BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2003
(semiannual survey)

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1. EXECUTIVE SUMMARY

In the first half-year period of 2003 the Bulgarian economy went on performing at a rate close to the growth rate of the last few years. The high economic growth was triggered by the steadily growing consumption, exports and higher FDI into new projects.

As a result, household real income, income from employment included, stepped up, as did employment, whereas the unemployed numbers reported a significant contraction. The country's average wages in the six months to July amounted to BGN 277, going some 5.5% up in real terms on a year earlier and hence outstripping GDP growth. Furthermore, real wages went on the increase in almost all sectors of the economy, with the service sector in the lead. Real disposable income, as calculated on the basis of the country's average wages, reported a 2.6% year-on-year rise, following a steady upward trend, as further evidenced by data of the NSI household budget surveys. In the first half-year period of 2003, real money income per capita grew by 9% on a year earlier, with the most robust contribution to the above growth being reported by income from employment (14.4%), followed by income from pensions and entrepreneurship (8% and 7.6% up in real terms).

The downward trend in unemployment in the six months to July was also evidenced by the findings of the NSI labour force surveys as well as the data on the registered unemployed number produced by the Employment Agency (EA). According to the labour force surveys, the average monthly unemployment rate in the first half-year period of 2003 ran at 14.7%, or about 3.9 percentage points down on a year earlier. Furthermore, according to EA data, the average monthly influx of registered jobless amounted to 571.2 thousand over the same period. Put in other words, in the six months to July the number of registered unemployed was steadily declining down to 506.4 thousand, accounting for a 23.2% decrease relative to the same period of 2002.

The unemployment rate stepped down as a result mainly of the interplay of the following factors at work: the labour market upswing in the private sector and the broadened scope of the active labour market measures underway. According to labour force survey data, the number of employed in the economy in the six months to July averaged 2790.2 thousand, or about 65 thousand higher on a year earlier. Employment in the economy stepped up solely as a result of the growing private-sector employment. In the second quarter alone, private-sector employed grew by some 179 thousand. It can therefore be assumed that since 2002 growth in the economy has been coupled not only with real income growth but employment growth as well.

Since the end of last year, government spending on social measures having to do with the reintegration of the jobless numbers into the labour market has gone on the increase, with the emphasis now being placed, among other things, on long-term unemployment. The average monthly number of unemployed covered by the active labour market measures of the government amounted to 79.4 thousand against 32 thousand over the same period of 2002, with the vast majority of them being encompassed by the national *From Social Aid to Employment Promotion* programme.

The higher real income from employment, pensions, entrepreneurship, etc. as well as the decreasing unemployment rate led to higher consumption in the country. In the first six-month period of 2003 final household consumer expenditures reported a 7.1% real-term rise on a year earlier. As a result, their share in GDP by final expenditure item stepped up by 2 percentage points, now accounting for some 73% of the country's total GDP.

Higher consumption triggered a certain increase not only in the demand for local goods and services but the country's demand for imports as well. In the six months to July imports grew by 16.9% on a year earlier up to MEUR 4179.8, with consumer goods imports reporting a most robust rise of 15.7%. The faster import growth vis-a-vis exports brought about a certain deterioration in the country's trade balance, and hence a larger current account deficit of the balance of payments. At the same time, the larger trade deficit was by and large due to the economic growth reported by the country. Total imports grew as a result of the robust contribution of raw material imports. The indicator's performance was determined by the expansion of the manufacturing enterprises, and the higher sales volumes, export sales in particular. Investment goods imports increased by 18.5%, with this growth fully matching national accounts data which pointed to an 18% real-term rise in gross fixed capital formation. Therefore, the expectations that the share of investments in GDP will carry on increasing in the years to follow give solid evidence that the comparatively fast growth rate of investment goods imports will be sustained in the mid-term as well.

The higher household real income, together with the improved participation rate in the economy, led to an increase in the credit exposure of the commercial banks to the non-government sector. Lending to the private sector stepped up by 19.6% (BGN 922.9 million), whereas loan extensions to households went up as high as BGN 404.2 million, reporting a 32.6% rise. At the same time, bank claims on the state-owned non-financial enterprises stepped up by a bare 0.8%, as all commercial banks sought to optimise the structure of their assets. Furthermore, over the period under review, net foreign assets in the banking system declined by 21.3%, a downward trend taken up last year and largely induced by the low interbank interest rates in the international financial markets. The share of loans to non-financial institutions went on the rise, going up as high as 47.5% in end-June. The strong growth of their share (by over 6 percentage points on a year earlier) took place at the expense of the contracting share of claims on banks and other financial institutions (by over 5 percentage points relative to end-2002). As for the structure of commercial banks' assets, the share of investment loans (corporate immovable property and construction) reported the fastest increase, a positive development signalling that banks were optimistic about the country's business environment and willing to finance projects of a longer term of implementation. Such a conclusion can be also arrived at judging by the growing share of housing and mortgage loans extended to individuals.

Despite its high growth rate, lending in the economy remained rather low (as estimated by the ratio of loans to the non-government sector to GDP which ran at 23.5% in end-June). However, the very high rate of credit growth gave rise to no fears and worries. And yet, special attention should be focused on the quality of loans to be extended. The higher bank lending over the last two years has not led to any sharp deterioration in the quality of banks' credit portfolios, and as of end-June standard risk exposures amounted to 91.7% (vs. 94.47% in December 2002), while risk exposures classified as loss ran at 2.55% (1.82% in end-2002). Non-banking financial institutions gained in importance, as bank intermediation further deepened.

A strong social stance of government spending policy and good revenue performance were the features that shaped fiscal measures in the first half-year period of 2003. Over the same period, general budget revenues accounted for 19.5% of the 2003 GDP forecasts, running 0.7% higher than in 2002. Though lagging behind the revenue and GDP growth, budget expenditures went on the increase, too, spurring a rise in the budget primary and cash surplus and ensuring a certain fiscal policy flexibility and predictability, given an ever worsening current account balance. In the six months to July the cash surplus of the general government budget reached 1.8% of GDP, running a percentage point higher relative to the same period of 2002. The hefty budget surplus of the first half-year period allowed for a significant increase on the fiscal reserve account. Government deposits and suspension accounts stepped up by BGN 1.1 billion, making domestic financing run negative, despite the higher volumes of government securities issued. The government debt/ GDP ratio declined compared to early 2003, now accounting for 49.8% of the GDP forecasts, or 6.1 percentage points lower on a year earlier.

One of the main problems faced by economic policies had to do with the lack of progress on large-scale privatization deals in key infrastructure sectors, which half way through its term of office the government defined as a major shortcoming of the privatization pattern adopted failing to achieve the key policy goal on the government economic agenda, i.e. fast and effective privatization as one way of attracting foreign investments to Bulgaria.

The reasons behind the lack of progress can be sought along the following lines: on the one hand, the Privatisation Agency does not have the administrative capacity to cope with the sale of large companies or the minority shares of a large number of SMEs. On the other, the absence of coordination between the legislative and privatization processes is a major stumbling block. Furthermore, privatization has been greatly delayed by cumbersome procedures having to do with privatization decisions to be made by the government and Parliament, which made deals all the more sluggish. It should be also noted that whenever a company is placed under privatization procedures its chances to get any financing are becoming more and more limited, which in turn may undermine the viability of the monopolies at a time when they carry out their operations in a free market and competitive environment.

In the first half-year period of 2003 Bulgaria's accession negotiations with the EU went according to schedule due mainly to the improved coordination and organization of intra-government action, following the adoption of the Strategy for Negotiation Acceleration and the Action Plan of 2001 as well as due to the experience already gained in the negotiation process. As of today, Bulgaria has provisionally closed 25 of the negotiation chapters, and the expectations of the Bulgarian government are that another two chapters, viz. Chapter 6 „Competition“ and Chapter 24 „Justice and Internal Affairs“, will have been closed by the end of 2003.

The country's macroeconomic stability and economic policy consistency are a necessary precondition for fulfilling the Copenhagen economic criteria of EU accession. However, a major problem faced not only by Bulgaria but most acceding and applicant countries has to do with the current account deficit of the balance of payments, the rampant unemployment rate and still poor financial intermediation. Unlike many of these countries, Bulgaria has sustained a moderately good level of its government budget balance, which is an important precondition for maintaining the country's macroeconomic stability. ❑

2. RECENT TRENDS IN THE PERFORMANCE OF THE WORLD ECONOMY

2.1. Growth

In the first half-year period of 2003 the world economy failed to rebound again from the recession of the past couple of years, but the expectations that it would go on the upswing in late 2003 were becoming more and more realistic. However, the IMF forecasts of September this year remained unchanged compared to the spring estimates, foreseeing a growth rate of some 3.2% and 4.1% respectively in 2003 and 2004.[1] Furthermore, for the first time since September 2001 the growth estimates have not been revised downwards. The turnaround in the downward trend of the growth projections are based on the decreasing geopolitical insecurity, following the swift end to the Iraqi conflict, further fiscal incentive packages designed to revive the US economy and the oil price decrease anticipated. In addition, as inventories step up, the world economy is expected to sustain the growth rate forecasts. At the same time, the estimates of JP Morgan Securities Inc., the World Bank and BNP Paribas as to 2003 and 2004 growth in the world economy run a lot more pessimistic than the IMF forecasts.

2003 and 2004 Growth Estimates of Different Institutions

Institution	*IMF*		*JP Morgan Securities Inc.*		*UBS Warburg*		*World Bank*			*BNP Paribas*	
Country	*2003*	*2004*	*2003*	*2004*	*2003*	*2004*	*2003*	*2004 -2005*	*2006 -2015*	*2003*	*2004*
World	*3.2*	*4.1*	*1.9*	*2.7*			*2*	*2.9*	*3.2*	*2.7*	*3.6*
USA	*2.6*	*3.9*	*2.3*	*3.3*						*2.3*	*3.2*
Japan	*2.0*	*1.4*	*1.0*	*0.6*						*0.6*	*1.0*
Euro area	*0.5*	*1.9*	*0.8*	*1.8*	*1.1*	*1.6*	*0.7*	*1.9*	*2.2*	*0.3*	*1.3*
Germany	*0.5*	*1.5*	*0.0*	*1.3*	*0.4*	*1.0*				*-0.3*	*0.8*
France	*0.5*	*2.0*	*1.0*	*2.2*	*1.2*	*1.8*				*0.8*	*1.6*
Italy	*0.4*	*1.7*	*0.7*	*1.8*	*1.3*	*1.5*				*0.4*	*1.0*
UK	*1.7*	*2.4*	*1.9*	*2.8*	*2.3*	*2.2*				*1.6*	*2.3*
Applicant states	*3.9*	*4.3*	*4.3*	*4.3*						*4.0*	*3.9*

Source: IMF, World Economic Outlook, September 2003, JP Morgan Securities Inc., Global Data Watch, June 2003, UBS Warburg, European Economic Perspectives, April 2003, World Bank, Global Economic Prospects 2004, BNP Paribas, Global Outlook, June 2003.

[1] *IMF, World Economic Outlook, September 2003.*

EC Growth Estimates for 2003 and 2004

Country	GDP Growth (on a year earlier) 2003			2004		
	Autumn 2002	Spring 2003	Diffrence	Autumn 2002	Spring 2003	Difference
Euro area	1.1	0.5	-0.6	2.3	1.9	-0.4
Germany	0.5	0.0	-0.5	1.9	1.5	-0.4
France	1.1	0.4	-0.7	2.3	1.7	-0.6
Italy	1.2	0.5	-0.7	2.4	2.0	-0.4
Spain	2.2	2.2	0.0	3.1	2.8	-0.3
Great Britain	2.0	1.7	-0.3	2.5	2.4	-0.1
USA	2.2	2.6	0.4	3.6	3.9	0.3
Canada	2.8	1.9	-0.9	1.0	3.0	2.0
Japan	0.8	2.0	1.2	3.2	1.4	-1.8
Brazil	2.8	1.5	-1.3	3.5	3.0	-0.5
Argentina	3.0	5.5	2.5	4.5	4.0	-0.5
CIE	3.4	3.4	0.0	4.3	4.1	-0.2
Applicant countries	3.9	3.9	0.0	4.5	4.3	-0.2
Bulgaria	5.0	5.0	0.0	5.5	5.5	0.0
Czech Republic	1.9	1.7	-0.2	3.3	2.6	-0.7
Estonia	4.9	5.0	0.1	5.2	5.1	-0.1
Hungary	3.6	3.0	-0.6	3.9	3.5	-0.4
Latvia	5.5	5.5	0.0	6.0	6.0	0.0
Lithuania	5.3	5.8	0.5	5.7	6.2	0.5
Poland	2.6	2.9	0.3	4.1	4.1	0.0
Roumania	4.9	4.7	-0.2	5.0	5.0	0.0
Slovakia	4.0	4.0	0.0	4.2	4.0	-0.2
Slovenia	3.2	2.2	-1.0	3.8	3.0	-0.8
Turkey	5.1	5.3	0.2	5.0	5.0	0.0
Russia	4.0	6.0	2.0	3.5	5.0	1.5
Ukraine	4.5	5.3	0.8	4.0	4.8	0.8
World	3.2	3.2	0.0	4.1	4.1	0.0

Source: World Economic Outlook, September 2003

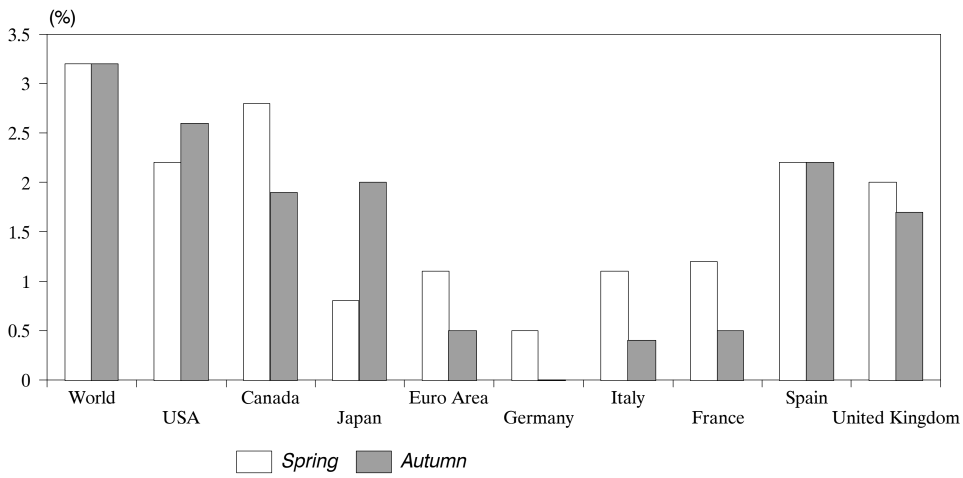
The growth prospects faced by the *US economy* may produce an adverse impact on the world economy, jeopardizing its growth. The excessively high federal budget deficit, and the current account deficit of 5.1% and 4.7% of GDP in 2003 and 2004 in particular, projected by the IMF give rise to fears as to the performance of the economy, although the growth reported of 2% and 2.3% in the first and second quarters of 2003 went well beyond the initial expectations. At the same time, the US economy was administered a powerful fiscal incentive injection of some USD 61 billion in the fiscal 2003 and another USD 149 billion planned for 2004[2].

[2] *BNB Paribas, Global Outlook 2003, June 2003.*

Stock prices have gone on the increase, the US currency lost significant ground to the other key currencies, and the long-term interbank interest rates have remained unchanged. In September 2003 the IMF revised its 2003 and 2004 US growth estimates upwards by about 0.4% to 2.6% and 3.9% respectively. The anticipations of JP Morgan Securities Inc. and BNP Paribas as to growth in the US economy are more pessimistic compared to IMF estimates, pointing to about 2.3% and 3.2% respectively in 2003 and 2004.

At the same time, first-quarter economic growth in the *Euro area* amounted to a bare 0.1%, while reporting a further 0.1% decline in the second quarter. Recession in the Euro area proved to be deeper and longer-lasting than expected, despite the brighter prospects of performance in terms of both the recent improvement in the business confidence indicator and higher stock prices.[3] The German economy reported a growth rate of 0.2% in the first quarter, and a decrease of 0.3% in the second. Over the same period, growth in the Italian economy amounted to 0.7% and 0.4%; and 1% and 0.6% in France, whereas the same indicator in Great Britain ran a lot higher at 2.2% and 1.8%.[4] According to estimates of the European Commission[5], growth in the Euro area by the end of this year is expected to vary between 0% and 0.4% in the third quarter and 0.2% and 0.6% in the fourth quarter. The low growth rate can be explained with the still low consumer and business confidence, rampant unemployment and the steadily rising but still low industrial output. These were also the reasons why the IMF revised its growth projections for the Euro area downwards by 0.5% on average to 0.5% and 1.9% respectively for 2003 and 2004. According to IMF estimates, Germany is not expected to report any growth in 2003. At the same time, the economy is anticipated to rebound as early as next year, posting a modest growth rate of 1.5%. In 2003 and 2004, Italy and France's GDP is expected to grow in real terms by 0.4% and 1.7% and 0.5% and 2% respectively. However, the forecasts of other international financial institutions as to growth in the Euro area and some of the bigger EU economies run more optimistic than IMF estimates.

Expected Growth Rate in the Industrial Countries in 2003



Source: IMF, World Economic Outlook 2003

IMF expectations of 2003 and 2004 GDP growth in the *Japanese economy* amounted to 2% and 1.4%, accounting for a significant upward revision compared to the spring estimates due to the higher than

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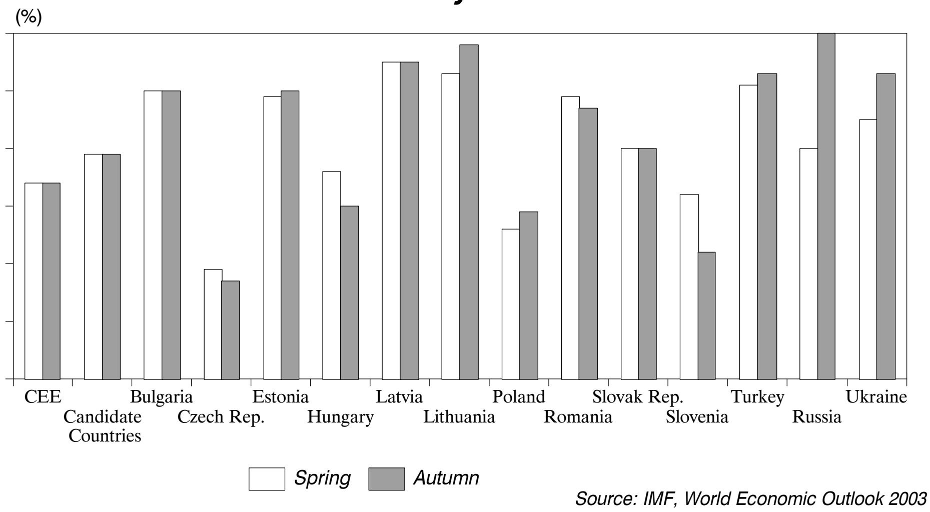
[3] *IMF, World Economic Outlook, September 2003.*
[4] *BNB Paribas, Global Outlook 2003, June 2003.*
[5] *European Commission's Directorate General for Economic and Financial Affairs, An Indicator-based Model for Quarterly GDP Growth for the Euro area, September 2003.*

projected growth rate of 2.5% and 0.7% respectively registered in the first and second quarters, improved external environment and higher stock prices. At the same time, the worsening financial position of the fiscal, corporative and financial sectors and steady deflation proved to be a major stumbling block for the revival of the Japanese economy.

The economies of the *applicant and acceding countries of Central and Eastern Europe* went on reporting high and stable growth sustained by their improved export performance and growing private consumption and investment volumes. Which is why the growth outlook for all of them remains stable, according to all international analysts. The IMF estimates of September this year for the above country groups run at 3.9% (2003) and 4.3% (2004). The 2003 and 2004 growth forecasts were revised downwards in the utmost degree for Slovenia (by 1 and 0.8 percentage points), Hungary (0.6 and 0.4 percentage points) and the Czech Republic (0.2 and 0.7%). The growth forecasts for Bulgaria in 2003 and next year remain unchanged at 5% and 5.5% respectively, with economic growth being sustained by the strong local demand and ever growing lending to the private-sector. However, as recommended by the IMF, sustainable growth in the Bulgarian economy can be only achieved based on the pursuit of restrictive fiscal policies with a view to the rising current account deficit. The growth expectations for Turkey remained unchanged, too, at 5.3% and 5% respectively in 2003 and 2004.

Expected Growth Rate in CEECs, Russia, Ukraine and Turkey in 2003



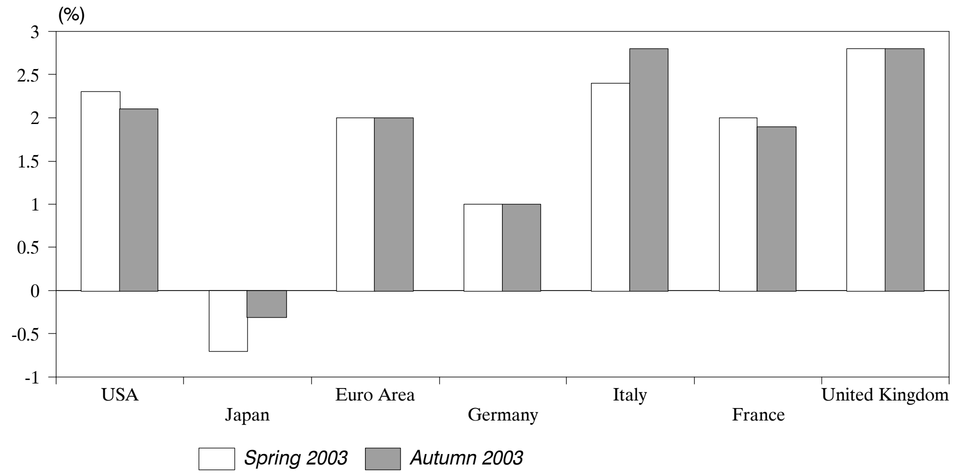
Source: IMF, World Economic Outlook 2003

The IMF and other forecasting agencies laid special emphasis on a number of risks that may jeopardise the growth prospects of the acceding and applicant countries as follows: firstly, their economies are heavily dependent on foreign demand, EU demand in particular. Secondly, maintaining a low government budget deficit is getting more and more difficult to handle, given an aging population, rising costs on meeting the EU environmental requirements and the terms and conditions for utilizing the EU pre-in funds. At the same time, the current account deficits in these countries are rather high. All this may undermine the long-term convergence of the CEECs on the Euro area criteria in a practical aspect as well as put their governments to the test in the short-term. And thirdly, the accession of these countries to the European Union is likely to make competition among banks fiercer and lead to lower interest rate spreads in the interbank markets and hence profit, and ultimately pose a liquidity hazard, although as of today the banking systems in the region are stable and well capitalized.

2.2. Inflation

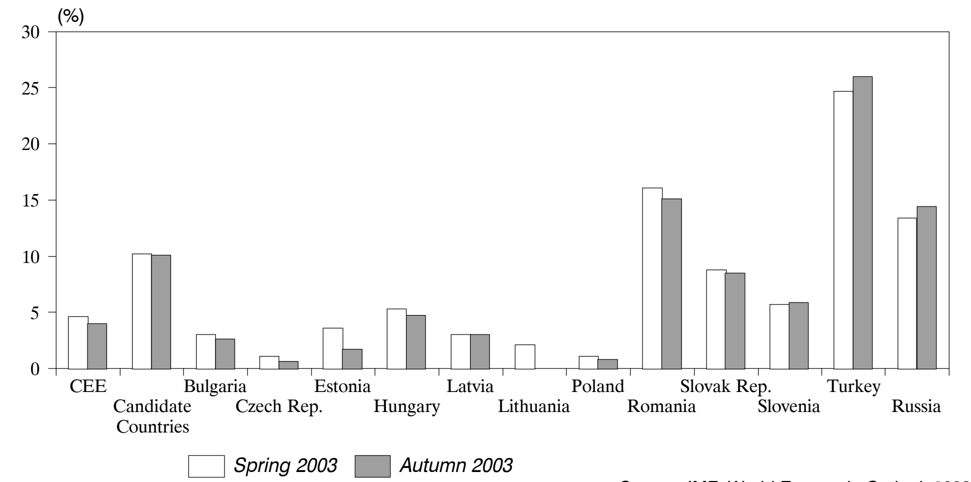
Under recession, inflation worldwide remained low and relatively stable. The September 2003 estimates of the IMF point to an inflation rate of well below 2% by the end of this year in the developed economies and further down to 1.3% in 2004. The IMF forecasts of *US* inflation are more favourable compared to the spring estimates, expecting it to hit 2.1% and 1.3% respectively in 2003 and 2004. At the same time, the Fund's projections for 2003 inflation in the *Euro area* remained unchanged at 2%, deteriorating by 0.1 to 1.6 percentage points for 2004. However, larger fluctuations in the IMF estimates are to be found for the 2003 inflation rate in Italy alone where it is anticipated to step by 0.4% up to 2.8%.

Expected Rate of Inflation in the Industrial Countries in 2003



Source: IMF, World Economic Outlook 2003

Expected Rate of Inflation in the CEECs, Russia, Ukraine and Turkey in 2003



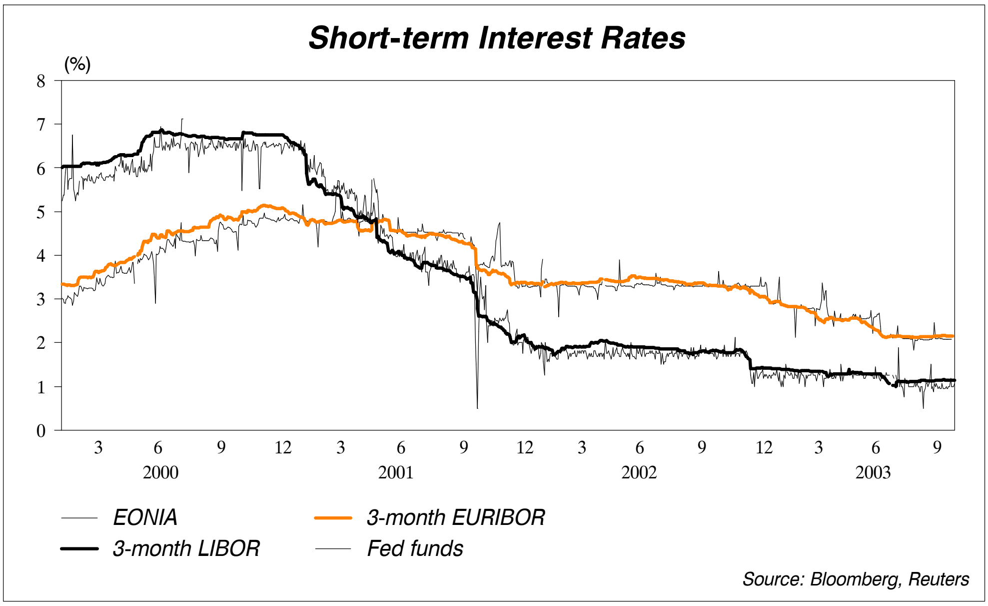
Source: IMF, World Economic Outlook 2003

Compared to the spring estimates, the IMF forecasts of September this year as to inflation in the *Central and Eastern European applicant and acceding countries* were revised slightly downwards to 10.1% and 7.3% in both years. The expectations of the IMF are that 2003 inflation will go on the rise in Slovenia and Turkey only.

2.3. Interest Rates

The absence of signs that the world economy was on its way to rebound from recession in the first half-year period of 2003 postponed the long expected increase in the interbank interest rates worldwide. On the contrary, the US federal funds rate was lowered by 25 basis points down to 1% in June. Earlier in the year, on 18 March the Federal Open Market Committee (FOMC) left the federal funds rate unchanged in the belief that any fluctuations in US growth had to do mostly with the higher oil prices and geopolitical uncertainty.

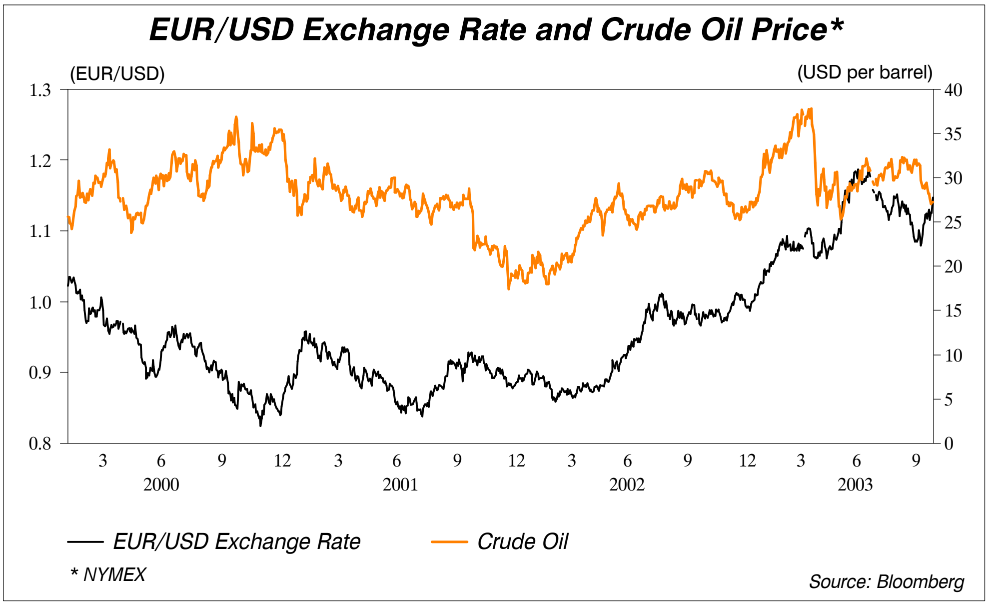
Over the same period, the refi rate in the Euro area was lowered twice - by 25 basis points in March and another 50 b.p. in June down to 2%. According to the IMF, the refi rate will have to undergo another cut if business activity in the Euro area does not recover fast enough or the single European currency goes up higher than expected. At the same time, *JP Morgan Securities Inc*. analysts[6] believe that the refi rate will remain unchanged by December this year when it will be cut down to 1.5%, steadying at this level by the end of 2004.



Most analysts believe that while steadily rebounding from the recession its has bottomed out, the Japanese economy now needs a strong further push, which monetary policies will fail to provide again by cutting the overnight call rate, as it has already reached nominal levels of around 0%. According to *JP Morgan Securities Inc*[7] forecasts, the overnight call rate will remain unchanged by end- 2004.

2.4. Exchange Rates

The downward trend of the US currency to the EUR persisted well in the first half-year period of 2003 as well, despite the end to the conflict in Iraq, the recovered consumer and investor confidence and higher stock prices. Since the start of the year, the US dollar depreciated by 13% to the single European currency[8], and while in January 1EUR was traded at 1.06 per USD five month later it went up as high as USD 1.17. According to the expectations of *BNP Paribas,* the US dollar will gain significant ground when the full effect of the rebounded global stock markets will



[6] *JP Morgan Securities Inc. Global Data Watch, June 20, 2003.*
[7] *JP Morgan Securities Inc. Global Data Watch, June 20, 2003.*
[8] *BNP Paribas, Global Outlook 2003, June 2003.*

come to the fore. The USD's appreciation is anticipated to be a rather short-lived one with a view to the hefty current account deficit and alterations in the patterns of deficit financing. Furthermore, most analysts tend to believe that the US currency is likely to further depreciate down to USD 1.2 per EUR, while reporting a yearly's average of USD 1.15 per EUR. In addition, the strong single European currency is expected to put a downward pressure on the growth outlook of the European economies.

2.5. Main Commodity Prices

Main commodity prices sustained their 2002 upward trend in the international markets. The most robust rise was reported by *crude oil* prices. The price average of USD 28.77 per barrel over the January-June'03 period stepped up by 24.5% on a year earlier, going well above the pre-crisis levels of USD 28.27 in 2000. The high oil prices could be attributed not only to the decreasing oil stocks but the tough manufacturing discipline maintained by the OPEC countries as well. Furthermore, there were a number of other factors at work like the severe winter weather conditions and hampered by the market situation deliveries to different points of destination, etc. Contrary to expectations, the war in Iraq has not produce the effect on oil price dynamics expected, as the growing OPEC oil output and quick recovery of the oil industry in Venezuela in the wake of last year's industrial strikes made up for the shrinking export volumes. Furthermore, Iraqi deliveries of crude oil are not expected to go up as high as the forecasts of 2.5 million barrels daily by the end of 2003, giving enough room to the OPEC countries to keep prices as high as ever. In 2004, however, Iraq is anticipated to go back again to the oil market as a key player, reporting export levels significantly higher than in the pre-war period.

According to estimates of the World Bank[9], oil prices are expected to retain their 2003 levels throughout the year, going, however, down to USD 25 per barrel in end-2004. According to IMF forecasts[10], 2003 and 2004 average oil prices per barrel will reach USD 28.5 and USD 25.5 per barrel, although it was as early as August'03 when the price average soared as high as USD 30 per barrel. The steady decrease in oil prices is anticipated to produce a healthy effect on the growth rates of the EU member-states, which are net importers of oil.

Also, *steel* prices set back at their pre-crisis levels of 2002, reporting a year-on-year increase of 39.66% (cold-rolled steel) and 43.51% (hot-rolled steel) over the January-June'03 period. Besides the growing demand worldwide, steel price dynamics has been further affected by the rising prices of nickel, which is a major raw material item in steel production. Part of the USD nominal-term price increase of ferrous metals was due to the depreciation of the US currency, as the currencies of the majority of the manufacturing countries are tied up to the US dollar.

Copper prices in the international markets remained relatively low, compared to their levels of USD 1767 per metric ton over the January-June 2000 period vs. USD 1652.17 on average in the same period of 2003. In the first half-year period of 2003, copper prices stepped up by only 4.29% on a year earlier. At the same time, copper demand in the Asian region went on the increase, as followed: by 21% in China and 8% in Japan. According to the forecasts of the World Bank[11], by end-2003 copper prices are expected to sustain

[9] *World Bank, Global Economic Prospects 2004, 2003.*
[10] *IMF, World Economic Outlook, September 2003.*
[11] *World Bank, Global Economic Prospects 2004, 2003.*

their current levels while rising up to USD 1800 per metric ton in 2004, following the recovered demand in the international markets.

The prices of *fertilizers* reported an insignificant increase in the six months to July, induced by the higher international agricultural prices. The higher natural gas prices - a major input item in the fertilizers industry- also produced some price impact. According to forecasts of the World Bank[12], the shrinkage in agricultural demand over the next two years as well as the lower natural gas prices expected are likely to bring about a 12-month drop of 4 percentage points on average in 2004 and 2005. ❑

[12] *World Bank, Global Economic Prospects 2004, 2003.*

3. BALANCE OF PAYMENTS, FOREIGN TRADE AND EXTERNAL FINANCE

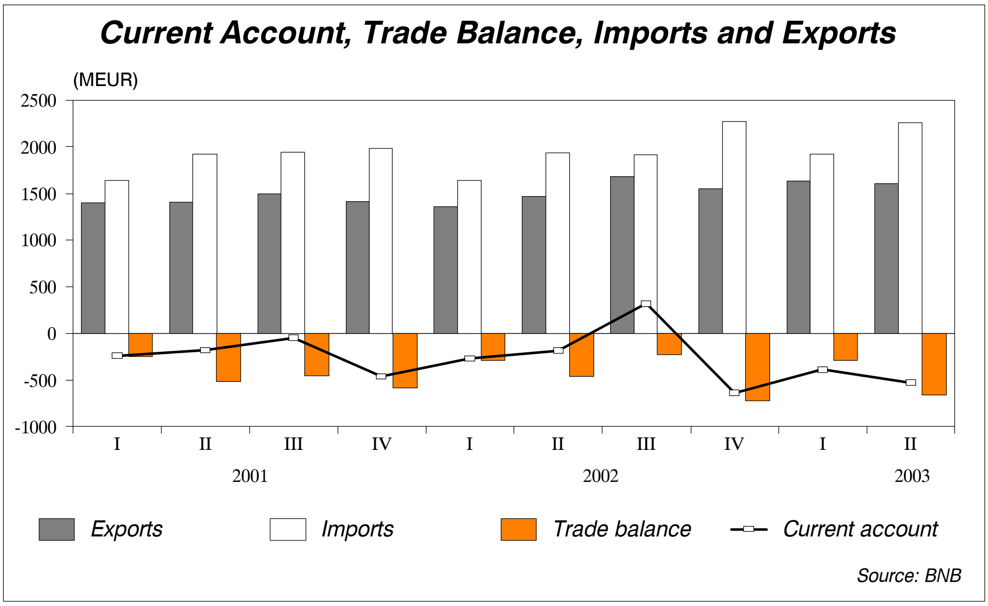
In the first half-year period of 2003 the *current account* deficit of the balance of payments almost doubled on a year earlier, hitting MEUR 918.2 or 5.2% of GDP. The current account deteriorated mainly as a result of the contributions of the country's trade balance (42.8%) and the *income* balance (41.5%). The balance on services worsened too, whereas net current transfers alone reported some improvement. The trade deficit over the same period (MEUR 943.6 or 5.3% of GDP) was due to the outstripping growth of imports (16.9% up on a year earlier) vis-a-vis exports (14.4%). In the six months to July 2003, imports amounted to MEUR 4179.8, and exports to MEUR 3236.1.

Current Account Balance

	I-VI 2002 MEUR	I-VI 2003 MEUR	Change MEUR	Contribution to change, %
Current account	-458.4	-917.8	-459.4	100.00
Trade balance	-746.9	-943.6	-196.7	42.82
Service balance	154.1	68.5	-85.6	18.63
Income balance	-110.4	-300.9	-190.5	41.47
Current transfers, net	244.7	258.3	13.6	-2.96

Source: BNB

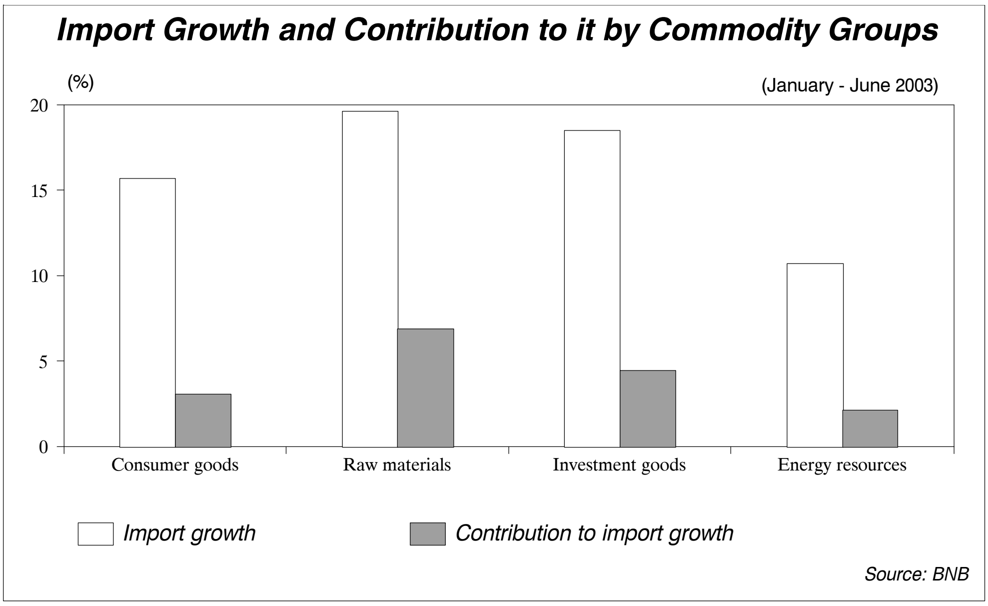
The country's trade deficit and the current account deficit ran higher than the preliminary estimates of AEAF, the European Commission and the other international institutions made in early 2003. As indicated by the analysis below, there is currently no conclusive and convincing evidence as to a likely destabilizing or detrimental effect of the growing trade and current account deficits on the economy and hence macroeconomic stability hazards in the short run. Furthermore, this does not call for any alterations to the macroeconomic policies implemented, since persistent current account deficits are also characteristic of other economies under a currency board arrangement that are on their way to join the European Union. At the same time, from the point of view of the country's macroeconomic stability and competitiveness in the long term, it is very important that these deficits are made consistent with the growth of the FDIs and FX reserves. The manifestation of a likely inflationary pressure in the following months can be an indication that adjustments are to be sought along the lines of fiscal policy action. Currently, the implementation of the 2003 consolidated fiscal programme (see Part Four), and built-in macroeconomic stabilizers allow for a certain flexibility of government macroeconomic policies and action to be taken in the last quarter, if needed. The headlong depreciation of the US currency in the six months to July, coupled with foreign exchange rate volatility, had a healthy effect on imports while hampering export growth, with a view to the comparatively low elasticity of trading towards the real foreign exchange rate.



The six-month rise in raw material imports of 19.6% reported the largest contribution to total *import* growth (6.9%). The indicator's dynamics was predetermined by the fast expansion of manufacturing enterprises, which reported a significant increase in sales, export sales included. Energy imports over the same period stepped up by 10.7% in nominal terms.

Investment goods imports also outstripped total import growth by 18.5% and made a 4.5% contribution to the aggregate indicator. Over the same period, growth in investment goods imports fully matched national accounts data on gross fixed capital formation (an 18% real-term rise) and FDI growth. The necessity as well as expectations that the upward trend in the share of investments as percentage of GDP will persist in the next years give solid grounds to assume that the relatively high and fast growth of investment goods imports at present will be retained in the future as well.

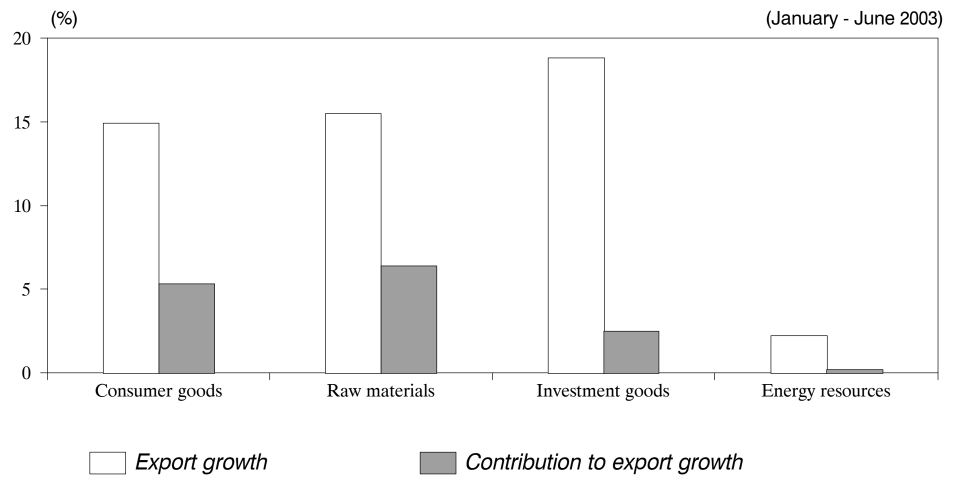
Consumer goods imports lagged well behind total imports by some 15.7% and reported a 3.1% contribution to import growth. A comparison to final consumption within GDP in the first half-year period (a 6.1% real-term increase, and a 7.8% nominal-term rise) indicates a certain switchover in consumption towards imports. The change in the patter of consumer behaviour is easy to explain by way of the higher household real income (see Part Four) and developments normally taking place where there is a re-orientation of consumer preferences to goods of higher quality and a certain lag in the changed attitudes of local manufacturers as a response to their new likes and dislikes. The higher consumer loans, the bulk of which were probably used for the purchase of goods with no local counterparts, gave another strong push to consumer goods imports over the January-June'03 period. As the dynamics of consumer goods imports is strongly linked with the dynamics of consumer loans, any



likely slowdown in the growth rate of consumer lending may bring about a certain delay (with a certain lag of time) in import growth.

Export growth (14.8%) was mainly triggered by the robust increase in textile and metallurgic exports (15.4% and 28.8% up respectively), with both groups reporting almost the same contribution to total export growth of about 4.7%. The growth in the latter group, however, contained a strong price effect as a result of the higher metal prices in the international markets. Of the other export items by commodity group, stepping by 20.7% in nominal terms, machinery reported the largest contribution of 20.7% in nominal terms. This group has followed a steady upward since 2002, gradually turning, together with the textile industry, into another competitive item of Bulgarian exports. The contributions of the remaining commodity groups remained rather marginal, as the shares of items of faster growth rates within total exports ran rather low. Thus for example, chemical and mineral exports stepped up by 3.6% and 0.4% respectively, whereas agricultural exports rose by 7.8%, given practically the same contribution rate to export growth of less than a percentage point.

Export Growth and Contribution to it by Commodity Groups



Source: BNB

As in 2002, in the first half-year period of 2003, Bulgaria's biggest trading partners were the EU member states, where some 56.7% of the export total was destined, and accounted at the same time for 49.3% of Bulgarian imports[13], with Italy in the lead (15.5% in exports and 10.4% in imports), followed by Germany (10.4% in exports and 14.1% of imports) and Greece (10.7% in exports and 6.8% in imports).

Tourism went on growing very fast in the six months to July, turning into a decisive factor for income generation on the current account of the balance of payments. The number of holiday makers visiting Bulgaria over the same period stepped up by 9.6%[14], although the Iraqi conflict made many tourists turn down the offers of travel agencies in some regions of the world. The number of EU holiday makers to Bulgaria outstripped the number of tourists from other destinations, running at 44.2% (vs. 40% on a year earlier). At the same time, the number of tourists from Central Europe grew at a rather fast rate, and Russian holiday markets now showed keener interest in Bulgarian resorts again.

The impact of the EUR/USD exchange rate on service exports remained rather strong. In the first half-year period of 2003, service exports, as calculated in EUR, contracted by 4% due mostly to fluctuations in

[13] *The percentages have been calculated in EUR.*
[14] *According to data of the Ministry of the Economy.*

the USD/EUR exchange rate. However, estimated in USD terms, service exports reported a most robust growth of 18.4%. In addition, the exchange rate's trend in the international markets was growth-conducive to transport service exports in particular.

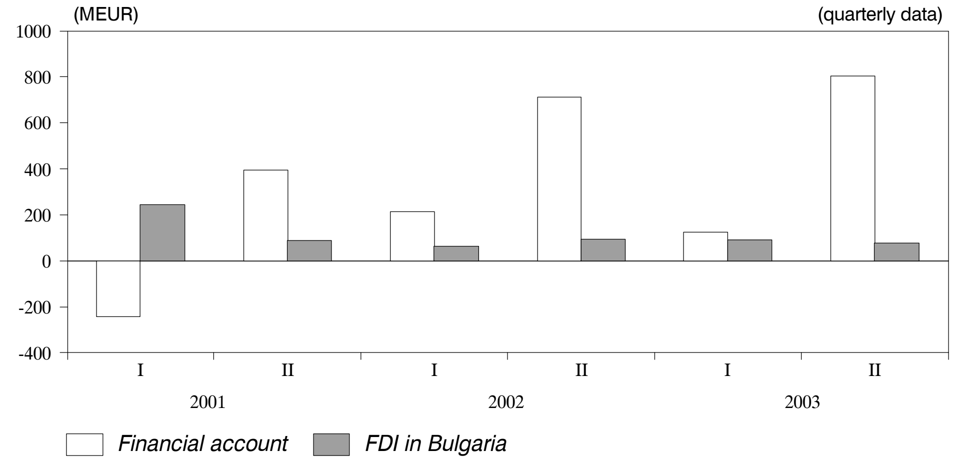
Service imports stepped up in both USD and EUR terms by 28% and 4.1% respectively. The *Travel-debit* item reported the slightest change, registering an 8.7% shrinkage in EUR, and a 12.7% rise in USD terms. At the same time, increasing by 8.2% in EUR terms, transport service imports ran significantly higher. The robust performance of transport services was probably due to their strong link with trade in goods which reported high growth rates. At the same time, the *Other services-debit* item went up by 11.9% in EUR and 38.9% in USD terms.

The *income* balance deteriorated as a result of the decline in inflows (22% down in EUR terms) and concurrent increase in outflows (50.4% up in EUR terms), given the same pattern of dynamics of data in USD terms. The decreasing inflows were partly due to the low interbank interest rates worldwide, although some other items, which are normally unaffected by the interest rate dynamics such as compensations of employees, also reported some decline. The high growth in income debit and income credit was mainly spurred by the one-time payment of dividends by a Bulgarian company to its foreign owners. In the six months to July *net current transfers* remained practically unchanged relative to the same period of 2002, as did the grant amounts extended by the European Union and other donors.

In the first half-year period of 2003, *the financial account* (MEUR 931.2) improved rather negligibly on a year earlier. FDIs to Bulgaria stepped up to some MEUR 474.2, covering 51.7% of the current account deficit, despite the lack of revenues from privatization. The most significant weight in the above vigorous growth of 93.5% was reported by the *Other equity* item[15]. As the privatization of the DSK Bank has been successfully completed, the expectations are that by the end of the year the share of FDI will step up well above the early-2003 estimates. The largest investment volumes in the six months to July were reported by Switzerland, Italy and Great Britain.

The portfolio investments of residents abroad reported a MEUR 56.9 worth of a shrinkage mainly due to the decreasing portfolio investments of commercial banks. The foreign currency deposits of commercial banks abroad alone contracted drastically by MEUR 139. Furthermore, March payments on the principal

Financial Account and Foreign Direct Investment in Bulgaria



Source: BNB

[15] It takes account of the change in the net liabilities arising between companies of foreign interest and foreign direct investors on financial, bond and trade credit.

of Brady bonds (FLIRBs and IABs) as well as the declining volumes of Brady bonds, Euro and global bonds held by residents were the main factors at work behind the MEUR 38.6 worth of a decrease in the *portfolio investments-liabilities* item. At the same time, stepping most vigorously by MEUR 355.3, the *other investments-liabilities* item[16] reported a most significant contribution to the positive balance on the financial account.

In the January-June'03 period, the country's *balance of payments* ran a MEUR 145.4 surplus. Foreign exchange rate fluctuations excluded, BNB's *foreign exchange reserves* stepped up by MEUR 300.9 compared to end-2002.

As of end-June the country's gross foreign debt amounted to USD 11915.2 million, accounting for 59.8% of the 2003 GDP forecasts.[17] Relative to end-2002, the gross foreign debt, as calculated in USD terms, rose by 8.9% while declining by 1.1% in BGN terms due to the USD/EUR exchange rate dynamics. The higher debt in value terms was brought about by the higher foreign lending to the private sector the share of which within the country's total foreign liabilities rose from 23.9% in end-2002 to 26.5% in end-June.

According to BNB statistics, the private sector's gross foreign debt in the six months to July increased by 20.9% up to USD 3158.3 million. The share of trading companies within the total private-sector foreign debt went up to 85.1% in end-June from 83.3% in end-2002. Growing by 26.8% and 30.9% respectively since the start of the year, intra-firm credit and other loans made the largest contributions to the rise in the foreign liabilities of trading companies.The short-term liabilities of private manufacturing enterprises reported an insignificant increase as percentage of GDP up to 60.1% in end-June while running slightly lower for trading companies at 57.8%.

The foreign liabilities of the private sector stepped up mainly as a result of the easier terms and conditions of foreign lending. Over the same period, the interest rate on loans extended by foreign banks went on running lower compared to the interest set by local banks. The average weighted interest on the loans extended by foreign banks abroad amounted to 3.6% (loans in USD) and (5.1% EUR loan extensions) or 7.9 and 5.2 percentage points down vis-a-vis local interest rates. In addition, notwithstanding the lower USD deposit interest the upward trend taken by the private-sector debt, dominated in EUR, was further reinforced. The share of the EUR denominated debt within the sector's total liabilities rose from 59% in end-2002 to 64.2% in the six months to July this year. This was a development fostered by the boosted trade with the EU member states and evidenced low foreign currency risk-averseness. ❑

[16] *The bulk (MEUR 146.8) of the above growth was due to the higher liabilities of the private non-financial sector on financial loans.*
[17] *2003 GDP forecasts run at USD 19 929.8 million.*

4. REAL SECTOR OF THE ECONOMY

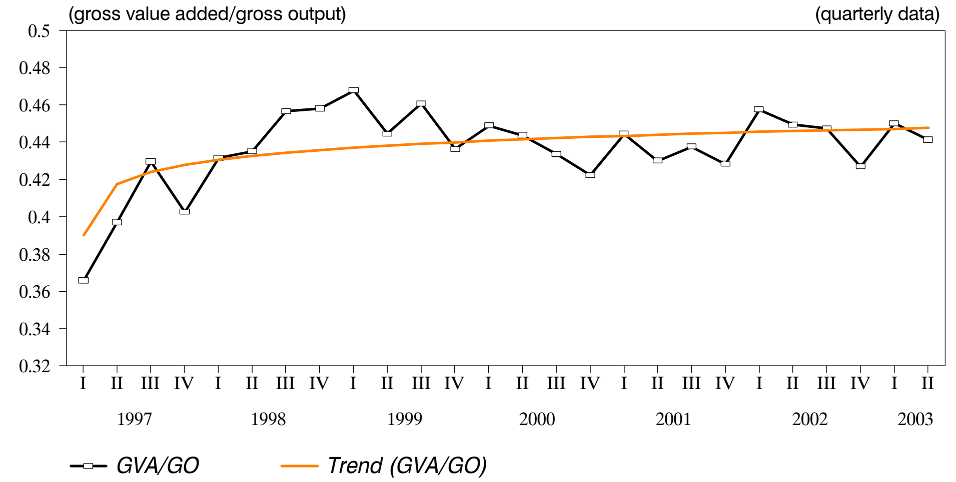
4.1. GDP

In the first half-year period of 2003, GDP grew by 4.1% on a year earlier up to BGN 15.3 billion. The growth rate remained close to rate of the first six months last year (4.2%[18]) despite the adverse external environment. Final consumption, household consumer spending (7.1% real-term rise and a relative share of 73%) in particular, was again the main engine of growth on the demand side.

The analysis of GDP by supply and demand element (see Appendix 1), together with the fiscal policy review (see Part Five) and credit market trends and FDI dynamics, indicate that the growth potential of the Bulgarian economy was still strong. All this gave AEAF analysts solid grounds not to revise their early-year estimates as to 2003 GDP growth of 5% and expectations for a slight increase in 2004.

In the six months to July gross value added (GVA) growth in the economy amounted to 4.1%. For another year in a row efficiency in the economy, as estimated by the weight of GVA in GO, ran higher in the first quarter than in the second, though at lower levels of the above ratio due mostly to the faster growth in interim consumption vis-a-vis GVA. The above trend was sustained by the processing industries and the finance, credit and insurance sector in particular and had to do with the alterations to the technological and product structure introduced to many enterprises in the wake of privatization, transfer of know-how and foreign investment injections. At the same time, agricultural efficiency reported the most drastic decline due mainly to the dramatic contraction in the sector's gross output.

Efficiency of the Economy



Source: NSI, AEAF

For more detailed information about the dynamics of GDP by element of final expenditure and supply, see Appendix 1.

[18] *On publishing the preliminary data for the first half-year period of 2003 the growth rate was revised upwards to 4.6%.*

Contribution of Final Use Components to GDP Growth

	H1 1998	H1 1999	H1 2000	H1 2001	H1 2002	H1 2003
Final consumption	6.44	9.50	5.19	3.86	2.82	5.87
Private consumption	4.73	9.72	4.05	3.46	2.37	5.77
Final household consumer spending	4.53	9.54	3.78	3.47	2.26	5.08
Final consumer expenditures of non-profit institutions serving households	0.01	0.04	0.03	0.02	0.02	0.01
Government consumption expenditure	0.19	0.14	0.24	-0.04	0.09	0.67
Collective consumption	1.71	-0.22	1.14	0.39	0.44	0.10
Gross fixed capital formation	2.02	1.12	5.30	2.93	1.46	3.06
Changes in inventories*	10.71	0.24	-2.52	-1.66	2.14	-1.41
Exports of goods and services	3.07	-9.02	7.99	7.47	0.24	6.63
Imports of goods and services	-12.29	-1.19	-10.48	-8.81	-2.09	-10.07
GDP	9.94	0.65	5.47	3.78	4.57	4.08

* In 2002 and 2003 the item also includes the statistical difference

Source: NSI, AEAF

4.2. Labour Market, Productivity and Wages

The key labour market indicators improved significantly in the first half-year period of 2003. The average *number of employed* in the economy stepped up by 65 thousand (2.4%) on a year earlier and hit 2790.2 thousand.[19]

Employment growth was wholly due to the rising numbers of private-sector employed (99.2 thousand or 5.8% up) relative to the same period last year. At the same time, public-sector employed declined by 34.2 thousand or 3.3%. Furthermore, in the second quarter of 2003 alone, private-sector employed rose by over 179 thousand, accounting for the highest ever absolute-term growth in employment inside a quarter reported since the onset of the reforms in 1991. The upward trend in the country's employment was further reinforced by data of the employment and wage surveys[20]. According to these data, the number of employed on labour contracts, accounting for the bulk of employment, went up by 127.1 thousand (6.7%) relative to the same period of 2002, rising by 115.2 thousand (10.1%) in the private sector while contracting by 12 thousand (1.6%) in the public sector[21].

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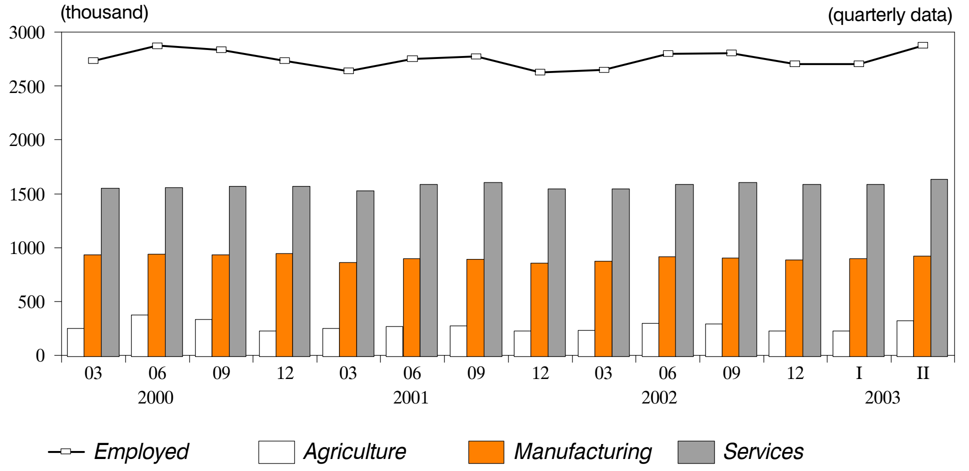
[19] *In early 2003 the NSI introduced a number of amendments to the methodology of labour force surveying to comply with EC requirements on statistical data collection, allowing for compatibility of data gathered in previous periods. They apply to as follows:*
- *survey periodicity from fixed time-basis surveys to non-stop quarterly surveying allowing for average quarterly assessments;*
- *in compliance with EC Regulation 1897/2000, the definition of unemployed is amended as follows: active job seeking is taken to be a series of contacts with job centres on a regular basis rather than the unemployment registration act itself as well as browsing for job adverts in all media, Internet including;*
- *in accordance with EC Regulation 2104/2002, the questionnaire shall also include questions as to the elementary module of education;*
- *the number of sample respondents has been reduced from 24 000 to 18 000 households;*
- *young men doing their obligatory army service have been excluded from the labour force total.*

[20] *Conducted by the NSI.*

[21] *In this case there is some mismatch with labour force survey data whereby public-sector employed decreased over the same period. It is noteworthy that the two surveys draw upon different methodologies of estimation, accounting for the different results and findings. On the whole, however, there is a very close overlapping of the trends in the employment dynamics, as evidenced by both surveys.*

About three-fourth of the private-sector industries in the economy reported an increase in their staff numbers[22]. A most notable rise of the indicator was reported by the mining and extraction industry where the employed numbers reported an over 2.5-fold increase. What is more, all private-run industries in the service sector reported higher employment, with financial intermediation and hotel and restaurant management in the lead with about 23.6% and 20.9% respectively. Also, most manufacturing industries registered a most substantial employment rise - electricity, heating, gaseous fuel and water supply (17%) and construction (15.6%), etc., which fully matched the upbeat expectations of managers as to the employment outlook in the NSI surveys of the first half-year period of 2003. At the same time, some processing industries reported a certain decrease in the number of unemployed, with a most strong decline being posted by the chemical industry (chemical substances, products and fibres) - (6.3%), and the manufacture of coke, refined oil products and nuclear fuel (12.2%) where the restructuring processes had not been brought to an end yet.

Number of Employed and Structure of Employment by Sector



Source: NSI, AEAF

Only 22% of the industries in the public sector registered some increase in the number of employed on a year earlier, with the highest growth being reported by welfare services (over 2 times) due to the government *From Social Aid to Employment* programme underway. The number of employed in the budgetary sphere stepped up by 10% as a result mostly of the higher public administration employment having to do with country's accession-driven administrative capacity reinforcement. The stringent reforms in education and health care afoot led to another contraction of public-sector employment in the above sectors of 3.7 and 4.2% respectively relative to the first half-year period of 2002.

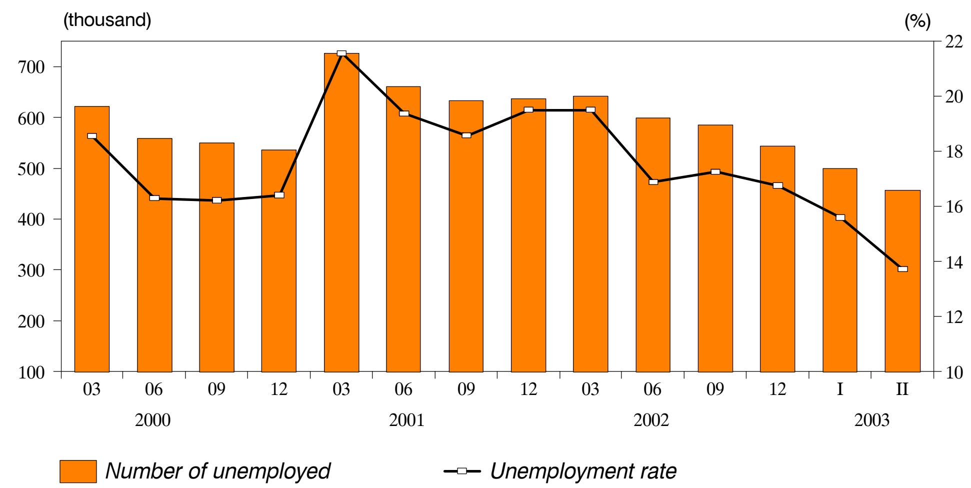
Both NSI and Employment Agency data indicate that the country's employment rate stepped down (to 13.7%[23]) in the second quarter as well, hitting a record low ever since the NSI started conducting surveys. According to labour force survey data, the monthly unemployment average in the six months to July amounted to 14.7% or 3.9 percentage points down on a year earlier.[24] The labour market upswing was wholly due to the country's macroeconomic stability, improved business climate and economic growth reported as well as the active labour market measures implemented by the government (see Appendix 2). It can therefore be

[22] *According to the NSI employment and wages surveys.*
[23] *According to labour force survey data.*
[24] *According to labour force survey data, the average monthly number of unemployed contracted by 142 thousand, whereas EA data point to a 104 thousand decline in the same numbers. According of EA data, the average monthly number of registered unemployed amounted to 517.2 thousand in the first half-year period of 2003. Throughout the same period the number of unemployed had been steadily decreasing to reach 506.4 thousand or a robust 23.2% down on a year earlier.*

assumed that since 2002 there have been certain developments in the economy whereby growth means not only higher real income but eventually higher employment as well.

The crackdown on the shadow economy in early 2003, i.e. the registration of labour contracts and insurance thresholds required, was one of the major reasons behind the fast growth in the number of employed. Furthermore, as evidenced by data provided by the National Social Security Institute (NSSI), the crackdown measures of the government proved to be growth-conducive, as by end-June the number of contracts registered amounted to 3 197 million, with 708 thousand of them concluded in the first half-year period of 2003 alone. All this led to a significant year-on-year increase in NSSI budget of BGN 201 million over the same period, giving more room for fiscal policy flexibility and easing the government to take further steps towards improving the country's business environment by reducing the social security burden or raising the welfare of pensioners.

Number of Unemployed and Unemployment Rate

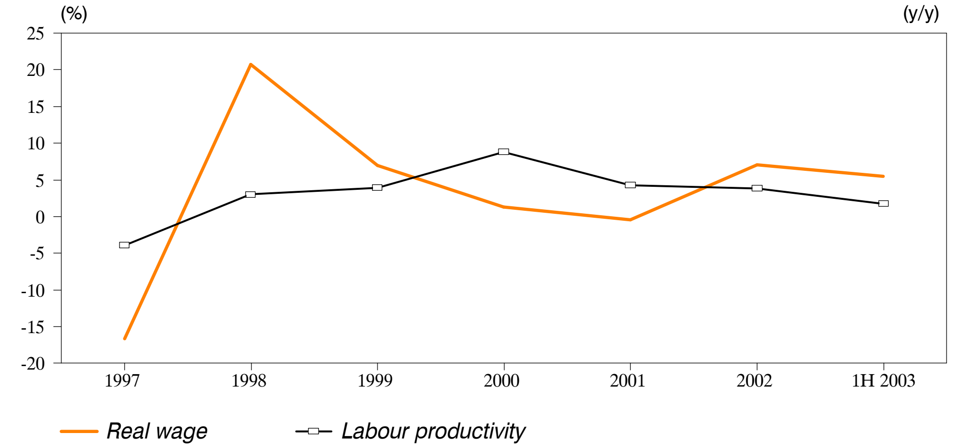


Source: NSI

For detailed information on the active labour market measures and programmes implemented by the government, see Appendix 2.

Productivity[25] in the economy stepped up by 1.7% on a year earlier (at 2002 prices), and while rising by 1.9% in the private sector it declined by 1.1% in the public sector due to the bigger decrease in GVA of 4.4% vs. the number of employed (3.3%).

Percentage Change of Real Wage and Labour Productivity



Source: NSI, AEAF

Productivity grew most significantly in the finance, credit and insurance

[25] *According to NSI data on GVA and the number of employed in the economy in the six months to July.*

industry (44%) where income stepped up most vigorously despite the employment redundancies due to the stronger competition in the wake of the privatization of the sector. A more substantial improvement in productivity was reported by the processing industries (9.8%) and transport and communications (6.6%) where GVA growth ran rather high, given a minimum increase in employment. As a result of the faster decline in the number of employed vis-a-vis GVA, productivity in the *production and supply of electricity, gas and water* sector stepped up by 6.1%. As for the manufacturing industries, it was only the extraction industry and construction that registered a certain deterioration in productivity (-7.7% and -4% respectively down) due in both cases to the faster growth in the number of employed compared to GVA. The trends tackled above have only further heightened the vital and crucial importance of the structural adjustment process in the economy to the improvement of productivity and competition.

Average real wages carried on increasing in the six months to July (a 5.5% real-term rise) on a year earlier. The country's real wages reported an increase in all sectors of the economy but *welfare services*. Furthermore, the real wage growth rate roughly matched sales dynamics, with wages tending to grow higher and faster in the sector of non-tradables which face no foreign competition. Averages wages in the public sector over the same period amounted to BGN 319 running higher than private-sector wages (BGN 251). However, the lower private-sector wages were coupled with higher year-on-year nominal- and real-term growth of 7.3% and 6.4% respectively vs. 6.3% in nominal terms and 5.4% in real terms[26] in the public sector.

The outstripping real wage growth vis-a-vis productivity in the first half-year period of 2003 gave rise to some fears as to the competitive position of local companies with a view to the trends afoot in foreign trade and the country's balance of payments. It is therefore important that any income policy should rely on the hard and fast rule that real wage growth must not run higher than productivity over a longer span of time and allow for timely and adequate adjustments in the medium term.

Since the start of the year the government has made use of all policy instruments available in an attempt to raise income in the country. Minimum wages stepped up by 10% on a year earlier, now fixed at BGN 110 on a monthly basis as from January. The outstripping growth of the country's minimum wages vis-a-vis average wages is an indication of the will and endeavour of the government to cut down the number of people in greatest need. *Real disposable income*, as calculated on the basis of the country's average wages, rose by 2.6% on a year earlier, running, however lower than average real wages since the reduced rates applied to the tax brackets on income from employment could not make up for the social and health insurance burden. The real disposable income per capita reported a 9% year-on-year rise compared to the first half-year period of 2002.[27] The biggest contribution to the real money income growth was made by income from employment (14.4%), followed by income from pensions (8%) and income from entrepreneurship (7.6%). The high increase in income from real estate sales and children's allowances had little contribution to total money income growth as they enjoyed a rather small relative share.

[26] *In budgetary organizations alone, wages stepped up by 5% in nominal terms and 4.1% in real terms due to the two-time wage update of 3.5% in the budgetary sector in January and July. Given the low inflation rate, the wage update carried out twice a year is hardly an adequate measure that needs to be further reviewed in the next two years.*

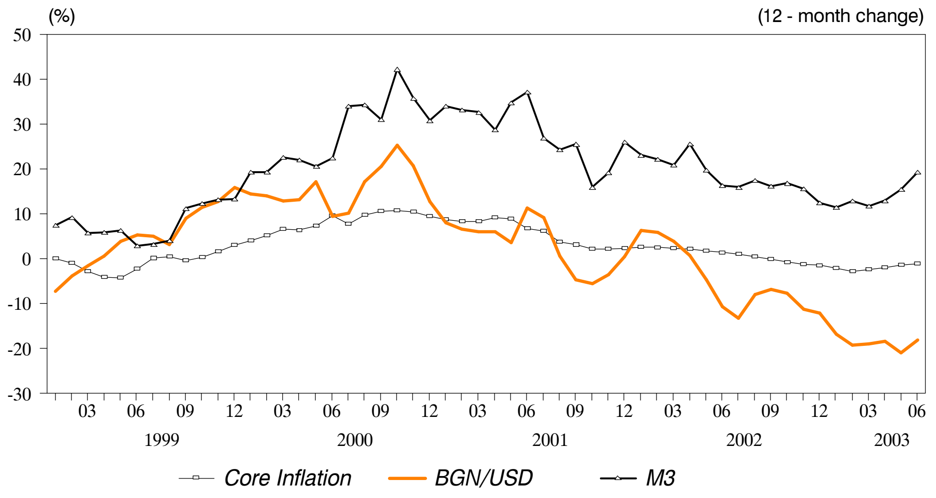
[27] *According to data of the NSI household budget surveys.*

4.3. Inflation

In the six months to July, inflation in Bulgaria ran rather low and one of the lowest among the EU acceding and applicant countries. Cumulative inflation throughout January to July amounted to -1.4% while averaging 0.8% over the same period (on a year earlier), or a percentage point higher compared to last year and early 2003 forecasts. The interplay of external factors are said to be the main reason behind the difference between actual inflation and preliminary estimates. In early 2003, crude oil hit comparatively high prices of around USD 32 per barrel, or a level close to 2000 prices. However, following the end of the Iraqi conflict in March, the average crude oil prices stepped down to USD 26 and steadied at this level well until end-June. The higher international oil prices led to a 19.9% rise in the producer prices of oil products in the first quarter and 5.6% increase in the consumer prices of liquid fuels in the January-February period. In the second quarter however under the impact of the lower oil prices worldwide and USD's lost ground to the other key currencies the producer and consumer prices of fuel went on the decrease. On the whole, oil prices contributed to the lower country's inflation (as estimated by the CPI), as well until June the oil price change (period's cumulative) had run negative at -13.5%. In addition, the USD exchange rate to the single European currency (the BGN respectively) made a further contribution to the negative rate of both total and core inflation[28]. At the same time, money supply growth (see Part Five) produced the opposite effect.

Core inflation, published by the AEAF on a regular basis, ran negative at -2.4%. The effect of the foreign exchange rate and money supply on the different components of core inflation had a different manifestation. Thus for example, with processed food prices, the weight of which in the consumer basket is about 29%, the effect of the foreign exchange volatility was a lot more pronounced vis-a-vis free service prices. At the same time, free non-food prices (a 15% weight) do not depend on the exchange rate dynamics but money supply and foreign price inflation. Non-food items face competitive imports and report as a rule the lowest and most stable inflation rate. Over the Jan'99 - Jun'03 period average monthly non-food price inflation amounted to a bare 0.5% on a 12-month basis.

Core Inflation, Exchange Rate and Money Supply



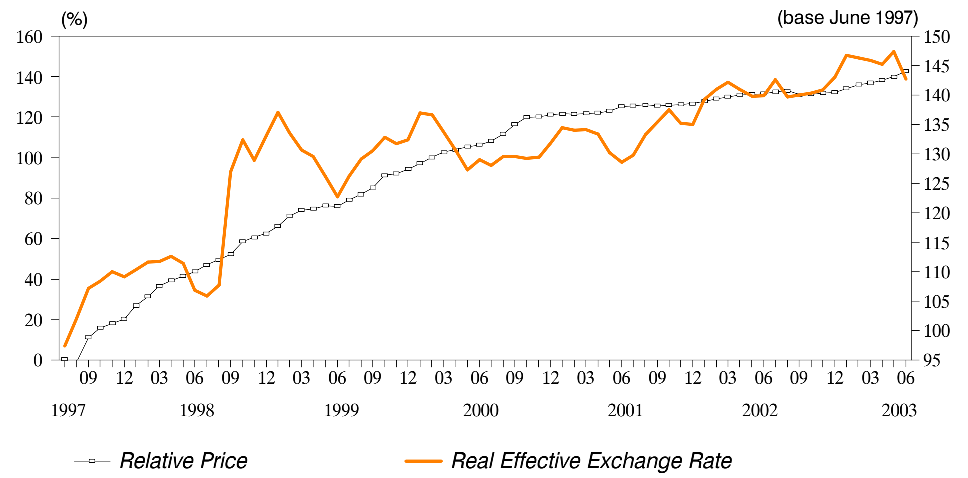
Sorce: AEAF, NSI

[28] *Core inflation is estimated to make data compatible with the international standards of statistical analysis and methodology which exclude the heavily dependent on seasonal factors energy goods and services as well as unprocessed food from the free market prices of goods and services. So estimated, core inflation is close in terms of the methodology of calculation to core inflation in the developed market economies. Published by the AEAF, core inflation calculations exclude only administered price inflation whereas unprocessed foods encompass fruit, vegetables, potatoes, eggs, milk, etc.*

Free service prices and administered prices reported the largest contribution to the overall price level since the institution of the currency board arrangement. In the six months to July, free service prices stepped up by 2.5%. However, given the wage dynamics by sector of the economy, it can therefore be assumed that the relative price dynamics of this group of services[29] is heavily dependent on the Balassa-Samuelson effect and the real effective exchange rate. It should be further noted that free service prices made a significant contribution to the real appreciation of the local currency vis-a-vis the currencies of Bulgaria's major trading partners.

Administered prices have again reported a significant contribution to the country's inflation for another year in a row since the institution of the currency board arrangement. From the start of the year to end-June administered prices registered an aggregate increase of 2.3% and a contribution of 0.6% to total inflation. Over the same period, the prices of intercity calls, medicines and water went up by 10.4%, 7% and 2.5% respectively. Furthermore, having stepped up by 14.7% and 10% on average in early July, the prices of electricity and heating supply are to bring about a certain rise in administered price inflation in the second half-year period of 2003 when no further rise in administered prices is expected.

Relative Price of Non-tradables and Real Effective Exchange Rate



Source: AEAF, NSI

Cumulative core inflation is anticipated to run rather low though positive again in the six months to January 2004 as a result mainly of the dynamics of the free market service and processed food prices. Food prices will also step up due to the stronger US currency and higher bread prices triggered by the poor wheat yields. As stocks worldwide have gone on the decrease, short-term estimates and forecasts will have to be revised downwards. Wheat and hence bread prices reported a further increase in August due to the deteriorating market situation and lower local supply, although the 2003 yields were estimated as sufficient to maintain the country's food security. The government responded adequately by ceasing any grain and flour exports and carrying out a number of interventions by selling wheat from the state wartime stocks. Bread prices are expected to increase slightly again in September and steady back ever afterwards.

4.4. Public Finance

Public finance sustainability stepped up significantly in the first half-year period of 2003. Fiscal policies were characterized by tough control on general budget expenditures, reinforced social profile of budget

[29] *Estimated as the ratio of the indices of free market service prices (non-tradables) to the free market price indices of non-food items (tradables).*

Major Public Finance Indicators

(in millions of BGN and %)	H1 2002	H1 2003	Change (%)
Revenues and grants	6 067 055	6 833 117	12.6%
(as % of GDP)	18.8%	19.5%	
Tax revenues	4 633 377	5 318 464	14.8%
(as % of GDP)	14.3%	15.2%	
Direct taxes	2 562 042	2 844 583	11.0%
(as % of GDP)	7.9%	8.1%	
Profit tax	592 019	630 414	6.5%
(as % of GDP)	1.8%	1.8%	
Personal income tax	511 013	525 465	2.8%
(as % of GDP)	1.6%	1.5%	
Revenues from social insurance contributions	1 459 010	1 688 704	15.7%
(as % of GDP)	4.5%	4.8%	
Indirect taxes	1 926 951	2 263 546	17.5%
(as % of GDP)	6.0%	6.5%	
Value added tax	1 222 296	1 471 745	20.4%
(as % of GDP)	3.8%	4.2%	
Excise duties and road fees	616 300	684 152	11.0%
(as % of GDP)	1.9%	2.0%	
Customs duties and charges	88 355	107 650	21.8%
(as % of GDP)	0.3%	0.3%	
Non-tax revenues	1 317 770	1 406 364	6.7%
(as % of GDP)	4.1%	4.0%	
Grants	115 907	108 289	-6.6%
(as % of GDP)	0.4%	0.3%	
Expenditure and transfers	5 796 007	6 206 673	7.1%
(as % of GDP)	17.9%	17.8%	
Current expenditures	5 374 607	5 806 455	8.0%
(as % of GDP)	16.6%	16.6%	
Interest expenditures	437 901	454 601	3.8%
(as % of GDP)	1.4%	1.3%	
Capital expenditures	408 740	379 578	-7.1%
(as % of GDP)	1.3%	1.1%	
Primary balance	708 949	1 081 045	52.5%
(as % of GDP)	2.2%	3.1%	
Cash balance	271 048	626 444	131.1%
(as % of GDP)	0.8%	1.8%	
Government and government-guaranteed debt	18 855 290	17 421 360	-7.6%
(as % of GDP)	58.3%	49.8%	
Domestic debt	1 949 208	2 234 536	14.6%
(as % of GDP)	6.0%	6.4%	
Foreign debt	16 906 082	15 186 824	-10.2%
(as % of GDP)	52.3%	43.4%	

Source: MoF, AEAF.

spending and over-performance of budget revenues vis-a-vis preliminary estimates. As a result, the share of budget revenues within GDP reported a most robust increase due mainly to the effect of the measures aimed at improving the country's business climate and curtailing the share of the shadow economy. General budget revenues now accounted for 19.5% of GDP[30], going 0.7% up on a year earlier. Though at a slower rate compared to both the revenue and GDP growth expectations, budget expenditures also stepped up but declined as percentage of GDP from 17.9% in the first half-year period of 2002 to 17.8% this year. The primary and cash surplus of the general government budget went on the increase up to 3.1% and 1.8% respectively of GDP vs. 2.2 and 0.8% percentage points on a year earlier. As can be seen from Part Two, the performance of the *savings-investment* balance in the budgetary sector (6.6% of GDP) proved to be a decisive instrument ensuring a sustainable growth path in the six months to July and making room for more fiscal policy flexibility and timely maneuver under the 2003 Government Budget Act as regards the growing current account deficit of the balance of payments.

The robust budget surplus run in the six months to July allowed for a sizable increase on the fiscal reserve account. Over the same period, the suspension accounts of the government rose by BGN 1.1 billion, making domestic financing run negative regardless of the higher volumes of government securities issues. The net issue of government securities amounted BGN 161.9 million consistent with the intentions of the government to raise steadily the share of domestic debt within the public debt total up to the EU levels. At the same time, revenues from privatization as a key source of financing shrank by 12% on a year earlier down to BGN 113.8 million.

Foreign financing (net) in the six months to July amounted to BGN 229.2 million, some BGN 46.8 million of which in the form of IMF extensions. The undertaking of new obligations under government investment loans made up for the BGN 92.2 million worth of payables on the principal of Brady bonds. Furthermore, over the same period Bulgaria was extended some MEUR 80 of World Bank loans aimed at promoting the country's employment and reinforcing the tax administration reform[31]. It should be also noted that ever since early 2003 Bulgarian authorities have started negotiating the government loans contracted in EUR in an attempt to reduce any foreign exchange risk.

Government debt[32] in the first half-year period of 2003 stepped down, in both BGN terms and as percentage of GDP (by 3.5% and 6.1% respectively), to BGN 17.4 billion in end-June. What is more, as percentage of GDP, the debt hit a record low of 49.8% ever since the onset of the transition. The debt's nominal-term decrease was due to the lost ground of the USD to the single European currency in the international foreign exchange markets. The relative share of the domestic debt within the government and government-guaranteed debt total went up from 11.7% in January to 12.8% in end-June 2003.

General government budget revenues in the first half-year period of 2003 reported a 12.6% year-on-on-year rise due mainly to the contribution of both tax and non-tax revenues, which registered a respective increase of 14.8% and 6.7%. At the same time, grant revenue declined by 6.6%, evidencing the low rate of country's utilization of the pre-in funds.

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[30] *Given 2003 GDP forecasts of BGN 34 966 million.*
[31] *The establishment of a National Revenue Agency.*
[32] *Government-guaranteed debt including.*

In the six months to July, tax revenues grew in importance to the budget and their relative share within total revenues stepped up by 1.4% to 77.8%, indicating that a positive tendency that tax procedures were now less cumbersome, more streamlined and transparent, had been set afoot. The nominal-term rise in non-tax revenues took place at the expense of the growing revenue amounts from ownership, in particular remittances made by government and local government institutions, as BNB remittances in the first half-year period of 2003 ran a lot lower. At the same time, revenues from fees and fines decreased in amounts, as a number of licensing regimes had been removed with a view to reducing government intervention in the private business sector.

Tax revenue growth was mainly triggered by the sizable year-on-year increase in indirect revenues of 17.5% up to 6.5% of GDP due to the tax legislation amendments effected providing for a certain rise in the excise duty rates on a number of goods that will eventually bring them into line with the minimum excise duty rates applicable in the EU[33]. On the other hand, the larger than expected foreign trade deficit proved to be another important reason behind the over-performance of the VAT revenue item, accounting for 18.8% of its 20.4% growth in the year. At the same time, VAT collection has improved tremendously with the introduction of the so-called VAT-account since the second half of 2002. Furthermore, revenue from customs duties stepped up most vigorously by 21.8% over the same period due to the growing imports into the country.

Direct taxes, social insurance contributions including, also reported a notable contribution to the total revenue growth of the general government budget, but their performance by item ran rather uneven as followed: profit and personal income tax revenues were going up rather weakly while revenue from social insurance contributions registered a remarkable rise. The reason for the different pattern of income tax dynamics, according to AEAF analysts, was to be sought with the action the government has undertaken to improve the collection of the social insurance contributions by introducing insurance thresholds by profession and obligatory registration of labour contracts. And yet, despite the revenue growth, the early-2003 expectations that the effective tax rate on labour is to step down by a solid percentage point to 37.6% are still relevant, which highlights the consistency of government policies aimed at reducing the direct tax burden.

The cautious policy of the government as to *budget spending* as well as its attempt at restricting its interventions in the economy led to a considerable shrinkage of general budget expenditures as percentage of GDP (down to 17.8%) in the first half-year period of 2003. At the same time, they grew by 7.1% in nominal terms on a year earlier. 2003 budget expenditures perform according to the fiscal programme projections, though there has been a certain pressure exerted by a number of institutions to raise expenditures for social and welfare purposes.

As for budget expenditures by function, there was some re-allocation of funds to sectors like education, health care and social insurance which was made up for by the relative decrease in government spending on defence, administration maintenance costs and interest savings. Also budget expenditures extended to support agricultural business reported a most robust growth due to the large amounts of subsidies in the sector, which can also be viewed as social expenditures. The reinforced social profile of the budget programme called for further larger amounts of expenditure in that area. At the same time, it is noteworthy that despite

[33] *Excise duty rates produce a favourable effect on VAT revenues as well, as the latter is applied to the value of goods, which also includes the excise duty.*

the increased government spending on health care, there were discerned some drastic shortages of money for basis medications. All this requires a thorough and exhaustive analysis of the very planning and organization endeavour and control in this segment so that any misuse of the fund reserves accumulated so far and amendments of the health insurance fund budget are timely avoided by the end of the year. The delayed reform in education was another source of pressure for the budget. The higher budget expenditures in the first half year period of 2003 were wholly due to the higher payments on school maintenance costs (15.8%) and wages and social insurance contributions of the employed in the sector (8.2%), i.e. a trend clearly clashing the government agenda in the sector (optimizing the school network) and evidencing a slower and sluggish reform pace.

General Government Budget Expenditures by Function (as % of total expenditures)

	H1 2002	*H1 2003*
General public services	*6.7%*	*6.5%*
Defence and security	*13.2%*	*12.3%*
Education	*10.3%*	*10.7%*
Health care	*10.5%*	*11.3%*
Social insurance and welfare	*35.2%*	*35.8%*
Housing construction, public amenities and utilities, environmental protection	*3.3%*	*3.0%*
Recreation, culture and religion	*1.7%*	*1.9%*
Economic affairs and services	*11.4%*	*11.3%*
Other expenditure, not classified	*7.7%*	*7.3%*

Source: MoF, AEAF.

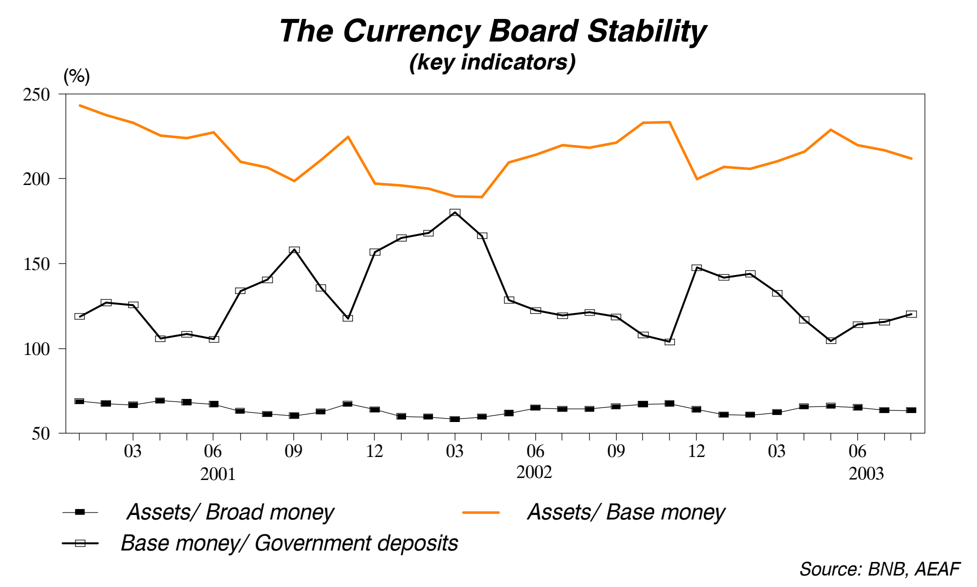
The breakdown of budget expenditures by economic element indicated a certain rise in the share of non-interest payments. The highest nominal-term six-month growth was reported by subsidy payments to non-financial enterprises (30%) due solely to the larger extension amounts to the agricultural sector. Also, wage bill costs and expenditures on social security contributions stepped up by 16.8% as a result mainly of the higher pay rate in the budgetary sphere and growing employment to meet the administrative capacity reinforcement requirements. At the same time, investment spending declined in both nominal terms and as percentage of GDP — from 1.3% in 2002 to about 1% this year due to the lower grant amounts received and rather poor utilization rate of funds extended under donorship schemes and programmes. A positive development over the same period had to do with some expenditure constraints on maintenance costs, which contracted down to 2.5% of GDP. Budget payments on pensions and social and health insurance contributions remained unchanged at 6.9% as percentage of GDP. As the switchover of health care financing to the health insurance fund was further carried on, government budget subsidies to support health care activities declined by over 9% on a year earlier. Interest payments went on contracting as percentage to GDP, running at 1.3% in the six months to July vs. 1.4% relative to the same period of 2002 due mainly to the lower interbank interest rates in the international markets and the government debt work-out effected in the last two years.

❑

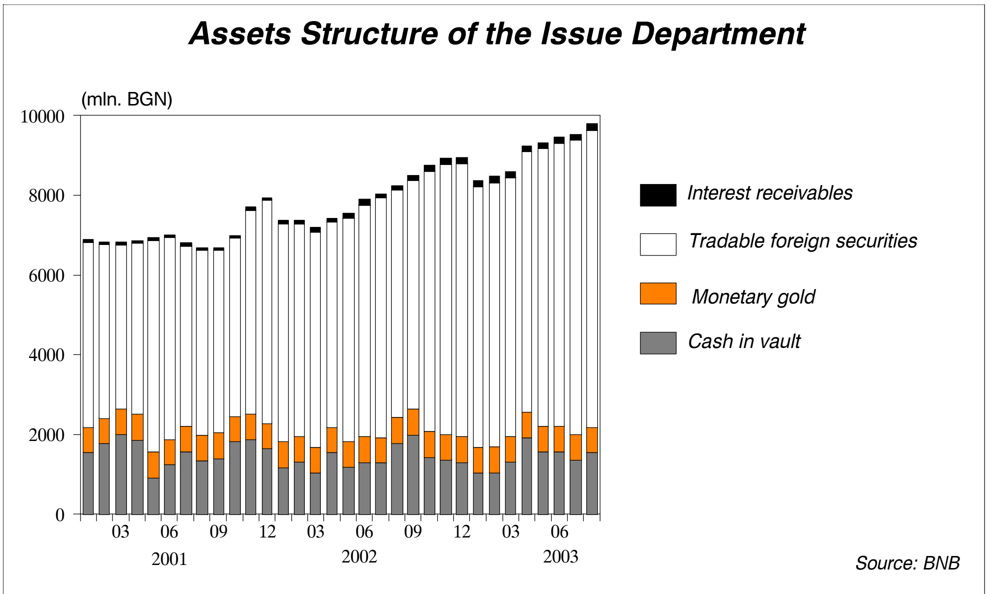
5. FINANCIAL SECTOR

5.1. Currency Board Performance

The currency board remained as stable as ever and well-capitalised in the first half-year period of 2003 as well. The assets of the BNB Issuing Department (gross FX reserves) amounted to BGN 9 451.3 million, hitting a record high ever since the institution of the currency board arrangement in Bulgaria. On a year earlier, the money stock (M3)/FX reserves ratio stepped up by 1.1 percentage point in end-June to reach 65.1%, whereas the reserve money/FX reserves ratio went some 20 percentage points up to 219.6%. The currency board's stability was sustained and further improved thanks to the interplay of factors such as: the USD's depreciation to the single European currency and steady low interbank interest rates in the international markets which eased significantly the country's foreign debt servicing as well as the tranche under the 2-year IMF facility arrangement (MEUR 33.3), the MEUR 150 worth of WB PAL extension in support of the balance of payments and repayments on Russia's debt to Bulgaria (MEUR 29.7).



Source: BNB, AEAF



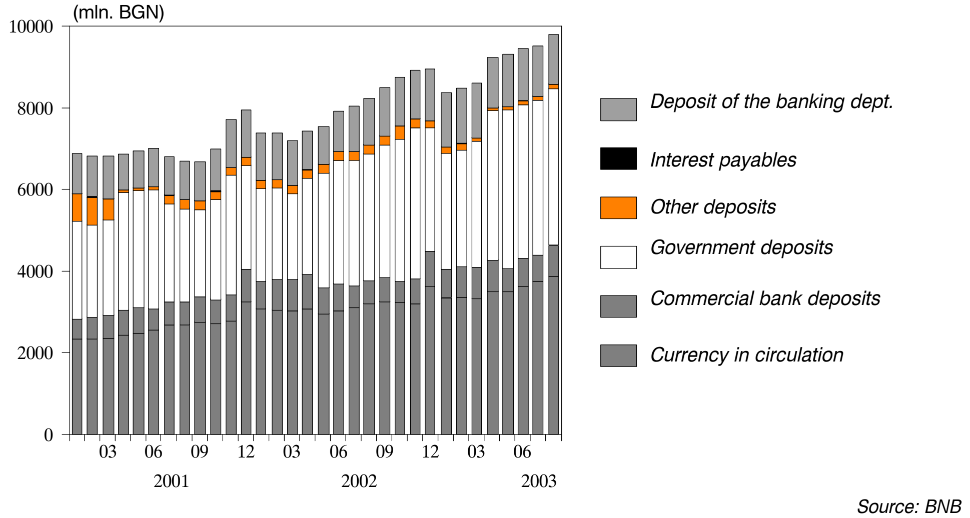
Source: BNB

On the assets side, there occurred no significant changes, and as of end-June foreign currency cash in hand increased by 20.9%; its share within total assets ran at 16.6%, or 2.1 percentage points higher on a year earlier, due to the forthcoming regular payments on the country's foreign debt in July. Tradable foreign securities reported a 3.3% nominal-term rise but their share shrank by 1.5%

down to 74.9%. The share of monetary gold followed suit, stepping down to 6.8% (vs. 7.2% in end-2002).

On the liability side, there were seen no important changes either. Both banknotes and coins in circulation and commercial banks' settlement accounts reported a year-on-year contraction of 0.3% and 19.7% respectively. As a result, their shares within total liabilities declined by 2.3 percentage points each down to 38.3% (money in circulation) and 7.3% (bank reserves). Relative to the same period of last year, the fiscal reserve account (government and budgetary organisations' deposits) in the six months to July grew by 24.4%, and its relative weight rose by 6 percentage points up to 39.9%. The larger fiscal reserve account (as can be seen from the analysis done in Part Three) had to do with the proper execution of the government budget, and was further fed by the net issue of government securities over the period under review, the IMF loan tranche, and WB extensions. The Banking Department's deposit reported a year-on-year rise of a bare 0.9%, but its share within total liabilities, however, declined by 0.6% down to 13.5%.

Liabilities Structure of the Issue Department



Source: BNB

5.2. Money Supply and Bank Credit

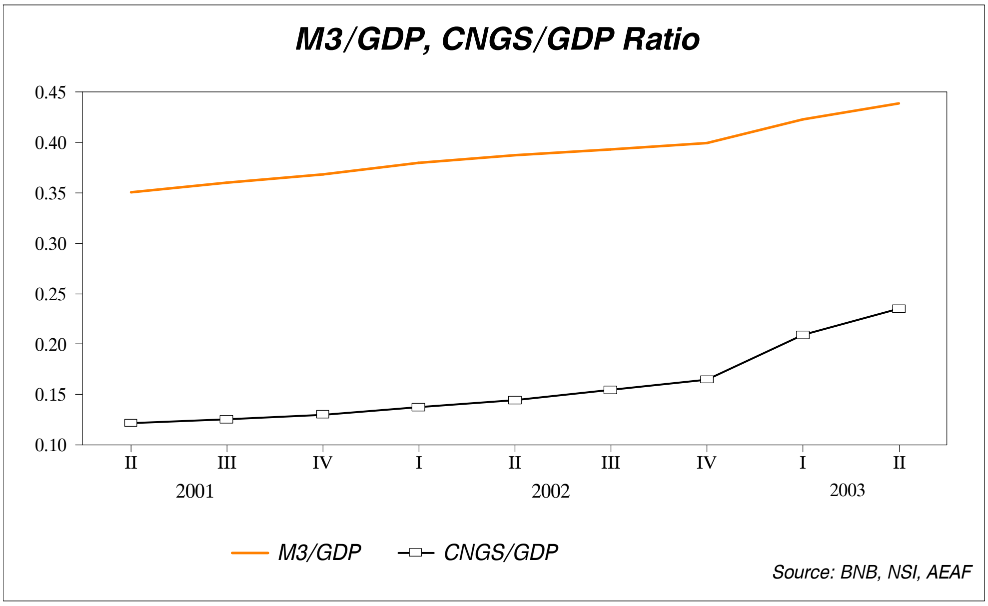
The transfer of a small amount (BGN 200 million at the most) of the fiscal reserve account from the Central Bank onto deposits with commercial banks[34], selected on a tender basis, outlined the new account management policy following a decision of the government of May 2003. By end of the first half-year period of 2003, some BGN 130 million of funds were effectively transferred on to 15- to 18-month deposits, allowing the Ministry of Finance to make immediate withdrawals without suffering any significant financial loss. The factors safeguarding the economy from the impact of a likely follow-up inflationary pressure had to do with the small transaction amounts, the requirement that all transfer amounts should be government security-collateralized, growing competition in the real economy, dominant private ownership and the sustainability of public finance. The transaction could also have a long-term effect on the country's money supply and inflation, as it would affect the dynamics of the money multiplier and hence bring about changes in its limit value. All this calls for a better coordination of fiscal policies and makes policy drafting in a longer-term perspective (other than the current 3-year period) a must with a view to Bulgaria's strategic objective of EU accession before the end of this decade.

[34] *All analysts believe that the decision fully complies with the current Bulgarian legislation and is within the competence of the government.*

Remonetisation of the Bulgarian economy persisted well into the first half-year period of 2003 as well. *Money supply* reported a 5.4% rise over the same period[35]. In nominal terms, money supply stepped up by 3.9% or BGN 547.9 million on a year earlier and 19.3% (BGN 2.35 billion) on a 12-month basis. The BGN component of broad money increased by 3.5% or BGN 302.2 million in the period under review. At the same time, the foreign currency component of M3 went some BGN 245.7 million up, running 4.7% higher relative to the end of 2002, with the USD's depreciation hindering its growth, given the large share of USD deposits (about 33% of total deposits). The M3/GDP ratio in end-June amounted to 43.9% vs. 39.9% on a year earlier.

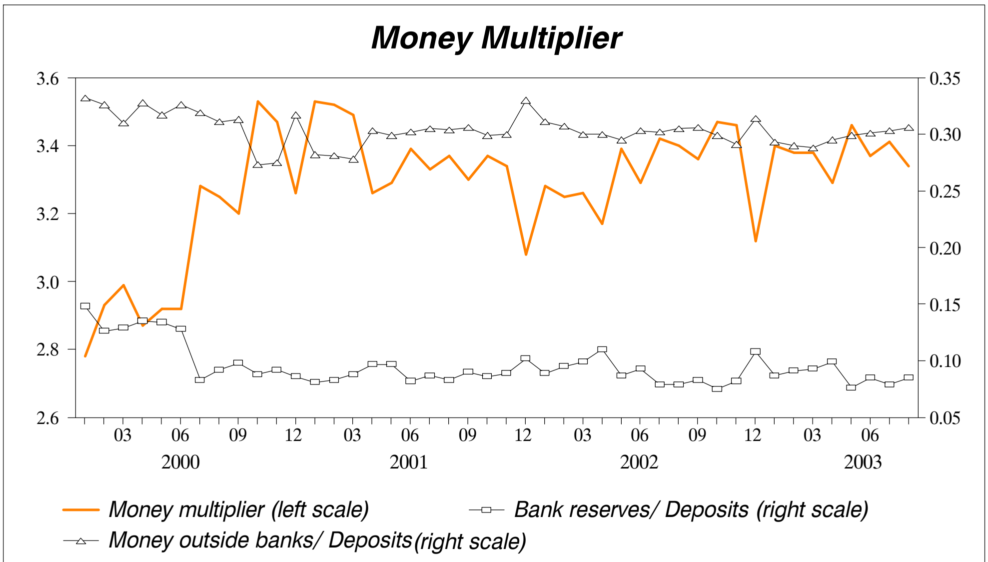
The performance of quasi-money and the most illiquid components of M3 was decisive to money supply dynamics in the six months to July. The effect of the most illiquid components was further heightened by the fact that they now covered all repo transactions[36] as a separate item as well as by the robust growth of blocked deposits. The highly liquid monetary aggregate M1 reported an insignificant rise of a bare 0.7% (BGN 40.7million) due mostly to the seasonal growth slowdown in early 2003. The seasonal pattern of contraction of highly liquid money is usually associated with the lower transaction demand for money as well as the tax payments due. M1's components went on the rise as followed: money outside banks stepped up by 0.6% (BGN 20.7 million), and overnight deposits increased by 0.9% or BGN 20 million. However, on a 12-month basis, highly-liquid money growth remained rather high at 26.8%.

All quasi-money components, i.e. time and savings deposits in BGN and foreign currency deposits went on the increase in the first half-year period of 2003. Quasi-money reported an aggregate rise of 3.4% (BGN 273.6 million). Its foreign currency component stepped up by 3.8% (BGN 194.2 million) whereas its BGN component went up by 2.7% (BGN 79.4 million). Households were again the largest contributor to the deposit money growth registered. As a result, BGN time and savings deposits reported a six-month increase of 13.4% or BGN 126.4 million. Apart from households (BGN 73.2 million), non-financial SOEs also made a significant contribution of BGN 59.6 million to foreign currency deposit growth, evidencing the sustained preferences of both economic agents and households to keep their savings in USD despite the EUR/USD exchange rate volatility, the structure of Bulgaria's foreign trade and progress made on the EU accession negotiations.



[35] *Deflated by the CPI (December'02=100).*
[36] *In compliance with the new methodology of money data reporting in force since 1 July 2003.*

Short-term deposits were again running well above long-term deposits, a trend expected to slowly but steadily turn around with a view to the outstripping relative growth of deposits of longer maturity.



Source: BNB, AEAF

The six-month dynamics of the *monetary base and the money multiplier* produced the opposite effect on money supply the growth of which over the same period was solely due to the multiplier's rise from 3.12 in end-2002 to 3.37 in June. At the same time, reserve money was progressively declining. It is important that the higher money multiplier reflected the effect of the deepening financial intermediation as well as the impact of some seasonal factors[37].

Monetary Base and Money Supply Mechanism

	Over the 31.12.2002 - 30.06.2003 period	Over the 30.06.2002 - 30.06.2003 period
Monetary base change (in BGN million)	-178.7	611.7
Coefficient of money multiplier variation (%)	0.02	0.03
Change in M3 by factor:		
1. due to a change in money multiplier (in BGN million)	1150.4	287.3
2. due to a change in M3	-556.7	2015.4
3. due to a change in money multiplier and monetary base	-45.9	47.6
Change in M3 (in BGN billion) =1+2+3	547.9	2350.3

Source: BNB, AEAF.

5.3. Credit Aggregates

The foreign assets of commercial banks tended to further contract. *Net foreign assets* in the banking system had a negative contribution to broad money growth due mainly to the 21.3% shrinkage of BGN 618.7 million in the net foreign assets of commercial banks[38]. Initially, in 2002 net foreign assets of commercial banks declined as a result of the interplay of a number factors such as the low interbank interest rates and

[37] *The seasonal rise in the demand for money for transaction purposes in December broadens significantly the monetary base and brings about a decrease in the money multiplier in end year while spurring its growth in the months to follow. This is further evidenced by the fact that on a 12-month basis the contribution of the monetary base runs higher than the contribution of the multiplier. At the same time, the growing positive contribution of the money multiplier to money supply growth on an annual basis is a positive development.*

[38] *Over the same period, BNB's net foreign assets stepped up by 8.8% (BGN 613.8 million), and the reasons behind that rise have already been dealt with in point 4.1.*

yield on the international markets. The decrease was later reinforced by the good prospects ensured by the domestic credit market, improved country's business climate, the augmented effect of the harmonized national legislation and shortened term of application as well as the growing predictability of fiscal policies.

Net domestic assets in the banking system reported a BGN 553.1 million worth of a rise (13.6%). Any growth in net domestic assets and hence money supply in the six months to July was hampered by the decreasing net claims on the government. Their decrease was induced by the growing government deposit amounts in the banking system which had to do with the early-year tax payments to the budget. Over the Dec'02 - Jun'03 period, domestic credit stepped up by 6.2% (BGN 473.1 million), with claims on the government sector reporting a drastic contraction of 70.5% (BGN 891.7 million), whereas lending to the non-government sector rose by 21.3% or BGN 1.4 billion. The growth rate of claims on the non-government sector ran higher on a year earlier. Furthermore, the non-government sector loans/GDP ratio went on the rise up to 23.5% in end-June'03 from 16.5% in end- 2002, remaining, however, well below its equilibrium point in the long term[39].

Rising by 28.8% (BGN 760.1 million) in the six months to July, the foreign currency component of non-government credit went on enjoying a fairly large share within total credit growth in both absolute and relative terms vs. a 16.1% increase of BGN 604.8 million of the BGN component, indicating that banks had been managing and effectively distributing foreign exchange risk in regard with the high share of foreign currency deposits within the deposit money total. Household loans stepped up by 32.6% (BGN 404.2 million), outstripping bank lending to the private sector (19.6%, or BGN 922.9 million). At the same time, bank claims on non-financial SOEs reported an increase of just 0.8%. As for loan extensions by repayment term, as of end-June long-term loans ran almost level with total short-term credit in the economy, retaining, however, its higher growth rate. The above trends alongside the high quality credit portfolio of banks (see point 4.4) were indicative of the healthy effect of bank privatisation[40].

5.4. Money and Foreign Exchange Markets

The base interest rate (BIR) stepped down by 0.8% to 2.54% in end-June[41], giving an account mainly of the performance of public finance and failing to be of any good use as a reference price of risk-free loans. On the initiative of the Association of Commercial Banks, since February BNB has started publishing data on the overnight interbank BGN market index SOFIBOR, which is not likely to replace the BIR in the short term as the interest rates in the interbank money market remain very volatile, which in turn makes it inappropriate as a point of departure in money pricing in BGN transactions.

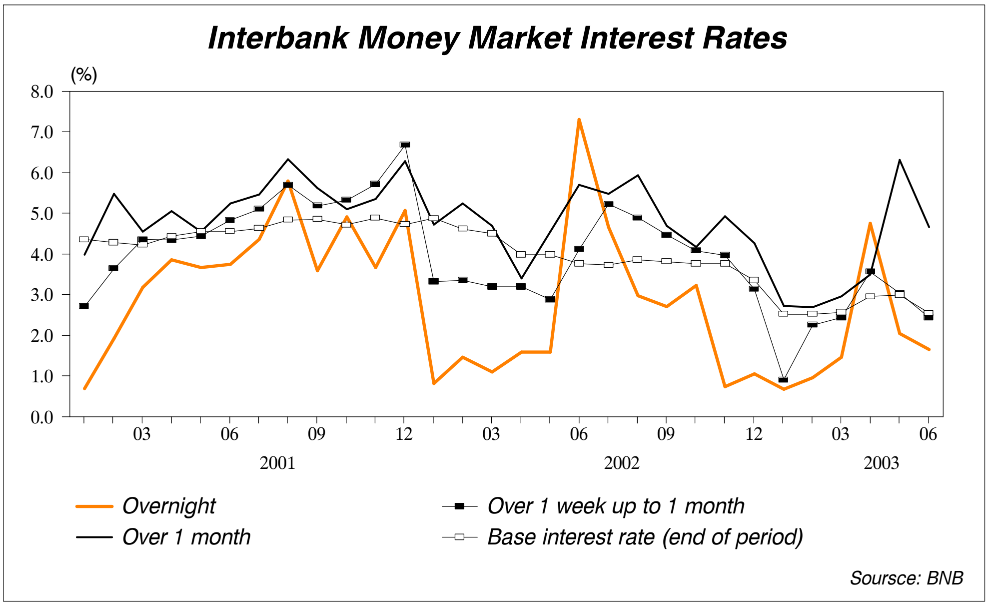
The average weighed interest, giving account of the interbank interest rates dynamics, varied within the broad band of 0.71-4.43%. It hit a record high in April due to some temporary shortfalls of money, having

[39] *Bulgaria is lagging significantly behind the other acceding economies in terms of the lending to the private sector/GDP ratio (see Part Seven).*

[40] *Unlike most commonly spread theories, which propound that there is usually a stagnation of the credit market in the wake of privatization, bank privatization in Bulgaria has been coupled with an ever growing bank credit to the local economy (non-government sector). The likely reasons had to do with the low starting level of lending to the non-financial sector following the market collapse of 1997 as well as with the consistent and well-coordinated government effort (bank regulations and the real sector), employment of experienced local managers in bank strategy implementation and drafting. Furthermore, the trends in the international financial markets underway over the last two years contributed to the credit expansion.*

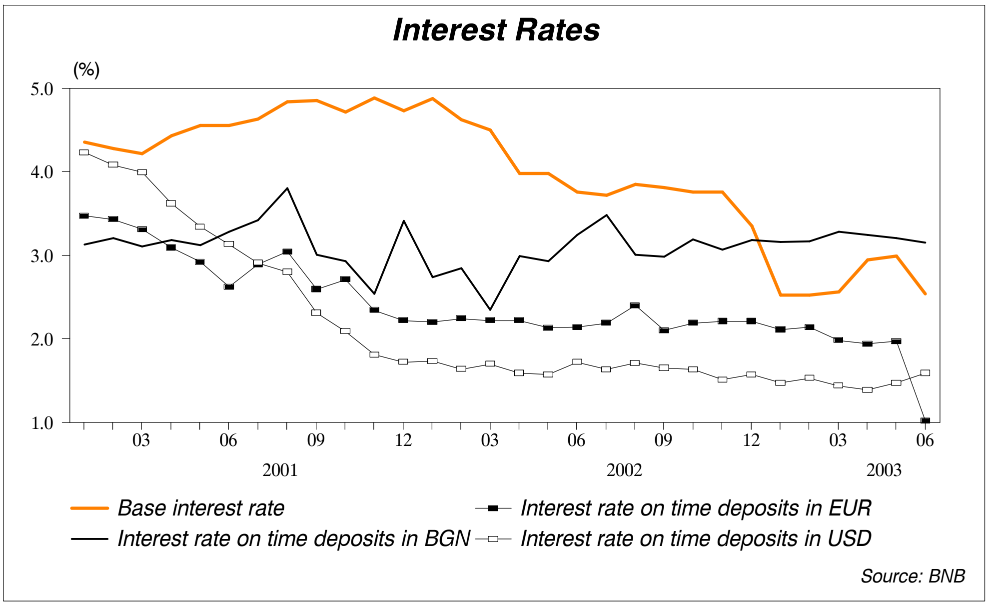
[41] *According to the methodology of the Central Bank, the base interest rate is set on the basis of the yield on 3-month government securities reported at the auctions held by the BNB. Since early-2002 the auctions have been held only once a month.*

to do with the higher than expected by banks tax payment amounts, and went on the decrease ever afterwards down to 1.65% in end-June. In the six months to July, the average daily volumes of interbank placements (BGN) reported a 2.5% year-on-year increase.



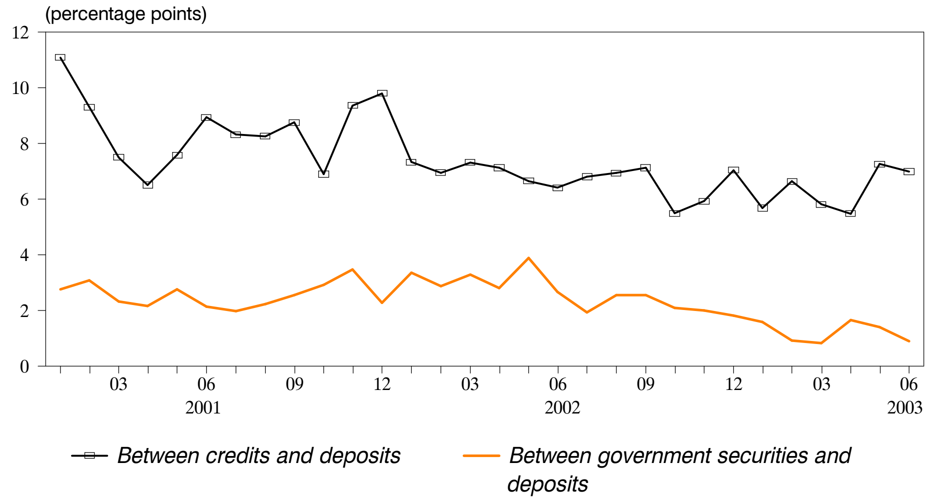
The liquidity crisis in the BGN market of mid-April was one of the gravest following the institution of the currency board arrangement, according to analysts. Probably, the reasons behind it had to do with the poor bank planning of cash flows that coincided with the need to regulate the minimum reserve requirements within the time limits set. As the Central Bank was not prepared to respond adequately, the Ministry of Finance had to hold a special buy-back auction of securities. It was as late as June that the central bank authorities came up with a blockbuster of measures to timely and significantly reduce risk in the event of another liquidity crisis as followed: first, commercial banks were allowed to certify with the BNB their accounts in EUR on the same value date as the working day and sell the BNB EUR against BGN on the same value date; and secondly, RINGS was successfully launched, allowing for all systematically significant payments[42] to be settled in „real time".

The dynamics of bank *deposit interest* followed a different pattern depending on the currency they were denominated in. The average weighted interest on BGN time deposits fluctuated around 3.2-3.3%, rising by 0.2% on a year earlier. At the same time, the interest rates on time deposits in EUR were steadily declining from 2.1% in end-2002 to 1% in



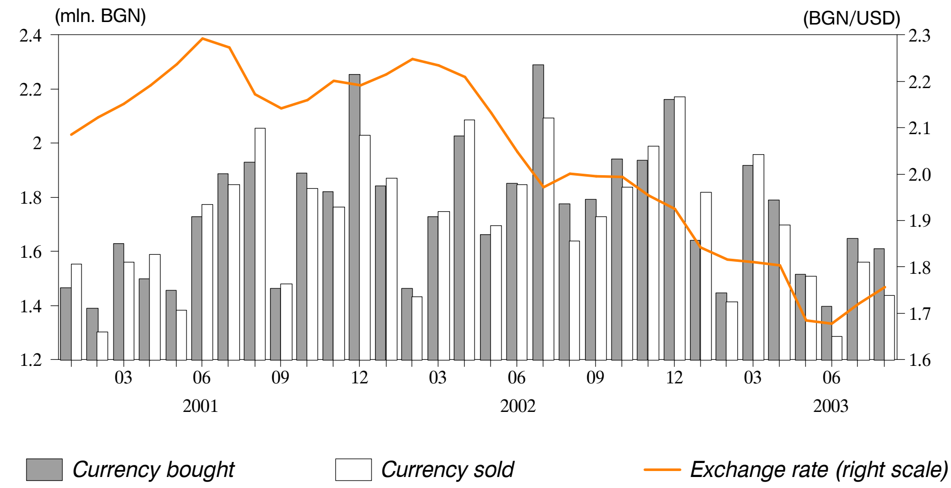
[42] RINGS covers transactions between the commercial banks and the BNB, payments on government securities and transfers equal or higher than BGN 100 thousand as well as settlements of banks' customers. The compatibility of RINGS with the TARGET settlement system of the European Central Banks will make the processing of payments in EUR and other international settlements easier upon accession to the EU.

Interest Rates Spread on the BGN Market



Source: BNB, AEAF

Interbank Forex Market



Source: BNB

end-June while time deposit (USD) interest reported an insignificant decrease, steadying around 1.5%. The low interest on time deposits in foreign currency took account of the low yield rate on the international financial markets.

Credit interest went on decreasing, though at a slower rate than expected. In the six months to July, it stepped down by 0.3% on average relative to the same period of 2002. The interest spread between short-term loans in BGN and time deposits (in BGN) averaged 6.3 percentage points vs. 6.7% in 2002.

Over the same period, the *single European currency* was steadily gaining ground to the *US dollar*. The USD/EUR exchange rate fluctuated within the USD 1.04-1.19 per EUR band. The exchange rate's dynamics was pre-determined by the military action in Iraq in March and April as well as the spate of bad news about the persistent current account deficit and ever growing fiscal deficit in the US economy. However, another cut down in the federal funds rate, though smaller than expected, and the statements of the Secretary of US Treasury in support of the strong USD dollar triggered a turnaround in the US currency's depreciation as late as the end of June when its was traded at 1.14 per EUR. Most analysts expect another decrease in the USD by the end of 2003.

Following closely the dynamics of the single European currency, on a year earlier the BGN appreciated by 18.7% on average to the USD in the six months to July. In end-June, the USD ran 12.7% cheaper on a 12-month basis.

In the first half-year period of 2003, the real effective exchange rate reported a 3.7% year-on-year appreciation to a basket of currencies of Bulgaria's major trading partners, running, however, 0.8% cheaper against the currencies of the EU member states.

On the interbank FX market, banks were a net buyer of foreign currency, with the volumes purchased exceeding the volumes sold by BGN 29.4 million. As for the structure of the home interbank FX market, there occurred no significant changes. In end-June, the share of the US dollar stepped down by 0.7% (25.2%), and the share of the EUR decreased by 0.6% (down 72.2%). The weight of the other foreign currencies rose by a 1.07 percentage point up to 2.6%.

5.5. Banking System

In the first half-year period of 2003, the banking sector performed most dynamically in both a qualitative and quantitative aspect. The quantitative indicator showed an accelerated growth of the balance-sheet value of commercial banks on a year earlier (5.5% vs. 1.4%). In end-June, assets in the banking system amounted to BGN 15.4 billion. The most significant changes in a qualitative aspect had to do with the completion of bank privatization[43], the start of RINGS and the launch of the overnight referent indices of the local interbank BGN market - SOFIBID[44] and SOFIBOR[45].

The strongly competitive environment in the banking sector as a result mostly of the privatization of the large state-owned banks with strategic foreign interest grew into a decisive factor for the sector's performance in 2003. Furthermore, the low interest rates in the international financial markets were crucial for the development of the country's banking system. The relatively low return on the low-risk investment instruments traded in the same markets (mostly deposits and government securities) made Bulgarian banks reduce investment abroad at the expense of the growing lending volumes to the local economy and household consumption.

Though not significant on a year earlier, the 2003 changes in the *structure of bank assets*[46] were mainly triggered by the latter factor. The share of bank loans to non-financial institutions and other customers stepped up as high as 47.5% in end-June. The vigorous rise in their share of over 6 percentage points was mainly due to the contracting share of claims on banks and other financial institutions abroad (by over 5 percentage points in the six months to July). The allocation of the imported funds to non-government sector lending was eased by the stable macroeconomic environment, economic growth, strong competition among banks and the establishment of good bank-customer relationships. A detailed analysis of the changes that occurred in the structure of bank portfolios is given in Appendix 3.

Following the privatization of the large state-owned banks, competition has grown into the factor setting the market patterns of behaviour and performance. Their aspirations to become deposit takers and lenders of high caliber made banks introduce a number of new products and invest in IT. Furthermore, strong bank competition forced them to introduce new corporate and retail banking services (bank service packages at a lower commission rates, overdrafts on card accounts, general life insurance in case of deposits over a certain amount, e-pay services, etc.). The number and quality of bank services offered were steadily ousting the enormous branch network as a key indicator of banks' shares in the retail market. Fierce competition in

[43] *In May the Bulgarian government and the Hungarian OTP bank concluded a sale contract for the DSK Bank. The sale of the second largest bank in Bulgaria is expected to be finalized by the end of September*

[44] *SOFIBID: Sofia interbank bid rate.*

[45] *SOFIBOR: Sofia interbank offered rate.*

[46] *With the adoption of the international accounting standards by commercial banks in early 2003, the format of presentation of the monthly aggregate balance sheets of commercial banks published by BNB has undergone a number of amendments, which make comparison between the 2002 and 2003 monthly balance-sheet data rather difficult. In the second quarter, the Bank Supervision Dept. of the Central Bank reduced the number of group items in the aggregate balance-sheet data of commercial banks from 5 to 3.*

the sector led to a switchover of banks from a predominantly extensive manner of operation (opening new branches, offering a small number of bank services) to an intensive pattern of development (optmising the branch network coupled with an ever rising number of bank products and options for remote banking in real time). What is more, the privatization of the DSK Bank is expected to result in stronger competition among banks and a redistribution of the market shares in certain segments of the sector.

On a year earlier, the dynamics of the *indicators of concentration* in the banking sector in end-June did not give solid grounds for any final conclusions. However, the relatively low levels of these indicators retained implied that bank competition was still running rather high. The concentration ratio and Herfindahl index ran the lowest again as regards lending to non-financial enterprises, slightly going up relative to the end of 2002 due to the higher lending of the second, third and fourth largest banks in terms of the loan extension amounts (UBB, Bulbank, Biochim). At the same time, the DSK Bank went on reporting the largest credit portfolio. The concentration ratio, estimated with regards bank lending to the non-financial institutions, is likely to further rise with a view to the huge credit resources of the abovementioned banks, while concentration as regards total assets and deposits in particular is expected to go on the decrease due to the relatively faster growth in the same balance-sheet items with banks other than the four frontrunners.

Measures of Concentration in the Banking Sector

	XII.1997	XII.1999	XII2000	XII.2001	VI.2002	XII. 2002	VI. 2003
Bank assets							
Herfindahl Index	0.27	0.12	0.11	0.09	0.09	0.08	0.08
Concentration Coefficient (%)	72.3	57	55.2	51.4	50.5	49.9	49.8
Claims on Non-financial Institutions and Other Clients							
Herfindahl Index	0.14	0.08	0.07	0.07	0.07	0.07	0.07
Concentration Coefficient (%)	62.4	43.6	42	41.1	41.6	41.85	44.08
Deposits of Non-financial Institutions and Other Clients							
Herfindahl Index	0.15	0.13	0.13	0.11	0.10	0.10	0.10
Concentration Coefficient (%)	65.8	61.7	62.2	58.2	56.3	55.8	54.57

Source: BNB, AEAF.

The financial conditions of banks remained stable in the first half-year period of 2003 as well. Over the same period, *net profit (commercial banks)* amounted to BGN 218.5 million vs. BGN 132.7 million on a year earlier[47]. Out of a total of 34 banks in operation, it was only one bank that reported a six-month net loss. Relative to the same period last year, the profit indicators in the sector improved significantly in the six months to July. The likely reason behind the above improvement, with respect to the dynamics of bank credit and deposit interest (see Point 4.3), had to do with the higher share of lending to non-financial institutions within total assets, which in turn resulted in the outstripping growth of income from interest vis-a-vis interest payments, and hence a higher net income from interest. The large banks were again bigger profit-makers

[47] *Data comparison between the 2002 and 2003 monthly financial statements (profit and loss account) of banks has been complicated by the new format of data presentation required by the Central Bank in reference to the international accounting standards adopted.*

compared to the smaller banks, and therefore more resistant to the competitive pressures within the system (see Appendix 3). Most smaller banks were and still are facing a growing need for consolidation to counteract the rising sector's competition, as evidenced by the analysis of the structure of operating profit by bank group.

Profitability Indicators of the Banking System*

(% of average assets)	*VI.2001*	*VI.2002*	*VI.2003*
Net profit	3.9	2.1	2.9
Operating profit	4.7	2.6	3.5
Net interest income	4.4	3.9	4.6
Operating expenditures	4.8	4.3	4.4
Foreign currency revaluation	0.2	0.1	0.2

** On an annual basis*

Source: BNB, AEAF.

Bank credit portfolio reported a slight deterioration in the six months to July. The robust growth in bank lending of the last two years has failed to bring about any sharp deterioration in the quality of bank credit portfolio. In end-June 2003, some 91.7% of the risk exposures of banks were classified as standard (vs. 94.47% in December 2002), and another 2.55% as loss (1.82% in the end of 2002).

The capital adequacy of commercial banks ran well above the requirements laid down by BNB Regulation №8. As of end-June'03, the indicator of total capital adequacy of the banking system (branches of foreign banks excluded) amounted to 23.87%, going 1.4% down relative to the end of 2002. At the same time, in the six months to July, the total risk component of commercial banks' assets stepped up by 18.8% (BGN 1299.8 million), and the capital base rose by 12.5% or BGN 216.9 million. The progressive reduction of the unjustifiably high capital adequacy indicators was a reflection of the altered lending policies of commercial banks as well as of the low risk in the economy.

As of end-June'03, *liquidity in the banking system* ran lower than in the end of 2002. The decrease implied that the banking system set back at the liquidity levels, entailed by a typical year-end rise in the liquid assets. In June, commercial banks' primary liquidity amounted to 9.8% (vs. 11.2% in December 2002), and secondary liquidity to 26% (29.25% in December 2002), almost fully matching the data reported on a year earlier.

5.6. Non-banking Financial Institutions and Capital Market Developments

Although the financial system was well dominated by banks, the intermediation of non-banking financial institutions further deepened in the first half-year period of 2003. The ratio of pension funds' assets to GDP and gross national savings stepped up to 1.2% and 9.8% respectively (vs. 0.8% and 5.1% on a year earlier). Insurance penetration in end-June reached 1.99%, reporting a year-on-year rise of 0.30%. The ratio of market capitalization of the stock exchange to GDP increased to 5.2% (vs. 4.1% in end-June'02). Nevertheless, non-banking financial intermediation in Bulgaria remained, with very few exceptions, rather underdeveloped vis-a-vis the other ten EU acceding economies.

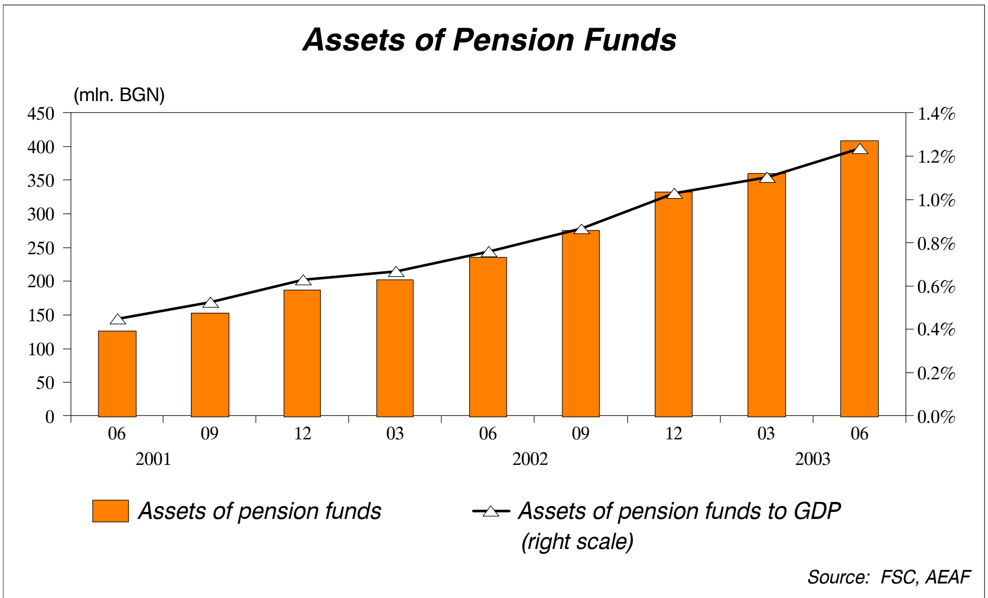
Key Financial System Indicators

% of GDP	2000	2001	2002 H1	2002 H2	2003 H1
Commercial bank assets	36.5%	41.1%	39.9%	45.0%	46.5%
Pension fund assets	0.3%	0.6%	0.8%	1.0%	1.2%
Insurance premiums	1.5%	1.6%	1.7%	1.9%	2.0%
Market capitalisation of the stock exchange	4.8%	3.7%	4.1%	4.3%	5.2%

Source: BNB, Financial Supervisory Commission, BSE-Sofia, AEAF.

In 2003, *pension funds* accumulated huge amounts of extra resources under both the mandatory and voluntary additional insurance schemes. In the first half-year period of 2003, there were operating in the pension insurance market seven companies managing the respective professional, universal and voluntary funds[48]. *Professional funds* took over the pension insurance of some 158.3 thousand people, or 5% up on a year earlier. The funds raised reported a most robust growth of 68.2% up to BGN 119.4 million, relative to the same period last year. The number of people insured with *universal funds* amounted to 1.37 million, and the funds accumulated to BGN 74.6 million (vs. only BGN 10.6 million in end-June'02). *Voluntary pension insurance funds* - now catered for 493.1 thousand insured (or 5.5% up on a year earlier), reporting a 39% rise in their funds up to BGN 214.8 million.

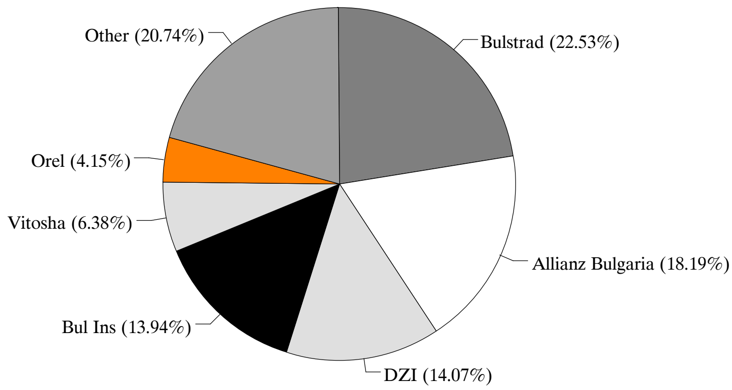
The concentration of assets with all types of funds remained high. The four biggest professional funds were responsible for 92.3% of all assets (86.6% in end-2002), whereas the universal funds managed some 88.6% of the assets total (81.7% in the end of 2002). The four largest voluntary funds also managed about 90% of the total. The first half-year period of 2003 witnessed a certain change in the structure of the pension funds' investment portfolios, but the bulk of resources were again invested in government securities. Furthermore, the share of investment in securities



[48] For the first time since the onset of the transition the number of pension insurance companies has declined due to merger of the Bulgarian Pension Insurance Company to Doverie Pension Insurance Company.

listed in the regulated markets went on the increase as followed: 9.6% (professional funds); 6.4% (universal funds) and 5.9% (voluntary pension insurance funds). The share of voluntary insurance funds' investment in mortgage bonds stepped up (9.7% in end-June from 7.6% on a year earlier) due mainly to the relatively high yield rate on this financial instrument. The growing interest of pension funds in the latter two instruments was spurred by the upswing in the local capital market and its rising importance to the re-allocation of resources in the economy.

Structure of Gross Premium Income in Non-life Insurance (as of 30.06.2003)

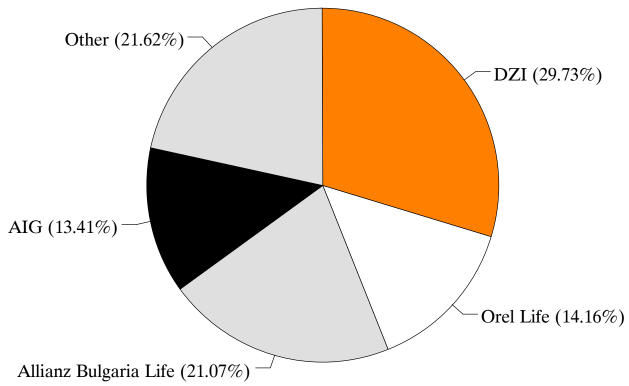


Source: Financial Supervisory Commission

Insurance companies reported a 23.3% year-on-year gross premium income rise in the six months to July. Premium income in the general insurance industry grew by (27.8%) while declining by 6.4% in the life insurance segment down to BGN 29.9 million. Taking into account that the bulk of premium income is realized as a rule in the second half of the year, insurance companies can be expected to post more robust results by the end of 2003.

Concentration in the insurance business over the same period ran rather high, shrinking, however, in the general insurance industry on a year earlier. The four biggest insurance companies managed some 68.7% of the premium income vs. 70.6% in end-June'02, indicating that competition in sector had gone on the increase. The concentration ratio in the life insurance industry stepped up as high as 78.4% (against 71.8% in end-June'02). The Herfindahl index of concentration in both industries reported a pattern of dynamics similar to the dynamics of the coefficient of premium income concentration.

Structure of Gross Premium Income in Life Insurance (as of 30.06.2003)



Source: Financial Supervisory Commission

Insurance Penetration

	1999	2000	2001	2002 H1	2002 H2	2003 H1
Poland	3.01%	2.92%	2.98%	3.27%	3.00%	3.32%
Slovakia	2.84%	3.02%	3.25%	3.97%	3.38%	4.18%
Estonia	1.69%	1.73%	1.83%	1.98%	2.00%	-
Lithuania	1.03%	0.98%	1.01%	1.74%	1.53%	1.73%
Latvia	2.43%	2.17%	1.99%	2.15%	1.99%	2.34%
Bulgaria	1.30%	1.45%	1.61%	1.70%	1.90%	1.99%
Hungary	2.61%	2.92%	2.82%	3.01%	2.91%	3.08%
Czech Rep.	3.29%	3.49%	3.64%	-	3.93%	4.62%

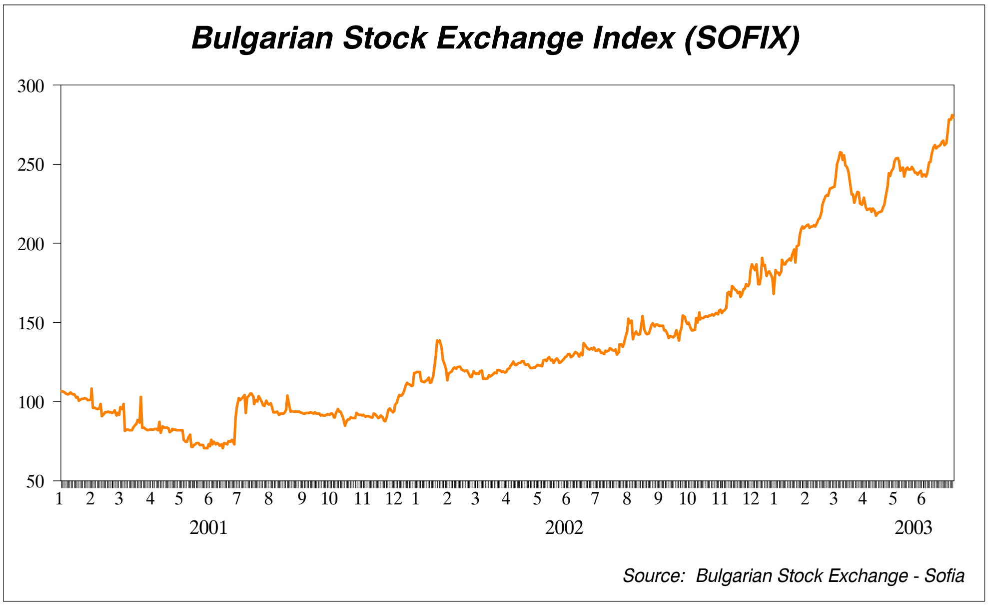
Source: Insurance and Pension Funds Supervisory Commission (Poland); Financial Market Authority (Slovakia); Hungarian Financial Supervisory Authority (Hungary); Estonian Insurance Supervisory Authority (Estonia); State Insurance Supervisory Authority (Lithuania); Financial and Capital Market Commission (Latvia); Association of Hungarian Insurance Companies (Hungary); Czech Insurance Association (Czech Rep.); Financial Supervisory Commission (Bulgaria).

The upswing in the *capital market* persisted well into the first half-year period of 2003. Over the same period, the Bulgarian Stock Exchange turnover volumes reached BGN 395.4 million, reporting a most robust growth of 94.9%. The market capitalization of the companies listed hit BGN 1.7 billion, going 34.1% up on a year earlier.

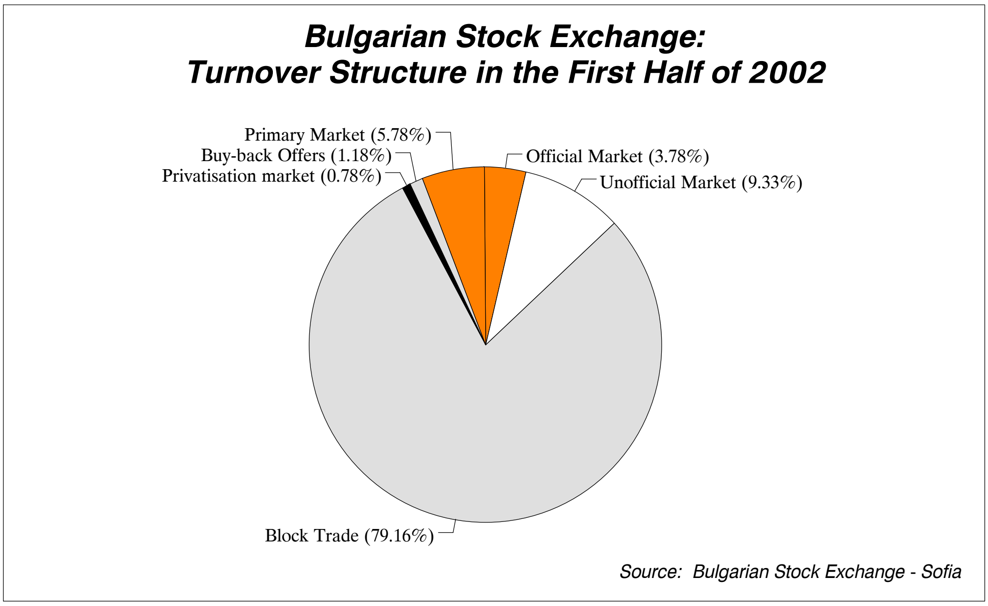
Stock Exchange Market Capitalisation

Market capitalization to GDP (%)	2000	2001	2002 H1	2002 H2	2003 H1
Poland	18.30%	13.80%	-	14.40%	14.40%
Slovakia	17.00%	16.90%	9.50%	9.80%	9.50%
Czech Rep.	22.30%	15.60%	17.20%	21.00%	23.50%
Estonia	34.50%	27.00%	29.70%	33.90%	38.20%
Lithuania	27.30%	22.10%	21.10%	19.90%	23.50%
Latvia	8.00%	9.10%	8.90%	8.10%	9.40%
Bulgaria	4.80%	3.70%	4.10%	4.30%	5.20%
Hungary	28.30%	19.60%	18.20%	18.10%	17.50%
Rumania	1.30%	3.30%	-	6.10%	6.40%

Source: Bratislava Stock Exchange, Prague Stock Exchange, Tallinn Stock Exchange, National Stock Exchange of Lithuania, Budapest Stock Exchange, Bucharest Stock Exchange, Bulgarian Stock Exchange, AEAF.



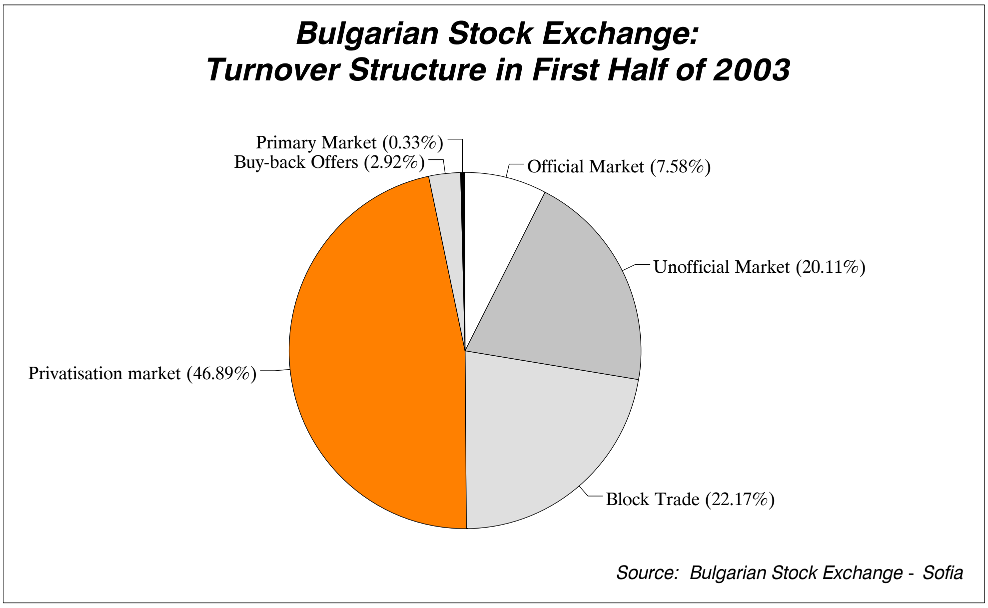
The official stock exchange index, SOFIX, hit a new record high of 279.63 points in end-June, posting a 52.7% six-month rise[49]. The share prices of almost all companies, making up the index, reported a notable increase, with *Sopharma* and *Blagoevgrad BT* in the lead with 83.6% and 50% respectively.



The IPO market registered the largest turnover volumes, stepping up by BGN 183.8 million and accounting for 46.9% of the end-June'03 stock exchange turnover total, as the shares of a number of attractive companies had been put up for privatization against compensatory instruments[50]. Trading in single shares, which over the six months to July had reported a three-fold rise (up BGN 109.5 million) on a year earlier, had a most significant contribution to the above growth. Furthermore, stock exchange and over-the-counter trading in shares and bonds went on the increase by BGN 22.3 million (up to BGN 30 million as of June 2003) and BGN 60.6 million (up to BGN 79.5 million over the same period) respectively.

[49] *According to a decision of March 2003, the number of companies involved in the make up of the stock exchange index was amended as followed: as its financial conditions further deteriorated, Chimko was taken out of SOFIX calculations to be later replaced by Neochim-Dimitrovgrad and Biovet Peshtera due to their rising liquidity.*

[50] *January 2003 witnessed the sale of some 72% of the equity of St Konstantin and Elena, and the privatization of the following companies: Energoremont-Rousse (49% of its share capital); Energoremont-Bobov Dol (25%); Energoremont Holding (49%); TPS Maritsa 3 (49%); and Bulgartabac (12.4%).*



Unlike in the first half-year period of 2002 when the BSE exchange turnover growth was mostly due to parcel trading, the latter's share now declined drastically down to 22.2% vs. 79.2% in end-2002. The enormous contraction in parcel trading in shares (of BGN 116.2 million down to BGN 44.4 million in end-June'03) was partially offset by the rising volumes of trading in compensatory instruments (BGN 42.3 million in end-June'03). ❑

6. STRUCTURAL REFORMS[51]

The pace of privatisation and structural reforms remained slower than anticipated by the government's programme. Over the January to June 2003 period, a mere 0.4% of the assets earmarked for divestiture had been privatised[52], and thus, as of end-June, the total amount of privatized assets in the country reached 81.4%. The overall financial effect from privatisation over the analysed period amounted to BGN 273.3 million. None of the envisaged at least two privatisation deals for enterprises of strategic importance[53] that would have guaranteed the transformation from a government monopoly to a competitive market and ensured the stability of the long-term supply of goods and services in these sectors was finalized in the period under review. As a result of the delay in the passage of the new Energy Act, the announcement of the tender for the privatisation of the electricity distribution companies was postponed.[54] The pace of structural reforms also slackened in some of the sectors financed primarily through budget appropriations, namely healthcare and education. The main reasons behind the slowdown can be found in the ambiguities in the legislative and regulatory frameworks treating the logical schemes for the transition from budget financing to self-financing or financing through personal contributions.

In the first half of 2003, certain reform progress was made in the realisation of some of the investment bonds[55] as well as in the offering of minority parcels of shares at the stock exchange. The process of privatisation and restructuring through the stock market was further speeded up by the passage of appropriate amendments to the legislation in force[56] . According to data from the Privatisation Agency, as of end-May 2003, some 10% of the compensatory instruments in circulation were realised through stock market privatisation.

The practical implementation of the structural reforms in 2003 reconfirmed the conclusions already made by the Agency in its 2002 Annual Report about the key role of political consensus in the processes of divestiture and restructuring of the industries dominated by the state-owned monopoly inherited from the central planning economy. Simultaneously, it is now possible to draw several more important conclusions on the advantages and shortcomings of the applied organisational forms for the administering of the process, on the role of experts and on the balance between statutory rights and responsibilities of the various government stakeholders in the period since the 1990s.

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[51] *See Appendix 4 for a more detailed description of the reform process in some priority sectors in the first half of 2003.*

[52] *Thirty-two parcels of shares and interest in enterprises and 12 detached parts thereof had been sold.*

[53] *It is the so-called „big privatisation". The sale of Bulgartabac Holding was called off in April and subsequently some 12.8% of the company's capital was offered at the stock exchange. The new strategy for the divestiture of the Holding is currently under preparation. The negotiations with one of the preferred buyers (Viva Ventures Holding) of the telecommunication giant BTK are at a deadlock due to the litigation of the privatization procedure itself. In October, the court explicitly prohibited contracting with the other preferred buyer (Koc-Turk Telekom) on the grounds of procedural violations.*

[54] *Delays also occurred in the pace of the privatization procedures of Bulgarian Maritime Navigation, Bulgarian River Navigation, Balkancar Holding, Bulgaria Air, etc.*

[55] *The sale of 12.8% of Bulgartabac's capital at the stock market was completed in early-June 2003 and some 20% of the state's residual interest in DZI were placed on the stock exchange in August.*

[56] *An amendment to the PPPCA was passed on 4 April 2003 according to which the companies that shall be publicly offered for sale at the stock exchange shall be listed ex officio as public companies following a proposition of the Privatisation Agency. The April amendments to the PPPCA extended the term of validity of the issued investment bonds till 30 June 2004 which is the deadline for completion of the mass privatisation process. In April, the Privatisation Agency took a decision on the preparation for sale of some 717 predominantly minority parcels that have to be offered at centralised public auctions. The first one of them was launched in early-July 2003.*

The first principal conclusion is that the universal privatisation bodies (the Privatisation Agency) have turned out to be unable to carry out the divestiture of state monopoly dominated sectors. Analogous to the preceding years, in 2003 the administrative capacity of the PA remained insufficient to perform simultaneously the sale of large monopolies and that of a great number of small and medium-sized enterprises or minority parcels thereof.

Second, the Bulgarian legislative framework again failed to strike an effective balance between the statutory authority and responsibilities of the various government institutions in the process of restructuring and privatisation. Each government since the 1990s has experienced similar problems in its efforts to achieve swift and effective divestiture regardless of the fact that the Council of Ministers itself has always initiated most of the amendments to the legal and regulatory framework of the process. In the course of privatisation of BTK and Bulgartabac one of the underlying theoretical principles[57] for the efficient restructuring of a given economic sector was once again violated, viz. the building and popularisation of the legislative and regulatory framework as a precursor to the structural changes.

Third, the practical execution of the above-mentioned privatisation deals once again demonstrated that the complicated approval procedure of the privatisation decisions for the so-called „big deals" in Bulgaria not only substantially protracts the time required for their finalisation but also provides no guarantee that the political consensus, even if in place, will be realized in practice.

Fourth, with the advancement of negotiations for Bulgaria's accession to the EU each postponement of the so-called „big privatisation deals" magnifies the impact of the factors destabilizing the macroeconomic environment due to both the considerably narrower opportunities of the monopoly companies to find financing sources other than the state budget[58] and the additionally reduced flexibility of public finance in view of the *de facto* participation of Bulgaria in the multilateral surveillance process of economic policies in the EU and the meeting of the undertaken commitments in the negotiation process with regard to industrial policy, competition and state aid rules.

Fifth, the privatisation process in the last two years re-confirmed the absence of qualified enough experts in the natural state monopolies (energy, communications, certain modes of transport, etc.) who are familiar with both the trends in the development of these sectors and the particularities of their adaptation to the global and local macroeconomic environment.

The restructuring of the banking sector and its successful divestiture which came to an end with the sale of the last remaining state-owned bank, viz. DSK Bank[59] can only attest to the correctness of above-drawn conclusions. Based on the analysis made in previous sections of this report, it is safe to say that the restructuring in the segment from a state monopoly to a competitive market has already been completed. The developments in the privatisation and restructuring of the banking sector observed in the last 4-5 years are exemplary of the successful mix of political will and consensus formed after the 1997 crisis, the swift

[57] *The adherence to this principle guarantees that each interested party is entitled to preliminary information on the various phases of the process and thereby acts as a factor behind the creation of predictable business environment and the attraction of sustainable investors' interest.*

[58] *Financing is crucial for the survival of monopoly entities in the transition period towards market liberalization and for their operation in a competitive environment.*

[59] *The contract for the sale of 100% of the bank's capital was signed on 20 April 2003 and the transfer of shares and payment took place in the last quarter of the year. Analysts have already named the deal the most successful in the entire history of bank divestiture in Bulgaria with a contracted price per share of EUR 33.10.*

and flexible modernisation of the legal and regulatory framework in compliance with the recommended international practice and the legislative incorporation of streamlined, clear and coherent divestiture and restructuring schemes and clear-cut mandated statutory authority, responsibilities and time frames between the government stakeholders including the Bank Consolidation Company. The bank reforms evidence also the role of foreign investors for the improvement of corporate management and the development of human resources that are adequate to demand. ❑

7. EU ACCESSION

In the first half-year period of 2003, Bulgaria's accession negotiations with the EU went according to the schedule agreed upon. Over the same period, the country closed another two chapters- Chapter 9 „Transport Policies" and Chapter 22 „Environmental Protection", while finalizing the negotiation rounds on phyto-sanitary issues under the Agriculture chapter. As of June, Bulgaria had provisionally closed 25 chapters out of 30 chapters altogether open for negotiation. The Bulgarian government is strongly determined to fulfil the commitments undertaken and finalise another two chapters Chapter 6 „Competition" and Chapter 24 „Justice and Internal Affairs" by the end of 2003. The attainment of the short-term negotiation goals made the government all the more confident that all negotiation chapters will have been closed in 2004 and Bulgaria will be duly invited to join the European Union in early 2007.

The State Agriculture Fund is the SAPARD paying agency and the key intermediary between local producers and EU grants. SAPARD projects totalled about 530, whereas projects investments amounted to BGN 352 million. As of mid-2003, project investment payments ran at BGN 94.3 million, BGN 47.2 million worth of grants including, accounting for 34% of the subsidy allocations provided for by the 2002 Financing Agreement. End-March saw the conclusion of the new 2002 Annual Financing Agreement, proving for some MEUR 55.6 worth of EC extensions to support agriculture and rural development in Bulgaria. It was since then that the EC agreement, allowing for an extension of the term of implementation of SAPARD for 2000, 2001, 2002 and 2003, has been effectively in force. One of the main reasons for the European Commission to amend the terms of utilization of EU grants was that most applicant countries had not been accredited to implement all measures under SAPARD, making it possible grants payments under the 2000 Annual Financing Agreement to be made by 31 December 2004. Furthermore, the 2001 and 2002 annual agreements have been extended by another two years (until 31 December 2005 and 31.12.2006 respectively). Extended by a year, the 2003 agreement will remain in effect by 31 December 2006.

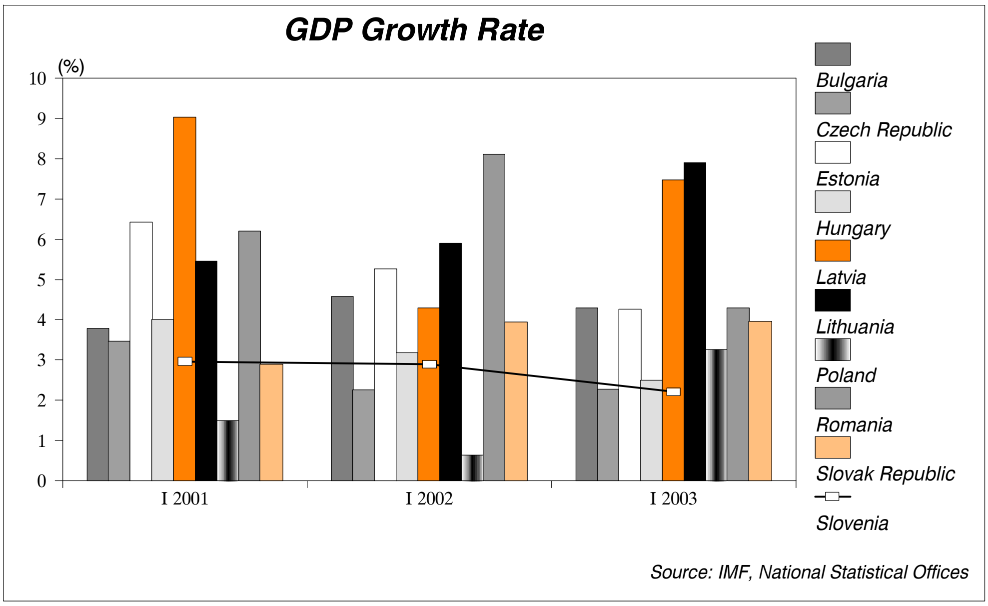
Over the period under review, the EU enlargement process in the 10 acceding countries was further carried on in the form of national referenda ending up in a positive vote for their accession to the Union. All this led to the Act of Accession of the ten acceding countries of 16 April 2003 in Athens that is to come into force on 1 May 2004. Croatia's application (of 21 February 2003) for the commencement of EU accession negotiations made the EC address the issue of a new enlargement wave that is to encompass the Western Balkan countries[60] as potential applicants

In the first half-year period of 2003, the acceding and applicant countries carried on reporting higher growth than the EU member states. However, economic growth in some of them slowed down on a year earlier, with this trend being most pronounced in Roumania where GDP contracted by some 3.8 percentage points down to 4.3%. At the same time, Bulgaria's GDP ran slightly higher than the 12 countries' average,

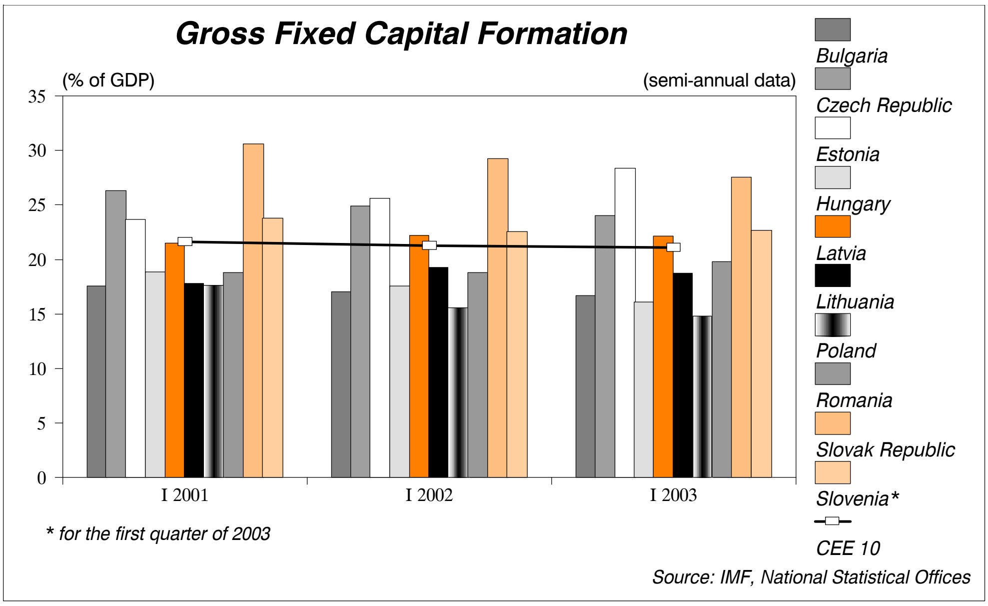
[60] *Albania, Croatia, Serbia and Monte Negro, Macedonia and Bosnia and Herzegovina.*

surpassing Slovenia (2.2%), the Czech Republic (2.3%), Poland (3.3%) and Slovakia (3.9%) and remaining close to growth in Estonia and Roumania but lagging well behind Lithuania (7.8%) and Latvia (7.5%).

As by final expenditure, the structure of Bulgaria's GDP was again relatively unfavourable vis-a-vis the other acceding and applicant countries. The share of final consumption within GDP ran again the highest (91.5%) well above the ten countries' average of about 80%. At the same time, the weight of gross fixed capital formation declined by 0.4% down to 16.7%. However, a certain decrease was also registered by Slovakia (by about 2 percentage points down to 27.5%), and Poland and the Czech Republic (by some 0.8% down to 14.8 and 24% respectively). The different indicator's performance, however, may restrict the country in sustaining high and stable growth in a longer-term perspective.

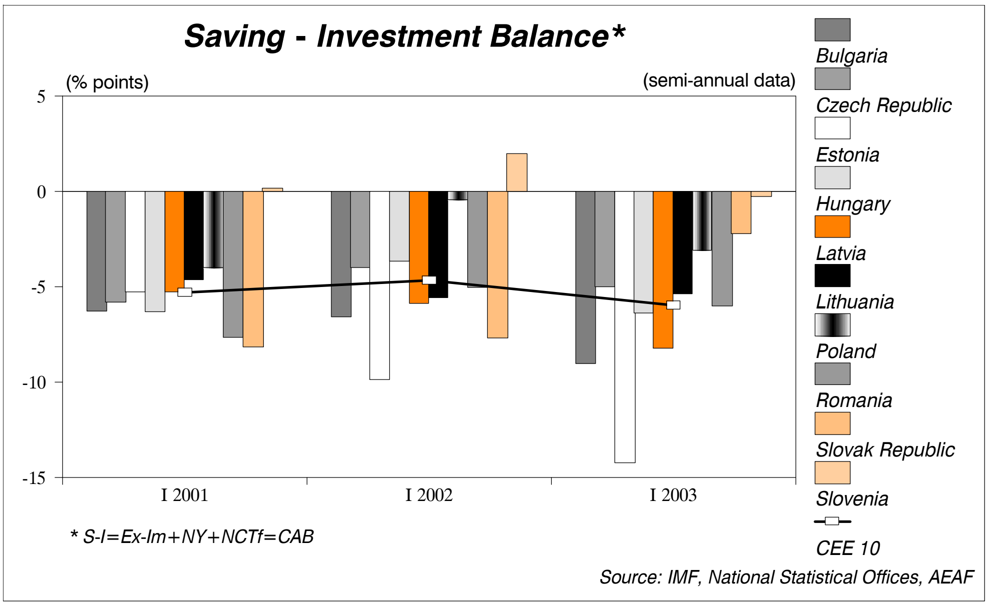


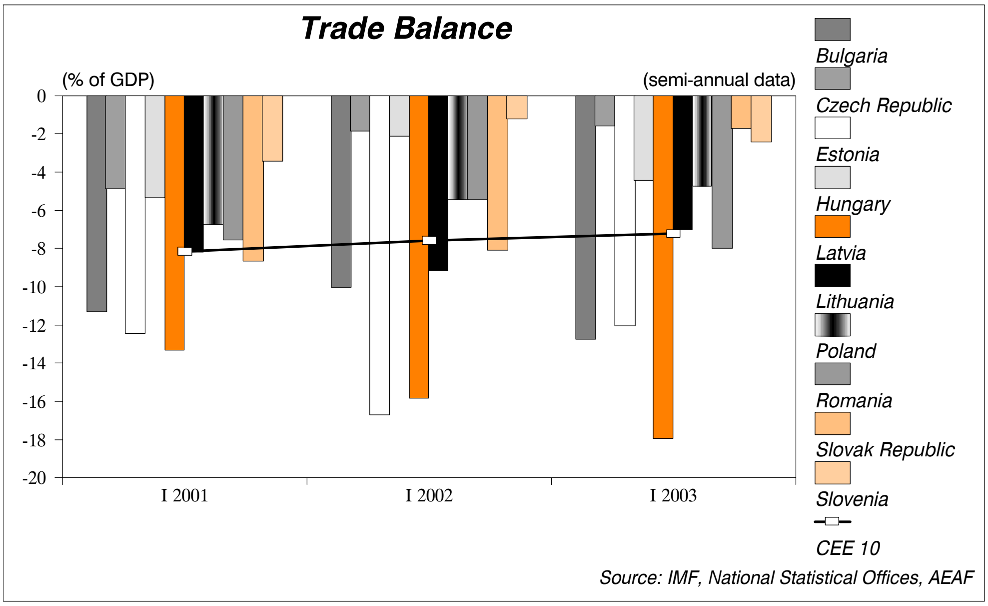
A major restraint on fixed capital formation growth in most applicant and acceding economies derived from the low rate of domestic savings and still weak financial intermediation that may have otherwise rechannelled funds to remunerative investment projects. In all of the above countries, the gross savings/gross capital formation ratio[61] ran negative on average, tending to further worsen. What is more, in all of them gross savings were steadily going on the decrease.



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

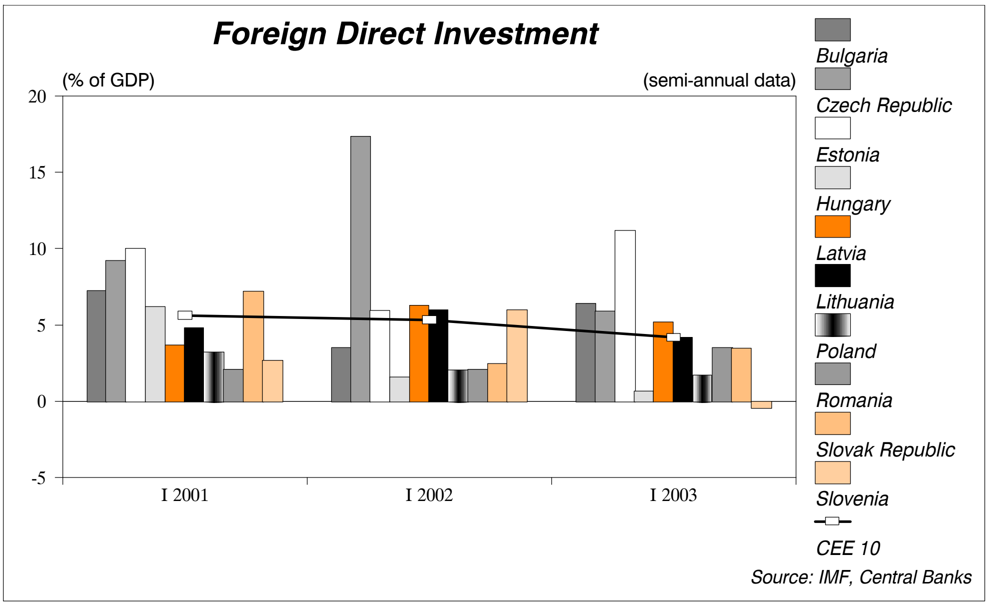
In the first half-year period of 2003 again, the balance of payments current account deficit turned out to be a most pressing problem almost all acceding and applicant countries had to deal with. What is more, the indicator deteriorated most dramatically on a year earlier. The largest current account deficit was reported by Estonia (16.5% of GDP, worsening by 4.5 percentage points), followed by Bulgaria (12.4% of GDP, or a 6.2 percentage point deterioration). Having reported a current account surplus of 1.4% of GDP in the first half-year period of 2002, Slovenia now ran a deficit of 0.3%, remaining, however, best placed in terms of the indicator's performance vis-a-vis the other acceding economies. At the same time, Slovakia reported a 6.6 percentage point improvement (1.3% of GDP). The trade balance, which in half of the above countries had deteriorated significantly, proved to be the key source of current account deficits. The trade deficit ran persistently the largest in Latvia, now worsening down to -17.9% on a year earlier, but the lowest in the Czech Republic (-1.5%), Slovakia (-1.7%), Slovenia (-2.3%) and Hungary (-4.4%).



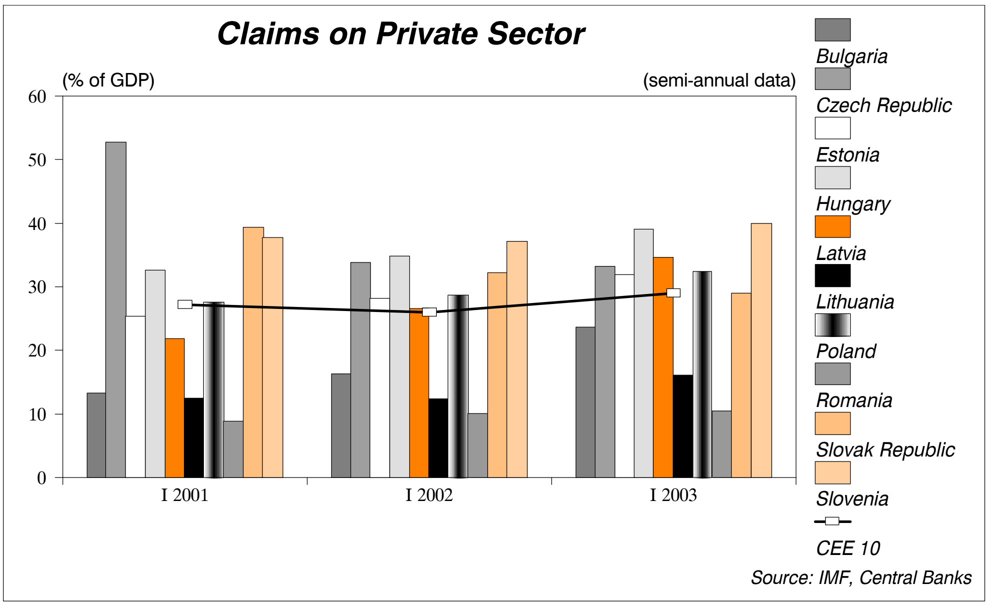


As percentage of GDP, FDI ran the highest in Estonia (11.2%), Bulgaria (6.4%) and the Czech Republic (5.9%). However, in most countries the above ratio reported a year-on-year decrease due mainly to the shrinking FDI inflows as a result of privatization. Nevertheless, the EU accession prospects and solid macroeconomic stability in these countries are expected to improve significantly business confidence and hence revive investor's interest in them.

Financial intermediation in the acceding and applicant economies deepened further in the first half-year period of 2003. Bank lending to the private sector[62] reported a most notable rise in Latvia (by 8.1 percentage points up to 34.6%) and Bulgaria (7.3 percentage points up to 23.6%). Despite the improved efficiency of the financial system, Bulgaria was again far behind the other countries, outstripping only Lithuania (16.1%) and Roumania (10.4%). The indicator stepped down in the Czech Republic and Slovakia alone, but had nonetheless ranked the countries among the first three acceding economies, reporting one of the highest ratios of 33.2% and 29% respectively. Although growing at a relatively slow rate of only 2.8 percentage points, the indicator hit a record high of 39.9% in Slovenia vis-a-vis the other acceding countries.

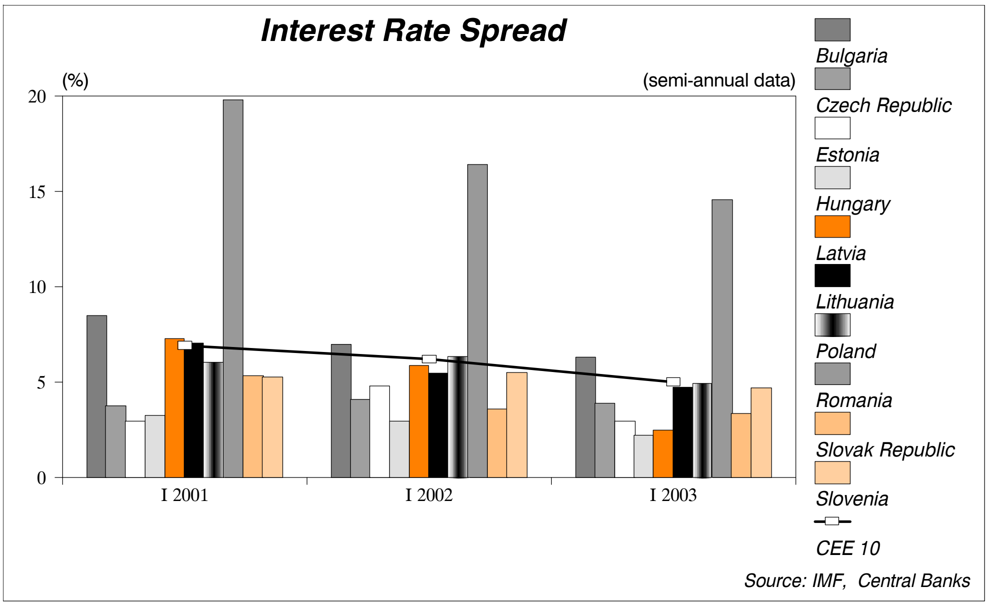


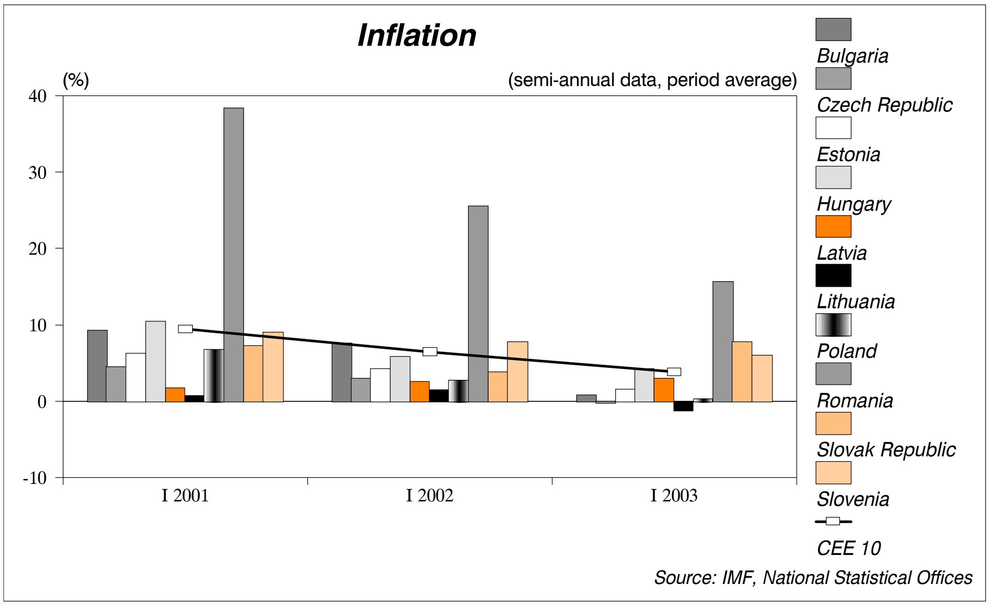
The interest rate spread in the CEECs went on decreasing, following suit the interest cuts in the markets worldwide. It reported a most significant decrease of some 3.4 percentage points (down to 2.5%) in Latvia where it ran one of the lowest to be outperformed only by the indicator in Hungary (2.2%). In Bulgaria, however, the interest rate spread (6.3%) ran well above the ten countries' average, but its steady decline indicated that financial and credit risk in the local economy was diminishing.



[62] *As percentage of GDP.*

Inflation in all acceding and applicant countries but Slovakia reported a year-on-year decline, turning into deflation in Lithuania (-1.2%) and the Czech Republic (-0.2%). Over the same period, the inflation rate in Bulgaria amounted to 0.8%, ranking the country immediately after Poland (0.3%), while running persistently higher in Roumania (15.7%, a 9.9 percentage point decrease on a year earlier), Slovakia (7.8%) and Slovenia (6%).





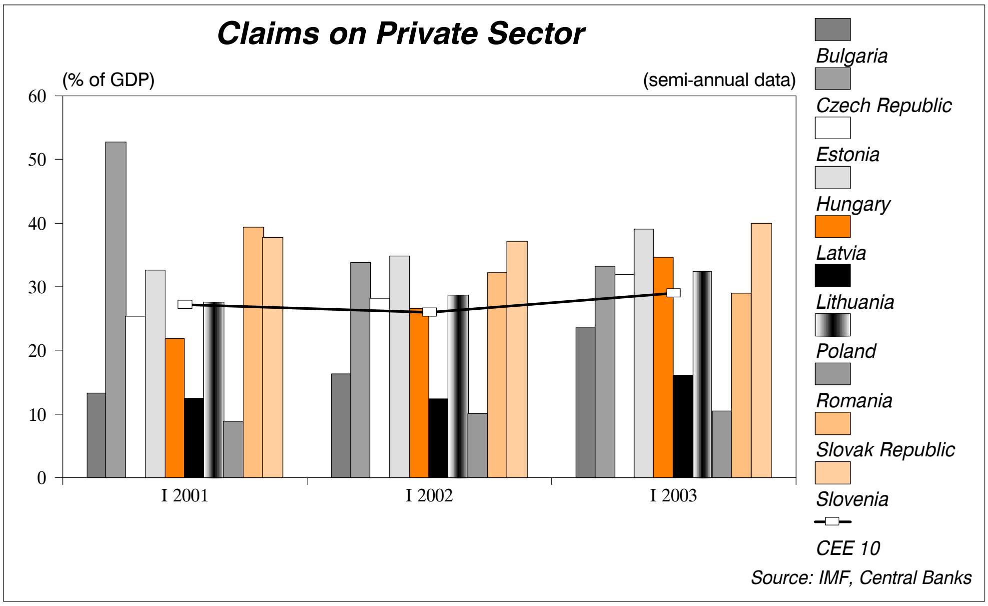
Not all countries managed to curb their general government deficit,[63] and as of end-June'03 Bulgaria was the only economy that had run a cash surplus (1.8%)[64]. At the same time, the cash deficit went on a steady rise in the Czech Republic, Estonia, Latvia, Lithuania and Slovakia, reporting a most drastic deterioration in the Czech Republic (by 2.2 percentage points down to -2.2% of GDP) and remaining low at about -0.04% in Latvia and Lithuania.

The performance of the short-term debt indicators of the acceding and applicant countries is vitally important as it takes into account the trends of economic development underway as well as the country-specific risk. According to UBS Warburg data of April 2003, the short-term debt indicators ran the lowest in Bulgaria (USD 1.4 billion), Roumania (USD 1.5 billion) and Lithuania (USD 1.7 billion). However, though improving the gross foreign debt/GDP ratio indicated that Bulgaria was again among the most heavily indebted economies to be outranked only by Slovakia, the Czech Republic and Roumania, which is why the credit standing of the Czech Republic

[63] As percentage of GDP. The indicators' estimates for 2002, 2002 and 2003 are based on the actual 2001 and 2002 GDP reported and 2003 GDP forecasts.

[64] The cash surplus reported was not related to any seasonal factors, as it had stepped up by a solid percentage point of GDP on a year earlier.

remained one of the highest vis-a-vis the seven first-wave EU acceding countries. Over the last few years, Bulgaria has been consistently improving its external position in terms of the credit rating scales, but lagging still well behind the performance of the Czech and Hungarian economies. Nevertheless, the international financial institution reevaluated the country's credit rating and in May 2003 Standard & Poor's raised Bulgaria's credit standing from BB to BB+/ stable outlook. Other international credit rating agencies like Moody's and JCRA also upgraded the country's credit rating, reassessing it as stable.[65]



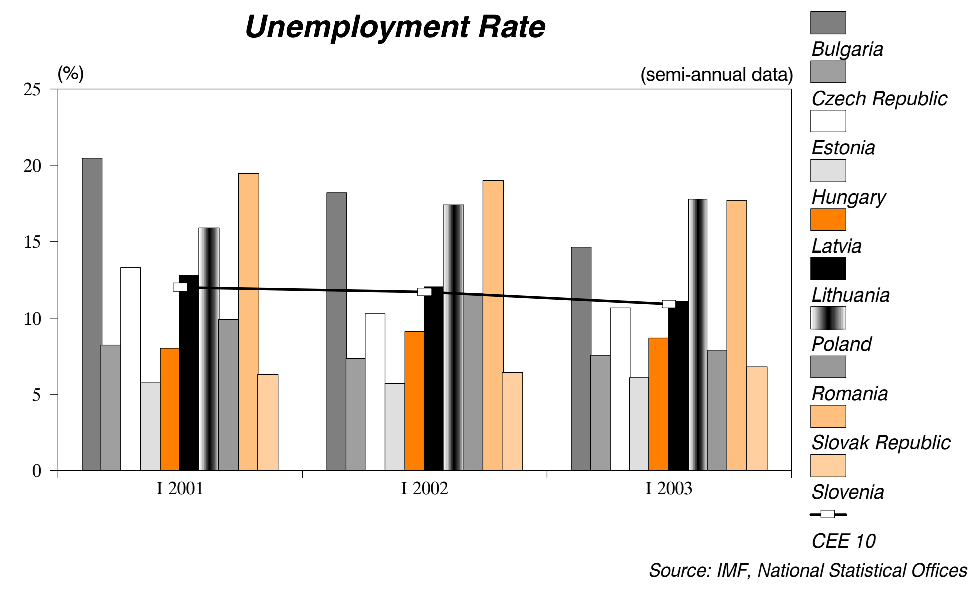
Credit Rating of Applicant Countries

	Moody's		S&P		Fitch IBCA		Short-term external debt, USD billion		Total external debt % of GDP	
	End-2002	April 2003	End-2002	April 2003	End-2002	April 2003	2001	2002	2001	2002
Bulgaria	B1	B1	BB	BB	BB	BB	1.2	1.4	78.3	73.4
Czech Rep.	A1	A1	A-	A-	BBB+	BBB+	9	10.3	38.3	36.7
Hungary	A1	A1	A-	A-	A-	A-	5.5	5.9	63.3	59.4
Lithuania	Baa1	Baa1	BBB	BBB+	BBB-	BBB	1.6	1.7	44.2	41.9
Poland	A2	A2	BBB+	BBB+	BBB+	BBB+	10.6	11.1	40.2	42.8
Rumania	B2	B1	B+	BB-	BB-	BB-	1.2	1.5	29.1	28
Slovakia	A3	A3	BBB-	BBB	BBB-	BBB	3.1	3.5	55.1	12.1

Source: UBS Warburg, EMEA Economic Forecasts - December 2002/January 2003, Ma.

In the first half-year period of 2003, the unemployment rate in the acceding and applicant countries amounted to about 10.9%, or well above the Euro area's average of 8.8%, running the highest in Poland and Slovakia (around 17.7%) and Bulgaria (14.7%) but much lower in Hungary (6.1%), Slovenia (6.8%), the Czech Republic (7.6%), Roumania (7.9%) and Latvia (8.7%). Rampant unemployment in some of the above countries was mainly due to the structural reforms underway, low labour force mobility and incompatibility of the

[65] Source: MoF.



qualification structure of workforce with the requirements of modern market economy.

Business cooperation among the acceding and applicant countries of Central and Eastern Europe further deepened, with capital penetration among the 12 countries growing into a key factor, allowing for the transfer of managerial and technological know-how, which is said to have been one of the major weaknesses of the Bulgarian private companies. Ever since 1990, there have been established some 194 local companies with foreign interest of the CEECs[66], with the Czech Republic (38.7%) in the lead, followed by Hungary (26.3%) and Poland (10.3%). As of today, however, there are no data available as to any Bulgarian interest in foreign companies in the above countries.

Bulgarian Firms Holding Shares in Companies from Central and Eastern Europe

	Till 2001 г.		*In 2001*		*In 2002*		*In 2003 (until August)*		*As of August 2003*	
Country	***Number of firms***	***(%)***	***No***	***(%)***	***бр.***	***(%)***	***бр.***	***(%)***	***бр.***	***(%)***
Czech Rep.	*67*	*40.9%*	*6*	*35.3%*	*6*	*31.6%*	*2*	*18.2%*	*75*	*38.7%*
Estonia	*1*	*0.6%*	*0*	*0.0%*	*0*	*0.0%*	*0*	*0.0%*	*1*	*0.5%*
Hungary	*42*	*25.6%*	*4*	*23.5%*	*4*	*21.1%*	*5*	*45.5%*	*51*	*26.3%*
Latvia	*5*	*3.0%*	*1*	*5.9%*	*0*	*0.0%*	*0*	*0.0%*	*5*	*2.6%*
Lithuania	*0*	*0.0%*	*0*	*0.0%*	*1*	*5.3%*	*0*	*0.0%*	*1*	*0.5%*
Poland	*15*	*9.1%*	*1*	*5.9%*	*4*	*21.1%*	*1*	*9.1%*	*20*	*10.3%*
Rumania	*12*	*7.3%*	*3*	*17.6%*	*4*	*21.1%*	*3*	*27.3%*	*19*	*9.8%*
Slovakia	*17*	*10.4%*	*2*	*11.8%*	*0*	*0.0%*	*0*	*0.0%*	*17*	*8.8%*
Slovenia	*5*	*3.0%*	*0*	*0.0%*	*0*	*0.0%*	*0*	*0.0%*	*5*	*2.6%*
Total	*164*	*100.0%*	*17*	*100.0%*	*19*	*100.0%*	*11*	*100.0%*	*194*	*100.0%*

Source: Bulstat, NSI.

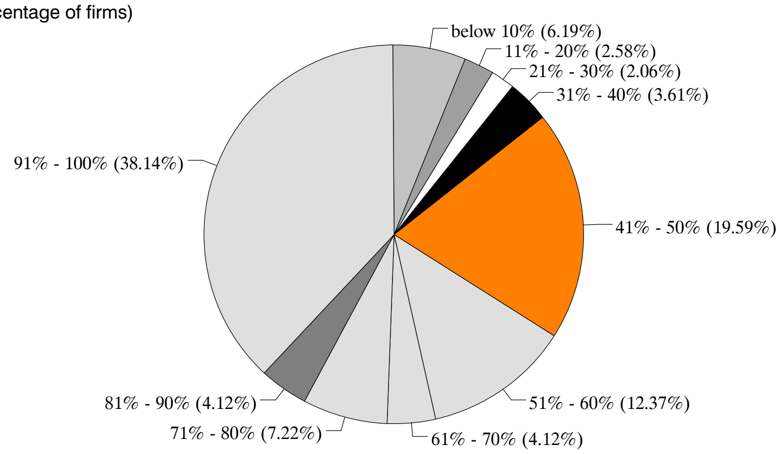
[66] *According to BULSTAT and NSI data.*

CEEC companies entered the local market in a number of areas, with the highest concentration being reported in trade (44.3% of the companies from CEE), and by companies involved in the wholesale trade and service sectors (33.5%). At the same time, CEE manufacturing and constructions firms operating in the local market amounted to only 17% and 5.2% respectively. Most foreign investors tended to turn to business activities of comparatively faster capital turnover and relatively lower investment amounts in fixed capital formation.

In about two-third of the cases (64.9%) foreign investors owe over 51% of the local company's equity, with over one-third of them (38.1%) being practically the sole owner of the company. All this shows that the vast majority of foreign investors have long-term interest in the local economy, gearing up to expand their operations with the country's accession to the EU and full integration into the internal market. ❑

Foreign Investor Share in the Capital of the Bulgarian Firms

(percentage of firms)



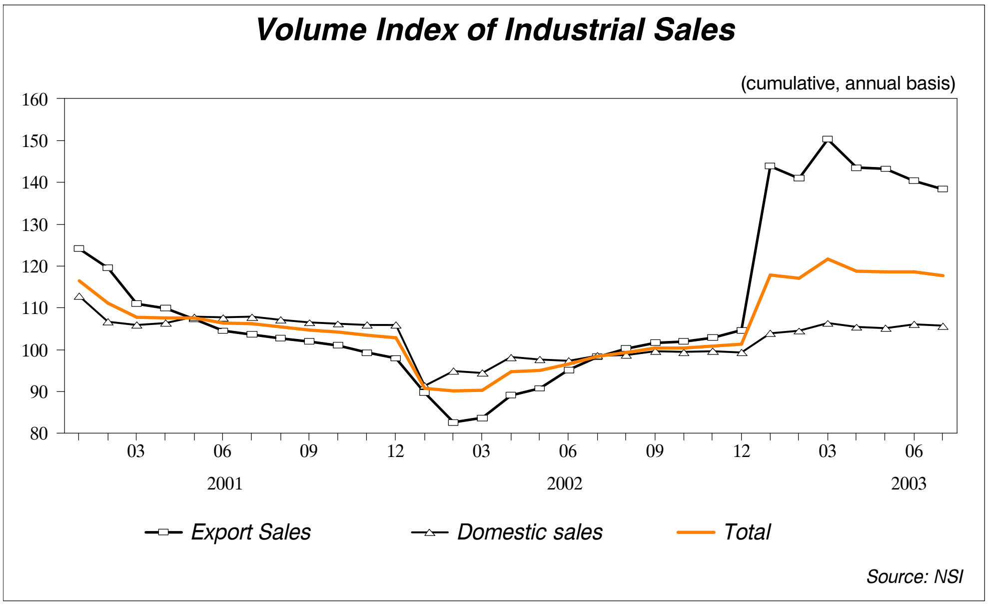
Source: Bulstat, National Statistical Institute

APPENDIX 1: **DYNAMICS OF GDP COMPONENTS**

Supply Side

On the supply side, the Bulgarian manufacturing industries reported a six-month record high growth of 6.7% while the usually most robustly performing sector of the economy, i.e. services registered a rise of only 3.6%. The engine of growth behind the above development was associated with the export-oriented industries. - Exports sales stepped up as high as 40.4%[1] , whereas domestic sales reported a rise of just 6.1%. The high levels of sales indicated that the Bulgarian economy was flexible enough and able to adjust to the competitive markets of industrial goods.

The processing industries made a key contribution to the above growth due both to their large relative share in the sector of over 60% and high growth rate (10.9%). Following a four-year decline, the extraction and mining industries now reported a 2.3% increase in GVA, making, however, any final analysis as to the long-term recovery of the sector rather hasty, as labour efficiency there had deteriorated for another year in a row. Gross output in the production and supply of electricity, gas and water decreased by 15.5% in the second quarter due to the ceased electricity exports to Turkey, which in turn led to a six-month GVA shrinkage of 2.3%, despite the improving sector's efficiency.



The data on the real growth of both gross output and valued added in the manufacturing sector were further evidenced by the findings of the NSI monthly surveys. In the six months to July, industrial output stepped up by 15% on a year earlier, with the capacity utilization rate now hitting a record high of about 62% ever since the start of the reforms. Unfortunately, there is no correlation between the indicators in the manufacturing sector and national accounts data, which in turn makes the use of the monthly survey findings an unreliable tool of any precise and more accurate quantification of the growth developments in the economy.

[1] *On an annual basis in the first half-year period of 2003.*

Indices and Shares of the Manufacturing Industries over the Jan-Jul 2003 Period by Contribution to Total Industrial Sales

	Relative share	2003 Index Performance (2002=100)	
		Total	Export
Industry - total	*100.00*	*118.6*	*140.4*
Metal production and casting	*8.68*	*141.1*	*144.7*
Food, beverages	*14.13*	*117.4*	*132.4*
Clothing, leatherwear incl.; fur processing	*5.64*	*127.8*	*156.1*
Machinery, equipment and household appliances	*5.80*	*119.3*	*146.1*
Textiles and products thereof, clothing excluded	*2.81*	*139.1*	*164.1*
Production of wood, paper and cardboard	*1.36*	*169.7*	*298.4*
Chemicals	*7.17*	*112.2*	*124.2*
Tobacco products	*2.39*	*130.9*	*173.3*
Manufacture of products of other non-metal mineral raw material	*3.67*	*117.3*	*134.5*
Furniture; manufacture of products, n.e.c.	*1.46*	*141.9*	*148.3*
Radio, TV and telecommunication equipment	*1.38*	*141.6*	*122.0*
Rubber products and plastics	*1.79*	*131.9*	*176.5*
Timber and products thereof, furniture excluded	*1.33*	*139.2*	*156.9*
Electrical machinery and equipment, n.e.c	*1.79*	*125.1*	*149.8*
Production and distribution of electricity, gaseous fuels and thermal energy	*15.82*	*102.7*	*62.4*
Vehicles, car excluded	*0.80*	*128.4*	*131.0*
Production of non-metal raw material	*0.81*	*121.3*	*128.6*
Metal products, machinery and equipment excluded	*2.07*	*106.2*	*124.0*
Leather, travel goods and footwear	*0.95*	*110.3*	*130.2*
Medical, precision and optical apparatuses and instruments; manufacture of watches and clocks	*0.33*	*121.1*	*148.3*
Metal ores mining	*1.69*	*102.9*	*85.9*
Cars, trailers and semi-trailers	*0.23*	*117.3*	*152.1*
Coal and peat mining	*1.63*	*99.4*	*-*
Water collection, treatment and distribution	*1.61*	*95.2*	*-*
Office and computing equipment	*0.23*	*62.7*	*58.4*
Publishing and printing, audio and TV records, CD writes, etc	*1.60*	*93.5*	*23.3*

Source: NSI, AEAF.

The aggregate business climate indicator[2] reported an 8-month rise on an annual basis, largely triggered by the improved performance of the composite indicator in the manufacturing sector. Most entrepreneurs in the sector tended to assess the current business situation as steadily improving and were more optimistic as to the business environment in the following six months, pointing at the same time to „less serious“ difficulties having with to do with the weak foreign and domestic demand relative to the same period of 2002. Furthermore, the number of managers facing financial hardships declined, which was in turn associated with the higher number of orders as well as the eased access to bank credit as a result of the stiffer competition in the financial system. At the same time, the local industries came under the strong pressure of competitive

[2] *Vzemete go ot obzorite. Tova e opredelenie ha pokazatelja „business klimat“.*

imports. The higher degree of „openness“ of the economy[3] has inevitably resulted in the worsening competitive position of the Bulgarian manufacturing industries in the local market. On the other hand, competitive imports also proved to be a strong incentive for the improvement of efficiency, introduction of resource-saving and environmentally-friendly technologies and innovations, and hence for the enhancement of the comparative advantages of local industries in the medium and long term.

On a year earlier, the current business situation indicator took a turn for the better, according to entrepreneurs in the construction sector. The trend was further reinforced by the 4.1% year-on-year increase in the sector’s gross output in the six months to July’03 vs. only 3% throughout January to June 2002 relative to the same period of 2001. However, declining orders prompted a certain amount of pessimism in managers’ assessments of the business situation in the immediate future, giving rise to some downbeat expectations as to an employment reduction and higher producer prices in the sector.

Gross Value Added in the Service Sector*

	H1 1998	H1 1999	H1 2000	H1 2001	H1 2002	H1 2003
Transport	90.72	92.25	94.34	98.14	102.30	105.95
Communications	127.10	167.46	203.11	264.06	315.81	351.69
Trade	97.90	103.77	117.24	129.63	134.61	140.07
Finance	104.74	102.66	111.52	126.21	131.05	151.02
Other	101.40	104.72	110.42	111.18	115.57	116.56
Services - total	100.80	105.41	113.13	119.22	125.84	130.35

* cumulative volume indexes, first half of 1997=100

Source: NSI, AEAF

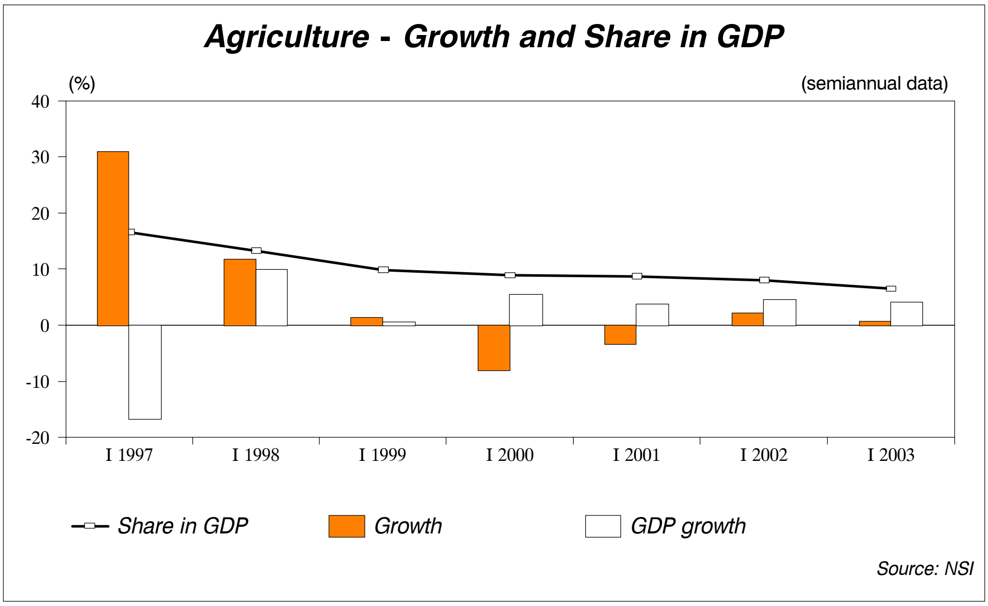
As a result of its large relative share, the service sector reported the most robust contribution to GDP growth, despite its slower growth rate vis-a-vis the manufacturing sector. Compared to the other two sectors, efficiency in the service sector tended to worsen at a slower pace. The first half-year period of 2003 witnessed a certain slowdown in the GVA growth rate (3.6%), but services have nevertheless sustained their post-1998 advance due mainly to the vigorous performance of the communications and finance, credit and insurance industries.

Following the 2002 growth, agriculture and forestry reported a 0.7% decrease in the first half-year period of 2003. As a result, the contribution of the agricultural sector to GVA in the economy carried on contracting. The share of the sector within the GVA and GDP totals ran at 7.5% and 6.5% respectively, indicating a decline of about 1.5% due mainly to the incomplete reform endeavour.

Agricultural business activity in early 2003 declined mostly as a result of the crop production contraction[4]. The 11 million of decares now under wheat remained 18.8% down on a year earlier. Furthermore, due to the unfavourable weather conditions the actual areas under crops may prove to run even lower. The poorer wheat yields in Bulgaria and harvest worldwide led to an enormous rise in wheat prices locally and internationally.

[3] *In the six months to July’03, imports and exports (goods and non-factor services) amounted to 67% and 55% of GDP vs. 61% and 53% on a year earlier.*

[4] *According to 2002 autumn estimates as to the intentions of the agricultural producers published by the Agri-statistics Department of the Agriculture Ministry.*



According to Ministry of Agriculture estimates[5], the country's wheat yields and output are expected to average some 303 kg per decare and 3 350 thousand tons respectively, able to meet local demand.

The upward trends underway in livestock production made up only partially for the poor performance of crop production. Total animal numbers went on the increase, but animal holdings reported a 9.5% year-on-year decrease in May[6]. The dairy industry reported a 14% growth, indicating the start of the consolidation process in many holdings that would ultimately lead to improved efficiency.

Government support to agriculture was again mainly carried out via the State Agriculture Fund. 2003 budget allocations in support of the SAF investment programmes amounted to BGN 70 million, with another BGN 100 million worth of co-financing contributions in the form of government loans for projects approvals under SAPARD measures 1 and 3 in case of bank credit denials. For the first time in 2003, there were envisaged budget appropriations in support of abandoned land cultivation schemes.

Demand Side

External demand, household consumer spending in particular, had again a dominant role in GDP growth. In the six months to July, final household consumer expenditures reported a 7.1% year-on-year rise and hence a 2% higher relative weight, accounting for 73% of GDP. The powerful increase in household consumption was spurred not only by the growth in household income (see point 4.2) but also by the credit expansion of the financial system (65.7% nominal -term increase on a year earlier) and the introduction of new financial products. The new equilibrium established in the credit market was indicative of the growing credibility of government economic policies as well as of the strong expectations that the real income growth reached would be further sustained.

As evidenced earlier by the balance of payments analysis (see Part Two), growing consumption in the economy was mostly met by imports, aggravating the imbalance between domestic savings and investments. In the first half-year period of 2003, domestic savings amounted to only 8%, reporting a 4.8 percentage point decrease on a year earlier. However, the savings-investment gap widened solely due to the private sector.

[5] *2002/03 Situational Analysis of the Wheat Market, marketing Department, MoA.*

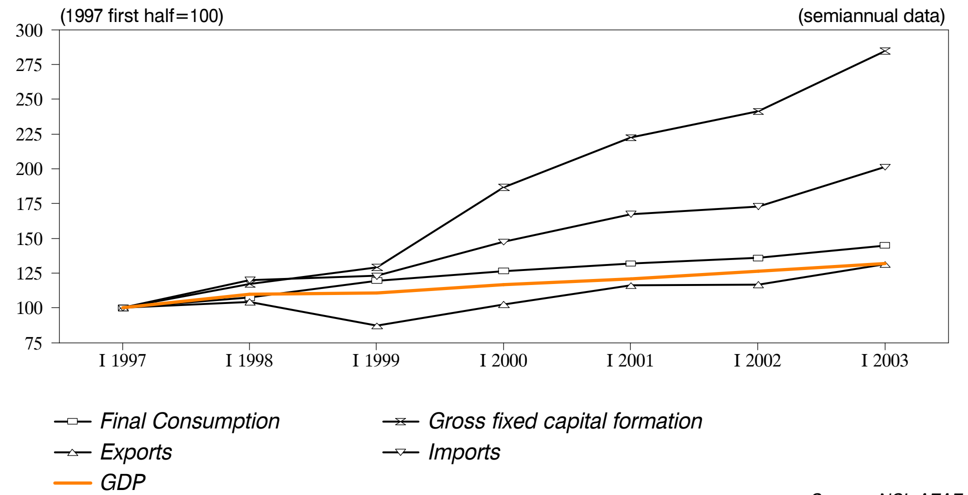
[6] *According to data of the Agri-statistics Department of the Agriculture Ministry.*

[7] *According to a NSI survey of April 2003, reporting data on investment activity in the manufacturing sector. Public-sector enterprises, too, reported a 21% six-month nominal-term decrease in investment spending on the acquisition of fixed assets, despite their intentions as to a certain investment spending cut-down.*

For the first time private-sector savings (households and companies) ran negative for two quarters in a row, posting a six-month contraction of 1.1% (BGN 171.5 million) as percentage of GDP. At the same time, public finance ran a significant cash surplus, turning the government budget into a net saver (6.6% of GDP).

In the six months to July, gross fixed capital formation (18%) was again the most vigorously growing component of GDP by final expenditure. The above development was somewhat unexpected as most private-sector entrepreneurs intended to cut down their investment programmes by 20% and increase fixed capital formation by about 3% only in nominal terms[7]. Most probably, they adjusted their investment intentions since the country's business climate had significantly improved. Furthermore, the faster than expected rise in bank lending to firms was another factor at play behind the gross fixed capital formation growth in the period surveyed. Also, lending to private-sector non-financial enterprises registered a most notable nominal-term increase of 51.4% vs. only 9.6% to the public sector.

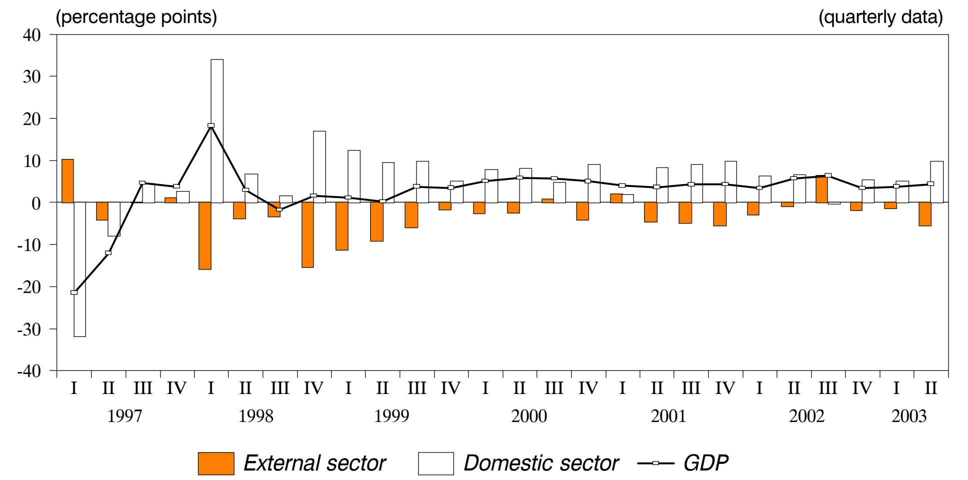
GDP Components, Cumulative Volume Indices



Source: NSI, AEAF

The external sector made a negative contribution to GDP growth due to the outstripping rise in imports (goods and non-factor services) vis-a-vis exports and the significant degree of openness of the economy. The fact remained, however, that the country's export performance contributed to growth in the economy in the utmost - 6.83% and 6.44% respectively in the first and second quarter. The above trend, together with outstripping growth of investment goods and raw material imports (see Part Two) and the positive net financial position of the government were a sign that the Bulgarian economy had probably switched on to a new growth path. And yet, any conclusions as to the sustainability of the long-term growth path are too early to be made, as currently the main risk middleman in an economy, i.e. the banking system, is giving no rise to any doubts or fears. ❑

Contributions to GDP Growth



Source: NSI, AEAF

APPENDIX 2: **GOVERNMENT'S ACTIVE LABOUR MARKET MEASURES AND PROGRAMMES**

The sizeable increase in the number of unemployed who had started a new job[8] was to a great extent a result of the increased coverage of government's active labour market policies (ALMPs). Over the January to June 2003 period, the number of all inclusions in the various labour market programmes and measures exceeded 100 thousand persons against around 25 thousand participants in the respective period of 2002. The monthly average number of inclusions in ALMPs ran at 79.4 thousand in the six months to July 2003 as compared to 32 thousand registered in the first half of 2002.

The increase of the unemployment outflow was one of the factors contributing to the contraction of total unemployment in the first six months of 2003. Over the January to June 2003 period, the average monthly number of job-seekers who had been deleted from the registration lists in the job centres had stepped up by 12.7 thousand (26.1%) on a 12-month basis entirely due to the large number of unemployed declaring to have found new jobs. The latter cohort had grown by 66% (12.2 thousand) on a year earlier and its share within the unemployment outflow had reached 49.6%, stepping up by 12.4 percentage points relative to the first 6-month period of 2002.

The *From Social Benefits to Employment Promotion* National Programme is the largest in scope labour market programme. In the six months to July 2003, the average monthly number of new inclusions in the programme amounted to 68 234 unemployed accounting for about 86% of all participants in ALMPs. The Programme is targeted at long-term unemployed persons and, therefore, the share of the latter pool in total unemployment sharply declined in the period under review. In the first half of 2003, the number of long-term unemployed (with unemployment spells of over 1 year) had contracted by 36.9 thousand, stepping down by 10.9% on a 12-month basis. In view of the fact that the bulk of this cohort comprise unemployed without any profession or vocation as well as with a low level of education, the Programme incorporates a network of literacy and qualification courses[9]. The goal is to take preventive action against falling into the long-term unemployment pool by improving employability that, in turn, will trigger a sustained decrease of the overall unemployment level.

Simultaneously, the government's policy to encourage sustainable employment in the private sector has been gaining more importance. In 2003, the Corporate Income Tax Act was amended to introduce a tax incentive in the form of a 100% tax remittance to companies investing in areas with high unemployment. The available data is still incomplete to allow an accurate assessment of the effectiveness of this measure promoting investment activity in the country's areas in decline. In the longer run, the action taken is expected not only to positively influence investments but also to contribute to the contraction of state budget expenditure allocations for social assistance to the population in these municipalities.

[8] *The indicator does not cover all newly-generated jobs.*

[9] *Some 5 000 persons will receive a qualification and at least 1 000 persons hired under the From Social Benefits to Employment Promotion National Programme will be made literate under the component „Liquidation of illiteracy and qualification of unemployed persons".*

Furthermore, tax incentives[10] are envisaged for employers who have hired unemployed with reduced working capacity, long-term unemployed or unemployed aged over 50 for a period of at least 12 months in a given fiscal year. The 2003 amendments to the Employment Promotion Act add to the preferential treatment of employers under the employment promotion regimes by providing financial stimuli to employers hiring unemployed persons, investing in their qualification and in the improvement of qualification of their employees. The measures targeted at the employment promotion and encouragement of entrepreneurship of persons with permanently reduced working capacity as well as those for the hiring of unemployed persons aged over 50 are of particular importance since these groups are always at risk to lapse in the long-term unemployment pool.

Budget expenditure assignments for ALMPs are expected to reach BGN 304 million by end-2003. The budget allocations for the *From Social Benefits to Employment Promotion* National Programme alone amount to BGN 217.6 million. It is somewhat difficult to estimate the degree of sustainability of the newly-generated jobs under the employment promotion programmes and measures. The annual budget allocations for ALMPs in the medium-term budget projections of the Ministry of Finance have been set at BGN 204 million over the 2004-2006 period. The smaller amount of expenditure assignments relative to budget spending in 2003 is preconditioned by the restrictions faced by the state budget. In 2004, the budget allocations for the *From Social Benefits to Employment Promotion* National Programme are projected at some BGN 111.2 million while the Programme is expected to encompass approximately 57 thousand unemployed persons. Spending cuts are therefore quite likely to induce a recurrent increase in the unemployment rate and a deterioration of the structural characteristics of total unemployment. The sustainable development of the private sector in the country which will be instrumental to preserve the current rate of job generation in the sector will be crucial to overcome the consequences of the above-mentioned negative trend.

The primary labour market upturn that is entirely a result of the more intense activity of private employers should not be overlooked. According to data from the Employment Agency, in the first six month of 2003 the number of job vacancies announced by the private sector in the job centres amounted to 66.5 thousand, stepping up by 1.5% on a year earlier[11]. ❑

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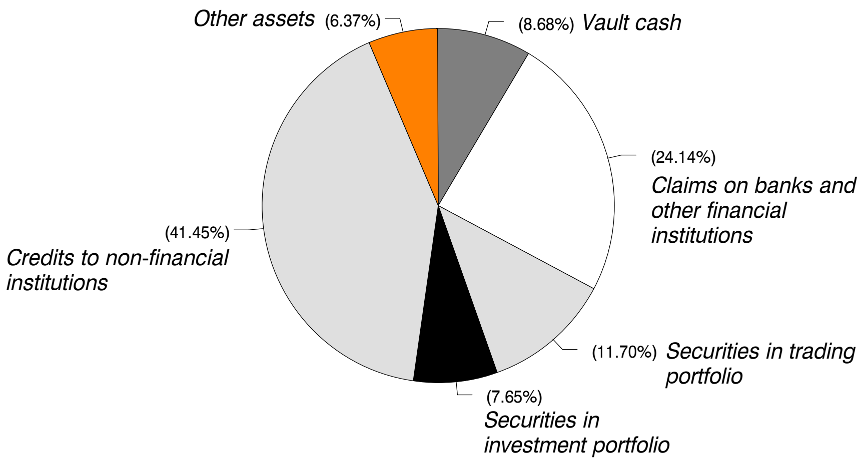
[10] The tax incentive is calculated by deducting the sums of labour remuneration and employer's contributions to PSS and NHIF from the entrepreneur's financial result (for tax purposes). It is applicable for the year when the person was hired.

[11] It is noteworthy that labour demand is not concentrated uniquely in the job centres of the Employment Agency.

APPENDIX 3: **STRUCTURE OF COMMERCIAL BANKS' ASSETS**

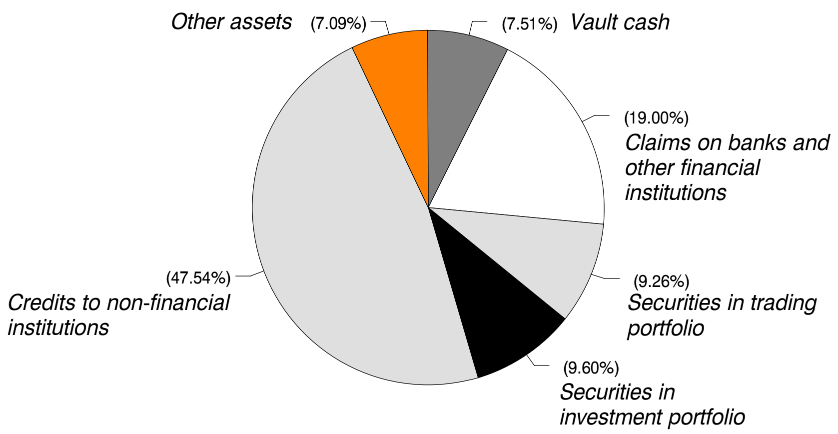
Commercial banks asset structure underwent no substantial changes. The share of credits to non-financial institutions went on increasing (by over 6 percentage points) to reach 47.5% of total assets as of end-June 2003 at the expense of the declining relative weight of claims on banks and other financial institutions (by over 5 percentage points relative to end-2002). Another change in commercial banks' assets structure had to do with the increase of the share of securities in their investment portfolio by about 2 percentage points relative to end-December 2002 up to 9.6% mainly as a result of investment in long-term government securities both BGN and foreign currency denominated. The relative share of securities in the trading portfolios stepped down by 2 percentage points over the same period to 9.3%.

Commercial Banks Assets as of 31.12.2002



Source: BNB

Commercial Banks Assets as of 30.06.2003

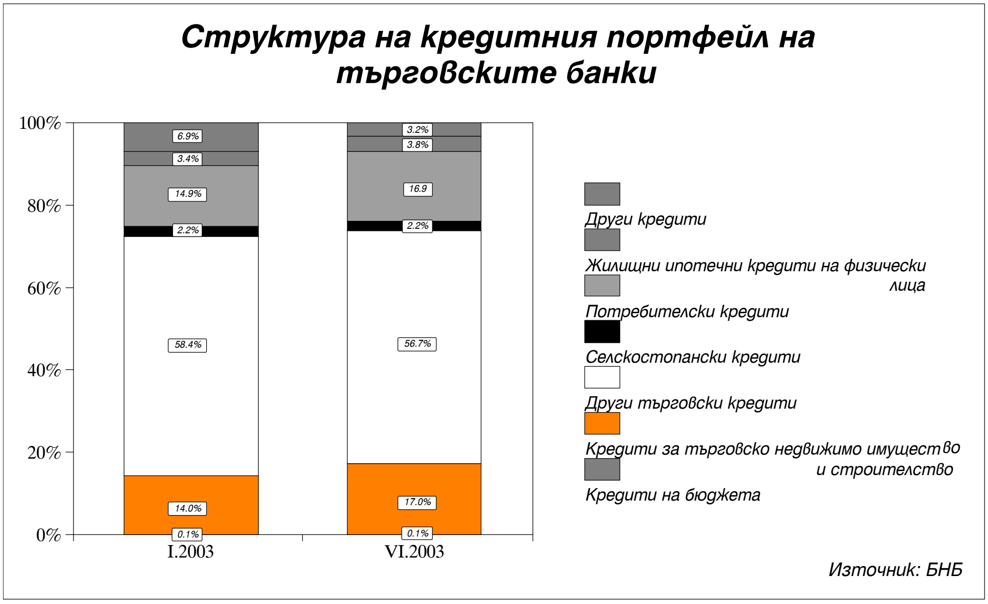


Source: BNB

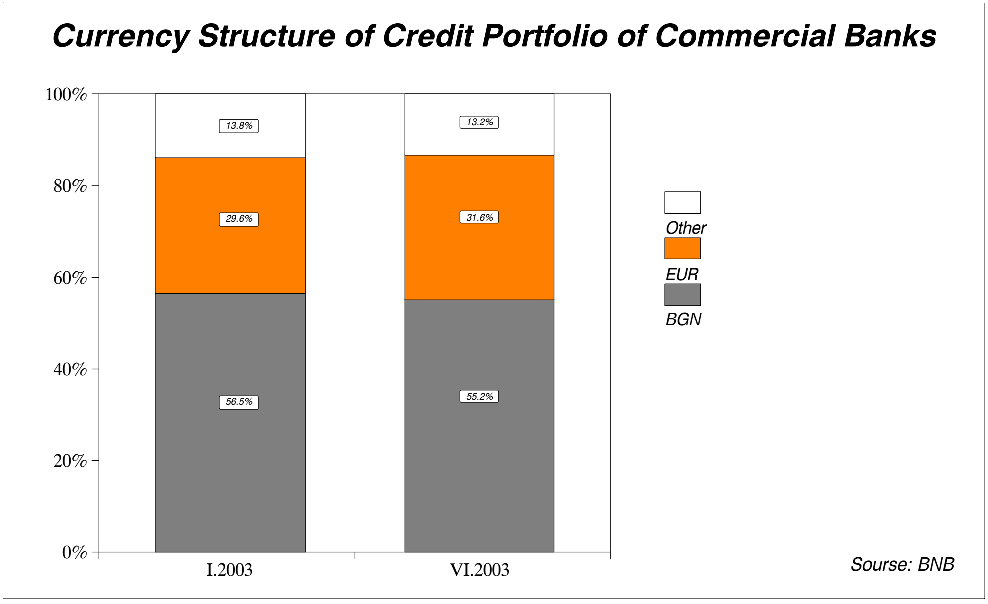
Within the structure of commercial banks assets, the share of investment credits (for construction and commercial real estate loans) reported the fastest growth - a positive trend indicating that commercial banks have optimistic expectations for the development of the business climate in Bulgaria and are therefore inclined to lend money for longer-term projects. The rising share of both housing and mortgage credits to households also supports a similar conclusion.

The share of consumer lending went on increasing, affecting the economy in two ways. On the one hand, it boosts household consumption, and *ceteris paribus*, consumer credits contribute to economic growth. On the other hand, this credit expansion fosters the consumption of imported goods and the latter's increase may provoke a deterioration of the country's trade balance.

Regardless of the slight fall in the weight of other commercial credits[12] they sustained the highest growth pace in absolute terms. The bulk of commercial banks' credit resources remained short-term, hence the perpetuation of the substantial share of commercial credits in banks' credit portfolios.



No important changes were discerned in the foreign currency structure of credit portfolios. The share of EUR-denominated credits stepped up at the expense of the shrinking relative share of credits in BGN and other currencies (mainly US dollars). It is noteworthy that foreign exchange-denominated credits (in EUR and USD) prevailed in the clusters of construction and commercial real estate loans and other commercial credits, respectively accounting for 72.3% and 53.1% as of end-June 2003.



The commercial banks classified in bank group I holding 75% of total banking system assets as of end-June 2003 accounted for about 81.9% of total banking system net profit[13]. The profit of commercial banks in bank group II (holding 19.3% of total banking system assets) ran up to 14.6% of the overall net profit of commercial banks as of 30 June 2003. Bank group III contributed 3.5% to the banking sector's net profit. The non-interest (operating) expenses/operating profit ratio hit the lowest value (107.6%) in bank group I and the highest (224.1%) in bank

[12] *Predominantly short-term credits for working capital needs.*

[13] *According to the new classification of the BNB, bank group I comprises the 10 largest banks with the highest balance sheet values at the date of the preparation of the respective monthly balance sheets and monthly revenue and expenditure statements. Bank group II comprises all other banks excluding foreign bank branches. Bank group III includes foreign bank branches.*

group II. A bank consolidation would have resulted in a cutback of operating expenses and would have therefore led to improved profitability of small banks.

Operating Profit by Components and by Bank Group as of 30.06.2003*

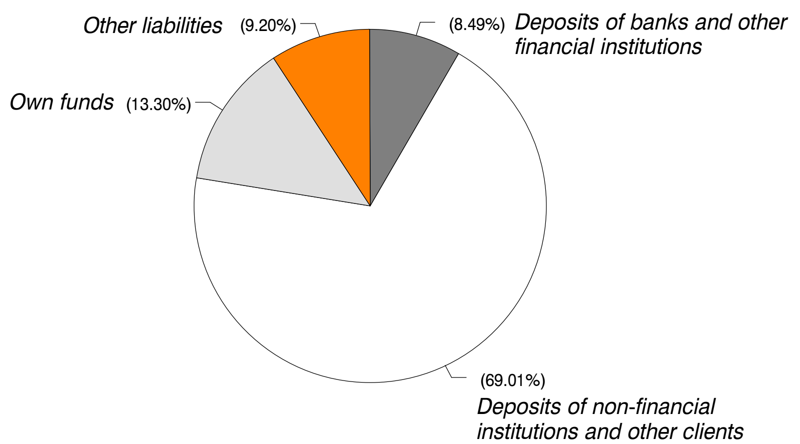
	Group I	*Group II*	*Group III*
Interest and dividend income, net	*124.0%*	*175.5%*	*146.5%*
Credit provisions, net	*21.0%*	*-3.1%*	*46.2%*
Trading portfolio, gain/loss	*12.2%*	*48.9%*	*25.5%*
Gain/loss on investments available for sale	*-0.1%*	*10.7%*	*9.1%*
Gain/loss on investments held to maturity	*2.8%*	*0.0%*	*0.0%*
Other non-interest income	*47.7%*	*92.1%*	*71.8%*
Non-interest expenditures	*-107.6%*	*-224.1%*	*-199.1%*

** a + sign denotes a positive contribution to profit; a - sign denotes a negative contribution to profit*

Source: BNB, AEAF.

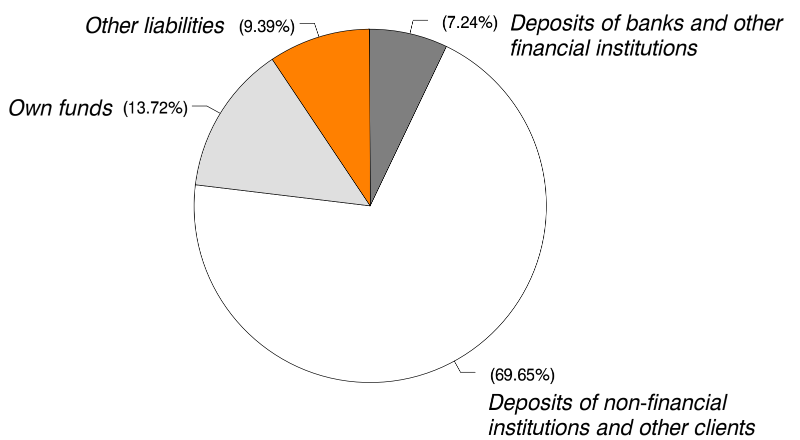
No noteworthy changes in the structure of commercial banks liabilities were reported in the first half of 2003 relative to end-2002. The share of deposits of banks and other financial institutions shrank by 1.3 percentage points at the expense of a modest increase in the relative weight of the other liability components (deposits of non-financial institutions and other clients, own funds and other liabilities). ❑

Commercial Banks Liabilities as of 31.12.2002



Source: BNB

Commercial Banks Liabilities as of 30.06.2003



Source: BNB

APPENDIX 4: **STRUCTURAL REFORMS IN SOME PRIORITY AREAS**

Energy Sector

In the first half of 2003 further action was taken to prepare the energy sector for liberalisation and to implement the reforms envisaged in the energy strategy of the country. Bulgaria's accession to the Union for the Coordination of Transmission of Electricity (UCTE) represented an important step forward in the development of the industry. Membership will guarantee the security of electricity supply and will alleviate the necessity to maintain a high percentage of reserve energy capacities.

In May 2003, the Council of Ministers approved a new draft Energy Act laying down the general rules at the domestic markets of electricity, natural gas and district heating and regulating the functions and statutory authority of the government agencies involved in the management, regulation and oversight of the energy sector. The Act introduced the option for an authorisation regime for construction of new capacity while the government will not assume any power purchase obligations. Thereby, the government opens the way for private investment in the sector without exposing the country to the risks of long-term power agreements.

The passing of the new Act will launch the liberalisation of the electric energy market. The draft Act provides for the establishment of a separate free retail market of electricity and for direct contracting between independent power producers and eligible consumers in the country. The balancing of either shortages or excess supply of electric energy will be carried out on the so-called balancing market that will be managed by a specialized unit within the electricity transmission company. Ten eligible consumers whose consumption is estimated at about 15% of the electricity market and five independent power producers offering to consumers some 9% of their available capacities will enter into the initial phase of the opening of the market. The new Act introduces two new legal definitions, namely those of the public supplier and the public buyer. Both will operate at the regulated segment of the market, the electricity prices whereat will be set by the State Energy Regulating Commission (SERC), and will be responsible for the provision of the so-called universal service to the non-eligible end consumers. In 2007, households will be given the statute of eligible consumers who will have the right to choose freely their supplier. The Act also introduces the legal entity of the electricity trader who will act as a middleman in the conclusion of direct supply agreements between the eligible consumers and independent generators as well as between the public supplier and the public buyer.

The draft Act determines the preservation of NEK's monopoly on electricity imports and exports until Bulgaria's accession to the EU and foresees the restructuring of the electricity transmission company by end-2005 by separating the system operator of the electricity grid.

According to data from SERC, a large number of industrial consumers meeting the requirements for the acquisition of the status of eligible consumer (own electricity consumption of over 100 GWh per annum and no outstanding debt owed to NEK) have abstained from participation on the free market of electricity either because they were not well informed on the advantages of bilateral contracting or on account of their inability to forecast their future electricity consumption. The balancing market price setting methodology determining the selling and buying prices in cases of shortages or surplus will be of primary importance for the development of the electricity market. In order to ensure the smooth functioning of the market, the difference between the asking prices and the offered price need to be relatively narrow thereby reducing the risk for electricity consumers.

The divestiture of electricity distribution companies - an important reform laid down in the Energy Strategy of Bulgaria - was delayed by the postponed voting of the new energy act. In end-July, the National Assembly approved the strategy for the privatisation of the seven electricity distribution companies and the launch of the sale procedures was expected in mid-year. According to the strategy, the companies will be grouped in three pools depending on the number of consumers and 67% of their capital will be offered for sale.

The three parcels will be put on the market simultaneously with a view to attracting greater investors' interest and encouraging competition among potential buyers. A several phase tender procedure is planned. At the initial stage, bidders will be selected on the basis of pre-set criteria. In the second phase bidders are expected to submit their non-binding (informal) tenders and after reviewing them the Privatisation Agency will select the tenderers to participate in the final phase. Investors will be allowed to submit applications for participation in all three tenders, however, they may acquire only one of the parcels. Only institutional investors may apply for participation in the tenders and they should meet certain requirements, viz. annual volume of electricity sales above a fixed threshold, size of own capital, credit rating and experience on a liberalized market. A positive development is the fact that the strategy does not foresee the sale at all costs (as it was in the case of the attempted divestiture of BTK and Bulgartabac). Rather, it opts for divestiture only in case there is an expression of interest by experienced investors in the sector that will carry out the effective restructuring of the privatised enterprises.

The presented model of divestiture seems commendable and, provided its successful implementation, will secure the balanced development of the three separate electricity distribution regions by optimizing the companies' expenditures through economies of scale. However, the requirement to the new owners to preserve the current labour costs in the forthcoming two years laid down in the Strategy, may jeopardize the process as the opportunities for a swift and efficient restructuring of the companies will be reduced.

The privatisation of the electricity distribution companies (EDCs) is a necessary step at present. A number of research analyses on the effect from the divestiture of such businesses reveal that privatisation is the most effective instrument to tackle the paramount problem of EDCs, namely the sizeable percentage of uncollectible receivables. Their share varies from 19.5% to 31.4% of total electricity sales (according to the Energy Strategy) and thus hides a great potential for improvement of the rate of return on capital. The envisaged amendments to the Code of Criminal Procedure that will treat the theft of electricity as a criminal offence are also expected to have a positive effect.

The absence of an enforced Energy Act at the time of issuance of the invitations for tender is the key factor that is likely to negatively affect the investors' interest in the sales. The new regulatory framework is yet to be adopted. The mode of creating the legal framework of the sector was ill-advised as instead of prioritizing the passage of the new act, efforts were targeted at the adoption of the accompanying regulations to the old Energy Act in force and this mistake resulted in the delay in the process of market liberalisation. Furthermore, the new long-term electricity price-setting methodology had not been approved by the time the tenders were announced (its adoption is expected in December 2003) creating further uncertainties around the participation of strategic investors in the divestiture of the energy companies.

A draft Energy Efficiency Act was also prepared in the period under review. The Act addresses the primary obstacle to the competitiveness of Bulgaria, namely the rational use of energy resources. The problem is further underlined by the anticipated electricity shortages that will come into being after the closure of nuclear power units No3 and No4 at Kozloduy NPP in 2006 as well as by the difficulties in attracting financing for the construction of new capacities.

The government's policy in this area will be mapped out by long-term national programmes and short-term programmes worked out at national, district and municipal levels and will be implemented by the Minister of Energy and Energy Resources and the Energy Efficiency Agency. A special Energy Efficiency Fund is to be set up with the tasks to assist in the implementation of energy-saving actions and measures. The rather all-embracing definition of the projects eligible for financing by the fund represents a drawback in the formulation of the draft Act. It is advisable to reduce the pool of funded projects to investment projects in the public sector that are unlikely to obtain financing from other sources.

The Act establishes a new legal entity - enterprises (suppliers of) for energy efficient services that will operate on the principle of financing by a third party and guaranteed energy savings performance contracting. To attract interest in these energy services, it is necessary to ensure by virtue of law the preservation of the savings generated by the energy efficiency projects throughout the entire contracting period and not only in the following year as currently stipulated in the draft Act.

In April 2003, Turkey discontinued its electricity imports from Bulgaria on the grounds of Bulgaria's alleged failure to meet its commitments under the 1998 bilateral agreement. The short-term power export agreements signed with Greece, Serbia, Montenegro and Macedonia offset the negative impact on the National Electricity Company. According to NEK expert estimates, the discontinued supplies to Turkey will result in a contraction of exports by some 1 billion kW/h in 2003. Turkey is expected to resume the importation of Bulgarian electricity in the winter months when electricity consumption in the country normally goes on the increase.

In May, the SERC launched the tender procedures for the gasification of two of the eight gas regions established in 2001. The delayed voting of the new energy act may well affect investors' interest in these projects as well, and hence households' options for access to alternative energy sources.

Communications

The future of BTK remained unclear in the first half of 2003. The decisions of the Privatisation Agency became subject to constant court oversight and, as a result, the privatisation process was considerably delayed. The reasons for the selection of BTK's buyer were inconsistent, being primarily determined by political rationale. The protracted divestiture negatively affected the telecommunication company and it was forced to abandon a large number of its investment projects envisaged for implementation in the 18-month period of lingering privatisation. The rebalancing of the prices of the fixed telephone services was also postponed and only one of the planned two stepwise increases in 2002 was actually realized. As a result of the changes, the price ratio local calls/trunk calls/international calls was altered from 1:20:50 to 1:15:37.5, according to data from the Telecommunication Commission against an average ratio for Europe in 2002 of 1:2.7:5.7. The prices of local calls remained the lowest compared to the other Central and East European countries, and as of early-2003, amounted to EUR 0.043 (VAT included) per 3-minute call and EUR 0.086 for a 10-minute call. At the same time, BTK prices of international calls ranked among the highest in Europe, revealing the presence of a sizeable imbalance in the relative prices of these services.

The voting of the new Telecommunications Act that shall regulate the business and public relations in the sector and provide the legal framework for the operation of the telecommunication sector in a liberalized market is delayed.

In the short- and medium term new operators are expected to enter the Bulgarian market of fixed-line telephony and leased lines and compete with the current monopolist BTK. Some have already submitted applications for licences to the Communications Regulatory Commission (CRC) that is expected to grant the first licenses in early-2004.

The abolition of *BTK* EAD special rights over the fixed-line telephone service and leased lines and the full market liberalisation since 1 January 2003 have intensified the role of the independent regulatory body, i.e. the Communications Regulatory Commission. The strengthening of the institutional capacity of CRC, securing effective and efficient control in the area of telecommunications, the introduction of new automated technological oversight systems, the phased alleviation of the existing licensing regimes, the shortening of the time required for the issuing of licences and securing the financial independence of CRC are of primary importance to foster the development of the market and ensure that loyal competition is in place. In March 2003, the CRC registered *Informacionno Obslujvane* AD as the first certification-service-provider related to electronic signatures.

The digitalisation of the fixed telephone network continued and is expected to reach some 46% of the network by end-2005. Regardless of the slackened growth pace of the telecommunication sector worldwide reported in recent years, the financial indicators of BTK have been constantly improving - from the phased-down cross-subsidisation of the various services to the technological modernisation and the digitalisation of the network.

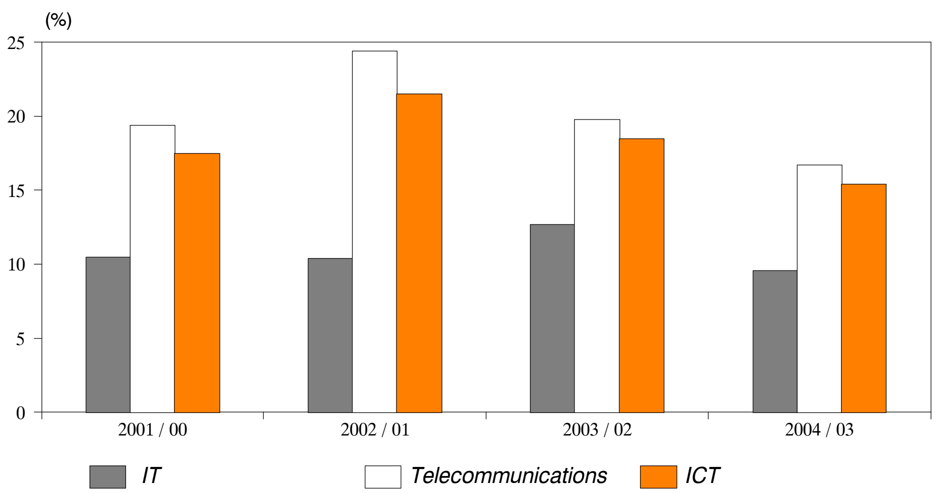
A Strategy for the development of electronics and electrical engineering in Bulgaria was worked out in February. The document comprises proposals covering a number of spheres such as public financing, company financing, information technologies, transport, education, and the optimisation of production or market lines at firms' level. In mid-May, a working meeting was held to discuss and review the initial draft of a Strategic Plan for the Development of the IT Industry in Bulgaria. The document was a product of the joint efforts of a number of experts from the Bulgarian IT Association, the Bulgarian International Business Association (BIBA) and the Bulgarian Association of Software Companies (BASSCOM) with the support of a USAID funded project. The concept of the strategic plan is to present the joint vision, interest and commitment of business circles and the government of Bulgaria for the development of the competitiveness of ICT industry in the country.

In end-June, four of the business associations in the Bulgarian ICT sector, namely the Bulgarian Association of Information Technologies (BAIT), the Bulgarian Electronic Engineering and Informatics Trade Association, the Telecommunications Association and the Bulgarian Internet Association signed a memorandum concerning the elaboration of joint opinion and position and the undertaking of concerted actions with a view to protecting the interests of the Bulgarian information society in the light of the forthcoming accession of Bulgaria to the EU. A regional branch of the European Software Institute (ESI) was established in Sofia in end-June. The new software centre was the first of its kind in Eastern Europe and the fourth one worldwide. It was created within the framework of a joint project between the Ministry of Transport and Communications (MTC) and UNDP that has been implemented by the Agency for the Development of Communications and ICT attached to the MTC and BASSCOM. The ESI centre in Sofia will be entrusted with the task to develop the competitiveness of the IT sector through know-how and expertise transfer and to contribute to the adaptation of proven technology and quality standards for the country's specific needs. The fact that there are only six such centres in the world presents Bulgaria with an exceptional advantage.

The building of an advanced telecommunication infrastructure has generated conditions for offering new telecommunication services. All Internet providers demonstrate a peaked interest in VoIP services as a significant source of income. Some of the major players on the market of alternative telecommunication services drastically reduced the prices of phone-calls. The turnover on the VoIP market is expected to further increase along with the penetration of foreign investment. High-speed access technologies, mainly via cable, and xDSL access are also undergoing significant developments. *Orbitel*, one of the largest Internet providers, was the first to challenge the monopoly of BTK by submitting its application for a fixed-line telephone operator licence. As a result of the enhanced efficiency of the communication services and the ever growing interest and share of the private sector in the already liberalised telecommunications market, in the first half of 2003 the gross value added in the Bulgarian ICT sector grew by 11.1%, accounting for the highest contribution to growth in the service sector.

According to the European Information Technology Observatory (EITO) data, the ICT market in Bulgaria has been developing at accelerated rates and is expected to retain its high growth pace in the forthcoming years. EITO forecasts an 18.5% growth of the Bulgarian market on an annual basis against a projection of 2.5% for Western Europe and 4.5% for the global market. The telecommunication sector accounted for over 80% of the market and, again according to EITO Report, its share is expected to gradually rise further. The mobile telephone services and mobile communication equipment had reported the fastest growth rates thanks to the rapid development of the second GSM operator in the country, viz. *GloBul*, the expansion of its market share and intensified competition on this market segment. Forecasts point to a 22.6% growth of telecommunication services in 2003 alone.

Bulgarian ICT Market: Annual Growth



Source: EITO 2003

Pension System

The reform of social insurance is one of the most important reforms pursued in recent years. The current tasks focus on the gradual increase of the weight of the second and the third pillars of the system. Furthermore, efforts are made to enhance the insured workers' participation in their social insurance contributions to the first pillar thereby pursuing a two-facetted goal: on the one hand, to increase the personal responsibility of workers for their social insurance and on the other hand, to encourage employers to open new jobs by reducing the social insurance burden on employers.

According to data from the NSSI, in June 2003, some 2.108 million people were insured under the pay-as-you go pillar, with their number stepping up by some 10% (191 thousand workers) on a year earlier. Revenues of Public Social Security grew by BGN 153.6 million relative to June 2002 to reach BGN 1 364.5 million. The increase of the number of insured employees as well the NSSI's higher revenues were to a great extent due to the new actions taken in early-2003 to improve contribution compliance. Thus, a mandatory registration of newly signed, amended and terminated labour contracts in the NSSI and minimal insurance incomes on economical activities (31 branches) and qualification groups of branches (9 occupations) were introduced. The increase of the minimum insurable income threshold of self-insured persons from BGN 170 to BGN 200 and the maximum insurable income of all insured persons from BGN 850 to BGN 1000 also contributed to the 12-month growth of NSSI's revenues reported in the first half of 2003.

According to data from the Financial Supervision Commission, the number of insured under the second pillar (mandatory supplementary pension insurance) amounted to 1.37 million, stepping up over two-fold on a year earlier. In the first six months of 2003 alone, the number of insured employees under the second pillar of the system had grown by 17.7% (206 thousand) indicating that the number of workers insured not only in the first but also in the second pillar had been going on the increase.

Since early-2003, the retirement age was raised to 62 years for men and 57 years for women. The required retirement age shall be increased stepwise (by six months in each consecutive calendar year) to reach 65 years for men and 60 years for women. The changes will have a positive effect on the pension system by reducing the dependency ratio (that is the number of pensioners per 100 insurance contributors). In the second quarter of 2003, the value of this indicator ran at 111.13 against 122.54 reported a year earlier.

Revenues from social insurance contributions reached BGN 1 340.984 million, of which employers' contributions worth BGN 966.569 million and personal contributions to the amount of BGN 258.926 million. The social insurance contribution rate (42.7% levied on the gross labour remuneration for labour category III) and the share ratio employers' contributions/employees' contributions (75:25) remained unchanged relative to 2002. The employers' contributions/employees' contributions ratio is envisaged to gradually change over the next years to ultimately attain the targeted equal sharing in 2009.

On 1 June 2003, pension benefits were raised by 6.2% on average while the minimum pension benefit and the related to it disability pensions and survivor pensions were increased by 7.2%. BGN 50 is the new amount of the social pension benefit for old age. Accordingly, the size of the minimum length of participation and old age pension benefit was raised to BGN 57.50 while the amount of the maximum pension benefit was limited to BGN 200. The amounts of certain pension supplements (for war veterans and the allowances for support by another individual) were also increased. In the first half of 2003, the average monthly pension benefit per pensioner reached BGN 103.57 against BGN 95.96 in the respective six-month period of 2002.

Healthcare Reform

Healthcare is one of the priority sectors for the government in the period 2004-2006. Since the establishment of the National Health Insurance Fund (NHIF) in 1998, the share of healthcare expenditures in GDP had been gradually increasing. Thus, in the first half of 2003, healthcare expenditures amounted to BGN 699 million (2% of the projected GDP for 2003) against BGN 607 million (1.88% of GDP) in the same period of 2002. Healthcare reforms brought about changes in the structure of healthcare financing by source. While the share of municipal expenditures for healthcare in total healthcare financing amounted to 54% in 1998, it fell to 14% in mid-2002 to further decline to 11% in the first half of 2003. The share of NHIF covered expenditures rose from 45% in the six months to July 2002 to 53% in the first half of 2003. According to data from household budget surveys, the weight of healthcare expenditures (expenditures for health insurance contributions excluded) in households' consumer spending had stepped up from 4% in 1999 to 5.7% in the first half of 2002 to 6% in the January-June period of 2003. At the same time, the share of state budget allocations in total healthcare spending had remained relatively unchanged, accounting for 34% in 1998, 38% over the January-June 2002 period and 35% in the first half of 2003.

The contribution of municipal budgets and the state budget to healthcare spending is expected to further decline in the forthcoming years at the expense of the rising volume of healthcare expenditures of the NHIF and households. The NHIF will provide the bulk of financing of hospital care services with only minimal contribution on the part of municipalities and the central government. Although healthcare expenditures are approximating the optimum levels of 4.2% of GDP, the healthcare system as a whole is experiencing shortages of funds. In mid-2003, the NHIF had to face a crucial problem having to do with the fact that the budgeted amounts for medicines and medical goods and accessories for in-home treatment had been almost entirely spent as early as June 2003. The primary reasons for that may be found in the low budgeted amounts for this item in 2003 (BGN 162.7 million as compared to BGN 239 million spend for this item in 2002) as well as in the fact that some of the funds appropriated for 2003 were spent to cover expenditures incurred in the last two months of 2002. Regardless of all measures undertaken in 2003 to reduce the amount of expenditures for medicaments, it turned out that given the same pace of spending on medicines till end-2003 the NHIF would require additional funds that had not been allocated in its 2003 budget. Although almost the entire operating reserve of the Fund was unblocked, the estimates still pointed to a shortage of further BGN 48 million only for medicine expenditures. The sharp deficit of financial resources for the healthcare system and the absence of any other opportunities for additional transfers from the state budget call for an enhanced efficiency of resource utilisation in healthcare. The sizeable rise in households' healthcare expenditures that was not matched by the expected improved efficiency of the healthcare system create discontent over the course of reforms so far and accordingly weaken the support of economic agents for a contingent increase of health insurance contributions that could provide additional funding with a view to improving the quality of health services.

The average salary in healthcare, social care and veterinary services had grown by 66% over the 1999-2002 period and by further 17% in the first six-month period of 2003 on a year earlier due to the relatively high growth of incomes of general practitioners and specialist physicians. ❑

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