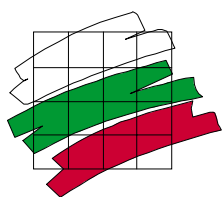


# BUSINESS SURVEY SERIES

## **BULGARIA 1997 ECONOMIC SURVEY**



**AGENCY FOR ECONOMIC  
ANALYSIS & FORECASTING**

31 Aksakov Str., 1000 Sofia, Bulgaria

---

© **Agency for Economic Analysis & Forecasting 1998**

31 Aksakov Str., Sofia 1000, Bulgaria

Tel. (+359 2) 980 04 84, 980 24 74

Fax (+359 2) 981 33 58, 980 93 22

e-mail: [aecd@ttm.bg](mailto:aecd@ttm.bg)

*All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, without the prior permission in writing of the Agency for Economic Analysis & Forecasting*

*Translated by Albena Toneva & Ventsislav Voikov.*

ISSN 1310-327X

*The assessment of the macroeconomic situation is made using data for the Bulgarian economy and the economic policy measures until October 1997.*

*No part of this publication may be reproduced without reference to the AEAf "BUSINESS SURVEY SERIES".*

---

---

Most of the European countries-in-transition managed to stabilize their economies and created conditions for economic growth. Bulgaria, however, was entangled in high and unstable inflation which blocked the efforts to stabilize the economy. Economic activity continued its slump after 1991, the rate of inflation accelerated in 1996 to 121% (up from 62% in 1995) to reach hyperinflationary levels in early-1997.

The economic crisis in the country in end-1996 and the beginning of 1997 was aggravated by pure political factors, namely the lack of confidence in the government. Therefore, the resolving of the political crisis in February 1997, the appointment by the President of the Republic of a caretaker government and the decision to hold early Parliamentary elections in April stalled almost immediately the development of the economic crisis. The first signs of financial stabilisation emerged in March. The depreciation of the lev came to a halt and the exchange rate of 3000 BGL/USD as of mid-February fell to 1589 BGL/USD in end-March. The February rate of inflation of 242.7% recorded a decline to 12.3% in March. Certain external factors also contributed favourably to the overcoming of the financial crisis, viz. the negotiations of a new standby agreement with the International Monetary Fund (IMF), the urgent loans extended by the IMF, the World Bank and the financial aid from the European Union. The successful conclusion of several big privatisation deals also added to the inflow of financial resources in the country and helped ameliorating the overall liquidity of the economy.

The economic policy measures undertaken after February, and especially after the general elections in April 1997, radically altered the economic environment in Bulgaria and bolstered the success of post-shock stabilisation.<sup>1</sup> The change of the principles for the

functioning of the central bank has been the major and most powerful pro-stabilisation factor since mid-1997. The scope of its action has been enhanced by better control over both the condition and credit policy of the commercial banks, the conservative fiscal policy implemented and the incomes policy. Thus, the necessary pre-conditions for paving the way toward sustainable economic growth were created.

The present survey will analyse the nature of achieved financial stabilisation (Part I) and the factors which contributed to this end (Part II). The analysis of the 1997 economic developments gives us reason to conclude that further application of a similar policy mix will be sufficient to sustain stabilisation in 1998.

Part III of the survey focuses on the problems of economic growth. The long-lasting high and volatile inflation and postponed privatisation substantially changed the structure of the national economy relative to its initial situation in 1990 towards a prevailing share of low-efficient branches and activities. Economic growth is attainable on condition that confidence in the long-term character of stabilisation is sustained and the re-structuring of the economy is accelerated through privatisation. □

---

<sup>1</sup> *Details on the economic policy measures undertaken by the caretaker government after February 1997 are presented in the Semi-annual Economic Review of the Agency „The Bulgarian Economy in the First Half of 1997“.*

---

# I. Financial Stabilisation in 1997

## **The New Laws on the Bulgarian National Bank and the Commercial Banks - Introduction of Hard Budget Constraints**

The Bulgarian National Bank (BNB) Act voted by the National Assembly on 5 June 1997 established new principles for the functioning of the Central Bank and changed the array of instruments for influencing monetary supply. From the traditional monetary policy instruments the BNB can only use the rate of required reserves whereas money issuing depends on the dynamics of the foreign exchange reserves of the central bank (the functioning of the Issuing Department is governed by the principles of the currency board).

According to the BNB Act, the Central Bank has the following functions related to monetary policy implementation:

- BNB cannot conduct open market operations (Article 56 of the BNB Act).
- BNB cannot lend money to the government or government institutions apart from credits against purchase of Special Drawing Rights from the IMF under terms stipulated in the law (Article 45 of the BNB Act).
- BNB cannot refinance commercial banks except in case of systemic risk for the banking system, and only up to a preset limit, for a period not longer than three months and against a full collateral of gold, foreign convertible currency or other highly-liquid assets (Article 33 of the BNB Act).
- BNB guarantees the free and unlimited exchange of leva to Deutsche marks and vice versa at a fixed exchange rate of 1000 BGL/DM (Articles 29 & 30 of the BNB Act).
- BNB is obliged to keep a sufficient amount of foreign reserves to back its money liabilities, i.e. banknotes and coins in circulation plus the

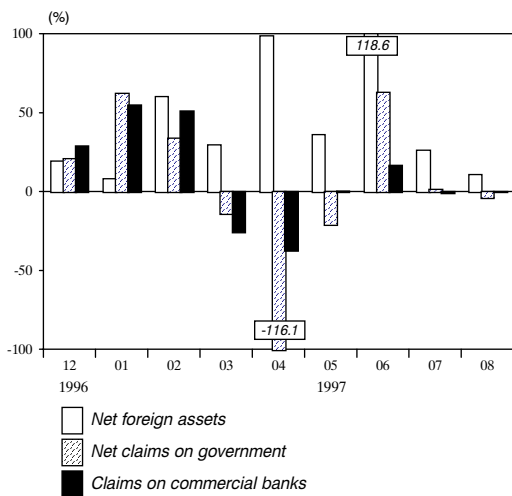
balances on accounts of other parties in BNB except for IMF accounts (Article 28 of the BNB Act).

The most important change of the issuing policy principles of the central bank imposed by the Law is the requirement to sustain full forex backing of BNB's money liabilities. Following the decision for the introduction of a currency board and the practical implementation of some of its principles as early as March 1997, the dynamics of the net forex assets of the Issuing department of the BNB became the main source of increase of reserve money.

The financial crisis in end-1996 and the beginning of 1997 was to a great extent due to both the imperfect banking sector legislation and the inefficient bank supervision. The amendments introduced in the new Law on Banks passed in June 1997 aimed at strengthening BNB's supervision of commercial banks and provided for better protection of the interests of both creditors and depositors. The main stipulations are the following:

- The procedures for bankruptcy and liquidation of insolvent banks were made more expedient. The suspension of the banking licence is subject to immediate execution and may not be appealed (Article 21 of the Law on Banks).
- The Bank Supervision department of the central bank was granted greater powers with regard to the appointment of managerial staff in the banks, the exercise of control over both the decisions of their governing bodies and the distribution of banks' shares by owners.
- The lending policy is subject to stringent rules while any possibility of granting large loans only by virtue of a personal decision of a member of the Board of Governors or the Board of Directors

**Composition of Reserve Money Changes\***

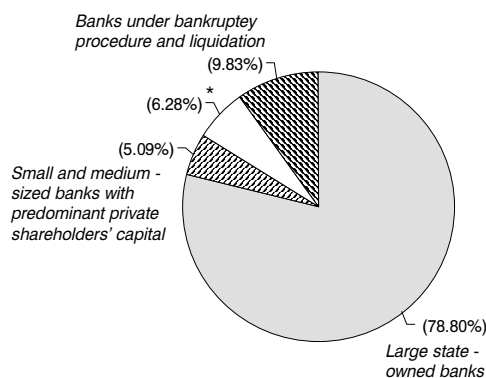


\* Contribution of the sources to the percentage change of the reserve money

Source: BNB

**Assets Distribution by Groups of Banks**

(as of 31.10.1997 e.)

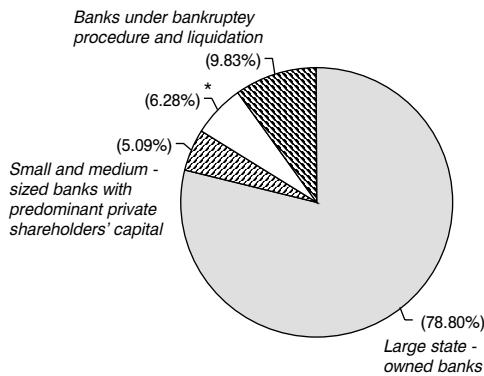


\* Banks with predominantly foreign shareholders' capital and foreign banks branches

Source: BNB, AEF

**Assets Distribution by Groups of Banks**

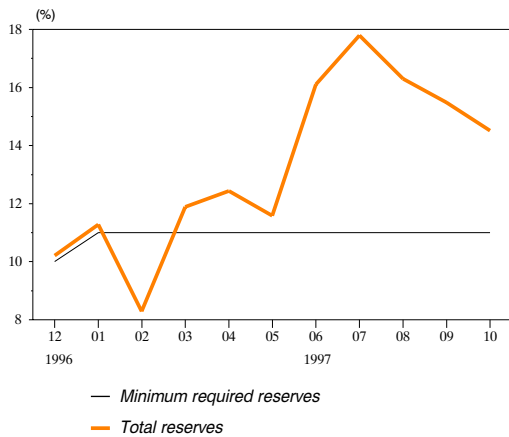
(as of 31.10.1997 g.)



\* Banks with predominantly foreign shareholders' capital and foreign banks branches

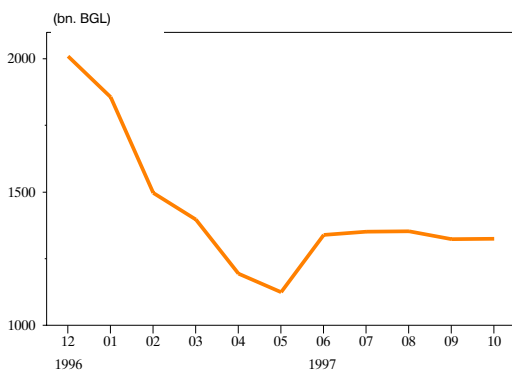
Source: BNB, AEF

**Commercial Banks - Required and Total Reserves at BNB**



Source: BNB, AEF

**Real Domestic Credit Change\***



\* Prices and exchange rate as of December 1996

Source: BNB, AEF

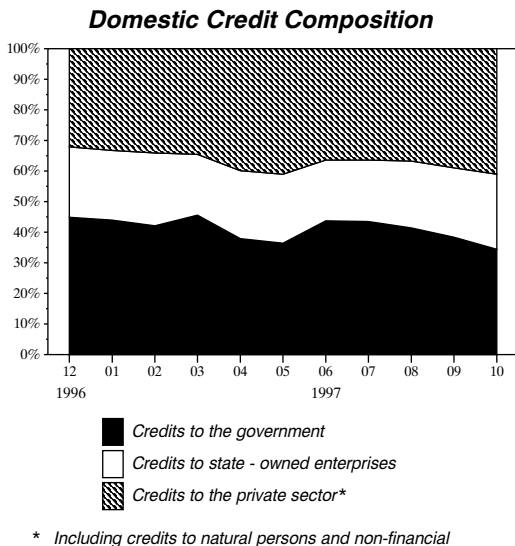
is excluded.

- The requirements and criteria for obtaining a banking licence from both local banks and branches of foreign banks were further increased.
- Commercial banks were obliged to present information on their financial condition and to publish every six months their balances and a report of the revenue and expense accounts in at least one central daily newspaper (Article 56 of the Law on Banks).

In 1996 17 banks were put under conservatorship due to negative net value and 13 of them were declared bankrupt in 1997. At the same time the banks' capitalisation improved and, as of 30 June 1997, the overall capital adequacy of the big state-owned banks and the small and medium private banks was 8.3% and 18% respectively. In September the capital adequacy of the banking system as a whole reached 18.6%.

The banks' liquidity has been improving since mid-1997. As of June 1997, the ratio money resources to attracted resources from non-financial institutions was 26% for the overall banking system, and the ratio money resources to total attracted resources was 16%. The ratio of actual to minimum required reserves of commercial banks on their accounts in the BNB also increased.

The structural reform in the banking sector was launched by the sale to foreign investors of two-thirds of the capital of United Bulgarian Bank. The underlying goal of the reform is to minimise state participation in the commercial banks' capital so as to achieve more effective management. The low relative share of private commercial banks is due to the bankruptcy of a large part of them. The changes in the structure of the banking system are marked by an increasing share of both banks



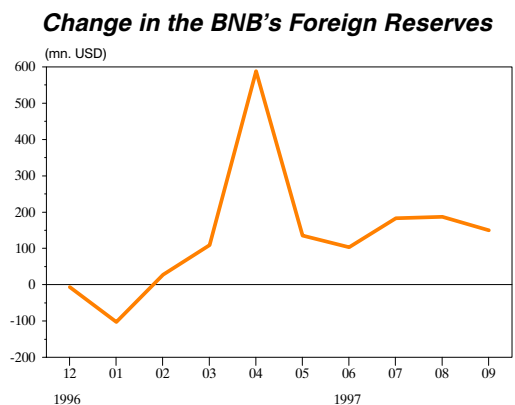
Source: BNB, AEF

with a majority stake of foreign share-capital and local branches of foreign banks as their share rose from 2.14% in end-1996 to 6.28% in end-October 1997.

The stricter control over the banking system, the high requirements with regard to the credit policy of commercial banks, and the latter's apprehension of the accumulation of new bad loans had a negative impact on the dynamics of domestic credit and, so far, it has not yet reached its 1996 level. The shrinkage of credits to the government in favour of credits to the non-government sector, and the private sector in particular, represents a positive trend.

### The Lowering of the Interest Rates - a Successful Outcome of Stabilisation

The lowering of interest rates emerged as a key problem of Bulgaria's economic development after 1991. All attempts to reduce the base interest rate through administrative measures resulted in financial destabilisation and further leaps of its level. The lowering of the interest rate to normal levels became possible only after the changes in monetary policy in July 1997.

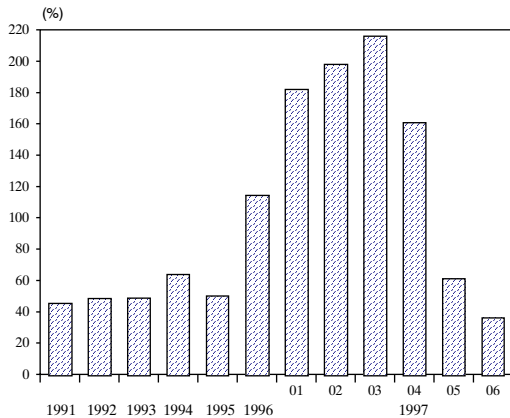


Source: BNB, AEF

In January 1997 the central bank introduced a new method for its base interest rate formation linking it to the rate of return at the primary auctions of government securities. Thus, market principles, viz. supply and demand of government debt, started to determine the base interest rate. On 27 November 1997 the BNB introduced technical changes in the procedure for its base interest rate formation in order to remove any doubts that it may be administratively determined. Thus, the base interest rate is determined as the average annual rate of return on three-months government securities reached on each primary auction.



### Dynamics of the Prime Interest Rate (annual interest rate)



Source: BNB

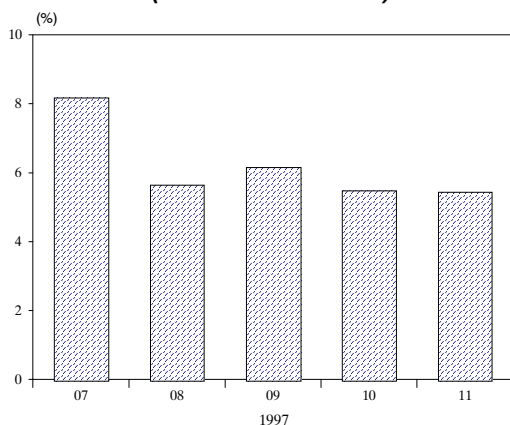
It becomes effective automatically on the date of issue and remains valid till the date of the next issue of three-months government securities.

The improved liquidity of the financial system was due to: first, the aid and loans from international financial institutions; second, the active trade balance; third, privatisation receipts; fourth, negative net issues of government securities; and fifth, the increase of deposits in the banking system.

### Loans Extended by International Financial Institutions and Privatization Receipts Relative to Net Issues of Government Securities

mn. BGL	01.97	02.97	03.97	04.97	05.97	06.97	07.97	08.97	09.97
Official loans, net	-2759	-16569	-18270	-11155	-4547	15811	8666	55536	-13045
IMF credits used, net	-12876	-11046	-29550	251434	-2823	0	223837	143273	0
Privatization receipts	1481	5049	2062	3342	226904	82040	45240	3243	11122
Net issues of government securities (incl. repaid)	-2349	-10009	123787	98471	35316	-132418	-14748	-57154	-30336

### Dynamics of the Prime Interest Rate after July 1st 1997 (annual interest rate)

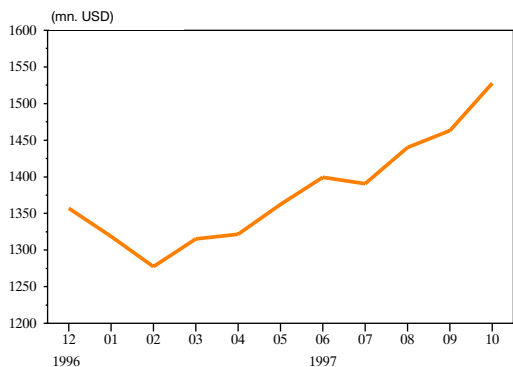


Source: BNB

The impact of the first three factors became visible in the balance of payments accounts. The overall balance over the period January to September 1997 ran a surplus to the amount of USD 982.9 mn in contrast to the deficit of USD 808.1 mn registered in the same period in 1996. The huge surplus in the current account amounting to USD 496.2 mn recorded in the first three quarters of 1997 was due to the positive trade balance (cf. the current account over the same period of 1996 ran a surplus of USD 65.7 mn). The capital account in the first nine months of 1997 was also favourable at USD 273.4 mn in contrast to its deficit of USD 748.1 mn over the same period in the previous year.

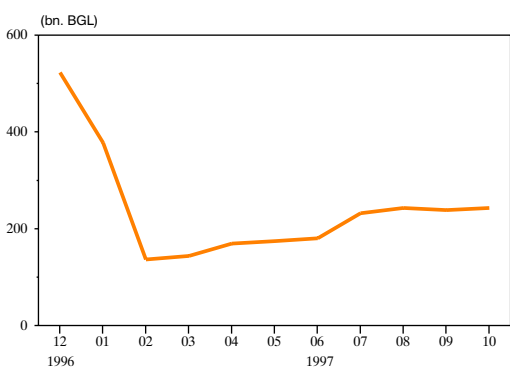
The central bank managed to increase its for-

**Dinamics of Foreign Currency Deposits**



Source: BNB, AEAf

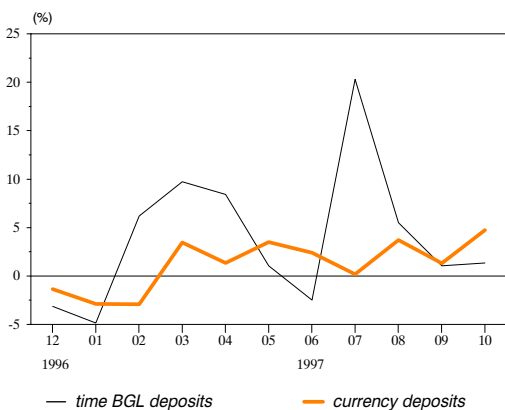
**Real Change in BGL Deposits \***



\* at prices as of December 1996

Source: BNB, AEAf

**Currency and Time BGL Deposits - Monthly Change \***



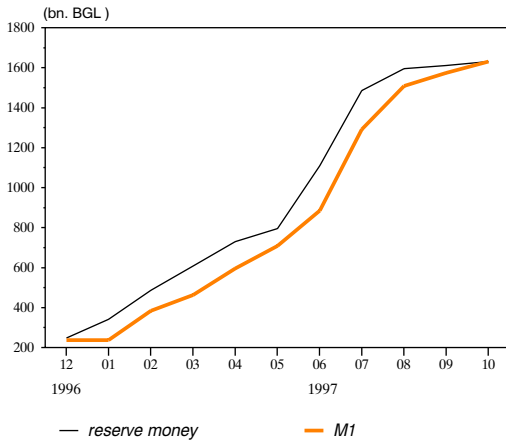
\* The increase of the BGL deposits due to interest paid on them has been neutralized

Source: BNB, AEAf

foreign exchange reserves by USD 1380.3 mn owing to the considerable surpluses on both the current and capital accounts and the net financing to the amount of USD 333.6 mn extended by the IMF. The highest rise was registered in the second quarter of 1997 (by USD 827.4 mn) which facilitated the introduction of the currency board enabling the BNB to accumulate sufficient forex reserves to cover reserve money and to stock enough resources to meet any contingent crises of confidence in the banking system. The currency board was introduced on 1 July 1997 with USD 1640 mn, or DM 2820 mn in forex reserves, i.e. a 136.8% increase relative to December 1996 when BNB's foreign exchange reserves amounted to USD 792.8 mn. As of end-December 1997 the available money resources in foreign currency of the central bank reached DM 4411 mn.

Since the introduction of the currency board, the rate of coverage of the reserve money (banknotes and coins in circulation, current accounts and deposits of commercial banks in the central bank) has not fallen below 230%, reaching 241% in November. This forex coverage is sufficiently large to maintain the high confidence in the currency board and the stability of the financial system. The introduction of the currency board triggered a rapid process of re-monetization, i.e. an increase of the highly-liquid components of broad money. Reserve money increased by Lv 1382.3 bn, or 558.9% in the period December 1996 to October 1997. The growth rate of reserve money was lower than inflation in all months except in August when it exceeded the rate of inflation by 6.3 percentage points (base: December 1996 = 100). In early-1997 the structure of reserve money was characterised by roughly equal relative shares

### Reserve Money and Monetary Aggregate M1 Dynamics



Source: BNB

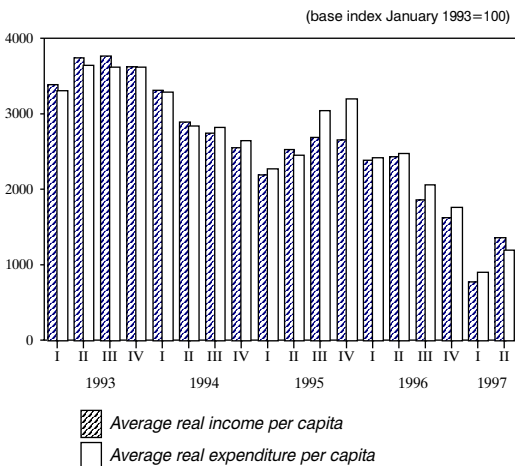
of money in circulation and deposits of commercial banks in the central bank whereas in October 1997 the ratio had shifted to 62:38 in favour of money in circulation. The restored confidence in the banking system found expression in the real growth of lev and foreign currency denominated deposits that started in March.

In conclusion, the increase of the forex reserves of the country in 1997 was due to both the external financial aid and the government measures undertaken to speed up privatisation and restore confidence in the implemented economic policy. The lowering of the base interest rate as a result of the increased liquidity represent the most important success of stabilisation in 1997. □

## II. Stabilisation Factors

### Incomes as a Nominal Anchor

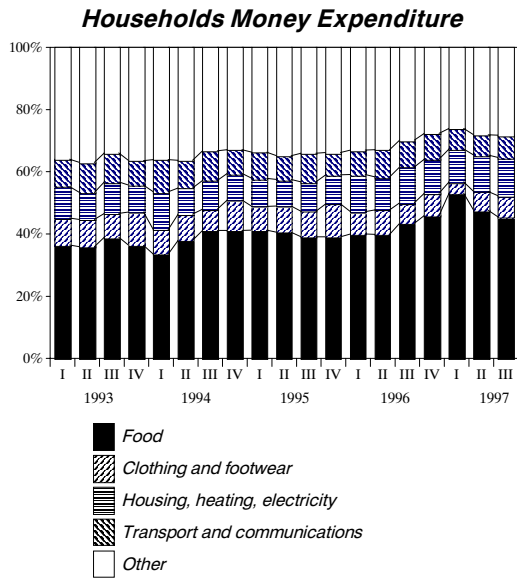
#### Money Income and Expenditure per Capita



Source: NSI, AEAf

Incomes in Bulgaria lost a great part of their purchasing power due to the high inflation in the period mid-1996 to early-1997, immediately affecting the real level of consumption. Data on GDP components from the expenditure side point to declining final consumption, thus excluding demand as a pro-inflationary factor. While final consumption in the first half of 1996 was 90% of GDP, it fell to 83% of GDP over the same period of 1997. The decline was mostly due to the reduction of individual consumption from 84% of GDP in the first six months of 1996 to 79% in the respective period of 1997.

After February 1997 the government adopted a cautious approach to incomes adjustment so as to avoid both cost-push and demand-pull, as well as deficit-financing inflation.

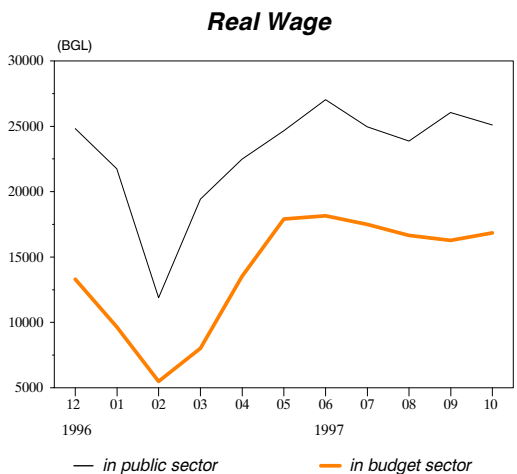


Source: NSI, AEAf

### *Regulation of wages in the state-owned sector and the budget sphere*

The gradual upward adjustment of real incomes brought about changes in both the level and structure of consumption. These changes did not exert inflationary pressure on the economy with the only exception of increased inflation in July which was induced by the liberalisation of prices of some foodstuffs and the shortages in their supply due to the economic crisis.

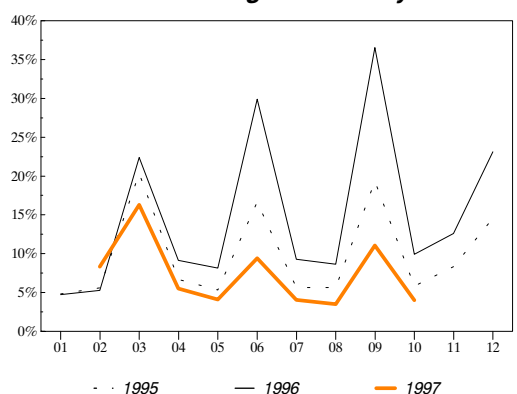
Real wages slumped in the first two months of 1997. In February it declined more than two-fold relative to December 1996. March witnessed the first adjustment of the real wage and it gradually reached in May its December 1996 level. The following months witnessed no substantial changes in public sector wages, yet it increased by 5-8% on average as a result of the bonuses paid at the end of each quarter.



Source: NSI, AEAf

The differentiation in nominal average wages across the branches of the public sector was amplified in the period of the largest slump. In February the coefficient of variation of the average wages by branches peaked to 0.83. Later it started falling due to the repeated upward adjustments of salaries in the budget sector and fluctuated within 0.48-0.50 in the period May to July. The coefficient of variation rose again after July to reach 0.59 in September as a result of the separate schemes of incomes compensation (while there was a wage freeze in the budget sector, nominal wages in the real sector continued to increase). In October the coefficient of variation dropped to 0.57 since bud-

**Share of Bonuses in Total Wage in Industry**

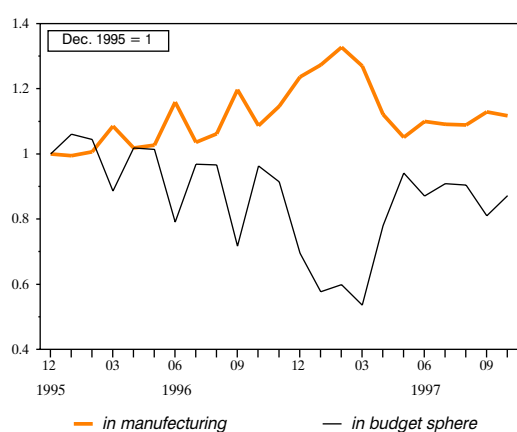


Source: NSI, AEF

get salaries were again compensated while the nominal wage in the real sector branches declined on a month ago. Nominal salaries in two of the most important sectors (Health care and Education), remained among the lowest in the country. This was to a great extent due to the inability of the state budget to allocate sufficient resources for the smooth functioning of these systems.

During the hyperinflationary months – January and February – the increase of the wage bill was under soft administrative restrictions. A Decree<sup>2</sup> adopted in February revoked the existing Ordinances on the control over wage bill increase. It allowed companies with book profit in the first quarter of the current year to increase their wage bill according to their financial results and actual revenues received, on condition that they pay regularly their state and municipal taxes and charges, social security contributions and if their net long-term fixed assets had increased relative to end-1996.

**Dynamics of Relative Wages**



Source: NSI, AEF

If an enterprise improved its financial results and regularly redeemed the above-mentioned financial obligations to the state or municipal budgets and the social security funds notwithstanding the lack of book profit, the allowed percentage of the wage bill increase was dependent on the improvement of its financial results. This requirement aimed at exerting pressure on state-owned companies to redeem all their obligatory payments.

In the first quarter of 1997 almost all enterprises with majority state participation either made profit or reduced losses. This was due to the rapid increase of producer prices while firms' operating

<sup>2</sup> Government Decree No 68 of 27 February 1997.

expenses were calculated at prices fixed in 1996<sup>3</sup>. A similar process was observed in 1996 when the rate of inflation accelerated.

In May the Council of Ministers adopted a new Ordinance on wage bill increase in the enterprises with a majority state-owned stake. It preserved the right of firms in good financial condition to increase the wage bill, however, regular servicing of debts to the banking system was added to the requirements for timely payments of obligations. In the following quarters of 1997 the Government further narrowed the range of enterprises allowed to allocate freely their pay-roll funds by imposing additional requirements, viz. regular servicing of payables to suppliers.

The companies which failed to meet any of the above-mentioned conditions were allowed to increase their wage bill by no more than 70% of the actual inflation, adjusted by coefficients measuring the improvement or deterioration of their financial performance, the servicing of their financial payables as well as the change in real labour productivity. The Ordinances provided for various sanctions in the third and fourth quarters of the year for firms which had failed to respect the stipulations and increased illegally their wage bill.

The underlying goal of the adopted changes in the regulatory regime of the wage bill increase was to improve financial discipline and introduce hard budget constraints simultaneously with the withdrawal of state intervention in the formation of incomes in enterprises in good financial condition.

---

<sup>3</sup> *This practice was conditioned by the legislative and administrative arrangement of the prices of electricity, water, coal and briquettes, thermal energy, natural gas, postal, telegraph and telephone services. The same was valid for fuels till May 1997.*

Data show that in the second quarter of the year 368 companies (8.3% of firms surveyed by the NSI) met all the requirements for unconditional wage bill increase. Only 12.5% of enterprises met the imposed restrictions. Most of the firms (about 58%) increased their wage bills between 1.5-fold and 3-fold in violation of the requirements. Apparently, this infringement was due to the desire to raise real salaries to their pre-hyperinflation levels, and the delayed publication – only in the end of the second quarter – of the Government Decree on the control of wage bill increase.

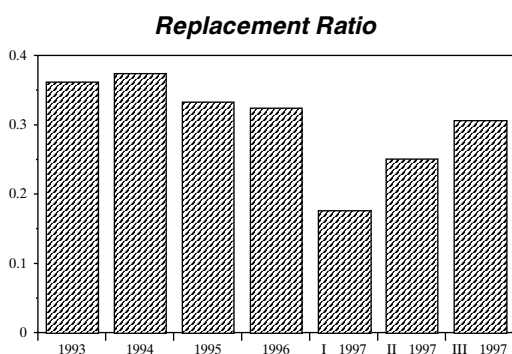
The number of immaculate firms declined slightly in the third and fourth quarters to 359 (8.2% of the monitored companies), however, some 45.5% of enterprises already strictly observed the provisions of the regulatory regime on the wage bill increase. The bulk of companies adjusted their wage bills up to two times, with 70.6% of them – up to 1.5 times. Violations of the Ordinance on the pay-roll funds increase were made through the bonuses paid.

The analysis of data on revenues and expenditures of non-financial enterprises in the public sector in the second and third quarters of 1997 reveal that the amount of the average wage paid was entirely independent of the financial results (i.e. profits or losses) of the respective firms. Wages in many of the loss-making companies were higher than the average for the public sector. For most of the firms, this was due to their particular industrial branch affiliation, viz. productions with hard labour conditions, for which the Labour Code provides for bonuses and extra allowance. Other companies, some of them large exporters, incurred losses in 1997 due to the price

dynamics or other issues of competitiveness, yet they registered good financial results in the preceding years. Any administrative cuts in wages in these enterprises would have been seriously opposed by both employees and trade-unions. Therefore, the reduction and eventual elimination of losses in these firms will require changes in the structure of their expenditures and the volume of sales.

The adjustment of salaries in the budget sector was made using statutory set coefficients. The 1997 State Budget Act was not passed until the end of the second quarter of the year and this impeded wage determination. Budget revenues and deficit became the main indicators for adjustment of salaries in the budget sector after the introduction of the currency board. The nominal increase of salaries in the budget sector in the period January to September 1997 amounted to 725%.

### *Social payments*



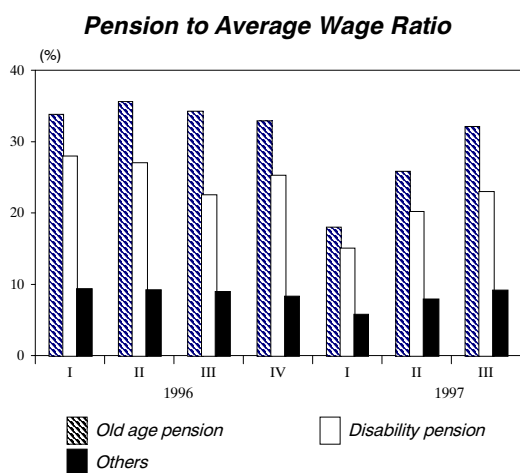
Source: NSSI, AEF

In the first half of the year the pension adjustment scheme implemented was to grant inflationary compensations to all pensioners. In this way, the differentiation between the various pensions was practically erased and in March and April the amount of the compensations exceeded the amount of the maximum pension. In May and June the individual pension was increased but the payment of inflationary compensations continued, too.

In July the Parliament voted an amendment to the Law on Pensions<sup>4</sup>. According to its provisions, the 1997 updating of pensions had to be based

<sup>4</sup> Published in Official Gazette #46/1997, effective from 1 July 1997.





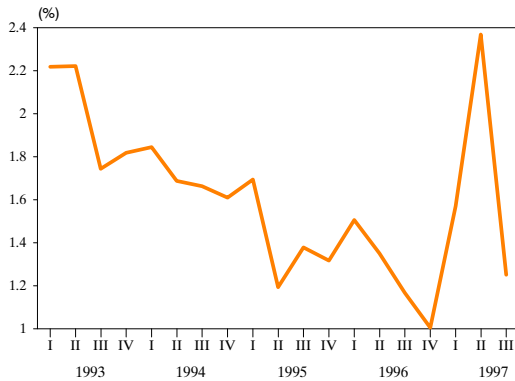
on the average wage in the first quarter of the year. It was twice lower than the average wage in July. That made the maximum individual retirement pension (equal to three times the amount of the social pension in the respective month) hard to attain. In practice, this provision sustained the trend for equalisation of individual pensions.

In the end of September the Constitutional Court declared anti-constitutional Paragraphs 1 & 2 of Article 50 of the Law on Pensions<sup>5</sup>. This act repealed the existing sanction on pensions paid to employed pensioners in those cases when the amount of their labour agreement incomes exceed the level of two minimum wages. This change will have a negative impact on the motivation for voluntary later retirement since it provides for the simultaneous receipt of a pension and an unconstrained labour remuneration. Following the deteriorating demographic structure in Bulgaria, the choosing of the earliest possible retirement age will again induce an increase in the number of pensioners and will respectively reduce the ratio between people paying for social security and people benefiting from social security funds. In case the present system of pension insurance is preserved, this would result either in a relative fall of the pension level or in a deficit on the accounts of the National Social Security Institute.

The slump in real incomes demanded urgent revision of the system of social aid. Three main mechanisms for target aid to low income households were in force in 1997: the Social Aid Rules<sup>6</sup>

<sup>5</sup> Decision of the Constitutional Court No 12 of 25 September 1997.

<sup>6</sup> Government Decree No 119 of 31 May 1997.

**Social Benefits in Households' Income**

Source: NSI, AEF

(SAR), the Ordinance on target aid<sup>7</sup> and the Ordinance on the application of the Program for urgent social aid<sup>8</sup>.

The Social Aid Rules (effective from 1 January 1997) fixed a lower limit of incomes per household. A household was entitled to monthly social aid to the amount of the difference between its determined differentiated<sup>9</sup> minimal income and the total sum of individual incomes of all household members if these incomes were below the pre-set limit. Till the beginning of May, households and social establishments with full budgetary support received additional aid from the Target Social Protection Fund to cover expenses for electricity and thermal energy.

In February the Government adopted an Ordinance on the distribution of the urgent financial social aid from the European Union granting special aid to households already encompassed by the system for target social protection. The amount of the aid was fixed at 2 ECU multiplied by the coefficients for the differentiated base minimal income as set by the Social Aid Rules. This provision infringed upon the principle of providing aid only up to a certain income per household and allowed a selective approach to the distribution of the additional aids.

<sup>7</sup> Regulation on target social aid to low-income households and social establishments with full budgetary support for the use of electricity, thermal energy, fuels and drinking water adopted by Government Decree No 205 of 15 August 1996, amended by Government Decree No 110 of 20 March 1997, and repealed by Government Decree No 398 of 27 October 1997.

<sup>8</sup> Government Ordinance No 1 of 11 February 1997 on the terms and conditions for granting of special social aid to low-income households and social establishments with full budgetary support through the Program of urgent social aid, published in the Official Gazette #17/1997.

<sup>9</sup> The differentiated base minimal income of a household depends on the number of household members, their age and state of health; Social Aid Rules adopted by Government Decree No 119 of 31 May 1997.

In the first nine months of 1997 a total of 155 364 people and households were included in the social aid schemes, with 61 625 of them receiving monthly aid. According to data from the Ministry of Labour and Social Policy, the Program for urgent social aid enveloped 25% of all households, or 18% of population in the country.

New Social Aid Rules<sup>10</sup> were adopted and entered into force in November. The range of those entitled to aid was narrowed due to the new coefficients determining the differentiated minimal income and the imposed property requirements for the individual or household-in-need as well as to the exclusion of the social establishments with budgetary support. The number of one-time aids for incidental urgent needs which could be received throughout a single year was reduced to three. The allowances for target aid are now determined on the basis of a fixed limit of consumed energy rather than on the basis of standard consumption per floorage. According to the new Social Aid Rules, the base minimal income is determined as an income sufficient to cover basic living needs. The set up of these criteria improved the system of social aid since it abandoned the principle of proportional distribution per capita of the available resources in favour of better targeting the necessary amount.

In the beginning of November 1997 the Government adopted a new Ordinance on the distribution of social aid from the European Union<sup>11</sup>. It fixed the base amount of the social at 4 ECU

---

<sup>10</sup> *Government Decree No 398 of 27 October 1997.*

<sup>11</sup> *Government Ordinance No 2 published in the Official Gazette #115/1997.*

monthly multiplied by the coefficients set by the Social Aid Rules and limited the amount of any single aid to 20 ECU.

### **The Anchor of the Exchange Rate**

The upward flexibility and downward rigidity of prices was a distinct characteristic feature of the prevailing model of price formation since the launch of economic reforms in Bulgaria. Inflationary expectations remained high and the short-term dynamics of macroeconomic indicators was unable to suppress them. In the period mid-1996 to February 1997 this model of price formation was driven to extremes typical for economies with accelerating inflation and foreign currency substitution, i.e. tying the dynamics of all prices to the exchange rate index.

Expectations for a possible pegging of the exchange rate after February 1997 contributed to the stabilisation of the overall price level. The fixing of the exchange rate – the fixed rate was announced in mid-June – slightly above the then market quotations created weak inflationary pressure which intensified the following month due to the depreciation of the selected reserve currency (the Deutsche mark) at the international financial markets. The prices of tradables entirely absorbed the exchange rate change by 6% in the period March to October. The impact of the exchange rate anchor became evident only in September when the appreciation of the Deutsche mark induced a drop in the prices of importables continuing through October.

The fixed exchange rate had both direct and indirect impact on price stability. The di-

rect effect stemmed from the predictability of the calculated expenditures for imported raw materials and the competition of imported goods with stable prices. The indirect impact found expression in the rising confidence in the macroeconomic policy implemented.

### Price Changes by Commodity and Service Groups, June – September 1997

	Growth rate (%)	Contribution to inflation (% points)
<b>Food items</b>	13.6	6.9
<b>Non-food items</b>	14.3	4.5
<b>Services</b>	20.2	3.1
<b>Public catering</b>	35.4	0.9
<b>Inflation</b>	15.4	15.4

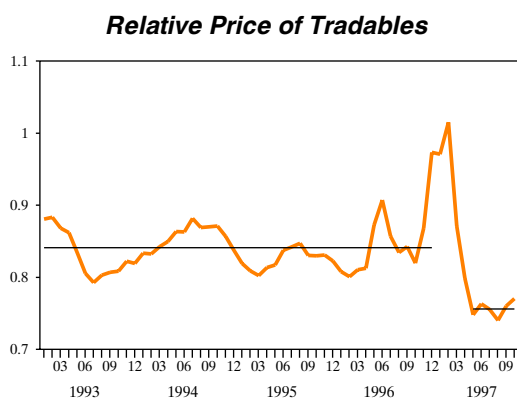
Experience unequivocally reveals that the exchange rate anchor produces results only in the presence of a liberal trade regime when imports competition becomes an effective mechanism for price stabilisation. In May and June<sup>12</sup> the Government liberalised most of the fixed and controlled prices. The relative share of the government-monitored foods and services in the consumer basket declined from 47.9% to 14.36%. Irrespective of the very narrow range of government-monitored goods, the price control impedes the restructuring process and creates inflationary expectations.

<sup>12</sup> Government Decree No 193 of 7 May 1997 liberalised the prices of fuels and Government Decree No 269 of 19 June 1997 abolished limit prices of foodstuffs and railway fares.

### Controlled Prices and Maximum Expected Pro-inflationary Effect from their Full Liberalisation

Government-regulated prices of goods and services	Weight in the consumer basket (%)	Maximum expected price increase after liberalisation (%)	Contribution to CPI (%)
<b>Fixed prices</b>	<b>11.86</b>	<b>32.1</b>	<b>3.80</b>
Electricity	5.16	40.0	2.06
Thermal energy	1.62	50.0	0.81
Coals	1.00	40.0	0.40
Natural gas	0.15	12.0	0.02
Postal and telephone services	1.03	50.0	0.52
Cigarettes	2.94	0.0	0.00
<b>Monitored prices</b>	<b>2.50</b>	<b>33.8</b>	<b>0.85</b>
Water for domestic use	0.52	50.0	0.26
Medicines	1.95	30.0	0.59
<b>Total</b>	<b>14.36</b>	<b>32.4</b>	<b>4.65</b>

**Note:** The forecast is made on the assumption that the prices of the other consumer goods and services (free prices) are constant. The estimate takes account of the changes in relative prices of controlled goods and services, the international prices, their elasticity and the availability of competition by analogous goods or substitutes.



Dynamics of domestic prices under a fixed exchange rate and a liberal trade regime depends on the price dynamics of non-tradables. The relative price of tradables<sup>13</sup> went down after the February hyperinflation and remained record low.

In the period January 1992 to December 1995 the relative price of tradables (to CPI) was 0.87 as

<sup>13</sup> Tradables are presented by imports in the broad sense. They account for 21.4% of the consumer basket and directly depend on the rate of exchange since their import is predominantly in USD. They include all „pure“ imports and analogous domestically produced commodities, i.e. household electric appliances, clothing, footwear and personal belongings. „Pure“ imports are citrus fruits, bananas, coffee, sugar, imported vodka and whisky, diapers, vacuum cleaners, watches, cameras, colour TV sets, video cameras, VCRs, tape recorders, auto cassette players, personal vehicles and spare parts, and fuels whose limit prices in BGL are set by the Council of Ministers on the basis of international prices at the current BGL/USD exchange rate. In 1997 they accounted for 11% of household money expenditures which are used as CPI weights.

against 0.85 in 1996. In the period May to September it fluctuated in the range of 0.75 to 0.77, recording the lowest values in the whole period since 1992. These low values identified the prices of tradables as an inflation-stabilising factor whereas the price dynamics of non-tradables exerted pro-inflationary pressure.

The larger contribution to inflation of non-tradables (mainly food items and service) was neither associated with the exchange rate dynamics, nor to the dynamics of producer prices. Since the introduction of the currency board, the latter registered a growth rate twice lower than consumer price inflation owing to their high sensitivity to exchange rate fluctuations. The analysis reveals that shortages of basic foodstuffs due to a slump in production became the main pro-inflationary factor. Till mid-August the basic food items also enjoyed protective import duties and therefore, higher demand could not be offset through imports. The highest customs duties were imposed on the goods suffering the greatest shortages, viz. 25% for cheese and meat, and 55% – for eggs. In July and August the prices of cheese, eggs and meat went up by 76.9%, 40.5% and 15.7% respectively.

The import liberalisation measures taken since mid-1997 concerned the main groups of food items. The import of wheat, barley, maize, sunflower and sunflower oil was made duty-free. The import of seed corn in the first nine months of the year increased by 48.3% on a 12-month basis. Import duties on veal, chicken meat and pork were reduced, thus leading to 42.5% rise of meat imports in the first three quarters of 1997. The Government allowed the duty-free import of 3000 tons of cheese and 4 mn eggs after 15 August and again lowered

the import duty on pork<sup>14</sup>. Notwithstanding the changes in duties, the import of cheese and eggs in the first nine months of 1997 declined by 16.3% on a 12-month basis.

Quarterly data show that the process of food items price stabilisation was triggered by the considerable increase of their import.

### Imports of Some Commodity Groups\*, by quarters

Commodity group	Import, II <sup>nd</sup> quarter (USD)	Import, III <sup>rd</sup> quarter (USD)	3-month growth rate (times)
<b>Meat</b>	2 299 937	9 188 014	4.0
<b>Cheese and curds</b>	51 625	1 069 934	20.7
<b>Eggs**</b>	176 477	753 943	4.3

\* Preliminary data for III quarter

\*\* Incl. yolk only and eggs without shells

The analysis by commodity groups reveals high correlation between price changes and imported quantities – the higher the price rise in July and August, the greater increase of the respective import after liberalisation of the trade regime. The price growth of food items was curbed only after the lowering of import duties. The prices of food-stuffs increased by mere 2% in September, and fell by 0.64% in October.

<sup>14</sup> Government Decree No 323 of 12 August 1997.



## Financial Position of State-owned Firms

In the first nine months of 1997 the public non-financial sector registered positive financial results, recording some 40-fold real growth<sup>15</sup> of net profit (after-tax profit) relative to end-1996.

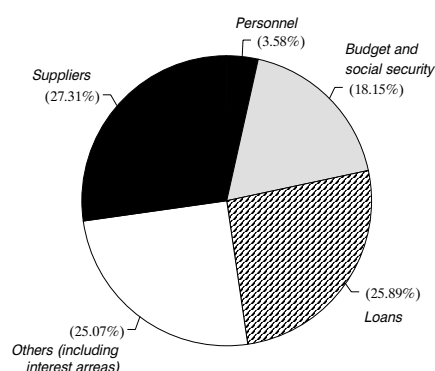
### Financial Indicators of the Public Non-financial Sector in Real Terms

(bn. BGL at producer prices of December 1994)

	1995	1996	I-IX 1997
<b>Operating profit</b>	45.31	35.87	63.53
<b>Gross profit</b>	-2.76	15.21	36.51
<b>Net profit</b>	-26.33	0.40	16.40

#### Composition of SOE' Indebtedness\*

September 1997

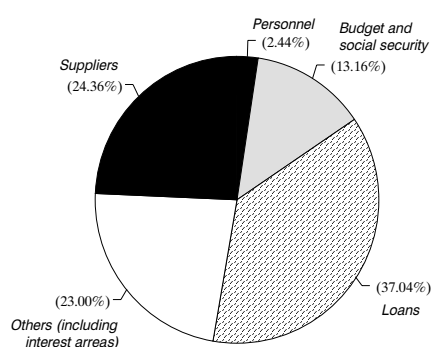


\* SOE - state - owned enterprises

Source: NSI, AEF

#### Composition of SOE' Indebtedness\*

December 1996



\* SOE - state - owned enterprises

Source: NSI, AEF

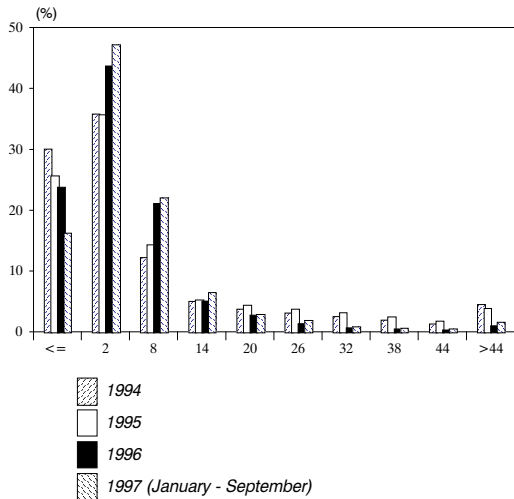
The positive financial results were mostly due to both the depreciation of the lev at the end of 1996 and early-1997 and the appreciation of the dollar on the international money markets in the second half of 1997. The share of the lev equivalent of the foreign currency earned by the state-owned firms represented one-third of sales revenue as of end-September 1997 while the volume of revenues in USD and Deutsche marks registered an over two-fold increase relative to the first half of the year.

The operating efficiency<sup>16</sup> of state-owned firms reached 17.74% in the first three quarters of 1997 compared to 10.3% registered in

<sup>15</sup> Calculated as a ratio of profits in the end of the first nine months of 1997 deflated by PPI in September 1997 to profits in December 1996 (PPI - December 1996 = 100).

<sup>16</sup> A ratio of operating profit to sales revenues as expressed in NSI's publication Current Economic Business.

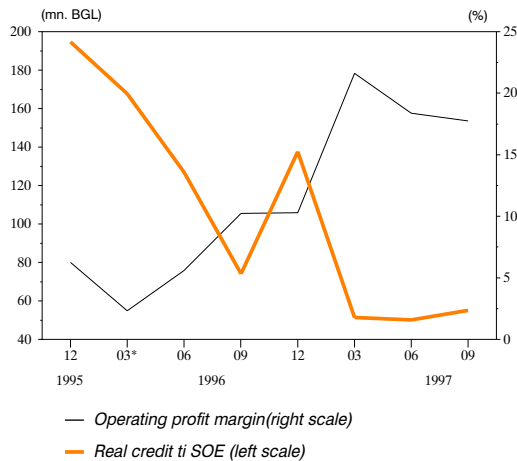
**Profitability\***



\* The ratio of operatin profits on sales

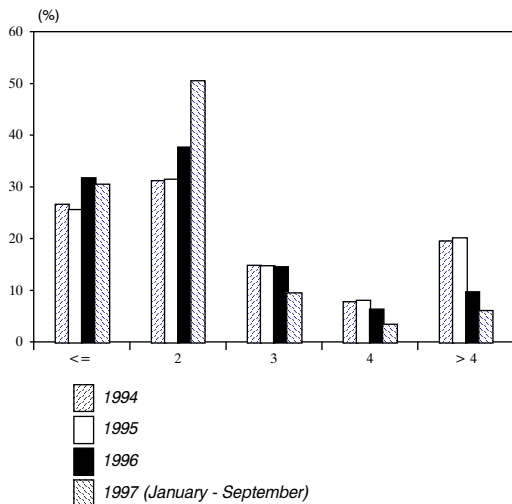
Source: NSI, AEF

**Real Credit and Operating Profit Margin**



Source: NSI, AEF

**Currant Ratio\***



\* Current assets - current liabilities

Source: NSI, AEF

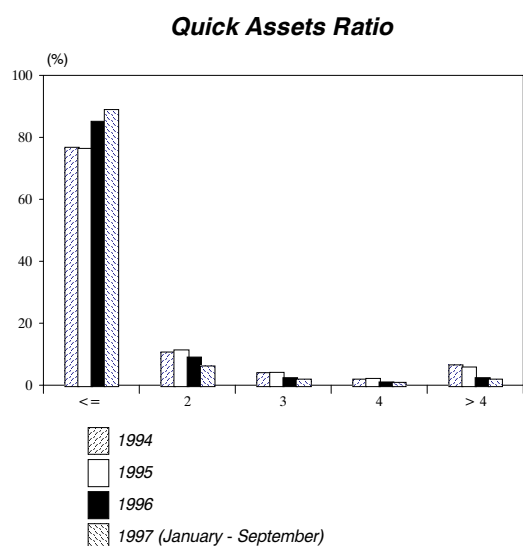
end-1996. Sales profitability<sup>17</sup> over the same period was 4.6% compared to 0.001% in end-1996.

The overall indebtedness of firms, calculated at producer prices of December 1996, declined to 57% of its end-1996 volume due to both the declining inflation growth rates and lower interest rates. Nevertheless, enterprise debt remained high, reaching Lv 4 698 bn as of 30 September 1997 (about 45% of sales revenues).

The decline of the relative share of credits drawn can be seen as an indicator of both the conservative credit policy of commercial banks and the improved financial conditions of firms enabling them to assume the financing of some of their short-term dues. The indicators of the firms' liquid assets ratio and quick assets ratio also improved.

The better financial condition of state-owned enterprises means elimination of quasi-fiscal deficits, yet it cannot be viewed as an indicator of real restructuring as it was mainly due to external factors, namely the depreciation of the lev and high inflation. The analyses of the behaviour of state-owned firms in Bulgaria and in the other European economies-in-transition demonstrate that state-run enterprises are unable to carry out alone the restructuring of their activity in order to raise considerably labour productivity and utilise more efficiently their resources. Privatisation remains the only instrument to achieve this goal.

<sup>17</sup> The ratio of net profit to sales revenues.



### Budget Revenue and Expenditure Anchor

The 1996 high inflation and financial destabilization led to a fast decline in real tax revenues. Given the relative stability of budget expenditures, the decline brought about a further increase in the budget deficit. In the period following June 1996, government debt service expenditures increased largely due to the impact of the crisis-ridden financial situation and the lack of alternative instruments to contain the crisis. 1997 maintained the general downward trend of real budget revenues, but with different rates by type of taxes and taxpayers and thus further deepened the inequality of the tax burden distribution.

### Real Growth Rate of Selected Variables (January-September)

	1996r. / 1995r.	1997r. / 1996r.
<b>Taxes</b>		
Income Tax	-11.4%	-24.3%
Profit Tax (overall)	9.1%	8.3%
VAT	-4.9%	-29.1%
Excises	-38.1%	-32.5%
Customc Duties	-7.4%	-31.1%
<b>Key Indicators</b>		
Wage Bill	-7.9%	-24.5%
Retail Sales	1.0%	-50.7%
Industrial Sales	-1.0%	-11.0%
Imports	-6.0%	-12.5%

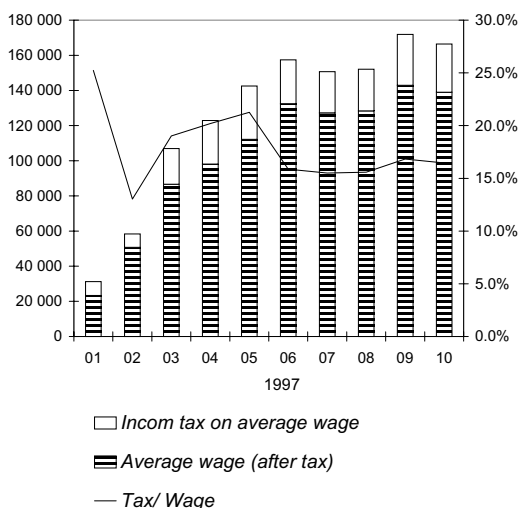
**Note:** Real taxes have been estimated on the basis of deflation by the CPI. The increase in retail and industrial sales estimated relies on NSI data. Import decline is given in dollar terms.

The tax burden on enterprises increased substantially due to the absence of an accounting practice for inflationary adjustment of the value of inventories and long-term fixed assets. Over the past few years, a considerable discrepancy between the market and book value of enterprises' assets. The book value of assets plays a major role in determining the tax-adjusted profit of an enterprise. Provided the book value of an asset is well below its market value, the depreciation allowances recognized by the tax authorities remain lower than the amounts needed for assets renewal. Thus, through taxes the state decapitalises the enterprises. The profit tax payable by non-financial enterprises was the only one, registering increase in real terms for the first ten- months period of the last two years.

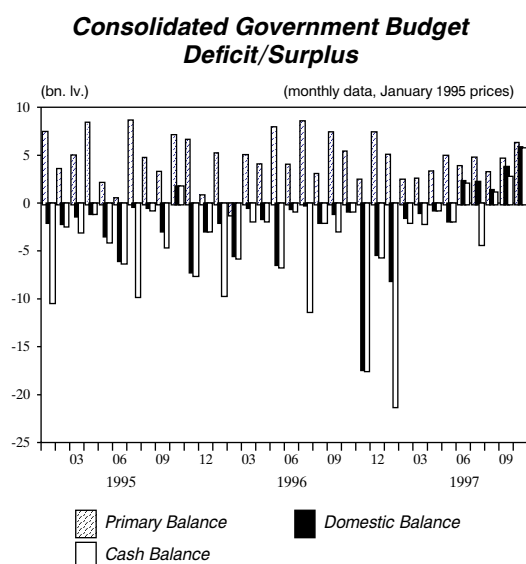
The tax rate on the country's average wage started to increase in 1996, stepping up from 13.7% to well above 25% in January 1997. The amendment to the income tax schedules, enforced in February and June, produced, although for only a short while, a rather favourable effect, relieving the tax burden on average wages - the average wage tax rate declined by almost 50% in February and by 25% in June, on a month earlier.

The reliance on indirect taxes as the primary source of budget revenues has increased their relative burden on households. The revenues from excise/retail sales ratio went up from 3.4% to 7.5%, given a 50% decline in retail sales in the nine months of 1997, on a year earlier, and a decrease in the share of expenditures on basic excise goods within total household budget expenditures. The reasons behind this decrease amounted to: first, the price increase in the basic excise goods (e.g. spirits whose production has been increasing)

**Income tax on Average Wage,  
January - October 1997**



Source: AEF



Source: MF, AEAf

outstripped the increase in the overall price level and second, the burden has been partly taken by producers who paid excise duties on goods produced but not sold.

Budget interest expenditures reached peak values in the fourth quarter of 1996 and the first quarter of 1997. Over the October-December 1996 period, some 44% of 1996 total interest expenditures were paid, and in the January-March 1997 period - 35% of the interest expenditures paid for the nine months of 1997 (or 29% of the ones envisaged by the 1997 Budget Law).

The relative exchange rate's stabilization and fall of interest rates after March 1997 considerably eased the government's debt servicing, especially by eliminating the high risk premiums on issuing new debt. From a serious problem, the practice to issue primarily interest-bearing government securities (depending on base interest rate) has turned into a factor bringing about a sharp decline in budget interest expenditures. The positive effect of low interest rates was felt in the months following Augusts.

Despite the favourable trends in the development of the Bulgarian economy discerned, the 1997 Government Budget Law (adopted in end-June) sustained the restrictive stance of the government's fiscal policy. The budget was running a continuous primary surplus throughout the year. The size of the surplus made the budget less dependent on external financing and allowed the Ministry of Finance to pursue a policy of domestic debt decrease via negative net issues of government securities. As of end-October 1997, government securities net issues covered only 23% of overall expenditures, against 32% in 1996. After taking into account the interest paid on govern-

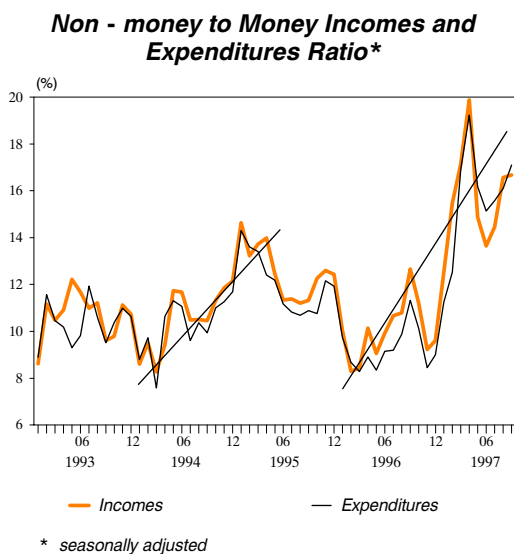
ment securities in the respective period, the decrease became all the more pronounced - from above 6% to below 1% of 1997 expenditures. Revenues raised from privatization deals ranked second in importance as a source of budget deficit financing. Compared to other sources, they have many advantages - they are a non-inflationary source of financing and do not incur further budget expenses, as is the case with debt instruments. □

### III. Barriers to and Potential for Future Economic Growth

#### The Crowding-out Effect of the Economy in Kind over the Market Economy

Along with the galloping inflation and the shrinkage in consumer demand, the beginning of 1997 witnessed the accelerated increase in the relative share of the economy in kind<sup>18</sup>. The symptoms of the process are to be found as early as the second quarter of 1996 when inflation started to spiral up. Such a shift economy in kind took place in 1995 as well, but its parameters quickly narrowed down to their 1993 and 1994 levels.

Due to difficulties in properly assessing households incomes and expenditures in kind, it is very likely that their absolute-term values are considerably higher than the values officially reported. It can be expected that in periods of high inflation the monetary valuation of household incomes in kind is highly undervalued, which in turn leads to local minimums. Disregarding them, however, the relative share of the economy in kind can be said



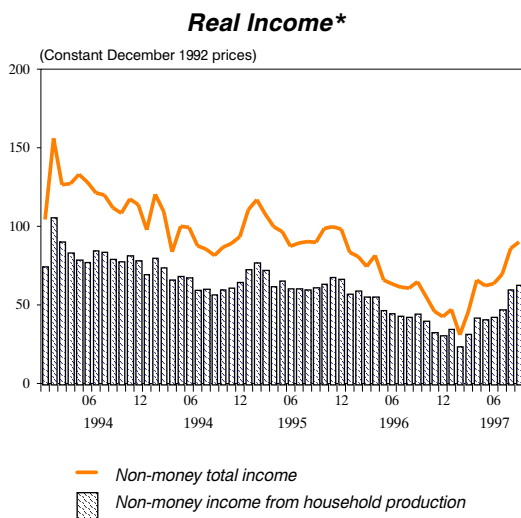
<sup>18</sup> Based on data from NSI monthly household budget surveys.

to follow a steady upward trend in periods of high inflation, starting March 1996 in particular. Some additional difficulties in analyzing the dynamics of the indicators have to do with their markedly seasonal character. At the end of each calendar year incomes and expenditures in kind are usually four to five times higher, relative to the beginning of the year. Removing the seasonal component of the indicators, the income in kind/money income ratio<sup>19</sup> in the nine months of 1997 increased by 57% on average, on a year earlier. Household expenditures in kind registered an increase of 67%. The same period witnessed a decline in retail trade of 35.4% and decreases in wholesale trade, industrial production and construction of 37.8%, 11.6% and 47.3% respectively. The deterioration of economic activity affected almost all industrial branches, with the only exception of electricity, gas and water production and distribution (a 2% increase), metallurgy (a 10.2% increase) and production and ore-dressing of metal and thorium ores (an 11.2% increase). Transport, too, registered an increase of 11.2%.

The economy in kind reached its 1997 peak in April when its relative share hit 20%, a maximum brought about not by an increase in real household incomes and expenditures in kind but a shrinkage in money consumption and real money incomes. In the summer months of 1997, the economy in kind contracted, compared to the market economy. However, household expendi-

---

<sup>19</sup> Household income in kind incorporates all products (food and non-food items), animals and feeds that a household has produced or borrowed, or free of charge contributions by friends and relatives, and economic organizations. Incomes/expenditures in kind are estimated on the basis of total incomes/expenditures by deducing money incomes/expenditures.



\* Seasonally adjusted deflated with CPI

Source: NSI, AEAf

tures in kind, surpassed incomes in kind, which can be said to be an indicator of the consumption of household stockpiles and the keen interest on the part of households in „injecting investments“ in the economy in kind. They led to high household incomes in kind in August and September, evaluated at actual prices and compared to the respective 1996 prices. Compared to 1993 and 1994, their real values were lower.

Household self sufficient production is a vital element of the economy in kind. The overall economic crisis has affected its dynamics but ever since the first half-year period of 1997 it started to increase in real terms. The produce obtained has partially offset the decline in food products sales in the home market. Assuming that household incomes in kind from self-sufficiency are only in the form of food stuffs, overall household consumption will then amount to the sum total of the sales of food products and in kind production. All this makes it possible to estimate approximately (slightly overvalued) the value of the relative weight of homemade products consumption, compared to the sales of food items.

The weight of in kind production increased substantially in periods of hyper-inflation and the better part of 1997. All this implies that consumption of self produced goods exceeded consumption of commercial goods in the period surveyed. The sharp and abrupt monthly changes were the result of household stockpiles. The latter alone, however, cannot give a long-run account of the high relative level of household production. The figures in the table show that the dimension and importance of the economy in kind exceed the reports given in the NSI monthly household budget surveys. Thus, for instance, in January and



February 1997, 10% and 17% respectively of food expenditures were re-allocated to the purchase of goods. If the sales reported represented actual figures, household production must have comprised the remainder to 100% of consumption. Data on the quantitative consumption of certain food products further heightened the above findings. Their consumption registered an insignificant decrease, despite the sharp decline in sales.

### Dynamics at Comparable Prices (against the respective month of the preceding year)

Month	Retail sales of food products (%)	Income in kind from household self-sufficiency (%)	Overall consumption of food products (%)	Relative weight of incomes in kind from household self-sufficiency within food consumption (%)
1.96	102.2	78.4	96.1	26.0
2.96	102.2	76.6	100.6	6.0
3.96	103.0	76.6	98.9	15.0
4.96	101.7	89.3	102.0	*
5.96	102.5	71.2	90.4	39.0
6.96	97.3	73.8	86.8	45.0
7.96	97.6	70.9	81.4	61.0
8.96	97.2	70.6	79.4	67.0
9.96	95.3	72.5	78.6	73.0
10.96	80.6	62.8	77.3	19.0
11.96	53.0	48.0	68.6	*
12.96	64.0	45.8	58.2	31.0
1.97	75.0	60.4	61.8	90.0
2.97	28.3	39.7	37.8	83.0
3.97	39.6	56.8	48.1	49.0
4.97	43.1	75.8	56.1	40.0
5.97	53.0	86.9	63.7	31.0
6.97	54.3	95.1	73.3	47.0
7.97	54.4	109.6	82.6	51.0
8.97	50.1	141.8	99.6	54.0
9.97	48.3	141.7	105.9	62.0

\* Over the months reported, consumption registered a lower decrease, compared to sales and incomes in kind, which was theoretically possible only if households had used their stockpiles. Practically speaking, this was only possible if retail sales and in kind production had been higher than reported.

Household production aims at satisfying a household's own needs. Individual producers trade only 1/3 of their production against money as a

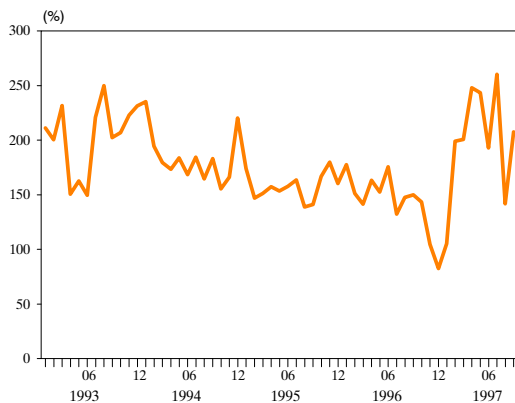
medium of exchange. What they are after is not efficiency of production or an optimum use of the resources available to achieve a competitive market price. They produce various goods to satisfy their own wants. In early-1997, the goods intended for personal consumption or exchanged without using money slightly increased. In August and September, however, money incomes from household direct production fell back to their previous years' levels. The increase in money incomes was mainly due to the produce traded in the municipal markets where increased supply made certain commodity groups less expensive in August and September (e.g. the consumer prices of fresh fruit dropped down by 13% on average in September).

The share of barter arrangements among individual producers is difficult to gauge. Most probably, it has increased parallel to direct production growth.

Construction data are another indicator of the growing importance of self-sufficiency. According to NSI data, in the ten months to October 1997, production in construction decreased by 47% at comparable prices, on a year earlier. At the same time, new housing had increased by 21% due mainly to private investors and individual construction, registering a 38% increase. The increase was clearly the aftermath of individual construction activity, not encompassed by sector data surveys. The number of construction permits obtained by private and individual entrepreneurs increased too.

The share of direct production was largest in villages. Over the early-1993 to 1997 period, due to a geographic re-distribution of the population the relative share of the village households surveyed decreased by 6% against the overall house-

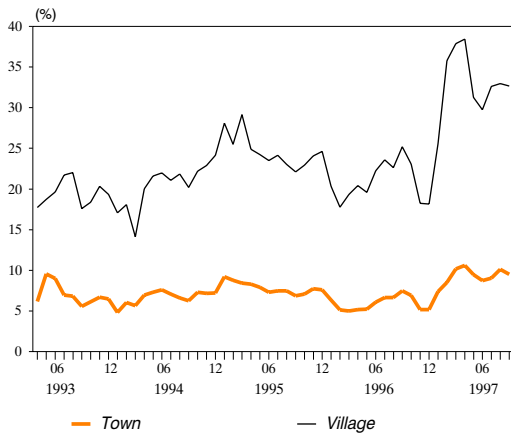
**Non - money to Money Incomes from Household Production Ratio\***



\* seasonally adjusted

Source: NSI, AEF

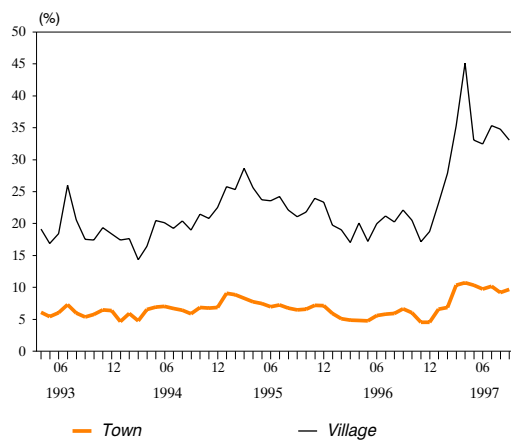
**Distribution of In - kind Incomes between Towns and Villages\***



\* seasonally adjusted

Source: NSI, AEAf

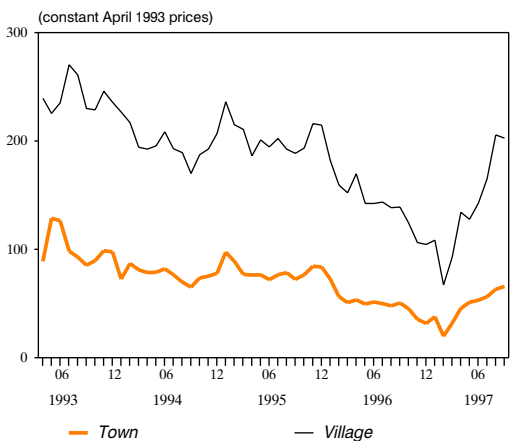
**Distribution of In - kind Expenditures between Towns and Villages\***



\* seasonally adjusted

Source: NSI, AEAf

**Distribution of Real Non - money Incomes between Towns and Villages\***



\* seasonally adjusted, deflated with CPI

Source: NSI, AEAf

hold number. This structural change had a curbing effect on the growth of incomes and expenditures in kind nationwide.

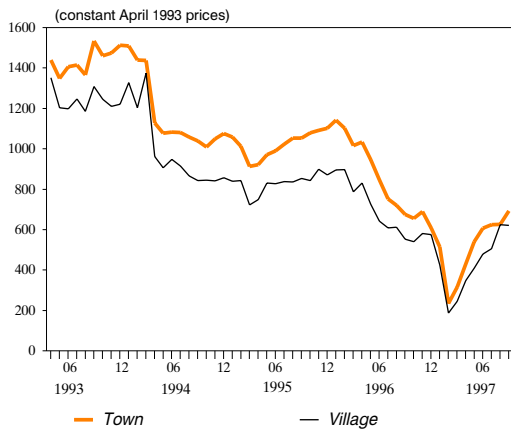
In villages, the economy in kind is ousting money as a medium of exchange. From December 1996 to April 1997 alone, in kind expenditures as percentage of money expenditures soared from 17% to 45%.

Given the impossibility to fully estimate the indicator's dynamics, it can be assumed that over the crisis-ridden period of hyperinflation, village households relied heavily on their own production. The share of household self-sufficiency in towns was three times lower, compared to villages. Its relative share within the 5-10% range, following the monthly dynamics of the village household self-sufficiency indicator, the reason being partially due to the transfer of incomes to towns and also the use of the CPI as a discounting instrument.

By February 1997, real town and village household incomes in kind had been decreasing at a slower rate, as compared to money incomes. Since February incomes in kind have quickly compensated for their lagging behind. The high rate of village population aging and its attempts to fully satisfy its wants out of direct production led to a shrinkage of the market and made investments in the underdeveloped network of shops non-profitable, more specifically in the mountainous and semi-mountainous areas. This tendency imposed a nationwide trade shrinkage, further deepened the infrastructure isolation of some geographical regions and checked growth potentials.

The development of the economy in kind has both its favourable and adverse effects. On the one hand, it generates additional incomes, cre-

### Distribution of Real Money Incomes between Towns and Villages\*



\* seasonally adjusted, deflated with CPI

Source: NSI, AEF

## Efficiency of Economic Structures

ates alternative employment opportunities and improves competition and viability. On the other, the production of various goods in limited quantities does not allow for economies of scale and specialization. Money consumption nationwide shrinks, makes production inefficient and fails to promote investment. Market relations are thus hampered, with regard to the difficulties in exchange. And last but not least, as nearly 100% of the incomes in kind are non-taxable, the balance of the tax burden is disturbed.

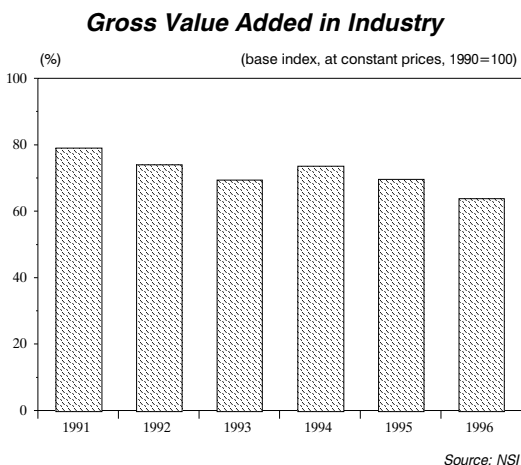
Bulgaria's GDP decline further deepened in 1996 and 1997. If the factor at work bringing about the contraction of the Bulgarian economy in the initial transition period was the transition itself, i.e. the dismantling of the command economy, the continuous recession and the strong contraction of economic activity in 1996 and 1997 evolved from the lack of structural reforms in the economy.

Resource re-allocation in the post-1991 period asserted itself in an upward trend of service sector within the gross value added generated in the economy - a sector that was entirely neglected under the command economy. The industrial sector share declined while that of agriculture remained unchanged throughout the period examined. 1996 saw a steep and enormous fall in the gross real value added generated in all the three sectors, relative to 1991.

The newly-shaped structure of the industrial sector has had a minor contribution to growth. The post-1991 period was characterized by a growing share of the branches with low efficiency<sup>20</sup>.

<sup>20</sup> Efficiency has been estimated via the gross value added/gross output ratio.

There emerged a negative tendency towards increases in the share of the extraction and primary processing industries. The structure of Bulgarian industry has thus approximated the industrial structure of the less developed countries. The overall share of gross industrial output in electricity and heating, ferrous and non-ferrous metallurgy, chemical and coal mining industry stepped up from 41% in 1991 to 51% in 1996. The chemical and oil-processing industries as well as ferrous metallurgy, accounting for 33% of gross industrial output in 1996, generated only 15% of the value added and thus contributed to the decline in the country's industrial efficiency.

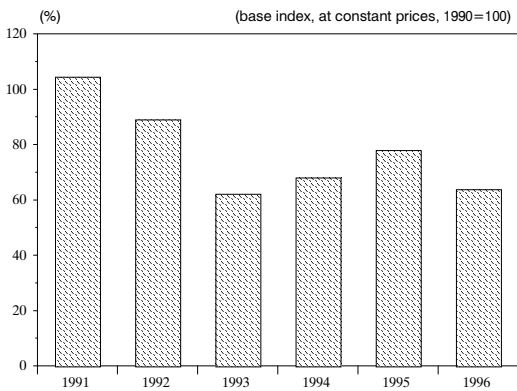


The enormous decline in machine building, the metal processing industry, electronics and electrical engineering, textile and knitwear and food industries had a crucial effect on total GDP decline. Their share within gross industrial output fell from 46.2% in 1991 to 36.7% in 1996. The share of value added in the gross output in these branches in 1996 surpassed the industrial average, amounting respectively to 37.8% (machine building and metal processing industry), 26.8% (electronics and electrical engineering), 32.4% (textile and knitwear industry) and 27% (food industry), given 24% on average in the industrial sector, which was another proof of the higher degree of their efficiency.

The gross value added generated in the industrial sector in 1996 declined by 19.3% against 1991 while gross industrial output decreased by 15%, thus providing solid evidence that the efficiency of the new industrial structure was rapidly decreasing.

Agriculture, a traditionally key sector in the Bulgarian economy has been affected by an acute crisis. Gross value added, at comparable prices,

**Gross Value Added in Agriculture**

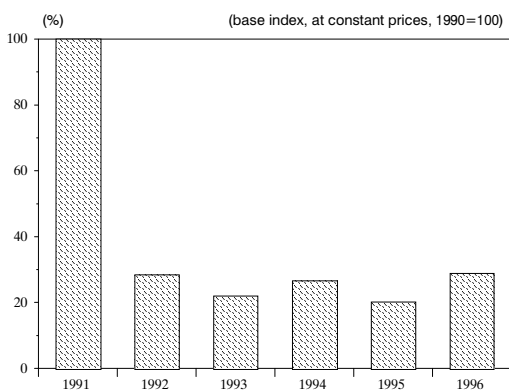


Source: NSI

generated in agriculture in 1996, dropped down by 38%, relative to 1991. There has been a continuous decrease in the areas under crops, average yields and the produce obtained, which is indicative of serious and unresolved problems in agriculture itself. On the other hand, the sector's efficiency over the 1991-1996 period surpassed average efficiency in the Bulgarian economy, thus pointing to important growth and development potentials.

While maintaining a degree of economic efficiency higher than the country's average, the service sector registered a considerable drop in the value added generated in 1996. The finance, credit and insurance sector had a decisive impact on its dynamics. The service sector generated 15% of the value added in the Bulgarian economy in 1991. In 1996, however, its contribution shrank to 10.6% registering a 71% drop in real value relative to 1995.

**Gross Value Added in Finance, Credit and Insurance**



Source: NSI

The unfavourable developments in the sector have exerted an adverse impact on the economy as a whole, for the stability of the financial sector is a pre-condition for the proper operation of the economic system.

Standing in sharp contrast, communications and transport were the only sectors registering positive growth rates throughout the period (the 1996 decline in transport excluded). Steady growth, coupled with high economic efficiency, makes communications an extremely attractive sector.

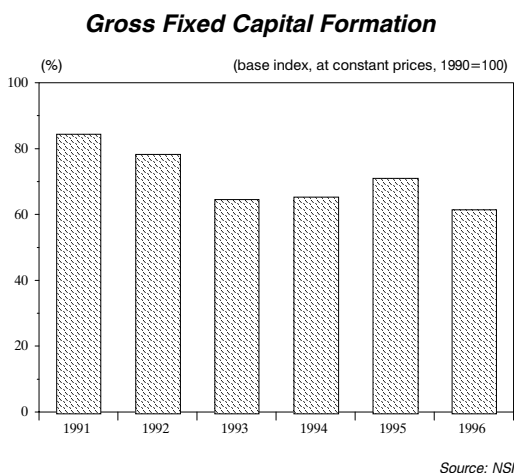
The overall economic efficiency reached a peak in 1993, followed by a fast decrease. Obviously the GDP growth in 1994 and 1995 was achieved at the expense of a decline in economic efficiency, signalling that no restructuring took place.

The main sources of growth were the export-

led industries such as the chemical industry and metallurgy, machine building and the metalprocessing industry, as well as some food industries, giving way to the headlong advance of the private sector. As growth in 1994 and 1995 was largely generated by the low efficient industries, it was unstable and therefore rather short. The current export structure, in which the energy- and import-intensive industries have large shares, contributes to the declining competitiveness of the Bulgarian economy and is unlikely to generate sustainable growth. The share of ferrous metallurgy in exports increased from 3.6% in 1991 to 8.1% in 1996, while the chemical industry maintained its 30% share. At the same time, the share of machine building and the metal processing industry stepped down from 18.7% in 1991 to 10.3% in 1996, the share of electronics and electrical engineering dropped to 4.5% in 1996 from 13.3% in 1991, and the share of the food-processing industry decreased from 19% in 1991 to 17.4% in 1996. Data analysis indicates that some leading exporters of industrial production have successfully restructured their businesses, taking advantage of government energy price subsidies, easy credit access, the lev's depreciation and deferred payments.

### **Investment and Privatization**

The enormous decline of investments in Bulgaria since 1991 exerted a negative impact on the overall economic development. The share of gross capital accumulation fell from 29.6% of GDP in 1990 to 11.2% in 1996. Coupled with the lag effect of investments on growth, it may lead to serious consequences and disturbances in the economy in the short- and long run. In a broader perspective, low investment activity now presupposes low



production capacity.

There have been substantial changes in the structure of investments since 1991. The share of fixed capital formation (FCF) costs in industry within total FCF costs in the economy declined from 56% in 1991 to 35% in 1996 (at 1991 and 1996 prices). At comparable prices, FCF costs in industry in 1996 represented about 45% of 1991 costs. Given the present macroeconomic situation and deplorable condition of the real sector, higher investment activity in the country becomes a must. Without overemphasizing the contribution of industry to growth, it is noteworthy that an increase in gross capital accumulation and long-term sustainable growth are impossible without the structural adjustment and technological innovation of the industrial sector.

The share of FCF costs in agriculture within total FCF costs in the economy stepped down from 7.4% in 1991 to a bare 1.2% in 1996. At comparable prices, FCF costs in agriculture comprised 11-15% of 1991 costs. Investments in agriculture have been hampered by both private producers' unwillingness to make substantial investment contributions because of the sluggish pace of the land reform and the limited financial resources individual producers have as a result of ownership fragmentation.

1997 saw no changes in the instruments of agricultural production support used. The *Land Improvement Fund* and the *Protection of Farmland Productive Quality Fund* continued to grant subsidies to support the country's gene pool. Government subsidies, however, were not intended to directly support agricultural production. Furthermore, as they usually supported certain institutions in a given area, they did not have a positive



impact on the sector.

Despite the opinions voiced that the Law on the Protection of Agricultural Producers needs to be amended, the *Agriculture* Fund continued to exploit the well-known (in terms of procedure and efficiency) ways and means of agricultural production support. In 1997, the Fund supported primarily wheat and maize producers and extended a preferential credit line for buying farming machinery and trailing equipment and creating and recovering of perennial crops. Over the 1997-1998 economic year, the Fund intends to allocate 70% of its resources to support wheat and maize production. This is working capital which is not expected to produce a long-term effect on production and will thus deepen regional disparities and fail to ensure the optimum use of local resources.

The relative share of FCF costs of the service sector within total FCF costs in the economy increased from 28.6% in 1991 to 52% in 1996. At comparable prices, the increase amounted to about 28-32%. The sector of science, R & D and education has registered a most drastic decline, which in turn may hinder technological innovation and hence, the efficiency and competitiveness of the Bulgarian economy.

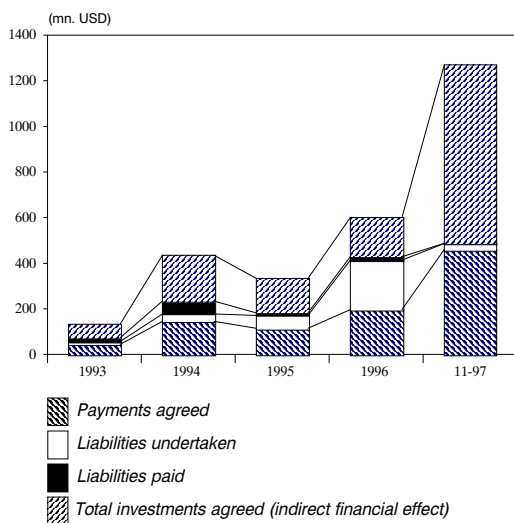
Under the transition to a market economy, an increasing part of GDP and gross value added has begun to be generated in the private sector. The share of the gross value added generated in the private sector stepped up from 18.6% in 1991 to 45.9% in 1996. The growing share of the private sector was due mainly to the increasing number of newly-established private enterprises and not to the privatization and/or restitution of state-run enterprises. In 1991, the share of FCF in the pri-

vate sector accounted for a tepid 3.3% of total FCF in the economy while in 1996 its share reached a record high of 52%. Private investments have been channelled to sectors with low investment requirements such as the service sector, trade, transport as well as agriculture, food industry and construction. The fulfillment of promises for investing under the privatization deal contracts will remain the only source of fresh resources for restructuring and innovation.

Since the outset of the privatization process in 1993 till October 1997, the state privatized about 20% of its property, of which about 9% via cash privatization and another 10% via mass privatization.

According to data of the Privatization Agency, in the eleven months of 1997, 451 privatization deals were concluded, of which 241 (by 1.5 times more relative to 1996 and twice as many as in 1995) deals encompassed the privatization of entire enterprises. The period witnessed the conclusion of the most important strategic privatization deals - the *Sodi Devnja* Plant to *Solvay*, Belgium for USD 160 mln, *Devnja Cement* Plant to *Marvex*, Spain for USD 45.5 mln, the *Interpred World Trade Centre* to the *DAEWOO* Group, South Korea for USD 20 mln, the *Beloizvor Cement* Plant to *Holderbergbank* for USD 32.5 mln and the package privatization deal of the *Zlatna Panega* and *Granitoid - Batanovtsi* Cement Plants for USD 27.5 mln to *Heidelberg Cement*. The financial agreements reached upon the conclusion of the above deals have changed the structure of the privatization receipts<sup>21</sup> in 1997.

#### Financial Results of Privatization\*



\* Date concerns contracted obligations, not actual

Source: PA, AEF

<sup>21</sup> It concerns the financial agreements reached upon concluding the deals and not the actual fulfillment of the privatization contract parameters.

From early-1997 to October, 30, 1997, the growth rate of the investments and payments negotiated (i.e. the price at which a given deal has been finalized) rose from USD 172 mln and USD 196 mln in end - 1996 to USD 781.8 mln (4-fold and USD 460 mln (2-fold) respectively in end-October 1997. All this implies that the deals concluded over the period surveyed, concerned the privatization of SOEs with low indebtedness (i.e. in a relatively good financial condition) which do not need immediate financial recovery but innovation and technological improvement.

Mass privatization in itself does not have a direct impact on investment growth. However, the financial results of the SOEs privatized via mass privatization have been improving, outstripping the results of state-run firms<sup>22</sup> and create expectations for high investment activity in these enterprises.

In October 1997, the government mapped out its 1997/98 Privatization Acceleration Strategy, approving a new approach to speeding up the privatization process. The strategy defines clear-cut targets aimed at the privatization of 73% of the state-own assets by end-1999.

Land ownership restitution in agriculture has been a most sluggish and cumbersome process.

As of October 27, 1997, ownership rights to 18.9% (1044.32 thousand ha) of total farm land (5517.6 thousand hectares) have been restituted in existing or old physically restorable borders<sup>23</sup>. The decisions issued, pursuant to Article 27, paragraph 1 and by virtue of the land division plans

---

<sup>22</sup> See *NSI Current Business Situation, October, 1997.*

<sup>23</sup> Article 18 g, paragraph 1 of the Regulations of Implementation of the Land Law.

enforced and maps handed, amounted to 47% (2596.2 thousand ha). Overall, in existing and physically restorable old borders and by land division, ownership rights to 65.9% of total farm land have been restituted. Land ownership restitution in 49.2% of the territories belonging to settlements (TbS) has been fully completed.

### The Pace of the Land Reform (by administrative districts as at October, 27, 1997)

Districts	Restituted Land Ownership Rights		in thousands of ha	%
	in old physical borders, %	pursuant to a land division plan, %		
overall in the country	18.9	47.0	3639.4	65.9
Bourgas	5.9	51.3	394.2	57.1
Varna	3.6	71.2	586.5	74.8
Lovetch	20.3	53.0	664.8	73.3
Montana	21.0	29.2	364.2	50.2
Plovdiv	30.0	38.0	346.6	68.0
Rousse	4.8	70.9	522.0	75.7
Sofia City	41.8	6.1	22.8	47.9
Sofia District	53.9	17.6	416.7	71.5
Haskovo	20.3	35.1	321.6	55.4

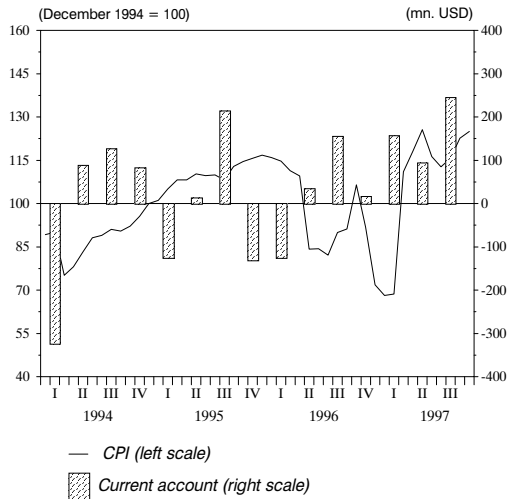
**Note:** The table shows the pace of the land reform in Bulgaria as at October, 27, 1997.

**Source:** Statistical Barometer, November, 27, 1997.

Title deeds to 11.9% of the total farm land subject to restitution were issued in 1997. Their number registered a 2-fold rise, on a year earlier, while the size of the farm land property legalized by title deeds increased by 2.5 times.

## Competitiveness

### Real Effective Exchange Rate and the Current Account

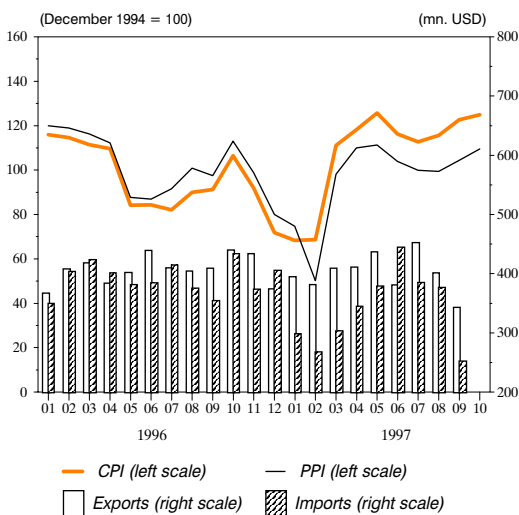


Source: BNB, AEAf

1) Indices above 100 show overvaluation and below 100 - undervaluation.

2) A basket of currencies (USD, DM, GBP, FRF) used deflated by CPI.

### Real Effective Exchange Rate and Exports



Source: BNB, AEAf

1) Indices above 100 show overvaluation and below 100 - undervaluation.

2) A basket of currencies (USD, DM, GBP, FRF) used deflated by CPI.

3) The exchange rate BGL/USD is used when deflated by PPI.

The real appreciation of a national currency, as calculated on the basis of the price index, is one of the consequences of the fixed foreign exchange rate policy. Real income growth, as a result of economic stabilization, usually leads to a robust increase in consumption. The interplay of these two factors may generate hefty trade balance and current account deficits. Under currency board arrangements, the current account deficits in Argentina, Estonia and Lithuania represent about 3-5% of GDP. Timely measures should therefore be taken to overcome the unfavourable effect of the national currency appreciation on current account transactions.

The real effective foreign exchange rate index is used as an indicator of Bulgarian export competitiveness. Deflated by the CPI and PPI, the lev's real effective foreign exchange rate points to some appreciation in end-year. Estimations rely on a basket based on the relative weights of the major currencies used in Bulgaria's foreign trade payments.

In early-1997, the indices registered a series of large fluctuations, followed by relative stabilization after the establishment of the currency board. Since March 1997 the lev has started to appreciate in real-terms, with the real exchange rate reach 124.97 in September 1997, CPI deflated (December 1994=100) and 109.42 PPI deflated.

In the short-term perspective of the January-September period, the real appreciation of the Bulgarian lev, as estimated on the basis of the price indices, did not result in deterioration of the current account balance. In a long-term perspective, however, once economic agents have adjusted to the new conditions, a deterioration in the country's trade balance can be expected due to

an increase in imports of consumer goods following a household income growth and an import increase in investment goods, as spurred by the economic recovery anticipated.

The real exchange rate index, based on the ratio between the unit labour costs in Bulgarian industry and the unit labour costs in Bulgaria's major trading partners, can also be used as an indicator of competitiveness.

### Unit Labour Costs in Industry

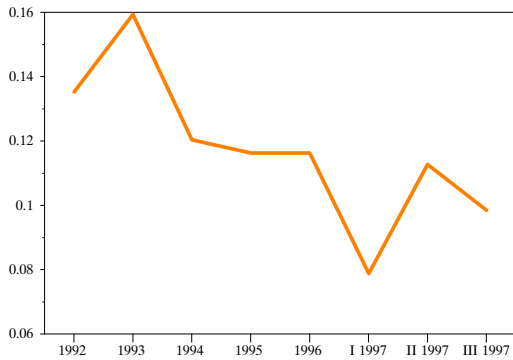
(index, 1990=100)

	1991	1992	1993	1994	1995	1996	1997
<b>Bulgaria</b>	74.2	123.6	145.5	109.9	106.2	106.2	100.5
<b>European Union</b>	105.6	109.0	111.2	107.3	107.8	110.2	111.4

Unit labour costs in Bulgaria have been lagging behind the change in unit labour costs in the EU and Bulgaria's main competitors.

The considerable depreciation of the lev in the last quarter of 1996 and the first two months of 1997 has led to a substantial decline in dollar wages. On the labour cost side, Bulgarian exports have sustained their competitiveness, despite the increase in wages over the past few months. Due to the low relative share of labour costs within total production costs, their further decrease is not expected to give any additional competitive advantage to Bulgarian exports. As a result of real wage growth and higher inflation rate, as compared to Bulgaria's major trading partners, the competitiveness of Bulgarian exports, in terms of labour costs, over the next year is expected to

**Unit Labour Cost in Manufacturing  
(Public Sector)**



Source: NSI, AEAf

decrease against labour costs in the rivalling CEECs which stand closer to labour costs in Bulgaria, as compared to the EU. This negative trend can be overcome only by way of structurally adjusting Bulgarian firms and lowering raw material costs, electricity and fuel costs in particular.

The standard indicators of the competitiveness dynamics of an economy as well as the stock-in-trade instrument of improving competitiveness (via depreciation of the national currency) are not applicable to the Bulgarian case. On the contrary, past experience implicates that large exchange rate fluctuations and strong depreciation have not contributed to export performance. Definitely they had a harmful effect on the overall operation of the economy. In the long-term, the growing efficiency of the Bulgarian economy and product innovation will be the factors at work, promoting competitiveness. □

# Contents

<b>I. Financial Stabilisation in 1997 .....</b>	<b>3</b>
<i>The New Laws on the Bulgarian National Bank and     the Commercial Banks - Introduction of Hard Budget Constraints .....</i>	<i>3</i>
<i>The Lowering of the Interest Rates – a Successful Outcome of Stabilisation .....</i>	<i>6</i>
<b>II. Stabilisation Factors .....</b>	<b>9</b>
<i>Incomes as a Nominal Anchor .....</i>	<i>9</i>
<i>The Anchor of the Exchange Rate .....</i>	<i>18</i>
<i>Financial Position of State-owned Firms .....</i>	<i>23</i>
<i>Budget Revenue and Expenditure Anchor .....</i>	<i>25</i>
<b>III. Barriers to and Potential for Future Economic Growth .....</b>	<b>28</b>
<i>The Crowding-out Effect of the Economy in Kind over the Market Economy .....</i>	<i>28</i>
<i>Efficiency of Economic Structures .....</i>	<i>34</i>
<i>Investment and Privatization .....</i>	<i>37</i>
<i>Competitiveness .....</i>	<i>43</i>