

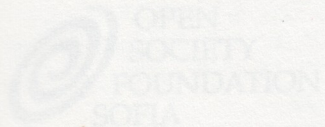


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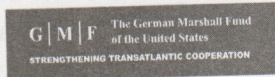
BULGARIA FOR NATO 2002

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STRENGTHENING TRANSATLANTIC COOPERATION



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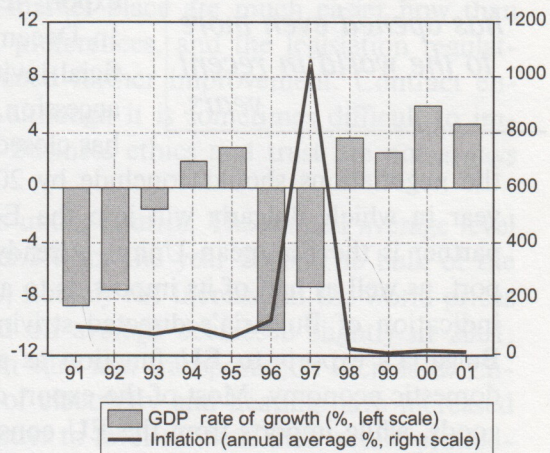
AN EMERGING ECONOMIC FACTOR

MACROECONOMIC STABILIZATION SINCE 1997

Since 1997 Bulgaria's economy went through two waves of the business cycle during the period from 1991-2001. The first wave started with the peak in 1991, continued through the trough in 1993 and reached another modest peak in 1995. The second wave started with that 1995 peak and continued through the recession in 1997. That wave has been in its recovery and expansion phase since 1998. By the end of year 2001 the Bulgarian economy was still in growth phase.

This development is especially remarkable in light of the fact that this is a small open economy greatly influenced by external factors. Several regional and international crises have influenced the Bulgarian economy in recent years. In 1999 two crises developed – the East-Asian financial crisis and the conflict in Kosovo. Two financial crises in neighboring Turkey followed, and the developments in the world economy after the terrorist attacks in USA on September 11, 2001 have also affected the Bulgarian economy. In March 2001 one of the major engines of the world economy – the United States – entered a recession. Although initially not very severe, this recession and its concomitant capital market volatility, in combination with the terrorist attacks and the war in Afghanistan the recession, have made a deep impact on the US and world economy. In the midst of these turbulent times, Bulgaria has managed to overcome its own 1997 recession and to continue on the path toward economic recovery and growth.

Figure 1. GDP and Inflation



Since 1998 the Bulgarian economy¹ has been enjoying stable economic growth. This successful macroeconomic stabilization has been due to many factors, namely the restructuring after privatization, the introduction of the Currency Board, the restrictive fiscal policy, the improved business climate, improved legislation, the free movement of capital, etc. Their general impact leads to a systematical growth in GDP. It has reached a peak of 5.8% in 2000 GDP per capita reached 24% of the EU average figure, which was a great improvement compared to previous years.

The achievements in macroeconomic stabilization were facilitated by the introduction of a Currency Board in July 1997, when the Bulgarian currency (BGL) was pegged to the German Mark (1 BGL=1 DEM). In January 1999 the BGL was pegged to the Euro at the fixed rate of the DEM (1 Euro = 1.95583 BGL). For the foreseeable future the plan is to keep the Currency Board intact.

The stable growth made possible by the currency board was accompanied by a rapidly decreasing budget deficit, and the balance-of-payments deficit was brought under control. The high growth was and continues to be supported by a high ratio of Investment to GDP (investment was 16% of GDP in 2000), although improvements in this area are needed.

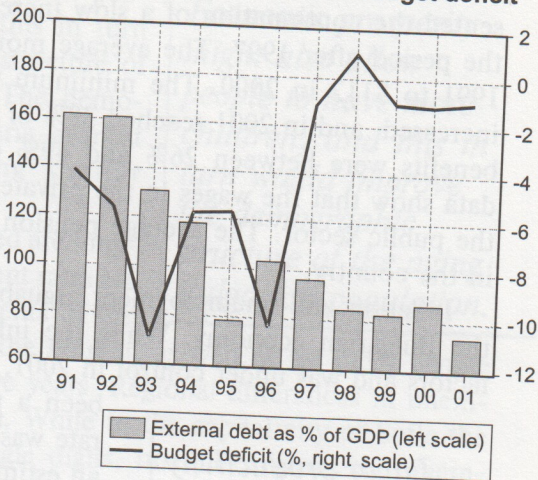
In the era of globalization, the Bulgarian economy has opened even more to the world in recent years.

In the era of globalization, the Bulgarian economy has opened even more to the world in recent years. One of the main indicators of openness, the sum of import and export, reached 122% of the GDP in 2000. In December 1999 Bulgaria received an official invitation to start negotiations for EU accession, and by the end of 2001 Bulgaria has closed 12 out of 30 chapters. The rest of the negotiations should conclude by 2003. Leaders envision 2007 as the year in which Bulgaria will join the EU. By now Bulgaria's main trade partner is the European Union. Already more than half of Bulgaria's export, as well as half of its import, is to and from the EU. This is one more indication of Bulgaria's directed striving toward accession into the EU. Bulgaria's exports to EU function as a growth engine for the country's domestic economy. Most of the export consists of food and manufacturing goods, while imports from the EU consist mainly of machinery, transport and other equipment.

¹ Data published by National Statistical Institute, Bulgarian National Bank, Agency for Economic Analysis and Forecasting, and author's own calculations. Data for year 2001 are preliminary or estimates.

Bulgaria's external debt has not increased and, indeed, even decreased in 2001. The ratio of external debt to GDP decreased from 160% in 1991 to 73% in 2001. Each year debt comes closer to the desired level of 60% or less of GDP. The base interest rate of the central bank (BNB) decreased significantly (to 4.5% in 2001) and has stabilized in the last couple of years. The same is true for the exchange rate after the introduction of the Currency Board. The stable exchange rate brought high confidence in the financial system and made possible long-term business plans.

Figure 2. External debt and budget deficit



The business climate has improved significantly. More than 60,000 companies are registered for VAT and the number is increasing. Small and medium sized enterprises make up the bulk of these companies. They give 25% of the value added and provide 40% of the jobs in Bulgaria. The two major business indicators, "Confidence in Industry" and "Business Climate Indicator," rose steadily in the recent years.

Entry into and exit from the market place are much easier now than before, but the licensing regime, preferences, and the legislation regulating local administration powers need further improvement. Contract enforcement has improved greatly, although it is sometimes difficult to implement the existing regulations. Business ethics and trust are not always satisfactory.

During year 2001 inflation was under control. The annual average level was 7.3% for 2001, down from 10.3% for the year 2000. The bulk of the inflation is due to external factors, notably the increase in the world prices of oil and gas. The price of food on average decreased slightly in 2001, while the prices of services, health care and transportation increased. Energy prices, especially the prices of electricity and heating have increased and will continue to increase in order to level off with their actual production cost. The year 2001 will also be remembered for its several month of deflation. Of course, deflation could be as harmful to the economy as inflation, but in this case it brought new highs in the morale and spirit of the Bulgarian people.

The average wage increased in real terms by 3.9% in 2001. This represented the continuation of a slow increase that was in place for most of the period after 1997. The average monthly wage increased from \$53 in 1991 to \$112 in 2000. The minimum wage established by the state has increased, and in 2001 reached 38% of the average wage. Unemployment benefits were between 26% and 49% of the average wage. The official data show that the wages in the private sector were slightly lower than in the public sector. The average pension equaled 36% of the average wage in the country.

Inflation and unemployment arguably are the two major problems for the Bulgarian economy. While the inflation was mostly due to external factors and was under control in 2001, the problem of unemployment has

Labor productivity grew consistently and the fastest growth was registered in the industrial sector.

Employment in the private sector has increased while the public sector's share has decreased considerably.

been a persistent one. The unemployment rate was down to 12% in 1998, but in 2001 an estimated 18-19% of the labor force was unemployed. This unemployment is caused mainly by the structural changes in the Bulgarian economy in recent years and thus is a natural process for the economic recovery and growth. Labor productivity grew consistently and the fastest growth was registered in the industrial sector. Employment in the private sector has increased while the public sector's share has decreased considerably.

Unemployment is heavily influenced by the underdevelopment of infrastructure, by the low mobility of the labor force, as well as by some tax and social policy problems. The employment rate is low (51%) and economic activity is even lower (47%). This means that many people, for one reason or another, have exited the labor force altogether.

The population pool is also shrinking and the population as a whole is decreasing. The decline in population is due to demographic and economic factors, but its impact on the labor force might be significant in the long term. Demographic factors include the drastically dropping birth rate and the aging population. Economic hardship as well as the desire to travel and fulfill professional careers has led many Bulgarians to choose a path of emigration or temporary residence outside Bulgaria. The stable economic growth and the expected accession to EU might bring many emigrants back.

Economic prosperity might also allow people to have more children, and this in turn would improve the demographic structure of the aging Bulgarian population. The demographic crisis is not unique to Bulgaria, as most European countries are having similar demographic problems.

More than half of the unemployed are long-term unemployed. The unemployment rates are very high for the very young segments of the labor force, who are just entering the market, as well as for older people reaching the end of their productive years. Regional differences in unemployment are important in Bulgaria. While in the capital city of Sofia the unemployment rate is down to single digits, in other regions the unemployment rate reaches 30%. It is fair to say that Bulgaria has a problem with job creation and the maintenance of an effective labor market, rather than an unemployment problem. The solution in this area has to be focused on the creation of more jobs so that unemployment benefit checks are replaced, slowly but surely, by paychecks. Currently, an average of 38 unemployed people compete for every job opening. Creating more jobs means not just any jobs, but jobs with prospects for career advancement, jobs in contemporary fields, and jobs requiring better training and qualification. For example, the percentage of the population employed in agriculture is falling for good, and as productivity in this sector increases that percentage will need to fall even further.

Another way to address the unemployment problem is to help businesses create more jobs. The Bulgarian government should offer more tax relief to employers who create new jobs and make investments in human capital. Help should be offered to the unemployed to re-educate themselves and improve their skills and qualifications. There are indications that a significant part of the young labor force is absorbed by the gray economy, where they work unregulated for lower salaries and without any benefits. Of course, with further stabilization and growth of the Bulgarian economy as well as the implementation of the existing legislation, the gray economy will hopefully be driven out.

Despite the stable economic growth, the quality of life for Bulgarian people is far from ideal, especially for some low-income groups. Many households still spend 50% or more of their income on food and many have decreased drastically their expenses for heating and hot water by simply reducing or refusing the central heating services altogether. During

Economic prosperity might also allow people to have more children, and this in turn would improve the demographic structure of the aging Bulgarian population.

the cold winters going without heat and hot water is more than just an inconvenience. This practice presents a serious a health risk, as well, especially to the elderly. The Health Insurance Act and the Social Security Code were adopted in order to regulate the ongoing social reforms, pension benefits and health insurance changes. Health insurance is a relatively new addition to social life in Bulgaria. It needs to expand and cover the whole population, and employers and employees should share the financial responsibility. The state's financial help should focus on the unemployed, retired people and other vulnerable groups.

Macroeconomic stability is a pre-condition for the development of the financial system. The privatization and restructuring of the banking sector were very successful, and major banking indicators improved drastically. The ratio measuring the "depth" of the banking sector (Quasi-money per GDP) decreased from the high levels of 50-60% in 1997 to the more appropriate levels of 20% or less. The money supply increased by 5% in real terms in 2001. The restructured bank sector needs to participate more in helping to restructure the rest of the economy. In fact, the banking system has the potential to become a powerful tool and engine for the structural changes that have already begun in all aspects of social and economic life.

The capital market in Bulgaria started almost from ground zero after 1989. The Bulgarian Stock Exchange is functioning now and the market capitalization of the listed companies is approximately 4.5% of GDP. The turnout is still low, but it is increasing.

Bulgarian infrastructure, though underdeveloped, is improving significantly. In some areas this is happening with the help of EU. The stationary telephone network is slowly improving and the mobile telephone network is booming. Mobile phones are becoming a staple for businesses and individuals, and the mobile network is extremely dynamic and competitive, and it covers most of the country's territory. Mobile phones have made business activities possible in areas where the stationary telephone network is still not developed.

PRIVATIZATION AND RESTITUTION

The privatization process in Bulgaria started in 1992. The highest point was in 1999, when several heavily indebted, large-scale state-owned enterprises were privatized. In that year alone, more than 1200 deals were closed and the revenue reached \$2.5 billion. By the end of the year 2000, more than half of the assets of all state owned enterprises were privatized.

In industry alone 90% of formerly state-owned assets are now in private hands. The manufacturing sector is almost entirely private. The private sector as a whole produces 70% of GDP and its share is constantly increasing.

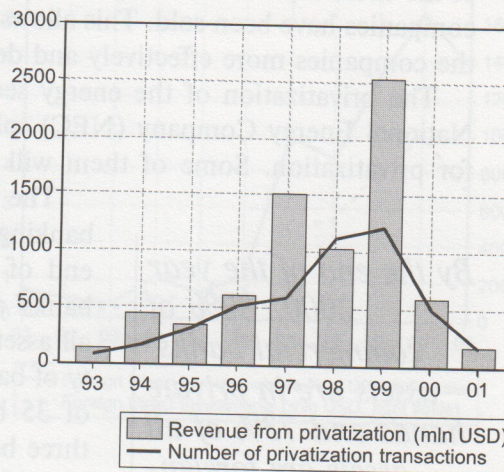
At the end of the year 2001, the privatization process has somewhat slowed down. There are still a small number of large and profitable companies scheduled for privatization in year 2002, however. Additional measures are being taken in order to increase the transparency and fairness of the privatization process. There are still some unclear ownership rights in land and housing areas.

Many of Bulgaria's loss-making companies have been liquidated. The liquidation program allowed accelerated bankruptcy procedures. The post-privatization process of restructuring and renovating a company takes 18 months on average. New owners have in general improved the management process significantly, although state law has imposed some restrictions and guidelines upon the owners regarding the investment process. In the early stages of privatization, some preferences were given to Management-Employee Buyouts, but since 2001 those preferences have been muted or eliminated altogether. Other methods of privatization, such as open competition, auctions and direct negotiations with potential buyers, have also been used.

By the end of the year 2000 the restitution of land ownership rights in Bulgaria was completed. Restitution frequently led to land fragmentation and to difficulties for the land market in the short run. The adoption of the Land Cadastre and the Register Act in the year 2000 set out to facilitate land transactions and real estate deals as well as land mortgages. It is still very difficult and expensive to consolidate land in Bulgaria, but the process has improved significantly. Currently, less than 1% of foreign direct investments are devoted to agriculture and land purchasing. The share of the agricultural sector in gross value added reached 14.5% in 2000.

Bulgaria expects some help in the agricultural sector from the European Union's SAPARD program. Individual farmers or companies are able to receive loans from the program for investment in agricultural production

Figure 3. Privatization



and infrastructure. As a pre-condition for the loan, the applicants are first required to invest from their own resources and only then they are eligible to apply for the loan.

While the fragmentation in the agriculture is still a problem, in the rest of the economy more than 2/3 of minority shares in the recently privatized companies have been sold. This allows the majority shareowners to manage the companies more effectively and decisively.

The privatization of the energy sector is more complicated. Since the National Energy Company (NEC) split up, most units are out of the lists for privatization. Some of them will be privatized, however.

By the end of the year 2000, 80% of commercial banks' assets are in private hands and 73% of all assets are foreign-owned.

The privatization and restructuring of the banking system was very successful. By the end of the year 2000, 80% of commercial banks' assets are in private hands and 73% of all assets are foreign-owned. The profitability of banking is high, and in 2000 only 4 out of 35 banks registered losses. In 2001 only three banks remain state-owned and at least one of them is scheduled for privatization. The concentration in the banking sector went down from 82% in 1991 to 55% in 2000.

The privatization and restructuring brought more competitiveness in the financial sector, although financial intermediation is still not sufficiently developed. Long-term credit is still difficult to obtain, especially in some sectors like agriculture. Services related to mortgage, housing, and consumer credit need further improvement. Credit for the private sector, for example, was only 14.7% of GDP in 2000.

INVESTMENTS

The period after 1997 has been characterized by increased investment demand and an increased investment growth rate. More than 60% of the investment in state-owned companies is used for renovation, new machinery, equipment, and especially the improvement of work safety and the environment. In the private sector, the same share of investment is used for the expansion of the production, new technology, and to increase the competitiveness of the company. Environmentally friendly technologies, alternative energies, and energy saving equipment are new concepts for the Bulgarian market, but they have gained popularity with some help from

EU. Since many different financial sources have become available, these types of activities have great future in Bulgaria.

Gross investment reached 19% of GDP in 1999 and slightly decreased in the following two years. At the same time gross national savings reached 14% of GDP in 1999 and fell to 10% the following year. Gross capital formation kept growing at an increasing rate and reached 25% growth in 1999 and 10-12% in each of the following years.

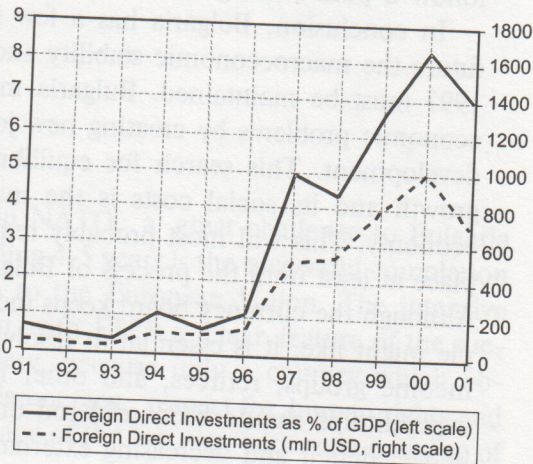
Private investments are generally low but increasing. More stimuli are needed to invigorate the private investment process. The state also stepped away from providing direct aid to troubled sectors. In 1999 2.2% of GDP was earmarked for direct state aid, and in 2000 this figure fell to 0.37%. This aid is mostly distributed to the steel and shipping industries, as well as to subsidies for central heating services.

The savings of the majority of the people fell considerably. This was mostly due to low level of income. Another factor is the nature of the financial system, which is underdeveloped in regard to consumer short- and long-term loans, mortgage financing, etc. Regardless of the limited options available at the moment, people need to be informed of the various possibilities for their personal investment strategies, investment portfolios, retirement accounts, credit cards and bank debit cards, etc.

Foreign direct investments (FDI) grew at an accelerated rate during this period. Some foreign investments were induced by privatization, while the lower cost of labor and the increasing profitability in some sectors attracted others. In the communication and finance sectors, profitability reaches 35% or more, while in industry on average this indicator is around 10% or less. The largest portion of foreign direct investment came from the EU, with Austria, Italy, and Germany as the leading foreign investors.

More than half of the foreign direct investments are concentrated in industry. The trade,

Figure 4. Foreign Direct Investments



More than half of the foreign direct investments are concentrated in industry. The trade, finance and tourism sectors follow.

finance and tourism sectors follow. In 1999 more than 50% of foreign direct investments come from outside European Union, but in 2000 this share fell to 22%. These statistics are consistent with Bulgaria's choice to follow a path leading to EU accession.

In conclusion, Bulgaria has a few important tasks ahead. In the near future the macroeconomic stability and controlled inflation achieved after 1997 must be maintained. Bulgaria must also try to tackle its remaining economic problems by creating new jobs and reducing the social costs of development. This search for equilibrium between sustainable economic growth and its social costs is the major challenge facing the Bulgarian economy. This will most probably require keeping the Currency Board in place at least until the process of Bulgaria's accession to EU is completed. Although the currency board keeps incomes from growing as much as people might like, it is essential to resolving the other problems of the lowest income groups, retirees, and other impoverished groups. Of course, all expenditures should be considered under the requirements for low or no budget deficit and decreasing external debt.

The Bulgarian financial system must improve considerably to allow for more accessible consumer credits, mortgages, etc. Appropriate investment policies, especially for the pension funds and other social security funds are in order. In the near future, having in mind the demographic structure of Bulgaria, it is safe to say that the social security pay-as-you-go system must be more aggressive and inclusive in order to succeed.

The prospect of Bulgaria's accession to EU is very elating and stimulating. At the same time, though, the Bulgarian economy has to prepare to withstand market forces and the competitive pressure it will face from more economically developed countries. Within the next few years, Bulgaria will be completely ready to face this challenge.