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The impact of adverse initial conditions and the resulting speed and sequence of reforms in determining the delayed EU membership of Bulgaria

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Abstract

The subject of the paper is the analysis of the speed, sequence and path of a formerly centrally administered economy, Bulgaria, to a market economy. Comparing the macroeconomic developments and transition reforms of Central and Eastern European (CEE) countries, Bulgaria is lagging behind. It is concluded that the stop-and-go nature of the conducted Bulgarian reforms and the lack of commitment to deep-seated reforms by successive governments were due to the adverse initial economic conditions that the country experienced during transition, as well as the intense external shocks the country endured. These factors were the main barriers to attaining sustained growth, and contributed to Bulgaria's delayed entrance to the EU.
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1. Introduction

There is currently an attempt to explain the economic outcomes of the transition process, and the differences in magnitude of these outcomes, based on the speed and sequence of the transition policies (Bitzenis & Marangos, 2007; Bitzenis & Marangos, 2008; Ellman, 2005; Marangos 2007 [2004a]; Popov, 2007, 2000). In addition, there is also currently an attempt to explore the various characteristics of transition economies, which existed at the beginning of the transition process that naturally influenced the speed and sequence of reforms (Di Tommaso, Raiser, & Weeks, 2007). This is in contrast to the shock therapy approach to the transition process, which involved the immediate establishment of a market economy with

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no consideration given to the initial conditions. The initial conditions of transition economies incorporate, for instance, the external and internal shocks derived from the breakdown of the central planning system, the dissolution of the Soviet Union and the wars and civil strives that all influenced one way or another the transition process. As a result, there was a variety of policies, which the countries of the Central and Eastern Europe (CEE)[1] region adopted in order to achieve transition to a market economy. A question derived from the above analysis is: "How did initial conditions influence the overall economic performance of transition economies and the consequent policies adopted in order to become a fully-functioning market economy?" This paper attempts to answer this question by using the Bulgarian transition process as a case study in determining the delayed membership to the EU.

2. Bulgaria's adverse initial conditions

Bulgaria was selected as a case study because the country has received very little consideration in the economic literature after 1989. At the same time, Bulgaria had unique characteristics, which we consider to be the most important factors influencing the initial stages of the transition process. The legacy of the communist regime created significant drawbacks, which were difficult for the Bulgarian transition governments to overcome. For example, Todor Zhivkov, the Bulgarian Communist Party leader and Bulgarian Prime Minister, was the longest serving communist leader in Eastern Europe, producing a long-lasting unreformed political environment. As we will demonstrate, this indifference to reform had consequences regarding the structure of government, the quality of the political scene, and the development of civil society during transition. Additional characteristics include: the stronger dependence of Bulgaria than any other transition economy on the Council for Mutual Economic Assistance (CMEA) and the Union of Soviet Socialist Republics (USSR) for foreign trade; the Bulgarian relations with the West, which were insignificant during the communist era; the physical distance of the Bulgarian market from the Western markets; the initial choice of the shock therapy model of transition method and the following gradual and stop-and-go nature of reforms (Bitzenis, 2006a, p. 88) and the limited FDI inflows during transition.[2] Our paper will concentrate on the analysis of Bulgaria's aforementioned characteristics as a means of investigating the impact of initial conditions on the speed and sequence of reforms on the transition process, which delayed specifically the Bulgarian membership to the EU.

The argument developed in this paper is that there were several characteristics/initial conditions which we consider, as Falcetti, Lysenko, and Sanfey (2006), Falcetti, Raiser, and Sanfey (2002), Macours and Swinnen (2000), Krueger and Ciolko (1998) and Marangos (2007 [2004a]), to be the most important affecting a transition economy's performance, not only at the start of the transition to a market economy, but also at any stage of adaptation of a specific program or measure, which encouraged or discouraged the transition. For example, countries from the ex-Soviet Union and ex-Yugoslavia with little experience as independent nation states had more difficulties in creating efficient political institutions. In addition, the legacy of the communist regime and the external economic shocks delayed economic recovery from the recession experienced due to the collapse of central administration in Eastern Europe and the former Soviet Union.

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While the goal of all transition economies was more or less the same, the performance of these countries was uneven and disheartening. Bulgaria's macroeconomic development lagged compared to most of the economies of the Central and Eastern European region, especially the CEE members of the EU, and it is still lagging even though it joined the EU. Ten countries of Central and Eastern Europe were accepted as full members in the European Union, while Bulgaria together with Romania entered the EU in January 1, 2007.

As of June 2004, Bulgaria closed provisionally all the 31 chapters of Acquis (*Acquis Communautaire*, or *EU Acquis*, is the term used to refer to the total body of EU law) and following there was a need for continuous satisfaction of the prescribed outcomes required by the Copenhagen political, economic and administrative criteria. To join the EU, a new Member State must satisfy the three Copenhagen criteria: (1) political criterion: stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; (2) economic criterion: existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union; and (3) acceptance criterion of the Community *acquis*: ability to take on the obligations of membership, including adherence to the aim of political, economic and monetary union.

We argue that the reason for this delay in membership was the adverse economic initial conditions and exogenous shocks that were extremely onerous for Bulgaria. While some adverse initial conditions were common to some degree for the transition economies, in Bulgaria's case they substantially delayed economic recovery. In reality, Bulgaria was not able to escape the stagnation, which appears to be necessary. All transition economies experienced a large reduction in Real Gross Domestic Product (RGDP) during the establishment of the market, although the stagnation was worse in Bulgaria comparing with most of the CEE economies. We will argue in this paper that the legacy of the past communist regime and the various external shocks were the most decisive and adverse characteristics and conditions affecting the Bulgarian transition economic performance. In particular, the adverse initial conditions of Bulgaria are divided into the following groups.

2.1. The legacy of the communist regime and various external shocks

The legacy of the communist regime provided the Bulgarian transition environment with the following unfortunate characteristics, which required time, sacrifices, and effort in order for the subsequent negative outcomes to be overcomed. In sum, these characteristics included: the highly bureaucratic procedures, the negative attitude of the people against consumption, and entrepreneurship as advocated by the ex-communist regime, the lack of profit-oriented enterprises as firms had to satisfy only centrally administered commands, the low level of productivity due to the lack of technology, the lack of competition, the lack of efficiency oriented behavior, and the absence of private sector pursuing profitability and efficiency. In addition:

(a) Lack of regulations, legal framework, financial intermediaries, and a stock market exchange, which are essential elements that facilitate the establishment of a market economy.

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(b) Bulgaria was mostly dependant on the Soviet Union and the CMEA both which collapsed. These external shocks were more unbearable for Bulgaria. Bulgaria was heavily industrialized in the form of strict Stalinism, and dependent mostly, for foreign trade, on the Soviet Union. The insufficient quality and variety of products and the limitation of natural resources were unable to offset the loss of CMEA partners with others from West.
(c) The new business mentality after the collapse of centrally administered socialism was in conflict with the nomenclatura[3] and organized crime (mafia) during the period of social transformation of Bulgarian society both of which, at the end, dominated economic affairs.
(d) The magnitude of property reform due to the restitution[4] and the significant delay in re-privatization of the property, which created a subsequent delay in the privatization process.

The Balkan business mentality (Kitromilides, 1996), according to Bitzenis (2007a, p. 101; 2004, p. 23) takes the form of a dominant tendency of people in the region for a quick and easy profit. In the Balkans, the motivation for quick and easy profit is unplanned, unprepared, and primitive in nature usually with illegal means, while in the developed countries people use more sophisticated methods for quick and easy profit. In addition, the Balkan business mentality is characterized by family oriented entrepreneurship, personal relationships which influence hiring decisions instead of merit, disorganization, non-collective behavior, and suspicion of citizens towards the state and regulations (and vice versa). As a result, the transition process, in the case of Bulgaria, created significant behavioral changes. Specifically for the Bulgarian case, the Balkan mentality, combined with the bureaucratic mentality and the unstable legal framework (as stated in point a) with its constant changes left space for bribery, corruption and the development of the mafia (as stated above point c) to flourish, creating an unfavorable business environment and hence producing another group of adverse conditions. Accepting Polanyi's (1975 [1944]) perception the development of capitalism requires the disembedding of the economy from society. Disembedding is a task that creates immediate tension, as the Bulgarian case demonstrates, as the vulnerable sections of the society resist the changes by generating a protective response by those who are being victimized by the process. The cultivation of consensus also created conflict (Epstein, 2006). Bulgaria is a case study in just how difficult the creation of a market actually is.

Further, Bulgaria was an underdeveloped Balkan economy, and suffered the most from the instability in the region compared to CEE countries (excluding the ex-Yugoslavian countries but including Slovenia), and only managed to overcome most of their subsequent negatives outcomes after 1999. The Persian Gulf crisis, which caused higher oil prices, the interruption of the trade between Iraq and Bulgaria brought Bulgaria close to disaster in times when the country was most vulnerable. The changes in Bulgaria's familiar trade environment were, most probably, the strongest obstacles for its economic reform. As a result, Bulgaria started the transition to a market economy with one of the worst initial trade conditions of CEE. In detail, the external shocks were:

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2.1.1. The collapse of CMEA

Bulgaria was one of the least industrialized countries of CEE and depended mainly on agriculture before the communist revolution. After the rise of the communist regime in 1949, Bulgaria developed a strong dependence on the Soviet Union, a country that was the cornerstone of Bulgaria's industrial development, providing the new communist country with capital and energy resources, the two resources Bulgaria lacked the most. The country experienced some growth during the communist period, but it failed to set solid bases for an independent and prosperous economy, due to the nature of the controlled economy that prevented competition and gave no incentives for quality and efficiency.

By the early 1980s, Bulgaria had become an industrialized country with a more or less stable economy and a reported per capita income roughly similar to Portugal and other Central and East European countries such as Poland, Hungary, and Yugoslavia (IMF, 1999, p. 160). However, the stable economy was a product of the protective environment of the CMEA. The following data demonstrate that a significant percentage of Bulgarian foreign trade was conducted with CMEA country members and especially the Soviet Union (WIIW; EIU). For example, in 1950, 54% of Bulgarian exports were to the Soviet Union and another 37% to other CEE countries, and only 9% with Western countries. In 1970, 53.8% of Bulgarian exports were to the Soviet Union and another 25.5% to other CEE countries, compared to 20.3% with Western countries. In 1990, 64% of Bulgarian exports were to the Soviet Union and another 12.1% to other CEE countries, and 23.9% with Western countries. The same trends take place with Bulgarian imports. Moreover, most of these trade partners had little concern about the quality of the products they bought and were not looking for a better deal elsewhere.

The CMEA was perceived as a continuation of the Soviet autarchic growth strategy due to its Soviet type structure and the fact that the USSR dominated total trade. This was certainly the case with Bulgarian foreign trade; from the second half of the 1950s, about 50–55% of Bulgaria's total foreign trade turnover was with the Soviet Union, and about 30–35% was with the other CMEA countries, especially the German Democratic Republic and Czechoslovakia.

The CMEA had a positive effect on East European trade, which during the period 1956–1960 had a larger growth rate than total world exports and even the trade of Western industrialized countries (Bruno, 1992, p. 763). The growth rate decelerated from 1961 to 1965 to a rate below the Western one, only slightly above the world total. During the 1960s, Bulgaria had the fastest rate of growth of foreign trade among the CMEA countries, with exports growing considerably faster than imports. By 1972, Bulgaria had the larger amount of foreign trade among the CMEA countries, followed by Romania, Poland, Hungary, the USSR, the GDR and Czechoslovakia. Bulgaria's economy was heavily dependent on imports, as it lacked in raw materials.

Most of the trade among the CMEA countries was conducted on a government-to-government basis. It was based on five-year agreements, supplemented by annual protocols which fixed the quantities and prices of the products to be traded. The commodity composition of CMEA trade and the international trade of each country was planned from the government, which was one of the problems of centrally planed international trade. “Central planning tends to be biased against foreign trade. Planners crave certainty, and foreign trade, even between planned economies, involves uncertainty. It is hard to plan production, harder still to plan

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consumption, and very hard to plan the differences between them. To plan trade between two countries, moreover, the planners have to match the two countries' differences, imparting more uncertainty to each country's plan" (Kenen, 1991, p. 239). The prices of primary commodities according to the Bucharest formula, adopted in 1975, were based on a five-year moving average of world prices but tended to lag behind. Approximately 60–70% of the intra-CMEA trade between the Central and East European countries, was with the USSR. The USSR's share in total foreign trade with Hungary was below 20% by 1990, and in contrast, Bulgaria had almost totally Soviet-oriented development policies and trade. In sum, the "... CMEA collapse in 1989, caused the most damage in Bulgaria, the bulk of whose exports had gone to the CMEA" (Bruno, 1992, p. 1).

Probably no other country received as much assistance from the combined effects of generous Soviet supplies of energy and raw materials, together with an equal Soviet willingness to accept Bulgarian manufactured goods in return, resulting in extremely generous terms of trade during the communist period. In the West, Italy and Germany were the main trade partners of Bulgaria; trade with the U.S. was negligible. The chief exports were machinery, food products, tobacco, non-ferrous metals, cast iron, leather products, and textiles; the principal imports were petroleum, natural gas, machinery, transportation equipment, steel, cellulose, and timber during the transition period (PlanEcon Report, 1991; UN, 1990).

In 1990, the Soviet Union itself began to unravel, and by the end of the year, it was out of existence, soon to be replaced by the Commonwealth of Independent States (CIS). On December 25, Mikhail Gorbachev resigned, and on midnight of December 31, the Soviet flag atop the Kremlin was replaced by the Russian tricolor. Bulgaria was left without its main trading partners, and with a structure in production, which would not stand a chance, in terms of competitiveness, in a non-controlled environment. It is very clear that in the 1990s there was a significant decrease in Russian trade with Bulgaria, and a subsequent increase in Bulgarian trade with the EU countries. The transition in Bulgaria brought about a dramatic rearrangement of the geographical distribution with CEE foreign trade. The share of trade with the CEE dropped radically, and that with the European Union increased significantly. The CEE relations with the Soviet Union, and then with Russia, ceased to play a dominant role in the region. On the other hand, the existing industry established by USSR financial aid, along with Bulgaria's highly skilled and relatively cheap industry workers gave Bulgaria an advantage among the other transition economies for foreign investors.

2.1.2. The unification of Germany and the loss of the GDR as a trade partner

The re-unification of West Germany with East Germany, which was also a major trade partner during communist years, was another strike to Bulgaria's weak economy.

2.1.3. USSR's energy crisis

After 1988, and the termination of the USSR subsidies and exports of energy sources and commodities in preferential prices, together with the subsequent political fragmentation that followed the USSR's collapse, both had a devastating effect on the Bulgarian economy. Bulgaria's energy supplies depended heavily upon the USSR (Schrenk, 1992). The energy crisis in the USSR resulted in severe energy shortage in Bulgaria.

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2.1.4. The Gulf crisis

The Gulf crisis cost Bulgaria approximately 2.5 billion US dollars. Iraq was one of Bulgaria's largest debtors through trade relations (with 1.239 billion USD in 1989 and another 0.7 billion USD in 1990 from Iraq's non-repayment of debt) and, thus, the agreement of repayment of the loan with the delivery of 600,000 tons of oil was devastatingly postponed due to the UN embargo. This cost Bulgaria $565 million USD – the cost of replacing of Iraqi – contracted oil at higher prices.

2.1.5. The embargo on former Yugoslavia

The embargo on former Yugoslavia cost approximately $8 billion total ($1.833 billion from the initial impact on the balance of payments (BoP), and another $6.2 billion impact on the BoP in the period July 1992–September 1994) promoting real problems with Bulgarian trade due to the loss of former Yugoslavia as a trade partner. Moreover, the ex-Yugoslavian road, rail and river routes were the nearest, cheapest, and possibly the only way to reach the West to export its products resulting in a fall in trade with neighboring countries, and a sharp increase in transportation and transaction costs. The rail and road routes through the former Yugoslavia were indeed some of the leader arteries for Bulgarian trade, and the alternatives through Romania and the Black Sea were slow and overcrowded.

Apart from the front-line states (Albania, the former Yugoslav Republic of Macedonia (FYROM) and Serbia), Bulgaria was probably the country most affected by the war in Kosovo. Before the war, some 50% of Bulgarian exports were transported through former Yugoslavia. The magnitude of the damage in the former Yugoslavian infrastructure will remain a problem for Bulgaria for at least a decade after 1999. In less than two years from the beginning of the transition (1989–1991), Bulgaria, Romania and Albania lost half of their exports (PlanEcon Report, 1991; UN, 1990). Although the others recovered by 2000, Bulgaria did not. In 1991, Bulgaria's imports had deteriorated by two thirds compared with the 1989 volume, while, at the same time, all other countries retained (more or less) a constant volume of imports. The decrease of imports was not indicative of an increase in the local production, but rather a loss of trade partners.

2.1.6. Crises in emerging markets

The economic crises in Mexico, East Asia, and the former USSR discouraged investors from investing in Eastern European emerging markets. The external shocks, in the form of the various financial crises of the 1990s in Mexico, East Asia, and particularly in Russia, contributed to delaying or interrupting the recovery of output in transition economies. Furthermore, repressed inflation, high black market exchange rates, and the war and civil strife in Armenia, Azerbaijan, and Tajikistan in 1992–1994, in Georgia and Moldova in 1992, and in Croatia and FYROM in 1991–1994, all took a major toll on the lives of the people in transition economies, infrastructure, and institutional development, undermining, as the World Bank (2002, pp. 11–15) argues the political consensus on reforms required for successful transition.

The problem that needs to be addressed is the important issue of building a consensus within the nation and government for the "successful transition" to capitalism. It can be argued that in Central and Eastern Europe and the former Soviet Union there never was such a consensus to this effect. The cultivation of consensus also created conflict (Epstein, 2006). People were ready for

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something substantially different than the centrally administered model. They wanted greater participation, empowerment, and ultimately personal freedom than the centrally administered model allowed. Nevertheless, it should not be assumed, as the international financial institutions funding the transition process assumed, that for these reasons everyone wanted a version of free market capitalism. Who decided that the transition to capitalism should be the national goal? Such goal cannot be assumed; the consensus had to be built. A popular movement for regime change is quite different than a popular movement for capitalism. Of course, the initial condition of government instability existed, in addition to that there was no consensus on exactly where to go with economic reform. Hence, it is possible to argue that Bulgaria prematurely embarked on the road to capitalism without considering alternatives. Transition analysis is also about mobilization politics and consensus-building and not only about specific economic reforms and policy prescriptions that will pave a smooth road to capitalism. Not everyone was supposed to want capitalism!

2.2. *Economic conditions*

The adverse economic initial conditions for Bulgaria were:

(a) Macroeconomic instability due to the burden of fiscal deficits, low productivity, bad loans both foreign and local, increasing shadow economy, an abnormally high percentage of GDP allocated to the industrial sector, low quality of produced products together with the lack of new trade partners, inability to balance the state budgets, monetary overhang[5] and depressed inflation. For example, Bulgaria's foreign debt was over $12 billion in 1992 (when Hungary had foreign debt of $21 and Poland $47 billion, but Poland's debt was forgiven when the shock therapy was launched), most of which was denominated in US dollars. However, the Bulgarian ratio of external debt over GDP in 1991 was 157.4, the worst in the region; the next highest, Hungary, had a 67.8 ratio (EBRD, 1994). The continuous depreciation of the domestic currency at the early years of the transition made the situation even worse, as the accumulated trade and budget deficits had to be paid in hard currency. Only one country, Romania, started its transition with no significant debt compared to the other transition countries, the debt was less than $2 billion in 1989 (EBRD, 1994).

(b) Bulgaria's current account deficit in 1990 was the second worst in the region after Romania with almost 1.7 billion dollars deficit (IMF, 1991). In 1991, the Bulgarian ratio of current account to GDP was also the worst in the region at −5.4% (EBRD, 1994).

(c) Low foreign exchange reserves and sufficiently high monetary overhang encouraged the government of Bulgaria to liberalize nearly 70% of prices but, having a flexible exchange rate regime, this resulted in an unstable macroeconomic environment. In July 1997, after the introduction of the currency board and the establishment of a fixed exchange rate with the German DM, the economy was stabilized, but at the considerable cost of unemployment reaching 17.9% in 2000 and 2001 (UN/ECE, 2004). In addition, GDP per capita was low: Bulgaria's GDP per capita in 2006 was around $10,400 in PPP prices, when at the same time in Hungary it was $17,300, the Czech

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Republic $21,600, Slovakia $17,700 and Slovenia $22,900, double Bulgaria's GDP per capita.

Also, the gross wage was less than 150 Euros per month in Bulgaria, while in Slovakia the gross wage was more than 400 Euros, in Poland and the Czech Republic around 600 Euro, in Hungary and Estonia around 500 Euros, and in Latvia and Lithuania more than 300 Euro (WIIW, 2005/6). Moreover, the low wages in Bulgaria, which could have supported the transition and could have led to significant FDI inflows, were a lost opportunity. More specifically, Bulgaria, Romania, Ukraine, and Russia have some of the lowest wages in the CEE region, but Bulgarian competitiveness in terms of cheap labor (skilled, semi-skilled and unskilled) was threatened due to the introduction of the currency board in July 1997, and the depreciation of the ruble in Russia at the end of 1998, which forced wages in Russia below those in Bulgaria. For example, in Bulgaria the average wage was 76 Euros in 1998 (based on exchange rate at the end of the period) and 85 Euro in 1999, while in Russia it was 144 Euros in 1997, 43 in 1998, and 56 in 1999 (PlanEcon Report, 1991).

The decision to delay the introduction of a fixed exchange rate regime, which was taken at the beginning of the transition, was proven to be wrong. Although Hungary and Poland started their transition with more debt than Bulgaria, they had $ 4.4 and $ 4.3 billion foreign gross reserves (including gold) respectively, while Bulgaria and Romania, very soon after the transition, ran out of foreign currency reserves (EBRD, 1994). Bulgaria and Romania had chosen flexible exchange rates due to the lack of foreign reserves at the beginning of the transition. The pre-existing loans before the initiation of the transition in hard currency, together with the depreciation of the national currency, created an unfortunate economic environment.

As Bulgaria and Russia shared a few common export goods such as metals and chemicals, and Russia had already attracted limited foreign investments, this competition created problems not only for Bulgarian exports, but also for FDI inflows, which remained almost stable in Bulgaria from 1997 to 1998 (from US$537 million to 505 million, when world FDI inflows increased by over 40% in the same year). Nevertheless, we should not ignore the fact that Bulgaria initiated a different path to stabilization, namely, monetary and exchange-rate stability, via the introduction of the currency board in July 1997, which was proven very successful in terms of economic development, macroeconomic stability, and the attraction of FDI inflows.

(d) The very low per capita income and standard of living, one of the lowest among CEE, as well as the growing poverty, led the Bulgarian government to be skeptical, and a few times to postpone the tightening of policies in the early years of transition.

(e) The weaker Bulgarian geographic, historic, and cultural links with Western Europe have also proven "lethal" for its transition to a market economy (Bitzenis, 2004).

2.3. *Political and government instability and the subsequent delays in privatization*

In the eight years from 1990 to 1997, eight governments were formed mainly by a coalition of political parties with limited power in the parliament (Bitzenis, 2004, p. 10). During this

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period some governments tried to introduce reforms but were thwarted in their efforts by social resistance; other governments did not even try for fear of electoral defeat, while yet others were unable to initiate reforms due to administrative weaknesses. After the fall of communism, Bulgaria faced great political and government instability, changing eight prime ministers in just over seven years (Feb 1990–May 1997). Moreover, according to Bitzenis (2007a, p. 107; 2004, p. 33), the literature considers political instability equal to government instability, ignoring the importance of institutional or structural instability. Government inability, unwillingness, or even limited political will to proceed with transition reforms, are also included in this group. Furthermore, the political unwillingness to undergo significant reforms, together with the inability of the post-communist Bulgarian governments, led to the delay of structural reform and privatization, and thus delayed the Bulgarian transition process overall. Privatization in Bulgaria has been carried out in an unstable political environment marked with frequent government changes matched with corruption and social capital (Bojicic-Dzelilovic and Bojkov, 2005, p. 83; Rosser & Rosser, 2001). The adverse governmental policies or government inaction were:

(a) Three economic crises, two in less than one year, led the Bulgarian people to suffer a significant loss of their money savings, and brought them to one of the lowest per capita consumption levels in the CEE region in the time period just after 1997 due to devaluations, and hyperinflation. This served as an entry barrier for most of the foreign companies that were in the process of examining and ranking the possible countries of the region as future host countries for directing their investments. In March 1994, the first economic crisis hit the country: the exchange rate between the LEV and the dollar doubled, and inflation rose to over 100% annually. As a result, currency substitution, in other words people preferred to hold hard currency instead of LEV began to intensify, affecting the banking sector.

The second crisis in 1996 in Bulgaria led to widespread loss of credibility and confidence in economic policy and domestic financial institutions. The specific macroeconomic policy response to the unfolding crisis was, of course, very complicated. Given the circumstances, stabilization of expectations that underlined the demand for the LEV, it was argued, could most likely be achieved only through a policy that explicitly used the exchange rate as an anchor. As such, Bulgarian monetary authorities implicitly attempted to use the exchange rate for stabilization, and again it was argued that the explicit announcement of targets would help to reduce uncertainty and promote enforcement.

Stabilization of Bulgaria's languishing economy in 1994, 1996, and February 1997 was based on the introduction of the currency board, a restructuring of the economy, and foreign financial support for reforms. Due to the fact that both the Socialists and the Democrats recognized that the introduction of a strict monetary regime was the way forward. The plunge of the LEV in the third crisis (January and February of 1997) created hyperinflation mainly due to the increase in the price of imports.

In sum, the financial crisis of 1996–1997 was a combination of a fiscal crisis, a banking crisis, and a currency crisis, all of which ruined the country's banking system and left public finances nearly bankrupt (Dobrinsky, 2000). After the resolution of the political stalemate, which led to the appointment of a temporary government in preparation for the April elections,

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and the decision by the IMF to proceed with negotiations on a standby agreement with the transitional government, the LEV stabilized and inflation slowed dramatically.

The financial crisis of 1996 and 1997 had unfortunate negative consequences on the Bulgarian economy. The crisis in general provided a context to realize painful but necessary decisive measures to deal with failing banks and enterprises, accelerate privatization, and improve the overall environment for domestic and foreign businesses. The currency board came into existence on July 1, 1997; the Bulgarian LEV was pegged to the Deutche Mark (DEM) as a reserve currency at a rate of 1000 BGL/DEM, later 1 to 1 (three zeroes deleted), and then pegged to the Euro.

(b) There was a significant delay in the liberalization of prices of products produced by state monopolies in sectors such as energy, gas, petroleum, telecommunications, railways, television, etc.
(c) As a result of ineffective government, there was also noticeably low progress in the development and growth of the private sector. In 1991, only 19% of GDP belonged to the private sector, one of the worst ratios in the region, larger than only the Czech Republic (17%), Slovenia (16%), and Slovakia (15%). In 1999, the Bulgarian ratio (62%) was lower than that of the countries, which began with a worst initial ratio by almost 15% (Hungary 85%, Poland 81%, Czech Republic 75%). The delay occurred not only because of the slow privatization progress, but also due to the slow creation and establishment of new small enterprises due to the inadequate institutional framework (Bitzenis, 2006a, 2007b; EBRD, 1994, 1995, 1997, 1999; Economist Intelligence Unit; IMF, 1999).
(d) The "favorable introduction of the laws" and the governmental financial support in the early years of the Bulgarian transition for the nomenklatura created not only corruption but also an unfavorable business environment.
(e) To overcome the negative conditions at the beginning of the reform, the Bulgarian government borrowed in convertible currencies from private commercial banks. This only worsened the situation, as the national currency depreciated.
(f) The inadequate restructuring of state-owned enterprises before privatization (high number of employees when less than half were needed, with no government willing to risk the political cost of layoffs) that discouraged foreign investors, or a final postponement of the restructuring, we argue, was actually not only a further delay but also led to an accumulation of extra debt, bad loans. Thus, these factors all led to slower privatization, and lack of significant offers and possible investment interest.

Dobrinsky (2000, p. 600) stated: "All economies in transition face the problem of restructuring state-owned firms; closing down unviable loss-making state firms is a difficult policy problem in any country in transition; keeping loss-making state firms afloat does imply fiscal costs to all governments in these countries; bad loans have been a major problem in the whole of central and eastern Europe; governments in other countries also engaged in financial bailouts of banks and enterprises; some countries were also burdened with a large foreign debt.[6] One prominent lesson from the Bulgarian experience is that any of these problems, if left unchecked, may give rise to a major financial crisis". Poirot (2003, p. 28) however con-

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cluded that earlier and faster privatization would not have improved economic performance, as Bulgaria's macroeconomic instability was a result of both underlying chaotic hysteresis and financial fragility.

(g) The problems associated with the privatization process, in particular: the lack of transparency, the inexperience in valuation of SOEs, the bureaucracy, the complex criteria of selecting the buyers, corruption, the late introduction of bankruptcy laws and hard budget constraints, as well as the accumulation of bad loans and the large debt of most of the SOEs, which the Bulgarian state did not restructure rapidly and effectively. "The implemented models of privatization in the end gave prevalence to a case-by-case insider privatization and enabled the central government's control at every stage of the process. Under-valuation of assets of enterprises slated for privatization, selective filtering of information, favorable terms of payments, repayment of bank loans out of the profits of the privatized enterprise, asset stripping, through hidden privatization were some of the most informal practices frequently used to secure privileged access for selected groups or individuals" (Bojicic-Dzelilovic & Bojkov, 2005, p.84, see also Maltev, 2006; Marangos, 2004b; Mikolajczyk & Roberts, 2006).

(h) The inability to stop inflation before the introduction of the currency board was due to political instability as a result of government instability and mainly because of ineffective government coalitions being in power.

(i) There was an inadequate institutional framework, thus an insufficient legal framework with constant changes, lack of enforcement of laws, together with highly inefficient bureaucratic procedures. All of them were an outcome of inexperienced political leaders. The ex-communist politicians working in the different environment that of a market economy in conjunction with the lack of laws and the bureaucracy inhibited the privatization process and left space for briberies, corruption and the creation of informal networks in addition to the nomenclature. The aforementioned issues demonstrates the lack of political consensus as "the political conflict over the selection of the privatization models and the institutional and procedural voids left by the regulating legislation have been skillfully used by a number of informal networks" (Bojicic-Dzelilovic & Bojkov, 2005, p.75) (see also Bitzenis, 2004, 2006b; Rosser & Rosser, 2001).

3. The road to a market economy: the sequence and speed of reforms in Bulgaria 1989–2005

Following the previous analysis, the inefficient actions of the governments in Bulgaria were the introduction of a flexible exchange rate regime in the early years of transition due to the lack of adequate currency reserves and the late introduction of any economic tool for the achievement of macroeconomic stabilization, such as the currency board. The currency board was established in July 1997 only after the insistence of the IMF due to the presence of a third financial crisis in only a few years (1994, 1996, 1997) and the very slow restructuring-privatization process, as a condition of receiving any further financial assistance from both the IMF and World Bank.

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Besides the political mistakes discussed above, the negative sentiment of people regarding restructuring/privatization, together with the inadequate legal framework with constant changes, or even, the total absence of appropriate laws at the beginning of transition strengthened the nomenklatura. Thus, bribery and corruption discouraged the inflow of significant amounts of FDI (Bitzenis, 2004, 2006a; Habib & Zurawicki, 2002; Dahlstrom & Johnson, 2007). The increase of the nomenklatura's power further delayed the privatization process, created social problems and income inequality, caused discontent to the citizens and reduction of per capita income, decreased governmental revenues, increased illegal actions, and most importantly created an unstable economic environment, which, we argue, also discouraged foreign investors. Moreover, the restitution problem in determining what belongs to whom, which property to return within the context of the increasing value of property because of the transition process and the unclear property rights in the beginning of the transition in Bulgaria are only some of many other factors that held back the whole transition process.

Economic policy until 1997 intensified the problems while other countries in the region such as Hungary, Poland, the Czech Republic, the Slovak Republic, and Slovenia were experiencing increasing economic growth. After the introduction of the currency board, which decreased money supply within a fixed exchange rate regime reduced aggregate demand, the previously elected government of 1997, with the assistance of the IMF, managed in less than four years to achieve some stabilization of the economy: single-digit inflation, drastic acceleration of the privatization process, and improvement of investment environment, which made Bulgaria more attractive to foreign investors, but at a ever-increasing cost of unemployment.

The elected government in 2001 managed to achieve a stable economy by maintaining the single-digit Bulgarian inflation rate, lowering the interest rates, and closing most of the chapters of EU *acquis* and continuing to prepare Bulgaria for its EU entrance in 2007. The achievement of the Bulgarian government of decreasing inflation from over 1000% in 1997 to single digits at the end of 1999 is more than remarkable.

Government stability was achieved in 1997, since the Bulgarian government did not change from the beginning of 1997 up to the middle of 2001. The Kostov government (1997–2001) enjoyed significant popular support and the UDF, the political party of the Kostov government, turned the economy around by restructuring and privatization, and achieved noteworthy successes as expressed by the IMF and the EU.

Compared to previous years 1990–1997 – seven years with eight prime ministers – in the years 1997–2005 there were only two different governments in power. Bulgaria achieved significant growth for the economy in general and by mid-2004 there was hope for the country's admission in the European Union once the country satisfied all the Copenhagen criteria. Bulgaria had already signed an association agreement with the EU, which constantly guided and supervised the country in its effort for full membership.

It is a challenging task to define the nature of the Bulgarian reform strategy since the start of transition. On the one hand, there are some indications that a shock therapy approach was applied (instant price liberalization of more than 70% of the commodities); on the other hand, some characteristics of gradualism are intrinsic to the Bulgarian transition (restructuring prior to privatization and the gradual privatization process). Although early analysts have

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presented Bulgaria as a country, which undertook a 'big bang' transition (Ganchev, Krempel, & Shivergeva 2001, p. 4; Macek et al., 1998, p. 3; Tsang, 1996, p. 1), the fifteen years of Bulgarian transition studied by the authors of this article indicate otherwise.

The instant price liberalization of more than 70% of the commodities in 1991 can be defined as shock therapy, but, exploring the introduced reforms during the course of transition, lead one to conclude that the majority if not all of the required reform policies had stop-and-go-nature. As this is revealed by the delay in the liberalization of prices in remaining 30% of the commodities, preservation of the big state monopolies, late introduction of bankruptcy laws and hard budget constraints, as well as accumulation of bad loans and inability to stop the inflation before the introduction of the currency board (mid-1997). All of this together resulted in the reinforcement of the nomenklatura, development of wild privatization, and in a very slow overall progress of privatization, re-privatization and restructuring (Bitzenis, 2006b; Dalkalachev, 1993; Dimitrov, 1996; Due & Schmidt, 1995). The developments in privatization were far from not only a "big bang" path, but also raise doubts over whether it falls under gradualism. It can be argued that political constraints impose a gradual approach to restructuring, which had implications on the speed and sequencing of privatization.

The introduction of macroeconomic stabilization reform brought about relative stability only until 1996. The setback in the reform can be traced to the postponed restructuring and inconsistencies in the enterprise and institutional reform. The significant initial price liberalization was not followed by further removal of price controls and there was a substantial delay in the liberalization of prices of certain products such as energy, gas, petroleum, and telecommunications that set back the upsurge in fixed investment, output, and employment. The adjustments in relative prices in Bulgaria began too late in 1999 reinforcing the stop-and-go nature of reforms (Bitzenis, 2006a, p. 88; Bitzenis, 2007b).

In the early 1990s, Bulgaria started active foreign trade liberalization, but instead of conducting further liberalization of the trade regime, the Bulgarian government increased the protection level in 1996–1997 through introducing a 5% import surcharge on about half of the imports, increased the maximum tariffs in agriculture, and implemented various trade restrictions, regulations, and licensing requirements, again reinforcing the stop-and-go nature of reforms. While tariffs and quotas are part of a market economy, the outcome was discouragement of trade and foreign investment in the country. This was done in order to reduce imports and to initiate the establishment of FDI projects since multinationals started to consider the potential move from trade to FDI. This is clear from the significant increase of FDI inflows in Bulgaria in 1999 by more than 50%, from US$537 million to US$819 million (Economic Survey of Europe, 2005, UNECE, 2005).

The initial privatization process was very slow and inefficient; one of its specific features was that it has been linked to strong political considerations, as there were many disagreements over the proper privatization course. The postponed restructuring and price liberalization in the early transition period, reinforcing the stop-and-go nature of reforms, partly were aggravated by the very low per capita income and the increasing poverty and income inequality. With rapidly changing of governments, no one government succeeded in implementing the announced reforms.

Due to the absence of continuity and consensus regarding economic reform, privatization was markedly delayed. The lack of political commitment in the form of both political will and

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political capacity, together with the structure of the coalition government and the lack of support by the citizens restricting the government, resulted in an inconsistent approach to economic restructuring and enterprise reforms, and by the end of 1998 the privatization of large state-owned enterprises had hardly started, reinforcing the argument of the stop-and-go nature of reforms (Bitzenis, 2007b).

Concerning the institutional reform, apart from the fact that an adequate legal and institutional framework was not in place in the start of the transition, it took much time for different governments to enforce vital laws and regulations for the market economy, such as bankruptcy law, property rights and competition rules. The delayed restructuring and complementary enterprise reforms, and the subsequent persistent provision of indirect subsidies to the state enterprises by the banking sector in Bulgaria, constrained the speed of banking reforms such as the implementation of prudential regulations and bank privatization, reinforcing the stop-and-go nature of reforms. Thus, despite "...the similarity of ultimate objectives and basic direction of changes required, countries' actual transition experience has differed enormously, with respect to both policies implemented and results achieved to date. The reasons for the differences include the country's initial conditions, the external environment (notably external shocks), and the specific policies pursued during the transition" (World Economic Outlook, 2000, p. 131).

4. Conclusion

While this case study is not necessarily generalizable to others due to the contextual profile of the country and, thus, the conclusions are not inevitably universal, the study makes a contribution to the literature by investigating reasons for the delayed membership of Bulgaria to the EU based on the initial conditions of the transition process, which have not been extensively explored. It might be concluded that the stop-and-go nature of the conducted reforms in Bulgaria and the lack of commitment to more deep-seated reforms were the main barriers to progress and the attainment of the sustained growth which resulted in the delayed membership to the EU. The nature of the stop-and-go reforms was the result of the liberalization of prices, together with the maintenance of fixed prices, the liberalization of trade followed by the imposition of tariffs, and the postponement of economic restructuring, privatization, and enterprise and banking reforms. Thus, the incoherent reforms, frequent change of governments until 1997, and delayed privatization and restructuring led to severe banking and economic crises in 1994, 1996 and 1997 and to the weak performance of the Bulgarian economy. All the signs of Bulgarian economic life were negative until mid-1997. The governmental failed to expand significantly the private sector and to create adequate financial intermediaries, having at the same time one of the weakest stock markets in the CEE region until mid-1997. However, after mid-1997, there was acceleration in privatization and restructuring, an expanded private sector (75% of GDP in 2002), single-digit inflation, low interest rates, macroeconomic stability, increased FDI inflows, significant entrance of foreign banks, further abolishment of the remaining monopolies, imposition of hard budget constraints, and adaptation of an adequate legal framework and finally entrance to the EU.

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Although the signs for economic growth (after July 1997 and especially in 1999–2005) are obviously positive, Bulgaria is behind most of the other CEE countries such as Poland, Hungary, Slovakia, the Czech Republic, Slovenia, and the Baltic States since it has not yet recovered, neither in GDP nor in industrial output. The accumulated Real Gross Industrial Output in Bulgaria for the period 1989–2004 was −35.6% and at the same time the accumulated Real GDP Bulgaria for the period 1989–2004 was −8% (Economic survey of Europe, 2005). Moreover, the Bulgarian government has to lower its high unemployment rate, balance the current account deficit, and finalize the remaining privatization agreements, together with the elimination of the remaining monopolies.

An issue that is of much importance nowadays is the future prospects of Bulgaria within the European Union, as Bulgaria and Romania finally joined the European Union on 1 January 2007, being the 26th and 27th EU members respectively. Therefore, it will be an interesting and challenging topic for future research to analyze and predict the costs and benefits to Bulgaria of its membership to the Economic and Monetary Union (EMU).

Notes

1. Central and Eastern Europe (CEE) refers to 28 countries: Bosnia and Herzegovina, Croatia, FYROM, Serbia, Montenegro, Slovenia, Hungary, Poland, Czech Republic, Slovakia, Estonia, Lithuania, Latvia, Romania, Bulgaria, Albania, Belarus, Georgia, Armenia, Moldova, Uzbekistan, Azerbaijan, Kazakhstan, Tajikistan, Turkmenistan, Kyrgyzstan, Ukraine, and Russia.
2. For example, between 1997 and 2003, accumulated FDI inflows in Bulgaria were only $754 per capita, whereas Croatia, Estonia, and Hungary had more than $2,000 per capita, and the Czech Republic more than $3,000 per capita (Bitzenis, 2006a,b, 2007b). We consider this to be a cause and effect for a delayed transition: the delayed transition resulted in a delayed privatization progress, therefore limiting FDI, and also, the lack of decisive FDI inflows resulted in a delayed transition, since the transition required financial support, the attraction of FDI inflows, and the diffusion of their spillovers into the economy.
3. A small, elite subset of the general population during centrally administered socialism who held various key administrative positions in all spheres of the economy and had more authority and claimed higher privileges; a kind of a ruling class.
4. The return of property to the rightful owners before the appropriation from the communist authorities.
5. Monetary overhang is a phenomenon where people have money holdings due to the lack of consumer goods. This is a phenomenon often present with repressed inflation and was a common occurrence in the Soviet Union and Eastern Europe. The solution to this problem is usually a swift burst of inflation.
6. As we already mentioned when Hungary had foreign debt of $21 and Poland $47 billion, but Poland's debt was forgiven when the shock therapy was launched.

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