BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2002
(semiannual survey)

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EXECUTIVE SUMMARY

In the first half of 2002, the pace of economic growth in Bulgaria accelerated regardless of the slower recovery of global economy and the economies of the country's major trade partners. The attained 4.3% growth rate is one of the highest among all EU applicant countries and, similar to 2001, all main economic sectors had a positive contribution to growth. Domestic demand remained the single growth-driving factor, with investment in fixed capital increasing by 8.1%. The extremely rapid growth of investment demand notwithstanding, the gross investment to GDP ratio in Bulgaria (19.2%) ran lower in comparison to most of the other EU candidate countries. The 4.6% labour productivity increase in the first six months of 2002 was conditioned by the outstripping growth rates of gross value added relative to the number of employed in the economy and can be seen as a sign that competitiveness economy-wise is going on the increase at a relative fast pace. In June 2002, the number of employed stepped up by 1.8% against June 2001 while its average year-on-year growth in the first half of the year ran at 1.1%. The unemployment rate reached 17.6% in June, falling by 1.8 percentage points on a year earlier.

In the eight months to September 2002, cumulative inflation ran at 0.6% – the lowest rate of CPI growth reported in the corresponding 8-month period since the start of transition. End-year cumulative inflation is expected to remain below 3.5-4%. The overall price growth in the first quarter of the year exceeded the initially forecasted level mainly due to the still wavering inflationary expectations in the country after the 1996-1997 economic and financial crisis. The following months witnessed a downward price adaptation in contrast to all previous inflation rises triggered by administered price adjustments in the transition period demonstrating that the Bulgarian economy responds to price shocks in a more predictable way in consistence with market macroeconomic theory. Average annual inflation in the eight months to September dropped to 5.9%, remaining however well above the average in the EU member states.

Public finances and the currency board are stable. Over the first six-month period of 2002, the general government budget cash deficit recorded a year-on-year rise of 0.6 percentage points of GDP, reaching 1.9% of GDP. The primary and domestic deficits of the general government budget however contracted by 1 and 0.8 percentage points of GDP respectively and amounted to 4.9% and 4.5% of GDP. Budget revenues steadied, remaining close to initial expectations. Control over budget expenditures was further optimised thereby allowing to gradually increase their flexibility. These developments, together with government debt restructuring operations, brought the debt/GDP ratio down to 58.2% in end-August 2002. BNB's gross forex reserves stepped up by 1.1% against end-2001 and peaked to an all-time high since the introduction of the CBA, reaching BGN 8 034.3 mn in end-July 2002.

The positive trends in the dynamics of the balance of payments current account and of bank lending to the private sector have been strengthening since the second quarter of 2002. In the first half of 2002, the difference between the monthly growth rates of exports and imports narrowed on a year earlier as a token of the enhanced stability of the main macroeconomic indicators, the rising competitiveness of the economy and the predictability of the business environment. Moreover, it led, together with the improvement of the services balance, particularly noticeable in June and July, to a 0.2 percentage points of GDP year-on-year contraction of the current account deficit in the seven months to August 2002. Bank credit to the non-government sector expanded by 21.3% or BGN 949.3 mn over the December 2001 – July 2002 period exemplifying both the international financial markets dynamics and the increased competition in the banking sector following its divestiture. The quality of commercial banks' portfolios went on improving.

The restructuring of the public sector continued and the government efforts were now targeted at the liberalisation of state-owned monopolies and further restructuring of the budget sphere. The government has already selected potential buyers for two of the large SOEs earmarked for privatisation (*Bulgartabac* and *BTC*), however the finalisation of both deals by end-2002 is unlikely. The preparation for liberalisation of the energy market is underway in conformity with the Energy Strategy of Bulgaria adopted by Parliament in early-2002 and the accompanying action plan. A further step in the accomplishment of the complete divestiture of the banking sector was made in July 2002 with the sale of *Biochim* Commercial Bank.

The abovementioned trends and developments point out that economic policy has responded adequately to the aggravating external environment in the last quarter of 2001 thereby helping to strengthen the confidence of the international financial community in Bulgaria in the following nine months of 2002. Increased confidence found its manifestation first and foremost in the raising of the country's credit rating by the leading international credit rating agencies (with the exception of Moody's), the substantial progress attained in the negotiations for EU membership and the positive assessments of the IMF and the World Bank of the reform progress in Bulgaria. The European Commission already recognised Bulgaria as a functioning market economy that should be able to cope with competitive pressure in the mid-term in its 2002 Regular Report on Bulgaria's Progress towards Accession.

In the first half of 2002, most of the welfare indicators did not change dramatically thereby substantiating the hypothesis of the time lag between the increase of growth and competitiveness, on the one hand, and the raising of welfare and the living standards, on the other. Over the January-June 2002 period, both private and public sector average real wages went on the increase on a year earlier, stepping up by 0.2% and 0.8% respectively. However, the average real wage economy-wide decreased by 0.2% due to the dynamics of the number of employed. In the first six months of 2002, real disposable income fell by 2.8% since the decline in the tax burden could not offset the raising of social and health insurance contributions.

EXTERNAL ENVIRONMENT

Growth

The performance of the world economy is still falling short of expectations that it would rebound from recession as early as the second half-year period of 2002. IMF forecasts of September 2002 point to growth of only 2.8% in 2002 and 3.7% in 2003. At the same time, the growth estimates of independent forecasters like the Economic Intelligence Unit (EIU) are more optimistic running at about 2.9% in 2002 and 3.9% in 2003. JPMorgan Chase Bank, however, expects a lower growth rate of 1.6% in 2002 and 2.8% in 2003 respectively.

The world biggest economy, i.e. the US economy reported growth of 0.3% in the first quarter and 0.8% in the second quarter of 2002[2]. Growth in the Euro-area over the same period amounted to a bare 0.2% and 0.6%. The international financial institutions expect the US economy to remain depressed well until the end of 2002. The 2002 and 2003 growth projections of the IMF of September for the US economy run at 2.2% and 2.6% respectively, also supported by the downward revisions in the growth estimates of independent forecasters[3]. The slower than expected recovery of the US economy was further underpinned by the loss of consumer and business confidence in the last couple of months due partly to the lower stock prices amidst corporate disarray. Despite the steady depreciation of the USD, the US economy ran sizable current account deficits that are expected to go as higher as 4.6% and 4% of GDP in 2002 and 2003.

2002 and 2003 Growth Estimates of Different Institutions

Institution	GDP Growth Estimates									
	World		USA		Euro-area		Japan		Germany	
	2002	2003	2002	2003	2002	2003	2002	2003	2002	2003
IMF[1]	2.8	3.7	2.2	2.6	0.9	2.3	-0.5	1.1	0.5	2.0
BNP PARIBAS**					0.9	2.2			0.5	1.9
JPMorgan Chase Bank	1.6	2.8	2.4	3.2	0.9	2.5	-0.3	0.8	0.5	2.1
KPMG' Investment Consulting Group			2.5	3.2*						
Economist Intelligence Unit	2.9	3.9	2.4	2.8	1.0	2.3	0.2	1.5		

* over the next five years
** of 6 September 2002

Growth in the Euro-area's biggest economies remained low as well, as follows: the German economy reported a contraction of -0.4% and -0.1% in the first and second quarter of 2002. Over the same period, GDP growth in Italy ran at 0% and 0.4%, in France at 1% and 1.1%, whereas in Great Britain it amounted to 1.2% and 1.3%.[4] As a whole these economies of the Euro-area failed to pick up speed and make good use of the short-lived recovery of the world economy in the first and second quarter of 2002, thus providing for sustainable growth in a longer perspective. All this accounts for the downward revisions in the growth

[1] *World Economic Outlook September 2002*
[2] *According to estimates of BNP Paribas.*
[3] *Thus for instance having being revised downwards from 2.9% and 3.2%, the growth estimates of the Economist Intelligence Unit of end-August run at 2.4% (2002) and 2.8% (2003) respectively.*
[4] *According to data released by BNP Paribas, Monthly Economic and Market Monitor, September 2002.*

IMF Growth Estimates for 2002 and 2003

Economy	*GDP Growth (on a year earlier)*					
	April 2002		*September 2002*		*Difference*	
	2002	*2003*	*2002*	*2003*	*2002*	*2003*
Euro-area	***1.4***	***2.9***	***0.9***	***2.3***	***-0.5***	***-0.6***
Germany	*0.9*	*2.7*	*0.5*	*2.0*	*-0.4*	*-0.7*
France	*1.4*	*3.0*	*1.2*	*2.3*	*-0.2*	*-0.7*
Italy	*1.4*	*2.9*	*0.7*	*2.3*	*-0.7*	*-0.6*
Spain	*2.3*	*3.2*	*2.0*	*2.7*	*-0.3*	*-0.5*
Great Britain	*2.0*	*2.8*	*1.7*	*2.4*	*-0.3*	*-0.4*
Switzerland	*0.8*	*2.6*		*1.9*	*-0.8*	*-0.7*
USA	***2.3***	***3.4***	***2.2***	***2.6***	***-0.1***	***-0.8***
Canada	***2.5***	***3.6***	***3.4***	***3.4***	***0.9***	***-0.2***
Japan	***-1.0***	***0.8***	***-0.5***	***1.1***	***0.5***	***0.3***
Brazil	*2.5*	*3.5*	*1.5*	*1.3*	*-1.0*	*-2.2*
Argentina	*-10/-15*	*0/-3*	*-16.0*	*1*	*-6.0/-1.0*	*1.0/4.0*
Turkey	*3.6*	*4.7*	*3.9*	*5.0*	*0.3*	*0.3*
CEE	***2.9***	***3.9***	***2.7***	***3.8***	***-0.2***	***-0.1***
Bulgaria	*4.0*	*5.0*	*4.0*	*5.0*	*0.0*	*0.0*
Estonia	*3.7*	*5.5*	*4.5*	*5.0*	*0.8*	*-0.5*
Latvia	*4.5*	*6.0*	*5.0*	*6.0*	*0.5*	*0.0*
Lithuania	*4.0*	*4.8*	*4.4*	*4.8*	*0.4*	*0.0*
Czech Republic	*3.3*	*3.7*	*2.7*	*3.2*	*-0.6*	*-0.5*
Hungary	*3.5*	*4.0*	*3.5*	*4.0*	*0.0*	*0.0*
Poland	*1.4*	*3.2*	*1.0*	*3.0*	*-0.4*	*-0.2*
Slovakia	*3.7*	*3.9*	*4.0*	*3.7*	*0.3*	*-0.2*
Slovenia	*2.6*	*3.6*	*2.5*	*3.2*	*-0.1*	*-0.4*
Roumania	*4.5*	*5.0*	*4.3*	*4.9*	*-0.2*	*-0.1*
Russia	*4.4*	*4.9*	*4.4*	*4.9*	*0.0*	*0.0*
World	***2.8***	***4.0***	***2.8***	***3.7***	***0.0***	***-0.3***

estimates of the international financial institutions. IMF growth forecasts for the Euro-area in 2002 and 2003 point to 0.9% and 2.3% respectively. As growth in the second quarter barely exceeded 1st quarter growth, and given the loss in consumer and business confidence in July, it is very likely that the Euro-area economy grows by less than the 0.8% projected in the third quarter of 2002.

The adverse impact of the summer floods in Europe on 3rd quarter growth is difficult to assess but it is expected to be overcome in a gradual manner by the end of the year. The forecasts of DG ECOFIN and the European Commission of 6 September 2002 expect 3rd quarter GDP growth to run at about 0.3% to 0.6%, indicating a major downward revision of some 0.3% compared to the estimates made a month earlier. Fourth quarter growth is forecast to steady within 0.3% – 0.6% level.

According to independent forecasters[5], the recovery of the economy in the Euro-area is already well behind the US economy, and further slowing down. Growth estimates have been revised significantly downwards from 1.4% to 1% in 2002 and 2.6% to 2.3% in 2003. Consumer demand is expected to go on the rise throughout the EU in 2003, except for Great Britain. Higher employment is expected to allow for additional consumption rather than some growth in savings. At the same time, investment growth is expected to follow a slow rate.

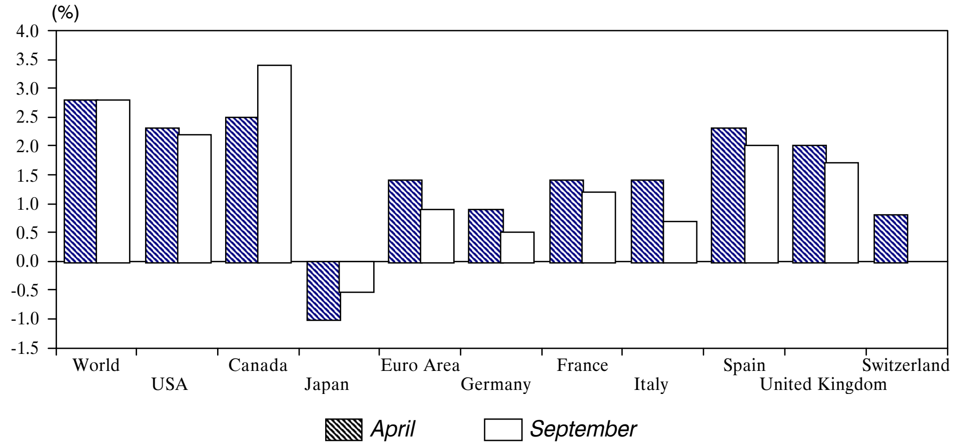
The rather large budget deficit as percentage of GDP of Germany (2.9%), France (2.6%), Italy (2%) and the excessively high deficit of Portugal (4.1%) may prove a serious impediment to medium-term growth in

[5] *For example, the EIU.*

the Euro-area in 2002. A likely violation of or non-compliance with the Maastricht criterion as to the government budget ceiling of 3% may undermine the credibility of economic policies. Although the initial deadline for curbing the deficits was set for 2004[6], the European Commission has recently decided on an extension by 2006, taking into account the slower recovery of the Euro-area economies and the adverse effect of the summer floods.

The GDP growth estimates for Japan in 2002 and 2003 run at -0.5% and 1.1% respectively, giving further evidence that the 10-year old recession that struck the economy, having do to with stable deflation, structural inefficiency, poor fiscal position and heavily burdened with bad debts financial system is not likely to be overcome in the short run.

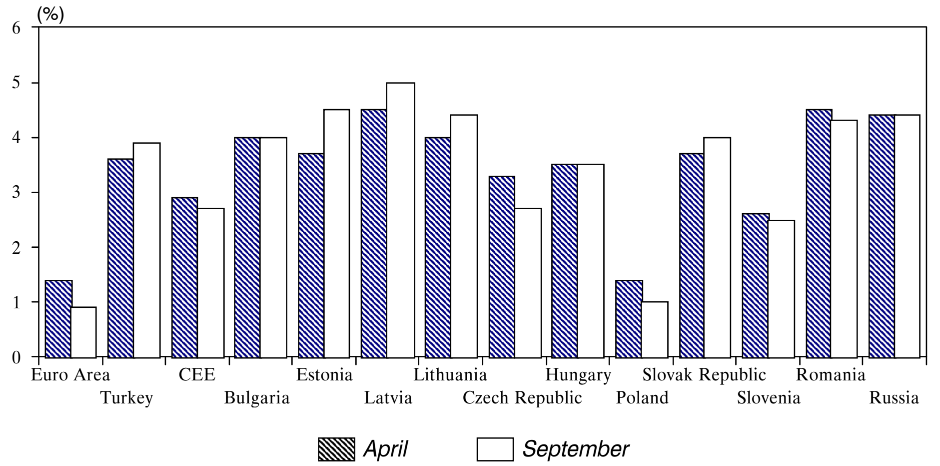
Expected GDP Growth Rate in the Industrialised Countries in 2002



Source: JPMorgan Chase Bank

The economies of Central and Eastern Europe remain comparatively less affected by the economic decline in Europe and worldwide recession. Relative to April estimates, the IMF revised its September 2002 and 2003 growth projections downward by only 0.2% and 0.1% percentage points. The latest forecasts for CEECs have been revised downwards mostly for the Czech Republic by 0.6% and 0.5% respectively down to 2.7% and 3.2%. The growth estimates for Poland, Slovakia, Roumania, and Slovenia have undergone a downward revision too while the 4%-forecast for Bulgaria has remained unchanged, ranking the country immediately after Slovakia and Russia. In 2003, the Bulgarian economy is expected to report the highest growth of 5% among the CEECs. Growth projections for Turkey remain unchanged at 2.5% and 4.5% respectively. On the whole, growth in CEECs is mainly driven by domestic demand, reinforced by

Expected Growth Rate in CEECs, Russia and Turkey in 2002



Source: JPMorgan Chase Bank

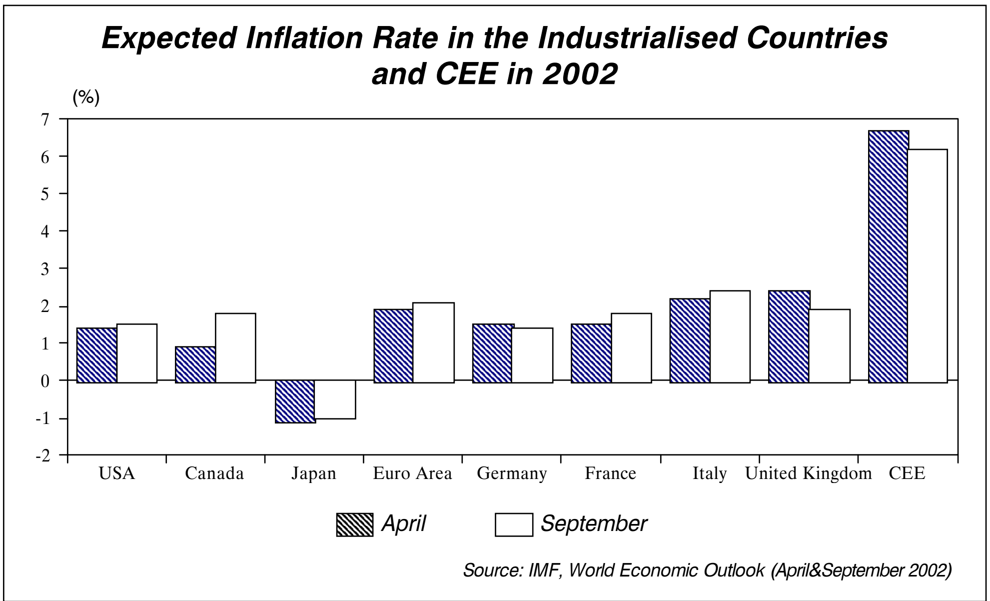
[6] *For Italy – in 2003.*

large amounts of FDI inflows, wage growth, decreasing inflation, and in some countries by sizable fiscal packages aimed at boosting business activity.

EIU estimates of 6 September 2002 in respect to Bulgaria are by and large more pessimistic than IMF forecasts. Thus, 2002 growth is expected to run not higher than 3% due to the slower rate of export growth and low FDIs as well as the weak consumer demand as a result of the energy price hike. As for the next year, the British analysts forecast a growth rate of 3.7% that may be further underpinned by the steadily growing foreign demand.

Inflation

According to all analysts, inflation worldwide remains moderate to low. US inflation in 2002 is expected to run at 1.7%, with forecasts over the next five years pointing to about 2.5% on a yearly average and 2.6%[7] in the next ten years. Compared to April, the IMF revised its inflation rate estimates only in respect to Germany from 1.5% to 1.4%, Great Britain (from 2.4% to 1.9%), and the CEECs (from 6.7% to 6.2%). The 2002 inflation rate in the Euro-area is expected to amount to about 2.1%, which is slightly above the 2%-target set by the European Central Bank.



Inflationary pressures remained comparatively weak and have allowed for a certain wage increase in the collective bargaining process in the first half-year period, despite the growing concerns of the central bank. As of August, headline inflation in the Euro-area amounted to 2.1%[8]. According to JPMorgan Chase Bank estimates, end-of-year inflation will hardly surpass 2%, despite the adverse impact of the higher oil prices and the fresh food price hike as a result of the floods.

According to all analysts, 2003 inflation will, too, remain moderate. And yet, deflation in Japan can be identified as a serious problem and is expected to further deepen due to the appreciation of the Japanese yen.

Interest Rates

The expectations that growth in the world economy by end-2002 is to take place at a rather sluggish rate give analysts grounds not to anticipate any forthcoming increase in interest rates. The federal funds rate in

[7] *According to the KPMG' Investment Consulting Group.*

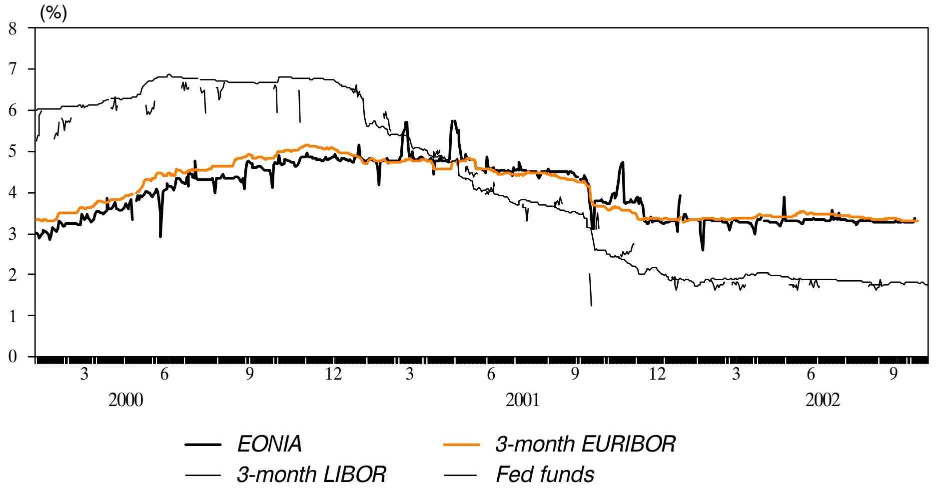
[8] *This is fact core inflation in the EU the estimation of which excludes monitored prices as well as the prices of seasonal goods, i.e. all food items and energy goods.*

the US is expected to steady at its present level of 1.75% by the end of 2003 at least, to be only raised afterwards by about 0.75 percentage points[9]. In case of a military conflict between the USA and Iraq, however, the Federal Reserve is likely to effect an interest rate cut aimed at stabilising confidence in the US economy and satisfying the growing demand for liquidity.

The refi rate in the Euro-area will not be raised from its present level of 3.25%. Although the economy of the Euro-area is recovering slowly, on 12 September 2002 the Board of Governors of the European Central Bank decided against another interest rate cut which only made the likelihood of anticipations against any further cuts more certain. Most analysts tend to forecast that the refi rate will be raised in two steps by 0.25 percentage points each in mid- and end-2003. Close to the above estimates stand the forecasts of Credit Suisse First Boston of 5 September 2002 which project an interest rate rise of about – of the percentage point up to 4% next year.

Notwithstanding the fact that the Japanese economy has bottomed out in a deep recession, monetary policies are no longer able to revive the country's business activity by interest rate cuts, as they have already reached levels of around 0%. The expectations therefore are that interest rates in Japan will remain unchanged by end-2003 at least.

Short-term Interest Rates



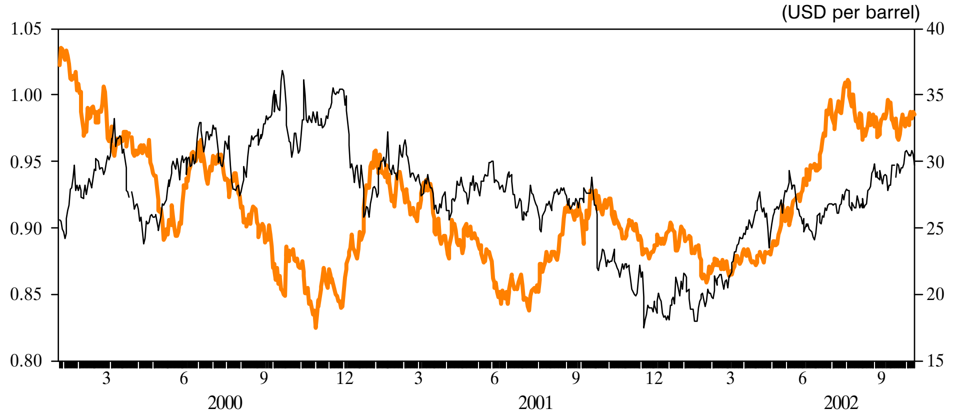
Source: Bloomberg, Reuters

Exchange Rates

The long expected for more than a year depreciation of the US currency to the EUR took place as late as the second quarter of 2002. The USD stepped down from USD 0.87 per EUR in the beginning of the second quarter to USD 1.01 per EUR in mid-July to steady at USD 0.98 per EUR in the following to months. The major factors at work behind the USD's lost ground to the single European currency had to do with the weaker than expected by financial markets growth of the US economy and fears of a turnaround from a surplus to a federal budget deficit, and further deterioration of the current account deficit of the world biggest economy. In addition, the downward trend of the USD was further reinforced by the decline in the American stock indices that was largely triggered by spate of bad news on accounting frauds in some US companies. Third quarter stabilization had to do mostly with the gradual but weak recovery of the US stock indices. And yet, expectations for another depreciation of the US currency to the EUR amidst the uncertainty evolving from the controversy of September data on the performance of the US economy – low consumer and business confidence, and rising number of registered unemployed, remain rampant.

[9] *According to JPMorgan Chase Bank estimates.*

EUR/USD Exchange Rate and Crude Oil Price (NYMEX)



Source: Bloomberg

According to most analysts, the weaker USD to the EUR may further produce a rather unhealthy effect on short-term growth in the Euro-area. The US currency remained comparatively strong due to the stronger growth potential of the US economy and rigidity of the European commodity and labour markets. In addition, the European economies are forced to face structural problems and the EU enlargement in 2004 as well as growing expenditures having to do with the ageing of the population. From the point of view of the USA, a weaker US dollar may cushion risks deriving from persistent recession.

Main Commodity Prices

Over the January-August period, the dynamics of the main commodity prices in the international markets was determined mainly by the interplay of two factors, i.e. the weak recovery of the world economy and low demand that followed up. Crude oil prices (Brent) over the same period stepped up by 43.17% and reported a USD 26.63 per barrel record high in period-end, setting back at their level prior to September 11th 2001 and steadying within an acceptable band of USD 22-28 per barrel, as triggered further by the comparatively good compliance of the OPEC countries with the quotas contracted and growing fears of a possible US attack on Iraq.

Oil supply has been steadily growing in Russia which is trying to find new market outlets for its ever rising oil output and injecting hefty investments in processing capacities and the development of a large network of distributors. Oil supply on the part of Norway has also gone on the increase. The high oil price levels are expected to affect the growth rates in Western European countries which are also net importers of oil. OECD estimates[10] imply that a rise in oil prices of USD 10 may result in an increase in the inflation rate of 0.5 percentage points and a 0.25% growth contraction in the industrialized countries.

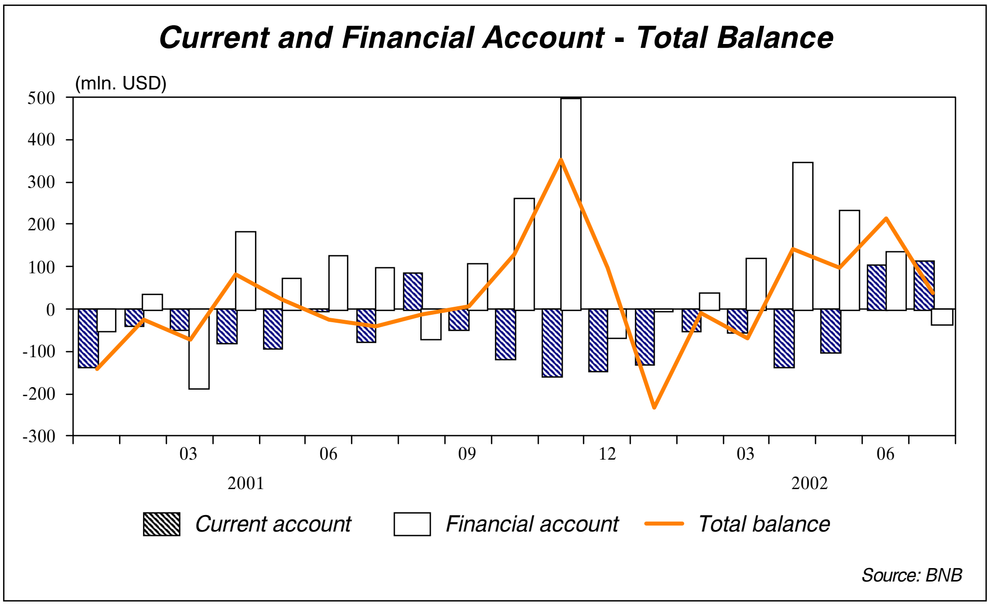
Relative to December 2001, cold- and hot-rolled steel prices rose by 12.08% and 35.71% respectively. Even if it rebounded in the second half-year period of 2002, steel demand would remain lower on a year earlier, leaving little, if any, room for any further price hike.

Refined copper prices in the first half-year period remained almost unchanged due to the higher supply compared to demand as well as the unambiguous forecasts as to the recovery of the US economy, a major consumer of copper. According to estimations of the International Copper Study Group, 2002 copper surpluses reported a most notable increase on a year earlier, totalling some 157 thousand tones as result of which copper stocks worldwide almost doubled.

[10] The Economist, *2001.*

BALANCE OF PAYMENTS, FOREIGN TRADE AND EXTERNAL FINANCE

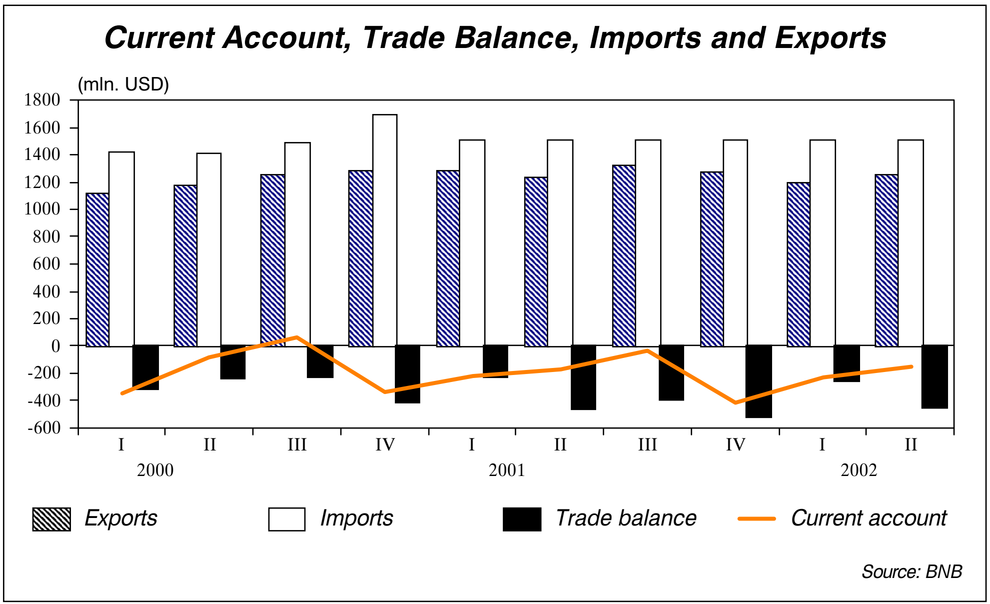
The current account deficit over the Jan-Jul 2002 period went on the decrease. Improving by 45.9% (USD 213.3 mn) on a year earlier, it amounted to USD 251.7 mn in the seven months to August 2002. The amendments to the country's economic policies made in the last quarter of 2001, together with the slower than expected and painstaking recovery of foreign demand and the international business situation in the commodity and financial markets helped curtail the current account deficit.



Since 1998 a number of external shocks have produced an adverse effect on the current account dynamics. All this has gradually led to fears that there might occur a fundamental disequilibrium in the external sector calling for tightening of the fiscal restriction in end-2001. The more stringent constraint gave rise to the downward trend in the current account deficit in both nominal terms and as percentage of GDP in June. The above development validated the forecasts of the Agency for Economic Analysis and Forecasting of early 2002 that the 2002 current account deficit expected would amount to 5.4% of GDP. Given the data now available, the 2002 current account deficit is expected to reach about USD 860 mn in absolute terms.

The country's export performance has adjusted to the lower foreign demand, contributing in turn to the weaker main commodity imports for the export-oriented industries. On a year earlier, growth of both imports and exports slowed down in the seven months to August 2002. Over the Jan-Jul 2002 period imports reported a 1.1% nominal- term shrinkage down to USD 4 129.5 mn against 15.7% growth in the same period of 2001. The weaker slowdown rate of export growth in nominal terms – from 10.5% in the seven months to August 2001 to 1.2% a year later, made a major contribution to the improvement of the country's trade balance. Improving by 8.9%, or nearly USD 77.9 mn on a year earlier, the trade balance over the Jan-Jul 2002 period amounted to USD 802.3 mn. The 0.9% year-on-year improvement in the terms of trade index was conducive to the performance of the Bulgaria's foreign trade in the period considered.

Following the rebound of the world economy, foreign demand for Bulgarian exports is expected to slowly but steadily recover by end-2002, an effect that is to be induced by growth in Bulgaria's major trading



partners and the higher export prices for local goods and commodities. Given the above assumptions, 2002 exports are estimated at about USD 5.3 – 5.4 bn. Imports are expected to grow by end-year, compared to 2001. Besides the recovering foreign demand for Bulgarian exports that is to trigger a certain increase in raw material imports in the export-oriented industries, forecasts also point to a bounce in energy imports[11] due to expectations of higher crude oil prices in the second half-year period as a result of the growing demand for stocking up worldwide and fears of likely military action against Iraq. Investment goods imports are expected to retain their relatively high growth rate while the upward in consumer goods imports discernible is an indication that this import item is less prone to changes in domestic demand. Given the above assumptions, estimates point to a 7% growth in total imports in 2002, expecting them to hit USD 7.2 bn.

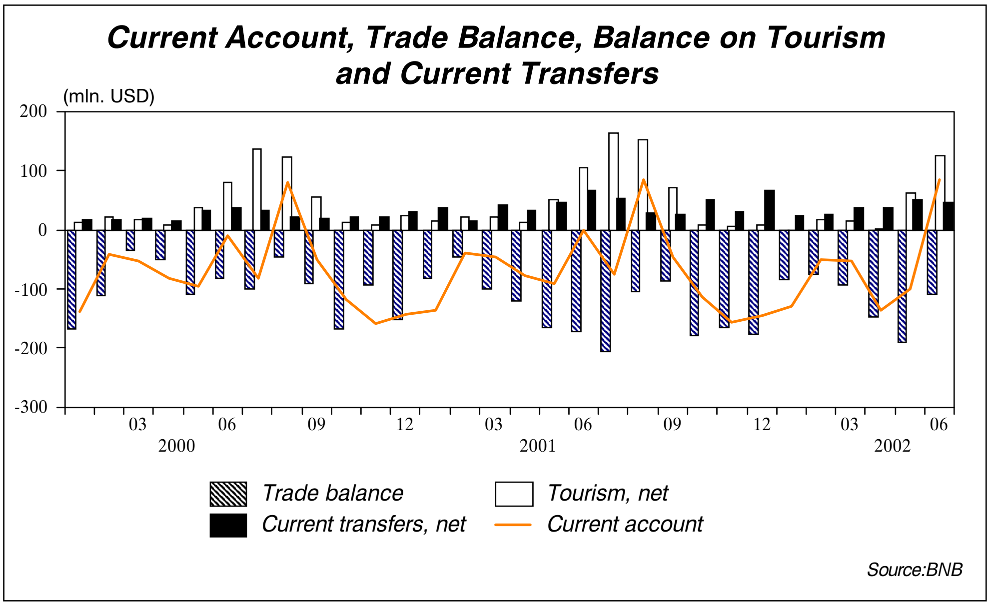
The current account deficit was partly financed by surpluses of the service and current transfers balance, which in the seven months to August 2002 remained close to their levels on a year earlier in nominal terms. The balance on services of the balance of payments current account in the same period ran positive at USD 351.6 mn, reporting, at the same time, a USD 2.8 mn worth of a year-on-year decrease. Summer tourism was and still is growing in importance as a main source of revenues for the balance of payments. In the May-Jul 2002 period alone when the holiday season is not in its swing, net revenues from tourism amounted to USD 370.3 mn, rising by 16.7% on a year earlier, despite the VAT on tourist services and visa regime applied to Russian citizens introduced in 2002. Revenues from tourism are expected to exceed USD 1.2 bn by the end of 2002.

In the eight months to September 2002, Bulgaria was visited by more than 2.1 mn foreign holidaymakers, going 8.23% up on a year earlier, with German and Greek tourist numbers reporting the highest growth. The number of holidaymakers from Great Britain, Poland and Hungary registered a most significant increase due to the revived business activity of tour operators in Bulgaria. The number of EU holidaymakers visiting Bulgaria has once again outstripped the tourist numbers from all over the world (by 18.5%). At the same time, the number of Russian and Ukrainian holidaymakers decreased drastically by 24.83% as a result of the visa regime and cumbersome issuing procedures.

On a year earlier, net current transfers increased by only USD 13.4 mn over the Jan-Jul 2002 period. The sluggish growth rate was mainly due to the lower grant amounts from the EU pre-ins (USD 42.3 mn less),

[11] *The expectations are mainly due to the fact that import prices in the seven months to August 2002 remained 4.6% lower on a year earlier as a result of the 6.6% decrease in crude oil import prices. In volume terms, import growth over the same period ran at 3.7%.*

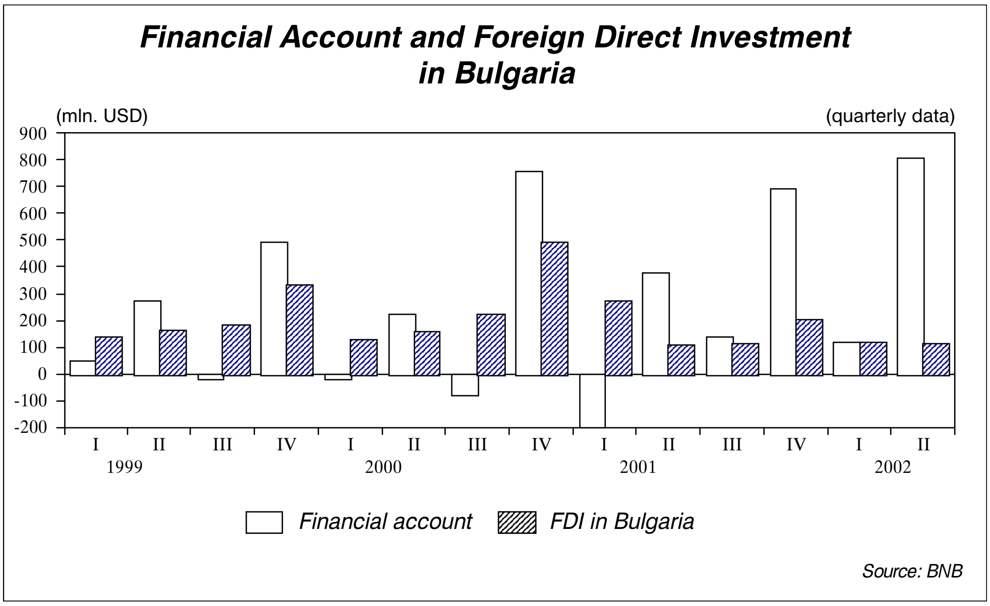
which in the six months to July amounted to a tepid USD 80.6 mn. By end-2002, however, they are expected to reach USD 225 mn.



While improving by USD 124.8 mn on a year earlier, the income balance ran negative at USD 111 mn in the period considered, with income credit (USD 213.2 mn) declining by USD 29 mn and income debit (USD 324.2 mn) reporting a most notable drop of USD 139.9 mn due to the lower interbank interest rates in the international markets in particular.

Improving by USD 556.7 mn relative to 2001, the financial account in the Jan-Jun 2002 period ran positive at USD 834.3 mn, covering the current account deficit almost thrice. Worldwide stagnation led to an increase in the intrafirm credit of locally-based foreign companies, triggering in turn a contraction in FDI inflows to Bulgaria. Over the period surveyed, FDIs amounted to USD 255.9 mn and reported a 42.3% year-on-year decline. Nevertheless, they covered the current account deficit fully.

The share capital attracted from privatization deals in the seven months to August reached USD 46.4 mn, stepping up by USD 27.2 mn, as did the share capital raised from non-privatisation deals which amounted to USD 295.2 mn. It increased by a bare USD 0.9 mn on a year earlier when the revenues from the sale of the second GSM operator were accounted for. The largest investments were made by Greece (as in 2001), the Czech Republic, Germany and Austria.



Over the same period, the portfolio investments made abroad by residents contracted by USD 164.8 mn, whereas these of commercial banks grew by USD 36.9 mn. As a result of the Brady-for-global exchange and the investments of residents in the new instruments related thereto, capital inflows to Bulgaria amounted to USD 296.3 mn. The *other investments-assets* item fell by USD 442.1 mn due to the USD 390.4 mn worth of a contraction in the foreign currency deposits of commercial banks abroad in the first five months of 2002.

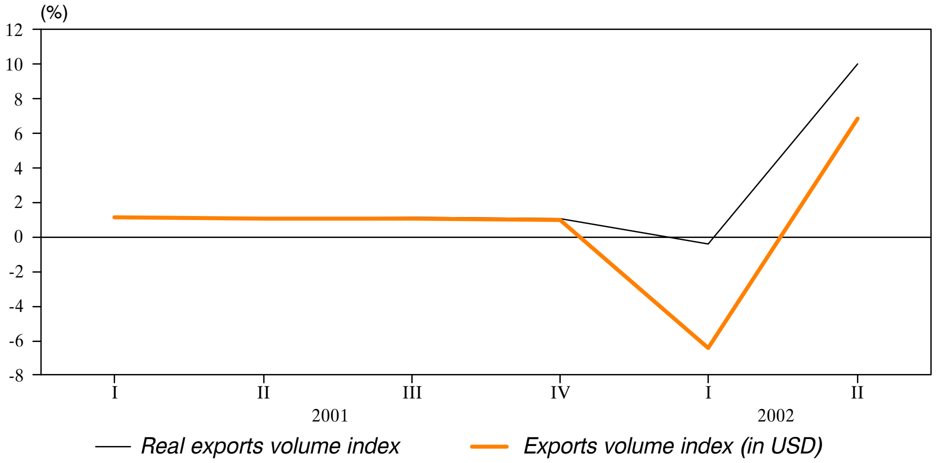
In the seven months to August 2002, BNB FX reserves stepped up by USD 101.4 mn against a USD 246.0 mn worth of a contraction in the same period of 2001. Bulgaria received only USD 13.4 mn of a World Bank credit extension while the net use of IMF credit shrank by USD 91.7 mn. As the BNB is a large assets-holder in EUR, exchange rate dynamics and the depreciation of the USD to the single European currency in particular are an important determinant of the performance of BNB FX reserves. Their growth, as induced by exchange rate fluctuations, amounted to USD 439.6 mn in the period surveyed.

Foreign Trade Structure

Export dynamics was essentially determined by the slow to moderate rate of growth in EU member states that are also a major importer of Bulgarian goods (56.6%). On a year earlier, total export growth slowed down to 1.2%, reaching USD 3005.4 bn. Relative to the same period of 2001, the export prices of Bulgarian goods stepped down by 3.7% in the seven months to August 2002. In volume terms, however, export growth amounted to 5.1% implying a comparatively good competitiveness of Bulgarian exports under an inimical international business environment.

Nominal and Real Exports Volumes

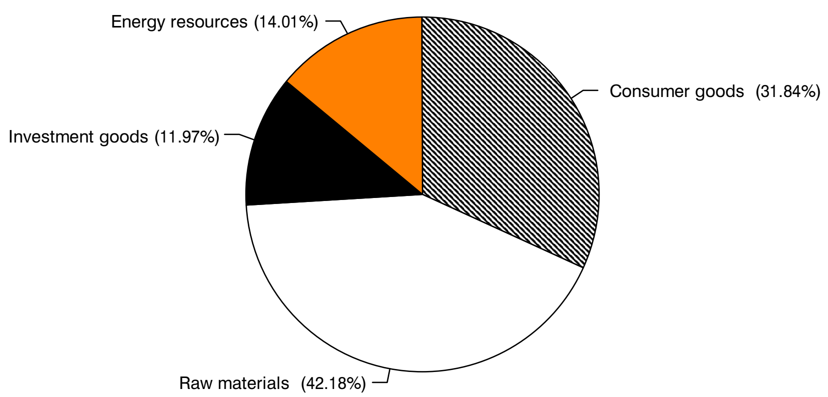
(12-month percentage change)



Source: BNB

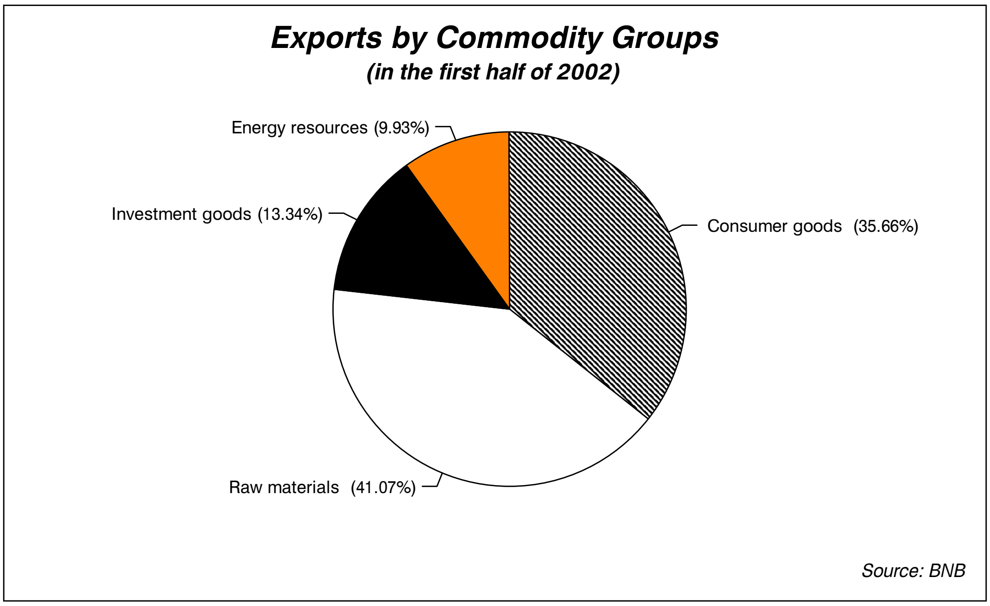
Exports by Commodity Groups

(in the first half of 2001)

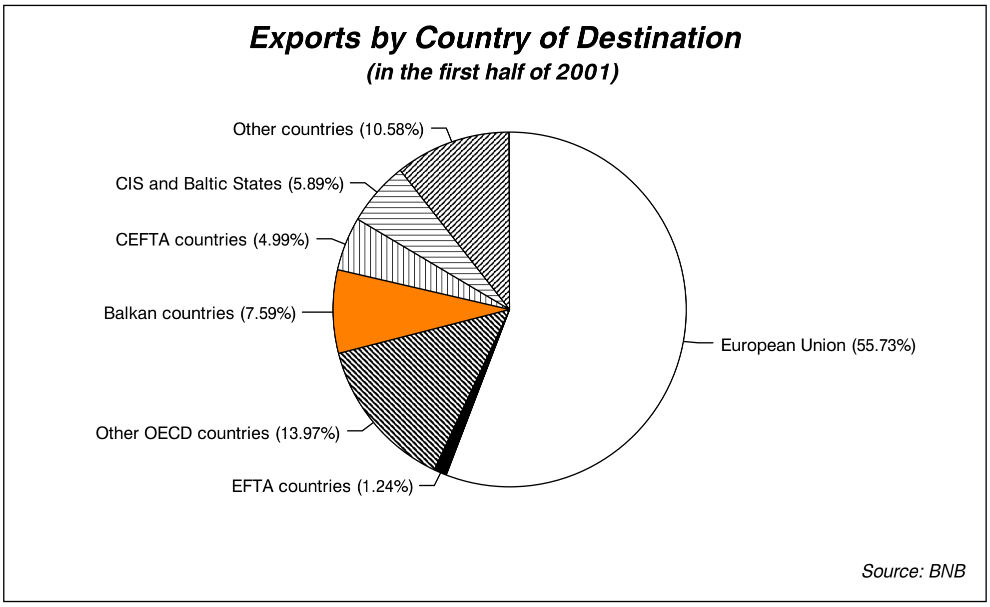


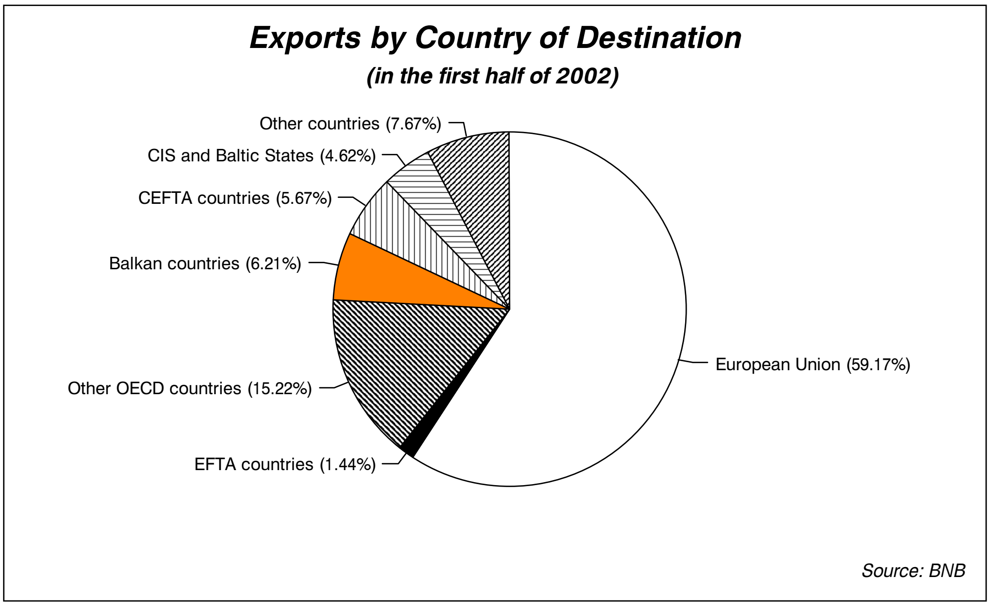
Source: BNB

Consumer goods exports reported an 11.0% year-on-year rise accounting for 35.5% of total exports. Footwear and clothing exports performed most robustly, increasing by 12.8% on year earlier to hit a relative share of 21.8%.Furniture and kitchen furnishing exports registered the highest growth of 38.2%. At the same time, cigarette, medicine and cosmetics exports reported a drastic shrinkage of 9.1% and 9% respectively. In the seven months to August 2002, investment goods exports stepped up by 10.7% relative to same period of 2001, indicating that Bulgarian exports were also oriented towards goods of high value added. Out of this group, vehicle and machinery, equipment and apparatuses exports reported a most significant rise of 69.1% and 12.4% respectively.



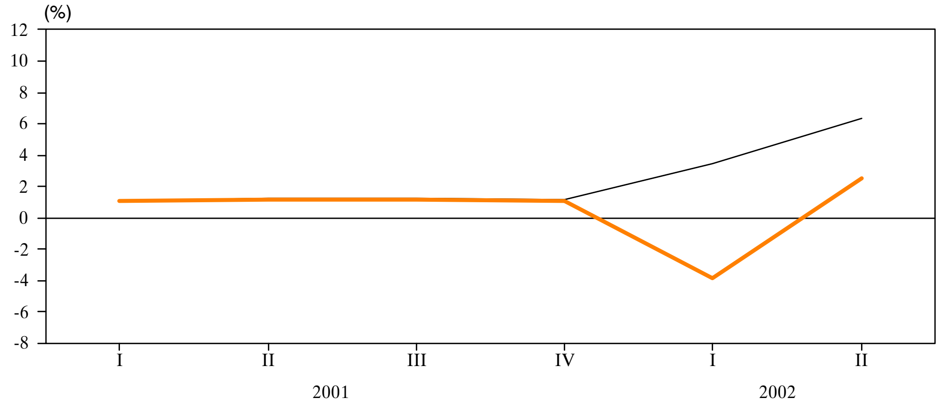
Raw material exports retained a high relative share of 41.6% within total exports, remaining, however, at their last year's levels in value terms. There were discerned in the group a wide range of differences prompted up by international price volatility compared to commodities of higher value added. Fertilizers exports responded most strongly to the deteriorating business situation worldwide, reporting a most drastic year-on-year contraction of 38.6%, as did non-ferrous metal and cast iron, iron and steel exports declining by 19.9% and 14.4% respectively. Food raw material and input exports and textile material exports rose by 65.8% and 17.0%





Nominal and Real Imports Volumes

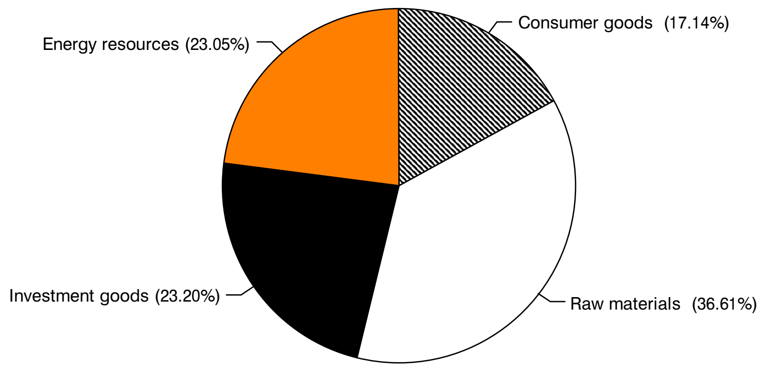
(12-month percentage change)



Source: BNB

Imports by Commodity Groups

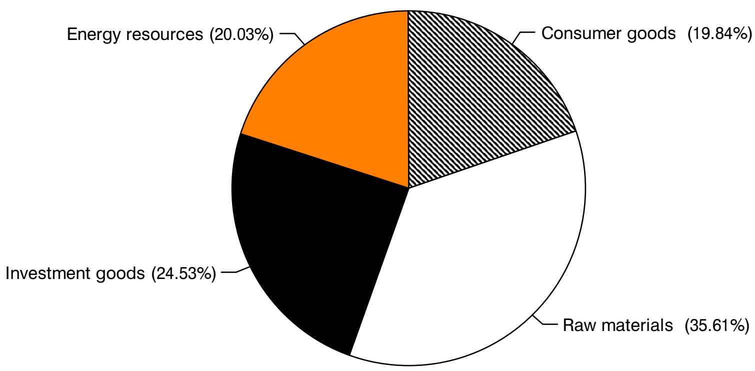
(in the first half of 2001)



Source: BNB

Imports by Commodity Groups

(in the first half of 2002)

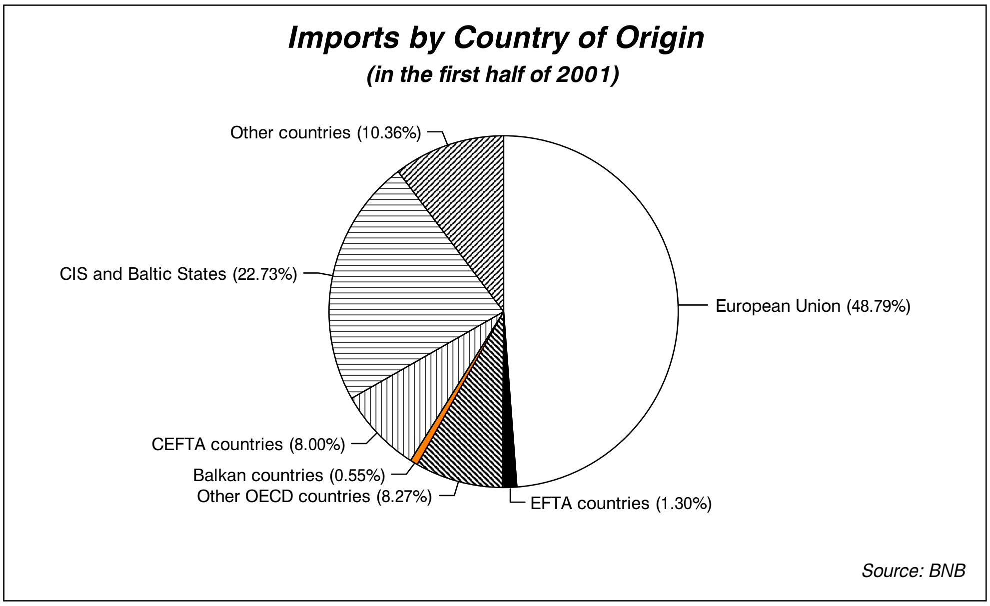


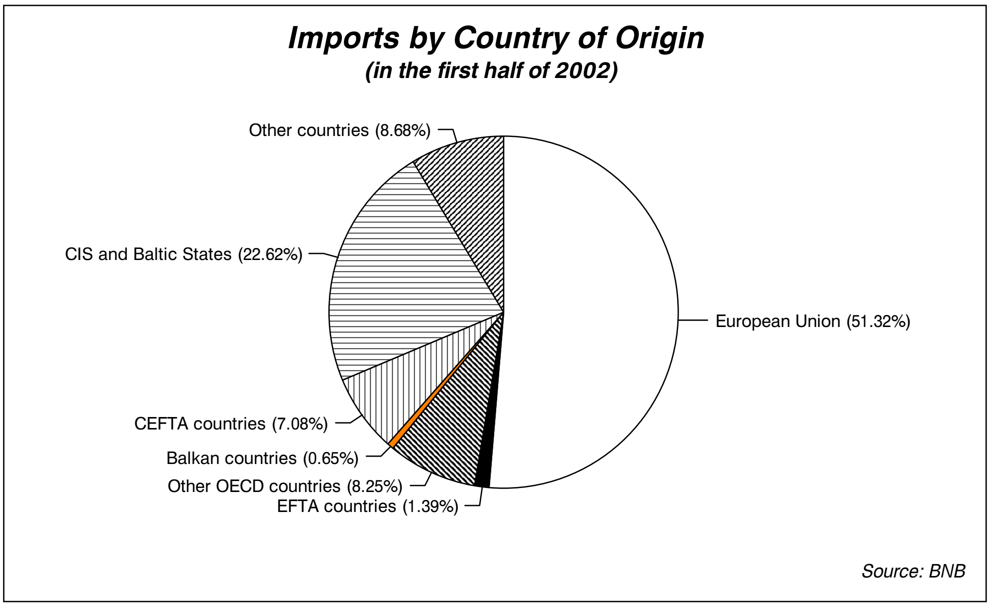
Source: BNB

respectively. Tobacco export growth went on the increase (by 13.7%).

Shrinking by USD 107.2 mn, or 26.5% on a year earlier, energy exports over the Jan-Jul 2002 period ran at USD 296.7 mn due mainly to 37.7% decline of USD 105.2 mn in oil exports. The above decline was also brought about by both the export contraction in value terms spurred by the lower crude oil prices and the 21.5% decrease in export volumes, compared to 2001. As a result of the impact of the price factor alone, oil and natural gas exports in the seven months to August reported a USD 50.6 mn worth of year-on-year drop.

Over the same period, the relative share of Bulgarian exports to the EU stepped up from 55.8% in 2001 to 56.6% in 2002, despite the still dull demand in the Euro-area. The EFTA countries and Switzerland in particular are another destination to which Bulgarian exports grew most robustly by 116.5%, now enjoying a relative share of 2.5% within total exports. Exports to the CEFTA countries also stepped up as follows: to Roumania (12.6%); Poland (28.6%) and the Czech Republic (32.4%). Reporting a 21.9% seven-month rise, Bulgarian exports to Turkey were steadily recovering following the 2001 crisis and ensuing weak business activity in that neighbouring country. At the same time, exports to Yugoslavia went on the decrease due mostly to the declining oil exports.





The upward trend in consumer goods imports persisted well throughout the seven months to August 2002 in the pursuit of consumption diversification under an economic revival in the post-1997 crisis period. On a year earlier, they increased by USD 91.3 mn, or 13.0% to reach USD 796 mn, now accounting for a relative share within total imports of 19.3%. However, the growth rate of this particular group of imports decreased, compared to 2001 (23.2%), which alongside the higher revenues from consumer goods exports provided for certain stability of the balance of trade in consumer goods. Investment goods imports stepped up by 2.9%, with the main contribution to this import growth being reported by spare parts and equipment (USD 18.9 mn or 13.8%); vehicles (USD 18.8 mn or 10.4%); and machinery and apparatuses – USD 15.5 mn or 4.1%.

Weaker demand in the international markets was the main reason behind the 2.8% year-on-year shrinkage in main commodity imports for the export-oriented industries. Ore imports reported a most dramatic contraction of 57.6% or USD 89.0 mn, having to do with the overall decline in metal exports. On the other hand, imports of textile material and plastics and rubber increased by USD 17.4 mn or 3.9% and USD 15.4 mn or 9.6% respectively.

On a year earlier, energy imports in the seven months to August decreased by 17.6% or USD 173.0 mn, with almost all energy import items going on the decline as follows: crude oil (6.3% or USD 45.7 mn); natural gas (17.4% or USD 41.5 mn); and coal (36.5% or USD 35.5 mn). The lower crude oil prices resulted in a USD 33.2 mn worth of contraction in imports in value terms. At the same time, import volumes stepped up by 6.1%. The import prices of natural gas were also low, leading to a USD 28.3 mn of a drop in import costs, whereas import volumes remained close to their 2001 levels. Relative to 2001, the price-induced positive effect alone of the lower crude oil and natural gas imports on the trade balance over the Jan-Jul 2002 period was estimated at USD 61.5 mn[12].

The geographic profile of both imports and exports over the same period provided further evidence of the growing strong relation of the Bulgarian economy with the EU member states. EU imports to Bulgaria reported a 6% year-on-year increase of some USD 121.7 mn, thus outstripping total import growth and accounting for a relative share within total imports of 52.0%. This steady trend was further reinforced by the appreciation of the BGN's real exchange rate to the EUR the relative share of which in the currency structure of imports now reached 61.2% against 53.9% of the Euro-currencies in the same period of 2001.

Outside the EU, Turkish imports into Bulgaria reported a significant increase of 42.3%, or USD 58 mn due mainly to the lower prices of Turkish goods as a result of the devaluation of the Turkish currency in the wake of last year's foreign exchange crisis. Imports from the Balkan countries increased too (23.3% up, or USD 5.3 mn) and while Yugoslavian imports to Bulgaria have gone on the rise, imports from Macedonia have stepped down. In the seven months to August 2002, imports from both the CIS and the Baltic states contracted by 16.2%, or USD 163.0 mn on a year earlier, with Russian imports to Bulgaria alone declining by 21.3%, as largely brought about by the cheaper prices of oil and oil products. For the same reason, Roumanian imports to Bulgaria declined, accounting for the 10.1% year-on-year shrinkage in CEFTA countries' imports.

[12] *According to BNB data.*

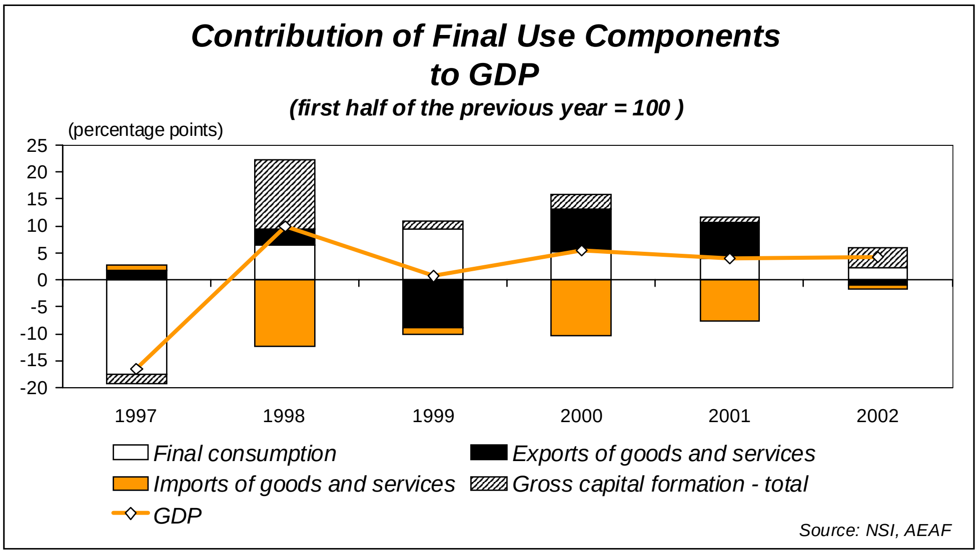
REAL SECTOR OF THE ECONOMY

GDP

The first half-year period of 2002 sustained the high GDP growth rate, despite the adverse external environment. On a year earlier, growth over the Jan-Jun 2002 period amounted to 4.3%.

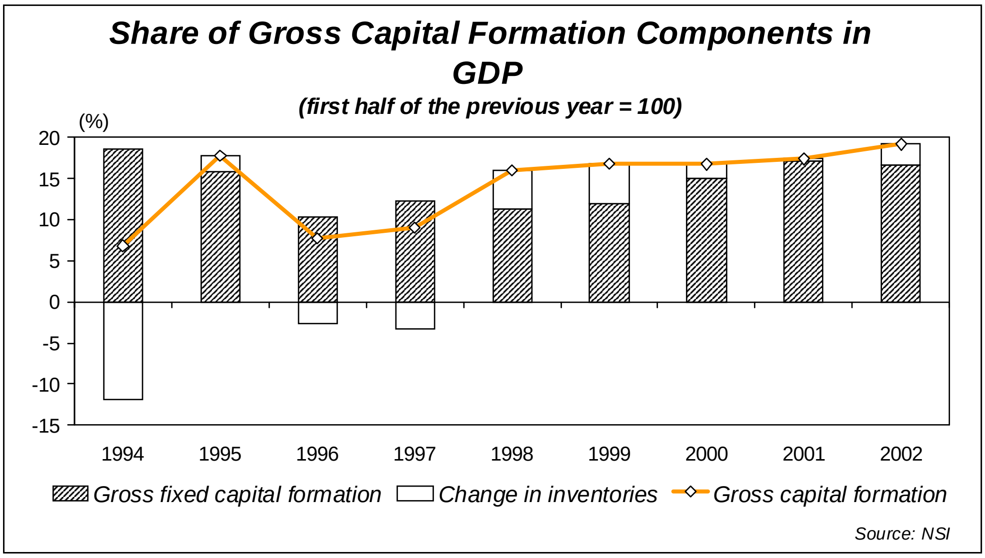
Demand

Robust domestic demand asserted itself as a major factor of growth in the first half-year period of 2002. Growth over the same period was mainly demand-pulled. Gross fixed capital formation increased by 21.4%, and final consumption rose by 2.5%. Rebounding exports in the second quarter also contributed to GDP growth but the weak export performance in the first quarter accounted for the overall negative 1 percentage point contribution of exports to total growth in the same period.



The contribution of final household consumer spending to GDP ran at 2.2 percentage points, turning out to be a major determinant of GDP growth due to the high relative share of final household expenditures within GDP, which stepped down to 71.4% from 72.6% on a year earlier. The above decline was mainly due to the lower household consumption of electricity, heating and water, lower self-sufficiency and the decline in the consumption of housing services. The negative growth of the latter two items was an indirect indication of a new increase in the market-produced value added in the economy. Household consumption of services reported a significant rise of 13.3% contributing to the total growth in final household consumer spending by 1.13 percentage points.

On the demand side, the 21.4% increase in gross fixed capital formation in the first half-year period of 2002 reported the largest contribution to GDP growth of 3.7 percentage points. The significant six-month increase lived up to the investment growth expectations summarized in the late April NSI investment survey in which managers pointed to a 21% year-on-year nominal-term rise in investments. As the share of the 2002 private- sector investments planned has risen to 64% from 61% within total expenditures on the acquisition of tangible assets, it can be assumed that investment growth in the private sector throughout 2002 will run significantly higher than public-sector growth. The largest investment injections are expected to be channelled to the electricity and water supply sector as well as in industries manufacturing goods for intermediate consumption.



Following a fast growth rate, the share of gross fixed capital formation stepped up to 19.2%, or 1.8 percentage points up on a year earlier. In the second quarter of 2002, its share rose as high as 20%, setting on a track to approximate its counterpart levels in the developed market economies[13]. Excluding, however, inventories which exhibited a most dynamic performance over the last couple of years, gross fixed capital formation can be said to have set at a rather low level compared to not only the developed market economies but to most transition economies as well, where the relative share of this item is a little higher. All this has given solid grounds to assume that over the next few years as well investment growth needs to outstrip GDP growth until gross fixed capital formation steadies at a level close to the level in the developed market economies and the technological restructuring of the economy is brought to a near end.

Following suit the improvements in the current account, the share of national savings within GDP (12.8%) in the first half-year period of 2002 reported an 11% increase on a year earlier. The nominal-term growth in savings of 28.3 percentage points was solely prompted up by the increase in private-sector savings. While improving in nominal terms, the balance on savings – investments as percentage of GDP (-6.4%) remained unchanged at its 2001 first half-year level.

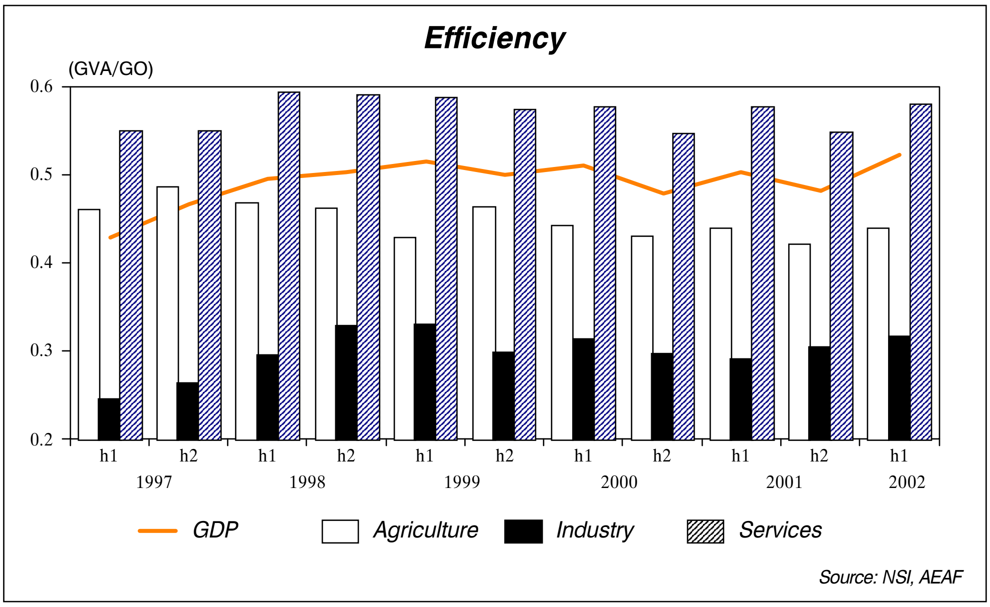
Supply

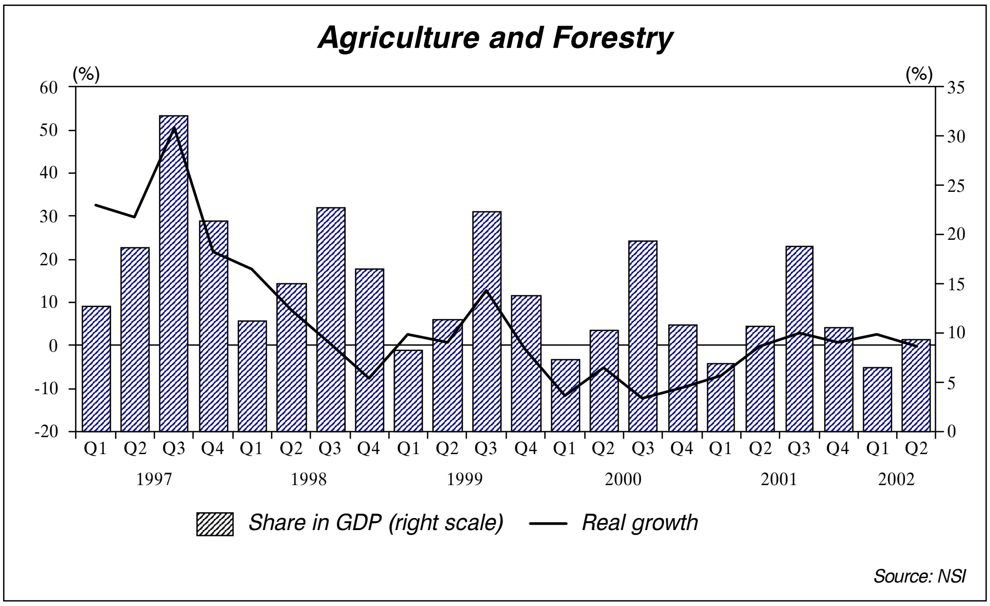
All sectors of the economy have once again contributed to gross value added (GVA) growth in the first half-year period of 2002, with services in the lead accounting for a share of 3.1 percentage points.

Sector of the Economy	***Contribution to GDP Growth (in % points)***
Agriculture and forestry	*0.08*
Manufacturing sector	*0.91*
Construction	*0.05*
Services	*3.09*
Adjustments	*0.18*
Gross Domestic Product	***4.30***

Efficiency in the manufacturing sector carried on rising – gross output stepped down by 0.2% in real terms while value added went up by 3.6%. Overall in the economy, efficiency improved on a year earlier due to investment injections of previous periods, as also evidenced by the high growth rate of fixed capital formation.

[13] *In the Euro-area, for example, the share of investments within GDP has amounted to around 21% over the last three years.*





Agriculture. The agricultural sector reported 0.9% growth due to its improved performance in the first quarter of 2002. Over the past few years the share of agriculture within GVA has steadied at around 13%, and is expected to gradually decline over the next couple of years, approximating the EU's average[14].

The competitiveness of Bulgarian agricultural producers remained relatively low as evident from the export contraction along with the rise in agricultural and food imports. To limit agricultural imports and safeguard domestic production, the government has applied higher individual duty rates on perishable food imports, implicitly setting minimum prices for products that are highly supply-sensitive to prices and making certain amendments to the customs tariff in August to that effect. Furthermore to avoid the dumping effect of imports, the duty rates on some low-priced as a result of the low import prices home agricultural products like tomatoes, potatoes, onion, cabbage, cucumbers, gherkins and pepper were raised.

The scarcity of agri-business investment as a result of the delayed reforms launched to guarantee ownership rights is the main reason behind the poor performance of the sector. To boost agri-business activity, the government is aiming to ease producers' access to credit resources through the State Agriculture Fund's (SAF) investment and subsidizing policies at a gradually improving rate of utilization efficiency, which, however, is insufficient to produce the desired effect to foster the sector's competitiveness. In 2000 when the sector reported a 10.3% output decline, State Agriculture Fund allocations amounted to 1.6% of GVA, whereas in the years witnessing some but fragile growth the ratio ran at about 0.5-1%.

[14] In the EU applicant countries, with the exception of Roumania and Turkey, the share of agriculture within GVA fluctuates between 3 and 8%, and within the 2-3% range in the EU member states.

Government support to the agricultural sector will increase with the advance of EU SAPARD, providing over the next couple of years for both a significant increase in central budget transfers via the State Agriculture and Tobacco Funds and in the allocations extended to agricultural and tobacco producers by the two funds themselves. Central budget transfers to the State Agriculture and Tobacco Fund are expected to amount to 0.5% of GDP in 2003, further rising to 0.75% in 2004 and 1% in 2005. SAF allocations over the 2003-2005 period will run at MEUR 20.5, 56.2 and 93.1 respectively. Tobacco Fund subsidies are expected to increase by 2005 as follows: MEUR 43.5, 53.7 and 63.9.

Industrial sector. In the first half-year period of 2002, the industrial sector reported a 3.6% year-on-year GVA increase. The growth in the manufacturing sector alone amounted to 4%. All industries, except the mining, registered some growth, with the increase in the production and supply of electricity, heating, gas and water surpassing significantly the sector's average by 7.5%. The sector also witnessed a high increase in labour efficiency, as measured by the ratio of gross value added to gross output. Having in mind the pending privatization of the seven electricity supply companies, efficiency in the sector is expected to further improve in the mid-term. The 11.1% decline in the mining industries was attributed to the deteriorating sector's efficiency, structural adjustment and winding-up of enterprises underway on the one hand, and low international prices, on the other.

The NSI data on the performance of some major industrial indicators released on a monthly basis point to an upward trend in inventories in the seven months to August. Over the same period, industrial output stepped up in both the processing industries and the production and supply of electricity, heating, gas and water, whereas sales contracted in the processing industries while rising, though at a slower rate, in the energy and water supply industries. Sales in the mining industries reported a lesser decrease of -0.7%, relative to sales in the manufacturing industries (-0.4%) implying a decrease in inventories.

The upward trend in inventories, as also evidenced by the national accounts for GDP by element of final expenditure, cannot be interpreted equivocally as an indication that the Bulgarian economy is about to go into recession. According to NSI business surveys, in July most managers tended to assess the rate of capacity utilization as insufficient falling short of their demand expectations in the following year. In July again, capacity utilization averaged 58.7%, improving on a year earlier but remaining well below the early-year rate when enterprises employed about 60% of their production capacity.[15] Since the second quarter of 2002, the order portfolio level of manufacturing enterprises has gone on the decrease while export orders reported a year-on-year increase. Since foreign demand was slowly but steadily recovering, insufficient export orders were assessed as not so a great a bottleneck to the operation of enterprises in July as they had been a year earlier, giving way to increasing financial difficulties, inconsistent economic legislation and competitive imports that were now of growing concern to managers. The increase in competitive imports can be viewed not only as a sign of the deteriorating competitive position of Bulgarian manufacturers in the domestic market but of the greater openness of the economy as well.

In the seven months to August 2002, industrial sales declined by 3.1% on a year earlier. Export sales decreased by 4.5% but ever since February when they reported a 24% 12-month contraction, the indicator

[15] *The bulk of enterprises operated at a capacity utilization rate of 60-80% but a number of other enterprises went on employing a small amount of their production capacity, thus pushing the sector's average further down.*

was improving on a month-to-month basis. Relative to the corresponding months of 2001, June and July export sales reported a respective rise of 7.4% and 13.3%.

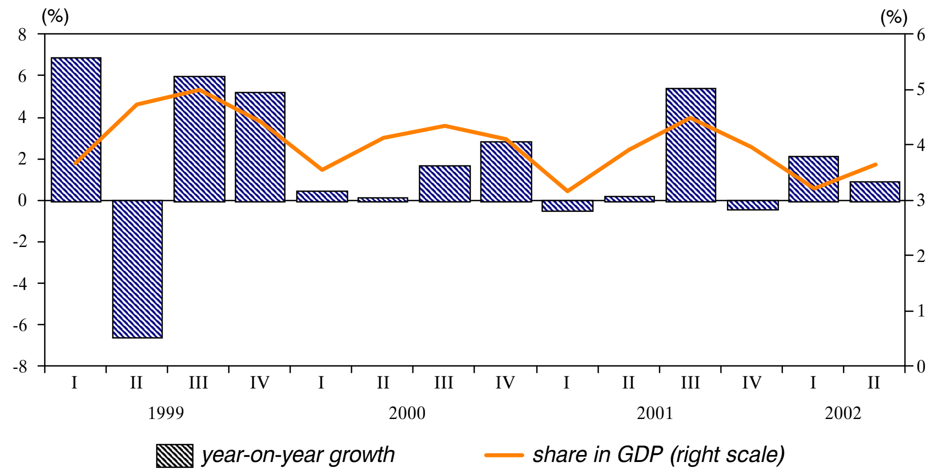
Since February export sales of machinery and equipment, textiles and clothing, food and beverages have been making an important contribution the recovered industrial exports. On the other hand, metallurgy and the chemical industry, which reported an aggregate share of 30% of export sales had contributed to the total export sales contraction in the manufacturing sector by 4.2 percentage points by July. As about two-third of the country's metal produce is intended for export, sales in the sector are strongly dependent on the international business environment[16].

On a year earlier, domestic sales shrank in a lesser degree (2.0%) compared to export sales over the Jan-Jul 2002 period, with the largest

Indices and Shares of the Manufacturing Industries over the Jan-Jul 2002 Period by Contribution to Total Industrial Sales

Manufacturing Industries	*Share*	*2002 Index Performance (on a year earlier)*
Industry – total	***100.0***	***96.9***
Manufacture of metal products	*8.0*	*116.0*
Manufacture of electrical and electronic equipment and machinery	*3.6*	*113.9*
Manufacture of products of other non-metal mineral raw material	*4.0*	*110.1*
Textiles	*2.5*	*113.0*
Electricity, heating, gas and water supply	*16.2*	*101.8*
Clothing	*4.2*	*106.9*
Timber and products thereof, furniture excluded	*1.3*	*114.0*
Other industries	*1.3*	*110.9*
Metal ore mining	*2.3*	*104.2*
Production of non-metal raw material	*0.8*	*107.8*
Production of wood, paper and cardboard, publishing and printing, audio and TV records, CD writes, etc	*1.1*	*103.6*
Leather, travel goods and footwear	*1.0*	*101.6*
Vehicles	*1.2*	*91.8*
Manufacture of rubber products and plastics	*1.5*	*92.6*
Coal mining, crude oil and natural gas extraction	*1.8*	*92.9*
Food, beverages and tobacco products	*16.6*	*97.8*
Chemicals	*8.2*	*90.9*
Metal production and casting	*8.4*	*80.7*

Construction



Source: NSI, AEAF

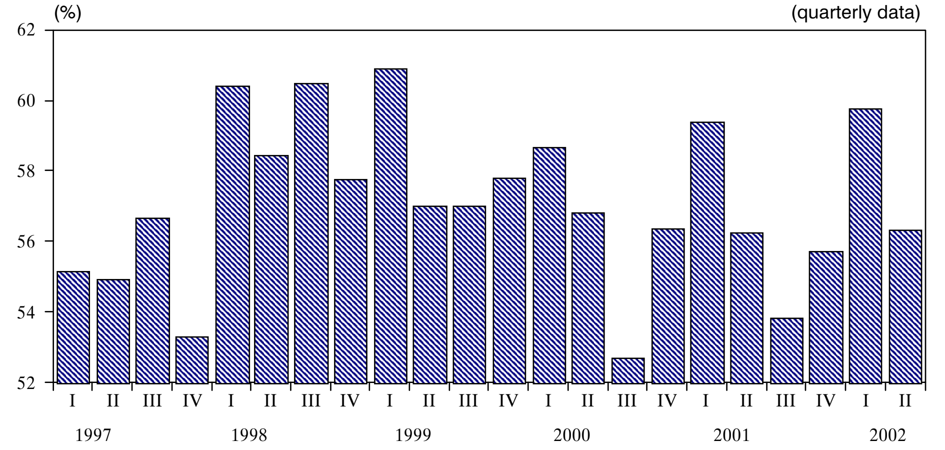
[16] *Data taken from the monthly World Bank* Commodity Price Data (Pinksheets) *bulletin at http://www.worldbank.org/prospects/pinksheets/index.htm.*

contribution to the domestic sales decline reported by the chemical industry (0.9%) and food, beverages and tobacco (13 percentage points). Food sales exhibited a rather unsystematic dynamics in the home and foreign markets. While domestic sales went on a steady decrease, export sales reported a significant volume rise.

GVA growth in the construction sector over the first half-year period of 2002 amounted to 1.4%. Though business activity in the sector is seasonally weak in the first quarter, 12-month growth in the first quarter of 2002 ran significantly higher at 2.1% against 0.9% in the second quarter. According to NSI business survey data, the financial conditions of construction firms improved tremendously and the number of customers in arrears declined. By contrast with the manufacturing sector, the importance of difficulties deriving from insufficient demand and low competitiveness of companies diminished.

Services. The service sector has been reporting a most robust growth since 1999. As a result, its share in gross value added stepped up from 50.7% in 1998 to 61.4% in the first half-year period of 2002. On a year earlier, the service sector registered a real-term growth of 6.6% and 5.3% in the first and second quarters. Over the same period, all service industries grew by over 3%, with communications performing most robustly. Since the institution of the currency board arrangement, the sector has reported a nearly three-fold rise in real terms due to the dynamic advance of IT, on the one hand, and rising demand, on the other. Final household consumer spending on communications services in the six months to July 2002 stepped up 23.3% on a year earlier. Efficiency in the communications business, estimated as the ratio of gross value added to gross output in the sector also went on the increase. Overall in the service sector, efficiency was highest in the first quarter but deteriorated significantly in the second quarter.

Ratio between Gross Value Added and Gross Output in Services



Source: NSI, AEAF

Employment, Unemployment and Wages

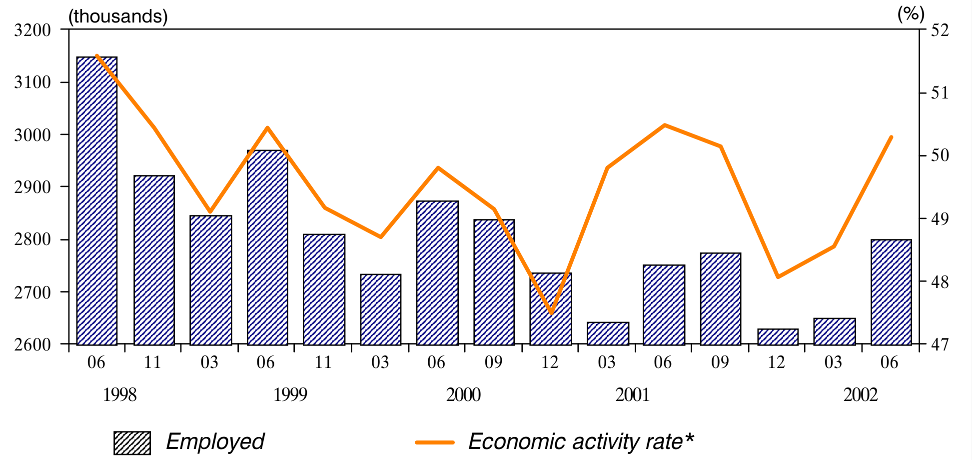
In the first half-year period of 2002, the number of *employed* in the economy[17] was steadily rising. In June, this number was 1.8% higher than a year earlier, and 1.1% above the first six-month average, relative to the same period of 2001. Employment increased mainly as a result of the sustainable growth in the economy in the first two quarters of the year. The number of employed on labour contracts, accounting for the country's core employment, stepped up by 2.2% in the six months to July on a year earlier, with this number going 10% up in the private sector against 6.2% in the public sector.

[17] *According NSI data taken from labour force surveys.*

The industries where the number of employed reported the fastest year-on-year growth were as follow: hotels and restaurants – 25.7%; trade, repair and safety maintenance of automobiles – 15.1%; tailoring and textiles – 8.1%; and construction – 6.6%[18]. At the same time, the budgetary sector where employment has gone on a steady decline over the last few years, reported some increase in the employed numbers of 0.5%. The number of employed in public administration stepped up by 3.5% while employed in the budgetary sector of health care and education contracted by 1.8% and 0.1% respectively. The employment reduction in public health care and education was made up for by the growing private-sector employment in the same sectors, as a result of which the two sectors contributed to total employment growth in the economy rather than its decrease in the first half-year period of 2002. However, the assumptions that the first half-year period may bring about an upswing in the health care and education employment dynamics are too hasty, as the structural adjustment of the sectors has not yet been completed.

In the six months to July 2002, employment declined most drastically in the manufacturing sector, following the decline in sales revenues there. Employment over the same period decreased as follows: metallurgy and metal products, manufacture of machinery excluded – 21.7%; manufacture of rubber products and plastics – 8%; and the chemical industry – 6.1%. The number of employed also decreased in industries where the privatization programme was brought to a near end but the restructuring of enterprises was still underway such as: production of coke, refined oil products and nuclear fuel (9.6%); financial intermediation – 7.7%; and production of energy raw material – 5.9%.

Number of Employed and Economic Activity Rate



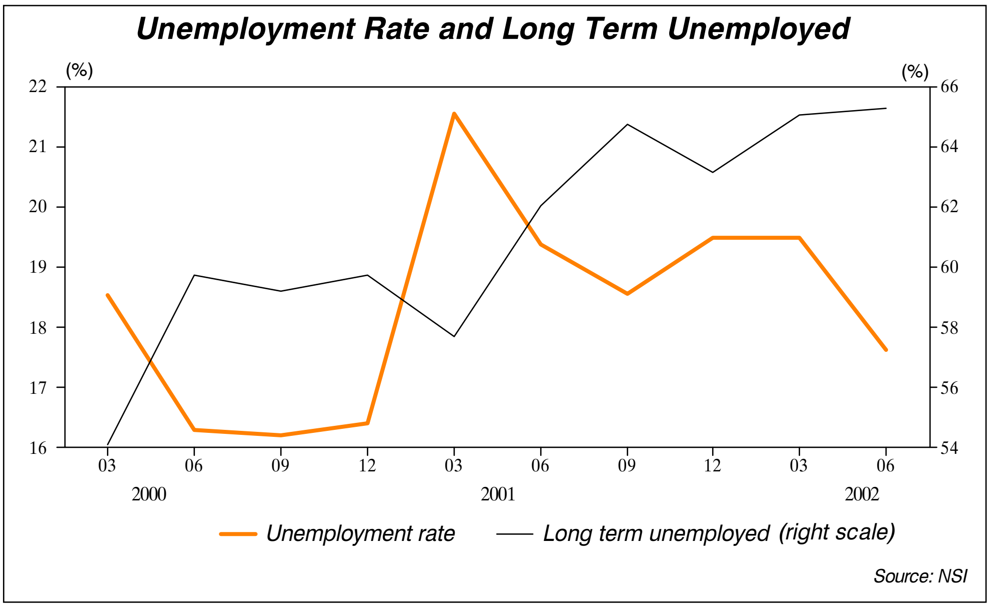
* As a percentage of the labour force to the working age population

Source: NSI

The 4.6% *improvement in productivity* in the economy in the first half-year period of 2002 was due to the higher GVA growth rate relative to the number of employed. Productivity reported a most rapid 11.9 percentage point increase in the transport and communications sector which fully matched data on higher efficiency and faster investment growth in communications. Productivity also improved in the processing industries and financial intermediation by 3.8% and 3.3% respectively. Of all industries reporting a GVA decline, though by a bare 0.3%, productivity in the mining industry improved as a result of the faster employment contraction of 11.3% in the same industry. At the same time, as the number of employed grew at a faster rate compared to GVA productivity deteriorated as follows: construction (-5.7%) and agriculture, forestry, hunting and fishery (-2%).

[18] *According to NSI data provided from employment and wage surveys. NSI business survey data also indicate that managers' expectations as to employment opportunities in the manufacturing sector have improved.*

Also, in the first half-year period of 2002, the number of *unemployed* tended to decline consistent with the steady upward employment trend over the same period. Decreasing by 1.8% on a year earlier, June 2002 unemployment amounted to 17.6%[19]. The average monthly number of unemployed in the eight months to September reported a 1.7% year-on-year decline. Since the start of 2002, the unemployed numbers have been steadily decreasing except for the April labour market downswing when some government temporary employment programmes terminated. All this indicates a certain lack of labour flexibility, also implying that the country's labour force may lapse into a „market failure" situation, were there no government intervention in the form of employment and vocational retraining programmes.



A positive labour market development in the period considered is that the declining number of employment redundancies has grown into a key factor for the decreasing number of registered unemployed, which in the eight months to September stepped down by 11% on a year earlier. The number of private-sector employment redundancies over the Jan-Aug 2002 period decreased by 11.6%, and job cuts in the public sector contracted by 9.8% on a year earlier[20]. This is an indication that the effect of budgetary sector restructuring and privatization on employment dynamics, discerned in preceding years, has now diminished, giving way to the phase of the business cycle. Alongside, the share of long-term unemployed with unemployment spells of over a year went on increasing by 2 percentage points. The number of long-term unemployed stepped up by 2.6% on a 12-month average. The structure of this unemployment cohort by profession, level of education and age shows that job-seekers of over 50 years of age and secondary or lower level of education and without profession stand the slimmest chance of finding new jobs.

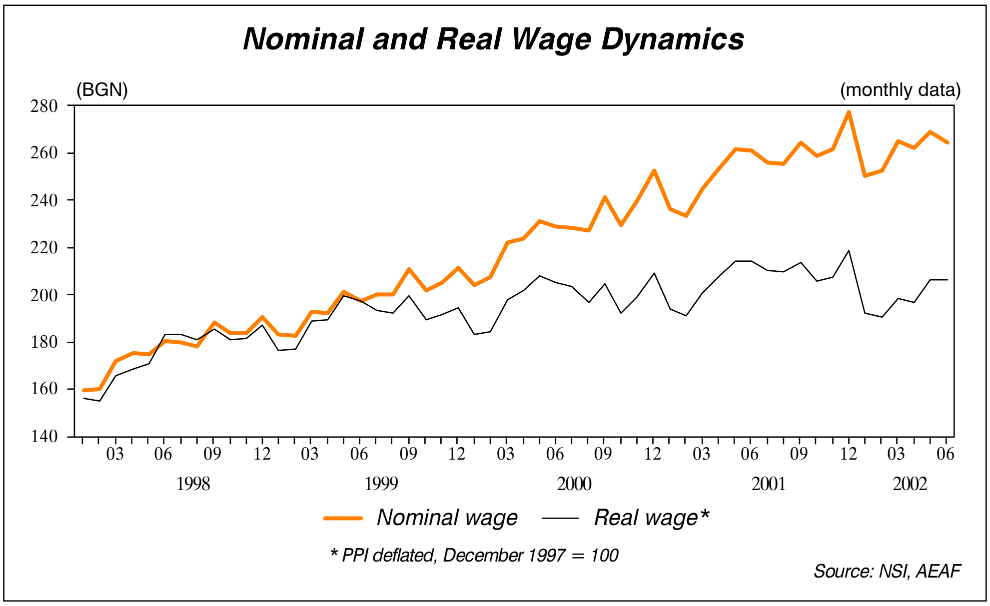
The outflow of registered unemployed stepped down by 12.4% on average in the eight months to September[21]. The number of job seekers who had found new jobs as percentage of the registered unemployed cohort declined by 3.2%, or 4719 due mainly to the amended employment policy priorities on the government agenda adopted in early 2002 and limited effect of temporary employment programmes. As a result, the number of vacancies announced under employment programmes and employment promotion measures stepped down by 11392 in the eight months to September on a year earlier while private-sector vacancies announced by job centres reported a 7% increase, pointing not only to some revival in the private sector[22],

[19] *According to the findings of NSI labour force surveys. A similar trend is evidenced by registered unemployed data of the Employment Agency under the Ministry of Labour and Social Policies.*

[20] *According to data released by the Employment Agency.*

[21] *According to data of the Employment Agency.*

[22] *Although job centres are not the only source of employment opportunities.*



but the healthy effect of employment policy amendments since the start of the year as well.

The country's *average wages* in the first half-year period of 2002 amounted to BGN 260 and reported a 0.2% year-on-year decrease at constant prices, although real wages went on the rise in both the private and public sectors[23]. Real wages in the public sector stepped up by 0.8% to BGN 300, whereas private-sector wages reported a real-term increase of a bare 0.2% up to BGN 234. Real disposable income over the same period had also declined by 2.8%. Wages and disposable income followed a different rate of decline, as the reduction in the tax burden effected in early 2002 could not offset the increase in the social security and health insurance contribution rate[24].

The different patterns of productivity and real wage dynamics led to further improvement of competitiveness in the economy in the first half-year of 2002, as evidenced by data on both the year-on-year export growth in the same period and the improvement in the balance of payments current account (see the *Balance of Payments, Foreign Trade and External Finance* Part).

Inflation

Inflation in the eight months to September 2002 amounted to 0.6%, hitting a record low over the same period since the onset of the transition. Relative to the average price level on a year earlier, average 12-month inflation over the Jan-Aug 2002 period decreased down to 5.9%. Inflation in the eight months to September declined rather inconsistently. January and February witnessed a sharp rise in the monthly inflation rate, with cumulative inflation in the first quarter reaching 5.2% due to the administered price increase and its indirect effect on the remaining prices. The implementation of the measure produced a stronger than expected impact on early-2002 inflationary and business expectations, despite the stability of the macroeconomic environment.

However, the effect of economic policies aimed at overcoming macroeconomic disequilibria and stabilising the country's macroeconomic environment implemented in late 2001 made up rapidly for the loss of economic agents' confidence resulting in deflation in most of the months following March. The price dynamics turnaround

[23] The different dynamics of the aggregate and composite indicators was due to the different patterns of dynamics of the number of employed in the two sectors. According to NSI data, the number of public-sector employed, excluding those on maternity leave, used to calculate the country's average wages, reported a 4.5% contraction while the number of private-sector employed stepped up by over 26%. Since public-sector wages are more than 25% higher than private-sector wages, the decline in public-sector employment at the expense of private-sector employed has led to a change in the weights used to estimate the country's average wages and hence a wage decrease, despite the increase by sector of the economy.

[24] Since the start of 2002, the social security and health insurance burden has been shared by employees and employers in a ratio of 25:75%, instead of the previously applied ratio of 20:80%.

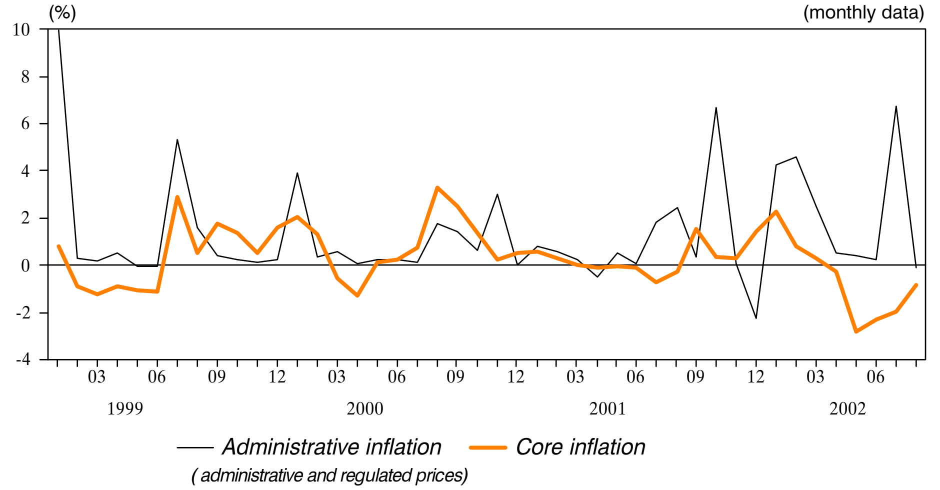
was growth-conducive and had a favourable effect on business situation expectations by the end of the year. As a whole, however, this episode of the price dynamics in Bulgaria's most recent economic history indicates that the adjustment of the country's economy in the wake of shocks entails larger fluctuations compared to most EU applicants due to policy misjudgements during the transition in the 1990s, which in turn made economic agents more sensitive to shocks, as compared to the more reform-advanced former command economies.

The inflationary expectations of economic agents prompted up by a administered price increase or the announcement of a planned price hike continued to affect the prices of other goods, though in a lesser degree. Thus, for example, administered prices in January and February stepped up by 4.2% and 4.6% on a monthly basis, triggering a rise in core inflation of 2.3% and 0.8% respectively. The above increase was higher than the one implied by the performance of the macroeconomic indicators at that time.

The cumulative rise in administered price inflation in the seven months to August 2002 ran at 20.5%, with the highest price increase being reported by cigarettes (44.2%), electricity (23%) and medicines (21.8%) due to the higher excise duty rates on cigarettes and the VAT levied on locally produced medicines since the beginning of 2002. Electricity and heating prices stepped up by 18.2% and 10.1% respectively, effective from 1st July. No further administered price increases are expected to take place by end-2002, but administered prices will have a prevailing contribution to annual inflation with a view to the cumulative growth in the administered price index in the seven months to August.

The low rate of cumulative inflation since the start of the year was solely due to the 4.9% decrease in free prices relative to December 2001 against a decline of a bare 0.4% in the eight months to September 2001. Free prices account for 78.75% of CPI basket and are largely dependent on international price

Administrative and Core Inflation



Source: NSI, AEAF

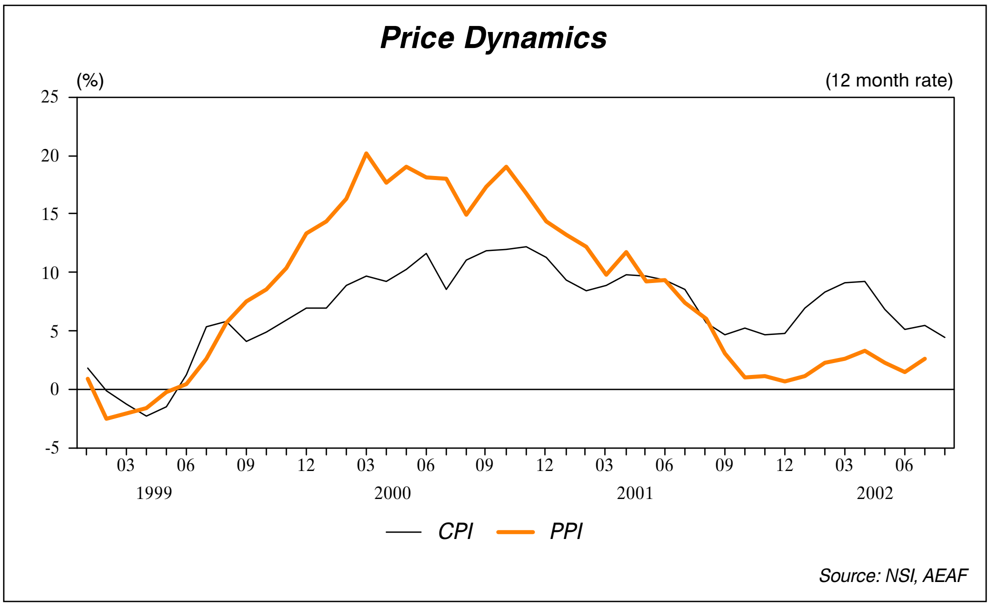
Price Change and Contribution of the Main Commodity and Service Groups to Inflation (August 2002 on a year earlier)

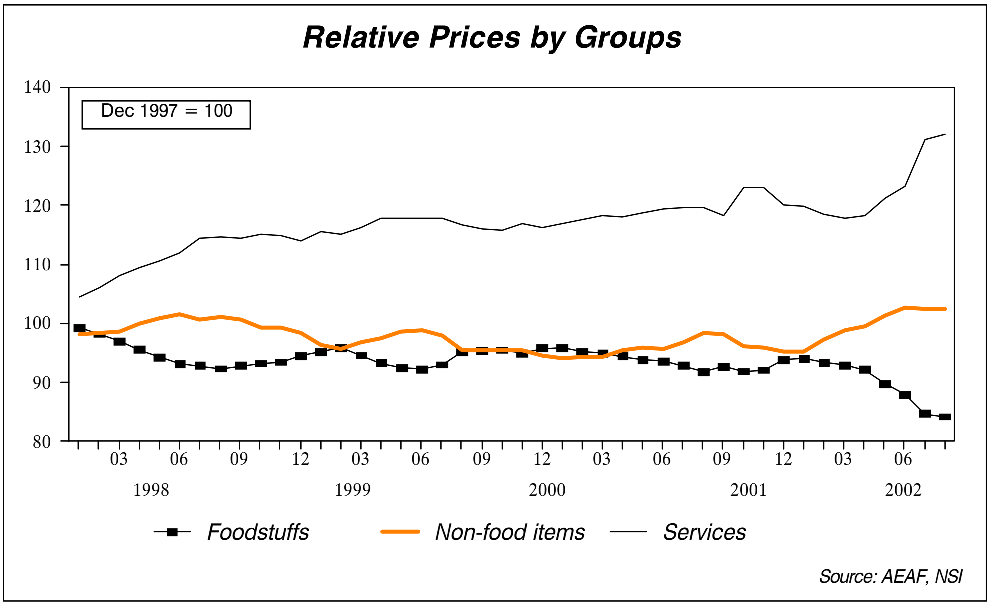
Commodity Group	*Price Change (%)*	*Contribution Rate to Inflation (in % points)*
A. Food items	*-9.7*	*-4.3*
B. Non-food items	*8.3*	*2.1*
C. Catering establishments (canteens and restaurants)	*2.4*	*0.1*
D. Services	*10.7*	*2.7*
Inflation	***0.6***	
A. Monitored prices	*20.5*	*4.4*
B. Free prices	*-4.9*	*-3.8*

dynamics, the BGN/USD exchange rate, relative price adjustments as well as the inflationary expectations and administered price change above handled.

The relative decline in international prices and depreciation of the US dollar on a year earlier checked the price increase in tradables and potential tradables, even triggering a certain decrease in some prices. In the eight months to September 2002 the group-aggregate price change in tradables and potential tradables ran at 0.5% and -6% respectively. The direct effect of the exchange rate dynamics on the CPI was estimated at about one percentage point decrease in overall inflation in the period after March 2002.[25]

The international price dynamics of raw materials exerted a strong pro-inflationary impact on *producer prices*. In the seven months to August 2002, producer price inflation stepped up by 2.6%, whereas in July it ran at only 0.1% on a year earlier. Ever since the institution of the currency board in Bulgaria, there has been discerned a strong correlation between the PPI and the CPI.





The Balassa-Samuelson effect[26] for the Bulgarian economy validates the supposition that the different inflation rates in Bulgaria and the Euro-area countries under a BGN/EUR exchange rate peg do not entail loss of competitiveness in the economy. The real appreciation of the Bulgarian currency was by and large due to the higher prices of non-tradables, what services are in actual fact. In the seven months to August 2002, tradables reported a further price rise of 6.3%.

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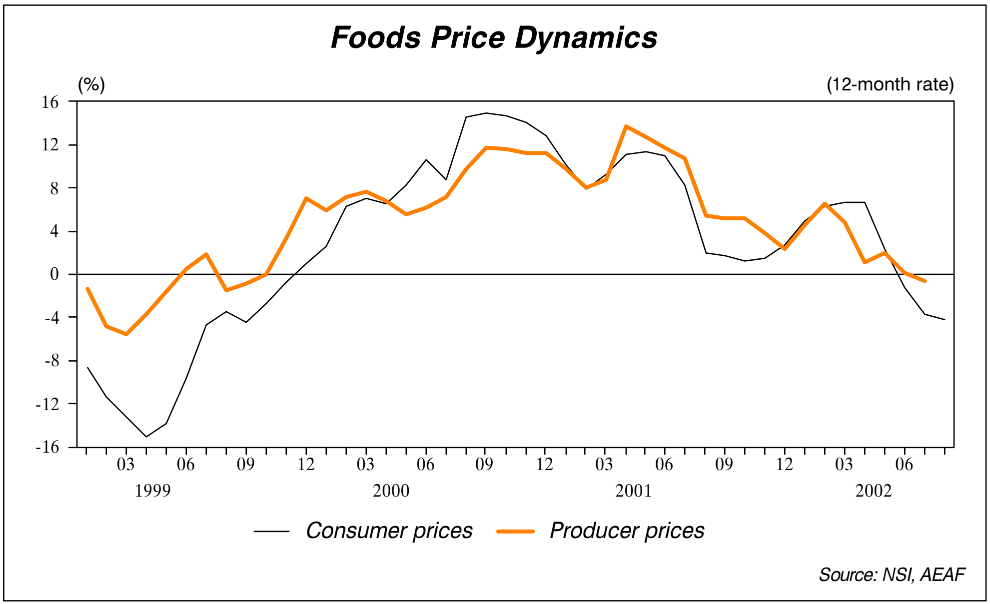
[25] *The nominal BGN/USD exchange rate depreciated by 2.7% over the Jan-Aug 2002 period on a year earlier. The depreciation of the USD was even more distinct in the Mar-Aug 2002 period when it lost ground to the Bulgarian currency by 11%.*

[26] *For detailed information on the effect in Bulgaria, see Choukalev, G. „The Validity of the Balassa-Samuelson Effect for the Bulgarian Economy", AEAF, March 2002.*



Of all the four groups making up the CPI basket, food items alone reported a price decrease (9.7%) over the Jan-Aug 2002 period. The group comprising all food products and beverages had a negative contribution to inflation of -4.3 percentage points and grew into a key factor for the low level of the aggregate price index. Food price dynamics is heavily dependent on seasonal fluctuations. Over the Apr-Aug 2002 period, food prices were steadying falling by -2.8% on a monthly average. The expectations are that the downward price trend will turnaround as early as September and monthly food price inflation will outstrip inflation in the remaining items in the CPI.

AEAF expectations are that core inflation will run higher than administered price inflation by the end of 2002 due mainly to the increase in food and service prices. 2002 inflation is expected to amount to 3.5% to 4%, running at the same time at about 6% on a yearly average.

PUBLIC FINANCE

The first half-year period of 2002 witnessed the first visible results of the long delayed strategic changes in public finance. The general government sector contracted as a result of the consistent policy effort at optimising the re-allocative function of public finance in the economy. Total revenues and grants amounted to 41.9% of GDP against 46.2% on a year earlier. Also, general government budget expenditures and transfers were curtailed to 40.1% of GDP, relative to 44.3% over the Jan-Jun 2001 period, in an attempt to guarantee the retention of budget discipline in proportions needed to maintain the country's macroeconomic stability and avoid any further and deeper current account imbalances while promoting sustainable growth under a currency board arrangement.

Budget Deficit and Government Debt

The implementation of the policy guidelines as regards the 2002 budget in the first half-year period guarantees the budget balance under a relatively less stringent fiscal restriction on a year earlier. The general budget primary and domestic surplus declined by 1.0% and 0.8% to reach 4.9% and 4.5% respectively of GDP. The general budget cash surplus stepped up by 0.6 percentage points, amounting to BGN 271 mn, or 1.9% of GDP in end-June. Domestic savings and the positive *savings-investments* balance went on the decrease, without ensuing, however, any deterioration in the current account of the balance of payments. The eased fiscal restriction and reduced government intervention were coupled with vast and extensive alterations on the revenues and expenditures sides of the general government budget.

The curtailing of almost all expenditure items without giving rise to social tensions or undermining the government's political will for economic reforms was the main factor at work leading to the generation of a general government budget surplus, despite the reductions on the revenues side. General budget expenditures aimed at improving the distribution of resources[27] declined by 3.7 percentage points over the six months to July on a year earlier, whereas interest expenditures stepped down by 1.6%. Expenditures allocated to support basic general government functions and expenditures having to do with income re-allocation remained 0.5% and 0.3%[28] lower over the same period.

In the first half-year period of 2002, there occurred a number of changes in the pattern of budget deficit financing. Unlike the preceding year when it amounted to – BGN 57.4 mn, the BGN 147.0 mn worth of a net issue of government securities now ran positive. Government's deposits and accounts went on rising, reporting a BGN 322.6 mn six-month growth. The deposits and accounts consolidated in the Single Treasury Account stepped up by BGN 258.9 mn. Their change made a major contribution to the BGN 482.6 mn worth of negative domestic financing[29]. Privatization revenues remained unchanged at their last year's levels[30] and

[27] Expenditures aimed at improving the allocation of resources in the economy include expenditures as follows: education, health care, science, housing construction, public amenities and utilities, environmental protection, recreation, culture and religion, other business activity and services.

[28] Expenditures allocated to basic general government functions cover spending on: defence and security, executive/implementing and legislative bodies and general administration. Expenditures related to income redistribution include social insurance contributions, social assistance and care.

[29] BNB loan extensions under article 45 of the BNB Act have been accounted for as an external financing item, as they reflect the country's arrangements with the IMF.

[30] If the 2001 dividend payments made by the Bank Consolidating Company (as a result of the privatization of Bulbank), accounted for as other domestic financing item, were taken into account, 2002 revenues from privatization would remain BGN 424 mn lower.

Major Public Finance Indicators

(in millions of BGN)	*2001**	*2002*
Revenues and grants	*6 062.1*	*6 067.1*
(as % of GDP)	***46.2***	***41.9***
Tax revenues	*4 630.7*	*4 633.4*
(as % of GDP)	***35.3***	***32.0***
Profit tax revenues	*752.2*	*592.0*
(as % of GDP)	***5.7***	***4.1***
Personal income tax revenues	*516.9*	*511.0*
(as % of GDP)	***3.9***	***3.5***
VAT	*1 203.5*	*1 222.3*
(as % of GDP)	***9.2***	***8.4***
Excise duties and fuel duties	***493.4***	***616.3***
(as % of GDP)	***3.8***	***4.3***
Customs duties and levies	*87.8*	*88.4*
(as % of GDP)	***0.7***	***0.6***
Social insurance revenues	*1 431.8*	*1 459.0*
(as % of GDP)	***10.9***	***10.1***
Non-tax revenues	*1 172.0*	*1 317.8*
(as % of GDP)	***8.9***	***9.1***
Grants	*259.3*	*115.9*
(as % of GDP)	***2.0***	***0.8***
Expenditures and transfers	*5 808.0*	*5 796.0*
(as % of GDP)	***44.3***	***40.1***
Current expenditures	*5 273.5*	*5 374.6*
(as % of GDP)	***40.2***	***37.1***
Interest expenditures	*608.1*	*437.9*
(as % of GDP)	***4.6***	***3.0***
Capital expenditures	*533.6*	*408.7*
(as % of GDP)	***4.1***	***2.8***
Primary balance	*862.2*	*708.9*
(as % of GDP)	***6.6***	***4.9***
Cash balance	*254.1*	*271.0*
(as % of GDP)	***1.9***	***1.9***
*Government and government-guaranteed debt***	*21 197.7*	*18 963.9*
(as % of GDP)	***71.6***	***58.4***
Domestic debt	*1 768.8*	*1 987.7*
(as % of GDP)	***6.0***	***6.1***
Foreign debt	*19 428.9*	*16 976.2*
(as % of GDP)	***65.6***	***52.3***

** To make comparison easier, the figures of net lending/borrowing and acquisition of stocks and shares, equities and other financial assets (net) have been taken out of the expenditure item.*

*** Debt data as of end-August.*

Source: MoF

are likely to fall short of the 2002 budget projections amounting to BGN 618.5 mn, has the privatization programme not been implemented by end-2002, resulting in a decrease in the deposit and account funds of the government.

As of end-June, external financing ran positive at BGN 81.5 mn. Principal payments to the London Club amounted to BGN 652.5 mn due mainly to the swap of Brady bonds for EUR- and USD-denominated global bonds. Swap offers of total nominal worth of USD 1 327.9 mn were accepted. The bonds issued were as follows: MEURO 835.5 mn worth of Euro bonds callable upon in 2 013, and USD 513.0 mn worth of USD-denominated bonds falling due in 2015[31].

In 2002, the government and government-guaranteed debt went on declining not only as percentage of GDP but in nominal terms as well[32], and as of end-August it amounted to MEUR 9 696.1 mn, or

[31] *For further details on the transaction, see document „Brady- for- New Global Swap. Results of the Swap", published on the website of the Ministry of Finance.*

[32] *October 2002 operations on foreign debt restructuring remain outside the consideration of this report.*

58.2% of the GDP forecasts[33], reporting a BGN 1 815 mn worth of contraction (12 percentage points of GDP). The share of domestic debt stepped up from 9.0% to 10.5% of total debt. The debt currency and interest structure improved due mainly to the Brady bond swap, as did the resultant predictability of payments and the performance of most debt indicators, despite the expectations for higher interest payments in 2002 and 2003.

Debt Restructuring

The Brady- for-global swap carried out in March 2002 included as follows:

– exchange of Brady bonds for EUR- and USD- denominated globals;

– swap for payments in cash;

– acceptance of bids for the new EUR-denominated global issue against cash payments.

The Brady-for-global swap was aimed at making locked-in and long-term cost savings on debt service. The long-term effects of the swap are expected to come along the lines of reducing refinancing risk of the debt upon retiring, and hence reduction in the risk premium, country's credit rating upgrade and follow up curtailing in debt servicing costs.*

The direct effect of the Brady-for-global exchange expected point to net cost relief on debt service of USD 397 mn of total worth over the next five years and USD 670 mn in the next nine years.

Results of the swap:

There were placed on the market bids of nominal worth of USD 2.7 bn, accounting for 56% of all Brady bonds in circulation. More than 85% of the bids were accepted at floor (non-competitive) prices. The average yield on the Brady-basket retired ran at 9.41% while the yield on the new Eurobond issue amounted to 8.44%. Forty-two percent of the

Results of the Brady-for EUR-denominated bond exchange auction

Brady bonds	*Floor prices (%)*	*Exchange prices (%)*	*Nominal worth of Brady bonds*	*Nominal worth of the new EUR issue (in EUR)*
IAB	*88.50*	*88.50*	*94 873 067*	*96 689 000*
FLIRB A	*90.50*	*90.50*	*121 372 440*	*129 100 000*
FLIRB B	*90.50*	*91.45*	*83 446 100*	*89 700 000*
Discount A	*90.50*	*90.50*	*142 377 000*	*151 438 000*
Discount B	*90.50*	*90.50*	*1 340 067*	*1 424 000*
Total			***443 408 674***	***468 351 000***

Results of the Brady for USD – denominated exchange auction

Brady bonds	*Floor prices (%)*	*Exchange prices (%)*	*Nominal worth of Brady bonds*	*Nominal worth of the new USD-denominated issue (in USD)*
IAB	*88.50*	*88.50*	*168 798 000*	*156 252 000*
FLIRB A	*90.50*	*90.50*	*41 818 000*	*40 392 000*
FLIRB B	*90.50*	*92.50*	*54 003 572*	*53 320 000*
Discount A	*90.50*	*90.50*	*198 916 000*	*192 123 000*
Discount B	*90.50*	*92.50*	*71 853 030*	*70 944 000*
Total			***535 388 602***	***513 031 000***

Results of the Brady-for-Cash exchange auction

Brady bonds	*Floor prices (%)*	*Exchange prices (%)*	*Nominal worth of Brady bonds*	*Payments in cash*
IAB	*88.50*	*88.25*	*85 041 503*	*73 548 144*
FLIRB A	*90.25*	*90.25*	*74 304 104*	*67 059 454*
FLIRB B	*90.25*	*92.25*	*1 573 000*	*1 419 633*
Discount A	*90.50*	*90.50*	*184 558 545*	*167 025 483*
Discount B	*90.50*	*90.50*	*3 596 982*	*3 255 269*
Total			***349 074 134***	***312 307 982***

* *If GDP had reached 125% of its 1993 level, there would have been additional payments on the coupon, DISCs in particular*

[33] *The 2002 GDP expected amounts to BGN 32 607 mn.*

bids were non-competitive and traded at the floor prices announced. DISC bonds accounted for 45% of all accepted bids. The more liquid FLIRBs and Discounts, series A were exchanged at the floor price. Nearly 90% of Discounts A and over 90% of FLIRBs B were offered for exchange.

The locked-in effect of direct transaction results indicate that the net relief in the external debt nominal worth amounted to USD 80 mn, and cost savings, calculated on a NPV basis – to USD 94 mn.

The employment of credit instruments other than Brady bonds are expected to improve the country's credit standing and hence reduce the risk premium in assessing privatisation deals on the part of investors.

Budget Revenues

While remaining unchanged in nominal terms over the first half-year period of 2002, tax revenues contracted by 3.3 points as percentage of GDP. At the same time, non-tax revenues reported a BGN 145.7 mn worth of an increase, hitting 9.1% of GDP, whereas receipts from grants shrank by BGN 143.4 mn and accounted for a bare 0.8% of total revenues and grants. On the revenue side, non-tax revenues tended to grow at a faster rate than expected, now enjoying a share within GDP 0.2% higher than in 2001. Revenues from fees, fines, sanctions, penalty interest spread, etc. alone increased by BGN 126.3 mn on a year earlier and accounted for 3.8% of GDP. On the one hand, the above development was indicative of the improved efficiency of the tax authorities in implementing the country's tax legislation and limiting corruption incidence. On the other, more and more often non-tax revenues appeared to be a form of quasi-taxation, affecting the business environment. All this makes them difficult to predict, giving rise to some uncertainty in the revenue programming process. In the six months to June 2002, revenues from grants amounted to a bare BGN 115.8 mn, reporting a 1.2 percentage point decrease in their share of GDP on a year earlier, implying that following its recovery of the last couple of years the Bulgarian economy is getting out of the scope of post-crisis country assistance donorship programmes. At the same time, it is indicative of the country's low institutional capacity to utilize funds under the EU pre-ins. The lower grant inflow/lower revenues from grants over the Jan-Jun 2002 period reinforced their unsustainability, invoking in turn a conservative approach to their programming.

Indirect tax revenues, enjoying the largest relative share within total revenues, fell to 13.3% of GDP due mainly to the underperformance of net VAT revenues, despite the broadened tax base in early 2002[34]. VAT-refunds to exporters have effectively increased[35]. The tax authorities have already taken measures to improve surveillance on VAT-refunds and limit VAT-related frauds, proposing the opening of VAT-refund bank accounts on a voluntary basis. Another reason for the net VAT revenue contraction had to do with the shortened VAT-refund term from four to three months, the six-month effect of which was estimated at BGN 32 mn. As a result of the enhanced tax control and business activity revival anticipated, VAT revenues are expected to increase in the second half-year period of 2002. At the same time, they are also likely to remain well below the BGN 2 779.9 mn projected throughout 2002 making the tax authorities withhold from any further easing of the fiscal restriction beyond the budget policy initially adopted.

Revenues from income and social security contributions in the first half-year period of 2002 remained 1.2% lower than their last year's share in GDP. Their dynamics was mainly determined by the labour tax

[34] *The amendments to the VAT Act of early 2002 apply to the bulk of medicines and the sale of holiday packages by licensed tour operators or travel agencies to be used in Bulgaria by foreign persons (an effective tax rate of 7%)*

[35] *From BGN 382.1 mn in the first half-year period of 2001 to BGN 595.7 mn in 2002, or a 55.9% increase.*

legislation amendments enforced in early 2002. Overall in the year, the effective tax rate on labour is expected to decline by about 2 percentage points of GDP[36]. As a result of the tax policies adopted, the effective tax rate on capital decreased as well. Profit tax revenues stepped down to 4.1% of GDP, reporting a 1.6 percentage point year-on-year shrinkage. The effective tax rate on consumption reported the least decline over the Jan-Jun 2002 period and accordingly tax revenues from consumption had decreased by a bare 0.3% of GDP over the same period. Revenues from income from property went from 5% to 4.8% of GDP, symptomatic of the continuous and smooth withdrawal of the state from government-remote activities.

Budget Expenditures

The consistent policies of reducing the re-allocative function of public finance in the first half of 2002 led to a parallel contraction in general budget expenditures as well. The largest contraction was reported by foreign interest expenditures (1.3%) and capital expenditures – 1.3% of GDP. Non-interest expenditures reported a 3.3 percentage point decline down to 37.0% of GDP. The lower interest payments, as due to the lower interbank interest rates worldwide, allowed for a larger cash surplus despite the deteriorating general budget primary surplus. The period witnessed more significant non-interest current expenditure savings as follows: administration costs (0.5% of GDP); health and medical service subsidies (0.2% of GDP) and social insurance contributions (0.2% of GDP), and pensions (0.2% of GDP). On a year earlier, budget expenditures on benefits and compensations rose as percentage of GDP mainly due to the increase in the health insurance payments made by the National Health Insurance Fund. The dynamics of the latter expenditure item was shaped by the restructuring of health care spending, with the National health Insurance Fund tending to take over the bulk of expenditures.

From the viewpoint of the functional distribution of expenditures, the largest expenditure contraction was reported as follows: business activities and services (from 7.4% to 4.6% of GDP); culture (from 0.7% to 0.6% of GDP); housing construction, public amenities and utilities, and environmental protection (from 1.9% to 1.3% of GDP); education (from 4.4% to 4.1% of GDP); and implementing and legislative bodies (from 2.6% to 2.2% of GDP). It was only health care expenditures that reported a 0.1% increase to reach 4.2% of GDP. The ongoing reforms in both sectors cannot be yet fully and equivocally assessed from the point of view of budget expenditure efficiency, as they need a more detailed and sophisticated socio-economic analysis. While contracting in education (mostly maintenance costs/overhead expenses), current expenditures in health care have gone on the increase due mainly to the growing health

Expenditure Structure by Function (Education and Health Care)

(as % of GDP)	*Education*		*Health Care*	
	2001	*2002*	*2001*	*2002*
Total expenditures	4.40	4.13	4.09	4.20
Current expenditures	4.31	4.05	3.83	4.06
Wages and staff costs	2.09	2.10	0.34	0.33
Insurance contributions	0.77	0.74	0.12	0.11
Maintenance/overhead expenses	1.19	1.04	0.50	0.51
Health insurance payments	-	-	1.36	1.83
Capital expenditures	0.09	0.08	0.26	0.14

[36] *For detailed information on effective tax rates, see Bulgaria's Pre-accession Economic Programme, August 2002.*

insurance payments on medicines for out-patient treatment. The latter reported a most robust year-on-year growth of 63.4% up to BGN 120.4 mn and are likely to call for some alterations in the National Health Insurance Fund's budget, including changes in the pattern of financing of medicine consumption, by the end of 2002.

2002 first half-year budget performance in a third very important social area, i.e. public social insurance (PSI)[37] where extensive and sweeping reforms are underway, complied with the budget programme projections. Reporting a significant improvement from 92.78% on a year earlier, revenues accounted for 96.34% of the projections. Revenues from insurance contributions made by employers amounted to BGN 849 mn, or 97.42% of the six-month programme, whereas personal insurance contributions amounted to BGN 231.2 mn, accounting for 97.38% of the revenue plan. PSI expenditures on pension payments over the Jan-Jun 2002 period ran at BGN 1 382.5 mn, representing 97.67% of revenue projections. The remaining PSI expenditure items did not exceed 2002 forecasts. According to estimates of the National Social Insurance Institute, there can be expected no further deficits beyond the PSI budget.

The so-called „second pillar" of the pension insurance system, covering people born after the end of 1959 has been effectively applied since the beginning of 2002. By September some BGN 24.5 mn of obligatory social insurance contributions to PSI had been re-channelled to private pension insurance funds. The total amount of insurance contributions remained unchanged at its 2001 level, i.e. 42.7% of the gross remuneration package, but the ratio in which employers and insured employed make their contributions was altered from 80:20 in 2001 to 75:25 in 2002, reducing the insurance rate for employers from 34.3% to 32.2% over the same period. This ratio is foreseen to step further down to 50:50 in 2007 aiming to promote job creation and raise employees' personal responsibility for their social insurance by curtailing the insurance burden shouldered by employers.

In early 2002, the minimum retirement age was raised by half a year and is foreseen to further rise by six months over the next five years until reaching 60 years of age for women and 63 years for men. The above measure had a positive effect on the pension system bringing about a decline in the dependency ratio[38], which amounted to 102 in 2002 against 103.1 on a year earlier. The decline in the dependency ratio was mainly due to the decreasing number of pensioners (32 000 less) relative to their 2001 average. The number of insured reported a 0.3% (6 000) year-on-year drop, with about 15% of the employed numbers still uncovered by the social insurance system.

Effective from 1 June 2002, retirement pensions stepped up by 6%, as did old-age pensions rising in the same proportion from BGN 44 to BGN 46.64. Provisions have been also made as to the minimum and maximum pension amounts as well as some pension supplements, e.g. for. war veterans and allowances for support by another individual. The lowest length-of-service pensions now amounted to BGN 48.97, and the highest pensions – to BGN 186.56. Thus in the first half-year period of 202, a retiree received BGN 95.96 on a monthly average. On a year earlier, average expenditures per pensioner reported an 8.9% nominal-term increase while rising by 1.2% in real terms.

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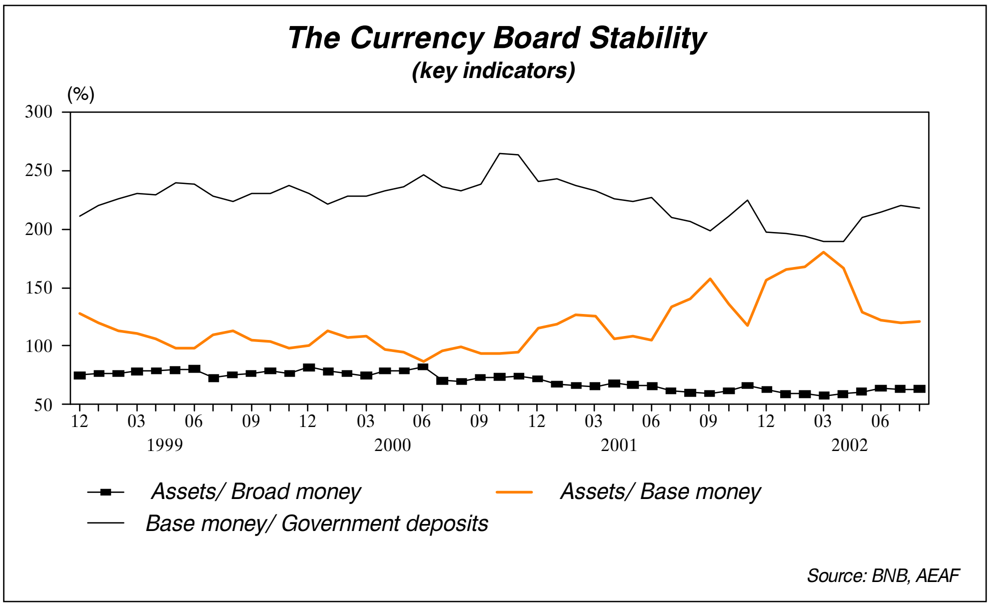
[37] *According to data of the National Social Insurance Institute.*
[38] *Number of pensioners per 100 insured.*

FINANCIAL SECTOR

Currency Board

The currency board in the country was further stabilised in the period since the beginning of 2002. The assets of the BNB's Issuing Department followed a steady upward trend regardless of their unstable dynamics, diverting from the trend in the first quarter of the year. Stepping up by 1.1% against end-2001, BNB's gross forex reserves peaked to their highest since the introduction of the CBA, reaching BGN 8 034.3 mn in end-July 2002. In the seven months to August, the central bank strived to optimise the structure of its assets by instruments aiming to increase their rate of return while observing the risk-related requirements of the BNB Act and taking into consideration the actual liquid assets requirements, arising from external debt service payments and the central banks operations on the domestic forex market in euro and leva. In end-July 2002, tradable foreign securities accounted for 74.7% of total central bank assets, reporting an increase of 4.3 percentage points relative to end-2001. The share of foreign currencies cash in hand within total assets contracted by about 4.8 percentage points over the same period, reaching 16%. Monetary gold preserved its share of around 8% of assets.



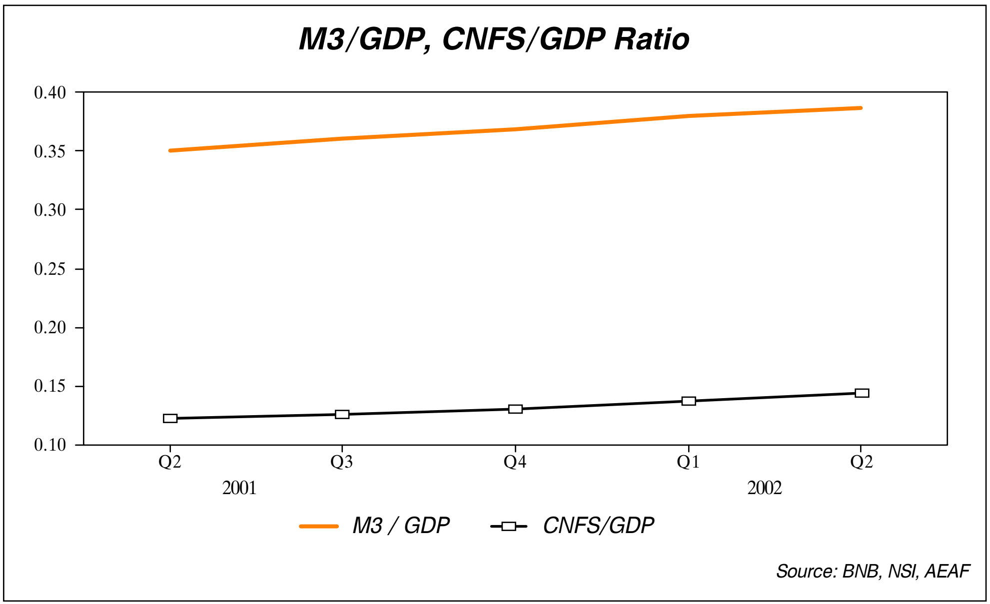
In end-July 2002, the liability side structure of the Issuing Department's balance sheet underwent some changes as well, having to do with the registered decrease of 4.9% and 27.9% of banknotes and coins in circulation and commercial banks' deposits and accounts with the BNB against end-2001. As a result, the share of money in circulation within total liabilities fell by 2.5 percentage points to 38.6%, and that of commercial banks' reserves by 2.7 percentage points down to 6.9%. Over the same period, government and budget organisations deposits reported a 19.2% growth and consequently their relative share in liabilities stepped by 5.8 percentage points up to 38.2% of total liabilities. The latter increase was primarily associated with external debt restructuring operations as well as with the net government budget revenues reported. Again in end-July, the Banking Department Deposit contracted relative to end-2001 leading to a 0.7 percentage point decrease of its weight in BNB's Issuing Department down to 13%.

The increase in the BNB Issuing Department balance sheet value together with the changes in the liabilities side structure caused the coverage ratio (FX reserves/reserve money (money base) to grow from

197% in end-2001 to 219.7% in end-July 2002. Stepping up by mere 0.2 percentage point, the gross FX reserves/broad money M3 coverage ratio also reported an increase over the same period.

Money Supply and Bank Credit[39]

In the seven months to August 2002, money supply reported a negligible increase in nominal terms. It grew by 0.76% or BGN 95.6 mn to reach BGN 12.7 bn. The real-term change in monetary aggregate M3[40] ran negative at -0.5%. On a 12-month basis, the nominal term growth of M3 amounted to 15.6% (BGN 1 710.8 mn), and its real-term rise reached 9.6% indicative of the sustained remonetisation of the economy.



The slackened and even negative growth pace of money stock and some of its components in the first half of 2002 was a result of lower demand for money for transaction purposes in early-year and the higher tax payments from firms and households in the period March to May, having to do with the income tax and profits tax payments deadlines. Highly liquid money (M1) decreased by 6% or BGN 294.9 mn in the seven months to August 2002. Quasi-money reported a rise of 6.1% equal to BGN 437.5 mn. The lowest liquidity components[41] of money stock had a negative contribution (BGN -47.1 mn) to growth of broad money in the period December 2001 to July 2002.

Highly liquid money (M1) components, viz. money outside banks and demand deposits in BGN reported similar rates of contraction in the seven months to August 2002, decreasing by 5.8% (BGN 180.6 mn) and 6.3% (BGN 114.1 mn) respectively. Demand deposits of social insurance funds and non-financial enterprises reported the largest falls over the analysed period. Foreign currency deposits had the largest contribution to the 49.5% (BGN 216 mn) growth of quasi-money. Over the examined seven month period, demand forex deposits shrank by 1.2% (BGN 14.1 mn) whereas time forex deposit stepped up by 7.7% or BGN 226.2 mn.

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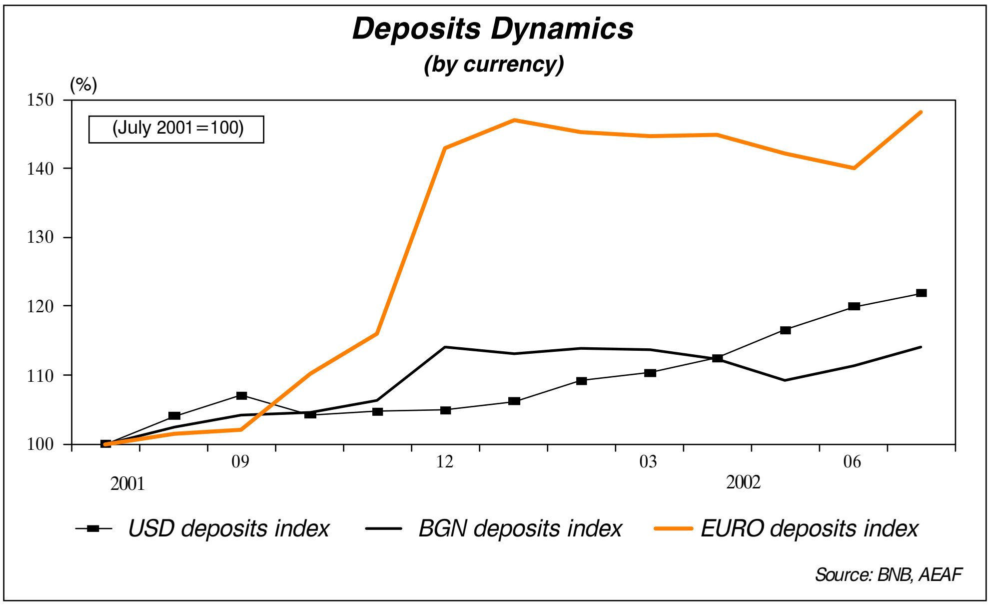
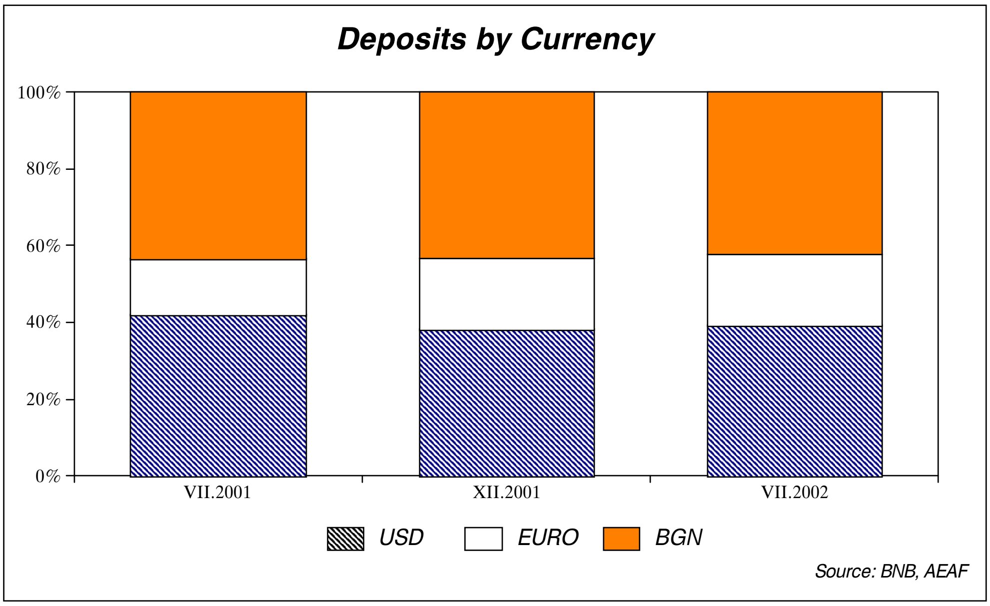
[39] *The Section on money supply and bank credit has been prepared using the new version of monetary statistics, introduced by the central bank in the first half of 2002. The main changes related to the monetary statistics are as follows:*
- *The banks under a bankruptcy procedure have been excluded.*
- *The definitions of certain monetary aggregates have been altered as follows:*
  - *The deposits of The Local Government and Social Security Funds, as well as The Central Government suspense accounts, have been excluded from the receivables of the government sector, and have been included in the monetary aggregates according to their degree of liquidity;*
  - *Foreign currency denominated deposits have been divided into demand, time, and savings deposits;*
  - *A new item of Debt Securities Issued has been set apart as a separate M3 instrument;*
  - *Demand deposits of non-bank institutions have been removed from money base (reserve money) and included in monetary aggregate M1.*

[40] *Deflated by the consumer price index for the December 2001 – July 2002 period.*

[41] *Blocked deposits, debt securities issued, etc.*

In 2002, economic agents were relatively slow to respond to the depreciation of the US dollar to the euro, and respectively to the BGN. For most of them, and for households in particular, the US currency remained the preferred saving vehicle in spite of its lower exchange rate and the relatively lower interest rates on time and demand deposits in USD. Still, deposits in euro sustained their upward trend though at a slower rate than in the second half of 2001 when their growth was triggered by the forthcoming putting in circulation of euro banknotes and coins.



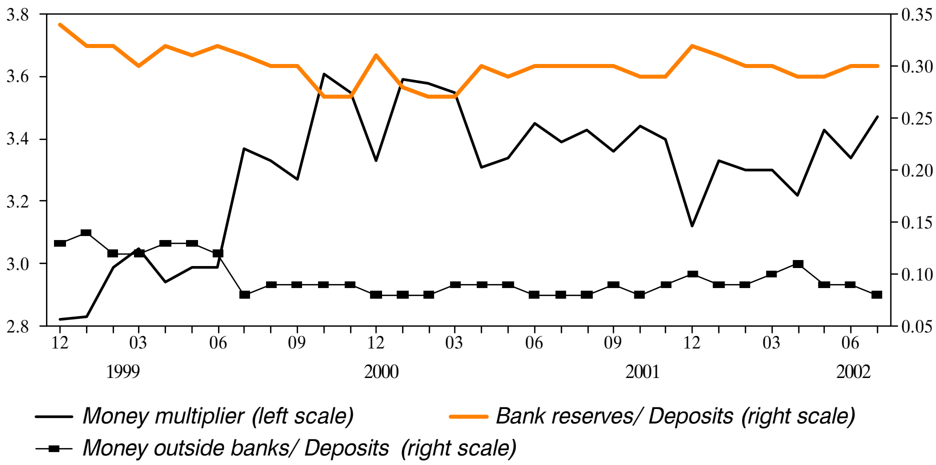


Out of all BGN components of quasi-money, time deposits in BGN reported the fastest growth rates, stepping up by 10.5% or BGN 199.7 mn in the seven months to August 2002 mostly driven by the rise in time deposits of social insurance funds and households. The increase of time BGN deposits of social insurance funds entirely offset the above-mentioned contraction of their demand BGN deposits and was supposedly associated with the measures taken to optimise the rate of return on their free money resources.

The recorded rise of money stock in the seven months to August 2002 was entirely predetermined by the increase of money multiplier from 3.12 in end-December 2001 to 3.47 in end-July. The change in money multiplier mostly reflected the enhanced role of commercial banks as financial intermediaries in view of increased lending to companies and households. On a 12-month basis (relative to July 2001), the contribution of money multiplier's dynamics to the increase of broad money ran considerably lower than that of money base growth, indicating that there was no sustained trend of accelerated deposit (money) multiplication realised by commercial banks.

The ongoing changes in the structure of commercial banks' balance sheets are also illustrative of the growing banks credit activity as a factor boosting the rise of money multiplication. The banking system net

Money Multiplier



Source: BNB, AEAF

Money Stock Dynamics

(from the point of view of the mechanism of money supply)

	Over the 31.12.2001 to 31.07.2002 period	Over the 31.07.2001 to 31.07.2002 period
Money base dynamics (BGN million)	*-375.8*	*418.6*
Change in money multiplier	*from 3.12 to 3.47*	*from 3.39 to 3.47*
Dynamics of money stock (M3) induced by factors of influence:		
1. Money multiplier's change (BGN million)	*1400.2*	*257.6*
2. Money stock change	*-1174.1*	*1420*
3. Changes in multiplier and money base	*-130.5*	*33.2*
Dynamics of money stock M3 (BGN million) =1+2+3	*95.6*	*1710.8*

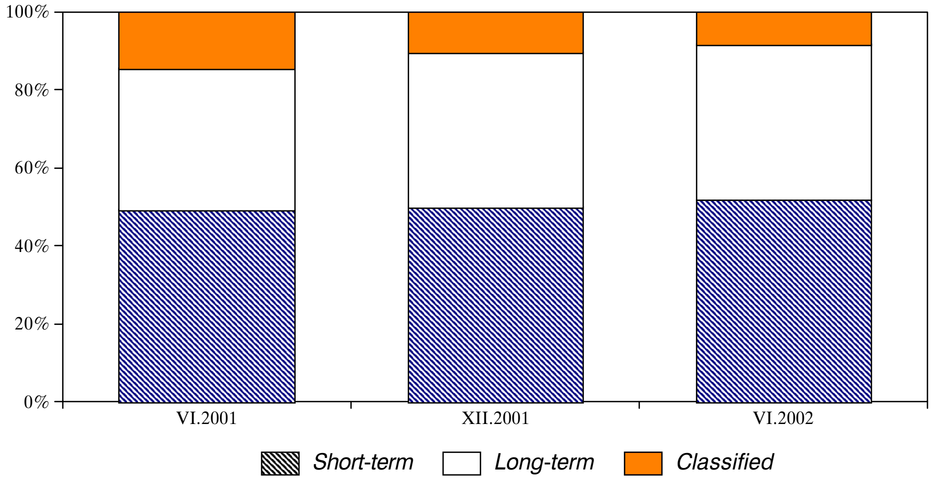
Structure of Credit to the Non-Financial Sector

	VI.2001	XII.2001	VI.2002
Agriculture and forestry, hunting and fishery	*1.4%*	*4.7%*	*4.9%*
Mining industry	*1.7%*	*1.6%*	*1.6%*
Processing industry	*41.5%*	*35.3%*	*33.1%*
Production and distribution of electricity, gaseous fuel, heating and water	*0.8%*	*1.9%*	*1.6%*
Construction	*2.8%*	*2.8%*	*4.4%*
Trade, repair of automobiles and household appliances	*39.0%*	*38.8%*	*41.0%*
Hotels, boarding houses and public catering	*7.9%*	*8.2%*	*8.4%*
Transport and communications, travel agencies and tour operators	*4.8%*	*6.7%*	*5.1%*

domestic assets grew by 14% or BGN 477 mn over the January to July 2002 period whereas its net foreign assets shrank by 4.1% or BGN 381.4 mn. BNB's net foreign assets rose by 7.4% or BGN 408 mn due to growth of central bank's gross forex reserves. However, the reported increase could not offset the 21.2% contraction (BGN 789.4 mn) of commercial banks' net foreign assets. In the period December 2001 to July 2002, domestic credit stepped up by 7.4%, or BGN 461 mn entirely as a result of the 21.3% increase (BGN 949.3 mn) of claims on the non-government sector.

The changes in commercial banks asset structure were brought about not only by the record low interest rates at the international financial markets but also by the sustained macroeconomic stability and post-1997 economic recovery favouring the establishment of long-lasting business relations between banks and their clients. Still, the foreign currency component of credit to the non-government sector exhibited faster growth rates than the BGN component. Both components stepped up by 34.6% or BGN 547.3 mn and by 13.9% or BGN 401.9 mn respectively, strongly influenced by the USD exchange rate dynamics over the analysed period and BNB's regulations on prudent foreign exchange risk management. Inasmuch as depositors continued to opt for savings in US dollars, commercial banks were forced to maintain a matching share of their assets in dollars. Lending to private enterprises grew by 20% or BGN 667 mn, loans to households – by 20.2% or BGN 173.7 mn while credit to non-financial state-owned enterprises rose by 24.7% or BGN 41.9 mn. Lending to the agricultural sector and construction reported the fastest growth rates leading to an increase of these sectors' relative shares. At the same time, the share of claims on processing industry went on the decrease. The maturity structure of credits underwent changes too. The share of long-term loans (of over 1 year) reported a gradual upward trend that is an indirect sign that risk associated with credited projects and overall economic risk have been going on the decrease. The contraction of the pool of substandard claims within total credit to the real sector is also an argument in favour of the preceding assertion.

Bank Loans to the Real Sector by Maturity



Source: BNB, AEAF

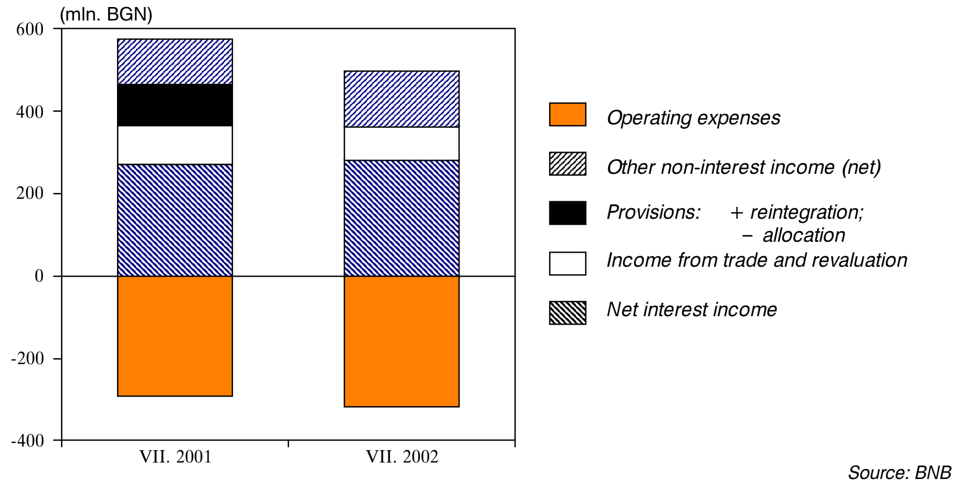
Performance of Commercial Banks

In the seven months to August 2002, the *profitability* and financial performance of the banking system remained stable[42]. As of end-July, commercial banks' net profit amounted to BGN 148.2 mn, reporting a 35.5% decline on a year earlier. The contraction had mainly to do with the lack of one-time incomes from the reintegration of provisions as was the case in the first half of 2001. Had the impact of this factor been eliminated, commercial banks' net profit in the seven months of 2002 would have registered a 13.4% increase on a year earlier. In end-July 2002, the three largest banks[43] accounted for 65.3% of the banking system's net profit, and their share in total profit reported a year-on-year contraction of 9.4 percentage points. On a year earlier, the main changes in the structure of banks' operating profit in end-July 2002 were as follows: the share of the traditionally weighty components, such as net interest income and net incomes from fees and commissions went on the increase at the expense of the lower share of income from trade and revaluation and the lack of income from the reintegration of provisions (net).

The *net interest income/operating expenses ratio* ran at 90.1% in end-July, reporting a 3.6 percentage points year-on-year fall. The value of this indicator in the largest banks is close to or higher than 1, indicating that their operating profit is sufficient to cover their operating expenses. Given the relatively small package

[42] *Out of 35 operating banks, only 4 small banks and 1 foreign bank branch reported losses at the end of the first half of 2002.*
[43] *Bulbank, DSK Bank and UBB.*

Structure of Commercial Banks' Operating Profit Before Tax and Extraordinary Items



Source: BNB

of services offered by the small banks, the importance of the above ratio is not to be overlooked. Thus, in end-July, the ratio hit much lower values than 1 (59.2%) in most of the small banks[44] deteriorating on a 12-month basis and indicating that they have become more and more dependent on a limited circle of clients (mainly corporate) and therefore their susceptibility to risks has increased. Mergers of small banks and takeovers remain logical ways to reduce these risks, however, there is still no sign of any such intentions in the sector. The recently passed amendments to the Banks Act by the National Assembly that aimed at increasing the transparency of bank capital are also likely to contribute to the lowering of risk stemming from excessively tight linkages between commercial banks and specific corporate clients. These amendments were already enforced and the Banking Supervision Department is now in a better position to monitor the financial situation of bank shareholders and to take preventive measures should such risks escalate.

In 2002, commercial banks' capital adequacy indicators sustained significantly higher levels than those fixed by BNB's Ordinance No8. As of end-June 2002, the banking sector[45] overall capital adequacy ran at 28.98%, stepping down by about 2.1 percentage points relative to end-2001. In the six-month period to end-June 2002, the indicator's two principal components, viz. the total risk component of the sector assets and the capital base had increased by 13.2% (BGN 651 mn) and by mere 5.4% (BGN 82.8 mn) respectively. The continuing fall of the unduly high capital adequacy indicators confirms that commercial banks had reversed their approach to credit lending to the real sector of the economy and to profitability in general.

Commercial banks credit portfolio had improved relative to end-December 2001. Thus, as of end-June 2002, some 93.87% of bank risk exposures were classified as standard against 92.3% in December 2001. In the end-June 2002, in spite of the increased bank claims on firms and households, only 2.2% of credit exposures were classified as a loss as compared to 2.5% only six months ago.

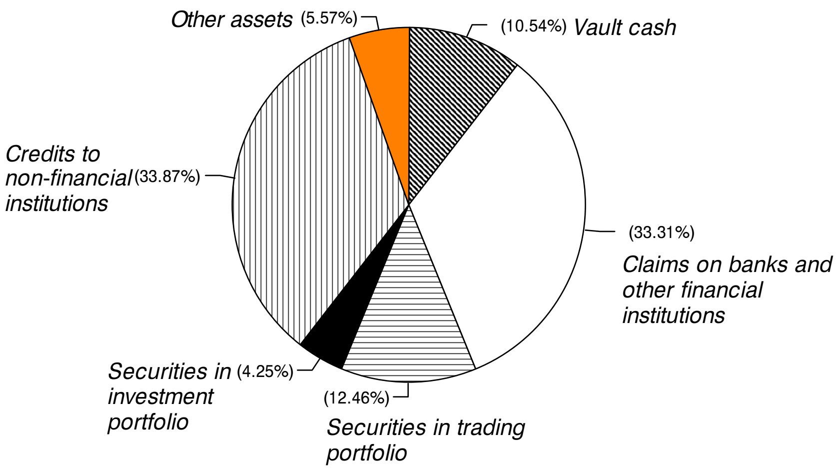
As of end-June 2002, the banking system maintained lower liquidity as gauged by the primary liquidity indicator than in end-2001. In June 2002, commercial banks primary liquidity indicator ran at 10.27% against 13.47% in December 2001 having set back to its normal levels before the withdrawal from circulation of the national currencies of the countries in the euro area. The value of secondary liquidity indicator, however, had stepped up to 26.15% from 25.47% reported in end-December 2001 mainly as a result of the increase of the share of government securities within banks' portfolios.

[44] *Banks with balance sheet value of up to BGN 100 mn, comprising Group IV according to BNB's classification.*
[45] *Foreign bank branches excluded.*

The banking system balance sheet value reached BGN 12.9 bn in end-July 2002, increasing by BGN 721.2 mn relative to end-2001. In the seven months to August, its growth rate of 5.9% ran lower than reported in the corresponding period a year ago (14.6%). Its slower rate of increase was due mainly to the depreciation of the USD against the BGN. In the seven months to August 2002, the BGN component accounted for a larger contribution (BGN 267.3 mn) to the rise of bank assets than the foreign currency component (up by BGN 353.9 mn). As of end-July 2002, the three largest banks held 44.7% of total banking system assets against 46.1% as of 31 December 2001.

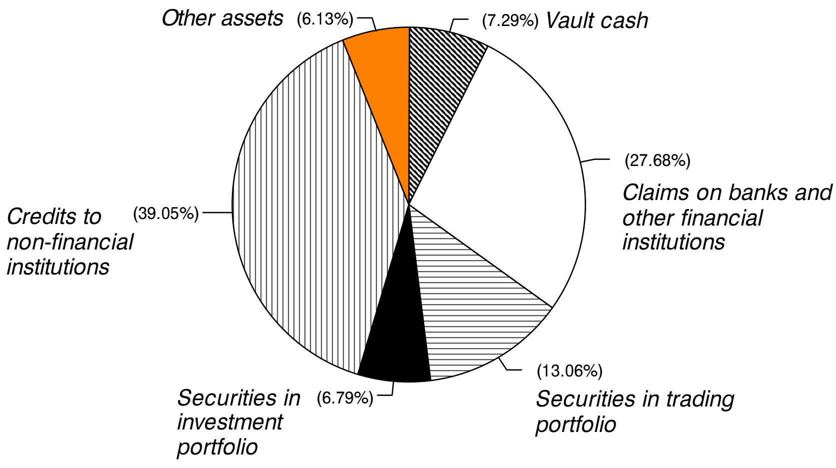
2002 sustained the changes in the commercial banks' asset structure that came into being in the second half of 2001 whereas the liabilities side structure underwent no worthwhile changes. The share of credits to non-financial institutions and other clients stepped up by 5.2 percentage points against end-2001, reaching 39.1% of total assets. The weight of claims on banks and other financial institutions decreased by 5.6 percentage points to 27.7% of total assets. The trend is likely to sustain in the forthcoming periods in view of the expectations for the international interest levels and the current development trends in the real sector. Government's endeavours to amend bank legislation will also help to sustain the trend since they aim to overcome the obstacles to the development of normal credit policy and activity in conformity with the international prudential practices. The anticipations for an upward trend in the share of credits in banks portfolios are also supported by some qualitative factors such as accumulated experience in the appraisal and evaluation of creditworthiness and credit projects, enhanced credit culture of borrowers and the build-up of credit history.

Commercial Banks Assets Structure as of 31.12.2001



Source: BNB

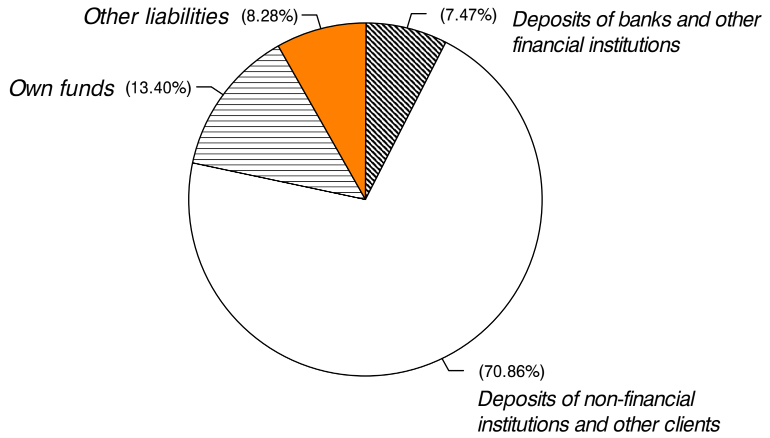
Commercial Banks Assets Structure as of 31.07.2002



Source: BNB

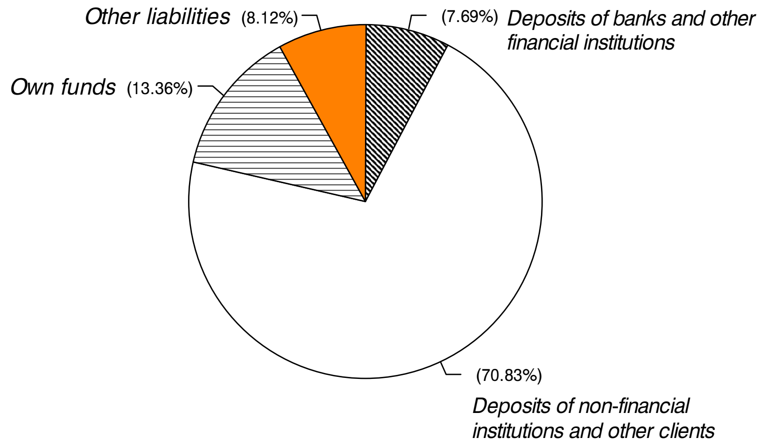
The other noteworthy trend in commercial banks assets structure had to do with the increase of

Commercial Banks Liabilities Structure as of 31.12.2001



Source: BNB

Commercial Banks Liabilities Structure as of 31.07.2002



Source: BNB

securities in banks investment portfolio in the seven months to August 2002. Their share stepped by 2.5 percentage points up against end-2001 to 6.8%. The fall was primarily brought on by the securities issued by the Bulgarian government on the international financial markets. Although to a lesser degree, the relative weight of securities in the operating portfolio also grew, stepping up by 0.6% relative to end-2001 to 13.1%. The share of cash balances fell by 3.3 percentage points over the same period to 7.3% in end-July, having risen substantially in end-2001 in view of the pending introduction of the euro banknotes.

Competition among commercial banks to repartition the markets went on intensifying in the first half of 2002. The following conclusions can be drawn based upon the dynamics of the concentration indicators for the banking system in the first six-month period of 2002:

- Competition to attract deposits strengthened. The changes discerned had mainly to do with the redistribution of market portions among the commercial banks included in the first and second bank groups

Measures of Concentration in the Banking Sector

	XII.95	XII.97	XII.99	VI .00	XII00	VI .01	XII.01	VI.02
Bank Assets								
Herfindahl Index	0.14	0.27	0.12	0.11	0.11	0.10	0.09	0.09
Concentration Coefficient (%)	60	72.3	57	55.6	55.2	53	51.4	50.5
Claims on Non-financial Institutions and Other Clients								
Herfindahl Index	0.14	0.14	0.08	0.08	0.07	0.07	0.07	0.07
Concentration Coefficient (%)	57.8	62.4	43.6	43.6	42	41.3	41.1	41.6
Deposits on Non-financial Institutions and Other Clients								
Herfindahl Index	0.13	0.15	0.13	0.13	0.13	0.12	0.11	0.10
Concentration Coefficient (%)	54.3	65.8	61.7	61.1	62.2	58.8	58.2	56.3

Source: J. Miller, S. Petranov - „Banking in the Bulgarian Economy", BNB, 1996; BNB; AEAF according to BNB's classification. The shrinkage of the market share belonging to the largest Bulgarian bank, viz. *Bulbank*, contributed the most to the lowering of concentration in this market segment. The contraction was in part an indirect result of the depreciation of the USD exchange rate to the BGN since most of the attracted deposits in *Bulbank* are still dollar-denominated.

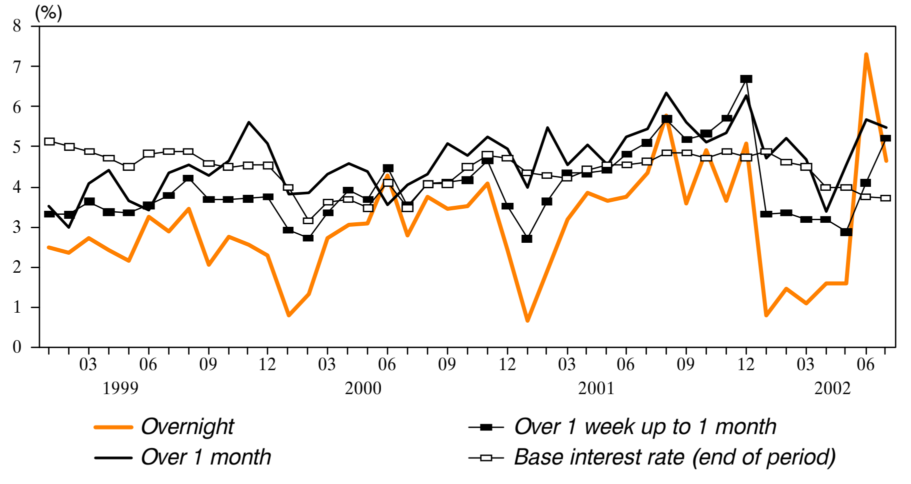
- The increase of the concentration coefficient of credits to non-financial enterprises was to a great extent associated with the expanding credit activity of the largest banks (*DSK Bank* excluded) that had previously maintained a relatively low share of loans in their assets structure.

- The ongoing intensification of competition in the banking sector raises more and more acutely the question of the future of smaller banks.

Money and Foreign Exchange Markets

In the seven months to August 2002, the base interest rate (BIR)[46] stepped by 1 percentage point down to 3.72%. Being determined by a small segment of the market of government securities, the BIR becomes less and less illustrative of the money price dynamics in the economy. Interest levels at the interbank money market in BGN are also highly affected by the inflow of liquidity in the banking sector from the budge and, unlike those on the market of short-term T-bills, register considerable fluctuations. In January 2002, the average weighted interest rate on all placements on the interbank money market ran at less than 1%. In the following four months, the average monthly interest rates on most market placements slightly rose depending on their maturity. In June, interbank interest levels sharply increased and, in certain days, interest on overnight deposits soared to the record high 30% on an annual basis. The average weighted interest rate on all interbank placements reached 7.03%, falling again in July to 4.47%. Certain days in July also witnessed a large shortage of BGN cash resources on the market. Such sharp interest rate fluctuations were not unique in the period after the introduction of the CBA in the country. They had to do with temporary shortfalls of cash usually caused either by bank transfers of tax and excise payments of clients or by the necessity to adjust the minimum required reserves before the deadlines set by the BNB. The marked interest level fluctuations at the interbank market are a sign that the market is still far from being a reliable instrument for regulation of commercial banks liquidity on an ongoing basis. These fluctuations also indicate that some banks failed to manage adequately their liquidity.

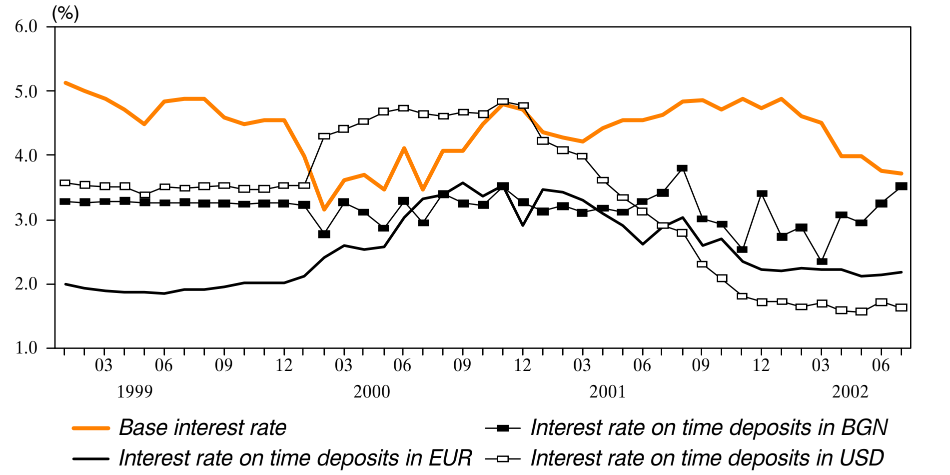
Interbank Money Market Interest Rates



Source: BNB

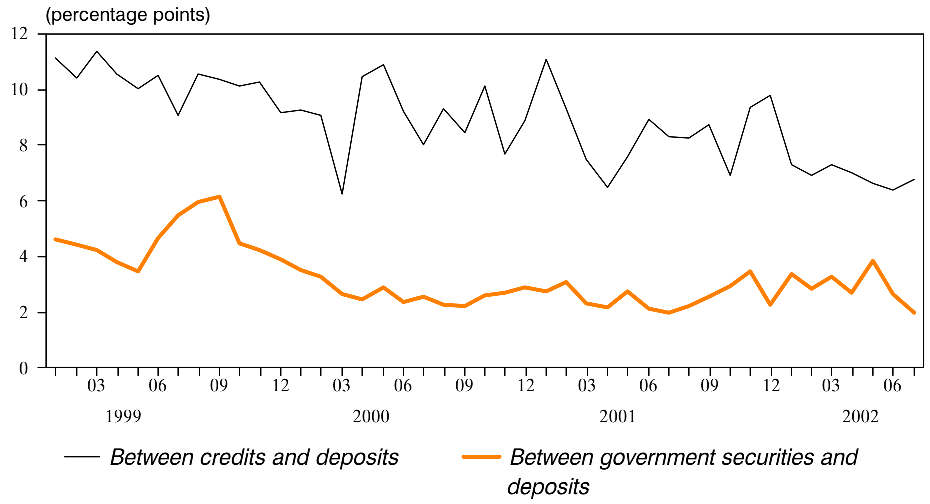
[46] *According to the methodology applied by the central bank, the BNB announces the* base interest rate *determined by the yield on 3-month treasury bills achieved at the primary auctions held by the BNB only once a month since January 2002. The fall in their rate of return has to do with the increased BGN liquidity of the commercial banks as a result of the negative net issue of government securities in the January-July 2002 period.*

Interest Rates



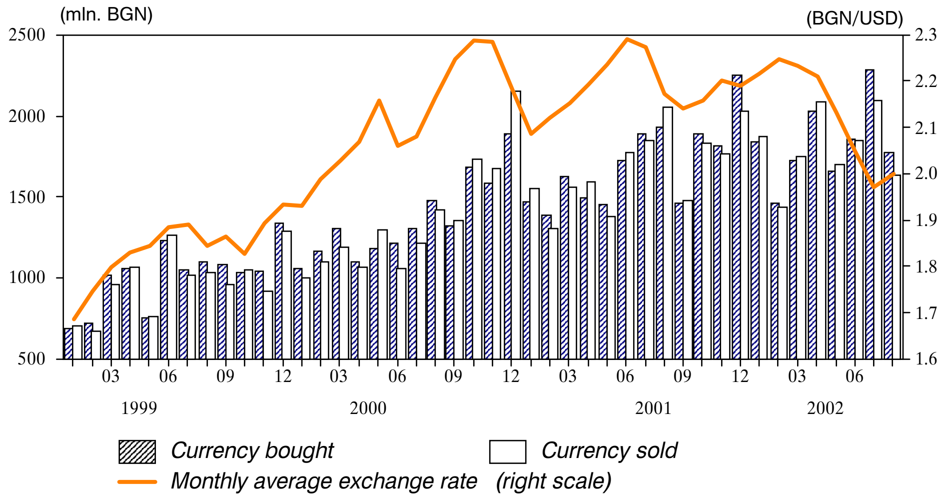
Source: BNB

Interest Rates Spread on the BGN Market



Source: BNB, AEAF

Interbank Forex Market



Source: BNB

In the seven months to August 2002, interest rates on deposits of the non-financial sector followed dissimilar dynamics depending on the currency of denomination. The average weighted interest rate on time deposits in BGN fluctuated within the relatively broad band of ± 1 percentage point. Its dynamics was influenced by the changes in the overall rate of return on BGN assets and by commercial banks' endeavours to alter the structure of their assets in favour of the BGN component. Interest on USD-denominated deposits went on decreasing throughout the whole period in question reflecting the interest rate fall on dollar deposits on the international market. Interest rates on time deposits in euro remained at their end-2001 levels of around 2.2%. The low interest levels on time deposits in foreign currency reflect the record low rates of return on the international financial markets.

A relatively weak downward trend in interest levels on credits was discerned in the seven months to August 2002. The interest difference between credits and deposits went on contracting, remaining however above the levels in most Central and East European countries. The average interest spread over the same 7-month period shrank from 8.5 percentage points on a yearly average in 2001 to 6.9 percentage points.

Following the EUR/USD exchange rate dynamics, in the seven months to August 2002 the BGN appreciated to the dollar by 2.4% relative to 2001 (2002 seven-month average annual against 2001 yearly average). Over the same analysed period, commercial banks were net buyers of foreign currency at the interbank forex market and the amount of the currency purchased exceeded the amount of currency sold by BGN 93.6 mn. The structure of transactions by foreign currency underwent no substantial changes relative to end-2001 and the upward trend in the share of transactions in euro was sustained. In July, the share of transactions in USD in total trading contracted by 2.5 percentage points relative to December 2001.

Non-bank Financial Institutions and Capital Market

Pension funds. In the fist half of 2002, eight private pension insurance companies operated in the pension insurance system and each of them had set up and registered a universal, an occupational, and a voluntary pension fund.[47] The assets of pension funds and the number of insured persons remained rather concentrated.

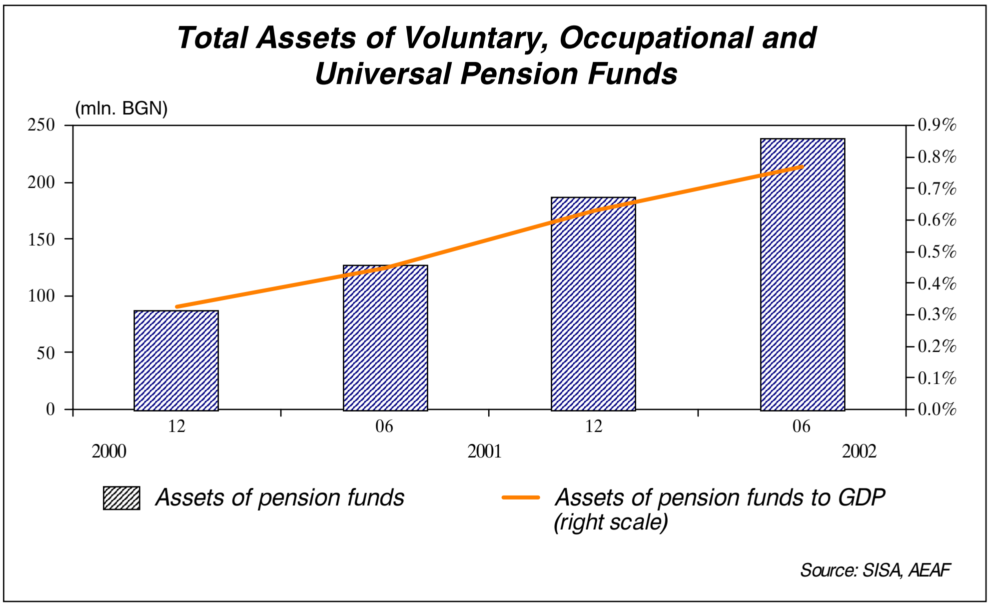
As of end-June 2002, the number of insured in the eight *occupational pension funds* stepped up by 3.97% against end-2001 to reach 150 756, out of which some 89.03% belonging to labour category II and the remaining 10.97% – to labour category I. By the end of the first quarter of 2002, total assets of occupational pension funds amounted to BGN 71.47 mn, increasing by 72.06% relative to end-December 2001. Currently, some 77.24% of the total number of insured persons are concentrated in three occupational funds, viz. *Doverie, Allianz Bulgaria* and *Saglasie.* The four largest occupational pension funds[48] managed 86.4% of total accumulated assets in occupational funds. Concentration remained unchanged relative to end-2001 when these funds possessed 86.3% of total assets. The composition of the investment portfolios of occupational funds was preserved. The relative share of assets invested in government securities steadied at its end-2001 level of 64.5%. The share of bank deposits decreased from 33.5% in end-December 2001 to 27.1% as of 30 June 2002 at the expense of the growing shares of investment in securities listed for trade at the regulated markets of securities (3.2%) and investment in municipal bonds (1.4%). Real estate accounted for 3.78% of assets invested.

Some 659 660 persons were insured in *universal pension funds,* concentrated in the three largest pension insurance companies[49] which accounted for 68.6% of the total number of insured. As of end-June 2002, universal funds' assets ran at BGN 10.77 mn, some 70.9% of which were managed by the three largest funds. Their investment portfolio comprised: 64.17% in T-bills, 30.7% in bank deposits and mere 1.4% in securities listed for trade at the regulated markets of securities.

The number of insured persons in *voluntary pension funds* – the third pillar of the pension system – also increased (by 3.64%) to reach 467 572 in end-June 2002. The lion's share of the market belonged to *Allianz Bulgaria* (52.5% of the total number of insured). The rest of insured persons were relatively evenly distributed

[47] *Data from SISA Bulletin, Issue #2/2002.*
[48] Doverie, Allianz Bulgaria, Saglasie *and* Lukoil Garant.
[49] Allianz Bulgaria, Doverie and Saglasie.

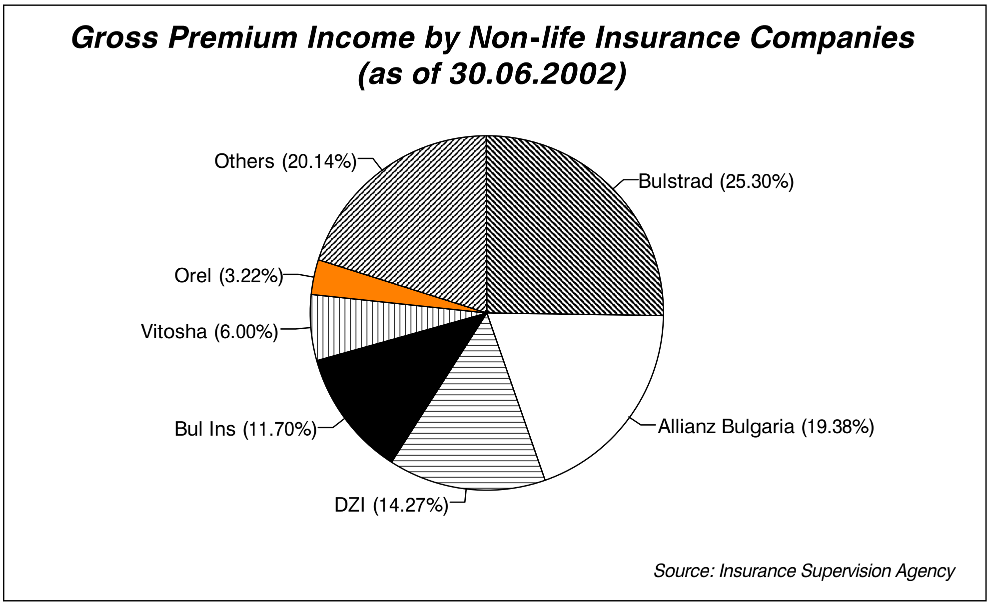
among the other seven voluntary pension funds. As of end-June 2002, the assets of voluntary pension funds amounted to BGN 156.6 mn, stepping up by 15.7% relative to December 2001. Voluntary pension funds assets are highly concentrated as well. *Allianz Bulgaria, Doverie* and *Lukoil Garant* managed 77.9% of total assets in this segment. The investment portfolio of voluntary pension funds was not diversified either. It comprised mainly government securities (56.5%) and bank deposits (29.5%). The relatively high share of investment in mortgage bonds (7.6%) as compared to the insignificant share of investment in securities listed for trade at the regulated securities markets (bare 1.7%) is noteworthy. The rest of invested assets comprised real estate (4.26%), municipal bonds (0.2%) and other investments (0.18%).



As at the end of the second quarter of the year, pension insurance funds had invested only at home and none of them had invested in foreign assets. Regulation No4 of the Minister of Finance on the terms and procedures of investment of pension funds assets abroad was promulgated on 14 June 2002. The provisions of the Regulation allow pension funds to invest in foreign securities and hence to diversify their portfolios thereby reducing their risk exposures.

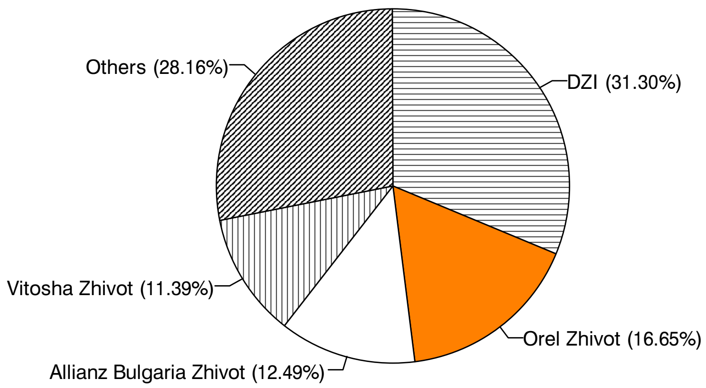
In the first six months of 2002, the ratio of mandatory and voluntary private pension insurance funds assets to GDP further went on the increase, steeping up by 0.14 percentage points against end-2001 to reach 0.77% in the end of the period.

Insurance market. A stable upward trend in insurance penetration and, respectively, in the role of insurance companies in financial intermediation is in place. In the first half of 2002, insurance intermediaries recorded a gross premium income of BGN 246.8 mn, reporting a 24% year-on-year increase (BGN 47.8 mn). Given the fact that the bulk of premium income is typically collected in the second half of the year, its outstripping growth on a



year earlier is likely to sustain by the end of 2002. The ratio of gross premium income of all companies operating in either life insurance or general insurance to GDP stood at 1.71% in the first half of 2002, reporting a year-on-year increase of 0.2 percentage points.

Gross Premium Income by Life Insurance Companies (as of 30.06.2002)



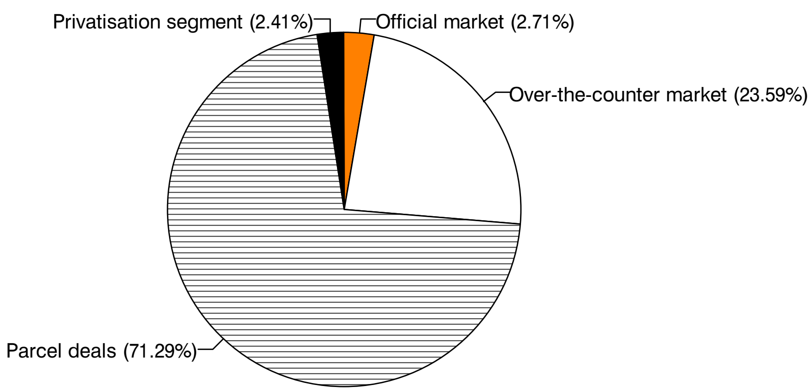
Source: Insurance Supervision Agency

Market concentration in non-life insurance sector remained rather high. The four largest companies *Bulstrad, Allianz Bulgaria, DZI* and *Bul Ins* held 70.6% of the gross premium income in general insurance in the first six months of 2002 while the concentration coefficient stood almost unchanged relative to end-2001 at 0.145.

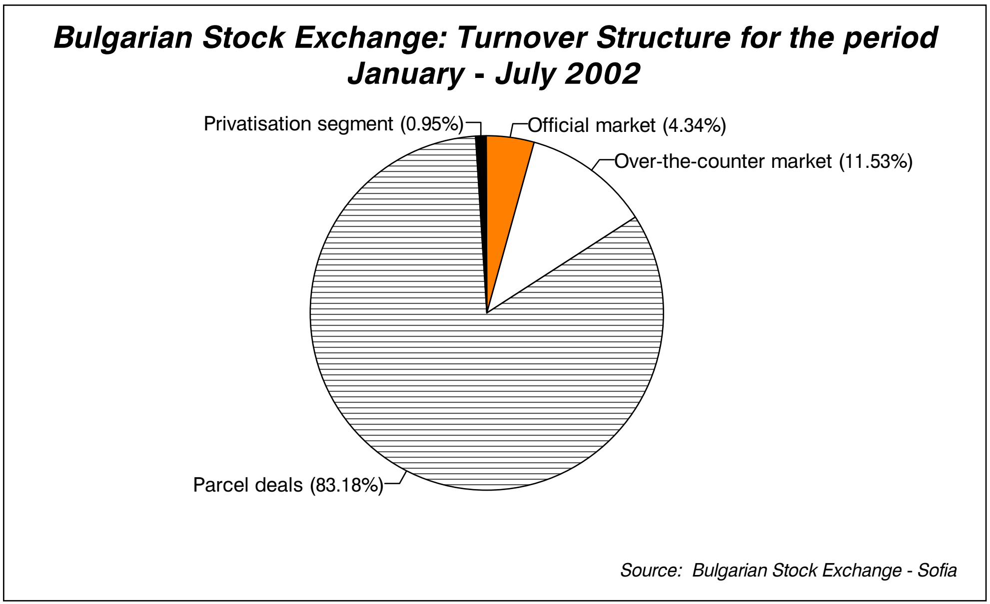
The distribution of premium income among companies operating in the life insurance segment of the market underwent some notable changes. Intensified competition in life insurance is evidenced by the decrease in the value of the concentration coefficient which dropped to 0.17 in end-June 2002 from 0.22 in end-2001. Concentration of life insurance premiums in the three largest companies reported a dramatic fall from 81.8% in end-2001 to 71.8% as of end-June 2002.

Capital market. The seven months to August 2002 witnessed a marked capital market upturn. Yet, the Bulgarian capital market remained underdeveloped in comparison to most of the other EU applicant countries. The bulk of stock exchange turnover comprised block or parcel deals which in practice are not stock exchange deals. The securities instruments apt to attract the investors' interest are still few. The government has envisaged policy measures for a capital market upswing and an increase in the transparency of privatisation. Parcels of shares and interest in the some large scale SOEs such as *BTC*, *Bulgarian Maritime Navigation* and *Bulgartabac* shall be offered for sale at the Bulgarian Stock Exchange – Sofia (BSE), through centralised public offerings and public auctions as part of the envisaged policy package.

Bulgarian Stock Exchange: Turnover Structure in 2001



Source: Bulgarian Stoch Exchange - Sofia



As of end-July, turnover at the BSE reached BGN 194.1 mn, exceeding by 23.8% BSE turnover in the entire 2001. Over the same period, the share of transactions on the *official market* went on the increase primarily as a result of the 4-fold growth of trading on segment „A" of the BSE. A primary corporate bond segment of the market was set up and the first issue of ordinary shares of the United Bulgarian Bank (UBB) was placed on 20 May 2002. Some 43 issues of shares were no longer traded and, as of end-July 2002, 371 issues of securities were traded on the BSE, out of which 41 issues on the official market.

The upward trend in the share of deals concluded on the *block segment* of the BSE was sustained. As of end-July, the turnover of block deals amounted to BGN 163 mn. The share of block trading within total trading at the BSE ran at 84%, up from 73% in 2001. In May 2002, the largest ever deal on the BSE was concluded on this market segment when Daewoo sold its 67% interest in Sheraton Sofia Hotel to four Greek buyers for the amount of BGN 47 mn.

In the seven months to August 2002, *trading in single shares* turnover amounted to BGN 31.1 mn, contracting by some BGN 0.5 mn on a year earlier (BGN 31.6 mn). The share of over-the-counter trading volumes went on the decrease, stepping down from 89.7% of trading in 2001 to 72.7% in end-July 2002.

Trading on the *over the counter market* fell dramatically and turnover in end-July reached bare BGN 14.4 mn. On the other hand, the mortgage bonds of *First Investment Bank* and the *Bulgarian-American Credit Bank* were actively traded on the OTC segment even though they were the only issues traded there. Turnover in the seven month period to August 2002 amounted to BGN 8.2 mn.

In end-July, the *official stock exchange index SOFIX* peaked at 152.38 points, reporting a year-on-year increase of 28.4%. The index' upward swing in July was induced by the increased price of *Lukoil Neftochim* shares. As for the shares of companies on which SOFIX is based, those of *Sopharma* AD Sofia and *Lukoil Neftochim* reported the highest increase in the period end-December 2001 to end-May 2002, stepping up by 65.8% and 62.3% respectively[50].

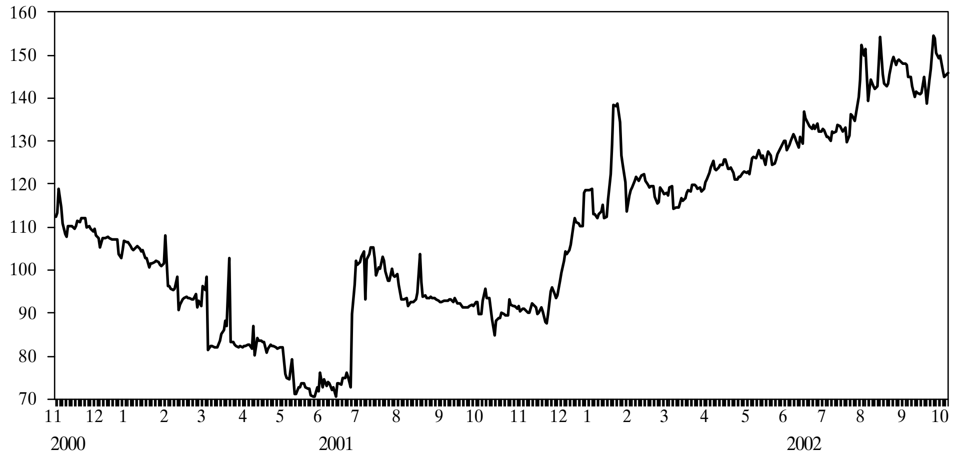
Late-June witnessed some major amendments to legislation regulating the public offering of securities[51]. The amendments aimed to enhance access of shareholders and investors to information on trade companies,

[50] *In February 2002, the shares of* Slunchev briag *were included in the pool on which SOFIX is based replacing the already private shares of* Balkanpharma – *Dupnica.*

[51] *The amendments to the Public Offering of Securities Act entered into force on 21 June 2002.*

to ensure greater protection of minority shareholders' interests and to set up a regulated market of compensatory instruments. A separate segment on the stock exchange for trading in compensatory notes is to be established in the second half of 2002. The objective of these measures is to achieve transparency and publicity of trade in this instrument as a prerequisite for settling a more equitable market price of compensatory instruments.

Bulgarian Stock Exchange Index (SOFIX)



Source: Bulgarian Stock Exchange - Sofia

STRUCTURAL REFORMS

In the first half of 2002, structural reforms were focused on the liberalisation of state-owned monopolies and the restructuring of the budget sphere. The privatisation procedures of two of the most important and key companies in the national economy, namely the tobacco monopoly *Bulgartabac* AD and the telecommunications monopoly *BTC* entered their final stages in spite of the unfavourable international business situation in both sectors. The government has already selected potential buyers for these companies and has reached an agreement with them on the key parameters of the deals. Both privatisation deals should be finalised by end-2002.

The deadlines for the conclusion of the deals may not be observed only in case of a court trial since would-be buyers have submitted both privatisation cases to the court. The preparation for liberalisation of the energy market is underway in conformity with the Energy Strategy of Bulgaria adopted by Parliament in early-2002 and the accompanying action plan. A new phase of the restructuring of agriculture – the creation of a competitive agricultural sector – was embarked upon with financing under SAPARD.

Simultaneously with the ongoing reforms in two key public services areas, viz. healthcare and education, the first steps in the practical implementation of multi-annual programme budgeting were made in April-May 2002. The change aims to create greater predictability of macroeconomic environment and facilitate all economic agents, and primarily foreign and local investors and taxpayers, in making more long-term behavioural decisions. Within the framework of the project, all levels of public administration will gradually start to negotiate and contract with the Ministry of Finance the parameters of their own budgets over a 3-year period at the least as part of the general government budget. Dialogue will be based on the strategic objectives, mid-term and short-tern government policy priorities underlying the Government Programme and substantiated in the 2002 Pre-Accession Economic Programme and the National Development Plan. On a pilot basis, the Ministry of the Environment and Waters prepared its 2003-2005 budget, employing the new programmatic approach to budgeting in the first half of 2002.

The most successful so far privatisation deal in the banking sector, viz. the divestiture of *Biochim Commercial Bank* was concluded in July 2002. Projected privatisation proceeds for the fist half of 2002 amounted to BGN 307.8 thousand[52]. As of end-June 2002, actual privatisation receipts and contracted payments ran at 227.2 thousand[53], accounting for a performance of 77% of forecast proceeds. As of end-August, a total of 121 privatisation deals had been concluded and the average yield per deal increased 2.58-fold, stepping up from USD 0.99 mn in 2001 to USD 2.52 mn.

The Privatisation of *Biochim* Bank

The deal for the sale of 99.59% of *Biochim Commercial Bank*'s capital to *Bank Austria Creditanstalt Grup* for the amount of 82.5 MEURO was finalised in end-July. In many ways, the deal was a successful one. Yet, at least three aspects of it are of particular noteworthiness. On the first place, all participants and observers

[52] *2002 Privatisation Programme.*
[53] *Privatisation Agency, 2002 Semiannual Report.*

of the privatisation procedure unanimously attested to its enhanced transparency, a unique feature of bank divestiture so far. This is evidenced not only by the fact that none of the would-be buyers or observers in the process brought a law suit against the deal but also by the absence of contradicting conjectures on the part of financial analysts and the mass media. The observance of confidentiality on the parameters of the deal until they were officially announced is also unprecedented in the history of bank divestiture in Bulgaria. Secondly, the government was successful to attract as a buyer an investor of good reputation on the international markets in a bank with inherited substandard and doubtful loans and of relatively worse repute in the society in comparison to the other larger Bulgarian banks[54]. Third, the financial effect from the deal was some 230% higher than the price of the bank's own capital thereby elevating the deal as the most successful of all privatisation contracts in the sector. All bids of potential buyers offered substantially higher prices for the government share of *Biochim* than the bids made in the previous privatisation procedures. Thus, for example, the highest previous bid for the same share of the bank was 3 times lower, amounting to 25.025 MEURO. All this is indicative of the enhanced efficiency of government control as well as of the apt approach to the selection of a managing team and the incentives offered to it in the period after the failure of the preceding privatisation procedure of *Biochim Bank.*

The Privatisation of Bulgartabac

Given the unfavourable international situation in the sector and the continuing global recession, the government policy to finalise swiftly the privatisation deal of *Bulgartabac* involves several particularities. First, the government's declared intention is to find a buyer that will offer a long-term strategy for the development of the holding which is compatible with the mid-term government programme for economic growth, elevation of the living standards and increase in competitiveness of the economy. Second, the specific requirements to the buyers were put forward at a later stage, after they had made their bids.

For the first time in a large-scale privatisation deal, the government declared the presence and substance of a long-term strategy as a priority in addition to price. Unfortunately, the change in the privatisation strategy was made known only after the start of the so-called second stage in the divestiture of Bulgartabac to a great extent under pressure from the public. The specific requirements that were put forward later were not defined in the strategy. The specific acceptance criteria[55] of potential buyers were then announced and it put some of the reputable and experienced investors[56] off participating in the procedure. Inasmuch as price and the volume of future investments remained the major selection indicators that counted for the final qualification, tension built up among the four bidders[57]. A couple of them submitted the case to the court which will ultimately result in the delayed conclusion of the deal.

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[54] *Bank Austria Creditanstalt comprises 970 bank branches and affiliates in 15 states in the region. The balance sheet value of its assets on this market amounts to 26 000 MEURO.*

[55] *The main selection criterion is the quantity of tobacco purchased which should not be less than 40 000 tons. The government reserves the right to infract the privatisation contract should the buyer fail to meet the undertaken commitments in this respect. The other requirements include: prohibition to sell three detached parts of Bulgartabac, viz. the tobacco factories* Sofia BT *AD,* Blagoevgrad BT *AD and* Plovdiv – Yuri Gagarin BT *AD for a period of 5 years and retention of at least 6 000 jobs. Thus, the potential buyer will have to raise the purchased quantities of tobacco by over 30% relative to those in 2001. The fact that in the 1997-2001 period Bulgartabac had purchased only 94% of Burley variety and 74% of Virginia variety produced adds to the above-mentioned restrictions. The latter tobacco variety is low quality tobacco less sought on the international market and requiring considerably higher processing expenditures. To change the structure of produce grown will involve time and additional investment. The other two requirements also restrict the flexibility of the buyer in developing a competitive company.*

[56] *E.g.* V. Tabac Satoraljaujhelyi DohanygyarRt., *a Hungarian experienced investor in the sector did not make a bid.*

[57] *1.* Tobacco Holding *GmbH, Vienna, Austria; 2.* Regional Perspective *Commercial Bank, Moscow, Russian Federation; 3.* Tobacco Capital Partners *AD, Sofia; 4.* Metatabac Consortium*, Sofia.*

The circumstances surrounding the privatisation of Bulgartabac are further exacerbated by several factors. First, competition in the sector has intensified on the part of Greece and Turkey in particular since their EU imports benefit from preferential treatment. Second, the oriental variety prevails in the produce of local tobacco growers while there has been a clear cut downward trend in demand for the oriental variety worldwide. Any change in the varieties grown in the country demands investment and, most of all, time. Therefore, it is of utmost importance to carry out a quantitative analysis of the price of the deal over time that will serve as the basis for the final decision of the government, especially in view of the fact that the initially announced privatisation schedule will most probably not be observed.

The Privatisation of BTC

Unlike the divestiture procedure of Bulgartabac, the main bid acceptance criteria, viz. privatisation proceeds, employment optimisation and volume of investment were clearly defined in the privatisation strategy for the Bulgarian Telecommunications Company (BTC). The strategy specified the minimum volume of required investment to meet the assumed commitments in the negotiation process with the EU for digitalisation of the fixed-line telephone network. The sector-specific policy in the area of telecommunications was finalised in April 2002.

In spite of the scrupulous initial preparation, the privatisation process was slightly delayed as a result of the shortcomings in the legal and regulatory framework and the lack of a coherent and clear normative framework for the functioning of fixed telephone network companies after the expiry of *BTC*'s special rights in early-2003. Furthermore, the principles for calculation of net expenditures of the future fixed-line market players as well as the terms and procedure for compensation of *BTC* in regard to its obligations to provide “universal service“ lack clarity. The strategy for the development of the sector has not identified the underlying principles for the construction of the new price methodology of the fixed-line telephone service. The government, however, succeeded to extend the exclusive rights of *BTC* on certain services by postponing the period when the company should be obligated to provide operators with an open access to its subscriber line till early-2005.

In October, *Advent* investment fund – a company enjoying good reputation in the sector and managing assets of over USD 6 bn was selected as the preferred buyer[58] of BTC. The company has invested in telecommunication projects in many countries[59], including CEEC. Real competition among potential buyers is in place thereby creating the prerequisites to attain satisfying parameters of the deal regardless of the unfavourable international state of affairs in the business. Still, any possible court proceedings against the deal instituted by parliamentary opposition may have negative implications on both the final parameters of the deal and the entire privatisation procedure.

Healthcare

Basic healthcare indicators have not changed dramatically after the launch of reforms in the sector in 1999. Infant mortality ratio fell by 0.2 to 14.4 per thousand in 2001. In the period 1999-2001, life expectancy

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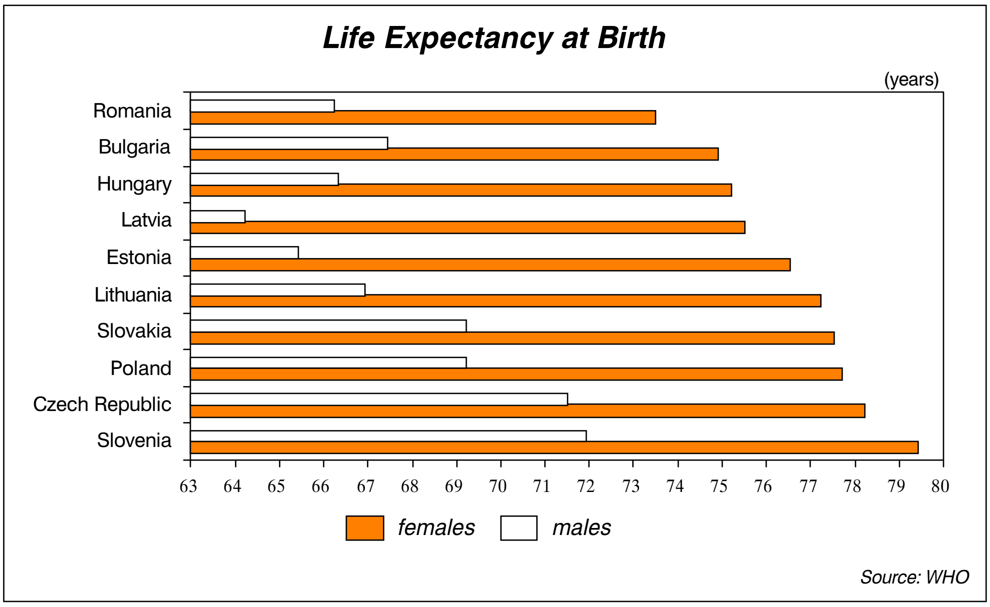
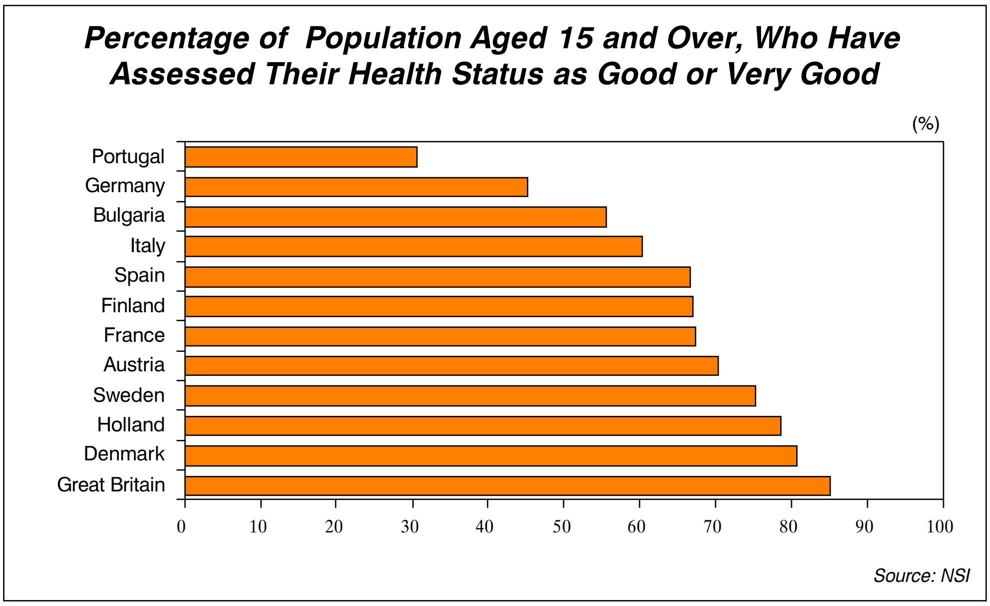
[58] *A consortium of Koc Holding and Tьrk Telekom was the other potential buyer of BTC. The Turkish Telecom operator is 100% state-owned and although it has 16 mn subscribers is currently experiencing some financial difficulties. Therefore, the Turkish government intends to privitise it within months. Although alien to the mobile telephone business, its partner Koc Information Group, part of Koc Holdings is one the three largest industrial holding groups in Turkey with investment in industry, commerce and finances.*

[59] *Denmark, UK, Austria, Italy, Spain, the Czech Republic, Hungary, Rumania, Slovakia.*

reached 70.9 years, increasing by 0.8 years relative to 1997-1999 period. Both indicators, however, retain more unfavourable values than the EU average. Crude death rate grew by 0.6 to 14.2 per thousand in 2001. According to data for 2000 of the World Health Organisation[60], life expectancy at birth for females is the lowest among all EU applicant countries with the exception of Rumania. Life expectancy at birth for males in Bulgaria is also low, yet higher than in the Baltic States, Hungary and Rumania. Judging by infant mortality indicator, Bulgaria ranks last but one (ahead of Rumania) among all candidate countries.



According to data from the Health Survey of the Bulgarian population conducted in March 2001[61], respondents (both male and female) assessed that their health status had worsened in the preceding 4 years. The relative share of males having poor health status had stepped up from 27.8% in 1996 to 35.9% in 2001. Individual poor health assessment of female respondents had increased from 38.8% to 44.4%. Over the 1996-2001 period, the share of people with poor health within the pools of children (0-14 years) and young people (15-24 years) had doubled. The indicator „Relative share of the population aged 15 and over assessing their health status as 'good' and 'very good'", used for international comparisons, amounted to 55.5% in Bulgaria, reporting a considerably lower value than in the EU member countries.



Since the establishment of the National Health Insurance Fund (NHIF) in 1998, the share of healthcare expenditures in GDP had increased by 0.6 percentage points to 4.2% in the first half of 2002 or BGN 607 mn. The structure of healthcare financing by source had also changed. The

[60] *World Health Organisation, The World Health Report, 2001.*
[61] *NSI, Health Survey of the Bulgarian population in March 2001.*

establishment of the NHIF resulted in a sharp decline (by 40 percentage points) in the share of municipal expenditures for healthcare to 14% in mid-2002 whereas the share of state budget allocations[62] had risen from 34% in 1998 to 38% in June 2002. On a year earlier, the share of municipal allocations in total healthcare financing further shrank by 4 percentage points or BGN 87.5 mn while the share of government budget declined by 7 percentage points or BGN 231 mn. The share of NHIF covered expenditures rose by 10 percentage points or BGN 274 mn. The NHIF financing of health services will further increase after the Fund assumes financing of the bulk of hospital care services in the second half of 2002.

Hospital expenditures accounted for the largest portion within total healthcare expenditures.[63] Their share grew from 22.8% before the start of reforms to 42.6% in the first half of 2002. Over the same period, expenditures for medicines reached an all-time peak after the launch of reforms of 24.6%, growing by 6.8 percentage points on a year earlier. These developments call for the increase of control over the issuance of gratuitous or partially reimbursed prescriptions and introduction of more accurate rules for the issuance of such prescriptions. It is also necessary to set up clear rules for the update of the list of medicines financed by NHIF. Healthcare capital expenditures however went on the decrease to reach 3.4% of total expenditures in the fist half of 2002. They reported a 2-fold year-on-year contraction due to the mismatch between the reform goals and the institutional capacity for reform implementation.

The share of labour costs[64] stepped down to 29% in the first half of 2002. At the same time, average salary in healthcare increased by 40% over the 1999-2001 period and by further 10% in the first six-month period of 2002 on a year earlier. In 2001, incomes of general practitioners were estimated at 6 times the average salary in the country while incomes of specialist physicians were 10 times higher than the average salary evidencing that healthcare reforms have resulted in a sizeable redistribution of incomes from the entire population to the providers of health services. Simultaneously, the share of expenditures for healthcare[65], excluding expenditures for health insurance contributions in household consumer spending had increased from 3.8% in 1999 to 5.7% in the first half of 2002.

According to a World Bank report of August 2002[66], financial flows in healthcare can be significantly optimised to guarantee higher efficiency of reform and improvement of the main health indicators of the population. For example, the average length of stay in the hospital (11.9 days) is still twice the level of Western Europe. Regardless of hospital bed reduction from about 10 per 1000 inhabitants in 1997 to 7 per 1000 in 2002, the overall impact on costs is small since reductions were achieved by reducing the number of beds per room while heating and other utility costs in practice had changed very little.

SAPARD Programme

The key objective of the EU Pre-Accession Programme SAPARD launched in 2001 is to modernize agriculture of the applicant countries and to increase its efficiency and competitiveness. Some 55% of the subsidy allocated to Bulgaria under the programme should be spent on investment in agricultural farms and for the improvement of processing and marketing of agricultural products. The choice of these spheres was

62 *Covering primarily the expenditures of the Ministry of Healthcare.*
63 *Including subsidies to hospitals and health insurance payments for hospital care.*
64 *Healthcare expenditures include: staffing costs for wages and social insurance contributions as well as health insurance payments for pre-hospital (outpatient) care.*
65 *According to data from NSI regular household budget surveys.*
66 *The World Bank,* Public Expenditure Issues and Directions for Reform. A Public Expenditure and Institutional Review. *Report No. 23979-BUL.*

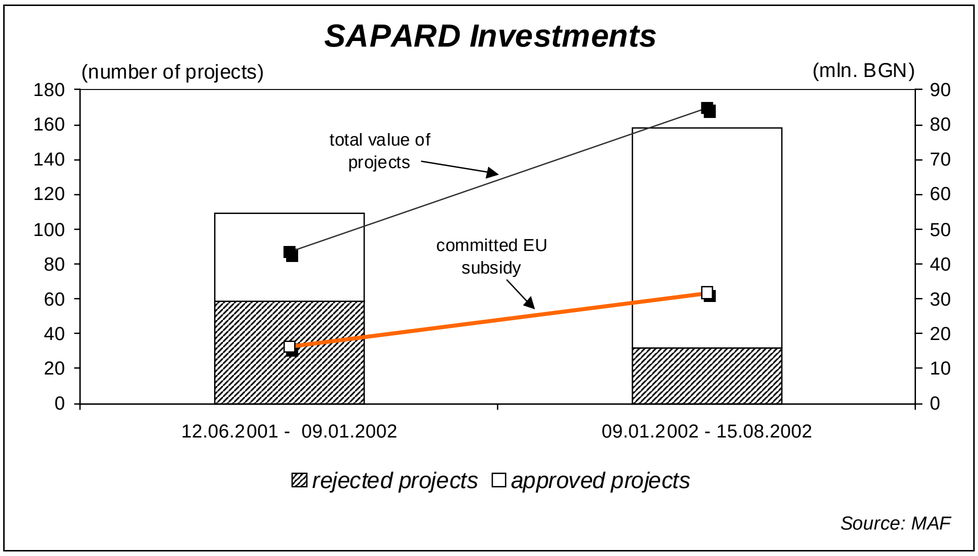
predetermined by the fact that they are directly linked to the private sector wherein motivation for the swift preparation of projects is presumably larger than in the public sector.

The enormous expectations for a great number of applicants submitting competitive projects for financing under the programme were not realised. As of early-2002, the number of investment projects submitted to the purposefully established SAPARD Agency at the Ministry of Agriculture and Forestry amounted to bare 109 as compared to the anticipated 500 projects on average per annum.[67] Some 54% of the presented projects were turned down as failing to formally meet the preset requirements for donor financing. The main reasons for the small number of approved projects are given below:

1. Difficulties in securing national co-financing of investment projects stemming from the fact that agricultural producers do not possess sufficient own financial resources to perform the investment while commercial banks view the sector as highly risk-exposed and, therefore, strictly implement a credit diversification policy;

2. Void documents, and particularly titles deeds, environmental impact assessments as well as information notes from the regional tax and social insurances offices with expired validity terms;

3. Lack of guarantees for stable orders such as preliminary purchase contracts with suppliers or failure to meet the requirement for at least a 50% share of income from agricultural activity in the applicant's total income.



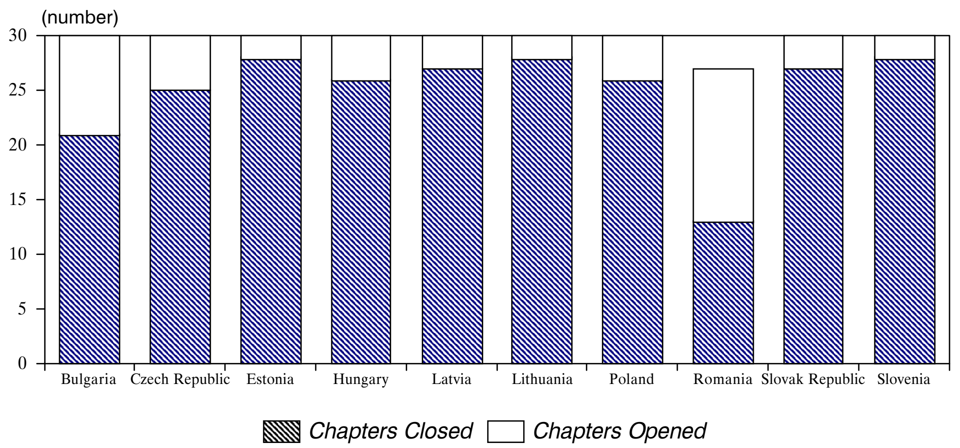
In 2002, the above-mentioned issues have been gradually finding a solution though slowly than expected. The share of approved credit projects rose substantially to 66% of the total number of applications in the seven months to August 2002. The absorption of the envisaged subsidy for 2001 has not started yet due to the delay in the launch of the programme. As of mid-2002, funds covering about 37% of the envisaged subsidy for 2000 had been contracted while absorbed resources had amounted to only 6% of the same subsidy.

[67] *For more details see „Report from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions. SAPARD Annual Report – Year 2001".*

EU ACCESSION NEGOTIATIONS

In the first half-year period of 2002, Bulgaria's accession negotiations with the European Union went according to schedule due chiefly to the improved consistency of intragovernmental organization and coordination of work, following the adoption of the Strategy for EU Negotiation Acceleration and action plan of 2001. In the eight months to October the Bulgarian government closed eight negotiation chapters[68], and like other applicants, Roumania excluded, submitted negotiation positions on all chapters. At the same time, the country has provisionally closed 22 negotiation chapters, ranking immediately after the first ten candidates[69].

Accession Negotiations: State of Play*



* As of July 2002

Source: Europian Commission

Bulgaria's negotiation strategy strikes a balance between the need to integrate the EU acquis into the national legislation, on the on hand, and reinforce its administrative capacity for its implementation, on the other, thus preventing the accelerated pace of the negotiation process from jeopardizing the effective implementation of the acquis adopted. The Bulgarian government has set itself an ambitious task to obtain a road map by the end of 2002 that will give the country green light for the successful conclusion of the EU accession negotiations and confirm EU commitments as regards Bulgaria's candidacy.

Implementation of the EU Economic Criteria for Membership

In the first half-year period of 2002, the applicant countries went on reporting relatively higher growth rates than growth in the EU, despite the slow recovery of the world economy from recession. Bulgaria registered 4.3% growth lagging only behind Lithuania (5.8%), Estonia (5.3%) and Latvia (4.4%). A relatively weaker growth among the candidate countries was reported by Poland (0.7%), the Czech Republic (2.6%) and Hungary (3%), all of them economies strongly integrated into EU and boasting high competitiveness but still running into the effect of outstanding structural problems[70]. While slowing down in the three countries on a year earlier, the growth rate in the remaining applicant economies has slightly sped up.

As for GDP by final expenditure element, the structure of Bulgaria's GDP was relatively more unfavourable,

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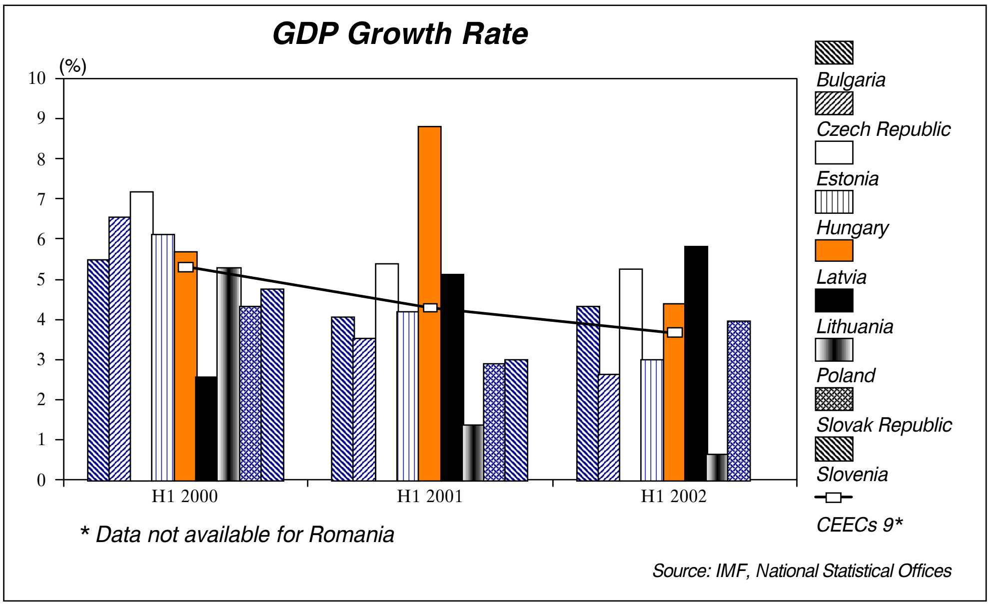
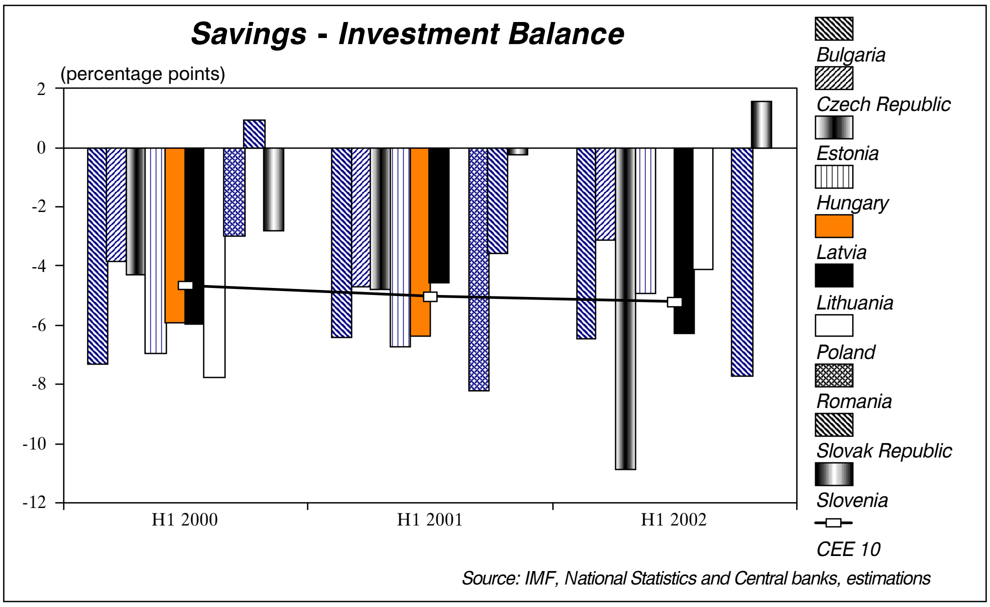
[68] *Chapter 1 „ Free Movement Of Goods"; Chapter 2 „Free Movement of People"; Chapter 10 „Taxation"; Chapter 11 „Economic and Monetary Union"; Chapter 13 „Social Policy"; Chapter 25 „Customs Union"; Chapter 28 „Financial Control"; Chapter 30 „Institutions".*

[69] *Of all CEECs, the most advanced countries in the EU accession negation process are Estonia, Lithuania and Slovenia (with 28 closed chapters), Poland – 26 chapters and the Czech Republic – 25 chapters.*

despite the year-on-year improvements reported. The share of final consumption within GDP was one of the highest[71], except for Roumania reporting a higher GDP share of 90.9% in the first quarter, whereas in the other candidate countries the indicator fluctuated within the 70%-75% band. At the same time, the 16.7% share of gross fixed capital formation in Bulgaria's GDP, though standing close to the indicator's level in Hungary (17.8%) and slightly exceeding the share in Poland (16.2%) ran one of the lowest well below the indicator's performance in Slovakia (29.2%), the Czech Republic (25.9%) and Slovenia (23.5%). With respect to the above said, Bulgaria was lagging significantly behind the other economies in its capacity to renovate its infrastructure and technologies.





A major restraint on fixed capital formation in most applicant countries and Bulgaria in particular derived from the low rate of domestic savings and weak financial intermediation. In all acceding countries but Slovenia the balance on gross savings[72] and gross fixed capital formation ran negative. Over the past few years, however, gross savings in Bulgaria and the other countries have gone on the increase, following a steady upward trend that persisted well in the first half of 2002.

In the first half-year period of 2002, the current account deficit as percentage of Bulgaria's GDP decline down to 5.9%[73]. By the same indicator, following the adjustments in government economic policy, Bulgaria

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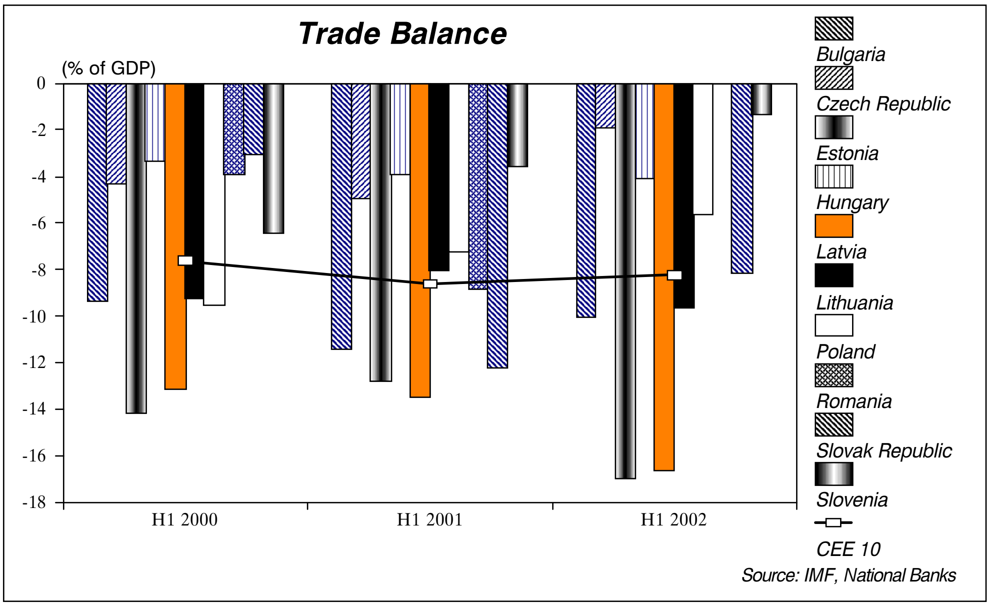
[70] *Economic policy adjustments in the wake of the outcome of the general parliamentary elections in these countries also contributed to a certain growth rate decline.*

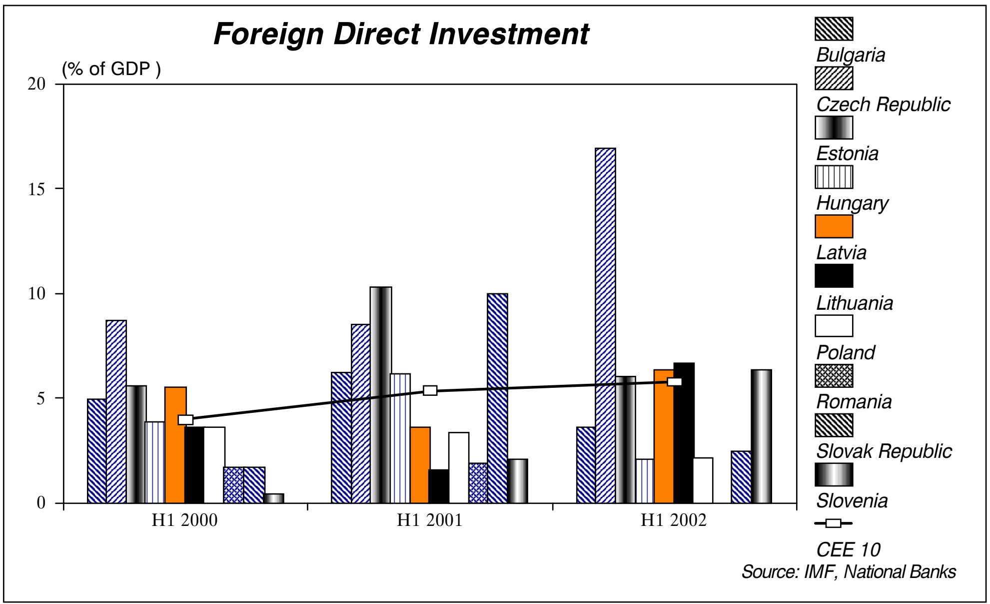
[71] *89.2% I the first half-year period, and 90.3% in the third quarter.*

[72] *As percentage of GDP calculated by the following formula: GDP+consumption(net)+current transfers(net)-consumption (See IMF, Balance of Payments. Compilation Guide, 1993).*

[73] *Relative to GDP in the first half-year period.*

was placed in a more favourable and advantageous position compared to other countries under a currency board arrangement or an exchange rate peg[74]. The countries' trade balances proved to be the key source of current account deficits. On a year earlier, 2002 first half trade deficit in Bulgaria was curtailed down to 10% of GDP while stepping up in some of the countries under a currency board to 17% (Estonia) and Latvia (16.6%). Only five applicant countries, Bulgaria including, reported a year-on-year trade deficit improvement. Over the same period, the trade deficit ran lowest in Slovenia (1.3%), the Czech Republic (1.9%) and Hungary (4%).





In the first half-year period, the main source of current account deficit financing – FDIs, stepped up as percentage of GDP as follows: by about 8 percentage points in the Czech Republic up to 16.9%, Lithuania – 6.7%, and Latvia and Slovenia – up to 6.4%. The indicator deteriorated significantly in Slovakia by over 7 percentage points and by around 4% in Hungary down to 2.1% and Estonia and Bulgaria – 6% and 3.6% respectively.

Bank lending to the private sector as percentage of Bulgaria's GDP reported a 1.2% year-on-year increase up to 15.5%. Non-financial sector credit growth in Bulgaria over the period considered ran highest among the applicant countries, now outstripping Lithuania (12%). Despite the improved efficiency of the financial system, bank lending to the private sector as percentage of GDP in Bulgaria remained far behind other acceding countries like Slovenia (38.4%), Hungary (29.9%), Latvia (29.3%) and Estonia (28.4%) in the first half of 2002.

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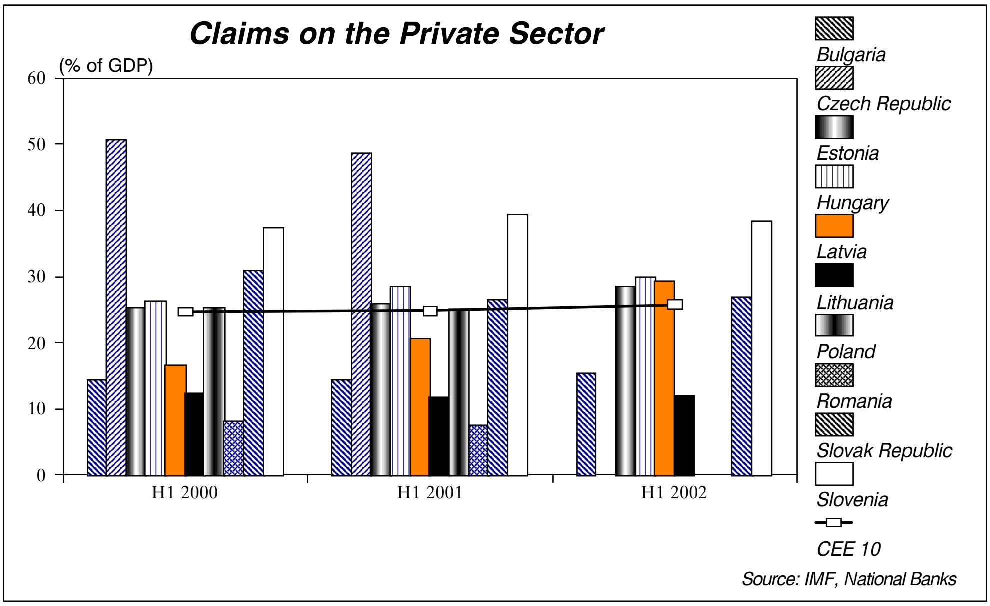
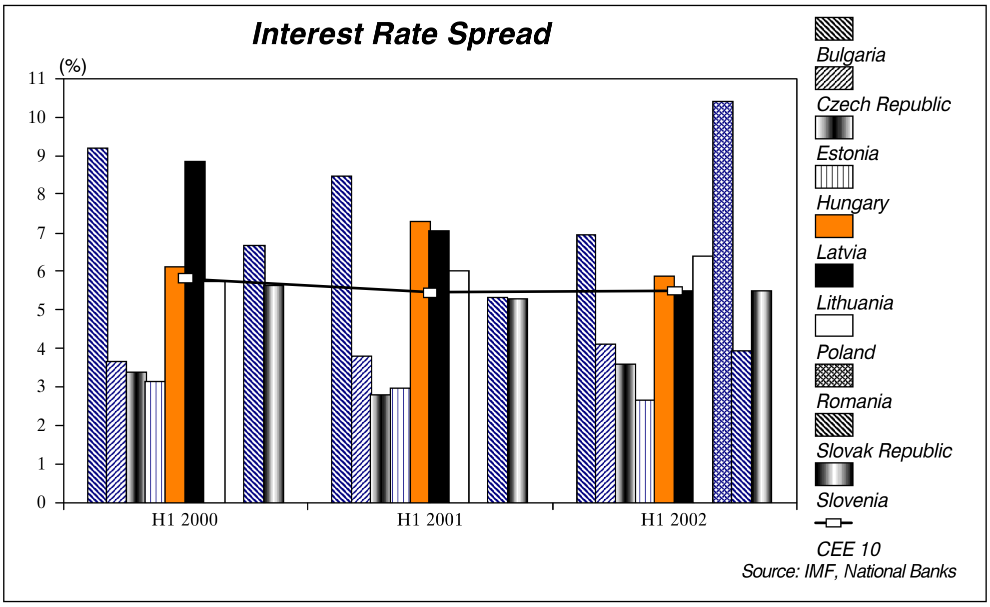
[74] *Lithuania and Latvia reported a current account deficit of 6.6%, deteriorating by 1.7 and 1.2 percentage points respectively on a year earlier. Rising by over 7 percentage points, Estonia's current account deficit amounted to 12.3%.*



As for the other key to the efficiency of the financial system indicator – the interest rate spread, it tended to decline in most candidate countries consistent with the global interest rate cuts aimed at reviving the world economy. The interest rate spread in Bulgaria over the period under review also decreased by 1.6 percentage points down to 6.9%, indicating that financial and credit risk has been steadily diminishing. Nevertheless, the indicator's level ranked among the highest compared to other applicant economies. It ran lowest in Hungary (below 2.5%) and Estonia (3.6%) while rising in the Czech Republic (from 3.8% to 4.1), Estonia (from 2.8% to 3.6 percentage points) and Slovakia (reporting a 0.2% increase up to 5.5 percentage points) alone.



Bulgaria was one of the EU candidate countries reporting the highest inflation rate of 7.6% in the first half-year period of 2002, already tending, however, to decrease. Inflation was lowest in Lithuania (1.5%), Latvia (2.6%), Poland (2.8%) and the Czech Republic (3%), tending to go up in the Lithuania and Latvia on a year earlier. At the same time, the variable stood highest at 27% in Roumania in the first quarter of 2002.

Most of the ten EU applicant countries have made good use of fiscal policy measures to curb their general budget deficit. The general government budgets of the Czech Republic, Estonia and Bulgaria ran a cash surplus of 1.4%, 1.2% and (0.8%)[75] respectively over the six months to June 2002. At the same time, the cash deficit in Slovenia, Poland and Hungary deteriorated by about a percentage points down -6.4%, -3.7% and -3.1% of GDP over the same period.

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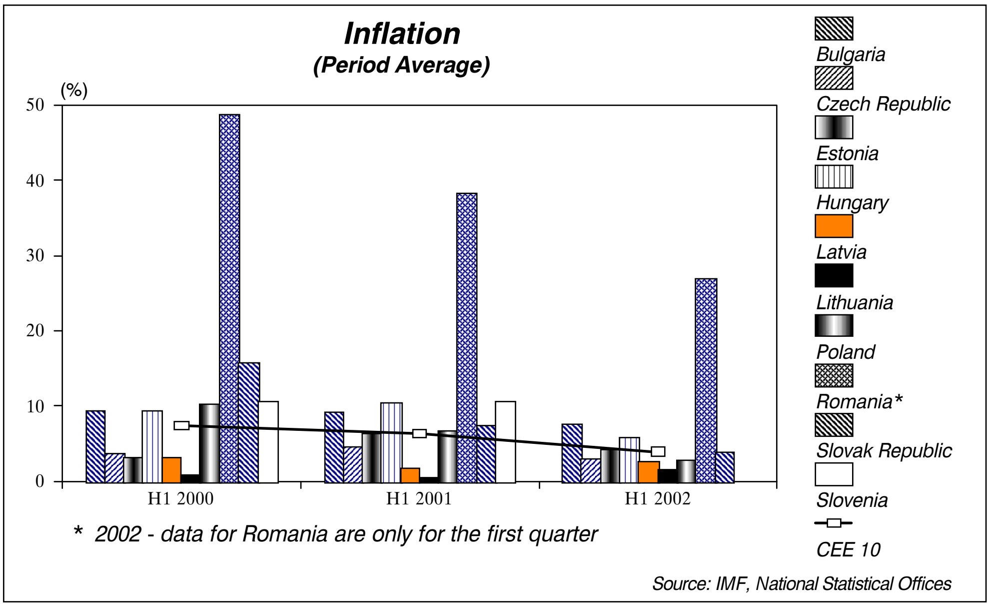
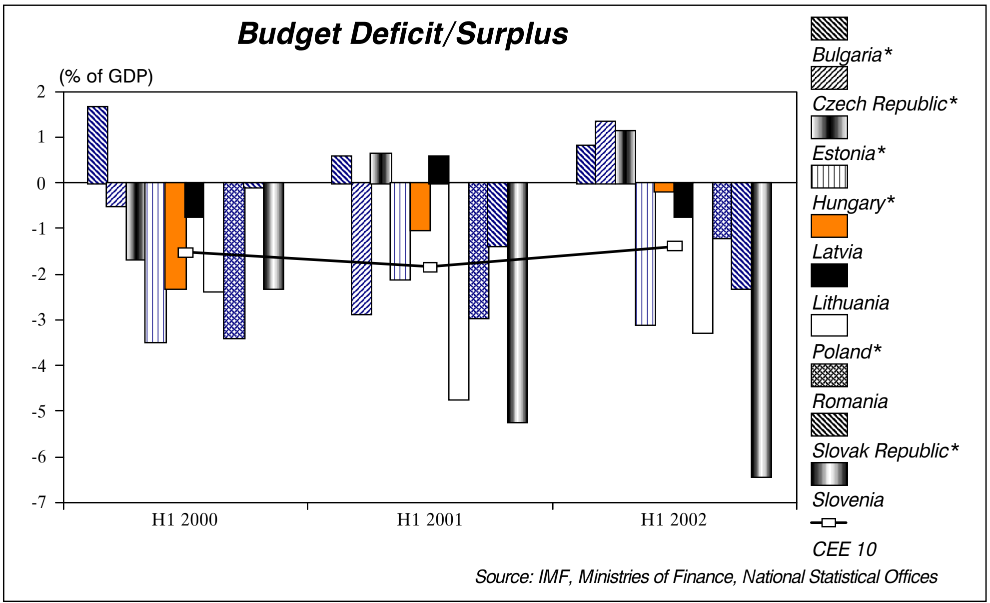
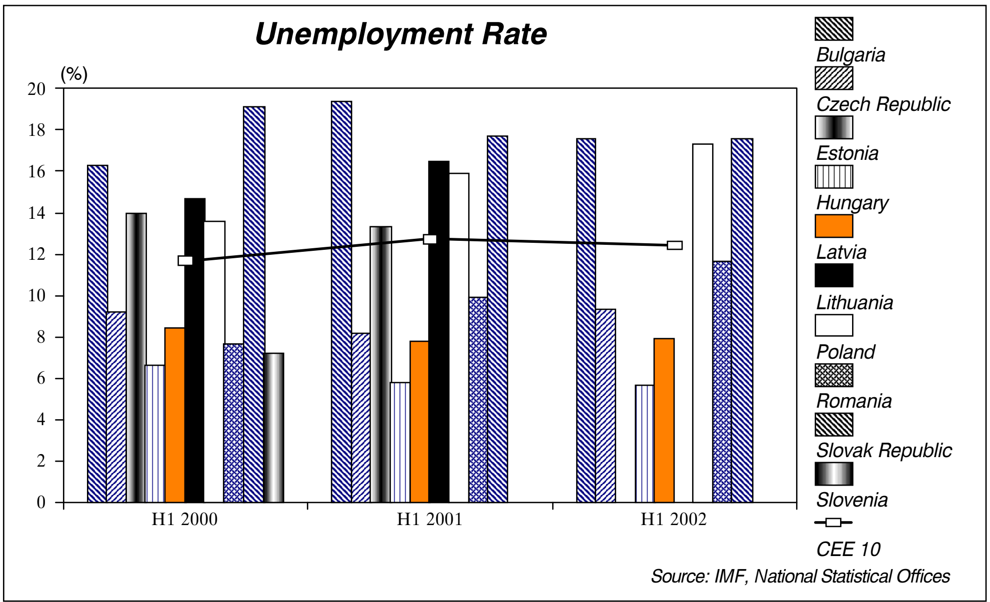
[75] *Account should be taken of the seasonal dynamics of the cash surplus in Bulgaria.*







Unemployment in most EU candidate countries remained rampant, running highest in Bulgaria and Slovakia (17.6%, as of June) and Lithuania (17.2%, as of Mach), and relatively lower and closer in general to the EU unemployment rate in Estonia (11.2%, as of March), Roumania (about 12%), Czech Republic (9.4%), Latvia (7.9%) and Hungary (5.7%). The high unemployment rate in the applicant countries was mainly due to urgent structural reforms underway aimed at improving competitiveness in the economy and reducing living standard disparities in the medium-term. At the same time, analysts deem the improved efficiency of the privatization process and larger FDI inflow to some candidate countries a key factor at work, accounting for the lower rate of unemployment there.

Taking into account Bulgaria's progress over the last year on the alignment of its legislation with the EU acquis, financial and economic liberalisation, equal treatment of economic agents as well as the performance of the main macroeconomic and financial indicators as of September 2002, the European Commission in its Regular Report on Bulgaria's Progress of 9 October 2000 recognised the Bulgarian economy as „a functioning market economy able to cope with competitive pressure and market forces within the Union in the medium term, provided it continues implementing its reform programme to remove remaining difficulties." At the same time, the Commission has laid special emphasis on the impediments to the implementation of the economic criteria Bulgaria is currently facing as follows:

- „reinforcing the efficiency of the administrative and judicial systems to allow economic agents to make decisions in a climate of stability and predictability;
- administrative procedures, affecting the enterprise sector, including bankruptcy procedures, must be streamlined;
- the level of financial intermediation continues to be low. As a result, bank lending to the private sector remains low, SMEs access to bank credit is limited, and the level of gross fixed capital formation as percentage of GDP is insufficient to promote sustainable growth in the economy;
- high unemployment rate;
- ineffective, as yet, operation of market entry and exit procedures;
- ineffective implementation of the country's legislation in some areas;
- special deficiencies in the land market that affect the performance of related economic sectors;
- further effort need to be applied to improve the efficiency and quality of education;
- low quality of local infrastructures." ❍

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