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Center for Economic Development

Bulgarian Economy 2005

The Bulgarian economy experienced a slow-down in growth during the second half of 2005. The business climate deteriorated and, around the end of 2005, stabilized at levels lower than the 2003 and 2004 average. The highest score of the Estat Business Climate Index was considerably lower than the highest 2004 levels.

The output growth rate registered a decline and exports were stagnated while imports rate sky-rocketed mostly due to the sharp increase in private consumption and investments. A negative trend is observed in the dynamics of industry, services and agriculture; the growth in industry is ahead of that for services while the agricultural sector continues downward. Labor productivity (measured as value-added per person employed) is falling behind the growth in employment. This translates into a regression to the negative trend of 2004 following a break in this trend registered in the first half of 2005.

At the same time, investments into the economy have grown considerably as a result of the lending boom, the requirements for companies to cover certain standards, and the recovery effort in the aftermath of recent floods.
The major macroeconomic problem – the current account deficit - is deepening, thus raising concerns about the overall financial stability. The share of energy resources in imports increased sharply; the share of investment goods is also up which means that the trade deficit is caused not just by the rise in consumption but also by the increased investment activities and should therefore not be judged as an entirely negative development.
Foreign investment for 2005 is expected to reach BGN 2.2 – 2.3 b; it is worth noting that no major privatization deal is involved in these estimates. If these investments are indeed harnessed into productive rather than speculative activities, they will guarantee the stability of the balance of payments and the Currency Board.

The “taming” of the lending expansion was a temporary phenomenon and a new surge rekindled concerns over the long-terms stability of the banking system. The stock market closed 2005 on a downward trend while insurance registered a growth as a result of some liberalization measures.
In the public finance field, the trend of increased reallocation through the budget continued; the budget surplus is also continuously growing while the tax and social security burden in 2006 will be at least as heavy as it was in 2005.
As regards individual business sectors, the positive developments in tourism and telecommunications have been most dynamic. Transport and agriculture, especially given the flood-inflicted damage, are lagging behind.
Economic growth in Q3 slowed down more than expected and reached 4.6 per cent on a year-over-year basis. Given the 5.6 per cent growth during the nine months of 2005 it seems highly improbable that growth for the entire year would top the 2004 figures (5.6 per cent) because Q4 growth can hardly exceed the 5.8 per cent mark.
The growth characteristics during the quarter under review include a considerably slow-down in production, stagnated exports of goods and services, increased stocks and higher consumption and investment manifested in higher import rates.
On the supply side, the GDP growth of 4.6 per cent (over Q3 of 2004) is formed from the (slower) growth in value-added of

3.4 per cent and (accelerated) growth in adjustments by 13.9 per cent. The growth in adjustments results in higher growth of GDP at market prices over the growth of value-added at basic prices and corresponds to the increased growth in the imports of goods and services.

Negative developments are observed in all three economic sectors (industry, services and agriculture). Although the valueadded for the industrial sector is growing at a higher pace as compared to the third quarter of 2004, the trend of acceleration registered in the first half of the year turned into deceleration. Nevertheless the growth in industry is again higher than growth in services; the latter continues to slow down. In 2005, agriculture suffered the most negative developments and continued on a path of progressive stagnation.
Another negative sign for growth potential is the fact that both the general indicator and the compound business climate indicators in industry, construction, retail trade and services measured over the last three months of 2005 through the NSI business surveys fall below the levels for the respective months of 2004.

On the demand side, a negative development has been the continued stagnation in the exports of goods and services; exports grew by just 0.9 per cent on year-over-year basis and its contribution to GDP growth was only 0.6 percentage points. At the same time the contribution of domestic demand sharply increased, reaching 15.9 percentage points, which is mostly accounted for by the increased consumption rate for households (a contribution of 7.0 percentage points) and investment (contribution of 4.7 percentage points). A new development in Q3 was the increase in stocks whose contribution to GDP growth rose to 4.1 percentage points over 1.7 percentage points for the preceding quarter. The accelerated imports on the background of unchanged exports deteriorated the overall negative contribution of foreign trade in goods and services to minus 11.3 percentage points.

Final consumption accelerated due to the increase in private consumption to 9.7 per cent while collective consumption registered a slowed-down growth rate at a year-over-year basis of 5.2 per cent.
The sharp increase in the growth of investment to 25.4 per cent in Q3 is attributable to quality and safety standards that enterprises had to cover by end-2005, the lending expansion of commercial banks and the efforts to recover flood-inflicted businesses. Still under the influence of these factors, high growth rates in investment can be expected for the fourth quarter.Starting from the second quarter of the year, stocks in the economy have grown considerably which is, to a certain extent, attributable to unfinished construction works. During the third quarter however (if the export dynamics does not change) we can safely predict an increased share of finished products intended for export but not actually exported.
Following a span during the first half of 2005 during which the export of goods and services gained pace and its growth rate exceeded the rates for the respective quarters of 2004, Quarter 3 saw only a little less than 1 per cent increase in the exports of goods and services over the exports in the third quarter of 2004. This situation also reflects the consequences of natural disasters that plagued the country in the summer. The imports of goods and services continued to grow at an accelerated pace during Q3 in response to the need to strike a balance between the delay in production and the sharp increase in domestic demand.

The increased share of capital formation in GDP (reaching 26.6 per cent for the three quarters) persists on the background of increased external savings and lower national savings.

Financing investments at the expense of national savings has shrunk to 55 per cent for the first nine months of 2005 over 77 per cent for the same period of 2004.
The current account deficit on the balance of payments for the ten months 48 since the beginning of 2005 was twice as high as the same period of 2004. Apart from the traditionally largest and increasing negative contribution of the trade balance deficit, the current account deficit has also deteriorated due to the lower positive balances for services and current transfers. The growth rate of exports has been decreasing in nominal terms while the growth rate of exports has been going up. In spite of the increase in the positive balance for tourism, the deteriorated negative balance for transport and the reverse trend (from positive to negative) for the balance for "Other Services" have resulted in a lower positive balance for services and the overall negative contribution of this group to the current account movements.
48 Source: BNB, balance of payments.

The only positive contribution to the current account movement is the smaller negative balance on incomes.
In 2005 the proceeds from travels grew at a considerably lower pace as compared to previous years and there is a downward trend in the net flow (in absolute terms) of current transfers. For the ten months of 2005 (over the same period of 2004) the net inflow of current transfers in absolute terms is 1.7 per cent less, and the proceeds from cash transfers - which represent 70 per cent of the overall volume of transfer payments have gone down 7.4 per cent. Deficit coverage on the current account with foreign direct investments will probably stay below the 100 per cent mark during the entire 2005. This coverage is even expected to fall below the 2001 levels; 2001 is the only year during the 1999-2004 period in which the deficit was covered below 100 per cent by foreign direct investments.
The ratio of foreign trade to gross domestic product - which illustrates the degree of integration of Bulgaria's economy into global economy - has grown from 103 per cent in 2004 to 119.5 per cent in 2005. The total trade volume for the ten months of the year has grown by about 23.7 per cent over the same period of 2004 with the increase for the entire year being about 22 per cent. The rate of growth in imports (27.6 per cent for the first ten months) has been ahead of export rates (18 per cent) all through the year. Thus the foreign trade deficit (exports FOB – imports CIF), which for 2004 reached 3.6 b Euro, or 45 per cent of exports, for the ten months of 2005 already climbed to EUR 4.1 b (53 per cent of exports) with a tendency to reach EUR 5.1 b (54 per cent of exports) before the year is out.
The product structure of exports registers a trend of gradual increase in the share of goods with higher added value. As regards imports, along with the sharp increase in the value and share of energy resources, a major increase is also measured for investment goods, almost half of which constitute machinery, plant, and equipment. The restructuring of most Bulgarian enterprises has been finalized; the construction of new plants and the expansion of existing ones are ongoing. This will enable the stable growth of exports by over 20 per cent per year. At the same time, no decrease in the growth rate of imports is to be expected.

The stable economic environment, the relatively good rate of return and moderate risk rates for investment in the country continue to attract foreign investors. Practically all international observers share the opinion that the considerable volume of foreign capital that has infiltrated the country and continues to grow is a sign of the high marks given to the potential of Bulgaria's economy to grow and provide good opportunities for business development. Annual investments are expected to reach EUR 2.2-2.3 b for 2005 (as much as in 2004) notably, without a major privatization deal.

In 2005, the monthly fluctuation of consumer prices was mostly determined by the dynamics of the market prices of consumer goods and services, which, in turn, depends mostly on the changes of food prices.
The sharp slowing down in the growth of value-added in the economy during the third quarter broke the trend since the beginning of 2005 of leading growth in productivity as compared to employment.
Throughout 2005 the number of unemployed people continued to drop, with the changes based on labor force surveys (LFS) and the Employment Agency data being very close. As a result, the index calculated using the LFS is now a single-digit number - 9.2 per cent for the third quarter of 2005, and under the Employment Agency methodology it was 10.36 per cent in November and will probably also shrink to a single digit soon.
In October 2005, the Estat index of business climate in Bulgaria reached its highest value for the year – 3.73. This figure is however considerably lower than the values of approximately 5 points registered in the middle of 2004. The fact that the maximum value was registered in autumn instead of summer is mostly attributable to managers' uncertainty associated with the general elections and the difficulties surrounding the new government in July and August. The index value registered in October is the result of for the year's highest investment attitudes (25.9), in combination with the satisfactory, almost unchanged condition of companies and the traditional skepticism vis-à-vis state policy in the economic sphere. In the first months of the Stanishev Cabinet, feedback on the condition of the business environment is much the same as that received at the end of the term in office of the government headed by Saxe-Coburg-Gotha.
The deteriorated overall economic outlook in country (following the 11- year long-term maximum reached in June) which was registered with the month-by-month decline of NSI general business climate indicator since July (by 2.3-3.5 points) also continued in October when the indicator dropped another 3.6 points from its September level. In November and December we can assume that there has been a certain stabilization in the business climate levels because the indicator in November is only 0.5 points below the October level, and in December it remains at November levels. Thus at the end of 2005 the business climate indicator fell below the average values for 2003. An unfavorable trend as regards the growth potential is the fact that both the general and the compound business climate indicators in the monitored sectors are, generally speaking, below the levels for the respective months of 2004.
In 2005, measures were taken in the country to support entrepreneurship and improve the business environment. Some of the more important ones include: the easing up the start-up of business with the adoption of the BULSTAT Act; the implementation of projects in support of SMEs; the faster and improved public procurement procedures, the preparation for the Single European market etc. Another major development was the launching of the National Innovation Fund. New SME credit lines were established; European standards were introduced in several sectors; the Bulgarian Export Insurance Agency stepped up its activity. The government announced its intention to boost public-private partnerships in a number of areas. Meanwhile problems persisted or deepened in some areas of major significance.

• The Government Program presented by the new cabinet does not set clearly enough the priorities in respect of structural reform, including the privatization and concessions of monopolies and infrastructure. It is possible that the limited resource of state-owned companies and the legal disputes over "major" privatization and concession deals to further slow down the structural reform in the country.

• Businesses are still not satisfied with the outcomes in terms of easing up of regulatory regimes and the implementation of ARARACEA.
• There still exists distrust in the objectivity and transparency of public procurement which should translate into further upgrading of the normative base and the capacity for its implementation.
• The major barriers that continue to impact negatively businesses and entrepreneurship are to a large degree associated with the state of the judiciary and the presence of corruption practices. The long-awaited reform of the judiciary branch registered no progress over the past year. Irrespective of the steps made in this direction, radical changes are yet to happen.

The development in public finance as at the end of 2005 is characterized by the preserved major trends underlying in structure of Budget 2006. Among these are the increase in the actual quota of reallocation through the budget, the overblown chronic budget surpluses and the strengthened role of the state in Bulgarian economy. The changes in tax and social insurance legislation will not result in smaller tax and social insurance burdens but will only lead to a shift in this burden from direct to indirect tax, which is in itself a positive development but does not represent an incentive for increased economic growth.

Positive developments on the labor market have continued, fuelled by economic growth and active measures and employment policies. The lasting and deepening structural discrepancies related to the level of education and qualifications of the workforce still present a serious problem. Companies are increasingly faced with difficulties to recruit properly qualified staff due to the deteriorated quality of secondary and university education. The Government's program in this area is appropriately tuned. The most important priority should be improving the employability of the workforce through training, qualification and basic literacy for the unemployed. The implementation of alternative forms of working time organization and of employment in general should be particularly encouraged; the flexibility in the labor market should be improved.

In 2005 personal incomes registered a moderate growth in real terms which is comparable to previous years. The Government's estimates predict a 10 per cent increase in incomes next year but there are a number of signs showing that such growth would prove hardly achievable in light of the accelerating inflation. The Government's policy on incomes has set some ambitious goals and proposed annual raises of the minimum wage, expanding the scope of collective bargaining by sectors and companies, and the application of flexible remuneration schemes through changes in the labor and social insurance legislation. These programmatic intentions sound well-grounded and show willingness for change and development but it still remains to be seen whether they can be legally and institutionally enacted.

Cutting the size of pension insurance contributions was the most important step in the area of social policy. It was justified by the success of the pension reform of 2000 and the improved collection rate for social insurance payments. At the same time there has been a constant trend in the course of the past year of increase in the assets of pension funds and growing numbers of insured individuals. The potential positive effect of the reduced social insurance burden in 2006 can only be realized in an environment of long-term financial stability of the state social insurance system. For this purpose, the government should take the following steps:
• set up an investment Silver Fund to finance the deficit;
• establish mechanisms for a more flexible participation in the pension system and boost the employment rate for active elderly people;
• improve the collection rate of contributions to the National Revenue Agency and establish an integrated information

system;

• establish economic incentives and a tolerant tax environment for the development of the second and third pillar of pension insurance and ensure the liberalization of the investment regime.

The healthcare reform posed one of the most important social problems in the course of the past year and these should find a solution in the shortest possible deadlines. These problems include: the collapse in the financial scheme for healthcare establishments where indebtedness reached over BGN 200 m at the end of the year; the large share of people whose health insurance status has been suspended (over 1 million people, or 13.6 per cent of the population); problems related to the supply of medicines and problems related to unregulated payments patients are forced to make for medical services.

The Government’s efforts to ensure high-quality health services and guarantee the social rights of health-insured people should focus on:

• restructuring and privatization of hospitals to achieve a balance of public expenses in health insurance;

• introducing a transparent and controllable mechanism to finance health services through national health accounts;

• establishing an integrated information system and introducing personal electronic cards to ensure efficient control on patients' health insurance status;

• ensuring the adequate legal regulation of contracts for the supply of free and partially paid medicines and price monitoring;

• regulating the conditions and procedure for supplementary payments by patients for services received.

The main priority for public administration in the area of environmental policy in 2005 was to achieve compliance of national legislation with the currently valid EU directives. The good progress in this aspect is beyond any doubt. The participation of Bulgarian projects in international emission trade schemes under the Kyoto Protocol has been active and successful, while results in the field of waste management and recycling, industrial pollution proved below expectations, and the management of natural resources at the regional and local level was ineffective.

The banking system continues to dominate the financial sector and financial mediation in this country. The latest statistics show that the lending boom was only temporarily restrained. Following a short decline, the growth in lending returned to its high levels and thus rekindled apprehensions for the medium-term and long-term stability of the banking system. In November BNB announced a new set of measures to curb the credit expansion; these can be positively appreciated. It is necessary to abandon administrative measures and turn entirely to market-oriented measures. The decision to monitor and regulate non-bank lending, and particularly leasing companies, is justified.

The capital market closed the year on a note of declining indexes in spite of the good performance of key traded companies. The turnover increased on the background of a smaller number deals, which is typical for underdeveloped markets like ours which is highly dependent on individual package transfers. Compensatory instruments registered a one-third decline in prices. The discussions over the institutional future of the Bulgarian Stock Exchange and the Central Depository in increasingly internationalized capital markets gained new prominence.

The insurance sector in Bulgaria registered a 35 per cent growth during the nine months of 2005. The structure of insurance portfolios is dynamically changing, following the trends of the European market. Important legislative changes were introduced in December more closely aligning Bulgarian legislation with the EU acquis. These changes place the sector in a free market environment but also increase the requirements the sector has to meet. There has been some concern about the two cases of insurance companies which had their licenses withdrawn by the Financial Supervision Commission (FSC). Against this background, the regulatory measures accompanying this liberalization (by FSC and other regulatory bodies), especially in the area of mandatory insurance, are of particular importance.

The end of 2005 revealed the major importance of Russian energy resources to the European and, more specifically, to the Bulgarian economy, and stressed the need for diversification of energy sources.

Currently, the steps towards liberalization on the electricity market do not rule out an administrative approach because the State Energy and Water Regulatory Commission preserves its role as regulator in charge of setting power generation quotas and prices. In the international market of electric power, Bulgaria became the co-founder of an Energy Community between the EU and South Eastern Europe countries. The common energy market thus established is expected to attract substantial investments into the energy infrastructure. The privatization procedure for the cogeneration plants in Varna and Rousse are again in a deadlock after the winning company in both deals withdrew from the deal in Varna. At the end of 2005, the longdeferred rehabilitation and modernization of Maritsa-Iztok 1 was launched.

In the transport sector, some changes were introduced in the management of state-owned companies. The Ministry of Transport (MT) announced its priorities but failed to achieve a breakthrough in any of the major concession deals. In 2005 the total passenger flow for the international airports in Sofia, Varna, and Bourgas reached five million people which demonstrated the need to improve the infrastructure of passenger terminals and increase their capacity. During the last quarter of 2005, yet another extended deadline was agreed for the new terminal of Airport Sofia, and the final decision on concession for the two seaside airports was postponed yet again. At the end of 2005, MT disbursed BGN 12 m from its budget to provide support to BDZ EAD. The financial stabilization of the company was also listed in the Government’s Program. In order to achieve lasting effect, the company should be restructured – an issue on which no clear plans have yet been outlined. There are still a number of aspects to be clarified about the Trakia Motorway. The Government announced that it is planning to commission 60 km of motorway in 2006; this however does not satisfy the country’s needs for new road infrastructure.

In 2005 tourism continued on its upward trend even though it failed to achieve the growth rates that are both desirable and achievable. A major reason behind this is the poor condition of the infrastructure which continues to be a barrier to the development of tourism in many of the country's regions. Experts claim that Bulgaria has the potential to welcome about 10 million foreign tourists each year. To date, however, this figure is more in the range of 3-4 million people. Revenues from tourism could reach EUR 7-8 billion on condition that the transport and other infrastructure is considerably upgraded and the sector successfully deals with existing deficiencies.

The process of rapid renovation and expansion of tourist facilities continued throughout 2005. In parallel with some undisputed success stories, the unresolved issues also persisted: chaotic and poorly planned construction that is damaging the environment. The difficulties in recruiting properly qualified staff were even more clearly outlined. The snowballing growth in specialized infrastructure is not accompanied by adequate staff training and qualification. There is still a lack of sufficiently targeted and properly addressed advertising effort to present Bulgaria as a tourist destination. The accumulation of these and some other problems condemns the country to the status of a location mostly visited by low-income tourists. Other specialized forms of tourism continue to be underdeveloped.

At the beginning of the winter season forecasts are good: they point at an increase in the number of tourists by 10-20 per cent. Winter resorts continue to be most attractive to Russian, British, Greek and Macedonian tourists.

The year was not a good one for the agriculture sector. The downpours in summer damaged (and, in many places, even destroyed) part of the crops. This strengthened the trend for the shrinking share of this sector in national economy. Efforts were mostly focused on the preparation for the country's accession to the EU. On the one hand, this means establishing the necessary organization for application of the acquis and tackling the delay (as registered in the Monitoring Report) in the setting up of a Paying and Intervention Agency and an Integrated Administration and Control System through which EU funds will be disbursed after 2007. On the other hand, a major challenge continues to be the change in the structure of agriculture, which is still dominated by small holdings that must merged and diversify their activity. The European Commission's recommendations also addressed the need to improve the coordination of efforts on trade mechanisms and common market organization for various agricultural products, strengthening veterinary control on the domestic market and building the necessary veterinary border inspection posts.

Clustering, a relatively new approach in the development of regions in Bulgaria, continued in 2005. This is an efficient tool for regional development, economic growth and achieving a balance and cohesion between regions. Over the past years a number of good practices were implemented in local government. Serious attention was given to public-private partnerships in developing strategic and planning documents for municipalities and in implementing specific projects. At the end of 2005, a consensus was reached on the European Union budget framework for 2007-2013. Over this period, Bulgaria will receive EUR 11.1 b, which is EUR 144 m more than the initially proposed amount. The resources Bulgaria will receive from EU pre-accession and structural funds are the largest when calculated on a per-capita basis as compared to all new Member-States. The money will be channeled for rural development and support to farmers, the construction of roads, improving the competitiveness of the economy and enterprises etc. The successful absorption of European funds requires the establishment of institutional and administrative capacity. Some of the most important strategic and planning documents in regional policy were adopted in 2005. These are: The 2007-2013 National Development Plan with its pertaining Operational Programs, and the National Regional Development Strategy. An major development was the elaboration of regional plans setting the goals and priorities in the development of planning regions in the country.

In the area of high technologies in late 2005, positive developments were mostly limited to the telecommunications market. Changes include the purchase by a foreign investor of one of Bulgaria's largest alternative operators – Orbitel, and also the (un)expected turn in the development of the point-tomultipoint licenses. At long last, the third GSM operator is now operational; it is owned by BTC - Vivatel. At the end of the year a new edition of the 2005 eBulgaria analysis was published; it measures the country's progress in respect of the use and spread of ICT in economic, political and public life.

2005 was marked by numerous changes in legislation associated with Bulgaria's major foreign policy goal: the country's EU accession in 2007. By that date, the process of harmonization of national law with the acquis must be completed. At the end of its mandate the 39th National Assembly adopted amendments to Constitution of RB; one of the major new aspects being that EU citizens would be legally allowed to acquire land ownership rights in Bulgaria as of the date of accession. ?he 39th National Assembly approved some major changes in executive court proceedings by introducing the institution of private bailiffs; it adopted a Code on International Private Law, several major pieces of legislation related to registrar proceedings, the public offering of securities and public procurement. In the first months of its mandate, the 40th National Assembly continued its efforts on the harmonization of national law. One of the major achievements in legislation was the adoption of the new Penal Procedure Code which defines in a new way the prosecutor's and investigative structures' role in the pre-court proceedings on criminal cases. The Parliament also approved amendments to the Commercial Code, the regulation of the public offering of securities and public procurement.

The rich text of the report could be foung in Bulgarian here.

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