Dimitrios Kyrkilis

Bulgaria: From Transition to the European Union Membership

1. Introduction

During the early stage of economic transition Bulgaria performed poorly experiencing a deep recession, soaring inflation rates, and high and increasing unemployment rates. In 1997 the real GDP level accounted for 69 per cent of the 1990 level compared with 88 per cent in 1991 while the unemployment rate was around 14 per cent. Annual inflation rates were in the range of 82 per cent to 62 per cent in 1992 to 1995 while escalated to 123 per cent in 1996 and 1,082 per cent in 1997.[1] Economic failures in this early period may be explained by adverse initial conditions, and lack of consensus over reforms mainly grounded on the uneven distribution of costs and benefits accruing from transition.[2]

Initial conditions were unfavourable. The country lacked any democratic tradition and had no memory of free market institutions. Despite the emphasis on heavy industry during communism, the economy inherited inefficient industries with a large share of non-viable enterprises hardly fit for restructuring. Among all transition countries Bulgaria had the highest dependence on trade with the former COMECON economies meaning that its international trade collapsed following the abolition of central plan in partner econo-

---

[1] Data sourced in Economist Intelligence Unit (EIU), *Country Profiles and Country Reports*, Bulgaria 1996, 1997, 1998, and 1999.

[2] J. Hoey–L. Kekic, *What's wrong with the Balkans?,* Country Forecast Economies in Transition, Regional Overview, The Economist Intelligence Unit, London 1st Quarter 1997.

mies. In addition, it inherited an unsustainable level of foreign debt.[3]

Both society and political parties failed to agree on a reform agenda. A large share of the population was afraid that it would be adversely affected by certain reforms, such as privatisation and enterprise restructuring, setting constraints to policy makers. The latter avoided painful reforms, especially structural and institutional reforms, they were indecisive about the reform agenda and the speed of reforms, thus implementing inconsistent and ineffective macroeconomic and structural reform programs. Reform policy failed to establish efficient institutions, especially a strong and well regulated financial system for supporting the smooth operation of markets.[4]

The combination of unfavourable initial conditions, weak structural and institutional reforms, and macroeconomic imbalances contributed to the emergence of a severe transition economic and political crisis in 1996-97 characterised by both hyperinflation and a heavy recession.[5]

The 1997 elections brought political stability to the country, with a government enjoying a clear majority in the Parliament and a strong commitment to market-oriented economic policies; which represented a significant qualitative break from the past. The new government decided upon a reform agenda that in fact initialized the economic transition process. The aim of the paper is to analyse

[3] For an analysis of weak initial conditions as applied to Bulgaria see S. Totev, "The Bulgarian Economy in Transition: Possibilities for Balkan Regional Integration", in G. Petrakos−S. Totev (eds), *The Development of the Balkan Region*, Ashgate, London 2000; and R. Dobrinsky, *Transition Failures: Anatomy of the Bulgarian Crisis*, WIIW Research Reports No. 236, May 1997.

[4] See R. Dobrinsky, "Multi-Speed Transition and Multi-Speed Integration in Europe: Recent Economic Developments in the Balkans", in Petrakos−Totev (eds), *op.cit*.

[5] See Tables 1, 2.

this process, assess its outcome, and identify the main hurdles the Bulgarian economy is expected to face in the future.

2. Macroeconomic Stabilisation

In July 1997 a currency board regime was introduced aiming at monetary stability by subordinating money supply growth to a target of constant exchange rate parity. The most evident result of the reform program was macroeconomic stabilisation translated to:

- Disinflation of the economy. However, the economy remained vulnerable to inflationary pressures stemming from cyclical volatility of food, energy and international commodity prices, as well as from hikes in excises and government regulated utility prices such as electricity, natural gas, and heating. These factors, in addition to growing domestic demand have caused inflation rates to fluctuate after 2001, but within a range of moderate single digit levels, as it is shown in Table 1.
- Fiscal consolidation (see Table 1) achieved through the application of a tight fiscal policy, in addition to tax reforms consisting of lowering the corporate tax rate, reducing the marginal income tax rates, increasing the untaxed income threshold, while applying higher excise taxes on alcohol and tobacco in order to offset the foregone tax revenues arising from these changes.
- Reduction of the public debt to sustainable levels (see Table 1), mainly through both streamlining the domestic public debt and relying mainly on foreign borrowing for funding the public sector borrowing requirements (PSBR). However, the overall decrease of the PSBR along robust GDP growth resulted in the declining of the public foreign debt to GDP ratio, from almost 95 per cent in 1997, to approximately 30 per cent at the end of 2005, and to an estimated about 23 per cent at end of 2006.

3. Economic Growth

Macroeconomic consolidation contributed to achieving sustainable and robust GDP growth. Annual growth rates are presented in Table 2.

Real GDP growth is mainly sourced in domestic demand, especially gross fixed investment whose share of GDP increased from 15.7 per cent in 1995 to 27.4 per cent in 2005. Final consumption maintained a rather stable ratio to GDP at around 86 percent partly due to the slight decline of household consumption as a percentage of GDP from 70.7 per cent in 1995 to around 68 per cent in 2003-2005, and partly due to the moderate expansion of the public sector consumption from 15.3 per cent of GDP in 1995 to above 18 per cent of GDP in 2004-2005.

The external sector has made a negative contribution to output expansion, overall. The merchandise trade balance, after yielding surpluses up to 1997, turned negative thereafter. Deficits have been increasing ever since, amounting to 21.6 per cent of GDP in 2006 (see Table 3) compared with 3 per cent in 1998. Despite strong merchandise export growth (see Table 2), especially after 2000; the share of exports to GDP increased from 40.8 per cent in 1995, to only 43.2 per cent in 2005. Meanwhile, imports expanded their share from 40 per cent to 63 per cent, in the same period. The merchandise exports to imports ratio fell from 102 per cent in 1995 to 68.5 per cent in 2005.[6] These figures indicate that Bulgaria's economic growth is biased towards imports.

From the supply side of the economy industrial output, after declining in 1997-99; achieved positive growth rates, accelerating from around 2.2 per cent in 2000-2001 to 18.3 per cent in 2004. In 2005 and 2006 the industry's expansion rate is estimated at 6.3 per cent and 8.2 per cent respectively. However, the share of industry to GDP fell from 31 per cent in 1995, to around 25 per cent in 2002-2006, on average.

[6] The above figures are presented aaccording to own calculations.

Agricultural activity developed along a mixed annual growth trend, reducing its GDP share from 12.7 per cent in 1995 to 7 per cent in 2006 and resulting in unstable contributions to the GDP.

Services proved to be the leading sector of the economy. After increasing its GDP share from 41 per cent in 1997 to 51.3 per cent in 2002, services maintained as share around 50 per cent in 2003-2005 followed by a decrease to 49 per cent in 2006. In average, the expansion rate of the sector was proportionate to the GDP growth rate for the whole period. It is evident that GDP growth favoured services at the expense of both manufacturing and agriculture.

4. The External Account of the Economy: Imbalances and Risks

The mounting merchandise trade deficits boosted the current account deficit, from below 6 per cent of GDP in 2000, to approximately 12 per cent of GDP in 2005 and to almost 15 per cent in 2006 (see Table 3). Current account deficits have been fully bridged by Foreign Direct Investment (FDI) inflows, amounting to an annual average of above 11 per cent of GDP in 2003-2005, compared with 6.5 per cent of GDP in 2000-2002. In 2006, FDI inflows are estimated to have reached a share of 16.4 per cent of GDP, almost equivalent to the GDP share of the current account deficit, and managed to meet 11.4 per cent of the estimated current account deficit.[7] Strong FDI inflows ensure the sustainability of the expanding current account deficits. However, there are concerns about the long run sustainability of FDI inflows at levels that are adequate to offset the current account deficits.

There is evidence that FDI inflows are being reallocated from the purchase of privatized entities, to real estate purchasing. In 2006 about one third of FDI inflows went to both real estate and construction, according to the European Bank of Reconstruction and Development (EBRD).[8] Given that the privatization process is

[7] For a detailed analysis of both the current account and FDI flow see Table 3.

[8] See European Bank of Reconstruction and Development, *Transition Report Update 2007*.

almost concluded;[9] this tendency is rather likely to persist. If this is the case, there might be two possible consequences.

a) The benefits of FDI to the economy in terms of assisting output expansion, and export-building capacity, as well as employment, and finally GDP growth; would be less than in the case of FDI directly related to business investment.

b) FDI inflows would become more unstable than in the case of business related foreign investments, reducing perhaps the overall amount of FDI inflows, and hence the current account deficit coverage ratio.

In any case, the external vulnerability of the economy would increase.

At the same time, Bulgaria has made significant progress in the process of adapting its institutions and laws to the standards prevailed in the European Union (EU). For instance, the country has introduced full currency convertibility allowing free mobility of any kind of capital, including business profits, a simple tax system, laws guaranteeing the equal treatment of foreign and domestic investments, e.g. foreign firms may purchase land for commercial and business purposes as domestic firms may do, there is no double taxation, etc. Despite that there are still steps to be taken towards full convergence to the EU norms, e.g a modern code of food safety and hygienic is still missing, the existing framework safeguards the smooth operation of markets and the prevalence of a business friendly enterprise environment. Both this and the EU membership would facilitate the future flow of foreign capital. The question is to what extent future foreign capital inflows would be adequate to cover an expanding current account deficit.

Expanding current account deficits set certain risks for Bulgaria's future economic growth. These risks are associated with monetary stability, the sustainability of which requires a steady inflow of foreign capital in order to cover the merchandise trade im-

[9] According to EBRD's transition indicators both small and large scale privatisation in Bulgaria has achieved a score of 4, meaning that the country has reached the standards of advanced market economies. See European Bank of Reconstruction and Development (EBRD), *Transition Report 2006*.

balances. Failure to secure such a steady inflow of foreign currency resources would require the implementation of austere domestic economic policies, aiming at curbing excessive growth of domestic demand. By lowering domestic demand growth both imports expansion would slow down and firms would be set under pressure to divert sales towards exports. However, such policies would have negative consequences for economic growth, as well as for per capita incomes, standards of living, and finally for the convergence towards European Union averages.

5. Sources of External Imbalances

The fundamental determinants of external imbalances are rooted in domestic structural imbalances. A large share of Bulgarian GDP, above 50 per cent consists of both non-tradable goods, i.e. services except tourism, and agriculture. Agriculture has performed poorly, due to structural deficiencies and low or no transformation, especially as regards property rights, redistribution of land, and financing. As a result, growth has been negative or low, and productivity has failed to improve. Although non-tradable goods cannot be exported, their production requires inputs partly imported. In addition, incomes generated in the non tradable goods sectors of the economy are partly spent on imported goods. Overall, as both non-tradable goods sectors' output and incomes expand,[10] imports are generated without necessarily being matched by exports. Development of tourism, international transportation services, and other tradable services, as well as of efficient agriculture, may contribute towards alleviating this source of external imbalances.

The fact that manufacturing accounts for a small share of GDP (see above), and it concentrates in a handful of low value added branches constitutes another domestic structural imbalance mir-

[10] Prices, hence incomes in non tradable goods and services sectors because they do not face international competition tend to increase faster than prices and incomes in tradable goods and services sectors. Besides, they represent an inflation source that both threatens international competitiveness and constraints the increase of real wages, constraining consumption finally.

rored in the structure of exports and imports. Although the vast majority of exports (over 60 per cent of total) consist of manufactures, the value of exported capital goods, as well high technology products, and differentiated goods, is still very low. High technology goods and investment goods account for around 3 per cent and 13 per cent of total exports respectively. Merchandise exports show a considerable concentration in consumer goods that account for over 35 per cent of total, while clothing and footwear alone constitute one of the main sources of exports, accounting for a share of total merchandise exports of almost 20 per cent. Raw materials and semi-fabricates account for above 40per cent of total exports of goods.

Acceleration of exports requires that they would be increasingly competitive by international standards. The international competitiveness of low value added products is based on their pricing, which, in turn is mainly supported by both favourable relative wage and exchange rates. Pressures for wage increases would erode competitiveness. This could be offset by increasing labour productivity, the realisation of which requires continuous investments. The extent to which fast enough investment rates could be sustainable in the long run, especially as both the need for increasing current consumption would also increase and the productivity of capital would decrease as capital accumulation would be building up is questionable. Besides, new sources of low labour cost competition emerge worldwide, reinforcing the need for even higher labour productivity, hence for an even faster investment rate.

At the same time, the need to preserve international competitiveness would lead to the application of restrictive incomes policies at home not allowing wages to increase faster than labour productivity. Such policies not only could keep labour cost low but they would facilitate the materialization of high profit rates necessary to sustain a high investment rate. In any case, the living standards of wage earners would be suppressed affecting domestic consumption accordingly.

The structure of imports is quite different from that of exports. Approximately one third of total imports consist of investment

goods that are necessary for the ongoing process of enterprise restructuring and economic modernisation. The country is also dependent on imported energy. Currently, energy imports account for around 17 per cent of total imports. Energy price volatility would affect the imports account accordingly. The proportion of imported raw materials and semi-processed goods used for manufacturing final products as a percentage of total imports is considerable. In fact, trade in these product categories is in deficit indicating that the import content of the aggregate output is significant and any increase of production including exports and acceleration of investment would increase imports and possibly the trade deficit. Yet, investment is meant to sustain high rates in order to sustain high labour productivity rates and, therefore, international competitiveness of exports. In that case investment goods imports would continue to be a significant part of total imports burdening the trade deficit.

As personal incomes increase demand structures shift in favour of sophisticated goods and services not supplied locally. These goods and services have an income elasticity of demand above unit, and their imports increase faster than incomes at home. In contrast exports have an income elasticity of demand below unit because they are rather traditional goods (Ricardo type). In that case the growth rate of exports is less than the growth rate of incomes abroad, thus facing an upper limit to their acceleration rates.

Overall, under the given structures of exports and imports, imports are rather likely to grow faster than exports, widening the merchandise trade deficit.

6. Conclusions

Although Bulgaria is a late reformer, macroeconomic stabilisation has been ensured thanks to the currency board regime and the political consensus on pursuing pro-market reforms systematically. This has contributed towards achieving robust and sustainable economic growth.

Current account deficits are substantial and expanding, and they are rooted in large and expanding merchandise trade deficits. In turn, trade deficits are determined by structural imbalances of the domestic economy. These imbalances may be found in the high imported inputs content of the final output caused by the narrow manufacturing base of the country that is concentrated in low value added Ricardo type of products. That implies that any increase of the final output would expand imports.

The concentration of domestic manufacturing in a narrow base of low value added branches affect the structure of exports that focus in low value added Ricardo type goods, which base their international competitiveness on low labour cost rather than technical characteristics, technology, and quality. The low labour cost advantage is being eroded by the emergence of new sources of low labour cost production sites abroad, (particularly in China) and by pressures for wage increases at home. Meanwhile, sustaining the low labour cost advantage of the country sets certain constraints to policy makers, which should keep wage increases below labour productivity rates. Such a policy would skew the distribution of income in favour of capital facilitating investment and luxury consumption. Both would result to increasing imports while the suppressed wages would equally suppress domestic consumption of less sophisticated goods able to be manufactured locally. Therefore, firms would need to export a larger share of domestic output, which would further constrain wage increases in supporting international competitiveness. Ultimately, this process may lead to a trap of low wages-low domestic final consumption- need for increasing exports-low wages, and so forth.

Additionally, luxury consumer goods of high quality enjoy an income elasticity of demand above one implying that their imports would increase faster than domestic incomes. Meanwhile, exports, because they are Ricardo type has an income elasticity of demand below unit, hence their growth rates would be lower than income growth rates abroad. In their effort to sustain market shares abroad they have to struggle against foreign competitors for lower prices.

Therefore, the need for maintaining the low labour cost advantage would continue.

Due to the narrow manufacturing base investment goods, energy products, semi finished goods, all of which are necessary inputs for the production process would continue to be imported, and they would expand as domestic output including exports and investment would grow.

The combination of the above determinants would sustain trade imbalances, and through these it would maintain the external vulnerability of the economy. In turn, this may set certain hurdles to the Bulgaria's economic convergence to the EU through the application of policies keeping wage rates lower then labour productivity rates, and curbing domestic demand in general. Only the restructuring of production in favour of modern, technology advanced, and quality and innovation driven sectors may alleviate the long run risks stemmed by the current production structure.

Table 1: Basic Macroeconomic Indices, 1995-2006

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
CPI, End-Year, %	32.7	311.6	547.7	1.6	7.0	11.3	4.8	3.8	5.6	4.0	6.5	6.5
Fiscal Balance, % GDP	-5.2	-18.9	2.0	1.3	0.2	-0.6	-0.6	-0.6	0.0	1.7	3.1	3.6
Public Debt, % GDP	68.7	94.9	92.4	78.5	73.0	73.9	63.4	53.4	44.8	37.6	29.2	22.8 (estimate)

Source: IMF, *Financial Directory*, International Monetary Fund, various issues; EBRD, Transition Report Update, European Bank of Reconstruction and Development, May 2007; own calculations.

Table 2: GDP Growth Rates, 1995-2006

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Real GDP Growth Rate, %, Year-on-Year	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.1
Merchandise Exports (Imports) Growth Rate, %, Annual	35.8 (32.2)	-8.5 (-10.0)	1.0 (-3.0)	-15.1 (0.3)	-4.5 (11.2)	20.4 (17.9)	6.0 (11.6)	4.7 (4.8)	32.3 (37.7)	40.2 (41.0)	18.4 (25.7)	28.2 (27.8)

Source: IMF, *Financial Directory*, International Monetary Fund, various issues.

Table 3: Current Account Balance and FDI Flows, 2000-2005

	2000	2001	2002	2003	2004	2005
GDP at Current Prices, USD million	12,600	13,599	15,600	19,985	24,648	27,188
Merchandise Trade Balance, USD million	1,175.52	-1,580.46	-1,594.44	-2,518.50	-3,643.26	-5,398.80
Merchandise Trade Balance, % GDP	-9.3	-11.6	-10.2	-12.6	-15.0	-20.3
Services Trade Balance, USD million	505.53	402.1	481.56	593.7	837.92	810.06
Income Balance, USD million	-323.00	-304.00	-261.00	-626.00	-658.00	-528.30
Transfer Balance, USD million	290.00	499.00	548.00	696.00	1,074.00	908.50
Current Account, USD million	-703.69	-983.99	-826.68	-1,855.40	-1,417.28	-3,132.69
Current Account, % GDP	-5.6	-7.2	-5.3	-9.3	-5.8	-11.8
FDI inflows, USD million	1,001.50	812.94	904.66	2,096.70	2,653.30	2,605.60
FDI outflows, USD million	-3.28	-9.66	-28.34	-26.50	-216.96	-307.60
Net FDI flows, USD million	998.22	803.28	876.32	2,070.20	2,436.34	2,298.00
FDI inflows, % GDP	8.0	5.9	5.6	10.4	10.8	12.04
Net FDI flows, % Current Account Deficit	141.9	81.6	106.0	116.6	171.9	73.4

Source: International Monetary Fund, *Financial Directory*, various issues; EIU, *Country Reports and Profiles, Bulgaria*, Economist Intelligence Unit, various issues; own calculations.