

THE ECONOMY OF BULGARIA - October 2012

Summary Report

Of the Center for Economic Development

Complete text of the Report in Bulgarian can be found at www.ced.bg

MACROECONOMIC DYNAMICS. Economic growth. As of October the economy of 2012 demonstrates a weak growth, driven mainly by domestic demand with slight expectations for improvement till the year end. The data so far show that the Bulgarian economy has performed better in the second quarter compared to the first quarter of 2012. Despite the registered GDP growth remains weak in the second quarter of 2012 as well, there is nevertheless a slight increase – on an annual basis by not seasonally adjusted data it has increased to 1% (from 0.9% for the first quarter of 2012). By adjusted data, the annual growth maintains the same rate (of 0.5%), and based on the previous quarter is 0.3%, after registering zero for the first quarter of 2012.

Value added has moved in the same direction with GDP by not adjusted data - it also grows (by 0.6% yoy following a decline of 0.9 percent for the first quarter). By adjusted data, however, GVA decreases yoy, but nevertheless its direction differs from GDP dynamics but it is still a good sign that after three consecutive quarters of decline on a quarterly basis there is GVA growth in the second quarter.

Based on our estimation of available NSI data¹ we expect GDP growth *for the third-quarter² to be a little over 1%³*, i.e. slightly higher than the one, registered in the first two quarters. *For the year, it is also possible to reach a growth rate a little over 1%*, for which formation we expect both better economic performance and a more active domestic demand in the second half of the year. The external environment as a whole remains uncertain, and expectations for improvement are generally shifted to the second half of 2013.

On the **production side of GDP** we expect that only three of the ten sectors will report a decline for 2012 (these are sectors "Creating and disseminating information and telecommunications," "Public administration, education, human health and social work," and "Culture, sports and

¹ Quarterly national accounts data on GDP and its components by mid-year completed with the picture from monthly short-term business statistics data and the surveys of the business for the first 8-9 months of 2012, i.e. the data available as of October 2012.

² According to the NSI [Release Calendar](#) GDP estimates for the third quarter of 2012 will be announced on November 15, 2012 and preliminary - on December 6, 2012.

³ In shaping our expectations of quarterly and annual dynamics we continue to use seasonally not adjusted data because they, unlike adjusted data, are bound to annual data. For a more complete picture and highlighting the trends, we comment on seasonally adjusted data.

entertainment, other activities of households as employers; undifferentiated activities of households producing goods and services for own consumption; activities of extraterritorial organizations and bodies"), while in the other sectors – a slight growth is expected. Only one of the sectors is expected to shift from growth in 2011 to a decline for 2012. The dynamics in the industry looks positive so far, but not very convincing. Both decline and growth will be smaller in size compared to the previous year.

From the three sectors, which according to annual data for 2011 showed best performance (i.e. sectors which demonstrated growth "industry"⁴, "professional activities"⁵ and "information"⁶ for 2011, which together created nearly 31% of GDP for the previous year), probably only two will show growth for 2012, and it will be weaker. Growth can be expected in industry and in "professional activities" for the third quarter yoy.

In 2011, the best progressing sector in the economy was *industry* - its value added demonstrated fastest annual growth rate (9.1%) and highest share in GDP (21.2%). Since the second quarter of last year, however, the growth of value added in industry began to decline on an annual basis and this has continued for a fifth consecutive quarter. In the second quarter of this year, there is even a decline (by 0.6% by not adjusted data). Quarterly dynamics is still fluctuating, but it can be noticed that in the second quarter it is accelerating which is a positive fact. By current prices the volume of value added in industry has for a third consecutive quarter been below its level from a year ago, which is disturbing.

So far monthly data do not give clear indications that the third quarter of 2012 will report better value added dynamics in industry. Available for July and August NSI data of real growth in industrial production on an annual basis fluctuate, unlike those for the second quarter, when they were positive for the three months. The index rates of the business climate in industry in the months of the third quarter are in general close to those from the previous three months. ***It is expected that third-quarter dynamics of value added will be similar to that in the second quarter. For the whole 2012 growth is expected of value added in industry, but it is unlikely to exceed 1.5%.***

For 2011 the value added in "Professional activities and research; administrative and support activities" (4.7% share in GDP) came second in size after growth in industry (8.1%). After this impressive growth in 2011, declines followed in the first quarter of 2012 (compared to the high base a year ago), while growth is reported for the second quarter on an annual and quarterly basis (compared to the low base a year ago). ***Although dynamics is fluctuating, it certainly demonstrates an upward trend. We expect an annual growth for 2012, but at a slower rate compared to that of 2011.***

"Creating and disseminating of *information* creative products; telecommunication" was the third (and last) sector, whose value added increased, albeit very little, last year (1.9% growth, 4.8% share in GDP for 2011). In the first quarter of 2012, similar to sector "*Professional activities...*," this sector has also declined. Unlike the other sector though - its declines for the first quarter have been much deeper, and in the second quarter while "*Professionally activities ...*" is growing, "*Creating and disseminating information ...*" continues to shrink. With the available two consecutive quarterly declines ***we can expect that in the third quarter it will register a decrease***

⁴ Sector "Mining, manufacturing, production and distribution of electricity, heat and gas; water supply, sewerage, waste management and recovery."

⁵ Sector "Professional activities and research; administrative and support activities. "

⁶ Sector "Creating and disseminating information, creative products and telecommunications."

oy. It is very unlikely for the sector to demonstrate a change by the end of the year which could lead to an annual growth.

In the course of 2012 shifts are expected among the other 7 sectors, which are included in the report by an increasing rate of decline for 2011. Growth in four of these seven sectors is expected for the year ("finance ...," "property ...," "trade ...," and "construction"), while decline is expected in 3 of them ("government ...," "agriculture ...," "culture ...").

The worse dynamics in sector "*Financial and insurance activities*"⁷ in the first quarter turned out to be short-term at least after demonstrated growths on annual and quarterly basis in the second quarter. ***A relatively weak growth is expected for the third quarter of 2012. Growth, although insignificant, is also expected for 2012.***

The restrained dynamics in sector "*Real Estate*"⁸ in the first quarter was followed by noticeable growth in the second one. It is unlikely to expect rapid acceleration till the end of the year. Nevertheless, this sector ***will most likely end the year by growth, albeit weak, in contrast to the decline last year.***

Data for the second quarter show that both sectors - "*Financial and insurance activities*" and "*Real estate*" became active sooner than expected – not before the second half of the year.

Declines in sector "*Government; education; human health and social work*"⁹ are continuing in the second quarter, and are bigger, compared to the first quarter. ***If there is any growth till the end of 2012 it will be negligible. For the whole year we expect a decline, but smaller than that of 2011.***

Three sectors show the same decline as in 2011 (1.1%): "*Trade ...*,"¹⁰ "*Construction*"¹¹, and "*Agriculture ...*"¹². They are covered in the report by quarters in a descending order according to their share in the economy for 2011.

The value added of sector "*Trade, repair of motor vehicles and motorcycles; transportation and storage; hotels and restaurants*" had definite dynamics in the first quarter – growth in seasonally adjusted data, decline in not adjusted. For the second quarter growth is registered, though very weak, compared to a year ago. ***For the third quarter, we expect growth, though weaker than that in the second quarter,*** as only in retail monthly data of real turnover growth are slightly better for July and August on an annual basis than those for the first three months, especially in the trade of food. Data on business climate (in retail) in September improve. We expect that retail will continue to contribute positively to the overall economic performance and ***the commercial sector as a whole will end 2012 by growth.*** Expectations for better dynamics in the sector are bound to positive estimates for the branch for the summer, and expectations for the coming winter tourism season.

Since the beginning of the year the annual dynamics in sector "*Construction*" is weak and diverse, yet it is a good sign that on a quarterly basis value added for a second consecutive quarter, has been growing, albeit weak. For the third quarter we have reasons to expect even better data as

⁷ In retrospect: the value added of sector "Financial and insurance activities" slowed down only in 2010 and for 2011 registered a slight decline (0.1%). The share of its value added in GDP for 2011 was 7% (highest since 2006).

⁸ The value added of sector "Real Estate" reported relatively small decline (0.6%) and 8.1% share in GDP for 2011.

⁹ For 2011 the value added of sector "Government, education, human health and social work" declined by 1%, and its share in GDP was 10.8%.

¹⁰ Sector "Trade, repair of motor vehicles and motorcycles, transportation and storage; hospitality industry" is second in importance to the economy after industry, with 17% share of value added in GDP for 2011.

¹¹ Sector "Construction" had a 5.6% share of value added in GDP for 2011.

¹² The value added of sector "Agriculture, forestry and fishing" had 4.8% share of GDP for 2011.

monthly data of annual change in construction output for July and August were positive and the business climate in the sector improves in September. We expect that data on construction will generally improve for 2012 compared to last year, **and in value added it will report annual growth, though just above zero.**

In the second quarter of 2012, the agricultural sector ("*Agriculture, forestry and fishing*") continued to grow, albeit at a slower pace after the registered in the first quarter double-digit growth yoy. On a quarterly basis, however, there was a decline and this is the reason to expect further slow-down in growth of agricultural value added till the year end. As a whole, 2012 seems unfavorable in terms of harvest which is the reason to **expect that this year agriculture will not register growth, but decline, though not very deep.** In nominal terms, given the surge in prices, there will be growth in the produce of the sector.

The second quarter was more favorable for sector "*Culture, sports and entertainment, other activities; Activities of households as employers; undifferentiated activities of households producing goods and services for own consumption; Activities of extraterritorial organizations and bodies.*"¹³ Declines yoy contracted and quarterly growth has been recorded for the first time for 10 consecutive quarters. Even if yoy growth recovers by the year end we **expect that the industry will record again annual decline, but significantly lower than that of last year.**

We expect that third quarter data will show contracted growth of value added in service-related sectors – this is noticed in the downward trend of the business climate in services registered by the NSI business surveys in services (excl. retail) for July, August and September, especially after the upward trend in April, May and June.

What stands out in the data on dynamics of the components of **GDP use** by the mid 2012? Unlike the first quarter, when stagnation was noticed in the foreign trade of goods and services, now according to second quarter data the most important factor in the economy as a whole is the high growth of *final demand* both on an annual and quarterly basis. Final consumer expenditure of households is the fastest growing (by 6.2% yoy by not adjusted and by adjusted rows - 3.9%, and by 2.9% on a quarterly basis). **For the third quarter, growth is expected to continue. For the whole year positive contribution can also be expected of final consumption to economic growth in general.** Our expectations are based on better indices of consumer confidence measured in July.

As for *investment* it should be noted that for a second consecutive quarter, it has grown on a quarterly basis. Since registering for the first quarter - for the first time since the fourth quarter of 2008 - annual growth (though only 1.3% by not adjusted data), in the second quarter on an annual basis there is decline, but it is close to zero. **We expect recovery in investment dynamics in the second half of the year. For the whole year it is likely to expect positive contribution of the investment component to annual growth, though quite modest.**

Foreign trade in goods and services in the second quarter, in contrast to the first quarter, improved - both exports and imports increased on an annual and quarterly basis. Import rates grow faster than import rates. *Exports* of goods and services increased by 5.1%, while *imports* - by 9.9% (by not adjusted rows). They grow correspondingly by 3.4% and 7.6% on a quarterly basis. The faster

¹³ The largest decline in 2011 (8.1%) sector was "Culture, sports and entertainment; other activities; activities of households as employers; undifferentiated activities of households producing goods and services for own consumption; activities of extraterritorial organizations and services." Its value is with the lowest share of GDP compared to 10 major sectors of the economy - for 2011 it was only 2.1%.

growth of imports corresponds to the growth in final consumption and the absence of deep declines in investment. ***We expect that by the end of the year imports will continue to grow faster than exports of goods and services and this will result in a negative net contribution of foreign trade in goods and services to annual economic growth.***

For three consecutive months - June to August 2012 - the **current account** balance is positive. Bearing in mind its positive balance in March, its sign has been positive for the whole period since the beginning of the year till August. For the first eight months of 2012 it has amounted to Euro 34.2 million (0.1% of GDP) but is by times less than the January-August period year ago (Euro 876.7 million or 2.3% of GDP). The surplus is due to the positive balance in *Services* and *Current transfers*, which are improving yoy. Trade balance keeps a negative trend so is the income balance, the first – growing, and the latter - shrinking.

The positive balance in *Services* is slightly growing. Its share in GDP remains 4.8%. In the three sub-positions of services balances remain positive. The balance of *travel* has increased slightly, the balance of *other services* has increased significantly, but this item is small in volume, however, the balance of *transport* has worsened.

The positive contribution of net *current transfers* is growing too. Their share of GDP rises to 3.6% compared to 3.2% of GDP for the same period in 2011.

The negative *trade balance* has grown over twice yoy. For the period January - August 2012 it reached Euro 2,563.6 million (6.5% of GDP) at a deficit of Euro 1,008.3 million (2.6% of GDP) for the same period in 2011. *Exports (FOB)* continue to grow, but at a much slower pace than the same period last year (by only 2.3% yoy compared to 35.7% growth in January-August 2011). *Imports (FOB)* also grow at a slower rate than last year, but then the rate of exports was faster than that of imports, while imports' rates are faster now. For the period January - August 2012 *imports (FOB)* have increased by 13% yoy compared to growth of 25.5% a year earlier.

The negative balance under *Income* is improving. For the period January - August 2012 it has shrunk to 1.9% of GDP against 3.2% for the same period in 2011.

For the whole 2012 we expect that the current account will have a negative sign, but relatively small.

Foreign Trade. In the first eight months of the year *trade turnover* has risen by 8 per cent with great contribution from imports. *Exports (FOB)* have increased by 2.3 per cent to Euro 13.6 billion. At the same time *imports (CIF)* have increased by 13 percent to Euro 16.9 billion. The *deficit in trade balance* of Euro 3.3 billion (twice bigger than the previous year) is due to the threefold increase in trade deficit with EU countries. The emerging trend of slowdown in exports is in line with expectations for a general contraction in world trade. Bulgaria's relatively good position in the current situation is due to the fact that export companies quickly respond and switch to other non-EU markets and offer relatively inexpensive mass products. So what in other circumstances is considered deficiency in the Bulgarian economy, with the continuing difficulties in most markets can become an advantage.

The changes in global markets led to a change in trade structure - the share of EU countries in exports fell from 62 to 59% to the advantage of non-EU countries. Exports to China grow twice while Russia replaces Serbia and Macedonia, while exports to the latter decrease. The volume of exported raw materials and investment goods decreases (albeit slightly) at the expense of consumer goods and energy resources. In imports the most significant change is the fast growth in imports of investment goods (28%), whose share has reached almost 24% of total imports.

It seems that global economy uncertainty and the stagnant production in the eurozone will continue in the coming months, which also means smaller demand and reduced potential for growth of Bulgarian exports. ***In this situation no significant change is expected in exports growth rate, while imports will probably continue to grow at faster rate over exports.*** Looking for new markets and filling new market niches, demonstrating flexibility and adjusting to the ever changing environment will be among the major challenges of export-oriented companies. However, if the trend of slowing exports to the EU continues, expansion of sales to other markets would not compensate for the loss, since on the EU market Bulgarian exporters are part of chains, while on third markets they supply mainly commodities and goods in a low state of processing.

The attracted **foreign direct investments** (FDI) amount to Euro 873 million (70% higher over the same period last year). This gives the grounds to say that investments are on the way to a recovery in investment activity. There is a change in the structure of attracted investments - the proportion of capitals for manufacturing and outsourcing of services is increasing at the expense of those in real estate and financial sectors. Most investments in manufacturing in recent years focused in the manufacture of automotive components for some of the largest vehicle manufacturers which, surviving, expanded their activities even in the crisis environment.

It is difficult to predict based on preliminary data, but it seems ***there is no way back to the boom of FDI from previous years***, and there will be two parallel trends - withdrawal of some investors for many reasons and entering of new ones in search of better opportunities. Weak economic growth does not offer good prospects to foreign investors, but fast absorption of EU funds, financial stability, lower production costs and skilled labor are still placing the country on the map of capital flows. Moreover, investors look for less bureaucracy and better quality public services, predictable regulatory environment, judicial security, availability of local suppliers, better infrastructure. What prevents not only foreign investors but also local businesses is the lack of consensus in overall vision of the country's economic development to provide predictability and long-term policy.

The July rise in electricity and fuel prices increased rapidly **consumer price** indices (CPI). Since in the first six months only 0.5% inflation has accumulated (CPI) in July the accumulation jumped to 2.5%, in September - to 3.7%. August and September also report higher than usual inflation. The highest levels of price increase are usually in Small Basket CPI, the lowest - in the harmonized CPI. By September the price increase in Small Basket is 4.7%, being 2.8% according to the harmonized index.

Increased electricity prices impact most significantly the price in "Housing (rent, repairs and maintenance), water, electricity, gas and other fuels." In July, the increase in this group was 6.3% according to CPI, but by the small basket it is higher (8.4%). The price increase of fuels impacts prices in group "Transport" a little less; it can be seen in all three months of the third quarter slightly smaller in September. In September the most significant rise is the in the prices of food.

NSI monthly business surveys show that pressure on price expectations of the business (for the next three months) rises in July, is the same in August and in September is shrinking for industry and trade, with a very small increase in services and construction. It should be mentioned that in July the NSI survey among consumers registers increase, and the opposite - decrease in inflation expectations in the long term (over the next 12 months). These dynamics indicate lack of internal pressure on consumer prices.

By end 2012 no sudden or significant increase is expected in consumer prices. ***The accumulated inflation for the whole year is likely to be about 4% (by CPI).***

In the second quarter of 2012 the reduction in the number of **employed** accelerated again (*NSI data* as of 05/09/2012, [Gross Domestic Product](#)) by 2.8% on an annual basis, as opposed to the trend of shrinking decline in previous quarters (in the first quarter decline in employed was 1.6%, after 2.3% in the fourth one and approximately 5% for the first three quarters of 2011). However, in four of the 10 sectors the number of employed increases: "*Creation and dissemination of information and creative products; telecommunications*" (3.6%), "*Public administration; education; human health and social work*" (2.1%), "*Professional activities and research; administrative and support activities*" (2%), and "*Financial and insurance activities*" (1%). Employees are increased in only two of the above sectors: "*Creating and dissemination of information; telecommunication*" (4%), "*Government; education; human health and social work*" (2%), while in the other two the increase is due to the subcategory self-employed.

There is acceleration in labor productivity growth in the second quarter (measured in man-hours), and this breaks the trend of shrinking growth observed in the previous three quarters.

For a second consecutive quarter the number of unemployed exceeds 400 thousand, according to labor force survey quarterly data. On an annual basis the unemployed increased in all age groups except in the 45-54 age range. ***For the third quarter quarterly unemployment is expected to be around 11%, but for the year it is expected to remain above 12%.***

Registered monthly unemployment at the beginning of year was above 11%, which fell slightly in the summer months and reached 10.6% in September. In the rows of Eurostat harmonized monthly unemployment rate¹⁴, however, unemployment in our country in August is still over 12%, with a slight upward trend.

Expectations of the business (according to NSI business surveys as of September) remain pessimistic regarding the movement of personnel in the next three months, in industry for quite some time there are no large fluctuations, the slight trend of improvement continues in retail, in construction and services there is a pronounced seasonal cycle. More optimistic, concerning unemployment in the coming 12 months, are consumers. After reduction in April, the July consumer survey records a further reduction in unemployment expectations for the next 12 months. The movement in indicators is the reason to ***expect reduction in employment to continue to slow down, but no noticeable reduction in unemployment will be possible in the short term.***

With the still weak performance on the production side of the economy in the first half, and in the stagnant environment of our major partners, and expectation to register at least slow growth till the end of the year, ***yet no rapid increase can be expected in employment. Registered unemployment rate will be above 11% at the end of the year and harmonized unemployment - over 12%.***

ENTERPRISE POLICY. The European Commission publishes a report on the progress in implementing reforms **promoting entrepreneurship**. The EC identifies three types of countries according to their performance - well-performing, such with good results in some indicators, but worse in others and "catching-up countries." Bulgaria is among the catching-up countries. The country puts efforts to improve the performance of state institutions, but the challenge is to make

¹⁴ Eurostat estimates use two rows of national data: quarterly samples of NSI (unemployed and economically active persons for the period) and registered unemployed in the month in the EA (labor offices). Eurostat calculates seasonally adjusted monthly data, where with statistical techniques and combines to certain levels the two rows, and produces a resultant row of interpolated and extrapolated data - seasonally adjusted, unlike preliminary NSI and EA data. In the three types of coefficients, besides the number of unemployed have different number of economically active persons. All coefficient in the row of EA are with the same denominator (economically active population from the census), the other two rows use the assessment of economically active population for each observed period.

them stable and more efficient by increasing their ability to improve the business climate. Bulgaria postpones important structural reforms that could improve its competitiveness. Such reforms include reducing bureaucracy at national and local level, fostering innovation, creating a well-functioning innovation system, development and improvement of energy efficiency of the economy. Bulgaria's innovation system needs reform. The country is committed to doubling its budget for development and innovation by 2020, which requires effective use of all mechanisms. This means Bulgaria should focus on key sectors and improve the cooperation of industry and business in innovations. Better use of Structural Funds is an important factor in overcoming these difficulties.

Innovative development of the Bulgarian business is among the areas in which the country lags far behind, and according to the latest report of the World Economic Forum (The Global Competitiveness Report 2012-2013), in terms of innovative development Bulgaria ranks 92-nd among 144 countries covered by the study. More mechanisms are needed than those used, to promote innovation in the country. Two main instruments are used now: OP "Competitiveness" (OPC) and the National Innovation Fund (NIF), which has not operated for several years. OP "Competitiveness" provides more opportunities to support innovative business development. In mid 2012 NIF resumed its activities but its budget for 2012 is only BGN 5 million, which is a very small amount - by times less than any scheme under OP "Competitiveness." It is necessary to develop clear rules for NIF fund use, which do not exist. It is also necessary to coordinate and reconcile the various instruments that will encourage innovation for the period 2014 - 2020. It is important to have a clear vision - what will be funded by the NIF and what through the future OP Innovation and Entrepreneurship.

In early September the government approved and entered in Parliament the long proposed amendments to the **Law on Investment Promotion**, which will provide *new incentives to large investors*. The reasons to offer new incentives are several: first, despite the financial and economic stability of the country and the favorable tax environment investors often prefer neighboring countries where government incentives are offered; secondly, weak interest in current advantages due to the fact that many investors are working within certain zones and do not need land or road construction. The new law will give investors the right to choose according to activity and preferences, but will not allow simultaneous use of two types of preferences.

Business representatives in Bulgaria are against the new incentives, arguing that it will create unequal treatment to investors - only large projects will be encouraged while small businesses are not covered in the law. Moreover, there is no analysis of the impact of such measures on the market. By supporting big companies and reducing their costs, competitiveness and survival of small businesses is further reduced. Equal treatment of economic agents can be achieved through significantly improving the business environment, providing greater predictability, drastically reducing bureaucracy, and improving the skills of the labor force.

In order to improve the **business environment**, in early October the government adopted a *plan to reduce the regulatory burden on business*. It includes 249 measures to be implemented until November 30, 2012. The majority of measures are initiated upon proposal of NGO representatives, professional and employer organizations, publications and comments in the media. In the period March - June, a review of regulatory regimes in all ministries was done and proposals were given to: remove regimes that impede small businesses; reduce the cost of implementation of regulations and the degree of state intervention, to reduce the administrative burden; to simplify procedures, documents and reduce the time for execution.

This is another "action" in the area of regulatory reform, such decisions are made periodically, but so far no clear or definite result or significant simplification in business environment has been achieved.

With regard to **public procurement**, the published in July European Commission Report on the Progress of Bulgaria under the Cooperation and Verification Mechanism states that weaknesses in the implementation of legislation in this area create many opportunities for corruption. They also have negative impact on efficient use of EU funds and generally lead to lower quality in the provision of public service and spending. The report highlights Bulgaria's reforms in the legislation on public procurement with a view to simplify and increase administrative checks. However, the report notes that these efforts have not yet led to expected results. The number of complaints received in the Commission on the Bulgarian public procurement system continues to increase there are obvious cases of serious breaches of EU rules in public procurement. The document points out that it is important that Bulgaria implements new control and check procedures effectively. Empowerment of PPA to conduct inspections on their own initiative will be an important message that all supervisory authorities should be more proactive.

Despite efforts the level of **corruption** in Bulgaria is quite high and is a major obstacle to economic development. This is supported by a number of respected studies and reports. In the latest Global Competitiveness Report 2012-2013 of the World Economic Forum corruption is once again ranked first among the factors hindering business in the country. In early September, the Council of Ministers approved the next schedule of urgent measures and actions of the government and the judiciary to implement the benchmarks in judicial reform and the fight against corruption and organized crime. The schedule covers the period until December 2013 and includes 130 legislative, administrative and organizational initiatives to ensure continuation of judicial reform and achievement of concrete results in the fight against corruption and organized crime. Emphasis is put on management, organizational and analytical measures of institutions that aim to improve practices, introduce models of good governance, precise coordination between law enforcement bodies and the judiciary.

At the end of each term in office an earnest desire is seen for attracting investor interest and for completion of privatization by the government. Regardless of political will, the Agency for **Privatization** (APPC) is rather an example of inefficient administration, and poorly working body. The limited number of state companies to be privatized, and the major number (not typical of this structure) deals for real estate and business liquidation, suggest a shift in the focus and main objectives of the APPC - sale of whatever state companies are left, either with majority or minority state share. It is evident that by the end of this government term there will not be a change – the so called "prohibited list" will continue to be a barrier for the privatization process in Bulgaria of over 20 years. Sporadic success in privatization is primarily due to need for tax revenues, and not to the will for structural changes or economy recovery.

As regards **concessions** the government has failed to attract investors for the proposed airports in the country. Concessioning part of the ports for public use was delayed for no reason. In September and October 2012, decisions were made to open concession procedures for a port terminal of public transport of national significance " Nessebar," port terminal for public transport of national importance "Lom," port terminal of national importance "Vidin – South," port terminal of public transport of national importance "Ruse-west," port terminal "Ruse-center" and port terminal "municipality of Tutrakan." The only concession procedure announced in railways was for the railway station in Plovdiv.

PUBLIC FINANCE. The consolidated fiscal balance continues to improve in the summer months and reaches a surplus of BGN 107 million in August. For the same period previous year expenditure exceeded revenues by BGN 731 million. As in the previous quarter the good performance is due entirely to the national budget, which records a surplus of about BGN 617 million. However, EU funding deficit continues to grow, reaching BGN 509 million in August.

Consolidated budget revenues for the first eight months of 2012 amount to BGN 17.8 billion, of which proceeds from EU funds are over BGN 919 million. Total costs are approximately BGN 17.7 billion, of which costs less contribution to the EU budget (BGN 562 million) are over BGN 17.1 billion. Consolidated revenues for the first eight months increase by 9.6% yoy, while expenditure increases only 3.8%.

Higher revenues result from growth in revenues in two main revenue sources - VAT and excise duties. The main drivers of higher revenues are the higher prices for energy and raw materials, which put pressure on prices of consumer and investment goods. Although it was expected that measures for connecting cash registers of traders, including gas stations with the NRA, will improve collectability, the Ministry of Finance estimates this effect in 2012 to have brought only BGN 40 million more of VAT revenues.

The state of international prices and the higher rate of imports in the country affect positively the revenue side of the budget, which can be even over fulfilled in nominal terms. This can create spending behaviour rather than using additional funds for deficit reduction. Additional funds have already been allocated: to the Ministry of Defense – BGN 10 million, Ministry of the Interior – BGN 18 million, Sofia Municipality – BGN 11.2 million.

The budget for 2013 seems feasible if the economy continues to develop close to its current pace. However, there are still many external risks in both the eurozone and globally. At this stage it is difficult to say whether the budget is such because of the coming elections or not. It rather depends on its performance in the first half of 2013 not that much on expenditure provided in it. In case of significantly higher expenditure in the first six months of the year there are new risks to the budget implementation.

Program budgeting is still not in the focus of attention, although existing formally for years. The financing for primary spending money is not oriented to specific goals but to the needs of the administration. There is no preliminary, interim or final evaluation of effectiveness of funds spent and the success of government programs. There is no justification for the allocation of more funds to certain ministries such as the Ministry of the Interior and Ministry of Defense, and fewer resources for the Ministry of Health.

Taxation policy. Further increase is envisaged for 2013 of the minimum wage and minimum insurance income. Similar administrative increase of costs for employers at a time when the economy is still recovering may have a negative effect. In 2012 the minimum wage and minimum insurance income were also increased, leading to a decrease in number of secured persons, which slightly increased in May-June. The latter, however, can be attributed to seasonal jobs that will disappear after the summer. Similar effect can be expected in 2013. Those in power also expect a continuing decline in employment for the next year - 0.1% on an annual basis.

Another change in tax laws is *the advance payments of corporate tax*. Companies with net income of BGN 300 thousand will be exempt from advance payment of tax and will pay all of it once. Companies with net income up to BGN 1 million will pay advance installments every three months rather than every month as it is now. This will facilitate the firms with lower profits, leaving more

operating capital. However one can expect some negative impact on corporate tax revenues, for example they will increase at a slower pace, as part of the revenues will be received in 2014.

There are proposals for introducing *single bill of payments* to the Treasury, which would replace the current multiple accounts for different taxes. This is a significant advantage for companies, which would save quite a few resources, but does not change the administrative burden of paying these obligations. It mainly involves completing several forms and explanations and their monthly submission within strict deadlines. However this exemption creates several problems. The collection of all debts in one single account can result in that funds intended for the payment of contributions may be used to cover tax liabilities, and hence may reduce revenues in the system, and from this - the cost for the corresponding services. This is even of greater importance for companies which pay excise duties, VAT, corporate tax and social security and health insurance contributions. The presence of just one delayed debt may lead to lower revenues in the system, no matter that the individual is a correct payer.

SOCIAL AND HEALTH POLICY. In social terms, the last months of each year focus on discussion and adoption of the budget for the next year and planned or not planned in it changes in the income and social security payments. This year they are influenced by the coming parliamentary elections in 2013 – i.e. in the election year things look different in the sense of greater tendency of the government to budget higher payments to certain social groups.

The issues related to financial sustainability of the system and adequacy of **pensions** remains to be solved in the next government term. It will pretty soon be necessary to make important decisions about retirement age, introducing same retirement age for both genders, limiting the access to disability pensions and other unpopular measures. Each year the amount of subsidies from the state budget to social security increases. In 2013 the amount will be 11% higher than this year, provided that all other conditions are implemented. Without significant reform the current pension model will be pressing on the budget, and will reduce opportunities of carrying out important policies.

Even at the end of their term in office GERB are continuing to insist that **healthcare** is their priority and that they work to reform it. This is extremely unconvincing and inappropriate when one looks at the isolated initiatives of Health Minister Desislava Atanasova, aiming to reduce price of medicines through administrative measures and through the project "*Principles for reforming projected volumes of activities in hospitals*" put by NHIF to a public discussion. The project caused dissatisfaction among stakeholders due to its highly restrictive nature and many unanswered questions in the field of hospital financing. As far as the public is informed, the discussion seems to be in a deadlock and it is not clear under what conditions it will be included in the national framework contract for next year.

Against this background, the entered by the Ministry of Health draft of "*Strategic Policy Framework of Health to improve the health of the nation during the period 2014-2020*" to the Parliament is somehow inadequate. The main objective of this document of winding title wording is to reduce child mortality and improve the health status of the population. It repeatedly addresses already known problems of the healthcare system without clearly giving practical steps to resolve them, by whom, who will provide funding, from what sources, etc. Bulgaria needs a comprehensive healthcare reform, rather than repeating well-known facts with no practical effect.

FINANCIAL SYSTEM. At the end of September foreign exchange reserves mark a significant growth compared to the same period in 2011 and the previous quarter. This is mostly due to increase in payables which at the end of the third quarter amount to BGN 6.9 billion. The reason for the significant increase in fiscal reserve is the issuance of government debt of Euro 950 million

in the form of Eurobonds in July, as the funds of the issuance have entered the Central Bulgarian Bank and will be managed by it until January 2013, when is the date of payment of the maturing debt for which the bonds were issued. In the third quarter of 2012 the monetary base (currency in circulation and liabilities to banks) also grows in its two components.

The state of the **banking system** remains stable. At the end of August 2012 the amount of assets and borrowings remained relatively unchanged compared to the previous month and year on year continues to grow. Liquidity of banks remains relatively high, and the total capital ratio significantly exceeds regulatory requirements. The capital and reserves of the banking system register growth. Borrowed funds from individuals and households continue to increase, which increases the stability of the deposit base, but reduces profitability of the banking sector due to its relatively high price. In the period June - August the negative trend in net interest income is increasing, but depreciation and devaluation costs also significantly reduce due to which the banking system generates higher profits compared to the same period of 2011. The gross loan portfolio of banks continues to grow, but the rate of increase is slowing due to acceleration of the decline in exposures to individuals. Since the beginning of the year there has been an increase in bad and restructured loans, at the end of August there is a slight drop in monthly volume. The main carrier of risk to the stability of the banking system remains the poor economic situation of the country. Weakened investment activity, reduced domestic consumption and consumer uncertainty regarding future income severely limit the demand for credit, and the rising unemployment, the reduced funds available to households and the general deterioration of Bulgarian company finances reflect on deterioration of bank credit portfolios. Given the unfavorable economic environment *no significant improvement can be expected in the state of the banking system in the short term.*

There are no significant changes in the state of the **lease market** in the second quarter of 2012 - the downward trend is maintained, but the pace is slow and the decrease is less as compared to the same period in 2011, and to the previous quarter. The volume of new business also continues to shrink. After two consecutive quarters of decline in non-performing loans, in the last quarter they rise again, and - due to the contraction in volume of receivables - their share in the portfolio increased considerably, reaching its highest value to date. The state of the lease sector continues to be strongly influenced by unfavorable economic environment. Given the low investment activity and reduced consumption in the country *no considerable improvement in the state of the lease services market can be expected in the short term.*

The negative trend in the development of **the insurance market** continued in the second quarter of 2012, and as of May the largest decline in annual premiums was reported since the beginning of 2011. In the period May-July 2012 the downward trend in gross premium income of the sector shaping the insurance market - general insurance – is maintained and premiums written decreased mainly in car insurance. After the first four months of the year when there was a decline in incurred claims, in May they are at the level of the previous year and over the next two months mark an increase in that revenue which with the contracted revenues limit the ability of companies in the sector to make a profit.

In the life insurance sector, the positive dynamics of revenues stops and as of May a decline was reported for the first time since May 2010. In June written premiums are again below those in the same period of the previous year, while in July there was an increase on an annual basis. In the incurred claims, however, the downward trend is maintained over the entire period from May to July.

Despite the negative dynamics in revenues as a result of taken by insurance companies back in 2011 measures to streamline their business, the sector records a positive technical result, income from investments and net financial result. In the period reduced consumption in the country continues to have a negative impact on the state of insurance industry. Considering the general state of the economy, the decline in disposable income of households and the rising unemployment, ***no significant improvement can be expected in the state of the insurance market in the short term.***

Capital Market. In the third quarter of 2012 all BSE indices increase their value - by between 5.6% and 12%. The number of transactions compared to the second quarter increased by 11.5%, while turnover declined by 19.7% and the overall rate for this period was BGN 92.1 million.

In the third quarter the blue chip index *SOFIX* added 10.6% to its value, but remained by 6.6% below its level for the same period of 2011. The sector index for companies investing in real estate *BGREIT* continues an upward trend and in the last quarter earns 12.0%. The *BGTR30* index adds 5.6% to its value in the quarter, while the broad *BG40* grows by 9.9% to 118.11 points, which is the highest value in the last year.

In the third quarter of 2012 the sector structure of stock turnover again experienced significant changes – a decline in the share of manufacturing industry by 27.6 percentage points, and that of companies in Real estate - by 7.3 pp. Traditionally, the dominant sector of financial and insurance activities adds 34.9% to its share in the third quarter and forms 62.1% of total turnover of the main BSE market. The shares of the other sectors remained unchanged from the previous quarter.

ENERGY. Bulgaria still lags behind in terms of *energy efficiency* compared to other EU countries. In this respect, it is essential that businesses realise that measures to improve energy efficiency will increase their competitiveness. By mid October this year seven proposals were submitted under the "Energy efficiency and green economy" scheme within OP "Competitiveness" yet over 90% of resources of the program is available to businesses. According to BCCI survey findings 45% of the companies have made partial improvements to save energy. Nevertheless, the overall energy efficiency is not common among businesses.

In late August, a contract was signed with U.S. "Westinghouse Electric Company," selected to make a feasibility study for the construction of a new block of *NPP "Kozloduy."* There is still a fierce debate for or against the construction of *NPP "Belene"* after a petition by the BSP for a referendum on the issue. Regardless of the outcome of the forthcoming referendum and mainly due to strong economic reasons it is not likely in the near future a new NPP to be built.

As regards "*South Stream*" project Bulgaria is committed by November 15 to make final investment decision for construction of the pipeline. Bulgaria's position was expressed again that project "*Nabucco - West*" should begin long before 2017 with the first phase: construction of interconnector between Bulgaria and Turkey, thus the territory of Bulgaria can be part of the route - the initial section from the border to Karnobat from "*Nabucco West*" and in Turkish territory that might be part of the project TANAP (Transanadolian pipeline) which will connect the Bulgarian-Turkish border with the Marmara. In August this year construction began of the *interconnector with Romania* which is expected to be completed in March-April next year.

The Council of Ministers *adopted new regulations of the Agency for Sustainable Energy Development.* It will optimize its performance in line with the increased importance of energy efficiency and renewable energy in both European and national scales. The Government proposed the Parliament to adopt a *new Law on oil stocks and oil.* Is also approved *draft Law on Maritime Areas, inland waterways and ports of the Republic of Bulgaria,* which provides special regulations

for certain issues related to the design and construction of energy facilities in or under the seabed within internal waters and territorial sea.

TRANSPORT. According to preliminary NSI data in the second quarter of 2012 *goods carried by road and water transport* increased by 10.8% compared to the first quarter, while the work done decreases by 1.6%. *Passengers transported* by land, water and urban electric transport increase by 2.4% and the work - by 0.3% compared to the previous quarter of 2012.

In the Global Competitiveness Report 2012 - 2013 of the World Economic Forum, Davos, the by factor infrastructure Bulgaria ranks 11 positions higher - from 87-th in 2011 to 76-th among 144 countries included. Yet, the results by many other indicators shaping this pillar are not very good. For example by "quality of roads" we rank 129-th, although there is an improvement by 7 positions compared to 136-th of last year.

In late August Lot 4.1 of "Trakia" Motorway was officially launched to traffic with a length of 14.8 kilometers - from the junction of Yambol to interchange Zimnitsa. The construction continues with different speed of separate sections of other motorways. In August 8 candidates were announced that will continue to further participate in the tender for selection of contractor for the design and construction of Lot 2 "Dupnitsa – Blagoevgrad" of the "Struma" motorway.

In late August the second metro diameter was put into operation from overpass Nadezhda to Cherni vrh blvd. A project is underway to extend the first metro rail, including Lot 1: Tsarigradsko Chausse to Sofia Airport. In October the construction of Danube Bridge 2 was finished. Its official commissioning depends on specific agreements between Bulgaria and Romania.

In late September the Ministry of Transport, Information Technologies and Communications announced the start of a project under OP "Transport" which will develop *analysis of the state of the railway sector in Bulgaria*.

The government adopted *National Action Plan for the promotion and accelerated uptake of green vehicles, including electric mobility in Bulgaria for the period 2012-2014*.

TOURISM. According to NSI in August 2012 **foreign citizens'** visits to Bulgaria are by 2.7% less than in July 2012, but by 3.3% above August 2011. The largest share of total number of foreigner visiting Bulgaria is from EU countries - 64.3%, followed by other European countries - 28.3%. Compared to August 2011, the visits of EU member states citizens fall by 3.8%. The visits of citizens from "other European countries" increase, and the greatest increase in visits is of nationals from Turkey, Ukraine and Russia. Trips of **Bulgarians** abroad increase - in August 2012 they were by 2.1% higher than in July and by 3.8% over the registered in August 2011.

According to preliminary analysis of the Ministry of Economy, Energy and Tourism (MEET) during the summer season tourists have grown by 7%, a major contributor to this is the increased number of tourists from Russia and the Ukraine. Most tourists are from Russia - for the first eight months of 2012, the Russian tourist market ranks first in Bulgaria, heading in number of tourists Germany, Greece and Romanian. Over the past five years, the share of Russian tourists to Bulgaria has more than doubled - from 5.7% in 2008 to 11.7% in 2012. The increased number of tourists from Russia to Bulgaria can compare to growth rates and number of tourists with that to Greece. The assessment of the balanced charter tour programs and the good "price-quality" ratio place the destination as very profitable for the season. The eased visa regime for Russian tourists is also important. According to MEET assessments this year around 5% growth in tourists from Germany is expected. According to hoteliers, however, their number will remain the same as last year.

Although 2011 showed a revival of visits from Nordic countries, preliminary data suggest that this year there may be a reduction from last year. The same assessment applies to visits from the UK.

Regarding the coming winter season experts expect that it will be very good. Sales started in June. Overall results last winter were not very favorable, *but in the coming season, Bulgaria is expected to reach the success parameters of 2010*, provided the weather is good.

In September the Parliament adopted at first reading the new *Tourism Act*. The purpose of the Act is to create conditions for sustainable development and competitiveness of the industry, conditions for specialized types of tourism, introduction of uniform criteria for the provision of travel services and protection of consumers of tourism services. The main expected results of the adoption of the Act are to improve the management of tourism at national level by expanding the functions of the National Tourism Council, creation of bodies with representatives of the tourism industry, forming advisory and expert bodies to help identify and implement national and local policy, introduction of regional structures for the management of tourism through tourism regioning of the country. The new Act introduces a term for categorization of tourist facilities - hotels, restaurants, and all accommodations will be categorized every five years, and not just once as before.

Since the beginning of September 2012 *decentralization of tourism is in operation* - MEET directorates responsible for tourism are moved to Plovdiv. The change is expected to promote a more balanced regional development and to create potential for additional activities related to administrative services outside the capital. Actual results of the decentralization of public administration are to be seen.

In 2013, BGN 8 million are provided for *advertisement of Bulgaria's tourism abroad*. This amount will be complemented with funds from OP "Regional Development" as well - it offers to about BGN 15-16 million for this purpose. The main objective of these campaigns is to present Bulgaria as a year-round tourist destination.

AGRICULTURE. In the second quarter of 2012 the trend of increase of the share of agriculture in GVA and GDP continued, reaching correspondingly 5.4 and 4.7 percent. Given the low *yield of spring cultures* there are no expectations that it will continue in the third quarter. The long drought in the summer resulted in a substantial decrease in production of maize and sunflower. Wheat and barley are less affected by adverse weather conditions, but cannot compensate for losses. Worldwide, however, there seems to be a shortage of grain and fodder *sustained price increases*. With serious decline in yield and the poor state and management of the *irrigation* infrastructure, there is need to recovery irrigation agriculture. Unfortunately there is still no plan for development of the irrigation sector and there is no work to restore the old depreciated irrigation infrastructure.

An important positive feature in the agricultural sector is the reduction of barren and increase of arable lands, the trend towards consolidation of agricultural land and intensification of the land market. The good market situation was supported by several factors: increasing interest in land as a basic production resource; possibility to obtain larger EU subsidies; active selling by land funds; tenders for the sale of land by the state fund. The active trading led to a significant increase in average transaction price. As a result of the consolidation of achievements, land funds achieved over 50 per cent increase in sales price compared to purchase price.

Assuming that funding helps the implementation of a certain policy, the agricultural sector *budget 2013* provides reduced national subsidies, and redistribution of resources. This aims at greater fairness, after for years the major support in agriculture went to grain producers, who received the bulk of the per area payments. The problem is that no analysis is done or evaluation of the impact of payments on different sectors in order to assess more accurately how much money should be

devoted to each of them, and there is no clear vision for the development of different sectors. Similar is the situation in the transfer of funds under the Rural Development Program from the unpopular to attractive for the farmers measures for absorption. Thus disproportionate funding is directed to certain activities, which harms the industry in the long term, since unresolved issues in the pending measures will deepen and will prevent a better balanced development of agriculture.

REGIONAL POLICY AND EUROPEAN FUNDS. There is an ongoing debate on the new guidelines of EU cohesion policy after 2013. In late 2011 the European Commission (EC) adopted a package of legislative acts in the field of cohesion policy for the next programming period (2014-2020). The aim is to boost growth and job creation in the EU by directing investment to the European strategy for growth and jobs ("Europe 2020"). Measures in the field of cohesion policy will focus on a few, but consistent with the stated objectives investment priorities. In the partnership agreements, which each EU member state is to sign, the objectives will be described. A financial performance reserve will be provided, intended to encourage regions to achieve greater progress toward the identified goals.

The use of funds for cohesion policy will be monitored very closely by the EC. There will be an opportunity to review the programs or temporarily suspended funding, to ensure that the impact of investment is not compromised by poor macroeconomic policies or insufficient administrative capacity. More efficient use of EU funds will be provided through simplification and harmonization of rules for the operation of various funds, including the Rural Development and Maritime Affairs and Fisheries. Uniform rules will be introduced for the five different funds and an integrated approach. This will ensure that the various funds serve coherent goals and strengthen mutual influence. The proposed legislation will primarily support social investments that provide more opportunities for people to cope with future challenges of the labor market.

New aspects in the EU cohesion policy are important for the regional, district and local authorities in formulating their priorities for the future. They must comply with the following after 2013: closer link between cohesion policy priorities of "Europe 2020;" integrated approach in using structural funds; implementation of incentives for effective implementation of cohesion programs; concentration of money resources on few major priorities; strict assessment of the results achieved; thorough assessment of the capacity for effective absorption of resources; strengthening of the partnership principle; strict application of the principle of subsidiarity; promotion of decentralization among local government; exchange of best practices between the municipalities and regions; expanding local and regional authorities, social partners and NGOs in the implementation of operational programs; improving institutional capacity and administration; simplifying procedures and reducing the administrative burden for beneficiaries; result-oriented approach.

Along with the debates about priorities in the EU cohesion policy for the next programming period, the country continued implementation of Operational Programs. The assessment of the government is that in 2011 the **rate of absorption** of EU funds is relatively good and this year it continues to improve. The budget for 2012 has set an ambitious goal - to pay BGN 3.8 billion of the total budget of about BGN 13 billion (less national co-financing). This amount is equal to all funds paid since our EU accession in 2007 to 1 July 2012. In mid 2012 however, only BGN 810 million were paid. Although large payments are usually at the end of the year, there are serious doubts about the successful implementation of the objective in this area. As more realistic is assessed the goal to pay BGN 2 billion, which will mean absorbing up to 39% of the total budget.

Unlike absorption, Bulgaria shows a fairly good pace in **negotiations** – by this indicator Bulgaria is in the "golden" ranking of EU countries. From BGN 15.6 billion EU and national funding we

have already contracted BGN 14.4 billion (over 80% of the budget). OP "Transport" has even overcontracted budget and OP "Regional Development" and OP "Environment" will probably contract all funding by year end. Most serious is the gap in OP "Competitiveness," which contracted less than half of the funds - about 45%.

Analysis of the performance of separate Operational Programs shows that best performing in the first half of the year are OP "Administrative Capacity" and "Technical support," which have recorded double and triple growth in payments annually. One reason for this is the rapid introduction of e-government, which became top priority for the government. However, these programs have small budgets and are not important for EU fund absorption. At the same time business program (OP "Competitiveness") shows a small increase. There are also problems with OP "Regional Development," which delays payments due to checks for errors in the contracts.