BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 1998
(semi-annual survey)

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1. The World Economy in the First Half-Year Period of 1998

Two major developments dominated over the world economy in the first 1998 half-year period. One of them was the aftermath of the mid-1997 financial and economic crisis in South-Eastern Asia. The other one was predetermined by the May Summit of the European Commission deciding on the 11 front-runners of the EMU as from January 1, 1999. Both developments had their impact on Bulgaria and will continue to influence the country's economy in the near future.

The Bulgarian economy is still in a state of recovery after the deep internal crises as of the end of 1996 and the beginning of 1997. Since the middle of 1997 a radical economic reform package is under implementation which is pointed to sustainable financial stabilization and economic growth. The success of the transformation process and its speed is dependent on the global economic development.

The Asian Crisis

The Asian crisis began in Thailand with a massive flight of short-term capital from the country and a follow-up dramatic devaluation of the Thai baht to spread swiftly all over Southeastern Asia. Practically, all currencies in the region depreciated against the US dollar. The crisis now became contagious to traditionally robust economies like South Korea and Hong-Kong.

In early-1998, the crisis in the region seemed to have been curbed, and as the May 1998 IMF World Economic Outlook pointed out financial markets had partially recovered, although all local currencies and other assets remained well below their pre-crisis levels. The crisis had a multiple effect on the global economy, affecting not only the developing countries but all emerging markets as well.

The first global effect of the Asian crisis had to do with the drastic rise in the risk premium on the developing countries' debts. Bulgaria had to put its first issue of Eurobonds planned off to a later date. This issue was intended as a signal to the financial community that the country had again embarked on integration endeavours into the international financial markets. This first issue was important in somuchas it would have provided a fresh and solid ground for assessment of the country's credit rating and investment risk that would have been useful to all foreign investors intending to start up business in Bulgaria or take part in the privatisation process. In the short-term, the crisis brought about not pre-caution but fear in investors, which in the Bulgarian case meant lower prices of the enterprises for privatisation and ebbing-out flows of foreign investment.

The second global effect of the financial crisis stemmed from the retarded growth rates of the crisis-hit economies, affecting the growth rate of the world economy. Instead of being low but positive, growth rates in the region[1] , Japan included, hovered around 4%-5% in the first half of 1998. The direct effect on Bulgaria amounted to a reduction in the country's exports to the region from USD 55.3 mln in the first half-year period of 1997 to USD 13.7 mln as a result of which its share within total export plunged from 2.3% in the first half of 1997 to a bare 0.6% in the first

[1] *Included are South Korea, Malaysia, Thailand, the Philippines and Indonesia.*

half-year period of 1998. Bulgarian exports to Japan, however, declined less substantially from USD 21.3 mln to USD 19.2 mln in the first halves of 1997 and 1998 respectively, with the share of this country remaining almost unchanged at 0.9%. The overall direct effect on Bulgarian exports was insignificant due to the small share of the region in total export. The changes in the country's export volumes, however, gave solid evidence of the crisis severity.

Bulgarian exports to Russia have been declining for two years in a row by about USD 30-40 mln on an annual basis. In the first half-year period of 1998, they fell by USD 40 mln compared to the same period of the previous year. The share of Russia in Bulgaria's total export went down from 7.6% to 6.6% in the first half-year of 1997 and 1998 respectively while Bulgarian exports to Russia, the Ukraine, Georgia and Moldova, taken together, registered a USD 107.4 mln-decline and their share within the country's total export decreased from 17.5% to 14.5%. Imports into Bulgaria from the region registered, too, a USD 135.5 mln-decline, in dollar terms.[2]

The third global effect of the Asian crisis affected the international prices of some primary goods, mainly inputs, which from mid-1997 to mid-1998 had steadily fallen by about 10% (May 1998 IMF Economic Outlook). The All Items Dollar Price Index of the Economist's Commodity Price Index, in the year to end-June 1998, registered a 22.1% fall in the prices, all food items registered a decline of 20.1%. The All Industrials Price Index of the Economist exhibited a fall of 24.3% for the

[2] Preliminary balance of payments data, published by the Central Bank.

Copper Price (USD/tonne)

Source: Monthly Commodity Price Bulletin, UN, June 1998

same period, a decline of 22.8% of non-food agriculturals and 25.5% for metals[3].

Since October 1997 prices of important inputs began falling like crude oil (by 25%[4] till March 1998) and basic foods, wheat[5] included.

Copper price provided a clear-cut example of the slump's depths.

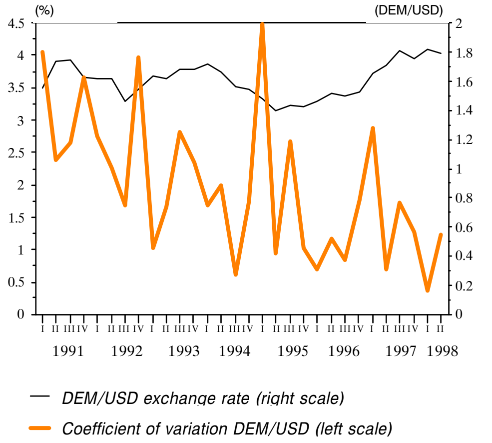
The overall international price decrease produced a negative rather than positive effect on all the developing economies, the latter being major exporters of inputs and non-processed products. In the Bulgarian case, the low international prices of metals and chemicals led to a fall in export revenues in dollar terms in the first half-year period of 1998. The cheaper import of fuels only partially offset the loss in export revenues. The decreasing international prices of primary goods favoured as well the anti-inflationary policy of the currency board in Bulgaria, in operation since July 1, 1997. From high inflation in the past eight years to hyper-inflation in early-1997, the average monthly inflation rate plummeted to 0.4% in the six months to July 1998.

The EURO

The May (May, 2) meeting of the European Council decided on the 11 front-running Member States, comprising the core of the EMU. As a result, exchange rates have been fixed on a reciprocal basis. All this raised the confidence in the euro and supported the Deutsche mark in the international forex markets. Compared to the last few years, the amplitude of the USD/DM day-to-

[3] *See The Economist, June 27 - July 3, 1998, p. 122.*
[4] *IMF, World Economic Outlook, May 1998.*
[5] *Argentinean wheat price stepped down from USD 155/ton in September 1997 to USD 125/ton in May 1998, registering a 20% decline.*

Exchange Rate Volatility DEM/USD (January 1991 - June 1998)



Source: BNB, AEAF

day fluctuations narrowed their band. The coefficient of variation hit a value high in the last week of October when the DM appreciated from 1.781 to 1719 per USD.

The Euro and the bright growth prospects for the European economies make the European Union an economic area protected from any financial crises in the emerging markets.

The growing foreign trade turnover and the exchange rate peg to the DM, the euro respectively, makes Bulgaria closely linked with the EU. This is a characteristic of the Bulgarian economy that can prove a safety belt against the crisis in the international financial markets.

Basic Characteristics of the Bulgarian Economy

In the first half-year period of 1998, the Bulgarian economy was characterised by a low inflation rate, stable lev's exchange rate, economic growth and expansion of the private sector. Household incomes and consumption went on increasing as did the country's foreign exchange reserves. In compliance with the principles of the currency board money supply increased too. The decapitalisation process in the economy was brought to an end, giving way to a rapid privatisation of all state-owned enterprises and banks.

Despite the positive developments in the Bulgarian economy supported by the IMF 3-year arrangement, the new WB's strategy for Bulgaria and the reinforced pre-accession programme of the EU, the crisis in Asia and Russia will influence unfavourably the Bulgarian economy. The crisis led to a marked change in foreign investors' sentiment and confidence, making them excessively risk avert. Most of them withdrew from the emerging markets, regardless of their fundamentals.

The present survey sets out to answer how stable the Bulgarian economy is and if it is able to stand up to the pressure of the global crisis. When the turmoil of the financial markets subsides investors will start to clearly distinguish between the countries which do and those which do not promote reliable investment opportunities. Will Bulgaria be able to join the countries which will become a centre of gravity for world capital?

Part 2 of the present survey offers an assessment of the impact of the international business situation on Bulgaria's foreign trade and the measures promoting the country's foreign trade. These measures have to do with the changes in the customs tariff and the foreign trade regime. Part 3 analyses inflation dynamics and the individual factors affecting its rate - the exchange rate, international prices, the structure of relative prices and domestic competition. The introduction of the currency board on July 1st 1997 fulfilled its task of an almost instantly curbing inflation. One-digit annual inflation, close to its rate in the developed economies, will prevent the real appreciation of the fixed exchange rate of the leva. Part 4 focuses on the developments in income and consumption. Part 5 examines the dynamics of wages and employment. Both indices grow in the first half of 1998 compared to the first half of 1997 and indirectly indicate the state of economic recovery. The regulation of the wage bill increase in the state sector is subjected to criticism. Part 6 provides a detailed study of the relation between wage dynamics and the financial results of state-owned firms.

Part 7 poses some key issues of the future development of the Bulgarian economy. The principles of the fiscal policy have been approved defending the necessity of maintaining a broadly balanced budget in the next few years. The operation of the banking system under the currency board arrangement is related to the growing confidence in the leva as a means of exchange and payments. The banking system still has to prove its credibility and improve its financial intermediator role. The major issue of Bulgaria is the sustainable economic growth which can be achieved through the process of transformation and enhanced savings incentives. Finally, the presented findings and recommendations has been summarized in the conclusions. ❑

2. Bulgaria's Foreign Trade and Balance of Payments

The Balance of Payments

Following the recovery of the Bulgarian economy and the revival of economic activity, imports began increasing at a relatively high rate, registering a 4.7% rise (fob) in the first half of 1998 on a year earlier[6]. The import of consumer goods and investment goods recorded the most dynamic increase of 54.9% and 27.0% respectively and their shares within total import represented 14.9% and 19.3% in the six months to July 1998. The group of inputs, accounting for the largest share in total import of 41.6% stepped up by 8.8% on the 1997 first half-year figure.

Import intended for domestic consumption with almost all commodity groups increased. The growth rate of textile, clothing and shoe imports was three-digit while food imports registered a 1.5-fold rise due mainly to the stable lev's exchange rate and recovery of income levels on the one hand, and the changes effected in the country's foreign trade regime, on the other.

Imports from CEFTA-countries registered the highest increase of 40%. This upward trend is likely to be further sustained following Bulgaria'a accession to the Trade Association[7]. The removal of most of EU import duties made it possible for imports from the Community to increase by 27.2% relative to the first half of 1997. Accordingly, by commodity groups, the import rise in *the machinery, means of conveyance, equipment and others*

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[6] *All balance of payments data is preliminary according to the August 1998 publication of the Bulgarian National Bank (BNB).*

[7] *On 1 January 1999 Bulgaria will become a full-fledged member of CEFTA.*

group amounted to 33%, that of the *vehicles* group to 97% while the import of *electric machinery and equipment* stepped up 62%. The import of chemicals, plastics and rubber increased by 25%.

As a result of a price decrease, the share of energy resources stepped down in total import from 33.6% to 24.2% in the first half of 1997 and the first half of 1998 respectively, the overall import decline in this commodity group amounting to 24.4% on a year earlier. The average import price b of crude oil in Bulgaria went down by 28% relative to the first half-year period of 1997. Similarly, oil imports from Russia, Bulgaria's main supplier of crude oil, decreased by 23.1%.

Fob exports due to the slump in international prices and partly to the domestic demand shrinkage decreased by 9.4% in nominal dollar terms on a year earlier amounting to USD 2192 mln. The slump affected the majority of commodity groups. Groups, registering an increase in foreign sales, had a low relative weight and therefore influenced export dynamics rather weakly. The slump spread most severely to the group of mineral products and fuels (a 38.9% decline) followed by chemicals, plastics and rubber (by 25.8%). The export[8] of cast iron, iron, steel and products thereof decreased by almost 9% in dollar value, of copper by 27%, of fertilisers by 58%, and that of organic and non-organic products by 9% and 41% respectively.[9] Most commodity groups registered an export decrease in both dollar value and physical volume. Thus for ex-

[8] *Based on data provided by the Information Centre of the Ministry of Finance.*

[9] *Here and further below only the export of Bulgarian goods for external consumption (regime 1) is dealt with, for it has no direct effect on production and GDP.*

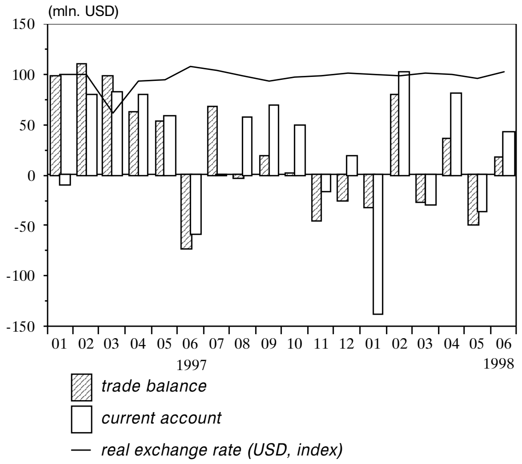
ample commodity groups with substantial weights in total export like pharmaceuticals, ethereal oils, electric machinery and equipment, sea and river vessels recorded too a reduction in dollar value.

Several examples of the negative impact influence of global price and demand decline on exports follow. The average export price of Bulgarian unrefined copper stepped down by nearly 20% while that of refined copper by 28%. The contraction in the physical volumes under both positions amounted to about 4% which accounted for a 36% overall reduction in export revenues in dollar value. Similar trends affected the export prices of other metals, zinc being the only exception which registered a rise both in the amounts exported and export revenues at a lower export price. The share of zinc, however, amounts to a bare 0.5% within total export.

The export performance of chemicals was affected by far more unfavourable developments. Foreign sales of nitrate fertilisers drastically contracted by 65% in dollar value and by 54% in physical volumes. Their average export price fell by 23%. Producers of phosphates however increased the amounts exported but the effect of the physical volume rise on nominal revenues was offset by a price decline.

Exports decline affected several commodity groups but some of them registered an expansion. The export of some textiles, timber and particularly of mineral fuels and lubricants registered an increase. Petroleum product (fuels and lubricants) recorded a 42% increase in foreign sales. The export of machinery and equipment, representing some 8% of total exports, stepped up insignificantly.

Current Account, Trade Balance and Real Exchange Rate



Source: BNB, AEAF

Cereal exports registered the greatest increase by almost 50 times. This however was solely due to the very low basis of comparison - the first half-year period of 1997 when the export of cereals was not yet liberalised and the country faced serious shortages to meet domestic demand.

Over the January-June 1998 period, Bulgarian exports to the EU markets rose by 2.7% on a year earlier, reaching USD 1083.9 mln, or 49.4% of total export due both to the continuous recovery of the growth rate in the EU and the concessional export relief granted under various agreements. Exports to the former USSR republics declined by 25.3%, the 21.5% decrease in exports to Russia including.

The impact of international prices on Bulgaria's foreign trade was unidirectional – a decrease in the dollar value of both export and import. The first half-year period of 1998 sustained the trade balance surplus which now amounted to USD 27.4 mln. On a year earlier, the country's external position deteriorated but not in the extent anticipated.

The first half of 1998 witnessed a trade balance deficit in services due primarily to the interest paid, and in a lesser degree to the negative balance of transport services. There was also a twofold increase in the receipts from tourism, from USD 89 mln in the first half of 1997 to up USD 185 mln on a year later.

The first six months to July 1998 saw a capital account surplus, which was a very important precondition for the proper operation of the Central Bank under a currency board. However, the inflow of financial resources stemmed up from the USD 342 mln worth of meduim- and long-term loans extended by the international financial organisations. Foreign direct investment amounted to USD 108.3 mln, representing a USD 165 mln decrease on a year earlier. Portfolio investment hit negative levels (-USD 7.9 mln) due to the low interest rates[10] in Bulgaria which did not provide any incentives to foreign investors to participate in the government securities market as well as due to the growing investment of local businessmen abroad.

The overall balance of payments remained positive in the first half-year period of 1998 and reached USD 293 mln, which together with the IMF credit, enabled BNB to raise its foreign exchange reserves by USD 423 mln. The assets of the Issuing Dept. hit USD 2.9 bln, or the equivalent of 6.5 months of imports and non-factor services. At the same time, the government had entered into intensive negotiations to settle the country's debt payments to foreign creditors. For example Bulgaria paid back USD 190.1 mln on some short-term obligations to former COMECON countries on clearing accounts.

In summary, the turmoil in the international markets affected negatively the foreign trade and the balance of payments of Bulgaria in the first half of 1998. However, the exports structure of the country is highly differentiated and allows for more flexible response to adverse external shocks. Some commodity groups being insignificant in volume till recently may expand in importance. The weak capital flows in and out the country was offset by negotiated official loans from the international financial institutions. hence, the foreign reserves of the country went up considerably.

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[10] *At the background of the outflow of capital from the emerging markets, it is a positive feature for Bulgaria.*

Changes in the Legal Basis of the Country's Foreign Trade in 1998

The government initiated counter-action against the negative tendencies in the development of the country's foreign trade. What followed were changes in the Customs Tariff and the 1998 foreign trade regime[11], which fully reflected Bulgaria's obligations under its WTO membership and the Europe Agreement and bilateral free-trade arrangements as well as the policy of gradual foreign trade liberalisation.

Changes in the Customs Tariff

As of January 1998 import duties[12] in Bulgaria decreased by 9.77% on average. Ad valorem duties (calculated as an arithmetic average) amount to 17.86% on average while preferential duties represent 16.21%. The general duties applicable to agriculturals average 27.45% while the duties applied to industrials average 15.25%. General and specific tariffs apply equally to the majority of positions. Since January 1, 1998 all fees on customs procedures amounting to 1% of the amount subject to customs duties (but not more than USD 700) have been removed.

The co-existence of ad.val. and specific duties as well as the combination of ad val., specific and seasonal duties persist, which in turn make the application of the Customs tariff more difficult.

There were changes in the country's trade with the EU, having to do with the implementation of the Europe Agreement. All industrials manufactured in Bulgaria are exported to EU markets duty free while EU industrial output is imported into Bulgaria at zero or 40% below the base tariff rates.

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[11] *Government Ordinance # 493 of December 23, 1997 on the country's export and import regimes published in the Official Gazette #126, 30.12.1997.*

[12] *Data from the Customs Office.*

In May a list of concessions for Bulgarian agricultural exports to EU markets at lower duty rates was adopted. The mutual concessions granted to EU-Bulgaria agricultural trade were enforced on July 1, 1997, following the negotiations on the adaptation of the Protocols under the Europe Agreement to the requirements of WTO membership. Tariff quotas will increase on an annual basis. As of July 1, 2000, the quantities exported will increase by 25 to 28%, compared to the quantities exported over the July1, 1995 - June 30, 1997 period. Preferential tariff rates normally amount to 0% or 20% of the conventional import duties applicable in the EU. For some more sensitive products as the so-called „red fruit“ the decrease has to do with the application of tariff rates amounting to 40-50% of conventional duties.

The access of EU agricultural exports to the Bulgarian market will be increasing because Bulgaria has to provide improved access under its WTO Agreement obligations. The degree of market access in Bulgaria depends on the degree of reduction in EU agricultural export subsidies. The compromise agreed will facilitate the establishment of a free-trade zone between Bulgaria and the EU, as laid down by the Europe Agreement, which will gradually encompass the agricultural sector as well.

Bulgaria finalised a number of agreements on trade liberalisation with the Czeck Republic and Slovakia (in effect since January 1, 1996) and Slovenia (since early-1998). The import duties estimated on Czech and Slovak, and Slovene products amounted to 5.84% and 7.74% respectively. The import duties on Czech and Slovak agricultural products (0.21%) and Slovene products (2.32%) are extremely low.

In 1997, there was a considerable 74% rise in Bulgarian exports to CEFTA-countries. Following Bulgaria's accession to the Association, customs duty rates on Bulgarian exports will be automatically lowered, with almost 90% of industrial exports enjoying zero rates. The duties on the rest of exports will be gradually lowered within a period of one to two years. The duties on the group of sensitive agricultural products will be removed as late as January 1, 2002. The duty rates on CEFTA imports into Bulgaria will be reduced as well. A free trade agreement with Turkey has been signed, effective as of January 1st 1999. It assumes that since the beginning of 1999 custom duties on 50% of industrials will be abolished. For the rest of the commodities, agriculturals included, customs duties will be phased out till 2002.

Changes in Bulgaria's Foreign Trade Regime

The frequent changes in the country's foreign trade regime[13] in the preceding years represented real barriers to the development of Bulgaria's foreign trade. Since 1997 there has begun the simplification of the cumbersome foreign trade restrictions. In 1998, export transactions in French beans, rice, pasta, soy oils and fractions thereof have been deleted from registration[14] procedures. Export transactions in non-processed skins of large ruminants and sheep and goat and pigs as well as software products, CD ROM, recorded audio and video cassettes have been introduced. Also subject to registration are export transac-

[13] *The country's foreign trade regime used to be established at the beginning of each year by a government ordinance, laying down restrictions on exports and imports.*

[14] *Registration is carried out by the Trade and Tourism Ministry, each application being granted a 3-month validity period from the date of registration. Registration is carried out within 24 hours following the filing of the application form required.*

tions in dairy products, wheat, maize and barley (propagating material excluded), sunflower seeds, sugar, industrially processed tobacco and tobaccos, liquid fuels, etc.

1998 saw no substantial changes in the licensing regime[15], as it is applied to all exports for which licences are requested upon entry into the EU, too. Almost all export taxes and temporary export bans were removed.

Since early 1998 Bulgarian textiles have enjoyed free access to the markets of EU and Turkey. The abolition of quotas in the first half-year period of 1998 boosted a 9.7% increase in the export of textiles, leather material, clothing and shoes on a year earlier. An important growth factor had to do with the growing competitiveness of domestic products, as brought about by the relatively low labour costs. The export of apparel and accessories (other than knitwear) stepped up by 27.2% while the export of the apparel and accessories group (knitwear) by 32%. ❑

[15] *Export transactions are registered inside a two-day period by the Trade Ministry and are granted a 3-month validity term.*

3. Inflation

Since end-1997 the rate of inflation has been steadily decreasing due not only to the impact of the exchange rate peg and stable monetary policy but international price dynamics as well. As compared to the preceding years when inflation[16] was high and volatile, the average monthly inflation rate since the enforcement of the currency board arrangement till end-June 1998 amounted to 1.45%, and in the first six months of 1998 to 0.4%.

Assessing the Impact of the Exchange Rate on Domestic Inflation

The lev's depreciation against the US currency was one of the key factors generating high inflation since 1991 to the pegging-date of the lev's exchange rate against the US dollar on July 1, 1997[17]. The effect of the exchange rate peg on price stabilisation was perceivable as early as end-1997 when 1997 last-quarter inflation amounted to 0.8% on average. In the six months to July 1998, average monthly consumer-price inflation amounted to 0.4% while the average monthly lev's depreciation against the US dollar to 0.14%. The stabilisation of the price level was brought about by the relatively stable expenditures on imported inputs as well as the more liberal trade regime relative to early-1997.

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[16] *The average monthly inflation rate ran as follows: 15.7% in 1991; 5.0% in 1992; 4.2% in 1993; 6.7% in 1994; 2.45 IN 1995, 12.55 in 1996 and 17.3% in 1997.*

[17] *The lev's exchange rate peg against the DM (BGL 1000 per DM) has been provisioned by the Central Bank Act.*

Assessing the Impact of International Prices on Domestic Inflation

International price dynamics affected most strongly the prices of tradables and potential tradables and hence the overall price index. Over the period surveyed, the prices of tradables[18] increased by 1.9% on average. In June 1998, all goods defined as tradables registered a price decrease against December 1997, the only exception[19] being sunflower oil, coffee, tea and wines. Excluding sunflower oil the price decline of tradables in the first half of 1998 is by 3.1%.

Major commodity groups with falling domestic prices have been fuels (by 10%), meat and meat products (by 12.5% on average).

All goods defined as potential tradables[20] registered a price fall decreasing by 1.8% in June against December 1997, canned fish, cigarettes, kitchen utensils, toiletries being the only exception.

Non-tradables registered a price increase by 3.1% in the first half-year period of 1998. They face no rival imports and cannot be affected by international price changes. The prices of soft drinks, beer, meal and drinks in catering estab-

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[18] The group of tradables includes all goods that do not face administrative barriers, transportation difficulties, etc. upon importation. Customs duties of and over 25% or licensing import regimes are said to be administrative barriers. All bulky goods of high transport costs or fresh unprocessed products whose quality is likely to deteriorate during transportation face transportation difficulties. Some of the commodities that fall within the tradable group are mainly food products - eggs, semi-processed meat products, citrus fruit, etc. as well as some non-food products such as household appliances, cars, electronics. The overall weight of the group within CPI amounts to 14.1%.

[19] In the four months to May 1998, the international sunflower oil price stepped up by 24.5%. Over the same period, domestic sunflower oil prices rose by 27.4%. Relative tea and coffee prices increased by 5.9% on average in the home market due to the higher international prices as a result of world supply shrinkage.

[20] The group of „potential" tradables includes all goods facing administrative barriers upon importation. The group encompasses petrol, chicken and pork meat, dairy products, finished food products, clothing and footwear, gas, medicines, etc. Their overall weight within CPI amounts to 45.9%.

lishments as well as these of some services related to rents and housing maintenance and all kinds of transport fares registered a higher rise. These goods and services accounted for 53% of overall inflation in the period surveyed, which amounted to 2.3%.

Assessing Relative Price Stability

High inflation makes relative prices unstable, which in turn grow into a new source generating inflationary pressures. Assessing the coefficients of variation, which have dramatically fallen by major commodity groups, means that prices have reached a relatively stable structure. The coefficients of variation of services registered the greatest fluctuation due to the outstripping price increase in services compared to the change in food and non-food items.

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

* *Seasonal fruit and vegetables which as rule have a very high coefficient of variation have been excluded.*

As expectations suggest the pressure for higher prices within the non-traded goods and services was strongest. The group had the largest contribution to cumulative inflation since the beginning of 1998.

Years	Tradables		Potential Tradables		Non-Traded	
	First Quarter	Second Quarter	First Quarter	Second Quarter	First Quarter	Second Quarter
1997	34.4	5.5	36.9	9.0	38.0	9.1
1998	3.2		3.6		5.2	

The stabilisation of relative prices was brought about by several factors at play: price levels in the home market stood closer to international prices compared to 1991; the relative weight of monitored prices in the consumer basket amounted to 15.8% while in 1991 it represented 32%; the exchange rate peg contributed to price stability. It can therefore be concluded that consumer prices reached a relatively stable level.

Assessing the Impact of the Level of Competition on Inflation

Foreign trade and price policy liberalisation has provided good ground for expectations that the level of competition in the Bulgaria domestic market will improve. Competition is a powerful instrument of curbing inflation by lowering its rate and maintaining prices a level not higher than the possible prices of imports, adjusted for taxes.

The assessment of the level of competition employs the DC-4[21] index of concentration and the Herfindahl-Hirschman index (HHI)[22] . In the final analysis, the estimations of both indices point to similar findings, i.e. that the level of competition in the country is very low.[23]

Concentration of Industries

(relative share of the number of industries in a given interval)

DC-4	% of all Industries		
	USA	Bulgaria	
		Revenues	Assets
80-100%	5	50	43
60-79%	12	19	17
40-59%	26	15	16
20-39%	37	13	14
0-19%	19	3	10
Total (%)	100	100	100
Total number of industries	**451**	**363**	**363**

Source: Clive S. Gray and Anthony A. Davis,
The Antitrust Bulletin/Summer 1993.
For Bulgaria - AEAF

Distribution of Industries by the HHI

Degree of concentration	Number of industries		Relative share of industries (%)	
	Revenues	Assets	Revenues	Assets
Full – 10 000	29	29	8	8
High – 1 800-10 000	193	180	53	49
Moderate – 1 000-1 800	70	63	19	17
Low – 0-1 000	72	92	20	26
Totals	**364**	**364**	**100**	**100**

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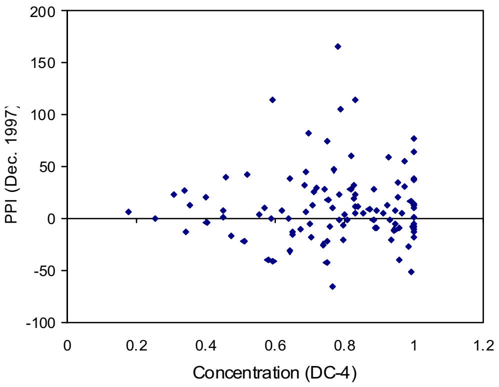
[21] DC-4 is a measure of concentration which stands for the ratio of revenues of the four largest firms in an industry to total revenues in the same industry.

[22] The Herfendahl - Hirschman idex is the sum of squares of relative shares of all firms in an industry.

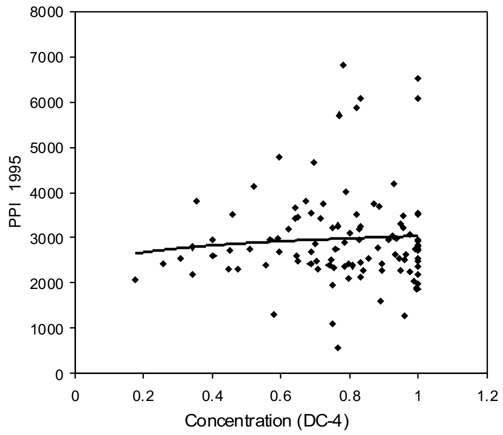
[23] For more information see Radoslav Krastev ,Free Trade or Protectionism. Competition as an Anti-Inflationary Factor, AEAF.

Short-term Correlation Between Concentration and Producer Prices by Industries



Source: AEAF

Long-term Correlation Between Concentration and Producer Prices by Industries



Source: AEAF

In the first half-year period of 1998, the level of competition by industries did not affect producer prices.[24]

It can be expected that the long-term correlation between prices and concentration will be more prominent. The distinction between short- and long-term periods is only provisional because what matters in an economy are not physical time limits but qualitative change in the economic environment. Using the PPI estimates (1995=100) gives some support to the theory that the monopoly power favours a higher price growth rate.

The analysis has not detected a statistically important correlation between the degree of concentration and producer price change, especially in a short-term perspective. Instead, an important relationship between the degree of concentration and price stability has come to the fore: industries with the largest price fluctuations manifest a high degree of concentration and the higher the concentration is the more unstable price behaviour. The unstable price behaviour in industries with a high degree of concentration has been confirmed by separating the industrial branches into two groups. The first sample embraces industries with a degree of concentration[25] below 0.5 for which the coefficient of variation relative to the average PPI stands at 22. The second sample covers industries with a high degree of concentration (over 0.5) where the coefficient of variation amounts to 48.

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[24] *The correlogrammes reflects producer price change in the .industries under the National Branch Classification by the third digit of aggregation. Included are 104 industrial branches while the power generation and distribution industries (electricity, heating and water) where prices are government -monitored have been excluded.*

[25] *The setting of quantitative limits in the distinction of concentration into high and low is subjective. It is assumed that industries with DC-4>0.4 are industries with a high degree of concentration. As there are very few industries falling below this limit in Bulgaria, the index has been lowered to 0.5.*

In conclusion, in the period surveyed, the effect of the fundamental factors on inflation did not refute the expectations made and led to its decrease within normal limits. Inflationary expectations[26] decreased and thus created predictability of the economic activity and investment climate in Bulgaria.

To summarize, first half 1998 inflation behaved as expected by going down considerably. Inflationary expectations subsided, too, establishing predictable and friendly environment for active business and investment. Prices of non-tradables represent the major source of inflationary tension while the fixed exchange rate and prices of tradables pressed down inflation. ❑

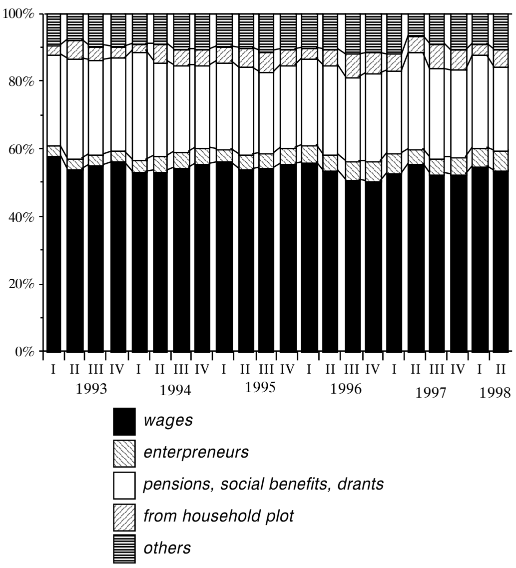
[26] *As revealed by the National Statistical Institute (NSI) monthly entrepreneurial surveys which are incorporated into the NSI* Business Situation *publication.*

4. Incomes and Consumption

Real Money Income - Seasonally Adjusted

Source: NSI, AEAF

Household Money Income



Source: NSI, AEAF

The steady growth of real income and consumption was the aftermath of the economic stability achieved, especially after their hyperinflation-induced collapse in early-1997. The overall real-term income increase, as recorded by the households budget surveys[27], amounted to 76% in the first half-year period of 1998 on a year earlier. The high income growth rate was indicative of the income recovery, following the dramatic decline especially in the first quarter of 1997. Compared to incomes in the second half of 1997, income increase on a year later, slowed down considerably. In real terms, incomes in the first half-year period of 1998 stepped up by 2.2%, relative to the second half of 1997. Over the January-June 1998 period, incomes from property registered the greatest rise of 188%, followed by non-wage income (by 104%) while income from wages increased by 75% in real-terms on a year earlier.

Despite the different dynamics of the various forms of incomes in the period reported, wages income[28] accounted for the largest share within household money income surveyed by the National Statistical Institute (NSI), followed by income from the budget and state social security funds - pensions, social aid and compensations, children allowances, unemployment benefits.

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[27] *The survey is conducted on a monthly basis by the National Statistical Institute (NSI).*

[28] *Wage dynamics will be paid special attention in the next chapter.*

Income from Pensions

Average Pension Expenditure per Pensioner in Real Terms*

* Base December 1995 г.
Post expenditures were changed from 6,5 per mille to 8,5 per mille since May 1998

Source: NOI, NSI, AEAF

In January, pensions underwent a one-time mark-up of 5% for the first half-year period of 1998, with the country's social pension now increasing to BGL 30350. The ratio of the average pension expenditures per pensioner to the country's average wage stepped down from 31.5% in January to 29.1% in May.[29]

Wages outstripped pensions due to the low inflow of social security contributions to the Social Security Fund. Although since the beginning of 1997 the pension has been related to the insurance income[30] of every month following January 1, 1997 this seems to have not provided a strong enough incentive to increase the insurance base income of those employed in the private sector. This was the reason behind the low inflow of social security contributions which did not allow for any substantial change in the average expenditures on pensions.

The financial problems the Social Security Fund is currently facing will be resolved by an all-embracing restructuring of the social security system which is already in progress. The establishment of a three-piller pension system with two pillars of the fully funded kind and based on the development of private pension funds is forthcoming.

[29] *In July there will be another pension adjustment based on BGL 78 500 of wage following a Decision of the NSSI of May 19, 1998, OG #67,1998. The increase in the average pension expenditures per pensioner (over the July 1997 - July 1998 period) will amount to 20%.*

[30] *Before the change the pension was related to the wage in selected three years of the overall period of labour experience. Now the requirement is to add to these selected three years income the insurance income on a monthly basis since January 1997.*

Income from Various Forms of Social Aid

Incomes from social aid[31] depend on the base minimum income which was already twice increased in the first half-year period of 1998 (in January and April by 9.3% and 4.6% respectively). The base minimum income is conditional on the ability of the government to guarantee a certain level of income and does not reflect the cost of the primary necessities in life. BGL 13 192 851 thousand worth of aid was paid up, supporting 154 462 people or households[32] under the Social Assistance Regulations.

Apart from the low-income group-targeted aid, social assistance[33] also include money aid that is distributed by other criteria such as children allowances, sick leave payments, etc. This was the main reason for the relatively even distribution of social benefits by decile groups, i.e. independently of the income level of individual households. The share of social benefits within the money income of the lowest income group of households[34] (the 1st decile group) averaged 5.4% in the first half-year period of 1998 against 3.6% on a year earlier.

The even distribution of social aid among households was nothing but a sign of the low efficiency and prodigality of the social aid system. The reform of the system has already been launched and is firmly based on the principle of family support, thus freeing resources that will be targeted to the low-income households.

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[31] In May,the Social Assistance Regulations underwent an amendment concerning the coefficients for disabled persons and the income on the basis of which aid is determined.

[32] Based on data as at August 4, 1998 of the Ministry of Labour and Social Policies.

[33] Based on sample data from NSI household budget surveys.

[34] Based on NSI household budget data.

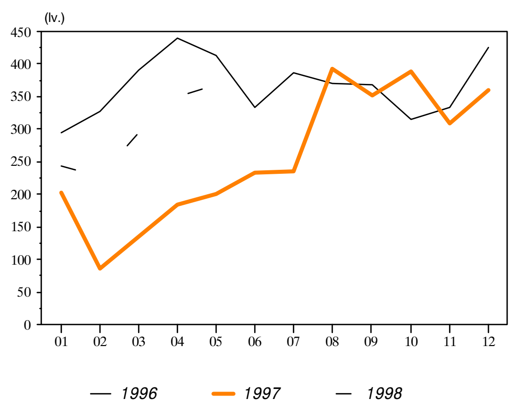
Distribution of Income from Social Aid by Decile Groups (on a monthlybasis, as %)*

Decile groups	1	2	3	4	5	6	7	8	9	10
Jan'97	8.3	8.2	9.0	5.5	6.4	8.3	8.5	16.5	12.0	16.9
Feb.	7.7	9.0	9.5	8.5	6.6	8.4	9.9	9.7	17.0	13.8
March	9.0	9.3	6.8	9.6	13.7	11.4	9.1	10.5	8.9	11.6
April	8.6	10.2	8.3	7.7	10.3	13.6	15.0	10.5	7.5	8.3
May	10.4	8.0	8.1	9.9	9.9	12.6	12.6	12.7	7.7	8.1
June	8.6	9.9	6.8	7.6	12.2	9.9	10.7	9.4	9.8	15.2
July	9.6	10.8	8.4	10.8	11.1	8.2	5.8	7.8	14.9	12.6
August	9.5	13.7	6.8	13.7	7.8	8.6	9.8	8.1	10.2	11.8
Sept.	11.1	10.2	9.5	7.3	6.8	10.4	16.1	5.6	6.5	16.4
Oct.	9.1	10.2	5.7	10.4	12.1	10.2	9.7	11.0	7.6	14.1
Nov.	8.2	4.9	13.1	11.1	8.8	4.0	14.4	11.0	12.2	12.3
Dec.	8.3	7.9	6.9	8.2	13.7	8.9	10.6	11.7	9.4	14.4
Jan'98	8.3	6.1	11.9	3.0	9.8	7.7	8.0	9.8	14.1	21.1
Feb.	11.6	8.9	9.5	6.7	12.1	12.4	12.3	11.2	6.3	9.2
March	10.2	12.4	7.8	9.5	8.5	9.3	8.0	10.3	14.4	9.6
April	9.9	9.7	7.6	11.0	10.5	13.2	10.6	13.2	9.4	4.9
May	8.6	7.5	6.2	10.6	6.2	9.4	8.6	7.8	5.6	29.2
June	7.8	10.1	7.6	13.7	4.7	9.9	7.3	18.0	7.4	13.4

** The first decile group represents 1/10 of the households surveyed belonging to the lowest income group. The relative shares reported are estimated as the ratio of the average income from social aid in a given decile group to the sum of the average income from social aid by decile groups, based on the households surveyed by the NSI.*

Income from Economic Activity

Income from Economic Activity in Real Terms*



** Base December 1995 г.*

Source: NOI, NSI, AEAF

Income from entrepreneurship, ownership and household production continued to play an auxiliary role for many households. Yet, it was and still is a way to increase total household income. Its share within the money income of the low-income groups did not exceed 10%, but was twice as higher as this with most of the high-income groups. Furthermore, the distribution of income from economic activity among the decile groups of households was extremely uneven. Households in the last tenth group generated half of their income out of business activity.

In the first half-year period of 1998, income from economic activity increased by 77% on a year earlier. It will grow in importance with the development of private entrepreneurship.

Consumption

Household consumption was gradually recovering to set back at its end-1996 levels. On a year earlier, following closely income dynamics, it increased by 76% in real terms over the January-June 1998 period. Relative to the second half-year period of 1997, consumption registered a 3.2% real-term increase in the first-half year period of 1998.

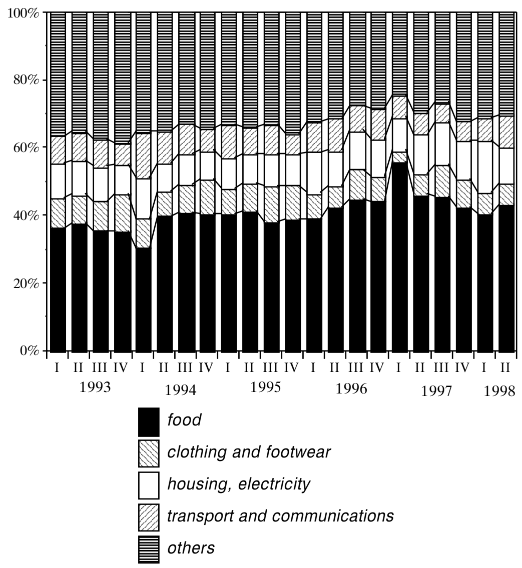
Over the period reported, the different household expenditures were growing at different rates, with expenditures on education and leisure time as well as on clothing and shoes and household production registering the highest increase of 213% (real-term), 128% and 128% respectively. There however was a substantial shrinkage in the consumption of the above products last year, which was now steadily recovering. Within the structure of consumption food expenditures remained relatively high.

Despite the upward trends discerned, consumption and hence household income continued to hover around their October-November 1997 levels, in real terms. The higher growth rates of consumption over incomes coincides with an aggressive expansion of consumption credits since mid-1997. Growing domestic demand favours economic growth but it also endangers the trade balance. However, the trade balance for the first half of 1998 is nearly balanced and imports of consumption goods grows as well as imports of investment goods. ❑

Real Money Expenditure - Seasonally Adjusted

Source: NSI, AEAF

Household Money Expenditures



Source: NSI, AEAF

5. Wages and Employment

Wage Dynamics in the State Sector

The first half-year period of 1998 witnessed a slight upward trend of the public sector wage. In end-June 1998, it surpassed its December 1997 level by about 2% at constant prices and registered a 6.5% increase against June 1997 wages.

The comparison of wages by months (especially when they are quarter- or year final) may bring out some misguided conclusions due to bonus payments made at that time of the year. This effect can be eliminated if assessment draws upon quarterly data. The average real wage in the public sector in the 2nd quarter of 1998 stepped up by over 5% on the 1997 last quarter figure and by 12.5% against the average wage on a year earlier. The decreasing inflation rate contributed to real wage growth. June witnessed negative inflation of -1.8% while cumulative inflation in the six months to July amounted to 2.3%, or well below inflationary expectations.

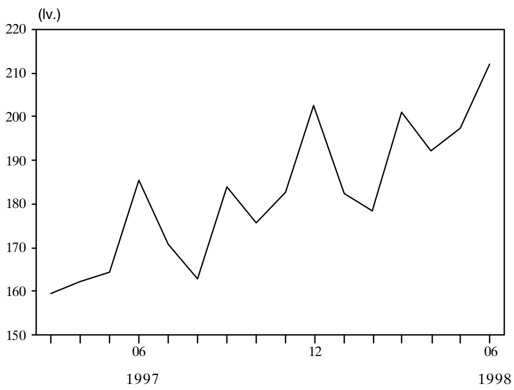
Real Wages in the Public Sector (constant prices - Dec. 1990)

Source:NSI, AEAF

Wage dynamics largely depends on all parameters of firms' business activity as well as the trends in their financial conditions. If the forecasts for real income growth generated in the economy in 1998 verify, the public sector real wage can be expected to significantly restore its mid-1996 pre-crisis levels.

Average wage dynamics in the private sector cannot be compared to previous periods because the NSI has started to report official data on its monthly dynamics as late as early-1998. Furthermore, any comparison between average wage levels in the private and public sectors will be inaccurate, for its is not clear whether private

Real Wages in the Manufacturing (constant prices - Dec. 1990)



Source:NSI, AEAF

sector wage is undervalued or overvalued. Private firms tend to report lower than the actually paid out wages for the purpose of decreasing the amounts of due wage payments such as social security contributions or unemployment benefits. On the other hand, the NSI surveys of wage-based income, conducted on a regular basis, encompass no more then 40% of private firms, usually leaving out small firms in the trade and service sector where wages are lower than the sector's average. In January when the NSI enlarged the scope of its monthly employment and wage surveys, incorporating the private sector, the average wage level decreased by 18% against December 1997 and by 10% against October 1997. which should be attributed entirely to the lower wages in the private sector.

Average private sector wages remained unchanged in the first half-year period of 1998, March and April being an exception when wages repeatedly increased by 4.2%. Minus bonuses, the increase amounted to 3.6%. Average wage growth in the private sector in these months was most probably caused by the change in the country's minimum wage as a result of the correlation between the individually contracted wage and the country's minimum wage.

Regulating Wage Growth in the State Sector

On a quarter earlier, according to a survey of 3058 state-owned firms[35], the wage bill paid up (social security contribution included) increased by 5.5% in the 2nd quarter of 1998 in real terms. The wage rise should not be a problem if it did not coincide with a decline in sales. Data on state

[35] *Surveyed on a quarterly base by NSI.*

sector gross output[36] for the first half of 1998 are contradictory[37]. Revenues from sales in constant terms[38] decline by 6.9% in the second quarter of 1998 compared to second quarter. The firms in the survey suffer a decline in sales at the domestic market while the increase in exports revenues is by 14.8% in nominal terms. Consequently the share of exports in overall sales increased to 31.2% in the second quarter compared to 25.5% in the first quarter.

The likely reasons behind the increase of wage bill at the background of falling nominal revenues from sales ran as follows:

- Firms from the public sector which had made a balance sheet profit and were not defaulting on their loans to creditors were free to form their wage bills in accordance with their financial results. Their wage policies were not by any means restricted by law or a government ordinance even when their output went on the decrease. The parameters of regulation take into account the current conditions of a firm but disregard its financial results over a longer span of time. With a view to long-term viability and competitiveness, it is therefore reasonable to subject to regulation profit-making firms without due liabilities, binding wages to labour productivity improvement against the preceding period.
- According to data provided by the NSI and the Ministry of Labour and Social Policies, the bulk of SOEs (state-owned enterprises) where wage bill growth is subject to regulation tended

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[36] *Inputs costs included.*

[37] *Contradiction springs from the different dynamics of revenues from sales (falling), employment (growing) and average wages (growing), financial indicators stable.*

[38] *Deflated by quarterly average PPI.*

to violate current legislation. According to estimates of the Agency for Economic Analysis and Forecasting, about 20% in the 1st quarter and 23% in the 2nd quarter of 1998, registered a wage bill increase, though they had proved loss-makers or had credit in arrears.

To summarize, the wage increase in the surveyed state-owned firms is not related to improvements of efficiency or labour productivity. The latter based on net value added (depreciation excluded) falls, revenues from sales go down too, employees grow in number. So, there is a process of redistribution of value added from the owner of assets - the state, to the workers. Hence, financial resources for innovation and investment squeeze in size.

In 1998 Trade Union organisations have openly questioned wage bill growth regulation in public firms. The overriding argument is that current regulation imposes hard restrictions and disallows firms in good financial condition to raise wages.

Clearly, such arguments do not derive from any legal provisions as there are no such restrictive texts. Neither can they be supported by real wage dynamics data in the public sector in the first half-year period of 1998. Under the current government ordinance, all firms registering higher sales revenues and without credit arrears to their creditors are practically left out of wage bill growth regulation. State-owned firms which for one reason or another cannot meet any of the above requirements may run into a great deal of trouble. Many public firms have increased their wage bills, despite the current regulation.

The current regulatory rules are common and universally applicable to all firms. They however are neutral to the business activity of all public enterprises and therefore cannot be said to prompt too excessive an intervention in the economy on the part of the administration. Other regulatory framework propsed, especially branch level wage negotiations, may reinforce administrative intervention while pursuing the opposite effect.

The elimination of wage bill growth regulation in public firms is highly unacceptable due to:

- A major challenge to the government economic policy is to bring the generation of deficit into the economy to an end. If it is a private firm, such deficits may lead to a change in ownership (management) or its bankruptcy. If it is a SOE, the generation of deficits is very unlikely to cause the firm's bankruptcy, but rather, under pressure - to bring about a transformation of its losses into a government budget deficit. Runaway wage bill growth is one way to run hefty quasi-fiscal deficits in the public sector (financial losses), posing real danger for future runaway budget deficit growth.
- Runaway wage bill growth, without being related to labour productivity improvement, may lead to a decrease in the competitiveness of SOEs, and all other conditions being equal, it may also weaken their market potential.

The completion of the privatisation process is a natural way to remove wage bill regulation. The government cannot directly interfere with the wage policy of private entrepreneurs. It can only passively intervene in the income levels by way of the minimum wage and average wage dynamics in budget organisations, adjusted to the overall development of the economy, and thus avoid labour market pressures.

Employment

In the first half-year period of 1998, the number of registered unemployed sharply decreased to reach 434674 in end-June, stepping down on the end-1997 figure by 90 000. The unemployment level (as estimated on the basis of the number of registered unemployed) decreased from 13.7% to 11.4% over the same period.

The structure of registered unemployed underwent certain changes in the first half-year period of 1998. The share of unemployed without any qualification registered a drastic rise. In end-June, they accounted for 62.4% of the unemployed workforce, with their relative weight further tending to grow. In case as a result of the structural adjustment of firms, the number of qualified registered unemployed increases and the share of poorly qualified unemployed is expected to decline. Similarly, over the July 1996-April 1997 period, the inflow of lay-offs increased as a result of the overriding economic crisis in the country. The increase, however, will fail to produce a lasting effect because once the process causing it has faded away (in our case the employment reduction expected as a result of firm management optimisation) the number of unemployed without professional qualification will again go on the increase for they stand little, if any, chances to find a new job. Over the period reported, the share of long-term unemployed was steadily growing, too. In end-June, the share of unemployed with an over a year period of registration reached 38% against 21.5% in end-June 1997 and 29% in end-1997. The share of unemployed that have entered the unemployment registration lists of labour agencies more than twice increased too. In end-June 1998, they represented 54.2% of the unemployed total against 51.9% in end-1997.

It can therefore be concluded that there has been a stable core of unemployed, standing minimum chances to find new jobs. It embraces unemployed without any professional qualification who can only enjoy temporary employment. Even positive real economic growth will have little effect on the reduction of the unemployed cohort without qualification. On the one hand, there are all the potential possibilities to improve labour productivity on the job, which in turn will increase output at a relatively stable and permanent employment level. On the other, the core of long-term unemployed because of their outdated skills, would run up against a great deal of difficulty in finding new jobs, given even an aggregate labour demand increase. Unemployment-related measures having to do with qualification improvement or re-training should therefore be enhanced.

According to the end-June 1997 Labour Force Survey data provided by the NSI, the reduction in the number of unemployed approximated the registration data gathered by labour agencies. Over the November 1997 - June 1998, unemployed decreased by 95.3 thousand. At the same time, total labour force increased by 23.5 thousand indicating economic recovery and growth. In either case, the change in the employment indices performance was brought about by a rise of 118.8 thousand in the number of employed. Another factor contributing to employment growth in the first half-year of 1998 had to do with the growing seasonal demand for labour.

The total number of employed increased as a result of a rise in the number of both those employed in the private sector by 165.2 thousand and self-employed by 33.9 thousand. At the same time, the number of employed in the public sector decreased by 74.2 thousand due, alongside other factors, to the ongoing privatisation process. On a net basis the contribution of the private sector to new job creation can be evaluated at 90 thousands - an impressive development of the sector in Bulgaria. ❑

6. Financial Conditions of SOEs

Privatisation of SOEs

The size of the state sector has been steadily decreasing. By number of the privatisation deals contracted (414), the first half of 1998 recorded the most essential results ever since the privatisation process has been launched. If this is one of the criteria to assess privatisation, the process can then be said to have sped up considerably in the first half year period of 1998, as compared to throughout the 1997 period. Over the January-June period, the Privatisation Agency[39] sold out 233 whole enterprises and 181 self-sufficient units of enterprises, surpassing the 1997 figure on a year earlier, by 103 and 57 respectively. The number of deals contracted in the first six months to July 1998 represented 85% of all deals concluded throughout 1997. By institutions, the Ministry of Industry reported the highest number of deals contracted of 110 (against 108 throughout 1997), followed by the Trade and Tourism Ministry (96 deals) and the Agriculture Ministry (66 deals).

If the pace and efficiency of privatisation are judged by its financial effect, it can be said that there was some delay mainly in the sale of core SOEs to strategic investors. The payments contracted in the six months to July 1998 accounted for 43% of 1997 payments, while the investment commitments made represented only 17% of their last year's level. The direct and overall effect of sales were indicative of the low privatisation receipts over the period surveyed.

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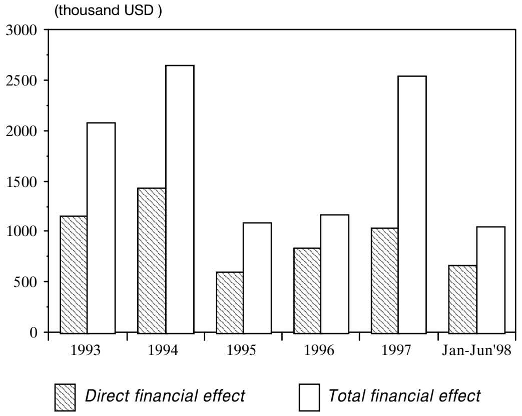
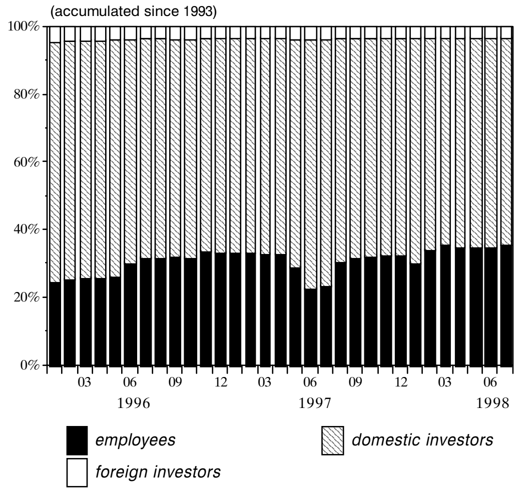
[39] *Privatisation Agency data.*

Direct and Total Financial Effects from a Privatization Deal



Source: PA, AEAF

Privatized State-owned Enterprises by Categories of Buyers



Source: NSI, AEAF

One of the reasons behind the postponement had to do with the delay in the selection of international consultants and long deadlines of 18 to 20 months to sell out SOEs via foreign intermediation. Over the period surveyed, there were no sales reported of the size of Sodya-Devnya or the cement plants privatised in end-1997.

Another reason for the low privatisation receipts had to do with the structure of deals, dominated over by manager-employee-buy-outs (MEBOs), relying on preferential treatment in making installments on the privatisation deals[40]. They in turn lowered the current value of the price of the firm.

A third reason related to the Asian and Russian crises which forced investors to retreat from the emerging markets and made the prices of the firms under privatisation procedures knock down. Lower prices, too, brought about a delay in the privatisation process.

Privatisation will carry on in the next year as well. As long as there are firms in state ownership, control over their financial conditions should be strictly exercised, thus avoiding the accumulation of quasi-fiscal deficits.

Financial Conditions of SOEs

In the first half-year period of 1998, firms from the public non-financial sector as a whole reported poorer results, compared to end-1997 due mainly to the seasonal profile of production. In the second quarter, however, there was a slight improvement on a quarter earlier.

While in the 1st quarter of 1998 51.4% of firms reported negative financial results (before tax),

[40] *The amendments of the Law for privatization adopted in April 1998 curtailed many of the preferences for the MEBOs.*

48.8% of them was profit-making and 8 firms made neither profit nor loss, in the 2nd quarter 38.4% of the firms was loss-making, 61.4% - profit-making and 9 enterprises reported neither profit nor loss. As a whole, the sector closed the first half-year period on a gross profit (before tax) amounting to BGL 490 bln, with 55% of the profit made in the 2nd quarter alone. Nine enterprises accounted for 70% (end-1997), 73% (March 1998) and 68% (June 1998) respectively of total profit in the sector while ten firms generated about 52% (March 1998) and 56% (June 1998) of total loss in the sector.

As of June, gross profitability of sales (the median value) amounted to 0.88% against -1% in March and 1.43% in end-1997. Profitability shrank as a result of the growing depreciation allowances due to assets revaluation[41] as well as real wage bill growth. Low, almost zero, inflation contributed to the decline in profits compared to previous years by eliminating accounting profits arising from price differentials of inputs.

The structure of expenditures indicated that despite expectations of financial deterioration upon assets revaluation, firms failed to pursue a restrictive wage bill policy, a relevant observation especially in the 1st quarter of 1998 when profitability of sales was almost nil and wages were steadily increasing. In the 2nd quarter of 1998 there was a certain adjustment discernible in the economic behaviour of firms which now kept labour costs almost unchanged while improving their

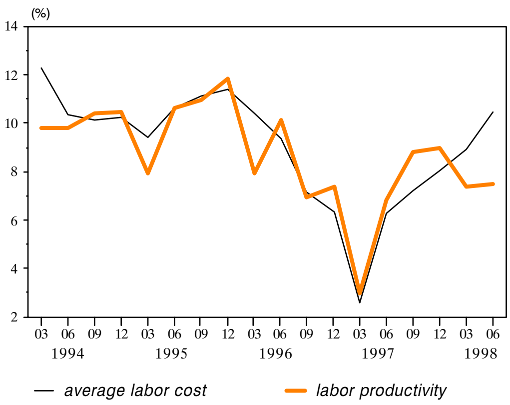
[41] End-1997 and 1st quart. 1998 estimates are based on a sample embracing 3800 firms in the public non-financial sector. 1998 first half-year period estimates draw on a sample covering 3284 firms. Real change is the difference between the 1st and 2nd quarter of 1998 values and 1997 last quarter values, estimated at December 1997 producer prices (the number of firms being equal in each pair of periods).

financial results. Nevertheless, the behaviour of enterprises in the first half-year period of 1998 resembled the behaviour of labour managed firms aiming at maximization of wages rather than profit.

	Structure of expenditures			As percentage of sales			Real change*	
	4th quart. 1997	1st quart. 1998	2nd quart. 1998	4th quart. 1997	1st quart. 1998	2nd quart. 1998	1st quart. 1998	2nd quart. 1998
operating	88.16	93.34	92.69	94.88	100.52	101.52	-6.94	-9.98
inputs	45.91	45.39	39.51	49.41	48.89	43.37	-13.09	-25.33
external services	9.17	7.85	10.52	9.87	8.46	11.54	-24.72	-1.32
wage bill	9.93	11.68	12.10	10.69	12.58	13.28	3.38	4.03
social security contributions	4.53	4.98	6.14	4.87	5.37	6.74	-3.27	15.95
depreciation allowances	0.53	4.19	6.09	0.58	4.51	6.68	588.26	874.68
other	2.72	3.05	2.95	2.93	3.29	3.24	-1.27	-7.81
financial	6.58	5.40	4.89	7.09	5.82	5.37	-27.87	-36.94
interest	2.01	1.84	1.26	2.16	1.98	1.38	-19.49	-47.87
contingency	5.26	1.26	2.42	5.66	1.35	2.66	-79.00	-59.91
total	100.00	100.00	100.00	107.63	107.70	109.76	-12.10	-14.48

* *On 4th quart of 1997 basis; deflated by the CPI against December 1997; the observation covered 2885 firms.*

Average Labor Cost and Labor Productivity in Public Nonfinancial Sector*



* *Consumer price index March 1994 = 100*

Source: NSI, AEAF

The level of labour productivity, as estimated on the basis of the net value added[42] per employee, in the first and second quarters of 1998 went down by 17% and 16% respectively against its end-1997 levels.

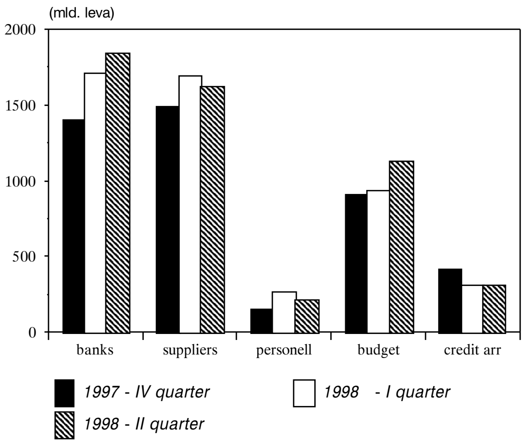
This was mainly due to the changes in the structure and volume of expenditures already cited, which led to deterioration of firms' financial results. Productivity in the first quarter of 1998 registered a 2.5-fold increase on a year earlier but remained well below its 1995 levels (the high-

[42] *Depreciation allowances excluded, in real terms; deflated by the PPI (March 1994=100).*

est levels over the 1994-1998 period), declining at a faster rate compared to labour costs. Solution to the problem is to be sought along two main lines: elimination of excess labour in the public sector and technological innovation.

Key issue of Bulgarian current economic policy is the imposition of hard budget constraints on all economic agents. Dynamics of indebtedness serves as an indicator of the existence or not of financial constraints in the state-owned firms.

Public Nonfinancial Sector's Indebtedness



Source: NSI, AEAF

In the 1st quarter of 1998, firms' indebtedness increased by 50% relative to end-1997. The second quarter witnessed its nominal decline while the ratio of liabilities to sales rose from 80% in end-1997 to 150% in end -March to further up to 180% in end-July 1998. Obviously, the fall in nominal revenues from sales was not matched by corresponding decline in liabilities at least in the very short run. It means that firms should urgently make steps to adjust their liabilities to the medium term trends in the business situation.

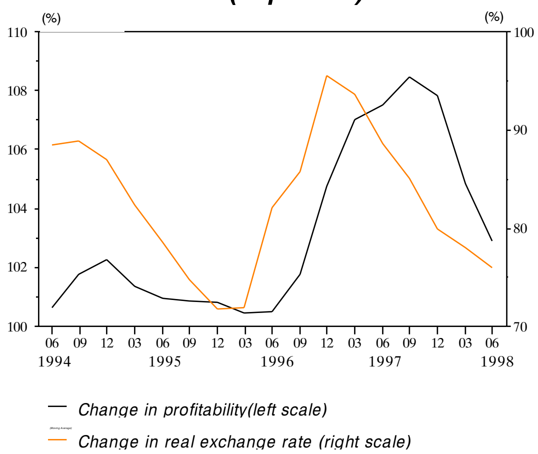
Liabilities of firms in real terms decreased to suppliers by 10.4% and to commercial banks by 14.7% (in the second quarter of 1998 relative to the first). However, their liabilities to the budget increased in real terms by 16.3%, including arrears on social security contributions. The government has identified itself as the most tolerant creditor softening as usual the budget constraints of the firms, especially for those in a weak financial status. However, the problem should be resolved till the end of 1998 by the implementation of schemes for reduction of liabilities to the budget.

The relations between SOEs and banks have been improving. Over the January-March 1998 period, total overdue credit decreased by 20%

against 1997, while the amounts of credit used went on the increase. according to the data from state-owned firms financial accounts survey the long-term loans have been raised by 2.5 times as of June 1998 compared to December 1997. Financial stabilization and overall predictability allow for long-term lending. As borrowing means growing indebtedness, firms should improve their management so as to guarantee the regular servicing of their loans.

The Impact of the Exchange Rate Peg on the Financial Conditions of Firms

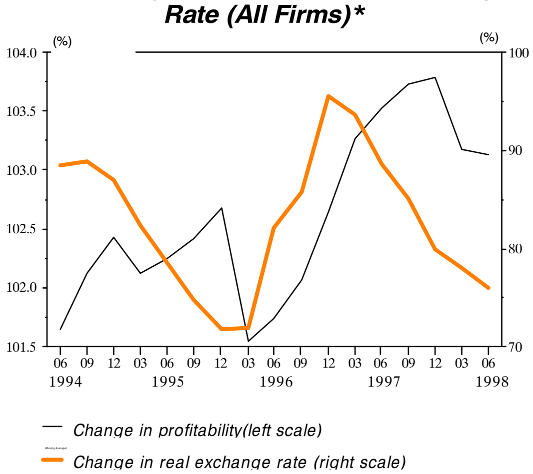
Profitability of Sales and Real Exchange Rate (Exporters)*



* March 1994 = 100

Source: NSI, AEAF

Profitability of Sales and Real Exchange Rate (All Firms)*



* March 1994 = 100

Source: NSI, AEAF

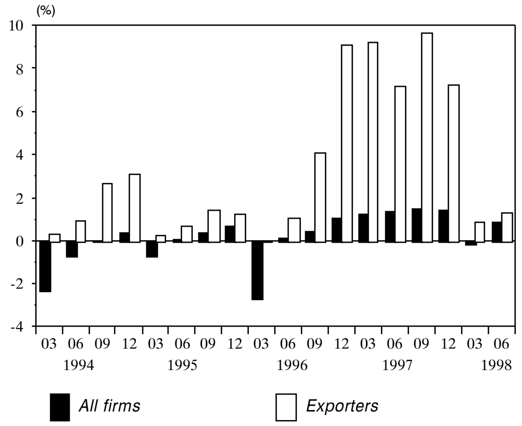
The financial results of exporters, defined as firms having a share of foreign exchange receipts in sales revenues over 50%, were influenced by fluctuations in the lev's exchange rate against the US dollar with a certain lag in time.

It is difficult to say that there is any obvious and lasting relationship between sales profitability in the sector and the lev's real exchange rate against the US dollar due to fluctuations in the former indicator throughout 1995 and the 1st quarter of 1996, although in the following period both variables have followed approximately the same dynamics (with a lag of one to two quarters).

In end-1996 and throughout 1997, the group of exporting enterprises had been reporting high profitability of sales which surpassed average sales profitability in the public non-financial sector by about 5 times.

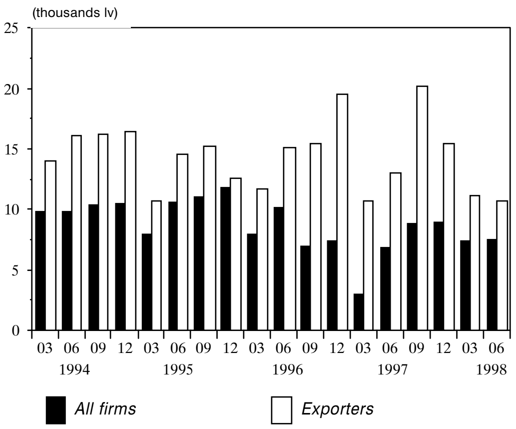
This was primarily due to the depreciation of the lev over the same period. In periods of appreciated national currency, the financial results of firms deteriorated as a rule, as apparent in 1995. Such a relationship might have applied to the first half-year period of 1998 as well if only the impact of the deteriorating business situation and

Gross Profitability of Sales - All Firms and Exporters



Source: NSI, AEA

Labor Productivity - All Firms and Exporters



Source: NSI, AEAF

decreasing export receipts, especially in the 2nd quarter of 1998 had been taken into consideration.

Labour productivity, gauged on the basis of the net value added per employed, was twice higher in export-oriented firms than labour productivity in the public sector as a whole, a characteristic that typically manifested itself from early-1994 to the first half-year period of 1998.

The comparison of labour productivity by periods implies that the Bulgarian economy has enough potentials to improve it, which in turn will offset the appreciation of the real exchange rate and falling international prices of some basic products. ❑

7. Some Key (and debatable) Issues of Bulgaria's Economic Development

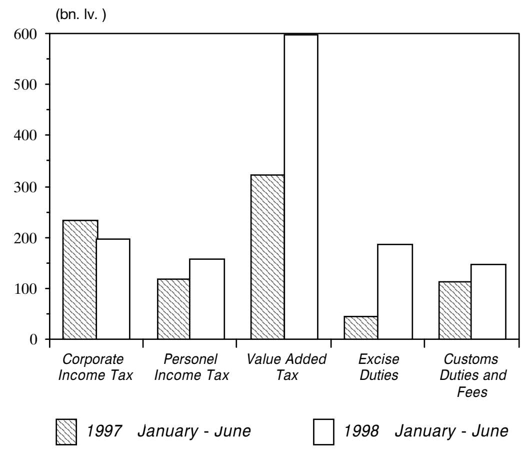
Fiscal Policy and Financial Stability

The successful implementation of a restrictive fiscal policy had a favourable impact on the economic development of the country in the first half of 1998. As a result, in the first six months of 1998 tax revenues registered a significant outstripping growth on a 12-month basis, increasing 1.4-fold in real terms[43].

New tax laws on corporate taxation and the taxation of natural persons entered into force in the beginning of the year as well as an amendment of the VAT Act. Financial discipline improved at least as far as natural persons and private sector are concerned.

The new corporate and personal income tax laws can be described as neutral since they considerably reduced most of the hitherto existing tax concessions. They provided for narrower monthly fluctuations of budget revenue. The almost even monthly distribution of profits tax receipts was to a great extent due to the introduction of the new tax base on which advance tax is liable to be paid. Corporate taxpayers are treated on an equal basis as the only differentiation is made between profit-makers and loss-makers. The obligation of the former to pay their advance tax payments each month secured regular budget revenues. The higher end-quarter revenues were due to the advance tax payments of those legal entities who ended last year with a negative financial result but realised profit in the respec-

Real Revenues of Main Taxes in the First Half of 1997 and 1998



Source: MF, AEAF

[43] *The real values are deflated by the consumer price index based on a geometrical mean.*

tive current period. The law makes a provision that any corporate taxpayer could reduce his advance tax payments on his own initiative in case they are expected to exceed the amount of annual tax due. Thus, the tax burden on taxpayers who ended the previous year at a profit but incur losses in the current year is somewhat reduced.

On the whole, in the first half of 1998 revenues from enterprises and financial institutions declined by some BGL 10 billion (by 22.5% in real terms) on a year earlier. This was mostly due to the revaluation of assets carried out by both state-owned and private enterprises. The revaluation brought about a reduction in budget receipts in early-1998 although the adjustment coefficients did not fully reflect actual inflation.

According to the new requirements stipulated by the personal income tax law, since the beginning of the year natural persons are being taxed on the basis of their total annual income earned under both labour and non-labour contracts. This reform had an immediate positive effect on budget revenue through the advance tax payments and at the same time forced every taxpayer to declare his personal incomes. It is already impossible to evade taxes by transferring one's incomes to other persons. Together with the streamlining of the progressive annual tax rate scale, a uniform non-taxable income for incomes earned under both labour and non-labour contracts was introduced.

The amendments to the personal income tax law not only contributed to the almost two-fold rise in income tax receipts in the first half of 1998 relative to the corresponding period in the previous year but also smoothed the monthly dynamics of budget revenues. The enlargement of the range of activities on which patent tax is paid also had a positive effect. Thus, the hard to tax activities were already covered by tax legislation and, on the other hand, the collection of tax dues was to a greater extent secured.

The VAT was the main source of budget revenue. The new, higher VAT registration base of BGL 75 million of taxable turnover encouraged firms to realise and report larger turnover in order to preserve their entitlement to deduction and reimbursement of the tax credit. As a result, VAT revenues in the first six months of the year increased almost three-fold relative to the first half of 1997. The terms and conditions for the reimbursement of the part of the tax credit exceeding the amount of the tax due by the respective taxpayer were also changed. The registered legal person deducts the tax subject to reimbursement from his dues in the following six months if he has no other obligations due to the state. This prevented the outflow of resources from the budget in the form of tax credit by circumventing the stipulations of the VAT Act.

Structure of budget tax revenue

	Profits tax	Tax on dividents and corporate earnings	Personal income tax	Turnover tax (VAT)	Excise	Customs duties	Other taxes
01.01-30.06 1995	12.3%	0.0%	13.9%	38.1%	11.9%	13.4%	9.9%
01.01-30.06 1996	15.5%	0.0%	13.1%	38.6%	12.4%	12.5%	7.9%
01.01-30.06 1997	27.9%	0.2%	13.9%	38.6%	5.5%	13.6%	0.2%
01.01-30.06 1998	14.9%	0.5%	11.9%	45.4%	14.2%	11.2%	2.0%

In the first half of 1998 total budget expenditures decreased by 4.9% in real terms relative to the preceding year due to an important change in their structure. In the preceding years, interest payments and particularly those on the domestic public debt represented a major expenditure item. By contrast, in the first six months of 1998, non-interest expenditures dominate. Goods and services expenses increased by 60% in real terms while government investment jumped more than seven times relative to June 1997.

By end-June 1998, some 47.7% of the interest payments due to the Paris Club and 97.1% of those due to the London Club in the current year had been paid, representing 69% of the total annual interest dues under the 1998 State Budget Act. Nevertheless, interest payment dropped almost two-fold relative to the first half of 1997 due to the 6.9-fold real-term decrease of domestic interest paid as a result of the reduction of domestic debt payments.[44]

In 1998, the budget generated a cash surplus in the first half-year period for the first time ever. The financing requirement shrank considerably thus enabling the government to observe the ban on direct budget deficit financing by the central bank without any difficulties. Low privatisation revenues, amounting to only 7.8% of the privatisation receipts envisaged in the State Budget Act for the first half of 1998 did not create any problems for the budget either. The central government budget covered its needs for financing by issuing domestic debt and purchasing of special drawing rights from the Bulgarian National

[44] *According to Art. 45 of the BNB Act, domestic interest includes interest payments to the IMF.*

Bank tantamount to the tranches under the Agreement with the IMF.

As of end-June 1998, the debt on government securities issued in the process of transformation of quasi-fiscal deficits of state-owned firms and banks into government debt accounted for the largest share (36%) within total domestic debt followed by direct debt to credit institutions[45] (30%), government guaranteed debt[46] (18%), and debt in the form of government securities issued for budget deficit financing (16%). As of June 1998, the total real-term reduction of domestic debt[47] on a 12-month basis amounted to 56%. Moreover, domestic debt was better covered by current revenue. While the rate of coverage in the end of the first half of 1997 was 25%, it amounted to 80% in the respective period of 1998. As a result, the ratio budget revenue to interest payments which indicates the country's ability to service its interest dues on domestic government debt increased from 1.37 in end-June 1997 to 13.42 in end-June 1998.

One-year government securities sustained their largest share (46%) in the total volume of debt securities in circulation, followed by government securities with a maturity of over 1 year (20%) and six-month government securities (19%). The volume of medium-term and long-term government securities gradually went up as a result of the stabilisation process in the country, increasing by 16.2% in the first six months of 1998.

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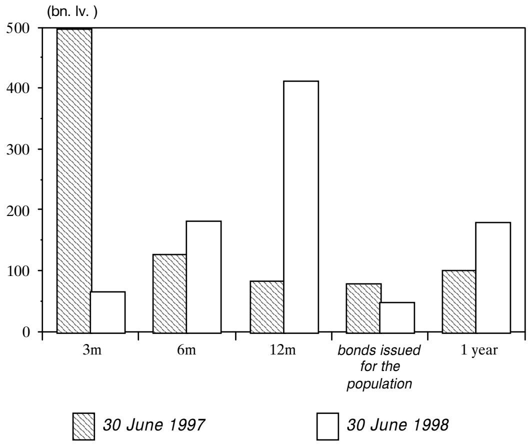
[45] This is the central government debt to the BNB under Art. 45 of the BNB Act, viz. purchasing of the IMF tranches by the Ministry of Finance.

[46] Since June 1998 the Ministry of Finance registers all government guaranteed debts.

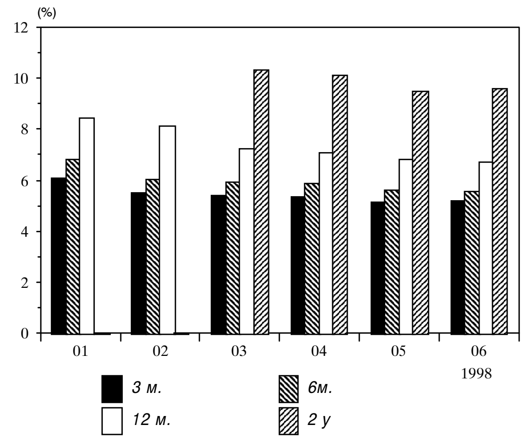
[47] Excluding credits extended by the IMF under Art. 45 of the BNB Act and government guaranteed domestic debt.

Outstanding Government Bonds as of 30.06.1997 and 30.06.1998



Source: MF, BNB

Annual Yield of the Issued Gvernment Bonds



Source: MF, BNB

The effect from the reduction of government securities issued for budget deficit financing became apparent in economic processes in two ways. On the one hand, demand for government securities by financial institutions stepped up. In the first half of 1998, the volume of orders placed was on average over twice bigger than the volume of government securities traded. This induced a rise in the average selling prices and resulted in the gradual lowering of return on these securities.

Liquidity in the banking system increased considerably because smaller net issues of government securities released financial resources which were relocated as credits to the non-government sector, and to households and the private sector in particular. In this way, the crowding-out effect which domineered the financial market in Bulgaria in the preceding years was terminated.

In the very short term, the liquidity of the banking system is also influenced by the actions of the BNB in its capacity of a fiscal agent of the government. Commercial banks did not experience any sudden liquidity disruptions since budget receipts in the first half of 1998 were relatively steady.

The lack of correspondence between the cyclical fluctuations of budget revenue and budget expenditures prevents any balancing of the budget in the short-term. The creation of a fiscal reserve in the BNB aimed exactly at adjusting of this disequilibrium. Therefore, in the first half of 1998 the deposit of the central government with the BNB registered an average growth of 6.2%.

To sum up, the stable financial situation of the government budget made it possible to reduce interest rates on government debt, to increase liquidity in the banking system and to ensure the regular servicing of the country's foreign debt in the first six months of the year. The crises in Asia and Russia did not have an impact on budget financing and interests precisely because of the balancing of budget revenue and expenditures and the reasonable management of government debt aimed at improving the maturity structure of government securities. The maintenance of a balanced budget will be a priority issue of the country's development in the years to come. By doing so, the budget, and through it the financial system become less vulnerable to external shocks which is a guarantee for the normal functioning of the currency board system in Bulgaria.

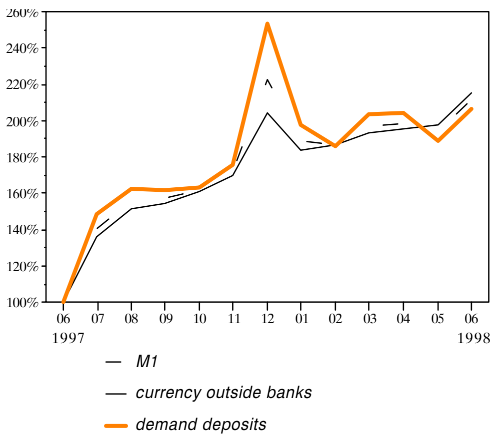
The Banking System under the Currency Board

The Process of Remonetization

The immediate effect of the financial stabilisation was the rapid growth of monetary aggregate M1 after February 1997. The trend was sustained till August 1997 and thereafter its rates of change remained positive, yet considerably lower except for December 1997.

Taking account of the seasonal nature of the monetary aggregates and their altered structure[48], this process practically continued throughout the first half of 1998. Broad money (M3) decreased by 1.7%[49] in real terms relative to December 1997.

Monetary Agregate M1 and its Components in Real Terms



Source: BNB,AEAF

[48] *The dynamics of monetary aggregates is somewhat seasonal in nature and concurring with the seasonal dynamics of the gross domestic product. In this respect, the first six months are traditionally weak for Bulgaria's economic performance, which normally peaks in the second half of the year.*

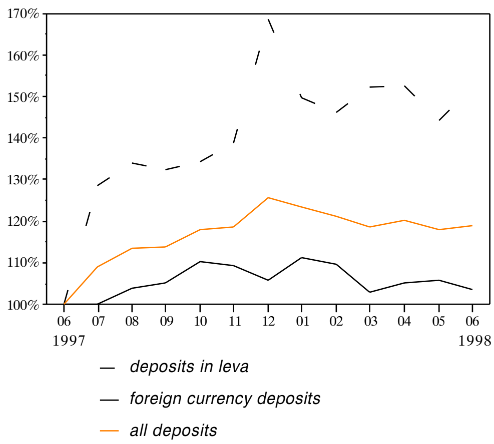
[49] *The real-term change of the monetary aggregates comprising a lev and a foreign currency component is reported after the lev component is deflated by the CPI for the corresponding period. The lev value of the foreign exchange component is calculated using the BNB official exchange rate for the last workday of the month preceding the period.*

This was due to both the real-term 4.9% shrinkage of narrow money (M1) and 2% decline of quasi-money. Only import deposits and frozen assets increased in real terms by some 30%, yet they could not offset the fall of the other components owing to their low relative weight (6%) in the total volume of broad money. On the other hand, money outside banks registered a real-term rise of 5.3% relative to end-1997 and much of this increase was accumulated in June. This month also saw an increase of demand deposits. Their downward trend in the preceding months was the main factor behind the shrinkage of monetary aggregate M1.

Remonetization signified that the dolarisation process was brought to an end and that the lev successfully performed its function as a means of payment and a means of exchange. Commercial banks can influence positively the process of remonetization by introducing new bank services such as debit and credit cards, home banking, and other credit facilities.

Confidence in the Banking System

Deposits in Real Terms

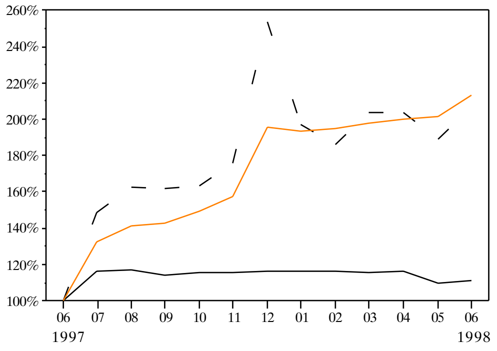


Source: BNB,AEAF

Confidence in the banking system has been slowly recovering after the collapse of the financial system in end-1996 and early-1997. The lev will have to reinstate its function as a store of value for a much longer period than the one needed to re-gain its function as a means of payment. The slow restoration of the deposit stock can be viewed as a symptom of this process.

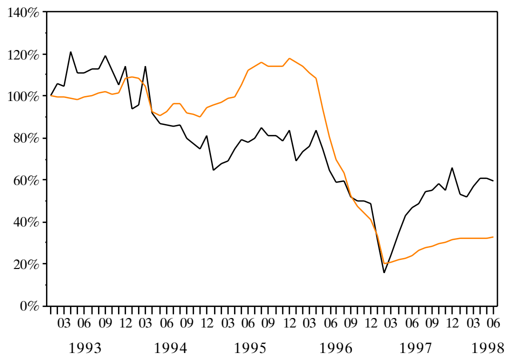
After the considerable growth of deposit stock in the second half of 1997 manifesting itself mainly in the form of 68% real-term increase in the lev component of deposits, the first six months of 1998 saw a real-term shrinkage of 9.7% of lev deposits.

Deposits in Leva in Real Terms



Source: BNB,AEAF

Income and Deposits of Households in Real Terms



Source: BNB, NSI, AEAF

One of the reasons for the registered drop was the growth of deposits in December 1997 and the ensuing utilisation of these savings to cover expenditures of firms and households. Another factor was grounded in the incomes dynamics. Incomes have been still going through a restoration process at a time when consumption was high as a share of income and when it was too early for an increase in the inclination for saving to take place.

The deposit stock was also influenced by interest rates which in the fist half of the year were still negative in real terms although much more favourable for savers compared to the corresponding period in the preceding two years.

If real interest rates on time lev deposits steadied at positive values, the attitude of all economic agents towards this type of saving would presumably change.

Savings deposits sustained their upward trend in the first half of 1998. Apparently, given the established interest rates, households preferred higher liquidity deposits.

Nominal and Real Interest Rates on One-month Time Deposits

	1993-VI	1994-VI	1995-VI	1996-VI	1997-VI	1998-VI
Nominal	24.45	26.93	26.61	20.14	54.09	1.40
Real	-7.55	-20.36	9.88	-18.57	-73.62	-0.92

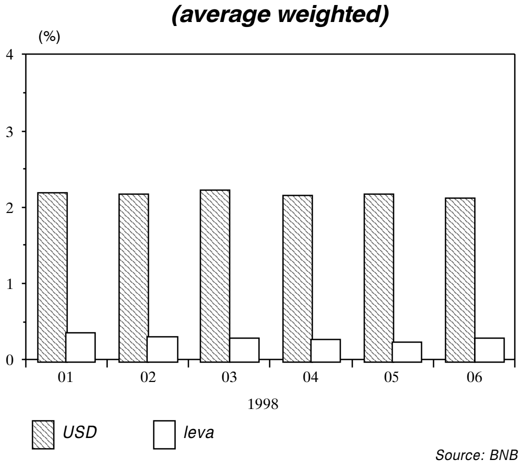
Having increased by some 6% since the introduction of the currency board until end-1997, foreign currency deposits registered a 2.3% fall in the first six months of 1998. Their dynamics was determined by the dynamics of the foreign exchange deposits of state-owned and private enterprises. They preferred to hold most of their available money resources in hard currency accounts in commercial banks and in case they needed more lev resources (e.g. for the payment of their taxes due to the budget) they withdrew money from them and transferred it to their lev demand deposits. Higher interest rates on foreign currency deposits induced these fluctuations. Foreign exchange deposits of households continued, though slowly, to rise.

The structure of deposits of the various economic entities indicates that foreign currency denominated deposits still prevail in spite of the registered increase of lev deposits of state-owned and private firms in particular.

The change in state-owned and private enterprises' deposits is to a great extent a sign of fluctuations in their financial conditions and the structure of economic sectors including a shrinkage of the state-owned sector as a result of ongoing privatisation. Relative to end-1997, the real-term decline of private enterprises' deposits in commercial banks amounted to 7.2% whereas that of state-owned companies – to 23.4%.

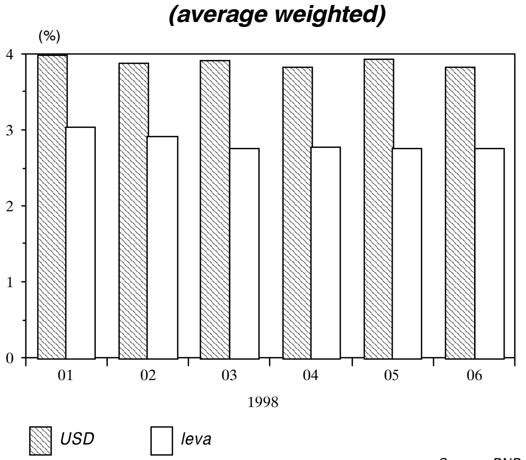
Apart from the low interest rates on lev deposits, the reasons for the registered fall in deposit stock in the first half of 1998 can also be found in the newly voted Deposit Insurance Act which set an upper limit for an insurance of a given deposit in a commercial bank amounting in USD terms to some USD 2 800. Certainly, the relatively low upper limit for a deposit insurance would presumably encourage savers to deposit their money in the financially most stable commercial

Annual Efective Interest Rates on Demand Deposits in Leva and USD (average weighted)



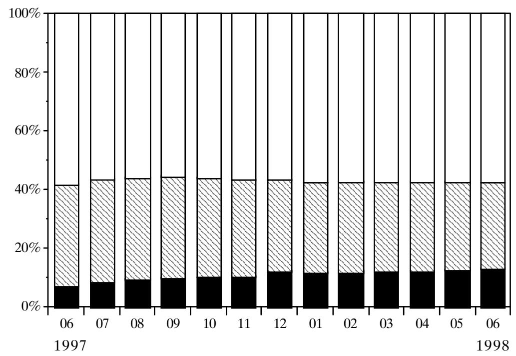
Source: BNB

Annual Efective Interest Rates on Time Deposits in Leva and USD (average weighted)

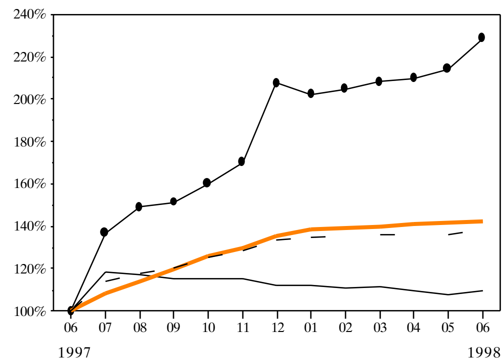


Source: BNB

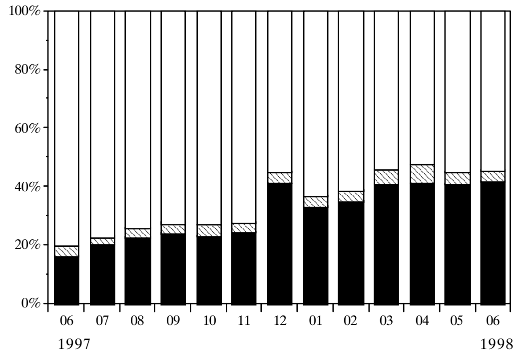
Structure of Household Deposits



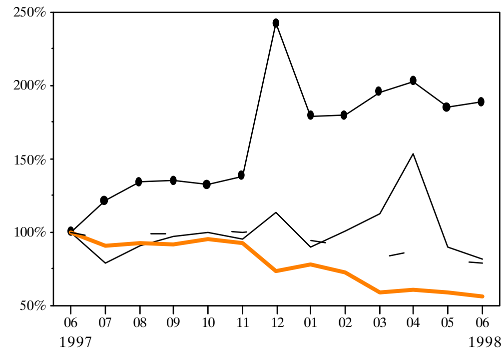
Household Deposits in Real Terms



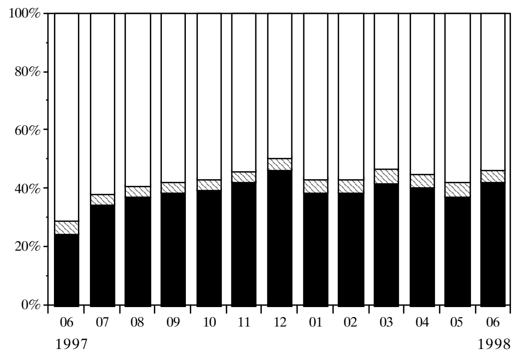
Structure of SOE Deposits



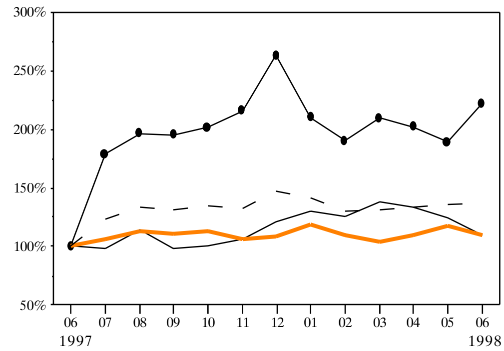
SOE Deposits in Real Terms



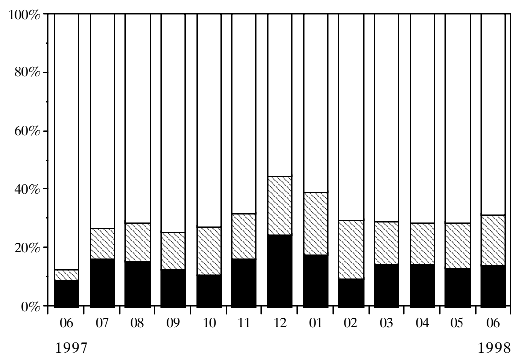
Structure of Private Firms Deposits



Private Firms Deposits in Real Terms



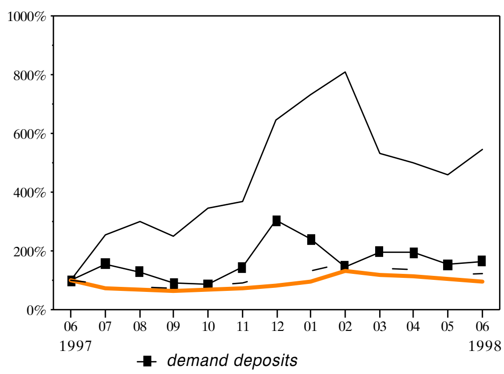
Structure of Deposits of Non-bank Financial Institutions



demand deposits
time deposits
foreign currency deposits

Source: BNB

Non-bank Financial Institutions Deposits in Real Terms



demand deposits
time deposits
foreign currency deposits
all deposits

Source: BNB,AEAF

banks. On the other hand, given the lack of any credit rating of all the banks operating in Bulgaria, the degree of deposit protection does not stimulate holders of large available money resources (mainly in hard currency) to deposit them in the banking system.

The overall dynamics of deposits indicates that confidence in the banking system is being restored very slowly. Notwithstanding the good financial indicators of most commercial banks, over USD 700 mn of the USD 900 mn withdrawn during the financial crisis still remain outside the banking system. It is quite likely that part of this foreign currency volume services transactions in the country, and particularly those in the grey economy.

Money Multiplier

	06.97	12.97	01.98	02.98	03.98	04.98	05.98	06.98
General money multiplier	3.62	2.77	3.00	3.12	3.10	3.10	3.07	2.93
Money outside banks/Deposits (%)	16.00	27.93	25.72	26.68	27.07	28.04	29.02	30.78
Bank reserves/Deposits (%)	16.10	18.28	16.12	13.92	13.92	13.23	12.99	13.80

The increase of the ratio money outside banks to deposits is an indirect indicator of the declining share of foreign currency as a means of payment in Bulgarian economy. The re-deposit in the banking system of a substantial part of the foreign currency held in cash by the economic agents would increase both the money multiplier and the prospects for crediting of real economy by commercial banks.

Is There a Change in the Money Demand?

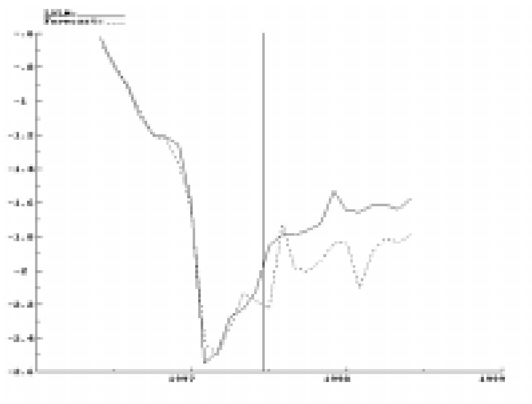
The dynamics of the main monetary aggregates reveals a one-off increase immediately after the introduction of the currency board and subsequent low rates of change. The question that arises is whether there has been a change in money demand function since the introduction of the currency board. This question can be posed in at least two ways. First, is there a change in the dependence controlling the level of money demand and second, is there a change in the dependence controlling the change of money demand. From the point of view of macroeconomic policy, the answer to the first formulation is required for the programming of the levels of monetary aggregates. The second formulation is of importance when money dynamics is correlated with relative quantities such as economic growth and inflation.

Estimation[50] is made on the basis of a linear system of variables which represent the base indexes[51] logs of the real-term lev component of M1, of real GDP, of the USD/BGL exchange rate and of consumer prices. These variables enter with two lags. Dummy monthly variables are also included in order to encompass seasonality. The exchange rate is treated as exogenous.

In the initial estimation of the system of equations based on data for the period January 1994 to June 1997, the diagnostic tests of residuals

[50] *Estimation is based on the approach of Hendry (Hendry D.,* Dynamic Econometrics, 1995*) whereby modelling starts with an estimation of a general linear system of equations, linking the examined variables. Only if the system has satisfactory properties we proceed to a validity test of any restrictions on it. The end result is a model eligible for economic interpretation. Since the coefficients' invariance is one of the properties which the general system must have before being restricted, an invariance test is done immediately after its estimation. The present analysis confines to this.*

[51] *Base - December 1993.*



– Actual Data

-- Data from the Model

are acceptable[52]. But forecasts resulting from the system of equations for the period after the introduction of the currency board demonstrate system tests that flatly reject any invariance of coefficients (significance level under 0.1%).

Apparently, the assessed equation underestimates the level of lev money demand after June 1997 as the difference between forecast and real values is relatively stable.

If we add a dummy variable in order to report this difference (which is precisely the one-off July increase of money in BGL) and re-estimate the system for the period January 1994 to June 1998, the rejection of the coefficients' invariance becomes devoid of foundation. The diagnostic tests of autocorrelation and heteroscedasticity are similar to those of the system without a dummy variable. Yet, normality (at a significance level of 1%) fails out of residual properties. However, this does not refute the conclusion since the empirical values of the tests statistics are well below the critical levels.

The following conclusion can be drawn on the basis of the econometric analysis. A one-off increase of the level of lev money demand was observed in the month when the currency board was introduced in Bulgaria (July 1997). The rise cannot be explained by traditional factors, viz. growth, inflation and rate of return. It was not temporary whereby money stock restored its June level afterwards. The increase was lasting, i.e. at given growth, inflation and rates of return, the lev

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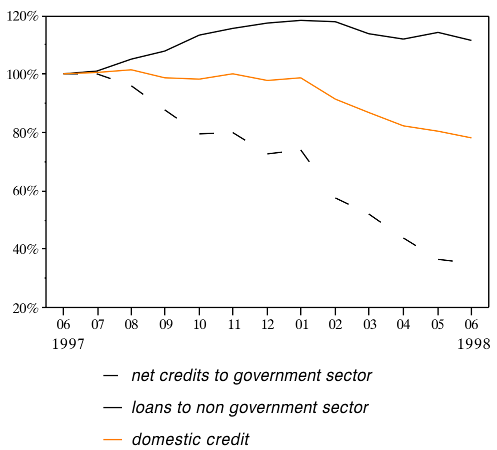
[52] *The autocorrelation test up to the third order does not reject its lack at a significance level of up to 35% for each of the equations, and for autoregressive heteroscedasticity up to the third order at a significance level of 65% and at a normality level of 25%.*

money demand after June 1997 has been greater than the theoretically calculated one would have been under the old regime with an active central bank. In terms of the objective of the present analysis we can conclude that the dependence controlling the **level** of money demand was changed. The results from the analysis do not support the assumption that the dependence controlling the relative change of lev money demand was also changed. The only time this dependence was disrupted was in July 1997. Subsequently, the economic agents preserved their previous behaviour formed under unstable and high inflation. It can be expected that in case of small changes in the economic policy followed aimed at softening of restrictions, their reaction will be manifested in lower demand for BGL and higher demand for foreign currency.

Domestic Credit Dynamics

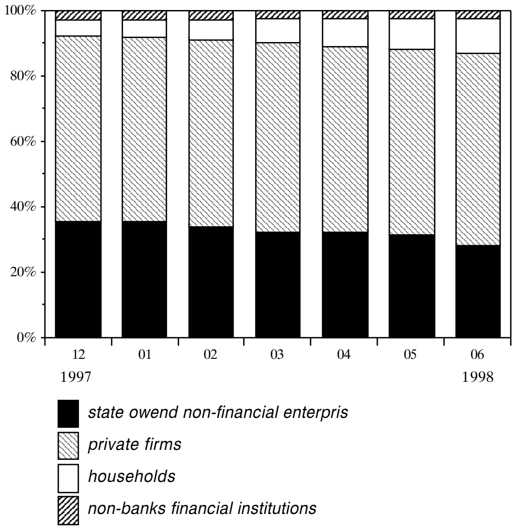
In the first half of 1998 domestic credit declined by 20.4% in real terms mainly due to the shrinkage of net claims on government (by 54.6% in real terms). The real-term decrease of credit to the non-government sector amounted to 4.3% and was due to the 23.8% contraction of claims on state-owned non-financial enterprises by commercial banks. The decline in credit especially to state-owned non-financial enterprises was also a result from the improved financial discipline after the introduction of the currency board which brought about a reduction in their credit arrears to banks. Credits to private enterprises also declined in real terms by some 1.1%, yet their structure underwent a substantial change as credits in foreign currency shrank at the expense of lev credits which stepped up by 25% in real terms.

Domestic Credits in Real Terms



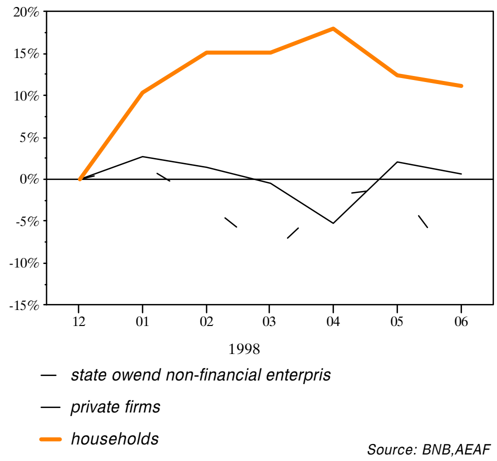
Source: BNB,AEAF

Structure of Loans to Non-Government Sector by Credit Recipients



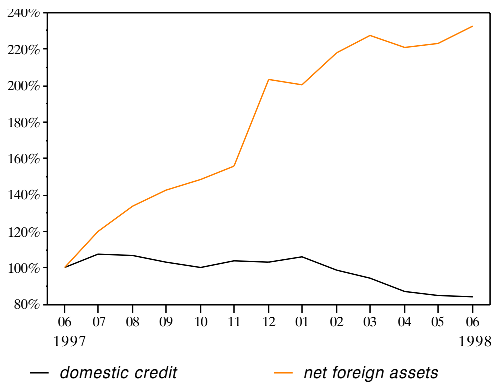
Source: BNB,AEAF

Nominal Mounthly Change of Loans to Non - Government Sector by Credit Recipient



Source: BNB,AEAF

Domestic Credit and Net Foreign Assets in Nominal Terms



Source: BNB,AEAF

Short-term credits accounted for the prevailing share of new credits to state-owned and private enterprises, viz. 79% of lev credits and 61% of credits in foreign currency in June. Commercial banks' claims on households followed a steady upward trend, increasing by 13.4% average monthly since the beginning of 1998.

The shrinkage of credits was accompanied by an increase of both net foreign assets of the banking system and higher liquidity assets. Apparently, commercial banks assess as high the degree of risk in real economy and prefer to still hold a considerable part of their assets in the form of deposits in foreign banks and in other less risky, yet less profitable assets. The relatively high recent activity of branches and subsidiaries of foreign banks regarding credits to Bulgarian enterprises counteracts this negative trend. On the other hand, tighter requirements for capital adequacy, the collateral security of big loans and the provisions for risk exposures stipulated by the new law on commercial banks and BNB Regulations force banks to cautiously increase credits to the non-government sector as they are the riskiest assets.

Economic Growth

The transformation of the Bulgarian economy from a command-type into a market one continues. From 1990 until early-1997 the process had been uneven with some major steps backward taken in the period 1994 to end-1996. The conditions for healthy economic growth in the forthcoming years were only created in mid-1997 with the adoption of a radical economic program for restructuring and development of a market economy. The Bulgarian economy in the first half of 1998 remained in the stage of recovery after the deep domestic crisis of 1996 and early-1997.

There were two major sources of growth in the first six months of 1998.[53] The first was induced by the greater final demand in the economy which became apparent in the real-term increase of consumption. Higher incomes, and especially the greater certainty of future incomes, as well as the rise in consumer credits induced a domestic demand upturn relative to the same period of 1997. The banking system's claims on households had stepped up more than two-fold in the period January to June 1998 whereas claims on government had fallen considerably on a year earlier.

In the first six months of 1998 exports declined by 9.4% in nominal USD terms relative to the corresponding period in 1997. It is difficult to estimate the change in the physical volume of

[53] *Is there economic growth in 1998? Heated debates about this have been going on ever since the beginning of the year. Problems arise due to the contradiction of data on the various economic indicators. Considering the development of employment, wages, consumption and monetary aggregates, the answer to the question is positive. Considering data on the condition of state-owned firms or on industrial sales, the positive answer is far from definite. The experts of the Agency for economic analysis and forecasting expect economic growth of at least 4-5% in 1998. Any misjudgement of growth based on available data is due to the fact that they do not fully encompass the processes in the private sector as well as to the different scopes of observation which make data incomparable.*

exports due to the lack of export deflators. Yet, precisely this indicator influences the economic growth rates of the country.

The second source of economic growth is „statistical". The raise of VAT registration base to BGL 75 million of annual sales (net of VAT) encouraged businesses to register more sales relative to 1997. As a result, and also due to the growth of domestic consumption, indirect tax revenues stepped up by 78% in real terms compared to the first half-year of 1997.

The analysis of economic processes carried out in the previous sections of the survey points to a revival of economic activity in 1998 as a result of the stabilisation and predictability in the economy. It will be wishful thinking to expect domestic demand to propel growth in the forthcoming years in view of Bulgaria's small domestic market. „The measurement effect" is also a one-off factor. Economic growth factors in 1998 are short-term rather than long-term. A negative phenomenon is the lack of sizeable foreign investment since it is the only driving force that can bring the economy to the path of sustainable economic growth.

A major issue facing economic policy is to mobilise domestic savings for the purpose of short-term and long-term capital financing and to further promote the development of the banking system as an effective nucleus of financial intermediation. The first task in this respect is to attract available money resources in the banking system. The reforms of the pension system and healthcare are aimed exactly at the accumulation of relatively long-term resources. The second task is to develop the domestic credit market. In 1997 commercial banks transferred some of their resources abroad. This process discontinued in the first half of 1998, yet the banks' deposits abroad were not transferred back in the country. Apparently, banks estimate the ratio risk to rate of return as more favourable abroad than in Bulgaria and therefore invest their resources outside the country.

The financial stabilisation eliminated much of the system risk in the economy with respect to the sharp exchange rate fluctuations, interest rates, etc. Which are the major sources of risk after the financial stabilisation and how to reduce risk in the economy?

The first source of insecurity is the obscure ownership structure of the economy. The privatisation scheme did not treat privatisation players on an equal footing and created conditions for cover-up of interests and distortion of the price of capital. The employee-management firms enjoyed better preferential terms regarding deadlines and types of payment than the other participants in privatisation. The abolishment of preferential terms for the employee-management companies in the sale of big enterprises was a positive step towards the transparency of privatisation deals and the placing of all participants in privatisation on equal terms[54].

The second source is the inefficient judicial system which is not able to ensure the execution of contracts and the fast liquidation of the debtor firm. It is still extremely hard for a creditor to sue a debtor and collect his dues. The inefficient judicial system underlies the big „moral hazard" in the economy and thereby increases the creditor's risk.

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[54] *According to the amendments to the privatisation law of April 1998.*

The third source of insecurity is the presence of monopolies in the structure of the Bulgarian economy. State monopolies in the country demonstrate non-market behaviour, their indicators of overall profitability are deteriorating, financial discipline is low and they utilise inefficiently their resources (except for the National Electricity Company). It seems that in state-owned enterprises the monopoly power finds expression in the accumulation of enormous losses thus forming an ineffective structure of the economy and jeopardising overall financial stability.

The second key issue of economic development is what sources for economic growth financing are accessible for Bulgaria.

There are three sources for long-term capital financing: profit, the increase of own capital and long-term credits.

The financial conditions of state-owned non-financial enterprises infer limited own investment resources. The revaluation of assets in early-1998 and the amendment to the corporate income tax law allowing accelerated depreciation may have a positive impact on the investment activity of companies.

The banking system is not in a position to extend long-term credits due to the large share of short-term liabilities in the consolidated balance of the system. It is reasonable to assume that commercial banks will finance short-term capital while capital markets will finance long-term capital. Economic growth correlates closely with the development of the capital market. Experience shows that a properly regulated capital market is more efficient in the accumulation of savings and their subsequent relocation to promising businesses than the direct or indirect (through government guarantees of private credits) state intervention in investment activity. ❑

8. Conclusion

The following negative trends in the development of the Bulgarian economy due to the business situation can be drawn from the analysis made so far alongside the respective counter-measures:

■ The decline of export receipts cannot be offset by the lowered prices of import goods. Inasmuch as the structure of Bulgarian exports is characterised by a great diversity of export products, there is a potential for a flexible reaction to any adverse trends on foreign markets by augmenting the export of goods and services with a hitherto negligible share in the volume of exports. The country's membership in the WTO, the Association Agreement with the EU, membership in CEFTA, and the creation of a free-trade zone with Turkey are all measures targeted at enlarging the scope of Bulgarian exports. Certainly, these agreements also open the Bulgarian market to import goods which will intensify competition. One of the tasks to be solved in the forthcoming years is precisely the creation of a smoothly functioning market economy able to stand up to competitive pressure from companies in the European Union.

■ The withdrawal of foreign investors from the emerging markets as a result of the financial crises in Asia and Russia had an impact on the meagre flow of capital in Bulgaria which, one way or another, instead of the anticipated huge inflow of investment after the introduction of the currency board on July 1, 1997. The agreed financial aid and loans from the European Union, the International Monetary Fund and the World Bank compensated the lack of foreign capital and will make it possible for the country to preserve the level of its foreign exchange reserves and ensure the normal functioning of the currency board in the future even if there is a prolonged withdrawal of foreign investors.

■ Deflation in the world economy facilitated the faster curb of inflation in Bulgaria and its subsequent reduction to a one-digit figure, i.e. close to the inflation rate in the developed economies, within the first year after the introduction of the currency board in the country. The stabilisation and subsequent slight fall of domestic prices influenced positively consumption but endangered the financial health of firms with increasing expenses, especially for pay-roll, regardless of the registered decline in nominal sales revenues. Therefore, the firms' indebtedness through sales is also increasing. They become vulnerable to new shocks and may jeopardise the entire financial stability of the economy. Such processes were detected in the financial conditions of firms in a sample of some 3 000 state-owned companies. The lack of available data prevents the detection of such processes in the financial condition of private firms. It is apparent, however, that all firms should take urgent measures for restructuring of their costs in order to resist the concussions on international markets and the intensifying of domestic competition after the liberalisation of foreign trade.

The rapid decrease of the monthly rate of inflation had a positive impact on exporters since it averted the process of domestic real overvaluation of the fixed exchange rate which would have happened at higher rates of inflation. Exporter companies are in a good financial condition and register higher than the average labour productivity. Nonetheless, they alongside all the other firms have a potential for improving of these indicators and thereby offset any unfavourable changes in international prices.

■ Growing domestic demand together with the increase in real incomes and the easy access to consumer credits stimulate economic growth in Bulgaria in the short-term, however, they may also deteriorate the trade balance of the country. The private sector enjoys favourable conditions for expanding and opened some 90 000 new jobs in the first half of 1998. The creation of the necessary conditions for economic growth involves the launch of a package of measures which will guarantee the stability of the implemented economic policy by reducing the system risk (through a balanced budget), elimination of all administrative and bureaucratic barriers to growth, encouraging the accumulation of domestic savings and their successful transformation into investment through the intermediation of the banking system and the capital market.

To sum up, the Bulgarian economy is still quite vulnerable to external shocks because it is an economy in transformation. The signed three-year agreement with the IMF, the programme for preparation of the country for membership in the EU and the developed strategy of the World Bank for Bulgaria envisaging expert assistance in and financial aid for the implementation of reforms in the pension system, healthcare and social aid are a guarantee for the stability, predictability and successful accomplishment of the transition to a market economy in the medium-term. ❑

CONTENTS