BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2002

annual report

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C O N T E N T S

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

2002 growth accelerated to 4.8% despite the slow rebound in the world economy, and Bulgaria's major trading partners in particular. Growth in the Bulgarian economy ran one of the highest among the EU acceding countries amidst enhanced macroeconomic and financial stability. The current account deficit of the balance of payments declined in both nominal terms and as percentage of GDP (down to 4.4%) regardless of the shocks induced by the EUR/USD exchange rate volatility, interbank interest rates and the uncertainty and collapse of some sensitive international markets amidst fears of a likely military action against Iraq. The general budget deficit and country's foreign debt went on the decrease down to 0.6% and 55.6% of GDP respectively.

The country's inflation hit a record low of 5.8% on a yearly's average since the onset of the economic reforms, despite the administered price adjustments and higher inflationary expectations of early 2002 related thereto. Financial intermediation in the economy further deepened, with bank lending to the non-financial sector reaching some 16.5% of GDP in end-2002, and pension funds' assets and the market capitalization of the stock exchange accounting for over 1% and 4.3% respectively of GDP. Real wages, real income and productivity went on rising (7%, 1.8% and 3.8% up). The private sector dominating over the economy was creating more and more jobs, with the employed total there going 2.9% up, whereas unemployment declined by 2.8 percentage points on a year earlier.

The accelerated growth and macroeconomic stability enhancement in 2002 are proof enough that Bulgaria has been adamantly pursuing the strategic goal of EU accession as from 2007 and successfully integrating into the global economy. In its 2002 Regular Report the European Commission recognized Bulgaria as *„a functioning market economy able to cope with competitive pressure and market forces within the Union in the medium term, provided it continues implementing its reform programme to remove remaining difficulties.“* [1] In end-2002 again, the most renowned credit rating agency Standard & Poor's upgraded the country's credit standing up to BB+/positive outlook. The other leading credit rating agencies also evaluated Bulgaria's economic outlook as positive.

The positive trends taken by the Bulgarian economy resulted not only from the improved terms of trade (0.5% up on year earlier) but also the economic policy outcome and sustained structural reform effort. As expected[2], economic policy priorities in 2002 addressed key structural issues having to do with the streamlining of market entry and exit rules and labour market regulations. There was made a thorough review of the legal and administrative measures in force with a view to bringing them into line with the best international practices. Furthermore, the government launched some long delayed and indispensable social policy measures to curtail and moderate social disparities in a stepwise manner in Bulgaria vis-à-vis the CEEC average. Also, together with the refinement of fiscal policies and practices, there were created further incentives fostering the flexibility and competitiveness of the Bulgarian economy in the long term.

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[1] *Commission of the European Communities, 2002 Regular Report on Bulgaria's Progress towards Accession (2002), p. 46.*
[2] *See 2001 and 2002 Annual Reports on the Bulgarian Economy, AEAF.*

The priority areas of the structural reform endeavour in the period surveyed were as follows: further liberalization and privatization of state monopolies, restructuring of the budgetary sector and completion of bank privatization. However, reforms in the above three segments followed a different pace in 2002. State monopoly privatization and restructuring lagged significantly behind privatization in the banking sector where one of the two privatization deals scheduled for 2002 was successfully concluded, i.e. the sale of Commercial Bank Biochim, and the pre-privatization arrangements for the State Savings Bank picked up speed. At the same time, the privatization of two of the economy vital enterprises - Bulgartabac Holding, AD (BTH) and the Bulgarian Telecommunications Company (BTC) was not brought to an end as planned, giving rise to a heated and sharp political debate. The reform effort in key areas of the budgetary sector - health care and education, failed to come to the supply optimization and financial stability desired.

The 2002 slowdown in state monopoly restructuring and privatization can only partially be explained by way of the alterations in the privatization approach and related thereto amendments to law and regulations, and administrative capacity adjustment and reinforcement carried out in the responsible government institutions. The structural reform experience gained in 2002 indicates that amendments to the format of administrative measures and the aspirations of the government to implement them as soon as possible alone will not do to speed up the developments underway, as their pace was checked by the political debate on the sale of BTC and Bulgartabac Holding, giving prominence to the short-term political and social impact of the deals rather than their effect on the quality of management and viability of the companies in the long run.

It follows that the acceleration and completion of the structural reforms and privatization with a view to Bulgaria's strategic objective of EU accession as from 2007 may only take place following a thorough evaluation and an in-depth analysis of the effect of the likely alternatives to state monopoly and budgetary sector restructuring in the given market segments on supply in the long-term. This is also the foundations of any political debate and follow up choice of values as to a new owner. Decisions as to the intervention of the government in each specific case of restructuring and privatization should take account of the political consensus reached and market realities. ❍

EXTERNAL ENVIRONMENT

Growth

The expectations that the world economy would rebound from recession as early as the second half-year period of 2002 did not come true. The lack of confidence among economic agents as well as the high oil prices checked the recovery rate worldwide. In April 2003, the European Commission revised its 2003 and 2004 world growth forecasts downwards by 0.4% to 3.2% (2003) and 0.3% to 3.7% (2004).[1] The IMF spring projections[2] matched the 2003 forecasts of the Commission while remaining more optimistic for 2004 up to about 4.1% (cf. the IMF autumn estimates of 2002 set at 4.6% growth in the world economy). At the same time, the estimates of JPMorgan Securities as to growth in the world economy were more pessimistic than IMF and EC forecasts, but remained on the whole, however, unchanged relative to the preceding period (indicating an adjustment of a bare 0.1 percentage point up to 2.4%[3]).

2003 and 2004 Growth Forecasts of the EC, IMF and JPMorgan Securities Inc.

	EC		*IMF*		*JP Morgan Securities Inc.**	
Country	***2003***	***2004***	***2003***	***2004***	***2003***	***2004***
World	*3.2*	*3.7*	*3.2*	*4.1*	*2.4*	*2.9*
USA	*2.4*	*2.5*	*2.2*	*3.6*	*2.7*	*3.3*
Euro area	*1.0*	*2.3*	*1.1*	*2.3*	*1.2*	*2.7*
Japan	*1.5*	*1.3*	*0.8*	*1.0*	*1.4*	*0.8*
Germany	*0.4*	*2.0*	*0.5*	*1.9*	*0.5*	*2.3*
Applicant countries	*3.5*	*4.3*	*3.9*	*4.5*		

** Global Data Watch, February 2003.*

Growth in the US economy in 2002 amounted to 2.4% while the GDP growth rate in the Euro area ran at a bare 0.9%[4]. The US government used fiscal and monetary policies to revive the economy. The Federal Reserve cut the federal funds rate down to 1.25%, whereas US Congress voted in a fiscal incentive package of around 1.5% of GDP.[5] According to EC estimates, the recovery of the US economy will persist well into 2003 and 2004 at a rather faltering pace, underpinned by monetary and fiscal policies as well as the steady productivity growth. The EC forecasts of the spring of 2003 as to 2003 and 2004 growth in the US economy ran at 2.4 and 2.5% respectively. IMF projections point to a US growth rate in 2003 and 2004 of 2.2% and 3.6% respectively, going 0.4 percentage points down compared to the 2002 autumn estimates. At the same

[1] *European Commission, Spring 2003 Economic Forecasts.*
[2] *International Monetary Fund, World Economic Outlook, April 2003.*
[3] *JPMorgan Securities, Global Data Watch, February 2003.*
[4] *According to the latest Eurostat data released in April 2003.*
[5] *The package included the 2001 tax reduction and some additional fiscal measures (government spending on defense included) voted in March 2002.*

time, the forecasts of some independent analysts like JPMorgan Securities (of February 2003) remained unchanged. Furthermore, US growth in 2003 is believed to be boosted by the steadily recovering consumption and investment activity in the second half-year period as well as the higher government spending on defense estimated at some USD 75 billion inside the fiscal year[6].

Despite the depreciation of the USD, the US economy went on reporting sizable current account deficits, which according to IMF forecasts would reach some 5.3%[7] and 5.1% of GDP respectively in 2003 and 2004.

EC Growth Estimates for 2003 and 2004

	GDP Growth (on a year earlier)					
Country	*2003*			*2004*		
	Autumn 2002	*Spring 2003*	*Diffrence*	*Autumn 2002*	*Spring 2003*	*Difference*
Euro area	***1.8***	***1.0***	***-0.8***	***2.6***	***2.3***	***-0.3***
Germany	*1.4*	*0.4*	*-1.0*	*2.3*	*2.0*	*-0.3*
France	*2.0*	*1.0*	*-1.0*	*2.7*	*2.3*	*-0.4*
Italy	*1.8*	*1.0*	*-0.8*	*2.4*	*2.1*	*-0.3*
Spain	*2.6*	*2.0*	*-0.6*	*3.2*	*3.0*	*-0.2*
Great Britain	*2.5*	*2.2*	*-0.3*	*2.7*	*2.6*	*-0.1*
USA	***2.3***	***2.4***	***0.1***	***2.8***	***2.5***	***-0.3***
Japan	***1.2***	***1.5***	***0.3***	***1.4***	***1.3***	***-0.1***
Applicant countries	***3.8***	***3.5***	***-0.3***	***4.4***	***4.3***	***-0.1***
Bulgaria	*5.0*	*4.5*	*-0.5*	*5.5*	*5.0*	*-0.5*
Czech Republic	*3.2*	*2.8*	*-0.4*	*3.8*	*3.9*	*0.1*
Estonia	*4.7*	*4.9*	*0.2*	*5.1*	*5.1*	*0.0*
Hungary	*4.5*	*3.7*	*-0.8*	*4.9*	*4.1*	*-0.8*
Latvia	*5.5*	*5.5*	*0.0*	*6.0*	*6.0*	*0.0*
Lithuania	*3.5*	*4.5*	*1.0*	*4.5*	*5.0*	*0.5*
Poland	*3.2*	*2.5*	*-0.7*	*3.9*	*3.7*	*-0.2*
Roumania	*4.6*	*4.9*	*0.3*	*4.7*	*5.0*	*0.3*
Slovakia	*3.9*	*3.7*	*-0.2*	*4.8*	*4.5*	*-0.3*
Slovenia	*3.6*	*3.4*	*-0.2*	*4.0*	*3.7*	*-0.3*
Turkey	*3.7*	*3.7*	*0.0*	*4.4*	*4.5*	*0.1*
Russia	*4.3*	*3.4*	*-0.9*	*4.0*	*2.6*	*-1.4*
World	*3.6*	*3.2*	*-0.4*	*4.0*	*3.7*	*-0.3*

Growth in most of the Euroarea biggest economies remained low. 2002 GDP growth rate in Germany, Italy, Great Britain and France ran at 0.2, 0.4, 1.8 and 1.2% respectively. The 2003 growth estimates for the Euro area of JPMorgan Securities were also revised downwards[8]. The major impediments to the rapid growth of

[6] *Excluding the USD 670 billion worth of a tax reduction proposed by the Bush administration (January 7, 2003) for the next ten years.*

[7] *Revised 0.6 percentage points up.*

[8] *Thus for instance while November 2002 forecasts pointed at 1.9% growth in the Euro area in 2003, February 2003 projections were revised downwards to 1.2% (including downward revisions for Germany from 1.4% to 0.5%; France from 1.7% to 1.5%; and Italy from 1.9% to 1.5%).*

the EU economies seem to be associated with the worsening competitiveness as a result of the appreciating single European currency, labour market deterioration and low investment activity, accounting for the lower growth expectations of the international institutions. The 2003 and 2004 EC growth forecasts for the Euro area run at 1 and 2.3% respectively, while IMF estimates point at 1.1 and 2.3%. According to the IMF, the fiscal policy tightening in compliance with the EU Stability and Growth Pact and appreciating EUR are one of the major factors at work behind the low growth expected.

The excessively high general government deficits as percentage of GDP of Germany (3.6%), France (3.1%), Portugal (2.7%) and Italy (2.3%) may prove a major stumbling block faced by mid-term growth in the Euro area, and any non-compliance with the Maastricht criteria as to the deficit ceiling of 3% may further undermine the credibility of EU economic policy. Although the initial deadline for curbing government deficits was set for 2004[9], the European Commission decided on an extension to 2006 with a view to the slower recovery of the Euro area economies.

In the fourth quarter of 2002 the Japanese economy carried on growing at a rate of 0.5%, with the engine of growth being private consumption and net exports, slowing however down to 0.3% altogether in 2002. The EC forecasts for the Japanese economy in 2003 and 2004 run at 1.5% and 1.3% respectively, and the country's economic outlook remain somewhat uncertain, as stable deflation, structural inefficiency and the heavily burdened with bad credit financial system may jeopardise the performance of the economy in the short-run.

The economies of Central and Eastern Europe remained comparatively less affected by the low growth rate in Europe and worldwide. The latest EC forecasts of April this year as to the 2003 and 2004 growth rate underwent insignificant revisions of 0.3 and 0.1 percentage points respectively down to 3.5% and 4.3% against September 2002 projections. The Commission's projections were in the utmost degree revised downwards for Hungary by 0.8 percentage points to 3.7% and 4.3% respectively, and for Poland by 0.7 points to 2.5% in 2003, with the growth expectations for the Czech Republic, Bulgaria, Slovakia and Slovenia running lower than in September 2002. The growth estimates for Bulgaria have been revised downwards by half of a percentage point to 4.5% in 2003 and 5% in 2004, but the country nevertheless ranks among the leading economies with the highest growth rate expected like Latvia and Estonia. The 2003 and 2004 growth projections for Turkey remained unchanged[10] - at 3.7% and 4.5% respectively. It can be therefore said that growing domestic demand in CEECs was the main stimulus and booster of sustainable growth in the region, making up for the export growth slowdown, and furthered by sizable FDI volumes and decreasing inflation.

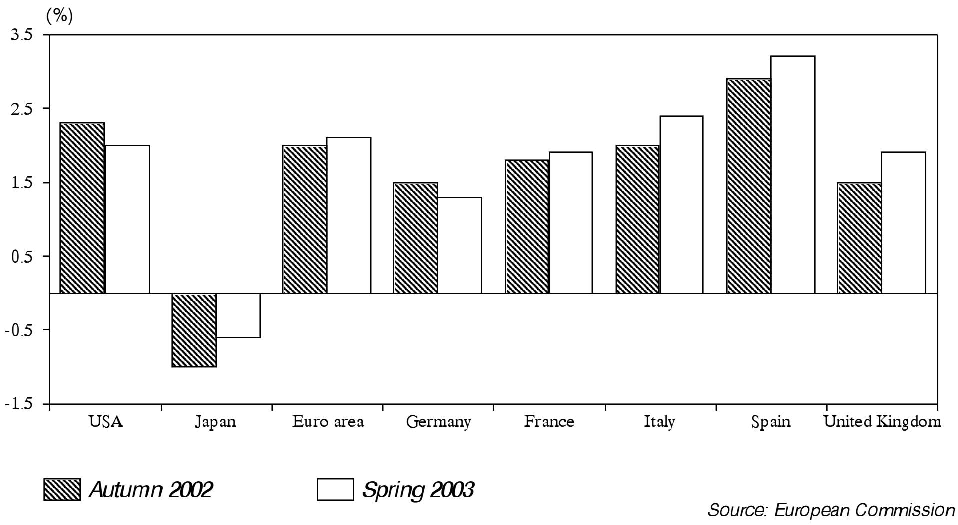
IMF forecasts for Bulgaria of April 2003 are more optimistic than EC estimates, projecting a growth rate of about 5% in 2003 and 5.5% in 2004. Notwithstanding the relatively high growth rate projected, the hefty current account deficit anticipated calls for budget restraints and an urgent structural reform agenda. The 2003 budget deficit of 0.7% of GDP projected is key to the curbing of the current account deficit and should therefore be coupled with measures aimed at enhancing the operation of the tax administration and expenditure management. The 2003 growth expectations of JPMorgan Securities[11] for Bulgaria amount to 4.7%, running lower than IMF estimates.

[9] *For Italy in 2003.*
[10] *A revision of 2004 expectations by 0.1%.*
[11] *Global Data Watch, February 2003.*

Inflation

According to IMF estimates, inflation worldwide will remain moderate to low, with the consumer price level rising by less than 2% in the developed economies and less by 6% in the developing countries. The EC expectations of US inflation run at 2% in 2003 and 1.7% in 2004, while IMF projections point to an inflation rate of 2.3% in both years. Relative to September last year, the projections of the European Commission of April 2003 as to the inflation rate were improved only with respect to Germany - from 1.5% to 1.3%, and the applicant countries from 11.6% to 10.8%. The 2002 headline inflation[12] in the Euro area amounted to 2.2%, accounting for a 0.2% year-on-year decrease. In 2003, inflation in the Euro area is expected to run at about 2.1%, or a 0.1 percentage point higher than the benchmark set by the European Central Bank. There are fears, however, that inflation may run higher than expected due to the likely pressures to be triggered by the faster wage growth in the area. On the other hand, such a development is very unlikely with a view to the economic stagnation worldwide.

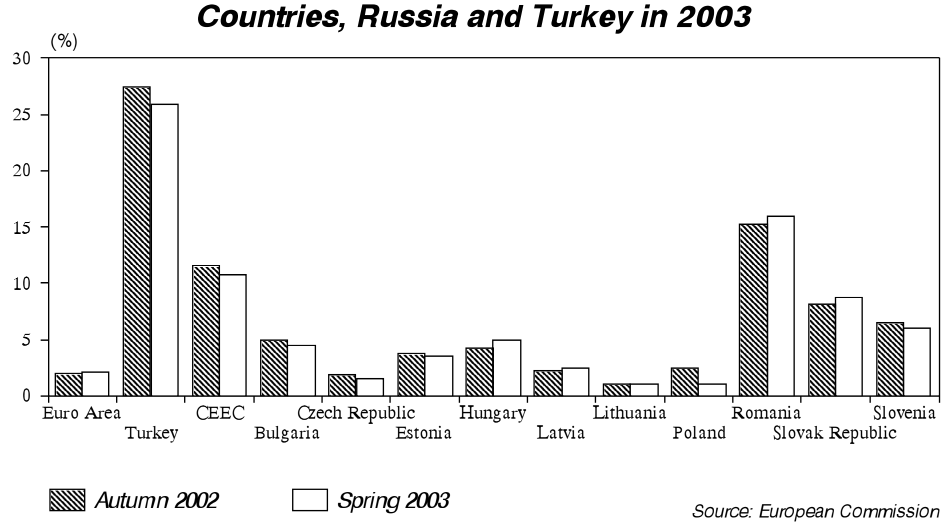
Expected Inflation Rate in the Industrialised Countries in 2003



Source: European Commission

Inflation in the acceding countries has gone on the decrease. 2003 and 2004 EC projections for the ten acceding countries run at about 2.7% and 3.3%, and the negligible increase is largely due to the administered price adjustments underway. EC estimates for Turkey and Poland in 2003 amount to 25.9% and 1.1% respectively, while inflation in Bulgaria is expected to run along a 4% annual basis.

Expected Inflation Rate in Central and Eastern European Countries, Russia and Turkey in 2003

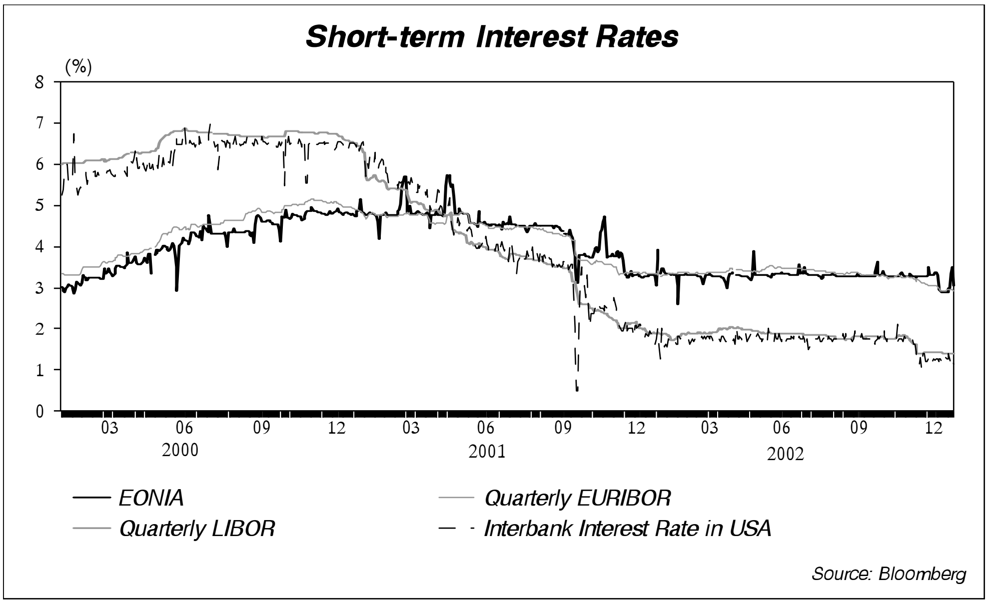


Source: European Commission

[12] *Headline inflation calculations cover monitored prices as well as some seasonal prices - all food items and energy goods.*

Interest Rates

The slow recovery rate of the world economy postponed the long expected increase in the interbank interest rates. In November 2002, the US Federal funds rate was cut down for another time in a row by 0.5% down to 1.25%. The initial expectations were that in case of a military conflict with Iraq the Federal Reserve would opt for an interest rate cut to revive confidence in the US economy and meet the higher demands for liquidity. Nevertheless, on 18 March 2003 the Federal Open Market Committee (FOMC) decided to leave the federal funds rate unchanged stating that the faltering rate of US growth was by and large due to the higher oil prices and geopolitical uncertainty rather that any other reasons while believing that doing away with any detrimental factors would give enough room to monetary policies and growing productivity in the US economy to spur recovery.



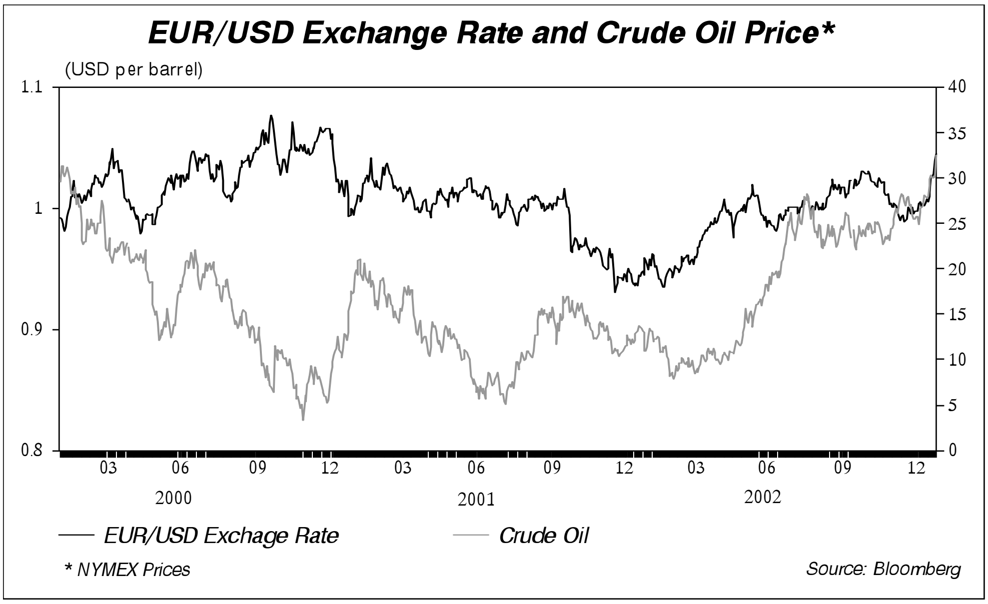
The refinancing rate in the Euro area was lowered four times in 2002, with the last interest cut of 6 November the same year going down to 2.75%. As the latest data have indicated that recovery in the Euro area was still rather unsteady and fragile, on 7 March 2003 the Governing Council of the European Central Bank decided on another 0.25% refinancing rate cut down to 2.5% in an attempt to revive the Euro area economy without putting at risk its main policy goal, i.e. the maintenance of price stability.

Although the Japanese economy is steadily rebounding from the deep recession its has bottomed out, it needs a strong further push, which monetary policies are unable to provide by lowering the interest rates, as they have already reached a nominal level of about 0%.

Exchange Rates

The headlong depreciation of the US currency to the EUR expected took place as late as the second quarter of 2002. The USD stepped down from USD 0.87 per EUR 1 in the beginning of the second quarter to USD 1.01 per EUR in mid-July, a downward trend persisting well into early 2003 when 1 EUR was traded at about USD 1.11. The bottom line factors at work behind the USD's lost ground to the single European currency had to do with the weaker than anticipated by the financial markets growth in the US economy, the turnaround from a surplus to a federal budget deficit (down to -3.3% of GDP against 0.5% on a year earlier), the upward trend taken by the current account deficit, as well as the growing international tensions worldwide. Another reason for the depreciation of the US currency related to the decline in the stock exchange indices triggered by evidence of accounting frauds in some of the US largest companies.

According to some analysts[13], the single European currency will carry on appreciating up to levels of USD 1.17 per EUR in end-2003 and USD 1.22 per EUR by 2004. The expectations of another depreciation of the USD to the EUR are still rampant due to the data on the US economy of April this year - unsteady growth, lower consumer and business confidence, strong stock price volatility, and higher unemployment rate.



Most analysts tend to believe that the expensive EUR to the US currency may put an extra downward pressure on the short-term growth outlook in the Euro area as a result of the worsening competitiveness there. On the other hand, the expensive single European currency helps maintain cheaper import prices, depressing producer prices and inflation as a whole.

Main Commodity Prices

In 2002, the main commodity prices reported an insignificant increase triggered by the growing Chinese demand, and the slow but steady recovery of the economy worldwide.

Crude oil prices set back at their pre - 11 September 2002 level in early 2003 and remained relatively high throughout the year. Average oil prices over the Jan-Dec'02 period stepped up by 2.3% on a year earlier, whereas oil import prices went up by 3.3%. The stabilization of the oil market was only possible following the concerted action of all oil producers to put the brakes on the ever growing supply. Furthermore, the interplay of political factors had a major contribution to the higher oil prices. In the second half of 2002, oil prices remained almost unchanged as s result of the crisis in Venezuela - the fifth largest producer of oil in the world, and increasing concerns about a possible military action against Iraq. In particular, the high oil prices led to a growth slowdown in the European economies.

According to estimates of the European Commission of April 2003, crude oil prices are expected to step up by 10.3% in 2003 to USD 27.6 per barrel (Brent) while going 14.9% down to USD 23.5/barrel on an yearly's average in 2004.

2002 cold- and hot-rolled steel prices increased by 9.7% and 14% respectively, despite the weak growth recovery worldwide that had otherwise led to a price decrease of almost all main commodities in the international markets. According to data of the International Iron and Steel Institute, steel output worldwide rose by 6.4% in 2002. The 20.3% growth in Chinese output had a decisive role not only for the higher market

[13] *BNP Paribas, Monthly Economic and Market Monitor, February-March 2003.*

demand but rising supply as well. Other factors at work behind the upward trend in steel prices had to do with the output reduction, replenishment of stocks worldwide as well as the import duty rates imposed by the USA to safeguard local production, which in turn triggered a significant price hike in the US markets.

Copper prices remained unchanged at their relatively low 2001 levels.[14] The Chinese economy was decisive to the stabilization of the copper market, as its growing consumption made up for the declining demand on the part of the USA and the EU. But there are still in the market significant surpluses that call for further reduction in output volumes worldwide. According to estimates of the International Copper Study Group, the gap between demand and supply reported a 3-fold decrease in 2002 on a year earlier.

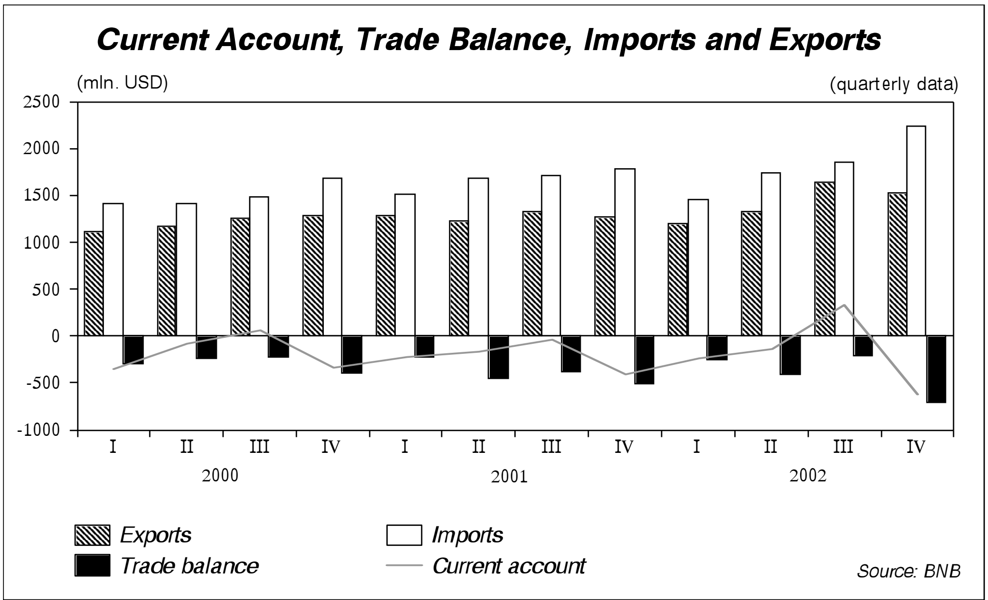
According to the Australian Bureau of Agricultural and Resource Economics (ABARA), 2003 and 2004 copper prices are expected to rise by 8.9% and 5.9% respectively against the period under review[15] due to the outstripping growth of demand compared to supply.

[14] *Average refined copper prices in reported a negligible decrease of 1.1% relative to the preceding period.*
[15] *Australian Commodities Quarterly Journal, March 2003.*

BALANCE OF PAYMENTS, FOREIGN TRADE AND EXTERNAL FINANCE

Balance of Payments and External Finance

Although in 2002 too the international business environment remained somewhat adverse to Bulgaria's export performance, the current account deficit went on the decline in both nominal terms and as percentage of GDP for the first time since 1998, surpassing the upbeat expectations as to the 2002 current account balance. The current account deficit stepped down to 4.4% of GDP[16], amounting to USD 677.4 million and running USD 164.8 million lower on a year earlier. At the same time, the country's trade deficit went on rising to USD 1592.8 million, going USD 12.3 million, or 0.8% up relative to 2001. Bulgarian exports in 2002 reported an 11.2% nominal-term increase against only 6% in 2001. On the other hand, there was a certain slowdown in the nominal growth of imports from 11.6 % in 2001 to 8.8% in 2002. Since the bulk of the country's foreign trade turnover is carried in Euros, account must therefore be taken of the EUR exchange rate's fluctuations against the US currency. BNB estimates indicate than even deflated, the percentage increase in imports and exports would step down only by a couple of points, without bringing about any turnaround in the trend currently underway.

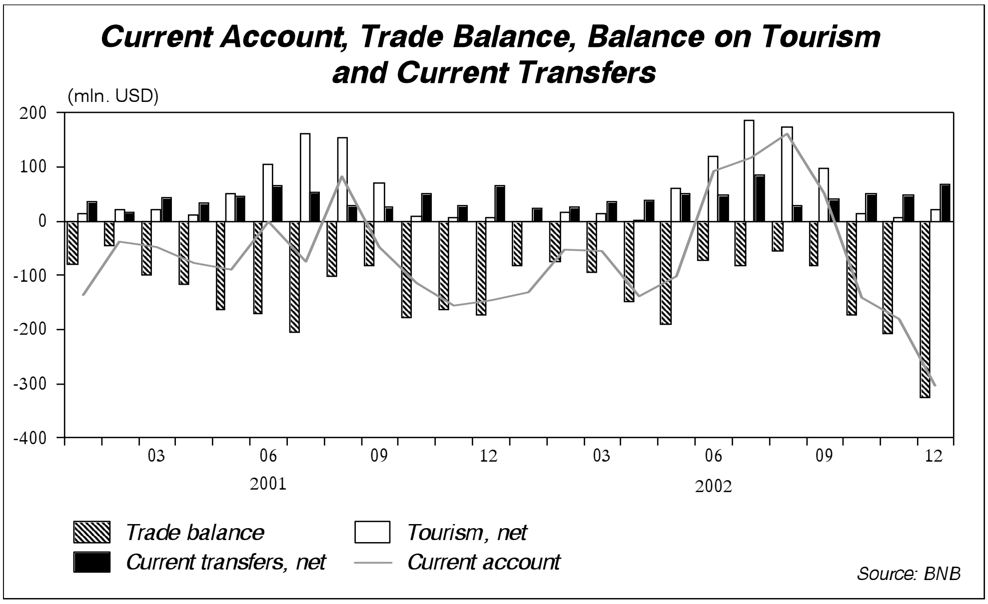


More than 70% of the trade deficit is financed by the surpluses on the service and current transfers balances. The balance on services in the BoP current account over the period surveyed ran positive at USD 593.9 million, reporting a USD 50 million worth of an improvement on a year earlier. 2002 revenues from tourism totalled USD 1334 million, stepping up by 11.1% on a 12-month basis. The summer holiday season is already on track to become a key source of revenues for the balance of payments, with net revenues from holiday-making over the May-Sept'02 period alone running as high as USD 951.5 million, or 12.8% up than in 2001. At the same time, the VAT on tourist services imposed and visa regime applied to Russian citizens checked the growing numbers of holiday-makers visiting Bulgaria from 17.1% in 2001 to 8.6% in 2002. The higher growth of

[16] *Given a 2002 GDP of BGN 32 324 million.*

revenues in USD terms vis-□-vis the number of tourists was due to the attraction of well-to-do EU holiday makers and the revaluation of earnings at the lower USD exchange rate to the EUR.

Net current transfers reported a USD 51 million year-on-year rise due to the USD 97.7 million higher cash transfers made by physical persons. EU pre-in grants (PHARE, SAPARD, ISPA) amounted to USD 123.7 million, or USD 13.9 million down on a year earlier.



Current Account, Trade Balance, Balance on Tourism and Current Transfers

Though improving by USD 76.1 million compared to 2001, the income balance ran again negative at USD 227.9 million. Income credit (USD 319.7 million) declined by USD 29 million, whereas income debit (USD 547.6 million) remained USD 108.4 million down, the latter's drastic decrease being solely due to the lower interbank interest rates worldwide.

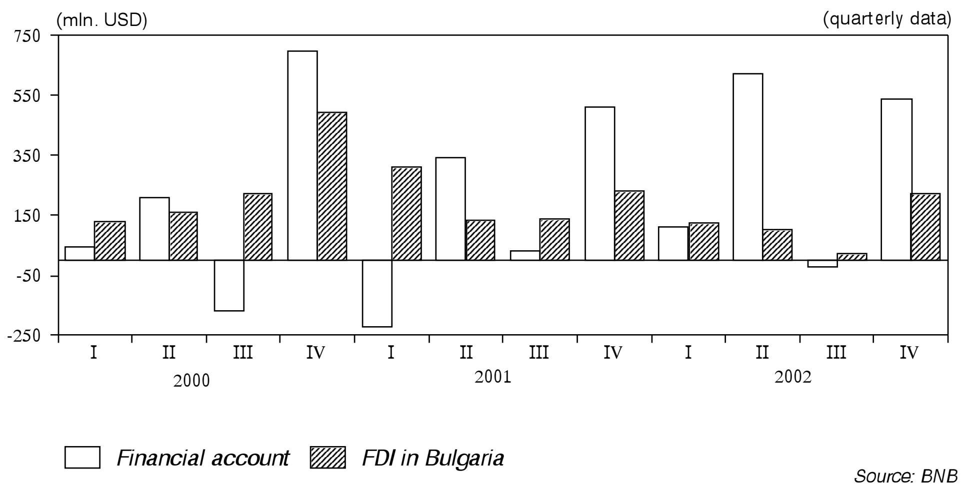
The financial account balance amounted to USD 1252.8 million, or nearly twice as high as the current account deficit, improving by USD 590 million on a year earlier. The low growth rates worldwide seemed to hamper the implementation of numerous investment projects and reduce the amounts of intra-firm credit of foreign companies operating in Bulgaria, which in turn led to a dramatic shrinkage in FDI inflows into the country. FDI over the period surveyed amounted to USD 478.7 million, reporting a USD 334.2 million worth of a plunge against 2001, and covering some 70.1% of the current account deficit in 2002 (against 96.5% on a year earlier).

Equity as a result of privatization in 2002 amounted to USD 135.6 million, reporting a 12-month increase of USD 116.4 million while equity as a result of non-privatisation (USD 199.6 million) stepped down by USD 350.1 million relative to 2001 when the revenues from the sale of the second GSM operator were accounted. The largest FDI volumes were made by investors from Austria, the Czech Republic, Greece and Germany.

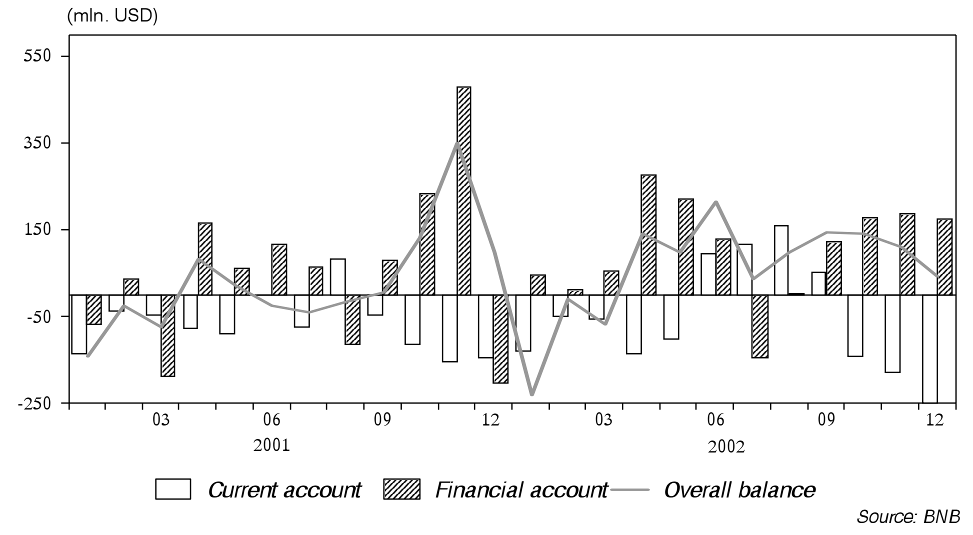
Over the same period, the portfolio investment of residents made abroad contracted by USD 225.1 million as a result of the shift of interest towards Bulgarian issues of Euro bonds. As residents tended to purchase government bonds, and the Sofia Municipality had to meet liabilities to non-residents, the *investment-liabilities* item decreased by USD 302.1 million.

2002 foreign currency deposits of commercial banks abroad declined by USD 299 million at the expense of the growing investment amounts in government securities and lending to local companies. All this led to a USD 609.2 million worth of a decrease in the *other investment-assets* item. At the same time, the *other investment-liabilities* item stepped up by USD 591.6 million due mainly to the higher amounts of foreign loans extended to locally operating companies.

Financial Account and Foreign Direct Investment in Bulgaria



Current and Financial Account, Overall Balance



BNB's FX reserves reported a 12-month growth of USD 586.3 million against USD 275.2 million on a year earlier. Exchange rate fluctuations included, the 2002 growth in BNB FX reserves amounted to USD 1166.5 million, reaching USD 4746.8 million in end-year. As BNB holds much of its assets in EUR, the USD's lost ground to the EUR produced a significant effect on the level of BNB FX reserves.

In 2002, Bulgaria received some USD 13.4 million of World Bank credit in support of its balance of payments. Net use of IMF credit over the same period decreased by USD 142.3 million.

As 2002 was the first year in a row to witness a certain current account deficit improvement, given a stable fiscal position, it may be expected that the 2003 deficit will steady at the same levels as percentage of GDP. The above forecasts take into account the expectations for a more rapid recovery of the world economy and hence the likely positive effect on Bulgaria's export performance, as further evidenced by the fading away conflict in Iraq that had had a detrimental impact on the world markets for quite a while and eroded business certainty in the region, sending oil prices sky-high.

According to preliminary BNB data, the country's **gross foreign debt** amounted to USD 10932.9 million in end-2002, declining as percentage of GDP from 78.2% in 2001 to 71% in 2002. Relative to end-2001, debt growth amounted to 3% due solely to the 30.5% year-on-year increase in private-sector foreign debt, indicating the positive attitude of foreign investors to the Bulgarian corporative sector and country's macroeconomic environment. The above growth was made up for by a proportionate public debt decrease, and the country's total foreign debt had thus not risen at a rate higher than GDP growth. On the other hand, the eased access of enterprises to financial resources implied better opportunities for investment and production expansion, and hence a higher productivity rate in the long run. Public debt[17] in end-2002 accounted for 76.2% of total foreign debt, decreasing by 3.4% on a year earlier. However, as percentage of GDP it amounted to 54.1%, remaining well below the Maastricht benchmark of 60%.

Under the gross foreign debt/GDP criteria, Bulgaria remained one of the most heavily indebted economies, despite the significant decrease in the ratio over the last few years. The lowest levels of the indicator were reported by the Czech Republic, Roumania and Slovakia, which is why the credit standing of the Czech Republic remained one of the highest vis-□-vis the seven first-wave acceding countries. Bulgaria has been consistently improving its external position in terms of the credit rating scales, but falling well behind the performance of the Czech and Hungarian economies, and together with Roumania reporting the lowest short-term foreign debt levels[18].

In end-2001, Standard & Poor's raised Bulgaria's credit standing from □+ to □□-/stable outlook, and further upgraded the country's rating in end-2002 to BB/positive outlook. Other international credit rating agencies like Moody's, Fitch IBCA and JCRA assessed the country's standing as to its debt as positive.[19]

Country's Credit Rating	*Moody's*		*S&P*		*Fitch IBCA*		*Short-term foreign debt, in billions of USD*		*Total foreign debt /GDP, %*	
	2001	*2002*	*2001*	*2002*	*2001*	*2002*	*2001*	*2002*	*2001*	*2002*
Bulgaria	*B1*	*B1*	*BB-*	*BB*	*BB*	*BB*	*1.2*	*1.4*	*78.3*	*73.4*
Czech Republic	*A1*	*A2*	*A-*	*A-*	*BBB+*	*BBB+*	*9.0*	*10.3*	*38.3*	*36.7*
Hungary	*A1*	*A2*	*A-*	*A-*	*A-*	*A-*	*5.5*	*5.9*	*63.3*	*59.4*
Lithuania	*Baa1*	*Baa1*	*BBB*	*BBB+*	*BBB-*	*BBB*	*1.6*	*1.7*	*44.2*	*41.9*
Poland	*A2*	*A2*	*BBB+*	*BBB+*	*BBB+*	*BBB+*	*10.6*	*11.1*	*40.2*	*42.8*
Roumania	*B2*	*B1*	*B+*	*BB-*	*BB-*	*BB-*	*1.2*	*1.5*	*29.1*	*28.0*
Slovakia	*A3*	*A3*	*BBB-*	*BBB-*	*BBB-*	*BBB-*	*3.1*	*3.5*	*55.1*	*12.1*

Source: UBS Warburg, EMEA Economic Forecasts - March/April 2003.

Foreign Trade

In 2002, the terms of trade indicator improved by 0.5% on a year earlier, favouring the country's foreign trade dynamics. Bulgarian exports remained relatively stable amidst the rising BGN to the USD, weak growth recovery rate worldwide and entailing lower demand. 2002 total exports reached USD 5687.8 million, and export prices reported a 1% year-on-year decline. In volume terms, Bulgarian exports rose by 12.4%, indicating a relatively good competitiveness of the country, given the adverse business environment worldwide. A detailed account of Bulgaria's foreign performance is given in Appendix 1.

[17] *It should be noted that BNB public foreign debt statistics differ from MoF estimates of the country's foreign debt, as the Central Bank employs the residence criterion (IMF, Balance of Payments Manual, 5th □d, 1993) to distinguish between foreign and domestic debt, while MoF statistics ignore it.*

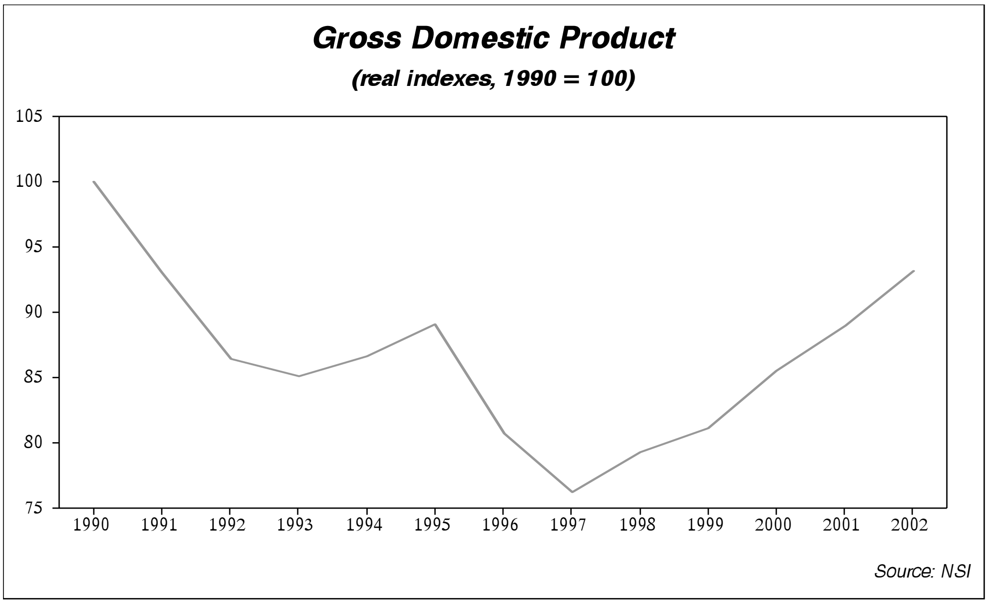
[18] *According to UBS Warburg.*

[19] *Source: MoF.*

REAL SECTOR OF THE ECONOMY

GDP

In 2002, the Bulgarian economy sustained its relatively high growth rate. According to preliminary data of the NSI, 2002 GDP amounted to BGN 32 323.7 million, reporting a 4.8% year-on-year growth and surpassing the 1995 record high ever since the onset of the transition to a market economy, but remained, however, well below its 1990 level.



All GDP components along the lines of both final consumption and output reported a positive contribution to the indicator's growth, and despite the lower international trade volumes, the Bulgarian economy was so geared up as to keep up with the growth benchmark of the post currency board period. Both domestic factors like consumption and investment and external factors contributed to the above development. For the first time since 1997, net exports have now reported a positive contribution to GDP growth due mainly to the more robust increase in the exportation of goods and non-factor services compared to imports.

Demand Side

In 2002, all main final consumption components reported some year-on-year growth.

Final consumption enjoyed the highest relative share within GDP of 87.3% and was decisive for its dynamics. Its 12-month growth amounted to 4.1%, reporting the highest contribution rate of 3.6 percentage points to total GDP change.

Final household consumer expenditures stepped up by 4.2% in real terms. Household spending by commodity and service group sustained its 2001 dynamics. Retail purchases as a main household expenditure item rose by 4.1%, with food expenditures reporting the highest weight in the year-on-year increase of 5.9%. Over the last few years household consumption of communications services was steadily reporting a robust growth (20.5%) due to the increasing demand for Internet and mobile cellular telephone services as a result of the strong competition in the sector and follow up price decrease. As in 2001, household consumption of water, heating and electricity contracted, with heating consumption reporting a drastic fall of 10.4%. In addition to the heating and electricity price adjustments, the above fall was also preconditioned by the heat accounting system to be introduced to households.

Self-sufficient farms were again a key complementary source of final household consumption. Self-sufficiency reported the highest year-on-year growth of 6.3% and hence contribution, surpassing GDP growth as a whole.

Relative Share and Growth Rate of the Major GDP Final Expenditure Item

	2001		2002	
	Relative share	*Growth rate*	*Relative share*	*Growth rate*
Final consumption	86.9	4.4	87.3	4.1
Gross fixed capital formation	18.2	23.3	18.1	9.3
Exports (goods and services)	55.6	10.0	53.1	6.2
Imports (goods and services)	63.1	14.8	59.7	4.7
GDP	100.0	4.1	100.0	4.8

Source: NSI, AEAF.

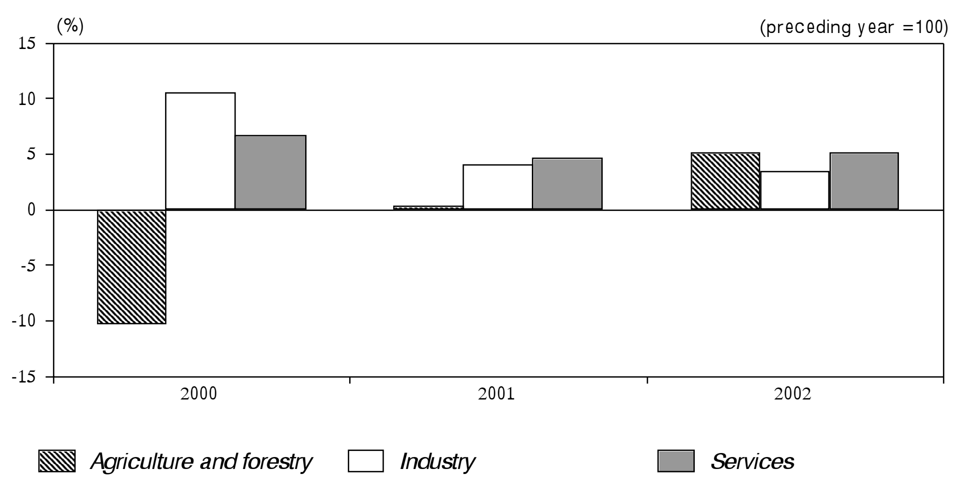
Relative to 2001, real government spending on goods and services went on the increase due to the 6.2% higher collective consumption in 2002. For the fifth year in a row, gross fixed capital formation reported one of the most robust growth rates vis-□-vis the other GDP components, triggered by its low relative share within GDP as well as by the restructuring of the Bulgarian economy and fresh new impetus given to entrepreneurship. Although for a second running year, investment growth (9.3%) had been nearly twice as high as GPD growth, there was discerned a certain slowdown in the expenditure amounts on gross fixed capital formation compared to preceding periods. Over the 1998-2001 period, investment spending stepped from well over 35% in 1998 down to 15.4% in 2000 due the uncertain business environment worldwide and declining interest of foreign investors in the emerging market economies, Bulgaria included. Another reason for the decreasing investment spending had to do with the slower pace of the privatization process, which for years on end had been a key investment pro-active factor in the country.

The other gross fixed capital formation item, i.e. inventory change went on the decline, which was a major indication of the growing demand for Bulgarian goods and relatively high liquidity in the economy.

Supply Side

On the supply side, all sectors of the economy made some contribution to value added growth, with the largest share enjoyed again by the service sector where some 60% of GVA (gross value added) was generated. Although the service and agricultural sector reported the same growth rate in 2002, the

Annual Growth Rate of Gross Value Added



Source: NSI, AEAF

latter's contribution amounted to a bare 0.7%, running four times lower than the contribution of the service sector (3 percentage points) due to its low relative weight in value added.

The GVA generated in the economy stepped up by 4.7% on a year earlier, with the share of the private sector going 1.3 percentage points up, now accounting for 72.7% of the indicator's value in the country's economy. Practically speaking, it was the sector that generated the 2002 growth in the economy (private-sector GVA rose by 7.6% on a year earlier) while the public sector reported a contraction of -2.7%.

A detailed account of output growth in the three key sectors of supply is given in Appendix 2.

Employment, Unemployment, Productivity and Wages

For the first time in the economic recovery period 2002 witnessed some stabilization and a slight improvement in the country's employment rate due primarily to the macroeconomic stability and outcome of the structural reforms accomplished.

According to preliminary 2002 data of the NSI, rising by 0.8% (24 171) on a year earlier, annual employment averaged 2 992.2 thousand. According to labour force survey data, 2002 employment had risen in all the three quarters but the fourth largely as a result of the decline in seasonal employment. On a 12-month basis, however, fourth-quarter 2002 employed numbers reported a one-percentage point increase on a year earlier.

The rising number of employed was wholly due to the higher private-sector employment (2.9% up, 63 481 on a year earlier) while public-sector employed contracted by 5% (or 39 310). The share of the private sector within the employment total reached 75%, increasing by 1.5% throughout the year, with the highest employment growth on an annual average being reported as follows: food, beverages and tobacco (7%); trade (5.6%); the textile and timber (furniture excluded) industries (about 5%).

Structure of the Annual Average Number of Employed in the Economy

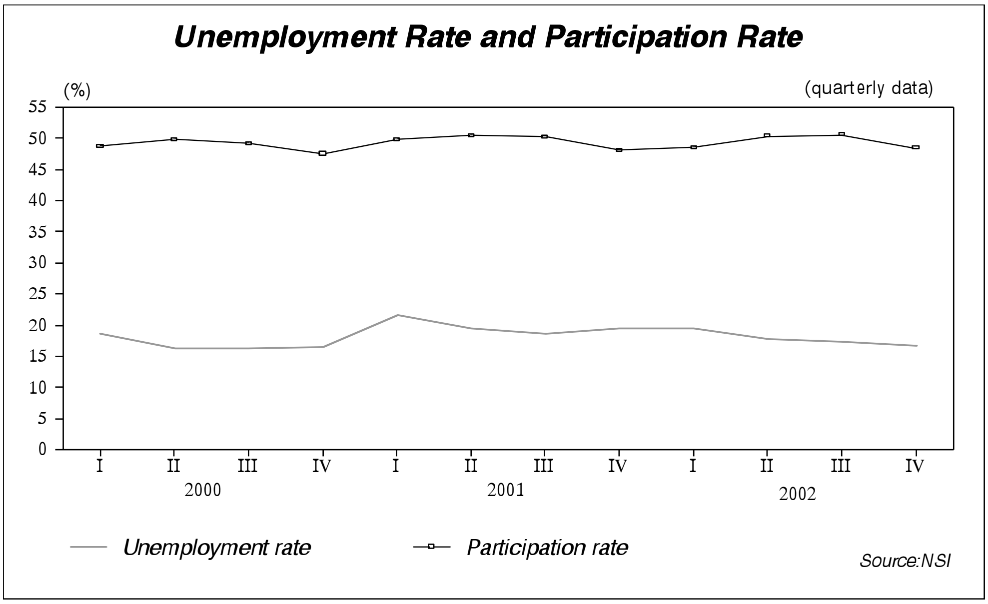
	2000	*2001*	*2002**
Total	2 980 108	2 968 069	2 992 240
Agriculture	781 566	766 796	767 134
Manufacturing sector	843 639	831 753	835 862
Services	1 354 903	1 369 520	1 389 244
% change on a year earlier	-3.49	-0.40	0.81
Structure	100%	100%	100%
Agriculture	26.23	25.83	25.64
Manufacturing sector	28.31	28.02	27.93
Services	45.46	46.14	46.43

** Preliminary data* *Source: NSI.*

The number of employed in the budgetary sector of the economy reported a 0.5% rise as a result of the higher average number of pay-roll employees in public administration. Data on the average annual number of employed pointed to a 2.9% rise, while the same indicator in education and health care contracted by 0.8% and 1% respectively. Public administration employment stepped up as a result of the administrative capacity reinforcement and institution building related to the EU accession process and utilization of the EU pre-in funds, as well as the transformation of some government agencies into ministries proper.

The delay in the large privatization deals in 2002 put off employment optimization in the same enterprises to a later date. This in turn may lead to growing job cuts over the next few years, but if the growth rate of the private-sector is further sustained, this would hardly bring about a new turnaround in the employment dynamics.

The number of unemployed tended to steadily decline in the wake of employment recovery, slower pace of restructuring and liquidation of loss-making enterprises and active labour market measures undertaken by the government, and 2002 thus witnessed a clear-cut downward unemployment rate, as evidenced by data of both the Employment Agency on registered unemployed and NSI labour force surveys.



According to the Employment Agency, the 2002 average annual number of registered unemployed reported a 2% (or 13.6 thousand) year-on-year decrease, with the exception of April when the registered unemployed total went on the increase as a result of the termination of the government temporary employment programmes, only to steadily decline at a faster rate in the last two months of 2002 due to the active labour market measures undertaken. The expectations are that 2003 will sustain the downward trend in the country's unemployment.

According to Employment Agency data, 2002 registered unemployed declined by 49.7 thousand on a year earlier. Private-sector redundancies stepped down by 38.6 thousand. It appeared that companies already privatised had done away with the employment redundancy found upon privatization and were not a source of new unemployment. Public-sector redundancies stepped down by 11.1 thousand, indicating that the effect of budgetary sector restructuring was less and less important to the country's unemployment dynamics.

NSI labour force surveys reported a similar downward trend in the 2002 unemployed numbers, which in all the four quarters of 2002 were steadily decreasing, and the indicator's performance reporting a more drastic contraction of 10.8% compared to the Employment Agency findings.

Unemployment (Employment Agency and NSI)

Employment Agency	***in thouds***		***NSI***	***in thouds***	
	2001	***2002***		***2001***	***2002***
*Number of unemployed **	*669.6*	*656.0*	*Number of unemployed**	*663.9*	*592.4*
Unemployment rate in end-year (%)	*17.9*	*16.3*	*Unemployment rate in end-year (%)*	*19.5*	*16.8*

** average annual number*

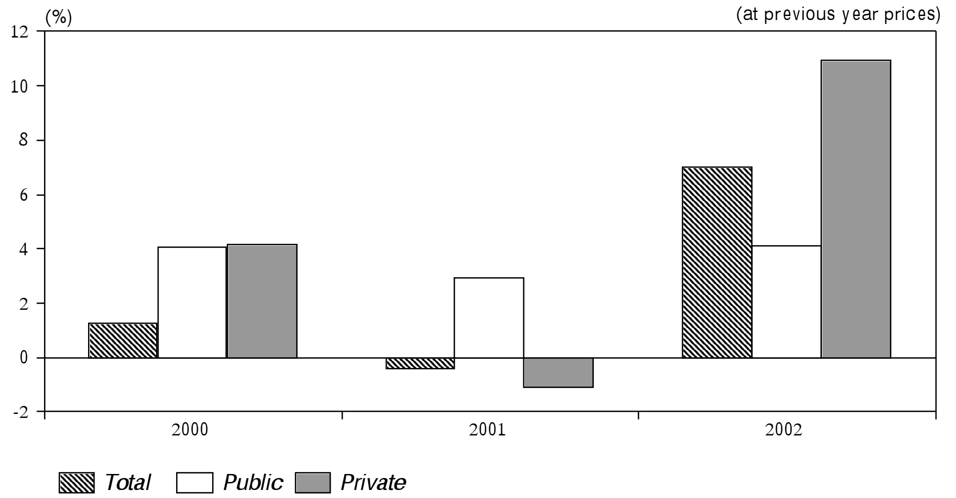
Together with the declining number of unemployed, NSI data also pointed to an upward trend in the number of discouraged that left the workforce cohorts. As a result, the participation rate stepped by 0.2% down to 49.4%. It can therefore be expected that with the recovery of the participation rate over the next few years, new job creation and active labour market measures to promote employment, the majority of discouraged people will get back to the labour market and thus foster participation in the economy.

A detailed account of government labour market policies is given in Appendix 3.

According to preliminary data on GVA and employment in the economy, 2002 productivity reported a 3.8% year-on-year improvement. Private-sector productivity increased by 4.5% due mostly to the higher gross output growth compared to employment. At the same time, productivity in the public sector improved by 2.4% as a result of the faster decline in the number of employed to GVA decrease rather than any higher participation rate in the sector. Productivity reported a most robust growth of 13.9% in the sector of finance, credit and insurance due wholly to the higher gross output. Higher productivity in the sector will lead to stronger competition among commercial banks and hence, enhanced financial intermediation. Productivity in the transport and communications sector reported a notable improvement of (12.4%) where production was more effective, given a decreasing employment rate. Labour efficiency was also higher in the production and supply of electricity, gas and water (2.8%), where a great deal of reform work is yet to be done to improve the competitiveness of Bulgarian energy companies, coupled with further efforts to optimise employment. Other sectors of the economy reporting a significant productivity improvement were as follows: agriculture, forestry and fishery (5.1%) and the processing industries (4%) where employment registered a rather modest rise compared to GVA growth. Of all sectors reporting some GVA decrease, the mining industry registered a relatively higher improvement in productivity (6.5%), indicating that the sector was undergoing further adjustment to the market requirements. Trade reported a productivity deterioration of 1.3%.

Average real wages stepped up significantly in 2002. According to preliminary NSI data, average real wages for the whole economy reported a 7% year-on-year increase (at 2001 prices), with the fastest wage growth rate posted by trade, repair and maintenance (35.2%), real estate transactions (21%), health care (12.3%) and public administration and education (by over 9.6% each). In all the above cases but public administration, average real wages in the private sector outstripped significantly public-sector wages.

Dynamics of the Real Average Wage



Source: NSI, AEAF

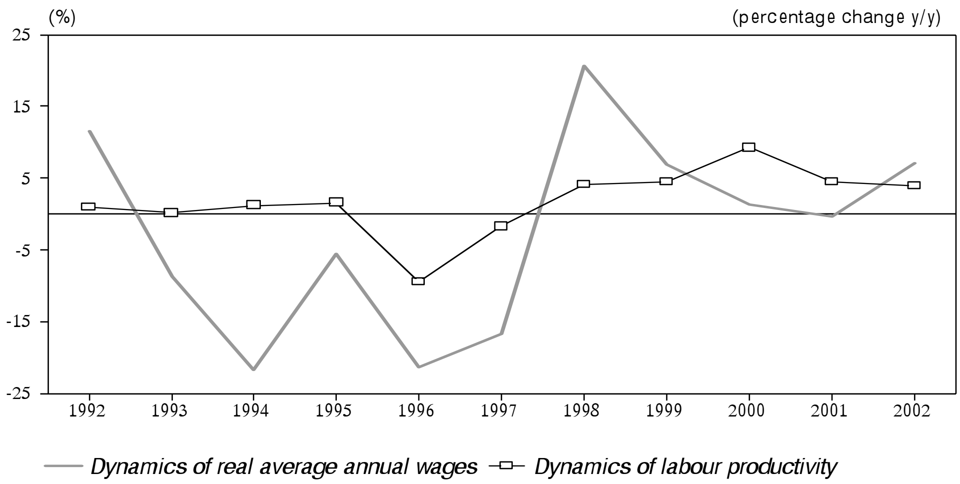
Average real wages rose by 11% in the private sector, by 4% in the public sector and 9% for budgetary organizations (at 2001 prices), with wage dynamics in the budgetary sector being strongly influenced by the 5% pay rise effected in January and July, 2002.

Real wage growth in the manufacturing sector varied between 3.2% (electricity, heating, gaseous fuel and water supply) and 8.2% (rubber and plastics).

According to household budget survey data, nominal household incomes reported a 14% year-on-year growth. Rising by 1.6 percentage points on a year earlier, wages were a key source of income, accounting for 49% of total household income. Income from entrepreneurship, mainly medium and small business, also stepped up, as did the share of income from social aid and benefits. Though at a strongly uneven rate by quarter, real household income had increased by 8.1% on a 12-month average relative to 2001.

Real wage growth in 2001 and 2002 lagged behind productivity growth in the Bulgarian economy. In 2000 average real wages rose by 1.3% against 1999, while productivity improved by 9.2%. In 2001, real average annual wages steadied at their level on a year earlier whereas productivity stepped up by 4.5%. 2002, however, witnessed a trend turnaround and real wage growth outstripped productivity growth by more than 50%.

Dynamics of Real Average Wage and Labour Productivity



Source: NSI, AEAF

Given the country's macroeconomic stability and 4.8% GDP growth, it seems unreasonable to assume that the outstripping real wage dynamics inside a year may have produced an adverse effect on competitiveness. At the same time, it should be noted that if sustained, the above trend is likely to undermine the competitive position of Bulgarian companies and jeopardise the sustainable growth mainstay of the economy.

Furthermore, any increase in income from employment inconsistent with domestic supply trends may bring about a sharp rise in consumption and the generation of a sizable foreign trade deficit and thus put the currency board stability at risk.

Inflation

In end-2002, annual inflation, as measured by the CPI, amounted to 3.8% whereas average annual inflation ran at 5.8%, hitting a four-year record low. 2002 inflation steadied at the level forecast. Early-2002 inflation was strongly affected by the higher excise duty rates on some services and VAT on locally produced medicines as well the higher fees on services. The above measures produced a stronger effect than expected only to fade away within two or three months when the month-on-month price dynamics set back within the range anticipated.

Non-food items and services reported the highest price increase due largely to the administered price change effected.[20] 12-month administered price inflation ran as follows: cigarettes (44.2%), medicines (20.8%), electricity (24.4%), heating (14.9%), water supply (13.9%).

[20] *Since the institution of the currency board arrangement in Bulgaria the government has applied administrative pricing to a reduced number of consumer basket items such as cigarettes, water supply, heating, electricity, medicines, postal and telephone services 21.3% in 2002.*

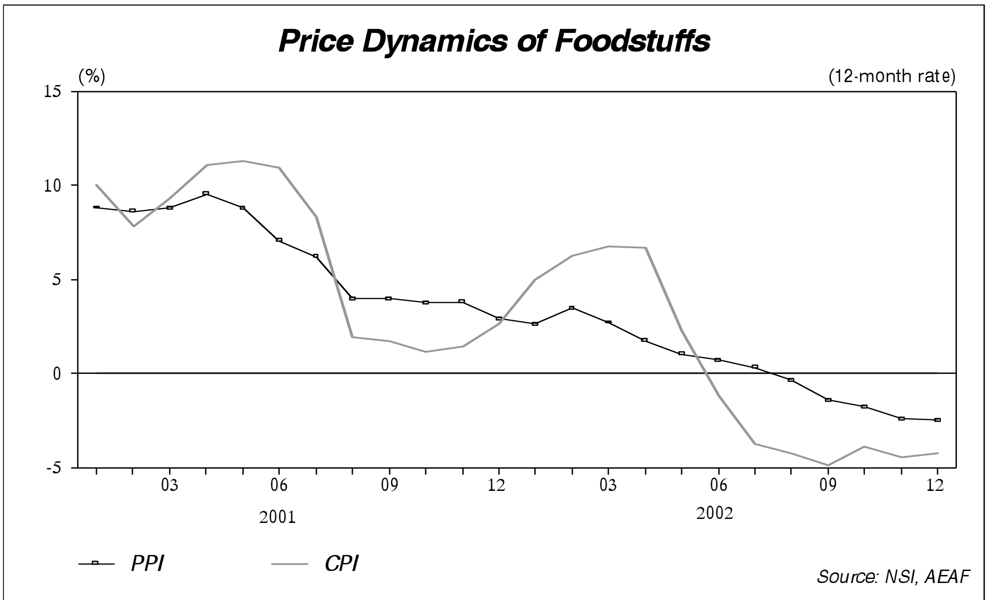
Price Change and Contribution of the Different Groups to 2002 Inflation

(on a year earlier)

Main group	*Price change (%)*	*Contribution to inflation (in % points)*
□. Food items	*-4.2*	*-1.9*
B. Non-food items	*10.4*	*2.7*
C. Restaurants and canteens	*3.9*	*0.1*
D. Services	*11.4*	*2.9*
Inflation	***3.8***	***3.8***
□. Administered prices	*20.5*	*4.4*
B. Free prices	*-0.7*	*-0.6*

Source: NSI, AEAF.

At the same time food prices went on the decrease. As the bulk of food items are tradables proper, their price dynamics is largely dependent on international price dynamics and the USD/EUR exchange rate. As a result of the interplay of the above factors, producer price inflation in the food industry stepped down in end-2002. There is a strong correlation between food producer and consumer prices. The same is true for producer and consumer price inflation.



Price Dynamics of Foodstuffs

An in-depth analysis of the external pro-inflationary factors and the Balassa-Samuelson effect is given in Appendix 4.

2003 inflation is expected to run close to its 2002 rate. First quarter 2003 cumulative inflation amounted to 1.2%. Oil prices worldwide have already gone on the decline and are likely to steady at USD 24 per barrel. Furthermore, the US currency is not expected to gain ground to the EUR throughout 2003. Both factors are anticipated to depress local prices and push inflation downwards. The food price level is likely to set back, rising, however, by 1 to 2% in the end of the year. 2003 administered price inflation will remain lower relative to end-2002. The aforementioned inflation forecasts draw upon the price projections (electricity and household heating) of the State Commission on Energy Sector Regulation, foreseeing a respective rise of 15% and 10%, effective from 1 July 2003. As for the remainder of administered prices (medicines, water supply, postal and telephone services) the forecasts are for a three to five percentage point hike.

Public Finance

Following the end-2001 tightening, 2002 saw a certain easing of fiscal policies. The primary surplus of the consolidated budget stepped down from 3.9% of GDP in 2001 to 1.6% in 2003[21]. Fiscal expansion took place at the expense of cost savings as a result of the lower interest payments rather than a higher cash deficit. The 2002 cash balance amounted to -0.6% of GDP, remaining almost unchanged on a year earlier (revenues from the sale of the second GSM operator excluded) while improving against the budget programme projections of -0.8% of GDP.

The 2002 savings-investment balance in the public sector reported a significant contraction due to the decrease in public savings rather than any increase in investment volumes. One reason for the above development is that lower savings resulted from a sizable increase in third-quarter current budget expenditures. Another reason had to do with the downward shift in the weight of local (municipal) interest payments. Non-interest expenditures had stepped up from 90.9% in 2001 to 94.4% in 2002. The interplay of the above factors led to a negative savings-investment balance, triggering the high current account deficit over the same period.

Saving-Investment Balance*

* Non-accrued quarterly data

Source: MF, AEAF

Consolidated budget revenues reported a 5.8% year-on-year rise (revenues from the sale of the GSM licence excluded) due mostly to the growth in indirect tax and non-tax revenues. Of all indirect tax items, excise duties made the most robust contribution to revenue growth, as a number of excise duty rates were raised in compliance with Bulgaria's commitments under the EU accession process. The contribution of non-tax revenues stepped up too, but the growing dependency of the budget on their performance can be identified as an adverse development with a view to their uncertainty.

2002 saw a certain shift in the weight of revenues from direct to indirect taxes, brought about by the government tax policies and aimed at doing away with any distortive effect direct taxation may have produced on economic agents' decision-making process as to how to allocate their profit. The 2002 Budget Act provided for a number of amendments to the country's tax legislation providing for a stepwise reduction in the share of direct taxes within the tax revenue total at the expense of the growing weight of indirect taxes. In the first place, the tax rate under the Corporate Income Act was unified at 15%, with the rate applied to large enterprises and companies having been reduced by five percentage points. According to estimates of the Agency for Economic

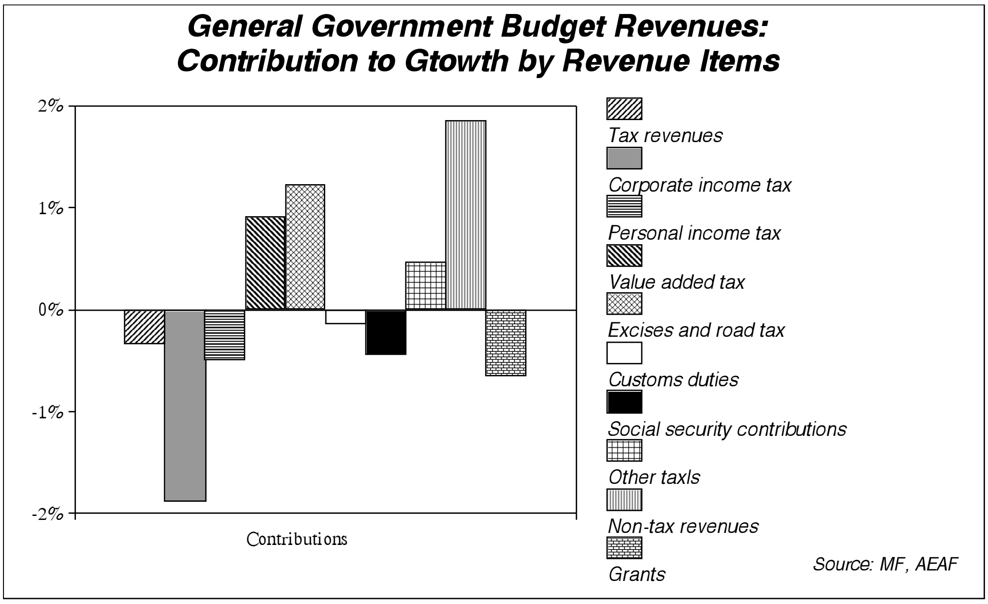
[21] *Data on budget execution in 2001 as well as in the preceding years have been revised and brought into line with ESA'95 requirements. For this and other reasons, the BGN 236.3 million worth of revenues from the sale of the GSM licence were accounted on the revenue sides instead of as a financing item. As a result, the primary balance stepped up to 3.9% instead of 3.1% have the revenues been handled as financing. The present analysis draws upon the revised data on budget execution in 2001.*

Major Public Finance Indicators

(in millions of BGN and %)	**2001***	**2002**
Revenues and grants	12 073.7	12 523.3
(as % of GDP)	**40.6%**	**38.7%**
Tax revenues	9 190.5	9 596.7
(as % of GDP)	**30.9%**	**29.7%**
Direct taxes	5 433.9	5 406.6
(as % of GDP)	**18.3%**	**16.7%**
Profit tax	1 129.6	951.2
(as % of GDP)	**3.8%**	**2.9%**
Personal income tax	1 062.8	1 052.4
(as % of GDP)	**3.6%**	**3.3%**
Revenues from social insurance contributions	2 984.9	3 075.7
(as % of GDP)	**10.0%**	**9.5%**
Indirect taxes	3 756.6	4 190.2
(as % of GDP)	**12.6%**	**13.0%**
Value added tax	2 454.4	2 688.0
(as % of GDP)	**8.3%**	**8.3%**
Excise duties and road fees	1 106.8	1 313.8
(as % of GDP)	**3.7%**	**4.1%**
Customs duties and charges	195.4	188.4
(as % of GDP)	**0.7%**	**0.6%**
Non-tax revenues	2 283.7	2 625.3
(as % of GDP)	**7.7%**	**8.1%**
Grants	363.2	301.2
(as % of GDP)	**1.2%**	**0.9%**
Expenditure and transfers	12 013.3	12 732.7
(as % of GDP)	**40.4%**	**39.4%**
Current expenditures	10 780.3	11 508.0
(as % of GDP)	**36.3%**	**35.6%**
Interest expenditures	1 105.8	712.8
(as % of GDP)	**3.7%**	**2.2%**
Capital expenditures	1 196.8	1 119.4
(as % of GDP)	**4.0%**	**3.5%**
Primary balance	1 166.2	503.4
(as % of GDP)	**3.9%**	**1.6%**
Cash balance	60.4	-209.5
(as % of GDP)	**0.2%**	**-0.6%**
Government and government-guaranteed debt	20 779.1	18 059.2
(as % of GDP)	**69.9%**	**55.9%**
Domestic debt	1 860.6	2 111.7
(as % of GDP)	**6.3%**	**6.5%**
Foreign debt	18 918.5	15 947.5
(as % of GDP)	**63.7%**	**49.3%**

*revised data

Source: MoF, AEAF.



Analysis and Forecasting, the implementation of the above measure led to a BGN 125 million worth of a decrease in profit tax revenues within the government budget.

Furthermore, personal income tax brackets underwent some amendments as follows: non-taxable income was raised to BGN 110 while the specific tax rates were further reduced, with the tax burden for the BGN 110-350 income bracket subject to the largest curtailment. The year-on-year wage bill increase of 8.4% was able to cushion the effect of the reduced tax rates and personal income tax revenues reported only an insignificant decline, to be further alleviated by the extra pay bonuses not made in 2001.

The 2002 performance of VAT revenues lagged well behind budget projections, in particular in the first-half year period. In the six-month to July, VAT revenue growth ran a bare 1.6% higher on a year earlier, reaching only some 44% of the 2002 projections.

In the second half-year period, VAT revenues caught up with the budget programme estimates due mainly to the enhanced tax collection and tightened control. The lower than expected VAT revenues in the first half of 2002 resulted from a certain underestimation of the effect of the shorter VAT-refund term (from 4 to 3 months), without being coupled with a concurrent amendment to the scope of application of tax control, an experience that has to be taken into account in case of further amendments to the VAT regime.

In 2002, general government expenditures amounted to 39.4% against 40.4% on a year earlier. The lower interbank interest rates in the international markets led to significant debt cost savings. Interest expenditures declined from 3.7% of GDP to 2.2%. At the same time, 2002 budget expenditure projections ran at 3.1% of GDP, allowing for the re-allocation of funds to other government functions while triggering a significant alteration to the expenditure structure. The growing spending on public goods like education, health care and defence took place at the expense also of expenditures on public administration maintenance and staff costs as well as economic services.

If further sustained, the 2002 tendency towards restructuring on the expenditure side will only validate the assumption that the government is able to raise efficiency while remaining strongly resolved to reduce its re-allocative function. It is noteworthy that compared to the average in the other acceding countries Bulgaria spends more money than normally on defence, which is unjustified by the country’s endeavour to integrate into NATO structures. Thus for instance, expenditures on defence in some CEECs - the Czech Republic and Poland which are also striving to achieve NATO standards ran at about 1.7% to 2% of GDP against 2.6% (or around 40% higher) in Bulgaria in 2002.

General Government Budget Expenditures by Function (as % of GDP)

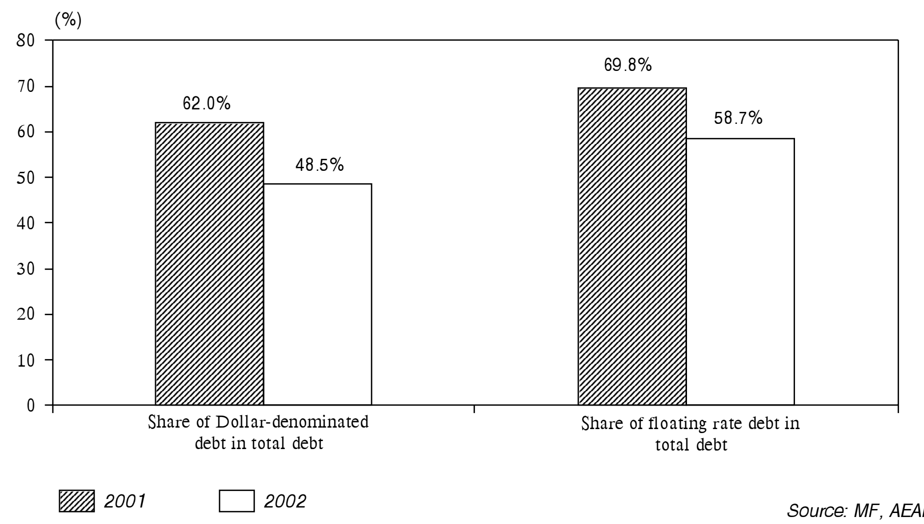
	2001	2002
Total	***40.7%***	***39.4%***
Feneral public services	*3.2%*	*2.9%*
Defence and security	*4.9%*	*5.3%*
Education	*4.0%*	*4.2%*
Health care	*4.0%*	*4.4%*
Social insurance and welfare	*13.6%*	*13.4%*
Housing construction, public works, public amenities and utilities, environmental protection	*1.8%*	*1.6%*
Recreation, culture and religion	*0.7%*	*0.7%*
Economic affairs and services	*4.8%*	*4.5%*
Other expenditure, non-classified elsewhere	*3.6%*	*2.3%*

Source: MoF, AEAF.

In 2002 expenditures performed rather unevenly by quarter due mostly to the uncertainty of revenues. In the nine months to October, total expenditures reported a 1.8% year-on-year contraction. Non-interest expenditures accounted for 69% of the consolidated fiscal programme projections while the nine-month performance of non-interest expenditures in 2001 amounted to 74.8% largely predetermined by the dynamics of revenue performance. The adequate response of the Ministry of Finance in respect to tax collection and restored revenue performance rate made it possible for expenditures to recover most robustly (by 31.8% against a three-year average of 24%) in the last quarter of 2002 as planned. The higher third-quarter expenditures were mainly due to the BGN 220 million worth of amounts extended to local governments to meet previous liabilities as well as the government decision on the payment of 13th salary in the public sector and Christmas pension mark-ups.

Any sharp increase in budget expenditures may also have a short-lived but adverse effect on the economy. Any sudden liquidity increase in the banking system may augment demand fluctuations and lead to domestic interest rate volatility and give out distorted and twisted signals to economic agents. In this sense, the follow-up money market imbalances and temporary increase in inflation over the initial expectations in early 2003 are easy to explain.

Changes in the Government Debt Structure



Source: MF, AEAF

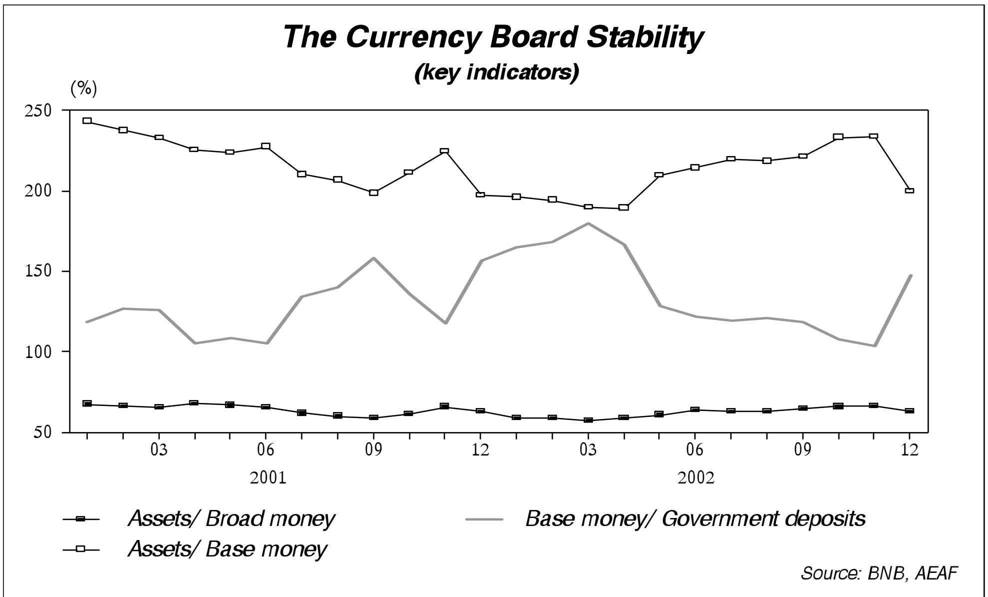
In end 2002, the government debt/GDP ratio ran at 55.9%, stepping down by 14.5%

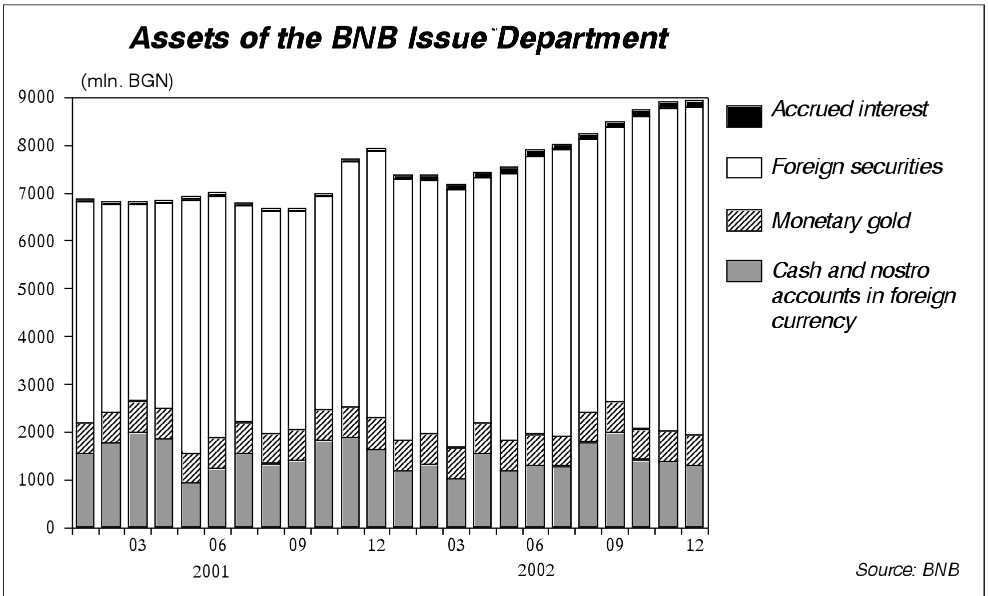
on a year earlier due to the nominal-term GDP growth and weaker USD to the single European currency. While declining by a bare 0.8% in USD terms, nominal-term foreign debt plummeted by 23.3% in BGN terms. 2002 saw two Brady-for Globals swaps, with the bonds being denominated in USD and EUR respectively, and with fixed interest rates. As a result, the sensitivity of debt servicing to USD/EUR exchange rate fluctuations and LIBOR dynamics stepped down significantly. Relative to end-2001, the share of the USD-denominated government debt contracted by 13.5%, and its floating-coupon proportion - by 11.1%. Following the two swap sessions, government debt reported a USD 155.6 million worth of a decrease.

FINANCIAL SECTOR

Currency Board Performance

The currency board remained stable in 2002 as well. In end- 2002, BNB gross FX reserves reported a 12.6% BGN-term rise on a year earlier, reaching BGN 8 947 million, or a record high level of the currency board's assets ever since the institution of the arrangement. The weaker US currency to the Euro and hence the BGN and the sustained lower interbank interest rates in the international financial markets reduced the country's foreign debt burden in 2002 and contributed to the year-on-year growth in BNB gross FX reserves. Furthermore, the foreign debt restructuring operations carried out by the government, two-year IMF arrangement concluded, and the curtailed current account deficit of the balance of payments came to the same effect.

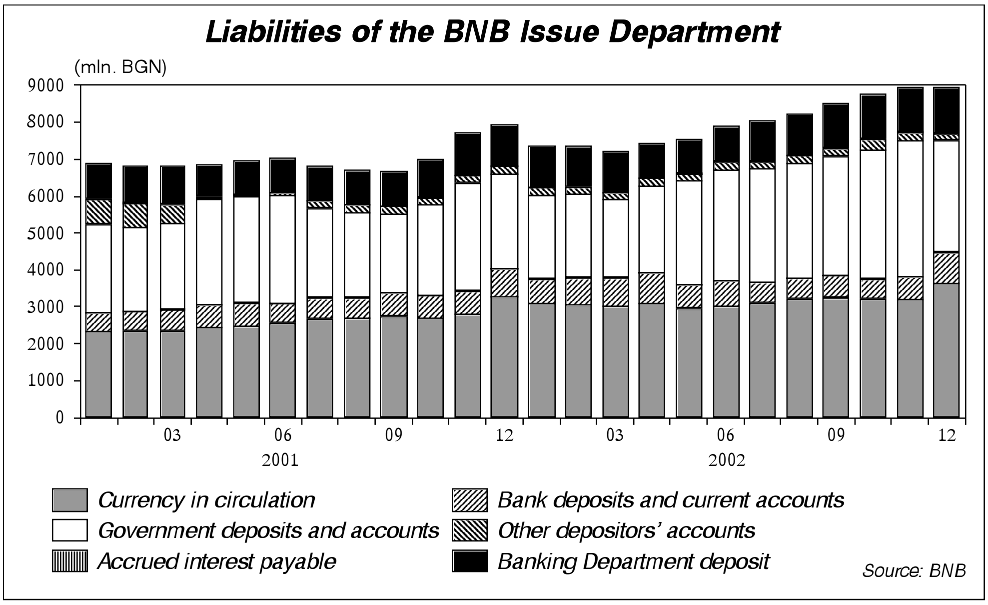




The base money coverage ratio (M3 vs. FX reserves) fluctuated within a comparatively narrow band of 57.6 - 66.4%, running at 63.3% in end-2002 (against 63% on a year earlier), and likely to steady around 60% in 2003 as well.

In end-2002, the reserve money/FX reserves ratio amounted to 199.6%, going 2.6 percentage points up on a year earlier, and expected to hit 200% in the course of the consolidated fiscal programme implementation.

Throughout 2002, the Central Bank's policies were seeking to optimise the Issuing Department's assets, as governed by the Ministry of Finance requirements to the fiscal reserve account. In end-year, foreign currency cash in hand had shrank by 21.3%, and its share within total bank assets amounted to 14.5%, accounting for a 6.3 percentage point decrease on a year earlier. On the other hand, tradable foreign securities rose by 22.6%, and their share went 6.2 percentage points up to 76.6%. At the same time, the weight of monetary gold declined to 7.2%.

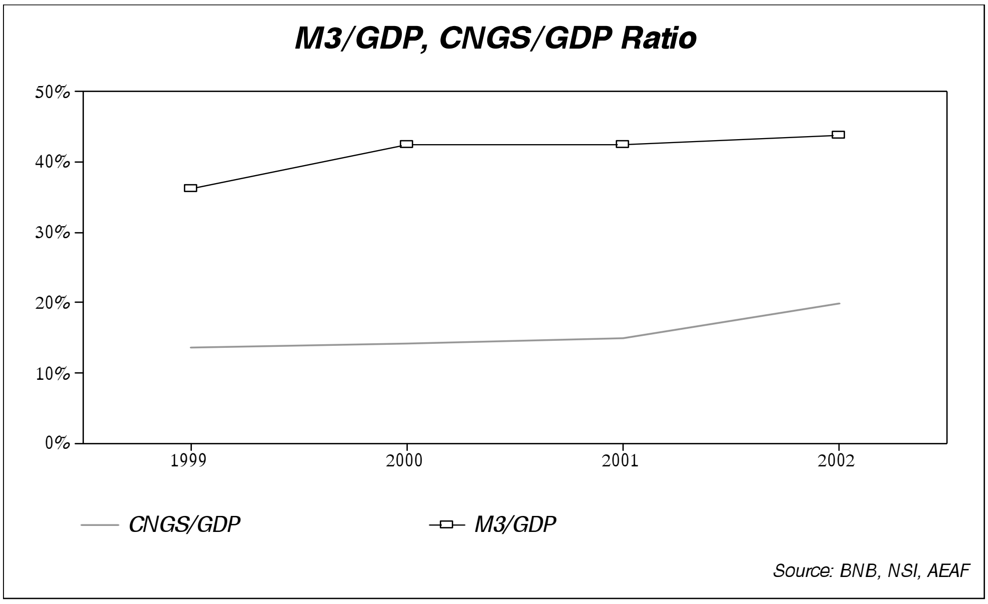


On the liabilities side, there occurred no significant changes. On a year earlier, banknotes and coins in circulation as well as suspense accounts and bank deposits reported a nominal-term rise of 11.2% and 11% respectively. Their shares within total liabilities, however, stepped down negligibly to 40.5% (0.5% down) - money in circulation, and 9.5% (0.1%) - bank reserves.

2002 government deposits (fiscal reserve account) went on the increase, reporting an 18% year-on-year rise. Their relative weight stepped up by 1.5% to 33.9%. At the same time, the Banking Department's deposit grew by 10.3% on a 12-month basis but its share within total liabilities declined by 0.3% down to 14.1%.

Money Supply and Bank Lending

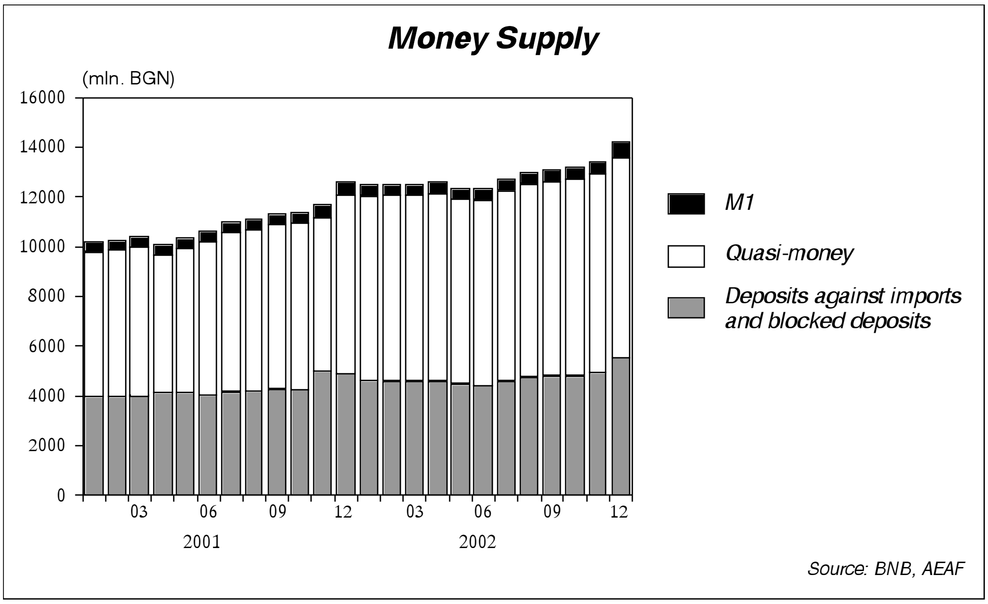
In 2002, the remonetisation of the Bulgarian economy carried on at a faster rate. Money supply reported a real-term growth of 8.2%. In nominal terms, broad money rose by 12.3% or BGN 1.55 billion, relative to end-2001. The BGN component of M3 grew faster (by 16% or BGN 1.2 billion) while its foreign currency component reported a 6.6% increase of BGN 328.9 million only as a result of the cheaper USD to the Bulgarian currency. In end-2002, the M3/GDP ratio ran at 39.8% against 36.9% on a year earlier.

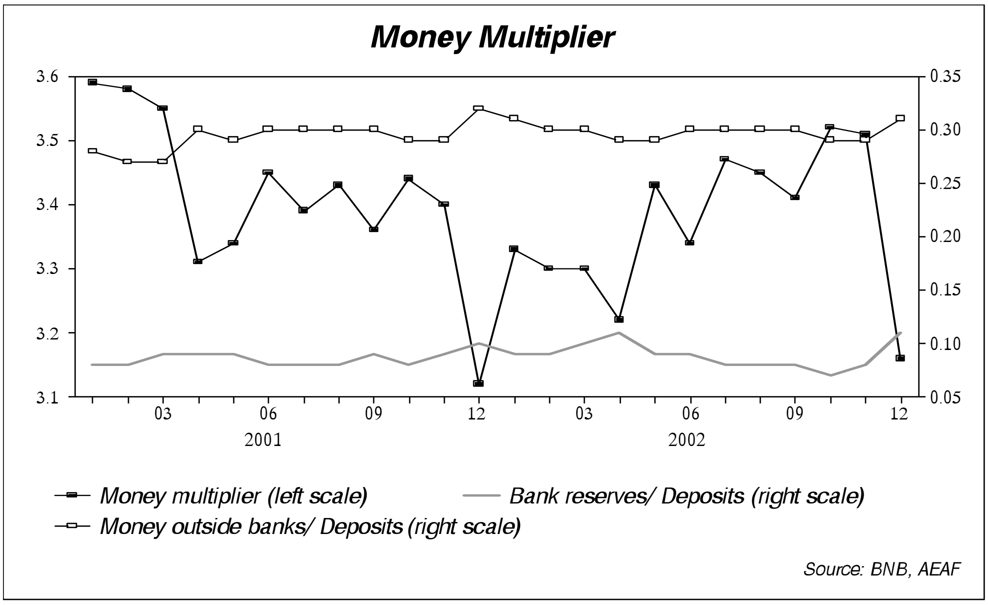


In 2002, of all money supply components, the highly-liquid monetary aggregate M1 reported the most robust nominal- and real-term growth of 13.5%

(BGN 658.8 million) and 9.3% respectively. Apart from the growing demand for money for transaction purposes matching the higher GDP growth, the other reasons behind the 12-month change in M1 had to do with the high summer holiday season, the budget transfers to local governments and social insurance funds to cover accumulated deficits and the year-end payment of extra bonuses in the budgetary sector. More specifically, stepping up by 22.6% (BGN 404.9 million), demand deposits in BGN reported a most significant contribution to the 12-month growth of M1. Money in circulation reported an 8.2% year-on-year rise of BGN 253.9 million that took place as late as the end of 2002.

Accounting for the bulk of money supply (56.8%), quasi-money stepped up by 11.4% or BGN 821.7 million on a year earlier, and the most illiquid components increased by 13.2% (BGN 65.9 million). Its BGN component ran 19.5% (BGN 478.7 million) higher than in 2001 due to the most robust contribution of household time and savings deposits. The BGN equivalence of foreign currency deposits grew by 7.2% or BGN 343 million. The lower 12-month growth in foreign currency deposits was triggered by the USD's lost ground to the Bulgarian currency in 2002, as USD deposits still enjoyed a rather significant share in the total deposit mass.





Household propensity to save did not undergo any significant changes in 2002. Households remained unresponsive and somewhat dormant to the cheaper US currency and low USD deposit interest rates, and opted again for savings in foreign currency, USD in particular. Given the market trends worldwide, the retained household preferences to savings in USD were indicative of the impotency of banks to act as intermediaries to optimise spending in the economy.

Money base reported a larger contribution to the nominal-term growth in money supply vis-à-vis the money multiplier - of BGN 1 405.6 million vs. BGN 126.6 million. Unlike in 2001, the latter's contribution ran now positive, reflecting higher bank lending, growing competition in the sector and enhanced financial intermediation. The money multiplier is expected to rise even further in the next couple of years, as higher bank lending improves as a rule its performance with a certain lag in time. Other things being equal, this will foster remonetisation in the economy.

Monetary Base and Money Supply Mechanism

	Over the 31.12.2000 - 31.12.2001 period	Over the 31.12.2001 - 31.12.2002 period
Monetary base change (in BGN million)	1 011.9	449.9
Coefficient of money multiplier variation (%)	4.05	3.71
Change in M3 by factor:		
1. due to a change in money multiplier (in BGN million)	-622.9	126.6
2. due to a change in M3	3 370.5	1 405.6
3. due to a change in money multiplier and monetary base	-208.7	14.1
Change in M3 (in BGN billion) =1+2+3	2 538.9	1 546.3

Source: MoF, AEAF.

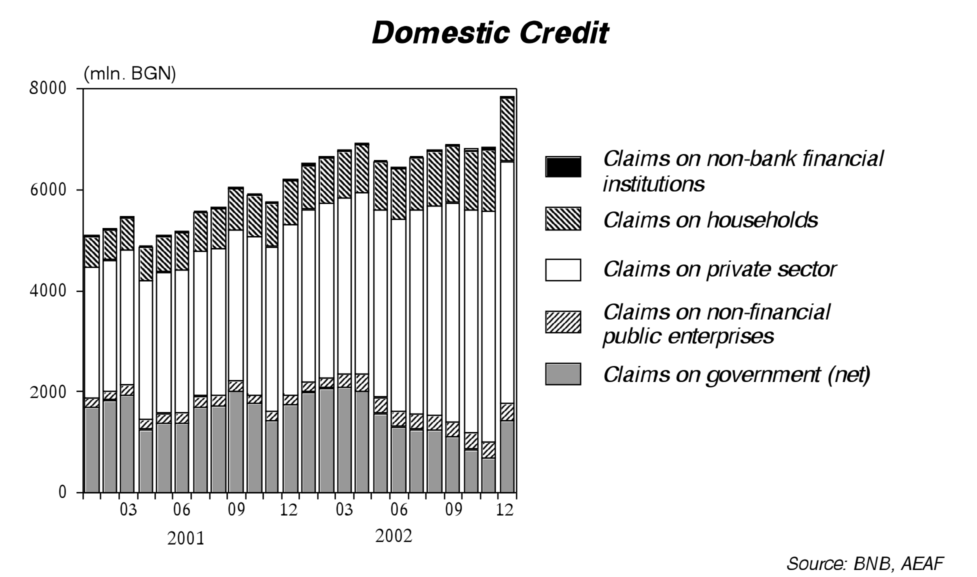
The financial markets trends worldwide, together with the lower systematic risk in the Bulgarian economy and growing competition among banks led to a significant domestic credit growth. Net domestic assets in the banking system increased by 37.8% or BGN 1.28 billion on a year earlier. At the same time, net foreign assets had stepped up by 2.8% (BGN 261.1 million), with the year-on-year growth being wholly due to the higher BNB FX reserves. The net foreign assets held by commercial banks went on the decrease resulting not only from the contraction of deposits with foreign banks but also from the extension of credit facilities by foreign lending institutions to support the economy.

The 2002 growth in net domestic assets in the banking system was mainly due to the rising domestic credit (26.6%, or BGN 1.65 billion up on a year earlier) as a result of the 44% year-on-year increase of BGN 1.96 billion in bank claims on the non-government sector. The non-government sector credit/GDP ratio went up to 16.5% against 15.4% in end-2001. Over the same period, bank claims on the government sector had declined by 18.1%, or about BGN 314 million.

The share of the BGN component within total domestic credit had risen from 50.9% in end-2001 to 55.6% in end- 2002. The decrease in the share of the foreign currency component was spurred by the USD's deprecation to the Bulgarian currency as well as the drastic fall in net foreign currency claims on the central government related to the increase in the fiscal reserve account with the Issuing Department of the Central Bank[22].

The foreign currency component of non-government sector credit grew at a faster rate vis-a-vis the BGN component - by 67.6% (BGN 1.07 billion) vs. 31% (BGN 894.9 million) due to the withdrawal of commercial banks from the international deposit market and the fact that the major savers in the economy, i.e. households, still opted for savings in foreign currency, USD in particular. Commercial banks in turn had to comply with BNB requirements as to the maximum amount of open foreign currency positions. Private-sector and household

[22] *Money supply statistics give account of claims on the central government on a net basis.*



Source: BNB, AEAF

loans reported the highest year-on-year growth of 42.8%, or BGN 1.42bn, and 43.6%, BGN 380.8 million, respectively. Foreign currency loans made a larger contribution to the increase in bank claims on the private sector (74.1%), while BGN credit enjoyed a bigger weight in claims on households of 92.1%. In the twelve months to December 2002, bank claims on non-financial state-owned enterprises and non-banking financial institutions had stepped up by BGN 131.6 million and BGN 14.1 million respectively.

Besides the quantitative change that bank lending had undergone, there were in 2002 a number of other policy developments that had to be accounted for. For example, bank lending policies as to credit maturity were further eased. The amounts on short- and long-term loan extensions on a monthly basis were running closer and closer together, though short-term credit went on enjoying a larger share in bank credit portfolio. The share of standard loans carried on rising, whereas the share of loans classified as loss was steadily decreasing, indirectly indicating that systematic risk in the economy had been by and large reduced. At the same time it was too early an indication to rush to any definitive decisions as to the link between bank portfolio quality and credit expansion, as the latter's effect is hard to predict over time.

Banking System

In 2002, the Bulgarian banking system remained stable and well capitalised. Commercial banks' *capital adequacy* indicators sustained significantly higher levels than those fixed by BNB's Ordinance No8. As of end-2002, the banking sector[23] overall capital adequacy ran at 25.2%, stepping down by about 6.1 percentage points on a year earlier. In 2002, the indicator's two principal components, viz. the total risk component of commercial banks' assets and the capital base increased by 40.6% (BGN 1 996 million) and by 13.2% (BGN 203.7 million) respectively. The continuing fall of the unduly high capital adequacy indicators is in line with the altered commercial banks attitude to credit lending and risk in the real sector of the economy.

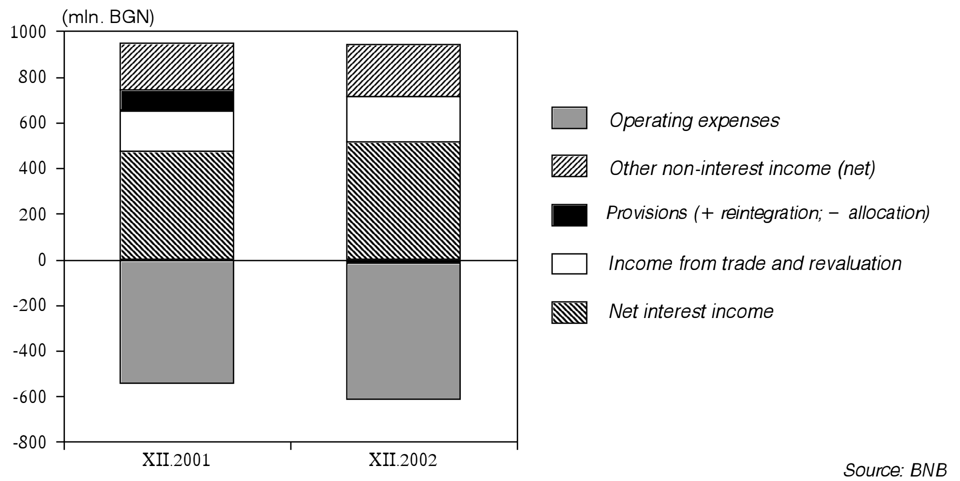
As of end-2002, the banking system maintained lower *liquidity* as gauged by the primary liquidity indicator than in end-2001. In December 2002, commercial banks' primary liquidity indicator ran at 11.2% against 13.47% in December 2001, having set back to its normal levels before the withdrawal from circulation of the national currencies of the countries in the euro area. The value of secondary liquidity indicator, however, had stepped up to 29.25% from 25.47% reported in end-December 2001 mainly as a result of the increase of the share of government securities within banks' portfolios.

[23] *Foreign bank branches excluded.*

In 2002, the *profitability* and *financial situation* of the banking system remained stable. As of end-December 2002, commercial banks net profit ran at BGN 266.6 million, stepping down by 16.5% on a year earlier (BGN 319.4 million reported in 2001). The decline is associated with the absence over the period of income from the reintegration of provisions, the latter being responsible for the substantial increase in operating profit in the first half of 2001. Had the impact of the reintegration of provisions been eliminated, commercial banks pre-tax profit in 2002 would have exceeded the 2001 profit figure by 2.5%. The three largest banks in Bulgaria, viz. *Bulbank, DSK Bank* and *UBB* accounted for about 63.6% of total banking system net profit in 2002 as compared to a share of 72.7% in 2001. The changes in the structure of commercial banks operating profit included an increase in the share of net interest income and net income from commissions and fees (the conventional banks revenue sources) at the expense of the shrinking share of income from trade, revaluation of assets and reintegration of provisions.

The *net interest income/ operating expenses ratio* ran at 86.5% in end-2002, reporting a 1.3 percentage point year-on-year fall (87.8% in end-2001). The value of this indicator in the largest banks[24] was close to or higher than 1, indicating that their operating profit was sufficient to cover their operating expenses. The ratio hit much lower values than 1 in some of the small banks[25] deteriorating on a 12-month basis and indicating that they have become more and more dependent on a limited circle of clients (mainly corporate) and therefore their susceptibility to risks has increased. Mergers of small banks remain a logical way to reduce these risks, however, there are still no publicly declared merger intentions of banks in bank group IV.

Commercial Banks' Operating Profit Before Tax and Extraordinary Items



Source: BNB

The banking system balance sheet value reached BGN 14 557.1 million in end-2002, increasing by BGN 2 336.6 million relative to end-2001. Its growth rate of 19.1% ran lower than the figure reported in the corresponding period a year ago (25%) mainly as a result of the depreciation of the US dollar against the lev. In 2002, the BGN component accounted for a larger contribution (BGN 1 550.1 million) to the growth of bank assets than that of the foreign currency component (BGN 786.5 million). As of end-December 2002, the three largest banks (*Bulbank, DSK Bank* and *UBB*) held 43.3% of total banking system assets against 46.1% as of 31 December 2001.

2002 sustained the changes in the commercial banks' asset structure that came into being in the second half of 2001. Thus, the share of credits to non-financial institutions and other clients stepped up by 7.5 percentage points against end-2001, reaching 41.4% of total assets whereas the weight of claims on banks and other financial institutions decreased by 9 percentage points to 24.1% of total assets.

[24] *Included in bank group I according to BNB's classification.*
[25] *Banks with balance sheet value of up to BGN 100 million, comprising bank group IV according to BNB's classification.*

Commercial banks credit portfolio had improved relative to end-December 2001. Thus, as of end-2002, some 94.47 % of bank risk exposures were classified as standard against 92.3% in December 2001. In end-2002, in spite of the increased bank claims on firms and households, only 1.82% of credit exposures were classified as a loss as compared to 2.5% a year ago. 2002 was marked by moderate credit expansion and any generalisation of the trends in the development of commercial banks credit portfolio would be unreliable[26]. However, it is safe to say that the structure of commercial banks assets has been gradually approximating the prevailing structure in countries with relatively well developed banking systems. A more detailed analysis of bank assets structure is given in Appendix 5.

Concentration in the banking sector went up following the privatization of *Biochim* Commercial Bank and the subsequent merger of *Hypovereinsbank* with *Biochim*. Yet, no reversal of trends was discerned in the dynamics of the measures of concentration in the sector. The following conclusions can be made:

- The opposing dynamics of the concentration coefficient and Herfindahl Index were most obvious in the dynamics of total assets and deposits having to do primarily with the redistribution of market shares between commercial banks classified in groups I and II, i.e. banks with balance sheet value of more than BGN 800 million and BGN 300-800 million respectively.
- The shrinkage of the market share of the largest Bulgarian bank (*Bulbank*) had the largest contribution to the decline of concentration in this market segment. The decreasing market share of the bank was to a certain extent associated with the depreciation of the US dollar to the BGN in view of the fact that the bulk of deposits in *Bulbank* were dollar-denominated.
- The increase of concentration with respect to bank claims gauged by Herfindahl Index was due to the more intensive credit operations of some of the larger banks.
- The ongoing intensification of competition in the banking sector raises a number of long-term issues having to do with the future of smaller banks and the contingent consolidation in the sector. The update of the strategies of most banks is likely to address these issues.

Measures of Concentration in the Banking Sector

	XII.1997	*XII.1999*	*XII.2000*	*XII.2001*	*XII.2002*
Bank assets					
Herfindahl Index	*0.27*	*0.12*	*0.11*	*0.09*	*0.12*
Concentration Coefficient (%)	*72.3*	*57.0*	*55.2*	*51.4*	*49.9*
Claims on Non-financial Institutions and Other Clients					
Herfindahl Index	*0.14*	*0.08*	*0.07*	*0.07*	*0.11*
Concentration Coefficient (%)	*62.4*	*43.6*	*42.0*	*41.1*	*41.9*
Deposits of Non-financial Institutions and Other Clients					
Herfindahl Index	*0.15*	*0.13*	*0.13*	*0.11*	*0.13*
Concentration Coefficient (%)	*65.8*	*61.7*	*62.2*	*58.2*	*55.8*

Source: BNB, AEAF.

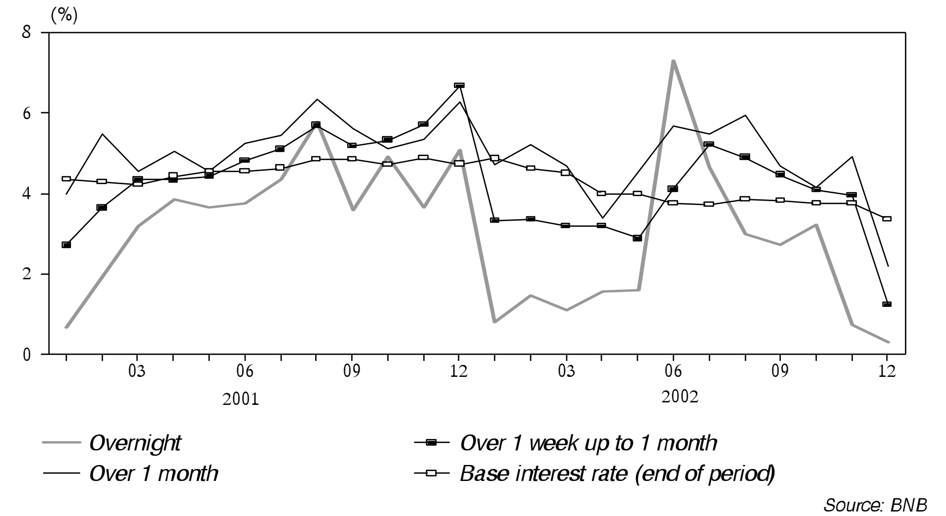
[26] *It is impossible to assess immediately after a credit is granted whether it would remain standard throughout the life of the loan.*

The promulgated in end-September 2002 amendments to the Banks Act that aimed at increasing the transparency of bank capital are also likely to contribute to the lowering of risk stemming from excessively tight linkages between commercial banks and specific corporate clients. According to the enforced in end-2002 amendments, the Banking Supervision Department is now in a better position to monitor the financial situation of bank shareholders and to take preventive measures and respond adequately should the need arise. The amendments are expected to contribute to the notable enhancement of transparency of share capital.

Money and Foreign Exchange Markets

In 2002, the base interest rate stepped down by about 1.4 percentage point to 3.35% in end-December.[27] The BIR continues to reflect primarily the situation of public finance and is therefore less illustrative of the money price dynamics in the economy. Interest levels at the interbank money market in BGN fluctuated within a very large band. In early-2002, they were highly affected by the inflow of liquidity in the banking sector from the state budget, steadying at around 1%. In mid-year, interbank interest levels sharply increased and, in certain days, interest on overnight deposits soared to the record high 30% on an annual basis. Such sharp interest rate fluctuations were not associated with any persistent liquidity problems of the banking system. Rather, they had to do with temporary shortfalls of cash usually caused either by bank transfers of tax and excise payments of clients or by the necessity to adjust the minimum required reserves.

Interbank Money Market Interest Rates



Source: BNB

Commercial banks interest rates on deposits followed dissimilar dynamics depending on the currency of denomination. The average weighted interest rate on time deposits in BGN fluctuated within a band of ± 1 percentage point (between 2.35% and 3.52%). Its dynamics was influenced by the changes in the overall rate of return on BGN assets and by commercial banks' market-based endeavours to alter the structure of their assets in favour of the BGN component. Interest rates on time deposits in euro remained at their end-2001 levels of around 2.2% (average weighted value). Interest on USD-denominated time deposits decreased from 1.72% in end-2002 to 1.57% in end-2002. The low interest levels on time deposits in foreign currency reflect the record low rates of return on the international financial markets.

In 2002, commercial banks admittedly strived to attract longer-term deposits (of 1 year or more) even by offering higher interest rates on such deposits. Combined bank and insurance products as well as bank

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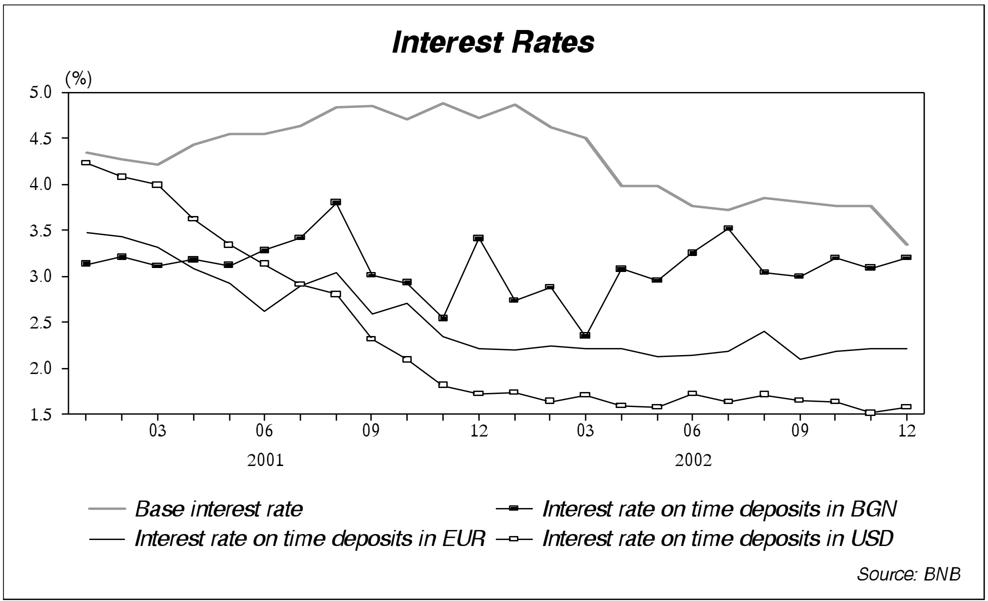
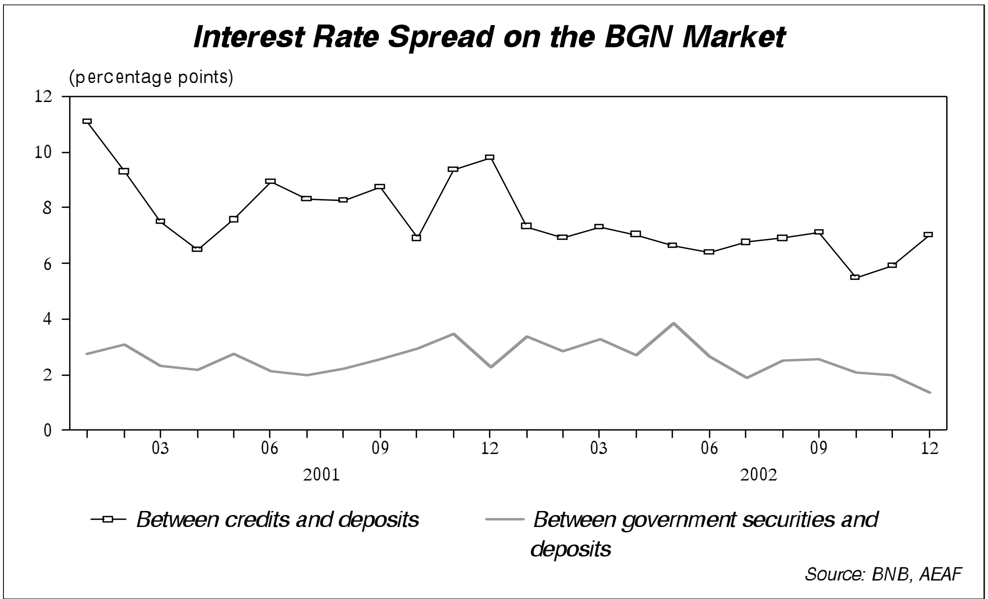
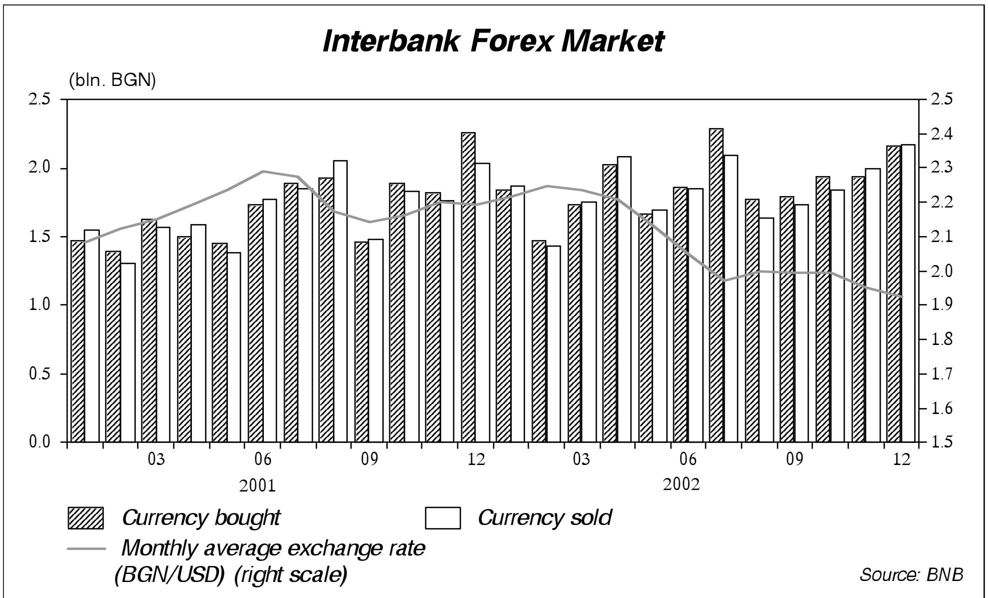
[27] *According to the methodology applied by the central bank, the BNB announces the* base interest rate *determined by the yield on 3-month treasury bills achieved at the primary auctions held by the BNB only once a month since January 2002.*







packages comprising several bank products offered under more client-oriented terms and conditions[28] are already available on the Bulgarian market.

A relatively weak downward trend in interest levels on credits was discerned in 2002. The interest difference between credits and deposits went on contracting, remaining however above the levels in most Central and East European countries. The average interest spread shrank from 8.5 percentage points on a yearly average in 2001 to 6.7 percentage points in 2002.

2002 sustained the upward trend in the volumes of interbank market placements in BGN. The average daily volumes of interbank placements increased by 0.9% that is a sign of commercial banks sustained efforts to efficiently manage the structure of their portfolios.

Following the EUR/USD exchange rate dynamics, in 2002 the BGN appreciated to the dollar by 4.9% on a

[28] *Current accounts in BGN and foreign currency, BORIKA debit card with an overdraft facility, international debit card, Internet banking, etc.*

year earlier (2002 average annual against 2001 yearly average). At end-year values, the BGN had appreciated by 15% to the dollar. Over the same analysed period, 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 336.9 million. The structure of transactions by foreign currency underwent some substantial changes relative to end-2001 as a result of the introduction of euro notes and coins in circulation. In end-2002, the share of transactions in USD in total trading reported a year-on-year contraction of 3.1 percentage points to reach 25.6% whereas the share of transactions in euro stepped up by 18.2 percentage points to 72.8%.

Non-bank Financial Institutions and Capital Market

The improvement of the indicators gauging the development of non-bank financial institutions and the capital market was sustained throughout 2002 indicative of the growing role of non-bank financial institutions in the economy. Regardless of the substantial progress in the development of this sector made in 2002, commercial banks continued to dominate the Bulgarian financial market.

Key Financial System Indicators

% of GDP	*1999*	*2000*	*2001*	*2002*
Commercial bank assets	*34.4*	*36.5*	*41.1*	*45.0*
Pension fund assets	-	*0.32*	*0.63*	*1.03*
Insurance premiums	*1.30*	*1.45*	*1.61*	*1.59**
Market capitalisation of the stock exchange	*5.77*	*4.82*	*3.72*	*4.25*

** As of end-September 2002*

Source: BNB, Financial Supervisory Commission, BSE-Sofia.

In 2002, all three pillars of the pension insurance system became fully operative and the accumulation of assets in mandatory supplementary and voluntary *pension funds* commenced. The amount of accumulated assets in pension funds increased by 77.9%, reaching BGN 332.5 million in end-2002. The upward trend is expected to sustain in the forthcoming years.

Financial intermediation of pension funds strengthened and improved in 2002. The ratios of pension funds assets to GDP and pension funds assets to gross national savings reported much better values in 2002. Thus, the assets to GDP ratio stepped by 0.40 percentage points up and reached 1.03% in end-2002 while the assets to gross national savings ratio increased by 2.73 percentage points, reaching 7.06% in end-year. Regardless of improved pension fund performance, Bulgaria is considerably behind the degree of financial intermediation of pension funds found in the other transition economies. For example, the ratio of pension funds assets to GDP in Poland ran at 4.2% in end-2002, remaining 4 times higher than in Bulgaria. A detailed analysis of accumulated assets in the different pension funds as well as an analysis of the structure of investment portfolios and competition on the pension insurance market in Bulgaria can be found in Appendix 6.

The steady upward trend in the dynamics of insurance was sustained throughout 2002. The role of *insurance companies* as financial intermediaries further strengthened. In the nine months to October 2002, insurance intermediaries recorded a gross premium income of BGN 375.3 million, accounting for 78.5% of the total premium income received in 2001. Given the fact that the bulk of premium income is typically collected in the fourth quarter of the year when economic agents contract the mandatory insurance policies, premium income in 2002 is expected to outperform previous year income by about 20%. Insurance penetration (the ratio of gross premium income of all companies operating in either life insurance or non-life insurance to GDP) stood at 1.59% in end-September 2002, reporting a year-on-year increase of 0.17 percentage points. The level of insurance penetration in Bulgaria is analogues to the value of the indicator in Lithuania notwithstanding the much better performance of Bulgaria over the 1999-2001 period. Judging by the value of this indicator, Bulgaria is still lagging behind other countries such as Hungary, Poland, the Czech Republic and Latvia. Regardless, the upward trend measured by the value of the indicator evidences the importance of the insurance sector for the development of the financial system of the country and the economy as a whole. A more in-depth analysis of Bulgaria's insurance market is presented in Appendix 7.

Insurance Penetration

	1999	2000	2001				2002			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Poland	3.01%	3.04%	-	-	-	3.10%	-	-	-	-
Slovakia	2.84%	3.02%	5.18%	3.87%	3.43%	3.25%	5.16%	3.97%	-	-
Hungary	-	2.92%	-	2.91%	2.83%	2.79%	3.36%	-	-	-
Estonia	1.69%	1.77%	-	-	-	-	-	-	-	-
Lithuania	1.03%	0.97%	1.04%	1.02%	0.99%	1.00%	1.85%	1.73%	1.52%	2.08%
Latvia	2.43%	2.17%	2.18%	2.17%	2.09%	2.02%	2.28%	2.15%	2.10%	2.76%

Source: Insurance and Pension Funds Supervisory Commission (Poland); Financial Market Authority (Slovakia); Hungarian Financial Supervisory Authority (Hungary); Estonian Insurance Supervisory Authority (Estonia); State Insurance Supervisory Authority (Lithuania); Financial and Capital Market Commission (Latvia).

In 2002, Bulgaria's *capital market* also sustained its upward trend of development, yet further advancement is required to reach a level adequate to and required by a functioning market economy. The volumes traded at the Bulgarian Stock Exchange (BSE) remained several times smaller in comparison to turnover at the capital markets of the other EU applicant countries.

In 2002, the market capitalisation of the companies listed at the BSE increased from BGN 1 101 million in end-2001 to BGN 1 375 million. The market capitalisation to GDP ratio stepped up by 0.6 percentage points to reach 4.3% in 2002. In spite of the improved performance in 2002 of all indicators measuring the state of the Bulgarian capital market, it continued to be underdeveloped, lagging behind the level of development found in other EU candidate countries. A detailed analysis of capital market development in 2002 is given in Appendix 8.

Stock Exchange Market Capitalisation

Market capitalisation to GDP (%)	1999	2000	2001	2002
Slovakia	13.6	12.9	29.7	27.1
Czech Republic	25.2	22.3	15.8	21.0
Estonia	36.6	35.2	27.4	33.9
Lithuania	29.8	27.0	21.9	19.8
Hungary	38.7	28.3	19.4	18.3
Rumania	1.0	1.3	3.3	6.1

Source: Bratislava Stock Exchange, Prague Stock Exchange, Tallinn Stock Exchange, National Stock Exchange of Lithuania, Budapest Stock Exchange, Bucharest Stock Exchange, Bulgarian Stock Exchange, AEAF

STRUCTURAL REFORMS

2002 sustained the structural reform exercise with a view to attaining the strategic objective of implementing the economic criteria of Copenhagen[29] and related thereto sustainable growth at a rate higher than the EU average. The priority areas on the structural reform agenda were as follows: further liberalization and privatization of state monopolies, restructuring of the budgetary sector and completion of bank privatization. The reform pace differed across the three segments. State monopoly privatization lagged significantly behind bank privatization.

As for bank restructuring and privatization, 2002 saw the conclusion of one of the 2002 deals planned - the sale of Commercial Bank Biochim. Further progress was made on the pre-privatization arrangements for the State Savings Banks according to schedule. At the same time, the reforms launched in key areas of the budgetary sector like health care and education failed to come to the service supply optimization and financial stability desired. The privatization of two of the economy vital enterprises, i.e. Bulgartabac Holding, AD and the Bulgarian Telecommunications Company, failed to take place as planned and gave rise to sharp political debates.

There were concluded in 2002 some 103 privatisation deals on 73 whole enterprises and 30 detached parts. Furthermore, 173 minority shares of enterprises already privatized were put up for sale. The output delivered, however, lagged well behind the 2002 Plan of the Privatisation Agency, providing for some 328 deals on the majority shares of companies and detached parts. The financial effect of privatization totalled USD 243 million, of which USD 162.7 million worth of contracted payments, USD 35.4 million of commitments undertaken, and USD 44.9 million of contracted investments, or well below the 2002 expectations. According to data of the Ministry of Energy and Energy Resources, revenues from privatization in the energy sector amounted to BGN 153 million, including BGN 47 million from privatization in the coal mining industry and BGN 95.8 million from sales of thermal plants. The share of privatized assets as part of the assets earmarked from privatization reported a negligible yea-on-year increase of a bare percentage point, now reaching 81.03%.

The slowdown in the privatization process could only partially be explained by way of the alterations to the privatization approach and related thereto legal amendments and restructuring of the line government institutions. A new Privatisation and Post-Privatisation Control Act was adopted as early as March 2002, providing for greater transparency and separation of privatization from post-control privatization. Furthermore, the government established a Post-Privatisation Control Agency on its own right.

The structural reform experience gained in 2002 indicates that amendments to the format of administrative measures and the aspirations of the government to implement them as soon as possible alone will not do to speed up the developments underway, as their pace was checked by the political debate on the sale of BTC and Bulgartabac Holding, giving prominence to the short-term political and social impact of the deals rather than their effect on the quality of management and viability of the companies in the long run.

[29] *See Section „EU Accession Negotiations" of this report.*

It follows that the acceleration and completion of the structural reforms and privatization by 2006 at the latest may only take place following a thorough evaluation and an in-depth analysis of the effect of the likely alternatives to state monopoly and budgetary sector restructuring. This is also the foundations of any political debate and follow up choice of values as to a new owner. Decisions as to the intervention of the government in each specific case of restructuring and privatization should take account of the political consensus reached and market realities. An account of the 2002 reform effort in some priority areas is given in Appendix 9. The approach proposed is a necessary and sufficient condition for reform acceleration, ensuring the attainment of the country's strategic goal.

EU ACCESSION NEGOTIATIONS

Bulgaria's accession negotiations with the European Union went according to schedule in 2002 due chiefly to the improved consistency of intragovernmental effort and coordination of work following the adoption of the strategy for negotiation acceleration and action plan as well as the experience build-up in the negotiation process. In 2002 the Bulgarian government opened three negotiation chapters[30] and closed nine chapters[31] altogether. Like some other applicant countries (Roumania excluded) Bulgaria has submitted its negotiation positions on all chapters and provisionally closed 23 negotiation chapters but Chapter 31 „Other".

Bulgaria's negotiation strategy draws upon the conviction that administrative capacity reinforcement should be indispensable to the incorporation of the EU acquis into the country's legislation.

The accelerated pace of the negotiation process and its timely completion have set out the following priority goals:

- further concerted action applied to implement the 2002 EC Regular Report recommendation:
- speeding up the legislative alignment process and administrative capacity reinforcement while ensuring effective monitoring of the processes;
- securing the effective utilization of the EU pre-accession instruments;
- ensuring a wide foreign political support to foster the quick conclusion of the negotiation process;
- launching local and international information campaigns to acquaint the public with the advantages of Bulgaria's accession to the Union;
- accelerating the translation and publicity of the acquis communautaire in Bulgarian.

The attainment of the above goals prevented the accelerated negotiation pace in 2002 from jeopardizing the effective implementation of the acquis already transposed. This balance needs to be further kept. In end-2002 Bulgaria obtained its road map that would foster the conclusion of the negotiation effort and herald Bulgaria's accession into the Union. The road map has provided for a detailed timetable and an increase in the EU pre-accession allocations to boost negotiations. EU pre-accession allocations will step up progressively to 40% in excess of the 2006 funds.[32]

EU Financial Aid to Bulgaria

EU budget appropriations	*2004*	*2005*	*2006*
	MEURO	*MEURO*	*MEURO*
Bulgaria	*368*	*399*	*430*
*Aid increase**	*20%*	*30%*	*40%*

** Relative to the average aid amounts over the 2001 - 2003 period, at 1999 prices.*

[30] *Chapter 7 „Agriculture", Chapter 11 „Economic and Monetary Union" and Chapter 30 „Institutions".*

[31] *Chapter 1 „Free Movement of Goods", Chapter 2 „Free Movement of People", Chapter 10 „Taxation", Chapter 11 „Economic and Monetary Union", Chapter 13 „Social Policy", Chapter 14 „Energy", Chapter 25 „Customs Union", Chapter 28 „Financial Control", Chapter 30 „Institutions".*

[32] *The increase has been calculated on the basis of the flat rate amounts extended to Bulgaria over the 2001 - 2003 period, at 1999 prices.*

The allocation of the funds among the three pre-accession instruments will take place in accordance with the country's specific needs and capacity for their utilization.

Furthermore, the road map has identified the challenges Bulgaria is currently facing as well as the main steps it must undertake to meet the EU membership requirements. The document is further aimed at extending support to Bulgaria in implementing the outstanding economic criteria of Copenhagen while restating the EU commitments as to Bulgaria's candidacy.

Implementation of the EU Economic Criteria for Membership

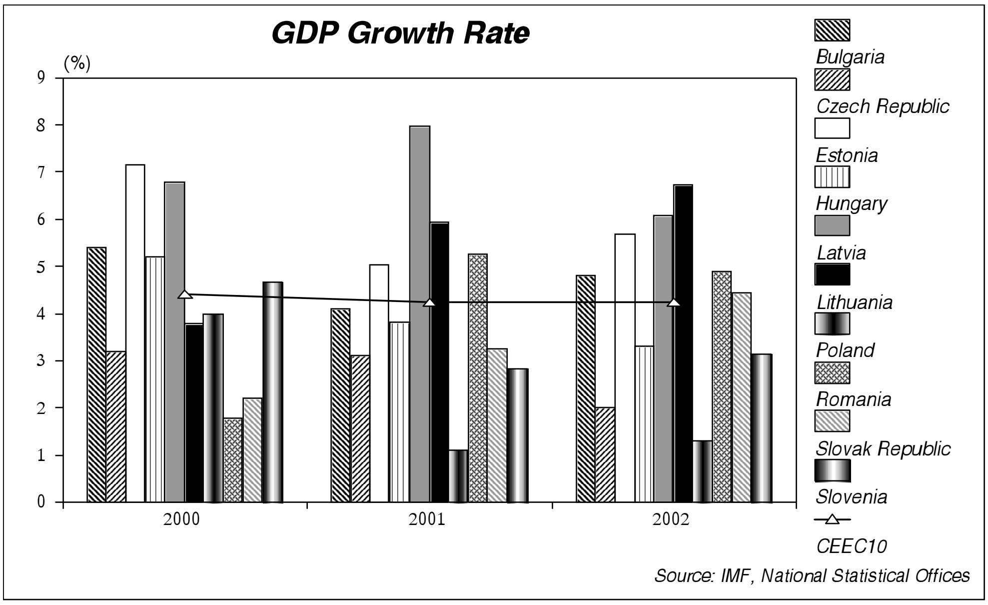
In its Regular Report on Bulgaria's Progress of 9 October 2002 the European Commission recognised the Bulgarian economy as „*a functioning market economy able to cope with competitive pressure and market forces within the Union in the medium term, provided it continues implementing its reform programme to remove remaining difficulties.*“ At the same time, the Commission has laid special emphasis on the impediments to the implementation of the economic criteria Bulgaria is currently facing as follows:

- reinforcing the efficiency of the administrative and judicial systems to allow economic agents to make decisions in a climate of stability and predictability;
- insufficient administrative and judicial capacity to implement and apply the acquis, as well to rationally and effectively manage the EU pre-accession funds;
- administrative procedures, affecting the enterprise sector, including bankruptcy procedures, must be streamlined;
- the level of financial intermediation continues to be low. As a result, bank lending to the private sector remains low, SMEs access to bank credit is limited, and the level of gross fixed capital formation as percentage of GDP is insufficient to promote sustainable growth in the economy;
- high unemployment rate;
- ineffective, as yet, operation of market entry and exit procedures;
- ineffective implementation of the country's legislation in some areas;
- special deficiencies in the land market that affect the performance of related economic sectors;
- further effort needed to applied to improve the efficiency and quality of education;
- low quality of local infrastructures.

The country's macroeconomic stability and economic policy consistency are indispensable to the implementation of the EU economic criteria for membership. The dynamics of the key macroeconomic indicators dealt with below gives a clear account of the current performance of the acceding economies, outlining the challenges that economic policies have to come to grips with.

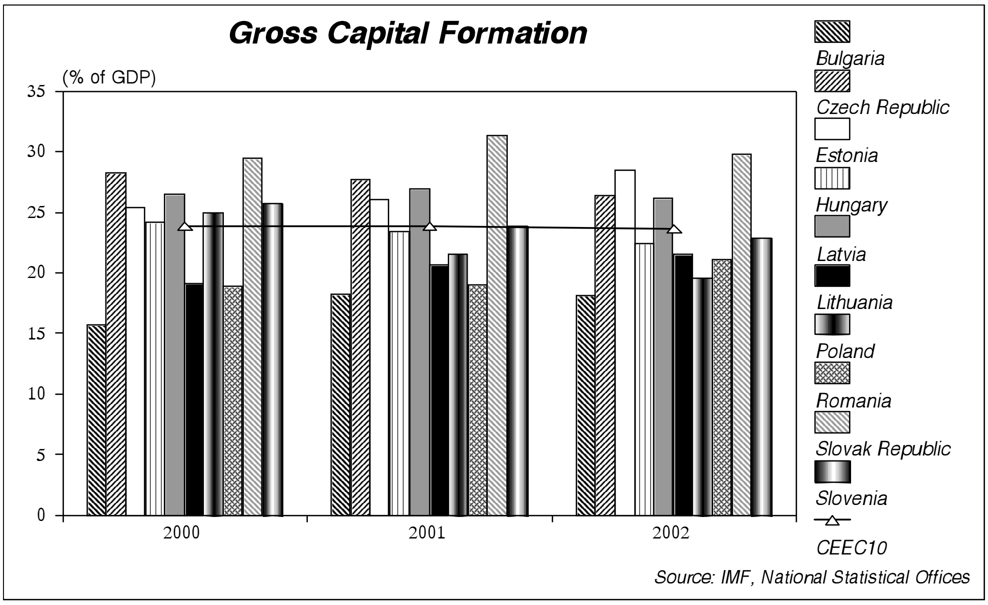
Macroeconomic Performance of the Applicant and Acceding Economies

In 2002, the applicant countries have again reported higher growth rates that growth in the EU. Bulgaria registered a GDP growth of 4.8%, lagging only behind Lithuania (6.7%), Latvia (6.1%) and Estonia (5.8%). A relatively weaker growth among the applicant countries was reported by Poland (1.3%), the Czech Republic (2%), Slovenia (3.2%) and Hungary (3.3%), all of them economies strongly integrated into the EU and boasting high competitiveness but still running into outstanding structural problems that have checked growth. In half of the applicant countries 2002 growth gained further momentum on a year earlier[33] while slowing down again in Hungary and the Czech Republic.



Source: IMF, National Statistical Offices

As by final expenditure element, the structure of Bulgaria's GDP in 2002 was again relatively more unfavourable, despite the year-on-year improvements reported. The share of final consumption within GDP ran again one of the highest (87.3%) against an average in the applicant countries of 80.4%. At the same time, the 18.1% share of gross fixed capital formation in Bulgaria's GDP was the lowest well below the indicator's performance in Slovakia (29.8%), Estonia (28.5%) and the Czech Republic (26.3%), implying that the country was lagging significantly behind the other economies in its capacities to renovate its infrastructure and technologies.



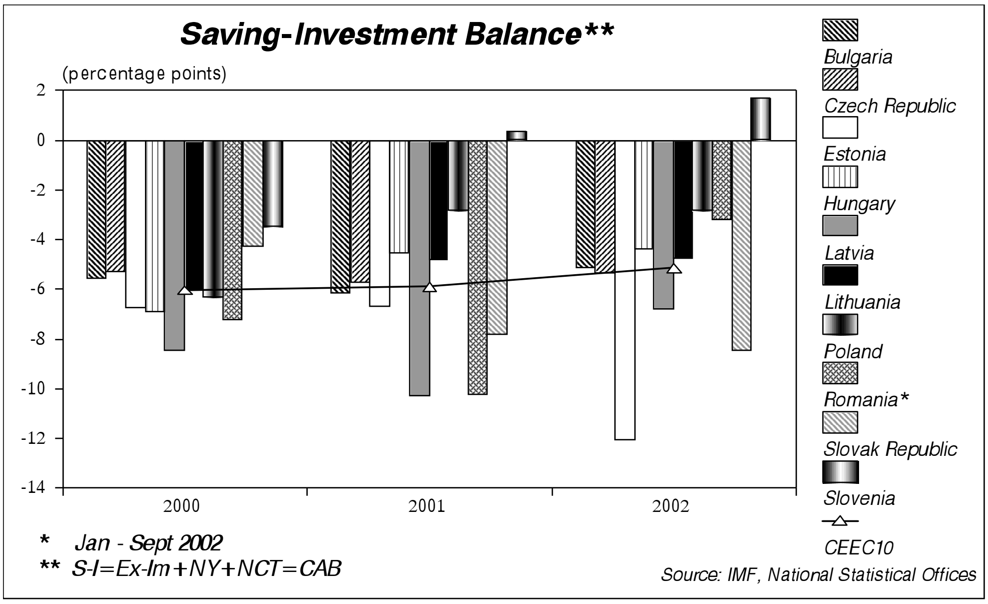
Source: IMF, National Statistical Offices

A major restraint on fixed capital formation growth in most applicant countries and Bulgaria in particular derived from the low rate of domestic savings and weak financial intermediation that may have rechannelled funds to remunerative and worthwhile investment projects. In all acceding countries but Slovenia, the gross savings[34]/gross fixed capital formation ratio ran negative, though in the past three years gross savings have steadily gone on the increase.

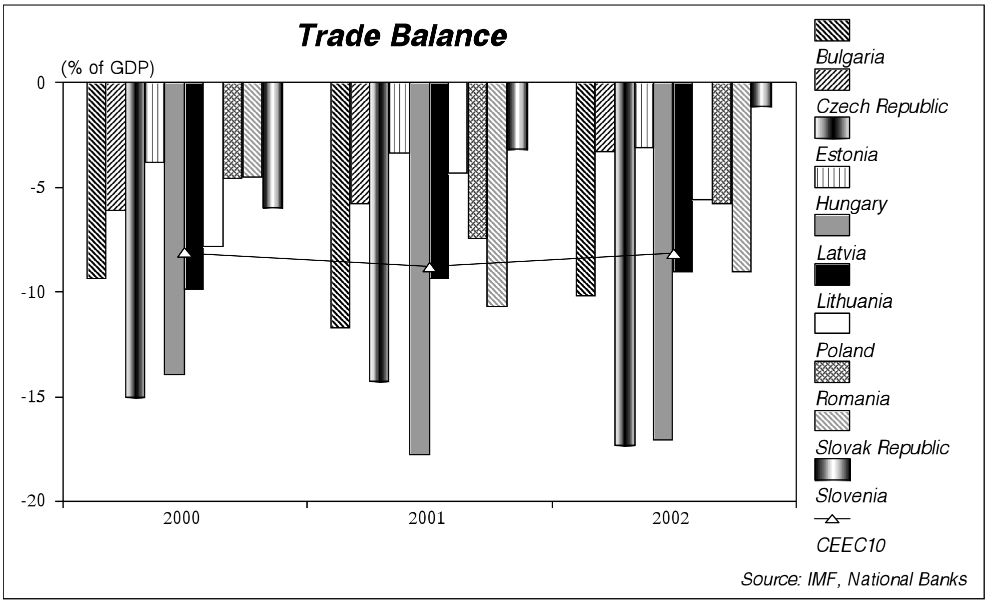
The balance of payments current account deficit was still a pressing problem applicant countries had to deal with. The 2002 current account deficit as percentage of Bulgaria's GDP declined to 4.7%, and therefore the country can be said to have been relatively better placed vis-□-vis the other economies under a currency

[33] *These were Bulgaria, Estonia, Lithuania, Poland, Slovenia and Slovakia.*

[34] *As percentage of GDP calculated by the following formula: GDP+consumption(net)+current transfers(net)-consumption (See IMF, Balance of Payments. Compilation Guide, 1993).*



board arrangements or an exchange rate peg[35], following the tightening of fiscal restrictions in end-2001. The countries' trade balances proved to be the key source of current account deficits. While running as high as 17.4% in Estonia and 5.6% in Poland, the 2002 trade deficit in Bulgaria was cut down to 10.2% of GDP. The remaining acceding economies, Bulgaria included, reported a year-on-year trade deficit improvement as percentage of GDP. Over the same period, the trade deficit ran lowest in Slovenia (1.1%), Hungary (3.1%), and the Czech Republic (3.3%).



In 2002, the main source of current account deficit financing - FDI stepped up as percentage of GDP as high as 16.9% in Slovakia (an 8.5 percentage point rise) and 14.2% in the Czech Republic (a 5.5 percentage point improvement)[36]. In addition to the above two countries, FDI inflows went on rising in Slovenia (up to 8.7%), Lithuania (5.3%) and Latvia (4.7%), while deteriorating most drastically in Estonia (4.9 percentage points down to 4.8%) and in a lesser degree in Bulgaria (by 2.9 percentage points to 3.1%) and Poland (a percentage point decline to 2.2%). In order to attract higher FDI, the acceding countries relied more and more heavily on new investment projects rather than privatization.

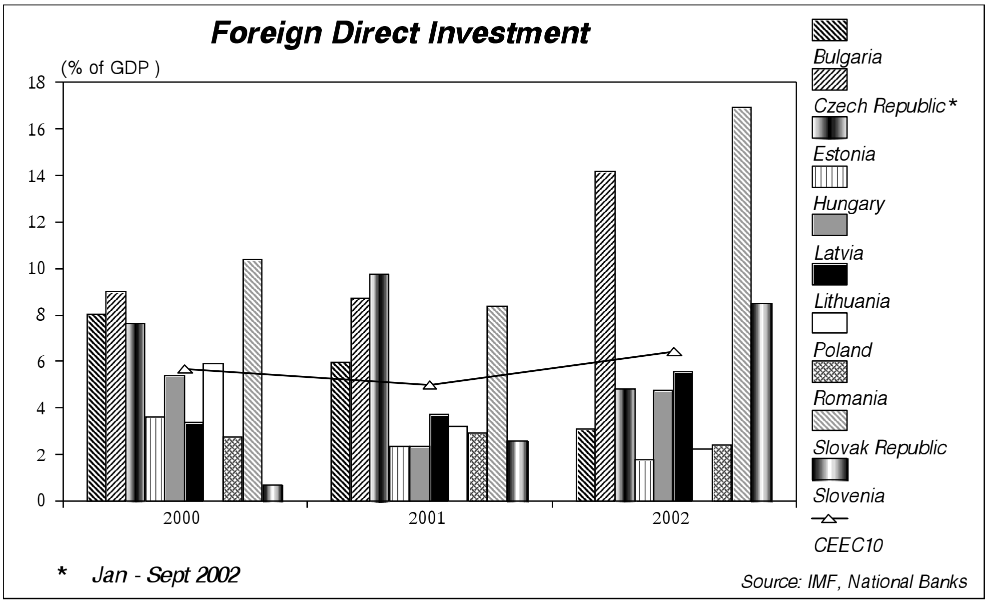
Financial intermediation in CEECs further deepened. Bank lending to the private sector as percentage of GDP reported a most significant rise in Latvia (6.6 percentage points up to 31.2%), Slovakia (a 6.2% increase to 31.8%) and Estonia and Lithuania (a 2.4 percentage point growth up to 29.8% and 14.6% respectively).

[35] Lithuania and Latvia reported a current account deficit of 4.8% (remaining unchanged on a year earlier) and 7.8% (improving by 1.9 percentage points) respectively. Deteriorating by 6.4 percentage points, Estonia's current account deficit amounted to 12.5%.

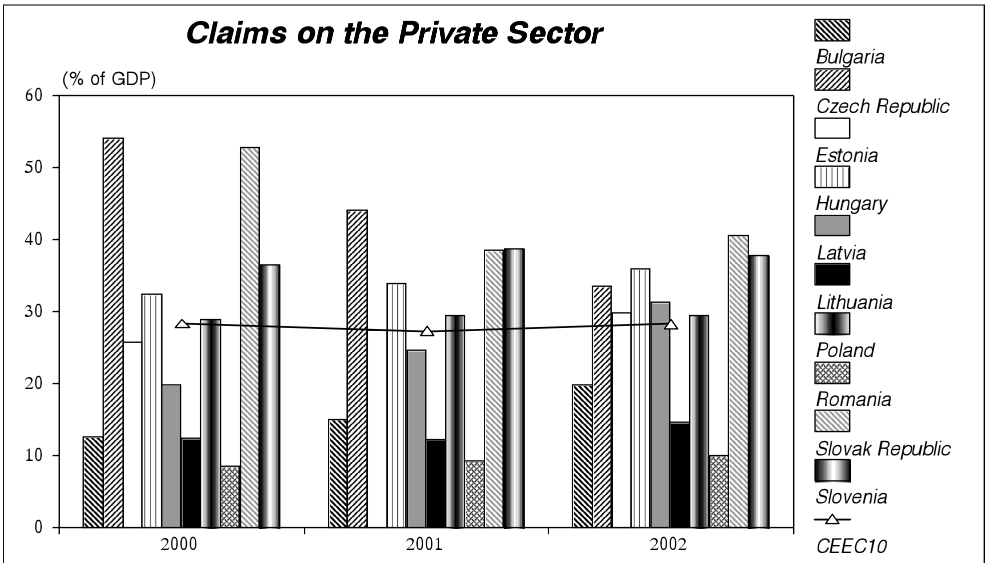
[36] In the nine months to October 2002.

As a result of the enhanced efficiency of the Bulgarian financial system, private-sector credit stepped up by four and a half percentage points to 19.8% but remained again far behind the average in the acceding countries. In three of the applicant countries - the Czech Republic, Poland and Slovenia, the indicator followed a distinct downward trend. It declined most drastically in the Czech Republic (by 10.6 percentage points down to 33.4%) but still ranked the country among the first five applicants reporting the highest ratio.

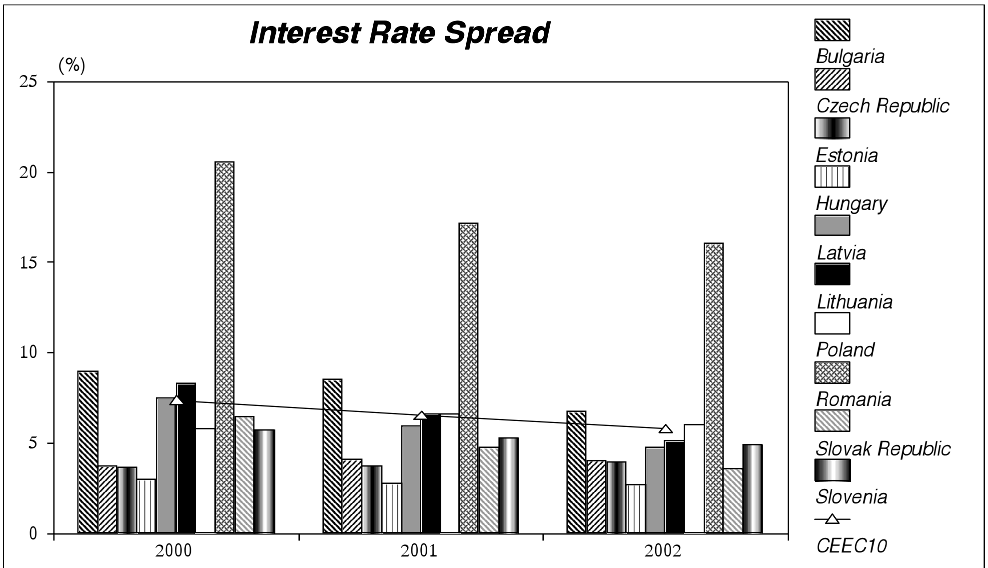
In 2002, another key to the efficiency of the financial system indicator, i.e. the interest rate spread, tended to steadily decrease in most candidate countries, following suit the interest rate cuts worldwide. The interest rate spread reported a most significant decrease of 1.8% down to 6.7% in Bulgaria, indicating that financial and credit risk was steadily diminishing. Nevertheless, the indicator's level ran the highest vis-à-vis the other acceding economies but



Source: IMF, National Banks



Source: IMF, National Banks



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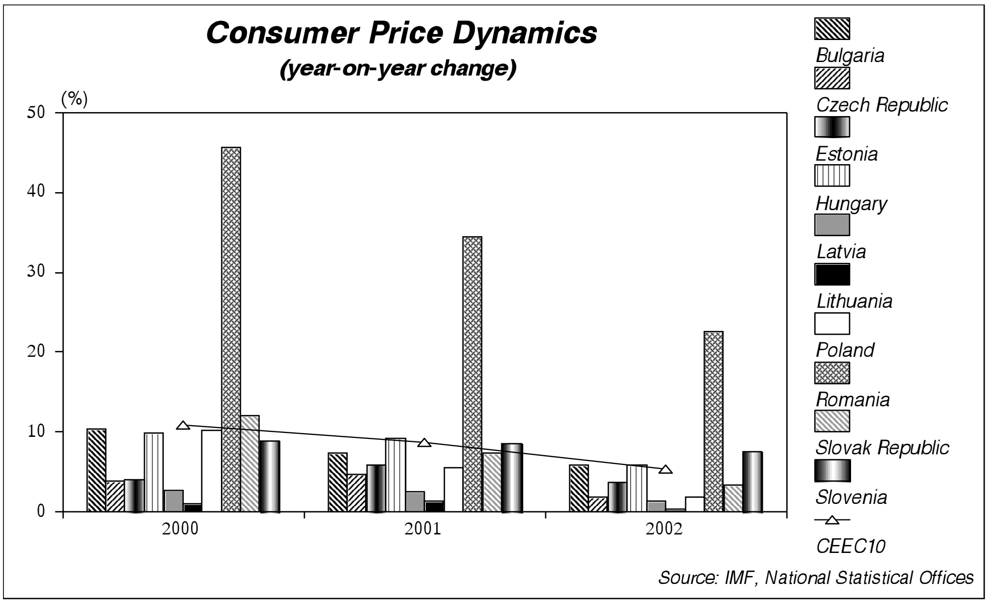
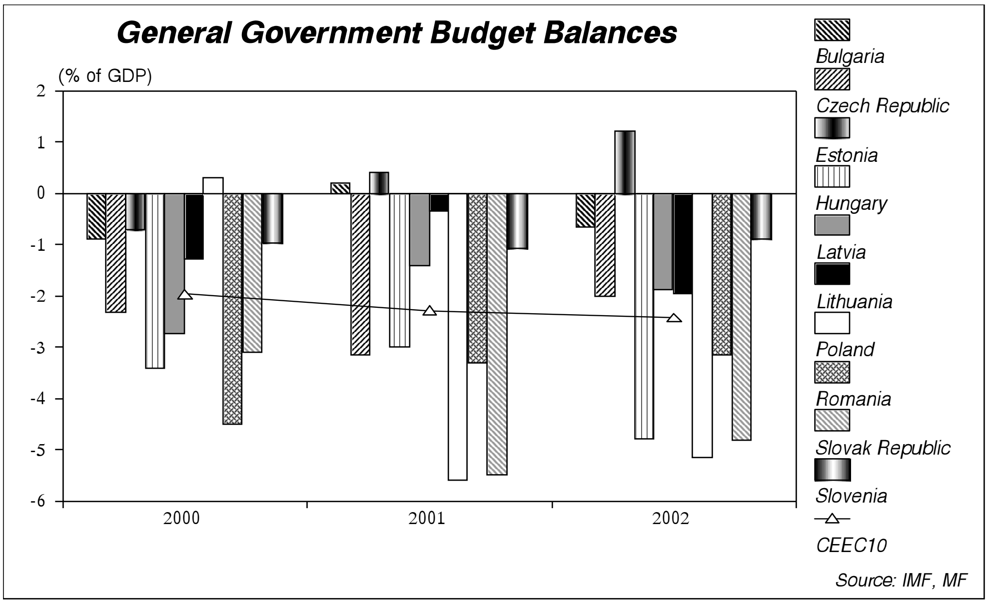
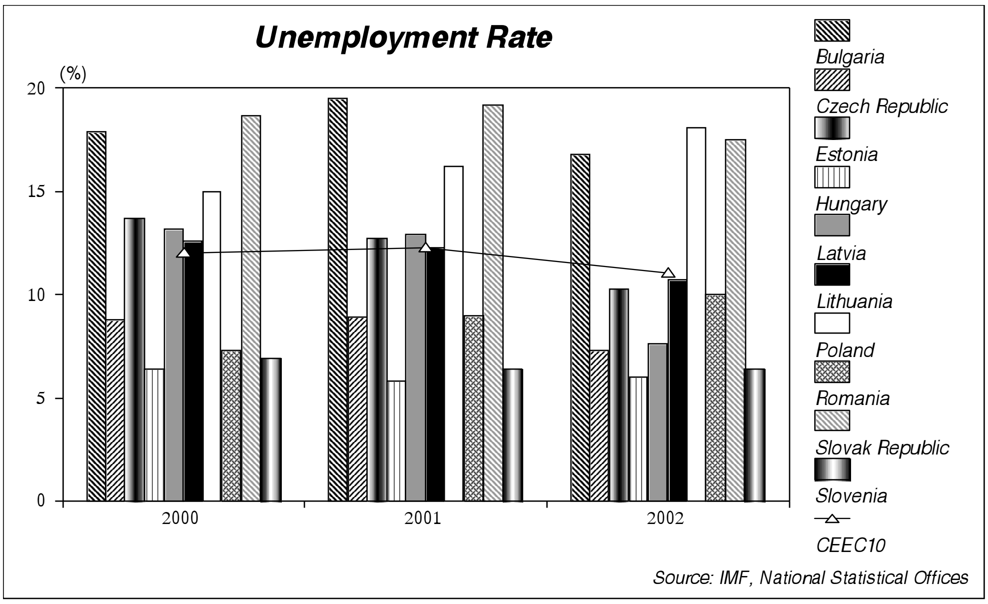






Roumania where it amounted to 16.1%.At the same time, it remained the lowest in Hungary (2.7%), Slovakia (3.6%), the Czech Republic and Estonia (4%).

Inflation in all acceding countries reported a year-on-year decrease. Average annual inflation in Bulgaria was relatively higher vi-s-vis the other applicants (5.8%), running the lowest in Lithuania (0.3%), Latvia (1.4%), the Czech Republic (1.8%) and Poland (1.9%) while rising as high as 22.5% in Roumania.

Most of the ten EU applicant countries have made good use of fiscal policies to curb their general government deficit. And yet it was Estonia alone that ran a cash surplus of 1.2%. in 2002. Having improved for three years in a row, the cash deficit in Bulgaria ran the lowest at 0.6% of GDP. The same trend was discerned in almost all acceding economies but Hungary (1.8% up to 4.8%) and Lithuania (a 1.6 percentage point rise up to 2%).

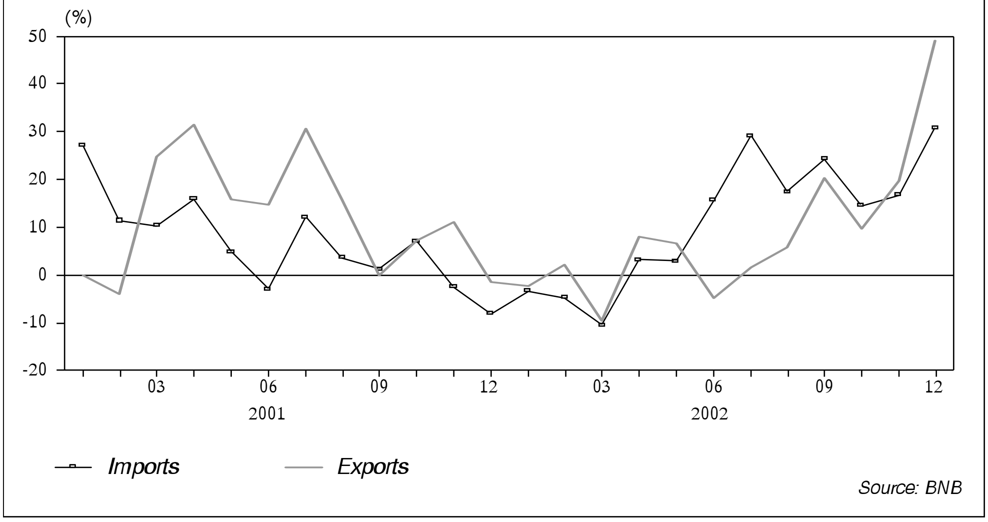
2002 unemployment in most acceding countries remained rampant, running the highest in Poland (18.1%), Slovakia (17.5%) and Bulgaria (16.8%), and relatively lower and generally closer to the Euro area's average of 8.2% in Hungary (6.0%), Slovenia (6.4%), the Czech Republic (7.3%), Latvia (7.6%) and Roumania (10.0%). The high unemployment rate in the applicant countries was mainly due to the structural reforms underway and low labour force mobility. At the same time, most analysts deemed the more effective privatization and larger FDI inflows to some candidate countries a key factor at work, accounting for the lower unemployment rates there. ❍

APPENDIX 1

Foreign Trade

In 2002, stepping up by 16.7% on a year earlier, consumer goods exports accounted for 35.2% of total exports. Household appliances and furniture exports reported a most robust growth of 50.1%, whereas tobacco (cigarettes), medicines and cosmetics registered an export decline of 22.6% and 1.9% respectively. In addition, the competitive advantages enjoyed by the Bulgarian light industries predetermined the high relative share of 20.9% of clothes and footwear in total exports.

Investment goods exports followed a steady upward trend, rising by 20.5% on a year earlier, with the most significant contribution being made by the exports of machinery and equipment, which rose by 18.3% and hit a relative weight within total exports of 4.9%. The same group covers also some high-tech goods of high value added share, which are less vulnerable to any abrupt and sharp changes in world trade.



Imports and Exports – Month-on-Month Growth Rate
(on a year earlier)

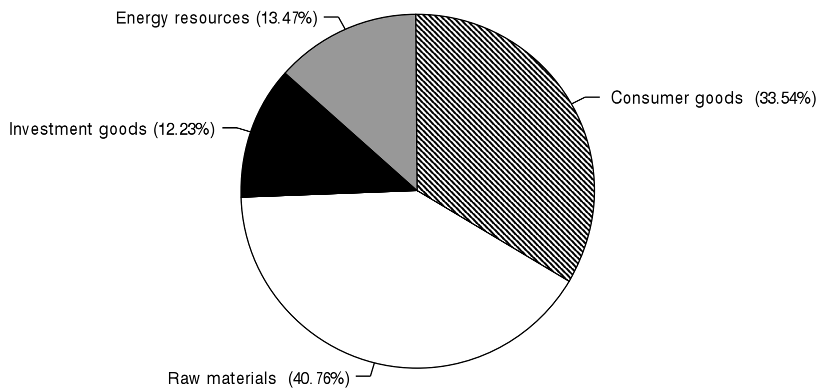
Though outstripped by consumer and investment goods, raw material exports retained a high relative share within total exports (41.8%). They are highly sensitive to international price volatility. 2002 fertiliser exports reported the most drastic year-on-year shrinkage of 33%. At the same time, food raw material and input exports grew most robustly by 98.4%, or USD 151.2 million, as did textile, and timber and paper exports (by 21.9% and 16.2% respectively). On the other hand, chemical exports steadied close to their 2001 level.

Affected most heavily by the unfavourable international market situation, energy exports reported a USD 131.8 million worth of a contraction (19.1%) due to the USD 117 million, 25.8%, lower oil exports. 2002 average crude oil prices reported a 2.3% year-on-year increase. According to BNB estimates, oil exports remained USD 38.3 million down on a year earlier, as a result of the impact of the price factor alone.

2002 did not witness any significant changes in the geographical profile of exports. The country's major trading partners were again Italy, Germany, Greece and Turkey, with the rebounding Turkish economy making an important contribution of some 28.4% to Bulgarian export growth to the same destination.

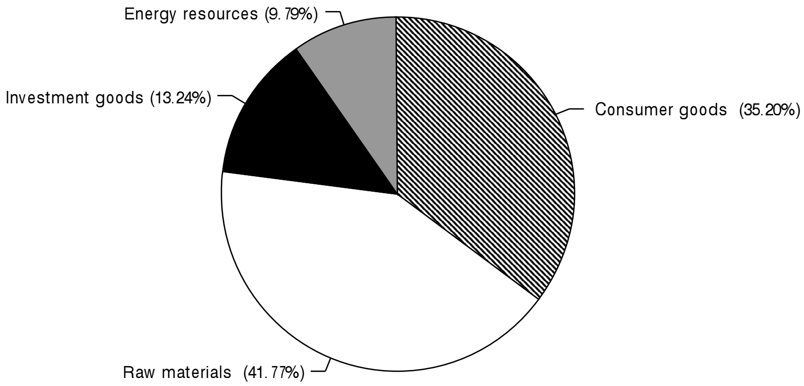
The European Union is the largest consumer of Bulgarian goods, enjoying a share of 55.6% within the country's total exports, and despite the weaker 2002 demand, Bulgarian exports to the same destination

Exports by Commodity Groups in 2001



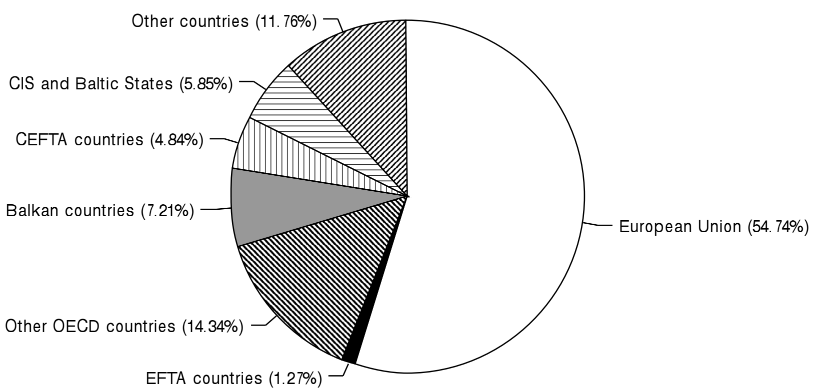
Source: BNB

Exports by Commodity Groups in 2002



Source: BNB

Exports by Country of Destination in 2001



Source: BNB

reported a 13.1% rise. Another region of destination whereto Bulgarian exports rose was EFTA, Switzerland in particular (a 63.8% increase), with their relative share within total exports amounting to 1.7%. While registering a 24.4% year-on-year growth to the CEFTA countries, Bulgarian exports to Slovakia reported a twofold rise. At the same time, exports to Russia, and Serbia and Montenegro shrank by 23.5% and 18.6% respectively.

Foreign demand is expected to steadily rebound by the end of 2003 and lead to an improvement in the country's export performance due to higher growth rates in Bulgaria's trading partners as well as the rising export prices in USD of many of the Bulgarian commodities. Given the above assumptions, 2003 exports are expected to outstrip 2002 growth.

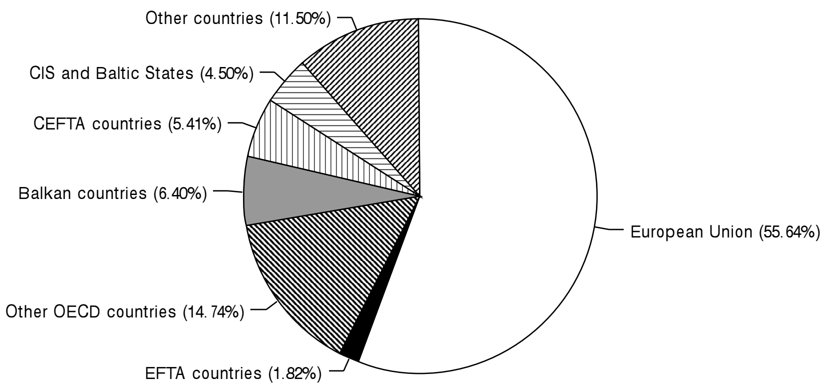
The higher export growth vis-□-vis improrts slowed down foreign trade deficit growth. 2002 imports amounted to USD 7897 million, reporting a

10.4% rise in volume terms. Import prices stepped down by 1.5% on a year earlier. According to BNB stsistics, total costs on the importation of crude oil and natural gas stepped down by some USD 6.4 million. At the same time, the higher crude oil prices triggered a USD 28.2 million worth of an increase in import costs. And vice versa, the decrease in natural gas prices lead to a USD 34.5 million shrinkage.

2002 consumer goods imports reported a 17.1% year-on-year growth, and their relative share within total imports reached some 19% due largely to the rebounding domestic demand and comparatively weak consumer price increase. Investment goods imports stepped up by 9%, with a major contribution to the year-on-year rise being made by machinery, equipments and apparatuses (USD 760 million) and vehicles (USD 412.5 million).

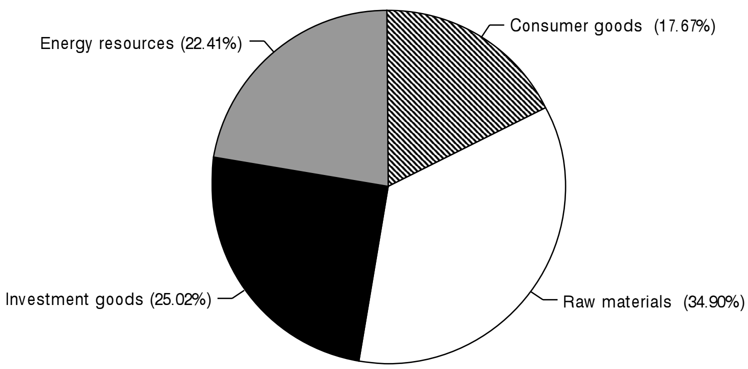
Despite the USD 204.5 million worth of an increase in value terms, raw material imports retained a relatively steady share of 34.7%, within the total.

Exports by Country of Destination in 2002



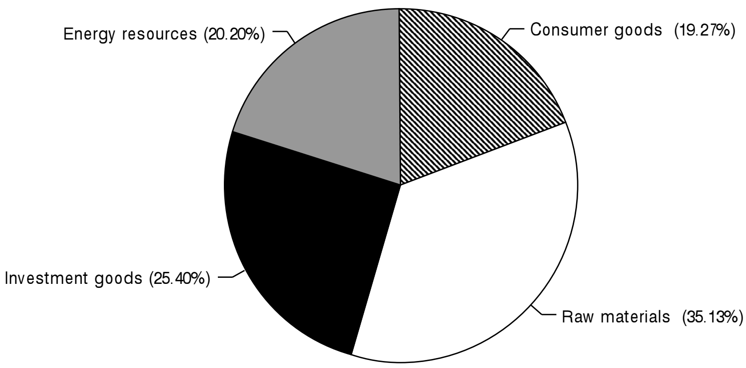
Source: BNB

Imports by Commodity Groups in 2001



Source: BNB

Imports by Commodity Groups in 2002



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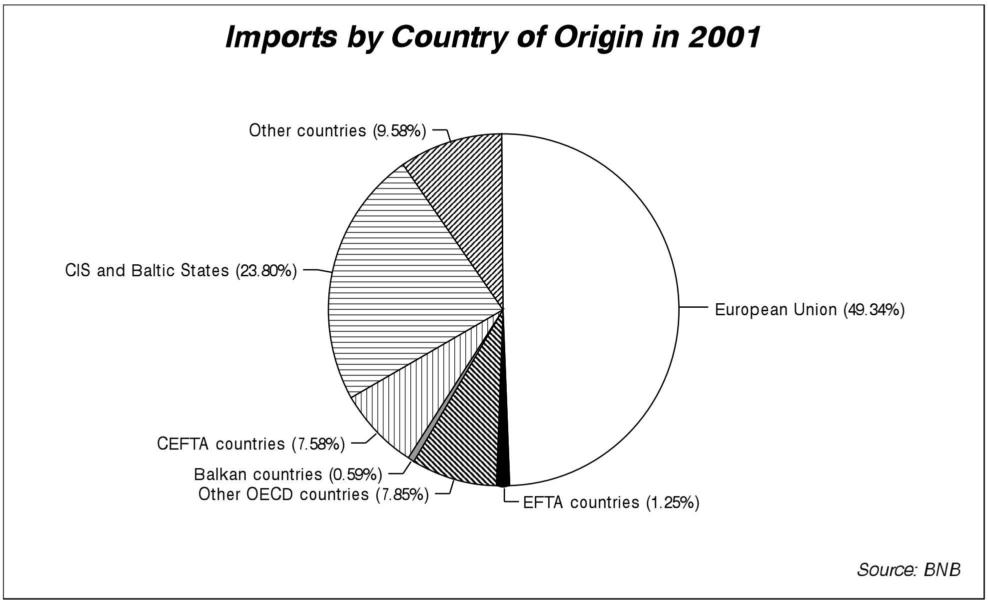
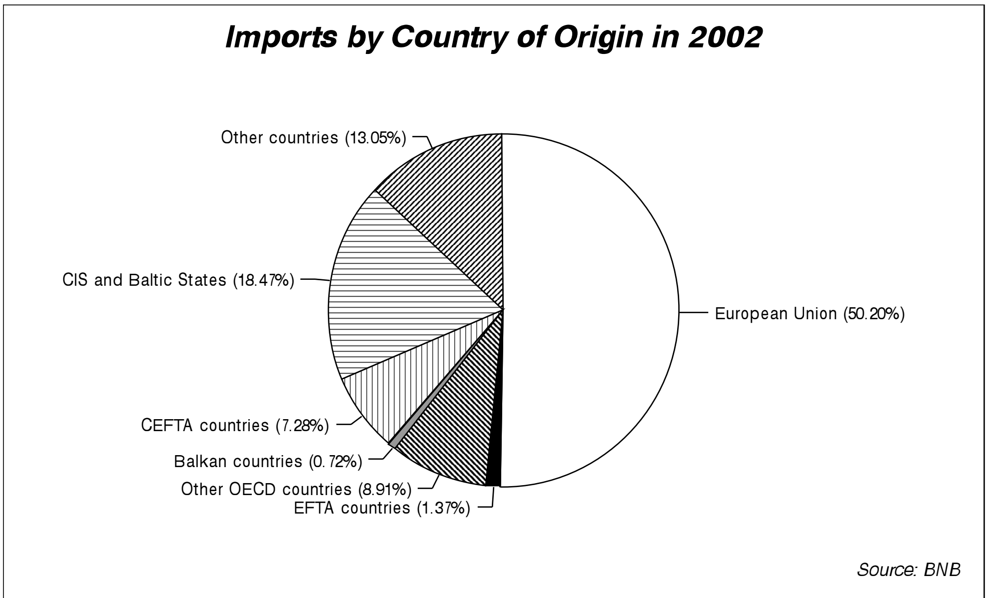




Textile, and plastics and rubber imports carried on growing by 12.8% and 19.4% respectively while ore imports reported a 19% shrinkage.

Although contracting by 3.2%, energy imports still enjoyed a significant share within total imports (19.9%) due among other things to the largely ineffective energy consumption of enterprises and households alike. Bulgaria is still energy-dependent on major suppliers, e.g. 68% of the 2002 energy imports into the country originated from the CIS, Russia in particular.

The geographic profile of imports in 2002 provided further evidence of the growing strong relation of the Bulgarian economy with the EU. EU imports to Bulgaria reported a USD 381.3 million worth of a rise, or 10.6% on a 12-month basis, now accounting for 50.2% of total imports. 2002 witnessed a drastic contraction in imports from the CIS and the Baltic states (15.6%), with Russia imports alone shrinking by 21.1%. Outside the Euro area, Turkish imports in Bulgaria grew most robustly (42.7%) due mainly to the lower prices of Turkish goods following the devaluation of the local currency.

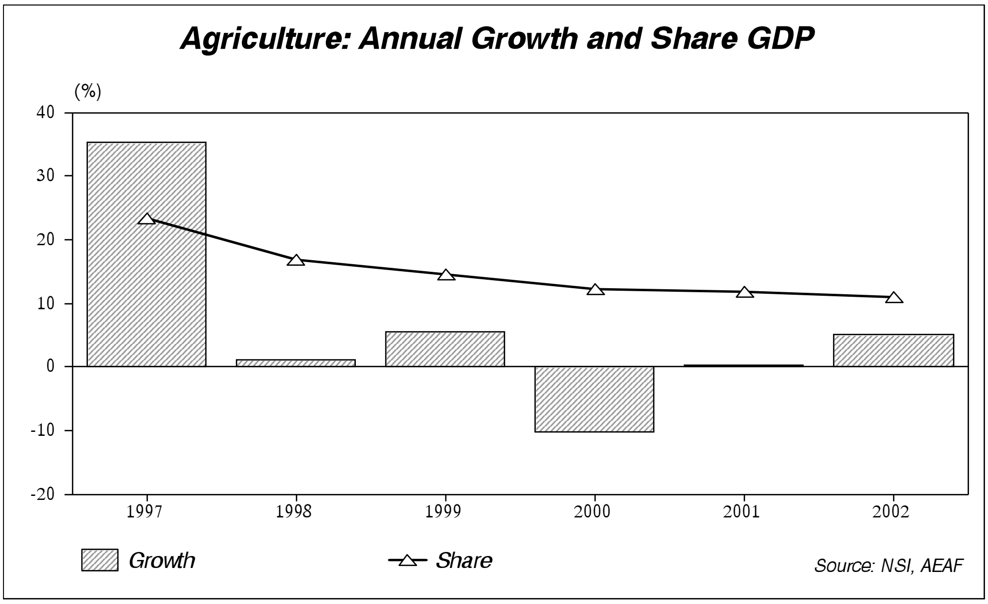
The growing foreign demand for Bulgarian exports in 2003 is expected to spur a certain increase in raw material and input imports for the export-oriented industries. At the same time, investment goods imports will retain their good growth rate while the steady upward trend in consumer goods imports indicates that this import item is less vulnerable to domestic demand dynamics. For the this and other reasons, forecasts point to a higher year-on-year import growth running close or even higher than exports. ❍

APPENDIX 2

GDP by Supply Element

Agriculture

The GVA generated in the agricultural sector went on the increase, following two years of poor performance when the indicator registered a -10.3% plunge (2000) and a negligible rise of a bare 0.3% (2001). In 2002, however, GVA reported a 5.1% year-on-year increase, growing most robustly by 7.8% on annual basis in the third quarter. Furthermore, the sector's efficiency stepped up by 2%, as measured by the GVA/gross output ratio.



The improved performance of the agricultural indicators was mostly due to the favourable weather conditions. In the summer months of 2002 there were huge precipitation volumes that were yield conducive for the spring crops. As autumn weather was predominantly poor, it was only the agri-technical activities carried out that brought about a 1.1% increase in wheat output[1]. Maize and sunflower reported higher average yields. At the same time, the 30% year-on-year growth in barley output was solely due to the larger areas under crops, but the average barley yields did not rise. In 2003, arable land is expected to decrease by about 2% mostly due to the decreasing areas under wheat, rye, seed sunflower. And yet, forecasts have pointed to a certain rise in cereal output induced by the higher sector's efficiency, as measured by the productivity per area unit ratio. Furthermore, the areas under maize seed and sunflower are anticipated to increase as a likely result of the farming restructuring underway aimed at improving profitability.

According to MAF data, all animal numbers but goats and buffaloes reported a year-on-year decline in the first half year period of 2002. Pig numbers contracted most drastically (-13%) while bird numbers stepped up negligibly (0.1%). Also, livestock production in the six months to July 2002 went on the decrease, including milk and egg production (-6% and -4.6% down). The expectations are that livestock production dynamics in 2003 will steady around the same levels on a six-month basis, except for the turnaround in pig breeding which is anticipated to make up for the six-month contraction. Around 98% of all animals are reared

[1] *According to data of the Ministry of Agriculture and Forestry.*

in the private sector on small farms or by individual farmers. Moreover, the bulk of livestock production is in actual fact self-sufficiency that hampers the advance of technology innovation in the sector. Characteristic of the last few years of sector's performance have been the low crop yields resulting from ineffective farming practices and lack of technological innovation, which in turn had to do with the existence of numerous small farms, giving rise to low-quality produce and inability of the country to meet the export quotas to the EU.

The decapitalisation of agricultural assets had to do with the extremely low agri-business investment and a number of credit-access restricting factors. According to the agricultural survey findings under the census of March 2001, 51.5% of the Bulgarian households are involved in some farming activity, but only 10.3% have some farm machinery in possession to cultivate land, which in turn predetermined the role of government intervention in the sector through the State Agriculture Fund and SAPARD funds.

The 2002 number of project approvals under SAPARD increased significantly, and as of end-year they amounted to 297, or a six-fold rise on a year earlier. Implemented so far have been 106 projects to the total worth of BGN 56.7 million, half of which extended in the form of financial aid. SAPARD started in June 2001 and is currently covering three measures as follows: „Investment in Agricultural Holdings"; „Improving the Processing and Marketing of Agricultural and Fishery Products"; and „Business Activity Development and Diversification Providing for Multiple Activity and Alternative Income". The bulk of project applications and approvals referred to the first measure, providing for investment in farm machinery and equipment.

In early 2003 the European Commission extended the utilization terms for the MEUR 53 and 54 worth of 2000 and 2001 SAPARD allocations to the end of 2004 and 2005 respectively.

In 2002, land supply exceeded demand, and the annual average land prices decreased, steadying at their 2001 level of BGN 141/dk. Land category had still a minor importance giving way to land location and adjacent developed infrastructure as the key pricing factors. 2002 saw the conclusion of 35 450 land estate deals, accounting for a 13% increase on a year earlier. The farm land traded stepped down by over 40% to 352 731 dk, indicating that deals referred mostly to small plots that may have been in turn associated with the land consolidation process underway.

At the same time, the land market in the grain growing regions was more developed than elsewhere in the country. Overall in the 1998-2002 period, there had been transferred ownership rights to 1.2 million dekares of land at BGN 1.44 per dk, with more and more food processors buying land of their own to avoid any raw material dependency on farmers, which applied to the wine and vegetable canning industry in the utmost degree.

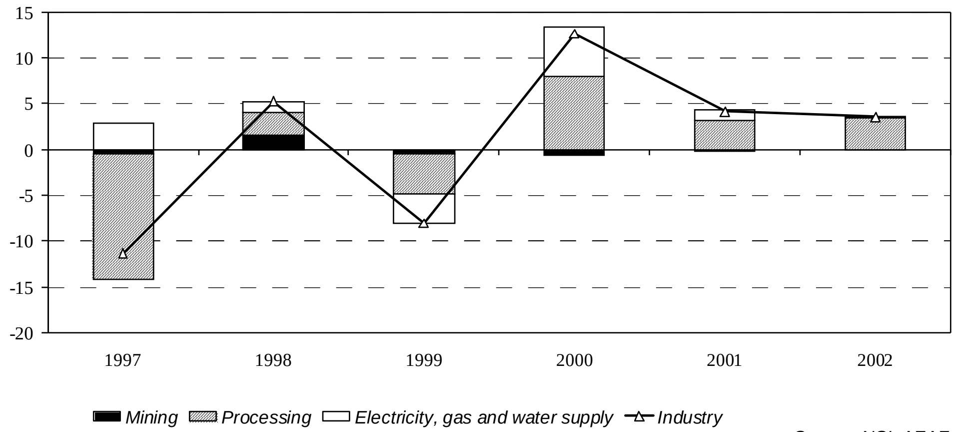
Land lease relations are indicative of land market performance. In 2002 the land lease contracts concluded amounted to 106 836, or twice as high as in 2001. According to a 2002 SAPI land market survey, land leasehold was a preferable form of land cultivation, as it did not require any large investment amounts in land purchase and contributed further to the rational use of land. In addition, land leasehold is a sufficient condition for aid eligibility under SAPARD.

Land market development on the whole was impeded by low profitability and high risk in the sector, as well as the country's farm land fragmentation as a result of the sluggish and cumbersome land reform. About 54.1% of the agricultural producers catered for land plots of no more than 2 dk, while the usable land average amounted to some 6.2dk. The Agriculture Ministry has adequately responded by drafting a land consolidation act, not yet processed by Parliament, the effect of which is to be manifested only in the long run. Meanwhile, agricultural land will be subject to the latest amendments to the Land Ownership and Use Act, providing for adjacent plot commutation and exchange with a view to land consolidation, with the technical costs on real-estate transactions being covered by the government. On the whole, however, the land market performance in the next year is not expected to report any significant change.

Industry

GVA in the industrial sector reported a 3.5% year-on year increase. At the same time, export sales stepped up by 4.5% due mostly to the higher foreign demand in the second half-year period of the year and contributed to the 1.3% growth in total sales. Domestic sales declined by 0.7% on a 12-month basis as a result mainly of the decreasing domestic sales in the tobacco and chemical industry.

Growth Value Added in Industry (%) and Contribution of the Subsectors (percentage points)



Source: NSI, AEAF

Enterprises of the *production and supply of electricity, heating, gaseous fuel and water* sector reported a sales decline due to the contracting export sales. According to BNB data, 2002 energy exports to the OECD countries stepped down by 28% on a year earlier as a result mainly of the lower electricity amounts exported to Turkey. And yet a positive development in the sector had to do with the improved efficiency in 2002, as estimated by the GVA/gross output ratio, and ever increasing productivity since 1999 in the absence of a drastic employment reduction.

Although gross value added in the mining and extraction industries decreased by 1.3% in 2002, sales in the sector went on the increase for the first time in the last couple of years. The only exception was the coal mining industry due to the scarcity of investment funds to modernize production. The majority of mines have been privatised by MEBOs or small firms of the same line of industry having no sufficient resources of their own. Moreover, natural gas proves a cheaper source of energy generation and more and more enterprises have switched over to gas. All in all, the extraction industry is an inefficient and highly energy-intensive sector where the value added/gross output ratio has been steadily declining in the last few years.

The processing industries made a most robust contribution to the 2002 total sales growth. All but the food industry reported a significant year-on-year increase in both export and domestic sales. The highest growth in 2002 was registered by the high-tech industries - manufacture of radio-, TV and telecommunications equipment and machinery (64.1%) and office and computing equipment (51.6%). Their share within total sales was still running rather low at only 1.8%.

2002 Industrial Sales

(on a year earlier)

	Real-term Change (%)	
	Total	**Export Sales**
Sectors Reporting a Positive Contribution to Sales Growth		
Machinery, equipment and household appliances	17.4	14.3
Radio-, TV, and telecommunications equipments	64.1	83.3
Cloting , leatherwear including; skin p[rocessing	21.0	27.2
Textiles and textile products, clothing excluded	27.8	42.0
Food and beverages	3.4	19.6
Products of other non-metal mineral raw material	10.2	4.4
Timber and products thereof, furniture excluded	25.6	35.0
Sectors Reporting a Significant Negative Contribution to Sales Growth		
Chemicals	-6.4	-4.2
Tobacco products	-14.4	7.9
Coal mining and peat	-7.3	
Publishing and printing; audio, video and CD writes	-6.3	25.9
Production and supply of electricity, gaseous fuel and heating	-0.8	-6.1

Source: NSI, AEAF.

Services

For a fourth year in a row the *service* sector has made the largest contribution of 3 percentage points to GVA growth in the economy. The real-term growth in GVA in the service sector amounted to 5.1%, with the GVA generated by the communications industry registering the highest increase of 16.8%. This industry has been developing most robustly over the past five years as a result of the swift advance of high technologies as well as the higher demand of end-users for mobile telephones and Internet services. Furthermore, a high GVA was generated by transport services (7.5%) pushed by the boosted business activity of Bulgarian producers and high growth rate of tourism in the country.

Notwithstanding the deteriorating international business environment and lower revenue from tourism worldwide, Bulgaria ranked among the leading holiday destinations in the world market by number of enrolments in 2002. According to NSI data, Bulgaria was visited by 2 992 590 holiday makers in 2002, or 8.6% higher than in 2001. According to BNB statistics, revenue from international tourism in USD terms stepped up by 11.8%. 2002 sustained the upward trend in the number of holiday makers from the EU (a 23.3% increase on a year earlier), with their share within the total number of tourist visiting Bulgaria rising from 37% to 42%. The growth in the holiday maker numbers from Central Europe remained steady, with their share going from 3% in 2001 up to 5% in 2002, while the number of Russian and Ukrainian tourists declined dramatically by 24.06% and 43.78% respectively as a result of the visa regime introduced.

Having persistently declined in growth terms, winter tourism now reported a positive development, having to do with the progress made on investment and infrastructure problems resolved in Borovetz where the first artificially snowed and lit ski runs were opened. Further more, new ski facilities were constructed in the Bansko Resort.

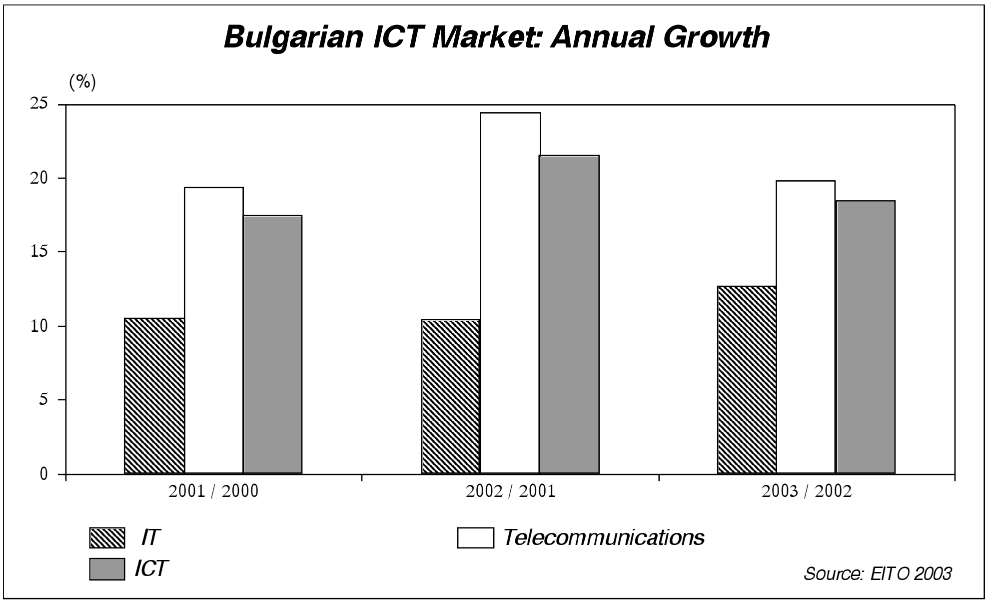
More and more Bulgarian tourist visited foreign resorts in 2002, with their number stepping up by 7.96% on a year earlier, and the most preferred destinations being Turkey, Macedonia, Germany and Greece.

Information and Communications Technologies[2]

With a view to the present stage of development of the global economy, the advance of the information and communications technologies (ICT) is indispensable to improving competitiveness in the economy and its growth potential.

The 2003 EITO Report[3] gives an account of the state of the industry over the last few years as well as incorporates estimates on the 2003 outlook. The report has been prepared with the assistance of the International Data Corporation (IDC) represented in Bulgaria by IDG - Bulgaria.

According to EITO data, the Bulgarian ICT industry has expanded most rapidly over the last few years and is expected to retain its high growth rate in the future as well. The ICT market reported a growth rate as high as 17.5% in 2001 and further up to 21.5% in 2002 while the sector worldwide has bottomed out, reporting growth of some 2.8% in 2001 to a bare 1.2% in 2002. For Western Europe, 2002 change ran at the negligible 0.2%. 2003 forecasts point to a 12-month growth rate of 18.5% in Bulgaria and only 2.5% in Western Europe, and 4.5% worldwide.



In 2002, the Bulgarian ICT industry was estimated at EUR 1.7 billion, with over 80% of the market being generated by the telecommunications segment that is to smoothly rise in the future according to EITO estimates.

The IT sector reported a 10.4% growth in 2002, estimated at MEUR 313 in absolute terms. The highest rise was posted by the applications (23.9%) and servers (17.4%) sub-groups. Telecommunications stepped up by 24.4%, reaching MEUR 1 386 in absolute terms. Mobile telephone services (57.1%) and mobile communications equipment (34.3%) performed most robustly in 2002 due to the expansion of the

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[2] *Information and communications technologies (ICT) can be generally divided into two main groups, i.e. information technologies (IT) and telecommunications, covering the market segments as follows:*

- *ICT equipment - computer hardware, office equipment, communications equipment to end-users, and network equipment;*
- *Software products - system software and applications;*
- *IT services;*
- *Telecommunications (transfer) services - fixed line and mobile cellular telephone services, Internet and on-line services, cable TV.*

[3] *Estimates as to the performance of the ICT market in Europe are made by a number of organizations, the most reliable of which are taken to be the projections of the European Information Technology Observatory (EITO), which releases annual reports on the European market as well as detailed studies of the ICT industry worldwide.*

second GSM operator (Globul) and the higher market share it now enjoyed, as well as the fierce competition in the same market segment.

Bulgarian ICT Market

Bulgaria	Value, euro million				Annual Growth		
	2000	2001	2002	2003	2001/ 2000	2002/ 2001	2003/ 2002
Server systems	26	25	29	36	-4.8	17.4	24.0
Workstations	0	0	0	0	-15.8	-12.5	-14.3
PCs	65	72	74	84	10.1	2.5	14.6
PC/Workstation add-ons	25	27	29	30	8.0	7.0	4.1
Computer hardware	**116**	**124**	**132**	**151**	**6.2**	**6.4**	**14.3**
Copiers	7	5	5	6	-28.6	16.8	7.2
Other office equipment	12	12	13	15	5.6	7.8	9.1
Office equipment	**18**	**17**	**19**	**20**	**-6.7**	**10.3**	**8.5**
Mobile telephone sets	39	55	57	59	41.7	3.5	2.7
Other end user communications equipment	22	25	26	26	11.2	2.7	1.2
End user communications equipment	**61**	**80**	**83**	**85**	**30.6**	**3.2**	**2.2**
LAN hardware	11	13	14	15	14.5	13.2	8.7
PBX, key systems and circuit switching equipment	73	76	71	68	4.3	-6.6	-3.4
Cellular mobile radio infrastructure	91	174	233	284	91.4	34.3	21.8
Packet switching & routing equipment	21	25	28	29	19.1	12.1	5.1
Other datacom and network equipment	33	40	44	49	21.3	9.5	10.9
Datacom and network equipment	**228**	**327**	**390**	**446**	**43.2**	**19.3**	**14.3**
Total ICT equipment	**424**	**548**	**623**	**701**	**29.1**	**13.7**	**12.5**
System software	12	14	16	18	14.4	11.8	12.7
Application software	18	21	26	31	15.7	23.9	19.7
Software products	**30**	**35**	**41**	**48**	**15.2**	**19.0**	**17.0**
IT services	**43**	**51**	**57**	**65**	**16.6**	**13.3**	**12.7**
Telephone services*	330	358	376	396	8.5	5.0	5.4
Mobile telephone services	288	321	505	692	11.6	57.1	37.0
Switched data and leased line services	27	32	37	42	17.9	17.3	14.1
CaTV services	47	54	60	68	14.2	10.2	14.8
Carrier services	**693**	**765**	**978**	**1 199**	**10.5**	**27.8**	**22.6**
Total ICT	**1 191**	**1 399**	**1 700**	**2 013**	**17.5**	**21.5**	**18.5**
Total IT	**257**	**284**	**313**	**353**	**10.5**	**10.4**	**12.7**
Total Telecommunications	**934**	**1 115**	**1 386**	**1 660**	**19.4**	**24.4**	**19.8**

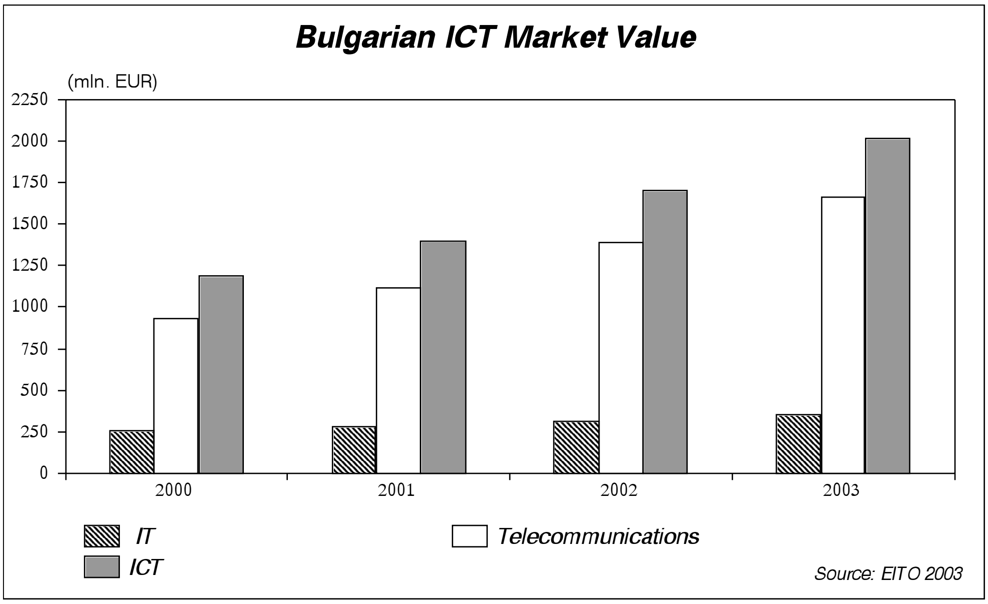
** Includes Internet and online services*

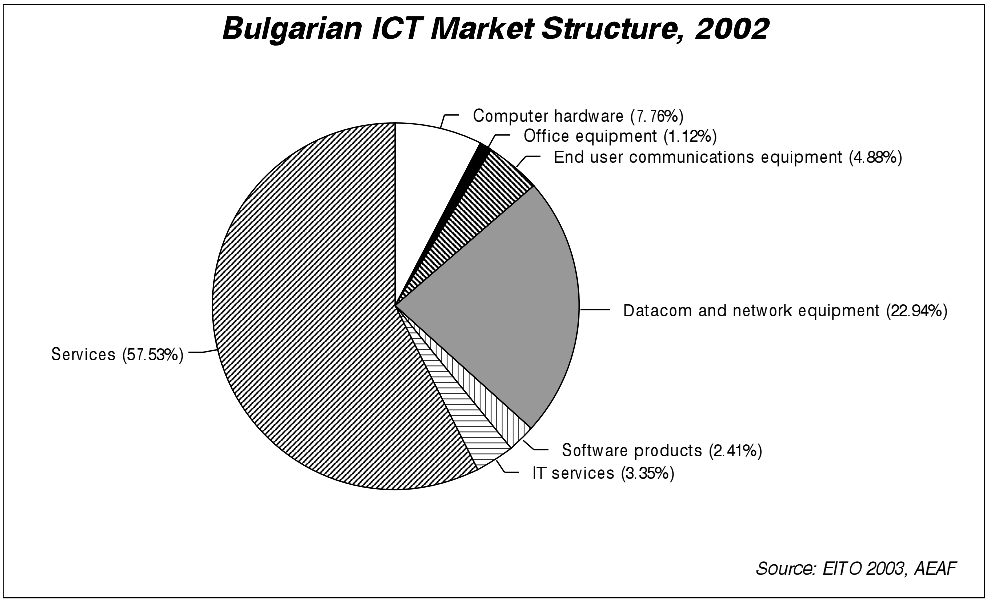
Source: EITO 2003

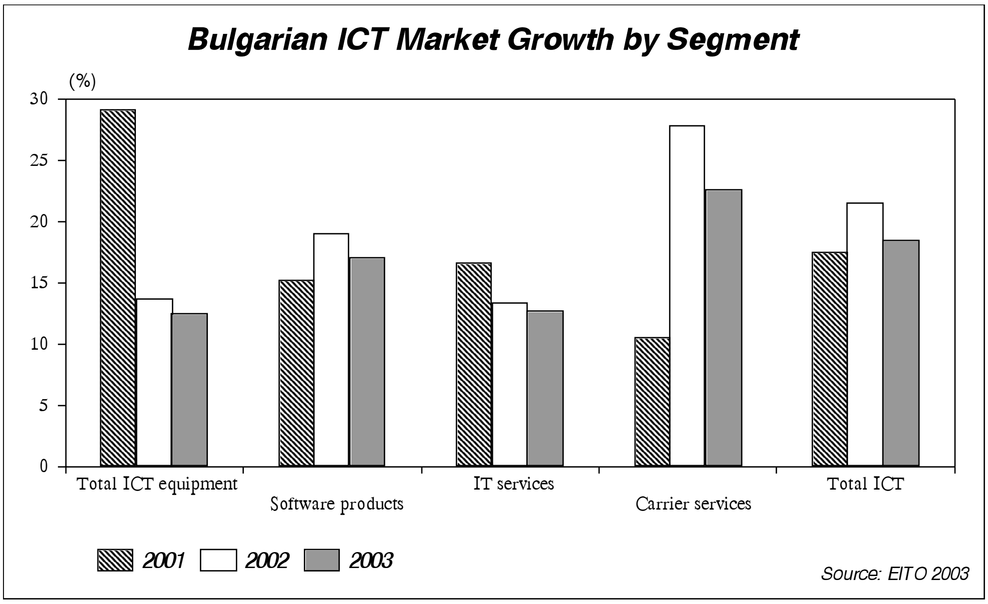
At a lower level of data aggregation, the highest 2002 growth was reported by telecommunications services (27.8%), network equipment (19.3%) and software products (19.0%). At the same time, none of the market segments reported a decline, but growth was most negligible with communications equipment to end-users (3.2%) and computer hardware (6.4%). As a result, the share of telecommunications services within the total ICT market had increased while the remaining groups reported some contraction.

Tracing down the dynamics of the different market segments, it should be noted that the ICT equipment segment grew fastest (29.1%), network equipment in particular (43.2%) followed by communications equipment to end-users (30.6%). 2002 estimates and 2003 projections pointed that the most robust growth rate was and is to be reported by telecommunications services - by 27.8% and 22.6% in the respective years.

Though the ICT industry has rapidly expanded over the last few years, the *IT costs per capita* indicator in Bulgaria is remaining well below its levels in the CEECs. In 2002, the indicator in Bulgaria amounted to only EUR 37 vs. EUR 257 in Slovenia, the highest CEEC level. The same indicator in the EU averaged EUR 755. ❍







APPENDIX 3

Government Labour Market Policy

The decline of the number of unemployed was also an outcome of the active government's interventions on the labour market. In view of the negative trends in the structural characteristics of labour market discerned in recent years (viz. higher supply of labour force than actual demand, mismatch between the qualifications of unemployed and the restructuring economy's needs of qualified specialists, unfavourable age and education structure of the pool of unemployed, large share of disadvantaged groups in the total number of unemployed and huge regional disparities), the MLSP developed and implemented a number of active labour market policies and measures.

The Employment Promotion Act was enforced on 1 January 2002 and strengthened the administrative and financial framework of active labour market policies (ALMPs). Furthermore, a reform of the social assistance system was launched by initiating and passing a number of amendments to its regulatory framework. The funds for the payment of unemployment compensations and benefits were separated from appropriations financing the active measures of the Employment Agency. Employment encouragement programmes and measures are funded by central government budget allocations thereby ensuring sustainability of financing. Given the fact that financing of ALMPs is restricted by the existing economy-wide budget constraints, it is safe to say that active labour market policy has brought about a better reallocation of available funds between programme funding and funding of measures for encouraging employers to open new jobs.

The underlying change in labour market policy in 2002 had to do with the transition from passive social protection of the unemployed toward provision of employment and suitable qualification training. The implementation of targeted approaches satisfying the specific needs of the various social groups was initiated so as to ensure the more purposive allocation of expenditures and thereby to enhance their efficiency. In 2002, employment promotion measures were primarily targeted at the risk groups while striving to increase the flexibility and adaptability of the labour market.

According to data from the Employment Agency, the number of unemployed who found new jobs in 2002 stepped up 20% on a year earlier due mainly to the November and December upturn of programmes and measures implemented. The total number of new participants in employment encouragement programmes and measures in 2002 amounted to 108 200 unemployed, reporting a 25.9% rise on a 12-month basis. The persons who had found jobs under employment programmes prevailed with their number stepping up by 25.9% on an annual basis. In the first half of 2002, the number of participants in ALMPs went on the decrease mostly as a result of the process of re-identification of labour market policy priorities. In the second half of 2002, the number of new participants in labour programmes and measures grew over 3-fold relative to the first half-year period while stepping up more than twice on a 12-month basis. The same period witnessed the launch of new programmes for subsidized employment of which the largest was *From Social Assistance to Employment* Programme. It was first introduced in September as a pilot programme in several municipalities and in November the programme was launched nation-wide. The programme is targeted primarily at the long-term unemployment cohort with unemployment spells of over one year. The problem with long-term unemployment remains a major challenge since the bulk of this unemployment pool consists of people without any professional qualification and with a low level of education standing the slimmest chances of finding a job. As a result of their lengthy stay without a job, the majority of them lose their skills and labour habits thereby additionally worsening their competitiveness on the labour market. The share of participants in *From Social Assistance to Employment* Programme accounted for 62.3% of the total number of persons encompassed by employment programmes thus contributing to the sharp contraction of the unemployed cohort reported in the last two months of 2002. According to data from the Employment Agency, in December 2002 the number of long-term unemployed declined by 7.7% on a year earlier. The downward trend is expected to sustain in 2003 because the programme will be implemented throughout the entire year.

It is noteworthy that subsidized employment programmes are successful in temporarily alleviating the problem with unemployment and therefore their implementation should be accompanied by a labour market policy favouring and encouraging job-generation and the creation of sustainable employment.

The government's policy should endeavour to provide not only incentives to businesses encouraging private investment in areas with high unemployment level but also to offer job creation stimuli. The envisaged amendments to the Corporate Income Tax Act and the Employment Promotion Act are expected to introduce further incentives to job generating businesses.

In 2002, employers exhibited enhanced interest in the measures undertaken by the MLSP with a view of encouraging businesses to hire unemployed persons. While in 2001 the number of persons starting a job under the various employment promotion measures targeted at specific groups of unemployed amounted to 15 687, in 2002 their number stepped up to reach 19 385. The measures encouraging the hire of unemployed youths aged up to 29 and those for hiring unemployed as part-timers were among the best performing ones. Employers have shown greater propensity to hire young people although the latter lack professional experience after graduation.

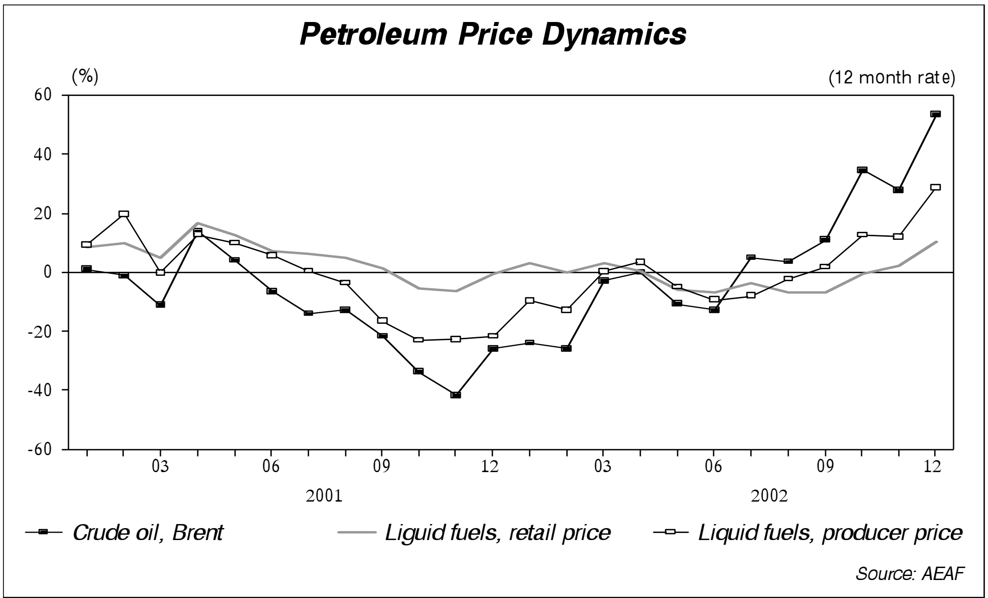
Training programmes help to increase labour market flexibility by improving the qualifications of the unemployed in line with actual market demand. In 2002 these programmes gained momentum and the number of unemployed who had completed courses for the acquisition of professional qualification or had passed motivational training reached 19 461, stepping up by 7.5% on a year earlier. However, their share within the total number of unemployed still remained rather small. Investment in qualification is a prerequisite under a market economy for the competitiveness and swift adaptability of labour force to the ever-changing market conditions. The elevation of the educational and qualification level of the unemployed motivates employers to hire such persons thereby boosting the chances of the latter to find a job while acting upon the unemployment level. The government's active labour market policy in 2003 places a special emphasis on the qualification programmes and the enlargement of their scope, which involves the allocation of more funding. Concurrently, the effectiveness of the implemented ALMPs needs to be evaluated so as to ensure the efficient distribution of the budgeted funds among the actions encouraging both demand and supply of labour force carried out under coordinated economic, social and fiscal policies.

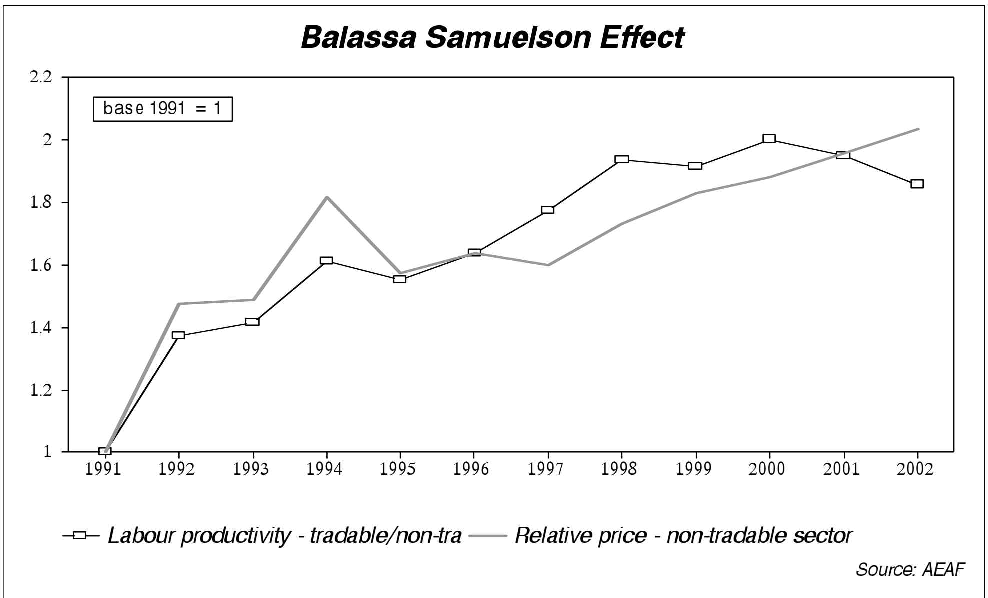
The increased demand for labour at the market represented another positive labour market trend in 2002. Notwithstanding the huge impact of active programmes on demand reported in November and December, the year was marked by a primary labour market upturn due entirely to the private sector. The real sector of the economy generated some 107 000 new jobs, or some 9.5% more than the 2001 figure. Thus, the share of private employers in total job generation stepped up from 65.1% in 2001 to 70.6% in 2002. ❍

APPENDIX 4

External Factors and the Balassa-Samuelson Effect in the Bulgarian Economy

In 2002, the external pro-inflationary factors, i.e. crude oil prices and the USD/EUR exchange rate manifested a converging pattern of dynamics. The US currency was steadily losing ground to the EUR throughout the year (12.2% depreciation in end-year), checking any further rise in the price level, while international oil prices were steadily increasing.





Crude oil prices (Brent) worldwide stepped up by 53.3% in dollar terms, and producer price inflation in end-2002 ran at 6.3%, with some 3.3 percentage points of the increase being due to the 28.7% rise in refined oil prices. The retail prices of liquid fuel reported a 10.4% increase. In the final analysis, the USD's depreciation made up largely for the higher crude oil prices. The producer price dynamics of liquid fuels stood closer to crude oil price dynamics worldwide than to consumer prices. As they are more flexible to international price volatility, this was an expected pattern of producer price behaviour.

As for consumer prices, non-food and service prices (administered and energy prices excluded) stepped up by 0.4% and 2.7% in end-year, and 1.2% and 4.2% on a 12-month average. The latter two figures can be taken to estimate the relative prices of market services (non-tradables) vs. market non-food items (tradables). On a year earlier, the relative price ratio amounted to 3%. Following the Balassa-Samuelson hypothesis, relative price adjustments can be explained by way of the increase in productivity in the sector of tradables vis-□-vis non-tradables. Drawing upon GVA data[1], relative service prices via-a-vis the manufacturing sector amounted to 2.6%, but productivity growth rate in the manufacturing sector is expected to run lower than in the service sector, indicating that the Balassa-Samuelson effect now had no contribution to 2002 inflation, unlike the preceding years. ❍

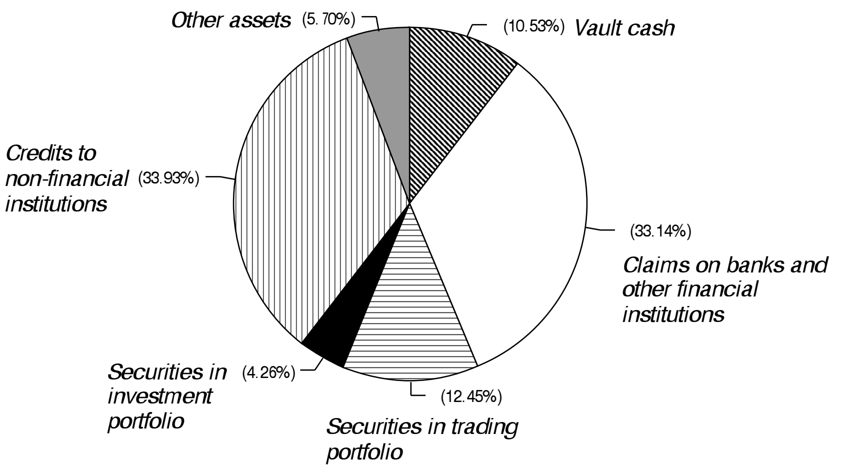
[1] *Estimations rely on 2002 forecasts.*

APPENDIX 5

Structure of Commercial Banks' Assets

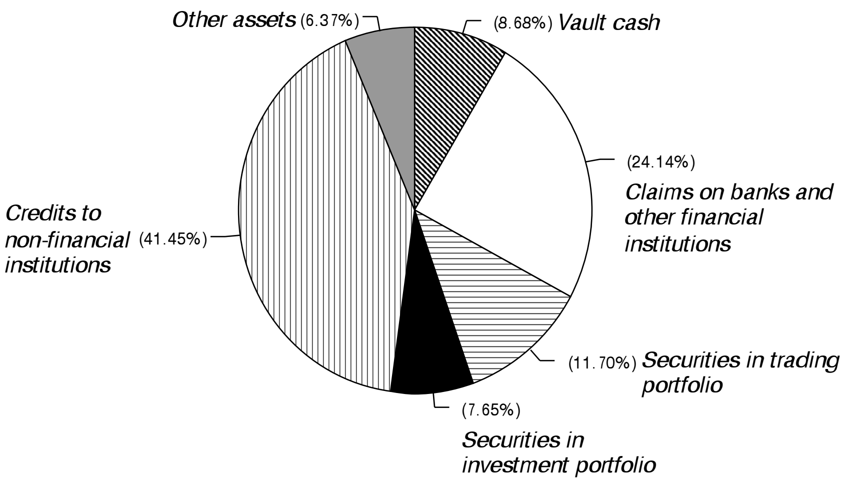
The transformation in the structure of commercial banks' assets that got underway in the second half of 2001 continued throughout 2002. The share of credits to non-financial institutions and other clients went on increasing (by 7.5 percentage points against end-2001) to reach 41.4% of total assets at the expense of the declining relative weight of claims on banks and other financial institutions (by 9 percentage points on a year earlier) down to 24.1% of total banking system assets.

Commercial Banks Assets as of 31.12.2001



Source: BNB

Commercial Banks Assets as of 31.12.2002

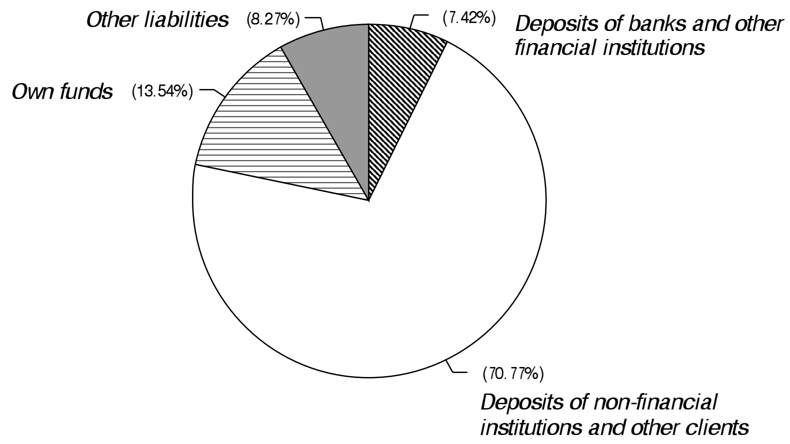


Source: BNB

Another change in commercial banks' assets structure in 2002 had to do with the increase of the share of securities in their investment portfolio by 3.4 percentage points on a year earlier up to 7.6% mainly as a result of investment in long-term securities issued by the Bulgarian government on the international financial markets. The relative share of securities in the trading portfolios negligibly fell on a year earlier, stepping down by 0.7 percentage points. The share of cash balances decreased by 1.9 percentage points relative to end-December 2001 when its high level was influenced by the pending introduction of the euro banknotes.

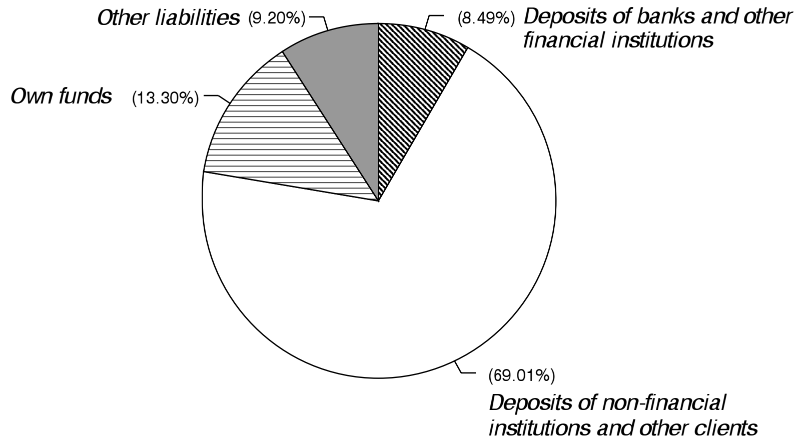
No visible changes in the trends in the banking system liabilities structure were discerned in 2002. The share of deposits of non-financial institutions and other clients stepped down by 1.8 percentage points to 69% regardless of the reported 16.2% (BGN 1 398.2 million) nominal growth of these deposits. In contrast, the weight of the deposits of banks and other financial institutions increased by 1.1 percentage point to 8.5% while that of other liabilities went up by about 1 percentage point to reach 9.2%. The recorded changes were associated with the money market upturn in 2002 as well as with the placement by foreign banks of money funds (credit lines) for the extension of credits to enterprises in Bulgaria. The share of banks' own funds reported a minor decline of 0.2 percentage points relative to end-2001 to reach a level of 13.3%. ❍

Commercial Banks Liabilities as of 31.12.2001



Source: BNB

Commercial Banks Liabilities as of 31.12.2002

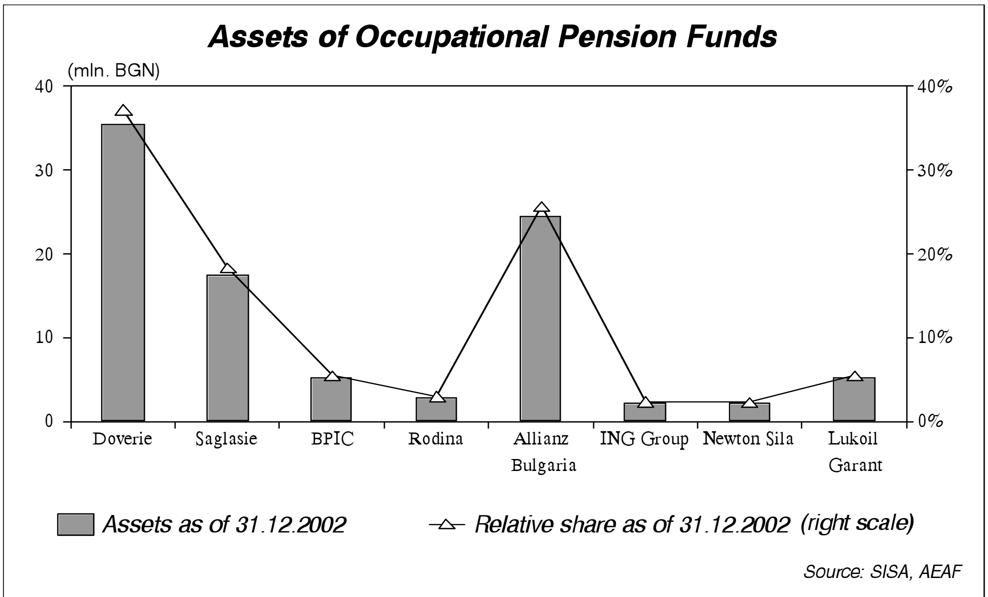


Source: BNB

APPENDIX 6

Pension Insurance Market

The pension insurance system in Bulgaria comprises eight companies and the respective universal, occupational, and voluntary pension funds registered by them. As of end-2002, the number of persons insured in *occupational pension funds* reached 155 200, reporting a 7% increase on a year earlier. The accumulated assets of occupational pension funds recorded an 84.8% year-on-year growth, reaching BGN 92.5 million. The assets continued to be very concentrated. The four largest occupational pension funds[1] managed 86.9% of total assets against 86.3%[2] in end-2001. The shareholders of *Balgarsko pensionnoosiguritelno druzhestvo* pension insurance company decided for a lateral amalgamation with *Doverie* pension insurance company. The amalgamation of the funds managed by both companies will additionally push up concentration in 2003.



The composition of the investment portfolios of occupational pension funds underwent some changes in 2002. In end-year, some 69.3% of occupational pension fund assets were invested in government securities (against 58.6% in end-2001) and 22.6% in bank deposits (against 37.3% in end-2001). It is noteworthy that the share of investment in securities listed for trading at the regulated markets went up by 5.8 percentage points on a year earlier to reach 6.4% of total assets. The development of the capital market and its increasing re-distributive role in the economy was the underlying reason behind the growing investments of institutional investors in instruments traded at the stock exchange. Thus, 2002 saw the trading at the Bulgarian Stock Exchange of shares of lucrative companies that attracted the investors' interest. In 2002, occupational pension funds made their first investments abroad albeit quite small in volume (0.02% of investment in end-2002). So far, none of the occupational pension funds have fully used the possibility to invest up to 10% of their resources abroad but not because of the lack of a clear regulatory framework[3]. Rather, this reluctance was due to the insufficient experience of pension funds as well as to the slackening growth rates of global economy and the fall of international interest rates.

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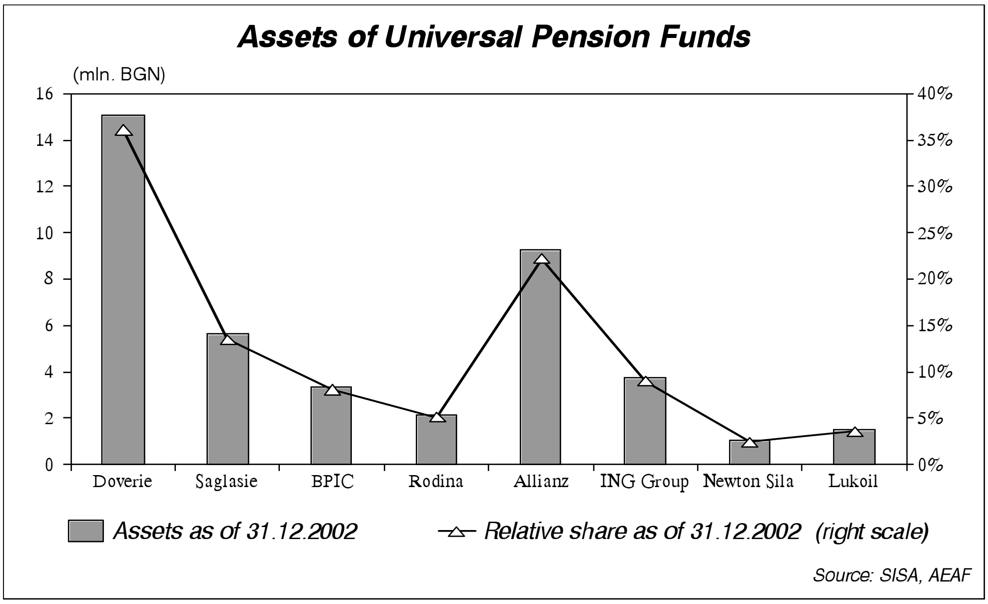
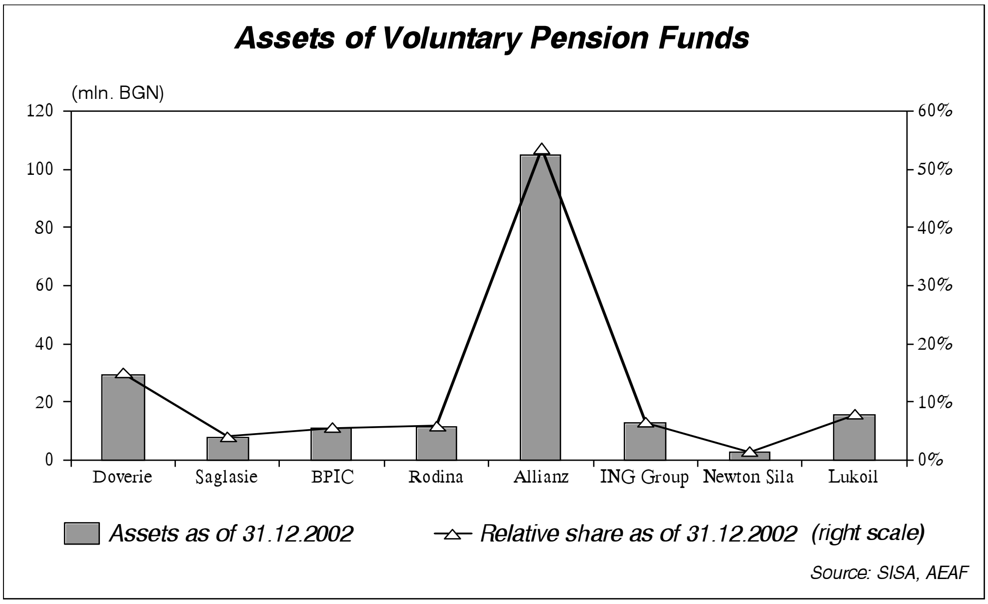
[1] Doverie, Allianz Bulgaria, Saglasie *and* Balgarsko Pensionnoosiguritelno Druzhestvo.

[2] Doverie, Allianz Bulgaria, Saglasie *and* Lukoil Garant.

[3] *Ordinance No4 on the terms and conditions of investment abroad of assets of pension insurance companies and supplementary pension insurance funds was adopted on 14 June 2002.*

As of end-2002, some 1.16 million people were insured in *universal pension funds*. Total accumulated assets in these funds stepped up from BGN 10.77 million in end-June 2002 to BGN 41.7 million in end-2002. The four largest funds managed some 80.8% of total assets. The investment portfolios of universal pension funds primarily comprised government securities (78.7%) and bank deposits (17%).





The number of persons insured in *voluntary pension funds* ran to 484 000 in end-December 2002, stepping up by 7.5% on a 12-month basis. The funds' assets grew by 44.4% to reach BGN 195.5 million in end-year. Although concentration in the sector lessened substantially, it still remained rather high with four voluntary pension funds holding 82.9% of total sector's assets.

The structure of pension funds' investment portfolio underwent no worthwhile changes in 2002. Out of the total sum of invested resources, some 54.2% were invested in government securities (as compared to 44.4% in end-2001) while bank deposits comprised 32.6% of investment (against 38.2 in end-2001). The share of bank deposits in pension funds' investment portfolio contracted at the expense of increased investment in mortgage bonds. The weight of the latter stepped up from 4.5% in end-2001 to 6.8% as of end-2002. Commercial banks went on issuing mortgage bonds in 2002 as part of their credit expansion policy. In view of the relatively high rate of return on mortgage bonds, they have emerged as a preferred financial instrument by institutional investors.

Inasmuch as the current total amount of accumulated resources in pension funds is still far from being too large, the market offered options for investment in financial instruments seem adequate. In spite of the low budget deficits reported in recent years, the government continued to issue sufficient volumes of government securities that satisfy investors' demand for such financial instruments. However, pension funds are expected to accumulate a great volume of cash funds in the future and the existing volume of available financial instruments will fail to provide sufficient investment opportunities. This potential mismatch may be resolved by granting more freedom to pension funds to invest on foreign financial markets and abolishing the high percentage requirement for investment in government securities. ❍

APPENDIX 7

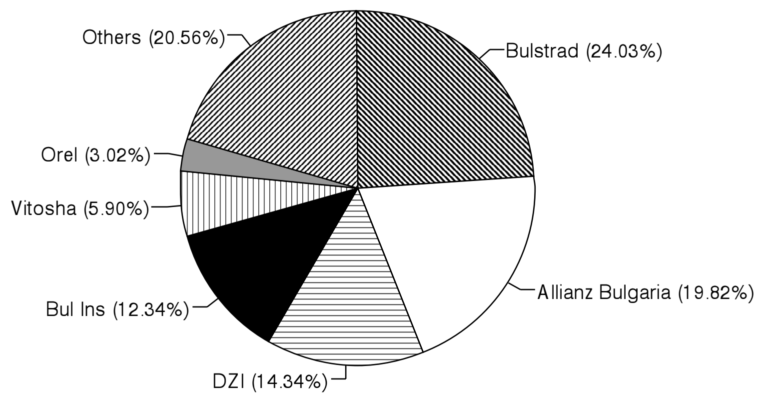
Insurance Market

Concentration in the non-life insurance segment remained high in 2002 as well. As of end-September 2002, the four largest companies *Bulstrad, Allianz Bulgaria, DZI* and *Bul Ins* accounted for 70.5% of premium income against 72.4% in end-September 2001. The value of Herfindahl Index measuring gross premium income (0.14 in end-September 2002 against 0.15 in end-September 2001) also indicates increased competition in non-life insurance. 2002 witnessed the onset of a redistribution of the market shares of insurance companies. *DZI* experienced the most important change in its market share largely as a result of the privatisation of the company in end-2002. Following the divestiture of the two remaining state-owned insurance companies, namely *DZI* and *Armeets*, the insurance market in Bulgaria was entirely transferred in private hands.

Substantial changes in concentration in life insurance were discerned in 2002. The concentration coefficient in end-September 2002 stepped down to 69.2% from 87.2% recorded a year ago. The value of Herfindahl Index in this segment declined from 0.26 in September 2001 to 0.16 in September 2002, thereby indicating intensified competition in the sector.

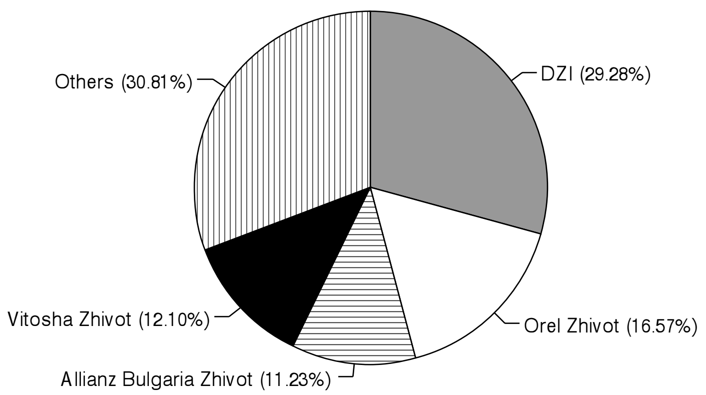
The Insurance Act was amended in 2002, called for by the alignment of the legal framework of insurance with the EU acquis. More specifically, amendments concerned

Gross Premium Income by Non-life Insurance Companies (as of 30.09.2002)



Source: Insurance Supervision Agency

Gross Premium Income by Life Insurance Companies (as of 30.09.2002)



Source: Insurance Supervision Agency

the stipulations on the investment of insurance reserves of insurance companies. Although the package of allowed financial instruments for investment remained the same, the requirements of the investment ratio of insurance reserves were changed. Thus, mortgage bonds shall not exceed 25% of the investment portfolio while no more than 15% of reserves may be invested in the mortgage bonds issued by a single commercial bank. The volumes of mortgage bonds issued went on rising in 2002 thereby offering insurance companies and pension funds investment options in longer-term instruments.

As of end-September 2002, the volume of invested insurance reserves reported a year-on-year growth of 25.5% mainly due to the sizeable increase of premium income of insurance companies. The investment structure of life insurance companies' insurance reserves underwent noteworthy changes. Thus, the share of loans against life insurance policy reported a considerable rise, stepping up by 14.5 percentage points to reach 18.3% in end-September 2002 whereas the weight of deposits in financial institutions fell by 10.2 percentage points to 9% of the investment portfolio. The changes in the investment portfolio were triggered by the high number of contracted short-term life insurance policies. Insurers operating in the non-life insurance segment went on investing their insurance reserves primarily in government securities (38.3% of the investment portfolio as of end-September 2002) and bank deposits (50.8% of the investment portfolio as of end-September 2002). ❍

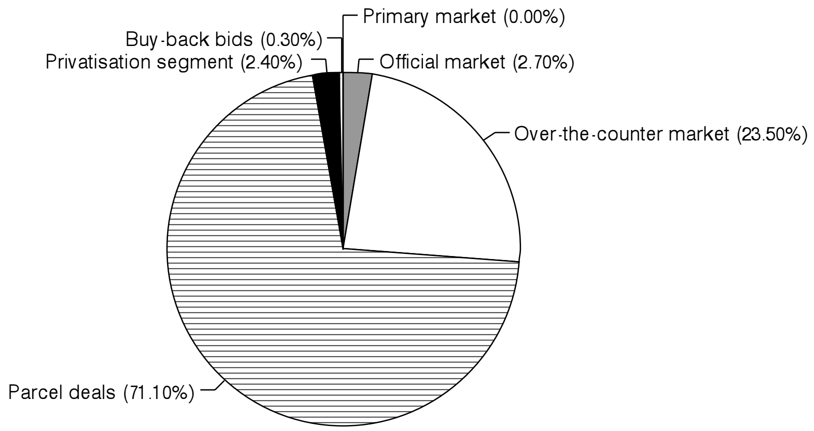
APPENDIX 8

Capital Market

In 2002, turnover at the BSE increased by 158.3% on a year earlier, reaching BGN 416.1 million[1]. In 2002, again the bulk of stock exchange trading was carried out by *block or parcel deals*. The turnover of block deals amounted to BGN 244.8 million in 2002, stepping up by 113.8% on a year earlier. In spite of the sizeable increase of turnover on this market segment, the share of block trading within total trading at the BSE ran at 58.8% in end-2002, stepping down from 71.3% in 2001.

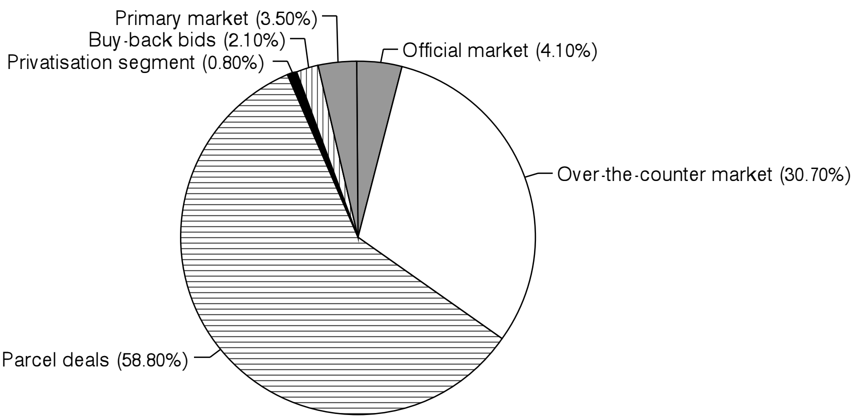
2002 saw the launch of trading in *compensatory instruments*[2] at the BSE and a separate market segment on the stock exchange for trading in compensatory notes was set up. A new Transactions in Compensatory Instruments Act was passed and enacted in 2002. Since September 2002, these instruments have been traded uniquely on the BSE with a view of ensuring the transparency and publicity of transactions in compensatory instruments and achieving a just completion of the process

Bulgarian Stock Exchange: Turnover Structure in 2001



Source: Bulgarian Stock Exchange - Sofia

Bulgarian Stock Exchange: Turnover Structure in 2002



Source: Bulgarian Stoch Exchange - Sofia

[1] *Turnover on all market segments, including buy-back transactions.*

[2] *Pursuant Art. 2 of the Transactions in Compensatory Instruments Act, compensatory instruments shall be* compensatory notes *and* housing-compensatory notes *as per the Indemnification of Owners of Nationalised Real Estate Act as well as* nominal compensation bills *under the Land Act and Forestry Act.*

of compensating citizens who have been indemnified with compensatory instruments. These instruments attracted the investors' interest immediately after trading was launched on the stock exchange due to the existing option to use them as paperbacked instruments in the privatisation of state-owned enterprises. Trading in compensatory instruments had a substantial contribution to turnover at the BSE. In 2002, turnover at the compensatory instruments market segment accounted for some 8.6% of block trading (BGN 21.1 million). The contribution of this market segment to trading in single shares turnover was even higher, reaching BGN 40.8 million or 28.2% of total trading volumes[3].

In 2002, the growth of trading in single shares turnover outstripped the growth pace of the block segment, reaching a year-on-year rate of increase of 241.9%. The share of trade in single shares in total trading also reported a notable increase, stepping up from 26.2% in 2001 to 34.7% in 2002.

It is noteworthy that all market segments of trading in single shares recorded marked growth. Turnover on the *official market of shares and bonds* reached BGN 16.9 million in 2002 against BGN 4.4 million registered in 2001 primarily due to trading carried out on market segment „C". Thus, trading volumes on this market segment reported a notable 3-fold rise on a year earlier worth BGN 10 million to reach BGN 11.4 million in 2002. March 2002 witnessed several important transactions in shares of the *Economic and Investment Bank* on this segment that contributed to the increase of trading turnover.

Turnover on the official corporate bonds market reached BGN 2.5 million in 2002 against BGN 816.9 thousand in 2001, reporting a hefty 2-fold year-on-year rise. In the second half of 2002, the ordinary shares of the *United Bulgarian Bank* were most actively traded, having been placed for secondary trading on this market segment after being listed on the primary corporate bond segment of the BSE. New issues of mortgage bonds of the *Economic and Investment Bank* and the *Bulgarian Post Bank* worth BGN 1.67 million and BGN 12 million respectively were listed. In September 2002 trading in the corporate bonds issued by *Energia* AD - Targovishte was discontinued and thereby adversely affected trading in this financial instrument in 2002.

In 2002, trading on the *over the counter market of bonds and shares* of the BSE also reported a hefty increase, stepping up over 2-fold on a year earlier. Turnover grew from BGN 37.9 million in 2001 to reach BGN 127.6 million in 2002. Trading volumes on the over the counter market (OTC) of shares rose by BGN 31.9 million while over the counter market of bonds grew by BGN 16.8 million. The mortgage bonds of *First Investment Bank* and the *Bulgarian-American Credit Bank* listed for trading in 2001 were again actively sought after thus contributing to the growth of turnover on the OTC segment. The *Bulgarian-American Credit Bank* placed another issue of mortgage bonds in 2002 and thereby the total number of mortgage bond issues traded on the stock exchange reached five with a total worth of approximately BGN 43 million. The intensified credit activity of commercial banks in recent years favours the issuing of more mortgage bonds since the latter became a very lucrative and hence an attractive financial instrument.

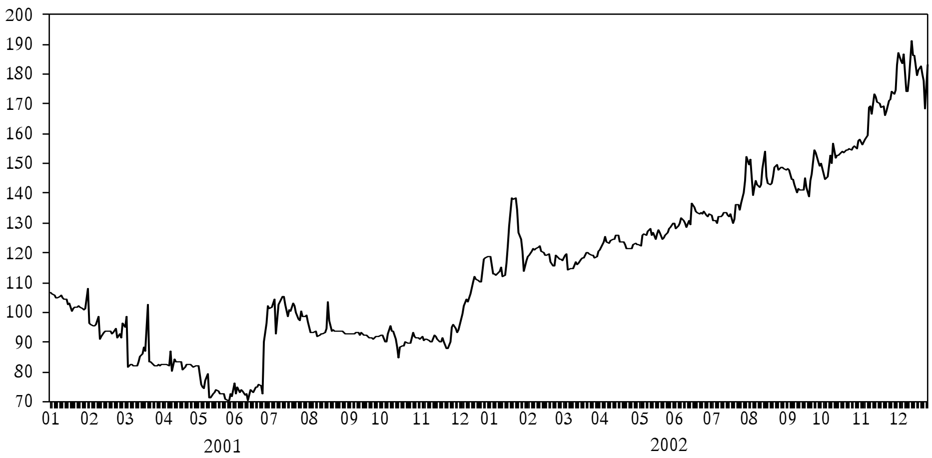
In 2002, the number of transactions at the *privatisation segment* of the stock exchange ran at 93 with a total worth of BGN 3.2 million (cf. BGN 3.7 million in 2001). Although the first privatization transactions in paperbacked instruments were carried out in the last two months of the year, turnover in 2002 remained lower than in 2001 most probably due to the existing unclear points as regards privatization on the stock exchange.

[3] *Turnover of buy-back bids and turnover on the privatisation segment excluded.*

The procedure for offering parcels of shares of large state-owned enterprises (such as the *Bulgarian Telecommunications Company*, *Bulgarian Maritime Navigation*, etc.) on the stock market was not finalised by end-2002. The delay in the offering of these parcels is likely to push down the interest of compensatory instruments' owners in these attractive shares and hence to affect their prices and trading.

In 2002, the turnover of buy-back bids reached BGN 8.9 million and 17 transactions were carried out on this segment. For comparison, the respective turnover in 2001 amounted to only BGN 461.6 thousand. A primary corporate bond segment of the market was set up and the first issue of ordinary shares of the *United Bulgarian Bank* was placed in May 2002. A municipal bond issue of the municipality of Sliven was placed on the primary market in early October 2002. After the whole issue worth BGN 3 million was purchased, the municipal bonds were listed for secondary trading at the official municipal bond market.

Bulgarian Stock Exchange Index (SOFIX)



Source: Bulgarian Stock Exchange - Sofia

In end-2002, the *official stock exchange index SOFIX* reached 183.08 points, reporting a year-on-year increase of 54.3%. On 10 December 2002, SOFIX peaked to its highest ever level of 190.97 points. The high values of the index were induced by the share price increase of almost all companies on which SOFIX is based. The shares of *Sopharma* AD Sofia, *Zlatni Piassatsi* AD and *Albena* AD recorded the highest price increase in 2002, stepping up by 198.8%, 83.1% and 59.5% respectively. ❍

APPENDIX 9

Structural Reforms in Some Priority Sectors

Tobacco Industry

Preparatory work for the divestiture of *Bulgartabac* Holding AD was launched in March 2002 with the adoption of a strategy for the privatisation of the tobacco industry monopolist. Between 51% and 80% of *Bulgartabac's* capital were offered for sale and substantial interest was expected on the part of strategic investors experienced in the tobacco and cigarette business. The government committed itself to swiftly privatise the tobacco monopolist without specifically expressing its expectations from potential investors and clearly defining the obligations, which the government would assume in support of the sector. There was no long-term strategy for the development of tobacco growing at the onset of the privatisation procedure. The legal and regulatory framework of the sector's operation was also awaiting amendments. The strategy for the development of tobacco growing was adopted only after the selection of the preferred buyer made in April 2003 while the draft Tobacco and Tobacco Products Act prepared by the MAF in November 2002 has so far not been considered by the National Assembly.

The international market situation and the competitive stance of the country had also a role to play in the process of divestiture. Alongside the persisting downward trend in the international prices of tobacco, Bulgaria found itself in a relatively less favourable position vis-□-vis its main competitors on the international markets, namely Turkey to which the EU applies zero tariff rates on tobacco and Greece where producers receive 4-fold higher subsidies from the state.

Following the imposed restrictions on Bulgarian tobacco imports in the USA and Russia[1], the EU emerged as the principal market of Bulgarian tobacco products. According to data from *Bulgartabac* Holding, some 50% of its produce in 2001 were sold on the EU market. According to estimates of the World Health Organisation, however, demand for tobacco products in the euro area is expected to contract by 10% to 20% by 2008 and therefore, production quotas eligible for EU premium payments were already reduced by 1.8% for 2002 and the following two years. Demand for Bulgarian tobacco products on the local market is also likely to fall in view of the envisaged reduction of tariff rates on imported tobacco from the EU.

The adopted in April Strategy for the development of the sector does not adequately reflect the trends at the international markets and the aspiration to rapidly conclude the privatisation of *Bulgartabac* Holding. According to the document, by 2007 output of raw tobacco should increase to 77 000 tons, tobacco exports are expected to step up more than two-fold relative to 2001 (up to 45 000 tons) and the potential buyer of the monopolist will have to guarantee the purchase of all tobacco grown. The purchase of produced tobacco was additionally guaranteed by the preservation of the existing producer subsidisation scheme, i.e. by retaining the level of minimal purchase prices, increasing concurrently the premium paid to tobacco growers

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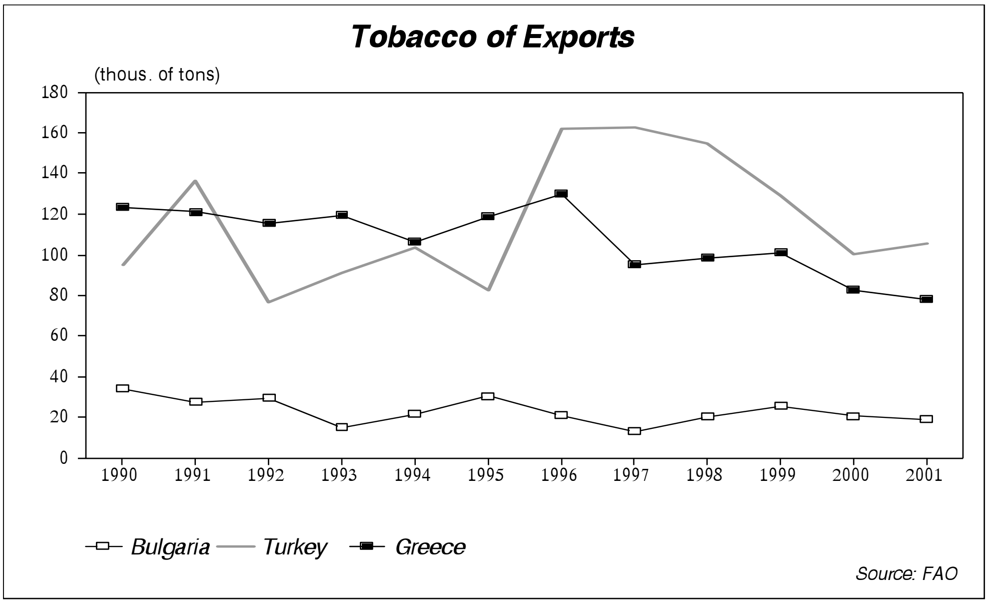
[1] *In end-1996, Russia abolished the preferential treatment of imports of tobacco products from Bulgaria and, consequently, Bulgarian cigarette exports drastically declined.*

and raising gradually the target cash support to producers. Thereby, the initial goal of swift privatisation was practically replaced by social considerations to support the sector and producers without ensuring the equal treatment of potential future players at the local tobacco market.



Furthermore, in the course of negotiations with the selected preferred buyer, viz. *Tobacco Capital Partners*, the Bulgarian side declined the buyer's proposals to bind the issuing of cigarette production licenses with an obligation to purchase certain quantities of tobacco (similar to the scheme adopted in the privatisation of the Polish state-owned monopoly) which would have placed all market participants on an equal footing and would have created real competition in the sector. The Bulgarian negotiators also rejected the demand of *Tobacco Capital Partners* to establish a National Chamber of Tobacco that would tackle all issues related to quality, brands and prices jointly with the government, tobacco purchasing and processing companies and representative of producers. In this way, the policy for the development of the sector would have been formulated in conformity with the existing market conditions as another prerequisite for the development of a competitive sector.

Given the above circumstances, the fact that the Parliament did not approve the privatization deal in early-2003 is not surprising especially in view of the following fundamental shortcomings in the preparation process for restructuring and divestiture of the tobacco monopoly: the absence of a clear-cut vision for the development of the sector in the long run, the lack of a cost and benefit analysis of the planned increase of producer subsidies and the uncertainty about the requirements towards potential investors.

The dull initial interest - there were only four bidders and none of them was a company enjoying repute and trustworthiness at the international markets - was the first sign that the chosen approach for the privatisation of the tobacco monopoly was inadequate. The potential benefits of a restructuring of the holding were not analysed in depth. The restructuring would have attracted strategic investors in the profit-making detached parts of *Bulgartabac,* thereby boosting investment in the sector and enhancing the quality of produce and ultimately raising the industry's competitiveness at the international markets. The international specifics of the organisation of tobacco growing characterised by company specialisation either in cigarette manufacturing or tobacco processing was also not taken into account especially in view of the fact that *Bulgartabac* consists of enterprises operating in both lines of business which made the holding unattractive as a whole entity to experienced investors in the industry.

The fact that Turkey as one of the country's main competitors on the market was also foreseeing the privatisation of its tobacco monopoly was overlooked. In January 2002, the Turkish parliament passed the Tobacco Growing Act which primarily aimed at the deregulation of the sector and the creation of the legal framework for the divestiture of *TEKEL*. The Act put an end to subsidies to tobacco producers, eliminated the minimum purchase prices, made open tobacco purchase tenders obligatory, provided for the revaluation of the company's debt in arrears as well as for the winding up of a number of non-profitable capacities and enterprises. *TEKEL* is expected to be privatised in 2003.

Information and Communication Technologies

The development of the information and communication technologies (ICT) is crucial to the improvement of the economy's competitiveness and the enhancement of its development potential. The programme of the Bulgarian government places a special emphasis on the development of ICT as one of the key sectors for the country's sustainable development. Specific actions were taken in 2002 to stimulate the development of this priority area, including legislative amendments and administrative action with an economy-wide impact, as follows:

- The VAT Act was amended with a view of refunding the tax credit of software exporting firms;
- The Corporate Income Tax Act was amended by raising the annual depreciation rate for computers and software from 20% to 50% from 1 January 2003 onwards;
- An updated telecommunications sector policy was adopted, reflecting and incorporating the country's positions on Chapter 19 „Telecommunications and information technologies" while specifically providing for the full liberalization of the telecommunications market from 1 January 2003 onwards;
- An E-Government Strategy was adopted;
- A Strategy for the introduction of ICT in secondary education was drafted.

Furthermore, the institutional framework of ICT was set up by establishing a Coordination Centre on Information, Communication and Governance Technologies at the Council of Ministers and an Executive Agency „Development of Communications and ICT" attached to the Minister of Transport and Communications. The main functions of the Executive Agency include the administering, collection and disbursement of funds for the development of telecommunications, postal infrastructure and ICT. A long-term innovation strategy was also elaborated. The strategy is in compliance with the recommended international practices and is due for adoption and enforcement in 2003.

BTK's special rights on the fixed telephone network and services expired in end-2002. However, the natural monopoly of the company on the communication infrastructure will continue to affect local market until the creation of competitive private networks. The delay in the divestiture of *BTK* was one of the unfortunate events in the ICT sector in 2002. Although the strategy for the privatisation of *BTK* was adopted as early as March 2002, the deadlines and terms set by the strategy were repeatedly prolonged. As a result of this protraction, as of end-April 2003 the sale of the single Bulgarian operator of fixed telephone services had only entered the phase of negotiations with potential buyer.

The privatisation procedure of *BTK* was launched in April 2002 in line with the adopted strategy. Up to 65% of the company's capital coupled with an option of third GSM operator licence were offered under a two-phase tender. Some 20% of *BTK*'s shares were foreseen for public offering at the BSE. Evidence of received revenues from the operation of fixed telephone services of over 500 MEURO in 2000 or operation of a fixed network with over 2 million subscribers were the minimum potential buyer requirements to telecommunication companies. Financial investors willing to participate in the tender were expected to manage funds of over 300 MEURO.

The adopted privatisation approach seemed adequate and well-grounded, given the unfavourable international telecom market situation[2] and the pending expiry of *BTK*'s special rights on the fixed network in end-2002. However, similar to the divestiture of the tobacco monopoly, the absence of an adequate new telecommunications act and accompanying regulations could not shed light on several important issues for potential investors, namely the underlying principles for the construction of the new price-setting methodology of the fixed-line telephone service; and the procedure and methodology for the calculation of net expenditures of the future operators on the fixed telephone network market with a view of their compensation for the obligation to provide a “universal service“. In this respect, the plain telephone service tariff rebalancing and the establishment of an information system reporting the company’s expenditures for the maintenance of all lines which will serve as the basis for the expenditure compensatory grant by types of services offered were delayed. The poor initial interest in the deal (only three bidders) was the first indicator of the unsuitability of the adopted approach to the execution of the privatisation deal. The maximum possible budget receipts from the deal were prioritised, with cash revenues contributing 80% of the final selection assessment against a 15% share of the employment programme and only 5% of the investment programme.

In October, *Advent* investment fund - a company enjoying relatively good reputation in the sector and managing assets of over USD 6 billion was selected as the preferred buyer of *BTK*. Subsequently, the Supervisory Board of the Privatisation Agency rejected the draft sale contract on the grounds that it failed to comply with the legislation in force. The absence of bilateral agreements, the unlawful extension of the deadline for the realisation of contracted investment from 2006 to 2008 and the attached condition to absorb the sums paid for *BTK* shares depending on the legislative acts of the National Assembly in the area of telecommunications were singled out was contradicting to current legislation.

Energy Sector

A fundamentally new energy sector policy was launched in 2002 aiming at the preparation of the sector for divestiture and stepwise liberalisation of the energy markets.

The Energy Strategy of Bulgaria was adopted in July. It foresees the gradual phasing out of operating subsidies, elimination of distortions caused by the cross-subsidisation policy and management of the investment process so as to free the government from assuming additional obligations. The policy to be followed involved the privatisation of assets and the placement of the risk related to the construction of new energy production capacities with private investors.

In line with the declared government intentions, a new Energy Act was drafted with a view of setting up the legal framework of energy liberalisation. The draft act foresees the introduction of a system of authorisation for new capacity while the role of the government will be reduced to the issuing of permits for the respective capacities without assuming any power purchase obligations.

The draft act regulates the transition from the existing single buyer model to a model of regulated access of eligible third parties. The opening of the market will be introduced by allowing electricity producers and

[2] *See Appendix 1 for the trends on the international ICT.*

eligible consumers to have direct access to the transmission and distribution networks and to contract freely. The share of eligible end-users is expected to gradually increase until full liberalisation is achieved by the date of accession of Bulgaria to the EU. The initial opening of the gas and electricity markets is envisaged for July 2003. In the initial phase of the opening, enterprises need to have own electricity consumption of over 100 GWh and gas consumption of over 80 million m^3 per annum so as to be eligible to acquire the status of eligible consumer. In the electricity generation sector, 10 eligible consumers and 5 electricity producers (accounting for some 15% of the market) will qualify for the initial opening of the market.

The restructuring of the sector also involves the price adjustment of energy resources, viz. electricity and district heating price rises, approval of a pre-set schedule for the adjustment of electricity tariffs and the introduction of gas distribution cost-reflective prices for households.

Since 2002 the price of coal is no longer subsidised and in mid-2002 the SERC approved an indicative 3-year schedule for the annual stepwise increase of the average household price of electricity. The schedule foresees that by 2004 household electricity tariffs will have increased to their full-cost recovery levels. The tariff adjustment process was accompanied by the adoption of several ordinances on the electricity, gas and district heating price-setting methodologies.

The government also met its social commitments by applying two mechanisms for assistance to low income households, namely (1) expansion of the scope of the existing energy benefit programme, which provides benefits to low-income households (about 25% of households) during the heating season and (2) introduction of a double-rate (block) tariff under which the consumption of a certain amount of electricity will be paid for at the current prices over the entire price adjustment period. Thereby, the phasing out of subsidies to producers and the gradual subsidy re-allocation to vulnerable end-users will be sustained.

The divestiture of a sizeable part of state-owned assets in the energy sector is seen as the principal instrument for the sector's restructuring. Considerable investments are required for both the rehabilitation and enhancement of efficiency of existing capacities so as to push up the attractiveness of the companies offered for sale. Unfortunately, the pace of this process has so far been unsatisfactory and therefore considerable further efforts remain necessary. After a notable delay, the financial agreement for the rehabilitation and modernisation of *Maritsa East 3* TPP between the American *Entergy* corporation and *NEK* EAD was signed in December 2002. With a total estimated value of about 500 MEURO, this project became the first large investment project in the energy sector. The preparation for accession to the Union for the Coordination of Transmission of Electricity (UCTE) in 2003 was another particularly important step in the efforts to strengthen the country's positions on the international market. In 2002, work advanced in a number of other projects such as the amplification of the transmission capacity of the electricity transmission and gas transmission networks, the overhaul of the district heating sector capacities, improvement of management of demand in the sector and the installation of individual heat-metering equipment.

The situation on the natural gas market is dissimilar from the one on the electricity market. The gas market is only partially developed and priority has been attached to the provision of gas to large consumers in the energy sector and manufacturing. The fall in demand following the loss of consumers' positions on the international markets is currently one of the gravest issues on the market. Supply of natural gas till 2010 is guaranteed by an agreement with Russia, however, the terms and conditions of the agreement are quire unfavourable for the Bulgarian part and the contracted quantities far exceed actual demand at present. The construction of a low pressure gas network is still pending regardless of the proven advantages of this energy source. The underlying reason behind the unbalanced development of gas market in Bulgaria is the delayed introduction of differentiated prices for the separate consumer groups.

In 2002, the main obstacle to the expansion of the low pressure gas market was eliminated with the introduction of cost-reflective tariffs. The Ministry of Energy and Energy Resources has drawn up an inventory of the new gas distribution networks to be built in individual gas distribution regions on the basis of the requests placed by municipalities.

The monopoly company *Bulgargas* EAD successfully completed in 2002 its restructuring and financial rehabilitation programme simultaneously with the accomplishment of its 3-year investment programme.

Railway Transport

In spite of the undertaken actions for the restructuring of *BDZ*, further serious reforms remain necessary with a view of eliminating further losses and improving the company's stance on the transport market. The company's gravest problems stem from the loss-generating arms of the company, low labour productivity, the continuing dependence on the state for the implementation of investment policy and the insufficient compensatory grant from the government in regard to the obligations for the provision of social services. Competition from the road transport is another challenge since the road transport sector has become highly efficient following its timely privatisation and restructuring.

The envisaged by the Railway Transport Act liberalisation of the sector was launched in 2002. *BDZ* was legally separated in two independent companies - an infrastructure maintenance company (Railway Infrastructure National Company) and a passenger and freight services operator (*BDZ*). After the accomplished restructuring, *BDZ* is obligated to pay an infrastructure fee and is entitled to two types of compensatory grants from the government: one compensating the losses incurred from loss-making activities and another one covering the company's expenditures for the granting of free of charge or discounted tickets to certain categories of passengers.

2002 sustained the downward trend in the number of passengers (24% down) and total lifted freight (4.2% down)[3]. In compliance with the undertaken commitments under the 2002 Action Plan, passenger tariffs were raised by 12% for express trains and by 10% for passenger trains. A number of loss-generating branch lines were closed and the passenger trains timetable was optimised. As a result of the changes made, passenger services were reduced by 8.4% on average. The railway freight transport underwent similar changes. The number of freight trains was reduced by 109 and 79 goods stations were closed down.

Two particularly important strategic documents tracing the future development of the sector were adopted in 2002: a 2003 Business Plan and a long-term 10-year strategy for the development of the railway transport.

The Action Plan over the 2003-2005 period foresees the restructuring of the railway operator *BDZ* by means of the institutional and legal separation of passenger and freight services in 2003 and the clear defining of relations between the government and the operator in relation to the financing of passenger transportation of socially vulnerable groups of the population via a signed contract between the government and the operator for a 100% subsidisation of expenditures related thereto.

[3] *According to data provided by the Ministry of Transport and Communications.*

The removal of cross-subsidisation of passenger transport by freight transport on 1 January 2004 and the adoption and introduction of new infrastructure marginal cost-reflective fees are also among the key priorities.

Further measures to improve competitiveness are also envisaged such as the development of new products and services and the partial modernisation of the rolling stock so as to raise the quality of the services offered.

The optimisation of operating expenses will advance, including the adoption of a staff reduction plan (foreseeing a 20% contraction of personnel in 2004 relative to 2001), the attainment by express trains of a minimum of 90% cost-recovery level by June 2004 and the development of reliable systems for expenditure budgeting. ❍

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