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Bulgaria

Economic Policy Review

Briefing Note

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Table of Contents

1. Executive Summary[1]

The current report aims to provide an assessment of the Bulgarian economy focussing on macroeconomic issues and financial services. It also takes a specific view on the impact of corruption on relevant developments.

The list of policies analysed is by no means exhaustive, but attempts to reflect the remit of the European Parliament's ECON Committee.

Political brief[2]

With Bulgaria's EU membership secured, relations between the Bulgarian Socialist Party (BSP) and its main partner in the ruling coalition, the centrist National Movement for Stability and Progress (NMSP, formerly Simeon II National Movement), are likely to deteriorate. They had been fairly stable with the immediate task of assuring EU accession limiting the in-fighting. But the political agendas of both parties have little in common beyond EU-related issues. Furthermore, the NMSP's approval ratings have fallen below the 5% minimum threshold for parliamentary representation (compared to a 43% share of the vote in the 2001 election and just under 20% in the 2005 polls). The NMSP's position has been subject to further speculation following its poor performance in this June's election to the European Parliament.

Although the NMSP's leader, Simeon Saxe-Coburg, remains committed to the ruling coalition, there seems to be a rising opposition to staying in the coalition among NMSP deputies with a majority of NMSP members appearing to support leaving the coalition. Even if the NMSP can keep together in the interim, local elections later in 2007 could act as a catalyst for fragmentation of the party.

The current parliamentary opposition led by the centre-right United Democratic Forces (UtdDF, an alliance dominated by the Union of Democratic Forces/UDF), the conservative Democrats for a Strong Bulgaria (DSB) and the nationalist Ataka is unlikely to play a role in the disintegration of the government of Prime Minister Sergei Stanishev (BSP). Furthermore, the NMSP is unlikely to favour leaving the government for co-operation with opposition parties in the current parliament, given the conflict that the NMSP has previously had with them.

Elections to the European Parliament were held in June 2007 with a new rightist political party, Citizens for European Development of Bulgaria (CEDB; EPP), finishing just ahead of the European Socialist Platform (PSE). Both secured five seats in the EP. Four of the 18 Bulgarian EP seats went to the predominantly ethnic Turk Movement for Rights and Freedoms (MRF; ALDE), nationalist Ataka (ITS) secured 3 seats while the NMSP (ALDE) managed to get just one seat.

The established political right in Bulgaria is still recovering from its poor showing in these elections. A crucial role is likely to be played by a new rightist political party, Citizens for European Development of Bulgaria (CEDB). Founded by Boiko Borisov, mayor of Sofia, the CEDB has been gaining political momentum since it was registered as a party in late 2006. Their support is based on the party's promise to reduce crime and corruption, and it owes much to the populist appeal of Mr Borisov. The party seems to hold conservative views in most economic and social policy areas, and supports Bulgaria's ongoing integration into the EU and NATO.

[1] This briefing note draws heavily on information and policy briefs from the European Commission, The Economist Intelligence Unit, the IMF as well as national agencies in Bulgaria.

[2] See Economist Intelligence Unit, Country Profile July 2007, Bulgaria; European Parliament DG External Policies, Policy Department Information Note on Political and Economic Developments in Bulgaria.

Perhaps prompted by the rising threats to its hold on power, the BSP is planning a reshuffle of the cabinet. Aside from the results of the European election and their fallout, some changes were made necessary by a political scandal that culminated in the resignation of the economy and energy minister and two deputy ministers.

Economic synopsis

- **Growth:** Real GDP is estimated to grow this year by 6.1% and by 6.2% in 2008, according to the European Commission's spring forecasts. The catching-up of the economy will continue to be supported by strong investment growth. Noticeably higher real wage growth backed by productivity gains and sustained job creation will imply a gradual increase in disposable incomes and thus private consumption growth. Public consumption could also rise in line with a moderate fiscal expansion.

- Robust domestic demand with imports outpacing exports despite a gradual strengthening of the export potential of the economy is expected to widen the **trade deficit** to above 22% of GDP in 2007. The **current account deficit** is also sizeable and expected to further increase this year to an estimated 16.6% of GDP mainly as the result of higher repatriated profits weighing on the income balance.

- **HICP Inflation** increased from an average 6% in 2005 to 7.4% in 2006 mainly due to higher excise duties on alcohol and tobacco. In 2007 inflation is expected to come in at around 4.5% thanks to lower oil prices and the base effect stemming from the excise duty increases in 2006.

- **Fiscal Policy:** A fiscal expansion is expected in 2007, but Bulgaria will remain in the comfortable position of budget surpluses with an estimated reduction of the surplus from 3.3% of GDP in 2006 to just 2% in 2007. On the revenue side, strong revenue growth and improved tax collection limited the effect of a 6 percentage points decrease in pension contributions. Reductions in corporate and personal income tax rates in 2007 will lower revenues despite further improved collection and compliance. At the same time, expenditure restraint and lower interest payments due to the early repayment of debt helped reduce the expenditure to GDP ratio.

- **Financial Services:** Bulgaria's financial sector is largely bank based, private and foreign-owned and profitable. Banks are predominantly deposit financed and have relatively high capital reserves. The change in the ownership structure has helped to enhance competition.

- **Corruption:** Bulgaria ranks as 57th on the 2006 Corruption Perception Index of Transparency International, with a score of 4.0. Of the EU Member States, only Poland and Romania score worse.
  In its June progress report on the Cooperation and Verification Mechanism with Bulgaria the European Commission assessed the country as having made mixed progress. According to the Commission, the Bulgarian government is committed to judicial reform and cleansing the system of corruption and organized crime. The necessary draft laws, action plans and programmes have been prepared.

  However, the real test can only be met through determined implementation of these actions, and there is still a clear weakness in translating intentions into results. While recognizing the efforts, the Commission maintains that much remains to be done and that progress is still insufficient.

The following table sets Bulgaria in comparison with some other central and eastern European countries in terms of some key economic figures:

Comparative Economic Indicators (2006), EU25=100

EU25=100	*Bulgaria*	*Romania*	*Hungary*	*Poland*	*Czech Republic*
GDP p.c. PPP	35,7	36,3	63	51	76,6
Labour productivity per employee	34	36,9	71,1	59,2	68,7
Employment (17-64)	58,6	58,8	57,3	54,5	65,3
Unemployment rate	9,0	7,3	7,5	13,8	7,1

Source: Eurostat

Main features of country forecast - BULGARIA

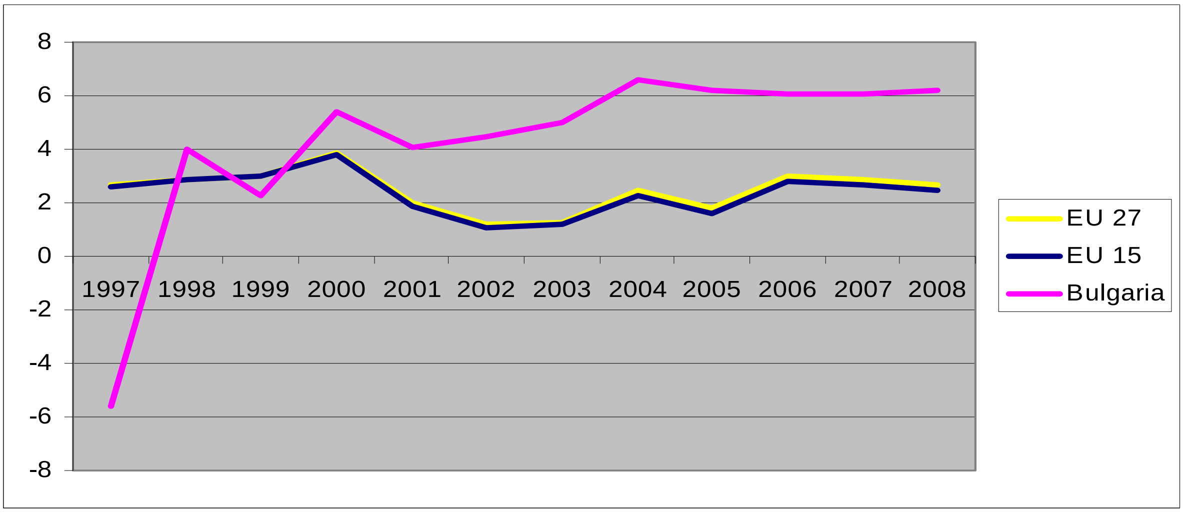
		2005			Annual percentage change					
	bn BGN	Curr. prices	% GDP	92-02	2003	2004	2005	2006	2007	2008
GDP at constant prices		42.8	100.0	0.1	5.0	6.6	6.2	6.1	6.1	6.2
Private consumption		30.0	70.2	0.9	5.5	5.9	6.1	7.5	7.8	8.0
Public consumption		7.7	18.0	-4.8	7.7	3.8	2.5	2.4	3.5	4.0
Gross fixed capital formation		10.3	24.2	-	13.9	13.5	23.3	17.6	16.0	14.0
of which : equipment		-	-	-	-	-	-	-	-	-
Exports (goods and services)		25.5	59.5	-	10.7	12.7	8.5	9.0	10.0	9.6
Final demand		75.3	176.0	-	9.0	9.0	9.4	9.8	8.8	8.7
Imports (goods and services)		32.5	76.0	-	16.4	14.5	13.1	15.1	12.1	11.6
GNI at constant prices (GDP deflator)		43.1	100.7	-	4.2	6.2	5.7	5.5	5.9	6.1
Contribution to GDP growth :	Domestic demand			-	8.2	8.6	8.8	10.4	10.2	10.2
	Stockbuilding			-	1.1	0.6	1.5	1.9	-0.5	-0.5
	Foreign balance			-	-4.3	-2.5	-4.1	-6.2	-3.6	-3.6
Employment				-0.9	3.0	2.6	2.7	2.4	1.4	1.2
Unemployment rate (a)				15.5	13.7	12.0	10.1	9.0	8.2	7.4
Compensation of employees/head				-	5.1	4.9	5.9	7.8	9.0	9.5
Real unit labour costs				-	1.2	-4.0	-1.3	-3.8	0.2	0.1
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				64.4	1.8	5.1	3.8	8.1	4.0	4.2
Private consumption deflator				67.1	0.2	4.4	5.2	5.2	3.2	3.5
Harmonised index of consumer prices				-	2.3	6.1	6.0	7.4	4.2	4.3
Trade balance (c)				-4.7	-13.7	-14.9	-20.2	-21.5	-22.1	-22.7
Current account balance (c)				-3.4	-5.5	-6.6	-12.0	-15.8	-16.6	-17.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.5	-5.9	-5.1	-10.8	-15.1	-15.6	-15.8
General government balance (c)(d)				-	-0.9	2.2	1.9	3.3	2.0	2.0
Cyclically-adjusted budget balance (c)(d)				-	-0.9	1.6	1.3	2.8	1.6	1.8
Structural budget balance (c)				-	-0.9	1.6	1.3	2.8	1.6	1.8
General government gross debt (c)				-	45.9	37.9	29.2	22.8	20.9	19.0

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
(d) Including proceeds relative to UMTS licences (see for more details note 10 on concepts and sources).

2. General Economic Situation

Growth Development

Bulgaria's real GDP growth over the years since the crisis of 1996/1997 is depicted in the graph below with high growth rates stabilising over the last few years as evidence of the catching-up process.



Source: Eurostat, values for 2007 and 2008 are estimates.

In 2006, GDP growth slowed significantly in the fourth quarter to 5.7% year on year compared to 6.7% in the third quarter with all three branches of the economy contributing to this development. The growth rate for the whole year stands at 6.1%.

Export-oriented sectors drive industry even if export performance remains weak (see below). Demand from the booming construction sector is ensuring a strong contribution to industry from construction inputs. With buoyant construction and investment activity real GDP growth is estimated by the Commission to reach 6.2% in 2008.

The financial and currency crisis of 1997

The economy of Bulgaria declined dramatically during the 1990s with the collapse of the Comecon to which the Bulgarian economy had close ties. These difficult conditions were exacerbated by inconsistent economic policies of the government. Liberalisation and privatisation of state-owned enterprises did not progress as quickly as planned and the subsidies for these companies led to a steadily growing budget deficit as well as problems at both state-owned and private banks, which had had to take over the loans granted in the days of central economic planning and to continue to lend to state-owned enterprises despite visible problems and risks. Lending to new or already privatised enterprises further added to the bad loans problem, as banks were not used to lending along purely economic lines.

The consequences were fatal. The central bank was handed the task of both eliminating the budget deficit and capitalising banks. As a result, the money supply and with it inflation increased dramatically to 96% reaching a staggering 1 061% in 1997. At the same time, most banks ran into financial difficulties and depositors began to fear for their deposits and for the value of assets denominated in lev (BGL). Where still possible, they subsequently withdrew their deposits and converted them into USD or DEM.

At the end of 1995, two big state-owned banks and several smaller private banks collapsed. In 1996, 17 banks, including four state-owned banks, ran out of funds. This triggered an economic crisis. In the first two months of 1997, the lev's exchange rate against the dollar rose by 600 per cent, triggering hyperinflation and a political crisis.

A new government had to deal with the financial crisis, and a currency board was set up in 1997. The amount of money in circulation was tied to existing DEM reserves (EUR from 1999). The currency board prevented any further deficit spending by the central bank and restored confidence in the local currency at the same time. Monetary stability and an improved investment climate were the result.

Source: Banking markets in central and eastern Europe: Bulgaria – emerging stronger from a crisis, Die Bank – Zeitschrift für Bankpolitik und Praxis, http://www.die-bank.de/index.asp?issue=082003&art=272

Inflation data from the IMF.

Foreign trade and external balance

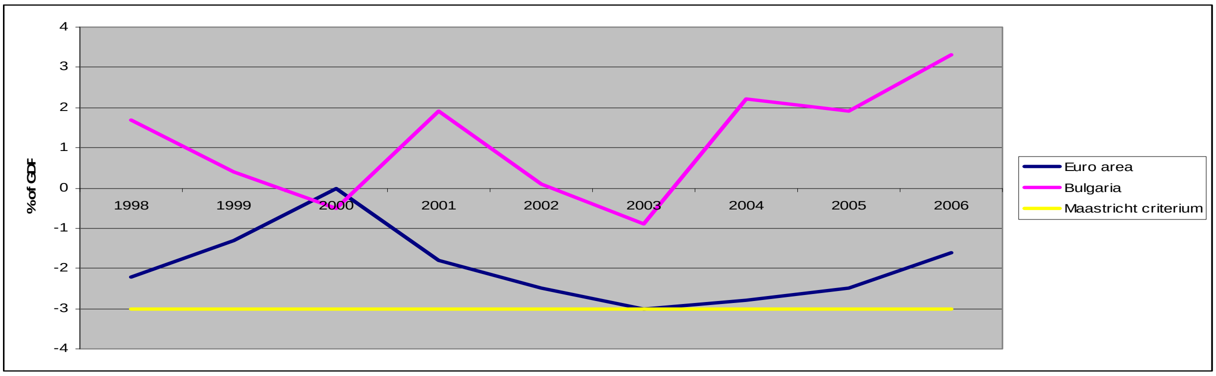
Bulgaria's export performance is weak and import growth in the first quarter of 2007 was relatively moderate (16% year on year) compared to recent standards yet considerably higher than export growth. The moderation in the import growth is mainly attributed to lower fuel import costs with exchange-rate developments having played an important role in reducing expenditure on energy imports.

The deteriorating net trade gap reaching 21% of GDP in 2006 ensured an increase in the current account deficit. A decrease in the surplus of the services balance due to lower growth of tourism revenues, lower current transfers and lower net incomes form abroad further added to the increase in the current account deficit which subsequently reached 15.9% of GDP in 2006. With the trade deficit expected to further widen to above 22% of GDP, with higher repatriated profits weighing on the income balance, the current account deficit is also expected to further increase. Financing the current account is currently not a problem. The deterioration in the current-account balance was more than offset by net financial inflows.

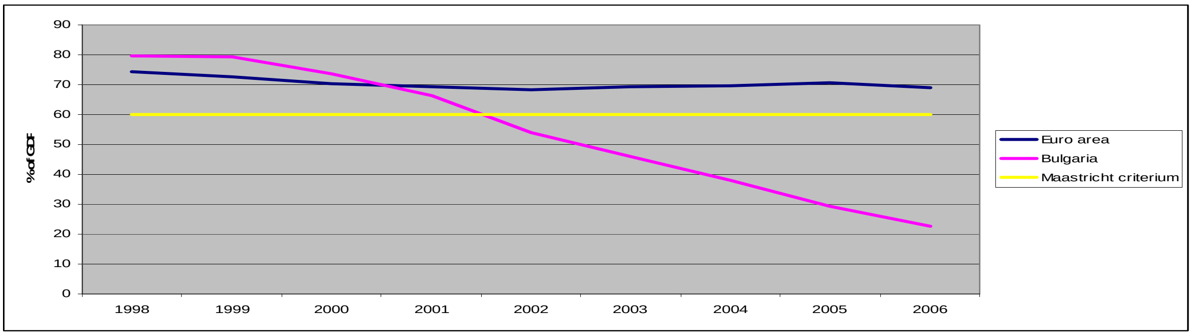
Indeed, foreign direct investment (FDI) is booming in Bulgaria. Among the components of the financial account, net inflows of FDI reached 761 million EUR, matching the performance of 2006, which was a record year for FDI. Boosted by foreign property purchases, it will continue to flow into the country, but a high level of foreign borrowing will nevertheless be required to finance the external deficit as privatisation and related inflows wind down.

Fiscal policy

Fiscal policy in Bulgaria is highly disciplined. In 2006 the budget closed with a surplus of 3.3% of GDP which was achieved despite increased wages in the public sector and more social spending. For 2007 and 2008, the European Commission estimates the budget surplus to decline to 2.0%.



Disciplined fiscal policy also allowed for the continuous reduction of the general government debt as depicted in the graph below. Here, the Commission forecasts a further decline in the coming to years.



The fiscal performance looks thus impressive. However, with a view to the growing external imbalances, spending restraint is becoming more and more important. If fiscal policy would be lax, an already sizeable current-account deficit could easily reach dangerous levels. A current-account deficit in combination with a currency board, as is the case in Bulgaria, is only sustainable as long as the country continues to attract significant inflows of foreign capital. So far, the financing of the Bulgarian current account deficit is no problem. However, eventually, the current-account deficit should decrease so that an unorderly unwinding of the external imbalance does not force a devaluation of the currency which could delay the adoption of the euro.

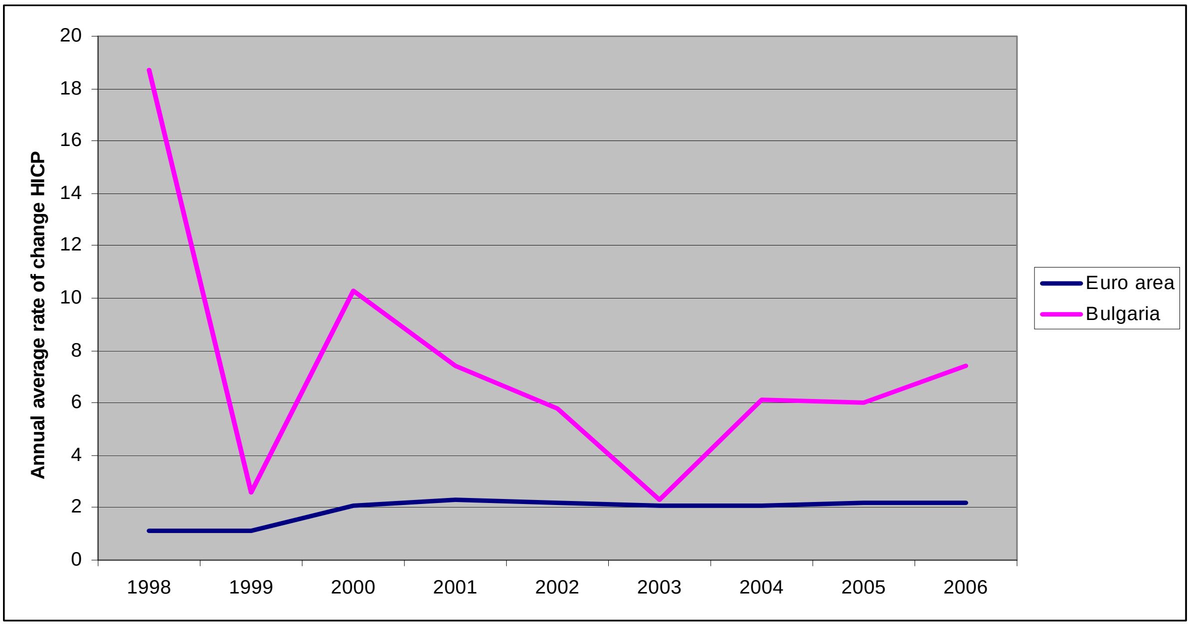
The revenue side performed well with higher direct tax receipts, notably corporate taxes the collection of which was up by 59.4% in year-on-year terms reflecting the increasing profitability of Bulgarian companies and the fact that a lower corporate tax rate seemed to have encouraged more compliance.

Expenditure grows relatively modestly due to modest increases in two of the largest spending categories: social expenditure and maintenance.

Expenditure on wages and salaries increased by 9.3% year on year but wage policy is becoming an increasingly divisive issue. The government conducts it in line with a long-standing ordinance which was originally recommended by the IMF. This forbids wage increases in loss-making enterprises in which the publicly owned stake is more than 50%. The government's actions in cases to which the ordinance applies (an increase was authorised for the Sofia heating utility prompting demands from other enterprises) were a further instance to expose a deep divide between the Bulgarian Socialist Party (BSP) and the National Movement for Stability and Progress (NMSP) joined in the ruling coalition.

Inflation

Annual consumer price inflation averaged 7.4% in 2006, according to Eurostat. For 2007 and 2008, the Commission estimates inflation to reach 4.2% and 4.3% respectively which constitutes a step in the right direction seeing that Bulgaria aims to join the euro zone as soon as possible and the inflation development represents a major obstacle to this. The graph below shows the evolution of consumer price inflation in Bulgaria over the last few years.



Excise duties on alcohol and tobacco were raised sharply in early 2006, and since duties were no further increased in 2007, a strong base effect will contribute to inflation falling significantly in 2007 as estimated by the Commission. Inflation in labour-intensive areas of the service sector was above the overall average which is consistent with strong nominal wage increases. On the other hand, the appreciation of the lev vis-à-vis the US dollar is constraining inflationary pressures from imports.

Exchange rate policy and monetary environment

Bulgaria has a currency board in operation which was first put in place in reaction to the 1997 financial crisis and has been maintained since with an unchanged parity of 1 EUR = 1.95583 BGL first vis-à-vis the Deutsche Mark and since 1999 against the euro. This arrangement means that the Bulgarian National Bank has no discretion over monetary policy.

The currency board arrangement is expected to remain in place until Bulgaria joins the euro zone. Risks to the lev's exchange rate are low in the short term, but would rise in the medium term if the external financing requirement relating to the high current account deficit were to become more difficult to cover.

Concerns about rapid credit growth prompted the National Bank to tighten lending restrictions in March 2005, but with credit growth slowing in 2006, these restrictions were removed at the start of 2007. There are signs that credit growth is accelerating again in 2007, and the annual rate of growth is likely to stay above the 20% year-on-year target agreed with the IMF.

As regards competitiveness, inflation and a strengthening of the euro are likely to cause the real exchange rate of the lev to appreciate moderately in 2007 and 2008. Bulgaria's comparatively low labour costs, however, should cushion the economy from the impact on price competitiveness of US dollar weakness vis-à-vis the euro.

Bulgaria's IMF stand-by arrangement[3] expired in March 2007. In April Bulgaria repaid its entire outstanding IMF debt. The repayment together with other early repayments of multilateral debt is a symbol of the strength of public finances in Bulgaria. It has also helped to reduce the stock of government and government-guaranteed debt. The authorities have decided not to enter into another lending arrangement.

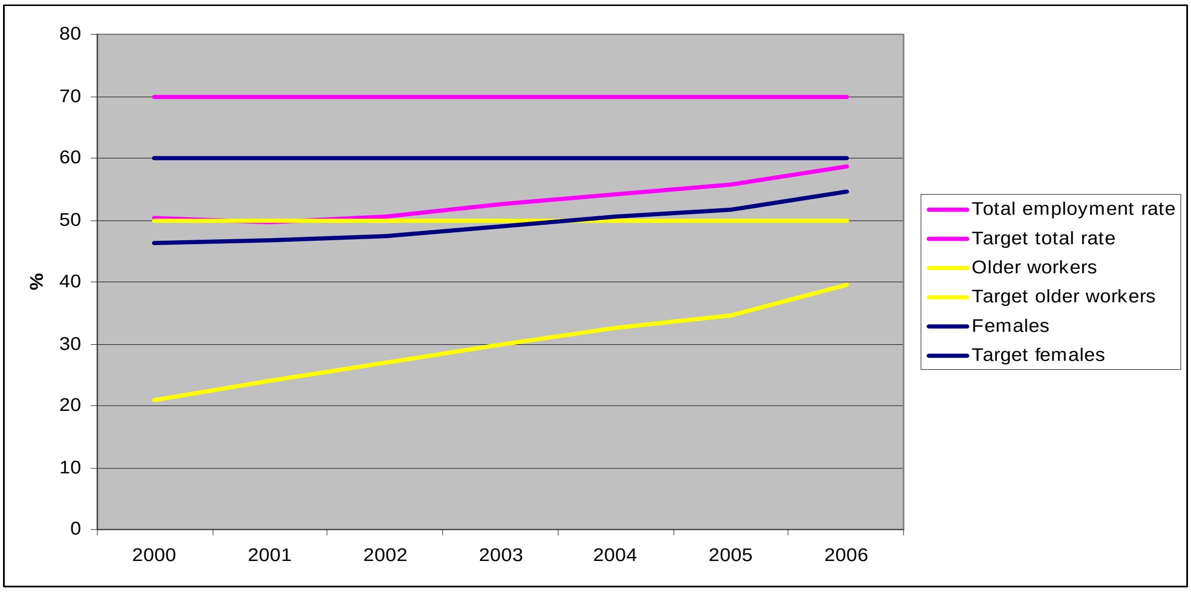
Employment and Wage policy

Registered unemployment is continuing to fall. Much of this development is due to strong demand for workers in construction and agriculture. The number of long-term unemployed, defined as those who have been registered unemployed for more than one year, has also continued to fall.

With regard to reaching the employment targets foreseen in the Lisbon Strategy, Bulgaria has made a favourable development since 2000. In 2000, total employment rate stood at only 50.4%, the employment rates for elderly workers and women were 20.8% and 46.3% respectively. In 2006, these values looked much improved, in particular as regards elderly workers, at 58.6% for the total employment rate, 39.6% for elderly workers and 54.6% for women.

[3] **Stand-By Arrangements** form the core of the IMF's lending policies. A Stand-By Arrangement provides assurance to a member country that it can draw up to a specified amount, usually over 12-18 months, to deal with a short-term balance of payments problem.

However, a long way remains to reaching the targets as the following graph illustrates.



Source: Eurostat, data for 2006 is provisional.

Gross nominal wages rose sharply in the first quarter of 2007 by an average of 16.7% year on year. Wages in the public sector increased by 13.1% while those in the private sector rose by 20.1%. Adjusted for inflation, this makes for fairly brisk real wage growth of 10.9% in the economy as a whole. The private sector recorded a higher value (14.2%) than the public sector (7.5%).

There are no signs yet that strong wage growth is eroding Bulgaria's labour-cost advantage, with Eurostat data still showing the country has the lowest average labour costs in the EU27.

3. Maintaining the currency board on the way into the Euro zone

With joining the EU Bulgaria took the commitment to become a member of the euro zone in compliance with the Treaty provisions. An Agreement signed in 2004 between the Council of Ministers and the Bulgarian National Bank (BNB) on the introduction of the euro in the Republic of Bulgaria states the second half of 2009 or 1 January 2010 as the target date. This has been reconfirmed many times in other documents related to European integration.

Consequently, Bulgaria expressed its intention to apply for ERM II membership at the earliest possible time after EU accession, while unilaterally maintaining the currency board arrangement in place. The strategy on the way to full EMU membership outlined in the Government/BNB agreement is based on the following principles:

- Joining the Exchange Rate Mechanism II at the earliest possible date after the date of official accession of Bulgaria to the EU;
- Maintenance of the currency board arrangement until joining the euro zone, at the existing level of the fixed exchange rate of the Bulgarian lev;
- A unilateral commitment on behalf of the Bulgarian government and BNB to maintain a zero deviation of the exchange rate from the fixed level;
- Adherence to the minimum period defined in EU legislation for participation in ERM II and a timely taking of all necessary actions concerning the euro zone membership application procedure.

The BNB and the government consider the above path as the only relevant strategy to exit the currency board arrangement. Regarding the changeover to the single currency, full compliance with the Maastricht criteria will be the responsibility of both the central bank and the government. Economic data show that Bulgaria has moved towards the Maastricht Criteria on nominal convergence and already steadily fulfils three of them: the debt, deficit and interest rates criteria. In addition, adhering to the currency board rules until joining the euro zone entry would seem to guarantee compliance with the exchange rate criterion.

Work on the inflation criterion, however, shows a more difficult picture as under a currency board the central bank cannot directly target the inflation. Although inflation is estimated to fall substantially in 2007 (from over 7% to 4.2%) and remain at a similar level in 2008 (4.3%), given a growing momentum behind disinflation, meeting the criterion[4] seems a relatively hard task to achieve taking into account that catching-up economies display higher rates of inflation.

The government of Bulgaria has vowed in its first Convergence Programme to continue working towards the achievement of a high and sustainable economic growth rate while maintaining a stable and foreseeable macroeconomic environment. With a view to the fulfilment of this objective, the topmost priority of the government will be the maintenance of sustainability of public finances and a level of government and government-guaranteed debt, which allows for a stable compliance with the Maastricht criteria.

[4] In July 2007, the Maastricht inflation criterion stands at 2.6%.

EU finance ministers approved Bulgaria's first Convergence Programme. Based on its content, the EU made two recommendations:

- Bulgaria should aim for higher budget surpluses in 2008-09 than are currently set out in the programme, in order to contain external imbalances. The government has already committed itself to a surplus of 2% of GDP this year, even though the budget approved by parliament was based on a surplus of just 0.8% of GDP. However, the EU is concerned that the surplus of 1.5% of GDP specified in the convergence programme for 2008-09 is too low.
- More progress should be made in reforming the healthcare system.

4. Financial Services

Bulgaria's financial sector is largely bank based, private and foreign-owned and profitable. Banks are predominantly deposit financed and have relatively high capital reserves. The change in the ownership structure has helped to enhance competition. Given the rapid rise in loans, in particular to households and for housing, Bulgaria's banking sector is exposed primarily to credit risk.

I. Banking

The Bulgarian banking sector is now mostly private and foreign-owned and conditions have improved considerably since the currency and financial crisis in 1997. The EBRD index of banking sector reform increased from 2.7 in 1999 to 3.7 in 2005, reaching a level similar to that of the new EU Member States. Since 1997, the number of banks has remained stable around 35, but the bank density (number of banks per 100,000 inhabitants) has risen slightly to 0.45, which is marginally lower than in the Euro area (0.54). The number of state banks has gradually declined, but the asset share of private banks increased from 53% in 1999 to around 98% at the end of 2004. Similarly, the share of total banking assets held by **foreign-owned banks** (which include the country's five largest banks) rose from 18% in 1997 to approximately 80% by the end of 2004. This share is much higher than that of the Euro area (22%).

The change in the ownership structure has helped to enhance competition in the Bulgarian banking sector. This is illustrated by the change in the level of **concentration** and the evolution of the spread between lending and deposit rates. The five largest banks accounted for around 52% of total banking assets at the end of 2004, compared with 62% in 1999. Furthermore, the drop in the spread between lending and deposits rates suggests that the change in structure has boosted competition in the Bulgarian banking system.

Banking intermediation in Bulgaria is still relatively low compared with the Euro area. This is partly due to the low level of per capita income, but can also be attributed to the financial crisis, when the ratio of banking sector assets to GDP dropped significantly from 180% in 1996 to 37% in 1999. Total banking sector assets increased on average by about 6 percentage points of GDP per annum, reaching 68% of GDP at the end of 2004, compared with more than 280% in the Euro area.

Bulgarian banks are predominantly deposit financed and have relatively high capital reserves. Foreign liabilities are increasing. Deposits of households and non-bank corporations remain the largest liability, accounting for 56% of total liabilities.

The Bulgarian banking system is generally well supervised, highly capitalised and profitable. However, credit growth has continued to accelerate in recent years, which may have increased financial stability risks. Since 2000, real domestic credit in Bulgaria has grown on average by more than 30% annually. Credit growth boosts financial deepening and can largely be considered a catching-up phenomenon brought about by deregulation, liberalisation and privatisation. It allows for a better allocation of savings to investment opportunities and facilitates higher growth. Although no significant deterioration in bank loan portfolios has been observed, most financial sector indicators are "lagging", thus credit growth developments require close monitoring.

While credit growth is high, the level of private sector credit is still relatively low and the debt burden of households and enterprises appears to remain contained. Financial intermediation in Bulgaria is still limited by international standards, as evidenced by a private banking credit-to–GDP ratio of 45% (2005). Lending to households and mortgage lending have risen particularly quickly in recent years, albeit from very low levels.

Household debt amounts to around 16% of GDP (2005), which together with a comparatively low ratio of interest payments to disposable income of around 1% does not constitute a heavy debt service burden. In terms of credit concentration, the largest exposures are to the processing industry (22.3%), the hotel industry (6.7%) and the construction industry (5.6%).

Relatively high profitability and a solid capitalisation are the basis for the banking sector's capacity to absorb negative shocks. **Increased foreign participation** in the banking sector through privatisation has helped to boost efficiency and financial intermediation.

II. Insurance

At the end of 2006 in Bulgaria there were 37 licensed insurers, 21 of them non-life insurance companies, 14 life-insurance companies and 2 mutual co-operative societies, whose activity was in the field of life insurance. 13 companies carried out activity on the market of voluntary health insurance.

In 2006 insurers realized a **gross premium income** of BGL 1,246,949 thousand (€ 637 555 thousand), a growth of 16.62% to 2005. In comparison with the period 2001 - 2005, when the growth of the gross premium income exceeded 23%, the increase of premium income decreased slowly. The accounted gross premium income was 2.54% of the GDP (insurance penetration). The integration of the Bulgarian insurance market in the single European insurance market will most probably lead to entry of new market participants and thus enhance competition. Quality improvements as well as new insurance products/services are expected.

The gross premium income in **life insurance** the gross premium income amounted at BGL 186,181 thousand (€ 95,193 thousand), while the **non-life insurance** premium income reached BGL 1,060,768 thousand (€ 542,362 thousand). A more dynamic growth was noticed of life insurance compared with non-life insurance, which was conditioned by the increase in incomes and enhancement of the insurance culture of the population. At the end of 2006 **the ratio between life insurance and non-life insurance** in the gross premium income were respectively 14.93% and 85.07% (14.03% and 85.97% in 2005). There was a stronger growth rate in life insurance than in non-life insurance, which confirmed the forecasted gain of the life insurance significance in the next years. A premium income of BGL 22,620 thousand was realized by the **voluntary health insurance** in 2006.

In the **structure of life insurance products** life insurance, (total 73.90%, thereof life proper insurance 83.79% and annuity 16.21%) stood for the greatest part. In the portfolio structure of the companies carrying out **non-life insurance** activity a major share of 64.06% was taken up by the motor vehicle insurances (Autocasco – 38.68% and Third Party Liability Insurance Related to the Possession and Use of Motor Vehicles, including insurance Green Card – 25.38%). In insurance Autocasco the premium income grew by 17.11% compared to 28.92% in 2005.

Foreign institutional investors show considerable interest in the insurance sector. The reason might be the relatively stable economic environment and the regulation/supervision of the insurance activity. Another issue was the fixed date set for Bulgaria's accession to the European Union, as well as the existing potential for growth of the Bulgarian insurance market. From 36 insurance companies, 24 were subsidiaries of foreign companies (10 in life insurance and 14 in non-life insurance).

In 2006 the subsidiary companies of foreign companies realized 69.81% of the premium income in insurance (68.46% in life insurance and 70.05% in non-life insurance). It may be expected that the interest in acquisition will continue, as the insurance sector is dynamically developing within the steadily developing economy.

On the basis of premium income **market concentration** differs remarkably between the sectors. While in the life insurance sector the first three companies are regaining market share since 2002 and market concentration weakens, in the non-life sector their share decreases constantly. The same situation can be observed in the voluntary health insurance sector where the most important insurer is loosing market share towards the rest of the market.

A **Guarantee Fund** is formed by contributions of the insurers carrying out obligatory insurance, from fines and property sanctions, from investments.

<u>III. Securities</u>

The development of the non-banking financial sector confirms the trend of stable increase in the activity of the non-banking intermediaries. The number of institutional investors and of the assets managed is as well constantly increasing.

Banking activities still have a predominant share in the sphere of financial intermediation, although decreasing, with the gradual but stable increase in the activities in the field of non-banking financial services.

At the end of 2006, the Stock Exchange's market capitalisation amounted to BGL 15.31 billion or 31.20% of the GDP (BGL 1.11 billion or 3.72% of the GDP in 2001).[5] In addition to the privatisation deals concluded through the Stock Exchange, predetermining factors for the growth were the increased demand and the increase in the prices of the greater part of the shares actively traded in combination with the increasing confidence to the non-banking segment of the financial market.

The **capital market** is growing steadily. The market was stimulated by the appearance of new institutional investors, represented mainly by the contractual funds, as well as a result of liberalisation of the investment limitations, with which the pension funds comply. On 31 December 2006 the market capitalization of BSE-Sofia amounted at BGL 15,314,019 thousand, climbing by 81.58% in 2005.

At the end of 2006 on all market segments there were 339 **public companies** registered to be traded. 30 public companies were listed on the exchange floor in 2006, and the shares of 12 public companies were discontinued from trading. Public companies' delisting slowed down. The processes of carrying out of public offerings of shares on the stock exchange intensified.

The market of **collective investment schemes** developed dynamically in 2006. The number of institutional investors increased as well as the accumulated assets.

In 2006 the most significant share in the **asset structure** of the collective investment schemes was made through investments in capital securities (shares) traded on BSE-Sofia. Their ratio was 15.58 percentage points higher than in the previous year, a five-fold growth in absolute

[5] Source: Financial Supervision Commission, Annual Report 2006, p.70 following.

terms. Investments in corporate bonds increased less, marking a decline of 7.21 percentage points of the aggregate CIS portfolio.

Funds, invested in **foreign securities** rose to 4.93% (1.38% in 2005).

The **Fund for Compensation of Investors in Securities**, whose major objective is to ensure integrity and safety on the capital market, has started operating on the 1st January 2006. The fund is financed by contributions of the investment intermediaries as well from revenues from the management of the Fund's assets which may be invested in government securities (GS), short-term deposits in banks and deposits in the Bulgarian National Bank (BNB). The resources from the Fund will be used for payment of compensation to the clients of an investment intermediary when the latter is unable to fulfil its obligations to the clients due to reasons directly related to its financial condition.

At the end of 2006, 84 investment intermediaries, from which 28 commercial banks and 56 investment intermediaries licensed by the Financial Supervision Commission participated in the Fund. Since the beginning of 2007 management companies will also participate in the fund.

IV. Supervision of the insurance and non-banking financial sector

The Financial Supervision Commission (FSC) was established in March 2003 under the Financial Commission Act. It is an independent executive authority and reports to the National Assembly. The Commission is a specialised government body for the regulation and control over the financial system, which unifies the regulatory tasks of the former State Securities Commission, the State Insurance Supervision Agency and the Insurance Supervision Agency. It follows the approach of integrated supervision over the insurance sector, including social insurance and the non-banking related securities sector.

The Commission has the powers for legislative initiatives, preliminary control over the companies' admission to the market (licensing regime), the right to control the activities of admitted companies and the right to impose sanctions.

One of the Commission's tasks is **consumer protection**. It aims to strengthen the financial knowledge of the general public in the financial sector on the basis of educational initiatives. For example the programme "The non-banking financial sector in Bulgaria" carried out twice a year, is oriented to students of economic schools.

Since 2003 the FSC collaborates with the Bulgarian National Bank on the basis of a Memorandum of Understanding. A Consultative Council on financial stability was established for the purpose of ensuring security and integrity of the financial markets development. Members come from the FSC, the National Bank and the Ministry of Finance.

5. Corruption: A Central Challenge

One of the major remaining problems in Bulgaria relates to corruption. The country ranks 57th in the annual Corruption Perception Index (CPI) for 2006 published by Transparency International with a score of 4 (10 being the best score possible). Of the EU members, only Poland (3.7) and Romania (3.1) score worse. The table below sets out all EU members and applicant countries in the order and ranking in the CPI of 2006.

Transparency International CPI 2006, EU Countries + candidates

Ranking	Country	Score		Ranking	Country	Score
1	Finland	9,6		28	Slovenia	6,4
4	Denmark	9,5		37	Cyprus	5,6
6	Sweden	9,2		41	Hungary	5,2
9	Netherlands	8,7		45	Italy	4,9
11	Austria	8,6		46	Czech Republic	4,8
11	Luxembourg	8,6		46	Lithuania	4,8
11	UK	8,6		49	Latvia	4,7
16	Germany	8		49	Slovakia	4,7
18	France	7,4		54	Greece	4,4
18	Ireland	7,4		**57**	**Bulgaria**	**4**
20	Belgium	7,3		*60*	*Turkey*	*3,8*
23	Spain	6,8		61	Poland	3,7
24	Estonia	6,7		*69*	*Croatia*	*3,4*
26	Portugal	6,6		84	Romania	3,1
28	Malta	6,4		*105*	*Macedonia*	*2,7*

Source: ICGG, University of Passau

In view of several problematic areas prior to Bulgaria's EU accession, specific accompanying measures were put in place to prevent or remedy shortcomings in the areas of aviation safety, food safety, agricultural funds and judicial reform as well as fight against corruption and organised crime. For the latter a Cooperation and Verification Mechanism was established, setting out benchmarks to provide the framework for monitoring progress in this area.[6]

[6] These are:

1. Adopt constitutional amendments removing any ambiguity regarding the independence and accountability of the judicial system.
2. Ensure a more transparent and efficient judicial process by adopting and implementing a new judicial system act and the new civil procedure code. Report on the impact of these new laws and of the penal and administrative procedure code, notably on the pre-trial phase.
3. Continue the reform of the judiciary in order to enhance professionalism, accountability and efficiency. Evaluate the impact of this reform and publish the results annually.
4. Conduct and report on professional, non-partisan investigations into allegations of high-level corruption. Report internal inspections of public institutions and on the publication of assets of high-level officials.
5. Take further measures to prevent and fight corruption, in particular at the borders and within local government.
6. Implement a strategy to fight organised crime, focussing on serious crime, money laundering as well as on the systematic confiscation of assets of criminals. Report on new and ongoing investigations, indictments and convictions in these areas.

In its first report on Bulgaria's progress on accompanying measures following Accession the Commission (COM(2007)377 final) comes to the following conclusions:

> "Bulgaria has made progress in varying degrees in meeting the benchmarks set out in the Cooperation and Verification Mechanism ... Greater evidence of implementation on the ground is needed in order to demonstrate that change is irreversible.
>
> The Bulgarian Government is committed to judicial reform and cleansing the system of corruption and organised crime. In all areas, the Bulgarian authorities demonstrate good will and determination. They have prepared the necessary draft laws, action plans and programmes. However, the real test can only be met through determined implementation of these actions on the ground every day. There is still a clear weakness in translating these intentions into results. Bulgaria has stepped up efforts at the highest levels in the fight against corruption and organised crime. While recognizing these efforts, much remains to be done.
>
> Progress in the short time since the Cooperation and Verification Mechanism was set up is still insufficient. Deeply rooted problems, notably organised crime and corruption require the irreversible establishment and effective functioning of sustainable structures at investigative and enforcement level capable of sending strong dissuasive signals.
>
> In addition, the structural changes which are needed impact on the society at large and require a step change which goes much beyond the mere fulfilment of the benchmarks. This requires a strong long term commitment by Bulgaria and can only be successful if the strict separation of the executive, legislative and judicial power is respected."

Ease of doing business and economic freedom

Several institutes publish indicators about economic freedom and ease of doing business in different countries. In the Ease of Doing Business Index of the World Bank[7], for example, Bulgaria scores 54th in the world (out of 175 countries, and several other EU Member States still score worse (Slovenia 61, Hungary 66, Poland 75, Italy 82, Greece 109).

The Index of Economic Freedom published by the US based Heritage Foundation, characterizes Bulgaria as "moderately free" with a score of 62.2% (free economies are valued between 80 and 100%). Although its meaning should not be overvalued, it displays interesting messages. While Bulgaria is close to the world average in most aspects of economic freedom, it clearly lags behind in property rights. This underlines the urgent need for change exactly in the areas of the judiciary and fight of corruption.

[7] Economies are ranked on their ease of doing business, from 1 – 175, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business. This index averages the country's percentile rankings on 10 topics (such as Registering Property, Getting Credit, Paying Taxes), made up of a variety of indicators, giving equal weight to each topic.

6. Outlook[8]

Underlying economic trends are expected to remain largely unchanged in 2007 and 2008, with real GDP growing at around 6% in both years. The catching-up of the Bulgarian economy will continue to be supported by strong investment growth. Moreover, absorption of EU Structural Funds starting in 2007 will give a boost to investment in public infrastructure. Noticeably higher real wage growth (backed by productivity gains) and sustained job creation will imply a gradual increase in disposable incomes and thus private consumption growth in the coming years.

In line with robust domestic demand, imports are expected to outpace exports despite a gradual strengthening of the export potential of the Bulgarian economy. The trade deficit is thus expected to widen to above 22% of GDP in 2007 and 2008. The current account deficit will further increase.

The unemployment rate is projected to fall further, to around 7½%, in 2008. An increasingly tight labour market will entail certain upward pressures on nominal wage growth. However, in line with a substantial increase in the investment ratio and ongoing economic restructuring, labour productivity is projected to accelerate steadily. This will mitigate the effect of the increase in wages on nominal unit labour costs.

The main economic policy challenge facing the government is to ensure that rapid growth in domestic demand does not destabilise the economy by fuelling unsustainable current-account deficits and putting pressure on the currency board arrangement. As monetary policy is constrained by the currency board, the burden of restraining demand falls on fiscal policy. The BSP-led government's intention to raise pensions and public-sector wages, and to invest in education and health reform, in combination with the requirement to make contributions to the EU budget, are likely to complicate the fulfilment of future budgets.

[8] Largely drawing on the European Commission's Spring Forecast.