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IN MEMORIAM:

DR. ROBERT KRIEBLE

(August 22, 1916 - May 8, 1997)

On May 8, 1997, Robert Kriebel, one of the founders of the Institute for Market Economics, passed away of heart failure. Here we publish some reflections of Dr. Richard Rahn, Chairman of IME International Advisory Board

It is rare to be able to make the unambiguous statement that an individual has made the world, not a better place, but a significantly better place, because of what he has done during his life. Bob Kriebel was one of those very rare individuals -- a world-class scientist, a highly successful entrepreneur and businessman, a philanthropist, an adventurer, an extraordinary fighter for freedom and liberty who altered the course of history, a visionary, and always a kind and generous gentleman.

Bob Kriebel invented what are commonly known as super adhesives where the bond is stronger than the materials it holds together. This invention has made life better and easier for virtually every manufacturer, hobbyist and homeowner on the globe. He literally changed the way many things are put together, from engines to toys. Starting with \$100,000 from family and friends in the 1950's, he built a billion dollar multinational corporation. He created tens of thousands of well-paying jobs all over the world.

Bob was a distinguished chemist who did not forget that the scientific method has equal applicability to the political and economic sciences. He was a successful entrepreneur and investor because he understood it is better to place your assets in those countries that are pursuing relatively pro-growth economic policies, and are moving towards freedom rather than away from it. Though not a trained economist, he understood far better than many in the economics profession that low tax rates, a low level of economic regulation and government spending, sound money, and strong enforcement of property rights and civil contracts do far more to better the human condition than government transfer payments. He not only understood these things, he acted to bring them about across the globe through his energy and his financial support of politicians and institutions that were moving the world towards freedom and away from statism.

There are literally dozens of pro-democracy and pro-free market institutions that Bob Kriebel generously supported, and in many cases helped to create. For example, he was one of the key early supporters of both the Heritage Foundation and the Free Congress Foundation. In addition, he gave away millions to help individuals who were in trouble all over the world, whether it was because of personal hardship, or because some totalitarian thug was trying to suppress the liberties of the people. His wonderful family, wife Nancy, daughter Helen, and son Fred shared his values, and have been supporting his work in their own right.

When the conventional wisdom was that the Soviet empire would go on many more years, Bob Kriebel saw the rot and decided to push the demise

a bit faster. In the 1980's he began financially supporting many of the dissident pro-democracy groups in Eastern Europe and the Soviet Union. He bought and delivered to them computers and fax machines. The US media, business, and political establishment ridiculed him. Business Week ran a derisive article entitled, "The Quixotic Quest of Robert Kriebel." Bob, of course, remained undeterred, and as usual was soon proven right, as the walls came a-tumbling down. Bob not only fought communism and helped to speed its demise, but understood that the destruction of communism was not enough. He realized that to have a safe, prosperous, and free world, you have to have people in place who understand democracy and free markets. He created the Kriebel Institute and spent millions of dollars of his own money on building a network of influential people in the former communist countries, and on political and economic training, to help ensure that qualified people would be available to serve in the new non-communist governments.

Almost no one in the United States had heard of Boris Yeltsin until Bob Kriebel got some of the Republican Congressional leaders to invite him for a trip to the US, which Bob helped to underwrite. Bob was one of Yeltsin's first American friends and apparently had a strong influence on him. A couple of years after the fall of communism in Russia, Bob was attacked by some communist deputies in the Russian Duma and in the communist press, as the evil capitalist who brought down communism. Bob's response was to fly to Moscow and hold a press conference to respond to his critics. He began by explaining that as much as he was honored by their accusations, he felt that he could only take a little credit for the end of communism.

For all of his accomplishments and wealth, Bob was a modest man who sought few creature comforts.

In his travels in Eastern Europe and the former Soviet Union, he rarely stayed in the first class hotels -- in those few cities where they were available -- but preferred to stay in hotels that could be afforded by the locals, which most of us Americans viewed as only one step up from camping. In Washington, he drove a little Ford Festiva. After a typically hair-raising ride with him one day (Bob drove more like an eighteen-year-old than an eighty-year-old), I asked him why he did not buy a bigger and safer car. He said, "The less money I spend on myself, the more I have to give away."

Bob was a man of great physical courage and energy. The day the Russian tanks were shelling the Russian "White House," Bob was in Moscow. He walked to the Moscow river embankment down below the building so that he "could have a close look." Bob was a pilot who enjoyed flying acrobatic airplanes until he was well in his seventies. Scuba diving was another of his hobbies. On one occasion, a couple of the Novecon board members and I met him at the bar in the Radisson Hotel in Moscow. There he was sitting on the bar stool waiting for us, and after a bit, he casually informed us that he had spent the previous night in a hospital in Minsk because of illness, but there he was ready to go to work the next day in Moscow.

Bob was a rarity among businessmen; he did not try to curry favor in Washington, yet he was among the most influential of all businessmen in the Nation's Capital. The influence came, not just for his support of members of Congress who agreed with him, but because he was so principled. For example, when the US Chamber of Commerce reversed long-standing policies against socialized health care and tax increases, in a short-lived attempt to gain favor with the Clinton Administration, Bob Kriebel was among only a handful of Board members who had the courage to

resign in a public protest. Within a number of months he was again proven right, as the Chamber's membership forced it back to the principled position.

Many new companies around the world owe their very existence to Bob Kriebel. He delighted in helping new entrepreneurs, particularly in newly freed economies. He understood that without a vibrant private business sector in the former communist countries, democracy would not prevail. He often talked to me about the need to build business partnerships in the transition countries. As a result, he co-founded the Novecon companies with me in our attempt to create profitable entrepreneurial partnerships in the former communist lands. His love of new technology never waned. Just a few weeks ago, I took him to Novecon Technologies' new little silicon carbide wafer plant in Herndon, Virginia, to meet with Gene Lewis, Jim LeMunyon and the Russian scientists who had developed the process. He took a great interest in Gene's explanation of the new and unique technological process. On our drive back to Washington, he had the enthusiasm of a twelve-year-old boy as he slapped the dashboard and said, "Those fellows really have something there."

Bob Kriebel never gave up the fight for freedom. Each week, until he was stricken last month, he would commute from his estate in Old Lyme, Connecticut to his office and little apartment in Washington. He spent his time helping people, and advising and supporting political leaders, institutions, and influential individuals to do the right thing. After a life of extraordinary accomplishment, Bob Kriebel could have easily chosen a life of quiet retirement. Instead, he remained a vigorous revolutionary for free peoples and free markets to the end.

Richard W. Rahn
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BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

Accelerating Privatization Through the Use of Bulgaria's External Debt Bonds

Rossen Rozenov, AECD

Bulgaria is lagging far behind other Central and East European countries with regard to the privatization of state property. Five years after the Law on Privatization was passed by the Parliament, only 5% of state assets have been privatized. After the final auction of the voucher privatization plan, this share is expected to rise to some 20%. Still, the majority of the enterprises will be state-owned. The reasons for the poor performance will not be discussed here since there has been considerable debate on this topic recently. Rather, the purpose of this paper is to propose specific policies to accelerate the privatization process. One of the means of achieving a more rapid change of ownership is through the use of external debt bonds.

I. Development of Debt-Equity Swaps

Privatization through Brady bonds is a sub-set of a broader set of bonds which encompasses various forms of debt-equity swaps. In the general case of debt-equity swaps the procedure is the following: A bank sells at a discount an outstanding loan extended to a country that has problems servicing its liabilities. A private investor buys the debt paper and presents it later to the central bank of the indebted country. The central bank redeems the paper at a certain exchange rate and the investor uses the money to purchase equity. Historically, the development of debt-equity swaps began after the debt crisis of 1982, although several cases of similar transactions were recorded earlier. Many Latin American countries recognized the opportunity to deal with the debt problem and adopted relevant legislation. Brazil was the first to implement a conversion scheme, followed by Argentina, Chile, Philippines, Venezuela, Mexico and others. The speedy development of a secondary debt market facilitated to a large extent the process since loans had market value and the creditor banks could use the secondary market value to determine the discount at which to sell the loan. With the growing number of debt-equity swaps the rules and the regulations underwent major changes. The practice to allocate conversion rights and to set redemption

prices through government decrees was gradually replaced by a more competitive approach based on auction systems. Some financial innovations were introduced in the late eighties, like debt for trade swaps (Yugoslavia) and debt for conservation swaps (Costa Rica).

According to the definition provided above, debt-equity swaps involve the participation of at least three parties: a creditor, a debtor and an investor. These parties have different interests and therefore each of them tries to obtain as many concessions as possible from the others.

II. Advantages and Disadvantages for the Participants

The benefits for the creditor bank are usually associated with an improvement in its liquidity position. The outstanding loans to highly indebted countries are provisioned against losses and thus, by selling a loan, the bank can invest the freed resources in more profitable assets.

Banks also would prefer to diversify their loan portfolios and reduce the credit exposure which could become very high later. This is because many rescheduling agreements require new loans to finance the adjustment programs of debtors. Since those new loans were usually extended by creditor banks, their country's exposure increased. For the same reason, banks often engaged in asset trading which sometimes preceded debt-equity swaps.

It is generally believed that the gains for the debtor country arise from the reduction of the debt stock. In order to avoid confusion, it is essential to point out that what really matters for the debtor country is the net impact of the debt-equity swap on the domestic economy. For this purpose the most convenient tool to evaluate the effects of a swap appears to be the balance of payments analytical framework.

In the simple case where the redemption value is equal to the face value of the loan, the decrease in external liabilities is matched exactly by a corresponding increase in the foreign direct investment, leaving the foreign assets remain unchanged. The analysis becomes a little bit more

complicated when the redemption price differs from the face value. The difference between the decrease in foreign liabilities and the increase in the foreign direct investment is recorded as realized capital gain. The above examples are based on the assumption that the discount value of the debt is at least equal to the redemption value. (If the reverse holds true, the investor will refuse to engage in the transaction.) Thus from the viewpoint of the net external position of a country, the debt-equity swap is nothing but an exchange of one type of obligation for another. However, an important difference occurs when we consider the problem in dynamics, that is how the transaction will influence the current account of the balance of payments. In order to determine the net effect we have to compare the scheduled debt service with the factor payments associated with the investment. If the income transferred abroad is greater than the interest payments on the loan, the outcome will be a deterioration of the current account and ultimately a decline in the foreign exchange reserves. In the long run there are some important benefits that can arise from positive external factors. Since the investors who buy the equity are often multinational companies, the economy benefits from the technological innovation. The purchase of equity is usually associated with additional investments which have a positive influence on the capital account of the balance of payments and increase the availability of foreign exchange. The advantages for the investing company derive from the opportunity to buy property at terms more favorable than the company would get if it proceeds in the traditional way. Depending on the specific legislation of the debtor country, and the secondary debt market dynamics, the discounts can be quite significant.

Although debt-equity swaps can be beneficial in some respects to all the parties involved, certain problems can occur as well. Banks might face difficulties in complying with account-

ing standards and local regulations.

The impact of the debt-equity swaps on the economy of the debtor country is often assessed in relation to monetary policy. If the government and the central bank as its agent issue money when redeeming the paper, inflation may accelerate.

From the investor's perspective, the gains from the transaction may be offset by the restrictions on debt conversion operations which some countries introduce. Although these restrictions differ in details they can be classified in three main groups: (1) control on the repatriation of income and capital, (2) ceilings for payments with debt instruments, and (3) industry requirements. The majority of countries that engage in debt-equity swaps transactions impose some of the above mentioned limitations.

III. Country Experience

Argentina was among those countries that first passed regulations for debt conversion operations as part of a rescheduling package. According to the scheme adopted in 1984, the eligible debt was transformed into promissory notes which could be used for purchasing equity. Later the regulation was changed in a way that reduced the benefit to the investor. He was not allowed to pay with debt instruments more than 50% of the value of the investment. This requirement reflected the rising concerns of the local authorities that debt-equity swaps displace the inflow of fresh money that would have occurred otherwise.

In 1987 the scheme was again revised and the proportion of debt to fresh money was increased to 70/30 percent. Argentine's legislation also imposed limits on the repatriation of income (4 years) and capital (10 years). Similar to the Argentine case, in Brazil the repatriation of capital was banned for 12 years while dividends generated by investment could be transferred freely abroad, but only if they did not exceed 12% of the registered capital. In addition, foreign investors were not allowed to take

control over local firms through debt-equity swaps.

Jamaica's approach to debt-equity swaps provides an example of a sector specific conversion scheme. In compliance with the debt capitalization program of 1987, the Bank of Jamaica determined the "priority areas" for which investors could apply. Some of the preferred activities included the construction of hotels and factories, and the production or processing of export goods. The amount of debt eligible under this program was US \$500 million and the government's intention was to achieve a 50% reduction of the debt stock in five years. In order to provide additional incentives to investors to engage in particular businesses, the Central bank charged different commission fees for different projects.

The last case that will be reviewed is the Mexican debt conversion program. The experience of Mexico is relevant to our discussion because it is the first country that accomplished debt restructuring under the Brady initiative. In the case of a debt-equity swap generally, we assume that the creditor bank wants for some reason to dispose of a loan by selling it to an investor. Although the analytical framework presented above did not explicitly envisage the conversion of Brady bonds into equity, the same consideration is valid.

The new conversion program of Mexico, enforced after the Brady deal, limited the scope of the debt-equity swaps to only the purchase of state-owned companies and participation in infrastructure projects. The debt instruments that could be used in privatization were discount bonds and par bonds. Up to 50% of the value of the investment could be paid with Brady bonds. The swap mechanism was based on auctions. Discount bonds could be converted at face value while the conversion rate for the PAR bonds was no more than 65% of the face value.

IV. Restructuring of Bulgaria's External Debt

In the period 1985-1989 Bulgaria recorded a growing deficit in its convertible currency trade. Two factors contributed most to the deterioration of the trade balance in the second half of the eighties. These are the decreased supply of Soviet oil which was previously re-exported to the OECD and developing countries, and the loss of competitiveness in the manufacturing sector.

The serious current account problems, coupled with an ambitious investment program, forced Bulgaria to borrow heavily from the international markets. As a result, the external debt rose to US \$9.2 billion in 1989, or 272% of all exports of GNFS.

National Bank of Poland, which together held some US \$540 million of Bulgarian debt, decided to arrange their claims on a bilateral basis and did not participate in the restructuring agreement.

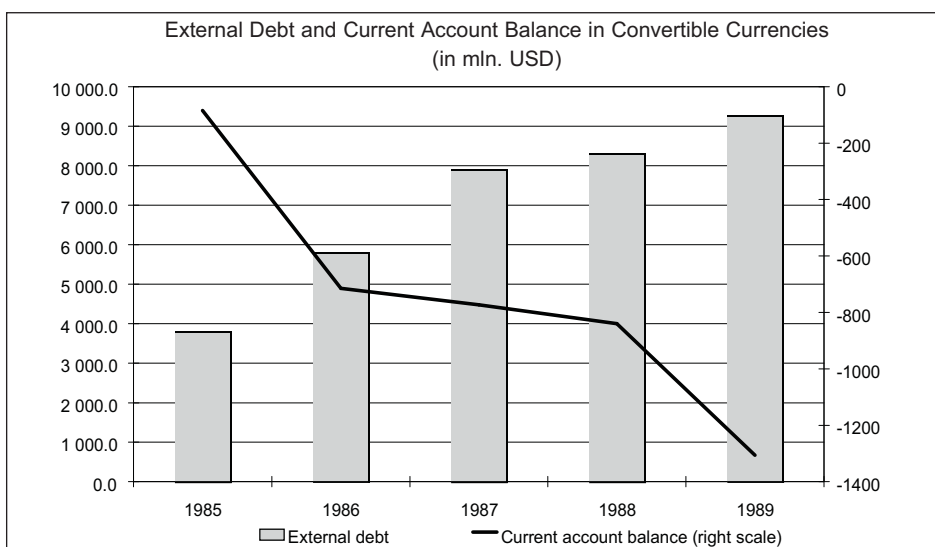
The total debt and debt service reduction operation costs are estimated at US \$740 million. These include:

- US \$257 million for the buyback of US \$1.02 billion of debt at price 25.19% of the face value;
- US \$219 million for the purchase of 30-year US Treasury bonds that serve as a collateral of the newly issued bonds;
- US \$170 million for the purchase of US Treasury bonds maturing in 1995 which cover the interest payments for 1995.

V. Debt Conversion Activities in Bulgaria

The legal foundation for debt-equity swaps in Bulgaria was laid by Regulation No. 278 of the Council of Ministers approved on November 26, 1994. This government's act practically enforced what already had been agreed in principle with the creditors under the terms of the London Club deal. The regulation respects the important principle of non-discrimination so that any holder of eligible bonds, irrespective of nationality, can participate in privatization through debt conversion. Only two out of the three instruments issued after the restructuring of Bulgaria's foreign debt can be used in privatization. These are the discount bonds and the front loaded interest reduction bonds. Discount bonds are exchanged for equity at face value and FLIRBs at 50% of their face value. (The different treatment creates a strong bias in favor of the DISCs since their current market price is about US \$0.60 per dollar while the price of the FLIRBs is US \$0.43 per dollar par value. A possible explanation for such an approach, which violates the principle of neutrality between the different instruments, is connected with the fact that at the time when Regulation 278 was prepared the FLIRBs were twice less expensive than the DISCs. The authorities did not take into account the fact that the relative price of the FLIRBs was likely to rise with the increase of the interest rate in compliance with the debt servicing schedule.)

The lev value of the bonds is determined by multiplying the dollar value by the average central bank exchange rate for the six month period preceding the date of the privatization contract. The backward looking approach was adopted because of the high volatility of the Bulgarian foreign exchange market. Clearly, when the exchange rate is appreciating investors lose value in levs compared to the situation when the bond is converted at the prevailing rate



In March 1990 the Bulgarian government announced a moratorium on the principal repayment after foreign exchange reserves were depleted. It took more than three years of negotiations to come to an agreement with the foreign creditors. The deal with the London Club was finalized in July 1994 and Bulgaria resumed the debt service in accordance with the adopted plan. The Bulgarian Brady deal covers the total amount of US \$8.13 billion outstanding debt, of which US \$6.11 billion principal and US \$2.02 billion interest overdue. About 300 foreign creditor banks joined the London Club. Russian banks and the

The overall debt reduction of 36.8% placed the Bulgarian Brady deal among the most favorable ones achieved by debtor countries. After the restructuring the amount of the outstanding debt is US \$9.1 billion of which US \$5.1 billion to holders of Brady bonds.

Three debt instruments were issued under the agreement with the private creditors: (1) collateralized discount bonds (DISCs), (2) front loaded interest reduction bonds (FLIRBs), and (3) interest arrears bonds (IABs). Table 1 summarizes the main characteristics of these bonds.

when the deal is made. Regulation 278 in its initial form did not contain clauses imposing restrictions of the kind that is often encountered in other countries' debt conversion programs. There were only several cases where Brady bonds could not be used: (1) in privatization of municipal property, (2) as a means of payment when there is a direct sale of shares, and (3) to cover penalties for the breach of privatization contracts, taxes, fees and other claims of the state.

Later however, when the socialist government took office in the beginning of 1995, the conversion regime was revised in a way that discouraged investors to engage in debt-equity swap transactions. According to the amendments in Regulation 278, the investor must take the obligation not to repatriate income generated by the investment for 4 years and capital for 10 years and the privatization authority cannot accept payments with Brady bonds exceeding 50% of the value of the transaction. There is enough evidence that the introduction of a debt-equity swaps program gave an impetus to the privatization process at the beginning. Some of the biggest privatization deals were paid for with Brady bonds. It should be stressed that the most significant transactions took place before the restrictions on repatriation and payments were imposed.

VI. Policy Recommendations

Bulgaria is preparing for the introduction of a currency board by the middle of 1997. The currency board is expected to ensure a stable macro-economic environment which is essential for the revival of economic activities. However, no stabilization program, no matter how strong it may be, is likely to be successful unless it is accompanied by fiscal and real sector restructuring. The Bulgarian experience of the last two years is an outstanding example in this respect. The approach to economic reforms of the former socialist countries has shown that restructuring should follow privatization. Restructuring will hardly occur under state control of the prop-

erty, or if it does, it will not be market based and could further increase distortions and inefficiencies instead of abolishing them. Therefore, in order to ensure the sustainability of the currency board a massive transformation of ownership must be accomplished.

The interim government that was appointed in February declared its strong commitment to fast and transparent privatization. There is no doubt that supply is important, but it is only one side of the market. It is equally important to have sufficient demand to match the supply. This is the key point which must be stressed. While the supply is entirely under the control of the authorities, the government can do very little about demand. Still it can facilitate the access to privatization by implementing the proper policies.

The first thing that needs to be achieved is to regain the confidence of the economic agents through a strong stabilization program. Investors, both domestic and foreign, should be convinced not to exercise the so-called "waiting option" but rather to invest their money in productive capital. But this is only the "macro" part of the story. On a micro level, even though many Bulgarian investors are willing to take part in privatization, they may not be able to do so because of the shortage of resources. The recent economic developments have led to a severe reduction of savings.

The debt-equity swaps provide a good opportunity to acquire equity cheaper than a 100% cash payment. If the low level of gross national savings is taken into consideration, the clause which limits payments in Brady bonds to 50% of the value of the investment is irrelevant to the current economic situation and should be discontinued. It has to be mentioned that the legislation allows the

remaining 50% to be paid in domestic debt bonds. The Privatization Agency, however, has the authority to require cash payment. (This was done in 1996 but later was abandoned.) The best approach to the issue would be to restore the previous regime and leave investors to decide what combination of instruments to choose. If there are a lot of bids for a particular enterprise, the Privatization Agency can organize auctions and choose the best terms. This will make the process transparent.

The restrictions on repatriation of income and capital are not unusual in the practice of developing countries. Unlike the Latin American countries which enjoy enough interest on the part of foreign investors, Bulgaria faces difficulties in attracting capital from abroad. Maintaining the present regulations is counterproductive since the country risk is still high and investors require trustworthy guarantees that they will be able to get their money back.

Direct investments are essential in the restructuring period, especially when the internal sources of the economy are insufficient to carry out the necessary reforms. Foreign investors often choose export-oriented industries which helps the country to improve its trade balance. The gains from the enhanced export performance can offset the outflow of income and thus the overall effect for the balance of payments will be positive. There are a number of indirect benefits to the economy arising from direct foreign investment, like increasing employment and a growing tax base. The technological innovation and more efficient management practices that are usually associated with new investments can significantly increase productivity and restore economic growth.

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The Exchange Rate Fixing After the Currency Board

Estimation by IME

Introduction

The level at which the exchange rate will be fixed is one of the most significant elements of the currency board regime. According to the IMF experts and Bulgarian decision-makers the BGL will be pegged to the current market level at the moment of the introduction of the currency board. And here the question whether that level is the long-term exchange rate level arises. Or, in other words, is that the long-term trend of the exchange rate level?

The currency board is a long-term decision and its parameters must be based on characteristics prevailing within a longer period of time. The proposals in the press for BGL 1600/USD, or BGL 1000/DEM (with a ridiculous DEM/USD ratio) are based only on the macroeconomic stability in terms of interest rates and exchange rates since February, 1997.

Background

In end-1996 the government simply printed BGL 115 bln. to finance the deficit. Before that the budget covered its deficit through T-Bill issues. The biggest clients were the commercial banks. Their balance sheets comprised mainly of short-term obligations and non-performing loans and they demanded high liquidity and yield on the debt. Banks tried to fill the gaps in their balance sheets with short-term investments in government securities with high yield. That led to the issuance of short-term securities and expensive for servicing debt. The huge primary surplus acquired in 1996 was not sufficient enough to cover the interest expenditures and the money printing remained the only way for servicing the government debt.

The combination of high liquidity in the economy and the political instability in the beginning of 1997 induced strong inflationary expectations. Most of the people withdrew their savings from the banks and converted them into hard currency. The exchange rate reached the record level of BGL 3000/USD, consumer prices increased by three times compared to end-1996.

The monetary policy since February

After the severe crisis in February the monetary policy was changed in two aspects: first, the Central Bank suspended refinancing the commercial banks; and secondly, the Basic Interest Rate (BIR) being not determined by the BNB Board any more, but on the weekly T-Bill auctions. The Ministry of Finance has been daily issuing seven-day and four-week T-Bills without setting a minimum

acceptable price. The idea was to direct the banking system's resources previously used in BNB repo operations, to the debt market, the BIR therefore determined under a sustainable money supply.

The outcome was quite encouraging. The BIR fell from 18% per month in March to 4.2% per month in the second half of May. The exchange rate "froze" at about BGL 1500/USD. The most important question here is whether we can consider that stabilization to be a sustainable one and whether we can fix the exchange rate at BGL 1500/USD.

The BIR is now determined as a weighted average of one- and four-week T-Bills' yield (since May, 26, the Ministry of Finance stopped issuing one-week T-Bills). The yield on four-week T-Bills is by 30% higher on annual base than the yield on the one-week ones, which makes the weighted average calculation of the price of money quite unreliable. The huge liquidity premium means that the market participants expect a depreciation of the local currency before the introduction of the currency board.

There is one more consideration which proves the unsustainability of the macroeconomic stabilization. The budget deficit accumulates almost all the savings in the banking system which allows for a very modest credit to non-financial institutions. Money is still being transferred from the banking system to the government and vice-versa, which inevitably will lead to reiteration of 1996: monetization of the debt and new inflationary shock.

Our opinion is that the current levels of interest rate and exchange rate are unsustainable. The high long-term interest rate is a serious proof for that. Therefore, the current exchange rate must not be used while preparing the macroparameters of the budget.

The deficits in the economy

It is quite reasonable to use the deficits in the economy as a starting point in the discussions on the exchange rate. The argument here is that the BGL denominated deficits will be covered by hard currency incomes and the level of the exchange rate should be so established that the

Table 1

Demand:	Amount:	Sources:	Amount:
Monetary Base	BGL 1,414.2 bln.	Foreign Exchange Reserves	USD 1,145 mln.
Banking System	USD 150 mln.	Portfolio Investments	USD 300 mln.
External Payments	USD 450 mln.	Direct Investments	USD 250 mln.
Budget Deficit	BGL 592.8 bln.		

demand and the supply of resources given in the economy becomes equals.

Our estimation is based on the following scenario: Just before the introduction of the currency board the short-term component of the debt will be monetized in order to prolong the debt maturity and facilitate its servicing. Money printing "for the last time" before the introduction of a restrictive stabilization program is an ever repeating scenario in Bulgaria since the World War First. A pure example of that kind of policy is the German postwar stabilization program in 1923, which is considered as a prototype of a stabilization program. Monetization of the short-term debt will increase the monetary base to BGL 1,414.2 bln. in end-June. This monetary base will have to be backed by a certain amount of foreign assets.

The other gap in the economy is the banking system. We completely rely upon the IMF estimation which calculates that gap to USD 150 mln., the deficit of the non-financial enterprises included as well. The real sector financed its losses through the banks causing a great shortage in the financial system. In other words, the deficits in the financial intermediaries reflects the deficits in the real sector.

Table 1 summarizes our assumptions for the sources and the way of distribution of the financial resources.

The level of the exchange rate which equals the two sides is BGL 1833 /USD

Conclusions

From the point of view of the deficits in the economy the exchange rate aims at BGL 1833/USD. The primary factor in every economic crisis is the big difference between the deficits and the real growth. When the growth is not sufficient to cover the deficits, a fiscal need for inflation appears. Both inflation and real growth play a role, though from opposite starting points, in equilibrating the economy. The currency board regime a priori denies inflation as a stabilizing factor and therefore the economy needs certain resources to make up for the inflation tax.

The above calculations are made under certain assumption for the capital inflows in the country. Under other possible assumptions the level of the exchange rate will be different.

Investor's Guide

MONETARY POLICY

IN 1997

Monetary policy in 1997 differed markedly from those of 1995-1996. Monetary reserves increased by 132% from January-March 1997. Price levels increased more than five times within the same period. The figures suggest that monetary policy was rather tight and that the money supply decreased in real terms.

The Bulgarian economy went through hard times in February. The foreign exchange rate peaked at BGL 3000 to the USD. The inflation rate was 242.7%. The huge monetization of the government debt at the end of 1996 underpinned both the high inflation rate and sharp depreciation. The government printed 115 billion BGL (US \$236 million) in order to finance the budget deficit. A lot of money entered commercial banks and households. The combination of increased liquidity and political uncertainty induced high foreign exchange purchases.

Table 1 Central Bank balance sheet (BGL bln.)

	12.96	03.97	Change (%)
Net foreign assets	89.5	392.4	338.4
Net claims on Government	68.4	72.7	6.3
Claims on commercial banks	255.2	439.4	72.2
Other assets (net)	-166.2	-331.6	-1145.7
Reserve money	246.9	572.9	132.0
Exchange rate (eop)	1021.9	2045.5	567.9

The Central Bank responded to the sharp depreciation and high inflation rate in February with a restrictive policy. Refinancing of the commercial banks dropped substantially in March. Also, the Central Bank no longer determines the prime interest rate. Instead, the prime interest rate is determined by the government bond auctions. The Ministry of Finance has been auctioning 7- and 28-day treasury bills on a daily basis. The idea behind these changes was to shift the money from repurchasing agreements toward government bonds and to let market forces determine the interest rate under a tight money supply. One can only speculate whether the interest rate at the auctions represents equilibrium or not, given the divorce between the monetary layer and the real economy. However, the results were rather encouraging. Interest rate dropped from 18% to 5.2% monthly, and the exchange rate was quite stable at around BGL 1500 per USD.

The important point is whether the monetary stabilization achieved in March and April is sustainable or not. In the long term, tight money brings about an increase of the debt in real terms and reduces real growth. A higher inflation rate is required in order to service increased real debt. If the government is not going to rely on inflationary taxes, it is important to support a tight money policy with supply-side reforms. The heart of the supply reforms is privatization. The privatization in 1995 and 1996 was rather slow. The Privatization Agency and branch ministries are the only points where sellers meet buyers. The establishment of a modern national stock exchange is a useful step toward more simple privatization procedures. We expect the government to issue shares of the state-owned enterprises on the stock exchange in order to speed up privatization.

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The Biggest 500 State Owned Enterprises

Selected Profiles!

Chimko SPJSCo.

Chimco SPJSCo. is one of the blue chips of the Bulgarian industry. The company has a strong market position in USA, France, Turkey, and Greece.

A new USD 50 mln. carbamide line is to start in September 1997. The capacity of the new line is 1800 t.per day.

Recently Chimco SPJSCo. signed an export contract with China. We expect both the macro-economic stabilization, associated with the establishment of the Currency Board at July 1, and higher foreign demand to boost sales in the second half of 1997.

	1994	1995	1996
Sales (mln.BGL)	5866.8	10177.2	27543.1
Total assets (mln.BGL)	5598.7	6757.0	n.a.
Current ratio	0.44	0.98	1.6
Equity (mln.BGL)	2699.8	2699.8	2699.8
Profit margin	1.0%	13.9%	19.4%
EBIT (mln.BGL)	1094.3	3033.7	5765.8
EBT (mln.BGL)	251.0	2595	3708.1
EBIT per share (BGL)	0.41	1.12	1.37

Product line: mineral fertilizers

Export	85.9%
Number of shares	2699833
Min.share price (BGL)*	1467
Max.share price (BGL)*	25000
Avg.share price (BGL)*	1897

* Prices at the first mass privatization auction

Kremicovci SPJSCo.

Kremicovci SPJSCo is one of the biggest loss-makers in the economy. The company has difficulties in covering its current liabilities.

However, steady revenues from abroad suggest that Kremicovci SPJSCo has a good market position in Russia and the Middle East.

There is a plenty of room for efficiency improvement. The 17,000-employee workforce is far too high, according to western standards. Efficient management could substantially improve the company's financial position.

	1994	1995	1996
Sales (mln.BGL)	21437.4	37232.5	68580.9
Total assets (mln.BGL)	31572.8	37351.6	n.a.
Current ratio	0.75	0.68	0.78
Equity (mln.BGL)	16287.9	18521	18521
Profit margin	-0.2%	-2.4%	0.3%
EBIT (mln.BGL)	-847.8	787	-13491
EBT (mln.BGL)	-1917.5	-642.7	-19728.2
EBIT per share (BGL)	-0.05	0.05	-0.7

Product line: cast iron, ferroalloys, steel

Export	18.5%
Number of shares	18520995
Min.share price BGL*	840
Max.share price BGL*	25000
Avg.share price*	1066

* Prices at the first mass privatization auction

No Comment! But Fingers Crossed

Excerpts from the Program of the Government of Bulgaria: 1997 - 2001

Foreword

The new Bulgarian government is the first to present a program on the day it is elected. It was made available to the IMF and the World Bank resident missions in English. This is a 109 page document. Here IME reprints some excerpts which constitute an interest for those looking at Bulgaria's economic performance and investment opportunities.

These are excerpts from the most elaborated parts of the Program, dealing with fiscal stabilisation and structural reform. In addition, these are parts that with some timetable and deadlines. Other parts of the Program lack an agenda. Fiscal and structural deadline have been borrowed from the IMF agreement and cover the period till the end of 1998. What is after is difficult to figure yet.

There is a good chance to succeed in the implementation of the austerity efforts. The reprinted parts give a list of indications which one should attempt to look at in the near future.

Krassen Stanchev, IME

Fiscal Stabilisation

..."The introduction of a **currency board** means that the government commits itself to an economic policy incorporating the following main elements :

- fiscal policy that does not require borrowing from the Central Bank on the part of the state budget;
- reforms in the financial and the banking sectors that will restore the confidence in the banking system and will guarantee its stability;
- reform in the real sector that will ensure the adherence to strict budgetary constraints on the part of all economic agents in the state-owned and private sectors;
- reform in the health care and the budgetary sphere (education, army, etc.);
- other structural reforms including acceleration of the land reform, price and trade liberalization and especially agriculture, as well as removing the obstacles to market development and foreign investment.

The fiscal strategy should be viewed in the broader context of the goals of economic growth and financial stabilization in the conditions of a monetary policy based on the currency board institution. From this standpoint, the role of the fiscal policy is brought down to the following :

- termination of inflationary budget financing;
- coordination of the goals of financial stabilization and structural reforms;
- efficient allocation of the scarce financial resources;
- provision of an adequate social safety net.

The goals of the **fiscal policy** in 1997 are as follows :

- prepare a state budget that eliminates the need of financing from the Central Bank. This goal requires a primary surplus in the consolidated government budget of 4.5% of GDP in 1997;
- impose restrictions on the issue of new domestic Lev debt and reduce the burden of interest payments on the budget.

The achievement of the budgetary goals depends on the revenues from privatization and on foreign financing, the latter being subject to meeting the criteria under the agreement with the IMF. During the year, significant budgetary and administrative measures will be introduced in order to reduce and ensure control

of expenditures, as well as adjust their structure. The stabilization of the revenues in the budget shall be achieved through specific measures to improve tax collection.

The middle-term fiscal strategy is directed toward guaranteeing the financial stability of the economy and creating conditions for high economic activity.

- The main task facing the budget is to ensure normal debt service which requires a primary surplus in the range of 4.5-5% of GDP during the first two years of the period in question. This limits the capacity of the budget to direct resources to the main budgetary systems. The latter's normal functioning shall be ensured by the following : restructure and optimize state expenditures including discontinuation of unessential items and transfer of certain activities from the state to the private sector, reduce the staff in the budgetary sector and improve its efficiency.

- The tax system improvement toward implementing the main tax principles of the market economy shall be subordinated to the most efficient possible mobilization of domestic resources.

- The main goal of the tax policy shall be to widen the tax basis together with reduction - following careful estimation - of the tax rates.

- Increased tax collection shall be based on the strengthening of the tax and customs administration.

- The revenues from privatization and the fiscal restrictions will enable the implementation of a program for the slow reduction of **government debt**. This will, in turn, create possibilities for the gradual redirection of lending resources to the production sphere. The delay of the structural reform in the real and financial sectors, as well as the extremely low financial discipline in the whole economy led to the accumulation of a disproportionate government debt. In order to discontinue the trend of domestic government debt expansion, the policy pursued shall be that of reducing the budget deficit even in the current as well as in future years. The current practice of transforming losses and deficits incurred by the real sector into government debt shall be perma-

nently discontinued.

- In order to ensure the unimpeded domestic debt service under the currency board (i.e. no possibility of its refinancing from the Central Bank), a special fiscal reserve will be employed, the funds of which shall guarantee the liquidity of the budget even under unexpected collapses in the budget cash flows.

- The optimal government debt management shall rest on the understanding that government securities are not solely for fiscal purposes but contribute to the development of the money and capital markets and for the stabilization of the financial system as a whole. Our efforts shall be directed toward the following :

- bring the debt maturity structure to a normal status;

- further liberalize the access of foreign investors to the domestic government securities market;

- bring the conditions and functional form of the new government debt issues in accordance with international standards;

- smoothen out the imbalances in the schedule of maturity of government securities and restore the calendar principle in the government's securities issue policy;

- encourage smaller non-bank investors to invest in government securities by diversifying the available government debt instruments;

- create prerequisites for the development of secondary government securities markets by introducing amendments to the current legal framework and improving the financial infrastructure;

- participate in international capital markets with appropriate bond issues with short-term and middle-term maturities, following careful analysis and precision in the preparation of the respective strategy."

..."The **banking system** suffered a severe blow in the spring of 1996. Fifteen banks were put under conservatorship, after which bankruptcy procedures were initiated. The banking system shall be rehabilitated prior to the introduction of the currency board. Weak and non-liquid banks shall not be admitted to the currency board system.

The stability of the banking system shall be the main goal and shall be based on the following principles and measures:

- State banks shall be supported in terms of maintaining adequate solvency and liquidity only in the context of fundamental changes in their management : either by management contracts or by privatization, both before and after the introduction of the currency board. The management contracts will be concluded with reputable foreign financial institutions and will be coordinated with the IMF, as well as aim to prepare the banks for privatization by increasing their debt collection and reducing the size of the banks.

- Rehabilitation of the banking system through the adoption and full implementation of international legal and bank supervision standards, and creation of a permanent deposit guarantee scheme. To this end, it is envisaged by the end of 1997 to introduce a self-financing scheme that will provide the depositors' security in accordance with the directives of the European Union.

- Parallel with the laws governing the introduction of a currency board, review of all banking supervision regulations issued by the Central Bank, as well as regulations on the capital adequacy, classification of loans, open currency positions and liquidity. As a result of this review, revised regulations that take into account international practice and the currency board institution will be approved.

- Development of achievable performance indicators regarding the capital adequacy of all banks. The banking supervision's key goal will continue to be the provision of conditions for all banks to work toward these targets. Changes to the capital adequacy regulation shall be introduced in order to reach international standards.

- Increase the confidence in the banking system through accelerated privatization of large state-owned banks. We intend to attract stable and reputable foreign investors whose presence in the Bulgarian banking sector represents a condition for increasing the level of management and the quality of financial services offered. We shall renew banking regulations to

the same end - the creation of a favorable investment environment in the banking sector."

Structural Reform

..."We shall carry out a **speedy, complete and irreversible privatization of enterprises** by employing all possibilities for the purpose, namely :

- sale of enterprise shares to Bulgarian and foreign buyers under full transparency and competition;

- sale of enterprise shares to employees under alleviated conditions;

- sale of parts of enterprises and small enterprises through auctions and bids;

- sale of enterprise shares on the stock market;

- sale of the control packages of large structurally important enterprises to strategic investors with the aid of leading international consultants and agents;

- offer enterprise shares against vouchers in the second wave of mass privatization;

- partial or complete privatization of the large infrastructure and production monopolies after their restructuring.

In order to accelerate the privatization process it is necessary to make serious changes in the procedures and the legal base but at the same time a complete turnaround in the approach toward privatization on the part of the government bodies directly or indirectly responsible for the process is also needed. In order to achieve our main goal - **to privatize all industrial and commercial enterprises, as well as a large part of the infrastructure by end 1998**, we shall carry out the following :

- remove the obstacles in the legal base by simplifying and coordinating the procedures for the preparation and completion of privatization deals;

- introduce structural changes in the bodies carrying out the privatization process in order to optimize the cooperation between them;

- make the required staff changes in all levels of the privatization bodies in order not to block the process through the indifference or biased interests of government clerks;

- clearly spell out the possibilities for employing mediators in privatization

deals, as well as employ highly qualified and motivated consultants who will complete a large part of the privatization deals on their own;

- encourage the quick sale of residual shares of partially privatized enterprises so as to enable the state to completely retire from the enterprises with predominantly private participation;

- attract strategic investors for the structurally important enterprises by means of an active targeted marketing strategy;

- prepare and carry out a program on the registration of state-owned shares and other securities, their public sale and trade on the stock market;

- prepare and carry out the second wave of mass privatization by amending the legal base and the procedures in such a way so as to avoid the weaknesses, errors and the unfavorable outcomes of the first wave. Simultaneously, we shall rouse the interest and enhance the opportunities for the Bulgarian citizens to participate in the voucher privatization;

- at the very beginning of our government, we shall approve a decision to privatize all state-owned enterprises by reducing the list of those that will remain predominantly state-owned to a minimum."

..."We receive a heavy inheritance. An enormous number of the **enterprises in the state-owned sector generate losses daily**. The accumulated debt of these enterprises and the open or hidden subsidizing of many of them is actually falling on the individual Bulgarian. **The reduction of the losses in the state-owned sector is one of the main elements of the structural reform during the preparation and completion of the privatization process.**

One of the main tasks of the Government will be **to discontinue the evil practice of accumulating losses by state-owned enterprises**, which directly harms the Bulgarian taxpayer. The reduction and termination of losses in the public sector shall represent one of the priorities of the structural reform. The streamlined restructuring of the Bulgarian industry will accelerate the formation of market relations.

The Government commits itself to

eliminating 30% of the losses in the public sector in 1997 (based on the end 1996 financial statements). Throughout the mandate of this Government, by 2001, 90% of the losses in the state-owned sector of the economy shall be eliminated. The possibilities for generating new losses shall be precluded.

Besides privatization, the Government shall undertake some other decisive measures to reduce the losses in the public sector, as follows :

- The process of liquidation of enterprises and businesses incurring constant losses from their main activity shall be accelerated. The line ministries shall set up appropriate structures to handle the liquidation and financial rehabilitation of the loss-makers. The most widely used option shall be the possibility for voluntary closure of loss-making enterprises as stated in Chapter 17 of the Trade Act. The Government shall propose such amendments to the Trade Act, The Law on Concessions, and the Privatization Law so as to accelerate the process of voluntary closure of state enterprises. We shall propose amendments to Part IV of the Trade Act in order to accelerate and optimize the forceful initiation of bankruptcy procedures on loss-making state-owned enterprises.

- With respect to the enterprises whose business is profitable but are nevertheless loss-makers due to their super-indebtedness, the Government shall set up a special program for quick debt-for-equity swaps. The structures under the line ministries dealing with the liquidation and financial rehabilitation of the loss-making enterprises will represent the main agents in the debt rescheduling and reduction and debt-for-equity swaps against shares from the state-owned enterprises. One of the Government's goals shall be to establish a transparent debt market which will facilitate the speedy restructuring of state-ownership in Bulgaria.

- The Government's legislative program shall include amendments to the Trade Act, the Privatization Law, The Law on the Financial Rehabilitation of Enterprises, the Law on Concessions, etc., in order to regulate the accelerated debt-for-equity swapping."

..."In the conditions of real markets, the good investment policy represents one of the conditions for long-term sustainable growth, modernization of production and the economic and social life as a whole, for becoming internationally competitive. This represents investments on the part of individual economic agents who prefer to postpone consumption today and invest in a higher future income, to take the risk of losing their own financial resources and make maximum efforts for the success of the business they have invested in.

We shall encourage every investment that brings money in the Bulgarian economy, creates jobs and brings tax revenues. Due to the almost complete de-capitalization of the economy, foreign investments meet these conditions closest and that is why they need to be encouraged. The Government shall develop a concept on the rehabilitation of the investment climate as a whole. A package of measures shall be proposed, aiming to improve the business conditions in the country, including the following:

- Set up a system for open and free access to investment information.

- Develop as clear and transparent as possible procedures in privatization, concessions, state and municipal orders, etc.

- Encourage small and medium sized businesses, the backbone of every economy. It is namely the functioning of small and medium enterprises that creates conditions for the development of the local market and the growth of market demand and consumption.

- Create favorable conditions for directing investments toward unfinished construction in order to speed up its commissioning at relatively lower investment costs.

- Tax policy that encourages economic growth and reinvestment through adequate treatment of depreciation and expenditures for investment.

- Available lending resources for investment : we shall ensure equal access to lending capital for all. We will create favorable conditions for crediting small and medium sized businesses. The Bank for Investment and Development must be set up by the end of 1997."

April 1997
