BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2003

annual report

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EXECUTIVE SUMMARY

Bulgarias GDP has grown for a six year in a row, with this growth running steadily over 4% since 2000, giving analysts solid ground to assume that the local economy is experiencing a period of sustainable growth.

Although relatively high, the 2003 GDP growth (4.3%) reported can be identified as rather unsatisfactory with a view to the policy goals on the countrys economic agenda and its growth potential. Higher domestic and foreign demand led to higher than expected growth in the economy. Final consumption stepped up by 6.6% in real terms, as did investments and exports (by 13.8% and 8% respectively). The bulk of the higher domestic demand was met by higher imports (14.8% up). 2003 growth in the Bulgarian economy ran higher vis-□-vis most EU member states. However, a great deal of effort is yet to be made as the country is to catch up with the average living standards in the Community upon accession, implying that growth should speed up approximating growth in the Latvian and Lithuanian economies of 8.9% and 7.5% respectively.

On the supply side, by sector of the economy, gross value added reported a most significant rise of 7.1% in the manufacturing industries due to the robust growth of export sales in the textile and clothing industry as well as in *metal production and casting*. For a second year in a row, sales in *machinery, equipment and household appliances* have grown most vigorously. Furthermore, end-2003 witnessed a notable sales increase in *vehicles, automobiles excluded*. The performance of the latter two industries is a positive development as they enjoy a relatively larger share of value added in end-user prices vis-□-vis some other leading industries, and have greater possibilities for the commodity diversification of Bulgarian exports. In addition, the food industry performed rather well in 2003, with both domestic and export sales going on the increase.

Agriculture reported a GDP decline of -1.3% due mainly to the poor performance of the grain sector, and was one of the reasons why the country failed to realize its growth potential. Having been a leader in the past, the service sector now reported lower growth.

2003 inflation in Bulgaria ran relatively low. End-of-year inflation amounted to 5.6%, going slightly higher than expectations due mainly to the higher cereal and bread prices reported in the fourth quarter. However, inflation in the nine months to October ran even lower vs. preliminary estimates, resulting in a lower than expected average annual inflation rate of 2.3%. At the same time, inflation in Bulgaria ran higher than the EU average due mostly to the ongoing administered price adjustments and the Balassa-Samuelson effect in the economy. And yet, a higher than the EU inflation rate was reported mainly by services, which are by definition non-tradables and hence do not jeopardise the competitiveness of the Bulgarian economy.

Fiscal policy was one of the main factors at work behind the countrys macroeconomic stability. The 2003 general government budget ended up in an insignificant surplus on the cash balance, easing the country to fulfil one of the key objectives of the three-year fiscal strategy ahead of schedule, i.e. the achievement of a balanced budget. The 2003 budget was executed as planned due to the over-performance of revenues, with tax revenue amounts reporting a 12.3% year-on-year increase. Growth in tax revenues outstripped expectations as a result of the robust revenue from VAT and social security contributions.

The countrys macroeconomic stability and growth boosted employment and real income while leading to a lower unemployment rate in 2003. According to preliminary NSI data, average wages stepped up by 10.3% in nominal terms and 7.7% in real terms. By sector of the economy, the average wage dynamics pointed to an outstripping growth of private-sector wages vis-□-vis the public sector. Nevertheless, public-sector remuneration kept running higher compared to the private sector. Income growth in 2003 was further evidenced by NSI household budget survey data. Money income per household capita rose by 7% in real terms on a year earlier. In addition, the altered structure of household consumption and home trade statistics gave a clear indication of the improving welfare of the population.

The 2003 unemployment rate stepped down significantly as a result of the boosted business activity in the manufacturing sector and active labour market measures implemented by the government, as evidenced by data produced by both Employment Agency statistics on the registered unemployed total and NSI labour force surveys. According to the Employment Agency, the unemployed total declined by 128 thousand jobless, or 19.5%, on a yearlys average compared to 2002. At the same time, NSI labour force survey data pointed to an even greater year-on-year decrease of 24.3%. According to the same data, 2003 unemployment averaged 13.7%, now running well below the unemployment rate in Poland and Slovakia but remaining still rampant.

One of the major developments underway in 2003 had to do with the deepening financial intermediation and rapidly growing lending of commercial banks without undermining the stability of the banking system as a whole. The currency board remained stable strengthening confidence in the countrys financial system and economy. Remonetisation in the economy persisted well into 2003 as well. As of end-year, the M3/GDP ratio reached 48.9% vs. 43.2% on a year earlier. Deposits reported an aggregate increase of 15.5% (BGN 1.24 billion), evidencing that confidence in the banking system had been restored. Furthermore, long-term deposits (time deposits of over 2 years and savings deposits) registered a most robust growth that will become all the more important for the performance of the Bulgarian economy in the future as it will mobilise long-term resources easing the extension of long-term investment loans.

Credit expansion followed an even faster pace in 2003. Non-government sector credit grew most vigorously by 48.3%, or BGN 3.1 billion due mostly to the increased creditworthiness of economic agents, stiff competition among banks and sound operation of the banking system. The high growth rate of private-sector credit, together with the quality of banks credit portfolios, has provided a solid ground for the countrys sustainable growth in the future.

Having stepped down by 0.7% on a year earlier, the interest rate spread between short-term BGN loans and time BGN deposits now averaged 6.1 percentage points (vs. 6.8% in 2002) largely as a result of the fact that interest tended to decline on loans rather than rise on deposits. The main reason behind the ever decreasing credit interest in 2003 had to do with the stronger competition among commercial banks as well as with the improved terms of business and lower credit risk related thereto.

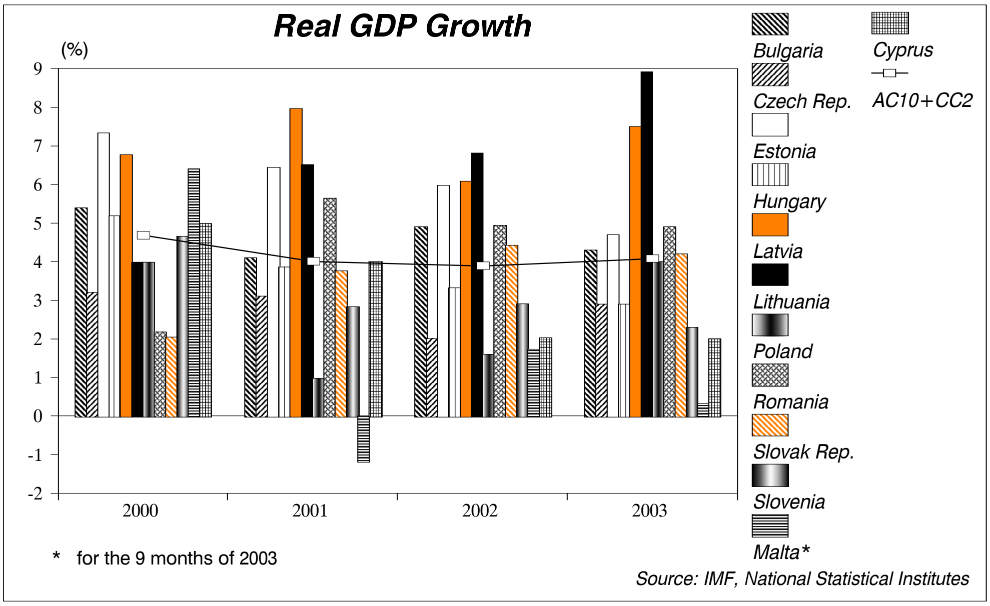
Throughout 2003, the non-banking financial institutions performed rather robustly deepening financial intermediation in the economy. However, the financial system is still dominated by banks, but the indicators of the non-banking financial institutions have improved tremendously. Nevertheless, they lag significantly behind the performance of the indicators in a functioning market economy.

Another major macroeconomic development in 2003 had to do with the drastic deterioration of the current account of the balance of payments. The current account deficit reached MEUR 1498.3, accounting for 8.5% of GDP. The huge current account deficit was triggered by the deteriorating income balance and worsening trade balance. In its turn, the countrys trade balance deteriorated mainly as a result of the higher domestic demand, underpinned by the higher lending activity of banks, strong depreciation of the US currency, good export performance and improved customs control. However, the countrys current account deterioration is an ambiguous issue, which needs further clarification. On the one hand, higher imports (raw material and investment goods), which are growth-conducive and hence intimately related to the recovery of the Bulgarian economy, entailed larger import volumes. On the other, the higher import of consumer goods may give rise to some major concerns. So far, the large current account deficit has been financed by way of FDI and some other items of the financial account as a result of which the 2003 balance of payments ran positive at MEUR 630.3. It should be noted that in spite of the relatively weak growth in the EU (a major trading partner of Bulgaria) and drastic depreciation of the USD to the single European currency, Bulgaria has reported significant export growth, which is by no means a sign of the deteriorating competitiveness of the local economy. At the same time, the remaining CEECs are facing persistent current account deficits, with the reasons for them often being the same as in Bulgaria. And yet, it should be admitted that if the deficit runs continuously high and cannot be financed by way of the financial account of the balance of payments, the economy may encounter serious performance problems. ❍

GROSS DOMESTIC PRODUCT

Bulgarias GDP has grown for a six year in row, with this growth running steadily over 4% since 2000. Having stepped up by 4.3% in real terms on a year earlier, 2003 GDP was estimated at BGN 34.4 billion, setting back at its 1991 level at constant prices, but still running some 13% down on its 1989 level. The succession of years in which GDP growth has run well over 4% give analysts solid ground to assume that the Bulgarian economy is experiencing a period of relatively high sustainable growth.

However, the country has lost much of its advantages as regards its economic development vis-à-vis the 10 CEE acceding countries and Roumania, despite the good performance of its economy in 2003. If the 2002 real GDP growth in Bulgaria had run one of the highest and well above the acceding countries average, in 2003 the country reported a growth around the groups average. Therefore, it is essential that growth runs close to, if not considerably higher than the indicators values in Lithuania (8.9%) and Latvia (7.5%), given the fact that like any other transition economy Bulgaria is to catch up with the EU[1] in terms of living standard and income per capita.

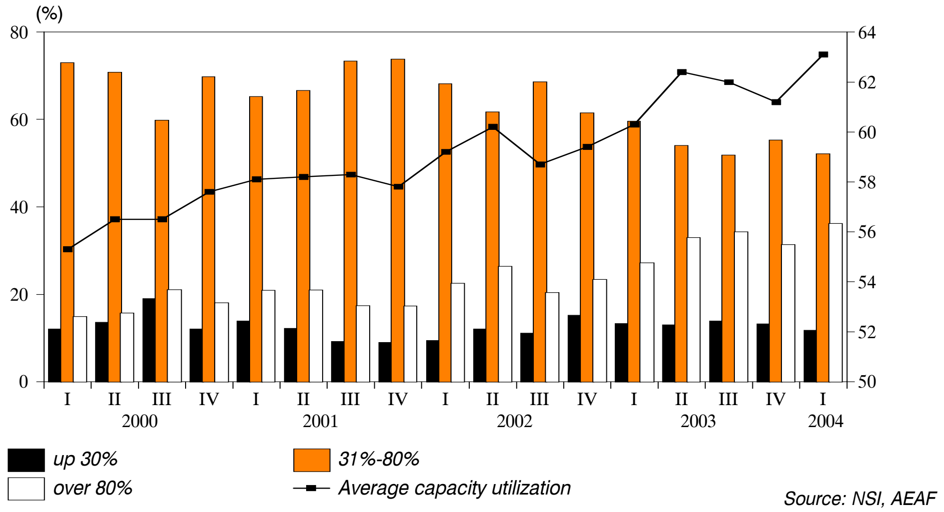


2003 GDP growth ran lower than projections[2], too. However, the growth of GDP by element of final expenditure surpassed preliminary estimates. Domestic demand reported a significant increase, with its contribution to GDP amounting to 8.9 percentage points. Final consumption stepped up by 6.6% in real terms, with final household consumer expenditures being again a key factor at work behind growth in the Bulgarian economy. Fixed capital formation retained its high growth rate of the preceding years, now enjoying an even higher share within GDP. Export growth (8%) also surpassed preliminary estimates. As a result, capacity utilisation in the economy hit a record high of 63.1% in the fourth quarter of the year.

A major reason behind the lower than expected GDP growth had to do with the vigorous increase in imports (14.8%). Apparently, most local firms had failed to satisfy the fast growing domestic demand, which in turn called for imports to meet some part of it. The above trend was by and large due not only to the

[1] *According to AMECO data, 2003 income per capita (purchasing power parity) amounted to 27.5% of the EU-15s average.*
[2] *The 2003 macroeconomic framework of the government budget provided for a GDP growth of 5%.*

Distribution of Firms by Capacity Utilization



rapid increase in home demand but also to its altered structure and the inability of the local companies to gear themselves up to the new household needs and demands.

Final consumption grew mostly as a result of the higher real household income (according to preliminary data, real wages rose by 7.7%), rising bank loan amounts to households (BGN 959.7 million up) as well as the longer credit maturity compared to 2002.[3] In 2003, consumer spending on food- and non-food items reported an 8.5% real-term rise. However, a positive tendency, indicating a certain improvement in the standard of living, was that expenditures on non-food items (9.5%) outstripped spending on food (8.3%). According to NSI data on retail sales, trade in household appliances reported the highest year-on-year increase of 16.3%. In addition, the stronger demand for durable goods was an indication of the improving countrys welfare as well as the upbeat expectations of economic agents. The above statistics may be further reinforced by data of the Union of Automobile Importers in Bulgaria whereby car sales had stepped up by 20% (17 220) and data of the Traffic Police, pointing to a 21.3% increase in second-hand car imports (159 597) on a year earlier. Furthermore, higher welfare in the country was also evidenced by the growing number of house purchases and higher real estate prices.

Consumption in 2003 was mostly import-oriented. On a year earlier, imports (consumer goods) in the eleven months to Dec03 stepped up by 38.6% in USD terms, whereas domestic sales registered a rather modest rise of only 6.7%. Domestic savings accounted for some 13% of GDP vs. 15% in 2002. Investments increased by 13.8% in real terms, bringing about a certain deterioration in the *savings-investments* balance, and hence strongly negative current account balance. This, however, was and still is a common problem faced by all EU acceding countries, Bulgaria and Roumania including. The gross savings/gross fixed capital formation ratio[4] has been running negative in all of the above countries on average, tending to further worsen. Furthermore, in most of them the ratio has deteriorated together with a decline in gross savings.

Due to the upbeat expectations of economic agents as to the predictability of economic policies 2003 investments reported a 13.8% increase, making a 2.51 percentage point contribution to GDP growth. The above increase was also possible due to the lower interest on bank credit as a result of the expansionistic lending policies of commercial banks long-term bank loans to the private sector stepped up at a faster rate on a year earlier.[5] Nevertheless, the share of gross fixed capital formation within GDP ran one of the lowest

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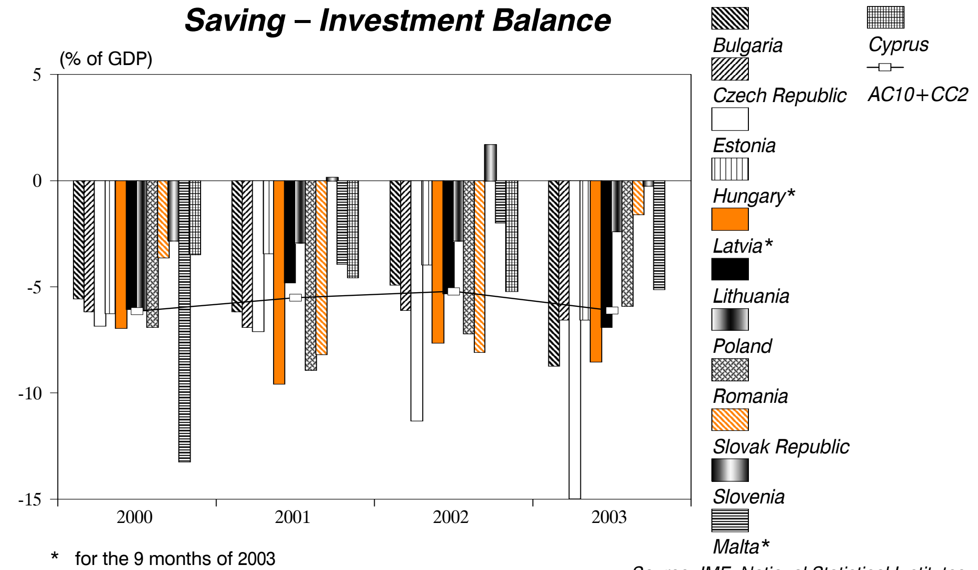
[3] *For detailed information, see parts „Income, Employment and Unemployment" and „Financial Sector".*

[4] *Taken as percentage of GDP, and estimated on the formula as follows: GDP+income(net)+current transfers (net) consumption. See IMF, Balance of Payments Compilation Guide, 1993.*

[5] *For further detail, see part „Financial Sector".*



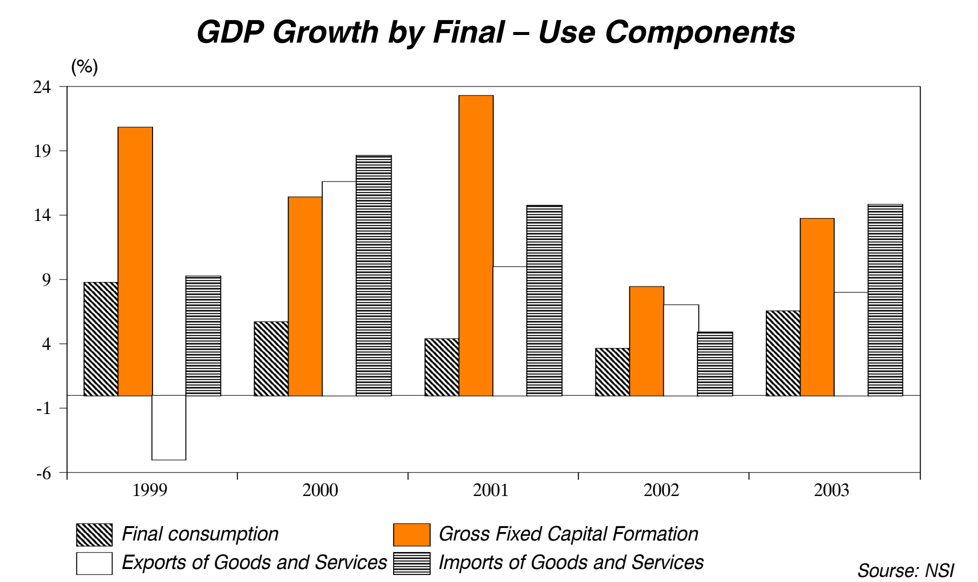
* for the 9 months of 2003

Source: IMF, National Statistical Institutes

at 19.6% among the ten EU acceding countries, Roumania including. The share remained rather low by the groups standards, although improving by 1.3 %. In most of the countries, the indicator was steadily improving while reporting a moderate increase in the Czech Republic, Estonia, Latvia, Slovenia and Bulgaria. At the same time, the low rate of domestic savings in Bulgaria can be identified as a major impediment to fixed capital formation growth. However, it should be noted that Bulgaria has outstripped Poland (18.5) for the first time as regards the indicators performance.

Exports reported an 8% year-on-year increase but had, nonetheless, failed to make up for the rising import volumes (14.8%). Net foreign demand made a negative contribution of 4.6 percentage points to 2003 GDP growth. As a result of the concurrent rise in import and export volumes, the openness of the Bulgarian economy, taken as the share of foreign trade in GDP, has increased, now making growth in the economy strongly dependent on external factors.

On the supply side, the lower than expected GDP growth was mainly due to the poor performance of the agricultural sector as well as the relatively weaker growth in the service sector. Gross value added (GVA) reported the highest rise (7.1%) in the manufacturing industries, living up to the expectations of boosted business activity in the same sector. The weight of the manufacturing industries within GVA stepped up to 30% due largely to the robust growth in export sales. On a year earlier, sales reported a 17.4% increase, with export sales alone going up by 35.8% vs. only 6.7% in domestic sales. Five industries accounted for more than half of 2003 export sales as followed: steel production and casting (16.5%); chemicals and clothing (by 10.5% each); machinery, equipment and household appliances (8.1%); and food and beverages



Sourse: NSI

(6.9%). The structure of exports remained relatively unchanged on a year earlier, with the clothing industry posting the highest share increase in total export sales from 7.8% in 2002 to 10.5% in 2003. At the same time, *electricity, gaseous fuel and heating generation and supply* reported a most significant decrease in the sales total. Over the same period, domestic sales growth was spurred by the strong contribution of the food industry and electricity generation.

2003 Sales (y/y)

	Real-term change (%) Total	Real-term change (%) Export Sales
Sectors Reporting a Significant Positive Contribution to Sales Growth		
Food and beverages	20.6	37.0
Metal production and casting	31.1	39.2
Clothing, leatherwear included; skin dressing	25.9	56.2
Textiles and products thereof, clothing excluded	42.2	64.0
Machinery, equipment and household appliances	19.5	40.2
Sectors Reporting a Significant Negative Contribution to Sales Growth		
Office and computing equipment	-34.3	-33.5
Water collection, treatment and supply	-2.8	

Source: NSI, AEAF

The Bulgarian manufacturing industries can be arbitrarily grouped together as follows: the first group comprises industries (metals and chemicals) where sales growth and profit are heavily reliable on the market situation worldwide. This is largely so because of the scale of operations, which presuppose demand volumes considerably larger than domestic demand for these enterprises to be efficient. Production and sales stimuli are strongly dependent on price volatility on the international markets. Provided growth in the USA and China is sustained, metal and chemical prices in 2004 are expected to steady around the level reached and even step up further, which is a favourable development for local producers. On the other hand, these industries may face a serious problem having to do with environmental acquis compliance upon accession to the EU, which will in turn call for vast investment injections and render their operations unprofitable in the long run. As for production costs, the low gas prices on the local market have had a healthy effect on competitiveness in both the chemical industry and metallurgy.

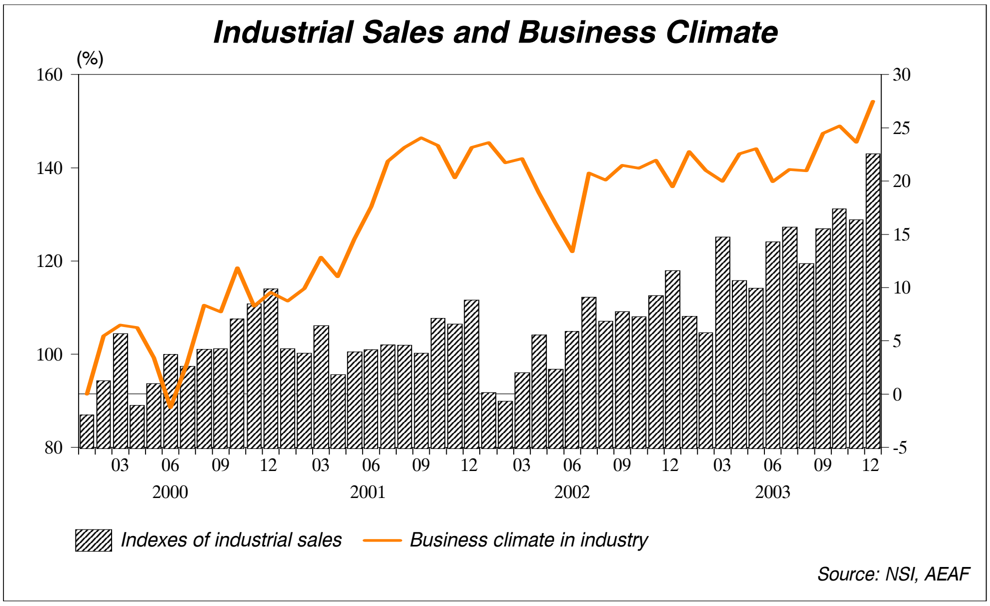
A second group encompasses the tailoring and textile industries where sales are mostly export-oriented. However, a key competitive advantage of the group has to do with the low production costs and the countrys close geographic location to its major trading partner, the EU. By end-2004, all non-tariff barriers to Chinese imports into the EU will have been removed, making the competitive pressure on Bulgarian producers in both the local and Community markets all the more stronger to bear. 2003 domestic sales in the clothing industry stepped down by 19.5%, whereas retail sales of textiles, clothes, foot and leatherwear went some 4.6% up due solely to the stronger competitive imports from countries enjoying the same comparative advantages as Bulgarian producers. Export sales in the textile industry posted the fastest growth rate vis-□-vis the other manufacturing industries. At the same time, domestic sales stepped up at a rate close to the sectors average. It is therefore vital that operations in the clothing and footwear industries switch gradually over from piecework to seeking solutions along the entire value added chain while creating their own products and trade marks. All this will require greater consolidation of capacity facilities and higher costs on R&D and advertisement.

Another group of industries reported a year-on-year rise in both export and domestic sales. Higher demand for durable goods prompted the robust furniture sales growth of 54% in the home market, making the industry a sales leader in the group. Domestic sales followed suit, rising rather fast by 43.6%. The expansion of the construction sector largely predetermined the domestic and export sales increase of 17.9% and 37% reported by products of other non-metal mineral raw material. *Machinery, equipment and household appliances* is another member of the same group which boasts no large concentration of sales revenue within few enterprises only but offers a great product diversity, contributing to the industrys growth sustainability.

Electricity, gaseous fuel and heating generation and supply registered a most notable rise in total sales. Despite the drastic decline in export sales, they stepped up by a modest 2.7%. Domestic sales rose by 5.6%, whereas export sales ran 10.8% down on a year earlier due mostly to the ceased exports to Turkey in the first half-year period of the year. In the second half, however, export sales rebounded, with lower exports to Turkey being offset by rising sales to other countries of destination.

The food industry ranked second by share within total sales. The industry performed most vigorously, with export sales rising by 37%. Domestic sales reported a 16.6% increase, outstripping consumption. All that indicated that local producers were able to face competitive exports. In addition, they have great growth potential, especially along the lines of export sales. However, the industry is meeting predominantly domestic demands at present, and further effort is yet needed so that producers bring their operations into line with the EU food safety requirements.

Vehicles, automobiles excluded was another sales leader in 2003. In the last months of the year, sales doubled, with 2003 growth going well over 40% due largely to the successful privatisation and follow-up restructuring of the countrys shipyards. The performance of the manufacturing sector influenced the business situation assessments of managers. Throughout 2003 the business climate indicator steadied well over 20 points, taking a smooth upward trend, as did the aggregate indicator.



In 2003, GVA in the service sector reported a 3.5% real-term rise, with growth in all industries but trade slowing down on a year earlier. As in the preceding years, *communications* and *finance* were again performing most dynamically, registering a GVA increase of 10.5% and 8.8% respectively. They were responsible for 1.6% of the sectors total growth, although the growth rate ran lower relative to the 1999-2002 period. The robust growth in *finance, credit and insurance* was mostly associated with the restored confidence in the countrys financial system following the crisis of 1996-1997, and the rapid advance of mobile technologies in the communications market.

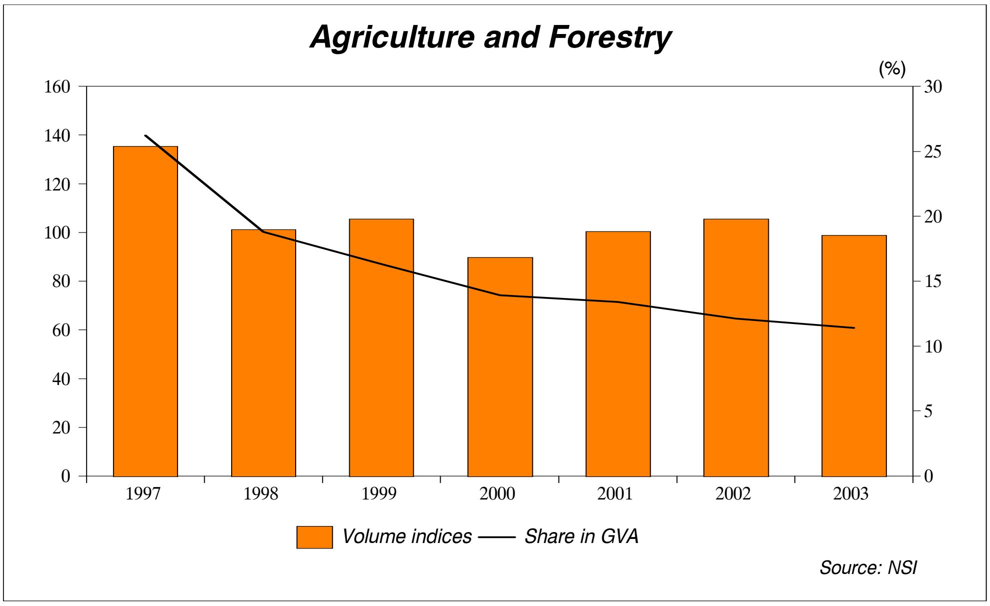
One of the vitally important for the Bulgarian economy sector, i.e. tourism reported a significant year-on-year growth. Fears having to do with the Iraqi crisis and spread of SARS turned out to be groundless, producing little effect on the holiday season in the country, and making it one of the most successful destinations in Europe. According to data of the EU Commission on Tourism, tourism worldwide reported a 1.2% decline while negligibly growing by a bare 0.4% in Europe. At the same time, BNB statistics point to a 21.4% increase in revenue from international tourism up to MEUR 1460. The number of holiday makers to Bulgaria stepped up by 18%, as did spending on the part of Bulgarians on tourist services (17.8% up to MEUR 661.1). The number of EU tourists, who had visited the country, carried on rising, hitting 43.8% in end-2003 (vs. 33.7% in 2002). Bulgaria has asserted itself in the international market of tourism mostly as a cheap and attractive holiday destination. Enjoying as a rule a rather high market share, the number of Russian tourists has steadied around 3 to 4% over the past four years. In addition, the recovery of the Central European tourism markets, the share of which stepped up from 6.4% to 9.6% inside a year, was a positive development for the sector.

However, a major problem Bulgarian tourism has to cope with is the underdeveloped resort infrastructure. To that end, the Local Taxes and Fees Act was so amended as to provide for revenue from resort fees to stay with local government budgets and be essentially used to support infrastructure upkeep. Another pressing problem the sector is currently facing has to do with the poor infrastructure and insufficient passenger capacity of airport areas in Varna, Bourgas and Plovdiv in particular. It is therefore necessary that these facilities are given on concession without delay, and the quality of service provided to foreign holiday makers improved considerably. At the same time, tourism is expected to be boosted by the Olympic Games to be held in Athens in 2004. According to data of the Ministry of the Economy, some 3000 sportsmen are expected to arrive in Bulgaria, and about 200 000 foreign tourists to spend around MEUR 120 on services.

In 2003, GVA in the agricultural sector reported a 1.3% real-term decrease. As a result, the sectors relative weight within GVA contracted to 11.4%. The poor performance of agriculture was mostly due to the poor 2003 wheat harvest. According to preliminary data of the Ministry of Agriculture and Forestry (MAF), on a year earlier, wheat yields declined most dramatically by 51%, whereas the areas under wheat ran 34.7% lower due mainly to the knock-down farm-gate prices in 2002. Furthermore, climatic conditions produced a most adverse effect on wheat yields, as they delayed land tillage and thus put off harvesting to a later date. Real wheat yields ran about 1.5 million tonnes down the preliminary 2003 estimates.

According to MAF forecasts, vegetable and potato production is expected to grow on a year earlier, but hardly make up for the severe decline in the grain sector, and crop production as a whole is anticipated to register a 12-month decrease. At the same time, livestock production is expected to make a positive contribution to GVA in the sector. The above expectations draw upon the upward trend in animal numbers (basic animal herds). In addition, meat production is expected to report a 13.2% rise relative to 2002, with its export performance going on the increase, following the removal of the ban on Bulgarian live animal exports into the EU.

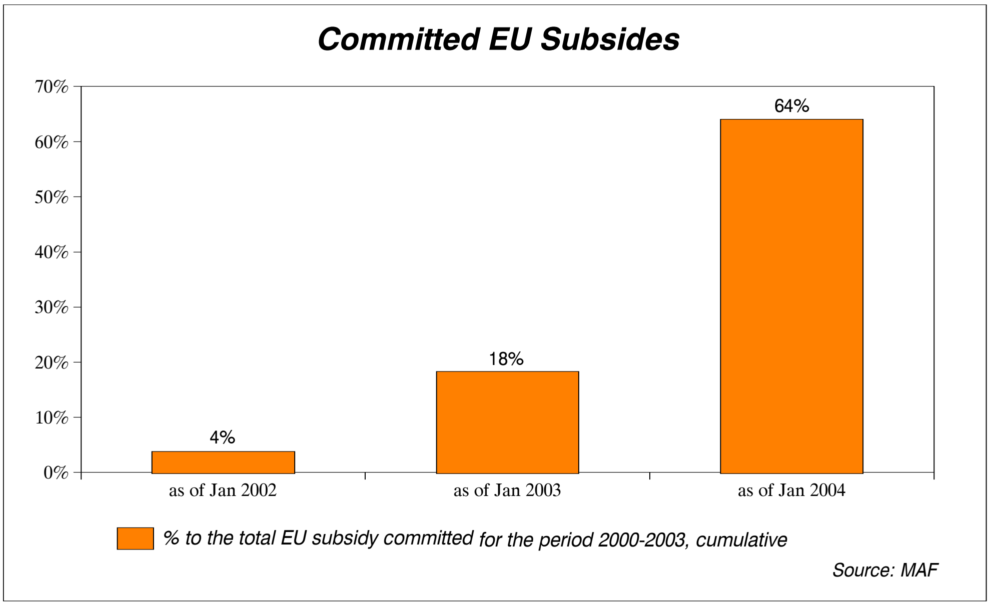
However, agriculture is encountering a most acute problem having to do with the high production costs in the sector, which often edge up on the average purchase prices of farm produce. All this has a rather demoralising effect on agricultural producers, as the majority of them fail to make farming worthwhile, and hence profit, refraining from expansion of activity. As a result, the share of non-arable farm land has gone on the increase, accounting for 8% of total farm land in 2002, or 1% up relative to 2001. According to



estimates of farm producers, this process persisted well into 2003, adding up another 2 percentage points to the share of non-arable agricultural land within the total. A data comparison between intermediate consumption and production costs indicates that unit production costs in the sector have been steadily rising year-on-year.

Some positive developments discerned over the past few years in the sector are as follows:

- The total number of animal holdings has decreased, running some 9.5% down relative to 2002. At the same time, average animal numbers have gone on the increase. All this is expected to foster livestock production efficiency;
- Agricultural exports have found many new market outlets as a result of the entry into force of the bi- and multi-lateral trade agreements and arrangements finalised in 2001;
- Mid-2003 saw the accreditation of another seven measures under SAPARD, opening new investment opportunities in the agricultural sector;
- The absorption capacity rate of SAPARD funds[6] has stepped up. In 2003 alone, the share of grant extensions within the total amounts negotiated went up most vigorously from 18% to 64% (as of January 2004)[7]. At the same time, the share of grant payments, corresponding to project implementations, runs at 17%. Of all project approvals since the start of SAPARD, implementations have amounted to 40%. ❍



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

[7] *MEUR 218.8 worth of grants negotiated under the Annual Financing Agreements with the EU over the 2000-2003 period.*

INFLATION

Throughout 2003 the country s inflation ran relatively low. Twelve-month inflation amounted to 5.6%, and 2.3% on a yearlys average while running higher than budget projections (4%) at end-of-year levels. This was largely due to the food price dynamics, bread, flour and pastry prices in particular, in the fourth quarter. However, in the eight months to September inflation amounted to only 1.2% (periods cumulative), going well below expectations.

2003 Inflation (end-of-year)

	Relative weight in CPI (%)	Change (as %)	Contribution (in % points)
Total inflation	**100.0**	**5.6**	
Food items	40.9	8.4	3.4
Non-processed items	12.3	0.3	0.0
Processed items (alcohol incl.)	28.7	12.0	3.4
Non-food items	15.3	-1.4	-0.2
Market services	14.4	4.0	0.6
Market fuel prices	5.3	-1.6	-0.1
Administered prices	24.1	8.1	1.9
Core inflation	**75.9**	**4.8**	**3.7**

Source: NSI, AEAF

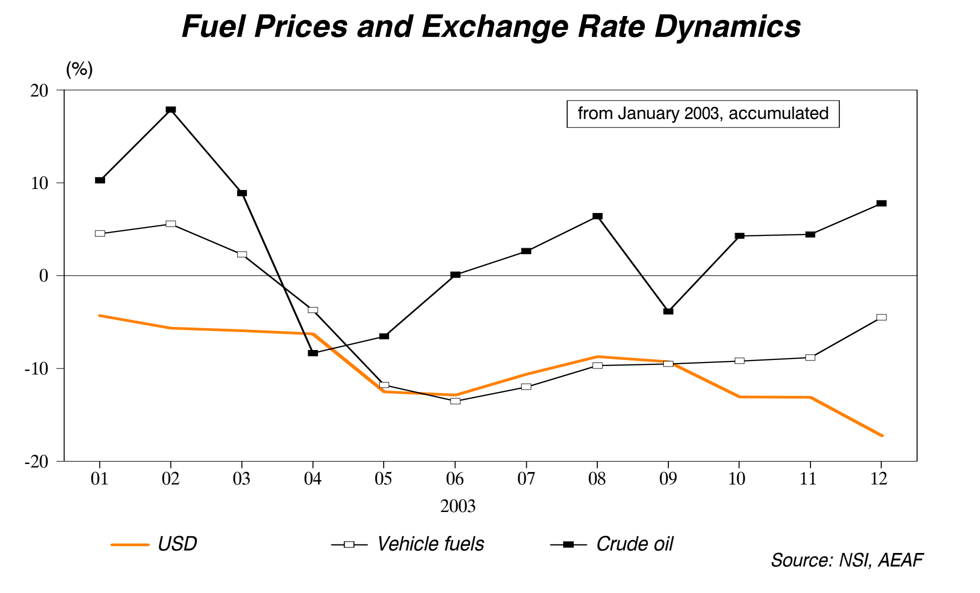
The year-on-year contraction in 2003 grain yields and wheat output was difficult to be taken into account by end-of-2002 estimates. The CEECs and the Black Sea region faced a similar situation. Wheat stocks worldwide reported a drastic decline, prompting a price rise in wheat and hence bread and pastries. In 2003, the prices of bread, pastries and flour went up by 33.4%, 13.5% and 25.9% respectively, bringing about a 2.4 percentage point increase in the consumer price level.

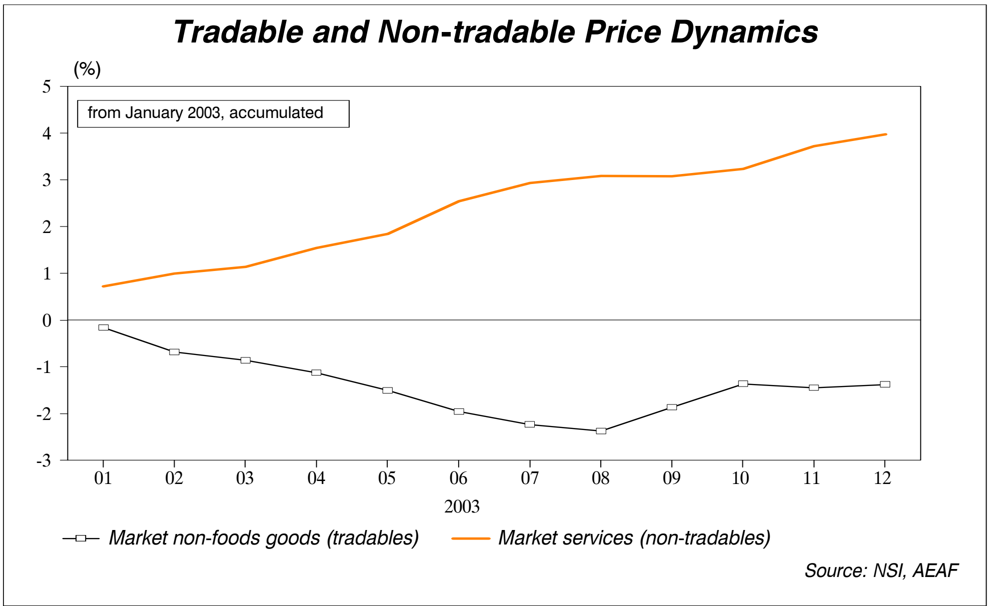
Non-processed food items had practically little effect on the inflation rate. Seasonal fluctuations (fruit and vegetables) affected only the monthly CPI dynamics, but their impact faded away by the year-end, and non-processed food price inflation rose by a bare 0.4%.

The 2003 decrease in non-food and fuel prices made a major contribution to the relatively steady low inflation rate as a result of the USDs lost ground to the single European currency and hence the BGN. The cheaper US currency outweighed the importance of the higher 2003 average prices of crude oil worldwide and brought local fuel prices, both producer and consumer, down.

Unlike non-food items, which face up to competitive imports, service prices, representing the group of non-tradables in CPI, are influenced by a number of other factors.

The higher 2003 administered prices made a 1.9 percentage point contribution to the higher inflation rate. By type of services, prices stepped up as followed: electricity supply to households (14.2%); heating (10%); medicines (5.4%); and water supply (3.5%), all of them expected price adjustments and taken account of





in the 2003 inflation forecasts. In 2004 administrative pricing is expected to send end-of-year inflation higher than anticipated due to the 10% increase in electricity and heating prices to take place in July, presumably. January 2004 saw the application of the new excise duty rates on cigarettes and fuels, brought into line with the EU excise policies, affecting inflation in the first months of the year. The remaining administered prices will also rise, though at a slower rate, compared to the preceding years. The contribution of administered prices to the price level is expected to run lower than in the preceding years, sending, however, inflation in Bulgaria higher than in the EU.

The contribution of market services to 2003 inflation amounted to a bare 0.6%. Ever since the institution of the currency board arrangement service price inflation, together with administered prices, has been a major pro-inflationary factor at work. The prices of market services have been mainly affected by nominal wage growth in the sector, which is in turn associated with the Balassa-Samuelson (BS) effect in the economy.

Productivity, GVA/Employed, 1999=100

	2000	2001	2002
Bulgaria	108.8	113.5	118.4
□U - 15	103.2	103.0	103.6

Source: NSI, AEAF

Productivity, as measured by gross value added, in the sector of tradables grew at a faster rate vis-□-vis the service sector, making wage growth in the tradable sector (mostly the manufacturing sector) and their convergence on the EU levels faster. The BS effect is thus passed onto the sector of non-tradables (mostly the service sector). Higher wages in the sectors producing tradable goods lead to higher wages in the economy and hence higher production costs on non-tradables where, however, higher wages result in higher prices since services do not face competitive imports. This effect will carry on generating higher countrys inflation than in the EU in the next couple of years and should therefore be seen as a gradual convergence of local relative prices on the EU levels rather than an economic policy drawback.

As Bulgaria accedes to the EU, the countrys price level will have to gradually approximate the EU average, entailing, however, an inflationary pressure. To obtain a direct comparison of the price levels in the different countries, the European Comparison Programme is used to calculate the price level indices (comparable price levels). They provide a measure of the differences in the price levels between partner countries by indicating the number of units of the common currency needed to buy the same volume of comparable and representative goods and services in each country compared to the base EU-15.

Data show a high correlation between GDP and the price level in a country. The higher the GDP per capita in a country, the closer the price level to the EU. In the sector of non-tradables, convergence in productivity and the living standard will bring about price convergence as well. Countries with a higher standard of living report as a rule a higher price level. Therefore, depending on how open an economy is to foreign markets, inflation in the sector of non-tradables will run higher than the countrys total inflation, resulting in higher local inflation vis-□-vis the other countries.

Per Capita Volume Index At The Level Of Total GDP and Price level Indices of GDP, EU -15 = 100

Accending Countries	1999		2000		2001		2002	
	GDP	Prices	GDP	Prices	GDP	Prices	GDP	Prices
Bulgaria	24	29	24	30	26	32	26	33
□stonia	35	47	37	48	39	51	40	53
Cyprus	74	80	76	80	78	80	76	82
Latvia	30	40	31	46	33	47	35	46
Lithuania	34	39	35	43	37	44	39	45
Malta	71	63	71	66	70	68	69	67
Poland	41	45	41	49	41	55	41	53
Romania	23	30	23	34	24	35	27	35
Slovakia	43	39	44	41	45	41	47	42
Slovenia	67	70	66	68	68	69	69	70
Turkey	27	47	28	51	24	42	25	46
Hungary	48	43	49	45	51	47	53	53
Czech Republic	.	.	60	43	61	47	62	51

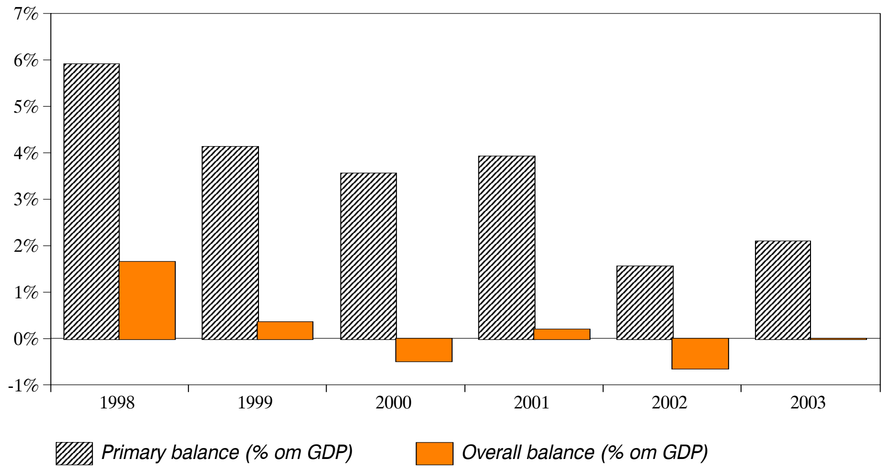
Source: NSI

Twelve-month producer price inflation, as measured by the year-on-year change in Dec03 PPI, amounted to 4.3%, going 4.9% up on a yearly average. The producer price index accounts for all industrial produce placed in the domestic market, but due to the foreign exchange peg and trade liberalisation producer price dynamics is also susceptible to external influence, i.e. foreign demand, as estimated on the basis of the quarterly index of export prices by commodity group and export statistics. As with consumer price inflation, food prices made a significant contribution (1.8%) to the PPI as well. Producer prices stepped up as followed: the milling industry (80.2%); feeding stuffs (15.9%); and bread and pastry prices (12.5%). Also, the export price index was steadily rising in the milling industry and cereals on a quarterly basis throughout 2003, indicating major supply shortages in the domestic market. Other commodity groups where producer prices stepped up under the impact of foreign demand were as followed: metal ores, clothing, cast iron, steel and other metal products. ❍

FISCAL SECTOR

Fiscal policies were one of the factors enhancing the countrys macroeconomic stability. The consolidated budget ended the year with a negligible surplus of only BGN 933 thousand, or 0% of GDP vs. a deficit of -0.6% on a year earlier. The government has thus attained one of the key goals of the three-year fiscal strategy, i.e. the achievement of a balanced budget ahead of schedule. The primary balance rose by half a percentage point up to 2.1% of GDP.

Primary and Cash Balance of the Consolidated Budget (% of GDP)



Source: AEAF

All the three balances on the consolidated government budget improved mainly as a result of the over-performance of revenues, which reported a 12.3% year-on-year increase, posting 5.2% over-performance against the fiscal programme. The above growth was mainly triggered by tax revenues. At the same time, non-tax revenues remained almost unchanged relative to 2002, going on the downswing after five years of robust growth. Tax revenue growth surpassed expectations due to the high revenue from VAT and social security contributions.

The 18.8% rise in revenue from social security contributions, which also enjoyed the largest share in the revenue total, outstripped wage bill growth (11.8%) due mainly to the crackdown on hidden employment. All this resulted in the legalisation of the income of some 336 000[8] employed, producing a most healthy effect on budget revenues. However, as the measures have not been meant to have a long-lasting effect, the faster growth of revenue from contributions in relation to wage bill is not expected to persist in 2004. The strong 2003 imports were the main reason behind the over-performance of indirect tax revenues. Revenue from VAT on imports rose by 16.4% on a year earlier, whereas budget revenues from VAT on transactions in the country went 6.7% up, without this being due to any sizable growth in VAT refunds. Although a number of excise duty rates had been substantially raised since the start of 2003, revenue growth from excise duties ran significantly lower than VAT revenue growth. Since revenue amounts from excise duties are less dependent on total import growth, this is yet another argument in favour of the decisive importance of imports to last years VAT revenue dynamics.

[8] *According to estimates of the National Social Security Institute.*

Direct tax revenues in 2003 performed as expected. Revenue amounts from the forfait tax fully met the 2003 budget projections. Changes in the income tax rates and brackets resulted in BGN 60 million worth of a loss for the budget. Nevertheless, average wage growth in the economy and higher employment made up for the reductions in the average personal income tax rate, and revenues from the same tax reported a relatively high increase of 8.4%.

The aggregate rate under the Corporate Income Tax Act remained unchanged at 23.5% in 2003 as well. Profit tax revenues stepped up by 7%. The reform in local government financing led to some alterations in the patterns of allocation of profit and income tax amounts between the local governments and the central budget. As the municipality tax was removed, local governments received a higher percent of income tax remittance (up to the administratively set expenditure amounts on centrally-mandated activities such as education and health care) in compensation. As a result, local revenues from shared taxes decreased most drastically by about 21% on a year earlier. However, fiscal decentralisation is aimed at seeking more transparent and fairer solutions to local government financing rather than raising local revenues.

Consolidated budget revenues

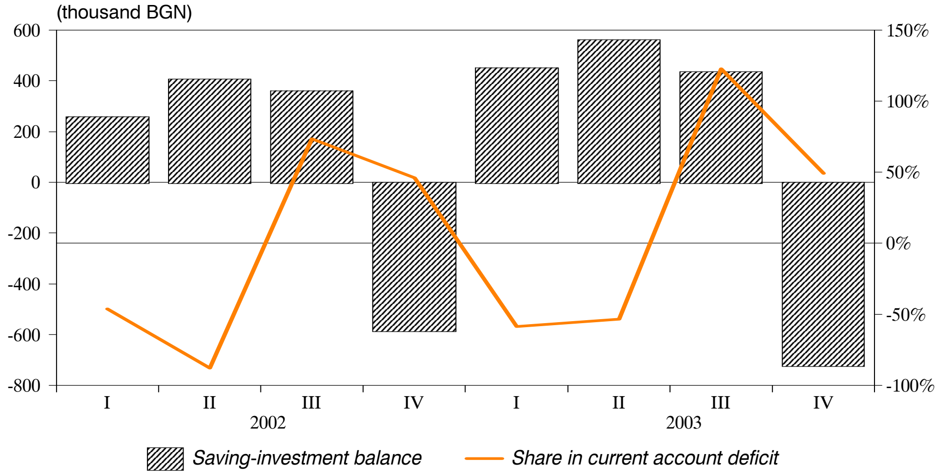
2003	Share in overall revenues (%)	Growth (year-on-year) (%)
Revenues and grants	**100.0**	**12.3**
Tax revenues	79.0	15.8
Corporate income tax	7.5	8.7
Personal income tax	8.1	8.4
VAT	22.0	15.4
Excise and road taxes	11.0	17.5
Custom duties	1.6	22.8
Social security contributions	26.0	18.8
Other taxes	2.7	26.6
Non-tax revenues	18.8	0.7
Grants	2.2	3.4

Source: MoF

Having risen by 10.5% (up to BGN 14.1 billion) on a year earlier, budget expenditures over-performed by 3.2% against the 2003 budget projections. Their growth was largely pre-determined by the robust performance on the revenue side. Restricting expenditure growth in line with revenue performance meant improving the *savings-investments* balance in the public sector and hence offsetting the ever-deteriorating current account deficit to a certain degree. 2003 budget savings reported a 23.2% year-on-year increase, prompted solely by the vigorous performance of revenues.

Despite the improved primary balance on the consolidated government budget, it cannot be assumed that fiscal policy in 2003 was further tightened relative to 2002. The share of the public sector in the economy, as measured by the consolidated government budget expenditures/GDP ratio, stepped up by a 1.4 percentage point up to 40.8%. All this led to a certain real-term rise in public-sector consumption, making a 1.3% contribution to growth. However, over the next couple of years, the real-term decline in expenditures planned is likely to bring about an ever-decreasing contribution of government consumption to GDP growth.

Government Savings-Investment Balance, Share in Current Account Deficit



Source: MF, AEAF

Interest payments went on decreasing as percentage of both the budget expenditure total and GDP due to the stronger Euro to the USD as well as the low interbank interest rates worldwide retained. Stronger domestic demand for government securities led to a decline in the yield rates, and hence expenditures on domestic interest. This, together with the total expenditure rise, made higher government spending on the rest of the functions possible.

As for non-interest payments, it should be noted that defence expenditures stepped down at the expense of the higher spending on health care and education. The social security system sustained its share within the expenditure total due mostly to the broadened scope of the active labour market measures, spending on which was estimated at approximately BGN 178 million in 2003. At the same time, the decrease in unemployment resulted in a most strong contraction in expenditure amounts on unemployment benefits of over 50% (BGN 124.6 million) on a year earlier. Public administration expenditures rose by 10.5% as a result of the 3.5% update in budgetary wages in January and June, as well as the 13.9% employment increase in the sector spurred by the countrys needs to reinforce its administrative capacity.

Furthermore, expenditures by economic activity went on the rise due to the increase in the state grain reserves in the second half of the year. However, any growth in budget expenditures by economic activity comes into clash with government withdrawal from the economy. This was partly due to the higher expenditures on investment and capital transfers (43.2% up on a year earlier), which contributed to the improved business climate in the country. These resources are managed by the National Fund under the Finance Ministry and presuppose higher involvement and project financing under the EU pre-ins. A second factor has to do with a legal provision requiring that the share of subsidies allotted to the State Agriculture Fund are kept unchanged. All this led to a certain rise in expenditures in the agricultural sector (11.1%) and a most robust growth of subsidy allocations to farming (45%).

2003 did not sustain the attempts of the government to raise efficiency on the expenditure side. As percentage of GDP, government spending on administration costs and interventions in the economy set back at its 2001 level. At the same time, expenditures on defence declined rather slowly, thus remaining well above their level in 2001. The countrys accession to the EU is expected to lead to a larger deficit having to do with its contribution to the Community budget and the need for ensuring national co-financing. Therefore, the above expenditure items should be gradually restricted, helping the country to carry out the necessary restructuring of budget expenditures during the pre-accession period. Maintaining a low budget deficit will not jeopardise the fiscal sector s stability. The high nominal economic growth coupled with a primary budget surplus and prudent debt management policies provide for a further decrease in the government debt/GDP ratio. The improved credit rating of the country will ensure external financing of the budget, whereas the relatively high yield rate on government securities will foster demand on the part of the local financial institutions. In addition, the pursuit of a moderately expansionist fiscal policy would be adequate if economic growth runs lower than the countrys growth potential as has been the situation over the past two years. The curtailed budget deficit had a favourable effect on the current account deficit. However, according to the Agency for Economic Analysis and Forecasting, the above effect is estimated at about USD 160 million and is unlikely to bring about any significant improvement in the current account. Therefore, the 0.7% rise in the budget deficit planned is not expected to put the countrys external position at a risk.

Consolidated budget expenditures by functions

2003	Share in overall expenditures (%)	Growth (year-on-year) (%)
Total	**100.0**	**10.5**
I. General public services	7.8	15.5
II. Defence and security	12.7	4.7
III. Education	10.7	11.2
IV. Health care	12.1	18.1
V. Social insurance and welfare	34.2	10.7
VI. Housing construction, public amenities and utilities, environmental protection	3.5	-1.2
VII. Recreation, culture and religion	2.0	28.2
VIII. Economic affairs and services	11.9	14.3
I□. Other expenditure, not classified	5.1	-4.6

Source: MoF

In end-2003, the government debt/GDP ratio amounted to 48%, going some 7.6 percentage points down on a year earlier due mostly to the nominal-term GDP growth as well as the cheaper USD to the single European currency and primary surplus. The countrys foreign debt stepped up by 8.9% in USD terms while contracting by 9.5% in BGN terms. Its share within total debt decreased by about 2 percentage points down to 86.4% due mainly to a shift in the budget deficit financing patterns to the domestic market. The weight of the USD-denominated debt went on shrinking at the expense of the EUR-denominated debt, reducing foreign exchange risk in debt servicing. USD debt accounted for 42.3% of the debt total (vs. 49.8% on a year earlier), whereas the share of the EUR debt went up from 28.4% to 34.9% over the same period. ❍

INCOMES, EMPLOYMENT AND UNEMPLOYMENT

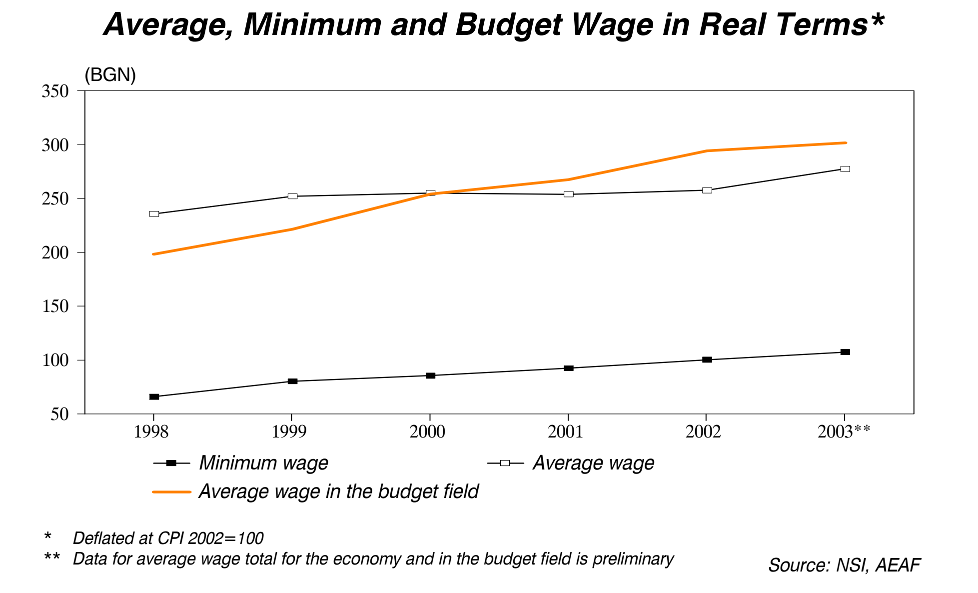
In 2003, the key labour market indicators reported a significant year-on-year improvement in their performance. Sustainable growth in the economy fostered a real-term income growth and an employment rise. In addition, the active labour market measures targeted at the specific risk cohorts led to a further decrease in the countrys unemployment.

The upward trend in average wages, discerned since 1998, persisted well into 2003 as well. According to preliminary NSI data, the countrys wages averaged BGN 284, registering a 10.3% nominal-term rise and a 7.7% real-term increase. Real wages went on the rise in all sectors of the economy but welfare services where they dropped mainly as a result of the growing number of employed whose pay ran close to the countrys minimum wages. Wages grew at a most fast rate in the service sector as followed: *trade, repair and technical service* (19.3%); *hotels and restaurants* (17.6%); *health care and social activities* (16.3%); and *financial intermediation* (14.3%). As for the manufacturing sector, wage growth ran highest in the *manufacture of electric, optical and other equipment* (13.7%); *rubber products and plastics* (13.3%); and *timber and products thereof, furniture excluded* (11.1%). There was a strong correlation between average wage growth and the manufacturing sectors dynamics by industry. Thus for example, in *electricity, heating, gaseous fuel and water supply* as well as in the construction sector real wage growth lagged significantly behind the countrys average at 7.1% and 6% respectively. Wages grew most slowly in the extraction and mining industry where the number of employed went on decreasing. At the same time, wages in the agricultural sector and forestry reported a real-term rise of 7.1% for the first time over the past four years.

The analysis of average wage dynamics by sector pointed to an outstripping growth of private-sector wages vis-□-vis the public sector. However, wage levels in the public sector remained higher than private-sector wages. 2003 average wages in the public sector ran 38.2% higher than in the private sector at BGN 343, reporting a 6.2% nominal-term rise and a 3.7% real-term increase.

Minimum wages are one of the policy instruments the government employs to make a direct impact on average wage dynamics. 2003 minimum wages amounted to BGN 110, going some 10% up on a year earlier. At the same time, notice should be taken of the fact that any rapid growth in minimum wages may result in higher labour costs on the part of employers on low-qualified work force and hence employment redundancies especially in regions suffering persistently higher unemployment compared to the countrys average. Therefore, any growth in minimum wages as an income policy instrument should not come into clash with the key concerns and goals on the countrys economic agenda, i.e. employment promotion and hence unemployment reduction. Another instrument of wage impact has to do with wage dynamics in the budgetary sector of the economy. According to preliminary NSI data, average annual wages in budgetary enterprises reported a 5% year-on-year nominal-term increase up to BGN 309. In real terms, wage growth amounted to 2.6%. Furthermore, wage increase in budgetary organisations was brought into line with the funding capacity of the budget to cover the above increment without disturbing its balance.

Average wage dynamics in the budgetary sector is also an instrument of indirect impact on income policies in the private sector. Private-sector wage formation is essentially based on a market principle and



heavily dependent on the financial conditions of the companies and their indebtedness to creditors. It is therefore assumed that private-sector income policy takes into account wage dynamics in the budgetary sector. In 2003, the stepwise increase in minimum and budgetary wages led to a certain rise in private-sector wages. According to preliminary NSI data, 2003 private sector wages averaged BGN 248, stepping up by 13.8% in real terms and 11.2% in real terms on a year earlier.

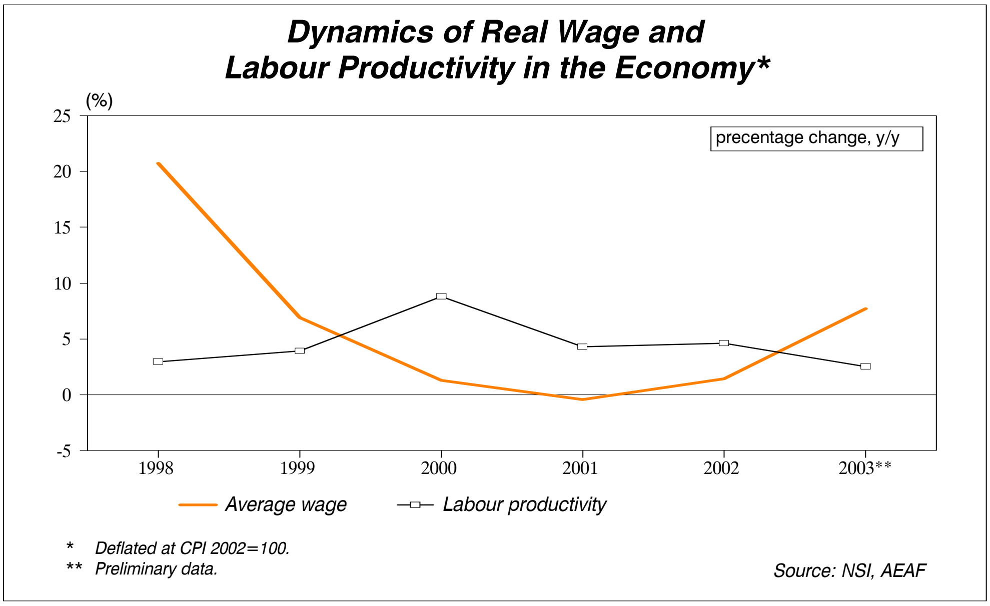
In 2003, productivity in the economy went on rising, though at a slower rate on a year earlier. Rising by 2.5% at 2002 prices, productivity[9] in 2003 remained well below the average in the past five years (4.9%). At the same time, real wage growth outstripped significantly increase in productivity. Over the 2000-2002 period, productivity tended to run well above real wage growth, which was an essential condition for the improvement of competitiveness in the Bulgarian economy with respect to labour efficiency. The slower growth rate of average wages vis-□-vis productivity, in the private sector in particular, indicated that the sector had a great potential for wage growth in the future. As the dynamics of productivity and wages will run closely together in a long-term perspective, real wages in the next couple of years are expected to grow at a faster rate compared to productivity.

Wage dynamics should be brought into line with the countrys economic growth and foster employment while reducing unemployment. The key government policies that may boost real wage growth are indirect and mainly targeted at promoting business activity, attracting FDIs, improving competitiveness while maintaining the countrys macroeconomic stability. A higher income level and living standard are only feasible if output, productivity and employment go on the increase. In addition, any improvement in productivity and the countrys competitiveness depends on the pace of structural reform progress.

In 2003, productivity ran the highest in the processing industries (10.3%), which reported the most robust value added growth, given a relatively small rise in the number of employed. Higher efficiency of production and the decreasing employment rate in the extraction industry led to a 10.1% increase in productivity. The indicator improved by 9.1% in *transport and communications* and 6.8% in *finance, credit and insurance* due to the higher growth rate of the newly generated income by the industry against employment. The boosted business activity in the area of financial intermediation was strongly influenced by competition among commercial banks and growing lending activity. As for the trade sector, productivity reported a 1.2% increase

[9] *Calculated as based on preliminary NSI estimates of GVA and the average annual number of employed in the economy.*

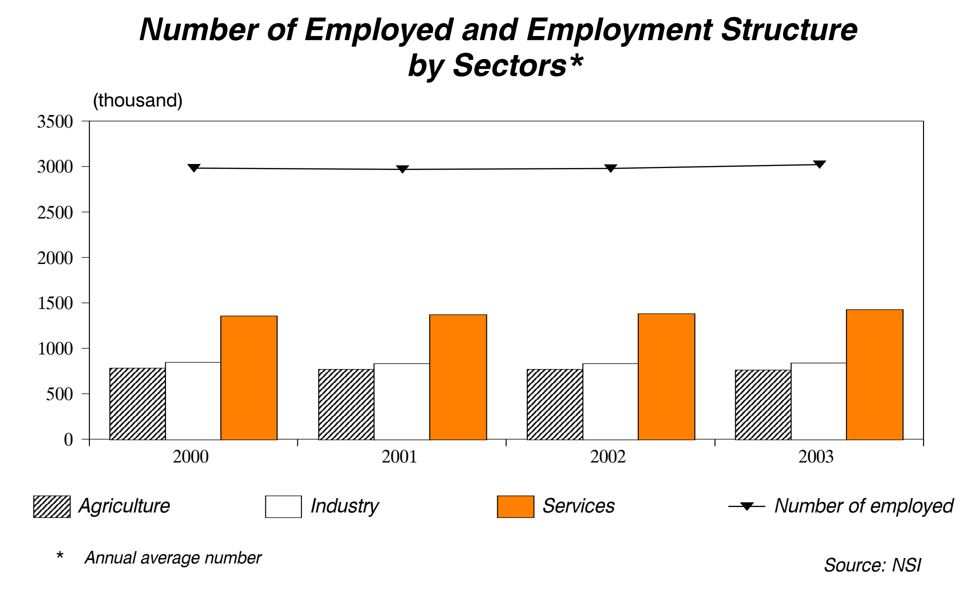
triggered by the outstripping growth of value added compared to employment but remained almost unchanged in *electricity, gas and water supply*. However, over the next couple of years the indicator is expected to go on the increase as a result of the structural reform effort to be applied coupled with work force optimisation in energy generation companies. The construction sector reported a 1.3% contraction in productivity due to the higher employment vis-□-vis GVA growth. At the same time, productivity in agriculture and forestry stepped up negligibly by a bare 0.1% due to the faster decline in the employed numbers against the decrease in agricultural income rather than any improved business activity in the sector.



Real income, as calculated on the basis of the countrys average wages, increased by 5.4% on a year earlier. The upward income trend in 2003 was further evidenced by official data taken from the NSI household budget surveys. Money income on average per household capita reported a 7% real-term rise on a 12-month basis due mainly to the real-term growth in income from employment (12%) and income from pensions (7.6%). Income from real estate sales and childrens allowances stepped up most vigorously by 47% and 23% respectively but their contribution to the aggregate rise in money income was rather insignificant as they enjoyed low relative weights within the total. Real income from entrepreneurship reported a 2.6% increase mainly in the medium- and small-sized business sector. At the same time, income from employment benefits and social aid declined most drastically due to the effect of the active labour market measures implemented by the government.

Economic growth, as measured by GDP performance, was further evidenced by data on employed numbers. 2003 employment grew at a faster rate compared to 2002. According to preliminary NSI data, the average annual number of employed amounted to 3 020.7 thousand, going 1.4% (42.1 thousand) up on a year earlier. The countrys employment went on the increase mainly as a result of the boosted business activity in the private sector, leading both to higher demand for labour on the part of entrepreneurs and job creation. 2003 private-sector employment stepped up by 0.8%. On the other hand, public-sector employment posted a significant contribution to overall employment, rising by 3.3% on a year earlier due mainly to the implementation of active labour market measures and programmes.

Employment analysis by sector pointed to a rapid year-on-year increase of employed numbers in the service sector as followed: other welfare services (41.6%) associated with the implementation of the National Programme „From Social Aid to Employment Promotion", and public administration (12.6%) having to do with the administrative capacity reinforcement exercise during the countrys pre-accession to the EU. The robust

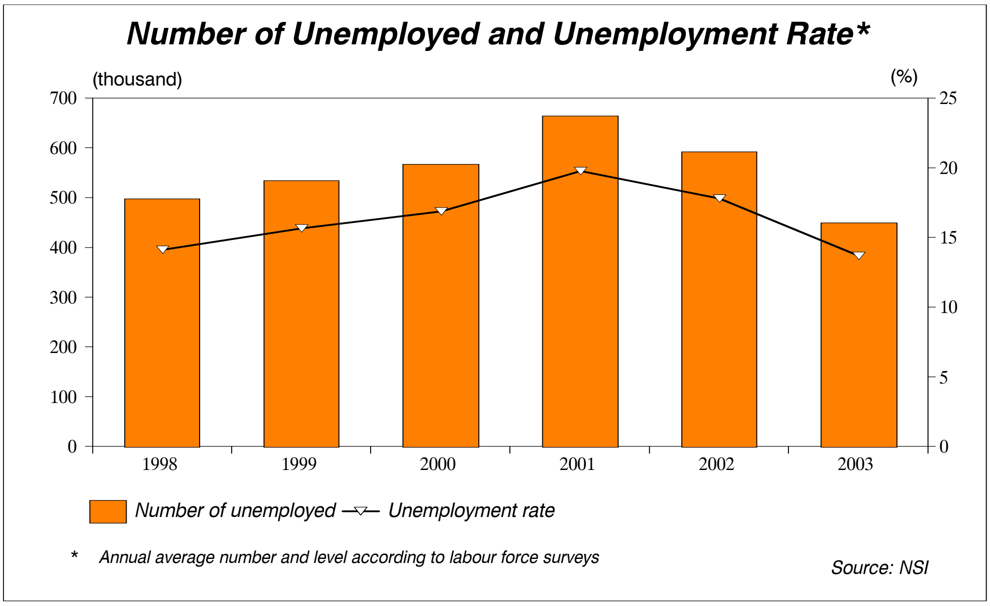


performance of the service sector over the past few years led to more job creation in 2003 in trade, repair and technical service of automobiles and motorbikes, and household appliances (3.2% up), and real estate transactions, lease and business services (1.1%). Employment growth in the processing industries, which reported a significant rise in the employed numbers, varied between 4.1% in the food and tobacco industries and 0.1% in the chemical industry (chemicals, chemical products and fibres). Furthermore, the number of employed reported a notable increase of 4.1% in the construction sector meeting the rapid expansion of business activity in the sector. However, employment declined in about 50 per cent of the industries. The average number of employed decreased mainly in industries dominated by state ownership and where privatisation is still imminent, i.e. electricity, heating, gaseous fuel and water supply and transport, storing and communications where employment stepped down by 1.7% and 2.2% respectively. A most drastic contraction in employment was reported by the manufacture of coke, refined oil products and nuclear fuel (10.6%) where restructuring had not been completed yet. The ongoing reform effort in health care and education resulted in another decrease in employed numbers of 6.2 and 2.4% respectively.

The measures of the government to further promote 2003 employment had to do with the obligatory registration of labour contracts with the National Social Security Institute and the application of social insurance thresholds by economic activity and vocation. As a result, revenues in government insurance funds went on the increase, creating favourable conditions for the social insurance contribution rate to steadily decrease in the next few years. This is expected to provide an enormous incentive to employers to create more jobs in the economy and hence foster growth.

As a result of the boosted business activity in the manufacturing sector and active government social policies, the unemployment rate reported a most significant decline, as evidenced by data of both the Employment Agency on registered unemployed and NSI labour force surveys.

According to the Employment Agency, the average 2003 number of registered unemployed ran some 128 thousand, or 19.5%, down on a year earlier. Throughout 2003 their number was steadily decreasing but in the fourth quarter when the interplay of seasonal factors took the upper hand and the temporary employment of jobless under social programmes of the Ministry of Labour and Social Policy was terminated. Annual average registered unemployment ran 3.5 percentage points down on a year earlier, hitting a record low ever since the Employment Agency started producing administrative statistics.



One of the factors behind the lower 2003 unemployment had to do with the 1.2% 12-month shrinkage in the unemployed inflow. Registrations with job centres and entitlements to social aid and unemployment benefits stepped down by 2.2% on a yearly average compared to 2002 due solely to the lower intensity of the restructuring process in the public sector and redundancies related thereto. The number of lay-offs in the public sector went down by 26.5% on average relative to 2002.

NSI labour force survey data on the unemployed numbers in the economy revealed a similar pattern of dynamics. Throughout 2003, survey respondents, who had identified themselves as jobless, were steadily declining, reporting a larger decline on an annual average compared to EA data. On a 12-month basis, they ran 24.3% lower relative to 2002.According to the labour force survey data, fourth-quarter unemployed numbers stepped 88.2 thousand down on average against the first-quarter average, and the unemployment rate accounted for 12.7% of the labour force, running 2.9 percentage points lower compared to the Jan-Mar03 period. Furthermore, there were in 2003 some great differences in the number of people who identified themselves as unemployed and the number of registered jobless (the former stepped some 70 thousand down on the latter). This was probably due to the modifications and alterations to the methodology of labour force surveying made in early 2003, in particular some amendments and specifications of the active methods of job seeking[10], as evidenced by the growing number of discouraged, reported by NSI. Thus, part of the survey respondents who had previous identified themselves as unemployed, now responded as leaving the countrys labour force. As a result, the participation rate went down as low as 49.2%, running 0.3% lower on a year earlier. The indicator may go on the increase in the next couple of years only if economic growth is sustained and active market measures further implemented.

2003 unemployment stepped down also due to the precisely targeted impact of the active labour market measures on the specific unemployment cohorts. According to EA data, the number of jobless who had taken on new jobs ran 16.7% up on a year earlier, representing 46.7% of the outflow total (4.9 percentage points up relative to 2002). Although not accounting for all jobs in the economy, the above increase was indicative of the higher intensity and magnitude of job creation. Around 79% of all job seekers found new jobs through the intermediation of job centres, with priority being given to jobless who took on jobs under programmes

[10] *Active job seeking is taken to be a series of contacts with job centres on a regular basis rather than the unemployment registration act itself as well as looking for job adverts in the press.*

and measures laid down in the Employment Promotion Act (amounting to 11.2 thousand on a monthly average). In 2003, the monthly numbers of unemployed involved in the active labour market measures and programmes averaged 94.6 thousand, or three times higher on a year earlier. The largest-scale initiative of the Ministry of Labour and Social Policies, i.e. *From Social Aid to Employment Promotion* Programme encompassed some 79.4 thousand unemployed on a monthly average or 84% of the jobless total involved in active labour market programmes and measures. Long-term unemployed with unemployment spells of over a year and eligible for monthly unemployment benefits are the key target group under the government programme, which is mainly aimed at ensuring a brush-up of skills, vocational training and more job opportunities in the private sector for this particular cohort. However, the reintegration of long-term jobless in the labour market is further hampered by the adverse professional qualification and educational structure of the group. The majority of them have neither any specific qualification, nor any particular degree of education, calling for their inclusion in both subsidised employment and vocational training programmes. According to EA data, the average 2003 number of long-term unemployed went well below the 2002 level, or 15.3% lower on an annual basis, but retained its weight within the unemployed total rather high, however. As the programme has a three-year duration, the downward trend is expected to persist in the next two years, and hence the share of the cohort to decrease significantly.

Employment policies were also aimed at stable job creation in the real sector of the economy. The strategy of the government provided for certain tax relief under the Corporate Income Tax to companies investing in regions suffering rampant unemployment and employers hiring jobless from the some of the risk groups. However, it is difficult to estimate the effect of the measure as currently there are no data on how many companies and employers have made use of the tax relief. In addition, it should be noted that the micro-lending programme of the government aiming to provide incentives to businessmen to create new jobs, and hence reduce the countrys unemployment, gained further impetus. According to data of the Ministry of Labour and Social Policies[11], in 2003 the number of credit borrowers applications approved by the partner banks and the Ministry amounted to 2 610 (or about 75% year-on-year rise) and BGN 27.7 million of total worth. They created some 4 823 new jobs, or 49% up on a year earlier. The implementation of the programme in 2004 is foreseen to result in another 3500 new jobs.

In 2003 employers tended to show keener interest in the employment promotion and vocational training measures under the Employment Promotion Act. The implementation of the employment promotion measures yielded some good results, despite the stringent requirements to employers introduced last year (retention of the work place for an additional period equal to the term of subsidised employment, tax compliance of employers, etc.). The number of jobless who had taken on new jobs and inclusions in vocational training modules under the different employment promotion regimes ran at 31 057, or 11.7 thousand (60.2%) up on a year earlier. Overall under the employment promotion measures, the 2003 number of employed amounted to 9 913 on a monthly average, and the new jobs created to 14 132. Employment promotion policies placed special emphasis on measures having to do with raising the professional qualification of the employed as well as the professional qualification and employability of the unemployed, which accounted for 65% of all inclusions under the measures. To prevent any unemployment spells as well as retain employment, the

[11] *2003 data have been estimated as the difference between reporting data on loan approvals as at 31 December 2003 (periods cumulative) and reporting data as at 29 December 2002.*

measure aimed at keeping and raising the professional qualifications of employed covered 14 611 inclusions. On a year earlier, the number of inclusions in measures having to do with professional qualification and/or apprenticeship/internship of unemployed under 29 years of age reported a most robust growth (3566 vs. only 93 in 2002), as did the number of inclusions in professional qualification measures through internship and/or apprenticeship, which ran twice as high as in 2002 on a an annual basis. As a result of the differentiated social policy approach to the specific risk groups, the number of jobless from some of the so-called vulnerable groups[12] employed in 2003 stepped up significantly (2 830). Their share within total inclusions under the employment promotion regimes was not large, but they reported a three-fold rise on a year earlier, showing the growing interest of employers in this particular cohort.

In 2003, vocational training courses of the Employment Agency were most actively carried out. The number of unemployed doing professional qualification courses in 2003 ran twice as high as in 2002 at 38 216. As at 31 December 2003, the number of trainees who had finished such courses amounted to 29 294, and their share within the registered unemployed total advanced by about three percentage points up to 5.5% on a 12-month basis. Professional qualification was at the centre of interest of unemployed, as it improves their competitiveness and labour mobility and offers them more private-sector job opportunities. At the same time, being an essential element of labour flexibility, higher work force professional qualification was given key priority on the government social policy agenda in 2003.

According to EA data, demand in the primary labour market[13] stepped up, spurred mostly by the higher activity of private-sector employers. Private-sector jobs announced with job centres reported a 13.5% year-on-year increase up to 121 478. The share of the private sector within job creation in the primary market improved by 3.8 percentage points up to 74.4%. At the same time, the weight of jobs occupied other than under the employment programmes within the total amounted to 52% vs. 48% of the jobs occupied under the programmes. On the other hand, it should be noted that since the Employment Agency enjoys a rather low market share in employment services in the country, job centres produce only part of the job data available.

Having reported a most significant decline in unemployment, Bulgaria was no longer the country reporting the highest unemployment among the EU acceding and applicant countries. The unemployment rate ran higher in Poland (18.5%) and Slovakia (15.6%). And yet, despite the progress made over the past few years, Bulgaria was far behind the EU average of 8.3%, outperformed by Cyprus (3.5%), Malta (5.7%), Hungary (5.9%), Slovenia (6.7%) and Roumania (7.6%). Rampant unemployment in most cases was associated with the poor labour mobility and mismatch of work force qualification with the requirements and demands of a functioning market economy.

According to EA data, 2003 funding of the largest-scale government programme „From Social Aid to Employment Promotion" accounted for some 60% of the budget appropriations. 2004 budget allocations to support active labour market measures run a lot lower at about BGN 204 million, which according to estimates of the Agency for Economic Analysis and Forecasting will do to ensure the same temporary employment of jobless as last year. Put in other words, the contribution of the active labour market measures

[12] Young people with reduced working capacity, people with long-term reduced working capacity, single parents and mothers with children under 3 years of age, former prisoners, unemployed women above 50 years of age and men above 55 years of age.

[13] Other than the employment programmes.

in 2004 is expected to run at 0%. Therefore, to sustain the downward trend in employment in 2004 as well, the private sector will have to play a major role. Provided the sector carries on generating employment in the economy and retains the current pace of job creation given the countrys macroeconomic stability, unemployment will go on the decrease, though not at the same fast rate as in 2003. ❍

FINANCIAL SECTOR

The financial system was one of the primary factors contributing to the countrys macroeconomic stability. A number of positive trends that manifested themselves in the preceding years sustained their development, viz. the currency board stability, the growth of lending to the non-government sector, the financial stability of the banking and monetary sectors, the deepening of financial intermediation of bank and non-bank financial intermediaries alike and the intensification of competition between commercial banks.

The currency board in Bulgaria remained stable in 2003 as well, thereby pushing upwards public confidence in the financial system and the economy as a whole. BNB gross FX reserves followed a clear-cut upward trend, reporting a 16% rise on a year earlier to reach BGN 10 382.7 million in end-2003. The sustained lower interbank interest rates in the international financial markets and the sizeable depreciation of the US currency to the euro reduced the countrys foreign debt burden and contributed to the enhanced stability of the currency board. Furthermore, the tranches under the two-year IMF arrangement, the World Bank PAL loan received, the amortizing payments on Russias debt to Bulgaria and DSK Bank privatisation proceeds also contributed to the growth of BNB FX reserves.

The base money coverage ratio (M3 vs. FX reserves) fluctuated within a band of 60.8 - 66.1%, running at 61.7% in end-2003 (against 64% in end-2002). However, this dynamics cannot be seen as a sign of reduced stability of the currency board. Rather, it was predetermined by the enhanced credit activity of commercial banks that made money stock grow faster than BNB gross forex reserves.

In end-2003, the reserve money/FX coverage ratio amounted to 197.1%, going 2.5 percentage points down on a year earlier. The value of this ratio is much higher than the level provided for in the BNB Act, thus indicating that currently there is zero probability that any shocks could shake the stability of the currency board in Bulgaria.

In 2003, the process of remonetisation of the economy carried on. Money supply reported a nominal-term growth of 20.4% or BGN 2.85 billion while in real terms it increased by 14% (BGN 1.96 billion)[14]. In end-2003, M3/GDP ratio reached 48.9% against 43.2% in 2002.

The increase of households incomes triggered growing demand for money for transaction purposes on behalf of economic agents. The higher demand for money for transaction purposes induced by economic growth in 2003 brought about a 22.7% increase (BGN 1.25 billion) of highly-liquid money in the economy. In certain periods, monetary aggregate M1 stepped up even further due to the additional impact of the high summer holiday season, the budget transfers to local governments to cover accumulated deficits and the end-year payment of extra bonuses in the budgetary sector. The latter two were anticipated by economic agents and therefore could not affect negatively the economy. Out of the two M1 components, overnight deposits reported higher growth rates, stepping up by 32.6% or BGN 719.5 million as compared to the 16.2% (BGN 539.2 million) increase of money outside banks.

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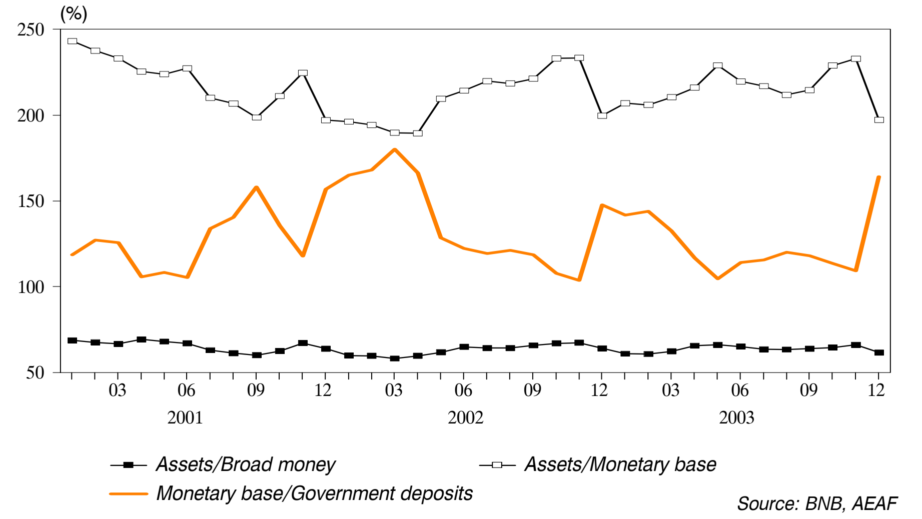
[14] *Deflated by CPI (base December 2002).*

The Currency Board Stability (key indicators)

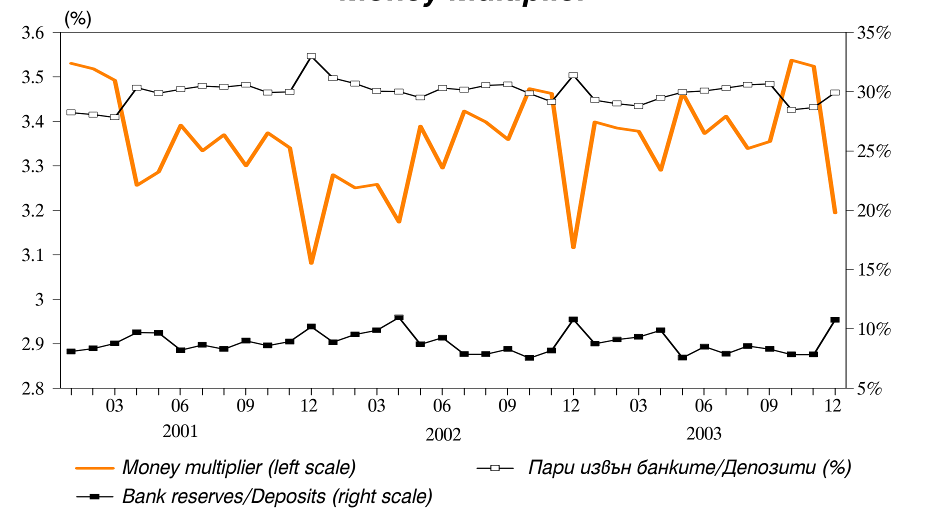


Source: BNB, AEAF

Quasi-money, comprising BGN time and saving deposits and foreign currency deposits, grew by 15.5% or BGN 1.24 billion. Foreign currency deposits sustained their prevailing share in the total deposit mass and, regardless of the substantial depreciation of the US currency in 2003, maintained higher growth rates in absolute and relative terms alike. This, their 12-month growth amounted to 17.8% (BGN 906.6 million) against an annual increase of 11.5% or BGN 335.8 million of BGN deposits. The high growth rate of the deposit mass was indicative of the restored confidence in the stability of the banking system.

Simultaneously, households long-term deposits (time deposits of over 2 years and saving deposits) also reported a robust increase. This trend is of particular importance for the future development of the national economy since the attraction of longer-term funds favours long-term investment lending. As for the deposit structure by maturity, long-term deposits still accounted for a small share in quasi-money yet their weight followed an upward trend to reach 19.7% in end-December 2003 against 18.3% in end-2002. Among the institutional sectors, households had the largest contribution to quasi-money growth as their cumulative deposits in BGN and foreign currencies stepped up by 15.7% to reach BGN 6.03 billion. The deposits of private firms contracted by 6.2% to BGN 1.2 billion whereas state-owned enterprises deposits grew by BGN 452.5 million to BGN 1.1 billion in end-2003.

Money Multiplier



Source: BNB

In 2003, money base reported a larger contribution to money supply growth vis-□-vis the money multiplier, stepping up by 17.5% (BGN 784 million) on a 12-month basis as a result of the higher demand for money for transaction purposes. The money multiplier grew from 3.12 to 3.19 in end-2003 due to the decrease of the money outside banks to deposits ratio from 31.4% in end-2002 to 29.9% in end-2003. The value of the money multiplier is expected to sustain its upward trend.

The dynamics of banking system assets reflected the successful completion of bank privatisation in Bulgaria and the swift development of the credit market in the country. In end-2003, net foreign assets in the banking system had increased by 1.6% (BGN 157.3 million), with the year-on-year growth being wholly due to the 22.4% or BGN 1.56 billion increase of BNB net foreign assets. In contrast, the net foreign assets held by commercial banks decreased by 48.3% or BGN 1.41 billion. The reasons behind the withdrawal of commercial banks deposits with foreign banks had to do with both the low rate of return on the international financial markets and the dynamic development of the local credit market. In 2003, the Bulgarian banks reported a substantial increase of the amount of attracted deposits and credit facilities of foreign banks and other non-residents thereby indicating the favourable risk/yield ratio in Bulgaria.

Monetary Base and Money Supply Mechanism

	Over the 31.XII.01 - 31.XII.02 period	**Over the 31.XII.02 - 31.XII.03 period**
Monetary base change (in BGN million)	1011.9	449.9
Coefficient of money multiplier variation (%)	□□ 3.08 □□ 3.12	□□ 3.12 □□ 3.19
Change in M3 by factor:		
1. due to a change in money multiplier (in BGN million)	143.6	351.1
2. due to a change in M3	1385.7	2442.8
3. due to a change in money multiplier and monetary base	61.4	16.0
Change in M3 (in BGN million) =1+2+3	**1545.3**	**2855.3**

Source: MoF, AEAF.

Net domestic assets in the banking system reported a 66.2% (BGN 2.7 billion) year-on-year growth while their most weighty component domestic credit grew by 33.9% or BGN 2.6 billion in 2003. Bank claims on the government sector contracted by 39.3% or BGN 495.3 million on a 12-month basis and their dynamics was shaped by the typical seasonal factors influencing the volume of the fiscal reserve such as the transfer of tax receipts to the central government budget and the amount of funds from the governments deposit spent in end-year.

Credit expansion carried on at even faster rates in 2003 being based on the enhanced creditworthiness of economic agents, the strong competition between commercial banks and the stable functioning of the banking system. The large growth of landing to the private sector together with the high quality of banks credit portfolios may be seen as an indicator of the favourable economic situation in the country. At the same time, they are also a prerequisite for sustaining stable economic growth in the future.

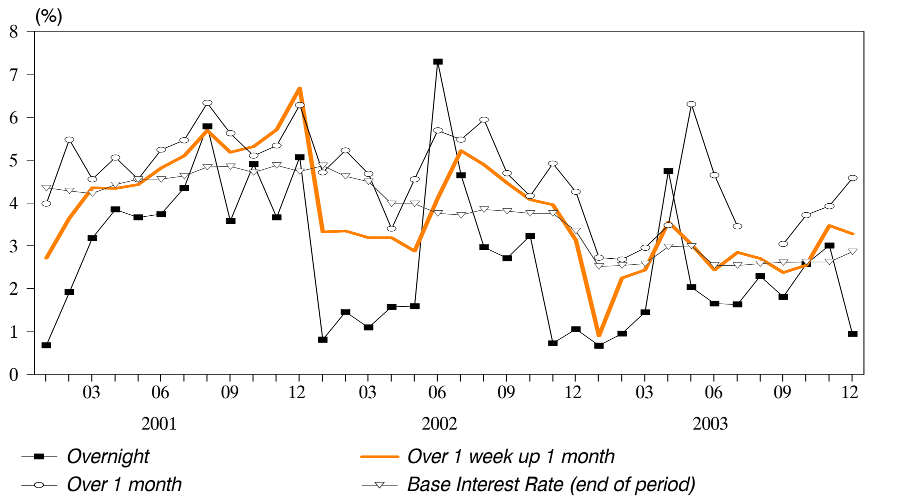
Credit to the non-government sector stepped up by 48.3% or BGN 3.1 billion exhibiting an accelerated dynamics compared to 2002. The non-government sector credit/GDP ratio went up to 27.6% against 19.8% in end-2002. The volume of newly extended credit in BGN (BGN 1.7 billion) exceeded that of new lending in foreign currency to the non-government sector (BGN 1.4 billion). Apart from the fact that households loans were predominantly denominated in BGN, the other reason behind the outstripping growth BGN lending had to do with the higher 12-month growth of BGN credits to private enterprises. As for the structure of lending by institutional sectors, again the largest increase was reported by lending to private enterprises (by 41.8% or BGN 1.97 billion) and household loans (by 77.3% or BGN 959.7 million). The credit maturity structure underwent a major qualitative change. As a result of the very high growth of long-term credits reported in the last two years, in end-2003 the share of this credit group in the total sum of loans extended to non-financial institutions and households already exceeded that of short-term lending. The upward trend in credit maturity as well as the gradual downward trend in interest levels will continue to foster the sustained growth rate of loan extensions to private firms. ❍

MONEY AND FOREIGN EXCHANGE MARKETS

In 2003, the base interest rate (BIR) stepped down by about 0.5 percentage points to 2.86% in end-December.[15] In February, the BIR plunged to its lowest in the last 14 years of 2.51%. The fall had to do with both the high liquidity in the banking system in early-2003 and the sustained record-low interest levels on the international financial markets. The base interest rate continued to reflect primarily the situation of public finance and was therefore less illustrative of the money price dynamics in the economy. Commercial banks refrained from using the BIR as a reference rate when determining their interest rate policies on deposits and credits alike. SOFIBOR and SOFIBID interbank BGN market indexes (created on the initiative of and with the sponsorship of the Commercial Banks Association and the Bulgarian Dealers Association) quoted by the BNB since 17 February 2003 have been gaining ground. However, the high volatility of both reference rates is still an impediment to their wider usage.

In April, the average weighted interest rate (giving account of the interest on all interbank money market transactions) peaked to its highest in 2003 as a result of the temporary shortfalls of money. The mid-April liquidity crisis on the BGN market proved to be the gravest one in the banking system since the institution of the currency board arrangement. The crisis was triggered primarily by poor commercial banks planning of cash flows (unexpected clients orders for the payment of taxes and excises and/or the coinciding need to regulate the minimum required reserves within the time limits set). To overcome the crisis, the Ministry of Finance held a special buy-back auction of securities and in June the central bank authorities came up with important measures to significantly reduce the risk of another liquidity crisis as follows: first, commercial banks were allowed to certify with the BNB their accounts in EUR on the same value date as the working day and sell the central bank EUR against BGN on the same value date; and second, RINGS was successfully launched, allowing for all systematically significant payments in BGN to be settled in „real time".[16] RINGS was welcomed and supported by the

Interbank Money Market Interest Rates

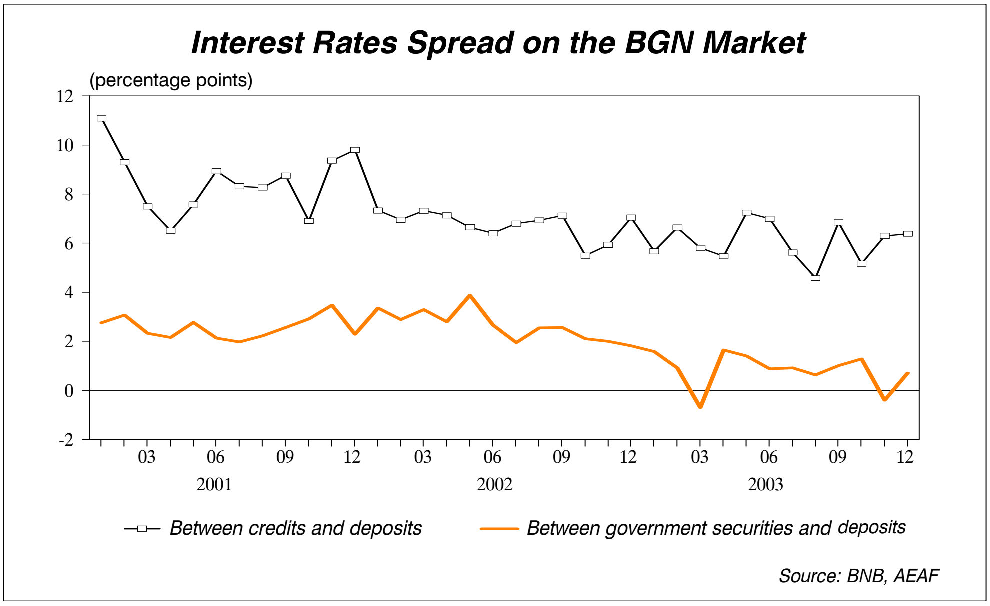


Source: BNB

[15] *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.*

[16] *RINGS covers transactions between the commercial banks and the BNB, payments on government securities and transfers equal or higher than BGN 100 thousand as well as settlements of banks customers.*

banking circles. The compatibility of RINGS with the TARGET settlement system of the European Central Bank will make the processing of payments in EUR and other international settlements easier upon Bulgarias accession to the EU. RINGS allows the more efficient management of commercial banks liquidity, enhances the reliability of the payment system and contributes to the reduction of systematic risk.



In 2003, the average interest rate spread between BGN short-term loans and time deposits narrowed by 0.7 percentage points to reach 6.1% against 6.8% in 2002. The contraction was primarily caused by the downward trend in interest levels on credits rather than by the increase of interest rates on deposits. Intensified competition between commercial banks as well as the improved business climate in the country and the associated reduction of credit risk were the main reasons behind the sustained downward trend in credit interest rates.

Notwithstanding the sustained narrowing of the interest rate spread in Bulgaria in recent years, it remained wider than the average in the 10 new EU member states. However, there is a clear-cut trend of a gradual approximation of interest rates spreads in Bulgaria and the other countries. The narrowest interest rate spreads were reported in Hungary (2.1% in the nine months to October 2003), Latvia and Malta (2.4%) followed by Estonia and Slovakia (3.1%). Cyprus was the only acceding country to report an increase of the interest rate spread from 1.5% in 2000 to 3.6% in 2003.

In 2003, the volumes of foreign currency purchased and sold on the interbank forex market were almost equal with the amount of the currency sold exceeding the amount of currency purchased by mere BGN 6.4 million. The structure of transactions by foreign currency underwent some substantial changes. In end-2003, the share of transactions in USD in total trading reported a year-on-year contraction of 5 percentage points to reach 20.6% whereas the share of transactions in euro stepped up by 4.6 percentage points to 77.4%. This dynamics was probably due to the response of forex market players to the continuing trend of US dollar depreciation to the Single European Currency. In 2003, the euro appreciated to the dollar at both average annual and end-year values by 16.6% and 17.8% respectively.

In 2003, commercial banks carried on developing as stable institutions with very good liquidity, capital adequacy and profitability indicators. A number of factors shaped the performance and condition of the banking system such as the macroeconomic stability, the competitive environment in the sector following the privatisation of state-owned banks by strategic investors and the low interest rates on the international financial markets. The banking system balance sheet value reached BGN 17 323.6 million in end-2003 increasing by BGN 2 687 million or 18.4% on a year earlier. In 2003, the BGN component stepped up by BGN

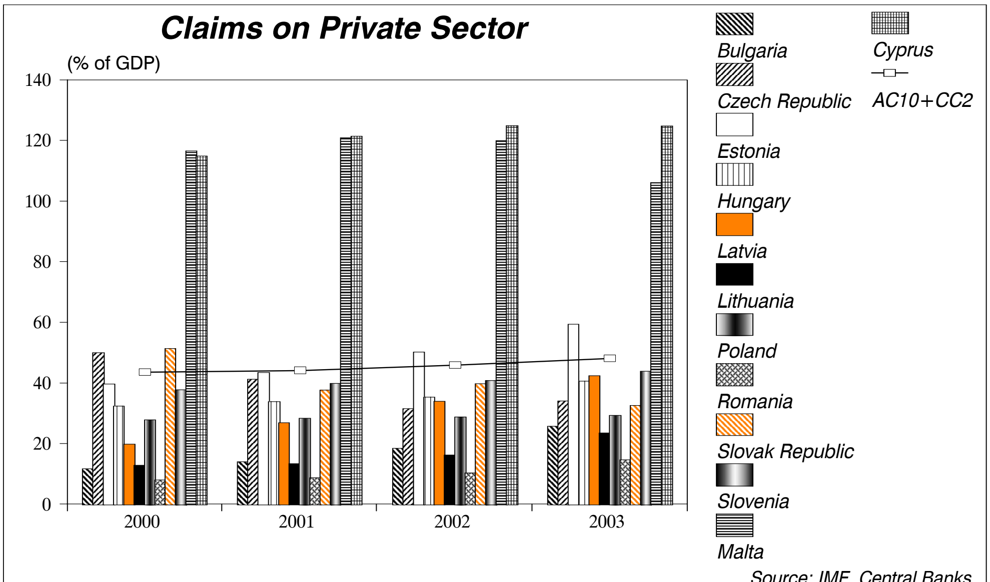
1 996.8 million (30.2%) thereby accounting for a larger contribution to the growth of bank assets than that of the foreign currency component (BGN 689.9 million or 8.6% higher on a year ago). The reported growth rate of bank assets ran lower than the figure reported in 2002 (19.9%) mainly as a result of the depreciation of the US dollar against the lev.

The above-mentioned factors also modelled the changes in bank asset structure. 2003 sustained the restructuring in the commercial banks asset structure. The low interest rates, the relatively low risk in the Bulgarian economy and the established long-term trustworthy bank-client relations contributed to the expansion of the share of credits granted to non-financial institutions and other clients and respectively to the contraction of commercial banks investment abroad. Thus, the share of credits to non-financial institutions and other clients stepped up from 41.2% of total assets in end-2002 to 52% in end-2003.

Credit expansion was one of the underlying trends in the development of the Bulgarian financial sector in 2003. However, the growth rate of loans to the non-government sector is expected to slacken in 2004 especially in view of the declining options to transfer bank assets from deposits in foreign banks to credits to the non-government sector in Bulgaria.

The closer examination of commercial banks credit portfolio is of primary importance since the growth rates of the various types of loans may affect the performance of other indicators for the Bulgarian economy. In 2003, the fastest growth rates were reported by commercial real estate and construction lending, followed by housing and mortgage loans to households. The increase of investment credit favours the development of the economy since investment loans contribute to higher economic growth. The observed trend in bank lending is indicative of the current lower risk in the national economy.

The share of consumer loans also stepped up to reach 18.2% in 2003, thus contributing to higher domestic demand and eventually - to higher GDP growth rate. On the other hand, this trend may have a negative impact on the national economy. The use of consumer loans for the purchase of goods with no local counterparts also results in an increase of the current account deficit. Yet, if the enhanced consumer demand triggered by the increase of consumer lending is met by imported goods rather than by locally produced goods, it is a problem of the Bulgarian firms whether they could respond to the changing market conditions. Therefore, commercial banks should not be blamed for the increased current account deficit just because they have been pursuing a policy to optimise their financial results. Notwithstanding the sustained upward trend in the weight of lending to non-financial institutions and other clients in total bank assets reported in recent years, the value of this indicator remained lower than that in other countries. Another indicator of the depth of financial intermediation,



Source: IMF, Central Banks

viz. the share of private sector credit in GDP remained lower in comparison to the average level in the 10 new EU member states. Thus, its value in Bulgaria ran at 26.6% in 2003 (stepping up by 7.8 percentage points relative to 2002) against 124.8% in Cyprus and 106.2% in Malta, being the leaders in the group of accession countries.

The higher bank lending in 2003 has not led to any sharp deterioration in the quality of commercial banks credit portfolios. Thus, as of end-2003 some 92.72% of bank risk exposures were classified as standard (against 94.47% in December 2003) while only 2.47% of credit exposures were classified as a loss as compared to 1.82% reported a year earlier. Given the ongoing credit expansions and with a view to achieving stricter control over commercial banks risk exposures, in August 2003 the central bank amended its Ordinance No9. The amendments led to an improvement of banks credit portfolios relative to the end of the second and third quarters of 2003.

Another change in commercial banks asset structure had to do with the increase of the share of securities in their investment portfolios at the expense of the contraction of the share of securities in the trading portfolios. In 2003, commercial banks opted for investment in longer-term securities such as BGN and foreign currency denominated government securities and euro-bonds with a view to gaining greater yield on their portfolios.

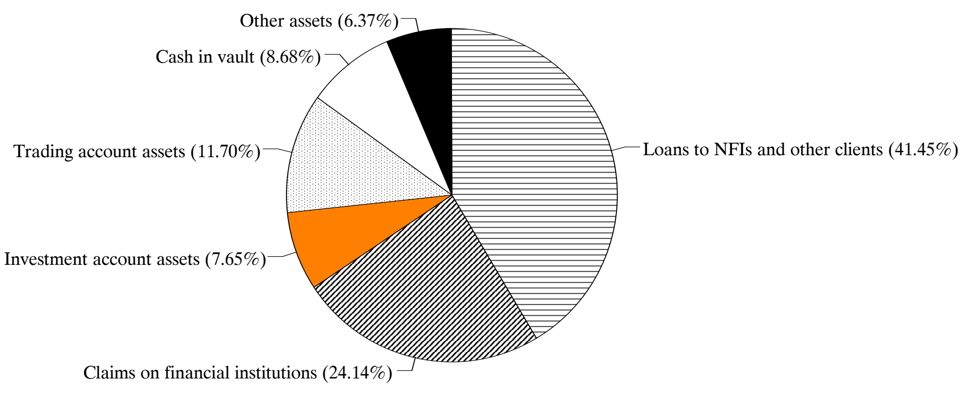
In 2003, no noteworthy changes were reported in the structure of commercial banks liabilities. The share of deposits of non-financial institutions and other clients stepped up by 1.29 percentage points at the expense of the shrinkage in the weight of the other liability components.

Competition among banks became stronger in 2003. Commercial banks went on introducing new corporate and retail banking services and products in the effort to attract more clients and meet the requirements and demand of the various market groups. Thus, they introduced combined products such as integrated bank and insurance services. The presence of foreign investors also resulted in stronger competition among banks and a redistribution of the market shares.

On a year earlier, the dynamics of the indicators of concentration in the banking sector in end-2003 gave ground for the following conclusions:

- The Concentration Coefficient and Herfindahl Index sustained their downward trend as regards bank assets and deposits, having to do with the contraction of the market shares of the largest banks (UBB, Bulbank, DSK Bank and Biochim) and the ensuing more even distribution of assets and deposits in the banking system;
- The Concentration Coefficient as regards bank claims went up

Assets of Commercial Banks as of 31.12.2002



Source: BNB

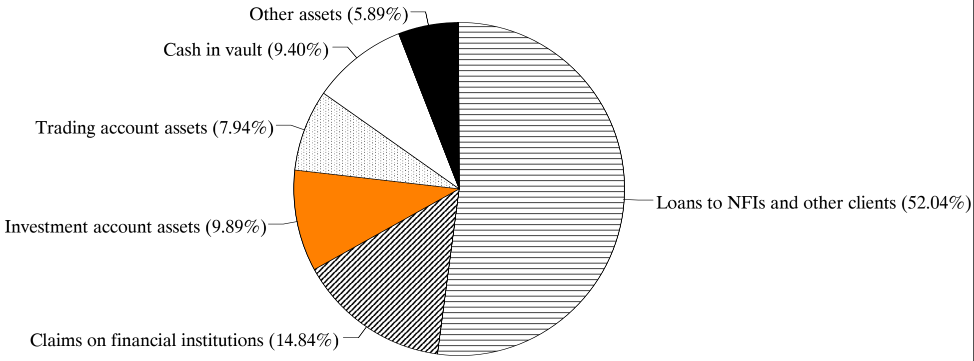
following the credit expansion policy embarked upon by larger banks.

The Bulgarian banking system remained stable and well capitalised. In end-2003, commercial banks net profit amounted to BGN 379.8 million, stepping up by 45.2% on a year earlier. The three largest banks were again bigger profit-makers, accounting for 58.7% of banking sector profit. However, their share in total profit declined from 63.6% reported in 2002.

The profitability indicators also improved in 2003. The net interest income/balance sheet assets ratio improved notably (by 0.7 percentage points) to 4.8% in end-2003 as a result of banks enhanced credit activity and greater profits from their interest-bearing assets at the expense of lower income from interest-bearing liabilities.

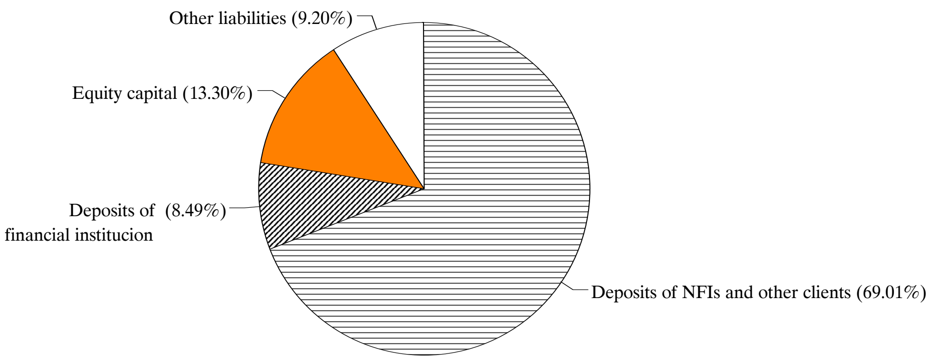
Commercial banks aspirations to maximise their interest income did not prevent them from observing the liquidity and capital adequacy requirements. They successfully managed their funds in such a way so as to achieve high profitability and,

Assets of Commercial Banks as of 31.12.2003



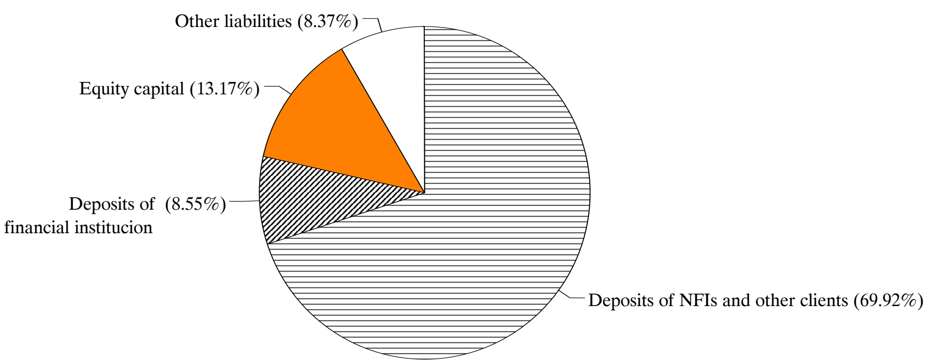
Source: BNB

Liabilities of Commercial Banks as of 31.12.2002



Source: BNB

Liabilities of Commercial Banks as of 31.12.2003



Source: BNB

Measures of Concentration in the Banking Sector

	XII.1999	XII.2000	XII.2001	XII.2002	XII.2003
Bank assets					
Herfindahl Index	0.12	0.11	0.09	0.08	0.08
Concentration Coefficient (%)	57.0	55.2	51.4	49.9	47.0
Claims on Non-financial Institutions and Other Clients					
Herfindahl Index	0.08	0.07	0.07	0.07	0.07
Concentration Coefficient (%)	43.6	42.0	41.1	41.8	43.2
Deposits of Non-financial Institutions and Other Clients					
Herfindahl Index	0.13	0.13	0.11	0.10	0.09
Concentration Coefficient (%)	61.7	62.2	58.2	55.8	53.1

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

at the same time, maintain stability and liquidity. Commercial banks capital adequacy indicators sustained significantly higher levels than those fixed by BNBs Ordinance No8. As of end-2003, the banking sector overall capital adequacy ran at 22.03%, stepping down by about 3.17 percentage points on a year earlier. In 2003, the indicators two principal components, viz. the total risk component of commercial banks assets and the capital base increased by 41.3% and by 23.4% respectively. The greater increase of the risk component of assets as a result of commercial banks credit expansion brought about a decline in the credit ratios. However, the changes present no risks to the banking system because the values of the indicators remain far above the levels required in the regulatory framework.

Profitability Indicators of the Banking System*
(% of average assets)

	XII.2001	XII.2002	XII.2003
Net profit	2.7	2.1	2.4
Operating profit	3.5	2.7	2.9
Net interest income	4.3	4.1	4.8
Operating expenditures	5.0	4.8	4.6
Foreign currency revaluation	0.3	0.1	0.2

* On an annual basis

Source: BNB, AEAF.

As of end-2003, the banking system maintained slightly higher liquidity as gauged by the primary liquidity indicator than in end-2002. In December 2003, commercial banks primary liquidity indicator ran at 11.98% against 11.2% in December 2002, having to do with the typical end-year rise of vault cash and assets in the settlement accounts with the BNB. The value of secondary liquidity indicator, however, had stepped down from 29.25% in end-2002 to 25.5% in end-December 2003 mainly as a result of the contraction of investment in commercial banks trading portfolios.

The dynamic and stable development of non-bank financial institutions was sustained in 2003 and the intermediation of these institutions further deepened. Although the financial system was well dominated by banks, the indicators gauging the development of non-bank financial institutions improved. The ratio of pension funds assets to GDP and gross national savings stepped up to 1.4% and 11% respectively (vs. 1% and 7.2% in end-2002). The ratio of market capitalisation of the stock exchange to GDP increased to 7.8%

from 4.3% in end-December 2002. As of end-September 2003, insurance penetration ran at 1.8% (vs. 1.9% in end-2002). Its lower level had to do with the impact of seasonal factors and, in end-2003, it is expected to exceed its previous year value. Regardless of the improved performance of non-bank financial institutions, their development and level of financial intermediation was far from the one found in a functioning market economy.

In 2003, pension funds continued to accumulate huge amounts of resources under both the mandatory and voluntary supplementary pension insurance. As of end-September 2003, the amount of accumulated assets in pension funds had reached BGN 453.5 million, stepping up from BGN 332.5 million in end-2002. The funds raised by occupational funds amounted to BGN 131.4 million in end-September 2003 vs. BGN 95.2 million in end-2002. Universal funds had accumulated BGN 93.7 million against BGN 41.7 million in edn-2003. Voluntary pension insurance funds had raised the largest volume of funds (BGN 228.4 million vs. BGN 195.5 million in end-2002). The concentration of assets with all types of funds went on the increase having to do with the merger of *Doverie* pension insurance company with *Bulgarsko pensionnoosiguritelno drujestvo*. The four biggest voluntary and universal funds were responsible for about 90% of all assets, whereas the four largest occupational funds managed some 92.3%.

Key Financial System Indicators

% of GDP

	2000	**2001**	**2002**	**2003**
Commercial bank assets	36.5	41.1	45.0	50.2
Pension fund assets	0.3	0.6	1.0	1.4
Insurance premiums	1.5	1.6	1.9	1.8
Market capitalisation of the stock exchange	4.8	3.7	4.3	7.8

Source: Financial Supervisory Commission, BNB, AEAF

2003 witnessed some changes in the structure of the pension funds investment portfolios but the bulk of resources were again invested in government securities. In end-September 2003, the share of government securities in total investment of voluntary and universal funds had declined by 1.8 and 1.1 percentage points respectively relative to end-2002, to reach 52.4% and 77.6%. Occupational funds however had increased their investment in government securities over the same period by 2 percentage points to 71.3% of total assets. The share of investment in bank deposits of all types of pension funds went on the decrease. The contraction of the weight of government securities and bank deposits of voluntary pension funds assets took place at the expense of the sizeable increase (by 11.8 percentage points) of the share of securities listed in the regulated markets up to 13.2% of total assets in end-September 2003. The capital market upturn and the placement of new financial instruments boosted the investment of more funds in these assets of higher yield. Occupational and universal funds opted for higher investment in real estate. Pension funds had not invested sizeable assets abroad in view of the lower interest levels at the international financial markets.

Pension funds are expected to accumulate huge resources in the future that have to be invested in order to receive a higher rate of return. The local economy is unlikely to have the potential to offer a diversity of instruments suitable for investment. In 2003, the legislative and regulatory framework was amended to liberalise the investment regime for pension funds. Thus, funds under the voluntary supplementary pension insurance are now allowed to invest up to 20% of their assets abroad while funds under the mandatory pension insurance may invest up to 15%. An increase of pension funds investment abroad will trigger the outflow of financial resources from the country which, in turn, will result in the deterioration of the balance of payments financial account, hence in fewer options to cover the deficit on the current account. This effect is estimated at 0.1% of GDP[17] in end-2007. The estimation of this effect[18] is based on the assumption that pension funds will avail themselves of the opportunity to invest abroad the maximum admissible percentage of their assets. The introduction of the new investment regime in 2003 will not immediately reflect on the economy since pension funds will be unable to instantly re-channel abroad the allowed amounts of funds. Investing abroad is a stepwise process and the effect from it will be discerned in two or three years. The outflow of financial resources from the local economy will come to an end at the point of equalisation of interest rates at home with those in the global economy owing to the impact of interest arbitrage and the financial integration.

Thousand BGN	**2003**	**2004**	**2005**	**2006**	**2007**
Voluntary funds	264 794	307 175	353 508	395401	433 253
Universal funds	96 465	159 932	263 092	416629	634 853
Occupational funds	150 565	200 888	255 770	314855	379 534
Total:*	511 824	667 995	872 370	1 126 885	1 447 640
Assets/GDP	1.5%	1.8%	2.1%	2.5%	2.9%
Investments abroad (% of assets)					
Universal and occupational funds	1%	5%	10%	15%	15%
Voluntary funds	1%	5%	10%	20%	20%
Impact on the balance of payments	1 794	7 809	20 438	40 272	50 006
Deterioration of the financial account (% of GDP)	0.01%	0.02%	0.05%	0.09%	0.10%

* Based on projections for pension funds assets over the 2003-2007 period of the Financial Supervision Commission

The assessment of the effect from the liberalisation of pension funds investment regime points out that the negative pressure on the economy in the medium term will not be substantial. Given the accumulation of sizeable financial resources by pension funds, the effect of liberalisation in the long run, however, may be of greater importance. Still, the faster development of the capital market in the country is likely to offset this negative impact.

The steady upward in the dynamics of the insurance market was sustained throughout 2003. Insurance companies went on offering a diversified portfolio of services to satisfy the insurance requirements of economic agents. In end-September 2003, insurance companies reported an 18.9% year-on-year gross premium income rise up to BGN 446.1 million. Premium income in the general insurance industry grew by 24.8% in end-September 2003 while declining by 15.8% (year-on-year) in the life insurance segment. The latter was triggered by the new amendments to tax legislation in the country.

As of end-September 2003, concentration in the general insurance industry had declined in contrast to its dynamics in the life insurance segment. The four biggest general insurance companies managed some

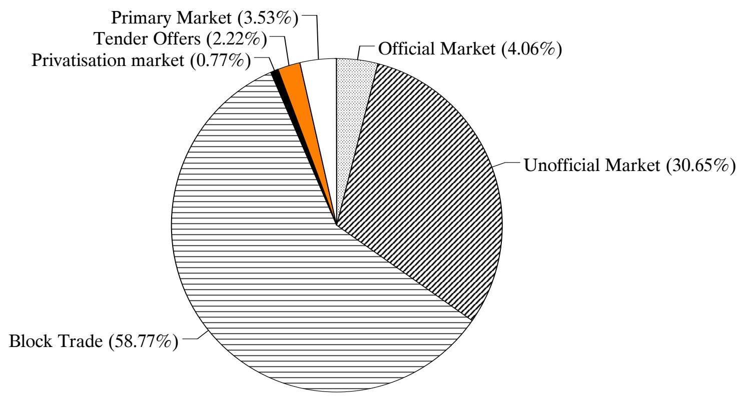
[17] *Using the GDP forecast of the AEAF.*

[18] *Estimation has not taken account of the interest and foreign exchange risks.*

67.96% of the premium income (70.52% in end-September 2002) while the concentration ratio in life insurance ran at some 79.4% of premium income as compared to 69.2% in end-September 2002. Herfindahl Index and the Concentration Coefficient followed similar dynamics in both sectors.

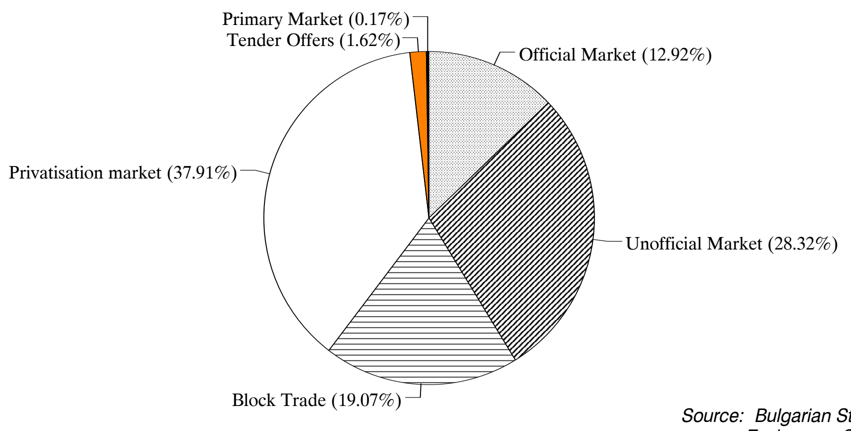
In 2003, Bulgarias capital market sustained its upward trend of development. The volumes traded at the Bulgarian Stock Exchange (BSE) reached BGN 793 million, reporting a most robust growth of 90.4% on a year earlier. Compensatory instruments and the shares of a number of attractive companies put up for privatisation against compensatory instruments played a crucial role at the capital market in 2003. Trading in the privatisation segment accounted for the largest share in total BSE turnover, reaching 37.9% in 2003. Shares of *DZI* (20% of the share capital), *Sv. Sv. Constantine and Helena* (72% of the share capital), *Bulgartabac* (12.4% of the share capital), *Maritsa 3* TPP (49% of the share capital), *Oil and Gas Prospecting and Extraction* EAD (100% of the share capital), etc. were placed at the privatisation market in 2003. The parcels attracted considerable interest from investors and were sold immediately after placement. The price fluctuations of compensatory instruments were highly dependent on any news for the placement of equity shares of certain companies on the stock market for privatisation against compensatory instruments. Regardless of the large amplitude of fluctuation, the prices of the compensatory instruments hovered around 23% of their face value. As for trading in single shares, some BGN 78 million worth of compensatory instruments were traded in 2003 vs. 40.8 million in 2002. Block deals in compensatory instruments ran at BGN 69 million, accounting for 45.3% of total parcel trading turnover.

Bulgarian Stock Exchange: Turnover Structure in 2002



Source: Bulgarian Stock Exchange - Sofia

Bulgarian Stock Exchange: Turnover Structure in 2003

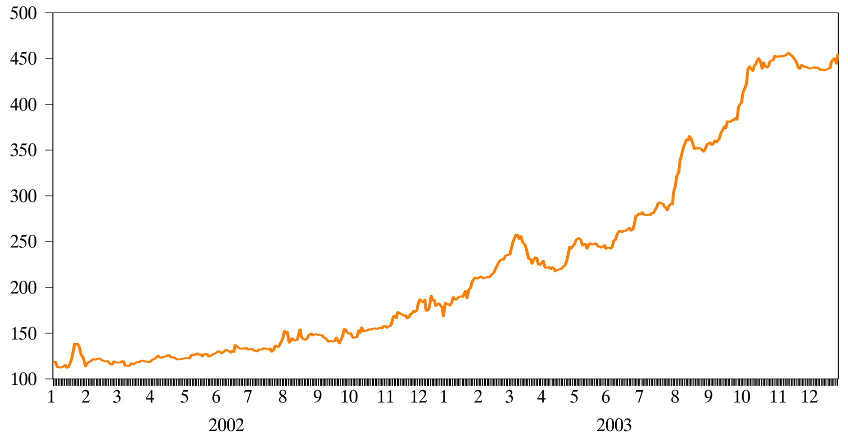


Source: Bulgarian Stock Exchange - Sofia

Trading in single shares also contributed to the growth of annual turnover at the BSE. As for the separate market segments, the official Corporate bonds segment reported the most notable growth of BGN 39 million year-on-year. Also, new corporate bond issues were listed on this market segment[19]. Bond issuers have so far preferred to place their bonds privately and only afterwards to list them on the stock exchange thus aiming to secure higher liquidity.

In 2003, trading on the over the counter markets of bonds and shares of the BSE also reported a hefty increase, stepping up by 52.1% (up to BGN 25.97 million) and 72.6% (up to BGN 120 million) respectively on a year earlier. The mortgage bonds of commercial banks were most actively traded on the over the counter market of bonds. New issues of mortgage bonds of *First Investment Bank* and the *Bulgarian-American Credit Bank* were listed for trading in 2003. The issue of mortgage bonds is associated with the heightened credit expansion of commercial banks in recent years and the upward trend in mortgage loans extension.

Bulgarian Stock Exchange Index (SOFIX)



Source: Bulgarian Stock Exchange - Sofia

The official stock exchange index, SOFIX, hit new record high values in 2003, peaking at 456.34 points on 10 November. In end-2003, the index reported a most robust rise of 148.2% on a year earlier as a result of the upswing in the share prices of the companies, making up the index. The most notable price increase was registered by the shares of *Blagoevgrad BT* and *Albena*, stepping up by 200.5% and 166.2% respectively.

In spite of the stable and dynamic development of the Bulgarian capital market in the last two years, it continued to be underdeveloped, lagging behind the level of development found in the advanced market economies. The capital market is expected to sustain the steady upward trend of development in the forthcoming years and to acquire an even greater role in the redistribution of financial resources in the Bulgarian economy. ❍

[19] *Corporate bonds issued by Overgas AD - worth BGN 20 million, AutoBohemia worth BGN 1 million and Kaolin AD worth BGN 5 million.*

BALANCE OF PAYMENTS

In 2003, the current account deficit of the balance of payments deteriorated drastically to MEUR 1498.3, or 8.5% of GDP (vs. MEUR 924.2, or 5.6% of GDP in 2002) due to the significant contribution of the trade balance and the income balance. At the same time, the other two current account items, i.e. the service balance and net current transfers went on the increase.

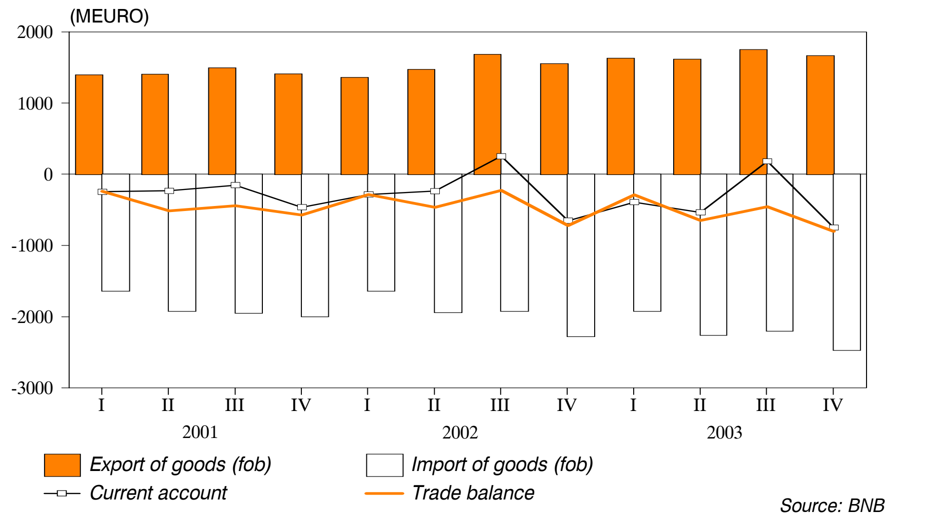
Current Account Items

	2002 (MEUR)	2003 (MEUR)	Change (in MEUR)
Current account	-924.2	-1498.3	-574.1
Trade balance	-1691.8	-2196.2	-504.4
Service balance	486.0	523.9	37.9
Income balance	-285.3	-438.6	-153.3
Current transfers, net	566.9	612.6	45.7

Source: BNB

The country"s trade balance worsened mainly as a result of the vigorous nominal-term import growth of 14.2% (up to MEUR 8858.8 at fob prices). Exports amounted to MEUR 6662.6 but could not make up for the higher import volumes, despite the relatively high year-on-year rise of 9.9%. 2003 trade balance amounted to - MEUR 2 196.2, or 12.5% of GDP.

Current Account, Trade Balance, Import and Export



Source: BNB

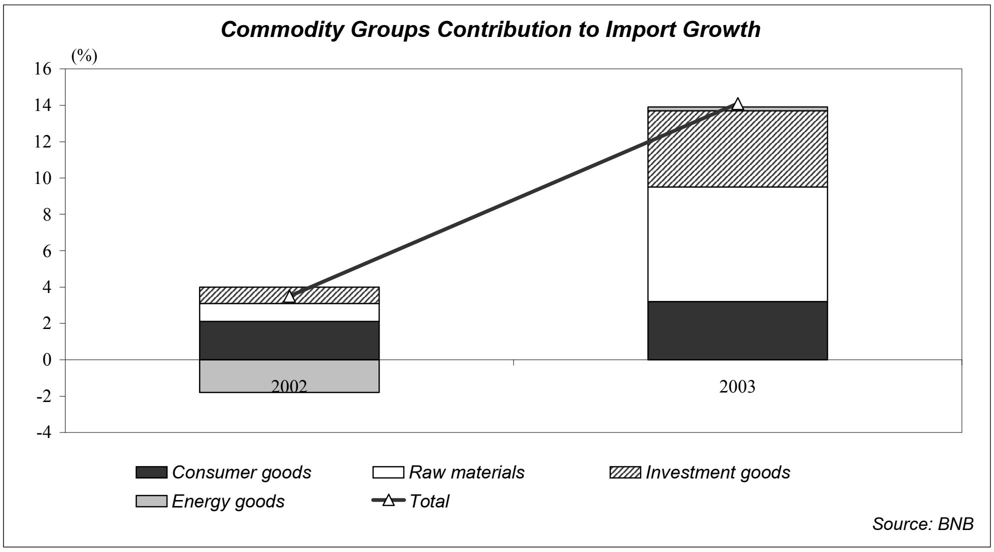
2003 import dynamics was mainly influenced by the higher domestic demand further enhanced by the growing bank lending activity, strong depreciation of the US dollar, moderately good countrys export performance, and last but not least tightened customs control.

Total imports grew as a result of the robust contribution of raw material imports, which stepped up by 18.1%. The indicators performance was predetermined by the rebounding local production, the export-led industries including. Thus for example, the MEUR 120.7 higher textile imports corresponded to the MEUR 198.9 worth of an increase in clothing and footwear exports.

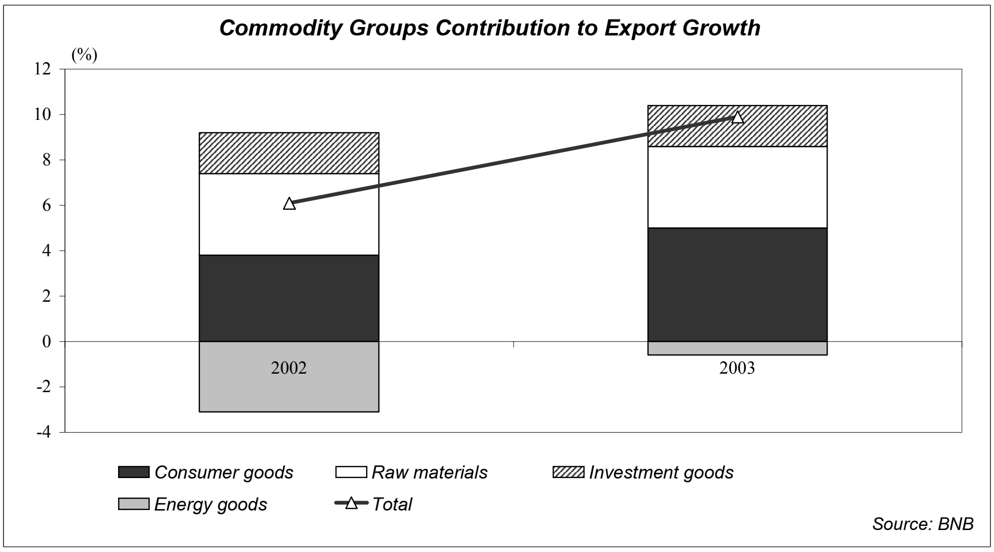
Investment goods imports went some 16.6% up, with part of this growth being spurred by the sizable FDI inflows and hence the building of new production capacity. Machinery, equipment and vehicles imports provided a solid ground for any further increase of productivity of Bulgarian industries and ultimately resulted in export growth. Investment import growth in 2003 fully matched national accounts data, which pointed to a 13.8% rise in gross fixed capital formation. Therefore, the expectations that the share of investments in GDP will carry on increasing in the years to come give conclusive evidence that the comparatively fast growth rate of investment goods imports will be sustained in the mid-term as well.

Consumer goods imports reported a most robust increase of 17% once again. This was largely due to the high growth rate of final consumption, as boosted by both higher real income and household consumer loans. The higher domestic demand in 2003 was by and large met by imports with no local counterparts, e.g. cars, reporting a 19.7% rise.

Energy imports stepped up by a bare 1% on a year earlier. Crude oil and gas import volumes declined by 1.1% and 5.8% respectively. Although energy prices in USD went on the increase, the strong depreciation of the US currency resulted in a price drop in EUR of 5.1% (crude oil) and 0.9% (gas), bringing about a year-on-year shrinkage in total imports of over MEUR 50.



Given the slowly rebounding world economy, Bulgarian exports reached MEUR 6662.6. The more expensive BGN (by over 20% on a 12-month average) to the US currency had a negative effect on the competitiveness of Bulgarian goods. However, this effect was only manifested under foreign exchange rate fluctuations of great amplitude due to the low elasticity of trade to the real exchange rate. In spite of the adverse external conditions, total exports reported a 9.9% year-on-year increase. The above growth was mainly spurred by the vigorous rise in textile and non-precious metal exports. Clothing and footwear exports went 15.8% up in EUR terms, as did cast iron, iron and steel exports, registering a 37.7% rise. Following a steady upward trend, textiles turned out to be a major item of Bulgarian exports. At the same time, non-precious metal exports stepped up mainly as a result of the higher metal prices worldwide. Therefore, any deterioration in the international metal market situation is likely to bring about a certain export contraction. In addition, the countrys export list needs to be further diversified so that the dependency and vulnerability of the Bulgarian economy to international price volatility are greatly reduced. In this regard, the significant year-on-year growth in investment goods exports of 13.6% was a positive development. Machinery, vehicle and other equipment exports have been following a steady upward trend since 2002, gradually turning into another competitive export item of high value added. It is therefore vital that this development is further sustained as an export alternative to textiles, the export potential of which is likely to run out with the rise in labour costs in the industry. The remaining commodity groups, reporting a significant contribution to total export growth, were as followed: food (21% up); furniture and home furnishing (16.6%); timber and paper (24.5%); textile stuff (16.2%); and non-ferrous metals (13.7%). On the other hand, food raw material exports declined most drastically by 31.9% or MEUR 102.4. Energy exports also contracted by 5.8%, or MEUR 34.6, on a year earlier due to the cease of electricity export to Turkey, which was largely offset by exports to Greece and Yugoslavia. At the same time, oil product exports increased by 7.6%, MEUR 27.2, with export volumes rising by 82.4 thousand tonnes, or 4.7%.



Despite the weak demand growth in the developed economies and stiff competition, as triggered by foreign exchange rate volatility in 2003, Bulgarian exports to the EU and OECD countries went on the increase (11.6% and 6.5% respectively). As in 2002, the EU member states were again Bulgarias biggest trading partners, where some 56.6% of the countrys export total was destined to, accounting, at the same time, for 49.3% of Bulgarian imports, with Germany in the lead (10.8% share in exports, and 14.3% in imports), followed by Italy (14% in exports, and 10.2% in imports) and Greece (10.4% in exports, and 6.6% in imports). The countrys trade deficit to the CIS and Baltic states amounted to MEUR 1460.5, and to China to MEUR 193.9.

In 2004, growth in the world economy, the EU in particular, is expected to speed up. Furthermore, it is not anticipated that the Feds and European Central Bank will let the US currency depreciate any further, implicitly providing favourable conditions for growth in the Bulgarian economy. At the same time, imports are expected to remain strong, with the factors at work being the high investment and lending activity in the country. As they are directly dependent on business activity in the Bulgarian economy, raw material and investment goods exports are expected to sustain their upward trend in the next couple of years. On the other hand, growth in consumer goods imports will slow down due mostly to a certain deceleration in consumer loan increase as well as the expectations that local companies will ultimately gear themselves up to the altered consumer demand in the country.

According to revised BNB data, the 2001 service balance amounted to MEUR 454.1, worsening by MEUR 173.3 relative to the initially reported data. The 2002 balance ran at MEUR 486, declining by MEUR 111.9. In 2003, the service balance amounted to MEUR 523.9. 2003 revenue from tourism reached MEUR 1460, reporting a 21.4% year-on-year growth, which fully matched the 18% increase in holiday-maker numbers visiting Bulgaria. The expectations are that interest in the Bulgarian tourism market will persist well into 2004 due mainly to the Olympic Games to be held in neighbouring Greece. Spending on the part of Bulgarian tourists abroad stepped up by 17.8% to some MEUR 661.1, indicating a major improvement in the countrys welfare over the past couple of years.

Revenue from transport services rose by MEUR 72.1 or 9.5%. At the same time, transport service imports also increased by 14.2% up to MEUR 1019.4. The higher turnover volumes of transport service trade were due to the higher commodity trade turnovers. According to the latest data on the 2001-2003 period produced, the *transport-credit* item varied between 12.4-12.6% of exports, whereas the *transport-debit* item accounted for 11.3-11.5% of imports.

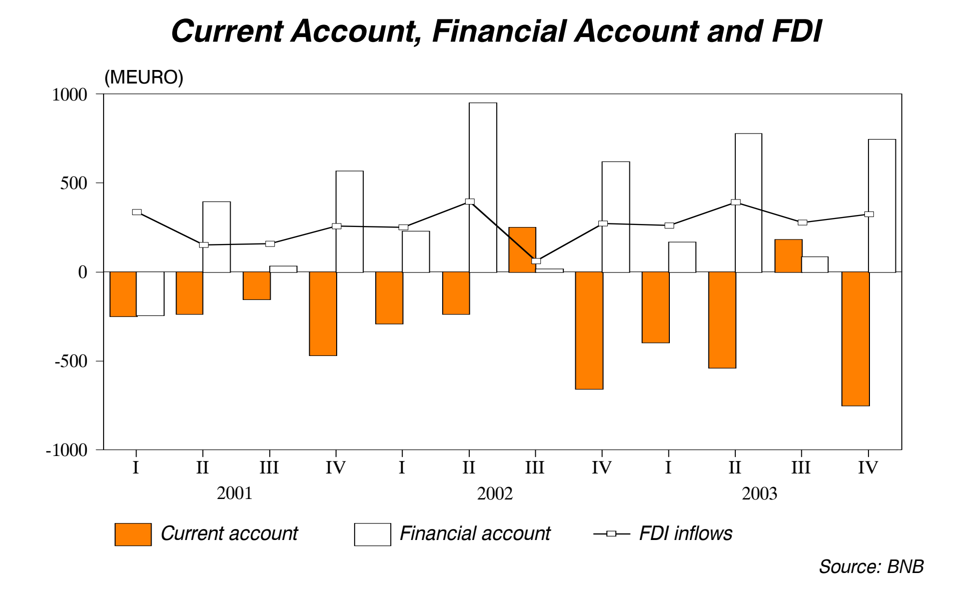
The deterioration of the income balance down to MEUR 438.6 was mostly due to the combined effect of the decreasing inflows on the credit side (-12.6%) and growing outflows on the debit side (18%). The decrease on the credit side was partly due to the low interbank interest rates worldwide, although some other items, which are normally unaffected by the interest rate dynamics such as compensations of employees, also reported some decline. On the other hand, the high growth on the credit side reflected the effect of the debt restructuring effort, which led to higher interest payments throughout the period as well as the one-time payment of dividends by a Bulgarian company to its foreign owners. Furthermore, dividend payments to non-residents are expected to go on the rise in the next couple of years with the rise in the FDI inflows into the country.

2003 net current transfers stepped up by MEUR 45.7 on a year earlier. Transfer receipts into the country reached MEUR 762.5, reporting MEUR 84.4 worth of an increase due mainly to the higher private transfers. Also, cash inflows to residents from compatriots working abroad are expected to further go up in the medium term. Net current transfers will go on covering over 30% of the trade deficit while promoting imports, consumer goods in particular, on the other hand. Following Bulgarias accession to the EU, net current transfers from the Community are expected to significantly rise.

The current account deficit was a common problem faced by the acceding countries in 2003 as well. Most of the economies, Bulgaria including, reported a drastic year-on-year deterioration in the indicator. The deficit ran the highest in Estonia (-13.7% of GDP) and Latvia (-9.1%) due, as in the case of Bulgaria, to the growing consumer loans, which in most casesw were oriented to imports and aimed at economic activity expansion.

Having declined by MEUR 40.9 on a year earlier, the financial account amounted to MEUR 1 774.3 FDIs to Bulgaria stepped up by MEUR 273.9 to MEUR 1253.9, now covering 83.7% of the current account deficit. The above growth was solely due to the *other equity* item (it reflects the change in the net liabilities arising between companies of foreign interest and foreign direct investors on financial, bond and trade credit). These are essentially intra-firm credit, which has to be repaid at some point, generating investment outflows in the future. The *share capital* item remained unchanged on a year earlier, with investment volumes in the banking sector surpassing investment in the real sector of the economy due by and large to the sale of DSK in October, which accounted for the bulk of 2003 revenue from privatisation. 2004 is expected to witness the privatisation of the Bulgarian Telecom and some companies under Bulgartac. According to preliminary data, reinvested profit reported MEUR 2.4 worth of a year-on-year increase. By country, the largest investment volumes were reported by Hungary, Greece and the Netherlands.

The *portfolio investments* of residents abroad went some MEUR 69.2 up due mainly to the higher portfolio investments of commercial banks in the second half-year period of 2003. At the same time, March payments



on the principal of Brady bonds (FLIRs and IABs) as well as the rising volumes of Brady, Euro and global bonds held by residents were the main factors at work behind the MEUR 122.8 worth of a decrease in the *portfolio investments-liabilities* item. The foreign currency deposits of commercial banks abroad shrank most drastically by MEUR 281.2 as a result of the higher lending activity in the country. The expectations are that the above trend will persist well into 2004 as well while fading away in the medium term. In addition, growing by MEUR 588.9, the *other investments-liabilities* item posted a most significant contribution to the financial account surplus. The year-on-year increase was triggered by the vigorous growth in the deposits of non-residents (MEUR 258.7) and the growing indebtedness of the private non-financial sector on financial loans (MEUR 239.8). The flow of funds is expected to follow the same direction, as the interest rate differential between Bulgaria and the EU or the USA is not foreseen to undergo any significant changes.

The balance of payments ran positive at MEUR 630.3, with the *errors and omissions* item reporting a surplus of MEUR 354.4. Net use of IMF credit stepped up by MEUR 35.3. In 2003, Bulgaria received MEUR 151.2 worth of a World Bank loan. Foreign exchange rate fluctuations excluded, BNB FX reserves rose by MEUR 816.7 on a 12-month basis. On a year earlier, the BNB FX reserves/imports (goods and non-factor services) ratio registered a significant improvement as of end-2003.

In the next couple of years the current account deficit is expected to go on the increase in nominal terms, but be fully covered by net FDI and other financial inflows and hence not jeopardise the countrys FX reserves.

❍

THE PERFORMANCE OF THE BULGARIAN ECONOMY ACCORDING TO EXTERNAL ESTIMATES

Confidence in the Bulgarian economy carried on rising in 2003, as evidenced by the upgraded credit standing of the country. Moodys and S&Ps raised Bulgarias credit rating to Ba2 and BB+ and reassessed the economic outlook as stable, as did the other two credit rating agencies Fitch and JCRA pointing to a positive outlook. The improved expectations largely derived from the countrys macroeconomic stability achieved and its accession to the EU, which will lead to a fuller integration of Bulgaria into the internal market and increase the predictability of economic performance. In addition, it should be noted that the European Commission[20] recognised Bulgaria as functioning market economy, stating that the country was now able to meet the competitive forces of the EU in the short run. The Commission has once again indicated its political and economic support to Bulgaria s candidacy by finalising the financing framework voted for on 10 February 2004.

Credit Ratings of Fitch and JCRA

	Fitch			JCRA		
Country	**Credit standing**	**Outlook**	**Date**	**Credit standing**	**Outlook**	**Date**
Bulgaria	BB+	Positive	24.07.2003	BBB-	Positive	02.07.2003
Czech Republic	A-	Stable	20.06.2003	A	Stable	01.05.2003
Cyprus	A+	Positive	04.11.2003			
Estonia	A-	Positive	22.10.2003			
Hungary	A-	Negative	15.07.2003	A+	Stable	22.03.2004
Latvia	BBB+	Positive	04.11.2003			
Lithuania	BBB+	Positive	28.01.2004			
Malta	A	Positive	04.11.2003			
Poland	BBB+	Negative	04.11.2003	A-	Stable	08.05.2003
Roumania	BB	Stable	18.12.2003	BB	Positive	17.12.2003
Slovakia	BBB+	Positive	22.01.2004	BBB+	Stable	20.02.2003
Slovenia	A+	Positive	04.11.2003			

Overall for the above countries, the credit standings are heavily dependent on their accession to the EU as well as the requirement for fulfilling the Maastricht criteria[21]. Ten of the above first-wave acceding countries joined the Union in May 2004. As for Bulgaria and Roumania, the likely date of accession is taken to be 1 January 2007. Bulgaria has already closed all negotiation chapters. However, Roumania is in a rather disadvantageous position as there are another eight chapters yet to be closed. Furthermore, The European Commission has questioned any further negotiating with the country in the wake of the corruption scandal

[20] *In its Regular Report of 9 October 2002.*

[21] *Which, among other things, include a tough and prudent budget policy.*

in the Roumanian government and evidence of illegitimate child adoptions abroad and abuse of childrens rights. At the same time, despite the improved assessments for Bulgaria, the fact remains that it is country with a relatively low credit standing vis-□-vis the remaining acceding countries.

The improved economic outlook of Bulgaria having to do with the countrys accession to the EU is also mirrored in the degree of business cooperation and depth of business relations between Bulgaria and the EU member-states. The country has become an attractive place for foreign investment.

Foreign interest in local capital is one form of business cooperation, allowing for the penetration of foreign managerial and technological know-how, which can be identified as a major weakness of the Bulgarian private companies. Another key advantage of business cooperation has to do with the exchange of experience and the introduction of innovations and the best international practices. As of March 2004, there were

Bulgarian Enterprises with Foreign Shares

	As of 2002 including		Bulgarian Enterprises with Foreign Shares In 2002		In 2003		In 2004	
	□.	%	□.	%	□.	%	□.	%
Acceding countries	662	20.9	51	18.1	59	19.6	6	18.8
Czech Republic	80	2.5	4	1.4	5	1.7	0	0.0
Estonia	4	0.1	0	0.0	0	0.0	0	0.0
Hungary	59	1.9	4	1.4	7	2.3	0	0.0
Latvia	5	0.2	0	0.0	0	0.0	0	0.0
Lithuania	1	0.0	1	0.4	0	0.0	0	0.0
Poland	25	0.8	3	1.1	1	0.3	0	0.0
Slovak Republic	22	0.7	0	0.0	1	0.3	0	0.0
Slovenia	5	0.2	0	0.0	6	2.0	0	0.0
Malta	12	0.4	0	0.0	2	0.7	0	0.0
Cyprus	449	14.2	39	13.9	37	12.3	6	18.8
EU-15	2212	69.7	199	70.8	222	73.8	24	75.0
Austria	290	9.1	27	9.6	26	8.6	6	18.8
Belgium	57	1.8	9	3.2	4	1.3	0	0.0
Denmark	33	1.0	0	0.0	3	1.0	2	6.3
Germany	443	14.0	35	12.5	31	10.3	6	18.8
Greece	364	11.5	29	10.3	34	11.3	2	6.3
Ireland	27	0.9	0	0.0	4	1.3	0	0.0
Italy	280	8.8	28	10.0	30	10.0	2	6.3
Luxembourg	49	1.5	7	2.5	11	3.7	1	3.1
Spain	45	1.4	8	2.8	8	2.7	0	0.0
Sweden	21	0.7	0	0.0	1	0.3	1	3.1
United Kingdom	239	7.5	17	6.0	33	11.0	0	0.0
Nitherlands	190	6.0	15	5.3	23	7.6	3	9.4
Finland	11	0.3	0	0.0	0	0.0	0	0.0
France	145	4.6	21	7.5	11	3.7	1	3.1
Portugal	18	0.6	3	1.1	3	1.0	0	0.0
Other	298	9.4	31	11.0	20	6.6	2	6.3
Romania	19	0.6	3	1.1	3	1.0	2	6.3
Turkey	178	5.6	26	9.3	15	5.0	0	0.0
Croatia	4	0.1	0	0.0	1	0.3	0	0.0
Macedonia (FYR)	36	1.1	1	0.4	0	0.0	0	0.0
Albania	1	0.0	0	0.0	0	0.0	0	0.0
Bosna and Herzegovina	1	0.0	0	0.0	0	0.0	0	0.0
Yugoslavia	59	1.9	1	0.4	1	0.3	0	0.0
TOTAL	3172	100.0	281	100.0	301	100.0	32	100.0

established some 3505 local companies with foreign interest from European countries[22], with Cyprus in the lead with 14%, followed by Germany (13.2%) and Greece (11.4%).

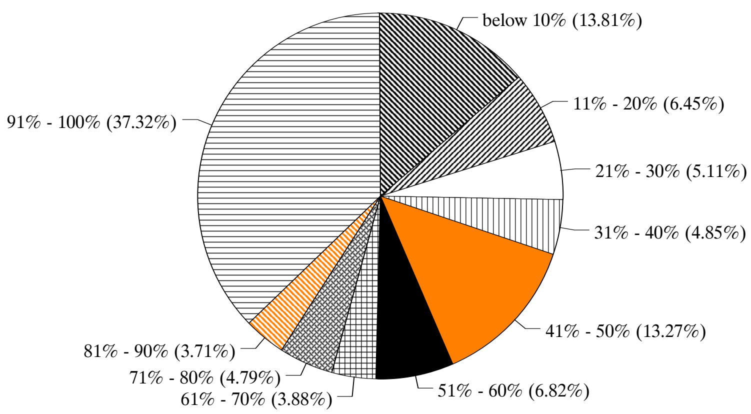
The number of branches of foreign legal entities and individuals is indicative of the countrys improved business climate and attractability to foreign investors. As of March 2004, there emerged 235 active economic agents[23], with some 15 and 27 new branches of foreign companies being opened in 2002 and 2003 respectively, as followed: 16.2% from Greece; 11.2% from Germany; 10.2% from Great Britain; and 9.8% from Turkey. Foreign companies from the Czech Republic (6.4%), Macedonia (6%) and Austria also established their own branches in Bulgaria. It is noteworthy that local company capital was dominated by foreign interest from the developed economies, e.g. EU member states. The same applies to the origin of foreign companies, opening their own branches in Bulgaria. Taking into account that company expansion in the acceding countries is yet to take place, it can be expected that they may rechannel their capital to the Bulgarian market, irrespective of the form of penetration, be it interest in local firms or by opening their own branches.

The scope of activity of local companies with foreign interest is rather diversified, with the greatest concentration being reported by services (35.9% or 1258 firms) and trade (wholesale, retail trade and intermediation (35% or 1226 firms). Of all trading companies, some 47.6% of them are involved in wholesale trade, 32.4% in intermediation, and another 20% in retail trade. It can be therefore concluded that foreign companies and investors have turned basically to business activities yielding higher capital turnover and relying on relatively low investment injections. A similar structure has been discerned with regard to foreign company branches in Bulgaria 40.2% of the branches are involved in wholesale trade and intermediation and 30.8% in the service industry.

In 1961 of the cases (55.9%) foreign companies own more than 51% of the Bulgarian company capital. The majority of firms own between 90% and 100% of the capital of the local company, indicating the long-term interests of foreign companies. In 13.8% of the cases foreign companies own less than 10% of the capital, and in another 13.3% of the cases between 40% and 50% of the local company capital.

Foreign Investment Shares in the Capital of the Bulgarian Enterprises

(as of march 2004, %)



Source: Bulstat, NSI

Foreign investors from the EU have manifested their long-term interest in Bulgaria and assessed the countrys economic outlook as positive, giving them a host of expansion opportunities following its accession to the Union and integration into the internal market. All this will lead to improved exchange of experience

[22] *According to BULSTAT data, NSI.*
[23] *According to BULSTAT data, NSI.*

and modernisation of the current capacity and technologies, and ultimately result in higher efficiency of the private sector, and hence the economy. In addition, business cooperation between Bulgaria and the above countries will create new jobs and introduce the best practices in local business culture. ❍

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