BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2000
(semi-annual survey)

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.

ISSN 1310-327X

The 2000 Economic Review for Bulgaria highlights the country's economic development since the beginning of 2000 drawing upon the data made available by end-September. It presents a brief overview of the major developments taking place in the world economy (e.g. the unprecedented economic boom, growing raw material prices, especially crude oil prices, the EUR's depreciation against the US currency) while tracing the influence of all these factors on the Bulgarian economy and the way economic agents and the government responded to their impact.

But apart from the international business situation, there are a number of internal factors at work like restructuring and reforming affecting the country's economy. Having in mind that by end-1999 more than 70% of the assets earmarked for privatisation were privatised, and mid-2000 saw the privatisation of 80% of these assets[1], it can be said that the key task of the transition period has been successfully completed. Furthermore, the changes that have been effected in the social security rationale, i.e. changes in the pension system and health care financing, are also influencing the economy. As a result of the reforms implemented, the restructuring process has gained momentum and the present economic review attempts at making a clear-cut distinction between the positive and negative effects of the reforms on society.

---

[1] *Excluding state-owned assets in the energy power generation sector and infrastructure.*

Also, the present review handles some of the important changes in the government economic policies which have been sustaining the principles of neutrality to entrepreneurship and consistency of measures focusing essentially on the removal of any administrative barriers to free initiative. Fiscal policy is responsible for ensuring the country's macroeconomic stability. Its restrictive stance has made it possible for the government to exert strict control over government budget expenditures and deficits while gradually reducing tax rates. In July, the levels of banks' minimum required reserves with the Bulgarian National Bank (BNB) were lowered which in turn led to an increase in the financial resources available. Against the rising interest rates in the international markets, interest rates in Bulgaria remained stable reporting an insignificant decrease.

In conclusion, the review summarises the major developments in the Bulgarian economy in 2000, offering a brief overlook on its development by end-2000. ❑

The World Economy in 2000 - A Brief Overview of the Major Economic Highlights

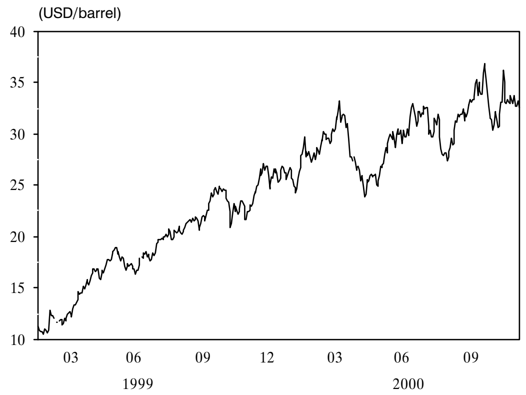
In 2000, the world economy has been developing under the impact of three main factors as follows: rapid recovery of the financial crisis-struck regions over the 1997 – 1999 period and overall economic upsurge, rising raw material and fuel prices, and depreciation of the single European currency against the US dollar.

Over the last three years, the changes occurring in the world economy have been swift, diverse and of huge fluctuation. Following the strong cooling down of the economy in 1998 and first half-year period of 1999, growth rates in 2000 have accelerated to reach a 15-year record high now covering all regions. Production in the East Asian economies where initial market turmoil and subsequent imbalances brought about the 1997–1998 financial crisis now rebounded at an annual rate of approximately 7%. The developed economies that retained their positive growth rate and thus prevented the financial crisis from growing into a worldwide recession continued to accelerate. The US economy reported a growth rate of about 4% in 1998 and 1999, expected to rise to 5.2% in 2000. The EU growth rate – Bulgaria's biggest trading partner, has sped up to 3.7% in 2000.

Driven as it has been by growing external demand, especially on the part of the EU, economic activity in CEECs remains high. In the eight months to September, growth rates in the region were high: Poland (6%), Hungary (6.2%), Slovenia (6.3%), Estonia (7.5%) and Latvia (5.3%). The Czech Republic reported a rather modest growth rate of 3.1% while growth in Romania, Lithuania and

Slovakia remained low at 1.5%, 2.0% and 1.9% respectively[2]. The Russian economy recovered rapidly after the 1998 crisis and reported a growth rate of 3.2% in 1999, and 7.2%[3] in the first half-year period of 2000.

Crude Oil Price (NYMEX)

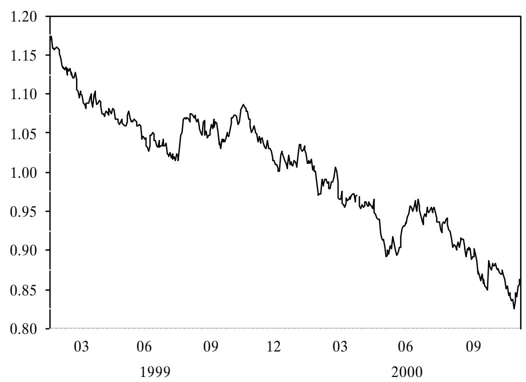


Source: Bloomberg

The sharp increase in demand worldwide has affected raw material prices and fuel prices in particular. Crude oil prices have been steadily rising since early 1999. The attempts of the developed countries to influence the oil price dynamics took effect as late as early-October 2000 when oil prices began to fluctuate within the USD 30-35 per barrel band.

The growing oil prices imply a rechannelling of income from net consumers of oil to net producers. This may impose certain restraints on the accelerating growth rates of the developing economies which are a lot more reliant on fuel imports than the developed countries. This in turn is likely to lead to the cooling down of the world economy in 2001.

USD/EUR Exchange Rate



Source: Bloomberg

2000 has sustained the downward trend of the EUR against the US dollar, a trend that has come to the fore with the very introduction of the single European currency for non-cash payment purposes in the Euro area. Thus over the 1999-Sept'2000 period, the EUR lost ground to the US dollar by more than 25%, with the depreciation the currency reported in the nine months to September alone amounting to over 12%.

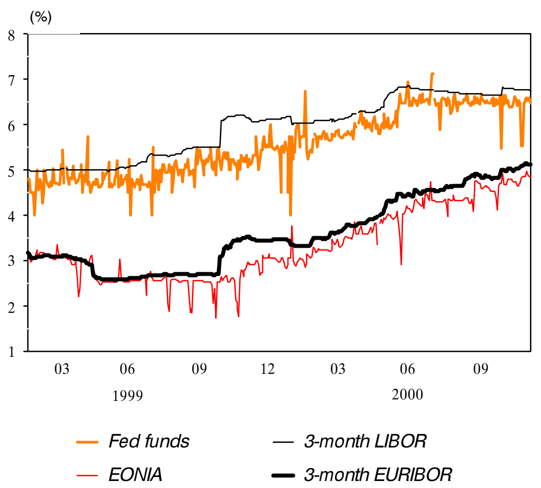
---

[2] *Based on* Monthly Update *statistics of* Business Central Europe*, October 2000, cumulative since start of year: Poland (1st half-year period), Hungary (1st half-year period), Slovenia (1st quarter), Estonia (2nd quarter, period average), Latvia (1st quarter), Czech Rep. (1st half-year period), Romania (1st quarter), Lithuania (1st half-year period), Slovakia (2nd quarter, period average).*

[3] *Based on Business Central Europe, October 2000 data.*

A factor contributing substantially to the EUR's weakness has to do with the outstripping growth rate of the US economy compared to the EU as well as with the brighter mid- and long-term perspective of development of the US economy due to the robust development of new technologies attracting more and more investors, especially European, into the USA. The rising prices of crude oil and other raw material (metals and chemicals) transactions in which are mostly carried out in USD also boosted US currency demand. There are various explanations as to why the EUR has been steadily losing ground against the US dollar, but its depreciation has, however, contributed to economic growth in the EU member states. On the other hand, the weakening EUR and growing fuel and raw material prices have generated an inflationary potential in the Euro area which as of September 2000 manifested itself as annual inflation of 2.8%, or 0.8 percentage points above the 2% inflation target which the European Central Bank is required to curb inflation within. US inflation hit 3.5% on a 12-month basis. Thus, both the European Central Bank and the Federal Reserve raised the money market interest rates on their transaction several times[4].

Short-term Interest Rates



Source: Bloomberg, Reuters

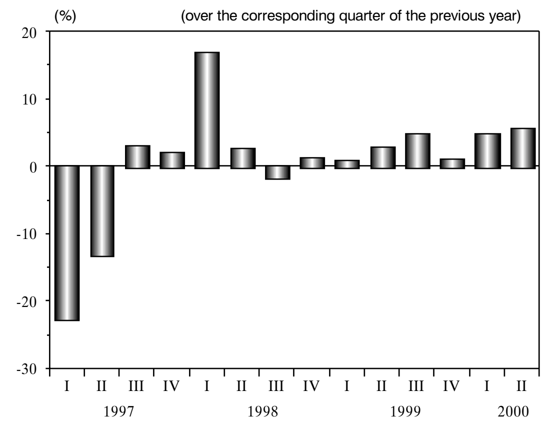
The world economic trends have influenced directly the Bulgarian economy. Over the last few years, the country's economy has not given in to the adverse impact of the international business environment, generating a positive growth rate of 3.5% (1998) and 2.4% (1999) for two years in a row. It responded quickly to the improving business situation of mid-1999 and Bulgarian

[4] *Drawing upon The Economists, Nov. 4-10, 2000 data: US inflation amounted to 3.5% in the 12 months to September.*

exports in the nine months to end-September 2000 grew at a two-digit rate in real terms. The weakening EUR provided a further impetus to export growth. On the other hand, alongside the rising fuel and raw material prices, it brought about an increase in production costs. ❑

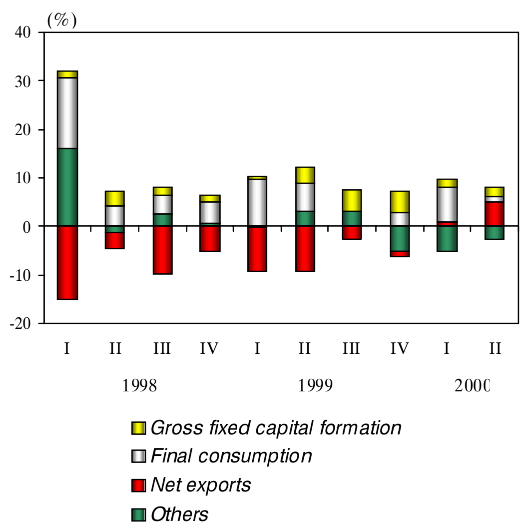
ACCELERATING ECONOMIC GROWTH IN 2000

GDP Growth Rate



Source: NSI, AEAF

Contribution of Final Expenditure Categories to GDP Real Growth



Source: NSI

GDP Dynamics

The successful implementation of the structural reforms, private sector development and high fixed capital formation rate have provided the basis the growth potential of the Bulgarian economy is being built upon. With the 1996/97 crisis still fresh in mind, it was as early as 1998 that the Bulgarian economy reported a 3.5% growth, and 2.4% in 1999, given the extremely adverse impact of the international business environment throughout the period reported. The 2000 first-half year period growth rate amounted to 5.2%, hitting a 10-year record high.

For the first time over the last three years net exports (both goods and services) had the largest contribution to the country's economic growth in the first half-year period of 2000, followed by domestic demand – consumption and investments. Bulgarian producers have obviously taken advantage of the favourable international business environment to expand their production volumes. As indicated by the figure below (*„Others“* heading), changes in inventories had a negative contribution to growth.

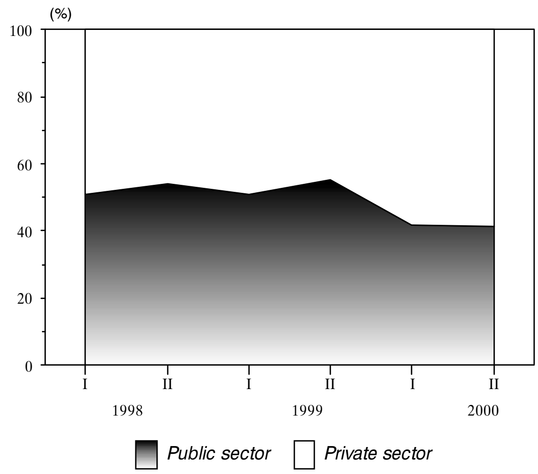
Table 1. Change in GDP Volumes by Expenditure Items

(on a year earlier, %)

	1st Quarter 2000	2nd Quarter 2000	1st Half-Year Period of 2000
Final consumption	5.9	1.5	4.8
Gross fixed capital formation	18.0	12.1	14.2
Exports	27.2	25.9	26.5
Imports	20.4	11.9	15.8
GDP	4.8	5.7	5.2

Source: NSI

Share in Expenditure on Acquisition of Tangible Fixed Assets



Source: NSI, AEAF

Fixed capital formation is important for creating and enhancing the potential of the economy for sustainable long-term growth insofar as it promotes new technologies and products. For a third running year, fixed capital formation has reported an extremely high rate of real-term growth, raising its share in GDP. In the first half-year period of 2000, the share of private investment within GDP registered an increase. According to data from the NSI investment activity surveys in the manufacturing sector, two-thirds of the private investment made were aimed at improving the product structure and technology of production while one-third of them were channelled to the renovation of current equipment and facilities or expansion of capacity.

Table 2. Real-Term Growth of Expenditures on Fixed Assets Acquisition in the Private and Public Sectors

(on a year earlier, %)

	1999	1st Quarter 2000	2nd Quarter 2000
Expenditure on fixed assets acquisition: country's total	16.6	19.5	17.4
O/w: the public sector	22.7	-2.2	-11.5
The private sector	10.2	42.0	53.2
Expenditure on the acquisition of equipment and machinery	9.0	4.4	20.0
O/w: the public sector	15.9	-24.4	-10.0
The private sector	2.9	34.6	59.6

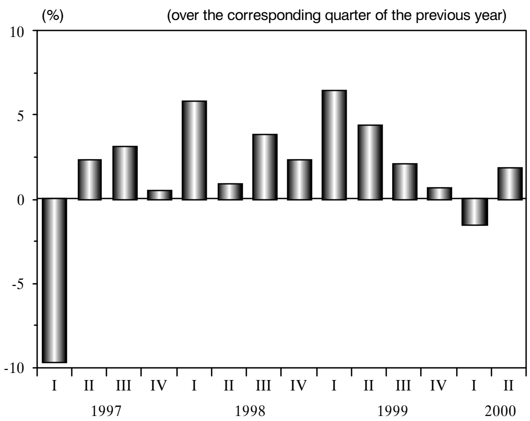
Source: NSI

As clearly seen from the table, public investments were mainly aimed at supporting construction and repair works, having to do with the building and maintenance of infrastructure sites and projects in transport while the private sector was dominated over by investment in equipment and machinery.

Apart from fixed capital formation, the system of national accounts reports inventory change as well. Within a year's span only from mid-1998 to mid-1999 inventories rose substantially due to sales difficulties as a result of the deteriorating international business environment at the time. Such a pattern of change was discernible in previous periods as well, especially over the 1992-1993 period, followed by an increase in exports in 1994 when inventories reported a decline. The same process of export potential improvement running parallel with inventory decline has been discerned since mid-1999. Therefore, it can be assumed that the value of inventories has been approximating its optimum level, which also explains the negative contribution of inventory change in the country's economic growth.

Again in 2000, the private sector has continued its robust development, registering a 16.1% real-term growth in the first half-year period while the public sector reported a negative growth rate.

Changes in Inventories



Source: NSI, AEAF

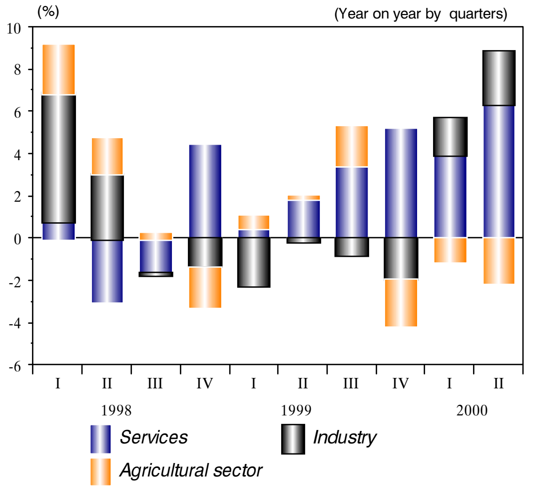
Table 3. Share of Private Sector Value Added (at current prices)

(%)

	Jan-Jun 1999	Jan-Jun 2000
Agriculture & forestry	96.6	97.1
Industry	50.2	65.5
Services	59.8	60.3
Total:	61.2	65.7

Source: NSI

Contribution to Gross Value Added Growth by Sectors



Source: NSI, AEAF

Overall in the public sector, value added declined by 9.8%, but the sectors enjoying a monopoly position like the production and distribution of electricity and heating, and communications reported a positive growth rate.

A breakdown by sectors shows that the manufacturing and service sectors contributed to growth whereas agriculture reported a 12.9% decrease. The agricultural sector enjoys a comparatively high share within GDP and the decline of its weight as a rule produces a negative effect on the growth rate. The decline was due to the private sector (12.5%) and the public sector (24.2%). A major factor behind the deteriorating performance of the agricultural sector in the fist half-year period of 2000 had to do with the shrinkage in agricultural and food exports to Russia and the Ukraine. In the seven months to August 2000, agricultural exports contracted by 21.4%. Given the unfavorable external demand, part of the agricultural produce was redirected to the domestic markets. Over the Jan-Sept'2000 period, food retail sales registered a 3.7% rise on a year earlier, which however was insufficient to make up for the loss in exports.

Reporting a most dynamic development over the last three years, the service sector accounted for 50% of GDP. The following sectors registered high real-term growth rates as follows: telecommunications (40.4%), trade (15.7%), followed by financial services (14.2%) and transport (13.8%)[5].

Performing well over the last few years, tourism contributed substantially to the improvement of

[5] *The real-term growth rate of the sectors in the first half-year period of 2000 on a year earlier is given in brackets.*

the balance of payments current account. In the seven months to August, Bulgaria was a first choice country for 1 657 000 holidaymakers.

Performance of the Manufacturing Sector

Hardest-hit by the post-1990 changes in the economy, the manufacturing sector registered a rather high growth rate in two quarters in a row in 2000. Over the Jan – Aug'2000 period, industrial sales stepped up by 4.5% in real terms on a year earlier, with export sales alone reporting a 30% real-term increase.

Table 4. Real-Term Change in Industrial Sales

(on a year earlier, %)

	Jan-Oct 1999	Jan-Oct 2000
Sales revenues in the manufacturing sector	-11.6	+5.8
Incl. revenues from export sales	-16.7	+28.7

Source: NSI, Current Business Situation

Three manufacturing industries of high concentration of capacity built well before 1990 where the business situation has been steadily and significantly improving over the 2000 reported an extremely high growth rate as follows: ferrous metallurgy (27.7%), non-ferrous metallurgy (34.9%), and coke, refined oil products and nuclear fuel (28.7%)[6]. They accounted for 5.3% of industrial sales growth.

An assessment of the structural changes in the manufacturing sector can be based on the response of sectors that have been expanding their capacity over the last few years or enjoyed

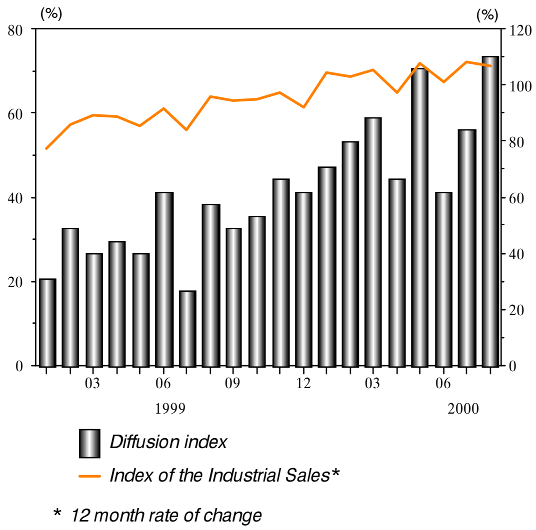
[6] *The real-term industrial sales growth in the first half-year period of 2000 on a year earlier is given in brackets.*

a high share of value added in gross output. 2000 sustained the upward trend of industries that can join this group, viz. printing and audio and video recording and CD writing (46.2%), manufacturing of radio, TV and telecommunication equipment (51.0%), office and computer equipment (38.5%)[7]. The share of these sectors in industrial output was very low and despite the high growth rate reported, their contribution to industrial sales growth amounted to only 1%.

Given this structure of the manufacturing sector, in the eight months to September, the industries enjoying a share of value added below the sector's average reported a 4.7% contribution to sales growth, whereas the weight of industries where the share of value added was above the sector's average remained negative within the negligible sales growth of 0.2%.

Although sales growth was primarily due to three sectors, the diffusion index reporting the percentage of sectors registering an increase within their total, reported a two-fold rise on a year earlier, i.e. the basis of growth has widened, now encompassing a larger number of manufacturing industries.

Diffusion Index and Index of Industrial Sales



Source: NSI

The broadened basis of growth has not been due to a spill-over effect of the first three sectors reporting the highest contribution to growth, as they are characterised by a low level of processing[8]. Then, a key contributing factor to the broadened basis of growth is entrepreneurship promotion under the strong conducive effect of both external and internal conditions.

---

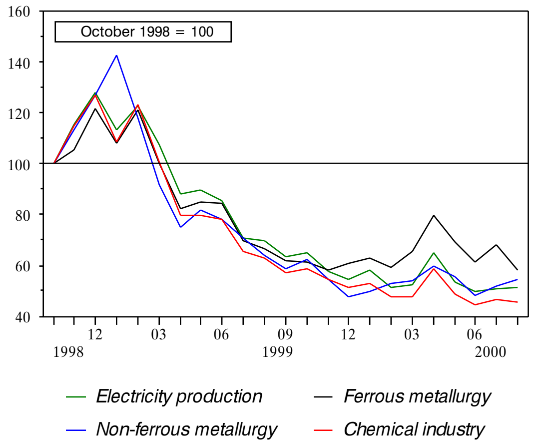
[7] *The real-term industrial sales growth in the first half-year period of 2000 on a year earlier is given in brackets.*

[8] *They are also highly import-intensive.*

There has been also another factor at work in 2000 – the growing raw material and fuel prices bringing about a value added squeeze in the manufacturing sector and undermining enterprises' competitiveness. Presumably, enterprises in metallurgy, electricity generation, and the chemical industry are likely to be affected in the utmost degree. If we take the Brent index to indicate the rising production costs of firms[9], then the ratio between the PPI in a given sector and the oil price index would highlight the ability of enterprises in a given sector to pass on their higher costs to consumers without losing their market share.

Judging by the figure below, we can assume that compared to other sectors, metallurgy has so far incorporated the growing production costs in final product prices most successfully, whereas relative producer prices in the electricity generation sector and the chemical industry have been gradually falling.

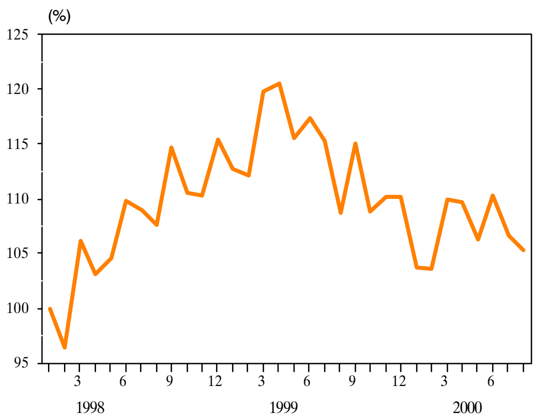
Ratio of Producer Price Index to International Price of Crude Oil (Brent) Index



Source: NSI, AEAF, World Bank

If an enterprise fails to pass on its higher production costs to consumers without losing its market share and thus its business is threatened to become illiquid or insolvent, it should take steps to restructure the major price elements either by curtailing labour costs or reducing its profit, or both. The response of enterprises to the higher costs on raw material and energy is hard to estimate but the ratio between average wage growth and the PPI can serve as a point of departure in the present estimates.

Ratio of Nominal Average Wage Index and PPI in the Manufacturing Sector



Source: NSI, AEAF

Mid-1999 witnessed a continuous clear-cut ten-

---

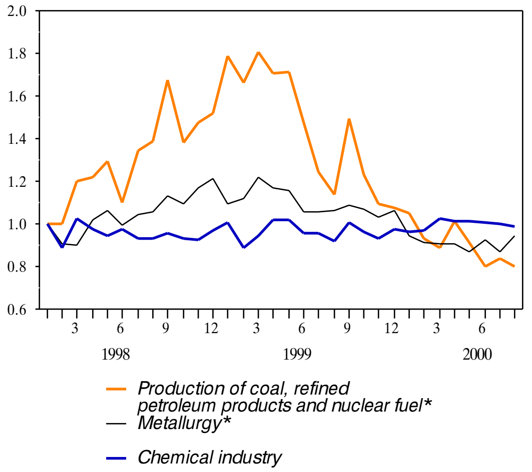
[9] *This is too strong an assumption as the share of fuels costs which are dependent on oil prices is not the same in the sectors selected. Therefore, the present analysis draws not upon the relative price level but their dynamics.*

dency of substantial relative labour cost reductions in producer prices. Has a company failed to pass on its higher raw material and energy costs to consumers, it should reduce its labour costs in order to survive.

The sectors most affected by the high fuel and raw material prices and reporting a most significant change in labour costs were as follows: metallurgy and production of coke, refined oil products and nuclear fuel. On the other hand, the structural adjustment of the enterprises privatised in the second-half year period of 1999 also influenced the dynamics of the wage index/PPI ratio in certain sectors.

The chemical industry as hardest-hit by the rising international prices has manifested poor adaptability to the changing international business environment. The so-called real product wages in the sector has been reporting an insignificant decrease, especially since the beginning of 2000, which together with the inability of the sector to pass on the higher production costs incurred to consumers, implies a low level of competitiveness sustained. On a year earlier, sales over the Jan – Aug'2000 period reported an increase of only 1.3%.

Ratio of Nominal Average Wage Index to PPI

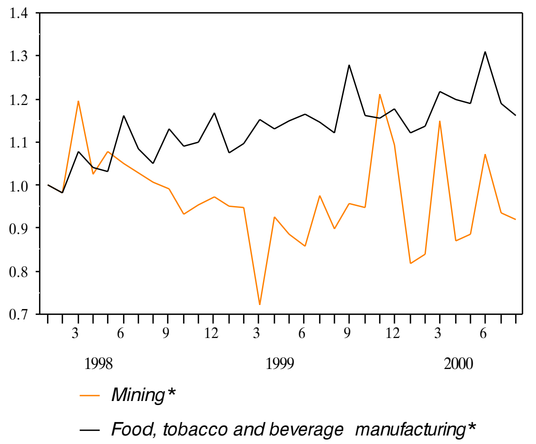


* Sectors with highest sales growth in the January-August 2000 period

Source: NSI, AEAF

Sectors reporting a most substantial industrial sales decline showed a different dynamic pattern of the average wage/PPI ratio. Unit production costs in the food and tobacco industries have distinctly tended to increase relatively. Food exports, too, followed a clear-cut downward trend in the period surveyed. Although dominated over by the private sector, the food industry is apparently losing part of its competitiveness.

Ratio of Nominal Average Wage Index to PPI

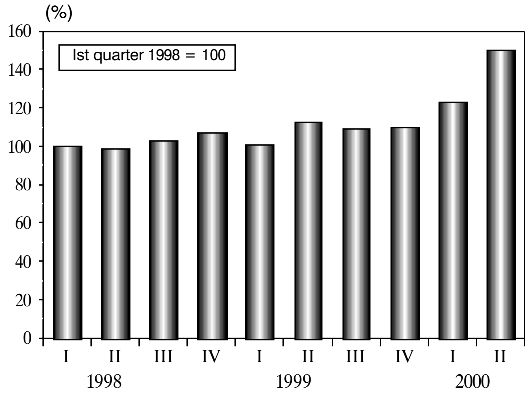


* Sectors with largest sales decline in the January-August 2000 period

Source: NSI, AEAF

Labour costs may be curtailed by employment reductions or improvements in labour productivity.

Gross Value Added per Employee in Manufacturing
(1996 Prices)



Source: NSI, AEAF

Launched in 1998, the process has gained momentum in the enterprises already privatised. Labour productivity has registered the highest increase in the processing industries which have been subject to the strongest competitive pressures and where privatisation has been completed. Due to the weak competitive pressure as a result of the monopoly position of producers, the mining industry and the electricity, gas and water production and supply sector did not report any labour productivity improvement. Monopoly market deregulation and the promotion and enhancement of competition in the economy may grow into an important factor for production technology renovation and labour productivity improvement, and hence growth acceleration.

In conclusion, it can be said that the positive GDP growth rate reflects the positive outcome of both the stepwise recovery process taking place in the Bulgarian economy induced by and based on consistent government economic policies and restructuring programmes, and the improved external environment. The service sector has continued to be an engine of growth, but the manufacturing sector has begun to pick up speed. On the other hand, as the manufacturing sector reported a positive growth rate in two quarters alone, one should not rush to the conclusion that it is getting out of the recession it has bottomed out. Such a conclusion may, however, be made if based on the observations that a growing number of enterprises in the sector tend to manifest appropriate flexibility and adaptability and thus take advantage of the positive shocks in the economy and respond adequately to the negative ones.

Foreign Trade and the Balance of Payments[10]

On a year earlier, exports in dollar terms over the Jan-Aug'2000 period reported a significant increase. However, it must be noted that the basis of comparison is very low – due to the Kossovo crisis export performance over the same period of 1999 was rather weak. The subsequent volume increase in exports and international price rise in raw material and fuels, which enjoy a significant share in the country's export basket, are the factors explaining the exceptionally high export value growth reported. On a year earlier, total exports in the eight months to September stepped up by 22.6%, with the following sectors reporting the highest share: textiles, leather, footwear and other consumer goods (23.9%), non-precious metals and products thereof (20.9%), oil products (13.6%)[11] .

Metals are highly sensitive to changes in international demand and prices. The shrinking external demand and collapse of prices over the 1998-1999 period resulted in a 35.5% contraction in metal exports, relative to 1997. Over the Jan-Aug'2000 period, metal export growth amounted to 50.1%, reflecting both the higher export volume effect and higher metal price effect[12].

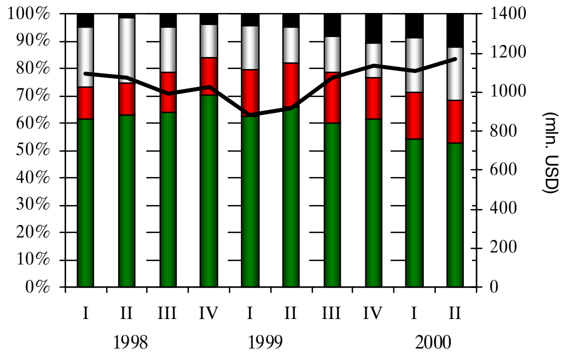
The deteriorating business environment over the 1998-1999 period brought about a 43% decline in chemical exports over the same period. In the

[10] The analysis has drawn on data taken from Bulgaria's Balance of Payments, October 24, 2000. The estimates are given in mln of USD.

[11] The share of the relevant commodity groups within total exports is given in brackets.

[12] Over the Jan-Aug'2000 period, metallurgy reported a real-term sales growth of some 30.7%, while the real-term increase in export sales amounted to 59.4% (preliminary NSI data).

Exports by Selected Commodity Groups



Export of oil products
Exports of metallurgical products
Exports of apparel
Other exports
Total exports (right-hand scale)

Source: BNB

eight months to September 2000, chemical exports rose by 25.0%, including a 105.1% growth in fertiliser exports. As regards export growth, the rapid price increase over the period outweighed the importance of the growing export volumes[13].

Oil exports followed the same pattern of dynamics: while declining by 28% in 1998, oil exports in 1999 stepped up by 22.9%, and reported an unprecedented growth of 144.0% in the eight months to September 2000 due mainly to the impact of price change.

Over the last couple of years, textiles, leather, footwear and other consumer goods have come to fore as a commodity group, reporting an ever rising share within the country's exports. The production of this type of goods is labour-intensive but competitive due to the low labour costs in Bulgaria. Exports in 1998 and 1999 reported a rise of 7.8% and 11.6% respectively, further going up by 17.9% in the eight months to September 2000. The high export growth rate was due to the growing export volumes over the same period.

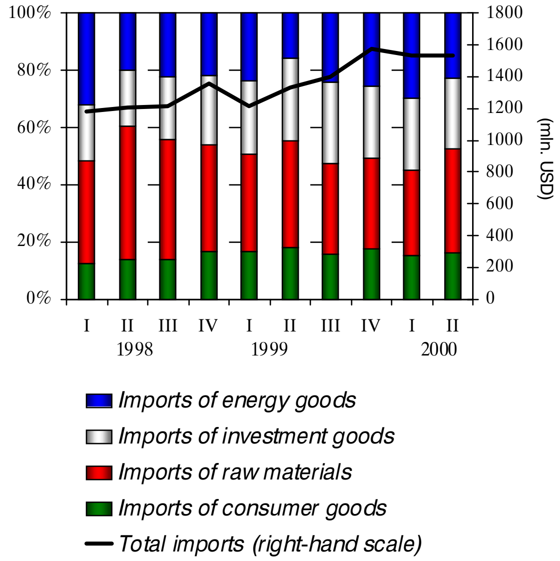
Following 1998, Bulgarian food exports to Russia were steadily falling due to the drastic shrinkage in Russian imports of 30% in 1999. Overall in the 1998-1999 period, exports stepped down by 9.2%, registering a 19.9% contraction in the eight months to September 2000, given an overall decrease in Bulgarian exports to Russia of 43%.

Total imports in the eight months to September 2000 stepped up 19.2%. The major import structure items were as follows: raw materials (33.5%),

---

[13] In the eight months to September 2000, the sector of chemicals, chemical products, synthetic and artificial fibres registered a real-term sales increase of 1.3%, whereas export sales in the sector rose by 14.4%in real terms (preliminary NSI data).

Imports by Selected Commodity Groups



Source: BNB

energy resources (25.6%) and investment goods, reporting a share of 25.4%. The high growth rate of gross fixed capital formation brought about a rapid increase in imported investment goods, with investments in machinery and equipment the local products/import counterparts being 1:1.

The rising international prices influenced import dynamics, in particular the import dynamics of raw materials and energy resources. According to BNB data, crude oil import volumes over the Jan-Aug'2000 period contracted by 17.5% on a year earlier, but import value had meanwhile risen by 19.2% due to the impact of the growing oil prices.

BNB has published estimates as to the impact of the growing crude oil prices and depreciation of the EUR on the balance of payments current account. In the Jan-Aug'2000 period, the rising oil prices led to the USD 150 mln worth of deterioration of the current account while the EUR's depreciation brought about a certain improvement in the current account of some USD 91.2 mln. As NSI data on country's GDP indicate, the terms of trade in the first half-year period of 2000 did not change against the same period of 1999 – the import and export price indices amounted to 114.2% and 114.3% respectively.

As a result of the interplay of all negative and positive factors reported, the trade balance ran a deficit of -USD 727.3 mln over the Jan-Aug period, stepping down the 1999 deficit by USD 45.7 mln. The current account deficit in the period considered amounted to USD 361.3 mln, improving by USD 72.5 mln against the same period of 1999.

The current account deficit was financed on the basis of the USD 143.8 mln worth of surplus on the capital and financial accounts, with FDI inflows, official BoP financing and BNB's reserve reduction reporting a contribution as follows: USD 366.4 mln, USD 130.9 mln and USD 47.3 mln. If we compare the sources of current account deficit financing employed in 1999 and 2000, we can discern that a major difference was triggered by the dynamics of banks' foreign currency deposits. While stepping down by USD 55.3 mln in 1999, banks' foreign currency deposits in 2000 rose by USD 548.9 mln. Deteriorating under the impact of the Kossovo crisis in 1999, the current account deficit led to a USD 116.2 mln of a decline in banks' foreign currency deposits while the deteriorating current account in 2000 brought about a USD 548.9 mln of an increase in banks' deposits[14]. Therefore, there is liquidity in the economic system and it is able to maintain a current account deficit of similar size.

Judging by the balance of payments in the eight months to September 2000 and the expectations that both the EUR and crude oil prices would stabilise in the near future, it can be assumed that there will be no significant BoP sustainability problems to cope with in the mid-term. Exports are growing driven by some traditional goods like metals and chemicals as well as by new products, mostly labour-intensive like clothes and furniture. In a more general aspect, the sustainability argument is supported by the macroeconomic picture in the country and expectations of a sustainable growth rate, growing FDI inflows and stability of the banking system. ❑

---

[14] *Commercial banks' behaviour is dealt with in greater detail in the section devoted to the financial sector.*

PUBLIC FINANCE

As a result of the more restrictive fiscal policy stance in the first half-year period of 2000, as compared to the same 1999 period, the primary and cash general government budget surplus amounted to 9.5% and 4.65% of GDP respectively.

Table 5. General Government Budget Balances

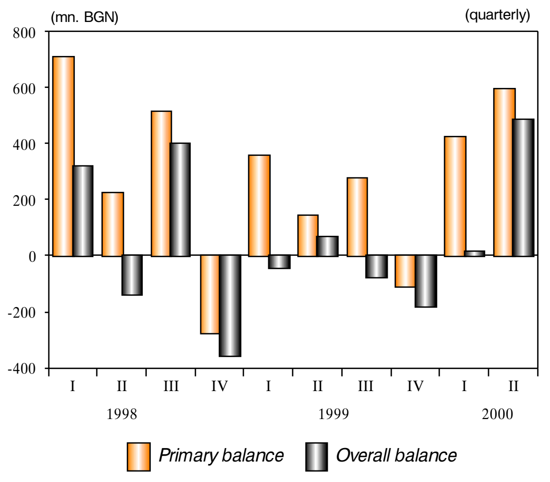
(as % of GDP in the first-half year period of the relevant year)

	1998	1999	2000
Primary balance	9.74	5.12	9.47
Cash balance	1.88	0.26	4.65

Source: MoF, AEAF

Government budget stability and surplus accumulation make the gradual reduction of tax rates possible, producing a positive and healthy effect on business growth. The steps taken in 2000 will be followed by other legal measures to be implemented in 2001.

General Government Budget Balances



Source: MF, AEAF

The changes in tax rates effective since the beginning of 2000, together with the health insurance requirement implemented since July 1999, affected the dynamics and structure of tax revenues. Pay-roll and indirect taxes (consumption tax) went on the increase while the corporate tax had relatively decreased. Tax structure is influenced not only by the amendments to the legal basis which are aimed at broadening the tax base (mostly applicable to social security and health insurance) but by the measures undertaken to improve tax compliance and collection as well.

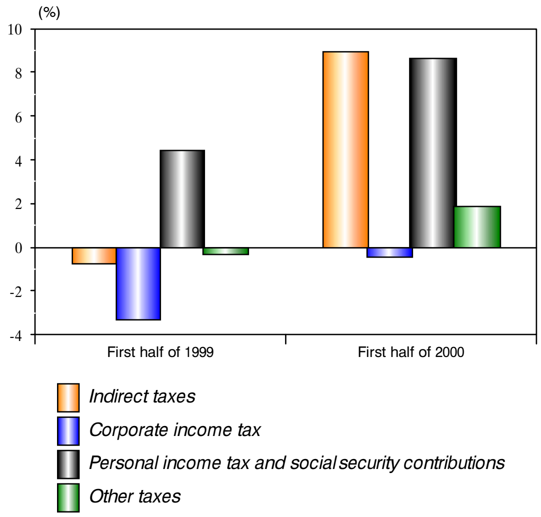
Table 6. Tax Revenues

(as % of GDP in the first-half year period of the relevant year)

	1998	1999	2000
Total revenues and external aid	45.0	46.0	49.5
Indirect taxes	14.3	13.7	15.4
Profit tax and municipality tax	5.8	4.5	3.9
Pay-roll taxes	14.7	15.9	17.3
Non-tax revenues	7.4	9.8	9.7
Other revenues and aid	2.8	2.0	3.2

Source: MoF, AEAF

General Government Budget: Contribution to Tax Revenue Growth



Source: MF, AEAF

In January, the profit tax rate was reduced while retaining the rate for municipalities, which accounted for the negative contribution of the profit tax within total revenue growth.

Clearly, the tax rate reduction failed to induce the tax revenue increase expected. Therefore, to avoid any balance disruptions in the general government budget, any future tax reduction should take place in a gradual manner, effecting a proportionate change in revenue structure, which may otherwise trigger a detrimental to the country's macroeconomic stability budget deficit deterioration.

July 1999 saw the introduction of the health insurance system. Revenues from health insurance contributions in the first half-year period of 2000 amounted to 2.3% of GDP. To avoid an increase in the level in total social securities on wages, the social security contribution rate for the different labour categories was reduced by 3.3 percentage points, and Professional Qualification and Unemployment Fund (PQUF) contributions decreased by 0.5%. The Obligatory Social Security Code, enforced in January 2000, provides for insurance with pension funds, which started to raise funds from the contributions of employees

Major Amendments to the VAT Law

	1997	1998	1999	2000	2001
1. Rate	22%	22%	20%[1]	20%	20%
- in case of exports	-	-	0%	0%	0%
2. Turnover (annual) necessary for registration	- voluntary registration is possible when turnover is below BGL 7.5 mln - obligation for registration when turnover is over BGL 7.5 mln	- voluntary registration is possible when turnover is below BGL 75 mln in case of non-exempt exports for over BGL 50 mln - obligation for registration when turnover is over BGL 75 mln	- voluntary registration is possible when turnover is below BGL 75 mln in case of exports for over BGL 50 mln - obligation for registration when turnover is over BGL 75 mln	- voluntary registration is possible when turnover is below BGN 75 000 but is above BGN 50 000 - obligation for registration when turnover is over BGN 75 000	- voluntary registration is possible when turnover is below BGN 75 000 but is above BGN 50 000 - obligation for registration when turnover is over BGN 75 000
3. Period for VAT credit refunding, in months	1 or 3	1	6	6	4
- in case of exports, in days	-	-	45	45	45

[1] VAT exemption has been removed for: bread, milk, yoghourt, water and firewood.

Major Amendments to the Corporate Income Tax Law

	1997	1998	1999	2000	2001
1. Rate					
- when taxable profit is up to BGN 50 000	26%[1]	20%	20%	20%	15%
- when taxable profit is over BGN 50 000	36%[2]	30%	27%	25%	20%
2. Municipal tax	6.5%[3]	10%	10%	10%	10%
3. Depreciation rate	9 categories with depreciation rate from 3% to 25%; straight-line depreciation method[4]	I category-4%; II category-20% III category-8%; IV category-15% The declining-balance method (with coefficient 1.5) has been allowed for some assets acquired since 31.12.1997	I category-4%; II category-20% III category-8%; IV category-15% The declining-balance method (with coefficient 1.5) has been allowed for some assets acquired since 31.12.1997	I category-4%; II category-20% III category-8%; IV category-15% The declining-balance method (with coefficient 1.5) has been allowed for some assets acquired since 31.12.1997	I category-4%; II category-20% III category-8%; IV category-15% The declining-balance method (with coefficient 1.5) has been allowed for some assets acquired since 31.12.1997

[1] In effect from 01.07.1996; when taxable profit is up to BGL 2 million; until 01.07.1996 tax rate was 30% when taxable profit is up to BGL 1 million.
[2] In effect from 01.07.1996 when taxable profit is over BGL 2 million.
[3] In effect from 01.07.1996; until 01.07.1996 tax rate was 10%.
[4] In effect from 01.07.1996.

belonging to the first and second labour category. It was in early-2000 that a recategorisation of employees working under specific conditions of work and paying higher security contributions than the normal was made. All this led to a decrease in social security costs for employers. Certain amendments have been made resulting in a substantial broadening of the insurance income base and tougher requirements to pension entitlement, which in turn offset the revenue decrease expected in the three insurance funds of the National Social Security Institute (NSSI).

According to NSSI data, revenues from security contributions in the first half-year period of 2000 accounted for 9.4% of GDP, i.e. they had stepped down their 1999 level by 0.3% only. As regards the sources of contribution payment, changes also occurred due to the partial transfer of the insurance burden from employers to employees. As a result of the 21% increase in minimum wages and 10% rise in security contributions, revenues from the contributions of self-insured reported a 48% nominal-term increase.

Revenues from PQUF contributions stepped down by 0.1 percentage points, accounting for some 0.8% of GDP in the first half of 2000. The contribution rate dropped from 4.5% down to 4% in mid-1999 while the high unemployment rate brought about a decrease in the number of insured.

2000 has sustained the positive changes in the expenditure structure of the general government budget. They can be deemed positive, for they are related to the relative decrease in budget expenditures on production subsidies (the withdrawal of the government from the economy) while raising expenditures aimed to underpin some typical public finance functions – provision of public services and promotion of the social security system.

Table 7. Share of General Government Budget Expenditures

(as % of GDP in the first-half year period of the relevant year)

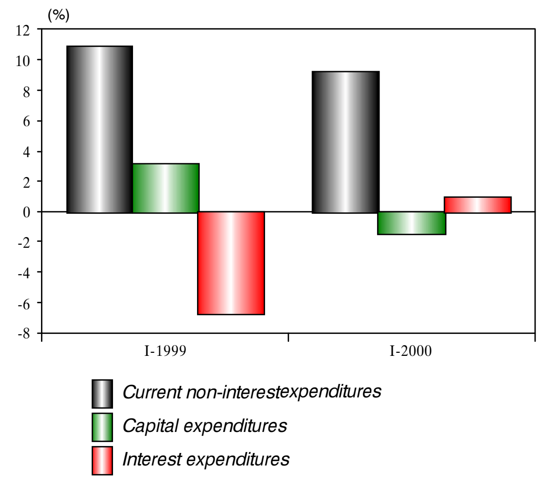
	1998	1999	2000
Total expenditure	**43.1**	**45.7**	**44.8**
Wages	4.7	5.9	5.7
Social security expenditures	12.8	15.0	17.0
Maintenance	7.2	7.6	7.5
Military Defence	4.3	5.0	4.7
Production Subsidies	2.2	1.8	1.0
Capital expenditure	3.0	4.2	3.3
Interest	7.9	4.9	4.8
O/w. domestic	1.8	1.1	1.2
O/w. on foreign debts	0.4	0.3	0.5
O/w. on foreign debts	6.0	3.8	3.6
Other expenditure	1.0	1.3	0.8

Source: MoF, AEAF

The 1999 decrease in government debt interest payments led to an increase in general government budget non-interest expenditures. As a result of the effect of the higher international money market interest rates and EUR's depreciation felt in 2000, the contribution of interest expenditures within total budget expenditure growth turned positive. This is a process expected to be sustained well in 2001, imposing rigid constraints on any possible non-interest expenditure rise.

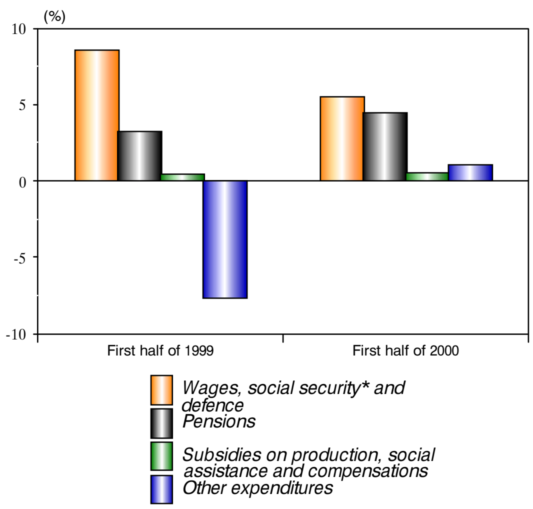
The social security programme of the government underwent a major amendment, the effect of which is to be fully revealed in the next couple of years. Overall, the GDP share of expenditures on social programmes and deriving thereof insurance of programme beneficiaries stepped up from 12.7% in the first half-year period of 1999 to 14.7% over the same period of 2000. In January

General Government Budget: Contribution to Total Expenditures Growth



Source: MoF, AEAF

General Government Budget: Contribution to Current Non-interest Expenditures Growth



* Including budgetary organisations, maintenance, health insurance fo pensioners, unemployed and other

Source: MF, AEAF

2000, social pensions rose to BGN 40, while maximum pensions stepped up from 3 to 4 social pensions. Following the onset of the health insurance reform, pensioners' health insurance contributions have been covered by the central government budget, and in the first half-year period of 2000 they accounted for 0.6% of GDP. As a result, budget expenditures on pensions as percentage of GDP went from 9.4% in the fist half of 1999 up to 10.8%[15] over the six months to July 2000. Social security payments under the Labour Code reported a negligible decrease within total NSSI expenditures due probably to the fact that sick leaves benefit payment was partly transferred on to employers.

For a third year in a row, the strong and rigid government fiscal policies have created favourable and predictable conditions for private business growth by effecting a number of tax reductions, broadening the tax base, seeking to achieve a better evenness in the distribution of the tax burden, and freeing resources from the banking system to finance the real sector of the economy. The tough fiscal discipline and flexible budget management contributed enormously to the balance of payments sustainability under a significant negative external shock like the rising fuel prices. Due to the fiscal restrictions imposed, interest rates have remained stable throughout the year. Also the maturity structure of government debt improved considerably as an important precondition of fiscal sustainability. As of end-August, the government debt/GDP (annual projections) amounted to 83.7%.

❑

[15] *Including expenditures on health insurance for pensioners covered by the central government budget.*

Monetary Aggregates

Whether the currency board arrangement is a barrier to growth or not is an issue that has been often in the limelight of much controversy and economic debate. The arguments backing up this are based on the contention that money supply dynamics may impose a major restraint on growth, that banks often fear and hence refrain from lending as there is no refinancing from the Central Bank (lender of last resort) as well as due to the strict supervision on the quality of their credit portfolio. Taken alone, all these contentions are true and credible. They however do not provide evidence that the currency board arrangement is an obstacle to growth. Within the same money supply, economic growth may follow a different pattern of dynamics depending on the velocity of money. If a policy goal is set to achieve growth for a short period of time, without taking into account the aftermath of such a monetary policy, then hazardous lending is the easiest way to do it. In principle, growth based on easy borrowing and random and indiscriminate lending of all kinds of business projects is as a rule transitory, followed by a deep economic collapse, as illustrated by the Bulgarian economy in 1994 and 1995, and the crisis it bottomed out in 1996. The cure the economy needs is sustainable long-term growth, and it is the currency board arrangement that has introduced financial discipline, guaranteeing the quality of growth.

On a year earlier and against the second half-year period of 1999, money supply in the first half-year period of 2000 reported a nominal-term rise of 19.6% and 12.6% on average[16] respectively.

---

[16] *Nominal-term growth is calculated as the ratio between the period averages in the Jan-June'2000 period against the relevant 1999 period.*

The BGN equivalent of BNB's foreign assets stepped up by 20.4% on average in nominal terms, relative to the first half of 1999. Against end-1999, reserve money did not report any real-term change, but increased by 8.7% on an annual basis, however. Broad money registered an 11% real-term increase on a 12-month basis, rising by 7% in end-September 2000 against end-December 1999.

Table 8. Monetary Aggregates

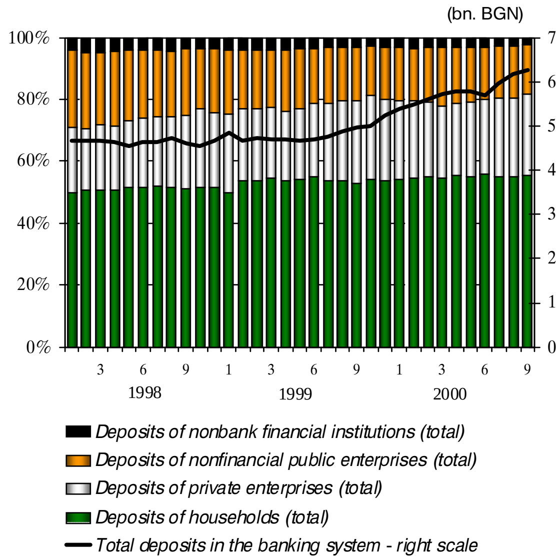
	Reserve money '000 lv.	M1 '000 lv.	M3 '000 lv.	GDP '000 lv.	Reserve money/GDP %	M1 /GDP %	M3 /GDP %
I st half 1997	1128	884	4011	5737	19.7	15.4	69.9
I st half 1998	2071	2160	5881	9607	21.6	22.5	61.2
I st half 1999	2163	2278	6022	9691	22.3	23.5	62.1
I st half 2000	2611	2886	7461	10789	24.2	26.8	69.2

Source: BNB, AEAF

In July, the minimum required reserve ratio was reduced from 11% to 8%. In the short-term, the reduction led to an increase in the money multiplier as a result of the decrease in one of its components, i.e. the reserves/deposits ratio. However, its other component – the money in circulation/deposits ratio remained unchanged. The reduction in the minimum required reserves is likely to affect the second component of the money multiplier in the mid-term as well.

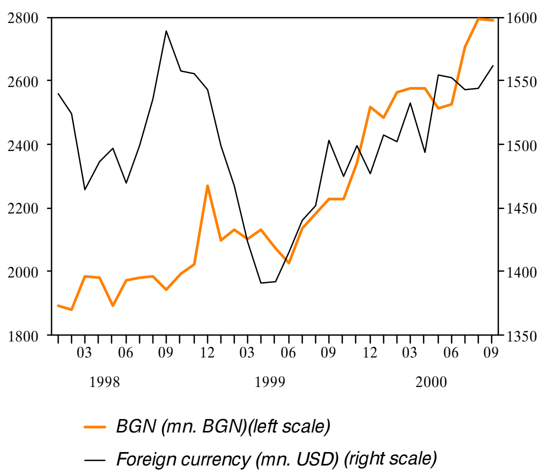
The July reduction in the minimum reserve requirements coincided with about USD 80 mln worth of exceptional budget expenditures, having to do with the one-time payment of pension mark-ups and more intensive foreign currency trading brought about by the high tourist seasons. Under the interplay of the above factors, highly-liquid money in July reported a jump-like increase, influencing in-

Structure of Deposits in the Banking System



Source: BNB

Deposits in the Banking System



Source: BNB, AEAF

flation. On a 12-month basis, the real-term growth in M1 amounted to approximately 14%.

Trust in the banking system of both households and companies is another important factor, influencing money supply dynamics. Following the 1999 redenomination of the Bulgarian currency, there have been qualitative changes in social attitudes to the banking system resulting in rapid deposit growth.

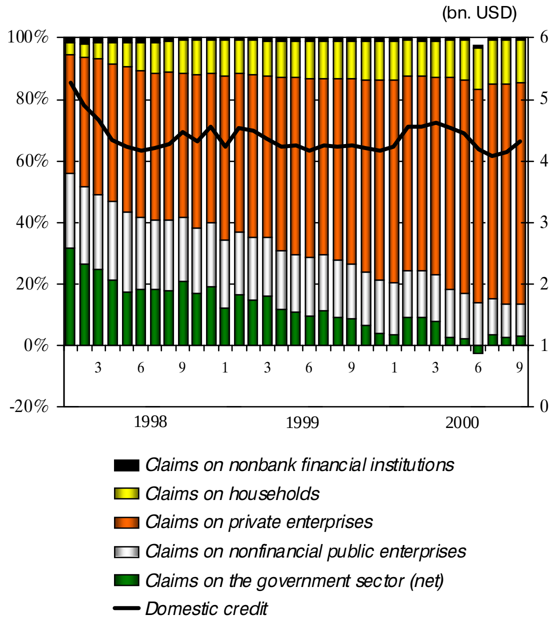
Relative to the first half-year period of 1999, household deposits in BGN reported a nominal-term increase of about 19%. Over the same period, corporate (private companies) deposits in BGN stepped up by 27%. Household foreign currency deposits rose by 25% in BGN terms and 10.7% in dollar terms against the first half-year period of 1999.[17] In dollar terms, corporate deposits in foreign currency remained unchanged on a year earlier. On a 12-month basis,[18] both quasi- money in BGN and foreign currency deposits registered a real-term increase of 14% and 6% respectively. Relative to December 1999, corporate deposits (private companies) in BGN and foreign currency reported an overall decline of 0.11% in end-June. For two months in a row (July and August), however, they stepped up significantly by 14.6% in nominal terms due entirely to BGN deposits.

The high banking system liquidity, more specifically in the months following July, led to a change in the structure of assets. Banks' deposits abroad rose by USD 275 mln in the first quarter, with the growth reported in July and August alone amount-

[17] *Nominal-term growth is calculated as the ratio between the period averages in the Jan-June 2000 period relative to the same period of 1999.*

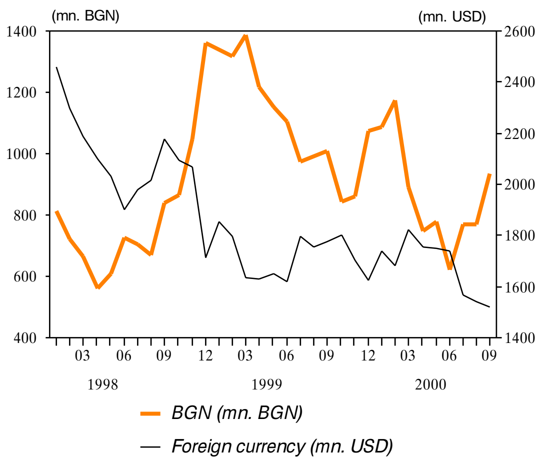
[18] *In the twelve months to September 2000.*

Structure of Domestic Credit



Source: BNB

Domestic Credit



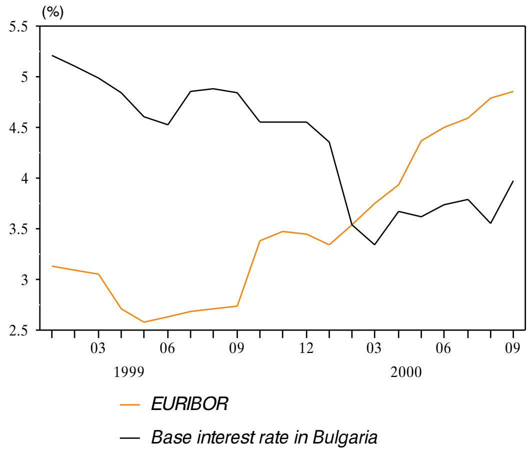
Source: BNB, AEAF

ing to USD 327.5 mln. Part of their growth was due to the reduction in the minimum required reserves and was in fact a transfer of assets from BNB to commercial banks, i.e. a transfer that was very likely to have a specific implication, for commercial banks would tend to invest in riskier assets of higher return. By contrast, BNB would have to comply with law.

On a year earlier, domestic credit[19] in the first half-year period of 2000 reported a 3.3% nominal-term increase on average. The increase was primarily due to the 14% rise in the BGN equivalent of foreign currency credit (in dollar terms, foreign currency credit remained unchanged). BGN credit, on the other hand, had decreased. There were several clearly shaped segments of the financial market following different patterns of dynamics. Having risen several times in the post-1997 period, household credit was steadily increasing though at a declining rate. In the first half-year period of 2000, lending to households stepped up by 9.2% in nominal terms, relative to same period of 1999. Private sector credit has been steadily and evenly rising at a high rate since mid-1997. In the six months to July 2000, lending in BGN to the private sector registered a 34.2% rise on average while the BGN equivalent of foreign currency credit stepped up by 19.3%, which recalculated in dollar terms implied a 5.9% rise. Lending to the public sector decreased due probably to the privatisation process as well as due to the fact there were still in the sector large enterprises – mostly monopolists which besides bank loans used other sig-

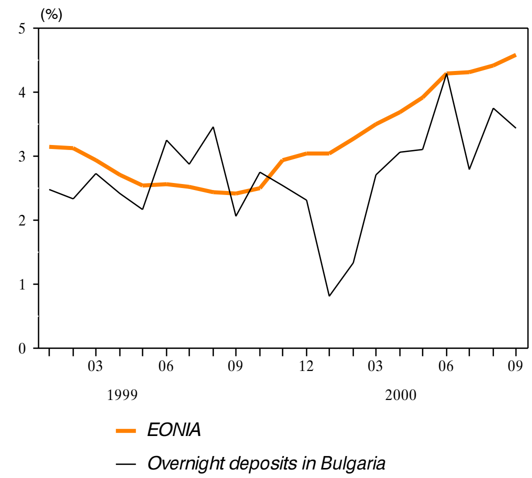
[19] The indicators showing domestic credit dynamics, by groups of borrowers included, are estimated as the ratio between nominal-term monthly average credit over the first half-year period of 2000 and nominal-term monthly average credit on a year earlier.

3-month EURIBOR and Base Interest Rate



Source: BNB, Deutsche Bundesbank

EONIA and Interest Rates on Overnight Deposits at the Interbank Money Market



Source: BNB, Deutsche Bundesbank

nificant sources of financing, including own resources.

Credit demand depends on the activity of firms and their choices as to the sources of financing. In 2000, profitability, especially in the private sector, has been very high. Business survey data indicate that the problems firms had as deriving from their financial conditions and customers' insolvency have decreased in importance in 2000. In 1999, assessments of the first indicator, i.e. problems related to the financial performance of firms averaged 40.6, improving at 37.2% in the eight months to September 2000.[20] Accordingly, the indicator related to problems deriving from customers' insolvency stepped up from 42.6% in 1999 to 39.7% in the eight months to September. The improved financial performance of firms made it possible for them to finance business projects relying on their own resources. FDI inflows and external loans produced the same effect. In the first half-year period of 2000, FDI inflows amounted to USD 250 mln, accounting for more than 30% in fixed capital formation.

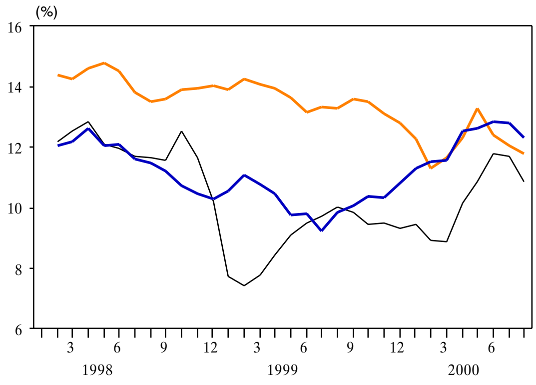
The supply of lending resources in an economy depends on bank policies. Under a currency board arrangement and strict supervision, they tend to impose rigorous requirements to business projects. The domestic credit/net foreign assets in banks' portfolios ratio is managed on he basis of risk and return evaluations. Given the fixed foreign exchange rate and free movement of financial resources, in EUR in particular[21] , banks are free to design a portfolio they consider optimum.

---

[20] The indicator's value is taken to account for the share of firms in finacial trouble, facing customer insolvency within the total number of firms surveyed.

[21] Under Regulation #4 of BNB on banks' exposures in foreign currency, article 4, para 1 and 2.

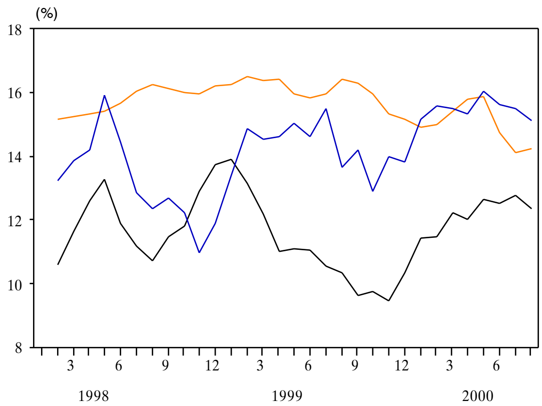
Interest Rates on Short-term Credits*



* 3-month moving average.
** Position "EUR" involves EUR and all currencies, part of EUR. Until end-December 1998 data refer to DEM only.

Source: BNB, AEAF

Interest Rates on Long-term Credits*



* 3-month moving average.
** Position "EUR" involves EUR and all currencies, part of EUR. Until end - December 1998 data refer to DEM only.

Source: BNB, AEAF

Theoretically, given the specific conditions in Bulgaria, domestic money market interest rates are supposed to converge to (in the ideal case, i.e. the risk premium excluded, be equal) their counterparts in the Euro area. In practice, however, since 1999 when money market interest rates in the Euro area went on the increase, domestic interest rates have remained stable, even slightly decreasing. The base interest rate and one-day bank deposit interest remained well below their counterparts in the European markets. Short-term credit (BGN) interest remained, too, relatively stable while interest on short-term credit in USD and EUR has started to rise since the beginning of 2000. Long-term credit interest has followed a similar trend.

The very fact that domestic money market interest rates have remained stable implies that they brought about a certain levelling out between the supply of financial resources (which as already noted, has reported a significant growth in 2000) and domestic demand. In the mid-run, domestic interest rates and their Euro area counterparts are expected to level out, with the interest difference on credits being determined by the creditworthiness of borrowers. ❑

2000 sustained the pro-inflationary impact of two key factors, viz. international price dynamics (raw material, and crude oil prices in particular) and the appreciation of the US currency. For a short period of time, crude oil prices reached a 10-year record high, rising in September by 46% above their Sept'99 level and by 27.8% above their Dec'99 level. On a year earlier, the oil price increase over the Jan-Sep'2000 period amounted to 77%. The depreciation of the single European currency against the USD from its introduction in January 1999 to September 2000 amounted to nearly 30%. Compared to December 1999, the EUR lost ground to the US dollar by 16.1% in end-September 2000.

The above two factors boosted inflation in EU member states. Inflation in the countries of the Euro area amounted to 2.8% p.a., with the inflation rate differing substantially across the member states from 1.3% in Sweden to 4.2% in Luxembourg. In Germany, for instance, the import price index reported a 13.4% increase in September, on a year earlier. Producer prices stepped up by 4.3% on an annual basis, and wholesale prices went up by 6.9%.

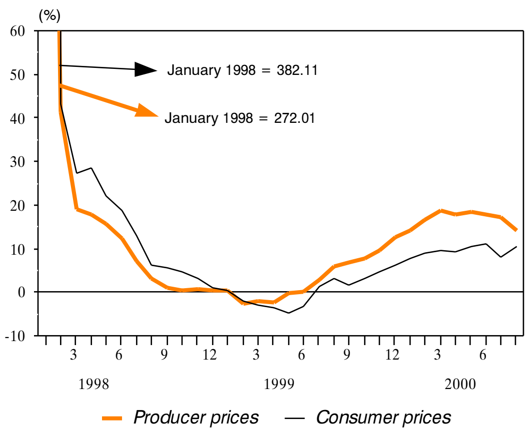
Table 9. Price Growth Rates

(cumulative since start of year, %)

	Jan-Jun'2000	Jul-Sep'2000	Jan-Sep'2000
Foreign exchange rate	**6.5**	**9.0**	**16.1**
International oil prices	18.0	8.3	27.8
Domestic producer prices of oil	25.7	16.4	46.3
Domestic retail oil prices	17.6	5.0	23.5
Producer prices	**6.0**	**5.8**	**12.1**
Consumer prices	2.6	6.1	8.8
Tradables	3.9	6.2	10.4
Potential tradables	-1.6	7.6	5.9
Non-tradable	5.8	4.7	10.7

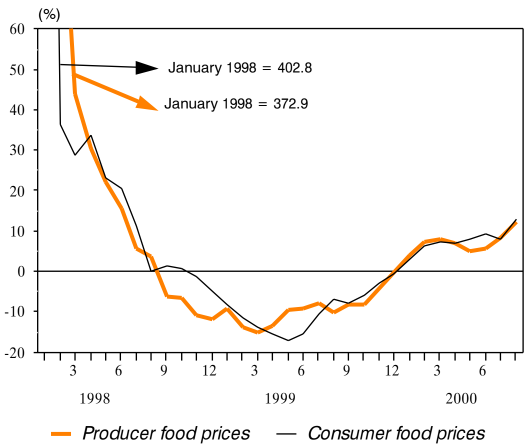
Source: NSI, BNB

12-Month Rate of Change of Producer and Consumer Prices



Source: NSI, AEAF

12-Month Rate of Change of Producer and Consumer Food Prices



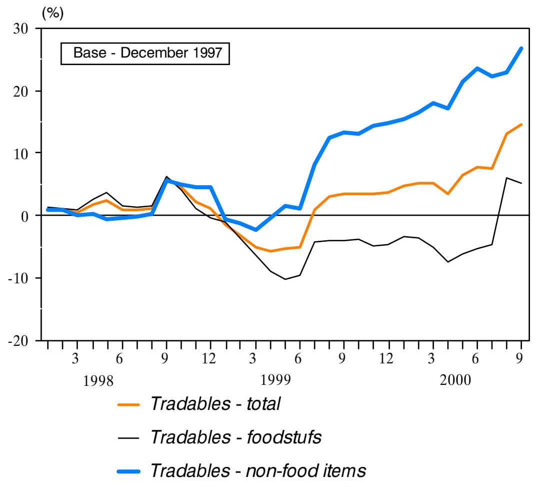
Source: NSI, AEAF

Oil prices and the depreciation of the single European currency influenced domestic producer prices directly.

In the eight months to September, producer prices rose by 12.1%, with the PPI in September 2000 reaching 17.4% on a year earlier. Over the same period, the price increase reported by refined oil products amounted to 46.3%. On an annual basis, their prices rose by 71.7% in September 2000. The price increase reflected fully the crude oil price change and the BGN depreciation since the beginning of 2000. The contribution of refined oil prices to the overall PPI amounted to about 50% as follows: 5.9 percentage points on a cumulative basis since the start of the year and 9.1% in September on an annual basis. On a year earlier, producer prices in September rose in the following sectors, relying heavily on raw material and fuel imports: ferrous metallurgy (by 25.7%); non-ferrous metallurgy (by 28.0%) and the chemical industry (9.3%).

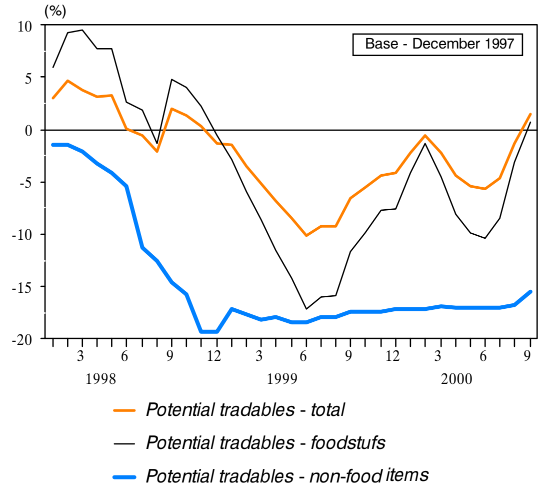
The direct impact of fuel prices on the CPI was not as distinct and pronounced as with the PPI. The contribution of petrol, diesel, gas and transport service prices to consumer price inflation amounted to 1.1 percentage points, given cumulative inflation of 8.8% over the Jan-September 2000 period. Inflation dynamics in Bulgaria over the eight months to September 2000 can be attributed exclusively to the food price index, for the share of food prices in the consumer basket amounted to 41%. The producer prices/food consumer prices correlation is extremely strong, although the CPI also encompasses fresh fruit and vegetables, which are influenced by seasonal factors. Over the Jan-June period, food producer

Change in the Prices of Tradables



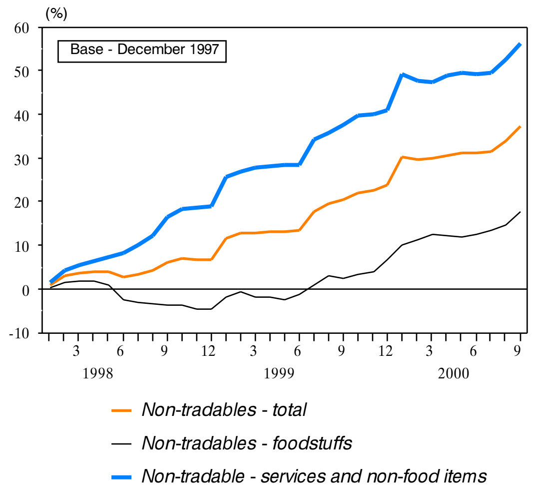
Source: NSI, AEAF

Change in the Prices of Potential Tradables



Source: NSI, AEAF

Change in the Prices of Non-tradables



Source: NSI, AEAF

prices registered an increase of only 1.6%. In the July-September period, they went up by 9.1%, reporting a jump-like rise in August. The consumer price increase in food items ran parallel with producer price growth. Food price inflation in the third quarter of 2000 approximated the 5.8% rate reported on a year earlier, verifying the seasonal pattern of the price index dynamics.

Table 10. Producer PrMice Change in Food Items

(cumulative, %)

	Jan-Jun' 2000	Jan-Sep' 2000	Jul-Sep' 2000
Food Production	1.6	10.9	9.1
Production, processing and canning of meat and meat products	0.5	18.3	17.6
Production and processing of fruit and vegetables	-21.6	-7.4	18.2
Production of vegetable oils, butter and fats	-3.9	10.6	15.1
Dairy production	-1.8	10.4	12.4
Production of bread, bakery and pastry	2.5	6.1	3.5

Source: NSI

August witnessed a price increase in a limited number of commodity and service groups, accounting for 2.9% of total inflation of 3.04%.

Their September contribution to total inflation of 2.4% amounted to 1.1 percentage points. Obviously, part of the August food price increase was speculative by nature. In September, for instance, sunflower oil prices stepped down by 5.4% coupled with a downturn in dairy and egg prices.

Table 11. Price Change in August and September

Commodity and Service Groups	Relative share in %	Price increase in %		Contribution to inflation in percentage points	
		August	September	August	September
Meat	4.319	14.5	2.8	0.6	0.1
Processed meat, sausages	3.513	8.1	2.5	0.3	0.1
Milk	2.109	5.8	5.2	0.1	0.1
Dairy products	3.748	8.9	0.3	0.3	0.0
Eggs	0.678	50.5	0.8	0.3	0.0
Vegetable oils	1.994	28.9	-5.4	0.6	-0.1
Pulses	0.520	13.2	9.0	0.1	0.0
Potatoes	0.670	15.7	90.7	0.1	0.6
Water supply	1.731	3.6	6.2	0.1	0.1
Electricity supply	7.135	3.9	0.0	0.3	0.0
Heating	2.491	2.8	4.7	0.1	0.1

Source: NSI, AEAF

In September, inflation spread over three basic groups of the consumer basket. Nevertheless, a limited number of commodity and services sub-groups registered a higher price increase as follows: bread (c 2.4%), fresh vegetables (3.3%), coals (5.9%), medicines (6.1%), petrol, diesel and gas (6.5%), bus and taxi fares (8.1%), postal services (16.6%), newspapers (10.5%), university education fees (29.8%), canteen meals (7.2%). These sub-groups were responsible for the remaining 1.3% contribution to September inflation.

Some pro-inflationary factors have been at work since the beginning of 2000, but the inflation rate in Bulgaria went on the increase as late as August, as triggered by the prices of food items the demand for which is characterised by a rather low price elasticity. At the same time, the price inflation jump reported lagged behind the sharp July increase in monetary aggregate M1 by a month. Estimates of the highly-liquid money dynamics/inflation correlation for a longer period of time, say from the institution of the currency board arrangement to date, indicate that there are extremely strong bonds of correlation between the two variables.

In the nine months to October, M1 dynamics and inflation followed a model as follows: over the January-June period, monetary aggregate M1 decreased by 3.7%, relative to December 1999. Over the same period, cumulative inflation amounted to 2.6%, with January inflation alone being 3.14% (as a result of the December'99 M1 growth). In the summer months due to the high tourist season, M1 in July and August increased by 9.5% and 2.4% respectively on a month earlier, or overall in the two months by 12.1%. The September rise in M1 on a month earlier amounted to 1.1%. As money supply affects inflation with a lag in time, inflation in July amounted to a bare 0.5% while accelerating in the months to follow to 3.04% (in August) and 2.38% (in September) respectively. The July-September inflation amounted to 6.1% (against 3.14% increase in M1 in end-September to end-June). Cumulative inflation since the start of the year amounted to 8.8% (against 9.2% rise in M1) whereas September inflation amounted 11.38% on a year earlier (given a 27.2% growth in M1).

Is inflation a good or bad phenomenon? Clearly, the dynamics of this variable cannot be assessed isolated from the performance of other macroeconomic indicators, growth and labour productivity in particular. Growing prices, especially when related with the rising share of profit in them, attract investors in the relevant sector, producing a positive effect on growth over time. Labour productivity improvement offset the adverse impact of inflation on competitiveness. In the long-run, income and prices in Bulgaria are expected to rise, converging to the EU average. ❑

Restructuring the Economy

Enhancing Competition

Domestic market competition in Bulgaria has come under the impact of two key factors at work, viz. the high degree of market liberalisation and a set of protective measures against unfair competition. As the restructuring process (implemented by way of privatisation, winding up of loss-making enterprises and financial recovery of state monopolies) gained momentum, the level of competition in Bulgaria has been steadily rising.

The analysis of competition draws upon the Herfindahl-Hirschman concentration ratio[22], as measured by years over the 1997 – 1999 period for 35 out of the 40 branch groups under the National Branch Classification (NBC)[23] .

---

[22] *Estimates employ the following formula of calculation:: HHI = $(r_1)2 + (r_2)2 + ... + (r_n)2$, where r_n is the relative share of revenues or assets of a given company within total revenues or assets in a branch.*

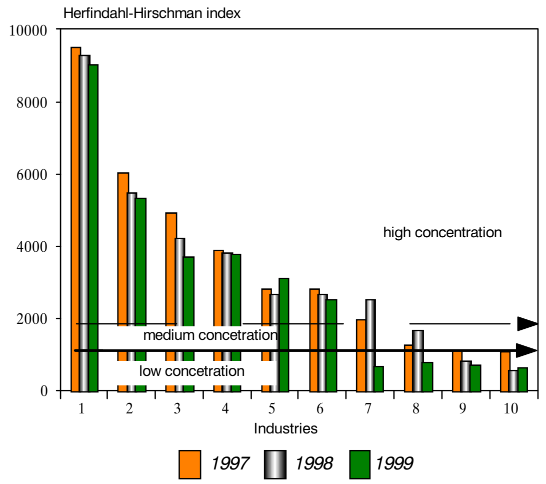
[23] *B-40 under NBC, excluding the following groups: public administration; finance, credit and insurance, NGOs, households hiring support staff, ex-territorial organisations.*

Table 12. Branch Distribution according the Concentration Ratio, as Measured by the Herfindahl-Hirschman Index (sales)

Degree of concentration	Number of branches			Relative share within total sales, %		
	1997	1998	1999	1997	1998	1999
Full (10000)	0	0	0	0.0	0.0	0.0
Significant (b/n 1800 и 10000)	7	7	6	21.4	18.1	16.4
Moderate (b/n 1000 и 1800)	3	1	0	0.5	0.2	0.0
Low (below 1000)	25	27	29	78.1	81.7	83.6
Branches, total:	35	35	35	100.0	100.0	100.0

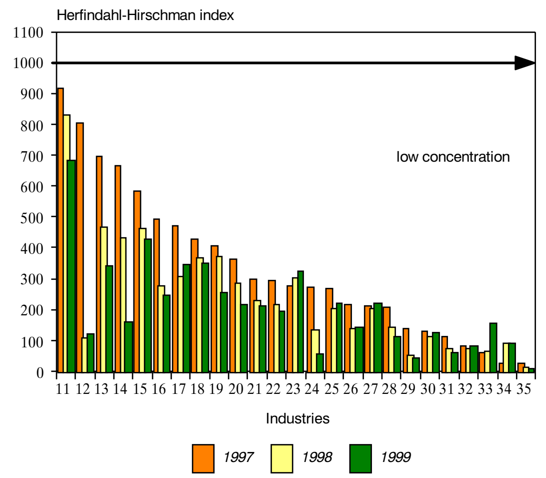
Source: NSI, AEAF

Industries with High and Medium Degree of Concentration



Source: NSI, AEAF

Industries with Low Degree of Concentration



Source: NSI, AEAF

The index points to a slow shift from branches of high concentration ratio to groups of branches with a lower degree of concentration. Obviously, the level of competition has increased as the share of branches reporting a low concentration ratio stepped up within total sales.

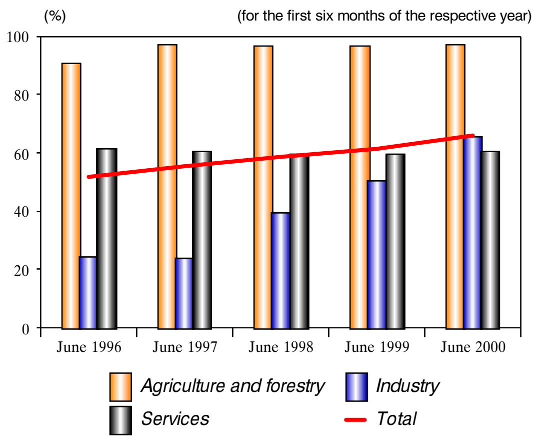
At a lower level of disaggregation, the index shows that the concentration ratio tended to decrease in 30 out of the 35 branches (i.e. 86% of all branches) analysed over the period surveyed, while rising or remaining at its 1997 level in only five branches. Drawing upon the data available, it can be concluded that there were two parallel processes underway in the economy as follows: first, the concentration ratio in branches, including branches where concentration is considered high, went on the decrease; and second, a shift from branches reporting a high concentration ratio to branches belonging to groups with a low degree of concentration.

In five of the branches reporting a high concentration ratio, three or less than three companies accounted for more than 75% of total sales revenues in the branch, with four branches being prevailed by an enterprise enjoying a dominant position responsible for over 50% of sales revenues in the same sector. In six branches where the first ten enterprises accounted for 50% of sales revenues, there were all the potentials to restrain competition.[24] In the mid-term, there is a need to carry out feasibility studies as to the implementation of specific policies aimed at deregulating the first six branches reporting the highest concentration ratio.

The measures aimed at enhancing competition (it's noteworthy that they have born fruit) are as follows: restructuring and privatisation of natural monopolies, ensuring the free movement of goods and price liberalisation (by limiting permits and licences), reducing state aids and protecting competition (protective measures against unfair competition).

Privatisation

Share of Private Sector Value Added in Total GVA



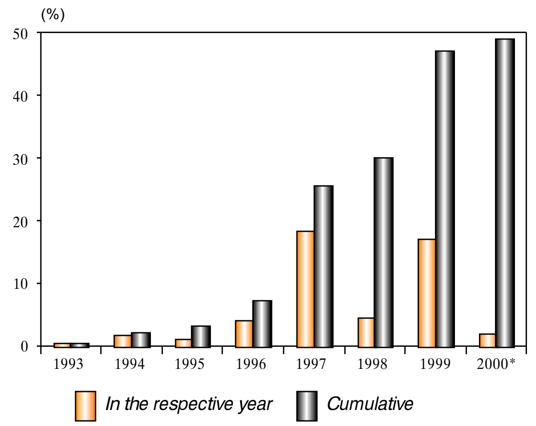
Source: NSI, AEAF

In the transition economies, the assertion of private ownership as the dominant form of ownership became possible due to the institution of an appropriate and adequate legal basis promoting private entrepreneuship by privatisation of state-owned assets. As a result of the interplay of the two factors, the share of the private sector within value added has been steadily growing, especially in the post-1997 period.

Privatisation plays an essential role in promoting and fostering private sector expansion. As at June 30, 2000, about 50% of state-owned enterprises' assets have been privatised (1.97% in the first half-year period of 2000), or nearly 76% of the

[24] *According to the methodology of estimation of a company's market share in a given market, adopted by the Competition Commission in the first half of 1998, a share below 5% reported by a market player is considered a case of insignificant effect on competition.*

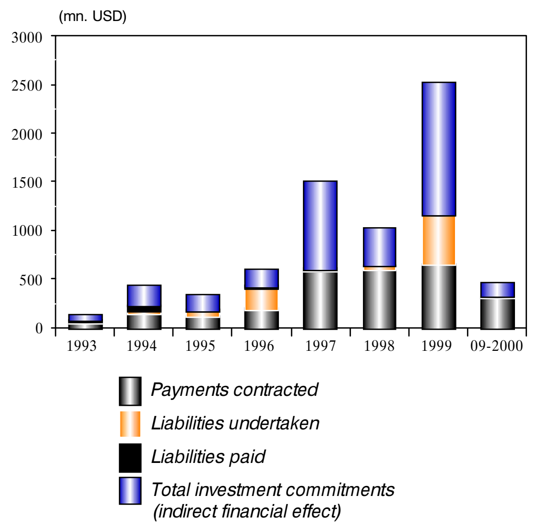
Percentage of Privatized State Assets



* Calculations are based on data as of 30.06.2000 and comply with World Bank criteria

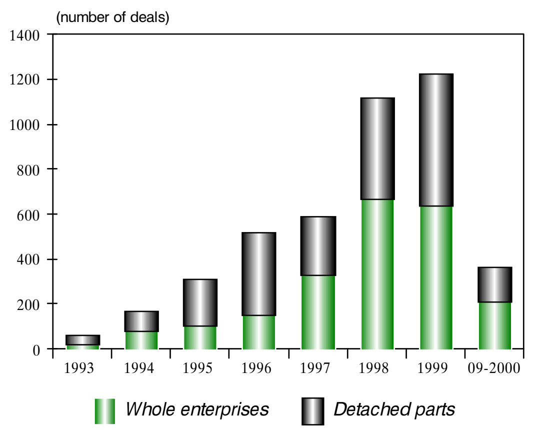
Source: PA

Financial Effect from Privatization Deals



Source: PA

Number of Privatization Deals



Source: PA

state-owned assets, earmarked for privatisation, infrastructure excluded.

Compared to the previous three years, the pace of the privatisation process in 2000 slowed down. It is, however, carried on along two main lines: sale of the residual shares of previously privatised enterprises owned by the state, and privatisation or pre-privatisation of large state-owned companies, enjoying a monopoly position in the market.

The technique of selling residual shares includes their sale to the majority shareholder of an enterprise or their placement on the capital market.

Parcels of Minority Shares Sold by June 2000

Total:	1150
557	sold out
379	sold to a majority shareholder
154	transferred to the Centre for Mass Privatisation
41	put up for sale at the Sofia Stock Exchange
19	to meet restitution claims

At the same time, amidst growing social pressures for publicity and transparency of privatisation deals the pace of the privatisation process slowed down. As many of the approved by the Privatisation Agency candidates proved to be non-viable, a number of deals were not concluded at all, which in turn resulted in the launching of new privatisation procedures for the same enterprises (Borosport, hydroelectric power stations, Balkankar, the Bulgarian Telecommunications Company (BTC).

Structural adjustment and partial privatisation of the large state-owned enterprises enjoying a monopoly position in the market was the next major concern on the government agenda, following the completion of the Isolation and Liquidation Programme in mid-1999. Among other enterprises these measures apply to monopolists of strategic importance like Bulgargas, the National Electricity Company (NEC), Water Supply and Sewage and the Bulgarian State Railways.

Restructuring and Privatisation of Natural Monopolies

A general principle of restructuring natural monopolies applied by the government is as follows: the state retains its ownership right to the electricity transmission network connecting producers with consumers while privatising electricity generation and distribution units; following the deregulation of the market, pricing in the sector will take place under the supervision of an independent regulatory body in compliance with a previously approved and enforced by law methodology.

The second half of 1999 saw the adoption of the Energy Power Generation and Efficiency Act, setting out some general provisions of restructuring the energy power generation sector. Next, the split of NEC into generation, transmission and distribution units was an important step towards privatising the new companies – producers and distributors in the sector. There were established eight independent enterprises generating electricity and seven trading companies – distributors of electricity. In end-September, 22 hydroelectric power stations were sold to private entrepreneurs, followed by a tender procedure for another 16 stations. The vertically integrated monopolist – NEC was transformed into an electricity transmission company, retaining its ownership of the country's high voltage power lines, four big water cascades and several smaller hydroelectric power houses.

Legal measures (ordinances) adopted in mid-2000 lay down the methodology of electricity price setting and provide for an independent regulatory body (State Commission on Energy Regulation) that will take over price regulation after 2002. Company licensing and contracting with NEC is imminent. Except for deals between final consumers enjoying a preferential status and producers, deals in electricity may be concluded between all players in the market, which as provided by law can take place after January 2002.

Electricity trade liberalisation is an important pre-condition for attracting private investors long before a set of regulations has been fully drafted. On the other hand, some of the provisions impose serious obstacles to competition in the energy market. For instance, as laid down by the Energy Power Generation Act, only an electricity transmission company shall import, export or transit electricity. Another glaring example is that the act requires a company that has been awarded a tender for constructing an electric power station of over 25 MW of capacity should contract a transmission company for the sale of electricity for a term not shorter than 10 years. Given this provision, NEC is supposed to bear all the risk of a changing electricity demand instead of the investor and hence, that may jeopardise effective investment in the electricity generation sector.

The combination of a monopoly position over electricity import and export and the long-term contracting requirement with electricity generating companies makes NEC a sole buyer in the market that, however, takes all the risks of sales. It contradicts the underlying principles of market deregulation, i.e. both producers and distributors are allowed the same access to the energy market, with NEC generating income from electricity transmission instead of sales. It also comes into clash with the economic rationale that an investor, in this case in electricity generation, should also take the risk of sales.

The Energy Power Generation and Efficiency Act also provides for certain relationships between district heating companies and consumers. Due to the financial hardship the sector is currently facing and the high budget subsidy allocations the Council of Ministers adopted a Recovery Plan for the sector in June 2000. The plan provides for the phasing out and complete removal of subsidies supporting heating companies as of 2001, at the same envisaging the liquidation of companies which have failed to adjust to the new conditions.

The structural adjustment of the country's sole gas supplier, Bulgargas, is still in an initial phase. The top business development strategy priority of the company over 1999 amounted to the improvement of collections (both current liabilities and liabilities in arrears).

The Bulgarian State Railways holding a monopoly over railway transport services has been reporting a poor financial performance. Under the general restructuring scheme, a major task in the pre-restructuring period is to improve the company's financial performance and limit subsidies. A railway transport development act is still in a drafting stage.

As the experience of other countries shows, the restructuring of natural monopolies should in the long-run improve supply efficiency at lower consumer prices.

Free Pricing and Free Movement of Goods (Limiting Licensing and Registration Regimes)

Free pricing is indispensable to the establishment of a well-balance structure of the economy. This is to be achieved by both limiting administered price setting and regulation of natural monopoly prices, and liberalising foreign trade. Following May 1997, the scope of administered and monitored prices narrowed significantly, encompassing only several commodity and service groups as follows: electricity and heating, briquettes, railway transport, water supply to households (monitored prices), gas, postal, telephone and fax services, tobaccoes, medicines and other pharmaceuticals (monitored prices). 1999 saw the removal of brown coal price controls. Despite the decreasing number of goods and services with administered prices, their share in the consumer basket has increased. In end-September 2000, their weight in household expenditures hit 19.5% as a result of the outstripping administered price growth in the post-1997 period compared to other product and service prices, induced to reduce losses and subsidies in the relevant sectors.

Table 13. Weight of Administered Prices within the CPI

(as % by Countries)

	1994	1995	1996	1997	1998	1999	09-2000
Bulgaria	42.0	46.0	48.0	14.4	15.8	17.2	19.51
Czech Republic	18.1	17.4	17.4	13.3			
Estonia	21.1	18.0	24.0	24.0			
Hungary	11.8	12.9	12.8	15.9			
Latvia	-	16.6	17.8	19.6			
Poland	12.0	12.0	11.6	10.6			
Romania	-	18.0	18.0	7.0			
Slovenia	18.4	22.5	22.4	20.4			

Source: 1999 and 2000 EBRD Transition Reports

The free movement of goods allows for a rapid domestic price convergence to international prices while protecting the market from strong fluctuations in the inflation rate. The Bulgarian government has removed almost all non-tariff barriers to trade (excluding some regulations applying to trade in specific goods). Customs duty rates have been reduced now approximating EU tariff rates. Following 1996, the average duty rate (under MFN status) has been steadily decreasing, now amounting to 24% (agriculturals) and 10.99% (industrials). The maximum duty rate was also lowered. Bulgaria is a party to many FTAs (Turkey, Macedonia, CEFTA and EFTA countries, and the EU) negotiating considerably lower duty rates compared to other country's trading partners. For example the 2000 average arithmetic duty rates of industrial products under the above agreements are below 3% (excluding the bilateral trade arrangement with Macedonia under which the average duty rate amounts to 4.98%).

Table 14. Average Arithmetic Duty Rates by Years – MFN

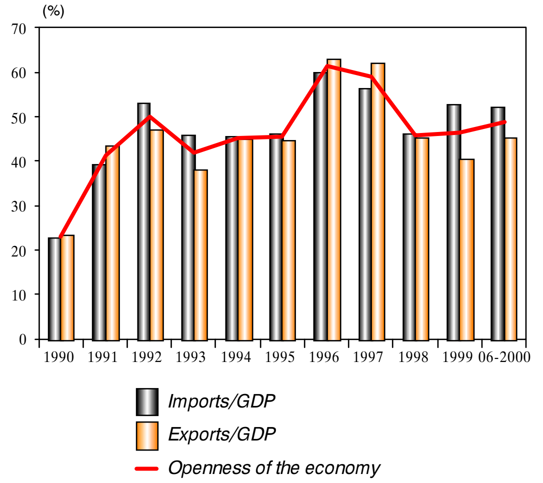
(%)

	1998	1999	2000
Overall, for the Customs Tariff	17.85	15.20	-
Agricultural products	27.31	24.61	24.00
Industrial products	15.25	12.56	10.99

Source: MoF

The share of foreign trade in GDP is one of the indicators for the openness of an economy to the world markets. The performance of the indicator in Bulgaria over the post-1991 period has been rather unsteady, the tendency however is towards opening the economy. This indicator has been most indicative over the last three years when

Degree of Openness of the Bulgarian Economy



Source: BNB, UNCTAD

foreign trade turnover tended to rise in parallel with GDP growth.

Free market access can be restricted not only by way of price regulation and high differentiated duty rates but by imposing a number of licensing and registration requirements as well. To limit business detrimental bureaucracies, in the first half of 2000 the government abolished about 100 licensing requirements while introducing simple procedures for obtaining still effective licences.

State Aid Cuts

The involvement of the state in the functioning of the market by giving tax breaks, subsidising certain branches and activities or through other, not so ostensible ways of state assistance may also have a restrictive impact on competition. Since 1998, tax rates in Bulgaria have followed a gradual downward trend and the government has not given any tax breaks to any company.

In the first half of 2000, government spending on subsidies to support the operation of non-financial enterprises was reduced by half relative to the first half of 1998. Since 1999, no subsidies have been given to industry (mining, fuel production and energy generation excluded) and construction. Over the same period, subsidies to mining, fuel production and energy generation had been dramatically reduced. Thus, in the first half of 2000, the amount of these subsidies was about five times lower than the respective sum in the first half of 1998, shrinking approximately three-fold on a year earlier.

Table 15. Production Subsidies to Non-financial Enterprises

	I-st half 1998		I-st half 1999		I-st half 2000	
	mln. BGN	% of GDP	mln. BGN	% of GDP	mln. BGN	% of GDP
Total (general government budget)	213.4	2.22	180.8	1.85	109.6	1.02
Out of which, for economic activities and services:						
Mining, fuel and energy production	139.0	1.45	89.7	0.92	34.2	0.32
Agriculture and forestry, hunting and fishing	0.4	0.00	10.9	0.11	2.7	0.03
Transport and communications	53.7	0.56	44.2	0.45	39.6	0.37
Industry* and construction	5.9	0.06	-	-	-	-
Other economic activities	9.5	0.10	12.8	0.13	0.1	0.00

** Mining, fuel production and energy generation excluded*

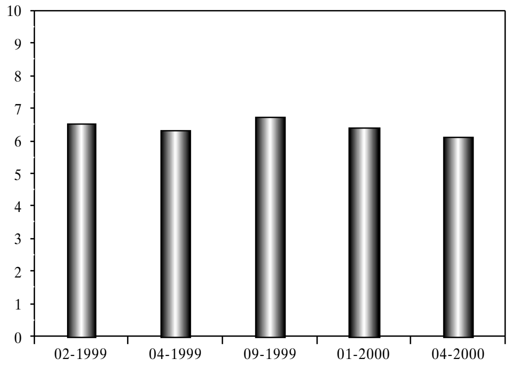
Source: MoF

Early-2000 saw the first steps in the creation of a legal framework, complied with the *acquis communautaire*, regulating the granting of state aids. Thereafter, all kinds of state aids are registered and reported in the newly established *State Aids* Directorate at the Ministry of finance. A specialised division in the Commission for the Protection of Competition oversees the legality of new aid. In practice, however, the effective coordination between both units has not been developed sufficiently well and therefore it is somehow difficult to estimate the total amount of state aid by years and as a percentage of GDP. For instance, in the period 1995-1997, state aids appropriated by the governments of EU countries amounted to 1.2% of their GDP whereas in Bulgaria subsidies to support the operation of non-financial enterprises alone accounted for a similar share of GDP. The drafting of legislation on the granting, registration and monitoring of state aids is still on the agenda.

Protection against Anti-competitive Behaviour

A well-functioning system for protection against anti-competitive behaviour is indispensable to the creation of a competitive market environment since such practices encroach upon the free market and, similar to government interference, create inequality among the various economic agents..

Incidence of Corruption*



** The zero index value corresponds to the ideal state (absence of corruption), and index of ten corresponds to pervasive corruption.*

Source: Coalition 2000

The fall in the corruption level is still a *sine qua non* condition for the normal functioning of the free market. The restructuring of public administration completed in 2000 and the legislative regulation of the civil servant's statute were the first steps in the fight against corruption practices. According to the April 2000 corruption indexes published by *Coalition 2000*, since early-2000 public intolerance of corruption has increased while the corruption indexes' values have been going, although slightly, on the decrease.

A new Law on the Protection of Competition came into effect in 1998. The Lawin itself, and particularly the section on the anti-trust rules, is practically in accordance with EU practice in this area. In contrast to the previous law, the current one focuses on the fight against hard-core anti-cmpetititve behaviour (anti-trust rules, protection against the abuse of monopoly or dominant position, protection against anti-competititve agreements, decisions or concert parties, concentration of economic activities, etc.).

According to the Proceedings Rules of the Commission for the Protection of Competition (art.2), this is an independent high-ranking, specialised collective state authority with the tasks to ensure the protection and see to the development of conditions for the expansion of competition and free initiative in economic activities. Since the entry into force of the new Law in 1998, the Commission has enacted over 300 decisions, out of which some 111 decisions had been ruled in the period January to end-September 2000. The prevailing part of those decisions concerned the abuse with dominant position at the market, mergers and contracts in restraint of trade (according to OECD data, these accounted for some 60% of all CPC's case studies in 1998).

The successful implementation of competition protective measures has a very positive effect on the improvement of general public welfare even though it may harm the interests of certain business circles. Consumers benefit from the increase of competition in manufacturing and distribution since, as a result, the prices of goods and services either fall or remain at reasonable levels and the quality and variety of products improve. Strong competition boosts both production and trade as entrepreneurs push their incomes up through higher efficiency following the rationalisation of the production process and with the help of their own (or acquired) technological advantages thereby improving the national competitiveness as a whole. The competitiveness of businesses is of utmost importance for the economy's viability as the latter depends on technological developments, new productions and the optimal economic restructuring as a result of the adequate distribution of resources on the basis of prices, the free market indicator. Competition in itself has a non-economic effect as well since the equal footing of economic agents is one of the preconditions for the development of free society.

The Banking Sector

The banking system in Bulgaria has been operating under the currency board restrictions for more than three years now. Commercial banks have been particularly cautious when it came to increasing their risk-exposed assets due to both the lack of central bank refinancing and the strict bank supervision. Simultaneously, those three years witnessed some considerable changes in the Bulgarian banking system as a result of the ongoing privatisation in the sector.

In early-2000, some 97.5% of *HebrosBank* plc assets were sold to *Regent Pacific Group* (Cyprus). The privatisation procedure for the sale of *Bulbank* – the largest state-owned bank which assets accounted for some 26% of total banking system assets – was concluded in end-September 2000. An international consortium with the participation of *UniCredito Italiano* and *Allianz* acquired 98% of the bank's equity capital.

Biochim Bank was not privatised according to the time schedule set up in coordination with the IMF. A new procedure for the privatisation of the bank was publicly announced in August after the Bank Consolidation Company ultimately turned down the bid made by *Neftinvestbank* which was determined as the best during the initial privatisation procedure. *Biochim* Bank is expected to be sold with the shortest possible delay (most probably in the first half of 2001). In contrast to 1999, when primarily Bulgarian and Turkish financial institutions showed interest in the bank's privatisation, the renewed procedure for the sale of *Biochim* Bank enjoys the interest of large Western banks.

In the 3-year period since the introduction of the currency board in the country till end-June 2000, the share of state-owned banks' assets in total bank assets shrank from almost 70% to 17%. Only two banks, viz. *DSK* Bank and the Promotional

Bank will remain state property after the privatisation of *Biochim* Bank. The withdrawal of the state did not bring about a loss of confidence in the banking system since in most cases strategic foreign investors, respected at the international financial markets, purchased the state-owned banks.

Table 16. Structure of Banking System's Assets by Type of Ownership

(as of end of period, %)

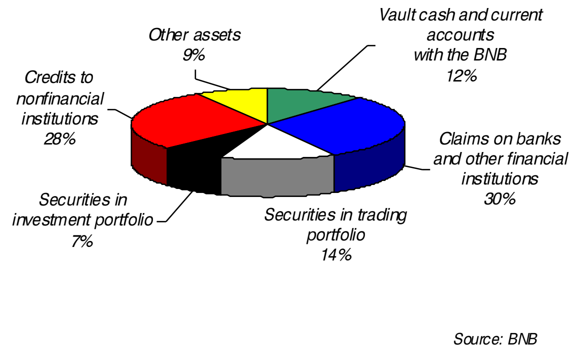
	XII.1997	XII.1998	XII.1999	IX.2000
State owned	68.1	53.8	48.6	16.9
Privatised with prevailing foreign participation	9.2	16.5	22.0	52.2
Foreign banks branches and subsidiaries	7.3	10.6	13.3	14.3
Other private banks	15.45	19.0	16.1	16.6

Source: BNB

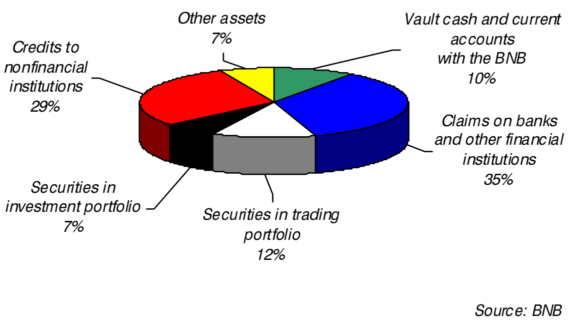
The financial situation of the banking system in the first half of 2000 remained stable. The bulk of operating banks in the country, i.e. 30 banks out of the total 34, reported profits in the first six months. In the corresponding period of 1999, some 22 banks out of 34 made profits. In early-2000, the Bulgarian National Bank revoked the licence of the *Balkan Universal* Bank plc and instituted court bankruptcy proceedings against the bank. These measures did not have notable consequences for the degree of confidence in the whole banking system by reason of the negligible share of this financial institution in total bank assets (under 1%) and the well-functioning deposit insurance system. As of 30 June 2000, the 12-month rate of return on commercial banks' assets amounted to 2.8% as compared to 3.5% reported in the first half of 1999.

In the first six months of 2000, banking system's assets stepped up by BGN 801 million (9.8%) to reach BGN 8 986.8 million. The bulk of this growth had to do with the 16.2% increase of foreign

Assets Structure
30.06.1999



30.06.2000



currency assets held (BGN 748.5 million)[25]. In USD terms, foreign currency denominated assets stepped up by 10.6% over the same period as a result of the BGN depreciation against the dollar. In the first half of the preceding year, the change in commercial banks' balance sheet value was insignificant. As of 30 June 2000, the largest three banks, viz. *Bulbank*, *UBB* and *DSK* Bank, held 50.5% of total bank assets as compared to their share of 51.6% reported in end-June 1999.

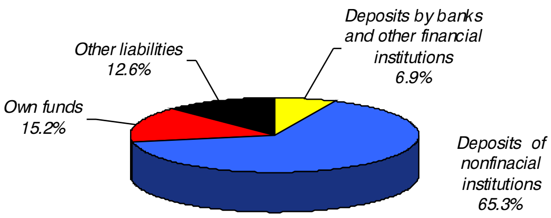
The increase by 5.3 percentage points of the share of claims on banks and other financial institutions (35.5% of total bank assets) represented the most notable change in the assets structure on a 12-month basis (relative to end-June 1999). The most probable factor responsible for this dynamics was the growing yield on USD and EUR denominated deposits held in foreign banks. The relative weight of credits extended to non-financial institutions and other clients stepped by 0.9 percentage points up to 29.3%. The changes in the assets structure indicate that commercial banks still prefer to invest their resources in low risk exposure assets bearing a low rate of return rather than to extend credits to the real economy.

The liability side structure did not undergo substantial changes in the year to end-June 2000. In the first half of 2000, the deposits of non-financial institutions and other clients registered the largest increase in absolute terms (by BGN 462 million). Over the corresponding period in the previous year, however, these deposits reported an absolute fall.

---

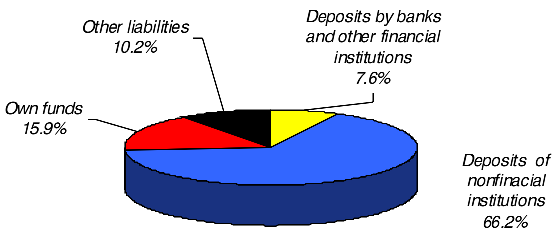
[25] *In the nine months to end-September 2000, total assets of the banking system stepped up by 23.1% (BGN 1 888.7 million) while foreign currency denominated assets increased by 37.3% (BGN 1 718.9 million).*

Liabilities Structure
30.06.1999



Source: BNB

30.06.2000



Source: BNB

In the period January to end-June 2000, commercial banks' capital and reserves stepped up by 11.6% (BGN 149.3 million). The three largest banks' capital and reserves alone increased by BGN 49.8 million.

In the first half of 2000, commercial banks' net profit amounted to BGN 121.9 million (c.f. BGN 130.6 million in the same period of 1999).[26] The profit made by the largest Bulgarian bank *Bulbank* in the first six moths of the year represented 54.3% of total commercial banks' profit. Relative to end-June 1999, commercial banks' operating profit structure underwent the following changes: the respective shares of both net interest income and net income from trade and revaluation stepped up at the expense of the decline in the relative weight of net earnings from fees and commissions. As of end-June 2000, the ratio net interest income to operating expenditures amounted to 89.1%, increasing by about 6 percentage points on a year earlier. This trend is indicative of the banking system's increased capacity to cover its operating expenses by its operating incomes. The higher growth rates of operating expenditures in 2000 compared to those in 1999 was probably due to the introduction of new bank products and services, requiring considerable initial investment.

Commercial banks' capital adequacy indicators continued to be well above the levels required by BNB's Ordinance No8. As of 30 June 2000, the banking system's overall capital adequacy indicator ran at 37.92%, stepping down by about

[26] *As of end-September 2000, commercial banks' net profit amounted to BGN 238.8 million (c.f. BGN 170 million in the nine months of 1999). Over the same period in 2000,* Bulbank*'s net profit reached BGN 176.9 million.*

4 percentage points on its level reported in end-1999. In the period 31 December 1999 to 30 June 2000, the total risk component of commercial banks' assets[27] had risen by 22.2% (BGN 627.6 million) while the capital base had increased by 10.9% (BGN 128.6 million). The decrease of the banking system's capital adequacy can be seen as a sign that commercial banks had started to extend, although quite tentatively, more credits to the real economy.

The state of commercial banks' credit portfolio improved relative to the end of 1999. As of June 2000, some 88.9% of banks' risk exposures were classified as standard (86.2 % in December 1999) while another 5.6% of risk exposures were classified as loss (as compared to 7.2% in end-December 1999).

As of end-June 2000, the banking system's liquidity sustained its relatively high level although the indicator's value declined relative to end-1999. In June 2000, commercial banks' primary liquidity indicator (foreign bank branches excluded) ran at e 13.03% (against 15% in December 1999). In the same month, the secondary liquidity indicator reached 30.56% (against 35.15% in December 1999).

Given the sustained stability of the banking system, commercial banks are not expected to trigger such an increase of the interest levels and the interest difference that would result in a deterioration of the investment environment in the country. ❑

---

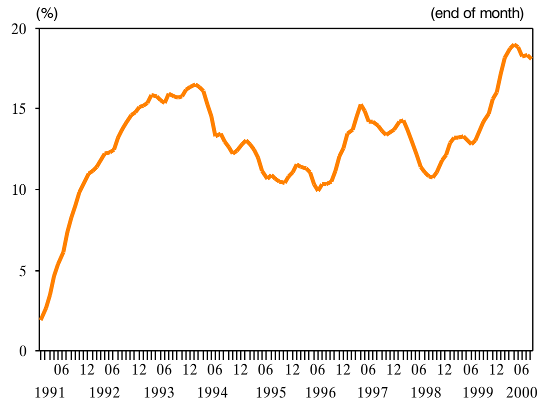
[27] *Foreign bank branches excluded.*

Labour Market

Unemployment – the Social Impact of Structural Changes

During the past ten years of transition, Bulgaria suffered three sharp rises of the unemployment level. The first one was monitored in the period 1991-1992 following the launch of market reforms. The latter, however, were not sustained in the forthcoming years and unemployment steadied at high levels. The second rise occurred in the period 1996 to early – 1997 due to the extremely grave overall economic crisi during this period. The third rise took place in the period mid-1999 to mid-2000, this time having to do with the on-going high intensity process of real structural changes. In contrast to Bulgaria, the other countries with a successful history of transition experienced only a single peak in the unemployment rate, namely at the start of reforms.

Unemployment Rate



Source: NES

According to data from the NSI survey *Standard of Living: Economic and Social Indicators* carried out in April 2000, some 92.2% of respondents considered unemployment as a very serious or an extremely serious problem. People aged 18-30 were the most sensitive to this issue with some 97% of them being convinced that unemployment was a very serious or an extremely serious problem. This finding corresponds to the results from the NSI Labour Force Survey according to which the highest unemployment coefficient (27%) was registered in a similar age group (people aged 20-29). Respondents having secondary education saw unemployment as their paramount concern. This phenomenon is not surprising as economic restructuring calls for professional re-qualification or forces workers to re-orient to new sectors while people with lower educational level find it harder to adapt to the new and ever changing requirements.

According to the results from the above-mentioned sociological survey, about 0.9% of households viewed themselves as rich whereas 15.1% of households considered themselves destitute. According to data from a similar survey carried out in 1999, the respective percentages were 0.2% and 12.9% of households, i.e. in the opinion of respondents their financial situation had deteriorated in the past 12 months. Inasmuch as this is a subjective assessment, it would be useful to compare these data with the distribution of households by the level of average per household capita income according to the household budgets survey data[28] :

Standard of Living	Subjective Assessment of the Average per Household Capita Monthly Income	Subjective Assessment of the Household Category	Actual Distribution of Households According to the Total Monthly *per capita* Income in the Sample of Surveyed Households
Destitute	BGN 61	15.1%	14.1%
Poor	BGN 101	41.6%	36.2%
Neither rich, nor poor	BGN 174	42.4%	36.0%
Rich	BGN 275	0.8%	11.4%
Very rich	BGN 441	0.1%	0.5%

The subjective assessments reveal a perception of impoverishment and further income disparity. Data from the income distribution across household budgets, however, do not support such a conclusion. Gini coefficient[29] , an indicator usually gauging the rate of disparity in household incomes distribution, had displayed no significant changes in the first six months of 2000 relative to

[28] Household budgets surveys are conducted monthly, polling a sample of 6 000 households. The analyses point out that the deviation from the sample tends to lower income households, consisting in their majority of retirees and unemployed.

[29] Calculated using monthly household budgets data.

the same period of 1999. The monitored negligible changes point to a more even incomes distribution:

Gini Coefficient

	Money income	Total income
1999 (First half)	31.73	31.26
2000 (First half)	31.68	31.25

Again according to household budgets data, the share of households without any savings had increased from 57.5% in 1999 to 59.7% in 2000. The share of households who had expended all their savings also stepped up from 9.6% in 1999 to 13.4% in 2000. Apparently, these changes in the total amount of available financial resources to households create the perception of impoverishment. Most probably, the increase in the unemployment level and the ensuing temporary loss of incomes that in turn has to be offset by savings is one of the reasons predetermining such a perception.

The unemployment rate is reported in two ways: by the Labour Force Surveys carried out by the NSI and on the basis of the number of registered unemployed at the job centres of the National Employment Service (NES). The data from both sources are not discrepant, however, throughout the past year the difference between the numbers of unemployed reported by the NSI and by the NES had been widening. Thus, in June alone, the number of registered unemployed at the job centres was by 137 593 people higher than the respective number reported by the Labour Force Survey. From an analytical point of view, data from the NSI Labour Force Surveys are more informative as these are the only surveys based on the correct definition of an unemployed person, namely someone who is not employed but is seeking a job. At the same time, the number of registered unemployed was influenced by the introduction of a health insurance contribution as well as by the requirement to register at the job centres in order to receives social aid and other social benefits.

Table 17. Labour Force Surveys Data

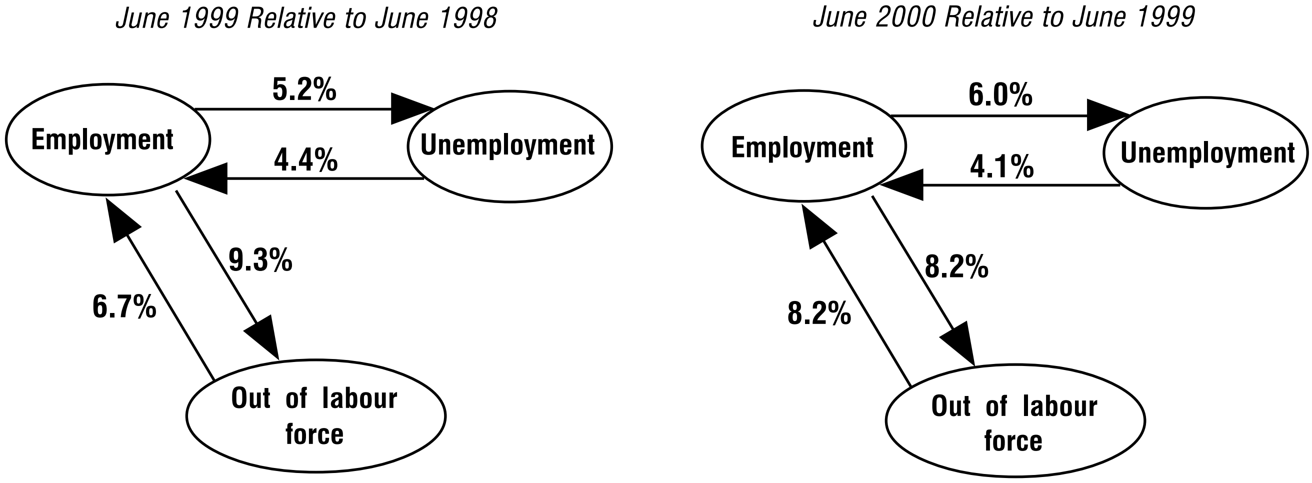
	March 1999	June 1999	March 2000	June 2000
Labour force participation rate (%)	49.1	50.4	48.7	49.8
Unemployment level (%)	15.9	14.0	18.5	16.3
Total number of employed	2844200	2970800	2733510	2872420
Number of unemployed	538300	486700	622350	558960
Number of private sector employees	1222100	1356600	1351050	1498950

Source: NSI

Relative to March 2000, labour force increased by 102 000 people in June, participation rate – by 1.1 percentage point, the number of employed rose by 139 000 persons, the number of unemployed decreased by 63 000, and the number of private sector employees grew by 72 000 people. The unemployment rate fell by 2.3 percentage points, viz. from 18.6% in March to 16.3% in June. Some seasonal factors were partly responsible for these changes as the second and the third quarter of the year typically register the highest economic growth rates. Apart from the seasonal impact, the substantial recovery of the economy in the first half of the year relative to 1999 had also started to strongly influence the unemployment level. (For comparison, *See* Graphs presenting the results of June Labour Force Surveys).

Some notable changes had taken place in the direction of the flows between the three labour market states, i.e. employment, unemployment and out of the labour force. The first change was the increased inflow to unemployment at the expense of the shrinking outflow from unemployment. In

Labour Market Flows (Base: Status *Employment*)*



* *The ratio of people who had moved from one labour market state to another in the respective 1-year period to employed people at the beginning of the period.*

other words, this suggests that an employee is more likely to lose his job than an unemployed person to find a new job, hence the increase of the unemployment level in the country. The second change had to do with the flows between the states „employment“ and „out of the labour force“. According to the Labour Force Survey, in the period June 1999 to June 2000, both flows tended to become equal whereas according to the preceding Labour Force Survey (June 1998 to June 1999) the flow of workers appearing to quit the labour force was larger. This finding means that persons in working age who had previously given up further job-seeking for whatever reason have been able to find a job in 2000 without passing through the state of unemployed, thus successfully competing with registered unemployed.

If we examine closely both employment inflows and assume that the flows from employment to the states of unemployment or out of the labour force[30] characterise the process of job destruc-

[30] *Both flows together accounted for 11.1% of the total number of people in the two labour market categories in the period June 1999/June 1998 and for 12.3% in the period June 1999/June 2000.*

tion while the reverse flows toward the state of employment[31] reflect the process of job creation, then we may conclude that the process of job creation has gained momentum in 2000 probably as a result of economic growth.

The processes of job destruction and job creation reflect the intensity of the ongoing structural changes in the economy. Although employment reductions were reported in almost all sectors (with the exception of communications and the production and distribution of electricity, gas and water), employment declines were not uniform and resulted in some changes in the structure of employment. Thus, the relative share of service sector employees went on the increase to reach 59.6% of the total number of employed at the expanse of the shrinking share of employment in industry (34.9% of the total number of employed). It is quite probable that structural changes, and consequently the new qualification and skills requirements were an important factor behind the stubborn unemployment level: the pace of labour shedding in industry in the last year was very rapid and there had not been enough time for the training of the newly unemployed and their subsequent job search re-orientation to other sectors.

The National Employment Service provides information on the number of newly employed persons. This figure may also be used as an indicator gauging the pace of job creation in the economy although it does not encompass all newly created jobs.

[31] Both flows together accounted for 14.5% of the total number of people in the two labour market categories in the period June 1999/June 1998 and for 14.2% in the period June 1999/June 2000.

Table 18. Gross Job Creation According to Data from the National Employment Service

	Newly employed persons	Newly employed persons through the job centres (JC)	Newly employed persons not assisted by the job centres	Share of newly employed persons through JC in total newly employed persons (%)
First half of 1999	111194	88233	22961	79.35
Second half of 1999	105745	84685	21060	80.08
First half of 2000	99131	69544	29587	70.15

Source: NES, AEAF

According to the NES statistical data, the number of newly employed persons not assisted by the job centres amounted to about 30 000 in the first half of 2000, stepping up by 28.8% on a year earlier and peaking to its highest value in the last three years. The latter fact is indicative of a more intensive job generation process in the country. At the same time, the National Employment Service did not have enough available financial resources to carry out the same active labour market policies as in 1999, hence the shrinking number of people who had found new jobs through the job centres.

The NSI provides monthly data on the number of employment redundancies following structural changes in the enterprises. This is yet another indicator directly exhibiting the influence of restructuring on the employment dynamics. Data on the registered at the NES unemployed entitled to unemployment compensations and benefits are also indicative of this interdependence.

Table 19. Lay-offs under Art. 328, Paragraph 1 of the Labour Code* and Registered Unemployed Entitled to Unemployment Compensations and Benefits

	Lay-offs under Art. 328, para. 1 of the Labour Code (NSI data)			Registered unemployed entitled to compensations (NES data)		
	Total	Public sector	Private sector	Total	Public sector	Private sector
First half of 1998	38563	21214	17349	75461		
Second half of 1998	38189	19595	18594	108165		
First half of 1999	60692	34460	26232	106861	81398	25463
Second half of 1999	50297	26158	24139	127830	78110	49720
First half of 2000	64790	39407	25383	131903	65313	66590

* *Laid-off due to production difficulties.*

Source: NSI, NES

The number of lay-offs under Art. 328, para. 1 of the Labour Code had increased by over 50% in the first half of 1999 and by over 30% in the second half of 1999 relative to the respective periods in 1998. This process continued through the first half of 2000. Since the NSI sample is relatively constant[32] and covers almost all medium-sized and large-scale companies in the country, both private (privatised) and state-owned, it is evident that the increase of the number of lay-offs under Art. 328, para. 1 of the Labour Code was primarily due to employment optimisation in the public and private enterprises.

The number of registered unemployed entitled to unemployment compensations and benefits was considerably higher than the number of people laid-off under Art. 328, para. 1 of the Labour Code primarily due to the different scopes of coverage of both information sources. The National Employment Service registers all persons entitled to unemployment compensations regardless of the company they had worked with (be it large or medium enterprises or small and micro-firms). Micro-firms, for instance, account for over 90% of all companies in Bulgaria. The difference between the NSI and NES data comprises mostly people laid-off from small firms not covered by the NSI monthly surveys as well as self-employed and self-insured persons who have temporarily or permanently discontinued their economic activity.

In the first half of 2000, the difference between the NSI data and those reported by the NES amounted to some 67 100. This figure is unusu-

---

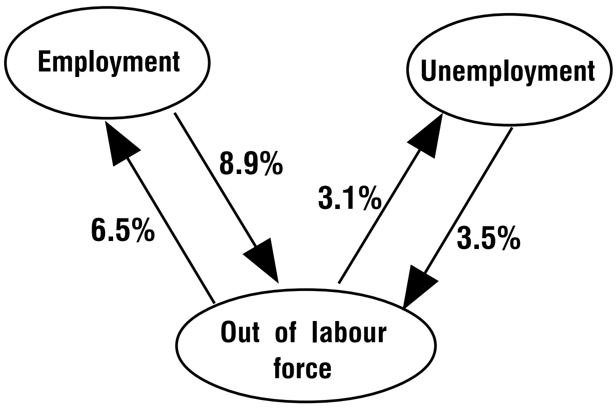
[32] *The NSI sample encompasses some 65% of all employed persons in the country. It covers all large-scale state-owned and private firms and almost all medium-sized firms.*

ally high and cannot be explained solely by seasonal factors typical for employment in small- and micro-firms in the service and agriculture sectors. Some of the reasons explaining such a great discrepancy may be found in the growing competition in the businesses where small companies are concentrated as well as in the merger of existing firms, especially in agriculture and the service sector. The changes in the social security payments scheme and the rise of the minimum wage may have also contributed to this effect. Thus, under the new social security mechanism, it became more difficult to evade payments due to the National Social Security Institute since part of them is directly deducted from the gross labour remuneration of employees similar to the way of income taxation of physical persons working under a labour contract. If, under the previous scheme, entrepreneurs had the opportunity to evade or fall into arrears with social security payments for their employees, under the new scheme, they most probably strive to preserve their labour costs or at least to curb the increase of the latter by undertaking employment reduction measures. In other words, social security reforms may have contributed to the relatively high number of registered unemployed entitled to unemployment compensations in the first half of 2000.

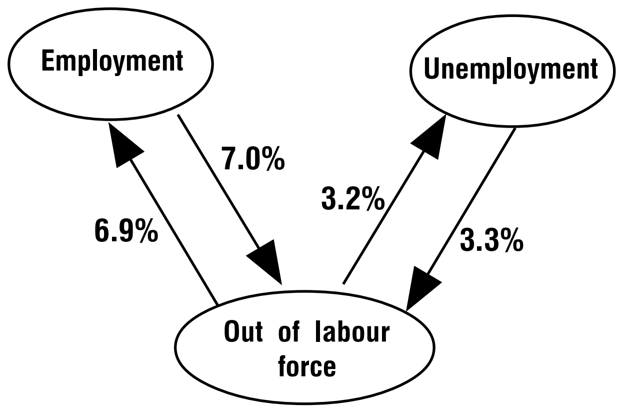
Not all laid-off persons become unemployed, however. Some of them immediately find a new job while others abandon the active job search and exit the labour force. According to NSI Labour Force Surveys, some 47% of the employment contraction in the period June 1999 to June 2000 had contributed to the rise of the unemployment level whereas the remaining 53% of the flow had exited the labour force. Therefore, over the same period, the increase in the number of unemployed as a result of employment contraction had amounted to only 46 000 people. The remaining about 26 000 persons of the overall 12-month increase in the number of unemployed represent the net number of people who were out of the labour force in June 1999 but one year later declared to be unemployed. A positive trend was discerned in the flow of discouraged workers as their number stepped down from 12.4% in June 1999 to 10.3% in June 2000.

Labour Market Flows (Base: Status *Out of Labour Force***)***

June 1999 Relative to June 1998



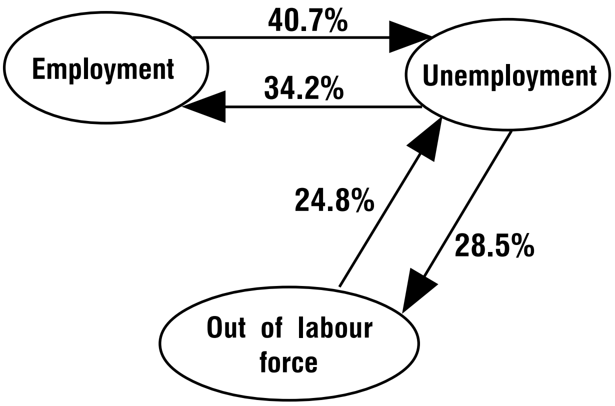
June 2000 Relative to June 1999



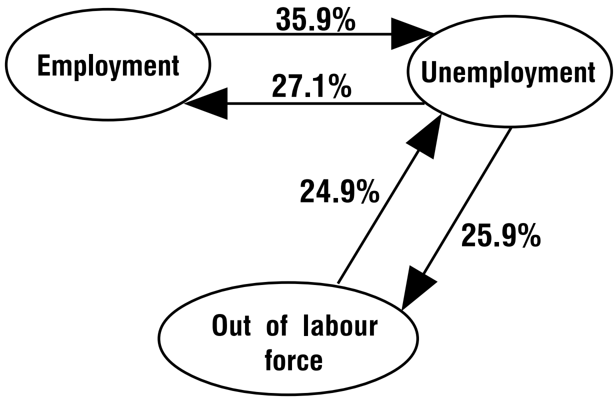
* *The ratio of people who had moved from one labour market state to another in the respective 1-year period to people out of labour force at the beginning of the period.*

Labour Market Flows (Base: Status *Unemployment***)***

June 1999 Relative to June 1998



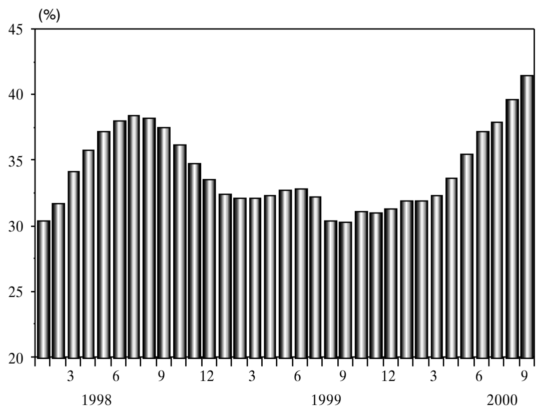
June 2000 Relative to June 1999



* *The ratio of people who had moved from one labour market state to another in the respective 1-year period to unemployed people at the beginning of the period.*

The assessment that job finding possibilities had been gradually, though slowly, improving should also take account of the fact that a cohort of unemployed with declining chances to find new jobs had already emerged. Within the span of a single year, the unemployment inflow had increased, accounting for 8.8% of the total number of unemployed whereas in the preceding one-year period between the NSI surveys, the net flow had accounted for 6.5%. Any deterioration of this indicator inevitably brings about an increase in the share of long-term unemployed with the accompanying important social and economic consequences.

Share of Long Term Unemployed in Total Unemployment



Source: NES

The loss of qualifications and skills, i.e. the loss of human capital and the impoverishment of certain strata of the population represent the primary social concerns caused by long-term unemployment. The persistence of high long-term unemployment level abates the pressure on wages and further reduces the chances of the unemployed to find a suitable job. In this respect, the active labour market measures of the NES become of particular importance for the aversion of the negative consequences from a stubborn long-term unemployment level.

Labour Productivity and Wages

The interests of both employers and the employees who preserved their jobs necessitated the employment reduction in the last twelve months to June. For employers, the issue had to do with the grave problem of firms' restructuring (particularly of the privatised ones) and the need to increase profits in order to make the necessary investment. In 2000, the growing expenses for raw materials and fuels exerted an additional pressure especially on those companies heavily relying on imported materials and in the case when these expenses could not be passed on to consumers. For employees preserving their jobs, employment redundancies created the necessary preconditions for an increase of the average wage. Data reveal that the growth rates of labour productivity outstripped the increase of wages.

Table 20. Growth Rates

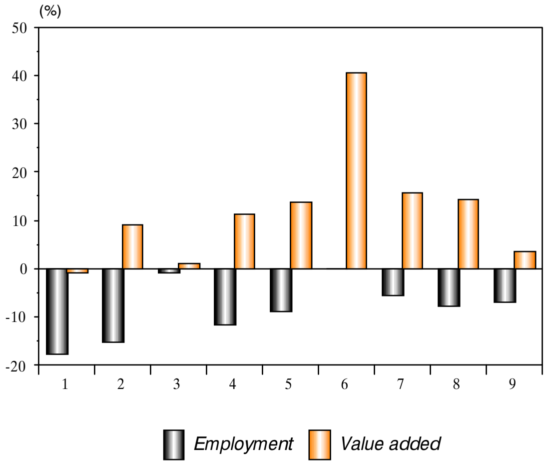
	Gross value added	Number of employed	Labour productivity	Real wage
Q1 2000/ Q1 1999				
Total	104.85	96.11	108.98	104.23
Industry	106.16	89.69	118.37	101.90
Services	107.04	99.83	107.23	108.57
Q2 2000/ Q2 1999				
Total	106.70	96.69	110.52	105.11
Industry	108.38	91.69	118.20	102.84
Services	111.29	95.61	116.40	109.99

Source: NSI, AEAF

In the first half of 2000, wages registered a 4.5% real-term growth against the corresponding period of 1999. Private sector wages increased at higher rates in comparison to public sector salaries, stepping up by 13% in real terms in the first six months of 2000 against the first half of 1999. This higher growth was to a certain extent due to the privatisation process as enterprises with high labour productivity and respectively higher wages passed from the public to the private sector. Over the same period, real public sector salaries steeped up by 2%. In the first half of 2000, wages in the budget sector registered an 8.7% real-term rise on a year earlier. Regardless, they remained some 12% lower than the average salary in the country.

Dynamics of Employment and Value Added by Economic Sectors

(first half of 2000)

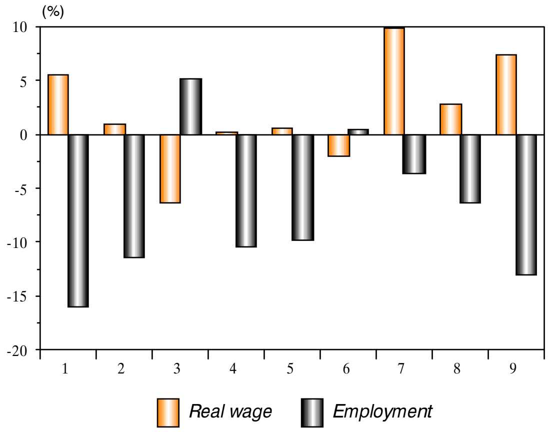


1. Mining industry
2. Processing industries
3. Production and distribution of electricity, gas and water
4. Construction
5. Transport
6. Communications
7. Trade
8. Finance, credit and insurance
9. Other services

Source: NSI, AEAF

Dynamics of Employment and Real Wage by Economic Sectors

(August 2000/August 1999)



1. Mining industry
2. Processing industries
3. Production and distribution of electricity, gas and water
4. Construction
5. Transport
6. Communications
7. Trade
8. Finance, credit and insurance
9. Other services

Source: NSI, AEAF

Employment and Real Wage Dynamics by Industrial Branches

(August 2000/August 1999)

1. Coal mining, oil extraction, etc.
2. Mining of metal, thorium and other ores
3. Quarrying
4. Food industry
5. Manufacturing of textiles
6. Manufacturing of clothing
7. Fur, leather and footwear industry
8. Wood processing
9. Pulp and paper industry
10. Production of coke and refined petroleum products
11. Manufacture of chemical products
12. Manufacture of rubber and plastic products
13. Manufacture of mineral products
14. Metallurgy
15. Metal processing, manufacturing of machinery and equipment
16. Manufacturing of electric machinery and equipment
17. Manufacturing of transport vehicles
18. Other manufacturing industries
19. Production of electricity, gas and water

Source: NSI, AEAF

By branches, service sector wages reported the highest increase, notably in the following services: non-governmental organisations' activity, public utilities and business-services. The following branches registered the lowest wage growth rates: production of coke, refined petroleum products and nuclear fuel, metallurgy, production and distribution of electricity, gas and water, manufacture of transport vehicles, mining of quarrying and mineral products. Consequently, in the seven months to July 2000 the average real wage in those branches was lower than its level in the same period of 1999.

Similar to 1999, in the first half of 2000 the highest wages were reported in the following branches: production of coke, refined petroleum products and nuclear fuel; production and distribution of electricity, gas and water; finance, credit and insurance; metallurgy; mining and dressing of metal, uranium and thorium ores. The branches manufacture of clothing and other apparel products; public utilities; fur, leather and footwear industry again reported the lowest remuneration.

The increase of the average wage depends on the financial results of the firms. Public sector companies must also comply with the regulations on the working salary increase, hence the additional barriers to the growth of their labour costs.

In the first half of 2000, state-owned firms[33] reported an increase of their operating revenues amounting to 10.9% at current prices. Deflated by the CPI, firms' operating incomes stepped up by 1.7%. Over the same period, the value added generated by public sector companies rose by 1.7% (at current prices) relative to the first half of 1999. By quarters, however, public sector firms' financial results exhibited a different dynamics: after a very good performance in the first quarter, in the second quarter of the year their indicators deteriorated. In the second quarter, the value added stepped down by 7% against its level in the respective quarter of 1999 (at current prices).

In the period January 1999 until end-March 2000, state-owned firms had been improving their profitability. While in the first three quarters of 1999, they reported profitability close to the zero level, in the last quarter of 1999, the indicator's value stepped up to reach 1.5%. In the first quarter of 2000, public sector firms' profitability peaked to its highest in the preceding 18 months, hitting 5.9%. This level is comparable to private sector

[33] *The analysis of public sector enterprises and their financial situation is based upon a fixed sample of 1 650 firms. The aggregate indicators have been calculated in collaboration with the NSI.*

enterprises' profitability in some branches such as manufacturing. Public sector companies in the branches: hotels and public catering and production and distribution of electricity, thermal energy, gas and water registered the highest profitability. The second quarter of the year, however, witnessed a sharp deterioration of state-owned firms' profitability (-5.7% for the enterprises in the sample). Particularly low profitability was registered by public sector firms operating in trade and mining industry (their profitability fluctuated around the zero value in the preceding quarters) as well as in manufacturing wherein profitability declined from -5.7% in the first quarter of 2000 to -10% in the second quarter.

Employment changes followed the opposite dynamics to that of financial indicators. In the first quarter, employment in state-owned enterprises in the sample contracted by 13% against the first quarter of 1999. In the second quarter, however, the average number of employed stepped up by 5.9% on a quarter earlier. The following branches had the largest contribution to this increase: production and distribution of electricity, thermal energy, gas and water (accounting for almost 60%), agriculture (17.8%) and hotels and public catering (14.9%). On the whole, the first half of 2000 saw a 9.9% decrease in the average number of public sector firms' employees relative to 1999.

The employment contraction and the increase of the value added generated by public sector enterprises in the first quarter contributed to the sharp rise of their labour productivity. Thus, labour productivity in the first quarter of 2000 was 26.8% higher than that in the first quarter of 1999 (at current prices) whereas in the second quarter, the indicator's value fell by 0.2% and approximated its level registered in the respective period in 1999. Over the first six months of the year, labour productivity in public sector firms reported a 12.9% higher value than its level in the first half of 1999 (at current prices). Wage dynamics differed from labour productivity dynamics. While, on a 12-month basis, the average wage stepped up by 9.4% nominally in the first quarter of 2000, it decreased by 1.1% in the second quarter of the year.

Apparently, state-owned firms faced some difficulties in the second quarter of 2000. During this period, they not only reported negative financial results but also accumulated new short-term liabilities to the various creditors. In end-March 2000, their short-term indebtedness shrank by 3.4% on a year earlier. In the following three months, however, their short-term dues stepped up by almost 43%, reporting in end-June 2000, a 12-month growth of 26.8% (at current prices). Short-term arrears to suppliers and employees reported the highest growth rates. These developments can be seen as a sign that firms' liquidity problems had appeared in the second quarter of 2000. The second quarter of the year witnessed a fast increase in liabilities of companies operating in the following two branches: production and distribution of electricity, thermal energy, gas and water (over three-fold) and mining industry (over two-fold). Short-term debts of state-owned firms operating in trade and in hotels and public catering branches stepped up by over 30% probably due partly to their lower liquidity and partly to the impact of seasonal factors.

The development of private firms followed a different dynamics. Private sector companies faced their relatively gravest difficulties in the second quarter of 1999. Thereafter, their indictors followed a gradual trend towards improvement and consequently, the first half of 2000 proved successful for private sector firms' performance[34] .

Labour productivity in private firms substantially improved[35] . In transport and communications, the generated income per employee stepped up more than 3.8-fold (at current prices). This indicator's value for private firms operating in construction, hotels and public catering increased over two-fold. In the first half of 2000, the remaining branches reported in most cases an increase of labour productivity by over 50% on a year earlier. It is probable that technical factors such as the inclusion of new privatised firms in the sample may have contributed to this effect. Regardless, the principal reasons behind the growing efficiency of private sector firms were the better utilisation of the factors of production following the completion of privatisation as well as the expansion of private sector companies to some branches characterised by a high share of value added such as communications, tourism and healthcare.

Private firms' profitability was higher than that of state-owned enterprises. Private firms operating in the mining industry, hotel and public catering, transport and communications, and healthcare reported typically high profitability. Private companies operating in construction and education registered negative profitability values most probably due to either shrinking demand (construc-

---

[34] *Apparently, private companies had been severely affected by the* Kosovo *crisis.*

[35] *The analisis is based upon a sample of over 3 000 private firms. Calculations have been made in collaboration with the NSI.*

tion) or the dominant position of the public sector (education) or the underreporting of newly generated income.

The better values of profitability and labour productivity indicators also explain the faster growth rates of private sector wages.

In conclusion, the higher labour mobility and the high unemployment rate due to the fast growing labour productivity in both private and public sector firms characterised the development of the labour market in Bulgaria in the first half of 2000. The overall economic effect was positive as these processes contributed to the increase of competitiveness and the vitality of the economy as a whole. The negative consequences from the unemployment growth can be partly offset by active labour market policies targeted at job creation and the requalification of unemployed persons. ❑

THE BULGARIAN ECONOMY TILL THE END OF 2000

The following conclusions on the prospects for development of the Bulgarian economy till the end of 2000 can be drawn from the analysis made so far:

- Data on GDP in the first half of 2000 and on the growth of industrial sales in the eight months to August 2000 provide sufficient grounds to expect that economic growth will exceed the forecast 4.5% entirely due to the contribution of industry and services. Value added in agriculture will decrease as a result of the unfavourable climatic conditions in the second half of 2000. The positive growth rates of gross production and value added in industry had to do with both the improved external business situation and the increase of competitiveness primarily owing to post-privatisation enterprise restructuring. The forming of a new, market firms' behaviour represented a positive phenomenon in manufacturing, as enterprises became sufficiently flexible to take advantage of the positive shocks or to react adequately to any negative ones.

- On the basis of the balance of payments dynamics in the eight months of 2000 and the expectations for stabilisation of the EUR and the international prices of crude oil in the near future, we have grounds to anticipate that the balance of payments will remain stable and will not experience any important problems in the medium term. Bulgaria's exports follow a steady upward trend fuelled not only by traditional exported goods such as metals and chemical products but also by new, predominantly labour-intensive products like clothing and furniture. By and large, the expectations for a stable balance of payments are upheld by the developments in the overall macroeconomic situation in the country, the anticipated sustainable growth rates and increasing inflow of foreign direct investment as well as by the stability of the banking system.

- Flexible governance and a strict control over the budget finances in conformity with the actual dynamics of the country's macroeconomic indicators have been administered throughout the year 2000 by maintaining of central government budget surpluses. The stern fiscal policy has contributed to the balance of payments' sustainability in the presence of considerable external negative shocks like the price increase of fuels.

- Given the fixed exchange rate of the BGN to the EUR and the free movement of capitals, interest rates in Bulgaria and in the euro area are expected to equalise in the medium term. The difference between interest rates on credits will depend on the „quality“ of borrowers. The banking system has available free resources and, under certain conditions and mainly given well-grounded business projects, may channel them into credits to the real sector for a further acceleration of economic activity. In 2000, the restrictions on domestic credit have not created barriers to economic growth.

- The average annual inflation will reach 10% due to the growing liquidity of the economy.

- Structural reforms are in full swing with the inevitable positive and negative consequences. The competition level in the country follows a steady upward trend thereby exerting pressure on businesses to improve their competitiveness – a factor of exceptional importance for the viability of the economy as a whole. At the same time, the unemployment rate registered a temporary increase.

- Labour market in the country has been marked by high labour mobility. The high unemployment rate had to do with the fast growth rates of labour productivity in both private and public sector firms. The overall economic effect was positive as these processes contributed to the increase of competitiveness and the vitality of the economy. The negative consequences of the unemployment growth can be partly offset by active labour market policies targeted at job creation and the requalification of unemployed persons. No substantial changes are expected in the unemployment rate and therefore in end-2000 it will steady at 16.2% (ILO definition). ❑

C O N T E N T S