



July, 1999

# **A s s e s s m e n t**

of Bulgaria's Compliance with the  
Copenhagen Economic Criteria  
for Membership in the European Union

## **1. Introduction**

The conclusions of the European Council in Copenhagen (1993) defined the criteria for EU membership. The economic part of the criteria is formulated in the implementation of two general conditions: 1) the presence of a functioning market economy and 2) capability in the medium term to withstand the competitive pressure of market forces in the EU. The European Commission's Opinion on Bulgaria's Application for Membership of July 15, 1997 was negative. During the last two and a half years, however, Bulgaria undertook serious economic reforms, which were underpinned by the implementation of radical steps towards liberalisation, macroeconomic stabilization, market restructuring, and harmonization of the legislation and institutions with those of the EU. The economic progress achieved has its quantitative and qualitative measures, which now place Bulgaria in a conducive situation upon a comparative analysis of the economic parameters with the countries of the first wave of EU accession and are serious grounds for a revision of the July, 1997 Opinion. This paper reviews Bulgaria's progress vis-à-vis macroeconomic stabilization and structural reform. It also provides a detailed assessment along the indicators used by the Commission for each of the two economic conditions from Copenhagen.

## **2. Macroeconomic Indicators and Structural Reform after the Publication of the Regular Report of the Commission in November of 1998**

In accordance with the Joint Assessment of the Medium term Priorities in the Economic Policies of the Republic of Bulgaria, signed on June 8, 1999 by Bulgaria and the EU, the aim of the Government's Programme for the 1998-2001 period is the acceleration and strengthening of structural reforms in the enterprise sector and in the budget sphere, ensuring sustained economic growth, and improving the living standards of the population.

The stabilization effect of the economic policy implemented, stemming from the currency board arrangement, strict fiscal policy and improved financial discipline in the public sector, continued throughout the second half of 1998 and the beginning of 1999. The main parameters of macroeconomic stabilization include economic growth, low inflation, budget surplus, stable and low interest rates, increased foreign currency reserves, recovery of real incomes, and a reduction of the relative internal and external foreign debt burden. The results achieved can be attributed to domestic factors despite the negative external impact of the financial crisis in Asia and Russia, its substantial effect on the pace of global economic growth, the fall in prices of Bulgarian exports, and the Kosovo conflict. Exports dropped, as a result of declined foreign demand and deterioration of transport conditions along the routes to the markets with the most favourable treatment for Bulgarian goods and which make up 60% of our exports (EU, CEFTA, and EFTA). This decline in exports was to a certain extent a natural result of the structural reform.

The legislative changes after the Regular Report from the Commission on Bulgaria's Progress towards Membership were aimed at speeding up privatization and limiting the advantages for Employee and Management Buyouts. The privatised assets as of May 31, 1999 are 33% of the total sum of assets in the State-owned enterprises; while over 50% of assets up for privatization have already been sold. These indicators will be exceeded substantially after the completion of the large-scale privatization planned for this year, such as the sale of the Bulgarian Telecommunications Company, Neftochim, Chimco, Balkancar. The preliminary data on the progress in privatization show privatised assets have grown to about 40% in July. The private sector contribution in the GDP is 63.7%. The companies in liquidation or bankruptcy as of March 31, 1999 were 4% of the total state-owned assets. Of these 136 are in a bankruptcy procedure, 248 are in the process of liquidation, which is a serious step forward in

taking out of the market the inefficient state-owned enterprises that in the past were a key obstacle to the restructuring of the economy.

Procedures have been started in all natural monopolies aimed at splitting off and preparation for privatization of those separate parts of their operations, for which there are no technological barriers to the development of competition.

During 1998 the private sector has produced 99.4% of the gross added value in agriculture. The restituted land at the end of May 1999 is 85.4%. It is expected that the restitution of the rest of the land will be concluded by the end of the year.

Following the privatization of the Bulgarian Post Bank in November of last year, the State-owned banks continue to hold about 60% of assets in the banking sector. With the privatization of Expressbank, Hebrosbank, and Bulbank in the course of 1999, however, the share of the State banks remaining to be privatised in the year 2000 will be small.

### **3. Existence of a Functioning Market Economy**

#### Price Liberalisation

The wide-scale liberalisation implemented in 1997 and 1998 allowed for a free market formation of prices based on supply and demand equilibrium. The prices of a restricted number of goods remain controlled and prices of goods produced by the natural monopolies are regulated. Their relative share in the consumer basket is 14%. For medications and water, which are 3.2% of the consumer basket, there is a regime of partial control based on monitoring and a ceiling on the commercial margin.

The total relative share of regulated prices is fully comparable with that in the developed market economies and in the first wave countries for accession to the EU. An important element of the price liberalisation was the unification of VAT rates, which completely eliminated the administrative impact on relative prices.

#### Foreign Trade Liberalisation

Bulgaria is implementing a consistent policy of deregulating foreign trade.

The tariff measures are comprehensive, predictable and represent the main instrument of trade policy. The changes since the beginning of 1999 were directed at a decrease in the average customs duty rates, as well as the maximum duties on import. Zero rates were introduced on an autonomous basis for almost the whole spectrum of goods under the Information Technologies Agreement, as well as on energy sources, medical technology and medications. The temporary tariff quotas for tax-free import of industrial goods or suspension of customs duties are eliminated. Since the beginning of 1998 all export taxes have been revoked (with the temporary exception of the export tax on wood).

At the beginning of 1999 the temporary import surcharge in support of the balance of payments, introduced in 1996, was also abolished.

The nominal level of tariff protection on industrial goods imported from the EU in 1999 is low: 3.6% (compared to 12.6% for countries with a most favoured nation treatment). In principle it does not hinder the competitive pressure on the Bulgarian economy in respect to imports from the EU.

Considerable progress has been achieved in respect to non-tariff measures as well. With the start of 1999 the non-automatic licensing on the import of natural gas and the export of metal scrap were abolished and at present the non-automatic licensing regime on imports and

exports is based exclusively on international norms. The application of the registration (automatic licensing) regime on imports and exports serves a purely monitoring function on the trade with basic goods. The scope of goods, to which this regime is applicable, though not in contradiction with the rules of the WTO, was substantially reduced after 1<sup>st</sup> January 1999.

It can be concluded that the degree of commercial liberalisation in Bulgaria is comparative, and in some cases exceeds, the level typical of the first wave countries for EU accession.

Absence of Barriers for Market Entry (establishing new businesses) and Market Exit (liquidation or bankruptcy).

The Transition Report of the European Bank for Reconstruction and Development (EBRD) presents a study, which analyses and compares the commercial legislation in the countries in transition. The rating for Bulgaria for 1998 is raised to 4 in comparison with the 1997 rating of 3. The final conclusion of the EBRD is that the Bulgarian Trade Act and the trade regime in the country are comparatively clear, applicable, and adequately implemented. Bulgaria's rating in this respect is the same as that of the Czech Republic, Hungary and Poland, and is better than Estonia and Slovenia.

The information on the registration of companies in Bulgaria shows that in reality there are no serious barriers to market entry. Both the number and the relative share of the production of private companies in Bulgaria have marked a significant increase in recent years. The relative share of the private sector in the gross added value has gone from 17.5% to 63.7% in the period between 1991 and 1998, with small and medium sized enterprises having the biggest contribution to this process.

The Bulgarian law ensures that the owners and creditors of companies can freely file a bankruptcy or liquidation procedure. These procedures are drawn from European legislation. The lack of sufficient experience and weaknesses of the operation and co-operation between institutions delay their implementation. There has been, however, a perceptible improvement in the implementation of procedures, which leads to an increased number of bankruptcies and liquidation proceeding. During the first four months of 1999 about 1200 procedures for liquidation and 50 for bankruptcy have been launched with a much faster pace than during previous periods.

It can be concluded that there are no substantial obstacles in the way of market entry and exit in Bulgaria.

Legal System. Execution and Enforcement of Contracts and Laws.

The three-instance court process was introduced and the Supreme Court was divided into a Supreme Administrative and a Supreme Court of Cassation. Conditions for speedier court proceedings were created thanks to the limited application of the ex officio principle by the courts and a simplification of the subpoena process, which will become even more efficient after the introduction of new personal identification in the second half of 1999.

One of the areas in which the State regulation and legal enforcement are especially successful is intellectual property. As a result of the actions taken and of the institutional framework established, in the spring of 1999 Bulgaria was taken out of the list of countries, in which intellectual property rights are systematically violated and evaded.

Progress in respect to the execution and enforcement of law and contracts can be seen in three areas: improved implementation of laws regarding property and financial violations; improved possibilities for speedy and effective process regarding the execution of contracts; some improvement in diminishing the general level of corruption.

The progress in the legal system is significant, but more work is needed on the training of magistrates and judicial authorities and on improving the judicial infrastructure.

#### Wide Consensus on the Main Areas of Economic Reform.

Between September 1998 and May 1999 the consensus in Bulgarian society on the main principles of economic reform continued to consolidate. In September 1998 a three year Extended Fund Facility with the International Monetary Fund was signed, which defines the basic parameters of the economic policies and further reforms up to the Autumn of 2002. There is a wide consensus in Bulgaria on the main direction in economic policies and reform apparent in the Declaration of the National Assembly of 17<sup>th</sup> May 1997, and indirectly verified by the EU in the Joint Assessment of the Medium term Priorities of the Economic Policies of Bulgaria.

#### Macroeconomic Stability

Bulgaria's economy during 1998 and the beginning of 1999 was characterized by a sustained macroeconomic stability. The dynamics of GDP, incomes, prices, interest rates, and the currency exchange rates are predictable, the deviations are much smaller than in previous periods, their magnitudes are entirely comparable or even better than those of the countries, which have already started negotiations for EU membership. Achieved is a sustainable internal balance between stable prices and constantly increasing budget revenues. The low interest rate has significantly increased investment and decreased the internal debt burden. Bulgaria has achieved marked progress in the nominal implementation of the Maastricht criteria, thanks to the successful introduction of a currency board arrangement. As a result of unfavourable external factors there has been a drop in exports, but the current account deficit is stable and has not led to a fall in the currency reserves.

#### Presence of a Developed Financial Sector

The harmonization of the legislative and regulatory framework of the financial sector in Bulgaria with that of the internationally recognized standards is continuing. In August 1998 the Bulgarian National Bank enacted Ordinance <sup>1</sup> 22 on the Establishment of a Central Credit Register, which increased the reliability of decision-making in the field of lending. Since the end of 1998 important changes were introduced in the national accounting standards aimed at bringing them closer to the international standards. An Early Warning System was established, which aims at identifying potential risks to bank portfolios.

The most significant change in the structure of lending is in its re-channeling from the state to the private sector. In 1998 the relative share of loans to the private sector grew from 43.6% to 65.6%, and reached 68% by the end of April 1999.

Progress was achieved in the financial status of banks. There is considerable growth in their capital adequacy and liquidity. Notwithstanding, the comparisons show that the relative share of bank intermediation is below the level of the developed market economies. The improvement in the quality and the efficiency of the financial sector necessitates the development of new and effective market niches, improvements in the market for loan collateral, and completion of the privatization of the big state-owned banks.

## **4. Ability to Cope with Competitive Pressures of Market Forces in the EU**

### Existence of a Functioning Market Economy and Macroeconomic Stability

The main elements of a functioning market economy in Bulgaria are present. Prices are deregulated with small exceptions in accordance with European standards. A radical commercial liberalisation has been achieved, which makes Bulgaria one of the countries with the most open economies among the accession candidates. There are no significant obstacles in the path of market entry or exit, with the exception of clearly defined cases, whose scope will diminish in the years to come. Macroeconomic stability is being sustained, regardless of the deteriorated external conditions. The basis for a wide social consensus on the main elements of the economic reform, whose grounds were laid two years ago, is solid. Serious progress is discernable in the financial and legal spheres in comparison with 1997 and the first half of 1998.

#### Presence of Developed Human and Physical Capital

Maintaining macroeconomic stability and low interest rates is a prerequisite for attracting investment in infrastructure projects. During 1998 the Government defined investments in infrastructure as a priority in the public sector until the year 2001. In light of the need for large-scale investment, internal savings are insufficient to finance it and foreign investments are especially important for the improvement of human and physical resources. Still insufficient are investments in research and development activities, software, licenses and know-how. These issues will be resolved in the medium term, provided the reforms are successfully completed.

Regarding human resources, Bulgaria has qualified personnel and a comparatively good educational system. Despite the negative impact of the economic recession between 1990-1997, positive changes are being observed and the country is in a competitive position as to its human resources. Especially important in this respect is the need to reinforce the link between education and business, as well as to integrate scientific research and education at all levels.

#### Degree of Impact of the Government's Policies and of Legislation on Competitiveness

The impact of the Government's policies and legislation on the competitiveness of the Bulgarian economy and of the separate enterprises is relatively favourable and increases the ability of Bulgarian businesses to withstand the competitive pressure of the free market.

Domestic trade in Bulgaria is liberalized, with the exception of the natural or regulated monopolies. More and more commodities markets are being established and in the coming years they will become more experienced. The foreign trade regime of Bulgaria is essentially liberalized while the trade policies of the country are being progressively harmonized with those of the EU and do not present obstacles to the accession process. The country is pursuing a policy of trade liberalisation also through entering into new free trade agreements. New agreements with CEFTA and with Turkey became effective since the beginning of 1999. Negotiations are in progress with the Baltic states, Macedonia, and Israel.

The Law on Protection of Competition (May 1998) is fully synchronized with European norms and requirements, while its dispositions and the year of application so far give grounds to conclude that in the medium term the protection of competition in Bulgaria will correspond to the European standards and that many markets with monopolies at present will be deregulated based on a specifically approved schedule.

As a result of a group of measures, by the end of 1999 the institutional framework for small and medium sized enterprises (SME) in Bulgaria will be consolidated and fully functional. Thus, it may be concluded that the priorities of the approved national strategy on SMEs will be implemented. The main difficulties here are the still limited access to financial resources and the insufficient qualification for small and medium sized entrepreneurs.

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## Degree and Speed of Trade Integration of Bulgaria with the EU

The most important indicator for the ability to withstand the competitive pressures of market forces in the EU, according to the Copenhagen criteria, is the degree of economic integration of the countries applying for membership to the EU.

Bulgaria's relative status along this criteria is comparable to that of the other applicants. Since 1991 the commercial relations of Bulgaria with the countries of the EU are developing and growing at a rapid pace. While in 1991 the relative share of the country's trade with the EU was 15.7% for exports and 20.7% on imports, in 1998 these were respectively 51.5% and 46.1%, and in the first quarter of 1999 grew to 60.3% and 49.3%. The EU is already the main trade partner of Bulgaria and the trend shows that in the medium term trade and integration will continue to grow. Regardless of the relative geographic distance with the EU, its share in Bulgaria's trade is larger than that with Spain and Greece prior to their accession. Countries like the Czech Republic, Hungary, Poland, and Slovenia not only have a geographic advantage, but also have no visa limitations in trading with the EU. Additional problems for Bulgaria's trade with the EU are the infrastructure obstacles ensuing from the Kosovo crisis.

The concentration of Bulgarian trade with the EU in commodity groups remains high and it can be expected that the comparative advantages based on low labor costs in Bulgaria will continue to dominate in the future structure of trade. Recent behavior and the expected development of trade between Bulgaria and the EU, combined with the implemented measures of trade liberalisation prove that there are sectors in Bulgaria's economy, which are competitive in the common European market.

## Share and Significance of Small and Medium sized Enterprises

SMEs in Bulgaria are one of the most important and dynamic elements in the economic system. They provide a significant, and in the private sector - a dominant part of jobs in the economy. Their economic efficiency is much higher than that of larger enterprises and they have a much larger sale per assets ratio. SMEs provide for a greater flexibility in the economy since they are quicker to react to changing conditions and to limit their losses and expand their operations.

The share of SMEs in Bulgarian economy is relatively high and growing. Regardless of the comparatively low density of SMEs in Bulgaria, the trend is for SMEs to play an ever-growing strategic role in the medium term as economic entities, which provide flexibility, entrepreneurship, and a significant number of new jobs.

## The Role of Foreign Investment in Increasing the Competitiveness of Bulgarian Economy

The medium term prospects for competitiveness and the flow of foreign investments into the Bulgarian economy are relatively good.

Bulgarian enterprises and their products are still not highly competitive on the foreign market, but the growing role of small and medium businesses and of the private sector will improve this situation. The commutative foreign investments per capita of the population remain below averages in Central Europe. In 1998, however, the share of direct foreign investments in Bulgaria's GDP is approximately equal to those in the forefront applicant-member countries. The share of green-field investment is growing. Viewed against the global financial crisis, and especially against the Russian crisis, this achievement shows a sustained trend towards an increase in direct foreign investment. In 1999 the main obstacle to this trend will be the crisis in Kosovo. Its significant deterring effect can be overcome, if several big privatization deals with strategic foreign investors are concluded. Another even more important element in this

direction would be if the EU indirectly promoted foreign investment, by opening negotiations for accession thus sending a very strong political message.

Since the beginning of 1999, the foreign investments regime in Bulgaria is simplified and more transparent. Thanks to macroeconomic stabilization and the accelerated liberalisation of foreign trade, the focus in attracting foreign investment has shifted towards special measures in creating an overall improvement in the general climate for investment in the country in the context of the privatization of strategic enterprises and operations.

## **5. General Assessment of the Compliance**

### **Presence of a Functioning Market Economy**

The main barriers to the presence of a functioning market economy have been eliminated by the liberalisation of prices and trade and a macroeconomic stability, which has been sustained for over two years. Stable prices, a low interest rate, and growing budget revenues are indicators pointing to a stable market balance between supply and demand. Remarkable progress has been achieved through the expansion of the private sector and the liquidation or bankruptcy procedures of a large number of inefficient enterprises. In the conditions of an accelerated liberalisation of foreign trade the balance of payments is stable and the currency reserves of the country are growing. There is wide consensus on the Government's policy. The comparison with the countries in the first wave for accession to the EU is favourable to Bulgaria. The assessment is that on the whole Bulgaria fulfils the Copenhagen criteria for a functioning market economy, but that further measures are needed to improve the financial and legal system.

### **Ability to Withstand the Competitive Pressures of Market Forces in the EU**

The medium term prospects for Bulgaria to cope with the competitive pressures of market forces in the EU are good. The main elements of a market economy in Bulgaria are functioning in the environment of macroeconomic stability. The impact of the Government's policy and of the legislation on competitiveness is generally favourable. The degree of commercial integration with the EU is notable and contributes to the further strengthening of the capacity of the economy to withstand competitive pressures. The share of small and medium sized enterprises in the Bulgarian economy is comparatively high and growing, and in the medium term they will play an important role. The prospects for competitiveness and for the flow of foreign investment into the Bulgarian economy can be assessed as relatively good.

### **Overall Conclusion**

For all practical purposes Bulgaria can be regarded as a functioning market economy and in the medium term will be capable of withstanding the competitive pressures of market forces in the EU, provided it sustains the present pace of economic and structural reforms.