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Understanding Reform: A Country Study for Bulgaria

The wiiw Balkan Observatory

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Understanding Reform

Project Supported by the Global Development Network (GDN)

Understanding Reform: A Country Study for Bulgaria

Final Draft of the Country Report *)

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Understanding Reform: A Country Study for Bulgaria

1. Introduction

Since 1989, when economic and political transformation in the former communist countries started, the reform process in Bulgaria has been rather uneven, and often has changed direction. Compared to the countries in central Europe, it took much longer to define the course of reforms and until 1997 Bulgaria was a laggard in the reform process. The economy was in disarray: the transformational recession was coupled with macroeconomic and financial instability, industrial decay, massive layoffs and a debt crisis. In 1996-1997, the deepening macroeconomic imbalances escalated into a severe financial crisis combining a crash in public finances, run on the banks and a collapse of the currency, all of which gave rise to a hyperinflationary hike in early 1997. However, since 1997 the situation has changed radically: the course of economic and political reforms has been firmly set and the policy orientation towards a pluralistic democracy and market economy has gained support among a wide majority of the society. In political terms, this was a definitive shift in values embodied in a firm orientation towards EU and NATO membership. In terms of economic policy, the emphasis was placed on fast macroeconomic stabilization (based on a currency board arrangement) and acceleration of structural reforms. There was a remarkable turnaround in economic performance: inflation rapidly fell to low single digits, public finances were brought under firm control and the economy grew steadily at a relatively high pace which allowed for the recovery of real incomes and private consumption.

The sudden implosion of the communist regime in 1989 wiped out the previously existing societal and political structures. The newly emerging structures and stakeholder groups were not stable and continuously changed size and shape. The political forces found it difficult to form their vision of the future in their absence of guiding external signals. The heterogeneous societal structure triggered frequent change of governments which, in turn, pre-empted the adoption of a longer-term reform policies. The outcome was a stop-and-go reform course, with frequent change in policy direction and revisions in previously adopted measures.

The 1996-1997 crisis was a turning point in Bulgaria's transition. It was also a turning point in the attitude of society towards the reform process serving as a kind of catharsis. The crisis also had a profound impact on stakeholder groups which took a more stable and lasting shape. The guiding external signals coming from the west also strengthened, which helped in shaping the policy course and in consolidating its domestic support. Domestic macroeconomic policies were largely formulated under IMF guidance while the structural reforms implemented during that period were also to a large degree prompted by the international financial institutions. The stabilization of the societal structure was reflected in the concomitant stabilization of the political structure which was reflected in the lengthening of the governments' terms in office. There emerged a broad consensus about the main direction of reforms which was supported by a wide majority of the population. The perceived irreversibility in reforms helped build the public understanding that the solution to the problems requires further reforms rather than their stalling.

In this study, we analyze Bulgaria's difficult economic and political transformation in an attempt to develop new insights into the mechanisms of the reform process. More specifically, we try to address three central questions: Why reforms in Bulgaria took or did not take place? What were the circumstances and condition that drove the reform process? What were the main outcomes of these reforms? Accordingly, we seek to identify the relevant issues for each of these questions and try to analyze the implied causal relationships and draw lessons and conclusions from Bulgaria's experience with reforms.

2. Methodological issues

A brief overview of the literature on Bulgaria's reforms

Bulgaria's economic and political transformation has been the subject of extensive research and there are numerous academic publications analyzing this experience and seeking to explain Bulgaria's peculiar reform path. A number of studies have attempted a more in-depth analysis of the initial stop-and-go reform effort and its policy rationale. Avramov (1994), Avramov and Antonov (1994), Avramov and Guenov (1994) analyze the macroeconomic policies of the first phase of transition and the underlying causes of the persistent macroeconomic instability. Dobrinsky et al. (1994) look at the macroeconomic structural changes that took place after the initial economic liberalization and opening up of the economy. In a collection of essays, Jones and Miller (1997) provide an overview of the most important macro- and microeconomic developments and policies in Bulgaria in the early 1990s. Kolarova and Dimitrov (1995) look at the political developments at the onset of transition, when the so-called "roundtable talks" shaped the political landscape for some years to come. Koford (2000), Kolarova and Dimitrov (1994) and Kolarova (1999) provide an analytical overview of the process of political change during this period.

The financial crisis of 1996-1997 is probably the episode that has attracted the most attention in the literature on Bulgaria's transition. Several studies (Avramov and Sgard, 1996; Dobrinsky, 1994, 1996; Dobrinsky et al., 2001; OECD, 1997) analyze the policies and the sequence of events that lead to the crisis. By looking at the dominant political constellation, Wyzan (1998) seeks to reveal the underlying political causes of the failure to implement a workable reform package. Most of these studies emphasize the key role of the policies tolerating financial indiscipline: this led to the accumulation of bad loans and quasi-fiscal deficits which, in turn, provoked the subsequent banking and fiscal crises. The nature of the crisis itself and its various facets have also been analyzed in detail in a number of publications (Balyozov, 1999; Berlemann, Nenovsky and Hristov, 2002; Dobrinsky, 1997, 2000). Ackrill et al. (2002) look at the incidence of poverty in Bulgaria, which increased considerably as a result of the crisis.

In the years after the crisis, the reform process in Bulgaria has gained momentum and reforms have started to bear fruit. The policies of this period and their outcomes have also been scrutinized by academic research. Miller (1999) and Nenovsky and Hristov (2002) focus on the operation of the currency board, as a new approach to macroeconomic management in Bulgaria. Dobrinsky (2001) brings to light some of the policy challenges faced by the Bulgarian authorities in an environment when, under the currency board arrangement, they lost much of the degrees of policy freedom. Horvath and Székely (2003) argue that, on the other hand, this environment provides the authorities with new opportunities to reform radically public finances. Nenovsky and Rizopoulos (2003) analyze the political economy of the monetary regime change of 1997 and describe it as an endogenous institutional change driven by the interactions of interest groups. Valev (2002) and Valev, and Carlson (2003) analyze the credibility of Bulgaria's currency board and its role in changing expectations. Valev (2003) explores the political economy of the reform process after the crises and highlights the effect of perceived irreversibility in the reform process.

A few studies have attempted a synopsis of longer periods in Bulgaria's transition, covering different phases and stages of economic and political transformation. Thus Mihov (2001) provides an overview of the economic policies and changes during the first decade of transition. Minassian (2001) addresses Bulgaria's (sometimes difficult) relations with the IMF and summarizes the outcomes of the Fund-supported programs of economic reform. Bitzenis (2003) looks at the process of privatization in Bulgaria and tries to explain some of the reasons for its uneven pace. However, none of them has provided a consistent explanation of Bulgaria's overall reform pattern based on rational choice decisions.

Despite this abundance of research, the available literature so far has not produced a comprehensive interpretation of the motivation and driving forces of Bulgaria's reform process. The diverse and uneven developments in Bulgaria during a decade and a half of transition still raise a number of intriguing questions and puzzles. Why did it take so long for the reform course in Bulgaria to take shape? What brought society into disarray (mirrored in chaotic policies) in the initial phases in transition? Then, given this unfavourable start, how did it become possible to stage the subsequent turnaround? What were the driving forces behind the new political and policy orientation? If society was so heterogeneous in the initial phase, what brought together the majority that supported the new political and policy course? In this study we try to address some of these difficult questions.

Methodological framework of the study and main hypotheses

The central research goal of this study – in the context of the overall "Understanding Reform" project – is to provide a broad and comprehensive picture of the transformation reforms in Bulgaria, their driving forces and outcomes. The study thus focuses on three main sets of questions: *Why?* (the motivation of the reform process and its goals); *What?* (the nature of the reforms and their implementation) and *How well?* (the outcome of the reforms and whether it matched the goals).

The main methodological technique applied in the study is that of an analytic narrative (Bates, 1998; Rodrik, 2003) which allows not only to organize better the chronological review of events but also to look for rational choices behind some of the seemingly messy developments. For this purpose we use extensively the results of some recent formal models of policy reform (see below). However, our methodologocal approach is generally problem-driven in the sense that that we start from our "research problem" (which is to understand the reform process in Bulgaria) and then we seek to apply methodological approaches that seem to offer the best clues to the various aspects of this problem, and not vice versa (from a specific theory to its application). In this sense, the methodology used is rather eclectic, employing different theoretical models and analytical techniques in dealing with various aspects and parts of the general research problem.

Thus in addressing the three main sets of questions and, especially, in trying to understand the motivation and driving forces of the reform process in Bulgaria we try to offer some possible clues to this question using some of the results of the recent literature on policy reform, namely the strand that is sometimes referred to as "positive economics of policy reform" by Rodrik (1993). This strand of the literature seeks to address the issue of the motivation of the policy process, i.e. what are the driving forces that lead to one or another course of policy action. And secondly, it implies endogeneity of the policy process as well as of the inherent political constraints, i.e. that subsequent policy decisions on the course of reform very much depend on previous policy and its outcomes as well as on the changing sentiments of the populace. This literature (see Rodrik, 1993) applies common analytical standards to economic and political behaviour: it assumes that policy agents are rational and forward looking and that policy making rules are derived from solving of optimisation problems with well defined objective functions. The new literature on policy choice emphasizes the motivational aspect of a policy reform which is usually considered in the context of interest groups in society while the reform process is represented in the form of a strategic game between interest groups. The stake of the game is how the costs and benefits of reform are to be shared among interest groups. The political constraints are usually related to the voting power of the constituencies supporting or opposing reforms (which may change endogenously during the course of reforms) and the credibility of the reform policies.

Following such an approach, some recent studies have been able to come up with plausible explanations of issues which have for long been kind of a puzzle in political economy, such as the questions: Why policy makers opt for apparently sub-optimal – and obviously unsustainable in the longer run – policies while policies that appear optimal are neglected? Why policy packages which work well in one country do not do so in another, and vice versa? If a reform package is finally adopted, what can explain the delay? In analyzing these issues we make extensive reference to the results of some well-known models of policy reform.

However, we complement the rational choice models with a wide variety of additional analytical tools that allow us to understand better other aspects of the reform efforts, as well as the reform process as a whole. Thus in exploring the starting point and the context of the reform process we employ a historic perspective which allows us to identify and highlight some important structural factors (constraints or catalysts) of the reform process in Bulgaria (which are relevant both to the *Why?* and to the *What?* questions), and to trace their evolution during the course of reforms. In addressing the *What?* question, in addition to a continuing focus on the context, we employ extensively an institutional approach. We thus seek to identify the role of institutional factors in the reform process, which allows, on the one hand, to better understand some of the driving forces of the reform agenda, and, on the other hand, to identify and highlight some of the reasons for the encountered difficulties, especially in the implementation phase. In this case we consider the institutional environment in the broader sense of formal and informal "rules of the game" (North, 1990). In addressing the *How well?* question, we use extensively factual analysis and macroeconomic statistical data in order to draw conclusions about the direction of change of economic performance over time. We also try to compare the declared reform goals with the actual outcomes of the reform process.

In employing the analytic narrative technique we also formulate hypotheses about the motivation of the process of reform and change in Bulgaria during the transition and we try to test them on the basis of the available empirical evidence. One of our main underlying hypotheses about the driving forces and direction of reforms is based on the notion of Bulgaria as a "switching periphery" at the Euro-Asian border. Being at the border of the two continents, historically Bulgaria has been experiencing the influence of "gravity forces" coming from different directions, and as a result of the changing strength of these forces, their combined effect has also been pushing domestic politics and policy in different directions. This underlying rationale of hypothesis is outlined in section 3.1. Based on this notion, we conjecture that the initial phase of economic and political transformation was one in which there was no definite and strong external push that would guide the course of domestic policies in any firm and specific direction. Instead, the external driving forces coming both from the west and from the east were weak and hesitant; besides, they themselves did not always follow firm directions but often changed track. Another related hypothesis is that of path dependence in the transition process. If "history matters", then the starting point is important for the actual course of subsequent reforms.

For the purpose of the study we also formulate and test some additional hypotheses related to the motivation and driving forces of policy reforms such as:

- The prevailing individual uncertainty about the outcomes of the restructuring and privatization of the enterprise sector (SOEs) can cause considerable delays in reforms (evidenced during the initial phase of transition in Bulgaria).

- Disagreement between powerful interest groups about the sharing of the reform burden can be another deterrent in the reform process (also evidenced during the initial phase of reforms).

- Institutional and structural bottlenecks and/or coordination failure can block the reform effort (as happened in the initial phases of Bulgaria's reforms); by contrast, a supportive institutional environment as well as better coordination can act as catalysts of the reform effort (as seen during the second phase).

- A major economic crisis (as that experienced in Bulgaria in 1996-1997) can open a window of opportunity for the acceleration of the reform process.

Furthermore, based on the available empirical evidence, we argue that the crisis marked in fact a major structural break in the process of Bulgaria's reforms: due to the magnitude of turbulence and the instability in the underlying structural processes the crisis triggered fundamentally different structural relations and decision-making patterns in the period that followed. These two periods in Bulgaria's reforms are broadly identified with "success" and "failure". Notably, these are fuzzy concepts which possibly contain elements of subjective judgement. However, in the paper we attempt to justify this assessment on the basis of quantifiable and objective measures and indicators, reflecting economic performance, the outcomes of reforms and the general domestic and external perception of the reform progress (table 1). In order to deal with the structural break, we essentially offer a sequential chain of two narratives: one dealing with reform failure (the initial phases of transition) and another one about success (the later stages). Accordingly, we analyze the economic and political context, and seek to identify and test plausible rational choice models for each of these fundamentally different sub-periods of the reform process.

3. The starting point of economic and political transformation

Bulgaria as a "switching periphery"

Due to its geographic location, Bulgaria's geopolitical status has always been that of a periphery. During the Ottoman rule (which lasted in Bulgaria for 500 years) it was a periphery of the Ottoman empire. After re-gaining independence in 1878 as a result of the Russian-Turkish war, Bulgaria agonized for a couple of decades between the gravity forces of Russian and western European powers, before sliding into the German sphere of influence for several decades. As a result of the new division of Europe after World War II, Bulgaria became part of the Soviet east European empire. The communist party that seized power for a period of more than 40 years pursued an orthodox pro-Soviet course, transforming the country into the most loyal foreign ally of the Soviets. This period lasted until the fall of the communist regime and the start of economic and political transformation in 1989.

Often the domestic political orientation of the country to one or another external "center" was also associated with the business interests of the local stakeholders. Switching from one center to another was always painful and was accompanied by a major overhaul of both the political constellation and of the economic power structure. Accordingly, those who happened to be on the "correct" political side were also rewarded with solid economic gains.

The peripheral status was not only a geographic feature but historically also a self-perceived feature in the mindset of many Bulgarians, and this had important implications for domestic politics and policy. The notion of the "great powers" always played a key role in domestic politics. Historically, a number of political forces used to define their identity relative to the "great power" that they chose as their guide and main foreign ally. So when they came to power, their foreign and domestic policy were anchored to the respective "great power" and this largely shaped Bulgaria's participation in the international division of labor. In turn, by offering their loyalty to the mighty ally, they sought to gain foreign protection and security for the country as well as economic benefits such as a preferential access to foreign markets and to other external resources.

Such a symbiosis reached its most comprehensive (and lucrative for Bulgaria and its elite of that time) form during the late Soviet years. It is a well-known fact that among the communist countries, Bulgaria was probably the most trusted political ally of the Soviet Union. At least up to a certain moment in time (until Gorbachev came to power) the USSR was willing to pay a certain price for this political loyalty in the form of relatively more generous economic concessions to Bulgaria such as excessive supplies (relative to other communist states) of energy and other resources at below world market prices and granting excessively large (relative to other communist countries) access to Bulgarian exporters on the Soviet market. The details of these concessions have never been revealed but by all available estimates the Bulgarian economy was the most closely attached to the Soviet one and the share of USSR in Bulgarian trade was the highest among all east European countries (Dobrinsky, 1997). Underpricing the exports of Soviet natural resources and overpricing of the Soviet imports amounted to net capital "grants" that communist states received from the USSR. Although the USSR practices such indirect capital transfers to all communist countries, their size obviously reflected the political preferences of the Soviets. Bulgaria's privileged position meant that it received disproportionately large grants as compared to other east European countries and this was a provision that lasted for some 25 years: from the beginning of the 1960s until mid-1980s.

The end of communism dealt a major blow to the role of Russia as Bulgaria's "leading great power" and signalled the end of this special relation. It also marked the beginning of another period of agonizing search for a new external political (and policy) anchor. At least at the beginning of transition the legacy of communism weighed heavily in this process: a large number of the former elite (who were now feverishly trying to transform their previous political clout into economic power) had strong informal links with the former Russian elite (which was occupied with a similar strategy). Due to that, there were strong domestic political forces that struggled to preserve the dominance of Russia as an external anchor. At the same time, part of the new political elite advocated a radical break with Russia and a full-fledged re-orientation to the West, pointing to the EU and US.

However, when the changes started, neither Russia, nor the West signalled any notable interest in Bulgaria: Russia was too pre-occupied with its own difficult transition[1], while the West appeared unprepared to make a decision on this part of the European periphery (partly because it still perceived it as part of Russia's sphere of interest). Note that from this perspective, Bulgaria's situation differed from that of the central European former communist countries which were immediately "recognized" by the West as belonging to its patrimony. The absence of clear external signals helped prolong the on-going soul-searching in Bulgaria's domestic politics. Under these circumstances, the shaping of the new political orientation of the country took more time than would have been the case in a different external environment.

The legacies of the communist past

In the second half of the 1980s the Bulgaria was adversely affected by two external developments. The coming of Gorbachev to power in the USSR meant a radical change in the economic relations of the two countries. First of all, Gorbachev tried to eliminate some of the price asymmetries in Soviet trade with communist countries which resulted in a decline (if not complete elimination) of the net capital grants to communist countries. Secondly, Gorbachev abolished the previous special economic privileges that Bulgaria used to enjoy,

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[1] The sudden "divorce" between Russia and Bulgaria is mirrored in the sharp drop of the volume of bilateral trade: thus while in 1989 the ex-USSR accounted for nearly 60% of Bulgaria's exports, in 1992 this share fell to 12%; in the same period the share of the ex-USSR in Bulgarian imports dropped from 34% to 19% (based on historic Bulgarian national statistics).

placing the country on an equal footing with other communist countries. A second blow to the economy came with the end of the Gulf war: Bulgaria used to be a major exported of arms both to Iran and Iraq and the end of the conflict meant the drain of a major source of hard currency earnings.

In hindsight, the changes that were taking place in the second half of the 1980s were pointing to the need for a major adjustment of the Bulgarian economy to the new conditions. However, the communist authorities were not prepared for this as it would have required some painful restructuring measures. Instead, they opted for the less painful but highly risky strategy of boosting foreign borrowing. By borrowing abroad, the authorities sought to compensate for the lost capital transfers from Russia, thus temporarily shielding the economy from the necessity to restructure and adjust. However, instead of the "free lunch" that Bulgaria used to enjoy, the new meal came at a very high price. As a result of this hazardous policy, within five years Bulgarian gross foreign debt more than tripled: from USD 2.9 billion in 1984 to USD 10.7 billion in 1989.[2] At the same time hard currency exports at best stagnated and exports to other communist countries started to decline.

By the degree of its dependence on USSR deliveries and on USSR markets the structure of the Bulgarian economy was probably more similar to that of some of the ex-Soviet republics than to the economies of other east European countries, especially those in central Europe. Consequently, the shock of the disintegration of the Council for Mutual Economic Assistance (CMEA, the trading arrangement between the communist countries) to the Bulgarian economy resembled the shock to these republics from the disintegration of the USSR, and was much stronger than the shock experienced by other post-communist countries. From this perspective, Bulgaria embarked on the process of economic and political transformation from a more unfavourable starting point compared to its east European neighbors.

The foreign debt was not the only economic problem that emerged in the eve of transition. The partial loss of privileged access to the Soviet market and the reduced demand in the lucrative weaponry market meant that part of the Bulgarian manufacturing industry was pushed to operate below its capacity and this led to a notable lowering of the rates of growth in the second half of the 1980s. The main problem (one that was fully exposed with the collapse of the CMEA) was that the structure of the manufacturing industry was tailored to fit only the very narrow niche of what USSR and other communist countries were willing to purchase. The quality of most of Bulgaria's manufactured goods did not meet international market standards and it was difficult, if not impossible, to re-orient the excess manufacturing capacity to other markets.

The external economic difficulties were mirrored by domestic problems. The discontinuation of the external subsidies also opened a gap in domestic public finances. The government tried to partially compensate for this through external borrowing but nevertheless, part of the imbalance was settled by printing money. As domestic prices remained under strict central control, this resulted in the acceleration of hidden and suppressed inflation through the accumulation of a sizeable monetary overhang. The long-held policy of soft budget constraints combined with massive re-distribution of income through the public budget (partly to subsidize loss-making firms) accompanied by massive overemployment and unsustainable wage growth exacerbated the mounting domestic imbalances. By 1989 the amount of accumulated forced savings of the population reached

[2] Foreign borrowing during that period consisted of both trade credit and official borrowing and. Creditors were willing to lend both due to the country's track record as a prompt client and due to its perceived export potential/debt servicing capacity. The latter, however, was mostly based on exports to CMEA countries that collapsed after the start of transition. See Dobrinsky (1997).

some two thirds of the country's national income which caused constant shortages throughout the economy (Dobrinsky et al., 1994).

In summary, Bulgaria's embarked on economic and political reforms from an extremely unfavourable starting point. Although such difficulties were not uncommon in the other post-communist eastern European countries that were undergoing a similar process, the magnitude of the problems faced by Bulgaria was much greater which, as discussed later, laid its footprint on the process of economic and political transformation. Accordingly, the adjustment effort needed in the initial phase of transition was much more painful, and implied very strong political constraints. This is probably part of the explanation why reforms and policies that worked in other transition economies turned out to be unsuccessful (or non-starters) in Bulgaria (we return to this issue in the next section). In this sense, history did matter in the case of Bulgaria's transition.

4. From non-reform to crisis (1989-1997)

The context

The sudden implosion of Bulgaria's communist regime at the end of 1989 broke the previously existing political and economic structures. As in most east European countries (with the exception of Romania) the communist regime collapsed practically without any resistance, indicating that it had already disintegrated internally: its ideological base was irreparably compromised while in terms of economic performance it had proven to be a failure. The deep societal crisis in the country – as well as in the whole ex-communist world – was prompting the need for a major change and this was the main, fundamental incentive and driving force for reforms.

However, compared to other countries in the region, the Bulgarian context was characterized by a number of specificities that de facto acted as deterrents to rapid and radical market reforms. Among these specificities were the unfavourable initial economic conditions, already discussed in the previous section. To these added factors related to the cultural, intellectual and ideological legacy and tradition.

Incidently, the "Russian influence" turned out to be one of such factors. We shall try to clarify this point in comparison with the situation in other east-European post-communist countries. Throughout eastern Europe, in the post-World War II era, the Soviet Union was largely regarded as an occupier. Indeed, large Soviet troops were stationed in all east European communist countries, with the exception of Bulgaria (in this, Bulgaria was an exception as a loyal ally but also as a historically friendly country). The resentment of the population in these countries to the communist regimes at least partly mirrored a resentment to the occupying force. Conversely, with the fall of the regimes, the pro-market, pro-capitalist orientation were often associated with, and reinforced by, an anti-Soviet drive. The presence of a large polity with such an orientation helped the formation of a core consensus on the market reforms in most east European countries. This did not occur in Bulgaria to such an extent as – mostly due to the historic circumstances but also to business interests related to the close economic links between the two countries – there was a large share of the population with a traditionally pro-Russian orientation. Parts of the group with pro-Russian orientation were at the same time vocal opponents to market reforms on ideological groups. Notably, the subsequent disintegration of the Soviet Union dealt a blow to this group and helped its further marginalization.

In addition to that – again, unlike other east European countries – Bulgaria did not have a major tradition of political and intellectual dissidence. In other parts of the region these were fairly well established and even organized (as the Polish *Solidarnoszcz*) movements, whose attitude towards reforms was already shaped before the start of economic and political transformation. A large number of post-communist political leaders originated from these dissident movements. While small dissident groups did exist in Bulgaria, they were not well organized and for the most part were not intellectually powerful.

Ethnic factors also affected the reform course as Bulgaria has a large ethnic Turkish minority. Although traditionally there had not been internal conflicts based on ethnicity, during the last decade of communist rule this minority suffered from political oppression (such as the forced change of names to Slavic as well as the de facto expulsion of groups of ethnic Turks to Turkey). This helped shape a specific political agenda for the ethnic Turks at the onset of economic and political transition.

The key actors

The start of transition brought to life new stakeholder groups and political forces, which shaped the new policy process. On the self-declared "left" was the former Communist (later transformed into Socialist) Party (BSP) which continued to have a strong but rather diverse constituency. In the early years the BSP itself was a rather heterogeneous political formation. Within the party, there were at least two main factions: a non-reform faction with a pro-communist/pro-Soviet (which was at the same time anti-market/anti-Western) orientation, and a reformist faction with a social-democratic orientation which, without denouncing Russia, also sought closer links with Western Europe. While the non-reform wing advocated the preservation of the old economic and political structures (it was against the very concept of market economy) while mimicking some *perestroyka*-type reforms, the reformist wing recognized the principles of the market economy and accepted them as the main goal of the reforms but advocated a "social market economy". But among those who leaned with BSP there were also members of the transforming old elite with business interest in Russia who regarded it as a political umbrella and a means to promote the preservation of closer economic links with Russia. At the same time, the BSP hosted the whole communist party nomenclatura which was trying to transform its past political power into economic power. At the same time BSP's mass electorate mostly consisted of lower income groups and this often created notable conflicts between the interests of the electorate and those of the elite that controlled the party. As a result the BSP did not have a firm and clear policy line in this initial period and often changed its course. However, until 1997, the non-reform wing of the party in the main dominated BSP's orientation and shaped the general line of its polices.

A newly emerging reform-minded opposition organized itself into a loose coalition named Union of Democratic Forces (UDF). While claiming to belong to the "right", the UDF was at first a very heterogeneous formation, and represented a wide political spectrum, both from the left and from the right. It brought together small political movements and groups with quite different political orientation: radical, christian-democrat, liberal, social-democrat, environmental, agrarian, etc. There was thus a similar identity conflict between declared policy goals (with a mostly rightwing orientation) and the political preferences of a large share of UDF's electorate. The most well-organized part of UDF were the claimants of restitution rights who had a strong common interest: the restitution of property titles held in the past by their ancestors. Thanks to being relatively well organized, they managed to set the priorities in the UDF's policy agenda in the initial period of transition (when UDF was in power in 1991-1992, these were among the first laws to be adopted by Parliament). With time, this rightwing hard core gradually took the lead within the UDF while the left-wing-minded part disintegrated or departed. Later on this political formation also changed its façade by transforming itself from a coalition into a single party.

It should also be noted that the collapse of the communist regime was followed by a rapid and lasting ideological polarization of the political debate. The UDF for quite some time centered its political arguments on the claim that it was the only political force that represented reform while BSP embodied the preservation of communism. Hence it – maybe unintendedly but somewhat simplistically – narrowly narrowed the focus of the political discussion onto the dichotomy "reform or non-reform" rather than on the nature of the future reforms. Ironically, this polarization contributed to the amorphousness of the political landscape as it blocked for some time the constructive formation of political formations centered around interest-based stakeholder groups. One major exception was the Turkish minority with its clear identification signs (ethnic, cultural, territorial as well as economic – notably skewed towards tobacco growing and processing) and an agenda that was shaped as a reaction to the political repression. The largely ethnical Movement for Rights and Freedoms (MRF) claimed the political center. Notably, MRF preserved its identity largely unchanged during the whole transition period whereas the other political actors underwent considerable transformation.

An important stakeholder group in the initial period was that of the employees in unviable SOEs affected by the loss of traditional CMEA markets. Most of these enterprises proved unviable under market conditions and their employees had much to fear from the envisaged restructuring of their firms, which meant job losses for a large number of them. SOE employees had thus a strong common (short-term) interest of maintaining the status quo, namely preserving their current employment and hence the continuing existence of their firms. As a large number of these firms were unviable under in a market environment, this was equivalent to a massive claim on budgetary subsidies.

Although SOE employees were not organized as a single stakeholder group (in terms of revealed political preferences they were split between BSP and UDF), they did have a major impact on the policy process in the initial stages of transition.. Being an important political constituency and electoral group, none of the governments in office could afford to neglect the interests of such a large group. Given the unionist tradition, workers were fairly well organized and could become a real political threat, as demonstrated by the numerous strikes in this period. Besides, they did have political representatives in both major political parties.

In addition, there were also the managers of SOEs who also had vested interests in maintaining the status quo in the firms under their control, which in their case implied both the preservation of the firms as going concerns and protection of their managerial positions. In particular, from their perspective, change of ownership, especially to a strategic investor, was often seen as a threat to their position as such a change would have implied a major change in the running of the firm, such that is usually associated with a new managerial team. Hence the interest of SOE managers and a stakeholder group included not only the claim to subsidies but also resistance to ownership change. Obviously, being a large and influential interest group, enterprise managers channelled their interests into the political arena. Most SOE managers at the start of transition were associated with BSP; when UDF came to power, it effectuated a massive purge of managers, installing its own supporters. However the change of political umbrella did not mean a change in the interests of enterprise managers as a stakeholder group.

Apart from these stakeholder groups – most of which had their origin in the past – there was a small but growing group of new entrepreneurs that managed (often using semi-legal channels or political umbrellas) to amass large chunks of capital during the early ears of transition. Compared to other economies in transition, in the case of Bulgaria this was not a plentiful bunch due to the absence of a strong natural resource base in the country (the easiest prey for this sour of "entrepreneurs"). But similarly to the "early winners" in other countries, the interests of this group were rather controversial: while supporting some reforms in the early phase, later they might seek to cement and compound their early gains by exerting influence on the actual reform agenda, which ultimately may degenerate into "state capture" (Hellman, Jones and Kaufmann, 2003).

Trade unions (both traditional and newly emerging) tried to get the representation power of these stakeholders and consequently accumulated considerable political clout (manifested in numerous large-scale strikes, with serious political consequences). However, unions turned out to be incapable of providing genuine support for the interests of their constituency and gradually lost their influence.

In March 1990 the Bulgarian government declared a unilateral moratorium on the foreign debt payments. While such a decision was probably technically inevitable, it was implemented in the worst possible manner, completely disregarding the creditors' interests. This *de facto* excluded a substantial group of stakeholders – foreign creditors and potential investors – from active involvement in Bulgaria's economic reforms in the initial period.

Given the historic tradition in Bulgarian politics, there was an obvious absentee in the stakeholders' constellation in the initial phase of transition: that of the strong external partner who would provide guidance in politics and policy to the extent of serving as their main anchor. The IFIs that did operate in Bulgaria obviously did not serve this purpose either. Bulgaria was granted membership in the IMF and the World Bank in 1990 and thus the international financial institutions also appeared on the policy scene through the conditionality of their funding activity. The start of market reforms in eastern Europe had given a new *raison d'être* to the IFIs and they were keen to be part of this historically unprecedented change. However, as discussed below, for quite some time Bulgaria's relations with them were tense due to mutual mistrust and lack of understanding of the actual economic problems on the ground.

The first phase of transition was featured by frequent change of governments representing different sides of the political spectrum (see their chronology in Appendix 1). The envisaged very short planning horizon was an inherent feature of the political process of this period which essentially pre-empted political strategies and polices targeting the medium or long-term horizon as a rational choice for politicians. The main problem was, that in the short- to medium-run, the needed reforms were expected to produce more losers than winners and hence these policies did not enjoy sufficient popular support. None of the governments in office demonstrated a full commitment to implement and bring to a successful end a wide-ranging and comprehensive economic reform package.

Stop-and-go reform policies

The initial phase of economic and political reforms in Bulgaria was framed by the so-called Roundtable Talks.[3] One of the important outcomes of these talks was the decision to call a Grand National Assembly with the mission to adopt a new Constitution. While this mission was formally achieved in 1991, the fact that the Grand National Assembly was dominated by the former communists, diminished the perceived legitimacy of the new Constitution. While BSP won the 1990 elections, its government did not last for long and at the end of the year was replaced by a broad coalition government, formally supported by the main political forces in the Grand National Assembly (this "unity", however, did not last for long either). The general elections in October 1991 brought the former opposition UDF to power for the first time. However, this government stayed in office only for one year due to internal conflict over the course of reforms, to be replaced by a non-partisan, "expert"

[3] These were peaceful negotiations between the communist regime and representatives of the dissident community which resembled closely the Central European mode of transition. See Kolarova and Dimitrov (1995).

government (*de facto* supported by an informal coalition between MRF and BSP). [4] After the 1994 general elections, BSP re-gained full control of parliament and formed its own government which stayed in office until the end of 1996.

The frequent change of governments of different orientation translated into a reform pendulum, with each new government pushing the reform process in different direction. Besides, the short terms in office meant that reforms initiated by one government were sometimes reversed by the subsequent one. One of the underlying goals of the broad coalition government (as formulated during the Roundtable Talks) was to ensure broad political consensus and support for the main reforms lying ahead. But consensus on the reform course de facto was never reached while the shared responsibility for the reforms in fact meant no responsibility. The UDF government of 1991 had a broadly liberal orientation and ambitious reform goals. However, its early fall after one year in office (mostly the result of internal conflicts) prevented it from implementing this program. In terms of the general reform effort, the period when the so called "expert government" was in office (from 1992 to 1994) was a period of stalled reforms. Lacking both strong political support and legitimacy (as it actually reversed the outcomes of the 1991 general elections), this government neither initiated major new reforms, nor showed any vigor in the implementation of reforms started earlier. When BSP came to power in 1995, its conservative, "non-reform" wing took control of the government. It launched a highly controversial economic program, based on extensive state intervention (including the re-introduction of extensive price regulations, the introduction of industrial policies and increased stated control over the financial system) and reversed other reform measures introduced by previous government. As it turned out, this policy course had devastating consequences for the Bulgarian economy.

Given this unstable and varying political constellation, the reform and policy process did not have a clear direction. As discussed below, the IMF had a very prominent role in shaping the macroeconomic policy agenda in this period. As to the institutional and structural reforms (see Appendix 1 for an overview of the various aspects of the reform process in these years) their course mostly reflected the political orientation of the parties in office and the interests of the stakeholder groups they represented. However, as the stakeholder groups were also changing shape in this period, it is difficult to trace their impact on the general direction of the reform process. Probably the most clearly identifiable policy impact of interest group pressures was that generated by the workers and managers of SOEs: being an important constituency of the two main political parties they consistently exerted pressure for interventionist measures in support of ailing firms (as discussed later this translated into important policy acts). The "early winners" did affect the policy process lobbying by corruption. However, it should be pointed out that it the case of Bulgaria their influence on the policy process never reached a scale that could be classified as "state capture". These groups had rather diverse interests and were never well organized as a stakeholder group.

Among the main political reforms initiated after the adoption of the new Constitution one could point out the effort to establish autonomy of the three branches of power. However, the drive towards great autonomy was likely overdone and resulted the absence of mutual checks and balances between them. Consequently, the growing sense of impunity instigated inefficiency and bred corruption, especially (but not only) within the judicial system (Kolarova 1999). The inefficiency of (and, increasingly, the perceived corruption within) the judicial system gradually became a major impediment to the reform process.

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[4] According to the Constitution, after the UDF government was voted down by a non-confidence vote, the other parliamentary parties could attempt to form a government. The BSP failed in its attempt but it supported a government formally nominated by MRF. So the "expert government" was de facto a coalition between BSP and MRF.

The most comprehensive reform package initiated during the first phase of transition was the stabilization program designed under the supervision of the IMF in 1990 and launched by the broad coalition government in February 1991. The program envisaged price and trade liberalization, current account convertibility and unification-*cum*-liberalization of the exchange rate (under a floating exchange rate regime), liberalization of the domestic credit market, fiscal and budgetary reform and the start of a process of demonopolization and restructuring of state-owned enterprises (SOEs) (Avramov, 1994). It also envisaged changes in the tax system: the introduction of a uniform profit tax rate while and the gradual unification of turnover taxes (Dobrinsky at al., 1994).

While this first reform program did push through important steps towards reforming the existing economic order (in the first place in liberalization) it did not achieve its main target, macroeconomic stabilization. The main reasons for this (such as design flaws and institutional and structural impediments) are discussed in more detail below. Here we would just add that, from a political economic point of view, the strong polarization of the political forces that took part in the broad coalition government was another factor that contributed negatively to its outcome. Under these circumstances political responsibility and ownership of the program were blurry and none of the political forces clearly identified itself with it. Thereafter, despite the political rhetoric of the time, macroeconomic stabilization de facto was abandoned as a policy priority by all governments in office and did not re-emerge as a key policy goal until 1997.

The ownership reform (the transfer of property from state to private ownership) – the cornerstone of economic and political transformation – is indicative of the difficulties in the policy process in Bulgaria. Although there were early attempts to adopt a legislative and institutional framework for the process of privatization (the legislative process is summarised in Appendix 1 while Appendix 2 gives an overview of the insitutional framework of the provatization process), implementation lagged considerably behind. In terms of regulation, one of the main problems was the apparent absence of a core consensus about the model of privatization (BSP favored mass privatization whereas UDF leaned towards commercial privatization) and about the direction of this process (an indication of this are the endless changes in the law – more than 30!). The low level of investor interest by foreign investors (which, in turn, was largely a fallout of the default on the foreign debt) was another impediment to privatization. Overall, until 1997 the pace of privatization was rather slow (table 4), especially, compared to other central and east European countries. Probably the only successful ownership reform in this phase was the restitution of property (agricultural land, real estate and industrial property) confiscated during communism which enjoyed relatively wide public support.[5] After the 1995 election, the BSP government finally launched its project for mass privatization (see Appendix 2).[6]

More generally, little progress was made in enterprise restructuring and reform which – in view of the extremely difficult and precarious situation of the manufacturing industry after the collapse of the CMEA market – was probably one of the most urgent and fundamental reforms faced by policy makers. In the absence of a clear vision on privatization, the ailing enterprise sector continued to be dominated by socialist "dinosaurs" – large and inefficient industrial SOEs, designed to serve the CMEA market but unviable under market conditions. Although the previous organizational structure of the manufacturing sector was

[5] According to opinion polls, about 45% of respondents claimed support for the ongoing restitution in 1992-1993. See Stanchev (2003).

[6] Ironically, the actual implementation of the mass privatization project (the completion of the first wave and the whole second wave) was largely done by the UDF (which came to power in 1997), an ideological opponent of the project.

partly broken down (through the "demonopolization" measures), this did not change the functioning of the core large single production units.

Even more importantly, virtually none of the governments in office in this period managed to impose hard budget constraints on the inefficient SOEs, a policy considered essential for their successful restructuring (Schaffer, 1998). Soft budget constraints took various forms but the most important among them were (often directed) soft credit by state-owned commercial banks and the (tolerated) accumulation of arrears to the budget (Dobrinsky et al., 2001). This policy instigated financial indiscipline in the corporate sector as a whole, which later became one of the key factors that precipitated the financial crisis. At the same time, the governance of SOEs weakened and eroded, which created a conducive environment for what came to be known as "spontaneous privatization", in fact – the siphoning of their assets, which further weakened their viability.

The reform of the financial sector started with an overhaul of the banking system: the creation in 1991 of two-tier banking system with an independent (at least on paper) central bank and a system of commercial banks out of the previous monobank system. In 1991, a Bank Consolidation Company was established with the goal of consolidating the 45 small state-owned banks into several larger banks, and then to privatize them. However, while the privatization of state-owned commercial banks was part of the agenda of financial reforms, very little was done in these early years for its practical implementation. By contrast, the entry to the market by new private commercial banks was rather liberal (in fact, lax): many new banks (often led by inexperienced teams) came into existence immediately after the start of financial reforms. On the other hand, the regulation of the financial system was poor: although prudential regulations were formally introduced, their enforcement was rather weak. Central bank independence was never stringently enforced and politicians applied various approaches to interfere with its policies. State-owned banks were also the objects of frequent interference by politicians who de facto used the banking system to intervene in the economy. The combination of political interference and weak supervision contributed to the general weakening of the whole financial system (both state-owned and private banks).

Even as regards the issue of European integration and the prospects of EU membership – a key driving force of economic reforms in central and eastern Europe – Bulgaria's record was mixed. Among the governments in office in this period, only the UDF government had a clear pro-European orientation. For BSP (which dominated most of the governments in office), in this period the prospect of EU membership was still a distant possibility but not an immediate target that would translate into specific policies. For a comparison, the policy goal of fast accession to the EU was a key policy target in the context of the reforms undertaken by other countries in the region and was supported by concrete policy measures. However, it should be added that this hesitance was mutual: while immediately after the fall of communism the EU clearly signalled that it regarded the countries of central Europe as part of its future enlargement, it was not so fast to make up its mind as to how far this enlargement could go.

In sum, Bulgaria's reforms until 1997 were hectic and unfocused, did not have a clear direction, and featured a stop-and-go course. Many of those that were initiated remained unfinished and many important reforms were not initiated at all. Overall, the failure to reach a broad agreement (both within the society and among the political forces) on the general direction of the reform process amounted to a major coordination failure (as suggested in one of our main hypothesis). To understand better the reasons for this uneven and largely unsuccessful reform path and the causes for the coordination failure, we now try to look and some of the underlying institutional and structural factors, to the political economy of failed and delayed reforms, as well as to the role of some external factors.

Institutional bottlenecks and structural impediments to the reform process

The collapse of communism was accompanied by a collapse of the previously existing institutional structures.[7] In fact some of the core formal public institutions (such as the constitutional order based on a monoparty political system, the system of central planning) were abolished immediately; others (the overwhelming part of the legislation as well as virtually all public institutions) were slated for an overhaul. Indeed, some of the new political forces considered the dismantling of the old public institutions as their primary policy goal, a goal that was assigned far higher priority than the goal of establishing new institutions to replace them. As a result, the speed of institutional destruction by far exceeded the speed of creating new public institutions.[8] The main negative outcome was that the attacks on the public institutions of the communist state often degenerated into an attack on the institutions of the state per se. Consequently this forced retreat by the state resulted in a major weakening of basic state institutions resulting in an "institutional hiatus", with severely negative consequences for the reform process itself (Kozul-Wright and Rayment, 1997).

Among the worst affected were the institutions of law and order which, according to some of the new political forces, as embodied the institutions of repression of the communist system. The police and other parts of the system of national security underwent a series of often ill-designed reorganizations and cuts. The reforms of the judiciary system were slow and did not contribute to the establishment of strong independent courts. Consequently, law enforcement – which had never been a strong point in Bulgaria's institutional environment[9] – rapidly and drastically deteriorated. Criminal activity mushroomed, with organized crime (unseen under communism) taking the central stage. Within a relatively short period of time a general perception of lawlessness was overwhelming, affecting all facets of everyday life.

But with respect to the process of market reforms, probably the most important negative implication was the failure to institute efficient mechanisms of contract enforcement – a key and vital ingredient of the market economy. Importantly, the institutional bottleneck in this area lay with implementation, as formally the newly voted laws contained the necessary protections of the contracting parties. However, the inefficiency in enforcement by both police and courts de facto emasculated the laws: the prevailing public perception was that the state was not in a position to enforce this protection.[10] The problems with establishing rule of law rule in general and, in particular, the weaknesses in contract enforcement were among the important institutional impediments for the progress towards a market economy in Bulgaria; they were also a serious deterrent to foreign investors in the first phase of transition.

In addition, the general atmosphere of lawlessness and the inefficiency of the institutions of law and order was a breeding ground for the mushrooming of numerous illegal and semi-legal business activities in the private sector and for the spreading of corrupt practices in the public sector. The first steps in the reform and development of the financial system provide good examples of such practices.

As noted, the actual entry to the market was rather lax. The candidates for operating a bank had to obtain a license from the Bulgarian National Bank (BNB) and the licensing procedure was far from being stringent and rigorous. The floor for the minimum required capital was rather low (and no proof of origin of the capital was required), and the

[7] As noted, we consider institutions in the sense of North (1990), e.g. as comprising the established formal and informal "rules of the game".

[8] Although international comparisons are difficult to make, it appears that other central and east European countries had a more cautious approach in this respect, especially regarding the state institutions of law and order and in maintaining a continuity in the operations of other important public institutions.

[9] Historically, this institutional feature probably has its origins in the period of Ottoman rule when disobedience to the law imposed by the occupying force was regarded as a heroic deed.

[10] Ironically, the existing vacuum in contract enforcement was partly filled by organized crime who offered private services in contract enforcement, using criminal methods of extortion.

requirements for skill and experience were rather basic. In addition, the absence of transparent BNB decision-making rules on licensing opened the way for external pressures and corruption. In consequence, many new small private banks (often operated by inexperienced teams and in some cases operating capital of dubious origin) rapidly entered the Bulgarian financial market (only in 1991-1992, some 15 new private banks came into existence). This would not have been a problem if the new banks performed efficient financial intermediation and were run in accordance with the principles of prudential banking. However, in fact a great number of these new banks were established with the main purpose of "tunnelling" funds to their owners. There were various tunnelling schemes but probably the favourite one was to borrow on a large scale refinancing funds from BNB and to extend these funds as credit to the bank owners or to firms associated with them.[11] Obviously, there was no screening whatsoever of these credits and often the credits were extended with the clear understanding that they will never be repaid. Some of these credits were intended for a risky expansion of business and others were obviously siphoned out for private consumption purposes. The emergence of such schemes was facilitated by the close crony relations between owners and bank managers (sometimes the same persons), by the inadequate prudential regulations (e.g. they failed to control for credit to insiders) and the low degree of their enforcement, as well as the inefficient banking supervision. Overall this amounted to outright theft of public funds by the bank cronies.

However, banking practices in the state-owned banks were not more efficient. However, these banks were subject to a different type of interference: they were prone to strong political pressure to allocate soft credit to ailing SOEs. This resulted in the channeling of funds to inefficient firms on a large scale: *de facto*, commercial banks were treated as part of the public financial system and a convenient source of hidden subsidies to such firms.[12]

The microeconomic result of these perverse practices was that the quality of the asset portfolios of both state-owned and private commercial banks rapidly deteriorated due to the accumulation of large amounts of substandard and non-performing loans. In macroeconomic terms, this was equivalent to a highly inefficient pattern of resource allocation with detrimental consequences for macroeconomic efficiency.

The process of commercial privatization also offers examples of perverse and corrupt practices, with harmful consequences for micro- and macroeconomic efficiency. Indeed, the absence of transparency in the process of privatization, combined with the existing privatization techniques (see Appendix 2), created a breeding ground for rent-seeking and abuse. Thus the Privatization Law initially stipulated different possible techniques of organizing the sale of an SOE, or particular chunks of it, such as public auctions, tenders, public offering of shares as well as a technique that was named "direct negotiations with potential buyers" (the latter also included the option of employee-management buy-outs (EMBO) at preferential terms). And it was the wide application of this last technique that tended to raise most doubts in the eyes of the public as it offered ample scope for possible corrupt practices. It basically allowed the potential buyers of a specific enterprise from the privatization list (the Agency would announce at the beginning of each year the set SOEs that were offered for sale) to approach directly the Agency (in fact, the particular officials dealing with this firm) and to declare their interest in buying that firm. In addition, the existence of this practice triggered extensive clandestine lobbying by interested parties during the annual compilation of the privatization lists. It fact, in the absence of transparency, the (often open) abuse of the option of privatization through direct negotiations with potential buyers provided all governments in office with the abundant opportunities of personal enrichment and/or of

[11] Other types of funds (e.g. deposits collected from the population) were also tunnelled in a similar fashion.
[12] For ideological reasons politicians were reluctant to engage in open subsidies from the budget which were considered as a legacy of communist practices.

offering generous favours to their political friends. For example, the government would change the management team with its own appointees prior to privatization and then it would sell the firm to this team through an EMBO.[13] Viewed from a macroeconomic perspective, all these practices resulted in massive misallocation of resources.

Another structural impediment to reforms in Bulgaria was the low "state capacity" (in the sense of Rius and Walle, 2003), which largely amounts to the capacity of the public administration to tackle different types of socio-economic policy challenges. In this sense, in the early years of transition the Bulgarian public administration obviously had a very low capacity to tackle the emerging entirely new for them social and economic problems. Again in comparison to other economies in transition (especially the countries of central Europe) was at a disadvantage, partly due to legacies of the past and unfavourable initial conditions. Thus during the years of communism there was no formal training in economics in any Bulgarian university (which was not the case in Hungary, Poland and partly Czechoslovakia) and hence both in the government and in the central bank there was a lacuna of trained people who could grasp the nature of the ongoing economic processes. Under these circumstances its was no wonder that the course of macroeconomic policy was largely shaped under the influence of external actors such as the IMF (by contrast, the first economic reform program was largely designed by local economists – see Kochanowicz, Kozarewski and Woodwart, 2004).

The arguments and facts presented in this section provide important evidence in support of one of our main hypothesis formulated in section 2, namely that the reform process in Bulgaria was impaired by structural and institutional bottlenecks.

The role of the IMF in Bulgaria's first reform attempts

The IMF has been part of the market reforms in Bulgaria ever since their start. However, for quite some time during the early years of transition relations between Bulgaria and the IMF were difficult and tense. There was mutual mistrust due to a lack of understanding of the actual economic problems on the ground, on the part of the IMF, and of the IMF's modus operandi, on the part of the local authorities (Minassian, 2001). Overall, the outcomes of these relations was dismal: the policies agreed upon within the funding agreements failed to work and the goals set in the framework of these agreements were not achieved. In fact, four consecutive funding agreements with subsequent disbursements subject to IMF conditionality between 1991 and 1996 were not brought to a successful end (table 2). In the search of the reasons for these failed reform efforts we shall look in more detail into the first IMF-supported stabilization program.

It should be pointed out that upon the fall of communism in 1989, the IMF as an institution was totally unprepared (as were the post-communist countries themselves) for the unprecedented challenges of the transition from plan to market. Not only were there no blueprints for operation in such an environment but the Fund had no country expertise on most of these economies that were not its members (Bulgaria being one of them). What the IMF had on its shelves were the blueprints of its standard policy and reform packages offered to developing countries requesting IMF assistance. Following the prevailing policy paradigm of the time, these blueprints were largely dominated by the "Washington Consensus" or what is now often referred to as "first generation of reforms" (Fanelli and Popov, 2003). IMF's approach to reforms was inherently neo-liberal, focusing on the necessity to remove all policy-generated obstacles to the functioning of markets. In somewhat simplistic terms, this amounted to a swift liberalization of the domestic product, financial and labor market as well

[13] Much later, in 2001, the Privatization Law was amended, prohibiting the use of this privatization technique (including EMBOs).

as of current and capital account transaction (trade liberalization being a priory issue). Structural issues were not at all part of IMF's agenda of that time (they were left to be to addressed by the World Bank, but without necessarily in coordination with the IMF) while institutional and other microeconomic aspects (such as governance), as well as history and initial conditions were left out of IMF's policy agenda altogether. Essentially, these were the standard policy packages advocated by the IMF to the former communist countries (including Bulgaria) at the start of the transition.

Following the abrupt default on the foreign debt in March 1990 Bulgaria was facing severe balance of payments constraints and approached the IMF for assistance. In the summer of 1990 an IMF team started – together with local counterparts – the work on the first funding agreements (launched in February-March 1991 – see table 2). Due to the deficiency of available analytical capacity by trained economists in the country, the Bulgarian part *de facto* could not be an equal partner in the process of designing the set of the envisaged policy measures. Thus the first IMF supported reform agenda was almost entirely designed by the IMF team. Besides, the preparation of the agreements took place in the absence of transparency and lack of any communication to the public.

Following IMF mainstream policy approach of the time, Bulgaria's macroeconomic stabilization program was based on targeted changes in the macroeconomic policy mix intended to drive the economy into the desired macroeconomic equilibrium (Minassian, 2001). In turn, these macroeconomic goals were fixed as fixed targets in performance, which were the primary components of IMF conditionality in implementation. Thus in the case of Bulgaria, where the stabilization effort was based on a floating exchange rate regime with money supply being the main nominal anchor, the stabilization program envisaged fixed targets for the maximum growth of money supply. In addition, the set of macroeconomic policy goals was supplemented with strict targets on the fiscal deficit. Besides, since income controls played the role of a secondary nominal anchor, there were targets on the growth of wages.

With respect to its design and contents (as noted earlier, the programme also envisaged wide-ranging and fast liberalization of economic activity), Bulgaria's macroeconomic stabilization program resembled closely similar programs launched a year earlier (in 1990) first in Poland and then in Czechoslovakia where overall they were considered successful. However, in the case of Bulgaria the stabilization effort largely failed to produce the expected results. The causes for its failure stem both from design problems (technical flaws) and from implementation problems (structural and institutional bottlenecks).

In the purely technical sense, the programme failed to capture some of the specificities of the macroeconomic situation in Bulgaria. First of all the IMF program was based on an unrealistic macroeconomic forecast, with a rather optimistic projection of economic growth (obviously the Fund did not have a realistic forecasting instrument for the Bulgarian economy). This later translated into ambitious but unrealistic macroeconomic policy targets that became part of IMF's conditionality in implementation. Foremost, this concerns the rather stringent fiscal targets which turned out to be unattainable in view of the depth of the transformational recession (its bottom was in 1991 – table 3) which eroded the tax base and the mounting transition-related problems in tax collection. In addition, the instruments of monetary control available at the disposal of the central bank were rather primitive (mostly credit ceilings on the credit expansion of commercial banks) turned out to be ill designed and inefficient.[14] Consequently, the targets with respect to money supply were also largely missed. The failure to meet the stringent technical policy targets set in the

[14] One purely technical reason was that they applied only to credits in local currency and not to credit denominated in foreign currencies.

program as IMF conditionality was the reason for the suspension of funding by the IMF already in mid-1991. But apart from the unrealistic technical targets, the very design of the stabilization program was not appropriate for the economic conditions in Bulgarian at that moment. It was rather narrowly focused on macroeconomic policy and performance and failed to grasp the complexity of the economic problems the country was facing (microeconomic and institutional factors were not addressed altogether).

Structural problems of the context played no lesser role for the failure of the stabilization program. With the benefit of hindsight it appears that the rather unfavourable initial conditions (such as an extremely high dependence on a fading market, inflexible domestic manufacturing base, very high domestic macroeconomic imbalances, the available human capital in the country) implied a longer adjustment period than was targeted in this program. In fact the rapid economic liberalization (particularly in trade) likely reinforced the shock to the economy thus contributing negatively to the achievement of the macroeconomic targets.

Ownership problems also affected negatively the implementation phase. The fact that the program was almost entirely designed by the IMF meant at the same time that for those responsible for its implementation it largely remained as a policy prescription imposed from the outside and policy makers were not committed to their implementation. In addition, due to the weak state capacity, its philosophy and methodology largely remained as a black box and likely there was no clear understanding of the workings of the transmission channels through which policy actions translated into actual economic performance. Moreover, very little was done to explain the goals of the program to the public so wide ownership of the reform was simply out of the question. More generally, despite its close involvement in Bulgaria's reforms, the IMF failed to assist in resolving the existing coordination problem with respect to the implementation of market reforms in Bulgaria.

Thus it is the combination of these numerous and complex factors that can explain why the first stabilization effort in Bulgarian failed while similar programs were more or less successful in other countries. For example, comparing with Poland, a very important difference is the ownership issue: in contrast to Bulgaria, the first Polish stabilization program was almost entirely designed in Poland, by Polish economists and experts, who not only knew much better the local conditions and context but also actively supported the effort and publicised its achievements (Kochanowicz, Kozarewski and Woodwart, 2004). An important difference both from Poland and Czechoslovakia were the initial conditions. First, both countries had a much smaller dependence on trade with USSR and consequently the depth of their transformational recession was lower. State capacity was higher in both cases and the institutional environment was generally more supportive to reforms. Public attitude in the two countries was also more supportive as there was a broad majority clearly demanding a radical break with the past. Czechoslovakia embarked on the reform process virtually with no macroeconomic imbalances which provided its policy makers with much wider room for manoeuvre. By contrast, Poland had just gone through a hear hyperinflation but this produced much wider public support for the stabilization effort. Notably, in both countries the initial macroeconomic targets were partly missed (but not by the same margin as in Bulgaria) but the programs were generally regarded as successful.

Problems of this sort discussed above accompanied the design and implementation of the subsequent three Fund-supported reform programs none of which was successfully finalized (table 2). Broadly speaking, the core problems accompanying their implementation remained the same: design flaws, unrealistic targets, disregard of the context, failure to address institutional and microeconomic factors, weak ownership, general mistrust by the public. In the technical sense, the targets set in the programs were missed soon after their launching and this triggered the suspension of funding.

However, over time, there was a gradual change in attitude on both sides and an evolution in the approach to reform by the IMF. One aspect that became increasingly apparent both to the IMF and to a number of local experts was the fact that the root causes of the dismal macroeconomic performance (including the persistently high inflation) were largely microeconomic in nature. Thus weak governance and soft budget constraints bred financial indiscipline; over time the resultant quasi-fiscal deficit translated into an open fiscal deficit and its partial monetization fed into high inflation. Thus issues such as governance and institutional change gradually started to appear in the IMF supported programs, although they still played subordinate role compared to the macroeconomic targets. The 1996 Fund-supported program was the first which addressed specifically problems like the rehabilitation of the banking system and the restructuring of the large loss-making SOEs. However, as discussed below, by escalation of the financial crisis in late 1996 and the fall of the BSP government in early 1997 radically changed the policy priorities and meant the end of this agreement.

Delayed reforms as a rational choice

The question that we shall try address now is, whether there is a possible rational explanation and interpretation of the policies during this period, and especially to the question why some key reforms were delayed? In fact, another way of looking at the question *"Why reform?"* is to address the question *"Why no-reform?"* In what follows we try to offer some possible clues to this question using some of the results of the recent literature on policy reform. In addition, we try to relate our analysis to the stakeholder groups identified above and their interactions.

The initial phases of transition in Bulgaria raise some intriguing questions related to the course of policy reforms and we shall try to analyze one of them, that seems central to the reform failure: Why was it so difficult to establish political support (more generally, a core consensus within a sufficiently large part of the society) on some of the key reforms that needed to be implemented, in the first place, the restructuring of the inefficient enterprise sector? The failure to do so, as noted earlier, was one of the primary sources of the subsequent financial crisis.

One *ex ante* complication of the needed reforms was the large degree of uncertainty associated with their outcome, especially in the short and medium run. While in the long run everybody could expect to be better off as a result of the transition from plan to market (and this was the basis for the overwhelming political support for the abolition of communism), the short- and medium-term outcomes were surrounded by a considerable individual-specific uncertainty for those who would have been directly affected by these reforms, namely, enterprise workers. Thus, if an unviable SOE was to be closed, the prospects for workers to find another job or to start their own business were rather shaky, and even if they would manage to relocate, they could expect a lowering of their real incomes due to the ongoing restructuring of relative prices. Similar uncertainties existed in the case when a firm was due to be privatized shortly. [15]

The model of resistance to reform in the presence of individual uncertainty developed by Fernandez and Rodrik (1991) provides a useful analytical framework for the analysis of the policy process in a situation of this type. This model analyzes the policy choice (to reform or not to reform) in an economy where the reform is associated with the relocation of labor,

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[15] One of the factors reinforcing the uncertainty related to the outcomes of enterprise restructuring – in contrast to central Europe which had similar starting positions – was the hesitance of FDI (one of the main engines of firm restructuring) to flow into Bulgaria in this period. But the causal effects are more complex as the low inflow of FDI reflected the generally unfavourable business and investment climate in the country in this initial phase of transition (figure 1) coupled with an unsettled foreign debt issue.

and the workers face individual uncertainties about the outcomes: they do not know whether they will win or lose as a result of the reform. According to its results, some reforms that would have been popular *ex post* may not enjoy support *ex ante* depending on the uncertainties regarding the identities of the gainers and losers of the reforms.

The model setup and its results can be easily extended to a more general set of assumptions, in particular, as regards the type of policy reform, so that to adapt it to the economic, political and social environment of an economy in the early phases of transition from plan to market, as Bulgaria in the early 1990s. Consider thus, a reform package combining trade liberalization (as in the original Fernandez-Rodrik model) with enterprise restructuring and restructuring of foreign debt. Enterprise restructuring measures (including privatization) can be identified with the hardening of firms' budget constraints to force firms to operate more efficiently; ultimately, this comes to the relocation of production factors (in the first place labor) from inefficient to more firms (sectors). Resolving the foreign debt issue and resumption of debt service in a highly indebted economy implies that the "debt-adjusted" equilibrium real exchange rate be lower than the "unadjusted" market rate (the equilibrium rate relevant to a situation when the debt is serviced by new borrowing) (Fabella, 1996). Since debt service is to be financed by the current account, the real exchange rate would have to readjust to a lower position and the "price" of such an adjustment usually is a reduced level of domestic demand and output to match the real depreciation of the exchange rate.

Both of these policy measures affect post-reform relative prices and can thus be interpreted in the framework of the Fernandez-Rodrik model. Firstly, they are associated with a major restructuring of the economy, implying even greater relocation of labor between sectors. Secondly, due to the superimposition of a real exchange rate realignment, they are likely to induce even greater changes in domestic relative prices. Hence, it is easy to show, that the general outcomes of the Fernandez-Rodrik model would also hold under these assumptions.

The formation of a voting majority in support of the reform is assumed to be a key factor for its implementation. The main theoretical outcome of the Fernandez and Rodrik (1991) model is that a situation when the individual gainers or losers of the reform cannot be clearly identified in advance is likely to be associated with the inability to form a voting majority in support the needed reform. Hence the likely policy outcome in this situation is preservation of the status quo.[16] This outcome in fact provides the evidence in support of one of our main hypotheses formulated in section 2.

Another puzzling question is why it took so long – compared to other countries with similar starting positions in the reform process – to introduce and sustain policies guaranteeing macroeconomic stability. While macroeconomic stabilization was always a central declared goal of macroeconomic policy ever since the start of transition, actual policies were often disastrous with respect to their outcome. As discussed earlier, the main flaw in the economic policy mix was toleration of a huge quasi-fiscal deficit and its subsequent monetization; this gave rise to persistently high inflation which escalated into hyperinflation in January-February 1997.

[16] In retrospective, this is exactly what happened to enterprise reform in Bulgaria until 1997: no government undertook a major restructuring of the ailing SOEs; instead they continued to operate under soft budget constraints and had access to various (direct and implicit) subsidies which helped them run as going concerns, at least for several years. Privatization in general was not assigned a high priority; the mass privatization program did not lead to immediate changes in the patterns of governance and performance. Ironically – again in hindsight – the individual-specific outcome for SOEs' workers likely was not too much different from what would have been under a speedier and more radical enterprise reform: between 1989 and 1993, 40% of industrial employees lost their jobs permanently (Figure 2).

The "war of attrition" model suggested by Alesina and Drazen (1991) seeks for a rational explanation of delayed stabilizations in a similar macroeconomic setup. In this model it is assumed that the underlying cause of macroeconomic instability is a chronic fiscal imbalance and hence the needed policy course is fiscal consolidation. Stabilization is identified with the balancing of the budget; this is achieved by an increase in taxes which are distributed unevenly across socioeconomic groups. Solving the model yields the conclusion that macroeconomic stabilization in this case is delayed because of significant distributional implications of the needed policy reform. In a heterogeneous society when socioeconomic groups may have to bear a disproportionate share of the reform burden each group attempts to shift the burden of stabilization onto other groups ("war of attrition") and this delays the timing of implementation of the reform.

The Alesina and Drazen (1991) model provides another rational explanation of the policy difficulties in stabilizing the Bulgarian economy in the initial phase of transition. Bulgaria's public finances were running a large and chronic open deficit (table 3). In the extended definition (including contingent fiscal liabilities of the government), this deficit was much greater, probably double the open deficit (exact estimates are not available). Balancing public finances required a major adjustment, which would have been extremely painful, regardless of whether the adjustment would have been effectuated on the revenue or expenditure side. On the expenditure side, arresting the expansion of the open and quasi-fiscal expenditure would have necessitated to discontinue with the open and implicit subsidies to ailing SOEs, resulting in their immediate liquidation and massive layoffs. On the revenue side, this would have necessitated to raise substantially tax revenue in a situation when the old tax system had collapsed while a new one was not yet in place; apart from the political constraints, raising tax revenue might have been technically impossible.

Ex post, fiscal sustainability in Bulgaria (in the sequence of hyperinflation followed by swift disinflation) was achieved through a *de facto* write-off of public debt and quasi-debt (eroded by hyperinflation) enforced on claim holders of such debt. Importantly, this also meant a write-off of private debt denominated in domestic currency. Ultimately, the costs were passed on to all holders of assets denominated in domestic currency (the "creditors"), the largest category among them being household savings. This outcome can be interpreted as a one-off tax levied by the government on the group of creditors, while the group of private debtors actually were granted a one-off tax relief.[17] In distributional terms the "reduction of the level of taxation" of the debtors is at the expense of a "rise in the level of taxation of the group of creditors". Such an interpretation, clearly defining two groups – "winners" and "losers" of the reform, fits comfortably into the framework of the Alesina and Drazen (1991) model.[18] As suggested by this model, the anticipated disproportionate sharing of the reform burden by these groups gives rise to a "war of attrition" which, in turn, provides a rational explanation of the delayed stabilization. This result provides the evidence in support of our second main hypothesis formulated in section 2.

In fact, the two model interpretations given above in the main look at the rationale behind the delay of one and the same policy reform – the restructuring of the enterprise sector, which ultimately was one of the main primary sources of financial and macroeconomic instability. However, they look at it from different angles: firstly, from the

[17] As the creditors paid for both public and private debt write-off, they were taxed more than would have been the case in the absence of private debt.

[18] In a similar vein, Nenovsky and Rizopoulos (2003) argue that the monetary regime change in 1997 was the result of a fight for power (over the appropriation and redistribution of common wealth) between different groups of national and international debtors and creditors. The monetary regime change reversed the position of dominance in the Bulgarian economy: before 1997 it was debtor dominated while after 1997 it became creditor dominated.

point of view of the implied uncertainty and, secondly, from the point of view of its distributional consequences. These two models thus provide consistent and complementary rational choice explanations of the reluctance of policy makers to go ahead with the needed reforms which was one of the main causes of the overall reform failure.[19]

The outcomes

The uneven course and piecemeal nature of the Bulgarian reforms in the early phases of transition are reflected in the country's dismal economic performance in this period. With a cumulative GDP decline of some 27% through 1993, Bulgaria experienced one of the most severe transformational recessions among all central and eastern European countries. Only during the first two years of transition (1990-1991) Bulgaria's GDP dropped by almost 20% while gross industrial output fell by 35% (table 3 and figure 1). Although there were no massive policy-driven layoffs, the output collapse had grave labor market implications, and the first years of transition were marked by an unprecedented deterioration of the situation in the labor market. Thus only between 1989 and 1992 the net job losses in the economy amounted to more than 1 mln people which was some 23% of the total employment before transition and around 12% of its population. The pool of unemployed (something that was non-existent in the past) was rapidly expanding (figure 2). The most affected segment of the labor market was industrial employment: apart from the open job cuts, many manufacturing firms facing financial difficulties stopped paying wages or paid reduced wages, with considerable. Despite the extensive labor shedding, the fall in industrial employment lagged behind that in the industrial output (table 3). However, the unemployment statistics for this period may not be quite accurate, as many firms forced part of their workforce to take extended involuntary unpaid leave. Although such persons did not formally qualify as unemployed, *de facto* they were without a gainful job.

No notable progress towards macroeconomic stabilization could be achieved in this period. The policy measures that were undertaken could not achieve their goals largely due to some specific, transition-related factors of macroeconomic instability. Thus, apart from the open fiscal deficit (which was largely monetized) another important source of inflationary pressure was the large quasi-fiscal deficit in the economy. The core roots of the quasi-fiscal deficit lay in the huge financial losses incurred by the unviable SOEs (as a result of their lost market and inability to adjust to market conditions) which in the course of time transformed into open fiscal deficit. Maintaining such firms as going concerns (under the pressure by interest groups) meant that their losses had to be covered from external sources, at least partly. As noted, open budgetary subsidies were deemed unacceptable for this purpose for ideological reasons. However, there were alternative ways of channeling funds to ailing firms. One of them was the toleration of firm arrears in their payments to the budget. This de facto was equivalent to a direct budgetary subsidy (moreover, not conditioned on performance) that added directly to the fiscal deficit. Another important channel were the soft credits extended by state-owned banks. However, as most of these credits were not serviced, over time the losses of the SOEs were de facto channeled to the banks. When the state later intervened to bail out the failing banks, the losses of these banks were recognized as public

[19] In fact, the socio-economic and political context in Bulgaria, the policy course and the observed outcomes of (the lack of) reforms are also consistent with other models in this strand of the literature. Thus Cukierman, Edwards and Tabellini (1992) derive the result that political polarization (very pronounced in Bulgaria in this phase) increases the probability of blocking the reforms (which entirely consistent with what happened in Bulgaria). Similarly, Murphy and Sturzenegger (1996) arrive at the result that the more ideological the political parties are (another typical feature of the Bulgarian political system at the time), the more likely it is that reforms would be blocked (as indeed happened).

liabilities and thus added to the persistently high fiscal deficit (table 3). The fiscalization-*cum*-monetization of the huge quasi-fiscal deficit inevitably translated into high inflation.

To sum up, one of the reasons for the failure to achieve macroeconomic stabilization was the fact that the policies in this phase of transition did not address comprehensively the problem of the quasi-fiscal deficit. In the sense of the models of rational choice discussed above, the authorities chose this policy course (rather than the more rapid restructuring of the enterprise sector) to avoid major social conflicts, and under pressure from interest groups. However, high inflation and macroeconomic instability were the price that the whole society had to pay for this delay. In the initial stage, the IMF (which was one of the main drivers of the policy reform) was largely focused on macro issue and likely failed to identify the core roots of the problem. By the time when it did, it was perhaps too late to avert the crisis.

As noted, these policies were equivalent to the preservation of soft budget constraints which, in turn, held back enterprise restructuring. Besides, the toleration of non-payments by the state (an important institutional failure) instigated widespread financial discipline in the economy. In the final run, the negative effects of these policies accumulated in the banking system in the form of bad loans. Notably, both state-owned and private banks were adversely affected, although for different reasons. In the state-owned banks this was largely the outcome of state intervention in the allocation of credit whereas private banks suffered from the corrupt practices of insiders.

Ironically, the inconsistent policies that tried to address the issue of the snowballing bad loans, only served to aggravate the problems. Both in 1991 and in 1992 the authorities decided to enact a partial debt relief of old enterprise credit (this operation covered about 25 per cent of the non-performing bad loans allocated before 1990). These steps were meant mainly as financial assistance to troubled enterprises and were not aimed at cleaning up the banks' portfolios, which at that time did not show signs of trouble. However, the program did not have a clear strategy (the debt relief was not conditioned on performance improvement) and this gave rise to severe moral-hazard problems. This inconsistent and partial policy – which did not lead to a once-and-for-all solution of the problem – gave the wrong signals to enterprises. In spite of the fact that it covered only a small portion of the SOEs, it created the overwhelming expectations of an "all forgiving" policy on behalf of the state, the outcome of which was that practically all SOEs gradually stopped servicing their old bank credits. Indeed, this expectation translated into a self-fulfilling prophecy.

The sharp deterioration of the banks' portfolios in 1993 caused by the upsurge of bad loans raised the political pressure for a new action. After heated political debates, in December 1993 the Bulgarian parliament adopted a law on the settlement of old bad loans of Bulgarian SOEs. This was a large-scale operation covering enterprise debt of over 3 bn US dollars (some 28% of Bulgarian GDP that year) which were replaced in the banks balance sheets with 25 year government bonds which the enterprise debt to the banks was converted into direct debt to the state. However, given the circumstances, this extremely costly operation could not resolve to accumulated problems. It only addressed one part of the accumulated stock but did to deal with either the total stock, and more importantly, with the flow problem. The problem was that there was a large amount of "new" bad loans (accumulated after 1990 and hence not eligible for conversion) and that these new bad loans were rapidly increasing.

The weak institutional environment was an important factor for the escalation of the economic problems. Thus bank supervision was poorly designed and not endowed with sufficient power to enforce prudential banking practices; there were also important loopholes in prudential regulations (OECD, 1997). A crucial flaw of the judiciary was the absence of effective mechanisms of securing contract enforcement, and this was a key factor for the proliferation of financial indiscipline (OECD, 1997). A bankruptcy law was only adopted in

June 1994 (before that there was no legislation dealing with the issue); anyway its adoption did not make much difference due to weak enforcement and increasing political pressure. Important public institutions (such as the judiciary and the central bank) were in fact subject to strong political pressure which caused serious distortions in their actions. The public administration was in a state of a permanent reshuffle: each new government initiated sweeping layoffs, bringing in its own cronies. The absence of stable rules and norms and the lack of transparency in the working of the public administration bred endemic corruption.

The lack of progress in stabilization had grave consequences for the living standards of the population. The combination of falling output and stubbornly high inflation remained continuously eroded the real value of both current income and of the monetary assets held in domestic currency. The drop in real incomes in these years was really unprecedented: between 1989 and 1996 the average real wages in the country dropped by some 60%.

The first years of transition were also marked by recurrent open social unrest which took the form of frequent strikes. While such an attitude to the ongoing reforms partly reflected the eagerness of the population to take advantage of the newly acquired democratic freedom, it was mostly driven by the rapid deterioration in the living standards of many people and the dismal situation in the labor market. The street protests often acted as a deterrent in the policy process, causing reversals in some policies or averting the adoption of others.

The crisis

BSP won the absolute majority at parliamentary elections held in December 1994 on the populist ticket of “moderating the social costs of transition”, a slogan that – given the high unemployment and spreading impoverishment – had a wide popular appeal. The BSP government that took office was the first one after 1990 that enjoyed a one-party majority in parliament and thus BSP had all the power to implement its policies. The party at that time was dominated its non-reformist wing and the latter pushed through a package of measures based on the concept of “public correction” which de facto meant more state interference in the economy. In the main this amounted to extensive price regulation (seeking to slow down the inflation), wider regulation of economic activity (licenses and permits) and, probably most important, wide direct interference in the allocation of credit by state-owned banks. The BSP government de facto regarded these banks as part of the system of public finance which, moreover, was under its direct control (rather than under the control of the parliament) and openly abused this usurped power. These practices culminated in 1995 with the public statement by the then Minister of Industry advising SOEs not to service their bank credits if they found themselves in financial difficulties.

After several years of deep depression, the years 1994 and 1995 were marked by a meager recovery (table 3), and the government attempted to take credit for that, claiming that this reflected the success of its policies. However, this recovery did not have any sound fundamentals as it was mostly driven by these unsustainable policies. In fact, in its attempt to revitalize the ailing economy, the government was pumping large amounts of public funds into it, a policy that over time only generated more instability.

In the mean time, the situation in the financial system was rapidly deteriorating, accumulating the combined negative effect of past and present inconsistent policies. The series of financial bailouts undertaken in the previous years added to the mounting fiscal problems, resulting in the direct fiscalization of the quasi fiscal deficits accumulated in the corporate and banking systems. The overall outcome was a sharp deterioration in the public sector financial balance and a skyrocketing domestic public debt which became a grave burden to the economy (table 3). Not only were the increasing public sector borrowings persistently crowding out business investment but the snowballing interest payments by the budget started to crowd out all non-interest budget expenditure (figure 3), while the government was forced to maintain a large primary surplus (figure 4). The fiscal burden was aggravate by the high nominal interest rates during this period (table 3)[20], in itself a result of the chronic macroeconomic instability. Although the resumption of the foreign debt service in 1995 (after Bulgaria reached a debt restructuring deal with the London Club in 1994) added to the overall debt burden, it was the service of domestic public debt that caused most pain: in 1996 domestic interest payment reached almost 17 per cent of GDP! In such a situation the fiscal authorities could not avoid chronic large budget deficits and the financing of this deficit resulted in its almost complete monetization.

Simultaneously, the escalation of bad loans led to a sharp deterioration of the banks' portfolios: at the end of 1995, some 75% of the outstanding commercial bank loans were classified as sub-standard or non-performing. Public confidence in the banking system started to erode in late 1995 with some banks experiencing liquidity problems. The panic which at first was only confined within the banks that were most affected by liquidity problems gradually escalated with the subsequent closure of several banks and towards mid-1996 took the form of a full-scale run on the whole banking system bringing about massive withdrawals of deposits. At the end of 1996, 15 commercial banks (both state-owned and private) were placed under conservatorship by the central bank which initiated bankruptcy procedures against them.

Under a free-floating exchange rate regime, as was the case in Bulgaria, it is the exchange rate that absorbs instantaneously the macroeconomic adjustments caused by financial pressure or external disturbances. Thus, unsurprisingly, the collapse of the banking system provoked massive currency substitution and capital flight, exerting a strong downward pressure on the currency and causing a drain of the official forex reserves (table 3). The final and desperate attempt by the monetary authorities to arrest the crisis was to raise the basic interest rate, its main policy instrument: in May 1996 the central bank set its basic interest rate at 280 per cent (annual compound) and in September at 1450 per cent! However, by that time the government and the monetary authorities had completely lost their credibility and these moves could not calm down the financial markets. Moreover, the subsequent monetary injection (imposed by the government through a special law) wiped out the effect of the interest rate hikes.

The collapse of the banking system aggravated the fiscal crisis creating another vicious circle. Due to the liquidity crisis in the banking system, by mid-1996 most new government security issues were under-subscribed and issues remained partially unsold. In turn, the Ministry of Finance which also experienced cash shortage started to pay the interest due on outstanding securities through newly issued ones reducing the cash supply to the banks which further worsened their liquidity problems. Consequently, the Ministry of Finance was forced to apply more often for cash advances from the central bank whereas the BNB often intervened as a first buyer of government securities. Apart from that, the central bank increased the uncollateralized refinancing of the commercial banks. Finally, a special law was passed in December, obliging the central bank to extend a huge one-time direct credit to the budget (of BGL 800 bn, equivalent to 45% of GDP in 1996). It was this enormous monetary injection that spurred a hyperinflationary hike at the turn of 1996.

The chaos in the financial system (and in the economy as a whole), the eroding real incomes as well as the steadily deteriorating expectations triggered a plunge in economic activity: the cumulative GDP drop in 1996-1997 amounted to some 15% (table 3). The crisis resulted in significant loses of financial wealth for a great number of people and provoked

[20] High nominal interest rates imply not only high interest payments on short-term government debt but also accelerated real amortisation of long-term debt as larger shares of real repayment were made at earlier phases of the debt.

mass street riots. In January 1997 the ruling socialist government was forced to resign. A caretaker government took office to prepare early parliamentary elections which were held in June.

5. From crisis to successful reforms (1997-2004)

The new context

The 1996-1997 crisis was a dividing line in Bulgaria's reforms. It was a devastating economic collapse: apart from the hyperinflation which was ruinous for the savings of ordinary households, it produced a deep recession, a chaos in the financial system resulting in the closure of some 15 banks, and bankrupt public finances. The crisis resulted in further impoverishment and deepening of the social stratification, and brought about widespread frustration with the policies pursued during the first phases of transition. The biggest losers were the low and middle-income classes, those that had held assets and savings in domestic currency. By the time of the crisis and during its course, many of them lost a big chunk of what they had to lose (both in terms of wealth and in terms of job security). In the public perception these losses were due to flawed policies, largely associated with the Socialist party which not only was in power at the time of the crisis but also either led, or supported most of the governments in office during the first phases of transition.

It could be noted that while reflecting the negative outcomes of failed policies, the overthrow of the BSP government was at the same time a demonstration of the progress in the process of democratisation in Bulgaria after the fall of communism. Although the people took to the streets in masses to protest, the ousting of the government basically took place in the absence of violence. The changeover of power was in full compliance with the acting constitution: after the resignation of the BSP government, the President appointed a caretaker government with the mandate to prepare early elections.

The general disillusionment with the previous policies translated into broad public support for a radical change in the course of economic reforms. This switch in political sentiment change in orientation partly reflected the ongoing societal shifts. In the runup to the crisis and, especially in its aftermath, there was a massive shake-up in stakeholder groups. With the advance in privatization and the ongoing liquidation of inefficient SOEs, the groups of SOE employees and managers (important stakeholder groups with clearly defined interests in the initial phase of transition) gradually lost their clout and importance in society. Trade unions weakened further due to their inability to act and defend the interests of their members, especially before and during the crisis, and have not been able to recover their previous political positions ever since; politics returned to the political parties. At the same time, new stakeholder groups were gaining both in numbers and in importance. This especially concerns the numerous and rapidly growing category of small entrepreneurs – owners and managers of small businesses (table 5). During the course of transition, small entrepreneurs gradually emerged as one of the most influential stakeholder groups. Subsequently, the growing number of foreign investors and the emerging class of domestic big entrepreneurs and executives also gained in importance. Private entrepreneurs had a vested interest in a stable and predictable economic environment, transparent policy and political stability. The non-governmental sector as well as the media, which were rather active during the crisis, subsequently strengthened their positions.

During the crisis and in its aftermath, the political symbol of change was the main opposition party (formally, coalition of parties), UDF. During the crisis the UDF led the political discontent, advocating discontinuation of the previous course of muddling through and the swift introduction of sweeping policy reforms. Even though the envisaged policy change was an obvious turn to the right, it was also supported by many people with traditional leftwing orientation who had suffered from the previous policy course. The caretaker government appointed in January 1997 was headed by the leader of one of the small parties that participated in UDF and actually gave the start of some of the new reforms. Consequently, the early elections held in June 1997 resulted in a crashing defeat for the socialists and a full-fledged victory of the UDF, which gained the absolute majority in these elections and formed its own government (see Appendix 1). Indeed, for the first time after the fall of communism, Bulgaria had a strong government, which enjoyed a comfortable parliamentary majority.

The crisis also triggered a major overhaul in the Socialist party itself. The policies of non-reform wing which dominated the government were completely discredited and this faction was ousted from the party's top positions. The reformist wing took full control of the party and this brought about a major change in its own political and policy orientation: domestically the new leadership supported the course of market reforms and externally it was an advocate of rapid accession to the EU.

Equally important, significant changes took place in the country's external environment. The declared domestic political will to go ahead with radical economic reforms and changes in the direction of policies, as well as their strong public backing (as evidenced by the 1997 elections) triggered a positive response by several important external agents. In the first place this was the IMF, which offered financial support, but under the conditions of a clear role in macroeconomic management (discussed below).

The other major external agent was the EU (represented by the European Commission). As noted, in the beginning of the 1990s the EU itself was unprepared for the fall of communism and had not made up its mind as regards the scope and direction of its further enlargement. Besides, it was too preoccupied with the introduction of the single market in 1992 and the expected accession of three new members (Austria, Finland and Sweden which joined in 1995). However, the views on the possible future eastern enlargement gradually took shape, with Bulgaria entering the scene as a prospective new member. Geopolitical factors that played a role in this re-orientation of the EU: it wanted to establish islands of stability in the highly politically unstable Balkan region. In this regard, despite its economic problems, in terms of political reforms, democratisation and ethnic tolerance Bulgaria featured prominently compared to its neighbors in the Western Balkans. The real turning point in the relations with the EU was the decision to start accession negotiations with Bulgaria in 1999 (after Bulgaria offered full support to NATO's operation in Yugoslavia), the first clear signal that the EU viewed Bulgaria as its future member. Later on, a similar signal came from NATO.

These unambiguous external signals put an end to the gravity vacuum that had emerged after 1989. On the one hand, they meant that the West had finally recognized the country as part and parcel of its patrimony and was willing to take a much more active role in defining and shaping its politics and policies. But, on the other hand, this was also a positive response to the radical re-orientation in Bulgaria's domestic and foreign policy and politics after 1997. In turn, these signals provided a powerful support for the domestic political forces with a pro-western political orientation.

All these changes in the context amounted to a major "structural break" in the driving forces of Bulgarian reforms in the sense of a major change in the underlying structural relations that drove the reform process and determined its direction. Taken together, these factors steered the overall re-orientation of Bulgaria's politics and policy and, more generally, the beginning of its "switching" from an eastern to a western periphery.

The political economy of policy change

We now turn to the motivational aspect of the reform effort in the years after 1997 with questions such as the following: Is there an interpretation based on rational choice that could explain the change in policy course in this later phase of reforms? What was the main motivational driving force behind the reform drive in this phase? How can we explain the stark contrast between reform failure and reform success in virtually the same society, just several years down the road? One of the puzzling issues in this regard is why reform policies that were impossible to implement in the first phase due to strong public resistance, were welcomed and applauded by the public in the next phase?

To address this issue we turn to another theoretical work in the literature on the positive economics of policy reform, that by Drazen and Grilli (1993). The model of Drazen and Grilli suggests a rational choice explanation why major economic crises may serve as catalysts of reforms and provide theoretical arguments in support of their claim that “the welfare losses associated with economic distortions and crises enable societies to enact measure that would be impossible to enact in less distortionary circumstances”. Thus, if society is heterogeneous and there is no consensus between interest groups over the reform path and the distribution of the costs and benefits associated with it (as was the case in Bulgaria), a crisis may be the only way to induce necessary policy changes.[21] The more severe the crisis (and the higher the inflation), the more likely it is that reforms (stabilization policies) will finally be implemented. To put it differently, in a situation of a crisis the costs incurred by the population, including the interest groups that will be most affected by reforms, become comparable to the costs of reforms and political support of the reforms starts to grow.

In fact, the Drazen and Grilli interpretation fits almost perfectly the situation in Bulgaria at the peak of the financial crisis in 1996-1997. Public finances were in a chronic and widening deficit, largely due to the escalating open redemption of contingent public fiscal liabilities. As a result of the surfacing into the open of the large quasi-fiscal deficit, public debt was snowballing but there was no consensus in society how to share the costs of the needed fiscal adjustment. As discussed above, the deficit was financed by printing money and the huge one-off operation of deficit financing through monetary emission that took place in the final months of 1996 gave rise to the hyperinflationary hike in January 1997. At that point, when inflation was threatening to get out of control completely, finally a political agreement (reflecting the changing attitudes throughout the whole society) was reached on the subsequent stabilization package. This outcome provides strong evidence in support of one of the main hypothesis formulated in section 2.

To understand the driving forces of the major policy switch and the scale of public support for this change one needs also to take into consideration switch the endogeneity of the policy process in a situation of a dynamic political equilibrium. In the stream of literature on the positive economics of policy reform it has often been pointed out that policies as well as the attitude of interest groups in society are not necessarily exogenously determined (Krueger, 1993): on the one side market responses to economic policies affect the political equilibrium and can induce changes in policy; on the other, economic interests are often functions of past policies. Thus both policies and the political equilibrium (support of or resistance to policies) can change endogenously over time. In the case of Bulgaria the attitude of the main interest groups, including the attitude and economic interests of those that resisted reforms most fiercely in the first phases of transition, were rapidly changing during the crisis as they were beginning to realize that past policies were leading to a catastrophe.

[21] Subsequently, Drazen (1996) suggested a theoretical framework that allows to apply a common approach and methodology to the above issue and to the “war of attrition” model, arriving basically at similar results and conclusions.

This was equivalent to a major shift in the political equilibrium in the country towards reform-oriented policies.

And finally, one cannot overestimate the importance of the external agents in legimimizing the change in policy direction and in providing a solid support for local politicians to follow this course after 1997. Notably, the realistic prospects for EU membership (regarded by local politicians as an impending reward for policy success) and the disciplining role of accession negotiations have been a crucial vehicle for pushing through a broad institutional, legislative and regulatory reform agenda. Similarly, the IMF had a prominent role in instituting policies of fiscal restraint in extremely harsh economic conditions, which has been the key factor of macroeconomic stability after 1997. It would be fare to say, that in the absence of these extremely strong external anchors, the risks of abandoning the reform course and slipping back into policy havoc would have been much greater.

The new policy course

The change in government in mid-1997 was accompanied by a major change in macroeconomic policy and the subsequent introduction of comprehensive structural and institutional reforms.

The key driver of the new reform effort in Bulgaria was again the IMF; however, this time its involvement was more instrumental and its contribution – more fruitful. By 1997 the IMF had gained considerable experience in dealing with transition-specific economic problems (largely learning from its own mistakes and from the mistakes of policy makers in the countries in transition). After several years of involvement in Bulgaria the IMF also had much better understanding of the local context, the institutional environment and the specific problems of the Bulgarian economy and was familiar with its political setup. The IMF was also frustrated by its series of failures in Bulgaria and was eager to achieve success. In this case the IMF also had a much more motivated and cooperative local partner. The UDF was keen to demonstrate its competence in reforming the economy. Also for the first time after the fall of communism it had full control of power to implement its own reform agenda.

The joint work on the formulation of the new reform program started already during the crisis and accelerated during the term of office of the caretaker government as practically there was no doubt that the UDF would win the coming parliamentary elections. By the time of the elections (June 1997) the main legislative and other policy documents were ready and the newly elected government could launch them from day one. Notably, compared to the first reform program of 1991 there were major differences both in terms of the approach towards macroeconomic stabilization and with respect to the conceptual framework and paradigm of the overall reform effort. In addition, due to the strong commitment of the new government to the new reform course, in this case there were no ownership problems in implementation. Besides, several years of reform efforts had helped in upgrading Bulgaria's state capacity which facilitated the implementation of reforms.

The key component and instrument of the policy approach towards macroeconomic stabilization was a currency board arrangement (CBA). The establishment of the CBA was *de facto* unilaterally imposed by the IMF as a non-negotiable pre-condition for new funding (it was a "take it or leave it" approach).[22] The debates on the CBA rationale during the period prior to its establishment were mostly of academic character and could not affect the decision making process. Actually, both at the time of its establishment and during the first several years of its operation it would have been rather difficult to argue for a CBA based on strictly

[22] During the negotiations with the IMF the UDF leader (later Prime Minister) Ivan Kostov actually was against the CBA as this arrangement undoubtedly reduced the degrees of his future policy freedom.

economic arguments (such as whether it reflected an optimum currency area). The decision thus was almost entirely political, aiming to institute a disciplining mechanism in macroeconomic (in particular monetary) policy, a "straitjacket" for irresponsible politicians. Under the CBA, which started operation in July, the nominal exchange rate was fixed against the Deutsche mark (subsequently to the euro) for an indefinite period of time with unlimited convertibility of base money. Under this arrangement there was no room for sovereign monetary policy: the central bank was banned from open market operations and refinancing of commercial banks. A country applying a CBA *de facto* "borrows" the monetary policy of the country of the reserve currency.[23]

Equally important, the macroeconomic policy mix was supplemented with a major change in the design and implementation of fiscal policy. Under the CBA the instruments of fiscal policy, in principle, remained available to policy makers; however, in practice, the degrees of their fiscal policy freedom are limited by the requirement to target long-term fiscal sustainability (Dobrinsky, 2001).[24] At the insistence of the IMF, Bulgaria's fiscal policy under the CBA was to be set up under a so-called medium-term fiscal framework which would guarantee fiscal sustainability. Its main role was to institute instruments and mechanisms that would allow policy makers to analyze in a consistent framework the longer-term implication of policy decisions taken an a given point in time and thus set a policy course that would ensure macroeconomic stability and continuity in the conduct of fiscal policy in the longer run (see Horvath and Székely, 2003). The medium-term fiscal framework was a major technical innovation in the whole of eastern Europe and in the course of its implementation proved a great success. It was in fact a second policy "straitjacket" related to the fiscal component of the macroeconomic policy mix.

However, the new reform program was much wider in ambition and scope than a macroeconomic stabilization effort. Foremost, it did try to address some of the important roof causes of the reform failures during the first phase of transition. Given the pitiful experience of the financial crisis and the almost complete loss of confidence in the banking system, one of the first priorities was to rehabilitate the banks that survived the crisis. Notably, the key emphasis in the reform measures was placed on some institutional aspects.

Some of the important new measures targeted further tightening of the formal prudential banking regulations and the functioning of banking supervision. Thus new technical criteria regulating risky exposition of commercial banks as well as tighter capital adequacy requirements were put in place and much more stringent requirements on bank reporting to the supervision authority. Other measures targeted the system of incentives in the banking system with the aim of actually enforcing good banking practices; an important innovation in this respect was the introduction of a threat of criminal penalty for the most severe abuses of the regulations of prudential lending. Other components of the reform programme targeted the discontinuation of the flow of bank credit to the unviable SOEs. For this purpose, a group of large loss-making SOEs were placed in "financial isolation" whereby they could not have access to normal bank credit but only to targeted budget subsidies which, however, were conditioned on performance (and thus targeted restructuring of these enterprises).[25] The implementation of the financial isolation program lasted several years; some of these firms were indeed restructured while others were liquidated.

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[23] In the case of Bulgaria, this was initially the Deutsche Bundesbank, and later, the ECB.

[24] Hence fiscal policy, by definition, is deprived of its main macroeconomic policy variable: the possibility of maintaining an independently targeted fiscal position. In this sense after 1997 Bulgaria had zero degrees of macroeconomic policy freedom.

[25] The financial isolation program was formally started already in 1996; however, vigorous implementation began only under the new government.

During the years that followed, a number of important structural and institutional reforms (most of which were designed under the IMF, World Bank and EC guidance) were also given a start. The Bulgarian authorities implemented a major tax reform including important changes in the system of taxation such as the unification of the personal income tax, simplification in the system of corporate taxation and reorganization of the tax collection system. The main direction of the tax reforms has been towards lowering of the tax burden (especially as regards direct taxes[26]) compensated by more efficient tax collection. The latter partly sought to eliminate the previous financial leaks from the budget towards unviable SOE in the form of tax arrears.

Major reforms of the pension and health care systems were launched in 1999 (see Appendix 1 for details) and other components of the social security system (such as social welfare) were also reorganized. All of these reforms targeted the achievement of long-term financial self-sufficiency of these systems and thus had important, though not immediate, fiscal implications (in the short run direct transfers from the budget continued but in diminishing levels). Privatization was finally given a solid start. The government declared that sales to strategic foreign investors would have the highest priority in its privatization efforts and this period saw several landmark sales of large SOEs. The years between 1997 and 1999 was the period of most intensive ownership transfer combining commercial privatization (table 4) and the subsequent waves of mass privatization (which mostly involved small and medium-sized SOEs). Bank privatization was given a high priority and by 2004 all state-owned banks were privatized to strategic foreign investors.

The start of accession negotiations with the EU in 1999 was another landmark in Bulgaria's reforms. The process of accession negotiations played an extremely important role in the process of market reforms in Bulgaria, especially in their institutional aspect. While the post-crisis reforms inspired by the IMF and the World Bank mostly sought to establish functioning market institutions, the preparation for EU accession implied a considerable widening and deepening of the reform process. It set the goal, within a relatively short historic time span to upgrade these institutions to a status typical of a mature market economy.

This preparation of EU accession involved negotiations under 30 "chapters" which comprise the EU's *acquis communautaire*.[27] "Closing" each of these chapters in the negotiation process signifies that the country has harmonized its respective legislative, regulatory or institutional environment with those in the EU.[28] This process implied an almost complete overhaul of the economic legislation and regulations and major changes in the functioning of public institutions in order to make them compatible with those of the EU. The accession negotiations were also an important learning process for the government official involved in them as they not only had to acquire new knowledge and skills but also had to get accustomed to the way they EU homologues operate.

Change of power without a change in the direction of reforms

The post-1997 period was marked by growing political maturity and stability. An important factor for the success of the reforms undertaken after 1997 was the fact that in the main they were supported by the major political parties including the reforming BSP where the reformist wing had taken control. Therefore, although there were differences with respect

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[26] Thus between 1998 and 2004, the average statutory tax rate on corporate profit taxes was lowered from 32.5% to 19.5%.

[27] The body of common rights and obligations which bind the Member States together within the EU. The chapters cover virtually all aspects of the macro- and microeconomic environment and the related policy areas.

[28] By mid-2004 Bulgaria closed all 30 chapters and the signing of the accession treaty was expected to take place in early 2005.

to policy priorities and the selected policy issues, since 1997 there has been a general political support for the overall direction of reforms. Thus all political parties have time and again voiced their support for the CBA as the key underlying instrument for maintaining macroeconomic stability. All main political parties supported the orientation towards fast accession to the EU and the measures necessary to achieve that goal. When the crucial issue on the membership in NATO was put to vote in parliament, it also received unanimous support (although BSP had agonized internally for a long period over its attitude on this issue).

The two main parties gradually took a more stable shape and place in the political spectrum. The UDF was re-organized from a coalition to a single party with a christian-democratic orientation (although some of the former coalition parties refused to be integrated into the new party and left). The BSP was taking the shape of a mainstream left-wing party of a social-democratic orientation. The MRF retained its claim on the political centre. The overall political constellation that was taking shape seemed to be that of a typical political system in a modern democracy. Having a comfortable parliamentary majority, the UDF government managed to successfully complete its term in office in 2001 (the first government after 1989 to do so) and was hoping for a renewal of its mandate.

However, in 2001 something extraordinarily unusual and unexpected occurred on the Bulgarian political scene. The former Bulgarian monarch Simeon II – son of the pre-World War II king and heir to the throne (the monarchy was formally abolished in 1946) – returned to Bulgaria and claimed his ambition for an active role in Bulgarian political life. Initially he sought nomination for the upcoming presidential elections but this ambition was denied by UDF who were not willing to share their absolute control of power.[29] But then Simeon decided to realize his political ambitions through direct participation in the political life and in the parliamentary elections. Astonishingly for most observers, the newly formed National Movement of Simeon II (NMSII), which only came into existence in April 2001, won a landslide victory at the June parliamentary elections and this brought about a major reshuffling of the Bulgarian political scene.

The former monarch enjoyed wide personal popular support from various and quite heterogeneous segments of the population ranging from selected parts of the business elite (which is not numerous but apparently highly influential within the movement) to the dominating in numbers group of those who were dissatisfied – maybe for different reasons – with the outcomes of the reforms. The latter was in fact the core of the so called "silent majority": those that abstained from vote in previous elections and who probably would not have voted in 2001 in the absence of the new alternative (this group had been steadily growing during the previous several years). This time the silent majority likely provided the decisive electoral support for the former king's political movement. In fact, the level of electoral activity in these parliamentary elections (some 67% of those eligible to vote) was among the highest during the past decade. But in addition, thanks to his personal popularity, Simeon II attracted a large portion of the non-core electorate of both BSP's and UDF's, who were disappointed by the traditional parties. Notably the waning of support for UDF was due to the fact that despite the obvious progress in the reforms, it failed to address some important issues such as corruption (see below).

The economic program of NMSII was highly eclectic, combining liberal ideas (reflecting the visions of a group of young financiers that designed the program and subsequently took key positions in government) and populist pledges (probably coming from the political entourage close to the former monarch). These parts of the program apparently

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[29] Formally Simeon was blocked from participating in the presidential elections through a constitutional procedure.

sought to appease the most numerous political constituency of the movement. In fact the program combined seemingly inconsistent and conflicting objectives: on the one hand, it asserted the goals to limit considerably state intervention in the economy, reduce public administration and public spending, and accelerate privatization; on the other, it pledged to reduce the level of taxation, increase public support to the weakest layers of society, expand the existing social programs, strengthen the police, create new public institutions. Besides, it envisaged meeting all these targets under the assumption of a zero budget deficit and the preservation of the currency board arrangement. NMSII pledged to strengthen the judiciary and fight corruption as well as to eliminate the remaining bureaucratic hurdles for doing business. Most controversially, Simeon committed himself to the target of achieving a "perceptible improvement in the living standards of the population within 800 days".

However, after NMSII took office, most of the populist pledges were *de facto* dropped and the government has followed a center-right type of economic policy. In fact, there was a remarkable degree of continuity in the policy course after the 2001 government changeover. The existing macroeconomic policy framework was kept intact and Simeon's government continued to stick to a prudential fiscal stance based on the medium-term fiscal framework. The NMSII carried on and developed further all institutional reforms initiated by its predecessor. There was full continuity in the accession negotiations with the EU. Thus the general direction of the reform process was preserved despite the change of government. In this, the changeover of power in 2001 was also very different from those before 1997 when every new government tended to reverse the policy course of its predecessor.

In this sense it could be argued that after 1997 the key political forces in the country *de facto* – albeit tacitly – agreed upon a policy and reform course that resembled the "Golden Straitjacket" described by Friedman's (1999) whereby their differences amounted to slight differences and nuances in the policy course. Friedman used this metaphor to define the policy course to which a government needs to abide if it strived for efficient integration into the world economy. This interpretation fits almost perfectly to the situation in Bulgaria: the tacit agreement among the Bulgarian political forces largely reflects their joint support to the course towards EU membership.

Improving macroeconomic fundamentals

In the period after 1997 Bulgaria's macroeconomic performance improved considerably, especially when compared to the preceding period (see table 1 for a comparison of the two periods of Bulgaria's reforms). However, not everything changed to the better at once. The first notable success was the fast macroeconomic stabilization underpinned by the combination of a CBA and prudent fiscal policy: already by 1998 inflation was under control and thereafter there have never been fears of a return to a path of high inflation (table 3). Quite remarkably, the macroeconomic policy framework established in 1997 and its main instruments have never been questioned either by the governments in office or by any of the opposition parties. This national consensus on the macroeconomic policy course has been a key factor for the successful macroeconomic stabilization in the years that followed.

Furthermore, there emerged a virtuous circle in macroeconomic stabilization related to the preparation for EU accession which contributed to a more harmonious operation of Bulgaria's macroeconomic policy framework. On the one hand, the policy mix based on the CBA allowed the economy to embark on a fast track towards nominal convergence with the EU prior to accession (as required by the Maastricht criteria). In turn, the wide-ranging measures of policy harmonization and the rapidly increasing trade with the EU contributed to an increasing degree of synchronization of Bulgaria's business cycle with that in the EU. Hence one could argue that the operation of the CBA contributed to the materialization of its own economic rationale (in particular, the optimum currency zone conditions, an issue that was largely ignored at the time of the establishment of the CBA).

After 1998 there has been a sustained recovery in gross output and a marked upturn in fixed investment (reflecting rising investor confidence), reversing the trend of previous years. The economic upturn was at first mostly driven by the recovery in services while the manufacturing industry was adversely by the ongoing restructuring of loss-making SOEs: the recession in the manufacturing industry continued until 1999 (table 3). However, thanks to the acceleration of new investment in the manufacturing industry (including a rapid upturn in FDI), manufacturing output also started to recover after 2000. The sustained economic upturn contributed to a rapid recovery in real incomes.

As a result of the comprehensive financial reforms, financial stability was also gradually restored. While the establishment of the currency board arrangement contributed greatly to macroeconomic stabilization, the latter would not have been possible without deep and institutional and structural reforms that targeted the core source of financial instability, the quasi-fiscal deficit. The new draconian prudential regulations (including the treat of criminal pursuit) introduced in 1997 forced bankers to be extremely cautious in lending;[30] as a result the flow of new bad loans actually disappeared. The financial isolation program was also quite instrumental in this regard. At the same time, these stringent measures helped the banks to restore their financial health and with that public confidence in the banking system also gradually started to return. The fact that most large state-owned banks were privatized to respected international financial institutions also played an important role for the return of public confidence in the banking system.

In the course of time, financial intermediation started to revive and since 2001 there has been a surge in credit activity (table 3). In stark contrast to the situation prior to 1997, the new credit boom has not been accompanied by a deterioration in the quality of the banks' portfolios. The economy started to remonetize but the devastating effects of the financial crisis have not been overcome yet: in proportion to GDP, most monetary aggregates (deposits, commercial credit, broad money) in 2003 were still below their pre-crisis level.

Major improvements materialized in the fiscal system and this brought about a remarkable consolidation in public finances. The cyclical upturn boosted the tax base and contributed to higher budget revenue. But more importantly, the institutional changes in the tax system helped to improve considerably the efficiency of tax collection and gave further boost to public revenue collection.[31] Over the whole period after 1997 actual fiscal revenue at the end of the year systematically exceeded the budgetary projections and this has allowed the governments some additional flexibility in spending without jeopardizing the fiscal stance. The fall in interest rates contributed to a drastic reduction in interest expenditure after 1998; which also allowed the government to reduce the primary surplus to less burdensome levels (figures 3 and 4) and to increase considerably real non-interest spending. The sharp fall of public debt as a proportion of GDP occurred as a result of the combined effect of several factors: the erosion of the real value of debt denominated in domestic currency; the partial restructuring of the debt and the continuing real appreciation of the currency (figure 5) which reduced the level of the external debt as a proportion of GDP.

The fast reform progress in these years is also evidenced by the regular assessments performed by EBRD which assesses annually the progress in transition in 27 east European and CIS countries that undergo transition from plan to market on a scale of comparable

[30] The sharp disruption in the flow of credit to the corporate sector (*de facto* a credit crunch) was another factor that affected adversely manufacturing activity in this period.

[31] One of the interesting innovations of the NMSII government was the hiring of a foreign consulting firm to supervise the operations of the customs offices which were notorious for their corrupt practices. By all accounts, this has been a successful experiment which resulted in a sharp increase in customs duties.

measure (table 6). In these assessments Bulgaria moved from being one of the laggards in reforms before 1997, to one of the more advanced reformers in the period thereafter. Another sign of positive change has been the surge in the flow of inward FDI after 1997, in contrast to the anaemic inflows prior to that (table 3). Foreign investors "vote with their feet" and this change is a clear indication of the improvement in the investment climate and the business environment in general. FDI contributed to the reconstruction effort in the country and the upgrading of its fixed assets.

Unresolved issues

However, the reform outcomes have not been uniformly positive and a number of unresolved issues still remain. Thus in the immediate aftermath of the policy regime change there were also some negative macroeconomic side effects. The acceleration of enterprise restructuring (and the closure of a number of loss-making SOEs triggered a surge in unemployment which remained very high until 2003 (table 3). It took several years of strong recovery and the introduction of some active labor market policy measures in 2002 (including a public works program) for the labor market to start recovering. Notwithstanding, the labor market continues to be marred by structural problems such as skill mismatch: the majority of large pool of long-term unemployed do not have the necessary knowledge and skills demanded by the expanding firms.

On the institutional front not everything went smoothly either. An important policy lapse of the UDF government was its failure (indeed reluctance) to address the problems of corruption. This had serious negative implications both for the outcomes of some reforms and for the government itself. At the time of the changeover of power in 1997 the prevalent expectation was that the new government would undertake radical steps to eradicate the endemic corruption. However, despite its publicly declared intentions in this area, the UDF did not launch concrete policy measures to break the institutional setup that bred corrupt practices. In fact, in 1998 when its public support was at its peak, the UDF cabinet missed a window of opportunity for constitutional amendments and radical administrative reforms.

What is more, in some of its practices the new government actually was perceived as even more corrupt than its predecessors. The most conspicuous examples are related to privatization. During the UDF rule the abuse of the dysfunctional institutional arrangements in the area of commercial privatization likely reached its peak. In this period commercial privatization developed into an utterly clientelist system (in the sense of Ruis and Walle, 2003), in which the ruling elite sought to provide unjustified private benefits to its key political friends.[32] But also in other areas of public regulation (such as public procurement, business permits, etc.) the government openly favored its cronies. In addition, the governing party *de facto* also reproduced the clientelistic pattern of recruitment of civil servants and party activists in the public administration.[33]

These practices provoked a highly negative public reaction and, despite the notable success in other aspects of the reform process, this gradually eroded public support for the UDF government. As suggested by some recent analytical studies, the failure in the fight against corruption was on of the most serious causes for the UDF's election loss in 2001. For

[32] In fact, this was likely a deliberate policy of at least one part of the UDF leadership. Thus one of the UDF leader reportedly openly stated that providing private benefits to its supporters through the process of privatization was a way to thank them for their political support in bringing the party to power.

[33] Despite the widespread corruption, clientelism did not reach the scope of state capture during the UDF term in office either. One additional factor that prevented this from happening in this period was the counterbalancing effect of the EU accession negotiations. The need to approximate Bulgarian legislative and regulatory norms to those in the EU not only played a strong anchoring role in the legislative process but also to a large extent filtered out the distortive effect of various pressure groups.

example, in his analysis of the 2001 elections, Valev (2003) argues that the high and rising unemployment in the post-1997 period is not sufficient to explain the loss of political support by the ruling "reformist" party. In the event, the reformists were voted out but reforms were not reversed (and this is what happened in other transition economies as well). The author goes on to argue that internal resistance to reforms had weakened considerably post-1997; in this period reforms were already largely perceived as irreversible. In such circumstances, the solution requires further reforms rather than their stalling as a policy reversal would only lead to a deterioration of economic situation.[34] By contrast, he argues that among the reasons for the election loss were the inefficiency of the government in fighting corruption and crime, the lack of transparency in privatization, the "communication failures" of the ruling political force in selling its policies to the public as well as were some unpopular moves undertaken by the government. Thus overall the 2001 vote was not at all a vote against the reforms; quite the opposite, it was a vote against the failure of the ruling party to make progress in one important area of the needed reform effort.

The fight against corruption was one of the key catchphrases in the program of the NMSII government and some progress in this area has been made by this government. In particular, the new amendments to the Law on privatization put an end to the privatization techniques that incited corrupt practices. Also, the new government undertook concrete steps towards increasing the transparency in the working of the public administration. However, notably corrupt practices are still perceived to be widespread and are far from being eradicated.

None of the post-1997 governments has invested sufficient efforts in reforming the judiciary system and its inefficiency has remained as an important institutional weakness. The negative implications of this failure (such as the high crime rate, the weakness in contract enforcement, etc.) are still al too visible in the Bulgarian institutional landscape. Some of the factors of these disappointing outcomes are related to implementation problems (new regulations targeting change in performance have been adopted but their implementation is poor due to internal resistance in the judiciary system and pressures likely originating in groups of organized crime) or to problems in the legislative problem (e.g. it is claimed that a more comprehensive reform in the judiciary system would require a change in the Constitution but that calls for a qualified majority in parliament which is difficult to reach). Progress in the reform of the judiciary system will remain an important challenge for Bulgaria on its way towards EU membership.

6. Conclusions

The process of economic and political transformation in Bulgaria after 1989 has been featured by a series of failures in its initial phases and relatively successful reforms in later stages. As evidenced throughout this paper, the factors that contributed to the uneven course of market reforms in the country, were are complex and interrelated. The analysis of the main driving forces of the reform process in the country – including the factors that served as impediments or catalysts to the reform process – is the main research objective in the paper. By developing an analytic narrative which integrates a multidisciplinary approach we have tried to highlight the interrelations between various aspects of the reform process and their outcomes. In addition, by formulating and testing a number of hypothesis we have sought to shed further light on some of the important driving forces of the reform process.

[34] In the sense of Fernandez and Rodrik (1991), this can be interpreted as the difference between *ex ante* and *ex post* opposition to reforms: *ex ante* hostility to the reforms is not necessarily inconsistent with *ex post* support, as the opposition from losers weakens once reforms have been given a credible start.

We find convincing evidence that the specificities of the context played important, if not dominating, role in the initial phases of Bulgaria's reforms. A multiplicity of contextual factors – such as the difficult initial economic conditions, specific cultural and historic legacies, unfavourable geography, low state capacity, etc. – entailed path dependence and *de facto* acted as strong deterrents to the market reforms. These difficulties were compounded by the disintegration of some important public institutions after the collapse of the communist regime (which triggered an institutional hiatus) and other flaws in the institutional environment, which in general not conducive for market reforms. Given the inadequate formal institutions and the specific cultural and historic legacies, micro incentives for reform were rather weak and often perverse, giving rise to adverse side effects such as financial indiscipline, rent seeking, corruption.

External factors also affected the dynamics of Bulgarian reforms. Being a small peripheral country at the European outskirt, external factors had always played an important coordination function in the shaping of domestic policies. In this sense, the fall of communism (when Russia "deserted" this function) opened a coordination vacuum in Bulgaria's politics and policy. For various reasons, as discussed in the text, the EU was slow to show interest in Bulgaria's reforms and the only important external actor in this period was the IMF. However, the first IMF-supported programs did not address adequately the transition-specific economic problems in the country. In terms of their underlying paradigm (which was dominated by the spirit of the "Washington Consensus") they put too much emphasis on macroeconomics and too little on the context and the institutional environment. Besides, due to communication problems and weak state capacity, these policies did not enjoy sufficient support from the government bureaucracy and were largely mistrusted by the wide public. Due to their design flaws and the "ownership vacuum", the fund-supported reform programs undertaken in the initial phase of transition largely missed their targets and goals.

The political economy of the reform effort in the initial phase of transition was also very difficult. Because of the legacies of the past, Bulgaria was facing the combination of a complex reform agenda and a very painful adjustment effort, which would have been a major challenge for any government. Political support of the needed reforms was weak, or even absent, due to high uncertainty about the possible gains, and this became a political obstacle to their implementation. Different interest groups feared, and were unwilling to accept, a disproportionate share of the costs of reforms. The political incentives for reforms were further abated by the short average lifetime of governments which reduced their policy horizons.[35] The political system was highly polarised and ideologically biased, centered around the two main political centres: BSP and UDF. Under these conditions, many important market reforms were put on hold. In fact, as shown in the paper, such an outcome is consistent with the results of some models of policy reform based on rational choice: under similar assumptions, a number of rational choice policy reform models predict a political stalemate and delay of reforms.

One of the main reform failures in this phase was the inability of the society to establish a core agreement on a coherent reform program addressing both the adjustment effort and the core market reform agenda. The needed adjustment effort was hardly marketable to an electoral constituency as it involved highly painful and unpopular measures; besides, the society was divided as to the general direction of market reform process. In the technical sense this was equivalent to a coordination failure among stakeholders and politicians. Stakeholder groups were unstable and changed in shape and structure during the

[35] Thus, if policy makers maximize a utility function which depends on the outcomes within the duration of the actual term in office, then policies that would eventually yield benefits only in the long-term horizon but would obviously incur high costs in the short-run, have little chances to enter the policy agenda.

course of reforms. Political polarization pushed the reform agenda in different directions. The absence of a strong external anchor – one that could implement the coordination function – also contributed to this coordination failure. The general outcome was a stop-and-go reform course, with frequent change in policy direction and revisions in previously adopted measures.

As argued in the paper, it is the multitude of these intertwined factors and developments that undermined Bulgaria's first reform efforts. In a complex and wide-ranging reform effort, all its aspects (from context, to institutions, to design, to political constraints, to implementation) have their role. Bulgaria's experience confirms that disregarding or that underestimating the importance of any of these components alone can drive a reform effort to a failure. The country's experience in this period also helps to understand better why policies that worked in other transition economies turned out to be unsuccessful (or non-starters) in Bulgaria: a different context and/or country-specific structural and institutional characteristics led to completely different country outcomes of a reform program of the same or similar design.

One of the intriguing twists in Bulgaria's transition has been the radical turnaround in policy and economic performance after the 1996-1997 crisis. We provide evidence in the paper that this major change in the course of reforms (which *ex post* turned out to be successful) was triggered by two concurrent developments: 1) the window of opportunity opened by the crisis itself and 2) the change in the external environment, at first the more efficient assistance by the IMF and later, the supportive role of the EU. At the same time, the second reform effort could be sustained and developed further thanks to important changes in the context and institutional environment which made them more conducive to market reforms. Some of these changes were gradual but in the course of time the supportive contextual and institutional aspects gradually started to outnumber and outweigh those features that hampered the reform process.

We show in the paper that the background and the framework of the successful reforms in Bulgaria were no less complex than those of the previous failed reform efforts, involving multifaceted interactions of various stakeholders and actors. The motivation of the second reform effort, as well as its initial agenda, were largely determined by the effect of Bulgaria's deep transition crisis. We show that – consistent with the results of policy reform models based on rational choice – the crisis did indeed stage the conditions for the implementation of delayed necessary but painful reforms. Thus in the case of Bulgaria it was only when inflation was threatening to get out of control completely, that a political solution on the stabilization course was agreed upon among the political forces. Moreover, in the course of time, the tacit political agreement on one key reform area (stabilization) gradually expanded to other important aspects of the reform agenda. It fact it reflected an emerging broad agreement among major stakeholders on the general direction of the reform process.

The core of the 1997 reform program was a complete overhaul of the macroeconomic order: the combination of a currency board and balanced fiscal policy were intended to do away with the irresponsible policy practices of the past. The actual launching of the reforms was designed to signal a complete regime change: the start of operation of the currency board coincided with the start of the new government's term in office. However, what made the stabilization effort sustainable was the fact that policy addressed from the very start some transition-related specificities of the context and the institutional environment that bred financial instability such as improper regulatory norms, malfunctioning of important public institutions, distorted incentives in banks and firms. Through the successful implementation of corrective measures targeting these problematic areas it became possible to arrest the quasi-fiscal deficit, the main source of financial and macroeconomic instability.

Fast success in macroeconomic stabilization allowed the government to refocus its main attention towards important institutional and systemic reforms such as privatization, public finance, pension system, health care. Success in financial and macroeconomic stabilization and a notable improvement in macroeconomic performance contributed to a growing credibility of the government reform effort and in this sense the sequencing of reforms was another ingredient of their overall success. In turn, fast progress in these areas of reform allowed Bulgaria to make up to a great extent for the significant delays incurred in the first phase of transition.

The role of external stakeholders – in particular, the IMF and the EU – for the turnaround in the course of Bulgarian reforms cannot be overstated. The IMF was the first to give impetus to the new reform effort. The Fund itself had learned from its own past mistakes, as well as from the experience of other countries, and by 1997 had introduced important changes in its approach to market reforms in economies in transition from plan to market. This new approach (in fact applied in Bulgaria after 1997) put much greater emphasis on the context and institutional environment. Both the political will of the reformist government and better communication with the IMF helped to resolve the problem of "ownership" regarding the new reform program.

At the same time, the role of the EU was increasing and gradually it became the dominant external anchor of the reform process through the mechanisms of accession negotiations. The preparation for accession to the EU in fact defined a broad reform agenda with clearly defined goals and means. The prospects of membership in this prestigious club of developed nations also established strong and clear incentives to the politicians involved in this process. Bulgaria's experience confirms what had also surfaced in the experience of the more advanced central European countries, namely that the realistic prospect of EU membership was the single most important driver and catalyst of the reform process in these countries, providing a powerful impetus for the acceleration of their market reforms. With the reorientation to a new dominant external power (from Russia to the EU and NATO), the process of "switching" of this peripheral area of the European continent (a changeover that had started with the fall of communism) was complete.

Bulgaria's experience is also insightful as regards the relations between reform agenda and reform outcomes and in particular, about the importance of the feedback from outcomes to the formulation of the reform agenda. In a number of episodes, this experience suggests endogeneity of the ongoing policy process and its political constraints/degrees of freedom. In other words, subsequent policy decisions on the course of reform very much depend on previous policy and its outcomes as well as on the changing attitude of the populace. The endogeneity of the policy process is partly responsible for the emergence of circles (both vicious and virtuous) which affected the speed of Bulgarian reforms (acting as deterrents or catalysts, respectively) and their outcomes (amplifying their negative, respectively, positive results). Thus in the initial phase of transition the dismal outcomes of partial reforms served to put breaks on the reform process. By contrast, the success in the first reforms initiated after 1997 boosted the government's credibility and contributed to the acceleration of the reform process. These outcomes emphasize the importance of a careful monitoring of the outcomes of the ongoing reforms and even of preventive corrections in case of major deviations between goals and expectations and actual outcomes.

Overall, as evidenced in this paper, Bulgaria's experience in economic and political transformation is one of failure and success. This rich and sometimes painful experience can provide important lessons to policy makers in other countries that face the need to introduce far reaching fundamental economic reforms. One of the more general lessons – equally relevant for success or failure – concerns the complexity of the reform process: market reforms are a multifaceted and multidimensional process and those who initiate in cannot afford to underestimate any of its aspects.

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Appendix 1

Milestones of Bulgaria's Reforms: 1990-2004

1. Reform of the political system

- Removal of Communist leader Todor Zhivkov from power (November 1989).
- Roundtable with the participation of the incumbent ruling Communist party and the emerging new political forces (1990). Outcome: decision to hold elections for a Grand National Assembly.
- Adoption of a new Constitution (1991). Establishing a pluralistic democracy and a market economy based on private property; separation of the legislative, executive and judicial systems.
- Establishment of a Constitutional Court and independent judiciary (1992).

2. General elections, presidential elections and governments in office

- Election for a Grand National Assembly (1990): BSP 47%; UDF 36%. BSP government, A. Lukanov (1990); Broad coalition government (1990-1991): D Popov.
- Presidential elections (1991): Zhelyu Zhelev (UDF)
- General election (1991): UDF 34%; BSP 33%;. UDF Government, F.Dimitrov (1991-1992); "Expert" government, D.Berov (1992-1994).
- General elections (1994): BSP 44%; UDF 24%. BSP government, Zh. Videnov (1995-1996); Caretaker government, S. Sofianski (1997).
- Presidential elections (1996): Petar Stoyanov (UDF)
- Early general elections (1997): UDF 49%; BSP 22%. UDF Government, I.Kostov (1997-2001).
- General elections (2001): NMSII 43%; UDF 18%; BSP 17%. NMSII government, S. Saxe Coburg-Gotha (2001-…).
- Presidential elections (2001): Georgi Parvanov (BSP)

3. Ownership transformation

- Commercial Law (company code) (1991). Set the rules of establishing new companies allowing the market entry of *de novo* private firms.
- Law on Foreign Investment (1991) allowing the market entry of foreign firms.
- Restitution laws (1991, 1992, 1997 and 1998). Regulate the restitution of various types of property (real estate, agricultural land, industrial property) confiscated during communism to their previous owners or their heirs.
- Law on privatization (1991-1992, subsequently revised more than 30 times). Regulates the change of ownership in SOEs
- Establishment of a Privatization Agency (1991).
- Establishment of the National Land Council (1992), dealing with land restitution.
- Establishment of Foreign Investment Agency (1995) with the mission to encourage assist foreign direct investment.
- Law on mass privatization (1995). Established a procedure of privatizing SOEs through a voucher scheme.
- Mass privatization: two waves (1996 and 1999) covering some 1600 SOEs.
- Establishment of privatization (investment) funds (1995-1996).

- Establishment of an Agency for Small and Medium-Sized Enterprises (1997) with the goal to promote the development of de novo private firms.
- Privatization of state-owned banks: all such banks were privatized between 1999 and 2003.
- Privatization in telecommunications and other utilities (2003-…).

4. Reforms of the financial system

- Law on the Bulgarian National Bank (1991). Established a two-tier banking system based an independent central bank.
- Law on Banks and Credit Activity (1992). Regulation of the activity of commercial banks.
- Establishment of the Bank Consolidation Company (1992) with the mission to privatize state-owned banks.
- Counterproductive financial bailouts of unviable SOEs and state-owned commercial banks (1991-1996).
- Financial Isolation Program (1996-1999). Restructuring and rehabilitation (or liquidation) of large SOEs
- Rehabilitation of the banking system (1996-1997). Liquidation of 15 bankrupt banks.
- Amendments to the Law on the Bulgarian National Bank (1997). Establishment of a currency board.
- Amendments to the Law on Banks and Credit Activity (1997). Significant tightening of prudential banking regulations.
- Establishment of the Bulgarian Stock Exchange in Sofia (1997).

5. Trade liberalization

- Removal of the state monopoly over foreign trade (1990)
- Gradual lifting of non-tariff barriers to trade and reform of the tariff system (main steps undertaken in 1991 and 1992)
- Free trade agreement with the EU (as part of the association agreement) (1993)
- Free trade agreement with EFTA (1993)
- Accession to WTO (1996)
- Accession to the Central European Free Trade Agreement (CEFTA) (1999)

6. European integration

- EU Association Agreement/Europe Agreement (1993)
- Decision to start EU accession negotiations (1999)
- Start of accession negotiations (2000) (27 out of 30 negotiation "chapters" closed by mid-2004; negotiations expected to be over by end-2004)
- Expected accession to the EU (2007)

7. Major institutional reforms (increasingly related to EU accession)

- Labor market reforms: New Labor code (1992); Social Protection Programs (1991-…; numerous amendments).
- Tax reforms: VAT introduction (1993); reform in corporate and personal income taxation (1993);

- Separation of the Social Security Fund from the central government budget (1995)
- Protection of competition: first Law on the Protection of Competition (1991): limited scope; second Law on the Protection of Competition (1998): norms similar to those of the EU; Establishment of a Commission for the Protection of Competition (1999).
- Reform of public finances: reforms in revenue administration and in expenditure management (1999-2003).
- Pension Reform based on the establishment of a three-pillar pension system (started in 1999 with the establishment of the National Insurance Institute); establishment of private pension funds (2000-…)
- Health Care Reform (started in 1999 with the establishment of the Health Insurance Fund) with the goal of establishing a financially self-reliant health care system.
- Reform in Public Administration (1998-…): reorganization of the public administration in line with EU principles and norms.

Appendix 2

The Institutional Framework of Privatization in Bulgaria

The process of privatization – in the sense of ownership transfer relating to existing SOEs (we do not deal with the privatization of agricultural land, housing and other more specific assets) was undertaken in the context of a rather complex (often confusing for foreign investors) organizational scheme. In particular, there were numerous public bodies and institutions that were empowered to implement privatization deals.

A clear division must be made between the two main strands in Bulgarian privatization: the so called "commercial" privatization where the ownership transfer took the form of a sale and the mass privatization in which selected groups of SOEs were auctioned to the population against freely distributed privatization vouchers.

Historically it was commercial privatization that started first. The major public body entrusted with a privatization mandate is the specially established in 1992 Privatization Agency (which is still in existence). Its main function is to organize and implement the sale of large and medium-sized SOEs (categorized in the Privatization Law by the book value of their total assets). The Agency itself has a rather complex managerial structure: apart from its operational office that was in charge of arranging the deals, there is a Supervisory Council (whose members are nominated by the Parliament) which is mandated to oversee the operation of the Agency and would give the final approval of the largest deals. The declared purpose of this dual structure was to ensure greater transparency in the workings of the Privatization Agency and reduce the scope of corruption. However, in practice transparency was never featured prominently in the operation of the Privatization Agency, especially in this initial period (e.g. none of its sub-bodies made public the motivation of the decisions taken), and the public tended to be rather suspicious of the incidence of corrupt practices.

Apart from the Agency, numerous other public bodies were assigned with the task of selling small SOEs. In fact, it was decide to apply a sectoral approach and each line ministry was authorized to sell the small state-owned firms that operated within its functional domain (e.g. industry, trade, tourism, construction, transport, communication, etc.). All in all, during different sub-periods, more that 10 line ministries were involved in the privatization of small SOEs). By 2004 most of the small SOEs have been privatized or liquidated. In addition to that, given the historical legacies, a number of SOEs were directly reporting to their respective municipal councils (especially in retail trade, repair shops and other communal services such as public transportation). In turn, all municipal councils were authorized with the privatization of all SOEs under their control regardless of size. While in mast cases these were mostly small firms, in the capital Sofia and other big cities, the amount of assets privatized by the municipal councils was quite substantial.

In both these areas of privatization, the Law stipulates the use of the same techniques as those applied by the Privatization agency. Notably, transparency was even a greater problem in the case of small and municipal privatization (in the latter case, actually the problem still exists).

The process of mass privatization was implemented by another specially established body, the Agency of Mass Privatization. Its main function was to organize a series of public auctions during which big groups of SOEs (selected by the Parliament) were offered for public sale. The main difference from the commercial privatization was that the only legal tender accepted in these auctions were the privatization vouchers, freely distributed to all adult citizens. Apart from direct participation, people could also participate in the auction by investing their vouchers in the newly established privatization funds. All in all three main waves of mass privatization were organized between 1995 and 1999, and covered around three thousand SOEs. By 2000 this process was over and the Agency of Mass Privatization wound down its activity. Overall, the process of mass privatization was quite transparent and there has not been widespread perception of corruption.

Table 1. The two periods of Bulgaria's transition

	Reform failure 1991-1997	Reform success 1998-2003
Real GDP growth, average annual rate, %	-5.1	4.1
Real GDP per capita growth, average annual rate, %	-3.9	5.2
Real investment growth, average annual rate, %	-11.0	19.1
Growth of total employment, average annual rate, %	-3.8	-0.3
Growth of industrial labor productivity, average annual rate, %	-1.0	4.5
Consumer prices inflation, average annual rate, %	233.1	7.9
Growth of average real wages, average annual rate, %	-11.4	6.1
Average share of food expenditure in household budget expenditure, %	47[1/]	42[2/]
BNB basic interest rate, %	99.6	4.2
Average short-term commercial lending interest, %	130.4	11.8
Commercial rate on (one-month) time deposits, %	71.8	3.1
Consolidated government balance (-deficit), % of GDP (period average)	-6.3	-0.4
Total public debt, % of GDP (period average)	139.8	70.4
FDI annual flow, % of GDP (period average)	1.3	5.6
Share of private sector in GDP, % (period average)	46[1/]	69
IMF funding agreements brought to a successful end (number)	0 (out of 4)	3 (out of 3)
Average term in office of governments (years)	<1	4 (as law)

[1/] 1995-1997; [2/] 1998-2002; [3/] 1994-1997
Source: Authors' calculations on the basis of national statistics

Table 2. Bulgaria's funding agreements with the IMF, 1991-2004

Facility	Date of arrangement	Date of expiration or cancellation	Amount agreed, SDR mn	Concluded successfully (yes/no)
Funding agreements with subsequent disbursements subject to IMF conditionality				
Standby Arrangement	Mar 15, 1991	Mar 14, 1992	279.0	no
Standby Arrangement	Apr 17, 1992	Apr 16, 1993	155.0	no
Standby Arrangement	Apr 11, 1994	Mar 31, 1995	139.5	no
Standby Arrangement	Jul 19, 1996	Apr 11, 1997	400.0	no
Standby Arrangement	Apr 11, 1997	Jun 10, 1998	371.9	yes
Extended Fund Facility	Sep 25, 1998	Sep 24, 2001	627.6	yes
Standby Arrangement	Feb 27, 2002	Mar 15, 2004	240.0	yes
Precautionary Agreement	Aug 6, 2004	Sept. 2006	100.0	
Other funding agreements				
Contingency and Compensatory Facility	Feb 25, 1991		60.6	
Systemic Transformation Facility	Apr 14, 1994		116.2	
Contingency and Compensatory Facility	Apr 11, 1997		107.6	

Source: IMF (2004); Minassian, 2001.

Table 3. Bulgaria: selected macroeconomic indicators, 1990-2003

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Population and GDP														
Total population, end-year level, ths. pers.	8669	8595	8485	8460	8427	8385	8341	8283	8230	8191	8149	7891	7845	7800
Real GDP (1989=100)	90.9	80.3	74.4	73.3	74.6	76.7	69.5	65.6	68.3	69.8	73.6	76.6	80.3	83.8
Real GDP/capita (1989=100)	91.7	81.7	76.7	75.8	77.4	80.1	72.9	69.3	72.6	74.6	79.0	85.0	89.6	94.0
GDP/capita (USD at current exchange rate)	1163	945	1015	1278	1150	1564	1190	1251	1548	1582	1546	1723	1984	2546
GDP/capita (USD at current PPPs)	5170	4740	4660	4800	5020	5380	5020	5920	6270	6540	7090	7680	8330	9039
Real economy (average annual rates of change, %, unless otherwise noted)														
Gross domestic product	-9.1	-11.7	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.8	4.3
Gross fixed capital formation	-18.5	-19.9	-7.3	-17.5	1.1	16.1	-21.2	-20.9	35.2	20.8	15.4	19.9	9.3	13.8
Gross industrial output	-16.8	-22.2	-18.4	-9.8	10.6	4.5	5.1	-18.4	-8.5	-8.0	8.3	1.6	6.5	8.3
Total employment	-6.1	-13.0	-8.1	-1.6	0.6	1.3	0.1	-3.9	-0.2	-2.6	-3.0	-0.4	0.8	3.5
Rate of unemployment 1/	1.7	11.1	15.2	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9	17.3	16.3	13.5
Employment in industry	-9.0	-17.9	-13.2	-8.3	-3.7	-2.2	-1.9	-3.6	-3.9	-9.3	-5.7	-1.4	0.1	2.8
Labor productivity in industry	-8.5	-5.2	-3.1	-2.8	12.6	7.4	7.1	-15.3	-4.1	1.4	14.7	3.0	0.5	11.2
Prices and wages (average annual rates of change, %)														
Consumer prices	23.8	338.5	91.2	72.8	96.0	62.1	121.6	1058	18.7	2.6	10.3	7.4	5.8	2.4
Producer prices in industry	14.7	296.5	56.1	28.3	75.7	53.4	130.0	971.1	18.7	2.8	17.5	3.8	1.2	3.4
GDP deflator	..	..	59.6	51.1	72.7	62.8	122.6	971.2	26.7	3.7	6.7	6.7	3.8	2.1
Average annual wages, nominal	31.5	165.8	113.5	57.8	53.5	53.2	83.8	865.6	43.3	9.7	11.7	7.2	13.0	3.7
Average annual wages, real (CPI deflated)	6.2	-39.4	11.7	-8.7	-21.7	-5.5	-17.0	-16.6	20.7	6.9	1.2	-0.2	6.7	1.3
Monetary aggregates (year on year rates of change, %) 2/														
Money supply (M1)	24.0	24.2	40.7	27.3	55.5	43.6	119.3	868.0	23.4	8.7	21.2	28.4	18.8	22.7
Money supply (broad money)	16.1	118.0	52.5	53.1	78.6	39.6	124.5	359.3	10.1	11.4	26.4	24.8	21.0	18.9
Time deposits (domestic currency)	..	513.8	129.7	86.6	50.0	54.9	27.6	146.8	-2.3	19.1	3.9	32.0	80.7	7.8
Domestic value of foreign currency deposits	..	582.0	-4.6	16.2	193.9	17.1	300.0	304.6	-3.0	10.5	48.2	22.9	7.5	17.5
Credit to the corporate sector	..	112.5	33.6	32.8	31.5	30.8	227.9	183.0	-1.2	9.5	1.0	16.4	24.7	37.0
Nominal interest rates (%) 3/														
BNB basic interest rate	4.5	56.5	58.2	58.1	81.8	59.8	245.8	137.1	5.4	4.7	4.0	4.6	4.1	2.7
Short-term commercial lending interest	..	67.8	74.0	78.3	102.6	79.8	300.2	209.9	14.2	13.6	12.2	11.7	10.0	9.2
Commercial rate on (one-month) time deposits	..	59.2	55.6	52.0	65.1	43.6	146.4	80.8	3.0	3.3	3.1	3.2	2.8	3.1
External variables (mn USD)														
Gross foreign debt (endperiod)	10007	12247	13806	13836	11338	10148	9602	9760	10252	10204	10364	10616	11245	13032
Forex reserves excluding gold (endperiod)	..	331	935	655	1002	1236	484	2249	2831	3083	3342	3290	4407	6291
Merchandise exports	5266	3279	3922	3721	3985	5355	4890	4940	4297	4006	4825	5107	5692	7439
Merchandise imports	5482	2647	4468	4757	4185	5658	5074	4932	5031	5515	6507	7240	7903	10742
Trade balance (-deficit)	-216	632	-546	-1036	-199	-303	-184	8	-734	-1509	-1683	-2134	-2211	-3303
Current account balance (-deficit)	-1152	-77	-360	-1098	-32	-198	164	1046	-61	-652	-702	-885	-677	-1648
FDI annual flow (mn USD) (BOP statistics)	4	56	42	40	105	90	109	505	537	819	1002	689	458	1361
FDI cumulative stock (mn USD)	4	60	101	141	247	337	446	951	1488	2307	3309	3998	4456	5817
Exchange rate														
Nominal exch. rate, ann. average (BGN/USD)	0.005	0.017	0.023	0.028	0.054	0.067	0.178	1.682	1.760	1.836	2.123	2.185	2.077	1.733
Nominal exch. rate, ann. average (BGN/EUR)	0.001	0.021	0.030	0.032	0.065	0.087	0.220	1.896	1.972	1.956	1.956	1.956	1.956	1.956
Nominal effective exch. rate, rate of change, %	..	30.0	275.5	44.7	16.1	99.7	29.6	159.3	802.1	4.5	2.3	7.4	1.3	..
Selected ratios (% of GDP)														
Monetization (M1)	..	15.5	14.0	13.1	10.9	9.3	7.4	7.2	10.0	10.5	11.5	13.1	14.6	16.6
Monetization (broad money)	..	60.8	67.5	65.1	63.0	56.9	44.1	23.0	25.7	27.3	30.3	33.5	38.1	43.5
Monetization (time deposits)	..	..	22.7	29.2	26.2	25.9	15.9	3.3	3.6	3.5	3.7	3.7	6.2	6.8
Monetization (foreign currency deposits)	..	22.4	21.5	14.1	18.7	15.4	16.0	12.5	10.6	10.3	12.1	14.0	15.4	15.9
Monetization (corporate credit)	..	67.6	68.5	64.0	50.2	35.5	34.5	16.3	13.9	13.8	13.5	12.5	13.2	17.4
Trade balance (-deficit)	-2.1	7.8	-6.3	-9.6	-2.1	-2.3	-1.9	0.1	-5.8	-11.6	-13.4	-15.7	-14.2	-16.6
Current account balance (-deficit)	-11.4	-0.9	-4.2	-10.2	-0.3	-1.5	1.6	10.1	-0.5	-5.0	-5.6	-6.5	-4.4	-8.3
Consolidated government balance (-deficit)	-4.9	-3.6	-5.2	-10.8	-5.8	-5.6	-10.4	-2.4	1.0	-0.9	-1.0	-0.9	-0.7	-0.1
Total public debt	..	..	161.4	156.0	159.5	107.9	149.9	104.0	83.1	77.7	80.0	68.8	59.6	53.3
FDI annual flow	0.0	0.7	0.5	0.4	1.1	0.7	1.1	4.9	4.2	6.3	8.0	5.1	2.9	6.9
FDI cumulative stock	0.0	0.7	1.2	1.3	2.5	2.6	4.5	9.2	11.7	17.8	26.3	29.4	28.6	29.3

1/ Endperiod ratio (%), registered unemployed only; 2/ December over December; 3/ Average annual compound rates
Source: National Statistical Institute; Bulgarian National Bank; author's own calculations.

Table 4. The privatization process in Bulgaria: commercial sales[1/] of firms and parts thereof, 1993-2004

	Privatization deals			Privatization revenue and other financial effects (mn USD)			
	New deals	Continuing deals [2/]	Total	Cash payment	Debt commitments	Investment commitments	Total
1993	63	0	63	44.2	28.0	59.0	131.2
1994	161	26	187	144.3	88.6	201.7	434.5
1995	318	35	353	113.7	68.2	151.9	333.8
1996	513	71	584	187.0	231.8	179.3	598.1
1997	584	184	768	571.4	36.2	890.9	1498.5
1998	1086	225	1311	567.3	44.5	369.5	981.3
1999	1211	474	1685	654.2	498.8	1373.1	2526.0
2000	590	736	1326	395.9	44.8	144.2	584.9
2001	231	496	727	175.5	3.0	34.7	213.2
2002	103	92	195	162.7	35.4	44.9	243.1
2003	118	229	347	267.0	1.3	13.8	282.2
2004 [3/]	165	1039	1204	413.8	89.1	509.4	1012.3

[1/] The data in the table do not include information on firms privatized through the mass privatization scheme or firms privatized by the municipal councils.
[2/] Sales of minority stakes in already privatized firms.
[3/] As of end-August 2004.

Source: Bulgarian Privatization Agency.

Table 5. The privatization of the Bulgarian corporate sector: breakdown of firms' total sales by ownership categories, 1995-2001

	1995	1996	1997	1998	1999	2000	2001
Total economy, of which	100.0	100.0	100.0	100.0	100.0	100.0	100.0
SOEs	73.1	67.1	52.8	30.3	26.9	22.3	20.3
Domestically controlled private firms (incl. privatized) with 20 or more employees	10.1	10.5	23.9	32.5	30.6	31.6	34.5
Domestically controlled de novo private firms with less than 20 employees	15.2	17.6	16.1	26.4	25.8	26.2	27.0
Foreign controlled firms	1.6	4.8	7.3	10.8	16.6	19.9	18.1
Total manufacturing, of which	100.0	100.0	100.0	100.0	100.0	100.0	100.0
SOEs	87.7	83.8	58.3	33.5	18.3	10.8	8.4
Domestically controlled private firms (incl. privatized) with 20 or more employees	6.8	8.5	31.6	46.6	47.3	46.7	59.6
Domestically controlled de novo private firms with less than 20 employees	3.6	4.5	3.6	6.3	6.1	6.1	9.1
Foreign controlled private firms with less than 20 employees	1.8	3.3	6.5	13.5	28.3	36.4	22.9

Note: The coverage in 2001 is different from previous years.
Source: National Statistical Institute; authors' own calculations.

Table 6. Bulgaria's progress in systemic and structural reforms: EBRD indicators, 1994-2003

		Enterprises			***Markets and trade***			***Financial institutions***		***Legal reform***	***Infra-structure***		
	Private sector share of GDP, %	Large-scale privatisation	Small-scale privatisation	Governance and restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial	Effectiveness of legal rules on investment	Infrastructure reform	**Progress in transition: average score**	Memo item: best performing country
1994	40	2	2	2	3	4	n.a.	2	n.a.	n.a.	n.a.	2.50	3.50
1995	45	2	3	2	3	4	2	2	2	3	n.a.	2.56	3.29
1996	45	2	3	2	2	4	2	2	2	4	n.a.	2.56	3.29
1997	50	3	3	2.33	3	4	2	2.67	2	n.a.	n.a.	2.75	3.67
1998	50	3	3	2.33	3	4	2	2.67	2	n.a.	n.a.	2.75	3.71
1999	60	3	3.33	2.33	3	4.33	2	2.67	2	n.a.	n.a.	2.83	3.71
2000	70	3.67	3.67	2.33	3	4.33	2.33	3	2	n.a.	n.a.	3.04	3.75
2001	70	3.67	3.67	2.33	3	4.33	2.33	3.33	2.33	n.a.	2.75	3.08	3.75
2002	70	3.67	3.67	2.33	3	4.33	2.33	3.33	2.33	n.a.	2.67	3.07	3.75
2003	75	3.67	3.67	2.67	3	4.33	2.33	3.33	2.33	n.a.	2.67	3.11	3.75

Note: minimum score = 1; maximum score = 4; 4.33 = transition over.
Source: EBRD Transition Report, various issues.

Figure 1. Indices of aggregate output and gross fixed investment (1989=100), 1989-2003

Figure 2. Employment and unemployment, 1989-2003

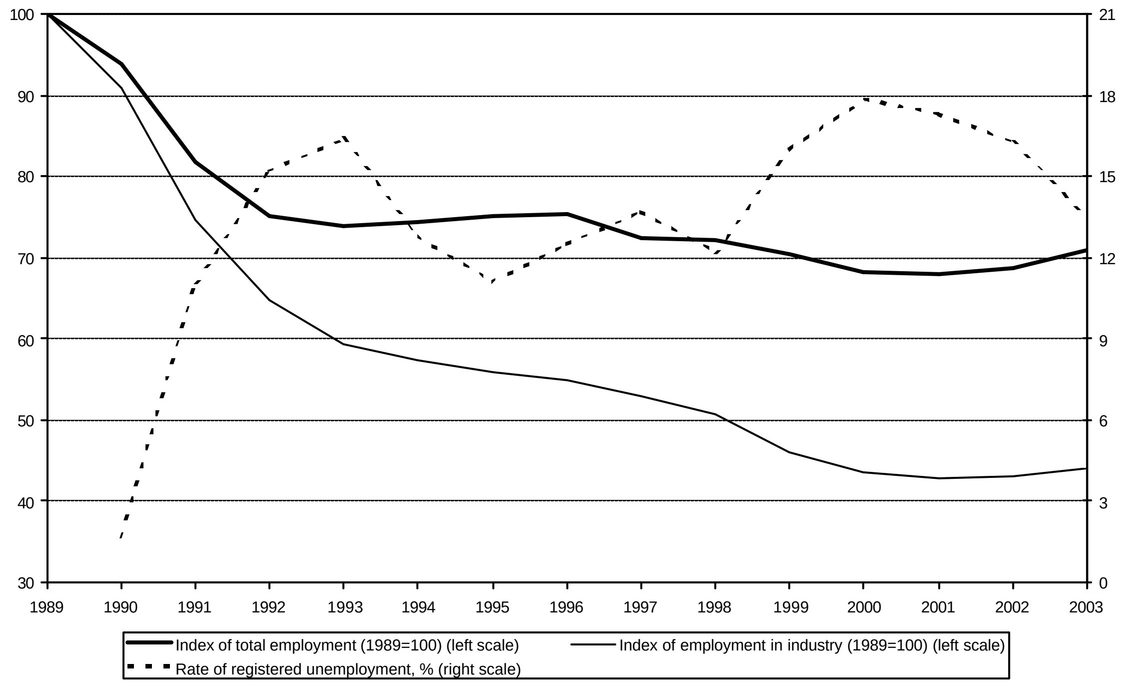

Figure 3. Consolidated general government balance: total revenue, non-interest and interest expenditure (% of GDP), 1992-2003

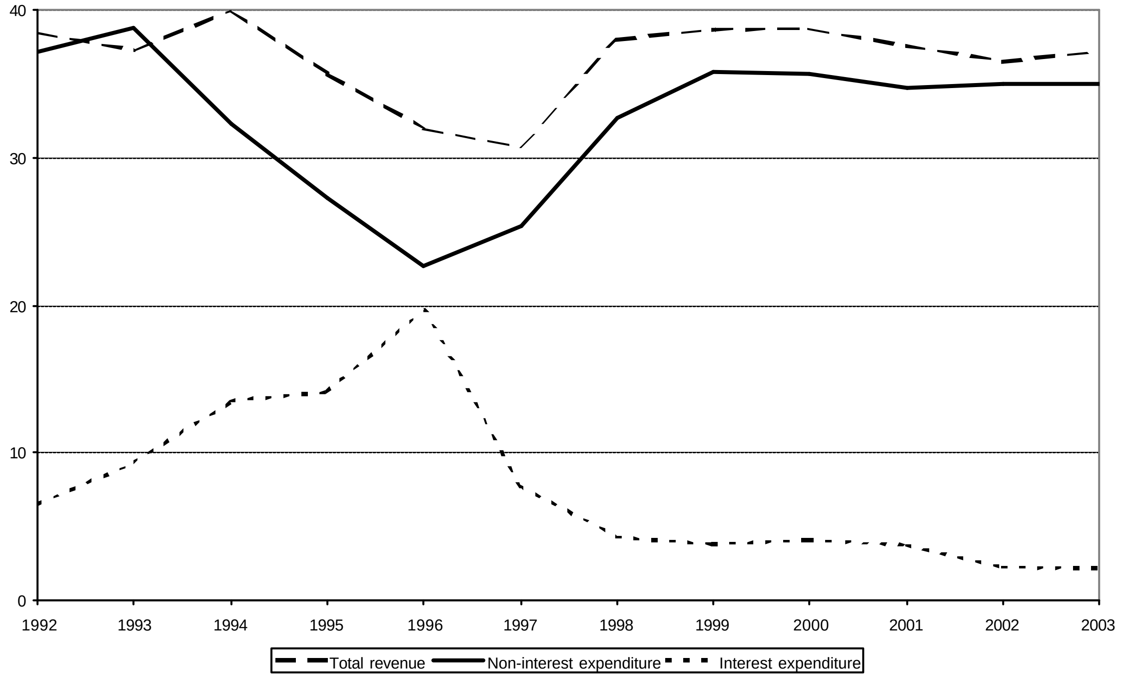

Figure 4. Consolidated general government balance: primary and overall balance (% of GDP), 1992-2003

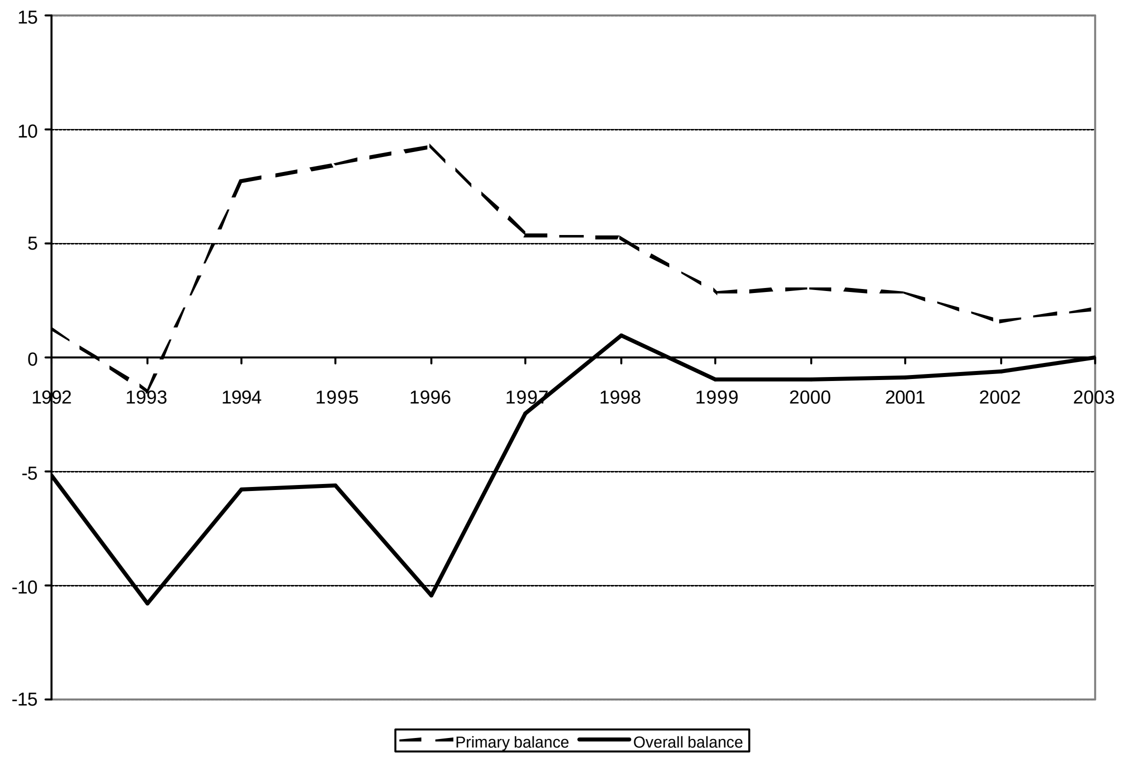

Figure 5. Indices of the real exchange rate (1989=100), 1989-2002