
AGENCY FOR ECONOMIC COORDINATION AND DEVELOPMENT

**THE BULGARIAN
ECONOMY IN 1993
ANNUAL REPORT**

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1. After two years of relatively clear-cut macroeconomic objectives, 1993 began with the suspension of the stand-by agreements with the IMF and statements about a forthcoming economic policy change.

One assessment and one event outline the 1993 economic outlook.

The **assessment** was made in AECD's 1992 Annual Report which announced the end of the „stabilization saga“. Given the deteriorated foreign financing and the never-starting structural reform, the traditional criteria of the IMF programmes for Bulgaria became unsustainable any further.

The **event** which „winds up“ the year is the general external debt agreement with the private bank-creditors. It may reestablish the narrow limits Bulgaria has been confined to in the last three years.

2. 1993 did not witness a new inflationary cycle. Instead, processes with similar destructive effect unfolded, viz. a full disintegration of state property management and a loss of coordination and control over the macroeconomic policy instruments.

Decision-making at all levels had one key objective - the aggressive filling-in of the economic vacuum left by the demise of the centrally-planned economy.

The politics brilliantly covered and justified these processes.

3. It is argued that the stabilization process could have proceeded within the old framework in 1993 too. However, by the end of 1992 all social support for a „repeat“ of the stabilization efforts, discredited by the lack of political will and responsibility, had been exhausted. From an economic standpoint, such a stabilization „from above“ would have been fruitless.

In this sense, 1993 is „lost“ for the economic reform. It will prove twice as futile, however, if policy-makers fail to draw the necessary conclusions for future economic management. Stabilization now means any promotion of market institutions, of rules of market behaviour and increasing control over the economy, even if such measures would initially lead to a certain deterioration in the traditional macroeconomic parameters. □

DECAPITALIZING THE STATE PROPERTY

4. The decapitalization of state property lies at the heart of the aggravating financial crisis in the real sector which branches into all sectors of the economy. Mounting debts and the ever deteriorating financial performance of state enterprises practically invalidated all macroeconomic policy efforts in the last three years.

State property management has opened a financial „gravity hole“ which absorbs the entire amount of household savings. Any further boost to savings would be unjustified as they generate no potential for investment. In addition, the country is cut off from all sources of „external“ savings.

Despite its seeming all-pervasiveness, the financial crisis of the state enterprises has a local character. The stratification of enterprises has clearly set apart the „hopeless“ from the „prospective“ cases. There is also a clear division among enterprises burdened by bad debts. Potentially bankrupt ones are evident and the artificial life support serves only to reproduce their financial problems.

The decapitalization of state property has got a „creative“ aspect as well. Post-communist reality allows „appropriated“ revenues to be used for the creation of new economic agents, a sort of post-communist *Gründerism*. The advantage goes to circles in or near the structure of power (former, present and future). The prevalence of state ownership makes spontaneous re-allocation of state assets unavoidable in the process of economic liberalization. Given the lack of hard budget constraints and bankruptcy legislation, the decapitalization of state property is an economically justified process.

The dominant form of state enterprise management is the „private management“ of state assets indicating „private“ control on the part of the „state“ owner. Economic management serves the interests of distinct groups which privately capitalize on the profits of state enterprises.

The process of decapitalization can be estimated. Its scope is so wide that financial statistics detects its major parameters despite the obvious efforts to evade accountability.

5. Accumulation of Losses. In the nine-month period of 1993 total net profitability of non-financial enterprises was negative. In industry it amounted to -13% against -6% in 1992. Since the end of 1992, 847 enterprises have been recording losses while only 362 enterprises have become profit-makers.

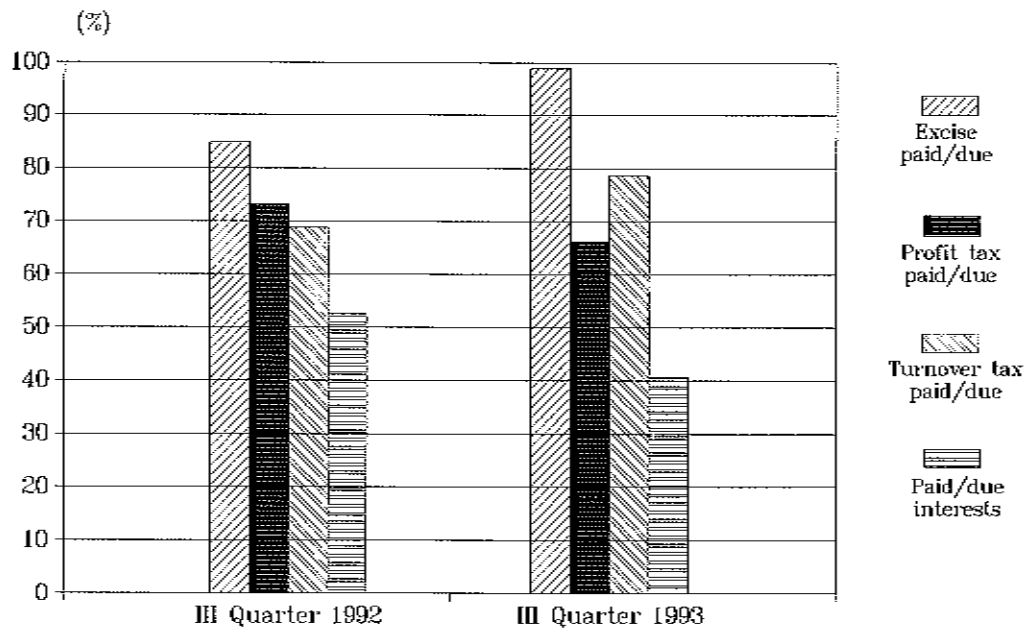
6. Insolvency Crisis. Three years after the reform outset, the bulk of enterprises have not changed their behavioral pattern. Earlier they were subsidized, now they fall into arrears without any sanction. They have been, and still function, under soft budget constraints.

The actual amount of payments to banks, suppliers and the budget indicates the real financial pressure on enterprises. At the reform outset producers were insolvent to all creditors: banks, suppliers and the budget. From mid-1992 till mid-1993, interfirm arrears steadied down and the rate of debt pay-off to „external“ creditors (banks and the budget) remained relatively low. Since mid-1993 interfirm arrears have been growing once again.

The insolvency crisis is manifested in two ways:

- A low rate of collecting one's liabilities. Overall, the levy rate increased in 1993. The interest payments, however, have been following a downward trend.

Real Financial Pressure on Firms



- Growing arrears in enterprise payables and receivables determine the expansion of interfirm debt. The share of arrears in payables and receivables reached 40-50%. Interfirm debt is clearly attributable. Data on enterprise payables and receivables identify industry as the net debtor in interfirm credit.

7. Capital Siphoning-off. The disastrous financial condition of enterprises is a result both of their economic performance and of the appropriation of value-added to wages and private businesses. The disintegration of state enterprises gives momentum to private sector growth.

The AECD has assessed the process on the basis of non-financial state sector accounts. They allow the financial condition of the sector to be assessed within the system of national accounts¹.

¹ Non-financial sector accounts are based on NSI's financial statistics. It is re-assessed to match OECD standards in conformity with the method of national accounting.

Statement of Income and Change in Net Worth of Non-financial State Enterprises (billions of leva, end of period)				
		I-IX 1992	1992	I-IX 1993
number of firms		5649	5732	5871
1	Sales + changes in stocks and work in progress	230.3	336.7	266.8
2	Input of goods and services from outside	179.3	262	205.8
3	Gross profit at factor cost (= 1 - 2)	51	74.7	61.1
4	Wages	28.2	40.8	40.7
5	Social charges	11.4	16.5	16.8
6	Gross trading profit (= 3 - 4 - 5)	11.4	17.4	3.6
7	Interest paid	11.8	17	10.1
8	Rent and dividends paid	2.8	5.4	1.8
9	Interest, dividends and rent received	4.8	7.5	4.4
10	Gross total profit (= 6 - 7 - 8 + 9)	1.6	2.6	-4
11	Direct taxes	3.6	5.4	2.6
12	Gross income finance (= 10 - 11)	-2	-2.7	-6.5
13	Depreciation of fixed assets	4.6	11	16
14	Net retained income (= 12 - 13)	-6.6	-14	-23
15	Net Revaluation (upward +) of fixed assets	26.8	275.8	24.7
16	Gchange in net worth (= 14 + 15)	20.5	262	2
17	Fixed assets	127.8	384.7	460.8

The table shows the aggregate account of non-financial state enterprises. It outlines the dynamics of gross profit at factor cost and the change in enterprises' net worth. Non-financial sector accounts indicate the end-result of state property decapitalization. This is the starting point for the privatization of state firms.

The following trends in capital siphoning-off can be discerned:

1°. In the first nine months of 1993 the nominal value-added exceeded its level in the same period of 1992 by 20%. This amounts to a 13% drop in real terms.

2°. Labour expenditures have been attracting a growing share of the value-added, almost covering its amount at the end of the nine-month period of 1993 (94.2% against 76.7% in 1992). This is a typical instance of state enterprise decapitalization.

3°. Some enterprises have the financial potential for net investment². However, the amount of net investment in this group (7 bn leva) is offset by the exceeding of depreciation over investment (12 bn leva) in the rest of enterprises. High disinvestment indicates that the bulk of allowed depreciation costs has been rechannelled to wages, interest on credits and other liabilities. In the final count, state firms have „eaten away“ about 5 bn leva, needed for investment.

4°. The steady negative values of net retained incomes are the clearest evidence that incomes siphon off from the state into the private sector. This process reflects the actual privatization of incomes generated in state enterprises. Whereas by the end of the first quarter of 1993 fixed assets revaluation covered the amount of negative net retained incomes, the second and third quarters saw a decrease in the net worth of state enterprise assets.

Negative net retained incomes over the nine-month period of 1993 (-23 bn leva), as well as the net growth in receivables from enterprise sales (6.1 bn leva) were covered by new credits (13.3 bn leva), unpaid taxes (8.9 bn leva), unpaid wages (2.5 bn leva) and net disinvestment (5 bn leva).

² Expenditures for fixed assets reduced by the amount of depreciation.

5°. There is a clear segmentation of enterprises with positive and negative net retained incomes³. Whereas net retained incomes of enterprises in the first group amount to 9 bn leva, the value-added generated by the enterprises in the second group does not even cover their wage expenditures. Negative net retained incomes of enterprises in the second group reached 29 bn leva. Therefore, most of these enterprises are economically superfluous.

6°. Decapitalization depreciates the sale value of enterprise assets and lowers future privatization revenues. Preliminary decapitalization and asset devaluation is a common practice in enterprises about to be privatized. The sale reveals the real value of firm assets which is not evident in the manipulated financial statements. □

³ *Incomes after paying taxes, interests and depreciation costs. Their amount determines the saving (investment) potential of the enterprise.*

MACROECONOMIC POLICY INSTRUMENTS PARALYZED

8. Macroeconomic policy instruments in 1993 were mutually incongruous. They were either used for inappropriate purposes or had a destabilizing impact which led to conflicting results.

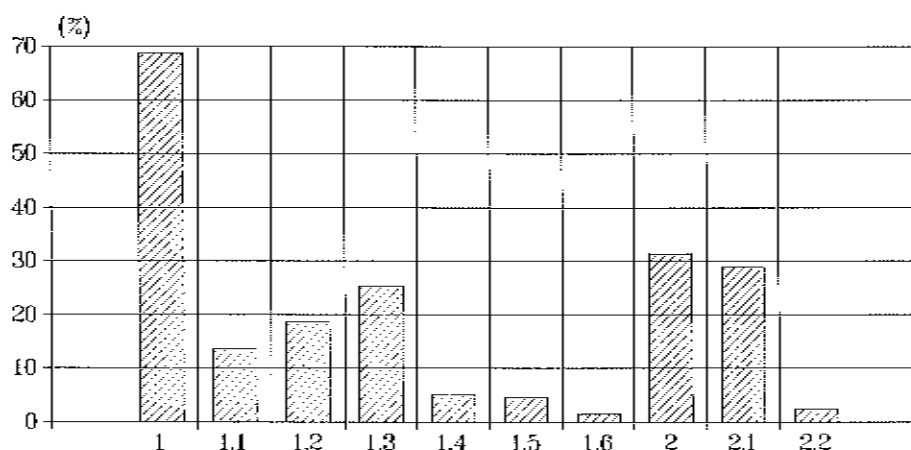
The incongruity stemmed from the introduction of automatic wage indexation, the loss of control over the exchange rate anchor, the accumulated negative potential and the attempts to achieve stabilization without structural reforms.

FISCAL POLICY PARALYZED

9. The loss of control over the budget in 1993 reflected the unmanageability of the economy. The fiscal crisis indicates that macroeconomic policy instruments have blocked as a result of the raised „anchors“ of macroeconomic restrictions.

The frustration stemmed from the regular wage indexation, the expenditures of the State Social Security Fund and the mounting payments in domestic debt servicing.

Consolidated Government Budget: Contribution of the Different Components to the Growth of Total Expenditures*

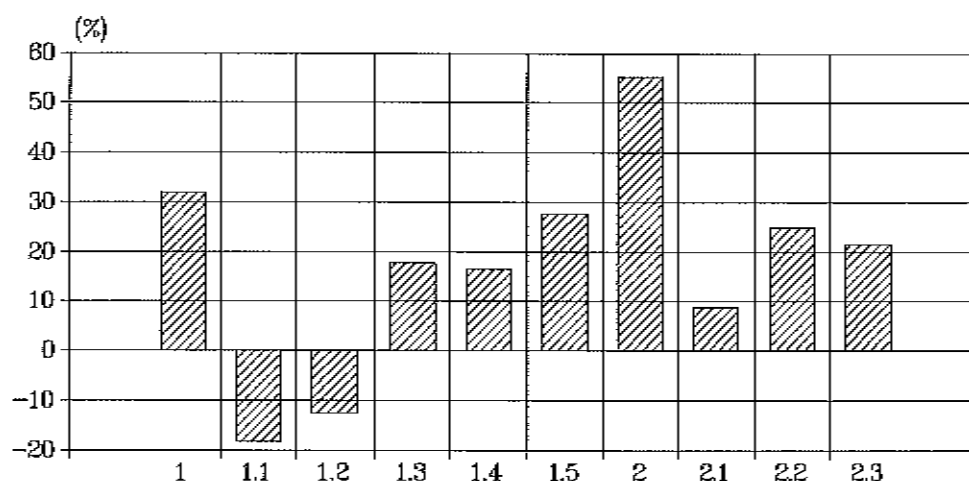


1. Non-interest expenditures; 1.1. Wages; 1.2. Purchases of goods and services; 1.3. Pensions; 1.4. Social aid; 1.5. Production subsidies; 1.6. Investment;
2. Interest payments; 2.1. Domestic interest payments; 2.2. Foreign interest payments.

* Contribution to the total expenditures' growth rate (Jan.-Sept. 1993/Jan.-Sept. 1992)

Source: MF, AECD

**Consolidated Government Budget: Contribution
of the Different Components to the Growth
of Total Revenues***



1. Direct taxes; 1.1. Profit tax on nonfinancial enterprises; 1.2. Profit tax on financial institutions; 1.3. BNB profit remittance; 1.4. Personal income tax; 1.5. Social security contributions; 2. Indirect taxes; 2.1. Turnover tax; 2.2. Excises; 2.3. Custom duties.

* Contribution to the total revenues' growth rate (Jan.-Sept. 1993/Jan.-Sept. 1992)

Source: MF, ABCD

The 1993 budget presupposed a more restrictive fiscal policy stance and a primary state budget deficit of 1.6% of GDP (0.9% of GDP in 1992) in the context of almost no freedom to manage budget expenditures.

The infeasibility of these targets was made evident in the report on the state budget implementation for the ten-month period of 1993. Over the ten-month period the primary state budget deficit amounted to some 7 bn leva. Having in mind that the control on the domestic and cash deficits depends on the management of the primary deficit, the government's failure in the latter is a sign of its inability to regulate the budget.

The flexibility of fiscal policy is conditional upon the degree to which the government may modify budget expenditures according to revenues. Since 1992 the government has been enjoying less and less freedom in that respect. There was a cutdown in production and investment subsidies, and in 1992 the expenses for maintenance of the

budget-financed sector were severely slashed. These measures exhausted the potential for manipulating with the more „flexible“ expenditures and touched on the core of „stable“ expenditures including interest and pension payments. Their share in total budget expenditures grew from 49% for the nine-month period in 1992 to some 54% in the same period in 1993.

Incomes Policy Versus Fiscal Policy

10. The clash between the objectives and instruments of the incomes and fiscal policies led to a low adaptability of the latter.

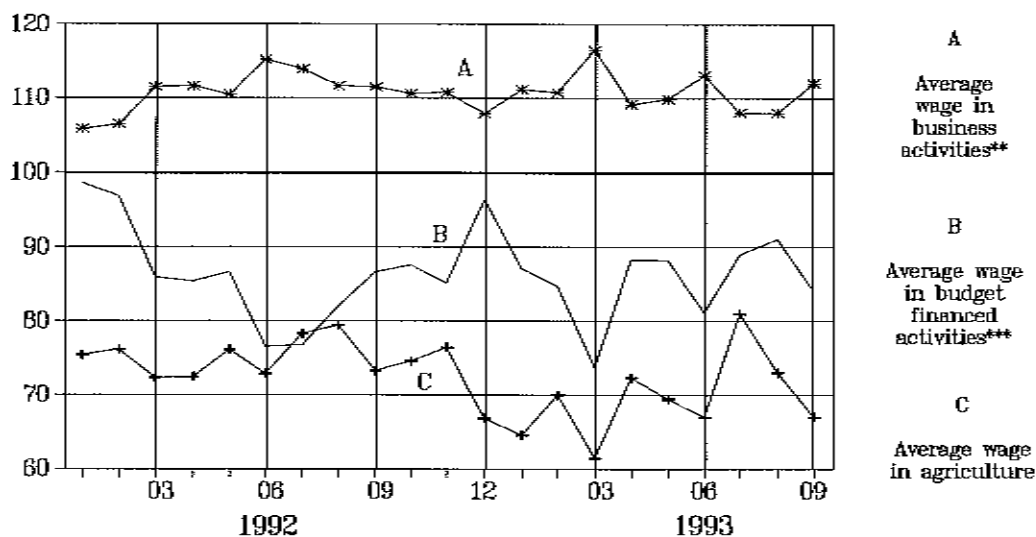
The breakthrough came with the introduction of regular wage indexation in the budget-financed sector which tied down the government's hands so that it could no longer operate with wage expenditures. Wages resembled „stable“ expenditures in their degree of manageability. Whereas in 1992 the minimum wage was raised just on one occasion, in 1993 it underwent four adjustments.

The introduction of regular wage indexation had the following consequences:

1°. A rising share of wages in budget expenditures. (From 9.2% to 11.9% and 12.3% for the nine-month period in 1991, 1992 and 1993 respectively). The degree of income indexation was a much debatable issue in 1993⁴. The comparison between the levels of the average wage accrued in the first nine months of 1992 and 1993 indicates that its growth was equal to consumer price inflation. In the period December 1992 - September 1993 the average wage was compensated 90.6% for inflation.

⁴ *The new method of assessment of price indices as of January 1993 made monthly chain indices in 1992 and 1993 incompatible. Therefore, they ceased to be an adequate measure for comparing real incomes in 1992 and 1993. Instead, the analysis of real-term incomes has begun to make use of the consumer price indices calculated by the National Statistics Institute, which measure inflation on a 12-month change basis. (Price index for a given month in 1993 compared to the corresponding month of 1992). Consumer price inflation in the first nine months of 1993 amounted to 59.15% against the same period in 1992.*

Relative Wages*



* Average wage = 100
 ** Industry; Construction; Transportation; Communication; Trade; Finance; Other.
 *** R&D; Education; Culture; Health; Government.

Source: NSI, AECD

2°. In March 1993 the ratio of wages in the budget-financed sectors⁵ to the average wage in self-financed sectors was the lowest in the last two years. Wage indexation in the first nine months of 1993 kept the average wage in budget-financed sectors at its level from the same period in 1992. This measure limited the outflow of government employees to the private sector.

3°. In the last three years pension payments were an absolute budget priority. Pension incomes increased by some 2% in real terms over the first nine months of 1993.

4°. Overall, due to wage indexation real-term household incomes rose by 2.6% instead of declining by 3.4%. Its large contribution to the overall incomes growth indicates that the regular wage indexation was an excessive expenditure load on the 1993 budget.

⁵ These are Science, Art and Culture, Education, Health Care, and Public Administration.

Fiscal Policy under the Burden of the State Social Security Fund

11. The budget of the State Social Security Fund (SSSF) became the key source of the structural deficit and the stable primary deficit in the **consolidated** government budget. The government budget loan to the SSSF has reached 6.1 bn leva since the turn of the year, just short of the primary deficit (6.8 bn leva). In addition, the SSSF has received a sizable short-term interest-free loan from the Professional Training and Retraining Fund.

Without the SSSF deficit the consolidated government budget would have run a primary surplus of 1.4 bn leva. Budget revenues from state-run enterprises, which are the main source of social security contributions, depend on their wage bill growth. The latter amounted to 39% in the nine-month period of 1993, falling far behind the rate of inflation. We should also take into account that SSSF contributions paid amounted to 60.2% of the amounts accrued over the same period (against 72% in the first nine months of 1992). Till October 1993 the SSSF deficit had grown 2.4-fold compared to the same period in 1992.

The Real Sector Versus the Fiscal Policy or the Disappearance of the Tax Base

12. The rising share of difficult-to-manage budget expenditures was paralleled by the decline in budget revenues. This process conditioned the sharp budget deficit increase. (Contrary to assumptions in the parliamentary debate on the budget bill, increased production subsidies did not contribute much to the budget deficit).

The main problem in 1993 related to the disappearance of the direct tax base. The structure of accrued taxes changed radically, with the profits-tax share falling below 19%. This indicates that the bad debts problem has not yet found its solution. AECD estimates show that

taxable profits would have increased by some 1 bn leva (over 21%) if there was a legislative decision on state enterprises' debts in the beginning of the year.

The shrinking of the tax base was largely conditioned by the revaluation of fixed assets, an effective balance-sheet technique for profits lowering and tax base reduction despite the normative depreciation quotas.

The natural fiscal policy response was to seek expansion of the tax base by raising the share of indirect tax revenues and tightening the revenue collection schedule. The adjustment of customs tariffs since mid-1992 has had a certain impact although actual customs duty revenues fell rather short of expectations.

Fiscal Policy and Domestic Debt

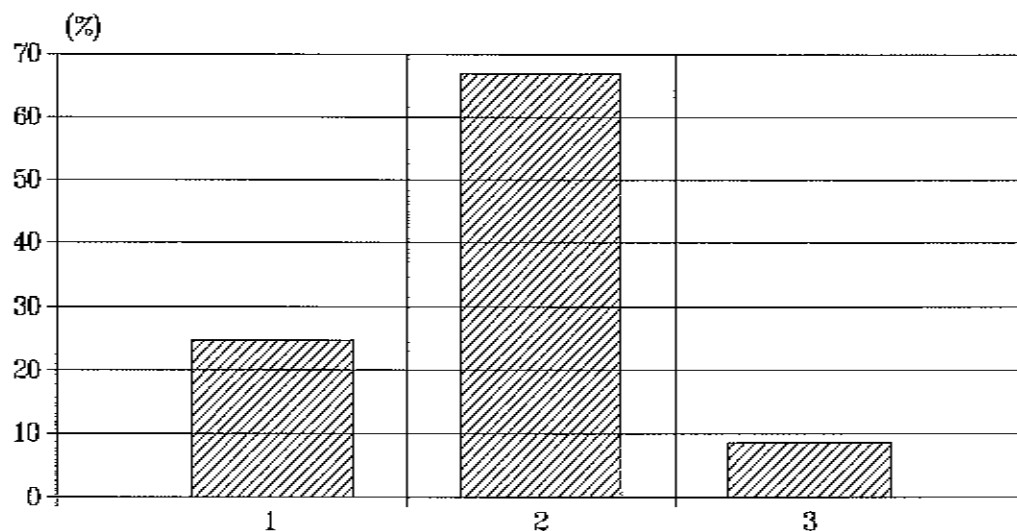
13. The structure of budget expenditures contained a third „stable“ source of deficit, viz. mounting interest payments. The cash deficit in the state budget consisted of a primary deficit (21.9%), domestic interest payments (68.6%) and foreign interest payments (9.5%).

The expenditure side of the budget included interest payments on the government debt to the BNB. This indicated a change in the government approach to dealing with the BNB, viz. its consent for a regular debt servicing. This step allowed for a regular compounding of interest⁶, thus raising the effective annual interest on the government debt. It reached 51.4% in October, or 3.4 percentage points over the average base interest rate for the ten-month period in 1993. The budget received 2/3 of the amount of interest paid to the BNB back in the form of transfers of excess BNB revenues over expenditures. In this way the

⁶ Irregular interest payments in 1992 did not allow interest compounding.

effective annual interest on the government debt to the Bank amounted to 15.9% by October.

State Budget: Contribution of the Different Components to the Growth Rate of the Cash Deficit*

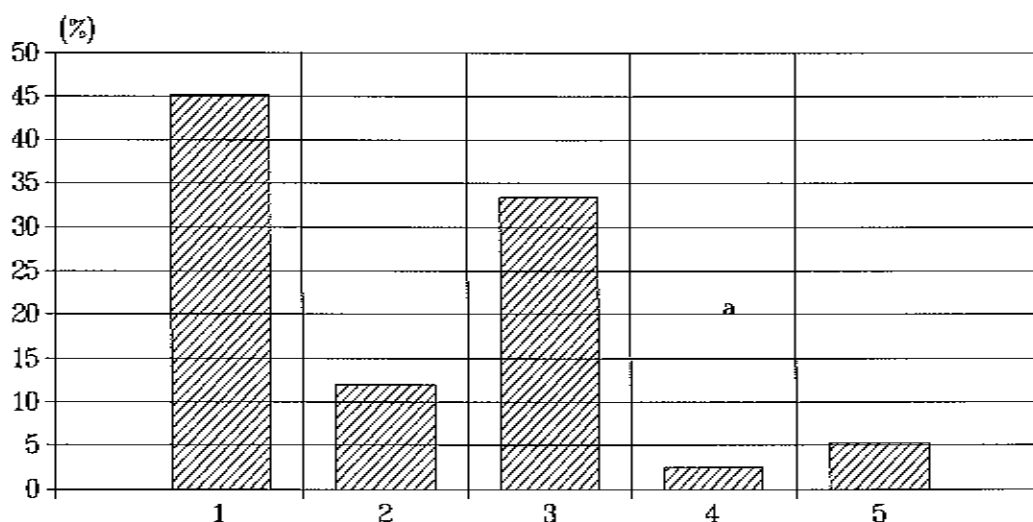


1. Primary deficit; 2. Domestic Interest; 3. Foreign interest.

* Contribution to the cash deficit's growth rate (October 1993/ December 1992).

Source: MF, AECD

State Budget: Contribution of Different Components to the Growth of Public Sector Borrowing Requirements*



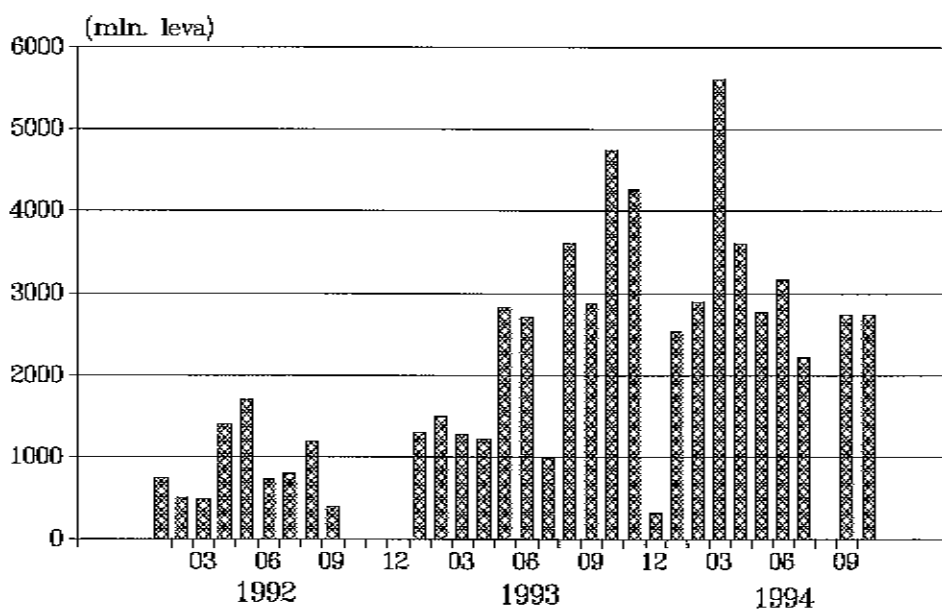
1. Cash deficit; 2. Payments to BNB; 3. Matured treasury bills; 4. Payments to commercial banks; 5. Payments abroad.

* Contribution to the growth rate of the PSBR (October 1993/December 1992)

Source: MF, AECD

In a new move, since March 1993 the budget deficit has been financed exclusively by government securities issues. Their terms of maturity follow a highly irregular time schedule which will extend into 1994.

Treasury Bills Maturities by Months*



* Maturities are referred to the issued securities up to the end of October.

Source: BNB, AECB

14. In the industrialized countries a diverse set of instruments is applied in budget deficit financing and government debt management. In Bulgaria two kinds of instruments are available: issuing money to cover budget expenditures (inflation, inflation tax, seignorage⁷) and restricting credits to the non-government sector. The former was more extensively applied in 1992, and the latter - in 1993.

Both instruments, as they are applied, have an adverse impact on the overall economic environment in the country. Unlike the non-financial sector, the budget borrows at preferential interest rates. The market environment is thus deformed, since commercial banks offset

⁷ Seignorage represents the Central Bank revenues from the manufacture or issuing of money (ready money and commercial bank reserves). They are a major fiscal revenue under chronic deficits and it transferred to the budget by the Central Bank. The inflation tax represents the capital losses of holders of non-interest assets (money in circulation and reserves) because of inflation. The higher the inflation, the higher (as a rule) the seignorage (and the inflation tax).

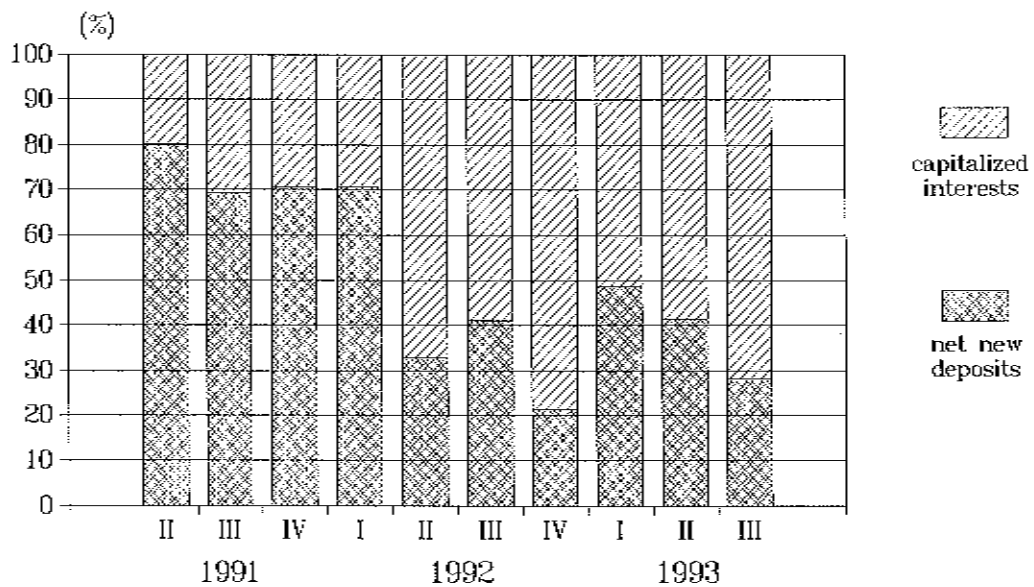
their losses from subsidized credits to the budget by higher interest rates and premiums on the other financial operations. By inducing high interest rates the budget sustains the level of inflation.

The accumulation of large short-term debt may inflict a liquidity crisis on the budget, should the banks refuse to roll over the maturing government securities. Such a danger can be averted either by monetizing or consolidating the debt. One instance of debt consolidation was the Ministry of Finance decision in December 1993 to repurchase government securities maturing in early 1994 in exchange for 12-month interest-bearing bonds.

Savings and Domestic Debt

15. Given the lack of external savings, households remain the only net creditor in the economy. Household savings have been re-channelled to credits for loss-making enterprises, and since 1991 - for credits to the budget.

Share of Net New Deposits and of Capitalized Interests in the Growth of Time Deposits



Source: AECD

This makes household savings of crucial importance to the overall financial equilibrium. The amount of household deposits depends on the interest rate fluctuations. This trend is reinforced by the re-channelling of time deposits towards liquid components.

In 1993 the dynamics of savings reached a shaky ground. Adjusting for interest accrued, the net growth in savings amounts to a bare 20%.

Bad Debts and the Budget

16. Covering enterprise bad debts by government bonds is in fact a transformation of quasi fiscal (financed by the banking sector) into truly fiscal losses (financed by the government budget).

There is a wide-spread assumption that the writing off of bad debts would be critical for the public finance. This is a one-sided view which emphasizes the effect in the short run. Bad debt settlement is, in fact, a rearrangement of the consolidated balance of the public sector⁸ which does not influence its cumulative wealth. National accounts do not distinguish between commercial bank financing of loss-making enterprises by BNB loans or by transfers from the budget which is subsequently monetized. Both methods are inflationary. However, the failure to achieve a bad debt settlement now would generate considerably larger fiscal losses in the future.

The tackling of the bad debt issue does not rule out the need to close down the unviable enterprises. Bad debt settlement would be incomplete without the simultaneous enacting of a bankruptcy legislation.

⁸ The public sector is that part of the economy governed and operated by the budget and state enterprises. The consolidated public sector links the financial flows of state enterprises with the budget.

17. In September the government put forward a draft decision on bad debts which followed a simple logic and made headway in that direction. The slow Parliament response and the continuing debate on the issue encouraged the low financial discipline of both debtors and creditors.

The budget has four „simple“ options for the solution of the bad debt problem.

1°. A quick privatization of state enterprises. Their bad debts are exchanged for equity, with no ensuing budget expenditures on their servicing.

2°. Ensuring a sufficient primary budget surplus for bad debt servicing.

3°. Covering bad debt payments by short-term securities.

4°. Covering bad debts by BNB credits.

The first option, involving bankruptcies, gives the most favourable medium-term prospect for economic recovery. The second option requires a primary surplus of at least 3% of GDP which is equal to non-interest expenditures of up to 34% of GDP.

In order to avoid the excessive overloading of the banking system, the budget should accumulate a primary surplus of over 9% of GDP in 1994 which equals a rise in revenues or a decline in expenditures to the same amount. However, the issue of tax neutrality comes to the fore: if the budget should service the bad debts of **some** state enterprises by **higher** taxes on **all** enterprises, wouldn't it aggravate the financial condition of all enterprises? The bankruptcy option is more suitable than the fiscal settlement of bad debts.

Although government securities and BNB credits can be applied together in a given ratio, the third and fourth options will yield similar results: trying to settle a 75 bn leva debt, the budget will end up

with twice as large debt at current prices. In addition, the budget should rely on extensive commercial bank financing which will exhaust the banks' credit resources.

MONETARY POLICY PARALYZED

18. Developments in 1993 made it plain that monetary policy cannot sustain the pace of economic reform on its own. It can balance the market and stabilize the economy for a time, but is ill-suited to handle structural problems and stimulate economic activity.

In 1993 the irrational structure of money flows was further intensified. Interest arrears on bad debts and the rising borrowing requirements of the government mainly determined the growth of credit aggregates. BNB's inconsistent interest-rate policy further undermined the confidence of economic agents.

There is an emerging trend for a higher growth rate of fiscal borrowing requirements than of the deposit base which exerts a steady inflationary pressure. There is a real danger of monetary policy losing its flexibility because of its passive conformity to fiscal needs.

Monetary Policy Versus Foreign Exchange Policy

19. In 1993 economic policy tools were assigned different weight, with monetary and foreign exchange policies having to make up for the „ruptures“ in fiscal and incomes policies. Inflation steadied down in the last two years due to the cumulative effect of the moderately restrictive monetary policy and the stable exchange rate. The real overvaluation of the leva served as an anti-inflationary anchor.

The uneven distribution of weight among economic policy tools was clearly manifested in the foreign-exchange market panic in October/November. It displayed the destabilization potential of „loosening“ the

exchange rate anchor. This was yet another indication that the Central Bank is not able to carry out an anti-inflationary policy **all by itself**, and hinted at the possible aftermath of a BNB failure to maintain its stance.

20. Unlike previous critical situations, the October/November crisis on the foreign market resulted from the interplay of several adverse trends and ill-timed responses.

- The initial impetus came from the rise of the USD against the major European currencies.

- The crisis was heavily influenced by psychological factors. The announced severe deterioration in budget implementation and the devastating official statements on that undermined public confidence in the ability of the economic policy to put things under control.

- Market anticipations were shaped to a great extent by the widely-publicized opinion of the BNB Governor that the further real overvaluation of the BGL could hardly be maintained. This was substantiated by the lowering of the base interest rate in August. The BNB argued there was a need for closing the differential between the rate of the leva inflation and the depreciation of the BGL/USD exchange rate, which practically meant a course to a more or less fixed real exchange rate of the BGL. Such a policy would inevitably weaken the inflow of short-term capital which, under the current financial isolation of the country, would lead to the destabilization of the foreign market and a loss of confidence in the BGL.

The interplay of these factors generated the currency substitution in the second half of October which unfolded in November. Any further development of this process would have crippled BNB's efforts in implementing monetary policy.

21. BNB's initial response to the foreign market crisis was slow and indecisive.

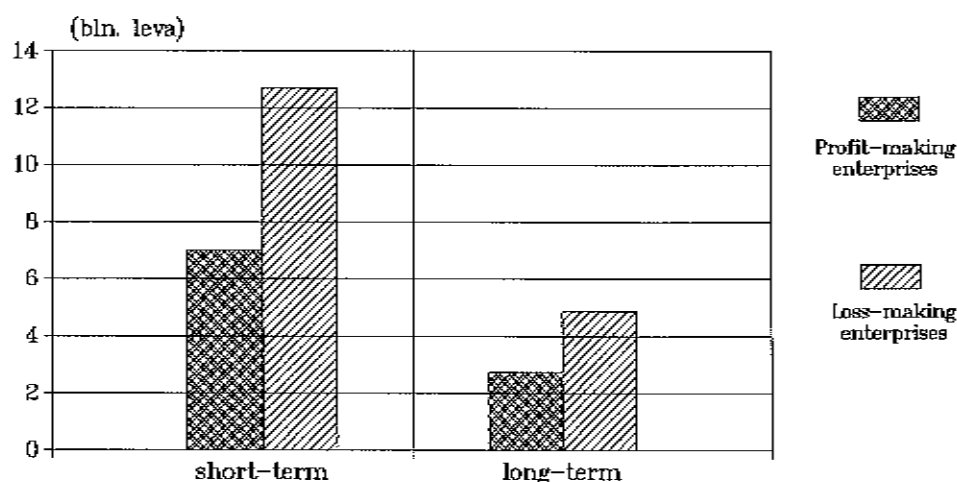
This led to a consequent firm tightening of monetary policy to fight the depreciation of the BGL, which, however, entails negative side-effects.

The new aspect in this particular foreign market crisis related to the behaviour of the money market regulator: first to induce certain expectations, and then to fight them with excessive effort and at high cost. The confidence both in the BGL and in the policy of the Central Bank was seriously shaken.

Monetary Policy and the Real Sector

22. Credit flows in the economy now depend on the gravity potential of bad debts. The credit ceilings of commercial banks have been „eaten away“ by mounting credit outstanding due to interest arrears on bad debts. The growth in bad credits comprised about 95% of the overall growth in the business sector credit outstanding in the first ten months of 1993. The growth in interest arrears represented two-thirds of the amount.

Allocation of the Extended Loans to State non-Financial Enterprises*



* January - September 1993

Source: NSI, ABCD

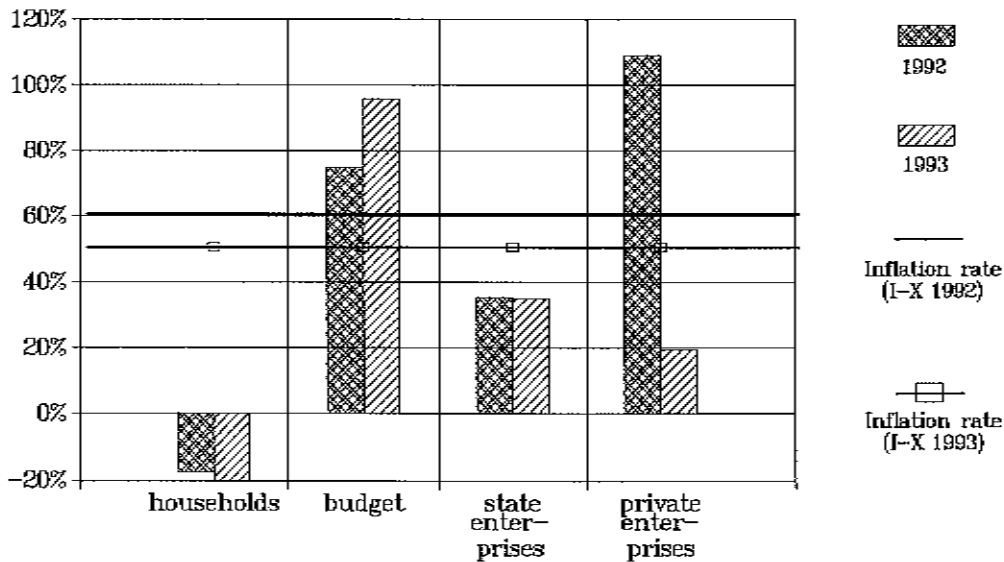
As the figure shows, profit-making firms are being crowded out of the credit market. Although commercial banks are shifting the emphasis onto more credit worthy payers, on the whole insolvent enterprises still attract half of the available credit resources.⁹

The Crowding-out Effect

23. The budget acts as a second gravity hole, absorbing resources in two ways.

In the ten-month period of 1993 credits to the government covered nearly half of the growth in domestic credit.

Change in the Indebtedness of the Main Institutional Sectors to the Banking Sector*



* October to december

Source: BNB, AECD

Since 1990 commercial banks have been channelling household deposits toward enterprises and the budget whose sustained indebted-

⁹ This relates to the overall credit turnover - the amount of credit extended in the period without relation to its partial or full repayment, while the previous paragraph referred to the distribution of the growth in credit outstanding.

ness has been gradually „eating away“ the credit portfolios of commercial banks. Whereas in 1992 the revenues of the banking system exceeded expenditures by over 10 bn leva, in the first half of 1993 interest payments exceeded interest revenues by 3 bn leva due to the growth in bad debts. Commercial bank losses (some 10 bn leva by the end of October) and provisions have lowered the expected budget revenues from financial institutions several-fold. This was a major factor behind the growing budget deficit and required additional securities issues which, in turn, crowded out the business sector of the credit market even further.

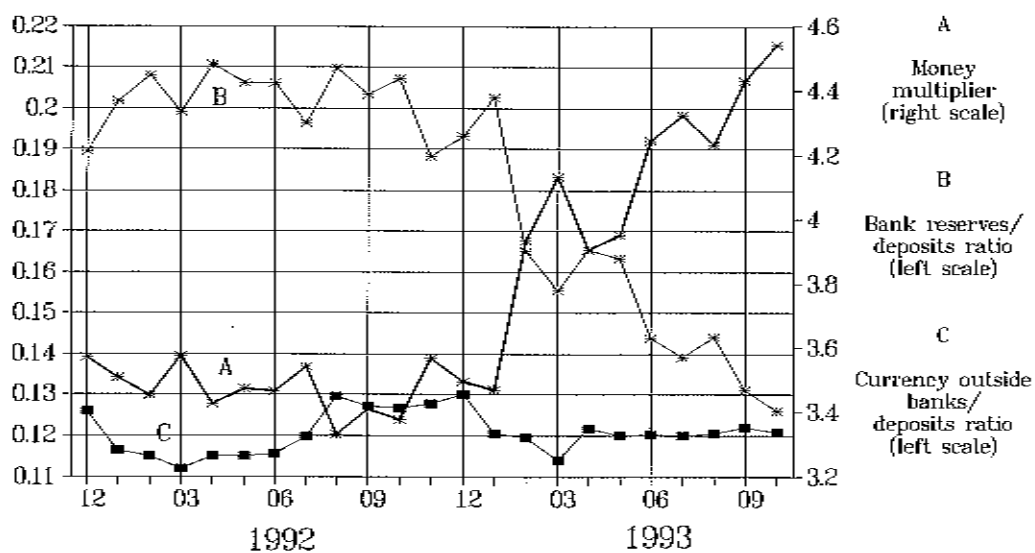
Since the turn of 1993 the government debt has been growing faster than credit resources and inflation. This indicates an intensive crowding-out of the non-government sector and an increase in the real government debt. The only institutional sector to increase its real debt was the government sector. The ratio of domestic government debt to credit resources in leva rose by 10 percentage points against the end of 1992. Even if budget expenditures are rationalized, the accumulated debt requires additional budget restrictions in the future.

The Management of Monetary Aggregates

24. By controlling reserve money and credits, the Central Bank is still able to keep the money stock growth below the inflation rate near the expected nominal rise in GDP.

The moderate growth in the money stock has been due to the much lower growth in reserve money, resulting from the restrictive BNB policy on commercial bank refinancing and the rise in the money multiplier. (From 3.5 to 4.5 over the ten-month period).

Money Multiplier*



* Broad money / reserve money

Source: BNB, AECD

At the end of October the money stock amounted to over 80% of GDP, reaching 217.8 bn leva. In 1994 this ratio is expected to fall due to the rechanneling of savings towards the capital market which has already attracted substantial financial resources of firms and households. This will provide a new source of financing for prospective enterprises that are rationed at the capital market. The sale of government securities outside the banking sector will also reduce the monetary aggregates, making them easier to be managed by the BNB. In the first half of 1993, however, commercial banks sold only about 1% of the net government securities issue to firms and private citizens.

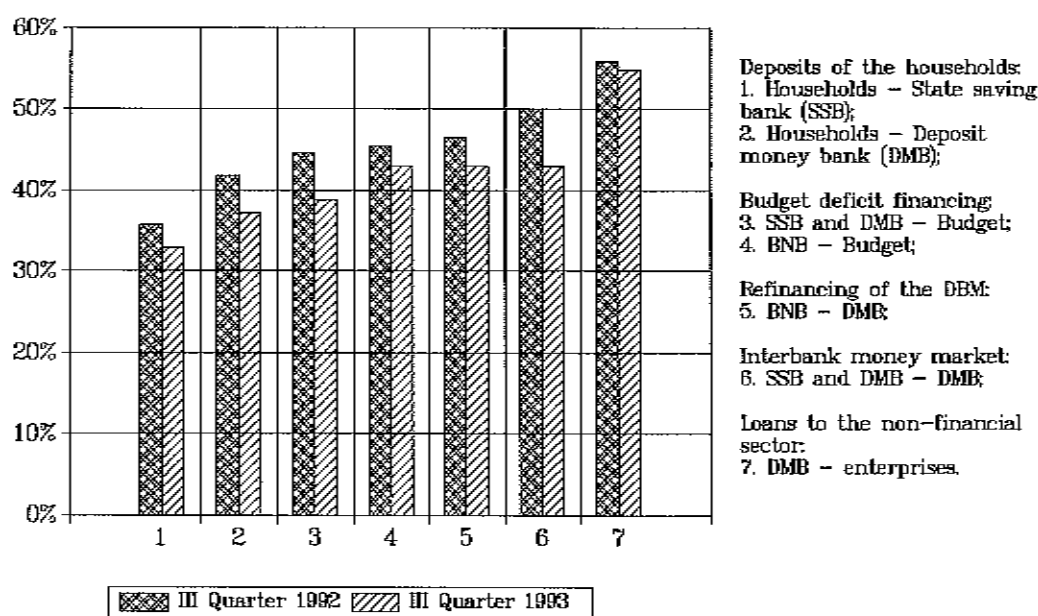
Structure of the Interest Rates and Financial Flows

25. The response of households, investors and exporters to interest rate changes comes in unpredictably long lags. The frequent changes of the base interest rate have had a destabilizing rather than

a regulative effect, making its seasonal adjustments inefficient. The burden of bad debts has made state enterprises practically insensitive to interest rate changes.

Without any justification, the BNB continued its indecisive 1992 interest rate policy throughout 1993. It made a record number (six) of changes in the base interest rate on „seasonal“ grounds. In the final count, the year-end level of the base interest rate was 1 percentage point higher than in the beginning of the year.

Interest Rates on Leva Transactions
Between the Sectors of the Economy



Source: BNB, AECD

26. The structure of interest rates in the Bulgarian economy is based on the following principles:

1°. The government is the most favoured institutional sector. It receives credits from the BNB, the commercial banks and the State Savings Bank (SSB) at the lowest interest rates;

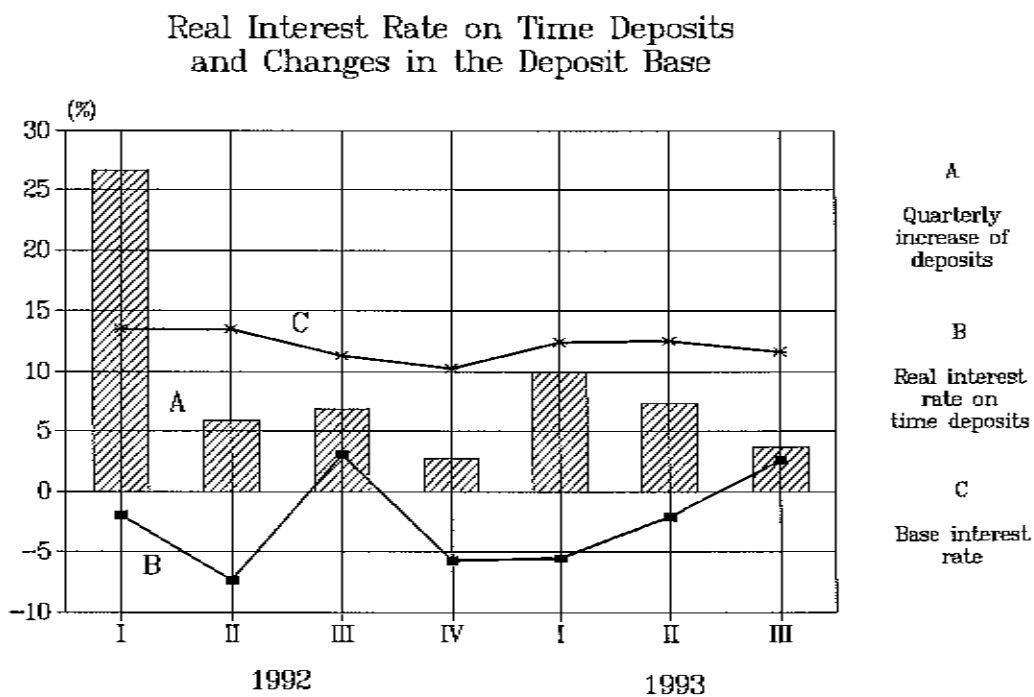
2°. Commercial bank refinancing is extended by the BNB at higher interest rates. The alternative credit source (the interbank market) offers more „expensive“ resources;

3°. Highest are the interest rates on commercial bank credits to the non-financial sector;

4°. The lowest interest rates are paid on bank deposits.

This structure reflects the degree of risk in the economy. It sustains the direction and volume of the existing irrational financial flows. The main circuit is the flow of „cheap“ resources from households to the budget and the banking system which, in turn, rechannels them (at a great risk and a high cost) towards the non-financial sector.

27. The response of separate sectors to interest rate changes tends to be stable.

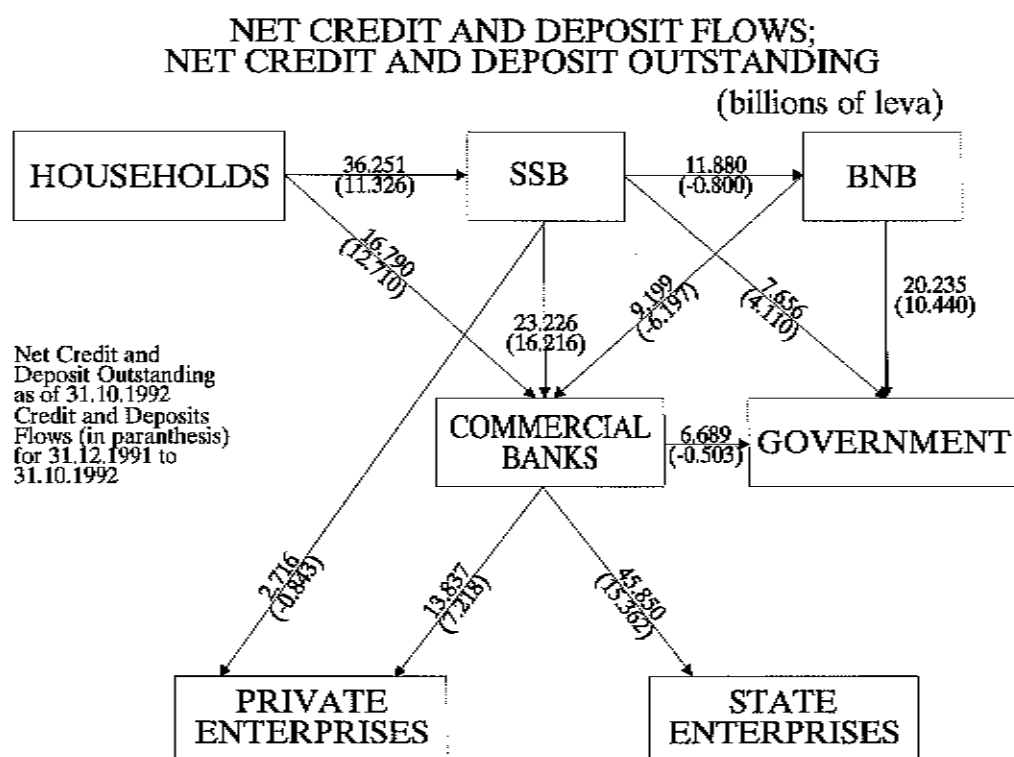


Source: BNB, AECD

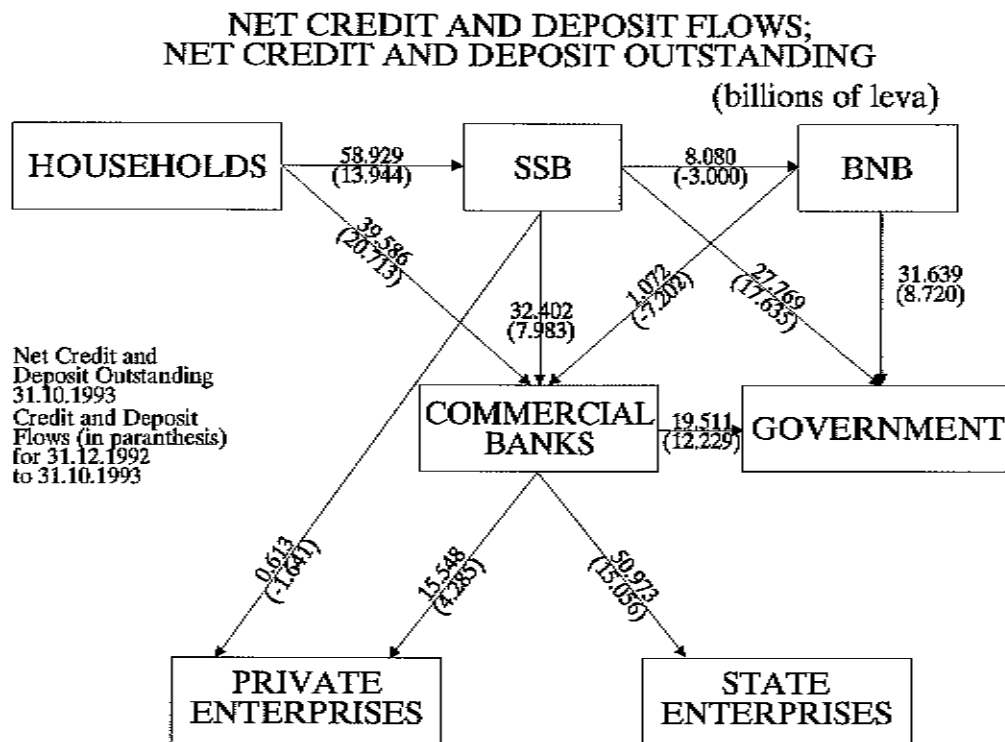
By the first quarter of 1993 households and firms responded as expected to the changes in real interest rates: the lowering of interests on deposits limited the growth in time deposits and vice versa. Since the turn of 1993 the share of net savings at relatively high interest rates has been falling. Therefore, interest rates have ceased to be the major factor determining the behaviour of savers.

The spread between interest rates on new credits and interest rates on commercial bank refinancing by the BNB continued to grow. Nevertheless, interest rates on new credits change in parallel with changes in the cost of refinancing.

28. The diagrams¹⁰ outline the changes in the financial flows between the institutional sectors of the Bulgarian economy.



¹⁰ The diagrams describe the credit flows only. The remaining money liabilities and receivables of institutional sectors (taxes, subsidies, wages) are not included.



1°. The flow of household deposits is restructured into commercial bank deposits.

2°. SSB financing of the budget takes up an increasing amount of its assets, restricting the SSB's ability to finance commercial banks and private businesses.

3°. Commercial bank refinancing by the BNB is sharply reduced.

4°. There is a slowdown in the growth in commercial bank credits to private businesses which are crowded out by the flows towards state enterprises and the budget. □

EXTERNAL ISOLATION

„A civilization will always attract barbarians. They are stronger and, unfortunately, instead of integrating into the civilization, destroy it.“

Sir Steven Runciman

29. In 1993 Bulgaria found itself in the worst possible external isolation. The suspension of the stand-by agreements with the IMF and the lack of compensatory financing from other institutions was added to the existing isolation from foreign financial markets.

The country's isolation was reinforced by the UN embargo on Serbia and Montenegro which closed the shortest route of Bulgarian exports to Western markets, as well as by the delay in the signing of the Association Agreement with the EU which made it clear that the Union should not be regarded as a stability anchor for Bulgaria. The country was and will be suffering from the protectionist ideology of Western countries and the mounting institutional instability in the EU itself.

All these factors „easterized“ the attitude to Bulgaria, enhanced its geopolitical isolation and forced it to use rather „barbarian“ means in trying to overcome the adverse historic and cultural legacies.

30. The external environment in 1993 cut off the Bulgarian economy from foreign financing and contributed to the deteriorating balance of payments. The country had two alternatives: either to impose stronger fiscal restrictions to adjust to the lack of foreign financing, or to loosen up the fiscal and incomes policies. The internal political setup imposed the second option of least resistance.

Under favourable developments in Bulgaria, a fundamental change in the external economic environment may be expected in 1994. The external debt deal, the resumed credit flows from the international financial institutions and the Bulgarian Europe Agreement may attract external financing to the country. This would allow more freedom but impose greater responsibility on economic policy decision-makers.

The Foreign Exchange Market

31. In 1993 the foreign market continued to service current payments of the country to a satisfactory degree. The volumes traded over the ten-month period exceeded the 1992 annual volume.

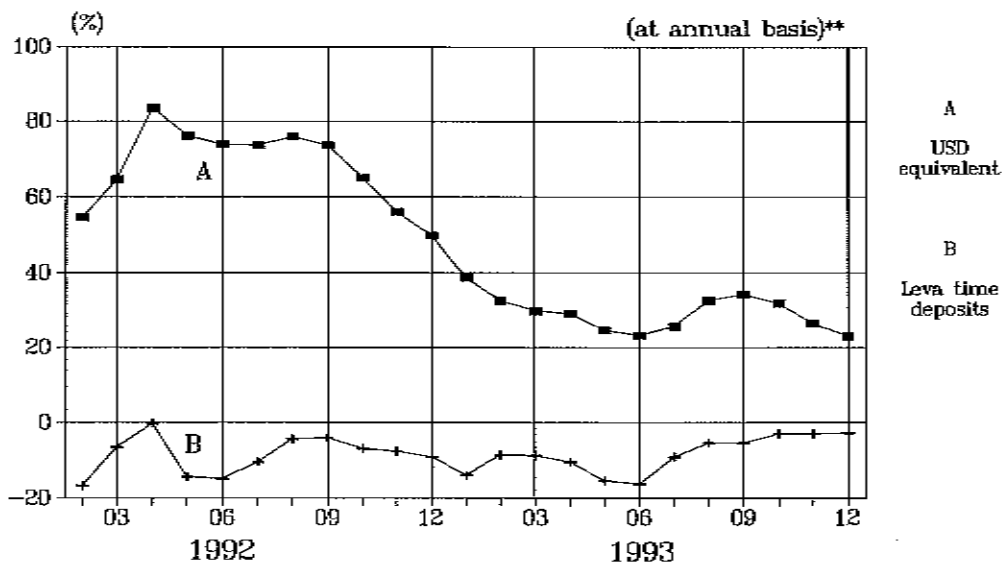
By the end of November commercial banks had accumulated 136 mln USD while BNB net sales amounted to 44 mln USD. Only 58.2% of foreign currency bought and 55.6% of currency sold came from customer transactions.

The BNB share of the market is about 11%. Therefore, the Bank can hardly be considered to artificially sustain „a certain level“ of the BGL/USD exchange rate. Transactions between fully licensed commercial banks comprise one-fourth of the market volume. The exchange rate was more stable in 1993 despite the two deep crises that shook the foreign market.

The speculative crisis still generate a stepwise appreciation of the exchange rate, whereby the depreciation of the BGL is not offset by the following downward wave.

32. The foreign market did not respond as expected to all the „fundamental“ factors which determine the exchange rate.

Real Interest Rates on Leva Time Deposits and Their Potential USD Equivalent*

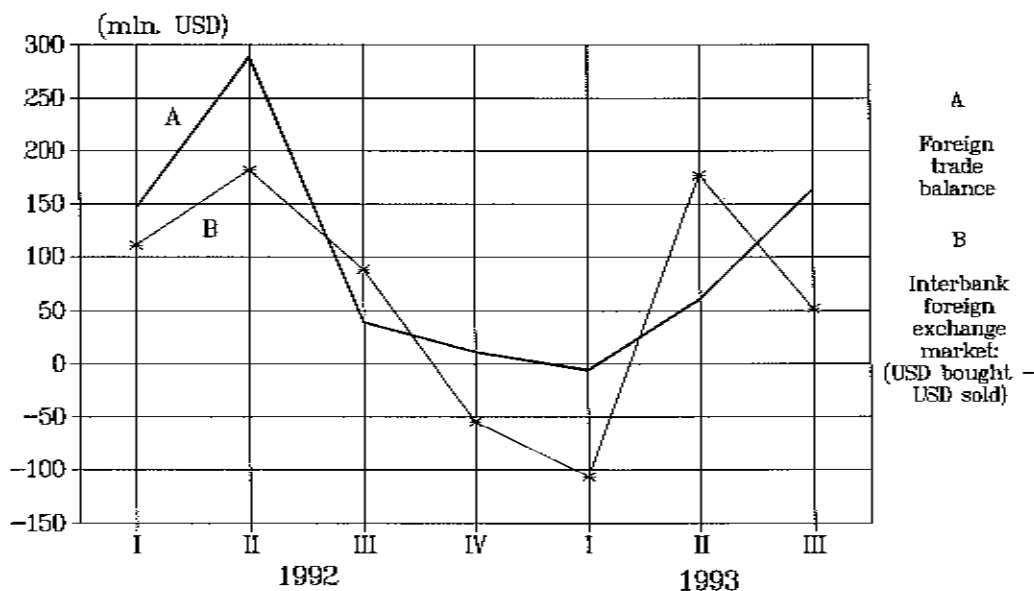


* Yield on USD, if converted into leva deposits.
 ** 9-months moving averages.

Source: BNB, AECB

The exchange rate movement is ultimately directed by the existing interest differential between the leva and currency deposits and the interventions of the Central Bank. The interest differential adequately explains the stability of the exchange rate, the depreciation of the BGL and the time deposit dynamics in the banking system.

Foreign Trade Balance and Net Position of the Interbank Foreign Exchange Market



Source: BNB, AECB

The comparison between the foreign market balance and the BNB-estimated trade balance confirms the inflow, although falling, of foreign currency in 1993.

Trade Flows

33. The large export volume in 1992 was followed by a substantial fall. Figures show an export decline by about 100-150 mln USD on a quarterly basis, almost entirely due to the fall in agricultural and mechanical and electrical engineering exports.

Agricultural exports declined by about 50% over the nine-month period, due to their large volume in 1992 and the continuing crisis in the agricultural sector. The surplus in trade with agricultural and food industry products fell from 419 mln USD in 1992 to 265 mln USD in the first nine months of 1993.

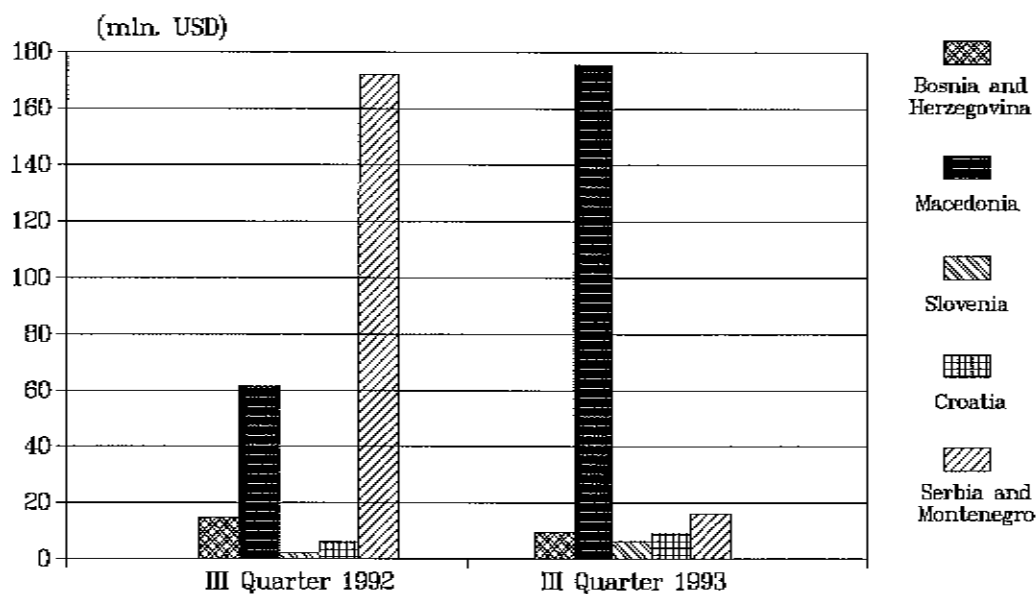
The geographical structure of exports followed the established trends. The Bulgarian Europe Agreement is expected to work no miracles. Given the present recession in the EU countries, the Union will not lift the protectionist measures off the „sensitive“ sectors despite the formal trade liberalization under the Agreement. The Europe Agreements of the other Central and East European countries also attest to that.

The UN Embargo on Serbia and Montenegro

34. The macroeconomic assessment of losses from the embargo is naturally based on the balance of payments.

The embargo did not have any strong immediate impact on trade with former Yugoslavia. Export reorientation to Macedonia after mid-1992 has almost offset the loss of markets in the embargo zone.

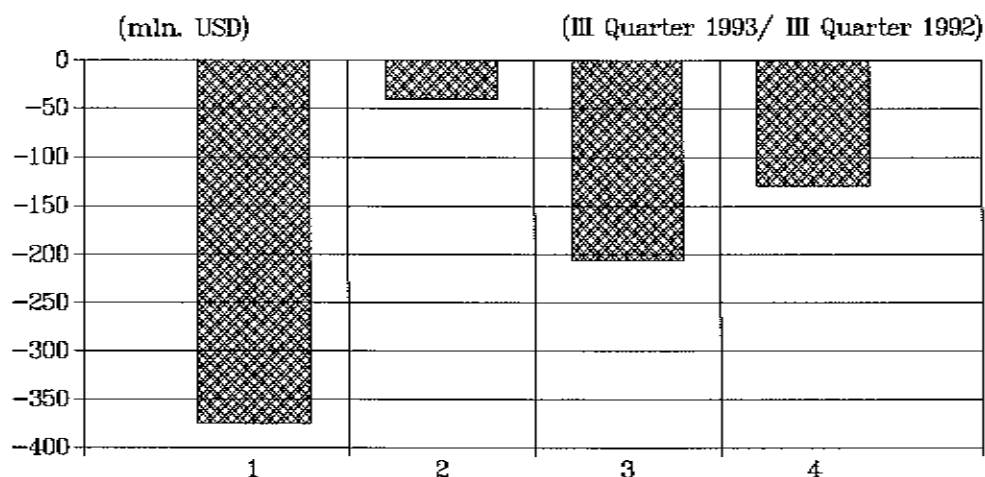
Exports to Former Yugoslavia's Republics



Source: BNB, AECD

The UN sanctions on former Yugoslavia partially account for the substantial decline in Bulgarian exports to the EU. In a natural response, the share of Bulgarian exports to Greece and Turkey increased, though at worsened terms of trade.

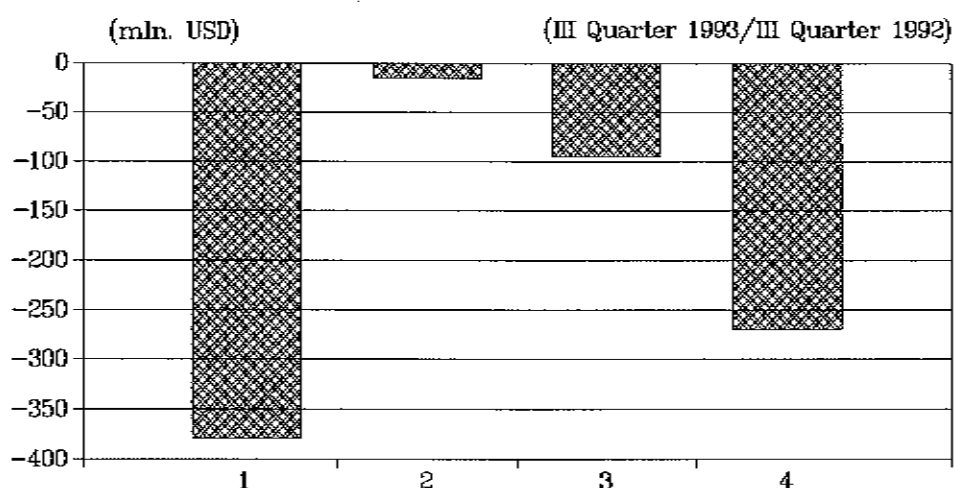
Contribution of the Decline of Exports to Former Yugoslavia and to the EC in the Decline of Total Bulgarian Exports



1. Decline of exports - total;
2. Decline of exports to the republics of former Yugoslavia;
3. Decline of exports to the EC;
4. Decline of exports to the rest of the world.

Source: NSI, AECD

Contribution of the Trade with
Former Yugoslavia and with the EC
to the Net Change of the Bulgarian Trade Balance



1. Net change of the trade balance - total;
2. Change of the trade balance with former Yugoslavia;
3. Change of the trade balance with the EC countries;
4. Change of the trade balance with the rest of the world.

Source: NSI, AECD

The embargo had a negligible negative impact on the 1993 trade balance. The deterioration of the latter was due mostly to changes in the trade with the EU and other countries.

The remaining current account positions in the balance of payments do not indicate any direct impact of the embargo. In 1993 incomes from tourism and international freight transport recorded the highest values in the last few years.

The foreign exchange rate and monetary policy were indirectly influenced by the embargo through foregone customs duty and profits-tax revenues. No decline was registered in budget revenues from customs duties and fees.¹¹

Overall, the effect of the embargo and its gradual lifting-off will be to blur the economic borders of the country and to raise uncontrolled shipments to former Yugoslavia through Bulgaria.

¹¹ This is due partly to changes in tariffs, effective from mid-1992.

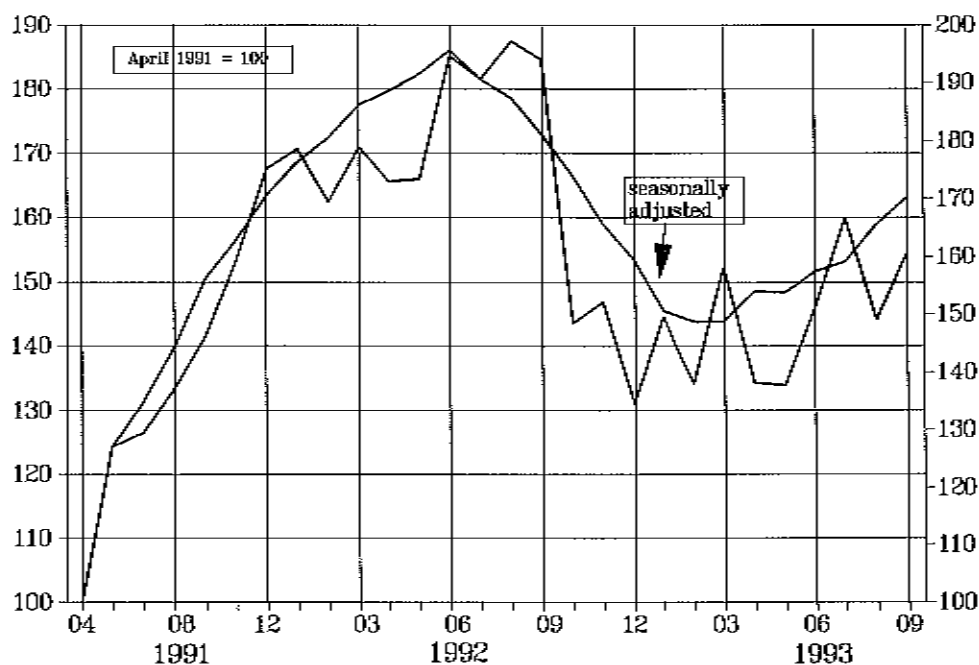
Competitive Pressures

35. The external isolation of the country has downgraded the „classical“ indicators of its competitive position.

1°. The NSI entrepreneurial surveys outline the psychological response of producers to the real appreciation of the BGL. The share of enterprises identifying competitive imports as a reason for production difficulties has sharply risen since March 1993. The „expensive“ lev enhances the competitive pressure of imports on exporters to cut their expenditures, thus curbing inflation. It is one of the reasons for the much slower increase in producer prices as compared to retail prices. The overvaluation of the BGL increases the purchasing power of incomes since households spend a large part of their income on imported goods.

The „overvalued“ BGL cuts down the profits of exporters whereas the producers' complaints of an „expensive“ lev pursue the legalization of higher production costs and the related larger enterprise decapitalization.

Unit Labour Costs in Industry



Note: Wage bill data not available for June and September 1991

Source: ABCD

2°. The dynamics of unit labour costs in industry indicates a growing share of wages in the value added. No national economy could hold a strong competitive position under a similar structure of expenditures.

Protectionism on the Rise

36. The unfavourable changes in the external economic environment have built up the pressure for protectionist barriers to imports. „Piecemeal“ demands have already been channelled into organized lobbying.

In mid-1993 the Council of Ministers Decree No.121 amended the customs regime, enhancing its protectionist measures. Ensuing changes pursued the same effect, being justified by the need for a steady budget revenue schedule.

37. Trade policy in 1993 had the following characteristic features:

1°. The government adopted a package of anti-dumping and safe-guard measures against subsidized imports.

2°. The foreign trade regime was more unstable, with a prevailing departure from its more liberal frame in 1992.

3°. Urgent measures were taken against the inefficient control on the customs valuation. It was unjustified to tackle administrative problems by tariff measures.

The increase in budget revenues was the ultimate aim of the stronger customs protection. The latter reduces the export orientation of the economy due to the more expensive traded inputs and the reorientation of producers to more profitable sectors.□

THE PRIVATE SECTOR

38. The difficulties in assessing the scope of the private sector are well-known. Estimates from various sources draws a general picture which has nothing to do with the cliché for a „90% state sector“ in the economy.

The economy of transition cannot be parcelled out into „forms of ownership“ according to the rigid classification of Marxist economics. Ownership forms in the Bulgarian economy have never been so ambiguous as at present.

The groundwork for privatization and the instances of secret privatization have radically changed the strategy of state firms. They behave neither as purely state, nor as purely private economic agents. The emerging private sector does not abide by explicit rules and budget constraints. Moreover, it does not exist in a pure form in any sector of the economy.

The most active processes in the Bulgarian economy are unfolding in the contact zone between the state and the private sector. Any estimates on the private sector scope and weight in the national economy should be regarded only as the lower limit.

39. According to latest official estimates, the private sector accounts for 18.5% of GDP. It predominates in agricultural sales, retail trade and a number of foreign trade items.

AECD estimates put employment in the private sector at about 900 000 people at year-end 1993. Given the stable unemployment cohort, the growth in private sector employment throughout 1993 offset the fall in state sector employment.

The private sector share in the national capital will continue to expand with the amount of restituted assets which are the „purest“ form

of ownership transfer. At the end of June 1993 they reached 6.1 bn leva, 54% of the assets claimed for restitution, worth 11.3 bn leva. The private sector has also got a sizable share in the financial flows between non-financial enterprises. Data from the Bank Consolidation Company on private bank assets (16%) should be treated with utmost care due to the recent scandals in the banking system, the emergence of banks capitalized by SSB credits and the absence of bank supervision.

The situation in agriculture is indicative of the harmful effect from the absence of legitimate owners. Whereas the private sector in stock-breeding is rapidly growing and gaining predominance, AECD estimates indicate that the 1993 crop output is expected to decline more in the private sector than in state farms. As compared to 1992, private arable land increased by only 2 percentage points, reaching 29%. Since the start of the land reform, the growth in privately cultivated land as assessed by the NSI in its annual statistics on perennial crops, has been small. Land holdings restituted within real boundaries were mostly at the expense of the plots allocated for „personal use“ before the reform outset.

The unsettled property rights in agriculture together with the interim regime for land use have had an adverse impact on the output volume, the structure of supply and the amount of arable land. The interim regime imposes certain restrictions and makes the situation rather unstable. This is substantiated by the fact that in 1993 uncropped land was twice as much (9%) as in 1992.□

DEPRESSION OR RECOVERY?

40. One of the most pointless, and therefore much discussed, issues with clear political overtones is whether economic recovery is imminent.

The most ambiguous and controversial stage in the analysis of the business cycle is to determine the turning points in the economic dynamics. A turning point would be the moment of a **permanent** reversal in the main trend of development. Under Bulgarian conditions, any of the following developments may be interpreted as a turning point: a considerable slowdown in the pace of recession, a transition from recession to depression, or a transition from recession to recovery.

The business cycle data available allow a rather precise assessment of the business cycle phase the Bulgarian economy is going through. The general conclusion is that in 1993 there was a considerable slowdown in the pace of recession and the state sector almost reached the trough. This, however, does not indicate an upswing to recovery; it may be indicative of a touchdown after the potential for a „free fall“ has been exhausted. The intensity of the possible recovery will depend on the nature of its underlying forces.

This assessment is based on the following indicators:

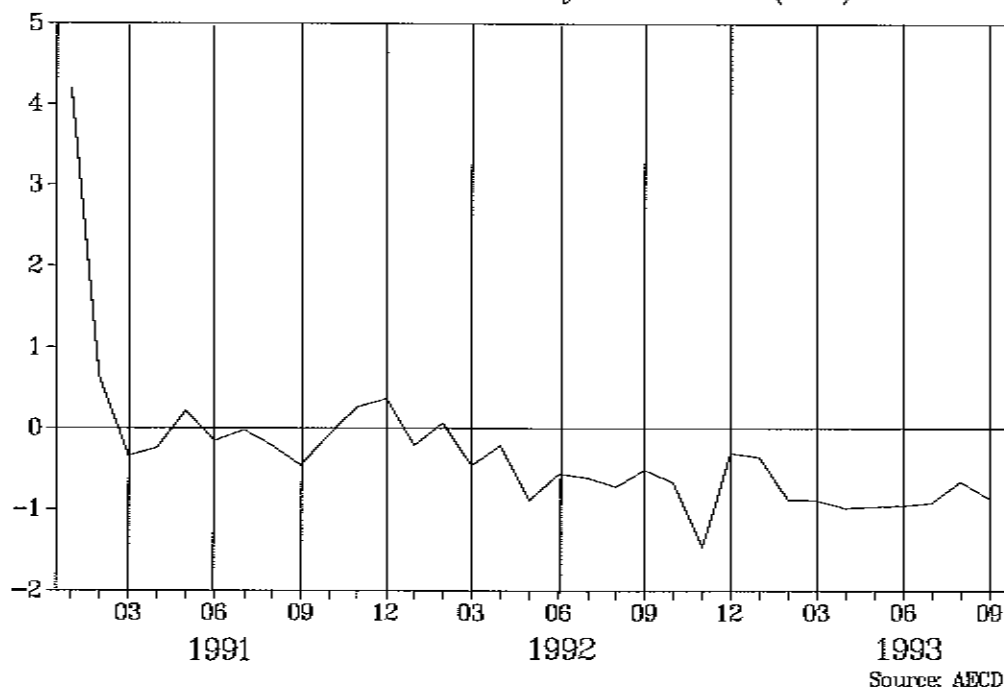
41. The business cycle indicators are indicative of the following:

1°. The steady low values of the Economic Activity Barometer throughout 1993 are typical for a depressive situation.

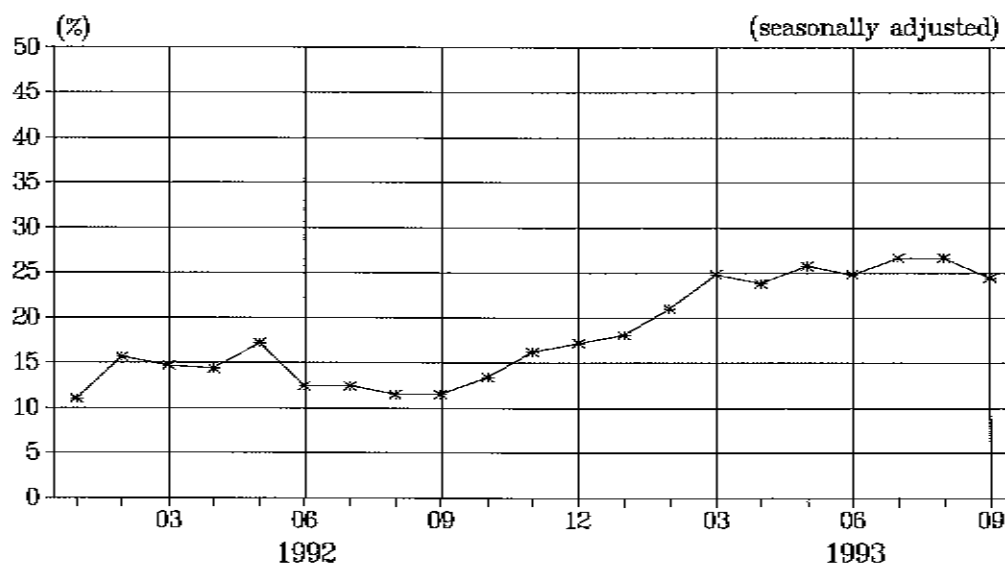
2°. Enterprises with growing sales have increased their share in total sales. It has steadied over 50% since April 1993, against an average of 30% in 1992.

3°. Branches with growing output have increased in number.

Agency for Economic Coordination & Development:
The Economic Activity Barometer (EAB)



Diffusion Index* - Industrial Output



* % of branches with growing output on a monthly basis. (Out of 15 industrial branches. Coal mining, electricity generation and oil-extraction have been excluded, because of their large seasonal fluctuations).

Source: NSI, AECB

4°. The entrepreneurial surveys identify the adverse financial conditions of enterprise, the low level of orders and competitive imports as the major difficulties in the real sector. Supply-side factors have

secondary importance for the business situation. This clearly indicates that a steady recovery is conceivable only after the removal of a number of structural obstacles and the financial recovery of the real sector.

5°. NSI data on the private sector issued in mid-1993 indicate that it is turning into a factor determining the overall dynamics of sales. According to AECD estimates the real growth in private sector sales in the first half of 1993 has entirely offset the drop in state enterprise sales. It is the first empirical proof that the overall direction of the Bulgarian economy is determined by the private sector growth and therefore the assumption of a continuous decline in business activity is entirely unjustified.

42. GDP and Its Components.

1°. BNB estimates show a 5.5% decline in GDP in the first half of 1993 compared to the first six months in 1992 when GDP decline was twice as high (12.6%). Overall for 1993, GDP is expected to have declined by about 4% against 5.5% in 1992.

2°. In the first nine months of 1993, household money incomes¹² rose by 2.6% in real terms. The wage bill¹³ in the state and cooperative sectors dropped by 13% due to the continuing fall in employment, whereas the average real wage has practically remained on its 1992 level. The growth in interest incomes, insurance indemnities and incomes from „other business activity“ has been higher than average. Incomes from „other business activity“ raised wages by an average of 35% in the nine-month period of 1992, and by 67% in the same period of 1993. Disposable money incomes of households increased on a faster rate (by 3.3%) than money incomes.

¹² Data from balances on household money incomes and expenditures.

¹³ The analysis of wage incomes is based on accrued wages which may differ in amount from wages paid.

3°. The growth in real incomes raised the real-term household expenditures on goods and services by 5% which approximated the growth in real consumption.

4°. The low degree of capacity utilization (54% at the end of September 1993) and the heavy indebtedness of enterprises in the real sector discourage investment. The registered increase of investments in GDP in the first half of 1993 resulted from a fixed assets revaluation. Over the nine-month period real expenditures on tangible assets fell by 22% against the same period in 1992.

5°. In 1993 the dynamics of finished product inventories differed from 1992, mostly due to export difficulties.

43. Sector Dynamics. Industrial output in 1993 oscillated within a narrower range of monthly volumes than in the previous two years. In the first ten months of 1993 industrial output declined by 7.2% compared to the same period in 1992, when it fell by 16.1%. The service sector is expected to register a sizable real growth.

The overall dampening of output decline in 1993 was counter-balanced by the low performance of agriculture. The slump in agricultural output is expected to reach 20% in 1993.

44. Employment. Steady level of employment is an important indicator of the stabilization of the business situation. The drop in state sector employment has grown weaker in comparison with the previous two years. Following the constant rise in joblessness since 1990 on, in 1993 the number of unemployed steadied down at about 600 000 people.

The increase in the unemployment inflow thinned out due to the slowdown in unemployment growth in the state sector. At the same time the average monthly number of unemployed deleted from registration

lists rose, intensifying the outflow. This was due to higher labour demand in the private sector and the weak motivation of unemployed to extend their registration in job centres beyond the term for receiving unemployment benefits. □

THE POLITICAL TWIST OF STATISTICS

45. 1993 made it perfectly clear that statistics would not achieve its deontology in the period of transition.

There are two reasons for doubt in the credibility of statistical data:

1°. The deontology of statistics is based on the credibility of data as acknowledged by economic agents. In a heavily politicized environment, the odds in favour of such acknowledgements diminish by the square number of the frequency with which governments change. The use of statistical data for legalizing the „achievements“ and the „failures“ of those in power turned into a common practice. The span of comparable time periods were reduced to the lifetime of a government. The sequential link between statistical data was lost; economic chronology was substituted for a political one.

2°. The second reason is grounded in the shortcomings in the issued statistical data. Frequent changes in the methodology, untenability of data as well as the lack of comparability in the time series have given rise to ambiguous interpretations.

46. Here are three examples:

1°. The new weighting scheme for CPI assessment as of January 1993 was necessary because of the obvious shortcomings in the old weights. This generated two kinds of distortions. Firstly, the NSI did not reassess past-period data making the figures for 1992 incomparable to those for 1993. This led to ambiguous interpretations of the indexation of incomes. Secondly, the new CPI slightly undervalues inflation as compared to the old method. This has sparked political allegations of manipulation and reduced the credibility of statistical data.

2°. GDP estimates had not been challenged so far. In 1993 the NSI re-assessed the 1992 GDP several times and the finalized figures have not yet been published. Such abnormal delays add to the familiar shortcomings in the very assessment, viz. the inconsistency between separate elements, the lack of appropriate deflators and the use of only one account conforming to the System of National Accounts (the production account).

3°. Customs statistics in foreign trade still suffers from serious errors. The discrepancy between preliminary and adjusted data is too large, making the short-term analysis of foreign trade flows impossible. The bias is so high as to accommodate a number of smaller commodity or geographic items. The effect of the bias is multiplied because the trade balance in the balance of payments is now based on the customs statistics.

47. From the viewpoint of economic policy, the lack of precision and credibility in statistical data has got two immediate consequences.

The difficulties in GDP assessment introduce arbitrariness into economic policy by making the scaling of economic processes impossible. The lack of a plausible GDP makes fiscal policy blind to the tax burden and the scale of the budget deficit, thus encouraging amateur assessments.

The instability of the CPI bears directly on indexation, whereas the regular wage indexation, in its turn, raises doubts in any price indice. □

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