Bulgaria's Transition to a Market Economy

ALFRED LEVINSON

Prior to the Second World War, Bulgaria was an agrarian economy with 80 percent of its labor force in agriculture. After World War II, the Communists industrialized and ran Bulgaria as a centrally planned economy. Today, only 17 percent of its work force is in agriculture. After the Czech Republic, Bulgaria is the most urbanized country in Central/Eastern Europe. Bulgaria has a small open economy in which exports and imports make up more than half Bulgaria's GDP.

Bulgaria's transformation to an industrialized economy was based initially on large financial and technological transfers from the USSR, high domestic investment rates, and a growing specialization in machinery exports into the large protected CMEA (Council for Mutual Economic Assistance) market. During this period its per capita income grew at an annual rate of more than 4 percent to about $5700 in purchasing power parity terms. According to the Organization for Economic Cooperation and Development (OECD) this growth performance placed Bulgaria between that of Germany and Austria. Its physical and social indicators give it a relatively high standard of living, on a par with Greece, Portugal and Spain.[1]

By the 1980s this growth pattern became difficult to sustain. Bulgaria was building its machinery exports to the CMEA area with components imported from the west. Since the machinery exports were paid for by the CMEA countries in transferrable rubles and the imported parts—in hard currencies, Bulgaria developed a large external debt in convertible currencies. This external debt in hard currencies reached more than three times the level of exports in 1989 and the debt service rose to almost four fifths of convertible currency exports. More than eighty percent of this debt was owed to private banks and almost forty percent of the debt was in the form of short term loans. This forced the country to become highly dependent on commercial banks for debt refinancing. When the banks started to review their lending practices to Central/Eastern Europe as a result of the political changes in 1989, Bulgaria found it impossible to roll over the debts coming due and in 1990 had to declare a moratorium on its debt amortization and soon after on interest payments. As a result, foreign capital inflows dropped sharply and imports from the west had to be dramatically cut.

"As one of the most energy intensive economies in Eastern Europe, Bulgaria was highly vulnerable to the terms-of-trade shock caused by the switch to world market prices in trade with the former CMEA countries."

Alfred Levinson is on the economics faculty at Sofia University in Bulgaria.

As one of the most energy intensive economies in Eastern Europe, Bulgaria was highly vulnerable to the terms-of-trade shock caused by the switch to world market prices in trade with the former CMEA countries. In addition, oil supplies from the Soviet Union were disrupted leading to a substantial decline in petroleum based exports. The Gulf crises increased oil costs and reduced trade with Kuwait and Iraq (traditionally important markets for Bulgarian goods). It appears that at least 60 percent of its exports may have been to the CMEA area with almost half to the USSR. With total exports accounting for almost a quarter of GDP, the Bulgarian economy was especially exposed to the large decline of CMEA trade which took place in 1991.

Large macroeconomic imbalances appeared in Bulgaria as a result of many years of forced saving. Money balances in relation to GDP in 1990 were almost twice as high as a typical country in the West and considerably higher than in Hungary, Czechoslovakia or Poland. On the domestic side, economic links were disrupted and investment dropped as the socialist government could neither guide the economy with traditional means nor introduce the minimum of market reforms needed to make its reform announcements credible. Consequently, GDP declined by 9 percent in 1990 and inflation increased to 26 percent.

The Bulgarian government began to restructure its banking sector in 1987. Between 1987 and 1990 the government created a two-tier banking system consisting of a central bank, seven major banks and more than 70 smaller commercial banks in the form of joint stock companies. It distributed the old loans and deposits to the newly created banks. None of these banks were actually private banks and the loans their were never repaid. In 1992, the government began consolidating these banks. However, the major shareholders of these banks were state enterprises and the central bank. Although the entire banking system was still run by the state, the government eliminated guaranteed life-time employment causing further economic problems. This was the macroeconomic situation the Bulgarian government faced as it formally began its economic transition in February, 1991.

The Transition to a Market Economy

Bulgaria, like Poland and Russia, tried "shock therapy" and abandoned it in short order. During 1991, retail prices were liberalized which account for 90 percent of retail trade turnover. Prices on fuel and energy rose dramatically. The government retained control over the prices of 14 consumer staples using price ceilings. Once retail prices had been freed, it proved impossible to keep the wholesale prices of fuels and agricultural products under control. By the middle of 1991, these were also freed. This resulted in an annual rate of inflation of 334 percent in 1991 as measured by the Retail Price Index (RPI). At the same time the government removed virtually all restrictions on imports and allowed the export of most goods to occur.

In February 1991 two institutions were established to oversee the privatization process. The National Agricultural Land Restitution Council was responsible for handling the restitution of agricultural lands to their former owners and the Agency for Privatization was to direct privatization of state enterprises. At the same time, the government created the legal basis for ownership rights, including the legal framework for foreign investment.

By establishing the legal foundations for decentralization and de-monopolization, it was hoped the managers of state enterprises would operate them in a competitive manner. The reformers hoped this would foster competition within state enterprises. The new laws also allowed private companies in many of these industries to compete against the state enterprises. The government the made the lev current account convertible[2] and increased the official exchange rate to one close to the black market rate. The central bank or, the Bulgarian National Bank (BNB), which is independent of the executive branch, received the authority to make monetary policy. At that time the only instruments that the central bank had to make monetary policy was the use of credit ceilings, setting minimum reserve requirements and the deposits of the commercial banks in the BNB. For its macroeconomic stabilization program, the central bank tried to use control of incomes and credit as its nominal anchors.

TABLE 1
The Bulgarian Economy

	1989	1990	1991	1992	1993
GDP-Real Growth Rates	-0.3	-9.1	-16.7	-7.7	-3.5
Budget Deficit—Cash Basis—as a % of GDP	-1.4	-8.5	-3.6	-6.0	-11.4
Unemployment Rate	—	1.8	11.0	14.8	16.2
Inflation Rate (RPI)	—	26	334	80	65

Sources: OECD, PlanEcon, National Statistical Institute

The shock therapy program was implemented in a few months time during 1991. The macroeconomic stabilization program relied on tight monetary, fiscal, and other policies to prevent the price hikes that resulted from price liberalization and tended to destabilize the economy. Consumer goods became widely available, albeit at higher prices. The scope for entrepreneurial activity increased dramatically. Government subsidies as a percentage of GDP were reduced from 15.5 percent in 1989 to 4 percent in 1991. However, output fell by 17 percent and unemployment rose to 11 percent [see Table 1].

The social safety net as represented by social security expenditures increased as a percentage of GDP from 10.4 percent in 1989 to 12.9 percent in 1991. They represented 24 percent of total Government expenditures in 1991. The budget deficit as a percentage of GDP increased from 1.4 percent in 1989 to 3.6 percent in 1991 on a cash basis. The current account deficit as a percentage of GDP on an accrual basis increased from 6 percent in 1989 to 11.2 percent in 1991.

The process of restituting agricultural lands, seized by the communists began. Unlike the Soviet Union, the agricultural lands which were nationalized in the 1950s were organized primarily into Kolkhoz. The first step of restitution was to dissolve the Kolkhoz, slaughter or sell off any livestock and give the farm equipment to the employees. Initially, the former owners only received the right to use the land but not the title to the land. Without the title, the owners could not sell or lease the land. Credits were not available to them to buy the farm equipment and other farm inputs. As a result agricultural production decreased and livestock herds declined by more than 38 percent.[3]

Credit costs rose 87 percent and real interest rates for enterprises were positive and very high in the second half of the year. This led to perverse borrowing decisions by the enterprises. Very few investments appeared to be profitable— in particular—investment in agricultural seeds and industrial equipment could not have been attractive at those interest rates. On the other hand, insolvent enterprises that were facing large outstanding debts would have every incentive to borrow as much as they could. As long as they could borrow, they could keep paying wages. Investment credit collapsed, but interest capitalization took up a large part of the slack. The newly emerging private enterprises were frozen out of the commercial credit market. This was counterproductive to moving the economy towards a capitalist market economy.

By the middle of 1992 shock therapy was effectively abandoned for a more gradual approach. During this period most prices had been liberalized. With the use of a tight monetary policy inflation had been reduced from 334 percent in 1991 to 80 percent by the end of 1992. The exchange rate of the Bulgarian lev after depreciating sharply against the dollar in 1991 had been stabilized during 1992. Most barriers to exports and imports had been removed. Consumer goods were now readily available. All over the country, small private businesses opened and the private sector flourished. Many state enterprises had been decentralized and demonopolized. The process for returning agricultural lands to their former owners was underway. The rate of decline in GDP had slowed from -16.7 percent in 1991 to -7.7 percent in 1992.

__"Despite these strides towards a market economy, Bulgaria still had a long road ahead of her."__

Despite these strides towards a market economy, Bulgaria still had a long road ahead of her. There had been virtually no privatization of large state enterprises. A mass privatization program had yet to be implemented. Credit was still scarce for the private sector. The cash budget deficit had risen from 3.6 percent in 1991 to 6.0 percent in 1992. Unemployment increased from 1.8 percent at the beginning of 1991 to 14.8 percent at the end of 1992. While unemployment compensation was available, it was estimated that no more than one-third of the population was eligible to collect it. However, many of those listed as unemployed may actually have held jobs in the private sector[4]. As a result of price liberalization in early 1991, real wages declined so sharply that by March they were at one-third of what they were in December, 1990. Wages were adjusted in the remainder of 1991 and 1992, but they only reached 50 percent of their December 1990 level. Although this incomes policy was the major source of the increase in the budget deficit, it was deemed necessary to insure political stability.

By the end of 1992, restitution was nearly completed. The government only needed to survey the lands in order to verify the property boundaries before the titles to the land could be given to the owners. However agricultural production continued to decline during 1992 in both monetary terms and in quantity. Although private farm production increased 13.6 percent in output, this could not offset the 27.3 percent decline in the state farming sector. While there were occasional spot shortages, food in the markets had become more plentiful with greater variety, partly due to increased imports during the winter months and the loss of the CMEA markets.

During 1993 the country continued to progress toward a market economy albeit at a slower pace. Inflation declined further to 65 percent. Wages kept pace with inflation. The tumbling wages, together with the persistent use of the soft budget constraint by the state enterprises, were the major sources of the large increase in the cash budget deficit/GDP ratio to 11.4 percent. GDP declined again, but at a slower rate than in 1992 [see Table 1]. By the end of 1994, it had bottomed out. Unemployment increased to 16.2 percent in 1993. Bulgaria's unemployment rate remains one of the highest in Eastern Europe —about the same as Poland. The private sector continues to grow and is now estimated to be as high as 40 percent of GDP. However, privatization of the state sector is still blocked.

In 1993 the exchange rate remained stable, it declined about 14 percent until October, after which the lev began a rapid descent. The lev fell so much that by April, 1994, the central bank had run out of foreign exchange needed to defend the lev and required an infusion of foreign currency from the IMF to prevent a collapse of the lev. During 1994, the lev lost half its value and dropped to 66 lev/dollar at the end of 1994. It is apparent that the lev was overvalued in 1993, probably causing some of the decrease in exports. Also during 1994, inflation increased to 120 percent due, in part, to the devaluation of the lev, the imposition of the VAT and the increase of imports, particularly food.

The Current Status of Bulgaria's Transition

The cornerstone of Bulgaria's macroeconomic stabilization program had been a tight monetary policy to contain inflation and using the exchange rate as the anchor for macroeconomic stabilization which worked until October 1993. This approach, which was similar to the policies followed by Poland, had been reasonably successful in providing for relative economic stability. But this has not been sufficient to keep the anti-communists in power in both countries. As early as the fall of 1992, the UDF[5] (Anti-Communist Coalition) had lost power. The BSP, the former communists, became the dominant power, but they didn't assume control of the government. Instead, they agreed to the establishment of a technocratic government which lasted until September, 1995. During this period the parliament remained paralyzed and the technocrats lacked the political skills required to allow the leadership to push through the reforms necessary to rapidly move the country to a fully functioning market economy. It was largely the actions of the central bank and the spontaneous growth of the private sector that kept the economy plodding along. In the 18 December 1994 election, the BSP became the majority party in the parliament. Bulgaria's transformation has been a slow and difficult one. The failure to create the necessary infrastructure to provide for a smooth privatization of the agricultural lands has devastated the agricultural sector. This has hampered Bulgaria's efforts to regain its historic role as a major food exporter.

"The transformation has had some unusual effects."

The transformation has had some unusual effects. As a result of declining the production of the state enterprises located in the cities, there has been a change in demographic patterns. Prior to 1990, Bulgaria had exhibited the typical demographic trend from rural to the urban areas. With the decrease in production in these state enterprises, this trend has been reversed with a shift in population from the urban to the rural areas in five of the nine oblasti and with all oblasti showing decreases in urban population. The hypothesis advanced to explain this is that those people with rural roots have returned home—in some cases with restituted land—to engage in subsistence farming.

As the transition progresses there has been a dramatic increase in automobile ownership. This has increased the demand for car batteries thus boosting the demand for lead. As a result, one of the country's two lead smelting plants may have to be reopened to meet this increased domestic demand.[6]

Lessons for Russia

During the shock therapy period Poland and Bulgaria implemented the following policies: (1) prices were liberalized, (2) an independent central bank and commercial banks were created from the old state banking system, (3) the central bank implemented a tight money policy and introduced a managed float of the exchange rate of the national currency by making it partially convertible, (4) most restrictions on imports and exports were removed, and (5) the state enterprises were de-concentrated and de-monopolized. These policies by themselves were sufficient to reduce inflation, stabilize the exchange rate, slow the rate of decline of GDP and, in the case of Poland show some growth. In Bulgaria, the VAT as an alternative to the turnover tax was not be implemented until April 1994. This sequencing differs somewhat from the order of liberalization proposed by McKinnon. In Russia, a greater emphasis was placed on privatizing the state sector, while the central bank did not implement a tight money policy and failed to stabilize the ruble until recently. This has resulted in macroeconomic instability with high inflation and a deteriorating ruble.

Using Bulgaria and Poland as examples, Russia should continue to use a tight monetary policy and to stabilize the ruble. Other components of a policy for transforming the economy to a market economy can be delayed. Russia can also learn from the mistakes that Bulgaria has made. Before it attempts to privatize agricultural lands it should carefully prepare the infrastructure needed to efficiently implement the privatization program. Given the length of time that has passed since the Russian farms were collectivized, the Chinese model would probably be more appropriate for Russia to emulate. Before it can do that it must create the necessary infrastructure. Unlike the Chinese communes, the Sovkhoz will have to divest themselves of the schools, hospitals, and benefit programs that they operate as part of the old collective farms. The government should take over these functions so that the former employees will still retain these benefits when the farms are privatized. This also applies to any of the state enterprises that operate their own schools, hospitals and other benefit programs.

Notes

1. OECD, Economic Surveys/CCEET: Bulgaria (Paris: OECD, July 1992), 9-10.

2. "Current account convertibility" means that the lev is convertible for trade purposes and other activities that are included in the current account part of the balance of payments accounts. The lev is not convertible for capital flows.

3. *Tekushta Stopansk Konjuktura*, January 1993.

4. OECD, 35-36.

5. The Union of Democratic Forces—the anti-communist coalition.

6. Levinson, Alfred, *The Effect of the Transition on a Village in South Central Bulgaria Where the Primary Industry is a Lead-Zinc Plant*, Sofia University, Sofia, Bulgaria: 1994, unpublished mimeo.