Bulgaria's Integration into the Pan–European Economy

The gap in export peformance between EU-8 and Bulgaria has been slowly closing in recent years

Bartlomiej Kaminski and Francis Ng

Bulgaria stands apart from new EU members in one important respect which has had huge implications for the process of industrial realignment to pan-European markets: while the country initially moved swiftly to implement first-generation reforms in 1991, the original bold program of dismantling central planning and overcoming transformational recession was quickly abandoned with the re-introduction of central controls. To make things worse, progress towards creating institutional conditions conducive to development driven by private entrepreneurial dynamism has been uneven since the collapse of central planning in 1989-1990.

It appears that weaknesses in state capacity combined with the state's capture by private interests groups stood in the way of moving quickly along with structural reforms until the 1996 financial collapse. The consequence of this was another transformational recession, with two consecutive years, 1996 and 1997, of falling aggregate output. Bulgaria, together with Romania and Moldova, are the only transition economies that experienced this second transformational recession, i.e., at least two consecutive years of contracting aggregate output. Technically, the Czech economy also experienced two consecutive years of falling aggregate output in 1997-1998. But the contraction of 0.8% and 1% was just a fraction of the fall experienced in a single year by Bulgaria, Moldova or Romania.

"Real" Structural Reforms Only in 1997

Hence, the real transition to competitive markets began only in 1997. In contrast to the first aborted transition, the conditions under which the second stabilization program was launched in 1997 were much more adverse and demanding than the ones in 1991. For one thing, almost half a decade of mismanagement wiped out the financial sector and led to a massive stripping of assets of state owned firms. Many state owned firms, which five years earlier might have been successfully privatized, lost any attraction to potential investors, foreign and domestic alike. Furthermore, human capital skills that were still available in early 1996 either disappeared due to migration or were simply depleted because of a lack of employment opportunities.

In consequence, it took much longer for the usual returns from macrostability, privatization and liberalizing structural reforms to materialize. Delayed —almost a decade into transition — structural reforms combined with a historically high dependence on "socialist trade" had deeply affected Bulgaria's path of restructuring and integrating into world markets. While initially Bulgaria's progress away from central planning appeared to be similar in terms of macroeconomic and export performance to that of other bold reformers, the differences surfaced rather dramatically during and immediately after the second transformational recession. The abolition of the state monopoly over foreign trade combined with the collapse of "socialist markets" initially resulted in an impressive reorientation of exports, albeit from very low levels, to EU markets. However, stagnation replaced initial growth in 1996-99. Had it not been for the rapid expansion of clothing exports under the EU-driven outward processing, total exports would have significantly contracted.

Structural reforms were delayed almost a decade, but in 2000-2004 export performance improved and FDI increased

Improved Competitiveness of Bulgarian Producers

Thanks to structural reforms and a liberal regional trading environment, Bulgaria successfully, though belatedly, began taking advantage of opportunities offered by participation in the EU-driven Eastern Enlargement regional integration project. Unfinished reform of the economic regime, on hold until the 1996 financial crisis, was responsible for lackluster foreign trade performance, a strong indication of the absence of industrial restructuring and development. The 2000-04 period witnessed improvements in export performance indicating that liberal reforms have activated some creative restructuring.

First, although one might have expected a stronger rebound in Bulgaria's exports after a contraction in 1998-1999, performance over 2002-2003 showed a significant improvement in the ability of Bulgarian producers to withstand competitive pressures in global markets. This refers also to their competitiveness in a single European market for industrial products, the so-called pan-European market. Particularly noteworthy is the fact that the largest increases occurred in 2002 and 2003. Rates of export growth stood at 12% and 31% respectively, despite the fact that the latter was tainted by the significant increase in the intensity of competition in preferential markets due to the removal of all tariffs on industrial products among signatories of the Pan-European Cumulation of Origin Agreement. The Agreement paved the way for the establishment in 2002 of a single European trading bloc for industrial products, encompassing the EU-25, EFTA, Bulgaria, Romania and Turkey.

Second, progress in implementation of structural reforms and converging to the EU *acquis communautaire* led to a significant enhancement in the quality of the domestic business climate.

Last but not least, there was a significant increase in FDI inflows accounting on average for around 8% of GDP over 2000-03. Although clothing and footwear dominated its export basket in 2003, there were some shift towards skilled labor and capital intensive exports usually associated with FDI.

The evolution of Bulgaria's total exports in terms of factor intensities before the second transformational recession was a testimony to aborted economic reforms. It not only defied expectations derived from the experience of other Central European economies and its production factor endowments but also dramatically increased the cost of adjustment to market conditions for the economy.

De-Industrialization in Early 1990s

The derailed economic reforms appear to have been responsible for a very unusual evolution of the factor content of Bulgaria's exports indicating a very significant de-industrialization that occurred during 1991-1995. Three different phases in the evolution of the factor content of EU-oriented exports illustrated this process. While the first phase in 1992-93 witnessed what turned out to be peak levels in the share of unskilled labor intensive products in EU-oriented exports from these countries, the second phase, 1994-1996, witnessed a major realignment in the export growth pattern, with skilled labor and capital intensive products emerging as major contributors to Bulgaria's exports.

The third phase following the 1996 crisis was reminiscent of developments in the early 1990s in European transition economies that launched radical first-generation reforms in terms of both its dynamism and change in export offer. While 1996-2000 witnessed little or no gains in the overall competitiveness of Bulgarian producers in world markets, except for clothing mainly in EU markets, there has been a significant increase in the presence of Bulgarian exporters in world markets more recently, especially in 2003. Although exports of unskilled labor intensive products continued towering over other exports, the top performers in EU-15 markets (with an increase in EU imports of at least 2.85 times between 2000 and 2003), accounted for 16% of Bulgaria's EU-oriented exports in 2003 up from 4% in 2000. The star performers are mostly from the electro-engineering sectors indicating the shift towards more processed goods. Among emerging fast growers, i.e., products whose exports growth exceeded annual changes in EU import demand by at least 30% in 2000-2003, capital intensive products stood out.

Shift Towards Higher Technology Content

New exports came mainly from restructured industrial capacities, auguring well for future competitiveness in international markets. Of the electro-engineering products that performed well on EU-15 markets exports of machinery top the list, contributing almost 40% to the total of top performers' exports. In consequence, the share of manufacturing in Bulgaria's trade did not only significantly increase but there was a shift towards products with higher technology content and capital goods. Simultaneously, the share of traditional inputs, i.e., products used for further processing, in Bulgaria's exports were accompanied by a marked increase in the share of machinery. This, combined with the increase of more technologically advanced manufacturing in Bulgaria's exports, suggests a gradual shift towards more processed exports.

The gap between Central and Eastern European economies and Bulgaria in terms of export performance and its factor embodiments appears to have been closing, albeit slowly, as exports of capital and skilled-labor intensive products began growing. While overall Bulgaria has a long way to catch up with other new EU members in terms of participating in "producer-driven" network trade, there were healthy symptoms of growth in 2001-2003. Bulgarian producers did not become part of the division of labor based on production fragmentation in vertically integrated sectors on any significant scale. But by 2002 they had made significant strides in information communication technology products and automotive parts with the share of parts and engineering products growing from 3.1% of Bulgaria's EU-oriented exports in 1998 to 5.4% in 2003. Furthermore, the shift towards furniture (more exactly, furniture parts) within "buyer-driven" networks' exports, information communication final products and automotive parts within "producer-driven" exports and strong expansion of exports of other parts and engineering products point to significant progress in industrial restructuring and ensuing gains in competitiveness.

Lessons Learnt

Bulgaria's economic development as observed through the lens of its EU-oriented exports offers valuable lessons for other economies. First, subsidization of exports is not sustainable and ultimately leads to a very high cost of adjustment. Second, the prospects of deeper, policy-induced integration into a more developed region provide powerful political and economic anchors to the reforms process. Last but not least, the returns usually associated with liberal reforms, i.e., gains in competitiveness combined with shifts towards products in line with a country's endowments in production factors take time. They began to surface only around three years after the reform process was launched. In contrast to the period preceding the second transformational recession, gains in competitiveness derived from corporate and industrial restructuring and not from subsidies.

Bartlomiej Kaminski is Associate Professor at the Department of Government & Politics, University of Maryland; Francis Ng is a trade economist at Development Research Group, World Bank, Washington, DC. Full text of the paper can be viewed at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=922989 **BT**

Bulgaria and Romania: Strong Growth, Likely to Moderate in 2007

	Real GDP growth			Real Exports Growth			Growth of Industr. Output			FDI Net (% of GDP)		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Bulgaria	6.6	6.2	6.1	12.7	8.5	9.0	17.1	6.7	6.1	9.1	14.5	15.9
Romania	8.5	4.1	7.7	13.9	8.1	10.6	5.4	2.2	7.1	8.9	6.6	9.4

Source: the World Bank