BUSINESS SURVEY SERIES

BULGARIA
1998 ECONOMIC SURVEY

AGENCY FOR ECONOMIC ANALYSIS & FORECASTING

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In 1996 and the first two months of 1997 the Bulgarian economy passed through a severe financial, banking and real sector crises. It reacted quickly and in a positive way to the change in economic policy in 1997.[1] The most important consequence of the stabilisation program launched in April 1997 was the compensated during the rest of the year fall in first quarter GDP of 21 percent. Ultimately, the actual drop in GDP turned out to be 6.9 percent instead of the forecasted 10 percent. In 1998 the macro and microeconomic policy mix proved its success in promoting the economic recovery. After a quick renewal of business activity in the second half of 1997, growth started to decelerate in 1998. One of the factors for the slowdown was the devastating march of the international financial crisis form one region of the world to another. The ongoing Kosovo crisis also contributed negatively to the overall economic performance.

This report contains three sections. The first section gives an overview of the main features of the macroeconomic stabilisation in 1998 – single digit (close to zero) end of period inflation, low and sustainable budget deficit and low (single digit) interest rates. Section two analyses the impact on economic growth of the interaction between the deteriorating international environment as a negative external factor and both the macroeconomic stability and the enhanced financial discipline as positive domestic factors. The final outcome is a growth rate of 4 percent instead of 6-8

[1] The change in the Bulgarian economic policy in 1997 is related to the change in the political situation after the severe economic crisis of 1996 and the beginning of 1997. In the April 1997 elections the Union of Democratic Forces (UDF) gained a majority in Parliament, and in May 1997 the UDF formed its government. An analysis of the economic program, adopted in 1997, and of the specific measures in 1998, is presented in the business survey series of the Agency for Economic Analyses and Forecasting, „Bulgaria – 1997 economic survey“, and „The Bulgarian Economy in the First Half of 1998“.

percent. Section three elaborates on the main prerequisites for a sustainable economic growth – the development of an efficient private sector, the privatisation and restructuring of the still existing state sector, the development of the banking sector and the financial intermediation function of banks. The last section draws the conclusions of the presented analysis. ❑

1. The Macroeconomic Stability of 1998

1998 witnessed the full effect of macroeconomic stabilisation policy based on the currency board and prudent fiscal policy. Inflation is low, the foreign exchange reserves of the Bulgarian National Bank (BNB) are increasing, interest rates have remained stable at a level which, under the low inflation rates, allows for positive real interest rates, incomes continued to increase to their pre-crisis level.

1.1. Inflation

The end of year inflation in 1998 is 0.96 percent. Even during the second half of 1997 inflation fell to low levels, compared to the dramatic first half of the year – cumulative inflation for the first half was 484.2 percent, and 16.2 percent for the second, with signs of lasting inflation decrease in the last three months of the year. The tying of the Bulgarian lev to the German mark contributed to the convergence of price dynamics in both countries.

The main factors that contributed to the low inflation in Bulgaria are four – (1) stable exchange rate, (2) stable money supply, (3) low share of goods with administered prices and (4) a reduction in international prices of major commodity groups.

From 1991 until the beginning of 1997 inflation in Bulgaria was high and unstable, which lead to general uncertainty of the macroeconomic environment. With the introduction of the fixed exchange rate, fortified by the currency board system, the average monthly inflation rate decreased considerably, reaching the extremely low level of 0.08 percent[2]. As the lev is fixed to the

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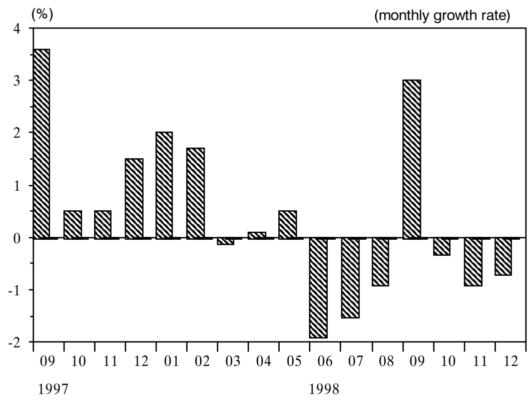
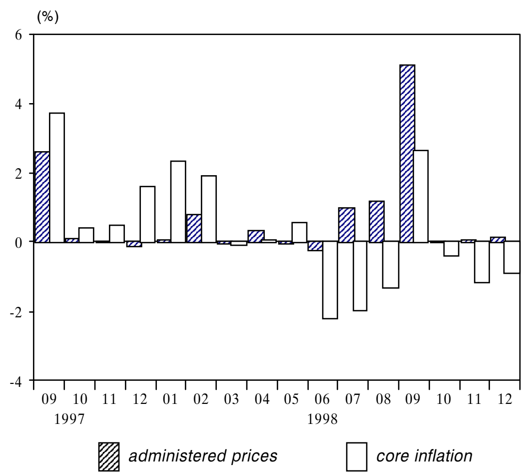
[2] *The average monthly inflation rates by years are: 15.7 percent for 1991; 5.0 percent for 1992; 4.2 percent for 1993; 6.7 percent for 1994; 2.4 percent for 1996; and 17.3 percent for 1997.*

Inflation



Source: NSI, AEAF

Core Inflation



Source: AEAF

German mark [3], domestic inflation converges to German inflation rate – at the end of 1998 German inflation was 0.5 percent [4]. Domestic inflation is due to the adjustment of domestic to international prices, and the changes of relative prices pushed by the rise of non-tradables goods' prices.

Against the background of a general price stabilisation, changes in the administered prices turn to be a major inflationary factor. In 1998 the share of goods and services with administered prices in the consumer basket is only 15.8 percent but their contribution to overall inflation is 1.36 percentage points. At the same time, the contribution of non-administered prices („core inflation") is negative (-0.40 points). The impact of administered prices increased in the middle of the year, with the raising prices of telephone and post services, water fees (in August), and of coal and heating (in September).

Over the 1991 – July 1997 period, a change in administered prices usually caused an initial inflationary outburst, followed by a series of price shocks of decreasing magnitude caused by the adjustment of non-administered prices to the change of administered ones. Thus, the aim of raising the real (or relative) price of these goods and services was not achieved. This in turn necessitated further increases of administered prices, and having in mind that their share in the consumer basket was growing steadily after 1993 to reach 52 percent in the beginning of 1997, this

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[3] A Currency Board Regime was introduces in Bulgaria on the 1st of July 1997. The Bulgarian lev was tied to the German mark by law, at the rate of 1000 lev per 1 mark. As of January 1st, 1999, the lev is fixed to the Euro at a rate of 1955.83 lev per Euro.

[4] The comparison is for illustration purposes only, as the indices are calculated using different methodologies.

process destabilised the whole economy without serving any real purpose.

In 1998 the increases of administered prices had a one-time impact on inflation and did not reflect in the dynamics of other prices. Under the fixed exchange rate and stable money supply, the changes in administered prices did increase the real price of the respective goods, and thus contributed effectively to the improvement in the financial situation of the enterprises that provide them.

In 1998 the international prices of fuels and major raw materials fell considerably. One of the reasons is the crisis in the international financial markets, which brought to a recession and contraction of demand in the affected regions of the world. However, there is a more fundamental factor that inspires a long-term reduction of demand for certain inputs – the new and more efficient technologies for their utilisation. The prices of goods traded at the international markets have fallen by an average of 18.9 percent, including a 21.3 percent fall in food prices and 15.9 percent fall in industrial prices.[5]

Contribution of Major Commodity and Service Groups to Inflation

Commodity and service groups	Weight in the consumer basket, percent	Percentage change, end of year	Contribution to inflation, percentage points
ALL	**100.000**	**0.96**	**0.96**
Foodstuffs	55.132	-4.81	-2.65
Non-food items	27.613	-0.09	-0.02
Services	15.522	22.24	3.45
Public catering	1.733	10.30	0.18

[5] *„The Economist“, December 12-18, 1998, page 128.*

Under the fixed exchange rate and the openness of the Bulgarian economy, international prices strongly influence the domestic inflation rate. However, in 1998 domestic prices did not exactly follow that pattern.

There were periods when international prices crashed and yet this didn't have an immediate impact on domestic prices. When (the lower) domestic prices do not fall as a result of the fall in the respective international prices, this serves as a sort of 'inflationless' equalisation of domestic and international prices. For instance, during the whole year international oil prices were falling, and domestic gasoline and diesel prices remained unchanged from March to December. It became more profitable for fuel distributors to import fuels rather than to buy them from the „Neftochim" monopoly. This lead to a twofold increase of the volume of imported fuels. Similar dynamics were observed in relation to the import of consumer goods and raw materials.

In 1998 prices of tradables[6] rose by 0.67 percent, and those of potentially tradable[7] goods and services fell by 4.87 percent at the end of the year. The prices of non-tradable goods and services rose by 7.76 percent. The last group includes goods and services the prices of which

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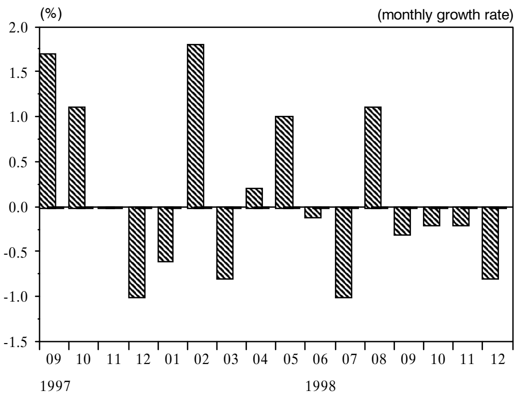
[6] *The 'tradables' group includes all goods and services for which there are no administrative, transport, or other barriers to import. Administrative barriers include tariff rates of above 25 percent or existence of permission-to-import regime. Transport barriers exist for goods that have high transportation costs, or are consumed fresh and transportation leads to loss of their qualities. Some of the goods included in the tradables list are: foodstuffs (eggs, meat and meat products with low level of processing, citrus fruits, etc.), non-food (household appliances, automobiles, electronics, etc.). Their combined weight in the consumer basket is 14.1 percent.*

[7] *„Potentially tradable" are those goods for which there are only administrative barriers to import. Such are: gasoline, pork and chicken meat, milk and dairy products, foodstuffs with a high level of processing, clothes and shoes, natural gas, medicines, etc. Their combined weight in the consumer basket is 45.9 percent.*

are not affected by international prices (services having the highest contribution to the annual inflation).

The stabilising effect of the exchange rate reflected on the domestic producer prices in industry – the first to respond to exchange rate changes in the past. End of period producer price inflation was 0.1 percent. (For comparison, industrial producer prices in Germany fell by 1.7 percent in 1998.) For example, the „Food manufacturing" branch sold its produce at 11.7 percent lower prices, which incorporates a decrease of all prices across the sectors of that branch with the exception of „Fish processing and canning" (16.9 percent rise) and „Production of vegetable and animal oils" (22.48 percent rise). (See the appendix to section 1.2)

Producer Price Inflation



Source: NSI, AEAF

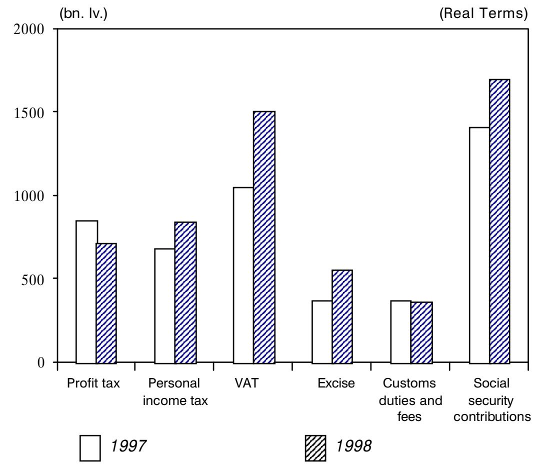
Eliminating the destabilising impact of the floating exchange rate the regression relationship between producer and consumer price inflation became closer. This may indicate the expansion of domestic production at the domestic market as well as the completion of the price equalisation process.

To summarise, under the current economic program the inflation in Bulgaria reached very low levels and in the future price dynamics should depend highly on the international price movements.

1.2. The Budget and Its Interest Expenditures

Fiscal policy in 1998 can be characterised by better discipline in both tax collection and spending of budget resources which brought to budget revenues 25.3 percent higher than the 1998 Budget Law level, and a surplus of the consolidated budget. Consolidated budget revenues rose by 21.7 percent in real terms

Main Tax Revenues of the Consolidated Government Budget



Source: MF, AEAF

compared to 1997, mostly due to the increased tax revenues, which reached 33.3 percent of GDP.

Indirect taxes are the main revenue source of the budget. In 1998 VAT revenues reached 8.5 percent of GDP, increasing by 42.9 percent in real terms over 1997.

The changes in the VAT Law, entering into force as of January 1st, 1998,[8] envisaged the abolition of voluntary VAT registration and the introduction of a higher limit to registration (BGL 75 million taxable turnover from domestic activity, and BGL 50 million for exporters). As a result the number of registered firms fell by more than a third, which improved the control exercised by the tax administration. The change motivated companies to reveal turnover that was hereto unreported, if they preferred to keep their VAT registration.

Since the beginning of 1998 [9] several key issues in the income taxation of natural and legal persons in the economy were changed. The introduction of the Corporate Income Tax Law (CIT Law) improved the system of profit tax advance instalments by smoothing the monthly revenues for the budget. Since the beginning of 1998, personal income is taxed on the basis of overall annual income (from both labour and non-labour

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[8] *New changes are entering into force as of January 1st 1999 – the VAT rate is reduced to 20 percent (from 22 percent). Also, a 'zero rate' is established for exporters, which puts a clear distinction between 'zero rate' and 'transaction not subject to VAT'. The first allows for the reclaiming of VAT credit, while the second does not.*

[9] *As of January 1st, 1999, the profit tax rate for large companies (taxable profit above BGL 50 million) is reduced from 37 to 34.3 percent. The number of assets for which accelerated depreciation schedules may be used is increased. Investors can claim tax credit for establishment or capital increase contributions, formation of working capital, to be used for the acquisition or reconstruction of buildings. This preference, however, is only valid if the investment is made in a municipality with unemployment rates 1.5 times higher that the average for the country for the last 3 years.*

The coefficient for advance monthly payment of profit tax increased from 0.9 for 1997 to 1.07 for 1998.

contracts) and a single tax exempt minimum was established.[10] Together with the 23.6 real growth of the average wage in the public sector this contributed to a real 23.1 percent growth of personal income tax revenues compared to 1997. In 1998 the share of revenues from taxing non-labour contract income increased almost twice (based on data for the first 9 months of 1997 and 1998).

The overall development of the economy was another factor for the higher than expected tax revenues. The restoration of the purchasing power of households stimulated domestic demand – in 1998 the enterprises declared 53.5 percent more VAT (in real terms) compared to the previous year, while VAT credit claims were reduced by 5.5 percent.

Structure of the Revenues of the Consolidated Budget

(Percent)

	1994	1995	1996	1997	1998
Profit tax	8.8	10.1	12.8	15.1	10.3
Personal income tax	10.6	11.1	12.1	12.1	12.3
VAT	17.6	18.1	20.2	18.7	22.0
Excise duties	8.2	7.1	4.6	6.5	8.1
Customs duties and fees	6.7	6.5	6.6	6.5	5.3
Social security contributions	21.6	21.5	21.6	25.1	24.8

In 1998 total expenditures of the consolidated budget increased 9 percent in real terms, reaching 37.7 percent of GDP. The most important change in the structure of expenditures is the sharp reduction of domestic interest payments. There are two main reasons for that development – the

[10] *As of January 1st 1999 the untaxable income is raised from BGL 720 thousand to BGL 900 thousand.*

low interest rate on newly issued government debt and the negative net issue of government securities for the year, which allowed a nominal reduction of domestic government debt.[11]

Expenditures Structure of the Consolidated Budget

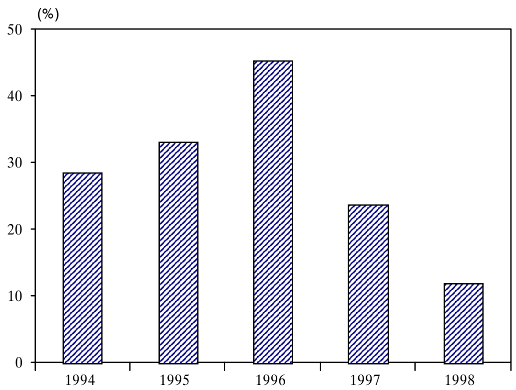
(Percent)

	1997	1998	real growth
Labour expenditures (incl. Social security contributions)	13.9	16.9	32.2
Maintenance	18.4	15.0	-11.5
Defence and security	10.1	10.9	17.5
Subsidies	3.1	5.4	91.4
Interest expenditures	23.6	11.7	-45.9
– foreign	8.2	8.4	11.7
– domestic	15.3	3.2	-77.0
Social security and welfare	24.9	29.0	26.8
Capital expenditures and increase of the state reserve	3.1	8.7	204.2

The decrease of interest expenditures allowed for higher spending on goods and services. Despite this, the budget maintained a primary surplus of 5.34 percent of GDP (5.47 percent for 1997), and the overall surplus reached 0.9 percent of GDP (2.95 percent deficit in 1997).

The accumulation of a budget surplus throughout the year allowed part of it to be used for covering temporary current expenditures, such as the payment of a 13th wage in the budget sector and a 13th pension at the end of the year. Wages and salaries expenditures increased by 32.2 percent in real terms, which reflects the intention of the government to restore real incomes in the budgetary sector. Social security

Share of Interest Expenditures in Total Expenditures of the Consolidated Budget



Source: MF, AEAF

[11] *Domestic debt decreased from BGL 4399.7 billion at the end of 1997 to BGL 3928.1 billion at the end of 1998, which is a decrease of 10.72 percent. (To obtain comparable figures, state guarantees are excluded from the 1998 figure.)*

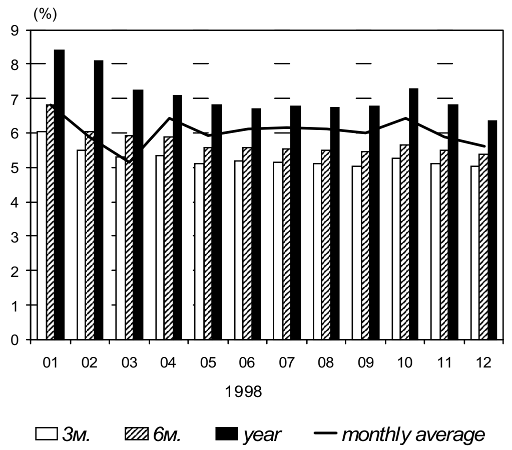
expenditures increased by a real 26.8 percent.

Capital expenditures posted the highest growth rate because of using part of the accumulated surplus for financing 63 infrastructure projects. Capital expenditures and the increase of the deposit on the fiscal reserve account rose over three times in real terms, reaching 3.3 percent of GDP. (1.1 percent in 1997)

The liquidity of the budget and the negative net issue of government securities in the second half of the year maintained a low level of interest rates in the economy.

The prudential fiscal policy of 1998 kept the government gross borrowing requirements at a low level, hence interest rate remained stable and at a relatively low nominal level comparable to German interest rates (adjusted for the country risk premium, which was declining in the course of the year). The accumulated surplus was partially spent on items of a temporary nature, thus keeping the overall spending level relatively low. Capital expenses went up – a move necessary for the recovery of the economy.

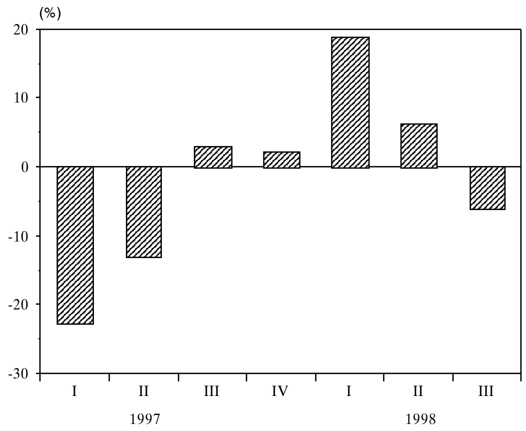
Government Securities: Annual Yield



Source: BNB, MF

2. The Economic Growth of 1998

GDP Growth*



* *Corresponding quarter of previous year = 100*

Source: NSI, AEAF

From 1990 until the beginning of 1997, the Bulgarian economy was in a state of uncertainty and macroeconomic instability, and consequently the growth rates in most of the years were negative. (See the Appendix to Section 2)

The macroeconomic stabilisation since March 1997 influenced the economy in a positive way and it started to recover quickly from the 1996 and beginning of 1997 crisis. This upward trend continued in 1998 despite the general worsening of the international economic environment, especially in the second half of the year.

2.1. The Development of the International Financial Crisis in the Second Half of 1998

In the second half of 1998 the East-Asian crisis hit Russia and Brazil. The heaviest shock to the international financial markets undoubtedly was the unilateral restructuring of the Russian government debt, the moratorium over the payments to private debt and the devaluation of the rubble in August 1998. As a result, the perception of investors of emerging markets risk changed dramatically, and the reaction was not only a psychological one. Many investors had to restructure their portfolios in an effort to partially cover their losses in Russia. A persistent capital outflow from the emerging markets and its orientation to the developed countries came forth.

These developments forced virtually all international financial institutions to revise their forecasts for the development of the world economy in 1998 and 1999.

Expected regional growth rates also underwent subsequent revisions. Bulgaria was injured by the slowdown of growth in the European Union. The latter adversely affected all transition economies in Central and Eastern Europe. (See Appendix to Section 2.1.)

Revisions to the Economic Growth Forecasts of the World Economy

(Percentage change in GDP)

Date of the forecast	1997	1998	1999	2000
October 1997	4.2	4.3	4.4	4.6
December 1997	4.1	3.5	4.1	4.4
May 1998	4.1	3.1	3.7	3.8
October 1998	4.1	2.0	2.5	3.7
December 1998	4.2	2.2	2.2	3.5

Source: IMF, World Economic Outlook, December 1998, Table 1.1, p. 7.

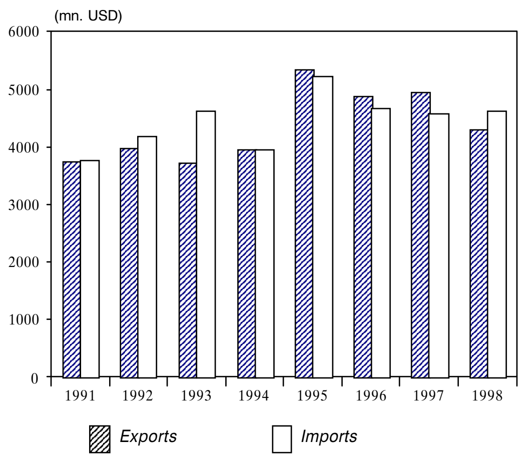
2.2. The International Financial Crisis Impact on the Balance of Payments

Any quantitative estimate of the impact of the international crisis on the Bulgarian economy can only be imprecise, but it is highly probable that otherwise the economic growth rate were going to be 6 – 8 percent instead of the expected 4 – 4.5 percent. The liberalisation of foreign trade is a component of the economic policy mix and the significant changes in the 1998 foreign trade regime partially counteracted the deterioration of the international environment.

The most important changes in the foreign trade regime in 1998 are as follows: almost all export fees and restrictions were removed; few foodstuffs, fuels and metals remained subject to the registration regime; the document processing fee was abolished; the import charge, introduced in 1996, was reduced from 5 to 2 percent, and as of January 1st 1999 it is abolished entirely.

The average customs rate (for *ad valorem* duties) for 1998 was 17.8 percent, for agricultural products – 27.5 percent. Further decline is

Exports and Imports



Source: BNB

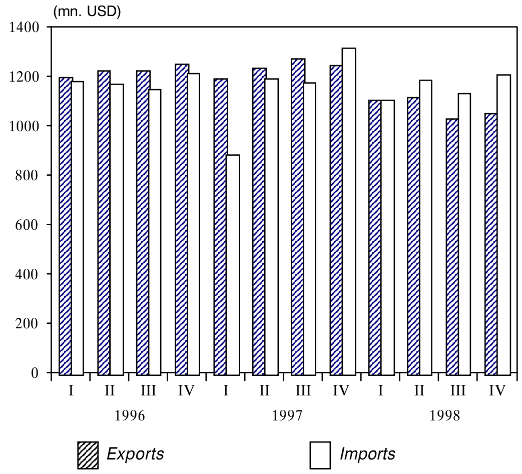
envisaged for 1999, when the average rate will fall to 16.2 percent. Over 85 percent of industrial imports from the EU and EFTA are not subject to customs duties. With the full membership of Bulgaria in CEFTA from January 1st 1999 and the implementation of the free trade agreement with Turkey, an even larger share of foreign trade will be free, which will have a stimulating effect on the development of a competitive domestic market. The easier access of Bulgarian products to the markets in those countries will improve the position of exporters.

Despite the favourable impact of these domestic changes in the trade regime, the dynamics of Bulgarian foreign trade turnover in 1998 were determined mainly by the deterioration of international markets for ferrous and non-ferrous metals, fertilisers and other chemical products – commodity groups with a high share in Bulgarian exports.

1998 clearly demonstrated the inflexibility of the structure of Bulgarian exports and the inability of the enterprises (especially the large state-owned ones) to respond adequately to external shocks. As a result of the global stagnation in 1998, preliminary data show that exports have decreased by USD 646 million in nominal terms, or with more than 13 percent compared to the previous year.

The downward trend affected about 60 percent of the commodity groups. Among the worst hit ones are chemical industry, metallurgy and food processing. An increase of sales abroad is seen in the apparel and tailoring industry (where exports increased by more that 25 percent), and some agricultural products. The liberalisation of trade with wheat in 1997 led to a five-fold increase of exports in this product group. Exports of oil seeds

Quarterly Exports and Imports



Source: BNB

and fruits exhibit growth of 45 percent.

The growth of exports in some branches of light industry and agriculture can be explained primarily by the low labour costs in the country. Bulgaria is at one of the last places in Europe in terms of wage levels. In the apparel industry, for example, around 85 percent of export revenues come from re-exports. The practice to work with material of the client in this sector becomes wide-spread (the share of re-exports of clothes in 1993 was 65 percent, i.e. there is an increase of 20 percentage points over 5 years).

Change in the Value and Volume of Exports. Share of Product Groups in Total Exports

(Percent)*

	Change in value	Change in volume	Share, 1997	Share, 1998
Cast iron, iron and steel	-8.7	-16.0	10.7	11.0
Mineral fuels, mineral lubricants and products from them	-32.2	-29.1	7.6	5.7
Copper and copper items	-20.3	0.5	5.8	5.2
Machines, equipment and appliances	9.3	13.4	5.3	6.5
Non-textile clothing	32.1	21.5	4.6	6.7
Fertilisers	-51.4	-36.8	4.2	2.3
Organic chemical products	-38.8	-26.1	3.8	2.6
Electric machinery and equipment	-15.5	-7.4	3.7	3.5
Tobacco and processes tobacco substitutes	-34.5	-22.6	3.3	2.4
Soft and alcoholic beverages, vinegar	9.9	-5.1	3.0	3.7

** Data for the first 9 months*

Source: AEAF calculations, based on NSI data

The dynamics of export revenues is determined by two variables – volume and price. Apparently, in the case of copper for example, the double-digit decline in nominal value hides the fact that there is a small increase in volume. This is due to structural changes inside the aggregated 'copper and copper items' product group – increased share of unrefined copper, which is cheaper compared to refined copper – and higher export volumes are due to re-export. The opposite tendency is observed in the export of beverages – the increased value of exports is entirely achieved through higher export prices. Most product groups, however, exhibit both falling prices and falling volumes. This combination is especially clear in the case of fertilisers and organic chemical products.

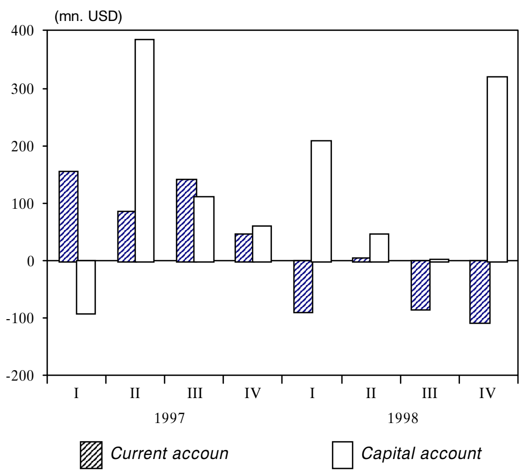
Imports in 1998 increased by 1.4 percent in nominal terms (FOB prices) compared to the same period of the previous year. The increase was smaller than expected, because of the fall in international crude oil and natural gas prices. Data shows that the average import price of crude oil in 1998 was 27 percent lower than in 1997. Over the reviewed period, the imports of mineral fuels has declined by 27.4 percent in nominal terms. Because of their large relative share, these products have a considerable impact on the dynamics of total nominal imports.

In contrast to exports where most groups exhibit decline, in the case of imports there is an increase in over 80 percent of the commodity groups. The imports of automobiles in 1998 were almost twice as large as in 1997, and the imports of electrical appliances and electronics have increased by 73 percent.

The international financial crisis had a negative impact on the flows in the capital and financial account of the balance of payments. Foreign direct investment in Bulgaria reached USD 364 million, USD 141 million less than the previous year. In1998 net portfolio investment was negative, in contrast to 1997 when the high interest rates and the stable exchange rate during the second quarter attracted foreign investors. The tendency reversed by the end of 1997 under the influence of the international crisis. In most of the months of 1998 there was an outflow of portfolio investment. The reasons are both the withdrawal of foreign investors, especially after the Russian crisis, and the increased amount of deposits held abroad by residents.

The negative tendencies in the components of the balance of payments did not pose a threat to the stability of the currency board regime. The capital account in 1998 was positive, to the amount of USD 577.5 million. This is a 25 percent increase over 1997, and is primarily due to the received medium and long-term loans from official creditors. The overall balance of payments remained positive (USD 456.5 million), which together with the IMF credits allowed BNB to increase its reserves with USD 582 million.

Current and Capital Account of the Balance of Payments



Source: BNB

2.3. The Different Aspects of Growth

Demand

The lower external demand in 1998 due to the international crisis affected foreign trade and the growth rate of the economy. Other transition countries which managed to stabilise their economies in 1994, managed to grow at the sizeable rates of 6 to 10 percent per year for the following years due to stability and especially the favourable external environment. Even Bulgaria realised moderate growth rates in 1994 (1.8 percent) and 1995 (2.9 percent), based almost exclusively on external demand, despite the otherwise unstable macroeconomic environment and falling domestic demand. In 1998 the country had the potential to grow at 6 to 8 percent, but this remained unrealised because of the decline of the world economy after the East Asian crisis.

Against the background of the international crisis, in 1998 domestic demand was the driving force behind growth.

Dynamics of GDP Components

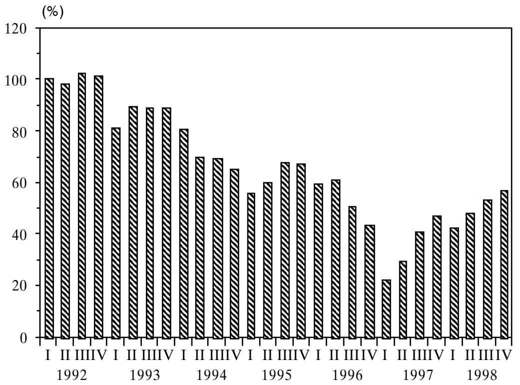
(Growth rate, percent)

	Q1	Q2	Q3	Q1-Q3	Contribution to growth (percentage points)
Final consumption	19.2	5.8	-1.0	6.4	5.3
Final household consumption expenditures (national accounts concept)	22.7	6.5	1.0	8.2	5.8
Final Consumption Expenditure NPISHs	7.9	11.2	22.2	13.8	0.1
Final Consumption Expenditure of the government	1.5	2.0	-15.7	-4.2	-0.5
Investment	-24.5	8.4	40.3	9.5	1.0
Exports of goods and services	-1.7	-8.2	-13.5	-8.2	-5.2
Imports of goods and services	18.6	-4.6	-3.1	2.5	-1.4
Gross domestic product	18.9	6.3	-5.9	4.3	4.3

In 1998 economic growth was stimulated mostly by the high households' consumption. According to the household budgets data for the January-November period, money expenditures has increased by 43.6 percent in real terms compared to the same period of 1997. For the first quarter alone the increase is 91.5 percent, and for the second and third quarters – 64.8 and 27.9 percent respectively.

The structural changes in consumption reflect the increase of real incomes – the share of food expenditures decreases, despite the fact that it remains relatively high (over 40 percent of monetary expenditures). The increased household consumption reflected on the increase of imports of consumption goods. However, part of the increased consumption demand was satisfied through domestic production.

Index of Real Money Expenditures of Households*



** Base: First quarter of 1992*

Source: NSI, AEAF

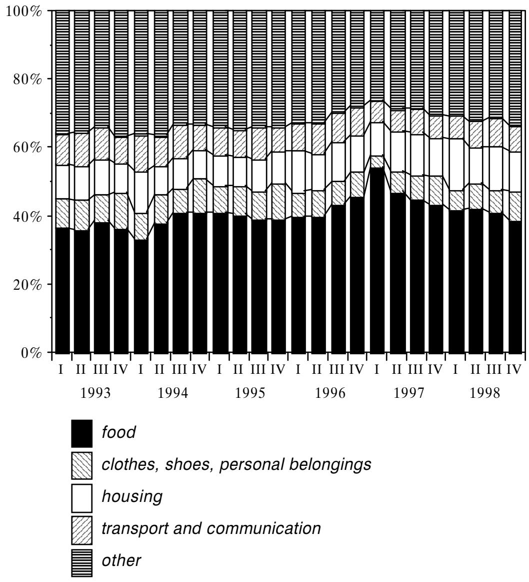
Changes in Domestic Consumption and Imports by Major Commodity Groups

January–September

Change over the same period of the previous year, percent[12]

	Household expenditures (household budgets survey data)	Imports, as per the Balance of payments[13]
Food, beverages, tobacco	62.6	56.2
Clothes and shoes	96.2	28.7
Furniture and upholstery	118.9	47.1
Medicines and cosmetics	103.8	44.2

Structure of Households' Money Expenditures



Source: NSI

Another important component of domestic demand is investment demand. Only in the third quarter did they increase enough in real terms to reach highest, compared to the other components of GDP, growth rates for the nine months of the year. The assumption that investment demand will be the driving force behind growth in the next several years becomes more and more justified. There always are lags in the economy, and investment demand tends to be very sensitive towards negative changes in the environment, and quite rigid with respect to positive ones. Increased investment demand is also an indicator of the positive expectations of investors for the future development of the country and for the confidence in the execution of the current macroeconomic policy.

To summarise, the engine of growth in 1998 was domestic demand, both in terms of household consumption and increased investment activity of the enterprises. Domestic demand influences the economy in two ways – first, it stimulates domestic production and, second, it increases imports.

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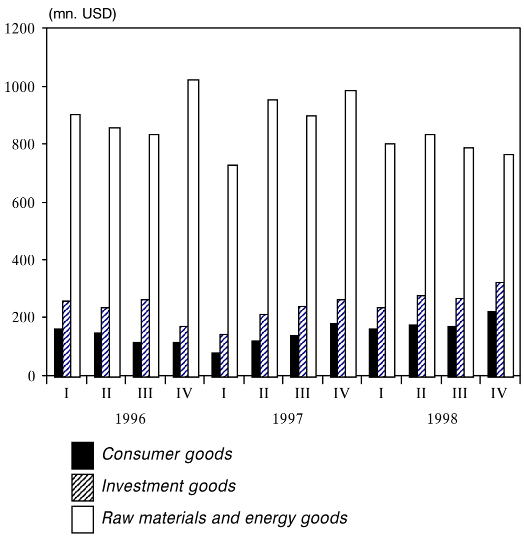
[12] *Change over the same period of the previous year, in dollar terms.*

[13] *Preliminary data as of November 10th, 1998 – BNB Monthly Bulletin 10/1998.*

Imports by End - Use



Source: BNB

The imports of consumer goods increased quickly on a quarter to quarter basis in 1997, but its 1998 level hardly poses any threat to the stability of the balance of payments. Imports of investment goods also increase by quarters in 1997, and there's obviously potential for further increases. If the trade balance of the country deteriorates because of the inflow of capital that finances imports of investment goods, then this is a positive phenomenon, because in this way it creates the basis for future growth of the economy.

Supply

Industry and agriculture were the economic sectors that generated economic growth in 1998.

Real Growth Rates of Gross Value Added by Branches

(percent, Respective quarter of 1997 = 100)

	Q.1	Q.2	Q.3	Q.1-Q.3, 1998
Agriculture and forestry	11.4	5.9	-2.0	2.1
Agriculture	10.2	5.1	-2.4	1.4
Forestry, hunting and fisheries	106.1	64.9	57.3	69.7
Industry	29.5	10.4	-8.1	9.1
Mining industry	66.1	19.1	-11.6	21.4
Manufacturing industry	23.6	10.1	-9.3	6.4
Electricity, gas and water	34.8	12.4	-19.1	12.1
Construction	39.7	4.2	15.4	16.1
Services	3.5	6.0	-9.7	-0.5
Transport	-2.6	-10.1	-44.8	-21.5
Communications	42.4	36.5	-38.5	9.9
Trade	33.3	4.9	12.8	16.0
Finance, credit and insurance	-20.2	43.3	14.3	6.6
Other services*	-3.4	5.5	-8.4	-2.2
Gross value added at basic prices	13.2	7.3	-6.5	2.9
Adjustments	82.0	-1.3	-0.8	16.0
Gross domestic product	18.9	6.3	-5.9	4.3

* including hotels and restaurants, real estate, renting and business activities, public administration and defence, compulsory social security, education, health service, NGO's

Source: NSI

The dynamics of the gross value added by sectors in the first two quarters of 1998 is indicative, on the one hand, of the intensity of the early-1997 crisis and, on the other hand, points out to the speed of economic recovery already in the second quarter of 1997. The slackening of GDP growth rates by quarters in 1998 is an evidence of the latter. Inasmuch as the third quarter of 1997 was exceptionally strong in comparison to the preceding periods, the reported fall of GDP in almost all economic branches in the third quarter of 1998 was not unexpected. However, construction, trade and financial services maintained their growth rates.

The year was marked by incessant debates on economic growth rates of 1998. Pessimistic assessments prevailed even after NSI reported that economic growth in the first half of 1998 amounted to 11.9 percent. The continuing fall of industrial sales since the beginning of the year reported monthly by the NSI as well as the decline of exports in US dollar terms were both a principal argument behind the cautious forecasts and a source of concern. Growth in 1998 is 4 percent according to the macroeconomic framework of the 1998 budget while AEAF estimates point at 4-4.5 percent.

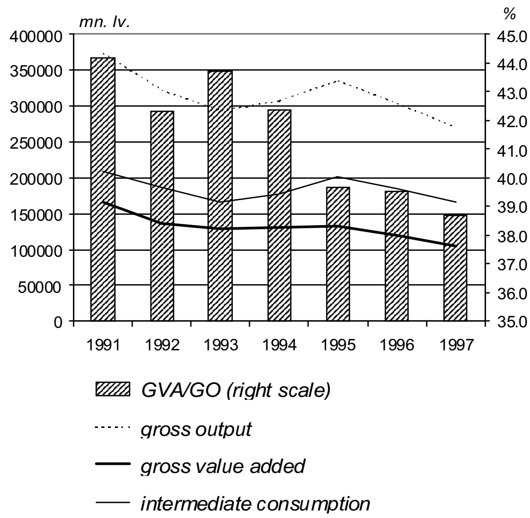
GDP and Gross Output Growth Rates by Economic Sectors in the Nine Months of 1998, Preliminary Data

(Respective period of 1997 = 100)

	National economy		Private sector	
	Gross output	Gross value added	Gross output	Gross value added
Agriculture and forestry	3.0	2.1	2.9	1.5
Industry	-4.5	9.1	27.8	17.0
Services	-1.8	-0.5	1.4	-2.4

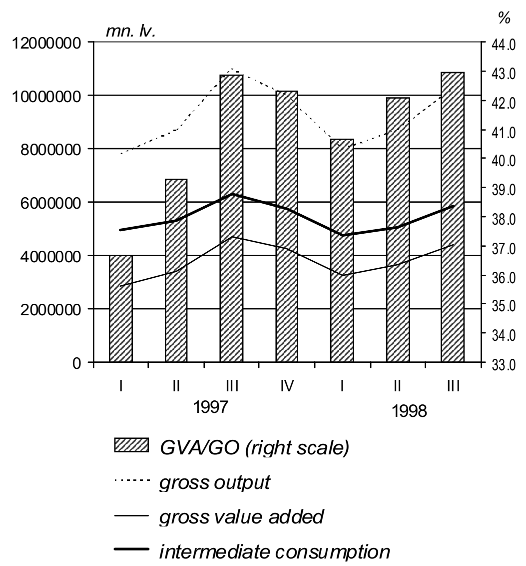
Source: NSI

Ratio of Value Added to Gross Output, Total Economy, 1991 Prices



Source: NSI, AEAF

Ratio of Value Added to Gross Output, Total Economy, 1997 Prices



Source: NSI, AEAF

When it comes to growth, what is usually meant is the increase of the value added by economic sectors and it may not necessarily correspond to the dynamics of sales or gross output.

The relation between GDP dynamics and gross output can be assessed through the relative share of value added in gross output.[14] In the economy as a whole, the ratio followed a steady downward trend in the period 1994 to 1997. In 1998, however, the trend reversed and the ratio registered a considerable increase.

The ratio „gross value added/gross output" improved in the third quarter of 1997. Henceforth the indicator sustained its levels, registering only minor fluctuations. In the first quarter of 1997, the ratio for the entire economy ran at 36.7 percent while in 1998 it reached 42 percent on average. The dynamics of the gross value added/gross output ratio in industry, trade and services was similar to that for the economy as a whole. In agriculture, the indicator started to increase in 1996 and the level reached in 1997 was sustained in 1998 (See Figures in the Appendix to Section 2.3.).

The gross value added/gross output ratio represents an indirect indicator for economic efficiency. Available data provide enough ground for the assertion that the functioning of the Bulgarian economy has become more efficient after the stabilisation of mid-1997. Therefore, the principal factor that influenced growth in 1997 and in 1998 was macroeconomic stabilisation as it contributed to the optimisation of the firms'

[14] The 1997 Annual Report of the Agency for Economic Analysis and Forecasting „Bulgaria: 1997 Economic Survey", chapter 3, already addressed the problem of the effectiveness of the Bulgarian industry.

expenditures (intermediate consumption shrank) – an outcome of reducing inventories and hence waste compared to inventories level in a high inflationary environment. Low interest rates alleviated the burden of servicing companies' debts thus allowing for restructuring of expenditures.

The improvement of financial discipline, which was most likely due both to privatisation and the improvement of financial discipline in the public sector was the second factor that positively influenced the increase of value added in the economy. The net contribution of the private sector to the growth of gross value added in the nine months of 1998 ran positive at 1.57 percentage points whereas that of the state sector amounted to 1.33 percentage points.

This phenomenon is best exemplified by industry. The relative share of private sector in gross industrial output stepped up from 29 percent in 1997 to 39 percent in 1998. Its share within value added in industry increased from 35.7 percent to 38.4 respectively. The new owners are motivated to restructure the privatised enterprise so as overall efficiency and competitiveness of production to increase. In the beginning, they can optimise their production costs solely by putting an end to wasteful practices and misappropriations, especially if, by virtue of the respective privatisation contract, they cannot optimise their labour costs as well. Notwithstanding the restrictions that the new owner presumably faced it is evident that their efforts targeted at improving production efficiency have had a substantial positive effect from a macroeconomic point of view.

In 1997 and 1998, the regulation of wage growth in the state sector was a factor contributing to the improvement of financial discipline in the economy and particularly in the state-owned firms.[15] The implementation of the government's wage policy, which was restricted to firms with prevailing state ownership, was repeatedly discussed throughout 1998. Trade unions argued for the abolition of all kinds of control on wage growth in the real sector and their stand is understandable. Their principal point was that the existing regulatory framework was very prohibitive.

If one company is private rather than state-owned, it can be assumed that any contraction in its economic activity or labour productivity would compel the entrepreneur to at best curb or even reduce his labour costs. Furthermore, if the firm starts generating losses, then the owner will attempt to cut down his expenses, including labour costs, in order to overcome his difficulties or even be forced – in extreme circumstances – to liquidate the enterprise. This incentive to optimise costs is absent in a state-owned enterprise. In this sense, the wage growth regulation substitute for the missing distinctly personified owner (entrepreneur) of SOEs. The applied regulation is fair and obviously efficient. All state-owned firms are treated on an equal footing regardless of their respective economic branch or geographical region. The main requirements of this regulation – and these are the standard prerequisites for any entrepreneurship – are that firms must be profitable and have no arrears on payments to other economic agents.

Do enterprises violate existing regulations? In 1997, some 8 percent of state-owned firms failed

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[15] According to regulations, only enterprises exhibiting profits and no delinquency on tax payments or arrears on bank credit and payments to suppliers can increase wages without restriction.

to strictly observe the guidelines on wage growth. According to data for 1998, in the first and second quarter of the year the share of violating firms went on the decrease relative to 1997. In the second quarter, about 5 percent of the enterprises in the NSI survey generated losses yet they increased wages paid on a quarter earlier. (We assume that all firms had no delinquencies on payments to other economic agents, as it is difficult to assess the dynamics of these indicators.) In the third quarter of 1998, however, the share of loss-making enterprises that raised wages relative to the preceding quarter again increased and reached some 18 percent of the companies in the sample. The prevalent scheme for violating the existing regulations involves the payment of bonuses at the end of each quarter.

The preservation and even the improvement of existing regulation controlling wage growth in state-owned enterprises is imperative. A similar measure targeted at financial disciplining of state-run firms was also envisaged in the 3-year agreement with the IMF. The question of imposing hard budget constraints on companies is of utmost importance to all enterprises regardless of their type of ownership. It is a criterion to what extent a given firm has managed to adapt itself well enough and can flexibly operate in a market economy environment.

A comparison between the sources of growth in 1994-1995 and in 1998 allows us not only to outline the impact of the international crisis on Bulgaria's economy but also to estimate the importance of macroeconomic stabilisation for growth. By comparing the sectors registering economic growth in 1998 to the respective sectors in 1994 and 1995, those sectors most severely affected by the crisis striking the international markets immediately stand out. The highest growth in 1994 was reported in the following branches – chemical and oil-processing industry, agriculture and forestry, trade, food industry, ferrous metallurgy and ore mining, and non-ferrous metallurgy. In 1995, transport (presumably with respect to grain exports) and agriculture registered particularly high growth. In 1998, transport maintained negative growth rates while chemical industry and metallurgy were the industrial branches that registered decline.

Contribution by Sectors to Overall Economic Growth

(Percentage points)

	1994	1995	1998 (January to September)
Industry	+1.9	-2.0	+1.7
Agriculture and forestry	+1.0	+1.8	+0.5
Construction	0.0	+0.1	+0.4
Trade	+0.7	+0.2	+1.3
Communications	0.0	+0.6	+0.2
Transport	+0.2	+2.1	-1.2
Other services	-2.6	-0.6	-0.6

Major factors that induced growth in 1998 are the macroeconomic stabilisation, the improved financial discipline in the public sector and the expansion of the private sector's share. However, the Bulgarian economy in view of its openness is particularly sensitive to the aggravation of the international business situation due to its openness. Large enterprises with limited product structure are highly dependent on changes in demand. These firms do not have the necessary diversification of production. Moreover, as they are still state-owned, they are not flexible enough to react effectively to negative external shocks.

Incomes

Gross domestic product is the total of incomes received by resident natural and legal persons in the course of a given year. The estimate depends both on the average income and the number of employees. In 1998, the share of compensations of employees in GDP increased at the expense of the shrinking share of gross operating surplus (profit) in all economic sectors while the number of employees declined.

Structure of Gross Value Added

(Percent)

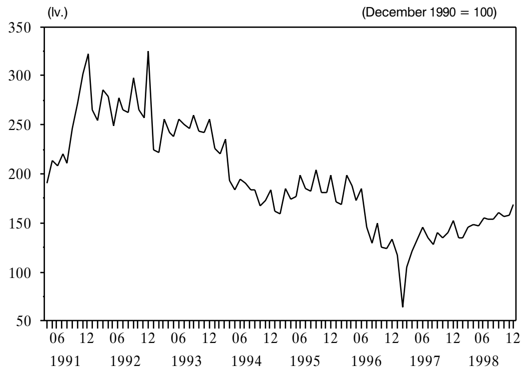
	1991	1992	1993	1994	1995	1996	1997	1998, 9m.
Gross value added at basic prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Compensation of employees	38.9	54.9	55.9	48.7	44.2	39.1	36.2	43.8
Wages and salaries	29.5	38.6	40.2	35.0	32.0	28.2	26.1	30.8
Social security contributions	9.4	16.3	15.7	13.7	12.2	10.9	10.2	13.0
Net taxes on production and import	-1.5	-1.6	-3.1	-1.3	-1.2	-0.9	-0.9	-1.4
Gross operating surplus, gross mixed income	62.6	46.6	47.1	52.6	57.0	61.7	64.7	57.6

Structure of Gross Value Added by Sectors

(Percent)

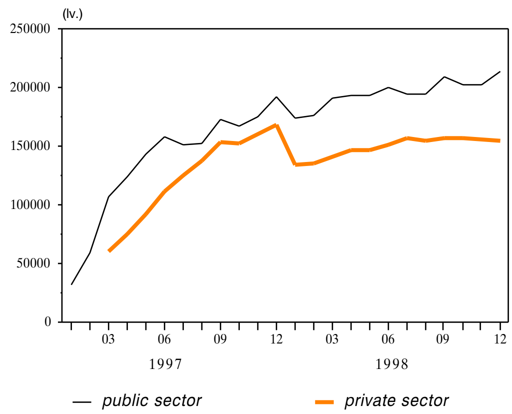
	Total		Agriculture and forestry		Industry		Services	
	1997, 9m.	1998, 9m.	1997, 9m.	1998, 9m.	1997, 9m.	1998, 9m.	1997, 9m.	1998, 9m.
Gross value added at current basic prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Compensation of employees	35.4	43.8	5.3	10.8	58.5	66.3	39.0	43.4
Wages and salaries	25.4	30.8	3.7	7.6	40.7	44.8	28.9	31.6
Social security contributions	10.0	13.0	1.6	3.1	17.8	21.5	10.1	11.8
Net taxes on production and import	-0.7	-1.4	0.0	-0.1	-1.1	-3.1	-0.9	-0.9
Gross operating surplus, gross mixed income	65.3	57.6	94.7	89.4	42.6	36.8	61.9	57.5

Real Monthly Average Wage in the Public Sector



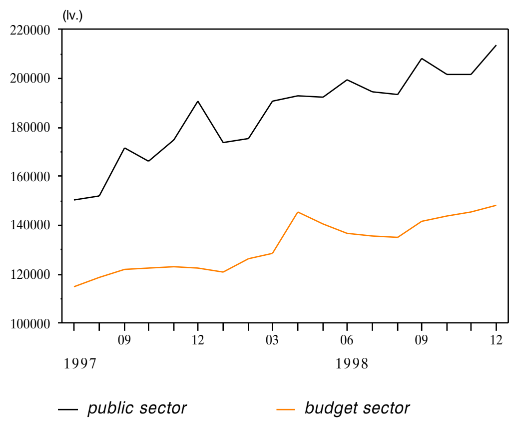
Source: NSI, AEAF

Nominal Monthly Average Wage



Source: NSI, AEAF

Nominal Monthly Average Wage



Source: NSI, AEAF

The dynamics of compensation of employees followed the dynamics of gross value added by sectors but it also depended on the value added sharing ratio „wage costs/profit“. (See Appendix to Section 2.3.). Wages and salaries accounted for the largest share in compensation of employees. Therefore, the steady upward dynamics of wages in 1998 was the first factor that contributed to the increase of the share of this incomes component within gross value added. According to NSI monthly data, the real-term 12-month rise of wages and salaries in end-1998 ran at about 15 percent in both the public and private sectors.

Nominal wages in the public and private sectors followed two different patterns of dynamics. In the first half of 1998, nominal wages in the private sector had constantly increased whereas, after August, they steadied around their July level. Nominal wages in the public sector registered a stepwise increase at the end of each quarter due to the bonuses paid □ a result of the wage-growth regulation. The nominal wage dynamics in the public sector suggests that in each consecutive quarter efforts had been made to preserve the wage level reached at the end of the preceding quarter.

The increase of nominal wages in the public sector in 1998 was also due to the indexation of salaries in the budget sphere. Consequently, the coefficient of variation of the average annual wages by branches in the public sector fell from 0.41 in 1997 to 0.35 in 1998. The relative average wages paid by the state budget are among the lowest in the public sector. In 1998, however, they started to slowly approximate the level of the average wage for the sector. Simultaneously, the relative wages in the branches with the highest nominal wage level such as the manufacture of coke, refined petroleum products and nuclear fuel went on the decrease in 1998. Thus, in 1997 the relative wage in the above-mentioned branches was three times higher than the average for the public sector while, in 1998, it was only 2.5 times higher. The relative wage in chemical industry dropped from 1.8-fold of the average in the entire sector in 1997 to 1.4-fold of the average in 1998. The relative wage in the mining of metal, uranium and thorium ores decreased from 1.5 times to 1.3 times the average in the public sector in 1997 and 1998 respectively, while the respective figures for the relative wage fall in metallurgy were 2.2 times and 1.9 times of the average wage. The outstripping growth of the lowest average wages in the public sector relative to the increase of average wages in the top-paid branches was determined by the capacity of the state budget to increase wage-related expenditures in the budget financed activities and thus to reduce the wage differentiation between the various branches. The shrinkage of sales in some branches such as chemical industry and metallurgy wherein average wages are among the highest also contributed to this effect.

Analysing wage dynamics in both economic sectors – public and private – we can conclude that employers in the private sector implemented a strict incomes policy in their firms and presumably have closely linked wage dynamics to either the dynamics of their companies' financial results or to labour productivity. A similar conclusion for the public sector is highly questionable. The payment of bonuses at the end of each quarter was the main way through which state-owned enterprises customarily violated the regulations controlling wage growth.

The employment dynamics was the second factor influencing the share of compensation of employees in gross value added. According to NSI monthly data on employment in the Bulgarian economy, in end-1998 the number of employed decreased by some 65 000, that is 3.1 percent down on a year earlier. The available data cover almost the entire public sector and about 50-60 percent of employees in the private sector.

Employees in the state-owned enterprises stepped down by about 100 000 in 1998, registering an approximately 8 percent drop relative to early-1998. Their number followed a steady downward trend throughout the year. The optimisation of production costs was the major reason for the development of this trend. The ongoing privatisation process may have been another factor contributing to employment contraction in the public sector yet its impact was not as significant as that of layoffs. An increase of the number of employees in state-owned enterprises was monitored only in the following branches and activities: manufacture of coke, refined petroleum products and nuclear fuel; production and distribution of electricity, gas and water; government; healthcare; arts and culture. The firms in the first two branches reported good financial results in the nine months of 1998, which most probably influenced positively employment dynamics in these sectors. The other above-mentioned sectors are financed in principle by the state budget, so employment growth in them can be seen as an indicator of the increased potential of the central government budget to make non-interest expenditures.

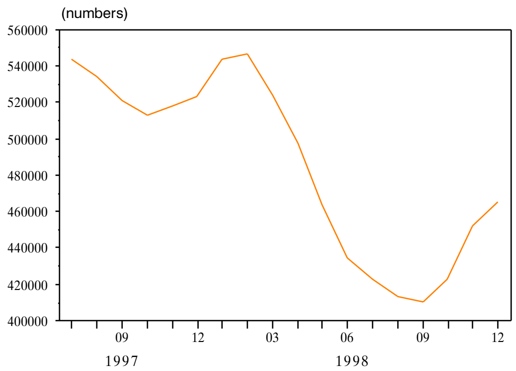
In the nine months of 1998, the number of employees in the private sector increased at approximately the same rates at which the number of employed in the public sector fell. Hence, the total number of employed monitored monthly by the NSI remained at a relatively constant level. The role of privatisation in the dynamics of the latter suggests that there was no mechanical transfer of employees from the public to the private sector. Seasonal employment along with privatisation dynamics was the factor contributing to the above-mentioned trend.

In the last quarter of 1998, however, the number of employed in the private sector shrank (as did the number of employed in the public sector) and in end-December their number was some 3 percent lower than their end-September level. Notwithstanding the employment shrinkage in the private sector observed in the fourth quarter, in end-year the total number of employed in the sector was some 5 percent higher than the level in early-1998.

While employment contraction in state-owned enterprises can be explained by the ongoing restructuring in them, the dynamics of seasonal employment is the only likely explanation for the shrinkage of employment in the private firms monitored in the last months of 1998. Against the overall employment contraction, the number of registered unemployed in end-December 1998 decreased by about 11 percent on a year earlier, according to data from the National Employment Service (NES).

The number of registered unemployed stepped down by almost 25 percent in the period March to September 1998 alone. This was partly due to seasonal labour demand by firms in agriculture, food industry and tourism in the spring and

Registered Unemployment



Source: NLO

summer months of the year. However, the reported decrease of the number of unemployed in the nine months of 1998 was rather considerable to be explained solely by the impact of seasonality.

There are grounds to believe that two main factors contributed to the simultaneous decline of both the numbers of employed and unemployed in 1998. The first reason was of legislative nature while the second was linked to the development of the private sector, and more specifically, to that part of it, which is not covered by the NSI surveys in view of the multitude of separate units. The changes in existing legislation related to people who quit the education system or the army and are no longer entitled to unemployment benefits. The estimated effect of the change is of 4.5 percentage points decrease in the number of registered unemployed. The remaining proportion, viz. some 6.5 percentage points, of the registered unemployment contraction monitored in 1998 was a result of the small size private firms opening of new jobs owing to economic recovery. [16]

The number of registered unemployed went on the increase again in the last quarter of the year. This was partly due to the decline of seasonal labour demand. Moreover, the number of layoffs for economic reasons and as a result of employment contraction also increased over the same period. The value of the indicator was some 50 percent higher than the levels discerned in the corresponding months in 1997. We can claim, therefore, that the rise of the number of registered unemployed in the last quarter of 1998 was due to

[16] *Available data from the labour force surveys are quite contradictory. Therefore, the assessment of aggregate labour force and its separate groups should be made cautiously and with some reservations.*

the acceleration of the restructuring process predominantly in the state-owned firms in the Isolation and Liquidation Lists. This process will continue in the first half of 1999 yet, most probably, the further increase of the number of registered unemployed as a result of it will not be as great. Still, some regions of the country may well experience serious problems concerning unemployment of the population.

Unemployment is likely to become one of the most serious problems for the Bulgarian economy in the forthcoming years. Having in mind that labour productivity is comparatively low both relative to previous periods and to other Central and East European countries, it is evident that firms in Bulgaria in general operate with a larger than necessary number of employees. The optimisation of employment will be inevitable in all existing firms regardless of their type of ownership. It is expected, therefore, that in the forthcoming periods both the state-owned and privatised companies will sooner reduce existing jobs rather than preserve or even increase them (private firms presumably operate with an optimal number of employees in the long-term). The newly emerging private sector will be the only economic sector able to create new jobs.

To summarise, the statistical data on employment is controversial because the decline in the numbers of both employees and unemployed is difficult to reconcile. Most probably, the increased share of employees' compensations in GDP is due both to an increase in the average wage and an increase in the number of employees in the private sector.

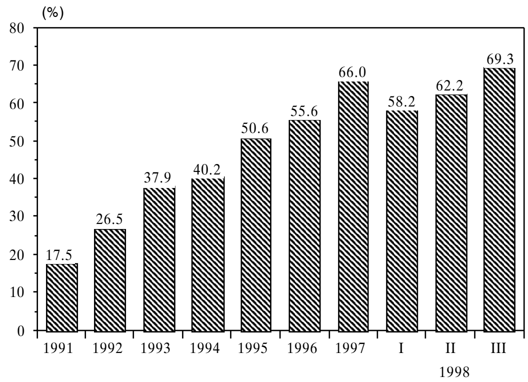
3. Preconditions for Sustainable Economic Growth

3.1. The Development of the PrivateSector

In 1998, the upward trend in the share of private sector in gross domestic product was sustained while its dynamics in the various branches registered important changes. The highest increase of the private sector's relative share was monitored in „Finance, credit and insurance" and „Construction". As a result of privatisation in manufacturing industry the importance of the private sector in industry as a whole increased from 44 percent to 51 percent. The share of private sector stepped up in almost all other sectors except in wholesale trade and transport. (See Tables in the Appendix to Section 3.1.)

An assessment of the private sector's efficiency can be again made on the basis of the share of value added in gross output. (See Appendix to Section 3.1.) In industry where the privatisation process accelerated considerably in the period 1997-1998, the indicator underwent substantial changes and the share of private sector increased from 38.3 percent in 1997 to 50.1 percent in 1998. (See Tables in the Appendix to Section 3.1.).

Relative Share of the Private Sector in GDP



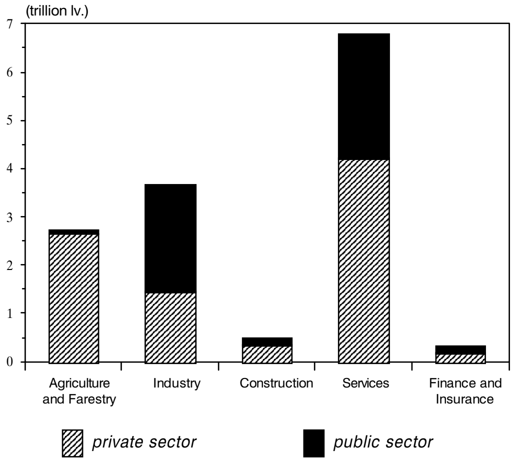
Source: NSI

Relative Share of Value Added in Gross Output by Branches in the Nine Months of 1997 and 1998

(Percent)

Economic sector	*Private sector*		*Public sector*	
	1997	**1998**	**1997**	**1998**
Agriculture and forestry	48.71	43.74	27.92	30.93
Industry	31.38	31.49	23.51	30.71
Services	61.40	63.82	48.89	52.22
Total economy (basic prices)	**48.73**	**47.10**	**31.28**	**39.04**

Volume of Value Added in the Private and Public Sector by Main Economic Sectors*



** Current prices for the first 9 months of 1998*

Source: NSI

The dynamics of gross value added in 1998 relative to 1997 was characterised by considerable differences across sectors. (See Tables in the Appendix to Section 3.1.). Services in the private sector should have been the first to improve their results immediately after the achievement of macroeconomic stabilisation and the restoration of the structure of consumption. However, they registered a decline and the reason for it may lie in the partial statistical coverage of services in the private sector and of newly emerging firms in particular. It is also quite possible that in the years before 1997 part of the industry value added was reported as a value added in the services' sector – due to the phenomenon of the shell companies. In most simple terms, the scheme used for the profit draining of state-owned enterprises on an exceptionally large scale was the following: private firms which performed transport or commercial services stood at the entry and exit of the respective state-owned enterprise. They transferred income from the state-owned enterprise to the respective private company through the prices of these services. In this way, the potential profit of SOEs in industry became value added in the private firms in transport or wholesale trade, or which is more likely, it was transformed into income abroad. This scheme applied to a smaller base or became redundant after the improvement of control and financial discipline in the public sector and following the privatisation of some SOEs.

An assessment on the place and importance of the private sector in industry should be better made on the basis of employment in the sector since the indicators of fixed tangible assets applied by the World Bank are rather inaccurate.

Relative Share of Employed in the Private Sector

(Percent)

Year	Total	Agriculture and forestry	Industry	Services
1996	47	93	23	38
1997	53	93	40	39
1998	56	94	49	41

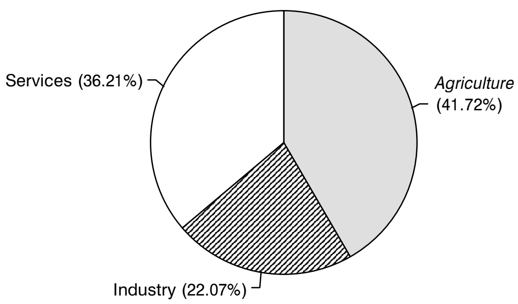
In 1998, some 56 percent of the average annual number of employed worked in private enterprises. The registered increase of 3 percentage points relative to 1997 was due to both privatisation in industry and the newly opened jobs for the most part presumably in the service sector.

Labour Productivity in the Private and Public Sectors Measured through the Ratio Value Added/Average Annual Number of Employed

(Thousands of BGL, at 1996 constant prices)

Sector	Total		Agriculture		Industry		Services	
Year	Private	Public	Private	Public	Private	Public	Private	Public
1996	590	420	320	270	360	510	1000	370
1997	560	390	430	200	440	420	790	280
1998	540	450	430	240	460	520	730	280

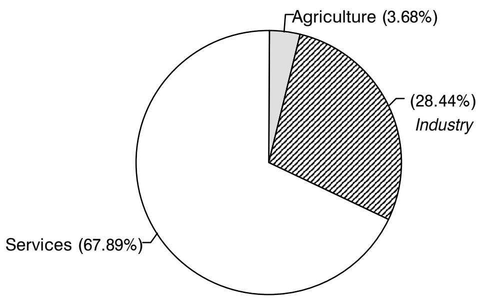
Allocation of the Employees in the Private Sector



Source: NSI, AEAF

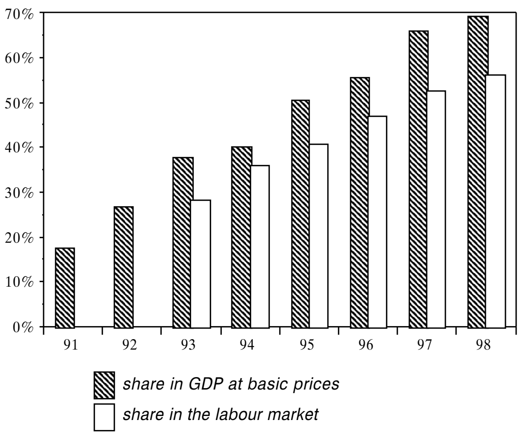
The role of the private sector may be assessed by its labour productivity. The highest labour productivity in the private sector was monitored in the service sector and it was almost three-fold higher than that in the state-run sector. Public services in education and healthcare reported very low productivity. These services are granted free to consumers and the value added in them is estimated on cost basis. Moreover, large parts of employees in the public sector work precisely in the field of healthcare, education and state government. Thus, in end-1997 and end-1998 they

Allocation of the Employees in the Public Sector



Source: NSI, AEAF

Private sector development



Source: NSI, data for 1998 is forecasted on the basis of preliminary information

accounted for 32.9 percent and 39.3 percent respectively of the total number of employees in the state sector. The relatively large and not too efficient state administration also contributed to the low labour productivity in public services.

Labour productivity in the state-owned industrial enterprises increased considerably, exceeding its 1996 level and registering higher values than that in private enterprises. The reasons for that can be found in the insufficient production assets and capital for productivity growth in the private sector in industry as well as in the concentration of production in public industry in several large monopolies paying high average wages. Moreover, their monopoly situation secures them high profits. Most probably, some 70 percent of assets in industry are still state-owned although the estimate is highly inaccurate. The exact share of industrial assets in the private sector is presumably higher in view of the large number of small and medium size firms that are not covered sufficiently well by statistics.

In agriculture, the private sector reportedly has much higher labour productivity that the state-run sector. The private sector's share in agriculture went up from 35 percent in 1991 to 94 percent in 1996, to reach 98 percent in the third quarter of 1998. Agriculture was the only branch to register average positive growth in the period 1992 to end-September 1998.

Notwithstanding the problems with the financing of production and sale of agricultural products which producers have so far encountered every year, the contribution of agriculture to the Bulgarian economy stepped up from 12 percent in 1992 to 26 percent in 1997.

Real Growth Rates of Gross Value Added by Sectors

(Percentage change over preceding year)

	1992	1993	1994	1995	1996	1997	1998, 9m.	average in the period
Agriculture	-14.8	-30.2	9.5	14.5	-7.4	26.2	2.1	8.4
Industry	-6.4	-6.2	6.0	-5.4	-11.8	-13.1	9.1	-3.5
Services	-26.9	0.6	-3.1	-0.7	-9.3	-23.6	-0.5	-7.9
Gross value added	-7.3	-1.5	1.8	2.9	-10.1	-12.8	2.9	-3.3

Source: NSI

Aggregate data on the development of private business and its impact on the economy show that regardless of its relatively rudimentary stage of development, it operates more efficiently than the state-run sector by distributing more rationally its operating resources and creating relatively higher volume of production.

Aggregate Data on the Relative Size of the Private Sector

(Percent)

	Share in GDP	Share in the number of employed	Assets	Credit
1997	66.0	53.0	24.0	43.6
1998*	69.3	56.0	30.0	65.6

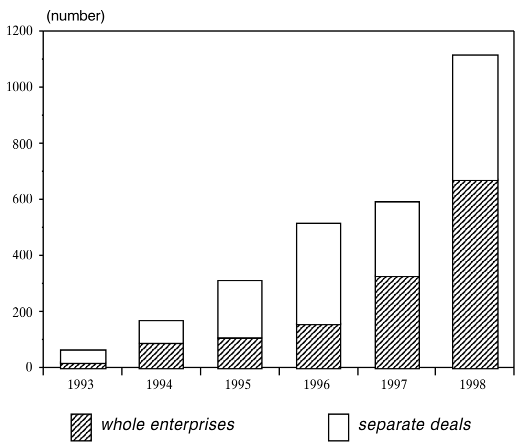
** Preliminary estimates of the AEAF. Data on GDP in 1998 cover only third quarter.*

Future economic growth in Bulgaria will depend on the opportunities for expansion of the private sector offered by the state, viz. privatisation, liberalisation of the terms and conditions for entry of new firms and acceleration of procedures for exit of inefficient enterprises. However, available data provide enough reasons to assert that the development of the private sector will generate economic growth in the forthcoming years.[17]

3.2. Privatisation

In end-1997, the National Assembly voted a Programme for the Privatisation of State-owned Enterprises in 1998 which was developed according to the Privatisation and Incorporation of State-owned and Municipal Enterprises Act (Privatisation Law). The Programme listed the minimal privatisation targets and expected proceeds from concluded deals. (See the Appendix to Section 3.3. on the realisation of the 1998 Privatisation Programme). Judging by the number of concluded cash privatisation deals, 1998 has been the most successful year since 1993. Data show that 1114 deals were concluded in 1998 (almost twice more than in 1997), out of which 671 sales of whole state-owned enterprises and 443 sales of self-sufficient parts of SOEs.[18]

Number of Privatization Deals



Source: PA

In 1998, the number of realised large sales to foreign (strategic) investors was smaller than in 1997 which, in its turn, reflected on the financial proceeds and the velocity of transferring of state-owned assets to private natural and legal persons. Management and employee buy-outs (MEBOs) accounted for the greatest number of concluded deals, registering a 3.8-fold increase on a year earlier.

[17] One of the implicit criteria for accession to the European Union is 70 percent of GDP to be produced by the private sector. Data on the third quarter of 1998 reveal that Bulgaria has almost met this requirement.

[18] Deals finalised by the institutions listed in Art. 3 of the Privatisation Law.

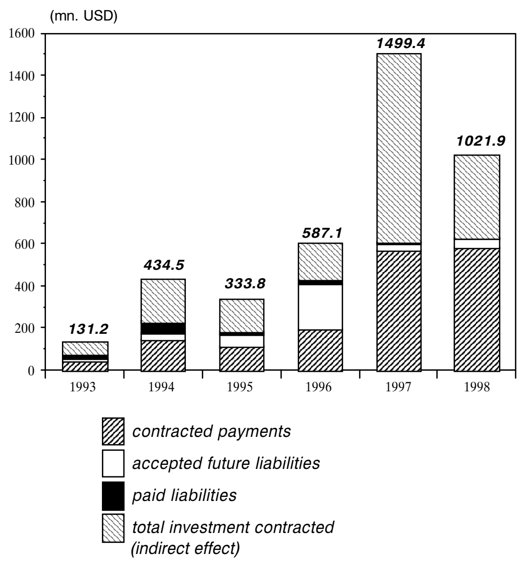
Structure of Privatisation Deals in 1998 by Type of Buyers

(Percent)

	Share in the total number of deals	Contribution to increase relative to 1997
Foreign buyers	3.32	0.19
MEBOs	44.35	69.46
Buyers under Art. 35	21.45	-0.57
Other investors	30.88	30.92
Total	**100.00**	**100.00**

The overall financial effect from privatisation in 1998 was by almost USD 470 million lower relative to the preceding year. The main reason for it lies in the fact that stress in 1998 was put on the acceleration of privatisation rather than on the value of proceeds. It is no longer insisted on investment commitments and preservation of existing jobs in the negotiations with potential buyers in order to avoid any obstacles to the fast finalisation of the deals. In 1998, the value of investment commitment decreased by 56 percent. The lack of large-scale deals with foreign investors and the prevailing share of MEBOs[19] in privatisation were other reasons for its lower direct financial result notwithstanding the overall several times increase of concluded deals.

Financial Effect from Privatization



Source: PA, AEAF

The turmoil on the international financial markets in 1998 was the principal external factor which adversely affected investors' interest in enterprises in Bulgaria. Foreign investors became extremely cautious when it came to investing in „transition economies" such as Bulgaria. The credit rating of Bulgaria was raised several times on account of the macroeconomic and political stability in the

[19] *Payments for deals involving MEBOs are typically made over time for up to 10 years under preferential treatment.*

country sustained for two years already.[20] (See Table in Appendix to Section 3.3). Moreover, Bulgaria moved upwards in the credit rating scale as a result of the lowering of credit ratings of the countries most severely stricken by the crisis. However, Bulgaria still remains in the group of countries attractive first and foremost to the speculative capital yet. At the same time, the experience of the other countries which operate a currency board (Argentina, Estonia, Lithuania and Latvia) points to the fact that the opportunities presented by the currency board system for a sustainable macroeconomic stability inevitably restore investors' confidence in the country.

The frequent amendments to legislation on privatisation reveal another explanation for the lack of interest of strategic foreign and local investors in the big enterprises slated for sale.[21] Although most of the amendments in legislation were targeted at its improvement, they induced uncertainty in foreign investors in regard to their statute, rights and obligations, which in turn pushed up their expenditures for consulting services. Another reason for the lack of interest is that enterprises from the Isolation List of firms in grave financial conditions (drawn up by the Ministry of finance according to the Law on Financial Rehabilitation of State-owned Enterprises) have been put to sale and such heavily indebted enterprises are difficult to sell. And the last but not the least, residents and especially MEBOs

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[20] Bulgaria's credit rating is better than that of Brazil, Romania, Russia, Ukraine and Indonesia and almost equals the credit rating of Turkey.

[21] In 1998, for example, the Privatisation Law was amended three times, the Trade Law and the Law on Corporate Income Taxation were amended twice while the VAT Law was amended four times.

were entitled to preferential treatment which put all other investors on a disadvantageous position.

The Privatisation and Incorporation of State-owned and Municipal Enterprises Act stipulates the terms and conditions for the preferential treatment of MEBOs. The National Assembly voted the Law in June 1992 but it has been amended many times ever since. However, the single aim of the numerous amendments was to enlarge the scope of preferential participation in various forms of the Bulgarian citizens in the privatisation process. The list of preferential terms included, *inter alia*, the right of employees to acquire free of charge up to 20 percent of shares in the privatised enterprises regardless of the type of privatisation; participation in privatisation with gratuitous vouchers; participation in MEBOs. It is evident that a broad range of privatisation preferences was granted to insiders of the privatised enterprise. This stipulation on its turn gives rise to conditions for biased treatment of the Bulgarian residents themselves. In 1998, the amendment to the Privatisation Law further increased preferentials to MEBOs by allowing employees to use vouchers from the second wave of mass privatisation as a means of payment. In early-1999, the National Assembly passed another amendment to the terms and conditions of MEBOs privatisation – they are forbidden to participate in public auction of shares and stocks while bids from MEBOs are now discounted by 10 percent.

The participation of the management and employees in the privatisation of a given enterprise occasions the following peculiar situation: the representatives of the privatising body (the line ministry) and the Board of Managers (it is obligatory that a representative of the very same line ministry participates in it) represent the same vested interests. This creates preconditions for lobbying, political interference and concerted efforts against the other potential buyers. Consequently, complaints from foreign investors about deliberate obstacles and the granting of misleading information became more and more frequent.[22]

The unequal treatment of the various potential participants in privatisation encumbers the privatisation process. From a political point of view, the Privatisation Law creates conditions for all Bulgarian citizens to participate in the privatisation whether they have the necessary resources to do it or not. From an economic point of view, however, the Privatisation Law is entirely inconsistent with the meaning of privatisation, viz. to produce economic agents placed on an equal footing and able to manage the respective enterprise under the conditions of fierce competition. In reality, privatisation in Bulgaria became a means for the re-distribution of wealth rather than an instrument for introducing new type of management in the economy in order to increase the efficiency and competitiveness of production. It is possible that some of the MEBO's privatisation deals turn into a success, but another part of them should consequently undergo further privatisation or liquidation that creates uncertainty in the privatised sector and threatens the near future economic growth prospects.

3.3. Restructuring of the Public Sector

The restructuring of the public sector can be achieved not only through privatisation but also

[22] *See White Book on Foreign Investment published in 1998 by the Bulgarian International Business Association (BIBA).*

through the improvement of efficiency and labour productivity in the state-owned firms. Inasmuch as privatisation is a process, the enterprises remaining in the public sector should operate under hard budget constraints as economic agents entitled to equal rights in order not to generate destabilising potential in the economy. The shortcomings in the economic behaviour of SOEs are connected precisely to the process of their privatisation. In waiting for privatisation, the enterprises are in an extremely unfavourable position as their managerial decisions are paralysed due to the lack of incentives for development. From this point of view, management and employee buy-outs can be a solution to the problem. Any anticipation for a successful MEBO privatisation could stimulate both employees and managers to observe strict financial discipline. One of the indicators for the adapted market behaviour of SOEs is their financial situation and the trend of its dynamics whether towards aggravation or improvement.

In the nine months of 1998, the financial indicators of state-owned enterprises deteriorated relative to the respective period of 1997.[23] Their operating profits (i.e. their pre-tax income before payment of interest dues) fell by some 64 percent at constant prices relative to the respective 1997 period while the decrease of their net profit over the same period ran at 55 percent. Thus, the operating profitability of SOEs which ran at 16.8 percent in the nine months of 1997 stepped down to 6.6 percent in the nine months of 1998. The deterioration of the overall financial results of

[23] *The sample of SOEs surveyed provides ground for an accurate enough assessment of their financial situation as it covers over 90 percent of state-owned firms.*

enterprises in the public sector in 1998 is not in itself a reason to believe that this was due to a sharp fall in their efficiency and competitiveness.

A factor that contributed to the decline in operating earnings of firms was the slowdown of inflation rates as a result of stabilisation. Hence, the artificial book profits realised under high inflation in the time lag between the purchase of raw materials and their input in production were eliminated. However, the major factors affecting the financial status of the state-owned enterprises are two: the turmoil on the international markets and the increase of internal production costs in the state-run firms. The crisis on the international markets resulted in a decline of exports in US dollar terms and consequently, profits of the SOEs in the sample fell by 8.5 percent. Simultaneously, their operating expenses increased by 2.7 percent due to both the higher depreciation allowances of firms after the revaluation of assets in early-1998 and the rise of labour costs.

The increase of depreciation allowances was caused by the long postponed adjustment for inflation of the value of fixed assets. In 1996-1997, the enterprises calculated one and the same nominal worth of depreciation allowances in their costs which, given the high inflation in that period, resulted in a drastic decrease of real depreciation expenses and consequently, in lower potential expenditures for renovation of equipment. However, firms had no other alternative in view of the tax legislation which did not recognise higher nominal costs on depreciation allowances. In reality, enterprises pushed up the price of their production to a level that covered their actual rather than calculated expenses for depreciation. This, however, was interpreted as profit by the tax regulations and, accordingly, a profit tax was levied. In this way, firms were deprived of resources that could have been used for investment.

The revaluation of assets was carried out in early-1998. The amendments to the Corporate Income Taxation Law in 1998 allowed firms to apply accelerated depreciation schemes, too. As a result, depreciation allowances in the nine months of 1998 increased over 10-fold at comparable prices on a year earlier.

There were fears in early-1998 that the revaluation and increased expenses of companies on depreciation allowances would induce an increase in prices due to the prime-cost type of price formation prevailing in the public sector whereby profit is calculated as percentage to expenses. In reality, producer prices did not undergo any changes and the expected pro-inflationary effect was averted. The higher depreciation allowances brought about a fall in profits, i.e. they induced redistribution of the gross value added towards an increase of depreciation expenses at the expense of the abatement of profit. The revaluation of the firms' assets was an indispensable prerequisite for the creation of healthy environment for their functioning whereby they are provided with opportunities to boost their investment activity and hence, to improve their competitiveness. From this point of view, the lessening of firms' profits due to the higher depreciation allowances is not a sign for deterioration of their economic situation.

Real wages in all economic sectors have been on the increase since the second half of 1997. In the nine months of 1998, labour costs (wages, social security contributions and other compensations) in the state-owned enterprises from the sample rose by 18.3 percent at constant prices relative to the respective period in 1997. In view of the 65 percent slump of real wages reported in the second half of 1996 and the first two months of 1997, the process of transforming profit into wages going on the SOEs in order to restore the latter's real level is entirely justifiable. The share of labour costs in state-owned firms stepped up form 16.4 percent in the nine months of 1997 to 18.9 percent in the 1998 respective period. Firms reduced the number of employees on the payroll by 8.5 percent in order to compensate for the decline in proceeds from sales yet, their wage-related expenses and social security payments in the period in question increased by 14.3 percent and 27.2 percent respectively at constant prices.

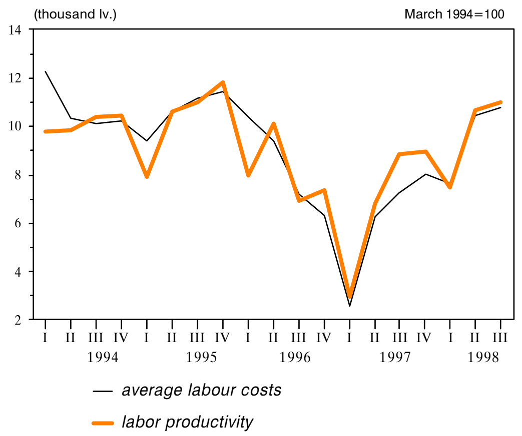
If we assume that in 1998 labour costs and depreciation expenditures had sustained their 1997 real-term level then the total operating expenses of SOEs from the sample would have fallen by 5.3 percent in the nine months of 1998 against the same period in 1997. This reported decline of expenses was due to the ongoing process of cost-optimisation in the economy (See Section 2.2.). Notwithstanding the substantial economy of raw materials, it could not offset the fall in sales revenues and the increase of the other overhead expenses.

The macroeconomic stabilisation not only eliminated „book profits“ whereby firms' revenues were transformed through the profit tax into budget revenues but also contributed to the sharp lowering of interest rates in the country and hence, to the shrinkage of interest expenditures of enterprises. Consequently, the effect on the companies' finances was tantamount to that on the public finances, viz. the decrease of interest expenditures induced an increase in non-interest expenditures. In the case of SOEs, raw materials and inputs expenditures shrank while wage-related expenses and the depreciation allowances stepped up.

According to available data on SOEs, in the nine months of 1998 their interest expenditures at constant prices fell by over 65 percent relative to the same period in 1997 and accounted for almost one-third of the level in the preceding year. It should be taken into consideration that extraordinary expenditures of firms wherein losses from exchange rate fluctuations account for the larger part also decreased in real terms (by some 6 percent) in the analysed period. Financial revenues of firms fell by about 44 percent in real terms yet the ratio financial revenues/financial expenses substantially improved, i.e. net claims on enterprises from the banking system became much less both in size and as a burden on firms. While in the nine months of 1997, the financial expenses of firms exceeded by over 80 percent their financial revenues, in 1998 the respective figure ran at only 11 percent. Consequently, the fall in net profit of firms was by some 28 percent less than it would have been given the aggregate increase of wage-related and depreciation expenses. This improvement can be regarded as the direct positive effect of macroeconomic stabilisation on the financial situation of enterprises.

The analysis of the factors, which contributed to the lower financial indicators of state-owned firms relative to 1997, allows us to draw the conclusion that 1998 witnessed some positive changes in the behaviour of SOEs. They optimised their expenditures of raw materials, raised expenses on depreciation allowances which form

Average Labour Costs and Labour Productivity in the Stated-Owned Non-Financial Sector



Source: NSI, AEAF

the basis for a more operative investment activity, they increased their labour costs within the limit permissible by the availability of profits without generating losses for the public sector as a whole. The figure on the average labour costs and the level of labour productivity reveals that SOEs on the whole observed the necessary financial discipline and that labour costs in 1998 increased at rates roughly the same or lower than the growth rates of labour productivity. As the figure shows a positive phenomenon in 1998, unlike in the years preceding 1997 was that the average labour cost curve was under the level of labour productivity curve.

Notwithstanding the positive changes in the behaviour of state-owned firms in general, they ought to have been more active and flexible in the overall optimisation of their production costs. They should have laid off more employees and further increased the efficient utilisation of the other production resources in order to offset the deterioration of their financial results due to the fall in sales.

Among state-owned enterprises, firms in industry were most seriously affected by the international financial crisis. In 1998, industrial sales declined by 9.4 percent on a year earlier entirely due to the 12 percent fall of sales of enterprises in the manufacturing industry. Sales in the other branches reportedly increased and most notably in the sector „Distribution of electricity, gas and water“. The largest decline in sales was registered by the manufacture of refined petroleum products and the chemical industry running at almost 28 percent and 15 percent respectively. Both sectors are of great importance for the dynamics of industrial production while, at that, most of the enterprises in them are predominately state-owned. The slump in sales in the public industrial sector alone amounted to 24.5 percent[24] and it could not be offset by the 36.4 percent rise of industrial sales in the private sector in view of the prevailing state-owned share in industry.

The problems of the Bulgarian industry in 1998 stem from its structure formed during the process of disintegration of the industry built up in the time of socialism. Recent years saw an upward trend in the share of energy-intensive and capital-intensive productions. Following the equalisation of domestic energy prices to international prices in mid-1997, these branches started losing their comparative advantages granted to them at the expense of funds diverted from other sectors and activities which otherwise would have presumably been more efficient. Bulgarian producers lose competitiveness due to the lack of investment in new technologies and the low level of efficient utilisation of available resources. The strong dependency of Bulgarian firms on imported raw materials and other resources is an important factor constraining their opportunities to cut down on expenses and gain competitive ground. The balance of inter-sectoral links indicates that 50 percent of intermediate consumption in ferrous metallurgy and 75 percent in chemical industry represent consumption of imported raw materials. The large volume of raw materials and energy resources imported in the country is also indicative of the former. (See Figure in Section 3.3.).

The problems facing the large state-owned exporters in 1998 raised the issue of the adverse

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[24] *Industrial sales in the private sector went up by 36.4 percent.*

effect of the implemented economic policy on the real sector. The analysis made reveals that this problem is not topical to all firms in the real sector as apparently the majority of them already felt the positive impact of macroeconomic stabilisation while stabilisation, on its turn, gains from the preservation of financial discipline. Furthermore, even the firms in bad financial condition did not suffer any adverse effects from the carried out economic policy since their aggravated situation was due to the fall of sales on account of recession in the respective branches rather than to economic policy measures in the country.

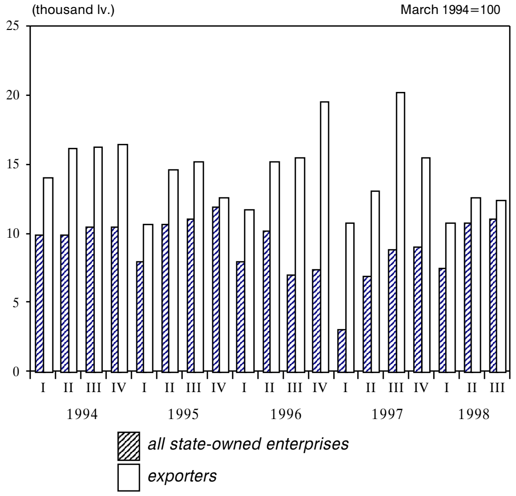
However, a further review of financial indicators of SOEs can be made, this time focusing on exporters. In theory, at a fixed exchange rate regime, the main risks to firms come from the loss of competitiveness due to the outstripping growth of the prices of non-tradables in comparison to those of tradables. This argument is based on the following logic: given the fact that labour is the most important non-tradable factor of production, exporters will face financial difficulties if the wage level increases faster than the prices of their products.

In 1998, the average wage in the country stepped up by 23.6 percent, substantially exceeding the increase of the consumer price index. Accordingly, by virtue of the above-mentioned arguments, the Bulgarian enterprises must have lost some ground at the international market. Those firms and branches utilising relatively more labour as a factor of production must have been the most seriously affected. In reality, however, precisely the labour-intensive sectors reported the best export results in 1998. According to data on incomes and expenses of firms averaged for the period 1991-1997, the highest relative share of labour expenses was registered in the following branches: apparel industry (33 percent), coal-mining industry (28 percent), machine-building (23 percent), and wood industry (20 percent). Notwithstanding the increase of labour cost in the country, the comparative advantages of the labour-intensive branches were preserved.

Bulgaria applies a fixed exchange rate regime with a currency board. In this case the money supply is not dependent on political pressure for raising the nominal money stock but subject to a strict rule, viz. money supply will grow only if there is an inflow of foreign currency in the country and demand for the national currency in exchange for foreign currency. In this case, wages may grow only on condition that the necessary financial resources to cover the wage increase are available. Certainly, the dependency between wage growth and the increase of labour productivity may be valid in the economy in general, nonetheless exceptions in the short term will always exist. In order to eliminate these exceptions it is indispensable to avail of a well-functioning system for fast bankruptcies. Nevertheless, the figure depicting labour productivity and average labour expenses points out that the correlation between these indicators in the Bulgarian public sector is within the framework of hard budget constraints. Both the labour productivity and profitability of exporters have been higher than the respective average values for the public sector more or less in the whole period in question.

The dynamics of labour productivity by branches is highly correlated to the fall of operating profits. The largest decline of labour productivity was

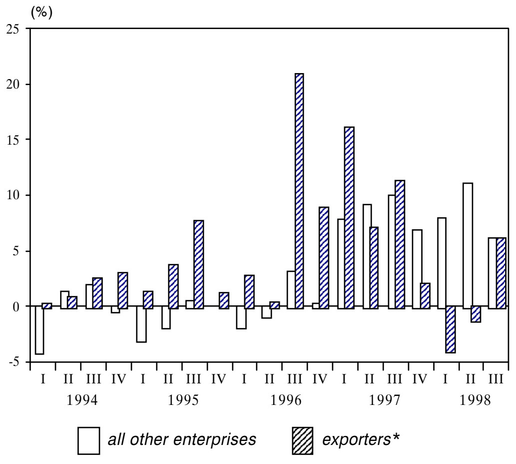
Labour Productivity of all State-Owned Enterprises and of Exporters Only



* Exporters are enterprises, which have realised more than 50% of their sales by exports

Source: NSI, AEAF

Profitability of State-Owned Non-Financial Enterprises (as Percent of Sales)



* Exporters are the enterprises, which have realised more than 50% of their sales by exports

Source: NSI, AEAF

monitored in the branches registering the largest falls in operating profits such as chemical industry, leather industry, and wood and wood-processing industry. And vice verse, labour productivity went on the increase in the branches (most of them in the service sector) reporting rising sales revenues. Statistical data reveal that the fall and the increase of labour productivity outstrip the respective decline and rise of sales revenue.

Labour productivity in firms-exporters is higher than the average in the other SOEs. It increases considerably under devaluation of the national currency and three to four months thereafter sharply approximates the average for the sector labour productivity. Such a behaviour of exporters suggests that they need incessant devaluation in order to be more productive than the firms which only suffer from the exchange rate changes. The different effects of devaluation were evident in 1996.

The dynamics of exporters' profitability is similar to their labour productivity dynamics. Before the introduction of the currency board system, the profitability of state-owned exporters had been higher than that of all SOEs. The maintaining of their higher than the average profitability signified constant devaluation of the national currency. The profitability of exporters has been falling ever since the fourth quarter of 1997 when the financial crisis in Asia triggered the slump of prices on the international markets. In the first half of 1998, exporters even reported negative profitability.

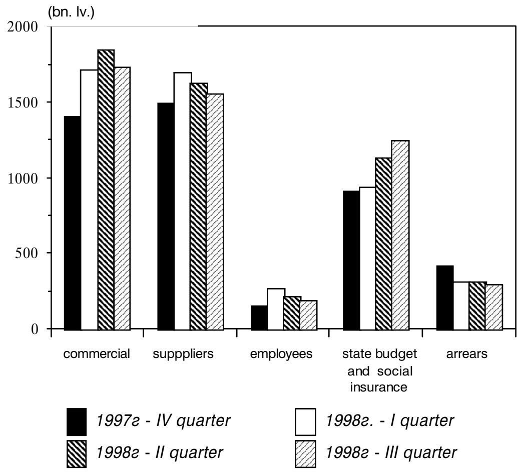
The correlation between devaluation and profitability was not applicable to exporters in 1995 when they registered much higher than the average for the public sector (which was negative) profitability regardless of the stable nominal exchange rate and the rapidly appreciating due to high inflation real exchange rate.

Available data point out that the problems of the Bulgarian firms mainly in the public industrial sector caused by the international crisis should not be confused with the implemented economic policy. Apparently, the current economic policy is conducive to the development of enterprises while those affected by the impact of the global crisis in the respective branches should undertake measures to cut down expenses and adapt to the new conditions. All the more that the slump in prices and demand for basic raw materials may prove to be long-term. In this case, devaluation will not assist the restructuring of the branches suffering recession but rather will affect adversely firms in the expanding sectors.

Apart from the general financial indicators such as operating profit, net profit, and profitability, firms' indebtedness is also a very important indicator. According to data on SOEs, in end-September 1998 total indebtedness of enterprises, both short and long-term, amounted to BGL 6.8 trillion. Indebtedness expressed as a percentage to sales revenues ran at 174 percent in end-September 1998 as compared to 41 percent in end-December 1997. These figures are indicative of the crisis effect wherein sales revenues fall in nominal terms while nominal financial dues remain unchanged. In this case, the effect from privatisation should also be taken into consideration on the assumption that lower indebted firms were privatised in 1997.

In the course of 1998, however, overall indebtedness of SOEs decreased except for their payments due to the budget and the National Social Security Institute (NSSI). In the third quarter

Liabilities of all State-Owned Non-Financial Enterprises



Source: NSI, AEAF

of 1998, delinquencies of state-owned firms on payment to the state budget and the NSSI increased by over 28 percent relative to the first quarter of the year. In the nine months of 1998, they went up by over 21 percent against the respective period in 1997. This fact identifies the state administration as the sole economic agent who does not impose hard budget constraints on SOEs and by doing so creates conditions for non-observance of financial discipline by both state-owned and private firms.

An effective instrument for hard budget constraints maintenance is the threat of entering the List for isolation and liquidation. According to the agreements with the IMF, a Law on the Financial Rehabilitation of State-owned Enterprises was passed in 1996 and Regulations for its implementation were adopted. Accordingly, two lists of loss-making and heavy-indebted SOEs were created. The measure was targeted at eliminating the losses and restructuring of debts of some enterprises specified by the Council of Ministers in order to curb the impact of the former on the other economic sectors. The latest amendments to the Law provide for the process to be completed by 30 June 1999.

In early-1998, some 214 enterprises in industry were included in both lists. Out of them, 114 SOEs have already been closed and targeted for liquidation with 50 of them already in liquidation. Twenty-four enterprises have been later removed from the lists as a result of the successful implementation of rehabilitation plans. The sale of assets in 44 firms in liquidation was completed and 14 enterprises had been removed from the trade register. Twenty-four SOEs from the group are in the last stage of the liquidation procedure by now.

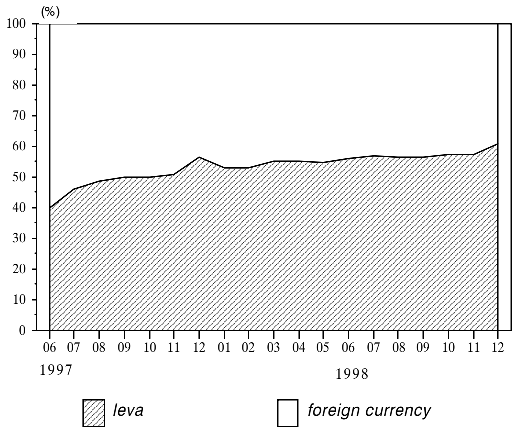
The finding of a lasting solution to the problems of firms in a grave or deteriorating financial situation had a positive macroeconomic effect on inflation, stability and the „health“ of both the banking system and the state budget. The adverse impact of these measures on unemployment will gradually subside over time on account of economic growth and the programs targeted at the unemployed and their re-qualification, which are currently under way.

To summarise, it is obvious that the current economic policy mix imposes financial discipline on the state-owned enterprises – the first step in the process of their restructuring, which has favourable macroeconomic implications.

3.4. The Development of Financial Intermediation

Financial intermediation and the development of the stock market are indispensable conditions for economic development. The Bulgarian banking system collapsed in 1996 when 17 banks were closed and declared bankrupt. Recovery following such a grave crisis is a slow process that may prolong in time. The introduction of a currency board in July 1997 had a positive effect on the banking system owing to the re-monetisation process that manifested itself immediately.

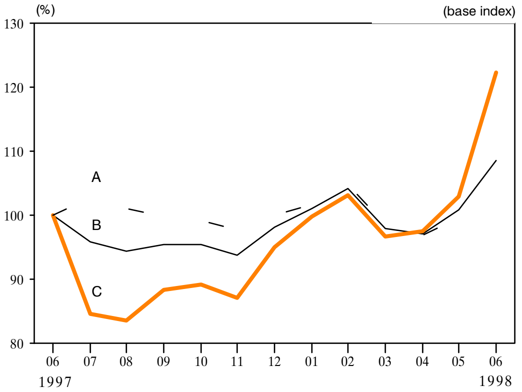
Share of Leva and Foreign Currency in the Total Volume of Broad Money



Source: BNB

The restoration of confidence in the national currency continued throughout 1998. The share of the lev component in total money stock increased from 56.4 percent in end-1997 to 60.8 percent in end-1998. Money supply in 1998 rose by 8.6 percent, deflated by CPI, in real terms. It followed the dynamics of highly liquid money (M1) and in particular that of money outside banks. The latter recorded the highest real growth on a year earlier, stepping up by 31.3 percent relative to end-1997. In real terms, quasi-money sustained the level

Broad Money and Its Components in Real Terms*



A - quasi money
B - broad money
C - M1

* *CPI - deflated*

Source: BNB, AEAF

reached in the end of the previous year.

If the share relating to commercial banks in liquidation is deducted from the sum of broad money and quasi-money, then the annual growth of those monetary aggregated amounts to 10.1 percent and 3.7 percent respectively.

Money growth in 1998 was influenced in two principal ways – through the mechanism of operation of the currency board, viz. by the sale of levs for Deutsche marks and through the changes in government's deposit in the BNB's Issue Department. The second way is also consistent with the currency board mechanism in Bulgaria since the government's fiscal reserve is incorporated within the BNB's money liabilities, i.e. it is covered by the foreign exchange reserves of the central bank. The government is in a position to influence the dynamics of reserve money through its deposit in the Issue Department or, in other words, it is able to carry out some sort of monetary policy. This opportunity, however, is restrained by the provisioned lower limit of the deposit's amount.

Notwithstanding its good financial situation, the banking system still has trouble in carrying out financial intermediation. The problem stems from the low money multiplier.

Money Multipliers in Bulgaria

	Dec.93	Dec.94	Dec.95	Dec.96	Jun.97	Dec.97	Mar.98	Jun.98	Sep.98	Dec.98
Money multiplier M3 (e.o.p.)	4.75	4.92	4.55	5.31	3.61	2.77	2.84	2.91	2.97	2.76
Multiplier M2 (M2/reserve money)	4.66	4.82	4.45	5.04	3.42	2.64	2.68	2.74	2.82	2.65
Multiplier M1 (M1/reserve money)	0.98	0.88	0.84	0.96	0.80	1.05	1.00	1.08	1.11	1.18
Money outside banks/Deposits (%)	12.0	10.1	11.8	10.7	16.0	27.9	27.5	30.6	31.8	35.9
Bank reserves/Deposits (%)	11.6	12.2	12.8	10.2	16.1	18.3	17.3	14.2	12.6	13.3

Money Multipliers in Germany

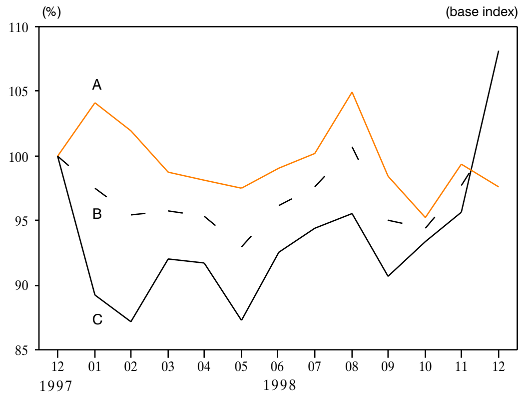
	Dec.93	Dec.94	Dec.95	Dec.96	Dec.97	Mar.98	Jun.98	Sep.98
Money multiplier M3 (e.o.p.)	7.12	6.62	6.73	6.99	7.30	7.48	7.36	7.59
Multiplier M2 (M2/reserve money)	4.93	4.39	4.22	4.21	4.30	4.32	4.29	4.44
Multiplier M1 (M1/reserve money)	2.71	2.61	2.74	2.94	3.03	3.02	3.03	3.14

The slowdown of the process of money multiplication was a result of several factors: first, insufficient confidence of economic agents in the commercial banks; second, the extremely cautious credit policy adopted by most banks; third, the maintaining of a high share of foreign assets in the total volume of the banks' assets; and fourth, the relatively low interest rates on deposits offered by banks.

The minimum required reserves of commercial banks in the central banks are a means of influencing the level of multiplier M1. Regulation No21 on the minimum reserve requirements, which entered into force in April 1998, granted greater rights to commercial banks for the management and use of their reserves in the BNB. The shrinkage of the banks' excess reserves as a result of the introduced new rules brought about a certain decrease of the bank reserves/deposits ratio, and of the bank reserves/demand deposits ratio in particular.

In 1998, the dynamics of the money multiplier M3 had a holdback effect on the growth of money stock. The value of broad money multiplier is unlikely to increase substantially in 1999. However, the financial intermediation of commercial banks is expected to improve through the popularisation of new bank services (home banking, debit and credit cards), the amelioration of financial

Deposits in Real Terms*

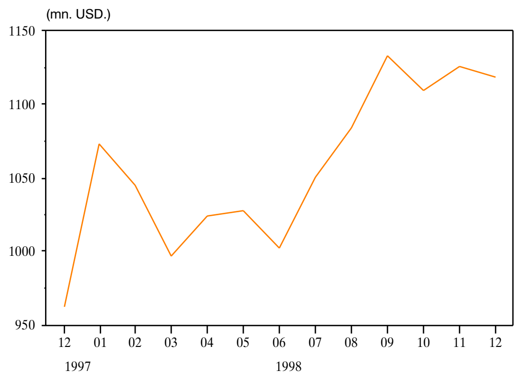


A - foreign currency deposits
B - all deposits
C - deposits in leva

* *Deflated by CPI*

Source: BNB, AEAF

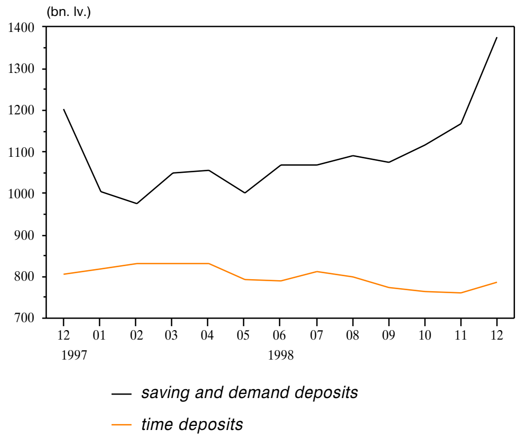
USD Deposits in Nominal Terms*



* *Data are from weekly statistical information of BNB and are related to operating banks only*

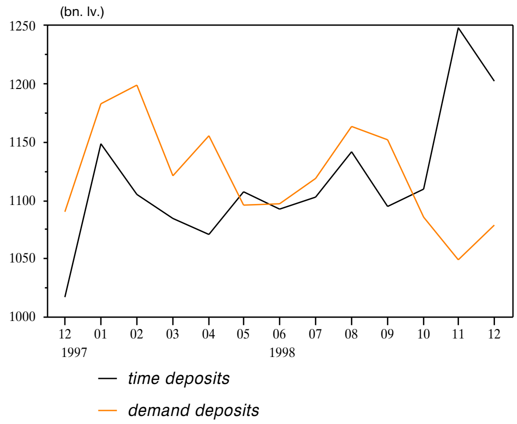
Source: BNB

Deposits in Leva in Nominal Terms by Maturity



Source: BNB

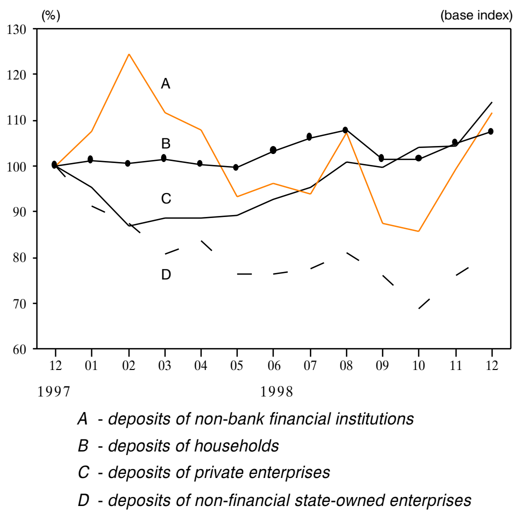
Foreign Currency Deposits (USD and DM) in Normal Terms by Maturity*



** Data are from weekly statistical information of BNB and are related to operating banks only*

Source: BNB, AEAF

Deposits in Real Terms* by Holders



* *CPI deflated*

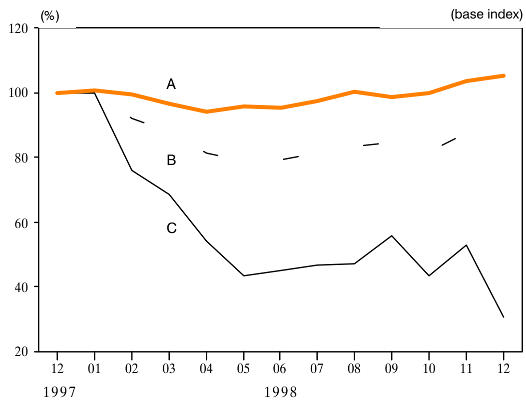
Source: BNB, AEAF

intermediation (viz., a larger part of the settlement turnover to pass through BISERA system) and the increase of credits to the non-government sector.

In 1998, the real-term rise of deposits in the whole banking system was 2.2 percent relative to end-1997 whereas deposits in operating banks grew by 3.9 percent. Demand lev deposits registered the highest increase. The lev value of deposits in US dollars was being influenced by the USD/BGL exchange rate dynamics. The actual annual increase of these deposits in the operating banks amounted to USD 156 mn, or 16.3 percent up on a year earlier. Notwithstanding the depreciation of the US currency, which ultimately brought about net losses in end-1998 to the holders of USD deposits, economic agents used these very deposits as a store of wealth. This fact is confirmed by the maturity dynamics of the lev and foreign currency deposits. While highly liquid deposits represented the bulk of lev deposits, the shares of time and demand foreign currency deposits were approximately equal.

The dynamics of deposits by types of holders shows that only households' deposits remained in real terms steadily above their end-1997 level while their registered fluctuations followed the changes in the USD/BGL exchange rate. Throughout most of the year, the deposits of private firms were in real terms below the level of end-December 1997 yet, ultimately, they registered real annual growth of 13.8 percent (the increase ran at 15.4 percent if deposits in banks in liquidation are excluded). Only the deposits of state-owned non-financial enterprises sustained almost a steady downward trend throughout the year. Their real-term decline relative to end-1997 amounted to 19.1 percent (18.9 percent if deposits in banks in liquidation are

Domestic Credit in Real Terms*

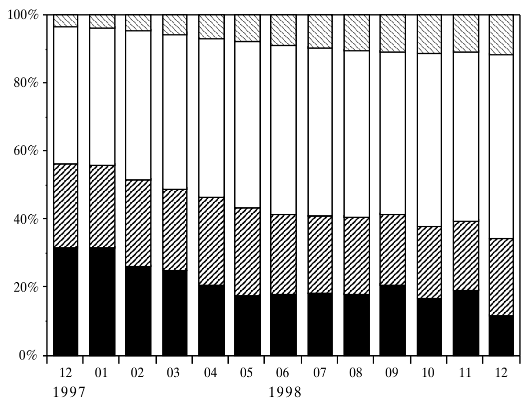


A - claims on non-government sector
B - total domestic credit
C - claims on government sector

* *deflated by CPI*

Source: BNB, AEAF

Composition of Domestic Credit



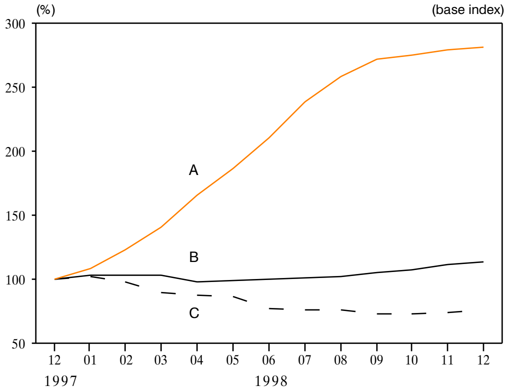
Source: NSI, AEAF

excluded). Among the most likely reasons for this shrinkage were privatisation, the deteriorating business situation in some economic branches, the relatively high interest rates that forced state-owned enterprises to use more internal resources as working capital.

Domestic credit continued to shrink in 1998 and in end-year it decreased by 18.5 percent in real terms relative to end-1997. The decline was primarily due to changes in the credit structure and in particular to the 69.2 percent real-term shrinkage of net claims on government from the banking system. If the part of domestic credit concerning banks in liquidation is deducted from total domestic credit, then the latter's real-term reduction was less, running at 10.5 percent while that of net claims on government from the banking system amounted to 55.5 percent. The revaluation at market value of government securities which was carried out in December also contributed to the shrinkage of claims on the government sector by commercial banks.

Credit to the non-government sector increased by 6.4 percent (BGL 222.3 bn) in nominal terms relative to end-1997 due to the 183.3 percent growth (BGL 310.9 bn) of credit lending to households and the 13.7 percent (BGL 271 bn) rise of credits to private enterprises over the same period. The real-term increase of credit to the non-government sector ran at 5.4 percent. Operating banks raised their credits to the sector by 41.8 percent, or BGL 701.2 bn, in nominal terms. The bulk of the increase was in credits to private enterprises to the amount of BGL 519.2 bn and in credits extended to households worth BGL 312.5 bn. The relatively low increase of claims on the non-government sector from the entire banking

Loans to Non-Government Sector in Real Terms



*A - claims on households**
*B - claims on private enterprises***
*C - claims on state-owned non-financial enterprises****

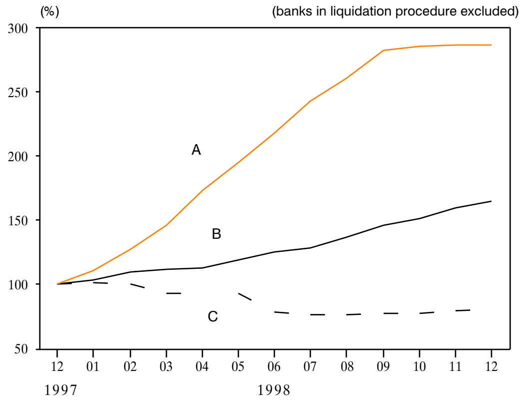
** Claims in households are deflated by CPI. Claims on stated-owned enterprises and private enterprises are deflated by CPI*

*** CPI - deflated*

**** PPI - deflated*

Source: BNB, AEAF

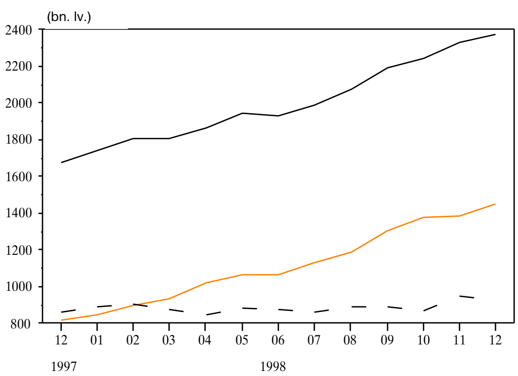
Loans to Non-Government Sector in Nominal Terms



A - claims on households
B - claims on private firms
C - claims on state-owned non-financial enterprises

Source: BNB, AEAF

Claims on Non-Government Sector (banks in liquidation procedure excluded)



— total *— in leva*

— in foreign currency

Source: BNB, AEAF

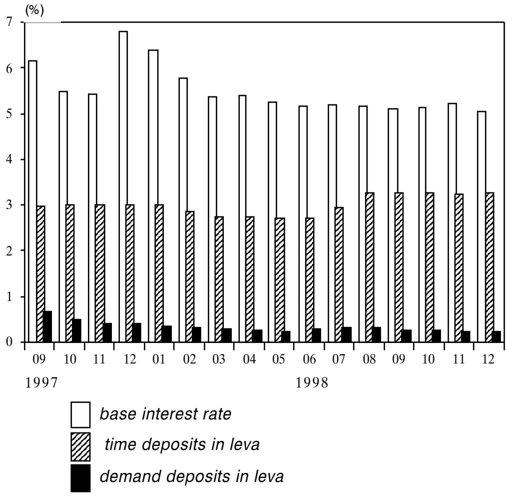
system was associated with the repayment of old financial obligations to banks in liquidation on the part of state-owned and private enterprises.

The considerable annual rise of claims on households from the banking system was due to the low basis for comparison. In the preceding years, the high nominal interest rates rendered bank credits unattractive to households. Consumer credits with a repayment period of over one year prevailed within the structure of new credits extended to this group. However, a part of these credits had been presumably used for financing of small businesses.

Short-term credits accounted for the largest share (over 85 percent) in the maturity structure of new credits to state-owned and private enterprises. The real-term shrinkage of credit lending by the banking system (by 25.3 percent on the part of the whole banking system and by 19.9 percent only on behalf of operating banks) to state-owned non-financial enterprises was associated with the financial difficulties experienced by the majority of the latter.

Most of the new credits to the non-government sector were denominated in levs rather than in foreign currencies. The fall of convertible currency-denominated credits may well be due to the drop of price levels in international trade, and particularly to price reductions of raw materials and fuels. If we assume that the bulk of credits in foreign currency were linked to foreign trade transactions then, given the reported 15 percent annual decline of the overall price level in world trade, the real-term increase of the US dollar value of these credits ran at 4 percent while the respective nominal decrease amounted to 11.6 percent. Operating banks increased their foreign currency

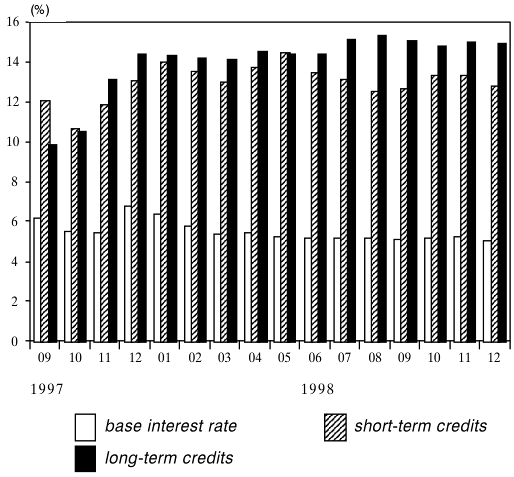
Interest Rates on Deposits in Leva after the Introduction of Currency Board*



* *annual simple interest rate*

Source: BNB

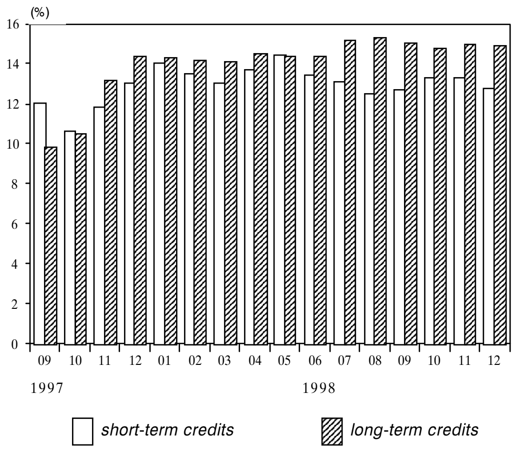
Interest Rates on Deposits in Leva after the Introduction of Currency Board*



* *annual simple interest rate*

Source: BNB

Interest Rates on Deposits in Leva after the Introduction of Currency Board*



* *annual simple interest rate*

Source: BNB

denominated credits to the non-government sector by 13.8 percent (USD 67.2 mn).

Interest levels in the country sharply plummeted after the introduction of the currency board. In 1998, interest rates were relatively stable. The average annual value of the base interest rate determined by the market according to the rate of return on three-month discount T-bills ran at 5.35 percent which was by some 2 percentage points higher than the 3-month LIBOR on Deutsche mark deposits. This risk premium seems to have been estimated as insufficient by foreign portfolio investors for they withdrew from the Bulgarian government securities market. The most prominent characteristic feature of commercial banks' interest policy was the maintaining of a relatively broad spread between interest rates on deposits and credits. The average value of the interest difference between time deposits and short-term credits in 1998 amounted to about 10 percent. The average weighted interest rate on time deposits fluctuated within 2.73 percent and 3.25 percent. These interest levels did not stimulate the growth of time lev deposits. The scope of fluctuation of the average weighted interest on short-term lev credits was 12.5 – 14.4 percent while that on long-term lev credits was 14.1 – 15.3 percent.

Interest rates on demand deposits in US dollars and in Deutsche marks were higher than the interest on demand deposits in levs. The average weighted interest rates on time deposits in US dollars exceeded the interest offered on time lev deposits. These differences are associated with the better opportunities for assets management granted by the international financial markets. Foreign currency denominated credits remained cheaper than credits in levs.

The relations between the various economic agents allow the drawing up of a diagram of the net financial flows among them. The diagram of the net flows of deposits and credits between the commercial banks and the institutional sectors in the period end-December 1997 to end-November 1998 reflects the problems of the commercial banks in managing their assets and liabilities. In 1998, the government sector was in the position of principal net creditor. The officially projected budget deficit in 1999 at up to 2.7 percent of GDP and the increased budget expenditures for wages and investment should induce the shrinkage of the government's net deposits in banks. In 1998, households which are customarily a net creditor to the banking system, came to the position of a net debtor, i. e. the increase of their deposits in the commercial banks was less than the value of credits extended to them. This anomaly is likely to persist in 1999, yet it would hardly go on the increase since, as it was already mentioned, the growth of credit lending to households after the introduction of the currency board and the lowering of interest levels was associated with restored demand for credits after a period of practical lack of such a demand. Therefore, these credits have so far retained an insignificant share within the total volume of domestic credit. The net financial flow from commercial banks to private enterprises will probably increase in 1999 in view of the speed-up of privatisation but also due to the fact that banks will have to raise interest rates on deposits if they want to enlarge their deposit base while credits to non-financial institutions, given good management, ensure the highest rate of return. In 1998, the state-owned non-financial enterprises were net creditor to the banking system since the shrinkage of commercial banks' claims on them exceeded the decline of their deposits. The net financial flow from the state-owned firms to commercial banks had to do with the repayment of old credits as a result of the policy of strict financial discipline implemented by the state. The substantial volume of financial flows to foreign financial institutions reflected commercial banks' preferences for holding highly liquid and low risk, yet low profitable assets. Demand and short-term deposits in levs and convertible currency accounted for the majority of the banks' resources. This situation forces them to manage very cautiously their assets.

4. Concluding Remark

1998 witnessed the full effect of macroeconomic stabilisation policy based on the currency board and prudent fiscal policy. Inflation is low, the foreign exchange reserves of the Bulgarian National Bank (BNB) are increasing, interest rates have remained stable at a level which, under the low inflation rates, allows for positive real interest rates, incomes continued to increase to their pre-crisis level.

The micro level changes of 1998 are of a behavioral nature. The enhanced financial discipline in the economy was due to the growing share of the private sector, the improved control and the wage regulation policy in the state sector. The implementation of the program for isolation and liquidation of loss-making state-owned firms in 1998, to be completed till June 1999, created a real threat for bankruptcy with the expected disciplinary effect on all firms.

The Asian crisis's spillover in 1998 and the global slowdown of economic growth affected negatively the Bulgarian economic growth prospects. The estimated growth rate of 1998 is 4% while the potential was for 6-8%.

A fundamental factor for economic growth promotion in the near future is the behavioral change of the firms both in the private and the state sector. They all should become more flexible and able to respond to adverse external shocks. The stable internal macroeconomic environment supported by a transparent and predictable medium term economic policy facilitates the adjustment of domestic firms to deteriorating external business opportunities. The challenges to economic growth in the medium term are related to the measures of government directed to the completion of the privatization process, the sustainability of the hard budget constraints on the state sector and the promotion of banking intermediation. ❑

APPENDICES

Appendix to Section 1.1.

Coefficients of Variation of Prices by Main Commodity and Service Groups

Years	Food items *		Non-food items		Services	
	First half	Second half	First half	Second half	First half	Second half
1991	32.1	13.9	33.9	15.1	28.4	7.6
1992	9.9	8.6	12.5	11.6	14.5	7.0
1993	6.5	7.7	8.8	9.0	11.7	6.3
1994	13.3	13.6	13.8	13.8	12.2	8.1
1995	5.2	5.9	7.4	6.2	7.1	5.3
1996	10.8	29.1	12.0	23.3	10.7	20.1
1997	34.8	6.2	35.0	6.4	39.6	10.7
1998	3.3	3.0	3.4	3.6	6.5	5.6

Note: Season fresh fruit and vegetables are excluded as they have a very high coefficient of variation.

Price Changes of Some Major Tradables

(Percent)

GOODS	Price changes over the period December 1997 to December 1998	
	At the domestic market [1]	At the international markets [2]
Durum wheat	-31.2	-15.5
Corn	-6.2	-20.1
Veal	-15.9	-6.3
Sunflower oil	20.0	4.0
Sugar	-6.5	-34.6
Wool	-2.5	-19.6
Cattle hides	-14.8	-16.7
Tobacco	-3.4	-10.6
Petroleum	-17.6	-33.8
Aluminium	-35.2	-18.9
Lead	-8.8	-21.0
Zinc	-25.8	-26.6

Notes: *1) Some of the reported changes relate to producer prices and some to consumer pricse;*
2) Calculations based on data for certain commodity exchanges in UNCTAD „Monthly Commodity Price Bulletin“.

Price Changes of Food Items

Food items groups	Price changes as of end-year (percent)	Contribution to inflation (percentage points)
Vegetables and potatoes	20.1	1.2
Vegetable and animal fats	13.8	0.4
Fruit	8.7	0.2
Alcoholic drinks	16.9	0.2
Soft drinks	16.6	0.1
Fish and fish products	-2.3	0.0
Vegetarian ready-to-cook and cooked meals	0.1	0.0
Coffee, tea and cocoa	4.3	0.0
Other food items (spices)	-1.7	0.0
Sugar and sweets	-4.5	-0.2
Milk, dairy products and eggs	-12	-0.9
Cereals, bread and dough products	-7.9	-1.4
Meat and meat products	-21.5	-2.2

Appendix to Section 2.

Main Macroeconomic Indicators of Bulgaria

	1991	1992	1993	1994	1995	1996	1997
Gross domestic product (billion BGL)	135.7	200.8	298.9	525.6	880.3	1748.7	17103.4
Investment	30.6	40.0	45.7	49.4	137.8	146.9	2025.0
Consumption	99.3	172.6	276.0	479.5	756.5	1547.7	14389.8
Net export of goods and services	5.8	-11.8	-22.8	-3.3	-14.0	54.1	688.6
Gross domestic product (percent)							
Investment	22.5	19.9	15.3	9.4	15.7	8.4	11.8
Consumption	73.2	85.9	92.3	91.2	85.9	88.5	84.1
Net export of goods and services	4.3	-5.9	-7.6	-0.6	-1.6	3.1	4.0
Real growth rate of GDP (percent)	-11.7	-7.3	-1.5	1.8	2.9	-10.1	-6.9
Investment		-7.3	-17.5	1.0	16.1	-21.2	-22.1
Consumption	-8.3	-3.1	-3.6	-4.5	-1.9	-6.7	-15.1
Inflation (percent)							
- end of period	473.7	79.4	63.9	121.9	32.9	310.8	578.6
- annual average	338.5	91.1	72.8	96.0	62.0	123.0	1082.2
Exchange rate (BGL/USD)							
- end of period	21.8	24.5	32.7	66.0	70.7	487.4	1776.5
- annual average	17.8	23.3	27.6	54.1	67.2	177.9	1765.2
Base interest rate (percent)	57.1	61.1	60.9	86.6	65.2	262.8	74.1

Appendix to Section 2.1.

	Hungary	Poland	Czech Republic	Slovakia	Romania	Slovenia
Inflation in 1997 (consumer prices, eop)	18.5	13.2	10.0	6.5	151.4	8.8
Inflation in 1998 (consumer prices, eop)	12.3 (Oct.)	9.9 (Oct.)	8.1 (Oct.)	6.6 (Oct.)	47.1 (Oct.)	6.4 (Nov.)
Trade balance, fob-fob, 1997, million US dollars	-1 730	-11 270	-4 540	-1 470	-2 850	-770
Trade balance, fob-fob, 1998, million US dollars	-1 330 (Jan.-Oct.)	-10 740 (Jan.-Oct.)	-1 610 (Jan.-Oct.)	-1 560 (Jan.-Oct.)	-1 820 (Jan.-Oct.)	-530 (Jan.-Oct.)
Share of export to EU, 1997, percent	69.9	62.3	58.4			63.1

Main Macroeconomic Indicators of Applicant Countries for EU Membership, 1998*

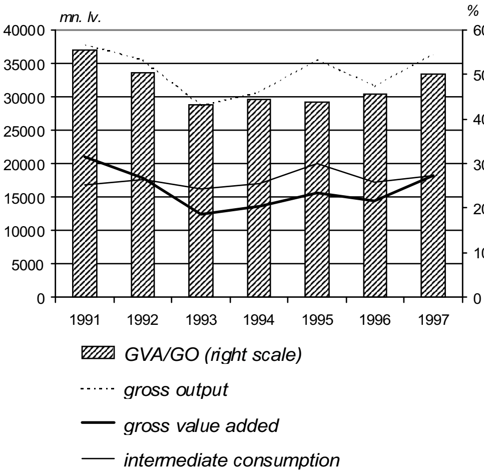
Country	GDP per capita (US dollars, PPP)**	Real GDP growth	Change of foreign exchange reserves (billion US dollars)	Unemployment rate (percent)	Debt/Export (percent)
Slovenia	11724	6.5	1.2	14.3	40.0
Czech Republic	11566	-0.9	-2.6	5.3	72.0
Slovakia	8585	6.1	-0.3	13.9	93.9
Hungary	7318	4.8	0.3	9.1	96.9
Poland	6406	5.8	6.3	9.6	133.0
Estonia	4688	5.5	0.0	3.7	8.5
Lithuania	4566	6.9	0.6	5.5	33.4
Romania	4356	-5.2	-0.3	9.0	85.0
Bulgaria	3860	4.5	0.6	12.2	156.0
Latvia	3729	6.4	0.1	7.2	19.6

* Preliminary assessments. Source: *Business Central Europe,* Vol. 5, No. 57 (December 1998/January 1999) and *Economic Reform Monitor,* No. 33, September 1998.

** Purchasing power parity, 1997.

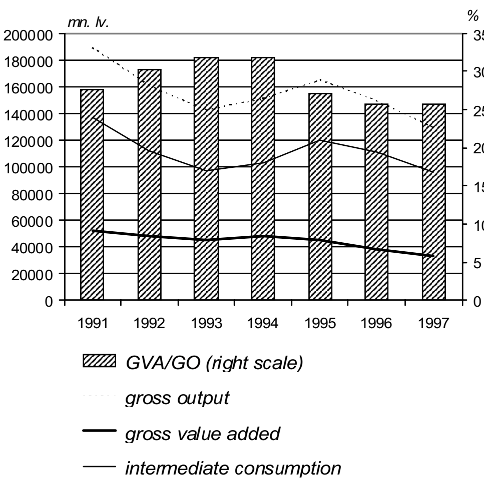
Appendix to Section 2.3.

Ratio of Value Added to Gross Output, Agriculture, 1991 Prices



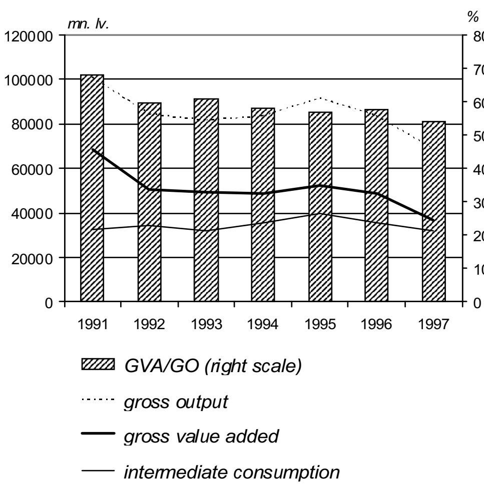
Source: NSI, AEAF

Ratio of Value Added to Gross Output, Industry, 1991 Prices



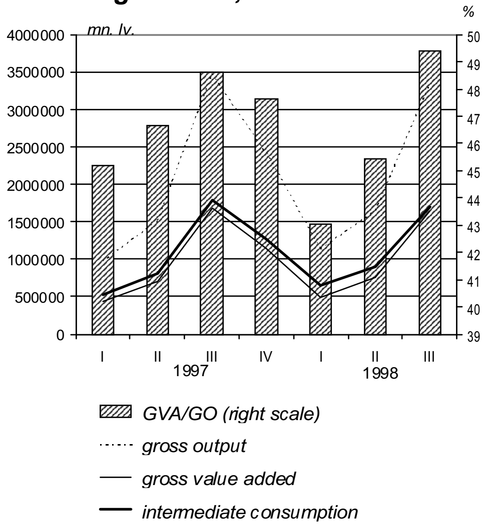
Source: NSI, AEAF

Ratio of Value Added to Gross Output, Services, 1991 Prices



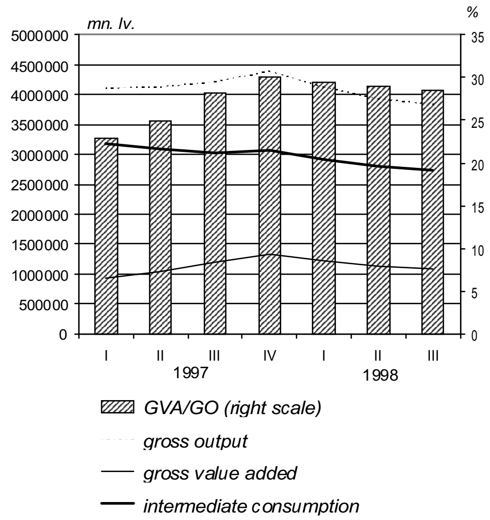
Source: NSI, AEAF

Ratio of Value Added to Gross Output, Agriculture, 1997 Prices



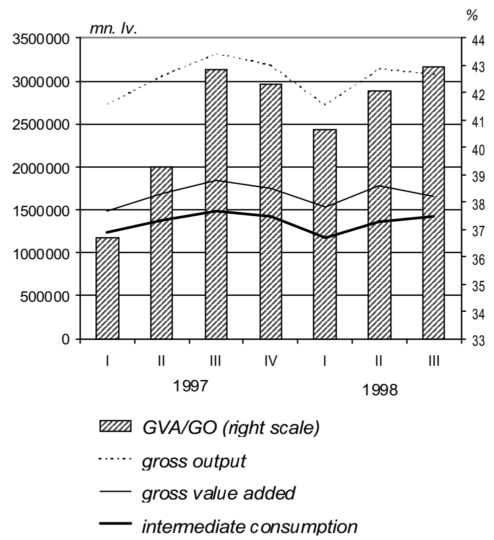
Source: NSI, AEAF

Ratio of Value Added to Gross Output, Industry, 1997 Prices



Source: NSI, AEAF

Ratio of Value Added to Gross Output, Services, 1997 Prices



Source: NSI, AEAF

Appendix to Section 3.1.

Relative Share of Private Sector in Gross Output and Value Added by Branches, Third Quarter* of 1997 and 1998

	Gross Output		Value Added	
Sector	1997	1998	1997	1998
Agriculture and forestry	**96.98**	**96.70**	**98.18**	**97.82**
Agriculture	98.00	98.16	98.68	98.94
Forestry, fishing and hunting	17.52	20.39	30.98	28.92
Industry	**38.34**	**50.15**	**43.67**	**51.08**
Mining industry	6.26	7.29	6.13	10.73
Manufacturing industry	42.55	54.74	51.31	56.60
Production and distribution of electricity, gas and water	0.31	0.26	0.32	0.24
Construction	58.73	73.11	61.53	74.88
Services	**57.24**	**57.83**	**61.65**	**60.70**
Transport	50.44	50.25	53.76	49.85
Communications	9.95	29.48	7.39	20.82
Trade	83.54	80.65	81.40	74.97
Finance, credit and insurance	46.82	59.81	46.10	69.70
Other services	**55.32**	**56.57**	**62.20**	**62.45**
Total, at basic prices	**62.28**	**65.78**	**70.65**	**69.25**

Note: *Since the first two quarters are seasonally weak for agriculture and unrepresentative of the relative share of private sector, the third quarter of the year was taken as a basis. Private sector's share in the third quarter is traditionally slightly higher yet it remains closer to the annual structure.*

Indexes of Production Volumes in the Private and Public Sectors by Branches

(Preceding year = 100)

Economic branch		1992	1993	1994	1995	1996	1997	1998, 9m.
Agriculture and forestry	Private sector	115.0	76.8	115.8	107.0	93.6	130.0	101.5
	Public sector	69.4	60.4	97.3	149.9	88.5	66.8	124.9
Industry	Private sector	133.6	147.7	116.2	133.1	101.9	149.4	117
	Public sector	90.8	87.3	103.7	83.8	82.9	66.2	104.1
Construction	Private sector	179.7	152.5	126.1	123.3	84.9	65.7	120.5
	Public sector	100.7	72.9	81.5	78.9	69.3	60.3	107.2
Services	Private sector	115.4	122.4	103.7	124.3	94.1	79.7	97.6
	Public sector	62.1	90.2	91.7	87.4	86.2	71.2	102.8
Transport	Private sector	239.8	169.7	119.3	191.6	85.9	119.4	73.3
	Public sector	97.2	97.8	97.7	121.6	109.4	101.2	84.7
Communications	Private sector			113.6	457.6	249.9	101.0	268.0
	Public sector	102.9	107.2	100.7	129.3	103.5	92.5	97.5
Trade	Private sector	187.0	132.0	122.1	119.2	78.6	64.1	109.2
	Public sector	55.7	78	90.4	74.5	78.3	58.6	148.4
GDP at basic prices	Private sector	117.8	114.6	108.3	121.6	95.4	102.2	102.4
	Public sector	75.1	86.7	97.3	88.1	84.8	68.5	103.9

Note: Data on real growth of the private sector depend on the privatisation process and the ongoing change of ownership of SOEs. The highest change was registered in industry wherein it is practically impossible to assess the share of growth as a result of privatisation and the respective share due to improvements in the performance of existing private firms.

Relative Share of Value Added in Gross Output by Branches, Respective Nine Months of 1997 and 1998

(Percent)

Economic branch	Private sector 1997	Private sector 1998	Public sector 1997	Public sector 1998
Agriculture and forestry	**48.71**	**43.74**	**27.92**	**30.93**
Agriculture	48.72	43.72	30.67	27.48
Forestry, fishing and hunting	44.84	50.48	23.67	34.27
Industry	**31.38**	**31.49**	**23.51**	**30.71**
Mining industry	36.82	38.93	37.63	32.47
Manufacturing industry	30.19	30.36	19.61	26.50
Production and distribution of electricity, gas and water	37.20	40.50	34.06	42.04
Construction	38.55	36.94	31.42	35.65
Services	**61.40**	**63.82**	**48.89**	**52.22**
Transport	31.39	33.49	27.46	32.08
Communications	43.64	42.62	61.06	66.13
Trade	50.98	51.23	58.12	68.45
Finance, credit and insurance	49.40	67.69	46.83	57.38
Other services	**82.67**	**80.57**	**58.53**	**56.26**
Total, at basic prices	**48.73**	**47.10**	**31.28**	**39.04**

Appendix to Section 3.3.

Imlementation of 1998 Privatisation Programme

Minimum targets[1]	Assessment of the accomplished
Privatisation of „the majority of state property."	According to data from the Privatisation Agency, some 31 percent of state-owned assets had been privatised
„The conclusion of a number of large-scale privatisation deals for SOEs with fixed assets of at least 8 percent of total fixed assets in the country with strategic foreign investors through the use of foreign consultants which will ensure substantial revenues to the state budget."	It is expected that this target will be fulfilled in 1999 when the contracts with foreign consultants will expire.
„The sale of over 5 percent of state-owned assets grouped in sectoral „pools" by attracting investment intermediaries."	The investment intermediaries on all „pools" were selected. Three deals were concluded.
„Expected privatisation of not less than 5 percent of total assets in the country" through centralised auctions.	Centralised auctions were not used as a means of large-scale privatisation. Not a single such auction was organised in 1998 although the National Assembly voted and approved the issuing of the new investment vouchers.
„Commencement of the sale of shares on the stock exchange and privatisation of at least 4 percent of state-owned assets."	Trade on the stock exchange remained torpid. Shares from enterprises privatised during the first wave of mass privatisation were predominantly traded.
„Accelerated sale of a large number of small and medium size enterprises by the line ministries through auctions or tenders."	The task was successfully accomplished mostly due to privatisation deals finalised by the Ministry of Industry.
„Further encouragement of debt for equity swaps and maximum utilisation of ZUNKs and Brady Bonds as a means of payment. „	A new Regulation on the terms and conditions for participation in privatisation through Brady Bonds entered into force in early-1998.[2] It allows the bulk of payments for cash privatisation deals to be in Brady Bonds (for up to 75 percent of the price in payment with FLIRBs and for up to 50 percent of the price for payment with discount bonds).
„Supporting privatisation through management and employee buy-outs" /MEBOs/.	The slackening of the terms and conditions for registration of management and employee privatisation firms induced the active participation of the latter in privatisation even to the extent that they put up for the purchase of relatively large enterprises in need of considerable investment. This necessitated amendments to the Privatisation Law which confined MEBOs privatisation to enterprises with relatively smaller assets.

[1] *See* Programme for the Privatisation of State-owned Enterprises in 1998*, published in the* Official Gazette*, No. 116 of 9 Dec. 1997.*

[2] *Published in the* Official Gazette*, No 6 of 16 Jan. 1998.*

The institutions stipulated in Art. 3 of the Privatisation Law to conclude: 1501 privatisation deals, out of which 750 for whole enterprises 751 for minority shares and self-sufficient parts.	Number of concluded deals: 1104, out of which 661 for whole enterprises 443 for minority shares and self-sufficient parts.
Expected financial proceeds: USD 665.156 million, out of which: Revenues budgeted in the macroeconomic framework of the consolidated budget: some USD 200 million out of which: BGL 460 billion in government securities.	Contracted payments: USD 580.97 million. Privatisation proceeds to the consolidated budget: some USD 200 million Reductions in the volume of government securities issued for the purpose of structural reform: about BGL 400 billion.

International Credit Ratings of Selected Countries and Bulgaria[3]

Country	Securities		Bank deposits	
	Long-term	Short-term	Long-term	Short-term
Argentina	Ba3(-)	NP	B1(-)	NP
Brazil	**B2**	**NP**	**Caa1**	**NP**
Mexico	Ba2(-)	NP	B1(-)	NP
Croatia	Baa3	P-3	Ba1	NP
Slovakia	Ba1(-)	NP	Ba2(-)	NP
Estonia	Baa1	P-2	Baa1	P-2
Lithuania	Ba1	NP	Ba2	NP
Latvia	Baa2	P-3	Baa3	P-3
Bulgaria	**B2**	**NP**	**B3**	**NP**
Romania	B3	NP	Caa1	NP
Greece	Baa1	P-2	Baa1	P-2
Turkey	B1	NP	B2	NP
Russia	**B3**	**NP**	**Ca**	**NP**
Ukraine	**B3**	**NP**	**Caa3**	**NP**
South Korea	Ba1(+)	NP	Caa1(+)	NP
Thailand	Ba1	NP	B1	NP
Indonesia	**B3**	**NP**	**Ca**	**NP**

Explanations:

Countries with respective ratings identical to those of Bulgaria

Countries with worse respective ratings than those of Bulgaria

[3] *Moody's Investors Service, http://www.moodys.com/repldata/ratings/ratsov.html. Data as of 31 January 1999.*

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