BUSINESS SURVEY SERIES

BULGARIA: THE ECONOMY IN THE FIRST HALF OF 1999

AGENCY FOR ECONOMIC ANALYSIS & FORECASTING

31 Aksakov St., 1000 Sofia, Bulgaria

31 Aksakov St., 1000 Sofia, Bulgaria
Tel. (+359 2) 980 04 84, 980 24 74
Fax (+359 2) 981 33 58, 980 93 22
e-mail: aecd@ttm.bg

Translated by Albena Toneva and Ventsislav Voikov.

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The economic policies of the government implemented for more than two years now have led to the stabilisation of the Bulgarian economy and created all the conditions for the promotion of entrepreneurship, fostering at the same time economic growth. The crisis of the international markets that started in 1997 and is still persistent[1] produced an adverse effect on the stabilisation effort, and as regards growth the 1998 net effect amounted to 3.5% annual growth of the economy. The otherwise unfavourable business situation in the first half-year period of 1999 was further aggravated by the Kosovo crisis over the April-June period. These external shocks coincided with a difficult stage of the structural reform when exporting state-owned enterprises were undergoing privatisation, restructuring or liquidation.

This report tries to differentiate the factors affecting positively and negatively the growth prospects of Bulgaria in the first half of 1999. The positive factors are of a long-term duration while the negative factors may be changed because all of them, the international environment excluded, are subject to policy determination.

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[1] *Signs that the crisis of the international markets can be overcome appeared as late as the end of the first half-year period of 1999.*

Structural Reform in Progress

As a result of the unfavourable external business situation, growth rates began to slow down as early as 1998. Thus the first quarter of 1999 witnessed a decline of 0.7%, relative to the first quarter of 1998.

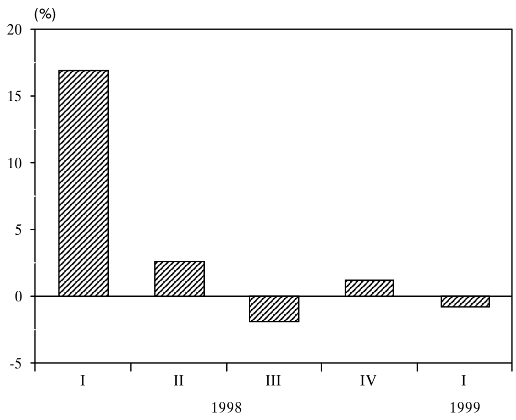
Table 1. Real Gross Value Added Growth by Sectors

(%, relevant quarter of the previous year = 100)

	1998 Q.1	Q.2	Q.3	Q.4	1999 Q.1
Agriculture and forestry	15.6	8.4	0.7	-6.8	15.0
Industry	22.3	10.1	-3.9	-7.0	-9.2
Services	1.5	-6.0	-4.1	10.7	-0.8
Transport	-10.5	-12.7	-12.7	-1.5	-15.9
Trade	16.9	2.2	8.8	2.2	-6.7
GDP	16.8	2.6	-1.8	1.2	-0.7

Source: NSI

GDP Growth*

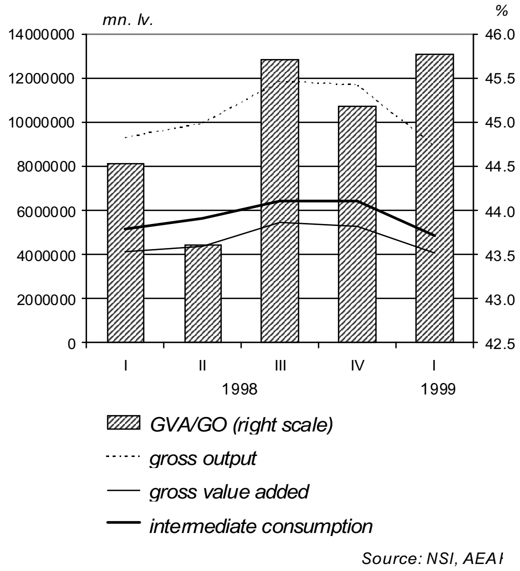


* *Corresponding quarter of previous year = 100*

Source: NSI, AEAF

The unfavourable business situation further aggravated by the Kossovo crisis over the April-June period could not put a brake on the progress of the ongoing structural reform. Despite the temporary disturbances and loss of gross output as a result of the completion of the liquidation programme for state-owned enterprises in dire financial straits, the fact remains that the structural reform produced undoubtedly a strong positive overall effect.

Ratio of Value Added to Gross Output, Total Economy, 1998 Prices



Improving Efficiency in the Economy

Economic efficiency continued to improve in 1999.

The factors at work influencing the growing relative share of value added in gross output were as follows: optimisation of costs and tightening of financial discipline[2]. Both factors resulted from the successful implementation of the structural reforms - privatisation, liquidation of loss making enterprises and improved control of the public sector via income policies.

Expansion of the Private Sector

The overall GDP decline in the first quarter of 1999 shows different value added dynamics in a contracting public sector and a fast expanding private sector.

Table 2. GDP Growth Rate and Gross Output by Sectors in the First Quarter of 1999
(preliminary data)

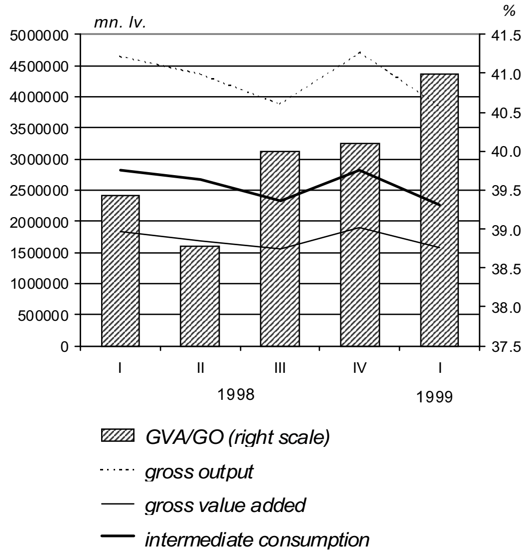
(%, relevant period on a year earlier = 100)

	National economy		Private sector	
	Gross output	Gross value added	Gross output	Gross value added
Agriculture and forestry	13.6	15.0	15.9	16.4
Industry	-11.9	-9.2	8.2	16.3
Services	-0.2	-0.8	5.4	2.0

Source: NSI

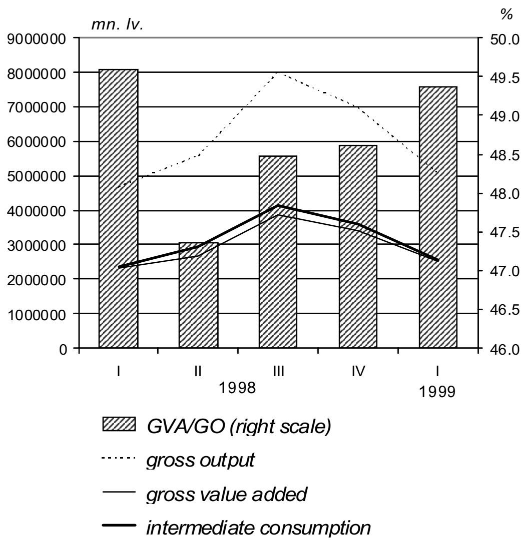
2 *The process has been analysed in detail in the 1998 Annual Report of the AEAF.*

Ratio of Value Added to Gross Output, Public Sector, 1998 Prices



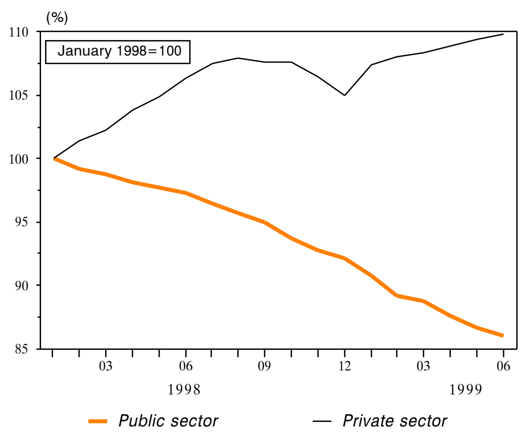
Source: NSI, AEAF

Ratio of Value Added to Gross Output, Private Sector, 1998 Prices



Source: NSI, AEAF

Change in the Number of Employed Persons by Sectors



Source: NSI

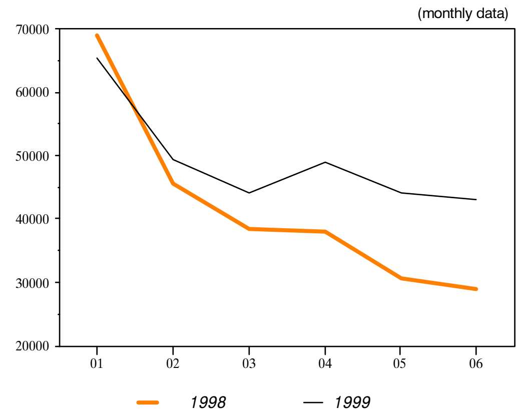
The share of the private sector in value added in the first quarter of 1999 stepped up by 2.5 percentage points on a year earlier. However, the structure of bank credit appears to be a more reliable current indicator of the share of private companies in the country's economy. In end-July the share of bank credits to the private sector accounted for 72% of banks' credit portfolio. Also, the growing number of economic agents registered under VAT (their number stepped up by 5% from 50959 to 53418 in the first quarter) is an adequate indicator of an improving economic activity and the absence of barriers to new entry.

Value added in the private sector registered high growth rates not only as a result of the mechanic process of privatisation of state-owned enterprises but also due to the higher productivity and efficiency of already privatised enterprises. Compared to state-owned firms, privatised enterprises reported positive financial results throughout 1998 and the first half-year period of 1999[3]. The 1998 profitability rate of all enterprises in the sample amounted to 14% while privatised enterprises by way of MEBOs reported even a higher rate of 15.5%. The operating profit of all 752 sample enterprises in the first quarter of 1999 amounted to 1.9% whereas MEBOs reported an even higher operating profit of 2.2%.

[3] The analysis draws upon NSI panel survey data encompassing 752 privatised enterprises.

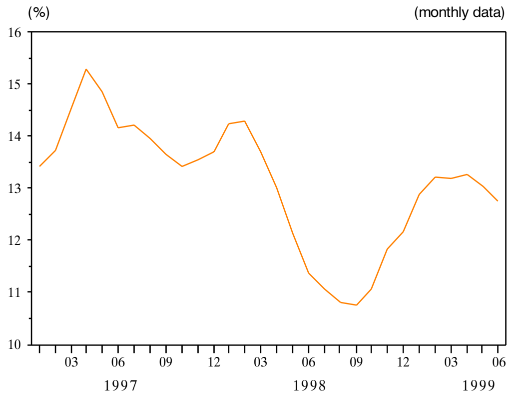
Employment-Related Issues

Number of Newly Registred Unemployed



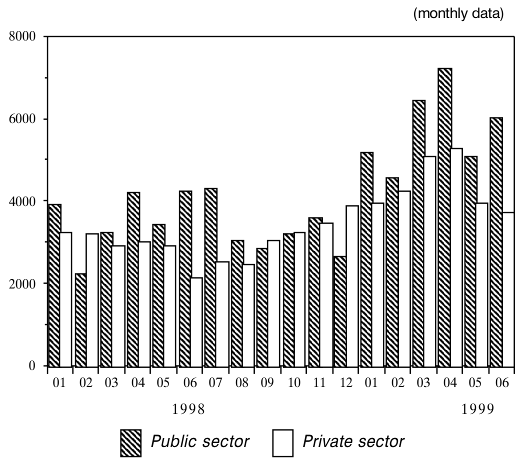
Source: MLSP

Unemployment Rate



Source: MLSP

Dismissed Persons by Sectors



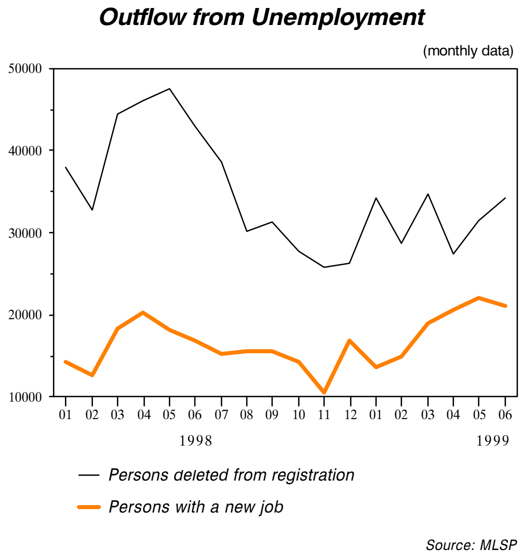
Source: NSI

Changes in employment and the employment level dynamics are an indicator of the level of economic restructuring achieved. On a year earlier, the number of employed decreased by 4.7% in the first half-year period of 1999. The employment decline in the public sector amounted to 11.8% while the private sector registered an increase of 5.3%.

Public sector employment declined not only as a result of the completion of the isolation and liquidation programme for loss-making enterprises in the sector but due to the privatisation process as well. In end-June the unemployment rate amounted to 12.8%, registering a 1.4% rise relative to June 1998.

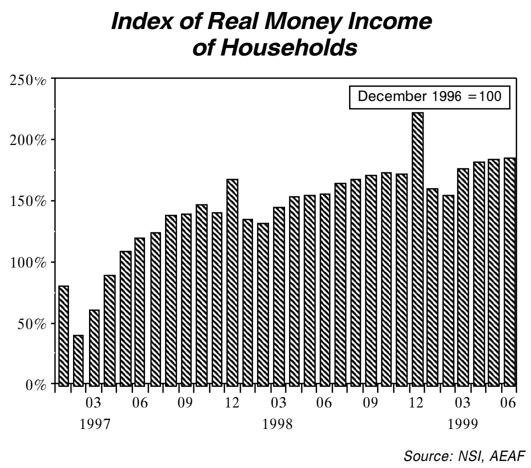
Since the beginning of 1999 the share of newly-registered unemployed dismissed by the private sector has grown. This inflow of unemployed was most probably related to the reduction of excess labour in the privatised enterprises due to the ongoing employment optimisation process. A part of dismissals is due to a quick response of the private sector to the sales disturbance during the Kosovo crises. Firms started to accumulate stocks of finished goods, reduced production and hence, employment in April-June period.

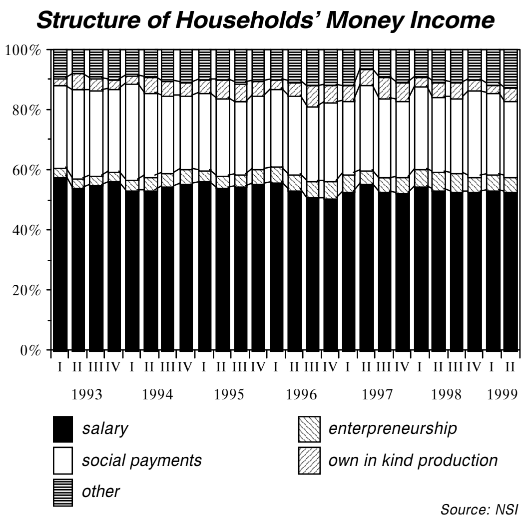
The number of unemployed with professional qualifications and university degree has also increased. They, however, stand better chances of finding new jobs quickly, as indicated by the dynamics of the outflow of unemployed. As unemployment offices provided better job



opportunities in the first half year-period of 1999, the share of unemployed starting new jobs within the total number of unemployed deleted from registration lists went up to 38.8% against 30.7% in 1998.

Factors for Activating Growth



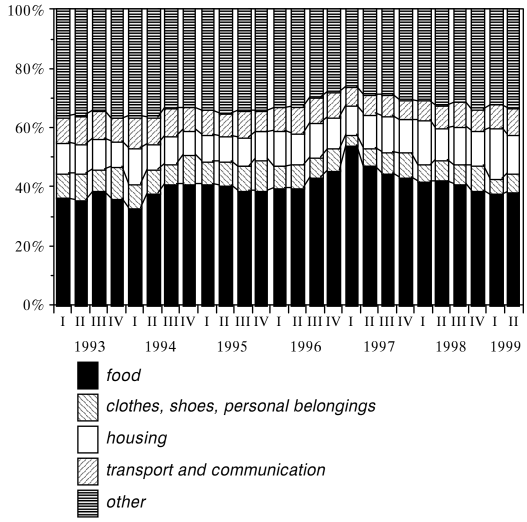


Consumption – an Effective Demand Increase

Higher incomes, greater certainty of future income as well as consumer credit growth boosted domestic demand in the first half of 1999, compared to the relevant period of 1998. According to household budget survey data, money incomes registered a 18.7% increase while final household consumption as a GDP component rose substantially by 15.3% in the first quarter of 1999 on a year earlier.

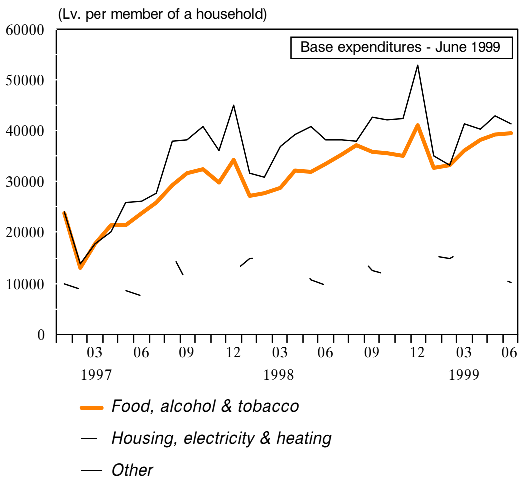
Disposable income changes affected the dynamics and structure of household expenditures. Overall in the first half-year period of 1999, household expenditures registered a 13% nominal-term increase, relative to the same period of 1998. Also, the October 1998 tendency of household money incomes to exceed money

Structure of Households' Money Expenditures



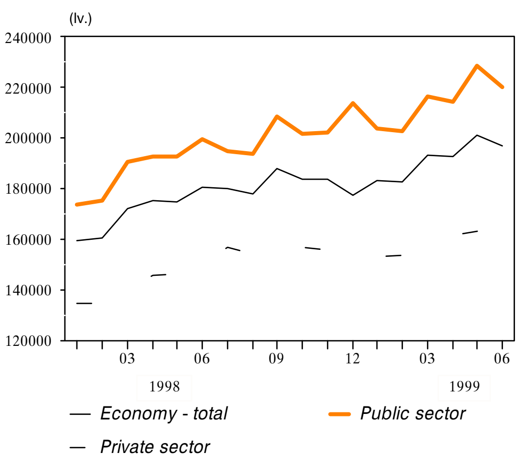
Source: NSI

Real Expenditures by Groups



Source: NSI, AEAF

Average Nominal Monthly Wage



Source: NSI, AEAF

expenditures was sustained throughout the first half of 1999.

As the prices of the different commodity groups exhibited a highly uneven and different dynamics in 1998 and 1999 due mainly to administered price adjustments, consumption growth can be best revealed only if the various household expenditures groups have been deflated by the relevant price index. Food expenditures registered a 21% real-term increase, electricity, heating and housing expenditures stepped up by 5%, and household spending on other goods and services rose by 11%, signalling that there was effective demand in the economy.

Maintaining Sustainable Labour Costs

Salaries as a major income source have begun to increase in real terms since the second half of 1997. In nominal terms, the country's average wage rose by 3.5% in end-June relative to end-December 1998[4], including a 7.1% increase in the private sector (a 9.1% real-term increase) and a 3.2% rise in the public sector (5.6% real-term increase).

Good financial performance and operation of enterprises are a key criterion for wage growth. In this sense government income policies may have a significant influence on the economy. Wage dynamics in the first half-year period of 1999 indicates that enterprises are extremely

[4] *December'98 and June'99 salaries include all bonuses paid in the two months.*

sensitive to changes in two major income policy instruments, viz. budget salary indexation and the minimum wage level.

Budget salary indexations often make the government face strong pressure from trade union organisations in enterprises for a pay rise. This pressure is very strong in state-owned firms in dire financial straits, which have to abide by and strictly implement wage growth regulations. Pressure may often give rise to demands that wage growth controls should be altogether removed or eased in enterprises with prevailing state or municipality interest. If pay rises run parallel with labour productivity improvement and stable financial performance (in the case of budget organisations it implies that the budget should be kept well balanced) wage growth will not jeopardise the stability of the economy. In this sense, wage growth controls in financially troubled state-owned enterprises are a must. In early-June, the government undertook measures to strengthen control of wage growth in financially troubled state-run enterprises - monopolists, producing goods and services subject to price administration, requiring that they should raise their average wage only after an explicit permission of the government no matter whether they had reported positive financial results or had been servicing their debts on a regular basis. The motive behind this measure package was that the government implemented certain price adjustment schemes aimed at the financial stabilisation of enterprises while uncontrollable labour cost increase (no matter how small and insignificant a share they had in total operating costs) would only impede the achievement of this policy goal.

The minimum wage is another important instrument of government income policy. According to NSI data[5], about 5% of the employed encompassed by the survey received wages that were close to the country's minimum wage. Their share within total employed in the public sector was rather insignificant (0.6%) whereas their share in the private sector amounted to 11%. Demands for the removal of wage growth regulations were coupled with minimum wage rise demands, having to do not with the effect on the labour market but rather with the necessity to raise more revenues for social security funds. The demanded level of the minimum wage is BGL 100 000. According to NSI data, more than 16% of the employed covered by the NSI employment and wage surveys received wages well below BGL 100 000, with their share by sectors of the economy amounting to 3% (public sector) and 22.5% (private sector).

The possible reaction of entrepreneurs no matter whether they are actually paying their workers wages of below or about BGL 100 000 or not, will be to reduce employment. It is unlikely that they will keep employment and lower wage differentiation within the firm or squeeze the profit margin. So the final outcome of an unreasonable increase of the minimum wage will be higher unemployment.

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[5] *NSI employment and wage survey data.*

Stabilising the Price Level

The overall price level decrease of mid-1998 persisted well into the first half-year period of 1999. Since the beginning of 1999 consumer prices have fallen by 2.0%, producer prices dropped by 1.8%. Purchase prices of agricultural goods in the first six months have stepped down by 19.6% on a year earlier.

Table 3. Price Change and Contribution to Cumulative Inflation over the Jan–Jun 1999 Period

Commodity group	Relative share in CPI, %	Price change, %	Contribution in percentage points
Total	100.000	-2.0	-2.0
Food items	47.822	-8.9	-4.1
Non-food items	29.310	0.0	0.0
Services	19.683	10.0	2.1

Source: NSI

Following the hyperinflationary shock and supply shortages of 1997, food prices caught up and even surpassed the international food price level in both absolute and relative terms. Hence, the steepest price decline compared to other commodity groups. Since mid-1997 the food market has been brought back to normal, with both domestic supply and imports going on the increase. International food prices took a downward trend in 1998 which persisted into the first half-year period of 1999 as well, now acting as an inflation-limiting factor in Bulgaria. Due mainly to the trade liberalisation arrangements with the EU and EFTA more than 85% of industrial imports is duty free. According to WB data (first half-year period of 1999), international food prices stepped down by 17%, agricultural prices by 10%, and coffee, tea and cocoa prices by 12.5%.

For the purposes of this analysis we have compared the food price level in 1996, 1997 and 1999, with food prices being recalculated in US dollar terms plus a VAT of 20%. The analysis resulted in the following conclusions: food prices in May 1999 (in dollar terms) were lower than in May 1997 prices (non-tradables excluded) and higher than food prices in May 1996.

Assessing the impact of international prices on domestic inflation, we have divided the commodity groups comprising the consumer basket into tradables, pontential tradables and non-tradables

Table 4. Price Change and Contribution to Cumulative Inflation over the Jan–Jun 1999 Period

Commodity group	Relative share in CPI, %	Price change, %	Contribution in percentage points
Total	100.000	-2.0	-2.0
Tradables	17.881	-6.2	-1.1
Potential tradables	41.020	-8.9	-3.6
Non-tradables	41.099	6.4	2.7

Source: NSI

Influenced by international price dynamics, tradables and potential tradables registered a negative price change and negative contribution to overall inflation. The prices of non-tradables have lagged behind international prices, and their rise tended to run parallel to household income growth. Services and administered prices, adjusted so far towards increases, account for the largest share in the group, bringing about a price level rise.

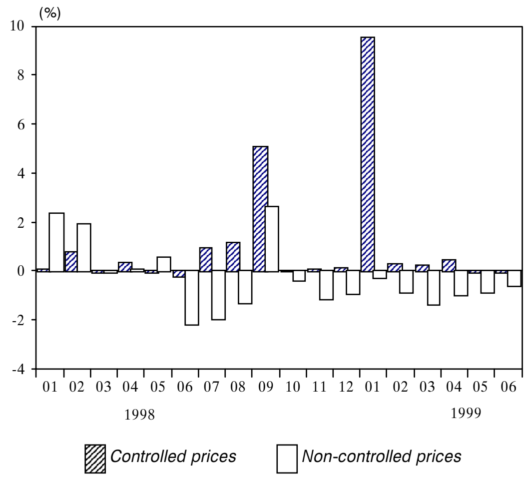
Cumulative monitored price inflation in the first half-year period of 1999 was considerably higher, compared to the same period of 1998.

Table 5. Price Change in the First Half-Year Period of 1998 and 1999

	Relative share in CPI, 1998	Jun'98 relative to Dec'97	Relative share in CPI, 1999	Jun'99 relative to Dec'98
Inflation – total	**100.000**	**2.3**	**100.00**	**-2.0**
Monitored prices – total	**15.841**	**0.9**	**17.21**	**10.5**
Monitored service prices	10.118	2.0	12.11	13.1
Monitored prices, services excluded	5.722	-0.9	5.10	4.4
Core inflation – total	**84.159**	**2.6**	**82.79**	**-4.7**
Core service inflation	5.404	24.5	7.57	5.0
Core inflation, service inflation excluded	78.755	1.1	75.21	-5.7
Services – total	**15.522**	**9.8**	**19.68**	**10.0**

Source: NSI

Monhly Change in Controlled and Non-controlled Prices



Source: AEAF

Monitored price growth was mainly due to the rise in administered service prices aimed at the financial stabilisation of enterprises offering these services. Apart from administered service prices, there are services sold at market prices in the service group. 1998 witnessed rampant market service price inflation, which was cushioned in early 1999. In the first six months of 1998, market service prices (core service inflation) rose by 24.5% while in the first half-year period of 1999 they registered a modest increase of 5%, indicating that their level has been now stabilised.

Monthly inflation in July and August ran at a rather high rate of 3.19% u 1.01% respectively. Inflation in both months was due to a monitored price rise as well as an increase in free market prices.

Table 6. Price Dynamics and Contribution to Inflation in July and August 1999

Commodity group	Relative share	Price change			Contribution in percentage points
	(in %)	Jul	Aug	Jul–Aug	Jul–Aug
Total	100.00	3.19	1.01	4.22	4.2
Monitored prices	17.21	5.48	1.76	7.33	1.3
Free market prices (core inflation)	82.79	2.61	0.81	3.44	2.9

Source: NSI

July 5, 1999 saw the increase in the prices of electricity, heating, drinking water, gas, and propane butane, followed by a coal price rise in August. These are monitored-price goods and services[6]. As shown on table 1, free market prices had a larger contribution to cumulative inflation in both months. The group also includes fuel prices (petrol and diesel). Part of their increase was attributed to some administrative measures. The amendments to the Liquid Fuel Charges for the Republican and Road Network Act require that producers and importers of fuel should accrue a higher charge on fuels. On the other hand, domestic petrol price growth was brought about by the 65% rise in international prices in the first six months of 1999. Fuel prices affected city and intercity bus fares. But it was only in August that

[6] *Prices of coal for households were liberalized since July 1, 1999.*

Percentage Changes in Broad Money, Producer Prices and Consumer Prices

Source: NSI, AEAF

monitored price growth was fully perceived and reported in CPI statistics, for, on the basis of NSI methodology, the average monthly monitored price is calculated as the average weighted of the prices and number of days on which a given price was in force. Also in August, the fuel price rise was fully reported as fuel prices rose twice in July. It can be assumed that higher fuel prices influenced the prices of other goods as well.

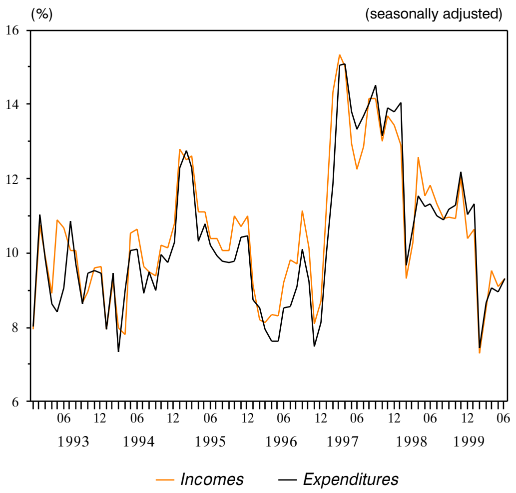
Money supply dynamics is another factor of price change. Ever since the currency board arrangement in Bulgaria there has been discerned a strong correlation between narrow money dynamics by months (on a 12-month basis) and the inflation rate as well as a clear-cut correlation between narrow money and producer prices in the manufacturing sector.

The BGL Redenomination Act was enforced on July 5. At this early stage, however, assessments of the impact of the redenominated BGL on prices are difficult, if not hasty. What we can say for sure is that the redenomination of the national currency has failed to affect non-food and service prices, as they did not report any rise in two months in a row, the influence of monitored prices excluded. By end-1999 inflation is expected to run at very low monthly rates (deflation is not excluded) brought about mainly by another rise in fuel prices.

The Economy in Kind

Following the 1997 hyperinflationary shock, the role of the economy in kind has been somewhat

Relative Share of in Kind Incomes and Expenditures



Source: NSI, AEAF

fading away. In the first half-year period of 1999, the relative value of both non-monetary income (in kind) and expenditures set back at their 1993 and 1994 levels.

The macroeconomic stabilisation and income recovery both in terms of absolute value and structure are a factor bringing about the contraction of the economy in kind. The ousting of the economy in kind by the market economy is indicative of the successful implementation of the structural reforms in the country and the growth potentials of the economy to be developed.

Behaviour of Commercial Banks

The banking system continues to enjoy a stable financial position. As of end-June banks' current profit amounted to BGL 130.6 billion against BGL 172.6 billion as of end-June 1998. Twenty-two of altogether 34 commercial banks reported a positive financial result totalling BGL 144.6 billion[7]. Banks' capital adequacy increased from 35.5% in end-June 1998 to 41.7% in end-June 1999, signalling that commercial banks have opted for transactions of lower and reasonable risk. Despite the 4.4 percentage points decline in the cash in hand/total assets ratio to 11.7% on a 12-month basis relative to June 1998, liquidity remained high. The capital and reserves/assets ratio stepped up by 0.8

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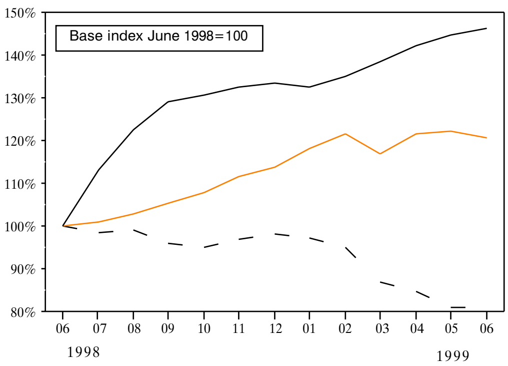
[7] *In the first-half year period of 1999, twelve banks reported a total loss of BGL 14 billion. For some of them, mostly foreign bank branches, the loss reported was due to the discrepancy between BNB regulations and their own internal rules as regards security of risk exposures and the allocation of provisions for risk claims.*

percentage points to reach 15.2% in end-June 1999 while the credits/deposits balance sheet coefficient rose by 9 percentage points up to 39.3%. The deterioration of the business situation in the real sector of the economy and the adverse effect of the Kosovo crisis on the Bulgarian banking system led to a 0.9% decrease in banks' total assets in early 1999. Some financial indicators registered unfavourable changes as follows:

Indicators	End of Jun 1998 period	End of Jun 1999 period
Return on assets	2.27%	1.74%
Net interest income to assets	2.06%	2.03%
Operating expenses to assets	2.09%	2.44%

Non-government Credits in Real Terms*



— Claims on non-financial SOE — Claims on private enterprises

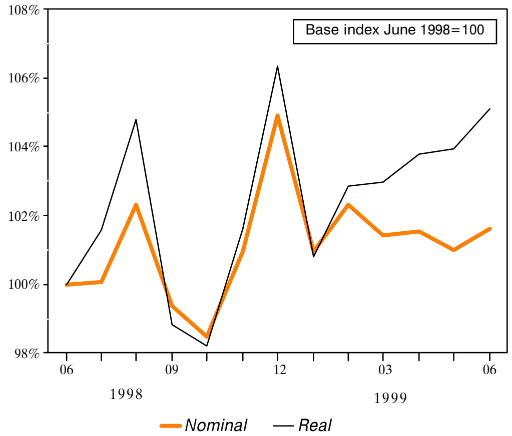
— Cliams on households

** Claims on households are CPI-deflated, while claims on state-owned and private enterprises are PPI-deflated.*

Source: BNB, AEAF

On the asset side, the share of credits to non-financial institutions stepped up from 23.3% in end-June 1998 to 28.4% in end-June 1999. On a year earlier, the nominal-term growth of domestic credit in June amounted to 0.1% while registering a 3.5% real-term increase, deflated by the CPI. Over the same period, banks' claims on the non-government sector rose by 10.5% (or BGL 359.7 billion) and fully offset the 46% (BGL 353.7 billion) decline in net credit to the government sector. Credit growth to the non-government sector was due to the 21% rise in claims on private companies (BGL 419.7 billion) and the 41.4% rise in claims on individuals and households (BGL 151.1 billion). At the same time, claims on non-financial state-owned enterprises declined by 18.7% in nominal terms or BGL 181.9 billion. Operating banks alone increased their lending to the non-government sector by 29.7% (BGL 575.2 billion). They however did not change their lending policies and extended working capital loans to a rather limited circle of creditworthy customers, provided they had offered viable security in return. Risk in the Bulgarian economy remains rather high and makes changes in banks' strategies for assets and liability management unlikely. The privatisation of the 3 largest state-owned banks by strategic foreign investors will probably bring about changes in their banking strategies and thus increase the share of loans to corporate customers and households within their total assets. Given a great interest spread between deposits and credits and effective risk management, changes in ownership and operational strategies may only improve the performance of banks having substantial credit resources.

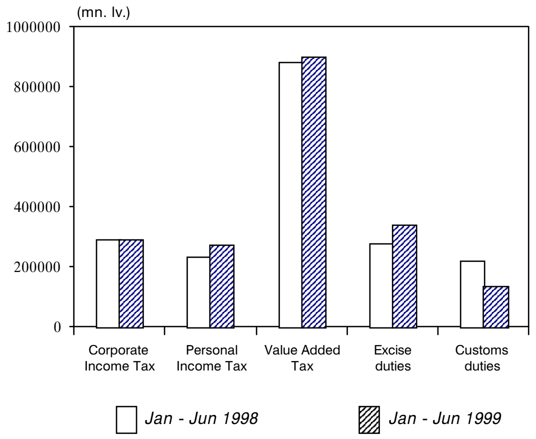
Total Bank Deposits



Source: BNB, AEAF

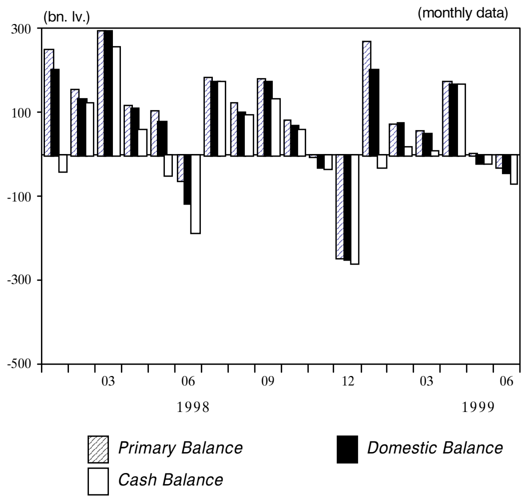
The analysis of deposit change by groups of depositors has indicated that confidence in the banking system has not been shaken. Corporate deposits have changed depending on the business situation, strongly affected by some seasonal factors. Though slowly, retail deposits, on the other hand, have steadily gone on the increase. In general, it can be concluded that commercial banks are gradually expanding their lending to the real economy on the basis of government debt amortisations and changes in their asset structure, developing great potential to extend credit resources to the real sector.

Revenues from Major Taxes in First Half of 1998 and 1999 at Constant Prices



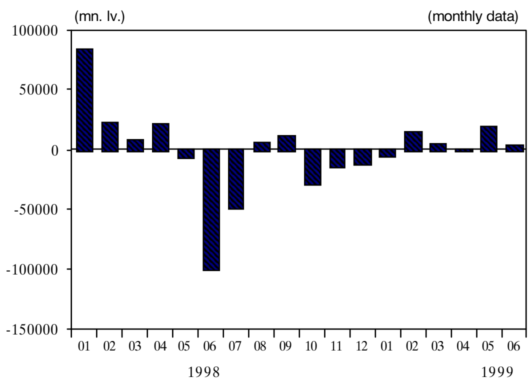
Source: MF, AEAF

General Government Budget Deficit/Surplus



Source: MF, AEAF

Government Securities Issues, net



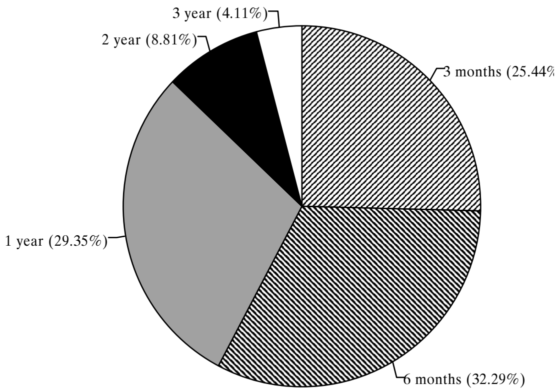
Source: MF, AEAF

Government Budget

In early 1999, a number of direct and indirect tax rates were lowered. This however did not affect central government budget revenues, which in the first half-year period of 1999 registered a 16.7% real-term growth, on a year earlier. The increase was mainly due to the rise in non-tax revenues. Tax revenues grew by 4.1% in real terms, a 8.2% real-term rise in direct tax receipts included. Over the first half-year period of 1999, total central government budget expenditures registered a real-term decline of 23.8%. Non-interest expenditures remained almost unchanged in real terms and their share within total budget expenditures rose from 66.5% to 86.7%, including the real-term increase in production subsidies to non-financial enterprises (by mid-year the implementation of this expenditure item covered some 77% of the budget law provision). Expenditures on public goods and services rose by 59.5% while government investment registered a 4.7-fold increase.

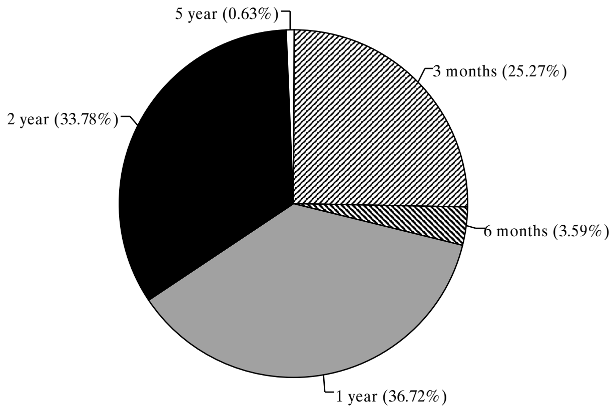
As a result of the above tendencies, the balances of both the central and general government budgets ran positive. Early 1999 saw the consolidation of a large number of extra budgetary funds and accounts aimed at a greater transparency of the budget process and improvement of money supply control, which set the beginning of budget finance centralisation. The net effect of extra budget account consolidation over the Jan - Jun'99 period amounted to BGL 793.5 billion. As budget revenues exceeded expenditures in the first

Government Securities in Circulation as of June 1998



Source: MF, AEAF

Government Securities in Circulation as of June 1999



Source: MF, AEAF

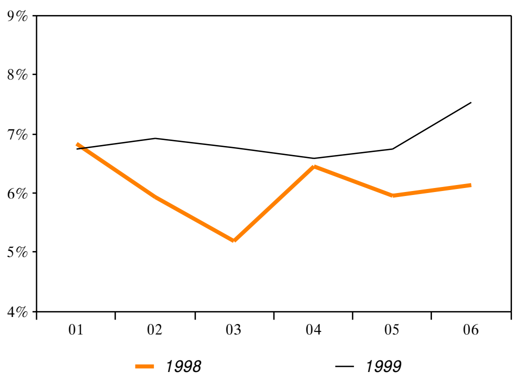
Table 7. Annual Government securities yied

(percent)

	Jan 1999	Feb 1999	Mar 1999	Apr 1999	May 1999	Jun 1999
3 months	5.04	4.91	4.88	4.71	4.49	4.83
6 months	0.00	0.00	5.12	0.00	0.00	5.69
1 year	6.76	6.50	6.30	5.79	5.34	5.62
2 year	9.35	9.14	8.97	8.07	8.57	11.72
5 year	0.00	0.00	12.79	15.37	0.00	0.00

Source: MF, AEAF

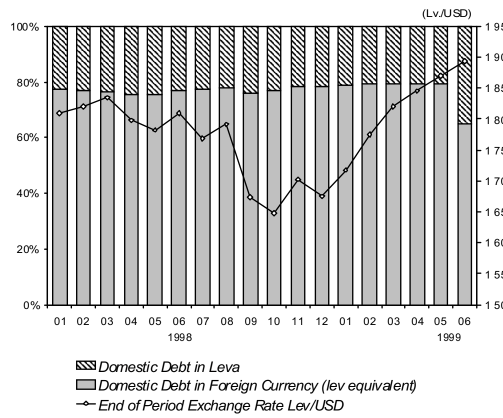
Average Government Securities Yield



Source: MF, AEAF

half-year period of 1999, the public sector borrowing requirement remained rather low. The absence of any government pressure on the financial system contributed to the stabilisation of interest rates and the improvement of the maturity structure of newly issued government securities. The ratio between interest payments and the primary surplus can be said to be a reliable indicator that the government was able to meet its interest obligations - the ratio stepped

Foreign Currency and Lev Components of Domestic Debt



Source: MF, BNB

up from 1.1 as of June'98 to 2.8 as of June'99. Four tranches under the 3-year IMF stand-by agreement had been extended, which eliminated any possible government financial pressure on the banking system as well as alleviated balance of payments pressures.

Factors Impeding Growth

Taxes and the Social Security System

The assessment of the impact of taxes on economic activity is usually controversial. The strategy of the government now is to decrease gradually the tax burden in a way that the fiscal position remains sustainable. We have pointed out the positive effect on the economy of the balance budget.

The undertaken changes in the tax rates in 1999 affected both direct and indirect taxes. Indirect tax change had a multiple effect. On the one hand it was the VAT that was lowered from to 22% to 20%, now covering a larger range of goods subject to taxation. Also, the number of excise goods decreased coupled with a change in the type of tax rates in the beginning of 1999. The tax burden on producers and importers of excise goods like tobaccos and coffee, etc was now heavier. Customs duties as well as the highest import duty rates were reduced in accordance with the foreign trade liberalisation policies of the government.

Direct taxes underwent substantial amendments, e.g. to personal and corporate income taxes to avoid heavy direct tax burden upon the introduction of the new health insurance system of July 1. The profit tax burden has been reduced from 37% to 34.3%. The Personal Income Tax Act was so amended as to provide for certain changes in the tax brackets of the monthly and annual tax scales, with non-taxable income being raised by 25%.

Table 8. Personal Income Tax on the Average Monthly Salary

(percent)

	Total	Public Sector	Private Sector
Jan 1998	15.0	15.8	13.1
Feb 1998	15.0	15.9	13.0
Mar 1998	15.7	16.6	13.5
Apr 1998	15.9	16.8	14.0
May 1998	15.9	16.8	14.1
Jun 1998	16.2	17.1	14.4
Jan 1999	13.8	14.9	11.5
Feb 1999	13.8	14.9	11.6
Mar 1999	14.4	15.6	12.1
Apr 1999	14.3	15.4	12.2
May 1999	14.8	15.6	12.4
Jun 1999	14.6	15.7	12.5

The present report attempts an assessment of the tax burden changes on pay-roll for employers and employees alike based on the June'99 average wage.

Table 9. Tax burden on the country's average wage in Jun 1999

(percent)

	since Jun 1 1998	since Jan 1 1999	since Jul 1 1999
Employer:			
Social security contribution (3rd tier))	37.0	37.0	34.7
Unemployment and Professional Qualification Fund	3.6	3.6	3.5
Health insurance contribution	0.0	0.0	3.0
Employee:			
Income tax	fix rate + (Gross salary-SSC-UIC-HIC)-lower tax bracket)*marginal tax rate		
Social security contribution (3rd tier)	2.0	2.0	1.0
Unemployment and Professional Qualification Fund	0.9	0.9	0.5
Health insurance contribution	0.0	0.0	3.0

Given the above rates, overall pay-roll tax burden changes can be estimated for employers and employees alike on the basis of total pay -roll. For employers the change amounts to 28.9% under the taxation system of 1998 and early 1999 and to 29.2% following July 1, 1999 (part of the additional pay-roll tax burden is covered by a reduction in the profit tax paid by firms reporting an annual profit of over BGL50 million. For employees the change amounts to 13.95% under the 1998 taxation system and to 13.22%, following July 1, 1999. Employees' net income will then represent 57.2% of total wage bill under the 1998 taxation system and 57.6% under the 1999 system. Therefore, the current changes in direct taxation simply adjusted to the introduction of the new health-care insurance.

This method of calculation, however, does not take into account some most recent changes in the national social security system aimed at improving tax compliance. An important step has to do with the broadening of the tax base of pension contributions without reducing the size of the contribution. These amendments largely contravene some underlying principles of the social security system. For instance early 1999 saw the introduction of a new tax on fringe benefits. Funds are thus transferred to the Social Security Fund without being added to personal social security accounts and hence cannot determine the size of future pension benefits, violating major principles of social security.

Other amendments to the social security system make the pay-roll tax burden even heavier and will have important consequences for the labour market unforeseen at the time they were adopted. Since January 1999 insurance payments on benefits and allowances for temporary disability, maternity, childbirth, etc. have been introduced. The amounts to be paid do not take into account the structure of expenses made on benefits and allowances covered by the different types of risk. As a result a greater rigidity of the labour market can be expected because of an increase in labour costs. Employers will become cautious when hiring people. For example, they might start requiring medical files or refusing to hire young females, etc.

Since early 1999 self-employed have been given the choice to make their own social security contributions on the basis of 2 to 10 minimum wages instead of 1 to 8 minimum wages. This however makes the social security burden heavier for self-employed.

The mobilisation of resources for the social security funds by broadening the tax base had to facilitate the normal operation of the social security system and the allocation of a reserve fund to cover 1-month payments. In the first quarter of 1999 the Social Security Fund (SSF) reported a deficit but overall in the first half-year period of the year it ran a surplus used for the accumulation of reserve funds. Eleven percent of 1998 SSF pension benefits was allocated to the reserve fund in the first six months of 1999. Thus, reserve allocations amounted to 52.5% of the year's projection, implying that the SSF was able to meet the reduction in social security contributions, following the enforcement of the health insurance legislation on July 1, 1999.

Social security issues are fundamental in that that they exert a direct impact on key macroeconomic indicators such the propensity to save, staff motivation, labour market flexibility and viability and flexibility of economic agents to respond to business environment changes. Social security contributions, as they are, are essentially a direct income tax for the following reasons:

1. With health insurance and the Unemployment and Professional Qualification Fund contributions, the benefits received are not linked with the size of the contribution made.

2. With pension contributions, there is only a weak relation between contributions and

pension benefits. Due to the deteriorating age structure of the population all current receipts are paid out in the form of pension benefits, with the size of a single benefit amounting to some 20% of the market capitalisation of a personal social security account, which in case of death is 100% lost. Therefore, pension contributions are essentially a pay-roll tax paid by working age individuals and consumed by retirees. Apart from favouring retirees, this tax erodes the propensity to save. Total social security contributions surpass in amounts the relative burden of other tax expenditures, growing into a powerful motive for income underreporting. This in turn results in poor tax compliance, increasing tax burdens on people doing legal business.

A major problem of social security stems from the fact that individuals are altogether disinterested in making social security contributions. A possible solution requires that employees shoulder fully the responsibility of social security contributions, be they pension, health insurance, unemployment, etc. But it is for the employer to decide whether to partially remit an employee's contributions depending on the business strategy of the enterprise. This is one way to do away with wage duality. For employers, wages are all labour costs to be paid, i.e. staff remuneration, contributions and any other benefits in kind while for employees, wages are nothing but the remuneration and some other fringe benefits they enjoy. Shifting the pay-roll tax burden on employees means preventing employers from shrinking back from social security responsibilities. On the other hand, whether employees will report their income or not depends, in the first place, on the quality of services provided by social and health insurance offices and in the second on whether effective public control over the implementation and observance of the social and health insurance legislation is possible. The disposable income of employees on labour contracts will not diminish only if payroll tax burdens are not increased and any pay rise is proportional to the amount an employer has had to contribute on the employees' behalf.

Licences and Permits

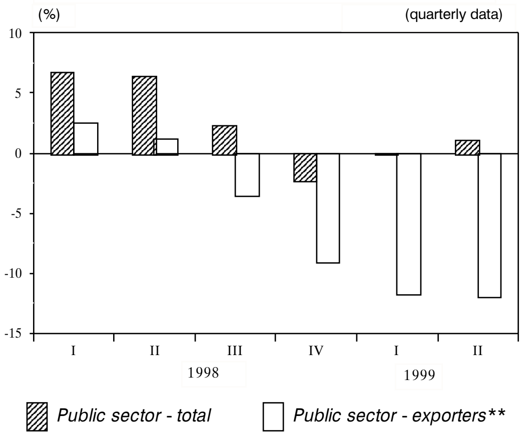
The complicated, rather unsystematic and expensive system of licencing regimes and permits is a major impediment to private business growth. Quality standards and consumer protection requirements necessitate the application of licencing regimes in certain areas of economic activity. The inefficient and sluggish administrative procedures and machinery and ever changing regulations and measures give rise to corrupt practices impeding business in many sectors of the economy. Exorbitant licence fees as well as the waste of time trying to get hold of a licence makes business a rather costly exercise and limits the number of economic agents, creating monopoly power (e.g. construction, telecommunications, city transport, retirement and health insurance, distribution of gas and heating, etc.).

The Problem Called „State Sector“

The privatisation process in Bulgaria is taking place at a very fast pace and state interest in the real sector of the economy is steadily declining. As of end-August 1999, 64% of all assets earmarked for privatisation was fully privatised, accounting for 42.3% of total public sector assets against 18% as of end-1997. As result, the number of state-owned enterprises surveyed by the NSI stepped down by about 500 from 3081 to 2585 in the first half-year period of 1999 alone. The analysis of state-owned enterprises' behaviour is based on the above NSI representative sample and resulted in the following conclusions.

State-owned enterprises reported a loss in the first two quarters of 1999. After-tax loss in the first quarter amounted to BGL 250 billion while declining to BGL 90 billion in the second quarter. Total loss in the state sector in the first half-year period of 1999 was entirely due to losses incurred on financial transactions reaching BGL 352 billion. The sector reported a BGL 75 billion worth of operating profit in the first six months of the year, BGL 39 billion worth of profit in the second quarter alone. State-owned enterprises reported a relatively high profit of approximately BGL 86 billion from extraordinary operations. The high expenses of state-owned enterprises undermining their financial performance and position are the aftermath of their indebtedness to both commercial banks and suppliers, accruing a high penalty interest rate in case of default or delinquency. The extremely low operating profit rate of enterprises (the ratio between operating profit and operating income) could not cover their expenses. In the first quarter the operating profit rate in the public sector amounted to 0.9%, slightly improving to 1.1% in the second quarter.

Profitability of State-Owned Enterprises*



* Ratio of profit to revenue from main activities of enterprises.
** Enterprises, which have realised a half and more of their revenue by export.

Source: NSI, AEAF

Low profitability was due to the persistent decline in sales. According to NSI data, on a year earlier, the decline in sales in the first-half year period of 1999 amounted to 13%. In the second quarter sales revenues of state-owned firms rose by 7.5% on a quarter earlier. The declining number of loss-making enterprises was another indicator registering positive developments. Their number in the first quarter of 1999 amounted to around 54% of the total, further decreasing to 48% in the second quarter. The concentration of both reported loss and profit remained high. About 90% of the total loss in the sector was generated by only 5% of the enterprises reporting loss in the second quarter of 1999, with the ten biggest loss-makers generating 64% of total loss in the sector. At the same time, the ten largest profit-makers generated 76% of total profit while 90% of it was generated by a bare 1.8% of firms of the total number. The Kosovo crisis and the ensuing losses incurred and lost earnings were the likeliest reason for the deteriorated financial performance of some companies in the sectors of transport and tourism in the second quarter of 1999.

Depending on their financial position as of end-June 1999, state-owned enterprises arbitrarily fall in three groups:

- enterprises reporting hefty book profits. Depending on the sector they operate in, some of them are state monopolies, generating and distributing electricity, water, etc., the telecommunications sector, some trading companies and enterprises in the food processing industry;

- enterprises in dire financial straits, reporting big operating losses, accounting for the majority of indebtedness in the sector. These are mainly enterprises in the chemical industry and metallurgy, all of them crisis-ridden branches over the last years; and the heavy machine building industry that has bottomed out ever since the collapse of the CMEA markets;

- a large group of SMEs whose financial performance and position is not decisive for the overall performance of the state sector.

The liabilities of public sector enterprises as of end- June 1999 stepped up by about 8%, relative to end-March 1999 (in nominal terms, they amounted to BGL 8.1 trillion as of end-June 1999). The burden of their indebtedness to suppliers (32.6% of total indebtedness), the budget and the National Social Security Institute (29.8% of total indebtedness) was even heavier. State-owned enterprises' indebtedness is focused in a very small number of firms, with 5.8% of the total number of firms responsible for about 90% of the sector's indebtedness while the ten biggest debtors account for 51.5% of the sector's total liabilities. Delinquencies are to be found among the enterprises in the sectors reporting the biggest loss over the period surveyed, such as the chemical industry and metallurgy, transport and tourism, coke and refined petroleum products. The bulk of enterprises in the first two sectors were included in the restructuring programme and were either privatised or underwent liquidation procedures. It can be expected that in the third quarter of 1999 the public sector will report better financial results not only due to the privatisation of some enterprises or winding up of others but also due to the ongoing privatisation process and hardening of the budget constraints on the sector.

The State Monopolies

Inefficient state monopolies continue to be a major barrier to private sector growth. Furthermore, under the Commercial Code most of them are not subject to bankruptcy proceedings or liquidation procedures. The Commission on Competition Protection has never so far sanctioned a state monopoly for market malpractices, despite some attempts.

Although some of the largest enterprises have been privatised, state monopolies are still having a dominant role in the economy. About 1/3 of the employment in the manufacturing sector and 53.2% of the fixed assets are concentrated in the ten largest state-owned enterprises.

Table 10. Concentration of the 10 Largest State-Owned Enterprises (1st Quarter'99 Data)

Subsidies	Indebtedness to suppliers	Delinquent payments to the budget	Credit in arrears	Share in total employment	Share within total assets
43.7%	40.6%	73.6%	38.4%	33%	53.2%

Theoretically speaking, the existence of monopoly power is characterised by a high profitability margin, surplus production capacity and minimum labour costs. The exercise of monopoly power will eventually result in smaller output, higher prices and welfare loss. If rationally applied, monopoly power may lead to the optimisation of income and expenses while using economies of scale to improve efficiency. State monopoly behaviour can be a lot different from the behaviour of private monopolies. Instead of generating profit, their monopoly power may degenerate into the accumulation of hefty losses, delinquent payments to the budget, payables in arrears to suppliers and high staff costs – well above average. The net effect of such behaviour will only incur higher welfare losses, in which case low production levels may bring about shortages in the economy, affecting its real sector. Drawing upon quarterly performance data of enterprises in the manufacturing sector, we can test the type of behaviour of state monopolies in Bulgaria. The monopoly power indicators herein used are as follows: market share in total sales in a sector, share in assets, share in the sector's total employment.[8] Some concentration indices have been further exploited to indicate the degree of competition in the private sector. The absolute value of a sector's average fixed assets has been used as an indicator of the barriers blocking the entry and exit of firms in an industry. Also, the indicators of efficiency and financial performance have been employed

[8] *With all indicators, we have used branches to the four digit under the National Branch Classification.*

as dependant variables on the method of the vertical financial analysis: profitability, return on assets, current liquidity and quick ratio/acid liquidity, share of value added in total income, share of unserviced credits and liabilities to the budget, share of subsidies, average wage. The rational behaviour theory has established a positive relation between the market share or concentration and the financial performance indicators of a company. The statistical analysis, however, has not indicated such a relation in none of the regression equations, often pointing to a negative relation, i.e. the analysis has confirmed the irrational inefficient state monopoly's behaviour hypothesis. However, there is a stable positive correlation between the market share of enterprises and average wages as well as between the barriers to entry and exit and the amount of subsidies extended. Despite the declining number of state-owned enterprises in the manufacturing industries, the loss reported as percentage of the GDP in the first quarter of 1999 went on the increase due mainly to state monopolies, ten of which concentrated about 2/3 of total loss. The concentration of unserviced obligations to the budget was even higher, with two of the largest state-owned enterprises responsible for over 50% of unserviced liabilities.

Persistent losses and indebtedness in arrears to suppliers and the budget eventually results in chronic shortages and deficits, the financing of which will have a crowding-out effect on the private sector in the long run, as revealed by the analysis of the correlation between the share of credit to the private sector and share of unserviced loans within total credit to the public sector.

The effective regulation and control of state monopolies can only draw upon a government economic policy based on the following principles and criteria:

1. Tough financial discipline and hard budget constraints.

2. Establishing independent institutions and natural monopoly regulatory authorities

3. Removal of licences that are more and more growing into barriers to the entry of new rival competitors or the exit of inefficient and non-viable economic agents from the market.

4. Privatisation of state monopolies or insulation of some auxiliary operations that can be made privatisable or given to concessionaires.

5. Ensuring transparency and reliability of feedback information from enterprises to the regulatory authorities.

The Underdeveloped State of the Capital Market

Capital markets are an effective instrument for raising money from local and foreign savings for the purpose of promising investment projects financing. In Bulgaria, however, both the turnover and the volume of trade on the Stock Exchange remain low.

The inadequate regulation of capital market became evident during and after the Asian crisis. A new bill on the public offering of securities is being drafted in the country to replace the current rather ineffective Securities, Stock Exchanges and Investment Companies Act of 1995.

The protection of minority shareholders' rights is an essential element of legislation in the economies in transition in so far as this protection may well deepen the capital market. The holders of the majority lot of shares will always be favoured at the expense of minority shareholders unless there is an efficient enough capital market to prevent it.

Current legislation in Bulgaria allows the increase of capital under condition. This condition stipulates that certain people must buy the new issue of shares at a stated price. This provision violates two underlying principles of trade on the stock exchange. First, the share of the company's capital held by minority owners decreases as a result of a decision taken by the general meeting of shareholders rather than as a consequence of market fluctuations of supply and demand and second, shares are traded at non-market prices. The bill on the public offering of securities abolishes the stipulation for the increase of capital of public limited companies (PLCs) under condition and ensures greater protection of minority shareholders' rights.

Minority owners' limited rights to withdraw from a public limited company when substantial changes in the ownership structure occur represent another major drawback of current legislation. The very fact that ownership is concentrated in one or two persons normally causes a fall in the price of shares regardless of the financial situation of the company. It is therefore reasonable to grant minority shareholders the right to drop out of the company by selling their shares to the holder of the controlling block of shares in order to preserve the market's liquidity. Current legislation in force provides for this possibility. However, the bill on the public offering of securities restricts these rights only to cases when a person has acquired either directly or through associates more than 95% of all shares whereat he has the right (but not the obligation) to make a bid to the remaining shareholders.

The change of ownership of a public limited company creates risks to both shareholders and creditors of the respective firm. A draft clause in the bill on the public offering of securities forbids the governing board of a PLC to transfer or grant the right of use of assets of total worth exceeding 50% of the assets value on the balance sheet of the company to a third person (by virtue of a signed contract) unless the general meeting of shareholders has explicitly authorised it to do so. However, the shareholders general meeting can be easily bypassed by breaking a big deal into several smaller deals that would not require the consent of the general meeting. Therefore, the future law must arguably either regard closely connected deals as one deal or link such deals in time and interpret them as a single deal with the company's assets.

The access to information represents another potential risk to minority shareholders. It is taken for granted that controlling shareholders possess much more sources of information than minority shareholders. Because of the present requirements for the contents of an invitation to make a bid, the future investor practically receives an obscure picture of the market position of the issuer and the prospects of sales. The changes in the national accounting standards also impede the clear-cut analysis of the inter-temporal dynamics of the company's financial situation. The changes in the definition of sales that took place in 1998 provide a good example of how the market position of a company can be misinterpreted since in 1998 sales were understood to include not only sales of own production but also any sales of current and fixed tangible and intangible assets. The notion of sales is central to financial analysis and any changes in the way of its calculation may result in unsound investment decisions.

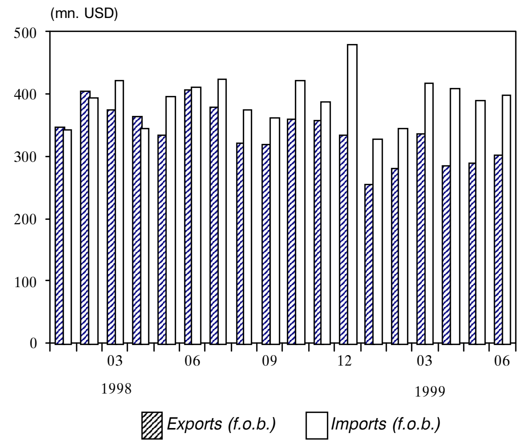
Trade with debt instruments is also important to the development of stock markets. At present only two issues of bonds (those of *ProSoft* Ltd. and the Municipality of Svishtov) are traded at the market. The Commercial Code stipulates that the value of a bond loan should not exceed 50% of the amount of paid-up capital. This means that the value of bonds issued by a company with small fixed capital established before 1989 will not be consistent with its actual volume of sales and investment. Therefore, any restriction on the size of the loan should arguably be tied to the value and liquidity of the issuer's assets rather than to the amount of paid-up capital.

The Deterioration of International Markets

Bulgaria's major foreign trade partners from the European Union, namely Germany and Italy, have been affected by the turmoil on the international markets since mid-1998 which resulted in a gradual decline of the country's monthly exports which remained at low levels in the first half of 1999. The Kosovo crisis and its consequences together with implementation of the crucial phases of structural reform in Bulgaria when a number of large companies were either privatised or liquidated added to the negative impact of the unfavourable situation at the international markets in early-1999. The problems of restructuring of the national economy addressed through privatisation and liquidation were still present and continued to suppress effective supply of export goods. Therefore, the substantial decline in exports registered in the first half of 1999 was due to the unfortunate coincidence of a number of adverse factors affecting both external demand and domestic export supply.

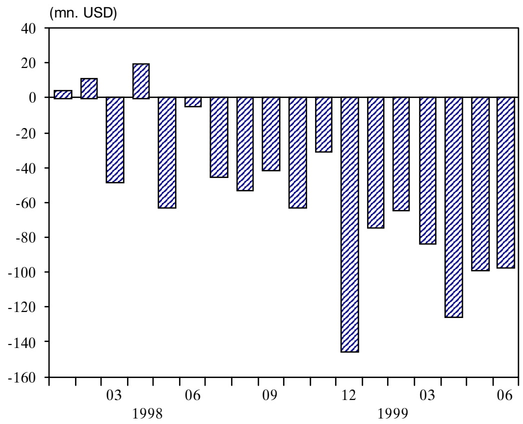
According to national accounts, exports revenues in the first quarter of 1999 fell by 24% relative to the corresponding period in 1998 while imports declined by 2.4% over the same period.

Exports and Imports



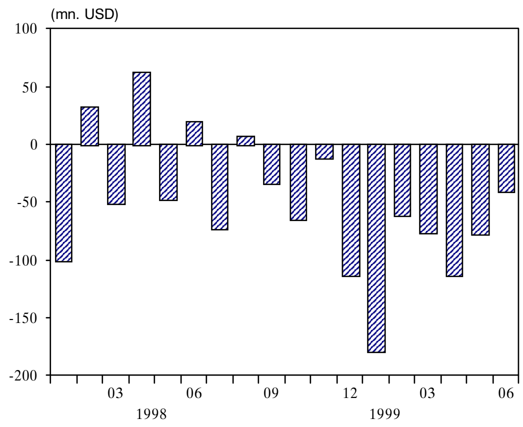
Source: BNB

Trade Balance



Source: BNB

Current Account of the Balance of Payments



Source: BNB

Table 11. Dynamics of GDP Components

(Changes in volumes in %, respective quarter of 1997 = 100)

	98 Q.1	Q.2	Q.3	Q.4	99 Q.1
Final consumption	17.7	5.0	5.0	5.5	12.8
Final household consumption expenditures	19.1	5.8	5.8	5.4	15.3
Collective consumption	17.7	0.7	-0.8	13.5	-1.6
Gross fixed capital formation	15.7	23.3	16.5	10.5	-1.7
Exports of goods and services	-7.5	-10.3	-26.6	-15.9	-23.9
Imports of goods and services	15.9	-5.3	-10.1	-7.2	-2.4
Gross domestic product	16.8	2.6	-1.8	1.2	-0.7

The Kosovo crisis had an impact not only on exports but also on the service balance. This adverse effect is particularly noticeable in the level of monthly receipts from transport services. They amounted on average to some 85% of their respective levels in the corresponding months of 1998 while a pronounced slump was observed during the months of military operations. Payments for transport services, however, followed the opposite trend, increasing on average to 110% of their levels in the corresponding months of 1998. The highest rise was reported in March, April and June 1999.

The detailed analysis of Bulgaria's exports and imports presented below was carried out using data based on handled customs specifications and supplied by the Computing Centre of the Ministry of Finance. The table displays the composition of foreign trade in the first half of the year by sections of the customs tariff.

Textiles and base metals sustained their highest relative share within Bulgarian exports in the first half of 1999 followed by chemical products, food, mineral products and machines. Energy resources (reported in the *Mineral Resources* Section) as well as machines and transport equipment traditionally accounted for the largest share of imports.

Table 12. Exports and Imports by Major Commodity Groups

(January – June, 1999)

Sections	Exports		Imports	
	Value ('000 USD)	Relative share, (%)	Value ('000 USD)	Relative share (%)
Live animals and meat products	33467	2.06	24230	1.07
Vegetable and fruit products	67267	4.14	42456	1.88
Animal and vegetable fats	10908	0.67	9993	0.44
Food products, beverages and tobacco	130740	8.05	93198	4.13
Mineral products	141498	8.72	475492	21.07
Chemicals and chemical products	155565	9.58	205350	9.10
Plastics, rubber and articles thereof	56542	3.48	95528	4.23
Raw hides and leather products	14469	0.89	25394	1.13
Wood, cork and products thereof	42252	2.60	8817	0.39
Pulp of wood, cellulosic materials and paper	19576	1.21	70837	3.14
Textiles	311273	19.18	292149	12.95
Footwear, hats, umbrellas, artificial flowers, etc.	51346	3.16	26492	1.17
Articles of stone, plaster, cement, glass, etc.	31234	1.92	26751	1.19
Gems, precious metals, jewels, coins	10030	0.62	1906	0.08
Base metals and metal articles	289477	17.83	111127	4.92
Machines, appliances, electrical equipment; parts	132382	8.16	315304	13.97
Transport equipment	77618	4.78	346594	15.36
Optical, photographic, medical instruments, apparatus, etc.	13440	0.83	48721	2.16
Guns, ammunition, parts and accessories	164	0.01	307	0.01
Miscellaneous goods and products	33773	2.08	35837	1.59
Works of art and antiques	90	0.01	219	0.01
TOTAL	1623109	100.00	2256702	100.00

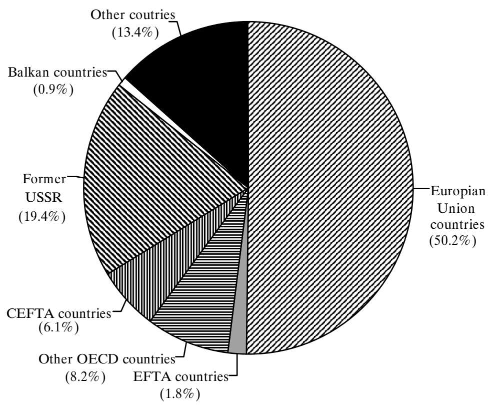
In order to discern clearly the reasons behind the exports and imports dynamics, we calculated the percentage changes of both their value and volumes in the first six months of 1999 relative to the respective period of 1998. Thus, for example, the export of knitted or crocheted clothes registered a 15.9% increase in volumes and a 26% rise in value. The export dynamics of clothes other than knitwear and of the goods reported in the *Other Textile Articles* Section followed different trend: while export volumes declined by 6.8% and 0.9% respectively, their respective values increased by 20.9% and 19.35%. Such a dynamics was indicative of a price rise of these goods on the international markets. The imports dynamics of these commodity groups followed analogous trends.

Within the group of base metals, the following goods registered a decline in export volumes: iron and steel (-45.4%), iron or steel articles (-14.5%), copper and articles thereof (-4%), aluminium and articles thereof (-25.1%) as well as zinc and potassium. The fall in export volumes of all these subgroups coincided with a decrease in their respective export dollar values. Within the group of base metals, only the export and import of lead registered a relatively small increase both in volume and value.

The volume and value of imported mineral fuels and oils stepped down by 21.2% and 21.9% respectively. The value of imported machines and equipment went on the increase as follows: by 57.1% for machines, apparatus and mechanical appliances; by 40.3% for electrical machines and equipment; by 81.7% for motor vehicles and tractors; and by 12.6% for precision apparatus. The heterogeneous nature of these groups precludes any definitive conclusions about their import volumes, however, there is good ground to believe that they also followed an upward trend.

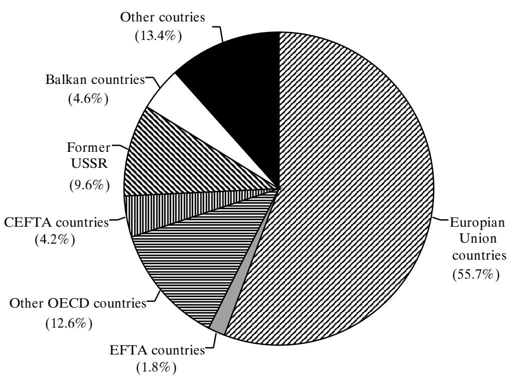
In the first half of 1999, the composition of exports and imports by country of destination underwent no changes.

Imports by Country for the Period January – June 1999



Source: BNB

Exports by Country for the Period January – June 1999



Source: BNB

The European Union sustained its position as the leading Bulgaria's foreign trade partner. The share of exports to the group *other OECD countries*, including *inter alia* Turkey, USA and Japan was also relative large. The relatively high share (19.4%) of imports from the CIS and Baltic States within total imports was sustained mostly due to the import of energy resources. In the first half of 1999 the foreign trade balance with Turkey registered a surplus of USD 46.2 million with Bulgarian exports amounting to USD 126.4 million, and imports to 80.2 million. The downward trend in total Bulgarian exports is evident from the registered fall in exports to Turkey as compared to the figure of USD 146 million in the corresponding six months in 1998. The dollar value of imports from Turkey, however, went up by 65.7% against USD 48.4 million registered in the period January to June 1998.

Imports from CEFTA member states increased from USD 123.6 mn in the first half of 1998 to USD 150.9 mn in the same period of 1999

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