

# The competitiveness of the Bulgarian economy

## The performance ratings

It is widely accepted by experts and analysts that there is a positive relationship between progress in market reform and the level of competitiveness of central and eastern European (CEE) countries in transition. In general, this vision is also confirmed by the results of comprehensive research efforts, which can be found in some recent publications: *The Global Competitiveness Report 2000* of the World Economic Forum<sup>1</sup>; *Benchmarking Competitiveness in Transition Economies*<sup>2</sup> of the Harvard Institute for International Development; and *Transition Report 2000*<sup>3</sup> of the European Bank for Reconstruction and Development.

The first two are focused on competitiveness, but the third sheds light on the progress of market reforms in transition countries. In Table 1 are included only those transition countries for which there is data available in the three publications.

**Table 1 – Reform efforts and competitiveness ranking**

	Hungary	Czech Republic	Poland	Slovakia	Bulgaria
Rank according to <i>Benchmarking Competitiveness in Transition Economies</i>	1	2	3	8	10
Rank according to the <i>Global Competitiveness Report 2000</i>	26 (+12)	32 (+7)	35 (+8)	39 (+6)	58 (- 2)
Transition Report					
a) Aggregate transition indicator	3.75	3.52	3.47	3.32	3.0
b) overtaking index (%)	100	93.87	92.5	88.53	80.0

*Benchmarking Competitiveness in Transition Economies* includes the results of a comparison of the competitiveness of 25 transition countries, while the *Global Competitiveness Report 2000* analyses and compares the 'current competitiveness index' of 59 of them. For instance, Hungary was ranked 38 in the *Global Competitiveness Report 1999* and 26 in the 2000 edition.

- 1 World Economic Forum: *The Global Competitiveness Report 2000*, New York: Oxford University Press.
- 2 Jeffrey Sachs, Clifford Zinnes and Yair Eilat (2000): *Benchmarking Competitiveness in Transition Economies*, Harvard Institute for International Development, January.
- 3 European Bank for Reconstruction and Development (2000): *Transition Report 2000*.

The EBRD's *Transition Report 2000*<sup>4</sup> presents the values of eight component transition indicators (see Table 4 for full details). These range from 1 to 4+, where 4+ indicates that the country's characteristics are comparable to those prevailing on average in advanced economies, and 1 represents the sort of conditions prior to reform in centrally planned economies with dominant state ownership of the means of production. The transition indicators are then linearised by assigning a value of  $+1/3$  to a positive sign and  $-1/3$  to a negative one. The aggregate transition indicator for each country is derived as a simple average of the eight component indicators. The 'overtaking index' is calculated by dividing the aggregate indicator of each country by the aggregate indicator of the country in the leading position (Hungary) and then multiplying by 100.

A two-faceted general conclusion may be drawn from the data in the Table:

- a. independently of differences in the methodology used in the two publications on competitiveness, they have produced the same results in terms of countries' ranks – Hungary occupies the leading position and Bulgaria is at the bottom. (Of course, one should bear in mind that the empirical data reflect the situation as at 1999. Therefore, the positive trend in the development of the Bulgarian economy in 2000 has not been taken into consideration)
- b. the ranking of countries according to the aggregate indicator of *Transition Report 2000*, which shows their progress in market reform, coincides with the ranking in terms of competitiveness.

However, it seems embarrassing, as well as difficult to perceive, how the 20 percentage points measuring the rate of protraction of the Bulgarian market reform process are translated into such a tremendous difference in the performance of Hungary and Bulgaria in terms of competitiveness.

On the other hand, the velocity of the reform in Slovakia and Bulgaria is almost equal but the resulting changes in competitiveness are in the opposite direction – Slovakia has overtaken six countries in one year (a good result) while Bulgaria's rank has fallen to the bottom. These signify that the relationship between the velocity of market reform and the resulting gains in competitiveness is not as simple as it looks at first glance. The over-simplification of the problem proceeds mainly from the widely-accepted practice in analysing the transition process and assessing its results in the context of a 'market-fundamentalist' approach,<sup>5</sup> instead of basing it on the theory of competitiveness.<sup>6</sup>

4 *ibid.*, p. 14.

5 For more details about „the 'market-fundamentalist' approach see: IMF: *World Economic Outlook, October 2000*, p. 92.

6 In the context of our discussion, Porter raises the following argument: 'In developing countries, if reform efforts continue to concentrate largely on IMF-style macroeconomic adjustments, we will face a continued succession of disappointments. Only by tackling the specific constraints to productivity and the numerous policies that blunt local rivalry will developing countries achieve sustainable improvements in prosperity. With global capital markets, countries can engineer spurts of growth through macroeconomic and financial reforms that bring floods of capital and that cause the illusion of progress as construction cranes dot the skyline.' (World Economic Forum: *The Global Competitiveness Report 2000*, p. 41.)

## Transition and competitiveness theory

The following analysis will mainly rely on the theoretical approach of Michael Porter, as developed in his famous book *The Competitive Advantage of Nations*.<sup>7</sup>

Porter's theory could be very helpful in understanding and investigating some important aspects of the transition to the market economy. Its most important aspect is the interpretation of transition as a process in which a less efficient economic system (the centrally-planned economy) is transformed into a more efficient one (the market economy). Both theoretically and empirically, it has been proved that the latter is capable of a much more efficient allocation and utilisation of available resources, leading to a higher level of prosperity of nations. As Porter states, this could be achieved through a specific mechanism – the operation of four basic determinants of national competitive advantage:

- a. factor conditions
- b. firm strategy, structure and rivalry
- c. demand conditions
- d. related and supporting industries.

Together, these represent the so-called 'diamond of competitive advantage'.<sup>8</sup>

Porter points out that the effect of one determinant is contingent on the state of the others. For instance, favourable demand conditions will not lead to competitive advantage unless there is a state of rivalry which is sufficient to cause firms to respond to them. Advantages in one determinant can also create or upgrade advantages in others.

It is further important for this analysis to take into consideration Porter's concept of the four successive stages of the competitive development of nations:

- a. factor-driven
- b. investment-driven
- c. innovation-driven
- d. wealth driven.<sup>9</sup>

Each one of the stages can be associated with one of the determinants relating to the specific performance of the diamond.

On the basis of Porter's theoretical approach, an important conclusion may be drawn which helps understand the essence of the transition process: from a theoretical point of view, the transition from the centrally-planned to the market economy should be understood as a process in which the conditions are created for upgrading the competitiveness of the economies of the former socialist countries.<sup>10</sup> This may be realised by means of a comprehensive implementation of the 'diamond of competitive advantage' in the economy. The operation of the diamond will make it possible fully to re-

7 M. Porter (1990): *The Competitive Advantage of Nations*, NY: Free Press.

8 *ibid.*, p. 71.

alise the potential for raising the competitiveness which exists within the factor-driven stage of development and to create the conditions to push the economy to the higher – investment-driven – stage.

- 9 The *factor-driven stage* is considered to be the initial stage in the competitive development of the national economy. It is characterised by virtually all internationally-successful industries in the nation drawing their advantage almost solely from the basic factors of production: natural resources; favourable growing conditions for certain crops; and an abundant and inexpensive semi-skilled labour pool. As regards the diamond, factor conditions alone provide the advantage. This source of competitive advantage limits sharply the range of industries and industry segments in which the nation's firms can successfully compete internationally. A nation's indigenous firms in such an economy compete solely on the basis of price in industries that require either little product or process technology, or else technology that is inexpensive and widely available. Technology is sourced largely from other nations and is not created. In the *investment-driven stage*, national competitive advantage is drawn from two determinants – factor conditions; and firm strategy, structure and rivalry. A nation's firms might still retain advantages in basic factor costs, but competitive advantage widens to include low-cost but more advanced factors (for example, university-trained engineers) and the presence of well-functioning mechanisms for factor creation, such as educational institutions and research institutes. The investment-driven stage, as its name indicates, is one where ability and willingness to invest is the principal advantage, rather than the ability to offer unique products or to produce using unique processes. At this stage, firms still compete in the relatively standardised, price-sensitive segments of the market and product designs often reflect the needs of foreign markets. Domestic demand at this stage is largely unsophisticated because the standard of living is modest, though improving, and because there exists only a narrow and still-emerging base of sophisticated industrial firms. In some industries, domestic demand for exported goods may be all but absent. A nation upgrades competitive advantage at this stage more from supply-push factors than demand-pull ones. During the *innovation-driven stage*, all the determinants are at work in a wide range of industries and their interactions are at their strongest. Consumer demand becomes increasingly sophisticated because of rising personal incomes, higher levels of education, an increasing desire for convenience and the invigorating role of domestic rivalry. The growing competitive strength of the nation's firms in a range of industries also leads to the emergence at home of sophisticated industrial customers. New entrants feed vibrant domestic rivalry in many industries, accelerating improvement and innovation. World-class supporting industries develop in the important clusters and new competitive industries emerge out of related industries. Competitive advantage as a result of factor costs becomes more and more rare, as growing success in many industries puts upward pressure on factor costs and the value of the currency. The sophistication of established universities, research facilities and infrastructure continues to grow, while new mechanisms emerge to create advanced and specialised factors, and upgrade them continually. This stage is called innovation-driven because firms not only appropriate and improve technology and methods from other nations, but also create them. The *wealth-driven stage* is, in contrast, one that ultimately leads to decline. The driving force in a wealth-driven economy is the wealth that has already been achieved. The problem is that an economy driven by past wealth is not able to maintain it. This is because, most importantly, the motivations of investors, managers and individuals shift in ways that undermine sustained investment and innovation, and hence their upgrading. In the wealth-driven stage, firms begin to lose competitive advantage in international markets. (See: Porter, *ibid.*, p. 545–560.)

### **Competitiveness-oriented reform strategy (CORS)**

According to Porter's theory, during the factor- and investment-driven stages of development, nations upgrade their competitive advantage 'more from supply-push than demand-pull' factors.<sup>11</sup> This is because the first and the second determinants of the 'diamond' make the greatest contribution to the strengthening of competitiveness through positive supply changes in the economy. On the other hand, the successful activation of the 'diamond' is only possible if aggregate demand is supportive enough for positive supply changes, or at least that there are no continuous or strongly negative changes in either external or internal demand.

An important conclusion may be drawn from this theory. The successful implementation of a competitiveness-oriented reform strategy (CORS) depends on a combination of internal and external factors:

- a. the reform package should be concentrated on the creation of a business environment which increases and strengthens competition between enterprises in the product and resource markets
- b. the reform package should not contain in itself measures that could provoke a fall in real incomes, which would induce negative changes in internal demand
- c. the external environment should also be supportive – i.e. there should be no threat at the start of the reform of a negative external demand shock on the country.

These conditions should be considered as the preconditions which must necessarily exist for the implementation of a CORS approach to become possible. They also determine the way in which the three basic pillars of market reform – market institution building; deregulation and liberalisation; and privatisation – should be combined and used in the transition process.

In the specific context of competitiveness theory, the basic goal of a reform strategy is to substitute the soft constraints leading to the inefficient allocation and utilisation of national resources, inherited from a centrally-planned economy, with hard constraints. In this way, a strongly-competitive business environment would emerge in the national economy, inducing positive supply-side changes.

This means that, of the three pillars, priority must be given to the institutional pillar because it is the main instrument through which the redistribution mechanism of a centrally-planned economy could be eliminated and a competitive national economy created.

10 Porter points out that centrally-planned economies 'Lack many of the most important elements of the „diamond“. There are few mechanisms for creating specialized factors. Restrictions on buyer choice remove sophisticated demand pressure. The lack of competition eliminates most interchange with related and supporting industries. Lack of motivation and the restricted flow of information blunt upgrading. Most importantly, effective domestic rivalry is absent. Centrally-planned economies will almost be relegated to competing on price competition and in standardized segments. National advantage will almost exclusively be factor-driven. Exceptions will be those special circumstances where some of the forces in the „diamond“ are allowed to work.' (ibid., p. 676.)

11 ibid., p. 550.

In the next section, we will discuss why an imbalance in reform strategy, where priority is given to price and trade liberalisation, negatively affects the competitiveness of the national economy. A similarly negative effect on competitiveness may be expected if priority is given to privatisation:

Although private ownership activates profit motives, private ownership is not sufficient to make firms efficient – complementary conditions are required to make privatization lead to effective restructuring. Privatization risks producing perverse results in the absence of hard budget constraints and competition. When privatized firms continue to receive subsidies, especially implicit support in the form of soft credit and tax arrears, they tend to focus their efforts on rent seeking rather than on restructuring.<sup>12</sup>

### **Redistribution-biased reform strategy (RBRS)**

The next question to be answered is: what would happen – from the point of view of competitiveness theory – if, at the very beginning of the reform, a negative shock occurs regarding internal demand?

The answer is simple – it would not be possible to implement a CORS approach. In such a case, the transition from a centrally-planned to a market economy – contrary to initial expectations – would not lead to any gains in competitiveness and may even cause competitive disadvantages to appear, together with a collapse in real output growth. The transition experience of CEE countries provides evidence that such a thing could happen. Most of the national reform strategies were designed in compliance with IMF conditionality, so they included the ‘big bang’ approach as an emanation of the ‘market-fundamentalist’ concept. This meant that, at the initial stage of the reform, priority was given to the simultaneous liberalisation of prices and trade. The predictions of competitiveness theory for the consequences of such a reform strategy are very illuminating.

Firstly, at the beginning of the reform, market institutions had not yet been created and the redistribution mechanism inherited from the centrally-planned economy was still operating through soft constraints, leading to inefficient resource allocation and utilisation. Privatisation too had not yet started and the number of agents on the supply-side of national markets was small. But it is not only the absence of market institutions and the small number of suppliers that matters. ‘Big bang’ means the simultaneous liberalisation of trade and prices, and it is well-known that, over a very short period of time, supply is perfectly inelastic and can produce no positive change in the economy. For all of the three reasons outlined above, the inflationary shock of a ‘big bang’ approach to the liberalisation of prices and trade is inevitable because no positive supply-side change is possible that could anchor the price level.

Secondly, inflationary shock causes a simultaneous collapse in real incomes, followed by a negative shock on internal demand. Demand conditions strongly deteriorate because buyers immediately change their preferences – from high quality to low quality (inferior) goods reflecting a negative income elasticity of demand. Enterprises are forced to give up the production of sophisticated commodities and to deteriorate the

12 IMF, op. cit., p. 105.

quality of their products in order to diminish prices. The final result is that the potential competitive advantages that they might have had – according to world standards – are turned into competitive disadvantages.

Thirdly, the collapse in real incomes induces strong disapproval of the reform itself. Social tension builds up and, in order to ease it, the political elite in charge of the reform is forced to keep inefficient and loss-making enterprises functioning (especially the large ones), in order to prevent a further collapse in real incomes through rising unemployment. In this way, social consensus is reached to postpone institutional reform via the preservation of the soft constraints which lead to inefficient resource allocation and utilisation – i.e. exactly the redistribution mechanism inherited from the centrally-planned economy.

The reform strategy that has just been teased out in this purely theoretical context will be termed a ‘redistribution-biased reform strategy’ (RBRS).

In the context of competitiveness theory, an RBRS approach creates a business environment which enforces barriers against the activation of the ‘diamond of competitive advantage’, leading to a deterioration in the national factor endowment and thus transforming the potential competitive advantages which may have been inherited from a centrally-planned economy into disadvantages. In a broader historical context, such a disappointing performance of the national economy may be termed ‘dedevelopment’.

A negative shock on external demand at the early stage of reform is the other reason which could make impossible the implementation of a CORS approach, thus forcing the transition country to adopt one based on an RBRS. Here again, the experience of CEE countries provides some historical evidence.

**Table 2 – Economic indices of selected CEE countries**

CEE country	Trade with CMEA countries as a share of GDP, 1990 (%)	Index of real GDP in 2000, (1989 = 100)
Bulgaria	16.1	74.1
Czech Republic	6.0	97.7
Hungary	13.7	104.5
Poland	8.4	126.8
Romania	3.7	77.0
Slovak Republic	6.0	102.7
Estonia	30.2	84.1
Latvia	36.7	64.1
Lithuania	40.9	65.3

Source: IMF (2000), op. cit. p. 115; *Economic Survey of Europe 2001*, No 1, p. 254

In Table 2 are represented six transition countries which were members of the Council for Mutual Economic Assistance (CMEA) – Bulgaria, the Czech Republic, Slovakia, Hungary, Poland and Romania – and three which were part of the former USSR – Estonia, Latvia and Lithuania. Reciprocal trade and economic co-operation have had a strong impact on national development in the region, which is evident from the Table – especially for Bulgaria, the Baltic States and, to a certain extent, Hungary. In fact, most of the large enterprises in these countries were specialist exporters to the regional market and, mainly, to the vast market of the former USSR. According to regional standards, these enterprises were considered to be efficient producers, able to exploit economies of scale – proof of which being that they managed to sell part of their products on the world market. Even so, the main driving force behind their development was exports to the former USSR. Therefore, if measured by world standards, their competitive advantages would have been either very weak or non-existent, owing not only to the lack of competition between suppliers but also the soft quality constraints and the specific technical standards and preferences which characterised demand conditions in the former USSR.

The ‘weak or non-existent competitive advantages’ of the large enterprises, specialised as they were in export terms, caused great risks for the beginning of the market reforms. The reason for this is that the elimination of the preferential regime of reciprocal trade, followed by the fast introduction of high tariff and non-tariff barriers, created an enormous trade diversion effect. In this situation the ‘weak or non-existent competitive advantages’ of large enterprises emerged as a constraint on trade-diversion. Hence, the more the country was specialised in exporting to the regional market, the stronger the trade-diversion constraint. The only way to solve this problem was to rely on an intensive and timely inflow of FDI as a source of the finance, technology, marketing and managerial skills needed to upgrade and strengthen competitive advantage in order to overcome the trade-diversion constraint.

Countries which, for some reason, could not attract sufficient FDI at the beginning of the market reforms would not be able to overcome the trade-diversion constraint, resulting in a simultaneous loss in export markets, i.e. a severe external demand shock.

However, a national economy affected by an external demand shock at the beginning of market reforms is compelled to adopt an RBRIS-type approach, whose main characteristic is delays in the building of market institutions.

Firstly, if hard constraints against inefficiency were enforced, this would mean large enterprises being closed down as they would have become loss-makers. This would lead immediately to a steep rise in unemployment and a substantial fall in real incomes. The same situation would then emerge as that already discussed in relation to the ‘big bang’ approach to price and trade liberalisation, although what is different here is the accent on large enterprises. Facing a low or non-existent inflow of the FDI necessary to strengthen their competitiveness, a government has no other choice but to support the continued vitality of such enterprises through the redistribution mechanism and its soft constraints regarding inefficient allocation and the utilisation of resources. This causes delays in large-scale privatisation. And, even if it is carried out at an early stage of the reform process, the results are very disappointing in the context of competitiveness.



It is clear from the above analysis that, in an extreme case, unfavourable initial conditions may be there from the very start of the reform process. That is, when reform starts in a situation of negative shocks for both internal and external demand, thus forcing the transition country to implement an austere version of an RBR. Again, this would produce very disappointing results in terms of the competitiveness of the national economy.

### **Macroeconomic performance in the transition period**

The macroeconomic performance of Bulgaria (Table 3) during the first seven years of transition has been marked by severe recession. Real GDP decreased by more than 30% compared to 1989. Two major collapses occurred – one in the beginning and another in 1996-97 – divided by a subtle recovery in 1994-95. The second period (1998-2000) is characterised by three successive years of real output growth.

The analysis that follows will focus first on macroeconomic performance in 1990-97, because this period is clearly associated with decreasing competitiveness within the national economy. The reason for this is the adoption of an austere version of a redistribution-biased reform strategy, implemented in consequence of negative shocks on both external and internal demand.

The negative external demand shock is evident – goods exports in 1991 diminished by 48.4% compared to 1990. The situation was also aggravated by the chronic deficit in the balance of trade in goods. This was the result of the break-up of CMEA and the increase in the price of energy imports from the former USSR. Due to the lack of inflows of FDI, successful trade diversion was not possible. Bulgaria also suffered from the conflict in the former Yugoslavia and the loss of markets in Iraq and Libya.

The principle of the asymmetric liberalisation of trade regimes, applied as part of the Association Agreement between Bulgaria and the European Union, has proved to be insufficient as an instrument for spurring Bulgarian exports to the EU, mainly concerning as it does trade in goods in which the EU has a strong competitive advantage. At the same time, those sectors in which Bulgaria seems to have a potential advantage belong to the group of so-called 'sensitive goods', and these are strongly protected in the EU by non-tariff barriers.

The negative internal demand shock was induced as a result of the so-called 'shock therapy', designed in line with IMF conditions and based on a 'market-fundamentalist' approach. It was launched on 1 February 1991 via a spontaneous liberalisation of prices in a situation in which privatisation and institutional reforms were either developing very slowly or had not yet even been started. Thus, the first major collapse in real incomes and wealth occurred.

The second major collapse in real incomes and wealth – and hence the second negative shock on internal demand – occurred as a consequence of the financial destabilisation of the economy which started in May 1996 and which culminated in hyperinflation in January and February 1997. In fact (see Table 3), real average monthly wages fell by 63% compared to their level in 1990. However, it is important to bear in mind that real GDP was also only 70% of its 1990 level and that, consequently, during the period as a whole, real incomes were diminishing faster than real GDP. The conclusion follows that changes in real incomes were not the cause of inflation – on the contrary, they served as a real anchor to the price level and, eventually, to the floating exchange rate which was applied before the adoption of the currency board arrangement in July 1997.

Another consequence of the extreme fall in real incomes is the drop in the savings and investment ratios, as consumption is much less elastic to changes in income than either savings or investment.<sup>13</sup>

The recession was accompanied by major contractions in employment and investment. During 1990-92, employment in the economy as a whole fell by about 25% – and in industry by over 35%. In the same period, real investment, at both the aggregate and the industry levels, declined by more than one-half. As a result, Bulgaria has not been able to diversify its exports beyond labour-intensive products and energy- and resource-intensive commodities.

In contrast to the poor performance of the Bulgarian economy arising from the adoption of an RBRS-type approach, the initial conditions in Hungary (Table 3, Memorandum items) were favourable to the implementation of a competitiveness-oriented reform strategy:

- large FDI inflows were available at the very beginning of the reform, which fostered successful trade-diversion and trade creation through the strengthening of competitive advantage. There was a fall in exports only in 1992, followed by very dynamic growth
- price levels have been relatively stable, an indication of favourable domestic demand conditions.

In 1996, the investment ratio in Bulgaria fell to its lowest level of 8.4% of GDP while, in Hungary, it reached a level of 26.8% with the savings ratio attaining 25.2.<sup>14</sup> This means that, while the Bulgarian economy was in the middle of an austere financial crisis, countries like Hungary, and also Poland, were in the process of a gradual transition to the investment-driven stage of competitive development. There was an upturn in the investment and savings ratios around the mid-1990s in both countries, corresponding to recovery and the growth of output:

In both of them, the recovery in gross domestic investment has been stronger than in gross domestic savings, indicating that they have attracted foreign savings to support the rapid growth of domestic investment. In contrast, domestic savings ratios, after recovering somewhat, have stopped growing (in Hungary) or declined (in Poland), suggesting a relative shift in the preferences towards present consumption.<sup>15</sup>

13 See: *Economic Survey of Europe, 2001*, No. 1, p. 175.

14 op. cit., p. 173.

15 op. cit., p. 175.

Table 3 – Macroeconomic indicators, 1989-2000

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP growth (%)	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	4.0
Real GDP (indices, 1989 = 100)	100	90.9	83.3	77.2	76.1	77.5	79.7	71.6	66.6	68.9	70.6	74.1
Consumer prices (annual average % change over preceding year)	6.4	23.8	338.5	91.3	72.9	96.2	62.1	123.1	1082.6	22.2	0.4	10.0
Real average monthly wage (Bulgarian levs)		378.0	230.8	260.2	263.2	216.0	202.0	159.9	140.2	152.7	163.3	175.3
Change in real wage over preceding year (%)			-38.9	12.8	1.1	-17.9	-7.5	-20.7	-12.3	8.9	6.9	7.3
Unemployment rate				15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9
Merchandise exports (\$bn)	6.651	5.232	3.433	3.992	3.769	3.935	5.345	4.890	4.940	4.194	4.006	4.808
Annual change (%)		-21.3	-34.4	16.28	-5.6	4.4	35.8	-8.5	1.0	-15.1	-4.5	20.0
Balance of trade in goods (\$bn)	-0.67	-0.35	0.73	-538	-1.35	-0.34	-0.29	-0.18	-0.01	-0.76	-1.51	-1.68
Inflows of foreign direct investment (\$m)		4	56	42	40	105	90	109	505	537	819	975
Gross domestic investment (% of GDP)						9.4	15.7	8.4	11.4	16.9	19.0	
Gross domestic savings (% of GDP)							14.6	7.8	15.0	16.4	13.7	
<b>Memorandum Items – Hungary</b>												
Real GDP (1989 = 100)	100.0	96.5	85.0	82.4	81.9	84.4	85.6	86.8	90.7	95.1	99.3	104.5
Consumer prices		28.9	35.0	23.0	22.6	19.1	28.5	23.6	18.4	14.2	10.1	9.9
Merchandise exports (\$bn)	9.673	9.731	10.226	10.681	8.921	10.701	12.867	18.704	19.100	23.005	25.015	28.092
Inflows of FDI (\$m)		311	1459	1471	2339	1146	4453	2275	2173	2036	1970	1957

Source: European Bank for Reconstruction and Development (2000): *Transition Report 2000*, p. 148-149; p. 172-173; *Economic Survey of Europe, 2001*, No. 1, p. 254-269; National Statistical Institute (2001): *Statistical Reference Book 2001*, Sofia, p. 57.

Actually, this is a sign of the activation in these countries of one more basic determinant in the 'diamond of competitive advantage' – the level of sophistication of internal demand. On the contrary, as a result of falling real incomes, domestic demand in Bulgaria during the same period was concentrated predominantly on goods with negative income elasticity, i.e. – inferior, low quality goods.

A comparison of the macroeconomic performance of Bulgaria and Hungary indicates that the type of reform strategy adopted at the beginning of transition has a very strong impact on the competitiveness of the national economy. It may either increase, as was the case in Hungary, ranked first among those central and eastern European countries included in *The Global Competitiveness Report 2000*, or decrease, as in the case of Bulgaria, which is ranked at the bottom. This implies that, in the next section, a comparative analysis needs to be made of the RBRS approach in Bulgaria and the CORS approach in Hungary. An important question is to identify whether the real GDP growth in Bulgaria in 1998-2000 is an indicator that a transformation from a re-distribution-biased strategy into a competitiveness-oriented one has started.

### **The comparison**

The aggregate transition indicator for Hungary (Table 4) shows a smooth positive trend of progress in market reform for the whole of the 1991-2000 period. On the other hand, the evolution of market reform in Bulgaria is characterised contrarily by rising values of the aggregate indicator in 1991-1995, with the value then remaining constant for two successive years before starting to increase again in 1997-2000. The overtaking index, which compares the velocity of the progress of reform in the two countries, shows a different trend: very unstable development in 1991-1994; a significant fall in 1995/6; and a stable increase in 1997-2000. These trends signify that our analysis should focus on the evolution of reform during the following periods:

- 1991-1997, when the differences between the RBRS and the CORS approaches in the two countries appear to be most pronounced
- 1997, as a turning point in the trend
- 1998-2000, as a period when a transformation of the RBRS approach into one based on a CORS is likely to have started in Bulgaria.

Table 4 – EBRD transition indicators for Bulgaria

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
<b>1. Privatisation and restructuring (simple average)</b>	1.0	1.23	1.57	2.0	2.33	2.33	2.77	2.77	2.77	3.23
<b>Overtaking index (%)</b>	59.9	52.8	52.3	61.9	64.7	63.5	73.5	71.6	71.6	83.5
Large-scale privatisation	1.0	1.7	2.0	2.0	2.0	2.0	3.0	3.0	3.0	3.7
Small-scale privatisation	1.0	1.0	1.7	2.0	3.0	3.0	3.0	3.0	3.0	3.7
Governance & enterprise restructuring	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
<b>2. Market liberalisation &amp; competition (average)</b>	2.67	2.67	2.67	3.0	2.67	2.67	3.1	3.1	3.2	3.2
<b>Overtaking index (%)</b>	89.0	89.0	89.0	87.5	77.8	77.8	87.8	87.8	90.6	90.6
Price liberalisation	3.0	3.0	3.0	3.0	2.0	2.0	3.0	3.0	3.0	3.0
Trade & foreign exchange system	3.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3
Competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
<b>3. Financial markets reform (average)</b>	1.0	1.35	1.5	1.5	2.0	2.0	2.35	2.35	2.35	2.5
<b>Overtaking index (%)</b>	50.0	67.5	60.0	60.0	66.7	66.7	64.4	64.4	64.4	64.9
Banking reform & interest rate liberalisation	1.0	1.7	2.0	2.0	2.0	2.0	2.7	2.7	2.7	3.0
Securities markets & non-bank financial institutions	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>4. Bulgaria – Aggregate transition indicator</b>	1.55	1.75	1.91	2.17	2.33	2.33	2.62	2.74	2.77	2.98
<b>5. Hungary – Aggregate transition indicator</b>	2.22	2.44	2.83	3.05	3.34	3.37	3.65	3.68	3.68	3.75
Overtaking index (%)	69.8	71.7	67.5	71.1	69.8	69.1	71.8	74.4	75.3	79.5

Source: Calculations of the author using data from: EBRD (2000): *Transition Report 2000*, p. 148-149; p. 172-173.

Explanation: Table 4 presents the values of eight component transition indicators included in *Transition Report 2000*. They range from 1 to 4+, where 4+ indicates that the country's characteristics are comparable to those prevailing on average in advanced economies and 1 represents conditions before reform in a centrally planned economy with dominant state ownership of the means of production (see earlier text).

## The first stage (1991-1996)

The overtaking index in 1996 was 69.1%, a value smaller than the 1991 figure (69.8%) and four years past the peak, reached in 1992. This means that the velocity of the reform in Bulgaria was low, causing a considerable lagging behind the performance of Hungary.

The more detailed overtaking indices within the spheres of liberalisation, privatisation and reform of the financial sector display a specific feature of the RBRS in Bulgaria – the liberalisation of prices has assumed priority while market institution building and privatisation have developed very slowly:

- a. The overtaking index for market liberalisation and competition has the highest value (89.0%) for 1991-1993 amongst the three indices quoted, but this subsequently falls to only 77.8% and remains constant over the next two years (1995-1996). It is important to notice that these changes were caused by variations in the sub-indicators of price liberalisation (which fell during 1995 and 1996) and of the trade and foreign exchange system (which saw a significant increase in 1994 with no change in subsequent years). Hence, the negative impact of the RBRS-type approach on the business environment was manifested in the sub-indicator of competition policy measuring no progress. Its value remained at 2.0 for the whole period, providing indirect evidence that soft constraints on inefficient resource allocation and utilisation were preserved; in contrast, the situation in Hungary improved considerably in 1994. This implies that Bulgaria lagged behind Hungary in the effort to create a competitive environment which would help the activation of the 'diamond of competitive advantage'
- b. The overtaking index in privatisation and restructuring is very unstable – it fell in 1991-1993, then started growing again in 1994-1995 before falling again in 1996 to 63.5%. This is due mainly to the value of the indicator of large-scale privatisation for Bulgaria reaching 2.0 in 1993 (the same level as had been reached in Hungary in 1991) and then remaining constant, without any positive change until 1996. This, of course, shows the considerable difficulties faced by the Bulgarian economy arising from the negative external demand shock and the low inflow of FDI. It is also important to note that the sub-indicator of governance and enterprise restructuring reached a value of 2.0 only in 1994 (corresponding to the situation in Hungary in 1991) and made no further progress until 1996. This is further evidence of the retarded state of institutional reform in Bulgaria
- c. the above conclusion is confirmed by evidence on the development of the financial sector. The sub-indicator of banking reform reached a value of 2.0 in 1993 and also made no further progress until 1996, this again being a level which corresponded to the situation reached in Hungary in 1991. This is further evidence of the preservation of the soft constraints against the efficient allocation of financial resources. These then became a barrier against positive supply-side changes in the economy and were the main reason for the financial crisis in 1996-1997
- d. the combination of slow progress in institutional reform and in large-scale privatisation created a business environment hostile to the emergence and activity of small and medium enterprises. These have vital importance in the activation of the 'diamond of competitive advantage'. This negative trend was strengthened by the delay in small-scale privatisation. In 1996, this indicator had a value of 3.0 for Bulgaria, corresponding to the situation in Hungary in 1993.

### **The turning point (1997)**

The empirical evidence shows a turning point in these trends in 1997. The aggregate overtaking index increased its value from 69.1% in 1996 to 71.8% in 1997 as a result of the following factors:

- a. there was an increase of ten percentage points in the value of the overtaking index in privatisation and restructuring. This was caused by an acceleration of large-scale privatisation while small-scale privatisation continued to stagnate
- b. the value of the overtaking index in market liberalisation and competition also increased by ten percentage points and reflected the increase in price liberalisation and the slight improvement in the competition policy indicator
- c. the overtaking index in the reform of financial markets decreased compared to 1996 due to the great progress achieved by Hungary both in the banking and the non-banking institutional sector, while in Bulgaria the latter remained very undeveloped, comparing only to the level of Hungary in 1991.

The positive developments in the Bulgarian economy in 1997 were caused to a considerable extent by the adoption of the currency board arrangement on 1 July 1997. In general terms, a CBA seems to create favourable conditions for the transformation of an RBRS-style approach into one based on a CORS. However, its role should not be overestimated. As a matter of fact, a CBA may induce both positive and negative impacts on economic growth in the long-run. It is designed mainly to guarantee the financial stability of the national economy and not to stimulate its growth.

A currency board arrangement may induce positive supply-side changes mainly as a result of the following factors:

- a. financial stabilisation and low inflation rates improve the expectations of both foreign and domestic private investors and may stimulate economic growth
- b. the introduction of a fixed exchange rate eliminates exchange-rate risk for foreign investors and thus stimulates the inflow of foreign direct investment
- c. a combination of a fixed exchange rate and interest rates above the level of the reserve currency country create the basis for profitable arbitrage operations which could enhance the inflow of foreign portfolio investment.

On the other hand, a CBA may cause negative demand changes largely for the following reasons:

- a. it will induce restrictions as regards the prevailing philosophy of economic and social policy, thus causing stagnation in internal demand
- b. when the rates of inflation in the country remain higher than those in the country of the reserve currency, then a real appreciation of the national currency occurs, diminishing the price competitiveness of national enterprises. This stimulates imports and discourages export activities, leading to a deterioration in the trade balance and a negative change in external demand. It is clear that, in this respect, a CBA may become an obstacle to the efforts to increase competitiveness at the resource-driven stage of development.

### **Recent performance (1998-2000)**

Some indicators have emerged signifying that a gradual transformation of the RBRS-style approach into one based on a CORS has started in Bulgaria. For instance, the aggregate overtaking index has increased by almost five percentage points per year, attaining a value in 2000 of 79.5%.

In the last three years, the improvement has been predominantly caused by progress in privatisation and in restructuring (an increase in the overtaking index here by 10 percentage points in 2000 compared to 1997). The driving force has mainly been the acceleration in 2000 of large-scale and small-scale privatisation (following the stagnation in 1998 and 1999). However, the disturbing fact is that no improvement has been reached in governance and enterprise restructuring – the present situation in Bulgaria corresponds to the conditions in Hungary in 1991/1992. This is a serious impediment to the activation of the ‘diamond of competitive advantage’.

Significant progress has been achieved in the sphere of market liberalisation and competition where, in 2000, the overtaking index has almost reached the level of Hungary (90.6%). This is mainly due to the liberalisation of the trade and foreign exchange system (100%); with no progress being reached in competition policy.

Disappointingly, no progress has been made in the financial sector of the economy. By 2000, the development of banking reform and interest rate liberalisation had only got as far as the level of Hungary in 1993 and, in the sector of the securities market and non-banking financial institutions, the situation in Bulgaria had stagnated at the level reached in Hungary in 1991.<sup>16</sup>

The general conclusion from the analysis is that there are positive indications of a gradual transformation of an RBRS approach into a CORS one as a result of the acceleration of privatisation and liberalisation, but the process is being significantly hindered by the slow progress in market institution building. This conclusion is also confirmed by the results of two other comprehensive studies on competitiveness which also identify that the competitive disadvantages of Bulgaria are concentrated mainly in the institutional sphere and can be further adduced from other spheres of the national economy (see box).

The macroeconomic performance in 1998-2000 does, however, provide additional evidence that the transformation of the RBRS approach into a CORS one has started (see Table 3):

- a. the most important indication is the acceleration of inflows of FDI – by 52.5% in 1999 and by 19.0% in 2000. The cumulative inflow of FDI per capita for the period 1989-1999 is \$284 – only 16.1% of the level in Hungary (\$1,764). But in 1998, the FDI inflow per capita in Bulgaria was 45.0% of the level in Hungary, and in 2000 it was 61.7%<sup>17</sup>
- b. the rates of real GDP growth have been positive for three successive years and the forecasts for 2001 are also optimistic
- c. real incomes are rising, thus creating favourable conditions for increasing domestic savings and investment, which may result in further positive supply-side changes.

Hence, the successful transformation of RBRS into CORS depends to the utmost degree on fast and comprehensive institutional reform. This is a great challenge for the nation as a whole because the lack of sufficient progress in this sphere so far has allowed the redistribution mechanism to reach the final stage of its sophistication – i.e. state capture. At this stage, it already emerges in the form of a redistribution-biased governmental

16 This conclusion is confirmed in the *Global Competitiveness Report 2000*: ‘Hong Kong, Singapore and the United States are places where it is very easy to start a new business. Russia and Bulgaria are virtually at the bottom of the list in ease of start-ups.’ (World Economic Forum, op. cit., p. 35.)

17 Economic Survey of Europe 2001, No. 1, p. 269.



policy, founded on soft judicial constraints as regards the corrupt and rent-seeking behaviour within public administration. Hence, the solution to this problem is to be found not in the economic but in the political sphere of social relations.

### **Competitive advantages and disadvantages of the Bulgarian economy**

According to the *Global Competitiveness Report 2000*, the competitive advantages of the Bulgarian economy are observed in the following main spheres according to the criteria used:

- a. openness: exchange rate alignment (14)
- b. sophistication of company operations and strategy: product design (27); technology development (30); international brands (31); import fees (36); public-funded schools (33); corporate activity (32)
- c. government: competence of public officials (6); government savings (11); fiscal surplus/deficit (12); corporate income tax rate (12)
- d. infrastructure: railroad indicator (25)
- e. technology: tertiary education (25); maths and science education (26)
- f. labour: unemployment insurance (6); employment rules (8); wage setting (14)

The competitive disadvantages and rankings of the Bulgarian economy are defined as follows:

- a. innovation: intellectual property protection (54); technology sophistication (55)
- b. start-ups: venture capital (53); loan availability (57); starting a new business (59)
- c. openness: average tariff rate (52); export promotion (52)
- d. finance: national savings rate (56); access to external finance (57); investment rates (58); stock market (58); sophistication of financial markets (59)
- e. sophistication of company operations and strategy: production process (58); marketing (58); approach to human resources (57)
- f. quality of the business environment: telephone service (57); availability of information (56); cellular telephone usage (56)
- g. government: protection of property rights (50); tax system encouraging investment (51); median income tax rate (56); payroll tax rate (57)
- h. infrastructure: road quality (54); e-mail usage (55); air transport efficiency (57); e-commerce (58); telephone service (58)
- i. technology: necessity of research by firms (50); licensing (54); brain drain (59)
- j. labour: unemployment rate (49); quality of health care (53); management/worker relations (54)
- k. institutions: organised crime (53); litigation against government (54); lawsuits (56); use of the courts (57).

According to the comparative analysis in *Benchmarking Competitiveness in Transition Economies*, Bulgaria is ranked 10<sup>th</sup> among 25 central and east European transition countries in competitiveness and, according to the values of the sub-indicators, its competitive advantages are identified in: infrastructure (6); technology (9); and institutions (9). The competitive disadvantages are observed in the following spheres: management and labour (17); financial sector (16); good government (13).

Source: World Economic Forum, op. cit., p. 116-117; Sachs, Zinnes and Eilat, op. cit., p. 27.

## Expectations

In the parliamentary elections of 2001, the Bulgarian electorate passed a vote of confidence in favour of a competitiveness-oriented reform strategy by voting against the party coalitions which had consecutively carried out the redistribution-biased reform strategy but which had disguised it with either left-wing or right-wing pre-election declarations. However, in addition to this, there are some other reasons to expect successful future developments.

Firstly, with the onset of the negotiations for membership of the European Union, the EU itself has become the central external factor influencing the development of the Bulgarian economy. In this way, the transition process is gradually becoming transformed into a process of accession to the EU. Hence, the medium and long-term objective is to meet the Copenhagen criteria for membership, the philosophy of which is oriented towards competitiveness and growth.

Furthermore, according to these criteria it is obligatory to establish modern market institutions capable of functioning in line with institutions in EU countries. In short, this is a guarantee of the proper balancing of the three pillars of market reform under which priority is given to the institutional pillar. Thus, under the pressure of an EU monitoring regime, a major obstacle to the adoption of a CORS-style approach is about to be eliminated.

Secondly, one more opportunity seems to be emerging which is likely to accelerate the adoption of a CORS-type approach and to heighten the competitiveness of the Bulgarian economy in the future. This concerns the Balkans and the prospects for political stabilisation and the economic reconstruction of the region. There are positive indications that the 'market-fundamentalist' type of conditionality which prevailed in the financial and technical support programmes of the IMF and the other international organisations will be replaced by a 'Marshall Plan' type of conditionality. The main difference is that the former is based on a country-by-country approach, which often causes strong trade diversion and export loss effects, as was the case in the early stage of transition in CEE countries, whereas the latter puts an accent on reciprocal trade-creation effects as a driving force behind economic growth in the reforming countries. Such a revised strategy has been incorporated in the Stability Pact signed by south-east European countries and the international community. This includes initiatives that will:

Increase regional integration, foster economic development and absorb these countries into European and global structures, especially the European Union.<sup>18</sup>

The successful implementation of this regional initiative is an opportunity for the Bulgarian economy to uncover and develop a strong strategic competitive advantage – its central position on the map of the Balkans.<sup>19</sup>

18 World Bank (2000): *The Road to Stability and Prosperity in South Eastern Europe. A Regional Strategy Paper*, Washington D.C: World Bank, p. 7.

19 Unfortunately, in the process of transition – due to the crisis in former Yugoslavia – the specific geographic position of Bulgaria has performed thus far more as a source of competitive disadvantage.