AGENCY FOR ECONOMIC ANALYSIS AND FORECASTING

BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2001

(semiannual survey)

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The analyses in the current Semiannual Survey are based on the avaliable economic information and data as of 15 October 2001.

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ABBREVIATIONS AND ACRONYMS

AEAF – Agency for Economic Analysis and Forecasting

BCC – Bank Consolidation Company

BIR – Base Interest Rate

BNB – Bulgarian National Bank

BSE – Bulgarian Stock Exchange

CEE – Central and Eastern Europe

CEFTA – Central European Free Trade Association

CIS – Commonwealth of Independent States

DISC – Discount Bonds

EBRD – European Bank for Reconstruction and Development

ECB – Europea Centrak Bank

EFTA – European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

GO – Gross Output

GVA – Gross Value Added

IAB – Interest Arrears Bonds

IEA – International Energy Agency

IMF – International Monetary Fund

LFS – Labour Force Survey

LIBOR – London InterBank Offering Rate

MF – Ministry of Finance

NES – National Employment Service

NSI – National Statistical Institute

NSSI – National Social Security Institute

OECD – Organization for Economic Cooperation and Development

OPEC – Organisation of Petroleum Exporting Countries

PSI – Public Social Insurance

TUF – Training and Unemployment Fund

NOTE FROM THE EXECUTIVE DIRECTOR

The regular Semi-annual Survey on the state of the Bulgarian economy prepared by the Agency for Economic Analysis and Forecasting goes beyond the scope of the traditionally analysed January to June period of the respective year. The enhancement of the period in review was intentional to take account of two factors, namely (i) the exceptional importance and impact of events that have shaped the global economy during the period when our Semi-annual Surveys are normally in preparation, and (ii) the changes in the country's economic policy envisaged by the new Bulgarian government elected in July 2001. By enlarging the analysed period we were able to take into consideration and incorporate in our report the latest information on:

(1) the reassessments of the global economic trends and external demand for Bulgarian exports after the 11 September 2001 tragic events in the USA;

(2) the dynamics of some primary macroeconomic indicators[1] in the country in the first half of the year that are normally available only in September and October;

(3) the short-term effect of the economic policy carried out in the first half of the year as it was one of the important arguments of the new Bulgarian government to propose the economic policy changes in the forthcoming months and in 2002.

You will notice that the contents of present Survey is different from our previous Semi-annual Surveys. The modifications stem from the ambition to better target our analyses thereby assisting the user to formulate a more accurate assessment of the trends in the development of the Bulgarian economy in the forthcoming months till end-2001 and in early-2002. The essentially important analysis of the ongoing structural reforms of the Bulgarian economy has not been examined in a specific chapter since in the January to September 2001 period, most of the envisaged restructuring measures were either postponed or partially implemented. The reasons behind the delay in structural reforms in the period in question could be found not only in the unfavourable global economic development trends which triggered new abrupt shifts in private capital flows but also in the declining political will for their implementation in view of the General Elections in June and the Presidential Elections in November. The adverse effects of the delay in structural reforms, however, are of long-term nature and therefore they did not manifest themselves in the analysed period.

Tsvetan Manchev

Executive Director of the AEAF

[1] *GDP and its components by expenditure and production method and by final consumption; employment and wages; banking system consolidated balance sheets and consolidated income statements in the second quarter and the first half of 2001.*

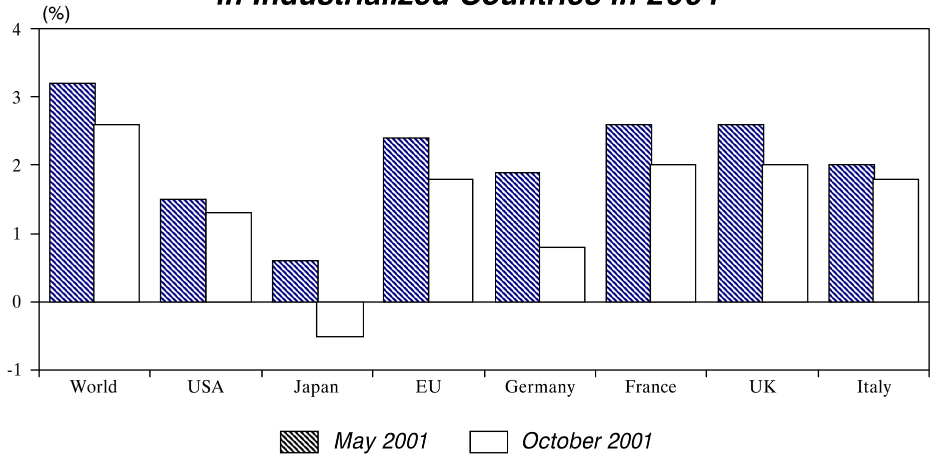
EXTERNAL ENVIRONMENT

The World Economy and Bulgaria's Major Economic Partners

The slowdown in the world economy continued throughout the first half of 2001. In the aftermath of the terrorist attacks in the US on September 11, 2001 and the subsequent measures taken by the international community against terrorism worldwide, the international financial institutions expressed the opinion that these events should affect the economic activity mainly in the short run, additionally heightening the risk of a slump in the US and world economy. At end-September, the international financial institutions[1] downgraded their May forecasts for the main macroeconomic indicators of all countries, including the expected GDP growth, inflation and unemployment.

The expectations are that the 2001 global growth would not exceed 2.6%, down from a 3.2% increase in world output projected in May, with the IMF experts assessing the risks of a global recession as rather high at this stage. With respect to the development of the main macroeconomic indicators in 2002, the current estimates of the international financial institutions have been also downgraded, albeit to a much lesser extent in comparison with the revised projections for 2001. This points to the conclusion that, at present, the international institutions do not expect the September's attacks in the US to have negative medium-term consequences for the world economy.

Expected GDP Growth Rate in Industrialized Countries in 2001



Source: IMF World Economic Outlook May 2001, October 2001

The *industrial countries* are currently facing similar problems that largely reflected a sharp contraction of business investment in IT. Over the past several years the US economy had been the main engine of global growth but the second quarter of 2001 saw the weakest increase in domestic output in eight years, with statistical data showing a tiny 0.2% gain in GDP over the first quarter. This led to a considerable revision of the forecasts for the country's GDP performance in 2001 from 2.4% growth previously to 1.7% even before the events of September 11. For a tenth month in a row industrial output contracted in July, following a 4.7% first quarter drop of which was the sharpest decline of the indicator since 1991.

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[1] *IMF World Economic Outlook, October 2001, unless otherwise indicated.*

The main concerns relating to the outlook for the US economy after the September's terrorist attacks are associated with the recent deterioration of consumer confidence, and hence with lower consumer demand. Accounting typically for about two thirds of GDP, consumer spending is the most important demand component of domestic output in the US. By remaining rather stable during previous crisis episodes it had played a key role for the overall stabilization of the economy, although the released September figures signalled weakening consumer demand and falling confidence. Retail sales dipped 2.4% in September which was the strongest drop from 1992 onwards, while the *Conference Board* index posted its steepest decline since 1990, decreasing to 97.3 points from 114 in August. The government approved, however, a fiscal stimulus package worth USD 100 billion that should add to the effect of recently reduced interest rates (in September alone, the Federal Reserve's key rates were cut twice) in supporting a pick-up in consumption.

The process of global growth has been negatively influenced by the present weakness of the US economy whose adverse impact is expected to be mostly felt in the *Asian-Pacific region* as the countries from the area are highly sensitive to the slump of IT investment in the US. According to the Japanese Ministry of Finance, there is a serious risk of the country experiencing its fourth recession in a row during the past ten years. Japan's GDP fell 0.9% in the second quarter of 2001, with the expectations being for a full year's drop of 0.5%. The smaller economies of East Asia are particularly sensitive to changes in global economic conditions as a reflection also of the higher share of exports in their GDP (the average level stands at 50% for the region as a whole). After having weathered intact the financial crisis of 1997-1998, the economy of Singapore recorded a 0.9% contraction in overall output during the second quarter of 2001. Following the 1.1% first quarter rise which was the lowest rate in the past 26 years, Taiwan's GDP fell 2.4% in the second quarter. Under most forecasts, this year's economic growth is seen at less than 2% for the region as a whole. Adding to the effect of lower import demand in the industrial countries, the situation in East Asia has been additionally aggravated by the underlying structural problems which include generally weak banking systems, higher margins of unused production capacities, considerable non-performing loans to the private sector, as well as insufficient domestic demand.

With the reported second quarter growth of 7.8%, the economy of China has apparently remained the sole island of stability in the whole region. In 2001, the country's foreign trade is expected to grow further by some 10% despite the unfavourable external environment. Another key factor of overall output growth is the country's huge domestic market which makes the Chinese economy relatively less dependent on foreign demand.

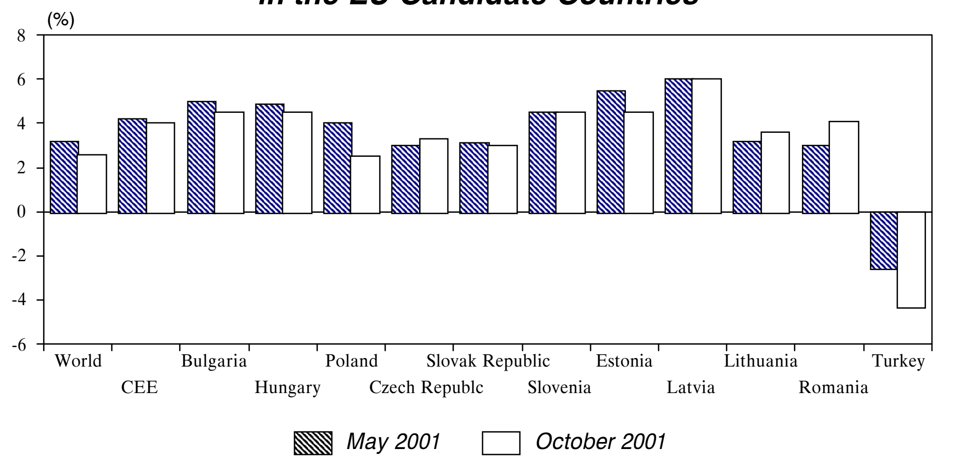
The recession in the world economy has considerably affected the export performance and investment activity in the countries of the *European Union (EU)*. During the second quarter of 2001 EU exports declined by 1.2%, while fixed assets investment fell 0.8% from the previous quarter. Domestic demand in the EU area also slowed down in the first half of 2001. On a quarter-on-quarter basis, household consumption grew only 0.6% during April-June after a 0.8% increase in the first quarter of 2001. This resulted in a meagre 0.1% q-o-q rise in aggregate GDP of the EU countries during the second quarter of 2001.

In the wake of the events of September 11, the growth forecasts for the EU area have been lowered by 0.6 percentage points both for this year and the next to 1.8 and 2.2% respectively.

The German economy which accounts for about 30% of the aggregate GDP of the EU slowed down in the second quarter of 2001 as local companies were forced to curtail their expenditures for new equipment and construction due to deteriorating global cyclical conditions. The country's GDP performance in the second quarter is widely expected to remain close to the first quarter outcome, with overall output inching up only 0.6% y-o-y, i.e. the slowest rate of increase since 1997. Yet, industrial output in Germany recorded positive growth in June, rising by 0.8% after four consecutive monthly drops. Meanwhile, the global slowdown in economic activity has also affected some other major EU economies such as Italy and France.

The impact of the unfavourable trends in the world economy has been so far of a more moderate magnitude for the *countries from Central and Eastern Europe and the CIS*, although this region will likely see a further deceleration in the rates of growth as well. The forecasts for the Central and East European countries point to an average GDP growth of 3-4.5% in 2001. The different economic and political situation in the aftermath of September 11 is expected to affect most strongly the growth process in Turkey and to a lesser extent that in Poland, Hungary, Slovakia, Estonia and Georgia. The 2002 expectations for this group of countries remain broadly unchanged, with some acceleration in the growth rates even being forecast except for the GDP performance of Hungary, Poland, Estonia, Georgia and Ukraine. In the case of Bulgaria, the growth projections of the international financial institutions for 2001 and 2002 were both reduced by half a percentage point as against their May levels.

Expected GDP Growth Rate in 2001 in the EU Candidate Countries

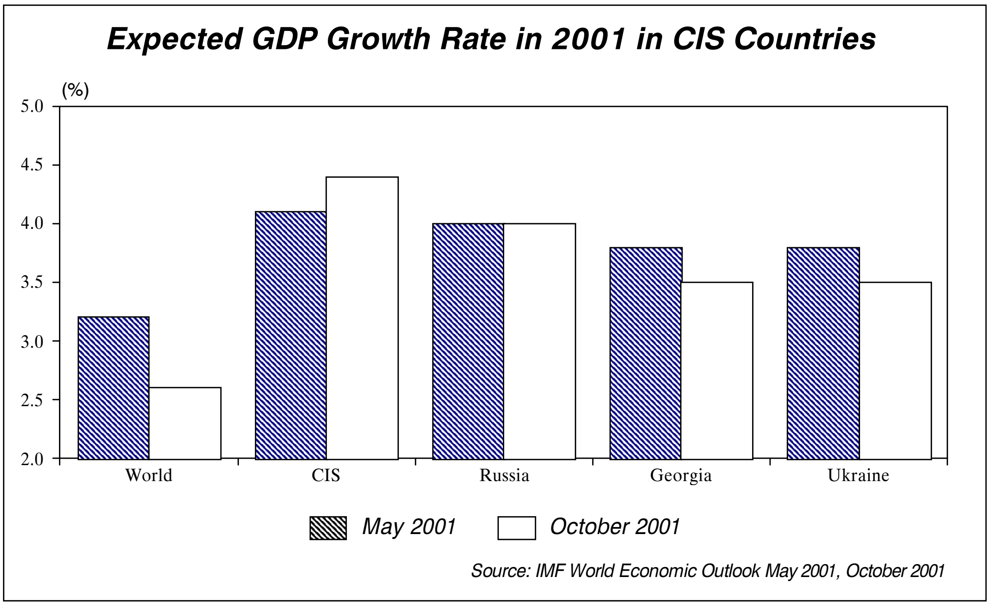


Source: IMF World Economic Outlook May 2001, October 2001

With respect to the countries from Central and Eastern Europe and the CIS, the negative effect of September's events in the US on GDP growth comes mainly in the form of deteriorating current accounts in the balance of payments. According to the October 2001 projections of the international financial institutions, a deterioration of this indicator in comparison with last year is seen in the case of the Czech Republic (by 0.3 percentage points to -5% of GDP), Slovakia (by 2.5 points to -7.3% of GDP), Bulgaria (by 1.6 points to -6% of GDP), Romania (by 1.6% points to -6% of GDP) and the CIS countries (by 6.5 points to 2.5% of GDP). In 2002, a further deterioration of the current account positions is to be expected for the CIS countries, most notably in Russia, and only to a lesser extent in Estonia, Latvia, Lithuania and the Czech Republic. It would appear, however, that this negative trend harbours more risks for the countries of Central Europe and especially for Hungary, the Czech Republic and Slovakia as their economies became rather closely linked the EU over the past several years.[2] In Hungary alone, the share of exports reached 61.7% of GDP for 2000, whereas the EU-bound exports accounted for 75.1% of total outward trade. The Czech Republic came second with relative weights of 57.2 and 68.6%, followed by Slovakia with 68.1 and 59.1% respectively. The slowdown in

[2] *According to estimates of the Vienna Institute for Comparative Studies.*

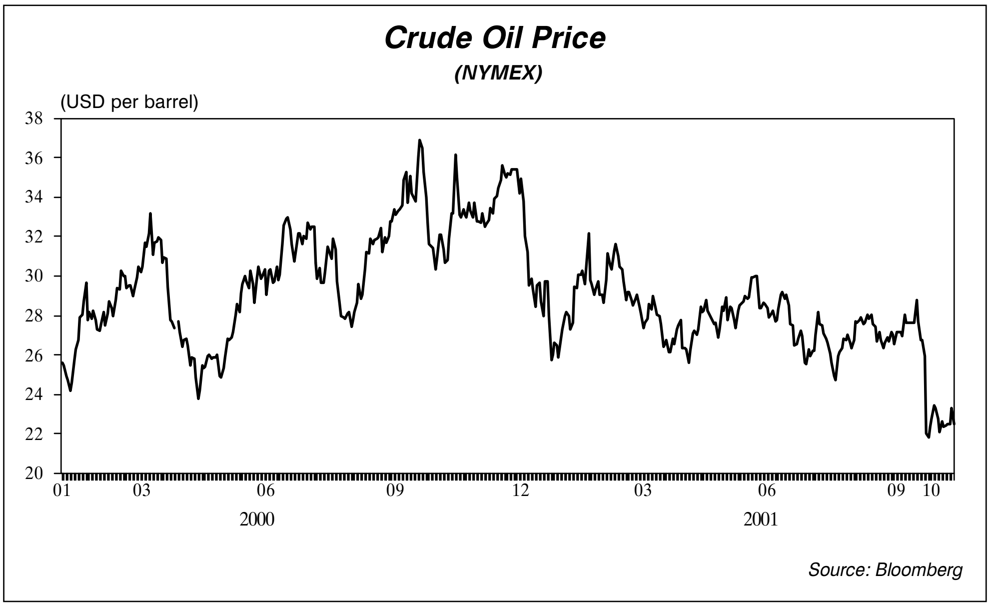
the rates of GDP growth might turn quite strong in Poland as well since the policy of higher interest levels to combat inflation will conceivably contribute to an overall depression of domestic consumption. In response to currently deteriorating economic conditions, however, the Council on monetary policy in this country has recently undertaken steps to reduce some key interest rates.



Most of the Central and East European countries will likely be forced to adopt a more restrictive fiscal stance in the final quarter of 2001 and during the course of 2002 as a precaution against deteriorating current accounts. The main reason for such a shift in fiscal policy is linked to the expected negative development in foreign investment inflows that are seen lower than anticipated in early 2001 due to an overall slowdown in carrying out major infrastructure projects across the region, including the Balkan countries as well. Such a reduction in capital inflows will pose additional difficulties in financing the current account deficits.

Following the February financial crisis in Turkey which was the second in a year-time span and provoked a 50% devaluation of the Turkish lira in combination with sharply higher interest rates, the country's GDP fell 8.5% during January-June 2001 on a year ago. Over the same period industrial production slumped by 6.2%. According to the international institutions, external debt servicing will remain the main challenge to the country during the second half of the year, with the possibility of a temporary suspension of payments still raising some concerns at this stage. Although the fears of a default have been largely alleviated as a result of the formal release in early August of the USD 1.5 billion tranche under the loan arrangement with the IMF, certain political factors in Turkey have continued to oppose the implementation of the agreed programme, thus heightening the perceived country risks among foreign investors. This, in turn, does not allow a reduction in the relatively rather high interest rates and additionally depress the level of economic activity in the country.

During January-September 2001, *the dynamics of the international prices* of raw materials largely reflected a weakening world demand as a result of slowing growth in the US and most of the European economies. The average monthly price of crude oil fluctuated within the range of USD 24.4 per barrel (in March) and USD 28.45 (in May), leaving the period average at a level by 6.2% lower than a year ago. Another key factor for the observed price developments was to be found in the decisions of the OPEC countries to cut production in a bid to maintain the targeted price for the organization's basket of crude types at about USD 25 per barrel. Immediately after the terrorist attacks in the US the price of oil rose briefly to USD 28.8 per barrel followed, however, by a subsequent drop in the OPEC basket price level to under the minimum set at USD 22 per barrel due to lower demand. The forecasts[3] for the remaining of 2001 are for falling demand for crude oil in line with the reduced air traffic in the aftermath of the September attacks in the US, as well as weakening prospects for a global recovery. In the last quarter of the year alone, global oil demand is expected to fall by 700,000 barrels a day to a level of 76.6 million b/d. Downward pressures on the current price levels have been also exerted by increased supplies from Russia and Norway, as well as some OPEC members.



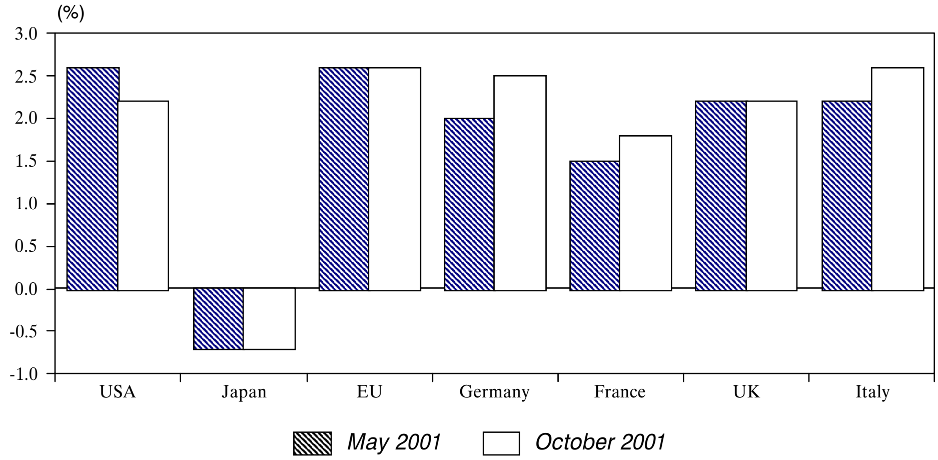
The deterioration of global cyclical conditions strongly affected the price dynamics of ferrous and non-ferrous metals that followed a sustained downward trend during January-September. The sharpest fall has been experienced by the world prices of steel products as the average price level of hot rolled coilsheet decreased by 23.2% y-o-y in the period under review, while the drop for cold rolled coilsheet amounted to 27.5%. By early October, copper prices plunged to a 28-month low, falling under USD 1 400 per ton. The international prices of fertilizers exhibited a similar trend.

In spite of the fall in world prices for key commodities, *inflation* in the developed economies as a whole has slightly risen. The October 2001 projections of the international financial institutions point to a relatively higher price level in the world economy this year in comparison with 2000 and a slackening rate of inflation in 2002. Falling inflation in the US is being, however, forecast for both this year and next. The projected 2001 and 2002 inflation levels in Japan were left unchanged in October as against the forecasts of May 2001. A slight pick-up in inflation for the full 2001 is expected in Germany, France and Italy. The 2002 projections for Germany and Italy remained unchanged, while France will likely see slowing inflation rates next year, according to recent estimates. With respect to the forecast inflation in the whole EU area during 2001 and 2002, no revisions occurred in October as compared with May estimates. The IMF projection for the 2001 inflation in the Euro area was, however, revised upward by 0.4 percentage points.

For the group of the EU candidate countries as a whole, the international financial institutions expect this year's inflation to remain at its 2000 level which will be followed by a slight pick-up in 2002. Higher inflation rates are, however, forecast in both 2001 and 2002 for Turkey and, particularly, Romania. In contrast, the October projections for the current year appear more optimistic in the case of Poland, Hungary, Lithuania and Bulgaria, although the expectations for 2002 deteriorated somewhat as far as Poland and Lithuania are concerned. In the CIS countries as a whole, an upturn of inflation has been recently forecast, with this trend

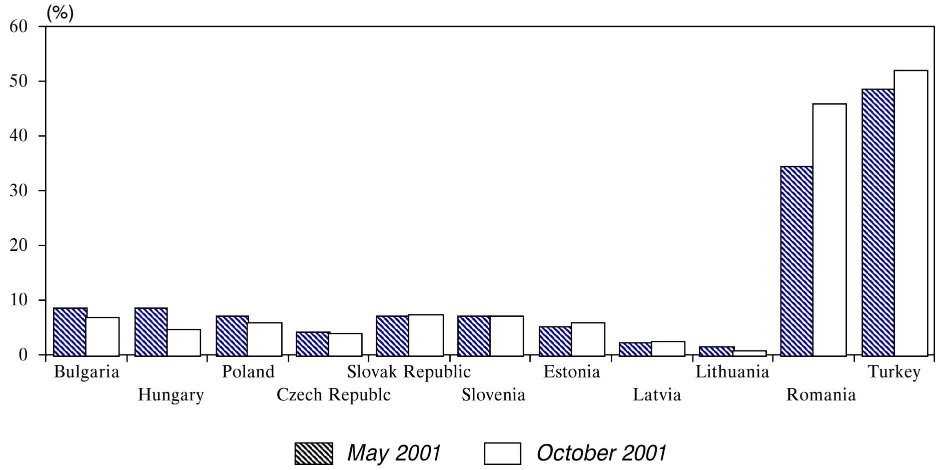
[3] *Monthly bulletin of the International Energy Agency (IEA).*

Expected Inflation Rate in the Industrialized Countries in 2001



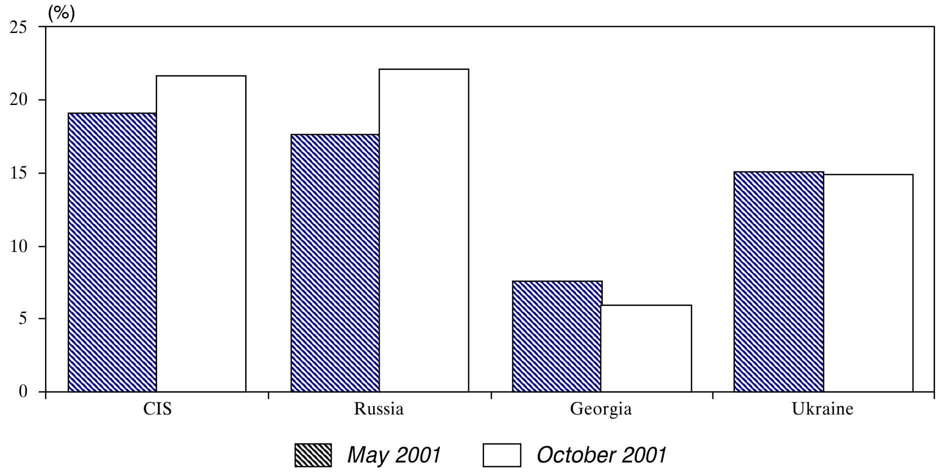
Source: IMF World Economic Outlook May 2001, October 2001

Expected Inflation Rate in 2001 in the EU Candidate Countries



Source: IMF World Economic Outlook May 2001, October 2001

Expected Inflation Rate in 2001 in CIS Countries

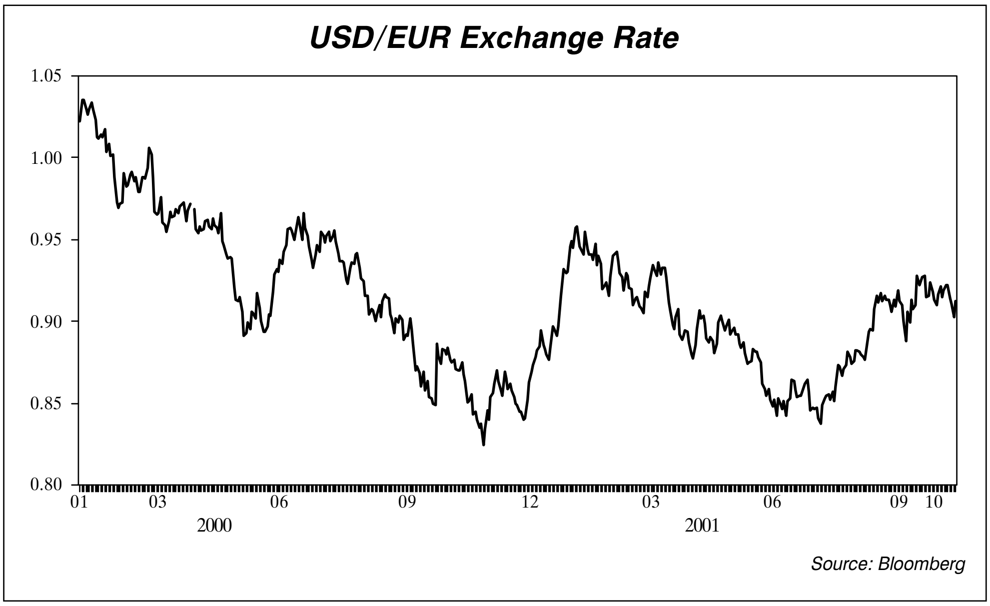


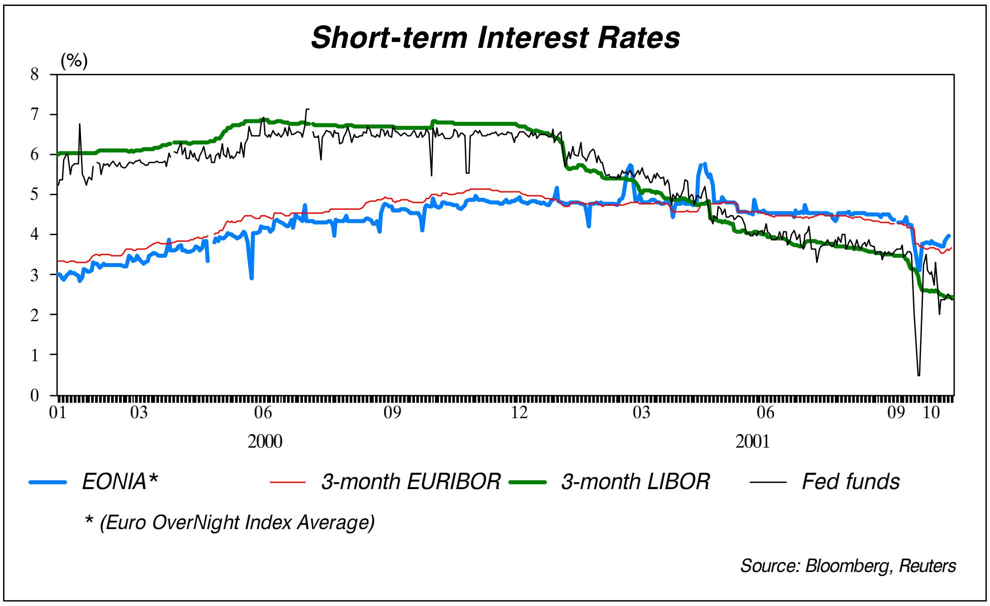
Source: IMF World Economic Outlook May 2001, October 2001

being more pronounced this year before some moderation in 2002. The expectations for lower inflation in Georgia and Ukraine during 2001, however, were strengthened in October as compared with earlier estimates.

While failing to pass the threshold of USD 0.96, the EUR had still climbed to a 6-month high in early 2001 but embarked on a subsequent downward trend. The US dollar's appreciation was largely underpinned by the aggressive policy of the Federal Reserve which has cut its key interest rates on nine occasions since the start of 2001 (by early October the target rate for overnight interbank loans has been trimmed to a level of 2.5%) in order to boost domestic activity and stave off recession in the country. The general expectations are that the interest rates in the US will be slashed further by 50 b. p. until the end of 2001.

Despite continuing evidence of rather slow growth in Germany, the European Central Bank (ECB) had long restrained





from cutting interest rates, focussing instead its attention to preserving price stability in the Euro area. Only in May, for the first time since the beginning of 2001, the Governing Council of the ECB took the decision to reduce its key rate to 4.50%. Although this led to the alignment of the interest levels in the Euro area and the US, the positive effect for the Single European Currency was rather modest as a result of the released concurrent data showing unfavourable growth trends in the largest EU economy, namely that of Germany. The intensified pressures on the ECB from leading economists, suggesting a further cut in interest rates, bore no fruits and the Euro continued to depreciate, easing to a fresh 8-month low in early July. The subsequent monthly figures of lower inflation in the Euro area strengthened, however, the expectations for an imminent reduction of the key rates and gave support to the single European currency. At the end of August the ECB trimmed for a second time this year the minimum bid rate in the main refinancing operations by 25 b. p. to 4.25%, thus reducing the differential vis-a-vis the US base interest level that was also slashed to 3.50%. On September 17, the ECB cut further its main interest rate by 50 b. p. to a level of 3.75% that remained unchanged through end-October. The latest reduction of the interest rates was aimed at strengthening both consumer and business confidence in the stability of the world economy.

EU Accession Negotiations

During the first nine months of 2001, the negotiations of Bulgaria's accession to the EU have proceeded according to the preliminary agreed timetable. Within this timeframe the accession talks are expected to be completed by the end of 2004, opening the way for Bulgaria's entry into the EU as a member state in the end of 2006. In May, the country submitted its Pre-accession Economic Programme which will be updated annually on the basis of the actual accomplishments in accordance with the EU recommendations.

Out of a total of 30 chapters that are subject to accession negotiations, for the period since last year to the end of September 2001 Bulgaria has provisionally closed 11 individual chapters[4] of the *acquis*, while 10 more chapters[5] have been opened. During the first seven months of 2001 the Bulgarian government submitted additional information on Chapter 3 „Freedom to provide services“, Chapter 6 „Competition policy“, Chapter 19 „Telecommunications and information technology“ and Chapter 28 „Financial control“. This will contribute to a more rapid completion of the negotiations under these chapters.

In terms of provisionally closed chapters, the leading performers are Hungary (with 22 individual chapters being closed), Slovenia (21 chapters), Slovakia (19 chapters), the Czech Republic (19 chapters), Estonia (19 chapters), Lithuania (18 chapters) and Poland (17 chapters). With respect to the number of chapters that have been opened, Bulgaria is currently rating close to Estonia, the Czech Republic and Slovakia. In the case of Bulgaria, there remain eight chapters to be opened, with the country having already communicated its position on three of them[6].

The agenda of the Bulgarian government for the time of the Belgian presidency of the EU, expiring at the end of 2001, includes the following main tasks: (1) opening of the accession negotiations on five more chapters[7] and (2) presenting at an intergovernmental conference the country’s position on three chapters, namely Chapter 14 „Energy“, Chapter 21 „Regional policy“ and Chapter 29 „Financial and budgetary provisions“. In view of accomplishing these tasks, there have to be no further delays in the process of aligning the national legislation with the *acquis*, especially in the negotiation areas where specific terms have been already mutually agreed.

On May 15, the State Fund for Agriculture gained the Commission’s accreditation as the SAPARD Agency. Thus, Bulgaria became the first candidate country to get the direct responsibility of managing financial resources from the EU Pre-accession funds on a decentralized basis, while being at the same time a non-member state which was a precedent in the 50-year history of the EU. Under the SAPARD programme, the EU annual commitment for Bulgaria is worth EUR 53.026 million till 2007. The initial measures within the framework of the programme are targeted at the enhanced development of the private sector in Bulgarian agriculture. They include investment in agricultural holdings, improving the processing and marketing of agricultural and fishery products, development and diversification of economic activities, provision for multiple activities and alternative income, as well as setting up producers groups. A 50% co-financing of the investment projects is being provided under the SAPARD programme, although, starting from next year, the producers of ecological products will have access to a 100% advance subsidy.

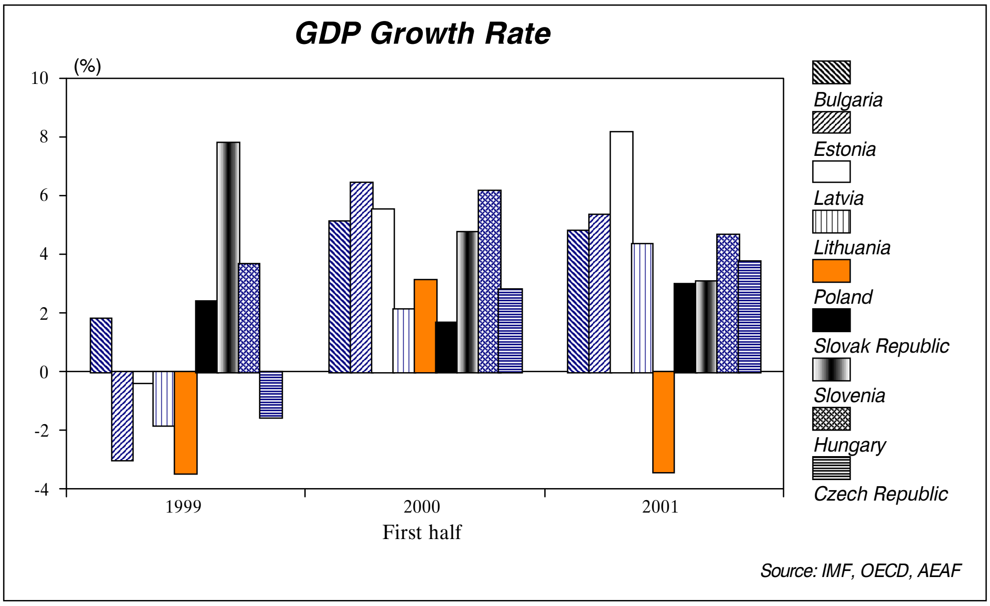
Twenty-eight of the investment projects submitted to the SAPARD agency have been already approved, with the majority of them being related to investment in agricultural holdings.

[4] *Chapters NN 4, 5, 8, 12, 16, 17, 18, 20, 23, 26 and 27.*
[5] *Chapters NN 1, 3, 6, 9, 10, 19, 22, 24, 25 and 28.*
[6] *Chapters NN 7, 15, and 11.*
[7] *Chapters NN 2, 13, 14, 21 and 29.*

The Country's Progress in Meeting EU Membership Economic Criteria

The successful completion of the EU accession negotiations has been already set as one of the main priorities of the new government of Bulgaria that was formed after the general elections of June 17, 2001. Therefore, the country's consistent policy towards the EU membership has been apparently reaffirmed. During the first half of 2001, Bulgaria has continued with its efforts to gradually meet the economic criteria for EU membership[8].

Bulgaria has recently recorded a higher *GDP growth rate* in comparison with most of the other candidate countries. In January-June 2001, Bulgaria's economy grew by 4.8% y-o-y, with the country ranking third after Latvia (8.19%) and Estonia (5.38%). In terms of economic growth rates, Bulgaria has outpaced Hungary (4.7%), Lithuania (4.38%), the Czech Republic (3.8%) and Slovenia (3.12%). Among the 10 candidate countries from Central and Eastern Europe, only Poland posted negative growth (-3.4%) during the period under review. In the first half of 2001, Turkey's economy also contracted by 5.9% on a year ago.

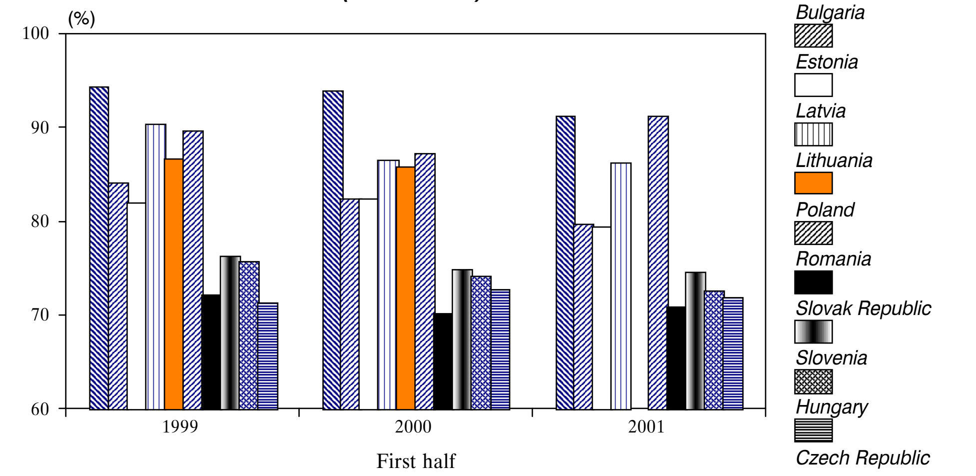


With respect to the *structure of GDP* by final consumption, Bulgaria has continued to rate rather unfavourably in comparison with the other accession countries. During the first half of 2001 Bulgaria remained the leader in terms of the share of final consumption in GDP (91.2%), whereas with regard to the relative weight of gross fixed capital formation (around 15% of GDP) the country ranked last but one. This points to the fact that Bulgaria is still trailing behind in terms of its capacity to ensure rapid restructuring and technological modernisation of the economy. Comparing the share of gross fixed capital formation in GDP, the country clearly lagged far behind the leaders among the EU candidates, such as Slovakia (30%), Slovenia and the Czech Republic (both around 25%). This, in turn, requires adequate economic policy measures in the face of the current unfavourable global conditions so that the long-term growth and competitiveness of the domestic economy could be ensured. In this context, the process of financial intermediation in the economy is gaining key importance and will conceivably entail measures to enhance the efficiency of the financial sector.

Bulgaria achieved considerable success in reducing *inflation* as well, with its final goal being the fulfilment of the Maastricht criterion. In the first half of 2001, the efforts to get the country closer to meeting this criterion yielded the same results as in the case of Slovakia (10.67%) and Hungary (10.45%). Inflation in

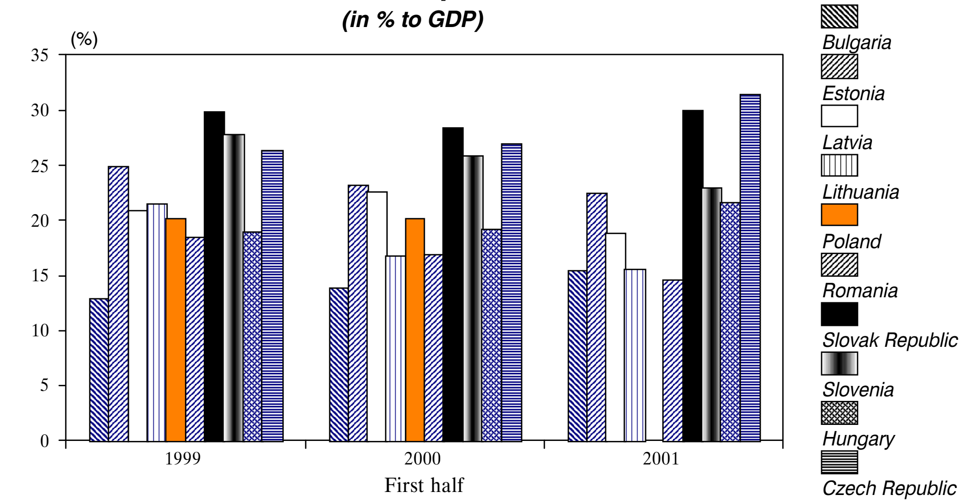
[8] *The next several paragraphs present a comparative analysis of the candidate countries with respect to some of the most important economic indicators for which there are available comparable data.*

Final Consumption
(in % to GDP)



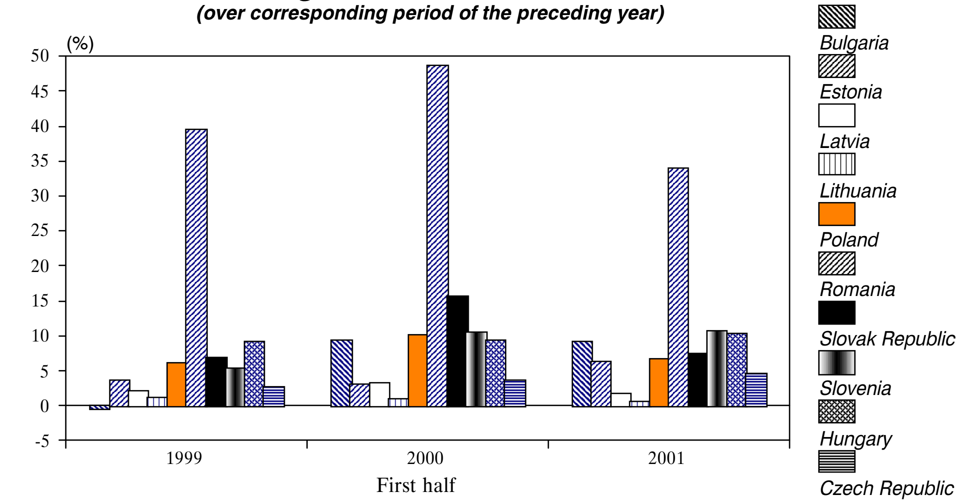
Source: IMF, OECD, AEAF

Gross Fixed Capital Formation
(in % to GDP)



Source: IMF, OECD, AEAF

Change in Consumer Prices
(over corresponding period of the preceding year)

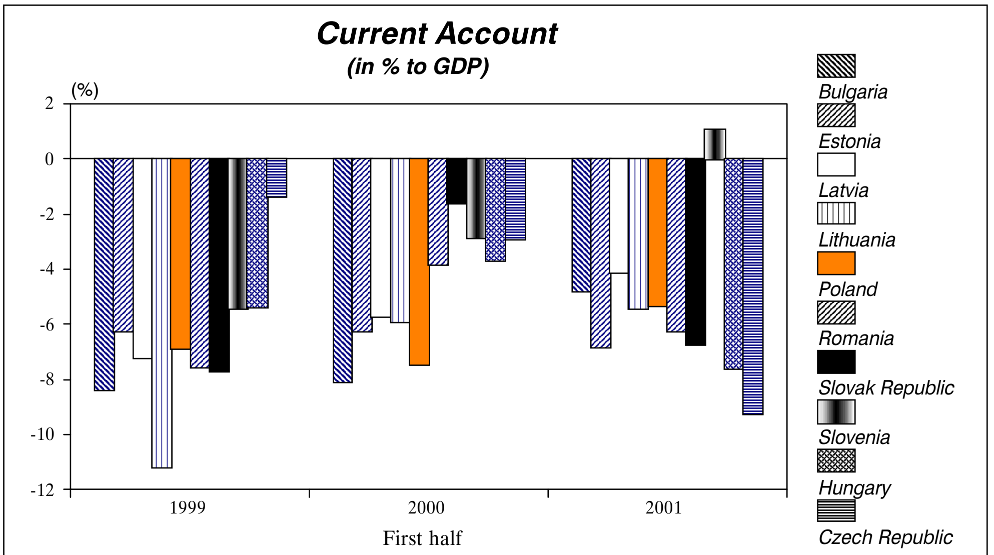


Source: IMF, OECD, AEAF

Bulgaria, Lithuania and Latvia decreased rather modestly during January-June 2001 on a year earlier, while the decline was more pronounced in Slovakia and Poland. In Slovenia, Hungary and the Czech Republic, however, the price levels rose in comparison with the first half of 2000. Yet, the candidate countries as a whole managed to broadly maintain price stability, although at this stage only Latvia and Lithuania could possibly attain the targeted rate of annual average inflation within the EU.

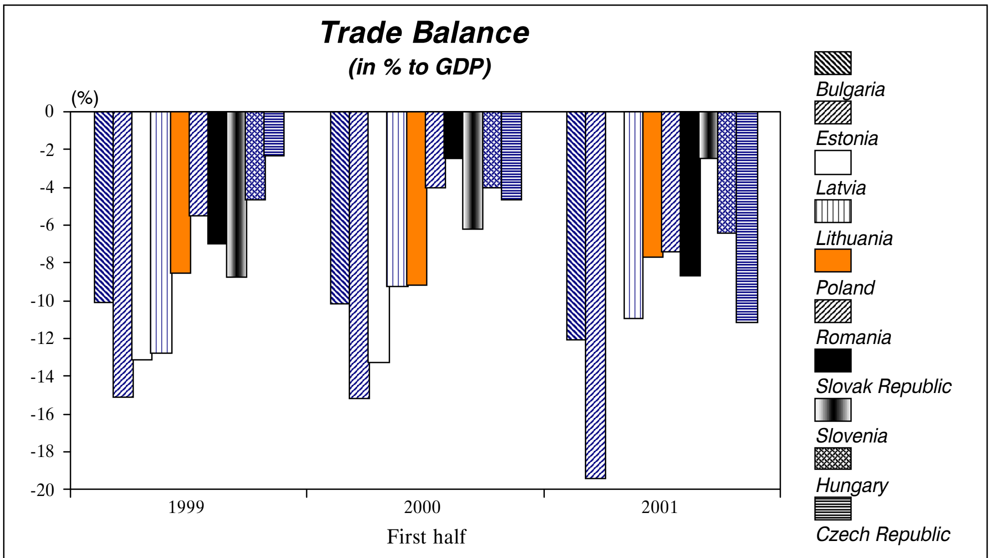
In the first half of 2001, Bulgaria ranked among the candidate countries with the lowest current account deficit/GDP ratio, recording a gap to the equivalent of 4.8% of overall output. This ratio was more favourable only in Slovenia (which posted a surplus of 1.1% of GDP) and Latvia (with a shortfall of 4.1% of GDP). In Estonia, Slovakia, Hungary and the Czech Republic (all of them functioning market economies according to the European Commission) the current account deficit rose as a proportion of GDP in comparison with the same period of last year. Continuing large or deteriorating trade deficits were the main cause for the current account gaps in the Central and East European countries.

In Bulgaria and Latvia, the increase of *the foreign trade deficit as a proportion of GDP* was rather moderate during the first half of 2001 over the same period of last year. However, this ratio grew at a rapid pace in Estonia as the trade shortfall reached 19.32% of GDP for the first half of 2001. Another country that has recently recorded quite a large deficit in outward trade was the Czech Republic (11.06% of GDP in the first half of 2001) which might appear rather surprising given the low level of the ratio in the first halves of 1999 and 2000.



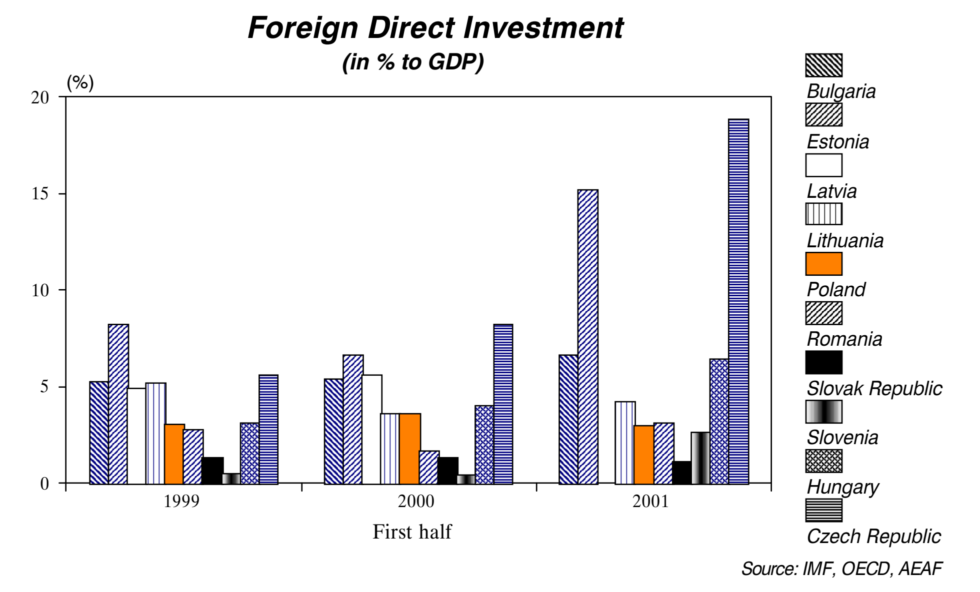
Source: IMF, OECD, AEAF

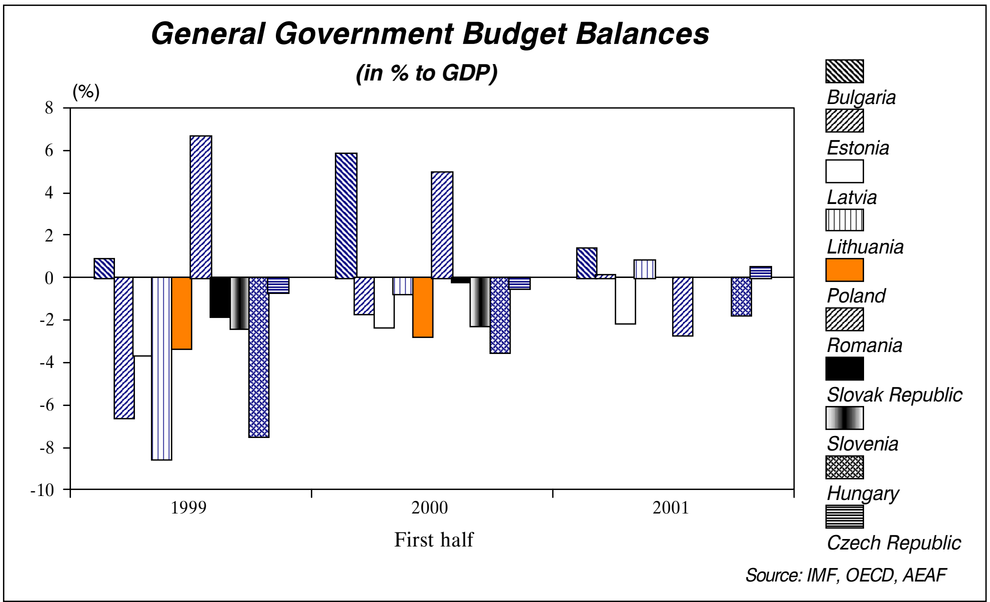
The external current account deficits have continued to be largely financed by private capital flows. The candidate countries with the highest *FDI/GDP ratio* during the first half of 2001 were the Czech Republic (18.85%) and Estonia (15.2%). For the rest of the accession countries (except Bulgaria where the FDI inflow rose to 6.66% of GDP in the first half of 2001) this indicator remained at relatively low levels, with Poland, Romania, Slovenia and Slovakia being at the rear of the ranking. Over the past three years, the FDI inflows in Bulgaria have been rising steadily, albeit at a much slower pace in comparison with the Czech Republic and Estonia. Yet, the fact that Bulgaria ranked third in terms of FDI growth during 2001 was a sign of predominantly positive assessments of the country's economic progress.

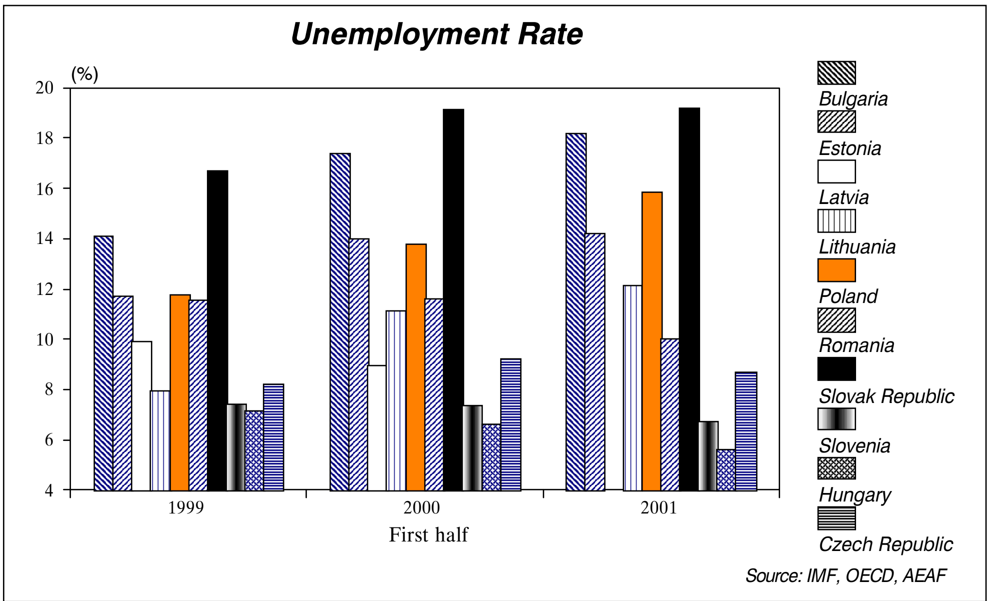


Source: IMF, OECD, AEAF

During the first half of 2001, most of the candidate countries have tightened their *fiscal policy* stance in a bid to curb the current account deficits. Some of the countries with relatively larger current account gaps, such as Estonia, Lithuania and Hungary undertook serious fiscal measures to redress the situation. Meanwhile,







the general government budgets of Lithuania, Estonia, the Czech Republic and Bulgaria recorded a surplus at the end of the first half of 2001.

The *unemployment rate* in the EU accession countries remained at rather high levels in 2001. Moreover, the first half of the current year witnessed a rising trend in registered unemployment as compared with the same period of 2000. With an average joblessness rate of 18.2% in the first half of 2001 Bulgaria was clearly among the countries that have been experiencing the most serious problems in this respect, the other two most notable examples being Slovakia (19.2%) and Poland (15.85%). Such higher levels of unemployment could be largely attributed to the ongoing structural reforms in the respective transition economies and to the rather undeveloped state of their infrastructure, although the pursued fiscal and social policies have also been in many instances inadequate.

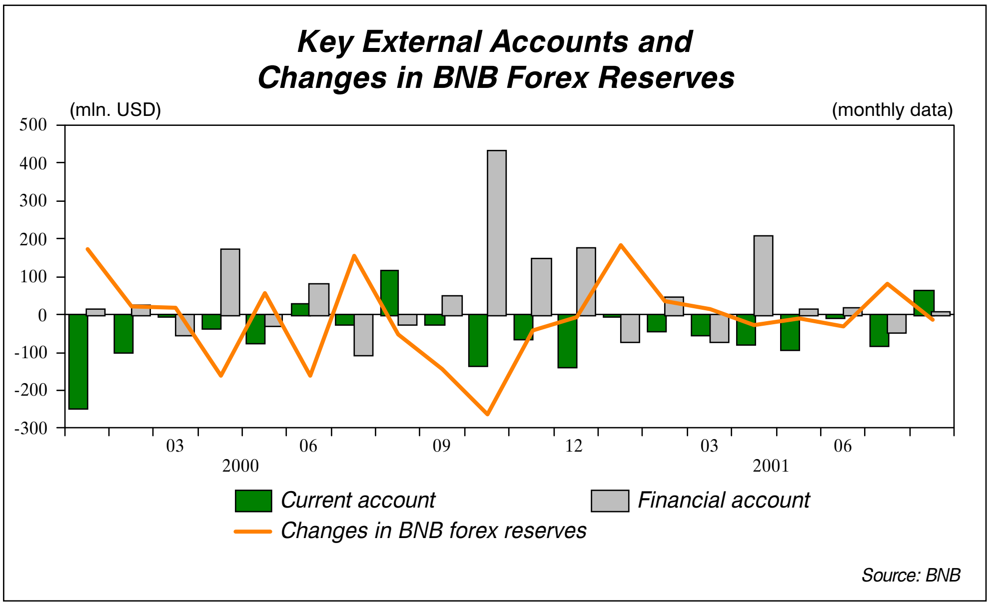
Among the Central and East European candidate countries Hungary, Slovenia and the Czech Republic have continued to enjoy relatively low levels of unemployment. The unemployment rates in these countries fell during the first half of 2001 on a year ago. Fairly low unemployment in these particular candidate states is generally attributable to significant FDI inflows that boost job creation, as well as relatively more efficient privatisation and restructuring of the state-owned enterprises. ❑

BALANCE OF PAYMENTS, FOREIGN TRADE AND EXTERNAL FINANCES

Balance of Payments

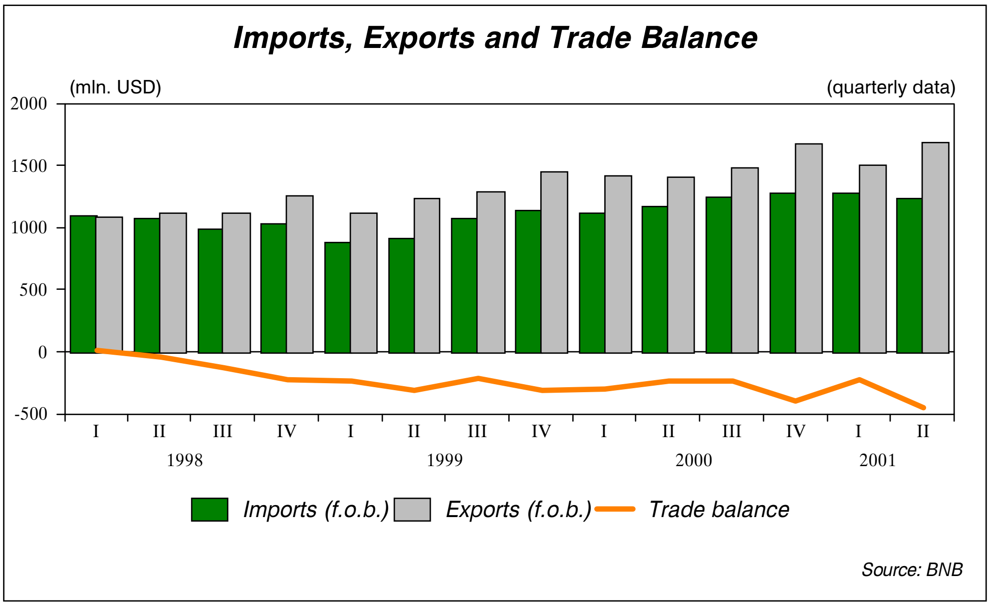
The Bulgarian balance of payments (BoP) deteriorated in the first eight months of 2001, thus adversely affecting the forex reserves stock. In light of the unfavourable developments in the world economy, especially during the third quarter, appropriate policy measures will be called for in the fourth quarter in order to put a check on the decline in central bank reserves. The exchange rates dynamics, most notably the appreciation of the dollar vis-a-vis the euro, also accounted for a substantial part of the loss of central bank reserves in the period, as a sizeable share of BNB assets are euro-denominated. This is an indication that the central bank has yet to build an adequate system for exchange rate and forex reserves management.

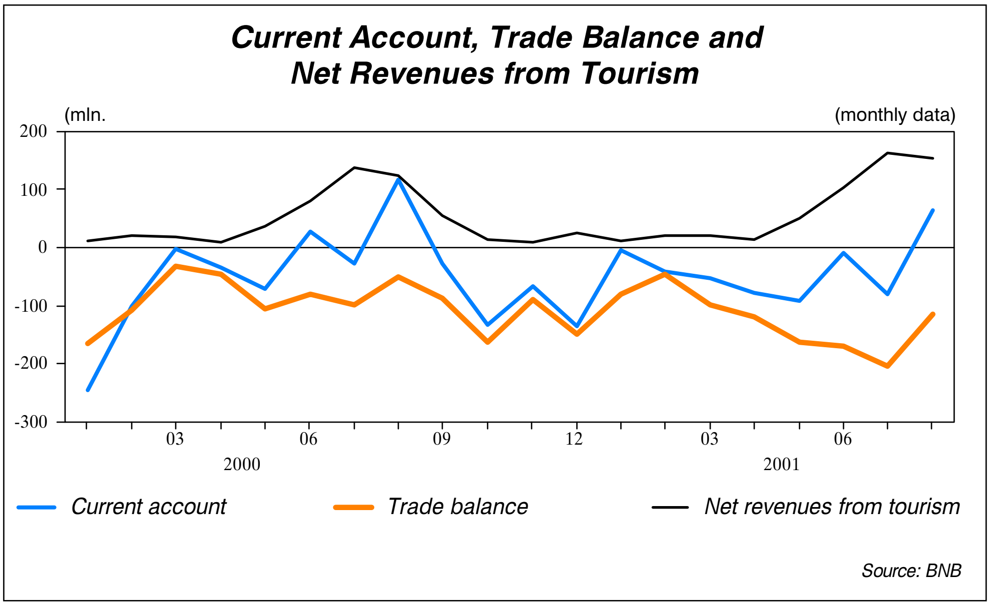
The *BNB forex reserves* shrank by USD 289.7 million in January-August 2001, as compared to a decline of USD 47.3 million in the first eight months of 2000. The contraction of reserves until August this year reaches USD 328.8 million once changes due to exchange rate fluctuations are included. It is noteworthy that last year the country received net BoP support financing of USD 67 million in the period considered, while this year external financing ran negative at USD -77 million. The latter points to the fact that meduim-term planning and securing of BoP support financing have been inefficient.



The adverse BoP developments stem primarily from the *current account* dynamics. The current account deficit reached USD 294.9 million in January-August 2001, an improvement of USD 42.5 million or 12.5% over the same period of 2000 (USD 337.4 million). No transactions were recorded in the *capital account* of the BoP. The positive *financial account* balance (USD 106.0 million) only partially covers the current account deficit. The financial account shows an improvement of USD 29.5 million or 38.5% over the first eight months of 2000.

A growing foreign trade deficit underlies the current account and overall balance problems. In January-August 2001 the *trade balance* was negative (USD -996 million), which constitutes a worsening of USD 313.5 million or 45.9% over the same period of 2000. The bulk of the trade deficit was formed in the second quarter of 2001, when it grew by twice the rates in the first quarter.





The *services balance in the current account* was positive (USD 646.6 million) in the first eight months of the year, some USD 200.2 million higher than the balance in the respective period of 2000. This was mainly due to the net inflow in the *Other Services* item, where the sale of the second GSM operator licence in January (USD 135 million) was recorded. If the receipts from this transaction were taken out[1], the services balance would have been only USD 65.2 million higher and the current account deficit would have reached USD 429.9 million.

Tourism stands out as an increasingly important source of current account inflows. In the eight months of 2001, net tourism revenues amounted to USD 535.3 million. This figure is USD 98.6 million or 22.5% higher than the same period of last year. In August alone, tourism revenues exceeded those in August 2000 by 24%.

Net current transfers increased by 60.3% over January-August 2000 to reach USD 314.2 million. This considerable increase was caused above all by grants received through EU pre-accession funds (PHARE, SAPARD, ISPA) totalling USD 123.6 million. EU financing through the pre-accession funds is expected to come to about USD 150 million.

The financial account dynamics in the first eight months of 2001 was determined primarily by *foreign direct investment* (FDI). The latter amounted to USD 331.6 million in the period January-August, i.e. some USD 128.2 million lower than the FDI inflow in the same period of 2000. FDI inflows went down as a result of reduced privatisation receipts as well as lower reinvested earnings and inflows of other FDI capital. The

[1] *The IMF methodology stipulates that such transactions should be recorded in the financial account of the balance of payments.*

countries with largest direct investments in Bulgaria are Austria, Italy and Germany. *Portfolio investment* ran negative at USD 173.5 million on a net basis in January-August 2001. This is explained by a combination of a liquidation of non-resident positions in Bulgarian securities to the amount of USD 46.9 million and Bulgarian portfolio investment abroad of USD 126.6 million.

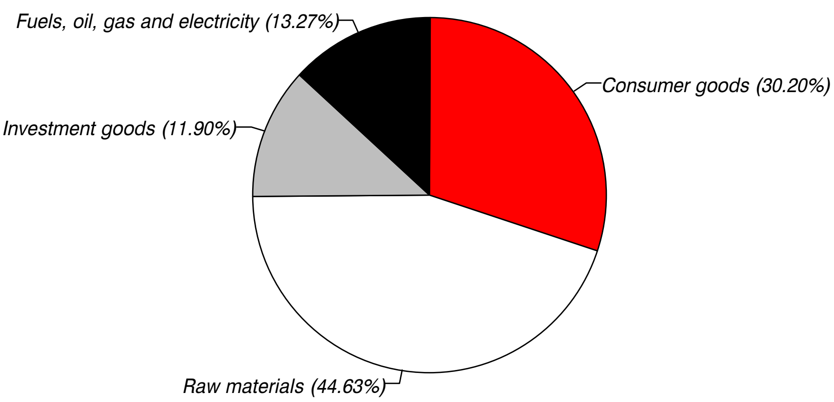
Foreign Trade

Export growth rates decelerated in January-August 2001 as compared to 2000. Exports stood at USD 3394 million in the first eight months of 2001, which constitutes an improvement of USD 272.8 million or 8.7% over January-August 2000. The rate of growth of exports in the first eight months of 2000 over the respective period of 1999 was 24.6%. Bulgarian export dynamics are predominantly determined by the lower growth rates in the country's main trading partner – the EU – which accounts for 55.3% of Bulgarian exports. The February financial crisis in Turkey also had an adverse impact on export performance. As a result of the crisis Turkey-bound exports went down by USD 38.8 million in January-August 2001, while in the same period of 2000 they increased by 72%.

If price effects are eliminated, export growth rates in January-August 2001 come to 12.1%, which is much closer to the 13.9% growth rate registered in the eight months of 2000. This means that Bulgaria is capable of maintaining fairly high growth rates in volume terms even in a worsened international business environment. The price change effects are manifested in a decline in petroleum product exports of USD 34 million in the period under consideration and the effect on petroleum product imports is a reduction of USD 40.8 million.

The share of raw materials in total exports remained rather high (41.3%) in the period January-August, as did the share of petroleum products (9.4%). The tendency to have higher variability in the prices of those commodities as compared to the prices of high-value-added goods to a large extent renders the country vulnerable to changes in global economic activity. Exports of iron, cast iron and steel have exhibited the greatest sensitivity to the downturn in the international business conditions, registering a drop of 13.6% in the period January-August 2001 in comparison to the respective period of 2000. This decline in value terms was precipitated for the most part by the falling international prices[2]. The physical volume decline is smaller, with the exception of flat-rolled (cold-rolled) steel products – 67.7%. Exports of non-ferrous metals are down by 3.2% or USD 10.6 million. In the raw materials category, exports of textile products exhibited the highest growth – USD 29.7 million

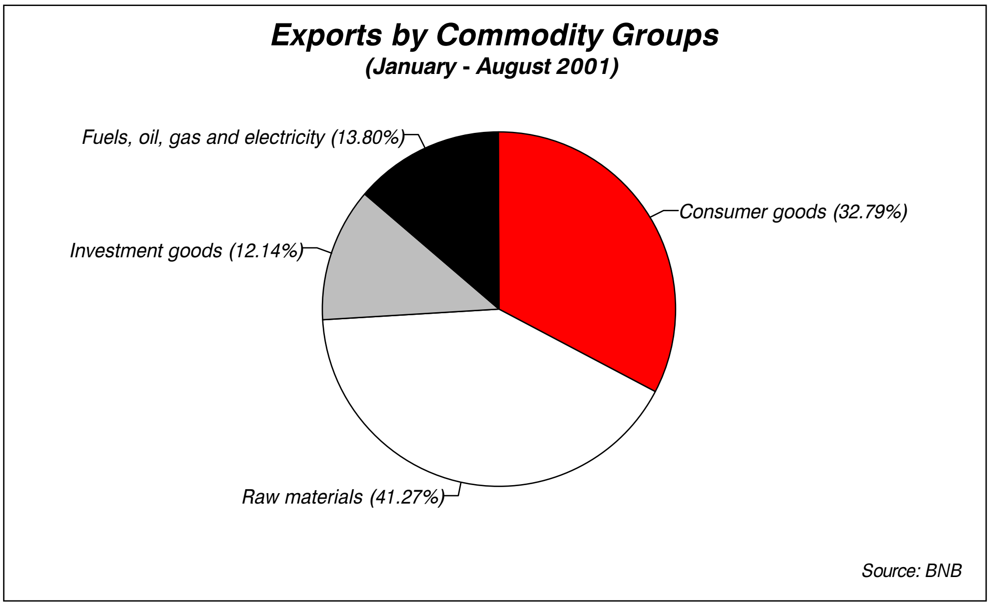
Exports by Commodity Groups
(January - August 2000)



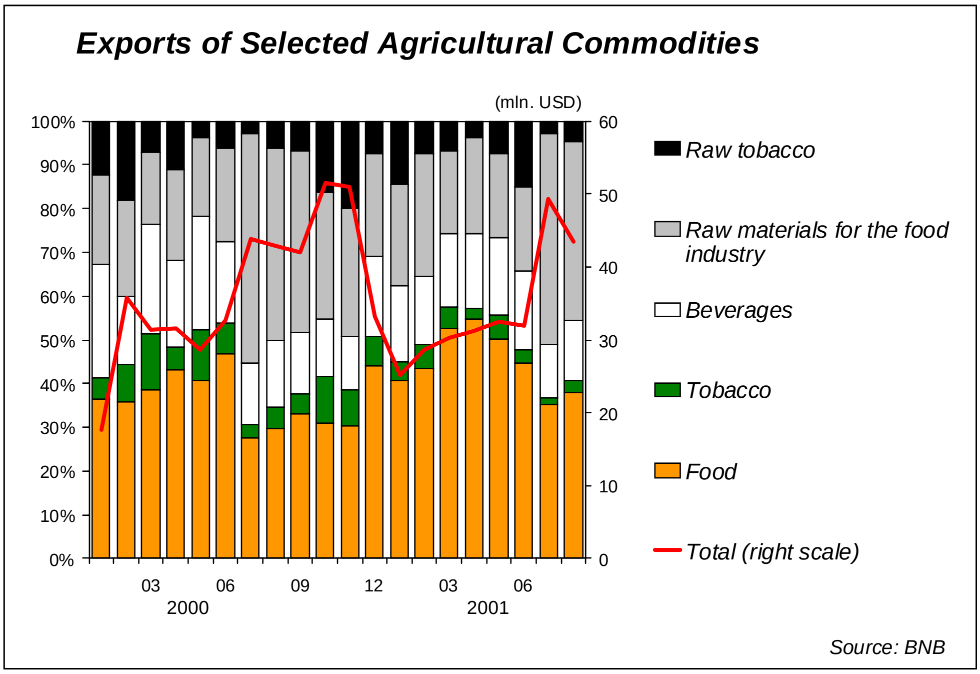
Source: BNB

[2] *The average price of the Bulgarian exports of hot-rolled steel in the period fell by 21.7% and that of cold-rolled steel – by 26.2%.*

or 32.9% in the first eight months of 2001. This was a result of the low labour costs in Bulgaria, as well as the investments made in the sector over the last few years, which have brought about an improvement in its competitiveness.

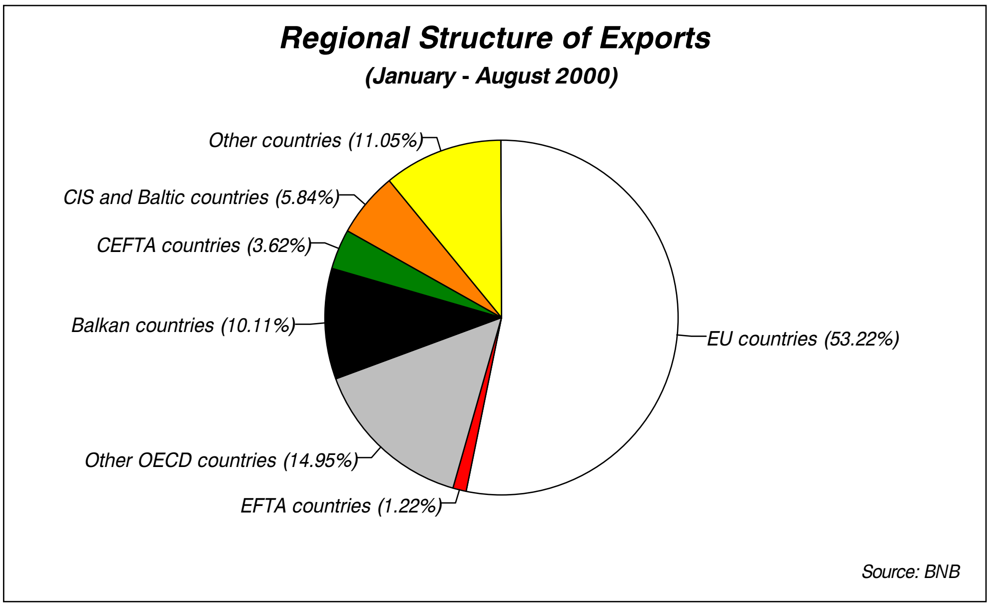


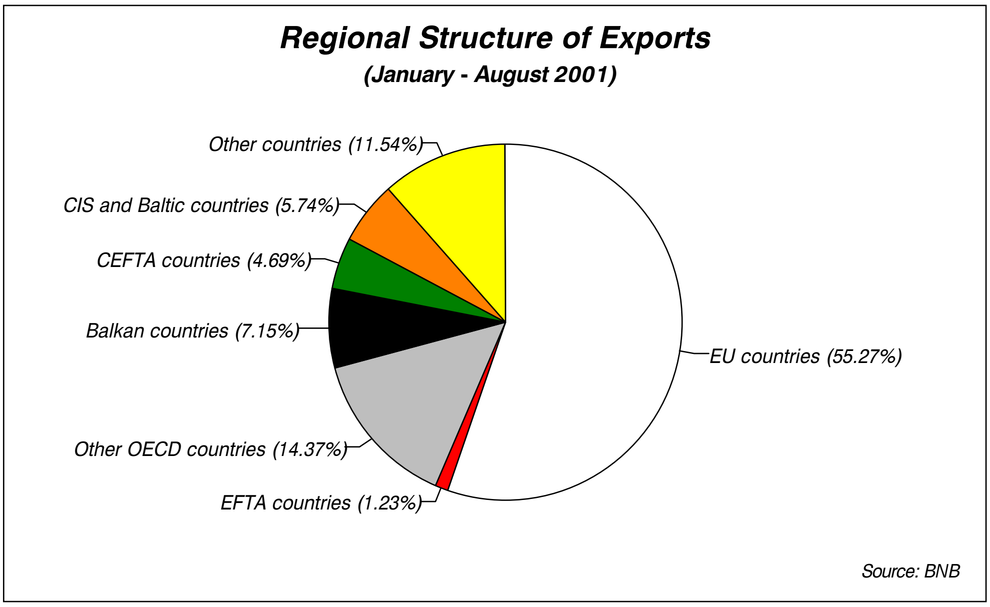
Exports of energy goods amounted to USD 468.5 million in the period January-August 2001, growing by USD 54.4 million or 13.1% year-on-year. This was entirely due to an increase in electricity exports of USD 74.3 million or 102.9%. The value of petroleum product exports shrank as a consequence of lower crude oil prices and there was an increase of 5.9% in volume terms.



Exports of apparel and footwear stood out as the most dynamic in the period January-August 2001. They expanded by USD 149.6 million or 28.4% on an annual basis. Such an outcome is a manifestation of the comparative advantage of the country, since labour inputs have a high share in the cost structure of the sector, while the price of labour in the country is low. Exports of plastics and rubber products also increased by USD 32.3 million or 21.2% in the period, as did exports of chemical products – by USD 10.2 million or 8.7%, with fertilisers only growing by USD 10.3 million or 18.8%. Fertiliser production is being restructured worldwide and production is being shifted from industrial countries to developing markets.

External demand for Bulgarian agricultural and food products marked an upturn in the first eight months of 2001 and their exports expanded by 3% on an annual basis. This put an end to the period of contraction of agricultural and food products exports that had set in for the past few years, but those exports have yet to catch up to reach their 1999 levels. Export growth for this group was driven chiefly by the expansion in food exports by 24.9%, which led to an increase in their share in total agricultural exports by 7 percentage points, and a rise in exports of raw materials for the food-processing industry by 5.8%. The low yields and, consequently, the 6% decline in tobacco production precipitated a drop in exports of tobacco and cigarettes of 6.5 and 48.9% respectively in the period under consideration.



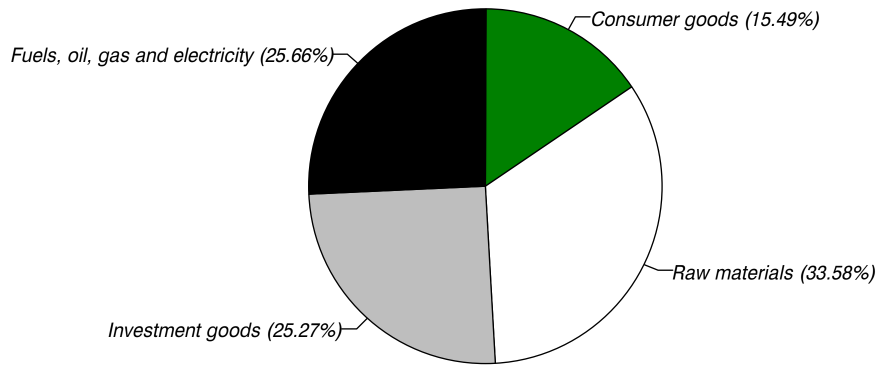


The geographic structure of exports in the first eight months of 2001 continued to exhibit an upward trend in the share of EU exports, in spite of the slack demand conditions resulting from the economic downturn in the EU. This is evidence in support of the claim that Bulgaria is deepening its economic integration with the EU in accordance with its overall economic policy objectives. The share of EU-bound exports in the period January-August 2001 reached 55.3%, up from 53.2% in the same period of 2000. This was a consequence of the higher EU-bound export growth rates in comparison with the overall export growth rate. There was a decline in exports going to Turkey and also to the other Balkan countries, which was mainly due to lower exports of mineral oils and products of their distillation to Yugoslavia – a drop of USD 87.1 million or 55.5%. Turning to CEFTA countries, there was a significant increase only of exports to Romania by USD 36.4 million or 81.3% year-on-year.

A serious slowdown in export growth is expected in the second half of 2001 as a result of the slackening economic activity worldwide, which will have an impact on almost all traditional markets for Bulgarian goods. The reduced external demand will mostly affect the all goods with high shares in overall exports: mineral products and fuels, metals, chemical and food products. Exports of apparel and footwear, machinery and electricity will probably continue to grow at relatively steady rates. Total exports in 2001 are expected to reach USD 5.1 billion.

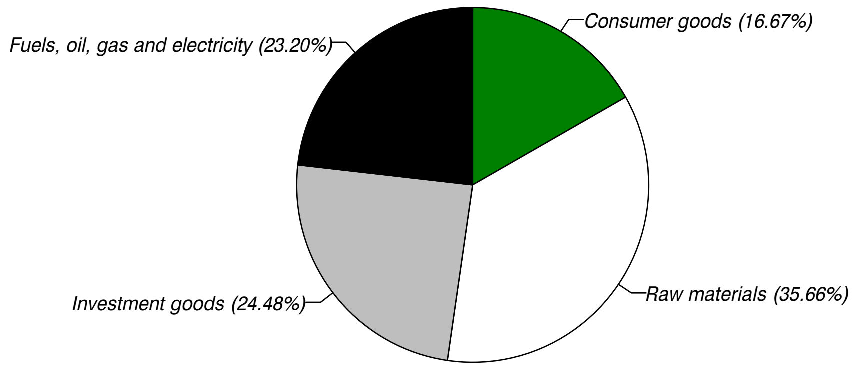
The large trade deficit in the first eight months of 2001 was mainly due to the high *import* growth. In the period in question, imports stood at USD 4 390.0 million and increased by USD 586.3 million or 15.4% over the respective period of 2000. Imports of raw materials registered the highest growth (USD 312.5 million or 22.6%). Within this group, textile imports – similar to exports – reported the highest increase – by USD 102.7 million or 26.7%. The share of consumer goods in overall imports ran at 16.7%, with an increase of 24.2% or USD 154.5 million against the first eight months of 2000. Imports of investment goods went up by 11.8%, the biggest contribution coming from increased imports of electrical machinery by USD 69.7 million and vehicles and transport equipment by USD 59.7 million. Notably, crude oil imports decreased as a result of both lower average import prices (7.3% down year-on-year) and of quantities contracting by 1.5%. On the other hand, natural gas prices increased by 16.1%, which inflated the import bill by USD 31 million, whereas the quantities imported remained close to last year's levels. Nitrogenous fertiliser producers who, in addition, faced unusually low world prices of their products most palpably felt the negative impact of this price change.

Imports by Commodity Groups
(January - August 2000)



Source: BNB

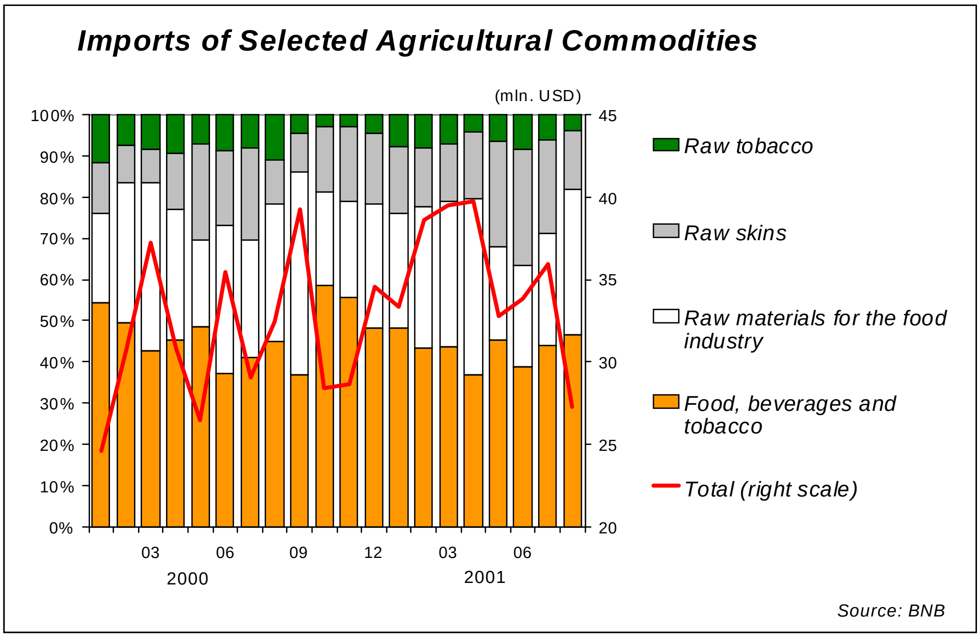
Imports by Commodity Groups
(January - August 2001)

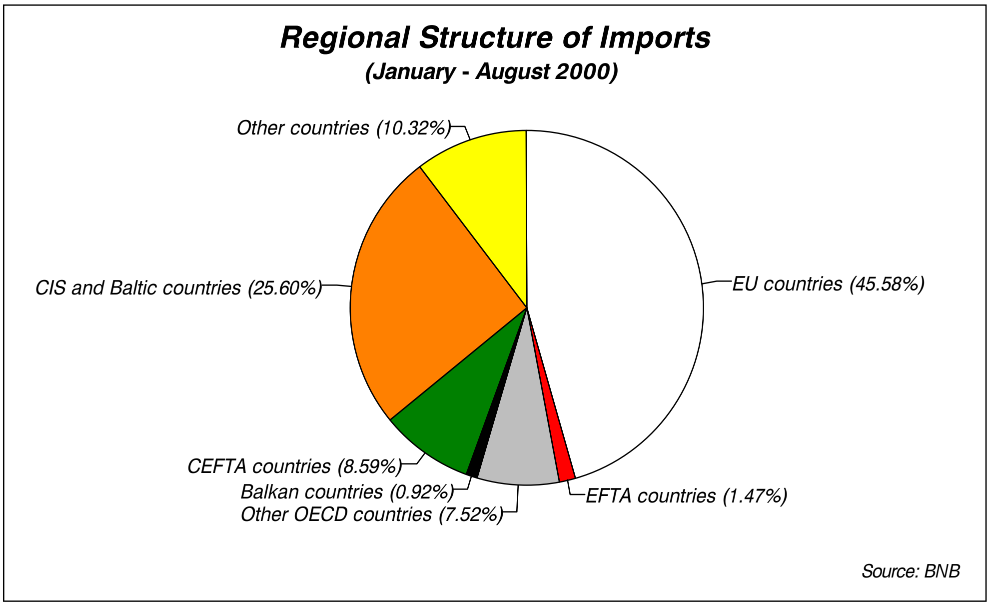


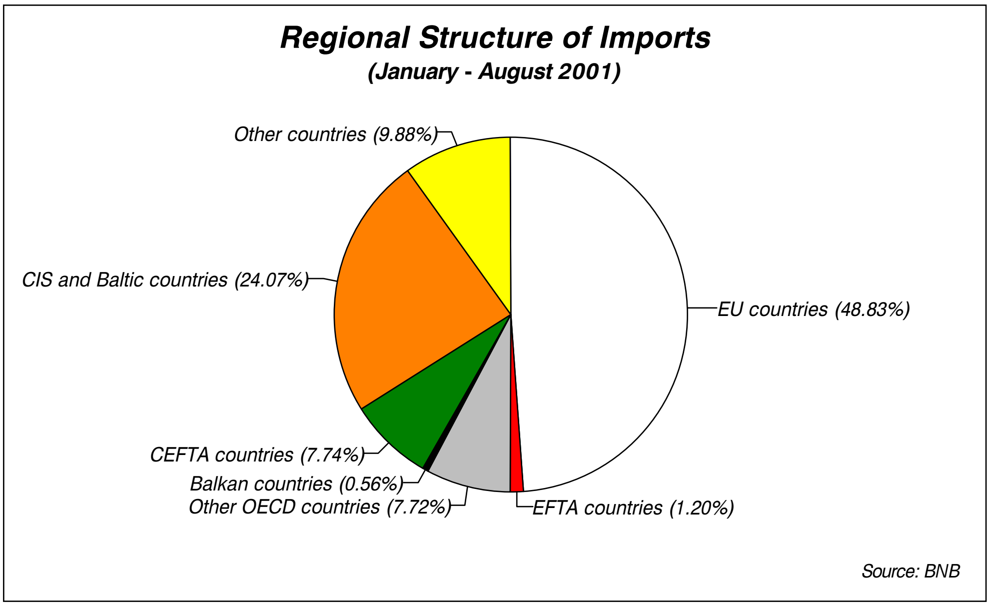
Source: BNB

Agricultural products imports were up by 14% in the period. Imports of almost all items in this category increased. Raw hides imports delivered the largest contribution with a growth rate of 47.5%. Only raw tobacco imports recorded a decline.

The geographic structure of imports, similarly to that of exports, confirms the strengthening of the economic ties between the Bulgarian and EU economies. Imports originating from the EU were up by USD 444.5 million in the period considered. This implies a growth rate of 23.6%, i.e. much higher than the overall import growth







rate. Such a steady trend was in part determined by the appreciation of the real exchange rate of the BGN against the EU currencies, which in turn brought about an increase in the share of settlement in eurocurrencies to 53.7% of all imports.

Imports originating from the CIS and the Baltic countries increased by 8.5% or USD 90.1 million in the period and the growth of imports from Ukraine only came to USD 34.5 million or 31.3%, while imports from Russia grew by 5.8% or USD 54.0 million. At the same time imports from USA were upped by 21.8% or USD 25.2 million, imports from Turkey expanded by 14.7% or USD 20.2 million and imports from CEFTA countries – by 4.1% or USD 14.5 million. Imports from the Balkan countries were down by 30.0% or USD 11.4 million as a consequence chiefly of lower imports from Yugoslavia and Macedonia.

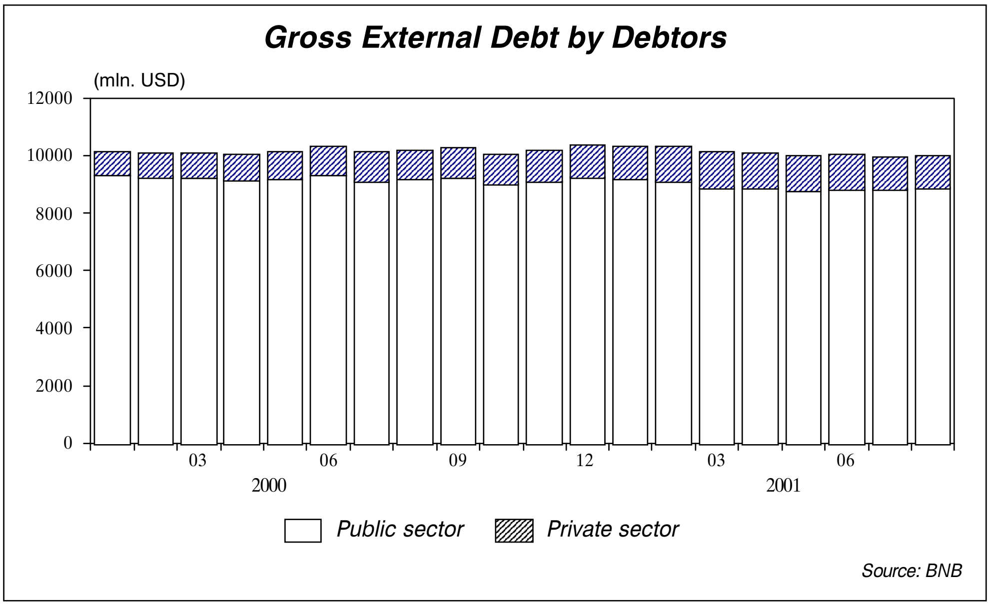
The tendency of outstripping growth rates of imports as compared to exports is expected to taper off by the end of

2001. This should come about as a result of both a decelerated growth rate of external demand for Bulgarian exports, which will put a cap on the growth of imports of raw materials and investment goods, and of restrictive fiscal and income policies, which should curb the growth of consumer goods imports in the fourth quarter of 2001. Nonetheless, the difference between the growth rates of imports and exports formed in the first eight months of the year will not be fully eliminated and total imports in the year will probably exceed USD 6.5 billion.

External Debt

As of August 2001, gross external debt[3] stood at USD 10 003.7 million, which was 1.9% lower than the stock of August last year. This, in conjunction with the expected real GDP growth, led to a lower debt/GDP ratio of 77% in August 2001 as compared to 86.4% in August 2000. The downward trend in the ratio should be preserved over the medium term to make it possible for Bulgaria to fulfil the Maastricht criterion for this indicator, viz. government debt/GDP ratio of 60%, including both domestic and external debt.

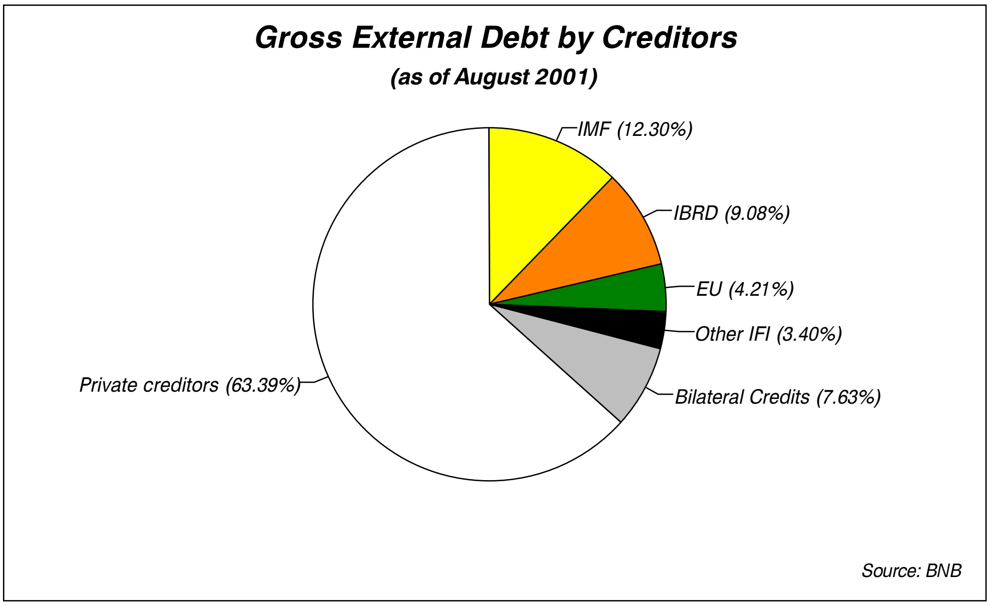
Bulgaria received new credits and deposits to the amount of USD 566.3 million in the period January-August 2001. Out of them, some USD 254.1 million were directed to the public sector. Over the same period, the public sector made amortisation and interest payments worth USD 895.9 million against USD 223.4 million made by the private sector.



The structure of external debt by creditors as of August 2001 shows a slight reduction in the share of loans from official creditors: down by 1 percentage point on August 2000. This was due to substantial payments on loans from the Paris Club of Creditors. Debt to private creditors was practically unchanged but, since debt to official creditors decreased, the share of the former in total gross external debt went up by 1 percentage point over August 2000, reaching 63.4%. The maturity structure of the debt also improved over the one-year period starting August 2000, as the share of short-term debt in total debt declined from 6.2 to 5.3%.

In July 2001 the first amortisation payment on the Bulgarian Brady bonds was made: USD 16.1 million were paid on Interest Arrears Bonds (IAB). The principal repayments on front-loaded interest reduction bonds (FLIRB) are scheduled to start next year. The LIBOR, which is the benchmark for calculating the interest coupons on the Bulgarian Brady bonds, was reduced by 1.6 percentage points in the end of July as

[3] *According to BNB data.*



compared to end-January 2001. This constitutes a significant relief of the interest burden on the Brady bonds in 2002, as interest payments are determined by the LIBOR at the time of the preceding interest payment.

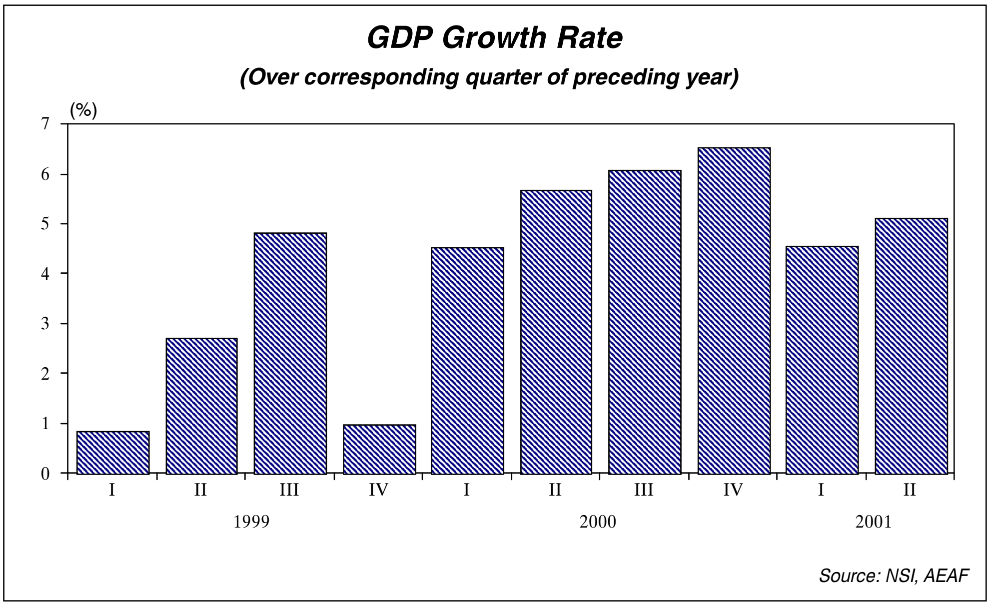
According to data provided by the Ministry of Finance, the currency structure of the external public debt remained practically unchanged throughout the period August 2000-August 2001. Taking into account the currency structure of the foreign reserves and the foreign trade, which are dominated by the euro, it would be advisable to consider optimising the currency structure of the debt. ❑

REAL SECTOR

Economic Growth

In 2001 the Bulgarian economy remained on the path of expansion. A real year-on-year GDP growth of 4.8% was registered in the January-June period. Despite the recession in the world economy, external demand for Bulgarian goods and services remained an important growth generator. The real-term 12-month increase (15.5%) of the goods and services exports in the first half of 2001 retained its double digit values from previous periods. It exceeded the 11.9% real imports growth in the period under consideration by 3.6 percentage points. However, taking into account the balance of payments (BoP) developments in 2001, it is hard to accept the data on real-term net exports of goods and services as absolutely trustworthy.

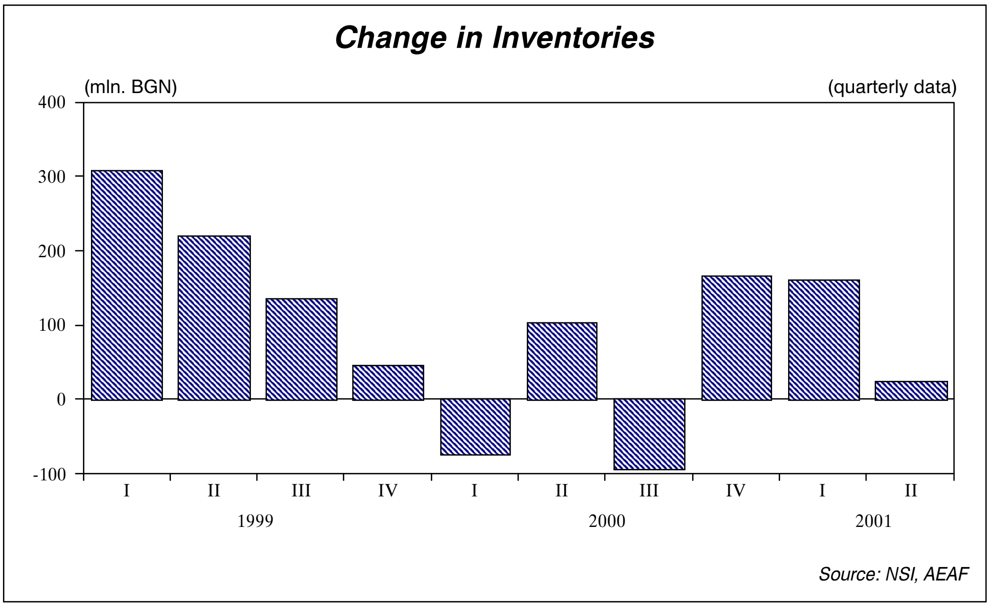
The first half of 2001 sustained the trend of the preceding three years of the real-term growth rates of fixed capital formation outstripping those of the other components of domestic demand. Thereby, the prerequisites for technological modernisation of the Bulgarian economy and sustained economic growth are being created.

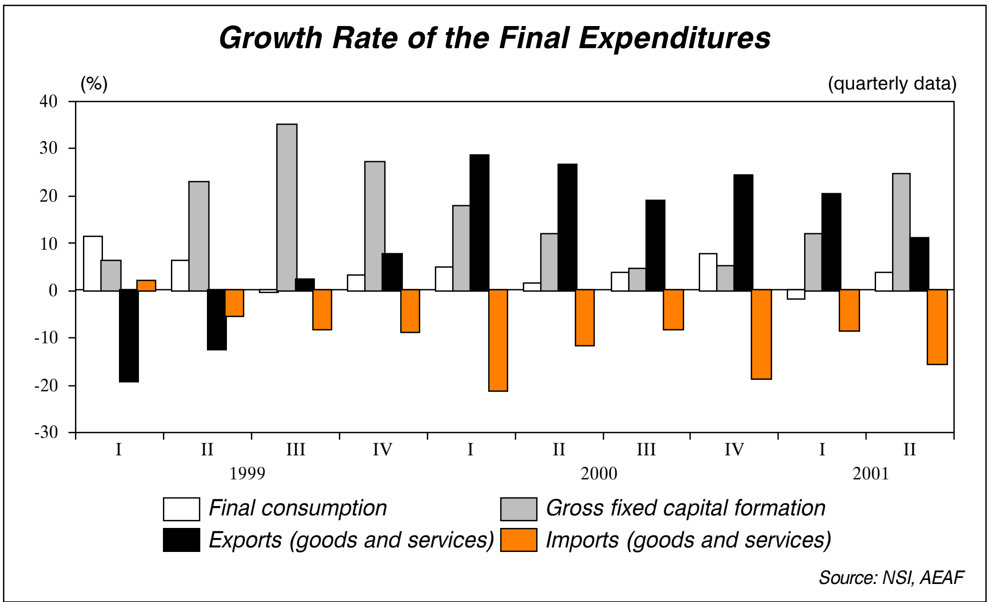


In the first six months of 2001, gross fixed capital formation reported 20.0% real term growth on a year earlier. On this basis, the optimisation of the GDP structure of the country continued in accordance with the tendencies in the rest of the former centrally planned economies. The relative share of investment in the first half of 2001 expanded to 15.4% mainly at the expense of the contracting share of consumption.

The first six months of 2001 witnessed an upward trend in finished goods inventories of enterprises, which is another sign of a possible slowdown of Bulgarian economic growth in the second half of the year. For three quarters in a row finished goods inventories in the Bulgarian economy have been growing. This fact, bearing in mind the recession in the world economy, cannot be fully attributed to the entrepreneurs' expectations for a significant future price rise of the factors of production.

According to the NSI National Accounts, in the first six months of 2001 final consumer spending of households accounted for 71.8% of GDP by components of final use, increasing in real terms by mere 0.4% relative to the same period of the preceding year. On a year earlier, final consumption in the economy stepped up by only 1.2% over the same period, regardless of the 30% real growth of expenditures of non-profit institutions





serving households. Government purchases were down by 3.3% in real terms in the period under consideration.

According to the NSI National Accounts, household consumption of communication services in Bulgaria registered the most dynamic real increase (16.5%) in the first half of 2001 compared to the corresponding period of 2000. At the same time, household consumption of other goods and services increased in real terms as follows: non-food items (11%), public catering (6.7%), tourist services (2.8%), electricity (1.7%) and food (1.5%). There was a real-term decrease in district heating consumption (by 29%), water consumption (by 7.1%) and consumption of transport services (by 13.6%). In kind consumption also declined by 20.5% over the first six months of the previous year. These data are in support of the conclusion on the slow improvement of the living standards of the population and the expansion of free market relations at the expense of self-sufficiency.

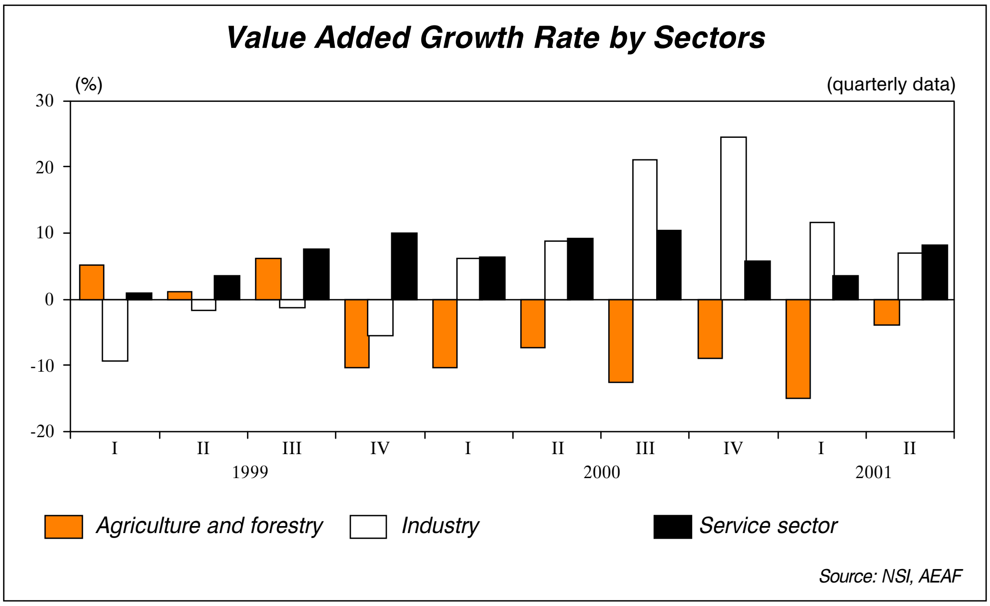
Household consumer spending dynamics in the first half of 2001 led to some changes in their structure. According to National Accounts data, the share of consumer spending on food and beverages dropped by 0.8 percentage points compared to the first half of 2000, still accounting for the largest share of 29.7% of total consumption[1]. The relative share of transport expenditures also shrank against the first half of the previous year (by 1 percentage point to 8.5% of the household money expenditures). The relative shares of non-foods and communication services stepped up by 1.8 percentage points to 27.6% and by 0.6 percentage points to 6% of money expenditures respectively.

[1] *Imputed rent, consumption through enterprises and institutions and in kind consumption excluded.*

Data from the NSI household budget surveys are in contrast with the upward real term trend of consumer spending. They pointed to a 1.3% real term year-on-year decrease of consumer spending in the first six months of 2001[2]. The comparative analysis of household consumer spending data from both data sources once again upholds the assertion that the sample of the household budget survey is not representative and is distorted towards the lower-income households. According to the household budget survey, real expenditures on the following items reported a significant reduction: healthcare, housing (rents, house maintenance and repair), water, electricity and other fuels, clothing and footwear. Consumer spending on communication services, food and non-alcoholic beverages, furniture, household electric appliances and accessories registered a real-term growth on a year earlier.

Food expenditures accounted for the largest relative share (39.6%) of total expenditures, stepping up by 2 percentage points against the first six months of 2000. Housing, water, electricity and fuels (13.4% of total expenditures) came next in importance. Their share dropped by 1 percentage point relative to the previous year. According to that survey, the other expenditures of greater significance for households were transport and healthcare, with respective shares increasing to 5.8% and 4.6%.

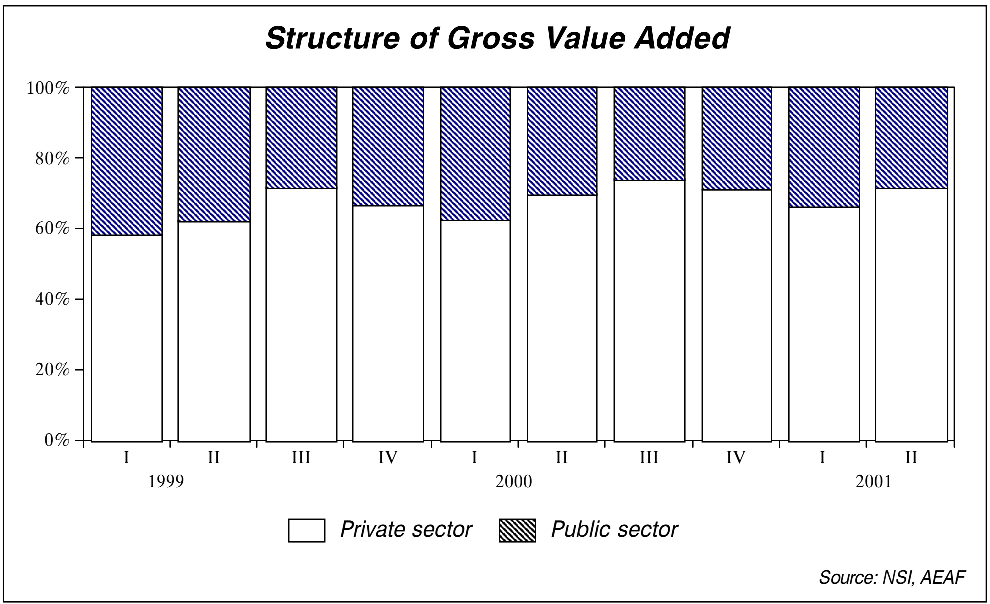
In the first half of 2001, industry (9.2%) and services (6%) were the sectors, which contributed most to economic growth. Key growth-boosting factors were the higher efficiency and labour productivity in the privatised and restructured companies and the higher external demand. In the first quarter, revenues from industrial export sales stepped up by 8.4% relative to the same period of 2000 and exports of goods in dollar terms – by 15%. In the subsequent months, however, industrial export sales registered a significant decrease. In January-August 2001, export sales revenues grew by only 1.7% on a year earlier due mainly to the deterioration of the international business environment. In industry, the processing sector had the biggest contribution to the real year-on-year growth of gross value added (GVA) in the first half of 2001 as a result of the considerable export volumes in the first quarter.



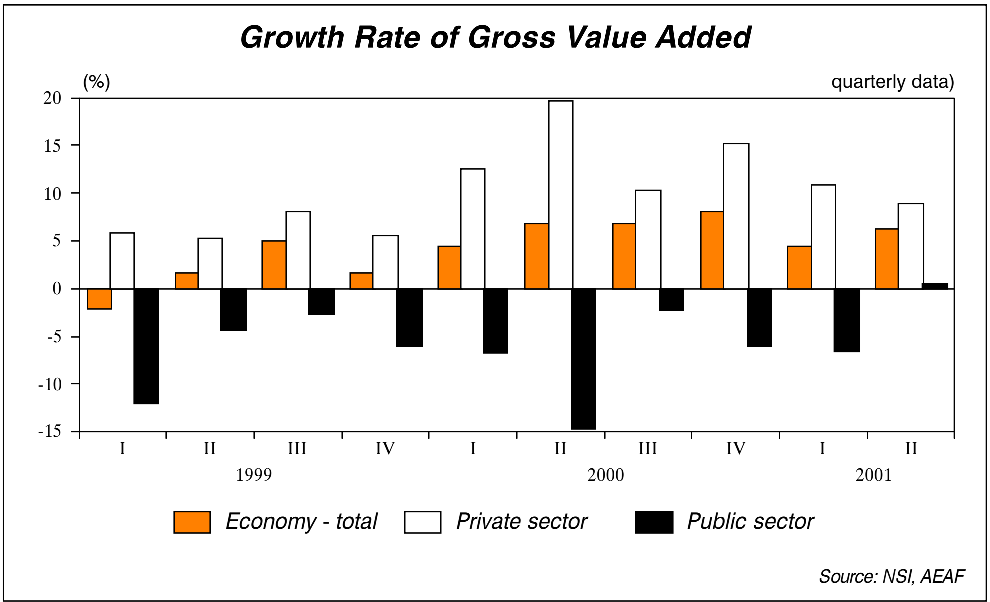
The „Agriculture and Forestry" sector registered a real-term decrease of 8.1% in the six months of 2001 relative to the same period of the previous year. It is the seventh consecutive quarter of negative growth in the sector. There was a certain slowdown of the decline rates in the sector in the second quarter of 2001 (it subsided by only 3.7% against April-June 2000) after the sector's value added having fallen by over 10%

[2] *The household budget survey is conducted every month on the basis of a sample of 6000 households.*

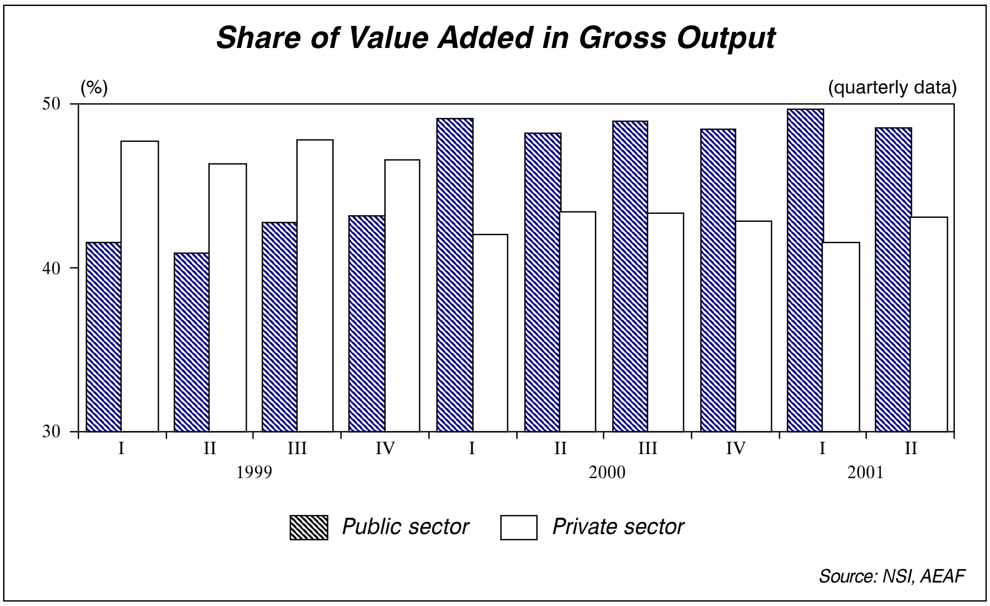
in 2000 and by 14.8% in the beginning of 2001. The causes lying behind the poor results are complex and interrelated. Most importantly, no explicit ownership rights have been established due to the inconsistent stop-and-go land reform, thereby creating impediments to the development and implementation of long-term strategies of the producers. As a result, investment in the sector is limited, agriculture lags behind in its technological renovation while agricultural output becomes more vulnerable to climatic conditions, accompanied with higher current production costs, all resulting in a more expensive produce of the same or even lower quality. The unfavourable atmospheric conditions had an additional negative impact on the sector in the last two years.



The National Accounts data reported that in the first half of 2001 the privatisation and restructuring process of the public sector continued, though at a decelerated pace, leading to a contraction of the relative share of the public sector in gross value added and gross output (GO). The former declined by 2.7 percentage points to 30.8% and the latter by 3.0 percentage points to 27.8%. This is indicative of the higher efficiency in this sector measured by the relative share of the public sector value added in its GO, which stepped up by 0.4 percentage points to 49.1%.



In the analysed period, the gross value added, created by the private sector registered a real-term growth of 9.8% on a year earlier. At the same time its efficiency, measured by the relative share of the value added in the sector's gross output, sustained its downward tend. In the first half of 2001 over the same period of 2000, this indicator's value decreased by 0.4 percentage points to 42.4%. Since the second quarter of 2000 the



efficiency of the private sector has been invariably lower than that of the public sector. This comes to show that through the large-scale privatisation in 1999 the state has disposed of a number of activities, creating low value added. In the medium term, it is expected that the improvement of corporate management and the optimisation of the production process in the private sector will result in higher efficiency and the GVA/GO ratio will surpass the value of the indicator in the public sector. An essential factor to this end will be the expected improvement of efficiency in the manufacturing sector – the bulk of which was recently transferred into private hands – as it is still characterised by low values of the GVA/GO ratio.

In January-August 2001, industrial sales rose by 3.6% in real terms, with export and domestic sales growing by 1.7% and 4.3% respectively. Since the beginning of the second quarter, the share of the domestic market of industrial output has been increasing, notwithstanding the fact that in May and July over a half of the exporting sectors reported growing export sales. The latter gives a warning that in the second half of the year the recession of the world economy would exercise a more retaining effect on Bulgarian economic growth.

The Bulgarian economy will sustain its growth in the remaining months of 2001, in spite of the unfavourable international business environment, additionally aggravated by the 11 September events in USA. The year-on-year GDP growth in 2001 is expected to reach about 4.5%. This forecast is by 0.5 percentage points lower than the GDP growth projected in the beginning of the year (5%). It reflects both the downward trend of external demand and the unfavourable international business conditions in the first nine months of the year as well as the direct impact of 11 September events in USA.

Employment, Unemployment, Wages

In the beginning of 2001, the NSI introduced some modifications in the Labour Force Survey (LFS) methodology. As a result, the *employment* dynamics in 2001 could not be compared to that in previous years. Following the changes of the LFS methodology, the number of unemployed sharply increased and that of employed in the economy decreased. The NSI has not yet disseminated any official explanation of the differences in the data, which practically break the dynamic series for both indicators. The Agency upholds the view that the difference to a great extent stems from the change of the nests for conduction of the survey. It is highly probable that some of the people who were long-term unemployed in the past two years, may have not been registered as unemployed before the 2001 survey. On this basis, the average number of employed in the first half of 2001 amounted to only 2 696 400 people[3], stepping down by 106 600 or 4% on a year earlier.

According to LFS data, however, the number of employed in the economy increased in 2001. In the first half of 2001, public sector employees increased by 1.5%, and private sector ones by over 8%. The upward trend in employment, particularly in the private sector, was due mainly to higher economic activity of private enterprises and, to a lesser degree, to seasonal factors. The employment dynamics as per the NSI wages and employment survey[4], also supports the above conclusion. According to the survey data, private sector employment went on the increase in 73% of the branches. The highest growth of the indicator was registered in the service sector[5]: „Hotels and restaurants“ (56.2%), „Healthcare, social work, veterinary activities“ (44.6%), „Agriculture, game-preserve and forestry, fisheries“ (32.1%), „Real estate, renting and business activities“ (17.8%), „Construction“ (10.3%). The following sectors have registered a decrease in employment: „Education“ (by 4.9%), „Pulp and paper industry, publishing and printing“ (by 5.8%), etc. Public sector employment contracted in 85% of the sectors, and more specifically in „Manufacture of rubber and plastic products“ (37.5%), „Other community, social and personal service activities“ (33.3%), „Manufacture of foods, beverages and tobacco“ (18.7%). Public sector employment stepped up in: „Real estate, renting and business activities“ (8.3%), „Manufacture of other non-metallic mineral products“ (6.4%) and „Hotels and restaurants“ (5.8%).

No serious changes in the employment dynamics are expected by the end of 2001 and the number of employed in end-2001 will be approximately 2 890 000 people. The first stage of the new government programme for restructuring of the state administration – implemented in the beginning of October 2001 – is not likely to bring about any considerable employment contraction in the country. As a direct result, employment in the public sector will probably be reduced by approximately 2.5%, and the shrinkage of overall employment is estimated at around 0.7%. It is even possible that the additional increment of private sector employment will entirely offset the negative effect on public sector employment in spite of the expected slowdown of economic growth rates in the last quarter of the year. The September business climate indicators in the country support this expectation.

The downward trend in the number of *registered unemployed* was sustained in the nine months of 2001.[6] In end-September they amounted to 630 000 people, or 7.8% less against end-2000. Registered unemployment constituted 16.5% of the labour force. The contraction of the inflow of lay-offs in comparison to the previous two years – due to the slowing pace of the structural reforms in 2001 – is an important factor for the gradual reduction of unemployment in the country. Both the NSI data on the number of lay-offs and the NES information on the registered unemployed, entitled to unemployment compensations and benefits indicate a reduction of lay-offs.

The data from the NSI employment and wages survey in the first half of 2001 indicate that lay-offs decreased by almost 50% on a year earlier. Most probably, in 2001 the economy entered a stage of surmounting the

[3] *According to data from the Labour Force Survey. These figures are usually smaller then the NSI official data on the annual average number of employed, because of the underestimation of the number of employed in agriculture and forestry. For instance, the average number of employed in 2000 was by 148 700 people higher than the LFS data for the same year.*

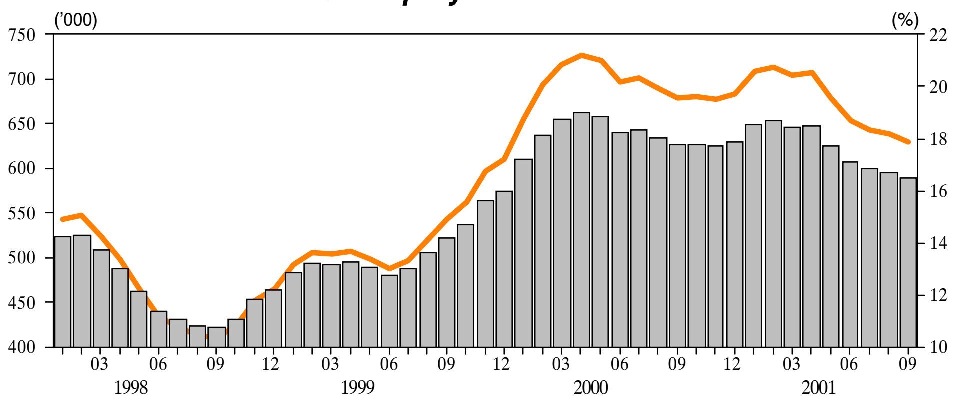
[4] *Some 60% of the employed in medium and large industrial companies are surveyed. The sample covers predominantly the public sector.*

[5] *Employment changes in July relative to January 2001, because previous years data are not comparable due to the modification of the classification of economic activities made in the beginning of 2001.*

[6] *National Employment Service (NES) data.*

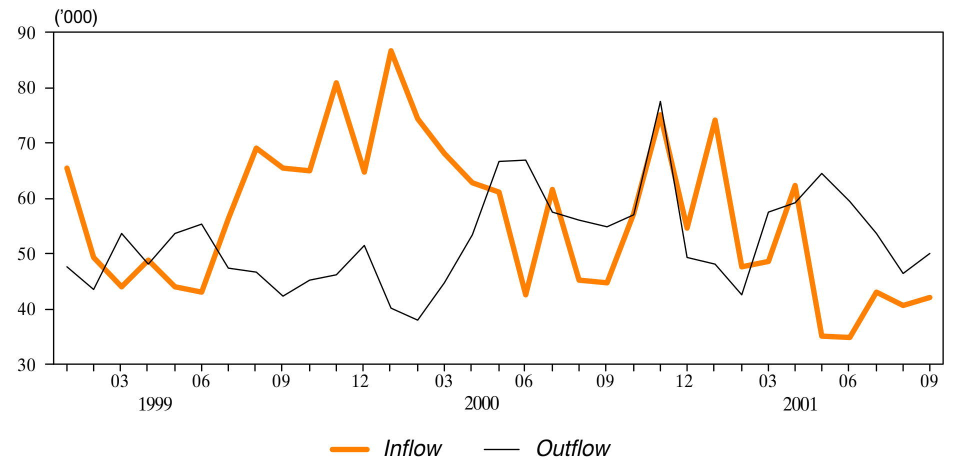
peak in unemployment in the country. In January-June 2000, some 66 513 people were laid off in the public sector (approximately 7.6% of the employed covered by the survey), whereas in the first six months of 2001 they amounted to only 8 559. Lay-offs in the private sector also declined compared to the previous year. In the first six months of 2000, some 46 313 people (5.3% of the employed) have been laid off in the private sector, against 18 325 or just 2% of the employed in 2001. At the same time, the data indicate a 7.9% year-on-year increase of the number of the newly employed persons in private enterprises in the first half of 2001.

Registered Unemployed and Unemployment Rate



Source: NES

Inflow and Outflow of Unemployed



Source: NES

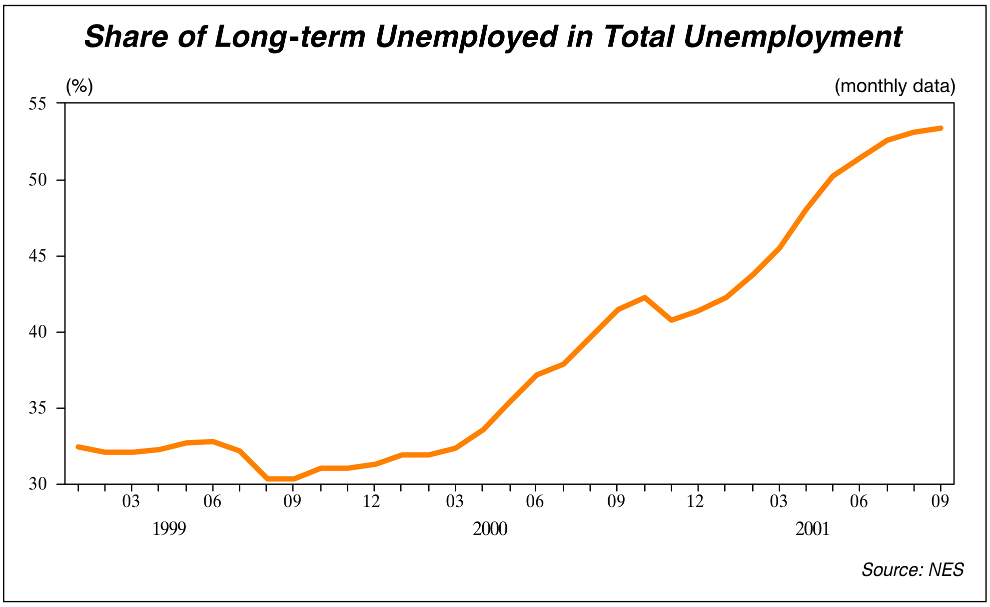
The NES information on the size and structure of the inflow of unemployed confirm the above-mentioned positive trends in the employment dynamics. The number of the dismissed persons, who registered at the job centres declined by 23.7% in January-September 2001 against the same period of 2000, reporting a steady downward trend. The outflow of registered unemployed stepped up by 0.7% in the nine months over 2000, entirely due to the 11.9% growth of the number of people who have found new jobs in 2001 thereby indicating a more intense job-creation during the nine months in review.

Notwithstanding the downward trend in the number of unemployed, the rate of unemployment remained high in the first nine months of 2001. Unemployment persists as one of the most acute problems challenging Bulgaria's economic policy. According to AEAF experts, there are no serious labour market legislative and institutional barriers to the future more rapid reduction of unemployment. With the Labour Code amendments adopted in March this year, the conditions for intensification of labour mobility have been created. Employers are already allowed to suspend a labour contract by paying compensation to the worker, which gives the former higher flexibility when laying off people. Trade unions are not an obstacle to the flexible operation of the labour market in view of their trifle influence over wages and employment, especially in small and medium enterprises, which are dominating in the economy.

The key employment and unemployment policy issues, namely the minimum wage in the country and the size of the unemployment compensations, do not have a destructive impact on the labour market either. However, they are not expected to contribute to the decrease of unemployment till the end of the year. As of 1 October 2001, the minimum wage stands 38% of the average salary in the country and this ratio is comparable to its values in most of the member-states of the International Labour Organisation. The unemployment compensations vary between 26% and 49% of the average salary in the country.

The high unemployment rate in Bulgaria can be primarily attributed to the insufficient demand for labour. According to NES data, in the nine months to September, some 38 unemployed on average competed for one job vacancy. Therefore, the encouragement of entrepreneurs' economic and investment activity are the effective unemployment reduction measures. In this respect, the economic policy should address mainly the attraction of foreign direct investments and reduction of the direct tax and insurance burden of the employers. The remaining active labour market measures, such as the additional qualification and re-qualification of the unemployed should be aimed at the segment consisting of the more vulnerable to unemployment population groups.

The NES information shows that persons over 50 years of age, with primary education or with no qualification face greatest difficulties in finding new jobs. They are the core of long-term unemployment. Remaining at the labour market for a longer period of time leads to the loss of qualification and skills and further reduces their chances of getting employed again. This, in its turn, results in a deterioration of the unemployment structure, raising the share of the long-term unemployed. According to NES data, the relative share of the long-term unemployed in September 2001 amounted to 53% of the unemployed. In the nine months of 2001, the number of long-term unemployed stepped up by 32.2% on a year earlier.



The unemployment rate by regions remained quite diverse in 2001. The variation coefficient of the unemployment rate by regions increased from 0.35 in July 2000 to 0.36 in July 2001. In July 2001, the highest unemployment rate was reported in the Targovishte region (32.4%) and the lowest in Sofia (4.5%). Regardless, the regional mobility of labour force in the country remains low mainly due to the poor infrastructure and the corresponding high fixed expenses for finding a job and going to work.

The upward trend of the real average *monthly salary* in the country, observed since 1998, persisted in the first half of 2001. The average salary in the country in the first six months of the year ran at BGN 248, stepping up by 3.5% in real terms on a year earlier. The real disposable income increased by 5.4% in the six months relative to the same period of 2000.[7] Having in mind the 12-month dynamics of the average number of employed and the value added in the economy in the first half of 2001, the gain of labour productivity in the economy in the same period was approximately twice as much as the increase of the average monthly salary. Therefore, the rising real wage did not negatively affect the competitiveness of the Bulgarian companies.

Nominal and Real Wage

Source: NSI

The average public sector salary registered a 12-month growth of 15.3% in nominal terms in the first six months of the year. Its increment exceeded the average private sector salary rise by 2.4 percentage points. As a result, the spread between both average wages widened to 23.8% in the first half of 2001. It is difficult to assess the current reliability of these data, since under-reporting of actual wages in order to reduce the tax and insurance burden is more widespread in the private sector than in the public sector. The implementation of the government intentions to link more closely the sum of the personal insurance contributions to the future pensions benefits will gradually curb the incentives to conceal the actual sum of the labour income.

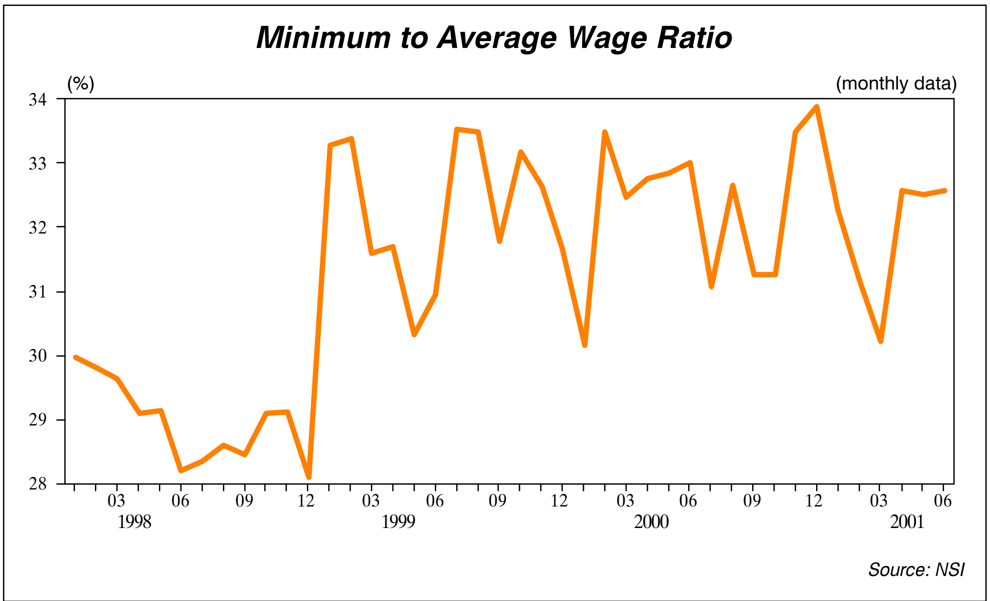
No sharp real-term rises of the average wage and disposable income can be expected by the end of the year owing to the expectations for slower economic growth rates and the objectively restricted capacity for government intervention in the wage formation in the public sector following the planned tightened fiscal restrictions in the last quarter of 2001. The government already announced its intentions not to raise budget sector salaries in the beginning of October and to pay annual bonuses to the budget sector employees only if the fulfilment of the targeted fixed budget deficit was ensured. In the first half of 2001, the average monthly salary in the budget sector – encompassing under 17% of total employed – reported a year-on-year nominal-term increase of 23.7%, and a real-term growth of 13.2%. Although the increase of budget salaries exceeded the rise of the average salary, budget employees still received 3.8% lower wages than the average for the country in the first six months of the year. In January-June 2001, the average salary in healthcare and education sectors remained by 13.3% and 9.7% lower than the country's average.

In the past few years, not a single government attempted to influence directly the private sector average

[7] *The different growth rates of the average salary and the real disposable income are attributed to the tax and insurance burden, analysed in the „Public Finance“ chapter.*

wage, which is determined to a great extent by market principles. The sole remaining instrument for an indirect influence of the state – the minimum wage – was again used in 2001. It was raised by 7.6% from BGN 79 to BGN 85 in April, and by another 17.6% in the beginning of October to BGN 100.

The increase of the *minimum wage* should force employers to further narrow the difference between the officially reported salaries and the actual remunerations paid. Nevertheless, the government should resort to the use of the minimum wage as an income policy instrument cautiously while taking into consideration the trend in the average salary dynamics. An inappropriate choice of the minimum wage/average salary ratio can have unfavourable macroeconomic consequences. On the one hand, employers in certain regions and sectors might offset the rise of labour costs by a proportional contraction of the number of employed, which would lead to a considerable growth of unemployment and social tension. The latter is particularly true for the economic sectors and regions where the bulk of the employed receive wages close to the minimum wage. On the other hand, employers might compensate for the labour costs increase, stemming from the administrative rise of the minimum wage, by cutting down on other labour costs in order to avoid the financial destabilisation of their firms. In this case, the transfer of income to people in the lower income categories would not contribute to the rise of the general welfare and living standards as a whole because of its detaining effect on real incomes of the remaining income groups.



The wage differentiation in the first half of 2001 was still more pronounced in the private sector. The variation coefficient of private sector average wages ran at 0.42. The latter reflects the fact that on the one hand, low labour costs companies operate in the private sector, and particularly in the following industries: leather, fur and footwear industry and manufacture of clothing and wearing apparel, where the average salary is approximately BGN 140. On the other hand, the highest wages are also paid in the private sector, viz. in the sectors production of coke and refined petroleum products and finance, credit, and insurance, where the average salary stands at over BGN 450. The salaries variation coefficient in the public sector was 0.38.

Price Adjustments and Inflation

The price stability in the first nine months of 2001 is an important feature of Bulgaria's economic development. Consumer price inflation over the period amounted to only 2.2%. On a year earlier, the overall CPI growth in September 2001 reached 4.7%. The price dynamics in the analysed period was in line with the preliminary expectations. The downward trend of consumer and producer prices on an annual basis was predetermined by the lower monthly CPI and PPI changes in 2001.

In contrast to the nine months of 2000 when food prices were the main inflationary factor, in 2001 service and non-food prices had the largest contribution to the reported increase of *consumer prices*. The 23% increase in the prices of healthcare and 6.6% growth of transport prices particularly pushed up the overall consumer price level.

In January-September 2001, food prices fell by 1.1%, thereby contributing 0.5 percentage points to the decline of the overall CPI. The most notable decrease was registered by the prices of vegetables (by 34.2%), eggs (by 12.5%) and dairy products (by 2.9%) whereas the prices of fruit stepped up by 18.3%. A slight increase of food prices is expected by end-2001 in view of their 1998-2000 price dynamics, the sustained downward trend in agricultural output in the first half of 2001, and the reported year-on-year rise of purchase prices of about 21% on average in the same period. The seasonal price dynamics of milk and dairy products prices will further contribute to this effect. The 10% increase of household electricity prices in October will have no impact on foodstuffs prices.

Price Changes and Contribution to Inflation by Commodity Groups (January-September 2001)

Commodity groups	*Price change (%)*	*Contribution to overall nflation (in % points)*
A. Food items	-1.1	-0.5
B. Non-food items	6.1	1.7
C. Canteens and restaurants	2.1	0.1
D. Services	3.9	0.9
Inflation	**2.2**	
A. Administered prices	6.4	1.3
B. Free prices	1.1	0.9

Free prices registered only a slight increment of 1.1% in the nine months of 2001 due mainly to the increase in the fresh fruit prices, with the latter contributing 0.4 percentage points to overall inflation. The jump-like rises of the administered fixed prices of certain goods and services, viz. water supply (13.6%), medicines (27.2%) and postal services (6.6%) had a more substantial contribution to the consumer price dynamics.

The external environment also affects the price dynamics in a small open economy, such as the Bulgarian one. The prices of tradables[8] and potential tradables[9] in the country are highly dependent on the changes of international prices and the EUR/USD exchange rate fluctuations. In the nine months of 2001, these external factors curbed the increase of domestic prices[10]. In January-September 2001, the prices of non-tradable goods and services stepped up by 2.8%, contributing some 1.3 percentage point to overall inflation.

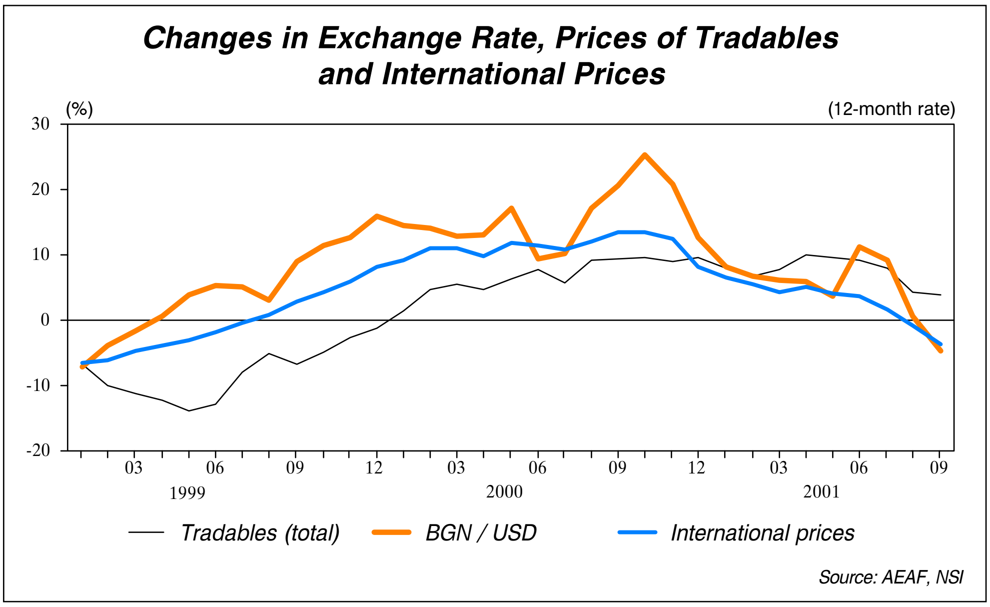
In 2001, the consumer price dynamics continued to follow the changes of *producer prices*. The latter reported an eight-month rise to August of 0.6%. Their 12-month increase reached 6.1% in end-August 2001. The

[8] *The group of tradables includes all goods that do not face administrative barriers, transportation difficulties, etc. upon importation. Customs duties of and over 25% or licensing import regimes are said to be administrative barriers. All bulky goods of high transport costs or fresh unprocessed products whose quality is likely to deteriorate during transportation face transportation difficulties. Some of the commodities that fall within the tradable group are mainly food products -eggs, semi-processed meat products, citrus fruit, etc. as well as some non-food products such as household appliances, cars, electronics. The overall weight of the group within CPI amounts to 19%.*

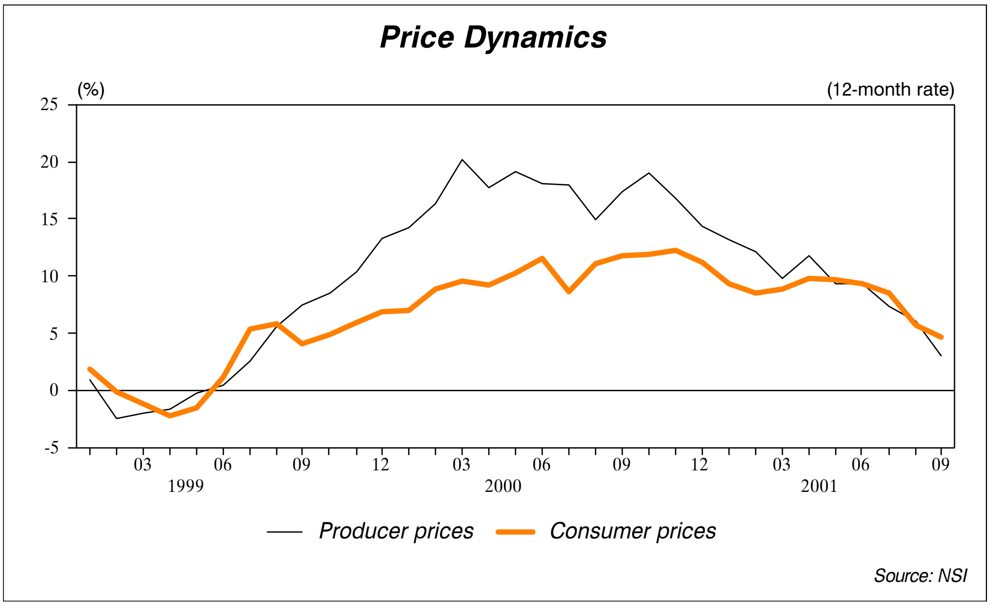
[9] *„Potential" tradables are said to be all goods, which face administrative barriers upon importation. The group encompasses pork and poultry meat, dairy products, finished food products, clothing and footwear, natural gas, medicines, etc. Their overall weight within CPI amounts to 36.6%.*

[10] *The figure presents the price dynamics of all tradables, with a combined weight of approximately 55.6% within the consumer price index (CPI). The remaining goods and services in the CPI are said to be non-tradables. They have had the largest contribution to inflation since the adoption of the Currency Board Arrangement.*

established downward trend of the international prices of oil and non-energy raw materials contributed to the low values of the producer price index.



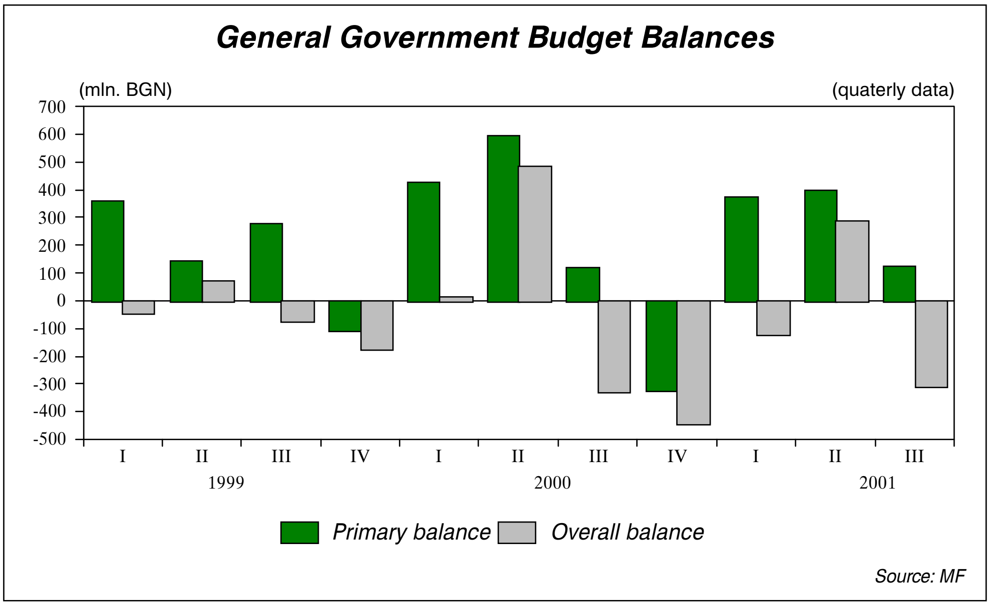
The highest producer price growth in the analysed period was reported in two sub-sectors, namely publishing (28.4%) and manufacture of furniture (23.9%). These increases were also demand driven, as industrial sales in these two sub-sectors stepped up by 24.4% and 19.2% respectively over the same period. Producer prices of refined petroleum products fell by 6.2% in the period till August due to the lower international prices of crude oil and the EUR/USD exchange rate. The producers of food products sold their output at a price around 2% higher than in the beginning of the year. Thus, having in mind the consumer price dynamics of foodstuffs, apparently wholesale and retail traders had cut down their profit margin.



New increases in some of the administered prices are expected by end-2001, however their impact on overall inflation will be substantially lower than their effect until September. The recently announced increases of administered prices in October, viz. household electricity (by 10%), district heating (by 10%) and telephone services (by 6% on average) will result in a one-time rise of October inflation by around 1.2 percentage point. These rises will not influence substantially inflationary expectations till the end of the year, because people were aware of the former in advance. The AEAF expects that the year-on-year inflation by months will sustain its downward trend, moreover so as the second half of 2000 saw higher growth rates of the overall consumer price level, influenced by the external pro-inflationary factors. The end-of-period inflation for 2001 is likely not to exceed 4.5%, and the expected average annual will reach 7.3%. ❑

PUBLIC FINANCES

In end-September 2001, the *cash deficit of the general government budget* ran at BGN 143.6 million[1] or 0.5% of expected GDP[2] in 2001 whereas in the nine months to September 2000, the budget had generated a cash surplus amounting to BGN 175.2 million (0.7% of GDP in 2000). The dynamics of the general government budget primary surplus is indicative of the degree of relaxing of fiscal restrictions in the nine months to September 2001. Thus, it amounted to BGN 889.7 million against BGN 1 140.6 million over the same period in 2000 (some 28.3% higher). The primary surplus/annual GDP ratio in the first three quarters stepped down from 4.5% in 2000 to 3.2% in 2001. It is likely that the projected annual deficit of the general government budget of 1.5% of GDP (or BGN 423.8 million) will not be exceeded.



The unfavourable developments of the global economy following the terrorist attacks in the USA on 11 September 2001 together with the higher than expected deficit on the balance of payments current account in the eight months to August brought pressure to bear upon the government to reconsider its fiscal policy in the remaining months of the year. Responding to the aggravating external environment, the Bulgarian government declared its intention to curb the 2001 general government budget deficit to 0.9% of GDP during the negotiations with IMF mission on the preparation of a new stand-by agreement. Thus, expenditures in the last quarter of 2001 should not exceed revenues by more than BGN 112 million if this target is to be achieved. To this end, in early-October the government launched a number of fiscal measures aimed at budget receipts and expenditures.

The general government budget deficit in the nine months of 2001 was due to not only the slight reduction in the tax burden and the changes in the GDP structure but first and foremost to the considerable increase in budget transfer payments.

On a 12-month basis, *revenues* in the January-September 2001 period stepped up by 8.8% nominally and by 0.5% in real terms while expenditures rose by 13% and 4.4% respectively. As percentage of GDP[3], general

[1] *Ministry of Finance preliminary data.*
[2] *AEAF estimate at BGN 28.461 billion.*
[3] *Estimated by the AEAF at BGN 20.204 billion in the January-September 2001 period.*

government budget receipts shrank from 44.7% in the three quarters of 2000 to 43.1% in the respective 2001 period while expenditures reported a slight growth from 43.7% to 43.8%.

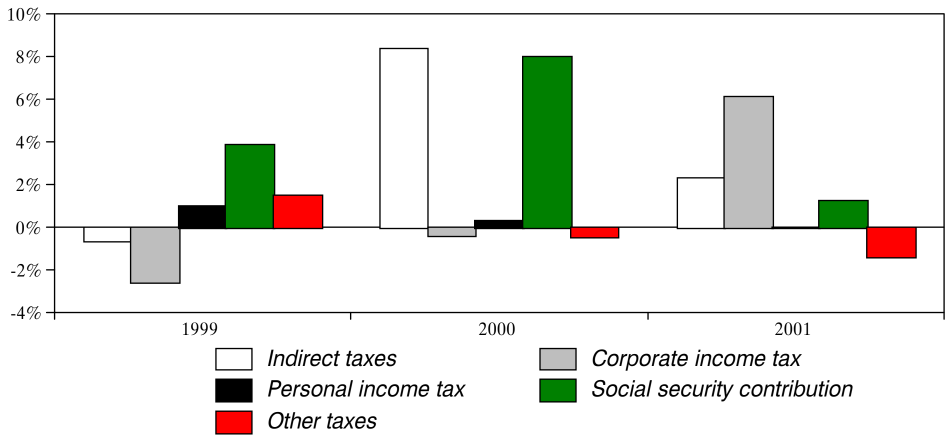
On a year earlier, profits tax and customs duties revenues reported the highest nominal-term increase (by 67% and 29% respectively) in the January-September 2001 period. In real terms, their respective growth amounted to 54.4% and 19%. In spite of the reduction in the profits tax rate[4], the profits tax-take in the first three quarters of 2001 reached 11.4% of total budget revenues against 7.3% in the nine months of 2000. The increase was mainly due to the payment made by the Bank Consolidation Company in March of the profits tax due on the sale of *Bulbank.* This one-time receipt was exactly equal to the cash surplus of BGN 167 million recorded in mid-2001, i.e. without it, in end-June 2001 the cash balance of the general government budget would have been close to zero. The registered growth of revenues from customs duties was a result of the increasing imports in the country.

General Government Budget

	January-September 2000	January-September 2001*
Revenues and grants (mln BGN)	8009.8	8711.1
(in % of GDP[3])	**44.7**	**43.1**
Tax revenues (mln BGN)	6271.2	6797.5
(in % of GDP[3])	**35.0**	**33.6**
Non-tax revenues (mln BGN)	1572.8	1603.8
(in % of GDP[3])	**8.8**	**7.9**
Expenditures and transfers (mln BGN)	7834.6	8854.7
(in % of GDP[3])	**43.7**	**43.8**
Capital expenditures (mln BGN)	654.9	805.7
(in % of GDP[3])	**3.7**	**4.0**
Interest expenditures (mln BGN)	965.4	1043.2
(in % of GDP[3])	**5.4**	**5.2**
Primary balance (mln BGN)	1140.6	899.7
(in % of GDP[3])	**6.4**	**4.5**
Cash balance (mln BGN)	175.2	-143.6
(in % of GDP[3])	**1.0**	**-0.7**

** Ministry of Finance: preliminary data*

General Government Budget: Contribution to Tax Revenue Growth*



* January - September data

Source: MF

The relative contraction of VAT receipts most was associated with the fall in the relative share of final consumption (viz. the VAT tax base) in GDP and the relative growth of exports on which VAT is not liable to be paid.

[4] The rate on taxable profits of less than BGN 50 000 was reduced from 20% in 2000 to 15% in 2001. Respectively, the rate on profits exceeding BGN 50 000 was lowered from 25% to 20%. The rate on taxable profits of municipalities was preserved at 10%.

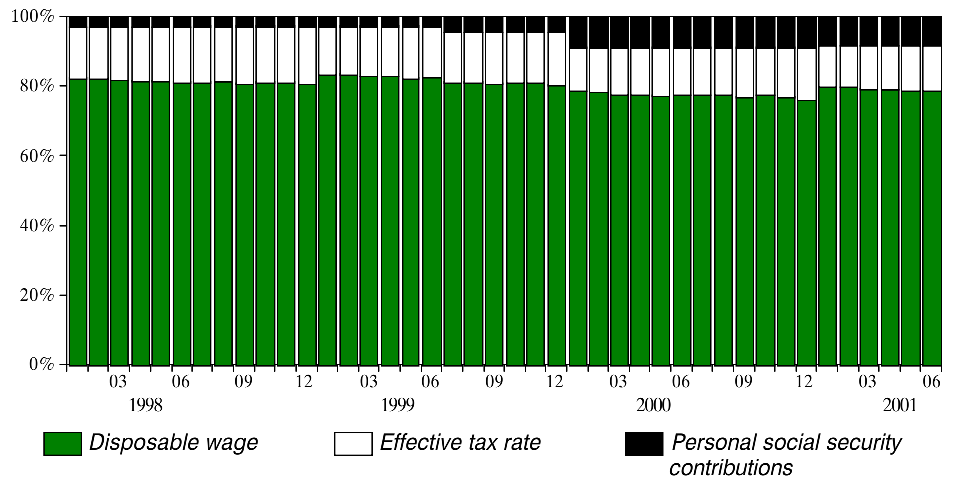
Structure of General Government Budget Tax Revenues*

	January-September 2000	January-September 2001
Profits tax	13.74	20.70
Income tax	18.59	16.81
VAT	40.42	38.22
Excise duties and road fees	17.32	17.48
Customs duties and fees	2.52	2.94

* In % of total tax receipts

Regardless of the 13.1% nominal-term increase in the average salary in the first half of 2001, personal income tax receipts in the January to September 2001 period had risen by a mere 0.3% on a year earlier, stepping down by 7.3% in real terms. This dynamics was attributed to the lowering of the effective tax rate. As a result of the increase of the annual non-taxable income from BGN 960 in 2000 to BGN 1 200 in 2001 and the amendments to the income tax schedules, the effective tax rate stepped down from 13.2% in the first half of 2000 to 12.5% in the respective period in 2001. This dynamics together with the reduction of the insurance contribution rate to the Pension Fund was instrumental to the increase in the disposable salary/average salary ratio.

Wage Structure



Source: NSI, AEAF

As of September 2001, insurance contributions revenues accounted for 24.9% of general government budget receipts against 26.1% reported in the nine months of 2000. Over the same period, they stepped up by 3.9% nominally, decreasing by 4.1% in real terms. Recent years saw a relative contraction of revenues in the budget of the Public Social Insurance (PSI). Revenues in the PSI stepped down from 9.8% of GDP in mid-1999 to 7.9% of GDP in the first three quarters of 2001. This monitored downward trend had to do with the ongoing social insurance system reform in Bulgaria. First, with the launch of mandatory health insurance the social security contribution to the PSI was reduced by 6 percentage points in mid-1999 and this portion was relocated to the National Health Insurance Fund (NHIF). Second, since the beginning of 2000 the social security contributions of workers in the labour categories I and II are no longer paid in the budget of the PSI but in occupational pension funds. Third, in the beginning of 2001 the contribution rate to the Pension Fund was further cut down by 3 percentage points in order to alleviate the social insurance burden and thus to encourage new job creation and improve contribution compliance. In 2002, the revenues of the PSI will further decrease as a result of the relocation to universal pension funds of a portion of the insurance contributions made by insured persons born after 31 December 1959.

On a year earlier, the growth of expenditures of the PSI in the January to September 2001 period considerably outstripped the year-on-year rise in revenues. Receipts stepped up by only 2% nominally whereas expenditures (transfers excluded) grew by 6%. Consequently, as of end-September 2001 expenditures (transfers excluded) exceeded revenues by 30% as compared to 24% in September 2000. Following its growing requirements to finance the shortages of funds for the payment of pension benefits, the PSI had to resort to temporarily interest-free loans from the state budget. They amounted to BGN 380.6 million in the period January to September 2001, exceeding 2.1-fold the amount borrowed a year earlier.

A number of factors contributed to the deteriorating financial situation of the Public Social Insurance:

First, the 3% reduction of the contribution rate to the Pension Fund. *Ceteris paribus*[5], the revenues of the National Social Security Institute as of mid-2001 would have been some BGN 140 million more than the reported had the contribution rate remained unchanged. In this case, the spread between expenditures (transfers excluded) and revenues of the PSI would have been reduced to 20% instead of the above-mentioned 30%. The antedated amendments to the Public Social Insurance Budget Act stipulating that licensed traders were allowed to reduce their annual insured income by 60% instead of the hitherto allowed 35% also contributed to the decrease of PSI revenues.

Second, the unfavorable number of insured persons/number of retirees ratio. Notwithstanding the implemented re-categorisation of labour and the increase of the retirement age, on a 12-month basis the number of pensioners stepped down at a lower rate (0.5%) in June 2001 than the number of insured persons (by 3.5%). As a result, the ratio retired persons/insured persons increased from 1.09 as of June 2000 to 1.13 as of June 2001.

Third, the ratio insured persons to employed persons[6] remained low, regardless of the reported annual growth from 75.8% in mid-2000 to 76.4% in June 2001. The monitored slight increase could be attributed to the changes in the contribution rate, yet it could not offset the loss of NSSI revenues triggered by its reduction. The low ratio is indicative of the fact that similar to 2000, low contribution compliance remained an influential factor for the financial situation of the PSI in 2001 as well.

Fourth, the growth rate of the insured income over the period in question was close to the growth rate of the average expenditure per pensioner. Thus, in the first half of 2000 the average expenditure per pensioner represented some 36.7% of the insured income on average against 36.2% in the six months of 2001. On a year earlier, the ratio average expenditure per pensioner/disposable wage remained unchanged at 44.1% on average in the first half of 2001.

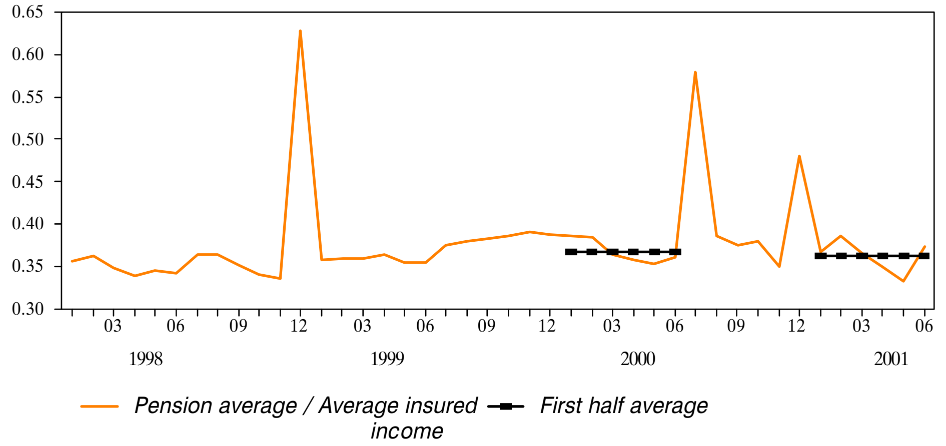
The above analysis proves that in 2001, the financial situation of the PSI and in particular its main component (the Pension Fund) has been negatively affected primarily by amendments in the regulatory framework such as the cuts in social security contributions and, to a lower extent, the shrinkage of the contribution base against an insufficient decline in the number of retirees. The dynamics of the average pension benefit could not be regarded a factor behind the deterioration of the PSI financial situation.

In the first half of 2001, the financial situation of the other two social funds, viz. the NHIF and the Training

[5] *The actual decrease in the number of insured persons and the reported growth of the contribution base.*
[6] *As per data on the number of employed in NSI Labour Force Survey.*

and Unemployment Fund (TUF) seemed stable. As of mid-2001, the NHIF sustained a positive balance although its surplus stepped down on a year earlier. Thus in mid-2000, the surplus of the NHIF financial account ran at 2.2% to GDP decreasing to 0.8% in end-June 2001. The shrinkage of the surplus was due to fact that for a year up to mid-2000 the NHIF collected health insurance contributions and started financing pre-hospital care only in July 2000. Bearing in mind that since July 2001 the NHIF has started gradually financing hospital care as well, a sharp unfavourable shift in its financial situation may well be expected by the end of the year. This comes to show that the importance of medium-term planning and budgeting had been underestimated and, as a result, it will bring about additional difficulties in the implementation of the tough 2001 fiscal programme.

Average Expenditure per Pensioner / Average Insured Income Ratio

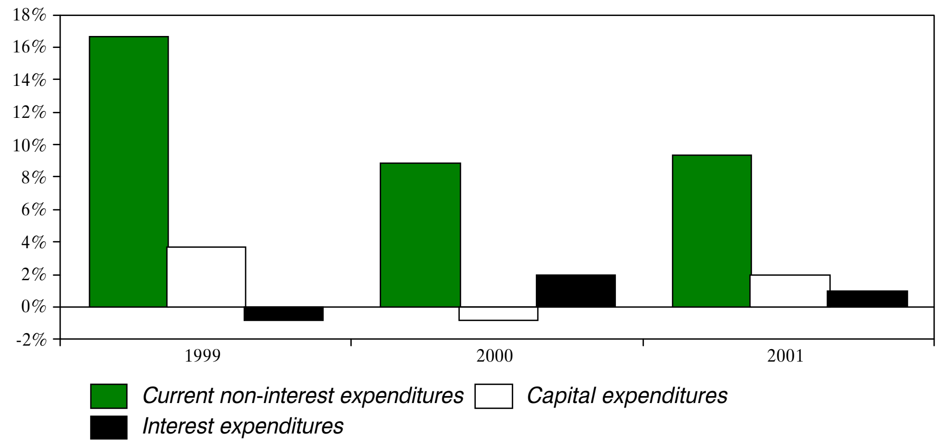


Source: NSI, AEAF

Regardless of the relatively high unemployment rate in the first half of 2001, the financial balance of the Training and Unemployment Fund steadied around the zero value. If transfers are deducted, the deficit of the Fund runs at about 0.5% of GDP, remaining unchanged on a year earlier.

As of end-September 2001, the *expenditures* of the consolidated budget of social insurance and social assistance accounted for 34.1% of total expenditures against 31.4% in the nine months of 2000. In addition to the growth of PSI expenditures, social aid benefits and compensations paid by local governments also reported a substantial rise. Budget subsidies also had a substantial contribution to the increase of current non-interest expenditures in the nine months to September 2001. Already in mid-year, subsidies to non-financial enterprises had exceeded by 55% the total budgeted amount for 2001. In the January to September 2001, subsidies from the general government budget had nominally stepped up by 24.8% on a year earlier. By and large, the increase was due

General Government Budget: Contribution to Total Expenditures Growth*

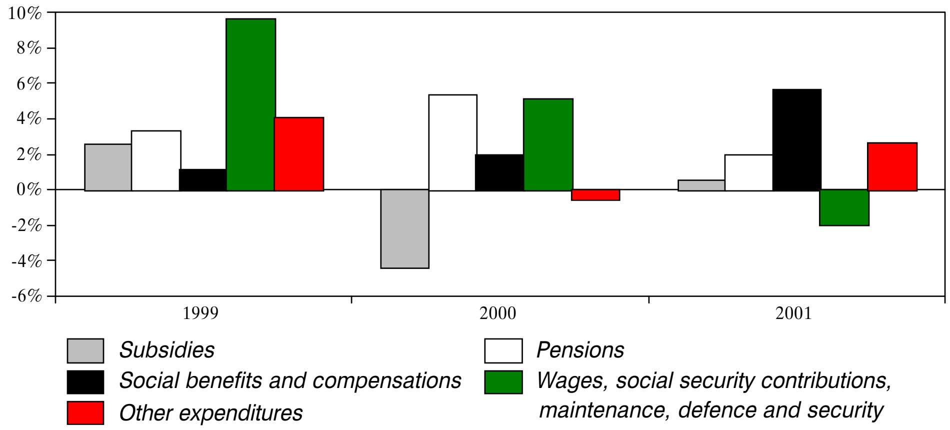


* January - September data

Source: MF

to the fact that the costs (wages and insurance contributions) of the hospitals registered as commercial companies were reported as subsidies. The dynamics of subsidies, however, is indicative that the policy of general budget constraints had not been consistently implemented.

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



* January - September data

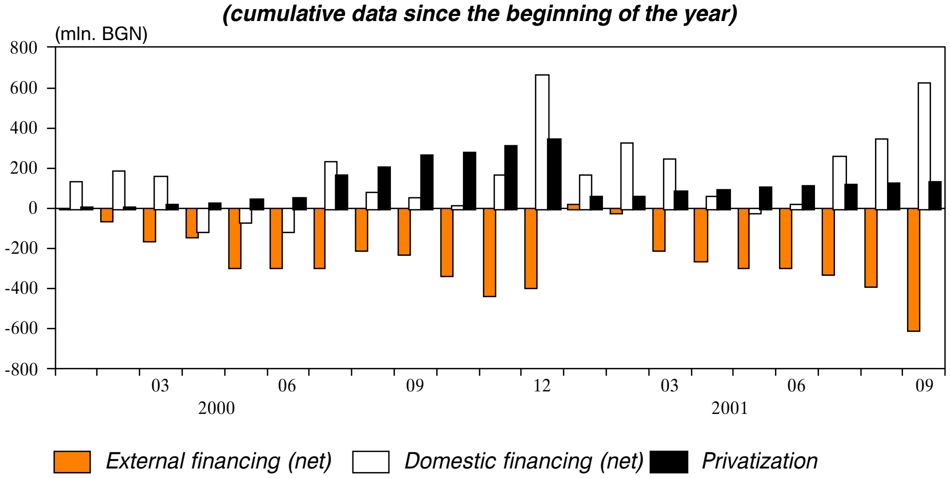
Source: MF

In 2001, the state strengthened its investment activity. The government's capital expenditures in the nine months of 2001 reached 9.1% of total budget expenditures against 8.4% on a year earlier. On a 12-month basis, capital expenditures stepped up by 23% nominally in the January-September 2001 period and by 13.6% in real terms. The growth was mainly due to the additional investment programme for 2001 worth BGN 300 million that was unexpectedly approved in April. Some BGN 178 million of it had been disbursed only in the subsequent two months. At the same time, state purchases[7] decreased from 44% to 38% of total expenditures.

On a year earlier, the share of interest expenditures in general government budget expenditures contracted by 0.5 percentage points in the period January to September 2001 (from 12.3% to 11.8%). The relative decrease in foreign interest payments was partly offset by the relative growth of domestic interest payments.

Financing of the General Government Deficit

(cumulative data since the beginning of the year)

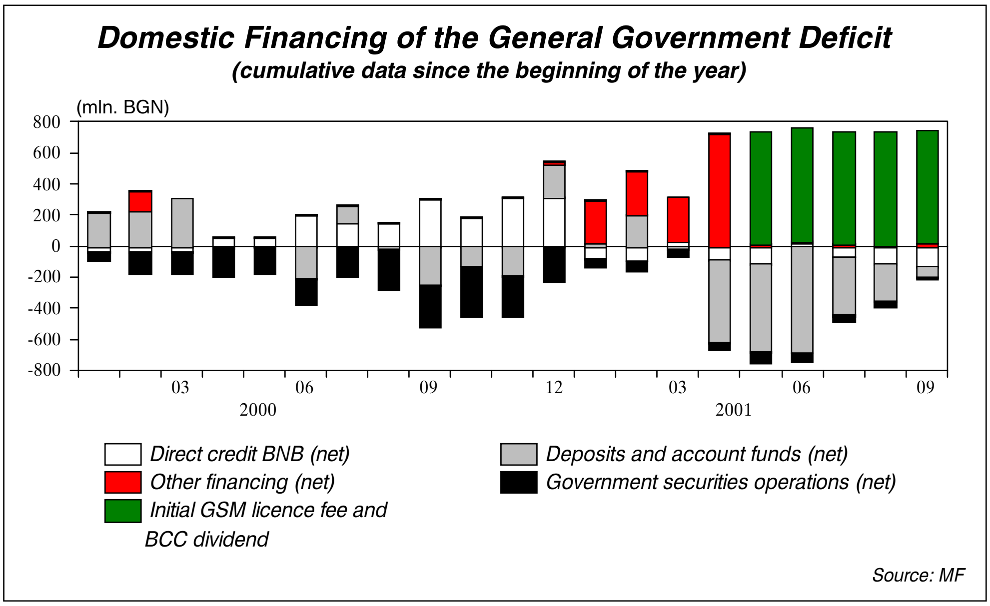


Source: MF

The general government budget cash deficit was predominantly financed by local funds and privatization proceeds. For comparison, the deficit in the same period of 2000 was almost entirely financed by privatization revenues. The structure of budget deficit financing sources in the last two years is indicative that after the completion of the privatization process in the country, Bulgaria should either stick to a zero budget deficit policy or generate

[7] *They include expenditures for wages and insurance contributions, maintenance costs and defence.*

a budget surplus. Otherwise, it would be hard for the country to fulfill in the medium term the Maastricht criterion for the government debt/GDP ratio.



In the nine months to September 2001, *domestic net financing* amounted to BGN 621 million. A year earlier, it ran negative at BGN -251.5 million. Exceptional financing[8] worth BGN 727.6 million accounted for the largest share in domestic financing in the nine months of 2001. Direct net credit from the BNB stepped down by BGN 135.8 million, net government deposits and assets in government accounts by BGN 68.3 million, and net financing by government securities by 6.5 million. Medium-term government securities had the largest relative share in total government securities issued for the purposes of budget deficit financing. The recent trend of growing maturity of this segment of government debt was sustained.

Privatisation proceeds amounted to BGN 132 million in the first three quarters of the year, decreasing by 43.1% (or BGN 174.3 million) on a year earlier.

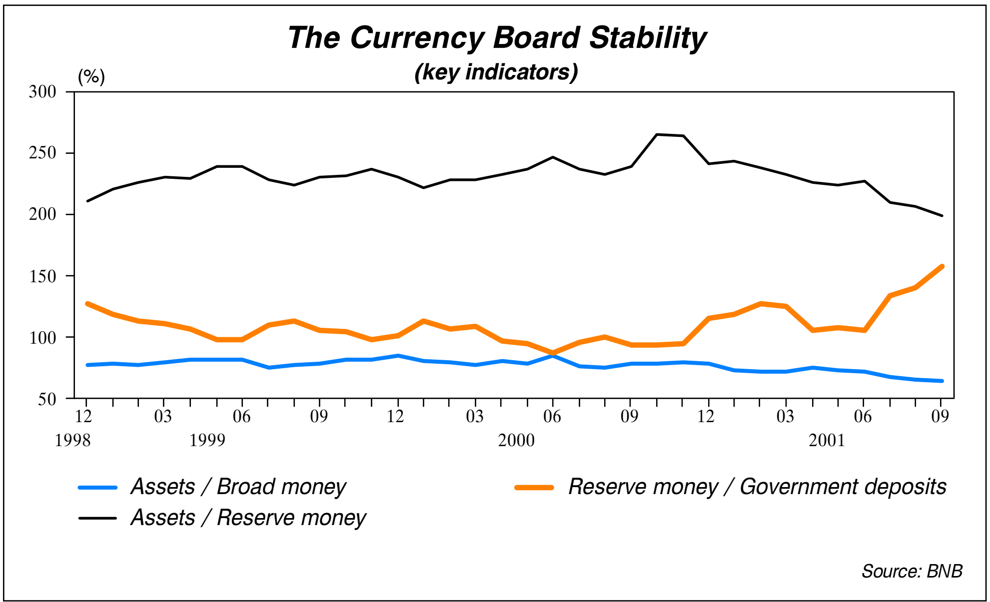
In the January to September 2001 period, *net external financing* ran negative at BGN -609.6 million. Over the same period of 2000, external financing had also maintained a negative value amounting however to only BGN -230.1 million. ❑

[8] *That is the initial licence fee for the second GSM operator and the dividend paid by the Bank Consolidation Company.*

FINANCIAL SECTOR

Currency Board

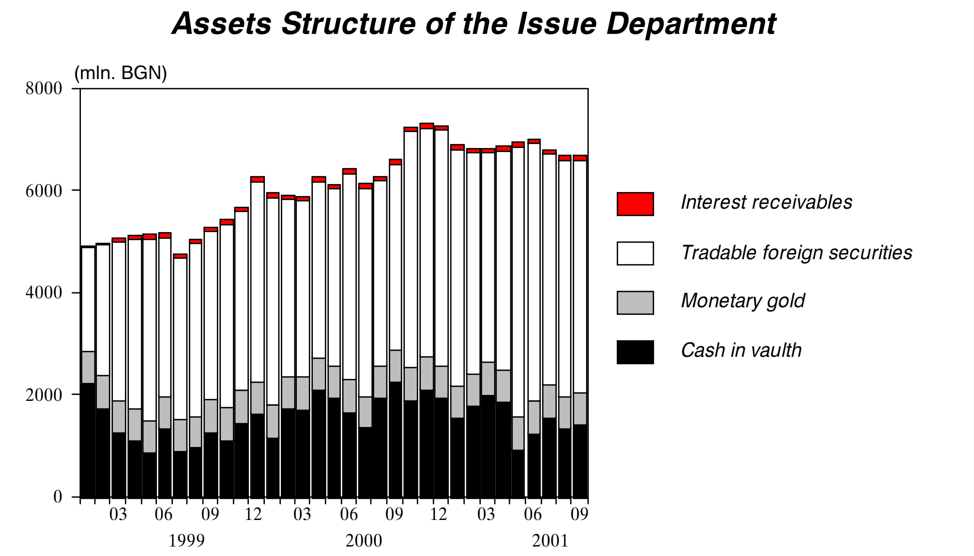
Notwithstanding the substantial foreign debt payments and the widening foreign trade deficit, the currency board in Bulgaria remained stable in the nine months to September 2001. However, the coverage ratio (gross FX reserves/broad money M3) ran at 64.9% in end-September, stepping down against end-December 2000 (78.3%). A downward trend in the coverage ratio has been discerned since mid-2001 mainly as a result of the higher growth rates of money supply and the contraction in the assets of BNB's Issuing Department. This negative trend can be reversed by the end of the year through the tightening of fiscal restrictions and securing external balance of payment (BoP) support in the medium term.



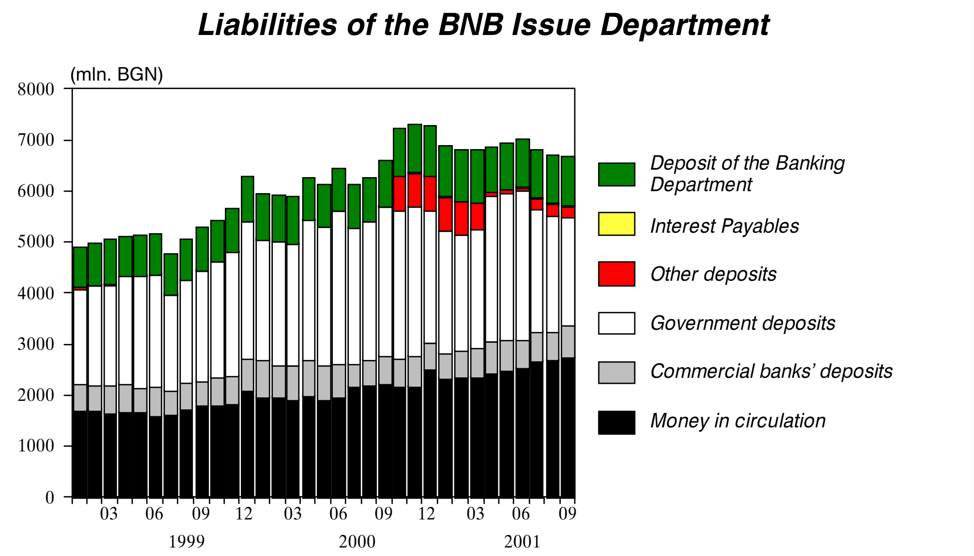
In the January to September 2001 period, the forex reserves/base money coverage ratio also sustained a downward trend. In end-September, the indicator's value reached 198.5%, decreasing by 42.3 percentage points against end-December 2000 (240.8%). The considerable fall in the indicator's level was associated with the changes in the liabilities side structure of the Issuing Department's balance sheet as the share of government's deposits (the fiscal reserve account) went on the decrease at the expense of the growing relative share of base money.

In end-September 2001, BNB's forex reserves amounted to EUR 3.4 billion, reporting an 8.1% contraction against end-December 2000. Assuming that no BoP support agreement is signed with the IMF, the assets of the currency board are likely to sustain their downward trend by the end of the year, stepping down, however, at a very slow pace owing to the lack of substantial foreign debt payments and the tightened fiscal restrictions. Nonetheless, as of 30 September 2001 BNB's forex reserves had increased by 1.2% on a year earlier.

The BNB does not publish data on the structure of assets of its Issuing Department by foreign currencies and by maturity. The lack of such data not only severely limits the scope and depth of analysis but also is conducive to speculations regarding the expediency of the maintained structure of the forex reserve by currencies and the efficiency of its management. The recently announced government intention to introduce transparent management models for the fiscal reserves, forex reserves and foreign debt are a constructive measure to subdue any such speculations. The objective of the envisaged approach is to minimise the fiscal risk and optimise the forex reserves and foreign debt management. The implementation of the proposed models should also take into account the high susceptibility of the Bulgarian economy to external shocks, which necessitates a prudent management of the fiscal and forex reserves.



Source: BNB, AEAF



Source: BNB, AEAF

In end-September 2001, the fiscal reserve account amounted to BGN 2 129.4 million, stepping down by 18.4% relative to end-2000. The decrease was primarily due to foreign debt service payments made by the government. Some government transactions concerning the liabilities of the Issuing Department[1] also affected the fiscal reserve dynamics in the nine months of 2001. These transactions had a string impact not only on the liabilities structure of the Issuing Department but also on the size of the monetary aggregates and money multiplier M3.

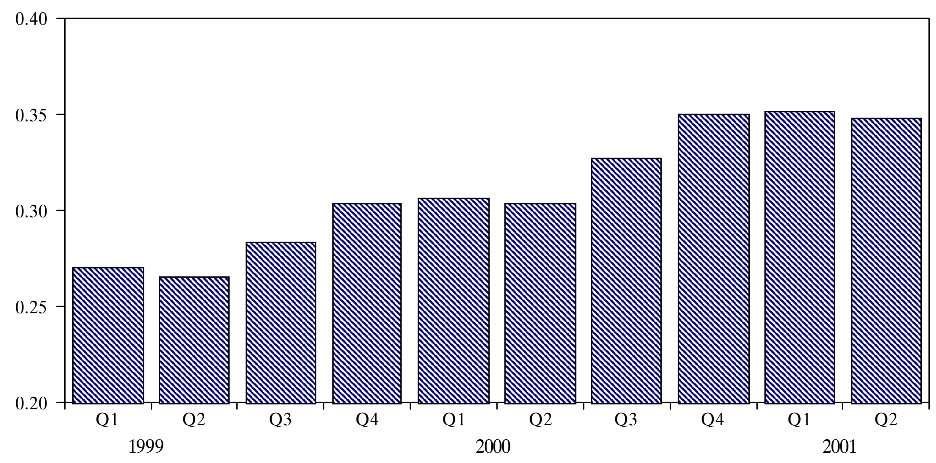
In the nine months of 2001, BNB's lender of last resort facility slightly weakened relative to end-December 2000. As of end-September, the Banking Department Deposit with BNB's Issuing Department decreased by 0.9% against end-December 2000. The Banking Department's deposit with BNB's Issuing Department/commercial banks' deposit base coverage ratio sustained its downward movement to reach 12.4% in end-September, or 1.5 percentage points lower than in end-December 2000.

[1] *In March 2001, the Bank Consolidation Company (BCC) paid profits tax in the state budget worth BGN 115.9 million and some BGN 51.5 million of tax in the municipal budget. In April it also repaid the dividend due to the state on its profit in 2000 amounting to EUR 226.8 million or BGN 443.5 million. These sums were paid from the BCC's deposit account with the BNB (part of the* Other Depositors *item of the Issuing Department's liabilities). In July, some BGN 132 mln (the deposit of a large state-owned company) were transferred from the Government's Deposit to the Deposit Account of Other Depositors as liabilities of the Issuing Department.*

Money Supply and Bank Credits

Money supply. In the nine months to September 2001, the growth rate of narrow money M0 outstripped the growth rate of value added in the economy. Over the same period, money in circulation had increased by 9.6%. Its growth was associated with the high tourist season and the periodic monetisation of government commitments (the payment of pension bonuses, municipal deficit financing, etc.). The high liquidity of the economy was sustained in the period in question regardless of the low inflation levels. Again in the nine months of 2001, commercial banks raised their reserves in the central bank by 15.4% (BGN 79.4 million). The increase was a result of the slow development of financial markets in the country, the downward trend in opportunity costs for holding money cash in hand closely following the lowering of interest rates at the international markets and the growth of deposit base.

M2 / GDP Ratio



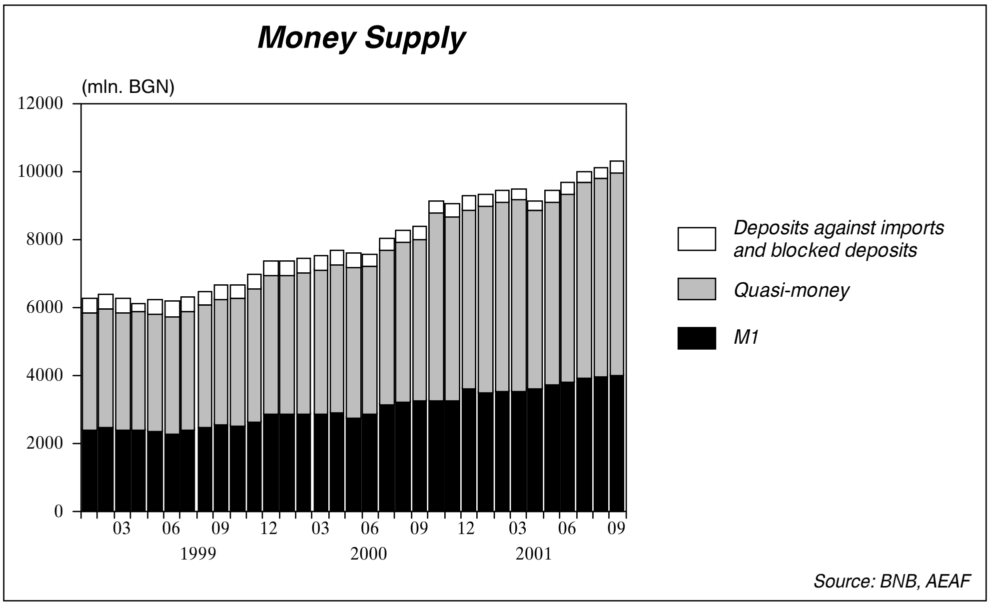
Source: BNB, NSI, AEAF

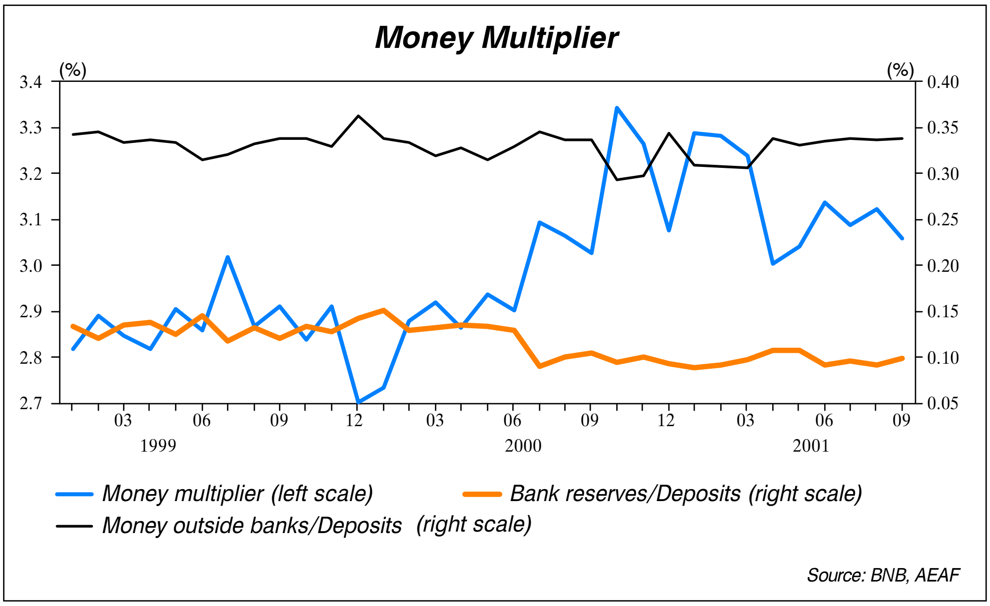
In the period January to end-September 2001, broad money M3 had increased by 10.9% (BGN 1 015.6 million) nominally, and by 9.9% in real terms thereby reconfirming the conclusion on the fast pace of the ongoing remonetisation of the national economy. The nominal growth rates of money stock had slightly slackened on a year earlier. Over the same period in 2000, broad money reported a nominal-term rise of 14% (BGN 1 031.9 million). Its real-term growth amounted to only 4.8% due to the higher rate of inflation.

Relative to September 2000, broad money had stepped up by 22.9% (BGN 1 923.3 million) in nominal terms. Money supply's real-term growth over the same period ran at 16.3%.[2] In the nine months of the year, bank deposits reported a 13.3% nominal-term increase (BGN 700.5 million), stepping up by 12.3% in real terms. On a year earlier, quasi-money had stepped up by 26.1% (BGN 1 234.7 million) and by 19.3% in real terms in end-September 2001. Its foreign currency component reported a more substantial growth of 33.1% (BGN 1 067.1 million) whereas saving and time deposits stepped up by 11.1% en masse or BGN 167.6 million. The appreciation of the USD/BGN exchange rate in the first half of 2001 affected the depositors' choice of foreign currency as a store of wealth. Notwithstanding the depreciation of the dollar to the BGN in the third quarter of the year and the continuing fall in interest rates on foreign currency deposits, the foreign exchange component of non-financial institutions' deposits sustained its upward trend even in the second half of 2001. On the one hand, such dynamics may well be due to the impact of seasonal factors like the tourist season. On the other hand, the higher growth rate of foreign currency deposits than that of BGN deposits is

[2] *The real-term change of monetary and credit aggregates is calculated, deflated by the CPI in the period reported.*

indicative that foreign currencies (and the USD in particular) remained the preferred saving vehicle of firms and households alike.





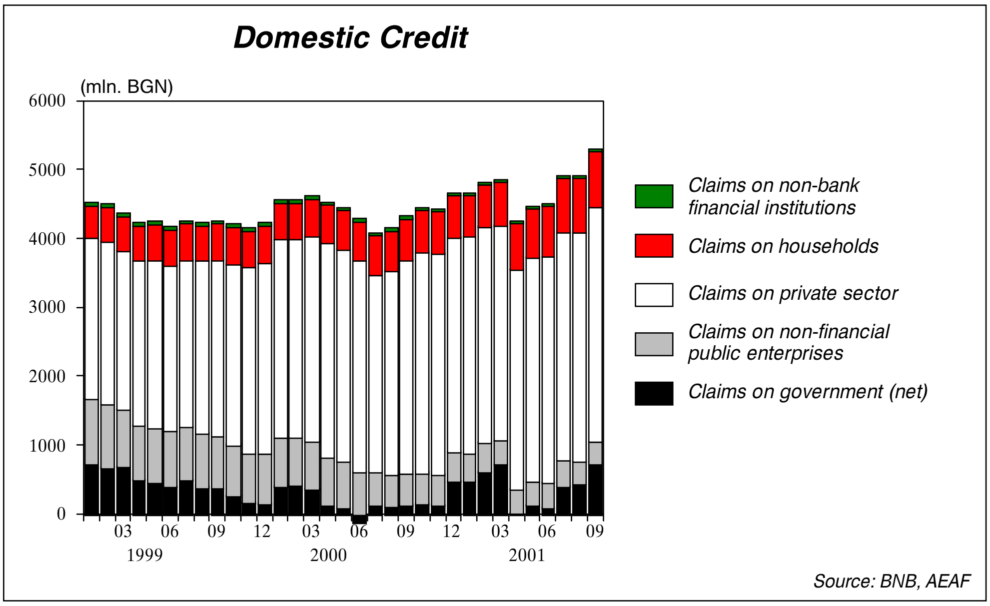
In the nine months to September 2001, the reported 11% increase of highly liquid money M1 (BGN 397.8 million) was close to the growth rate of M3. Its real-term rise over the same period ran at 9.9%. In the first three quarters of 2001, monetary aggregate M1 increased at a faster pace than its growth rate registered a year earlier. Such a dynamics is a sign that economic agents had maintained higher liquidity in the nine months of 2001. For comparison, M1 had increased by 9.2% (BGN 276 million) in nominal terms and by 0.4% in real terms in the period January to September 2000. On a 12-month basis (September 2001 against end-September 2000), M1 reported a 23.1% nominal-term growth (BGN 757.4 million) and a 16.5% real-term rise.

Money multiplier did not undergo any substantial changes in the nine-month period to September. Its fluctuations discerned in March and April were associated with the transformations in the liabilities side of the BNB's Issuing Department balance sheet.[3]

Domestic credit. The pace of growth of domestic credit in the nine months of 2001 outstripped the respective growth rates of money stock and net foreign assets of the banking system. Thus, domestic credit had increased by 14% (BGN 653.1 million), reporting a real-term growth of 13%. For comparison, the registered nominal rise of domestic credit in the January-September 2000 period amounted to 2.1% (BGN 87.7 million),

[3] *See AEAF* Monthly Business Survey *#4/2001 for more information.*

decreasing by 6.2% in real terms. The dynamics of domestic credit and net foreign assets supports the assessment that in the nine months of 2001 the export of capital from the banking system had shrank on a year earlier at the expense of free capital's re-direction to the domestic economy. This process is particularly noticeable in the third quarter of the current year.



Bank claims on the government sector registered the most substantial changes in the nine-month period to September. Since early-2001, credit to the government has stepped up by 46.8% nominally (BGN 228.2 million) and by 45.4% in real terms. Over the same period in 2000, government credit had reported a 12% nominal contraction (BGN 18.8 million) and a 19% real-term decrease. On a 12-month basis, credit to the government increased by BGN 580.4 million, recording 5.3-fold nominal-term and 5-fold real-term growth. The active participation of the government on the credit market was a consequence of both the relaxing of budget discipline and the measures for government debt restructuring taken at the end of the period. There is no evidence, however, that the non-financial sector is steadily ousted from the credit market in view of the measures aimed at the tightening of fiscal restrictions in the fourth quarter of the year that had been already announced by the new government and the lower than initially expected projected budget deficit in the 2002 draft-budget.

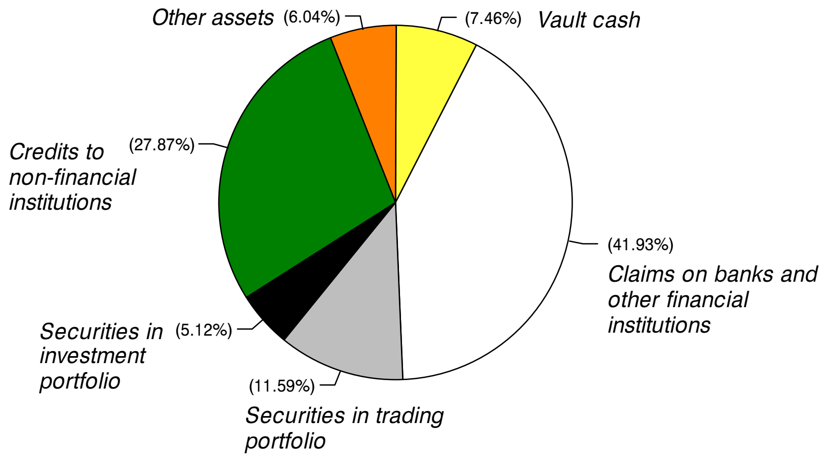
Credit to the non-government sector in the January-September 2001 period increased by BGN 424.9 million, stepping up by 10.2% in nominal terms and 9.2% in real terms. For comparison, in the nine-month period of 2000 these credits grew by BGN 106.5 million, reporting a nominal-term rise of 2.6% and a real-term contraction of 5.7%. Credit to state-owned enterprises sustained its downward trend, stepping down by 21% (BGN 88.5 million) since early-2001. Credit lending to households, however, reported a considerable growth of BGN 214 million, or 35.4%. Credits to private companies stepped by 13.7% (BGN 513.47 million) up in the nine months to September 2001.

The Banking System

Structure of bank assets and liabilities. The January to September 2001 period and particularly the third quarter of the year witnessed some changes in the structure of commercial banks' assets. On a year earlier, the share of credit lending to non-financial institutions and other clients as of 30 September 2001 increased by 5.4 percentage points up to 33.3% at the expense mainly of the 4.5 percentage points shrinkage (down to 37.5%) of the relative share of claims on banks and other financial institutions, and particularly on foreign banks. This trend is likely to be sustained by the end of the year due to the lower yield on deposits in foreign banks following the overall fall in interest levels at the international financial markets. The intention declared by the new parliamentary majority to remove those legislative shortcomings that impede commercial banks' credit lending to the real sector without, of course, infringing upon regulations on prudent credit risk management is yet another factor supporting expectations that the relative share of credits to firms and households will go on the increase. The expectations for a slackening of economic activity in the fourth quarter of the year will counterbalance the impact of the above-mentioned factors.

Assets Structure of the Banking System

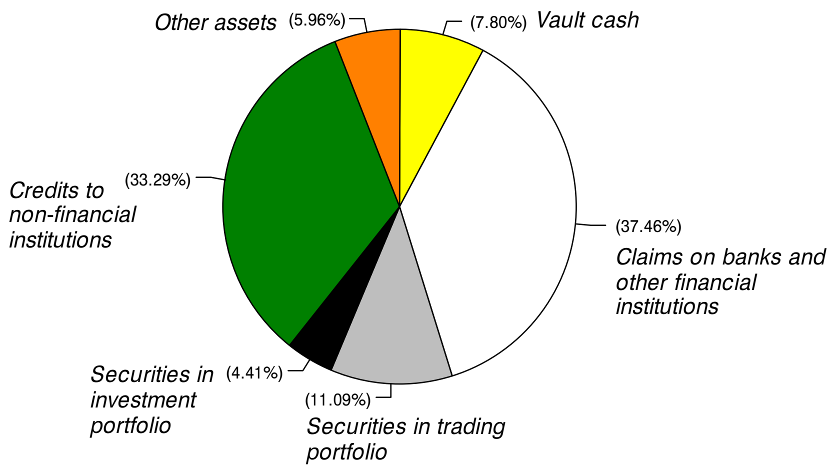
(as of 30.09.2000)



Source: BNB

Assets Structure of the Banking System

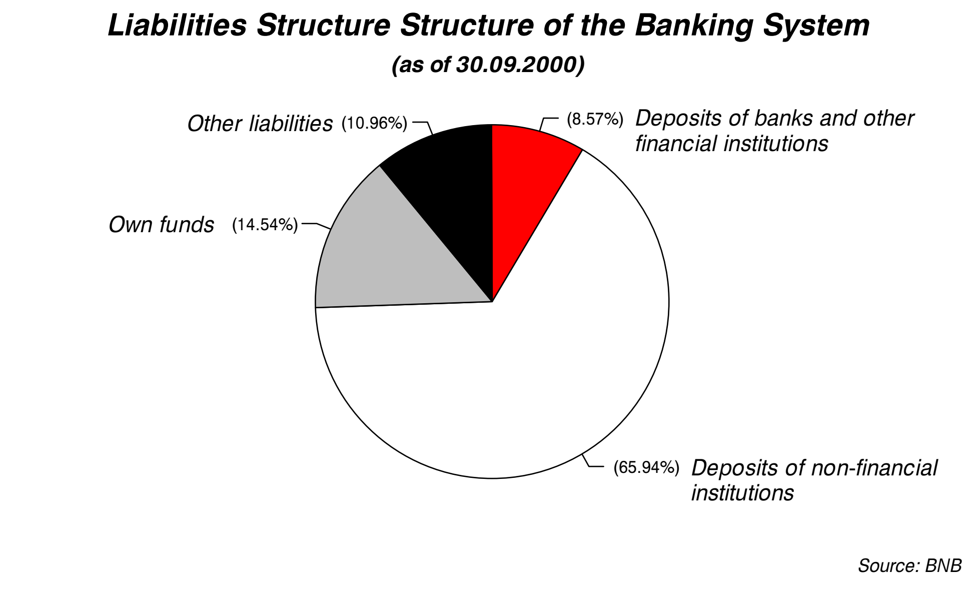
(as of 30.09.2001)

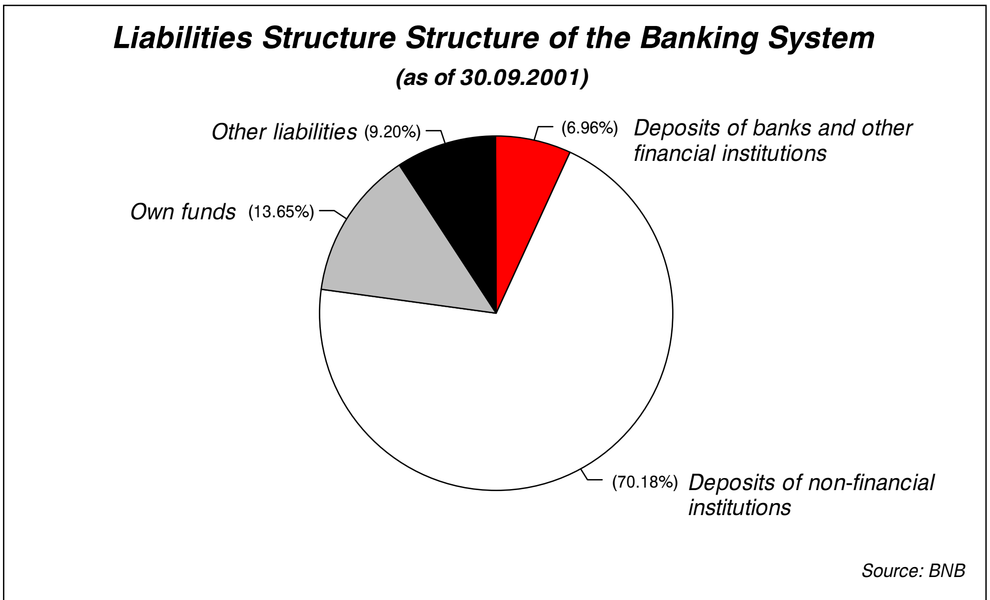


Source: BNB

In the nine months of 2001, bank claims on private enterprises, households and state-owned enterprises increased by 21% (BGN 488.3 million), 36.5% (BGN 207.4 million), and 8.7% (BGN 9.7 million) respectively. The overall growth of credits extended to non-financial institutions and other clients reached 26.3%, considerably exceeding the reported 17% increase over the same 9-month period in 2000. In the three quarters of the current year, claims on banks and other financial institutions stepped up by 10.6% (BGN 412 million) against some 58% reported a year earlier. The registered changes in the structure of bank assets are yet another indicator that the interaction between the real sector and commercial banks has been strengthened in 2001.

On a year earlier, no substantial changes had been monitored in the bank system liabilities structure in the end-September 2001. The share of deposits of non-financial institutions and other clients had stepped by 4.2 percentage points up to 70.2% at the expense of the contracting relative share of the other





components of bank liabilities. In the January to September 2001 period, the deposits of non-financial institutions and other clients grew by 25.6% or BGN 1 635.6 million. For comparison, they increased by 21.4% or BGN 1 172 million in the same period of 2000. Foreign currency deposits of non-financial institutions alone stepped up by 30.8% or BGN 1 088.6 million. The outstripping growth of foreign currency funds invariably affects the decisions on the structuring of commercial banks' investment portfolio since banks are obligated to manage prudently the foreign currency risk in compliance with BNB's Bank Regulations.

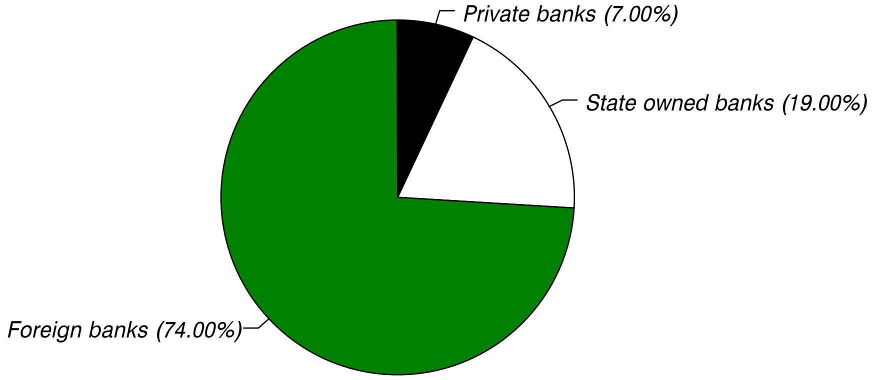
Structure of ownership, bank competition, and financial situation of the banking system. The bank capital ownership structure had a decisive role for the lowering of concentration and increasing of competition in the banking sector in 2001. As a result of bank privatisation in the preceding three years[4] , in end-June 2001 the share of bank assets in private hands amounted to 81%, with the share of foreign shareholder banks or branches alone reaching 74%.

The entry of foreign investors in the banking sector, accompanied with the introduction of new bank management and the development of new bank products and services triggered as early as 1999 a downward trend in concentration in the sector. The trend was sustained in the first half of 2001 when the Herfindahl Index fell to its lowest values (0.10) discerned in the whole transition period. With only one exception, all indicators on the degree of concentration in 2001 examined by the AEAF registered their lowest values. It

[4] *According to the government's preliminary intentions, privatisation in the banking sector ought to have been completed by the end of 2000. As of September 2001, however, the third and fourth largest (according to balance sheet size) banks in the country still remained state-owned.*

Ownership Structure of Bank Assets

(as of September 2001)



Source: BNB

is therefore evident that competition in the banking sector sustained its upward trend.

On a 12-month basis, the lowering of the degree of bank assets concentration in the first half of 2001 is associated with the ongoing operational restructuring of the banks privatised in recent years (*Bulbank*, *Expressbank* and *Hebros Commercial Bank*), the assertive market strategy of some of the average-sized private banks (*First Investment Bank*, *Economic and Investment Bank*) and the entry of new foreign banks on the Bulgarian market (*Citibank*).

Measures of Concentration in the Banking Sector

	12'91	12'93	12'95	12'97	12'99	06'00	12'00	06'01
Bank Assets								
Herfindahl Index	0.38	0.30	0.14	0.27	0.12	0.11	0.11	0.10
Concentration Coefficient (%)	80.9	73.4	60.0	72.3	57.0	55.6	55.2	53.0
Claims on Non-financial Institutions and Other Clients								
Herfindahl Index	0.18	0.24	0.14	0.14	0.08	0.08	0.07	0.07
Concentration Coefficient (%)	69.2	66.0	57.8	62.4	43.6	43.6	42.0	41.3
Deposits on Non-financial Institutions and Other Clients								
Herfindahl Index	0.15	0.15	0.13	0.15	0.13	0.13	0.13	0.12
Concentration Coefficient (%)	66.2	57.3	54.3	65.8	61.7	61.1	62.2	58.8

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

In the first half of 2001, the concentration of claims on non-financial institutions also fell to its lowest level in the whole period of economic transition. This dynamics had to do with the changes in the market behaviour of two of the large Bulgarian banks, namely *Bulbank* and the *Bulgarian Post Bank* as credit lending to firms and households was prioritised in their new market strategies. On the other hand, the lowering of the concentration coefficient of credit to non-financial institutions suggests increased competition among banks for the attraction of prime-rate borrowers. The current number of such borrowers in Bulgaria is relatively small inasmuch as the bulk of companies have no long history of creditworthiness.

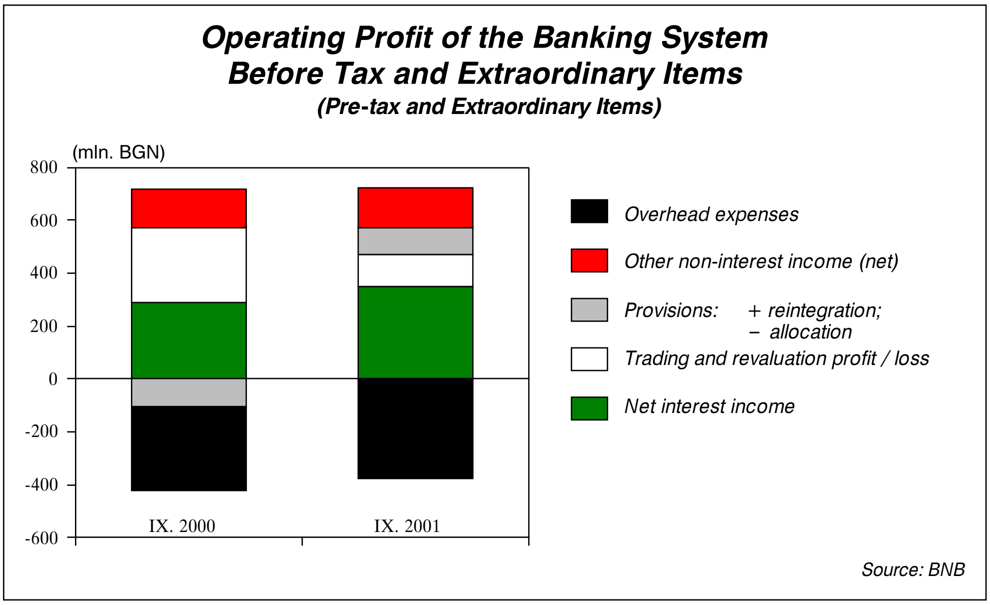
The sustained abatement of the Herfindahl Index and the concentration coefficient with regard to attracted resources from non-financial institutions observed in 2001 is a sign that the developed branch network of some commercial banks (e.g. *DSK Bank*) is no longer a sufficient prerequisite for the attraction of companies' and households' deposits alike. The banks with a moderately developed branch structure offering, however, the latest bank products and high quality service gain more and more competitive advantages.

In the nine months of 2001, the Bulgarian banking system maintained its good financial situation. On a 12-month basis, the rate of return on commercial banks' assets as of end-September 2001 amounted to 3.5%

and was roughly equal to the figure reported a year earlier. While the relatively high level of the indicator in 2000 was mainly due to *Bulbank*'s profit[5], in 2001 the contribution of the other commercial banks to the sustained high value went on the increase.

In the January-September 2001 period, commercial banks' net profit amounted to BGN 274.9 million, stepping up by 15.1% (BGN 36.1 million) on a year earlier. The reported profit of the three largest Bulgarian banks over the same period accounted for 73.9% of total profit as compared to 87% as of end-September 2000. The lower profitability of small banks suggests that future mergers may lead to a restructuring of the banking sector. In practice, the process of bank consolidation has already begun as average balance sheet size commercial banks had acquired financial institutions in liquidation. Two such acquisitions were registered in the nine months of 2001.

The structure of commercial banks operating profit in the January-September 2001 period underwent some changes on a year earlier. Thus, the shares of net interest income, net income from trade and net income from commissions and fees went on the decrease as a result of the considerable income from the reintegration of provisions reported in the first half of 2001 in particular. Inasmuch as incomes from the reintegration of provisions are irregular, their weight in operating profit is likely to decline by the end of the year. The net interest income/operating expenses ratio ran at 93.6% in end-September, reporting a 1.3 percentage point year-on-year increase. The value of this indicator is a sign of the growing capacity of the banking sector to cover its operating expenses with its operating profit. At the same time, the growth rate of commercial banks' operating expenses in 2001 was close to the one registered in the previous year irrespective of the downward trend in interest rates.

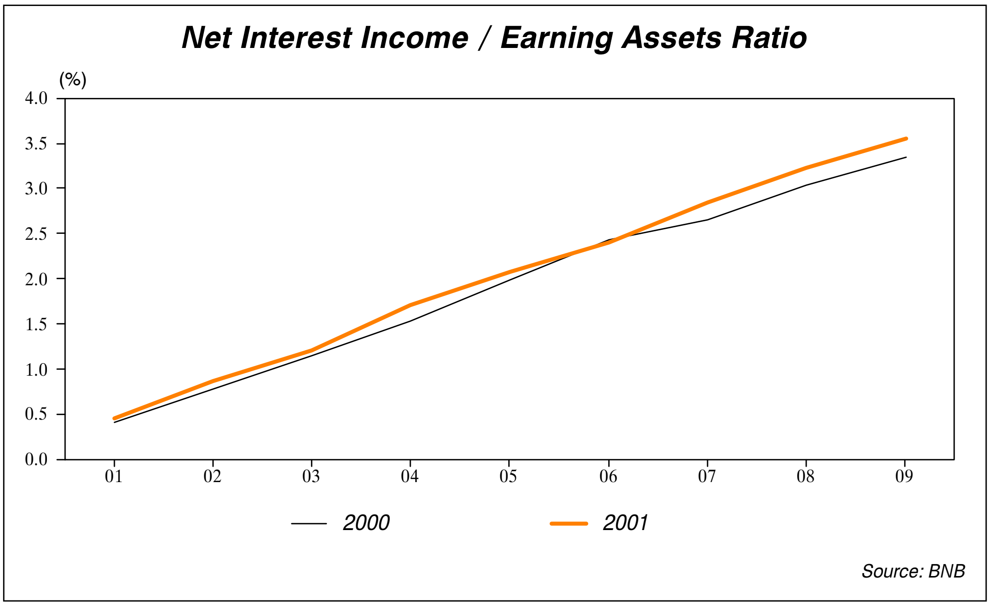


The dynamics of net interest income/earning assets ratio is also indicative of the higher banking system efficiency. In most of the reviewed months in 2001, this ratio's values remained higher than its respective values discerned in 2000.

In the first half of 2001, commercial banks' capital adequacy indicators sustained significantly higher levels than those fixed by BNB's Ordinance No8. The observed increase in credit activity, however, had inevitably resulted in lower capital adequacy. As of 30 June 2001, the banking sector overall capital adequacy reached 32.05%, stepping down by about 6 percentage points relative to end-June 2000. On a 12-month basis (end-June 2001 to end-June 2000), the indicator's two principal components, viz. the total

[5] *Having to do with the sale of* Bulbank*'s shares in other financial institutions.*

risk component of the sector assets and the capital base had increased by 27.3% (BGN 943.5 million) and 7.6% (BGN 99.5 million) respectively.



Commercial banks credit portfolio had improved relative to end-June 2000. Thus, in June 2001, some 92% of bank risk exposures were classified as standard against 88.9% in June 2000. In the end of the first half of 2001, some 2.74% of credit exposures were classified as a loss as compared to 5.6% in end-June 2000. This dynamics is in support of the conclusion that the improvement of credit risk management has been an important element of the banking system restructuring in recent years.

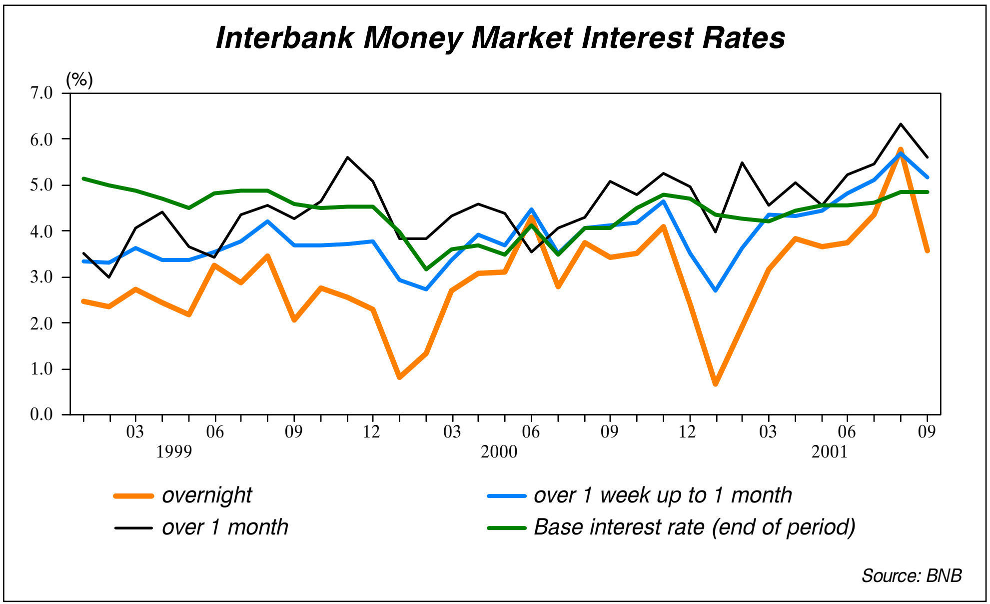
As of end-June 2001, banks continued to maintain relatively high liquidity although its level reported a substantial fall on a year earlier. In June 2001, the banking sector primary liquidity indicator (foreign bank branches excluded) ran at 9.07% against 13.03% in June 2000. The value of secondary liquidity indicator amounted to 19.91% against 30.56% reported in June 2000.

The requirements on commercial banks' activity stipulated in some EU Directives[6] were fully transposed in the Bulgarian legislation with the Law on the Amendment of the Commercial Code passed in October 2000. The amendments are expected to accelerate and improve court bankruptcy procedures and remove the contradictions in law enforcement in Bulgaria. The steps undertaken in the nine months of 2001 to harmonise Bulgarian legislation with the *acquis communautaire* have not yet resulted in a visible speed-up of bankruptcy procedures.

Money and Foreign Exchange Markets

Money markets. Since January 2001, the BNB announces the *base interest rate* (BIR) determined by the yield on 3-month treasury bills achieved at the primary auction every second week instead of on a weekly basis. In the nine months to September 2001, the new methodology did not affect the BIR dynamics as the latter continued to follow the dynamics of the BGN liquidity of the banking system. In early-2001, when commercial banks BGN liquidity sharply increased as a result of the received substantial net budget payments on government securities, the BIR fell to 3.96% in the beginning of February. Thereafter, the base interest rate started to increase, however gradually and waveringly, reaching 4.76% in mid-September.

[6] *Four EU Directives, including* inter alia *Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State and Twelfth Council Company Law Directive 89/667/EEC of 21 December 1989 on single-member private limited-liability companies.*

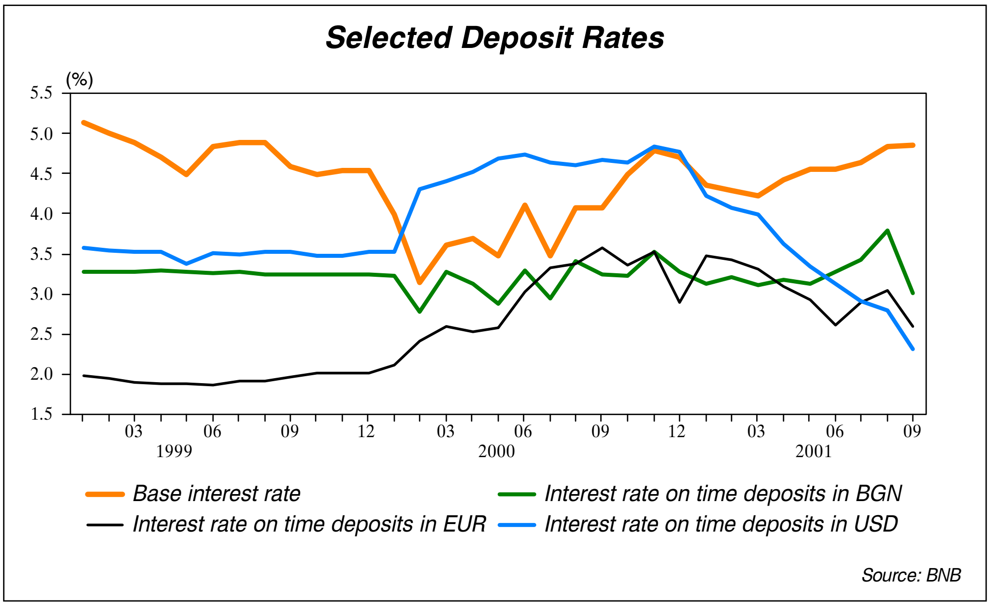


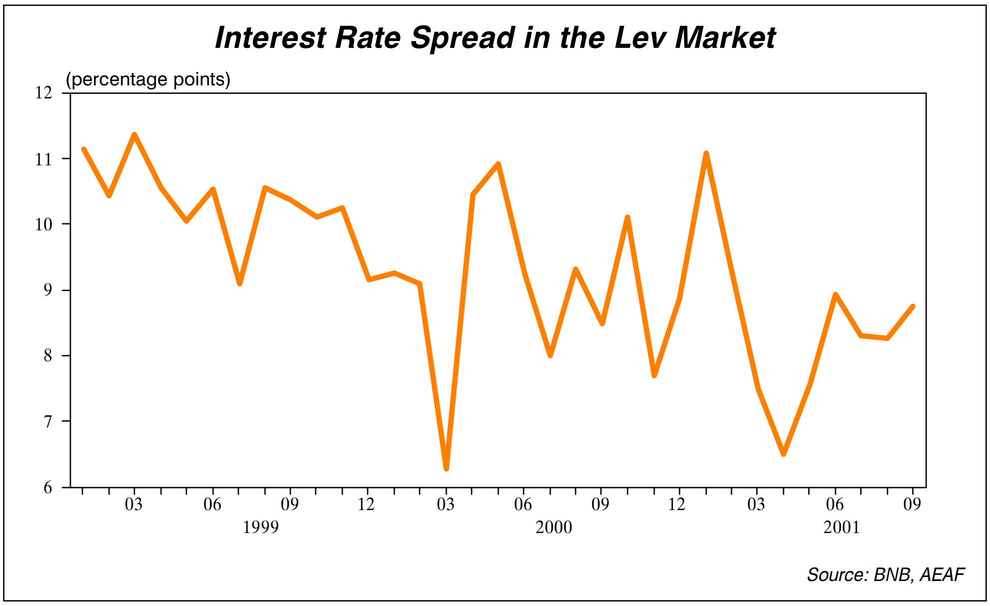
Throughout most of the January to September period, *interest rates at the interbank money market in BGN* remained very low, even falling below the BIR. Their dynamics was primarily influenced by the net payments on government securities made by the budget. Yet, the monthly transfers of taxes ordered by client companies, the bank transfers of subsidies and pensions from the budget and, last but not least, the monthly regulations of the minimum required reserves had also affected the dynamics of these interest rates. It is also an interesting phenomenon that interest levels at the interbank market of placements in BGN did not follow the interest rate dynamics at the international markets.

It is noteworthy though that not all commercial banks had succeeded in improving the efficient management of their free resources as proved by the increased volatility of interbank market interest rates. Thus, in January the shortest-term interest rate on interbank placements reached 0.69% average daily as compared to the 5.9% average daily interest reported in April. August saw the average daily interest rates peaking to their highest level of 15.6%. In the same month, longer-term interbank market interest rates sharply exceeded the base interest rate.

The *volumes of interbank market placements* followed a clear-cut upward trend. While the average daily volumes of interbank placements in 1999 amounted to BGN 35.6 million, in 2000 they increased to BGN 55.6 million, stepping up again in the nine months of 2001 to reach BGN 78.5 million. The expanding interbank trade is indicative that commercial banks had nevertheless been striving to manage more effectively the maturity structure of their portfolios. Increased competition in the Bulgarian banking system is of particular importance in this respect. Simultaneously, the increasing instability of the international financial markets also encouraged trade at the domestic interbank market in 2001.

In 2001, the dynamics of *deposit interest rates* both in BGN and foreign currencies remained relatively stable, proving that the BIR dynamics brings no pressure to bear on commercial banks' deposit interest rates policy. The fluctuations of interest levels on time BGN deposits monitored in the nine months of 2001 were primarily a result of banks' attempts to diversify interest terms depending on volumes and length of time. In the January to September 2001 period, average interest rates on BGN and foreign currency deposits followed differing dynamics. Whereas interest levels on bank deposits in BGN followed a slight upward trend until end-August, interest rates on forex deposits, and deposits in USD in particular, stepped down in compliance with international interest rate dynamics. In September, interest on both BGN and forex deposits went down. Time deposits in USD reported the most tangible fall over the nine-month period in question, stepping down from 4.77% average weighted value in end-December 2000 to 2.31% in end-September. Interest rates on BGN deposits decreased by 0.8 percentage points (to 3.01%) in September 2001 alone. Interest levels on forex deposits in Bulgaria are expected to drop further by end-2001 in view of the new interest rate decrease at the international market triggered by 11 September 2001 events in the USA.





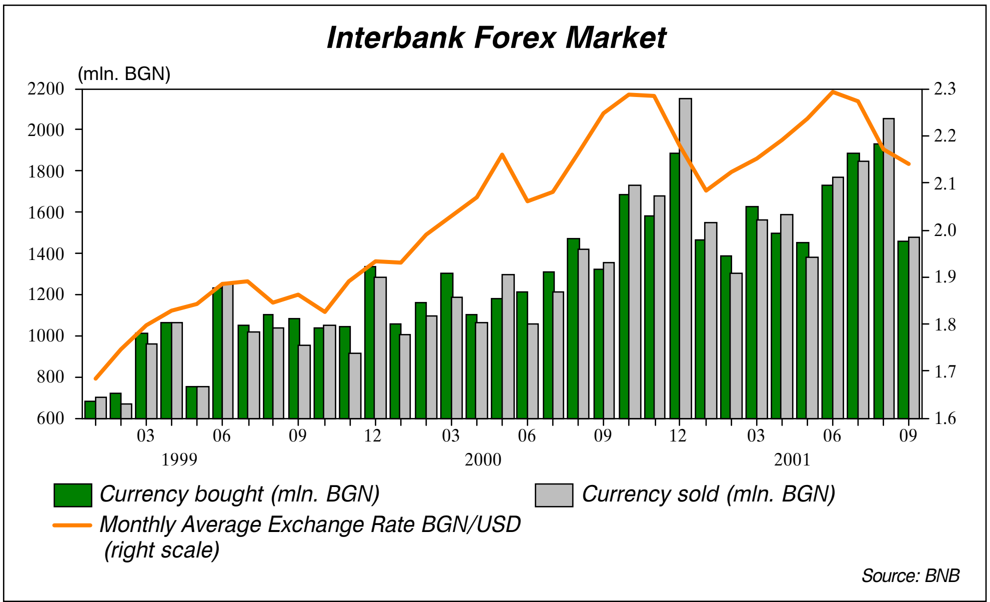
Commercial banks' lending rate policy remained almost unchanged in 2001. Regardless of the monitored since mid-2000 overall decrease of *credit interest rates* offered by Bulgarian commercial banks, the spread between average deposit rates and lending rates remained wider in comparison with most Central and Eastern European countries. In contrast to 1999, when interest on short-term credits exceeded time deposit interest by more than 10 base points in all quarters of the year, in 2000 and 2001 the interest difference embarked on a certain downward movement. The average interest spread shrank from 10.5 points in the seven months of 1999 to 9.0 points and 8.8 points in the respective periods of 2000 and 2001. The lending spread between short-term and long-term borrowing in BGN remained stable in contrast to the foreign currency segment of credits wherein lending price fluctuations did not follow a clear-cut and singular trend.

Foreign currency market. In the first half of 2001, the Single European Currency gradually depreciated to the US dollar. The USD/EUR exchange rate fell from 0.94 USD/EUR in early 2001 to 0.84 USD/EUR in early-July 2001. Thereafter the EUR began to appreciate as a result of the growing apprehensions for recession in the USA. On the other hand, the interest level lowering in the USA outstripped the interest rate reductions in the Euro area thereby leading to an interest difference favouring the EUR. On a year earlier, being pegged to the EUR and following its dynamics the BGN depreciated by 5% on average to the USD in the nine months to September 2001.

In end-September 2001, the BGN registered a 4% appreciation to the USD relative to end-September 2000.

In the January-September 2001 period, banks were net buyers of foreign currency at the interbank forex market with the amount of purchased currency exceeding the currency sold by BGN 47.3 million.

Given the trends in the BoP dynamics in 2001, the substantial purchases of foreign currency by the banks seem surprising. The considerable volume of foreign currency circulating in the country remains the only possible explanation for this phenomenon. Banks, however, will gradually absorb these quantities with the expansion of financial intermediation in the country. The structure of transactions by foreign currency at the interbank market underwent substantial changes in the reviewed 9-month period. In September, the share of USD transactions stepped down to 33.3% of total trading against 38.2% recorded in end-2000 and 52.3% in September 2000. At the same time, the sizeable increase in the share of transactions in EUR and other European currencies at the Bulgarian interbank forex market is indicative of the ongoing accelerated EU integration of the national economy.



In the first half of the year, the BNB purchased Deutsche marks to the amount of BGN 73.1 million, with the value of these buys remaining almost unchanged on a year earlier. The amount of DM sold at the BNB's cash desks ran at BGN 7.9 million in the period January to early July 2001, recording an annual increase of BGN 1.5 million. The volumes of BNB cash purchases of DM are likely to step up in the remaining months of 2001 induced by the introduction of the Euro coins and banknotes in the beginning of 2002 and the withdrawal from circulation of the Euro area currencies.

Non-bank Financial Institutions and the Capital Market

Pension funds. The implementation of a modern legal framework for the operation of the private pension funds in 2000 was the first step toward limiting state intervention in the functioning and management of the pension system. In the first nine months of 2001 nine private pension insurance companies licensed by the State Insurance Supervision Agency in end-2000, along with the respective occupational, universal and voluntary funds, were set up. These are authorised to manage the funds raised through the supplementary voluntary and supplementary mandatory pension insurance schemes[7].

[7] *POK „Doverie“ AD, POK „Saglasie“ AD, „Balgarsko pensionnoosiguritelno druzhestvo“ AD, SKPOK „Rodina“ AD, POD „Allianz Bulgaria“ AD, „ING Pensionnoosiguritelno druzhestvo“ AD, POAD „Newton-Sila“ and „Berlinische Leben“. The shareholders of the last company decided to dissolve it by the end of the year.*

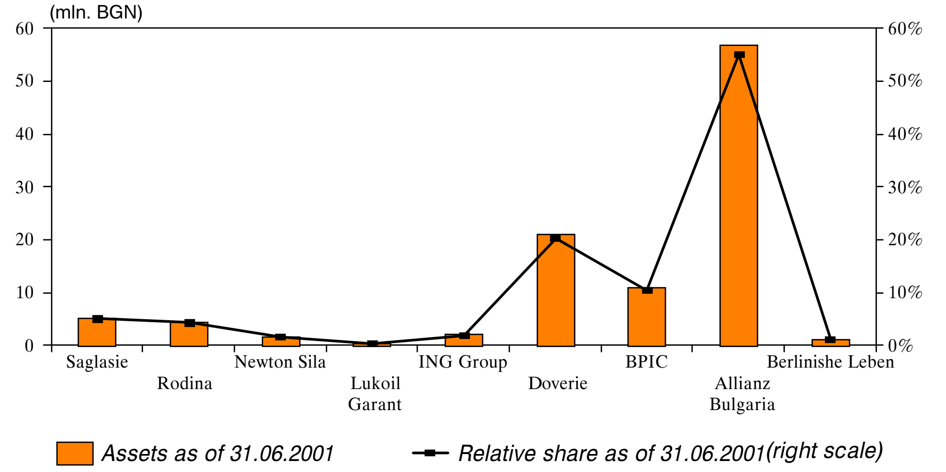
February 20, 2001 was the deadline for choosing an *occupational pension fund* for employees in labour categories I and II, who are insured by their employers for early retirement. Some 112 658 applications were filed before the deadline[8]. The funds for early retirement of labour categories I and II workers had previously been accumulating with the National Social Security Institute (NSSI), since the licensing of pension funds had run late. As of 1 August 2001 the savings transferred from the NSSI to the nine occupational pension funds amounted to BGN 35 673 000 and the total number of the persons insured was 131 393 with 10% of the applications being filed twice or more. The total amount of funds raised under the second pillar of the pension system is small but these will increase substantially in 2002, when the supplementary voluntary pension insurance in universal funds will come into force.

Some 633 158 applications for participation in the licensed *universal pension funds* were filed with the NSSI through mid-2001, accounting for about 60-70% of the expected total number of persons eligible for insurance in universal pension funds. This figure is probably an overestimate and the actual participation rate is lower since one person may file applications for more than one pension fund.

The assets of the *voluntary pension funds*, which are the third pillar of the pension system, increased by 58.06% to BGN 103.40 million in nominal terms in the first half of 2001 as compared to the respective period of 2000. They are very concentrated. The assets of the voluntary pension fund managed by the pension insurance company „Allianz Bulgaria" AD comprise more than half of the total assets of the voluntary pension funds. The two largest voluntary pension funds – those of the pension insurance companies „Allianz Bulgaria" AD and POK „Doverie" AD – had under their control more than 75% of the resources pooled in this segment of the pension system as of 30 June 2001. It is expected that by 2003[9] the share of „Allianz Bulgaria" AD will go down to 33.5% and that of POK „Doverie" AD will drop to 24.7%. This is an indication that competition among the different pension insurance companies for increasing the assets of the pension funds under their control will intensify. As a result of this the assets of the voluntary pension funds will get more evenly distributed among them.

The ratio of pension funds assets to national savings reached 3.22% in the first half of 2001 against 2.79% for the same period of 2000. The ratio of pension funds assets to GDP stood at 0.38% in the first half of 2001, up by 0.1 percentage points as compared to last year. The upward trend in those ratios attests to the

Assets of Voluntary Pension Funds

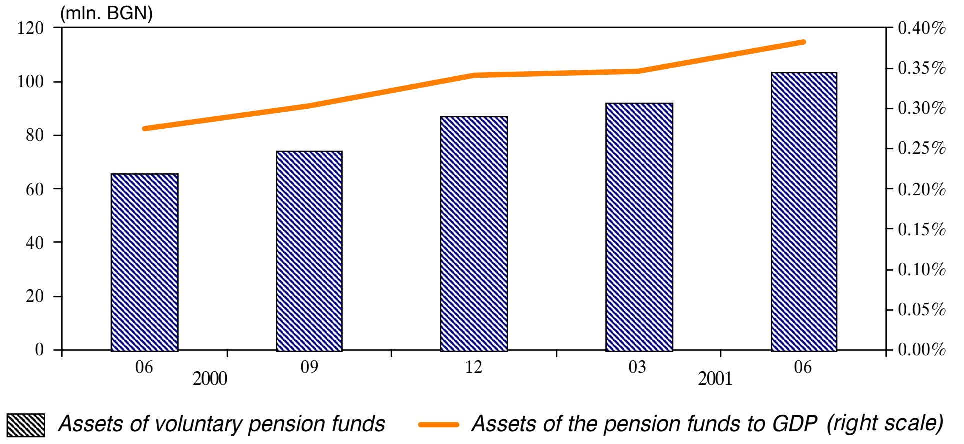


Source: State Insurance Supervision Agency

[8] *According to the Bulgarian Association of Voluntary Pension Insurance Companies Newsletter, Issue 3, 2001.*
[9] *State Insurance Supervision Agency Newsletter, Issue 1, 2001.*

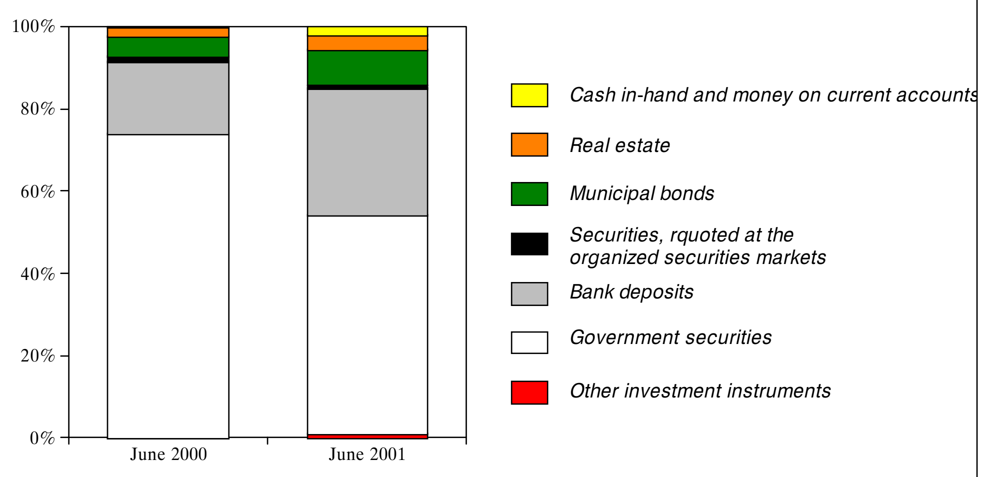
growing role of pension funds as financial intermediaries. However, Bulgaria is considerably behind the degree of financial intermediation of pension funds found in the other pre-accession countries. In Poland, for instance, the ratio of pension funds assets to GDP in 2000 was already 1.45%, a fact that brings out the cost of delayed pension system reforms in our country.

Assets of Voluntary Pension Funds



Source: State Insurance Supervision Agency, Bulgarian Association of Supplementary Pension Insurance Companies, AEAF

Investment Portfolio of Voluntary Pension Funds



Source: State Insurance Supervision Agency

The activities of the pension funds on the financial markets in the period January-June 2001 were limited. Pension funds continued to invest on the domestic market, primarily in government securities and bank deposits. This is a result both of the slow progress in financial market development in Bulgaria during the first half of 2001 and of stringent legal requirements with respect to the financial instruments pension funds are allowed to invest in.

In the first half of 2001, the share of government securities in total pension funds investment reported a significant reduction, stepping down from 73.95% in the first half of 2000 to 53.13%. In the period considered, the share of bank deposits increased from 17.58% to 30.80%. This shift in the composition of pension funds portfolios is mainly due to the smaller volumes of government securities issues at the end of 2000 and in early 2001. The downward trend in the share of government securities in pension funds assets will probably continue as a result of the expected tight fiscal policy until the end of the year and the tendency for total pension funds assets to grow over time.

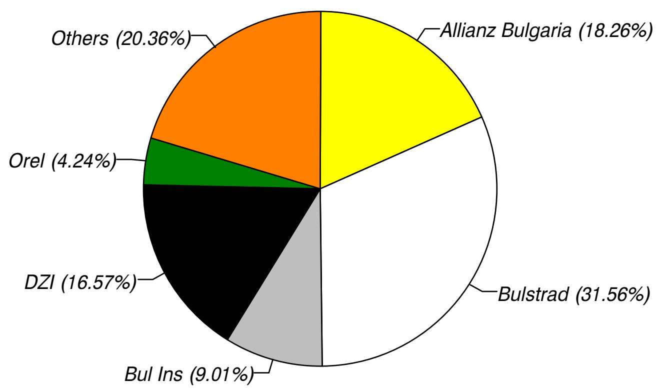
In the period January-June 2001 pension funds investments in municipal securities increased from 4.77% to 8.76% while property investments mounted from 2.18% to 3.40%. Investments in local companies' equity declined from 1.52% to 0.80% as a consequence of the low liquidity of the country's capital market. So far, none of the pension funds has used the possibility to invest up to 10% of their resources abroad. The latter fact can be explained by the funds' insufficient experience in corporate management.

Insurance companies. Insurance intermediaries recorded gross premium income of BGN 387 645 000 in 2000[10], while only in the first quarter of 2001 this figure reached BGN 106 491 000 or 27.47% of the income for the whole 2000.

The ratio of gross premium income of all companies operating in either life insurance or general insurance to GDP in the first quarter of 2001 stood at 1.81%. The same indicator was 1.36% in 1999 and 1.52% in 2000[11]. This also corroborates the growing importance of insurance companies as financial intermediaries. Still, insurance companies are not yet in the position to offer serious competition to banks in attracting savings.

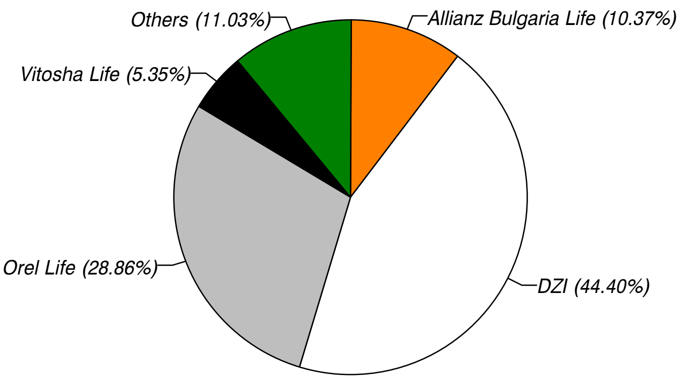
Market concentration in the insurance sector remains substantial in 2001. The three largest companies ZPAD „Bulstrad", ZPAD „Allianz Bulgaria" and „DZI General Insurance" hold 66.39% of the general insurance market. Concentration in life insurance is even bigger. The three largest companies in this segment – ZK „Allianz Bulgaria Zhivot", DZI EAD and ZK „Orel Zhivot" – recorded gross premium income of BGN 9 041 000 or 83.62% of the premiums collected in the whole life insurance segment.

Structure of Gross Premium Income in Non-Life Insurance (as of 01.04.2001)



Source: Association of Bulgarian Insurers

Structure of Gross Premium Income in Life-Insurance (as of 01.04.2001)



Source: Association of Bulgarian Insurers

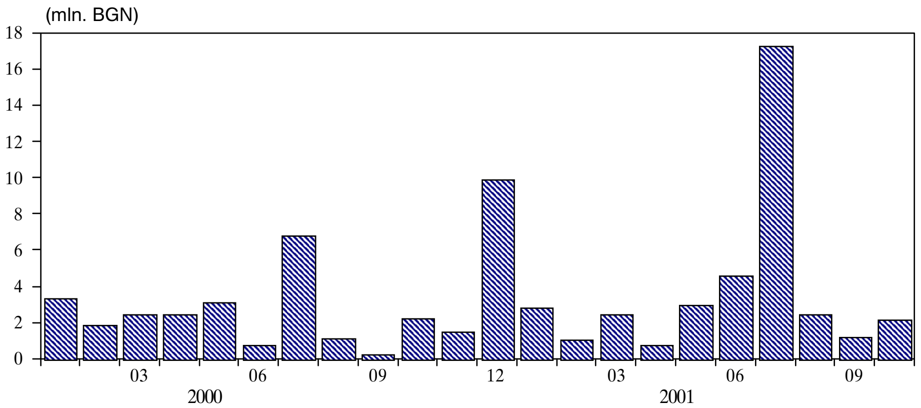
Insurance companies, like pension funds, invest mainly on the domestic market in government securities and bank

[10] *According to data provided by the Bulgarian Insurers Association.*
[11] *According to data provided by the Bulgarian Insurers Association.*

deposits. This is explained by the low capital market liquidity in the country, taken in conjunction with the lack of diverse financial instruments. In 2000 life insurance companies' investment portfolios comprised 70.7% government securities and 15.9% bank deposits. The investment portfolios of the companies in the general insurance segment also feature primarily government securities and bank deposits but the share of deposits is larger than that of government securities – 53.06% and 38.67% respectively. The reason for the different composition of the portfolios of the two types of insurers is the greater need for liquidity in the general insurance segment.

Capital market. The Bulgarian capital market remains underdeveloped in 2001 as well. This is evidenced by the small volumes traded on the Bulgarian Stock Exchange (BSE). These volumes are practically negligible when compared to the volumes traded on the world's leading stock exchanges or even the stock exchanges of the countries in Central and Eastern Europe (CEE). The main reasons can be traced to the lack of diverse financial instruments on the newly emerged stock market in the country as well as the low savings rate.

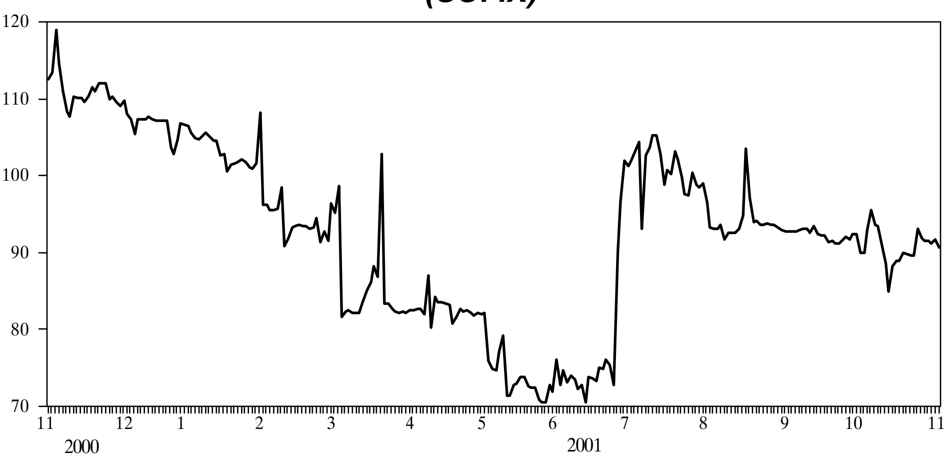
Bulgarian Stock Exchange (Sofia)*, Trade Volume



** Block deals not included (block deals are traded over the counter, but they should be registered at the Stock Exchange*

Source: Bulgarian Stock Exchange - Sofia

Bulgarian Stock Exchange Index (SOFIX)



Source: Bulgarian Stock Exchange - Sofia

Although the volumes traded on the BSE are not large, there is a marked increase in the first nine months of 2001 against the same period of 2000. The total volumes traded in the nine months amounted to BGN 35.24 million or 61.36% higher than January-September 2000. The bulk of the trading was done in the third quarter of 2001. In July 2001, the turnover on the official and over-the-counter market was BGN 10.52 million higher than that of July last year, reaching a two-year peak of BGN 17.28 million.

The official stock exchange index SOFIX, which was introduced in October 2000, also indicates that trading on the BSE is picking up after the slump throughout the first half of the year. The index is constructed as the ratio of the total market capitalisation for the respective day of the companies covered over that for the previous day. SOFIX declined 28.67% in the beginning of June 2001 as compared to January 2001: down to 76.05 from 106.61 points. End-June 2001 witnessed a rapid turnaround in the capital market developments, with SOFIX soaring to 96.52 points. This is explained by the decision of the majority shareholder in „Solvay Sodi“ to buy back minority shares at a price much higher than the market one. Another reason for the upswing on the BSE in the third quarter of 2001 is the increased investor interest in the liquid equity of „Lucoil Neftochim“ and „Bulgartabac“. This brought about a substantial increase in the prices of their shares with a consequent pickup in trading. Thus, SOFIX crossed the 100 point mark and stayed above that level throughout most of July 2001. ❑

CONCLUSION

The analysis of Bulgaria's economic development in the nine months to September 2001Bulgaria made in the current Survey suggests that Bulgaria entered 2001 with expectations for a high economic growth rate and a sharp increase in the standard of living. These expectations were nurtured by both the registered 5.8% annual GDP growth rate in 2000 – the highest since the start of transition to a market economy – and the pre-election programmes of political parties in the General Elections held in June.

The optimistic expectations and the pre-election context had to a great extent shaped the economic policy carried out in the first half of the year. The bulk of politically unpopular measures underlying the annual economic restructuring and privatisation programmes were either postponed or partially implemented. In April 2001, the government unexpectedly announced an additional annual investment programme worth BGN 300 million. Some BGN 178 million of the appropriated funds had been disbursed only in the subsequent two months. At the same time, the negative signs of an aggravating external environment and the widening of the BoP current account deficit after March 2001 were belittled by the local economic agents due to the asymmetry of available information. The importance of the medium-term planning of external balance of payments financing as a buffer against shocks had also been underrated.

The absence after May 2001 of an adequate to the changing macroeconomic conditions external balance of payments support and the severe blow to the global economy caused by 11 September tragic events in the USA put on the agenda the requirement for economic adaptation so as to forestall any durable undermining of macroeconomic stability that would jeopardise confidence in the currency board arrangement. Set in this context, the policy measures of the newly elected government to sharply reduce the budget deficit in the last quarter of 2001 and to rapidly issue Eurobonds are not unexpected. The international financial community in the person of the IMF and *Standard & Poor's* approved of them. The credit rating of the country was improved by the agency almost immediately after the news about (i) the agreement reached with the IMF on the key parameters of Bulgaria's 2002 economic policy and budget, and (ii) the launch of the marketing campaign for the Eurobonds issue through the leaders on this market, viz. *JP Morgan* and *Morgan Stanley*.

The fourth quarter of 2001 is expected to witness slower economic growth rates as a result of the declining external demand for Bulgarian exports and the government measures to tighten fiscal restrictions. A relatively higher curb in imports and government purchases will probably accompany the slowdown in growth rates. The growth rates of consumption and investment will slacken to a lower extent since the growth potential on the supply side remains high. Given an adequate reaction of financial intermediaries and financial markets, money stock growth rates are also expected to decrease temporarily. This will additionally attenuate, and in practice will rule out, the possibility for any increase of inflationary expectations and, in fact, of the inflation rate itself by end-2001 and early-2002.

The measures aimed at overcoming the existing imbalances in the Bulgarian economy are not expected to hold up long-term economic growth. Such a conclusion is also supported by the parameters of the recent government 2002 draft-budget that is currently under consideration by the National Assembly. ❑