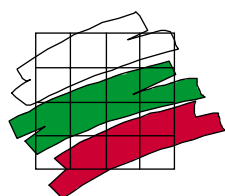


BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2001 annual report



**AGENCY FOR ECONOMIC
ANALYSIS AND FORECASTING**

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ABBREVIATIONS AND ACRONYMS

AEAF – Agency for Economic Analysis and Forecasting
BCC – Bank Consolidation Company
BDZ – Bulgarian State Railways
BIR – Base Interest Rate
BNB – Bulgarian National Bank
BoP – Balance of Payments
BSE – Bulgarian Stock Exchange
BTC – Bulgarian Telecommunications Company
CBA – Currency Board Arrangement
CEE – Central and Eastern Europe
CEFTA – Central European Free Trade Association
CIS – Commonwealth of Independent States
CPI – Consumer Price Index
EU – European Union
FDI – Foreign Direct Investment
FX – foreign exchange
GDP – Gross Domestic Product
GVA – Gross Value Added
ICT – Information and Communication Technologies
ILO – International Labour Organisation
IMF – International Monetary Fund
LIBOR – London InterBank Offering Rate
MAF – Ministry of Agriculture and Forestry
MEBO – Management and Employee Buy-out
MoF – Ministry of Finance
NEK – National Electricity Company
NES – National Employment Service
NSI – National Statistical Institute
OECD – Organization for Economic Cooperation and Development
OPEC – Organisation of Petroleum Exporting Countries
PPI – Producer Price Index
PPPCA – Privatisation and Post-Privatisation Control Act
SAPARD – EU Special Accession Programme for Agriculture and Rural Development

EXECUTIVE SUMMARY

In 2001, the Bulgarian economy reported stable growth for the fourth year in a row, following the severe economic and financial collapse of 1996 – 1997. The 4% growth rate ran highest among the EU candidate countries, despite the economic recession worldwide. The welfare and living standard indicators set back at their pre-crisis levels in 1995, now surpassing them. Real wages stepped up by 3% in real terms, remaining as in the preceding year about 2 percent down labour productivity to further boost competitiveness in the country's economy. All this provides irrefutable arguments that the policy mix of a currency board arrangement and strong fiscal stance was the right choice for a small and open economy like the Bulgarian one under the conditions of economic globalisation. The above trends coupled with an adequate economic policy response to the deteriorating external environment in the last quarter of 2001 helped strengthen the confidence of the international financial community in Bulgaria. Higher confidence, in turn, allowed for a significant restructuring of the country's foreign debt in end-2001 and substantial progress in the pace of the EU accession negotiations in early 2002.

Despite the recession in the world economy following September 11th terrorist attacks on the USA and the adverse situation in some of Bulgaria's major export markets, it was again external demand that was the key factor of GDP growth. On the other hand, in 2001 domestic demand tended to gain importance to GDP growth as well. Although the gross fixed capital formation/GDP ratio remained lower (20.4%) than in most applicant countries, fixed capital formation reported a 19.9% real-term year-on-year increase.

For the first time over the last couple of years, all sectors of the economy reported positive value added growth in real terms. As in the preceding years, the service sector developed most dynamically, reporting a real-term rise in value added of some 4.2% due largely to the expansion of the private sector in communications and tourism as well as the recovery of the privatised enterprises. Mid-2002 witnessed a turnaround in agricultural shrinkage, discerned in 2001.

Monthly inflation ran lower than in 2001. Average 12-month inflation amounted to 7.4% against 10.3% on a year earlier, but remained well above the EU's average. Again, the main sources of inflation were administered price dynamics and the faster price increase in some non-tradables spurred by the Balassa-Samuelson effect. Labour productivity reported a most significant increase of 9.9% in the processing industries that are defined as an entirely tradable sector, giving strong evidence that 2001 real wage growth did not undermine the competitiveness of Bulgarian enterprises.

Worldwide recession and declining demand produced an adverse effect on the country's balance of payments, the trade deficit in particular, which stepped up by 33.4% relative to 2000. On a year earlier, import and export growth rates reported a most significant decrease of 6.8 and 14.6 percentage points respectively that was further reinforced by the downward price trend of many tradables. The current account deficit thus reached 6.5% of GDP. The improved balance on services (a USD 40.2 mln worth of a rise on a year earlier) and current transfers (USD 196.4 mln up) could only partially make up for the deteriorating trade deficit. The importance of tourism as a source of revenues for the balance of payments was tending to steadily rise.

The strong fiscal policy stance in 2001 was again a key factor of currency board stability. The consolidated government budget deficit declined by 0.2% on a year earlier down to 0.9% of GDP against 1.5% initially provided for in the Government Budget Act as a result of the tightened fiscal restriction in the last quarter of the year imposed by the more drastic than expected balance of payment deterioration in the nine-month period of 2001 and the need to make fiscal policies more effective as an instrument to restructure the economy. Fiscal policy amendments had therefore reduced the redistributive function of the consolidated government budget in the last quarter of 2001. Total budget revenues and expenditures/GDP ratios stepped by 1.4 and 1.5 percentage points down to 40% and 40.8%. The maintenance of a low budget deficit was fully in line with the Bulgaria's sustained effort to achieve the Maastricht criterion for the same indicator.

Decreasing by 7 percentage points on a year earlier, the government debt/GDP ratio went down to 70.1% in end-2001 due not only to the favourable growth trend of GDP and budget deficit reduction but also to a series of successful external debt restructuring operations including the debut issue of Bulgarian Eurobonds and the buyback of Brady bonds. The lower interest rates in the international markets and continuously applied policy of deficit financing by revenues from privatisation also contributed to the improved government debt/GDP ratio. The mid-term target for the ratio to fulfil the Maastricht criterion is to set at 60% steadying around that level.

The FX reserves went on rising in 2001, reporting a 3.4% increase in USD terms on a year earlier while their coverage ratio against reserve (base) money decreased due to the faster remonitisation rate in the economy. The currency board stability was not undermined by the above trend, as the FX reserves of the Central Bank carried on exceeding significantly all its liabilities. The high remonitisation rate in the economy was similar to the rate in other transition economies that had experienced a financial crisis and was brought about by the restored confidence in the national currency and the economy, and the expectations triggered by the adoption of the single European currency on January 1st 2002. The latter fostered significant growth in Euro-currency deposits compared to the preceding years and the exchange of larger other currency amounts in euros by households and firms alike in the fourth quarter of 2001. Highly-liquid money (M1) growth rate outstripped broad money increase, reflecting among other things the economic agents' increased preferences towards liquidity as a result of the lower interest rates in the economy.

In 2001 the banking system remained well capitalized and profitable, with competition among market players going on the increase, and in the absence of serious consolidation developments in the sector and deeper integration into the European financial markets it went on playing a dominant role in financial intermediation. The capital market, on the other hand, could boast of nothing but underdevelopment, with all the possibilities it offered for improved privatisation transparency underused. Trading volumes in the Bulgarian Stock Exchange and market capitalization remained several times lower compared to the stock markets of the other candidate countries under a currency board.

Following the consistent amendments to the country's legislation in the last couple of years, pension insurance funds were steadily and securely stepping into the role of important financial intermediaries in the distribution of financial resources in the economy. Insurance companies also offered a wider range of services, though the indicators of insurance penetration and expansion stood lower than in most applicant countries. The concentration of assets in the insurance sector and with universal, professional and voluntary pension insurance funds remained relatively high.

On a year earlier, non-financial sector lending in 2001 (20.5%) grew at a faster rate, with the government withdrawing from the credit market. Compared to previous years, non-financial sector credit growth outstripped the growth in banks' net foreign assets, evidencing that part of the capital flows were being allocated to the home credit market. The above trend was at least partially due to the interest rate downward trend on the international markets as well and lied at the core of the lowering of the local interest rate on USD deposits. 2001 did not see any clear-cut trend in credit interest rate dynamics. The base interest rate and interbank interest rates were strongly influenced by public finance liquidity. Given the domestic interest rate dynamics, their gradual convergence on the Euro-area benchmarks can be said to have been less pronounced compared to other currency board applicant countries.

In 2001, following closely the dynamics of the reserve currency, the Bulgarian lev reported a lesser depreciation to the UDS on a year earlier. In the interbank FX market, banks were net buyers of foreign currency, with the BGN 245 mln year-on-year increase indicating growing confidence in the currency board regime. As the FX structure of the interbank market changed significantly, the share of USD transactions stepped down sharply by 9.5 percentage points on a year earlier at the expense of the growing share of transactions in Euro-currencies.

2001 sustained the restructuring developments in the Bulgarian economy that promoted higher competitiveness, whose pace was launched in a new perspective by the mid-year parliamentary and November presidential elections. Despite the privatisation slowdown in 2001, about 80% of the enterprises earmarked for privatisation were privatised as of end-year. The acceleration and completion of the restructuring, structural adjustment and privatisation processes in state-owned enterprises are an important pre-condition for further improvement of competitiveness in the economy. The bulk of state-run assets whose privatisation is pending belong to companies enjoying a monopoly market position in key sectors of public infrastructure and the economy. Early-2002 marked an important step forward in the legislative effort to more precise privatisation regulation in the sectors. The new Privatisation Act provides for a precise identification of the state-owned assets earmarked for privatisation and profound changes in the privatisation methods and techniques allowing for improved transparency and oversight.

In 2001, there already was all the evidence that the priority restructuring measures should be further complemented and better coordinated. Together with the restructuring and privatisation of the state-owned sector, greater importance needs to be given to streamlining the rules of market entry and exit and labour market regulation. It is essential that the implementation of these two priority measures is better coordinated in the light of the social dialogue. Besides the dominant private ownership in the economy, the complementation of the measures becomes all the more important and urgent due to the persistent employment decline in 2001 (1.3% down its 2000 rate) and growing unemployment that had risen by 3.1 percentage points inside a year up to 19.5%, despite the relatively high GDP growth reported. The significantly lower employment rate and higher unemployment rate in Bulgaria vis-a-vis the first ten candidate countries are a potential source of social tension and unrest that may bring about a new reform delay and a drift away from the goal of EU accession. All this implies that the post-crisis stabilisation scenario should be further developed and reinforced to ensure an adequate environment for the functioning of the market forces as an essential pre-condition for well-balanced growth and higher living standard in the long run.

Seen in the light of Bulgaria's major goal to achieve full membership in the EU in a mid-term perspective,

the lower living standard compared to the first ten candidate countries is another solid argument favouring the urgent need to complement the priority measures. According to the assessment of the European Commission¹ published in early 2002 as to the applicants' ability of real convergence based on GDP per capita in purchasing power parity standards, Bulgaria ranked last among the 13 acceding countries, accounting for 24% of the EU's average in 2000. Of the first ten countries in the first wave it was only Latvia and Lithuania that reported a level of the indicator below 35% of the EU's average in the same year. Furthermore, the report of the World Bank² on the first ten years of transition of formerly command economies points to larger and graver disequilibria and distortions in Bulgaria against the average in the Central and Eastern European countries.

In view of the above developments, structural reform analysis has purposely incorporated some of the most important elements of the strategies implemented in various segments of the economy. They have been considered in the light of the recommendatory international practices for such programmes. As the Agency for Economic Analysis and Forecasting is rather restricted by data and resource availability to conduct sector analyses, it has instead made a comparison of the reform progress in these segments in Bulgaria and the other applicant countries. Special attention has been focused on the restructuring and privatisation in tourism as an example of the positive effect of sustained reforms along the lines recommended by international practices and post-privatisation control.

The report has intentionally avoided touching upon the quality of macroeconomic statistics produced by the NSI. It is our belief that this would only unnecessarily shift the focus of analytical research, making the reader's perception of facts and figures more difficult. The number of indicators ensuring reliable database for decision makers and serving as early warning signs have gone on the decrease. As it has often happened, there were considerable data discrepancies³ between the statistical surveys of indicators of relevant economic importance and behaviour. As a result, in 2001 and early 2002, the NSI made a series of significant revisions in core macroeconomic statistics like the GDP growth rates, and its components and deflators, etc. These revisions have, however, transcended the commonly accepted statistical error deviations for these indicators in other applicant countries.

¹ European Commission, „Real Convergence in Candidate Countries – Past Performance and Scenarios in the Pre-Accession Economic Programmes“, November 16, 2001.

² World Bank, *Transition – The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union*, 2002.

³ We will only touch upon a couple of examples – consumption data from household budget surveys and consumption statistics under the national accounts; household deposit data from household budget surveys and deposit dynamics data from bank statistics, monthly data on net sales revenues in the sector of trade, repair of automobiles and household appliances and quarterly data on retail sales. Data discrepancy evolves from the different methodologies of estimation employed by the NSI.

EXTERNAL ENVIRONMENT

Major Trends in the Performance of the World Economy

End-2000 witnessed a certain slowdown in world economic growth, which in turn led to a decline in aggregate demand and spurred pessimistic expectations as to trade growth of about 1% in 2001 against 11% volume growth on a year earlier. The above trend was brought about by an interplay of factors as follows: in the first place it was oil prices that went on the increase over the 1999-2000 period and led to higher inflation, which the central banks responded to by raising the interest rates. Second, the prices of stocks and shares owned by companies in the IT business fell drastically, and owing to the deeper financial market integration and internationalisation of companies these shocks spread out faster than in the past.

The international business situation further deteriorated following the terrorist attacks on the USA of September 11th. The general feeling of uncertainty and insecurity stifled the economy worldwide leaving it in disarray. Higher transportation costs and insurance prices hampered international trade, and the avoidance of risky transactions impeded FDI in particular.

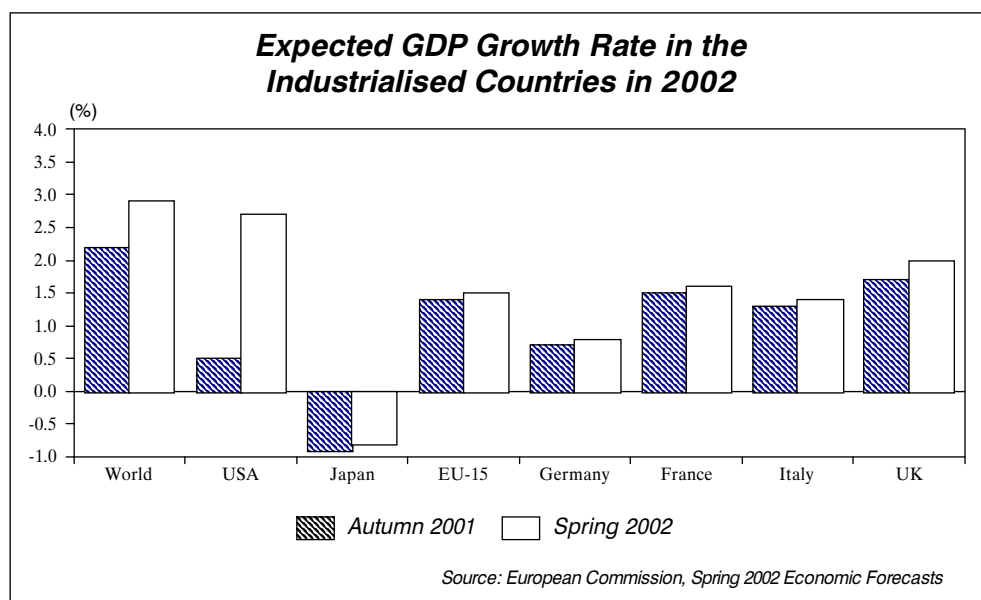
In a mid-term perspective, the expectations are for a gradual growth recovery. It can be also anticipated that lower interest rates and inflation as well relaxed monetary and fiscal policies will revive the economy, once the fear of insecurity wears out. International trade is expected to be the major engine of growth. Forecasts point that in 2002 trade will steadily recover reporting higher volumes, even hitting a growth rate of around 7% in 2003.

In its Summer Report the European Commission revised its 2002 and 2003 growth forecasts upwards to 2.9% (against 2.2% according to the 2001 autumn forecasts) and 3.9% (3.7% according to previous assessments).

The impact of last autumn terrorist attacks on the US economy proved to be less grave than initially expected. It was generally believed that for four quarters in a row (2001 2nd quarter – 2002 1st quarter) the US economy would steadily report a very low even negative growth rate. Instead, as early as the first quarter of 2002, it registered a 5.8% growth on an annual basis. The European Commission revised its estimates of US growth upwards from 0.9% in the 2001 autumn report to 1.2% in the 2002 spring forecasts. The Commission's forecasts for 2002 have been also revised upwards from 0.5% to 2.7%, giving way to optimistic expectations that US growth would reach 3.1% in 2003. The economy-enhancing measures, including the fiscal stimulus package (amounting to about 1.5% of GDP) proposed by President Bush are expected to help the economy rebound. World Bank forecasts point to 2.7% growth of the US economy over the 2001-2010 period.

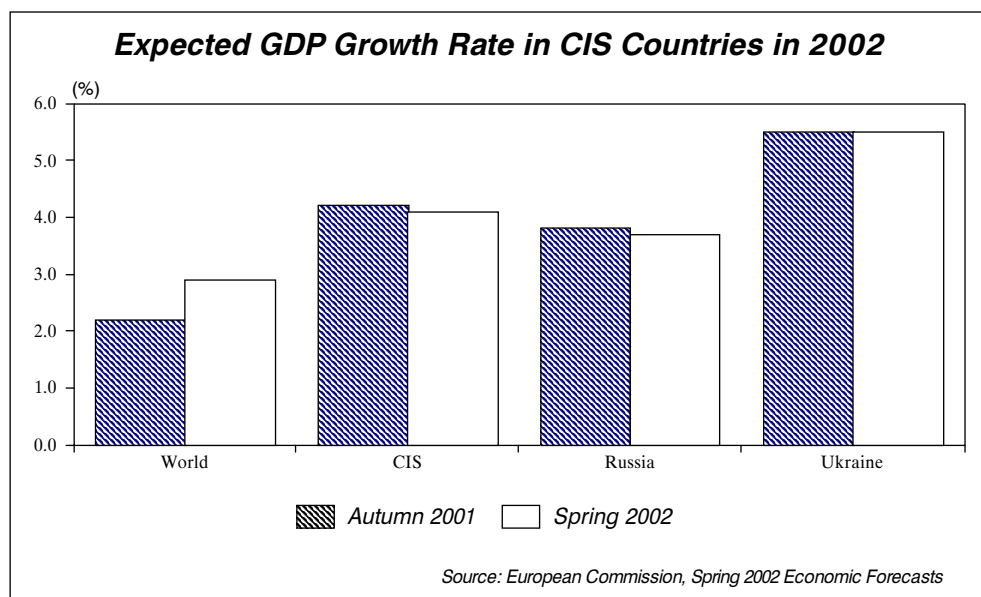
For the tenth year in a row, the Japanese economy has failed to come out of the deep recession still facing stable deflation, structural adjustment inefficiency, poor fiscal position and misperforming financial system, overburdened with bad loans. It is hardly expected that Japan will bottom out of the decade-old recession as early as 2002. World Bank forecasts are that the 2001-2010 growth of the Japanese economy will be about 2%.

Despite the structural reforms launched, the Euro-area could not avoid worldwide recession. The area's average growth in 2001 is expected to amount to only 1.6% against 3.4% on a year earlier. Most macroeconomic indicators are likely to improve in the first quarter of 2002 as a result of the lower tax burden, less expansionist monetary policy and decreasing inflation. The 2002 average Euro-area's growth projections have been revised upwards by 0.1% to 1.4% and are expected to step up to about 2.9% in 2003. World Bank growth forecasts for the Euro-area over the 2001 – 2010 period point to a rate of about 2.4%.



The German economy has experienced severe difficulties, with GDP growth in both 2001 and 2002 not expected to run higher than 0.7%. The World Bank has forecasted 2001-2010 German economic growth at about 1.9%. Growth expectations for Italy have improved amounting to 1.8% and 1.4% respectively in 2001 and 2002. The European Commission's spring growth projections for France and Great Britain have also been revised upwards to 2% and 1.6% on average in 2001 and 2002 and 2.2% and 2% respectively. Due to the growing investment volumes and consumption related with the Summer Olympic Games Greece has been reporting relatively stable development.

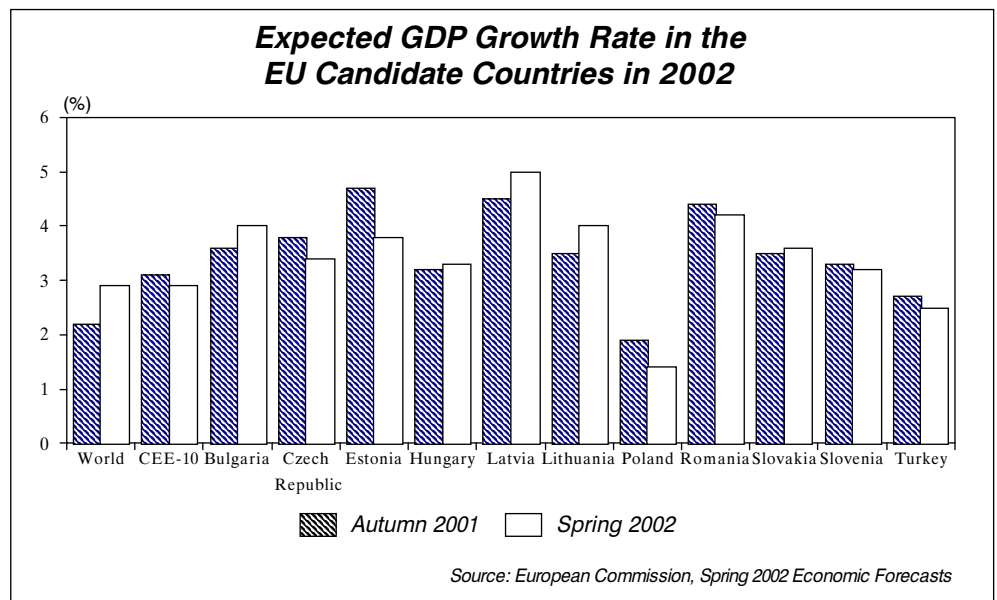
Relatively closed and large economies such as China, Russia and India are the likeliest to report the highest growth rate. China's growth is expected to steady above 7% as a result of the significant fiscal stimuli and large FDI inflows. On the other hand, the 2001-2002 period is likely to witness a certain growth slowdown in Russia to 5% and 3.7% respectively against 8.3% in 2000 that will nonetheless remain well above the world's average. At the same time, it is noteworthy that the Russian economy is very susceptible and sensitive to the price volatility of energy goods.



Growth in most countries applying for EU membership did not slow

down significantly, the only exception being Poland and Turkey. The 2001 European Commission's estimates point to a growth decline in the Polish economy down to 1.1% against 4% on a year earlier. In 2000 the Turkish economy reported a growth rate of 7.2%, expected however to contract by -7.4% in 2002. The deterioration of the world economy, and the EU economy in particular, in late 2001 is expected to influence adversely growth expectations in the candidate countries, as they are mostly open economies with a high degree of integration into the EU. As a result of the stable domestic demand, most applicants demonstrated stability in relation to the economic decline worldwide.

2001 international price dynamics was particularly influenced by lower demand triggered by the slowdown of the economy. Crude oil prices reached a monthly average through of USD 18.6/barrel in December, followed by a steady early 2002 recovery up to USD 23.69 per barrel in March. In April oil price quotations surpassed USD 27/barrel, hitting a

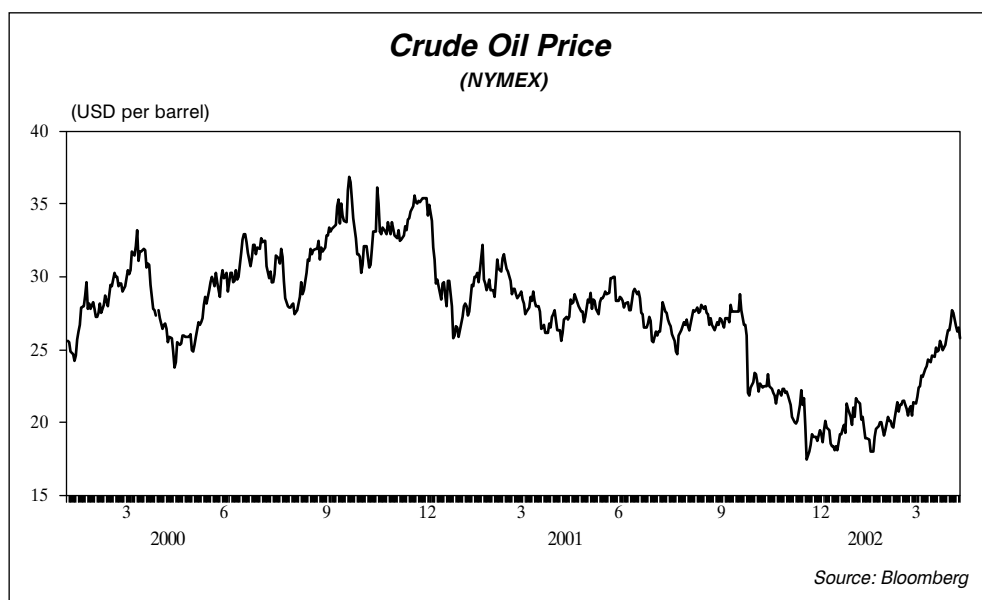


six-month record high, affected by Mid-East tensions and fears of delivery interruptions evolving from Iraq's attempts to persuade Arabian exporters to impose an embargo on the USD and other Israel-backing supporters. Also, oil prices rose as a result of a decision of the OPEC countries to further curtail oil output by another 1.5 mln barrels on a daily basis, following a year-round reduction of 3.5 mln barrels per day in 2001. Another factor at work spurring oil price growth had to do with the growing oil demand related to the first signs of recovery of the US economy.

Any possible persistence of the high oil price levels may jeopardize the beginning economic recovery. OECD estimates indicate that an oil price increase of USD 10 may contribute to an inflation increase of 0.5% and reduce growth by 0.25% in the developed economies, with Europe and Japan most seriously affected. Though a larger importer of oil and oil products than Europe and Japan as it may be, the USA is also an oil producer and reports smaller net imports as a share of GDP and will therefore be less affected by a possible rise in world price.

Metal prices were also affected by the demand contraction worldwide. In October, steel prices hit a 20-year average monthly through of USD 280/t for cold-rolled steel and USD 200/t hot-rolled steel, steadying around the same levels afterwards. According to EUROFER forecasts, steel consumption is expected to carry on shrinking in the first half-year period of 2002, reporting negative growth to only gradually rebound in the second half, with the Europe-wide demand contraction throughout the year being estimated at 0.7%.

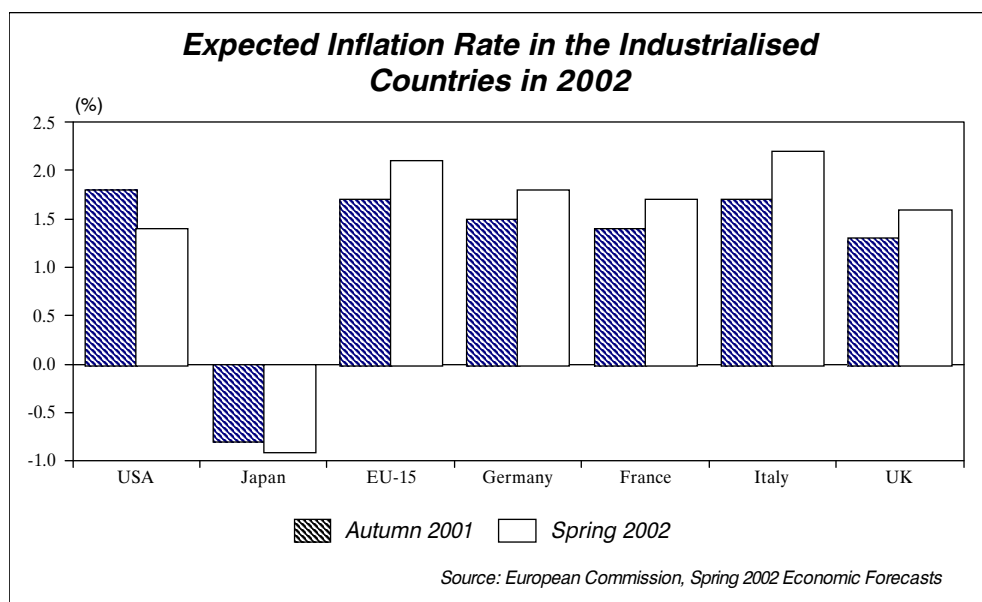
As the USA remains a major consumer of copper, price quotations are mainly determined by the state of the American economy. 2001 average prices reported a 13% drop, stepping down from USD 1813/t on a year



earlier to USD 1578/t. According to preliminary data of the International Copper Study Group, the market surplus in 2001 reached 753 thousand tons against a deficit of 478 thousand tons in 2000. The demand for refined copper declined by 5.3% (538 t) on a year earlier, whereas output worldwide stepped down by 2.9% in 2001 relative to 2000.

The prices of fertilisers also declined. Due to the 2001 rise in gas prices the production of fertilizers in the USA is expected to contract giving way to higher import volumes.

The higher oil and food price level led to 2.5% inflation in the Euro-area (measured by the Harmonised Index of Consumer Prices). However, the variable is expected to go below the mid-term inflation target of 2% in the first quarter of 2002. As a whole, Euro-area inflationary expectations in 2002 and 2003 have been revised upwards to 2.2% and 2% respectively.

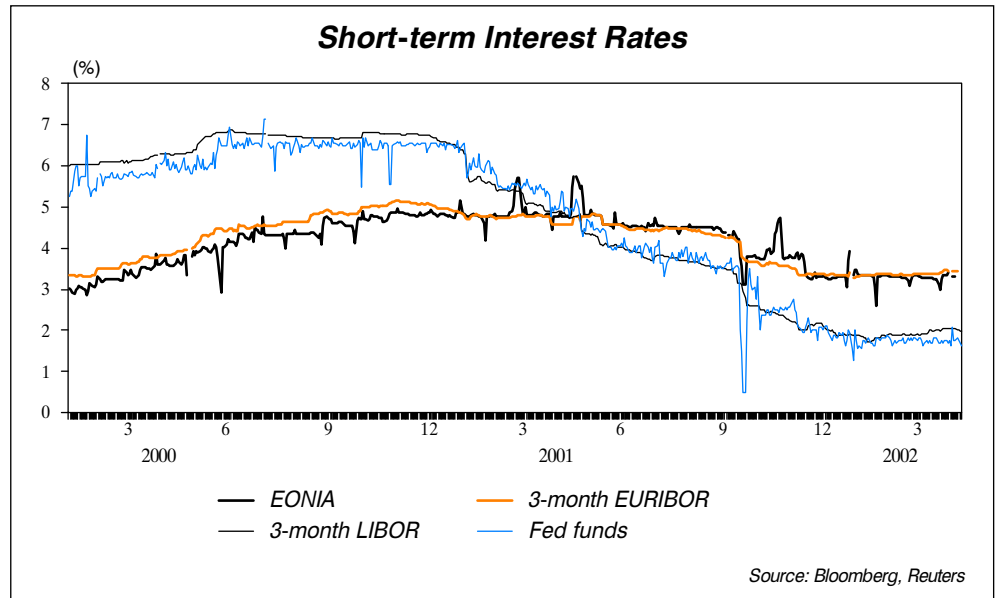


In order to revive the US economy the Federal Reserve carried out a series of interest rate cuts down to their present level of 1.75%. In early 2002, Alan Greenspan stated that the Federal Reserve was not planning any further lowering as the prospects of the US economy had largely improved and the first signs of higher business

activity were to be seen as early as the first quarter of 2002.

The European Central Bank followed suit lowering short-term interest rates four times in 2001 down to 3.25%. Brought about by the decreasing inflation rate, the response of the CEB was also aimed at overcoming the adverse consequences that ensued from the terrorist attacks on the USA and the deteriorating performance of the economic indicators. At the same time, Japan could no longer lower the short-term interest as they had already reached 0%.

The 2001 government deficit in the Euro-area is expected to deteriorate to 1.3% of GDP (against a 0.2% surplus in 2000), further rising as a share of GDP in 2002 as well. Germany and Portugal are anticipated to report a higher government deficit than the Euro-area's average estimated at 2.8% and 2.6% of GDP in 2002.



EU Accession Negotiations

In 2001 and early-2002 Bulgaria's accession negotiations with the EU went according to schedule. The expectations are that the negotiations will be brought to an end by end-2003 and Bulgaria will accede to the Union in end-2006.

By April 2002, out of a total of 30 chapters under negotiation since 2000 Bulgaria closed 15 of them⁴ while opening another 14 chapters⁵. In 2001 alone the country opened 16 chapters, closing 4 of them and another 2 the negotiations on which had started in 2000.

In March 2002 Bulgaria commenced negotiations on two key chapters, viz. Chapter 7 „Agriculture“ and Chapter 11 „Economic and Monetary Union“ the country's positions on which were presented to the Commission in June 2001 and October 2000. The onset of the negotiation process on the chapters was a confirmation of the country's reform progress towards a functioning market economy. In two communications to the Commission, the latter of which sent in March 2002, Bulgaria has re-stated and specified in the course of Chapter 11 negotiations its commitments to guarantee the independence of its central bank of the government, removing all legal options for privileged access of the government sector to financial intermediaries and achieving compliance with the financial acquis by mid-2006. On the basis of the arrangements reached in April 2002, Chapter 11 was temporarily closed. The government has set itself the ambitious task to conclude negotiations on and close Chapter 7 „Agriculture“ by December 2003.

Despite the progress made during the Spanish Presidency in the first half of 2001, Bulgaria is still lagging significantly behind most EU applicants in the negotiation process. Thus for instance as regards the number of chapters already negotiated, as of March 8th 2002, Slovenia ranked first with 26 closed chapters, followed

⁴ Chapter 4 „Free Movement of Capital“; Chapter 5 „Company Law“; Chapter 8 „Fisheries“; Chapter 11 „Economic and Monetary Union“; Chapter 12 „Statistics“; Chapter 13 „Social Policy“; Chapter 15 „Industrial Policy“; Chapter 16 „Small- and Medium-Sized Enterprise“; Chapter 17 „Science and Research“; Chapter 18 „Educational and Vocational Training“; Chapter 19 „Telecommunications and IT“; Chapter 20 „Culture and Audio-vision“; Chapter 23 „Consumer and Health Protection“; Chapter 26 „External Relations“; Chapter 27 „Common Foreign Policy and Security Policies“.

⁵ Chapter 1 „Free Movement of Goods“; Chapter 2 „Free Movement of People“; Chapter 6 „Competition Policy“; Chapter 7 „Agriculture“; Chapter 9 „Transport Policy“; Chapter 10 „Taxation“; Chapter 14 „Energy“; Chapter 21 „Regional Policy“; Chapter 22 „Environmental Protection“; Chapter 24 „Justice and Home Affairs“; Chapter 25 „Customs Union“; Chapter 28 „Financial Control“ and Chapter 29 „Budgetary and Financial Provisions“.

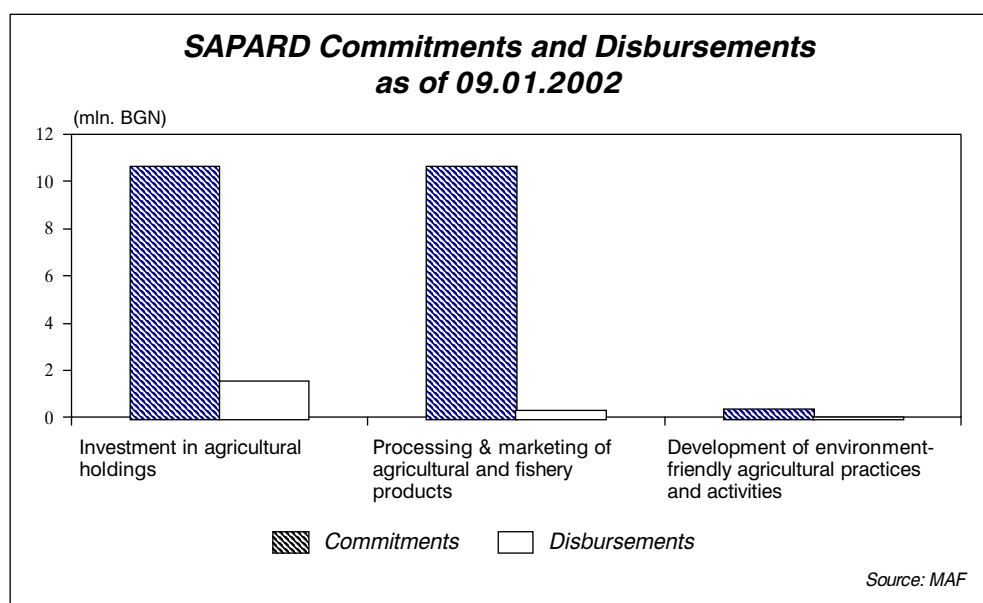
by the Czech Republic (25 chapters), Latvia (24), Hungary and Lithuania (23), Estonia and Poland (20). The acceleration of the negotiation pace should and can only be considered in the context of the reform progress reported by Bulgaria. Therefore efforts should be focused on the consistent alignment of the country's legislation with the EU acquis, rigid financial discipline as regards public finance, faster structural adjustment and privatisation pace in the state-owned sector while offering the private sector an economic incentive package that is comparable to EU entrepreneurship stimuli. Following the Laaken Summit of end-2001, the Bulgarian government has committed itself to obtaining, by the end of 2002, a road map specifying the negotiation timetable by the time the country accedes to the EU.

2001 saw the start of the EU Special Accession Programme for Agriculture and Rural Development (SAPARD) providing for EUR 53 mln worth of EU assistance contribution to the Bulgarian agricultural sector in 2000 that is to be fully absorbed by end-2003. Further assistance amounting to EUR 54 mln was also allocated under the 2001 Financing Agreement scheduled to be utilized by the same date. The first three measures under the Rural Development Plan were accredited in June 2001, marking the actual application of SAPARD funds as follows: investment in agricultural holdings, improving the processing and marketing of agricultural and fishery products, development and diversification of rural economic activity.

As of end-2001, 50 projects out of 109 altogether were approved. The eligible expenditures approved amounted to a total worth of BGN 43.4 mln, BGN 16.3 mln of which covered by EU funds, accounting for only 15.2% of utilization rate of the EU assistance to the agricultural sector. The reasons behind the relatively low utilization rate of SAPARD funds have to do mainly with the borrowing difficulties farmers face in funding initially their projects⁶ and the quality of project proposals (there have been more declines than approvals). Almost all funds have been distributed between the first two measures, i.e. investment in agricultural holdings (49.2%) and improvement of agricultural and fishery product processing and marketing. The *development and diversification of rural business* measure reported the lowest share of investment funds approved of only 1.7%. As of end-2001, nine of the approved projects were completed, with the total aid amount paid up running at BGN 1.9 mln (1 BGN 389 198.22 ensured by the EU) or only 9% of the funds negotiated that the

European Commission is to provide under the Financing Agreement.

The following measures under the Rural Development Plan are to be accredited in 2002: wholesale and assembly markets; forestry, farm land afforestation, forestry investment; processing and marketing of forestry products; rural renovation and development; setting



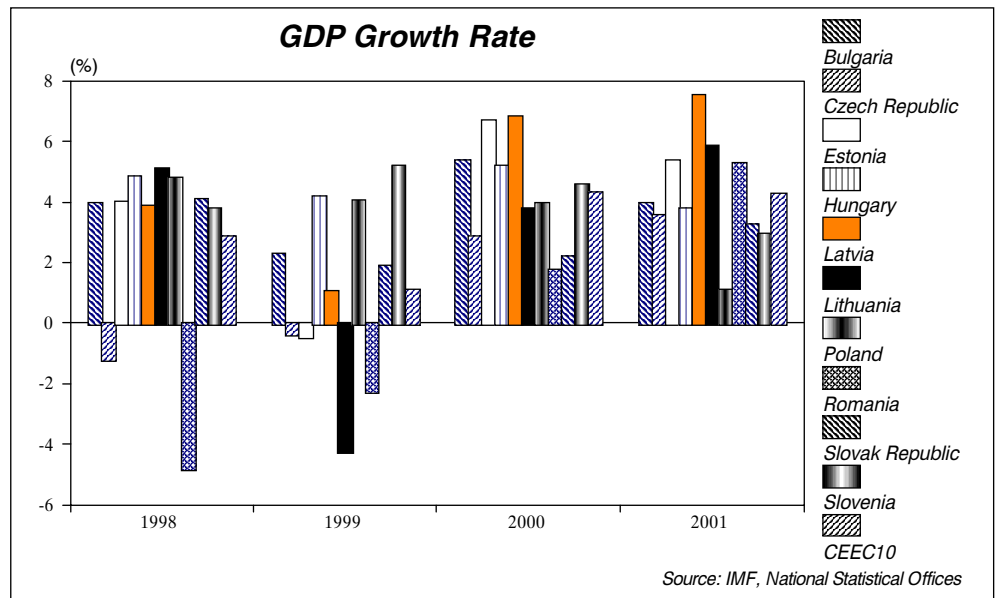
⁶ In order a project to be approved, applicants should provide the whole amount of project financing. EU assistance and budget subsidies are extended once the project has been completed.

up producer groups; protection and preservation of rural heritage and culture; development and improvement of intra-rural infrastructure; improvement of vocational training; technical assistance.

Fulfilment of the Economic Criteria for EU Membership

In 2001 Bulgaria reinforced its convergence effort at gradually achieving the economic criteria of Copenhagen. The country reported a relatively high GDP growth rate of 4%, ranking fifth immediately after Latvia (7.56%), Lithuania (5.86%), Roumania (5.3%) and Estonia (5.4%), outstripping some of the most advanced EU applicants like Hungary (3.8%), the Czech Republic (3.6%) and Slovenia (2.96%).

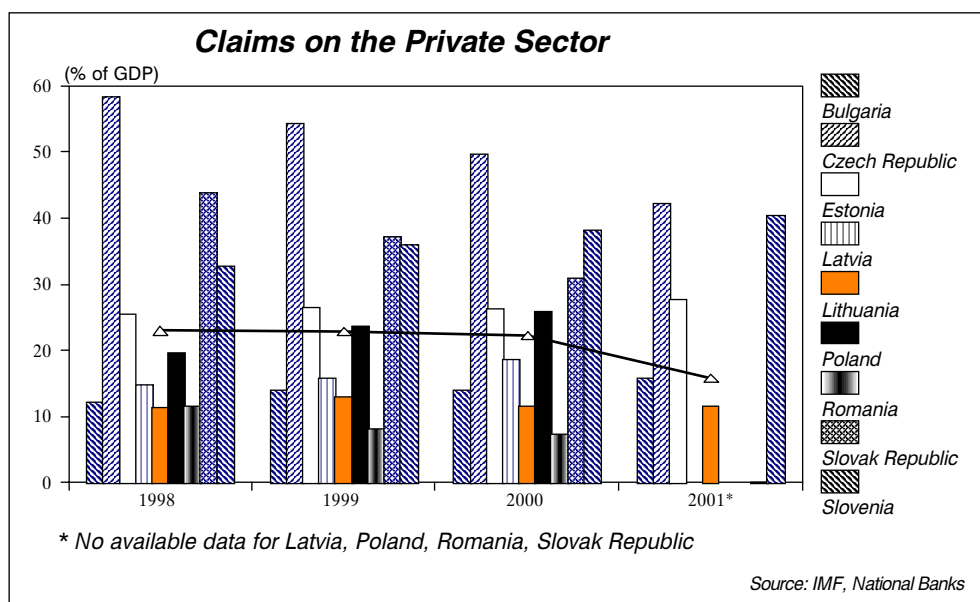
As for GDP structure by elements of final expenditure, in 2001 Bulgaria went on enjoying a most unfavourable position vis-a-vis the other applicant countries. Final consumption accounted for the highest share of 87.2% within GDP while the share of gross fixed capital formation in GDP ran lowest at 17.8%. At the same time, the share of



gross fixed capital formation in Slovakia's GDP (31.9%) was twice as high as its share in Bulgaria, indicating that the country was still lagging behind in the structural adjustment process and technological and infrastructure renovation.

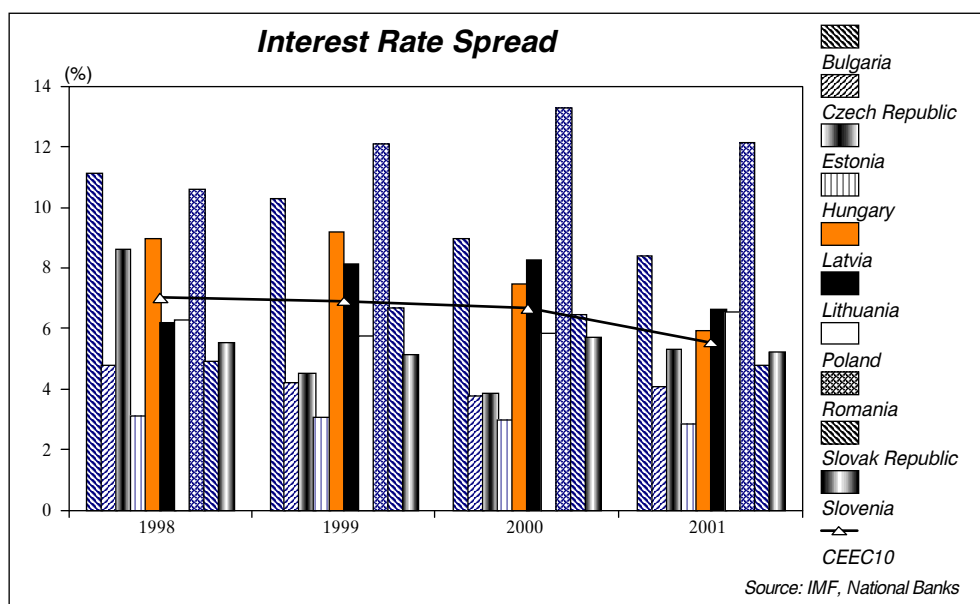
One of the major criticisms of the European Commission to Bulgaria in its report of November 13th 2001 was focused on the country's underdeveloped financial system. Its efficiency as an intermediary between savers and investors and ability to optimally allocate financial flows to the real economy can be traced down by the share of financial institutions' claims on the private sector within GDP. According to the same indicator, in 2001 Bulgaria (15.7%) ranked last but one before Lithuania (11.5%). On a year earlier, the ratio in the nine months to October 2001 had stepped up in all the ten applicant countries, with Slovenia reporting the highest year-on-year rise, and the Czech Republic and Slovenia in the lead with 57.8% and 51.2% in the period surveyed. Bank lending to the private sector was still underdeveloped compared to the first-wave forerunners. The Bulgarian financial system is still underdeveloped and therefore failing to effectively perform an essentially intermediary function. All this has led to ineffective allocation of the financial flows to the real sector, checking the growth potentials of the country's economy.

Another important measure of a country's financial system development and stability is the interest rate spread, which indicates its credit and financial risk. The general tendency in the EU applicant countries over the last four years has been towards narrowing the interest rate spread (with the exception of Estonia raising the spread from 3.86% to 5.3% and the Czech Republic from 3.74% to 4.08%) that followed suit the interest rate cuts worldwide to overcome recession and revive the economy. Although stepping down by a solid



percentage point, indicating that the Bulgaria's financial and credit risk had decreased, the indicator's value remained well above the average in the ten candidate countries. In 2001, the economies reporting the highest interest rate spread were Roumania (12.14%), followed by Bulgaria (8.14%), Lithuania (6.63%)

and Poland (6.56%), with Hungary and the Czech Republic registering the lowest indicator's value of 2.85% and 4.08% respectively.



Bulgaria has made considerable progress on lowering the inflation rate in compliance with the Maastricht Treaty provisions, cutting average 12-month inflation from 10.31% in 2000 down to 7.36% in 2001. At the same time, the Czech Republic, Estonia and Lithuania were the only applicant countries reporting an inflation rate

increase in the same year. Taken as a whole, all candidate countries have achieved relative price stability, but at present it is only Latvia and Lithuania that can afford the maximum acceptable average annual EU inflation rate. Turkey went on experiencing enormous difficulties, reporting average 12-month inflation of over 54% in 2001.

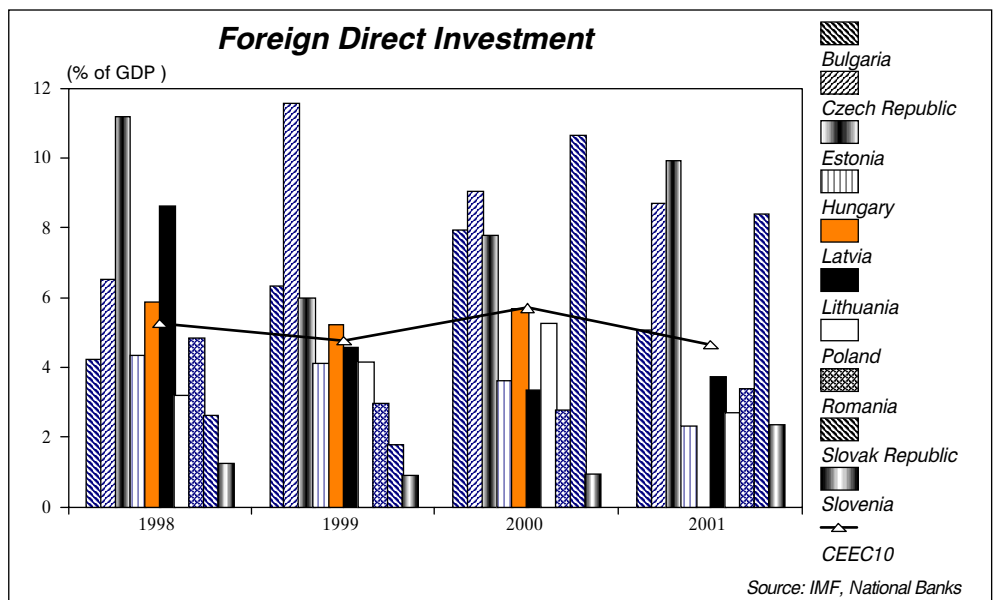
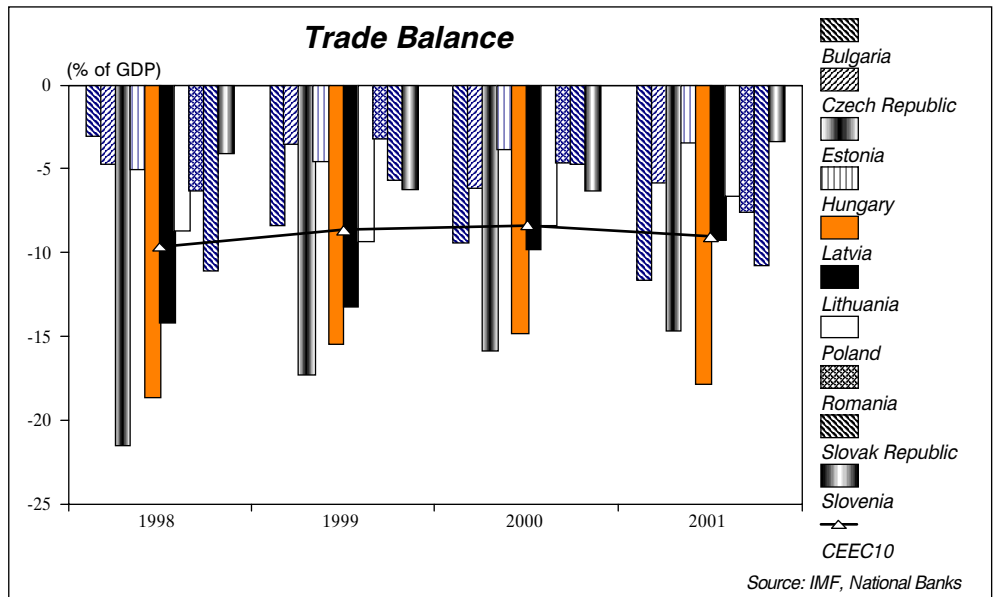
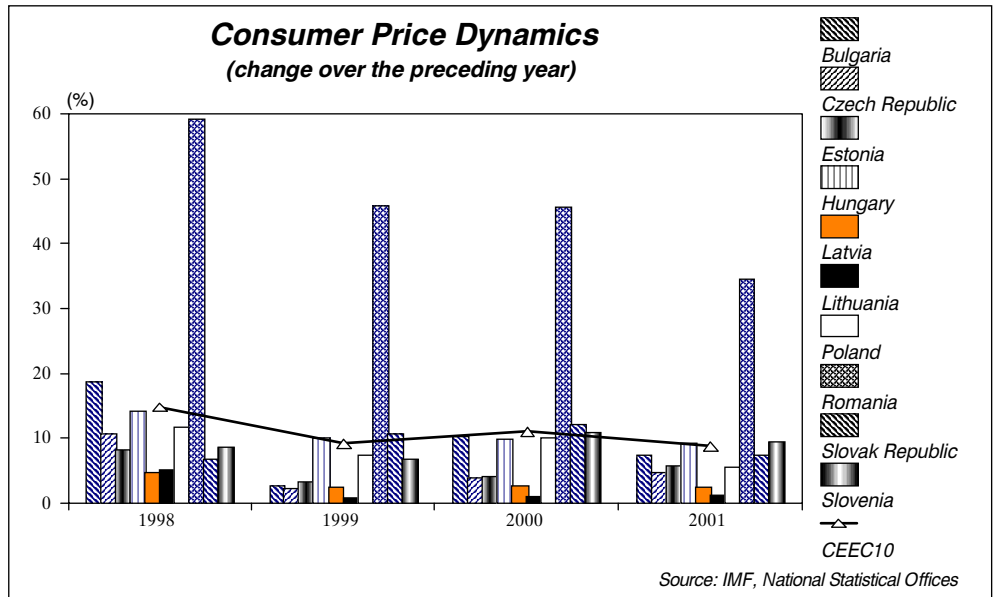
In 2001 Bulgaria was one of the countries registering a relatively high current account deficit/GDP ratio (-6.5%) to be outstripped only by Latvia (-10.2%) and Slovakia (-8.8%) reporting even a more deteriorating performance. On a year earlier, the indicator had improved in all applicant countries but Bulgaria, Latvia and Slovakia, implying that the bulk of the countries' economies remained resistant to the growth slowdown worldwide, in the EU in particular.

The trade balance proved to be a major source of current account deficits in the countries under review. Thus in 2001 Bulgaria, Latvia, Roumania and Slovakia ran higher trade deficits whereas in Hungary the

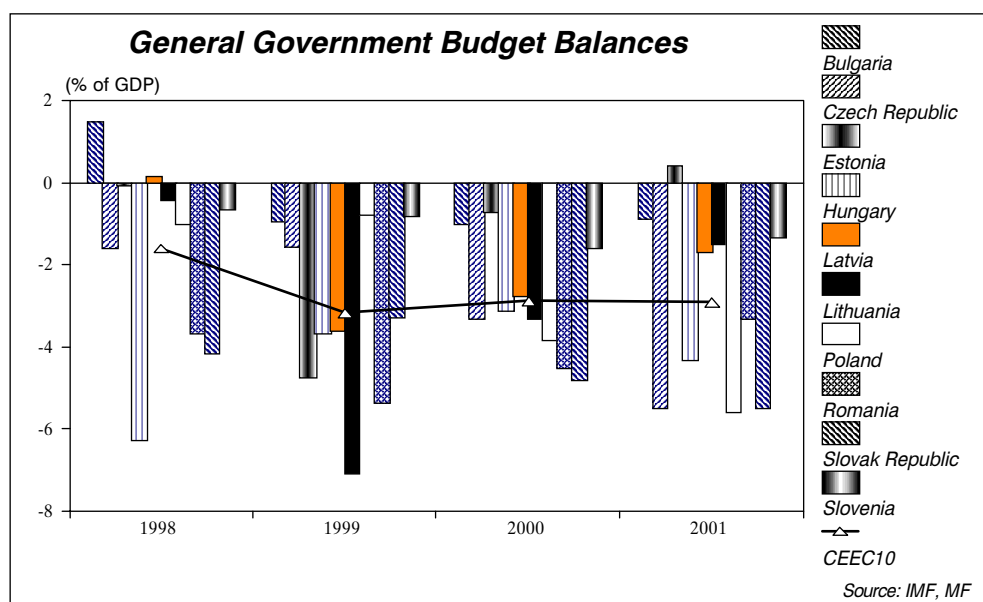
indicator remained relatively stable. The rest of the applicant countries registered a lower trade deficit, with Slovenia reporting a significant improvement.

Current account deficits are mainly financed by attracting foreign capital. The countries enjoying the highest relative share of FDI within GDP in 2001 were Estonia (9.9%), the Czech Republic (8.7%), Slovakia (8.4%) and Bulgaria ranking immediately after it (5.1%). The share of FDI in Bulgaria's GDP had nonetheless decreased on a year earlier, remaining well below the ten EU applicants' average.

Most candidate countries employed fiscal policy instruments to make up for current account deficits. Countries reporting the highest current deficit in relative terms like Latvia, Poland and Bulgaria undertook serious fiscal measures to overcome external imbalances. As a result, the 2001 cash deficit in Latvia, Lithuania, the Czech Republic and Bulgaria went on the



decline, with Estonia generating even a surplus at the end of the period surveyed. The low 2001 consolidated budget deficit in Bulgaria met the country's arrangements with the IMF and, in value terms, ran lower (-0.9%) than the Government Budget provisions and the ten EU applicants' average.



The short-term external debt indicators of the candidate countries are indicative of their economic performance and take into account the inherent country-specific risk. Data show that Bulgaria (5.6%) and Poland (13.6%) were among the economies reporting a most favourable ratio of their external debt⁷ to GDP.

The gross external debt/GDP ratio, however, placed Bulgaria among the most heavily indebted economies. The indicator ran highest in the Czech Republic, Poland and Lithuania, and it was not by accident that these countries were given the highest credit ratings among the eight applicants presented (A-). Bulgaria has been continuously striving to improve its credit rating, and the international financial institutions followed suit re-assessing the country's credit risk. In end-2001, S&P raised the country's credit rating from B+ to BB-.

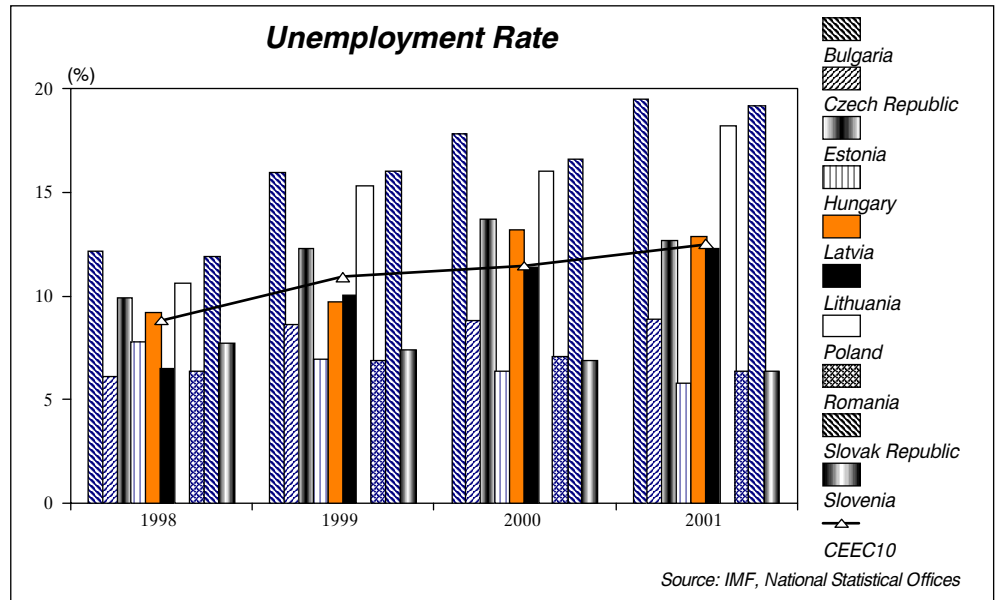
	<i>Bulgaria</i>	<i>Poland</i>	<i>Hungary</i>	<i>Czech Rep.</i>	<i>Slovakia</i>	<i>Lithuania</i>	<i>Estonia</i>	<i>Latvia</i>
<i>Short-term external debt/</i>								
<i>gross external debt (%)</i>	5.6	13.6	16.8	41.4	27.4	38.5	33.5	56.5
<i>Gross external debt/GDP (%)</i>	73.1	38.7	64.9	38.4	66.4	41.8	60.9	72.3
<i>Credit rating (S&P)</i>								
<i>Long-term debt in foreign currency</i>	BB-	BBB+	A-	A-	BBB-	BBB	A-	BBB

Sources: The relevant applicants' central banks.

The unemployment rate in the EU applicant countries remained relatively high in 2001, having tended to continuously rise over the past four years. On a year earlier, 2001 unemployment rose in Slovakia (19.2%), Poland (18.2%), and Lithuania (12.5%). Bulgaria, on the other hand, was facing a most serious problem, reporting an unemployment rate of 19.5%. The high 2001 unemployment rates in the EU applicant countries were primarily due to the structural adjustment process effected in the economy.

⁷ To make data comparable for all applicant countries, trade credit data from GDP statistics have been included in short-term debt estimations for Bulgaria.

Hungary, Roumania, Slovenia and the Czech Republic have been registering the relatively lowest unemployment rates among the applicant countries, further going on the decrease in 2001, a trend underpinned by the large amounts of foreign investment, new job creation and more effective privatisation and SOE structural adjustment.

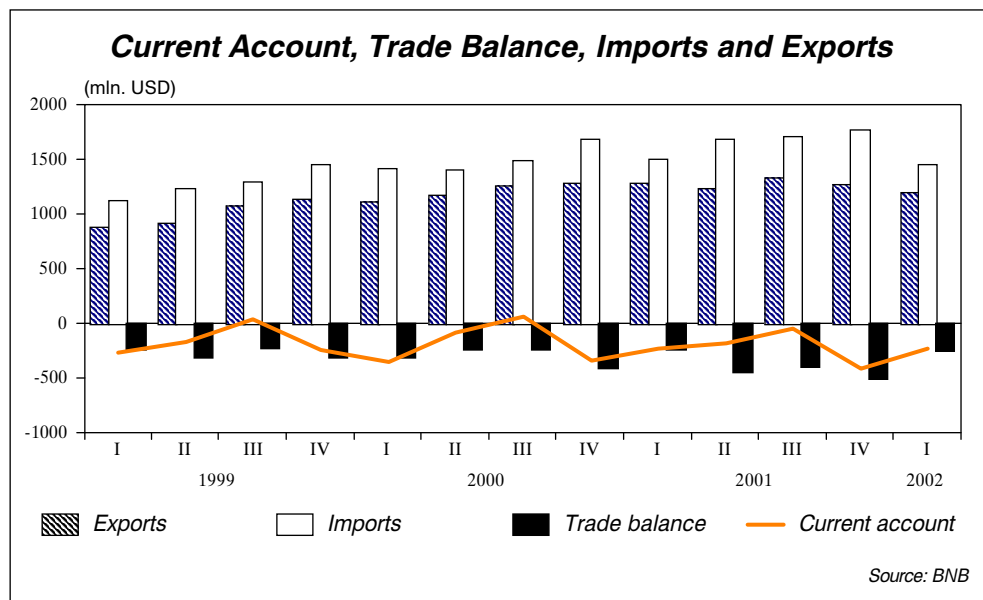


BALANCE OF PAYMENTS, FOREIGN TRADE AND EXTERNAL FINANCE

Balance of Payments

One of the main problems the Bulgarian economy is currently facing is the large current account deficit which in 2001 amounted to USD 885 mln (or 6.5% of GDP according to preliminary data), stepping up by USD 183.5 mln on a year earlier.

The major reason behind the deteriorating current account deficit was the higher 2001 trade deficit compared to 2000. The unfavourable trends in the world economy and contracting demand worldwide produced an adverse effect on the country's balance of payments, its trade balance in particular. Rising by USD 390.2 mln relative to 2000, the trade deficit reached USD 1565.8 mln in 2001. Also, on a year earlier, both import and export growth slowed down. In volume terms, 2001 imports increased by 11.1% against 17.9% in 2000 while exports reported a more dramatic shrinkage to 5.7% against 20.4% on a year earlier.



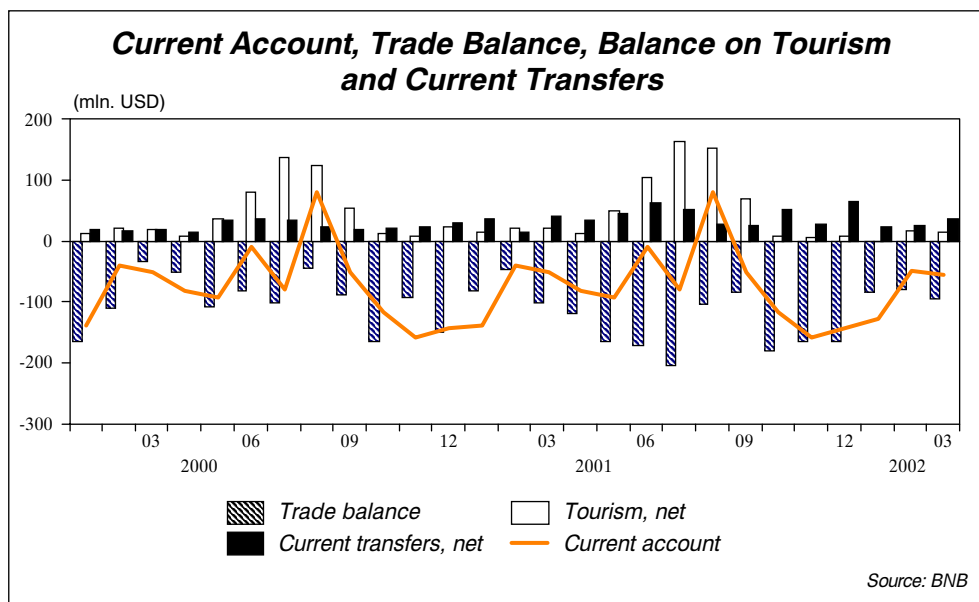
The improved balance on services and current transfers supported the current account balance by partially covering the trade deficit. In 2001, the service balance in the balance of payments (BoP) current account ran positive at USD 545.7 mln, improving by USD 40.2 mln relative to 2000. Tourism has come to the fore as an important

source of revenues for the country's BoP. 12-month net revenues from tourism amounted to USD 632.2 mln or 17.9% up their 2000 level. At the same time, net revenues in the swing of the holiday season reported a most robust growth of 25.4% over the same period. Registering an 11.8% increase on a year earlier, 2001 revenues from international tourism amounted to USD 1201 mln and accounted for 8.9% of GDP.

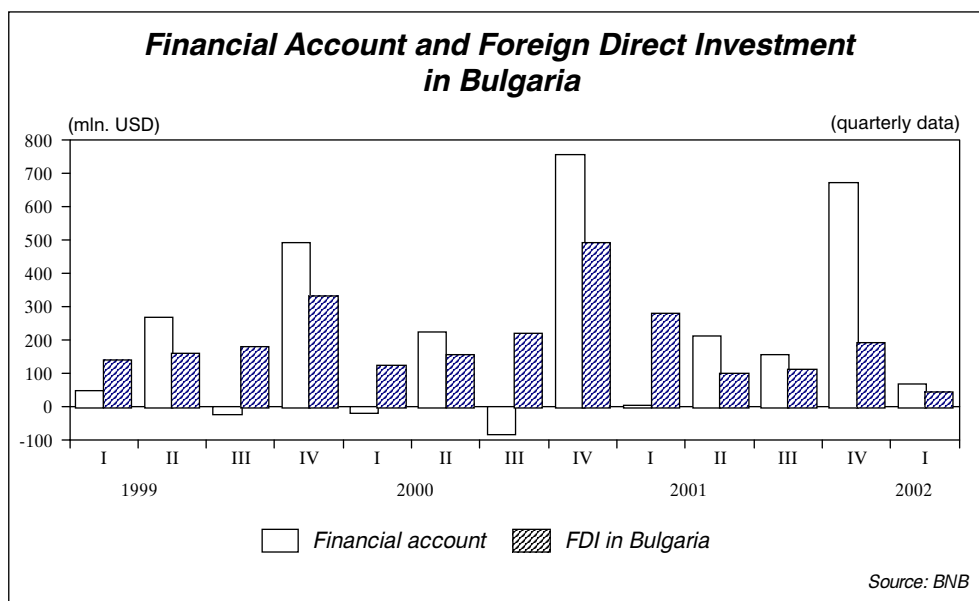
In 2001, having deteriorated by USD 29.8 mln relative to 2000, the income balance ran negative at USD 351 mln. Income credit (USD352 mln) stepped up by USD 29 mln, and income debit amounted to USD 703.1 mln, increasing by USD 58.8 mln due mainly to the dividends paid to foreign investors by commercial banks and interest payments on Brady bonds.

Improving by USD 167.4 mln on a year earlier, the 2001 financial account balance amounted to USD 1050.6 mln and covered fully the current account deficit. As there were no significant revenues from privatization,

FDI stepped down by USD 313 mln relative to 2000 and amounted to USD 688.5 mln. Greece (buying the second GSM operator licence) Austria, Italy and Germany made the largest FDI to Bulgaria. The portfolio investments of non-residents increased by USD 22.9 mln, with bank investment rising by USD 98 mln. As a result of the Euro bond issue, portfolio investments – liabilities stepped up by USD 105.1 mln.



December saw a USD 147.5 mln worth of an increase in commercial banks' deposits abroad due mainly to the USD 141.3 mln higher foreign currency deposits of residents as a result of the change-over to the single European currency. In 2001, the other investments-assets item reported a USD 294.1 mln worth decline against a



rise of USD 136.6 mln in 2000 while the other investments-liabilities item remained almost unchanged registering a decrease of a bare USD 4.6 mln.

In 2001 the FX reserves of the Bulgarian National Bank (BNB) rose by USD 299.6 mln relative to a 2000 increase of USD 409.2 mln. The foreign exchange rate fluctuations included, their 12-month growth ran at USD 118.9 mln. The more expensive US currency to the EUR affected significantly the country's FX reserves because BNB held an important part of its assets in euros. In 2000 the country was extended a USD 136 mln of a facility on a net basis in support of its balance of payments while external financing in 2001 amounted to USD 70.5 mln. Having risen by USD 135.9 mln in 2000, Bulgaria's net liabilities to the IMF now declined by USD 168.5 mln.

The current account deficit over the last few years has increased in both absolute terms and as percentage of GDP. This upward trend can be explained with a series of external shocks the Bulgarian economy has been subjected to since 1998. Despite the temporary effect of the shocks at present and revenues of the long-term

type on the financial account that almost fully cover the deficit, the persistence of this trend over time may become an early warning sign of an underlying core disequilibrium in the external sector. Since currently there is not enough evidence supporting the above argument, the 2002 forecasts of the AEF reflect expectations for a worldwide recovery of the economy and hence improvement in the balance of payments. Given the data currently available, the 2002 current account is expected to run a deficit of about USD 970 mln.

Foreign Trade

In 2001 Bulgarian export dynamics was mainly determined by the growth slowdown in EU member states which are the country's major trading partners and importers of about 55% of Bulgarian goods. As a result of the deteriorating business activity in the world markets that was directly related to the recession-stuck US economy, the demand for Bulgarian exports contracted. The February financial crisis in neighbouring Turkey also had its adverse effect on the country's export performance. Total export growth in 2001 slowed down on a year earlier, rising by only 5.7% to reach USD 5099.2 mln.



In 2001, as a result of the weaker international market demand, the prices of many key Bulgarian exports stepped down by 2.5%⁸, compared to 2000. Thus, in physical terms, exports rose by 8.4%⁹, pointing to a comparatively sustained volume growth under a deteriorating international business situation.

In 2001 consumer exports rose most significantly by 19.1% on a year earlier and accounted for 33.6% of total exports. Apparel and footwear exports reported a most dynamic performance, increasing by 29% on a year earlier to hit a relative share of 20%. The contribution of this group to total export growth of 5.7% amounted to 5.8% due to the country's comparative advantage in the industry as a result of the high share of labour in production costs and relatively low labour costs in Bulgaria. Food, furniture and household appliance exports reported a most robust rise of 25% and 26.8% respectively. At the same time, tobacco (42.6%) and beverages (9.2%) registered a significant export shrinkage.

On a year earlier, the export of investment goods rose by 12.7% in 2001 which was a positive development having in mind that these are mainly products with high value added. All investment export sub-groups reported a rise as follows: spare parts and equipment – 16.9%, vehicles – 41.2%, electrical machines – 17.6%, and machinery, equipment and apparatuses – 9%.

⁸ Estimates draw upon export price indices data according to NSI.

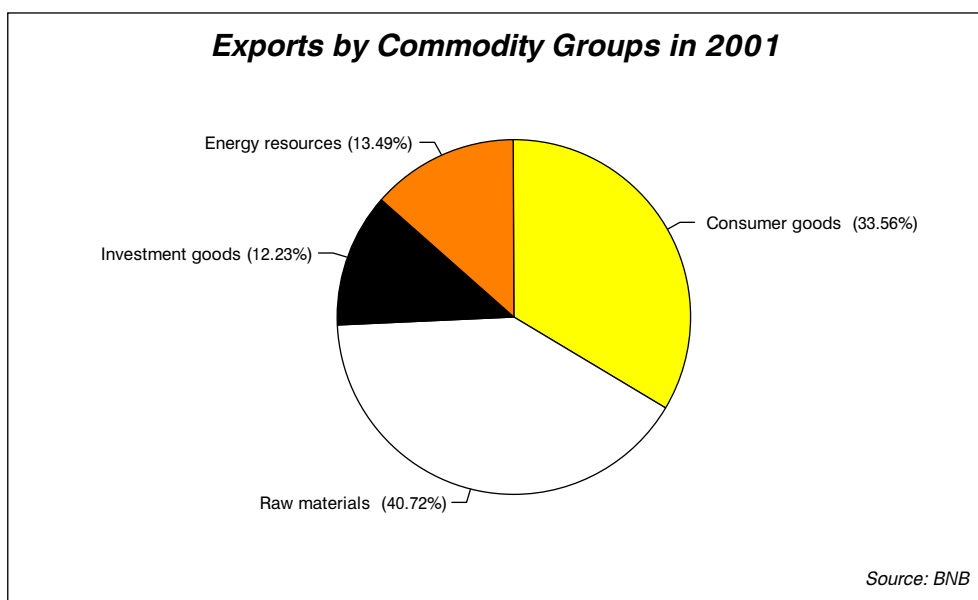
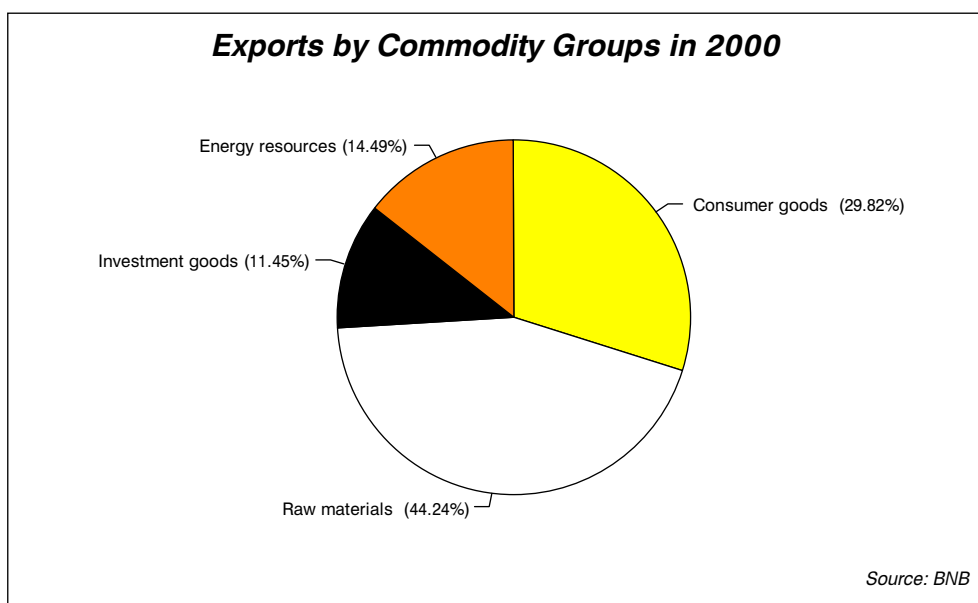
⁹ According to BNB statistics, 2001 export volume growth amounted to 11.1% against 13.2% on a year earlier.

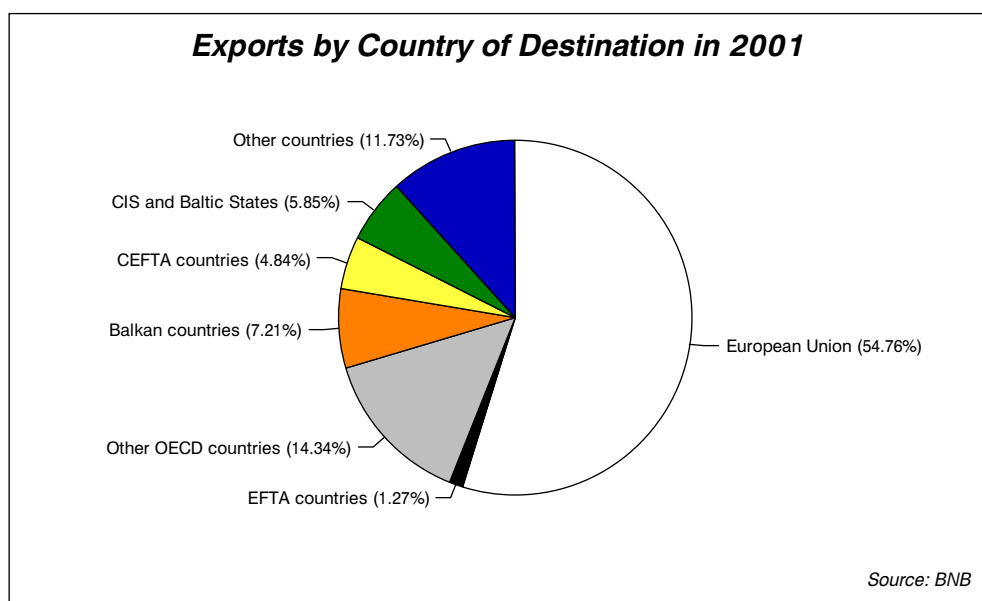
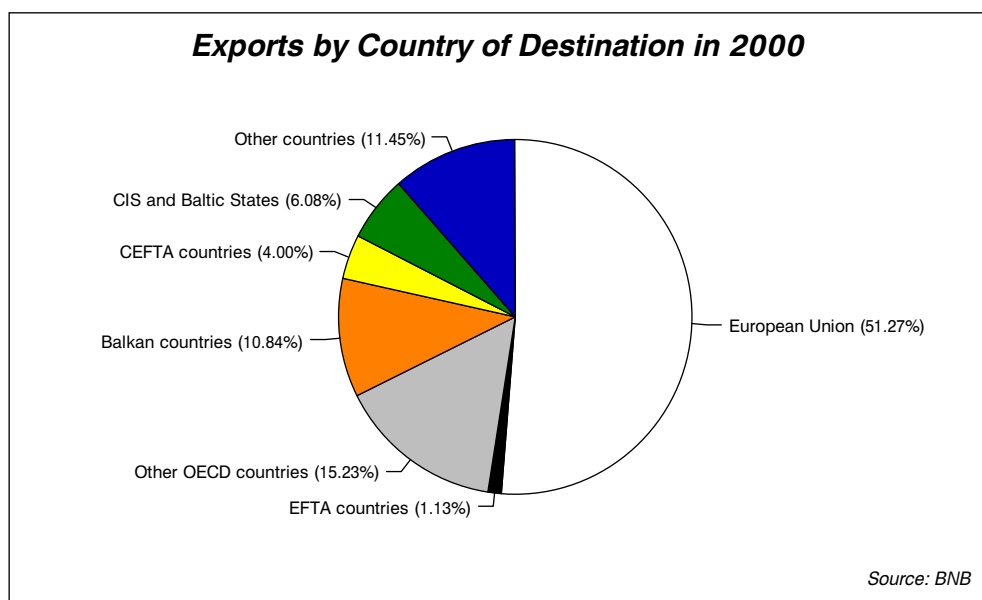
Input exports retained their high share of 40.7% within total exports while falling by USD 60.4 mln (2.8%) in value terms on a year earlier. The larger price fluctuations of raw materials compared to the price volatility of goods with higher value added made the Bulgarian economy rather vulnerable to global changes in business activity. Responding to the deteriorating business environment worldwide, metal exports reported a most drastic decline of 8.7%. At the same time, on a year earlier, textile exports had grown rather fast by USD 39.4 mln, or 27.3%. Input exports in the food industry also stepped up by 14.5%. Chemical exports remained close to their 2000 level, taking however a downward trend.

Contracting by USD 10.4 mln relative to 2000, the export of energy resources amounted to USD 688.8 mln despite the enormous growth of 54.1% (USD 81.1 mln.) in electricity exports. The export decline was wholly due to the USD 83.1 mln (15.5%) worth of a contraction in oil product exports in value terms. As export volumes increased by 6.5% on a year earlier, the contraction was preconditioned by a decrease in the value of exports brought about by the lower 2001 crude oil prices. As a result of the impact of the price factor alone, oil and natural gas exports shrank by USD 72.8 mln in 2001.

The relative share of Bulgarian exports to the EU had stepped up from

51% in 2000 to 55% in 2001. Bulgarian exports to CEFTA countries were also steadily rising by 28.1%, now enjoying a relative share of 5%, due mainly to the robust growth (48.7%) in exports to Roumania on a year earlier. The February foreign exchange crisis in Turkey and ensuing weaker business activity triggered a 16.2% (USD 79.7 mln) contraction in Bulgarian exports to its neighbour compared to 2000. Exports to other Balkan countries also went on the decline as a result mainly of the lower oil product exports to Yugoslavia.





Currently, the expectations are that weaker external demand will continue affecting goods, enjoying a significant share in total exports like mineral products and fuels, metals, chemicals and food products, as a result of the lower growth rates in Bulgaria's major trading partners and lower prices of the commodity groups mentioned. 2002 total exports are thus estimated at USD 5400 mln.

The higher import growth compared to exports led to an increase in the country's foreign trade deficit. Stepping up by 11.1% on a year earlier, 2001 imports amounted to USD 6664.7mln. In 2001, import prices had shrank by 1.7%¹⁰ against 2000 due mainly to the lower

prices of crude oil. In terms of volume growth¹¹, 2001 imports were 13%¹² higher than in 2000.

Input imports reporting an increase of 17.9% or USD 383.1 mln had the largest contribution to total import growth, with textiles registering a most significant rise of 22.8%, or USD 134 mln. It is noteworthy that in end-2001 the import growth rate slowed down due mainly to the weaker demand in the international markets and lower country's output volumes.

As can be discerned, consumer imports have tended to constantly rise over the last couple of years. Their relative weight within total imports hit 17.7%, accounting for a year-on-year rise of 28.7% or USD 285.6 mln against 2000.

Though not alarming in itself, the upward trend in consumer imports and hence the deterioration of the

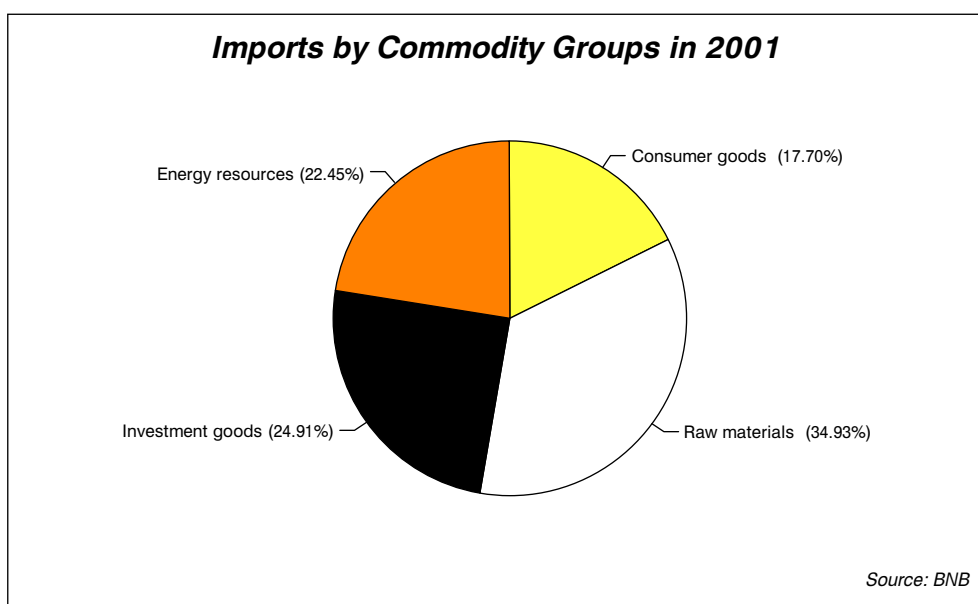
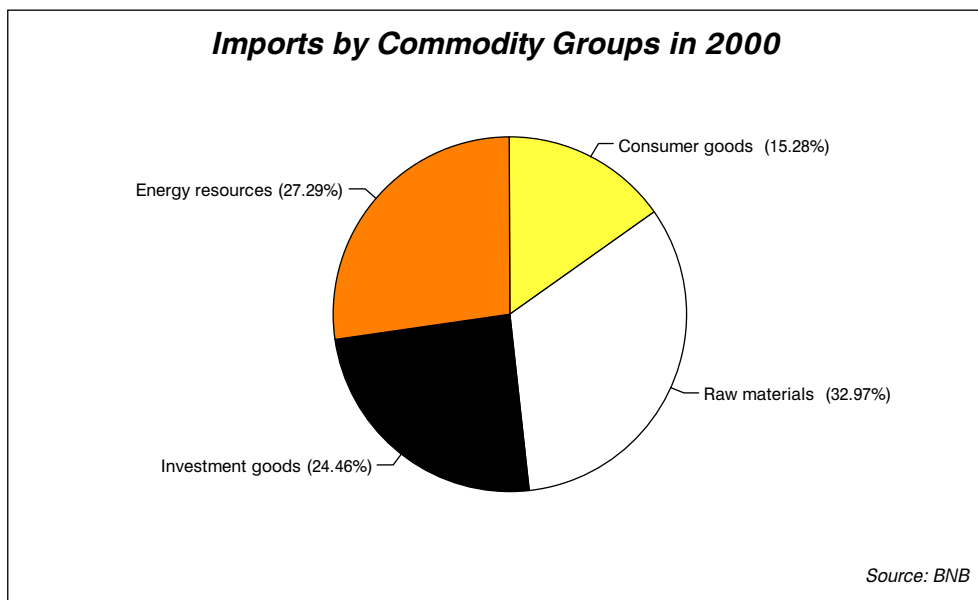
¹⁰ According to NSI data.

¹¹ According to BNB statistics, 2001 import volume growth amounted to 15.9% against 1.5% in 2000.

¹² Estimates draw upon import price indices according to NSI data.

current account balance should be adequately provided and secured by short-term financing. In a long-term perspective, the stability of the external sector can only be guaranteed by sufficient export revenues.

The import of investment goods rose by 12.8%, with the largest contribution to the import growth being reported by electrical machines (USD 127.7 mln) and vehicles (USD 77.5 mln). 2001 saw an 8.4% (USD 149.6) decline in energy resources imports relative to 2000 as a result mainly of the contracting crude oil imports (21.9%, or USD 230.7 mln less than in 2000). Due to the lower 2001 prices crude oil imports stepped down by USD 126.6 mln whereas the volumes imported shrank by only 9.3%. On the other hand, while gas prices went on the increase making imports more expensive (by USD 20.4 mln), import volumes remained close to their 2000 levels. Relative to



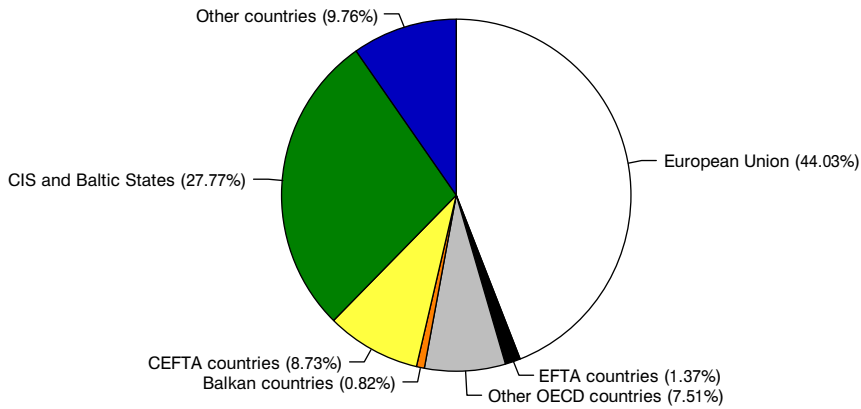
2000, the positive effect of the oil product import contraction due solely to the price factor amounted to USD 106.2 mln¹³.

The geographic profile of both imports and exports in 2001 evidenced a strongly growing relation of the Bulgarian economy with the EU. EU imports to Bulgaria grew by USD 709.1 mln, or 24.7% on a year earlier, now reporting an even larger relative weight within total imports of 49.4% – a stable upward trend that was further reinforced by the BGN's real exchange rate to the Euro currencies whose relative share in Bulgarian imports reached 55.6%.

2001 imports from the CIS and the Baltic countries decreased by 5.2% or USD 93.1 mln on a year earlier, with Russian imports alone having stepped down by 8.9%. At the same time, due to the local currency's

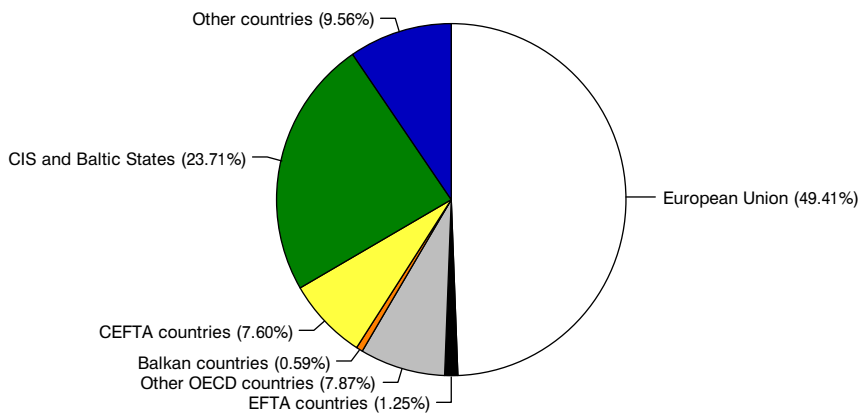
¹³ According to BNB data.

Imports by Country of Origin in 2000



Source: BNB

Imports by Country of Origin in 2001



Source: BNB

devaluation imports from Turkey increased by 27.2% or USD 58.3 mln. Imports from the Balkan and CEFTA countries reported a decline of 19.1% and 3.2% respectively.

Given the lower 2002 growth rate forecasts for the Bulgarian economy, the projections are for a lower import growth compared to 2001. The weaker external demand for Bulgarian exports is expected to produce an additional effect restricting input imports. At the same time, the import of investment goods is likely to sustain its relatively high growth rate whereas the upward trend in consumer imports discerned in 2001 and the first two months of 2002 is a sign that this import component will probably follow a

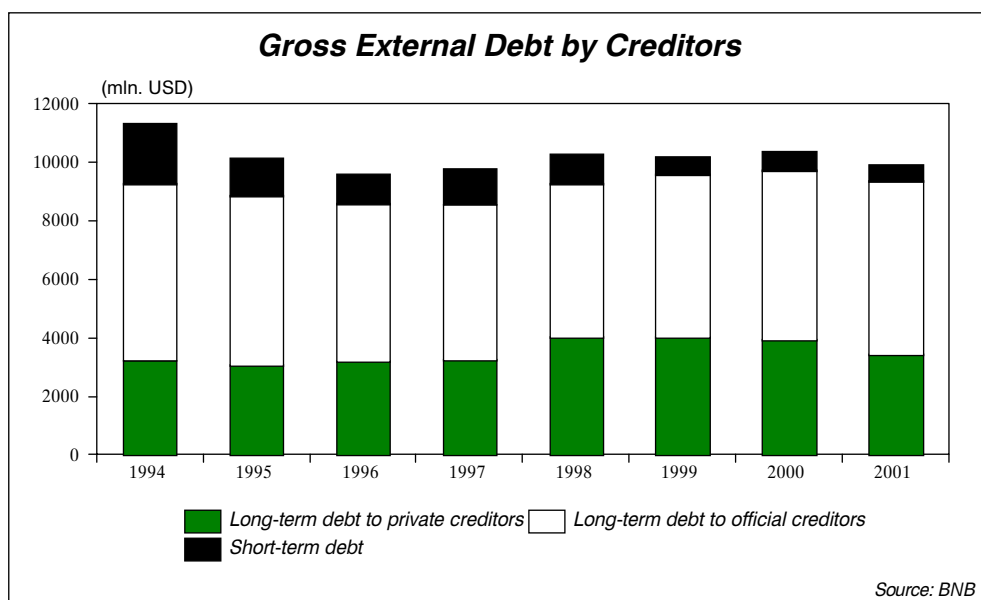
comparatively high growth rate. Therefore, import growth forecasts are set at about 8%, allowing for levels of around USD 7200 mln (at FOB prices).

External Debt

In 2001, the external debt/GDP ratio stepped down, with 2002 expected to sustain the downward trend. According to BNB statistics, having decreased by 9.2 percentage points on a year earlier, the ratio in end-2001 amounted to 73.1% due not only to the GDP growth reported in the same year but the 4.4% debt contraction in USD terms.

Relative to December 2000, the country's external debt had decreased by USD 460.8 mln, with both long- and short-term debts going on the decline. As for the long-term debt, the country's liabilities to the Paris Club and the IMF reported the largest drop of USD 218.4 mln and USD 212.3 mln respectively while debt to private creditors had risen by USD 151.7 mln on a year earlier. As a result of the government measures to optimise Bulgaria's debt to private creditors, there occurred important changes in the debt structure. Due

to the buyback of Brady bonds in September the country's debt to the London Club of Creditors stepped down by USD 201 mln. Also, November witnessed the launch of the debut issue of Bulgarian Eurobonds. The operations undertaken aimed at achieving a better match between the foreign exchange structure of the country's debt and



foreign trade. Changes in the structure of the long-term debt to private creditors were also brought about by the gradual increase in debts to other sectors reaching USD 827.3 mln as of end-December 2001, or USD 237 mln higher relative to end-2000.

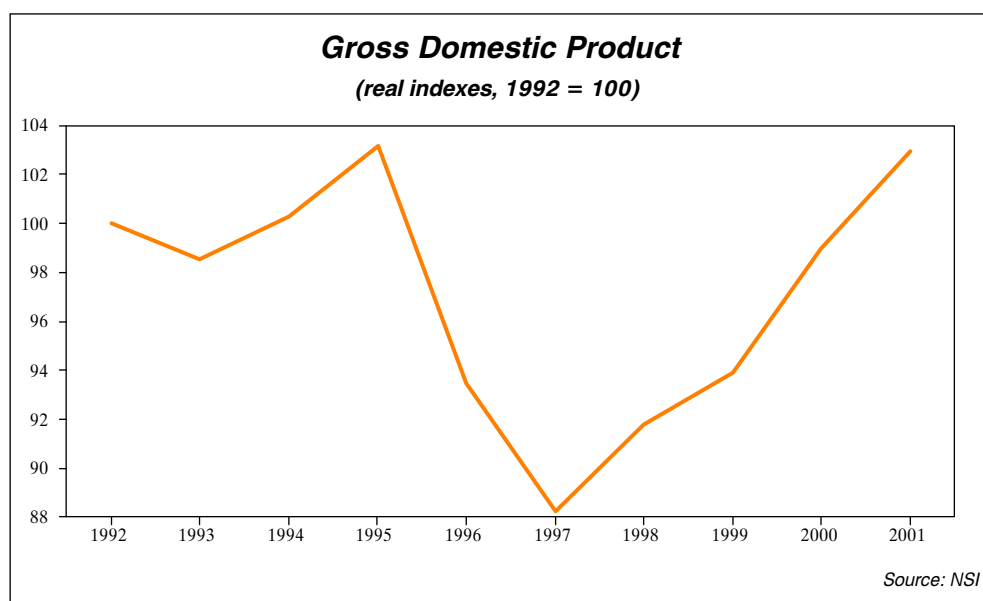
In 2001, the country's short-term debt reported a drastic decrease of USD 92.7 mln down to USD 553.7 mln, which in turn triggered a decline of its share within total debt down to 5.6%.

REAL SECTOR

Gross Domestic Product

Demand

According to preliminary NSI data, in 2001 the Bulgarian economy reported economic growth of 4%. For the fourth year in a row, GDP has registered real-term growth, approximating the 1995 level, which marked a peak in the years of economic reform in Bulgaria, and overcoming the dramatic collapse of the 1996/97 crisis period. It can therefore be expected that if the 5% growth target is achieved, the economy will reach the pre-1989 levels of income in the next five to six years.



Although in 2001 the global economy slowed down affecting the external demand for local exports, it remained the most important growth factor for the Bulgarian economy. The real-term (8.5%) increase in exports (both goods and non-factor services) sustained its high values of previous periods. At the same time, imports grew by 13% as a

result of which net exports as an element GDP final consumption ran negative and led to a negative contribution of the external sector to GDP growth of -3.2 percentage points.

Growth and Contribution Rates (CR) to the Components of GDP Final Consumption

	1999		2000		2001	
	Growth	CR	Growth	CR	Growth	CR
Final consumption	8.8	7.29	5.7	5.01	4.5	3.92
Gross capital formation	20.8	2.71	15.4	2.33	19.9	3.13
Exports (goods and services)	-5.0	-2.35	16.6	7.40	8.5	4.73
Imports (goods and services)	9.3	-4.36	18.6	-9.36	13.0	-7.94
Gross domestic product	2.3		5.4		4.0	

The share of final consumption within GDP went on rising. Given its high current level of 87.2%, it can be expected that the upward trend will turn around and final consumption growth will run close but lower

than GDP. The prevailing weight of final consumption within GDP is a major determinant of the indicator's dynamics. In 2001, the contribution of final consumption to GDP growth amounted to 3.9 percentage points.

Final household consumer spending, which according to NSI national account data accounted for 69.1% of GDP in 2001 (against 68.8% in 2000) reported a 5% real-term increase on a year earlier. These data corresponded to the consumer import growth of 28.7% in USD terms, as well as to the higher consumer credit to households. Despite the sharp fluctuations in the consumption of non-profit institutions serving households (NPISH) (a rise of 15% in 2001 and 7.2% in 2000), its contribution to GDP growth was insignificant due to its low share in final consumption. Final government spending reported a 0.4% real-term decline largely brought about by the tightened restrictive stance of fiscal policies as regards budget expenditures.

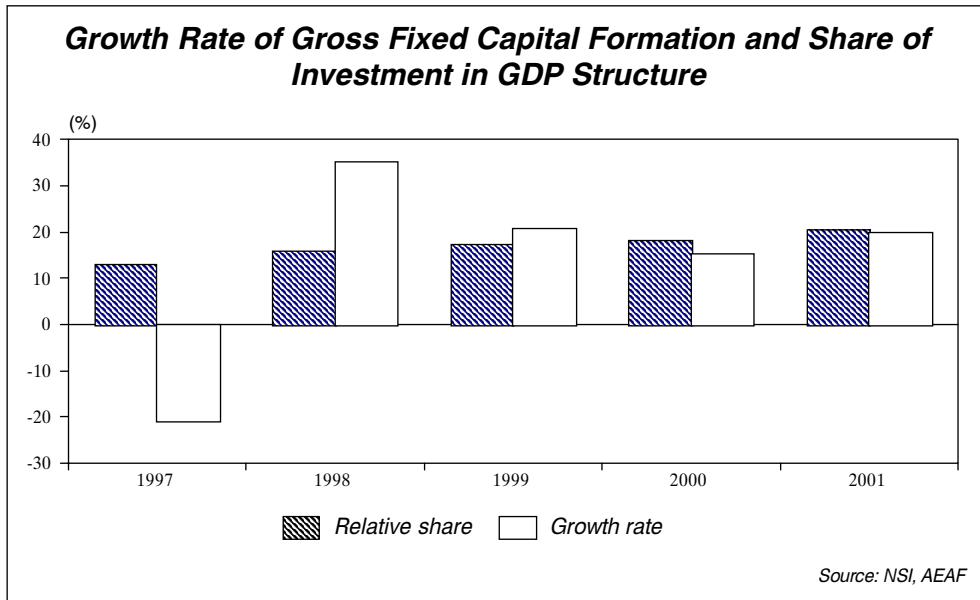
National household consumption (net export of tourist services excluded) rose by 4.5%, and domestic household consumption (net export of tourist services included) by 4.9% in 2001. Stepping up by 17.6% relative to 2000, household consumption of communication services reported a most dynamic performance over the year, underpinned by the development of mobile telephone services and stronger competition in the sector, as well as the growing household demand for Internet services. Thus household consumption in 2001 reported a real-term increase as follows: tourist services (11.2%), food products (8.5%), non-food products (8.4%), catering establishment services (4.5%) and water (2.8%).

Heating consumption, on the other hand, registered a most drastic real-term contraction of 29.2% due largely to the restructuring processes going in the energy sector that relate to the stepwise relative price adjustments of energy resources. Any further energy price increase to be borne by households is likely to lead to further shrinkage in the consumption of some energy services. On the other hand, it will pose new challenges to producers (production costs must be optimised as a result of declining consumption) and the government aid system where the energy aid programme is one of the best functioning. The consumption of transport services and electricity decreased insignificantly by 1.2% and 0.1% respectively.

Self-sufficiency stepped up by 7.4% in 2001, following an upward trend that could be partially explained with employment reductions over the last few years and household orientation towards the household economy as an alternative source of income.

In 2001, the contribution of investment demand (fixed capital formation and changes in inventories) to GDP growth amounted to 3.3 percentage points, with gross fixed capital formation reporting a real-term growth of 19.9%. Investment growth was further evidenced by balance of payments data – in USD terms, the import of investment goods has recurrently reported sustainable growth over the last few years as follows: 40.6% (1999), 6.7% (2000) and 12.8% (2001).

The economic environment uncertainty in the first half of the 1990s and following financial collapse of 1996/97 pre-determined the extremely low GDP share of investments. At the same time, the delayed outset of the privatisation process was a major impediment to the entry of foreign investors in the Bulgarian market. Since 1997 investments (both local and foreign) have been steadily rising in parallel with the reinforced financial and macroeconomic stabilization effort and faster privatisation pace. The bulk of them have been injected in labour intensive sectors like the textile and food industry where Bulgaria enjoys a comparative advantage due to the relatively low labour costs in the country. The outstripping growth of gross fixed capital formation vis-a-vis GDP growth led to the optimisation of GDP structure. Notwithstanding the above trend, the gross fixed capital formation/GDP ratio has remained well below the indicator's value in the developed



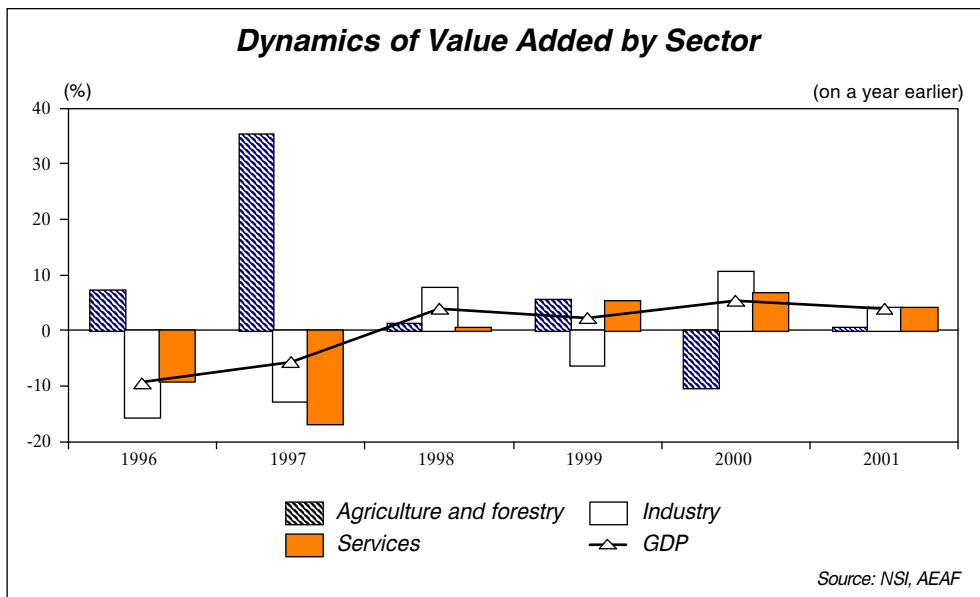
market economies and the other EU applicant countries. It can be expected that in the next couple of years, too, gross fixed capital formation will rise at a faster rate compared to GDP growth.

The expansion of investment demand over the last few years alongside the relatively high propensity to save has led to a deepening

current account deficit of the balance of payments. While national savings as percentage of GDP reported an 8.5% increase the internal rate of saving reported a 1% decline. The expectations of continuous consumption growth at a rate close to GDP growth presuppose a relatively steady constant saving rate in the mid-term. It is therefore important to encourage the full and efficient utilization of pre-ins with a view to ensuring adequate conditions for an increase in the rate of national savings.

Supply

On the supply side, all sectors of the economy reported some contribution to value added growth in 2001, with the service sector in the lead generating more than half of the gross value added (GVA) in the economy. Though the service and manufacturing sectors reported the same growth rate, the contribution of the manufacturing sector ran twice as low as the contribution of the service sector due to its lower share in value added.



The gross value added generated in the economy stepped up by 3.7% in 2001. The share of the private sector rose by 2.1 percentage points up to 71.7%. In some sectors like agriculture, the processing industries, construction and trade, the share of private business surpassed 90%.

The public sector reported a GVA contraction of -4.5% due wholly to the decline in the mining industry where the restructuring process had not been yet completed. The 7.3% GVA growth in the private sector was mainly brought about by the

better indicator's performance in the processing industry, trade and financial services. In a mid-term perspective, efficiency in the manufacturing sector is expected to improve as a result of the sector's corporative, product and technological restructuring.

GVA Volumes and Contribution by Sectors in 2001 (2000 = 100)

	<i>Physical Volume Index</i>	<i>Contribution</i>
<i>Agriculture and forestry</i>	100.5	0.1
<i>Manufacturing sector</i>	104.2	1.2
<i>Services</i>	104.2	2.4
<i>Total: (at basic prices)</i>	103.7	3.7

Agriculture

Drought over the last couple of years affected the performance of the agricultural sector most adversely. The 2000 output decline exceeded 10%. 2001 signalled a turnaround in the downward trend when the contraction was compensated by the better economic results reported in the third and fourth quarters. Though low the sector reported 0.5% growth fostered by the higher cereal output whose share within crop production varied between 28% and 36%.

Major Crop Yields

<i>Crops</i>	<i>2000</i> <i>(thous t)</i>	<i>2001</i> <i>(thous t)</i>	<i>Percentage</i> <i>change</i>	<i>Share in crop</i> <i>production (in %)</i> ¹⁴
<i>Wheat</i>	3 406	4 077	19.7	18.33
<i>Barley</i>	636	930.9	46.37	4.22
<i>Maize grain</i>	1 098	872.6	-20.53	8.2
<i>Sunflower</i>	599	405.1	-32.37	4.77
<i>Potatoes</i>	206	278.2	35.05 ¹⁵	8.42

Source: MAF, Agristatistics Department „Yields of Major Agricultural Crops – 2001 harvest“.

The output growth reported by all crops was due to the larger areas under crops as well as the higher yields (wheat being the only exception). A major reason for the 2001 maize output decline had to do with a decrease in the areas under maize of over 30% unlike the preceding years when the output contraction was triggered by the lower average yields. Average maize yields reported a significant rise in 2001 as follows: irrigated maize for sowing – 78.2%, non-irrigated maize – 21.1%. Potato yields (63.52% year-on-year increase) followed a similar trend, with higher yields, however, making up for the reduction in the areas under crops. Tobacco and vegetable production (tomatoes and cucumbers) is expected to grow by 47% and 6%/14% respectively, and fruit output to go on the decrease.

¹⁴ The shares have been estimated drawing upon NSI data on 2000 major crop production results.

¹⁵ A 13% increase according to NSI estimates.

2002 forecasts point to a reduction in arable land under all crops (with the exception of barley) due to the unfavorable climatic conditions for spring crops observed in the last couple of years.¹⁶

Change in Areas under Crops			
Year	Area	Area	Change
	(thous decares)	(thous decares)	(%)
1997 – 1998	35 337		
1998 – 1999	35 745	+408	+1.2
1999 – 2000	35 238	-507	-1.4
2000 – 2001	34 694	-544	-1.5
2001 – 2002	33 237	-1 457	-4.2
1998 – 2002	-2 100	-5.9	

Source: MAF, Agristatistics Department, surveys: „BANSIC 2001“ and „Yields of Major Crops – 2001 harvest“

Industry

In 2001 all sub-branches of industry reported some growth, with the exception of the mining industry. The contraction in the mining industry was largely due to the lower output of metal ores that accounted for over 30% of the sales in the sector. The output decline was in turn triggered by the lower international copper and zinc prices and the structural adjustment of the mining industries underway.

Industrial Sales			
<i>(January – December 2001 period on a year earlier)</i>			
	Relative share	Real-term	
	in total sales in 2001	change (%)	
		Total	Export
Sectors Reporting a Significant Positive Contribution to Sales Growth			
Production and supply of electricity, gaseous fuel and heating	14.2	4.3	46.1
Clothing, including leatherwear; skin processing	3.8	15.3	12.1
Radio, TV and telecommunication equipment	0.8	49.2	23.4
Machinery, equipment and household appliances	5.1	4.7	7.7
Chemicals	8.2	1.5	-1.6
Leather, travel goods and footwear	0.9	12.7	5.5
Sectors Reporting a Significant Negative Contribution to Sales Growth			
Metal production and casting	9.1	-9.8	-13.4
Food and beverages	14.4	-2.5	9.4
Publishing and printing, CD writing, audio and video recording	1.9	-15.4	-14.0
Coal and peat mining	1.9	-11.8	-

Source: AEAF, NSI

¹⁶ Forecasts have been made on the basis of a survey conducted by the Agristatistics Department of MAF concerning agricultural producers' intentions. Arable land includes all areas under annual crops, artificial meadows, fallow land and household plots.

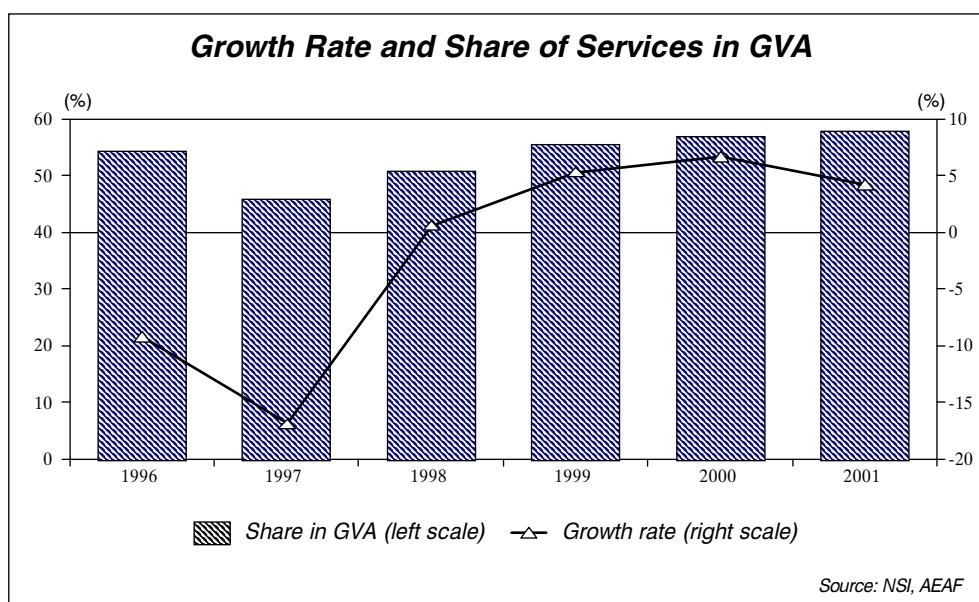
On a year earlier, 2001 industrial sales reported a real-term rise of a bare 0.1%. *Metal production and casting* registered a most drastic sales decline as a result of the weaker international demand and lower metal prices worldwide. Relative to 2000, the aggregate price decrease in the group of metals and mineral raw materials amounted to about 10%¹⁷. The lower average annual prices also led to a contraction in chemical (fertilizers in particular) and timber exports.

In the nine months to November 2001, the business climate indicator in the manufacturing sector was steadily improving. The terrorist attacks on the USA of September 11th, however, brought about a downswing in the trend but by end-2001 the indicator quickly rebounded to show the first signs of recovery. 2001 capacity utilization rate averaged 58.4%, hitting a 3-year record high of 59.2%. Managers in the manufacturing sector, retail trade, construction and transport continued to face the same bottlenecks as before, viz. low home and foreign demand and financial difficulties.

Service Sector

Over the last few years the service sector has been developing most dynamically reporting continuous growth since 1997. Setting back at its pre-crisis level, the relative weight of services within GDP amounted to 51.2% in 2001. At the same time, gross output growth tended to outstrip gross value added, indicating a major deterioration in the sector's efficiency. If the latter trend persisted, investment activity in the service sector could also be expected to slow down.

Communications, trade, and finance, credit and insurance were among the sectors reporting the fastest growth rate. The rapid development of communications was mainly spurred by the demonopolisation of the market, swift IT advance and market players' focus on new market niches. The trend was further evidenced by demand data indicating a high growth rate of household consumption of communication services.



¹⁷ Calculations draw upon WB monthly release of „Global Commodity Markets. Commodity Price Data (Pinksheets)“, <http://www.worldbank.org/prospects/pinksheets/index.htm>.

GVA Growth Rate (in %) in the Service Sector by Industries

	1998	1999	2000	2001	1998 – 2001
<i>Transport</i>	-9.5	3.3	2.2	0.0	-4.5
<i>Communications</i>	17.9	30.3	21.9	25.1	134.1
<i>Trade</i>	0.2	9.2	9.7	10.6	32.8
<i>Finance, credit and insurance</i>	5.7	15.7	9.1	6.9	42.8
<i>Other</i>	1.2	2.1	5.0	0.6	9.1
Services	0.6	5.3	6.7	4.2	17.8

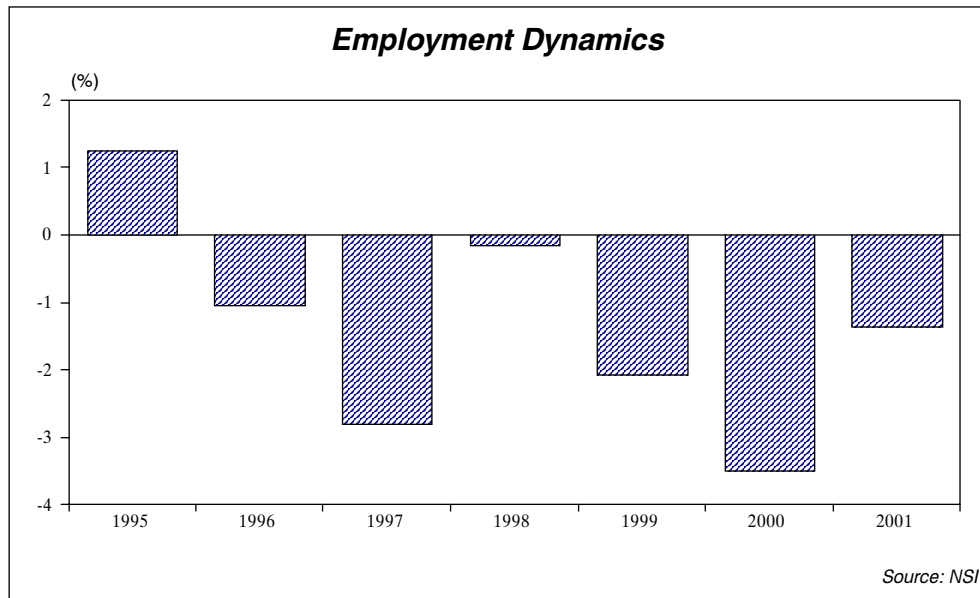
Source: AEF, NSI

Employment, Unemployment and Wages

Since 1999 the Bulgarian economy has been persistently displaying a most striking feature, i.e. sustained and relatively high GDP growth and steadily declining employment that resulted in a growing unemployment rate and dull business activity at times. The main reasons behind this were as follows: privatisation acceleration over the 1998 – 2000 period; the launch of bankruptcy and winding-up procedures for SOEs in poor financial conditions with no claimed investor's interest (the first half-year period of 2000 in particular), pension and health insurance reforms (following the second half of 2000), reforms in the budgetary sector aimed at

curtailing employment in public administration, education and health care.

Despite the 4% GDP growth in 2001, employment had once again declined. According to preliminary NSI data, stepping down by 1.3%, the number of employed in 2001 averaged 2940.3 thousand. An economy-wide analysis of the employment dynamics by sectors points to the



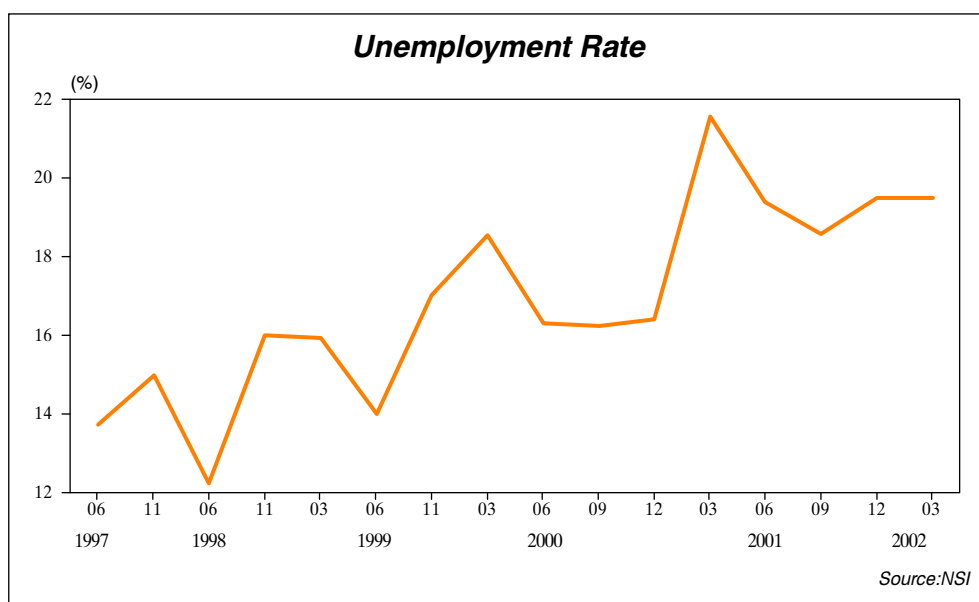
ongoing structural adjustment process as the major factor at work behind the 2001 employment redundancy. The number of employed in the mining industries reported a most drastic contraction of 12.7% of the 2000 average, with the job redundancies effected solely in state-run enterprises while private enterprises retained almost the same employment rate.

Some of the mines that no investor's interest has been claimed in and hence not privatised are still in the winding up. The number of employed in health care and education decreased significantly (by over 6.5% in both cases) as a result mainly of the state-sector job redundancies in the same branches that had to do with a major government policy guideline to optimise current budget expenditures and therefore employment

reduction in all economic activities financed by the government budget. In some of the processing industries – machine building, leather and fur dressing, timber processing (furniture excluded), woodpulp and printing – employment redundancies varied between 5% and 10%, with the state-run sector being again a major contributor to declining employment. In any of the cases, however, the assumption that privatisation has contributed to the indicator's dynamics cannot be rejected, all the more so that some of the industries reported a relatively high real-term growth rate of sales.

Although the country's employment decreased, the number of private-sector employed stepped up by 2.2% to account for 73.4% of total employment in the economy (against 70.8% in 2000). It must be noted that 2001 failed to see the conclusion of important privatisation deals, and therefore, private-sector employment growth cannot be explained with the impetus the privatisation process had gained over the 1998 – 2000 period. Job creation in new or already privatised enterprises most probably resulted in a growing number of private-sector employees. Employment increased most significantly in private services where most industries reported a rise of about 15%¹⁸, followed by construction, the food, chemical and textile industries. As for the production and supply of electricity, heating, gas and water, private-sector employment reported a double-fold rise indicating that the privatisation process had already started in a sector still well dominated by state ownership.

According to data of the National Employment Service (NES) on the registered unemployed numbers in the country and NSI labour force survey data, the number of unemployed has taken a clear-cut downward trend since mid-2001. According to NES data, the number of registered unemployed reached a peak in



February, followed by a significant steady decrease in the indicator. The average 12-month number of registered unemployed in 2001 was 3.4% (23.9 thousand) lower than the 2000 average. At the same time, early 2002 data show that the indicator's downward trend was sustained well after the end of 2001 as well, with the differences between the corresponding months of two successive years tending to widen.

NSI labour force survey data reveal a similar 2001 dynamics. In December 2001, the number of unemployed remained 90 thousand less than in March the same year, while the unemployment rate amounted to 19.5%, stepping down by 2 percentage points inside the same nine-month period. By contrast with NES data, NSI estimates indicate that the 2001 number of unemployed rose by about 100 thousand, relative to 2000. It is

¹⁸ Perhaps, this is one of the few cases where the privatisation process could have contributed to average 12-month employment growth in the private sector. In the sector of financial intermediation, for instance, private-sector employment had risen by over 30% partly due probably to the privatisation of Bulbank in the second half of 2000. However, the sector cannot boast of a high number of employed and hence a significant weight in the country's employment dynamics.

very likely that the labour force survey sample of respondents fully replaced by the NSI in early-2000 took account of developments that had occurred the previous year, in particular the faster pace of restructuring in the state-owned sector of the economy having to do with the launching of winding up procedures, budgetary sector employment redundancies as well as pension and health insurance reforms. This hypothesis was further reinforced by the different dynamic patterns the number of employed followed according to NSI and NES data in 2000. While, according to NSI data, the number of unemployed was steadily declining throughout 2000, according to NES statistics, this number reached a peak over the period reviewed in the first half of 2000. If the difference between NSI and NES figures in 2000 had amounted to about 150 thousand unemployed (data are gathered on the basis of different methodologies), in 2001 the two institutions reported almost the same number of unemployed.

And yet, it should be taken into account that the higher 2001 unemployed numbers (according to NSI data) on a year earlier was due not only to the lower number of employed in the economy but the declining number of discouraged outside the workforce cohort. According to AEAF estimates, about 100 thousand people had flown out of the cohort of discouraged into the stream of unemployed, contributing to the higher 2001 unemployment rate relative to 2000, which in turn led to a sharp increase in business activity in 2001 on a year earlier. The indicator's dynamics, seasonally adjusted, has been following a steady downward trend since 1993. In 2001, the indicator reported values that were approximating its 1998 level, remaining however well above the 1999/2000 levels. In December 2001 the number of discouraged jumped by 160 thousand relative to September the same year, hitting an absolute maximum for the whole period surveyed. As a result, the participation rate of the population plunged to 48.1% in December 2001, or down to a value comparable with the 2000 levels.

It is difficult to assess what part of the sharp fluctuations in the number of discouraged resulting in sharp fluctuations in the unemployed numbers and hence labour force dynamics can be attributed to some methodological problems of the survey or the individual and momentous disposition of the respondents as to their status in labour force. Clearly, the bulk of polled people find it very difficult to distinguish between discouragement and unemployment. All this leads to a constant shift of relatively large outflows from one cohort to another and vice versa. Many analysts tend to classify all discouraged that have stopped searching actively for a job in the group of unemployed which contradicts the methodology of labour force survey adopted by the International Labour Organisation (ILO). In fact, for a very large group of job seekers registration with employment centres is a way to validate their eligibility for social aid benefits rather than an active job search. Unemployment benefits (together with possible income from hidden employment) may generate sufficiently high alternative income that prevents employment centres from offering job seekers relatively low paid jobs under the temporary employment programmes including. Most unemployed have chosen to be on the waiting list rather than actively search for a job. According to a study of the impact of labour market measures conducted in 2000, more than 60% of the registered unemployed applied for a job vacancy less than once a month, underlying their passive stand in the labour market.

Another problem that makes the finding of a quick fix to country's rising unemployment very difficult has to do with labour force flexibility on a regional scale. There exist underscoring differences in the unemployment rate across regions that are tending to further widen.

The likely reasons behind the low regional flexibility of labour force amount to as follows: underdevelopment of the real estate market, cultural and behavioural stereotypes and patterns, inadequate professional

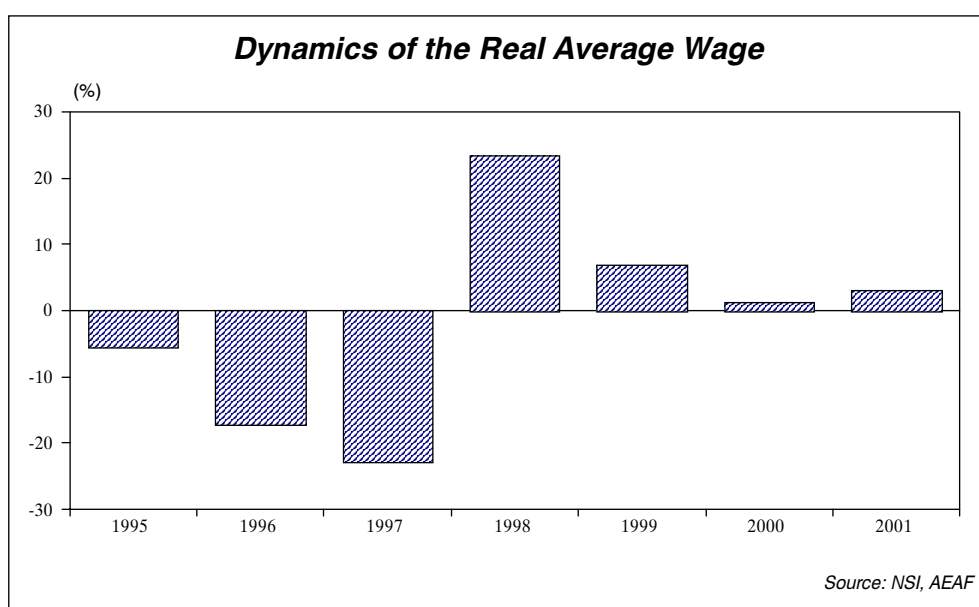
qualification and training of the unemployed, etc. as well as the failure of potential earnings to reach a cost-reflective level when one changes his residence to start a new job. In many cases a change in residence entails not only transportation costs (that are covered under a government aid programme implemented by the Ministry of Labour and Social Policies to support unemployed in finding new jobs elsewhere) but also house rents that are often higher than the income earned from wages and would be otherwise non-existent has a person found a new job in the place he/she lives. The relative low level of income from employment relative to income from other sources (e.g. rent from property) is therefore a significant hindrance to regional labour force flexibility. All this implies that government economic policies should be focused on making regions with a stable higher unemployment rate than the country's average more attractive and foster higher investment inflows to regions persistently reporting a higher unemployment rate. It is therefore imperative that social and technical infrastructures in these regions are improved and labour market measures reinforced (promoting vocational training programmes, loan financing of projects, etc.) while relying on tax relief in a lesser degree.

On a year earlier, the country's average annual wages in 2001 stepped up by 3% (at 2000 prices), with the following service industries reporting a most robust year-on-year rise in real average wages: tourism (39.8%); real estate transactions, leasing and business services (by over 12.5% each); and health care

(7.2%). In all the above cases, average private-sector wages significantly outstripped the public-sector average. Thus for example, in the real estate, leasing and business service sectors real wages in the public sector went on the decrease, despite their high growth in the private sector. As for health care, real wages in the public sector rose by 7.4% only against 31.1% in the private sector. Real wages in tourism followed the same dynamic pattern.

Average wages in the manufacturing sector exhibited variations of little magnitude across industries. The manufacture of vehicles where even nominal average wages had declined excluded, real wage growth in the remaining industries varied between – 3.9% in metallurgy and 4.4% in the timber industry (manufacture of furniture items excluded). It should be then noted that the relationship between the average wage dynamics and sales revenues in the manufacturing industries is more distinct and clearer-cut than the correlation between employment and sales.

Real wage growth in 2001 ran higher than in 2000 (1.2%) while reporting a lesser increase compared to productivity¹⁹. On a year earlier, labour productivity in the economy rose by 5.1% in 2001 (at 2000 prices),



¹⁹ Calculated as the ratio between gross value added and the number of employed in the relevant sector.

with the manufacturing sector registering a most notable rise of 8.1% outperformed, however, by the processing industries (9.9%), as due to both the growth in the value generated in the manufacturing industries and continuous employment contraction. At the same time, the rather modest growth in real wages in the sector implied either that the financial conditions of the processing enterprises had greatly improved or managers had shirked from reporting part of the real wage increase in the same enterprises. The income growth generated in the service sector resulted in rising labour productivity (by 4.3%). The number of employed in the service industries remained almost unchanged at its 2000 level.

As average wage dynamics over next couple of years is expected to remain close to productivity dynamics, it can therefore be assumed that if the restructuring process in many of the enterprises that have reached an optimum job number²⁰ is about to end soon, the GDP growth expected will be divided between real wage growth and employment growth. Then the two policy goals can only be reconciled by sacrificing real income growth from employment (other things being equal and given some GDP growth) to higher employment, hence unemployment reduction, or vice versa.

Since GDP growth ran higher than the country's real wage growth and the number of employed on labour contracts had declined, income from entrepreneurship outstripped income from employment in real terms, bringing about a likely decrease in the share of wages and salaries down to its 2000 level of 39% and outweighing the importance of income from employment to the generation of income in the economy. It is then essential that government policies focus on stimulating, along with wage growth and income from social aid, the generation of income in the economy as a whole.

The government influences directly the country's wage dynamics by way of minimum wages, public-sector wages as well as amendments to the tax and social and health contribution rates and structures. In a market economy, however, the government policy focus should be laid on its indirect instruments of impact such as tax and fee rates, promotion of competition boosting local market players' entrepreneurship, attraction of foreign capital and investment, etc.

In 2001, minimum wages were updated twice as follows: in April from BGN 79 to BGN 85 (or a 7.6% rise) and in October from BGN 85 to BGN 100 (a 17.6% mark up). Obviously, minimum wage growth failed to influence fully average wage dynamic in so far as average annual minimum wages stepped up by 15.8% in nominal terms and average wages reported a 10.6% nominal-term rise. Therefore, minimum wages may affect average wage growth but the effect produced is mainly limited to the country's lowest wage dynamics.

Public-sector average wage growth ran 2.4% lower than in the private sector (at 2000 prices). The government is further hampered by the ongoing privatisation of SOEs in its attempts to influence directly average wage dynamics in the economy. Second, to enterprises that are not being financed by the budget the government is consistently applying an income policy where wage dynamics is shaped by the company's financial performance and servicing of liabilities. Put in more precise terms, non-budgetary sector enterprises are largely free to set their wages according to the principles that determine the income policies of private firms. The influence of the government on the country's average wages is thus reduced to amending wages in budgetary organizations mostly. Average real wage growth in the budgetary sector alone ran higher than in the public sector as a whole (4.7% at 2000 prices) due mainly to the contribution of the health care sector.

²⁰ The above argument does not apply to industries and sectors where privatisation has not yet been completed (communications, railways and energy power generation) and the budgetary sphere.

At the same time, wage growth in public administration and education ran lower than wages not only in the public sector but in the whole of the country's economy as well.

Average wages by sectors (services excluded) exhibited a very close dynamics. It can therefore be assumed that employers tend to take into consideration not only government policies towards wages (wage amendments in the budgetary sphere) but productivity dynamics as well. The faster wage growth in the service sector was also due to the Balassa-Samuelson effect.²¹

Inflation

On a year earlier, 2001 monthly inflation decreased. As a result, CPI inflation reported a year-on-year decline relative to the corresponding month of 2000, stepping down from 11.3% in end-2000 to 4.8% in end-2001. Average 12-month inflation fell from 10.3% to 7.4%.

Non-administered prices rose by 3.2% in 2001 against 10.8% on a year earlier. They accounted for 80% of the consumer basket. A major factor behind the administered price change had to do with international price dynamics, further affected in the transition economies like the Bulgarian one by relative price adjustments.

Price Change and Contribution of the Commodity Groups to Overall Inflation

(December 2001 relative to December 2000)

<i>Commodity group</i>	<i>Price change (%)</i>	<i>Contribution to inflation (in % points)</i>
<i>A. Food items</i>	2.7	1.2
<i>B. Non-food items</i>	5.6	1.5
<i>C. Canteens and restaurants</i>	3.3	0.1
<i>D. Services</i>	8.1	2.0
<i>Inflation</i>	4.8	4.8
<i>A. Monitored prices</i>	11.1	2.3
<i>B. Free prices</i>	3.2	2.5

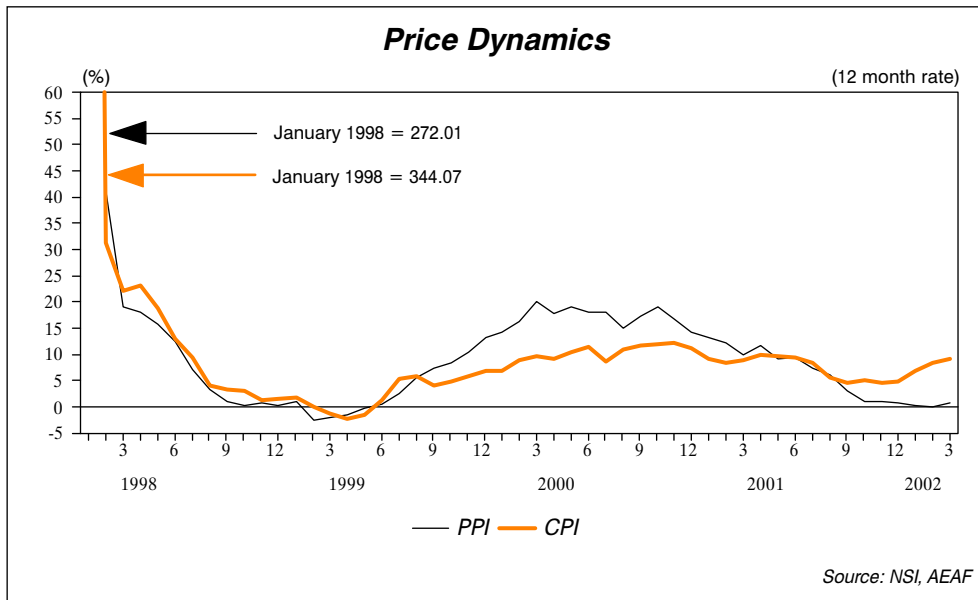
Source: NSI, AEAf.

In end-2001 all groups of inputs traded in the international markets reported a price drop. Oil prices stepped down by 26.4%, and the prices of non-energy goods registered an 8.9% fall in USD terms²².

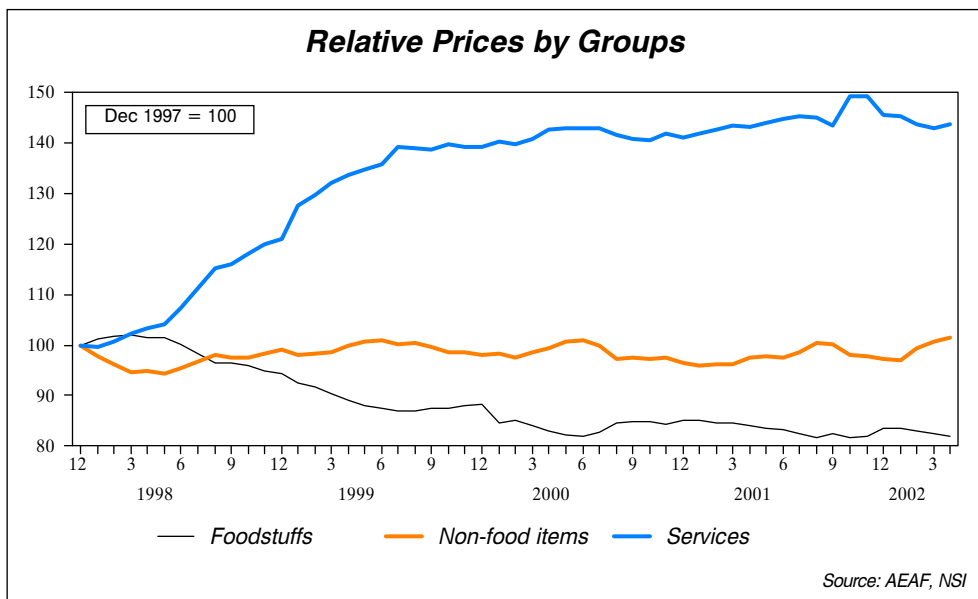
The nominal BGN/USD exchange rate also tended to depreciate on a monthly basis relative to 2000. The concurrent effect of these two factors led to lower inflation of tradables what in fact are the bulk of goods covered by the PPI. In end-2001 the PPI rose by a scant 0.7% against 14.4% growth on a year earlier. Ever since the institution of the currency board arrangement in Bulgaria there has been discerned a strong correlation between the CPI and the PPI.

²¹ See Chukalev, G. „The Balassa – Samuelson effect in the Bulgarian Economy, 2002.

²² World Bank, <http://www.worldbank.org/prospects/index.htm>.



Relative price change was another source of inflation. The relative prices of services outstripped significantly food and non-food relative prices. The higher service price inflation compared to the overall inflation rate in the economy was spurred by administered price adjustments and the validity of the Balassa-Samuelson (BS) effect²³ for the Bulgarian economy.



The impact of the BS effect led to the real appreciation of the Bulgarian currency vis-a-vis the currencies of Bulgaria's major trading partners. Thus over the 1995 – 2000 period the real effective exchange rate had appreciated by 19.1% (as measured by the deflator of GVA), with

almost three-fourth of the appreciation being due to the BS effect, a fact that can be hardly interpreted as loss of competitiveness for Bulgarian producers, as the bulk of the real-term appreciation was brought about by the prices of non-tradables such as services. The real-term overvaluation of the national currency is characteristic of the transition economies, in particular of countries under a currency board. Over the 1997-2001 period, the BGN reported a 33.1% real-term appreciation (measured by the CPI) vis-a-vis the national currencies of Bulgaria's major trading partners. On a year earlier, the BGN appreciated by 2.2% in 2001.

In 2001, the administered price rise reported a significant contribution of some 48% to end-year cumulative inflation. Monitored prices (both goods and services) increased at a most rapid rate as follows: medicines (28.1%), drinking water (16.6%), telephone services (13.6%), electricity (5.9%), and heating (5.5%). The

²³ The faster growth rate of productivity in the sector of tradables (industry) vis-a-vis the non-tradable sector (services) presupposes higher wages in the sector of tradables. Price growth in the tradable sector, however, is checked by the law of the single price. Wage rises in the sector of tradables are passed onto the non-tradable sector as well to prevent the outflow of workforce to the higher paid sector. Wages in the sector of non-tradables can go higher by raising the prices of the goods and services produced in it and thus result in higher relative prices of tradables against non-tradables.

contribution of administered prices to 2002 inflation is expected to run even higher on a year earlier, as in the two months to March alone they were already on the track to rise by 11.7%, registering a contribution to overall inflation of 2.5 percentage points.

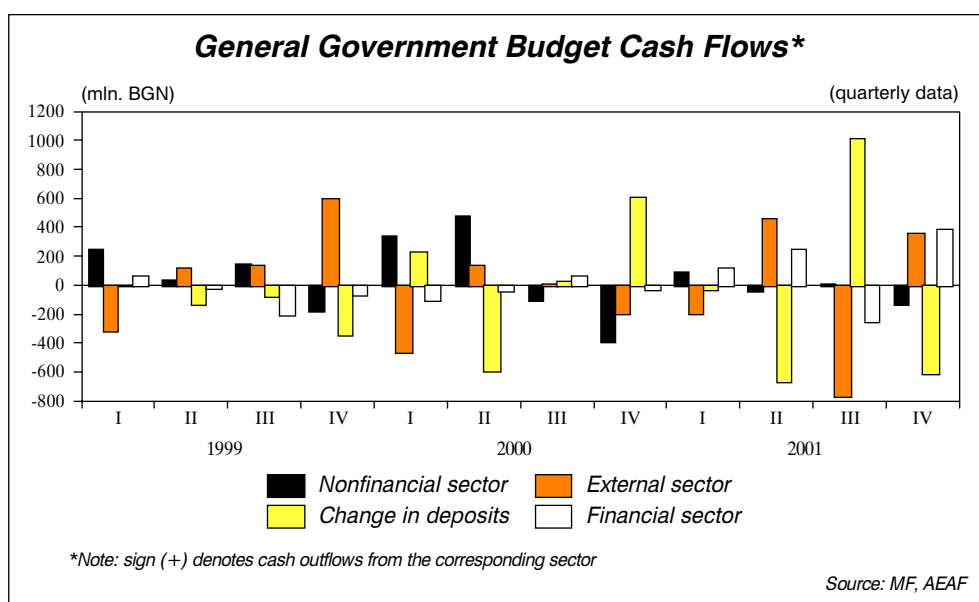
It can be expected that the amendments to the tax and excise duty rates effected in early 2002 as well as the higher oil prices on a year earlier will bring about an increase in overall price inflation that is to further rise as a result of the higher administered electricity and heating prices. The country's inflation in end-2002 is expected to amount to 7-8%.

Public Finance

In 2001, retaining its strong restrictive stance the government fiscal policy was again a key factor of currency board stability. Running 0.2% lower on a year earlier, the primary surplus amounted to BGN 850.5 mln. (or 2.9% of GDP)²⁴ as of end-2001. The redistributive function of the consolidated government budget decreased in so far as the total revenues and expenditures/GDP ratios reported a decline of 1.4 and 1.5 percentage points respectively down to 40% and 40.8% of GDP. The cash deficit reached amount to 0.9% of GDP, running lower than the initial government budget projections. The cash deficit target was further revised in the year due to expectations of a higher than anticipated balance of payments current account deficit.

In 2001, the revenues from almost all taxes declined as percentage of GDP, the only exception being profit tax revenues (despite the trimmed tax rates) and receipts from liquid fuel fees. A major reason behind the consolidated budget revenue contraction as percentage of GDP had to do with the tax relief package adopted in 2001²⁵.

2001 saw a different cash flow dynamics. The consolidated government budget had again performed its re-allocative function in the distribution of funds from the financial sector to households, the non-financial and external sectors. The large amounts of one-time profit and municipality tax payments made by



financial enterprises²⁶ turned households from a major net lender into a major net borrower. The policy of expenditures adopted in the first half of 2001 further contributed to the above development, with non-interest

²⁴ According to preliminary Ministry of Finance data.

²⁵ The tax relief package includes as follows: shortening the VAT-refund term under the Value Added Tax Act from 6 to 4 months; 5% reduction in the profit tax rate under the Corporate Tax Act; amendments to the tax rates and brackets under the Personal Income Tax, and a 3% decrease in the contribution rate for the Pension Fund.

²⁶ BGN 167 mln worth of profit and municipality tax payments made by the Bank Consolidation Company (BCC), the profit of which was primarily formed by the sale of Bulbank.

Major Public Finance Indicators

	2000	2001*
Revenues and aid (in mln of BGN)	11 065.1	11 837.9
(as % GDP)	41.4	40.0
Tax revenues (in mln of BGN)	8 707.2	9 190.5
(as % GDP)	32.5	31.0
Profit tax revenues (in mln of BGN)	716.1	1 129.6
(as % GDP)	2.7	3.8
Personal income tax revenues (in mln of BGN)	1 098.0	1 062.8
(as % GDP)	4.1	3.6
VAT (in mln of BGN)	2 359.0	2 454.4
(as % GDP)	8.8	8.3
Customs duties and levies (in mln of BGN)	220.7	195.4
(as % GDP)	0.8	0.7
Revenues from social security contributions (in mln of BGN)	2 943.8	2 984.9
(as % GDP)	11.0	10.1
Non-tax revenues (in mln of BGN)	2 154.2	2 284.2
(as % GDP)	8.1	7.7
Aid (in mln of BGN)	203.7	363.2
(as % GDP)	0.8	1.2
Expenditures and transfers (in mln of BGN)	11 334.3	12 093.1
(as % GDP)	42.4	40.8
Current expenditures (in mln of BGN)	10 072.3	10 794.0
(as % GDP)	37.6	36.4
Interest expenditures (in mln of BGN)	1 083.3	1 105.8
(as % GDP)	4.0	3.7
Capital expenditures (in mln of BGN)	1 036.5	1 183.5
(as % GDP)	3.9	4.0
Primary balance (in mln of BGN)	814.1	850.5
(as % GDP)	3.0	2.9
Cash balance (in mln of BGN)	-269.2	-255.2
(as % GDP)	-1.0	-0.9
State and state-guarenteed debt (in mln of BGN)	20 617.0	20 752.1
(as % GDP)	77.1	70.1
Domestic debt (in mln of BGN)	1 767.2	1 860.5
(as % GDP)	6.6	6.3
External debt (in mln of BGN)	18 849.8	18 891.6
(as % GDP)	70.5	63.8

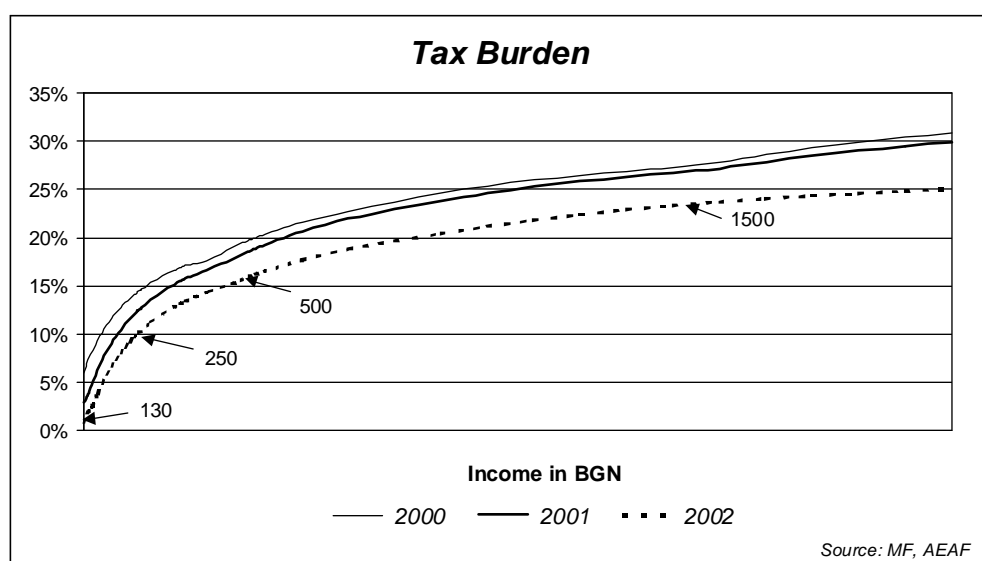
* According to preliminary data (at a consolidated budget level)

Source: MoF and AEF.

payments amounting to 40.3% of GDP against 36.1% in 2000. The dynamics of cash flows by quarters indicates that public finance stability depends on the maintenance of fiscal reserves in the form of deposits or funds on accounts that allow cash imbalances to be timely covered. The magnitude of changes in the fiscal reserves, in particular in the second and third quarters, was indicative of major problems in the cash flow management and the planning and/or implementation of the government fiscal policy last year.

In 2001, consolidated government budget revenues overperformed by BGN 411 mln against projections due to the higher revenues from aid and profit tax. These two sources of revenue generation do not exhibit a stable behaviour and therefore cannot be expected to overperform again in the next couple of years²⁷. The continuous restructuring on the revenue side also resulted in a different buoyancy²⁸ of the different revenue items in relation to GDP. The intentions of the government to reduce the share of direct taxes within total revenues at the expense of indirect taxes failed to take place, however, in 2001. The overperformance of profit tax revenues already commented could make up fully for the contraction in income tax revenues, accounting for direct tax buoyancy to GDP of 1.95. The buoyancy of all revenues and aid ran at 0.65, of direct taxes – 1.0, of social security revenues – 0.13, and that of non-tax revenues – 0.56. The expectations for 2002 are that direct taxes as percentage of GDP will step down at the expense of the rising share of indirect taxes due mainly to the amendments to the country's tax law.

The amendments to the tax rates and brackets under the Personal Income Tax Act as well, taking effect in 2001, alleviated the tax and social security burden of tax payers reporting income of up to BGN 500, i.e. the low and average income groups of tax payers, with the decline in income tax revenues from



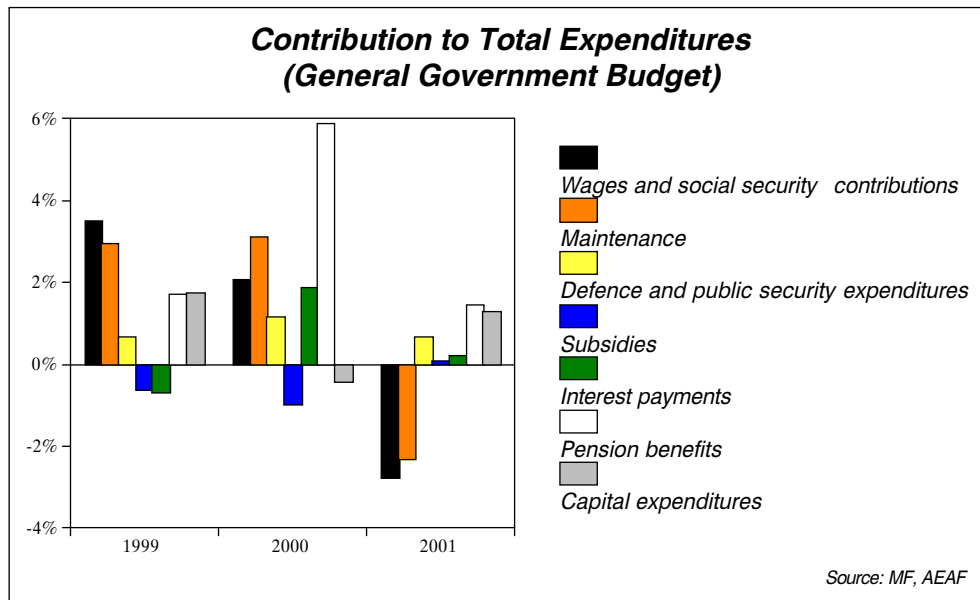
4.1% to 3.6% of GDP working to their best advantage. The above income groups reported a significant reduction in the tax burden from 0.9 to 3.6 percentage points and the social security burden from 1.5% to 4.1%. Early 2002 saw a change in the social contribution rate paid by employees and employers from 20/80 to 25/75 as well as amendments to the tax brackets, providing for the largest reduction in the social security burden of tax payers reporting income of above BGN 500, rising in a progressive manner starting from 0.6%. Its decrease with the average income groups was rather marginal (-0.3%) while the burden for income levels of around BGN 110 – 130 even stepped up by 1.9 percentage point.

In 2001, the consolidated government budget underwent significant adjustment on the expenditure side. Total expenditures declined from 42.4% to 40.8%, signalling a turnaround in the upward trend followed since

²⁷ Out of a total nominal-term revenue growth of 6.98% on a year earlier, 1.44% was due to revenues from aid, 1.17% to non-tax revenues and 4.37% to tax revenues. Profit tax revenues accounted for 3.74% of the 6.98% growth.

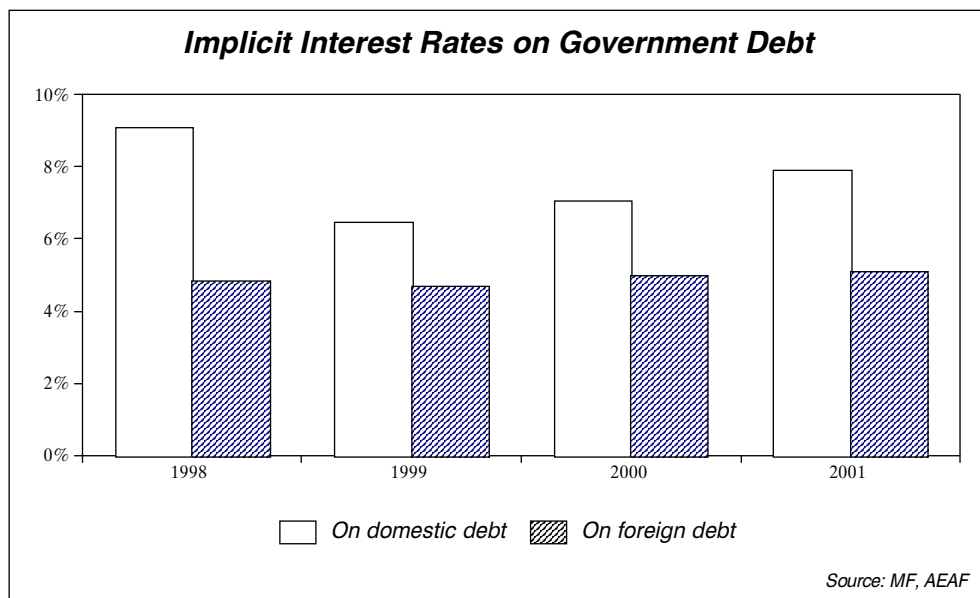
²⁸ Revenue buoyancy has been calculated without taking into account recent tax law amendments.

1997. Budget expenditures were curtailed mainly at the expense of the 1.2% contraction of current expenditures in GDP while capital expenditures rose insignificantly. From the point of the functional classification, what happened was essentially a re-allocation of financial resources from public administration services and institutions (science included), defence, education, pension and social aid (about 1.7% of GDP) to health care (0.3% of GDP) and business activities and services (0.8% of GDP). Total expenditure buoyancy in relation to GDP ran at 0.63, of current non-interest expenditures – 0.73, of interest expenditures at 0.19 and that of capital expenditure at 1.32. The drastic decline in expenditures on wage bill costs resulted in a contraction on the expenditure side.



Budgetary-sector wage bill costs and expenditures on interest, pensions and student grants declined in both relative and absolute terms in 2001. As percentage of GDP, they stepped down from 21.4% to 19%, whereas their share within total expenditures shrank from 50.4% and 46.5%. The level of budget expenditure in an

economy is an important indicator of the potency of fiscal policies to respond adequately to shocks calling for a reduction in the expenditure projections. The values reached ran lowest over the last ten years and were mainly due to the reduction in wage bill costs from 7.7% of GDP in 2000 to 6% in 2001.



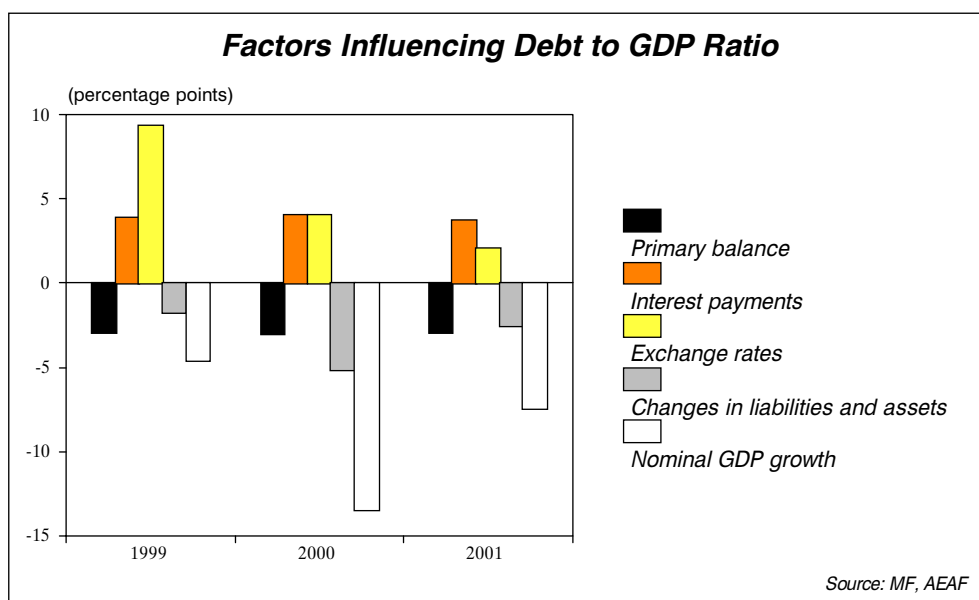
The sustainability of expenditure policies was also affected by the lower LIBOR - induced contraction in interest expenditures (since mid-2000) and the balanced issuing policy. The implicit interest rates on the domestic and foreign debts had nonetheless gone on the increase. The more expensive domestic financing was indicative of

the lack of financial repression. The higher price of domestic financing was among other things influenced by as follows: a 12.9% decrease in the average annual domestic debt size; prolonged maturity of government

securities in circulation from 25.5 to 35.4 months and the large share of official creditors in the debt structure. The existence of financial repression on the part of the government implies some control on capital flows and supervision of local financial intermediaries. Financial repression is also a source of fiscal risk that can make domestic debt financing expensive in the long term letting it loose out of control.

In 2001, the consolidated government budget cash deficit was mainly financed by revenues raised from the start-up licence fee of the second GSM operator and the BGN 674.8 mln worth of dividend paid by the BCC outweighing the importance of privatisation revenues (BGN 180.8 mln) to the financing process. The increase in deposits and funds on accounts (BGN -290.1 mln) offset the positive net worth derived from transactions in government securities (BGN 67.8 mln). Due mainly to the large amounts of payments to the Paris Club and the IMF, external financing²⁹ amounted to BGN -383.6 mln.

Underpinned by the nominal-term GDP growth, the government debt/GDP ratio in end 2001 slipped by 7 percentage points down to 70.1% on a year earlier. The consolidated government budget primary surplus run in the same year, the policy of deficit financing by privatisation revenues and external debt buyback also made a significant



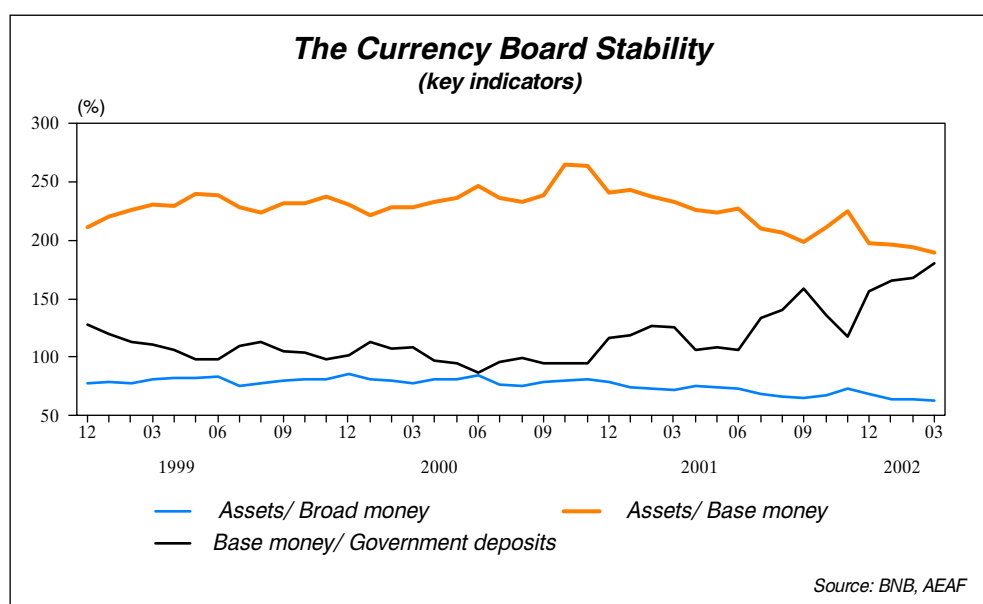
contribution to the debt's decline. At the same time, it was the depreciation of the EUR to the US currency for the third year in a row and interest payments at work that hindered the government debt/GDP ratio from decreasing.

²⁹ For the purposes of accurate reporting and precise estimation, the BNB – net item has been transferred from domestic to external financing, taking into account the country's arrangements with the IMF.

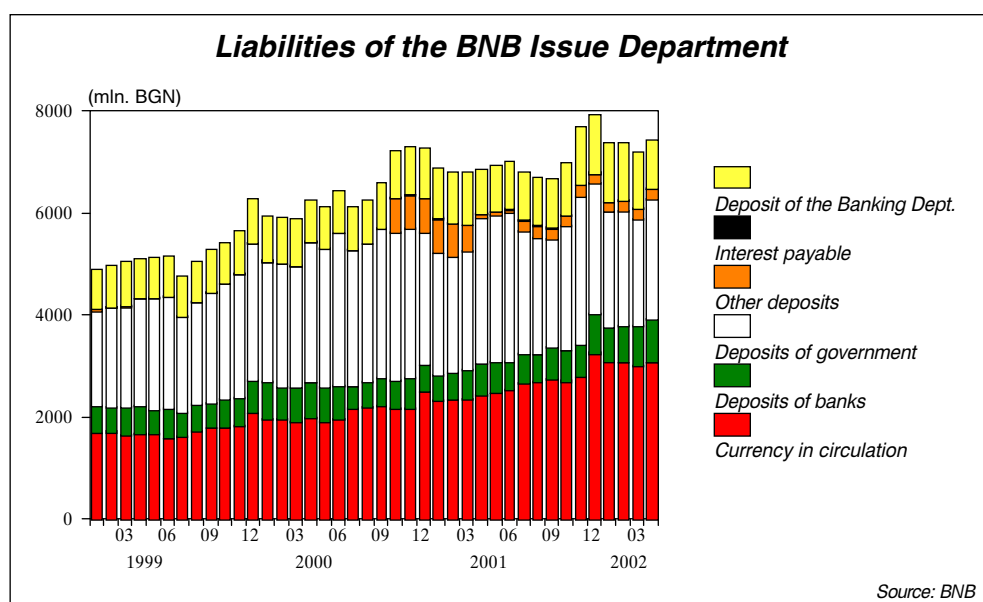
FINANCIAL SECTOR

Currency Board

The upward trend in BNB's Issuing Department assets was sustained in 2001 as well. In end-year, the currency board assets stepped up by 9.2% in BGN terms on a year earlier to reach BGN 7 943 mln. The assets structure underwent substantial changes. The share of foreign currency cash in hand contracted by 5.9 percentage points to 20.8% of total assets. At the same time, tradable foreign securities accounted for 70.4% of total assets, reporting a 6.8 percentage points increase.



balance sheet as the share of government's deposits went on the decrease at the expense of the growing relative share of base money. However, the stability of the currency board is not at risk as a result of the



The forex reserves/ base money coverage ratio followed a downward trend throughout most of the year. The indicator's value reached 197% in end-2001 against 240.8% in end-December 2000. The considerable fall in the indicator's level was associated with the changes in the liabilities side structure of the Issuing Department's balance sheet as the share of government's deposits went on the decrease at the expense of the growing relative share of base money. However, the stability of the currency board is not at risk as a result of the reported fall in the forex reserves/base money coverage ratio since the gross international foreign exchange reserves considerably exceed the aggregate amount of the central bank's monetary liabilities.

Government and budget organisations deposits amounted to BGN 2 571.2 mln in end-2001, shrinking by 1.4% on

a year earlier. Over the same period, the Banking Deposit with BNB's Issuing Department reported a substantial increase of 20%, reaching BGN 1 146.6 mln. The Banking Department's deposit with BNB's Issuing Department/commercial banks' deposit base coverage ratio went on the increase in the fourth quarter, to reach 13.5% in end-year, or 1.1 percentage point higher than in end-December 2000.

In 2001, the central bank continued to pursue the same passive monetary policy it had followed since the introduction of the currency board arrangement (CBA). Unlike the central banks of the other accession countries with a functioning CBA, the Bulgarian National Bank can use its limited monetary policy instruments only if the overall liquidity of the interbank market is at risk. The adjustment of the minimum reserve requirement ratio from 11% to 8% in mid-2000 that aimed to provide an additional liquidity to the banking system and to reduce commercial banks' expenditures was the only exception to this practice. After the introduction of the CBA in Bulgaria, the central bank does not seem to have actively encouraged the consolidation, universalisation and integration in the sector by purposefully organizing and using its available instruments to foster the development of sound and internationally competitive universal banks.

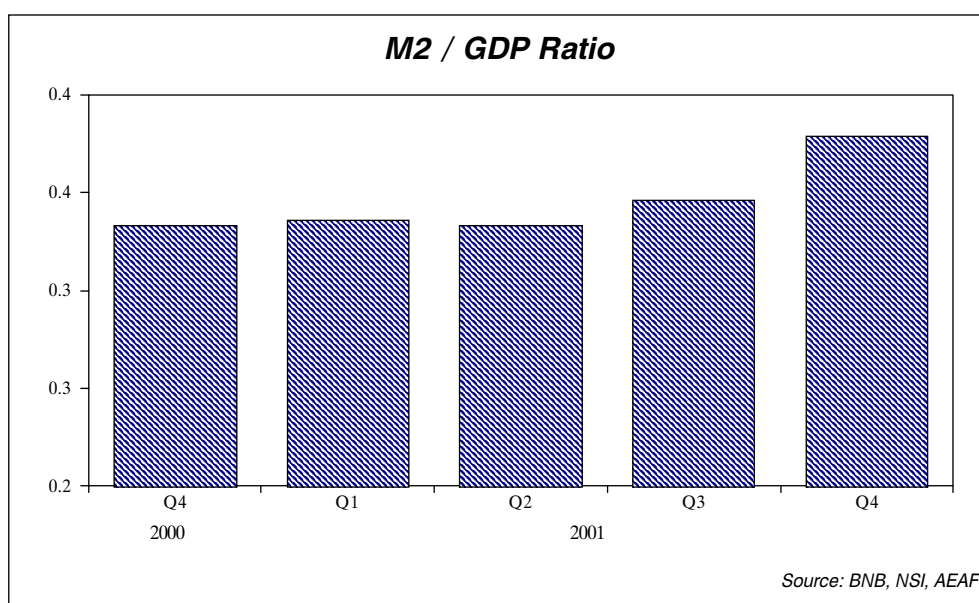
In 2001, the BNB resorted only once to its set of monetary instruments. In October, taking account of the deterioration of the banking system's liquidity in the preceding two months, the central bank changed the spot value date for foreign currency direct sales to the BNB by the commercial banks to one day instead of the previously applied three-day period. This decision produced immediate results and, consequently, the banking system experienced no liquidity problems till the end of the year.

Money Supply and Bank Credit

In 2001, money in circulation rose by 30.3%. Its highest increase was registered in December due mainly to the forthcoming introduction of the euro banknotes and coins and the related sales of large quantities of foreign currency by households and firms alike.

Monetary aggregate M3 stepped up by 24.8% nominally or BGN 2 303.4 mln, and by 19.1% in real terms.³⁰ Thus, broad money reported a higher real-term growth in comparison to 2000 when they increased by 13.6%. In 2001, the real-term rise of its BGN component (22.2%) outstripped the real growth rate of the foreign currency component (15.1%).

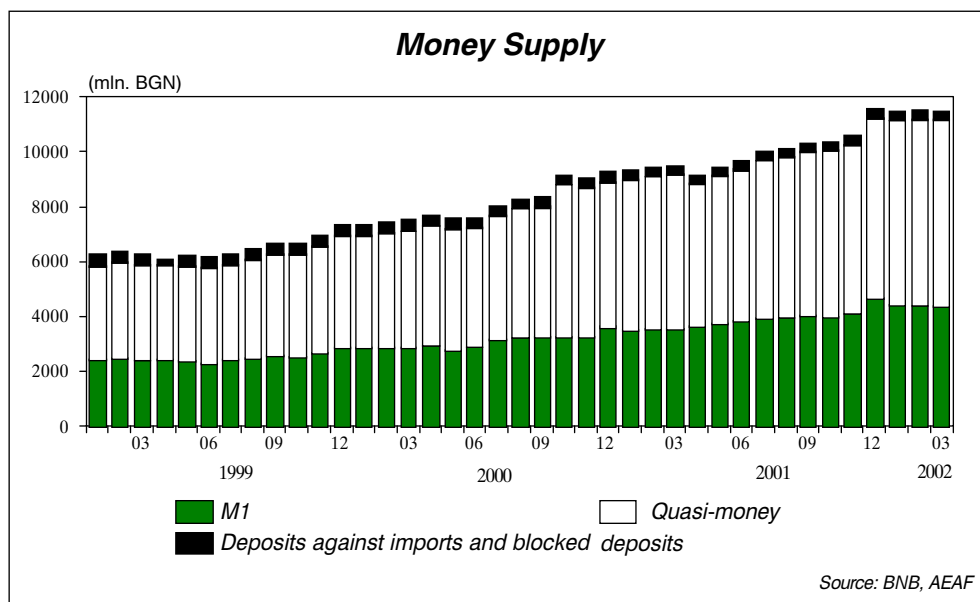
The remonetisation of the Bulgarian economy, measured by the M2/GDP ratio was sustained in 2001. The higher indicator's values were a result of the restored confidence in the national



³⁰ The real-term change of monetary and credit aggregates is calculated, deflated by the CPI in the period reported.

currency and in the economy as a whole. In end-2001, this ratio reached 38% against 33% in end-2000. In 2001, quasi-money reported a 24.4% nominal growth (BGN 1 287.7 mln) and an 18.7% real-term rise relative to end-December 2000. Regardless of its higher annual relative growth rate of 28.5%, the BGN component's contribution (BGN 403.3 mln) to the overall annual increase of quasi-money ran lower than that of the foreign currency component (BGN 884.3 mln). Time and saving deposits also registered considerable growth rates, stepping up by 32% and 21.3% respectively relative to 2000. The increase of foreign currency deposits was due to the fact that households and firms alike placed their free national denominations of the euro with the banking system. The appreciation of the US dollar in the last quarter of 2001 also contributed to the increase of forex deposits regardless of the fall in interest rates on USD deposits.

The growth rate of highly liquid money M1 outstripped the growth pace of broad money. Monetary aggregate M1 stepped up nominally by 28.4% on a year earlier, and by 22.5% – in real terms, reporting faster growth rates than in 2000. For comparison, in 2000, highly liquid money rose by 21.2% nominally, and by 8.9% in real terms. In 2001, economic agents opted for higher liquidity and the usage of the national currency



as a means of payment went on the increase.

Money outside banks and bank reserves reported higher growth rates in 2001 than those of deposits with banks. As a result, the ratios bank reserves/deposits and money outside banks/deposits increased from 9.4% to 11.2% and from 34.3% to 36.2% respectively. The higher

values of both indicators contributed to the decrease of money multiplier from 3.08 in 2000 to 2.88 in 2001.³¹ Had the impact of the exchange rate on monetary aggregates been taken into account, money multiplier's value would have fallen to 2.83. Therefore, the increase of broad money was due to the substantial growth of narrow money (M0) – by 33.5% or BGN 1 012 mln.

In 2001, domestic credit nominally increased by 17.6% (BGN 816.7 mln) on a year earlier, reporting higher year-on-year growth rates than in 2000 (y-o-y rise of 9.8%). Its real-term rise over the same period ran at 12.1%. Domestic credit grew at a faster pace than net foreign assets thereby indicating that commercial banks had withdrawn some of their funds deposited abroad to increase credit lending to the national economy. The lowering of interest levels at the international markets also induced the contraction of net foreign assets.

³¹ It should be noted though that in end-2000, the revenues for the sale of Bulbank deposited with BNB's Issuing Department were included in quasi-money. Later, in 2001, these funds were transferred in the government's deposit and therefore, they are no longer part of broad money. These transactions additionally affected the multiplier's value.

At the same time, credit to the government sector went on the decrease. In 2001, the government seemed to have withdrawn from the credit market in comparison to the preceding year. In 2001, net credit to the government shrank by 9.3% on a year earlier, or by BGN 42.5 mln whereas in 2000, it had increased by BGN 331.7 mln, stepping up over twofold against the preceding year.

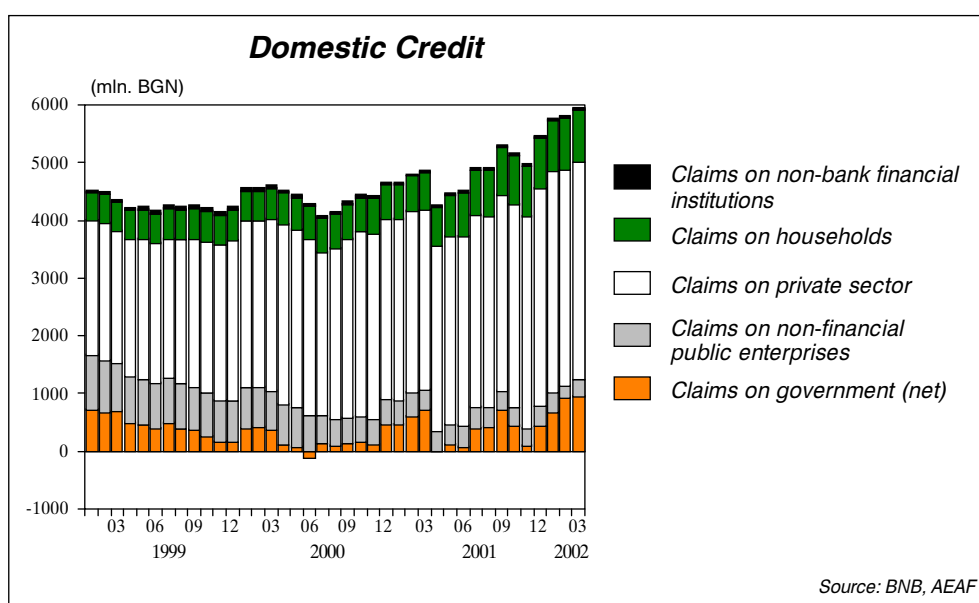
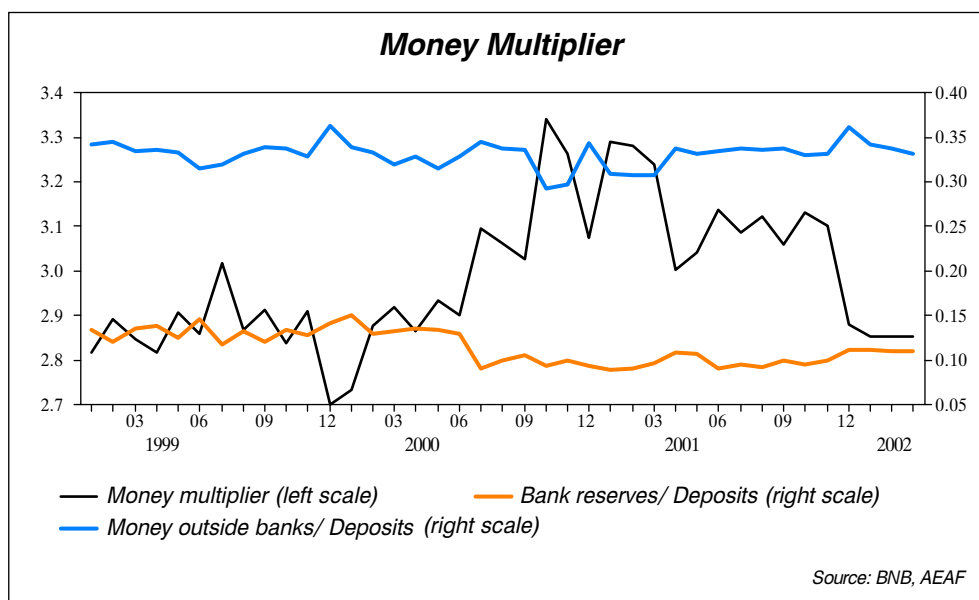
Lower credit to the government sector freed additional resources for credit lending to the non-financial sector. Credit to the non-government sector nominally rose by BGN 862.2 mln (up 20.7%) while its real-term growth ran at 15.2%. Credit lending to state-owned

enterprises sustained its downward trend in 2001 as well, contracting by 18.9% in nominal terms (BGN 79.6 mln) on a year earlier, and by 22.6% in real terms. Loans extended to households, private companies, and non-bank financial institutions increased by 45.1% (BGN 272.5 mln), 21.1% (BGN 658.1 mln) and 45.8% (BGN 11.1 mln) respectively.

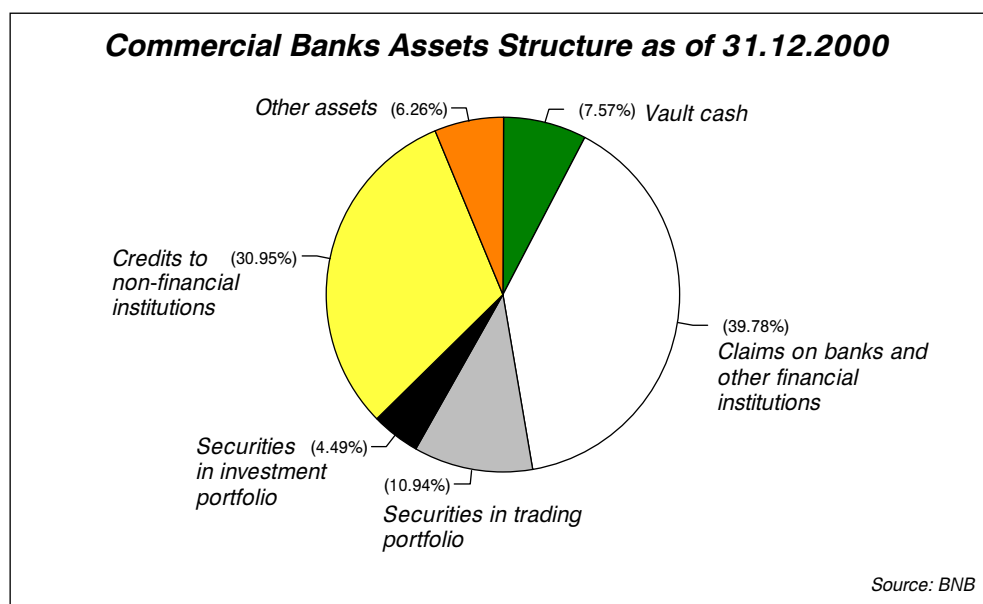
Banking System

In 2001, the banking system assets rose by BGN 2 466 mln (25.3%) to reach BGN 12 203.7 mln in end-December 2001. The foreign currency component of assets contributed BGN 1 461.2 mln to the above increase against BGN 1 004.8 mln worth of contribution of the BGN component. As of 31 December 2001, the three largest banks (*Bulbank*, *United Bulgarian Bank (UBB)* and *DSK Bank*) held 46.1% of all assets of the banking system (cf. 49.9% as of end-December 2000).

In 2001, commercial banks' asset structure underwent some changes, particularly noticeable in the second half of the year. As of 31 December 2001, the share of credits to non-financial institutions and other

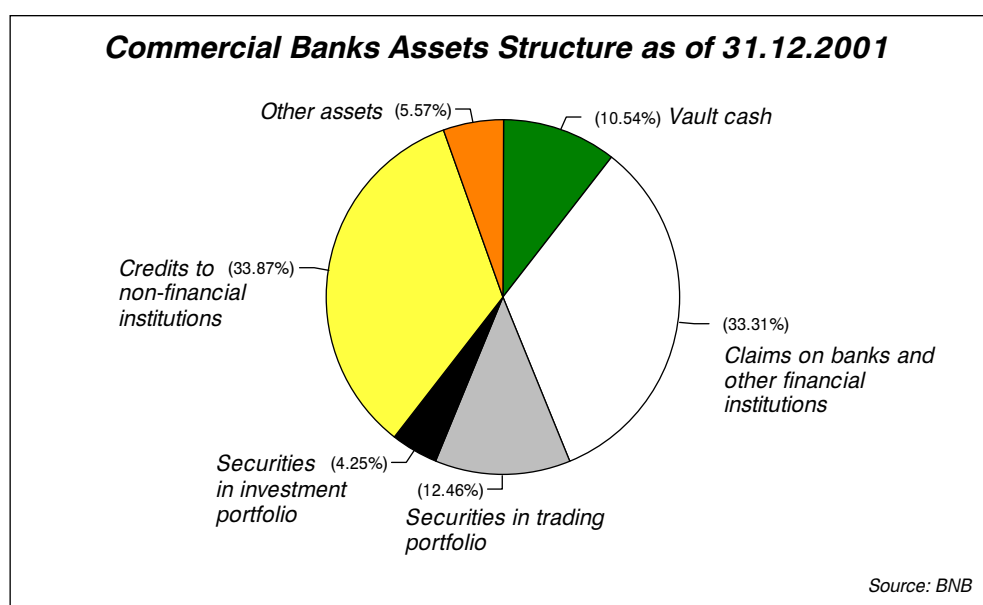


clients grew by 2.9 percentage points on a year earlier up to 33.9%. The relative share of claims on banks and other financial institutions (and predominantly on foreign banks) shrank by 6.5 percentage points to reach 33.3% of total banking system assets. This trend is likely to be sustained in 2002 due to the falling rate of return on deposits with foreign banks triggered by the general lowering of interest rates at the international financial markets. The measures undertaken to remove the legislative shortcomings hampering credit lending to the real economy was another factor behind the growing relative share of credits to firms and households. The share of cash balances in total assets grew by 3 percentage points on a year earlier to reach 10.5% in end-2001 mainly due to the increase of the foreign currency component of the most liquid element of bank assets. This change in the asset structure had to do with the introduction of the euro banknotes and is therefore temporary in nature.



No visible changes in the trends in the banking system liabilities structure were discerned in 2001. The share of deposits of non-financial institutions and other clients stepped up by 5.2 percentage points to 70.9% at the expense of the contracting relative share of the other liability components. In 2001, the deposits of non-financial institutions and

other clients increased by 35.2% or BGN 2 253.3 mln. For comparison, their growth in 2000 ran at only 16.8% or BGN 922.6 mln.

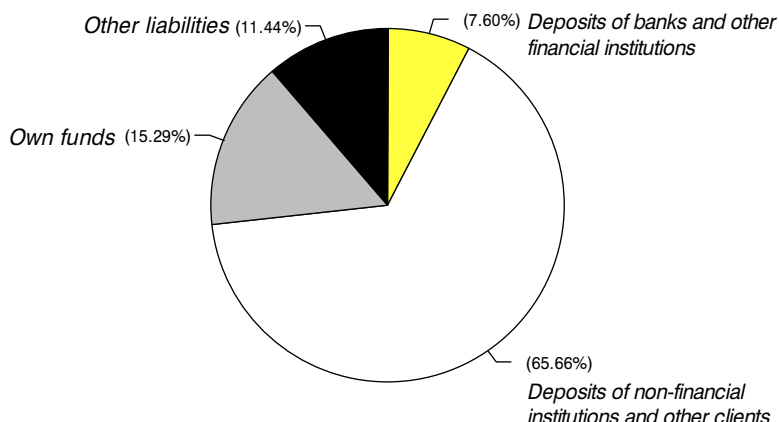


The asset structure of the banking system by type of ownership underwent no substantial changes since no major bank privatisation deals were concluded in 2001. As of 31 December 2001, the share of private bank assets accounted for 80.1% (against 80.2% in end-2000) of the banking system total assets while the remaining 19.9%

(19.7% in end-2000) were held by state-owned and municipal banks. In end-December 2001, some 76% of total bank assets as compared to 73.3% in end-2000 were in the hands of foreign banks or foreign investors.

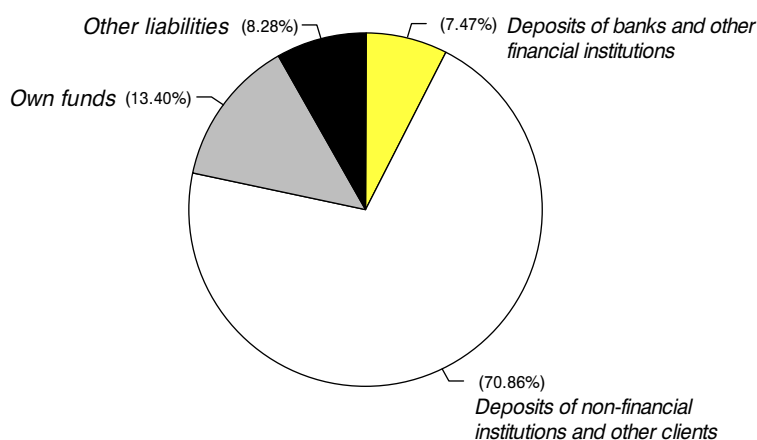
The slowdown in the bank privatisation process monitored in 2001 had mainly to do with the changes in the top level of government and public administration following the general elections held in mid-year yet it did not impede the strengthening of bank competition. On the contrary, the effect from the privatisation of most of the state-owned banks in the preceding four years – manifesting itself in the decrease of concentration and intensification of bank competition – was most vividly felt in 2001. Almost all indicators gauging the degree of concentration in a given sector such as the concentration coefficient and Herfindahl Index fell in end-2001 to their lowest levels discerned in the last decade.

Commercial Banks Liabilities Structure as of 31.12.2000



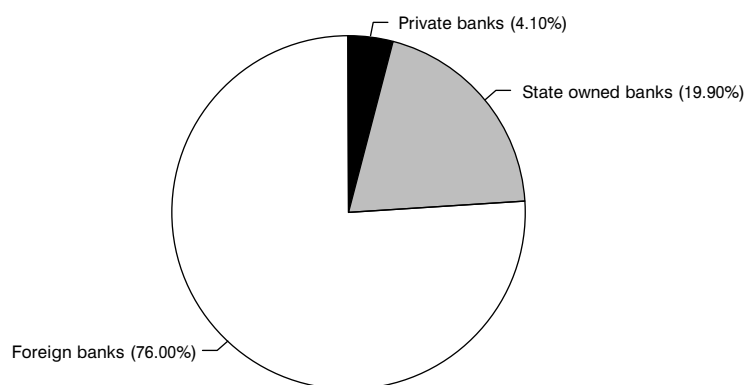
Source: BNB

Commercial Banks Liabilities Structure as of 31.12.2001



Source: BNB

Ownership Structure of Bank Assets



Source: BNB

Measures of Concentration in the Banking Sector

	XII.1991	XII.1993	XII.1995	XII.1997	XII.1999	XII2000	XII.2001
Bank assets							
<i>Herfindahl Index</i>	0.38	0.3	0.14	0.27	0.12	0.11	0.09
<i>Concentration Coefficient (%)</i>	80.9	73.4	60.0	72.3	57.0	55.2	51.4
Claims on Non-financial Institutions and Other Clients							
<i>Herfindahl Index</i>	0.18	0.24	0.14	0.14	0.08	0.07	0.07
<i>Concentration Coefficient (%)</i>	69.2	66.0	57.8	62.4	43.6	42.0	41.1
Deposits of Non-financial Institutions and Other Clients							
<i>Herfindahl Index</i>	0.15	0.15	0.13	0.15	0.13	0.13	0.11
<i>Concentration Coefficient (%)</i>	66.2	57.3	54.3	65.8	61.7	62.2	58.2

Source: J. Miller, S. Petranov, „Banking in the Bulgarian Economy“, 1996; BNB; AEF

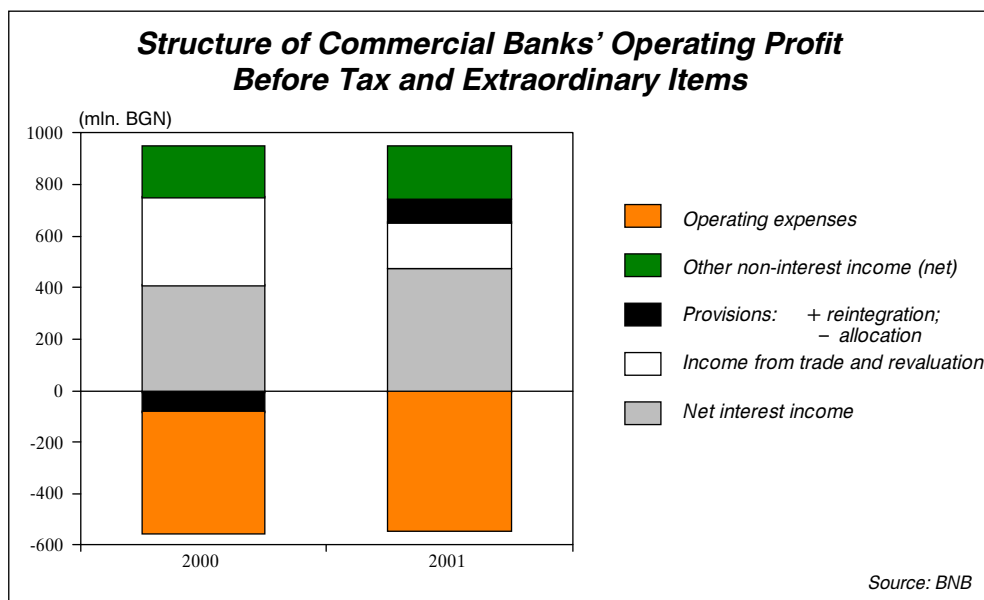
Striving to attract new clients, large and small commercial banks alike seek to offer new products and services and to identify and focus on new market niches. The universal banks offering the whole range of bank services and products such as *Bulbank*, *DSK Bank*, *UBB*, *Biochim Commercial Bank*, *SG Expressbank*, *Postal Bank* and other gradually emerged as the front-runners. Most of these banks are in the hands of foreign investors. It is conceivable that they will remain the only banks offering the whole set of bank services in the medium term. Increased competition in the sector makes it even more difficult for the small and some of the medium-sized banks to operate as universal banks. Thus, some of them are forced to focus and specialise in the offer of specific bank services, such as corporate banking, credit lending to small and medium enterprises, agricultural credit, purchase of warehouse receipts, mortgages, etc. It is noteworthy though that with a few exceptions the management of these banks had never publicly declared that they would give up universal banking. On the one hand, such a stance is indicative of the lack of a well-defined market strategy. On the other hand, a similar attitude on the part of the small and medium banks speaks that the Bulgarian bank market is still underdeveloped, considerably lagging behind the developed markets of the EU member states. In the medium term, those of the smaller banks that have managed to specialise in trade in a particular market niche, and thus to become sufficiently competitive, are likely to survive. Consolidation is the most reasonable and likely option of the remaining small banks. Unlike the Bulgarian small and medium-sized banks, the branches and subsidiaries of foreign banks in the country typically trade in a specific market segment while a certain part of them refrains from retail banking. Most of the foreign bank branches and subsidiaries concentrate on a specific group of corporate clients.

In 2001, the profitability and financial situation of the banking system remained stable. Out of 35 operating banks, only 4 small banks and 2 foreign bank branches reported losses at the end of the financial year. As of end- December 2001, commercial banks net profit ran at BGN 299.2 mln as compared to BGN 274.2 mln reported in 2000. The banks included in the first bank group according to BNB's classification, viz. *Bulbank*, *DSK Bank* and *UBB*, accounted for about 75.3% of total banking system profit. The substantial increase in operating profit in 2001, and particularly in March and April, had to do with the considerable income from the reintegration of provisions, reflecting the relative improvement of the business climate for banking in

Bulgaria as a result of the structural reforms carried out in the last few years.

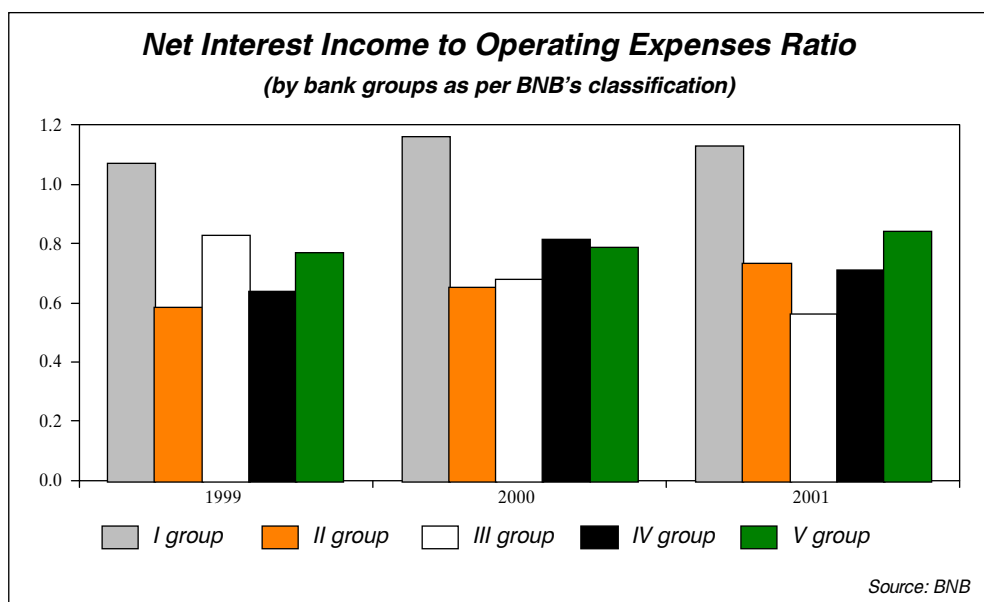
On a year earlier, the changes in the structure of bank operating profit included an increase in the share of income from reintegration of provisions at the expense of the shrinking share of the traditionally weighty components such as net interest income and net income from commissions and fees.

The net interest income/operating expenses ratio ran at 86% in end-year, reporting a 1.7 percentage point year-on-year decrease. The value of this indicator in the largest banks is close to or higher than 1, indicating that they were capable to cover their operating expenses with their operating profit. At the same time, the ratio hit



much lower values than 1 in most of the small banks. Such low values are a sign that small commercial banks have an inadequate capacity to cover their operating expenses with their operating profit and, *ceteris paribus*, they remain less competitive than larger banks. The above-mentioned discrepancies in the banking system have persisted over time and therefore provide a weighty argument in favour of its restructuring and probable future consolidation of small commercial banks.

The central bank's stance toward the structural changes in the banking sector seems to be neutral. Such an attitude is to a certain extent dictated by the requirements of the currency board arrangement, restricting the ability of the BNB to exercise any active tuning of the banking sector. Still, the BNB is not entirely



deprived of instruments to guide the sector. Apart from its exclusive right to determine the minimum reserve requirements of commercial banks and the method of their calculation, the central bank largely sets „the rules of the game“ in the banking business with the help of its prudential regulations. Moreover, the BNB is the only institution authorised to issue bank permit licences, and therefore to decide on the entry on the

bank market. Increasing competition and the growing necessity for restructuring and consolidation of the banking sector will most probably force the Bulgarian National Bank to abandon its passive and neutral stance. It is not unlikely that the BNB will take a firmer stand with regard to the issue of new bank licences and will reinforce supervision over smaller commercial banks.

In 2001, commercial banks' capital adequacy indicators sustained significantly higher levels than those fixed by BNB's Ordinance No8. As of 31 December 2001, the banking sector (foreign bank branches excluded) overall capital adequacy reached 31.14%, stepping down by about 4.4 percentage points relative to end-2000. On a 12-month basis (end-2001 to end-2000), the indicator's two principal components, viz. the total risk component of the sector assets and the capital base had increased by 26.5% (BGN 1 029.6 mln) and 11% (BGN 151.1 mln) respectively. The lowering of the unduly high capital adequacy indicators discerned in 2001 confirms that commercial banks had reversed their approach to credit lending to the real sector of the economy.

Commercial banks credit portfolio had improved relative to end-December 2000. Thus, in end-2001, some 92.3% of bank risk exposures were classified as standard against 91.7% in December 2000. In the end-December 2001, some 2.5% of credit exposures were classified as a loss as compared to 3% a year earlier. The increased bank claims on firms and households did not result in a deterioration of commercial banks' credit portfolio.

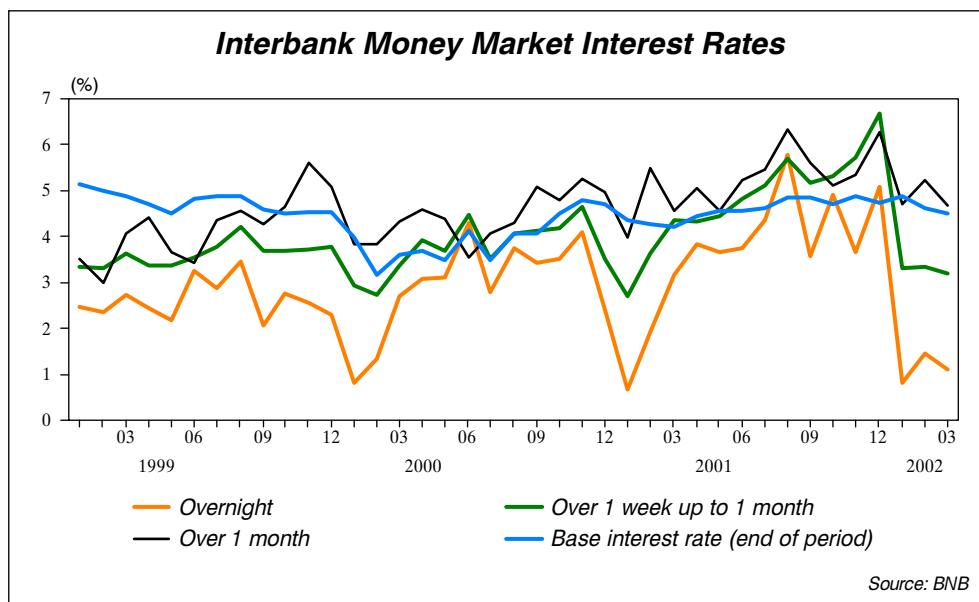
As of end-December 2001, the banking system maintained higher liquidity than in end-2000. The rise in the indicator's value was probably due to the larger purchases of foreign currency made by commercial banks having to do with the above mentioned withdrawal from circulation of the national currencies of the countries in the euro area. In December 2001, the banking sector primary liquidity indicator ran at 13.47% against 10.36% in December 2000. The value of secondary liquidity indicator amounted to 25.47% against 25.98% reported in December 2000.

Money and Foreign Exchange Markets

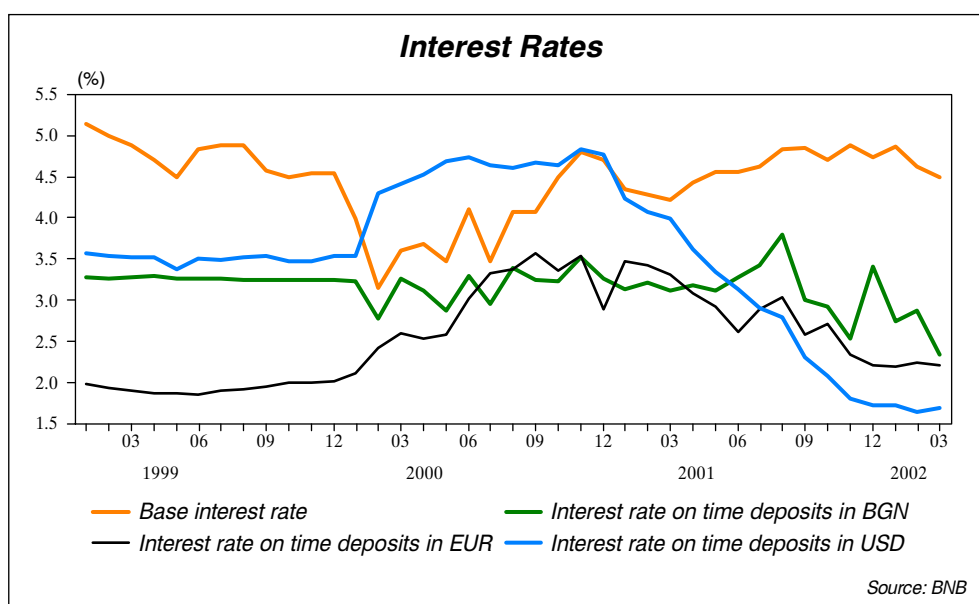
The base interest rate (BIR) remained stable throughout 2001. At the BNB auctions, demand for 3-month treasury bills reflected the BGN liquidity of the banking system. Therefore, in early-2001 when the received maturity payments on government securities substantially exceeded the worth of new issues, and demand for 3-month bills soared, the base interest rate slumped to under 4%. The trend was reversed in the forthcoming months and in the second half of the year the BIR fluctuated within a band of 4.5-5%. On the whole, in 2001 the base interest rate fluctuated considerably less than in 2000 and the value of its standard deviation was twice lower than a year earlier.

Interest levels at the interbank money market in BGN were also strongly affected by the inflow of liquidity to the banking system from the budget in early-2001. In January, interest on overnight placements fell to under 1%. In the following months till May, interest rates returned to their previous year average levels. Although the second half of the year witnessed no great interest rate fluctuations, the upward trend was sustained and in December the average interest on interbank placements reached 5.38% against 2.64% in December 2000, indicative of the existing liquidity management problems in certain banks. The average annual interest rate on interbank market placements in 2001 exceeded by only 0.4 percentage points its average value in 2000.

In 2001, the volumes of interbank market placements were considerably larger than the volumes traded in the previous year. The average daily volumes of interbank placements increase two-fold on a year earlier which is a sign of the improving efficiency of the interbank market in regulating liquidity of the banking system.



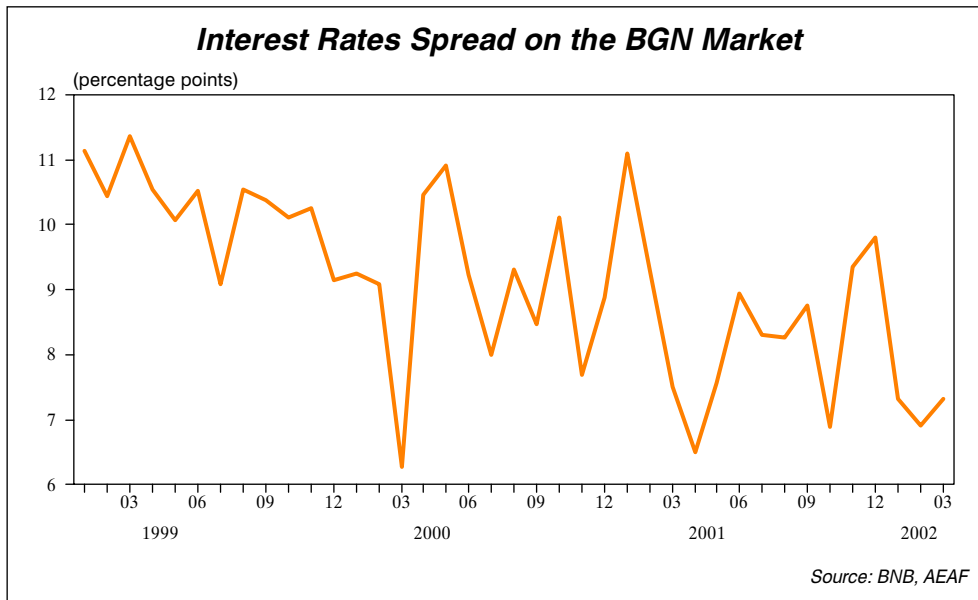
Deposit interest rates followed diverse dynamics depending on the currency of their denomination. While interest levels on time deposits in EUR and BGN remained relatively stable at around 3%, interest on USD deposits followed a steady downward trend throughout the whole year, reflecting the lowering of interest rates on USD



deposits at the international markets. Thus, in the 12-month period till December 2001, interest on time deposits in USD dropped by 3 percentage points. This trend however is likely to stop in 2002 and gradually reverse by the end of the year.

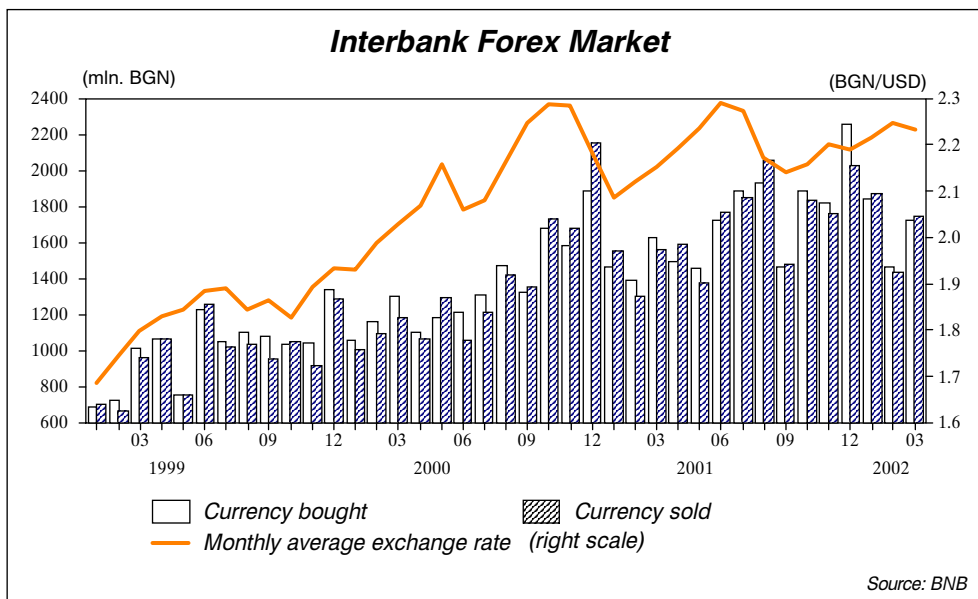
No clear-cut trend in credit interest rate dynamics was monitored in 2001. Although the interest difference between credits and deposits slightly shrank, it still remained well above the levels in most Central and East European countries. The average annual interest difference fell from 9 percentage points in 2000 to 8.5 percentage points in 2001.

The depreciation of the euro to the dollar that started in early-2001 was sustained through July when the slackening of inflationary pressure in the euro area acted in support of the euro, giving rise to expectations that the European Central Bank would lower interest rates and economic growth in the area will resume. In 2001, Federal Reserve's key rates were cut 11 times, falling from 6.5% to 1.75% whereas interest rates in the euro area stepped down by a total of 1.5 percentage points, having been cut on four occasions.



In the last quarter of 2001, the Federal Reserve cut its key interest rates by a total of 1.25 percentage points, thereby acting in support of expectations for a recovery of the US economy. The unfavourable figures on unemployment and industrial production in the euro area also contributed to the depreciation of the euro to the US dollar in the last quarter of the year.

After the serious depreciation of the BGN by 15.6% in 2000, the pace of depreciation attenuated and therefore, 2001 witnessed the smallest average annual depreciation of the national currency reported in the last four years. Following closely the EUR/USD exchange rate dynamics, in 2001 the



BGN depreciated by 2.9% to the dollar on a year earlier. The average annual exchange rate of the BGN to the US currency reached BGN 2.185 per USD. Commercial banks were net buyers of foreign currency at the interbank forex market and the amount of the currency purchased exceeded the amount of currency sold by BGN 245 mln. The structure of transactions by foreign currency underwent substantial changes relative to end-2000 yet the upward trend in the share of transactions in European currencies was sustained. The share of transactions in USD accounted for 28.7% of total trading in December 2001, reporting a year-on-year contraction of 9.5 percentage points. Given the forthcoming withdrawal from circulation of the national currencies in the euro area, the amount of cash foreign currency bought by the BNB in December went on the increase to reach EUR 42.9 mln thereby exceeding even the volumes bought immediately after the introduction of the CBA in Bulgaria.

Non-bank Financial Institutions and the Capital Market

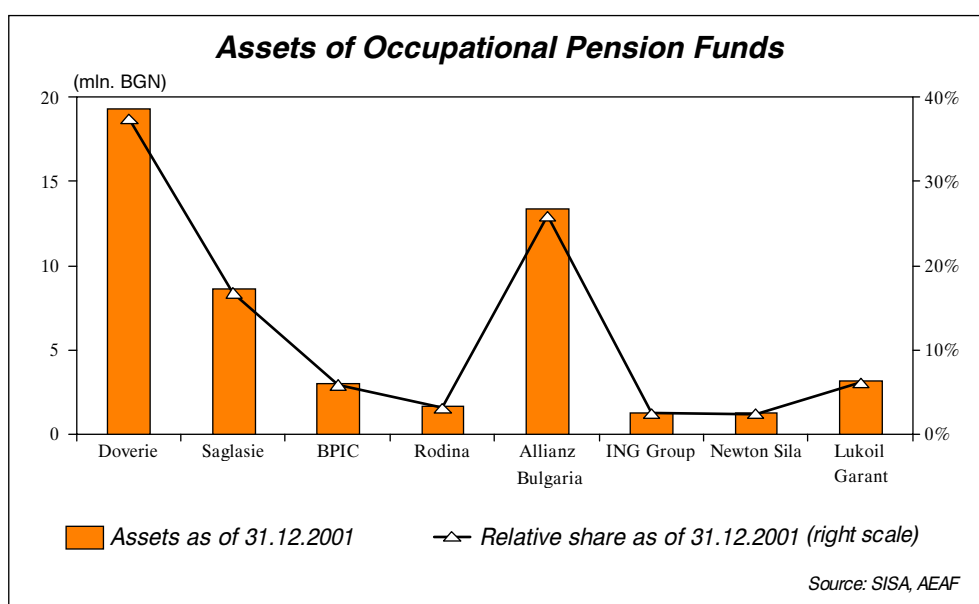
In 2001, the pension insurance system further developed following the entry into force in 2000 of the new

legislative framework regulating its functioning. Eight private pension insurance companies³² had been licensed and each of them set up and registered a universal, an occupational, and a voluntary pension fund.

The deadlines for choosing a universal pension fund and an occupational pension fund elapsed in 2001. The completed filing of applications created the preconditions for establishment of the second pillar of the pension system. The number of filed applications for participation in universal funds amounted to about 1.2 mln while the number of persons additionally insured in an occupational pension fund reached 115 000. The largest number of applications were filed for the universal funds managed by POK *Doverie* and POD *Allianz Bulgaria* AD, respectively 38.4% and 19.9% of all applications.

The assets of occupational pension funds increased to reach BGN 51.5 mln in end-2001. They are very concentrated. The four largest occupational pension funds, viz. *Doverie*, *Allianz Bulgaria*, *Saglasie* and *Lukoil Garant* manage 86.3% of total accumulated assets in occupational funds as of end-2001.

The occupational pension funds started to invest the funds pooled in the individual insurance accounts of the insured persons only in the end of the second quarter of 2001 due to their delayed licensing. The composition of their investment portfolio in end-2001 was not well diversified. In end-year, some 64.5% of occupational pension fund



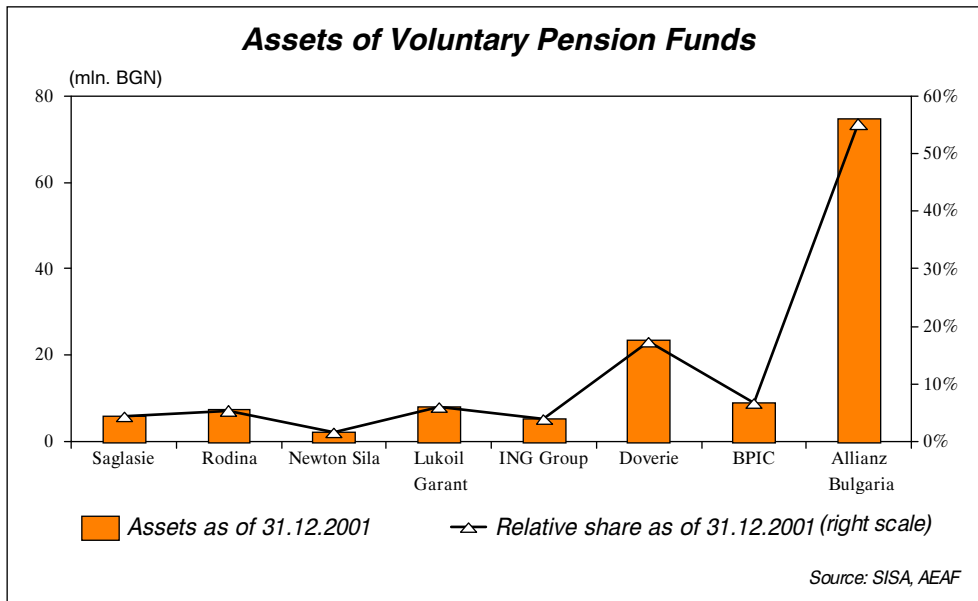
assets were invested in government securities and 33.5% in bank deposits. The remaining assets were invested in municipal securities (0.9% of assets), in securities listed for trading at the regulated markets (0.4%) and mortgage bonds (0.2%). So far, occupational pension funds have invested only at home and none of them has used the possibility to invest up to 10% of their resources abroad due most probably to the lacking clear regulatory framework.

The assets of voluntary pension funds – the third pillar of the pension system – also increased (by 56.6%) to reach BGN 135.4 mln in end-2001. The role of pension funds as financial intermediaries, helping to better distribute free money resources across the economy, also stepped up. The number of insured persons rose by 18.6% against end-2000, reaching 451 158 people. *Allianz Bulgaria* and *Doverie* accounted for the largest shares in the total number of insured persons in voluntary pension insurance funds, respectively 53.1% and 18.4%.

Voluntary pension funds assets are highly concentrated as well. In end-2001, *Allianz Bulgaria*, *Doverie*, *Balgarsko pensionnoosiguritelno druzhestvo* and *Lukoil Garant* managed 84.9% of the total assets in this

³² POK „Doverie“ AD, POK „Saglasie“ AD, „Balgarsko pensionnoosiguritelno druzhestvo“ AD, SKPOK „Rodina“ AD, POD „Allianz Bulgaria“ AD, „ING Pensionnoosiguritelno druzhestvo“ AD, POAD „Newton-Sila“.

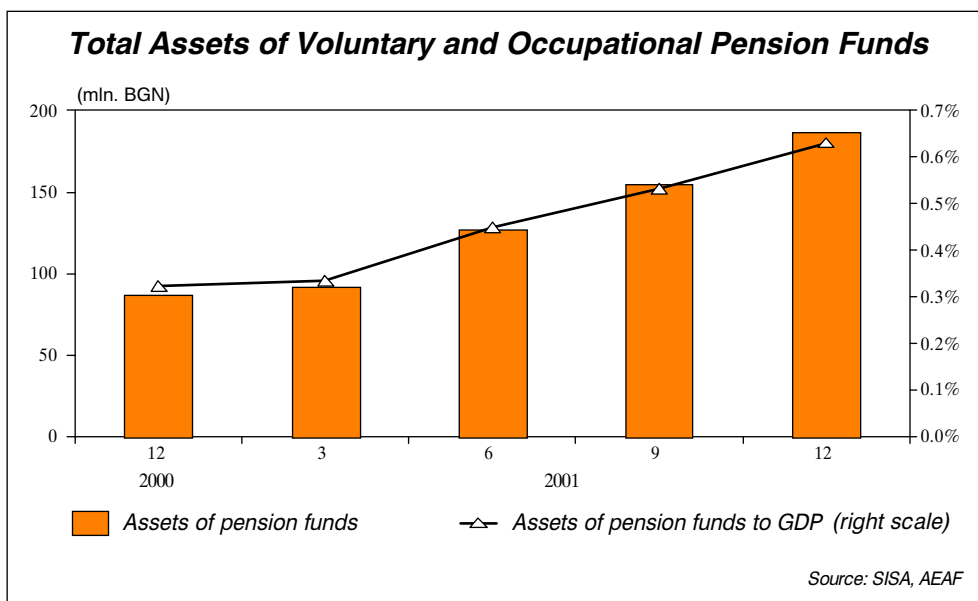
segment against 93% in end-2000. It is noteworthy that one of the new pension insurance companies, namely *Lukoil Garant*, was successful in rapidly attracting about 6% of voluntary pension fund assets and emerged as the fastest expanding new entrant on this market.



The investment portfolio of voluntary pension funds is not diversified either. It comprises mainly government securities (44.4% in end-2001) and bank deposits (38.2%). In 2001, these funds also invested in some of the first mortgage bonds issued by *First Investment Bank* and the *Bulgarian-American Credit Bank* at

the Bulgarian Stock Exchange.

The ratio of voluntary and occupational pension funds assets to GDP stepped by 0.31 percentage points up and reached 0.63% in end-2001. The ratio of pension funds assets to gross national savings also increased (by 2.02 percentage points), reaching 4.6% in end-year. However, Bulgaria is considerably behind the degree of financial intermediation of pension funds found in the other pre-accession countries. Underdeveloped financial intermediation of pension funds in Bulgaria was a result of their delayed licensing and the ensuing postponed accumulation of resources in the individual insurance accounts of insured persons.



In 2001, insurance companies expanded their business in the country. There are still no data and figures covering the whole year. Yet, in the nine months of 2001, insurance intermediaries recorded a gross premium income of BGN 305.9 mln, a figure equalling 78.9% of their premium income registered in 2000. The value of this indicator is

expected to have sufficiently increased in the last quarter of the year allowing the annual gross premium income to exceed that in 2000. The economic expansion of insurance companies is a result of both the

increased diversity of services offered and the reduction of the tax rate on insurance and all other premiums and incomes from 3% to 2% in end-2000.

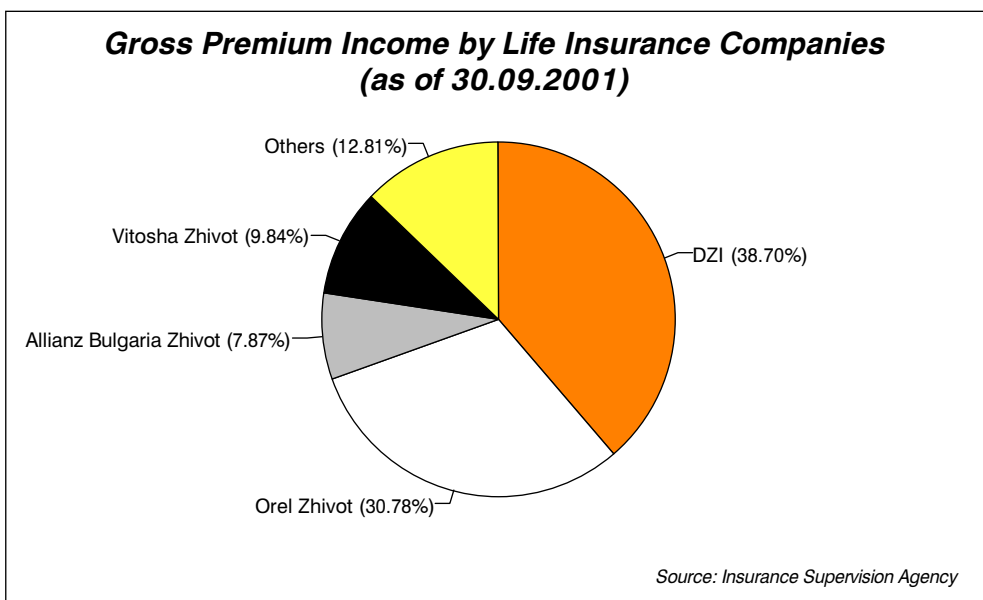
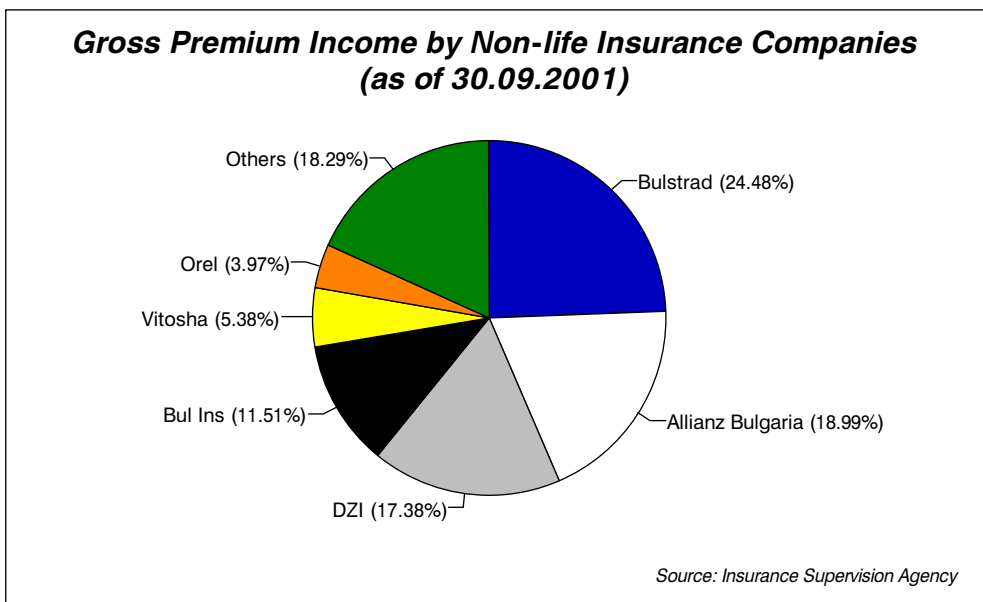
The ratio of gross premium income of all companies operating in either life insurance or non-life insurance to GDP in the end of the third quarter of 2001 stood at 1.43% against 1.45% in end-2000. Judging by the value of this indicator, Bulgaria is still lagging behind other countries such as Latvia and Estonia where gross premium income as a share of GDP ran at 1.99% and 1.85% respectively in end-September 2001.

Market concentration in the insurance sector remained substantial in 2001. The four largest companies *Bulstrad*, *Allianz Bulgaria*, *DZI* and *Bul Ins* accounted for 72.4% of premium income against 71.4% in end-2000. The value of Herfindahl Index measuring gross premium income also stepped up from 0.14 in 2000 to 0.15 in end-September 2001.

Concentration in life insurance is even bigger although a downward trend had emerged. The four largest companies in this segment – *Allianz Bulgaria Zivot*, *Orel Zivot*, *DZI* and *Vitosha Zivot* – recorded 87.2% of the premiums collected in the whole life insurance segment as of end-September 2001 against 90.8% in end-2000. The value of Herfindahl Index in this segment declined from 0.33 in 2000 to 0.26 in September 2001, a sign of intensified competition in the sector. The growing competition is a consequence of increased demand for life insurance products from clients.

The growth of life insurance premium income brought about an

increase of investment of insurance reserves. The growth rate of investment in the first three quarters of 2001 amounted to 9.31%, exceeding the growth pace of insurance premiums. The structure of non-life insurance companies' investment portfolios underwent some changes yet the share of bank deposits remained prevailing.



The share of bank deposits shrank by 8.2 percentage points to 44.9% while the share of government securities rose by 3.2 percentage points to 41.9%. Government securities accounted for the largest share in life insurance companies' investment portfolios comprising 61.2% of total assets in end-September 2001. The reason for the different composition of the portfolios of the two types of insurers is the greater need for liquidity in the non-life insurance segment following the different terms of insurance contracts. Regardless, it is evident that both non-life and life insurance companies' portfolios still lack diversification.

The Bulgarian capital market remains underdeveloped in 2001 as well. The volumes traded on the Bulgarian Stock Exchange (BSE) are several times smaller than the volumes traded at the stock exchanges of Lithuania, Latvia, and Estonia. Thus, the volumes traded in Latvia and Estonia amounted to EUR 761.9 mln and EUR 1 100.8 mln per annum whereas the total annual volume of trade on the BSE ran at EUR 82.1 mln. The main reasons for this can be traced to the low savings rate in Bulgaria in comparison to the Baltic States and the insufficient offer of attractive corporate securities in the country.

In 2001, turnover at the BSE increased by 19.9% on a year earlier, reaching BGN 160.5³³ mln. The shares of 133 companies were no longer traded and, as of end-2001, some 407 share issues were traded on the BSE, out of which 30 issues on the official market. The reduction of the number of companies listed in the public register had no impact on overall trade on the stock exchange since the securities of the deleted companies had not been actively traded at the stock exchange sessions. The low liquidity and transparency of the capital market, the high expenditures required to issue securities, the lack of incentives for a company to go public are among the reasons behind the limited offer of new financial instruments. The legislative and regulatory framework provides no protection of minority shareholders' rights and no just mechanism for compensating the owners of compensatory instruments exists. Specific measures are envisaged for implementation in this respect targeted to foster the development of capital market and to advance economic growth in the country by ensuring a more efficient distribution of free resources across economic sectors. The measures to be taken include: the passage of a law regulating transactions and operations with compensatory instruments (Law on Compensatory Instruments Transactions), the establishment of a single register of compensatory instruments and the organisation of trade in compensatory instruments on the stock exchange. The offer of share capital of large state-owned enterprises (the *Bulgarian Telecommunications Company*, *Bulgarian Maritime Navigation*, etc.) on the stock market can also represent a step forward in the development of capital market in Bulgaria.

In 2001, again the bulk of stock exchange trading was carried out by block or parcel deals. The turnover of block deals amounted to BGN 114.5 mln in 2001, stepping up by 24.8% on a year earlier. The share of block trading within total trading at the BSE ran at 71.3%, up from 68.5% in 2000.

In 2001, the volumes of trading in single shares also increased on a year earlier (by 19.5%) although at a slower rate than block trading. Over-the-counter trading volumes accounted for 89.7% of trading. The new security instruments registered in 2001 on the BSE, viz. the mortgage bonds of *First Investment Bank* and the *Bulgarian-American Credit Bank* contributed to the increase of turnover on the over-the-counter market. The registered end-year active trading in these bonds evidenced the high liquidity potential of these securities.

In contrast to the over-the-counter-market, turnover on the official market of bonds and shares plummeted

³³ Turnover of share repurchase transactions excluded.

by 63% on a year earlier to just BGN 4.4 mln. Turnover on segment „A“ of the BSE wherein only one company is listed, namely *Olovno-Zincov Complex – Kurdjali*, plunged. In 2001, the company's shares were traded only at two sessions with considerable changes in the share price, thereby triggering a hefty decrease in the market capitalisation of the same stock market segment. Similarly, turnover on the corporate bond market fell by 75.5% to BGN 816 900. This segment lists the bond issues of two companies – *ProSoft* and *Energia – Targovishte*.

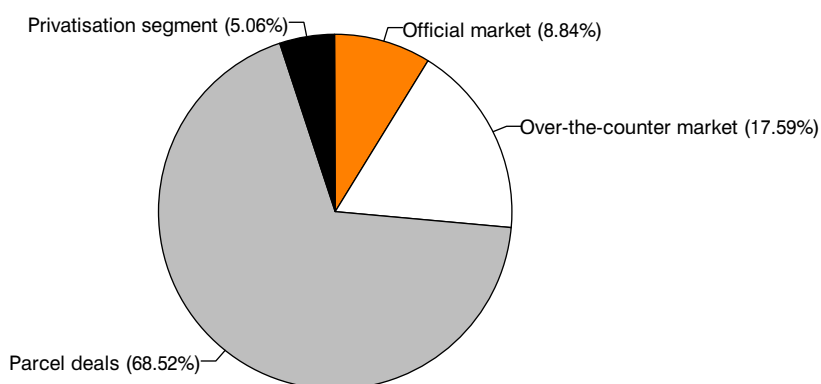
In 2001, no new issues of corporate bonds were listed in the corporate bond segment of the stock market. The Commercial Code imposes clear restrictions on the issuing of corporate bonds. Thus, the issuer must be a public limited company and have at least two annual financial statements approved by the general meeting of shareholders. Another possible reason for the limited number of traded corporate bonds may be found in the lack of credit rating gauging the riskiness of the various companies. The raising of funds through new bond issues is cheaper and it is therefore expected that financing through corporate bonds will expand in the future. High interest rates on commercial bank credits and the higher collateral requirements will induce enterprises to resort to non-bank financing of their businesses.

In 2001, the residual state-owned shares of 15 companies were sold at the privatisation segment of the market for a total of BGN 3.72 mln. For comparison, in 2000, the BSE privatisation segment turnover was much higher at BGN 6.77 mln and the residual parcels of shares of 7 firms were sold.

The BSE official index SOFIX peaked at 118.63 points in end-2001, reporting a year-on-year increase of 11.1%. The index' downward trend monitored in the first half of the year was sharply reversed in end-June 2001 when trading at the BSE picked up substantially.

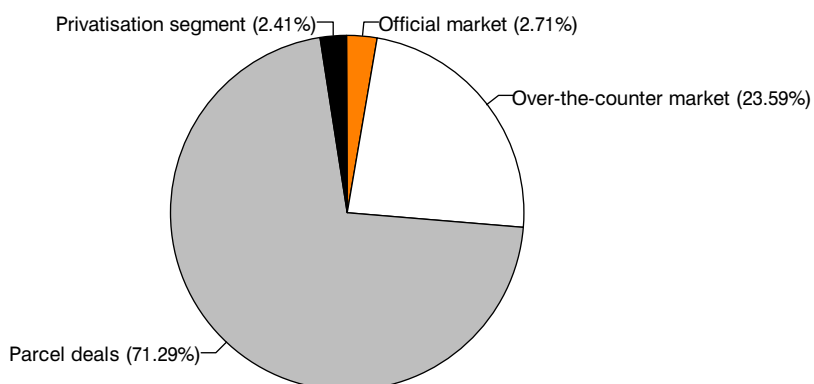
The number of companies on which SOFIX is based was changed in 2001. In

Bulgarian Stock Exchange: Turnover Structure in 2000



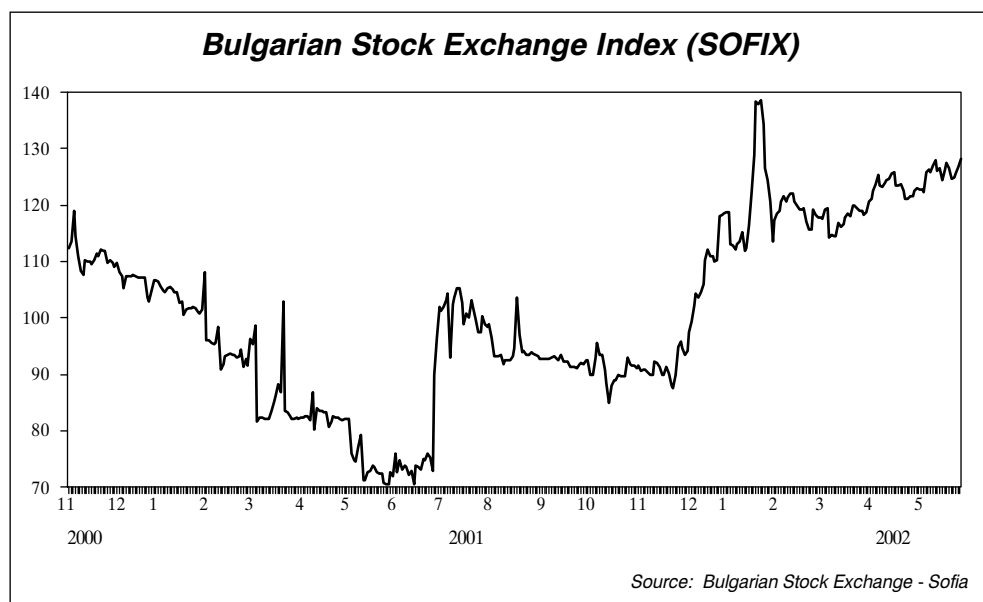
Source: Bulgarian Stock Exchange - Sofia

Bulgarian Stock Exchange: Turnover Structure in 2001



Source: Bulgarian Stock Exchange - Sofia

October and November *Balkanpharna – Dupnitsa* and *Solvey Sodi* were deleted from the public company register after having bid to buy back their shares. They were therefore excluded from the coverage of SOFIX and *Balkanpharna – Dupnitsa* was included.



The market capitalisation of the companies at the BSE declined from BGN 1 288 mln in end-2000 to BGN 1 101 mln in end-2001. The market capitalisation to GDP ratio ran at 3.7% in 2001 against 4.8% a year earlier. One of the reasons for the registered fall was the decreasing number of offerings at the stock exchange. The market

capitalisation to GDP ratio in Bulgaria remains much lower than in the Baltic States. Thus, in 2001 the values of the ratio in Lithuania and Estonia ran at 26% and 28% respectively.

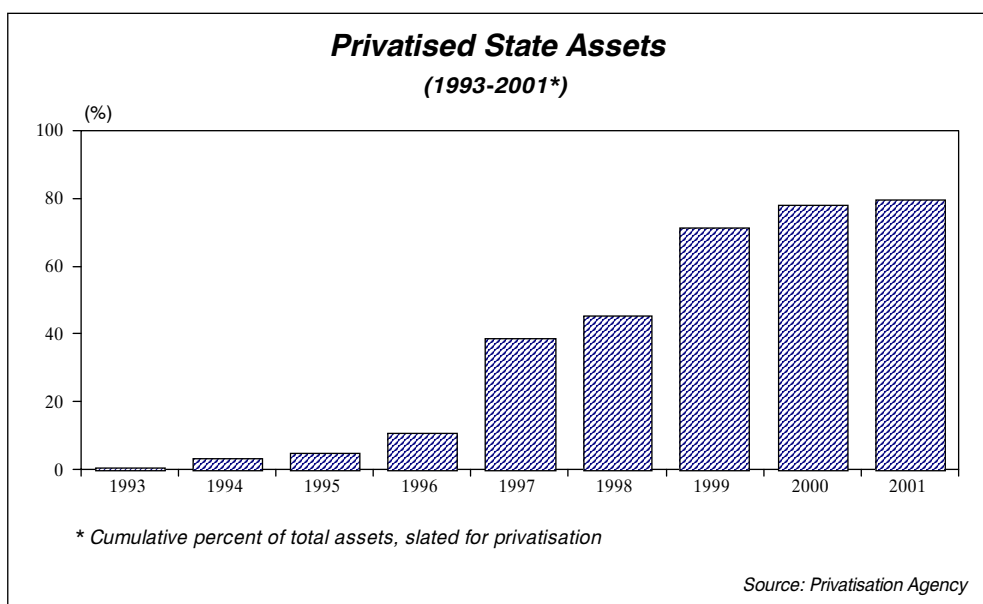
STRUCTURAL REFORMS

Necessity to Further Expand and Develop the Reform Model

In 2001, Bulgaria sustained its economic growth for a fourth year in a row after the 1996-1997 economic and financial crisis. Sustained growth of the national economy is indicative that opting for a combination of a currency board arrangement and sound fiscal policy was the optimal policy mix for a small open economy as the Bulgarian one, given the ongoing economic globalisation. There is a political consensus among policy-makers in the country that the speed-up and completion of restructuring and privatisation of state-owned enterprises is the key prerequisite for the further improvement of competitiveness of the national economy. The Program of the current Bulgarian government has also placed an emphasis on this underlying target. Given the political consensus, government commitments and the appropriate policy mix, the processes of economic restructuring aimed at achieving better competitiveness continued throughout 2001 although their speed was affected by the regular parliamentary elections in mid-year and presidential elections in November.

As of end-2001, some 80% of state-owned assets slated for privatisation had been transferred in private hands and now the private sector produces the bulk of value added in the national economy. There still remain some 1 966 enterprises with a predominant state participation. The majority of state-owned companies awaiting restructuring and privatisation are market monopolies in key public infrastructure and manufacturing industries. They are crucial to the building of a competitive economy, hence to the attraction of foreign investment in the country. Reforms in these sectors, however, have been repeatedly postponed. Economic analyses demonstrate that these companies are not capable of coping with competition pressure after the envisaged opening of the market at the future accession to the EU.³⁴

The new Privatisation and Post-Privatisation Control Act (PPPCA) that entered into force in March 2002 was a major step in the efforts to accelerate structural reforms launched after the financial crisis. The Law principally aims at improving the terms and conditions for privatisation in the country. The PPPCA has provided for equal

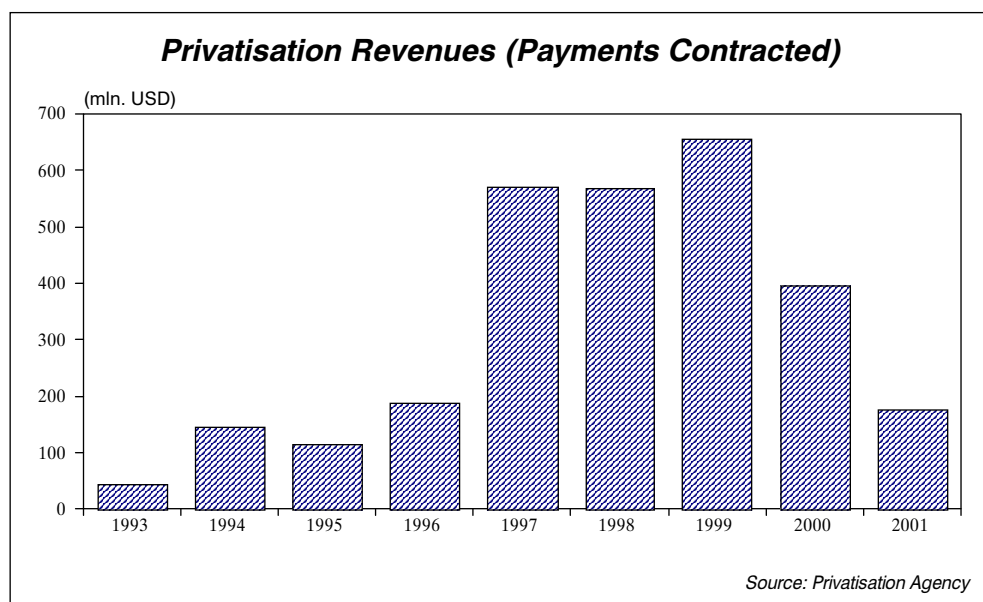


³⁴ European Commission, „2001 Regular Report on Bulgaria's Progress Towards Accession „, 13th November 2001.

treatment of legal entities and physical persons alike, without giving any preference to MEBOs and abolishing the right of employees to buy shares on preferential terms. The privatisation of a detached part of a company with more than 50% of state interest that technologically relates to concession procedures gives the buyer under the privatisation contract the right to step in the function of a concessionaire. State-owned shares in companies shall be only offered by public offering, public auctions and public tenders. Direct negotiations with potential buyers, subject in the preceding years to numerous speculations about corruption and the lack of competence of government authorities in view of their lacking transparency, will no longer be employed.

The act has put an end to mass privatisation and separated privatisation procedures and post-privatisation control, assigning them to different agencies. The Privatisation Agency has assumed full responsibility for the privatisation of state-owned interest in the share capital of companies or detached parts thereof with more than 50% of state interest. A new Agency for Post-Privatisation Control shall be the only competent authority to exercise post-privatisation surveillance in privatised companies. The law also ruled out explicitly any re-negotiation of the commitments undertaken under privatisation contracts.

The *Bulgarian Telecommunications Company (BTC)*, *Bulgartabac Holding*, *Bulgarian Maritime Navigation*, *Bulgarian River Navigation*, 7 electricity distribution companies and 36 district heating companies are slated for privatisation in the 2002 Privatisation Program. Expected privatisation proceeds in case the Programs is performed amount to about BGN 750 mln, out of which cash revenues of some BGN 620 mln.



As evident from the analysis of economic developments in 2001, the country's economic policy faces serious challenges such as low economic activity of the population, a sustained high unemployment rate and a low level of real incomes in comparison to the other EU accession countries. These challenges fall beyond the scope of the

devised post-crisis economic reform strategy and therefore the stabilisation model needs to be developed further to ensure the creation of conditions for a balanced long-term economic growth. Economic theory of industrial organisation under an already dominating private ownership recommends the encouraging of investment, entrepreneurial and labour activities of economic agents as an expedient. The implementation of the above requires broad political consensus on the new priorities of the restructuring process by placing primary importance also on the measures to streamline the regulations governing private sector functioning and those aimed to enhance labour market flexibility. Thus, the development of a modern legislative framework in the key areas specified below will gain momentum.

The first key issue is the creation of an appropriate regulatory framework for summary proceedings in cases of winding-up or insolvency. The second area is to create legislation protecting creditors' rights in the collection of claims. The lack of appropriate legislation in these two areas has been so far one of the reasons for the slow expansion of credit lending, thereby hampering the development of new firms since it forced commercial banks to implement an extremely cautious credit policy and, consequently, additionally raised the price of credit resources.

Third, the amelioration of the overall business climate in the country is predetermined not in the last place by improving transparency in the business environment, suppressing corruption practices and increasing overall security in the country (lower crime level). The accomplishment of these tasks requires that an efficient legislative framework, taking account of the recommendations of international and non-governmental organisations³⁵ be put in place.

Together with the required amendments to current legislation, further improvements are needed in the regulatory and institutional framework for its enactment. The entry of new firms on the market fosters competition and is a major job generation factor. New businesses and jobs supposedly have higher productivity than the existing ones. However, on average seven different permits are needed to start a new business in Bulgaria whereas Estonia and Poland – two of the countries that have well advanced in their reforms – require only three permits.³⁶ Therefore, the review and streamlining of existing regulatory regimes should be one of the priorities of economic policy in 2002. The regulatory regimes must also be consistent with the legislative amendments underway and, to this end, coordination between the various government bodies and the social partners should be enhanced.

The Reform Process in Some Priority Sectors

Energy. The energy sector in Bulgaria – as one of the key infrastructure industries in every economy – faces grave structural problems. The level of energy intensity in the national economy is the highest among all EU accession countries. Energy intensity is now higher than at start of the transition (in 1998, the value of the indicator ran at 1 628 kgoe³⁷/USD 1 000 against 1 332 kgoe/USD 1 000 in 1989). Moreover, household electricity consumption in Bulgaria is three times higher than in Rumania, Slovakia and Lithuania.³⁸

Household electricity tariffs policy is the main reason for the structural disequilibria of the electricity market in the country. Electricity prices have not been used as a powerful tool to boost reforms and investment in the sector as recommended by economic theory. In Bulgaria, energy prices still do not cover energy generation costs. The failure to carry out the envisaged action plan on energy price reforms consistent with recommended international practices and industrial organisation theory has so far primarily been justified with social concerns. The action plan in the sector devised in consultation with the IMF immediately after the 1996-1997 crisis envisaged a phased increase of the average household tariffs to equalise tariffs to industrial consumers by mid-2001. These commitments had not been performed and the inevitable electricity price rises that should be instrumental to the restructuring and rehabilitation of the sector had been postponed for the forthcoming years.

³⁵ *International Transparency Agency.*

³⁶ *Stoiev, G., Macroeconomic Development in Bulgaria after the 1996 – 1997 Crisis. A Labour Market Perspective, 2002.*

³⁷ *Kilogram of oil equivalent*

³⁸ *Energy Strategy of Bulgaria, April 2002.*

Given the above-mentioned circumstances, the low revenues of energy companies impede the implementation of energy-saving measures, which according to a report of the State Agency for Energy and Energy Resources would have resulted in a 17% reduction of total energy consumption. Neither do they encourage investment in the sector thereby forcing the government to undertake additional commitments before the investors.

Electricity Prices 1998 – 2001 (BGN/kWh, VAT excluded)

	1998	01.1999	07.1999	01.2000	07.2000	07.2001	10.2001
<i>Low voltage dispatch and distribution costs</i>							0.084
<i>Industrial consumer tariffs (actual)</i>	0.067	0.071	0.072	0.072	0.072	0.072	0.072
<i>Household tariffs (envisaged)</i>	0.042	0.054	0.059	0.071	0.076	0.084	0.084
<i>Household tariffs (actual)</i>	0.042	0.048	0.048	0.059	0.061	0.061	0.067

Source: Energy Strategy of Bulgaria, April 2002.

The structural disequilibria at the gas market are also grave due to a great extent to status of Bulgargas as a Single Buyer in natural gas imports and the terms of payment with gas suppliers. Gas supplies have been contracted till 2010, however, the contracted volumes are considerably higher than demand. The low and dwindling demand for gas by industrial consumers is conditioned by both the current business cycle state of global economy and the restructuring phase of most companies. Although the advantages of gas as an energy resource has been proven, the development of gas retail sales market is very slow. Again, the main reason for the imbalanced development of this market is to be found in the administratively determined prices and the price setting mechanism preventing investment in the expansion of the transmission and distribution network. Furthermore, the regulatory improvements in this sector in the last few years are not fully taken advantage of, again due to the distorted price setting.

Inconsistent reforms, including those in the last years, have contributed a lot to the preservation and deterioration of structural disequilibria in the energy sector. The energy sector liberalisation was prolonged after the crisis. In fact, it started with the passage of the Energy and Energy Efficiency Act in July 1999 intended to ensure the appropriate conditions to carry out a structural reform and attract private investment in the energy sector. The Act did not provide the option to introduce licensing regimes for the construction of new capacities that do not require the conclusion of power purchase agreements. Thus, the investment decisions related risk for the government was not limited while it should have been placed with investors. In practice, the hitherto existing price setting was further cemented in this way. Still, the Act guaranteed a number of ways to dismantle state monopoly in the sector. However, by end-2001, these opportunities had been only partly used. The organisational changes that took place in 2000³⁹ represented the only progress made in the implementation of the law. Thus, vertically-integrated state-owned Natsionalna Elektricheska Kompania (NEK) was „un-bundled“ into 15 legally separate generation, transmission/dispatch and distribution entities.

On 11 April 2002, the government approved the new energy strategy of the country. The major principles underlying the new government energy strategy include: the volume of investment in the energy sector is

³⁹ The Sofia Municipal Court Decision on the transformation of NEK was published on 16 June 2000 in the Official Gazette.

to be determined on the basis of sound and theoretically-substantiated long-term demand forecasts while the investment risk shall be for the investors; the government will conclude long-term contracts only for a limited number of strategic projects.

As for the legislative framework, the government is expected to table in parliament a new draft Energy Act, which shall provide for the legal framework to carry out successfully the above mentioned reform principles. The accompanying regulations of the Energy Act currently in force – most of them still to be prepared – should be enacted by the end of the year. The strategy also envisages that the plan for the sale of all electricity transmission companies to strategic investors should be ready by end-June 2002. It is expected that some 10% of all energy sector enterprises must be prepared by end-2002 for the opening of the market. The privatisation of the sub-peak power plants in Bobovdol, Rousse and Varna is planned to take place in 2003-2004.

Information and communication technologies (ICT). ICT is another key infrastructure sector in every economy. As evident from most of the indicators measuring the availability of information and communication technology products in households and businesses, Bulgaria is lagging behind the CEE countries. According to the ITU⁴⁰ statistical data, as of end-2001 the degree of access to and usage of information and communication technologies in Bulgaria is one of the lowest among all EU accession countries. The relative values of the indicators point out that mobile communications, personal computers and internet are still not widely used especially in comparison with the unquestionable leaders in this area, viz. Slovenia, the Czech Republic and Estonia.

The lower degree of availability and usage of ICT in the country is due to a number of factors, all of which have to do with the slow liberalisation of the sector. The Bulgarian Telecommunication Company (BTC) – still holding the monopoly on fixed telephone lines – supports over 50% of the entry Internet capacity in Bulgaria. The delayed licensing of a second GSM operator (the operator started offering mobile services only in September 2001) is a sign of the low reform pace in Bulgaria. The experience of two of the most advanced accession countries in the area of ICT – the Czech Republic and Estonia – presented in the Box below also speaks for the urgent need of a fast liberalisation of the ICT market in Bulgaria.

⁴⁰ *International Telecommunication Union.*

Basic ICT Indicators by Countries, 2001

<i>Indicator</i>	<i>Bulgaria</i>	<i>Estonia</i>	<i>Latvia</i>	<i>Lithuania</i>	<i>Poland</i>	<i>Rumania</i>	<i>Slovakia</i>	<i>Slovenia</i>	<i>Hungary</i>	<i>Czech</i>	<i>Republic Croatia</i>
Population (mln)	8.00	1.43	2.35	3.68	38.63	22.39	5.40	2.00	9.97	10.25	4.66
<i>Total telephone subscribers (thou)</i>	4 463.9	1 154.8	1 381.6	2 083.7	21 450.0	7 954.0	3 703.6	2 315.4	8 698.0	10 615.0	3 455.0
Total telephone subscribers per 100 inhabitants	55.1	80.8	58.8	56.6	55.5	35.5	68.6	116.1	87.2	103.3	74.2
<i>Cellular mobile subscribers (thou)</i>	1 550.0	651.2	656.8	932.0	10 050.0	3 860.0	2 147.3	1 515.7	4 968.0	6 769.0	1 755.0
Cellular mobile subscribers per 100 inhabitants	19.4	45.5	27.9	25.3	26.0	17.2	39.8	75.8	49.8	66.0	37.7
Cellular mobile subscribers as % of total telephone subscribers	34.7	56.4	47.5	44.7	46.9	48.5	58.0	65.5	57.1	63.8	50.8
<i>Estimated PCs (thou)</i>	361 ^(*)	250	360	260	3 300	800	800	550	1 000	1250 ^(*)	400
Estimated PCs per 100 inhabitants	4.5	17.5	15.3	7.1	8.5	3.6	14.8	27.5	10.0	12.2	8.6
<i>Internet hosts, total</i>	26 926	51 040	25 003	35 155	489 895	46 283	72 557	29 558	167 585	215 525	21 988
Internet hosts per 1000 inhabitants	3.4	35.7	10.6	9.6	12.7	2.1	13.4	14.8	16.8	21.0	4.7
<i>Internet users (thou)</i>	605	430	170	250	3 800	1 000	650 ^(*)	600	1 480	1 400	250 ^(*)
Internet users per 100 inhabitants	7.6	30.0	7.2	6.8	9.8	4.5	12.0	30.0	14.8	13.7	5.4

^(*) 2000 data

Source: International Telecommunication Union, UN

Development of the Telecommunication Sector in the Czech Republic and Estonia

The amendments to the Act on Telecommunications in the Czech Republic in 1992 launched the liberalisation process of the telecommunication market in the country by providing for partial demonopolisation and liberalisation of the sector. As early as 1995 and 1996, territorially delimited licences had been issued for the offer of fixed telephone services and in 2001 the operators received nation-wide licences. Although already 8 operators offer fixed telephone services, the state-owned *Czech Telecom* still holds the largest share of the market. The government's interest in the company is 51% and it is intended for sale in 2002.

The first analogue cellular phone network* started operating as early as 1992 yet the number of subscribers and services grew after 1996 when 2 GSM network licences were issued. As of end-2001, there were 3 mobile networks in the Czech Republic while the number of mobile subscribers considerably exceeded the number of fixed-line subscribers. In 2001, two licences for the construction of the latest „third generation“ mobile systems** were also issued.

In Estonia, the development of telecommunication infrastructure also started in 1992 when the Scandinavian telecommunication giants *Telia* and *Sonera* were attracted as strategic investors in the national *Estonian Telecom*. These investors granted the latest know-how and allocated substantial financial resources for the building of a modern and efficient telecommunication network. Having restructured the former state-owned *Estonian Telecom* and listed it on London and Tallinn Stock Exchanges, the government retained ownership of 27.3% of the holding. The Swedish *Telia* and the Finish *Sonera* jointly hold 49% while public investors possess the remaining 23.7% of the company.

The Cable Act regulating and abolishing the restrictions on the offer of cable network services was passed on 1 February 1999. In 2000, a new Telecommunications Act was voted. Its stipulations, reflecting the recommended international practice, regulate telecom operators' requirements and the procedure of government supervision. The Digital Signature Act entered into force in December 2000 and its accompanying regulations were passed shortly after it.

The ICT sector reports the highest growth rate in Estonia. The National information society project *Tiger Leap* started in 1997 and its first phase continued till 1999. Currently, the project's second stage *Tiger Leap Plus* covering the 2001-2005 period is being implemented to provide access to Internet in every school in Estonia. As of end-2001, some 65% of educational establishments in Estonia, including all universities, had an Internet access. Internet clubs providing Internet access to the general public are also being built all over the country. The other measures in this area include: the first ever *Mobile Parking Project* (May 2000) – payment of parking fees via a mobile phone; the *e-Billing Project* (July 2000); and the *e-Government Initiative* (August 2000). In September 2000, an IT College was established and since spring 2001 an *e-Tax Board* has been operating to monitor the developments in the system of e-tax returns and tax payments via Internet.

In early-2001, *Estonian Telecom*'s special rights on fixed telephone lines and on the provision of national long-distance and international telephone services were repealed. New providers of fixed telephone services entered the market yet the *Estonian Telephone Company* – part of *Estonian Telecom* holding – is still dominating the market. Reputable international companies such as *Tele 2*, *Uninet*, *KPNQwest* and *Microlink* are among the new market entrants.

The largest share in the mobile communications market belongs to *Estonian Mobile Telephone*, yet another company in *Estonian Telecom* group. It started building back in 1991 a mobile analogue network that currently covers the entire territory of the country. Simultaneously, it developed a digital GSM network, covering 75% of the area and 95% of the country's population. The second largest GSM operator, i.e. *Radiolinja Eesti*, part of *Finnnet* group is on the market since 1995 while the third digital mobile operator *Tele 2* has been offering services since 1997.

The whole area of the country is now covered with fibre optic cables as a result of substantial investment in telecommunication infrastructure. Estonia is connected with submarine fibre optic cables with Sweden and Finland; direct lines to Russia and Latvia have been built guaranteeing first-rate international communications. Internationally recognised companies like *Levicom Broadband*, *EsData*, *Unineti Andmeside*, *Data Telecom* and *Microlink* are the major companies offering data communication services. The Internet providers offer the latest technology services such as leased lines, connection via a modem, ISDN, ADSL, WWW-services, e-mail, e-mail to GSM or pager, VoIP, etc.

E-banking is nowadays more and more used for bank transfers, tax payment and other bank operations in Estonia. As of end-October 2001, banks' Internet clients were estimated at about 430 000 people, accounting for over 30% of the entire population. In 2001, the largest Estonian bank *Hansabank* ranked the sixth in Europe by volume of e-bank operations. In recent years, e-retail trade reported at least 2-digit growth rates. Commercial banks and retailers jointly provide on-line shopping and payment for goods and services. Some of the on-line shops already offer shopping via a mobile phone thanks to WAP service provided by mobile operators.

Sources: *Ministry of Transport and Communications of the Czech Republic, Telecommunications in the Czech Republic 2001*; *Estonian Investment Agency, Estonia – Your New Source for IT Solutions, 2000*; *Estonian Investment Agency, IT and Telecommunications 2001*; *The Central and Eastern Europe Business Information Center (CEEIBC), IT and Telecommunication Sectors*; *Emerging Europe Research Group, Estonian Telecom Market Summary 2001*.

* Using the NMT 450 standard.

** Universal Mobile Telecommunication System – UMTS.

In Bulgaria, the first program for the privatisation of BTC dates from 1995. The deal was repeatedly postponed either due to the unfulfilled extremely high expectations for a possible financial result from it (till end-1996) or to the unfavourable business climate in the sector after 1999. As a result of the delay in the privatisation of BTC, and hence of its restructuring, the company and the country face serious structural problems. In end-2002, BTC's monopoly on the market of fixed telephone services and leased lines – generating the bulk of the company's revenues – will expire. The new entrants on the market will target the profit-making services of BTC, and its corporate subscribers in particular, as the latter's share in the company's revenues accounts for about 80%.

The outdated machinery and equipment of BTC poses another problem. Most of the equipment currently in operation consists of electro-mechanical exchanges that require huge operation and maintenance personnel and technically do not allow for the launch of up-to-date services and methods for a more flexible charging of subscribers. Under a currency board arrangement, the government is not able to invest the necessary financial resources in the rapid rehabilitation of the network. Given the present structure of subscribers, any rehabilitation investment would have a very low rate of return since the bulk of BTC's subscribers maintain low telephone traffic. Third, although BTC intends a phased liberalisation of telephone service prices, it still maintains high international and national long-distance tariffs and very low local call tariffs. This policy has allowed the operators providing data transmission through Internet to quickly evade the monopoly of BTC on these lucrative services and attract customers. These operators finance the price of local calls and offer much more favourable international and long-distance tariffs. This is yet another example that Bulgaria does not use prices and price-setting as a powerful tool to boost restructuring and impose tight budget constraints.

Fourth, the Bulgarian Telecommunication Company is overstaffed by reason of its outdated equipment in use and the lack of incentives for restructuring. As of end-2001, over 26 000 people were on the company's payroll. Overstaffing has clear negative impacts on the competitiveness of the national phone operator.

A new strategy for the privatisation of BTC was adopted in 2002, and up to 65% of the company's capital were immediately offered for sale while another 20% of its shares are to be publicly offered on the Bulgarian Stock Exchange. The privatisation of BTC is also seen as a sign towards potential investors of the improvement of infrastructure and investment climate in the country. Furthermore, without the availability of developed ICT in the country, Bulgaria will not be able to accede to the EU and to implement its ambitious program for the development of high technologies.

Railway transport. The reform of the Bulgarian State Railways (BDZ) was launched only after 1997. Before that, the government did not develop a clear strategy and an action plan in the sector, it used to subsidise passenger and freight services in various ways and prices were occasionally used – as in the above-mentioned two infrastructure industries – only to balance demand and supply.

In 1997, the government in cooperation with the World Bank devised a recovery plan for BDZ. The plan introduced new vertical organisation by reducing the number of management levels and mandating accounting separation within BDZ of infrastructure and commercial services. All industrial activities were to be brought out of BDZ and slated for privatisation. These measures helped to identify all bottlenecks and loss-generators in the system.

However, the implementation of the plan was delayed, on the first place due to the slow passage of required legislation. Indeed, the Railway Act was adopted only in November 2000. The Act provided the legal

basis for the institutional separation of railroad infrastructure and operations, repealed the state monopoly on passenger and freight transport and allowed for the provision of concessions. However, this last possibility has so far not been used.

On the other hand, the restructuring of the sector was delayed as a result of the drastic deterioration of the situation on the international rail transport market. Due to the restrictions on international traffic through Yugoslavia during the war in Kosovo in 1998 and the international embargo on the country in the following years in conjunction with the sharp rise in international fuel prices after 1997, BDZ incurred losses to the amount of BGN 87 mln only in 2000. The difficult financial situation of the company considerably delayed the rehabilitation, envisaged in the plan, of 414 km of track, including electrification and the introduction of information systems to increase efficiency and railroad security. The 9 800 job cuts in BDZ in three years meant to reduce operating expenditures proved to be an insufficient measure.

In 2001, a special short-term action plan had to be adopted. It envisaged an increase in freight charges and passenger tariffs by 20% and 15% respectively; the sale of redundant fixed assets and further cuts in some operating expenses (curbing expenditures on fuel and additional lay-offs). In 2001, the subsidies for BDZ included BGN 60 mln for passenger services and BGN 60 mln for infrastructure. The planned passenger services support for 2002 is BGN 70 mln. In end-2001, the government decided to restructure the capital of BDZ by readjusting the company's arrears to the budget towards raising its own capital.

In 2002, a long-term business plan for BDZ is to be devised outlining the main directions for the development of the company in a competitive market environment. The strategy will also envisage the implementation of a number of stabilisation measures, including the restructuring and cut-down of liabilities and phasing out subsidisation of passenger services by freight charges.

Tourism. Tourism is one of the priority sectors in the Bulgarian economy. The first positive results of structural reforms in the sector have already been discerned in 2000 and 2001. The successful development of tourist industry benefited not only from the lack of a legalised state monopoly on the sector as in the case of the analysed infrastructure industries but also from the relatively swift privatisation including the participation of renowned foreign investors. Although the divestiture of state assets in the sector is almost accomplished, the restructuring of the sector continues.

Divestiture in tourism started in 1994 with the privatisation of *Vitosha* Hotel and *Varna Grandhotel*. *Sheraton* Hotel Sofia was transferred in private hands in 1996 and some 33% of the shares of *Albena* plc were sold in 1997. The period 1998-1999 saw the privatisation of the remaining major hotel complexes such as *Trimontsium Interhotel* and *Europa Novotel*. Reputable international hotel chains like *Hilton*, *Iberotel*, *Iberostar*, *Princess* and *Radison* entered the Bulgarian market also during these years. The leading German travel agencies *Neckermann*, *TUI* and *ITS Reisen* entered the Bulgarian tourist market, making substantial investments in tourist infrastructure on the Black Sea Coast. Furthermore, they proposed joint marketing and advertising strategies to create the new image of the Bulgarian tourist products and services. In 2000 alone, *Neckermann Touristics* restored 3 880 hotel bed-spaces and invested EUR 10 mln at the Black Sea Coast, raising the category of the hotels it managed. According to data from the Bulgarian Foreign Investment Agency, the concern *C&N* made additional investments of EUR 30 mln in 2001. As of end-2001, some 96% of the sector's total assets had been in private hands.

As a result of both domestic and foreign investment in new projects, the tourist sector became one of

the fastest growing industries in Bulgaria. In 2001, revenues from international tourism reported an almost 12% rise on a year earlier while the number of German tourists visiting the country registered a 42.3% year-on-year growth. The latter had mainly to do with the investments made by German travel agencies in the Bulgarian tourist industry. On the whole, the importance of EU and CIS countries for the sector's growth is following a steady upward trend. Net current transfers in the balance of payments associated mainly with the offer of tourist services stepped up substantially, increasing from USD 289.7 mln in 2000 to USD 486.1 mln in 2001.

Arrivals of Visitors from the EU, Russia and Ukraine to Bulgaria

<i>Year</i>	<i>1999*</i>	<i>2000*</i>	<i>2001*</i>	<i>2001/2000 % change</i>
<i>Total visitors as tourists</i>	<i>2084746</i>	<i>2354052</i>	<i>2755717</i>	<i>+17.06%</i>
<i>European Union</i>				
<i>Total</i>	<i>672388</i>	<i>797687</i>	<i>1008219</i>	<i>+26.41%</i>
<i>Relative share</i>	<i>32.26%</i>	<i>33.89%</i>	<i>36.59%</i>	<i>+2.7%</i>
<i>Russia and Ukraine</i>				
<i>Total</i>	<i>104249</i>	<i>164901</i>	<i>201054</i>	<i>22%</i>
<i>Relative share</i>	<i>5.00%</i>	<i>7.00%</i>	<i>7.30%</i>	<i>0.3%</i>

Source: Ministry of Economy; NSI, 2000 Statistical Reference Book, 2001 Statistical Reference Book

The terrorist attacks in September 2001 did not particularly affect revenues from international tourism in Bulgaria. Thus, in September 2001, revenues stepped up by 22.6% indicating that the season of summer seaside resort tourism in Bulgaria is getting longer. A slight fall in revenues from winter tourism was reported apparently due to the lack of important investment and appropriate marketing and advertising in this area.

The introduction on 1 October 2001 of visa requirements for the citizens of Russia and Ukraine inevitably affected the number of tourist visits from both countries. The number of Russian tourists reported a year-on-year decrease of 69% in October, 59% in November, and 45.9% in December 2001. It is expected that the contracted easier visa issue procedures at destination airports will limit the unfavourable impact of visa requirements on the inflow of tourists from the CIS since most of them enter the country by plane.

Tobacco industry. Having been postponed for over a decade, the restructuring of tobacco industry in the country has entered a decisive phase. The ongoing changes were necessitated by the fact that in recent years the EU imposed new requirements on the quality of cigarettes, drastically lowering the admissible maximum nicotine level. Therefore, the share of low-quality tobacco varieties grown in the country that do not meet the imposed requirements need to be dramatically reduced in the favour of high quality tobaccos. Although the oriental variety represents over 60% of the tobacco purchased by *Bulgartabac* from local producers, in recent years there has been a clear cut downward trend in its input in the cigarettes manufactured by the holding at the expense of other tobacco varieties. Regardless, the currently prepared National strategy for the development of tobacco growing till 2005 envisages that export volumes of oriental tobacco will double in the forthcoming years. The quality improvement of tobacco processing will be instrumental to the accomplishment of this task and will require new investment and technology transfer in the tobacco processing factories.

Having lost its largest market, the state-owned tobacco monopoly *Bulgartabac* Holding is no longer able to provide the investment funds needed for the restructuring of the sector. While in mid-1990s *Bulgartabac* held about 12% of the Russian market, its market share had slumped to about 1% in 2001 and forecasted to rise to some 3% in 2002. Given these developments, the privatisation of the holding as a whole enterprise attracted very low interest from strategic investors. This is evidenced by the bid offers submitted before the deadline in early-May 2002. In May, *British-American Tobacco* – one of the potential buyers of *Bulgartabac* announced its intention to withdraw from the Bulgarian market. The reason for its decision not to participate in the privatisation of the tobacco holding is to be found in the discordant intentions of BAT and the government since BAT was only interested in the purchase of two cigarette factories part of the holding whereas the government intends to sell the entire holding as a single enterprise.

The Strategy for the sale of the holding submitted to the National Assembly on 12 February 2002 has slated 51-80% of the holding's assets for privatisation. Some 20% of *Bulgartabac*'s capital is to be publicly offered on the Bulgarian Stock Exchange, out of which 7% are already being traded there. Another postponement of the privatisation of the holding will result in a further fall in its price, already affected by the withdrawal of large strategic investors. A lower price is even likelier in the light of the expected launch in fall 2002 of privatisation procedures for divestiture of state-owned cigarette companies in Italy and Serbia. The existing options to postpone the privatisation of the holding as a single enterprise and privatise the detached parts thereof in which investors have shown interest bidding an acceptable price are likely to further reduce the opportunities to restructure the remaining parts. At the same time, social concerns such as the guarantee of social protection and support to tobacco growers will also contribute to the delay of restructuring and to a lower efficiency of the privatisation deal from the point of view of the future development and competitiveness of the Bulgarian tobacco and cigarette industry. Certainly, these issues will additionally affect the price of the holding in case a deal is concluded. Given the above restrictive conditions, it is the analysts' opinion that the specific terms and parameters of the deal for the privatisation of *Bulgartabac* Holding or its eventual postponement will be an important test on foreign investors' confidence in the country, even in the medium term.

Agriculture. The outcome of the agricultural reforms carried out so far has been in the limelight of much controversy. On the one hand, according to NSI data, by end-2001 91.54% of forest and woodland ownership was restituted to former owners while the property rights of legal owners to farm land had been restored in existing or recoverable old real boundaries or by land division plans as early as end-2000. On the other, agriculture has attracted the lowest investment volumes. Thus cumulative FDI per employed in the sector over the 1998 – 2000 period amounted to only USD 16⁴¹ against USD 1 066 per employed in the other sectors of the economy. Furthermore, the sector's efficiency has been steadily deteriorating since 1997. In 1997 again, gross value added accounted for 47.9% of gross agricultural output to further deteriorate down to 42.6% in 2001. After seven quarters in a row of continuous decline, agriculture reported some but fragile growth as late as the last two quarters of 2001 (according to preliminary NSI data).

The underdeveloped land market has been a major impediment to robust foreign and local investment injections in the sector and hence the sluggish reform pace. SAPI land market data of November 2001 indicate that trade in farmland was gaining a steady impetus. The Nov'2000 – Nov'2001 period saw the

⁴¹ According to BNB data.

conclusion of 31 324 deals while the area traded amounted to 59 305.7 decares or 0.1% of the farmland used. Over 95% of the land plots that are a subject of a sale or acquisition is mostly arable. The higher number of real estate transactions were contracted in the North East of Bulgaria. About 54% of the deals covering some 68% of the land sold were carried out in the districts of Varna, Dobrich, Razgrad, Silistra, Turgovishte and Shoumen. The region's average weighted market price per decare amounted to BGN 123.

2001 deals were contracted at BGN 141/decare on a market's average against BGN 137 per decare on a year earlier and despite the low land prices, supply exceeded demand. According to SAPI data, the prices of farmland, calculated according to the current levels of rent payments, should fluctuate within the BGN 150-250 per decare range. The upward trend in land prices and their stabilization around the 2001 maximum levels are expected to persist well into 2002 as well. An important characteristic of the Bulgarian land market is that the category of land has practically no impact on prices. Land location, on the other hand, is a major buyer's requirement. The prices of arable land plots close to a road network ran two to three times higher than the prices of plots with no access to roads.

In the second half of 1999, the government launched procedures making amends by compensation bonds for land that could not be restituted to former owners. Thus, BGN 1 173.4 mln worth of compensation certificates were issued by end-2001, 73% of which already used – on a large scale in the privatisation process (97.13%) or in acquisition of farmland on a very small scale (a scant 2.87%).

The above tendencies in the pace of agricultural reforms and low competitiveness underlie the urgency of a broad public consensus on agricultural development priorities that will serve as a groundwork for a sector-wide operative strategy in the mid-term. All this will facilitate the negotiation process and country's accession effort as well as the working out of a well-reasoned and rational position towards the pre-ins in the agricultural sector. Has the reform process persisted at the current sluggish and ineffective pace, the sector may be threatened to lose its competitiveness in the mid-term, which will in turn produce a strongly adverse macroeconomic and social effect, given the current employment rate in agriculture and absence of alternative sources of rural income. □

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