

Editor's Note

In this issue we publish the IME overview of recent economic development in Bulgaria. This paper is intended to be presented to the members of the Senate of the Republic of France. It is a shorter version of 1998 IME report on Bulgaria's Current Economic Situation and Long-Term Growth Prospects. The report per se is an attempt to reflect country's economic development in a broader institutional perspective, not merely extrapolating current trends but rather taking into account policies, an international context and the administrative capacity to follow certain policy paths. The 1997 edition was a part of a larger report, "Bulgaria: Risks of Political Future," drafted jointly by the Center for Liberal Strategies (CLS) and IME, and published and circulated by the UNDP. The goal of the paper is to provide an orientation, rather than a full account of possible developments.

Drafting team: **Svetlana Alexandrova**, Ph.D., Senior Economist; **Andrey Ivanov**, Ph.D., Senior Policy Analyst; **Asia Yonkova**, **Lachezar Bogdanov** and **Georgi Stoev**, Economists. In certain sections, we used calculations made by **Rossen Rozenov** and **Tzvetan Manchev**, part-time 1996 and 1997 IME researchers. **Krassen Stanchev**, Ph.D., IME Executive Director, is responsible for putting the paper together.

Also inside:

Georgi Stoev
on privatization schemes and
property transfer

A supplement with selected
macroeconomic indicators

Briefly
On the 1999 Budget

Bulgaria: Economic Situation And Developments

IME

Background

Bulgarian economic reforms began in February 1991, but have had an uneven history. The philosophy of the reform agenda was similar to that of Poland, but succeeding Bulgarian governments failed to stick to it and implement it. In 1993-1996, privatization had virtually stopped, elements of central planning (price controls, transfers to loss-making state-owned enterprises, central government control over these enterprises, political control over central bank's board and policies, etc.) were restored, and in early 1997, the country entered a hyperinflation curve.¹ The only feasible way to restrict the printing of money was to undertake a political change, eliminating the political element in the central bank's activities by fixing the exchange rate and the introduction of a currency board arrangement (CBA).

In February 1997, under the leadership of then newly-elected President Petar Stoyanov, political factions in the legislature agreed on fresh elections. Then Mr. Stoyanov appointed a caretaker cabinet which promised a CBA solution and resumed talks with the IMF and the international community in March and April, and stopped printing money, thus curbing inflation. Elections took place in April, and a reform-minded, rather centrist party, the United Democratic Forces (UDF), won an absolute majority in the National Assembly; the leader of the party, Mr. Ivan Kostov, an economist, former minister of finance in the coalition cabinet of 1991, became prime minister. For the first time since the beginning of the reform period, the country had a united Presidency, National Assembly and Council of Ministers, all equally committed to promoting reform.

Macroeconomic Heritage

The year 1996 was an extreme case of financial shocks. At the end of December, when the Socialist cabinet of Mr. Videnov resigned, the National Statistics Institute (NSI) said that accumulated inflation was 310%. (In the first quarter of 1997, inflation shot up to 438%). The CPI-deflated interest rate on bank deposits (even after the drastic increase in the basic interest rate (BIR) of the Bulgarian National Bank (BNB) in late September, to 300% a year) was negative — minus 43%. (In February 1997, the BIR reached 18% a month, while inflation reached an unprecedented 242%.)

The differential in yields on local currency and hard currency deposits looked as follows: on January 2, 1996, the BNB rate was 70.719 Bulgarian leva (BGL) to one U.S. dollar, and on December 12 (the 1996 BGL depreciation peak), it was 511.69 BGL/USD; that is, a depreciation of 624%. The accumulated interest rate on one-

month time deposits barely reached 104%. However, merchants and manufacturers couldn't keep prices below costs. By mid-January 1997, the rate was already 1,000 BGL/USD, and by the first week of February it had reached BGL 3,000.² In March 1997, after the tight and coordinated monetary policies of the caretaker cabinet and BNB, the local currency appreciated by 50%, back to 1,500 BGL/USD, and stabilized at that level.

In mid-1997, the CBA was introduced. The monetary base would not exceed the gross foreign reserves of the central bank, which was banned from financing the government and refinancing commercial banks, and the currency was pegged to the German mark, at a rate of 1000 BGL/DM.

One year after the introduction of the CBA, financial stabilization is obvious. Inflation for the first half of 1998 is 2.3% and will probably be 6% by the year end. Foreign reserves have increased significantly, which is a prerequisite for a stable money market. The fiscal deficit was reduced from 13.4% of GDP in 1996 to 3.1% in 1997, and became a surplus for the first six months of 1998. Unemployment has not increased significantly, because of slow process of state property transfers and the delayed liquidation of loss-making enterprises.

A three-year agreement with the IMF has been signed. It will bring in US \$840 million to support the balance of payments. The same amount will come from other international institutions. The government enjoys the confidence of international support in its mid-term. It has even adopted a thorough three-

year economic development program. Most of the targets in the program may be viewed as achievable, but the basic macroeconomic aim — a sustainable private sector and competition-led economic growth — is rather optimistic. The IMF and the cabinet in Sofia believe that the 1998 GDP growth rate will turn out to be 4-5%. But there are two factors that may lead to a surprise: 1) the pace of structural reform is slowing down, and if there is no prompt change the economy could face another disaster; and 2) the world economy is approaching a deep recession, the impact of which on Bulgaria has not been taken into account. We maintain that growth will hardly reach 3%, and that there must be a miscalculation. It is the same with inflation: the government has stated that the inflation rate for 1998 will be 9%, but there is no real reason for it to be more than 6%.

Agreement with the IMF

Negotiations with the IMF on the three-year program (Extended Fund Facility, or EFF) were finalized on July 31. There is no precedent of such a program for a European emerging economy. The closest example is that of Argentina's EFF of December 1997. The difference between the two is that while Argentina's three-year program deals with the consolidation of that country's economic recovery, Bulgaria still has to attain the prerequisites for sustainable growth. For this reason, Bulgaria's Policy Memorandum is much more detailed.

The IMF, as well as the criticism of free-standing observers, have forced the cabinet to acknowledge that the ultimate objective of the reform process is

to create a "competitive, predominantly private economy." The declared priorities of the EFF are:

- to complete the privatization of banks and enterprises,
- to develop and deepen financial markets,
- to restructure social safety nets,
- to simplify and strengthen taxation and the tax authorities,
- to reform the agriculture and energy sectors,
- to further liberalize exchange rate and trade regimes, and
- to foster much-needed institutional reforms in order to underpin a competitive market economy.

A precondition for all of these is to maintain the CBA and increase the transparency of government expenditures. In order to achieve the latter, the cabinet agreed to reduce and eliminate quasi-fiscal subsidies, which were usually channeled through off-budget accounts. In 1997, funds distributed in this manner equaled 1/8 of GDP, and in 1998 the government has stuck with this tradition in order to retain its control over economic affairs.

It has been agreed that keeping the CBA as a stabilizing institutional factor would require that in the coming three years:

- that the Bulgarian National Bank (BNB) ensure that the reserves of the issue department are at least equal to its liabilities;
- that the BNB does not extend credits to the government;

¹ The 1991 reform consensus was based on the recognition of negative effects, after the then-Socialist cabinet declared a moratorium on the country's foreign debt payments, in March 1990. Market reforms proceeded successfully until the elections of October 1991. The democratic minority cabinet of 1991-1992 attempted to follow their philosophy, but without daring to go without price controls and privatize promptly. Delays caused corruption in public-sector management. The emerging private sector grew on the decapitalization of the state-owned enterprises (SOEs), and monopolies. With eroded parliamentary support, the democratic cabinet resigned in late 1992, and a cabinet of experts came into power. In mid-1994, it signed a Brady plan for Bulgaria, restructuring its foreign debt by 47%. Debt payment schedules required growth rates of 4-5% of GDP in 1995 and 1996. Technocrats, backed by ad hoc majorities in the legislature, failed to promote the private sector and an investment-friendly environment. Their successors, the Socialists, not only gave up 1991's reform ideas but introduced opposing economic policies. Zhan Videnov's administration, backed by an absolute majority in the Parliament, supported the loss-making public sector, at the price of draining the banking sector and causing severe macroeconomic disequilibrium, bringing the country back to the brink of defaulting in mid-1996, this time with a Brady deal in place.

² Some markets dollarized completely; in real estate, virtually all (96%) transactions were executed in US dollars, and in the car market 80% of deals were transacted in DM. In some special weeks most consumer goods were salable in hard currency. Despite regulations, the USD became a dominant accounting unit.

- that commercial banks' required reserves are kept above 11% of liabilities;
- that the government does not amend the existing exchange rate regulations and refrain from agreements that do not comply with Article 8 of the IMF Charter.

Besides canceling major off-budget accounts (Energy Resources Fund and the State Reconstruction and Development Fund), there number of prior actions that the cabinet has committed itself to undertake in order to have the EFF Agreement enforced. Here is a list of most important of these actions:

- eliminate price and profit margin controls;
- adopt an action plan for phasing out energy subsidies over the coming three years;
- raise prices on district heating for households;
- adopt a program to deregulate and restructure the electricity sector, separating generation, transmission and distribution;
- sign contracts with consultants for the privatization of the 30 biggest state-owned enterprises and state-owned banks ;
- remove restrictions on debt-equity swaps;
- refrain from setting a binding price for privatization auctions For bank privatization, the preliminary requirement is to have contracts with intermediaries for the privatization of Bulbank and Expressbank.;
- achieve an 8% capital adequacy ratio for all banks and revoke the licenses of banks that fail to meet the minimum capital requirement of BGL 10 billion; and
- adopt a timetable for the introduction of uniform ID numbers for all tax-payers and establish a separate system for the monitoring of large-scale taxpayers.

It is important to mention that most of

these preliminary requirements, as well as many of the policies in the EFF, have been in place for number of years. They were suggested by independent economists (domestic and foreign) and think tanks not because they are extraordinarily clever, but rather the opposite — because they are obvious.

Savings and Investment

Macroeconomic instability has been a factor in the constant diminishing of every incentive for saving and investing. Because of the country's inability to attract foreign investment, it needed a mobilization of domestic savings. However, for the period between 1991 and 1994, investment as a percentage of GDP decreased, from 22.6% to 8.2%. A sharp drop in investment activity is visible after 1992. The underlying reasons are in the volatile macroeconomic environment, weakened demand, and the absence of privatization. According to the BNB, at the end of 1996 gross domestic savings as a percentage of GDP were at 13.5%, while gross investment was 12.5% of GDP. In 1997, the population had 1.452 billion levs in savings, no more than 8.5% of GDP. Investment remained basically unchanged, at 12.9% of GDP.

According to the BNB, the population's deposits grew by 25.5 billion levs in 1993, and by about 18 billion levs in 1994. But throughout the entire 1991-1996 period, the interest rates on deposits were lower than the CPI. This has gradually undermined the purchasing power of savings, and depositors have suffered losses. In the period between 1991 and 1997, two years marked record negative real interest rates: -24% in 1994 and -43% in 1996.

In 1998, the BGL deposits of the population have been relatively stable. Moreover, they have shown a slight trend of increasing, due to low and even

negative inflation, making the real interest rate a bit higher. The population's hard-currency deposits did not change significantly, either. This can be explained mainly by the stable domestic currency and the fact that the interest rate differential between BGL and DM (USD) has stayed unchanged. In general, the weak inclination to save is a consequence of low interest rates and a restrictive income policy.

Private Sector Capitalization

Private businesses used to start up alongside a comparatively developed public sector frozen by delayed privatization and quasi-fiscal subsidies. During the first years of the reforms, state manufacturers worked at fixed and low profit rates. This made high retail profit margins possible, actually creating private business. Private business started to act as retailers or suppliers. Similarly, private financial institutions were established with credits from public banks. It became easier to siphon off assets from public enterprises and financial institutions than to invest in a green field, and this phenomenon has affected all aspects of business practices, including the structure of expenses. It was destructive to both the old state sector and the emerging private business sector.

The increased number of private companies did not result in an adequate political establishment to promote the interests of the private sector. The majority of private firms are sole proprietors. There is, however, no reliable data on how many sole proprietorships have been established in order to reduce social welfare and other taxes.

At the end of 1989, Bulgaria had about 24,500 private firms registered. By mid-1994 private companies already numbered 330,000, though by the end of 1996 their number had decreased to

³ The World Bank book, *Financing Government in Transition: Bulgaria (The political Economy of Tax Policies, Tax Bases, and Tax Evasion)*, edited by Zeljco Bogetic and Arye Hillman, The World Bank, Washington D.C., 1995, lists the following reasons for the rapid growth of private firms during that period: individuals "prepared themselves for the capitalist market economy by becoming "capitalists"; unemployment made the opportunity costs of "going into business" low, tax and other incentives to register, and "the choice to be small"; i.e., to be invisible to the tax authorities" (p.50).

307,000.³ Statistical data on the sector, however, are quite unreliable. In 1997, for example, the total number of registered economic agents was 425,424. Of those, 270,208 did not submit their annual balance sheets, which can be interpreted as meaning either that they do not operate but have not yet undergone the necessary court procedure to close the business, or that they operate in the "shadow" sector of the economy.

Private firms capitalize on family resources. An IME survey in 1996 indicated that 75-80% of them were set up in this manner. But they grow on links with the public sector. Private entrepreneurs reduce SOEs' operating costs as sub-contractors. Given their size, however, SOEs are difficult to restructure. Lack of (political) will to do so sets incentives to decapitalize them. The benefit of SOEs was that they eliminate idle use of inventory and personnel; private firms benefited as suppliers but did not report or invest the profits.

The private sector contributed 58.79% of the gross value added in 1997. For the first half of 1998 its share reached about 62%. However, the prevailing number of private companies were registered in sectors with a low level of capital consumption. Thus, the number of newly-registered private companies in industry and construction is still lower than the corresponding figures for other CEE countries. Likewise, there are huge discrepancies between the firms registered in different regions of the country.

For the nearest future the prospect looks bright, with the introduction of more friendly tax legislation and the liberalization of foreign trade. The cabinet has already signed consultant contracts for most of the Bulgarian "blue-chip" privatization deals (i.e. telecommunications, the petrochemical plant in Bourgas, etc.); bank privatization has started with the United Bulgarian Bank and Bulgarian Post Bank sales. The negative sides of the process are, however, still in place, and consist of the following:

- the process is still not transparent;

- the pace is still slow;
- the emphasis is still put on "negotiations with potential buyers," rather than auctions;
- the sellers (different government agencies) restrict the execution of buyer's rights through the inclusion in privatization contracts of provisions requiring the new owner to maintain a certain employment level and the completion of an "investment plan" (for more details, see below, next section);
- the public capital market is still underdeveloped; and
- commercial banks still prefer to invest outside the country, due to high risk and unsettled creditors' rights protection.

A Note on banks

Real banking sector reform in Bulgaria started in 1989, when communist-era

central banking was swapped for a modern two-tiered banking system with a typical central bank and 59 commercial banks, most of them established from previous branches of the BNB. The legal framework for the functioning of the banking system was created with the passage of the Law on the Bulgarian National Bank (1991) and the Law on Banks and Credit Activity (1992), later replaced by the acts that introduced the CBA.

As a result of the low entry barriers into the banking sector, the number of private banks increased significantly — from two in 1990 to 26 in 1995. Their assets as a proportion of the total assets of the banking system were 3.1% in 1992, 6.4 % in 1993, 15.6 % in 1994 and 22.4 % in 1995. In 1996, private banks' assets share of total banking sector assets fell to 15.2%, due to loss of public confi-

Table 1 Bank Assets Structure in late 1996 and 1997

	State-owned	Private	Foreign	Total	k
Oct. 1996	84.8%	12.6%	2.6%	100.0%	0.74
Nov. 1996	85.2%	12.2%	2.6%	100.0%	0.74
Dec. 1996	86.3%	11.1%	2.6%	100.0%	0.76
Jan. 1997	88.3%	8.8%	2.9%	100.0%	0.79
Feb. 1997	89.0%	7.8%	3.2%	100.0%	0.80
Mar. 1997	88.4%	7.8%	3.8%	100.0%	0.79
Dec. 1997	67.1%	14.8%	18%	100.0%	n.a.

Table 2 Commercial Banks in Bulgaria, 1990-1997

	1990	1991	1992	1993	1994	1995	1996	1997
Year-end Total	70	78	59	41	45	47	35	34
incl. Foreign	0	0	0	1	3	5	7	9
Licensed during the year	61	8	2	7	10	4	2	2*
incl. Foreign	0	0	0	1	2	1	2	2
Consolidated banks	0	0	22	29	9	3	0	0
Banking groups following consolidation	0	0	1	4	3	1	0	0
Revoked licenses during the year	0	0	1	0	0	0	14	4

dence in private banks.

In 1993-94, there were more loss-making state banks than private ones, and their total losses were larger as well. Nine commercial banks (four large state banks, three small ones and two small private banks) accounted for 79.1% of total losses in the banking system in 1993 and for 87.2% of total losses in 1994. In 1995 the large private banks followed suit, and the number of loss-making private banks increased.

Commercial banks' losses were largely due to bad loans. There were two major sources of bad loans in the Bulgarian banking sector: non-performing loans extended to SOEs in the pre-transition period, and the credit expansion of most banks, especially private ones, after 1990.

One of the factors that led to new "bad borrowing" was the government policy of replacing direct budget subsidies to the real sector with quasi-fiscal subsidies, through new credit injections. There was no political will to close the loss-makers until mid-1996, and they had to be kept alive through credit amnesties, which deepened the crisis in the banking sector even more. The only state-owned bank to avoid new doubtful lending was Bulbank, which finally aggregated 91% of all standard loans at the end of 1996.

A weak private sector, bad banking management, the over-supply on the banking market, the concentration of credit risk, the negative structure of credit portfolios and the increasing

share of non-performing credits, the decapitalization of the banking system and the ensuing loss of confidence in the banking system, etc., led to turmoil in the banking system.

A precondition for the banking crisis was set at the beginning of reforms in 1990, when the process of establishing a deeply fragmented banking system began, with a large number of small state-owned banks specialized in providing funds to particular branches and regions. Almost all of them inherited a significant number of non-performing credits, extended to enterprises during the socialist era. To a great extent their further decapitalization was due to the slow process of bank consolidation.

One of the most serious problems leading to the banking crisis of 1996-1997 was that of both the non-performing loans extended to SOEs in the pre-transition period and the non-performing credits granted after 1990 by most banks, especially the private ones. Some 50% of all loans granted by state-owned banks to non-financial institutions were not collectible. To a great extent this is due to the state's emphasis on lending to so-called "strategic SOEs." For many SOEs, the only way to service debts was new borrowing. The preservation of loss-making enterprises in the public sector used to be a key government policy.

By the end of 1995, 41% of all loans granted by both state and private banks to non-financial institutions were irrecoverable. Only 39% of total lending by private banks was regularly serviced.

The problem with most of the private banks stemmed from the common practice of extending credits to persons and firms related to the banks' top-level management. Some of the banks were created for the sole purpose of directing money (collected by both deposits from the population and through refinancing by the Central Bank) toward newly-emerged private firms, with no intention of collecting the loans back.

The deterioration of banks' credit portfolios was also due to the lack of effective creditors' rights enforcement. No legal procedures for the bankruptcy of insolvent SOEs were in place.

The result: from May 1996 until April 1997, 18 banks were closed and put under special supervision by the BNB; thus, 24% of total assets in the banking system were put under conservatorship. This is estimated to be the biggest recent banking crisis worldwide. Of 27 private banks existing at the time, the four largest ones were put under special supervision.

The financial condition of commercial banks has improved to a great extent since the beginning of 1997. As a result of the depreciation of the BGL and the brief period of hyperinflation, the capitalization of the banking system has improved. The depreciation of the local currency helped banks to restructure their portfolios.

Following the new Banking Act, which replaced the previous Banking and Credit Act, and the Basle Accords and BNB regulations, the capital adequacy of all banks has improved significantly, reaching a level of 8%. The 1998 target level of 10% seems like it will not be a problem at all.

Currently, all Bulgarian banks can be divided into three groups. The first group consists of public or recently-privatized banks (UBB, Expressbank, Bulbank, Bulgarian Post Bank, SSB, Biochim, Hebrosbank), representing 76% of banking system assets. At the end of June 1998, their total capital adequacy was 35.3%. This indicates the stability that was; the previous year total capital adequacy was 11.9%.

Table 3 Balance profit and losses of commercial banks (BGL, millions)

	1991	1992	1993	1994	1995	1996	1997
Profit	7201	2903	1896	8702	4646	181	406
Losses	1845	2291	4172	10056	29181	63	37
Net Profit	5356	612	-2276	-1354	-24535	118	369
Number of banks with losses	2	6	11	15	23	n.a.	n.a.
including private banks and foreign banks ⁰	0	0	5	7	15	n.a.	n.a.

The second group of banks includes small private and one community banks (Municipal bank, Unionbank, First Investment Bank, Corporate Bank, Bulgarian Commercial and Industrial Bank, International Orthodox Bank, Creditexpress, First East International Bank, Trakiyabank, Bulgaria-Invest Commercial Bank, Teximbank, Credit Bank, Balkan Universal Bank, Central Cooperative Bank, Bulgarian-Russian Investment Bank, International Bank for Commerce and Development). These banks hold 18.1% of total banking system assets. Their total capital adequacy was 32.2% at the end of June 1998.

The third group includes four foreign banks and five branches (ING Bank, Bayerische-Bulgarische Handelsbank, BNP-Dresdner Bank, Raiffeisenbank, Xiosbank, National Bank of Greece, Eurobank, Bulgarian Investment Bank and Ionian Bank), representing 6.8% of the banking assets in Bulgaria. One more foreign bank, Ziraat Bankasi, opened its sixth international branch in Sofia on June 11, 1998. The total capital adequacy of this group at the end of June was 34.1%.

A long-term problem for Bulgarian banks seems to be a making an adequate profit from bank activities. Banks still consider lending a very risky activity because the business environment has not improved significantly, as well as the fact that the execution of creditors' rights is low and banks have faced problems collecting on non-performing loans. In general, they are reluctant to finance the real sector for two reasons. On the one hand, the banking sector has not regained its confidence that companies can pay their credits back, while on the other, companies are not willing to put up with the extremely high guarantees required by the banks. The tough lending requirements of the commercial banks prevent private-sector investment in capital-consuming sectors, such as industry. This additionally reduces the quality and variety of banking services are rather limited, and include taking deposits, giving very short-term credits and intermediation in payments in Bulgaria and abroad. It is

expected that the future development of the capital market will have a serious effect on commercial banks. The development of the capital market may create additional opportunities for banks to diversify their services, by getting involved with intermediation in trade with securities.

Interest rates have fallen significantly since March 1997. They are likely to remain low, since no one demands credit but the government, which is enjoying budget balance or even surplus.

As agreed with the IMF, bank privatization should be completed by the year 2000. The only banks to remain in the public sector would be the largest retail bank, the State Savings Bank (SSB), and Biochim. The SSB is restricted to lending money to corporations, is the only bank which has a 100% government guarantee on its deposits, and holds about 95% of outstanding mortgage loans. By mid-2000, the SSB should enter a privatization procedure. The reality is rather less encouraging. The process is painfully slow, and the Bank Consolidation Company (the seller) is finding it hard to attract strategic foreign investors who can bring a breath of fresh air (money) into the banking system. The task seems extremely difficult, especially in light of international capital market turbulence.

Trends in trade: In search of competitive advantages

If we look at Bulgarian exports prior to the beginning of economic reform in the 1990s, we will realize that the highest

share was among ex-COMECON countries (today emerging market leaders) to the CMEA market itself. As a share of total exports, Bulgaria — along with then-Czechoslovakia — was the last to decrease CMEA-export efforts as of 1989; the other countries had started reducing this trade in 1986. Another difference is that Bulgaria exported mostly to the ex-Soviet Union, while the other countries traded among themselves. According to the calculations of Rumen Dobrinski, the share of CMEA trade in the second half of the 1970s and 1980s averaged about 60% of Bulgaria's total trade. Closest to Bulgaria was Czechoslovakia, with 51-52%, Romania's CMEA share of trade was less than 30%, and Hungary and Poland were always between 40% and 50%⁴. Dobrinski shows that the accumulation of Bulgaria's foreign debt coincided with a lack of alternative export routes in 1986, and was related to an attempt to

Table 4 International trade flows of Bulgaria as percent of GDP

Year	Export	Import	Total turnover
1989	34.5	32.3	66.9
1990	23.3	22.7	46.0
1991	42.3	33.3	75.5
1992	45.6	51.9	97.5
1993	34.4	46.8	81.2
1994	41.5	43.1	84.6
1995	40.9	43.2	84.1
1996	49.2	51.0	100.2
1997	50.1	46.2	96.3

Table 5 Relative share of exports to some groups of countries

	1996		1997		1998 (6 month)	
	USD m.	share	USD m.	share	USD m.	share
EU	1,912.5	39.1%	2,128.7	43.3%	1,083.8	49.5%
Other OECD	554.0	11.3%	661.7	13.5%	249.0	4.7%
EFTA	49.5	1.0%	44.3	0.9%	15.5	0.7%
CEFTA	94.8	1.9%	137.1	2.8%	119.9	5.5%
Balkan countries	514.2	10.5%	291.9	5.9%	397.6	7.5%

Table 6 Relative share of imports from some groups of countries

	1996		1997		1998 (6 month)	
	USD m.	share	USD m.	share	USD m.	share
EU	1,780.3	35.1%	1,823.1	37.3%	1,044.9	44.5%
Other OECD	275.4	5.4%	343.8	7.0%	227.1	9.7%
EFTA	86.4	1.7%	86.8	1.8%	34.0	1.5%
CEFTA	159.9	3.2%	231.7	4.7%	120.0	5.1%
Balkan countries	163.3	3.2%	95.2	1.9%	68.4.	2.1%

Table 7 Main partners in Bulgarian foreign trade, 1997

Country	Exports		Country	Imports	
	USD mln.	Share		USD mln.	Share
Total	3,650	72.9	Total	3,777	75.8
Italy	575.1	11.7	Russia	1,374.8	28.1
Russia	391.8	8.0	Germany	563.2	11.5
Germany	468.1	9.5	Italy	347.1	7.1
Turkey	442.3	9.0	Greece	156.5	3.2
Greece	405.9	8.3	France	156.5	3.2
Yugoslavia	124.6	2.5	Austria	118.0	2.4
Ukraine	146.5	3.0	Ukraine	176.6	3.6
Macedonia	98.2	2.0	USA	181.2	3.7
UK	130.6	2.7	UK	126.9	2.6
France	132.3	2.7	Turkey	101.6	2.1
US	128.8	2.6	Netherlands	91.0	1.9
Spain	76.2	1.6	Switzerland	77.5	1.6
Moldova	99.9	2.0	Czech Rep.	63.0	1.3
Netherlands	75.4	1.5	Belgium	60.5	1.2
Georgia	122.7	2.5	Brazil	65.5	1.3
Romania	28.5	0.6	Romania	57.7	1.1
Belgium	76.2	1.6			
Austria	54.0	1.1			

increase exports to COMECON countries, an attempt which obviously failed from the very first steps if we convert the turnover into US dollars.⁵

Besides some sporadic attempts to impose protection tariffs, in the "nor-

mal" years of 1991-1994 the Bulgarian economy demonstrated extraordinary openness, as shown in the table.

Following a decrease in 1990, the percentage share of foreign trade in the GDP became relatively stable. The

data in column 2 indicate that Bulgaria was a highly open economy (for the sake of comparison, in 1994 Switzerland's exports/GDP ratio was 35%).

The same is true for groups of trade partners, but to a lesser extent. The following tables demonstrate the group dynamics in total exports and imports, respectively.

Data on recent years have shown a tendency of increased trade with the EU, CEFTA and Balkan countries.

We may draw the following conclusions. There is no distinct leader for the country's exports. The export share is highest for Italy, Germany, Greece and Turkey. The CEFTA share of exports for 1997 and for the second quarter of this year has grown. The CEFTA import share has increased also. Further increases in trade with CEFTA countries as a result of the CEFTA agreement might be expected. The level of imports from Russia is higher than that from other foreign partners. However, foreign trade with Russia declined in comparison to 1996. Imports from Russia decreased significantly. This is due to the decrease in the import of energy resources and raw materials (see below, Table 11 on the commodity structure of Bulgaria's exports), and proves that the economy is searching for alternatives for mineral resources imports.

Bulgaria's situation reflects the situation in other Balkan countries. Meanwhile, some considerable markets are virtually missing: exports to France are roughly five times lower than those to Germany, the UK or Italy.

The share of exports to neighboring countries Greece and Turkey is 18% of total foreign turnover, while the import share is 6%. Bulgaria's exports to Turkey increased last year. The country's longest border is with Romania, but exchange with this largest emerging market in the region is far from being active.

Broadly diversified trade with neighboring countries equals the share with

⁴ Rumen Dobrinski, *Transition Failures: Anatomy of the Bulgarian Crisis*, Vienna, WIIW, 1997, p.7.

⁵ Rumen Dobrinski, *ibid.*, pp. 8-12.

remote ones. This incurs, presumably, additional opportunity costs.

Even the leading export products involve high import components. In 1997 significant increases in exports were seen in the following sectors: ferrous and non-ferrous metals (20.7%), textiles and clothing (10.2%), and mineral products (9%). Marked declines in exports were registered in the following sectors: food and agricultural products (-23.6%), and chemical products (-6.6%). High energy consumption is the main reason behind Bulgarian chemical products' loss of competitive advantage. The foodstuffs export decrease is due to the tobacco component. There are reserve opportunities in livestock and cattle-breeding, but investment in this area requires restructuring in the enforcement of land property rights and a relatively long rate of return. The balance is categorically positive in energy consumption and sub-product sectors. The trend toward exports of raw materials and non-processed commodities persisted in 1997. The further liberalization of foreign trade and the elimination of entry barriers will facilitate trade with Balkan countries.

Bulgarian foreign trade is sensitive to changes in relative prices and international demand. The international market environment is not favorable for Bulgarian foreign trade, particularly in terms of the drop in carbamide prices. A feature of Bulgarian exports are their low profitability, because of the high share of imported inputs that go into export commodities. The Bulgarian government will negotiate with the IMF to introduce capital account convertibility by the end of the year. (Article 8 of the IMF Statutes).

Since the introduction of the currency board, Bulgarian foreign trade's com-

modity and geographical structure have not changed significantly.

Foreign trade under a currency board regime represents a major challenge. If we look at countries in similar conditions,⁶ it is obvious that it takes two to three years for an economy to adjust and identify its competitiveness.

1998 Tequila Effects

There are two notions of the so-called "Tequila" effect: a) [portfolio] investors pull out, expecting unfavorable developments; and b) impacts of such capital flows from other economies. The importance for Bulgaria of different notions of

Table 8 Scheduled external debt service by creditors 1999-2004 (USD millions)

	1999	2000	2001	2002	2003	2004
Amortization (total)	651	584	812	566	537	558
IBRD	51	66	70	74	87	95
EBRD/EIB	32	42	47	52	35	33
IMF	137	200	295	157	38	14
G-24	172	115	83	20	0	0
Bilateral	38	58	72	86	101	98
Bonds	32	18	0	0	0	0
Other Commercial	7	7	2	0	0	0
Commercial Bank	0	0	10	20	40	50
London Club	0	0	16	111	190	222
Paris Club	182	178	217	46	46	46
Interest payments (total)	519	486	523	479	456	443
IBRD	61	62	63	60	58	56
EBRD/EIB	18	21	22	23	24	27
IMF	61	47	33	13	2	2
G-24	26	10	1	0	0	0
Bilateral	18	20	21	22	21	20
Bonds	1	0	0	0	0	0
Other Commercial	0	0	0	0	0	0
Commercial Bank	3	7	14	17	19	19
London Club	277	281	364	342	332	319
Paris Club	54	38	22	3	0	0
Total Debt Service	1170	1170	1335	1045	993	1001

Source: Merrill Lynch, BNB

Table 9 Current account balance, 1991-1998 (USD, millions)

	1991	1992	1993	1994	1995	1996	1997	1998f
Exports	3,737	3,956	3,727	3,935	5,345	4,724	4,914	4,500
% change		5.9	-0.7	5.6	35.8	-11.6	0.5	-8.4
Import	3,769	4,169	4,612	3,952	5,224	4,580	4,518	4,600
% change		10.6	10.6	-14.3	32.2	-12.3	-1.4	1.8
Trade Balance	-32	-212	-885	152	122	144	396	-100
Current Account								
Balance	-77	-361	-1098	-45	-25.6	-22.3	445.7	-200
as % of GDP	-11.7	-12.6	-14.7	-2.5	2.6	1.6	4.4	-1.8

Source: BNB, IME

⁶ See: Nissan Leviathan (ed.), Proceedings of a Conference on Currency Substitution and Currency Boards, World Bank Discussion Paper No. 207, World Bank, 1993; Argentina, The Convertibility Plan: Assessment and Potential Prospects, World Bank Report N15402-AR, July 12, 1996, pp. 9-11, 18-21.

Tequila effect stems from the open character of the economy and the role of foreign debt as a constraint to domestic decision making.

The stabilizing effect of the currency board regime was partially felt even before it was actually introduced in July 1997. The lev stabilized at the level of BGL 1,500 per US \$1 in March and later depreciated with the Deutschmark, by about 11-12%. Attracted by the prospects of high yields (due to the interest rate of 18.2% a month, political turbulence in late December 1996 and January 1997, and prompt, peaceful and negotiated outcome of the political crisis which opened opportunities for agreement with IFIs to support the country's balance of payments), foreign portfolio investors took the risk and brought about US \$300 million into the country, according to IME estimates. This happened in January and early February, but already by April 28 the interest rate (determined by that of three-month T-bill yields) had fallen to a monthly level of 6.2%, and to 3.59% a month by May 26. With no opportunity to invest in equities (due to the absence of an institutionalized capital market), they withdrew their investments and left with respective gains of about US \$80-120 million in May and June, before the introduction of the currency board.

Thus, "Investors Pull Out Because of Russia," or some sort of Tequila effect, has in fact happened, on a small scale, without causing any instability. There is no reason why the same might not happen again with more severe impact in the future, and that is why it is important to know why it happened so easily this time:

- the first factor was the very size of the investment;
- the second was the amount of savings outside banks, approximately US \$1 billion.

Citizens and corporations bought dollars for everyday use during the winter and kept them, changing several million dollars a day and thus not allowing the

exchange rate to skyrocket when investors converted their local currency gains into hard currency ones. This was the confidence in banks that worked, but it shows that the level of savings (the credibility) would have a decisive role in the future. Another factor has to do with the general environment, which, in fact, has limited the amount of investment.

But the impact of 1998's turbulence of global capital flows also has indirect effects, which consist of the following:

- it raises obstacles to Bulgarian companies' (and government's) access to foreign capital;
- it increases difficulties in the sale of Bulgarian banks;
- it blocks Bulgarian exports to Russia, which low level until recently was believed to provide future opportunities. Tourism losses in 1998 have reached about 10% of registered revenues, solely because of ceased transfers from Russian banks.

In addition to these, any deepening of Russia's political crisis is likely to have an impact on energy-export companies, resulting in bad management, less investment, and smaller supply volumes to economies like Bulgaria.

Future similar effects would depend on the ability of the Bulgarian economy to grow. However, one of the factors influencing the growth rate, that concerns both portfolio and strategic investors, lies in the identified liabilities of the Bulgarian economy. Figures reflecting Bulgaria's foreign debt payments make up the following table.

The Bulgarian economy would need to produce around US \$1,120 of surplus every year, just in order to meet its foreign debt obligations. This amount is roughly 10% of the 1996 GDP, when it contracted by almost 11%.

An additional factor to be taken into account is the level of domestic debt services. A currency board regime presupposes that there is no essential difference between foreign and domestic debt, except agreed foreign debt pay-

ments' seniority (Brady and other provisional debt-restructuring deals). However, a problem stems from the BGL being pegged to the DM: part of the domestic debt is dollar-denominated, amounting to \$950 million; its value appreciates with the depreciation of the DM against the USD. Thus, 10% annual DM depreciation (as was the case in 1997) would lead to a ten percent increase of the dollar-denominated debt.

Some grounds for the assessment of prospects for growth is provided by the following two tables, allowing comparison between Bulgaria and other transition countries that have a currency board.

Current account balances in countries with a currency board regime show dynamics. It seems that it makes no difference whether it is a country emerging from a central-planning past or an emerging market in general. In the case of Bulgaria, a factor which may have an impact on export abilities is the peg to the German mark, if the latter drastically depreciates against the U.S. dollar. We do not however think such a development is likely.

In 1998 the real challenge in this respect would rather stem from domestic economic policy patterns. If the government fails to:

- liberalize trade,
- establish transparent privatization and capital markets rules,
- promote sound and prudently-run financial sectors, or
- forego entry barriers for domestic and foreign entrepreneurs,

then the currency board regime will not be able to perform its preventative functions.

Besides its openness, the Bulgarian economy remained virtually untouched during the October-November 1997 crisis on the global capital markets, the Asian Crisis and the Russian financial collapse of the summer of 1998. The explanation is in the underdeveloped

nature of the Bulgarian stock market, and in the unclear supply side and doubtful demand side of this market.

The supply side is hampered by limited information disclosure on the stocks offered, or by the low quality of the information. Fixing this problem would require at least six to eight months of work by the Securities and Stock Exchange Commission and the Parliament. Also, there are a limited number of resource companies that have already put shares on the floor (Bulgartabac) or are likely to offer shares on the exchange (such as, say, BTC). An additional problem is constituted by the fact that potential sellers would prefer to avoid entry barriers and use the OTC market; this is especially true for the voucher funds, holding about 13% of the assets. FDIs (Solvay, Union Miniere etc.) do not seem willing to place equities on the local stock exchange, given opportunities to raise funds internationally.

The demand side is not developing due to various factors: portfolio investors already have bitter experience because of lacking protection of minority shareholders; banks are restricted to acquiring equities in the real sector and debt-equity swaps have been limited by a number of regulations; and investors' interest is diminished by the lack of information and unclear gains prospects.

The Bulgarian economy is likely to remain self-protected from shocks coming from the volatility of global stock markets, due to its underdevelopment, and the price is likely to be fewer FDIs and slower growth. The Asia financial crisis has not had a significant impact on the Bulgarian economy. Its effects would stem from the influence of the exchange rate fluctuation on Bulgarian exports. The danger to Bulgaria's external balance equilibrium comes from the Russian crisis. The Russian import share is high (28% for 1997), and the crisis will have an unfavorable impact on the Bulgarian-Russian foreign trade balance.

On the regional (Balkan) level, this

would mean lost economic opportunities. The latter should be considered on two levels.

The first is a scenario in which emerging economies in the region fail to proceed with market reforms. This has already happened in Albania, after a relatively good start (see tables paragraph 1 of the Annex, Bulgaria and Other Transition Economies) in the early 1990s, but accompanied by under-development of financial services. The Yugoslav Federation, despite its potential, has relatively low prospects for economic growth in the coming three to four years.

However, this market would have disadvantages vis-a-vis Bulgaria, namely:

- Bulgaria's domestic market prices of tradable goods are being adjusted to the foreign price levels for food and agriculture products. The prices of non-tradable goods are low, compared to other European countries. The expectations are the level of the non-tradable prices to equalize by the year 2000;
- lower labor costs;
- probably, the stability backed by 1997-1998 balance of payment financing by IFIs, while the Yugoslav Federation (not Macedonia) will be lacking such an external constraint to populist economic policies; and
- last but not least, this petite common Balkan market is vulnerable to civic unrest and/or disorders.

Bulgaria's advantages come from its lower starting point and the higher social cost of transition paid by the Bulgarian public. Although the hardest time has passed, by the year 2000-2001 Bulgaria will have an idle but well-trained and educated labor force. By the end of 1998 unemployment is expected to reach 15% due to the liquidation of loss-making SOEs.

A special case in point is Romania. It had a reform start similar to Bulgaria in 1997, but it is a market three times bigger (22.2 million), which has attracted more foreign investment in absolute terms (per capita figures are compara-

ble, see paragraph 1 of the Annex) and which is passing through a similar political transition as Bulgaria in 1997. Bulgaria's advantage is its more united leadership.

However, as is obvious from the section on savings and investment, the Bulgarian economy still has to identify its competitive advantages, a process which is related to privatization, restructuring and the implementation of the general liberalization policies listed above. If the latter could proceed within a one-year term (up to mid or late 1998), privatization and restructuring would bring about results in terms of identification of competitive advantages by the year 2000, and after. (Meanwhile, the impact on productivity and employment is likely to be immediate, due to the underdevelopment of the private sector.)

Efforts should aim at facilitated access to outside markets and of outside capital to local markets and cross-country cooperation, operation of businesses and specific industry sub-sectors, and the need to pass through the following stages:

- facilitated trade through lowering tariff and non-tariff barriers;
- macroeconomic and political stability;
- cross-regional infrastructure projects;
- compatible financial and capital market regulation; and
- joint strategies to strengthen regional competitiveness.

Growth prospects and advantages

The first 1997 stabilization results demonstrated surprisingly fast curbing of inflation, a speed which is not known from the experiences of other currency board systems in Central and Eastern Europe. The effect of 1997 DM-depreciation on Bulgarian production competitiveness was eliminated by increased aggregate costs in the economy. This should be regarded as an indicator of a need for structural support for stabilization efforts, probably requiring prompter

privatization than that which was targeted for 1997 and 1998 in the government's agreement with the IMF and the World Bank.

In 1998 there was even deflation for the first eight months of the year. This was due to the low prices of some commodities in the summer — mainly food and vegetables. It could be said that the

negative trend in prices was a result of decreased domestic demand — something extremely dangerous for a recovering economy. Nevertheless, inflation for the whole year is not expected to reach 6%.

The economic growth problem appears to be a crucial one in the years after 1998.

Our assumption is that the real GDP in BGL will have a growth between 3.5 and 4.5 until 2005. We forecast gradual increase of the growth starting from 3.5 and gradually increasing. The government expects real growth of 3,7% for 1999, however our forecast is more modest. The reasons for that are the slow process of the structural reform and the severe decline in prices of base metal and chemical products, which account for about 40% of the country's exports. The expectations show that a sustainable growth will be reached after the year 2004. Real GDP per capita shows a stable trend of increase because of the GDP growth and the constant population decrease. Given the above assumptions for the GDP growth significant GDP per capita growth is to be expected not until 2004-2005.

Factors to Reduce Country Risks in the Short Term

As mentioned earlier, a key factor is the currency board system. Besides this, other supporting factors are as follows:

- IFIs have a major role in Bulgarian economic decision making, and in the short run would restrict populist policies and force the country to speed up reforms;
- Bulgaria has no choice but to compete with neighboring countries to attract foreign investment;
- Bulgaria has no alternative leadership, and the incumbent one is the most market oriented, enjoying high approval rates; and
- for the first time in its transition history, Bulgaria has all sections of its government dominated by a market-oriented political party.

To these we may add a "bureaucratic factor": the Bulgarian government may still attempt to delay privatization and limit the reduction of transaction costs and enforcement of private property and contracts, but the economy has no room for maneuvering. The reason: the 1998 rationale of EFF policies still has to be internalized by the Bulgarian administration and institutions and the public.

Table 10 Inflation 1997-1998

	1997		1997	
	monthly % change	accum.	monthly % change	accum.
January	43,8	43,8	2,0	2,0
February	242,7	392,9	1,7	3,7
March	12,5	454,5	-0,1	1,7
April	-0,7	450,6	0,1	3,8
May	5,6	481,4	0,5	4,3
June	0,8	486,1	-1,9	2,3
July	3,7	507,6	-1,5	0,8
August	5,5	541,0	-0,9	-0,1
September	3,6	564,1	3,0	2,9
October	0,5	567,5	n.a.	n.a.
November	0,5	571,0	n.a.	n.a.
December	1,5	580,9	n.a.	n.a.

Table 11 Bulgaria 1998-2005: IME Forecast

	Real GDP 1997 BGL bn	GDP growth %	Real GDP 1997 \$ bn	Population	GDP per capita 1997 \$
1997	17 134	-6.9	9.8	8 600 000	1 139
1998	17 734	3,5	10,43	8 600 000	1 213
1999	18 354	3,5	10,80	8 587 500	1 257
2000	18 997	3,5	11,17	8 575 000	1 303
2001	19 757	4,0	11,62	8 556 000	1 358
2002	20 547	4,0	12,09	8 537 000	1 416
2003	21 369	4,0	12,57	8 518 000	1 476
2004	22 330	4,5	13,14	8 499 000	1 546
2005	23 335	4,5	13,73	8 480 000	1 619

* BGL/USD exchange rate used - 1700
** Long-term decrease in population - according to NSI

Balance sheet as of 31 December 1997 (in '000 BGL)

	1996	1997
Assets	15643	106374
I. Fixed Assets	4385	30295
Depreciation	(1987)	(10524)
Net fixed assets	2398	19771
II. Current assets	13245	86603
1. Materials		6
2. Work in progress	7	7
3. Future period expenses	273	1426
4. Debtors	638	19295
5. Finance assets	12327	65869
- cash in leva	359	9357
- cash in foreign currency	11968	56512
Current liabilities	437	1993
I. Taxation and social securities	437	1993
Net current assets	12808	84610
Total assets less current liabilities	15206	104381
Funds	13623	104351
1. Permanent endowment fund		
2. Other restricted funds		104351
3. Unrestricted funds	13623	
Prior year income (loss)	(78)	1583
Current year income (loss)	1661	(1553)
Total funds and income	15206	104381

1997 Grants and Achievements

(Annex to the 1997 Financial Report)

In 1997 IME has received grants amounting DEM 66,000, USD 86,784 and BGL 16,546,793 which is about USD 135,000. They were extended to IME by the following foundations and institutions:

Friedrich Naumann Foundation (FNSt) financed IME with DEM 66,000. The funds were divided into five sub-projects:

- Bureaucrats in Business, dealing with the assessment of the decision-making costs and the cost of regulation on state-owned enterprise;
- Assessment of the Availability of Economics Information (Registries, Statistics, Central Bank, etc.) in cooperation with Access to Information Program;
- Credit Registries and Exchange of Banking Information;
- Presentation of Business Interests in the Bulgarian Parliament, co-funded by the PHARE Democracy Program (see below); FNSt financed the part of the project which was dealing with the presentation of business community attitudes to the current economic policies at the weekly talk show, Live Money, of the most popular in Bulgaria private broadcaster, Darik-Radio, and also supported the publication of the first Directory of the Members of Parliament (distributed among business associations and NGO's);
- Assessment of the Informal Labor Market in Bulgaria which continued the monitoring of unregistered labor contracts, started in 1996; In addition, FNSt supported part of the IME equipment costs.

Chesapeake Associates, acting as a contracted agent of the US AID, financed the project Barriers to Economic Growth on the Balkan Peninsula: Ways to Lift Them with USD 46,852. Project expenses amounted to USD 45,165.

- the project was a continuation of the previous year efforts to estimate the impact of growth of such phenomena like: quasi-fiscal subsidies, fragmentation of capital and financial markets, and entry barriers; on this foundation IME outlined the need set of pro-growth policies which was communicated to the public at large and policy leaders at a conference: What Policies Ensure Growth and Prosperity (April 1997);

Income and expenditure account as of 31 December 1997 (in '000 BGL)

	1996	1997
Income		
I. Ordinary income	19596	152419
1. Economic activity income	836	671
2. Increase work in progress	165	1153
3. Donations and grants	18595	150595
II. Financial income	3262	50876
1. Interest income	17	749
2. Gains from exchange rates fluctuation	3245	50127
III. Extraordinary income	108	497
Total (I+II+III)	22966	203792
Expenses	1996	1997
I. Ordinary expenses	21063	181580
1. Expenses of materials	1082	10721
2. Expenses for services	11625	114928
3. Personal expenses		
a) salaries	2646	18739
b) social securities	886	8038
4. Depreciation	871	1618
5. Other expenses	3953	27536
II. Financial expenses	165	23439
1. Bank charges	105	1289
2. Losses from exchange rates fluctuation	60	22139
3. Interest expenses	/	11
III. Extraordinary expenses	34	12
IV. Taxes	43	
1. Income tax	3	314
Total (I+II+III+IV)	21305	205345
Income Less Expenditure	1661	(1553)

- seeking concrete policy changes to eliminate fragmentation of financial markets, IME promoted the debate on the currency board arrangement for Bulgaria, organizing (in cooperation with Bulgarian International Business Association) an international conference: Currency Board: Opportunities and Threats in the midst of the political and economic crisis of early 1997 (January 1997), and drafted the Deposit Guarantee Bill (adopted in March 1998) to discontinue the government protection of insane bank policies
- due the fact the project started in 1995, during the market distortions stemming from the embargoes on ex-Yugoslavia and Macedonia, IME accumulated a number of observations on corruption and deviated economic freedom; in a form of a List of Needed Anti-corruption Policies they were communicated to the newly elected members of Parliament and the cabinet at their meetings with non-government experts (see below).

Freedom House Foundation financed the project Needs for Deregulation of Tax System in CEE with USD 13,000. The project expires in April 1998. Project expenses in 1997 were USD 1,944, and the project continued in 1998. It deals with a comparison of tax reforms in Poland, Slovak Republic and Bulgaria, with the business community attitudes to reforms, and relevant policy recommendations which take into account relevant experience from tax reforms in USA, UK, Sweden, Germany, Italy and Switzerland.

The **World Bank Small Grant Program** financed the project Financial Sector Risk Management in Transition Economies with USD 13,800. The project expires in March 1998. Project expenses in 1997 amounted to USD 4,396 which were spent on a research into provisional systemic risks in the banking sector and evaluation of the currency board related solutions.

The **World Bank Resident Mission** financed the organization of a seminar for the newly elected members of Parliament (90% of whom were seated in the legislature for a first time: Bulgaria's Government

Debt - History, Current Situation and Solutions with BGL 592,614. Thanks to this project and other IME achievements under the above mentioned projects, the institute was invited to assess current policies of the government as a part of a group of public policy institutes which in 1997 (July and November) met twice all the majority MP's and the cabinet.

Open Society Fund - Sofia financed the project Concept for a Micro-lending to SME's and Marginalized Groups. The grant equaled USD 5,000 and was the first attempt to evaluate accumulated experience and opportunities for such form of financing in Bulgaria.

In 1997 **EU PHARE Program** (via Netherlands Economic Institute) financed the project Competitiveness of Bulgarian Food Industry on EU Markets with first installment of USD 3,214 (out of the total value of the project of XEU 10,000, expiring in 1998) allocated in 1997.

The **EU PHARE Democracy Program** financed the project "Presentation of Business Interests in Bulgarian Parliament" with first installment equal to USD 4,918. The IME expenses on the project in 1997 amounted to USD 3,979. The total amount of the grant is XEU 9,000. The project expires in September 1998 and deals with presentation of business community interest in the following areas: taxation, privatization and bankruptcy. Along with FNSt, PHARE Democracy co-financed Live Money weekly talk-show, mentioned above.

The **Center for Liberal Strategies** financed with BGL 3,051,750 IME research activities as follows:

- Preparation of economic growth scenarios for Bulgaria until 2010;
- Comparative study of Bulgaria and other transition countries based on International Financial Institutions' data;
- Survey of basic financial indicators for the last 5 years (foreign debt, trade balance, etc.)

Handwerkskammer Koblenz - Sofia Bureau granted BGL 5,193,718 for applied research on "Conditions for Small and Medium Size Business in Germany, Poland and Greece: organization and representation of interests; recommendations for Bulgaria". The funds were spent entirely in 1997.

The **Foreign Investment Agency** financed IME costs of preparing the program and organizing speakers for the first Bulgaria Investment Forum '97, the funding amounted to BGL 7,708,711. BIF idea is provide an opportunity for a broad dialogue on possible improvements of Bulgarian and regional Balkan investment environment, bringing together leading representative of the local and foreign investors community, IFI's, government and corporations.

Privatization Schemes and Property Transfer

Georgi Stoev, IME

Historical Background

The privatization process in Bulgaria began at the beginning of 1993. Since then, a total of 1,102 whole companies and detached units of another 1,229 enterprises have been sold. The state delegated its privatization rights to the branch ministries and the Privatization Agency (authorities as per Article 3 of the Privatization Law). The municipalities delegated their privatization rights to regional privatization agencies. The central Privatization Agency is responsible for the largest transactions, for companies whose long-term assets' value exceeds 350 million Bulgarian levs. Since 1993 the Privatization Agency (PA) has contracted 459 deals, out of which 58 are with foreign investors. The PA's total revenue from foreign investors is about US \$620 million, which is a significant part of total foreign investment in Bulgaria for the period 1993-1998 and is 43 % of the total privatization proceeds.

The activity of the privatization authorities in all the cases shows a trend of increasing. There were more and more privatization deals as the years went by. The situation with the financial effect of privatization was slightly different. The years in which there were more deals did not necessarily show a greater direct financial effect (cash revenues plus liabilities undertaken).

A correlation between direct financial effect and investments contracted can be observed up until 1996, as the latter were two times less on average than revenues and liabilities undertaken. The year 1997 showed the only exception to this pattern, when investments contracted exceeded the direct financial effect by US \$283 million. This was due mainly to increased activity by the PA, whose deals with foreign investors usually brought in much more in investments contracted than in revenues. In 1997 the PA contracted deals that brought in US \$352 million as cash revenues and \$611 million in future investments. The biggest deals with foreign investors — MDK Pirdop, Sodi Devnya and Devnya Cement — accounted for almost half of the direct financial effect of privatization for that year (US \$285 million). By October 1998 there is no sign that we will see the same picture as in 1997. One reason is that the PA has definitely indicated that its favored buyers

Table 1 Privatization Deals 1993-1998

	Authorities as per art. 3		Ministries		PA	
	Whole companies	Detached units	Whole companies	Detached units	Whole companies	Detached units
1993	21	41	17	34	4	7
1994	88	77	67	62	21	15
1995	105	204	84	156	21	48
1996	158	357	110	259	48	98
1997	329	262	274	233	55	29
1998	401	288	339	237	62	51
Total	1102	1229	891	981	211	248

Table 2 Number of Deals and Financial Effect (USD m) 1993-1998

	Number of deals	Direct financial effect	Investments contracted
1993	62	72,185	58,971
1994	165	232,81	201,738
1995	309	181,919	151,914
1996	515	416,573	170,561
1997	591	607,997	891,346
1998	689	410,772	268,828

from now on would be those paying in cash.

Privatization Schemes

The topic of this paper is privatization and property transfers as legal procedures. Thus, I will be examining the techniques for privatization which are regulated by a legal framework. That the latter is objectively correctable is the focus of my critique.

The originally adopted Privatization Law (1992) and the amendments made to it afterwards outlined five different schemes for selling state-owned enterprises. Since 1993 all five schemes have been used, and all of them have shown broad gaps between theory and reality. The five different schemes are:

- voucher-based mass privatization;
- public offerings of stocks;
- sealed-bid auctions;
- tenders; and
- direct negotiations with potential buyers.

Auctions are used mostly for selling minority stakes, while tenders and negotiations are the ways bigger stakes and whole companies are sold. Thus, the last two techniques are effectively used for management-employee buy-outs, which proved to be the most controversial method of privatization.

- A method not mentioned in the Privatization Law is that of equity increases and the initial sale of the new stocks or shares to private persons. It is a technique which is rarely accompanied by a public offering of the new

shares.

- Liquidation is a technique through which the company's assets become the property of another person, and when this person is private, liquidation becomes effective privatization. Regulation of the last two types of privatization schemes mentioned is specified only in the Trade Law.

Grounds for Corruption

The conceptual frameworks that deal with the issue of privatization make a clear distinction between general and specific factors for corruption. Among the general factors are those resulting from the state of transition of the post-communist economies, including "the previous regime's philosophical insistence that capitalism and the free market were lawless and corrupt at their core."¹ The specific factors can be found at the core of the different privatization schemes, the main ones being:

- low speed - the slower the process of a deal, the more time there is to arrange a corrupt transaction;
- transparency - less publicly-available information increases the control rights of the administrators and makes privatization look like part of the gray economy;
- level of complexity of the decision-making - more complex decisions make the administrative discretion higher, thus increasing the control rights of corrupt officials; and

- stability and simplicity of the legal framework regulating privatization and property transfers.

The first five schemes, treated by the Privatization Law, can be viewed in a slightly different way. Mass privatization, public offerings and auctions are the open ways to privatize, while tenders and negotiations are considered private invitations to potential buyers. An interesting comparison between Bulgaria and Hungary can be made. In that country, the open procedures of privatization account for nearly 70% of all privatization deals.² In Bulgaria, where this information is hard to find, the percentage of open procedures is unknown but it is surely far below 70%.

Mass privatization created new economic agents — the privatization funds. The funds collected the vouchers of the majority of participants in mass privatization. Thus, they obtained a huge resource which was to be used at the open auctions. The funds were regulated by a separate law, which outlined that the Securities and Stock Exchange Commission was responsible for their licensing. The license fees were not flat, but a percentage of the resources accumulated. In certain cases this turned out to be an expensive experience. Thus there was created the initial source of corruption which is natural in any public institution that has the right to grant a license. Then came the secondary corruption source: all the available information about the funds was concentrated in the Commission. Insiders could make a good use of all they knew about the resources of different funds. What is more, the Commission, the main idea of which is to regulate the stock market, imposed barriers to the transfer of stocks owned by privatization funds. This was an additional obstacle to the development of a Bulgarian capital market. And the underdevelopment of the stock market became another hindrance to the transparency of privatization through public offerings, which is discussed below.

¹ D. Kaufmann and Paul Siegelbaum, "Privatization and Corruption in Transition Economies."

² Dr. Maria Dezserine, "Accessibility and Transparency of the Public Procurement Process in Hungary, Albania and the Slovak Republic."

Privatization scheme	Major Sources of Corruption
Mass privatization	low speed unstable legal framework
Public offering of stocks	low transparency
Sealed-bid auctions	low speed low transparency high administrative discretion
Tenders	low speed low transparency
Direct negotiations	low speed low transparency high administrative discretion
Equity capital increases	low transparency

Theoretically speaking, there are no significant possibilities for corruption to be found when looking at the **public offering** procedures. This is a scheme that includes all the necessary attributes for reduced corruption; it is public, transparent, fast and executed by an independent agent. Nevertheless, if we look into details we will find that this is only a theoretical illusion. "Elkabel" and "Chimmash" were among the first enterprises privatized in this way on the stock exchange. The sale of "Elkabel" went on for several months, while "Chimmash" was sold in only a few days. The main reason was not the greater market capitalization of "Elkabel," but rather the lack of information and clarity about the other company, which hindered the fast sale of the state-owned stake. The current law on securities trading and stock exchange regulations obviously cannot ensure transparent stock trading and enough publicly-provided information about companies. All of this gives us no reason to talk about a transparent market with free competition. The scale of the stock market itself permits manipulation by a single person with ridiculous amounts of money. Moreover, this method of privatization provides grounds for corruption on another level, which seems to have been left unexplored. The intermediaries that executed the public offerings were chosen in a way that could be hardly viewed as competitive.

Management-employee buyouts (MEBOs) definitely have their economic advantages. Unfortunately, this kind of deal is usually preceded by a full cycle of relations 'in the shade.' The reasons are twofold: first, it is in the basics of the negotiations and tender schemes themselves, and second, the concrete conditions of a MEBO deal. Tenders and trade sales are slow methods of privatization. Specific transactions are negotiated individually, which additionally maximizes administrative discretion. The contracts are signed either by the central or a regional Privatization Agency, or by a branch ministry. Neither are independent of the executive power. Usually, MEBOs present all of the factors necessary for corrupt conduct — they are slow and administrated by a government-dependent body. The relatively favorable terms of payment on such deals often bring more than one candidate (each management-employee based), and then the government decision loses its last signs of transparency.

Privatization through **equity capital increases** is another technique for the de-nationalization of enterprises which is not mentioned in the law, which only outlines ways of selling already-existing state-owned shares and stocks. Actually, a several-times increase of a company's equity capital executed via open or not-so-open sales to private persons results in an effective privatization of the company. A recent example was the sale of newly-issued shares of

"Vinprom-Rousse" to an American firm. This seems to be the least transparent type of privatization, because there is no adequate information about the terms of the deal and the company itself. This kind of transaction is regulated only by the Trade Law, which defines the rules of equity increases. The general conditions outlined by the Trade Law are hardly enough for regulating a privatization deal.

Insolvency and liquidation have turned out to be a favorite privatization technique for former executives of state-owned companies. Like equity increases, this method is regulated by the Trade Law. The law follows the principle of a creditor's right to get his claims paid back first after a company has been pronounced insolvent. This rule gives a creditor the chance to become the new owner of a company's assets. The mechanism is quite simple: the company is being siphoned for some period of time, and when it is no longer able to meet its debt obligations, an insolvency procedure is initiated by its main creditor. The latter is usually a firm led by former or present manager of the company, or persons connected to such a manager. Therefore business relations between the state-owned firm and a private firm are needed to turn the wheel. After the declaration of insolvency, the company's assets become private property and the company ceases to exist. This is an excellent example of transference of property with no transfer of control rights. Though simple and clear, the scheme works almost flawlessly.

The Role of Privatization Intermediaries

In 1997 the Government and its Privatization Agency approved a list of 30 enterprises the transactions of whose sales are to be closed by privatization agents. The activity of the agents was financially supported by the EU PHARE program and USAID. The agents' expenses are covered on a monthly basis by the sponsors, thus giving them an incentive to work as long as possible on a given deal. There is no incentive to speed up the process,

Privatization Intermediary

BRIB

Credit Suisse First Boston (Europe) Ltd.

Expandia Bulgaria Co. Ltd.

KPMG Bulgaria

Finlombarda Spa

Nord Impuls GmbH

Price Waterhouse Coopers

Dresdner Kleinwort Benson / CA IB

Roland Berger&Partners GmbH (Ger.)

RES & Co. (UK)

DFC S. A. (Spain)

WS Atkins International Ltd. (UK)

Raiffeisen Investment AG (Austria)

Arthur Andersen (UK)

KPMG - Barents Group (USA)

Morgan Grenfell & Co. Limited

TOB (Germany) - Speedwing (UK)

Pool / Industry

Pool Machine Building - 2

Pool National Electric Company (NEC)

Pool Metallurgy - 1

Pool Tourism

Pool Chemical Industry

Pool Electronics

Pool Balkancar

Pool Bulgartabac Holding

Electronics and Metalwork Engineering

Plastics, Rubbers and Fibers

Shipbuilding

Steelworks

Miscellaneous

Agrochemicals and Petrochemicals

Chemical and Petrochemical Industry

Bulgarian Telecommunications
Company (BTC)

Air Transportation

because the agents get paid independently of the final result of the deal. The situation with the agents for the pools of companies, introduced before the end of last year, is a bit different. Their remuneration, whether it is fixed or variable, is dependent on the final result of the transaction.

However, more than a year after the introduction of the privatization intermediaries, there are only preliminary recommendations for buyers. One of the reasons is the slow pace of procedures concerning that kind of deal. Moreover, the PA has recently accepted regulations which make the agent function just like a consultant. The recommended offer is treated in the same way as any other on the short list of offers. There is another team on behalf of the PA to analyze the offers and the company standing. The only thing that the agent does is to get the money after the transaction is accomplished. Therefore we cannot say that the introduction of privatization intermediaries has contributed to higher speed or transparency of privatization, and thus it has not changed in any way the conduct of corruption.

'Cash Revenues or Future Investments' Dilemma

Tender and negotiation techniques give the opportunity to select a buyer who gives the best combined offer, not just the best price. The price remains an important factor, but only in combination with many others, among which the chief one is considered to be future investments. Of the PA's deals with foreign investors, 46 show that the amount of investments contracted is more than or equal to the cash revenue. Only 12 show the opposite relation. Obviously the choice should be made according to much more complicated principles than for the other privatization schemes. At least there must exist a method of quantitative comparison between cash payments now and promised investments in the future. The easiest and perhaps the best way to do that is to compare the effects of each on the budget. Still, the

**Future jobs ⇒ Future wages ⇒ Future budget revenue from
income tax ⇒ Present value of income tax budget revenue**

**Future jobs ⇒ Less unemployment subsidies in the future
⇒ Present value of unpaid subsidies**

problem remains almost without a solution. Cash receipts are calculated right away on the income side of the budget, but future investments have no direct effect on it. They could touch both the income and expenditure sides, in at least three ways:

- increasing the company's profits, thus increasing the tax income;
- employing more people, generating more wages and more tax income;
- employing more people, thus less government unemployment subsidies.

None of the three effects can be calculated even approximately. The future profitability of a company can hardly be forecast in such an economic environment. The level of future employment, if not fixed in the privatization contract, is even harder to predict. Therefore the complexity of the decision makes it less transparent.

Roughly speaking, there are two ways to avoid the complexity, and thus the low transparency, of such a deal. First, the price can become the only important factor in an offer. Any other factors may be taken into consideration if the prices offered are equal. Second, only factors that can be quantitatively assessed and compared to each other should be considered decisive. For instance, a set number of future jobs in a company have a budgetary effect which is comparatively easy to calculate and whose present value gives a basis for comparison to an immediate cash payment.

This is an elementary illustration of how a simple model of the effects of future employment can work. And last but not least, making the mechanics of the calculations involved in a deal simpler can result in higher speed of the negotiations.