

Newsletter

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Editor's Note

In this issue IME presents a compilation of materials that summarize economic developments in 1999 and recapitulate economic reforms of the last ten years. The papers are based on past IME publications, recent research and findings of a broader project "*In Search of Growth: Bulgaria's Lessons and Policy Options*". The IME team included: Assenka **Yonkova**, Svetlana **Alexandrova**, Georgy **Stoev**, Diana **Kopeva**, Yordanka **Gancheva**, Latchezar **Bogdanov**, Tzveta **Dimitrova**, Krassen **Stanchev** and Zora **Blagoeva**

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In Search for Economic Growth

Institute for Market Economics

After 1989, Bulgaria faced a post-socialist recession. In the ensuing nine-year period, only three years registered growth in real GDP (1994, 1995 and 1998). Since 1989, real GDP has lost more than one-third of its initial volume.

It is generally accepted that the reasons for the decline were the loss of the former COMECON markets and the official foreign debt (plus 1990 default), restricting the overall investment capacity of the economy.

However, these causes are relevant only to the period before 1994, when the economy registered its first positive real growth since the beginning of the transition. The costs for this upward move were:

- a significant delay in needed restructuring of the real sector and
- a sharp decline in the central bank's foreign reserves.

Structural reforms had barely started, when in 1996 the economy turned downward once again. In early 1997, the country faced a hyperinflation shock, combined with a steady decline in real GDP. The medicine for this ailment was found in the introduction of the currency board arrangement (CBA). This brought monetary and financial stability and in 1998, the economy recovered to a growth rate of 3.5%. In fact, the limiting of government discretion via the CBA coincided with the recovery.

GDP per capita (in current year USD) showed an even more dramatic drop than real GDP, from US \$2,513 in 1989 to US \$946 in 1991. It should be noted, however, that it was not until 1991 that the exchange rate used by for official statistics caught up with the market rate.

Structure of GDP

In the post-socialist years the demand-side GDP structure changed in the direction of an increased share of households' consumption, and decreased shares of the government's final consumption and investments. The share of net exports has varied from -7.4% to 5.5%. Although the share of the government's expenditures for final consumption has shrunk to 15.1%, the state has retained a dominant share in the economy, as more than 40% of GDP goes through the budget. Moreover, a huge part of the economy's assets are still owned by state companies.¹

The sector structure of aggregate output is most correctly represented by gross value added (GVA). This showed a significant decline for the industry share, and an equivalent increase of the shares of services and agriculture. Several factors led to this change in the structure of GVA:

- the industrial sector's restructuring, through privatization and liquidation of state-owned enterprise;
- the restitution of lands, increasing the share of agriculture; and
- the emergence of the private service sector.

Privatization and liquidation of the state-owned companies contributed to the change in the ownership structure of GVA, as the share of the private sector reached 63.7%, starting from almost zero in 1989, and almost tripling its share between 1992 and 1998. The private sector produces 75% more than the government-owned enterprises, while employing only 40% more. This also indicates a higher productivity level in the private sector.

Lessons of the Post-socialist Recession

Despite the Kosovo war, which placed additional obstacles before Bulgarian exporters, in 1999 the country seems to be heading for a second consecutive year of moderate growth,² after the sharp decline in 1996-1997. There is a general belief that restructuring (meaning also a reduction in output) of state-owned industry is coming to an end. On this basis, there are, among economists and IMF mission personnel, hopes for more robust growth next year. In terms of the search for growth, 1999 and 2000 mark a turning point. For this reason it is more than appropriate to assess past experience and derive conclusions for the future.

Graph 1: Real GDP Index: 1989=100

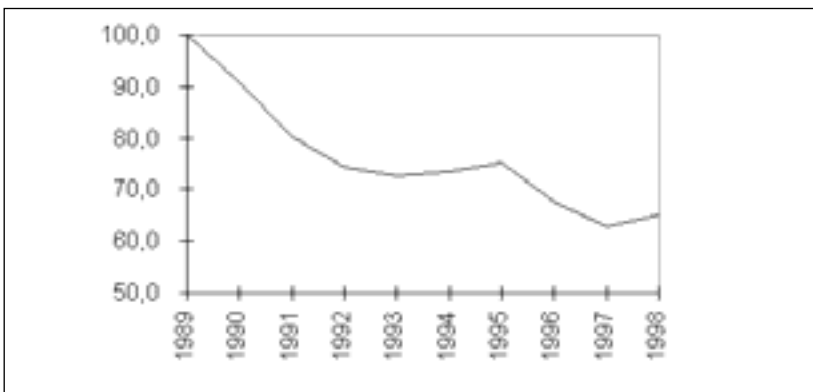


Table 1: GDP per capita (current year US Dollars)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
2,513	1,933	946	1,014	1,278	1,150	1,563	1,192	1,232	1,480

Table 2: Demand-side Structure of GDP

	1991	1998
Industry	42.8	28.7
Agriculture	14.2	21.1
Services	43.0	50.2

Table 3: Structure of Gross Value Added

	1991	1998
Private consumption	55.9%	71.3%
Government consumption	17.2%	15.1%
Investments	22.6%	14.7%
Net exports	4.3%	-1.1%

Sources: NSI and IME calculations

There are several major reasons for the long-lasting transitional recession in Bulgaria. They may be summarized as follows:

1. The transition period relatively quickly removed the institutional framework of the centrally-planned economy, while the establishment of the free-market institutional framework (in terms of regulations, institutions and relations) turned out to be a long trial-and-error process. The first years after 1989 brought about a gap in the *coordination of the economy*.³ The result was a delay in the reallocation of resources previously employed by the socialist industry. Unclear property rights, the non-functioning legal system and the under-developed financial system may be viewed as major characteristics of this framework.
2. The restructuring of the real sector required a political will to privatize and liquidate loss-making enterprises. In turn, there was a need for administrative backing to implement, follow and sustain the will to lift that responsibility off the government's shoulders. Either a lack of political will or misconceptions about privatization and liquidation let the economy lose seven years.
3. Government-retained control over state-owned assets slowed the liberalization of economic life (in terms of domestic and foreign trade controls and permissions, procedural and tariff barriers, combined with unstable tax regulations) and has kept the business environment rather unfriendly.

The following policy lessons seem to be relevant:

- the transition could have been much less costly (in terms of lost wealth and economic opportunities) if the state had concentrated on the establishment of the free-market institutional framework, rather than over-regulating the newborn private sector. For a period of nine years it is obvious that the private sector has often compensated for the decline in the government sector⁴, it has been constantly increasing its role in different segments of GDP creation, and in the first half of 1999 it compensated for the sharp decline of the government-owned former export leaders;
- monetary stability was empirically proven to be a crucial factor for development, and the best — in Bulgaria's circumstances — way to achieve it was CBA; i.e., the restriction of the government monopoly on the money supply and tying the monetary "policies" of the central bank to its foreign reserves; thus, envisioning of competitiveness and the flexibility of economic entities seem to have become a key precondition for prosperity.

1. Even after completion of the largest privatization deals (expected in the first half of 2000), about 35% of the assets will remain state property.
2. The National Statistics Institute (NSI) estimated 0.5% real GDP growth for the first half of 1999.
3. The term is used by Janos Kornai, in his "Transformation after Socialism."
4. An exception is represented by the period from mid-1996 to early 1997, during which private sector output was declining as well, though at a slower pace.

Private Sector Development: Structure and Barriers

Institute for Market Economics

General Picture: The state of the Private Sector

The development of the private business sector in Bulgaria began amidst a dominant public sector frozen by delayed privatization and quasi-fiscal subsidies. Politically-set priorities made the state manufacturers operate at low profit mar-

all picture of the emerging Bulgarian market. It turned out to be easier to siphon off assets from public enterprises and financial institutions than to invest in a green field.

Not surprisingly, all of this affected the major characteristics of the private sector. There is strong evidence that the fixed capital of small

Table 1: Private Sector - Dynamics of the Share of Extended Credit in GVA (% of total)

	1993	1994	1995	1996	1997	1998*
Share of credit extended	12.40	13.90	25.90	21.21	57.49	63.3
Share of enterprise investments (expenditures for purchasing fixed assets)	22.76	39.04	44.45	38.53	54.40	n/a
Share of GVA	35.40	39.40	48.00	52.50	58.80	63.7

* Preliminary
Source: BNB, NSI and IME calculations

gins, meaning low production prices. This enabled high retail profit margins and actually created numerous private businesses. At the same time, private businesses also began to act as suppliers, and due to both weak government supervision over state-owned enterprises and intentional policies, the latter suffered significant losses from this "cooperation". The private sector also began to take part in foreign trade activities, which had previously been monopolized by centralized state companies. Combined with the various tax and duty preferences for different entities (e.g. student cooperatives) in existence at the beginning of the transition, this provided enormous profit opportunities. Similarly, private financial institutions were established, using credits from state-owned banks. Understandably, those banks' credit policy was to provide "friendship" credits to their own managers or shareholders, which will be never paid back. This fact is of ultimate importance to the over-

private firms is mainly financed from personal and family sources. Personal savings, family property or inheritance, assistance from acquaintances (or, presumably, non-institutionalized — informal — start-up credit) are the most often-used means of support for starting businesses. A survey conducted by IME in 1996 proved that 82.4% of the private companies surveyed were financed mainly by personal, family or friends' savings.

The structure of credit deserves special attention: 62% of firms have not resorted to credit at all, while 41.5% have been financed "by acquaintances." Inter-firm credit is probably included within this group.

Naturally, businesses having been started up in an unofficial way affects their consequent unofficial practice. Another strange fact is that 20% of those interviewed in early 1996 declared that they do not have any bank account at all.

Table 1 above suggests two major conclusions:

First, until 1997 the private sector's share in total bank credit was substantially lower than its contribution to GVA. This could either mean that private companies were achieving higher capital efficiency, or that they had access to non-institutionalized credit. The situation in 1997 and 1998 had changed, and the figures show an almost equal private sector share in credit and GVA. The reason, however, is not that commercial banks have significantly increased the amount of credit extended to private companies, but rather that most public sector enterprises have been denied access to new loans. Central bank data prove that in 1998 public sector companies received about 36% of the short-term and 4% of the long-term credit extended during that year.

Second, the share of investment in fixed assets in private companies is lower than the value added they produce. This could mean that private entrepreneurs utilize their assets better

At the same time, large state-owned enterprises' performance was on the decline. In 1998, a year with real GDP growth of probably 4-5%, sectors in which state companies dominated suffered severe declines in sales and profits. Sales in the oil-refining and chemical (basically fertilizer plants) industries shrank by some 27-28% in 1998 compared to 1997, those in the steel industry by about 10%, etc. Large state enterprises continued to accumulate bad loans. The difference this year is that the major lenders appear to be the government (through tax arrears) and energy suppliers — Bulgargas and the NEC — state monopolies themselves. Government estimates show the level of this kind of bad loans to be about DEM 1.5 billion, or six times more than the structural reform funds planned for in the 1999 Budget.

The sector distribution of private companies leads to several conclusions.

Most companies are engaged in trade (60.4%), industry (12.25%) and services (8.86%). This is not surprising if we recall the legacy of credit

Table 2: Private business by activity in 1997

Sector	Industry	Agriculture & Forestry	Construction	Trade	Transport	Services	Finance	Other	Total
Total									
number	23,110	6,620	7,617	113,956	12,899	16,721	1,082	6,676	188,681
%	12.25	3.51	4.04	60.40	6.84	8.86	0.57	3.54	100.00
employees	379,087	90,449	55,594	244,150	34,394	45,007	11,948	25,114	885,743
%	42.80	10.21	6.28	27.56	3.88	5.08	1.35	2.84	100.00

Source: NSI and IME calculations

Table 3: Private sector by number of companies and level of employment, 1995-1997

Employees	1995		1996		1997	
	Firms	Empl's	Firms	Empl's	Firms	Empl's
Self-employed	162,039	151,538	151,033	127,161	122,305	133,637
1-9	39,182	102,927	45,982	119,680	55,032	137,038
10-19	3,760	50,194	4,642	62,155	5,109	68,824
20-49	2,780	84,331	3,184	96,363	3,638	109,888
50-99	985	67,046	1,122	76,471	1,336	92,650
100-249	522	76,890	563	83,586	899	137,462
250 or more	137	64,606	174	88,225	362	206,244
Total	209,405	597,532	206,700	65,3641	188,681	885,743

Source: NSI and IME calculations

than public sector managers do, while, on the other hand, private firms engage in labor-intensive rather than capital-intensive activities. Given that labor productivity in private firms has been consistently higher than that in state-owned ones, it turns out that private entrepreneurs generate higher income with the same amount of fixed assets.

and fixed assets in the private sector. Since privatization was delayed, access to credit was restricted and few incentives for investment were provided, private entrepreneurs specialized in sectors with low capital consumption.

Due to various entry barriers, high transaction costs, and the sector orientation of the private sector, the share of small firms, and especially of so-called microfirms, is extremely high. About 95% of the businesses in operation are employ nine or fewer people. Companies having more than 100 workers represent less than 1% of the total (even in 1997, when privatization was accelerated and numerous large enterprises were for the first time counted as private). Companies having fewer than 100 employees provided jobs to 77% of all those employed by the private sector in 1995, with the share down to 62% in 1997. This, together with the credit statistics for the period, proves that there are barriers that keep businesses small, both in terms of employment and in terms of assets.

Government policies that most affect the business environment

1. Quasi-fiscal subsidies

Of the various mechanisms that governments have used to subsidize enterprises, we will here outline only a few:

- Via exchange rate policy. Prior to February 1991, the Central Bank discretionarily provided foreign currency at rates several times lower than the black market to only a limited number of companies. The latter then reaped the retail profits. The same scheme was later applied to selected commercial banks in periods of shortage of foreign currency in the country (1994, 1996). This policy had serious negative impact; it distributed wealth according to political criteria, thus hampering market competition and keeping ineffective enterprises afloat.
- Via the banking system. Political pressure made banks lend freely to state-owned enterprises without submitting them to prudent credit analysis. In 1994-1996 the semi-official government policy toward state-owned enterprises was to allow them to cease loan repayments. Acting as a lender of last resort, the BNB bailed out commercial banks up until 1996. The outcome was severe inflation from printing more currency, the obliteration of savings through devaluation and bad investment, and finally the decapitalization of further sources of capital for private investment.
- Via monopolies on utilities and energy. Two major patterns can be distinguished here. Before 1997, the scheme involved administrative control over prices, which provided for cheap supplies of energy and raw materials to the ineffective heavy industries, so as to avoid restructuring them. The suppliers, on the other hand, were compensated with easy credits from the banking system. The second mechanism was "invented" later, in 1997 when, forced by the International Financial Institutions (IFIs), the government had to allow for pricing of the monopoly-provided energy and utilities that at least covered costs. As a result, ineffective state-owned companies merely suspended payment on deliveries. Government estimates in the middle of 1999 show the level of this kind of bad loans to be about DEM 1.5 billion, or six times more than the structural reform funds planned for in the 1999 Budget.

2. Price Controls

The Price Law of 1995 was significantly amended in 1997 and price controls were again basically eliminated. In 1998, only 15.8% of the consumer basket remains under such control. In

previous years price controls (as a percentage of the consumer basket) were as shown in Table 4:

However, policies are still mixed: there is an active Decree of the Council of Ministers, No. 269 (of July, 1997) that regulates the prices of basic consumer commodities — bread, meat, cheese, milk, meat, sugar, eggs, vegetable oil, etc. — requiring that all transaction contracts for these goods provide for a so-called "final" (or retail) price at which they are purchased by the

Table 4: Share of controlled prices as percentage of consumer basket

Year	Share
1991	14.0%
1992	13.4%
1993	16.5%
1994	18.9%
1995	49.0%
1996	52.4%
1997	45.0%
1998	15.8%

Source: NSI, IME calculations

consumer. The share of commodities whose prices are regulated by the government equaled 2.78% of GDP in 1998.

Price controls on some foods — bread and dairy products — were eliminated in 1999. The outcome of the price controls maintained in 1995-1996 was an enormous shift to informal operation by a huge portion of retail companies.

3. High transaction costs

In Bulgaria, these costs have not been measured in any detail. The only attempt at measurement¹ was initiated by the IME in mid-1996, when we surveyed small and medium-sized private firms.

Costs of contract enforcement

- The firms surveyed determined that the average amount of time to prepare a contract is 14 days. It is the job of 77% of company owners, who spend 10 days per contract.
- of the businesses interviewed had had no cases of unfair execution of a contract. But cross-tabulation shows that among these were all of the companies that prefer to rely upon "family" and "acquaintance" resources.
- The protection and insurance markets marked a fast development after the political changes of 1989-1990. 65% of firms in the sample reported they had not suffered from defaults on contracts, while 65.7% had insured their firms' property.

- Despite negative press and public attitudes, private businesses found security and protection expenses inevitable. 34.9% of those in the sample had incurred additional protection expenses and 10.6% had resorted only to security firms' services.

Costs of dealing with the government

- (24.5%) of the firms surveyed admitted to keeping "secondary" accounts. For most of these firms (60%), the separate accounting is necessitated by cash payments.

Table 5: Tax Cost of formal employment

	Avg. wage in public sector (BGL ¹)	Personal income tax due (BGL)	As % of avg. gross wage	Obligatory social welfare contrib. by employee (BGL)	As % of avg. gross wage	Obligatory social welfare contrib. paid by employer (BGL)	As % of avg. gross wage	Cost to employer per 100 BGL net income received by a worker
1991	959	116	12,1%			354,83	37%	155,88
1992	2 047	301	14,7%			757,39	37%	160,64
1993	3 231	390	12,1%			1195,47	37%	155,81
1994	4 960	700	14,1%			2083,20	42%	165,35
1995	7 597	969	12,8%			3190,74	42%	162,77
1996	14 392	2639	18,3%	288	2%	6044,64	42%	178,25
1997	141 640	20208	14,3%	4108	2,9%	59488,91	42%	171,43
1998	208 135	35746	17,2%	6036	2,9%	84502,81	40,6%	175,91
1999	210 000	31143	14,8%	9450	4,5%	86520,00	41,2%	175,03

* in old Leva
Source: IME

Table 6: Effective corporate income tax rate

Tax Obligated Entities	1989 - mid-1996	Tax Obligated Entities	mid-1996 - end 1997	Tax Obligated Entities	1/1/1998 - end 1999	Tax Obligated Entities	from 1/1/2000
Corporations with no state or municipal ownership		All legal entities		All corporations (except insurance companies)		All corporations (except insurance and gambling companies)	
Taxable profit of up to BGL 1 million	30%	Taxable profit of up to BGL 2 million	30.81%	Taxable profit of up to BGL 50 million	28%	Taxable profit of up to BGL 50 million	28%
Taxable profit of more than BGL 1 million	40%	Taxable profit of more than BGL 2 million	40.16%	Taxable profit of more than BGL 2 million	37%	Taxable profit of up to BGL 50 million	34.30%
Corporations with state or municipal ownership	52%			Insurance companies	7% over gross premium income	Insurance companies	7% over ; premium income
Banks and non-bank financial institutions	50%					Life insurance companies	5% over ; premium income
Foreign persons	40%					Gambling on sport events	8% over ; wager incor
Non-profit organizations	40%					Other gambling	12% over ; wager incor
State Savings Bank	70%						

Source: IME

• Two-thirds of firm owners themselves (or persons hired specifically for the purpose) spend up to one month of their annual working time handling liabilities to the government. The average amount of time spent for this purpose within the firm is about two months.

Taxation

The table above illustrates the dynamics of total labor costs imposed by the government by the tax and social welfare system. The last column shows the total cost to the employer per BGL 100 of net income received by the worker. With few exceptions, the cost has been consistently rising over the past nine years. Moreover, the government plans a further increase in health insurance contributions, from this year's rate of 6% to 12%. The effective personal income tax burden (against average salary) being relatively stable, the overall increase in labor costs imposed by the government is mainly due to the social welfare system. The policy behind this tendency is one of increasing revenues by increasing tax (contribution) rates. The result is a vicious circle of fewer and fewer legally employed workers, and higher and higher tax rates over the years. Naturally, in order to maintain informal employment, businesses also need to be able to collect informal revenues, and thus activities go into the "shadow" economy.

The table above provides a brief overview of the profit tax burden in Bulgaria. In absolute terms the effective tax rates are decreasing. The basic tendency in the corporate tax system is to abolish tax exemptions and reliefs. During the 1992-1996 period all exemptions for investment in certain categories of assets were canceled. Since 1998, there are no exemptions for newly privatized companies, and since 1999 no exemptions for certain groups of foreign investors exist. Moreover, over the last two years, the scope of tax-deductible expenses has been significantly reduced. The impact of the abolishment of investment tax exemptions is twofold: first, it places a barrier before start-up businesses, which have a clear incentive to start with labor but without capital-intensive activities; second, together with the rigid credit environment, the incentive to finance investment through informal activities (avoiding tax payment) is higher.

Entry barriers for private businesses

Licensing requirements impose entry costs upon start-up entrepreneurs. Thus, they increase the overall cost of doing business, and at the same time reduce competition. The table below demonstrates a steep upward trend in the number of activities requiring licenses or permits.

Since most of the requirements imposed in 1998 and 1999 were justified by harmonization of Bulgarian legislation with EU directives, this tendency is expected to continue. The overall impact of following such policy hand-in-hand with foreign trade liberalization is diminishing the competitiveness of domestic entrepreneurs.

Table 7: Number of activities requiring licenses or permits

Year	Newly enforced licensing requirements	Total licensing requirements in place
Until 1989	2	2
1989	4	6
1991	3	9
1992	1	10
1993	5	15
1994	6	21
1995	21	42
1996	13	55
1997	10	65
1998	21	86
1999	20	106

Source: IME

Conclusions

The private sector's share in the economy has reached almost two-thirds; up until 1996 it grew significantly faster than the amount of credit received and fixed assets employed.

Stringent personal and corporate income taxation, combined with delayed privatization and high entry barriers, have resulted in a huge informal sector; also, private businesses are predominantly small and engaged in labor-intensive activities.

Since 1997, the state has abandoned discretionary policies that affect the macroeconomic environment; however, it is expanding its role in the direct regulation of business activities with an increased scope of licensing, or at least registration, requirements.

1. The survey was conducted in April and May of 1996, and is representative for private enterprises in the cities of Sofia, Plovdiv, Varna and Silistra.



Banking Sector Development in Transition

Institute for Market Economics

The transition from a centrally-planned to a market economy, as experienced in Bulgaria over the past decade, involved two important types of changes: changes in institutions (in a formal sense) and changes in patterns of economic behavior. These in turn demanded institutional and behavioral changes in the financial system, and respectively the building of efficient financial markets. The importance of these changes stems from the fact that the banking system and capital markets, because of their linkages to savings and investment decisions, play a great part in the improvement of resource allocation, macroeconomic stability and the performance of the economy. Because of the country's inability to attract a sufficient amount of foreign investment, it obviously needs a mobilization of domestic savings. In this context, the proper design for its financial markets is of great importance. Fragmentation of these markets can be a major impediment to economic growth.

Background

The banking system is of crucial importance to economic performance. A special feature in the Bulgarian case is the predominance of banking and the underdevelopment of capital markets. Due to the limited scope of the market for corporate securities, as an alternative to bank credits for funding capital investment, the predominant part of lending in the country is not securitized. Under such circumstances, banks became the primary institutions to perform assessment and monitoring of the risks and returns of financial intermediation.

The initial conditions regarding market-oriented reforms in the banking sector were not favorable for a prompt transition, and they still have an impact on banking system development.

1. The centrally-planned banking system did not perform most ordinary bank functions. There was one bank, the Bulgarian National Bank (BNB), with a network of municipal branches, which acted rather as a control agent. Before 1981, there were only two other banks: State Savings Bank,¹ which held all individual and household deposits, and the Foreign Trade Bank (now Bulbank), which performed all international banking transactions.
2. The state monopoly on banks and enterprises distorted the very notion of bank loans. As Joseph

Stiglitz pointed out, "it was like the left pocket owing the right pocket money."² In addition, before 1990, there was no requirement to provision bad loans. As a result, the banking system inherited a significant amount of non-performing credits, which had a negative effect on its development over the last ten years.

3. The need for resolution of bad loans resulted in series of policies undertaken since 1991. The common denominator was a sort of triangle operation: replacing bad loans with state bond issues on the asset side of the banks' balance sheets and replacing bank credits with state claims on the liabilities side of the enterprises' balance sheets. This was implemented in part through special bond issues in 1991 and 1992, which covered the non-performing loans of some 120-130 enterprises. Eventually, the Law on the Settlement of Non-Performing Credits Negotiated Before December 31, 1990 (LSNC) was adopted in December of 1993. It stipulated that government issues bonds were to replace all remaining debts (negotiated before 1991) in arrears for more than 180 days. In more detail: the BGL-denominated ZUNKs (named after the law's Bulgarian acronym) amounted BGL 32 billion (some US \$1 billion, at the end of 1993), while the USD-denominated ZUNKs amounted to \$1.8 billion. Thus, they became a major item of the asset side of the balance sheets of several large state-owned banks.

4. The state monopoly on banks and enterprises impeded, and still impedes, the development of banking strategies in the banking sector.

The first signs of reform in the Bulgarian banking sector were noticed in 1981, when Mineralbank was established for the purpose of providing credits to newly-created small and medium-sized enterprises. Then the establishment of seven new banks in 1989 had a serious impact. The main goal of their creation was to extend credits to different industrial sectors. That same year the communist-era central banking system was swapped for a modern two-tier banking system featuring a typical central bank and with commercial banks, though mostly BNB branches. The legal framework came later, with the adoption of the BNB Law (1991) and the Law on Banks and Credit Activity (1992).



In the midst of all this, in 1990 there was a total of 70 banks in Bulgaria. The dynamics of the number of banks over the last eight years are shown below:

The newly-established commercial banks fall into several categories:

1. Large state-owned banks, specialized in financing the larger industrial sectors. During the period 1994-1995, eight out of nine large banks with assets exceeding BGL 30 billion were state owned. At the end of 1995, these nine banks (excluding State Savings Bank) held 74.9% of all financial assets in the system.
2. Small and medium-sized commercial banks, former BNB branches.
3. Private banks, established in 1990 and afterward, especially active until 1993: these emerged under a very liberal, low capital requirement and close to no-barrier, entry regime. Also, there was no requirement that the origins of the start-up capital be disclosed and proven; therefore, most private banks were started up with borrowed funds. The number of private banks increased significantly (from two in 1990 to 26 in 1995); and their share in total bank assets was 3.1% in 1992, and 22.4% in 1995.

ers. Sooner rather than later, banks realized this was a perfect scheme for siphoning money via BNB's and State Saving Bank's refinancing.

Foreign banks were allowed to operate (getting full licenses) after 1994; they were viewed as a possible means of securing the liquidity of the system. Foreign banks indeed tend to be larger and to have better loan portfolios, higher net worth and higher ratios of operating income to costs. But they were also able to select better corporate clients for themselves; thus, a kind sub-banking industry emerged: better banks had better clients, while the overall soundness of the system improved little.

Foreign banks in Bulgaria confirmed the following obvious benefits of foreign bank entry: greater competition, improved variety and quality of financial services and reduction of the probability of systemic crises.

The Crisis

The above-mentioned legacies of a fragmented banking system, with its large numbers of small state-owned banks and small, undercapitalized private banks, created the conditions for the severe banking crisis of 1996. Almost all of these small banks inherited a significant number of non-per-

Table 1: Commercial Banks in Bulgaria

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Year-end Total	70	78	59	41	45	47	35	34	34
of which Foreign	0	0	0	1	3	5	7	9	7
Licensed during the year	61	8	2	7	10	4	2	2*	1
of which Foreign	0	0	0	1	2	1	2	2	1
Consolidated banks	0	0	22	29	9	3	0	0	1
Banking groups following consolidation	0	0	1	4	3	1	0	0	0
No. of licenses revoked over the year	0	0	1	0	0	0	14	4	0

Source: BNB

The expansion of private banks had two major impacts on the development of the banking industry:

- increased the number of players but did not favor the market and competition: new entrants sought refinancing from the BNB to repay their own loans or competed for privilege contracts with the government or "politically sensitive" enterprises in order, again, to ease access to refinancing; thus there was no improvement in performance or quality of services; and
- the amount of large credits and the share of bad loans in private banks increased, as a result of the close connections between most of the private banks with their debtors — shareholders and individuals and firms related to them.

During the period in question, the regulations allowed banks to extend credits to shareholders and/or to persons connected with the sharehold-

forming credits, extended to the enterprises during the Communist era (or after 1990, when neither ZUNKs nor bankruptcies could cure newly accumulated arrears). This development coincided with the BNB's failure to effect sound supervision.

Delayed privatization and restructuring of the real sector, lack of financial discipline and widespread possibilities for state-owned enterprises to use soft credits and thus to transfer their losses to the banking system, combined with poor lending practices and attempts by the BNB to "cure" the situation with "measured" issues of notes, gradually led to the decapitalization of banks and transference of the costs to the general public.³

The net loss of the banking sector in 1993 amounted to BGL 5 billion, in 1994 it hit nearly BGL 7 billion; the problems were aggravated in 1995, when the net loss increased to BGL 30 billion by mid-year and about BGL 100 billion by the year's end. In 1996, nine of the ten state-

owned banks, which held 80% of banking sector assets, reported negative capital.

In 1996, real GDP contracted by 10.9%. Accumulated inflation for the year was 310%. The real interest rate on bank deposits was negative: minus 43% (even after the drastic increase in the base interest rate in late September, to 300% per year). The Bulgarian currency depreciated by 624% against the USD and foreign reserves fell below USD 440 million, the level needed for foreign debt servicing. The central bank's monetary policy ceased to be at all effective. Domestic debt increased and the debt service to GDP ratio rose from 10.4% in 1995 to 17.3% in 1996.

These developments were combined with weak banks and loss of confidence in the banking sys-

were channeled to the forex market, thus putting additional pressure on the lev. Throughout the period 1992-1996, the ratio of savings to GDP was very low — 11% on average, compared with more than 30% in faster-growing economies. Negative real interest rates⁵ and the limited choice of financial instruments also discouraged savings.

In this situation the central bank was not able to take radical measures against insolvent banks, thus prolonging and deepening the problems. By 1996, the legal framework for bank bankruptcy and deposit protection had still not been developed. Instead of solving the problems of the banks' bad performance, the BNB intensified its lender-of-last-resort function and poured money into illiquid banks. These liquidity injections, together with increased pressure on the central bank to finance the budget deficit, additionally accelerated inflation.

In May of 1996, the legal procedures for bank bankruptcy were introduced. Immediately afterward, 14 banks, representing 24% of total bank assets, were put under conservatorship. Of 27 private banks, the four largest and most well known were put under special supervision. Between May of 1996 and April of 1997, the number of banks closed and those put under special supervision by the BNB rose to 18. This was tantamount to the closure of one-third of the Bulgarian banking sec-

Table 2: Profit and Loss Account of Bulgarian Commercial Banks: 1991 - 1995 (BGL, millions)

	1991	1992	1993	1994	1995
Profits	7,201	2,903	1,896	8,702	4,646
Losses	1,845	2,291	4,172	10,056	29,181
Net Profit	5,356	612	-2,276	-1,354	-24,535
Number of banks with losses	2	6	11	15	23
of which private or foreign banks	0	0	5	7	15

Source: BNB

Table 3: Selected Macroeconomic Indicators: 1992-1998

	1992	1993	1994	1995	1996	1997	1998
Nominal GDP(BGL, millions)	200,832	298,934	550,514	867,691	1,660,237	17,055,205	21,577,020
Real GDP Growth (%)	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5
Dollar Exchange Rate (BGL/USD, year average)	23.34	27.65	54.25	67.17	177.9	1,641	1,714
Inflation (CPI, %)	79.5	63.9	121.9	32.9	310.9	578.6	1.0
GDP per capita (USD)	1,008	1,276	1,147	1,537	1,129	1,227	1,700
Money supply — M1 (BGL, millions)	37,833	48,303	75,131	107,886	236,628	23,429	28,261
Money supply - Broad Money (BGL, millions)	158,567	234,072	418,009	583,663	1,310,275	220,061	6,597,173
BNB's Forex Reserves (US \$, billions)	0.9	0.7	1.0	1.2	0.5	2.2	3.0
Foreign Debt (% of GDP)	145.6	128.3	117.5	78.1	98.3	96.9	84.1
Foreign Debt(US \$, billions)	12.1	12.5	10.4	10.5	9.6	9.7	10.2
Debt Service Ratio	n/a	16.3	12.6	10.4	17.3	n/a	n/a

Source: NSI, EBRD, BNB, Andrew Kenningham, "Bulgaria: Leveraging off the Deutsche Mark," *Economic Outlook and Fixed Income Investments*, Merrill Lynch, July 1997; OECD *Economic Surveys: Bulgaria 1997 and 1999*.

tem and the domestic currency on the part of the general public and business, as well as intentions to convert savings into hard currency and keep as much as possible in cash. It is estimated that deposit withdrawals from the banking system during the financial crisis in 1996-1997 totaled US \$830 million. By mid-1997 BGL deposits fell by 88% in real terms and their share of GDP fell from 41% (in 1995) to 13%, while foreign currency deposits fell by 40%.⁴ The withdrawn funds

tor. In addition to these measures, the bank supervision department took several measures against 19 banks aimed at macroeconomic and financial stabilization, including a ban on the payment of dividends without the BNB's permission, a ban on the extension of new loans, measures to collect loan repayments, limits on interest rates on deposits and reduction of operational costs.

The situation is estimated to be one of the world's worst banking crises in recent history. The reasons

for the crisis have already been mentioned above, but they can be summarized as follows:

- delays in real sector reforms and soft budget constraints; the preservation of loss-making enterprises in the public sector was government policy during the period and the state had considerable influence over lending to "strategically important state-owned enterprises"
- a weak private sector;
- over-supply on the banking market;
- inadequate bank management;
- concentration of credit risk and negative structure of credit portfolios, increasing the share of non-performing credits; some 50% of all loans granted by state-owned banks to non-financial institutions were uncollectible, and furthermore, for most state-owned enterprises the only way to service their debts and cover their losses was to take new loans from banks; by the end of 1995, 41% of all loans granted by both state and private banks to non-financial institutions were irrecoverable and only 39% of total lending by private banks was regularly serviced, resulting in net losses and further bank decapitalization;
- lack of an effective legal framework to execute creditor rights and require collateral;
- lack of sufficient information about borrowers and lack of a Credit Register;
- weak banking supervision and a lack of enforcement of existing supervision regulations;
- inadequate bank capitalization;
- institutional weaknesses; and
- inadequate internal controls and procedures.

A total of 33 banks survived (including State Savings Bank and branches of foreign banks), but some of them are small and private and at any rate will have to overcome some serious problems.

The Aftermath

As mentioned above, after seven years of delayed structural reforms, several failed attempts to implement a coherent stabilization policy and a chronic lack of financial discipline, Bulgaria experienced the most severe financial crisis since the start of reforms: a paralyzed banking system, undermined credibility of key institutions, substantial depreciation of the Bulgarian currency and several months (December 1996 - February 1997) of record hyperinflation. Overcoming this situation required a combination of policy measures, affecting the exchange rate, money supply and state budget, to restore confidence in the financial system.

A consensus was reached that such a combination of policy measures should include the adoption of a currency board arrangement (CBA), as a rule-based mechanism for enforcing financial discipline.

This stabilization mechanism included fixing the exchange rate, balancing the budget and ensuring the independence of the central bank.

The currency board was introduced in Bulgaria on July 1, 1997. The Bulgarian lev was legally fixed to the reserve currency, the DEM, and became automatically convertible into reserve currency. The monetary base (and thus currency issues) is fully covered by foreign reserves. Money supply is determined by money demand and is outside the BNB's control. This means that money supply became dependent on capital movements (inflows and outflows) and the balance of payments status.⁶ Thus money supply reflects the health of the financial sector. The BNB became much more independent, as it was prohibited from extending credits to the state or to any state agency. A special feature of the CBA is the inability of the economy to respond to external shocks through exchange rate adjustment.

The CBA proved to be efficient for the country's financial stabilization. The annual rate of inflation (CPI) decreased sharply, from 578.6% to 1% in 1998. That same year GDP showed 3.5% growth (the highest in the transition period), after a 6.8% decline in 1997. Foreign reserves increased to DEM 5.2 billion in June 1999. A more detailed survey of the currency board's design and implications is beyond the scope of this analysis. We will rather concentrate on its impact on the development of financial markets.

For the Bulgarian banking system, adoption of the currency board imposes the necessity for considerable changes in commercial banks' behavior. Some of the factors behind such changes becoming essential are:

- an extremely limited lender-of-last-resort option for banks in financial difficulty; there is very strictly defined possibility for the BNB to provide limited, highly collateralized credits, only to solvent banks with a temporary shortage of liquidity; the fact that banks cannot rely on central bank refinancing means that they have to improve their liquidity and risk management in order to maintain adequate liquidity and solvency, and this also means increased importance for foreign banks, because they settle most payment transactions through their headquarters and can rely on their headquarters for liquidity support;
- the adoption of prudential regulations;
- stricter supervisory policy;
- higher requirements concerning banks' solvency; and
- the elimination of soft credits and enforcement of hard budget constraints.

The current situation

As a result of the BGL's depreciation and the brief

period of hyperinflation, the capitalization of the banking system has improved since 1997. The depreciation of the domestic currency helped banks to restructure their portfolios and to clean up their balance sheets. The main tool for the banking system's recapitalization was revaluation of the gains from banks' assets denominated in foreign currency, while the real value of liabilities denominated in BGL was essentially reduced. Commercial banks' profitability was also improved during the period of the lev's devaluation. The decline in net income from valuation adjustments conforming with the currency board's introduction is the main reason behind the current decline in

tem assets. The third group is comprised of nine branches of foreign banks and their subsidiaries, representing approximately 10.6% of the banking system assets in Bulgaria.

According to the Banking Act, which replaced previous Banking and Credit Act and the Basle Accords, the BNB issued Regulation N8 dealing with capital adequacy and minimal founding capital requirements. All banks in Bulgaria were obliged to have 8% capital adequacy ratio by the end of 1997, a 10% capital adequacy ratio by the end of 1998 and 12% by the end of 1999.

Since the introduction of the currency board and new banking regulations, a tendency toward main-

Table 4: Main Balance Items of Some Bulgarian Banks, as of June 30, 1999

Items(BGL, mln.)	Bulbank	Post Bank	Hebrosbank	Expressbank	UBB	Biochim
Cash	261,730	41,598	37,722	35,340	115,597	83,944
Claims on banks and other financial institutions	899,696	153,990	50,971	38,667	345,131	97,135
Claims on non-financial institutions	221,740	68,643	103,285	160,848	140,216	72,235
Attracted deposits	1,252,387	323,396	225,982	228,441	603,768	353,060
Own capital	254,148	20,571	22,949	27,109	94,700	3,010
Reserves	54,823	10,676	17,869	34,440	148,900	18,301
Profit	87,703	1,064	6,738	24.7	18,724	-19.7

Source: BNB

Table 5: Total capital adequacy ratio of Bulgarian commercial banks (%)

Groups of commercial banks	1995	1996	1997	1998	1999 (end-March)
Group One	10.2	15.4	28.77	38.95	44.8
Group Two	18.8	13.4	23.61	34.76	40.2
Group Three	98.4	52.2	17.17	26.98	24.7

Source: BNB

profitability ratios related to 1997.

Currently, the Bulgarian banking system comprise 35 banks (including Promotional Bank and the branches of foreign banks). These banks can be divided into three groups.

The first group consists of seven banks: United Bulgarian Bank (UBB), Expressbank, Bulbank, Bulgarian Post Bank, State Savings Bank (SSB), Biochim and Hebrosbank. They represented 70.7% of banking system's assets as of the end of June, 1999. This means that these banks (four of them are still state owned) are crucial to the banking system's stability and overall performance. One state-owned bank, Bulbank, holds 26.8% of total banking system assets. At the same time, 44.8% of Bulbank's assets represent claims on banks and other financial institutions, bearing a resemblance to the central bank's refinancing function.

The second group consists of mostly private banks, which hold up to 19% of total banking sys-

tem assets. A high level of capital adequacy has been observed.

Most of the banks operating managed to improve their capital adequacy by provisioning most of their bad debts. We should stress the fact that the commercial banks managed to increase the volume of their provisions for classified credits thanks to the high net incomes they accumulated as a result of exchange rate divergence, incurred by the devaluation of the BGL. The revaluation of the current-exchange bad debts and other current-exchange assets also resulted in the growth of legal provisions. Among the sources for improvement of capital adequacy are the retained profit from the past two years and shareholders' additional capital contributions.

At the end of June, 1999, the average level of capital adequacy for the overall banking system was extremely high, at 41.7%. The three largest Bulgarian banks (Bulbank, UBB and SSB) reported an even higher capital adequacy ratio, of 54.16%. Such expansion in banks' capital adequacy means not only an improved capital base, but also an increased share of low-risk (and low-yield) investment.

Limitations on the granting of credits (imposed by the economic crisis and the activities undertaken by the executive power and the Bulgarian National Bank), combined with the real devaluation of bank liabilities resulting from the hyperinflation of 1996-1997, were the determining factors for the

improvement of liquidity in 1998. This high liquidity, combined with low credit demand and low budgetary demand for inside credit granting, is the main reason for the record-breaking low interest rates in the last two years.

Regardless of the reforms that have been carried out in the banking sector since 1997, there remain a lot of problems to be overcome. Among the major ones are:

- Small scale of the banking sector. The total assets of the banking sector in Bulgaria, which equaled about 43.4% of GDP in 1997, dropped to 34.9% of GDP in 1998, which is far below the standard in developed countries (where this proportion is normally more than 100%).
- A lack of sufficient confidence in banks.
- Low quality and extremely restricted variety of bank services, which for most Bulgarian commercial banks are extremely restricted and include: taking deposits, extending limited volume, very short-term credits and intermediation in payments in Bulgaria and abroad. The main reasons behind this situation could be indicated as a lack of sufficient banking know-how for most of the banks, as well as the low level of competition in the banking sector.

An IME survey among small and medium-sized

fourth with 18.1%.

- Inadequate profit from bank activities. At the moment the average profitability of banks' portfolios is considerably below interest rate level, since part of banks' assets (bad loans, buildings, etc.) pay no income.

The lack of opportunities to invest banks resources is resulting in an orientation toward keeping mainly high liquidity assets: cash, assets in bank accounts and government securities. By April of 1999, the greatest part of banks' assets (32.4%) was in deposits with other banks, particularly abroad. The relative share of cash balances on the banks' balance sheets was 11.5%, and government securities represented some 21% of banks' assets. Most likely, banks will continue to maintain high liquidity and greater opportunity costs.

A positive sign is that in 1998 the banking sector as a whole operated at a profit. However, profit margins were very low, although only 12 out of all 35 banks operating in Bulgaria reported losses for the first half of 1999. The interest rate differential between interest rates paid on deposits and the rates received on domestic or foreign securities remains a major source of profit.

- Extremely limited credit activity. Banks' credit portfolios saw their most dramatic decrease over

Table 6: Average Ratio of Net Interest Income to Total Bank Assets

	1993	1994	1995	1996	1997	Average
Bulgaria	-0.1	-3.1	1.7	5.7	2.4	1.3
Croatia	13.9	2.7	2.6	3.4	3.2	5.2
FYR Macedonia	16.0	16.0	10.3	8.9	6.2	11.5
Hungary	3.7	4.8	4.9	4.2	3.1	4.1
Poland	3.8	4.7	5.1	4.9	2.3	4.2
Romania	9.5	6.4	7.3	5.1	10.7	7.8
Slovenia	5.9	1.9	3.4	4.1	4.3	3.9
Estonia	5.4	5.9	5.1	4.8	4.1	5.0
Lithuania	10.5	8.9	6.8	5.3	3.9	7.1

Source: Fabrizio Coricelli, "Financial Market Development and Financial Liberalization in Economies in Transition: Tales of Failure and Success," University of Sienna, CERP and Central European University, March 1999.

private companies in five regions of Bulgaria presents some interesting results concerning the quality of bank services. When asked what made you choose the bank that you use at the moment, respondents pointed most often to a factor that is only indirectly related to bank service quality: 61.9% of the companies surveyed selected their bank for its security. This is understandable, in light of recent bank closures and the resulting lack of sufficient confidence in banks. It is probably more important (but not surprising) that the second most frequently mentioned factor was convenient bank location (39%). The quality of services (37.6%) only came in third place, and another quality-related factor, the speed of service, came in

Table 7: Structure of Banks' Financial Assets (as of April 1999)

(% of total assets)	April 1999
Cash	11,5
Claims on banks and other financial institutions	29,8
Securities in trading portfolio	13,1
Securities in investment portfolio	7,5
Loans extended to non-financial institutions and other clients	28,8
Assets for resale	0,3
Interest receivable and other assets	4,5
Fixed assets	4,5

last few years, thus becoming one of the most serious impediments to economic growth in the country. The share of credit extended to the real sector in the total assets of the banking system dropped from 35.4% in mid-1997 to 28.3% in May of 1999.

In fact, the scarcity of commercial credit is not extraordinary, given the lessons of the past few years, the low level of confidence in banks and the limitations imposed by the currency board. The

take risks associated with investment lending. Despite cautious lending, there is a tendency toward increasing the share of credits that are not regularly serviced. While the share of regular credits in banks' portfolios was 87.3% in as of the end of 1998, by mid-1999 this share had declined to 83.1%. Also, 7.7% of all credits extended by the banking system are classified as uncollectible.

Table 8: Bank Credit Dynamics Relative to GDP (%)

Year	Credit to the real sector (% of GDP)	Credit to the private sector (% of GDP)
1991	83	9.5
1992	75	8.9
1993	66	12.0
1994	49	14.6
1995	40	21.6
1996	63	36.9
1997	20	13.1
1998	17	12.8

Source: BNB, IME calculations

main factors for such behavior are:

- lending is still considered to be too risky an activity, because the business environment has not improved significantly and the risk in the real sector remains relatively high: there are expectations that the current liquidity problems in the real sector might cause an additional deterioration in commercial lending; in addition, the largest SOEs are under a program of isolation from bank credits, while at the same time, most private companies have a very short track record;
- the insufficient quality of investment projects;
- the execution of creditors' rights is extremely slow and banks face problems in collecting on non-performing loans; there are limited opportunities for realization of the collateral;
- restrictive banking regulations concerning commercial lending: banks are restricted from extending "big" loans, exceeding 25% of the bank's own capital (this barrier is especially valid for smaller banks, whose capital levels are low), there are strict provision requirements and requirements for collateral, etc.;
- limited growth of the amount of funds attracted to banks and relatively limited credit resources; and
- the limited extent to which the BNB is allowed to refinance commercial banks.
- The quality of banks' credit portfolios has not yet improved significantly. This is mainly due to their low capital base and their unwillingness to

take risks associated with investment lending. Despite cautious lending, there is a tendency toward increasing the share of credits that are not regularly serviced. While the share of regular credits in banks' portfolios was 87.3% in as of the end of 1998, by mid-1999 this share had declined to 83.1%. Also, 7.7% of all credits extended by the banking system are classified as uncollectible.

- The low level of competition among banks. The banking system is dominated by a small number of banks that are still state owned. The presence of foreign banks is modest in comparison with that in other transition countries.
- The predominance of state ownership in the banking system (most of the major Bulgarian banks are still owned by the state) continues to have a negative influence on the operation of the banking sector. The large state banks suffer from the "surplus bureaucracy disease" and poor organization, the quality of bank services is low and management is not sufficiently motivated to increase the banks' efficiency and profitability.

- There is a lack of typical investment banks and mortgage banks operating in Bulgaria.

- There is a lack of major international financial institutions on the Bulgarian market to improve the quality and availability of financial services, increase competition and provide modern banking know-how, skills and technology.

- The lack of sufficient skills on the part of bank staff leads to inefficient asset management.

- There still exist comparatively close commitments between some of the small and medium-sized banks with their shareholders' firms.

Although some progress in bank privatization has been made, the major efforts are still forthcoming. In accordance with the agreements with the IMF and the World Bank by the end of June, 1997, the first privatization deal was finalized: that of United Bulgarian Bank. As a result of its privatization and consequent increase in capital, UBB rose to the top of the list of Bulgarian banks, as ranked by equity in 1997.

In February of 1998, the Bank Consolidation Company (responsible for bank privatization) adopted a resolution strategy for the privatization of state-owned banks that shifted the strategic focus to one of selling the best banks first, in order to attract additional capital and expertise.

On August 14, 1998, a stake of 78.23% of the capital of Bulgarian Post Bank was sold to American Life Insurance Company (ALICO) and the Greek Consolidated Euro-Finance Holdings. They acquired the PostBank shares for US \$38 million.

The privatization of a third state bank,

Expressbank, was negotiated in September of 1999. The buyer is the French Societe Generale. There are still significant delays holding up privatization of the largest Bulgarian bank, Bulbank.

If we try to assess the Bulgarian banking system according to the main characteristics of an effective banking system,⁷ we can summarize our conclusions in Table 9.

Table 9

Characteristic	Grade ¹	Observations
Banking services	Low	Narrow market of bank services
Market-driven interest rates	Low ⁸	Lack of sufficient depth of financial markets improperly developed mechanism for market interest rate.
Widely distributed private ownership of banking institutions	Low	State-owned banks are few in number but hold some 70 % of the sector's total assets.
Presence of a competitive, level playing field for all banks, both domestic and foreign	High	All regulations affecting the cost of doing business are the same for domestic and foreign banks do not favor individual institutions.
Presence of efficient, safe and liquid money, debt and equity markets	Low	Some progress is being made but markets need major efforts in order to be improved.
Payment system	Medium	Reasonably good progress, but delays still occur
Legal framework	Medium	Low in the area of creditors' rights protection bankruptcy procedures (adding considerably credit costs) High in the area of new banking law prudential regulations.
Banking supervision	Medium	Significant progress has been made but problems remain, especially with bank examinations.
Deposit insurance	High	
Independent central bank	High	

Policy Options

There are several lessons that may be drawn from the development of the Bulgarian financial sector over the past decade.

- More prolonged restructuring causes more damage to the economy and requires more costly stabilization measures.
- Continuous structural weakness of the financial system produces a crisis environment. Delays in financial sector restructuring are a contributing factor to significant delays in overall economic development.
- Financial stability requires stable financial institutions, a high degree of confidence, stable markets, a dynamic private sector and a supportive legal framework that contributes to effective internal governance of financial institutions and external discipline by market forces.
- A stable and efficient financial system is a neces-

sary but not the only condition for sustainable economic development. This also requires well-developed and adequate macroeconomic policies.

- The absence of effective reallocation of resources and a supporting credit system are an impediment to the efficient restructuring and growth of enterprises.
- An important precondition for the development

of financial markets is an effective legal system, ensuring the protection of private rights and contract enforcement.

Currently, the Bulgarian financial sector does not provide the effective intermediation necessary for sustaining growth. The further development of financial markets could contribute to the resolution of the problems of liquidity and the low level of investment in Bulgarian enterprises. Under the current situation, with its lack of sufficient inflow of foreign direct investment, scarcity of credit resources and the insignificance of the capital market as a source of external financing, the only possible source of investment remains companies' retained earnings.

Expansion of banks' credit activity is one obvious factor for achieving economic growth. However, there are no clear signs that in the short run commercial banks will reverse their attitude toward such expansion of commercial lending. Several possible measures could have a positive effect on

the credit capabilities of banks. Among these measures are:

- amendments to the legal framework, whose purpose should be the protection of the creditor's rights: this includes empowering banks to take concrete steps toward collecting their claims in the case of default, further development of bankruptcy and liquidation procedures; without a legal regime that clearly defines and protects property rights, the development of a modern banking system, with banks functioning as real financial intermediaries, is almost impossible;
- establishment of a Credit Register, in which detailed information about all borrowers should be collected and further should be subject to free circulation among the banks: such a gathering and processing of information about the borrower's current creditworthiness would improve the management of credit risk;
- stricter asset classification and adequate provisioning practices against loan losses, to minimize the delay in recognizing bad loans;
- development of sufficient skills on the part of bank staff with regard to project appraisal, project monitoring, risk assessment and risk management;
- requirements for higher bank capital, which would provide better incentives against excessive risk-taking than exist at present; and
- following the adopted regulation policy, which is aimed at protecting banks from the establishment of long-term relationships and extension of large credits to companies owned by or connected with the banks' own shareholders, or to other state-owned or private companies.

The involvement of banks in financing the real sector, however, depends not only on institutional and legal measures, but also on the current state of the restructuring of the real sector. A strong influence would be exercised on banks' activities by the ongoing process of privatization, isolation and liquidation of loss-making state-owned enterprises.

The inflow of foreign investment would also positively influence the banking sector, by providing new credit resources to the banks and creating the preconditions for the growth of credit demand on the part of reliable clients.

Apart from the above-mentioned measures, there are a lot of steps that can be taken in order to ensure further financial market development. Among these steps are:

1. Establishment of a supportive environment for private sector operation;
2. Fostering the privatization of the remaining state-owned banks: it is important for Bulgaria to attract serious foreign investors to buy the largest Bulgarian banks, thereby providing fresh money inflows, to increase the investment potential of the banking system, to improve bank management (including staff technical skills) and to make these banks competitive and profitable;
3. Consolidation of banks: consolidation could contribute to restoration of the intermediary functions of most small and mid-sized private banks, as well as to overcoming their problems of a low capital base;
4. Improvement of supervisory standards and practices;
5. Development of asset-backed securities (mortgage bonds, pass-through bonds, etc.) in order to enhance liquidity;
6. Enhancement of competition in banking;
7. Development of the capital market: this would have serious impact on commercial banks because of the creation of additional tools for risk management and increased profitability of bank services; and
8. Creation of possibilities for banks' clients to monitor banks' activities, in order to be able to choose between institutions: in this context it is important that the quality and accessibility of information be improved and that a bank rating system be established.

1. Although State Savings Bank did not have the status of a bank, it was considered to be one.
2. See: Stiglitz, Joseph, "Financial Systems for Eastern Europe's Emerging Democracies," ICEG Occasional Paper, 1993. There is a correlation between government presence in the banking system and level of income: in low-income economies government banks control 70% or more of the banking system, in medium-income economies the level is 40-50% and in high-income economies government banks are almost non-existent.
3. A detailed description of the money transfer mechanism may be found in: Avramov, Roumen and Guenov, Kamen, *Rebirth of Capitalism in Bulgaria*, Sofia, AECD, 1995.
4. See: Yotzov, Victor, Nenovsky, Nikolay, Hristov, Kalin, Petrova, Iva and Petrov, Boris, "The First Year of the Currency Board in Bulgaria," *Bulgarian National Bank*, 1998, p. 18.
5. In the period between 1991 and 1997, two years showed record negative real interest rates: -24% in 1994 and -43% in 1996.
6. See: Avramov, Roumen, "The Role of a Currency Board in Financial Crises: The Case of Bulgaria," *BNB Discussion Papers*, 6/1999.
7. See Corrigan, E. Gerald, "Building Effective Banking Systems in Latin America and the Caribbean," *Inter-American Development Bank*, May 1997.
8. IME's assessment.