition 9 (*Events of Default*), those Notes (if any) which are for the time being held by or on behalf of the Issuer or by any person owned or controlled directly or indirectly by the Issuer, or by any Agency, shall (unless and until ceasing to be so held) be disregarded and be deemed not to remain outstanding. "**Control**" means the power, directly or indirectly, through the ownership of voting securities or other ownership interests or otherwise, to direct the management of or elect or appoint a majority of the board of directors or other persons performing similar functions in lieu of, or in addition to, the board of directors of a corporation, trust, financial institution or other entity.

In advance of any meeting of Noteholders or Written Resolution the Issuer shall provide to the Fiscal Agent a certificate of the Issuer setting out the total number of Notes which are held in circumstances where the Issuer has at the date of such certificate the power to direct the casting of votes in respect of such Notes. The Fiscal Agent shall make any such certificate available for inspection during normal business hours at its Specified Office and, upon reasonable request, will allow copies of such certificate to be taken.

(h) Noteholders' Committee

(i) The Noteholders may, by a resolution passed at a meeting of Noteholders duly convened and held in accordance with the Fiscal Agency Agreement by a majority of at least 50 per cent. in aggregate principal amount of the Notes then outstanding, or by notice in writing to the Issuer (with a copy to the Fiscal Agent) signed by or on behalf of the holders of at least 50 per cent. in aggregate principal amount of the Notes then outstanding, appoint any person or persons as a committee to represent the interests of the Noteholders if any of the following events has occurred:

(A) an Event of Default;

(B) any event or circumstance which could, with the giving of notice, lapse of time, the issuing of a certificate and/or fulfilment of any other requirement provided for in Condition 9 (*Events of Default*), become an Event of Default; or

(C) any public announcement by the Issuer, to the effect that the Issuer is seeking or intends to seek a restructuring of the Notes (whether by amendment, exchange offer or otherwise),

provided, however, that no such appointment shall be effective if the holders of more than 25 per cent. of the aggregate principal amount of the outstanding Notes have either (i) objected to such appointment by notice in writing to the Issuer (with a copy to the Fiscal Agent) during a specified period following notice of the appointment being given (if such notice of appointment is made by notice in writing to the Issuer) where such specified period shall be either 30 days or such other longer or shorter period as the committee may, acting in good faith, determine to be appropriate in the circumstances, or (ii) voted against such resolution at a meeting of Noteholders duly convened and held in accordance with the Fiscal

Agency Agreement. Such committee shall, if appointed by notice in writing to the Issuer, give notice of its appointment to all Noteholders in accordance with Condition 15 (*Notices*) as soon as practicable after the notice is delivered to the Issuer.

(ii) Such committee in its discretion may, among other things, (i) engage legal advisers and financial advisers to assist it in representing the interests of the Noteholders, (ii) adopt such rules as it considers appropriate regarding its proceedings and (iii) enter into discussions with the Issuer and/or other creditors of the Issuer. The Issuer shall pay any fees and expenses which are reasonably incurred by any such committee (including, without limitation, the costs of giving notices to Noteholders, fees and expenses of the committee's legal advisers and financial advisers, if any) within 30 days of the delivery to the Issuer of a reasonably detailed invoice and supporting documentation.

14. FURTHER ISSUES

The Issuer shall be at liberty from time to time, without the consent of the Noteholders, to create and issue further notes ranking equally in all respects (or in all respects save for the date for and amount of the first payment of interest thereon) so that the same shall be consolidated and form a single series with the Notes.

15. NOTICES

Notices to Noteholders will be valid if published in a leading newspaper having general circulation in Luxembourg (which is expected to be the *Luxembourg Wort*) and/or the Luxembourg Stock Exchange's website, www.bourse.lu or, if such publication is not practicable, in a leading English language daily newspaper having general circulation in Europe. Any such notice shall be deemed to have been given on the date of first publication. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules of any stock exchange or other relevant authority on which the Notes are for the time being listed or by which they have been admitted to trading.

16. CURRENCY INDEMNITY

If any sum due from the Issuer in respect of the Notes or any order or judgment given or made in relation thereto has to be converted from the currency (the ''**first currency**'') in which the same is payable under these Conditions or such order or judgment into another currency (the ''**second currency**'') for the purpose of (a) making or filing a claim or proof against the Issuer, (b) obtaining an order or judgment in any court or other tribunal or (c) enforcing any order or judgment given or made in relation to the Notes, the Issuer shall indemnify each Noteholder, on the written demand of such Noteholder addressed to the Issuer and delivered to the Issuer or to the Specified Office of the Fiscal Agent, against any loss suffered as a result of any discrepancy between (i) the rate of exchange used for such purpose to convert the sum in question from the first currency into the second currency and (ii) the rate or rates of exchange at which such Noteholder may in the ordinary course of business purchase the first currency with the second currency upon receipt of a sum paid to it in satisfaction, in whole or in part, of any such order, judgment, claim or proof.

This indemnity constitutes a separate and independent obligation of the Issuer and shall give rise to a separate and independent cause of action.

17. GOVERNING LAW AND JURISDICTION

(a) The Notes and any non-contractual obligations arising out of or in connection with the Notes are governed by English law.

(b) The Issuer irrevocably agrees for the benefit of the Noteholders that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Notes (including a dispute relating to any non-contractual obligation arising out of or in connection with the Notes) and that accordingly any suit, action or proceedings arising out of or in connection therewith (together referred to as ''**Proceedings**'') may be brought in the courts of England.

(c) The Issuer irrevocably and unconditionally waives and agrees not to raise any objection which it may have now or subsequently to the laying of the venue of any Proceedings in the courts of England and any claim that any Proceedings have been brought against the Issuer in an inconvenient forum and further irrevocably and unconditionally agrees that a judgment in any Proceedings brought in the courts of England shall be conclusive and binding upon the Issuer and may be enforced in the courts of any other jurisdiction. Nothing in this Condition shall limit any right to take Proceedings against the Issuer in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions against the Issuer preclude the taking of Proceedings in any other jurisdiction, whether concurrently or not.

(d) The Issuer hereby irrevocably and unconditionally appoints Law Debenture Corporate Services Limited at its registered office for the time being in England for the time being as its agent for service of process in England in respect of any Proceedings.

(e) The Issuer hereby irrevocably waives any right to claim sovereign or other immunity from jurisdiction or execution and any similar defence, and irrevocably consents (to the fullest extent permitted by Bulgarian law, as may be amended from time to time, or any other applicable law, as may be amended from time to time), to the giving of any relief, the imposition of any security measure (except pre-judgment attachments or injunctions) or the issue of any process, including, without limitation, the making, enforcement or execution against any assets, revenue or property of the Issuer whatsoever (irrespective of its use or intended use) of any order, ruling, award or judgment made or given in connection with any Proceedings provided, however, that immunity is not waived with respect to (i) present or future ''premises of the mission'' as defined in the Vienna Convention on Diplomatic Relations signed in 1961, (ii) ''consular premises'' as defined in the Vienna Convention on Consular Relations signed in 1963, or (iii) military property or military assets or property or assets of the Republic of Bulgaria related thereto.

(f) If any Condition is or becomes invalid, illegal or unenforceable in any respect under any law of any relevant jurisdiction (including under the laws of England or the Republic of Bulgaria), the validity, legality and enforceability of the remaining Conditions shall not be affected or impaired in any way nor shall it affect or impair the validity or enforceability of such Condition in any other jurisdiction. If the choice of English law as the governing law regarding any non-contractual obligations arising out of or in connection with the Notes is declared null and void by a court of competent jurisdiction pursuant to a final non-appealable decision and as a result Noteholders are not able to validly exercise their rights under the rules of unjust enrichment of English law, Noteholders shall be entitled to file claims against the Issuer in compliance with the unjust enrichment rules of Bulgarian law, where applicable.

There will appear at the foot of the Conditions endorsed on each Note Certificate the names and Specified Offices of the Paying Agents, the Registrar and any Transfer Agents as set out at the end of this Offering Circular.

SUMMARY OF PROVISIONS RELATING TO THE NOTES WHILE IN GLOBAL FORM

Global Note Certificate

The Notes will be represented by a Global Note Certificate that will be registered in the name of a nominee for, and deposited with, the common safekeeper for Euroclear and Clearstream, Luxembourg.

The Notes are intended to be held in a manner which would allow Eurosystem eligibility – that is, in a manner which would allow the Notes to be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any or all times during their life. Such recognition will depend upon satisfaction of the Eurosystem eligibility criteria.

Interests in the Global Note Certificate may be held only though Euroclear or Clearstream, Luxembourg at any time. See ''*Book Entry Procedures*''.

Except in the limited circumstances described below, owners of interests in the Global Note Certificate will not be entitled to receive physical delivery of Note Certificates. The Notes are not issuable in bearer form.

Exchange for Note Certificates

The Global Note Certificate will become exchangeable in whole, but not in part, for Note Certificates if (a) Euroclear or Clearstream, Luxembourg is closed for business for a continuous period of 14 days (other than by reason of legal holidays) or announces an intention permanently to cease business or does in fact do so, or (b) any of the circumstances described in Condition 9 (*Events of Default*) of the ''*Terms and Conditions of the Notes*'' occurs.

Whenever the Global Note Certificate is to be exchanged for Note Certificates, such Note Certificates will be issued in an aggregate principal amount equal to the principal amount of the Global Note Certificate within five business days of the delivery, by or on behalf of the registered Holder of the Global Note Certificate, Euroclear and/or Clearstream, Luxembourg, to the Registrar of such information as is required to complete and deliver such Note Certificates (including, without limitation, the names and addresses of the persons in whose names the Note Certificates are to be registered and the principal amount of each such person's holding) against the surrender of the Global Note Certificate at the Specified Office of the Registrar. Such exchange will be effected in accordance with the provisions of the Fiscal Agency Agreement and the regulations concerning the transfer and registration of Notes scheduled thereto and, in particular, shall be effected without charge to any Holder, but against such indemnity as the Registrar may require in respect of any tax or other duty of whatsoever nature which may be levied or imposed in connection with such exchange.

Amendment to the Terms and Conditions of the Notes

In addition, the Global Note Certificate will contain provisions which modify the ''*Terms and Conditions of the Notes*'' as they apply to the Notes evidenced by the Global Note Certificate. The following is a summary of certain of those provisions:

Payments: Payments of principal and interest in respect of the Notes evidenced by the Global Note Certificate will be made against presentation for endorsement by the Fiscal Agent and, if no further payment falls to be made in respect of the relevant Notes, surrender of the Global Note Certificate to or to the order of the Fiscal Agent or such other Agent as shall have been notified to the relevant Noteholders for such purpose. A record of each payment so made will be endorsed in the appropriate schedule to the Global Note Certificate, which endorsement will be *prima facie* evidence that such payment has been made in respect of the relevant Notes.

Payments on business days: In the case of all payments made in respect of the Global Note Certificate, ''**business day**'' means any day on which the TARGET System is open.

Payment Record Date: Each payment in respect of the Global Note Certificate will be made to the person shown as the Holder in the Register at the close of business (in the relevant clearing system) on the Clearing System Business Day before the due date for such payment (the ''**Record Date**'') where ''**Clearing System Business Day**'' means Monday to Friday inclusive except 25 December and 1 January.

Notices: Notwithstanding Condition 15 (*Notices*) of the ''*Terms and Conditions of the Notes*'', so long as the Global Note Certificate is held on behalf of Euroclear, Clearstream, Luxembourg or any other clearing system (an ''**Alternative Clearing System**''), notices to Noteholders represented by the Global Note Certificate may be given by delivery of the relevant notice to Euroclear, Clearstream, Luxembourg or (as the case may be) such Alternative Clearing System. For so long as the Notes are admitted to trading on the Luxembourg Stock Exchange and it is a requirement of such exchange or of applicable law or regulations, a notice will be valid if published in a leading newspaper having general circulation in Luxembourg (which is expected to be *Luxemburger Wort*) or published on the website of the Luxembourg Stock Exchange (*www.bourse.lu*).

Prescription: Claims against the Issuer for payment in respect of the Notes while the Notes are represented by a Global Note Certificate shall become void unless it is presented for payment within ten years (in the case of principal) or five years (in the case of interest) of the appropriate Relevant Date (as defined in Condition 8 (*Taxation*) of the ''*Terms and Conditions of the Notes*''), in respect of them.

Meetings: For the purposes of any meeting of Noteholders, the holder of the Notes represented by the Global Note Certificate shall (unless the Global Note Certificate represents only one Note) be treated as two persons for the purposes of any quorum requirements of, a meeting of Noteholders and as being entitled to one vote in respect of each integral currency unit of the currency of the Notes.

Events of Default: If principal in respect of any Note is not paid when due, the Holder of a Note represented by the Global Note Certificate may elect for direct enforcement rights against the Issuer under the terms of a Deed of Covenant executed as a deed by the Issuer on 4 June 2012 to come into effect in respect of a principal amount of Notes up to the aggregate principal amount in respect of which such failure to pay has occurred in favour of the persons entitled to such payment as accountholders with a clearing system. Following any such acquisition of direct rights, the Global Note Certificate and the corresponding entry in the register kept by the Registrar will become void as to the specified portion. However, no such election may be made in respect of Notes represented by the Global Note Certificate unless the transfer of the whole or a part of the holding of Notes represented by the Global Note Certificate shall have been improperly withheld or refused.

Book Entry Procedures

Custodial and depositary links are to be established between Euroclear and Clearstream, Luxembourg to facilitate the initial issue of the Notes and cross market transfers of the Notes associated with secondary market trading. See ''*—Settlement and Transfer of Notes*'' below.

Investors may hold their interests in the Global Note Certificate directly through Euroclear or Clearstream, Luxembourg if they are accountholders (''**Direct Participants**'') or indirectly (''**Indirect Participants**'', and together with Direct Participants, ''**Participants**'') through organisations which are accountholders therein.

Euroclear and Clearstream, Luxembourg

Euroclear and Clearstream, Luxembourg each hold securities for their customers and facilitate the clearance and settlement of securities transactions through electronic book entry transfer between their respective accountholders. Indirect access to Euroclear and Clearstream, Luxembourg is available to other institutions which clear through or maintain a custodial relationship with an accountholder of either system. Euroclear and Clearstream, Luxembourg provide various services including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Euroclear and Clearstream, Luxembourg also deal with domestic securities markets in several countries through established depository and custodial relationships. Euroclear and Clearstream, Luxembourg have established an electronic bridge between their two systems across which their respective customers may settle trades with each other. Their customers are worldwide financial institutions including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations.

Relationship of Participants with Clearing Systems

Each of the persons shown in the records of Euroclear and Clearstream, Luxembourg as the holder of a Note evidenced by a Global Note Certificate must look solely to Euroclear or Clearstream, Luxembourg (as the case may be) for his share of each payment made by the Issuer to the holder of a Global Note Certificate and in relation to all other rights arising under a Global Note Certificate, subject to and in accordance with the respective rules and procedures of Euroclear or Clearstream, Luxembourg (as the case may be). The Issuer expects that, upon receipt of any payment in respect of Notes evidenced by a Global Note Certificate the common safekeeper by whom such Note is held, or nominee in whose name it is registered, will immediately credit the relevant Participants' or accountholders' accounts in the relevant clearing system with payments in amounts proportionate to their respective interests in the principal amount of the Global Note Certificate as shown on the records of the relevant clearing system or its nominee. The Issuer also expects that payments by Direct Participants in any clearing system to owners of interests in a Global Note Certificate held through such Direct Participants in any clearing system will be governed by standing instructions and customary practices. Save as aforesaid, such persons shall have no claim directly against the Issuer in respect of payments due on the Notes for so long as the Notes are evidenced by a Global Note Certificate and the obligations of the Issuer will be discharged by payment to the registered holder, as the case may be, of a Global Note Certificate in respect of each amount so paid. None of the Issuer, the Fiscal Agent or any other Agent (as named in the Fiscal Agency Agreement), will have any responsibility or liability for any aspect of the records relating to or payments made on account of ownership interests in a Global Note Certificate or for maintaining, supervising or reviewing any records relating to such ownership interests.

Settlement and Transfer of Notes

Subject to the rules and procedures of each applicable clearing system, purchases of Notes held within a clearing system must be made by or through Direct Participants, which will receive a credit for such Notes on the clearing system's records. The ownership interest of each actual purchaser of each such Note (the "**Beneficial Owner**") will in turn be recorded on the Direct and Indirect Participants' records.

Beneficial Owners will not receive written confirmation from any clearing system of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which such Beneficial Owner entered into the transaction.

Transfers of ownership interests in Notes held within the clearing system will be affected by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in such Notes, unless and until interests in a Global Note Certificate held within a clearing system are exchanged for Note Certificates.

No clearing system has knowledge of the actual Beneficial Owners of the Notes held within such clearing system and their records will reflect only the identity of the Direct Participants to whose accounts such Notes are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers. Conveyance of notices and other communications by the clearing systems to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

The laws of some jurisdictions may require that certain persons take physical delivery in definitive form of securities. Consequently, the ability to transfer interests in a Global Note Certificate to such persons may be limited.

Trading between Euroclear and/or Clearstream, Luxembourg Participants

Secondary market sales of book entry interests in the Notes held through Euroclear or Clearstream, Luxembourg to purchasers of book entry interests in the Notes held through Euroclear or Clearstream, Luxembourg will be conducted in accordance with the normal rules and operating procedures of Euroclear and Clearstream, Luxembourg and will be settled using the procedures applicable to conventional eurobonds.

USE OF PROCEEDS

The net proceeds of the issue of the Notes, expected to amount to approximately EUR 941,754,000 after deduction of expenses incurred in connection with the issue of the Notes, will be used by the Issuer to repay existing state debt and to increase the fiscal reserve of the Government.

THE REPUBLIC OF BULGARIA

Geography and Population

Bulgaria covers an area of approximately 110,994 square kilometres in Southeastern Europe in the eastern part of the Balkan Peninsula and is bordered by Romania to the north, Serbia and Macedonia to the west, Greece and Turkey to the south and the Black Sea to the east. Bulgaria has a population of approximately 7.3 million as of 31 December 2011.

The capital of Bulgaria is Sofia which is situated in the western part of the country, at the foot of the Vitosha Mountain. Sofia has a population of approximately 1.3 million as of 31 December 2011. The population density of Bulgaria is approximately 66 persons per square kilometre.

History

The name ''Bulgaria'' is derived from the Bulgars, who were a people who migrated from Central Asia and united with the Slavic tribes to found the First Bulgarian Kingdom in 681 AD. The Bulgars were absorbed in the larger Slavic population, a process that was facilitated by the adoption of Orthodox Christianity by Boris I in 865 AD. In the late 9th and early 10th centuries, Bulgaria became the strongest nation of Eastern Europe during the reign of Boris's son Simeon. During this period, Old Church Slavonic, the first written Slavic language, and the Cyrillic alphabet were adopted.

Bulgarian power declined steadily during the following half-century, and Bulgaria was eventually incorporated into the Byzantine Empire. The Bulgarians revolted against Byzantine rule in 1185 and established a second kingdom, but feudal strife and involvement in foreign wars caused the gradual disintegration of the kingdom in the late 13th century.

By the end of the 14th century, the Ottoman Empire gained control of Bulgaria. During the next five centuries the political and cultural existence of Bulgaria was dominated by the Ottoman Turks, although many of Bulgaria's national customs and values were preserved. Numerous uprisings during the centuries were defeated by the Ottomans. The uprisings created conditions for Russia to intervene, and in 1877 Russia declared war on the Ottoman Empire. The war ended with the 1878 Treaty of San Stefano, which created a semi-independent Bulgarian state and was revised subsequently by the controversial 1878 Berlin Treaty. Foreign policy efforts were, thereafter, focused on the unification of other territories in the Ottoman Empire inhabited predominantly by the Bulgarian population, the first such successful effort completed in 1885 with the Unification of the Principality of Bulgaria and the then called Eastern Rumelia. Other efforts were linked to the so called Balkan Wars of 1912 and 1913. The country, known as Kingdom of Bulgaria, became fully independent from the Ottoman Empire in 1908.

Bulgaria allied itself to Germany during World War I and the greater part of World War II. In 1944, however, Bulgaria joined the Allied powers and fought with them until the end of the war in Europe. In 1946, the peace treaty with Bulgaria reconfirmed its pre-war borders and territory.

After World War II, Bulgaria was occupied by the Russian Red Army, and within a short time a communist regime secured power. In 1947, the monarch, King Simeon II, was deposed, and a new constitution declared the country a ''people's republic''.

By 1948, a hard-line pro-Soviet communist regime had been established, led by Georgi Dimitrov. The communist regime continued under the leadership of Todor Zhivkov from 1954 to 1989. However, by 1989, as in the rest of Eastern Europe, the collapse of the communist system in Bulgaria was inevitable. In November 1989, Mr. Zhivkov was ousted.

Recent History

1989 to 1997

In relative terms Bulgaria is a young democracy and, accordingly, its internal and external political relations are often characterised by the uncertainty that arises from a relatively brief democratic political or constitutional history.

From 1989 until early 1997, the political environment in Bulgaria was characterised by a longer continued influence of the former communist party (now called the Bulgarian Socialist Party) than in many other Eastern European and former Soviet Union countries, and by more changes of government and a relative lack of political cohesion as compared to such countries. Prior to 1990, Bulgaria's economy was oriented toward the COMECON countries, which included the former Soviet Union, Poland, Hungary, Bulgaria, the German Democratic Republic, the former Czechoslovakia, Romania, Cuba, Vietnam and Mongolia, and the collapse of the COMECON regime in 1991 had a negative impact on Bulgaria's GDP. By 1997, the cumulative fall in real GDP as compared to 1989 was 33.5 per cent.

During the 1980s, under the communist regime, Bulgaria incurred significant amounts of debt, with total external debt reaching USD 10.2 billion in 1989. In 1990, faced with growing debt service problems, particularly on commercial debt, the Government declared a moratorium on its principal and interest payments. In the early 1990s, Bulgaria reached restructuring agreements with its Paris Club of official creditors and London Club of private creditors, including a Brady Plan restructuring completed in June 1994. Internal public debt was also a significant problem for Bulgaria during this period, and the significant interest cost on internal debt was one of the principal reasons for severe economic difficulties which arose in late 1996. In the early and mid 1990's, growing losses in state owned enterprises and the banking sector coincided with increasing domestic debt, payment arrears and the continuing refinancing of distressed commercial banks. The banking crisis reached its peak between the middle of 1996 and the first quarter of 1997, with the value of deposits in the banking system falling from the equivalent of USD 7.4 billion at the end of 1995 to USD 1.8 billion in March 1997 reflecting both the closure of banks and the exchange rate depreciation. Beset by the financial crisis, the Bulgarian Socialist Party-led government resigned at the end of 1996.

1997 to 2009

In the period from 1997 to 2009, Bulgaria was governed by three governments: the UDF government (May 1997–July 2001), the coalition between Simeon II National Movement and the Movement for Rights and Freedoms government (July 2001-August 2005), the coalition between Simeon II National Movement, the Movement for Rights and Freedoms and the Bulgarian Socialist Party (August 2005–July 2009).

In this period, Bulgaria embarked on a steady course towards becoming a market economy. Characteristic features of the economy were the privatisation of big state companies; establishment of a Currency Board; conservative fiscal policy; harmonisation of the Bulgarian legislation with EU regulations and attracting foreign investments.

Along with these consistent policies, Bulgaria progressed with its privatisation process with the share of privatised assets amounting to 65.49 per cent. of all state-owned assets at the end of 2009. As a result of these policies over 86 per cent. of the economy in 2009 was in the private sector. In 2004, Bulgaria became a member of NATO and in 2007 joined the EU.

2009 to present

In July 2009, the Citizens for European Development of Bulgaria Party (the "**GERB**") won the parliamentary elections for the 41st National Assembly and the Parliament elected Mr. Boyko Borissov as the head of the 87th government. The main targets set by the Government are increasing income, growth and modernisation of the economy, financial stability of the country, limitation of budget expenditure, and preserving and creating new jobs. The Government has adopted policies for coping with the economic crisis, including a reduction of government expenditure, promotion of employment and pursuing a tax and social security contributions policy that is favourable to Bulgarian and foreign investors and is oriented towards reducing the share of the grey economy.

After Bulgaria's economy shrank, notably in 2009 under the pressure of the global economic and financial crisis, in 2010 the economy entered a stage of gradual recovery. This recovery was accompanied by a restructuring of the economy and its transformation into an export-oriented model. As a result of the measures taken by the Government for further improvement of public finance sustainability, as well as the policies aimed at the promotion of competitiveness in the economy, the budget deficit of the Consolidated Fiscal Programme by the end of 2011 was lower than expected at EUR 805.7 million (2.1 per cent. of GDP), with the reported cash deficit being significantly lower than that planned in the 2011 State Budget Law (2.5 per cent. of GDP).

The Government's key objective continues to be the adoption of policies conducive to preserving macroeconomic stability and enhancing trust in the economy and Bulgaria's attractiveness to investors, in order to encourage economic growth and employment. Major priorities include: preserving low tax rates, continuing reforms aimed at reducing regulatory and administrative burdens, and introducing access to government services via the internet through the creation of a single public internet portal for administrative e-services. See "*The Republic of Bulgaria – International Relations – European Union – Economic Relations with the EU*", "*The Economy – Recent Economic Developments and Trends*" and "*Public Finance – Tax Policy*".

Political System

Legislature

Bulgaria is a parliamentary republic. The legislative power of Bulgaria is vested with the National Assembly which is a unicameral parliament. The National Assembly consists of 240 members who are elected for a period of four years by proportional representation under the Election Code of Bulgaria which was adopted by the National Assembly on 19 January 2011. Under the legislation existing at the time of the last elections, 209 of the representatives were elected by proportional representation in multi-seat constituencies and 31 were elected in single-seat constituencies.

To qualify for a seat in the National Assembly, a party or coalition must achieve at least 4 per cent., of the national vote. Any Bulgarian citizen who does not hold another citizenship, is above the age of 21, is not under a judicial interdiction, and is not serving a prison sentence is eligible for election to the National Assembly. Early parliamentary elections may be held if no agreement on the formation of a government is reached, or if a government loses a vote of confidence, or a vote of no-confidence succeeds, or upon resignation, where no successor has the support of the existing National Assembly.

The National Assembly passes, amends, supplements, and repeals laws; passes the state budget and the budget report; establishes the taxes and determines the rate of state taxes: passes resolutions on the holding of a national referendum; schedules the presidential elections; elects and removes the Prime Minister and, on his recommendation, the members of the Council of Ministers; effects changes in the Government on a motion from the Prime Minister; takes part in the constitution of other key agencies and other bodies of the State (Constitutional Court, Supreme Judicial Counsel, BNB, Financial Supervision Commission (''**FSC**'') among others); approves state loan agreements and ratifies international treaties (where applicable) and has certain other powers. The National Assembly also exercises parliamentary control over the executive branch of the Government. Certain issues, like adopting a new Constitution and resolving on any changes to the territory of the Republic, are beyond the powers of an ordinary National Assembly and are reserved for a 400 member Grand National Assembly.

Elections for the 41st National Assembly were held on 5 July 2009 according to a mixed (proportional and majoritarian) system with ballot lists of parties, coalitions and majoritarian candidates, registered in 31 multi-mandate and 31 single-mandate constituencies. 18 parties, coalitions and 357 majoritarian candidates took part in the elections.

Six political parties passed the 4 per cent. electoral threshold for participation in the National Assembly: the GERB Party achieved the highest number of votes (39.72 per cent. of the proportional vote) followed by the Coalition for Bulgaria Party (17.70 per cent.), the Movement for Rights and Freedoms Party (14.45 per cent.), the ''Ataka'' Party (9.36 per cent.), the Blue Coalition Party (6.76 per cent.) and the Order, Lawfulness and Justice Party (4.13 per cent.). 209 members of the National Assembly were elected according to a proportional system, with the ballot lists of political parties and coalitions, registered in multi-mandate constituencies. 31 Members of Parliament were elected according to a majoritarian system in single-mandate constituencies by simple majority vote.

The following table sets out the total number of mandates won by each party and coalition according to both proportional and majoritarian systems:

	Elected by majoritarian system by simple majority vote	Elected by proportional system based on regional lists	Total
Parties and Coalitions			
GERB Party	26	91	117
Coalition for Bulgaria Party	0	40	40
Movement for Rights and Freedoms Party (DPS)	5	32	37
''Ataka'' Party	0	21	21
Blue Coalition Party	0	15	15
Order, Lawfulness, Justice Party	0	10	10
Total	**31**	**209**	**240**

Source: Central Elections Commission.

Pursuant to the Constitution of Bulgaria adopted on 12 July 1991 by the 7th Grand National Assembly of Bulgaria, the next elections for the National Assembly shall be held within two months following the expiry in 2013 of the mandate of the present National Assembly.

President

The President of Bulgaria (the "**President**") is the Head of State, elected under a system of majority representation by direct popular vote for a term of five years and for a maximum of two five-year terms. To be eligible for the position of President, a candidate must be a natural-born Bulgarian citizen over 40 years of age, have resided in the country for the five years preceding the election and be eligible for election to the National Assembly. The President is elected with a majority of the valid votes, *provided that* a majority of all eligible voters took part in the election. If none of the candidates for President receives the required majority in the first round, a second round vote is held within seven days between the two leading candidates. The candidate who wins the majority of the vote is declared a winner.

The current President is Rosen Plevneliev. He was elected with 52.58 per cent. of the votes in the last presidential election held on 23 October 2011, with a runoff held on 30 October 2011. The inauguration of Mr. Plevneliev as President took place on 20 January 2012. Pursuant to the Constitution of Bulgaria the next presidential election shall be held not earlier than three months and not later than two months before the expiry in January 2017 of the term of office of the incumbent President.

The President embodies the unity of the nation and represents the State in its foreign relations. The President is also the commander-in-chief of the armed forces and the Chairman of the Consultative National Security Council. The President instructs the prime ministerial candidate, who is nominated by the party holding the highest number of seats in the National Assembly, to form a government. If such nominee does not succeed in forming a cabinet, the President assigns the mandate to a nominee from the second largest party in the National Assembly and if such nominee is also unsuccessful, the President assigns the mandate to one of the other parties. If the third attempt to form a government fails, the President appoints an interim government, dissolves the National Assembly and schedules new elections. The President also has the power of a delaying veto over legislation. If the Parliament votes for a second time on a bill that the President has vetoed, the President must sign it. The President schedules the elections for a National Assembly and for the bodies of local self-government and sets the date for national referendums pursuant to a resolution of the National Assembly. His powers also include awarding orders and medals, the naming of towns, villages and geographical places, granting asylum and citizenship and exercising the right to pardon. A Vice-President assists the President.

Government

The executive power of Bulgaria is vested in the Council of Ministers. The Council of Ministers consists of the Prime Minister, Deputy Prime Ministers and ministers.

The Council of Ministers directs and implements the State's domestic and foreign policy in accordance with the Constitution and the laws of Bulgaria. It ensures public order and national security and exercises overall guidance over state administration and the armed forces. The Council of Ministers informs the National Assembly on issues concerning the obligations of Bulgaria resulting from its membership in the EU. The Council of Ministers manages the implementation of the state budget, organises the management of the State's assets and concludes, confirms or denounces international treaties when authorised to do so by law. As the supreme executive body, the Council of Ministers adopts and promulgates certain acts of delegated legislation, including decrees, resolutions and orders. The Council of Ministers is also entitled to initiate the adoption of laws by drafting, deliberating and forwarding bills to the National Assembly.

The President assigns a mandate for the formation of a new government. See "*Republic of Bulgaria – Political System – President*". Once the prime ministerial candidate forms a government, the Prime Minister and the Government are elected by the National Assembly.

The Prime Minister takes charge of, coordinates and bears responsibility for, the overall policy of the Government. He appoints and removes deputy ministers and may suggest changes in the cabinet to the National Assembly. The Prime Minister or the minister concerned countersigns the President's decrees with certain exceptions, such as decrees vetoing legislative Acts of Parliament, decrees for dissolving the Parliament and for the appointment of an interim government. Ministers implement state policy in their respective fields.

The powers of the Council of Ministers shall terminate if the National Assembly passes a vote of no confidence to the Prime Minister or the Council of Ministers, if the Prime Minister loses a vote of confidence, or if the National Assembly accepts the resignation of the Council of Ministers or of the Prime Minister, or if the Prime Minister dies. Once a newly elected National Assembly is formed, the Prime Minister and the Council of Ministers are to submit their collective resignation. However, the

Council of Ministers shall continue performing its functions until the election of a new Council of Ministers.

The current Prime Minister of Bulgaria is Boyko Borisov. He was sworn in as Prime Minister on 27 July 2009 after the GERB Party won 39.72 per cent. of votes and took the highest number of seats in the National Assembly (117 of 240) in the parliamentary elections held on 5 July 2009.

Judicial Branch

The judicial branch of the Government is independent from the legislative and the executive branch. The civil and criminal justice system has three levels: trial courts, appellate courts and the Supreme Cassation Court. In civil cases, an appeal to an appellate court is as of right, while an appeal to the Supreme Cassation Court is by leave. In criminal cases, appeals to both appellate courts and the Supreme Cassation Court are as of right. In 2011, a specialised criminal court was established. It has jurisdiction over organised crime. Its judgments are subject to appeal to the Specialised Criminal Court of Appeals and the Supreme Cassation Court.

The administrative justice system has two levels: specialised administrative courts and the Supreme Administrative Court. In some cases the Supreme Administrative Court acts both as a first-instance court and a cassation court. The martial justice has three levels – courts martial, the Martial Court of Appeals, and the Supreme Cassation Court.

The Supreme Judicial Council administratively manages the judicial branch. It is a part of the judicial branch, and is independent from the executive and the legislative branch. It consists of the Chairpersons of the Supreme Cassation Court and the Supreme Administrative Court, the Chief Prosecutor and 22 other lawyers of high professional and moral integrity with at least 15 years of professional experience. They are appointed by the National Assembly and by the judiciary itself, and have a term of 5 years. The Supreme Judicial Council appoints, promotes, demotes, transfers and discharges all judges from office. It also approves the budget of the judicial branch.

The Judicial Inspectorate is administratively attached to the Supreme Judicial Council. It consists of 11 members elected by the National Assembly. Its task is to check the activity of the judicial system bodies without interfering with the independence of the judges. The inspectors are independent in their work.

Judges may acquire permanent tenure after five years in office, a performance appraisal and the requisite decision by the Supreme Judicial Council. After that, they may only be discharged from office in the following circumstances:

- reaching the age of 65;
- resignation;
- the entry into force of a sentence for deprivation of liberty for an intentional crime;
- *de facto* inability to perform their duties for more than one year;
- serious or systematic failure to discharge their official duties; or
- behaviour that undermines the prestige of the judicial branch.

In addition, judges have criminal and civil immunity for acts performed in discharge of their official duty, unless the act constitutes an intentional crime.

The Constitutional Court is separate from the civil, criminal and administrative justice system. It is responsible for the following:

- rendering binding interpretations of the Constitution;
- reviewing the constitutionality of legislative acts of Parliament (including ratification laws) and of acts of the President. If a legislative act of the Parliament is declared unconstitutional by the Constitutional Court, it no longer applies;
- settling competence disputes between the Parliament, the President and the Council of Ministers;
- reviewing the constitutionality of international treaties entered into by Bulgaria before their ratification;
- adjudicating the constitutionality of political parties, the lawfulness of the election of the President and the Vice President, and of a member of the National Assembly; and

- having jurisdiction in impeachment cases against the President and the Vice President.

As is the case with other constitutional democracies, Acts of the Parliament are occasionally subject to challenge in the Constitutional Court. The Constitutional Court is composed of 12 judges appointed in equal quotas by the National Assembly, the President, and the judges of the Supreme Cassation and Administrative Courts. Each judge is appointed for a single term of 9 years.

The European Commission established a mechanism for cooperation and verification of the Bulgarian legal system pursuant to Article 4(3) of the Treaty of Accession of Bulgaria to the EU by a decision dated 13 December 2006. This mechanism aims to ensure that the Bulgarian legal system meets the standards of the EU and requires Bulgaria to address specific benchmarks in the areas of judicial reform and the fight against corruption and organised crime. This decision also empowers the European Commission to take appropriate measures in the case of imminent risk to the implementation and application of, *inter alia*, mutual recognition in civil law matters, including the suspension of the obligation of Member States to recognise and execute Bulgarian judgments and judicial decisions.

This mechanism is an ongoing process and involves the publication of progress reports by Bulgaria on an annual basis and by the European Commission every six months. Despite the criticism of the European Commission in certain reports, no measures have been imposed. See "*Risk Factors – Changes in Bulgaria's relationships with western governments and institutions may have a negative impact on the economy of Bulgaria*".

Since Bulgaria's accession to the EU, judgments originating in another Member State are recognised and enforced in Bulgaria pursuant to a simplified procedure established by:

- Council Regulation (EC) No. 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters;
- Council Regulation (EC) No. 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility;
- Regulation (EC) No. 805/2004 of the European Parliament and of the Council of 21 April 2004 creating a European Enforcement Order for uncontested claims; and
- Regulation (EC) No. 861/2007 of the European Parliament and of the Council of 11 July 2007 establishing a European small claims procedure.

Regional Government Structure

The Constitution of Bulgaria sets out the principles for administrative division and local self-governance within the country:

- The territory of Bulgaria is divided into municipalities and regions;
- Municipalities are the main administrative and territorial units that are responsible for local governance;
- Municipalities are independent legal entities with property rights and their own budgets;
- Citizens can participate in the municipal government indirectly through local elections and directly through referendums and general meetings; and
- Sofia is the capital of Bulgaria.

The administrative structure of Bulgaria and the public relationships connected with local self-governance and local administration within the country are further governed by the Territorial Administration of Bulgaria Act and the Local Self-government and Local Administration Act, as well as a number of Acts of Parliament regulating self-governance of municipalities.

By provision of the 1998 Amendment to the Administrative Division Act of the Republic of Bulgaria, Bulgaria is divided into 28 regions. Regional boundaries, administrative centers and changes thereto are determined by a Presidential decree, subsequent to a proposal by the Council of Ministers. Regions are named after their administrative centres. Each region is governed by a Regional Governor, who is a representative of the executive branch and is appointed and dismissed by decision of the Council of Ministers.

The regions of Bulgaria are currently sub-divided into 264 municipalities. Municipalities are established by a resolution of the Council of Ministers, which is confirmed by a presidential decree. Mayoralties are settlements with a population in excess of 350 inhabitants. The municipality is the main administrative territorial unit, where local self government is exercised.

Mayoralties form the internal administration structure of municipalities. Cities with a population of more than 300,000 people (Sofia, Varna, Plovdiv) are sub-divided into districts. Municipal Councils and Mayors are elected in the municipalities. Mayors are also elected in mayoralties, as well as in the districts in Sofia, Varna and Plovdiv.

The Local Self Government and Local Administration Act empowers Bulgarian citizens to resolve issues of local importance directly by means of a referendum or a general assembly of the local community or indirectly through their elective bodies, in the fields of:

- municipal properties, municipal enterprises, municipal finance, taxes and fees, and municipal administration;
- planning and development of the territory of the municipality and settlements therein;
- education, health, culture, public works and utilities;
- social welfare services;
- protection of the environment and the reasonable use of natural resources;
- maintenance and conservation of cultural, historical and architectural monuments; and
- development of sports, recreation and tourism.

The population in each municipality elects its Municipal Council, as well as the Mayors of the municipalities and the mayoralties. The Municipal Council elects the Mayors of the districts by secret vote on proposal of the Mayor. The elections are carried out in compliance with the provisions of the Elections Code of the Republic of Bulgaria, promulgated in 2011.

The Municipal Council is responsible for formulating and implementing the policy of the municipality's growth and development in connection with the activities described above and is empowered, among other things, to:

- set the internal structure and bodies of the local administration and appoint the Chairman of the Municipal Council;
- adopt and amend the budget of the municipality, as well as exercise control over its implementation and approve the relevant report;
- determine the rate of local taxes and fees within the limits established by the Parliament;
- make decisions on the acquisition, management, and disposal of municipal property;
- decide on bank loans, and other municipal debt, issuance of municipal securities and guarantees;
- enact decisions concerning the territorial development plans, as well as adopt municipal development strategies, projections, programmes and plans which also reflect European policies for development of local communities; and
- resolve other issues of local importance that do not fall within the exclusive competence of other governmental bodies.

The acts of the Municipal Council are subject to control by the Regional Governor and can be appealed before the competent administrative court. The Mayor of the Municipality is entitled to require further discussion on acts which do not comply with law or are against the best interests of the municipality.

The Mayors of municipalities, mayoralties and districts are officers of the executive branch and manage the implementation of governmental activities within their territorial units. The acts of the Mayor are subject to control by the Regional Governor and the Municipal Council, and can be appealed before the competent administrative court. The last elections for self-government bodies were held on 23 October 2011.

International Relations

Bulgaria is a member of a large number of international organisations, including the United Nations, the Organisation for Security and Cooperation in Europe, the Council of Europe, the WTO, the International Labour Organisation, the Central European Initiative, the Organisation of the Black Sea Economic Cooperation ("**BSEC**"), the International Monetary Fund, the World Bank, the European Investment Bank, the Council of Europe Development Bank and the European Bank for Reconstruction and Development ("**EBRD**"). Although Bulgaria is not currently a member, it has implemented a number of measures proposed for it by the Organisation for Economic Co-operation and Development ("**OECD**"), including the OECD Anti-Bribery Convention.

European Union

Bulgaria became a full member of the EU on 1 January 2007. Bulgaria submitted its application for EU membership in December 1995. Following the Helsinki European Council's decision in December 1999, the accession negotiations between Bulgaria and the EU lasted for four years, having been started in 2000 and concluded by the European Council of 17 December 2004. The European Parliament gave its support to Bulgaria's EU membership on 13 April 2005. The Accession Treaty of Bulgaria to the EU was signed on 25 April 2005. Bulgaria is a Member State with derogation as it has not yet joined the Eurozone.

Bulgaria currently holds 18 seats in the European Parliament. After the European Parliamentary elections of 2009, the GERB Party holds five seats, the Movement for Rights and Freedoms Party and the Coalition for Bulgaria Party each hold three seats, the "Ataka" Party, the Blue Coalition Party and the National Movement for Stability and Progress Party each hold two seats and the Platform European Socialists Party holds one seat.

Economic Relations with the EU

As membership of the European Economic and Monetary Union and the adoption of the single currency are both required by the Accession Treaty and have been set as objectives by the Government, Bulgaria is in a continuing dialogue with the EU on these matters. The Treaty on the Functioning of the European Union requires the Commission and the European Central Bank ("**ECB**") to report to the Council, at least once every two years, on the progress made by the Member States in fulfilling their obligations regarding the targets of the Economic and Monetary Union. In the 2012 Convergence Report, the Commission stated that Bulgaria fulfilled the price stability criterion, the interest rate criterion and would meet the fiscal criterion. Bulgaria did not fulfil the exchange rate criterion since the Bulgarian lev is not participating in ERM II. The Commission noted however that during the two-year assessment period the Bulgarian lev remained fully stable relative to the euro, in line with the operation of the currency board arrangement. Full legal compatibility has not yet been achieved, in particular the Law on the Bulgarian National Bank and the Conflict of Interest Prevention and Ascertainment Act.

As a non-Eurozone Member State, Bulgaria does not contribute to the capital of the European Financial Stability Facility, a mechanism established in 2010 between the Eurozone countries with the objective of providing temporary financial assistance to Eurozone Member States. Bulgaria does not participate in any European Financial Stability Facility support activities through bilateral loans. Bulgaria is not involved in the activities of the European Financial Stabilisation Mechanism since the European Commission borrows the funds in financial markets under an implicit EU budget guarantee.

A new permanent crisis resolution mechanism – the European Stability Mechanism – will become operational as of July 2012, assuming the functions of the European Financial Stability Facility and the European Financial Stabilisation Mechanism. As a non-Eurozone Member State, Bulgaria will not contribute to the European Stability Mechanism capital.

As a Member State, Bulgaria is subject to multilateral surveillance by the European Council. Bulgaria is obliged to prepare an annual Convergence Programme covering fiscal policy, Bulgaria's main assumptions underlying its economic outlook and an assessment of economic policy measures and their budgetary impact. This information must cover the current and previous year and include forecasts for at least the next three years. In December 2011, the European Parliament and the Council adopted a package of six new legislative acts, which aim to strengthen economic governance in the EU. Part of that package is the Macroeconomic Imbalance Procedure to detect and correct risky economic developments in Member States. In the first ever annual Alert Mechanism Report, adopted on 14 February 2012, the European Commission identified 12 EU Member States, including Bulgaria, whose macroeconomic situation needs to be analysed in more depth. In the subsequent in-depth review, published on 30 May

2012, the Commission stated that Bulgaria is experiencing imbalances, but they are not excessive. It advised more attention to be paid to the level of external indebtedness and to certain macroeconomic developments related to corporate sector deleveraging and the labour market adjustment process.

Bulgaria was among the first EU members to ratify the Lisbon Treaty on 21 March 2008 and is actively engaged in its implementation. On 2 March 2012, Bulgaria also signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union aimed at strengthening fiscal discipline and introducing stricter surveillance, in particular by establishing a ''balanced budget rule''.

The EU is providing funds to Bulgaria through the Pre-Accession Instruments PHARE, Cohesion Fund (Regulation 1164/94)/ISPA and SAPARD aiming to increase the administrative capacity of the institutions, accelerate the development of transport and environment infrastructure and guarantee stable growth in agriculture and rural areas. At the end of 2011, all these instruments were approaching their final stage of implementation and their rate of absorption was as follows: PHARE – 86 per cent.; Cohesion Fund (Regulation 1164/94)/ISPA – 89 per cent.; and SAPARD – 96 per cent.

Within Article 32 of the 2005 Accession Act, the Schengen Facility was created as a temporary instrument to help beneficiary Member States to finance actions at the new external borders of the EU, for the implementation of Schengen *acquis* and external border control between the date of accession and the end of 2010. The funds allocated to Bulgaria through Schengen Facility Instrument were fully absorbed.

The EU structural assistance for the period 2007 to 2013 is rendered by the European Social Fund, the European Regional Development Fund and the Cohesion Fund. It is provided under Operational Programmes (''**OPs**'') elaborated by EU Member States and approved by the European Commission. They are designed to improve working and living conditions in EU Member States in different economic sectors, including transport and environment protection infrastructure, investments in business, sustainable development, information society, energy efficiency, direct and indirect assistance to research and development and enhancement of public administration capacity. The current strategic priorities in EU funds absorption in Bulgaria are determined in the National Strategic Reference Framework 2007 – 2013. Within this framework the following seven OPs are implemented: ''Transport''; ''Regional Development''; ''Environment''; ''Development of the Competitiveness of the Bulgarian Economy''; ''Human Resources Development''; ''Administrative Capacity'' and ''Technical Assistance''.

From its accession to the EU to 30th April 2012 Bulgaria has received EUR 1,588 million in funds related to EU Structural and Cohesion Funds (''**SCF**'').

Due to the strong commitment of the government to maximize the absorption of the EU assistance, allocated to Bulgaria and the measures undertaken, the initial delay has already been overcome and it is expected that at the end of 2015 SCF will be fully absorbed.

The following table sets out the current status of the OPs co-financed by the SCF for the period 2007 to 2013:

	Programme Budget	Contracted		Payments	
	Total	Total as of 30.04.2012	Implementation (%)	Total as of 30.04.2012	Implementation (%)
			(EUR millions)		
OPs					
''Transport''	2,003.48	1,842.59	91.97%	552.20	27.56%
''Environment''	1,800.75	1,251.73	69.51%	224.17	12.45%
''Regional Development''	1,601.27	1,317.64	82.29%	368.99	23.04%
''Competitiveness''	1,162.22	521.63	44.88%	289.40	24.90%
''Human Resources''	1,213.87	917.75	75.61%	246.90	20.34%
''Administrative Capacity''	180.79	123.39	68.25%	54.52	30.16%
''Technical assistance''	56.82	32.73	57.61%	13.18	23.20%
Total SCF:	**8,019.20**	**6,007.46**	**74.91%**	**1,749.36**	**21.81%**

Source: Ministry of Finance

The Bulgarian contribution to the EU budget was EUR 1,794.86 million for the period 1 January 2007 to 31 December 2011. The following table sets out the resources paid by Bulgaria to the EU Budget for the period 2007 to 2011:

	2007	2008	2009	2010	2011	Total 2007-2011
			(EUR millions)			
Traditional Own Resources	60.78	86.30	52.89	42.43	49.13	91.53
Customs Duties	60.78	85.90	52.48	42.03	48.77	289.96
Sugar Levies	–	0.40	0.40	0.40	0.40	1,600.61
VAT based resources	46.23	52.55	50.96	45.99	51.20	246.93
GNI based resource	176.54	200.71	250.18	237.08	77.24	1,141.76
UK rebate	20.76	28.64	25.07	14.71	18.35	107.53
Gross reduction in favour of the Netherlands and Sweden	–	–	2.42	2.23	2.42	7.06
Total "National Contribution" (2+5):	243.54	281.90	328.63	300.01	349.25	1,503.33
Total Own Resources (1+6)	304.32	368.20	381.51	342.44	398.38	1,794.86

Source: Ministry of Finance

North Atlantic Treaty Organisation

Bulgaria became a member of NATO on 29 March 2004. Since then, the country has been an active and predictable member of the Alliance. Bulgaria contributes to operations and missions of NATO in crisis response and to the development of military capabilities. Bulgarian armed forces are currently contributing 650 troops to the NATO-led International Security Assistance Force in Afghanistan which will be withdrawn in phases by the end of 2014. Bulgaria maintains its commitment to the security of Kosovo through its participation in KFOR with 10 military personnel. The country regularly participates in NATO Training Missions, such as in Iraq, where it contributed to the training of Iraqi security forces.

Bulgaria highly values the role of NATO as an important international forum for dialogue and consultation. The country is an active participant in many initiatives and programmes of the Alliance, such as the NATO-Russia Council, NATO-Ukraine Commission, NATO-Georgia Council, NATO's Mediterranean Dialogue and Istanbul Cooperation Initiative.

Black Sea Economic Cooperation

Bulgaria was one of eleven countries to sign the Summit Declaration and the Bosporus Statement in Istanbul on 25 June 1992 giving rise to the BSEC. The BSEC is a multilateral political and economic initiative which aims to foster interaction and harmony among Member States and ensure peace, stability and prosperity by encouraging good relations with neighbouring countries in the Black Sea region.

Many countries, including seven EU Member States, the United States, Egypt and Tunisia have observer status, while the European Commission and the Energy Charter are among the BSEC's partner organisations.

Organisation for Security and Cooperation in Europe

Bulgaria has been a participating state since 1975. In 2004 Bulgaria took over the OSCE chairmanship for one year after receiving unanimous approval in the 10th Meeting of the Ministerial Council in Porto, Portugal in 2003.

Double Taxation Agreements

To date, Bulgaria has concluded bilateral agreements on the avoidance of double taxation with 68 countries, including Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Russia, Spain, the United Kingdom and the United States.

Foreign Investment Treaties

Bulgaria has entered into 64 bilateral investment treaties (''**BITs**'') with countries including Austria, China, France, Germany, Russia, the United States and the United Kingdom. BITs have been signed with all European countries except Ireland, Norway, Estonia, Montenegro, Andorra, Bosnia and Herzegovina, Liechtenstein and Monaco. In North and South America, BITs have only been concluded with the United States, Cuba and Argentina. In Africa, BITs have been concluded with Algeria, Tunis, Egypt, Morocco and Tunisia. In Asia, BITs have been concluded with China, Vietnam, Indonesia, Singapore, Thailand, India, Mongolia, South Korea, Iran, Azerbaijan, Armenia Kazakhstan, Qatar, Bahrain, Oman, Kuwait, Israel Jordan, Lebanon, Syria and Yemen.

THE ECONOMY

Background

Since the introduction of the Currency Board in July 1997, Bulgaria has achieved sustainable economic growth resulting from macroeconomic stability and structural reforms. The annual growth for the period from 2000 to 2008 was 5.8 per cent. on average. The high rates of investment in fixed capital were among the main factors for the accelerated economic growth before the crisis. Household consumption was also strong due to extensive financial flows into the Bulgarian economy.

Since Bulgaria's accession to the EU in 2007, reforms have been made for the improvement of the business environment. The country's macroeconomic stability, consistent economic and prudent fiscal policies, improvement of institutional environment and continuous cuts in taxes and social insurance contributions have been at the core of Bulgaria's strong economic performance, increased investment activity, higher employment and real income growth.

Currently, the Government is committed to completing key structural reforms, which have a growth enhancing impact in the medium and long-term. Efforts are directed towards strongly improving the competitiveness of the economy, increasing employment and improving the sustainability of public finances.

The successful completion of pension reforms is a prerequisite for the long-term sustainability of public finances and of macroeconomic stability and economic growth. The reforms include a gradual increase in the minimum retirement age and reform of the military early retirement schemes by extending the length of service by two years. See "*Public Finance – Pension System – Recent Pension Reforms*". Through the implementation of action plans and programmes and the introduction of reforms in the administrative sector, the Government aims to improve the quality of work of civil servants, reduce the administrative burden of information requests and introduce integrated administrative services. Furthermore, the current use of European funding for the improvement of infrastructure will also increase the competitiveness of the economy.

Bulgaria's stable public finances and improved infrastructure will support growth in the medium term. As outlined in the National Reform Programme of the Republic of Bulgaria (2012–2020) (the "**National Reform Programme**"), Bulgaria plans to promote research and development investment to improve the quality of scientific activity and facilitate access to financing for small and medium enterprises ("**SMEs**") and to increase energy efficiency and reduce energy dependency.

Key challenges for the future include further reforms in the public sector, labour market and education. The National Reform Programme specifically focuses on increasing access to education, retaining pupils in education and raising the overall level of education, as well as improving the access of young people to the labour market.

Recent Economic Developments and Trends

In 2009 and 2010, the Bulgarian economy faced many challenges due to the global financial and economic crisis. After a decline in GDP of 5.5 per cent. in 2009, economic recovery began during 2010 and annual growth was 0.4 per cent., mainly due to an increase in exports. The weakening of domestic demand led to a quick adjustment in the current account balance and low core inflation in the period 2009 to 2011. Growth for 2011 was 1.7 per cent. and inflation was 3.4 per cent. using HICP methodology.

The recent economic crisis provided an opportunity to restructure the Bulgarian economy and optimise labour costs. The process of optimisation led to an improvement in the competitiveness of the economy and resulted in significantly increased rates of real exports, which was the primary driver of growth. In 2010 and 2011, Bulgaria's exports increased significantly (at constant prices) and surpassed their pre-crisis levels. The composition of Bulgaria's exports to EU markets also improved with the rising share of capital-intensive and skilled-labour products, although such share is still considered low compared to other EU countries.

The rapid contraction of the current account deficit from 2009 to 2010 is indicative of the high degree of flexibility of the economy. The correction in the current account balance led to a deficit of 1.0 per cent. of GDP in 2010, and year end 2011 the current account showed a 0.9 per cent. surplus.

Domestic demand in the country is still weak. Low consumer confidence led to an increase in savings, which, combined with the decline in employment, led to a decrease in household spending in the last three years. The uncertain economic environment contributed to a decrease in investment activity in the country and it remains suppressed.

In 2009, the budget deficit of Bulgaria reached 4.3 per cent. of GDP (on an accrual basis). The Government adopted prudent fiscal policies to return to macroeconomic stability. Fiscal consolidation was reflected in a reduction in the budget deficit to 3.1 per cent. of GDP in 2010, and 2.1 per cent. of GDP in 2011. See "*Public Finance – Fiscal Policy*". In March 2012, Bulgaria notified the European Commission that the 2011 general government deficit was below the EU's reference threshold. Following the validation of these figures by Eurostat on 23 April 2012 and the European Commission's 2012 spring forecast that the deficit will consistently remain below 3 per cent. of GDP, the Commission has concluded that the correction of Bulgaria's excessive deficits can be maintained. On 30 May 2012, the European Commission recommended a Council decision to abrogate the Excessive Deficit Procedure for Bulgaria.

The following table sets out certain macroeconomic data regarding the Bulgarian economy for the period 2007 to 2011:

	2007	**2008**	**2009**	**2010**	**2011**
		(EUR billions, except for percentages)			
Economic Data					
Nominal GDP	**30.772**	**35.430**	**34.932**	**36.052**	**38.483**
Real GDP (growth in %)	6.4	6.2	(5.5)	0.4	1.7
Real exports (growth in %)	6.1	3.0	(11.2)	14.7	12.8
Real imports (growth in %)	9.6	4.2	(21.0)	2.4	8.5
Unemployment (%)	6.9	5.6	6.8	10.2	11.2
Consumer prices (average growth in %)	7.6	12.0	2.5	3.0	3.4
Producer prices (growth in %)	8.0	13.3	(4.3)	7.2	8.6
State budget surplus (deficit)	**0.357**	**0.592**	**(1.513)**	**(1.124)**	**(0.806)**
as a % of GDP	1.2	1.7	(4.3)	(3.1)	(2.1)
Total revenues	**12.592**	**14.161**	**12.697**	**12.369**	**12.741**
as a % of GDP	40.9	40.0	36.3	34.3	33.1
Total expenditures	**12.235**	**13.570**	**14.210**	**13.493**	**13.547**
as a % of GDP	39.8	38.3	40.7	37.4	35.2

Source: Eurostat

The following table sets out certain data relating to the balance of payments for the period 2007 to 2011:

	2007	**2008**	**2009**	**2010**	**2011**
			(EUR millions)		
Balance of Payments Data					
Current account surplus (deficit)	**(7,755.2)**	**(8,182.5)**	**(3,116.2)**	**(375.8)**	**361.4**
as a % of GDP	(25.2)	(23.1)	(8.9)	(1.0)	0.9
Export of goods	13,511.9	15,204.0	11,699.2	15,561.2	20,226.7
Import of goods	20,757.2	23,801.7	15,873.1	18,324.8	22,201.3
Change in BNB's foreign exchange reserves	**2,908.4**	**674.2**	**649.8**	**383.9**	**158.7**

Source: BNB.

Gross Domestic Product

Real GDP growth amounted to 6.4 per cent. in 2007 and 6.2 per cent. in 2008 As the breakdown of GDP by expenditure shows, growth during these years was driven mainly by domestic demand. Investment activity intensified with the share of gross fixed capital formation in GDP reaching 33.6 per cent. in 2008. Investment expansion was mostly promoted by the current and expected high return on investment. Another contributing factor was the need to bring local production in line with various EU requirements. Income growth has driven the growth in household consumption. High domestic demand led to an increase in imports and a negative contribution of net exports. Services were the main contributor on the supply side during this period.

The effects of the continued global financial and economic crisis were first felt at the end of 2008 with a decrease in exports of goods and services. This negative trend became more pronounced in 2009 when GDP fell by 5.5 per cent. in real terms. The primary factor for the economic slowdown was the further decrease in exports due to low foreign demand. Private consumption, which drove economic growth in most of the years preceding the global financial and economic crisis, also declined by 7.6 per cent. This decline was largely driven by a drop in consumer confidence and a rise in unemployment. In 2009, investment also shrank due to the deterioration in the business climate. On the supply side, the crisis was first felt in industry and subsequently by a decrease in the value added in services from mid-2009 due to the deterioration in demand.

The contraction in the economy continued in the first quarter of 2010, but growth resumed in the second quarter of 2010 and overall growth for the year was 0.4 per cent. The economic recovery started with an increase in exports and slower decline in domestic demand.

Bulgarian real GDP growth reached 1.7 per cent. in 2011, which was mainly driven by external demand, as was the case in 2010. The negative contribution of domestic demand decreased to 0.6 percentage points. In 2011, gross fixed capital formation declined by 9.7 per cent. The unstable external economic environment, characterised by periods of considerable deterioration and high uncertainty in estimating future returns from investment projects, largely accounted for the limited investment activity in Bulgaria. Final consumption shrank by 0.3 per cent. Household expenditure had the largest negative contribution to GDP growth (0.4 percentage points), as the high unemployment rate and uncertainty about future income restrained consumer spending. Bulgarian exports continued growing in 2011 at an annualised rate of 12.8 per cent., reaching their highest levels to date in constant prices. Imports of goods and services strengthened compared to the previous year, reaching growth of 8.5 per cent., driven largely by export-oriented economic activities. On the supply side, gross value added increased by 1.8 per cent. with the main contribution coming from manufacturing.

As a result of debt problems deepening in some Eurozone countries, the outlook for the European economy in 2012 has deteriorated. Reduced economic activity in the EU will likely result in a slowdown of economic growth in Bulgaria in 2012, in particular through a reduction in net exports. The Ministry of Finance's 2012 forecast for the development of the Bulgarian economy is based on the assumption that the external economic environment will start to improve in the second half of 2012 and that debt problems in the Eurozone will be successfully resolved. Real growth is expected to reach 1.4 per cent. mainly as a result of the smooth recovery in domestic demand. Consumption is expected to increase slightly in 2012, by 0.7 per cent. Both the stabilisation of the labour market during the second half of 2012 and the slight increase in credit activity will have a positive impact. Investment activity in the country is expected to recover in 2012, due to the base effect (the decline in investments, accumulated over the last three years, amounts to approximately 40.3 per cent.) and accelerated absorption of EU funds, mainly for roads, environmental and utility infrastructure.

The following table sets out the components of real GDP in the period 2007 to 2011:

	Actual				
	2007	2008	2009	2010	2011
	(EUR billions, using constant prices[(1)], except for percentages)				
Total consumption expenditure	23.460	24.059	22.291	22.397	22.323
of which:					
Private	19.058	19.707	18.216	18.237	18.135
Government	4.420	4.376	4.092	4.170	4.192
Gross fixed capital formation	7.575	9.231	7.607	6.217	5.614
Export of goods and services	15.070	15.529	13.786	15.817	17.842
less:					
Import of goods and services	20.940	21.826	17.248	17.663	19.168
Real GDP	**26.367**	**27.999**	**26.466**	**26.570**	**27.013**
Percentage change (%)	6.4	6.2	(5.5)	0.4	1.7

(1) Constant prices are chain linked with 2005 as the reference year. Includes structural changes in the economy which have occurred within the period under observation, however the sum of component data does not necessarily equal the value acquired in calculation of the aggregate. Therefore data for total real GDP presented in the above table may not be equal to the sum of the components presented in the table.

Source: Eurostat

The following table sets out nominal GDP and the annual percentage shares of nominal GDP by sector in the period 2007 to 2011:

	2007		2008		2009		2010		2011	
	(EUR billions, except for percentages)									
Industry (except construction)	6.287	20.4	6.443	18.2	6.638	19.0	6.923	19.2	8.170	21.2
Construction	2.097	6.8	2.754	7.8	2.767	7.9	2.220	6.2	2.152	5.6
Agriculture; fishing	1.444	4.7	2.113	6.0	1.453	4.2	1.522	4.2	1.860	4.8
Services	16.032	52.1	18.210	51.4	19.153	54.8	20.380	56.5	20.966	54.5
Nominal GVA	25.859	84.0	29.519	83.3	30.011	85.9	31.044	86.1	33.148	86.1
Taxes less subsidies on products	4.914	16.0	5.912	16.7	4.922	14.1	5.008	13.9	5.335	13.9
Nominal GDP	**30.772**	**100.0**	**35.431**	**100.0**	**34.933**	**100.0**	**36.052**	**100.0**	**38.483**	**100.0**

Source: Eurostat

The following table sets out real annual growth of GDP by sector in the period 2007 to 2011:

	Actual				
	2007	2008	2009	2010	2011
	(real growth, % change on previous year)				
Industry (except construction)	11.5	2.2	(8.0)	(1.5)	9.1
Construction	13.3	17.4	(0.3)	(17.9)	(1.1)
Agriculture; fishing	(27.2)	32.4	(9.5)	(6.2)	(1.1)
Services	7.5	4.1	(1.3)	4.4	(0.1)
GVA	6.4	6.3	(3.3)	0.5	1.8
Taxes less subsidies on products	6.8	5.7	(16.5)	(0.5)	0.8
Real GDP	**6.4**	**6.2**	**(5.5)**	**0.4**	**1.7**

Source: Eurostat, Ministry of Finance

Principal Sectors of the Economy

Services

The services sector is the biggest sector of the Bulgarian economy and in 2007 it represented 52.1 per cent. of nominal GDP. Services were the primary contributor to the increase in GDP in 2007 and 2008 and reported real growth of 7.5 per cent. and 4.1 per cent., respectively. The following branches were the most important for the development of the sector: financial intermediation, trade, real estate, renting and business activities, and transport. In 2009, as a result of low domestic demand in the country, gross value added in services declined by 1.3 per cent. as compared to 2008. As this sector is highly dependent on the development of consumption, it performed relatively well in 2010 but due to economic uncertainty concerning the European economy in the second half of 2011, the services sector registered a slight decline of 0.1 per cent. in 2011. In the medium term, as a result of the recovery in domestic demand, a slight increase in real growth of services is expected.

Industry

In 2011, the industrial sector (which includes mining and quarrying; manufacturing; electricity, gas, steam and air conditioning supply; water supply; sewerage, waste management and remediation activities, but excludes construction) accounted for 21.2 per cent. of nominal GDP as compared to 20.4 per cent. in 2007. At the same time, construction decreased its share in total nominal GDP from 6.8 per cent. in 2007 to 5.6 per cent. in 2011. The contribution of total industry to real GDP growth decreased by 3.1 percentage points in 2007 to 1.6 percentage points in 2008. After two years of decline, industry registered real growth of 6.6 per cent. in 2011 mainly due to the performance of manufacturing while the construction sector continued to decline.

Industry (excluding construction)

Manufacturing was the first sector adversely affected by the global economic crisis which started to register a decline in real growth terms in the last quarter of 2008. The negative trend in manufacturing was mainly due to a sharp decrease in industrial sales to foreign markets as a result of the unfavourable external environment. The manufacture of basic metals, chemicals, chemical products, coke and refined petroleum products, as well as the manufacture of textiles, clothing, leather and related products, were the first in the sector to be affected by low foreign demand. In 2010, manufacturing started to recover and in 2011 industry excluding construction registered real growth of 9.1 per cent., supported mainly by stable external demand. Industrial production registered growth of 5.8 per cent. during 2011, and industrial turnover realised in foreign markets grew by 25.6 per cent. The strong increase in foreign market sales was influenced by export-oriented sectors such as the manufacture of basic metals and fabricated metal products (except machinery and equipment) and manufacturing of food products, which were also positively affected by the fuel and food prices in international markets during the first half of 2011. Value added in manufacturing is expected to increase slightly in the medium terms mainly as a result of the higher share of medium high-tech production. At the beginning of 2012, the Bulgarian automobile manufacturer Litex Motors in partnership with Great Wall Motors of China began production at Bulgaria's only automobile factory.

Construction

In the pre-crisis period, FDI inflows in Bulgaria were mainly directed to construction and real estate due to strong demand from both foreign and domestic consumers. Increase in real household income, credit growth and the expected increase in real estate prices as a result of EU membership resulted in a boom in the construction industry. The decrease in the gross value added in construction started in the third quarter of 2009, although early signs of a decline in housing construction appeared by the end of 2007, when the number of building permits began to decrease. The negative trend in construction also affected house prices and resulted in a cumulative decline of 33.6 per cent. for the period 2009 to 2011. The decline in construction slowed to 1.1 per cent. in 2011 compared to a 17.9 per cent. drop in 2010. According to construction production indexes, a more significant decline was registered in civil engineering, which decreased by 20 per cent. in 2010. Civil engineering is expected to recover in the medium term due to the planned construction of roads and environmental and utility infrastructure supported by the accelerated absorption of EU funds. The first signs of recovery appeared at the beginning of 2012 as civil engineering increased in January and in March. The recovery of the building construction sector, on the other hand, is expected to be delayed as a result of sustained over-building during the pre-crisis period.

Agriculture

In 2011, the agricultural sector accounted for 4.8 per cent. of nominal GDP in comparison to 4.7 per cent. in 2007 and had almost no contribution to GDP growth. In 2011, the export of oil seeds and fruit constituted the biggest share in Bulgarian exports of agricultural products, followed by corn. A positive trend which was observed in the agricultural sector in previous years and which improved the effectiveness of the sector is the consolidation of production. According to the 2010 census of farms, their number decreased by 44 per cent. compared to the census in 2003. At the same time, the utilised agricultural area increased by 25 per cent., which led to an increase in the average utilised area by individual farms from 4.4 hectares in 2003 to 10.1 hectares in 2010.

Energy Market

In 2011 the Council of the European Union specified the need for liberalisation of the electricity and gas markets as part of its recommendations to Bulgaria. In response, the country has taken a variety of measures to ensure its long term energy security including implementation of the Energy from Renewable Sources Act of 2011 (as amended) and the Third Energy Liberalisation Package, under which a Law amending the Law on Energy was drafted. The key amendments regulate independent energy generation and supply and the transmission and distribution of electricity and natural gas. These amendments strengthen the powers of the national energy regulator, facilitate cross border trade in energy, promote cross border cooperation and investment, increase market transparency with regard to network operation and supply and better protect consumers' interests.

Bulgaria is implementing measures to diversify the sources and routes of natural gas by building gas system interconnections with neighbouring countries. In the short term the construction of an intersystem gas connection between Bulgaria and Serbia and Bulgaria and Romania are planned. A feasibility study for the construction of the Bulgaria – Serbia intersystem gas connection was launched in January 2012. The construction of the Ruse – Giurgiu intersystem connection will connect the national gas transmission networks of Bulgaria and Romania. The total value of the project is EUR 23.8 million and the construction works are planned to start in August 2012 and be finalised at the end of 2012, with the gas pipeline becoming operational at the beginning of 2013.

Bulgaria also supports the implementation of major projects to build pipelines from the Southern Gas Corridor to the EU, including the ''Nabucco'' pipeline, the ''South Stream'' pipeline and the South East European Pipeline (SEEP). Other possible projects to reduce Bulgaria's energy dependency include expansion of the existing gas storage ''Chiren'' and construction of new gas storage as well as providing new domestic sources of energy by promoting geological exploration for new conventional and unconventional oil and gas fields.

Despite such measures, Bulgaria is still reliant on a limited variety of fuel sources and any delay or failure by Bulgaria to successfully secure access to fuel sources at favourable prices in the future could have a material adverse effect on the Bulgarian economy. See ''*Risk Factors – Bulgaria is dependent on the import of fuels and fluctuations in international fuel prices*''.

Labour Market

The Bulgarian labour market has followed a varying pattern of development over the last five years. The robust economic growth and investment activity in the course of the years preceding the economic downturn resulted in average employment growth of 3 per cent. per year, along with unemployment reaching the lowest historical record of 5 per cent. in the second half of 2008, and increased labour force participation. High capital inflows to some of the non-tradable sectors such as construction, real estate and financial services, allowed a strong trend in job creation. At the same time, strong domestic demand supported vigorous development and employment growth in other service sub-sectors such as wholesale and retail trade, transportation, accommodation and food service activities.

The table below sets out the primary indicators and developments in the labour market for the period 2007 to 2011:

	2007	2008	2009	2010	2011
Employment (SNA, thousands)	3,726.7	3,825.3	3,725.0	3,550.7	3,401.6
Employment (SNA, %, year-on-year)	3.2	2.6	(2.6)	(4.7)	(4.2)
Unemployment (thousands, LFS)	240.2	199.7	238.0	348.0	372.3
Unemployment (%, LFS)	6.9	5.6	6.8	10.2	11.2
Unemployment (thousands, Employment agency)	287.0	233.7	281.0	350.9	332.6
Unemployment (%, Employment agency)	7.7	6.3	7.6	9.5	10.1*
Participation rate (15–64, %)	66.3	67.8	67.2	66.5	66.0

* 2011 registered unemployment rate was recalculated using the 2011 Census working age population.
Source: NSI, Employment agency

The decrease in external demand since the second half of 2008 and the contraction of capital inflows pushed local employers to cut expenditure, including labour costs. Following a delayed reaction, partly sustained by the introduction of short-time working schemes, employment started to decrease in mid-2009 and has maintained this negative trend through the last three years. The industrial sector was the most severely affected by the crisis, with employment numbers decreasing by 20.6 per cent. in 2011 compared to 2008. However, the rate of employment decline in the industrial sector slowed down year-on-year to 4.2 per cent. in 2011, while in the service sector it accelerated to 4.4 per cent in 2011.

The strong decrease in employment against the backdrop of growing GDP has been due to the new export-driven growth profile and the sluggish recovery in domestic demand. The higher labour demand reported in some export-oriented industries (manufacturing of machinery, electrical and transport equipment) has not been able to offset the persistent decline in the number of those employed in economic activities highly dependent on domestic demand such as wholesale and retail trade, transportation, accommodation and food services and construction.

The ongoing process of expenditure consolidation also contributed to the overall decline in employment in the last three years. In 2011, public administration (excluding military personnel and police) employment declined by 15,200 persons, or 11.8 per cent., compared to 2008.

The table below sets out the number of employees in the public sector, overall and in the largest budgetary sectors:

	2007	2008	2009	2010	2011
			(thousands)		
Public employment, total	646.0	614.8	603.2	565.8	565.2
Public administration; compulsory social security*	135.1	129.4	129.4	117.0	114.2
Education	178.9	164.5	158.5	156.2	156.8
Healthcare and social securities	106.8	104.9	106.7	104.7	77.5

* Excluding military personnel and police officers.
Source: NSI

According to the EU Labour Force Survey (''**LFS**''), the unemployment rate rapidly increased in the three years to 2011, reaching 11.2 per cent. in 2011. The adverse effect was more pronounced among men, given that most of the job losses were concentrated in sectors where men predominate, such as manufacturing and construction. Low-skilled labour was adversely influenced due to the reallocation of jobs towards more productive employment and youths also strongly suffered as they are the least experienced workers. According to the LFS, youth unemployment between the ages of 15 to 29 increased from 6.7 per cent. in 2008 to 17.5 per cent. in 2011. In contrast to the LFS figures in 2011, the overall number of registered unemployed persons decreased by 5.2 per cent. year-on-year due to the implementation of active labour market programmes and measures. The active labour market programmes and measures have been designed to support the unemployed, in particular the most vulnerable groups of the population – such as youths, older persons, low-skilled, disabled and other marginalised groups – to enhance their employability through inclusion in subsidised employment and training. Programmes for subsidised employment have usually been activated at the beginning and at the end of each year in an attempt to counteract seasonal private sector activity.

Both LFS and the Bulgarian Employment Agency reported a further rise in the unemployment rate year-on-year in the first quarter of 2012, to an estimated 12.9 per cent. and 11.4 per cent. respectively. The anticipated seasonal work revival and gradual recovery in confidence throughout the year would decrease the level of unemployment, thus contributing to labour market stabilisation.

Hiring capacity in Bulgaria remained low, which prevented most of the inactive from re-entering the labour force and delayed those who had been laid-off from being hired again. As a result, in 2011, labour force participation of persons aged 15 to 64 decreased for a third year in a row to 66 per cent.

Wages

In 2007 and 2008 labour incomes were on track to significantly increase following robust investment activity, high labour demand and the process of reducing the grey economy whereby persons previously employed in the grey economy joined the official sector, for example, by reducing corporation tax rates to ten per cent. The average wage sustained a double digit growth rate mainly due to private sector developments. Among industries which made the biggest contribution were trade, construction, real estate, hotels and restaurants, as well as most manufacturers. These industries have been among the most significantly developed in terms of investments, and the latter have improved their productivity relatively quickly which has had a positive influence on average wage growth. In addition, labour supply has come under pressure, triggering a rise in wages and unit labour costs. Furthermore, private sector wage growth was prompted by the annual update of minimum insurance thresholds, as a result of which undeclared income has been unveiled and reported in official statistics. In 2007 and 2008, public sector wages increased as well, however they did not place any upward pressure on private sector wages. The Government encouraged the increase in real incomes by cutting direct taxes, social insurance contributions and through gradual increases in wages.

Since 2009, a gradual slowdown in income growth was reported in certain economic sectors. Export oriented industries were affected most strongly as a result of the lower demand in foreign markets. The services sector was affected by the crisis at a later time. Trade, real estate and transport made the biggest contributions to the slowdown in the wage growth. In 2011, the average wage in the economy grew by 9.1 per cent. in nominal terms and by 4.7 per cent. in real terms. A significant optimisation of expenditures was observed in the public sector as well. The nominal wage growth in the public sector slowed to 3.1 per cent., while decreasing by 1.1 per cent. in real terms. At the same time, the average wage in the private sector exhibited considerably higher rates of change, up 11.2 per cent. and 6.7 per cent. in nominal and in real terms, respectively.

The following table sets out nominal and real annual wage growth in the public and private sectors in the period 2007 to 2011:

	Actual				
	2007	**2008**	**2009**	**2010**	**2011**
Average monthly wage (EUR)					
Total economy	220.16	278.55	311.43	331.37	361.64
Public sector	266.54	332.80	364.86	382.75	394.62
Private Sector	202.83	260.50	293.38	313.83	349.11
Nominal wage growth (average annual %)					
Total economy	19.5	26.5	11.8	6.3	9.1
Public sector	18.2	24.9	9.6	4.9	3.1
Private Sector	21.5	28.4	12.6	6.2	11.2
Real wage growth (average annual%)					
Total economy	11.1	13.0	9.1	3.2	4.7
Public sector	9.9	11.5	7.0	1.8	(1.1)
Private sector	13.0	14.7	9.9	3.1	6.7

Source: NSI, Ministry of Finance

In the period 2000 to 2008, labour productivity in Bulgaria followed a stable rate of increase and accelerated compared to the rest of the EU both for total economy and manufacturing. The biggest contribution to the growth rate was made by financial intermediation, information and communication activities, manufacturing industries and trade. Although productivity has been increasing, the average wage growth was faster and contributed to a rise in real unit labour costs (“**RULC**”). Worsening competitiveness was influenced by disparities between supply and demand of labour in certain economic activities and administrative factors such as the annual update of minimum insurance thresholds, which in many cases led to wages being officially reported in the private sector.

Following the decline in economic activity, decreasing sales revenues and limited finance resources from 2009, employers faced the need for labour cost adjustments. This was carried out through the redistribution of working time, employment reduction and limiting wage growth. These factors have had a favourable impact on unit labour cost developments. In 2011, labour productivity in the Bulgarian economy increased by 6.1 per cent. and had a favourable effect on maintaining the cost competitiveness of the economy. RULC decreased by 3.7 per cent. determined primarily by the tradable sector of the economy, which is directly exposed to competitive pressure and is a driver of economic growth. From this perspective, the current dynamics of incomes does not put pressure on competitiveness and enterprises manage to optimise their labour costs.

The following table sets out real labour productivity and RULC growth in the period 2007 to 2011:

	Actual				
	2007	**2008**	**2009**	**2010**	**2011**
			(average % change year-on-year)		
Real labour productivity growth.....	3.2	3.5	(3.0)	5.3	6.1
RULC growth..................................	0.1	3.7	8.1	2.7	(3.7)

Source: NSI, Ministry of Finance

The Government expects the growth rate of wages will remain restrained due to low labour demand. The adjustment in the competitiveness determinants will move along with productivity and real wage growth. The income policy of the Government in the medium term will be consistent with overall economic development and contribute towards maintaining fiscal stability.

Inflation

Bulgaria has the lowest per capita income in the EU, as well as the lowest price levels. There is a strong correlation between productivity, income and the price level in Bulgaria relative to the EU-27. Accelerated growth in the country’s productivity compared to the EU average has resulted in a corresponding increase in incomes in Bulgaria, as well as higher domestic price inflation relative to the EU average. This has resulted in higher “structural inflation” in Bulgaria than in the rest of the EU.

Bulgaria brought its tax policies, including indirect taxes, in line with EU requirements following its accession to the EU. The alignment of the local excise duty rates started in 2001 and is almost completed. In 2008, 2009 and 2010 the contribution of the new tobacco duties added approximately 0.4 percentage points, 0.8 percentage points and 0.9 percentage points respectively to average overall HICP inflation.

The adjustment in administered prices in Bulgaria’s first years as a member of the EU resulted in a one-off increase in consumer price inflation.

As Bulgaria is a small and open economy, price inflation depends largely on the interplay of external factors: crude oil and other raw material price dynamics and import price inflation. Bulgaria’s currency board regime makes it very difficult to control inflation, due to the lack of independent monetary policy.

The relatively high rates of inflation reported in 2007 and 2008 were largely determined by the international prices of food and crude oil, which reached historical peaks during this period. In the first two years following EU accession, the employment rate continued to increase as a result of the increase in private sector business activity which led to an increase in demand for labour. Labour market shortages also put pressure on the prices in the country via the increased unit labour costs and increased domestic demand during the period. In the second half of 2008, as a result of the global financial and economic crisis, international prices started falling, which affected domestic prices as well. As a result, annual inflation decelerated to 7.2 per cent. at the end of the year, followed by a clear trend of disinflation during 2009.

The following table sets out the rate of inflation for the period 2007 to 2011:

	2007	**2008**	**2009**	**2010**	**2011**
			(average % change year-on-year)		
All-items HICP	**7.6**	**12.0**	**2.5**	**3.0**	**3.4**
Food and non-alcoholic beverages	13.5	16.2	(0.9)	(0.5)	6.5
Alcoholic beverages, tobacco	0.8	10.0	17.9	23.9	5.2
Non-energy industrial goods	4.4	6.0	2.9	0.3	(0.4)
Energy	5.1	12.5	(5.7)	9.2	8.9
Services	7.8	12.7	5.8	1.5	1.9
Core inflation*	6.6	10.2	4.7	1.0	0.9

* Overall index excluding energy, food, alcohol and tobacco
Source: Eurostat

Economic growth in the period 2007 to 2008 was strong but was coupled with an accumulation of certain macroeconomic imbalances: high current account deficit, high inflation, high house prices and an increased RULC. Easing domestic demand pressures, due to weakened economic activity in the aftermath of the economic crisis, resulted in low inflation in the country in the period between 2010 and 2011. As a result of the ongoing restructuring and optimisation processes in the Bulgarian economy, RULC declined. Price and cost competitiveness improved in 2010 and 2011. Generally, the real effective exchange rate (the "**REER**") appreciation is a consequence of real convergence in terms of productivity, income and prices. The accumulated labour productivity growth in Bulgaria compared to the EU average is higher than the real appreciation of the REER calculated with different deflators.

Consumer price dynamics in 2011 largely followed international food and energy price developments, while the favourable base effect of the 2010 excise duty hikes on tobacco products and the sluggish recovery of domestic demand had a restricting effect on the rise of consumer prices. Headline inflation, as measured by the HICP, slowed to 2 per cent. year-on-year at the end of 2011, while its annual average rate reached 3.4 per cent. The latter was slightly above the previous year's level due to carry-over effects (relatively higher inflation rates were reported in late 2010 and early 2011).

In the first three months of 2012, the 12-month moving average inflation rate continued to slow down, falling to 2.7 per cent. in March. If the HICP is considered by reference to main components, the increase in food prices narrowed to 5.8 per cent. The prices of non-energy industrial goods and services (core inflation) almost retained their average rate of change. Energy prices accelerated at the beginning of the year but the 12-month moving average rate is estimated to have slowed down to 7.2 per cent. in March.

The main risks of inflation concern developments in international prices and the speed of economic growth in Bulgaria. International prices of crude oil may increase more substantially as a result of recent political crises in the Middle East. The limited supply of some agricultural goods on a global scale as a result of adverse weather conditions, especially for cereals, could further trigger higher inflation in Bulgaria. The debt crisis in the Eurozone countries will also continue to cause further depreciation of the euro relative to the US dollar. This makes US dollar quoted imported goods more expensive, and through higher production costs tend to feed into higher prices of a number of goods and services. At the same time, lower economic growth will further limit increases in prices of non-food goods and services (core inflation), since households will adapt to the uncertain economic environment through saving rather than spending. See "*Risk Factors—Bulgaria's economy remains vulnerable to external shocks, including the recent global economic crisis and those that may be caused by future significant economic difficulties of its major trading partners or by more general "contagion" effects, which could have a material adverse effect on Bulgaria's economic growth*".

PUBLIC FINANCE

Under the European System of Accounts 1995 (“**ESA 95**”), the public finance system in Bulgaria comprises the central government subsector, the local government subsector and social security funds, which together comprise the “general government sector”. The rules defining the general government sector are harmonised internationally and are updated regularly. The fiscal year applicable to the general government sector is the calendar year.

The National Statistical Institute of Bulgaria (the “**NSI**”) is responsible for compiling public finance data, reported to the European Commission under the ESA transmission programme, and the fiscal notification tables reported twice a year to Eurostat in accordance with the Council Regulation No. 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure annexed to the Treaty Establishing the European Community, as amended, and the Statements contained in the Council minutes of 22 November 1993.

The legal framework for the national budget uses a cash based methodology for compilation and execution of the Annual Budget Law that the Ministry of Finance of Bulgaria uses to show the position of the budget in the national budgetary documentation. The main difference between the national methodology and the concept of ESA 95 is that the first methodology monitors revenues and expenditure on a cash basis, whereas the ESA 95 monitors revenues and expenditures on an accrual basis. The most significant effects of using ESA 95 methodology to produce Bulgaria’s general government sector data stem from (i) flows on an accrual basis (i.e. when economic value is created, transformed or extinguished, or when claims and obligations arise or are transformed or cancelled) and (ii) the extension under ESA 95 of the definition of the general government sector.

At the core of the Bulgarian public finance system lies the Consolidated Fiscal Programme (“**CFP**”) that covers the state budget, the budgets of the two social funds (the State Social Insurance and the National Health Insurance Fund (the “**NHIF**”), several autonomous budgets such as the budgets of the Bulgarian Academy of Science, state universities, Bulgarian National Radio, Bulgarian National Television and the Bulgarian News Agency, municipal budgets and extra-budgetary funds and accounts. This concept is similar to the IMF Government Finance Statistics Manual 2001 concept of general government.

The state budget encompasses the executive budget, the budget of the National Assembly and the judiciary budget. The executive budget consists of a central-government budget and of the budgets of ministries and state bodies. CFP includes the state budget, the autonomous budgets, and the budgets of all 264 municipalities. In accordance with the Organic Budget Law of 2012 (“**OBL**”), the Council of Ministers does not have any power to make changes in the draft budgets of the judiciary and the National Audit Office before submitting them to the National Assembly. The Council of Ministers can however assess these budgets and submit an opinion to Parliament.

Key elements of the Bulgarian fiscal framework include fiscal objectives and the main assumptions for the mid-term development of the Government’s horizontal policies (such as different rates for health and social insurance contributions etc.). Bulgaria’s Medium Term Fiscal Framework (the “**MTFF**”) is based on macroeconomic indicators. It contains a presentation of fiscal policy objectives and a series of integrated medium term macroeconomic forecasts. The MTFF is valid for the term of office of the Government. The statutory base of the MTFF is the OBL.

Revenue and expenditure aggregates are presented on a cash basis. The existing fiscal framework is fully consolidated and comprises all budget and extra-budgetary accounts of the Government. The MTFF also takes into account any recent statutory and structural changes. At the stage of programming special attention is paid to cash flows of EU funds, including necessary resources for their national co-financing.

The indicators in the MTFF are essentially those from the Convergence Programme of the Republic of Bulgaria (2012-2015) (the “**Convergence Programme**”). The MTFF is developed and approved by the Council of Ministers at a relatively early stage of the budgetary procedure. Any changes to the MTFF are reflected in an update of indicators in the CFP and budget for the relevant year.

The MTFF and any main assumptions form the basis for the production of the Three Year Budget Forecast (“**TYBF**”) and for Government approval of the expenditure ceilings for First Level Spending Units. The TYBF is updated annually. It contains the main budgetary aggregates classified by economic and functional parameters, expenditure ceilings for First Level Spending Units (excluding municipalities) and budgetary relations (transfers, subsidies etc.) between the budgets of the CFP (including the budgets of municipalities, autonomous budgets etc.). All ministries and state agencies develop their TYBFs based on their policies and programmes. Municipalities’ TYBFs only concern their local activities.

At the end of the fiscal year, the National Assembly approves the minimum threshold of the fiscal reserve in the Annual State Budget Act.

The fiscal rules (balance, expenditure and debt) and different combinations between them applied in the past have played a major role in the enforcement of budgetary and fiscal discipline. Until 2007, the Ministry of Finance included buffers in the Annual State Budget Act to counteract various fiscal risks. The planning was based on identifying target values for the budget balance and expenditure (both consolidated) as a percentage of GDP. The Government aimed to keep the size of the public sector at levels close to 40 per cent. of GDP. Bulgaria complies with the Maastricht Treaty concerning maximum public debt levels (60 per cent. of GDP).

The Budget Balance Rule (as defined in the OBL) sets limits to the level of budget balance on a cash basis. The target is presented as a percentage of nominal GDP. The Budget Balance Rule provides a margin of adjustment to the Government by specifying a deficit ceiling. The Government has some freedom to adjust the limit.

The Expenditure Rule (as defined in the OBL) sets a specific ceiling of 40 per cent. of GDP on the size of general government sector expenditures. The rule does not provide a margin of adjustment to the Government by specifying an expenditure limit. The ceiling is determined by the establishing act of the rule.

The Debt Rule (as defined in the Government Debt Act 2002) specifies that the outstanding portion of the consolidated government debt at the end of each year as a ratio of projected GDP may not exceed the previous year ratio if the latter is more than 60 per cent. On a local government level the Debt Rule is supported by rules that determine ceilings for local government debt payments and guarantees.

All three rules are multi-annual, applied on a cash basis and cover all sectors of general government – central and local government and social security. In order to meet the requirements of the EU Stability and Growth Pact referring to deficit and debt compiled by the ESA 95 methodology, monitoring and additional estimates of the aggregates on an accrual basis are conducted.

Since 2011, an additional fiscal measure has been introduced. The 2011 Annual Budget Act provides for a limit of liabilities to suppliers and officials on long-term secondments as at 31 December 2011 and was approved for the government authorities, ministries and agencies. With the approval of this provision the undertaking of commitments in 2011 is linked to the framework of approved budgetary allocations for 2011, accrued liabilities for 2010 and the estimate of accrued liabilities as at the end of 2011. This measure has supported the consolidation measures and strengthened financial discipline and accountability in the process of budget execution and making of commitments to incur expenditure. The limits approved for 2012 are decreased by about EUR 102.26 million in nominal terms (0.2 per cent. of GDP) compared to the 2011 ceilings.

Fiscal rules will be further brought in line with the requirements of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union with the ongoing elaboration of the Law on Public Finances to incorporate stricter rules on deficit, debt, structural balance and medium term objectives as well as on underlying macroeconomic forecasts to transpose Council Directive 2011/85/EU. See "*The Republic of Bulgaria—International Relations—European Union—Economic Relations with the EU*".

Fiscal Policy

The prudent fiscal policy adopted by all levels of Government after the introduction of the currency board arrangement in 1997 has been supported by the implemented reforms in the area of budgeting and public finance management.

In the first two years after its accession to the EU, Bulgaria's fiscal policy was based on promoting sustainable economic growth while maintaining the stability of its public finances. The main priorities were the implementation of measures encouraging investment and reduction of the tax rates and social security contributions. One of the main challenges faced was counteracting the increasing trade deficit and the deficit of the current account by targeting sizable surpluses in the budget.

The crisis reversed favourable economic and financial conditions that prevailed in Bulgaria until 2008. Bulgaria was well prepared for the crisis due to its strong budgetary position, the surpluses run prior to the crisis and the significantly reduced state debt. In 2008, general government surplus reached 1.7 per cent. of GDP, a result clearly affected by the financial crisis. Since 2009 the Government has run a deficit, which Bulgaria is gradually consolidating.

In 2010 and 2011, Bulgaria undertook stringent measures and managed to bring down the deficit to 3.1 per cent. of GDP and to 2.1 per cent. of GDP, respectively. The Government undertook the necessary consolidation effort both on the revenue and expenditure side by implementing measures for improving tax collection, strengthening spending controls, freezing ministries' and agencies' spending on wages and salaries, implementing structural optimisation of administration and further improving rules and procedures for public finance management.

The medium-term budgetary objective of Bulgaria is set to reach a structural deficit of 0.5 per cent. of GDP at the end of 2015 and remains more ambitious than the requirements of the revised EU Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The gap between the fiscal targets set in the Convergence Programme and the medium-term objective will be narrowing and will surpass the target in 2014.

The Government is strongly committed to continue the implementation of conservative and disciplined fiscal policy targeting a balanced fiscal position in 2015. The planned deficit reduction for the period until 2015 will be achieved while keeping the direct tax rates unchanged, gradually increasing the rates of some excise duties with a view to reaching the minimum EU rates within the agreed deadlines, and improving tax collection. In a situation of limited financial resources, the Government has committed itself to implement a policy of enhanced efficiency and effectiveness of budgetary expenditure and to support the continuation of structural reforms in line with the objectives set out in the National Reform Programme 2012-2020.

Tax Policy

Bulgaria's tax strategy for the period between 2007 and 2012 has been characterised by continuity and predictability. The main goal of Bulgaria's tax policy is to support macroeconomic stability and promote growth, attract foreign investment, improve budgetary results and increase fiscal stability in the long term.

Fiscal policy applied in recent years has mitigated the negative impact of the crisis on the Bulgarian economy, improved the business environment, stimulated investment activity, promoted employment and reduced the grey economy. A priority for Bulgaria's tax policy is to provide a stable tax environment and avoid any sudden change in terms of tax rates in the present economic climate.

Tax rates in direct taxation remain unchanged at 10 per cent. for corporations (one of the lowest in the EU) and 10 per cent. for individuals which is the lowest in the EU. This has been one of the most important incentives for investments and economic growth. The process of consistently shifting the tax burden towards indirect taxes by raising certain excise tax rates is in accordance with the agreements with the European Union for reaching the minimum EU levels.

Revenues

The principal source of revenue in the State Budget is taxation, particularly VAT, excise duties, corporate profit tax and personal income tax. A number of significant tax reforms have been introduced which aim to shift the taxation burden from direct to indirect taxes to achieve more progressive taxation and the tax base to be broadened by removing exemptions and reducing activities in the grey economy.

Corporate income tax

For the period 2005 to 2007, the corporate income tax rate decreased from 19.5 per cent. to 10 per cent. and tax on dividends from 15 per cent. to 7 per cent. (in 2008 it reached 5 per cent.) which was a tax incentive for business. These tax rates are among the lowest in the EU, which in turn reflected very positively on investment and increased profits for companies. The fiscal effect of these steps was more evident in 2007 when revenues from corporate income tax rose significantly in spite of the reduced rates. Current tax rates remain unchanged. This played an important role in the increase of budget revenues from corporate income tax due to the promotion of foreign and local investments and the reduction of the informal sector.

The following table sets out corporate income tax revenues as a percentage of GDP in the period 2007 to 2011:

	Actual				
	2007	**2008**	**2009**	**2010**	**2011**
	(EUR millions, except for percentages)				
Total Revenue	937	1,139	901	692	765
Tax Rate	10%	10%	10%	10%	10%
Total Revenue *as a % of GDP*	3.0%	3.2%	2.6%	1.9%	2.0%

Source: Ministry of Finance

Despite the significant decrease in the tax rate in 2007, the revenues from corporate income reached 1,139 million EUR in 2008. Revenues fell during the economic crisis and in 2010 they were 692 million EUR. After the beginning of the economic recovery in 2010 and 2011, revenues from corporate income taxes increased from 692 million EUR in 2010 to 765 million EUR in 2011, an increase of 10.5 per cent.

Personal income tax

In 2007, revenues from personal income tax were higher than the EUR 740 million forecasted in the Budget, reaching EUR 925 million. The main reasons for the increase were the growth in the salaries of employed persons during the year and reduced unemployment in general. In 2008, significant changes in law were made by which a flat tax rate of 10 per cent. was introduced and the requirement for a non-taxable minimum was abolished.

There were no significant legislative amendments between 2008 and 2011. Revenues for this period rose gradually (except for 2010 compared to 2011) from EUR 1,008 million in 2008 to EUR 1,114 million in 2011. This was as a result of the growth of average salaries from EUR 286.1 million in 2008 to EUR 361.2 million in 2011, representing an increase of 35 per cent. However, at the same time the unemployment rate doubled from 5.6 per cent. in 2008 to 11.2 per cent. in 2011.

The following table sets out revenue from personal income tax as a percentage of GDP for the period 2007 to 2011:

	Actual				
	2007	**2008**	**2009**	**2010**	**2011**
	(EUR millions, except for percentages)				
Total Revenue from personal income tax	925	1,008	1,049	1,039	1,114
Tax rate	24.0%	10%	10%	10%	10%
Total Revenue from personal income tax *as a % of GDP*	3.01%	2.84%	3.00%	2.88%	2.90%

Source: Ministry of Finance

Excise duties

In order to implement EU requirements, excise duties on some products are increasing gradually during the years, but others remain steady.

The following table sets out excise duties for the period 2007 to 2011:

	2007	2008	2009	2010	2011
			(EUR millions)		
Excise duties					
Tobacco products	688.6	876.9	904.0	777.4	866.0
Fuels	866.7	1027.0	948.5	911.4	956.8
Alcoholic beverages and beer	89.5	109.4	88.0	115.4	134.2
Other stock	50.3	58.2	25.2	20.0	16.6
Revenues	**1,695.1**	**2,071.5**	**1,965.7**	**1,824.2**	**1,973.6**

Source: Ministry of Finance

Revenues from excise duties are stable despite the impact of the economic crisis. This is due to the legislative measures undertaken against the evasion of excise duties and improvements in customs administration.

VAT

VAT levied on the supply of goods and services and other activities in Bulgaria complies with the rules of Council Directive 2006/112/ES on the common system of value added tax. The following VAT rates apply from 1 January 2012: a standard rate of 20.0 per cent., a reduced rate of 9.0 per cent. applicable to accommodation provided at hotels and similar establishments, including the provision of vacation accommodation and letting out of places for camping sites or caravan sites and a reduced rate of 0 per cent. for export and selected services such as international transport.

Furthermore, the VAT system provides for exemptions (without the right to deduct the input tax) for certain services, such as educational, healthcare and welfare and financial services (with exceptions).

With the entry into force of the changes in VAT Act in 2007, a more liberal regime in respect of payment of tax liabilities was introduced, for example, reduced customs control and introduction of new rules for the administration of VAT. This created a favourable business environment by reducing tax and customs administrative formalities for persons to a minimum.

The following table sets out the revenues from VAT as a percentage of GDP for the period 2007 to 2011:

	Actual				
	2007	**2008**	**2009**	**2010**	**2011**
		(EUR millions, except percentages)			
Total Revenue	337.4	382.7	328.9	320.4	338.0
Tax rate	20%	20%	20%	20%	20%
Total Revenue *as a % of GDP*	10.96%	10.80%	9.42%	8.89%	8.78%

Source: Ministry of Finance

During the economic crisis in 2009 and 2010, the ratio of VAT revenues to GDP decreased, but in 2011 VAT revenues reversed this negative trend after several measures to improve the collection of VAT were undertaken. These measures included: an increase in the number of on-site inspections, improvement of performance of mobile units, more frequent and more thorough audits, the introduction of more rigorous accounting rules and judicial prosecution of unlawful practices inflicting losses on the budget, the implementation of on-line connections between the cash registers of traders and the National Revenue Agency (''**NRA**''), remote connection of fiscal devices with the NRA and automatic exchange of information between the NRA and the Customs Agency.

Fiscal decentralisation

Legislative amendments in the municipality laws in 2006 gave municipalities the power to determine and collect the following local taxes: real estate, inheritance, donation, vehicle, lump-sum, and tourist tax as well as tax on acquisition of property.

Municipalities also have the power to collect local fees in a number of local matters such as disposal of waste, administrative services etc.

Since 2008, property tax amounts have been determined by the municipal councils within limits set by the law.

Fiscal goals

Bulgaria's tax policy in its essential elements is oriented towards the maintenance of economic stability during crisis, promotion of business investments and employment. Some of these goals may be reached through the implementation of the following measures: tax reliefs for business and achievement of the minimum tax rates of the EU; simplification of the tax system and preciseness of the tax laws in order to eliminate the inconsistencies and imperfections in the practice of taxation and to obtain transparency and understanding for taxpayers; retention of direct taxes' rates in combination with lower social insurance burden on employers in support of economic growth and employment; and retention of a higher share of indirect taxes as compared to the direct taxes.

General Government Sector

The table below sets out the revenues, expenditure and net lending/borrowing for the general government sector of Bulgaria and the second table represents the net lending/net borrowing by sub-sector for the years 2007 to 2011 (under ESA 95 methodology):

ESA 95 code	General government sector	2007	2008	2009	2010	2011
				(EUR millions)		
OTR	Total Revenue	12,591.5	14,161.3	12,696.4	12,368.4	12,741.1
OTE	Total Expenditures	12,234.1	13,569.7	14,209.4	13,492.4	13,546.8
B9	**Net lending (+) Net borrowing (–)**	**357.4**	**591.6**	**(1,512.9)**	**(1,124.0)**	**(805.7)**
				(% of GDP)		
OTR	Total Revenue	40.9	40.0	36.3	34.3	33.1
OTE	Total Expenditures	39.8	38.3	40.7	37.4	35.2
B9	**Net lending (+) Net borrowing (–)**	**1.2**	**1.7**	**(4.3)**	**(3.1)**	**(2.1)**

Source: Ministry of Finance

ESA 95 code	B.9 Net lending (+) Net borrowing (–)	2007	2008	2009	2010	2011
				(EUR millions)		
S.1311	Central government	350.8	634.1	(1326.7)	(708.1)	(891.8)
S.1313	Local government	(33.4)	(137.2)	(313.3)	(4.5)	(9.0)
S.1314	Social security funds	40.0	94.7	127.1	(411.4)	95.1
S.13	**General government**	**357.4**	**591.6**	**(1,512.9)**	**(1,124.0)**	**(805.7)**
				(% of GDP)		
S.1311	Central government	1.1	1.8	(3.8)	(2.0)	(2.3)
S.1313	Local government	(0.1)	(0.4)	(0.9)	0.0	0.0
S.1314	Social security funds	0.1	0.3	(0.4)	(1.1)	0.2
S.13	**General government**	**1.2**	**1.7**	**(4.3)**	**(3.1)**	**(2.1)**

Source: Ministry of Finance

Bulgaria's fiscal position is strong compared to other EU countries. The public debt to GDP ratio of 15.96 per cent. at the end of March 2012 was the second lowest in the EU, after Estonia. Successive governments have shown a strong commitment to fiscal prudence, resulting in a significant decline in the public debt to GDP ratio from over 100 per cent. in 1997. Prudent fiscal policy has been based on targeting the fiscal stance on surpluses during expansionary economic periods and accumulating a buffer in fiscal reserve account against potential shocks and strong fiscal consolidation after entering the global crisis and economic recession. Prudent fiscal policy is extremely important for the sustainability of the currency board arrangement and long-term fiscal sustainability.

The economy grew significantly during the five years from 2003 to 2008, and the budget recorded surpluses averaging 1.5 per cent. of GDP for the period. The sizeable fiscal and financial buffers accumulated in the growth years provided important cushions to support the economy through the downturn. The economy entered into recession in 2009 and the fiscal stance deteriorated to a deficit of 4.3 per cent. of GDP for 2009 due to a sharp slowdown in Government revenues. In 2010 the general government deficit registered a considerable improvement to 3.1 per cent. of GDP driven by the decisive actions for fiscal consolidation, mainly on the expenditure side: up to 20 per cent. expenditure cuts on an annual basis for the ministries, agencies, and some autonomous budgets and up to 15 per cent. decreases in transfers to municipalities; the Government has postponed an old age pension indexation and has locked in budgeted wage and pension costs. In 2011 most of the fiscal consolidation measures from previous years were extended and the deficit was improved further. Bulgaria achieved additional fiscal tightening in the amount of 0.4 per cent. of GDP compared to the objective set in the Convergence Programme of 2.5 per cent. of GDP. The estimated deficit of the general government sector for 2011 improved to 2.1 per cent. of GDP, well below the 3 per cent. of GDP reference value in the EU's Stability and Growth Pact. It is expected that this year the Council of the EU will close the excessive deficit procedures for Bulgaria.

The Convergence Programme, which was recently submitted to the European Commission, projects that the general government deficit will gradually disappear over the medium term along with the negative output gap. The programme also expects the Government debt ratio to peak at 20 per cent. at the end of 2012 and then decline to 18 per cent. at the end of 2014 (calculated on an ESA 95 basis). An updated debt management strategy for 2012 to 2014 which will be announced later this year that it will be consistent with the CP as well as the EU Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union a new fiscal rule.

Consolidated Fiscal Programme – Cash Basis

Although ESA 95 is the prime methodology used for the general government budget, the National Assembly approves the Annual Budget Law compiled under the national budget methodology, which is on a cash basis. The approved deficit on a cash basis however, is fully consistent with the general government deficit target set in the Convergence Programme (ESA 95).

The following table sets out the sub-category of revenues and expenditures under the CFP in the period 2007 to 2011 (on a cash basis):

	2007	2008	2009	2010	2011
			(EUR millions)		
CONSOLIDATED FISCAL PROGRAMME					
Total revenues	**12,303.2**	**13,965.1**	**12,803.2**	**12,236.6**	**12,975.7**
Tax revenues	**9,880.1**	**11,333.8**	**10,313.7**	**9,721.9**	**10,529.7**
Direct taxes	**1,861.8**	**2,147.4**	**1,949.8**	**1,730.5**	**1,879.3**
Profit tax	937.0	1,139.4	901.0	691.9	764.8
Income tax	924.8	1,008.0	1,048.7	1,038.5	1,114.4
Social insurance contributions	2,500.3	2,757.2	2,696.1	2,541.0	2,817.0
Indirect taxes	**5,167.6**	**6,011.7**	**5,316.7**	**5,089.5**	**5,432.3**
VAT	3,373.8	3,827.2	3,288.9	3,204.3	3,380.5
Excise duties	1,695.1	2,071.6	1,965.7	1,824.2	1,973.6
Insurance premium tax					11.0
Customs duties	98.7	113.0	62.2	60.9	67.1
Others	**350.4**	**416.9**	**350.6**	**360.4**	**400.4**
Sugar Levy	**0.0**	**0.5**	**0.5**	**0.5**	**0.8**
Non-tax revenues	**1,807.5**	**2,047.5**	**1,811.4**	**1,695.1**	**1,697.8**
Grants	**615.7**	**583.7**	**678.1**	**819.5**	**748.1**
Total Expenditure with the EU contribution	**11,301.3**	**12,947.6**	**13,123.3**	**13,679.9**	**13,736.4**
Total Expenditure	**10,996.9**	**12,579.5**	**12,741.8**	**13,337.5**	**13,338.0**
Total noninterest expenditure	**10,674.4**	**12,280.4**	**12,475.5**	**13,089.0**	**13,058.4**
Current noninterest expenditures	**8,715.8**	**10,096.4**	**10,611.7**	**11,214.1**	**11,486.0**
Compensation	1,638.2	1,961.1	2,097.9	2,120.1	2,123.0
Wages and salaries	1,613.8	1,934.2	2,058.6	2,078.2	2,080.6
Scholarships	24.4	26.9	39.2	41.9	42.4
Social security contributions	490.4	535.5	538.5	502.4	537.5
Maintenance and operating	2,284.1	2,532.0	2,208.5	2,271.0	2,280.1
Subsidies	399.4	569.4	649.5	759.3	814.2
Social expenditures	3,903.8	4,498.4	5,117.3	5,561.2	5,731.2
Pensions	2,396.8	2,866.2	3,319.6	3,576.7	3,634.2
Social assistance	609.3	785.5	948.5	991.5	978.9
Health Insurance fund	897.7	846.8	849.3	993.0	1,118.1
Capital expenditures	**1,958.6**	**2,184.0**	**1,863.8**	**1,874.9**	**1,572.4**
Interest	**322.5**	**299.1**	**266.3**	**248.4**	**279.6**
External	237.9	214.9	185.9	171.9	178.8
Domestic	84.6	84.2	80.3	76.5	100.7
Contribution to the EU budget	**304.3**	**368.2**	**381.5**	**342.4**	**398.4**
Primary balance	**1,324.5**	**1,316.5**	**(53.9)**	**(1,194.8)**	**(481.1)**
Deficit/Surplus (-/+)	**1,002.0**	**1,017.4**	**(320.1)**	**(1,443.3)**	**(760.6)**

Source: Ministry of Finance

The CFP recorded surpluses until 2008 and deficits for the years 2009 to 2011. Despite the fiscal consolidation measures of the newly elected government during the second half of 2009, both on the revenue and expenditure side, the budget fell into deficit. Since 2010, the Government continued fiscal consolidation through tightening the medium-term expenditure ceilings with a view to ensuring stability of the budgetary position. On the revenue side the main tax rates remained unchanged. This ensured a predictable environment for business and investments and was favourable for the gradual recovery of domestic demand and growth prospects. The Government is determined to preserve low tax rates to encourage private investment, both domestic and foreign.

The fiscal consolidation measures adopted by the Government ensured that the budgetary position reached a reliable and sustainable state well below the reference value of 3 per cent. of GDP set by the EU Stability and Growth Pact as soon as 2011.

As mentioned previously, Bulgaria exercised prudence in the growth years, running fiscal surpluses and creating a large fiscal reserve. The fiscal reserve has been enshrined in the annual budget law for 2012, with a legal minimum of EUR 2.3 billion (not less than 5.7 per cent. of GDP).

The following table sets out the fiscal reserve account for the period 2007 to 2011:

	2007	2008	2009	2010	2011
Fiscal reserve account					
EUR millions	2,980.6	3,808.0	3,923.1	3,073.8	2,555.8
% of GDP	9.7	10.7	11.2	8.5	6.6

Source: Ministry of Finance

Approved Annual Budget Law for 2012

The annual budget law for 2012 was approved by the National Assembly on 8 December 2011 and came into effect on 1 January 2012. Compared to the 2011 budget, the state budget for 2012 provides for an increase in revenues by EUR 1,300.5 million (a 9.7 per cent. year-on-year change due to the expected increase of EU funds transfers; grants from the EU are expected to increase by 2 percentage points of GDP in comparison to 2011) and expenditures by EUR 812.3 million (a 5.8 per cent. year-on-year change). The projected deficit is expected to decrease by EUR 445.2 million (1.2 per cent. of GDP) from the 2011 programme deficit of EUR 1,003.7 million.

The CFP deficit for 2012 is expected to be EUR 558.5 million and is based on the general government budget deficit target of 1.6 per cent. of GDP (ESA 95) as opposed to 2.1 per cent. budgeted in 2011.

	CFP		of which			
	Annual Budget Law		National budget		EU funds*	
	2011	2012	2011	2012	2011	2012
			(EUR millions)			
Total revenues	**13,400.2**	**14,700.7**	**12,303.66**	**12,736.8**	**1,096.6**	**1,963.9**
(% of GDP)	34.8	36.6	32.0	31.7	2.8	4.9
Tax revenues	10,585.1	11,042.5	10,585.1	11,042.5		
Non-tax revenues	1,682.8	1,656.4	1,682.8	1,655.9	3.1	0.5
Grants	1,132.4	2,001.9	38.8	38.5	1,093.6	1,963.4
Total expenditure	**13,988.9**	**14,801.2**	**12,458.4**	**12,503.8**	**1,530.5**	**2,397.3**
(% of GDP)	36.4	36.9	32.4	31.1	3.9	5.7
BG contribution to the EU budget	414.9	458.0	414.9	458.0		
(% of GDP)	1.1	1.1	1.1	1.1		
Transfers for national co-financing			(421.3)	(443.8)	421.3	443.8
(% of GDP)			(1.1)	(1.1)	1.1	1.1
Budget balance	**(1,003.7)**	**(558.65)**	**(991.4)**	**(668.8)**	**(12.6)**	**110.4**
(% of GDP)	**(2.6)**	**(1.4)**	**(2.6)**	**(1.7)**	**0.0**	**0.3**

Source: Ministry of Finance
* The total expenditure on EU funds includes EU financing and national co-financing.

On the revenue side the projected increase entirely reflects an assumption of a rise in EU funds transferred and a respective increase in EU grants by nearly 2.1 per cent. of GDP. Tax revenues, on the other hand, are projected to raise nominally only by 4.3 per cent., consistent with a much more conservative growth of the 2.9 per cent. increase in real GDP assumed in the budget.

On the expenditure side the framework envisages a nominal increase of 5.8 per cent. This mainly reflects a projected 2 per cent. points of GDP increase in investment outlays, mostly reflecting the projected rise in EU funds transferred. The programme envisages the nominal level from 2011 of spending on national programmes to be sustained in 2012 while spending on EU projects is projected to increase nominally by approximately 50 per cent.

EU flows

The 2012 budget reflects the impact of the contributions to, and grants from, the EU budget. Contributions to the EU budget in 2012 are estimated at approximately EUR 458 million, or 1.1 per cent. of GDP. In 2012, Bulgaria expects to receive EU transfers of approximately EUR 1,964.5 million, or 4.9 per cent. of GDP.

Privatisation

The privatisation process in Bulgaria started in 1992. Most of the major sectors of the economy have been privatised and the resources of state companies available for privatisation are considerably limited.

Until 31 December 2009, the proceeds from privatisation were distributed according to the Privatisation and Post Privatisation Control Act, respectively 10 per cent. to the Privatisation and Post-Privatisation Control Expenditures Fund and the remaining 90 per cent. were channelled to the central budget (from 2008 allocated to the benefit of the State Fund for Guaranteeing the Stability of the State Pension System (the "**Silver Fund**")). Since 1 January 2010 the proceeds from privatisation are allocated entirely to the Silver Fund.

As of 31 December 2011, the total amount (in terms of value) of privatised assets amounted to 66.26 per cent. of all state assets. Shares in 5,258 state enterprises have been sold, including 2,936 enterprises and 2,322 separate parts of companies. 4,224 sales of minority stakes have also been completed. The total financial effect of privatisation transactions amounted to US$12,366 million, including US$ 6,316 million in payments, US$1,192 million in assumed liabilities and US$4,857 million in investment commitments.

The largest number of privatised enterprises are in the areas of industry (1,646), trade (1,175), agriculture (621), construction (536) and tourism (524).

A total of 174 privatisation transactions that have taken place in Bulgaria since the beginning of privatisation process were made involving foreign investors, which has contributed substantially to the financial results provided above. As a result of privatisation, Bulgaria has attracted large investors from the Czech Republic, Russia, Austria, Germany, Belgium, Greece and other countries.

Some of the largest enterprises in Bulgaria have already been privatised, such as all formerly State-owned banks (with the exception of the Encouragement Bank which has remained State-owned), the Bulgarian Telecommunications Company and Kremikovtzi EAD, TPP Bobov Dol EAD, Neftochim EAD, BTC EAD, Maritime Navigation EAD, Sodi Devnya EAD, SOMAT EAD, Arsenal EAD, Asarel Medet EAD, Bulgartabac Holding AD and many others.

Privatisation in the period 2007 to 2011

The following table summarises results of the privatisation process in the period 2007 to 2011:

Report Year	Revenue	Primary Divestitures
	(EUR millions)	
2007	198.2	District Heating Company Russe EAD
		DHC Plovdiv
		DHC Varna EAD
		DHC Sliven EAD
		Medical Equipment EAD
		Bulgaria Air EAD
		TPP Varna – partial payment ("**p.p.**")
		EDC Plovdiv and Stara Zagora – p.p.
2008	251.4	Bulgarian Maritime Fleet EAD
		TPP Bobov Dol EAD
2009	23.3	TPP Bobov Dol–p.p.
		EDC Plovdiv and Stara Zagora – p.p.
		Hotel Vitosha and Riga Hotels – p.p.
2010	13.4	KCM EAD–p.p.
		EDC Sofia Region – p.p.
		EDC Pleven EAD – p.p.
		TPP Bobov Dol – p.p.
		TPP Varna EAD – p.p.
		Bulgarian Maritime Fleet EAD – p.p.
2011	164.8	Bulgartabac Holding AD
		Arsenal AD
		Industrial Construction Holding EAD
		EVN EDC companies – minority stakes

Source: Ministry of Finance

2012 Forecast

Forecasted cash receipts from privatisation in the central budget for 2012 amount to EUR 63.8 million according to the CFP for 2012.

The majority of estimated receipts from privatisation during the year are expected from the privatisation of the following holdings of the state: 100 per cent. of the capital Technoexportstroy EAD (design and construction), 100 per cent. of the capital VMZ EAD (production and marketing of special products) and 79.83 per cent. of the capital of Orphei Audiovideo EAD (design, production, marketing and distribution of all types of audiovisual products).

Additionally, the following stakes will be subject to privatisation, the proceeds of which will remain available to the state companies that own the shares. The four remaining minority stakes in the capital of the electricity distribution companies owned by State Consolidation Company EAD are: 33 per cent. of the capital of E.ON Bulgaria Sales AD, Varna and 33 per cent. of the capital E.ON Bulgaria Networks PLC, Gorna Oryahovitsa; 33 per cent. of the capital of CEZ Bulgaria, Sofia and the sale of 33 per cent. of the capital of CEZ Electro Bulgaria, Sofia; subject to privatisation is also 100 per cent. of the capital of BDZ Freight Services Ltd, owned by Holding Bulgarian State Railways EAD.

Pension System

The pension system in Bulgaria has undergone substantial structural reform since the late 1990s. The traditional pay-as-you-go system was transformed into a three-pillar system through the introduction of compulsory and voluntary fully funded pensions. The current Bulgarian pension system came into force with the Mandatory Social Insurance Code on 1 January 2000 (renamed the Social Security Code in 2003). It is based on the principle of security through diversity and includes the following:

Mandatory pension insurance (Pillar I)

The public system of mandatory pension insurance of the pay-as-you-go type (Pillar I) ensures linkage of the pensions amounts with contribution periods and earnings. New, more restrictive eligibility criteria on the basis of length of service and old age were introduced in 2000. Promoting the principle of mandatory participation and universality, the first pillar covers all economically active persons. There is differentiation among the categories of insured persons, depending on the number and types of included social insurance risks. These include: mandatory social security for all social risks, compulsory social security for disability, old age, death, accidents at work and occupational disease, and compulsory social security for disability due to general disease, old age and death.

The first pillar is financed through contributions from employers and employees, as well as through transfers from the state budget for covering all non-contributory pension benefits and some non-contributory periods, which are regarded as insurance periods. Since 2009, the state has become a ''third insurer'' and pays contributions equal to 12 per cent. of the total insurance income.

The first pillar is administrated by the National Social Security Institute, which is responsible for entitlement to and payment of pensions and other social insurance benefits in the event of temporary incapacity to work, maternity and unemployment. The pension policy is formulated and implemented by the Ministry of Labour and Social Policy.

Inflows to the first pillar are allocated into separate and financially independent public social insurance funds being: the Pensions Fund, the Accidents at Work and Occupational Disease Fund, the General Disease and Maternity Fund and the Unemployment Fund. The fifth fund for pensions not related to labour activities is financed through transfers from the central budget. The deficit of the Pensions Fund is covered by subsidy from the government budget on an annual basis.

In 2012, the rate of social insurance contributions to annual social insurance income for the third labour category (labour without risk for which employer pays no financial contribution in Professional Pension Funds (''**PPFs**'')), is as follows: 17.8 per cent. for the Pension Fund (for persons born after 1 January 1960, 5 per cent. of this 17.8 per cent. are transferred to Pillar II); between 0.4 per cent. and 1.1 per cent. for the Accidents at Work and Occupational Disease Fund (differentiated by type and degree of risks for main groups of economic activities; these contributions are only at the employers expense); 3.5 per cent. for the General Disease and Maternity Fund and 1 per cent. for the Unemployment Fund.

Supplementary mandatory pension schemes (Pillar II)

The supplementary mandatory pension schemes are capital-based schemes with defined social security contributions, accumulated and capitalised in individual pension accounts. They do not replace the first pillar pensions and allow for receiving more than one pension, thus increasing the replacement rate without any increase of the social insurance burden.

The scope of the second pillar is narrower than that of the first pillar and it covers only old-age and death risks. It is also more limited because it covers two categories of persons. First, persons subject to mandatory social insurance in a universal pension fund – all persons insured under the first pillar and born after 31 December 1959. Second, persons subject to mandatory social insurance in a professional pension fund – all persons working under the conditions of labour ''at risk'' requiring employers to make additional payments into the Public Provident Fund in order to acquire the right to a time-limited pension for early retirement, which precedes the pension based on the length of service and age, without any cumulative effect on the two pensions.

The supplementary mandatory pension schemes are based on monthly contributions to a universal and/or professional pension fund in amounts set out in the Social Security Code 2000. Currently, the contribution to a universal pension fund is 5 per cent. (paid in the same ratio as the other part of the social insurance contributions), which is transferred from the first pillar Pension Fund contributions. The contribution to a professional pension fund has been 7 per cent. for the second labour category (labour ''at risk'' for which the employer pays additional contributions into PPFs each month) and 12 per cent. for the first labour category, at the sole expense of the employer.

As at 31 December 2011, the second pillar of the pension system had approximately 3.4 million participants. Total assets of this pillar comprise EUR 2.05 billion. For the period from 1 January 2007 to 31 December 2011, the number of insured persons increased by around 20 per cent. and the assets of the second pension pillar rose four times from EUR 0.51 billion to EUR 2.05 billion.

Supplementary voluntary pension schemes (Pillar III)

The supplementary voluntary pension schemes are also capital-based. They involve voluntary contributions at the expense of insured persons, insurer or at the expense of insured persons and the insurer in order to provide life or term pension for old age or disability, as well as survivor pensions. They are organised and administered by shareholding companies with pension licenses.

As of 1 January 2007, occupational pension schemes were introduced into this pillar. The contributions paid by employers (up to EUR 30.68 per month) and insured persons (up to 10 per cent. of the taxable income) are tax exempt, while the benefits to be paid may differ between a life-long, time-limited or lump sum pension.

Recent pension reforms

Recent pension reforms include the gradual increase of the required length of service and the statutory retirement age – as of 1 January 2012, the required length of service will be raised by four months each calendar year, until 37 years length of service for women and 40 years length of service for men is reached in 2020 and as of 1 January 2012, the statutory retirement age will be raised by four months each calendar year, to reach 63 years for women (2020) and 65 years for men (2017).

Other recent pension reforms include raising the social security contributions to the Pensions Fund by 1.8 percentage points as of 1 January 2011, as of 2013 consumer price indexation will be applied, as of 1 January 2014 the maximum levels of newly awarded pensions will be abolished and the maximum levels of old pensions will be gradually increased, as of 1 January 2015 early retirement pensions of first and second labour category workers will be covered only by second pillar professional pension funds and as of 1 January 2017 the contribution rate for universal pension funds will be increased from 5 per cent. to 7 per cent. and as of 2017 the accrual rate for the new pensions will be increased from 1.1 to 1.2.

Health Insurance

Bulgaria has a mixed system of health care financing. Health care is financed in a large part as a compulsory social health insurance system funded from wage-related contributions of employed individuals and from general tax revenue which covers the contributions of the non-working population (children, pensioners, unemployed, people taking care of disabled members of the family, people with right to social welfare etc). Another important source of revenues is direct payments from general taxation allocated by the Ministry of Health.

Mandatory health insurance is income based and amounts to 8 per cent. (increasing insurance contributions from 6 per cent. to 8 per cent. in 2010) of the payroll paid in 40/60 parts between the employee and the employer. The contributions are collected by the regional branches of the NRA which pools them and allocates to the accumulation account of the NHIF, which in turn distributes the funds to the Regional NHIFs. The NHIF was established in 1999 and is regulated by the Law on Health Insurance of Bulgaria. It guarantees healthcare services to eligible persons and reimburses the costs related to such services, including medicines and medical aid equipment. In order to be covered, a person either has to personally make contributions or have contributions made on their behalf.

Approximately 85 per cent. of the entire population regularly pay health insurance contributions. In the working population the employer deducts insurance contributions from the monthly payroll and transfers these amounts to NHIF accounts. In the case of children, pensioners, students, soldiers, unemployed and other dependent categories the insurance contributions are transferred from the budgets of relevant institutions. The self-employed persons pay into NHIF accounts directly.

Health care expenditure in Bulgaria is below the average amount spent in the EU. In 2007, total spending amounted to 7 per cent. of GDP, compared to the EU average of 9.3 per cent. Public spending as percentage of GDP was 4.2 per cent. in 2007, well below the EU average of 7.2 per cent. When measured in per capita terms, in 2007 Bulgaria had the second lowest total expenditure (655 Purchasing Power Standard ("**PPS**") vs. European average of 2,285 PPS) and the lowest public spending (394 PPS vs. 1,732 PPS in the EU27). Fiscal consolidation to bring government revenues and spending in line has continued to have its implications on the health sector in 2011 and public expenditures represent 4.3 per cent. of GDP.

MONETARY AND FINANCIAL SYSTEM

Bulgarian National Bank

The BNB is the central bank of Bulgaria. It was established on 25 January 1879.

Primary Objective, Tasks, and Reporting

The primary objective and the tasks of the BNB are stipulated in the Law of the BNB (the ''**LBNB**''), adopted by the 38th National Assembly on 5 June 1997. The BNB is the central bank of Bulgaria, which is independent from the state and reports to the National Assembly. The BNB's independence from the state is guaranteed by the LBNB, and by the Treaty on the functioning of the European Union. Since 1 January 2007, the BNB has been a full member of the European System of Central Banks and actively participates in the decision-making process in the area of banking and finance in the European Union. The BNB Governor is a member of the General Council of the European Central Bank and a member of the General Board of the European Systemic Risk Board. The BNB reports to the National Assembly.

The primary objective of the BNB is to maintain price stability through ensuring the stability of the national currency and implementing monetary policy as provided for by the LBNB. The BNB acts in accordance with the principle of the open market economy with free competition, favouring an efficient allocation of resources.

The tasks and responsibilities of the BNB also include:

- maintaining full foreign exchange cover of the total amount of monetary liabilities of the BNB, by taking actions needed for the efficient management of the BNB's gross international reserves;
- investing the gross international reserves in accordance with the principles and practices of prudent investment, with investments in securities being limited to liquid debt instruments satisfying the provisions of the LBNB;
- regulating and supervising other banks' activities in the country for the purpose of ensuring the stability of the banking system and protecting depositors' interests;
- contributing to the establishment and functioning of efficient payment systems and overseeing them;
- regulating and supervising the activities of payment system operators, payment institutions and electronic money institutions in Bulgaria;
- issuing banknotes and mint coins in Bulgaria (an exclusive right of the BNB);
- acting as the fiscal agent and depositary of the State by virtue of concluded contracts at market conditions and prices of services.

According to the LBNB, the BNB cannot extend credits or guarantees to the Government and governmental institutions, municipalities and municipalities institutions. The BNB cannot provide credit to banks except in the case of a liquidity risk threatening to affect the stability of the banking system and only in accordance with stringent requirements set out in the LBNB.

The BNB keeps accounts and records in compliance with the Accountancy Act and in accordance with international accounting standards. The expenditure of the BNB is in accordance with the annual budget approved by the Governing Council of the BNB and published in the Darjaven Vestnik (''**State Gazette**''). The reports on the budget outlays of the BNB are examined by the National Audit Office, which prepares a special report on the results of the examination. The report on the budget expenditure of the BNB is addressed to the National Assembly simultaneously with its annual report.

The BNB publishes the balance sheet of the Issue Department on a weekly basis, showing the position of its basic assets and liabilities, inclusive of the gross international reserves and the total amount of the BNB's monetary liabilities. The BNB publishes the position of its basic assets and liabilities in the State Gazette at the end of each month, presenting separate balance sheets of the Issue and Banking Departments, an annual financial statement and the profit and loss account of the BNB.

The consolidated financial statements of the BNB are certified by an external auditor and is published together with the auditor's report in accordance with the requirements of international accounting standards. Twice a year the BNB prepares a report which reviews and assesses the BNB's activities during the previous period. These reports are published.

Governance

The management of the BNB is carried out by the Governing Council, the Governor and the three Deputy Governors. The Governing Council consists of seven members: the Governor of the Bank, the three Deputy Governors, and three other members. The Governor of the BNB is elected by the National Assembly. The National Assembly elected the Deputy Governors – heads of the main departments, defined by the LBNB – on a proposal by the Governor. The other three members of the Governing Council are appointed by the President of the Republic. The term of office of the members of the Governing Council is six years. The replacement of the Governing Council follows a staggered schedule with a mandate expiring every year.

Structure of the BNB

The LBNB establishes three main departments at the BNB – an Issue Department, a Banking Department and a Banking Supervision Department. Each department is headed by a Deputy Governor elected by the National Assembly.

The main function of the Issue Department is to maintain full foreign exchange cover of the total amount of monetary liabilities of the BNB, by taking actions needed for the efficient management of the BNB's gross international reserves.

The head of the Banking Department is responsible for the supervision over payment system operators, payment institutions and electronic money institutions, in accordance with the rules provided for by a law and the regulations for its enactment. In exercising his supervisory powers, he, separately and at his own discretion, applies the enforcement measures and sanctions as provided for by law.

Supervision over the banking system is exercised by the Deputy Governor heading the Banking Supervision Department, in accordance with the rules provided for by law and the regulations for its enactment. In exercising his supervisory powers, he shall apply, separately and at his own discretion, the actions and penalties as provided for by law.

The BNB concentrates the powers and responsibilities on monetary policy and bank supervision, which equips the BNB with macroprudential tools in addition to the standard microprudential tools. The general strategy followed by the BNB is to address the monetary policy and the overall systemic risks issues via calibrated counter-cyclical changes in both macro- and micro-prudential policy tools.

Currency Board

The primary objective of the BNB to maintain price stability through ensuring the stability of the national currency has been achieved since July 1997 within the framework of the currency board governed by the LBNB.

Legal Framework

The operation of the currency board in Bulgaria is based on three major principles laid down in the Law on the BNB, namely:

- a fixed exchange rate of the Lev to the euro which is BGN 1.95583 per EUR 1;
- the total amount of BNB monetary liabilities is fully covered by high quality foreign reserves. The aggregate amount of the monetary liabilities of the BNB consist of: all banknotes and coins in circulation issued by the BNB; any balances on accounts held by other parties with the BNB, with the exception of the accounts held by the International Monetary Fund. The gross international reserves of the BNB shall be equal to the market value of the following assets of the Bank: (a) banknotes and coins held in freely convertible foreign banknotes and coins held in freely convertible foreign currency; (b) funds in freely convertible foreign currency held by the BNB on accounts with foreign central banks or with other foreign financial institutions, whereof obligations are assigned one of the two highest ratings by two internationally recognised credit rating agencies; (c) the Special Drawing Rights (SDRs) of the International Monetary Fund held by the BNB; (d) debt instruments held by the BNB and issued by foreign countries, central banks, other foreign financial institutions or international financial organisations, whereof obligations are assigned one of the two highest ratings by two internationally recognised credit rating agencies, and which are payable in freely convertible foreign currency with the exception of debt instruments given or received as collateral; (e) the balance on accounts receivable and accounts payable on forward or repurchase agreements of the BNB, concluded with or guaranteed by foreign central banks, public international financial organisations or other foreign financial institutions, whose obligations are

assigned one of the two highest ratings by two internationally recognised credit agencies, as well as futures and options of the BNB, binding foreign persons and payable in freely convertible foreign currency; (f) the monetary gold held by the BNB as a component of foreign reserves; and

- the reserve currency is treated on equal terms with the national currency and the BNB has the obligation to unconditionally and irrevocably sell and purchase levs against euro at the exchange rate fixed by the Law on the BNB. Hence, the BNB does not intervene on the foreign exchange market but the BNB exchanges on demand domestic currency against the anchor currency and vice versa at the fixed rate. The national currency is issued solely against providing reserve currency at the fixed exchange rate without a spread.

In addition to the above principles:

- The BNB cannot extend loans and guarantees in any form whatsoever, including through purchase of debt instruments, to the central government, municipalities, as well as to other government and municipal institutions, organisations and enterprises.
- The BNB may not provide credit to banks except in the case of a liquidity risk threatening to affect the stability of the banking system. The terms and procedure for extending such a credit, and criteria for identifying the existence of liquidity risk are set by an ordinance of the BNB. The credit may be extended solely up to the amount of the excess of the lev equivalent of the gross international reserves over the total amount of BNB monetary liabilities. In order to support the banks, this provision also excludes the possibility of issuing national currency beyond the limit corresponding to the currency board principles. This provision has not yet been used since the introduction of the currency board arrangement in Bulgaria.
- The BNB combines typical monetary policy functions (money issuance, regulation over the minimum reserve requirements, oversight of the payment systems) with banking supervision (both regulatory and supervisory powers), and fiscal agency functions. The BNB has both a macro-and micro- prudential mandate.
- The BNB invests its gross international reserves in accordance with the principles and practices of prudent investment which are intended to protect the quality of assets in which these reserves are invested.

Operational Framework

The legal framework of the currency board arrangement guarantees an automatic mechanism of balancing national currency demand and supply at the fixed exchange rate determined by the law. Under the currency board, it is impossible that the issue of national currency exceeds the level of the gross international foreign exchange reserves, which could, otherwise, lead to erosion of the fixed exchange rate (a key difference between a currency board and a standard fixed exchange rate regime). The change in the level of BNB gross international reserves reflects the net result of the change in the demand for national currency by economic agents, the Government and banks, as well as changes in the market value of gold (as part of international reserves) and financial assets in which these reserves are invested (see table below).

Under the conditions of the fixed exchange rate against the euro and a free movement of capital, the BNB has no control over the interest rates and therefore, monetary conditions in Bulgaria follow to a great extent those in the euro area. Thus, the currency board largely reproduces the monetary conditions in which the euro area economy is functioning.

The main instrument used by the BNB to influence the domestic monetary conditions is the regulation of the minimum required reserves that banks maintain with the central bank. As the minimum required reserves held at the BNB are not remunerated, their amount implicitly affects the overall cost of funding of banks and thus influences the banks' policies in setting their lending rates. For example, the reduction of the minimum required reserves rate since early 2009 has boosted liquidity in the banking system and contributed to falling interest rates in the interbank money market. It is also possible for the BNB to indirectly influence the monetary conditions in Bulgaria by applying macroprudential and microprudential tools as well as administrative measures. Nonetheless, the objective of those measures is mainly financial stability rather than affecting monetary conditions.

Fiscal policy also may affect money supply and liquidity in the economy through a change in the amount of the government deposit with the BNB and the net government securities issuance, reflecting the financing of the fiscal deficit and the deficit-debt adjustment operations of the Government. For example, during the years of high economic growth the Government was running fiscal surpluses and was accumulating a fiscal reserve predominantly deposited at the BNB. At the end of 2008 and in early 2009 the Government increased its discretionary spending by withdrawing funds from the government deposit at the BNB, which increased liquidity in the economy.

The implementation of these macroeconomic policy instruments affects the level of the international reserves. In the years preceding the global financial and economic crisis the steady increase of bank deposits at the BNB reflected both BNB policy and the increase of financial intermediation in the economy. In 2004 to 2007 BNB introduced a number of measures aimed at containing the rapid credit expansion during that period and at building a counter-cyclical buffer. (See "*Monetary and Financial System – Banking Supervision and Regulation – Recent Developments in the Banking System and Macro-economic Effects.*") In late 2008 and early 2009 the reduction of the minimum required reserves rate provided liquidity to banks at the time of a contraction in global liquidity. The fiscal policy prior to the global crisis also contributed to an increase in international reserves through accumulating part of the budget surpluses in the government deposit at the BNB. With the intensification of the global crisis, the Government decreased its deposit at the BNB thus contributing to a decrease in gross international reserves during that period.

The high savings rate in the economy resulted in a steady increase in the domestic deposit base of banks, which is reflected in the expansion of their deposits with the BNB in 2010 to 2011. During the last two years, the Government financed its cash deficit predominantly with resources from the government deposit at the BNB, which negatively affected the gross international reserves. The effect on the BNB reserves was counterbalanced by the expanding bank deposits at the BNB, by the increasing Banking Department deposit (partly capturing the international reserves valuation effects) and by positive developments in demand for currency in circulation.

The increased liquidity of the private non-government sector allowed the economic agents in Bulgaria (banks and non-bank institutions) to make repayments on their foreign obligations or to increase their foreign assets at the end of 2008 and the beginning of 2009. The process of reducing the net foreign liabilities of financial intermediaries and non-financial corporates continued in 2010 to early 2012.

The BNB's international reserves reached EUR 13.4 billion (33.6 per cent. of projected 2012 GDP) at the end of April 2012, increasing by 11.9 per cent. as compared to April 2011, thus covering 179 per cent. of the monetary base and 129 per cent. of all monetary liabilities of the BNB. At the end of March 2012, the reserves covered over 6 months of imports of goods and non-factor services, while the reserves to short-term external debt ratio increased to 129.4 per cent. as of February 2012.

The following table sets out international reserves for the period 2007 to 2011:

	As of 31 December				
	2007	**2008**	**2009**	**2010**	**2011**
			(EUR millions)		
International reserves	**11,936.6**	**12,713.1**	**12,918.9**	**12,976.7**	**13,348.7**
International reserves growth, year-on-year (%)	33.7	6.5	1.6	0.4	2.9
Coverage of monetary base, (%)	164.5	175.3	195.2	179.8	175.1
Coverage of short term ext. debt, (%)	127.2	98.4	106.5	115.3	133.8
Coverage of imports, months, annually	5.9	5.5	8.0	7.3	6.3

Source: BNB

The following table sets out the total assets and liabilities of the BNB's Issue Department for the period 2007 to 2011, as well as at 30 April 2012:

	2007	2008	2009	2010	2011	April 2012*
			(% of GDP)			
Cash and foreign currency denominated deposits	5.8	3.8	6.1	8.1	8.9	8.8
Monetary gold and other monetary gold instruments	2.3	2.2	2.8	3.8	4.1	4.0
Investments in securities	30.6	29.8	28.1	24.1	21.7	20.8
TOTAL ASSETS:	**38.8**	**35.9**	**37.0**	**36.0**	**34.7**	**33.6**
Notes and coins in circulation	14.0	13.2	11.8	11.8	11.6	10.8
Liabilities to banks	9.6	7.2	7.2	8.2	8.2	8.0
Liabilities to Government and to government budget institutions	10.7	10.5	10.5	7.7	5.8	5.7
Liabilities to other depositors	0.6	0.4	0.6	0.7	1.3	1.6
Banking Department deposit	3.9	4.5	7.0	7.6	7.8	7.5
TOTAL LIABILITIES:	**38.8**	**35.9**	**37.0**	**36.0**	**34.7**	**33.6**

*Notes: *April 2012 data as a percentage of the projected 2012 GDP.*
Source: Bulgarian National Bank.

The Banking System

Structure and Development of the Bulgarian Banking System

The following table sets out the top ten banks operating in Bulgaria according to their total assets as at 31 March 2012:

	OWNERSHIP	TOTAL ASSETS
	(%)	*(EUR millions)*
Top ten Banks		
Unicredit Bulbank	UniCredit Bank Austria AG – 96.5	6,185
DSK Bank	OTP Bank RT, Hungary – 100	4,529
United Bulgarian Bank	National Bank of Greece – 99.9	3,361
Raiffeisenbank (Bulgaria)	Raiffeisen Bank International AG, Austria – 100	3,243
First Investment Bank	Ivaylo Dimitrov Mutafchiev – 28.9, Tzeko Tododrov Minev – 28.9	3,202
Eurobank EFG Bulgaria	EFG New Europe Holding B.V., Netherlands – 54.3, EFG Eurobank Ergasias S.A., Greece – 34.6, CEN Balkan Holdings Limited, Cyprus – 11.2	2,995
Corporate Commercial Bank	Bromak EOOD – 50.35 Bulgarian Acquisition Company II S.A.R.L – 30.0	2,189
Société Générale Expressbank	Société Générale, France – 99.7	1,616
Central Cooperative Bank	CCB Group EAD – 68.6	1,610
Piraeus Bank Bulgaria	Piraeus Bank S.A., Greece – 99.9	1,586

Source: BNB.

The following table sets out the top ten banks operating in Bulgaria according to their total equity as at 31 March 2012:

	OWNERSHIP	TOTAL EQUITY
	(%)	(EUR millions)
Top ten Banks		
Unicredit Bulbank	UniCredit Bank Austria AG – 96.5	1,048
DSK Bank	OTP Bank RT, Hungary – 100	713
United Bulgarian Bank	National Bank of Greece – 99.9	566
Raiffeisenbank (Bulgaria)	Raiffeisen Bank International AG Austria – 100	490
Eurobank EFG Bulgaria	EFG New Europe Holding B.V., Netherlands – 54.3, EFG Eurobank Ergasias S.A., Greece – 34.6, CEN Balkan Holdings Limited, Cyprus – 11.2	405
Piraeus Bank Bulgaria	Piraeus Bank S.A., Greece – 99.9	316
First Investment Bank	Ivaylo Dimitrov Mutafchiev – 28.9, Tzeko Tododrov Minev – 28.9	247
Société Générale Expressbank	Société Générale, France – 99.7	226
Corporate Commercial Bank	Bromak EOOD – 50.35 Bulgarian Acquisition Company II S.A.R.L – 30.0	207
Central Cooperative Bank	CCB Group EAD – 68.6	172

Source: BNB.

The transition to a stable, well-regulated, and competitive banking system in Bulgaria has been a long process. The legal framework for commercial banking was established soon after the introduction of market reforms in the early 1990s and led to the rapid increase in the number of private banks, the consolidation of numerous state-owned banks, and the entry of foreign banks into the market. However, the sector continued to be dominated by inefficient state-owned banks. A number of factors contributed to the deterioration of the balance sheet of the banking system culminating in a severe banking crisis and bank failures in 1996–1997. The adoption of a currency board in 1997 in the aftermath of the crisis signified a fundamental change in the institutional framework of the banking sector introducing new prudential requirements for commercial banks and strengthening the regulatory and supervisory powers of the BNB. In the first half of the 2000s, banking legislation underwent another major revision to comply with EU banking directives in the process of EU accession. Moreover, the Government initiated the privatisation of all state-owned banks in 1997 attracting a number of strategic foreign investors. Currently, there is only one state-owned bank with a market share of 2.39 per cent. As a result, by the time Bulgaria joined the European Union on 1 January 2007, over 80 per cent. of banking assets were controlled by foreign banks and over 98 per cent. were privately owned.

The financial sector is dominated by the banking system – the share of banks' assets is approximately 80 per cent. of the assets in the financial sector. As at 31 March 2012, there were twenty four commercial banks (of which nine domestically-owned banks), seven foreign bank branches, and 200 credit institutions licensed in EU countries with notification to carry out activities on a cross-border basis. As at March 2012, the total assets of commercial banks and foreign bank branches operating in Bulgaria amounted to EUR 39.82 billion, an increase of 1.5 per cent. as compared to 31 December 2011.

The following table sets out the aggregate assets and profits of the banking system for the period 2007 to 2011 as at 31 December, and as at 31 March 2012:

	Year ended 31 December					
	2007	2008	2009	2010	2011	March 2012[(1)]
			(EUR millions)			
Assets	30,214.3	35,560.1	36,214.6	37,688.4	39,219.9	39,823.4
Loans	19,402.8	25,658.1	26,817.7	27,528.4	28,653.7	28,686.6
Deposits	20,010.4	21,514.6	22,254.6	24,171.3	27,336.0	27,815.1
Profit	588.4	702.4	384.5	306.6	242.3	89.8*

Note:
*Non-annualised

(1) Unaudited results
Source: BNB

Twelve credit institutions are subsidiaries of groups but are fully subject to the regulation and supervision of the BNB. The banking sector is well diversified, both in regard to the form of ownership and with regard to the size of the institutions, which is a prerequisite for active and healthy competition. As of March 2012, 72.7 per cent. of the total assets in the banking sector are managed by affiliated banks of European banking groups, of which 68.4 per cent. are managed through subsidiaries of EU banks, 4.3 per cent. through branches of EU banks, 25.0 per cent. are managed by domestic credit institutions and 2.3 per cent. are managed by non EU institutions. Foreign investors, consisting mainly of Greek and Austrian banks hold the majority of the share capital of commercial banks in Bulgaria. Four Greek bank subsidiaries (National Bank of Greece, EFG Eurobank Ergasias, Piraeus Bank and Emporiki Bank) and two Austrian banks subsidiaries (UniCredit Bank and Raiffeisen Bank International) held respectively 24.7 and 23.7 per cent. of all commercial banks' share capital as at 31 March 2012. As at 31 March 2012, 71.7 per cent. of the share capital of the banking system was owned by foreign entities. The banking system (banks and branches of foreign banks) has low concentration. The market share of the five largest banks by total assets (respectively UniCredit Bulbank, DSK Bank, United Bulgarian Bank, Raiffeisenbank (Bulgaria) EAD and First Investment Bank) collectively comprised 51.5 per cent. as at 31 March 2012.

All Bulgarian banks currently comply with the liquidity and capital requirements set by the BNB. The banking system displayed a very high level of capitalisation reflecting the strong regulatory policies of the BNB. The system-wide capital adequacy ratio ("**CAR**") is well above the BNB regulatory minimum of 12 per cent. and of the EU minimum of 8 per cent. The CAR as at 31 March 2012 was 17.5 per cent., showing a marked improvement from the end of 2008 when it was 14.9 per cent. Moreover, Bulgarian banks' capital is made up almost exclusively of Tier I capital. The Tier I capital ratio was 15.8 per cent. as at 31 March 2012 and has improved from 11.2 per cent at the end of 2008.

The liquidity level of the banking system has markedly improved since the end of 2008 mainly due to the fact that the Bulgarian banks have reduced their reliance on foreign funding by increasing their funding through domestic deposits. Borrowing from foreign parent banks remained another important source of financing; however, net debt to parent banks (calculated as the difference between debts owed to parent banks and the funds held with them) decreased significantly since end-2008. The overall decline in foreign liabilities of the commercial banks reflects to a large extent the lack of demand for credit. The Bulgarian regulatory framework on bank liquidity is conservative. The liquid assets to short-term liabilities ratio increased from 26.6 per cent. as at end-2008 and 2009 to 29.1 per cent. as at 31 March 2012. The liquid assets to short-term liabilities ratio constituted 30.1 per cent., and 28.9 per cent. as at end-2010 and 2011, respectively. Since the change of strategy at the outset of the global economic crisis in late 2008, bank financing has depended on residents' deposits. As households saved and cut spending, deposits increased despite falling deposit rates. In 2011, banks operating in Bulgaria primarily financed their activities from local deposits. Deposits from individuals and households held with banks increased by 13.8 per cent. during 2011.

The banking system in Bulgaria remains profitable despite a difficult economic environment. Banks entered the recession with strong momentum in profitability, which has enabled them to remain reasonably profitable in spite of the deterioration of asset quality. The banking system's aggregate profits declined considerably compared to end-2008 but the banking system continued to be on the profit position as at 31 March 2012. In 2011, the banking sector as a whole had a profit of EUR 242.3 million, almost three times lower than that in 2008 (EUR 702.4 million). The fall in the profit reflected rising provisioning costs and the decrease in net-interest income. In 2011, seven banks and four branches of foreign banks recorded a loss (but the solvency and liquidity positions of affected institutions remained adequate and far above the regulatory minimum), whereas seventeen banks and three branches of foreign banks recorded a profit.

The confidence in the banking system is high and is manifested in an increase in deposits over recent years, which provides sources for sustainable organic growth. Deposits have also strengthened due to an increase in savings. The growth in deposits from individuals and corporations amounted on average to almost 8 per cent. year on year between 2008 and 2011. Foreign banks have maintained their presence in the Bulgarian banking market and there is no evidence of significant deleveraging by foreign-owned institutions. Assets of domestic banks increased by EUR 1.53 billion or 4.1 per cent. from 31 December 2010 to EUR 39.22 billion as at 31 December 2011. Loans to customers increased by EUR 1.12 billion or 4.1 per cent. from 31 December 2010 to EUR 28.65 billion as at 31 December 2011.

In contrast to many other countries, Bulgaria's credit growth remained positive, albeit low during the economic crisis in the period 2009 to 2011. Recently, corporate credit has increased while outstanding household credit has decreased. Overall credit grew on average 3.8 per cent. year on year between 2009 and 2011. The low growth in credit to the private sector was due to the combination of supply and demand factors: banks tightened their lending standards while households and corporations faced economic uncertainty and were therefore reluctant to incur additional debt. The lower rate of credit growth, as compared to pre-crisis levels, was also a result of a decrease in bank lending volumes and increased provisions, which hampered the issuance of new loans.

Asset quality weakened in 2011 on the back of weak economic growth and rising unemployment. Gross non-performing loans ("**NPLs**") reached 16.2 per cent. in March 2012 – up by almost 14 percentage points since the end of 2008. This level refers to gross loans and includes risk already reported in the income statement through impairment. If the gross amount of loans were reduced by impairment, as at 31 March 2012, the share of net non-performing loans (over 90 days) in total net loans was 10.7 per cent. Asset quality deteriorated across all categories of loans with a higher share for non-financial corporations compared to consumer and mortgage loans. Worsening credit portfolios have been accompanied by increased provisioning of non-performing loans and the existence of excess capital above of the regulatory minimum. The provisioning ratio remains high at 67 per cent. Banks also hold mortgage collateral of sufficient value despite the fall in house prices. As at 31 March 2012, highly liquid collateral covered 35 per cent. of the total volume of corporate loans, while housing loans accounted for 63 per cent. of mortgages established in favour of banks (loan-to-value in the residential mortgage sector). The amount of accumulated capital surplus (the excess of capital over the regulatory minimum) of EUR 1.48 billion as at 31 March 2012 – has increased considerably since the end of 2008 (EUR 0.82 billion). This additional buffer represents almost 4 per cent. of GDP as of the end of December 2011. The 2011 audited financial results showed an additional potential support for capital.

Banking Supervision and Regulation

Framework

Banking supervision is carried out by the BNB as stipulated in the LBNB and the Law on Credit Institutions. The regulatory framework of the Bulgarian banking system is in compliance with all applicable EU regulations and reflects the requirements of Directive 2006/48/EC, relating to the taking up and pursuit of the business of credit institutions, Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, 2010/76/EU on capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, Directive 2010/78/EU and Directive 2002/87/EC on financial conglomerates.

The BNB is responsible for supervising credit institutions operating in Bulgaria through, *inter alia*:

(1) reviewing applications for banking licenses and granting licenses in accordance with applicable banking laws and regulations;

(2) collecting and reviewing information related to credit institutions and evaluating this information on the basis of various requirements including capital adequacy and liquidity ("**off-site supervision**");

(3) conducting on-site inspections and audits, as well as evaluating the accuracy of financial reports provided to BNB, the financial soundness of the institution, and the effectiveness of its risk management function ("**on-site supervision**"); and

(4) taking enforcement measures against certain credit institutions, including the withdrawal of banking licences and initiating bankruptcy proceedings against banks before a competent court.

The term and procedure for granting licenses, conducting activities, supervising and termination of credit institutions for the purpose of ensuring a stable, reliable and sound banking system and for protecting depositor interests are governed by the Law on Credit Institutions. The Community Law and the Law on Credit Institutions requires achievement of an adequate level of supervisory transparency which should provide the opportunity for comparison between the supervisory practices across Europe. Also, the directives 2006/48/EC and 2006/49/EC contain a large number of options and national discretions which may be applied on the basis of the national circumstances.

In addition, the BNB regulates and supervises the activities of payment system operators, payment institutions and electronic money institutions in Bulgaria. Thus, the BNB carries out supervision over credit and payment institutions. As far as the other participants in the financial sector are concerned, their supervision and regulation is executed by the FSC. It is responsible for the oversight of securities exchange, non-bank investment firms, asset management firms, insurance companies, pension funds, etc. This model of supervision (by industry) provides independence of each supervisory institution and limits conflict of interests. Moreover, by specialising oversight in a specific area, better coverage is achieved and effectiveness is increased.

The Financial Stability Advisory Council ("**FSAC**") has a mandate in the macroprudential and in the financial stability field. The FSAC was established in February 2003 by the Law on Financial Supervision Commission. It serves as a platform for the institutions jointly responsible for the stability of the financial system and consists of Minister of Finance, Governor of the BNB and Chairperson of the FSC. The main goal of the Council is to assist for more effective cooperation in maintaining financial stability through exchange of information and assessment of the state and development of the financial system and the financial markets in the country, the potential effect of external and internal factors over it and coordination of the activities. For the purpose of facilitating the international cooperation in relation to the financial stability, the Council members may conclude agreements for cooperation with institutions performing tasks in this sphere in EU Member States and other countries.

The BNB implements Common Reporting Framework ("**COREP**") and financial reporting framework ("**FINREP**") reporting on capital requirements and consolidated and sub-consolidated financial reporting for supervisory purposes. The FINREP is based on the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS) adopted by the European Commission as per Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 and aims to increase the comparability of financial data reported by credit institutions.

The main focus of banking supervision remains on the monitoring and control of the following relevant risks: credit, liquidity, market, and operational risk. The BNB undertakes on a continuous basis preventive measures to improve risk management and strengthen the capital base of the banking system.

In order to do so, over the past several years the BNB has implemented additional requirements focused on capital adequacy, liquidity, reporting and data collection, as well as strengthening internal controls and risk management policies and procedures. Also, the BNB monitors closely the systemically important financial institutions.

Capital Adequacy

The regulation reflects the requirements in the EU Directives on the Capital Adequacy of Banks, respectively the new international agreement on bank capital standards, or Basel II. It provides for the minimum amount, the elements and structure of credit institutions' own funds and the minimum capital requirements for the risks assumed by them, as well as disclosure requirements. The capital adequacy ratio under Pillar 1 required for Bulgarian banks is 12 per cent., which is higher than the minimum requirement (8 per cent.) in EU.

As a part of its macro-prudential policy, the BNB requests that credit institutions keep a minimum 10 per cent. Tier I solvency ratio. Currently all credit institutions are in compliance.

The reporting forms and guidelines under the regulation are based on the COREP on capital adequacy prepared by the European Banking Authority (CEBS).

Liquidity

The Law on Credit Institutions requires that each bank manages its assets and liabilities in a way so as to meet at any time its due obligations by adopting financing and liquidity plans reflecting the specific nature of its activities; maintaining liquid funds to cover mismatches of incoming and outgoing cash flows; maintaining a system for monitoring and control of interest rate risk in all operations and information necessary calculate its liquidity position at any point in time.

In this regard the BNB Ordinance on Liquidity Management and Supervision of Banks and its provisions are brought to compliance with the principles of the Basel Committee on Banking Supervision for management of banks' liquidity. It sets forth requirements for liquidity management and the manner of reporting liquid assets, the maturity structure of assets, liabilities and off-balance sheet items and calculating liquidity ratios. The Ordinance also provides a framework for the calculation of cash inflows and outflows, which are of fundamental importance when determining the liquidity of banks.

Credit activity

The BNB Ordinance on the Large Exposures of Banks and the reporting form and guidelines to it transpose the European legislation requirements for regulating banks' large exposures, defines the tolerable amount of concentration risk and basically seeks to restrict the potential losses of banks or bank groups as a result of concentration of exposures.

The BNB Ordinance on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions to Cover Credit Risk and the reporting form with guidelines to it aim to ensure a common provisioning policy across international bank groups in line with the development of international practices following the introduction of Basel II. The document sets forth minimum requirements for the scope of the policy of evaluating risk exposures while describing the responsibilities of the relevant units regarding the implementation of the policy, procedures and mechanisms of internal control, and the methodology of assessment of the credit risk management system. Specific provisions for credit risk are not an element of the Bank's accounting costs. They are regulatory based supervisory instrument aiming to strengthen the shock absorption capacity of credit institutions. Specific provisions for loan losses are deducted directly from own funds before calculation of the banks' capital adequacy using a standardised approach to credit risk under the BNB Ordinance on the Capital Adequacy of Credit Institutions.

Regulatory Developments

In addition to the above mentioned regulatory framework in July 2007, the BNB adopted the "*General Principles of the BNB Licensing Policy*". Its purpose is to set clear criteria for assessing bank license applicants by drawing on the BNB's cautious and conservative policy of bank licensing and taking into account the great impact that quality assessment of prospective members to the banking mediation has on the financial stability of the banking system and on the country as a whole.

In December 2008, the minimum reserve requirements on all received funds were reduced from 12 per cent. to 10 per cent., except for funds received from abroad and from state and local budgets. The former were reduced to 5 per cent. and for the latter no reserves were required.

In February 2010, as part of the countercyclical policy in regulating banks' activities, the BNB Governing Council adopted changes that aim to harmonise the national requirements with those of the EU legislation and fully comply with the requirements of Directive 2006/48/EC which Member States must apply. The BNB's formal approval regime for the use of the standardised approach for operational risk was also removed, thereby encouraging banks to introduce improved methods for operational risk management.

In October 2010, the BNB amended the regime relating to treatment of large interbank exposure. The amendments impose a requirement for partial inclusion in the regime of exposure to parent banks and subsidiary banks from a group. The purpose is to provide additional protection against excessive exposure to companies belonging to the same group. The BNB also introduced harmonised criteria and a system of limits for inclusion in the primary capital of perpetual hybrid instruments. The possibilities provided for diversification of capital structure and improvement of Tier I equity. This will allow banks to better plan and manage their capital positions.

In October 2010, the BNB approved changes on Bank Liquidity Management and Supervision that are related to the implementation of harmonised qualitative requirements to bank liquidity management. As part of liquidity and liquidity risk management, banks are required to maintain liquidity buffers to help them overcome liquidity problems in an adverse environment. The new provisions enhance the use of stress tests. The results will be used by banks as a basis for determining the amount and composition of liquidity buffers and positions, and for updating their contingency action plans and 'liquid crisis' scenarios.

In December 2010, the Governing Council of the BNB passed an ordinance on the requirements regarding the remuneration in banks that came into effect on 1 January 2011. The new ordinance introduced the requirement that remuneration policies be implemented for categories of staff whose activities significantly affect the risk profiles of banks. These amendments to the Bulgarian banking legislation incorporate the new European provisions on the principles and requirements regarding remuneration policies in banks.

In March 2011, changes were made to the Ordinance for Payment Institutions, Electronic Money Institutions and Payment System Operators Licensing. These changes implemented Directive 2009/110/EC and actualised the procedures for the licensing, operation, calculation of own funds, internal control and risk management, reorganisation and liquidation of electronic money institutions, as well as other requirements to be complied with by electronic money institutions.

Cross-border cooperation

Foreign owned subsidiaries and branches are important institutions in the Bulgarian banking system. As such, the BNB co-operates with supervisory institutions in other relevant jurisdictions, through joint inspections of institutions, participation in activities with other supervisors and exchanges of information. The BNB has signed several multilateral agreements related to the supervision of international banking groups that have been operating in Bulgaria. The BNB is a member of supervisory colleges, as well as in some newly established cross-border stability groups. Each year the BNB participates in the gathering under the framework of the multilateral Memorandum of Understanding agreed in Athens in July 2007, aimed at further advancing cooperation in the area of banking supervision in Southeastern Europe and safeguarding financial stability in the region.

Recent developments in the banking system and macroeconomic effects

73 per cent. of the banks operating in Bulgaria are subsidiaries or branches of large EU-based banking groups. Bank subsidiaries in Bulgaria are subject to conservative and prudent BNB supervision. In compliance with its mandate and adhering to a counter-cyclical macro- and micro-prudential policy the BNB has consistently applied a series of regulatory and prudential requirements, which are typically more conservative than the average in the EU. These included higher risk weights, conservative loan-to-value ("**LTV**") restrictions, as well as many macroprudential measures undertaken long before the crisis, such as: high regulatory minimum for capital adequacy, higher provisioning and liquidity requirements, conservative treatment of collateral, higher risk weights for certain asset classes for the purposes of risk weighted assets ("**RWA**").

The specific measures undertaken by the BNB in pursuance of its objectives have been pre-emptive and counter-cyclical, aiming to preserve and strengthen the buffers, already accumulated in the Banking System.

Prior to 2004 most of the state-owned banks were privatised and the banking legislation underwent a major revision bringing it into compliance with EU banking directives in the process of EU accession negotiations. The EU membership of Bulgaria was confirmed with the signing of the Treaty of accession to the EU in 2005, which gave a further boost to investor confidence and investment activity in the economy. Following the privatisation process and as a result of the increase of financial intermediation and EU-integration, bank credit to the private sector accelerated rapidly. On the demand side, the main contributing factors were the favourable macroeconomic environment, high expected return on investment and positive income convergence expectations. The decrease of interest rates on loans in Bulgaria started in the early 2000s and was further accelerated by the signing of the Treaty of accession to the EU in 2005. The interest rates on corporate loans fell from 12.6 per cent. on average in 2000 to an average of 8.3 per cent. in 2007, and the interest rate on consumer loans fell from average 16.4 per cent. in 2000 to average 7.9 per cent. in 2007. On the supply side, banks, partly utilising parent banks' resources, intensified the competition for financial market share and actively expanded their operations, partly by easing their credit conditions. Reflecting an intensification of the banking competition throughout this period, banks were also steadily decreasing the interest credit-to-deposit differential, while expanding the variety and the quality of the financial services offered to the population. Loan-to-deposits ratios were initially very low and gradually increased during this period as the subsidiaries were utilising resources from their parent banks. Nevertheless, the ratio remained low as compared to other Central and Eastern European Countries.

In order to mitigate financial stability risks and adhering to a counter-cyclical policy, the BNB introduced in 2004 to 2007 a series of measures, aimed at containing the rapid credit growth, including:

- a restrictive policy regarding banking license issuance;
- broadening the definition of liabilities comprising the reserve base for the calculation of the minimum required reserves ("**MRR**"); in the period up to December 2008 the ratio was uniform and applied to the total deposit base of banks (with the exception only of the period July-November 2004);
- tightening bank supervision through a number of macro-prudential measures related to the exposures' classification and provisioning, capital adequacy, tightening the treatment of current profit, risk weights and LTV ratios;
- administrative measures in the form of credit ceilings and additional MRR (effective from April 2005 to January 2007);
- increase of the MRR ratio from 8 per cent. to 12 per cent. (effective from September 2007). Since December 2008, the MMR ratio has been 10 per cent.; and
- stress-testing (quarterly for credit and liquidity risks) since 2002 as a supervisory tool (both using top-down and bottom-up approaches).

With the abolition of the administered credit ceilings the competition for market share intensified again and the rapid credit expansion was partly financed by foreign resources supplied by parent banks.

The following tables set out monetary and credit developments and interest rates for the period 2007 to 2011 as at 31 December, and as at 31 March 2012:

	2007	2008	2009	2010	2011	As at March 2012
			(EUR millions, end of period)			
Broad money	21,506	23,406	24,384	25,943	29,122	29,413
M1	10,597	10,158	9,267	9,401	10,751	10,928
Quasi-money	10,898	13,202	15,087	16,505	18,310	18,448
CLAIMS ON NON-GOVERNMENT SECTOR	19,318	25,415	26,375	26,731	27,743	27,707
Non-financial corporations	11,931	15,672	16,013	16,406	17,428	17,458
Financial corporations	340	490	573	617	650	669
Households and NPISHs	7,047	9,253	9,789	9,708	9,665	9,580
NET FOREIGN ASSETS OF OTHER MFIs	(2,154)	(5,548)	(4,686)	(3,511)	(1,783)	(1,314)
Foreign assets	4,026	3,909	4,097	4,076	4,638	5,169
Foreign liabilities	6,180	9,457	8,783	7,587	6,422	6,483

Source: BNB

	2007	2008	2009	2010	2011	As at March 2012
			(annual growth, end of period, %)			
Broad money	31.2	8.8	4.2	6.4	12.3	10.7
M1	28.9	(4.1)	(8.8)	1.4	14.4	17.2
Quasi-money	33.4	21.1	14.3	9.4	10.9	7.3
CLAIMS ON NON-GOVERNMENT SECTOR	62.5	31.6	3.8	1.3	3.8	3.5
Non-financial corporations	70.2	31.4	2.2	2.5	6.2	6.3
Financial corporations	33.3	44.2	16.8	7.6	5.5	1.6
Households and NPISHs	52.4	31.3	5.8	(0.8)	(0.4)	(1.0)
NET FOREIGN ASSETS OF OTHER MFIs						
Foreign assets	(4.7)	(2.9)	4.8	(0.5)	13.8	17.9
Foreign liabilities	82.9	53.0	(7.1)	(13.6)	(15.4)	(9.6)

Source: BNB

	2007	2008	2009	2010	2011	As at March 2012*
			(% of GDP)			
Broad money	69.9	66.1	69.8	72.0	75.7	73.9
M1	34.4	28.7	26.5	26.1	27.9	27.4
Quasi-money	35.4	37.3	43.2	45.8	47.6	46.3
CLAIMS ON NON-GOVERNMENT SECTOR	62.8	71.7	75.5	74.1	72.1	69.6
Non-financial corporations	38.8	44.2	45.8	45.5	45.3	43.8
Financial corporations	1.1	1.4	1.6	1.7	1.7	1.7
Households and NPISHs	22.9	26.1	28.0	26.9	25.1	24.1
NET FOREIGN ASSETS OF OTHER MFIs	(7.0)	(15.7)	(13.4)	(9.7)	(4.6)	(3.3)
Foreign assets	13.1	11.0	11.7	11.3	12.1	13.0
Foreign liabilities	20.1	26.7	25.1	21.0	16.7	16.3

Note: *Data as a percentage of the projected 2012 GDP.

Source: BNB

The following table sets out annual average interest rates for the period 2007 to 2011 and the average interest rates for March 2012:

	2007	2008	2009	2010	2011	March 2012
			(period average, %)			
LEONIA	4.0	5.2	2.0	0.2	0.2	0.2
SOFIBOR 1M	4.6	6.7	4.5	2.4	2.1	1.2
SOFIBOR 3M	4.9	7.1	5.7	4.1	3.8	2.9
Nominal interest rate on time deposits*	3.8	5.0	6.0	4.9	4.4	4.1
Nominal lending interest rate (NFC)**	8.3	8.9	8.8	8.5	8.8	8.2
Long-term interest rate***	4.5	5.4	7.2	6.0	5.4	5.1

Notes:

* Nominal interest rate of new business on time deposits, weighted average across non-financial corporations and households sectors, currencies and maturities.

** Nominal interest rate of new business on loans to non-financial corporations, weighted average across currencies and maturities.

*** Long-term Interest Rate for Convergence Assessment Purposes

Source: BNB

As a result of the BNB macroprudential approach and all the measures taken during this period by the BNB, the overall systemic risk has been maintained at a manageable level. Consequently, banks followed prudent credit standards and improved their risk management practices. They maintained a high liquidity position and built significant capital buffers, while also delivering high return on their equity.

The following table sets out banking system indicators for the period 2007 to 2011 as at 31 December, and as at 31 March 2012.

	2007	2008	2009	2010	2011	As at March 2012
			(end of period, %)			
Return on assets (ROA)	2.4	2.1	1.1	0.8	0.6	0.9
Return on equity (ROE)	23.9	20.3	9.0	6.6	4.9	7.0
Capital adequacy	13.9	14.9	17.0	17.4	17.6	17.5
Tier I	10.8	11.2	14.0	15.2	15.7	15.8
NPL (more than 90 days overdue)	2.1	2.5	6.4	11.9	15.0	16.2
Net NPL (more than 90 days overdue)	0.2	1.0	3.9	8.0	9.6	10.7
Liquidity	28.0	21.7	21.9	24.4	25.5	25.8
Credit growth (private sector)	66.7	32.2	4.5	2.7	4.1	3.7
Loans/ Total Deposits	97.0	119.3	120.5	113.9	104.8	103.1
Loans/ Residents Deposits	102.4	124.2	125.5	118.8	109.8	108.0
Primary capital leverage (units of assets in proportion of one unit of Tier I capital)	13.1	11.7	9.2	9.6	9.3	9.4
Leverage (units of assets in proportion of one unit of balance sheet capital)	9.5	8.8	7.5	7.4	7.4	7.4

Source: Bulgarian National Bank

The global economic crisis beginning in 2008 brought about a change in the business model followed by the banks in Bulgaria. With the outbreak of the global crisis the uncertainty about the future mounted and resource availability declined worldwide, with banks in Bulgaria adopting increasingly cautious lending practices and turning to financing from local sources. As the competition for local resources intensified, the behaviour of interest rates on deposits in Bulgaria was decoupled from that of the euro area and domestic deposit rates increased. Rising funding costs and tightened credit conditions were reflected in the upward trend in the loan interest rates in 2008-2009. Driven by the high global liquidity and low international interest rates and the importance of domestic factors like the high domestic savings rate, profitability, and improved liquidity and capital adequacy ratios, the average interest rates on loans started to decline in 2010-2011.

In the medium term, based on the high savings rate of households and hence, the respective steady increase of local deposits, the banks are expected to finance their domestic credit activities and to continue the orderly adjustment of their net foreign liabilities. The BNB expects a moderate credit growth, allocated mainly to the corporate sector. The BNB's forecast envisages a continuation of the moderate downward path of the interest rates on loans in the medium term.

Due to the BNB's macroprudential policy approach and conservative supervision the banking system has weathered the global financial and economic crises as well as the domestic recession in 2009 quite well to date. Unlike the experience in some other countries, no bank in Bulgaria required direct state assistance, and no taxpayer funds were spent in support of the financial industry. The sound banking system is one of the main contributors to the overall macroeconomic stability in the country. The banking system continues to be highly liquid (with a liquidity ratio of 25.8 per cent. as of March 2012), well capitalised (with overall capital adequacy ratio (CAR) of 17.5 per cent. and Tier I CAR of 15.8 per cent.) and profitable (with return on equity of 7 per cent.).

Deposit Insurance

The Law on Bank Deposit Guarantee, which was enacted in 1998 established Deposit Insurance Fund in Bulgaria and as of 31 December 2010, the Fund guarantees the full payment of funds held on depositor's accounts with a bank regardless of the number and size of the deposits up to EUR 100,000.

Money Laundering and Terrorist Financing Regulations

The money laundering and terrorist financing prevention framework of Bulgaria is based on Law on the Measures against Money Laundering and the Law on Measures against Financing of Terrorism, which is fully compliant with EC 2005/60 Directive. The preventive measures against money laundering, terrorist financing, and financial fraud are of key importance for the financial sector. The BNB makes sure that banks and financial institutions have adequate and effective policies and procedures, including stringent 'know your customer' rules which prevent banks and financial institutions from being used intentionally or unintentionally for criminal activities. The current money laundering and terrorist financing prevention framework facilitates cross-border co-operation between Bulgaria and the other members of the EU. In addition to the Law on Measures against Money Laundering, the Governing Council has issued various related letters on money laundering and terrorist financing prevention guidelines.

The Payment System

Organising, supporting, and developing national payment systems by implementing and overseeing efficient payment mechanisms is a duty of the BNB under the LBNB. The BNB's major goals were to curb systemic risk and facilitate Bulgarian integration into the euro area payment infrastructure.

Bulgaria's Lev settlement payment systems are:

- RINGS, a real-time gross settlement system operated by the BNB; and
- Ancillary systems settling RINGS transactions:
    - BISERA, a system for servicing customer transfers to be settled at a designated time, run by BORICA–Bankservice AD;
    - BORICA, a system for servicing payments initiated by bank cards in Bulgaria, run by BORICA–Bankservice AD; and
    - SEP, a mobile telephone electronic payment system, run by SEP Bulgaria AD.

Bulgaria's euro settlement payment systems are:

- The TARGET2 national system component, TARGET2-BNB, run by the BNB;
- An ancillary system settling transactions in TARGET2-BNB; and
- BISERA7-EURO, a system for servicing customer transfers to be settled at a designated time, run by BORICA–Bankservice AD.

Securities settlement systems in Bulgaria are:

- The book-entry government securities settlement system, run by the BNB; and

- The system for registering and servicing book-entry securities transactions, run by the Central Depository.

In 2011, RINGS processed over 86 per cent. of Bulgarian payments. All banks participate in RINGS. Processing most payments by value through this system cuts payment system risks, a major BNB payment system goal.

On 1 February 2010, the Bulgarian banking community joined the Trans-European Automated Real-time Gross Settlement Express Transfer system ("**TARGET2**"). The BISERA7-EUR ancillary system for designated time servicing of customer transfers in euro was launched the same day. This great step to Bulgarian integration into European financial market and payment infrastructures was made possible by the success of the TARGET2 accession project.

As a central bank, the BNB operates a National Service Bureau for the TARGET2-BNB national system component and is responsible for the business relations of participants in the component and for coordination with the ECB.

TARGET2 membership facilitates convergence with the European payment systems and payment market in line with BNB policy on reducing system risk and integrating Bulgaria into the euro area payment infrastructure. Participation in TARGET2 provides mechanisms for business processes' stability and continuation. Bulgarian banks in the TARGET2 national system component can opt for real-time euro settlement, improving security and cutting settlement times within the European Economic Area. Participation offers effective settlement and liquidity management. TARGET2 makes retail payment systems more competitive and broadens their scope through services in euro in line with the needs of banks and their customers.

Bulgarian banks and payment systems may participate on equal price terms in a modern payment system with up-to-date infrastructure, functionality and organisation, and exceptional security and efficiency. Through access to European payment mechanisms, TARGET2 accession on 1 February 2010 sets the direction of future Bulgarian payment systems development.

To ensure banks' availability in EUR-payments to and from banks of other countries that joined the Single Euro Payments Area ("**SEPA**") as of 13 December 2010, a bilateral interconnection was established between BISERA-EUR7 system and SEPA-Clearer operated by Deutsche Bundesbank.

The link between BISERA-EUR7 and SEPA-Clearer allows to reciprocally exchange SEPA credit transfers between bank communities in Bulgaria and Germany in a reliable, fast and effective manner. The implementation of the connection between the two systems is based on the technical Interoperability framework established by the European Automated Clearing House Association, EACHA.

The bilateral interoperability arrangement ensures banks participating in BISERA7-EUR availability to and from banks participating in SEPA-Clearer, with no need for using any other transfer execution methods. The transactions exchanged between the two clearing and settlement mechanisms are routed via SWIFT, whilst the settlement is effected in TARGET2.

On 12 December 2011, a SEPA interconnection was established with Equens SE, which increased the number of participants accessed via the system.

Limiting system risk and improving Bulgarian payment systems' reliability and efficiency were the major goals of payment systems supervisors. They monitored observance of Bank for International Settlements, the International Organisation of Securities Commissions, European Central Bank, and ESCB standards and recommendations.

Non Bank Financial Institutions

The non-banking financial sector in Bulgaria stabilised in 2011 and its performance is improving, representing 24.8 per cent. of GDP at the end of the year. Given the fact that the global financial crisis and the resultant depressed economic activity had a negative impact at different times and to different degrees on the individual segments of the non-banking financial market in Bulgaria, their recovery was not uniform.

Bulgarian Financial Supervision Commission

The FSC is a specialised body for regulation and integrated supervision over different segments of the non-banking financial sector – capital markets, insurance markets, supplementary pension insurance market and the market of voluntary health insurance. The main objectives of the FSC are to provide for the integrity, transparency and credibility of the financial markets and the protection of the interests of investors, insurance policy holders and pension scheme members.

When performing its functions and exercising its powers, the FSC lays down clear priorities and guidelines for market development in compliance with internationally recognised principles and standards for regulation and supervision. The institution follows a consistent policy aimed at the establishment of optimal conditions for the realisation of the economic potential of the non-banking financial intermediation. The consumer protection and enhancement of the public confidence in the use of financial products and services is one of the strategic objectives of the FSC.

Similar to the BNB, the FSC enjoys organisational and functional independence from other State bodies and therefore, such bodies may not instruct the FSC as to the conduct of its activities and the exercise of its powers. The Chairperson and the other four members of the FSC are elected by the National Assembly and may not be removed prior to the end of their term unless in accordance with the grounds set out in the Law on the FSC.

The FSC is the authority which issues licenses which are a prerequisite for carrying out certain types of activities, explicitly provided in the laws regulating the activities of the participants in the financial markets. As a competent authority in relation to the non-banking financial sector, the FSC has all necessary tools and powers to enforce the legislation.

As a result of the global financial crisis, the European System of Financial Supervision (ESFS), the EU supervisory framework for the banking, securities and insurance and occupational pensions sectors, came into operation as of 1 January 2011. This system functions on the basis of a single set of harmonised rules, obligatory for the supervisory authorities of all EU Member States. The FSC is also an important part of this system, as it is responsible for the supervision of the capital markets and insurance and supplementary social security sectors.

Capital Markets

The capital markets were directly affected in 2008 by the global financial markets and have recovered more slowly in subsequent years. However, the Bulgarian stock market capitalisation entered positive territory in 2011, increasing by 15.6 per cent. on an annual basis.

Insurance Market

The insurance market in Bulgaria in 2009 recorded a decrease of 6.3 per cent. of the gross premium income reflecting negative second-round effects of the global financial and economic crisis and depressed economic activity at home. In spite of this, the funds of insurance companies reduced by intangible assets were maintained high above the solvency margin throughout the economic crisis.

The individual segments in the insurance sector are at different stages of the development. General (non-life) insurance (comprising 18 entities), which represents the largest share (80 per cent.) on the insurance market in Bulgaria, is experiencing diminishing negative growth rates reaching 0.9 per cent. year-on-year at the end of 2011 with a positive outlook.

Life insurance (comprising 14 entities) has stabilised in the last two years, providing an alternative for long-term savings investment. The gross premium income of this segment increased by 1.2 per cent. year-on-year in 2011. Voluntary health insurance companies, which are the newest entities on the insurance market (comprising 19 companies), after three years of high growth rates, have slightly decreased by 4.0 per cent. in 2011 given the low absolute value of their premiums. The overall recovery of the insurance sector is expected to take place together with the recovery of domestic demand.

Pension Funds

The supplementary pension insurance system in Bulgaria constitutes the second and the third pillar of the national pension insurance system and is of the defined contribution type. It will continue to be in a phase of accumulation of resources in the medium term, which makes the Supplementary Pension Insurance Funds (‘‘**SPIFs**’’), managed by the Pension Insurance Companies (‘‘**PICs**’’) important institutional investors.

As a direct result of the global financial crisis the assets of the PICs decreased by 9 per cent. in 2008 and the net assets of SPIFs decreased by 0.8 per cent. respectively, after which they have exhibited an increasing trend. In 2011, the assets of PICs increased by 10 per cent. year-on-year and the net assets of SPIFs increased by 15.3 per cent. As a result of these developments, the role of the non-banking financial sector in the financial intermediation sector in Bulgaria has stabilised at a share of approximately 14 per cent. in the structure of institutional investors for the last three years reaching 14.6 per cent. in 2011.

The assets of the 10 existing PICs continued to grow in 2011, reflecting the increase in the number of insured people. The net assets of the 29 existing SPIFs are also increasing due to increased contributions and the result of their investment decisions.

The world economic crisis resulted in a negative rate of return of the SPIFs in 2008, which was compensated for in the subsequent two years. The modified weighted rate of return on a biannual basis for SPIFs is as follows:

	31 Dec 2008 – 31 Dec 2010	**31 Dec 2009 – 31 Dec 2011**
SPIFs		
Universal Pension Funds – Second Pillar (%)	(3.63)	2.18
Professional Pension Funds – Second Pillar (%)	(4.77)	2.75
Voluntary Pension Funds – Third Pillar (%)	(6.56)	2.79

Source: FSC

The development of net assets of the SPIFs, reaching 6.1 per cent. of GDP in 2011, will depend on the stabilisation of income perspectives in the medium term and investment alternatives on the financial markets.

Investment intermediaries

The observed improvement of the market capitalisation of the Bulgarian Stock Exchange in 2011 is also reflected in the positive assets development of the investment intermediaries which increased by 21.0 per cent. on an annual basis. There are 77 Bulgarian investment intermediaries, 26 of which are banks.

Collective investment schemes ("UCITS")

33 management companies ("**MCs**") manage 101 collective investment schemes ("**CISs**"), of which eight are investment companies and 93 contractual funds. The assets of CISs have been growing in the difficult recovering years of 2009 and 2010, slightly relaxing their performance in 2011.

Special Purpose Investment Companies ("**SPICs**") are companies investing in real estate (similar to REITS) or securitising in receivables. There are 72 SPICs supervised by the FSC, eight of which are securitising in receivables. Among the remaining 64 SPICs securitising in real estates, eight have specialised in agricultural land. In 2009 and 2010, assets of SPICs showed a moderate decrease of approximately 3 per cent. annually, reflecting the decline of real estate prices. Assets of SPICs increased by 12.4 per cent. in 2011 due to the balanced portfolio of securitised products.

The following table sets out the non-banking financial sector in Bulgaria in the period 2008 to 2011 as at 31 December:

	2008	2009	2010	2011
		(% of GDP)		
Capital market capitalisation	17.9	17.3	15.3	16.5
Insurance and voluntary health insurance premiums*	2.6	2.5	2.4	2.2
Net assets of the Supplementary Pension Insurance Funds (SPIFs)	3.3	4.6	5.7	6.1
Non-banking financial sector (total)	**23.9**	**24.4**	**23.3**	**24.8**
Assets of the non-banking sectors (EUR millions)				
Assets of Investment Intermediaries (IIs)	2,827	2,301	1,969	2,383
Assets of Collective Investment Schemes (CISs)	168	194	245	243
Assets of Special Purpose Investment Companies (SPICs)	829	808	785	882
Insurance and voluntary health insurance premiums*	938	879	851	844
Net assets of the Supplementary Pension Insurance Funds (SPIFs)	1,175	1,614	2,039	2,351
Rate of change (%)				
Assets of Investment Intermediaries (IIs)	(28.4)	(18.6)	(14.4)	21.0
Assets of Collective Investment Schemes (CISs)	(64.0)	15.6	26.3	(1.0)
Assets of Special Purpose Investment Companies (SPICs)	18.1	(2.5)	(2.8)	12.4
Insurance and voluntary health insurance premiums*	19.9	(6.3)	(3.2)	(0.9)
Net assets of the Supplementary Pension Insurance Funds (SPIFs)	(0.8)	37.3	26.3	15.3
Relative structure of financial intermediation (shares, %)				
Assets of Investment Intermediaries (IIs)	6.8	5.5	4.5	5.2
Assets of Collective Investment Schemes (CISs)	0.4	0.5	0.6	0.5
Assets of Special Purpose Investment Companies (SPICs)	2.0	1.9	1.8	1.9
Insurance and voluntary health insurance premiums*	2.3	2.1	2.0	1.8
Net assets of the SPIFs	2.8	3.8	4.7	5.1
Non-banking financial sector (total)	**14.3**	**13.8**	**13.5**	**14.6**

Source: Bulgarian FSC
Note: * Data for 2011 is as at 31 December and is preliminary.

Bulgarian Stock Exchange-Sofia ("BSE-Sofia")

In July 1991, the first Bulgarian stock exchange was established with the introduction of the Commercial Law in Bulgaria. At that time no specific legal framework existed and the exchange operated on the grounds of the general regulatory framework applicable to all privately held companies.

In July 1995, the first Securities, Stock Exchanges and Investment Companies Act was adopted. The Bulgarian capital markets operate within the framework of the following main legal provisions: Public Offering of Securities Act of December 1999, Markets in Financial Instruments Act of June 2007, Act on the Activities of Collective Investment Schemes and other Undertakings for Collective Investment of October 2011, Commerce Act of June 1991, Measures Against Market Abuse With Financial Instruments Act of October 2006, Special Investment Purpose Companies Act of May 2003, Privatisation and Post-privatisation Control Act of March 2002, Financial Supervision Commission Act of January 2003 and Ordinances of the Financial Supervision Commission. The current regulatory framework is harmonised with EU regulations in the financial markets area. Access to the market is on a non-discriminatory basis and foreign investors may trade on the BSE-Sofia under the same terms as all domestic investors.

Between 2004 and 2007, the BSE-Sofia was growing dynamically in terms of both liquidity and market performance and quickly turned into a venue of choice for capital raising purposes. However, the indices and the overall liquidity of the exchange sharply declined as a result of the financial and economic crisis. In order to revive the market, the Government announced an ambitious privatisation program for the state's share in strategic companies through the stock exchange. As a result of this, in December 2011 the Government successfully sold its minority stake in one of the leading energy distributors in the country.

On 15 December 2010, BSE-Sofia went public and its shares were admitted to trading on the BSE-Sofia from 6 January 2011. Currently, the Bulgarian Ministry of Finance holds a majority stake of

50.05 per cent. in the BSE-Sofia's capital, with the remaining shares being held by brokerage firms and banks, other legal and natural persons and institutional investors. As a result of a strategic decision of the Government in the first half of March 2012, the Ministry of Finance empowered the Privatisation Agency to initiate the privatisation procedure of its stake both in the exchange and in the Central Securities Depository where it also holds a controlling share. Both stakes are to be privatised in 2012 and the potential candidates must meet certain requirements in order to be able to guarantee long term market and business development.

Since 16 June 2008, BSE-Sofia uses the Xetra trading platform of Deutsche Boerse. On-exchange trading is carried out on a continuous trading basis with opening and closing auctions. Since 1 March 2012, BSE-Sofia operates the Main Market BSE and the Alternative Market BSE. The following financial instruments are traded on BSE-Sofia: stocks (common and preferred), corporate and municipal bonds, UCITS, compensatory instruments, subscription rights and warrants. The number of issues admitted to trading on BSE-Sofia amounted to 507 at the end of 2011 which constituted a decrease of 21 issues as compared to the end of 2010.

SOFIX, BSE-Sofia's main index, was launched on 20 October 2000. The index lost 11.18 per cent. in 2011. The overall market capitalisation of BSE-Sofia stood at EUR 6.358 billion. at the end of December 2011, with an increase by 15.6 per cent. year-on-year and a decline by 0.58 per cent. in the first quarter of 2012 (market capitalisation as at the first quarter of 2012- EUR 6.321 billion). The total turnover increased by 5 per cent. in 2011 reaching EUR 367 million. In addition, BSE-Sofia maintains three other indices, one of which, BG REIT, is a sector index tracking the performance of seven listed REITs.

Since September 2011, BSE-Sofia has been acting as a calculation agent of the National Corporate Governance Commission, with respect to the first Bulgarian index, tracking 7 selected companies that implemented the best corporate governance practices in their business operations. As of 31 December 2011, 69 stock exchange members (47 investment firms and 22 banks) were admitted to trading.

The settlement cycle is T+2 and settlement is conducted on a mandatory delivery-versus-payment basis for all on-exchange trades via the computerised book-entry system of Bulgaria's Central Securities Depository. The depository recently started an ambitious technological and regulatory overhaul. The primary purpose of this to turn the institution into a fully functional clearing and settlement organisation that effectively supports the entire financial market.

BALANCE OF PAYMENTS AND FOREIGN TRADE

The following table sets out Bulgaria's balance of payments in millions of EUR in the period 2007 to 2011 as at 31 December:

	2007	2008	2009	2010	2011
			(EUR millions)		
Balance of Payments Data					
Current account	**(7,755.2)**	**(8,182.5)**	**(3,116.2)**	**(375.8)**	**361.4**
Goods, credit (f.o.b.)	13,511.9	15,204.0	11,699.2	15,561.2	20,226.7
Goods, debit (f.o.b.)	(20,757.2)	(23,801.7)	(15,873.1)	(18,324.8)	(22,201.3)
Trade Balance	(7,245.3)	(8,597.7)	(4,173.9)	(2,763.7)	(1,974.6)
Services, credit	4,760.0	5,355.4	4,916.3	5,163.7	5,408.2
Transportation	1,105.6	1,210.6	1,007.6	986.5	1,094.5
Travel	2,593.8	2,873.8	2,681.2	2,747.1	2,852.4
Other services	1,060.6	1,271.0	1,227.5	1,430.1	1,461.3
Services, debit	(3,586.5)	(4,045.7)	(3,616.5)	(3,147.0)	(3,121.0)
Transportation	(849.0)	(987.2)	(801.5)	(699.0)	(910.2)
Travel	(1,303.0)	(1,566.6)	(1,258.7)	(931.2)	(958.7)
Other services	(1,434.4)	(1,491.9)	(1,556.2)	(1,516.8)	(1,252.1)
Services, net	1,173.5	1,309.6	1,299.9	2,016.7	2,287.2
Goods and services, net	(6,071.8)	(7,288.1)	(2,874.0)	(746.9)	312.6
Income, credit	828.1	985.7	804.3	615.4	644.1
Compensation of employees	551.3	604.2	425.7	290.1	291.8
Investment income	276.9	381.5	378.6	325.3	352.2
Direct investment	1.3	40.8	4.8	14.4	17.4
Portfolio investment	109.8	194.2	294.4	255.6	256.8
Other investment	165.7	146.5	79.4	55.3	78.0
Income, debit	(3,192.4)	(2,741.3)	(2,002.5)	(1,749.8)	(2,288.1)
Compensation of employees	(47.9)	(88.2)	(63.8)	(11.6)	(12.4)
Investment income	(3,144.4)	(2,653.1)	(1,938.7)	(1,738.1)	(2,275.6)
Direct investment	(2,559.6)	(1,848.9)	(1,311.8)	(1,205.8)	(1,687.0)
Portfolio investment	(125.8)	(95.8)	(73.4)	(80.6)	(76.5)
Other investment	(459.0)	(708.4)	(553.6)	(451.7)	(512.1)
Income, net	(2,364.3)	(1,755.7)	(1,198.3)	(1,134.3)	(1,644.0)
Current transfers, net	680.8	861.3	956.1	1,505.5	1,692.8
Current transfers, credit	1,254.6	1,614.9	1,562.7	2,056.2	2,246.1
Current transfers, debit	(573.8)	(753.6)	(606.6)	(550.7)	(553.3)
Capital account	**(587.3)**	**277.4**	**477.1**	**290.9**	**493.9**
Capital transfers, net	(587.3)	277.4	478.7	256.3	461.5
Financial account	**13,676.4**	**11,463.3**	**1,163.4**	**(698.5)**	**(1,194.3)**
Direct investment	8,838.2	6,205.7	2,505.3	1,035.4	1,204.8
Abroad	(206.2)	(522.1)	68.3)	(173.1)	(136.5)
In Bulgaria	9,051.8	6,727.8	2,436.9	1,208.5	1,341.2
Mergers and acquisitions	(7.4)	0.0	0.0	0.0	0.0
Portfolio investment	(518.4)	(730.9)	(619.1)	(661.2)	(357.2)
Assets	(129.3)	(252.9)	(623.5)	(574.9)	(43.9)
Liabilities	(389.1)	(478.0)	4.4	(86.3)	(313.4)
Financial derivatives	(61.2)	(43.5)	(18.3)	(24.7)	(65.3)
Other investment	5,417.7	6,032.0	(704.5)	(1,048.0)	(1,976.5)
Assets	552.2	104.9	(632.3)	(35.3)	(790.8)
Liabilities	4,865.5	5,927.1	(72.2)	(1,012.6)	(1,185.7)
Net errors and omissions	**(2,170.1)**	**(2,884.1)**	**825.9**	**399.5**	**497.6**
OVERALL BALANCE	**3,163.7**	**674.2**	**(649.8)**	**(383.9)**	**158.7**
Reserves and related items	(3,163.7)	(674.2)	649.8	383.9	(158.7)
Official reserve assets	(2,908.4)	(674.2)	649.8	383.9	(158.7)
Use of fund credits and loans, net	(255.3)	0.0	0.0	0.0	0.0
Exceptional financing transactions	0.0	0.0	0.0	0.0	0.0

Source: Bulgarian National Bank

The following table sets out the balance of payments of Bulgaria as a percentage of GDP for the period 2007 to 2011 as at 31 December:

	2007	2008	2009	2010	2011
			(% of GDP)		
Balance of Payments Data					
Current account	**(25.2)**	**(23.1)**	**(8.9)**	**(1.0)**	**0.9**
Trade Balance	(23.5)	(24.3)	(11.9)	(7.7)	(5.1)
Services, net	3.8	3.7	3.7	5.6	5.9
Income, net	(7.7)	(5.0)	(3.4)	(3.1)	(4.3)
Current transfers, net	2.2	2.4	2.7	4.2	4.4
Capital account	**(1.9)**	**0.8**	**1.4**	**0.8**	**1.3**
Financial account	**44.4**	**32.4**	**3.3**	**(1.9)**	**(3.1)**
Direct investment	28.7	17.5	7.2	2.9	3.1
Portfolio investment	(1.7)	(2.1)	(1.8)	(1.8)	(0.9)
Financial derivatives	(0.2)	(0.1)	(0.1)	(0.1)	(0.2)
Other investment	17.6	17.0	(2.0)	(2.9)	(5.1)
Net errors and omissions	**(7.1)**	**(8.1)**	**2.4**	**1.1**	**1.3**
OVERALL BALANCE	**10.3**	**1.9**	**(1.9)**	**(1.1)**	**0.4**

Source: Ministry of Finance calculations based on BNB and NSI data.

Current Account

In 2007 and 2008, Bulgaria's current account balance was driven by a rapidly expanding trade deficit. Foreign trade dynamics were largely shaped by a boost in investment activity, strong local consumption fostered by real income growth, global price changes and increased bank lending. In addition, Bulgaria's full membership in the EU led to the removal of trade barriers and market expansion. Merchandise exports and imports increased in 2007 and 2008 before falling significantly in 2009. Exports started to recover early in 2010 and growth continued further in 2011. The increase in exports was underpinned by a gradual recovery in the economies of Bulgaria's major trading partners. Furthermore, the growth rates of exports in 2010 and 2011 were above the EU average and this illustrates Bulgaria's increasingly competitive position. The share of Bulgarian exports in intra-EU imports and world imports continued to increase during the crisis as well. At the same time the growth rate of exports outstripped that of imports. The rebound in imports started in March 2010, but due to persistent subdued domestic demand, imports are mainly driven by demand for raw materials for the export-oriented manufacturers. As a result of this dynamic, after expanding in 2007-2008, the trade deficit narrowed in each of 2009, 2010 and 2011. As a percentage of nominal GDP, Bulgaria's trade deficit was 23.5 per cent. in 2007, 24.3 per cent. in 2008, 11.9 per cent. in 2009, 7.7 per cent. in 2010 and 5.1 per cent. in 2011.

The services sector balance has been positive in all periods since 2007 and increased in nominal terms in each year except for 2009. In 2009, both exports and imports of Bulgaria's services contracted, but the sector weathered the crisis. Revenues from tourism accounted for over 50 per cent. of the revenue total from services, making the strongest contribution to the positive balance in the period surveyed. After a drop in 2009, the number of holiday makers visiting Bulgaria increased, bringing in an annual year-on-year increase in receipts. With the acceleration in external trade in 2010 and in the first half of 2011, revenues from the export of transportation services also increased significantly. In 2011, the surplus of computer and IT services doubled, confirming the positive performance of this sector in recent years and the minimal impact of the crisis on it.

The income balance was negative in the 2007-2011 period. The deficit was due to repayment of investment income mostly related to the FDI inflows in the country. The positive contribution of net transfers to the current account balance improved from 2007. At the beginning of the period, budget transfers to other countries increased significantly, with approximately 60 per cent. accounting for Bulgaria's regular contribution to the EU budget. As Bulgaria improved its EU funds transfer management, EU transfers showed a steady annual increase in 2010 and 2011.

Positive trade dynamics, improving services and net transfer balances resulted in a sharp adjustment in Bulgaria's current account in the last couple of years. The deficit shrank from 25.2 per cent. of GDP in 2007 to 1 per cent. in 2010 and turned into a surplus in 2011. The balance will remain dependent on trade dynamics. With the recovery of domestic demand, an increase in imports as well as a slight deterioration of the trade balance are expected. The Ministry of Finance expects the current account surplus to decline in the medium term and in 2014 to 2015 the balance will be slightly negative.

Imports and Exports of Goods by Region

The following table sets out the shares of exports and imports of goods by region for the period 2007 to 2011 as at 31 December:

	Exports (%)				
	2007	**2008**	**2009**	**2010**	**2011**
EU	**60.83**	**59.88**	**64.85**	**60.81**	**62.47**
of which:					
Germany	10.28	9.10	11.29	10.66	11.9
Romania	4.89	7.25	8.63	9.11	9.6
Italy	10.30	8.37	9.34	9.71	8.5
Greece	9.10	9.92	9.55	7.95	7.0
France	3.99	4.14	4.48	4.04	4.2
Belgium	6.18	5.90	5.67	3.77	5.1
EU-15	49.21	46.42	50.62	45.67	47.0
EU-new Member States	11.62	13.46	14.22	15.14	15.44
Balkan countries	**19.74**	**17.44**	**14.39**	**15.57**	**14.25**
Turkey	11.43	8.80	7.24	8.46	8.52
Serbia	4.66	4.65	3.55	3.77	2.58
Other European countries	**5.28**	**5.91**	**5.42**	**7.60**	**8.33**
Russia	2.42	2.71	2.50	2.84	2.60
Asia	**7.91**	**9.54**	**7.78**	**8.62**	**7.60**
China	0.55	0.72	0.82	1.20	1.44
America	**4.02**	**2.83**	**2.27**	**2.09**	**2.30**
USA	2.33	1.56	1.56	1.36	1.30
Other countries	**2.22**	**4.41**	**5.29**	**5.31**	**5.05**

	Imports (%)				
	2007	**2008**	**2009**	**2010**	**2011**
EU	**51.9**	**50.7**	**53.3**	**51.1**	**48.4**
of which:					
Germany	11.5	11.0	11.1	10.4	9.7
Italy	8.6	7.9	7.9	7.6	7.2
Romania	3.9	4.7	4.7	5.9	5.8
Greece	5.1	4.7	5.5	5.4	5.0
France	3.8	3.6	3.9	3.4	3.3
Poland	2.1	2.3	2.3	2.3	2.0
EU-15(1)	40.6	38.3	40.0	37.6	35.4
EU-new Member States(2)	11.2	12.4	13.3	13.5	13.0
Other European countries	**20.5**	**22.3**	**19.0**	**20.8**	**20.9**
Russia	17.1	17.7	15.5	17.1	16.6
Asia	**11.2**	**12.9**	**13.1**	**13.4**	**15.7**
China	5.2	5.3	5.4	5.4	6.0
Balkan countries	**9.4**	**7.8**	**7.8**	**8.3**	**7.1**
Turkey	6.9	5.6	5.5	5.5	4.6
Americas	**6.1**	**5.3**	**5.8**	**5.4**	**7.0**
USA	1.7	2.0	1.9	1.5	1.6
Other countries	**0.9**	**1.0**	**1.0**	**1.0**	**1.0**

Note:

(1) EU new Member States include CY, CZ, EE, HU, LV, LT, MT, PL, RO, SK, SI.

(2) EU 15 include AT, BE, DK, FI, FR, DE, EL, IE, IT, LU, NL, PT, ES, SE, UK.

Source: Ministry of Finance calculations based on BNB data

Trade balance by region

EU Member States are Bulgaria's main trading partners. Exports to the EU accounted for 62.5 per cent. of total exports in 2011 as compared to 60.8 per cent. in 2007 and 64.9 per cent. in the crisis in 2009. A tendency of diversification in EU-trade is evident, as the role of the new Member States (especially Romania) has recently increased. Among non-EU countries, most trade relations are with countries from the Balkan region, although their relative share in the total exports is decreasing. EU imports into the country represented 48.4 per cent. of total imports in 2011 as compared to 51.9 per cent. in 2007. The relative shares of imports from Turkey, Germany and Italy decreased, whereas the relative weight of imports from Asia and EU new Member States in total imports increased.

Composition of trade

The following table sets out the composition of trade for the period 2007 to 2011 as at 31 December:

	Imports				
	2007	**2008**	**2009**	**2010**	**2011**
Consumer goods (%)	**16.40**	**17.26**	**20.71**	**19.98**	**18.10**
Food, drinks and tobacco (%)	3.58	4.31	6.58	6.11	5.91
Furniture and household appliances (%)	3.95	3.86	4.21	3.50	2.74
Medicines and cosmetics (%)	2.85	2.92	4.36	4.16	3.91
Clothing and footwear (%)	1.29	1.38	1.69	2.41	1.98
Automobiles (%)	2.22	2.19	1.01	0.95	1.02
Others (%)	2.51	2.59	2.85	2.86	2.55
Raw materials (%)	**36.16**	**33.53**	**34.20**	**35.68**	**37.42**
Ores (%)	5.12	3.60	4.28	5.19	6.30
Iron and steel (%)	4.90	5.31	2.98	3.30	4.11
Other metals (%)	2.37	2.50	1.80	2.69	2.91
Textiles (%)	6.35	4.78	5.53	4.82	4.66
Wood products, paper and paperboard (%)	2.07	1.96	2.07	1.95	1.81
Chemicals (%)	1.59	1.50	1.74	2.09	1.98
Plastics and rubber (%)	4.60	4.43	4.71	5.05	4.79
Raw materials for the food industry (%)	1.63	1.89	2.39	2.48	2.45
Raw skins (%)	0.48	0.32	0.40	0.41	0.41
Raw tobacco (%)	0.18	0.30	0.51	0.51	0.44
Others (%)	6.86	6.93	7.79	7.19	7.56
Investment goods (%)	**27.76**	**27.38**	**24.93**	**21.83**	**21.25**
Machines and equipment (%)	9.70	9.47	8.92	7.01	6.72
Electrical machines (%)	3.73	3.49	4.26	4.01	3.33
Vehicles (%)	6.68	6.62	3.31	2.98	3.63
Spare parts and equipment (%)	3.28	3.22	3.27	3.88	4.60
Others (%)	4.37	4.58	5.17	3.94	2.97
Mineral fuels, oils and electricity (%)	**19.68**	**21.75**	**19.94**	**22.21**	**22.98**
Fuels (%)	17.17	19.08	16.92	17.72	17.91
Crude oil and Natural gas (%)	15.26	17.13	15.34	16.20	16.41
Coal (%)	1.46	1.76	1.40	1.29	1.30
Others (%)	0.45	0.19	0.18	0.24	0.20
Others (%)	2.52	2.67	3.02	4.49	5.07
Oils (%)	2.52	2.67	3.02	4.49	5.07
Electricity (%)	0.00	0.00	0.00	0.00	0.00
Other Imports (%)	**0.00**	**0.08**	**0.23**	**0.30**	**0.24**
TOTAL IMPORTS/CIF (EUR millions)	**21,861**	**25,094**	**16,875**	**19,245**	**23,346**

Source: MoF calculations based on BNB data.

	Exports				
	2007	2008	2009	2010	2011
Consumer goods (%)	**24.05**	**22.48**	**28.12**	**25.39**	**22.16**
Food (%)	3.81	4.06	5.73	5.4	4.4
Tobacco (%)	0.24	0.25	0.57	0.8	0.8
Beverages (%)	0.82	0.69	0.62	0.5	0.4
Clothing and footwear (%)	11.27	9.10	10.12	8.7	7.5
Medicines and cosmetics (%)	2.14	2.17	3.33	3.4	3.1
Furniture and household appliances (%)	3.47	3.74	4.79	3.7	3.2
Others (%)	2.31	2.46	2.96	2.9	2.7
Raw materials (%)	**45.18**	**44.50**	**42.68**	**43.85**	**46.53**
Iron and steel (%)	7.50	6.18	3.74	4.2	4.4
Other metals (%)	12.15	11.76	10.42	11.5	12.4
Chemicals (%)	2.94	2.72	1.86	1.6	1.6
Plastics and rubber (%)	2.80	2.33	2.43	2.4	2.5
Fertilisers (%)	0.68	1.20	0.37	0.8	1.0
Textiles (%)	3.75	3.11	3.24	2.1	2.0
Raw materials for the food industry (%)	3.00	6.36	7.87	8.4	9.0
Wood products, paper and paperboard (%)	2.21	1.70	1.57	2.1	1.9
Cement (%)	0.12	0.12	0.08	0.1	0.1
Raw tobacco (%)	0.75	1.02	1.77	0.9	0.8
Others (%)	9.28	8.01	9.34	9.7	10.8
Investment goods (%)	**15.99**	**16.55**	**16.23**	**17.14**	**17.44**
Machines and equipment (%)	5.16	5.25	4.63	4.5	4.7
Electrical machines (%)	1.59	1.65	2.34	2.2	2.7
Vehicles (%)	1.27	1.31	1.71	2.0	1.9
Spare parts and equipment (%)	3.78	3.69	3.17	3.7	3.8
Others (%)	4.19	4.64	4.38	4.7	4.3
Mineral fuels, oils and electricity	**14.77**	**16.45**	**12.93**	**13.58**	**13.83**
Petroleum products (%)	12.74	13.03	10.18	10.7	10.8
Others (%)	2.03	3.42	2.76	2.9	3.0
Other Exports (%)	**0.00**	**0.03**	**0.04**	**0.04**	**0.04**
TOTAL EXPORTS/FOB (EUR millions)	**13,511.9**	**15,204**	**11,699.2**	**15,561.2**	**20,226.7**

Source: Ministry of Finance calculations based on BNB data.

Imports in Bulgaria are diversified with raw materials and fuels taking the largest shares. The swift advance of the construction sector and the up and downstream industries in the pre-crisis period increased imports of iron products, non-alloy steel, metal constructions and spare parts. In 2005-2008 imports of high value added goods increased. This was due to the country's integration into the EU common market, which called for the implementation of rigid standards of manufacturing, coupled with sizable investment amounts. In addition, significant FDI inflows into the local economy gave further impetus to the import of investment goods. With the economic crisis and subdued economic activity, the share of investment goods declined. The negative growth of imports of investment goods decelerated gradually in 2010 and increased to 18.1 per cent. in 2011. Recently Bulgaria has made efforts to increase energy independency. See "*The Economy—Energy Market*".

Prior to 2008, base metals (including copper, iron and steel) and their products, mineral fuels and oils were important components of Bulgaria's exports. Among the main contributors to growth were also textiles, clothing and footwear. With Bulgaria's accession to the EU and increased competition, their relative share of total exports declined. Meanwhile the weight of investment goods such as machines (including electric machines, machines for general use, energy production machines, automobiles, bicycles and other vehicles) increased annually, reaching 17.4 per cent. of total exports in 2011 as compared with 14.5 per cent. in 2006.

Foreign Direct Investment

The years before the global economic and financial crisis were marked by high economic growth and an accelerated real convergence of the Bulgarian economy following the country's accession to the EU in 2007. In those conditions, expectations for relatively high returns on investment and high growth accelerated financial inflows, primarily in the form of FDI. As of 2005, FDI in export-oriented sectors such as the processing industries increased considerably, while FDI in real estate and construction peaked dramatically in the run-up prior to the crisis. The decline in FDI flows in those sectors following the 2008 crisis contributed to the substantial drop in real estate prices. Meanwhile the investment in export-oriented sectors like manufacturing, hotel services, transportation and trade remained relatively stable in the crisis. In 2010, FDI inflows in manufacturing were the largest in Bulgaria and were principally aimed at upgrading and expanding existing production units. The low overall FDI level in 2010–2011 reflects lower capital inflows due to investors' risk aversion, on the one hand, and net repayment of intercompany loans as a result of the lower investment demand on the local market, on the other.

The following tables include data for the end of year stock of FDI in Bulgaria, grouped by country of origin of the investment, and annual flows by economic activity:

	Total FDI stock by country of origin				
	2007	**2008**	**2009**	**2010**	**2011**
			(EUR millions)		
EU	**21,895.9**	**26,597.1**	**29,162.9**	**29,960.3**	**31,166.7**
of which:					
The Netherlands	4,591.1	4,692.3	5,772.0	7,327.1	8,068.9
Austria	5,183.0	6,061.5	6,442.5	5,553.4	6,087.2
Greece	2,304.9	2,694.0	3,032.4	2,868.9	2,846.4
UK	2,109.1	2,685.4	2,897.3	2,663.4	2,436.3
Germany	1,281.1	1,859.6	2,007.4	1,988.3	1,878.3
EU-15	18,755.2	22,454.6	24,533.1	25,235.3	26,313.1
EU-new Member States	3,140.7	4,142.5	4,629.8	4,725.0	4,853.6
Russia	**522.0**	**792.4**	**1,005.1**	**1,169.0**	**1,367.0**
USA	**917.9**	**1,459.6**	**923.2**	**931.5**	**897.4**
TOTAL	**25,769.7**	**31,658.2**	**34,170.0**	**35,080.0**	**36,828.9**

	Annual FDI flow by economic activity				
	2007	2008	2009	2010	2011
	(EUR millions)				
TOTAL	**9,051.8**	**6,727.8**	**2,436.9**	**1,208.5**	**1,341.2**
Agriculture, hunting and forestry	71.8	59.6	23.5	1.0	9.5
Construction	815.1	611.6	278.1	88.7	44.4
Education	0.8	0.6	0.3	0.6	0.1
Electricity, gas and water supply	280.1	238.1	307.3	322.3	153.5
Financial intermediation	2,175.1	1,679.9	681.2	236.2	152.2
Fishing	0.0	0.2	1.1	0.1	(0.2)
Health and social work	4.6	2.2	0.8	(10.5)	0.1
Hotels and restaurants	167.6	99.2	57.7	53.5	56.4
Manufacturing	1,057.9	628.4	(219.8)	583.1	(69.5)
Mining and quarrying	61.9	1.7	45.6	34.0	8.9
Not allocated	159.6	194.9	83.1	108.3	175.9
Other community, social and personal service activities	90.5	58.1	(23.0)	(27.0)	46.0
Real estate, renting and business activities	2,597.9	2,094.1	527.6	(75.4)	42.4
Transport, storage and communication	255.8	(269.5)	271.4	57.6	498.4
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	1,313.1	1,328.6	402.1	(164.1)	223.2
Export-oriented	2,928.1	1,848.0	580.5	565.1	726.9
Other	6,123.7	4,879.7	1,856.5	643.3	614.4

Source: BNB.

Gross external debt

The following table sets out the end of year stock of gross external debt ("**GED**") of Bulgaria by institutional sectors for the period 2007 to 2011:

	GED as at 31 December									
	2007		2008		2009		2010		2011	
	EUR mln	*% GDP*	*EUR mln*	*% GDP*	*EUR mln*	*% GDP*	*EUR mln*	*% GDP*	*EUR mln*	*% GDP*
GED	29,016.8	94.3	37,246.5	105.1	37,816.4	108.3	37,051.4	102.8	35,384.7	91.9
General Government Debt(1)	3,099.6	10.1	2,525.3	7.1	2,827.9	8.1	2,873.0	8.0	2,783.0	7.2
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	3,099.6	10.1	2,525.3	7.1	2,827.9	8.1	2,873.0	8.0	2,783.0	7.2
Banks	5,770.8	18.8	9,072.9	25.6	8,378.8	24.0	6,861.8	19.0	5,637.7	14.6
Short-term	4,327.9	14.1	6,783.7	19.1	6,218.4	17.8	5,227.7	14.5	4,060.6	10.6
Long-term	1,442.8	4.7	2,289.2	6.5	2,160.4	6.2	1,634.1	4.5	1,577.1	4.1
Other Sectors Debt(2)	9,394.8	30.5	12,070.1	34.1	12,048.4	34.5	12,402.1	34.4	12,177.1	31.6
Short-term	5,056.1	16.4	6,138.7	17.3	5,910.0	16.9	6,029.8	16.7	5,914.5	15.4
Long-term	4,338.8	14.1	5,931.4	16.7	6,138.4	17.6	6,372.3	17.7	6,262.6	16.3
Direct investment: intercompany lending	10,751.6	34.9	13,578.2	38.3	14,561.3	41.7	14,914.5	41.4	14,786.8	38.4
Memo items:										
Long term debt	19632.8	63.8	24324.1	68.7	25688.0	73.5	25793.9	71.5	25409.6	66.0
Short term debt	9384.0	30.5	12922.4	36.5	12128.5	34.7	11257.5	31.2	9975.1	25.9

Notes:

(1) General Government Debt includes central government debt, local government debt, debt of social security funds and debt of all non-market non-profit institutions that are controlled and mainly financed by government units.

(2) Other Sectors Debt includes debt of private and state-owned non-bank enterprises and debt of households.

Source: BNB

Bulgaria's GED is mostly private debt, as the expansion of the economy prior to the crisis attracted substantial capital inflows in the form of direct investment (intercompany lending) and support from parent banks to local subsidiaries. With the contraction in economic activity in 2009, the need for external financing decreased. The moderate recovery that followed was accompanied by restricted domestic spending and growth in domestic bank deposits. As a result, the liquidity position of the banking sector improved and banks reduced their external indebtedness through repayment of short-term loans.

The total external debt of the sector shrank from 25.6 per cent. of GDP at the end of 2008 to 14.6 per cent. of GDP at the end of 2011, which was 2.3 per cent. below the 2007 level. Intercompany lending and Other Sectors Debt contributed to the decline in GED as well, with the external debt stock of the companies also edging down in 2011. General government external debt decreased throughout the period 2007 to 2011, declining from 10.1 per cent. of GDP at the end of 2007 to 7.2 per cent. of GDP at the end of 2011. The repayment of loans to non-residents from the public as well as from the private sector placed Bulgaria among countries with an improving external debt position in 2011. After increasing to 108.3 per cent. of GDP at end of 2009, the overall external debt stock shrank to 91.9 per cent. of GDP at the end of 2011. Average maturities of GED have also increased with the share of short-term GED being 28.2 per cent. of total GED and the share of long-term GED being 71.8 per cent. of total GED as of the end of 2011. The currency structure remained favourable, with 88.6 per cent. of total debt being euro-denominated.

INDEBTEDNESS

Management of State Debt

The Government Debt Act was adopted in 2002 to unify existing regulatory arrangements and ensure clarity with regard to procedures and the authority to issue debt.

The provisions of the Government Debt Act include the following:

- a comprehensive definition of different types of debt;
- an outline of debt related powers;
- restrictions as to debt growth;
- an obligation to announce a medium term debt management strategy and publish an annual report on its implementation;
- regulation of the powers and procedures for issuing government guarantees; and
- regulation of the fiscal agency of BNB.

The Council of Ministers is the body which approves debt on behalf and at the expense of the State and issues government guarantees in accordance with the requirements of the Constitution. The authority to issue government securities ("**GS**") and to negotiate and sign government loan agreements and government guarantee agreements within the ambit of the State Budget Law is delegated to the Minister of Finance. The Ministry of Finance manages and monitors debt and provides official information on debt performance.

The BNB is the agent for state debt. The BNB is responsible for maintaining systems for registering and servicing state debt, organising and holding auctions of GS, registration of transactions with GS in the secondary market and other mutually agreed activities. See "*Monetary and Financial System – The BNB*".

Government policy regarding the primary market of GS contributes to the efficiency and transparency of both the primary and secondary market of GS, and ensures the provision of accurate information in relation to such GS. Some decisions that are particularly relevant to primary market development include the choice of auction system and the establishment of a system of primary dealers.

The Government Securities Auction System

The Government Securities Auction System (the "**GSAS**") was initially developed by the BNB in 1991 as part of the Electronic System for Registration and Trade in Government Securities ("**ESROT**"). The system has been developed and updated on multiple occasions.

In 2004, the BNB introduced a new auction system. It was developed as an independent system ensuring a fully automated direct execution of auction bids in line with the provisions of Ordinance No. 5 of Ministry of Finance and BNB on the Procedure and Terms for Acquisition, Registration, Redemption and Trade in Government Securities ("**Ordinance No.5**"). The replaceable technical devices used by GSAS for communication with GS auction participants (SWIFT and WEB-based interface in applying universal electronic signature) comply with international procedures and standards and enable the smooth integration of new users regardless of their location at minimum costs.

The updated system considerably reduces the auction time and the time for communicating auction results to bidders. This is an open auction system and can be updated to keep up with the GS market developments and regulatory amendments.

GSAS functionality meets issuers' requirements for technical support of debt management operations by allowing auctions of different types to be held simultaneously. The interest rate conventions set up in the system are aligned with those of EU Member States.

Auctions are conducted pursuant to Chapter Two and Chapter Six (dealing with repurchases) of Ordinance No. 5. Participation in these auctions is performed by competitive bids. By decision of the Minister of Finance, some of the GS selling auctions also allow non-competitive bids. Bidders may change their bids in an auction until closing bid time, after which the bid becomes irrevocable. The last quotation of each relevant bidder is considered to be their final bid.

The Minister of Finance approves which bids are acceptable. Based on that approval, an auction is closed and the auction data are directly transferred to ESROT through a dedicated interface. The competitive bids are paid up at the price quoted in the bid and this is a rule followed in the so-called multiple-price auction. Non-competitive bids are paid up at the weighted average price of approved competitive bids.

The System of Primary Dealers

The System of Primary Dealers was established in Bulgaria in 1996 in line with the practice in other European countries with developed financial markets. The requirements GS primary dealer applicants should comply with are set out in Chapter Two of Ordinance No. 15 of Ministry of Finance and BNB on the Control over Transactions in Government Securities ("**Ordinance No. 15**"), which stipulates the selection procedure. The list of the primary dealers of GS is approved by the Minister of Finance. The investment intermediaries and banks which are included in the list sign a contract for primary dealership in GS with the Ministry of Finance. This contract defines the contractual obligations of the parties. The system of primary dealers ensures non-discriminatory access to the GS market and is strictly abided to by the Ministry of Finance and the BNB.

The primary dealers of government securities for the period 1 January 2012 to 31 December 2012 include Allianz Bank Bulgaria AD, DSK Bank EAD, Corporate Commercial Bank AD, United Bulgarian Bank AD, Municipal Bank AD, First Investment Bank AD, Raiffeisen Bank (Bulgaria) EAD, Cibank AD, Citibank N.A. – Sofia Branch, Société Générale Expressbank AD, Unicredit Bulbank AD, Central Cooperative Bank AD and Eurobank EFG Bulgaria AD

In addition to the above, the Ministry of Finance maintains an active dialogue with participants in the government debt market.

Secondary market of GS

In accordance with the Law on the Government Debt and the Government Debt Agency Agreement between the Ministry of Finance and BNB, the latter develops and organises a GS settlement system ("**Settlement System**") with members, who can be primary dealers, sub-depositories of GS or other persons determined pursuant to Article 3 of Ordinance No. 5 under common rules ensuring the fulfilment of obligations by the system participants based on an agreement. The Settlement System comprises of the ESROT and a System of Government Securities Settlement Accounts ("**GSSA**") connected through a direct interface for automated data exchange. The ESROT participants are also participants in GSSA.

The Settlement System functions in compliance with the recommendations for the GS settlement systems developed by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organisation of Securities Commissions, the recommendations of the Committee of European Securities Regulators/ESCB, and the ECB standards of using securities settlement systems in the EU for the credit operations of the ESCB. The settlement of GS is accomplished through the Real Time Gross Settlement System of the BNB in central bank money. Settlement cycle is T+0 and the settlement model is delivery versus payment.

The BNB operates the Central Securities Depository ("**CSD**") for GS. Participants in ESROT are primary dealers of GS; GS sub-depositories; investment intermediaries other than GS primary dealers, whose license covers investment services under the Law on the Markets in Financial Instruments, including those from other Member States, banks other than primary dealers or sub-depositories of GS and other CSDs. The system is designed as a two tier model. In the first level of holding, the CSD maintains the accounts of the GS sub-depositories in the system and the second level comprises GS sub-depositories who maintain the accounts of their clients.

Key responsibilities of the Ministry of Finance in relation to the debt issue policy

The Ministry of Finance is responsible for measures regarding domestic and external government debt management and planning, organising and controlling activities related to implementation of the issue policy in the domestic market.

As part of the debt issue policy, the Ministry of Finance carries out activities related to the announcement of any forthcoming auctions for GS issuance on the basis of Ordinance No. 5.

The Ministry of Finance is also responsible for scheduling the monthly and annual calendars for domestic GS issues, including monitoring and analysing domestic debt instruments market developments, especially the quotations of the respective issues on the secondary market.

The BNB and the Ministry of Finance are together responsible for transparency of the government debt market by providing public disclosure (on the website of the Ministry of Finance and the BNB) of:

- debt management strategy;
- monthly issue calendars;
- monthly bulletins with extensive government debt statistics and analysis;
- annual review of government debt;
- legal acts; and
- detailed information about the status and tendencies of government debt (including forthcoming issues and the level of state guarantees.

In 2003, the State Budget Law introduced annual limits on the maximum volume of new government and government guaranteed debt that may be assumed as well as the maximum amount of outstanding government debt as of the end of the year.

The local government debt, debt of social insurance funds, the BNB, 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.

In accordance with the Government Debt Act, the outstanding portion of the consolidated government debt (central government debt, local government debt and debt of the social insurance funds) at the end of each year as a ratio of projected GDP may not exceed the previous year's ratio if the latter is more than 60 per cent. In the case of non compliance with the 60 per cent. rule, the Council of Ministers may propose restrictions on the issuance of municipal debt and social security funds debt in the State Budget Law for the respective year.

The Minister of Finance develops a three year government debt management strategy (the "**Strategy**"), which is approved by the Council of Ministers. The Strategy is updated annually, and this up-date will be approved by the Council of Ministers together with the three-year budget forecast. This allows for the timely and adequate redefinition of part of the objectives and measures in accordance with economic development, market indicators and results achieved in the course of the implementation of the Strategy.

The Strategy is a fundamental document aimed at summarising the main priorities of the Government in the area of medium term government debt management and defining the tools used for its implementation. Its main purpose is to assess and limit as much as possible the various risks generated by the debt structure and profile. The main objective of the Strategy is to ensure smooth financing of the budget and refinancing of the debt at an optimal cost and degree of risk.

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 financed by loans with a government guarantee are selected by the Council of Ministers. A list of such projects constitutes a part of the State Budget Law for the respective year.

Methodology

For prudential accounting and monitoring purposes, Bulgaria reports its debt data under the national methodology, in accordance with the System of National Accounts 1993 methodology, as adopted by the United Nations Statistical Commission in 1993. As a member of the EU, Bulgaria also reports its consolidated debt to Eurostat, the statistical body of the European Commission, in compliance with ESA 95 methodology. See "*Public Finance*" for more information on ESA 95 methodology.

With respect to both methodologies, Bulgaria uses its national methodology for reporting purposes with international financial institutions ("**IFI**") and for comparison with other countries. The state debt under national methodology is only the debt incurred directly by the state under the provisions stipulated in the State Debt Act. Local authorities and social securities funds issue debt under special regulations, namely the Municipal Debt Act and Social Insurance Code, which impose specific terms and conditions when undertaking debt.

For the purposes of Eurostat reporting, Bulgaria reports the data relating to general government debt. This consists of the debts of Central Government, local governments and social securities funds. Eurostat's methodology differs from national methodology as it includes the financial obligations of the state which are not connected with real financial instruments (e.g. financial leasing or the debt of public non-financial entities, where revenues accounting for more than 50 per cent. of their total incomes are from the Government).

The classification of Bulgaria's external and internal debt depends on the governing law of the debt issued. All issuances under Bulgarian law are classified as internal debt and all debt issuance under foreign law including debt incurred abroad in the form of loans (such as from IFIs or bilateral credit agreements) are classified as external debt.

The following table sets out general government debt and its subsectors reported under Eurostat's requirements for the period 2007 to 2011 as at 31 December, and as at 31 March 2012:

	As at 31 December					31 March
	2007	2008	2009	2010	2011	2012[(3)]
	(EUR millions)					
General Government Debt	5,296.84	4,849.24	5,112.88	5,858.78	6,285.54	6,411.79
General Government Debt as % of GDP	17.21	13.69	14.64	16.25	16.33	15.96
Central Government Debt	5,190.93	4,734.53	4,948.40	5,637.07	6,054.94	6,215.61
Central Government Debt as % of GDP	16.87	13.36	14.17	15.64	15.73	15.48
Local Government Debt	178.17	223.86	332.65	429.94	480.18	462.98
Local Government Debt as % of GDP	0.58	0.63	0.95	1.19	1.25	1.15
Social Security Funds Debt	13.79	12.58	11.24	9.85	8.34	8.32
Social Security Funds Debt as % of GDP	0.04	0.04	0.03	0.03	0.02	0.02
GDP	30,771.9	35,430.0	34,932.3	36,051.8	38,482.6	40,163.6

1 General Government Debt under Eurostat methodology is not equal to the arithmetical sum of the three sub-sectors debts due to consolidation between sub-sectors.

2 Includes debt leasing contracts and the debt of the government owned rail-company National "Railway Infrastructure".

3 Estimated data as of 31 March 2012

Source: Ministry of Finance.

State Debt

State debt under Bulgaria's national methodology comprises only debt incurred directly by the state under the provisions stipulated in the State Debt Act. State debt discussed in this section differs from the definition of GGD and Central government debt which are defined in accordance with Eurostat methodology. See "*Indebtedness – Methodology*".

According to the Ministry of Finance, the nominal amount of state debt at the end of 2011 was EUR 5,945.9 million, of which EUR 3,487.6 million was external debt and EUR 2,458.3 million domestic debt (see table below). In nominal terms the state debt increased by EUR 560.9 million compared to the level registered at the end of 2010. At the end of 2011, the relative share of domestic state debt was 41.3 per cent., and of external state debt was 58.7 per cent. The state debt to GDP ratio at the end of 2011 was 15.5 per cent., which represented a 0.8 per cent. increase compared to the level reported at the end of 2010. This was due mainly to the increase in the nominal amount of domestic debt.

At the end of 2011 the state debt structure (currency, interest rate, type of instruments and maturity) was well balanced. The debt amortisation profile is relatively well distributed, with the exception of 2013 and 2015, when both outstanding international bonds become due. The share of state debt denominated in EUR and BGN at the end of 2011 was 81.9 per cent. (28.6 per cent. in BGN and 53.3 per cent. in EUR, respectively). Fixed rate state debt was 82.4 per cent. and floating rate state debt was 17.6 per cent. of the total.

Of the outstanding state debt, 38 per cent. are GS issued on the domestic market, 28 per cent. are bonds issued in the international capital markets and 34 per cent. are external loans from IFIs and bilateral loans. 44 per cent. of these external loans are in the form of government investment loans intended for the implementation of investment projects which are a priority for Bulgaria's economy.

With respect to the Eurostat requirements and ESA 95 methodology. Bulgaria's ratio of general government debt to GDP has ranked second lowest in the European Union, standing at 16.3 per cent. (see table above) as at the end of 2011 for the third consecutive year. By way of comparison, in 2011 the ratio of government debt to GDP was 82.5 per cent. in the European Union (EU 27) and 87.2 per cent. in the Eurozone.

The Ministry of Finance forecasts an increase in the level of state debt at the end of 2012 of up to 20 per cent. regardless of which methodology is used to report debt. The reason for this increase is forthcoming debt funding in terms of domestic and external bond issues and state loan disbursements. This will be reversed immediately after the 2013 Eurobond issue has been redeemed.

The domestic market noted the following positive trends:

- The average weighted annual yield of GS issued in 2011 was 4.21 per cent. This is a decrease from the yield in 2010 (5.06 per cent.).
- During 2011, the Ministry of Finance auctioned GS with a total volume of EUR 626.6 million, while actual demand amounted to EUR 1,461.7 million. Thus, the oversubscription was about 2.4 times (bid-to-coverage ratio).
- In the first quarter of 2012, the Ministry of Finance successfully conducted 11 auctions for the sale of GS in the main maturity segments – two, five, seven and 10.5 year in BGN and EUR, with a total approved quantity of BGN 586.6 million (EUR 300 million). In the same period, the yield curve made a ''parallel shift'' towards lower levels of yields. The average weighted annual yield of the issued GS in the first quarter of 2012 was 3.92 per cent. The average bid-to-coverage ratio for this period was 2.70.
- On 13 April 2012, the ECB published data for the harmonised long-term interest rate for convergence purposes. The indicator for Bulgaria as of March 2012 was 5.07 per cent. which was a record low level for the last four years.
- The recorded yield on the auction for sale of 10.5-year GS conducted on 12 March 2012 was 4.95 per cent. This is a record low yield level for this maturity segment since March 2008.
- As of March 2012, the yield on the primary market for five year GS decreased. The yield on the auction held on 19 March 2012 was 3.71 per cent. compared with 6.87 per cent. in June 2009.
- The yield on the auction for sale of two year bonds held on 26 March 2012 was 2.11 per cent. This is the lowest yield ever recorded on the primary market for a Bulgarian interest bearing bond.

The following table sets out state debt (excluding state guaranteed debt) in accordance with the Ministry of Finance methodology in the period 2007 to 2012:

	As of 31 December					
	2007	**2008**	**2009**	**2010**	**2011**	**31 March 2012**
			(EUR millions)			
Domestic state debt	1,636.09	1,571.34	1,538.71	2,011.50	2,458.28	2,618.65
as a % of nominal GDP	5.3	4.4	4.4	5.6	6.4	6.5
External state debt	3,526.73	3,270.23	3,289.77	3,373.49	3,487.60	3,492.70
as a % of nominal GDP	11.5	9.2	9.4	9.4	9.1	8.7
Total	5,162.81	4,841.57	4,828.48	5,384.99	5,945.88	6,111.35
as a % of nominal GDP	16.8	13.7	13.8	14.9	15.5	15.2
Nominal GDP	30,771.91	35,429.99	34,932.28	36,051.83	38,482.56	40,163.59

Source: Ministry of Finance

At the end of 2011, state guaranteed debt (''**SGD**'') amounted to EUR 612 million and the majority of this was composed of external SGD. The ratio of SGD to state and state-guaranteed debt (total debt) was 9.3 per cent. (see table below).

Compared to the end of 2008, SGD fell by EUR 25 million in nominal terms by 31 December 2011. The ratio of SGD to GDP at the end of 2011 was 1.6 per cent. which represents a decrease of 0.2 per cent. compared to the end of 2008.

The relatively low values of these indicators are a prerequisite for low vulnerability of the debt portfolio to shocks driven by contingent liabilities. At the end of 2011, there were 15 government guaranteed loans, which were mainly divided between the transport (24.6 per cent.) and energy (64.8 per cent.) sectors.

The following table sets out SGD in accordance with the Ministry of Finance methodology in the period 2007 to 2012:

	As of 31 December					
	2007	2008	2009	2010	2011	31 March 2012
SGD, EUR millions	547	635	612	637	612	562
% of total debt	9.58	11.59	11.25	10.58	9.33	8.42
% of GDP	1.78	1.79	1.75	1.77	1.59	1.40
SGD in BGN – % of SGD	0	0	0	0.22	1.00	1.50
SGD in USD – % of SGD	20.29	10.02	6.47	4.25	3.00	3.15
SGD in EUR – % of SGD	56.12	47.82	46.82	41.84	39.80	41.97
Debt in other currencies – % of SGD	23.57	42.13	46.72	53.70	56.22	53.44
Debt with fixed interest rate – % of SGD	37.87	49.50	54.14	60.63	63.22	61.04
Debt with variable interest rate – % of SGD	62.12	50.47	45.88	39.38	36.80	39.02
Average interest rate % of SGD	4.62	3.9	2.21	2.22	2.5	2.41
Remainder of SGD in years	11.14	11.1	11.01	10.68	10.13	9.82

Source: Ministry of Finance.

State Debt Service

The following table sets out state debt service in accordance with the Ministry of Finance methodology for the period 2007 to 2011:

	Actual				
	2007	2008	2009	2010	2011
			(EUR millions)		
Domestic State Debt					
1 Interest of domestic state bonds	72.9	77.3	71.2	65.2	86.6
2 Cost of cash management	0.2	0.2	0.2	0.2	0.2
3 Interest of domestic loans	—	—	—	—	—
4 Fees	—	—	—	—	—
Total Domestic State Debt	**73.1**	**77.5**	**71.4**	**65.5**	**86.8**
Foreign State Debt					
1 Interest of foreign state bonds	162.0	136.6	127.4	127.6	126.5
2 Interest of domestic bonds – non-residents	0.6	0.9	0.9	0.9	0.8
3 Cost of foreign cash management	0.3	3.3	0.6	0.2	0.3
4 Interest of foreign loans	80.7	76.0	55.8	38.9	45.2
5 Fees	0.3	0.5	1.0	1.0	1.0
Total Foreign State Debt	**243.9**	**217.3**	**185.8**	**168.6**	**173.8**
Total State Debt	**317.0**	**294.7**	**257.2**	**234.1**	**260.5**

Source: Ministry of Finance

Credit Ratings

The following table sets out Bulgaria's current long term sovereign foreign currency ratings:

	Standard & Poor's	Moody's
Rating	BBB	Baa2
Assignment Date	1 Dec 2009	22 July 2011
Last Confirmation Date	21 Dec 2011	28 May 2012

Source: Ministry of Finance.

Notes: Bulgaria has not had contractual relations with Fitch Ratings since 2010.

Relationship with Supranational Financial Institutions

International Monetary Fund ("IMF")

Bulgaria joined the IMF in 1990. At present Bulgaria has no active agreement with the Fund and all its obligations to the IMF are fully settled. The IMF holds regular Article IV consultations with the country on a 12-month cycle and makes unscheduled staff visits. The last IMF staff visit was conducted on 2 May 2012. Currently Bulgaria's quota share in the Fund is 0.27 per cent. of the total IMF quota.

World Bank

Since Bulgaria joined the World Bank (IBRD) in 1990, the World Bank has provided significant financial support for structural reforms and development in the infrastructure, social, health, environment, telecommunications and energy sectors. As at 30 April 2012, the World Bank had authorised approximately USD 3.0 billion in loans to Bulgaria, of which only approximately USD 0.2 billion were undisbursed. These amounts apply to both government loans and loans guaranteed by Bulgaria. Current debt exposure of Bulgaria amounts to approximately USD 1.2 billion.

European Investment Bank ("EIB")

Bulgaria signed its first framework agreement with the EIB in 1991 and became a full member of the EIB upon its accession to the EU in January 2007.

The main areas of the EIB operations in Bulgaria are transport, energy and telecommunications. The EIB also provides loans to private enterprises, municipalities and financial intermediaries to support SMEs. In 2007, Bulgaria and the EIB signed a Credit Agreement for a structural programme loan, Bulgaria EU Funds Cofinancing 2007-2013 for up to EUR 700 million and providing for national co-financing of projects under the Transport, Environment and Regional Development EU Structural and Cohesion Funds OPs. As at 31 December 2011, the EIB had committed EUR 3.2 billion to Bulgarian borrowers, of which EUR 2.3 billion had already been disbursed.

Council of Europe Development Bank ("CEB")

Bulgaria has been a member of CEB since May 1994. Since the beginning of its operations in Bulgaria, CEB has committed around EUR 232 million in socially oriented projects for increasing employment in SMEs, environmental protection, health and public infrastructure.

European Bank for Reconstruction and Development

Bulgaria is a founding member of the EBRD. As at 31 December 2011 the EBRD has committed over EUR 2.45 billion to the corporate, financial institutions, infrastructure, energy and energy efficiency sectors, of which EUR 0.308 billion was granted to the public sector and EUR 2.142 billion to the private sector.

TAXATION

The following is a general description of the material Bulgarian and EU tax considerations relating to the acquisition, ownership, disposition and retirement of the Notes. It does not purport to be a complete analysis of all tax considerations relating to the Notes. This summary does not take into account or discuss the tax laws of any country other than the Republic of Bulgaria nor does it take into account specific double taxation treaties, the individual circumstances, financial situation or investment objectives of an investor in the Notes.

Prospective purchasers of Notes should consult their own tax advisers as to which countries' tax laws could be relevant to acquiring, holding and disposing of Notes and receiving payments of interest, principal and/or other amounts under the Notes and the consequences of such actions under the tax laws of those countries. This summary is based upon tax laws of the Republic of Bulgaria as in effect on the date of this Offering Circular and is subject to any change in law that may take effect after such date, including changes which could have a retroactive effect.

Republic of Bulgaria

Individuals

Payment of principal on the Notes to individuals is not subject to taxation in Bulgaria.

Interest payments on the Notes received by an individual who is a Bulgarian tax resident, or who is a non-Bulgarian tax resident established for tax purposes in a Member State of the EU or the European Economic Area, or who is a non-Bulgarian tax resident acting through a fixed base in Bulgaria, is exempt from taxation in Bulgaria.

Interest on the Notes received by an individual who is a non-Bulgarian tax resident and is established for tax purposes outside of a Member State of the EU or of the European Economic Area is subject to a one-time withholding tax in Bulgaria at the rate of 10 per cent.

Capital gains realised from the sale or exchange of Notes realised by an individual who is a Bulgarian tax resident, or who is a non-Bulgarian tax resident acting through a fixed base in Bulgaria is included in his or her annual taxable income and is subject to personal income tax in Bulgaria at the rate of 10 per cent.

Capital gains realised from the sale or exchange of Notes by an individual who is a non-Bulgarian tax resident, irrespective of the place where the individual is established for tax purposes, is subject to a one-time withholding tax in Bulgaria at the rate of 10 per cent. Although the law names this tax on capital gains a ''withholding'' tax, it is paid by the recipient of the income.

Legal entities

Payment of principal on the Notes to a legal entity is not subject to taxation in Bulgaria.

Interest on the Notes and capital gains realised from the sale or exchange of Notes received by a legal entity which is a Bulgarian tax resident or which is a non-Bulgarian tax resident acting through a permanent establishment in Bulgaria is included in the corporate income taxable base of the recipient and is subject to corporate income tax in Bulgaria at the rate of 10 per cent.

Interest on the Notes and capital gains realised from the sale or exchange of Notes received by a legal entity which is a non-Bulgarian tax resident, are subject to a one-time withholding tax in Bulgaria at the rate of 10 per cent. Although the law names this tax on capital gains a ''withholding'' tax, it is paid by the recipient of the income.

Gross-up

Notwithstanding the above, in accordance with the Terms and Conditions of the Notes, if withholding tax is payable in Bulgaria, subject to certain exceptions set forth in Condition 8 (*Taxation*) of the ''*Terms and Conditions of the Notes*'', Bulgaria shall pay such additional amounts as will result in the receipt by the holders of the Notes of such amounts as would have been received by them had no such withholding or deduction been required under Bulgarian law.

Bilateral Treaties for Avoidance of Double Taxation and Tax Input

As at the date of this Offering Circular, Bulgaria is a party to 68 bilateral treaties on the avoidance of double taxation. In cases where Bulgarian law imposes tax on interest received or capital gains realised in relation to the Notes, these treaties may provide different forms of tax relief. Prospective purchases of Notes should consult their own tax advisers with regards to the applicability and effect of such treaties.

Other taxation

No Bulgarian stamp duty, registration, transfer or similar tax is payable in connection with the acquisition, ownership, sale or disposition of the Notes by Bulgarian or non-Bulgarian holders of Notes.

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income (the "**EU Savings Directive**"), each Member State is required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to or for an individual or certain limited types of entity established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system (the applicable rate of withholding now being 35 per cent.) in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). The withholding system is subject to an exception whereby the beneficial owner of the interest or other income may elect for the exchange of information instead. A number of non-EU countries and territories including Switzerland have adopted, or agreed to adopt, similar measures (a withholding system in the case of Switzerland) and certain dependent or associated territories of Member States have adopted the same measures. The European Commission has proposed certain amendments to the EU Savings Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

If an amount of, or in respect of, tax were to be withheld from a payment of principal or interest under a Note, pursuant to the EU Savings Directive, any other European Union Directive implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. See Condition 8 (*Taxation*) of the "*Terms and Conditions of the Notes*". However, the Issuer is required, as provided in Condition 12 (*Agents*) of the "*Terms and Conditions of the Notes*", to maintain a Paying Agent in a Member State that does not impose an obligation to withhold or deduct tax pursuant to the EU Savings Directive or any law implementing or complying with, or introduced in order to conform to, the EU Savings Directive or any such other Directive.

SUBSCRIPTION AND SALE

Subscription Agreement

BNP Paribas, HSBC Bank plc and Raiffeisen Bank International AG (together, the "**Joint Lead Managers**") have, in a subscription agreement (the "**Subscription Agreement**") dated 4 June 2012, agreed jointly and severally to subscribe and pay for the Notes at their issue price of 99.182 per cent, of their principal amount less a combined management and underwriting commission. Each Joint Lead Manager is entitled in certain circumstances to be released and discharged from its obligations under the Subscription Agreement prior to the issue of the Notes. The Issuer has agreed to indemnify the Joint Lead Managers against certain liabilities in connection with the issue of the Notes.

Selling Restrictions

United Kingdom

Each Joint Lead Manager has severally represented, warranted and undertaken that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000, as amended (the "**FSMA**")) received by it in connection with the issue or sale of the Notes in circumstances in which section 21(1) of the FSMA does not apply to the Issuer; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

United States of America

The Notes have not been and will not be registered under the Securities Act. Subject to certain exceptions, Notes may not be offered, sold or delivered within the United States or to, or for the account or benefit of, U.S. persons.

In addition, until 40 days after the commencement of the offering, an offer or sale of Notes within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act.

Bulgaria

Each Joint Lead Manager has severally represented and agreed that:

(a) the Notes have not been and will not be registered for a public offer in Bulgaria; and

(b) neither it nor any of its affiliates, nor any persons acting on its or its affiliates behalf, have publicly offered or sold, or will publicly offer or sell, any Note within Bulgaria, other than in accordance with the laws of Bulgaria.

General

Each Joint Lead Manager has severally represented, warranted and agreed that it has, to the best of its knowledge and belief, complied and will comply in all material respects with all applicable laws and regulations in each country or jurisdiction in which it purchases, offers, sells or delivers Notes or possesses, distributes or publishes this Offering Circular or any other offering material relating to the Notes. Persons into whose hands this Offering Circular comes are required by the Issuer and the Joint Lead Managers to comply with all applicable laws and regulations in each country or jurisdiction in which they purchase, offer, sell or deliver Notes or possess, distribute or publish this Offering Circular or any other offering material relating to the Notes, in all cases at their own expense.

GENERAL INFORMATION

Authorisation

1. Bulgaria has obtained all necessary consents, approvals and authorisations in Bulgaria in connection with the issue and performance of the Notes. The creation and issue of the Notes was authorised by the 2012 State Budget Act of the Republic of Bulgaria, the resolutions of the Council of Ministers dated 3 May 2012 and 5 June 2012, and by the law on ratification of the Fiscal Agency Agreement, the Subscription Agreement and the Deed of Covenant, adopted by the parliament on 8 June 2012, sealed by the President on 15 June 2012 and published by the State Gazette Issue No. 46 on 19 June 2012, in force as of 23 June 2012 (the "**Law on Ratification**").

Listing and admission to trading

2. Application has been made for the Notes to be admitted to listing on the official list and trading on the Luxembourg Stock Exchange's regulated market.

3. The total expenses related to the admission to trading of the Notes are expected to be approximately EUR 5,500.

Legal and Arbitration Proceedings

4. Bulgaria is, from time to time, involved in a number of legal and arbitration proceedings. Bulgaria is not, however, involved in any legal or arbitration proceedings (including any such proceedings which are pending or threatened of which Bulgaria is aware) which may have, or have had during the 12 months preceding the date of this document, a significant effect on the financial position of Bulgaria.

No Significant Change

5. There has been no significant change in the tax and budgetary systems, gross public debt, foreign trade and balance of payments, foreign exchange reserves, financial position and resources and income and expenditure figures of Bulgaria since 31 December 2011.

Documents on Display

6. For so long as any of the Notes are admitted to listing on the official list and trading on the Luxembourg Stock Exchange's regulated market, copies of the following documents (together with English translations thereof) may be inspected during normal business hours at the specified address of the Fiscal Agent and the Listing Agent in Luxembourg:

   (a) this Offering Circular and any supplements thereto;

   (b) the Fiscal Agency Agreement, together with the supplement thereto; and

   (c) the Deed of Covenant.

   A copy of this Offering Circular is available on the Luxembourg Stock Exchange's website at www.bourse.lu.

Yield

7. The projected yield of the Notes will be 4.436 per cent. Such projection has been calculated on the basis of the offering price as at the date of this Offering Circular and is not an indication of actual future return for investors.

ISIN and Common Code

8. The Notes have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The ISIN is XS0802005289 and the common code is 080200528.

9. The address of Euroclear is 1 Boulevard du Roi Albert II, B-1210 Brussels, Belgium and the address of Clearstream, Luxembourg is 42 Avenue JI Kennedy L-1855 Luxembourg.

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