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EXTERNAL FINANCING OF THE BULGARIAN ECONOMY DURING THE TRANSITION

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by

Ivanka Petkova, Ph.D.

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55 N. Rilski Str.
1000 Sofia, Bulgaria
tel/fax: (3592) 818 487; 874 135

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INTRODUCTION

Bulgaria embarked on its way to a market economy at a less advanced stage of political and economic transition. Unlike other Central and Eastern European countries the starting conditions for Bulgaria's transition period were more difficult:

- Before the beginning of economic reforms a tight central control on the economy has been followed;
- The country was to a greater extent dependent on the COMECON trade relations than any other member country;
- In addition, the external debt problem limited every initiative connected with capital need;
- The debt moratorium declared in 1990 made Bulgaria's access to foreign government and commercial external financing impossible.

First liberalization measures have been undertaken in 1991-1992. The reform faced political obstacles and external unfavorable developments.[1]

Additional financing was possible to come mainly from international sources. On the other hand, international support was important for two other basic reasons:

- External financing was critical for Bulgarian economic policy makers because of enabling them to apply orthodox economic policies.
- The international financial institutions were the basic determinant for Bulgaria to be able to serve its external debt.
- Agreements of Bulgaria with international financial institutions are considered to have a positive effect on foreign investor attitudes to the country.

Very active in supporting Bulgaria in this respect were the IMF and the World Bank of which Bulgaria became member in September 1990. These institutions made the main financial contribution to the stabilization and the structural programs of Bulgaria.

This paper will focus on the external financing of Bulgaria by the International Monetary Fund and World Bank because of their crucial role in supporting Bulgaria's transition to a market economy.

II. EXTERNAL FINANCING IN THE CONTEXT OF THE STRUCTURAL AND STABILISATION POLICIES

The IME granted financial assistance to Bulgaria on conditional basis to support economic liberalization

It is predominantly viewed, that the IMF disciplined the process of outlining and structuring macroeconomic policy in Bulgaria.[2] In 1995 principals outstanding on IMF loans account for SDR 162,29 million and interest payments are expected to reach the amount of SDR 35,53 million.[3] The IMF lending to Bulgaria is approximately 140% of the IMF quota of the country.

Since Bulgaria became member of the World Bank, the Bank has made 7 loans, with a further 5 projects at an advanced stage of loan processing.[4] The World Bank financial contribution for Bulgaria amounted US$ 600 million.

Bulgaria's stabilization and structural policies until the end of 1995 can be divided into four periods:

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[1] According to official government figures, in 27 months (from July 1992 to September 1994) Bulgaria lost , directly, or indirectly, US$ 6 200 million as a result of the embargo on Serbia and Montenegro. (168 Hours BBN, June 5-11, 1995)

[2] Avramov, R. in: Economic Transition in Bulgaria, AECD, Sofia, 1994, p. 17.

[3] Ibid. , p. 101.

[4] Project Summaries, World Bank Resident Mission in Sofia, October 1995.

1. The period between February 1991 and June 1992

The typical feature of the first period measures was the broad liberalization of the economy (price liberalization started; the local currency - the Bulgarian Lev, was made convertible for current account transactions;

the exchange rate of the Bulgarian Lev started to float. These steps have been accompanied by stabilization measures.

In 1992 Bulgaria received the first tranche of the

Structural Adjustment Loan granted by the World Bank**.** The loan amounted US$ 250 million.[5]The Bulgarian counterpart was the Bulgarian National Bank. The loan was co-financed by other donors.[6] The World Bank loan had to be disbursed in two tranches in 1992 and 1994.

The first tranche was disbursed in 1992 against oil imports.

The whole amount of the second tranche of the Structural Adjustment Loan of the World Bank was disbursed by 1995. One of the reasons for the postponement of the second tranche was the delay in outlining basic rules on bank supervision.[7]

The loan was directed to supporting the structural reform in Bulgaria. The sources were implemented in creating the basic institutional and legal framework for the market economy transformation in the country. Efforts were focused on the establishment of proper conditions for private sector developments. These were considered as conditions needed for the medium-term sustainable economic growth and restoration of Bulgaria's creditwothiness.

An important World Bank's project was the **Technical Assistance Loan.** Counterpart of this 2 years loan was the Ministry of Finance. The loan amounts US$ 17 million.[8] Beneficiaries however are several ministries, governmental agencies, commercial banks and participating enterprises. The loan is focused on the formulation of strategic issues, to provide legal advice, to support the development of the private sector. Funds are used in close co-operation with EC PHARE, USAID, the UK Know-How Fund and other donors. The loan is designed to finance 100% of the foreign costs. The implementation of the loan started in 1991.

In applying the project basic form was the supporting of several studies:

- on the Bulgarian foreign trade regime;
- on the restructuring of the banking system;
- on the risk probability of the Nuclear Power Plant "Kozlodui" etc.[9]

The relationship of Bulgaria as a borrower with the IMF started by negotiating a stand-by-loan of SDR 279 million

(US$ 400 million) for 1991. The sources were used for

- balance of payment equilibrium and
- currency reserves.

The loan was negotiated to be granted in 5 tranches.

Additionally Bulgaria received a 6th tranche for foreign financing. Another loan has been granted to Bulgaria for compensating the increased costs on the import of energy resources. Repayment of loan principal started in 1994 and will continue to the year 2000. The interest are paid on a quarterly basis.

In 1992 main objectives of IMF financial resources were the support of the stabilisation and the structural programs. The Second Stand-By Agreement in 5 tranches has been adopted, which reached 50% of Bulgaria's IMF quota. The sources have been used for financing the balance of payments deficit. By the end of January Bulgaria received 4 tranches

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[5] Ibid.

[6] The Japanese Export-Import Bank extended an US$ 100 million loan, which became effective in 1994, and the USAID granted US$ 10 million in 1991.

[7] Bulgarian National Bank Annual Report for 1992, p. 106.

[8] Project Summaries, World Bank Resident Mission in Sofia, October 1995.

[9] Part of the sources has been used between 1992 and 1993 for hiring a resident advisor to the Coincil of Normative Acts, existing to tha t time at the Council of Ministers.

At the end of 1992 the net bank borrowing of the budget was bigger than the proportion under the Stand-By-Agreement. For this reason Bulgaria did not received the fifth tranche.

In 1992 important technical assistance has been granted by the IMF for modernisation of the banking system.[10]

2. The period between mid 1992 - early 1994

During the second period stabilization policy weakened within a framework of slowdown privatization and in general of reform efforts. A foreign exchange crisis arose at the end of 1993. Inflation accelerated at an annual level of more than 100%.

In 1993 Bulgaria received the fourth tranche of the 1992 Stand-by - Agreement with the IMF. Conditions for a new stand-by agreement to be signed in 1993 were:

- drafting and introducing amendments in the legal framework(adoption of laws on VAT, on Bankruptcy and Protective Concordat);
- substantial progress in the structural reform

The IMF agreement was a precondition:

- to accomplish contracted terms and to receive already negotiated funds from the World Bank and the OECD countries;
- to provide necessary funds for servicing the foreign debt deal.

The economy of Bulgaria is still developing a energy intensive industry. The World Bank prepared an **Energy Project for Bulgaria. T**he involvement of the World Bank is substantial, however there was a delay in implementing the project, which started in 1993.

The Bulgarian counterpart of the energy project is the National Electricity Company (NEK).

The loan is implemented to support positive changes in the energy intensive economic structure of Bulgaria. First steps in this direction were:

- the partially liberalization of the petroleum fuel prices;
- the raise of other energy items prices;
- the preparation of a least cost development program;
- studies on the rehabilitation and safety improvement of the power system.

The loan include three components:

a. improvement of supervisory control and the transmission systems of the electricity grid (through installation of equipment, software);

b. increasing the capacity of a the Chaira pumped storage plant;

c. technical assistance for implementing business lines in the operation of NEK (introducing computerized management information and cash management systems).

The disbursement of the loan amounts US$ 11,7 million.

The fulfillment of several conditions are associated with the disbursement of resources:

- to increase average electricity prices to 3.5 US cents equivalent by September 1993;
- to establish by the end of June 1994 a new independent price setting mechanism;
- NEK gradually to increase its provisions for depreciation;
- NEK to improve its financial management.

The expected benefits of the project are:

- to reach lower costs of electricity supply;
- to improve the management efficiency of NEK.

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[10] - The Bulgarian National Bank - the central bank was the main beneficial. It received technical assistance both from IMF experts and experts offered by other financial institutions. Issues covered were reporting and internal control of the BNB, the payment system regulations, bank supervision, foreign exchange operations, securities trading etc. (Bulgarian National Bank Annual Report for 1992, p. 106.)

The implementation of the Management Information System of NEK has been started. Other components of the project have been postponed by the non-compliance with some of the loan conditions (on increase of the electricity prices and on the establishment of the price mechanism).

Since 1994 the **Private Investment and Export Finance Project** of the World Bank is effective**.** The loan amounts US$ 55 million. It is directed for investment financing in two basic fields:

- the creation of new and the development of existing private enterprises in Bulgaria;
- short-term financing of transactions, connected with export.

The financing procedure goes through local commercial banks. The First Private Bank and the Raiffeisenbank are participating as financial intermediaries in the project. Regulation amendments are needed for giving access of other domestic financial intermediaries to participate in the project.

About 12,6 million has been disbursed for 16 private sector investment projects by the end of 1994.[11]

3. The period was between 1994 and early 1995

The third period began with restrictive monetary and fiscal policy. The new IMF stand-buy agreement was the basis of introducing a new incomes policy. The foreign exchange reserves of the country rose steadily in 1994. The reserve growth was not only due to the improved trade performance. Multilateral and bilateral loans contributed to the reserve rose. In addition the sharp depreciation of the BGL encouraged a substantial move out of BGL into US dollars during the first half of 1994.[12]

After four years of negative growth the economy has rebounded. A 1.4% real GDP rose has been achieved in 1994

In June 1994 an agreement was reached between Bulgaria and the London Club on restructuring the country's debt on Brady terms. Bulgaria's debt was reduced by an equivalent of 50%, predominantly in the form of interest payment relief. Because of the large part of interest reduction in Bulgaria's Brady deal, not all of Bulgaria's debt ratios were similarly reduced.[13] The establishment of a debt-to-equity scheme in 1994 was deemed an important element of a successful program for further economic reforms. The possibility of swapping FLIRBs or discount Brady bonds has been given to both domestic and foreign investors to participate in privatization The bonds are rather currency instruments, because of the lack of the requirement to convert them into BGL before making the investment.

The Brady agreement was of essential importance for managing the debt burden of more than US$ 9 billion of unserviced debt of Bulgaria. The deal has been accomplished with the active support of IMF and the World Bank. They co-ordinated the contribution of the international financial community to cover the cost.

A Debt and Service Reduction Loan has been negotiated with the World Bank. The loan became effective in September 1994 and disbursement was completed within a month. This loan served as a financial assistance for meeting the "up-front costs" of the London Club Debt Agreement of Bulgaria.

With this in connection the IMF approved two loans for Bulgaria amounting SDR 189.96 (US$ 259 million)including

- SDR 69.74 million (US$ 97 million)under the Third one-year Stand-By Agreement and
- SDR 116.22 million (US$ 162 million).under the Facilities for Transition Economies.

[11] Ibid.

[12] The intervention policy of the BNB aimed at rahter subduing sharp falls but not preventing further decline in the BGL

[13] For this reason the total outstanding debt is large at US$ 10,5 billion. US$ 5,3 billion of the total amount of the debt is a Brady debt.

The future Brady debt burden will increase significantly in early next century. Due to the country's multilateral and official debt however the overall debt burden will start to increase in 1997. The repayment capacity of the country was sufficient in 1995 due to the foreign exchange reserves accumulated (US$ 1,4 billion).

In the second half of 1994 due to non-compliance with the commitments contained in the memorandum to the agreement, the third tranche of the loan was not disbursed.

In 1994 repayment on principals of loans disbursed by IMF until 1993 began. Interest payments on the debt to IMF were made on a regular basis.

- Repayment on principals amounted SDR 47,95 million.
- Interest payments accounted for SDR 28,09 million.[14]

The release of the second tranche of the Structural Adjustment Loan was connected with some conditions:

- further following the policy of macroeconomic stability;
- creating of a database on the external debt and adoption of a viable debt strategy;
- additional measures on trade liberalization and reduction of non-tariff barriers and export restrictions;
- private sector development through enforcement of the legal framework for privatization and restitution of agricultural land;
- financial sector restructuring through an adequate legal framework, banking supervision and restructuring and consolidation of state-owned commercial banks
- restructuring of the state enterprises;
- creation of an adequate social safety net.

These conditions could not be met in 1994.

The earlier disbursements of the IMF funds and the successful conclusion of the Debt and Debt Service agreement with commercial creditors , with the support of the World Bank and the IMF, contributed to the stabilization of the BGL and the slowdown in inflation in the second half of 1994.

The export financing part of the **Private Investment and Export Finance Loan** is not very actively applied. In early 1995 the Loan Agreement has been amended to make disbursement more easier.

4. The fourth period started in early 1995, when a new government came to power**.** In 1995 the private sector was the main factor for positive economic growth. The economic indicators showing positive developments in 1995 can not be considered as a result of a clear and consequent macroeconomic policy followed by the authorities. Some of the results achieved were unexpected even for the government officials. Rather the trend to economic recovery is a result of medium-term factors impact, which arose some years ago. The private sector, which is more than 30 per cent of the Bulgarian economy, contributed to 3/4 of the economic growth in 1995. The private sector expanded by 8 per cent in comparison to 1994 including not only the trade sector but in construction and industry.

Another positive macroeconomic change in 1995 was the lower inflation rate. The annual inflation rate has been brought down from 122% in 1994 to 32,9% in 1995. Several factors contributed to this downwards trend. First of all it was due to the restrictive monetary policy of the Bulgarian National Bank and of its ability to keep the nominal exchange rate relatively stable. The positive balance on current account payments was the second major factor. It was due largely to import suppression and export growth associated with the decline of the BGL. The third factor determining the inflation rate was the restrictive income policy during the last years. In 1995 the government changed the income policy, turning back to the indexation approach. The wages growth was higher than the consumer prices' rate of increase. The domestic debt burden of Bulgaria is growing. In 1995 it is estimated at US$ 4,5 billion, which is close to one half of the country's GDP.

[14] Bulgarian National Bank Annual Report on 1994, p. 101.

In 1995 the government limited the possibility of applying Bulgarian Brady bonds as a payment instrument in privatization deals. No more than 50% of the total purchase price of an investment in enterprises to be privatised could be paid with Brady bonds. Approximately US$ 150 million , mostly FLIRBs, have been applied in debt-for-equity swaps.

Improvements in the trade balance and the inflation decline in 1995 supported the stabilization of the national currency. This upward trend forced the central bank to purchase US dollars in order to keep the BGL/US dollar exchange rate stable. These interventions contributed to the growth of the foreign exchange reserves. This was the main reason Bulgaria not to work on achieving the fourth stand-buy agreement with IMF in 1995.

Since 1995 the banking sector is fragile. In 1995 the anti-inflationary policy aggravated the liquidity of commercial banks. The central bank was reluctant to provide extensive refinancing. Two state-owned banks were rescued by the government in June at a very high cost. The combined pressure of bank undercapitalisation, large portfolios of bad debts and low yielding instruments for transferring it into a state debt (the so cold ZUNK-bonds) render the banking sector fragile. For a long time the government was reluctant to acknowledge the magnitude of the problem and did not react properly. Further delays in structural reform could boost the financial sector in a more acute crisis. On the other hand an indecision of this important issue could affect negatively a fourth stand-buy agreement with the IMF. In order to avoid the risk that a number of banks could face collapse and of financial resources needed for servicing the external debt in 1997, the government adopted a financial sector restructuring and recapitalising program.

Failures from the previous years making financial discipline of state-owned enterprises undermined are now of crucial for the current performance both of the real economy and the banking sector. There is a need to liquidate some enterprises and to make other operating on a commercial basis. The other concern are the commercial banks and especially those, which have an unproper lending behavior

In 1995 Bulgaria did not received the last tranches of the Third Stand-By Agreement because of nonfulfilment of some of the conditions mentioned. The Agreement is of necessity not from the prospective of external financing of the balance of payments deficit.[15] Rather it is important for creating more stability, increased financial discipline and better creditworthiness of the country.

In 1995 progress has been made in implementation of **the Telecommunication Project of the World Bank.** Counterpart of the World Bank in Bulgaria is the Bulgarian Telecommunication Company (BTC). Beneficiaries are both private and public businesses. The loan is guaranteed by the Government. The EBRD[16], the EIB, the EC-PHARE funds are included in the project. The World Bank loan amounts US$ 30 million.[17] The total project is US$ 340 equivalent, (of which BTC - US$ 195,3 million and EBRD - US$ 75,1 million).

The loan is associated with the modernisation and reform of the telecommunication sector following infrastructure development, policy and institutional reforms. Funds are used for technical assistance, policy advice and investment financing. The project comprises of the establishment of a digital infrastructure to enable Bulgaria

- to participate in several telecommunication systems;
- to generate additional revenues from transit traffic.

The World Bank extended a loan[18] for agricultural development under the **Agricultural Development Project for Bulgaria.** Objective of the project is to finance medium and long-term sub-loans granted by domestic commercial banks to private investors in agriculture and agricultural processing.

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[15] In addition, Bulgaria strictly follows its financial commitments to the IMF.(Bulgarian National Bank Report for the first six months of 1995, p. 68.)

[16] The EBRD financing will amount to ECU 32 million (US$ 42 million), “EBRD and the Environment”, Bulgarian Factsheet, October 1995

[17] Project Summeries, World Bank Resident Mission in Sofia, October 1995

[18] The World Bank loan amounts US$ 50 million. It is effective since July 1995

The most important issue in the structural reform for 1996 is whether it will encourage the economic incentives to enable generating sufficient revenues needed for the repayment of the foreign debt obligations of the country. Progress in theses areas is considered as a precondition for the Financial and Enterprise Sector Adjustment Loan to be negotiated. A positive outcome will depend on whether reforms are actually implemented.

III. CONCLUSION

1. Since the announcement of the 1990 moratorium on debt repayments the basic amount of external financing came from international financial institutions. Bulgaria received from them a substantial support.

2. The IMF has been very supportive of Bulgaria in two basic aspects. The first one is direct financial support. The total loan to date amounts US$ 966 million. The IMF put in place three stand-by programs. The third expired in March 1995. The second kind of IMF financing supports the reforms' philosophy.

3. Many of the projects under the World Bank program are co-financed either by other international (EBRD, EIB) or national (USAID, Japanese Export-Import Bank)financial institutions and agencies.

4. The external assistance to Bulgaria has been directed to basic economic sectors: energy, banking and finance, industry, private sector development, agriculture. Several investment programs as well as structural adjustment funds have been applied. Many of the projects have been implemented later than expected.

5. The IMF and the World Bank support to the reforms in Bulgaria are still of vital importance. Agreements with these institutions further serve as one of the factors in attracting foreign investments. It is still evident, that the lack of foreign investments places limits on funds for restructuring industry and promoting export expansion.

6. A flexible and practice-oriented approach has been followed as to the applicability of financial assistance. Terms and conditions of projects have been amended when needed, according to new requirements which had arisen.

7. The policy towards further market-oriented structural reforms (if followed by the Government), and to foster economic growth, will require maintaining close relations with the IMF and the World Bank.

8. Because of further decapitalising of enterprises the increase in savings in 1995 will not be insufficient to finance investments needed. This makes external financing critical not only for supporting the exchange rate but to maintain positive export-oriented trends in the economy.