THE BULGARIAN ECONOMY: TRANSITION IN THE TRANSITION

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The general elections of December 1994 marked a turning point in the Bulgarian transition. The victory of the Bulgarian Socialist Party (BSP) was part of a common trend across Eastern Europe. At the same time, the change in the political landscape produced an important shift in the orientation of economic policy. This paper focuses on three issues--a general overview of the macroeconomic developments of 1991-95, selected problems related to privatization, and some aspects of the external background to the Bulgarian transition. A final section assesses the economic policy of the new BSP government and its further prospects.

MACROECONOMIC DEVELOPMENTS

Several features are specific to the Bulgarian economic transition over the past five years.[1] Radical change in the Bulgarian economy started with the implementation of a wide-ranging, International Monetary Fund-supported stabilization program in February 1991. The program had two anchors--restraint of the money supply and of nominal wages--and was designed to overcome the macroeconomic disequilibria inherited from the Communist regime and exacerbated by its collapse. Policymakers believed that in order to carry out a more or less consistent stabilization policy they had to gain greater control over the classical tools of macroeconomic policy. They liberalized prices, the foreign trade regime, and the foreign exchange market in an effort to eliminate a large monetary overhang. At the same time, restrictive monetary and fiscal policies, supported by an adequate incomes policy, were instituted in order to control inflation. It was expected that a vast structural reform would support the macroeconomic stabilization.

Among the many important changes in macroeconomic policy during recent years, two are related to the debt problem of the Bulgarian economy: the 1993 Bad Debts Act, which transferred non-performing debts incurred prior to 1991 from enterprises to the budget; and the settlement with the London Club of Private Foreign Creditors that reduced the face value of Bulgaria's foreign debt by 40 percent and fixed terms for repaying the remainder with International Monetary Fund (IMF) assistance on the pattern pioneered by U.S. Treasury Secretary Nicholas Brady for Mexico in 1989.* With the latter agreement, Bulgaria's foreign debt problem was resolved satisfactorily. After a four-year interruption in payment to private foreign banks (1990-94), Bulgaria resumed servicing its foreign debt.

The first important setback in the stabilization effort occurred in 1993, when a loose fiscal and incomes policy and a highly inconsistent macroeconomic policy generated a budget deficit that reached 11 percent of Gross Domestic Product (GDP), paving the way for a major crisis in the spring of 1994. An abrupt depreciation of the *leva* in March 1994 followed a series of foreign exchange market crises in late 1993 and early 1994. Among the underlying causes were the very liberal licensing policy of the Bulgarian National Bank (BNB); the lack of coordination between the BNB and the finance ministry; automatic wage indexing; and frequent, unjustified changes in interest rates during 1993. Of particular importance was the BNB's severe shortage of foreign exchange reserves in March, which seriously undermined its capacity to intervene in the market. The delay in previously scheduled G-24 and IMF financing made matters even worse. A new stand-by arrangement with the IMF was not signed until April.

Fueled by the depreciation of the *leva*, inflation remained out of control, reaching a post-1991 peak of 120 percent in 1994, compared to 64 percent in 1993. Depreciation shifted relative prices in favor of tradable goods. This greater competitiveness boosted exports even though their weak upward trend since the third quarter of 1993 also reflected an increase in re-exports. The most immediate effect of the 1994 devaluation was a sharp fall in imports. A current account surplus was thereby achieved in 1994.

By the end of 1994 (on a December-to-December basis), the real exchange rate of the *leva* remained virtually unchanged, but the negative side effects of the crises were dramatic. For months during 1994 there were waves of currency substitution, flight from the *leva*, and symptoms of "dollarization" of the economy. The household savings ratio fell, and the interest rate differential faded, stimulating capital flight from the country. The first signs of an incipient recovery were observed in mid-1994. From late 1994 through 1995, they developed into a more vigorous economic revival, resulting in positive growth rates for both years.

Despite the turmoil in the foreign exchange market and the difficulties of the financial sector, domestic output turned a corner in 1994. After four consecutive years of

* This settlement is subsequently referred to as a Brady-type arrangement.

decline, GDP posted real growth of 1.4 percent in 1994. Industrial output rose by 3 percent. Nine of eighteen branches in public sector manufacturing registered positive real growth. The leaders were ferrous metals, chemicals, and printing. For the first time, the private sector played a decisive role in overall output. The growth of private output compensated for the decline in the non-industrial state sector. This growth was concentrated mainly in services and agriculture. After a deep agricultural depression, there was an 11 percent increase in that sector's productivity in 1994, primarily as a result of expanding private production. This recovery was accompanied by declining unemployment. The National Statistical Institute's labor force surveys show that employment growth in the private sector offset the decline in public sector employment.

The 1994 recovery is largely attributable to two factors--revival of private consumption, reflecting a decline in both the savings ratio and inflation-induced consumer hoarding; and improvement in the financial position of enterprises. A drop in unit labor costs and resulting increases in productivity prompted better export performances and falling real wages. Meanwhile, the accounting effect of the 1993 Bad Debts Act transformed the principal from non-performing credits into government debt. The remarkable stability of the exchange rate was supported by a significant inflow of foreign currency.

According to almost every economic indicator, 1995 will have been the first post-1989 year of more promising macroeconomic indicators--inflation of 35 percent, real GDP growth of 2 to 2.5 percent, industrial growth of 3 percent, declining unemployment, a foreign trade surplus, and strong accumulation of foreign exchange reserves. Although these projections are to some extent due to statistical bias and subject to qualification, they nevertheless reflect broad real trends in the economy.

Fiscal Policy

Fiscal policy made a series of dramatic shifts between 1991 to 1995. Strong restraint in 1991-92 was followed by a marked relaxation during 1993. New restraint in 1994 lowered the budget deficit to 6.5 percent of GDP. To a great extent, however, this performance was due to an "inflation tax," estimated at 11.9 percent of GDP during the first half of 1994. In a nine-month period of 1994, owners of interest-free and low-interest assets incurred capital losses of over 125 billion *leva* due to inflation and negative real interest rates on deposits. In the same period, flight from the *leva* increased consumption and the purchase of foreign exchange, eroding the base for the inflation tax.

Restrictive fiscal policy during 1994, coupled with the positive effects of a newly introduced value-added tax (VAT), created a surplus sufficient to cover almost half of the budget's interest expenditures, by far its fastest growing expenditure. The growth of interest payments accounted for 60 percent of the growth of total budget expenditures. Because of severe restrictions on the wage bill of the budget-financed sector, expenditures on wages, pensions, and social benefits accounted for only 20 percent of the growth in total expenditures.

Even though the 1995 budget was conceived as a restrictive one, the first three quarters of the year saw a strong deterioration in fiscal restraint. While a slight improvement has been observed during the last months, the deficit target fixed by law for the entire year was almost reached in September. The main factors behind this development were the limited ability to collect taxes and the disappearance of the "inflation tax," which had helped to cut the budget deficit in 1994.

Fiscal policy has been troubled by structural problems during the past several years. The growth of the private sector combined with fading control over state-owned enterprises substantially reduced the tax base. Social security liabilities and servicing of internal and external debt created a budget overload that reduced flexibility to direct resources toward productive goals, a situation that was exacerbated by difficulties in tax collection. There was also an important structural shift in revenues and expenditures. The bulk of revenues now come from indirect taxes, principally the VAT introduced in April 1994, rather than from direct taxes on profits. There is still an excessive dependence on remittances from the BNB in the form of seignorage. On the expenditure side, subsidies and investment expenditures have dropped dramatically, with a growing share of interest payments taking their place.

The principal threat in the medium-term is the growing government debt. The domestic government debt represents about 50 percent of 1994 GDP. Its two main sources are the financing of budget deficits (mainly through short-term debt instruments) and the government bail-out of pre-1991 bad debts of state enterprises. In the future, the resumption of foreign borrowing means that foreign debt payments will also grow rapidly. The servicing of interest on government debt represented 13.7 percent of GDP in 1994, 12.3 percent for internal debt and 1.3 percent for foreign debt. Debt service amounted to fully 53 percent of budget expenditures as of 31 July 1995, 39 percent for domestic and 14 percent for foreign debt.

Monetary Policy

At the start of the 1991-92 adjustment, monetary policy was the main anchor of the stabilization effort. Tensions and inconsistencies appeared later when the BNB was not able to manage several exchange rate crises, notably a major one in March 1994. Even though the BNB has an independent legal status and has gained some control over classical monetary policy instruments, its policy is still heavily dominated by government measures and even more by the structural crisis in the financial sector.

The 1993 Bad Debts Act did not succeed in dividing the bad debt burden fairly among enterprises, banks, and the budget. In fact, the law intensified the process of decapitalization of the banking sector and did not solve its structural problems. The banking sector posted losses amounting to roughly 3 percent of GDP in 1994. During the first half of 1995, nominal losses increased fourfold on an annual basis and substantially exceeded state non-financial sector losses. As a result, the Bad Debts Act was amended in 1995.

In 1994 the banking system was struck by a severe liquidity crisis provoked by the BNB's tight monetary policy, a squeeze in the demand for credits, a *leva* deposit outflow reflecting the rechanneling of resources outside the banking system, and widespread decapitalization. During 1995 monetary policy was relaxed substantially. Interest rates dropped from 72 to 34 percent, and the money supply grew more rapidly. These developments were primarily the result of the need to refinance problem banks, which attracted the bulk of BNB refinancing through unguaranteed deposits. The BNB was forced to help the most troubled banks (those with the bulk of bad debts exchanged them for low-yield bonds) and to inject *leva* liquidity into them. This compromised the BNB's refinancing policy. The troubled banks were placed under soft budget constraints while other banks were crowded out and forced to restrict their lending drastically. The measures taken by the government in May 1995 with respect to banks in difficulty resulted in revenue losses for the BNB and consequently in its lower than expected contribution to the budget.

Lower inflation in 1995 allowed an easing of monetary policy. This lower inflation left real interest rates on deposits positive for a record-long period. The BNB was also in a more comfortable position in the foreign exchange market. As a result of the strong growth in reserves, the BNB was able to prevent speculative trading, at least for the time being. The problem of how to produce a controlled devaluation of the *leva* remains. So far the BNB has been unable to devise a strategy for the successful resolution of this issue.

PRIVATIZATION AND THE LEGITIMACY PROBLEM

According to the conventional view, Bulgaria is lagging behind in the transition process, a perception that seems difficult to change in international and even national public opinion. In the ranking of East European economies in the "transition race," Bulgaria is now grouped with Romania and occasionally with Albania. This position is undoubtedly accurate in the framework of the standard "democracy plus privatization" approach. By this definition, the transition is conceived as a linear path between the old and new regimes, the crucial intermediate indicators being the private sector's share in GDP and the weight of democrats in government.

This standard definition does tend, however, to oversimplify the transition process. Even if there is sufficient evidence for such a rough ranking, there is no less evidence for the argument that all East European countries are traveling an identical path of structural transformation and macroeconomic dynamics. What differentiates them one from another is a set of factors that are not related to economic performance per se, but to historical, geopolitical, and cultural background and to the strong differences in the initial the conditions of the transition. These forces make the transition more or less in line with the standard development path of a market economy in West European terms.

Data

The most simple, most often quoted, and most misleading indicators of the speed of transition are the official data on the number of privatization agreements as a reflection of the measurable extent of privatization. According to the National Statistical Institute, as of the end of July 1995, Bulgaria's Privatization Agency (PA) had concluded 185 deals and taken 1,110 formal decisions. An additional 714 deals and 1,791 decisions applied to the privatization of municipal ownership. The PA decisions covered a total of 224,515 employees, about 12 percent of public sector employment. The proceeds from the completed deals amount to 4.5 billion *leva* or about $70 million. The bulk of the already privatized state or municipal property has been acquired by individual Bulgarians (60.9 percent) or private firms (28 percent). Only 1.6 percent of the deals involved foreign buyers.[2]

Two more capital flows must be added to these *very* low totals. The first is the restitution of agricultural land to its owners, which turned out to be an extremely sophisticated legal and economic process that is expected to be finalized by the end of 1996. The second is the restitution of urban real estate. Though implemented with differing intensities by successive governments, restitution created a homogeneous stratum of legitimate new owners who capitalized their assets mainly in trade and services.

A summing up of these four types of property still falls far short of the figures estimating the weight of the private sector in the economy. Despite the difficulties and the uneven progress in official privatization, Bulgaria's economic landscape has undergone dramatic change. According to official data, which provide a minimum estimate, the private sector accounts for roughly 30 percent of GDP and about one-third of employment. In several branches, the private sector share is dominant. In trade, for example, it accounts for 80 percent of output. In agriculture, where large-scale restitution of land to former owners is under way, the private sector produces more than 60 percent of output. In construction and transportation (excluding rail and sea shipping) it generates one-half of output. Only in manufacturing is the private sector's share restricted to about 10 percent.

The real weight, dynamism, and influence of the private sector, however, is far greater than even these statistical data suggest. Further insight may be found in a recently published set of data on credit flows that is arranged by a more precise institutional classification. According to these data, the private, non-financial sector owes 168 billion *leva* to commercial banks, exceeding the 156.6 billion *leva* owed by the state-owned non-financial sector. The private sector accounts for 30 percent of the credits extended by commercial banks (households excluded), while the state non-financial sector accounts for 27 percent and the government for the remaining 43 percent.

Behavior

The spontaneous development of private businesses from many different sources fills the gap between official privatization figures and the real scope of the private sector, which probably exceeds even the 30 percent figure cited above by another 20 percent. Bulgaria is experiencing burgeoning entrepreneurial activity. Although privatization of state-owned enterprises has proceeded relatively slowly, private firms have free access to markets, and their presence is now being felt, particularly in financial markets. There is no doubt that a corporate culture is emerging and spreading across the economy. There is also a large-scale hidden decapitalization of the state sector through capital transfers from state-owned to private enterprises. Shadow foreign exchange, credit, and capital markets have emerged against the background of loose financial control.

Finally, Bulgaria has a vast network of speculative and illegal activities. Most of these sources are intimately interwoven and form the economy of "grey forms" that dominates the economic background in Bulgaria as in every other East European country. This is a no-man's-land where unregulated privatization is widespread and the decapitalization of the state sector proceeds apace. The grey area lacks laws and institutions, but real redistribution of national wealth and economic power is occurring there all the same.

Any assessment of the actual progress of the Bulgarian transition must include these elements of economic reality. The statistically measurable share of the private sector cannot be considered an accurate indicator thereof. That share is not only too small, but it is in any case difficult to measure because of the unclear boundaries between the private and state sectors and the lack of market behavior. Instead, a more instructive approach is to focus on another dimension of the transition--the degree of budget constraint restraining the main actors and the character of these new economic actors in transitional economies. This could be defined as a behavioral approach.

There are at least four distinct types of behavior in transitional economies. The first is competitive behavior, which can only develop in open markets where entry is relatively unrestricted. These types of markets are usually found in the service sector and in trade. Unfortunately, in transitional economies, the rapid development of such markets is frequently hampered by extortion. The second, collusive behavior, occurs when a state firm is surrounded by satellite private firms that appropriate the value-added produced. In the third type, corrupt behavior, decisions are made by either the government or banks in order to favor specific firms or to extend badly secured credits. Finally, there is lobbying behavior in which state-owned firms seek special privileges for industry or agriculture.

These types of behavior often make it difficult to determine whether a particular firm is state-owned or private. For example, a state enterprise that buys its raw materials at special prices from a satellite private firm and commercializes its production through another related private firm cannot be considered a purely state-owned property. Thus the problem becomes not so much the slow pace of official privatization, but rather its proceeding on a fast track with little regulation and without authentic market signals or behavior. As a result, there are now private firms whose irresponsibility in many respects matches that of state-owned enterprises. The lack of credible legal penalties has stimulated the extension of credits to private enterprises whose borrowing then becomes a new wave of bad debts. Most of these loans are consumed or exported abroad as flight capital. This has become a source of trouble for many private banks, leaving them, like state-owned banks, in need of massive refinancing from the BNB. According to figures for the first half of 1995, many private banks are among the top loss-making banks in the country. These losses are derived from unsound credit practices and the accumulation of bad credits. More importantly, these practices have created an informal but powerful anti-privatization coalition composed of state and private banks or enterprises seeking to maintain the status-quo.

It is in this context that the problem of the *nomenklatura*--the former Communist appointees whose continuing presence is a concern to both East Europeans and Western observers--must be addressed. If the transition is assumed to be a radical but *peaceful* change of political and economic regimes, then it involves a redistribution of wealth whereby the initial advantage is inevitably enjoyed by individuals or groups who exercised real economic power under the previous regime. A model of transition based on their violent ouster is in principle possible, but it demands a revolutionary context missing in the Bulgarian case. The first steps of the Bulgarian transition were sufficiently well controlled to protect the former holders of effective economic power against threats to their position.

Initial money-laundering and the related emergence of private businesses clearly indicated that the transfer of capital followed mostly from the proximity to positions of real power through connections or information networks. The radical liberalization of the economy made the manipulated or semi-spontaneous redistribution of state-owned assets along these lines unavoidable. The recent attitude toward private capital in Eastern Europe has been shaped in an ideological, ethical, and political context. In the case of Bulgaria, negative attitudes have deep historical--that is, pre-socialist--roots as well. But the legitimation of the private sector has been hampered by focusing public attention on this attitude.

It must be acknowledged that historical experience has proven that the large-scale redistribution of national wealth on an ethical basis has never been possible. An economy recognizes only faits accomplis, and its functioning is based on existing actors. Assertions that elsewhere in Eastern Europe, such as in the Višegrad Group, this process is progressing smoothly on moral grounds are unconvincing. Only two conclusions can be drawn with certainty. First, each step toward a clear regulatory framework including private capital makes society more normal. Second, what is good for the economy is what leads to growth with minimum inflation and bad debts. In this sense, there is no better legitimation of private capital than its contribution to such growth.

The Economics of Transfers

The macroeconomic outcome of the present type of transitional economy could be labeled the economics of transfers.[3] The problem is the pervasive generation of negative savings and losses spread across the entire economy. They originate primarily in a clearly defined core of loss-making enterprises within or related to the old productive structure of the economy. The losses of the state non-financial sector totalled 17.6 percent of GDP in 1993, the peak year.

As a result of the previously described behavior of many private firms, important losses were also generated by the private sector and concentrated in certain banks. Those huge losses have to be financed in some way, and this is done on a very restricted scale from *internal* sources such as retained earnings, reserves, and capital. The major sources of financing of these losses in the real sector are *external*--that is, the accumulation of debts to different sources, such as the banking system, inter-enterprise credits, and other institutional lenders, either government or private. An intricate chain of transfers of income, losses, and capital has been built up in this fashion. The major avenues of this build-up include transfers from state-owned enterprises to the private sector and households; transfers from state-owned enterprises to the budget through government-sponsored debt bail-outs and budget arrears; transfers from state-owned and private firms to the banking system through interest arrears and vice-versa--from the banking system to the state and private sectors through the extension of doubtful new loans; transfers from the banking system to households through negative real interest rates on deposits; transfers from the banking system to the BNB and the budget through so-called emergency operations designed to rescue troubled banks; and transfers from the budget to households through both the inflation tax and direct taxation.

To sum up, post-Communist reality is a continuous struggle to shift the burden of transition onto the capital and revenues of other sectors and individuals, serving primarily to bail out those that are the source of the problem. Decapitalizing "the other one" is the basic rule of behavior.[4] "The other one" may be an enterprise or the banking system, but in the end the losses are socialized through the budget and the BNB by means of increasing tax pressure and inflationary redistribution of wealth. So the greatest burden is eventually borne by the enterprise sector and even more by households. The transfer of this burden onto households has sparked demands for its secondary redistribution in the form of income transfers from the public sector, obliteration of the dividing line between household budgets and the private sector, and a distorted combination of current consumption and investment. As a result, larger areas of economic activity are sinking into the underground economy. These protective reactions are nurturing organized crime, corruption, and chaos.

In a situation of ill-defined ownership rights, underground privatization, and unclear rules of the game, all attempts to solve the domestic debt problem remain palliative. The perverse cycle of accumulating bad debts cannot be interrupted without restructuring their main sources through legal privatization and the liquidation and bankruptcy of nonviable enterprises and banks. Part of that debt must be transferred to the private sector. The government must also recapitalize the troubled state-owned banks. If this cannot be done, the bail-out problem will reappear as pervasively as in 1993. It already encourages the current idea of a new "hospital bank." Experience seems to show, however, that a clear attribution of debts in the economy, and thus a solution of the bad debts problem, will not be achieved before two preconditions are met. There must be a stable initial redistribution of economic power, and the principal players must realize that the costs arising from the absence of rules more than offset the benefits. Economic, social, and political resolve will be required to reach both preconditions.

THE EXTERNAL CONSTRAINT

From the onset of the transition, the external environment has been a permanent constraint on the Bulgarian and every other East European economy. It has assumed different features, but remained an essential limit on the options available for economic policy.

International Financial Institutions

Bulgaria became a member of the IMF and the World Bank in late 1990. Since then relationships with international financial institutions have become an essential element of the internal economic policy debate. The debate over external conditionality has long played a part in Bulgarian political history. Today conditionality has changed form. The emphasis placed on quantitative performance criteria characteristic of the first years of stabilization has been supplanted by more vague and elusive measures of structural transformation. The honeymoon period in the contacts with the IMF and the World Bank lasted two years (1991-92). A deliberate interruption followed in 1993 and then an emergency reactivation of contacts in the aftermath of the devaluation crisis of 1994. A new pause, in a different economic context, may be observed in 1995, but with a pressing agenda for the current year.

Foreign Debt

The foreign debt issue has been the main external macroeconomic constraint on the Bulgarian economy since 1990. The Brady-type deal was concluded in July 1994 after a long process of complex negotiations. Although its immediate impact on capital flows is limited, the deal will determine the broad macroeconomic policy options for Bulgaria during the coming years. Important external and fiscal transfers will have to be realized in order to service the foreign debt. It is worth noting that the expected peak of foreign debt payments during 1996-97 is related to the servicing of loans from international financial institutions, not to London Club creditors. This element will become an important factor in the forthcoming negotiations with the IMF and the World Bank.

Russia

The Russian problem is a geopolitical constant for Bulgaria. Although Bulgaria has changed the structure of its foreign trade dramatically to more than one-half with Organization for Economic Cooperation and Development members, Russia and the former Soviet republics remain an important market. Trade activities are, however, often conducted in a rudimentary financial environment. It is completely unrealistic to think about the former Soviet markets in pre-1989 terms. Those big markets are definitively gone, and any effort to recapture them through state agreements, given the presence of Western competitors, will be unproductive. Nevertheless, the deals signed with Russia in the area of energy infrastructure will have a very important impact on the entire Bulgarian economy. They will reshape not only its geopolitical position but will also have an influence on the lower level of economic relations.

The Embargo on the Former Yugoslavia

The effects on the Bulgarian economy of the embargo against Serbia and Montenegro have been hotly debated since 1992. These effects have been calculated in two ways--either as a total of individual firms' estimates of their losses or by indirect or hypothetical approximations of the impact of the sanctions on the balance of payments. Both approaches are controversial, and too much attention has been devoted to quantitative assessments which either overestimate the losses, thereby reducing the credibility of the petitioning side, or are downgraded by international financial institutions in order to avoid a precedent for compensation.

It is far more useful to examine the main channels of the embargo's influence on the Bulgarian economy--trade, taxes, capital flows, and incomes. The trade effects were twofold. First, the embargo greatly reduced Bulgarian trade with Western Europe. At the same time, it stimulated an important restructuring of trade throughout the Balkans, with the Former Yugoslav Republic of Macedonia (FYROM) occupying a crucial place. Unfortunately, it is very difficult to assess the direction and magnitude of the combined effect of these changes. Clearly the embargo cost Bulgaria excise and profit taxes while generating uncontrolled short-term capital flows in and out of the country. Finally, there were very intensive black market contacts that provided underground incomes to the population in border regions. In fact, the most significant effect of the embargo may be the powerful boost that it gave to the grey economy. Speculative networks were created, and the accumulation of illegal capital accelerated. Overall, the embargo stimulated the growth of unregulated privatization and became a powerful factor in economic corruption.

In a more general and long-term context, the embargo reshaped the geopolitical situation of countries "on the other side" of the conflict. Because of their effect on trade and capital flows, the sanctions radically changed Bulgaria's comparative advantage. In addition, the much higher risks associated with doing business in the Balkans reinforced the division of Europe and cemented the differences among East European countries themselves.

In the future, economic realities in the region will be determined by the incipient rapprochement between Greece and the FYROM and the postwar reconstruction effort in Bosnia-Herzegovina. The former will affect the FYROM trade flows that were reoriented toward Bulgaria during the embargo. The effect of the later is difficult to assess. It will be conditioned by the diplomatic activity and global considerations of the Great Powers.

THE "NEW ECONOMIC POLICY"

The December 1994 elections were more than a major political event. They marked a turning point in economic policy as well. The new BSP government came to power with an expressed desire to change the philosophy of the transition. This vague intention represented both a general trend in Eastern Europe and a reaction to specifically Bulgarian economic problems. The issue was addressed in the electoral program of the BSP as well as in a series of documents produced later by the new government. Their openly populist and statist tone was adopted in order to underline the break with a traditionalist approach. Bulgaria's economic problems were presented as the consequences of the failure of a pure, also labeled "wild," market model. These problems also served as arguments to support a more interventionist approach to the economy. The way out of the crisis was not the further introduction of market mechanisms and institutions, but rather corrective state action. The well-known phenomenon of "reform fatigue" was skillfully exploited to reach the statistically largest strata of the population--pensioners, fixed-income employees, and peasants. As is usual in an embryonic capitalist society, losers there outnumber winners elsewhere.

The BSP government has courted the business community mainly through openly protectionist rhetoric and promises to help small private businesses through tax incentives. Privatization was not rejected as a goal, but major emphasis was placed on mass privatization schemes. The centerpiece of these appeals was revival of production. This objective was presented as a responsibility of the government, which should boost economic activity through infrastructure investment, tax incentives, and subsidized credit. In the financial sector, the government declared its unwillingness to permit widespread bankruptcies of troubled banks. These banks subsequently received support through tax deferrals and an increase in the budget deficit.

Thus the core of the BSP economic program was to strengthen government activism, to harden administrative regulation, to set formal priorities in the productive sector, and to protect national capital. This approach was intentionally and wrongly labeled "Keynesian" in order to gain some badly needed intellectual legitimacy abroad, at least in Europe. In fact, such policy obviously and deliberately departs from the mainstream of the Keynesian general equilibrium approach in order to address, at any cost, the immediate problems of the economy.

The electoral appeal of such left-wing ideology on economic policy issues could be partly explained by developments in the period following 1991. Results departed in many ways from the expected outcomes of an initial model that rested on IMF-supported stabilization programs. There were many reasons for the shortcomings of the initial approach. The inertia and complexity of post-Communist society was underestimated on the eve of the transition. The politics of transition, in particular, became an unpredictable limitation on the process of economic decision making. Political and other vested interests obstructed the formation of truly independent economic institutions, thereby precluding the implementation of a coherent and consistent macroeconomic policy. Because it was not supported by clear and enforceable rules of the game and by a genuine political commitment to ownership restructuring, stabilization degenerated into an exercise in solving immediate economic problems. The amount of external support for the transition, in the form of both official and voluntary capital inflows, turned out to be well under initial expectations. In addition, Bulgaria experienced the effects of severe external shocks such as the recession in Western Europe and the embargo on the former Yugoslavia. Changes in institutional and legal structures lagged substantially behind the liberalization of economic activity.

From today's perspective, it seems that the initial approach was not politically marketable for a long period of time under a democratic regime.[5] There was no possibility of bargaining for support for the reforms from the losers--the majority of the population--without abandoning some basic principles of the reform itself. This was impossible because of an underlying assumption that before the benefits of market reforms can be enjoyed, broad segments of society must accept severe losses. The fact that these losses were accompanied by a concentration of wealth in the hands of a small minority made the process too similar to the Communist experience to be readily accepted. In Bulgaria, as elsewhere, the vast majority of the population shapes its political behavior more according to short-term interests, which are often subject to political manipulation, rather than according to medium-term economic rationality.

Assessing BSP Policy

After a year in power, it is easier to assess the economic policy of the BSP government. Prevailing appraisals of the new left-wing governments in Eastern Europe have tended to separate pragmatic and ideological orientations and personalities. Although such a distinction can be justified in certain periods or areas, it is more important to stress the convergence of the two tendencies. In the majority of cases, they clearly tend to converge on a much more tangible goal--direct control over the economy by the ruling party or by the forces that have dominant decision making leverage in it.[6]

There are several important shifts for 1995 that at first glance could be called the new government's "ideological revenge." Many of the laws passed in 1992-93 were revised and new ones adopted with such a political motive in mind. One example is the amendment of the Land Ownership Law, which was declared unconstitutional by the constitutional court. Another, although it lacks any major practical consequences, is the Law on Prices. A third is the revision of some restitution laws, also overruled by the constitutional court. Finally, there is a more pronounced protectionist tendency that enjoys widespread public support. This support can be explained by the prevailing Western attitude that Bulgaria is a second-order transition country and specifically by the anti-immigration measures of the European Union (EU). The BSP has also tried to change the terminology of the economic debate. Many supposedly forgotten terms and concepts have been revived by the government in its effort to evade the market principles that have formed the core of the economic policy language in recent years.

But these steps were only partly motivated by ideological concerns. Ideology masks their real purpose, which is to centralize the decision making process. This has been most visible in the banking sector. Top government advisers were nominated for the supervisory boards of the leading state commercial banks. A second wave of consolidation of the banking system is also planned under close government monitoring. The ultimate goal of this effort is to pave the way for a new industrial policy *à la française*, through the state-owned banks. In fact, however, the situation of these bank is so parlous that it has become clear that it is necessary to rehabilitate the banking system itself. The centralization of economic power is also reflected in the creation of overarching administrative mechanisms such as the Ministry of Economic Development. Branch ministries, the Industry Ministry in particular, secured privileged loans for some enterprises or entire sectors. Many special funds were established with the declared goal of helping so-called priority sectors. Although not yet operational, they flash a clear warning, which is reinforced by virulent anti-banking rhetoric from the ministry of industry. More importantly, the Reconstruction and Development Fund, which is based on the proceeds of loans from international financial institutions, may now be used to finance several important state enterprises in difficulty and to fund an agrarian fund for price supports. It is little wonder, therefore, that the issue of financial discipline in public enterprises came to the fore in contacts with members of these international financial institutions.

Despite these efforts, however, the structure of the Bulgarian economy is so profoundly changed that no government is in a position any longer to impose itself unconditionally everywhere. There is no private vacuum to fill in the mature post-Communist economies because the presence of strong poles of private or privately controlled financial power cannot be ignored. Any new scheme for a single state economy would conflict with already established interest groups, party-controlled economic structures, and financial elites. Even individual state projects cannot proceed without being seriously questioned. A case in point is the government's embarrassment over what position to adopt toward Topenergy, a Bulgarian-Russian joint venture with the active participation of former Socialist Prime Minister Andrei Lukanov.

Under these circumstances, the implementation of a Czech-inspired mass privatization scheme as the centerpiece of the BSP government's economic policy is perfectly consistent behavior. Without discussing the macro- and microeconomic rationale of this proposal, it may be pointed out that all mass privatization operations in Eastern Europe have had one ultimate goal--to legitimate the existing structure of economic power in those countries. The problem of legitimation is particularly important for a country such as Bulgaria, where the rules of the game remained unclear for too long. In fact, this sort of privatization provides an ideal opportunity to depersonalize ownership formally while maintaining control over the important parts of the economy. Mass privatization is a political enterprise fully in line with the rhetoric of a left-wing government, even though its highly touted social aspects may be judged artificial.

The new BSP government has taken credit for the positive macroeconomic performance of 1995. This is a standard propaganda exercise aimed at capitalizing politically on the ongoing recovery in a fashion familiar in Western politics. But the recovery can hardly be attributed to the policy of that new government because it began in 1994 and was well under way by the time the BSP assumed power. To a certain extent, the economic revival can be credited to the macroeconomic policy followed in 1994, just as the 1994 crisis could be related to the loss of control over such policy in 1993. In broader terms, the recovery has followed from the adjustment of the Bulgarian economy that followed the initial shock of 1991 and later institutional changes.

Future Prospects

From a short-term perspective, the current economic recovery remains fragile. Of crucial importance to it is the continued inflow of short-term capital and foreign currency and its effect on the exchange rate of the *leva*. In a catastrophic scenario, the highly unstable financial system could collapse and stop the recovery cold. In this case, a dramatic new effort at macroeconomic stabilization would be necessary. The failure of the classical two-anchor model to curb inflation leaves two further ways open--to try again under the initial approach but enforce it better from the institutional side or to find a new anchor which, theoretically, could only be the exchange rate. Whichever option is chosen, it can be successful only if the political will can be found to launch and implement it consistently through macroeconomic measures coordinated more credibly than in the past.

The medium-term outlook for the Bulgarian economy must be conditioned to a great extent on how the government faces an agenda of five hard-core economic issues that must be addressed under any circumstances. The first of these is arrangements with international financial institutions and their price in terms of conditionality, especially in the areas of structural reform and financial discipline. With the approaching maturity of important tranches from loans extended by the IMF and the World Bank, these institutions will seek to conclude agreements with Bulgaria. A second and related consideration is the new geography of comparative advantage in the region in the post-embargo period and Bulgaria's ability to attract some of the resulting financial flows, both private and public. Third is the issue of rehabilitation of the financial system, including genuine enforcement of bankruptcy procedures and the possible liquidation of some banks. The banking system must be restructured by capitalizing viable banks, diversifying financial services, and deepening capital and money markets. A fourth concern is the pace of the mass-privatization program and general progress toward the development of a private sector in a competitive market environment. In particular, it is necessary to enforce explicit rules with regard to taxation, the securities market, and the supervision of banks. Finally, the attitude of the EU toward revision of its emigration policy and its selectivity regarding East European countries will determine Bulgaria's prospects for membership.

All of these economic developments will be influenced by the evolution of the balance of power within the BSP itself. There are now differences between party elites and the rank-and-file which, where economic interests are concerned, have reached a critical point. The extent of progress in legitimating the private sector and stabilizing economic power will, to a great extent, determine the medium-term outlook for Bulgaria. For the past several years, the conflict surrounding this process has contributed to economic destabilization.

Notes

1. A detailed account of the 1991-94 experience may be found in R. Avramov and V. Antonov, eds., *Economic Transition in Bulgaria* (Sofia, Bulgaria: Agency for Economic Coordination and Development, 1994).

2. The figures are not weighted averages. If the value of the deals were taken into account, foreign capital's participation would be substantially higher.

3. The macroeconomic aspects are analyzed in detail in R. Avramov and K. Guenov, "The Rebirth of Capitalism in Bulgaria," *Bank Review*, the journal of the Bulgarian National Bank, Sofia, April 1994.

4. This is the basic rationale of any economy and developed countries are not immune as the savings and loan crisis in the United States, the Credit Lyonnais case in France, and the bad debts problem in Japan have shown. It is the degree of control over this economic instinct that distinguishes an economy of primitive accumulation from a mature market economy.

5. This ex post facto explanation is not sufficient reason to reject the initial approach. Leftist or academic criticism of shock therapy is too easy and abstract. It fails to take into account that countries such as Bulgaria did not have any other valid options. Besides, the underlying economic logic of the stabilization effort is still valid.

6. This goal has been pursued by every political formation that has been in power since the beginning of the transition.

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